February 2019

Marketing material

Staying the course after a very good start

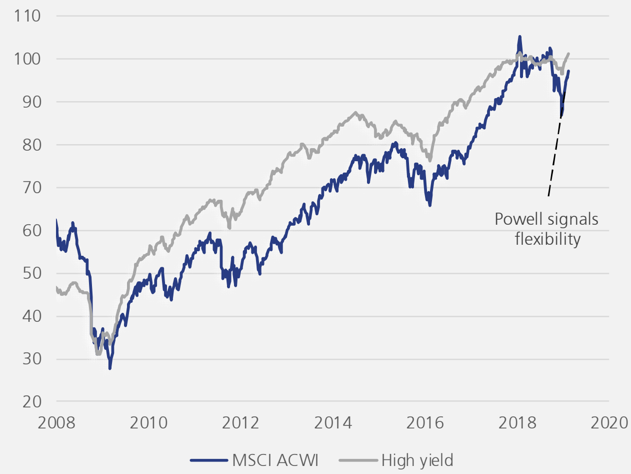
The year-to-date risk rally is the strongest in a decade. The Federal Reserve's recent decision to pause, if not reverse, monetary tightening should help markets and inflation expectations to recover further. However, after having strategically raised our equity quota in December, we refrain from chasing prices higher. Instead, we rebalance equities back to neutral.

Strongest rebound in almost a decade

After a volatile quarter and a panic selloff in December, January brought relief to risk assets: US high yield credit rebounded to a new high, while the S&P 500 is on track to book the strongest two-month gain since fall 2010. The broad rebound in equities, initially led by the emerging markets (EM), has lifted the MSCI all-country index about 10% higher year-to-date.

The recovery is justified by economic fundamentals and a more benign monetary policy bias. At the same time, we are in a late-cycle environment and face some unusual risks of structural nature (deep political divisions within and amongst allied democracies, elevated populism and economic nationalism, Sino-American geostrategic rivalry, etc.). These risks cloud the longer-term outlook and favor prudent caution.

Graph 1
Global equities and US high yield bonds
(Total return indices in USD)



Source: Bloomberg, LGT Capital Partners
Bloomberg Barclays US Corporate High Yield Total Return Index Value Unhedged in USD and MSCI All-Countries World Index in USD, rebased per September 30, 2018.

Nevertheless, some recent developments are clearly supportive for markets from a shorter-term, cyclical viewpoint, namely:

- Monetary policy has turned more dovish
- The cyclical macro data remains fairly constructive
- US earnings are strong and global valuations are modest
- There are signs of progress on the trade front

Below, we take a closer look at each of the above points.

A more dovish monetary policy outlook

US monetary policy makers addressed the key investor concern early this year, when, on January 10, Chairman Jerome Powell said that the Federal Reserve (Fed) would be "patient" and "flexible" in terms of its future interest rate policy.

By the end of the month, the Fed had also officially clarified that this approach included its policy of not reinvesting the proceeds of the maturing bonds it owns (known as "quantitative tightening" or "balance sheet normalization"). Moreover, this dovish shift is also spreading to other economies:

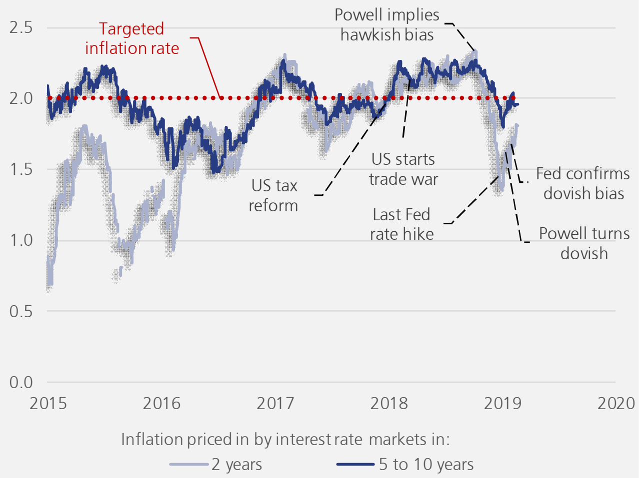
- On Monday, for example, the European Central Bank (ECB) Governing Council member Francois Villeroy de Galhau described Europe's economic slowdown as "significant" and stated the ECB could change its guidance accordingly if the deterioration continues
- On Tuesday, Bank of Japan (BOJ) Governor Haruhiko Kuroda told parliament that continued strength in the yen could also prompt the BOJ to create more money to buy financial assets and further reduce bonds yields. More generally, the BOJ might also ease later in the year to offset the negative impact of a consumption tax hike planned for October
- Meanwhile, other central banks, including the People's Bank of China (PBOC) and the Reserve Bank of Australia (RBA), remain inclined to (continue to) ease

