Capital Partners
your partner for alternative investments

LGT Beacon

Global macro and market review

August 17, 2018

Marketing material

Moving toward a neutral positioning

The S&P 500 nearly reclaimed its historic January high over the past six weeks. Strong corporate earnings and good economic data helped investors to forget the trade conflict for a while. Then, the escalating Turkish lira crisis highlighted how quickly a continued rise in US interest rates and tariffs can hurt some economies and weigh on global market sentiment.

We have recently noted that certain risks have started to cloud the broader market outlook, which should have been a very bullish one otherwise. To recapitulate, these include:

- Rising trade protectionism, which can hurt productivity and boost inflation
- Monetary tightening, especially in the US, which decreases US dollar liquidity
- Political divisions within important policy institutions, e.g. in the European Union (EU), following the recent formation of a populist government in Italy

Of course, risks are always matched with potential opportunities, which could include:

- Continued economic growth, driven by pent up demand for capital investment and domestic consumption
- An extended period with low real interest rates, if gains in nominal interest rates lag behind inflation, which supports credit creation, consumption and risk-taking
- Reasonable and in some cases increasingly attractive asset valuations, which raises long-term expected returns
- A further liberalization of global trade and investment as a result of US pressure, (at least) among nations that are allied and/or share strategic interests with the US

Strategy: gradually moving toward a neutral positioning

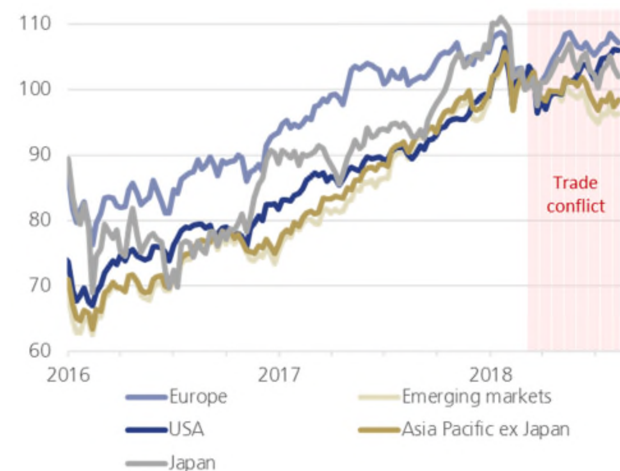
Such bifurcated, contrasting and uncertain prospects reaffirm the validity of our active counter-cyclical investment approach – i.e. selling into meaningful market strength and buying into exaggerated weakness. At the same time, recent developments make us increasingly inclined to gradually move toward a neutral positioning in equities, from a moderate overweight at present. A neutral starting point would be more appropriate to opportunistically shift the asset class weights as and when needed. Indeed, over the last several weeks, we took steps toward a more balanced positioning.

First, we added some exposure to hard currency-denominated debt of issuers from emerging markets (EM). We also trimmed our European equity holdings somewhat, following a comparative rebound: by early this month, the Euro Stoxx 50 had recovered about 5.5% from June's low, being the first among major non-US indices to approach previous highs (graph 1). We thus felt these levels were appropriate for a sale.

Graph 1

European markets have rebounded relatively fast

(MSCI net return indices, rebased to the start of the trade conflict*)



* March 8, 2018, when the US announced import tariffs on steel and aluminum. Hedged local currency indices in USD used for developed markets, unhedged USD indices for EM and Asia-Pacific ex. Japan. Source: LGT Capital Partners, Bloomberg

We should add that we remain inclined to reduce EM equities once they recover, while maintaining a preference for US assets, given the relative strength of the US economy.

Still valid: sell on strength, buy on exaggerated weakness

The sale of European equities was in line with our sell-on-strength approach, while the purchases in the fixed income space also came after long periods of weakness, which we deemed exaggerated given fundamentals.

EM bonds had suffered markedly with the start of the trade conflict on March, when the US announced steel and aluminum import tariffs. This slide was mainly the result of depreciating currencies. Tariffs tend to add strength to the USD, partly as an offsetting market mechanism. Nevertheless, the EM hard currency segment has begun to stabilize more recently, so we took the opportunity to increase our exposure in this space (Graph 2). Most EM remain in a good shape economically, and their bonds offer a good yield-pick over developed market government bonds.

