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What will the rest of the year bring?

Global equities were trendless and the performance of risk assets overall was lacklustre in the first half of 2018. Trade tensions are causing jitters, but as long as fundamentals can re-assert themselves, there could still be some life in risk markets.

ECONOMIC INDICATORS & PICTET WEALTH MANAGEMENT ESTIMATES (E) (AT 29 JUNE 2018)*

EQUITIES INDEXES	CURRENT	DECEMBER 2017	DECEMBER 2018E	
S&P 500	2718	2674	2850	
Stoxx 600	380	389	395	
Euro Stoxx	377	386	395	
CAC 40	5324	5313	5400	
DAX 30	12306	12918	13600	
MSCI Italy	59	60	62	
IBEX 35	9623	10044	10100	
MSCI EM	1070	1158	1200	
TOPIX	1731	1818	1850	
SMI	8609	9382	9500	
INTEREST RATES (IN %)	CURRENT	DECEMBER 2017	DECEMBER 2018E	
Switzerland - short	-0.75	-0.75	-0.75	
Switzerland - 10 year	-0.06	-0.15	0.10	
Euro area - Refi rate	0.00	0.00	0.00	
Euro area - Deposit rate	-0.40	-0.40	-0.40	
Germany - 10 year	0.30	0.43	0.60	
France - 10 year	0.67	0.79	1.10	
Italy - 10 year	2.68	2.02	2.90	
Spain - 10 year	1.32	1.57	1.80	
US - Fed rate (mid range)	1.88	1.38	2.38	
US - 10 year	2.86	2.41	3.00	
UK - Repo rate	0.50	0.50	0.75	
UK - 10 year	1.28	1.19	1.50	
Japan - Overnight	-0.10	-0.10	-0.10	
Japan - 10 year	0.04	0.05	0.10	
CREDIT SPREADS (IN BP)*	CURRENT	DECEMBER 2017	DECEMBER 2018E	
European IG	121	87	110	
European HY	381	279	320	
US IG	129	99	120	
US HY	361	363	390	
EM Corporates (USD)	327	282	310	
EM Sovereign (USD)	367	286	320	
* Bank of America Merrill Lynch indices				
FOREIGN EXCHANGE	CURRENT	DECEMBER 2017	DECEMBER 2018E	
EUR/USD	1.17	1.20	1.19	
EUR/CHF	1.16	1.17	1.15	
USD/CHF	0.99	0.97	0.97	
GBP/USD	1.32	1.35	1.35	
USD/JPY	111	113	107	
COMMODITIES	CURRENT	DECEMBER 2017	DECEMBER 2018E	DECEMBER 2019E
Gold	1253	1302	1307	
Oil (WTI)	74	63	70	62
GDP GROWTH RATES	CURRENT (YOY)	2017	2018E	2019E
US	2.8%	2.3%	3.0%	2.3%
Euro area	2.5%	2.5%	2.3%	1.8%
UK	1.2%	1.8%	1.3%	1.2%
Suisse	2.4%	1.0%	2.0%	1.8%
Japan	1.1%	1.7%	1.0%	1.0%
China	6.8%	6.8%	6.6%	6.3%
World	3.9%	3.7%	3.9%	3.8%
CONSUMER PRICE INFLATION	CURRENT (YOY)	2017	2018E	2019E
US (core PCE)	1.9%	1.5%	1.9%	2.4%
Euro area (headline HICP)	1.9%	1.5%	1.5%	1.7%
UK (headline CPI)	2.4%	2.7%	2.3%	2.1%
Switzerland (headline CPI)	1.0%	0.5%	1.0%	1.5%
Japan (core CPI)	0.9%	0.5%	0.8%	1.0%
China (headline CPI)	1.8%	1.6%	2.2%	2.5%
World (headline HICP)	4.0%	3.7%	3.8%	3.7%
As of 29.06.18 Source: Bloomberg, Factset, Eikon, AA&MR				

*Past performances or forecasts are not per se a reliable indicator of future performance.

UNINTENDED CONSEQUENCES



CESAR PEREZ RUIZ

Head of Investments and CIO
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“The market is unconvinced by the Fed’s plans for rate hikes”

In the name of America First, President Trump has withdrawn from a host of international organisations, reneged on global agreements and told other countries to reduce their reliance on US military force. His campaign on trade tariffs should be seen in a similar light. In the eyes of Trump’s supporters, America First seems to be working. Consumer and small business confidence is rising, the economy is at close to full employment, and GDP in the second quarter rose by about 4%. With mid-term elections coming up in November, Trump can be counted on to play to the domestic gallery, whatever the rest of the world thinks.

The Fed too is focusing on a domestic agenda, while global considerations are secondary. The central bank’s stately, well-signposted moves to tighten policy find their justification in healthy growth, a tight labour market and an inflation rate moving closer to its 2% target. The Fed’s focus on normalisation seems all the more justified in that it has to deal with additional, pro-cyclical fiscal stimulus from the Trump administration. But is it missing something?

At its June policy meeting, the Fed appeared unmoved by the Trump administration’s aggressive trade policy stance. While noting the “risks” involved, the Fed merely said that US economic data seemed unaffected by trade tensions so far. Yet the Fed’s stepping back from policy accommodation is increasing the problems of the more fragile emerging markets. Dislocation comes not just from hikes in US interest rates, but also from the planned shrinkage of the Fed’s balance sheet, which could suck further dollar liquidity out of the global financial system (the end of European Central Bank asset purchases will also reduce global liquidity).

The problem is, given the state of the world, the market is unconvinced by the Fed’s plans for rate hikes (the median of Fed member forecasts is for four quarter-point hikes this year and three in 2019). The lack of conviction can be seen in the steady flattening of the yield curve. Flattening could conceivably turn to inversion, which would see shorter-dated bonds offer a better yield than longer-term issues, a phenomenon seen before nine of the last 10 economic recessions.

Ten years ago, the Fed launched a massive quantitative easing (QE) programme, buying up assets in a bid to steady the markets as the financial crisis flared. Copied by many of the world’s other main central banks, QE not only staved off a collapse of the global financial system, it also sparked a rally in risk assets, while corporations have increased their profits.

But the combination of companies enjoying record margins and investors pocketing record returns at a time when wage growth remains weak, housing prices spiral out of the reach of the young and globalisation continues to wreak havoc on local communities is likely to provide tailwinds for populists for some time to come.

Meanwhile, Trump has chosen China as a convenient bogey man to advance protectionist measures his electorate appreciates. The situation is highly delicate: Trump needs to be able to show some sort of success before the elections, but the Chinese do not want to lose face. Compromise is likely, but if Trump feels things are not going his way, there is every chance he might look for different scapegoats—perhaps even denouncing the Fed for unwarranted restrictions of monetary policy and threatening its independence.

Ten years ago, the Fed was a trailblazer with its aggressive QE initiative while Barack Obama became the standard bearer for liberal democracy. Now, America seems less interested in a global leadership role. Whether this is a positive or negative development, it makes the world a more uncertain place. Black Swans are, by their very nature, unknowable. But if ever there were a place to look for them, it might be in the unintended consequences of declining US ambitions to set the agenda in so many domains. While growth is still looking good, the uncertainties mean we have become more neutral on risk assets like equities.

