The year of the zodiac

In 2020, like the calendar, the sequence of events will be key. We believe a recession will be avoided – although potential accidents will make this tentative, as the global economy slows and political risks remain elevated. Returns will certainly be lower than in 2019, which was an exceptional year, but we still expect mid-single digit earnings growth in 2020.
The zodiac is an area of the sky that, from the vantage point of Earth, is the apparent path of the sun across the celestial sphere over the course of the year. In Western astrology, that path is divided into twelve signs, which correspond with the calendar, following the same sequence, year after year. 2020 is the year of the zodiac because the sequence of events – rather than the individual news headlines and developments themselves – will be crucial.

We believe a global recession will be avoided in 2020, despite US growth deceleration. However, this will depend on the avoidance of a number of potential accidents – from a trade-war escalation, to an Elizabeth Warren candidacy, to an unintended cliff-edge Brexit at the end of the transition period. The potential for such accidental outcomes is where the sequence of events matters.

Central banks are reaching their monetary policy limits so fiscal stimulus will be necessary to support business and consumer confidence and economic growth, as advocated by many central bankers. To that end, political elections will be crucial this year, especially in the US. From an investment standpoint, we favour those countries with expansionary fiscal policies already in place, such as France, India, the UK, China and Japan.

2019 was an exceptional year for markets – a high bar for 2020. We believe earnings growth will pick up slightly in developed markets and are staying neutrally positioned on equities. This environment is a stock picker’s one where, rather than sectors and styles, individual company profiles will determine the winners from the losers. We continue to like companies with pricing power, particularly via a barbell approach between growth and quality cyclicals. These should be the best positioned to withstand a downturn. At the same time, we avoid low-volatility and bond-proxy stocks like utilities, telecoms and consumer staples.

In the credit space, we prefer Europe over the US, although coupons will drive returns rather than spread compression. For yield, we prefer to go down the capital structure than the credit quality spectrum. Protection will also be key – safeguarding portfolios against potential accidents. For this we favour defensive currencies and gold, and asset-backed debt over cash-flow-backed debt.

Finally, I would be remiss not to mention the overarching role the fight against climate change alongside environmental, social and governance issues will play this year. We are proud to be at the forefront of this, having signed the Principles for Responsible Banking last year. As policymakers step up their commitment and shape funding, investment and legislation, the impact will be increasingly widespread. There is a lot of work for all of us to do, and we stand in partnership with you, our communities and our peers to make tangible progress that will benefit our planet, society and our future generations.
In a nutshell

2019 was an exceptional year in markets.

World trade has declined in only two years since the turn of the century – both times corresponding with economic recession – until now. The recent contraction in trade, a result of both the US-China trade war and global growth fears, has been in the absence of recession. We do not expect a recession to arrive in 2020 either, assuming trade tensions recede rather than escalate of course.

Propelled by central bank easing, developed market equities enjoyed an excellent year, with the S&P 500 index reaching new record highs. This was all the more remarkable given in the same year there was an earnings recession, the US-China trade conflict and various geopolitical uncertainties keeping markets on their toes. We expect lower returns in 2020.
The tariff disputes that stretch back almost two years could, we believe, have a domino effect on various strands of economic growth and ultimately lead to the threat of recession. The initial damage of trade wars is to corporate confidence, which then feeds into lower corporate investment and hiring plans. This could then lead to higher unemployment, lowering consumer confidence and spending.

Tariff disputes are undermining one of the pillars of modern capitalism—open markets and free trade. For example, the Chinese responded to a ban on US component and services companies from doing business with Chinese telecoms equipment maker Huawei by ordering the removal of all foreign computer equipment and software from public institutions. Thus, the world’s two largest powers are racing to ensure a certain autarky in high tech. Alas, as global supply chains decouple, the end result could be that everybody loses. Already, Chinese exports to the US have fallen more than 20% over the past year, while the move to ban business with Huawei may cost up to USD 11 billion in lost sales to US companies. Data show a year-on-year reduction if world trade of the order of 2.7%. If this trend continues it would represent a significant paradigm shift for the world economy and financial markets.

In the event, our central scenario for 2020 is that the partial ‘Phase 1’ trade deal cobbled together by the US and China in December will hold, more or less, while monetary policy and a dose of fiscal stimulus should help stave off recession in the world’s largest economies. Yet the damage caused by trade tensions—one of the reasons why we expect just 1.3% GDP growth in the US in 2020 (and 2.9% globally)—is why we have relatively subdued expectations for financial market performance in 2020.

With returns of about 25%, developed-market equities had an exceptionally strong 2019, in large part due to multiple expansion and low bond yields. In 2020, however, we believe that returns for asset classes will be more in line with our long-term average annual expectations. We see developed-market equities delivering a total return of around 5%, mostly in the form of dividends and buybacks for US equities and dividend yield for European equities. However, with margins no longer expanding and profit growth expected to slow, high valuations could well be increasingly questioned. With this in mind, government bonds, however low our return expectations, should continue to play their protective role.