For the time being, policy makers have clearly put any ongoing and tentative tightening plans on the backburner, globally. The risk of a monetary policy error has thus clearly fallen in the near-term.

In response, inflation expectations have recovered markedly since early January: short-term cyclical inflation expectations quickly climbed back closer to the targeted future inflation rate of 2% per year, while the long-term expectations stabilized around that level (graph 2).

If these trends persist, financial markets should also continue to rebound, while real economic activity is likely to regain momentum in their wake.

Graph 2
Stabilizing market-based inflation expectations
(Implied future annual inflation rate in %)



Source: Bloomberg, LGT Capital Partners
USD inflation swap zero coupon 2 years for cyclical inflation outlook. US nominal bond forward 5 years minus inflation-linked bond forward 5 years for the long-term outlook.

Macro trends vary by region but are sufficiently constructive

The policy shift probably occurred just in time to eliminate the risk of a recession in the near future, as some economies have arguably been slowing too much. In January, the purchasing managers' index (PMI) readings for manufacturing had fallen below the growth threshold in China and Japan and came very close to that mark in the Eurozone.

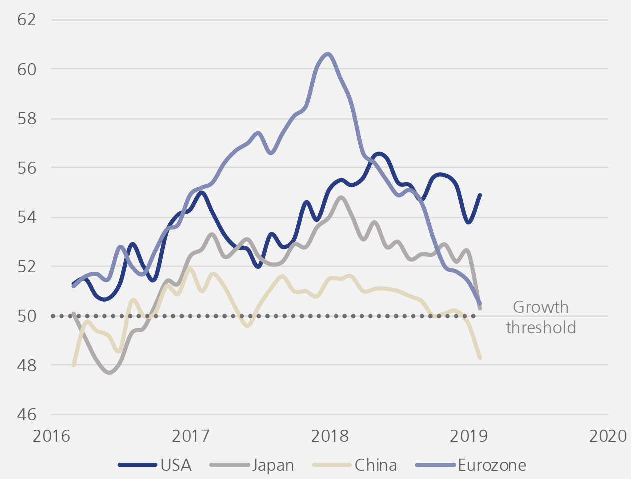
However, the broader picture remains sufficiently positive. Notably, the US economy even appears to be regaining some momentum already (the manufacturing PMI actually rebounded last month, see graph 3). The US was perhaps due for a pick-up in cyclical momentum even without a more dovish Fed, once political issues (government shutdown) and weather conditions (extreme cold in parts of the country) were out of the way.

Japan, meanwhile, might also be due for a similar rebound – after all, in the last quarter of 2018, the most intense tropical cyclone since 1993 had caused significant damage to Japan's economy, including the complete flooding and shutdown of the country's third-largest airport (Kansai International). Moreover, two major free trade agreements with European and Pacific Rim countries totaling four times the size of Japan's own economic output took effect this year, which should help underpin trade and investment in coming months.

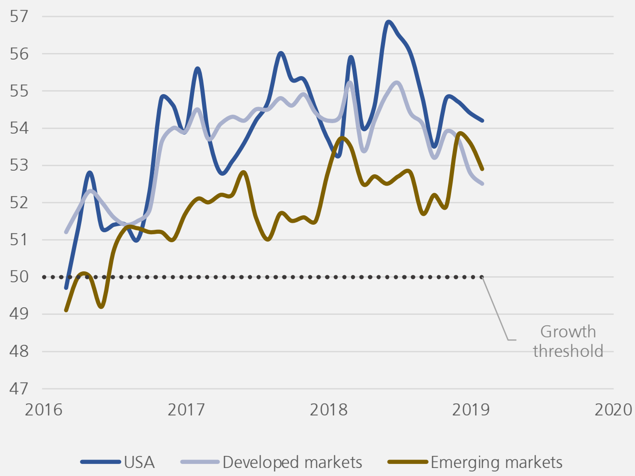
By contrast, Europe's outlook could admittedly prove more complicated, as it largely depends on political developments (possible Brexit in March, snap elections in Spain in April, European Parliament election in May, etc.). Industry-specific factors, in particular German auto industry issues (threat of US auto tariffs, a presumed lack of commercial success in the electric vehicles market, and a factory retooling cycle), could also be playing a role. Increased ECB policy flexibility would thus certainty help here.