Investment Strategy Highlights

An overview of Pictet Wealth Management's stance on asset classes.*

ASSET STANCE

- › Risk assets have disappointed this year for several reasons. First, markets are unsettled by the incoherence in US economic policy—between market-friendly tax cuts and deregulation on the one hand, and aggressive, protectionist trade policy on the other. Second, markets see economic growth slowing next year (from 3% this year to 2.3% in 2019 in the US and from 2.3% to 1.8% in the euro area, according to our estimates). These factors have fed into a lack of visibility that has pushed down valuations. A third concern is more restrictive monetary policy, with short-term rates marching steadily higher in the US and the ECB set to end its asset purchases.
- › With these considerations in mind, we have developed a central scenario that splits the rest of this year in two. Initially, we expect markets to remain unsettled as trade disputes rumble on. But we think the pressures could lessen by the time of the US mid-term elections in November.
- › The elections could allow for a certain clearing of the air—certainly in terms of US trade policy—that will allow minds focus again on strong market fundamentals. Our generally prudent short-term stance therefore becomes more upbeat as we move closer to the end of this year.

COMMODITIES

- › Oil supplies are set to remain tight until mid-2019. We expect a significant risk premium to prevail until at least the middle of next year, so that oil prices remain above their long-term fundamental equilibrium. Our forecasts for the end of 2018 remain at USD 70 / bbl for WTI and USD 77 / bbl for Brent.

CURRENCIES

- › A very prudent European Central Bank, poor economic data and Italian politics saw the euro suffer in June. While the euro may still face short-term headwinds, our central scenario sees a progressive upturn in the currency's fortunes against the US dollar over a 12-month horizon.
- › We believe that extensive discounting of Fed rate hikes by the market could check any further substantial rise in the US dollar, which remains in a long-term downtrend.

EQUITIES

- › Earnings momentum in the US remains strong, but trade concerns contributed to lower valuations in June, even in tech. We are neutral on US equities but more bullish on less tech-exposed European stock markets.

OUR CURRENT ASSET CLASS STANCE

	STANCE				
	Very bearish	Bearish	Neutral	Bullish	Very bullish
CASH/CURRENCY					
USD (vs EM and G10 currencies)					
EUR (vs USD)					
CHF (trade-weighted index)					
DEVELOPED MARKET EQUITIES					
US					
Euro area					
Europe					
Switzerland					
Japan					
EMERGING MARKET EQUITIES					
Asia					
Latam					
SOVEREIGN BONDS					
US					
Euro periphery					
Core Euro					
Local currency EM					
CORPORATE BONDS					
US high yield					
US investment grade					
EUR high yield					
EUR investment grade					
Hard currency EM					
GOLD					
HEDGE FUNDS					
PRIVATE EQUITY					
REAL ESTATE					

* 3-6 month horizon. In view of our highly active, tactical positioning, we are moving back from a 12-month horizon to a 3-6 month outlook for the asset stance we present.

- › The positive legal ruling on the AT&T / Time Warner tie-up led markets to immediately price in further consolidation in the US media sector.

FIXED INCOME

- › While our central scenario of a year's end 3% 10-year US Treasury yield remains unchanged, alternative scenarios are still possible. Overall, safe-haven US Treasuries should perform well if trade tensions persist, putting downward pressure on yields.

ALTERNATIVES

- › Heightened M&A activity means we expect event-driven hedge fund managers to continue to benefit from rising opportunities in merger arbitrage.
- › But we are monitoring for potential crowding risk in specific deals, as well as the impact

that antitrust regulations and a trans-Atlantic trade war could have on these strategies.

- › Private equity managers continue to seek to differentiate themselves as the competition for deals heats up. Finding good deals in the secondary space is becoming an especially tough challenge.

NOTICE: This asset class stance is provided for illustrative purposes only. In general, asset allocations will differ among investors according, in particular, to their individual circumstances, risk tolerance, return objectives and time horizon. Therefore, the asset allocation in this publication may not be suitable for all investors and shall not be used as the basis of an investment decision.



CHRISTOPHE DONAY

Head of Asset Allocation &
Macro Research,
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INVESTMENT STRATEGY

The next six months

After a trying first half, what comes next for equities?

Equities have disappointed this year in spite of sound economic growth. Yes, the S&P 500 was up 2.65% (in US dollars) in the first six months of 2018, but was virtually flat if one excludes tech sector-related stocks. But the Stoxx Europe 600 was down slightly over the first half in euros and even more in US dollars. Even worse was the performance of the MSCI Emerging Markets Index, which returned -6.5% (in US dollars).

There were five main reasons for such frustrating markets. First, markets are unsettled by the incoherence in US economic policy—between market-friendly tax cuts and deregulation on the one hand, and aggressive, protectionist trade policy on the other. Second, markets see economic growth slowing next year (from 3% this year to 2.3% in 2019 in the US and from 2.3% to 1.8%

in the euro area, according to our estimates). The third reason, a lack of visibility, derives in part from the first two. But even without concerns over the impact of trade tensions and loss of momentum, the current economic growth cycle is one of the longest ever, stretching back to 2009. This lack of visibility or conviction has pushed down valuations, even though corporate profits continue to grow. Tighter financial conditions are a fourth concern. Whether it is the Federal Reserve's campaign to reduce its balance sheet or the steady reduction in the European Central Bank's (ECB) monthly asset purchases, central banks across the developed world are already injecting less liquidity into the system. The fifth and final reason for equities' lacklustre performance is more restrictive monetary policy, with short-term rates

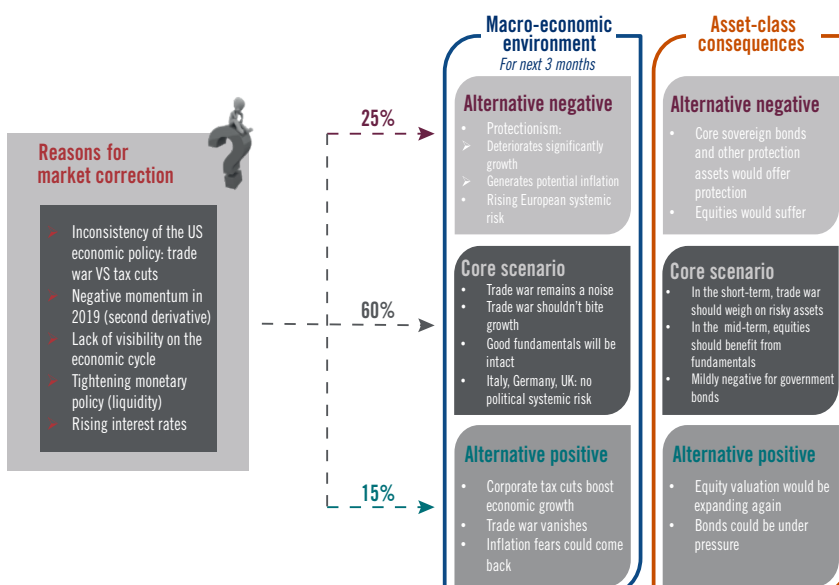
Marching steadily higher in the US and the ECB set to embark on the same road.

With these considerations in mind, we have developed a central scenario that splits the rest of this year in two (*see Chart*). Initially, we expect markets to remain unsettled as trade disputes rumble on. But we think the direct impact of these measures will be limited and that trade deals between the US and its partners will be reached. This is our central scenario, to which we assign a 60% probability. We do have an alternative, more negative scenario that sees a 25% chance of an open trade war and escalating protectionism that hurts risk assets while core government bond prices boom.

“We are splitting the rest of this year into two parts”

However, we think trade rhetoric could lessen by the time of the US mid-term elections in November. The elections should allow for a certain clearing of the air that will allow minds focus again on strong market and economic fundamentals. Our generally prudent short-term stance therefore becomes more upbeat as we move closer to the end of this year. The pressure we expect risk assets could continue to come under means that we have become more defensive on instruments like developed-market equities and high-yield bonds in the short term and that we are paying more attention to assets like US Treasuries, which offer protection to portfolios. However, our assessment of prospects for risk assets becomes more upbeat the closer we move to the close of this year. ■

OUR CORE AND ALTERNATIVE SCENARIOS FOR ECONOMIC AND MARKET PROSPECTS AT MID-2018



**NADIA GHARBI**Europe Economist
Pictet Wealth Management

Italian public debt back in the spotlight

How far the new Italian government goes in implementing its fiscal plans will determine Italian debt dynamics in the years ahead, with inevitable consequences for the bond markets.

