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Past monetary largesse and current geopolitics point toward stagflation

Marketing material

We concluded our quarterly strategy review last week, just as market volatility had spiked ahead of a number of major central bank policy meetings. Within days, these meetings confirmed that global monetary tightening is set to continue at more rigorous pace. Economic growth is likely to slow further in the coming months. Against this background, we decided to remain positioned on the defensive side.

The US Federal Reserve, the Bank of England, the Swiss National Bank and the Bank of Japan have announced their latest policy decisions on June 16 and 17, which largely confirmed that monetary tightening is here to stay as a major headwind for the economy and financial markets. In this report, we provide a summary of our current views and investment decisions. For the months ahead, we recognize serious challenges for the economy, as well as some potential opportunities in markets.

First, the macro challenges:

- Fears of stagflation remain elevated as high and sticky inflation pressures central banks to tighten more swiftly and rigorously
- This policy stance points to continued economic slowdown and potentially a recession with stagflationary features
- Waning post-pandemic dynamics and deteriorating business and consumer sentiment also contribute to the recession/stagflation angst
- The war in Ukraine and China's lockdowns add to the uncertainty, and solutions to these issues aren't visible yet

On the other hand, there are some factors that mitigate the situation somewhat:

- News flow, market pricing, and investor positioning suggest that we may be near a peak in the general unease
- Many of the supply-side forces that are driving inflation don't have endless staying power, while others will fade due to monetary tightening
- Evidence of a lasting wage-price spiral is still rather scant, and the negotiating position of workers may weaken as the economy slows
- The central banks' need to catch up with inflation is now broadly anticipated while China's problems are also well-documented, leaving room for positive surprises going forward
- Fiscal policy remains supportive in most developed markets, in part buoyed by defense spending, while China is relaxing fiscal policy to support growth (its economy is also not facing the same inflationary pressures as the US and Europe)

Sticky inflation, falling growth

With regard to the broader macro picture, the current mix of factors increase the risk of sustained inflationary momentum, which would erode productivity and hence real economic output. The incoming data continue to move in the wrong direction, with few signs that inflation is topping out yet (graph 1).

Graph 1
Rising inflation, declining growth expectations
(GDP-weighted global growth and consumer price indices)

Source: Bloomberg, LGT Capital Partners

Thus, some form of stagflation now seems inevitable in the near future. Price pressures remain stubborn throughout the economy, beyond the volatile energy and food segments, while private demand is still high and unemployment remains low – the latter is most notably the case in the US.

Moreover, in many countries the pandemic has at last temporarily strengthened labor's political position, which improves workers' negotiating power and thus risks triggering a sustained wage-price spiral. Lastly, the war in Ukraine solidifies the politicization of economic relationships in important sectors such as energy and technology – which creates further potentially long-lasting inflationary forces and headwinds for growth.

Central banks under pressure

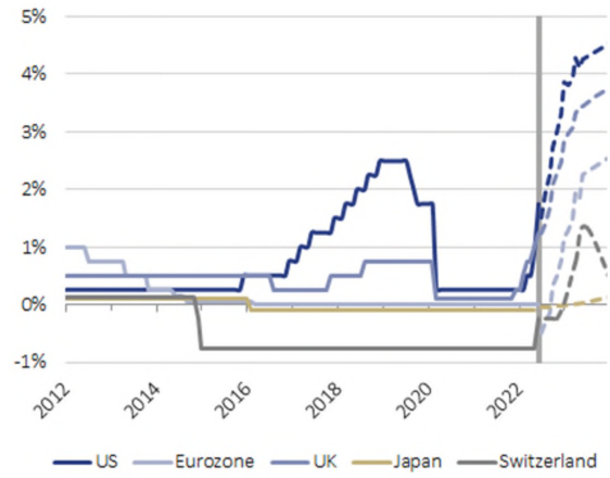
Sticky inflation will likely force many central banks to catch up with reality on the hawkish side in order to regain the credibility that was arguably lost when they allowed inflation to get out of hand.

The Swiss and Japanese central banks are the exceptions in this regard, as they manage economies with lower domestic price pressures than most other economies. However, even these central banks face pressures to adjust their policies to some degree, as the Swiss National Bank's surprise rate hike showed last week. The Japanese have stayed put for now, as core inflation (excluding energy and food) is still near zero – but could also make a move at some point in the future. Nevertheless, the net global monetary policy impact is clearly pointing toward a significant tightening (graph 2).

