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LGT Beacon
Global macro and market review

February 14, 2018

Realigning strategy with our constructive view

Various short-term excesses began to resurface in markets in January. Luckily, the sharp correction that ensued provided the overdue cold shower, which should help cool expectations, bring prices more in line with fundamentals, and thus prolong the bull market. As our macro view remains positive, we used the rout to put some of our cash back to work.

Our quarterly tactical asset allocation review (QTAA) in December and our Annual Outlook in January acknowledged a robust macro outlook, characterized by increasingly self-sustained growth in nearly all economies and subdued inflation in most. However, concerning the financial markets, we were wary about some emerging signs of investor complacency and exuberance - i.e. the typical phenomena of the later stages in any bull market cycle.

Consequently, despite the positive macro backdrop, our December QTAA adopted a defensive bias: we replenished cash reserves by trimming our then pronounced overweight in equities to only a modest one, reduced emerging markets (EM) in the fixed income segment, and raised hedge funds back up to our strategic quota.

Similarly, in our full-year outlook we advised investors to sharpen their focus on fundamentals and the quality of investments - and to prepare to respond to opportunities when markets move in extreme ways. By early February, our concerns had proven correct and the first global selloff in years wiped out most of January's equity market gains (graph 1).

Opportunity to buy back US and EM equities

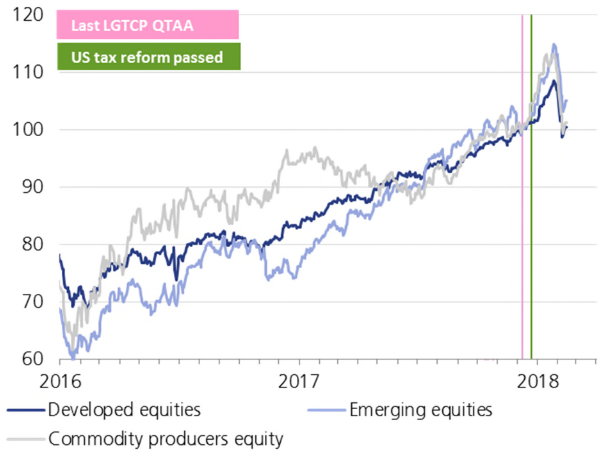
Fortunately, the market rout of the past couple of weeks has corrected many of the potentially self-destructive market excesses, making us more comfortable with aligning our investment strategy more closely with our macro views. We have thus reversed some of December's moves by drawing on about a third of our cash reserves to increase equity positions in the US and the EM (these were the two markets we had sold in December).

The US is where the recent build-up of short-term excess had started to accelerate most, right after the passage of the US tax reform package in late December. The recent selloff took prices too far down in our view, given the positive current macro environment. The EM, meanwhile, are among the markets that remain more attractively valued, face a less challenging interest rate outlook, and had dropped least during the turmoil. In short, both markets became more attractive for different reasons. The EM remain supported by both technical and fundamental factors, while the US is where the correction created short-term opportunities.

Graph 1

Performance of selected equity market segments

(MSCI equity indices, rebased to 100 on last QTAA date)



Source: LGT Capital Partners, Bloomberg

Restoring a better balance

The business-friendly narratives surrounding US President Donald Trump's tax reform package had evidently played a role in firing up expectations too much, too quickly.

To be clear: this is not to say that the tax changes will not have a net positive impact on corporate earnings in the US - they will. The problem lies with the pace and magnitude of the shift in expectations, not the fact of the improved outlook per se. The main challenges in navigating late-cycle bull market arise when market participants' expectations start to take off, which inevitably leads to disappointment at some point in the future. In this context, the following developments stood out since our last QTAA in early December:

- Globally, earnings revisions have surged at the fastest pace since 1990 (start of MSCI per share data), with stock prices briefly rising even faster than the forecasts in January.
- In the US, the two-year bond yield surged above the S&P 500 dividend yield for the first time since before the global financial crisis of 2008. Hence, there is a risk-free short-maturity alternative to the broad equity market for the first time in a decade.

Luckily, the selloff has started to correct these potentially accelerating imbalances - or at least put them on a more reasonable path.

