LGT Beacon
Global macro and market review

October 18, 2018

Marketing material

Countercyclical opportunity: buy the dip in equities

Fear of further increases in US interest rates and some other looming anxieties culminated in a major equity selloff early this month. However, the broader markets' signals were more constructive: yield curves steepened, breakeven rates ticked up, credit spreads narrowed, and emerging markets assets stabilized; so we decided to buy the dip in equities.

Our overall assessment for the coming months has not changed: we are constructive on the world economy, while acknowledging a number risks (cyclical loss of momentum, impact of monetary tightening, the so-called trade war, etc.). In asset allocation terms, this still translates into:

- Only a small overall overweight in equities, currently favoring defensive global strategies, the US and Japan
- A big underweight in fixed income, with a rather short portfolio duration, tilted in favor of the emerging markets (EM), global inflation-linked bonds (GILB), high yield credit (HY), and investment grade corporate debt (IG) – in that order of preference
- A generally high and stable strategic allocation (SAA) to the broader alternative classes (i.e. infrastructure, real estate, private equity, hedge funds, and insurance-linked strategies); the only exception is commodity producers' equity, which we recently removed from our SAA
- An active preference for the US dollar due to the favorable growth momentum of the US economy and the resulting monetary policy outlook, combined with a passive overweight in EM currencies; the latter results from our positions in EM equity and debt
- Maintenance of high cash reserves for increased flexibility in volatile markets

Ad-hoc investment decisions

That being said, following the recent selloff in global equities and the turbulences in the Italian bond market, LGT Capital Partners (LGTCP) took some ad-hoc tactical decisions last Friday.

- We **counter-cyclically** redeploy some or our excess cash to **modestly increase our overall equity risk** following the sharp selloff
- We implement this by (a) **rebalancing all equity regions** back to the tactical quotas set in September and (b) by implementing the second step in our planned quota **increase in listed private equity** (LPE, as highlighted in the LGT Beacon last month)
- In the LGTCP portfolios with allocation to regular (thus illiquid) private equity funds, these tactical moves were replicated using equity index futures positions

Graph 1

Equity markets sold off strongly in early October

(MSCI net return indices, rebased to start of trade war*)

*Start of so-called trade war = US announcement of general import tariffs on steel and aluminum on March 9, 2018. Source: LGT Capital Partners, Bloomberg

Broader macro signals improved during the equity market corrections

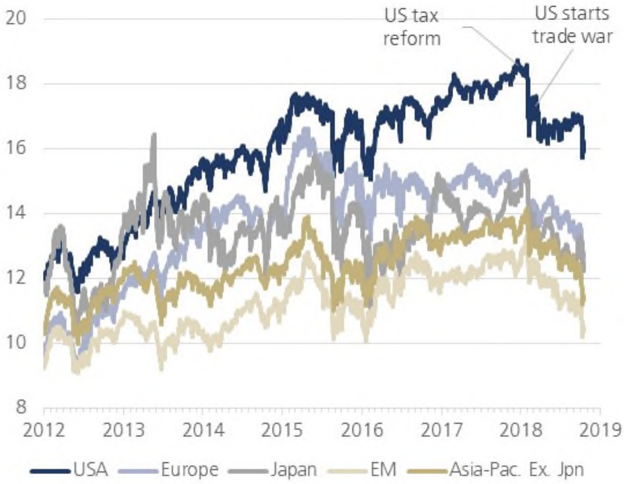
The equity correction was generally large, with actual losses varying from region to region (graph 1). However, in terms of valuations, the selloff has more or less fully wiped out any valuation expansion observed since late 2015 (graph 2). US equity valuations, for instance, are now back to early 2016 levels, or only shortly after the Federal Reserve began raising interest rates.

Investors seem to have turned fearful of monetary tightening again, effectively suggesting that the profit growth of the past two years was a fleeting phenomenon. That certainly goes too far in our mind.

Graph 2

Equity markets: price to earnings ratios collapsed

(MSCI, 12-month forward earnings estimates)



Source: LGT Capital Partners, Bloomberg

Admittedly, some of the past two years' aggregate profit was arguably due to temporary, transitory factors, such as benign tax accounting changes, or unexpected and large financial and commodity price gains.

However, the fact remains that corporate revenue growth, the item that is least sensitive to accounting changes, remains exceptionally stable and strong.

