Investment perspectives Q1/2023

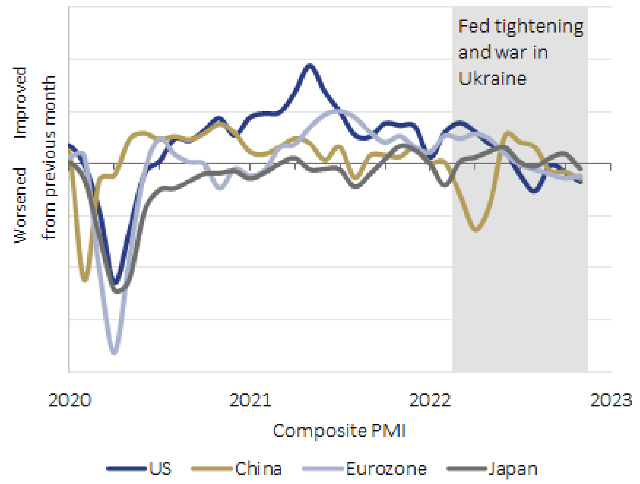
Marketing material

The year's final quarter has proved mostly risk-friendly, buoyed by signs of peaking US inflation and hence of a prospective slowing of the pace of interest rate hikes. Moreover, Chinese equities participated in the global rebound this time, as Beijing began to signal a more growth-friendly policy stance. Still, we believe markets will continue to face challenging realities going into next year and have revised our positioning accordingly.

Macro review: mixed signals

The world economy is sending mixed signals about its current state and future path. Forward-looking surveys and other leading indicators, such as the various purchasing managers' indices, point to steadily decelerating growth that could well lead the global economy into an outright recession next year (graph 1). Macro outlook publications from the public sector, the financial industry as well as academia also see an increased risk of a recession next year.

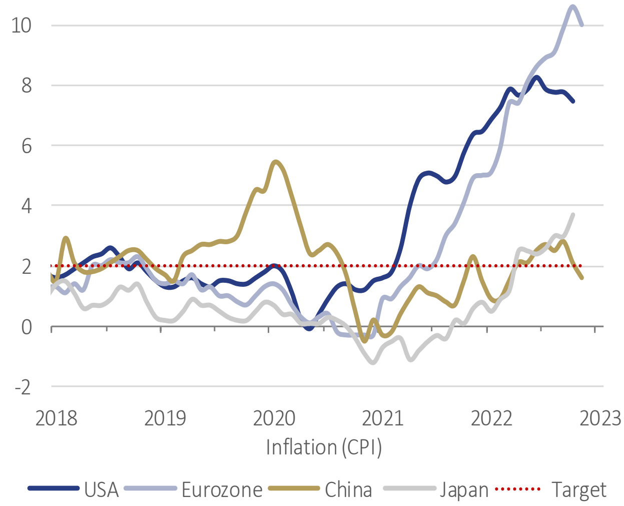
Graph 1
Business outlook surveys point to a looming recession
Composite purchasing managers' indices



Source: Bloomberg, S&P Global, LGT Capital Partners

At the same time, hard data around consumption and employment is still robust in most major economies. For instance, the US economy created 4.5 million of new non-farm jobs over the past year – or about 1.2 million more than the consensus had anticipated. By contrast, during the strong post-COVID-19 recovery of 2021, the consensus had not underestimated the economy by that much. Europe and Japan have thus far avoided an outright energy crisis despite being net fossil fuel importers, unlike the US, Canada, Norway, or Australia. Europe's and Japan's industries at least partially benefited from the weaker home currencies against the US dollar, mitigating the negative impact of the sanctions against Russia and Belarus as well as the burden of inflation on their consumers' purses. Overall, most big economies have weathered the COVID-19 shock and its aftermath rather well – at the potentially critical cost of stoking elevated inflation. That said, inflation pressures are easing somewhat of late (graph 2).

Graph 2
Inflation has tentatively peaked in some big economies
Consumer prices indices, change year-on-year in %



Source: Bloomberg, LGT Capital Partners

Still, with a sustainable decline being far from certain, central bankers are likely to stay on edge and keep tighter monetary policy in play for longer. Furthermore, geopolitics remain tense as well, even though the final quarter of this year brought some signs of a diplomatic détente between China and the US, and the West more broadly. Over time, this relaxation is likely to prove tactical in nature, rather than strategic.