Graph 2

Broader debt and credit segments

(Total return indices, rebased to the start of the trade conflict*)

* March 8, 2018, when the US announced import tariffs on steel and aluminum. EM local currency = J.P. Morgan GBI-EM Diversified Composite unhedged Index in USD. EM hard currency = J.P. Morgan EMBI Global Diversified Composite Index in USD. High yield = ICE BofAML Global High Yield Constrained Index in USD. Source: LGT Capital Partners, Bloomberg

Turkey: challenging outlook, but broader contagion risk is limited

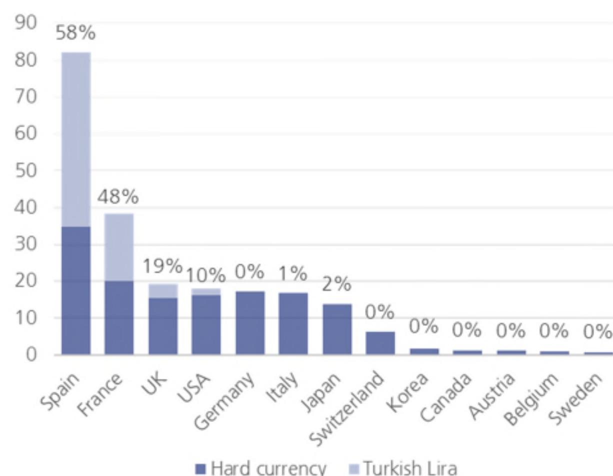
By contrast, the EM local currency segment remains weak. Given the situation in Turkey, the time for action has not yet come in our view. The Turkish lira (TRY) has dropped about 40% against the USD and about 25% against the euro since end-July, offering a reminder of what can happen to relatively weak economies that do not respond appropriately to economic realities – and simultaneously engage in political conflicts with the West. The outlook for Turkey thus remains challenging and will in large part depend on Ankara's policy responses to its specific problems.

To some degree, Turkey's currency crisis naturally weighs on market sentiment as well, particularly on the broader EM space and the exposed parts of the European markets (e.g. banks in Spain, France and Italy). That said, at present we believe that the risk of a lasting contagion to other markets is rather limited. The exposure of European banks to Turkish debt is not very large in relation to the size of the respective economies, and Europe has improved its financial crisis management in response to the euro crises of the past half-decade. Banks from other emerging economies, meanwhile, have very little or no exposure to Turkey (graph 3).

Graph 3

Claims of foreign banks on Turkey

(Billions of USD, share of Lira debt in percent)



Source: LGT Capital Partners, Bank for International Settlements

Turkey is facing a rather exclusive mix of problems, largely of its own making. The country simultaneously runs a fiscal and a current account deficit and is dependent on energy imports, which weakens its position further during strong USD phases. Despite that background, the government has prioritized continued fiscal and monetary expansionism to keep growth high, disregarding the risk of runaway inflation and further policy credibility losses.

In addition, Ankara is engaged in the Syrian war as well as a number of political rows with several European countries and Washington. Topping things off, President Recep Tayyip Erdogan's rhetoric seems to ignore basic economics, such as the need to raise interest rates, reign in the budget deficit and uphold institutional policy credibility. The recent appointment of President Erdogan's son-in-law as finance minister has not helped the latter.

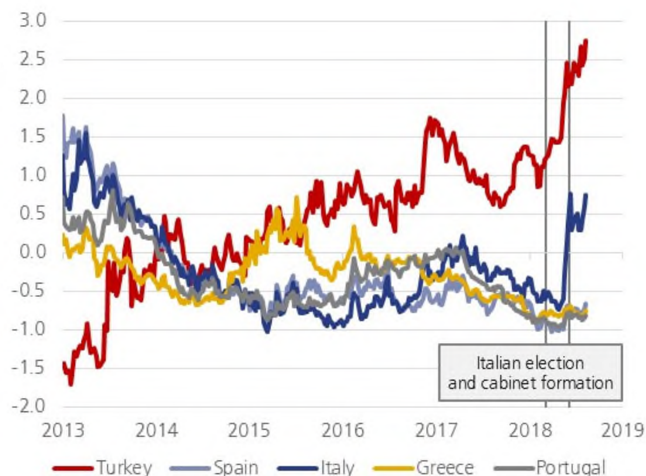
Nevertheless, beyond Turkey, the fallout has been and should remain limited. Southern European government bonds spreads, representing perceptions of default risk, have risen on the heels of the Turkish lira's collapse – but the moves were not abnormal. Italian credit default swaps have surged markedly, but that is primarily related to the fiscal and other policy discords between Rome and the EU, rather than to Turkey. Spanish, Portuguese or Greek spreads have barely

