May 15, 2018

The increased incentive to just sit on the fence

The global economy is doing well, volatility has receded, and the rise in US bond yields has slowed. Simultaneously, even short-term US real rates have turned positive at a time of some extraordinary geopolitical events. For the first time in a decade, investors are being rewarded for sitting on the fence. This weighs on the momentum of the stock market rebound.

There is no lack of extraordinary international political events lately: April began with an escalating exchange of import tariff threats between the US and China. The tensions have eased with the start of official negotiations (graph 1), but the dispute could flare up again at any point as numerous trade-related decisions and events are approaching.

At the same time, the two Korean states' leaders held a historic summit, vowing to work toward denuclearization and to formally end the Korean War. Furthermore, a summit between US President Donald Trump and North Korean leader Kim Jong-un will be held on June 12.

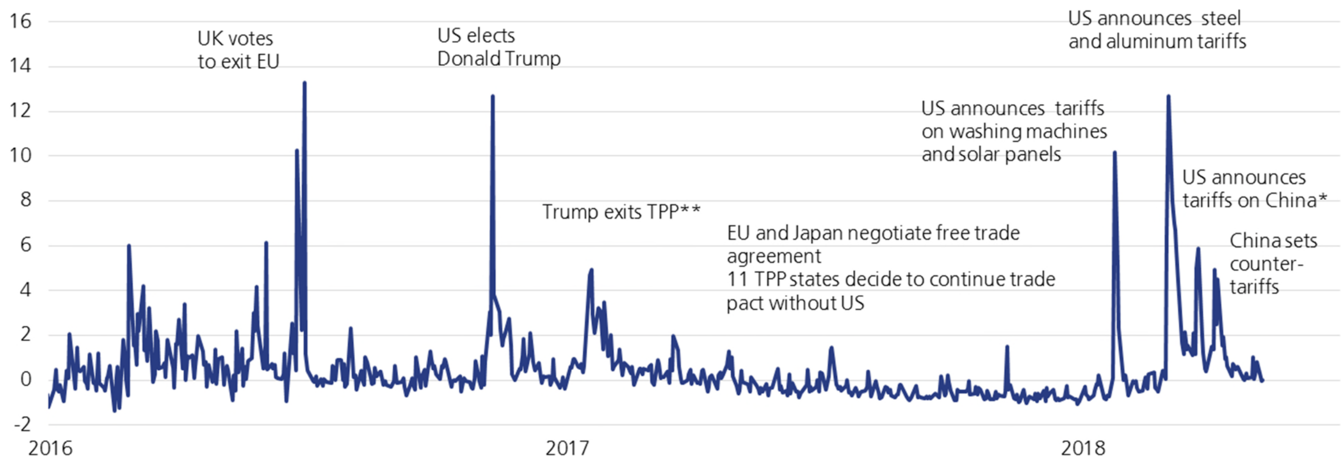
After years of intense saber rattling, a significant détente has occurred on the Korean peninsula, which is clearly a positive. The process until actual agreements are signed, however, may prove long and difficult.

Then, on May 8, the US opened a (not entirely) new geopolitical front by announcing its withdrawal from a 2015 agreement to curb Iran's nuclear program, announcing that it would reinstate financial sanctions against the Islamic republic. This event, albeit expected to some degree, may further contribute to a higher level of oil prices, which could in turn make it more difficult for central banks to ease monetary policy if growth were to slow markedly in the future - increasing the risk of a stagflationary outcome.

Political events fail to trigger strong market reactions

On the other hand, a case can be made that these developments could end up producing mostly positive results in the end, such as new, workable agreements on trade and a lasting peace in Korea. Indeed, market volatility has receded somewhat over the past month.

Graph 1
Trade war tracker index
(One-year deviation from the mean value)



*Tarrifs on selected high-tech value-added sectors, later countered by similar Chinese counter-measures
**TPP = Transpacific Partnership between Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore and Vietnam
Source: LGT Capital Partners, Bloomberg

Nevertheless, upward momentum in the stock markets has faded in tandem as well. The latter is remarkable, given that most of the economic data continue to point toward only a modest and temporary slowdown of global economic growth (if any), with only marginally higher (energy price-driven) inflation rates. The US corporate earnings season for the first quarter, meanwhile, was among the strongest on record in terms of the number of companies beating (even the significantly increased level of) expectations.

