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LGT Beacon

Global macro and market review

August 8, 2017

A good start into the second semester of the year

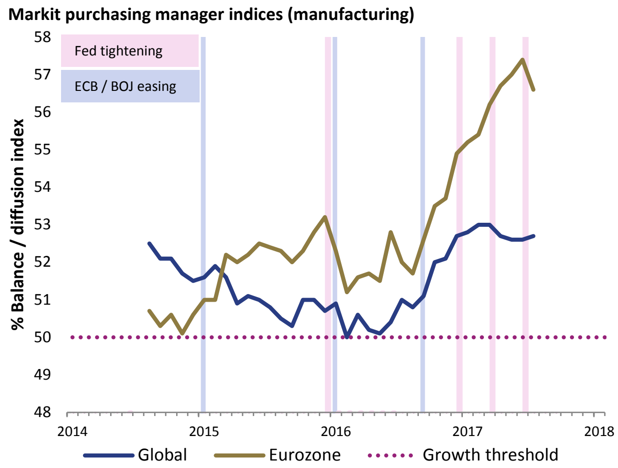
The incoming economic data point to robust global growth while monetary policies remain supportive - even if policy tightening is brought forward somewhat in Europe, subdued inflation should prompt Japan and perhaps even the US to surprise on the dovish side. We keep our preference for equities and for currencies with a hawkish surprise potential.

The year's second half started well: corporate earnings are generally growing faster than forecast, while the macro data began to surprise on the upside again recently, after a rather mixed June. Equity prices rose (MSCI World All-Countries: +2.7% in July) and our currency positions paid off.

Both lagging and leading indicators point to continued economic growth. The European Union (EU) stood out again, with the Eurozone's purchasing manager survey reading holding near records - and far ahead of an already constructive global trend (chart 1).

Graph 1

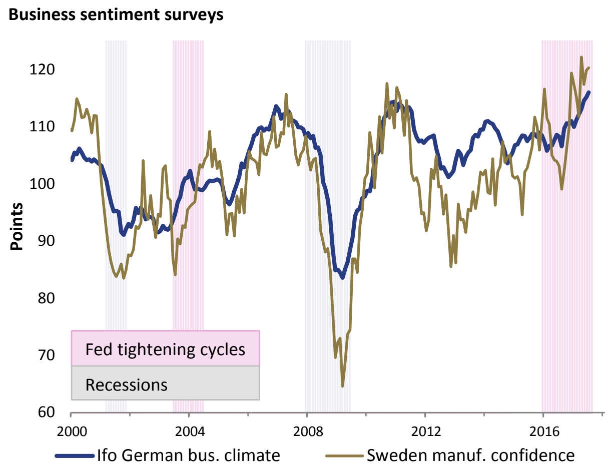
Business surveys point to steady growth



Furthermore, some national EU sentiment indicators kept surging to new highs. For instance, Germany's Ifo business climate index jumped to the highest since reunification in 1990, tracking a surge in a similar but more sensitive Swedish barometer (chart 2). Sweden's real gross domestic product, meanwhile, surged to an annualized quarterly gain of 7.1% in the second quarter, far exceeding the consensus economist estimate – and even China's current growth rate. Such outcomes would not be possible without a robust rebound of European demand and global trade.

Graph 2

Swedish and German confidence at all-time highs



Data out of Asia confirmed this picture: South Korea and Taiwan again reported double-digit export gains, as they have been for most of this year. Exports have also been accelerating in China and Japan in recent months, with imports growing even faster in both economies.

Inflation remains subdued in foreseeable future

In the US, meanwhile, growth data held up at acceptable levels, but with few – if any – signs of a meaningful rebound in inflation toward the targeted level. In addition, the initial optimism about the relatively new US administration's economic plans has been largely priced out by now on a macro level (although some positive expectations are still reflected in various stock market sectors). Thus, unless we get stronger-than-expected surges in US wages and/or energy and import prices in the coming months, the Federal Reserve might thus prove somewhat less hawkish that generally assumed at present - while several other central banks now seem likely to take (further) steps toward a gradually tighter monetary policy bias (e.g. in the Eurozone and Sweden, as well as in Canada and Australia).

