LGT Beacon

Global macro and market review

March / April 2019

Tactical asset allocation for Q2/2019

Marketing material

Risk asset prices rebounded strongly over the past quarter following a US-led dovish shift in the monetary policy outlook, but economic growth continues to decelerate and bond markets are signaling an increased risk of looming recessions. We stay neutral in equities and add exposure to fixed income segments that we view as fundamentally attractive.

LGT Capital Partners concluded its quarterly tactical asset allocation (TAA) review for the second quarter of 2019 last week. The following developments of the past three months set the backdrop of our deliberations:

- The US Federal Reserve (Fed) and subsequently some of other major central banks have pivoted to a more dovish monetary policy outlook, triggering a swift rebound in risk asset markets
- However, this shift has also led to a rapid decline in term premia (i.e. the difference between long- and short-term interest rates), which is widely regarded as an early recession warning
- Reports that the Sino-American trade talks were making at least partial progress and signs that recent Chinese stimulus measures would help to stabilize growth also contributed to the improved investors' sentiment
- The actual macro data point to a continued deceleration of global growth, although the US economy has held up remarkably well, while Europe has seen the most precipitous cooling and most other regions limped along somewhere in between

Against this backdrop, our macro assessment for the coming quarter was set as follows:

- In our **baseline scenario**, the world economy continues to grow – however, growth momentum is decreasing further
- In our less likely **risk scenario**, the deceleration could take a more pronounced form as various structural factors (global trade conflicts, noisy European politics, etc.) exacerbate recession fears

Consequently, we decided the following tactical adjustments in our investment strategy:

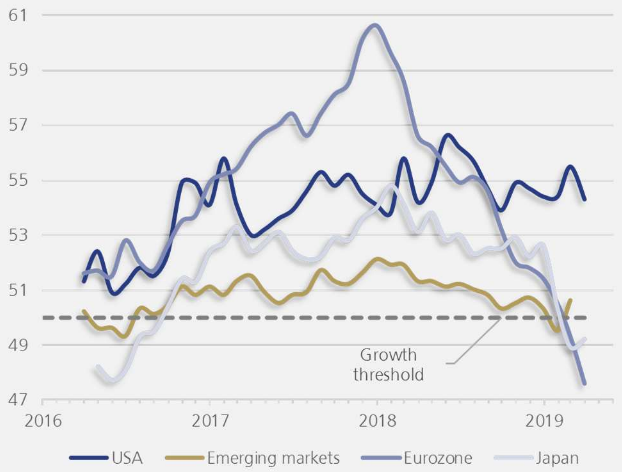
- Maintain a **broadly neutral equity allocation** with fundamentally and technically justifiable regional adjustments
- Modestly **reduce the underweight in fixed income and duration** against cash following the decline in risk-free interest rates and term premia (also known as "yield curve inversion") by **adding exposure in selected credit segments**

Hence, we believe markets could remain stuck in a sideways transition pattern for a few months, before market participants gain more clarity about the macro outlook and market direction.

Macroeconomic developments in detail

As mentioned, the macro data has continued to soften, and remains indicative of a continued global slowdown.

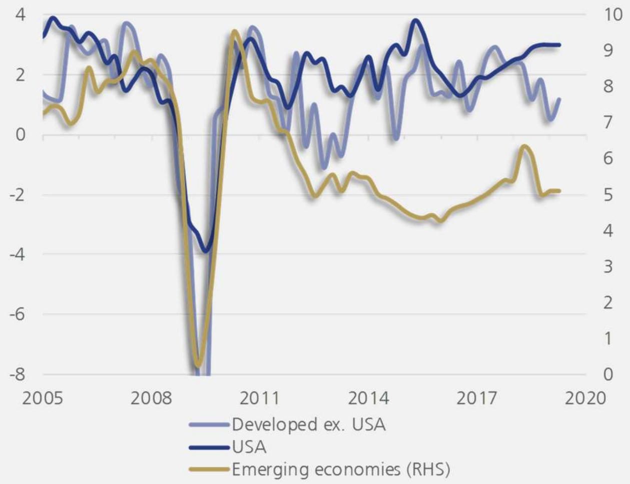
Graph 1
Purchasing managers' indices for manufacturing
(Balance/diffusion indices)



Source: LGT Capital Partners, Bloomberg, IHS Markit
PMI above / below 50 signals economic expansion / contraction

However, while US leading indicators have retreated only rather gradually, the preliminary manufacturing purchasing managers' indices for Europe slumped to their lowest levels since 2012 recently (graph 1). In terms of overall economic growth, the US clearly stands out thus far (graph 2).
Notably, the emerging markets (EM) have registered the greatest deceleration since the US launched its so-called trade war in March 2018 (when Washington announced steel and aluminum import tariffs against most allies and adversaries alike), and a stabilization may be due here.

