December 13, 2017

Tactical asset allocation for Q1/2018

We expect global economic growth to remain robust, with headline inflation rising only gradually. Still, given this past year's strong gains in equity prices and the slump in volatility, we think it's prudent to limit risk exposure and temporarily raise cash reserves. That said, we continue to overweigh equities. In currencies, we shift back modestly in favor of the US dollar.

In this report we present our macro assessment and asset allocation for the next three to six months. The decisions concern LGT Capital Partners' multi-asset strategies.

Economy: synchronous growth and low inflation

Our base scenario remains broadly unchanged: we have globally synchronized economic growth with subdued inflation, and the data is pointing to continuity going into 2018. For example, the recent US purchasing manager index (PMI) readings, which tend to lead gross domestic product (GDP), foretell a growth rebound to historically average levels of 3-3.5% (graph 1).

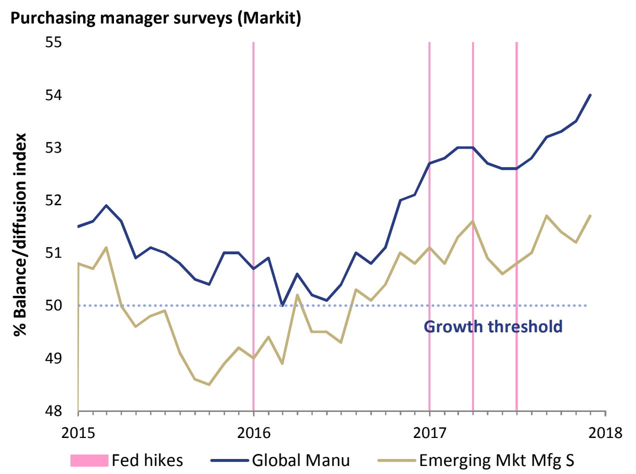
Graph 1
US economy is already expected to accelerate

Source: Bloomberg, LGT Capital Partners

The international PMIs keep pointing in the same direction as well (graph 2), with the developed economies maintaining a lead over the emerging ones (in terms of relative momentum).

At the same time, inflation readings have partly started to recover, but generally remain below target (graph 3).

Graph 2
Business surveys point to steady global growth



Source: Bloomberg, LGT Capital Partners

Meanwhile, the monetary policy settings now seem well-calibrated in most major economies. Hence, inflationary concerns due to an overheating economy remain as unwarranted as disinflationary fears that could lead us into a recession.

Risk scenario: growth dynamics could accelerate

That said, if growth dynamics accelerate further from here, there is a risk of (some) major central banks responding too aggressively, i.e. by bringing forward or intensifying their tightening paths.

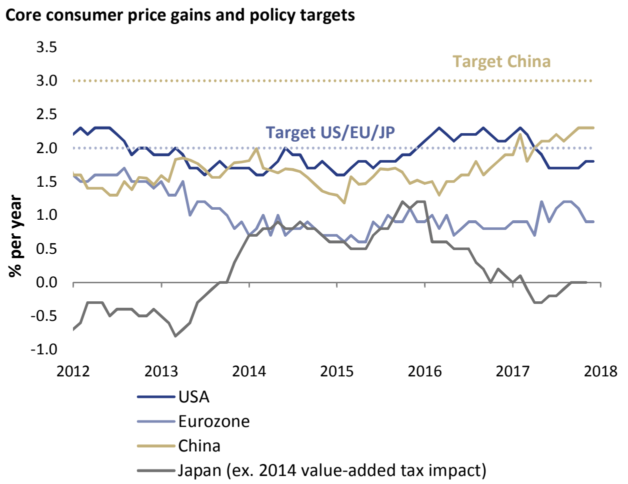
We thus also keep our alternative scenario of a disinflationary slowdown in economic growth, although we continue to attribute a low probability to its occurrence.

Thus far, the US Federal Reserve has been treading cautiously when it comes to its tightening path. Still, by international comparison, it appears somewhat more inclined to accelerate the pace of rate hikes beyond what's currently anticipated - particularly if congress passes tax reform in the coming weeks. New policy biases could also be telegraphed more clearly this coming spring - i.e. after Jerome Powell formally takes over the Fed's board of directors from Janet Yellen.

