Marketing material

Big selloffs and midterm elections bode well for a rebound

Within the context of our balanced strategy, we remain positive for equities for the coming weeks. Fundamentals do not justify a selloff, while the year after a US midterm election has historically always favored stocks. During last month's turmoil, we counter-cyclically bought equities. More recently, we closed a short British pound position.

Stock prices have started to stabilize this month, after the biggest selloff in years in October. For US equities, it was the worst since 2010. The most convincing trigger for this phase were policy signals by the US Federal Reserve (Fed).

Make Fed policy restrictive again

After all, the selloff began on Oct. 3, when Fed Chairman Jerome Powell in unscripted comments remarked that monetary policy was still supportive of growth, probably "a long way from neutral," and that it might eventually have to turn "restrictive." This potential shift was confirmed on Oct. 18, when the Fed published its last meeting's minutes, revealing that policy makers had discussed making policy restrictive by the end of 2020.

Of course, such considerations are not really new and conditional on how the economy continues to perform. Importantly, they are the appropriate consequence of a stronger and hence potentially more inflationary economy. Nevertheless, these developments scared or influenced many investors, particularly those with short-time horizon strategies, no firm fundamental convictions and/or low risk tolerance levels.

In addition, these concerns come at time when elevated political uncertainties (trade war, Brexit, Italy, etc.) frequently weigh on sentiment, and after the cyclical upswing of 2016 and 2017 has faded in most of the world. Investors now fear that the positive US economic momentum – and hence earnings growth – has peaked as well.

Against this background, today we highlight the fundamental backdrop of our relatively constructive assessment for risk assets and examine some potentially relevant historical market behavior patterns and current market signals. These observations help to underpin our forward-looking assessment for risk asset markets.

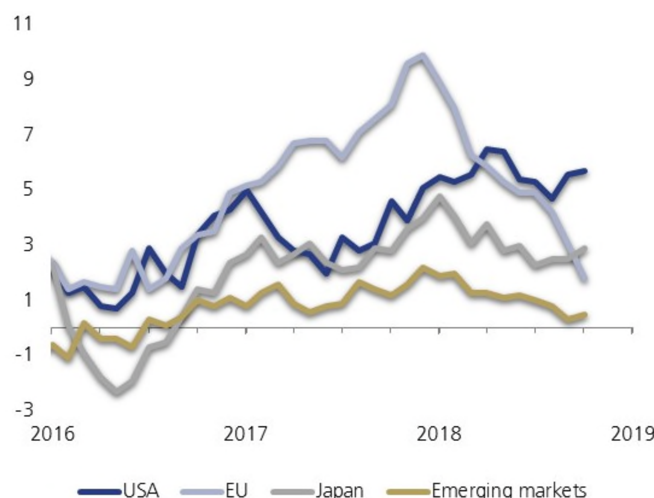
Cyclical slowdown may be ending

First, on the macro picture. The manufacturing purchasing managers' indices (PMI) published in November showed that that slowdown may be ending in most major economies: the PMI for the US, Japan, and the emerging markets (EM) are pointing higher (graph 1), with the national readings for its top-five economies, i.e. China, India, Brazil, Russia, and South Korea, all up as well.

Only Europe continues to decelerate, as it has during all of this year (after an impressive surge in 2016-2017). However, all PMIs remain above the growth threshold. Hence, while economic growth will be slower in the coming year, a further meaningful deceleration from current indicated levels looks increasingly less likely.

Graph 1

Business surveys for the major DM and the EM
(Purchasing managers' indices for manufacturing)



Balance/diffusion indices with the threshold adjusted to zero. Readings above zero signal improving business outlook, and vice versa. DM = developed markets. Source: Bloomberg, LGT Capital Partners

Fed signals and stock market volatility

Second, we examine the US stock market volatility patterns (VIX, graph 2). The recent turmoil is reminiscent of the pattern between summer 2015 and early 2016: starting in August 2015, the Fed began preparing investors for a monetary policy shift from accommodative to neutral.

