

# Barometer: Stocks to power on despite lofty valuations

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## Asset allocation: equities to add to gains as earnings eclipse valuations

After a nine-month rally in equity markets and a recent spike in bond yields, some investors may see fit to reduce their exposure to stocks. On the surface at least, bonds appear to offer better value than equities. The gap between stocks' earnings yields, the inverse of the price-to-earnings ratio, and bond yields is narrower than it has been in two decades.

However, valuations are a less powerful indicator when corporate earnings growth continues to be strong (see Fig. 2). For this reason, we maintain our overweight stance in equities.

By our estimates, companies in the MSCI World equity index should deliver earnings growth of over 30% this year, while profits for firms based in emerging markets could rise by over 65%.

Another positive is the inflation trajectory: we expect price pressures to ease in the coming months, even if higher oil prices have briefly pushed headline US inflation to almost double the target level.

True, some investors may be worried about stretched valuations for AI and technology stocks. But the industry is responsible for generating more than half of global earnings growth in 2026.

Our overweight position in equities is accompanied by a neutral stance on bonds and an underweight position in cash. The recent rise in the average yield on global government bonds to 4% for the first time has taken valuations across fixed income markets to attractive levels. Yet high public-sector debt levels and the conflict in Iran are likely to keep yields higher for longer.

Our business cycle indicators show resilient global growth.

The US economy is expanding at its potential rate of around 2%. Our composite indicator of capital investment is rising above its long-term average since 1990, driven by non-residential investment, especially among technology companies. AI-related spending has been increasing at an annualised pace of over 20% for the past two years, with the US Federal Reserve expecting a potential AI-driven productivity boom to lift the US GDP growth rate towards 4% in the coming decades.

This more than offsets some weakness in the US housing market.

S&P 500 consensus analyst earnings per share expectations, USD

Data covering period 23.09.2024-23.09.2026. Source: LSEG, IBES, Pictet Asset Management.

Europe's economy, meanwhile, is supported by a broadening recovery in consumption, manufacturing and trade. We see evidence that the region's public spending on renewables, defence and infrastructure, amounting to 15% of total EU GDP, is steadily being transmitted throughout the economy. Over time, we expect this fiscal boost to help the region's growth rate approach that of the US. Our analysis shows that European fiscal spending could eventually halve the US/Europe GDP growth gap.

Japan is one of the stronger developed-market economies, as leading indicators, including manufacturing surveys and machinery orders, point to stronger industrial activity and capital spending.

China continues to lag behind, as weak domestic demand and subdued private consumption weigh on the world's second-largest economy.

Emerging economies outside China, however, are benefiting from resilient global trade and strong investment in technology and manufacturing supply chains.

Our liquidity analysis shows that resilient growth has given major central banks the leeway to prioritise inflation-fighting. However, we see little evidence to suggest that this is the start of a sustained global tightening cycle, given that underlying core inflation dynamics remain benign.

Our valuation models support our view that current conditions do not justify reducing equity exposure, although stretched positions and the possibility of a downward revision to what are currently high earnings expectations remain risks.

Our composite equity risk premium in the US, a measure of the excess return investors earn over a risk-free rate from holding equities, stands at 250 basis points, almost half its historical average. We see this as a material constraint on medium-term returns rather than an immediate signal to sell equities altogether. However, a further 50-basis-point rise in US 10-year bond yields or a 10-15% expansion in the S&P 500's valuation multiple would push relative valuations into territory that has historically preceded sharp market corrections.

Elsewhere, our technical indicators support our overweight stance in equities, with hedge funds expected to deploy more of their cash holdings towards the year-end.

## **Equities regions and sectors: follow the earnings**

Strong corporate earnings growth is the key reason we remain overweight global equities – and it is also the main driver of our regional and sector allocation.

Regionally, we see the strongest earnings growth potential in emerging markets. Our top-down model – based on Pictet Asset Management's macroeconomic forecasts, adjusted for actual results reported so far – suggests that earnings in the emerging world will be some 66% higher this year than they were in 2025. For comparison, we expect growth of 30% in the US, and 15% in the euro zone.

Our positive view on the developing world reflects a healthy macroeconomic picture, supported by resilient global trade and strong investment spending linked to technology and manufacturing supply chains. Our economists see emerging market GDP expanding by 3.8% this year, compared to 1.6% for their developed peers.

China's demand for imports from emerging markets remains strong despite weakness in its domestic economy, helping sustain favourable external conditions. Combined with positive capital flows and growing demand for industrial metals to support electrification, this creates strong grounds for maintaining an overweight in emerging market equities outside China.

The case for US stocks is more nuanced. On the positive side, there is support from AI-related capital spending and resilient labour markets. However, so far there are few signs of AI investments translating into sustainably higher economic growth or higher productivity. Until this materialises, we prefer to remain neutral.

We are also neutral on Europe, where the positive impetus from fiscal spending is offset by greater

vulnerability to high oil prices.

Global core AI stocks 12m forward PE (absolute and relative to market)

Source: MSCI, LSEG, Pictet Asset Management. Global Core AI includes Nvidia, Microsoft, Broadcom, Meta, Amazon, Alphabet, Oracle, Palantir, AMD, Arista, Micron Tech, Applied Materials, LAM, KLA, Synopsys, Intel, Cadence Design, Marvell, Monolith Power, Dell, HPE, Pure Storage, SMC, Teradyne, Entegris, SAP, ARM, Samsung, TSMC, SK Hynix, ASML, ARM, Tokyo Electron. Data covering period 23.09.2011-23.09.2026.

