PICTET
1805

+61%
Cumulative gain of 10-year Bund since March 2009 (in euros)
Page 2

2.5%
Our forecast for US growth in the second quarter
Page 4

+3.6%
The S&P500's performance in the first five months of 2016
Page 6

-34%
Net income of Japanese companies versus expectations
Page 7

+7.9%
Indian GDP growth in the first quarter
Page 9

4.74%
Yield on European high-yield bonds at end May
Page 10

-6.0%
Fall in gold prices in May
Page 11

30%
Discount to book value that European banks were trading at in late May
Page 13

Economic prospects in the US and Europe brighten, but some fear that European banks are 'turning Japanese'

June 2016

Perspectives

EDITORIAL OUTLOOK

Wicksell or Fisher: a century on, who is going to be right?

Christophe Donay,
Head of Asset Allocation and
Macroeconomic Research,
Chief Strategist

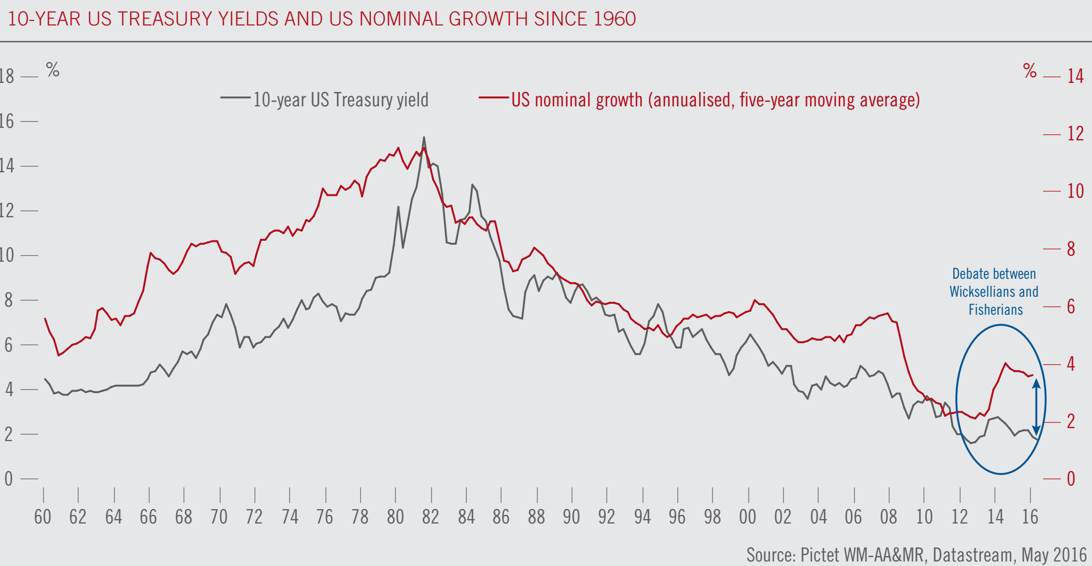
Central banks have been intervening wholesale on financial markets since 2008. Where is all this interventionism leading? Two economists from the last century could provide some pointers, however disconcerting.

The extension by the European Central Bank (ECB) of its quantitate easing (QE) programme from sovereign bond purchases to corporate bonds in June offers the most recent evidence of the interventionism of central banks, following on from the QE programmes implemented by the US Federal Reserve between 2008 and 2013 and by the Bank of Japan (BoJ) since 2013. These large-scale interventions have resulted in disruption of financial-market mechanisms. The prices of assets is meant to be 'manufactured' through the trade-off between supply and demand, but the pricing and valuation of some assets, particularly bonds, no longer reflects values warranted by economic fundamentals because as buyers of bonds the aims of central banks differ from those of investors. Through QE, central banks are seeking simultaneously to avoid a spike in long-bond yields and to enable governments and private-sector companies to raise financing more cheaply. By no stretch of the imagination are central banks basing their bond-purchase programmes on the fundamental valuation of bonds. As a result, a gap has developed between market rates and their equilibrium price.

In 1898, Swedish economist Knut Wicksell put forward the idea that going rates of interest on financial markets could differ from the 'natural' rates of interest (deemed to be rates consistent with a stable price level) that were justified by fundamentals. He pointed out that, when market rates were below natural levels, economic growth was stimulated. From this standpoint, it is fair to say that the policies being pursued by central banks in the last few years have been Wicksellian. By way of comparison, with nominal growth of around 3.5% (2% growth and 1.5% inflation), the 'natural' rate of interest for 10-year US Treasury bonds should be in the region of 3.5% instead of the current rate of about 1.8%.

At the turn of the 20th century, the American Irving Fisher took an opposite view to Wicksell. He challenged the idea of a 'natural' rate of interest. Instead, he put forward the argument that, over the long run, the level of interest rates would always reflect the relationship between the fundamental forces at work in the economy. In the aftermath of the 1929 crash (during which he lost most of his wealth), Fisher sought to construct a theory of economic crises. He explained that boom-bust phenomena were directly linked to excess credit and that the bursting of bubbles caused by excess credit inevitably led to what he called 'debt deflation'. According to Fisher, one of the repercussions of debt deflation was a slump in nominal interest rates and an increase in 'real' interest rates (i.e. adjusted to take deflation into account). From this standpoint, central bankers are currently taking action to counteract this Fisherian scenario by endeavouring to help economic agents to deleverage while underpinning asset prices.

Today, there are traces of these two schools of economic thought in how investors are sizing up the market. The Wicksellians believe that in today's climate, where markets are being swamped with money pumped in by central banks via QE, long-term sovereign bond yields need to rise steeply to revert to their 'natural' rate of interest. An unexpected spike in



inflation might be the trigger for this upward movement. According to proponents of this scenario, bonds would then be sent crashing, as they were in 1994[1]. Conversely, the Fisherian camp believes that low government bond yields essentially reflect the anaemic state of the economy and that, as a result, central banks will do their utmost to ensure interest rates stay low to ward off any relapse into recession. Wicksellians are duly offloading their positions in government bonds, whereas Fisherians are building up theirs. Over the last few years, the Fisher camp has been on top as 10-year US Treasuries and German Bunds have delivered cumulative gains in local currencies of 38% and 61%, respectively, since March 2009.

Whatever way things turn out, central banks certainly have the power in their hands to tip the bond market one way or the other. Today, some, like the ECB and the BoJ, are still actively trying to remove hindrances to growth by forcing down the cost of borrowing and encouraging deleveraging.

