Marketing material

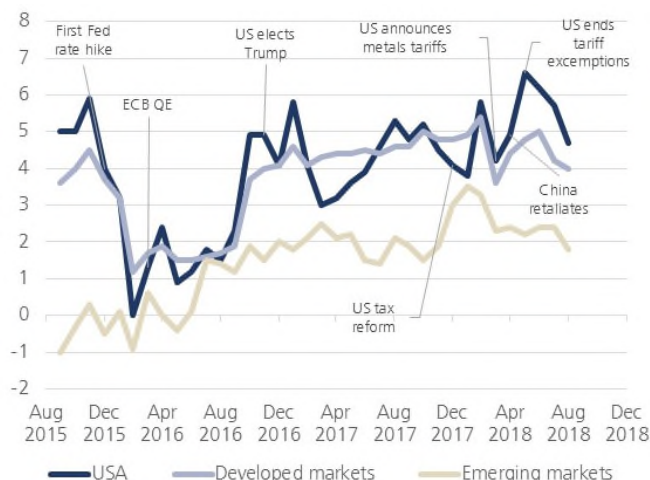
Tactical asset allocation for Q4/2018

After completing our quarterly asset allocation strategy review, this issue explains LGT Capital Partners' macro and market views, and its investment positioning. All in all, we have decided to reduce the total equity risk of the Princely Strategies to neutral, via measures that result in a shift in favor of US equities and the US dollar.

Over the past few months, the global economic picture has deteriorated slightly: the world economy is still growing at a decent pace, but peak momentum is likely behind us. This has also softened the outlook for inflation, which was never particularly strong in the first place.

- In our **base scenario**, we therefore anticipate a global growth slowdown, generally with only marginally higher inflation rates
- In our – unlikely – alternative **risk scenario**, we no longer expect a stagflationary development (i.e. an environment with less growth and more inflation). We now view a normal disinflationary downturn as a more likely outcome (less growth and less inflation). However, we consider a recession unlikely

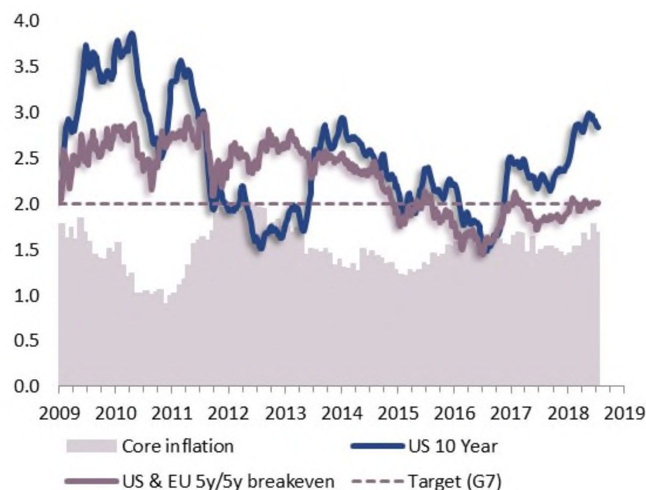
Graph 1
Purchasing Manager: the peak moment is behind us
(Markit Composite Purchasing Managers' indices)



Diffusion indices, adjusted: Values above zero signal an improvement in the business outlook, values below zero a deteriorating outlook. Source: LGT Capital Partners, Bloomberg

Although interest rates are on the rise in the US, they have recently receded back somewhat at the long end, while they remain at a relatively low level historically speaking. This signals that markets do not see the risk of an acute, let alone sustained, acceleration of inflation – which is evident in both survey- as well as market-based inflation expectations. Moreover, long-term inflation expectations, such as the five-year/five-year forward breakeven rate, are stable around or near the targeted levels (Graph 2). Admittedly, in some emerging economies, such as Argentina and Turkey, inflation is likely to increase - in the wake of the recent currency depreciations, but the overall outlook remains modest when put into a historical context.

Graph 2
Inflation and inflation expectations are broadly where they should be
(Percent per year, combined indices for the US and Europe)



Source: LGT Capital Partners, Bloomberg

Financial market valuations, with a few exceptions such as the US and Chinese technology sectors or parts of the US bond markets are generally not expensive – and in some cases remain rather low. The rise in corporate debt levels in

some sectors offers a precautionary warning, but at the same time is also a typical – and hence normal – feature of economies in their late-cycle stage and is offset by high corporate earnings growth.