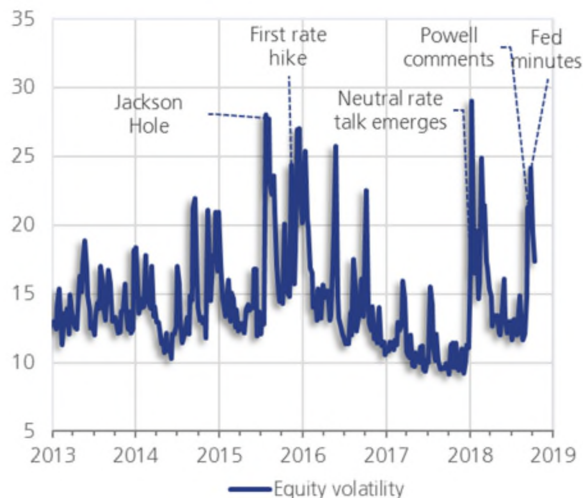
The first VIX surge came right after the annual central banker conference in Jackson Hole, Wyoming, where policy makers first signaled a consensus to begin raising rates even if inflation were to remain below target. At the time, like today, many investors feared the economy was not ready for that yet. Then, following the Fed's first policy rate increase in December 15, 2015, there was a second volatility outburst, which included a stock market crash in China in January 2016. That second outburst was already somewhat less intense than the first. Thereafter, the VIX gradually retreated, and everything turned out fine in macro terms: the world saw a remarkably strong and synchronous uptick in growth in 2016 and 2017. The Fed was proven right.

Similarly, in late January of this year, Fed circles began to cautiously prepare investors for the logical next phase - i.e. the move from neutral to restrictive - and volatility surged accordingly soon. This policy signal was finally officially confirmed in October, with Powell's remark and the Fed's minutes – and again there was a second, somewhat less intense spike up.

Graph 2

Fed policy signals and recent market volatility

(CBOE S&P 500 Volatility Index)



CBOE = Chicago Board Options Exchange. Source: Bloomberg, LGT Capital Partners

The point being: if you believe the Fed knows what it is doing, you can expect the markets to calm down going forward. The fact that volatility jumps every time the Fed signals a policy shift is no harbinger of a bear market per se – the Fed may be proven right again, especially given that the Fed's future decisions will be data-dependent anyway. Meanwhile, markets have been be proven wrong repeatedly.

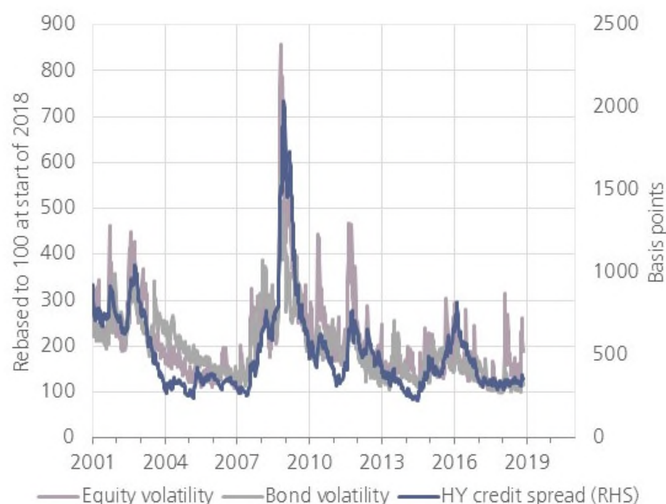
To complete our observations, we also compare the VIX with some useful indicators of investors risk perceptions in other capital market segments (graph 3) – i.e. the difference in yield (spread) between US high yield bonds and US treasuries and the MOVE volatility index for the US government bond market. These indices tend to move in sync during real crises and bear markets.

However, both the HY spread and the MOVE index remained comparatively stable during the most recent VIX surges. In short, the fact that the broader capital markets remained relatively calm suggests that the stock market turmoil may have been largely noise.