In the near term, a hike of 25 basis points in the Fed's official rates over the summer, coupled with accelerating US growth, could lead to an increase in US long-bond yields. As such, 10-year Treasuries present an asymmetrical risk for investors. If this risk were to turn to reality, we might be able to conclude that the Wicksellians were right after all following a two-year-long spell of divergent trajectories for nominal growth and 10-year interest rates, which has prevented rates from reverting to their 'natural' levels (see chart). However, if a recession were to occur in the US as interest rates moved back towards their 'natural' levels and if the Fed were to expend less effort trying to prevent it, we could also declare that the Fisherians were right. Nonetheless, a recession does not look likely in the US considering the stream of generally robust macroeconomic data from the domestic economy.

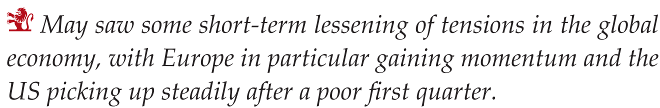
[1] *The price of bonds fluctuates inversely to movements in long-term interest rates: a rise in long-bond yields causes bond prices to drop, and vice versa. As things stand today, a jump in 10-year bond yields from 1.8% to 3.8% would cause the value of US Treasuries to fall by around 17%.*

MACROECONOMICS

The skies over the US and Europe remain relatively bright

In spite of near-term risks, we maintain our relatively upbeat assessment of prospects for the US and euro area economies, while the authorities are doing enough for the Chinese economy to 'muddle through'

Christophe Donay, Bernard Lambert, Nadia Gharbi and Frederik Ducrozet



May saw some short-term lessening of tensions in the global economy, with Europe in particular gaining momentum and the US picking up steadily after a poor first quarter.

The world economy has caught some favourable winds ahead of what is shaping up to be an eventful month of June.

Composite Purchasing Manager Index (PMI) readings for the euro area weakened very slightly in May, but indicate that the economy is firmly in expansionary territory. Germany's economy is proving solid and even the outlook for France may be picking up, leading us to reaffirm our forecast of 1.8% growth for the euro area this year. In the US, first-quarter real GDP growth was a lowly 0.8%, but consumer spending—over two-thirds of the US economy—remains strong, reflecting a buoyant labour market, and we expect the US to record annualised GDP growth of 2.5% in the second quarter. On the other side of the Pacific, concerns about China have also faded for the moment. Growth came in at 6.7% in the first quarter, consistent with our forecast for Chinese growth this year of 6.5%. Meanwhile, the rise in oil prices to close to $50 per barrel has been helping Brazil and Russia, so that the 5.4% year-on-year contraction in Brazil's economy in the first quarter, while it looks bad, was actually somewhat better than expectations. However, like Russia, Brazil remains firmly in recession and faces major structural problems.

Elsewhere, the current respite may not last. The increasing hawkishness of the Fed (the markets have been increasingly pricing in a rate hike in June/July) has caused a rebound in the value of the US dollar, and could yet put renewed pressure on already fragile emerging markets. The European economy is improving, but inflation levels remain stubbornly low and the banking sector continues to be stung by negative deposit interest rates. And Japan is another source of potential volatility. Quantitative easing, and even negative interest rates, have not helped lift inflation. The Bank of Japan, which also meets in mid- June, is under intense pressure to do something to curb the rise of the yen and faltering growth figures, while the government faces calls to introduce even more fiscal stimulus, having announced on 1 June the postponement of a rise in the consumption tax rate planned for next April.

US: stronger growth will resume in Q2

Although revised up from 0.5% to 0.8% q-o-q annualised, US first-quarter growth was certainly disappointing. Fortunately, the latest data available are pointing to a noticeable improvement in Q2. Investment in equipment remains in the doldrums and another negative contribution from inventory build-up seems likely. But housing data are upbeat, April's advance trade figures were encouraging and – most importantly of all – consumer spending growth appears to be bouncing back sharply after having disappointed in the first quarter. We continue to expect a significant pick-up in US GDP growth to about 2.5% in the second quarter, not least because of strong consumer spending growth, which may well top 3.0% in Q2 2016.

Minutes from the April Federal Open Market Committee (FOMC) meeting, released in May, and recent speeches by Fed members have increasingly enticed futures markets to pencil in a Fed rate hike in June or July. Growth is certainly improving in Q2, the US economy is close to full employment and financial conditions have eased considerably since peaking in January. However, survey- and market-based inflation expectations remain quite low

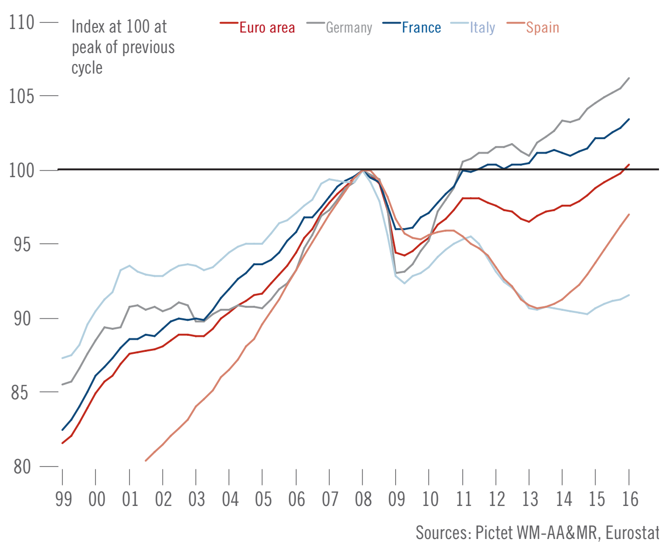
We continue to expect a significant pick-up in US GDP growth, to about 2.5% in the second quarter

and the dollar is rising once again, leading to renewed tightening of financial conditions. Moreover, there remain important downside risks, notably those associated with global economic and potential financial developments, Chinese FX and economic policies, the Brexit referendum in the UK and the US elections in November. So, while the possibility of a rate hike in June, and even more so in July, has increased, we still believe it is slightly more likely that the FOMC will wait until September before acting. In any case, the Fed is, we believe, likely to tread very carefully, probably limiting itself to just one rate hike this year.

Euro area prospects remain upbeat, despite hiccoughs

After the strong readings recorded in Q1, the latest euro area business surveys are signaling some softening of momentum, meaning that euro area GDP growth could slow from over 2% to around 1.5% in annualised terms in Q2. However, both soft and hard indicators remain consistent with solid domestic demand, helping to partially compensate for any weakness from external factors. On the fiscal front, the European Commission's country-specific recommendations regarding the European Stability and

HOW EURO AREA ECONOMIES HAVE FARED SINCE THE FINANCIAL CRISIS.



