# LGT Beacon

Global macro and market review

January 2023

Marketing material

## Investment perspectives January 2023

- **Equities have the best start of a year in a generation as last quarter's risk-on sentiment returns**
- **China's swift reopening buoys global equities while the drop in longer-term interest rates supports credit**
- **Relative growth dynamics shift in favor of Asia, as macro and policy cycles begin to diverge**
- **Continued rate hikes in the West and a possible tightening in Japan leave trip wires in financial markets**
- **Headline inflation will ease as goods' prices deflate but broader services inflation will remain sticky**
- **China's abrupt exit from Zero-COVID policy accelerates cyclical rebound but structural issues remain in place**
- **Investment decisions: raise emerging Asia equities and end USD overweight, but maintain overall defensive tilt**

The positive momentum of the last quarter has extended into the start of the new year, with equities rising and interest rates trading well below recent highs. In the US, a slowing economy, falling inflation rates, and softer wage gains weighed on government bond yields, with the US yield curve dropping about 50 basis points year-to-date.

In Europe, a rather mild winter led to steep declines in regional natural gas prices, which reduced inflation pressures and bolstered expectations for a softer than forecast recession.

In Asia, China has abandoned its strict Zero-COVID policy almost overnight, reopening its economy much faster than even the most optimistic market watchers had dared to predict – and prompting most of them to rush to upgrade their macro outlooks for the second-largest economy.

Against this backdrop, the global growth outlook appears more robust now than it did just a few weeks ago, allowing markets to start 2023 on a strong footing. Below we provide our current macro and investment views in a nutshell.

### Key messages in brief

| | | | |
|---|---|---|---|
| 1 | Asynchronous macro policy and cycles | Inflation and growth are falling in the West, while China rebounds and Japan faces delayed stagflation phase | Regional allocations on watch, esp. Emerging Asia |
| 2 | Relative changes will move markets | As West nears peak tightening and China turns pro-growth, risk assets can move strongly on marginal economic and political news | Active management of equity and currency risk, steady course in liquid alternatives |
| 3 | Good time to be a lender | Higher rates and low asset valuations make credit more attractive than equity on risk-adjusted basis | Gradual deployment to private debt, flexibility in public credit markets |
| 4 | US assets overvalued | While the US country premium won't fade easily due to economic and geopolitical advantages, valuations increasingly favor other markets and regions | Active weights of USD vs. other currencies on watch |
| 5 | Defensive, disciplined flexibility | Macro regime requires tactical flexibility in liquid markets and steady commitment to private markets | High cash reserves, steady commitment to private markets |

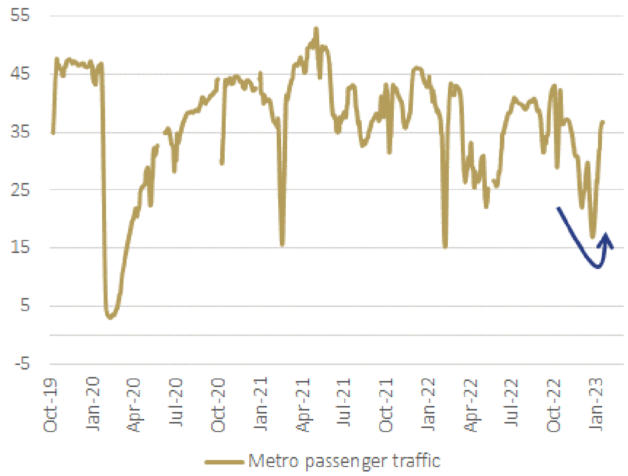
Source: LGT Capital Partners

## Policy divergences shift relative dynamics in favor of Asia

China's rapid reopening has taken everyone by surprise, including, unfortunately, the wider population. While the resulting nationwide health care crisis instantly depressed socioeconomic activity in many areas, for the wider economy this should be good news in the medium term. The urban mobility data suggests that in big cities such as Shanghai and Beijing, a recovery is already under way (graph 1). That said, some caution is due with a view to the Lunar New Year holidays later this month, which could cause further outbreaks and underwhelming economic data in the months ahead. There are also broader structural headwinds in place that to some extent limit the growth potential of the second-largest economy in the longer term.

