Tactical asset allocation for Q2/2018

The macro trends remain positive, but have gained an inflationary tilt - owing to the recent pro-business, pro-cyclical US tax reform, as well as the risk of rising trade barriers. The latter in particular could keep volatility elevated. We have thus decided to reduce our interest rate risk and further raise cash, while reaffirming our flexible approach in equities.

Our economic outlook has changed little from the previous quarter, although it has become slightly more inflationary for the developed markets (DM), while shifting further in favor of the emerging markets in terms of growth momentum (EM).

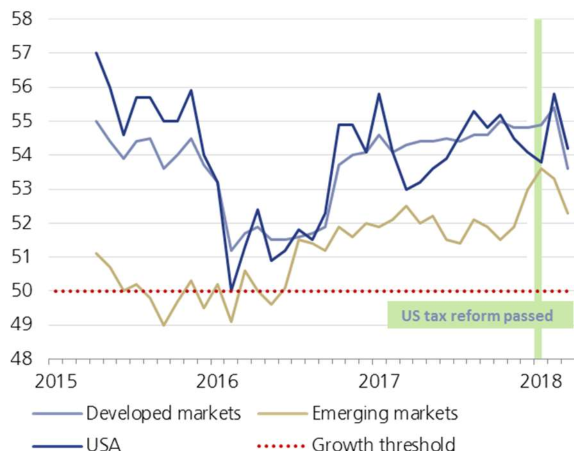
Baseline scenario: inflationary growth

Specifically, in our baseline scenario, economic growth remains synchronous around the globe. Although momentum is naturally slowing, the DM continue to grow mostly above potential and are running into capacity constraints - which supports investment, reduces unemployment, and hence lifts wages over time. In the US, the tax reform that was passed shortly before Christmas further underpins the cyclical expansion by bolstering household and corporate earnings, albeit at the cost of widening the federal fiscal deficit. The cyclical outlook remains positive in Europe and Japan as well.

Graph 1

Business indicators remain at high levels

(Markit purchasing managers' composite indices)



Source: LGT Capital Partners, Bloomberg

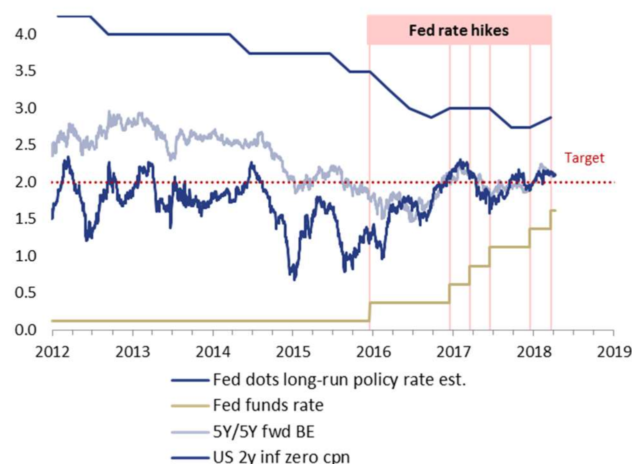
As a result, both actual and expected inflation rates are either already at targeted levels (U.S.), or rising towards them (Eurozone, Japan). Hence, the Federal Reserve's strategy of a gradual (and clearly data-dependent) monetary policy normalization was reaffirmed and should eventually spread to the other economies, albeit perhaps not as quickly as the recent strengths in the euro and the yen seem to imply.

Either way, owing to - finally - being on target in a stable manner (graph 2), the Fed remains firmly in the lead when it comes to tightening monetary policy.