Graph 3

Risk indicators not in synch this time

(Equity and bond volatility shown on LHS)



Source: Bloomberg, LGT Capital Partners

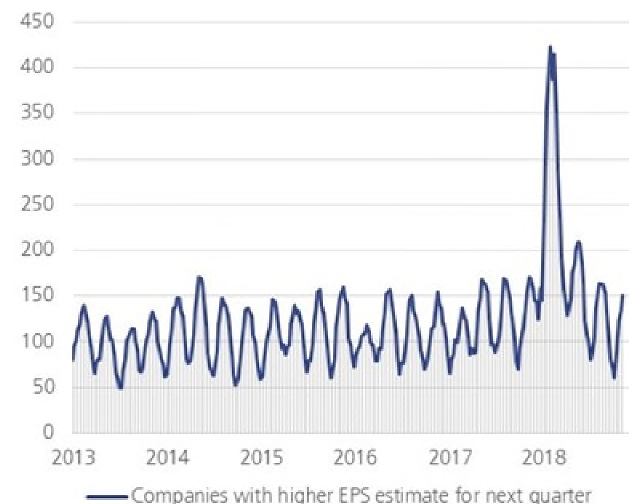
Peak earnings or just another case of expectations management?

With respect to corporate earnings, the bearish narrative is that the peak is behind us and many analysts are warning that companies have started to issue more cautious business outlooks. However, the hard data evidence does not back these claims, as the next charts show (graphs 4 and 5).

Graph 4

Companies with higher estimated EPS next quarter

(S&P 500, six-week moving average of weekly total number)

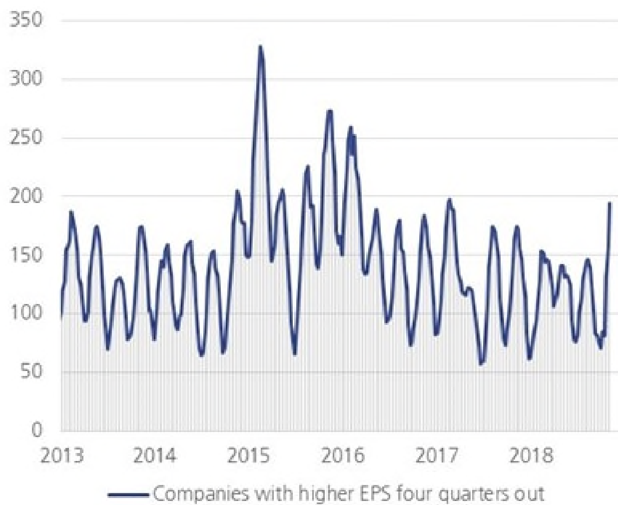


EPS = earnings per share. Source: Bloomberg, LGT Capital Partners

Graph 5

Companies with higher estimated EPS four quarters out

(S&P 500, six-week moving average of weekly total number)



EPS = earnings per share. Source: Bloomberg, LGT Capital Partners

The number of companies with higher EPS next quarter is indeed lower than earlier this year, when the US tax reform triggered an upward surge – but it is still on the higher end of the bull market range. Estimated EPS for four quarters forward have actually been rising. Their level is also around the high end of the normal bull market range.

We would advise against attaching too much weight to hearsay about what company executives say in their conference calls with analysts - it may be just a matter of overly negative interpretations due to a temporarily depressed market sentiment.

The measurable data suggests a continuation of a rather robust earnings environment, following another strong reporting season (graph 6).

Markets after big selloffs and US mid-term elections

Third, we look at how the S&P 500 has historically performed in the three months following monthly drawdowns of the same magnitude, which we define as losses that are two standard deviations larger than the norm (graph 8, next page). Then, we look into market returns following US mid-term elections, regardless of the actual political outcome (graph 7, next page).We examined the history going back to 1949 and found the following:

- In absence of a recession, the US stock market has nearly always rebounded within a few months following such an extraordinary selloff
- The returns were also positive 80% of the time one to three months following a midterm election
- Perhaps more importantly, US stocks have also always risen significantly in the 12 months after a midterm election – regardless of the outcome and recessions
- Last but not least, the S&P 500's average annual post-midterm election return was 16.4% and hence above the normal annual return of 11.3%

In short, while the first few weeks after a selloff can prove volatile, the odds clearly favor the upside over the medium to longer term. Negative returns are certainly very rare when the economy is not in (or very near) a recession. The only exception occurred after the first Greek debt crisis in 2011.

Furthermore, even when the economy was in recession, the failure to recover coincided with rather extraordinary events: escalation of the Vietnam War in 1970 with beginning of the US bombing campaign in Cambodia, the Turkish invasion of Cyprus in 1974, and the last century's two largest financial crises of 2000 and in 2008.

