Capital Partners
your partner for alternative investments

Torn between two paths for the global economy

Marketing material

Markets seem torn between two future paths. On the one hand, we have lingering concerns of an overheating economy on the back of an ongoing demand rebound and supply squeezes – an inflationary confluence that keeps central banks rushing toward a restrictive policy regime. On the other hand, rising interest rates fuel fears of a sapping economy, with many investors now expecting an imminent recession. We take a balanced route through this challenging environment.

A challenging outlook persists

The past few weeks' data highlight the persistence of a challenging market outlook:

- The global economy continues to cool but inflation remains hot, with price pressures generally broadening and hence potentially entrenching themselves in more and more sectors of the economy, beyond the pandemic-related areas, energy and food.
- Central banks are likely to keep tightening monetary conditions by scooping up liquidity and raising interest rates as quickly as possible, leading many investors to turn ever-more bearish on markets.
- Over the past half year, financial markets have priced in a higher level of interest rates, but no outright recession yet – corporate earnings forecasts thus have room to fall.
- Europe is on the brink of a recession, as high inflation erodes consumers' spending power, while the industrial sector may be forced to cut production to cope with a potential energy supply crisis; in addition, Italy – the currency area's largest debtor – seems to be headed for early elections, risking political uncertainty at a critical time (European Central Bank rate hikes, policy transmission risks).
- Geopolitical conflicts and China's broader domestic policy choices add a meaningful degree of extra uncertainty.

Mitigating factors and counter-cyclical opportunities

At the same time, there are some mitigating factors of a counter-cyclical, if not counter-intuitive, nature:

- Commodity prices have fallen significantly from their year-to-date highs in recent weeks. Energy is down about 25%, and many industrial metals and food-related commodities have dropped even more (graph 1). While these declines reflect concerns about China's elusive recovery and a possible recession in the West, they do take the edge off the inflation problem. Consumer goods' prices may thus soon start to soften, which would in turn confirm expectations that inflation has peaked somewhere around current levels.
- Investors' sentiment surveys and positioning data are very bearish and many indicators are consistent with levels that have historically been followed by relief rallies – sometimes even trend reversals. For instance, the latest institutional survey by Bank of America Merrill Lynch shows that growth optimism is now the lowest on record, as is the share of institutional asset allocators that are overweight equities (with data going back to 2008).
- Risk asset valuations are becoming increasingly attractive in several sectors and returns in some of these segments have indeed started to stabilize of late (e.g., growth vs. value and cyclical vs. defensive sectors in equities). In the

Graph 1

Commodity prices have declined on a broad basis

Commodity	Price change in % from 2022 high	Date of 2022 high	Relevant sector
	(in USD)	DD.MM.YYYY	
Lumber	-42.3	04.03.2022	Industry/housing
Aluminum	-40.3	07.03.2022	Industry/housing
Wheat	-37.3	17.05.2022	Food
Palm oil	-37.4	29.04.2022	Food
Copper	-32.5	07.03.2022	Industry/housing
Cotton	-31.5	17.05.2022	Industry/housing
Oats	-29.3	31.05.2022	Food
Brent oil	-26.3	07.03.2022	Industry/housing
WTI oil	-26.2	07.03.2022	Industry/housing
Corn	-25.6	16.05.2022	Food
Orange juice	-21.1	19.04.2022	Food
Nat gas	-18.8	08.06.2022	Industry/housing
Cocoa	-19.0	10.02.2022	Food
Soybeans	-17.9	09.06.2022	Food
Coffee	-16.0	10.02.2022	Food
Rubber	-12.2	09.06.2022	Industry/housing
Sugar	-10.5	13.04.2022	Food