After all, the US economy is closest to hitting the 2% annual inflation goal over the medium term, with the core inflation rate being a good indicator of medium-term inflation trends. By comparison, the European Central Bank and the Bank of Japan are more likely to extend their current policy biases, given that their economies are both still further away from their targets (graph 3).

Graph 3

Inflation: moving little closer toward target



Note: Japan raised value-added tax on goods sold in 2014, which had a one-off impact on the inflation rate. The effect is ignored here. Source: Bloomberg, LGT Capital Partners

Lastly, the geopolitical and political risks remain well-contained - at least in the sense that the "know unknowns" are unlikely to derail global economic growth in the near term in our view. Hence, the backdrop for risk assets remains generally good.

Some tactical caution may be warranted

At the same time, we are increasingly observing some late-cycle phenomena. For instance, sentiment indicators point to elevated optimism, while industry surveys show that most institutional investors are "uncomfortably long" - i.e. participants are overweight risk assets, while at the same acknowledging that such risk-taking is no longer appropriately rewarded (equity valuations are perceived as elevated, credit spreads are very low by historical standards, etc.). There are also signs of emerging exuberance, such as the hype surrounding cryptocurrencies or the surge in the so-called short-volatility carry-trades[1].

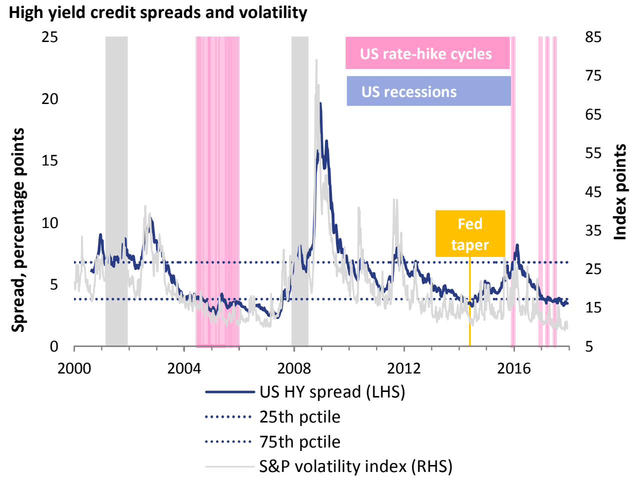
Tactical positioning: maintain overweight in equities

Of course, here we must note that periods leading up to market euphoria phases tend to deliver some of the highest returns - and can last for years (chart 4). This fact, combined with our positive underlying assessment of economic fundamentals, naturally compels to generally keep the equity overweight in our diversified portfolios.

However, the strategy team has also deemed it prudent to temporarily raise cash reserves, which would allow us to opportunistically redeploy capital in markets during sentiment-driven corrections, if and when they occur.

Graph 4

Risk premia can stay low for years



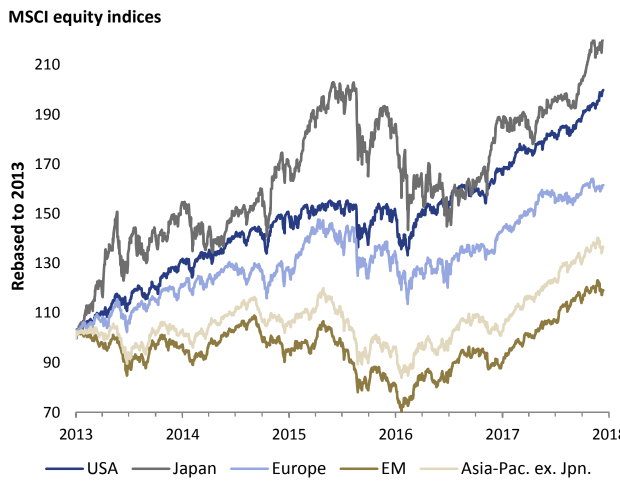
Note: The chart above shows that credit spreads and equity volatility can stay very low for years during the later phases of a bull markets, without being disrupted by rising policy interest rates. Source: Bloomberg, LGT Capital Partners

Taking profit in US and the emerging markets

Specifically, we decided to sell positions in the US and the emerging markets (EM). As a result of these adjustments, we now hold a neutral position in the US and small overweights in the EM and Asia-Pacific excluding Japan (APXJ). At the same time, we decided not to reduce our conviction overweights in Europe and Japan.