Graph 6

US earnings season: overall very robust

(Reporting data per November 16, 2018)

Reporting period: Q3 2018	Percentage of reports published	Earnings growth year-on-year	Earnings surprise (actual vs. consensus)	Positive surprises / total	Revenue growth year-on-year	Revenue surprise (actual vs. consensus)	Price-earnings ratio (12 month forward)	Number of sectors above consensus
USA (S&P 500)	93%	26.3%	6.7%	82.5%	8.0%	0.7%	15.5	11/11
Energy	100%	125.1%	15.2%	75.9%	19.5%	1.7%	13.6	n/a
Materials	100%	29.6%	4.7%	73.9%	10.7%	1.0%	14.1	n/a
Industrials	94%	16.3%	1.9%	77.6%	6.1%	0.6%	15.6	n/a
Consumer discretionary	77%	24.7%	14.4%	79.6%	8.9%	0.7%	19.5	n/a
Consumer staples	84%	9.4%	4.8%	77.8%	2.7%	0.0%	18.4	n/a
Health care	95%	14.8%	5.1%	88.3%	7.0%	0.7%	16.0	n/a
Financials	100%	37.9%	4.7%	79.1%	4.5%	0.7%	11.4	n/a
Information technology	87%	25.3%	7.6%	94.8%	10.6%	1.4%	16.7	n/a
Communication services	95%	27.7%	8.8%	95.2%	12.2%	0.3%	21.0	n/a
Utilities	100%	13.0%	6.6%	86.2%	1.2%	-1.1%	16.8	n/a
Real estate	100%	8.9%	2.0%	78.1%	13.1%	1.2%	36.3	n/a
Europe (Stoxx 600)	91%	11.4%	1.7%	50.6%	4.8%	0.8%	12.8	6/11
Eurozone (Euro Stoxx)	93%	8.8%	1.1%	51.2%	3.1%	0.8%	12.4	6/11
Japan (Topix 500)	98%	7.3%	0.0%	48.8%	5.9%	4.4%	12.1	6/11
Asia-Pacific ex Japan	88%	12.7%	2.9%	46.7%	8.4%	8.0%	11.5	8/11
Emerging markets	85%	13.2%	2.1%	47.5%	8.4%	7.7%	10.6	8/11

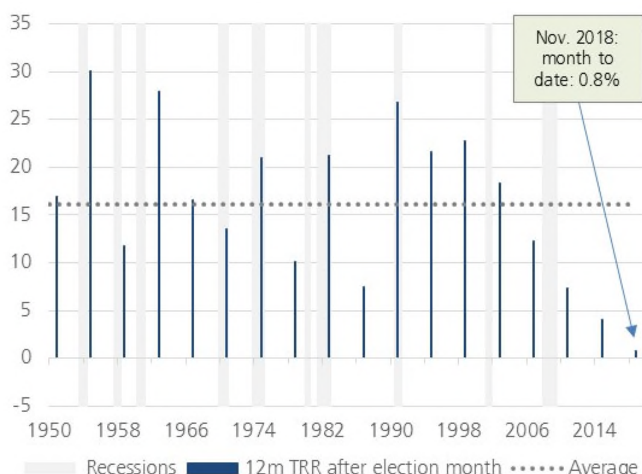
MSCI indices are used for the EM and Asia-Pacific. Source: LGT Capital Partners, Bloomberg

The empirical evidence thus confirms that the equity markets are probably headed higher from here, at least as long as we do not enter a recession in the coming months.

Graph 7

S&P 500 return after a midterm election

(Total returns in the 12 months following the election month)



Source: Bloomberg, LGT Capital Partners

We should note that we expect a slowdown in economic and profit growth going forward, but view a recession as highly unlikely before 2020. Geopolitical developments are harder to predict, but it is worth remembering that even if such events occur, history shows that markets still tend to trade higher within a year.