Graph 1

**Chinese metro passenger traffic in major cities**
(7-day moving average of daily passenger count)




Sum of daily metro passager count in Chongqing, Shanghai, Beijing, Chengdu, Guangzhou, Shehzen, Suzhou, Zhengzhou and Xi'an, in million.
Source: Bloomberg, Weibo, LGT Capital Partners

Nevertheless, investors and analysts alike are looking ahead to a brighter cyclial outlook for China this year, which should have an overall net positive impact on global growth as well. The emerging Asian economies, which have the fewest reservations vis-à-vis engaging economically with China, stand to benefit most from this reopening. The fact that the Thai Prime Minister personally welcomed the first incoming Chinese tourists with flowers at the airport in Bangkok earlier this month, when many developed economies rushed to restrict entry, illustrates this point.

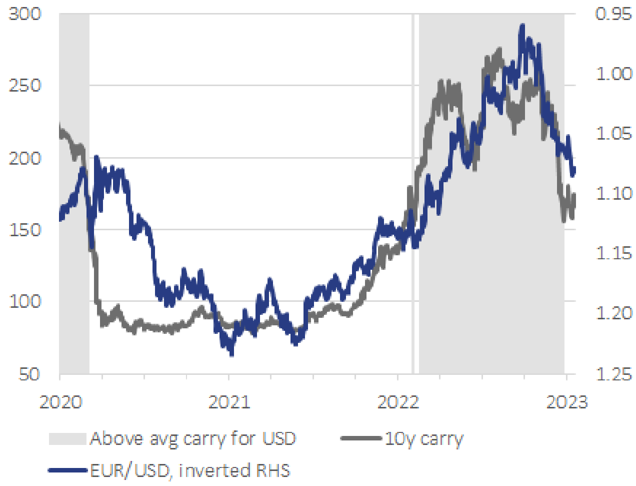
Elsewhere in Asia, the Bank of Japan (BoJ) has surprised markets in late December by setting a new policy rule that allows the government's 10-year bond yield to rise from 0.25% to about 0.5%. The decision can be understood as a first step toward policy normalization. After all, global interest rates have risen significantly over the past two years, and the BoJ is inching closer to achieving its goal of a sustainable annual inflation rate at around 2%. This month, several of the country's big companies have announced general wage increases of 5% or more – i.e., well-above both the current and expected inflation rates.

Such wage increases, if they spread, would help make domestic inflation more entrenched and hence encourage the BoJ to pivot towards a continuous tightening. In other words, Japan could soon enter the stagflationary phase that the US and Europe experienced last year, albeit on a more moderate level. Nevertheless, the mere prospect of such a policy shift triggered a rally in the Japanese yen, which has reclaimed part of last year's steep losses against the US dollar.

The broader story is that economic cycles and monetary polices have started to diverge more strongly at the margin. As the US is expected to stop raising policy rates later this year, Europe and Japan are behind the curve in that sense. These differences have led to sharp reversals in the carry rates – or the differentials between the interest rates of various currencies. And the US bond carry has plummeted both against the yen as well as the euro since late last year. That said, we give more credence to the ECB's commitment to keep tightening. Ultimately, Japan is facing more muted inflationary challenges, and hence the USD carry will remain far larger over the yen than over the euro.

Graph 2

**US yield advantage and US dollar direction**
(Difference in 10-year government bond yields in basis points)




Source: Bloomberg, LGT Capital Partners

## Investments: increase exposure to Asian equity and the euro

We have raised our allocation to emerging Asian equities to neutral, after being underweight the segment relative to the developed markets for more than 18 months. This change is mainly due to the improved growth outlook for the region following China's decision to quickly end its pandemic-related self-isolation.