On the dovish side, the Swiss National Bank (SNB) has few incentives to act against the recent euro rally versus the Swiss franc (CHF), which was balanced by weakness in its other holdings, while the Bank of Japan (BOJ) remains the most unreformed dove standing. Despite a domestic mini-boom, Japan is farthest away from hitting its annual inflation target of at least 2% anytime soon, while recent political events help to further entrench its policy regime (see special topic, page 5).

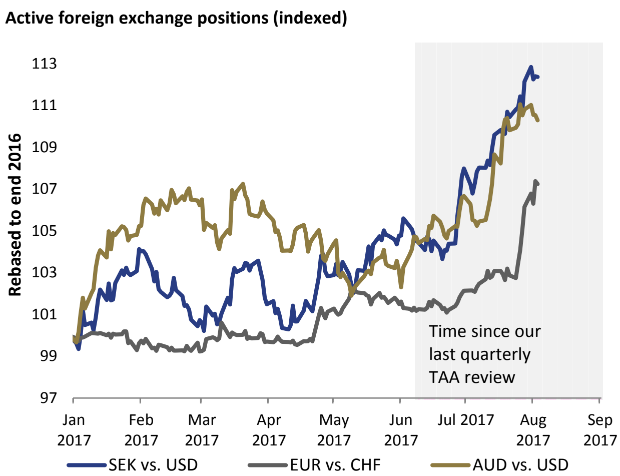
Tactical asset allocation: staying the course

Hence, the global policy mix remains supportive for economic growth and equities, while it also reaffirms our gradual/modest pivot away from US assets (equities, high yield credit) and the US dollar (USD) in recent quarters.

Our tactical asset allocation (TAA) remains as set following our last quarterly investment review in June (table, page 4): we continue to favor equities over fixed income, with our active quotas in Europe and Japan somewhat more pronounced than those in the emerging markets (EM) and Asia-Pacific excluding Japan (APXJ). The US is our least pronounced overweight.

Graph 3

SEK and AUD surge as CHF slumps



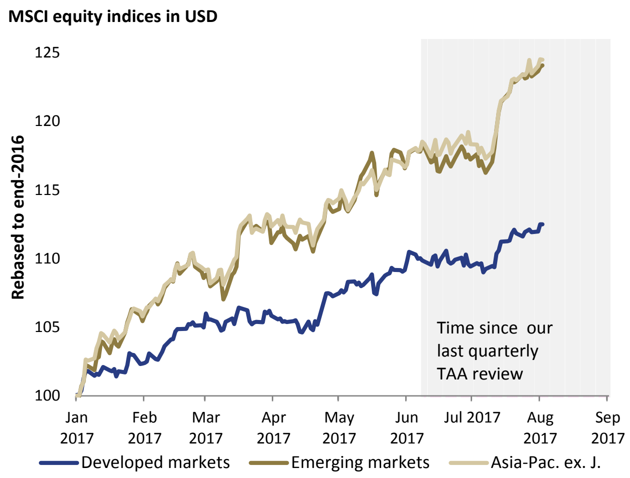
In currencies, our biggest longs are the Swedish krona (SEK) and the "others" segment, which includes the above-sampled Australian dollar (AUD), while our biggest short remains the CHF. These currency positions worked very well for us during the quarter (graph 3) - especially as our portfolio management team implemented some additional and timely trades in the relevant currencies.

Equities: temporary regional divergence

Admittedly, the European and Japanese equity positions may seem rather unfortunate at present, as they have been correcting or consolidating in recent weeks. However, this headwind is outweighed by extraordinary lockstep strength in the EM and APXJ (graph 4). We benefit from this development because, in addition to our current TAA overweight in both markets, our neutral (i.e. strategic) exposure to that space is high when compared to our industry peers.