Finally, China's slowdown comes with two upside risks: it increases Beijing's political incentives to defuse the tensions with the U.S. and makes further fiscal and monetary easing in the near future more likely.

Graph 3
Purchasing managers' surveys: manufacturing
(Balance/diffusion indices by Markit)



Graph 4
Purchasing managers' surveys: services
(Balance/diffusion indices by Markit)



Source: Markit, Bloomberg, LGT Capital Partners
Readings above 50 suggest an improvement in business outlook; the opposite is true for readings below 50.

That said, overall the economic data points to a somewhat slower, but still sufficient global growth outlook in most major economies. The service industry PMIs have deteriorated much less than the manufacturing PMIs and comfortably above the growth threshold globally (graph 4).

In fact, the services PMIs rebounded in China, the Eurozone and Japan last month. The services industries are less exposed to trade issues and represent more than three-quarters of the economy in the developed markets and already account for more than half in China.

Strong US earnings and moderate global valuations

Corporate results for the last quarter of 2018 varied by region. Based on the releases available thus far, profitability and growth remain robust in the U.S. but mixed in the other markets (although actual level of earnings was still slightly higher that forecast globally).

At any rate, in the US, where the season is almost complete, overall corporate results again surprised on the upside in most respects, with nearly three-quarters of S&P 500 companies beating expectations.

Moreover, revenue continued to outgrow nominal gross domestic product (GDP) in all regions. Hence, the weakness of non-US earnings appears to stem from margin erosion, rather than lack of growth, triggered by a mix of higher trade tariffs, a stronger US dollar, rising wages, volatile financial markets, and/or commodity prices. US companies by contrast, continue to enjoy strong margins as well as top-line growth.

Graph 5

Corporate results, economic growth and valuations

(Reporting period Q4/2018)

	Earnings per share, yoy	Revenue per share, yoy	Nominal GPD, yoy	Price to forward earnings ratio
USA	10.8%	6.3%	5.5%	16.4
Energy	91.2%	11.7%		
Materials	-1.0%	2.1%		
Industrials	18.6%	6.8%		
Consumer Discretionary	13.2%	7.6%		
Consumer Staples	5.0%	2.7%		
Health Care	11.2%	8.3%		
Financials	-1.4%	3.0%		
Information Technology	5.0%	0.7%		
Communication Services	21.1%	13.0%		
Utilities	-6.0%	3.1%		
Real Estate	6.8%	12.3%		
Europe	1.2%	5.9%	2.8%	13.1
Eurozone	0.6%	3.0%	2.5%	12.6
Japan	-22.1%	4.0%	-0.3%	12.2
Asia-Pacific ex Japan	0.4%	5.0%	5.7%	12.9
Emerging markets	0.7%	4.8%	5.0%	11.6

Source: Bloomberg, LGT Capital Partners
GDP = Gross domestic product, most recent available quarter.

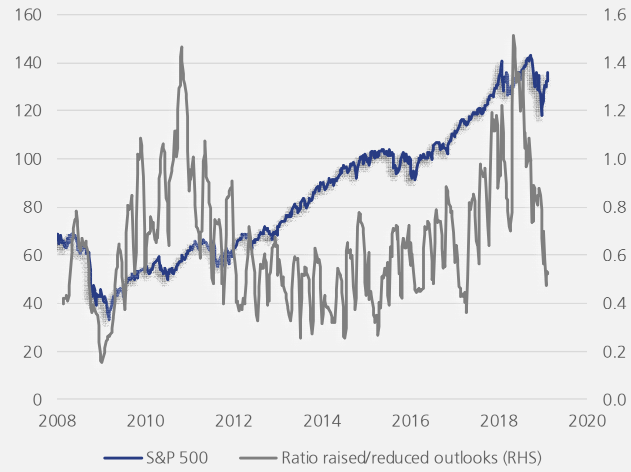
It is also worth noting that most US companies issued cautious (i.e. reduced) profit outlooks – and that this type of caution may have peaked.