**LAURÉLINE CHATELAIN**Fixed Income Strategist
Pictet Wealth Management

The Five Star Movement (M5S)–Lega government that came to power in Italy at the start of June with an ambitious expansionary fiscal agenda has put Italian debt back into the spotlight, although there are still several question marks regarding the government's real intentions.

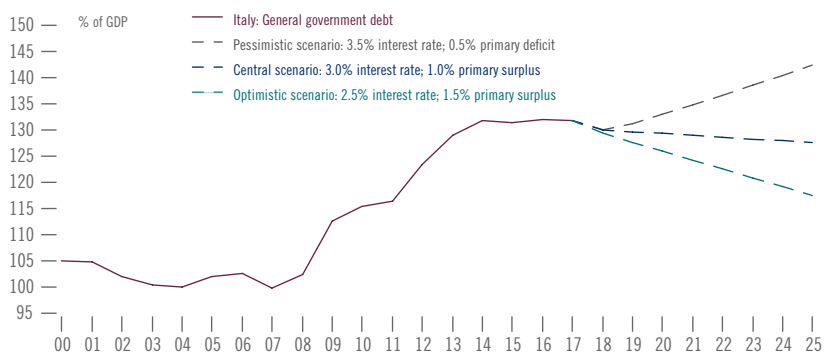
Among its pledges, three proposals would be particularly costly: a flat tax of 15–20%, the repeal of the pension reform that raised the retirement age, and the introduction of a minimum income for active job seekers. How much these proposals would actually cost is very difficult to work out, as crucial details of the government's plans are still unclear. But the policy measures included in the government agreement could cost €109–126bn a year, or between 6.2% and 7.1% of GDP, according to estimates made by several Italian thinktanks. The government's premise is that some of this additional spending would be offset by stronger demand as households and corporates would benefit from increased spending power. Additional details should emerge in the 2019 draft

budget programme, which is expected to be presented to parliament by 20 September and needs to be submitted to the European Commission by mid-October.

Needless to say, the Italian government's expansionary fiscal proposals are unlikely to be welcomed by the European Commission, even assuming they are watered down somewhat. Unlike Spain, Italy has exited the excessive deficit procedure launched against it by the European Commission in 2013. Nonetheless, the Commission is concerned about Italy's compliance with the European fiscal compact. This involves a medium-term commitment from EU member states with a large public debt to reduce that debt to below 60% of GDP. In Italy's case, the commitment entails making a structural adjustment equivalent to at least 0.8% of GDP in 2018. Italian debt has been an ongoing issue between Rome and Brussels in recent years.

That said, Italian public finances have improved in recent years. The country's budget deficit was 2.3% of GDP in 2017, its lowest level since 2007 and down from 2.5% in 2016. Italy has run an average primary surplus of 1.7% of GDP over the past six years and, apart from in 2009, has run a primary surplus every year since the launch of the euro in 1999. In 2017, its primary surplus was 1.5% of GDP (EUR 26bn) and it is expected to reach 1.9% (EUR 32.9bn) in 2018, according to European Commission forecasts. But what worries investors most is Italy's high public debt combined with its poor potential growth. At 132% of GDP, Italy has the second-highest public debt load in the euro area after Greece. While Italy's debt ratio has remained broadly stable

CHART 1: ITALIAN GENERAL GOVERNMENT DEBT UNDER THREE STYLISED SCENARIOS

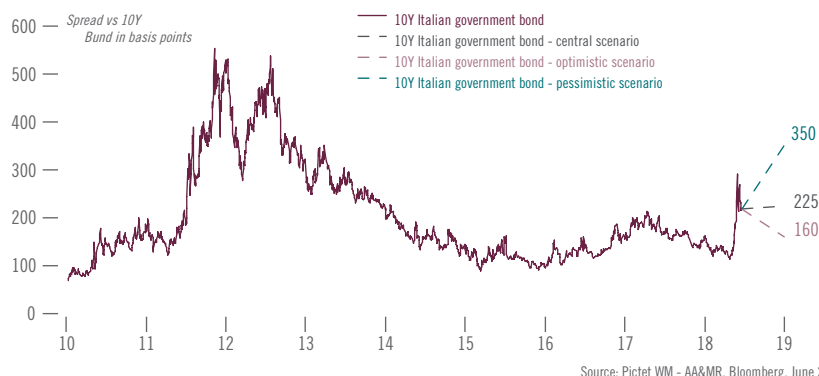


Source: Pictet WM - AA&MR European Commission, June 2018

over the past five years, the sustainability of its public debt remains highly vulnerable to unforeseen shocks, let alone a recession or financial crisis. It is crucial to understand the extent to which the new government's proposals will impact the sustainability of Italian debt.

In our central scenario for Italy, we envisage the new government implementing only part of its fiscal spending promises, resulting in a reduction of the primary surplus to zero in 2019. Thereafter, we assume that the primary balance stays at zero in 2020 before edging higher to 1% on average in the subsequent years. Based on conservative assumptions about Italy's public deficit over 2019–20 and official projections from the European Commission over the longer run, Italy's public debt ratio should continue to drop, albeit very slowly, remaining close to 125% of GDP by 2025. In short, under our central scenario, even assuming significant dilution of planned fiscal measures, the sustainability of public debt would remain at risk and vulnerable to any adverse shock.

CHART 2: 10-YEAR ITALIAN GOVERNMENT BOND SPREAD: THREE SCENARIOS



In a more optimistic scenario, Italy would continue to run a primary surplus of about 1% in 2019–20 and 1.5% thereafter, enabling public debt to fall below 120% of GDP by 2025.

But we also see the possibility of a more pessimistic scenario in which Rome defies Brussels and runs a primary deficit of 1% in 2019 and 0.5% thereafter. This would still involve considerable watering down of initial election promises, but would be broadly in line with recent guidance from the Italian prime minister. If

interest rates were to rise, as they inevitably would under this adverse scenario, then Italian public debt could rise toward 150% of GDP by 2025.

Our analysis suggests that Italy's public debt ratio could still fall if all of the following conditions are met: there is a commitment to return to a small primary surplus of about 1% of GDP over the medium term; there is no sustained increase in the government's average borrowing costs beyond 3%; and Italy records average nominal GDP growth of about 2.5%. ■

A VICIOUS CIRCLE

Reassuringly, Italian government debt is mainly held by domestic investors, while the proportion of debt in foreign hands had fallen from 39% in 2011 to 32% by March 2018. Moreover, the distribution of domestically held debt has changed, with the Bank of Italy's share rising from 4% to 16% since 2011, while Italian banks' ownership of government bonds has stayed the same at 27%. The good news is that the Bank of Italy has no plans to sell the government bonds it purchased through the ECB's quantitative easing programme. The bad news is that a strong rise in Italian government bond yields could result in significant losses for domestic banks. Hence, the contagion from sovereign debt to banks could lead to systemic risks resurfacing even though the European banking sector's financial soundness has improved since the financial crisis.

Thanks to the fall in European yields since 2012, the implicit interest rate on Italy's government debt stood at a historical low of 2.9% in 2017, down from 4.1% in 2011. Since the average maturity of Italian debt is seven years and because it is due to refinance

only half of its marketable debt over the next five years, higher government bond yields would take time to translate into increased debt servicing costs. This means that even a rapid rise in yields would have only a gradual impact on the sustainability of Italy's debt.