The same applies to the comparatively high valuations of US equities. Firstly, these are not very high in absolutely terms. Secondly, they are justified by (very) strong corporate profit growth. However, some regional differences and issues have recently become more apparent. As a result, our constructive fundamental assessment does not anymore automatically lead to a risk-friendly positioning.

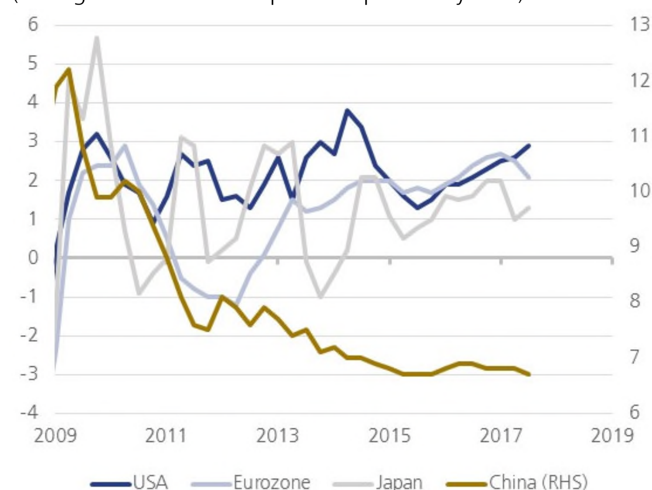
Global macro outlook: divergences become visible

While the global economy continues to expand at a decent pace, the synchronous upcycle is probably behind us and the momentum is generally fading (graph 1). The US may once again prove to be the only exception. At least in comparison to the other regions, the US economy could continue to run at full speed, acting as a global growth engine. President Donald Trump's economic policy mix (deregulation, infrastructure investments, business tax reform) is working in that respect. Even the possible political escalation of the so-called trade war has thus far failed to dim the sentiment of American entrepreneurs and consumers, as recent polls and market developments highlight.

Graph 3

Growth: global divergences

(Change in real GDP compared to previous year *)



GDP = gross domestic product. Source: LGT Capital Partners, Bloomberg

Nevertheless, the global synchronous upswing has started to stutter somewhat (chart 3). Economic growth is cooling off in the eurozone and has lost momentum in Japan (which was recently also hit by natural disasters). Most notably, the outlook for some emerging markets (EM) has deteriorated more markedly following the recent currency markets turbulences.

The partially significant currency devaluations increase the debt burden of EM borrowers, while driving domestic interest rates higher. In China, too, the recent upturn is ebbing away, and the growth rate has returned to its gradual downward trajectory. The trade conflict with the US and stock market losses of more than twenty percent since January are further weighing on the Chinese outlook. The markets have responded accordingly to these globally increasing divergences. Although the bull market remains intact for now, the various potential risk issues have made market participants more uncertain, and increased the markets' news sensitivity.

Five potential risks were reviewed

In this context, we identified topics that will influence markets in the next three to six months. Three of these we deemed as minor, i.e. they need to be monitored but have only minor or marginal tactical allocation consequences (they may be addressed with the ongoing portfolio management by our various asset class teams):

- US midterm elections in November
- Italian-EU relationship (Quitaly)
- Approaching British exit from the EU

However, two topics are potentially more impactful, and required changes in our tactical asset allocation:

- The ongoing trade conflict, or "trade war" (a term that we deem as overblown at this point)
- Potential contagion of the emerging market crises

Specifically, we assess these five topics as follows:

US midterm elections: limited impact

The market is rightly largely ignoring this theme at present. If the polls are right and the Democrats win the majority in the House of Representatives, short-term heightened political uncertainty and associated turmoil can be expected, but this does not necessarily mean the end of the US bull market. Some market participants argue that the resulting deadlock might even be positive for markets, as it was in the late 1990s and the 2010s (with Democrats as Presidents and Republican majorities in the House).

Our assessment of the likely market responses:

- Negative impact on US stocks possible, but not very likely; in fact, US equities could continue to outperform and even exaggerate on the upside, as investors pile into the positive momentum trade

Will Italy trigger a new euro crisis?

The market will probably overestimate this risk at times, as Italy's populist government is likely to continue to display a reduced willingness to implement market reforms, maintain budget discipline, and to politically confront the European Union (EU). The budget negotiations will create uncertainty.

In a worst-case scenario, the European Central Bank could act as a market stabilizer of last resort.