Despite the good fundamentals, the stock markets have generally failed to regain any meaningful upward momentum. While recent laggards such as Europe and Japan finally rebounded after several months on the back foot, the broader global indices for both developed and emerging markets continue to trade little changed year-to-date. In short, investors seem unsure what to make of all this unusual mix of events, preferring to stand on the sidelines for now.

Economically, there is a sense in the markets that the growth cycle may have peaked, while the extraordinary geopolitical developments either seem to be too good to be true, or are liable to lead to difficulties further down the road.

Strategy: stay prudently constructive, but keep ample reserves in cash

Against this background, our strategy of combining very high cash reserves with a modest overweight in equities remains appropriate overall. Investors will probably need more time to make up their mind and regain full confidence in the bull market. A sharp selloff in stock markets might also reignite interest by driving valuations to truly attractive levels. In case of a continued gradual rebound, the previous highs may offer resistance again.

That said, we believe the economy remains on track for continued growth, which will eventually reignite interest in equities. Short-term fluctuations aside, the economic outlook remains positive around the globe. For example, the three-month moving averages of the global manufacturing purchasing managers' indices continue to point higher, as a loss of momentum in Europe is balanced by gains in the US and elsewhere (graph 2). Furthermore, while the developed markets (DM) are in a late stage of their growth cycle, the emerging markets (EM) are still in the early stages of their rebound. Representing close to half of the global economy, they thus can make up for the moderation of growth in the DM going forward.

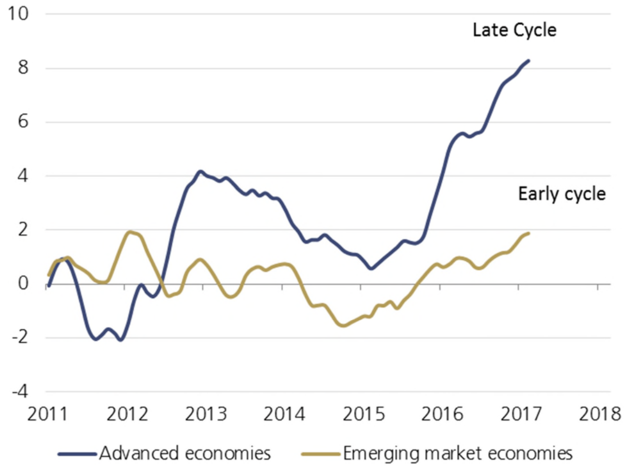
Global trade has stabilized markedly

Moreover, Sino-American trade tensions notwithstanding, global trade volumes have just recently recorded the strongest annual growth rate in at least seven years, supporting a continued world-wide acceleration in industrial production (graph 3). After an era of underinvestment in fixed assets, the DM are now increasingly meeting capacity constraints, just as the EM re-emerge from the commodity slump of a few years ago. For this reason, while the trade growth is likely to moderate going forward, the underlying positive drivers are expected to remain in place - with or without partly higher tariffs in the US and China (it is worth noting that other major economies have recently concluded major free trade agreements, as we show in graph 1).

Graph 2

Manufacturing purchasing managers' indices

(Three-month moving averages, deviations from threshold value at 50 points)



Source: LGT Capital Partners, Markit Economics, International Monetary Fund

Graph 3

Global activity: trade and industrial production

(Three-month moving average; annualized percent change)

Source: LGT Capital Partners, International Monetary Fund

Surprisingly strong US earnings season

Furthermore, the first quarter's corporate earnings season in the US was one of the best in recent history, with aggregate earnings per share (EPS) up almost 25% year-on-year, surpassing the forecast value by about 6%. It is also worth noting that consensus expectations had risen by the strongest level in decades ahead of the earnings season, following the passage of the US tax reform shortly before Christmas. So these results beat an elevated level of forecasts.

While the rebound was biggest in energy and materials, owing to the steady rebound in industrial commodity prices over the past year, ten of the eleven main stock market sectors delivered double-digit earnings growth. Importantly, revenues per share, which aren't impacted by changes in tax accounting, rose about 8.5%, also slightly beating expectations.