US earnings revisions need to cool down

The consensus analyst forecast for global earnings per share (EPS) had started to surge in lockstep with soaring stock prices following the passage of the US tax reform bill (graph 2). This surge was driven mainly by the US (graph 3). This is problematic for the following reasons:

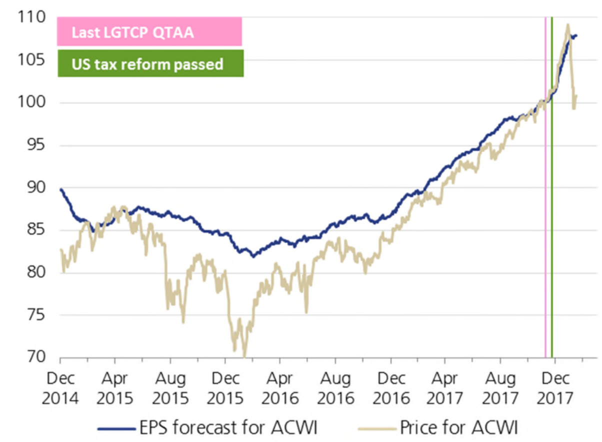
- More than two-thirds of expected extra gains in US earnings result from tax accounting changes, rather than actual business growth.
- Higher expectations tend to reduce the magnitude of future positive surprises.

In short, the US market was beginning to price itself for perfection. Of course, we may well end up with a perfect outcome for shareholders - but envisioning a perfect outcome is just not prudent.

Graph 2

Global earnings revisions and stock prices

(MSCI ACWI data, rebased to last QTAA date)



Source: LGT Capital Partners, Bloomberg, ACWI = All-Countries World Index

The good news is that the correction has quickly restored a valuation buffer - and that earnings revisions tend to follow the markets, rather than lead them. The recent turmoil has hence provided an overdue cold shower, which will help cool expectations - and give businesses a better chance to surpass the anticipated profit levels.

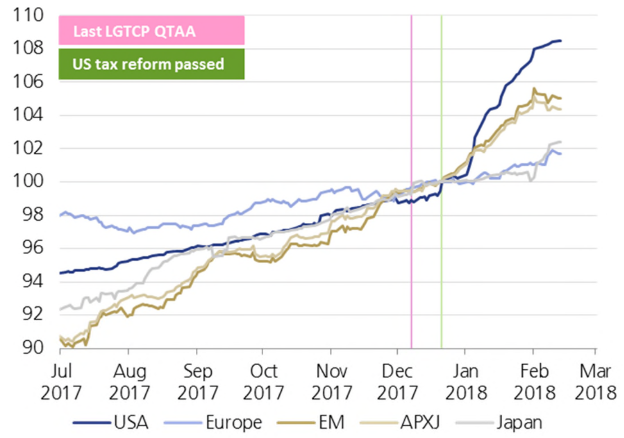
Meanwhile, a global comparison suggests that US earnings expectations may also have been rising too quickly relative to the other regions. After all, the US is in a more mature stage of its business cycle and its companies are arguably about to boost capital investment, which can raise costs and depress margins.

The case for a pronounced acceleration in earnings looks stronger in most other regions - where the business cycles are younger and where corporate earnings have been underperforming the US for many years, be it due to Europe's various debt and collective governance crises or due to the commodity slump of 2014/2015. These areas have more room for a catch-up in momentum and for positive surprises in the foreseeable future.

Graph 3

US leads global surge in earnings revisions

(MSCI indices, rebased to US tax reform passage date)



Source: LGT Capital Partners, Bloomberg, APXJ = Asia-Pacific excluding Japan

In particular, expectations toward Japan seem very low by comparison, as the above graph shows - along with our continuously fundamental data overview table on page 6. This suggests that analysts remain cautious on Abenomics, while they continue to respect the (negative) impact of the Japanese yen (JPY), which has been rather strong in the past two years.

These low expectations leave plentiful space for positive surprises and imply that current valuation metrics for Japan are overblown, given that Japanese earnings continue to grow faster than the global average and to surprise more strongly than the other markets (see table 1, next page).

To conclude, while rising expectations are not per se a problem, the pace and magnitude of the global earnings revisions suggest that the time has come to watch out for broader excesses in expectations and valuations.