Source: Bloomberg, LGT Capital Partners

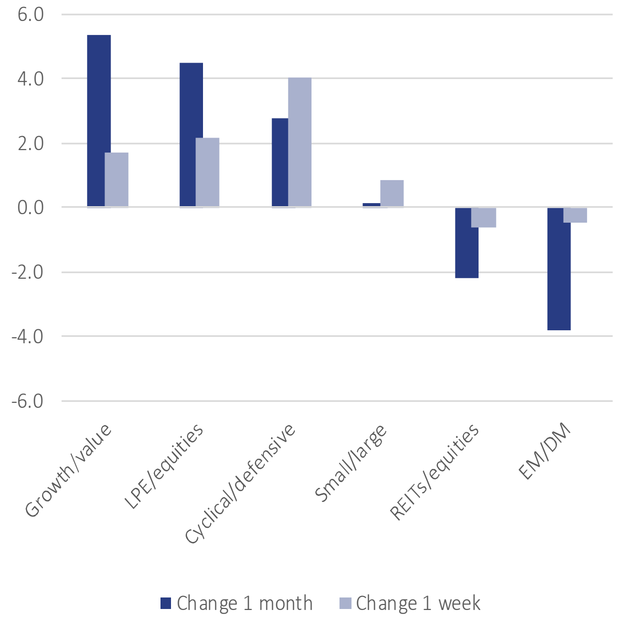
credit markets, US high yield debt is now yielding more than 8%, which is attracting some investors. While we remain cautious about calling a bottom in these particular areas, last month we identified value in Listed Private Equity and raised our allocation to that segment – which has indeed started to outperform since (graph 2).

- The corporate earnings outlook is relatively robust in general. While downside revisions will occur in case markets begin to price in a broader or longer recession, periods of high inflation are synonymous with strong gains in nominal gross domestic product (GDP) – hence, the resulting high revenue growth mitigates the downside, at least for high quality companies that are able to pass on the higher prices.

Graph 2

Some equity market areas are tentatively stabilizing

(Relative returns in % in US dollars)



LPE = Listed Private Equity, REITs = Real Estate Investment Trusts, EM = emerging markets, DM = developed markets. Source: Bloomberg, LGT Capital Partners

No easy answers for risk allocators

In the currently uncertain economic, political and market environment, the right answer for asset allocators is not as simple as favoring an outright avoidance of all equity risk, certainly not from a medium- to long-term viewpoint. This is also reflected in the views and the positioning of our managers in the Liquid Alternatives space. While most are more cautious than they have been in many years, they still avoid clear directional bets due to the risk of being whipsawed in erratic and potentially very volatile markets.

From our vantage point, i.e., that of a broadly diversified Endowment that puts significant weight on private markets as well as assets that offer downside mitigation, inflation-protection, or aren't correlated to the economic cycle, we believe that it is appropriate to maintain a slightly defensive overall tactical positioning. That said, the revaluation of many financial assets offers long-term buying opportunities in some cases.

Hence, after entering this year with unusually high excess cash levels, we have been successively and selectively putting money back to work in the financial markets over the past months.

Shifting weight in favor of defensive and high quality equities

Most recently, we decided to reallocate some of our broad global equity exposure in developed markets to strategies with a dedicated defensive tilt. Specifically, we raised our allocation to Global Defensive Equities – a segment that we defined to consist of Minimum Volatility Equities and our internal Quality Equities. This serves to attain two goals:

First, to have a slightly more resilient portfolio in the case of a significant economic slowdown, as these defensive strategies are tilted towards sectors and companies whose earnings are less cyclical in nature (e.g., information technology, health care, consumer staples, communication services).

Second, to keep sufficient upside potential in case we pass the market trough, as quality stocks have revalued considerably in this year's interest rate-driven correction and are susceptible to a recovery once fears of ever-higher interest rates abate. It is also worth noting that Quality has been underperforming as stagflation fears mounted over the course of the past couple of quarters, which adds a counter-cyclical element to our decision.