Table 1

Overview of earnings season results for Q1/2018

(Individual results, aggregated to index level)

	Companies that have reported / total companies in the index	Actual EPS growth (year-on-year)	Difference vs. consensus forecast
USA	90%	23.5%	6.1%
Europe	81%	5.2%	3.3%
- of which Eurozone	78%	6.8%	2.7%
- non-Eurozone	89%	3.2%	4.4%
Japan	68%	2.5%	-5.4%
Asia Pacific ex Jpn	62%	13.8%	-4.8%
Emerging markets	59%	14.7%	-4.2%

Results as of May 10, 2018

Source: LGT Capital Partners, Bloomberg

Results were more uneven and mixed in the other regions, but still satisfactory. For example, EPS in Asia and the EM came in below forecast this quarter - but growth is still high. Besides, some markets had been growing much faster than expected in the previous quarters, so a single weak season does not yet signal the end of a trend. Last but not least consensus forecasts for one-year forward EPS remain modest for markets other than the US.

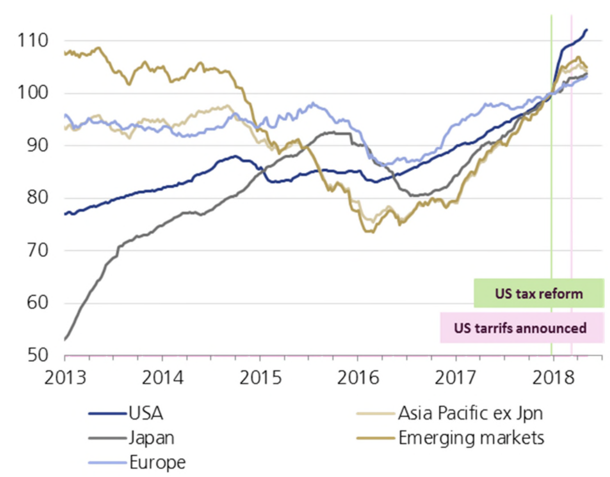
Earnings expectations for companies outside of the US are moderating again

The chart below shows that while the US and Japan may be near to the cyclical peak in regards to the earnings (if we assume a major slowdown of growth), the other markets are still at about 2013 levels. If the global economy continues to expand, there is still sufficient room for growth. Furthermore, non-US earnings forecasts have started to decline after the announcement of the US trade tariffs on March 8 (graph 4), which should make future positive surprises easier.

Graph 4

One-year forward earnings per share

(MSCI indices, rebased to the date of tax reform passage)



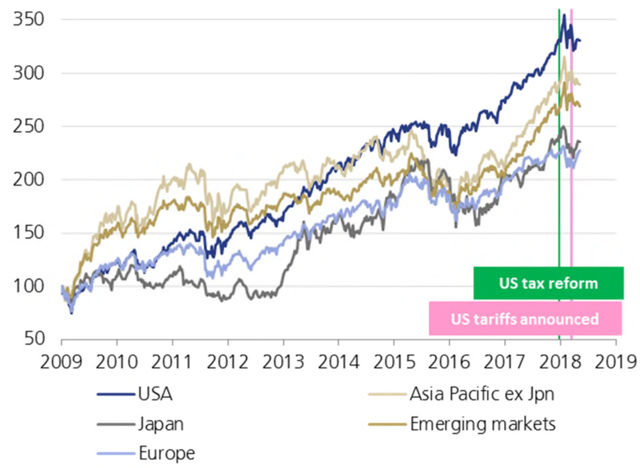
Source: LGT Capital Partners, Bloomberg

Yet, as noted earlier, even the US stock market, where both actual and expected earnings were strong, is not nearly as strong as these fundamentals would imply. The US stock market index has yet to reclaim the January highs. The same is true for all other indices (graph 5). Hence, valuations have been compressed further, especially in the US.

