Silver lining?

Percival Stanion explains how a well-diversified portfolio can achieve a positive return on investment, despite the current pessimism around the global economy

For the vast majority of equity investors, 2016 got off to a turbulent start. Concerns about the health of China's economy and fears about a US recession hit investor sentiment, leaving major stock markets nursing double-digit losses by end-February. Markets have since started to recover, but investors may need to brace themselves for a rocky ride as we start a new quarter.

Indeed, there's no shortage of pessimism for the global economy. Growth in developed economies remains sluggish, while the emerging world has slowed markedly, especially in China. Central banks in key developed economies have cut interest rates to near or below zero, depressing an expected return on investment.

However, we have reasons to be optimistic about investing in a wide range of growth-related assets, such as equity, high-yield bonds or certain alternative investments. Many investors have been able to rely on unusually high returns from bonds to underpin their performance, but this pattern is unlikely to be repeated. This is why we believe a well-diversified portfolio that strikes a right balance between risk and safety is a way to achieve a positive return on investment over inflation or cash in the next few years.

Our medium- to long-term outlook for the global economy is positive. Take the US economy for example. Manufacturing and oil sectors are under pressure because of a strong US dollar and a sharp fall in energy prices, which weighed on business investment. However, services and housing activity is healthy, while domestic demand remains resilient. Indeed, consumer spending is holding up well thanks to lower oil prices, which are boosting disposable income. Moreover, in the light of recent market turmoil, the Federal Reserve is unlikely to raise interest rates aggressively – another factor that would support economic growth in the world's biggest economy.

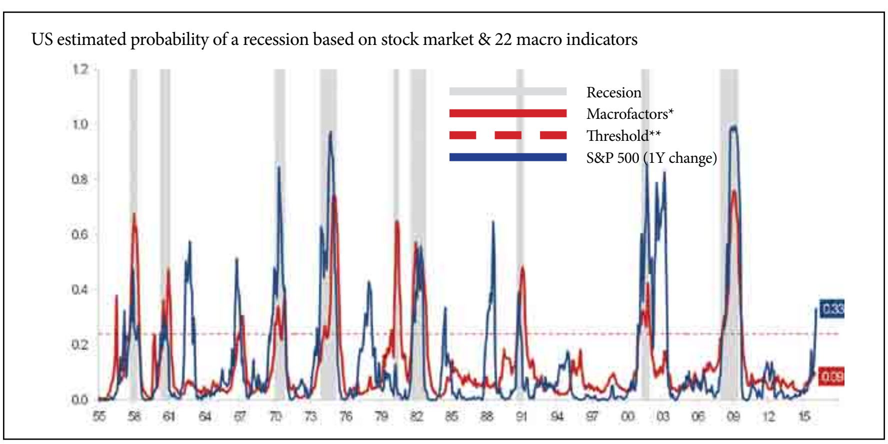
Given this benign backdrop, we find attractive opportunities in US high-yield bonds, while we believe valuations for US stocks are less compelling. US high-yield bonds are trading at levels that suggest a US recession is on the cards, which is starkly at odds with the picture presented by our proprietary economic model. Our model puts the probability of US recession at less than 10 per cent, compared with a reading of over 30 per cent in the market *[see chart]*.

We see a small positive improvement in demand for credit in Europe. Germany in particular is benefiting from the low cost of capital, which raises the prospect for higher corporate profits, especially among telecoms and small-cap companies. Japan's economy has faced some macroeconomic uncertainty, but domestic companies are steadily improving their return on equity – which we see is a long-term structural trend. Both Europe and Japan are prominent in our portfolio as they offer some of the most attractive risk premia in our view.

We think growth in emerging economies should stabilise, and with it the valuation gap with developed stocks should narrow in favour of emerging peers. We will tread cautiously, however, given risks from some local political problems, with Brazil being a prime example. It's too early to issue an outright blanket buy signal on the emerging world, but it makes sense to look for investment opportunities, especially in industrialised Asia. Here, companies are likely to be the first beneficiaries of a likely pick up in consumer spending in major economies.

In alternative asset classes, we like UK commercial property. It offers a handsome yield on what is an asset-backed security. However, uncertainty over a 'Brexit' risk is likely to put a cloud over foreign flows into the property sector until after the June referendum.

Finally, gold may offer some attractive investment opportunities as a hedge against inflation. As central banks around the world deploy more unorthodox ways of printing money, an expansion in their balance sheets may eventually lead to inflation.



US estimated probability of a recession based on stock market & 22 macro indicators

Source: Pictet Asset Management, NBER, CEIC, Datastream, 2016.
*22 macro indicators of household, corporate &trade sectors/ **optimal threshold determined such that the benefits of hits equals the cost of misses

Written by Percival Stanion, head of international multi-asset, Pictet Asset Management

In association with PICTET 1805 Asset Management