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LGT Beacon
Global macro and market review

December 13, 2018

Marketing material

Tactical asset allocation for Q1/2019

The occasional surges in interest rate angst and the US-Chinese trade dispute are weighing on markets, even as most economies continue to grow at a decent pace and the US Federal Reserve is softening its tightening talk. We do see room for a rebound in risk appetite in the near term, but adopt a neutral overall stance on risky assets for now.

Last week, we concluded the quarterly tactical asset allocation (TAA) review for the first quarter of 2019. In a nutshell, LGT Capital Partners' macro and market assessment for the next three to six months has changed little from September: we remain reasonably constructive on the global economy - and even see room for a rebound in risk appetite, particularly in the beaten-down emerging market (EM) assets.

In our **baseline scenario**, the global economy keeps growing, albeit at a slower pace than in the most recent quarters (graph 1). Meanwhile, inflation expectations, which have moderated somewhat recently (graph 2, next page), remain broadly on target in most regions, as actual price pressures are building up very timidly – hence allowing central banks to err on the dovish side.

In our less likely **risk scenario**, the current late cyclical slowdown becomes more pronounced, owing to the rising interest rates and the disruptive impact of the trade disputes. However, a global recession in the near future remains a very remote possibility in our view.

Structural factors are liable to weigh on markets for longer

In addition, we also continue to view the rise in economic nationalism and the ongoing trade disputes as a **negative structural factor** - i.e. one that potentially generates lasting headwinds. This seems to be particularly true with regard to the geopolitically motivated Sino-American confrontation, despite the recent relief rallies brought about by signs of a détente in their so-called trade war. At the same time, while positive political surprises or breakthroughs are hard to predict, we acknowledge that they cannot be excluded either.

Against this background, our overall TAA stance consists of a neutral position in equities, an underweight in bond duration and credit, and ample cash reserves. For now, positive deviations from the neutral quota are limited to the US dollar, the Norwegian krone, gold and EM local-currency debt.

Graph 1
Global growth has been holding up well
(Year-on-year change %; forecasts in dotted lines)

The regional indices are weighted by each country's nominal gross domestic product (GDP). Forecasts are consensus estimates compiled by Bloomberg. Source: LGT Capital Partners, Bloomberg

Economic growth is slowing as politics become less predictable

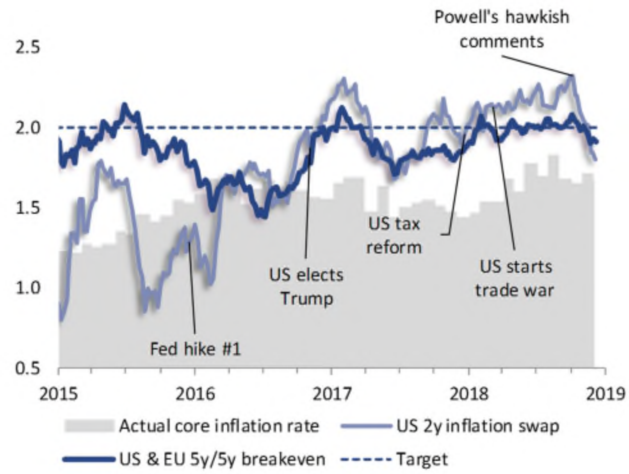
Economic growth has moderated further recently, although it is still likely to remain sufficiently strong going forward. In the EM, particularly in China, the loss of momentum may even have started to bottom, as the purchasing managers' surveys tentatively suggest (graph 3, next page).

At the same time, rising US interest rates and the escalating trade disputes are clearly weighing on business sentiment and making markets nervous, while many unsolved issues remain on a regional level, ranging from the populist Italian government's budget plans to the United Kingdom's (UK) painful divorce from the European Union (EU), or the plentiful governance issues in some developing nations.