Graph 4

EM lead an unbroken global bull market



Nevertheless, given our benign macro outlook, Europe and Japan should regain momentum going forward. The ongoing corporate earnings season is encouraging in this regard, as companies from these two markets performed better than the global average (graph 5):

Graph 5

Reporting season results

Earnings per share (EPS) for Q2/2017

	Reported	Results above estimates	EPS growth versus Q2/2016	EPS versus consensus est.
MSCI World	79.6%	70.4%	17.6%	7.4%
USA | S&P 500	85.2%	77.5%	10.4%	4.8%
Europe | Stoxx 600	77.0%	56.8%	26.3%	9.0%
Eurozone | Euro Stoxx	79.7%	55.7%	23.0%	12.0%
Japan | Nikkei 225	76.4%	76.9%	28.3%	17.7%

Source: LGT Capital Partners, Bloomberg. Data close Aug. 7th, 2017

With respect to the Eurozone, we noted that some analysts are questioning the earnings outlook due to the recent euro (EUR) rally, but we are less concerned in this regard from a macro viewpoint.

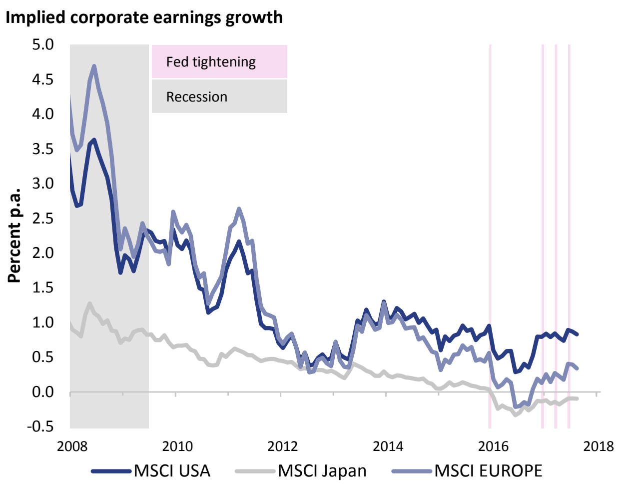
Firstly, we do not expect broad-based EUR strength to persist (our TAA is neutral on the EUR, see page 4). Secondly, currency effects are often exaggerated - and can be offset by other factors, such as good risk management and strong domestic demand. Japan's corporate results underline this point, as the above-listed earnings surge was achieved during a period in which the yen was broadly stable, with interim bouts of strength.

The ongoing corporate reporting season reminds us that investors and analysts on average remain cautious on Europe and Japan, while they are increasingly optimistic on the US. The earnings growth rates implied by current market valuations are still near-zero for Europe and Japan, while they have recovered more markedly for the US (graph 5) - hence, these markets possess a larger potential to keep surprising positively in coming quarters.

That said, we should add that investors are not overoptimistic for the US yet. While the absolute level of implied expectations is higher for the US, it is not extremely high. Against the background of our benign global macro outlook, all markets are thus likely to trend higher.

Graph 6

Investors are far from exuberant



Fixed income and other asset classes

Concluding, our TAA in fixed income and the broader alternative asset space remains unchanged too. At the margin, we have become somewhat more cautious on hard currency-denominated EM debt in favor of local currency securities, in line with our less favorable USD view, and slightly more constructive for the energy and commodity space, which had been sold-off hard in recent months.

END OF TAA-RELATED REPORT

Special topic:

Is Japan's reflationary effort fading?

Concern about Japan potentially watering down or abandoning its reflationary economic policies and reforms, known as "Abenomics," has increased recently. A number of domestic political setbacks, including a defeat of the ruling Liberal-Democratic Party (LDP) in the Tokyo metropolitan assembly election, have reduced Prime Minister Shinzo Abe's approval ratings below 40% for the first time, casting doubt on his chances to run for an unprecedented third three-year term next year.