Graph 2
Economic growth: US continues to show strength
(Annualized quarterly change in real GDP, in %)

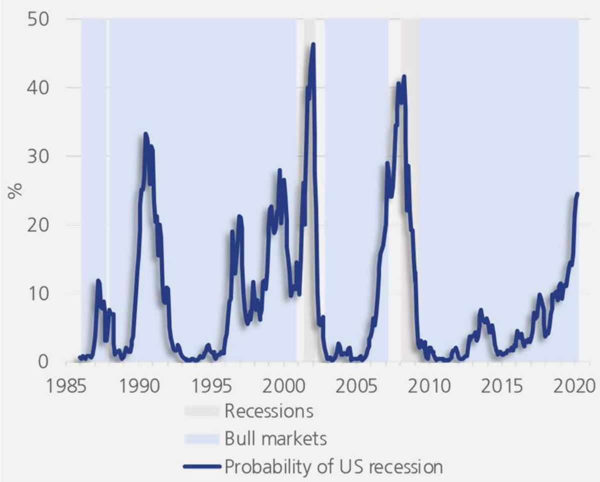


Source: LGT Capital Partners, Bloomberg
RHS = right hand side of the graph's scale; GDP = gross domestic product

Bond markets see surging risk of a recession

Alongside these developments, the market-implied recession risk has surged (graph 3) even after the Fed turned more dovish in response to the moderating inflation expectations during the course of the second half of last year.

Graph 3
The danger of a recession in the next 12 months
(Probability based on term premia)



Source: LGT Capital Partners, Bloomberg, New York Federal Reserve Bank

In the US, the Fed shifted policy in January. In March, it went a step further: it hinted that it would refrain from raising interest rates further this year and announced to dial down its balance sheet reduction program ("quantitative tightening") to a complete halt by September. The Fed cited weak inflation as one of the key reasons for its new policy outlook.
Nevertheless, US activity has proven rather robust so far. In our view, the US economy should continue to soften only gradually in the coming months, due to the petering out of the 2017 fiscal stimulus, and then stabilize around potential. Inflationary pressures could then re-emerge later in the year, as wages continue to rise amid a tight labor market.

> *"I don't feel that we have kind of convincingly achieved our two percent mandate in a symmetrical way."*
>
> - *Fed Chair Jerome Powell, March 20, 2019*

Less certain near-term prospects in the other regions

In Europe, the European Central Bank (ECB) ramped up long-term lending to the region's banks and pushed back rate hike plans beyond 2019. While this could prove fruitful for growth later in the year, current activity in Europe is likely to remain under pressure for a while. The European political front will also continue to be noisy, at least as long as uncertainty persists with regard to Brexit and possible US tariffs on European autos remain on the table. On the other hand, we expect the upcoming European Parliament elections to prove rather uneventful for financial markets.

In Asia, Japan is maintaining its reflationary polices, thus supporting nominal growth. As headwinds from last year's natural disasters start to fade, growth momentum should improve. China's policy makers, meanwhile, have announced additional support for the economy in recent months. More importantly, past easing measures have started to manifest themselves in the real economy, which should reduce the need for additional downward revisions to expected economic activity. However, further negative data surprises would undeniably exacerbate global growth worries further. This would be to the particular detriment of most emerging economies, where activity has only recently started to show tentative signs of stabilization.

Lastly, Sino-American trade negotiations seem to be progressing rather well, and a trade deal that could freeze tariffs at current levels, or roll them back partially, continues to be widely expected by market participants.

Tactical positioning for the quarter

While we expect the global economic backdrop to moderate going forward, positioning for an imminent recession would be premature. It is true that an **inverted yield curve** (i.e. long-term interest rates are lower than short-term rates, see graph 4), as seen in the US recently, has successfully predicted past recessions with a lead of 6 to 24 months. However, this usually happens only if the inversion lasts for a couple of weeks. There is also valid concern that years of unorthodox monetary policy and the resulting distortion of long-term interest rates may have weakened the curve's predictive signal.
Furthermore, it is difficult to align the strong year-to-date rally in risk assets with a recessionary environment or the onset of a bear market. Nevertheless, a careful examination of incoming macro data remains imperative as we continue to give the current bull market regime the benefit of doubt.
Against this background, there has also been a broad consensus in our discussions that fundamental or behavioral finance data currently do not favor an outright bullish positioning in **equities**. The equity markets are still undergoing a transition phase, and underlying patterns continue to favor a more or less neutral risk allocation.