Graph 2

Inflation expectations have moderated

(Future inflation rates implied by interest rate markets)

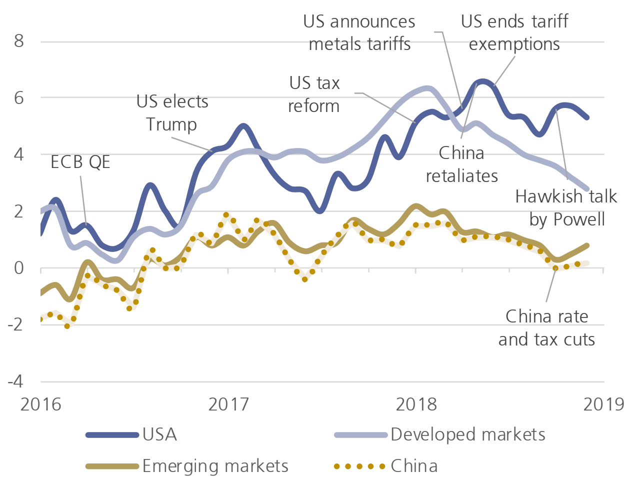


The USD inflation swap zero coupon rate is used as a proxy for the annual inflation rate two years from today. The US and EU 5 year / 5 year forward breakeven rate index is a weighted index of the corresponding instruments for the US, UK, and Germany. The 5 year / 5 year forward breakeven rate represents the implied five-year forward inflation rate five years from today, i.e. long-term inflation expectations. Source: LGT Capital Partners, Bloomberg

Graph 3

Global PMIs point to slower but sufficient growth

(Balance/diffusion indices; growth threshold at zero)



PMI = Purchasing Managers' Indices for the manufacturing industries, as surveyed by IHS Markit and its various international partners. Source: LGT Capital Partners, Bloomberg

Fed policy rhetoric becomes less hawkish

On the other hand, some of these negative factors may have started to abate somewhat. Most importantly, the US Federal Reserve has recently signaled that it could slow down the pace of policy tightening going forward, giving a nod to market concerns.

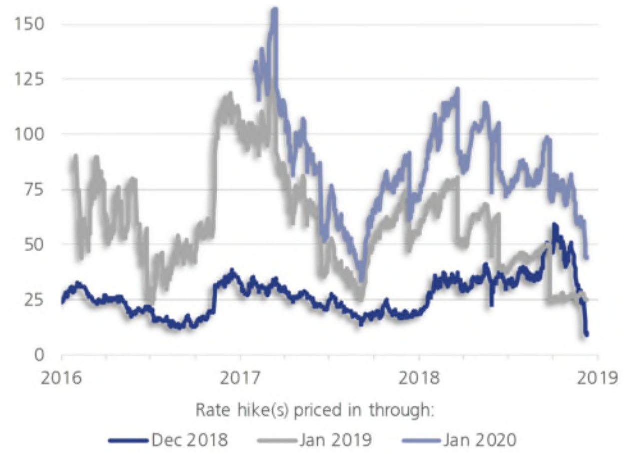
In fact, based on traded interest rate instruments, the probability of future US interest rates hikes has generally tumbled since Fed Chairman Jerome Powell signaled a less hawkish stance in a speech at the New York Economic Club on November 28, 2019.

In fact, the US interest rates futures now price only two interest rate increases over the course of 2019, and have even started to price out the hike for December 19 of this year - which was universally expected until recently (graph 4). Arguably, the surge in the rate hike pricing from August to October may have contributed to the interest rate angst that had eventually spooked investors. Conversely, the current de-escalation of these expectations should help calm markets in due time. The actual Fed decision later this month could thus prove very interesting.

Graph 4

Markets price in slower pace of Fed rate hikes

(Implied change in the Fed funds rate in basis points)



The indices are based on the spread of short-term Eurodollar interest rate futures contracts for this month's possible hike and on Fed funds futures pricing for hikes further out. Source: LGT Capital Partners, Bloomberg

The US-Chinese trade war, meanwhile, could bring more short-term pain – in particular as far as the geopolitically and ideologically motivated part of the Sino-American confrontation is concerned. On the other hand, at least in purely economic terms, Washington and Beijing may be getting closer to a workable economic arrangement that could help restore market sentiment – at least if the recent statements of Presidents Donald Trump and Xi Jinping are taken at face value.

