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USD 4trn	Foreign reserves accumulated by the People's Bank of China following the financial crisis **Page 2-3**
+0.5%	Q1 growth (annualised) for the US was the lowest rate since Q1 2014 **Page 4**
50.1	The official manufacturing PMI number for China in April, indicating scant expansion in activity **Page 5**
0.71x	Price-book ratio (PBR) for European banks at end April, up from 0.60x in February **Page 6**
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Risk back in focus as mood brightens in Europe and emerging markets

May 2016

Perspectives

EDITORIAL OUTLOOK

Central banks face test of credibility

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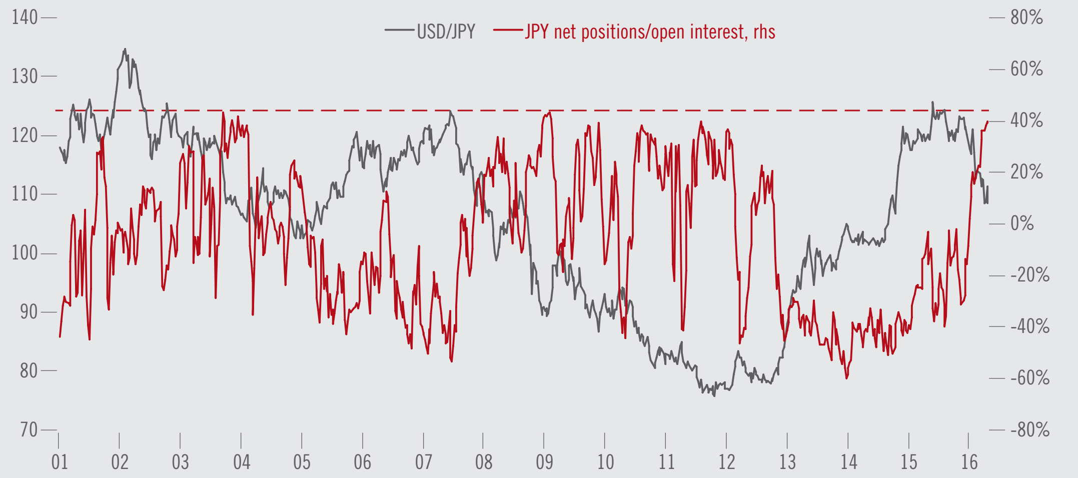
Central banks contributed to halting the financial crisis (starting with the US Federal Reserve's first quantitative easing package, launched in late 2008), with successive rate cuts helping companies and households in the West to deleverage. The Bank of Japan (BoJ) and European Central Bank (ECB) followed with aggressive policies at a later stage, when the US recovery was already underway. Central banks' commitment to their mandates has been fundamental in supporting market valuations, but these desynchronized monetary policies have caused market volatility. At the same time, central banks' credibility is at risk as inflation remains chronically low throughout much of the developed world and global economic growth is sluggish in spite of almost eight years of increasingly accommodative policies.

The European Central Bank's (ECB) second series of targeted long-term refinancing operations (TLTRO II), announced in March, is a good example of how the credibility of central banks plays a role in lifting market sentiment. Last December, the ECB introduced negative interest rates on deposits in an effort to boost inflation and growth. But the repercussions of negative rates on the margins of already hard-pressed banks quickly became apparent. The ECB addressed the issue with TLTRO II just three months later. Not only does TLTRO II help to ease monetary conditions and support credit flows to the private sector (at least on the margin), but it also mitigates the pressure of negative rates on banks' margins by actually 'paying' them to lend. Most importantly of all, the technical details of TLTRO II, along with additional measures adopted by the ECB such as the purchase of corporate debt, firms up the impression that the ECB will continue to take a flexible, but determined approach to policy to stabilise the European economy.

Back in July 2012, the comment by ECB president Mario Draghi that the central bank would do "whatever it takes" to save the euro was seen as a decisive turning point in the euro area's sovereign debt crisis. Now, the ECB is using its tool kit to try boost credit and help the banking sector. Bank shares have responded positively, and there are indications that the ECB's policies are beginning to work in the real economy: euro area credit flows in the first quarter grew at their fastest level since 2011.

In contrast, Japan's monetary policies have had mixed results so far. Negative interest rates (introduced in January) have not stopped the yen from pushing higher, and recent inflation figures have cast serious doubt on the ability of the BoJ to reach its 2% inflation target any time soon. When it met at the end of April, the BoJ thus found itself under pressure to make another effort to stimulate the economy and/or to adopt a flexible approach to negative interest rates like the ECB has. In the event, the BoJ decided not to move – at the risk of sowing even more confusion over its response mechanisms and sparking a bigger and more destabilising ascent in the yen. BoJ governor Haruhiko Kuroda justified inaction by arguing that it will take time for the combined effects of quantitative easing and negative interest rates to "sink in". Unfortunately, the market has responded by increasing the risk premium on Japanese assets, while continued currency appreciation is putting yet more pressure on the BoJ to act at a later stage.

BOJ CREDIBILITY ON THE LINE: % CHANGES IN USD RATES VERSUS THE YEN AND IN NET YEN POSITIONS



Sources: Pictet WM – AA&MR, Datastream, CFTC, May 2, 2016

The People's Bank of China (PBoC) has also come under significant strain. In the aftermath of the 2008 financial crisis, it intervened heavily in foreign-exchange markets to keep the yuan low, accumulating USD 4trn in reserves in the process. But its handling of the renminbi has proved more uncertain lately, with the value of the currency wobbling. As a consequence, we have seen significant capital outflows and the PBoC has again had to deploy part of its reserves to defend the currency. This explains the tumultuous markets we saw at the start of this year. The situation may have stabilised for now, thanks to stronger capital controls, but confidence needs to be fully restored in Chinese policy making.

So, central bank policies will continue to be crucial for the stability of markets. The potential loss of these policies' credibility is the biggest risk markets currently face.