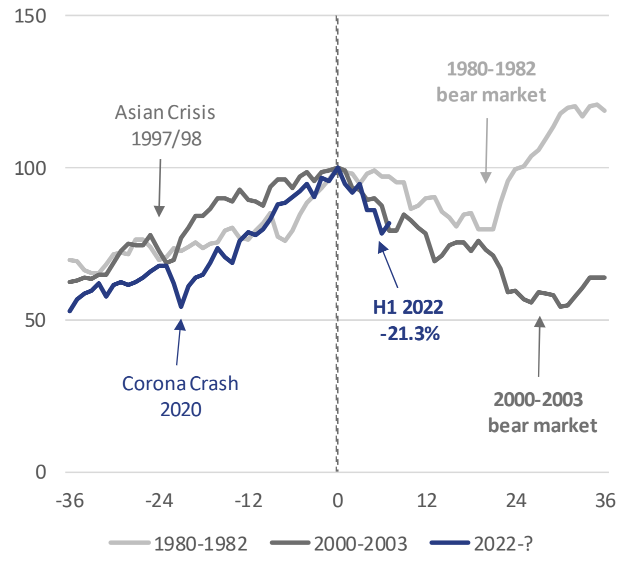
Historical patterns of bear markets

Equity markets have entered a bearish environment over the course of the first half of this year. In this context, it is worth examining some past bear market patterns (graph 3).

Graph 3

Shorter bear market or lasting doldrums?

(Selected US bear markets and corrections, index peak =100, time from peak level in months)



Source: Bloomberg, LGT Capital Partners

Admittedly, the chances that this year's drawdown will prove very short-lived and be followed by a V-shaped rebound, as was the case during the Asian Crisis of 1997-1998, or after the initial panic of the COVID-19 virus outbreak in 2020, seem low. The bearish trend has already lasted for most of this year. If the economy were to enter a long-lasting recession, such as the one that followed the collapse of the great Dotcom boom in the late 1990s, the bearish trend would certainly be prolonged and go deeper.

However, there is also the example of the stagflation phase of 1980-1982, which saw markets gradually recover soon after a drawdown that was similar in magnitude as the one we saw this year. Arguably, this phase is more comparable to today's situation – in particular because, back then the Federal Reserve, like today, had chosen to stamp out inflation in order to avoid repeating the experience of the 1970s long-lasting stagflationary malaise.

Annual inflation started the 1980-1982 period at 13.9% and ended it at 3.8%, averaging about 10%, with real GDP growth averaging around 0% – which is very similar to the outlook many investors fear will materialize over the coming year or two. By comparison, the average inflation rate in 2000-2003 measured only around 2.6%, with real growth running at about 1.7% (for an overview of current consensus expectations, see table and graph on page 6; they show that current inflation numbers are comparable to those in early 1980s, while real growth will likely continue to slow further).

The stagflationary phase of the early 1980s as a possible guide

From an earnings perspective, the stagflationary 1980s were worse than the aftermath of the Dotcom bust, with the US corporate earnings per share (EPS) declining by about 12%, compared to a relatively modest drawdown of 6.6% in the 2000-2003 period. Given that consensus earnings expectations remain rather high at present (see table on page 6), we see another potential similarity with the early 1980s – that is, downward revisions of profit forecasts in the coming months.

Graph 4

The parameters of the two comparable bear markets

(EPS = earnings per share in USD)

	1980-1982	2000-2003
Inflation and real output		
Average inflation p.a.	10.0%	2.6%
Average real GDP growth p.a.	0.1%	1.7%
Equities		
Change in corporate EPS	-12.0%	-6.6%
Max drawdown in US equity prices	-27.0%	-49.0%

Source: Bloomberg, LGT Capital Partners

Still, the stagflationary episode of the early 1980s proved more equity market-friendly in the end, as the Federal Reserve eventually succeeded in bringing inflation back under control, allowing it to ease monetary conditions again without risking runaway consumer price gains.

The example shows that a stagflationary outlook per se does not need to necessarily drive risk asset prices much lower from where they are today, given that we have already seen a big drop. The first half-year's US equity market return of approximately -21% already stands out as one of the worst on record, going back to the 1920s.