Graph 2

Current and projected central bank policy rates

(Dotted lines represent the priced future policy level)



Source: Refinitiv, LGT Capital Partners

The broader issue is that geopolitics and supply-chain problems are outside the sphere of monetary issues, and hence central banks can only reduce inflation by suppressing domestic demand. Notably, private demand is now the biggest driver of the current inflation surge in the US (graph 3), making demand-destruction a necessary inflation-fighting strategy.

Getting that strategy right in order to avoid a recession is a tall order that will keep investors worried and drive growth forecasts further down. The US, where domestic demand is still excessive, a soft landing is possible – but in most other economies, demand is weaker, which makes tightening-induced recessions more likely.

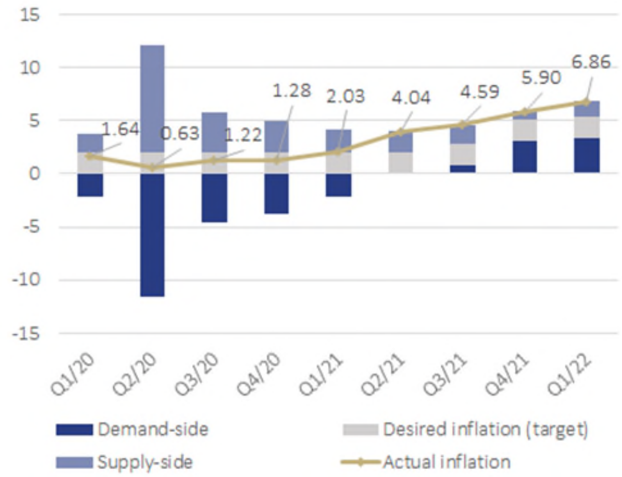
Europe's energy shock and China's self-isolation

The war in Ukraine and the economic sanctions against Russia further exacerbate the situation by limiting and disrupting energy and agricultural supplies. While the conflict remains localized, rather than escalating to a wider military confrontation that directly involves other countries, there is no easing of the sanctions in sight yet.

Graph 3

Composition of inflationary pressures

(GDP deflator, change in %, year-on-year)



The GDP (gross domestic product) deflator represents the broadest indicator of prices across the entire economy, rather than only the consumer sector. Source: David Beckworth, Mercatus Center of George Mason University, LGT Capital Partners

A compensating increase of output by major non-Russian energy producers, such as Saudi Arabia or the US, is not occurring either – be it for political, regulatory or economic reasons, such as a lack of confidence in the longer-term outlook for hydrocarbons.

While this situation weighs on all economies to some degree, the energy shock's impact is the biggest in Europe – due to its very dependence of Russian energy. Tellingly, German business and consumer confidence have dropped sharply since the Russian invasion in February (graph 4).

Graph 4

Germany: business and consumer confidence drop

(Change in growth forecasts since January, in %-points)

Source: Bloomberg, LGT Capital Partners

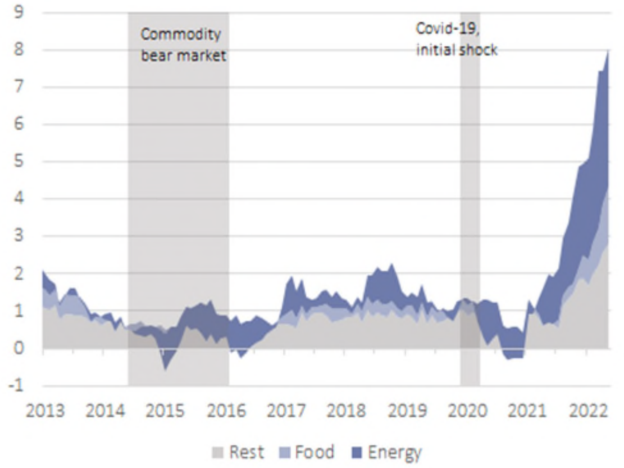
Furthermore, besides the proximity to the conflict, aggregate income levels and wage growth are both lower in Europe than in the US. There is thus much less excess demand, while current inflationary pressures are largely imported.

