PICTET
1805

Reality check means markets could be facing a pause

Market Outlook

Pictet Wealth Management | 6 April 2017

Risk assets had an exceptionally strong first quarter, but a repeat performance will require overcoming numerous obstacles. So argue *Christophe Donay*, Head of Asset Allocation & Macro Research, Chief Strategist at Pictet Wealth Management.

The first quarter was an exceptional one for risk assets—so exceptional in fact that it is difficult to see how their performance can be repeated in the present quarter without some strong catalysts.

According to our analysis, annualised returns on equities in the first quarter were up to three times higher than their historic average in the case of developed-market equities, and six times higher in the case of emerging-market ones.

Such has been the performance of equities and equity-like assets—and such are the valuations they command—that there is scant room for disappointment without some sort of short-term correction being triggered. Conversely, for markets to maintain their recent momentum would require a continuation of the flow of positive news on economic fundamentals and corporate profits, but also the contribution of some other, extraneous factors.

There are four areas that hold out the potential for disappointment, but also for more positive outcomes: politics, fiscal policy, economic data, and the role of central banks.

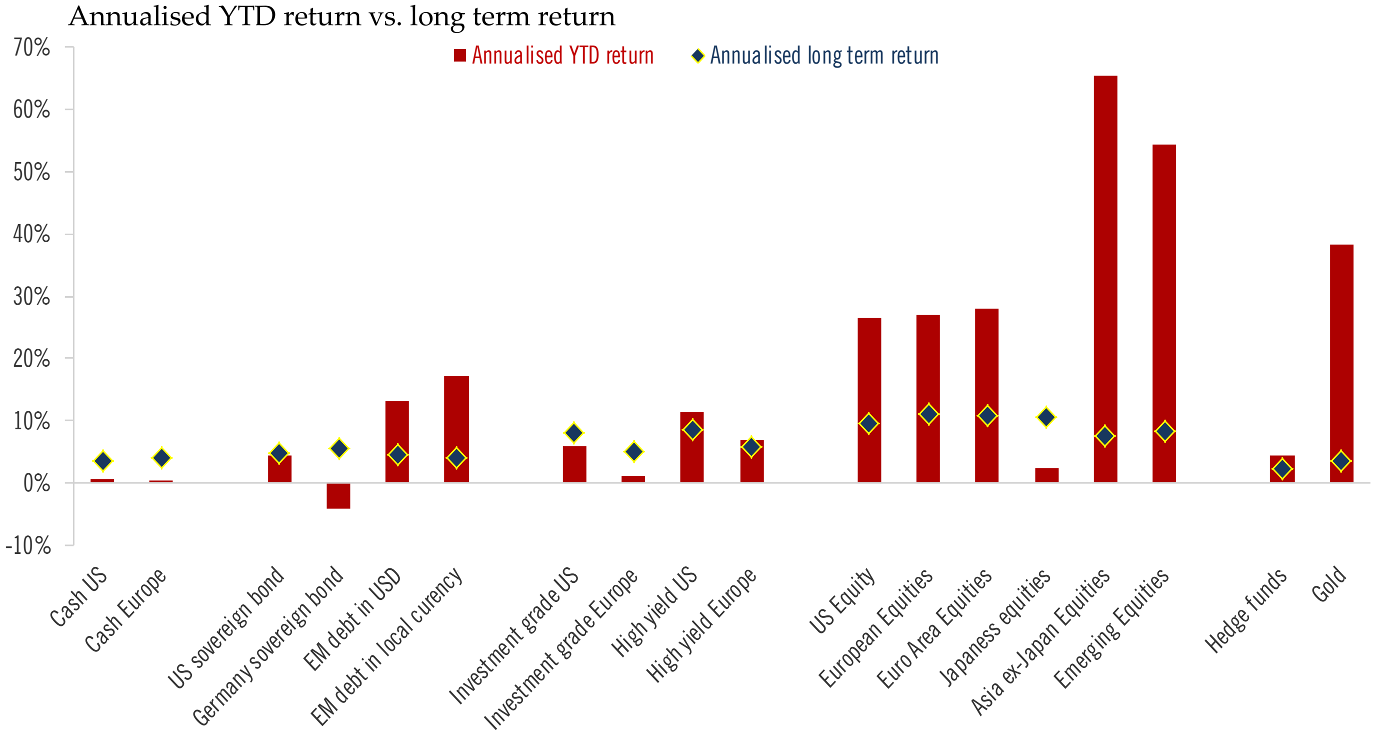
First, on the political front, the coming weeks and months will be dominated by polls in different European countries, most notably the presidential election in France. Although nothing can be excluded, our core scenario holds as improbable the most extreme outcomes (such as ‘Frexit’). Even should populists win power in one or another European country, coalitions and cohabitation—and with them compromise on important matters such as the euro and EU membership—seem more likely than not. The French elections could

Contacts
David Masters
Lansons
+44 20 7294 3687
pictetteam@lansons.com

Sarah Weigall
UK media
Pictet Wealth Management
+44 20 7847 5412
sweigall@pictet.com

Dyuti Laura Daeppen
European media
Pictet Wealth Management
+41 58 323 1344
ddaeppen@pictet.com

Equity-like returns so far outpacing the long-term average



Source: Pictet WM - A&MR, Factset, Global Financial Data. Data compiled on 3 April 2017.

be one of a number of political concerns to be laid to rest in Europe, at least in the short term. And while the opening salvoes of the Brexit negotiations rumble in the background, some political concerns may be laid to rest in Europe, at least in the short term.