changed beyond what can be considered normal volatility (graph 4).

Graph 4

No contagion: Southern European yield spreads

(Z-scores of spread, expressed in deviations from the mean)



Difference in 10-year government yields over German bonds. Source: LGT Capital Partners, Bloomberg

Concluding, we add that within our fixed income strategies we had switched a substantial portion of Turkish lira bonds into short-dated Turkish USD bonds before the country's central bank meeting on July 24, resulting in a significant underweight of this market.

Furthermore, we went outright short TRY last week, and have taken a longer-term hedging position that will pay off if the extremely undervalued lira starts to stabilize at some point through May 2019.

Macro update: fundamentals and diplomacy defuse trade tensions

In general, the macro events of the past several weeks were rather benign. While the Turkish crisis followed the imposition of additional US tariffs against Turkish steel and aluminum exports, global trade tensions have actually been receding. Even though the US enacted and threatened to impose further import duties on China, the Sino-American confrontation did not escalate further, and most other major nations moved to promote economic cooperation. That allowed equities to rise on the back of good earnings and positive macroeconomic news.

Specifically, several diplomatic and political developments since early July offered the major countries' leaders a chance to promote pro-trade agendas and cooperation:

- In early July, the 16 countries attending the Regional Comprehensive Economic Partnership (RCEP) in Tokyo agreed to reach a consensus trade pact by end-year
- At their 20th annual summit, China and the EU expressed their joint support for rule-based trade and reaffirmed their joint engagement to reform the World Trade Organisation (WTO)
- One day later, the EU and Japan went a big step further by signing their Economic Partnership Agreement (EPA), which includes a significant reduction and phase-out of tariffs as well as strategic cooperation agreements in various policy areas and science
- Then, in late July, US President Trump and EU Commission President Jean-Claude Juncker produced a rather rare positive surprise, by agreeing to begin talks about a broader reduction of Transatlantic barriers
- Finally, in early August the US and Japan also formally launched their bilateral talks on trade, both sides voicing support for "free and fair" trade
- Last week, Larry Kudlow, the US president's chief economic adviser, summarized most of the above developments by saying that an alliance is emerging between the US, Europe, Japan, Australia, and possibly Canada, to jointly negotiate trade issues with China

It is worth noting that the RCEP could become the largest trade area to date, potentially including the ten nations of the Association of Southeast Asian Nations (ASEAN: Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam) and the six Asia-Pacific states with which ASEAN has existing free trade agreements (Australia, China, India, Japan, South Korea and New Zealand).

The pact would partly overlap with the Comprehensive and Progressive Transpacific Partnership (CPTPP), which includes Japan, Canada, Australia and Mexico as its largest members.

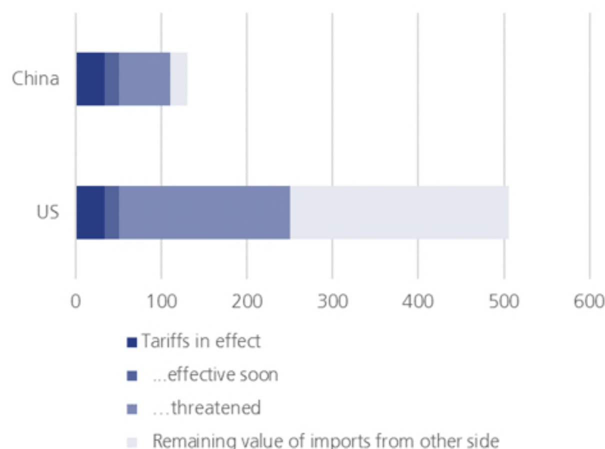
China refrains from escalating further

Beijing, meanwhile, has recently agreed to resume talks with the US and thus far also refrained from further escalating its retaliatory measures beyond what it had already said it would do. Admittedly, part of the reason for this calm may be that China is simply running out US imports to impose duties on (graph 5).