As a result, our tactical positioning in equities is now tilted in favor of Asia in both the developed and emerging markets, albeit in a defensive context. Overall, equities remain slightly underweight – as are bonds and credit versus cash. This defensive tilt is based on our view that the global economy is set to slow, with financial and monetary conditions remaining tight or tightening further even after the US Federal Reserve stops raising interest rates. Furhermore, central banks will be less inclined to support growth in order to avoid rekindling inflation.

As a consequence, hidden trip wires are likely to remain in place in the markets for overly bullish investors.

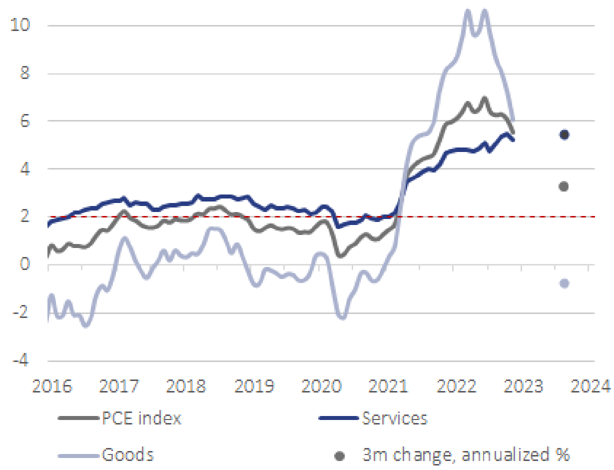
In currencies, we have closed our long US dollar position against the euro, motivated by the outlook for peak US policy rates and the related direction of the interest rate differentials. In addition, momentum traders appear to be in the process of changing direction when it comes to their US dollar positioning, possibly fueling a more sustained euro rally.

## Inflation: prices for goods will deflate, but remain sticky in services

Headline inflation rates in the US and probably also in Europe are likely to decline quite steeply over the course of 2023. However, they are unlikely to fall to the targeted 2% due to the increasingly entrenched price pressures in the services sectors, which make up more than three-quarters of a typical developed economy and about 60% of most inflation indices. Furthermore, the risk of a revival of broader and stickier inflation pressures will continue to exist, depending on how central banks react to this coming disinflation.

Put simply, while goods sectors are facing outright deflation this year, the much heavier-weighted services segment prices will continue to rise, keeping the overall inflation rate well above target, albeit significantly below the current level – that is what current trends are suggesting. The three-month annualized rate of change for each of the price indices can serve as an approximation of where inflation is headed this year (graph 3).

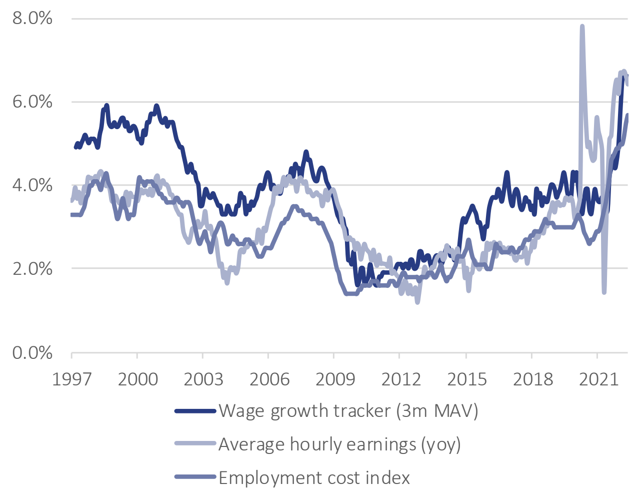
**Graph 3**
**US inflation: goods versus services**
Year-on-year change in %




PCE = Personal consumption expenditures price index series.
Source: Bloomberg, LGT Capital Partners

For investors, the key question is whether disinflation will occur with a deep recession, i.e., a hard landing. While a soft landing, i.e., the avoidance of a deep recession, is possible, current data trends make it questionable. Wages and employment costs continue to rise, supporting the underlying – and stickier – foundation of inflation (graph 4).