The same cannot be said about the US. The presidency of Donald Trump has gotten off to a rocky start, to say the least. With his bid to 'repeal and reform' Obamacare blocked for the moment, attention has swiftly turned to Trump's ambitious plans for tax cuts and reform as well as significant infrastructure spending, the second item that is feeding into the market's evolution at present.

Faith in supply-side boost
At least some of the strong market gains of recent months have been due to confidence of a substantial supply-side boost in the US. But the outlook has become hazy on that front, with Trump's plans facing a series of hurdles in Congress. These plans may not be voted until October and November, which means their full effect will not be felt until 2018. We are not at all sure that markets are willing to wait that long. And when Trump's budget package comes through, it may not be all that the markets have been built up to expect. Because they are easier to push through, cuts to personal taxes could take precedence over cuts to corporate rates, for example. We are still expecting a

substantial package for corporations at some stage—but apart from the lack of a precise time frame, the boost to earnings growth will depend on the size of the cut to the effective corporate tax rate, which remains unknown. At the very least, the lack of visibility concerning Trump's plans could be reason enough for markets to pause.

As for economic data, the third factor influencing market prospects, there is still a gap between 'soft' data, including forward indicators and confidence surveys of various kinds, and actual 'hard' statistics. Strong US consumer confidence contrasts with relatively poor consumer spending trends, for example. Business investment too has lagged business surveys. And in Europe, data for industrial production has been less upbeat than surveys of business confidence.

While we believe that 'hard' data will improve in line with the soft variety, as the US economy in particular picks up after a disappointing first quarter, there is a chance that hard data and confidence surveys only meet half way. Would that be enough to assuage markets' expectations? Here too, there is plenty of room for disappointment.

Central banks withdraw support

Finally, central banks are starting to withdraw their support. The Fed is well embarked on a rate-tightening cycle and is set to unveil plans to reduce its balance sheet during the course of this year. The European Central Bank is somewhat behind, but may shortly provide forward guidance on its plans to end negative bank deposit rates, and by September outline its plans for tapering its monthly asset purchases next year. Unless properly handled, these kinds of central bank initiatives are liable to increase anxiety in markets that have grown used to abundant central bank-supplied liquidity.

In short, while economic fundamentals continue to provide some support, we are left contemplating monetary policies that are less generous at a time when the type of fiscal policies that could compensate are not yet in place.

Summary of reality-check outcomes

	Best case	Worst case	Our expectations
Politics	No extreme party elected	Election of an extreme party somewhere in a developed economy	No extreme party elected or cohabitation
US Fiscal policy	Huge tax cuts	Protectionism and anti-immigration	Delayed and mild fiscal boost
Soft vs. hard data	Hard data accelerates significantly, while soft data stabilizing	Soft data decelerating without support of hard data	Weakening soft data & strengthening hard data
Monetary vs. fiscal policy	Fiscal policy takes over from monetary policy	Monetary policy mistake by a major central bank	Central banks remain friendly towards growth

Source: Pictet Wealth Management AA&MR. Compiled on 3 April 2017.

These considerations, plus the rapid run-up in prices, suggest risk assets could be facing a short-term reality check, thus justifying moves to protect portfolios. A pause should not be all that surprising for other reasons. In currencies, before recent wobbles, the upcycle in the real traded-weighted value of the US dollar that started in July 2011 was already appearing lengthy by historic standards. In the early 1980s, 'Reaganomics' (a mixture of tax cuts, deregulation and other supply-side measures) helped drive the dollar index to historic highs. Something similar may be needed again for the dollar to realise some of the limited potential we believe it may still have.

Trump trade falters

The same arguments can be made when it comes to equities. While the so-called 'Trump trade' has being showing signs of faltering, for the moment lofty valuations are being justified by improving earnings outlooks. But with prices at over 17x 12-month forward earnings in the case of the S&P500 and 15x in the case of the Stoxx Europe 600, the room for disappointment is limited. There may not be a case for a large sell-off of equity markets (fundamentals continue to improve), but at the very least markets could trade sideways for a while as they grapple with changes in the stance of central banks as well as lack of visibility on US fiscal policy.

In credit markets, the strong performance of high-yield bonds (which typically behave like equities) means that spreads over benchmark government bonds have tightened considerably. They are still well off the ultra-low levels seen just before the financial crisis of 2008 and low spreads may well be justified by the improving economic picture and a declining default rate—indeed, fundamentals allow us to remain buoyant about the prospects for equities and equity-like assets as a whole once the current doubts are overcome. But sufficient reasons can now be found for seeking to protect portfolios via decorrelated assets such as gold and US Treasuries. The latter continue to play their protective role. Alas, since autumn last year, the rise in yields means that protection has become more expensive than before.

-Ends-

Notes to the Editor

The Pictet Group

The Pictet Group is a partnership of six owner managers. It offers only wealth management, asset management and related asset services. The Group does not engage in investment banking, nor does it extend commercial loans. With more than CHF 430 billion in assets under management at 31 December 2016, Pictet is today one of the leading Europe-based independent wealth and asset managers.

Headquartered in Geneva, Switzerland and founded there in 1805, Pictet today employs more than 4,000 people. It has 26 offices in: Amsterdam, Barcelona, Basel, Brussels, Dubai, Frankfurt, Geneva, Hong Kong, Lausanne, London, Luxembourg, Madrid, Milan, Montreal, Munich, Nassau, Osaka, Paris, Rome, Singapore, Taipei, Tel Aviv, Turin, Tokyo, Verona and Zurich.