Table 1

Corporate reporting season results for Q4/2017

(Based on broad equity indices, such as Stoxx and MSCI)

	Companies that have reported/total companies in the index	Actual growth (year-on-year)	Difference vs. forecast
USA	68.2%	15.7%	4.8%
Europe	42.7%	53.9%	7.2%
- of which Eurozone	32.4%	158.4%	12.4%
- non-Eurozone	63.4%	3.1%	1.7%
Japan	81.6%	34.3%	42.2%
Asia Pacific ex. Jpn	31.5%	-1.6%	2.0%
Emerging markets	68.2%	8.9%	4.8%

Results as of 12 Feb., 2018

Risk-free alternatives to equities reappear

Apart from having reintroduced an element of caution in terms of the earnings outlook, the selloff has also initiated the restoration of a more reasonable balance between stocks and so-called risk-free investments. As the following graph shows, the two-year US treasury yield has been steadily rising in an uninterrupted manner since last September. It finally surged above the S&P 500's dividend yield when Congress passed the tax reform bill.

For the first time since before the financial crisis of 2008, rather short-term investments now offer yields that are similar or higher than the dividend yield of the broad equity market - but at practically no risk if held to maturity. Fortunately, the selloff has stopped (or at least slowed) the extreme pace of this yield divergence. That should give investors more time to adjust to this new situation, which represents a welcome normalization from a medium- to long-term viewpoint.

Graph 4

Risk free rate and dividend yield in the US

(Annual return in percent)

Source: LGT Capital Partners, Bloomberg

Economic growth outlook remains benign

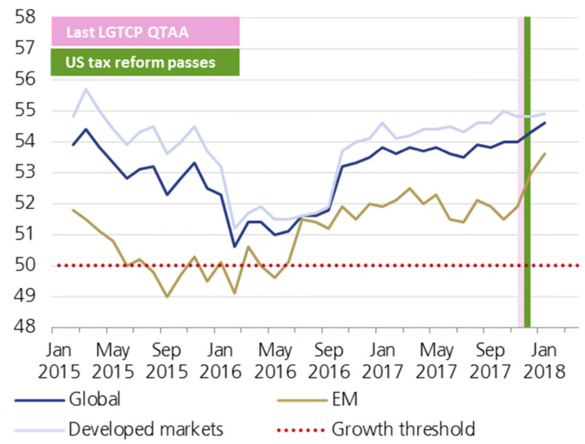
Concerning the fundamental outlook, in our view there has been neither a deterioration, nor a meaningful tightening of interest rate policy (relative to what seems appropriate given the macro dynamics). In fact, monetary conditions in the US may have turned too easy since December, which is why US bond yields have risen so much on the heels of a depreciating US dollar (USD).

Overall, global economic momentum remains strong, with the most recent readings of the various national purchasing managers' surveys still pointing higher, along with actual as well as expected inflation rates. Thus, if the trends remain robust, the earnings revisions may very well prove correct in the end.

Graph 5

Business surveys point to robust outlook

(Markit purchasing managers' indices)



Source: LGT Capital Partners, Bloomberg

The Fed may be falling behind the curve on inflation

Meanwhile, actual inflation readings and (perhaps more importantly) inflation expectations have started to generally move higher in recent weeks. For the US, inflation expectations have finally risen well above the target (of 2% annual inflation on average), which suggests that monetary policy settings in the US are now too easy - rather than too tight or just about right.

The US is also the only large economy that is expected to hit and even exceed its inflation target in due time. The Federal Reserve (Fed) has thus gained some extra room to accelerate its tightening path.

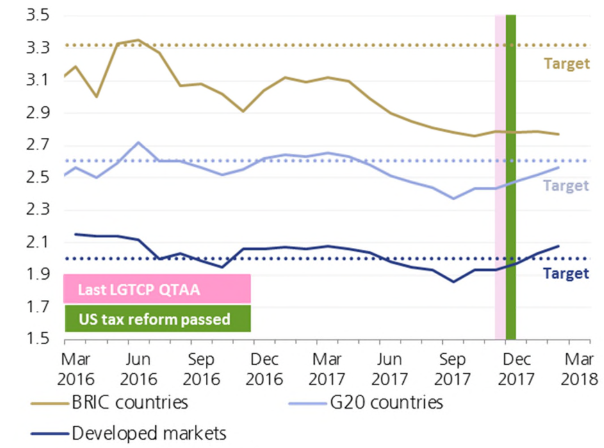
In fact, a measured tightening in the Fed's outlook may very well be what is needed to calm markets and slow the rise of interest rates. The surge in the treasury yields since late last summer may primarily reflect investors' concerns that the Fed could fall behind the curve on inflation. For markets, it is of critical importance that the monetary policy outlook is just about right - and that is another typical challenge during the late-cycle phase of any bull market.

