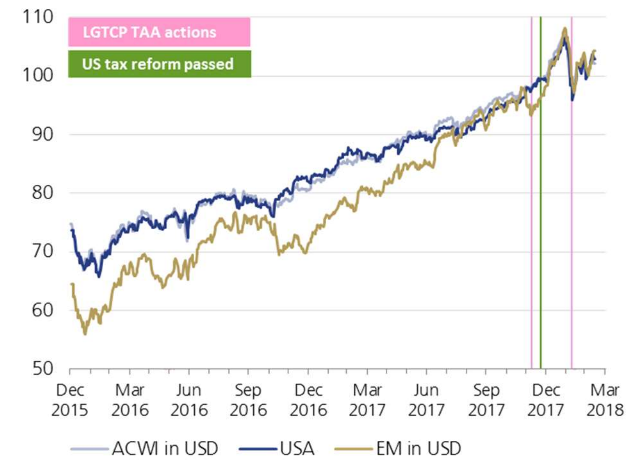
March 15, 2018

A volatile but welcome normalization process

The recent selloff reintroduced caution among investors. For the first time in years, markets are asking for a risk premium for various uncertainties. This is part of a welcome - but at times difficult - normalization. We thus believe our strategy, which combines a modest equity overweight with a defensive and countercyclical bias, remains appropriate.

During the February market panic, we used part of our cash reserve to buy equities in the emerging markets (EM) and the US. The countercyclical action has paid off thus far. Global equities have risen 2.4% since then, led by the EM (+4.1%) and the US (+2.7%). Despite the interim jump in volatility, equities are also trading higher than during our last quarterly tactical asset allocation review (QTAA) in December.

Graph 1
Performance of selected equity market indices
(MSCI net return indices, rebased on ad-hoc TAA date)



Source: LGT Capital Partners, Bloomberg

We thus reaffirm the strategy of combining a modest equity overweight with a defensive bias (i.e. elevated cash reverses, avoidance of high-beta investments, broad diversification across asset classes). Our macro view remains constructive, albeit bifurcated. The economic outlook remains underpinned by robust (above-potential) economic growth around the world, with inflation generally appearing to move toward targeted levels in most major economies. However, in such late phases of a growth cycle, investors tend to be more susceptible to exaggerations and herding behavior, which ultimately reduces the quality of investments, increases financial risks, and hence requires commensurate prudence.

Getting back to normal

The following post-selloff market developments are worth mentioning:

- Equity markets have stabilized and volatility has receded, but remains relatively high
- Valuations have tumbled and earnings expectations have cooled off, with regional expectations converging again
- Interest rates continued to rise, but the yield curve has stopped flattening and the dividend yield has stabilized

These developments are mostly part of a normalization of market conditions. This process is occurring as the global economy is re-emerging from the prolonged phase of slow growth and repeated crises following the Great Recession of 2008/2009 - and is thus generally welcome.

A less complacent market

As the following chart illustrates, volatility has generally dropped from its extreme peak levels, but remains generally higher than before the selloff in all major markets (graph 2).

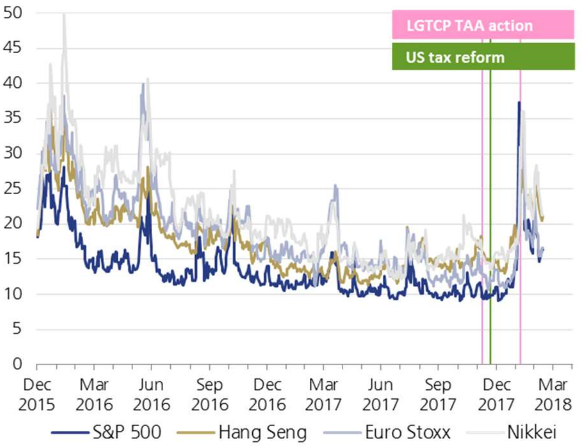
In our Annual Outlook, we had already highlighted the widespread elements of complacency among investors, as evidenced by the divergence between geopolitical and economic policy risks (which have been rising for years), and the implied volatility (which kept falling to record lows). The February correction has led to markets offering a more appropriate consideration of the various risks (graph 3).