Graph 5

Equity markets since 2013



Source: Bloomberg, LGT Capital Partners

Apart from the strong economic rebound, as highlighted in previous editions of the LGT Beacon, Europe continues to offer less demanding equity valuations, monetary policy remains supportive and political risks have receded. While European equities have performed less well than other markets in recent months, these factors should allow the market to catch up in due course.

In Japan, Abenomics[2] is politically back on track following last October's lower house election and the equity market has performed handsomely this year - even without the tailwind of a weakening currency. Corporate profit growth is broad-based and market valuations are still among the most appealing worldwide.

Fixed income: reduction of EM debt

In fixed income, we stay short duration and maintain our pronounced underweight in developed sovereigns. We also keep corporate credit spreads below our strategic quota. Even though both investment grade and high yields spreads could tighten further, the risk premia in either segment are simply not attractive enough for us, especially relative to equities. We have also reduced our position in EM debt based on our outlook of rising US rates and a stronger US dollar.

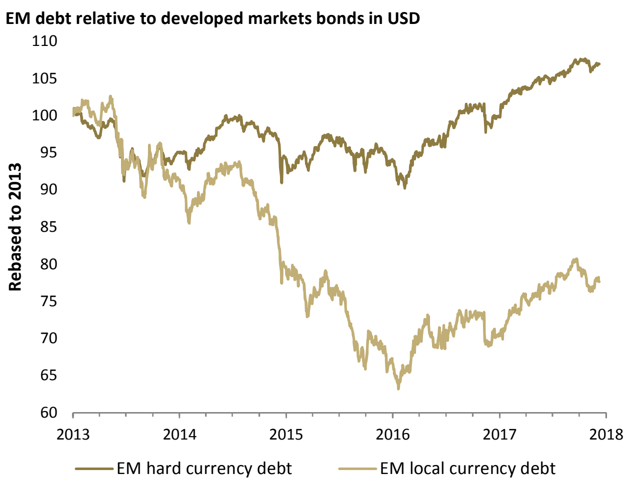
On a relative basis, however, we continue to prefer EM debt (neutral) to government bonds issued by developed markets (DM, underweight). Within the EM space, we still favor bonds issued in local currencies (small overweight) over their hard-currency counterparts (underweight).

Alternatives: rebalancing hedge funds

The tactical positions in alternative assets and strategies are left unchanged at a neutral positioning, which this time involved a rebalancing in our hedge fund (HF) allocation.

HF strategies have underperformed during this year's strong bull market, which had gradually led to a reduction of the segment's weight. We have now increased back to the level we deem necessary in the context of our unchanged strategic asset allocation - i.e. our long-term view for the coming years.

Graph 6
EM bonds relative to DM bonds



Source: Bloomberg, LGT Capital Partners

As a result of the sales in equities and fixed income, the cash position in our model portfolio has roughly doubled, which enables us to redeploy in the financial markets if and when the opportunities arise. Still, we maintain a moderate overweight in equities, against a significant underweight in fixed income.

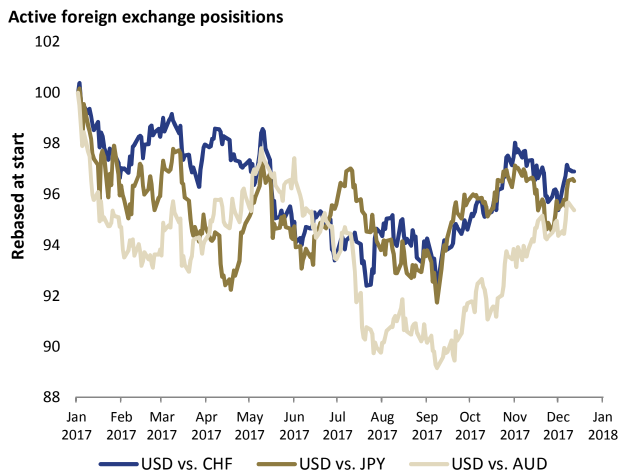
Currencies: USD back in our favor

In our foreign exchange (FX) overlay, we made several changes. Firstly, we have fully closed the remaining tactical long positions in the Swedish krona (SEK) and the Canadian dollar (CAD). Expectations of a more restrictive monetary policy changes in the respective economy have faded, while the technical price signals have deteriorated.