"Abenomics" is a clear success

Such concerns are premature in our view. With the LDP primary elections not due before September 2018, Abe has sufficient time to work on a comeback. Meanwhile, Japan's economy is performing very well. Real gross domestic product has been growing above potential for six consecutive quarters - the longest such phase in more than a decade. Corporate earnings have rebounded faster than elsewhere from the 2015 global commodity slump and are currently expanding faster than the global average – even as Japan's exchange rate has stabilized over the past two years.

Capital investment and property prices have picked up, credit is modestly but steadily growing again after decades in reverse, and the labor market has tightened despite a rising labor participation rate (primarily due to women joining the workforce). Bankruptcies are approaching the lowest levels since the peak boom level of 1989 and full-time job offers match the number of job seekers for the first time since 1974.

Such developments suggest a profound underlying improvement, especially when compared to the 20 years before Abe assumed office in December 2012. Against this background, wages and the much-coveted full-time jobs should start rising more clearly – and the broader public should take notice in due time, to the benefit of the Abe administration.

Regime change at BOJ hard to reverse

Lastly, with inflation lagging far behind the central bank's target, BOJ policy is likely to remain easy, or ease further. Importantly, Abe will almost certainly able to make a key macro decision for the coming years well ahead of the LDP primary, i.e. by April 2018, when current BOJ President Haruhiko Kuroda's term expires. His reappointment remains in the cards. At the same time, all likely alternative candidates are at least as committed to prioritize reflation as Kuroda.

In this context, it is worth noting that the last two stability-oriented dissenters (policy makers stressing potential risks arising from monetary expansion) in the nine-member BOJ board were replaced by reflationists (prioritizing monetary expansion to hit the inflation target) in July. Thus, after more than four years, the philosophical regime change at the BOJ has been fully completed - and cannot be reserved without equally protracted institutional procedures.

Concluding, while political risks need to be monitored, our base case is that Japan will remain on a reflationary path.

Graph 7

Stock market gains measured in various currencies

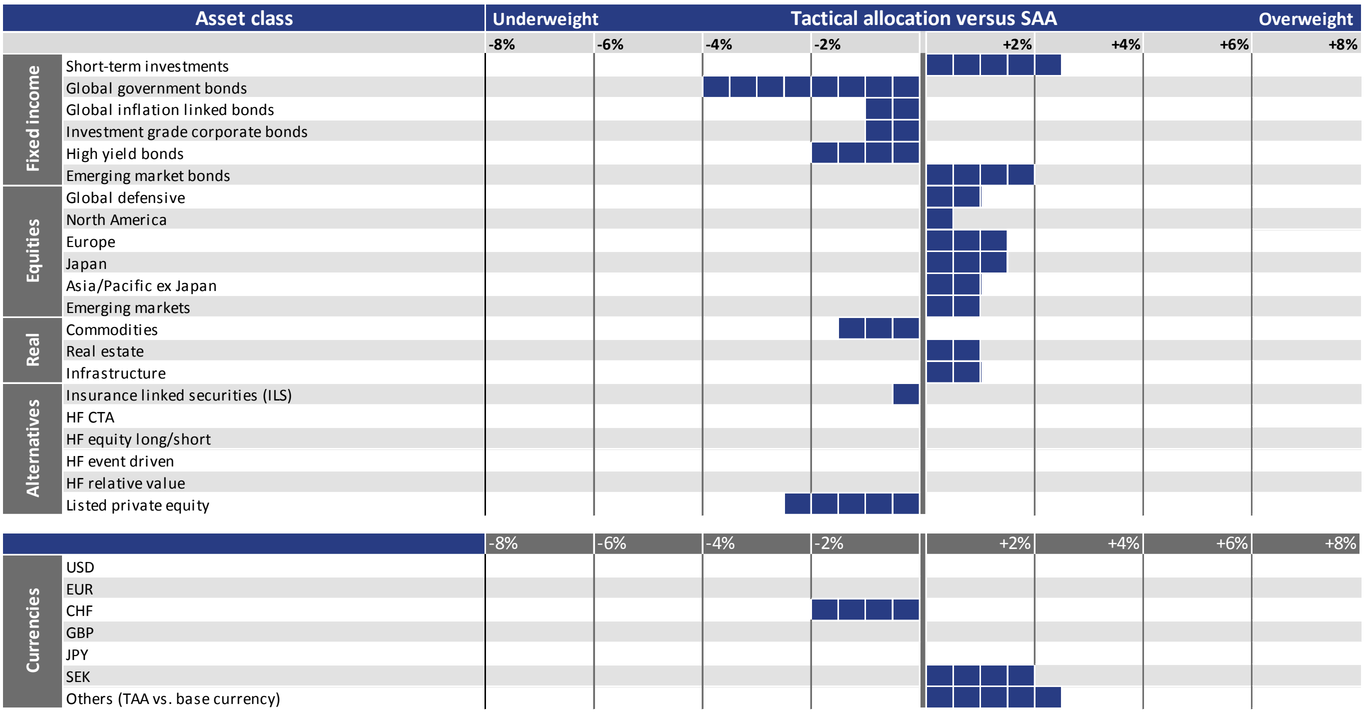
Annualized total returns since Abe's election in Dec. 2012				
in	USD	EUR	CHF	JPY
S&P 500	15.3%	18.2%	16.9%	21.9%
Nikkei 225	**11.4%**	**14.2%**	**12.9%**	**17.8%**
Euro Stoxx (broad index)	9.5%	12.2%	11.0%	16.1%
SMI	8.7%	11.3%	10.1%	15.3%
Hang Seng	8.4%	11.0%	9.8%	14.8%
Dax	8.2%	10.8%	9.6%	14.8%
Stoxx Europe 600	8.0%	10.7%	9.5%	14.5%
FTSE 100	4.3%	6.9%	5.7%	10.5%
MSCI EM	3.5%	6.1%	4.9%	9.4%