Generally, as the following two graphs imply, economies outside of the US have more room to be patient before shifting to a more hawkish policy communication.

Graph 6

Expected inflation and inflation targets

(Annual inflation rate forecasts for 2018)

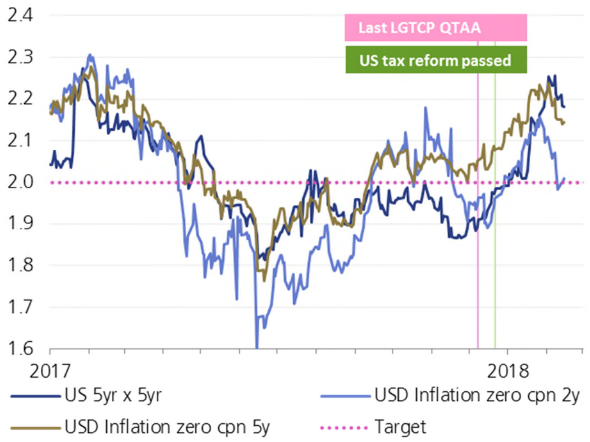


Source: LGT Capital Partners, Bloomberg

Graph 7

Market-implied inflation to exceed target in US

(Rates implied by various inflation-linked securities)



Source: LGT Capital Partners, Bloomberg

Fed can turn to more hawkish bias

In the context of policy credibility, we believe the Fed is a credible central bank that is capable of and committed to fulfilling its stated mandates of full employment (which does not have defined level rate) and low but positive inflation (defined as 2% per annum).

Many recent reports suggest that the new Fed chairman, Jerome Powell, is disinclined to shift to a tighter policy course - especially amidst a market turmoil. However, once markets calm down, it is unlikely that the Fed will stay behind the curve for too long if inflation expectations keep rising. Thus, if recent trends persist, the Fed is likely to adjust its policy rhetoric to reflect an appropriately more hawkish tone in coming weeks.

Finally, such a shift in the policy outlook could further help complete the process of restoring a better balance between asset prices and expectations - and go a long way toward making this bull market and economic expansion more sustainable.

We continue to prefer the USD

Concluding, we note that our views on the major currencies have not changed much from a fundamental perspective - we continue to favor the USD in general against most currencies. The strong US economy and the respective monetary policy outlook continue to support the case for the Greenback.

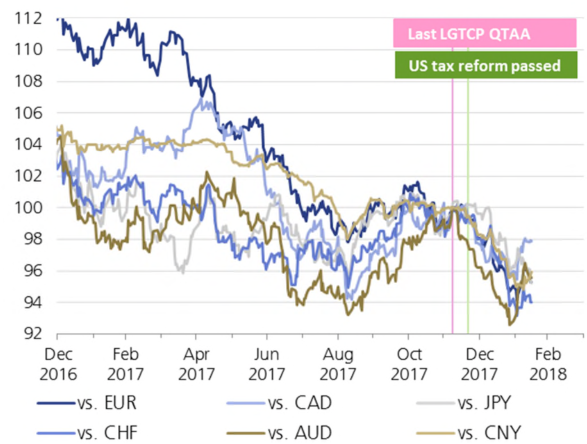
However, recent market trends have gone against us, as the USD has weakened since December. Therefore, we have re-adjusted positions based on these technical developments over the past six weeks. These actions have resulted in a smaller long position in the USD, and a long positon in the euro (EUR).

The increase in the overweight in the “other” currencies (see TAA graph on page 5) results from our increased allocation to EM equities.