Excess savings did rise in Europe during the pandemic as they did in the US, but they are now declining faster due to the energy shock. The energy problem thus contributes to a larger upward pressure on inflation in Europe. Surging energy and food prices are responsible for about 65% of the latest increase in the Eurozone's consumer price index, compared to less than the half in the US (graph 5).

Graph 5

Energy and food: main drivers Eurozone inflation

(Euro area consumer price index, change in %, year-on-year)



Source: Bloomberg, LGT Capital Partners

This high dependence on energy in particular, combined with the already weakening domestic demand, is also the reason the European Central Bank is likely to remain less hawkish than the Fed: demand-destruction in Europe would lead to a recession with greater certainty, without fixing the imported energy inflation problem.

Outlook for emerging markets

In the emerging markets, the poorer economies face the risk of food shortages due to the lack of Ukrainian and Russian wheat and other grain supplies, raising the prospect of political unrest in some countries. Diplomatic talks aimed at allowing Ukrainian exports to exit Odessa and other mined ports have not produced tangible results yet, while the strong US dollar further exacerbates the headwind by adding to imported inflation and encouraging capital outflows.

Meanwhile, China's adherence to its strict zero-Covid dogma means that it can lock down any part of the country again every time it registers an increase in Covid-19 cases. Sudden seizures of socioeconomic activity therefore remain a potentially recurring problem for businesses. Beijing's ongoing macro easing measures are likely to prove insufficient under such circumstances, as their impact is conditional on Covid-related developments. In addition, disruptive regulatory interventions remain possible and the country's over-indebted property sector continues to deleverage.

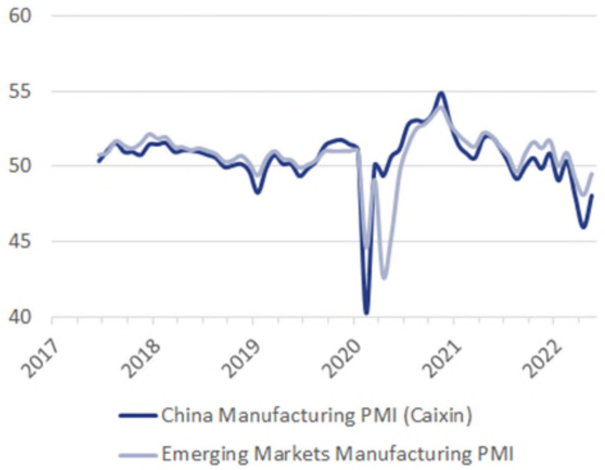
Finally, the geopolitical tensions between China and the US and some other Western and Asian countries cannot be ignored either, especially as Russia's assault on Ukraine has brought the US and its allies closer politically, making this development more pronounced.

Hence, we remain cautious on emerging markets in general and emerging Asia in particular, although China's financial market outlook is to some extent mitigated by very low valuations when compared to the developed economies.

Graph 6

Emerging markets: business activity is still contracting

(Purchasing managers' surveys, balance/diffusion indices)



Source: Bloomberg, LGT Capital Partners

Portfolio: stay the course for now

Against this background, and in light of last week's very volatile environment, we decided to affirm rather than revamp our current tactical asset allocation at this point. We believe that the market has rerated to incorporate the end of ultra-easy financing conditions to revalue financial assets with permanently higher discount rates. Thus, any signals of easing upward pressures on inflation and interest rates could provide some relief from ongoing market stress. We therefore deem it appropriate to maintain a tactical asset allocation that is slightly defensive but closer to neutral overall.

On the flipside, we also do not think that current valuations/earnings forecasts have priced in a real economic recession yet, and remain inclined to reduce equity exposure when markets go through another relief phase.

Over the preceding couple of months, we had selectively increased allocations to some marked-down assets (Investment Grade bonds, Global Equities, gold, and Listed Private Equity), trimming our previously large cash position.

Nevertheless, overall our positioning remains on the defensive side, i.e. we hold underweight positions in both fixed income (duration and credit risk) as well as public equities, combined with overweight allocations to Listed Alternatives, especially gold, as well in Listed Private Equity and real estate investment trust.