Robust revenue and profit growth

Specifically, analysts on average expect US revenue growth per share to continue to grow at nearly 10% per year (graph 3) – about twice the rate of nominal gross domestic product (NGDP) growth. US NGDP rose 5.4% on an annualized basis in the second quarter of this year, which is meaningfully above the 30 year average of 4.7% and highlights the strength of the current late-cycle phase.

European companies are reporting similar sales growth rates, at about 6% in the most current quarter, compared to a NGDP growth of 3.6% for the eurozone. Similarly, even in Japan, i.e. the economy with the lowest potential growth rate, corporate revenue is growing at about 5% and hence also about twice the rate of NGDP expansion. NGDP in Japan grew 2.8% per annum last quarter.

Graph 3

US sales per share

(Consensus 12-month-forward SPS estimates for S&P 500)

SPS = Sales per share. LHS = left-hand scale; RHS = right-hand scale.
Source: LGT Capital Partners, Bloomberg

Hence, while we expect the global economy to naturally cool off from its current late-cycle phase of strength, the recent market slump implies a sudden collapse, which is clearly a market exaggeration.

Graph 4

US earnings season: initial reports positive

(Reporting data per October 18, 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)
USA (S&P 500)	**11.2%**	**21.9%**	**4.3%**	**89.3%**	**7.7%**	**0.5%**	**16.2**
Energy	3.3%	38.4%	0.3%	100.0%	7.2%	-0.5%	15.2
Materials							13.5
Industrials	16.9%	33.1%	2.3%	83.3%	10.2%	0.8%	16.2
Consumer discretionary	9.4%	15.6%	7.0%	100.0%	15.0%	0.6%	20.0
Consumer staples	21.9%	7.4%	2.6%	85.7%	6.5%	-0.1%	17.7
Health care	4.8%	14.3%	1.8%	100.0%	10.1%	0.6%	16.5
Financials	20.9%	24.5%	5.3%	85.7%	4.5%	0.9%	11.7
Information technology	12.1%	24.0%	3.5%	100.0%	6.8%	0.0%	17.7
Communication services	9.1%	78.4%	20.7%	100.0%	15.1%	0.3%	21.9
Utilities							16.8
Real estate	9.4%	22.2%	6.7%	66.7%	15.9%	2.3%	34.8

Source: Bloomberg, LGT Capital Partners

The major economies are still in a sweet spot of the business cycle, where most economies are growing above their respective potential rate which is ultimately supportive for earnings growth.

Good start into the earnings season

Meanwhile, the initial reports from the corporate reporting season for the third quarter of 2018 suggest that revenue growth momentum has remained largely intact (graph 4). In the US, 56 of the S&P 500's members have reported thus far. Sales per share (SPS) are up close to 8%, while earnings per share (EPS) surged more than 20%. Both line item numbers are once again higher than predicted.

What is particularly encouraging is that most consensus-surpassing companies of the initial sample were from cyclical sectors (industrials, information technology, and consumer discretionary). The fact that cyclicals were strongly represented in the initial sample reduces the potential impact on the overall result.

Earnings from the more defensive sectors are by definition more stable and should thus not deliver big negative surprises. The same is probably true for the energy and financial sectors this time around, as their operating earnings were quite visible due to the gains in financial and energy markets in the relevant period. The reporting season's final results are thus also likely to remain positive.

Initial signals from Japan, with also about one twentieth of the Topix 500 companies having already reported, point in exactly the same direction. European reports are more mixed thus far, but that may be due to the region's wider diversity and differences in the mix of initial reports (higher proportion of financials, commodity producers and defensive sectors).

Earnings revision trends are either improving or stabilizing

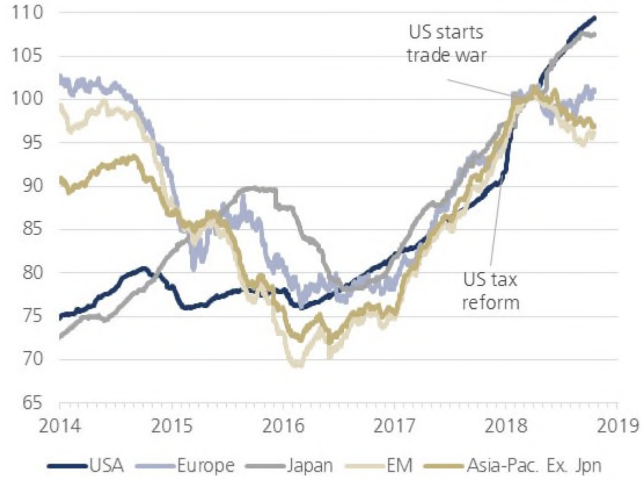
In terms of the forward-looking earnings revisions, as of today, consensus EPS forecasts for the coming year continue to modestly rise in the US and Japan, while they have stabilized (and perhaps turned the corner) in the other economies. It is also worth noting that the jump in expectations that followed the US tax reform of last December has now been priced out in the Europe, the EM, and Asia (except for Japan). At any rate, the selloff seems exaggerated from this viewpoint as well.