Luckily, a high level of corporate caution has historically not contained much information about actual future profits. In fact, the ratio of increased outlooks to reduced outlooks has been frequently as low as today or even lower on several occasions during the bull market of the past recent years – without any lasting negative impact on the actual earnings or the market. In terms of the decline of that ratio, the recent slump was the most extreme since 2011 (graph 6).

Graph 6

Corporate caution approaching the decade's lows

(Reduced/increased guidance ratio and equity prices)



Source: Bloomberg, LGT Capital Partners
The ratio represents the number of US companies issuing lower financial guidance divided by the number of companies issuing higher guidance; we use eight-week rolling moving averages for improved visualization. RHS = Right hand side

Thus, the current level of corporate caution may simply help future earnings surpass expectations once again. In that sense, it may be a positive contrarian signal.

At any rate, with price to forward earnings ratios ranging from around 12 in Japan and the EM to around 16 in the US, current valuations are certainly rather moderate – and even cheap in many other regions.

Progress on the trade front

Finally, a settlement (or at least a de-escalation) of the US-Chinese trade conflict in the coming weeks could provide another trigger for markets to rise further. Naturally, a failure to deescalate the tensions could disappoint. However, US President Donald Trump has stated that the talks are making progress, indicating he was willing to extend the original March 1 deadline by a few months to avoid an immediate imposition of tariffs on Chinese goods, and win more time for talks.

Meanwhile, while largely overlooked at present, there has also been progress elsewhere, as two new free trade zones have come into force this year: **Comprehensive and Progressive Agreement for Trans-Pacific Partnership** (CPTTP, January 1) and the **Economic Partnership Agreement** (EPA) between the European Union (EU) and Japan, which includes a trade accord, known as JEFTA (effective February 1).

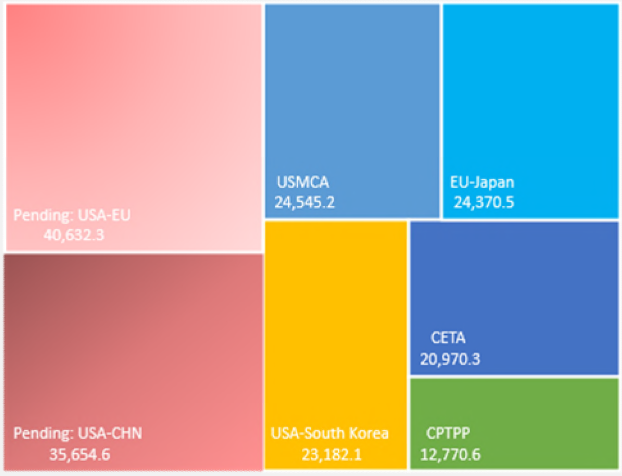
These two treaties cover markets with a total GDP of about $32 trillion, or about 40% of global GDP.

Before too long, the US will most likely conclude new trade agreements with EU and Japan – just as it eventually did with Canada, Mexico and South Korea last year. While these accords may not necessarily represent better agreements, they will certainly reduce policy and trade regime uncertainty.

Graph 7

Major recent and pending trade agreements

(Ranked by total GDP of participating nations)



Source: Bloomberg, LGT Capital Partners
GDP = Gross domestic product for 2019 at current prices in billions of USD, as estimated by the International Monetary Fund
USMCA = USA-Mexico-Canada-Agreement
CETA = Comprehensive Economic and Trade Agreement between the EU and Canada