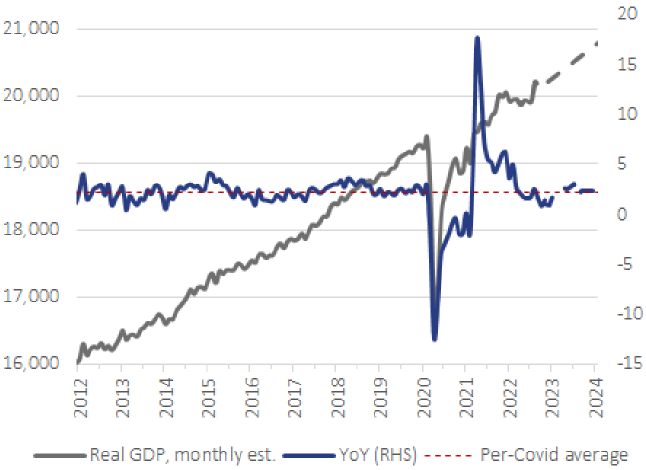
**Graph 4**
**Wages and employment costs keep rising**
Year-on-year change in %




Source: Refinitiv, LGT Capital Partners

Moreover, based on the last six months of data, the current trajectory for the US real economic output remains relatively robust, i.e., around its potential rate (graph 5). If these trends persist, the Fed will feel encouraged to tighten further even as plummeting goods prices bring down headline inflation. In turn, that would disappoint investors, who presently expect a monetary policy easing to begin in about a year. While a continued Fed effort to exorcise inflation would of course be good for the economy and financial assets in the longer term, it would hurt corporate earnings and further weigh on market valuations in the shorter term.

**Graph 5**
**US real economic growth, monthly estimate**
In billion USD, year-on-year change in %




GDP = gross domestic product.
Source: Bloomberg, LGT Capital Partners

For these reasons, the inflationary disruption of the economy and the financial markets is not yet over in our view. The policy-based efforts to end this disruption will continue to require investors' attention in terms of their investment strategies and asset allocation choices this year.

# Economic outlook for China

The two main issues regarding China in 2022 were the local property sector downturn and the Zero-COVID policy. Towards the year-end, the government announced measures to address these.

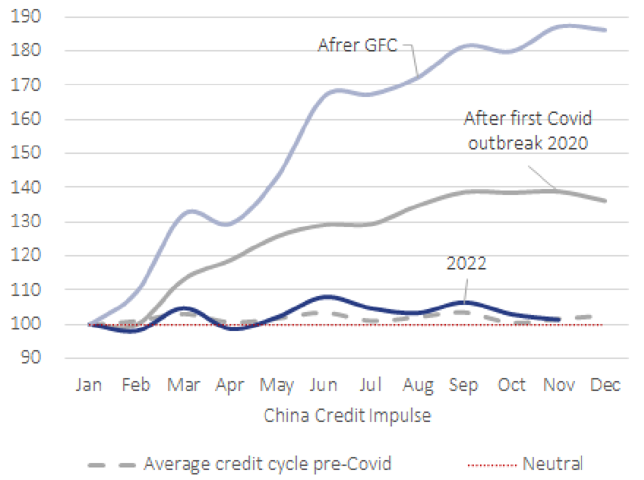
Firstly, Zero-COVID was largely dismantled, ending the various containment measures, and hence bringing forward the rebound in pent-up demand. However, some obstacles remain in the short term. Externally, while China decided to fully reopen its borders this month, many countries have swiftly imposed health-related protocols on entries from China, in turn prompting China to take countermeasures. Domestically, the resulting rapid spread of the illness has challenged health care providers and disrupted economic activity. The upcoming Chinese New Year holidays may further spread the disease inland, before the health crisis peaks out.

Secondly, Beijing has announced various support measures for property developers that will prevent major housing project defaults for the time being. However, the high level of leverage in the system and the weakening demand for real estate remain a headwind, while the stimulus provided thus far is still historically modest (graph 6).