Our assessment of the likely market responses:

- Temporarily negative for European equities, bonds (esp. Italian) and the euro (EUR); supportive for the US dollar (USD), Swiss franc (CHF) and the Japanese yen (JPY)

Hardening Brexit outlook

Investors seem to underestimate the potential repercussions of the United Kingdom's (UK) exit from the EU (Brexit). While associated risks are reflected in the thirty-year low of the British pound (GBP) against the USD, UK equities and real estate prices have held up well so far. However, uncertainties could continue to weigh on investors' sentiment as we head toward Brexit day on March 29, 2019, hurting capital expenditures in the UK, while rising import prices undermine domestic consumption. These known risk factors could thus yet lead to larger market distortions, especially in the case of a "hard" Brexit (i.e. an exit without an agreement that spells out continuities and/or clarifies transitional rules).

Our assessment of the likely market responses:

- Negative for the GBP and partly for UK equities

Trade conflicts: a headwind for the medium-term

The trade issues will persist in the medium-term, with tensions receding only temporarily on occasion. However, most investors have thus far treated the issue as a transitory phenomenon – a view that is particularly evident in the US markets. Indeed, real trade flows have so far admittedly not been appreciably affected by the protectionist announcements and rhetoric, thanks to the robust economic expansion.

In our opinion, however, the risk of a disruptive trade war is liable to weigh on markets over the medium-term. The new tariffs and retaliatory measures are likely to have a creeping effect on real activity, especially as they could gradually come into force at a time when the world economy is already decelerating.

Furthermore, while US trade policy primarily focusses on rebalancing its trade relations with China, recent tensions with Turkey have shown that trade warfare can hurt even traditional US allies – including those that have benefited from geopolitically-motivated US support for decades. Such strategic assumptions seem less certain these days.

With sentiment towards the EM more fragile at present, there is a risk of market dislocations spreading further. President Trump's personality and his insistence on achieving his stated political and economic goals can lead to erratic and unpredictable actions and statements, which does not help either. All in all, trade warfare will remain a risk factor in the medium term in our view.

Our assessment of the likely market responses:

- Negative for EM assets; a reduced exposure seems warranted from a risk management perspective
- Positive for US dollar (USD) and US stocks, perhaps generally supportive for developed market assets

Currency crises: contagion to other emerging markets possible

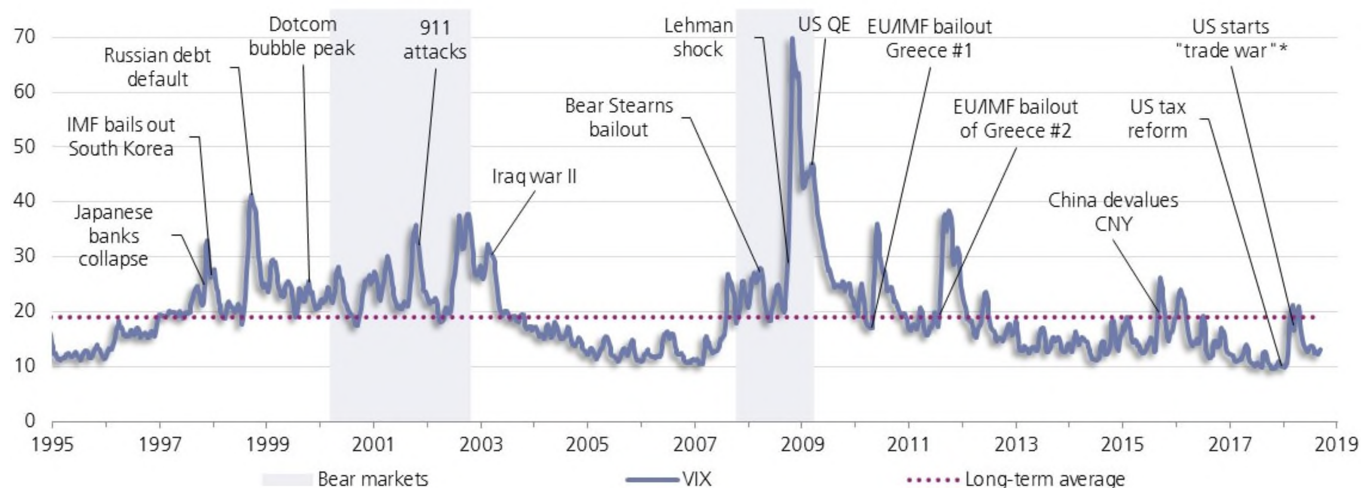
The market has rightly priced contagion risks. The strong USD, rising US interest rates, and the rise in oil prices are weighing on the twin deficit countries and energy importers, as well as EM debtors with high refinancing needs in hard currencies. In combination with the geopolitical confrontations and trade conflicts, conditions for some EM could become even more challenging going forward.