Graph 4
First inversion of US 10y-3m yield curve since 2007
(10 year government bond yield minus 3 month note yield, in percentage points)

Source: LGT Capital Partners, Bloomberg

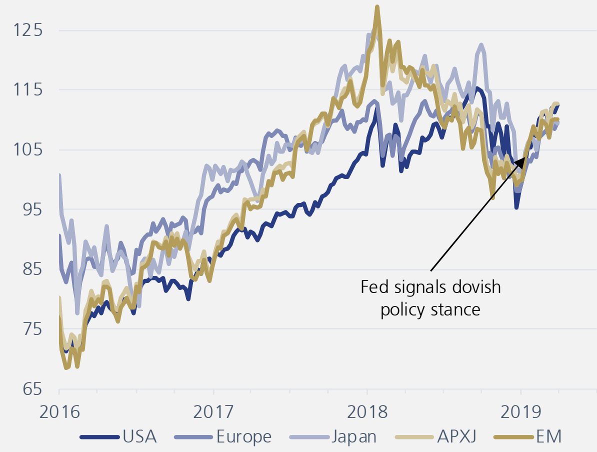
On balance, we are still slightly inclined to use future bouts of volatility as a chance to deploy idle cash. Within the equity space, we favor the US relative to Europe, while other regions remain broadly neutral.

In **fixed income**, a lower for longer environment with a tilt for carry trades and hunt for yield has re-emerged following the shift in global monetary policy. We continue to keep portfolio duration below the long-term target, with underweights in developed market government and corporate bonds. Emerging market bonds remain our only overweight position in the fixed income space.

Equities: favoring the US

In equities, markets have thus far rebounded quite uniformly around the globe in response to monetary policy changes as well as signs of progress in the Sino-American trade negotiations. We thus generally believe keeping equities around neutral remains appropriate going forward, but expect increasing deviation based on differences in economic and earnings performance. **We hence buy more US equities at the expense of Europe.**

Graph 5
Equities: favoring the US
(MSCI net return indices, rebased to the start of 2019)



Source: LGT Capital Partners, Bloomberg
APXJ = Asia-Pacific excluding Japan in USD; EM in USD; developed market in local currency because the currency risk is generally hedged

Relative growth has been diverging in favor of the US following the manufacturing slump in Europe, which should tilt future earnings in favor of US companies. Furthermore, the technical picture in the US remains more convincing too.

We keep Asia-Pacific excluding Japan and the EM near neutral as well, as we expect most of these markets to consolidate after the considerable rebound they registered in response to the progressing Sino-American trade negotiations in recent months (i.e. a "buy the rumor, sell the fact" type behavior).

We also maintain Japan at neutral. Along with Europe, the country's performance has lagged in the past quarter. However, in the event of a successful trade agreement and/or continued stabilization of Chinese growth, Japan stands to benefit more than Europe.

Fixed income: reducing underweight in IG and increasing overweight in EM

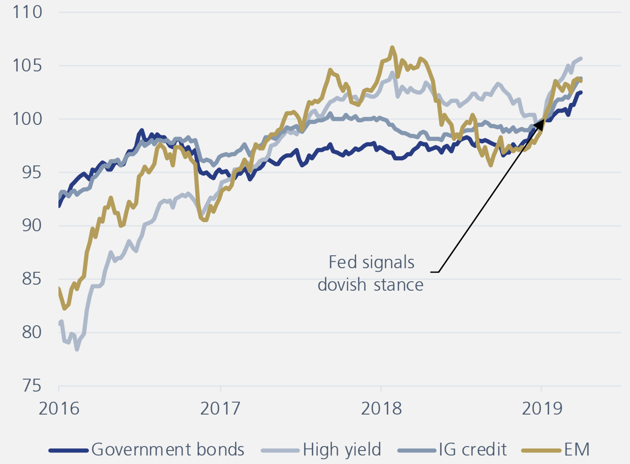
In fixed income, we remain **underweight duration and credit risks** but to a lesser extent than in December. Specifically, we reduce our underweight in investment grade (IG) corporate bonds, given abating headwinds from global monetary policy.
We also buy EM hard currency bonds to profit from attractive carry (i.e. higher interest rates compared to developed markets).