Graph 2

US inflation expectations on target

(Market-implied medium- and long-term inflation rates)



Source: LGT Capital Partners, Bloomberg

Unsurprisingly, on March 22, the Fed raised the federal funds rate target range by 25 basis points, to between 1.5% and 1.75%. The Fed's median rate projections for the next two years have also rose by slightly more than 25 basis points, while the estimated long run policy rate moved 12.5 basis

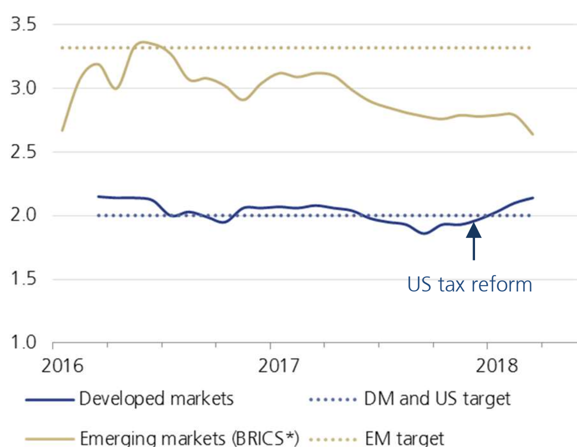
points higher, to 2.875%, implying five hikes of 25 basis points each over the next three years.

Last but not least, in the EM, China's cyclical upswing has surprised on the upside recently, perhaps supported by the notion that the recent concentration of political power helps underpin confidence in the country's ongoing reform and modernization process. More broadly speaking, most EM have only recently re-emerged from the commodity slump of a few years ago, and are still in an earlier stage of their business cycle, with inflation trends still clearly below target in most cases (graph 3). In short, the emerging economies offer more room for a cyclical catch-up before running into similar capacity constraints as the developed world.

Graph 3

Inflation estimates by region

(Median estimates of private sector economists, annual inflation rate in percent)



*BRICS = Brazil, Russia, India, China, South Africa. The inflation target for the BRICS is the nominal gross domestic product-weighted sum of the national targets. Source: LGT Capital Partners, Bloomberg

Risk scenario: protectionism and stagflation

On the downside, the U.S. administration's recent trade policy initiatives have turned more unabashedly protectionist in tone and method, although perhaps not in terms of their intended final outcome. On March 8, Washington announced conditional across-the-board steel and aluminum tariffs, aiming to strong-arming both allies and rivals into trade concessions in areas ranging from cars to intellectual property and investment. On March 22, the U.S. added substantial additional tariffs on Chinese imports. In principle, these trade issues can (and probably will) be resolved in the various trade agreement renegotiations, and are thus not likely to significantly stymie global trade and growth.

The U.S. is already involved in trade negotiations with a number of countries and allies (Canada, Mexico, Europe, Japan, etc.), which provides the context for the tariff threat. With regard to China, the U.S. negotiating approach may prove counterproductive due to the strategic rivalry between the two powers. However, Washington's core grievances versus China are largely shared by Europe, Japan, and most of the remaining ten members of the Transpacific Partnership (TPP), which makes concessions from Beijing more likely.

Nevertheless, the U.S. administration's aggressive tone could gradually erode market sentiment more substantively, and/or trigger meaningful retaliatory measures from China and perhaps other major economies at some point. In our alternative scenario, we thus now see the risk of a stagflationary setback, i.e. an economic slowdown with higher inflation. In that sense, the geopolitical and political risks are now slightly more pronounced than before.

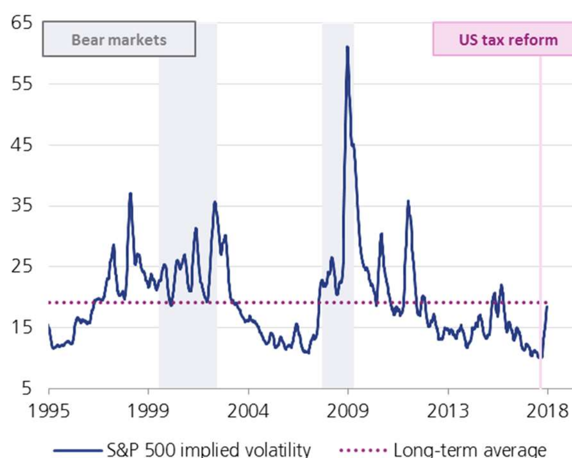
Strategy: risk-aware, but constructive and flexible

In markets, our concerns regarding the potential build-up of unsustainable euphoria, expressed following our last quarterly review in December, proved justified, as volatility levels have risen from exceptionally low levels back to a level that is more normal for mature bull markets (graph 4). The past quarter's selloffs have thus helped wipe out some extremely one-sided positions in markets (e.g. the short-volatility strategies), rolling back investor complacency.