These issues have already hit some of the structurally weak countries with a high level of home-made problems (esp. Argentina, Brazil, India, Indonesia, South Africa, and Turkey).

Graph 5

Potential trade war: don't worry about it?

(Chicago Board Options Exchange S&P 500 Volatility Index)



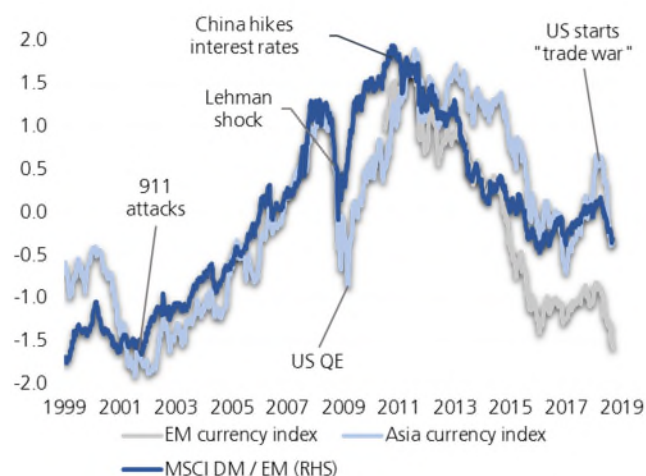
Source: Bloomberg, LGT Capital Partners

This regional risk must be taken into account in the asset allocation. However, there is a timing issue. Selling EM right now could prove too pro-cyclical so any sales of EM assets should be considered carefully - much has already happened in the market. EM currency trends and the relative performance of EM markets go hand in hand in equities (and to lesser extend in EM bonds) and the J.P. Morgan EM Currency Index has already fallen to an extreme low, deviating by approximately two standard deviations from its average (graph 5).

Graph 5

Emerging market equities and currencies

(Standard deviation from index average)



EM: J.P. Morgan Emerging Markets Currency Index, composed of Turkish lira, Russian ruble, Hungarian forint and South African rand, each weighing 8.3%, as well as Brazilian real, Mexican and Columbian pesos, Chinese yuan, Indian rupee and Singaporean dollar, with 11.1% each. Asia: J.P. Morgan Asia Dollar Index, consisting of Chinese yuan (41.8%), Korean won (12.5%), Hong Kong dollar (10.2%), Indian rupee (7.35%) and Indonesian rupee (4.9%). Source: LGT Capital Partners, Bloomberg

Our assessment of the likely market responses:

- Negative for EM assets (equities, bonds, currencies) and gold, positive for USD and other hard currencies, US equities and high-quality debt

Positioning: equity risk neutralization

Against this background, LGT Capital Partners' strategy team decided to reduce EM positions and neutralize the overall equity risk exposure (i.e. including alternative investments) of the Princely Strategies.

Fixed income:

- Reduce overweight in EM debt as a risk management measure. Fundamentally, we continue to find EM debt attractive (very low currency valuations, high yield pickup, or "carry"). We also do not want to reduce the quota too much at this point, as we see signs that in the short-term the market participants already priced enough negativity in. There is potential for stabilization

- The proceeds from the sale are redirected into investment grade credit bonds to lock in somewhat higher spreads in Europe and put some of our excess cash to work

Overall, bonds remain underweight, albeit marginally less than before. Portfolio duration also remains below average, to take into account the risk of rising interest rates.

Equities:

- We are selling some of our positions in the EM and in Asia-Pacific ex Japan. The total equity risk of our strategies is thus reduced to about neutral (that is, including the equity risk contained in our alternative assets segment)

As result of the above sales, the US and Japan are now the only markets on overweight. Europe and the emerging economies are kept at broadly neutral positions, while Asia-Pacific ex. Japan is now slightly underweight. Finally, we have maintained our preference for global defensive equity strategies.