Graph 5

The trade salvos between China and the US

(Billions of USD)



Source: LGT Capital Partners, Bloomberg, US and Chinese announcements compiled from various media reports

Still, another reason may be that the Chinese senior party officials have been privately meeting to discuss strategy and policy issues in the beachside resort of Beidaihe in Hebei Province in mid-August.

The country's Communist cadres have been holding secretive meetings in this resort town since the days of Mao Zedong in the late 1950s - sometimes taking important historic decisions that were announced and implemented later. One such decision was the cannon bombardment of Kinmen, the Taiwan-controlled offshore island.

Overall, it is probably too early to say whether China really plans to soften its stance. At the same time, some reports suggest that domestic criticism of some aspects of President Xi Jinping's policies has increased in the face of the trade conflict, which might lead to a compromise toward a more pragmatic line in foreign affairs.

Robust corporate earnings and strong economic growth in the US

Last but not least, with regard to the purely economic fundamentals, corporate earnings growth remains stronger than expected in nearly all sectors in the US and a large part of the world. Profit growth has reached about 25% year-on-year in the US and roughly 9% in the rest of the world overall (based on the MSCI All-Country World Index ex US).

A closer look at the results country by country (graph 6) shows the US and Japan delivering the strongest results across almost all eleven main sectors.

At the same time, the US economy registered the strongest growth since 2014 in the second quarter (annualized gain of 4.1% versus the previous quarter), while the purchasing managers' surveys perked up again recently.

The forward-looking purchasing managers' surveys out of Europe and Japan also point to continued cyclical strength in these markets, while the EM appear to be tentatively stabilizing – resulting in the overall global trend picture shown below (graph 7).

Graph 7

Growth outlook remains favorable

(Three-month moving average, Markit Composite PMI)

PMI = Purchasing Managers Index; Composite = PMI for manufacturing and services. Source: LGT Capital Partners, Bloomberg

The next LGT Beacon will be published in mid-September.

END OF REPORT

Graph 6

Global comparison of earnings season results

Reporting period: Q2 2018	Reported / total	Earnings growth year-on-year	Earnings surprise (actual vs. consensus)	Positive surprises / total	Revenue growth year-on-year	Revenue surprise (actual vs. consensus)	Price-earnings ratio (12 month forward)	Number of sectors growing above forecast
USA (S&P 500)	**457/498**	**25.59%**	**5.49%**	**83.37%**	**10.07%**	**1.38%**	**16.6**	**9 of 11**
Energy	31/31	129.86%	-6.36%	45.2%	23.09%	1.49%	16.3	
Materials	24/24	51.81%	5.66%	83.3%	26.55%	2.05%	15.0	
Industrials	68/70	17.39%	5.14%	88.2%	8.83%	1.61%	16.2	
Consumer discretionary	58/70	21.00%	10.07%	82.8%	9.22%	0.42%	20.2	
Consumer staples	24/32	10.83%	5.03%	91.7%	4.99%	1.26%	18.1	
Health care	60/62	15.28%	6.39%	95.0%	7.80%	1.17%	16.0	
Financials	68/68	22.53%	5.64%	77.9%	5.89%	2.25%	12.7	
Information technology	58/71	36.94%	6.65%	91.5%	14.81%	1.54%	18.1	
Telecom services	3/3	21.93%	6.35%	100.0%	3.51%	-0.20%	10.4	
Utilities	28/28	12.27%	9.13%	82.1%	0.11%	1.11%	17.0	
Real estate	33/33	6.62%	0.35%	78.8%	12.12%	2.55%	38.5	
Europe (Stoxx 600)	**383/443**	**5.15%**	**1.44%**	**52.78%**	**5.40%**	**0.51%**	**13.7**	**2 of 11**
Eurozone (Euro Stoxx)	**251/278**	**-1.06%**	**0.82%**	**50.00%**	**1.44%**	**0.00%**	**13.2**	**2 of 11**
Japan (Topix 500)	**494/501**	**11.79%**	**12.51%**	**60.40%**	**6.34%**	**2.87%**	**12.7**	**10 of 11**
Asia-Pacific ex Japan	**340/459**	**6.29%**	**-6.71%**	**50.54%**	**5.63%**	**4.35%**	**12.2**	**2 of 11**
Emerging markets	**533/714**	**5.81%**	**-8.99%**	**62.81%**	**6.01%**	**4.25%**	**11.0**	**2 of 11**