Continued trade issues and a subdued outlook for commodities mean that emerging-market equities could remain under pressure. In credit, we are increasingly sceptical about the lower reaches of US high yield, whereas European credit should benefit from renewed European Central Bank asset purchases.

Threats to free trade and a wobbly global economy

After strong returns in 2019, we are prudent on prospects for returns across assets next year.
Why we prefer Asia within the emerging-market equity space

Going into 2020, while we are underweight emerging-market equities, within that asset class we prefer Asia – China and India in particular. Our Asia Chief Investment Officer elaborates on what we like about these markets in the current environment.

Many readers may be surprised about your bullish stance on China, given everything it is contending with right now – from the trade war with the US to the political unrest in Hong Kong, not to mention its slowing economic growth. Could you share some insight on this view?

There is no doubt that the Chinese leadership has its hands full at the moment but the key thing is that they have the means to address the issues of political unrest in Hong Kong, trade tensions, deceleration in the economy and rising debt defaults in some segments of the economy.

Chinese growth is undoubtedly moderating but it remains at a solid pace with net jobs creation (see chart). Inflation is rising momentarily and preventing further supportive monetary measures being taken. The Chinese central bank is the only one among the four largest to have not yet resumed significant quantitative easing through balance-sheet expansion. This could change in H1 2020.

Hong Kong is clearly a thorny issue but China has the means to support its economy while maintaining the access path for foreign investors eager to buy Chinese assets. The recent second initial public offering (IPO) of Alibaba in Hong Kong is evidence of the territory’s unchanged and unchallenged status for now. While the size of Hong Kong’s economy is significant – particularly in regard to its services sector – its share of mainland China’s GDP has come down considerably since the 1997 handover – from nearly a fifth to less than 3%. Rather, the deceleration of the Chinese economy is a function of 1) its debt reduction efforts 2) the ongoing trade tensions.

While slowing, Chinese consumer income growth remains strong in cities, with new types of spending on the rise in education, healthcare and leisure. The wealth effect is also supportive, with the rise of real estate prices and the fast pace of growth over the past ten years.

And then there is the fiscal stimulus angle, another one of our investment themes for 2020. As the global economy slows and central banks run out of stimulus options, fiscal easing will be key to sustaining the current cycle. China, along with India, is one of the countries on the front foot when it comes to stepped-up fiscal policy. Given the lagged effects of fiscal stimulus, we should start to see the results come through in the Chinese economy even more this year, especially on the health of China’s domestic sector.

India’s economic growth has stalled considerably since 2016. Will fiscal stimulus not come as too little too late?

Fiscal stimulus in India should not be considered as a standalone, but rather understood within the particular context of the Indian economy. One of India’s rare qualities is that its economic growth is driven by domestic demand, rather than international trade. This buffers it not only from the ongoing trade disputes but also from the global slowdown. At the same time, it has demographics on its
side. India’s youth makes up over 40% of its working-age population, compared to around a quarter in ageing China. With a domestic-driven economy, getting these youth employed – with 12 million people entering the workforce each year – will be pivotal to Indian growth and stability. However, if achieved, it will unlock huge potential for the Indian economy.

We think Indian growth will reaccelerate from Q2 2020. Personal income tax changes are likely to be introduced over the first quarter and this will be money directly into consumer pockets. While household debt has gone up, it remains low relative to other emerging markets. And from an investment standpoint, Indian corporations are projected to realise over 18% profit growth in 2020. These factors should prove supportive to Indian companies this year.

The economies of south-east Asia are still growing at rates above the global average. Are there any compelling opportunities you see within that sub-region?

Indeed, while many south-east Asian economies have been impacted by the US-China fall-out, they are still growing at a relatively healthy clip. At the same time some countries in the region have governments in place that are poised to implement growth-supportive policies.

Indonesia’s GDP growth is still high at around 5%, although it lacks an accelerator for now. Its economy could also benefit from a series of potential reforms, which should be a mid-to-long-term positive. Jokowi aims to simplify regulations, and his finance minister, Sri Mulyani, has affirmed policy plans targeted at boosting foreign investment into Indonesia, which is also supportive of its currency.

Indonesia remains particularly interesting for bond investments. Its real rates remain high, the quality of its issuers and liquidity is improving and its currency, the rupiah, has been one of the strongest in the region against the USD over the past year. This is a sign of supportive foreign inflows to the local-currency debt market.

Indonesian companies contend with overlapping regulations, at both the central and regional government levels, one of the biggest bottlenecks preventing foreign investment into Indonesia. A proposed corporate tax rate reduction from the current 25% to 20% would boost earnings per share growth by 7%. For listed companies who meet certain criteria, the tax rate could fall further, to 17%, translating to additional earnings per share growth of 11%.

Singapore is Indonesia’s largest foreign investor and the top recipient of Indonesia’s non-oil and gas exports in the region. How does the outlook for Singapore look?