Source: Bloomberg, LGT Capital Partners. Closing prices per Aug. 7th, 2017.

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

Our tactical asset allocation (TAA, i.e. positions versus our neutral strategic quotas) is set following a quarterly scoring process, and reviewed monthly. Further trades can and are regularly implemented to capture short-term market movements in between these meetings, without signifying a change in our views. Our current TAA (set on June 9th, 2017) can be summarized as follows:

- **Overweight in equities, tilted in favor of Europe, Asia and the EM, against an underweight in fixed income**
- **Real alternative assets: property and infrastructure preferred over commodities and listed private equity**
- **Currencies: short CHF, long SEK and “others” (resulting from positions in the EM and Asia-Pacific)**



The above shown model portfolio is based on the LGT GIM Balanced (USD) portfolio, managed by LGT Capital Partners. Currency risk in developed markets is always fully hedged in our portfolios as a matter of policy.

Performance of relevant markets

		1 month	3 months	year to date	3 years, p.a.[1]	5 years, p.a.[1]
Bonds						
Global government bonds	USD	1.1%	0.9%	1.5%	3.4%	3.2%
Global inflation-linked bonds	USD	1.0%	0.6%	1.1%	1.6%	1.1%
Investment grade corporate bonds	USD	1.0%	1.7%	3.5%	3.0%	3.1%
High yield bonds	USD	2.1%	3.3%	8.2%	4.6%	6.7%
Emerging market bonds	USD	2.6%	2.9%	8.9%	3.9%	3.3%
Equities						
Global defensive	USD	2.9%	3.9%	11.5%	10.0%	10.8%
North America	USD	2.4%	3.9%	11.6%	9.3%	13.0%
Europe	EUR	1.8%	0.4%	10.5%	9.2%	10.7%
Japan	JPY	1.7%	2.8%	7.4%	10.8%	18.4%
Asia Pacific ex. Japan	USD	6.5%	10.0%	26.6%	5.3%	7.6%
Emerging Markets	USD	7.6%	10.3%	26.6%	3.3%	4.5%
Real assets						
Commodities (commodity producers' equities)	USD	6.3%	3.5%	-1.0%	-7.7%	-1.5%
Real estate (real estate investment trusts, or REITs)	USD	3.6%	4.0%	7.5%	5.7%	8.0%
Infrastructure (master limited partnerships, or MLPs)	USD	-1.3%	-4.6%	-3.7%	-10.4%	0.7%
Alternatives						
Insurance linked securities (ILS)	USD	0.6%	1.5%	2.7%	5.7%	7.5%