We believe central banks will keep trying to lift growth and inflation. To do this, they will have to proceed by trial and error, using unconventional measures as they now have little (if any) room to reduce interest rates without causing unintended consequences. This is why central banks have started to insist increasingly on the need for action on the fiscal front too – whether by postponing a planned hike in the sales tax rate in Japan, or lowering taxes and boosting infrastructure spending in Europe. Some policy makers have even dared evoke 'helicopter money' – a further experiment that could see central banks printing money to fund government spending instead of buying bonds in the open market as the various quantitative easing schemes of recent years have done. Unlike interest rates, helicopter money would hold out the advantage of not relying of increased borrowing to work. This would be easier to implement in Japan where coupons have already been used in the past in a "use it or lose it" campaign. A similar scheme would be much more difficult to implement in Europe, as Mario Draghi recently flagged. But whatever happens, we can count on central banks continuing to implement supportive policies; we just need markets not to lose patience with them.

Europe firmer, the US disappoints, and China offers some respite

Macroeconomic data out of Europe has proved relatively robust. But we have cut slightly our growth forecast for the US, and while China has avoided a hard landing we remain concerned about the amount of credit being pumped into the economy.

Christophe Donay, Bernard Lambert, Nadia Gharbi and Frederik Ducrozet

While we are encouraged by news from the euro area, which has benefited from decisive ECB largesse, the effectiveness of radical central bank actions to put growth on a firmer trajectory is being questioned in Japan.

At its April policy meeting, the Fed proved circumspect about the timing of its next rate hike. Recent dollar weakness, a market rebound, some decent labour statistics, and a lessening of tensions in emerging markets all suggest the Fed can afford to be less dovish, but weak inflation expectations and the habitually low first-quarter GDP reading provided some justification for caution. The Fed may also prefer to await the outcome of the Brexit referendum in the UK (23 June) before deciding its next move. Our core economic scenario for 2016-17 assumes that the UK remains in the EU, but the referendum outcome is highly uncertain. In the euro area, forward indicators such as credit growth and purchasing manager indicators remain relatively encouraging.

Oil prices fell back only very briefly after the failure of the Doha meeting to curb oil production at the end of April, but quickly rose again towards USD45–as good a sign as any that oil prices hit a cyclical low of around USD30 at the beginning of this year. This development is providing a welcome fillip to some emerging markets, while the broader brightening of investors' mood means capital inflows to emerging markets are picking up again. Some encouraging signs emerged from China during April, including a surge in export data and industrial profits. However, the build-up of private-sector debt in China remains a source of jitters, and justifiably so.

The rise in the yen since the Bank of Japan (BoJ) introduced negative deposit rates in January was already suggesting a loss of confidence in the BoJ's ability to sway the currency and spark inflation. At the end of April, the BoJ decided against any further significant initiatives on this front. Although the ECB has moved to offset the effects of negative deposit rates on euro area banks, the apparent failure of the BoJ's own negative rates must raise questions over the appropriateness of some of the more radical monetary policies for supporting growth.

The Fed might wait until September before hiking rates

US GDP data confirmed that growth was particularly feeble in Q1— at +0.5% quarter on quarter (q-o-q) annualised, the lowest quarterly growth rate since Q1 2014. Growth continued to be dampened by negative net exports, collapsing investment in the oil sector and a drop in stockbuilding. A slowdown in consumer spending growth and a surprisingly sharp contraction in investment in equipment also constituted significant headwinds during the first quarter. Unfortunately, the US economy seems to be still lacking momentum. However, financial conditions have eased back noticeably since January, the impact of the collapse in investment in the oil sector will steadily diminish, and prospects for consumption and housing remain relatively bright. We continue to believe a serious downturn in the US economy is unlikely this year and we actually expect GDP growth to bounce back noticeably in Q2 and Q3. Nevertheless, we are cutting our yearly average growth forecast for 2016 from 2.0% to 1.8%. This is still a relatively healthy rate, and in line with the economy's potential growth (currently around 1¾%).

REAL US GDP AND COMPONENTS: Q-O-Q GROWTH RATE, ANNUALISED

	Weights	Q2 15	Q3 15	Q4 15	Q1 16
Personal consumption	*68.4%*	+3.6%	+3.0%	+2.4%	+1.9%
Residential investment	*3.4%*	+9.3%	+8.2%	+10.1%	+14.8%
Non residential investment	*12.7%*	+4.1%	+2.6%	-2.1%	-5.9%
Government spending	*17.8%*	+2.6%	+1.8%	+0.1%	+1.2%
Final domestic demand	***102.3%***	**+3.7%**	**+2.9%**	**+1.7%**	**+1.2%**
Exports	*12.6%*	+5.1%	+0.7%	-2.0%	-2.6%
Final demand	***114.9%***	**+3.8%**	**+2.7%**	**+1.3%**	**+0.8%**
Stockbuilding (contribution)	*0.6%*	+0.0%	-0.7%	-0.2%	-0.3%
minus Imports	*15.5%*	+3.0%	+2.3%	-0.7%	-0.2%
GDP	***100%***	**+3.9%**	**+2.0%**	**+1.4%**	**+0.5%**

Sources: Pictet WM - AA&MR, BEA

The Federal Open Market Committee (FOMC) statement published on 27 April left the door open for a potential June hike, but didn't signal that this possibility was yet being considered any more seriously than before. The economic dataflow seems unlikely to improve decisively before the FOMC's June meeting is upon us. Moreover, the UK referendum on Brexit will take place on June 23, just a week after the meeting. Although a hike in June (or July) remains possible, we now think the most likely scenario is one where the FOMC remains on hold in June and hikes only once in 2016, probably in September. For 2017, we continue to expect three additional 25 basis point hikes.

Euro area inflation only to pick up later this year

Euro area real GDP accelerated markedly in Q1 (+0.6 q-o-q, after +0.3% in Q4), outperforming most other developed countries. This remarkable resilience in the face of a challenging global environment was once again the result of strong domestic demand – the main engine of euro area growth for over two years now. Going forward, household consumption should remain supported by the ongoing improvement in labour market conditions. Importantly, investment spending has finally picked up since the end of last year, the outlook improving on the back of ECB support. In Q1, bank credit to the private sector grew at the strongest pace since 2009 and the ECB's latest Bank Lending Survey points to further improvement ahead despite the adverse effects of negative rates on banks' profitability. While near-term downside risks remain, not the least due to weak global growth and political uncertainty in Europe, we have maintained our above-consensus forecast for euro area GDP of +1.8% in 2016.