Sources: Pictet WM-AA&MR, Eurostat

Growth Pact have confirmed that it is prepared to envisage greater flexibility on spending rules (although in return for stronger commitment to reforms). In May, Italy was granted unprecedented scope to relax austerity, while Portugal and Spain avoided fines for not complying with their fiscal targets. Meanwhile, the Eurogroup agreement on Greece on 25 May was a net positive even though key details on debt restructuring have essentially been postponed until after the bailout programme is completed in 2018. Nevertheless, near-term risks remain, not the least of which is the UK referendum on continued membership of the European Union on 23 June and the re-run of the Spanish general election three days later. The recent drop in business confidence was particularly visible in the euro area periphery and thus requires close monitoring. Still, all the aforementioned downside risks need to materialise for our above-consensus forecasts to be challenged, including our forecast of euro area GDP growth of 1.8% in 2016.

Meanwhile, core inflation slipped back below 1% in April in the euro area and nominal wage growth eased in Q1, with negotiated wages down to a record low of 1.4% year-on-year despite some signs of strength in Germany. While we do not envisage any major change to the ECB's stance for now, its asset purchases are likely to be extended beyond March 2017, probably forcing another adjustment to quantitative easing rules, most likely starting with an increase in issuer limits in September.

The Chinese economy stabilises

Data for China have been a little weak in recent weeks, considering the amount of credit that has been pumped into the economy this year, and the economic rebound glimpsed in March has not been sustained. The official manufacturing PMI remained at 50.1 in May, unchanged from April and barely in expansionary territory, while the non-manufacturing (services and construction) PMI slipped again, to 53.1, from 53.5 in April and 53.8 in March. Industrial output growth slipped back to 6% y-o-y in April from 6.8% in March, fixed-asset investment slackened to 10.5% in January-April from 10.7% in January-March, and retail sales growth fell to 10.1% in April from 10.5% in March. Broadly, although the slowdown in manufacturing has bottomed out, the services sector appears to be struggling to maintain its previous momentum. This suggests that, although policy support has been sufficient to avert a hard landing for now, it is unlikely to result in a boost to growth from current levels.

Moreover, there are signs of divisions among the authorities over economic policy, with criticism in a speech by the president Xi Jingping and, more strongly, in an article that cites an unnamed "authoritative figure", believed to be one of Xi's allies, of the reliance on increasing indebtedness to support strong economic growth. This acknowledgement that excess credit growth is storing up problems is significant. However, the tendency has been to reach for the credit lever when growth slows, and previous calls for a shift in economic policy towards a greater emphasis on structural reforms have thus far borne little fruit.

Credit did tighten in April. Total social financing (overall lending to the economy) slackened to RMB751bn, from RMB2.3tr in March. But this may represent more of a reining in after the huge credit surge of the first quarter than a fundamental policy shift. We expect that the authorities will continue to rely for the present on 'stop-go' policies—using monetary and fiscal stimulus as needed to maintain a high rate of growth. Accordingly, we maintain our forecast for real GDP growth of 6.5% this year, at the bottom of the authorities' 6.5-7% target range.

Risk on again, but important hurdles ahead

While risk appetite has been showing signs of improving in line with asset-class performance, a looming Fed rate hike and a rebound in the US dollar, together with upcoming political events, make markets tricky to navigate.

Christophe Donay, Jacques Henry, Luc Luyet and Alexandre Tavazzi

FINANCIAL MARKETS

Local-currency returns in % from financial markets. Data as of 31.05.2016

		Index	Since 31.12.2015	May 2016
US equities*	USD	S&P 500	3.6%	1.8%
European equities*	EUR	Stoxx Europe 600	-2.7%	2.7%
Emerging-market equities*	USD	MSCI Emerging Markets	2.4%	-3.7%
US government bonds*	USD	ML Treasury Master	3.3%	0.0%
US investment grade*	USD	ML Corp Master	5.3%	-0.1%
US high yield*	USD	ML US High Yield Master II	8.1%	0.7%
Hedge funds	USD	Credit Suisse Tremont Index Global**	-1.9%	0.3%
Commodities	USD	Reuters Commodities Index	5.7%	0.8%
Gold	USD	Gold Troy Ounce	14.3%	-6.0%

Sources: Pictet WM - AA&MR, Datastream, Bloomberg ** Dividends/coupons reinvested ** End-April 2016*

Although valuations are high, we still see some limited potential in equities. However, interest-rate risks and a packed political agenda have led us to hedge equity positions and limit bond duration.

Market rebound comes up against high valuations

The rise in oil, and of commodity prices in general, has helped improve the earnings estimates for energy companies, while companies in other cyclical sectors have benefited from apparently brightening prospects, at least in developed markets. The global pricing environment seems to be improving, enabling a bottoming of earnings estimates. First-quarter earnings results in Europe and, to a lesser extent, in the US, were noticeable for the number of positive surprises, while banks outperformed in recent weeks. Signs that the yield curve was steepening again would improve the earnings prospects of financials, and thus contribute further to upbeat sentiment.

But the rebound in stock prices after their February low point has been much quicker than the improvement in earnings, so that valuations are close to the peaks recorded over a year ago. Our central scenario is that there remains limited upside potential in equity markets thanks to improving earnings, encouraging us to remain tactically overweight stocks. But with valuations high and the global environment characterised by growth constraints that limit multiples expansion, we remain relatively prudent. Indeed, we have started to hedge our equity positions given two main short-term risks facing markets. One is the risk that the markets fail to price upcoming Fed rate hikes correctly. The other is the potential fallout from a host of political risks, ranging from the Brexit referendum and Spanish general election this month to the constitutional referendum in Italy in October and the US presidential election in November.

While a 10-year US Treasury yield of around 1.8% looks attractive from a European perspective, there are also grounds to worry that real interest rates (after inflation) on long-term US Treasuries have turned negative, so that risks to yields are asymmetrical. That does not mean we expect a huge rise in bond yields, but it does mean we have been cutting duration. At the same time, investors continue to be paid for risk exposure to sections of the corporate bond market, especially high yield. The fall in interest rates due to quantitative easing (QE) and the prospect of ECB corporate bond purchases has led to a hunt for yield that continues to boost European high yield, for example.