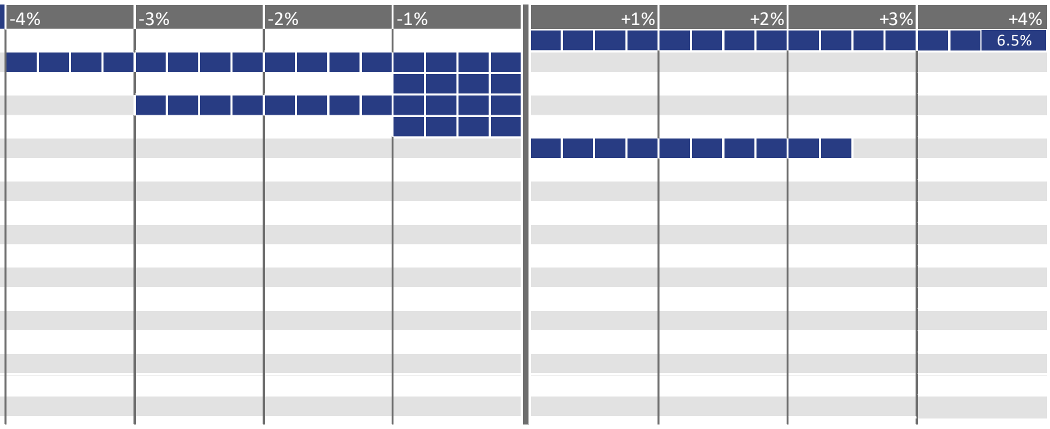
END OF REPORT

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

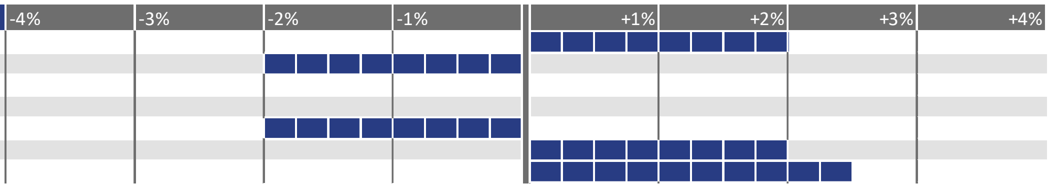
We set the tactical asset allocation (TAA) versus our neutral strategic quotas (SAA) quarterly, with a time horizon of three to six months, as review it regularly in the interim. In late January, we took profits and closed our tactical long position in gold.

- **Equities: all regions at neutral, with a modest bias in favor of defensive strategies**
- **Fixed income: underweight duration and credit risk, with a clear preference for EM debt**
- **Currencies: long positions in USD and NOK versus the AUD and the EUR; EM currencies remain a passive overweight**
- **Cash: Liquidity at a very high level amid risk of increased market volatility going forward**

Fixed income	Short-term investments	0.0%
	Global government bonds	11.0%
	Global inflation linked bonds	9.0%
	Investment grade corporates	6.0%
	High yield bonds	5.0%
	Emerging market bonds	7.0%
Equities	Global	2.0%
	Global defensive	7.5%
	North America	10.5%
	Europe	5.0%
	Japan	2.5%
	Asia/Pacific ex Japan	2.5%
	Emerging markets	6.0%
Alt. / Real	Listed private equity	3.0%
	Hedge funds	12.0%
	Insurance linked securities	6.0%
	Real estate (REITs)	5.0%
	Gold	0.0%



Currency[2]		SAA
Currencies	USD	86.0%
	EUR	0.0%
	CHF	0.0%
	JPY	0.0%
	AUD	1.0%
	NOK	0.0%
	Others	13.0%