Graph 5

Performance of the main stock market indices

(MSCI total return indices, rebased to the start of 2009)



Source: LGT Capital Partners, Bloomberg

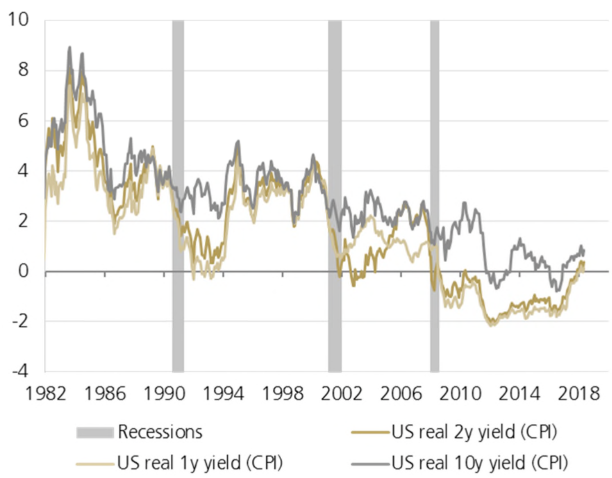
Make cash great again

In view of the mentioned late cyclical and geopolitical concerns, valuations have apparently not fallen enough to entice investors to re-enter equity markets at this point. A key reason for this lack of interest may also be found in the increasing attractiveness of cash in US dollars (USD). For the first time in a decade, even short-term risk-free US securities now offer positive real returns (graph 6). Hence, investors who do not need to hedge their USD exposure are now rewarded financially to just play it safe while they wait to see how things go - an attractive proposition in times of elevated policy uncertainty and political change.

Graph 6

Short-term US interest rates have turned positive

(Percent per annum)



Source: LGT Capital Partners, Bloomberg

That said, as the chart above illustrates, real interest rates are still very low by historical standards. Normally, real rates tend to be higher on average during bull markets. However, after an abnormally long period in negative territory since 2008, it is perhaps not surprising that markets need some time to get used to the novelty of returning to what was once the norm.

Patience will pay off

Overall, as long as the macro trends remain positive, investors are very likely to return to seeking higher returns in riskier markets. Our basic assumptions can be summed up as follows:

- Global economic growth should remain quite robust, reducing equity valuations further and eroding concerns that earnings levels have peaked
- Inflation will generally meet or modestly exceed targets, but not prove excessive, limiting the rise in interest rates
- The restored confidence in projected earnings growth will balance the negative impact of the relatively modest rise in interest rates (known as the discount rate effect)

Confrontations always lurk in geopolitics, but the current tensions are likely to stay manageable and lead to pragmatic compromises. The Korean détente may prove a good example of the path forward. For now, we nevertheless prefer to wait for a better opportunity to re-enter markets, be it after an exaggerated selloff or as a result of the healing effect of time.

END OF REPORT

Special topic: Détente on the Korean peninsula: buy the rumor, sell the fact?

In our November edition of the LGT Beacon, we noted on how positively East Asia's stock exchanges had reacted to the escalating saber rattling between Pyongyang and Washington. As our last chart shows, the resumption of North Korean weapons testing in early 2016 had marked a clear upturn in regional stock markets (graph 7).

Between January 6, 2016, when North Korea resumed a nuclear bomb test after a three-year break, and the start of the Winter Olympics in South Korea on February 9, 2018, when the Korean diplomatic thaw process began, the MSCI Korea delivered a total return of around 60%, compared to a comparatively modest 34% for the MSCI World. Other Far Eastern bourses performed similarly well. While this strength was predominantly driven by economic factors, the speculative prospect of a diplomatic settlement of the conflict must have played a role as well. At the time, we though a positive outcome might not yet be fully priced in.

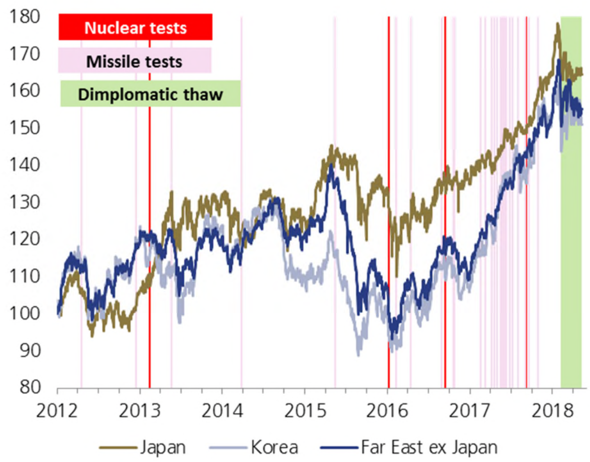
Meanwhile, the thaw is a fact: there was a historic summit of the Korean presidents, Moon Jae-in and Kim Jong-un, and there will soon be an unprecedented meeting between a North Korean leader and a sitting US president. Even Japan and China, following a rather chilly relationship in recent years, have begun to meet and talk more frequently at the highest level.