House view: maintain a prudent and balanced positioning

Concluding, we sum up our house view again as follows:

- Economic momentum and earnings growth are slowing, but remain relatively robust, which may indeed warrant some additional monetary tightening in the US going forward
- At the same time, political and geopolitical uncertainties are liable to keep exacerbating and prolonging phases of market volatility against this backdrop
- These uncertainties, along with the fact that we are relatively late in the economic cycle, favor only a modest overweight and well-diversified overweight in equity risk at most; which should be managed actively and with a countercyclical approach during market exaggerations

Tactical move: close a short in the GBP

Last but not least, with regard to recent tactical changes, this week we closed a short position in the British pound (GBP) against the US dollar (USD). While we see continued GBP weakness on fundamental grounds, pressure will be increasing on both the UK and European Union leadership to minimize potential economic disruptions. The latter makes for an asymmetric risk profile – meaning that while the GBP still has some downside, the short-term upside in the event of an agreement that ensures a non-chaotic Brexit is much larger. We remain reluctant to buy the GBP, but regard a short position as too risky.

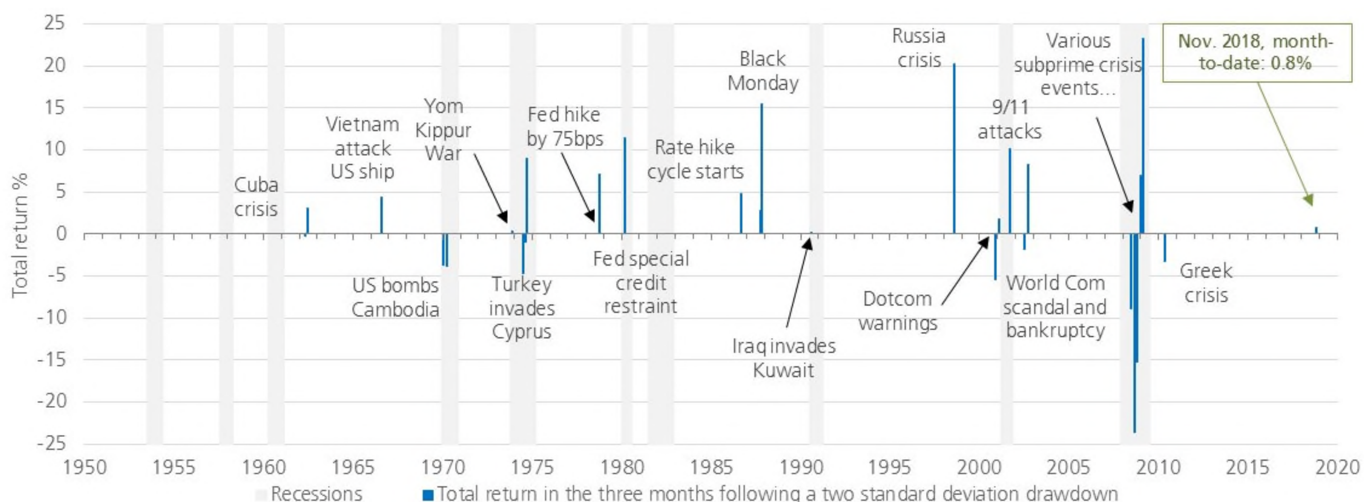
Finally, we remind readers that our overall assessment on risk asset markets for the next few months remains broadly balanced, rather than outright bullish. We remain just as willing to sell undue rallies, just as we were prepared to buy exaggerated drops.