Room for a rebound in EM assets

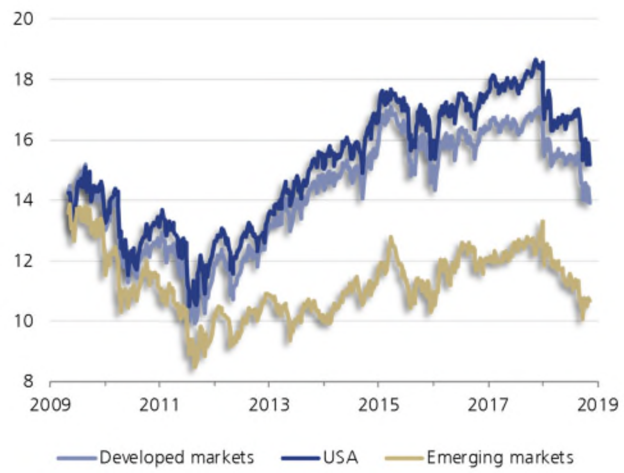
In our view, the global market turmoil that began in early October reflected a repricing of risky assets to accommodate the prospect of persistently higher interest rates in general (as higher future discount rates reduce the current value of cash-generating financial assets).

Secondly, the selloff was also exacerbated by a wash out of crowded positions in certain segments, e.g. in the US technology sector. Lastly, the trade war has already repriced EM assets by a meaningful degree, making a rebound from current levels more likely in our view. In fact, EM stock market valuations have reached levels last seen after the commodity price collapses of 2014/2015 (graph 5), while real interest rate differentials to developed markets are high and EM currencies attractively valued.

We take account of these pro-EM factors primarily by maintaining the tactical positions in EM local currency debt (overweight) and EM equities (neutral), and by shifting our Asian position from Japan to the rest of Asia-Pacific region, which tends to move in lockstep with EM equities (see further below).

Graph 5

Valuations reflect a high degree of investor caution
(Price-earnings-ratios, MSCI stock market indices)



Price to estimated forward 12 month earnings per share. Source: LGT Capital Partners, Bloomberg

Equities: neutralizing regional differences

We are refraining from any regional differentiation in equities and keep regions at neutral for now. However, that means we are shifting away from Japan (reduced from overweight) toward the broader Asia-Pacific region (increase from underweight). Together with the EM, the latter had been sold off most since the start of the so-called trade war (graph 6).

Graph 6

Equity markets in EM and Asia suffered most this year
(MSCI indices, rebased to 100 per March 9, 2018*)

*US announcement of tariffs on metals imports. Source: LGT Capital Partners, Bloomberg

Fixed income: no tactical changes

The overall tactical positioning in **fixed income** is maintained, with government bonds of developed markets, investment grade credit (IG) and high yield bonds (HY) kept at more or less significant underweight versus the strategic quota. At the same, we retain a clear **preference for EM bonds** on the back of attractive yields and undervalued EM currencies.

Alternatives and real assets: long gold position opened

Positions in **liquid alternatives and real assets** also remain unchanged, with one exception: **we opened a new, off-benchmark long position in gold.**

Graph 7

Gold: new long position opened
(Closing prices in USD per ounce)

Source: LGT Capital Partners, Bloomberg

In the long-term picture, the precious metal has been trading in a broad sideways range for the past five years. On a shorter time horizon, however, it has started to move off a base built during the last three months, with fundamental support coming from the recently more dovish tone of the Fed, healthy physical demand, and large net speculative short positions as a potential contrarian signal.