Alternative investments:

- We buy Listed Private Equity (LPE) to reduce our underweight. This is a measure taken as part of a discussion of our strategic asset allocation (SAA)

Going forward, we intend to hold all alternative asset classes at their strategic (i.e. neutral) quotas as a matter of principle. After all, the inclusion of alternative investments is primarily meant to generate strategic, rather than tactical, diversification benefits. Consequently, given that our LPE position remains underweight even after the above purchase, we plan to conduct more purchases in the coming months.

Currencies:

- We open long positions in USD and short positions in GBP and Australian dollar (AUD)

The strength of the US economy, the resulting monetary tightening, and the fact that it is considered a safe haven in uncertain times favor the USD. On the short side, the GBP should remain weak as long as there is no credible prospect for a soft Brexit (i.e. an orderly exit agreement, with as few unknowns as possible). The current political uncertainty keeps many foreign investors away, while the Bank of England seems reluctant to raise interest rates further. The AUD, meanwhile, is often viewed as proxy for Chinese growth - which is not advantageous when growth is slowing on the heels of the trade disputes and the ongoing leverage cleanup in the domestic banking system. In addition, the Reserve Bank of Australia has also recently lowered its rate outlook.

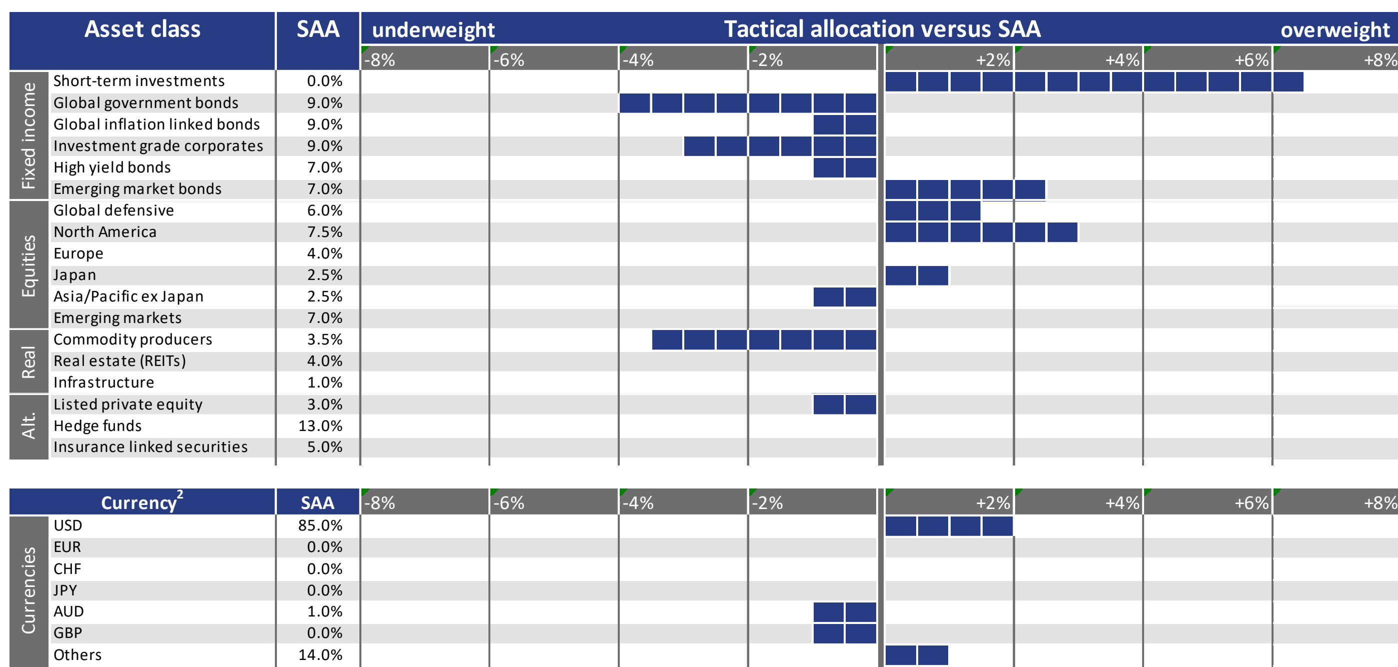
Overall, EM currencies continue to be passively overweight, albeit to a lesser degree than last quarter. This is due to our active position in EM debt. The overall tactical positioning of the Princely Strategies of LGT Capital Partners is shown in the graph on the next page.