Our central scenario of a slight fall in the public debt ratio could ensure that the spreads of 10-year Italian government bonds over their German equivalents remain in a range of 200–250 bps until the end of this year (the spread was 238 bps on 29 June), only falling back to 160 bps if Italy continues to run a primary surplus in 2019. But should our more pessimistic scenario (*see above*) turn into reality, one can imagine spreads shooting up to at least 350 bps.

The high fiscal uncertainty surrounding Italy and the risk of contamination mean we have turned bearish on peripheral euro area bonds in general, with the direction of Italian government spreads dependent on the debt trajectory. ■



THOMAS COSTERG

Senior US Economist
Pictet Wealth Management

REGIONAL FOCUS

Getting on, but the US economic cycle still has juice

Trade tariffs could take a small chunk out of US growth, but should not be enough to tip the US into recession.

The latest salvo of US protectionist trade actions aimed at steel and Chinese imports comes at a complicated time for the US economy, which is showing signs of entering a late-cycle stage when it is more sensitive to shocks. The US had experienced 108 months of uninterrupted expansion by the end of June 2018, already exceeding the 73 months of growth in its previous expansionary phase (November 2001–December 2007), and close to the longest-lasting US growth phase in history (119 months between April 1991 and February 2001).

According to the adage, economic cycles do not die of old age. In other words, there is no clock that says the current business cycle is about to end. That said, ageing does bring some challenges, especially as catalysts for further growth are proving harder to find. Take the US car market, which in 2016 regained its pre-financial-crisis ‘cruising speed’ of roughly 17.5 million new car sales per year. But car sales have fallen slightly since that peak. The car market has regularly supported US economic expansions in the past, but this is no longer the case.

Very broadly, there are two main drivers of economic slowdowns, or even recessions. One is when corporate margins come under pressure, for instance due to sharp rises in wages or debt servicing costs. Before the past two recessions, unit labour costs, a measure of wage growth adjusted for productivity gains, were growing by more than 3% year on year. But this measure stood at just 0.5% in Q1 2018, the latest available data point, a sign the US economy is not yet overheating.

Meanwhile, the Federal Reserve is raising interest rates, but only at a gradual pace that we expect to continue. Fed

interest rates peaked at 5.25% in the previous expansion, but they are now barely at 2.00%. The bottom line is that interest rates remain low. And at the same time, US corporates continue to keep a tight leash on costs and are generating strong cash flow overall. Simply put, there are as yet no signs of any dangerous margin squeeze that could destabilise the business cycle.

In fact, the December tax cuts provided further support to corporate margins, and this has been visible in recent data. According to the Federal Reserve’s Z1 Financial Accounts data, corporate cash rose by 14.6% year-on-year in Q1, exceeding nominal GDP growth (GDP growth plus inflation) of 4.7%. This is not just a result of tax cuts, however, as cash increased by 12.9% year-on-year in Q4 2017, before the December tax cuts came into effect, and by 9.1% year-on-year the quarter before that. In fact, cash generation has been roughly double the rate of nominal GDP growth (see chart).

The second main driver of economic slowdowns is often a downturn in the asset price cycle. We are only

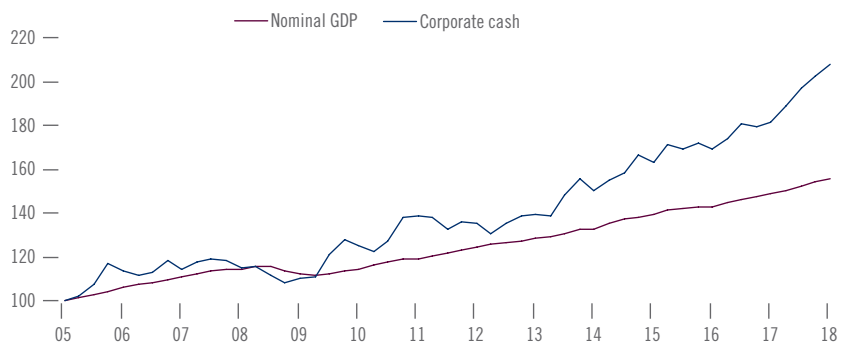
moderately anxious about this for now. However, there are some sub-segments of the real estate market worth keeping an eye on—commercial real estate, for instance, where prices have been cooling.

The US supertanker could slow, but not capsize

President Trump’s latest tariffs could end up increasing input costs for US companies. However, while we think trends in some sectors need to be watched (foreign cars are in President Trump’s crosshairs and some supply chains could be affected), the direct aggregate macroeconomic impact of the tariffs should remain limited in our view. The US has a relatively closed economy with a large domestic market, with trade (imports plus exports) representing just 28% of GDP.

According to our analysis, the direct impact of the first tariffs on steel and aluminium, introduced in June, and the first batch of tariffs on Chinese imports, starting on 6 July, combined should only detract 0.1 percentage points from

US CORPORATE CASH VS. NOMINAL GDP (REBASED 2005 = 100)



Source: Pictet WM-AA&MR, Fed Z1 Financial Accounts, BEA, June 2018

annual US growth. Further tariffs threatened by the Trump administration could detract another 0.3 percentage points. As long as the underlying pace of US activity remains above 2% per year, which is likely to be the case over the next 12 to 18 months, tariffs should not be enough for the US supertanker to capsize. Additional support for this view comes from recent solid business surveys, which show the business community remains upbeat and is ignoring trade noise.

Meanwhile, our view that US tariffs are chiefly part of a negotiating technique inspired by President Trump's signature *The Art of the Deal* playbook has not changed, even though the Trump administration has turned some of its threats into action. We continue to believe that the president's policy is guided by his need for symbolical political wins and that the air will become clearer once the November mid-term elections are out of the way. The worst-case scenario of a full-blown trade war

should be avoided thanks to resistance from pro-trade business lobbies, Congress and the stock market.

In conclusion, tariffs aside, we need to keep a close eye on potential vulnerabilities in the ageing US business cycle. But signs of recession remain relatively scarce at this stage. The robustness of corporate margins is reassuring, while some sectors exposed to international trade flows could endure some tariff-related pain without that pain spreading to the economy at large. ■



DAVID GAUD

Chief Investment Officer (Asia)
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REGIONAL FOCUS

Indian equities earn brownie points

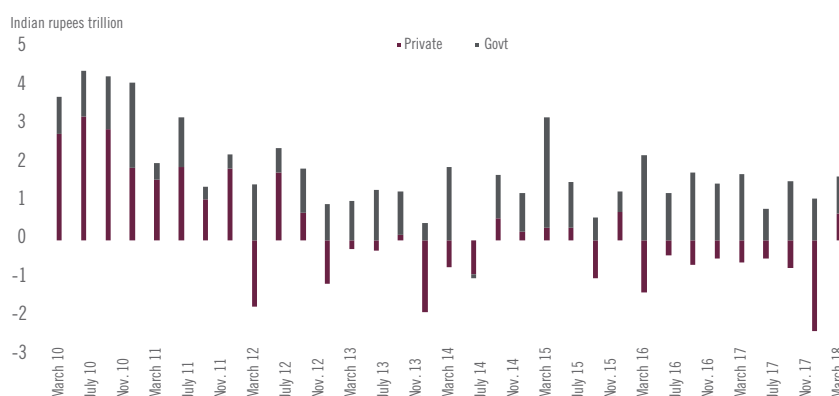
Like other emerging markets, India has suffered in recent months, but a bright economic outlook and more reasonable valuations mean that the country's equities are becoming more attractive.