END OF REPORT

Graph 8

S&P 500 three-month return after a big selloff

(Big selloff is defined as a two standard deviation drawdown

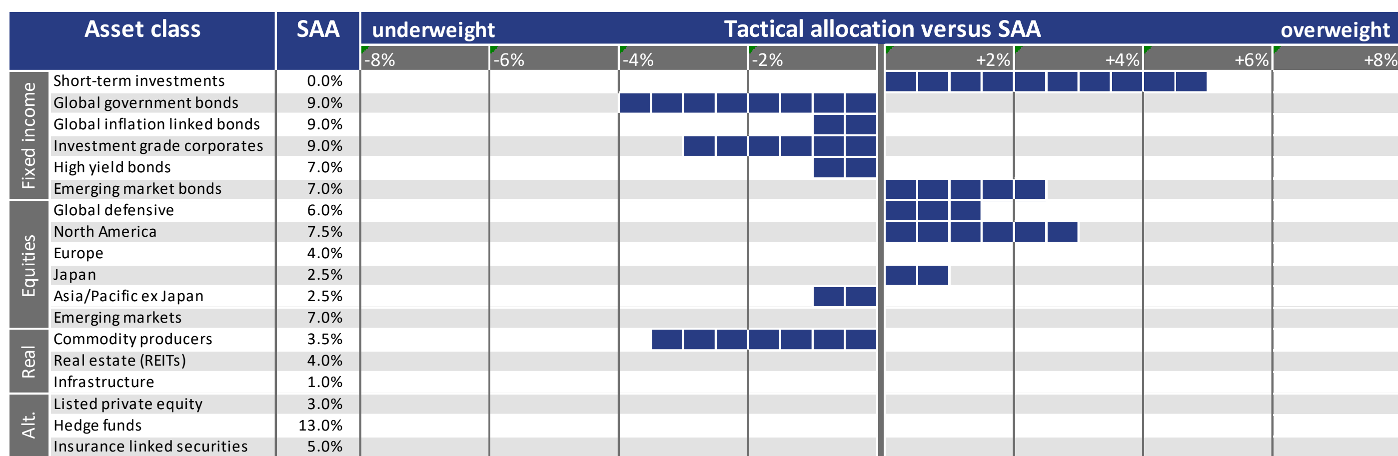


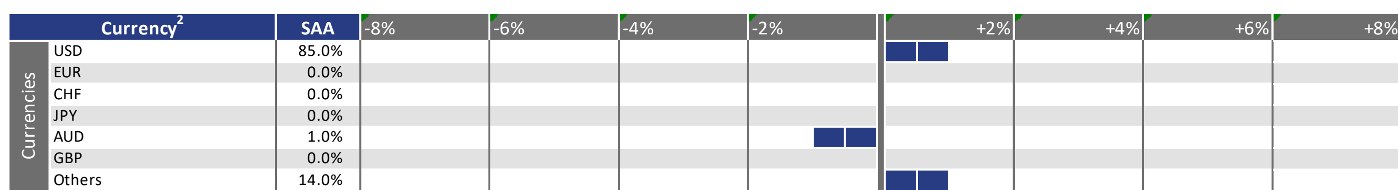
Source: Bloomberg, LGT Capital Partners

LGT Capital Partners: tactical asset allocation for the Princely Strategies in USD

Our tactical asset allocation (positioning vs. our neutral strategic quotas) is set quarterly, with a time horizon of three to six months. It is reviewed regularly, and ad-hoc when needed. The current TAA was last set on September 7, 2018, and adjusted in mid-October and mid-November. Our total equity exposure includes equity regions as well as the real and alternative asset segments.

- **Total equity risk slightly above neutral following October's rebalancing of all equity regions and the increase in LPE**
- **Fixed income allocation remains largely unchanged after a September reduction of EM debt in favor of IG credit**
- **We are long USD versus the AUD and have a reduced passive overweight in EM currencies**





The TAA positions shown are based on the LGT GIM Balanced (USD) strategy managed by LGT Capital Partners AG. The TAA can be transferred to similar portfolios as a general rule, but investment restrictions or liquidity considerations may lead to deviations in implementation. In currencies, "others" represents indirect exposures resulting from over-/underweights of unhedged positions in markets, against a portfolio's base currency; the effective position of the base currency may thus deviate from the direct tactical position shown above.