Korean stock prices, however, have become more volatile this year - in line with all other markets in the wake of the rise of global risk factors (e.g. fears of soaring US interest rates, the Sino-American trade war). Still, they continue to hold up relatively well for now. The MSCI Korea has shed about 2.5% year-to-date, while the MSCI World is basically unchanged. However, the détente nevertheless continues to play a positive role when global macro fears recede.
Since the start of the Korean thaw on February 9, Korean equities have gained about 5.3%, compared to about 3.3% for the MSCI World.

Nevertheless, given the strength during the period of escalating belligerence, Korean stocks may not continue to perform as well going forward. Markets often price in future speculative events in advance, a pattern known as "buy the rumor, sell the fact". After two years of pronounced outperformance, the possible general idea of a "peace dividend" may already have been priced in.

Generally, we expect Korean equities to perform well once the global market environment improves - but in order for Korea to continue to outperform as strongly, markets will probably need to see additional and more concrete developments with even greater positive surprise potential. While that may very well happen eventually, a wait and see posture is more appropriate for now.

Graph 7
East Asian equities and events on the Korean peninsula
(MSCI net return indices in USD, rebased to the start of 2012)

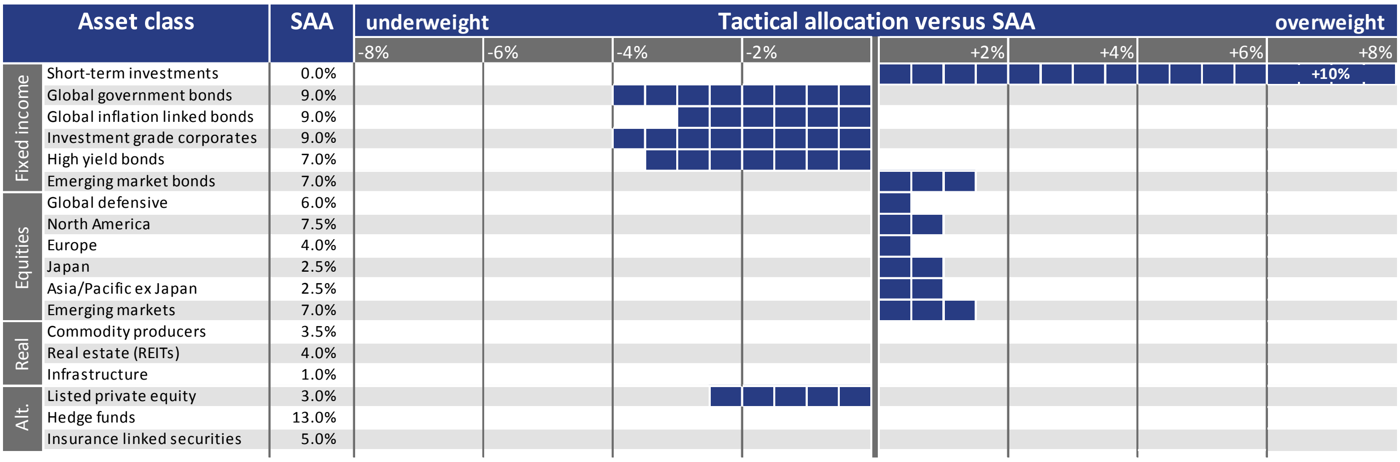


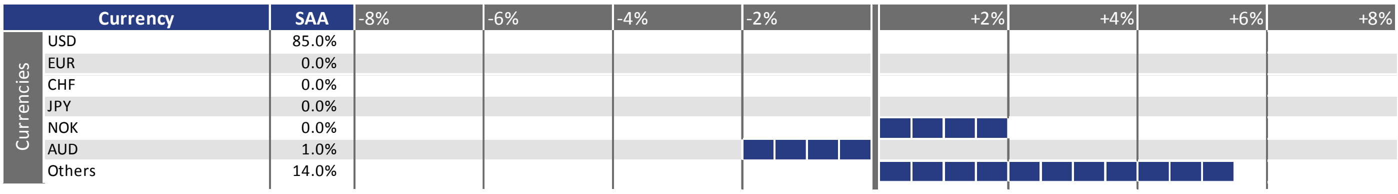
Source: LGT Capital Partners, Bloomberg

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)**





The TAA positions shown are based on the LGT GIM Balanced (USD) strategy managed by LGT Capital Partners Ltd. 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	-0.4%	1.1%	-0.3%	2.4%	2.8%
Global inflation linked bonds	USD	0.0%	1.2%	0.0%	1.9%	1.0%
Investment grade corporate bonds	USD	-0.5%	-0.4%	-2.0%	1.7%	2.0%