Singapore’s macro momentum is turning positive again, with exports and industrial production gaining strength in H2 2019. Like many of its peers, the Monetary Authority of Singapore has eased monetary policy while the government has taken a mildly expansionary fiscal stance to support growth. Our house view has a year-end USD/SGD target of 1.30. Any US-China détente could improve sentiment and bolster capex, removing a headwind to external demand. Singapore is home to an active and rich selection of Real Estate Investment Trusts (REITs), which are particularly interesting in the current global context of low inflation and interest rates. Real estate is actually one of the few sectors where there is good inflation and the risks are well compensated by the yields.

1 Source: World Bank 2018
Equities we like in 2020

With increasingly demanding equity valuations in an environment of slowing growth, selectivity will be critical in 2020.

Investment Platform
Pictet Wealth Management

Naturally, equity returns are driven by earnings growth – or how profitable companies are – over certain time periods. In 2020, we believe earnings growth will be driven by top-line sales growth and net profit margins. Given that the former figure, sales growth, tends to track nominal GDP growth, we can project equity earnings growth based on our expectations for GDP growth in 2020 (see chart 1). Based on current elasticity (which measures the sensitivity of earnings growth to a change in GDP growth), we expect 4% earnings growth for US large caps and 2.6% for European equities in 2020.

Operating margins have been on an upward trend among US large caps over the past four decades, and we expect them to remain high in 2020. While wage increases may hurt company margins, these should be offset by falling raw materials prices. Based on this, we forecast around 4% earnings growth for developed-market equities this year.

While we expect low-to-mid-single digit earnings growth in developed markets, cash returns to shareholders should remain in line with historical standards. Given solid profitability, free cash-flow generation is strong in the corporate world, enabling free cash yields to remain well above risk-free rates and high enough to deliver cash returns to shareholders (via dividends and buybacks). However, economic slowdown will put pressure on the top line, so we also stress adding protection to portfolios.

Real assets provide a sound investment opportunity in a low-growth, low-yield environment. These can be accessed through equity markets by identifying those companies that continue to grow and sustain their margins, innovate and reward shareholders. Indeed, we believe equity returns will be driven by dividends and share buybacks this year, so the latter point is of particular relevance when selecting companies in 2020.

**Structural growers**

These companies show growth irrespective of the current economic cycle and can be found in three key sectors: industrials, healthcare and tech.

- **Industrials** Should we avoid a global recession in 2020 – as in our core scenario – companies in the industrials sector should continue to grow and improve margins this year. The industry’s organic sales growth has been resilient overall, but within the sector there is wide dispersion among companies. The winners have positively surprised on margins through supply-chain improvement, increased outsourcing, more flexible cost structures and pricing power vis-à-vis lower cost of raw materials. Within these, we favour those whose businesses are decorrelated from the economic cycle.

- **Healthcare** The sector has consistently shown sales and earnings per share growth and is composed of four distinct segments: medical technology, services, life sciences and pharma & biotech. We prefer the US over Europe for its edge on the innovation front in addition to low leverage levels and high free cash flow. Within pharma, we are particularly selective. Given the potential impact of any regulatory changes, especially as the US election season gets into full swing this year.

- **Tech** High sales growth should translate into stronger earnings growth next year, particularly among the big tech players, while semiconductors could be reaching a price floor. Whereas 2019 was all about multiple expansion (i.e. share prices going up in the absence of earnings growth), we expect a stronger sector focus on earnings growth in 2020.
Dividend growers
We expect around 70% of total return to come from dividend and buyback yield this year. Given the slow growth environment, this means free cash-flow generation matters even more for companies to sustain and grow their dividends. Furthermore, we are now in a historically rare situation where the highest free cash-flow generators are the biggest companies with the strongest growth profiles (see chart 2).

Value stocks
Traditionally there are three broad investment styles: income (high dividend payers), value and growth. Generally, growth companies are those that may not generate high cash levels currently, but are growing at such a rate that future cash-generation potential is high. Value companies, which tend to be sold at a discount to growth companies, are today found in cyclical sectors like banking and energy. Value companies often generate solid current cash flow, but have lower future growth prospects.

Over the last decade, growth stocks have solidly outperformed value as interest rates have fallen across the board. When interest rates fall, the discount applied to future cash flows also falls. In effect, falling interest rates make future cash worth more than today. Moreover, in a global environment of low global economic growth, companies with stable earnings are especially attractive to investors. Hence the outperformance of stocks with great future growth potential. The stellar growth returns have been driven by the large tech-sector companies like Amazon and Apple and, more generally, consumer-oriented sectors. Indeed, Apple is now worth more than entire US large-cap energy sector. In general, natural resources have been weighed down by slowing global growth.

Given that growth companies have been favoured by the market over the last decade, value-style companies now look extremely cheap by comparison, and we have seen a trend reversal in recent months. Since last August, value stocks have outperformed growth significantly (see chart 3). Signs of stabilisation in the macro data, hope of a US-China trade deal and a rebound in bond yields should add further support to value stocks. We advocate a blended approach to investing in this style, blending value, as determined by company valuation, with quality, as determined by balance-sheet health.