Graph 4

Volatility rises from historical lows

(12-week moving average of VIX*)



Graph 5

Valuations have fallen markedly during Q1

(MSCI data, price to estimated earnings for the year)

*VIX = Chicago Board Options Exchange S&P 500 Volatility Index. Source: LGT Capital Partners, Bloomberg

From a behavioral finance perspective, markets have actually become more attractive. Valuations meanwhile have come down quite markedly during the first quarter, thanks to a combination of higher expected earnings for the year and the broadly unchanged level of stock prices on an index level (graph 5).

The price-to-earnings ratios are broadly where they were at the start of 2016, when the period of extraordinarily low volatility began. These factors are in turn balanced by a deterioration of technical trends.

The resulting picture is admittedly mixed, but not negative. Hence, we stick to our strategy of combining a modest overweight in equities with defensive and anticyclical elements - i.e. to hold elevated cash reserves in order to be able to "buy the dips" (and "sell the rallies") during market exaggerations.

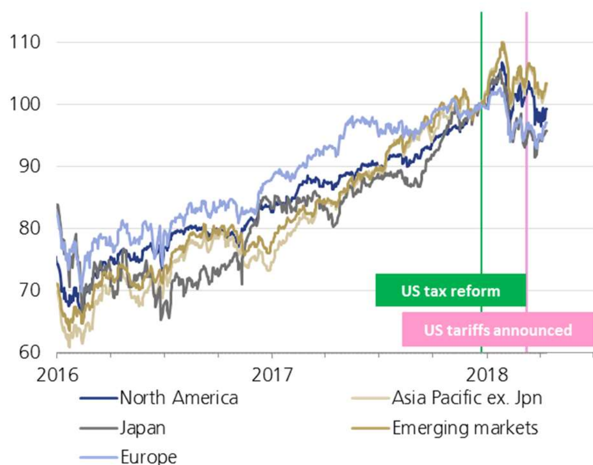
Equities: regional shift from Europe to U.S. and the EM

Specifically, we have pivoted from Europe in favor of the EM and the U.S. - although we take an anticyclical, opportunistic approach in the latter case ("buying the dip" and "selling the rally"). With the S&P 500 having slipped back close to February's low, it has become more attractive again (we had already actively traded the S&P 500 in and out during the first quarter). We also increased our EM position during the February selloff - and decided to add to it again now.

Graph 6

Equity markets mixed since US tax reform

(MSCI indices, rebased to tax reform date)



Source: LGT Capital Partners, Bloomberg

We have also reduced our European position primarily due to technical factors (loss of momentum, unconvincing rebound from the selloff, etc.), while our cyclical view remains broadly as positive as in December. Our positive view on and positioning in Japan remain unchanged.

Overall, our positioning in the DM is now marginally above neutral, while our EM overweight is somewhat more pronounced.