Forward indicators enable us to maintain our above-consensus forecast of 1.8% growth for the euro area in 2016

Meanwhile, inflation fell back into negative territory, to -0.2% in April, but the ECB is unlikely to overreact, for a number of reasons. First, smoothing out Easter-led volatility in the HICP numbers, core inflation has been on a modestly upward trend for over one year, up to around 1% according to our estimates. Second, ECB staff forecasts were revised sharply lower in March and they now look conservative for the first time in years. Third, higher oil prices should more than compensate for a stronger currency until base effects kick in later this year.

In short, economic and price indicators have been coming in on the strong side, reinforcing the ECB's message that stimulus measures are working. More time is needed, however, as Mario Draghi made clear, and over the coming months we expect the ECB to focus on the implementation of its March stimulus package, including TLTRO II and corporate bonds purchases in Q2.

The Chinese economy stabilises

Data for China over the past month support our view that a hard landing will be avoided—in the short-term, at least—and even suggest some upside risk to our forecast for real GDP growth of 6.5% in 2016. Real GDP grew by 6.7% y-o-y in the first quarter, down only slightly from 6.8% in the final quarter of 2015. The official manufacturing purchasing managers index (PMI) fell slightly to 50.1 in April from 50.2 in March, but remained in expansionary territory, as did the non-manufacturing (services and construction) PMI, which declined to 53.5 in April from 53.8 in March. While the services sector continues to grow robustly, the slowdown in manufacturing appears to have abated.

Meanwhile, the authorities have been doing the right things to stabilise the renminbi, which has even appreciated slightly against the US dollar—albeit helped by the dollar's recent weakness against major currencies on increased dovishness from the Fed. As a result, capital outflows from China have fallen a little—although they remain high. Another positive for sentiment on China is that corporate results have been better than anticipated recently.

However, the amount of credit being pumped into the economy remains a concern. Total social financing (overall lending to the economy) jumped to RMB2.3trn in March from RMB780bn in February—down from January's high of RMB3.4trn, but still excessive. Worryingly, activity in the poorly controlled shadow-banking sector also strengthened. Rapid credit growth to fund infrastructure investment will add to imbalances in the economy. The stabilisation of economic growth has also been achieved in part by reflating the property sector. China's deep structural problems remain far from resolved, even if good headline data means markets are enjoying a breather from concerns about China for the moment.

Some potential left in euro equities, but valuations are high

Market dislocations and bouts of volatility in different asset classes continue to create opportunities for the tactical approach we currently favour. Our stance is being determined by the further modest potential we see in European equities, and by doubts about core government bonds in the face of gradually increasing inflation and growth.

Christophe Donay, Jacques Henry, Luc Luyet and Alexandre Tavazzi

FINANCIAL MARKETS

Local-currency returns in % from financial markets. Data as of 29.04.2016

		Index	Since 31.12.2015	April 2016
US equities*	USD	S&P 500	1.7%	0.4%
European equities*	EUR	Stoxx Europe 600	-5.3%	1.9%
Emerging-market equities*	USD	MSCI Emerging Markets	6.4%	0.6%
US government bonds*	USD	ML Treasury Master	3.2%	-0.1%
US investment grade*	USD	ML Corp Master	5.3%	1.3%
US high yield*	USD	ML US High Yield Master II	7.3%	4.0%
Hedge funds	USD	Credit Suisse Tremont Index Global**	-2.2%	0.3%
Commodities	USD	Reuters Commodities Index	4.8%	8.3%
Gold	USD	Gold Troy Ounce	21.6%	4.7%

Sources: Pictet WM - AA&MR, Datastream, Bloomberg

** Dividends/coupons reinvested ** End-March 2016*

The outlook for European banks was seen to improve in April on the back of recent ECB policy announcements and market volatility declined. However, the Bank of Japan's inaction in the face of yen strength tested investors' patience.

Still potential in euro bonds and equities

The recent rise in bond yields suggests that investors believe the economy and financial markets have found a footing–although the rise in yields still appears modest, especially when set beside the rebound in oil prices since they reached what appears like a cyclical low of around USD30 per barrel in January. Although there has been some stirring in core inflation, further rises in long-term rates are still not being priced in by the market. As a consequence, we calculate that returns from 10-year benchmark bonds could be negative this year.

Rising confidence can also be seen in a tightening in corporate bond spreads. European credit markets have undoubtedly been helped by the European Central Bank (ECB), particularly its announcement that it will purchase corporate bonds in a broad range of sectors. There is thus ample reason to remain upbeat about European credit, at least in the short term. Spreads on US high yield widened significantly early this year because of the seemingly dire prospects for the energy and mining sectors. Spreads have fallen since then, but non-investment-grade US bonds still look attractive in an environment characterised by modest but steady economic growth together with low inflation and default rates.

First-quarter earnings on both sides of the Atlantic provided a number of positive surprises against generally weak expectations, although earnings momentum remained mediocre in sectors such as technology and retail. We believe that we are close to the peak of an equity rebound, but that broad European equity indexes still have the potential to post further modest rises on the heels of strong ECB support for the banking sector. Thanks to banks, earnings expectations for European equities have improved markedly, and energy stocks could also play a modest role in lifting European equity indexes further. Yet European equities are currently trading at forward price earnings ratios (PERs) of over 15x, well above the historic average of 13x. Forward PERs for US equities are also above their historic average. Failing a significant change in economic fundamentals, we believe it will be difficult for European equity indices to rebound by more than a modest amount (even allowing for market overshoots). Sticking to our tactical stance, we believe that the risks associated with 'Brexit' have already been amply discounted in the value of sterling, but we remain broadly neutral on UK equities ahead of the Brexit referendum of June 23.

Will European equities catch up?

The implementation of negative rates in Europe and in Japan had penalised the banking sectors and equity markets in both places. After the full explanation of the ECB bond purchase plan by Mr. Draghi, it now appears that the ECB's policy announcements of March 10 are more favorable to the financial sector than initially thought. The resultant decline in credit stress has enabled European bank equities to recover since March 10. Bank valuations rose from a price to book ratio (PBR) of 0.6x in February to 0.71x at end April. The recovery in European banks' market price since March 10 has helped the Stoxx Europe 600 index to outperform the S&P500 in local currency over the same period. Thus, the year-to-date performance gap between the two indices contracted from 3.8% at the start of April to 1.8% at the end. The gap could potentially close further, as European banks' average PBR since June 2012 stands at 0.85, implying some further rerating potential.