Within equities, our biggest underweight regions are Europe and emerging Asia, due to the adverse, albeit distinct, macro headwinds these segments face when compared to the other markets, as elaborated in our macro section. In currencies, we have a clear preference for the US dollar against the euro. Cash remain slightly overweight, at one percent of the portfolio.

Liquid alternatives and private markets

In Liquid Alternatives and hedge funds in general, managers are expressing more cautious views than before, although that is not yet necessarily uniformly visible in their positioning – as is often in the nature of volatile environments. Our discretionary hedge fund managers in general have the mandate to run relatively market-neutral portfolios, and remain reluctant to take directional net exposures – most, however, are nowadays opting for lower risk allocations than on average historically.

Global macro managers in the industry have deleveraged, with many portfolios holding 50% or more in cash. Hedge funds have generally become more bearish in their outlook for risk assets. Notably, managers confirm that investor sentiment has deteriorated rapidly on fears of war, inflation, central bank activity, supply-chain disruptions, de-globalization, as well as the risk of a recession.

Our systematic managers, including Trend Following, Short-Term-Trading, Quant Macro and Quant Equity, have delivered strong results thus far in 2022. The main drivers were short positions in sovereign bonds, long US dollar positions against a series of currencies, as well as long positions across the commodity complex and especially energy. Overall, managers tend to be long precious metals, energy and the US dollar, and short equities and bonds, with rather neutral to slightly bearish exposures to industrial metals. There are some contrarian exceptions, however, with one large manager for instance having pronounced long positions in Japanese and other Asian equities against even bigger short exposures in North American and European markets, combined with a short position in the US dollar.

The LGT Capital Partners' internally managed strategies have positioned themselves for volatile and/or bearish risk asset markets, which means they are also avoiding strong directional bets at present, due to the whipsaw risk: in the current environment, significant rebounds can quickly follow big selloffs, and vice versa, which makes big positions costly to reverse.

Concluding, it is worth noting that we had increased allocations to liquid alternatives at the end of 2021, anticipating a more volatile market regime. That decision has paid off thus far, as expected.

Private markets: markdowns of net asset values expected

With regard to private equity, our investment team is currently cautious with regard to co-investments and secondaries, anticipating the potential for further markdowns in valuations due to the adverse macro situation – albeit to a lesser extent than currently observed in the public markets. On the other hand, they continue to make commitments in the primary segment, with the focus on building a diversified portfolio across vintages and geographies. At the same time, we remain highly selective, picking the best opportunities within a broad area of investments.

Moreover, private debt has performed well thus far, as investors showed a preference for shorter duration assets. The key contributors in the first quarter, for instance, were opportunistic private credit funds, special situations exposures, as well as structured credit strategies.

From the broader LGT Group Endowment perspective, Listed Private Equity is becoming increasingly attractive, as it is trading at a discount to net asset value of more than 30% on average. While we expect NAVs to be marked down over the coming months, the currently higher discounts should offer a significant buffer. Historically, engagements in LPE at such public market valuation levels have proven profitable over the medium term. Our rules-based Anti-Cyclical Value Opportunities framework thus recently indicated a value opportunity in this space, prompting us to increase our exposure slightly.