HF CTA	USD	1.9%	-2.6%	-2.2%	3.1%	1.1%
HF equity long/short	USD	1.7%	2.9%	7.7%	3.8%	6.6%
HF event driven	USD	0.9%	1.7%	5.0%	3.0%	6.2%
HF relative value	USD	0.6%	0.8%	3.3%	3.3%	5.3%
Listed private equity	USD	4.8%	8.0%	22.3%	9.9%	15.8%
Currencies [2]						
US Dollar	USD	-2.6%	-5.9%	-7.6%	5.3%	3.5%
Euro	EUR	1.3%	2.7%	5.1%	0.5%	2.5%
Swiss franc	CHF	-3.6%	-3.1%	-2.7%	2.5%	3.5%
British pound	GBP	-1.2%	-5.0%	-1.7%	-4.1%	-0.6%
Japanese yen	JPY	0.6%	-3.4%	-1.7%	2.2%	-4.1%
Swedish krona	SEK	1.2%	3.2%	4.6%	-1.0%	-0.9%

[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

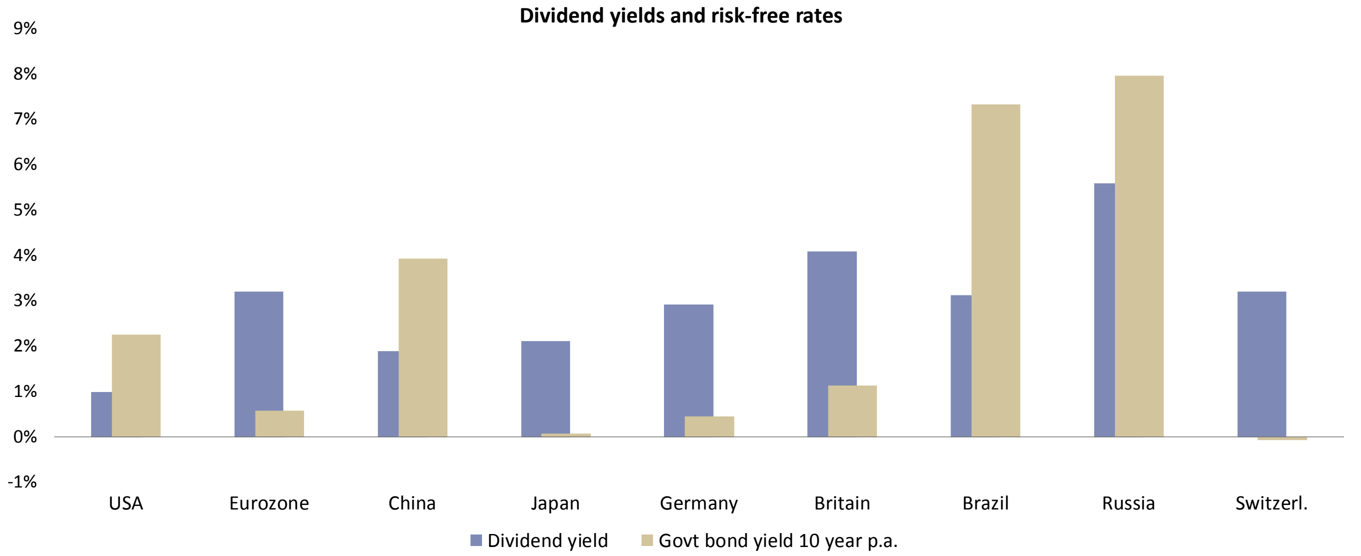
Macro fundamentals		USA	Eurozone	China	Japan	Germany	Britain	Brazil	Russia	Switzerl.
Gross domestic product (GDP)										
- nominal, in billion USD		19,417	11,729	11,795	4,841	3,423	2,497	2,141	1,561	659
- nominal, per capita 2017[1]	USD, PPP	59,609	38,322	16,676	42,860	49,815	44,001	15,485	27,466	61,014
- expected real growth for 2017	Consensus	2.2%	2.0%	6.7%	1.3%	1.9%	1.6%	0.5%	1.4%	1.4%
- expected real growth for 2018	Consensus	2.3%	1.7%	6.3%	1.0%	1.7%	1.3%	2.0%	1.5%	1.7%
- real growth in most recent quarter[2]	q/q annualized	2.6%	2.4%	7.0%	1.0%	2.4%	1.2%	4.3%	-2.3%	1.2%
Unemployment rate[3]		4.3%	9.1%	4.0%	2.8%	5.7%	4.5%	8.2%	5.1%	3.2%
Inflation, core rate (CPI)	y/y	1.5%	1.2%	2.2%	-0.2%	1.6%	2.4%	3.0%	3.3%	0.3%
Purchasing manager indices (comp.)	Neutral = 50	54.6	55.7	51.9	51.8	54.7	54.1	49.4	53.4	60.9
Structural budget balance/GDP 2017	IMF	-4.0%	-1.1%	-3.7%	-3.7%	0.2%	-2.8%	-7.6%	-2.5%	0.2%
Gross government debt/GDP 2017	IMF	108%	91%	49%	239%	65%	89%	81%	17%	45%
Current account balance/GDP 2017	IMF	-2.7%	3.0%	1.3%	4.2%	8.2%	-3.3%	-1.3%	3.3%	10.8%
International currency reserves	bn USD	42	262	3,081	1,198	38	117	185	348	772
Govt bond yield 2yr[4]	p.a.	1.35%	-0.48%	3.54%	-0.11%	-0.68%	0.22%	8.45%	8.58%	-0.78%
Govt bond yield 10yr[4]	p.a.	2.26%	0.59%	3.93%	0.07%	0.46%	1.14%	7.34%	7.96%	-0.07%
Main policy interest rate[5]	p.a.	1.25%	0.00%	4.35%	-0.10%	0.00%	0.25%	9.25%	9.00%	-0.75%