Despite the upward valuation adjustment, we do not see a change in the overall equity market environment. Markets have risen without a corresponding rise in earnings expectations, yet valuations are close to their previous peaks at 17.9x, 15.9x and 12.9x respectively for the S&P500, Stoxx Europe 600 and Topix. We are therefore sticking to our tactical stance, as high valuations should limit further potential gains.

Equity volatility eases, commodities bounce back

Having reached elevated levels, implied equity volatility started to ease in April in Europe, declining from 23% to 20% and getting closer to the US level of 15%. This translated into a bounce back in European equities. The Stoxx Europe 600 returned 1.9% in April. The range of returns for other equity markets was narrow, varying from -0.5% for the Japanese TOPIX to +1% for the MSCI Emerging Markets Index (in US dollars). Equity and bond return correlation is still negative. Negative interest rates on 10-year Japanese government bonds continued to push bond investors to longer duration: 30-year Japanese bonds returned 5.3% in April, and 26.4% over the first four months of 2016 overall. The best asset class in April, rising almost 10%, was commodities thanks to a 19% surge in oil prices. Gold prices rose a further 4.7% in April.

BOJ disappoints markets

On 28 April, the Bank of Japan left its monetary policy unchanged. This was a major disappointment for foreign investors, who had stopped selling Japanese equities aggressively ahead of the BoJ's policy meeting. The yen strengthened further in the wake of the BoJ meeting, standing at 108 to the US dollar on 29 April, compared with 121 on average in 2015. The strong rise in the yen has started to dent corporate earnings, which have been revised steadily downwards since September 2015. Current earnings growth expectations of 16.3% for the fiscal year to end-March 2017 look challenging without the support of a weaker yen. Macroeconomic data is also lackluster. Headline inflation is back to 0%, demonstrating that deflationary pressures are still in place and real annual GDP growth is below 1%, making the Japanese authorities' GDP target for 2020 difficult to achieve, especially as long-term structural reforms have still not materialised. Despite undemanding valuations relative to other developed equity markets, the Japanese TOPIX index is struggling to bounce back and is still 16% below its November 2015 peak.

Central banks on hold

In recent months, major central banks have been 'on hold'. After the major stimulus initiative unveiled on March 10, the ECB has signalled that further easing is unlikely in the coming months. Meanwhile, the Fed has switched to a very cautious stance, reducing the odds of an imminent rate hike. The Bank of Japan has decided to keep its monetary policy unchanged despite recent JPY appreciation, and it has again postponed the timeframe for reaching its 2% inflation target. Consequently, monetary policy divergence has halted, at least temporarily. Given the current risk-on environment, high-yielding currencies are facing strong tailwinds. US data will need to improve over the next few months to convince the Fed to prioritise domestic conditions again when determining monetary policy.

Doha won't help rebalancing

The failed attempt to find an agreement on an output freeze between OPEC members and Russia at the Doha meeting in early April confirms that little should be expected from OPEC in terms of curbing oil supply. At the same time, the resilience of the oil market suggests that this doesn't really matter. What does matter is the strength of the demand, which has been supported by improving risk-on sentiment, the pace of the decline in non-OPEC production, and potential unplanned outages facing oil producers.

Wilting of the dollar helps emerging-market currencies

Persistent US dollar weakness has been a feature of markets since late last year. This weakness, ascribed to falling expectations for US interest rate rises, has helped revive risk appetite, spurring emerging-market currencies in the process. Some hold the view that at the latest G20 meeting in Shanghai in February, world leaders agreed on the need to refrain from currency competition in order to calm financial markets. Nevertheless, the dollar's fall complicates efforts to revive the European and Japanese economies.

-10.7%

A decline in manufacturing activity in April for the first time in three years added to pressure on sterling, which has lost ground as the 23 June 'Brexit' referendum on the UK's EU membership has loomed closer. Growing confidence that the UK will remain in the EU sparked a revival in sterling during April, but **a run of disappointing economic data—partly ascribed to uncertainties over the referendum—has continued to cast a shadow over sterling.** All in all, sterling lost 10.7% against the euro between November 23 and May 2.

-8.3%

Bar a respite during the market volatility at the beginning of this year, **the dollar fell 8.3% against the euro between the end of November and early May after mixed US economic data made the Fed more cautious about the pace and scope of monetary policy normalisation.** The US dollar has also been slipping against the currencies of some commodity producers, including Canada, since the beginning of this year.

+15.4%

With Brazil mired in recession and political crisis, the Brazilian real sunk steadily against other major trading currencies during much of 2015. But **currency problems seem to have peaked during the autumn, with the real climbing 15.4% against the US dollar from end September to end April and by 12.5%** against the euro. Explaining this rise are some of the highest interest rates of any major economy, perceptions that the political crisis is nearing some sort of resolution, and a revival in commodity prices.

18.1%

Like Brazil, South Africa was buffeted by declining commodity prices in 2015 and political governance has become a major issue. An unexplained cabinet shuffle by president Jacob Zuma in December and his survival of an impeachment vote in April briefly put further pressure on the rand. But these factors have been outweighed by US dollar weakness together with a revival in global sentiment (and commodity prices), which meant **the rand rose 18.1% against the US dollar between January 19 and the end of April.**

+9.9%

On May 3, the euro hit a nine-month high of USD1.16. The trade-weighted euro has also made ground, rising 9.9% against a basket of 38 currencies between mid-April 2015 and the beginning of May. To the backpedalling by the Fed on its plans for interest rate hikes must be added signs that the recovery of the euro area economy is finally gathering steam. Indeed, first-quarter GDP growth in the euro area (0.6% q-on-q) was better than in the US. However, **the rally in the euro clashes with a series of massive easing packages from the ECB, including an expansion and extension of its bond buying programme.**

-3.1%

Last August, the People's Bank of China (PBoC) adjusted its exchange-rate policy, sparking a sharp decline in the offshore renminbi. The currency suffered even more as doubts rose over the state of the Chinese economy and capital flight intensified. But in January the PBoC caught currency speculators off guard by reducing offshore renminbi liquidity. Signs that the Chinese economy is stabilising have also dented expectations that the Chinese authorities will try to resort to further currency renminbi depreciation—for the moment at least. **The renminbi fell 3.1% against the US dollar from end-August 2015 to end-January 2016, but then rose by 1.5% to May 2.**

12.9%

Although the Bank of Japan (BoJ) announced negative deposit rates in January, the yen has soared against the US dollar, gaining 12.9% in the first four months of 2016. Persistent Fed dovishness that has weakened the dollar seems to have overcome the BoJ's best efforts, with the central bank seemingly running out of ammunition in its battle to lift inflation and growth. A decision by the BoJ at the end of April not to rectify its negative rate policy or to push monetary easing further led to a further rise in the yen.