MSCI indices for Asia-Pacific ex Japan and EM. 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 August 7, 2018.

- **Moderate overweight in equities, large underweight in fixed income (except for EM debt), very high cash reserves**
- **Real/alternative assets: generally neutral, with the exception of LPE and commodity producers' equities**
- **Currencies: no active positions, passive overweight in mainly EM currencies relative to base currency**

	Asset class	SAA	Tactical allocation versus SAA (underweight -8% -6% -4% -2% / +2% +4% +6% +8% overweight)
Fixed income	Short-term investments	0.0%	
	Global government bonds	9.0%	
	Global inflation linked bonds	9.0%	
	Investment grade corporates	9.0%	
	High yield bonds	7.0%	
	Emerging market bonds	7.0%	
Equities	Global defensive	6.0%	
	North America	7.5%	
	Europe	4.0%	
	Japan	2.5%	
	Asia/Pacific ex Japan	2.5%	
	Emerging markets	7.0%	
Real	Commodity producers	3.5%	
	Real estate (REITs)	4.0%	
	Infrastructure	1.0%	
Alt.	Listed private equity	3.0%	
	Hedge funds	13.0%	
	Insurance linked securities	5.0%	

	Currency[2]	SAA	-8% -6% -4% -2% / +2% +4% +6% +8%
Currencies	USD	85.0%	
	EUR	0.0%	
	CHF	0.0%	
	JPY	0.0%	
	Others	15.0%	

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	-0.2%	1.2%	0.5%	2.3%	3.4%
Global inflation linked bonds	USD	0.2%	1.6%	1.4%	2.6%	2.1%
Investment grade corporate bonds	USD	0.6%	1.7%	-0.7%	2.5%	2.9%
High yield bonds	USD	-0.1%	0.0%	-0.9%	6.2%	4.7%
Emerging market bonds	USD	-2.2%	-1.7%	-5.9%	#VALUE!	3.2%
Equities						
Global defensive	USD	1.2%	4.4%	3.2%	8.6%	10.0%
North America	USD	1.0%	4.4%	6.7%	11.7%	12.3%
Europe	EUR	-0.8%	-2.8%	0.2%	5.0%	7.3%
Japan	JPY	-3.1%	-5.8%	-5.5%	1.4%	9.2%
Asia/Pacific ex. Japan	USD	-2.8%	-7.4%	-7.1%	9.7%	6.0%
Emerging markets	USD	-4.4%	-9.6%	-10.3%	8.6%	3.7%
Real assets						
Commodities (commodity producers' equities)	USD	-5.2%	-9.6%	-1.6%	8.1%	0.2%
Real estate (real estate investment trusts, or REITs)	USD	1.0%	4.9%	1.7%	5.3%	7.4%
Infrastructure (master limited partnerships, or MLPs)	USD	9.8%	7.8%	9.3%	-0.9%	-1.7%
Alternatives						
Insurance linked securities (ILS)	USD	0.5%	1.2%	4.0%	4.6%	5.3%
HF CTA	USD	-0.1%	-1.9%	-3.5%	-1.4%	2.5%
HF equity long/short	USD	0.7%	1.2%	1.9%	5.5%	5.5%
HF event driven	USD	0.4%	2.0%	2.5%	5.0%	4.5%
HF relative value	USD	0.9%	1.4%	2.5%	4.2%	4.5%
Listed private equity	USD	-2.2%	1.6%	3.0%	8.8%	9.8%
Currencies [2]						
US dollar	USD	1.9%	3.4%	5.5%	1.0%	4.4%
Euro	EUR	-0.8%	-0.6%	-0.5%	2.0%	0.8%
Swiss franc	CHF	2.3%	4.0%	3.0%	0.4%	2.8%
Norwegian krone	NOK	-2.3%	-1.3%	1.9%	-0.1%	-3.6%
Australian dollar	AUD	0.0%	-0.3%	-2.6%	0.5%	-0.8%
Japanese yen	JPY	4.1%	3.4%	7.6%	5.5%	1.5%