**Chart 2: Over the last four decades, large companies’ free cash flow margin has been trending upwards**

<table>
<thead>
<tr>
<th>%</th>
<th>Free cash flow margin less US nominal growth rate, 1953-2019*</th>
</tr>
</thead>
<tbody>
<tr>
<td>15</td>
<td></td>
</tr>
<tr>
<td>10</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td></td>
</tr>
<tr>
<td>0</td>
<td></td>
</tr>
<tr>
<td>-5</td>
<td></td>
</tr>
<tr>
<td>-10</td>
<td></td>
</tr>
<tr>
<td>-15</td>
<td></td>
</tr>
</tbody>
</table>

* Large-cap stocks, ex-financials, utilities and REITs

Source: Pictet WM - Equity Research, Empirical Research, December 2019

**Chart 3: While growth stocks have outperformed value over the last decade, since mid-August value has made a comeback**

Source: Pictet WM - CIO Office, Bloomberg, December 2019
A bond picker’s year

We expect US corporate earnings growth to remain lacklustre in a context of slowing economic growth. For this reason, we would remain discriminatory within US credit, favouring quality, but the restart of the ECB’s bond buying should help reduce volatility in euro credit in 2020.

Laureline Renaud-Chatelain, Fixed-Income Strategist, Pictet Wealth Management
Teodora Hristova, Credit Analyst, Pictet Wealth Management

Credit, especially high yield (HY), continues to offer attractive yield pick-up over government bonds on both sides of the Atlantic (see charts 1, 2). But after strong total returns in credit in 2019, underpinned by a fall in sovereign yields and sharp credit spread tightening, we view 2020 as essentially a bond picker’s year. This means that we will be looking for pockets of opportunity to boost total returns, which we expect to be low single-digit-to-flat for developed-market credits, except in US HY, where returns may be negative.

An important theme in 2019 was the underperformance of the riskiest segment of the US credit market (companies rated CCC and lower). This performance gap was due to factors such as an elevated nonfinancial corporate debt-to-GDP ratio, falling profits and a rise in the HY default rate. This in turn led to a rising leverage ratio (net debt over profit) in US HY, whereas US investment grade (IG) companies on average have managed to stabilise it. Should US growth falter in 2020 as we expect, corporate earnings growth will likely remain lacklustre.

In this environment, we express our preference for quality in US credit by being neutral US IG and underweight US HY. We favour robust companies able to deleverage at a time of stagnating or falling profits (particularly in the BBB rating segment), and look to extend duration in the high-quality segment (A-rated) to benefit from relatively steep credit curves. In US HY, we continue to favour the BB-rated segment over its riskier counterparts, as several leading indicators are signalling a further rise in the HY default rate. In general, we would take advantage of the primary market for spread compression as the current low-yield environment diminishes carry, especially in euro.

The relaunch of the European Central Bank’s (ECB) corporate sector purchase programme (CSPP) last November means euro IG has a strong technical advantage over US IG. According to our projections, the ECB could own about 11% of the euro IG universe excluding banks by the end of 2020 (up from 8.6% at end-October). Euro IG spreads tightened in anticipation of the start of the previous CSPP in June 2016, and again at the height of the ECB’s asset purchases in 2017, as the stock of euro IG bonds held by the ECB grew. The large share of negative-yielding government bonds in euro is also a source of increased demand from euro investors seeking yield.

Back in 2016, the ECB’s presence in the IG market encouraged companies to raise their corporate bond issuances, resulting in a balance between increased demand and supply. This time around, we are already seeing some signs of a surge in supply, with gross issuance up 30% in the year to end-October. Increasing volumes of reverse Yankee issuance (euro-denominated bonds issued by US companies) are also adding to supply, with the share of US companies on the ICE BofAML euro IG index rising from 13.4% in December 2015 to 18% four years later. Hence, demand and supply dynamics should be broadly balanced in 2020, resulting in a neutral impact on euro IG spreads, and supporting our neutral stance on this segment.

The programme will likely also support the performance even of instruments not eligible for purchase under the CSPP, such as reverse Yankees, corporate hybrids, bank and insurance subordinated debt, and even euro HY, as investors move away from the sovereign and IG bond market in their hunt for yield. Because of this technical support, lower default rates (thanks to low exposure to shale oil-related energy companies) and higher average quality (the euro HY universe contains a larger share of BB-rated issuers as well as the HY-rated subordinated debt of investment-grade issuers), we are neutral on euro HY, whereas we are overweight its US equivalent.

In developed-market credit in general, we like industries that offer higher-than-index excess returns over government debt and those that are insulated from trade war pressure like telecoms, real estate, utilities and insurance.

In senior debt, we prefer reverse Yankees, which tend to offer a wider spread than their European peers, in the telecommunications, media, and medical device sectors. Medical devices are relatively immune to regulatory risks in healthcare, but could undergo a wave of consolidation, like healthcare at large. Real estate in Europe still offers relatively high carry, with lower-for-longer interest rates continuing to support valuations. While senior debt in the banking sector does not offer an attractive yield, we are overweight senior bail-inable bonds, which are rising in popularity and are set to overtake senior preferred debt.