Graph 8

US tax reform also triggered broad USD weakness

(USD vs. selected currencies, rebased to tax reform passage date)



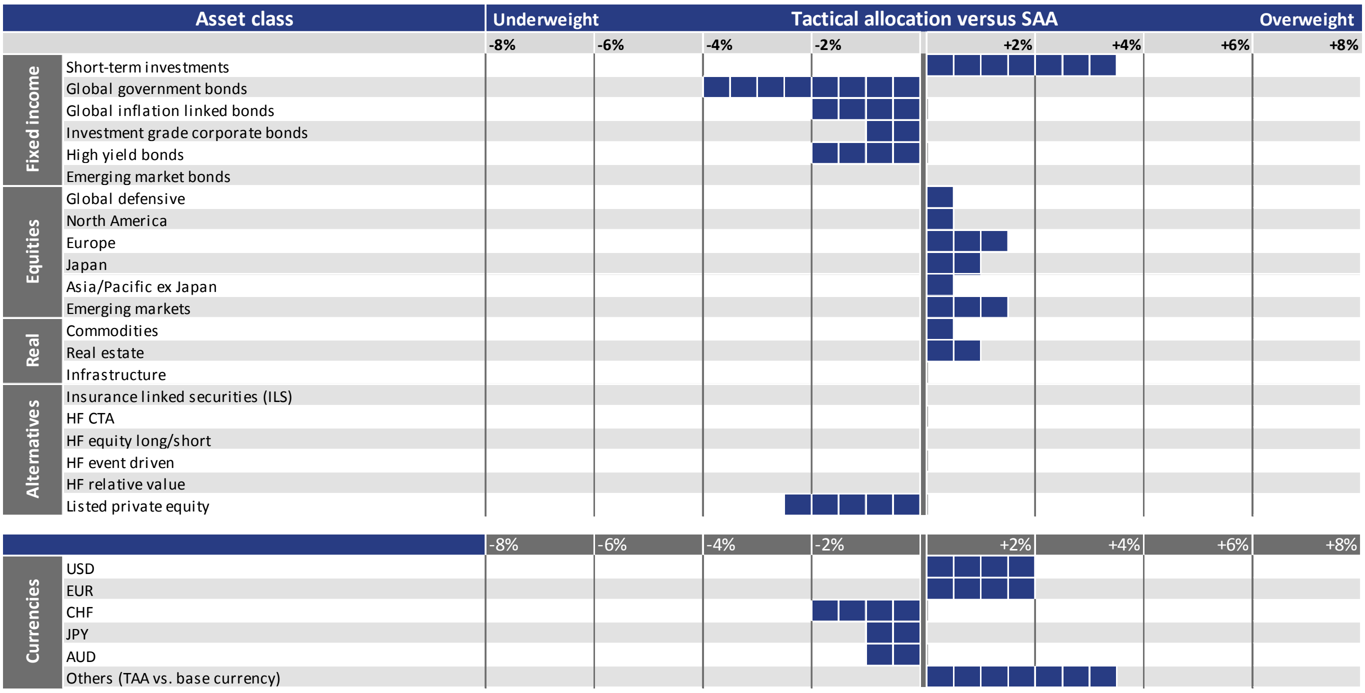
Source: LGT Capital Partners, Bloomberg

END OF REPORT

LGT Capital Partners: tactical asset allocation for a balanced model portfolio in USD

Our tactical asset allocation (TAA, positions versus neutral strategic quotas) is set every quarter with a time horizon of three to six months and reviewed monthly, as well as ad-hoc, when needed. Further action may be implemented for purely technical reasons at any time. The current TAA was last revised on Dec. 7, 2017, and adjusted ad-hoc on Feb. 6, 2018.