[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	19,391	12,607	12,015	4,872	3,685	2,625	2,055	1,527	679
- nominal, per capita 2017[1]	USD, PPP	59,501	38,322	16,660	42,832	50,425	44,118	15,603	27,834	61,422
- 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	2.9%	2.1%	6.6%	1.1%	2.0%	1.3%	1.8%	1.8%	2.2%
- real growth in most recent quarter[2]	q/q annualized	4.1%	1.6%	7.4%	1.9%	2.0%	1.6%	1.6%	-2.3%	2.4%
Unemployment rate[3]		3.9%	8.3%	3.8%	2.4%	5.2%	4.0%	8.2%	4.7%	2.6%
Inflation, core rate (CPI)	y/y	1.9%	1.1%	1.9%	0.0%	1.4%	1.9%	4.5%	2.4%	0.5%
Purchasing manager indices (comp.)	Neutral = 50	55.7	54.3	52.3	51.8	55.0	53.6	50.4	51.7	61.9
Structural budget balance/GDP 2017	IMF	-4.6%	-0.6%	-4.0%	-4.0%	0.9%	-2.3%	-6.4%	-1.4%	0.2%
Gross government debt/GDP 2017	IMF	108%	87%	48%	236%	64%	87%	84%	17%	43%
Current account balance/GDP 2017	IMF	-2.4%	3.5%	1.4%	4.0%	8.0%	-4.1%	-0.5%	2.6%	9.3%
International currency reserves	bn USD	42	284	3,118	1,196	37	122	185	381	801
Govt bond yield 2yr[4]	p.a.	2.62%	-0.49%	2.86%	-0.11%	-0.64%	0.70%	8.86%	8.58%	-0.74%
Govt bond yield 10yr[4]	p.a.	2.88%	0.57%	3.33%	0.10%	0.32%	1.25%	9.48%	9.27%	-0.09%
Main policy interest rate[5]	p.a.	2.00%	0.00%	4.35%	-0.10%	0.00%	0.75%	6.50%	7.25%	-0.75%

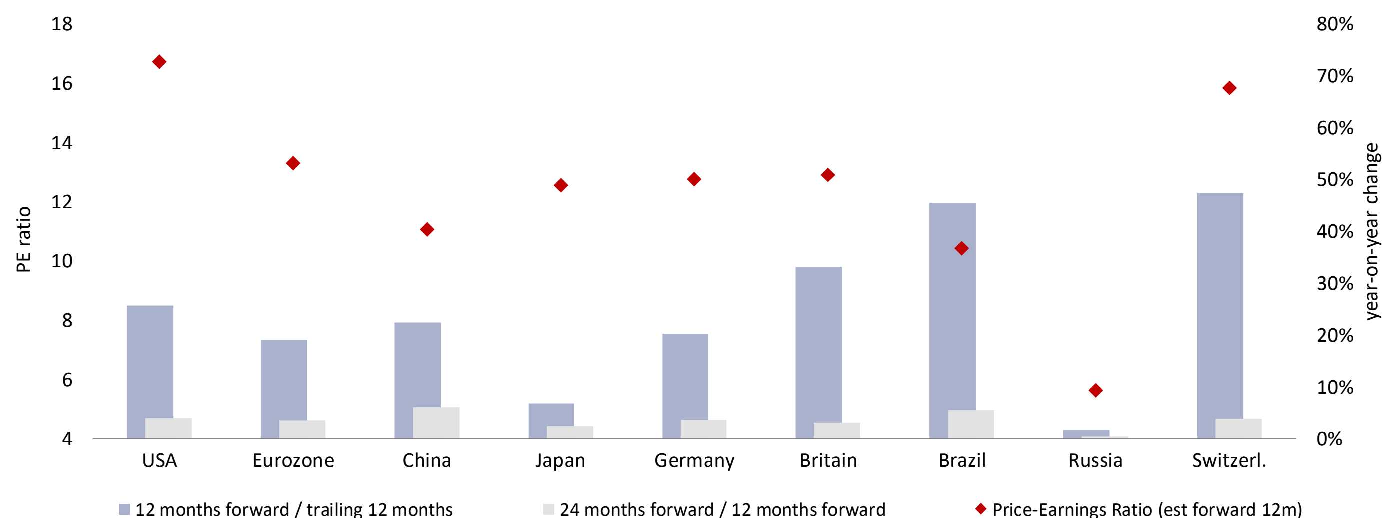
[1]IMF estimates. [2]annualized, most recent qtr. [3]PRC ex. migrant workers. [4]Currency swap rates for China and Brazil, closest ESM or EFSF bonds for Eurozone. [5]Max target rate for Fed, middle of the target range for SNB