On the currency front, tensions threaten to rise again as the US dollar rebounds ahead of Fed rate tightening. However, we believe there are constraints on how far the Fed can go, as future potential rises in the trade-weighted dollar due to improvements in the domestic US economy could destabilise dollar-exposed emerging market debtors.

Hurdles ahead for DM equities

Equity markets continued to recover in May. Better-than-expected Q1 earnings and higher 2016 earnings estimates for the energy and cyclical sectors were behind the continued rebound of major indices. On a US dollar basis and including dividends, the S&P 500 returned 3.6% in the first five months of 2016, while the Stoxx Europe 600 remained in negative territory, returning -2.7% over the same period. Hurt by disappointing earnings revisions, Japan was down 1.8% using the same metrics.

Earnings growth has started to improve in developed markets, allowing financial stress to abate. High-yield energy spreads have substantially declined in the US, while prices for European banks' CDS have remained stable. Reflecting this improvement, market volatility has declined. The Vix and V2X indices fell from 15.7% to 14.2% and from 24% to 21%, respectively, in May. While positive earnings revisions should continue thanks to higher energy prices, markets have hurdles to overcome in the coming

weeks and months if they are to march much higher. These include the 'Brexit' vote on 23 June and Spanish elections on 26 June, a potential Federal Reserve tightening this summer and US presidential elections in November. Volatility spikes around those events are possible despite the improvement in earnings growth. This leads us to maintain a tactical stance toward equities, trying to get the most out of short-term market movements.

Cross-asset return dispersion grew in May

The two best-performing assets since the beginning of the year, namely crude oil and gold, showed diverging trends in May, with oil advancing a further 5.4% and gold decreasing 6.0%. Dispersion grew between equities as well, with developed equity markets posting strong returns while emerging equities disappointed. While the S&P500 returned 1.8%, the MSCI Emerging Markets Index returned -3.7% (in US dollars) and the MSCI Asia (Ex Japan) Index -1.3%. Emerging markets were hurt by the less dovish tone adopted by the Fed during the month. Diverging monetary policy between the Fed and ECB translated also resulted in different returns on 10-year sovereign bonds, with a slight negative return for US 10-year US Treasuries in local currency and a further 1.3% gain for the German Bund. The main factor affecting most asset-class returns of late has been the US dollar, which has been strengthening again.

Some respite in Japan following yen weakening

The TOPIX outperformed other developed equity markets in May, returning 2.9% compared with 1.8% for the S&P 500 and 2.7% for the Stoxx Europe 600 (all returns in local currency). But this outperformance was mainly due to currency movements as the yen eventually weakened 3.2% in May after having strengthened since H2 2015, illustrating the enduringly strong correlation between the Japanese stock market and currency. The Q1 16 reporting season was extremely poor as Japanese companies reported sales that were 3.8% and net income that was 34% below expectations. Industrials suffered the most due to a strong yen. As the effectiveness of Bank of Japan monetary policy is diminishing, fiscal stimulus looks the best option to prop up the economy, which explains the postponement of the VAT hike announced on June 1. The possible annoucement of more fiscal stimulus in the weeks ahead would provide support for Japanese equities.

The Fed awakens (part two)

The cautious stance adopted by the Fed since the start of the year has forced markets to rethink completely the path they see toward monetary tightening. At the beginning of May, markets were forecasting as low as 7% the probability of a Fed rate hike in June. However, with the international situation improving and with better US data, the Fed surprised the markets in May by suggesting its willingness to raise rates, potentially as soon as June. Already, a decent flow of US data and a more active Fed has helped the US dollar appreciate significantly. And looking forward, the expected improvement in US economic activity in the second and third quarters should continue to favour a stronger US dollar. However, as we remain of the belief that there will be only one Fed rate hike in 2016, the pace of US dollar appreciation is likely to be less impressive than in previous years.

Oil outages boost prices

The continued strength of oil prices in May was supported by record oil outages. Although they are usually temporary in nature, like Alberta's wildfires, there could be a structural element to these outages underway. Outages are often caused by conflicts, such as those in the Middle East, which have stabilised at new higher levels. But in addition, it is possible that cost cutting by oil majors and oil-producing countries has contributed to an increased risk of outages of a technical or security nature. We could be in for persistent volatility in oil supply, and therefore in oil prices.

Consumers are sending contrasting signals

With the OECD estimating that global growth will stagnate at a "modest" 3% this year, domestic consumers are expected to take the strain of supporting the national economy in many large countries – but with varying degrees of success.

£7bn

UK GDP growth dipped in the first three months of this year (to a quarter-on-quarter rate of 0.4%), but domestic spending remains a bright spot. In spite of the economic uncertainties surrounding the Brexit referendum, **UK consumers seem intent on 'shopping 'till they drop', spending an average of £7bn a week in April**, according to the Office of National Statistics. That was 4.3% higher than in the same month in 2015.

+3%

US consumer spending surged by over 1% in April over the previous month, consistent with our view that consumer spending will top 3% annualised in the second quarter. Given that it is the mainstay of the US economy, **the rise in consumer spending could push US real GDP growth up to 2.5% in the second quarter**, according to our estimates.

-44%

Brazil is mired in recession, with GDP contracting for the past five quarters. **The latest GDP report showed a 0.8% drop quarter-on-quarter in household demand** in the first quarter. Another telling sign of the slump in domestic demand is the 29% year-on-year decline in Brazilian-made car sales and 44% decline in imported car sales in the first quarter.

-0.9%

German consumers are sending contrasting signals. The above-expectations rise of 0.7% in German GDP in the first quarter was boosted by domestic demand (which more than counterbalanced weak exports), while other statistics showed a healthy 2.3% rise in retail sales in the year to end April. However, **consumer momentum may be slowing, with retail sales dipping 0.9% in April and 1.4% in March** on a month-on-month basis.

+1.5%

Figures from INSEE, the French statistical office, show households spending money at the fastest rate since 2004. **INSEE revised sharply higher its estimate of consumer spending in 2015 to 1.5%, while it estimated that spending grew by 1.7% in the first quarter of 2016**. Meanwhile, the consumer confidence gauge in the euro area's second-largest economy rose to 98 in May, its highest level since October 2007.

65.3

China remains intent on shifting from an export-dependent economy to a domestic consumption-led one. But after four months of improvement, **the FTCR China Consumer Index, a survey of Chinese consumers, weakened in May**. The survey showed falls in household income and discretionary spending compared with April. At 65.3, the reading was still well above the 50 mark that separates expansion from contraction, but well below readings of close to 80 that were seen in 2013.