8.1%

As the sheen on emerging markets has faded, the Turkish lira has been considered one of the more vulnerable emerging-market currencies because of a persistent current account deficit, high inflation, complex and unorthodox monetary policies, worsening domestic politics and a tense geopolitical backdrop. More recently, however, **monetary policy in the US and Europe has helped boost liquidity worldwide and stoked investors' risk appetite, triggering a rally in emerging market currencies, including the lira**. Helped also by better-than-expected economic growth, the lira rose 8.1% against the US dollar between January 22 and May 2, although it is still lower than it was a year ago.

Another good month for risk assets

Driven by banks, European equities have raced ahead of their rivals, while corporate bonds also made solid returns in April. In addition, EM debt also made a comeback during the month.

Equities

The rebound spreads

More sectors join the party

April was another good month for equities, with the MSCI World index returning 1.6% (in US dollars). Materials and energy-related sectors did particularly well. The MSCI Latam and Eastern Europe indices rose by 6.0% and 3.6% respectively (in US dollars), bringing their 2016 performance up to 26.4% and 19.0%, respectively. The real change was the rebound in the banking sector, especially in Europe. The details of the new ECB bond purchase scheme led to a decline in European banks' credit spreads. US and EU yield curve steepening allowed bank stocks to rally (+8% in US and Europe). The Stoxx Europe 600 index benefitted particularly from this rebound, rising by 1.9% in April. In US dollar terms, the European index's 2016 performance is still behind that of the S&P500 (-0.1% versus 1.7%). Japan is still negative, with the Topix returning -1.6% in the first four months of 2016, as the strong yen hurts earnings growth.

The expected rise in energy and commodities sector earnings has not taken place yet, but analysts have started to revise upwards their expectations for European banks' earnings, penciling in earnings per share (EPS) growth of 3.4% for the overall market in 2016. US and Japanese earnings are expected to rise by 0.7% and 17.6%, respectively. Despite the expected improvement in earnings, with price to earnings ratios of 17.9x for the S&P500, 15.9x for the Stoxx 600 and 12.9x for the Topix at end April, valuations remain high end compared to the 15-year average.

Bonds

DM sovereign yields rise

Sovereign bonds yields rose in April due to higher oil prices and a risk-on environment, but this upward move was dampened by central banks' dovishness.

Sovereign bond yields rose in April, with the notable exception of Japan. The German 10-year Bund yield increased by 12 basis points (bp) to reach 0.27% at end April and US 10-year Treasury yield rose 6bp to 1.83%. Peripheral euro area spreads also widened, by 15bp in the case of Italy and 4bp in the case of Spain. This general upward movement in yields is due to several positive developments. First, the oil price rallied by 20% to finish the month above USD45/b, second, the broad US dollar index remained stable over the month, third, equities and credit markets rallied as risk appetite increased. Of course, the European Central Bank and the US Federal Reserve's (Fed) dovish communication supported this move.

Illustrating these markets drivers, the US 10-year inflation breakeven rose significantly, in concert with oil prices, to 1.72%. However, the Fed's dovishness surprised markets and led to a renewed fall in expectations for rate hikes in the US, compensating for the upward move in breakeven rates. A break of US 10-year Treasury yields above 2% should not happen until the Fed signals its readiness to hike again.

Emerging-market sovereign debt yields kept falling in this favorable environment, with the JP Morgan Emerging Market Bond Index Global returning 1.9% (incl. coupon) in US dollars and 1.7% in local currency.

Corporate bonds

US credit outperforms euro

US high yield (HY) benefited strongly from higher oil prices in April. The ECB's latest measures helped euro HY.

Investment grade (IG) and high-yield alike rallied during April. The Bank of America Merrill Lynch (BofAML) US HY index returned 4%, with yields reaching 7.8% thanks to higher oil prices. Within the HY index, the energy and metals & mining sectors strongly outperformed, with returns (incl. coupons) of 12.6% and 11.3%, respectively. The performance of the BofAML US IG (up 1.4%) was more broad-based.

In Europe, the European Central Bank's (ECB) detailing of its corporate bonds purchase programme was central to credit's performance. Three elements of this programme are worth underlying. First, insurance companies and bank subsidiaries of non-bank parent companies (eg. financing arms of auto firms) will be eligible. Second, the ECB may buy bonds issued by subsidiaries based in the euro area but with foreign parent companies. Third, bonds rated investment grade by at least one credit ratings agency will also be included in the programme, meaning that some bonds belonging to HY indices will be eligible.

These details led to BofAML euro IG bond yields plunging to just over 1% for the first time in a year. BofAML euro HY returned 2% thanks to the upturn in the banking sector, with yields 39bp lower at 4.76%.

US HY is still outperforming its euro counterpart year-to-date, thanks to higher oil prices and a dovish Fed, but the tendency could reverse once the ECB's programme starts in June and a Fed funds rate hike comes nearer.

Hedge funds

Merger spreads or credit spreads?

Event-driven multi-strategy managers continue to prefer the Merger Arbitrage strategy over credit despite recent market developments

Event-driven multi-strategy managers continue to see Merger Arbitrage as a great opportunity for alpha generation. This is best illustrated by their steady exposure increase to the strategy over the last few months. That said, attractive spread levels and corporates willing to deploy large cash balances are being overshadowed by recent breakdowns in deals such as the Allergan / Pfizer merger, the drop in Q1 2016 M&A volumes and decreasing CEO confidence.