Graph 6

**China's credit impulse cycles by comparison**

Rebased to 100 at the start of each year




Source: Bloomberg, LGT Capital Partners

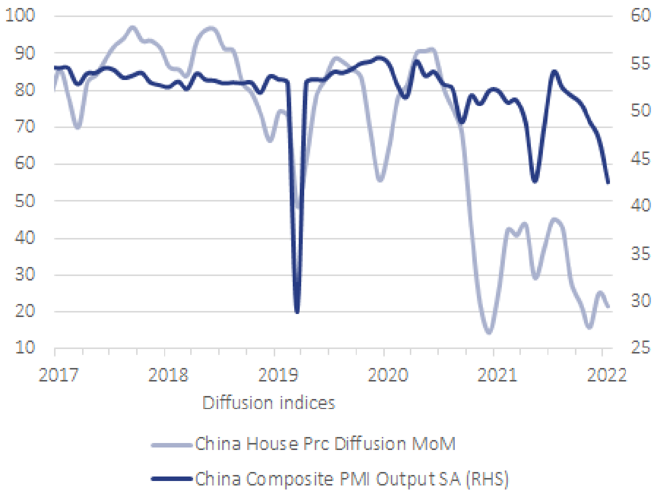
Furthermore, as China did not provide as much support to its households as the developed economies during the pandemic, the coming rebound might prove rather muted by comparison. We thus expect more policy support as well as industry consolidation to occur during the year. Real estate investment activity will consequently likely remain subdued initially in 2023, before picking up later in the year. Although the worst is over, current surveys on the outlook for housing and industrial activity support our cautious stance on China's economic and its financial assets (graph 7).

That said, a cyclical recovery will unfold once the COVID wave begins to peter out, which would also support the global economy by adding demand for goods and services and reducing supply chain pressures and hence goods prices.

Graph 7

**Housing and purchasing managers' surveys**

(Readings below 50 indicate a deteriorating outlook)




Source: Bloomberg, LGT Capital Partners

Concluding, regarding the other issues of concern – i.e., the reordering of the country's private sector, and geopolitics, there are some indications that the worst is over there too. Authorities have recently granted a long-withheld approval of a capital increase to a major tech company and approve new mobile games, which could imply that the regulatory crackdown is over. Also, the G20 summit in November showed that the US and China are now more willing to reengage diplomatically.

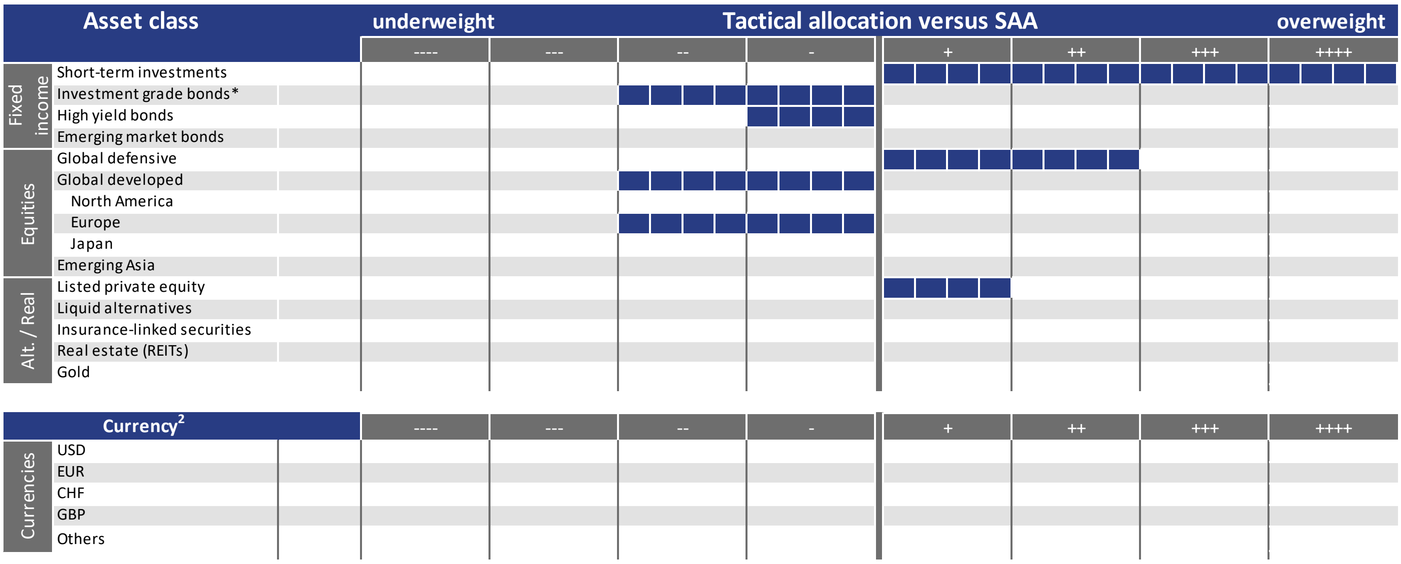
While this détente is probably tactical in nature, investors are still likely to welcome any signs of a thaw, given that Chinese financial markets have already priced in many of the risks by underperforming their international counterparts markedly over the past two years.