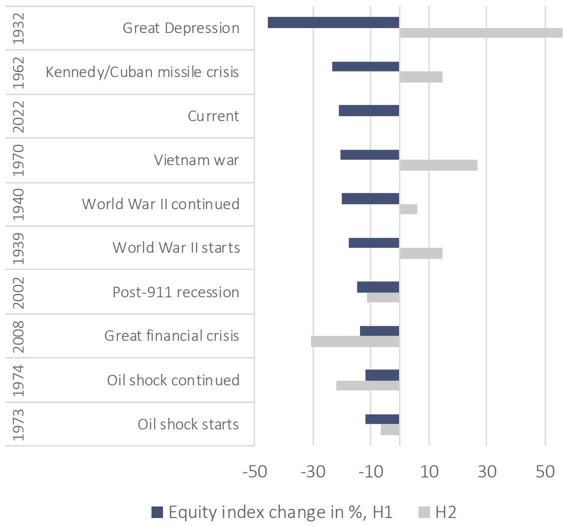
Historically, such negative semesters have been followed by market recoveries of some sort – even during World War II or the Vietnam War. Bear markets persisted when the initial drawdowns were rather small or when combined with major debt crises, as was the case after the collapse of the Lehman Brothers in the autumn of 2008, which then snowballed into a global financial crisis.

In short, we believe a defensive overall tilt remains appropriate in the current market environment, and that investors should be prepared for increases in market volatility by holding diversifying assets beyond government bonds. We would also note that we had decided to increase our allocation to Liquid Alternatives at the end of last year, which has contributed positively to our strategy since – and allows us to hold somewhat more equity risk than we would have otherwise in a market environment such as the current one.

Graph 5

Equities after historically large semester drawdowns

(Index returns in USD)



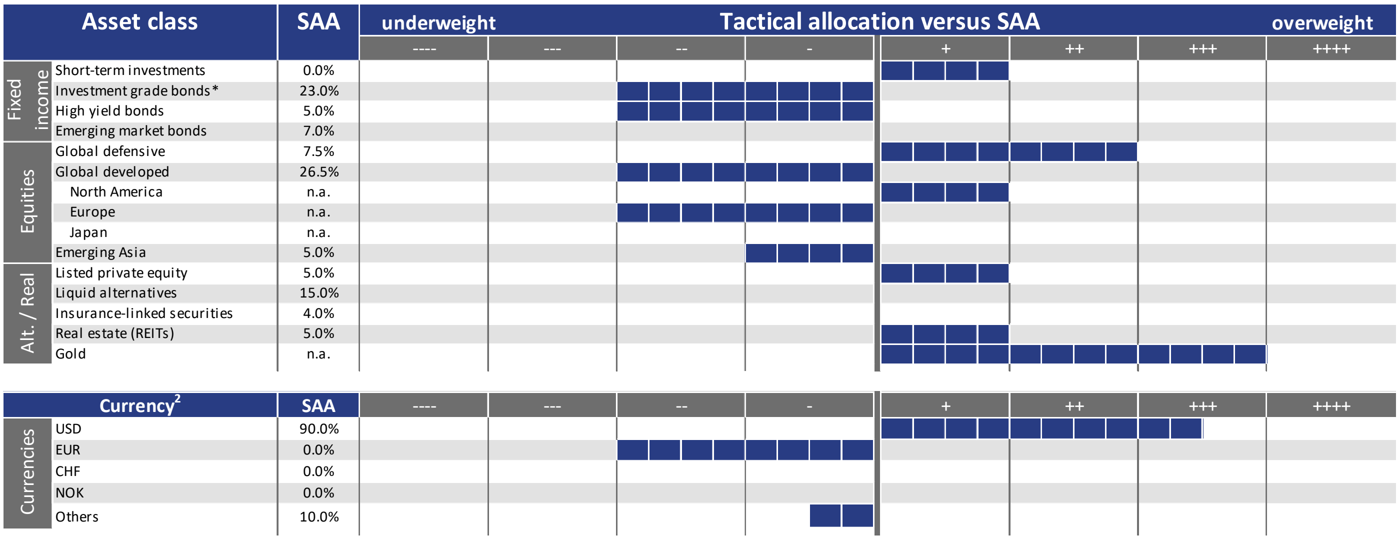
Source: Bloomberg, LGT Capital Partners

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 small underweight, tilted in favor of our global defensive allocation and US equities**
- **Fixed income: underweight, with high yield and investment grade bonds below neutral**
- **Alternatives: overweight, resulting from net long positions in REITs, LPE, and 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