The first half of this year was relatively difficult for Indian equities. A decline of over 5% in the value of the Indian rupee against the US dollar turned a local-currency gain for the Nifty 50 into a loss of 3% in US dollar terms, which meant that Indian equities underperformed the MSCI Asia ex Japan. The rupee's slide was due to a number of macroeconomic factors, including rising inflation expectations (as a result of higher oil prices in particular) and a widening of the country's fiscal deficit.

A move by the Reserve Bank of India (RBI) to raise rates to protect the currency was well received by the market. Less noticed, the RBI also relaxed reserve requirement rules for banks, and this may help boost loan growth.

Up to now, stringent rules have served to ween Indian corporates off credit, with deleveraging proceeding reasonably well. The net debt-to-equity ratio of non-financial stocks quoted on the Sensex 200 index has

CHART 1: PRIVATE AND PUBLIC INVESTMENT IN INDIA (INDIAN RUPEES TRILLION)



Source: Pictet WM - CIO Office, Standard Chartered, June 2018

fallen from a high of 59% at the end of 2015 to under 50%. The biggest efforts have been made in the power, telecom and property & industrials sectors. Levels of stressed debt (as a percentage of operating profits) have also declined.

Deleveraging should pave the way for a gradual increase in Indian corporate investment. Although capex

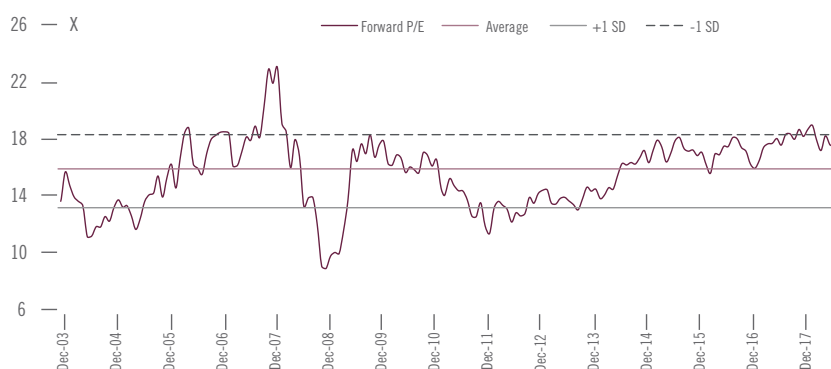
growth has been subdued, there are incipient signs of a pick-up in sectors such as cement, metals & mining and autos. The output gap has nearly closed and private investment is recovering after eight quarters of decline (see Chart 1). Having long been the 'missing link' in Indian growth, an upturn in capex, if confirmed, would indeed be welcome news.

In spite of the growth hiccups of recent months, the outlook for India is holding up well: the RBI maintained its GDP forecast for the fiscal year to the end of March 2019 at 7.4%, highlighting improving capacity utilisation, better credit uptake, a pick-up in investment activity, buoyant global demand and higher consumer spending.

Another reason we have become less pessimistic about Indian stocks is that the expected profit growth of Sensex 200 companies in 2018 is in the region of 21%, while the forward price-earnings ratio has fallen from 19x at the beginning of this year to around 16x (see Chart 2). While valuations might still look relatively high, the quality of its leading private firms means that India has always traded at a premium to other emerging markets. The average return on equity for the MSCI India is 14.6%, compared with 12.6% for the MSCI Asia ex Japan.

There are a few issues that prevent us from becoming more optimistic

CHART 2: MSCI INDIA 12-MONTH FORWARD PRICE/EARNINGS (P/E) RATIO



Source: FactSet, I/B/E/S, MSCI, Goldman Sachs Global Investment Research, June 2018

about Indian equities. The first is the uncertain direction of oil prices. Their recent surge has petered out, but oil prices remain volatile. The second is possible “populist” moves by the administration of prime minister Narendra Modi to boost the “minimum support price” (MSP), a subsidy for farmers, ahead of the 2019 general election. The proposed significant

hike in the MSP would weigh on public finances and could increase the fiscal burden. It could also weaken bond market confidence. And while Indian equity valuations have become more reasonable and the Indian market overall more interesting, the investment case for countries like China, Singapore and Malaysia remains stronger. ■



SWEE SAN TAN

Financial Analyst (Asia)
Pictet Wealth Management

REGIONAL FOCUS

Consumer staples: local brands versus the multinationals

The key to unlocking the growth potential of the consumer staples market in Asia is understanding consumers’ evolving tastes. Some local companies have first-mover advantage, but multinationals can still make inroads.

Domestic Asian (ex Japan) champions have historically thrived on products that cater to local tastes. They typically have a head-start on multinationals in terms of product localisation and their strong relationships with distributors when it comes to rolling out products across traditional trade channels. A deep understanding of local preferences has been

a key driver of the success of domestic companies, whereas many foreign multinationals have been unwilling to adapt their offerings and often roll out the same products across different regions, sometimes with very disappointing results.

For example, in Indonesia, Indofood has managed to maintain the popularity of its instant noodles

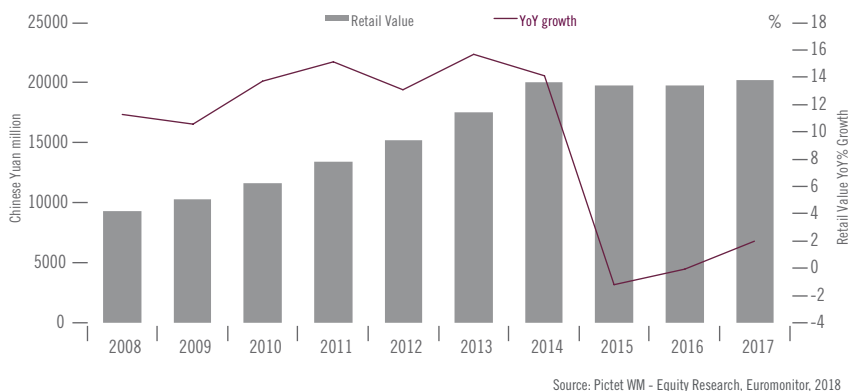
brand, Indomie, by catering to local tastes at affordable prices. The company has been able to extend its product range to the extent that it is now the de facto national brand for instant noodles in Indonesia, with a 70% market share. Indofood has the most comprehensive distribution network in the country, with its noodles available at over 300,000 points of sale across 13,000 islands and 33 provinces. Rival Japanese company Nissin, by contrast, has been unable to make much of a dent in the Indonesian market: slow to offer local flavours and with more expensive products, its market share 25 years after entering Indonesia is a mere 1%.

In the Philippines, Nestlé used to dominate the instant coffee segment, with a 63% market share in 2012 due to its first-mover advantage, having entered the country back in 1944. But in 2012, local company Universal Robina Corp (URC) launched a direct attack on Nestlé's dominant position. Its white coffee brand 'Great Taste' is milkier and sweeter than Nestlé's instant brown coffee and was an instant success with Filipinos, who tend to have a sweet tooth. As a result, URC's market share had risen from 5% (a distant third) in 2012 to 30% two years later.

But multinationals still have a chance to prosper in the region as consumer tastes in Asia are constantly evolving. Multinationals can gain traction if they successfully manage to exploit these changes using sophisticated data analysis and surveys to understand consumer habits. Successful companies have demonstrated their ability to understand and even develop Asian consumer habits to increase their total addressable market. Other successful strategies include targeting changing demographics and capturing Asian consumers' move towards premium brands as their incomes rise ('premiumisation').

Multinationals can even end up displacing incumbents. In China, for example, global chocolate majors

RETAIL VALUE (CNY MN) & YOY% GROWTH FOR CHOCOLATE CONFECTIONERY IN CHINA



have squeezed out local rival Le Conte over the past 10 years. Le Conte made the mistake of eroding its high-end brand image by offering promotions and steep discounts at a time when consumers were moving towards premium chocolates. Le Conte had been positioning itself as a high-end gift product (because eating chocolate had been uncommon in China), but nobody wanted to give a discount product to friends and family. These factors presented foreign companies such as Mars, Ferrero and Nestlé with the opportunity to step in and solidify their brand image at the high end of the market.