Fixed income: further reduce exposure, except in the EM

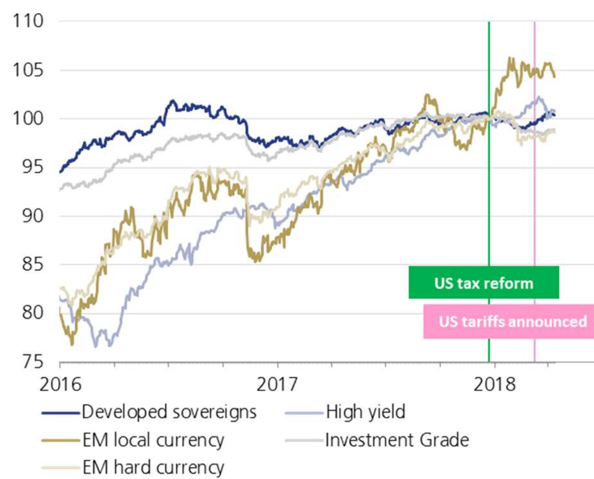
In fixed income, we stay short duration and decided to expand our pronounced underweight in developed sovereigns to the corporate space. We have also trimmed exposure to inflation-linked securities, and maintain our overweight in the EM.

Specifically, we have sold positions in Investment Grade (IG) and to lesser degree also in High Yield (HY) and in Global Inflation-Linked Bonds (GILB).

Graph 7

Performance of debt market segments

(Total return indices*, rebased to tax reform date)



*Indices used: J.P. Morgan for DM and both EM categories, Bloomberg Barclays for IG, ICE Bank of America Merrill Lynch for HY. Source: LGT Capital Partners, Bloomberg

We are aware that credit has historically performed well during late-cycle market phases, i.e. when interest rates rise due to a robust economy. However, the risk premia are simply too low and thus unattractive for us at current levels.

Similarly, while inflation-linked bonds generally benefit from a more inflationary outlook going forward, we prefer to address the related risk (i.e. the rise in interest rates) by managing portfolio duration via the level of cash reserves.

The notable exception in our overall fixed income allocation are the EM, where we maintain a modest overweight, resulting from a clear preference for local currency-denominated securities over their hard-currency counterparts. Our EM credit view is consistent with our favorable fundamental macro assessment on this category of economies, their equity markets, as well our currency scorings.

Alternatives and real assets: staying the course

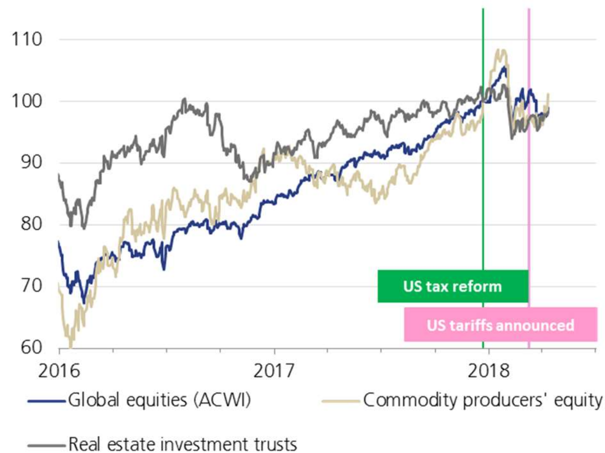
During the previous strategy review in December, we had upgraded hedge fund (HF) strategies back to our neutral strategic quota, due to our conviction in their long-term usefulness as diversifiers. Now, we have also decided to sell positions to rebalance our overweights in real estate investment trusts

(REITs) and commodity producers equities back down to neutral. Finally, we maintain our long-standing pronounced underweight in Listed Private Equity (LPE). The overall tactical underweight in alternative and real assets has thus slightly increased as result.

Graph 8

REITs and commodity producers' equities

(Total return indices, rebased to tax reform date)



Index providers: FTSE EPRA index for real estate investment trusts and MSCI for commodity producers and global equities. ACWI = MSCI All-countries World Index.
Source: LGT Capital Partners, Bloomberg

Conceptually, going forward, we generally intent to stay broadly neutral in the alternative asset space, since these allocations are strategic, rather than tactical, in nature. Tactical (hence more frequent) changes will primarily concern the traditional public markets for equities, bonds and currencies.

Liquidity: substantial increase in our cash reserves

Including the changes in alternatives and real assets, our total equity risk exposure was further reduced to only a modest overweight, while the fixed income quota has also dropped significantly.