Fixed Income		1 month	3 months	Year-to-date	3 years, annualized[1]	5 years, annualized[1]
Global government bonds	USD	2.4%	-1.1%	-8.0%	-1.1%	1.2%
Global inflation linked bonds	USD	-1.2%	-10.5%	-18.1%	-1.3%	0.5%
Investment grade corporate bonds	USD	1.8%	-0.4%	-8.1%	0.2%	1.5%
High yield bonds	USD	0.2%	-6.7%	-14.9%	-1.1%	0.9%
Emerging markets, local currency*	USD	-3.2%	-8.4%	-16.8%	-7.2%	-3.2%
Emerging markets, hard currency*	USD	0.0%	0.0%	0.0%	0.0%	0.0%
Equities						
Global	USD	5.4%	-7.9%	-14.1%	9.3%	9.0%
Global defensive	USD	3.7%	-8.3%	-11.2%	3.0%	5.9%
North America	USD	6.2%	-9.1%	-16.3%	11.4%	11.2%
Europe	EUR	3.2%	-6.5%	-10.5%	4.4%	4.3%
Japan	JPY	5.5%	2.1%	-1.6%	10.6%	6.5%
Emerging markets	USD	0.4%	-6.7%	-18.1%	0.3%	1.0%
Alternative and real assets						
Listed private equity	USD	8.4%	-10.9%	-27.2%	10.8%	9.3%
Hedge funds	USD	-2.5%	-3.8%	-4.1%	4.3%	3.5%
Insurance linked securities (ILS)	USD	-0.4%	-0.6%	-0.1%	4.7%	3.1%
Real estate investment trusts (REITs)	USD	5.0%	-15.7%	-18.0%	3.8%	5.6%
Gold	USD	-6.5%	-11.1%	-6.1%	6.4%	6.5%
Currencies (vs. rest of G10) [3]						
US dollar	USD	1.1%	5.3%	9.6%	2.3%	2.7%
Euro	EUR	-2.6%	-0.8%	-2.7%	-1.1%	-0.3%
Swiss franc	CHF	0.5%	4.3%	2.9%	3.0%	2.2%
British pound	GBP	-1.4%	-2.3%	-4.2%	0.9%	0.9%
Japanese yen	JPY	0.4%	-2.0%	-9.8%	-6.3%	-2.0%

[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
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
Per Capita, purchasing power parity[1]	USD, PPP	76'027	21'364	40'965	48'814	63'271	55'301	56'036	57'812
Real growth this year[1]	Consensus	2.1%	4.0%	2.7%	1.6%	1.5%	3.4%	2.4%	3.6%
Real growth next year[1]	Consensus	1.3%	5.2%	1.3%	1.8%	1.5%	0.6%	1.4%	1.9%
Real growth current quarter	Consensus	1.5%	5.3%	1.2%	1.1%	1.4%	0.6%	1.4%	1.5%
Unemployment this year	Consensus	3.7%	4.1%	6.8%	2.6%	5.0%	3.9%	7.3%	5.3%
Inflation this year	Consensus	8.0%	2.3%	7.5%	2.0%	7.6%	8.5%	5.7%	6.9%
Inflation next year	Consensus	3.6%	2.3%	3.5%	1.2%	3.5%	5.0%	3.3%	3.4%
Purchasing manager index[2]	Neutral: 50	52.3	55.3	52	53	51.3	52.8	51.4	54.6
Structural budget balance/GDP	IMF	-5.3%	-7.0%	-3.5%	-7.3%	-2.0%	-4.4%	-5.3%	-2.3%
Gross government debt/GDP	IMF	125.6%	77.8%	95.2%	262.5%	70.9%	87.8%	112.6%	101.8%
Current account balance/GDP	IMF	-3.5%	1.1%	1.8%	2.4%	5.9%	-5.5%	-1.8%	1.1%
International currency reserves	bn USD	35	3'071	546	1'189	37	110	52	79
Govt bond yield 2yr [3]	% p.a.	3.2%	2.1%	0.6%	-0.1%	0.6%	2.1%	0.5%	3.3%
Govt bond yield 10yr [3]	% p.a.	3.0%	2.8%	1.3%	0.2%	1.3%	2.2%	1.8%	3.1%
Main policy interest rate ?	% p.a.	1.8%	4.4%	0.0%	-0.1%	0.0%	1.3%	0.0%	1.0%
Spread 10y-2y treasury yield	Basis points	-19.2	61.0	65.2	31.0	64.6	6.6	130.1	-18.1