“Many foreign multinationals have been unwilling to adapt their offerings to Asian tastes”

Targeting a new demographic could be the path of least resistance for regional companies trying to penetrate markets in Asia (ex Japan). Instead of going head to head with incumbents or multinationals, some companies have succeeded in establishing themselves within a particular niche. A good example comes from China. Vitasoy, a Hong Kong-based company, was known for a soy milk product that it positioned as a soft drink in eastern and coastal cities in China. But a Chinese company,

Dali Foods Group, noticed that the Chinese soya milk market lacked a national, home-grown brand and that the market was far larger than Vitasoy had believed. In April 2017, Dali launched a premium soy milk product, Dou Ben Dou, which is marketed as a breakfast drink, mainly in smaller cities. Dali's product development team also recognised that Chinese consumers were willing to pay a little more for premium high-quality and healthy products, especially for repeat-consumption items such as soya milk. Dali therefore decided to source its organic, non-genetically modified soya beans locally, commanding a premium price in the process and managing to match Vitasoy's monthly sales revenue within 12 months.

Overall, regional/local food and beverage companies in Asia have first-mover advantage when it comes to launching products that suit local tastes, but multinationals have taken the lead in certain categories in which the growth of the middle class is creating a market for premium products. Logically, an appropriate approach for investors would involve stock picking among companies that understand Asian consumers' evolving tastes and have a track record of launching products able to capture growth in demand. ■



CARLOS CADAVID

Team Leader, Fixed Income
Pictet Wealth Management Advisory

ASSET FOCUS

Commercial paper offers yields last seen 10 years ago

Thanks to Fed tightening, investors can get a better fixed rate by holding short-term US paper than tying up their money in 10-year Treasury bonds. One area of the short-term universe worth exploring is commercial paper.



ALEXANDRE TAVAZZI

Global Strategist
Pictet Wealth Management

The short end of the US dollar yield curve is being affected by a series of events that are apparently unrelated, but that are all leading in the same direction: higher short-term interest rates. First, the US Treasury is being forced to accelerate its issuance of bonds to finance an increasing US budget deficit. So far, it has preferred issuing bonds with short maturities. Second, as a result of the recent tax reforms, foreign firms operating in the US are being forced to issue debt in the US market as they can no longer be financed by their parent companies. And last but not least, the Fed continues to tighten monetary policy as the economy improves and as it seeks to reduce the size of its balance sheet.

These changes in supply and demand dynamics are leading to a rise in short-term rates and a flattening of the yield curve. Two-year US government bond yields had risen from 0.8% at the start of 2017 to almost 2.60% by late June. The yields of 30-day non-financial commercial paper rose from 1.0% to 2.3% over the same period.

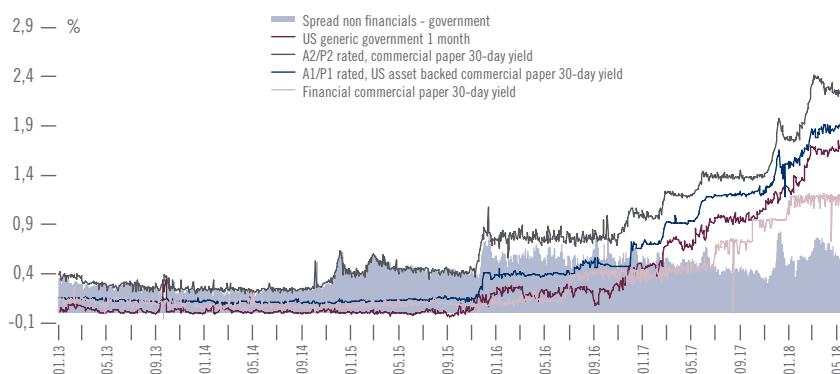
As rates have risen and the US Treasury curve has flattened, investors have continued to focus on the front end of the curve, aiming to reduce their sensitivity to rates by taking shorter duration exposure.

This has led to reduced liquidity in 1–3-year fixed-maturity bonds and floating rate notes – in the latter case, because coupons are commonly reset every six months and linked to short-term benchmark rates (usually LIBOR), there is less sensitivity to interest rate changes, enabling investors to reduce their duration risk.

Focus on front end of curve

Since the start of the year, as the Fed has continued to raise policy rates, three-month LIBOR has also increased. In the meantime, corporations' demand for short-term paper seems to have dropped. Yet with the commercial paper and commercial deposit maturity schedule expected to pick up from June onwards, financing will have to be carried out at higher rates as issuers have so far been allowing maturities to roll off instead of aiming to lock in rates.

US COMMERCIAL PAPER YIELD



Source: Pictet WM - CIO Office, Bloomberg, June 2018

2.3%

30-day commercial paper yield
in late June.

The short-term credit risk gauge, also called the LOIS (Libor overnight indexed swap) spread, raised concerns in mid-April, when it reached levels last seen during the financial crisis in 2009. The direct effect has been an increase in commercial paper rates (especially for three-month maturities) and also in rates on corporate bonds with maturities of less than a year. The LOIS spread is the risk premium that a borrower pays to lock in a loan for the coming three months instead of having to roll over their debt every day. This spread is a reflection of short-term credit risk, as the default risk of a borrower increases with time.

We believe short-maturity (1-3 year) bonds, commercial paper and short-maturity floating-rate notes issued by investment-grade companies are a good source of value for investors in the current environment. These instruments can effectively reduce the interest rate sensitivity of fixed-income portfolios and have the potential to preserve investors' purchasing power as inflation has not exceeded central banks' targets in developed economies. With the three-month LIBOR rate reaching 2.33% in late June, a level last seen 10 years ago, they represent an attractive source of yield. ■



LAURENT GABERT

Head of Real Estate
Pictet Alternative Advisors

ASSET FOCUS

Property disruption is a source of opportunity

Disruption in the real estate market is rising as a result of urbanisation, technology, environmental concerns and demographics, calling for greater discernment when investing.

The environment for property investment remains favourable overall, with economic growth decent and interest rates and inflation only rising modestly. Investor sentiment is buoyant, credit markets remain supportive, and leverage is under control. And while a number of megatrends are challenging traditional investment paradigms, they are also providing opportunities for hands-on asset managers with a strong local presence and execution capability.

Urbanisation continues apace, with rural hordes crowding into cities in the developing world and a number of 'star cities' still attracting young people from their less-favoured rivals. Demographic trends of another sort—the ageing of western populations and the coming of age of Millennials—are also affecting housing needs and aspirations. The result has been a general

trend away from home ownership to rental in many prime residential markets and the emergence of trends such as 'co-living', whereby residents with common life interests share space. These demographic factors are being overlaid by environmental concerns and technological change, leading to calls for greener and more efficient buildings, in turn increasing the cost of construction relative to other capital goods. But this is not necessarily bad news. Whether it is strong demand for new types of residential space, such as senior housing, student accommodation or spaces for 'co-living', the stage is set for investors with the asset management skills these kinds of properties require and who are ready to deal with the costs of transformation.

Meanwhile, retail property is being affected by "commoditisation"—a phenomenon that is also creeping up on the

office market. E-commerce, coupled with the preference of urban Millennials for retail convenience and proximity, has led to disenchantment with the traditional out-of-town shopping mall. Analysts think that 30% of existing retail space in the US needs to be repositioned or, failing that, be torn down.