Conversely, the cash position in our portfolios has increased substantially, which enables us to redeploy in the financial markets if and when opportunities arise.

Currency overlay: Norway and the EM preferred

In foreign exchange (FX), we closed remaining tactical long positions in the US dollar (USD) and the euro (EUR), and the short position on the Japanese yen (JPY) and the Swiss franc (CHF).

These changes were primarily triggered by shifts in the technical assessments, rather than our fundamental or monetary policy views, which have changed little. Expectations of a more restrictive monetary policy stance in the U.S. seem to be largely priced in by now. At the same time, markets expect the European and Japanese central banks to start preparing for their respective policy normalizations. While we maintain our doubts regarding these views, we respect the apparent market verdicts, and take a neutral active view on nearly all major currencies.

Our fundamental and technical scorings coincide more clearly in the case of the Norwegian krone (NOK, favorable) and the Australian dollar (AUD, unfavorable). We thus open a new long NOK position against the AUD. The diverging prospects in interest rates as well as the oil versus iron ore outlook make the case of this long/short combination.

Graph 9

FX: Norwegian krone vs. Australian dollar

(Spot price-based indices, rebased to tax reform date)

EM currency index = J.P. Morgan Emerging Market Currency Index (EMCI) Live Spot.
Source: LGT Capital Partners, Bloomberg

Lastly, we maintain a passive overweight in primarily EM currencies, resulting from our active positions in emerging market equities and bonds.

END OF REPORT

LGT Capital Partners: tactical asset allocation for a balanced model portfolio in USD

Our tactical asset allocation (TAA, positions versus neutral strategic quotas) is set every quarter with a time horizon of three to six months and reviewed monthly, as well as ad-hoc, when needed. Further action may be implemented for purely technical reasons at any time. The current TAA was last revised on March 29, 2018.

- **Overweight in equities, strong underweight in fixed income (excluding EM), and very high cash reserves**
- **Real/alternative assets: neutral at strategic quota, with the exception of listed private equity**
- **Currencies: Long NOK versus AUD and increased passive overweight in "others" (mainly EM and Asian currencies)**

	Asset class	underweight	Tactical allocation versus SAA	overweight
		-8% -6% -4% -2%		+2% +4% +6% +8%
Fixed income	Short-term investments			+10%
	Global government bonds			
	Global inflation linked bonds			
	Investment grade corporates			
	High yield bonds			
	Emerging market bonds			
Equities	Global defensive			
	North America			
	Europe			
	Japan			
	Asia/Pacific ex Japan			
	Emerging markets			
Real	Commodity producers			
	Real estate (REITs)			
	Infrastructure			
Alternatives	Insurance linked securities			
	HF CTA			
	HF equity long/short			
	HF event driven			
	HF relative value			
	Listed private equity			
		-8% -6% -4% -2%		+2% +4% +6% +8%
Currencies	USD			
	EUR			
	CHF			
	JPY			
	NOK			
	AUD			
	Others			