[1]IMF estimates. 2annualized, 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	27,464	8,051	11,944	5,785	2,250	3,569	842	529	1,745
Growth in earnings per share, estimated (MSCI)										
Next fiscal year / current fiscal year	Consensus	11.7%	9.1%	14.5%	5.5%	7.5%	7.6%	11.1%	12.6%	10.4%
FY year after next / next FY	Consensus	10.5%	8.9%	13.9%	7.6%	7.7%	9.1%	20.5%	7.4%	9.6%
Growth in revenue per share, estimated (MSCI)										
Next fiscal year / current fiscal year	Consensus	5.1%	3.5%	11.4%	2.4%	3.2%	3.9%	7.2%	7.0%	3.5%
FY year after next / next FY	Consensus	5.0%	1.8%	11.2%	2.1%	3.4%	5.3%	7.3%	6.0%	2.5%
Valuation metrics (MSCI)										
Price-Earnings Ratio (est forward 12m)	Consensus	19.3	15.3	14.7	14.5	13.8	15.5	13.2	6.8	18.8
Price-Sales Ratio (est forward 12m)	Consensus	2.0	1.1	1.7	0.9	0.9	1.3	1.4	0.8	2.1
Dividend yield	Consensus	1.0%	3.2%	1.9%	2.1%	2.9%	4.1%	3.1%	5.6%	3.2%

*Includes Hong Kong. Corporate fundamentals are based on consensus estimates ."Reversal +" denotes a return to profits, "Reversal -" an expected loss next year. Source: Bloomberg.

Comparison of selected market fundamentals



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