In US IG, we like the major telecommunication and media incumbents, which have strong balance...
sheets and thus can withstand heavy investment and the so-called ‘streaming wars’. Extra spread pick-up can be found in selected stories in specialty chemicals (price-makers with large market shares and exposure to important trends like electric car batteries, composite materials and electronics look especially attractive). Select stories within tobacco also offer good value relative to the index. Technology is relatively expensive, but we like disrupters that focus on 5G technology, the internet of things and cloud data storage. We are cautious about companies whose business models are being challenged and those that continue to prioritise share buybacks over paying down debt.

Looking at the euro credit universe, we like the overall pick up in yield that subordinated debt offers over senior debt. In corporate hybrids, there is a decent first call date calendar in Europe in 2020, while the high probability of refinancing offers buying opportunities. Since the secondary market looks relatively expensive with tight spreads and high cash prices, the primary market offers the best way to benefit from spread compression, albeit low yields mean low coupons by historical standards. We like corporate hybrids in the defensive telecommunications and utilities sectors as well as in real estate, believing that volatility will be suppressed by the ECB’s renewed CSPP. Looking at subordinated bonds in the banking sector, we expect additional tier-1 (AT1s) and selective tier-2 (T2s) bonds in Europe to continue to outperform senior debt, supported by investors’ search for yield as well as by low supply and ratings upgrades. Extension risk has abated, but we are mindful of low resets and prioritise high coupon instruments as the kind of capital appreciation seen in 2019 may not be repeated. ■

**CHART 1: US SOVEREIGN AND CREDIT YIELDS**

<table>
<thead>
<tr>
<th>Year</th>
<th>US 10-year Treasury yield</th>
<th>ICE BofAML US IG yield</th>
<th>ICE BofAML US HY yield</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013</td>
<td>2.94</td>
<td>6.30</td>
<td>1.78</td>
</tr>
<tr>
<td>2014</td>
<td>3.45</td>
<td>6.90</td>
<td>1.94</td>
</tr>
<tr>
<td>2015</td>
<td>3.50</td>
<td>6.80</td>
<td>1.85</td>
</tr>
<tr>
<td>2016</td>
<td>3.50</td>
<td>6.50</td>
<td>1.75</td>
</tr>
<tr>
<td>2017</td>
<td>3.50</td>
<td>6.20</td>
<td>1.65</td>
</tr>
<tr>
<td>2018</td>
<td>3.50</td>
<td>6.00</td>
<td>1.55</td>
</tr>
<tr>
<td>2019</td>
<td>3.50</td>
<td>5.80</td>
<td>1.45</td>
</tr>
</tbody>
</table>

Source: Pictet WM-AA&MR, Factset, December 2019

**CHART 2: EUROPE SOVEREIGN AND CREDIT YIELDS**

<table>
<thead>
<tr>
<th>Year</th>
<th>German 10-year Bund yield</th>
<th>ICE BofAML Euro IG yield</th>
<th>ICE BofAML Euro HY yield</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013</td>
<td>0.59</td>
<td>-1.02</td>
<td>-0.32</td>
</tr>
<tr>
<td>2014</td>
<td>1.05</td>
<td>-0.98</td>
<td>-0.35</td>
</tr>
<tr>
<td>2015</td>
<td>1.55</td>
<td>-0.93</td>
<td>-0.32</td>
</tr>
<tr>
<td>2016</td>
<td>2.05</td>
<td>-0.88</td>
<td>-0.29</td>
</tr>
<tr>
<td>2017</td>
<td>2.55</td>
<td>-0.84</td>
<td>-0.26</td>
</tr>
<tr>
<td>2018</td>
<td>3.05</td>
<td>-0.80</td>
<td>-0.23</td>
</tr>
<tr>
<td>2019</td>
<td>3.55</td>
<td>-0.76</td>
<td>-0.20</td>
</tr>
</tbody>
</table>

Source: Pictet WM-AA&MR, Factset, December 2019
The correction in prices since the September peak may mean this is a good time to consider the investment case for gold.

LUC LUYET
Currencies Strategist
Pictet Wealth Management

As recessionary fears receded somewhat in the final months of 2019, gold prices gave back some (but by no means all) of their gains. However, the precious metal’s role in diversifying and protecting portfolios is set to be better appreciated again if, as we expect, global growth moderates in 2020 and trade disputes remain an issue. Indeed, gold as an insurance policy is particularly attractive when there are risks of US dollar depreciation, of high inflation or of elevated financial market uncertainties. The cost of such insurance is the absence of yield, which means the cost of holding gold is particularly high in periods of elevated interest rates. But the fresh Federal Reserve rate cuts we expect in 2020 as US growth slows will put downward pressure on the US dollar and mean bond yields remain low. Our belief that equity volatility will increase should also contribute to gold’s attractiveness. The structural growth in gold purchases by the official sector (i.e. central banks) should continue to further support the yellow metal.