Conversely, exposure to credit has declined over the last two years, with managers taking advantage of the recent rebound in oil prices and a dovish Fed to exit positions. The extension of the ECB's asset purchase programme to companies issuing bonds in the euro area was another supporting element. But opportunities in the distressed space remain scarce for the moment. Most companies still have the capacity to refinance as proved by a high level of new issues. Increasing levels of defaults and credit rating downgrades suggest that the rebound could be based more on technical factors as more distress is likely despite a slowdown in the expected pace of Fed rate hikes.

Precious metals

Silver in the spotlight

Silver is usually referred in financial markets as 'high-beta gold' or the 'poor man's gold'. As such, the recent appreciation in silver prices is not surprising given the robust performance of gold.

April was a good month for gold, with prices rising by +4.9% per ounce in US dollar terms. But it was a stellar month for silver, which rose by about 15.6%.

Silver tends to be highly correlated to gold (the average 12-month rolling correlation since 1980 stands at 0.70), so it is not surprising that both performances point in the same direction. Looking at demand, industrial demand is the key differentiating factor between these two precious metals. Industrial demand accounts for less than 10% of total gold demand, but more than 50% of total demand for silver. Consequently, higher prices for industrial metals tend to favour silver over gold. This is why silver is often viewed as a hybrid metal—part precious, part industrial.

Consequently, silver's recent outperformance likely reflects the recent improvement in the outlook for industrial demand, mostly stemming from stabilisation in China. However, the increasing debt burden means investors should remain wary about the policy support that has been underpinning demand in China.

Currencies

The BoJ on hold

Despite lowering its growth and inflation outlook and postponing the timeframe for hitting its 2% inflation target, the Bank of Japan (BoJ) left monetary policy unchanged in April.

The policy board of the BoJ decided to keep its monetary policy unchanged at its April 28 meeting even though the central bank revised downward its forecast for growth (by a cumulative -0.9% from fiscal year 2105 to fiscal year 2017) and for inflation. Although the change in forecasts for fiscal 2017 inflation was minor (1.7% vs. 1.8% in the BOJ's January estimate), the timeframe for reaching the 2% inflation target has been pushed back from "the first half of fiscal 2017" to "during fiscal 2017".

Consequently, the status quo decided by the BoJ in April is a bit surprising, especially given the recent appreciation of the Japanese yen and growing concerns that the BoJ has limited options left to fulfil its inflation mandate.

Unsurprisingly, FX markets reacted by pushing the yen higher. Coupled with wage negotiations that are likely to produce disappointing results, the odds of the BoJ reaching its inflation target during fiscal 2017 seem very slim without additional monetary easing. Furthermore, fiscal measures will also probably be required. Yet a second hike in the sales tax is scheduled for April 2017 and will likely hurt growth.

Bond investors: protection or return, need one choose?

While core sovereign bonds should continue to protect portfolios, the ECB's latest measures could boost European corporate bonds. Hard-currency EM bonds also have the potential to generate good yields without exposing investors to direct foreign exchange risk.

Lauréline Chatelain, junior strategist, Asset Allocation & Macro Research, Pictet Wealth Management

Historically, combining equities and bonds in a balanced portfolio has produced an improvement in terms of risk (the so-called diversification benefit), but also in terms of returns when long-term yields decline. As core sovereign bonds are often negatively correlated to equities during periods of market tension, a balanced portfolio therefore reduces performance volatility. In essence, fixed income fulfils two essential roles: First, bonds, like equities, are meant to produce a positive return. Second, bonds serve to protect investors against market shocks and systemic risks.

Core sovereign bonds' protection role

The yield attractiveness of core sovereign bonds has progressively vanished of late, with 10-year US Treasury yields at just over 1.80% at the end of April and German 10-year Bund yields below 0.30%. However, the protection role of sovereign bonds remains intact, as during periods of financial stress their price rises in parallel with the drop in yields. Since July 2007, equity markets have experienced 20 periods of turmoil of varying duration, and during 16 of them US 10-year Treasuries have posted positive total returns. From December 1, 2015 to February 11, 2016—a period during which the S&P 500 fell by 12.6% — the 10-year US Treasury returned 4.9%. However, core sovereign bonds can also post negative returns at the same time as equities, the most recent episode being during the so-called *taper tantrum* when the prospect of the Fed adopting a less accommodative stance led to a 5.6% decline in the S&P 500 and a 5.1% fall in the total return of 10-year US Treasuries between May 22 and June 24, 2013.

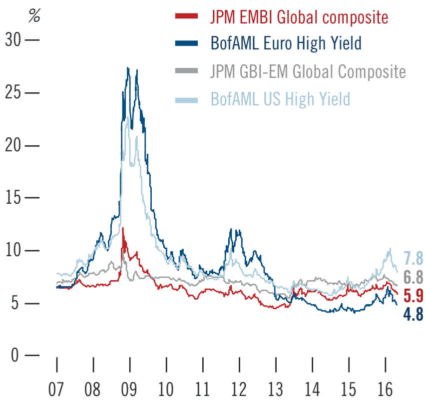
Lauréline Chatelain
Asset Allocation and Macroeconomic Research

But a repeat is not necessarily on the cards. We expect the Fed to continue to reassure investors that it will proceed carefully and slowly with rate tightening. Also, low oil prices and the lagged effects of US dollar appreciation, coupled with slow wage growth, should keep core US personal consumption expenditure (the Fed's inflation reference) below the Fed's target of 2% this year, reducing the risk of the Fed falling behind the curve (and thus having to tighten abruptly to avoid inflation overshooting). Risks remain, however, as falling commodities prices and China's slowdown could re-surface as issues while the Brexit referendum in the UK in June could cause turmoil in Europe. Therefore, we think that US 10-year Treasuries will still play their protection role this year, even if they offer meagre total returns. With a US GDP nominal growth at 3.24% year-over-year for Q1 2016 and with the Federal funds rate (the rate targeted by the Fed) at low levels, US 10-year bond yields should increase in the coming years, in line with our expectations of continued nominal GDP growth and tighter monetary policy. Using our in-house projections for short-term rates, (see our Autumn 2015 *Horizon* report), the annual total return currently expected for the next 10 years from 10-year US Treasuries and Bunds stands at 1.5% and -0.5%, respectively.