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: slightly underweight overall, tilted in favor of defensive strategies and the US and Asia over Europe**
- **Fixed income: underweight, tilted in favor of emerging markets and high yield credit**
- **Alternatives: small overweight, resulting from position in Listed Private Equity**
- **Currencies and cash: neutral in currencies exposures and significant cash reserves (4%)**




Reference portfolio: LGT GIM Balanced (USD). The positioning shown above is valid for all similar portfolios in general. 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 | 0.1% | 3.2% | 2.1% | -2.5% | 0.6% |
| Global inflation linked bonds | USD | 1.2% | 10.2% | 3.0% | -3.0% | -1.1% |
| Investment grade corporate bonds | USD | 0.9% | 5.4% | 2.0% | -0.7% | 1.7% |
| High yield bonds | USD | 3.0% | 10.1% | 3.8% | -0.7% | 1.4% |
| Emerging markets, local currency | USD | 4.9% | 13.5% | 3.8% | -4.9% | -2.3% |
| Emerging markets, hard currency | USD | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| **Equities** | | | | | | |
| Global | USD | 4.2% | 9.8% | 4.6% | 6.3% | 7.1% |
| Global defensive | USD | 2.6% | 11.3% | 2.1% | 1.8% | 5.1% |
| North America | USD | 4.0% | 7.7% | 4.3% | 7.2% | 8.5% |
| Europe | EUR | 8.0% | 15.9% | 7.5% | 4.9% | 5.0% |
| Japan | JPY | -2.4% | 0.4% | 1.0% | 5.6% | 2.9% |
| Emerging markets | USD | 7.5% | 17.4% | 7.5% | -1.3% | -1.1% |
| **Alternative and real assets** | | | | | | |
| Listed private equity | USD | 10.7% | 18.5% | 10.1% | 7.2% | 8.3% |
| Hedge funds | USD | 0.0% | 2.0% | -1.5% | 4.3% | 3.3% |
| Insurance linked securities (ILS) | USD | 0.9% | 6.6% | 0.2% | 2.7% | 3.0% |
| Real estate investment trusts (REITs) | USD | 6.7% | 14.1% | 7.1% | 0.0% | 5.0% |
| Gold | USD | 6.7% | 15.4% | 4.5% | 6.8% | 7.4% |
| **Currencies (vs. rest of G10) [2]** | | | | | | |
| US dollar | USD | -1.9% | -8.1% | -1.0% | 1.5% | 2.7% |
| Euro | EUR | 0.2% | 1.6% | -0.1% | 0.4% | -0.1% |
| Swiss franc | CHF | -0.6% | -0.1% | -0.7% | 3.3% | 3.6% |
| British pound | GBP | -0.8% | 0.6% | 0.7% | -0.6% | 0.0% |
| Japanese yen | JPY | 4.7% | 8.3% | 1.0% | -4.9% | -1.0% |
| Canadian dollar | CAD | 0.6% | -5.5% | 0.3% | 0.6% | 1.0% |
| Norwegian krone | NOK | -1.4% | -0.9% | -1.6% | -2.2% | -2.4% |