While the shifting sands in retail are causing disruption, they can also represent a source of opportunity. The decline of out-of-town shopping malls does not mean that well-sited urban shopping centres that constantly adapt are finished. Retail outlets close to transport hubs also continue to offer potential, as does other urban retail property adapted to Millennials' preferences.

The past 15 years have seen an oversupply of global office space, helped by cheap financing and buyer appetite. Office investors are facing moves by corporations to optimise space

(‘densification’), and companies are demanding more flexible solutions to their office space needs—invariably meaning shorter leases. An illustration of how complex the market has become can be seen in London, where the largest take-up of office space over 2012–17 was by WeWork, which provides shared workspaces for start-ups and entrepreneurs. But property investors have the chance to ride this wave of disruption in office space by repositioning existing assets to meet new demands and spotting under- or badly managed assets in good locations.

At present, although the real estate market looks fully priced we are not

in a phase of “irrational exuberance”. Implied cap rates, and the rate of return of a real estate investment property based on the income it is expected to generate, are reasonable across various segments, ranging from 5% for industrial space in the US to 9% for hotel properties. Yet all segments of the US property market have been trading at discounts to net asset value, according to Green Street Advisors. This suggests that investors are waiting for repricing. But even with increased volatility, there is scope for property investment strategies to perform. ■

LONDON OFFICE MARKET: LARGEST TAKERS 2012-2017

WeWork 2,577,864 square feet (sq ft)	Amazon 1,012,649 sq ft	Deutsche Bank 857,839 sq ft
	The Office Group 853,524 sq ft	i2 Office 457,995 sq ft
Google 1,344,121 sq ft	Apple 515,865 sq ft	Facebook 381,065 sq ft
	Regus 512,219 sq ft	Société Générale 280,797 sq ft

Source: Pictet Alternative Advisory, Cushman and Wakefield, June 2018



CESAR PEREZ RUIZ

Head of Investments and CIO
Pictet Wealth Management

INVESTMENT INSIGHTS

The end of halcyon days

In this interview, Cesar Perez Ruiz, Head of Investments & CIO at Pictet Wealth Management, explains why he is becoming more cautious.

Halfway through 2018, where do financial markets stand, in your view?

The first thing to note is that the increase in volatility we had been expecting after a long period of calm finally arrived early this year. The surge in volatility we saw in late January into early February was due to fears of inflation. And yet inflation hasn’t really materialised in the ensuing months. So markets have focused on a different set of fears—this time about growth, whether that be economic or corporate. There has been a loss of momentum in some regions, particularly Europe, while emerging markets face some significant challenges as a result of higher US rates. Trade disputes, to the extent that they

hurt business confidence, are also adding a chill to the air.

Having received a sizeable fiscal stimulus, the US economy is growing strongly, while inflation is low. And US corporates’ earnings growth has accelerated at a blistering pace over the past two quarters as a result of last December’s tax cuts. And yet despite this positive backdrop, the S&P 500 rose by less than 1% in the first half of the year. The impact of tax cuts will fade over time, so earnings growth should slow down to a more normal annual pace of 8–10% from over 20% of late. The market should be able to live with this, but alarm bells could ring in some quarters if earnings growth decelerates more rapidly.

We also have to pay particular attention to the Phillips curve (the inverse link between inflation and unemployment) —whether it is dead or dormant is the billion-dollar question. If we look back to 1966, it only took US inflation to bounce from 1% to 3% for the markets to be hit by a significant correction. There are also a lot of “tourists” in the markets taking on too much risk: they could well be unsettled once earnings growth slows and inflation picks up. That said, we remain relatively upbeat overall, but we are looking at the data very carefully and expect further spurts of volatility.

What are your thoughts about president Trump and international trade tensions?

I am worried Trump's direct negotiating style simply might not work with the Chinese, who are very sensitive to losing face. Besides, when it comes to China, differences with the US go beyond trade and involve geopolitical rivalry. With the mid-term elections coming up in November, Trump's popularity rating goes up every time he announces measures to "defend" American industry. Yet once you include all the US corporations with manufacturing facilities in China, the argument that the US runs a large trade deficit with China does not hold water. So one wonders if president Trump really does have the interests of corporate America at heart as he presses on with trade tariffs.

"Alarm bells could ring in some quarters if earnings growth decelerates too rapidly"

What are the prospects for consumer spending in the US as interest rates rise?

US consumers have not been increasing their spending that much in spite of the tax cuts. Instead, they seem to have been intent on increasing their rate of saving, which had fallen to a very low level. And some cracks have appeared in the US growth picture. Car sales have virtually plateaued, for example. But with disposable income on the rise, we remain relatively optimistic about discretionary consumer spending in the near term, although any large, sustained rise in oil prices would need to be watched. We have believed that corporate investment rather than the consumer would be the main driver of US growth this year, but here too the situation is not as satisfactory as it could be. Our forecast of 3% growth for the US economy this year is based on non-residential investment rising by 7% (inflation-adjusted) in 2018, but the latest investment data have been a little below par and are increasingly skewed towards energy and tech-related industries. We

expect US growth to come in at 2.3% in 2019—considerably lower than the 4% Trump is hoping for.

The European economy has been struggling through a soft patch. Does Europe need a fiscal stimulus?

Let's not forget that the euro area is still growing above potential, which we estimate to be 1.5% per year. So the euro area is doing fine, and jobs are still being created. But growth is not evenly spread across the region and there are places, notably Italy, that do need fiscal stimulus. If we don't see some fiscal leeway, providing investors something to invest in in Italy (infrastructure for instance), then populism will continue to progress. To help steady the situation, we really need European institutional reform—as well as a solution to illegal immigration—but progress is painfully slow and the window of opportunity for reform will gradually close as we move closer to the European Parliament elections next year. Yes, there is the European Stability Mechanism, but we have to use all the tools we can if markets put pressure on Italy. In the meantime, the European Central Bank has used up a lot of ammunition: it is already having trouble finding enough government bonds to buy under its existing asset purchase programme—which, in any case, is due to be wound down at the end of this year. It's hard to see what's left in the toolkit should recession strike.

How do you rate emerging markets' prospects?

We have been conservative on emerging markets for some time and that has proved to be the right call. But assets in some countries are looking increasingly interesting as valuations have come down. Hard-currency emerging sovereign bonds offer the same yield as US high yield, but come with higher ratings. However, we need to be sure we are on solid ground politically before we make any move. Local-currency debt could look attractive at some stage, but a big chunk of the market is in Brazil and Mexico, where elections are coming up. Even China is beginning to look vulnerable, at least in the short term.

The threat of tariffs on an additional USD 200bn of US imports may never turn into reality, but the worsening of trade relations with the US comes at a sensitive time for the country, where the authorities' aggressive attempts to deleverage the Chinese economy have already pushed down growth and there have been a number of bond defaults.

So are you becoming more cautious overall?

I am becoming more cautious about the prospects for the markets. We have moved from a relatively bullish to a more neutral short-term stance on equities and we have been taking credit risk out of portfolios. After nine years of growth in the US, we are definitely in the late stage of the economic cycle. I also think it is possible that the Fed could make a policy mistake in the current fraught environment. That said, we are still in a "Goldilocks" scenario of decent growth and low inflation. Only a small number of sectors, mostly tech-related, now account for any market progress. But, the top tech companies are cash-rich with little debt, so we may not necessarily see another "dot-com" bust. I also think that portfolios based on active management and diversification will thrive as volatility increases. We are already seeing that in the improved performance of a number of hedge fund strategies. ■



CHRISTOPHE DONAY

Head of Asset Allocation &
Macro Research,
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INVESTMENT STRATEGY

An innovation shock in three waves

Technological advances can be expected to disrupt economies, politics and investment returns.