Awareness of this situation can help investors moderate any news-driven excitement and avoid the potential pro-cyclical pitfalls - selling near the low / buying near the high. This may be particularly true in the current international environment, which has become clearly more confrontational and controversial politically than in the past.

Graph 2

Volatility indices of the major markets

(Option price based estimates of future volatility)



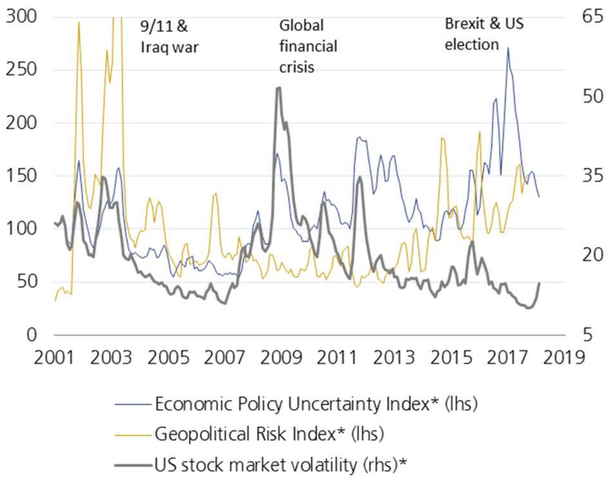
Source: LGT Capital Partners, Bloomberg

For instance, despite the headlines, instantly discounting the US tax reform bill's positive impact on the economy, as happened in January, was overhasty. Similarly, the US president's subsequent imposition of tariffs on some countries' steel and aluminum exports or his acceptance of an invitation to meet North Korea's ruler may not lead to meaningful changes in the general outlook either.

Graph 3

Complacency on the back foot

(Policy uncertainty vs. implied market volatility)



* Smoothed: 3 month rolling averages

Source: Bloomberg, Baker, Bloom & Davis, Federal Reserve Board, LGT Capital Partners

The key point for us is that a reasonable level of volatility - i.e. "noise" and "uncertainty" - is generally welcome because it supports the proper functioning of markets. It keeps late cycle complacency at bay and helps improve long-term returns, particularly for well-diversified portfolio strategies, such as our own.

Earnings revisions and divergences moderate

In our last report we argued that the surge in US earnings revisions following the passage of tax reform late last year needed to cool off, to create the room for businesses to keep beating forecasts. This has happened in the meantime to a sufficient degree.

The price to earnings ratio has generally dropped to early 2016 levels, despite continuously robust earnings and macro data. The selloff has hence reintroduced an element of risk-awareness among investors. Moreover, investors have started to retreat from discounting overly good outcomes: stock prices, on average, are now moving with a degree of caution relative to the path of earnings expectations (graph 4). The one-time tax-related rise in profit aside, the trajectory of revisions is now about the same as it was before the selloff.

Graph 4

Markets are trailing earnings forecasts again

(MSCI ACWI data, rebased to ad-hoc TAA date)

ACWI: All-Countries World Index; EPS: Earnings per share.

Source: LGT Capital Partners, Bloomberg

More time will probably have to pass until the new expectations can be met or surpassed, which would justify decidedly higher prices.

In comparative regional terms, investors still expect the US to deliver the strongest acceleration in profit growth, while they recently started to cut their expectations for Europe, with the other markets somewhere in between.