Beyond this, the precious metal may become a more popular investment again if higher inflation rates materialize going forward. The rising equity/bond market correlation could also increase its attractiveness as an alternative portfolio diversifier among investors. For now, our position is primarily motivated by aforementioned technical and behavioral finance considerations.

Currencies: selected G10 trades in favor of the NOK and USD

In currencies, **we open a long position in the Norwegian krone (NOK) and a short position in the euro (EUR).** The Norges Bank has commenced a monetary tightening cycle and we expect it to continue raising policy rates gradually as the economy is doing well and the country's external position remains robust. The gyrations of spot oil prices have had only a weak effect on Norway's currency as the country is a low cost producer and boasts ample reserves in state finances to cushion weaker oil prices.

Graph 8

NOK is well positioned for a rally

(Price of one euro in Norwegian krone)

Source: LGT Capital Partners, Bloomberg

As for the euro area, leading indicators suggest a continuation of the cyclical dent in economic growth. Add to that the woes resulting from the proposed Italian budget and the highly uncertain Brexit proceedings, and the outlook for the common currency remains murky at present. In addition, carry interest can be earned from moving out of EUR (and the CHF) into most other major currencies (known as G10).

Lastly, we keep (a slightly more pronounced) **short position in the Australian dollar (AUD) against a long US dollar (USD) position.** The AUD is sensitive to global growth in general and the Chinese economy in particular. Thus, the recent global slowdown and its own weak domestic GDP figures weigh on the currency and put the Reserve Bank of Australia on hold in terms of interest rate hikes – we hence used the most recent counter-rally to sell more AUD.
The USD, meanwhile, remains the most attractive carry destination among the G10 currencies (i.e. the currencies of the ten largest developed markets) and we therefore opt to hedge a bit less of our exposure in the Greenback.

We might add that our CHF and EUR denominated portfolios now hold very high outright USD exposures and thus continue to profit from the significant interest rate differential.

Graph 9

AUD is still headed lower against the USD

(Price of one AUD in US dollar)

Source: LGT Capital Partners, Bloomberg

Last but not least, the **passive overweight in EM currencies** reduces the weight of the denomination currency of each portfolio, i.e. the USD in the case of the model portfolio referenced in this report.

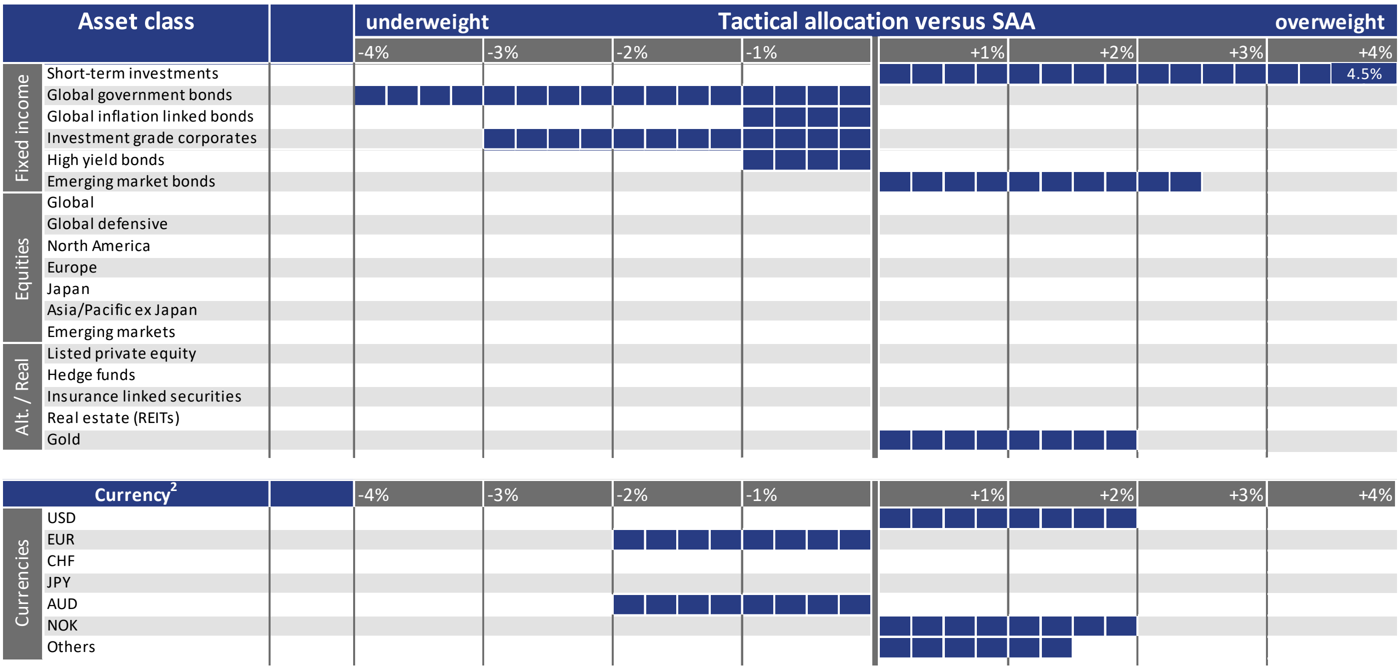
Concluding, it is worth noting that in a separate decision-making process, our investment committee has recently approved some changes in the strategic asset allocation (SAA) - i.e. our benchmark neutral quotas. These changes will become effective on January 1, 2019. Investors will be informed accordingly.