END OF REPORT

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

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

- **Total equity risk was reduced to broadly neutral in September (sales of EM and Asia-Pacific equities)**
- **Fixed income allocation remains largely unchanged after a reduction of EM debt in favor of IG credit**
- **We are long USD versus the AUD and GBP; the EM asset sales have trimmed our 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	-0.3%	0.7%	0.3%	2.3%	3.4%
Global inflation linked bonds	USD	-0.2%	0.8%	1.2%	2.6%	2.2%
Investment grade corporate bonds	USD	-0.2%	0.9%	-0.9%	2.3%	2.9%
High yield bonds	USD	0.3%	0.5%	-0.4%	6.4%	4.9%
Emerging market bonds	USD	-1.6%	-2.1%	-7.0%	4.4%	3.3%
Equities						
Global defensive	USD	1.7%	3.7%	4.3%	11.5%	10.1%
North America	USD	1.8%	3.7%	8.4%	14.9%	12.2%
Europe	EUR	-2.8%	-2.9%	-1.5%	7.1%	6.7%
Japan	JPY	-0.9%	-4.0%	-4.8%	5.9%	8.5%
Asia/Pacific ex. Japan	USD	-5.0%	-10.4%	-8.9%	11.4%	4.9%
Emerging markets	USD	-5.4%	-11.0%	-11.7%	10.2%	2.6%
Real assets						
Commodities (commodity producers' equities)	USD	-3.2%	-8.0%	-1.3%	11.7%	-0.2%
Real estate (real estate investment trusts, or REITs)	USD	0.6%	0.9%	1.4%	8.1%	6.8%
Infrastructure (master limited partnerships, or MLPs)	USD	-2.6%	5.2%	8.9%	2.0%	-1.9%
Alternatives						
Insurance linked securities (ILS)	USD	0.3%	0.9%	4.3%	4.2%	5.1%
HF CTA	USD	0.1%	1.5%	-4.0%	-1.2%	2.4%
HF equity long/short	USD	0.8%	0.6%	2.6%	7.0%	5.9%
HF event driven	USD	0.2%	1.1%	2.6%	5.9%	4.6%
HF relative value	USD	0.0%	0.9%	2.7%	4.7%	4.5%
Listed private equity	USD	0.8%	2.3%	4.5%	11.4%	9.7%
Currencies [2]						
US dollar	USD	-0.4%	2.9%	4.7%	0.8%	4.3%
Euro	EUR	1.3%	1.4%	0.7%	1.6%	1.2%
Swiss franc	CHF	2.0%	4.4%	4.8%	0.6%	3.3%
British pound	GBP	1.8%	-0.2%	0.4%	-5.4%	-0.1%
Australian dollar	AUD	-3.4%	-4.2%	-5.7%	0.8%	-1.7%
Japanese yen	JPY	-1.1%	1.7%	5.9%	3.7%	1.7%

[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	19,391	12,607	12,015	4,872	3,685	2,625	2,055	1,527	679
- nominal, per capita 2017[1]	USD, PPP	59,501	38,322	16,660	42,832	50,425	44,118	15,603	27,834	61,422
- 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%	2.1%	6.6%	1.0%	2.0%	1.3%	1.7%	1.8%	2.2%
- 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]		3.9%	8.2%	3.8%	2.5%	5.2%	4.0%	8.2%	4.7%	2.6%
Inflation, core rate (CPI)	y/y	2.0%	1.0%	2.0%	0.0%	1.4%	1.9%	4.2%	2.6%	0.5%
Purchasing manager indices (comp.)	Neutral = 50	54.7	54.5	52.0	52.0	55.6	54.2	47.8	52.1	64.8
Structural budget balance/GDP 2017	IMF	-4.6%	-0.6%	-4.0%	-4.0%	0.9%	-2.3%	-6.4%	-1.4%	0.2%
Gross government debt/GDP 2017	IMF	108%	87%	48%	236%	64%	87%	84%	17%	43%
Current account balance/GDP 2017	IMF	-2.4%	3.5%	1.4%	4.0%	8.0%	-4.1%	-0.5%	2.6%	9.3%
International currency reserves	bn USD	42	279	3,110	1,199	37	127	185	383	804
Govt bond yield 2yr[4]	p.a.	2.72%	-0.48%	2.99%	-0.11%	-0.54%	0.78%	9.39%	9.78%	-0.72%
Govt bond yield 10yr[4]	p.a.	2.95%	0.62%	3.51%	0.11%	0.42%	1.49%	10.23%	9.91%	-0.04%
Main policy interest rate[5]	p.a.	2.00%	0.00%	4.35%	-0.10%	0.00%	0.75%	6.50%	7.25%	-0.75%