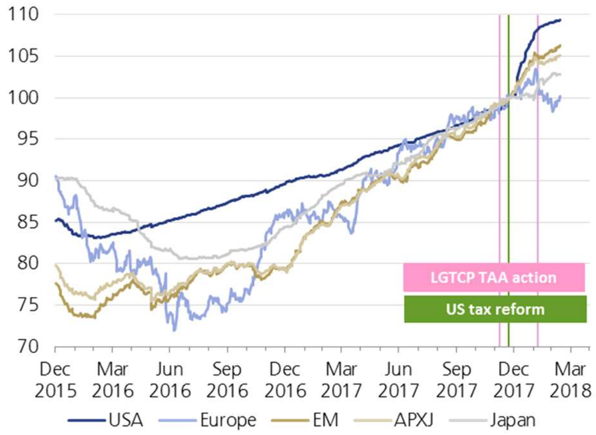
That is as far as the revisions (i.e. change in the forecasts) are concerned. When it comes to the predicted level of profit growth, Japan is still seen as the laggard by the consensus (see table, page 6).

Nevertheless, with the exception of the recent caution on Europe, regional earnings expectations have generally started to converge as well (graph 5). US corporations will most likely find it more difficult than their overseas counterparts to keep beating elevated expectations - but the retreat of extremes is a positive for all markets.

Graph 5

Regional deviation of revisions less extreme

(MSCI indices, rebased to US tax reform passage date)



APXJ: Asia-Pacific excluding Japan

Source: LGT Capital Partners, Bloomberg

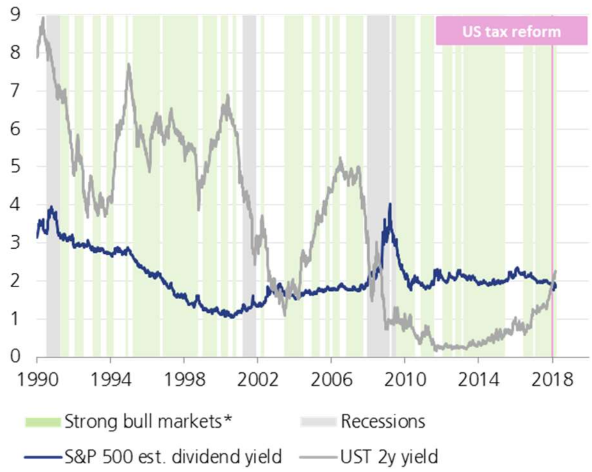
Higher rates point to benign fundamentals

Prior to the February selloff, the steep rise in US interest rates (and the flattening yield curve) had been frequently cited as a source of concern for investors. That problem also seems to be less acute now. While rates have continued to move gradually higher from historically still very low levels, the deterioration of the dividend yield for equities was stopped, keeping equities more attractive for longer. Of course, it is also important to note that it is perfectly normal for the dividend yield to be much lower than risk free rates during bull markets (graph 6).

Graph 6

Risk free interest rate and dividend yield

(Percent per year)



*Strong bull markets: 3 month rolling moving average of quarterly gain is higher than the long-term average quarterly gain, based on S&P 500 index

Source: LGT Capital Partners, Bloomberg

Thus, the recent concerns primarily reflected investor anxieties as the process of normalization (of the inflation outlook and consequently of monetary policy) gradually progresses, and markets pass important thresholds and signpost.

At the same time, the yield curve has stopped flattening in recent weeks, while various credit spreads have stopped rising (albeit from very low levels). These developments suggest that investors have fewer concerns about a potential recession in the future. While concern about the US tax reform significantly boosting the US fiscal shortfall may also have played a role in driving rates higher, the overall market response seems quite normal and benign.

After all, a higher interest rate level is justified by fundamentals, and as such, as long as the economic outlook remains benign and intact, interest rate developments therefore seem to also represent a welcome normalization of market conditions, rather than a problem.