Chasing yield

Given the low yields offered by benchmark government bonds, there are certainly incentives for investors to take on more risk in order to achieve higher fixed-income returns. Higher-yielding fixed-income securities are available to those ready to assume credit risk (ie. the risk of the issuer defaulting), including corporate issuers with investment-grade and high-yield ratings. Another option is EM debt denominated in local or hard currency (generally US dollars). High-yield and EM sovereign debt currently offer 400-600 basis point (bps) over their respective risk-free counterparts (US Treasuries and German Bunds) (see chart 1).

CHART 1: YIELDS ON EM SOVEREIGN DEBT & HIGH-YIELD CREDIT (JAN. 2007-APR. 2016)



Source: Pictet WM - AA&MR, Datastream

1. US dollar versus euro credit

Investment-grade (IG) corporate bonds are safer than high-yield (HY) equivalents, as IG issuers hardly ever default. Bank of America Merril Lynch (BofAML) US and euro IG indices both posted slightly positive total returns from December 1, 2015 to February 11, 2016, the most recent period of financial market tension, whereas BofAML US and euro HY indices returned -7.8% and -5.6%, respectively. Hence, IG corporate bonds offer higher yields than core sovereign bonds with comparatively low risk. But since February 11, 2016, the HY segment has rebounded more than IG, with US HY posting a total return of 13.2% and euro HY a return of 7.4%. Higher oil prices and a dovish Fed explain this turnaround, triggering a risk-on move that has benefited credit and equities alike.

Several factors—most notably monetary policy and levels of corporate indebtedness—help explain the divergence between the euro and US indices and the potentially better positioning of euro HY and IG.

Monetary policy. A positive catalyst for European credit is the ECB's accommodative monetary policy. In March 2016, the ECB announced a new targeted long-term refinancing operations (TLTRO II) scheme designed to reward banks for lending. The ECB also decided to directly buy IG bonds issued by all non-banks based in the euro area. The ECB's corporate bond purchase programme should also be favourable to euro HY, with the central bank willing to buy corporate paper as long as just one credit agency gives it an investment-grade rating, even if its average rating is sub-investment grade. The BofAML euro HY index has benefited from the recent respite in the banking sector (22% of bonds outstanding on the index come from banks), which is due partly to the ECB's recent measures.

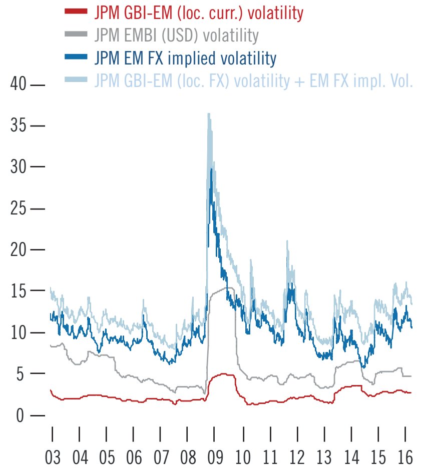
Debt cycle and energy exposure. US firms have taken advantage of historically low yields to issue bonds, leading to excessive indebtedness, especially among companies connected to the shale oil boom. Hence, credit ratings agency Moody's expects the effective US HY default rate to rise from 4.1% currently to almost 6% by the end of this year. US HY remains extremely correlated with oil prices, as the energy sector makes up about 12% of the BofAML US HY index. The rise in oil prices explains its outperformance relative to euro HY since February. But even with oil prices holding above USD 40 per barrel, the increased number of defaults could heighten investors' concerns and lead them to demand a higher risk premium. By contrast, the default rate for euro HY stands at only 2.7% and should barely rise this year. Unlike the US, rating upgrades continue to outpace downgrades in euro HY. The euro HY index also has low exposure to the energy sector (6% of total euro HY bonds outstanding) and so remains less correlated with oil prices.

2. EM sovereign debt

EM sovereign debt, like credit, is very sensitive to commodity prices, the US dollar, and the fortunes of the Chinese economy. Since mid-February, oil prices are rebounding, the US dollar has declined from its 2015 highs, and China has been boosting credit. These factors are favourable to EM sovereign debt, although the catalysts for investment decisions regarding debt issued in hard currency and the debt in local currency are somewhat different.

Country exposure. Important disparities exist in the composition of emerging bond indices depending on whether they are in US dollars or in local currency. The JP Morgan local-currency index (EM-GBI Global Composite index) is strongly exposed to Latin America, with Mexico and Brazil making up 36% of the total, and with only 15 countries represented. By contrast, the JP Morgan hard-currency index (JPM EMBIG Global Composite) contains 65 countries. This country diversification reduces idiosyncratic risk and, for example,

CHART 2: VOLATILITY OF EM SOVEREIGN BONDS INDICES IN LOCAL AND HARD CURRENCY (JAN. 03-APR. 16)



Source: Pictet WM - AA&MR, Datastream

exposure to Brazil's political saga. In essence, investing in local-currency debt requires an in-depth understanding of the situation each issuing country finds itself. By contrast, the Fed's monetary policy and US inflation are more important factors in hard-currency EM debt, with US dollar-denominated EM bond yields consisting of US Treasury yield plus a credit spread that represents the issuing country's probability of default.

Risk exposure.
Investing in local currency EM debt is riskier than in the hard currency equivalent, as the former contains forex risk. Therefore, currency volatility has to be added to the underlying volatility of the debt when determining its underlying attractiveness (see chart 2). Last year for example, the Brazilian real declined by almost 50% against the US dollar: such a massive movement reduced US investors' return from local-currency Brazilian debt by half. While they have picked up in recent weeks, emerging-market currencies could experience renewed depreciation against the US dollar if the Fed hikes again, even though we think any such reaction will probably be less dramatic than in 2015. Hard-currency EM debt should be less hurt by renewed US dollar strength.

Conclusion
Core sovereign bonds should keep playing their protection role in the case of renewed market tensions, as we do not anticipate any severe downturn similar to the *taper tantrum*. However, these safe-haven bonds will probably not post attractive annual returns in the next 10 years, leaving investors looking for alternatives that offer higher yields and better total returns, such as corporate credit and EM sovereign debt. In high yield, spreads above the risk-free rate are high enough to protect investors should default rates rise to around 5% in Europe and 6% in the US – although the latter figure is equivalent to Moody's default forecast for end-2016. In the case of EM sovereign debt, the absence of direct forex risk means that hard currency debt carries less risk than the local currency equivalent.