Corporate fundamentals		USA	Eurozone	China	Japan	Germany	Britain	Brazil	Russia	Switzerl.
Exchange capitalization*	bn USD	31,214	7,877	11,222	6,052	2,250	3,555	770	564	1,591
Growth in earnings per share, estimated (MSCI)										
12 months forward / trailing 12 months	Consensus	25.6%	19.0%	22.4%	6.8%	20.2%	33.1%	45.5%	1.7%	47.3%
24 months forward / 12 months forward	Consensus	4.0%	3.6%	6.0%	2.5%	3.7%	3.1%	5.5%	0.4%	3.8%
Growth in revenue per share, estimated (MSCI)										
12 months forward / trailing 12 months	Consensus	5.2%	3.9%	12.9%	2.5%	4.0%	2.8%	5.9%	2.1%	4.1%
24 months forward / 12 months forward	Consensus	4.7%	2.8%	10.8%	2.7%	3.4%	1.9%	5.7%	6.0%	2.3%
Valuation metrics (MSCI)										
Price-Earnings Ratio (est forward 12m)	Consensus	16.7	13.3	11.1	12.5	12.7	12.9	10.4	5.6	15.8
Price-Sales Ratio (est forward 12m)	Consensus	2.1	1.0	1.3	0.9	0.9	1.1	1.3	0.8	2.0
Dividend yield	Consensus	1.0%	3.4%	2.4%	2.3%	3.1%	4.4%	3.8%	6.6%	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)



Important information

This marketing material was issued by LGT Capital Partners Ltd., Schützenstrasse 6, CH-8808Pfäffikon, Switzerland and/or its affiliates (hereafter "LGT CP") with the greatest of care and to the best of its knowledge and belief. LGT CP provides no guarantee with regard to its content and completeness and does not accept any liability for losses which might arise from making use of this information. The opinions expressed in this marketing material are those of LGT CP at the time of writing and are subject to change at any time without notice. If nothing is indicated to the contrary, all figures are unaudited. This marketing material is provided for information purposes only and is for the exclusive use of the recipient. It does not constitute an offer or a recommendation to buy or sell financial instruments or services and does not release the recipient from exercising his/her own judgment. The recipient is in particular recommended to check that the information provided is in line with his/her own circumstances with regard to any legal, regulatory, tax or other consequences, if necessary with the help of a professional advisor. This marketing material may not be reproduced either in part or in full without the written permission of LGT CP. It is not intended for persons who, due to their nationality, place of residence, or any other reason are not permitted access to such information under local law. Neither this marketing material nor any copy thereof may be sent, taken into or distributed in the United States or to U. S. persons. Every investment involves risk, especially with regard to fluctuations in value and return. Investments in foreign currencies involve the additional risk that the foreign currency might lose value against the investor's reference currency. It should be noted that historical returns and financial market scenarios are no guarantee of future performance. © LGT Capital Partners 2018. All rights reserved.

Picture on title page:

Quentin Massys (Löwen 1466-1530 Antwerp), detail from "The Tax Collectors", after 1501 © LIECHTENSTEIN. The Princely Collections, Vaduz-Vienna