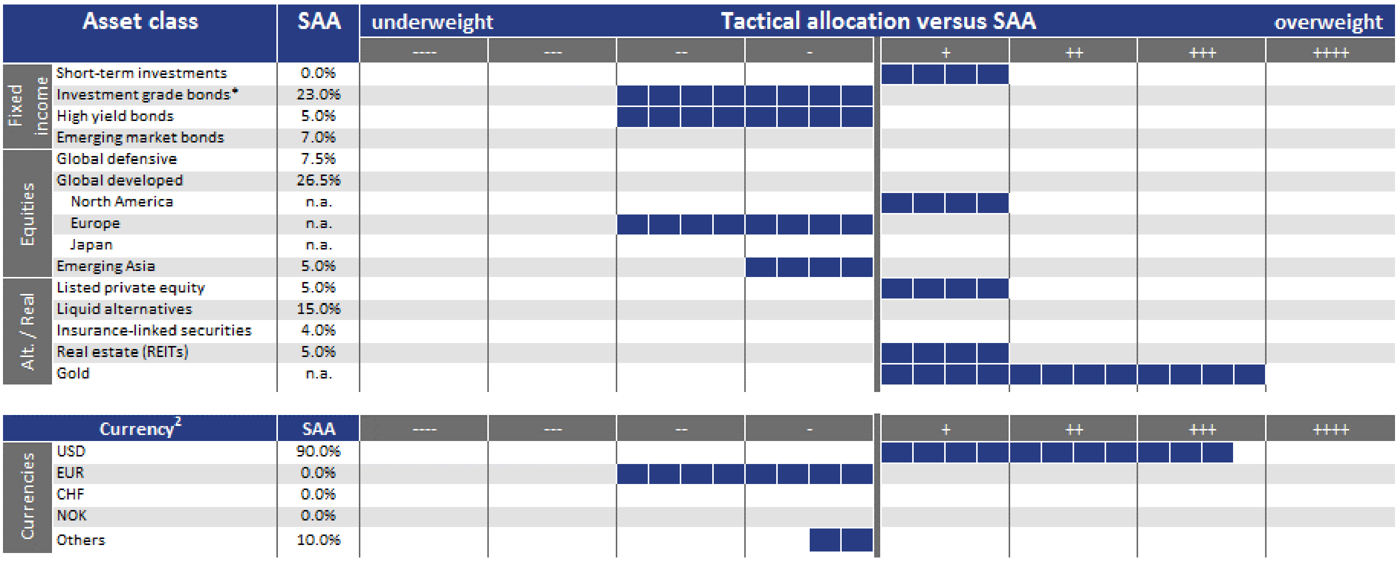
From a strategic viewpoint, while the current environment requires adjustments in the pace and/or the selection of investments, our strategic view for the asset class remains positive and we continue to hold a high strategic allocation to private markets. We thus continue to add and look out for new managers with skills as well as high quality assets on the direct side, as we believe they will deliver robust returns in the coming years.

END OF REPORT

LGT Capital Partners: tactical asset allocation

The tactical asset allocation (TAA) is set quarterly with a time horizon of up to six months. The table shows our current positioning versus the strategic allocation (SAA) of the LGT Group Endowment, or Princely Strategy.

- **Equities: overall underweight due to bearish positions in Europe and emerging Asia**
- **Fixed income: underweight as we hold high yield and investment grade bonds clearly below neutral**
- **Alternatives: overweight due to slight long positions in REITs and LPE, and a pronounced long position in gold**
- **Currencies: long position in the USD against the EUR and passive underweights in EM currencies**



Reference portfolio: LGT GIM Balanced (USD). The TAA is valid for all similar portfolios but various restrictions or liquidity considerations can lead to deviations in implementation. In currencies, "others" represents indirect exposures resulting from unhedged positions in markets against the base currency. * Includes global government, inflation-linked and corporate bonds.

Performance of relevant market segments

		1 month	3 months	Year to date	3 years, p.a.[1]	5 years, p.a.[1]
Fixed Income						
Global government bonds	USD	-3.4%	-6.0%	-10.2%	-1.7%	0.6%
Global inflation linked bonds	USD	-3.1%	-4.2%	-4.0%	2.2%	2.7%
Investment grade corporate bonds	USD	-2.0%	-4.5%	-9.7%	-0.3%	1.3%
High yield bonds	USD	-2.6%	-8.5%	-14.9%	-1.0%	1.3%
Emerging markets, local currency*	USD	-2.3%	-7.1%	-14.1%	-5.4%	-2.1%
Emerging markets, hard currency*	USD	0.0%	0.0%	0.0%	0.0%	0.0%
Equities						
Global	USD	-3.7%	-14.3%	-18.5%	7.8%	8.0%
Global defensive	USD	-3.3%	-10.5%	-14.3%	2.1%	5.2%
North America	USD	-3.6%	-16.8%	-21.2%	9.5%	10.3%
Europe	EUR	-4.5%	-8.5%	-13.3%	3.5%	3.3%
Japan	JPY	-1.3%	-3.3%	-6.5%	9.1%	5.6%
Emerging markets	USD	-1.4%	-9.4%	-16.6%	1.1%	2.5%
Alternative and real assets						
Listed private equity	USD	-8.9%	-24.1%	-32.9%	8.7%	8.2%
Hedge funds	USD	-0.6%	0.0%	-1.8%	5.6%	4.0%
Insurance linked securities (ILS)	USD	-0.1%	-0.2%	0.3%	5.1%	3.4%
Real estate investment trusts (REITs)	USD	-6.1%	-14.5%	-21.9%	1.5%	4.7%
Gold	USD	-1.5%	-5.0%	-0.2%	9.2%	7.9%
Currencies (vs. rest of G10) [3]						
US dollar	USD	1.9%	7.7%	9.0%	2.2%	1.8%
Euro	EUR	1.0%	1.8%	-0.4%	-0.8%	0.4%
Swiss franc	CHF	2.6%	3.4%	2.1%	2.6%	1.8%
British pound	GBP	-0.5%	-1.6%	-2.7%	0.7%	0.9%
Japanese yen	JPY	-5.3%	-6.0%	-9.9%	-6.5%	-2.8%
Canadian dollar	CAD	0.7%	4.0%	5.9%	2.9%	2.2%
Norwegian krone	NOK	-0.5%	-6.5%	-4.7%	-3.6%	-1.8%