Among sectors, we continue to favour IT, which is supported by strong earnings growth, rising AI capex and improving earnings outlooks. According to our analysis, mega-cap AI companies still account for some 41% of total global corporate profits and for two-thirds of global earnings growth. Furthermore, valuations are now more compelling: for the first time since the start of the AI boom, these companies are trading at a discount to the broader market based on 12-month forward price-to-earnings ratios (see Fig. 3).

We also see potential in financials, which are set to benefit from higher interest rates and buoyant corporate borrowing.

The outlook for consumer discretionary stocks has also improved, with inflation on track to normalise next year and the US jobs market stabilising. We therefore upgrade the sector to neutral.

Conversely, we downgrade industrials to neutral, seeking to avoid outsized exposure to the most energy-intensive and rate-sensitive parts of the economy.

We also remain cautious on consumer staples, a sector that is disadvantaged both by being overly defensive in a relatively positive investment environment and by structural headwinds stemming from shifting consumer behaviour, to which incumbents have been slow to adapt.

## **Fixed income and currencies: government bonds not yet a 'buy'**

With the average yield on world government bonds in the Bloomberg Treasury index having broken above 4% in recent weeks, the highest level since 2000, investors might be tempted to channel more of their capital into fixed income on valuation grounds. The case for doing so looks all the stronger considering that the earnings yield offered by S&P 500 stocks, the inverse of the price-earnings ratio, is at its lowest level relative to sovereign bonds for more than 20 years.

Shorter-dated government securities look especially cheap. In our view, yields on such securities are discounting more interest rate increases in the US than the Fed will eventually deliver. That's because we believe inflationary pressures should eventually ease.

Yet for all this, we are not convinced by the arguments for shifting to an overweight stance on government debt.

Even if we believe the US central bank will hike rates less aggressively than markets expect, there are risks other than inflation that could continue to cause turbulence in government bond markets.

To begin with, public sector deficits remain stubbornly high, placing upward pressure on government borrowing costs. At the same time, economic growth in the US and other parts of the world continues to surpass consensus forecasts.

Then there are potential changes to the US central bank's interest-rate-setting framework. With new Fed

chairman Kevin Warsh having committed to reviewing how, among other things, the institution measures inflation and how it might prevent future inflation overshoots, any shift in stance has the potential to trigger a renewed spike in yields. For these reasons, we prefer to hold a neutral stance in developed-market government bonds.

Interest rates, historic and implied, in US, Europe, UK and Japan

Source: Pictet Asset Management; forecast range to 31.12.2028

To further guard against unexpected changes in the Fed's policy framework, and further geopolitical upheaval, we also remain overweight in gold.

Offering greater value to investors seeking income, however, are emerging market local-currency bonds. Contrary to expectations, and previous experience, emerging economies have proved resilient following the outbreak of the US-Iran conflict. Growth has remained healthy, supported by solid domestic consumption and strong export growth. Emerging market currencies have also been less volatile than they have previously been during energy price spikes. At the same time, yields on local-currency bonds have increased by an average of just 60 basis points, as measured by the JPMorgan GBI-EM bond index. That's a far smaller rise than the 100-basis-point-plus spike seen in US government bond markets, a testament to the asset class's newfound stability.

## **Global markets overview: bond markets bleed**

Major fixed income markets fell across the board as worries intensified over surging energy prices and the rising cost of servicing USD 40 trillion government debt in the US. The Treasury market suffered its biggest ever weekly sell-off, sending the 10-year yield above 5.2%, the highest since 2007, while 30-year yields rose above 5.5% for the first time since 2004.

European government bonds lost over 2% as growing concerns over France's fiscal outlook ahead of the 2027 presidential election lifted the premium investors demand to hold French debt over the German equivalent to the highest since the 2008 financial crisis.

Even emerging market bonds failed to escape the carnage as a stronger US dollar and higher energy prices intensified pressure on energy-importing economies.

Data covering period 23.09.2025-23.09.2026. Source: LSEG, Pictet Asset Management.

Global equities ended the month weaker as investors grew nervous that major central banks would follow the Fed in tightening monetary policy, which could weigh on growth and the outlook for corporate earnings.

Interest rate-sensitive sectors, such as real estate and utilities, were among the biggest losers, while materials and consumer discretionary, which are more exposed to economic cycles, also declined. IT and communication services bucked the trend, as the sectors' strong earnings results and forecasts encouraged investors to increase their exposure. Energy stocks ended the month broadly flat.

US stocks ended the month broadly unchanged, while other developed-market equities were down around 1%. Latin American stocks were the best performers, rising by some 0.6% thanks to strong commodity prices. Asian stocks rose 0.3%, attracting inflows into their technology and advanced manufacturing sectors.

Oil prices rose nearly 18% during the month, bringing their gain for the year to more than 70%.

The dollar rose across the board after the Fed raised interest rates. The yen gained more than 1% after a volatile month that saw the currency strengthen on signals of intervention and then retreat in response to higher US yields. The euro, sterling and Swiss franc fell by around 2% against the dollar.

We maintain our overweight stance on equities as corporate earnings remain resilient and inflation looks set to ease in the coming months.

In equities, we favour the regions and sectors that offer the best earnings growth prospects, such as emerging markets and IT.

Even if government bonds are now offering attractive yields, we are not convinced the worst is over for developed fixed income markets. We consequently remain neutral on government bonds and overweight emerging market local currency debt.

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Source: <https://www.pictet.com/us/en/insights/am/october-barometer-financial-markets-outlook>