Performance of relevant markets

		1 month	3 months	Year to date	3 years, p.a.¹	5 years, p.a.¹
Fixed Income						
Global government bonds	USD	-0.7%	-1.3%	-0.5%	1.7%	2.9%
Global inflation linked bonds	USD	0.0%	-0.1%	1.1%	2.3%	1.8%
Investment grade corporate bonds	USD	-0.2%	0.1%	-1.2%	1.9%	2.4%
High yield bonds	USD	-0.3%	0.8%	0.0%	6.7%	4.3%
Emerging market bonds	USD	1.1%	-1.2%	-5.0%	4.4%	2.8%
Equities						
Global defensive	USD	-2.9%	0.6%	2.6%	9.2%	9.0%
North America	USD	-3.4%	-0.4%	5.4%	12.5%	10.8%
Europe	EUR	-3.8%	-6.1%	-4.5%	5.2%	5.5%
Japan	JPY	-1.8%	-1.0%	-3.2%	5.7%	8.5%
Asia/Pacific ex. Japan	USD	-5.9%	-9.0%	-13.1%	6.9%	2.9%
Emerging markets	USD	-3.4%	-7.4%	-13.3%	6.8%	1.2%
Real assets						
Commodities (commodity producers' equities)	USD	-1.1%	-3.0%	0.7%	8.6%	-0.3%
Real estate (real estate investment trusts, or REITs)	USD	-4.6%	-3.1%	-2.7%	4.1%	4.8%
Infrastructure (master limited partnerships, or MLPs)	USD	-2.3%	4.0%	5.1%	-0.2%	-3.1%
Alternatives						
Insurance linked securities (ILS)	USD	0.8%	0.6%	4.1%	3.8%	4.7%
HF CTA	USD	-4.2%	-3.1%	-7.5%	-2.2%	1.9%
HF equity long/short	USD	-0.5%	0.5%	1.7%	7.3%	5.1%
HF event driven	USD	0.4%	0.8%	2.8%	6.8%	4.3%
HF relative value	USD	0.3%	1.3%	3.0%	5.2%	4.4%
Listed private equity	USD	-6.4%	-5.8%	0.0%	9.8%	7.0%
Currencies ²						
US dollar	USD	1.1%	1.1%	4.8%	1.3%	4.8%
Euro	EUR	-0.7%	-0.4%	-0.3%	1.8%	0.8%
Swiss franc	CHF	-2.4%	1.4%	2.3%	-0.3%	2.5%
British pound	GBP	0.5%	1.2%	1.0%	-4.7%	0.0%
Australian dollar	AUD	-0.5%	-3.2%	-5.5%	0.5%	-2.1%
Japanese yen	JPY	1.0%	1.4%	5.0%	3.6%	1.6%

¹ Annualized returns ² Currencies are represented by Bloomberg's correlation-weighted indices (BCWI), which measure a currency against the remaining ten other major freely convertible currencies, to show the broader strength / weakness of a currency.

Economic and corporate fundamentals

Macro fundamentals		USA	Eurozone	China	Japan	Germany	Britain	Brazil	Russia	Switzerl.
Gross domestic product (GDP)										
- nominal	bn USD	19,485	12,633	12,015	4,873	3,701	2,628	2,055	1,578	679
- nominal, per capita 2017[1]	USD, PPP	59,792	38,322	16,696	42,942	50,804	44,292	15,637	27,893	62,125
- expected real growth for 2017	Consensus	2.3%	2.5%	6.9%	1.6%	2.5%	1.7%	1.0%	1.5%	1.0%
- expected real growth for 2018	Consensus	2.9%	2.0%	6.6%	1.1%	1.9%	1.3%	1.5%	1.8%	3.0%
- real growth in most recent quarter[2]	q/q annualized	4.2%	1.6%	7.4%	3.0%	2.0%	1.6%	0.8%	-2.3%	2.8%
Unemployment rate[3]		3.7%	8.1%	3.8%	2.4%	5.1%	4.0%	8.2%	4.5%	2.5%
Inflation, core rate (CPI)	y/y	2.0%	0.9%	1.7%	0.2%	1.5%	1.9%	4.5%	2.8%	0.4%
Purchasing manager indices (comp.)	Neutral = 50	53.9	54.1	52.1	50.7	55.0	54.1	47.3	53.5	59.7
Structural budget balance/GDP 2017	IMF	-4.0%	-0.7%	-4.0%	-4.1%	0.9%	-1.8%	-6.4%	-1.2%	0.4%
Gross government debt/GDP 2017	IMF	105%	87%	47%	238%	64%	88%	84%	16%	42%
Current account balance/GDP 2017	IMF	-2.3%	3.5%	1.4%	4.0%	7.9%	-3.8%	-0.5%	2.2%	9.8%
International currency reserves	bn USD	42	282	3,087	1,200	36	127	185	382	800
Govt bond yield 2yr[4]	p.a.	2.89%	-0.54%	2.91%	-0.12%	-0.57%	0.80%	8.27%	9.49%	-0.72%
Govt bond yield 10yr[4]	p.a.	3.21%	0.69%	3.48%	0.15%	0.48%	1.58%	8.56%	9.23%	0.05%
Main policy interest rate[5]	p.a.	2.25%	0.00%	4.35%	-0.10%	0.00%	0.75%	6.50%	7.50%	-0.75%