[1] Annualized return [2] Equal-weighted hard and local currency total return indices [3] Bloomberg correlation-weighted currency indices, except for CNY [4] J.P. Morgan Emerging Market Currency Index Live Spot in USD | Source: Bloomberg

Economic and corporate fundamentals

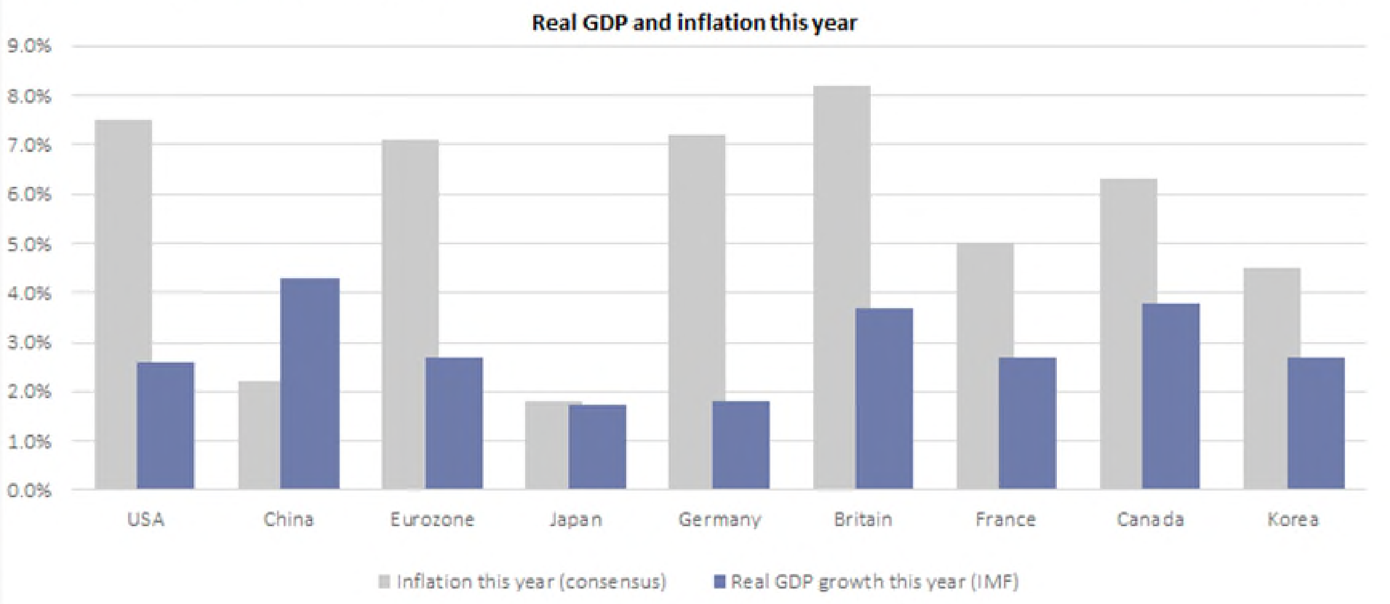
		USA	China	Eurozone	Japan	Germany	Britain	France	Canada	Korea
Gross domestic product (GDP)										
Nominal, this year[1]	bn USD	25,347	19,912	14,493	4,912	4,257	3,376	2,937	2,221	1,805
Per Capita, purchasing power parity[1]	USD, PPP	76,027	21,364	40,965	48,814	63,271	55,301	56,036	57,812	53,051
Real growth this year[1]	Consensus	2.6%	4.3%	2.7%	1.8%	1.8%	3.7%	2.7%	3.8%	2.7%
Real growth next year[1]	Consensus	1.9%	5.2%	2.0%	1.8%	2.2%	1.2%	1.8%	2.4%	2.5%
Real growth current quarter	Consensus	1.8%	5.2%	2.3%	1.2%	2.4%	1.3%	1.9%	1.8%	2.5%
Unemployment this year	Consensus	3.6%	4.0%	6.9%	2.6%	4.9%	3.8%	7.3%	5.3%	3.5%
Inflation this year	Consensus	7.5%	2.2%	7.1%	1.8%	7.2%	8.2%	5.0%	6.3%	4.5%
Inflation next year	Consensus	3.5%	2.3%	2.9%	1.1%	3.3%	4.4%	2.7%	2.8%	2.2%
Purchasing manager index[2]	Neutral: 50	53.6	42.2	54.8	52.3	53.7	54.6	54.6	56.8	51.8
Structural budget balance/GDP	IMF	-5.3%	-7.0%	-3.5%	-7.3%	-2.0%	-4.4%	-5.3%	-2.3%	-1.3%
Gross government debt/GDP	IMF	125.6%	77.8%	95.2%	262.5%	70.9%	87.8%	112.6%	101.8%	52.0%
Current account balance/GDP	IMF	-3.5%	1.1%	1.8%	2.4%	5.9%	-5.5%	-1.8%	1.1%	2.2%
International currency reserves	bn USD	37	3,128	542	1,205	37	113	52	80	425
Govt bond yield 2yr[3]	% p.a.	3.2%	2.2%	1.1%	-0.1%	1.2%	2.3%	0.9%	3.3%	3.5%
Govt bond yield 10yr[3]	% p.a.	3.2%	2.8%	1.7%	0.2%	1.7%	2.7%	2.3%	3.5%	3.7%
Main policy interest rate[4]	% p.a.	1.8%	4.4%	0.0%	-0.1%	0.0%	1.3%	0.0%	0.3%	1.8%
Spread 10y-2y treasury yield	Basis points	2.9	57.3	61.3	31.5	53.3	33.8	137.3	15.7	25.1

