Monthly Asset Allocation

Private Banking Europe Investment Committee

October 17, 2018

In a nutshell

- **Following an initial risk reduction in August 2018, the focus is now on risk reallocation within the portfolio**
- **We reduce risk by increasing the investment grade bond quota at the expense of subordinated bonds**
- **In order to keep risk at "neutral", we increase US equities and still hold an overweight in Cash**

Late cyclical symptoms worry the markets – focus on reallocation of risk

The imminent US midterm elections, Brexit negotiations, the Italian budget dispute and seasonality have given market participants a turbulent start to the fourth quarter. The classic late cyclical symptoms contribute to further concern: on the one hand, the partial clouding of leading economic indicators and, on the other hand, the permanent question of capital market participants as to the time of the beginning downturn in the economic cycle. On a global basis, however, the macroeconomic environment remains solid. Against this backdrop, it seems premature to further reduce the risk in the portfolios. Following an initial risk reduction in August 2018, the focus is now on risk reallocation within the portfolio.

At the asset allocation level, we maintain a neutral risk positioning for a cross asset mandate. Within the portfolio, however, the risk distribution is restructured. The focus is on two considerations: Firstly, we cover our risk budget primarily through the equity exposure, less through indirect asset classes such as hedge funds or subordinated bonds. Secondly, we are implementing a shift towards more liquid asset classes. As a result, we are reducing risk in the fixed income area by reducing subordinated bonds and building up top-quality corporate bonds. In alternative investments, we reduce the hedge fund quota to zero.

Table 1: Generic Tactical Asset Allocation LGT Private Banking Europe (October 17, 2018)

	Asset Class	SAA	underweight – Tactical allocation versus SAA – overweight (-8% -6% -4% -2% +2% +4% +6% +8%)	USD	EUR	CHF
Equities	US equities	20.0%		22.0%	17.0%	17.0%
	Europe equities	6.0%		8.0%	11.0%	7.0%
	UK equities	3.0%		3.0%	4.0%	2.0%
	Switzerland equities	1.0%		1.0%	2.0%	8.0%
	Japan equities	4.0%		4.0%	4.0%	4.0%
	APAC ex JP equities	3.0%		3.0%	3.0%	3.0%
	Emerging markets equities	6.0%		6.0%	6.0%	6.0%
	Total Equities	**43.0%**		**47.0%**	**47.0%**	**47.0%**
Fixed Income	Government bonds	6.0%		3.0%	3.0%	0.0%
	Inflation-linked bonds	6.0%		6.0%	6.0%	5.0%
	Investment grade bonds	12.0%		16.0%	16.0%	20.0%
	High yield bonds	6.0%		0.0%	0.0%	0.0%
	Subordinated Debt	0.0%		0.0%	0.0%	0.0%
	Emerging markets bonds	6.0%		8.0%	8.0%	8.0%
	Total Fixed Income	**36.0%**		**33.0%**	**33.0%**	**33.0%**
Alternatives	Hedge funds	7.0%		0.0%	0.0%	0.0%
	Listed private equity	2.0%		0.0%	0.0%	0.0%
	Real estate trusts	3.0%		3.0%	3.0%	3.0%
	Insurance-linked bonds	3.0%		4.0%	4.0%	4.0%
	Commodities	2.0%		2.0%	2.0%	2.0%
	Precious metals	2.0%		4.0%	4.0%	4.0%
	Total Alternatives	**19.0%**		**13.0%**	**13.0%**	**13.0%**
	Cash	**2.0%**		**7.0%**	**7.0%**	**7.0%**
			-8% -6% -4% -2% +2% +4% +6% +8%			
Currencies	USD	86.5%		82.5%	8.0%	8.0%
	EUR	0.0%		0.0%	74.1%	0.0%
	CHF	0.0%		0.0%	0.0%	74.7%
	GBP	0.0%		0.0%	0.0%	0.0%
	JPY	0.0%		2.0%	2.0%	2.0%
	Others (incl. EM)	13.5%		15.5%	15.9%	15.3%

Source: LGT Investment Services Europe

*all calculations based on a "Balanced Portfolio" in USD including AI. For EUR and CHF portfolios weights differ for subclasses; over- and underweights apply analogously.

Table 2: Current asset allocation preferences

Next meeting: Nov 12, 2018	What we like	What we dislike
Equities	▪ European equities ▪ **NEW:** US equities	
Bonds	▪ Low duration ▪ **NEW:** Investment Grade bonds	▪ Sovereign bonds ▪ High yield bonds
Alternative Investments	▪ Gold ▪ Insurance linked bonds	▪ Hedge Funds ▪ Listed private equity
Currencies	▪ Japanese yen	

Sources: LGT Investment Services Europe

By building up US equities, the risk budget is kept at a neutral level. This is not an active risk build-up, as the cash ratio remains unchanged. In the event of a further setback on the capital markets, we can gradually reinvest this cash reserve.

Equities: Groundbreaking US profit season

Capital markets are focusing on the upcoming US earnings season for the third quarter 2018, which many market participants see as the first litmus test of sustainable profit and revenue growth in the US. It is questionable to what extent the US government's tax reform has contributed to this and what proportion of the reported results is effectively due to the strong, late-cycle US economy. Expectations are high and there is confidence that US firms will continue to deliver this quarter. It remains to be seen how the stronger US dollar will affect the margin situation of international US companies. The outlook for the coming year, which companies are traditionally expected to announce at the end of the third quarter, seems even more important to us. The capital market expects earnings growth in the near double-digit range in 2019. Our recommendation to primarily allocate risks at the equity level also means that we are currently tactically overweighting our strategic asset allocation in the US securities and Europe equity sectors. We see the greatest short-term potential for returns in these two regions, while we remain cautious about emerging market equities.

Fixed Income: Risk reduction by increasing the investment grade bond quota at the expense of subordinated bonds

US interest rates have continued to rise, both at the short end and on ten-year US government bonds. Our target range of 3.25-3.50% for the fourth quarter of 2018 has already been reached. We expect further upward pressure in the coming months, triggered by rising wage inflation and an oversupply of US government bonds for the coming quarters, as the buyer No. 1 – the US Federal Reserve – is continuously withdrawing as its balance sheet shrinks. Overall, the balance sheets of the global central banks will not be inflated any further in the coming years. This has also prompted us to reduce risk within the bond quota and to reduce subordinated bonds in a cross-asset context in favor of corporate bonds and equities. In the case of high-yield bonds, we see little return potential at asset allocation level for the existing risks in the late-cyclical economic environment.

Currencies: Continued narrow trading range of US dollar and the European single currency

The US dollar and the euro remain within a narrow trading range. On the one hand, the US dollar could not benefit from the further interest rate fantasy at the short end; on the other hand, the widening of the interest rate differential at the long end (the difference between the ten-year US government bond and the German government has risen to 2.75%) has boosted the greenback. The recovery attempts of the European single currency were not sustainable either, since the budget dispute in Italy and the pending Brexit negotiations are currently clear braking factors for the euro. In the turbulent equity phase, only the Japanese yen held up well and fully lived up to its reputation as a risk-off currency. At the portfolio level, we remain overweight in the yen and would tend to reduce the strength of the US dollar further.

If you require further information or advise, please contact your LGT relationship manager.

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