High yield bonds	USD	-1.1%	-0.5%	-0.4%	5.2%	4.5%
Emerging market bonds	USD	-3.0%	-2.4%	-3.2%	4.2%	1.9%
Equities						
Global defensive	USD	0.8%	0.0%	-0.4%	7.4%	8.4%
North America	USD	3.0%	0.5%	2.5%	9.7%	11.5%
Europe	EUR	4.9%	6.1%	2.5%	5.1%	7.9%
Japan	JPY	4.4%	5.1%	0.1%	4.5%	8.4%
Asia/Pacific ex. Japan	USD	1.3%	0.4%	1.9%	7.1%	6.6%
Emerging markets	USD	0.0%	-2.4%	1.4%	6.3%	4.7%
Real assets						
Commodities (commodity producers' equities)	USD	6.7%	10.7%	7.7%	4.6%	2.2%
Real estate (real estate investment trusts, or REITs)	USD	3.5%	5.5%	-0.6%	3.7%	4.3%
Infrastructure (master limited partnerships, or MLPs)	USD	8.6%	-1.5%	-0.2%	-9.3%	-4.1%
Alternatives						
Insurance linked securities (ILS)	USD	0.7%	1.1%	2.7%	4.5%	5.4%
HF CTA	USD	0.3%	2.6%	-2.3%	-1.4%	1.8%
HF equity long/short	USD	0.4%	-2.0%	0.8%	4.7%	5.7%
HF event driven	USD	0.4%	-0.7%	0.6%	3.8%	4.6%
HF relative value	USD	0.7%	-0.2%	0.9%	3.5%	4.0%
Listed private equity	USD	1.7%	-1.3%	0.9%	8.0%	9.8%
Currencies [2]						
US dollar	USD	3.4%	5.3%	1.4%	1.9%	3.5%
Euro	EUR	-0.3%	-0.1%	0.7%	3.4%	1.7%
Swiss franc	CHF	-1.0%	-3.9%	-1.6%	-1.4%	2.7%
Norwegian krona	NOK	-0.3%	1.4%	3.8%	-1.7%	-3.6%
Australian dollar	AUD	-0.1%	-0.9%	-2.6%	-0.6%	-2.6%
Japanese yen	JPY	0.8%	1.4%	4.4%	5.0%	1.9%

[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%	2.3%	6.5%	1.3%	2.3%	1.5%	2.5%	1.8%	2.0%
- real growth in most recent quarter[2]	q/q annualized	2.3%	1.6%	5.7%	1.6%	2.4%	0.4%	0.4%	-2.3%	2.4%
Unemployment rate[3]		3.9%	8.5%	3.9%	2.5%	5.3%	4.2%	8.2%	5.0%	2.7%
Inflation, core rate (CPI)	y/y	1.9%	0.7%	2.0%	0.3%	1.6%	2.3%	2.8%	1.9%	0.5%
Purchasing manager indices (comp.)	Neutral = 50	54.9	55.1	52.3	53.1	54.6	53.2	50.6	54.9	63.6
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	44	285	3,125	1,194	38	124	185	379	822
Govt bond yield 2yr[4]	p.a.	2.55%	-0.48%	3.38%	-0.13%	-0.56%	0.81%	7.82%	7.48%	-0.71%
Govt bond yield 10yr[4]	p.a.	3.01%	0.71%	3.85%	0.06%	0.61%	1.47%	8.57%	7.77%	0.10%
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%