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 December 7, 2018.

- **All equities region are now at neutral; regional differentiation ends after a shift from Japan to the rest of Asia**
- **Fixed income allocation remains underweight duration and credit risk, with a clear preference for EM debt**
- **Long positions in USD and NOK versus the AUD and the EUR; EM currencies remain a passive overweight**
- **Cash reserves at very high levels amid increased market volatility; long position in gold**



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	1.8%	1.3%	1.6%	2.4%	3.3%
Global inflation linked bonds	USD	0.6%	0.3%	1.6%	2.7%	2.0%
Investment grade corporate bonds	USD	0.3%	-0.2%	-1.0%	2.1%	2.4%
High yield bonds	USD	-1.5%	-2.3%	-2.5%	7.1%	3.5%
Emerging market bonds	USD	0.2%	0.9%	-5.7%	5.0%	3.1%
Equities						
Global	USD	-3.5%	-8.0%	-3.6%	8.3%	7.9%
Global defensive	USD	-0.9%	-3.1%	1.5%	9.3%	9.0%
North America	USD	-3.1%	-8.7%	-1.0%	10.7%	9.1%
Europe	EUR	-3.9%	-7.7%	-8.7%	4.6%	5.1%
Japan	JPY	-5.5%	-5.9%	-10.7%	1.9%	6.0%
Asia/Pacific ex. Japan	USD	-0.7%	-5.7%	-14.0%	9.1%	3.6%
Emerging markets	USD	-0.1%	-3.7%	-14.9%	10.2%	1.8%
Alternative and real assets						
Listed private equity	USD	-7.2%	-15.1%	-10.8%	7.6%	
Hedge funds	USD	-2.1%	-2.8%	-2.1%	2.6%	2.4%
Insurance linked securities (ILS)	USD	-1.6%	-1.7%	2.5%	3.3%	4.2%
Real estate (real estate investment trusts, or REITs)	USD					
Gold	USD	3.6%	3.1%	-4.5%	5.0%	0.3%
Currencies (G10) [2]						
US dollar	USD	-0.1%	1.7%	5.9%	0.6%	
Euro	EUR	0.9%	-1.2%	-0.7%	1.7%	0.1%
Swiss franc	CHF	1.9%	-0.8%	3.7%	0.2%	2.0%
British pound	GBP	-2.9%	-2.7%	-2.6%	-6.4%	-1.5%
Japanese yen	JPY	0.2%	-0.5%	5.1%	3.0%	2.4%
Norwegian krone	NOK	-1.0%	-2.5%	0.7%	1.1%	-2.8%
Swedish krona	SEK	0.1%	-0.1%	-6.2%	-2.0%	-2.7%
Australian dollar	AUD	0.4%	2.3%	-3.1%	0.7%	-0.3%
Canadian dollar	CAD	-1.2%	-1.5%	-1.1%	1.7%	-0.6%
New Zealand dollar	NZD	2.3%	6.8%	1.9%	1.4%	0.3%