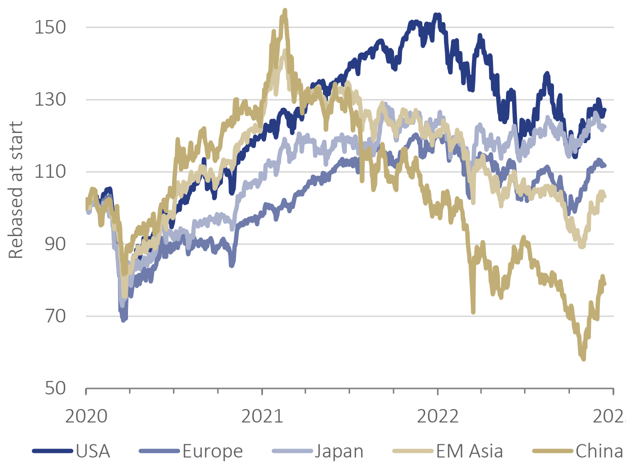
Outlook: central banks are likely to stay hawkish

The year's final quarter has proved risk-friendly, buoyed by signs of peaking US inflation and hence of a prospective slowing of the pace of interest rate hikes. Indeed, real interest rates dropped in most Western countries over the past month, providing a tentative, marginal easing of actual financial conditions. Moreover, unlike during previous relief rallies, Chinese equities participated in the global rebound this time. Beijing relaxed some aspects of its zero-COVID policy and ordered banks to refinance the broader property sector for another year. These measures raised hopes of a sustainable cyclical recovery in China, while eliminating the risk of a systemic sector bankruptcy in the near term. Therefore, most asset classes rallied, including equities (graph3).

Graph 3

Equity markets rebounded in recent months

MSCI net return indices



Hedged for all developed markets, in USD for emerging Asia. Source: Bloomberg, LGT Capital Partners

The exceptions were oil and coal as policy makers appeared keen to ensure that efforts to limit Russian oil revenues do not squeeze global energy supplies and contribute to further economic problems.

Regardless, when all is said and done, inflation remains sticky and policymakers are determined to err on the side of caution – which means they will only shift course once inflation is firmly under control, even if that comes at the price of engineering a recession.

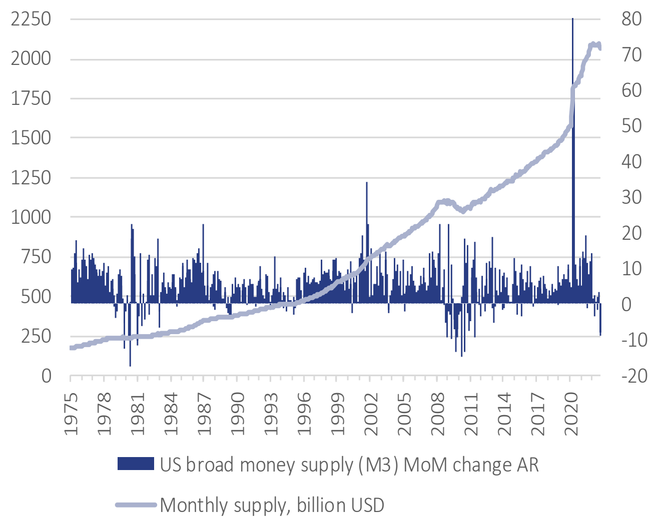
Inflation is ultimately the result of excess demand for goods and services relative to their near-term supply. Consequently, it cannot vanish quickly unless macro policy is used to suppress demand commensurately. The most direct way to do this is to tighten monetary policy and hence reduce money supply, which is what is happening at present.

In fact, liquidity withdrawal is now the most intense since the Great Financial Crisis (when the resulting financial losses weren't replenished quickly enough by new money) and before the stagflationary 1970s – i.e., the last time the central bank moved aggressively to suppress demand in the economy and eradicate unwanted inflation (graph 4).

Graph 4

US broad money supply has dropped markedly

Annualized month-on-month change in %



Source: Bloomberg, Center for Financial Stability, LGT Capital Partners

Given the unprecended expansion in money in the immediate aftermath of the initial pandemic shock, this liquidity withdrawal might have to continue for longer if it is to have a sufficient impact on broader demand. The other option, i.e., to aim to gradually reduce inflation by allowing supply to increase to meet the new, higher level of demand, presupposes a less tense, business-oriented geopolitical environment and comes with the risk of allowing higher inflation expectations to become entrenched.

Thus, these past quarters' market moves to price in a soft landing, i.e., the avoidance of a harsh recession, might yet prove too optimistic, or at least premature. Geopolitical tensions are also far from fully fading into the background. In this choppy market environment, an anti-cyclical approach remains the most appropriate tactical stance for investors, in our view. Hence, we have decided to adjust the risk allocation in our strategy accordingly.