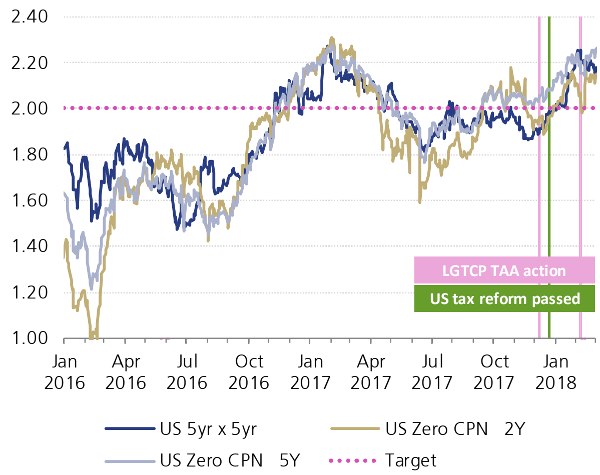
US inflation outlook has improved

Inflation expectations, meanwhile, have recovered and remain moderately above target, but have not generally climbed to new highs at the longer end of the spectrum.

Graph 7

US inflation expectations generally above target

(Implied future inflation rates, based on traded instruments)



Source: LGT Capital Partners, Bloomberg

In terms of actual inflation readings, the US has finally joined the Eurozone in surprising on the upside. Inflation surprises have been positive for some time in Eurozone, albeit from a low level (graph 8).

Sustained upside inflation surprises, when inflation is near or above target, fully justify an acceleration in monetary tightening. Importantly, when monetary tightening occurs under these parameters, it should be viewed as a medium- and longer-term positive for financial markets, as opposed to tightening in times of weak inflation expectations.

Graph 8

Inflation showing signs of life in developed economies

(Inflation data surprises in the major economic regions)

Source: LGT Capital Partners, Bloomberg

Moderate future inflation, of course, is a positive for corporate earnings, reflecting their pricing power. The key point of all of the above is that companies now have a better chance to actually deliver higher-than-expected earnings and hence dividends in the future, which would justify commensurately higher valuations.

Growth momentum still strong

Finally, we would like to point out that we will be conducting our QTAA review at the end of March. It thus makes sense to conclude this report by briefly revisiting the big picture - which is unlikely to change over the coming few weeks.

The past month's market developments occurred amid a robust, and somewhat more reflationary economic backdrop. Admittedly, there are some indications of a modest slowdown in Europe. For example, the Eurozone's purchasing manager indices have started to turn lower - but that's in line with expectations, given the very high level they had reached since the second half of 2016 (graph 9).

Graph 9

Business surveys point to robust outlook

(Markit purchasing managers' composite indices)

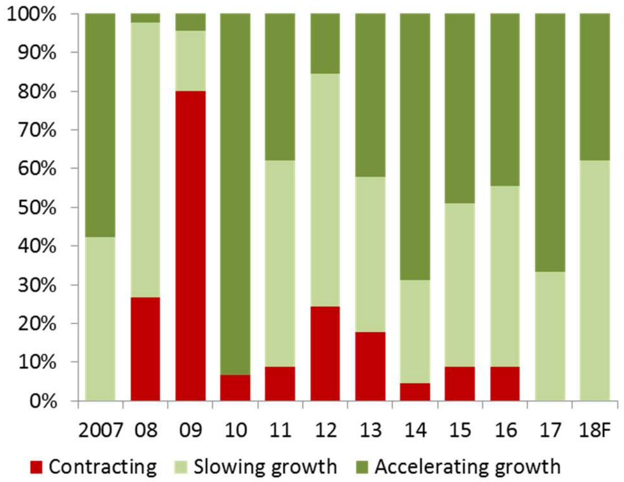
Source: LGT Capital Partners, Bloomberg

In addition, Europe's moderation is fully balanced by an uptick in the US, while the EM are holding up well too. Around the world, most economies thus remain on track for above-potential growth this year - which would market the second year of synchronous growth across all countries in more than a decade (graph 10).

Graph 10

Growth, still in sync around the world

(YoY change in real GDP, 45 countries tracked by OECD)



2018: Forecast.