Further out, the rise in the US of radical economic policy ideas like modern monetary theory (MMT), which essentially proposes a substantial, coordinated loosening of monetary and fiscal policies, could spur demand for gold. Indeed, a direct consequence of MMT would be downward pressure on real rates, which would have a strong bearing on the gold price (see chart). Some might argue that America’s fiscal indiscipline and current-account deficits mean that the US dollar is already not as fit to be considered a safe haven as gold. Moreover, the dollar has become a crowded trade in recent years (as its current significant fundamental overvaluation confirms), while growing uneasiness about Washington’s willingness to use the currency to its own geopolitical ends (by imposing sanctions, for example) means that some central banks have been diversifying their reserves into other stores of value, including gold.

Other ‘defensive’ currencies like the yen and the Swiss franc may also prove resilient in uncertain economic times. The yen’s value tends to go up in times of global stress as Japanese investors rush to bring home their large stockpile of net foreign assets. But both the yen and franc offer negative yields, which mean they come with ‘hoarding costs’, just like gold. And whereas there is a structural trend for central banks to buy gold, the Bank of Japan and Swiss National Bank both have the liberty to print more yen or Swiss francs to curb their appreciation.

That leaves gold—although apart from the absence of yield income and the cost of storage, gold prices are volatile. Yet continued trade tensions combined with the factors discussed above all point to gold as a viable diversifier of portfolios and an insurance against risks in financial markets. A small allocation might be appropriate to cushion portfolio returns without impacting long-term performance.

Investors interested in gold but unwilling to forego the annual dividend income that equities typically provide could consider gold miners, whose share performance is often decorrelated from the broader market. After some grim years, the recent rise in prices is focusing attention on the opportunities for consolidation, especially as the gold-mining industry is more fragmented than other extractive industries (for example, three large miners dominate the iron ore industry). The past year has seen a wave of M&A, with particular pressure on single-asset gold companies to merge into larger, multi-mine businesses. As elsewhere, consolidation is to be welcomed by investors as long as assets can be merged seamlessly and value is enhanced.

AS REAL RATES GO DOWN, THE GOLD PRICE GOES UP

Source: Pictet WM-AA&MR, Bloomberg, December 2019
Loosening the purse strings

Since the financial crisis, central banks have been at the centre of efforts to repair economies. But a decade of loose monetary policy is providing proof of the law of diminishing returns as global growth continues to slow in most of the major economies we follow. As Mario Draghi, the former European Central Bank (ECB) president, put it “It’s high time, I think, for fiscal policy to take charge”—a view adopted wholeheartedly by his successor, Christine Lagarde.

In general, we believe that economic policies need fresh impetus to stimulate flagging growth. This could involve closer coordination between governments’ fiscal and budgetary efforts and central banks’ monetary stimulus. But this will be an ongoing process. For 2020 alone, one of our top investment themes is the outlook for fiscal spending. In essence, we believe that countries that have fiscal space (see chart) and/or use persistently low interest rates for fiscal and budgetary stimulus should be able to weather the global slowdown better than others. Their numbers include China, India and the UK, as well as France. All of these countries are rolling out spending programmes and tax cuts. China has even managed to coordinate monetary, spending and tax measures to support its slowing economy. Because of political deadlines, we see less scope for budgetary and fiscal measures in the US in 2020, feeding into our underweight stance on US equities. At the same time, a growing backlash against austerity could see Latin American governments loosen the purse strings.

A big question mark hangs over Germany, although it is one of a number of developed countries with fiscal space to manoeuvre. The country’s draft budget plan for 2020 is actually expansionary, with a decline in the structural balance planned. While we believe that only a quite substantial economic downturn will slacken the political establishment’s adherence to ‘black zero’ (an unofficial, self-imposed commitment to balanced budgets), the current coalition under Chancellor Angel Merkel is looking increasingly fragile, Germany’s infrastructure is creaking and industries like car-making are under severe strain. The battle against climate change is playing an increasing role in German (and European) fiscal policy and it is possible that a new raft of green initiatives overcomes objections within Germany to increased government spending.

A relilation of the German economy might or might not lead to a jump in German Bund yields (the Bunds’ safe haven status could put a cap on yields if a major fiscal initiative results from a severe economic downturn) and presupposes a drastic change in German mindsets. But it would signal a major change in the direction of European policy making. So could a decision by the ECB to buy green bonds as part of its asset-purchasing programme after its upcoming strategic review.

In Asia, India announced significant corporate tax cuts in 2019. These are likely to have a positive impact over the medium term, helping offset the challenges being faced by the country’s shadow banking sector and relieving a central bank whose rate-cutting campaign has been compromised by rising onion prices. And just as the Chinese authorities stand ready to step up fiscal support to cushion a decline in structural growth, December brought news of a bigger-than-expected USD 121 billion stimulus package in Japan. This is one of Japan’s largest spending packages since the 2008-2009 financial crisis and should help offset the recent consumption tax hike. In short, in Asia as in Europe, fiscal expansion is shaping up to be a major theme in 2020 as major economies prove increasingly ready to use interest rates that will remain low to grapple with anaemic growth and inflation.
As we go into the new year, emerging markets (EM) face a number of headwinds. However, we see opportunities at a granular level, preferring EM debt over equities and select Asian equities within EM equities.