Secondly, we have sold the Swiss franc (CHF) and purchased euros (EUR), to switch the short legs of the above positions back from the EUR to the CHF. Germany is now more likely to form another grand coalition government without having to resort to re-elections, which underpins the EUR. As a result, our FX overlay is tactically long the USD and has short positions in the CHF, AUD and JPY.

Lastly, we maintain a passive overweight in primarily EM currencies, resulting from our active positions in equities, fixed income and other allocation elements.

Graph 7
Currencies: USD preferred over CHF, JPY and AUD



Source: Bloomberg, LGT Capital Partners

LGT Capital Partners will conduct its next quarterly TAA review in early March.

END OF REPORT

Footnotes:

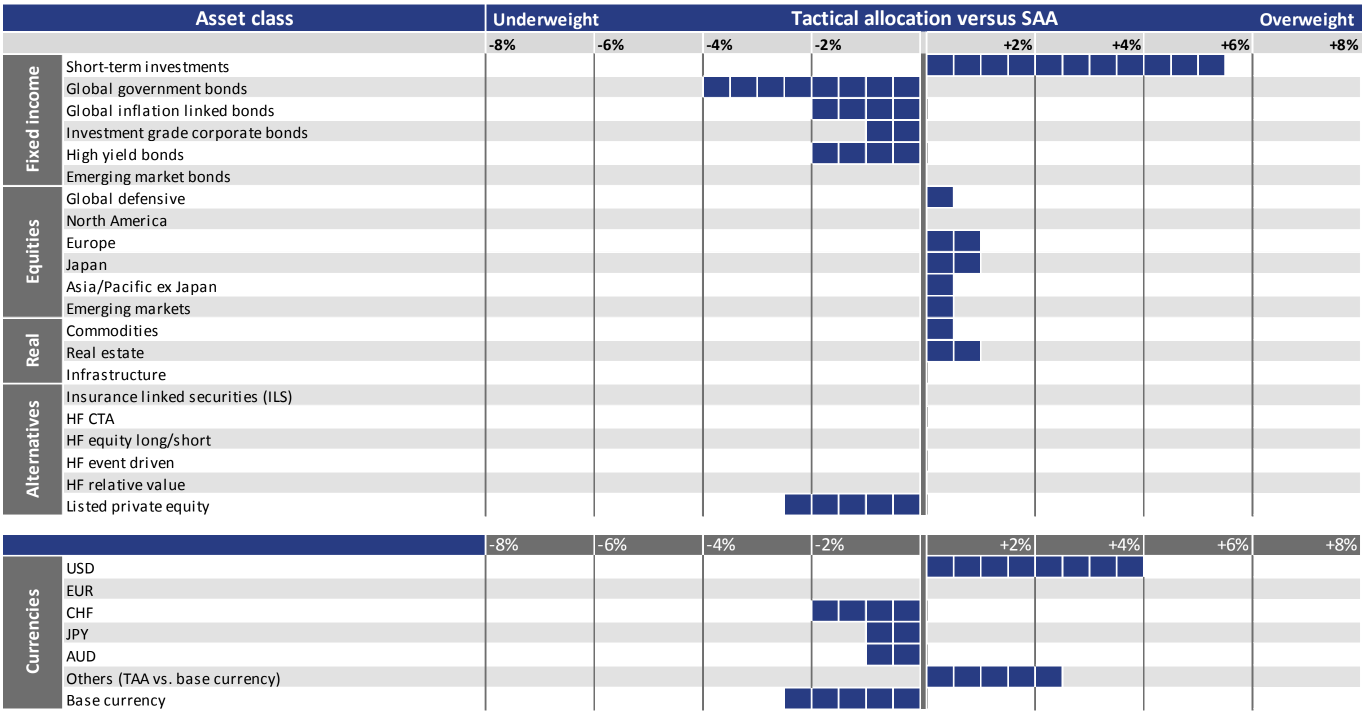
[1] Strategies that offer a defined or limited profit (potential) but a very large (theoretically unlimited) loss potential. Such strategies involve the writing of equity put options to fund holdings in other risky assets.

[2] Abenomics refers to the economic policy mix adopted by the Abe administration since being first elected in December 2012.