In economics, we can observe long economic cycles, or supercycles, derived from surges in technological innovation. We believe the current tech-driven supercycle comes in three waves (see chart). The first phase of the current cycle of radical innovation started in the early 1990s with the arrival of new information technologies that led to the dot-com boom. The second, in which we find ourselves today, began around 2005, when the full disruptive force of radical innovation began to be felt. This phase has been characterised by breakthroughs in areas such as quantum computing, genomics, nanotechnologies and advanced robotics. It has also seen the emergence and consolidation of the power of big tech disrupters including Google, Amazon, Facebook and Apple (GAFA).

If one accepts that technology supercycles typically last 45-60 years, then the third wave should hit our shores around 2025. This phase could see a convergence of different sources of innovation in nanotechnology, biotechnology, information technology and cognitive science (known under the acronym NBIC) to create an exceptionally powerful period of economic growth. And during this phase, we might see the disrupters being disrupted. Consumers might no longer need Amazon, for example. If one has Blockchain, traditional intermediaries to process and validate financial transactions may cease to have a *raison d'être*. The convergence of big data and huge reductions in marginal costs could lead to increased personalisation of product or service offers, even in the realm of private banking. And we could see increasing convergence between artificial intelligence and the emotional intelligence of humans.

What does all this mean for investors? The very nature of radical innovation can, as we are discovering, be disturbing. Globalisation and the arrival of a technologically advanced China have contributed to disinflation and even episodes of deflation over the past decade. A further consequence of the current wave of innovation is that the traditional dominance of sovereign states are under threat in areas such as health, privacy protection, education and even the creation of money (witness the growth of crypto-currencies). This sort of disruption has contributed to populist backlashes that could conceivably lead to the re-emergence of the kind of "strong men" we saw in Europe in the 1920s and 1930s.

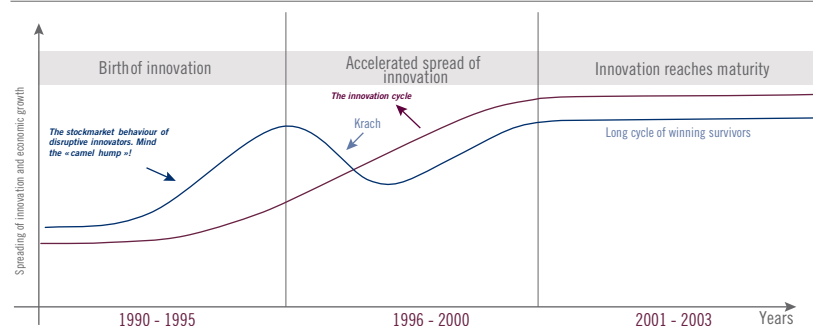
Technological innovation and investors

But recent history provides an example of the fall-out of disruptive innovation for investors. The dot-com boom started in the 1990s, when mass digital technology emerged. Indiscriminate investor buying led to the dot-com bubble beginning to form in 1995 before it inevitably burst in 2001. Investors' current enthusiasm for disruptive innovation might not turn out any differently.

But market corrections are impossible to time. Rather prosaically, the only answer is to invest actively and diversify between different sources of innovation to reduce volatility in an innovation-themed portfolio. Our own research into nine areas of innovation, ranging from e-powered vehicles to robotics, shows that it is possible to halve volatility by spreading investments across five of them and thus minimise the "camel hump" effect, when market euphoria gives way to undifferentiated selling, as happened during the dot-com bust.

But there is an even more important message to convey. While the dot-com boom turned to bust, technological advances and their economic consequences continued to spread—and even as our expectations for 10-year total nominal returns of a traditional 60/40 portfolio are shrinking (from about 9% annually to about 4%), our analysis shows that investing in disruptive innovation has generated excess returns in recent years. While past performance is no indicator of the future, within the framework of a strategic asset allocation, investing in innovation is likely to boost portfolio performance in a low-return environment. ■

THE «S» CURVE AND THE INVESTMENT CYCLE OF INNOVATION



Source: Pictet WM - AA&MR, June 2018

**CHRISTOPHER SEILERN**Senior Financial Analyst
Pictet Wealth Management

The same as what we said last year, except not

This time last year we argued here in *Perspectives* that Technology, despite its prodigious run, was not in a bubble. Now, 12 months on and 25% higher, we are no longer so sure, as rising rates and relative valuations are becoming real issues. Ironically, though, our investment conclusion remains essentially the same.

This time last year we argued that although the technology sector had risen some 30% in the prior 12 months, there was in our view no reason to worry about a bubble. Yes, absolute and relative price/earnings (PE) ratios were high, but there was simply no comparison with the degree of lunacy seen back in 2000.

Additionally, the fundamentals of most big tech companies were extremely healthy, as they had highly secure market positions, opportunities to grow further and prodigious cash generation.

So what is different one year later? Simply put, valuation premiums have risen and, more importantly, so have rates, making bond yields more attractive. Neither development should inspire confidence, even among the most upbeat tech investors.

Let's look at the PE valuation premium first. Back in June last year, the technology sector was valued roughly 10% higher than the broader market,

a five- or six-year high. Fast forward to today and that premium has doubled, and we now have to look back almost twice as far back to find a similar premium.

And yet there is no iron law that says a 20% valuation premium is an absolute ceiling and that going forward, multiples will necessarily compress. Quite the contrary, in fact: as we have seen so many times in the past, markets sometimes become irrationally exuberant. However, the more exuberant they become, the less time they have left to remain exuberant. With the valuation premium now at a 10-year high, we feel this is not a bad point to temper our bullishness about tech.

Second, and perhaps more importantly, is what is happening with interest rates. If we look at the decade up to 2012, the PE of the technology sector plunged from close to 50x to 12x, while rates (in this case, the two-year US bond yield) fell from 2% to close to zero (*see chart 1*).

CHART 1: TWO-YEAR US TREASURY BOND YIELD VERSUS EARNINGS YIELD FOR THE S&P 500 TECHNOLOGY INDEX



Source: Pictet WM - AA&MR, Factset, June 2018

By mid-2017, rates were starting to bounce off their bottom and tech multiples had almost doubled, prompting many investors to start mumbling about a second dot-com bubble. But at that time, even though rates and earnings yields were clearly converging, we were still not too concerned about excess exuberance.

Best ideas should continue to perform

But now, with the massive spike in rates we have seen over the past nine months, coupled with even more multiple expansion in tech, we are no longer as bullish as we were a year ago. With the spread between rates and the tech earnings yield still at 2% (down from 8% 10 years ago, see Chart 2), one could argue that there is still some room for manoeuvre (the spread has been negative several times over the past two decades). But if one strips out the really unusual events (the ballooning and bursting of the dot-com bubble in 1999–2001 and the financial crisis of 2007–09), it is clear that the spread is already much closer to extreme levels than we should be comfortable with.

Does this mean that tech multiples cannot go any higher? Of course

CHART 2: SPREAD BETWEEN TWO-YEAR US TREASURY BOND AND TECH EARNINGS YIELD



Source: Pictet WM - AA&MR, Factset, June 2018

not! Or does it mean that tech won't continue to outperform the broader market? That is not a certainty either. It just means that multiple expansion is highly unlikely to remain a significant component of tech's total returns and that, if anything, we should probably expect multiple compression to be a potential headwind to performance from here.

And yet our investment conclusion today is very similar to the one we had last year—namely that technology remains an area whose absolute growth will more than likely outstrip that of the broader market, and that the only real concern is the price

premium we are expected to pay for that growth. So, once again, a selective approach to stock picking, especially when it comes to slow-growth and expensive stocks, strikes us as the best way forward. However, unlike the dotcom episode, we believe the best ideas in the sector will continue to outperform, even if we expect tech to suffer in aggregate relative to the broader market. ■

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