- **Overweight in equities, modestly titled in favor of non-US markets**
- **Keep significant underweights in fixed income and duration, with a relative preference for EM bonds**
- **Real/alternative assets: REITs and commodity producer equities preferred over listed private equity**
- **Currencies: USD preferred, except against the EUR; we have passive overweight in EM and Asian 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%	-0.8%	-1.2%	1.7%	2.9%
Global inflation linked bonds	USD	-0.8%	-0.9%	-1.1%	1.6%	0.8%
Investment grade corporate bonds	USD	-1.1%	-1.1%	-1.4%	2.2%	2.4%
High yield bonds	USD	-1.3%	0.8%	-0.4%	6.3%	5.1%
Emerging market bonds	USD	-2.0%	1.1%	-1.3%	5.2%	2.7%
Equities						
Global defensive	USD	-3.5%	0.0%	-2.4%	7.8%	10.2%
North America	USD	-4.4%	3.3%	-0.5%	9.2%	12.6%
Europe	EUR	-7.2%	-3.6%	-4.9%	4.3%	7.9%
Japan	JPY	-8.2%	-3.2%	-5.0%	6.5%	13.5%
Asia/Pacific ex. Japan	USD	-4.4%	1.7%	-0.9%	8.2%	6.1%
Emerging markets	USD	-3.6%	4.5%	0.6%	8.1%	4.2%
Real assets						
Commodities (commodity producers' equities)	USD	-10.0%	1.2%	-4.8%	0.2%	-1.0%
Real estate (real estate investment trusts, or REITs)	USD	-4.8%	-5.0%	-6.6%	1.3%	5.1%
Infrastructure (master limited partnerships, or MLPs)	USD	-6.5%	8.7%	2.1%	-8.6%	-2.3%
Alternatives						
Insurance linked securities (ILS)	USD	0.7%	3.0%	1.5%	4.3%	5.9%
HF CTA	USD	-6.6%	-3.3%	-4.1%	-2.1%	1.8%
HF equity long/short	USD	3.0%	5.4%	3.0%	7.2%	6.5%
HF event driven	USD	1.6%	3.1%	1.6%	5.6%	5.3%
HF relative value	USD	1.5%	2.4%	1.5%	4.7%	4.6%
Listed private equity	USD	-4.0%	5.0%	0.5%	9.6%	11.4%
Currencies [2]						
US dollar	USD	-0.9%	-4.2%	-2.6%	-0.2%	3.5%
Euro	EUR	0.6%	0.9%	0.7%	2.9%	1.7%
Swiss franc	CHF	3.0%	2.1%	2.1%	-0.3%	3.2%
Canadian dollar	CAD	-2.0%	-2.9%	-2.6%	-0.6%	-1.6%
Swedish krona	SEK	-0.5%	0.8%	-0.4%	1.7%	-1.9%
Japanese yen	JPY	2.8%	1.7%	2.7%	3.6%	0.2%

[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	19,362	12,526	11,938	4,884	3,652	2,565	2,081	1,469	681
- nominal, per capita 2017[1]	USD, PPP	59,495	38,322	16,624	42,659	50,206	43,620	15,500	27,900	61,360
- expected real growth for 2017	Consensus	2.3%	2.4%	6.9%	1.7%	2.5%	1.7%	1.0%	1.7%	1.0%
- expected real growth for 2018	Consensus	2.7%	2.2%	6.5%	1.3%	2.4%	1.4%	2.5%	1.9%	1.9%
- real growth in most recent quarter[2]	q/q annualized	2.6%	2.4%	6.6%	0.5%	3.2%	2.0%	0.6%	-2.3%	2.4%
Unemployment rate[3]		4.1%	8.7%	4.0%	2.8%	5.4%	4.3%	8.2%	5.1%	3.0%
Inflation, core rate (CPI)	y/y	1.5%	1.0%	1.9%	0.1%	1.5%	2.7%	2.9%	1.9%	0.5%
Purchasing manager indices (comp.)	Neutral = 50	53.8	58.8	53.7	52.8	59.0	53.5	50.7	54.8	65.3
Structural budget balance/GDP 2017	IMF	-4.4%	-0.9%	-3.8%	-4.0%	0.3%	-2.8%	-7.8%	-2.0%	0.2%
Gross government debt/GDP 2017	IMF	108%	91%	48%	240%	65%	89%	83%	17%	43%
Current account balance/GDP 2017	IMF	-2.4%	3.1%	1.4%	3.6%	8.1%	-3.6%	-1.4%	2.8%	9.9%
International currency reserves	bn USD	44	269	3,162	1,205	37	125	185	367	811
Govt bond yield 2yr[4]	p.a.	2.10%	-0.50%	3.69%	-0.15%	-0.57%	0.70%	8.10%	6.97%	-0.79%
Govt bond yield 10yr[4]	p.a.	2.82%	0.83%	4.10%	0.07%	0.75%	1.62%	8.64%	7.29%	0.19%
Main policy interest rate[5]	p.a.	1.50%	0.00%	4.35%	-0.10%	0.00%	0.50%	6.75%	7.50%	-0.75%