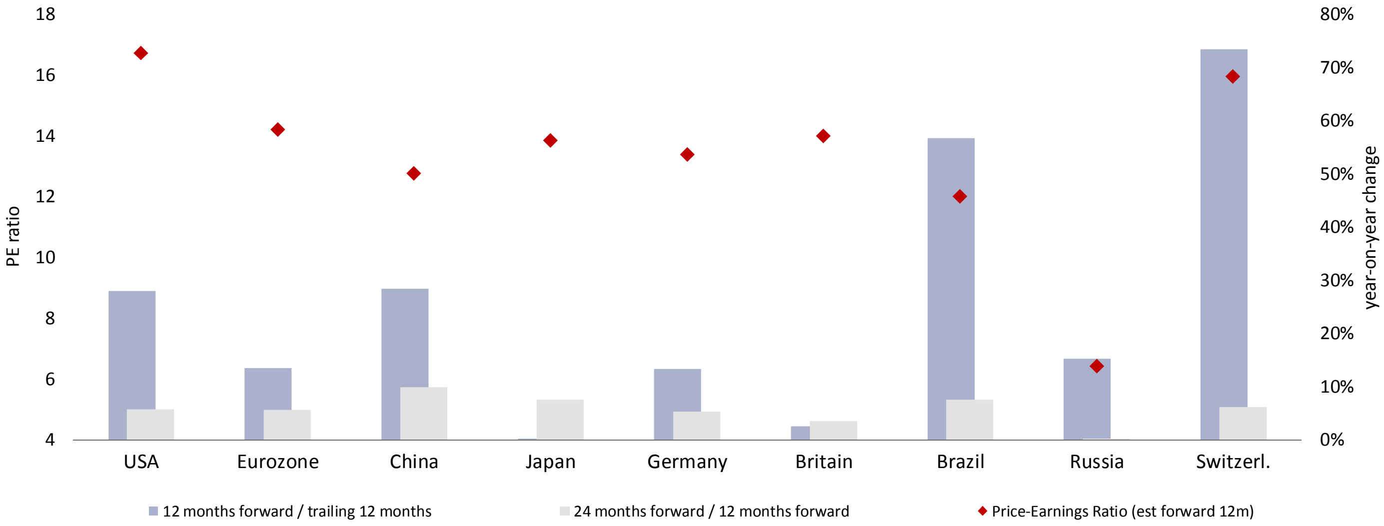
[1]IMF estimates. [2]annualized, most recent qtr. [3]PRC ex. migrant workers. [4]Currency swap rates for China and Brazil, closest ESM or EFSF bonds for Eurozone. [5]Max target rate for Fed, middle of the target range for SNB

Corporate fundamentals		USA	Eurozone	China	Japan	Germany	Britain	Brazil	Russia	Switzerl.
Exchange capitalization*	bn USD	30,319	8,624	13,395	6,470	2,480	3,864	911	617	1,602
Growth in earnings per share, estimated (MSCI)										
12 months forward / trailing 12 months	Consensus	28.0%	13.5%	28.4%	0.2%	13.3%	2.6%	56.7%	15.2%	73.4%
24 months forward / 12 months forward	Consensus	5.7%	5.7%	9.9%	7.5%	5.3%	3.6%	7.6%	0.3%	6.2%
Growth in revenue per share, estimated (MSCI)										
12 months forward / trailing 12 months	Consensus	5.0%	3.4%	12.8%	2.5%	3.4%	2.6%	6.3%	3.1%	4.4%
24 months forward / 12 months forward	Consensus	4.9%	1.1%	8.3%	24.9%	3.4%	2.0%	5.3%	3.7%	2.0%
Valuation metrics (MSCI)										
Price-Earnings Ratio (est forward 12m)	Consensus	16.7	14.2	12.7	13.8	13.4	14.0	12.0	6.4	15.9
Price-Sales Ratio (est forward 12m)	Consensus	2.0	1.1	1.5	0.9	0.9	1.2	1.6	0.9	2.0
Dividend yield	Consensus	1.0%	3.2%	2.1%	2.2%	3.0%	4.2%	3.4%	6.0%	3.4%

*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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