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 following a quarterly scoring process and reviewed monthly. Further trades are implemented to capture short-term market movements in between meetings, without signifying a change in our views. Our current TAA was last revised on Dec. 7th, 2017 and can be summarized as follows:

- **Maintain overweight in equities, modestly tilted in favor of Europe and Japan**
- **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, especially vs. JPY, AUD and CHF, with a passive overweight in EM and Asian currencies**



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]
Fixed Income						
Global government bonds	USD	0.7%	0.2%	2.5%	2.7%	3.1%
Global inflation linked bonds	USD	0.3%	0.1%	2.0%	2.2%	1.0%
Investment grade corporate bonds	USD	0.2%	-0.1%	3.8%	2.9%	2.7%
High yield bonds	USD	0.7%	0.6%	9.7%	6.7%	5.6%
Emerging market bonds	USD	1.4%	-0.6%	10.5%	5.9%	3.0%
Equities						
Global defensive	USD	2.3%	3.4%	16.9%	10.3%	11.5%
North America	USD	2.9%	6.5%	20.0%	11.0%	14.0%
Europe	EUR	0.5%	2.4%	12.9%	9.4%	10.0%
Japan	JPY	0.5%	12.1%	19.6%	9.4%	19.2%
Asia/Pacific ex. Japan	USD	-1.0%	3.0%	33.0%	9.4%	6.6%
Emerging markets	USD	-0.7%	1.8%	32.4%	8.6%	3.9%
Real assets						
Commodities (commodity producers' equities)	USD	-1.1%	5.5%	6.7%	3.3%	-0.4%
Real estate (real estate investment trusts, or REITs)	USD	0.0%	1.0%	9.7%	5.3%	7.3%
Infrastructure (master limited partnerships, or MLPs)	USD	0.9%	-2.2%	-8.4%	-8.2%	-0.3%
Alternatives						
Insurance linked securities (ILS)	USD	0.5%	2.9%	-0.5%	3.7%	5.9%
HF CTA	USD	-0.5%	1.4%	2.1%	0.2%	2.8%
HF equity long/short	USD	1.1%	3.7%	12.1%	5.3%	6.7%
HF event driven	USD	0.1%	1.2%	6.1%	4.1%	5.6%
HF relative value	USD	0.0%	0.8%	4.4%	3.7%	4.8%
Listed private equity	USD	1.2%	1.5%	22.8%	11.4%	13.7%
Currencies [2]						
US dollar	USD	0.6%	4.2%	-5.1%	3.0%	4.6%
Euro	EUR	1.7%	2.3%	7.5%	0.9%	2.2%
Swiss franc	CHF	1.1%	0.5%	-2.2%	2.0%	3.0%
Canadian dollar	CAD	-0.8%	-1.8%	-0.3%	-0.8%	-1.4%
Swedish krona	SEK	-1.5%	-3.2%	2.2%	-1.5%	-1.0%
Japanese yen	JPY	0.7%	0.8%	-1.9%	4.8%	-2.4%