Consequently, it made sense for us to buy the dip and rebalance equity positions in all regions, and to increase our LPE exposure. From an opportunistic point of view, LPE typically offers a comparatively high beta (sensitivity to the overall market), which also suits us well at present - since we are expecting a rebound in prices. That said, we should add that given our broader and more balanced view, we would of course be willing to rebalance again at a higher level – i.e. to sell the rally.

Graph 5

Global earnings forecast at start of reporting season

(12-month forward EPS, rebased to start of trade war*)



*Start of so-called trade war = US announcement of general import tariffs on steel and aluminum on March 9, 2018. EPS = earnings per share. Source: LGT Capital Partners, Bloomberg

Bond market signals have turned positive

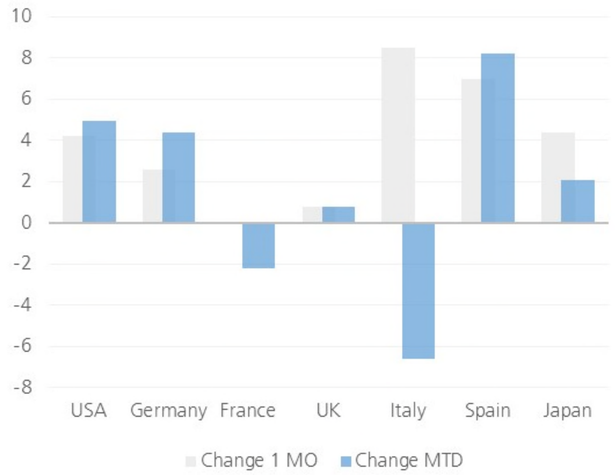
Furthermore, the broader financial markets (bonds, currencies) have behaved in a rather benign way over the past month, which reaffirms the view that the equity selloff was of a temporary nature.

For starters, yield curves have steepened somewhat globally, expect in Italy (graph 6) - which is exactly what one would wish for given the recent debt-risk associated spike in Italian spreads. The overall bond market moves thus represent an improvement. A flattening or inverting yield curve is associated with an increasing risk of a recession at some point in the future.

Graph 6

Yield curves have mostly steepened

(Change in the difference between 10 year and 2 government bond yields, in basis points)



1 basis point = 0.01 percentage point. Source: LGT Capital Partners, Bloomberg

Italy's budget plans are not extreme

The opposite is true for Italy, where the flattening of the yield curve suggests a normalization (i.e. a reversal or containment of rising default fears). Italy's budget spending plans may exceed European Union (EU) rules, but they are ultimately not extreme: projected to be 2.4% of gross domestic product in 2019, Italy's fiscal deficit is among better half of the G20 nations.

The budget proposed by US President Donald Trump for 2019, for instance, comes down to a deficit of about 4% of NGDP. In addition, Italy generates a primary surplus, so it can afford a measured deviation from fiscal rules to some extent.

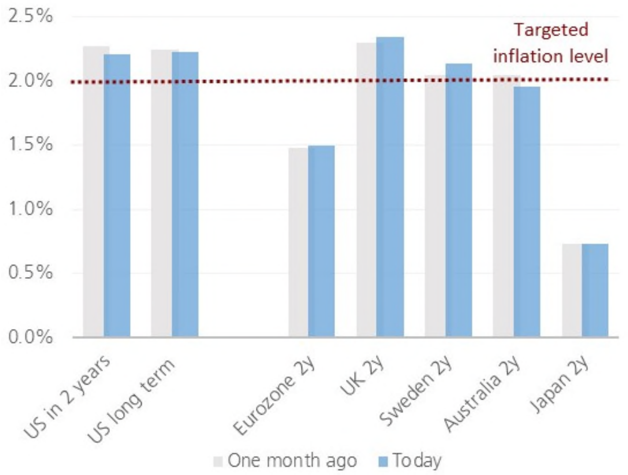
Overall, we do not expect the political confrontation between Rome and Brussels over fiscal spending plans to trigger another major euro-crisis. We believe the two parties will reach a sensible compromise.