[1] Annualized return [2] Bloomberg correlation-weighted currency indices. Source: Bloomberg

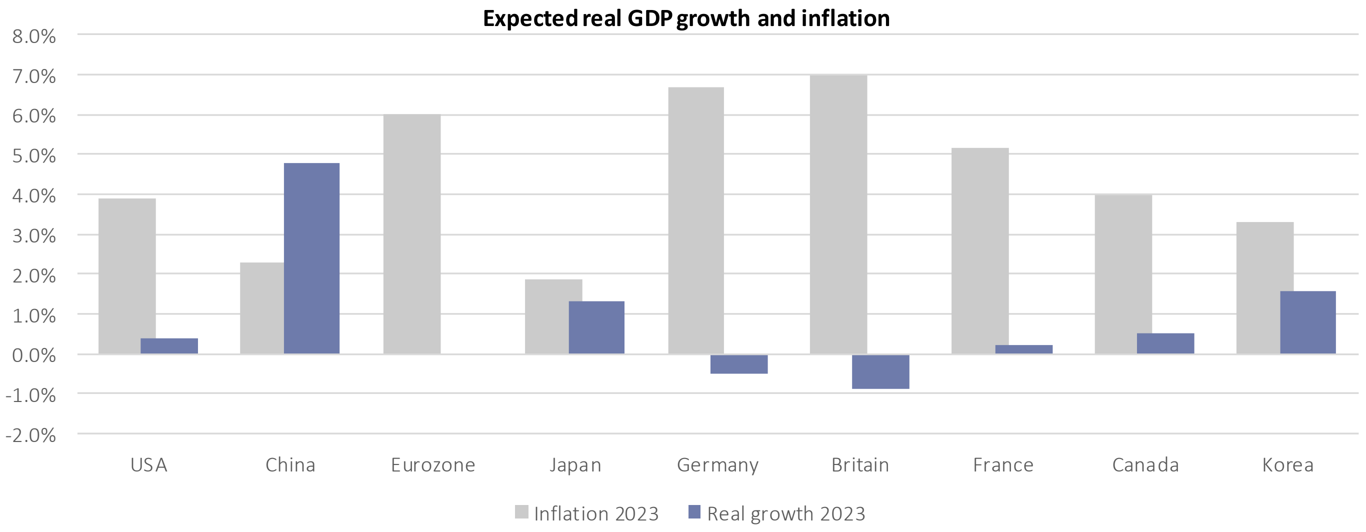
# Economic and corporate fundamentals

| | | USA | China | Eurozone | Japan | Germany | Britain | France | Canada | Korea |
|---|---|---|---|---|---|---|---|---|---|---|
| **Gross domestic product (GDP)** | | | | | | | | | | |
| Nominal, this year[1] | bn USD | 26,185 | 21,643 | 14,224 | 4,366 | 4,120 | 3,479 | 2,807 | 2,327 | 1,792 |
| Per Capita, purchasing power parity[1] | USD, PPP | 78,422 | 23,038 | 40,965 | 51,594 | 65,865 | 57,822 | 58,421 | 59,872 | 56,694 |
| Real growth 2023 | Consensus | 0.4% | 4.8% | 0.0% | 1.3% | -0.5% | -0.9% | 0.2% | 0.5% | 1.6% |
| Real growth 2024 | Consensus | 1.3% | 5.0% | 1.4% | 1.0% | 1.3% | 0.9% | 1.2% | 1.5% | 2.3% |
| Real growth current quarter | Consensus | 0.9% | 5.1% | 0.4% | 1.0% | 0.1% | -0.9% | 0.5% | 1.0% | 2.3% |
| Unemployment 2023 | Consensus | 4.8% | 4.0% | 7.0% | 2.4% | 5.4% | 4.7% | 7.7% | 6.4% | 3.5% |
| Inflation 2023 | Consensus | 3.9% | 2.3% | 6.0% | 1.9% | 6.7% | 7.0% | 5.2% | 4.0% | 3.3% |
| Inflation 2024 | Consensus | 2.5% | 2.2% | 2.3% | 1.1% | 2.9% | 2.5% | 2.4% | 2.2% | 1.9% |
| Purchasing manager index[2] | Neutral=50 | | | | | | | | | |
| | | | | | | | | | | |
| Structural budget balance/GDP | IMF | -5.3% | -6.5% | -2.9% | -3.2% | -1.8% | -1.7% | -4.8% | -1.2% | 0.3% |
| Gross government debt/GDP | IMF | 122.9% | 84.1% | 91.3% | 261.1% | 68.3% | 79.9% | 112.5% | 98.7% | 54.4% |
| Current account balance/GDP | IMF | -3.1% | 1.3% | 1.4% | 2.2% | 5.3% | -4.5% | -1.5% | -0.2% | 3.5% |
| International currency reserves | bn USD | 36 | 3,128 | 547 | 1,104 | 37 | 110 | 51 | 80 | 392 |