The table shows the LGT GIM Balanced (USD) strategy managed by LGT Capital Partners. The TAA is generally valid for all similar portfolios, but investment restrictions or liquidity considerations can lead to deviations in implementation. In currencies, "others" represents indirect exposures resulting from unhedged positions in various 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	1.0%	3.2%	1.0%	2.2%	3.5%
Global inflation linked bonds	USD	0.8%	1.0%	1.0%	2.8%	2.2%
Investment grade corporate bonds	USD	1.6%	3.1%	2.0%	3.1%	2.7%
High yield bonds	USD	1.9%	3.9%	5.0%	9.5%	3.8%
Emerging markets [2]	USD	1.8%	6.5%	4.5%	6.7%	3.0%
Equities						
Global	USD	4.3%	5.1%	10.7%	12.8%	8.2%
Global defensive	USD	4.4%	4.8%	8.0%	10.1%	9.3%
North America	USD	4.6%	5.9%	11.8%	14.9%	9.6%
Europe	EUR	4.2%	4.1%	9.4%	9.1%	5.0%
Japan	JPY	2.9%	0.3%	8.1%	9.3%	7.0%
Asia/Pacific ex. Japan	USD	4.2%	8.4%	9.1%	14.3%	5.4%
Emerging markets	USD	3.1%	8.0%	8.7%	14.9%	4.2%
Alternative and real assets						
Listed private equity	USD	4.1%	4.0%	14.1%	14.0%	5.4%
Hedge funds	USD	3.2%	1.0%	3.2%	3.9%	2.3%
Insurance linked securities (ILS)	USD	0.5%	0.6%	1.6%	3.6%	4.2%
Real estate investment trusts (REITs)	USD	5.8%	6.2%	11.2%	8.1%	7.3%
Gold	USD	4.7%	9.3%	4.5%	3.0%	0.2%
Currencies (G10) [3]						
US dollar	USD	0.1%	0.2%	-0.2%	0.4%	4.5%
Euro	EUR	-0.1%	-0.2%	-1.3%	1.2%	0.1%
Swiss franc	CHF	-0.3%	-0.5%	-2.1%	0.1%	1.7%
British pound	GBP	1.4%	2.5%	2.4%	-3.2%	-1.0%
Japanese yen	JPY	-1.1%	2.4%	-1.3%	1.0%	2.7%
Norwegian krone	NOK	-0.2%	-0.5%	0.6%	0.3%	-3.3%
Swedish krona	SEK	-3.4%	-2.9%	-5.5%	-3.1%	-3.5%
Australian dollar	AUD	0.2%	-1.3%	1.7%	0.5%	-0.6%
Canadian dollar	CAD	1.2%	0.7%	3.8%	2.1%	0.6%
New Zealand dollar	NZD	2.1%	0.5%	2.1%	1.7%	0.2%

[1] Annualized returns [2] Equal mix of hard and local currency bonds [3] Currencies represented by the Bloomberg's correlation-weighted indices (BCWI); the BCWI measure a currency against the remaining nine other major freely convertible currencies (G10) to show the broader market trend

Economic and corporate fundamentals

		USA	Eurozone	China	Japan	Germany	U.K.	India	Brazil	S. Korea
Gross domestic product (GDP)										
- nominal	bn USD	21,482	14,026	14,172	5,221	4,117	2,810	2,958	1,930	1,700
- nominal, per capita 2018 [1]	USD, PPP	65,062	40,965	19,559	46,069	54,984	47,042	8,443	16,727	43,212
- expected real growth for 2019	Consensus	2.5%	1.4%	6.2%	0.8%	1.2%	1.4%	7.2%	2.5%	2.5%
- expected real growth for 2020	Consensus	2.5%	1.5%	6.0%	0.5%	1.5%	1.6%	7.3%	2.5%	2.5%
- real growth in most recent quarter	QoQ, p.a.	3.4%	0.8%	6.1%	1.4%	-0.8%	0.7%	6.1%	3.1%	4.1%
Unemployment rate 2019	Consensus	2.5%	7.9%	3.8%	2.4%	5.0%	4.0%	8.2%	4.9%	2.4%
Inflation rate 2019	Consensus	2.0%	1.1%	1.9%	0.1%	1.5%	1.9%	3.8%	4.1%	0.5%
Purchasing manager index (comp.) [2]	Neutral = 50	54.4	51.0	50.9	50.9	52.1	50.3	53.6	52.3	48.3
Structural budget balance/GDP 2019	IMF	-5.6%	-1.0%	-4.5%	-2.8%	0.7%	-1.7%	-6.5%	-7.1%	1.6%
Gross government debt/GDP 2019	IMF	107.8%	82.0%	53.9%	236.6%	56.0%	87.2%	68.1%	90.5%	40.4%
Current account balance/GDP 2019	IMF	-3.0%	2.9%	0.7%	3.8%	7.9%	-3.2%	-2.5%	-1.6%	4.7%
International currency reserves	bn USD	41.8	378.4	3,087.9	1,216.1	59.2	141.8	369.8	371.9	398.8
Govt bond yield 2yr [3]	p.a.	2.51%	-0.44%	2.55%	-0.18%	-0.57%	0.75%	7.18%	9.15%	-0.77%
Govt bond yield 10yr [3]	p.a.	2.66%	0.49%	3.20%	-0.04%	0.10%	1.18%	7.52%	8.95%	-0.29%
Main policy interest rate [4]	p.a.	2.50%	0.00%	4.35%	-0.10%	0.00%	0.75%	6.25%	6.50%	1.75%