The important point is that these reflationary signals were confirmed by developments in the markets for inflation-linked financial instruments (graph 7).

Graph 7

Market-based inflation expectations have slightly risen

(Implied future inflation rates in percent per year)



The 2 year estimates are based on zero coupon inflation swap rates. The US long term inflation rate is the US 5 year / 5 year forward breakeven rate. Source: LGT Capital Partners, Bloomberg

Finally, following a period of turmoil and fears of contagion due to events in Argentina and Turkey in late summer, the EM markets for bonds and currencies have started to stabilize over this month, despite the equity selloff. At the same time, high yield (HY) credit markets have held up quite well, as credit spreads generally narrowed somewhat.

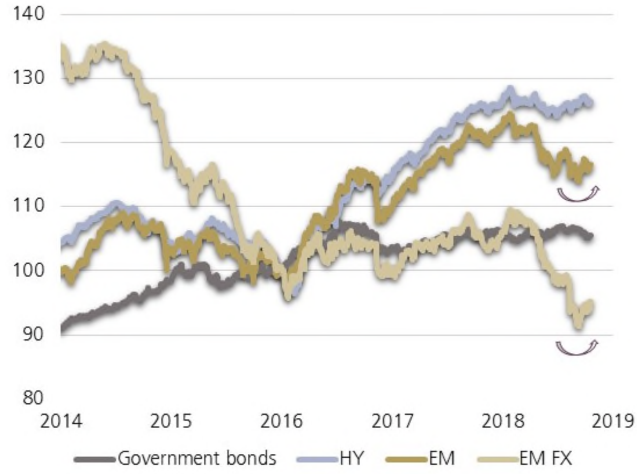
As a result, both EM and HY have outperformed the traditional government bonds of major industrialized nations. Concluding, combined with the signals from the yield curves and the inflation-linked securities' prices, these credit markets signals confirm that the broader financial markets have been sending a somewhat reflationary signal during the stock market turmoil, rather than a warning of increasing risks.

Against this background, we concluded that October's equity selloff will likely prove transitory once again, and felt confident enough to adjust our overall equity risk.

Graph 8

EM bond and EM currencies stabilize

(Total return indices rebased to start in 2016, in US dollars)



For government bonds (of developed economies) and the emerging markets, we show J.P. Morgan's total return indices in USD. The government bond index is hedged for currency risks. The EM index shown consists of unhedged and hedged indices at a 50-50 ratio. Source: LGT Capital Partners, Bloomberg

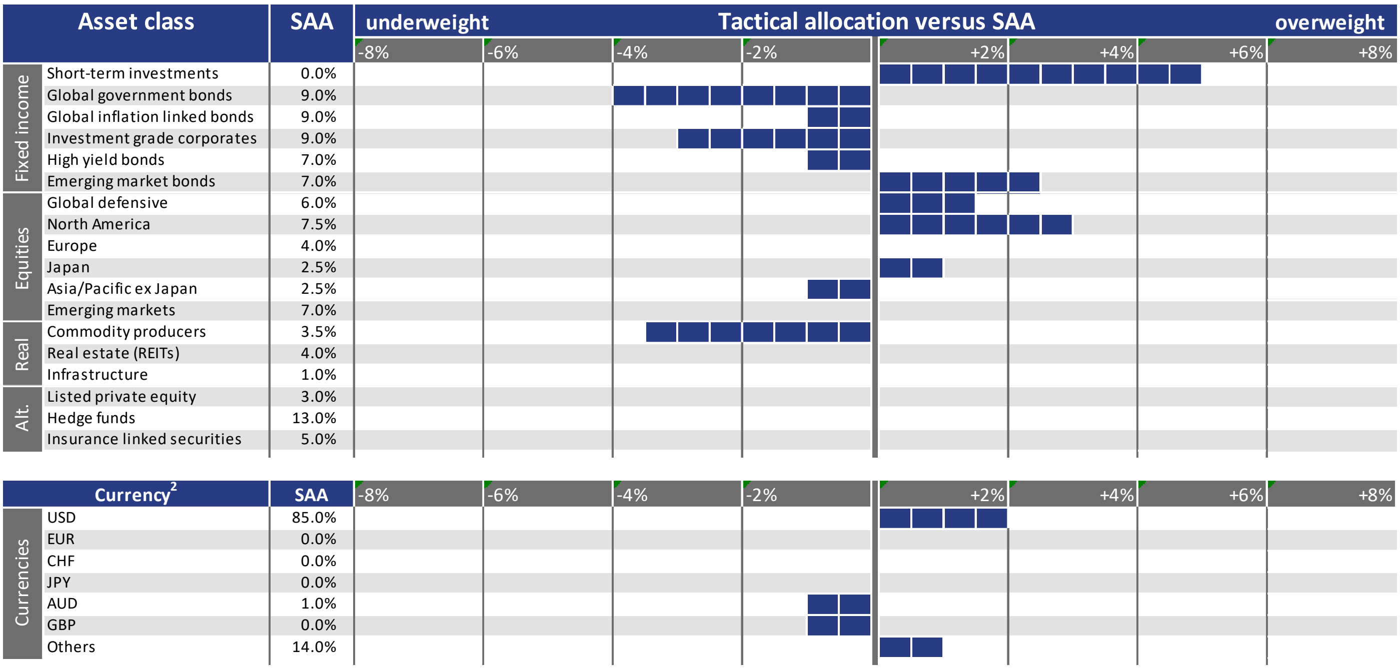
As a final reminder, given that our overall assessment remains more balanced, rather than outright bullish, we should again note that we would be equally willing to sell the rally once markets have sufficiently recovered.