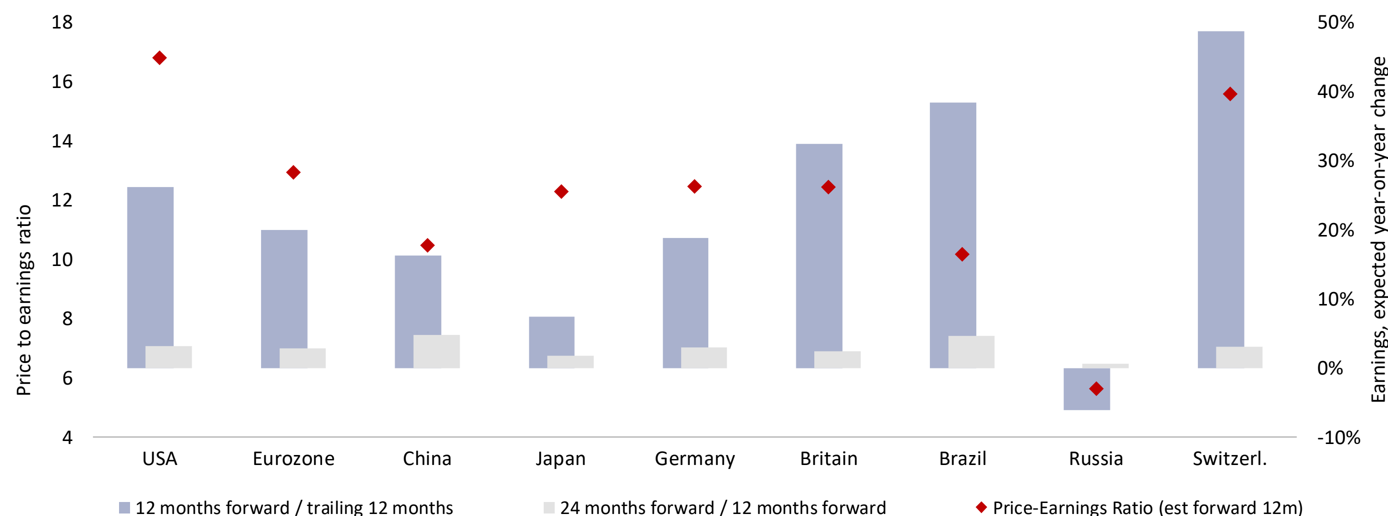
[1]IMF estimates. [2]annualized, most recent qtr. [3]PRC ex. migrant workers. [4]Currency swap rates for China and Brazil, closest ESM or EFSF bonds for Eurozone. [5]Max target rate for Fed, middle of the target range for SNB

Corporate fundamentals		USA	Eurozone	China	Japan	Germany	Britain	Brazil	Russia	Switzerl.
Exchange capitalization*	bn USD	31,738	7,791	10,738	5,979	2,237	3,491	720	539	1,595
Growth in earnings per share, estimated (MSCI)										
12 months forward / trailing 12 months	Consensus	26.1%	20.0%	16.2%	7.5%	18.8%	32.4%	38.3%	-6.0%	48.7%
24 months forward / 12 months forward	Consensus	3.2%	2.9%	4.8%	1.8%	3.0%	2.4%	4.7%	0.6%	3.0%
Growth in revenue per share, estimated (MSCI)										
12 months forward / trailing 12 months	Consensus	5.1%	3.9%	12.8%	2.7%	4.5%	2.8%	6.2%	1.3%	4.5%
24 months forward / 12 months forward	Consensus	4.7%	3.1%	10.1%	2.7%	3.8%	0.2%	5.2%	4.2%	2.2%
Valuation metrics (MSCI)										
Price-Earnings Ratio (est forward 12m)	Consensus	16.8	12.9	10.5	12.3	12.5	12.4	10.2	5.6	15.6
Price-Sales Ratio (est forward 12m)	Consensus	2.1	1.0	1.2	0.8	0.9	1.1	1.3	0.8	2.0
Dividend yield	Consensus	1.0%	3.5%	2.5%	2.3%	3.2%	4.6%	4.0%	6.9%	3.4%

*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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