Source: LGT Capital Partners, Bloomberg

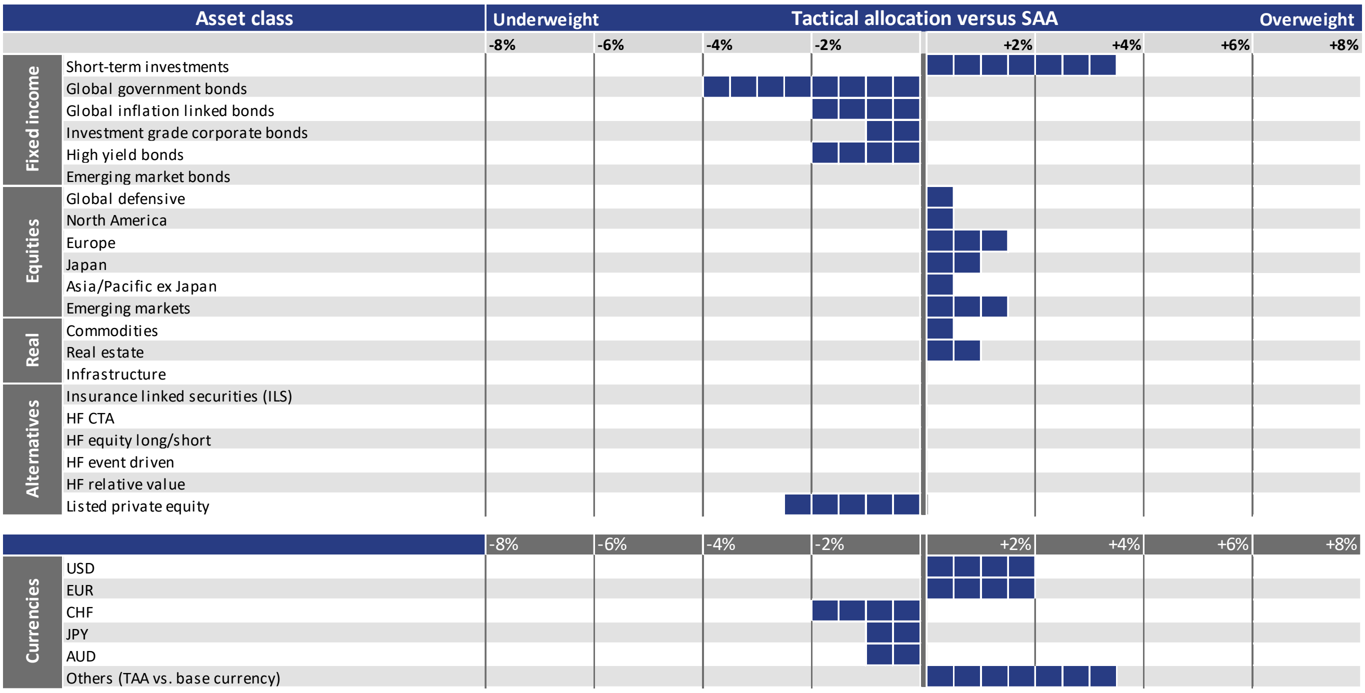
The results of our upcoming QTAA review will be presented in this publication in mid-April.

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 Dec. 7, 2017 and adjusted ad-hoc on Feb. 6, 2018.