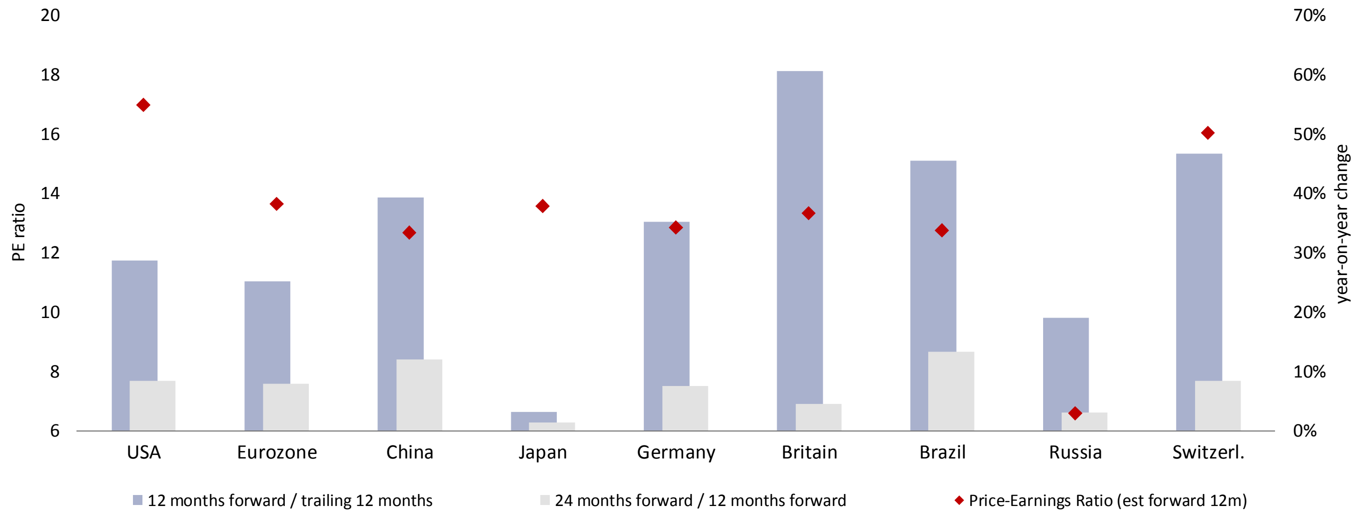
[1]IMF estimates. [2]annualized, most recent qtr. [3]PRC ex. migrant workers. [4]Currency swap rates for China and Brazil, closest ESM or EFSF bonds for Eurozone. [5]Max target rate for Fed, middle of the target range for SNB

Corporate fundamentals		USA	Eurozone	China	Japan	Germany	Britain	Brazil	Russia	Switzerl.
Exchange capitalization*	bn USD	29,472	8,385	12,743	6,318	2,408	3,662	943	624	1,709
Growth in earnings per share, estimated (MSCI)										
12 months forward / trailing 12 months	Consensus	28.8%	25.2%	39.3%	3.2%	35.2%	60.6%	45.5%	19.1%	46.7%
24 months forward / 12 months forward	Consensus	8.4%	8.0%	12.0%	1.4%	7.5%	4.6%	13.4%	3.2%	8.4%
Growth in revenue per share, estimated (MSCI)										
12 months forward / trailing 12 months	Consensus	4.8%	3.2%	12.5%	2.7%	3.3%	4.4%	7.8%	4.9%	3.3%
24 months forward / 12 months forward	Consensus	5.0%	-4.6%	-15.2%	2.1%	3.4%	-1.9%	6.1%	3.3%	2.7%
Valuation metrics (MSCI)										
Price-Earnings Ratio (est forward 12m)	Consensus	17.0	13.6	12.7	13.6	12.8	13.3	12.7	6.6	16.0
Price-Sales Ratio (est forward 12m)	Consensus	2.0	1.0	1.5	0.9	0.9	1.2	1.5	0.9	2.0
Dividend yield	Consensus	1.0%	3.4%	2.2%	2.1%	3.2%	4.5%	3.4%	6.1%	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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