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Euro area growth forecast for 2016 draws level with the US

Disappointing US GDP figures for the first quarter mean that we have lowered our forecast for US growth to 1.8% in 2016—the same level as for the euro area where figures have been quite upbeat.

Data in charts and tables on this page are as of April 29, 2016

MAIN ECONOMIC INDICATORS

Pictet estimates – (consensus*)

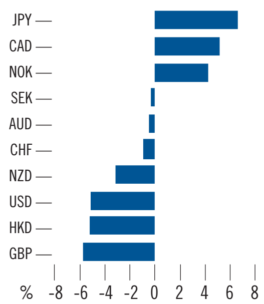
GDP growth rates	2014	2015	2016E		2017E	
US	2.4%	2.4%	1.8%	(2.0%)	2.0%	(2.4%)
Euro area	0.9%	1.5%	1.8%	(1.5%)	1.7%	(1.6%)
Switzerland	1.9%	0.9%	1.1%	(1.1%)	1.6%	(1.5%)
UK	2.9%	2.3%	2.0%	(2.0%)	2.3%	(2.2%)
Japan	-0.1%	0.5%	0.6%	(0.6%)	0.5%	(0.5%)
China	7.3%	6.9%	6.5%	(6.4%)	6.2%	(6.2%)
Brazil	0.1%	-3.9%	-3.7%	(-3.8%)	0.9%	(0.6%)
Russia	0.5%	-3.3%	-1.6%	(-1.3%)	1.2%	(1.1%)

Inflation (IPC) Annual average, except year-end for Brazil	2014	2015	2016E		2017E	
US	1.6%	0.1%	1.6%	(1.3%)	2.4%	(2.2%)
Euro area	0.4%	0.0%	0.2%	(0.3%)	1.5%	(1.4%)
Switzerland	0.0%	-1.1%	-0.6%	(-0.6%)	0.2%	(0.2%)
UK	1.5%	0.0%	0.9%	(0.7%)	1.8%	(1.7%)
Japan	2.7%	0.8%	0.2%	(0.0%)	1.8%	(1.6%)
China	2.0%	1.4%	2.2%	(1.5%)	1.8%	(1.7%)
Brazil	6.3%	9.0%	6.9%	(7.1%)	5.5%	(5.6%)
Russia	7.8%	15.5%	7.0%	(7.5%)	5.7%	(5.7%)

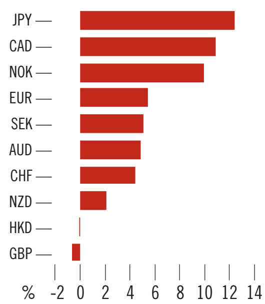
*Source: Consensus Economics Inc

EXCHANGE-RATE MOVEMENTS (SINCE 31.12.2015)

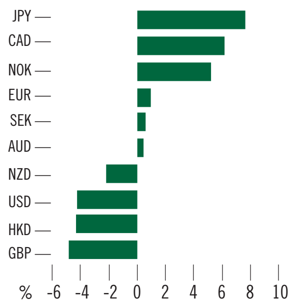
Against EUR



Against USD

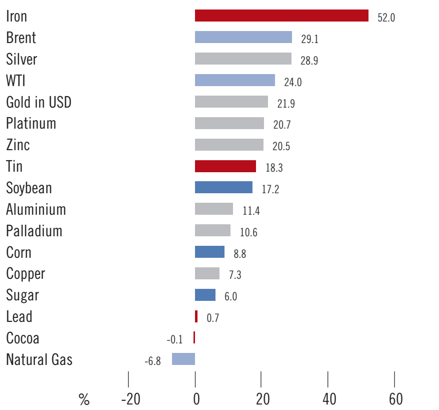


Against CHF

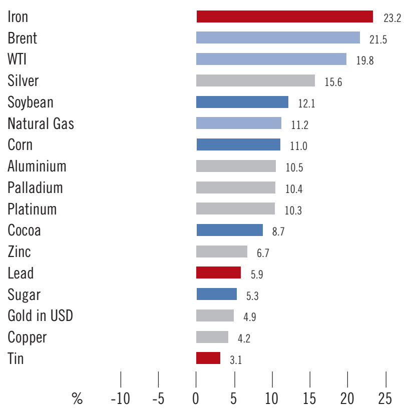


COMMODITIES

Performance since 31.12.2015



Performance for previous month



INTEREST RATES

	Short (3 months)	Long (10 years)
US	0.50%	1.8%
Euro area	0.00%	0.3%
Switzerland	-0.75%	-0.3%
UK	0.5%	1.6%
Japan	-0.1%	-0.1%
China	2.10% (1 year)	2.4% (5 years)
Brazil	14.25%	12.5%

BOND MARKETS

Returns since 31.12.2015

STOCK MARKETS

Returns since 31.12.2015

	USD	EUR	CHF	GBP
MSCI World*	1.5%	-3.8%	-2.9%	2.1%
S&P 500*	1.7%	-3.5%	-2.6%	2.4%
MSCI Europe*	0.2%	-5.0%	-4.1%	0.8%
Tokyo SE (Topix)*	-1.6%	-6.7%	-5.8%	-1.0%
MSCI Pacific ex. Japan*	0.9%	-4.3%	-3.4%	1.5%
SPI*	-1.6%	-6.7%	-5.8%	-1.0%
Nasdaq	-4.6%	-9.6%	-8.7%	-4.1%
MSCI Em. Markets*	6.4%	0.9%	1.8%	7.0%
Russell 2000	-0.4%	-5.6%	-4.7%	0.2%

* Reinvested dividends

SECTORS

Returns since 31.12.2015	US	Europe	World
Industrials	5.8%	-0.6%	4.8%
IT	-3.7%	-9.6%	-3.7%
Materials	7.6%	5.9%	12.2%
Telecommunications	10.7%	-8.8%	5.7%
Health care	-3.7%	-11.0%	-4.4%
Energy	11.4%	7.1%	13.0%
Utilities	11.8%	-2.0%	7.5%
Finance	-2.8%	-14.3%	-4.0%
Consumer staples	3.3%	-2.6%	3.3%
Consumer discretionary	1.0%	-9.4%	-1.4%

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