- **Overweight in equities, modestly titled in favor of non-US markets**
- **Keep significant underweights in fixed income and duration, with a relative preference for EM bonds**
- **Real/alternative assets: REITs and commodity producer equities preferred over listed private equity**
- **Currencies: USD preferred, except against the EUR; we have passive overweights in EM and Asian 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	0.6%	-0.8%	-0.6%	1.8%	2.9%
Global inflation linked bonds	USD	0.4%	-0.7%	-0.7%	1.8%	0.8%
Investment grade corporate bonds	USD	0.0%	-1.7%	-1.7%	2.0%	2.3%
High yield bonds	USD	0.7%	0.8%	0.3%	6.9%	5.1%
Emerging market bonds	USD	0.8%	0.2%	-0.5%	6.3%	2.9%
Equities						
Global defensive	USD	1.9%	0.8%	0.4%	9.3%	9.9%
North America	USD	2.5%	4.4%	3.3%	11.4%	12.9%
Europe	EUR	0.6%	-2.9%	-3.3%	3.6%	7.4%
Japan	JPY	2.4%	-3.0%	-3.5%	4.4%	12.0%
Asia/Pacific ex. Japan	USD	3.6%	6.6%	4.0%	10.7%	7.4%
Emerging markets	USD	3.4%	9.6%	5.9%	11.8%	5.7%
Real assets						
Commodities (commodity producers' equities)	USD	-0.9%	0.8%	-4.2%	4.2%	-0.6%
Real estate (real estate investment trusts, or REITs)	USD	2.6%	-3.7%	-4.3%	3.4%	5.1%
Infrastructure (master limited partnerships, or MLPs)	USD	-4.1%	-1.8%	-2.0%	-7.5%	-3.1%
Alternatives						
Insurance linked securities (ILS)	USD	0.1%	2.6%	1.7%	4.3%	5.7%
HF CTA	USD	1.4%	-3.0%	-2.8%	-2.8%	1.9%
HF equity long/short	USD	-1.5%	2.7%	1.4%	5.7%	6.1%
HF event driven	USD	-0.6%	2.1%	0.7%	4.5%	5.1%
HF relative value	USD	-0.6%	1.4%	0.5%	3.8%	4.3%
Listed private equity	USD	0.9%	4.7%	2.5%	11.0%	10.9%
Currencies [2]						
US dollar	USD	1.1%	-3.6%	-2.1%	-1.5%	3.1%
Euro	EUR	0.4%	1.7%	1.1%	4.6%	1.9%
Swiss franc	CHF	-0.8%	1.3%	1.1%	0.7%	3.1%
Canadian dollar	CAD	-2.8%	-4.9%	-5.3%	-2.0%	-2.2%
Swedish krona	SEK	-2.3%	-0.6%	-2.5%	0.7%	-2.4%
Japanese yen	JPY	1.6%	2.2%	4.1%	3.3%	0.7%

[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	2.7%	2.3%	6.5%	1.3%	2.4%	1.5%	2.6%	1.8%	1.9%
- real growth in most recent quarter[2]	q/q annualized	2.5%	2.4%	6.6%	1.6%	2.4%	1.6%	0.4%	-2.3%	2.4%
Unemployment rate[3]		4.1%	8.6%	3.9%	2.4%	5.4%	4.4%	8.2%	5.2%	2.9%
Inflation, core rate (CPI)	y/y	1.5%	1.0%	2.5%	0.1%	1.6%	2.7%	2.8%	1.9%	0.5%
Purchasing manager indices (comp.)	Neutral = 50	55.8	57.1	53.3	52.2	57.6	54.5	53.1	55.2	65.5
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	274	3,134	1,199	37	124	185	373	836
Govt bond yield 2yr[4]	p.a.	2.26%	-0.47%	3.64%	-0.14%	-0.57%	0.83%	7.50%	6.85%	-0.83%
Govt bond yield 10yr[4]	p.a.	2.84%	0.71%	4.05%	0.05%	0.62%	1.47%	8.12%	7.25%	0.12%
Main policy interest rate[5]	p.a.	1.50%	0.00%	4.35%	-0.10%	0.00%	0.50%	6.75%	7.50%	-0.75%