[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	20,513	13,738	13,457	5,071	4,029	2,809	1,909	1,576	709
- nominal, per capita 2018[1]	USD, PPP	62,518	39,614	18,120	44,550	52,897	45,643	16,112	29,032	64,988
- expected real growth for 2018	Consensus	2.9%	1.9%	6.6%	1.0%	1.7%	1.3%	1.3%	1.7%	2.9%
- expected real growth for 2019	Consensus	2.6%	1.6%	6.2%	1.0%	1.6%	1.5%	2.4%	1.5%	1.7%
- real growth in most recent quarter[2]	q/q annualized	3.5%	0.8%	6.6%	-2.5%	-0.8%	2.4%	3.2%	-2.3%	-0.8%
Unemployment rate[3]		3.7%	8.1%	3.8%	2.4%	5.0%	4.1%	8.2%	4.7%	2.4%
Inflation, core rate (CPI)	y/y	1.8%	1.0%	1.8%	0.2%	1.7%	1.9%	4.1%	3.4%	0.2%
Purchasing manager indices (comp.)	Neutral = 50	54.7	52.7	51.9	52.4	52.3	50.7	51.6	55.0	57.7
Structural budget balance/GDP 2018	IMF	-5.1%	-0.7%	-4.2%	-3.7%	1.0%	-2.0%	-7.3%	1.6%	0.3%
Gross government debt/GDP 2018	IMF	106%	84%	50%	238%	60%	87%	88%	15%	40%
Current account balance/GDP 2018	IMF	-2.5%	3.0%	0.7%	3.6%	8.1%	-3.5%	-1.3%	6.2%	10.2%
International currency reserves	bn USD	41	281	3,062	1,198	37	135	185	379	794
Govt bond yield 2yr[4]	p.a.	2.77%	-0.58%	2.78%	-0.14%	-0.60%	0.68%	7.75%	9.40%	-0.74%
Govt bond yield 10yr[4]	p.a.	2.88%	0.58%	3.29%	0.06%	0.23%	1.18%	8.49%	9.05%	-0.15%
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	28,540	6,846	10,512	5,466	1,969	3,027	833	580	1,485
Growth in earnings per share, estimated (MSCI)										
12 months forward / trailing 12 months	Consensus	19.9%	18.2%	13.4%	4.0%	10.3%	40.8%	57.3%	-4.7%	44.6%
24 months forward / 12 months forward	Consensus	1.8%	0.8%	1.1%	1.0%	1.4%	0.9%	1.0%	0.0%	0.5%
Growth in revenue per share, estimated (MSCI)										
12 months forward / trailing 12 months	Consensus	5.5%	3.9%	11.9%	3.2%	4.5%	2.9%	7.0%	2.7%	3.9%
24 months forward / 12 months forward	Consensus	4.7%	3.2%	11.0%	2.6%	4.1%	1.4%	6.1%	3.8%	1.7%
Valuation metrics (MSCI)										
Price-Earnings Ratio (est forward 12m)	Consensus	15.2	11.6	10.4	11.6	11.1	11.1	10.7	5.4	15.0
Price-Sales Ratio (est forward 12m)	Consensus	1.9	0.9	1.2	0.8	0.8	1.0	1.4	0.7	1.9
Dividend yield	Consensus	1.0%	3.8%	2.6%	2.5%	3.6%	5.0%	3.6%	6.7%	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)