**Emerging-market opportunities in 2020**

As we go into the new year, emerging markets (EM) face a number of headwinds. However, we see opportunities at a granular level, preferring EM debt over equities and select Asian equities within EM equities.

**Investment platform**

Pictet Wealth Management

**Macro drivers in emerging markets for 2020**

Macro drivers in emerging markets for 2020 currently appear rather mixed. Indeed, our expectations for six broad macro indicators (monetary policy, EM-DM growth differential, US dollar, Chinese cycle, commodity prices and global trade) together paint a picture of greater headwinds than tailwinds in EM.

**EM monetary policy**

On the positive side, EM central banks implemented significant monetary easing efforts in 2019 and should remain accommodative in the coming year. This will allow the positive impact of rate cuts to feed through to the underlying EM economies. Furthermore, we do not see any significant risk of policy reversal at this stage, at least in the first half of 2020.

**EM-DM growth differential**

The growth differential between emerging and developed economies is expected to widen in 2020, as the former rebound from a challenging 2019, while the latter slow, particularly driven by the US.

**The US dollar**

At the same time, the US dollar – which tends to have a more direct impact on asset prices – is expected to depreciate, which should be a positive factor for EM markets. While we expect the greenback to depreciate against defensive currencies like the Swiss franc and Japanese yen this year, it is unclear which EM currencies will gain relative to the dollar and to what extent. We are therefore less confident in a significant boost to EM assets stemming from an overall weakness in the US dollar.

**China**

Chinese growth should continue to slow this year, as Beijing carefully engineers a soft landing for the economy while controlling credit re-leveraging at the same time. Many EM economies are closely linked to China, which makes up considerable demand for many of their exports.

**Commodity prices**

A slowing global economy softens demand for oil, which is already at risk of oversupply. At the same time, given China is the largest consumer of most commodities, a softening Chinese economy is likely to add further downward pressure to global commodity prices.
Global trade

There is no ignoring the headwinds to global trade – from a slowing global economy to direct trade disputes, old and new. Even after the US and China agreed a Phase 1 deal, all signs point to lingering tensions between the two superpowers in the years to come, which may well continue to disrupt global trade.

As informed by the complexity of these considerations, our EM macro outlook is more cautious than might be expected on growth projections alone. Navigating the current environment will therefore require careful selectivity both across and within EM asset classes to identify pockets of opportunity.

The remaining EM opportunity – in local currency bonds

Despite the uncertain macroeconomic picture, we believe there is value to be found in EM, particularly in the debt space. We are overweight EM debt, favouring EM sovereign bonds in local currency in particular, thanks to their important carry (yields are around 5.2%). EM corporate bonds offer around a 300 basis-point (bp) spread in USD, and present an attractive opportunity when remaining focused on quality companies. Toward the end of 2020, we expect this spread to widen slightly toward 350 bps (see chart 1), in sympathy with DM credit spreads in this low growth environment.

Drilling down to the regional level is key. EM Europe offers more carry and a higher spread, due to Turkey. In Latin America, substantial stress due to social unrest presents a key risk that we will be monitoring closely. Meanwhile, Asia offers a lower-risk opportunity, for example via Chinese corporates, which have tighter spreads at 270 bps.

When it comes to bottom-up selection, we look at the overall leverage ratio, selecting companies that are deleveraging. EM investment grade companies have really delivered here in recent years, with current leverage ratios even lower than their US peers. Indeed, the asset class has been referred to as “the only other option” for yield seekers disappointed by the sizeable DM investment-grade universe.

2019 performance of EM sovereigns was driven by EM central bank rate cuts, which proved supportive, as inflation remained subdued. The EM local currency index currently shows record low yields at 5.2% (see chart 2). We expect these to rise a bit given EM central banks will have less room to cut rates in 2020. At the same time, it is worth bearing in mind that EM currencies depreciated against the USD in 2019 and any reversal would enhance the performance once converted back to USD, along with the carry which remains comfortably high compared to DM sovereign bonds.

In 2020, China will open its capital account to foreign investors, which should pave the way for the inclusion of Chinese sovereign bonds in renminbi in the main EM indices. This is likely to trigger new inflows and given its A+ rating on average, we will be monitoring investor appetite for these bonds, as a sign for their safe-haven characteristics. We have also identified Argentina, Mexico and Russia as key players in this space to watch in 2020.

Selective opportunities in EM equities

While we remain overweight EM equities overall, within the asset class we prefer Asian equities on a bottom-up basis, such that our exposure to the region is neutral. From a top-down perspective, Asia is the driving engine of the EM equity space, in terms of both earnings and valuations. The region also dominates in size, accounting for more than 70% of EM earnings and market cap (see chart 3). This is mostly due to China, which has by far the biggest economy and equity market across all developing countries.