| | | | | | | | | | | |
| Govt bond yield 2yr [3] | % p.a. | 4.2% | 2.3% | 2.5% | 0.0% | 2.5% | 3.5% | 2.5% | 3.6% | 3.4% |
| Govt bond yield 10yr [3] | % p.a. | 3.5% | 2.9% | 2.1% | 0.4% | 2.1% | 3.3% | 2.5% | 2.9% | 3.4% |
| Main policy interest rate [4] | % p.a. | 4.5% | 4.4% | 2.5% | -0.1% | 2.5% | 3.5% | 2.5% | 2.5% | 3.5% |
| Spread 10y-2y treasury yield | Basis points | -70.0 | 57.6 | -36.6 | 37.6 | -37.5 | -13.8 | 2.5 | -69.9 | -2.3 |

[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 | 42,978 | 16,403 | 8,950 | 5,593 | 2,355 | 3,112 | 3,152 | 2,879 | 1,729 |
| Growth in earnings per share, estimated (MSCI) | | | | | | | | | | |
| 12 months forward / trailing 12 montl | Consensus | 11.9% | 3.3% | 23.0% | 12.8% | 14.8% | 30.0% | 40.2% | -0.8% | -23.8% |
| Next fy / 12m fwd | Consensus | 8.2% | 12.0% | 7.8% | 1.1% | 10.0% | 5.8% | 1.0% | 3.7% | 34.0% |
| Growth in revenue per share, estimated (MSCI) | | | | | | | | | | |
| 12m fwd / trail 12m | Consensus | 3.4% | 11.4% | 2.7% | 6.1% | 5.1% | 5.8% | 14.2% | 5.0% | -1.3% |
| Next fy / 12m fwd | Consensus | 3.6% | 8.7% | 2.3% | 0.3% | 3.1% | 1.6% | -0.3% | 1.8% | 6.4% |
| Valuations (MSCI) | | | | | | | | | | |
| Price-Earnings Ratio (est 12m fwd) | Consensus | 17.7 | 11.5 | 12.5 | 12.1 | 11.5 | 13.0 | 10.3 | 12.7 | 12.7 |
| Price-Sales Ratio (est 12m fwd) | Consensus | 2.3 | 1.0 | 1.1 | 0.8 | 0.8 | 1.2 | 1.2 | 1.8 | 0.7 |
| Dividend yield | Consensus | 1.7 | 2.3 | 3.4 | 2.7 | 3.5 | 3.1 | 4.2 | 3.2 | 2.6 |

* China market cap includes Hong Kong | Source: Bloomberg Data per: 18.01.2023



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