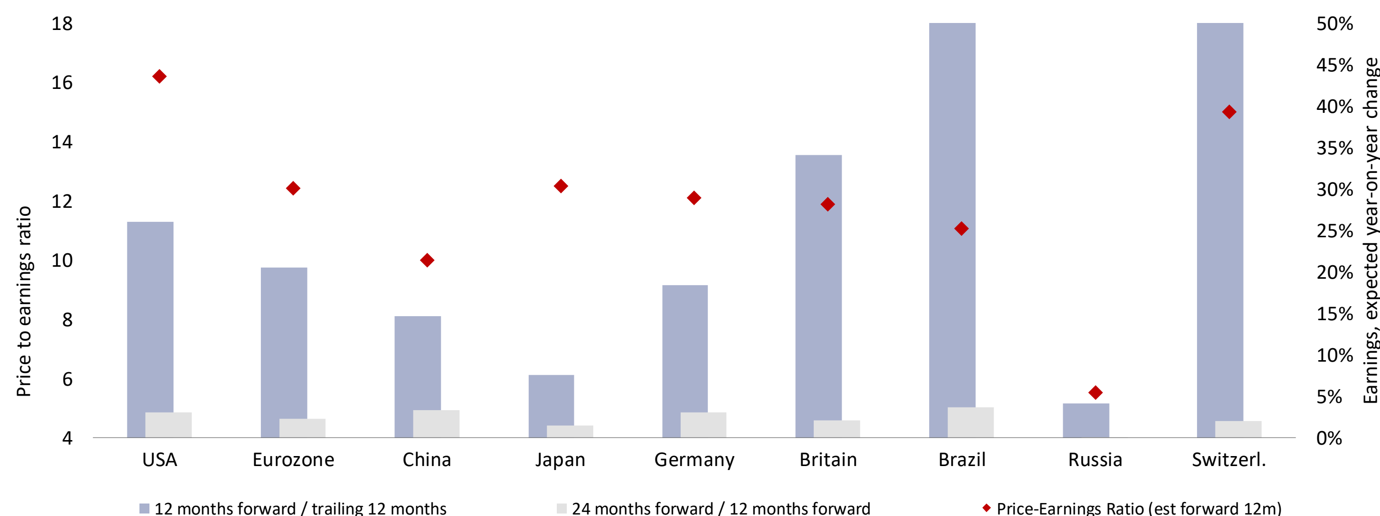
[1]IMF estimates. [2]annualized, most recent qtr. [3]PRC ex. migrant workers. [4]Currency swap rates for China and Brazil, closest ESM or EFSF bonds for Eurozone. [5]Max target rate for Fed, middle of the target range for SNB

Corporate fundamentals		USA	Eurozone	China	Japan	Germany	Britain	Brazil	Russia	Switzerl.
Exchange capitalization*	bn USD	30,837	7,527	10,117	5,975	2,176	3,411	879	627	1,543
Growth in earnings per share, estimated (MSCI)										
12 months forward / trailing 12 months	Consensus	26.0%	20.5%	14.7%	7.6%	18.4%	34.1%	57.9%	4.1%	50.3%
24 months forward / 12 months forward	Consensus	3.1%	2.3%	3.3%	1.5%	3.1%	2.1%	3.7%	0.1%	2.0%
Growth in revenue per share, estimated (MSCI)										
12 months forward / trailing 12 months	Consensus	5.6%	4.3%	13.0%	2.6%	4.7%	3.7%	6.9%	3.5%	4.3%
24 months forward / 12 months forward	Consensus	4.5%	2.9%	10.9%	2.6%	4.5%	1.3%	4.9%	2.6%	1.9%
Valuation metrics (MSCI)										
Price-Earnings Ratio (est forward 12m)	Consensus	16.2	12.4	10.0	12.5	12.1	11.9	11.1	5.5	15.0
Price-Sales Ratio (est forward 12m)	Consensus	2.0	1.0	1.1	0.9	0.9	1.1	1.4	0.8	1.9
Dividend yield	Consensus	1.0%	3.6%	2.6%	2.3%	3.3%	4.7%	3.5%	6.5%	3.5%

*Includes Hong Kong. Source: Bloomberg

Current equity market valuations and earnings growth expectations

(Implied growth based on Bloomberg BEst Estimates for the next 12 to 24 months)



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