-0.8%

Consumer spending remains weak in Japan. In spite of the efforts of the authorities to stimulate the economy, and in spite of a strong yen, which has reduced the price of imports, **April retail sales were down 0.8% on a year earlier**. On 1 June, the Japanese prime minister announced the postponement of a planned consumption tax hike scheduled for next April to avoid undermining an already fragile economy.

+7.2%

Indian economic data comes wrapped in health warnings, but first-quarter GDP growth of 7.9% in the year to 31 March suggests that India is currently among the healthiest of emerging markets. **Brisk consumer spending has been helping to accelerate growth, with car sales, for example, rising 7.2% in the year to 31 March**. Although recent increases in oil prices are a net negative for India, an upcoming pay rise for civil servants could continue to bolster consumer spending.

The markets learn to live with a more hawkish Fed

Developed-market equities and European credits were winners in May, while emerging-market assets remained in the doldrums and US dollar strength pummeled precious-metal prices. But further potential currency movements need watching as the Fed moves to tighten policy.

Equities

Profits pick up

Japan trails the pack.

In May, the MSCI World index returned 0.7% (in US dollars), helped by the S&P500's +1.8% and the Stoxx Euro 600's +2.7% returns in local currency. The rather hawkish mid-month statement from the Federal Open Market Committee (FOMC) resulted in much-heightened market anticipation of tightening of US monetary policy over the summer and a stronger US dollar. As a consequence, the MSCI Emerging Markets index returned -3.7% over the month in US dollars. Measured in US dollars and including dividends, the S&P 500 was in positive territory in the first five months of 2016 (+3.6%), while Japan (-1.8%) and Europe (-2.7%) were negative.

The positive performance of developed markets reflects the corporate earnings published for Q1 2016. European and US earnings were 11.2% and 1.4% higher than expectations respectively, while Japanese earnings trailed estimates by 37.5%.

Thus, after three consecutive years of downward earnings estimates, Q1 should mark an important bottom for the S&P 500 and Stoxx Euro 600 growth estimates. The bulk of the improvement is coming from energy and cyclicals, where earnings revisions have lagged the improvement in oil prices. Unfortunately, revisions have not been strong enough to allow valuations to decline from their already high levels. The forward price-to-earnings multiple stood at 17.6x in the US at end May, at 15.3x in Europe and at 13.1x in Japan. Given the high valuations, further market performances could be limited.

Bonds

The return of the Fed

A hawkish Fed led to higher US Treasury and emerging market yields in May.

In minutes from the April FOMC meeting and in various speeches, the US Federal Reserve (Fed) signalled its readiness to hike rates again "in coming months". This hawkishness surprised markets and led them to re-price the direction of Fed monetary policy. The market increased its estimate of the probability of a hike at the June or July FOMC meetings to about 70%, and the two-year US Treasury yield, which is taken as an indicator of policy tightening, rose 10bp. Ten-year US Treasury yields increased less, to 1.85%. In Europe, government yields fell, with the 10-year German Bund yield back to 0.14% at end May, after having touched 0.30% in April. Peripheral euro area yields also fell as the environment turned risk-on, with less perceived uncertainty regarding the Brexit referendum and an agreement reached in Greece on the disbursement of a second tranche of loans. The increased pace of the European Central Bank's (ECB) quantitative easing together with reduced net issuance also helped push yields down. As European and US monetary policies move further along different paths, sovereign yields should also keep diverging, with US Treasuries yields rising more than European yields.

The Fed's hawkishness also hit emerging-market sovereign yields in local currency as the US dollar renewed its appreciation. Emerging-market yields could continue their upward move in anticipation of a Fed rate hike this summer.

Corporate bonds

Credit rallies after a turbulent start to May

Higher oil, a risk-on environment in Europe, and a fall in issuance triggered an end-of-month rally in credit.

May was turbulent for credits, with yields rising at the beginning of the month due to lower oil prices, higher issuance and continued stress in the European financial sector. But all these negative catalysts reversed towards the end of the month. For a start, oil prices rallied 6% during the course of May, ending the month close to USD50/barrel. The rise in oil prices led to lower yields in the US high yield (HY) energy sector, with the lowest-rated bonds experiencing strong outperformance. Hence, US HY returned 0.7% and yields fell to 7.65%. For its part, euro HY finished the month slightly positive as worries about banks were counter-balanced by the risk-on rally in peripheral sovereign bonds, with yields falling back to 4.74%.

Euro investment grade (IG) outperformed its US counterpart in spite of strong issuance, as companies sought to profit from the low level of yields (1.06% at the end of May) due to the anticipated start of the ECB's corporate bond purchase programme in June. The Fed's hawkish discourse led to a climb in US IG yields (to 3.16%) and a slightly negative performance (-0.1%). Monetary policy and HY default rate divergence between Europe and the US should favour European credit and keep depressing volatility.

Hedge funds

Should I stay or should I go?

Ahead of the Brexit vote, managers are hedging their bets.

When it comes to the mist of uncertainty surrounding the upcoming Brexit vote, it may be better to look at the bookies than the polls. Even when the polls are showing a 50-50 split in the vote, the bookies see a 60-70% probability that Britain will remain in the EU. It seems to be a consensual view among hedge fund managers too that the UK will choose to stay in Europe.

But Brexit is still regarded as a potential tail event and any impact of a vote to leave the EU – while probably short-lived – would not go unnoticed. Should the British vote for Brexit, hedge fund managers expect the pound to weaken, which would benefit exporters, whereas importers would suffer and domestic consumption would slow due to the uncertainty and adjustment to GDP growth prospects. Long/short managers are accepting the risk and have not made any drastic adjustments to their books, apart from monitoring their exposures and diversifying their positions. Some Global Macro managers, on the other hand, are using option strategies, such as dual-digital options, to hedge the Brexit risk. The strategies are structured to benefit from sterling weakening against the euro. But to pay out they would also require the euro to fall against the dollar, the view being that a UK exit weakens the EU project. Such structures avoid the costs of simply buying options outright, given elevated volatility, and serve as a low-cost way of seeking protection.

Precious metals

Hurt by USD strength

Precious metals suffered in May, coinciding with renewed US dollar appreciation.

May was not a particularly good month for any precious metal. Gold lost 6.0% (in US dollars), silver 10.4%, platinum 9.0%, and palladium 12.2%. The renewed strength of the US dollar has likely been a key reason for the underperformance of precious metals.