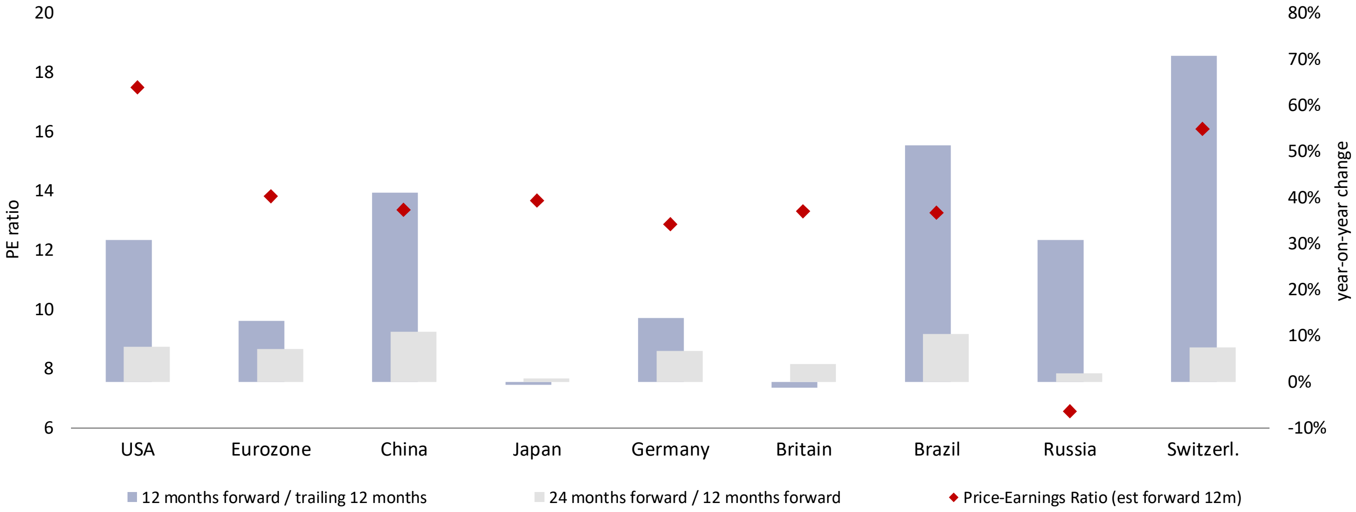
[1]IMF estimates. [2]annualized, most recent qtr. [3]PRC ex. migrant workers. [4]Currency swap rates for China and Brazil, closest ESM or EFSF bonds for Eurozone. [5]Max target rate for Fed, middle of the target range for SNB

Corporate fundamentals		USA	Eurozone	China	Japan	Germany	Britain	Brazil	Russia	Switzerl.
Exchange capitalization*	bn USD	30,948	8,607	13,801	6,481	2,442	3,727	1,024	652	1,668
Growth in earnings per share, estimated (MSCI)										
12 months forward / trailing 12 months	Consensus	30.8%	13.3%	41.0%	-0.6%	13.8%	-1.2%	51.4%	30.9%	70.7%
24 months forward / 12 months forward	Consensus	7.6%	7.2%	11.0%	0.8%	6.8%	3.9%	10.5%	2.0%	7.6%
Growth in revenue per share, estimated (MSCI)										
12 months forward / trailing 12 months	Consensus	4.9%	3.2%	13.0%	2.9%	3.1%	4.1%	6.7%	3.9%	4.0%
24 months forward / 12 months forward	Consensus	5.1%	-0.4%	-12.0%	2.0%	2.3%	-0.8%	7.2%	4.3%	1.2%
Valuation metrics (MSCI)										
Price-Earnings Ratio (est forward 12m)	Consensus	17.5	13.8	13.4	13.7	12.9	13.3	13.3	6.6	16.1
Price-Sales Ratio (est forward 12m)	Consensus	2.1	1.1	1.6	0.9	0.9	1.2	1.6	0.9	2.0
Dividend yield	Consensus	1.0%	3.4%	2.0%	2.1%	3.2%	4.5%	3.2%	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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