[1] IMF estimates [2] Manufacturing PMI for Korea [3] Currency swap rates for China and Brazil and closest ESM/EFSF bond for Eurozone [4] Max target rate for Fed

		USA	China	Eurozone	Japan	Germany	Britain	France	Canada	Korea
Exchange capitalization*	bn USD	39,915	16,414	7,619	5,152	2,012	2,891	2,547	2,789	1,676
Growth in earnings per share, estimated (MSCI)										
12 months forward / trailing 12 montl	Consensus	20.4%	-5.1%	19.9%	12.8%	15.3%	33.3%	66.7%	26.6%	8.8%
Next fy / 12m fwd	Consensus	4.1%	8.7%	3.1%	3.6%	3.2%	1.3%	0.4%	1.8%	4.1%
Growth in revenue per share, estimated (MSCI)										
12m fwd / trail 12m	Consensus	9.3%	10.8%	7.6%	9.9%	6.6%	15.2%	11.8%	6.3%	7.2%
Next fy / 12m fwd	Consensus	2.2%	5.7%	1.1%	1.1%	2.0%	0.6%	-0.8%	2.8%	2.9%
Valuations (MSCI)										
Price-Earnings Ratio (est 12m fwd)	Consensus	16.0	11.6	11.2	12.1	10.0	11.5	9.8	11.4	8.3
Price-Sales Ratio (est 12m fwd)	Consensus	2.1	1.0	1.0	0.9	0.7	1.1	1.2	1.7	0.7
Dividend yield	Consensus	1.7	2.4	3.6	2.6	4.0	3.3	4.4	3.2	2.5

* China market cap includes Hong Kong | Source: Bloomberg

Data per: 22.06.2022



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