END OF REPORT

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. 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 GBP 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%	4.3%	2.7%
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%	1.0%	4.7%	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%	0.6%	-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%	2.90%	-0.11%	-0.58%	0.80%	8.27%	9.49%	-0.72%
Govt bond yield 10yr[4]	p.a.	3.20%	0.69%	3.48%	0.15%	0.47%	1.58%	8.56%	9.29%	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%

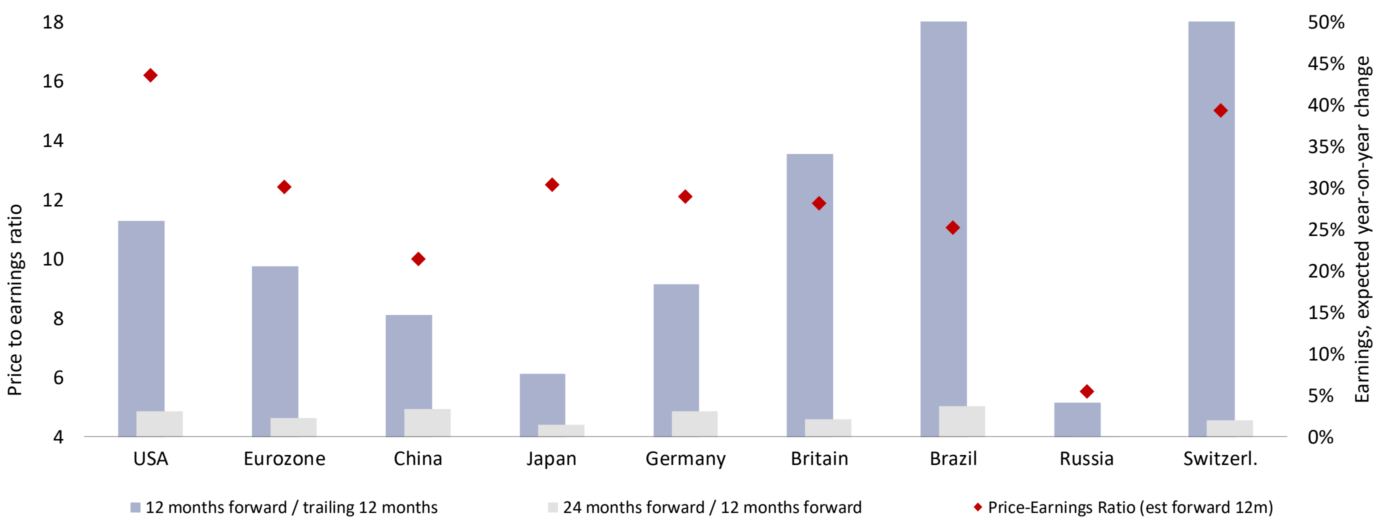
[1]IMF estimates. [2]annualized, most recent qtr. [3]PRC ex. migrant workers. [4]Currency swap rates for China and Brazil, closest ESM or EFSF bonds for Eurozone. [5]Max target rate for Fed, middle of the target range for SNB

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)



Important information

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