Because of China’s dominant position, any meaningful improvement in EM earnings would require a rebound in the Chinese economic cycle. In order for EM valuations to improve, the global cycle must reaccelerate and/or the trade war end. In either case, Asia would be a primary beneficiary.

Furthermore, Asia – driven by China and India in particular – is the only EM region that is able to generate endogenous growth. At an aggregate level, its economies provide a good mix of cyclality (Korea, Taiwan) and defensiveness (China, India). We can modify exposure as needed within Asian equities.

At the same time, the most compelling EM equity markets outside of Asia currently – Russia and Brazil – already have strong support from institutional EM investors, who have over-weight exposure to both markets. Beyond these markets the picture is bleaker. Latin America continues to be impacted by social unrest that is often coupled with sluggish growth. Meanwhile, within the EEMEA region, South Africa has strong macro issues and imbalances and Saudi Arabia faces risk of austerity and limited external investor interest.

All in all, Asia’s risk-return characteristics appear relatively attractive to us within the EM equity space. In the context of our 2020 macro scenario, we prefer to stay exposed to EM Asia than to other EM regions, which could suffer more from a global downturn or a risk-off stance from international investors.

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1. Based on the JP Morgan GBI-EM Global Diversified Index on 9 December
2. Based on the JP Morgan CEMB Diversified Index on 9 December
Pictet commits to the Principles for Responsible Banking

Last year Pictet signed the Principles for Responsible Banking, six principles that are designed to provide banking-industry signatories “with a single framework that embeds sustainability at the strategic, portfolio and transactional levels and across all business areas”.

Following on from the Principles for Responsible Investment, which were launched in 2006, 30 banks from around the world with a combined USD 18 trillion in assets came together to establish the Principles for Responsible Banking (PRB) under the United Nations Environment Programme Finance Initiative last year.

The global banking industry is still re-establishing the trust that was severely damaged in the fall-out of the global financial crisis a decade ago. There is a real need for the industry to define and affirm its role and responsibilities in creating a sustainable future through its business practices, how it directs financing and wields influence.

The PRB framework focuses on the types of products and solutions provided to clients and how they ultimately create value – not only for clients but for all other stakeholders as well. In other words, it looks after clients’ best interests while also taking into account negative externalities that could have spill-over effects beyond client portfolios. A pertinent example of this is the sub-prime mortgage crisis. Sub-prime mortgages overlooked the best interests of the borrowers – many of whom lost everything when their property values fell below the amount owed on the mortgage. And the crisis that ensued when the sub-prime bubble burst had negative effects far beyond those directly involved – public funds bailed out banks, jobs were lost and global economic growth is still below its pre-crisis level over ten years later.

The plan in action

At Pictet, we have reinforced and empowered our pre-existing Sustainability Board into a Group Stewardship Board that will provide our Partners and relevant departments and committees with an appropriate

IN PRACTICE, OUR COMMITMENT TO THE PRB’S SIX PRINCIPLES MEANS:

**PRINCIPLE 1**
**ALIGNMENT**

We will align our business strategy to be consistent with and contribute to individuals’ needs and society’s goals, as expressed in the Sustainable Development Goals, the Paris Climate Agreement and relevant national and regional frameworks.

**PRINCIPLE 2**
**IMPACT & TARGET SETTING**

We will continuously increase our positive impacts while reducing the negative impacts on, and managing the risks to, people and environment resulting from our activities, products and services. To this end, we will set and publish targets where we can have the most significant impact.

**PRINCIPLE 3**
**CLIENTS & CUSTOMERS**

We will work responsibly with our clients and our partners to encourage sustainable practices and enable economic activities that create shared prosperity for current and future generations.
overview and tracking of our impacts as related to the PRB and the PRI. Areas monitored by the Board include our direct environmental and social impacts, responsible investment and active ownership, and developments around the Sustainable Development Goals (SDGs), Paris Agreement and other relevant regulation and emerging standards.

One of our priorities for 2020, and key to defining our targets, will be to roll out the appropriate methodology to analyse the exposure to climate risk of all of our investments, including our own assets. We also plan to work on identifying key areas outside of climate that need attention and that are more along the lines of the planetary boundaries framework.

Through a four-pronged strategy, we will aim to align best practices across the firm, putting in place strong Environmental Social and Governance (ESG) data governance and tools, strengthening our responsible product range and ramping up advocacy and collaboration with international organisations and other financial industry players. One notable engagement we spearheaded together with Swiss Sustainable Finance was to exclude controversial weapons from mainstream indices. To date this initiative has now collected 173 signatories from 20 different countries representing USD 9.1 trillion.

Our beliefs and the urgency of the environmental and social problems that confront us today have also been broadly discussed throughout our client events over the past couple years. We have been working as well on developing and extending the range of extra-financial reporting across our investment offering – a key focus for us over the next 18 months. Making the invisible visible is a key to driving change.

**PLANETARY BOUNDARIES FRAMEWORK**
Nine global environmental challenges, their respective boundaries and a “safe operating space” for economic activities

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