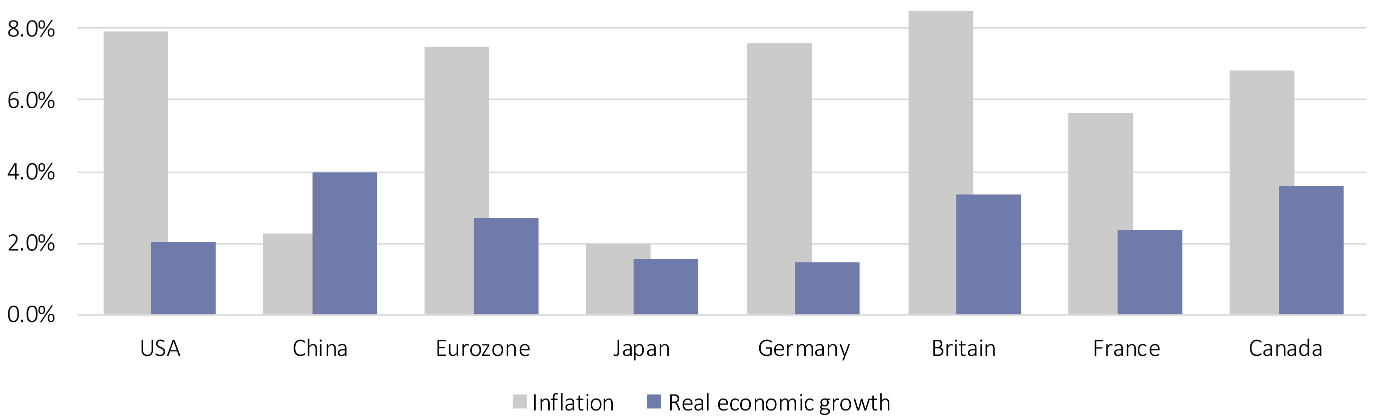
[1] IMF estimates [2] Manufacturing PMI for Korea [3] Currency swap rates for China and Brazil and closest ESM/EFSF bond for Eurozone ? Max target rate for Fed

		USA	China	Eurozone	Japan	Germany	Britain	France	Canada
Exchange capitalization*	bn USD	42'761	16'384	7'611	5'341	1'947	2'885	2'631	2'752
Growth in earnings per share, estimated (MSCI)									
12 months forward / trailing 12m	Consensus	20.5%	-5.3%	21.2%	13.3%	15.1%	35.7%	71.6%	27.2%
Next fy / 12m fwd	Consensus	4.0%	7.4%	2.2%	3.4%	2.3%	0.6%	1.9%	1.0%
Growth in revenue per share, estimated (MSCI)									
12m fwd / trail 12m	Consensus	9.4%	10.0%	8.5%	10.4%	6.4%	16.7%	15.1%	3.5%
Next fy / 12m fwd	Consensus	2.0%	4.9%	0.6%	1.0%	1.3%	0.4%	-1.0%	4.9%
Valuations (MSCI)									
Price-Earnings Ratio (est 12m fwd)	Consensus	16.9	11.4	11.3	12.6	9.9	11.8	9.7	11.2
Price-Sales Ratio (est 12m fwd)	Consensus	2.3	1.0	1.0	0.9	0.7	1.1	1.2	1.7
Dividend yield	Consensus	1.6	2.4	3.7	2.5	4.0	3.2	4.2	3.3

* China market cap includes Hong Kong | Source: Bloomberg

Data per:

Expected real GDP growth and inflation this year



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