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	1.1%	0.8%	0.3%	1.8%	2.9%
Global inflation linked bonds	USD	0.8%	0.3%	0.0%	1.7%	0.8%
Investment grade corporate bonds	USD	0.3%	-1.1%	-1.4%	1.8%	2.1%
High yield bonds	USD	0.2%	-0.4%	0.5%	6.3%	4.9%
Emerging market bonds	USD	0.2%	-1.1%	-0.4%	5.0%	2.5%
Equities						
Global defensive	USD	-1.5%	-2.3%	-1.1%	7.5%	8.7%
North America	USD	-4.7%	-4.8%	-0.9%	8.9%	11.6%
Europe	EUR	-0.5%	-5.2%	-2.8%	2.1%	8.0%
Japan	JPY	-0.3%	-7.6%	-4.3%	3.3%	9.3%
Asia/Pacific ex. Japan	USD	-2.7%	-2.5%	1.0%	6.8%	7.1%
Emerging markets	USD	-3.6%	-2.3%	1.9%	6.8%	5.4%
Real assets						
Commodities (commodity producers' equities)	USD	4.4%	-5.4%	0.2%	3.5%	1.0%
Real estate (real estate investment trusts, or REITs)	USD	0.7%	-1.9%	-3.7%	2.5%	3.9%
Infrastructure (master limited partnerships, or MLPs)	USD	-5.8%	-15.3%	-7.5%	-10.7%	-5.0%
Alternatives						
Insurance linked securities (ILS)	USD	0.3%	1.1%	1.9%	4.3%	5.5%
HF CTA	USD	-0.5%	-5.6%	-3.3%	-3.5%	1.7%
HF equity long/short	USD	-0.3%	0.7%	0.7%	5.3%	5.7%
HF event driven	USD	-0.5%	0.2%	0.2%	4.1%	4.7%
HF relative value	USD	0.0%	0.8%	0.8%	3.8%	4.2%
Listed private equity	USD	-3.6%	-5.3%	-0.8%	8.6%	10.1%
Currencies [2]						
US dollar	USD	-0.2%	-0.6%	-2.2%	-1.3%	3.3%
Euro	EUR	0.1%	0.9%	1.1%	4.5%	2.0%
Swiss franc	CHF	-1.4%	0.5%	-0.4%	-0.5%	2.6%
Canadian dollar	CAD	2.1%	-1.7%	-2.4%	-1.3%	-1.5%
Swedish krona	SEK	-1.3%	-4.2%	-4.1%	0.9%	-2.7%
Japanese yen	JPY	-0.6%	3.8%	3.8%	3.1%	1.4%

[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	19,362	12,526	11,938	4,884	3,652	2,565	2,081	1,469	681
- nominal, per capita 2017[1]	USD, PPP	59,495	38,322	16,624	42,659	50,206	43,620	15,500	27,900	61,360
- 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	2.8%	2.4%	6.5%	1.3%	2.5%	1.5%	2.7%	1.9%	2.0%
- real growth in most recent quarter[2]	q/q annualized	2.9%	2.4%	6.6%	1.6%	2.4%	1.6%	0.4%	-2.3%	2.4%
Unemployment rate[3]		4.1%	8.5%	3.9%	2.5%	5.3%	4.3%	8.2%	5.0%	2.9%
Inflation, core rate (CPI)	y/y	1.6%	1.0%	2.0%	0.3%	1.6%	2.4%	2.7%	1.8%	0.6%
Purchasing manager indices (comp.)	Neutral = 50	54.2	55.2	51.8	51.3	55.1	52.5	51.5	53.2	60.3
Structural budget balance/GDP 2017	IMF	-4.4%	-0.9%	-3.8%	-4.0%	0.3%	-2.8%	-7.8%	-2.0%	0.2%
Gross government debt/GDP 2017	IMF	108%	91%	48%	240%	65%	89%	83%	17%	43%
Current account balance/GDP 2017	IMF	-2.4%	3.1%	1.4%	3.6%	8.1%	-3.6%	-1.4%	2.8%	9.9%
International currency reserves	bn USD	45	273	3,143	1,205	38	127	185	378	826
Govt bond yield 2yr[4]	p.a.	2.31%	-0.51%	3.41%	-0.15%	-0.57%	0.89%	7.36%	7.54%	-0.83%
Govt bond yield 10yr[4]	p.a.	2.78%	0.59%	3.80%	0.04%	0.50%	1.39%	8.02%	7.86%	0.00%
Main policy interest rate[5]	p.a.	1.75%	0.00%	4.35%	-0.10%	0.00%	0.50%	6.50%	7.25%	-0.75%