These changes are appropriate responses to the renewed decline in interest rates and term premia in the developed world. From a fundamental point of view (credit risk assessment, economic outlook), credit is more attractive than government bonds, while EM bonds remain attractive against other asset classes as well, i.e. relative to the more volatile EM equities. Finally, we retain our overweight in local currency EM bonds, which remain attractive due to high real yields and undervalued currencies.

Graph 6

Fixed income markets have recovered as well

(Total return indices, rebased to the start of 2019)



Source: LGT Capital Partners, Bloomberg, JP Morgan, Bloomberg-Barclays, ICE Bank of America Merrill Lynch

Foreign exchange: diverging paths for Norway and Australia

In currencies, we close our US dollar (USD) overweight and our euro (EUR) underweight. The two currencies had previously formed respective legs in our short Australian dollar (AUD) and long Norwegian krone (NOK) calls.

The adjustment of these pair trades is a direct result of the new dovish Fed regime, which reduces the USD's fundamental attractiveness. The EUR on the other hand has been suffering from faltering global growth, the ECB's easing efforts, and the manufacturing slump on the continent.

However, given that these events have now occurred, we do not see much further downside from this point onward.

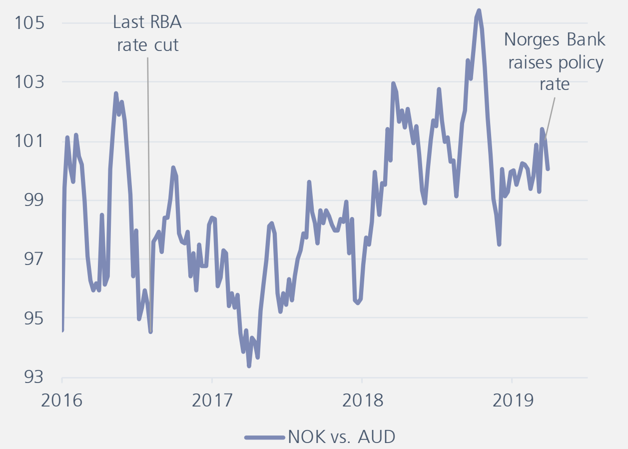
Consequently, we now hold a long NOK, short AUD position. Contrary to the global trend, the Norges Bank has recently raised interest rates by 0.25 percentage points, and outlined its intention to continue hiking going forward.

Conversely, market participants have started to price in rate cuts in Australia amid persisting headwinds from both the global as well as the domestic economic front. In fact, the housing market in Australia has taken a turn for the worse as home prices have fallen more than 5% year-on-year. In light of these events, we expect the Reserve Bank of Australia to join the dovish global central bank camp and cut rates in the coming months resulting in more downside pressure on the Aussie dollar.

Graph 7

Long NOK / Short AUD has further upside

(Rebased to 100 at the start of 2019)



Source: LGT Capital Partners, Bloomberg

Lastly, we maintain a passive overweight in EM currencies, resulting from our active position in respective bonds. This overweight, by design, reduces weight of the denomination currency of each portfolio, i.e. the USD in the table on page 5.