Unfortunately for these commodities, the improvement in the outlook for US growth in the second and third quarters should continue to support a stronger US dollar, which should ultimately weigh somewhat on their performance. However, it is worth noting that a stronger US economy is an overall positive development for metals that rely on industrial demand, such as palladium (which relies on US car sales). But gold, for which there is almost no industrial demand, is in a different position. With the Fed looking ready to raise rates in the next few months, reducing the risk that inflation will overshoot, the short-term prospects for gold are less encouraging than they were. Furthermore, markets have thus far taken the Fed's more hawkish stance in their stride, reducing the attractiveness of gold demand that stems from 'fear' trades. However, robust jewellery demand and falling supply from mines should limit the potential downside risk facing gold.

Currencies

June, potentially a volatile month

Key monetary and political events could make June stressful for FX markets.

Seeing the Deutsche Bank FX volatility index near its low for the year at the end of May, it is hard to imagine that many events that could rock FX markets are coming up in the coming weeks.

On the political side, the UK referendum on leaving the European Union (23 June), if it passes, could have a significant impact on sterling. Although surveys seem to point towards the British remaining in the EU, it is worth remembering how unreliable UK polling has been in the past. Furthermore, in Spain there are risks that the general election of 26 June could lead to a government more prone to reversing economic reforms, which would likely induce some volatility around the euro.

On the monetary side, the Fed could decide to raise rates during the June FOMC meeting (14-15 June). Such an early hike would likely boost further the US dollar, as a June hike was not being priced in by the market as recently as at the beginning of May. Furthermore, dollar strength could lead to renewed concerns about Chinese policies. Indeed, the Chinese yuan has been weakening against the US dollar again and is now at levels last seen during the market turbulence in January.

We acknowledge that 'Brexit', an anti-reform Spanish government and a June rate hike in the US are not part of our main scenario. However, that markets do not seem more worried by these risks than they are makes us uneasy.

Are European banks turning Japanese?

A series of factors, notably ever lower and even negative interest rates, mean that European banks have fallen out of favour. Some believe they could go the same way as banks in Japan, where years of low rates have driven down valuations. But ECB success in reflating the European economy could mean a different outcome for Europe's banks.

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From 1 January 1 to 26 May 2016, the banking sector was the worst performing of all 19 sectors on the Stoxx Europe 600 index. The index itself was down 2%, but the banking component suffered a loss of 12% in euros during this period. The underperformance of the banking sector is not new.

Indeed, the European banking sector has dramatically underperformed the European market over the past five years. Over the past five years, European banks have returned -22%, against the Stoxx index's +23%. Only basic resources have performed worse.

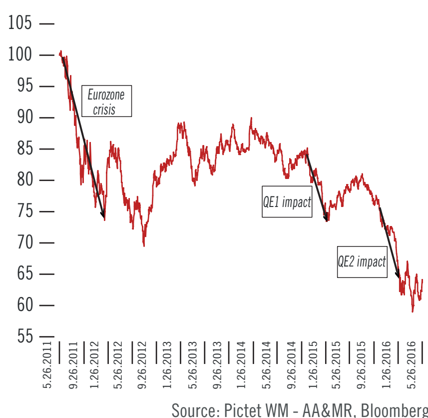
There have been three broad periods of underperformance for banks over the last five years (see chart 1). The first was in 2011, during the euro area sovereign crisis, and the second was in late 2014/early 2015 due to the impact of the European Central Bank's (ECB) first quantitative easing (QE) programme. The third and most recent period of underperformance stretches back to the end of last year and is due principally, but not exclusively, to the impact of the ECB's second QE programme.

What has characterised the ECB's recent stimulus programmes has been a move toward lower and increasingly negative interest rates at the short end of the curve, and lower risk-free rates at the longer end.

Dealing with low absolute and negative interest rates

It is relatively simple to understand why a flatter yield curve and negative interest rates, which have been the

CHART 1: RELATIVE PERFORMANCE OF EUROPEAN BANKS VS. STOXX EUROPE 600 INDEX, MAY 2011–MAY 2016



Source: Pictet WM - AA&MR, Bloomberg

consequence of the ECB's actions, are bad for banks. As banks typically borrow at the short end of the yield curve (demand deposits can be withdrawn at any time) and lend at longer maturities (about half of mortgages in the Eurozone are at fixed rates over several years), a flatter yield curve reduces banks' margins, all things being equal. The effect on bank margins of negative interest rates is a more recent and pernicious phenomenon. So far, no large euro area banking system has passed on negative rates to its retail client base. This is lowering the margin, if any, that banks earn on deposits. Unless banks can offset this on other parts of their balance sheet, notably through higher lending rates, this is a net negative.

Outside the euro area, banks in Sweden, Denmark and Switzerland have mostly been able to offset worsening deposit margins through higher mortgage lending margins. The banking sector in all three countries is highly concentrated and their initiatives have had the support of banking regulators and central banks to avoid the overheating of the housing sector that negative interest rates could cause. However, a similar outcome is unlikely in most euro area countries, where mortgage pricing and margins are often related contractually to Euribor. Consequently, lower Euribor rates mean less interest income for the banks.

Banks' latest bout of underperformance is largely due to the impact on bank margins of lower rates, but there have been other sources of concern as well regarding banks' prospects:

- Volatility and downward-trending markets have been pressuring market-related revenues, notably in asset management and investment banking;
- The low level of commodity prices, in particular the oil price, is leading to loan losses in the energy sector, generating concerns that the global corporate credit cycle may be turning;
- Teething issues with the new ECB-led Single Supervisory Mechanism (SSM), designed to regulate euro area banks, caused uncertainty and banks' borrowing costs to rise early this year.
- Action by the regulatory arm of the ECB may have amplified existing problems in some banking markets, such as in the case of Italian banks' non-performing loans.

Bank earnings forecasts have come down significantly as a result:

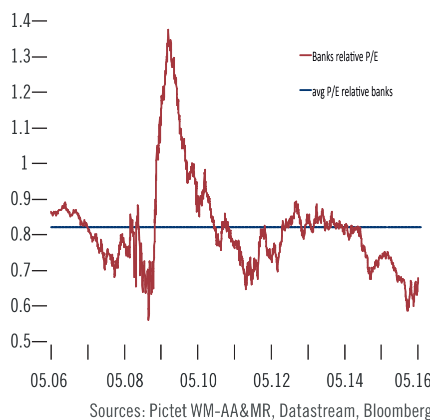
12-month forward estimates fell by 16% in the first five months of 2016, against a 4% downward revision for the European equity market. Estimates for dividends in the banking sector have also been reduced.