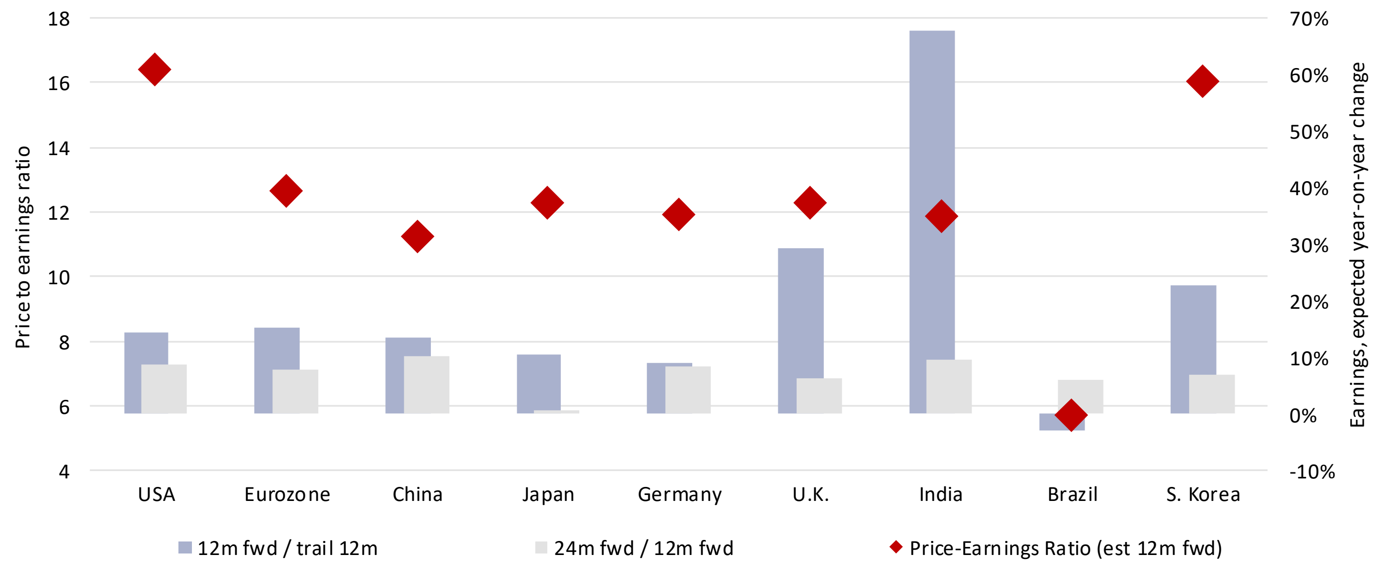
[1] IMF estimates [2] Manufacturing PMI for Korea [3] Currency swap rates for China and Brazil and closest ESM/EFSF bond for Eurozone [4] Max target rate for Fed

		USA	Eurozone	China	Japan	Germany	U.K.	India	Brazil	S. Korea
Exchange capitalization*	bn USD	30,258	7,364	11,592	5,790	2,063	3,305	986	597	1,591
Growth in earnings per share, estimated (MSCI)										
12 months forward / trailing 12 months	Consensus	14.4%	15.4%	13.6%	10.6%	9.0%	29.4%	67.6%	-3.0%	22.8%
24m fwd / 12m fwd	Consensus	8.8%	8.0%	10.3%	0.7%	8.4%	6.3%	9.6%	6.0%	7.1%
Growth in revenue per share, estimated (MSCI)										
12m fwd / trail 12m	Consensus	5.6%	3.8%	11.2%	3.1%	5.4%	3.8%	7.4%	4.2%	3.3%
24m fwd / 12m fwd	Consensus	4.1%	-0.7%	-17.2%	2.6%	2.9%	-0.4%	7.8%	-1.0%	-0.7%
Valuations (MSCI)										
Price-Earnings Ratio (est 12m fwd)	Consensus	16.4	12.7	11.2	12.3	11.9	12.3	11.9	5.7	16.0
Price-Sales Ratio (est 12m fwd)	Consensus	2.0	1.0	1.2	0.8	0.8	1.1	1.6	0.8	2.1
Dividend yield	Consensus	2.0%	3.8%	2.5%	2.5%	3.6%	4.9%	3.8%	7.5%	3.4%

* China market cap includes Hong Kong | Source: Bloomberg Data per: 2/21/2019

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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