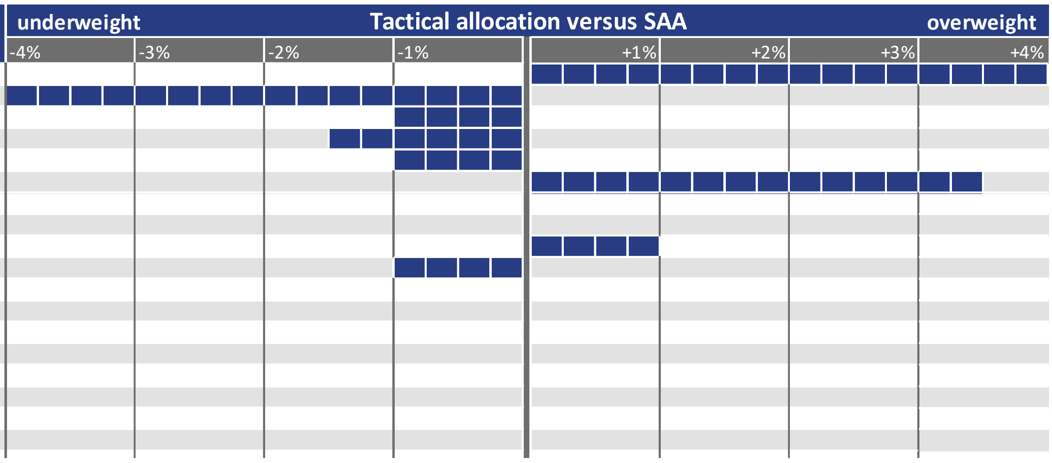
END OF REPORT

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

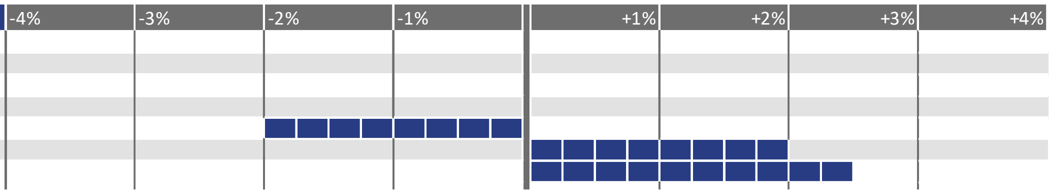
The tactical asset allocation (TAA) relative to the neutral strategic quotas (SAA) is set quarterly with a time horizon of three to six months and adjusted when deemed necessary in the interim.

- **Equities neutral, with a preference for the US at the expense of Europe**
- **Fixed income: still underweight duration and credit risk, with a clear preference for EM debt**
- **Long NOK vs. AUD while EM currencies remain a passive overweight; liquidity remains high**

	Asset class	SAA
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%

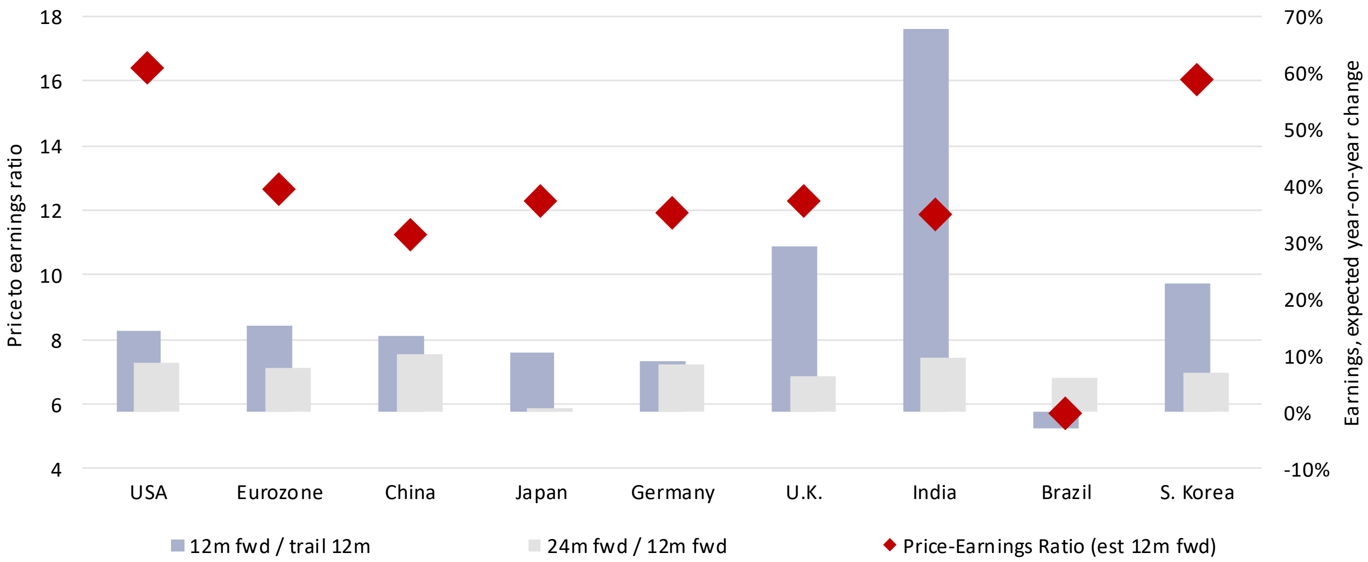
[1] IMF estimates [2] Manufacturing PMI for Korea [3] Currency swap rates for China and Brazil and closest ESM/EFSF bond for Eurozone [4] Max target rate for Fed

		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: 4/1/2019

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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