[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

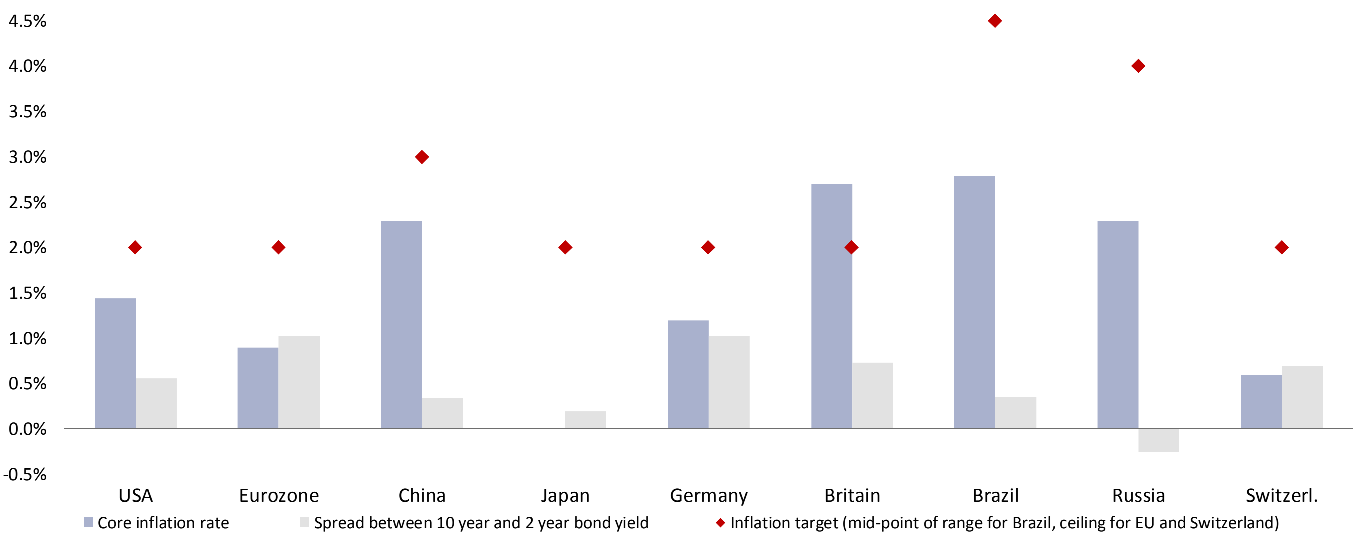
Macro fundamentals		USA	Eurozone	China	Japan	Germany	Britain	Brazil	Russia	Switzerl.
Gross domestic product (GDP)										
- nominal	bn USD	19,362	12,526	11,938	4,884	3,652	2,565	2,081	1,469	681
- nominal, per capita 2017[1]	USD, PPP	59,495	38,322	16,624	42,659	50,206	43,620	15,500	27,900	61,360
- expected real growth for 2017	Consensus	2.2%	2.3%	6.8%	1.5%	2.5%	1.5%	0.8%	1.8%	0.9%
- expected real growth for 2018	Consensus	2.5%	2.0%	6.4%	1.2%	2.2%	1.4%	2.5%	1.8%	1.8%
- real growth in most recent quarter[2]	q/q annualized	3.3%	2.4%	7.0%	2.5%	3.2%	1.6%	0.6%	-2.3%	2.4%
Unemployment rate[3]		4.1%	8.8%	4.0%	2.8%	5.6%	4.3%	8.2%	5.1%	3.0%
Inflation, core rate (CPI)	y/y	1.4%	0.9%	2.3%	0.0%	1.2%	2.7%	2.8%	2.3%	0.6%
Purchasing manager indices (comp.)	Neutral = 50	54.5	57.5	51.6	52.2	57.3	54.9	48.9	56.3	65.1
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	43	260	3,119	1,199	39	118	185	356	791
Govt bond yield 2yr[4]	p.a.	1.82%	-0.56%	3.83%	-0.15%	-0.73%	0.47%	8.25%	7.86%	-0.88%
Govt bond yield 10yr[4]	p.a.	2.38%	0.46%	4.17%	0.05%	0.29%	1.20%	8.61%	7.61%	-0.19%
Main policy interest rate[5]	p.a.	1.25%	0.00%	4.35%	-0.10%	0.00%	0.50%	7.00%	8.25%	-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	29,350	8,280	12,669	6,223	2,407	3,618	803	575	1,719
Growth in earnings per share, estimated (MSCI)										
Next fiscal year / current fiscal year	Consensus	10.5%	8.8%	15.2%	4.2%	10.5%	6.3%	13.9%	10.5%	15.8%
FY year after next / next FY	Consensus	10.6%	9.3%	15.3%	7.6%	8.6%	7.5%	17.9%	3.7%	9.7%
Growth in revenue per share, estimated (MSCI)										
Next fiscal year / current fiscal year	Consensus	5.2%	2.5%	12.5%	2.3%	3.0%	4.8%	5.4%	6.2%	3.5%
FY year after next / next FY	Consensus	4.9%	2.8%	11.9%	1.8%	3.6%	4.4%	7.4%	5.4%	2.0%
Valuation metrics (MSCI)										
Price-Earnings Ratio (est forward 12m)	Consensus	20.2	15.8	15.2	15.0	15.3	15.1	14.1	7.4	19.9
Price-Sales Ratio (est forward 12m)	Consensus	2.2	1.1	1.8	0.9	1.0	1.3	1.5	0.9	2.2
Dividend yield	Consensus	1.0%	3.1%	2.0%	1.9%	2.7%	4.2%	2.8%	5.4%	3.1%

*Includes Hong Kong. Source: Bloomberg.

Current inflation rates remain below target and yield curves imply little upward pressure



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