From a valuation standpoint, the underperformance and earnings downgrades of European banks in recent quarters has left the sector trading at an unusual discount to the market. Chart 2 shows the forward price-earnings (P/E) ratio of the European banking sector relative to the broad European equity market over the past 10 years. The chart shows that, on average, the sector has traded at an 18% discount to the market, compared to a current discount of about a third. Apart from the nadir of the global financial crisis in 2008, banks have not traded at such a low level relative to the market in the past 10 years, not even during the worst of the euro area crisis of 2011-2012.

European banks trade at a discount to book, like Japanese banks

On the basis of price-to-book (P/B) ratios, European banks are increasingly trading at a discount to book value, as chart 3 shows. The last time banks traded at a premium to book was before the financial crisis and for a short time in 2009 following a short-term rebound. Since then, banks have increasingly traded at a discount to book value. Amid much volatility, that discount has widened to about 30%, with probably few prospects of improvement for the rest of the year.

CHART 2: EUROPEAN BANKS' FORWARD P/E RELATIVE TO THE STOXX 600 EUROPE INDEX, MAY 2006–MAY 2016



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

The discount to book value suggests European banks cannot return their cost of equity. Indeed, their current average return on equity (ROE) is around 5%. Even though the average ROE is expected to improve to 7-8%, this is still below the cost of equity (which is probably closer to 10%, about 2% higher than the cost of the highest credit-risk instruments, which yield about 8%).

It could get worse. Indeed, having been spared the dangerous experience of negative interest rates and anticipating higher Fed interest rates in the coming months, US banks are now trading at around book value for an ROE of 8%. But Japanese banks, after decades of de-rating, now trade at about half their book value, i.e. at a 30% discount to European banks.

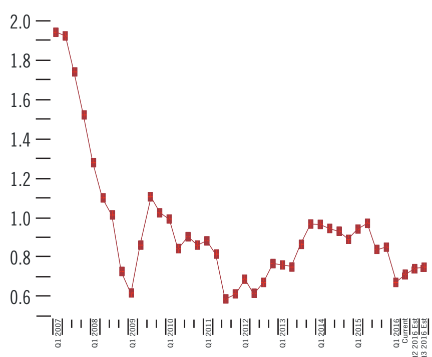
Japanese banks have been operating for many years in a very low interest rate environment. While loan losses have been small (as in Europe), Japanese banks' ROEs have also been low (3-6% on average) for years because their net interest margins have been depleted by low, and now negative, interest rates.. Average loan yields in Japan have come down to 1.2% above the deposit rate, having dropped 35% over the past 15 years. As the European banking sector shows some of the same characteristics as Japan's, the fear is that it is on a similar trajectory. The average loan yield in Europe is still about twice what it is in Japan (around 2-3% for core Europe), but is also on a downward trend.

Is there any way the European banking sector might avoid turning Japanese, with ever-lower absolute (P/B) and relative (P/E) valuations in the quarters to come? Much will depend, we believe, on the ultimate success of recent ECB policies and on a sustainable recovery. "Europe is not Japan", the optimists proclaim, but while we tend to agree on many levels, ultimately what matters for the banking sector is whether the economy can return to a higher path of nominal growth, including higher inflation and inflation expectations. In this regard, we see two possible outcomes for the euro area over the medium term.

Reflation will help Europe's banks

Our baseline scenario is that the ECB's strategy to reflate the economy will prove successful and that reflation will eventually provide some support to European banks. While underlying inflation has remained weak (below 1% until recently), the ECB's hope is that the cumulative effects of the various

CHART 3: THE PRICE TO BOOK VALUE OF EUROPEAN BANKS, Q1 2007– Q3 2016 (ESTIMATE)



Sources: Pictet WM-AA&MR, Bloomberg

unconventional measures it has introduced will help bring inflation back closer to its 2% target by 2018 against a more favourable global backdrop. While financial markets are currently not pricing in the success of ECB policies, confidence in the central bank could grow with time. Meanwhile, inflation expectations could get a boost from higher commodity prices.

Alternatively, things could get worse before they get better. In this scenario, monetary policy fails to push inflation higher. Even though the ECB is unlikely to give up trying to raise prices, something new would have to be tried. We believe that the only credible option would involve a fiscal response that could take several forms.

It is worth noting that the euro area's updated fiscal compact allows for greater fiscal flexibility in exceptionally bad economic times. Any significant fiscal response would therefore not need to be coordinated at the EU level. Instead, it could take the form of a de facto response by national governments to yet another deterioration in economic conditions, which, along with continued ECB buying of public and private debt securities, could come close to a form of 'helicopter money'. Under this alternative scenario, the ECB could still expand its existing policy framework, including asset purchases and TLTROs, but the decisive trigger for a turn in market sentiment would rely on the fiscal side. A combination of considerable fiscal and monetary easing would, we believe, have the effect of driving prices higher.

In short, although the timing and composition of the policy response differ according to the scenario, we expect European inflation to edge gradually higher either way. This slow and bumpy normalisation of inflation rates is likely to result in steeper (nominal) yield curves eventually, especially in core euro area countries, which should have a positive net impact on European banks' margins through various price and volume channels.

Conclusion

All in all, the current environment of protracted 'low-flation' and the Japanese precedent suggest caution when it comes to European banks' near-term prospects. There is a real possibility that we will have low interest rates for some time, putting continual pressure on banks' margins and causing their earnings estimates to decline even further, reinforcing investors' concerns about profitability. This suggests cautious positioning in the banking sector, avoiding most names with mid-single digit ROEs, which may be value traps. The more attractive banks are the quality names or winners in their respective areas that display above-average profitability and strong balance sheets and that can pay out attractive recurring dividends. Lloyds Banking Group, BNP Paribas and Intesa Sanpaolo might fit into this category. At the sector level and after a long period of underperformance for banks which has left them trading at low multiples relative to history, we also believe investors should stand ready to jump in if and when inflation expectations shift higher.

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Commodities and credit stage a comeback

Some of the most striking features of the year so far have been the rise of the yen and the rebound in the price of oil and other commodities. Risk appetite has also returned, with US high-yield bonds and the MSCI World showing positive performances (in US dollars).