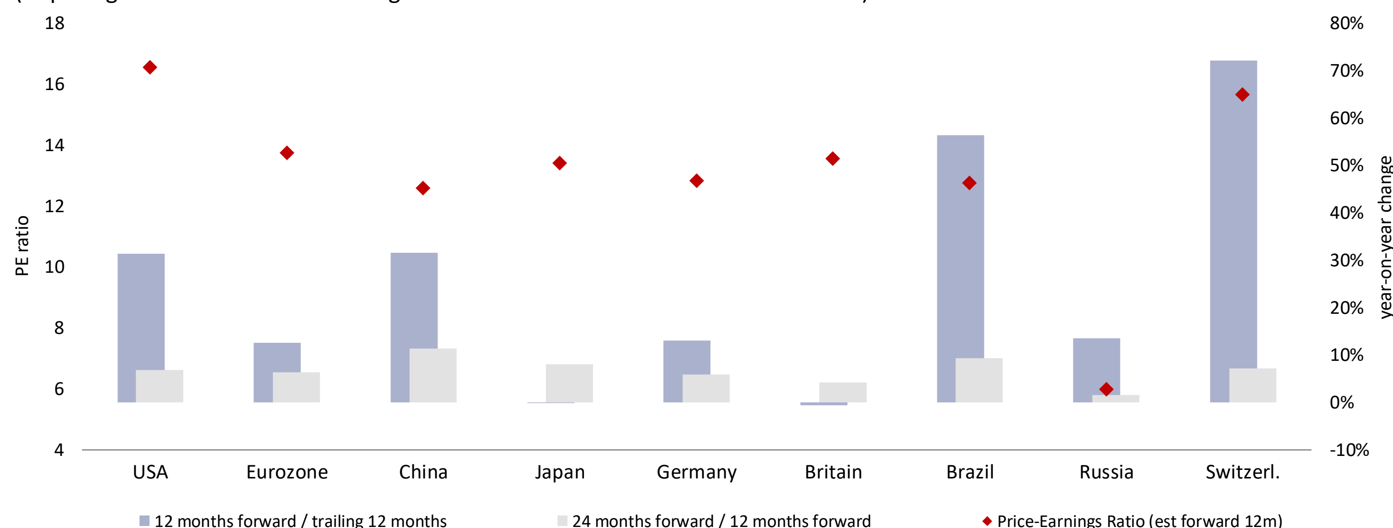
[1]IMF estimates. [2]annualized, most recent qtr. [3]PRC ex. migrant workers. [4]Currency swap rates for China and Brazil, closest ESM or EFSF bonds for Eurozone. [5]Max target rate for Fed, middle of the target range for SNB

Corporate fundamentals		USA	Eurozone	China	Japan	Germany	Britain	Brazil	Russia	Switzerl.
Exchange capitalization*	bn USD	29,567	8,630	13,505	6,363	2,485	3,778	966	561	1,608
Growth in earnings per share, estimated (MSCI)										
12 months forward / trailing 12 months	Consensus	31.5%	12.6%	31.6%	0.0%	13.1%	-0.5%	56.4%	13.6%	72.1%
24 months forward / 12 months forward	Consensus	7.0%	6.4%	11.5%	8.2%	6.0%	4.3%	9.5%	1.6%	7.3%
Growth in revenue per share, estimated (MSCI)										
12 months forward / trailing 12 months	Consensus	4.8%	3.4%	12.3%	2.1%	3.5%	3.3%	6.4%	3.7%	4.3%
24 months forward / 12 months forward	Consensus	4.8%	1.3%	8.7%	1.1%	4.0%	2.3%	7.7%	8.1%	2.6%
Valuation metrics (MSCI)										
Price-Earnings Ratio (est forward 12m)	Consensus	16.6	13.8	12.6	13.4	12.8	13.6	12.8	6.0	15.7
Price-Sales Ratio (est forward 12m)	Consensus	2.0	1.1	1.5	0.9	0.9	1.2	1.6	0.8	1.9
Dividend yield	Consensus	1.0%	3.4%	2.2%	2.3%	3.1%	4.4%	3.3%	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)



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