Data in charts and tables on this page are as of May 31, 2016

MAIN ECONOMIC INDICATORS

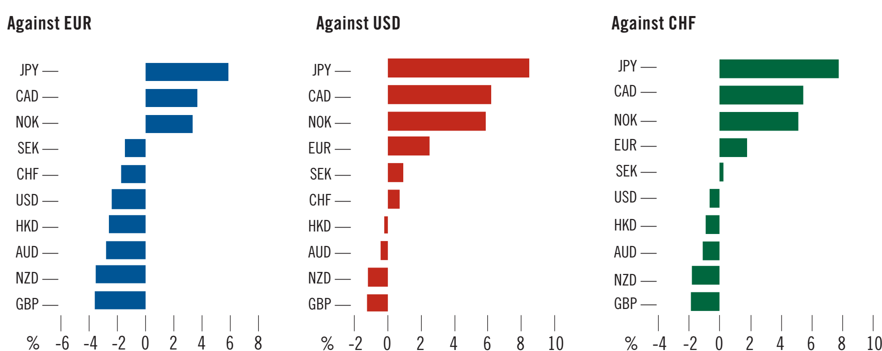
Pictet estimates – (consensus*)

GDP growth rates	2014	2015	2016E		2017E	
US	2.4%	2.4%	1.8%	(1.8%)	2.0%	(2.3%)
Euro area	0.9%	1.5%	1.8%	(1.6%)	1.7%	(1.6%)
Switzerland	1.9%	0.9%	1.1%	(1.1%)	1.6%	(1.5%)
UK	2.9%	2.3%	1.9%	(1.9%)	2.3%	(2.2%)
Japan	-0.1%	0.6%	0.6%	(0.5%)	0.5%	(0.5%)
China	7.3%	6.9%	6.5%	(6.4%)	6.2%	(6.2%)
Brazil	0.1%	-3.9%	-3.7%	(-3.7%)	0.9%	(0.7%)
Russia	0.5%	-3.3%	-1.6%	(-1.3%)	1.2%	(1.1%)

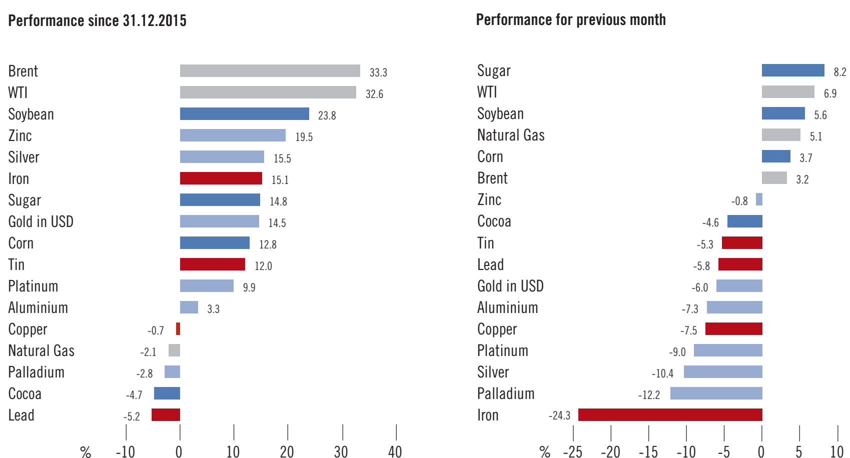
Inflation (IPC) Annual average, except year-end for Brazil	2014	2015	2016E		2017E	
US	1.6%	0.1%	1.5%	(1.2%)	2.4%	(2.3%)
Euro area	0.4%	0.0%	0.3%	(0.2%)	1.4%	(1.3%)
Switzerland	0.0%	-1.1%	-0.6%	(-0.6%)	0.2%	(0.2%)
UK	1.5%	0.0%	0.7%	(0.7%)	1.8%	(1.7%)
Japan	2.7%	0.8%	0.2%	(0.0%)	1.7%	(1.5%)
China	2.0%	1.4%	2.2%	(1.5%)	1.8%	(1.7%)
Brazil	6.3%	9.0%	8.4%	(7.0%)	5.5%	(5.5%)
Russia	7.8%	15.5%	8.0%	(7.5%)	5.9%	(5.7%)

*Source: Consensus Economics Inc

EXCHANGE-RATE MOVEMENTS (SINCE 31.12.2015)



COMMODITIES

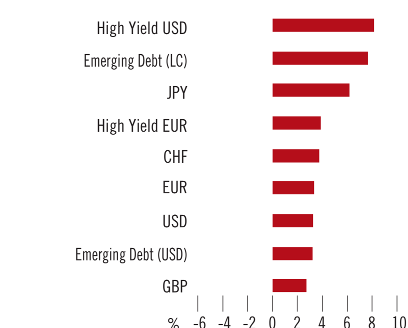


INTEREST RATES

	Short (3 months)	Long (10 years)
US	0.50%	1.8%
Euro area	0.00%	0.2%
Switzerland	-0.75%	-0.3%
UK	0.5%	1.4%
Japan	-0.1%	-0.1%
China	2.10% (1 year)	2.4% (5 years)
Brazil	14.25%	13.1%

BOND MARKETS

Returns since 31.12.2015



STOCK MARKETS

Returns since 31.12.2015	USD	EUR	CHF	GBP
MSCI World*	2.1%	-0.4%	1.4%	3.4%
S&P 500*	3.6%	1.1%	2.9%	4.9%
MSCI Europe*	-0.2%	-2.6%	-0.9%	1.0%
Tokyo SE (Topix)*	-2.3%	-4.6%	-2.9%	-1.0%
MSCI Pacific ex. Japan*	-0.4%	-2.8%	-1.1%	0.8%
SPI*	-1.6%	-4.0%	-2.3%	-0.4%
Nasdaq	-1.2%	-3.6%	-1.9%	0.1%
MSCI Em. Markets*	2.4%	-0.1%	1.7%	3.7%
Russell 2000	1.7%	-0.8%	1.0%	3.0%

* Reinvested dividends

SECTORS

Returns since 31.12.2015	US	Europe	World
Industrials	5.1%	1.5%	3.9%
IT	1.3%	-5.3%	0.6%
Materials	7.3%	1.7%	7.3%
Telecommunications	10.8%	-6.3%	5.5%
Health care	-1.8%	-8.6%	-3.3%
Energy	9.7%	3.8%	9.8%
Utilities	12.8%	-2.1%	6.8%
Finance	-0.6%	-12.9%	-3.9%
Consumer staples	4.0%	1.0%	3.8%
Consumer discretionary	0.8%	-8.3%	-2.0%

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