Positioning: trim and fine-tune risk exposure and build up downside mitigation

Given the risk of further tightening and hence a looming global recession, we take advantage of the recent relief rallies to take profits on various portfolio positions, notably in developed market equities and to a lesser extent in emerging Asia (where we were already underweight). We also reduce duration risk as investment grade bonds have also performed well of late. As result, our overall underweight in equities is thus more pronounced, bonds are now underweighted again, and our cash position is markedly overweight.

In terms of fundamental view shifts, we downgraded Japanese equities to neutral from overweight. Japan was one of the resilient markets over the past year when measured in local currency, owing largely to an exceptionally weak Japanese yen during that period. However, this trend has seen a partial reversal, while pressures are mounting on the Bank of Japan to shift to a less loose monetary policy stance. The domestic cyclical outlook for Japan is thus less favorable than it was before.

Government bond yields have also partially reversed their steep climb this past quarter, and we have decided to set investment grade bonds to a tactical underweight again. We think bonds and equities will remain positively correlated in the face of a persisting stagflationary environment of slowing growth and elevated inflation.

At the same time, we also implement a strategic shift from public equities to high yield bonds on the back of the adjusted asset pricing and changed long-term relative attractiveness of credit over equity beta. From a longer-term viewpoint, the macro environment has shifted in favor of this debt class, where valuations have adjusted more in line with fundamentals. Equities, by contrast, are still not priced for either a deep recession, or a continued tightening.

In a further strategic move, we also increased liquid alternatives, namely systematic strategies – this is in line with choppy markets ahead, be it from a tactical or strategic time horizon. We also sold the small existing tactical position in gold. The precious metal has thus far worked as a geopolitical risk hedge but failed to protect investors from the spike in inflation, with rising real interest rates being the dominant adverse factor.

In currencies, we maintain the long US dollar/short euro because we qualify recent moves as a temporary retracement in a largely intact strong US dollar trend. Similarly, despite the prospect of a hawkish tweak in Japan's monetary policy, we refrain from taking a long position on the yen, preferring to account for that risk by trimming Japanese equities.

Finally, we note that this tactical review coincided with the conclusion of our strategic asset allocation (SAA) revision for the coming five to years. The new strategic allocation (i.e., neutral) quotas have thus been integrated in the model portfolios for referencing purposes. In essence, the new SAA leads to a shift from public equities to high yield bonds and liquid alternatives (systematic strategies). The details of the SAA review are communicated separately.

Private markets: unchanged conviction, with increased focus on debt

Investments in private markets are not determined by cyclical macro developments in principle. Still, 2022 has been a challenging year, which will be reflected to some degree in the returns of this asset class in 2023. Nevertheless, it is important to note that a challenging macro setting also tends to broaden the opportunity set in this segment.

Firstly, the strategic outlook for private markets has not deteriorated from a fundamental viewpoint – on the contrary, it has improved somewhat relative to public equities as it offers access to specialized market areas and skills that are less dependent on cyclical or short-term macro factors.

Graph 5

Recent investments in the private markets space

Selection of recent manager additions, as of 30 November 2022

November	**EMK, London** **Private equity - Small/middle market boyout** Founded in 2002, the firm specializes on control investments in mid-sized technology-enabled services and enterprise software companies in the United States.
November	**Park Square, London** **Private debt - Senior direct lending** This is a co-investment alongside Park Square in a leading European developer and producer of ingredient solutions, serving over 18,000 customers.
November	**Symphony Technology Group, Menlo Park** **Private equity - Small/middle market buyout** Founded in 2002, the firm specializes on control investments in mid-sized technology-enabled services and enterprise software companies in the United States.
October	**Bain Capital Credit, Boston** **Private debt - Special situations** Founded in 1998, the firm invests across various credit strategies, ranging from leveraged loans to distressed debt and private lending.
October	**FSN Capital Oslo** **Private debt - Senior direct lending** This is a co-investment alongside FSN Capital in a B2B distributor in the Nordics, operating across 16 countries throughout 100 locations, with a one-stop-shop solution model.

Source: LGT Capital Partners

Primary investments are made over time by design, helping to smooth out typical cyclical gyrations. Moreover, for well-prepared investors, times of tight credit conditions tend to reveal attractive entry opportunities in the secondary market, as some investors come under pressure to sell some of their assets, often at discounted prices against latest valuations in the books.

Secondly, and in line with our overall macro views, the attractiveness of private debt has also improved in broader terms as well, i.e., relative to most other asset classes, rather than just public equities.

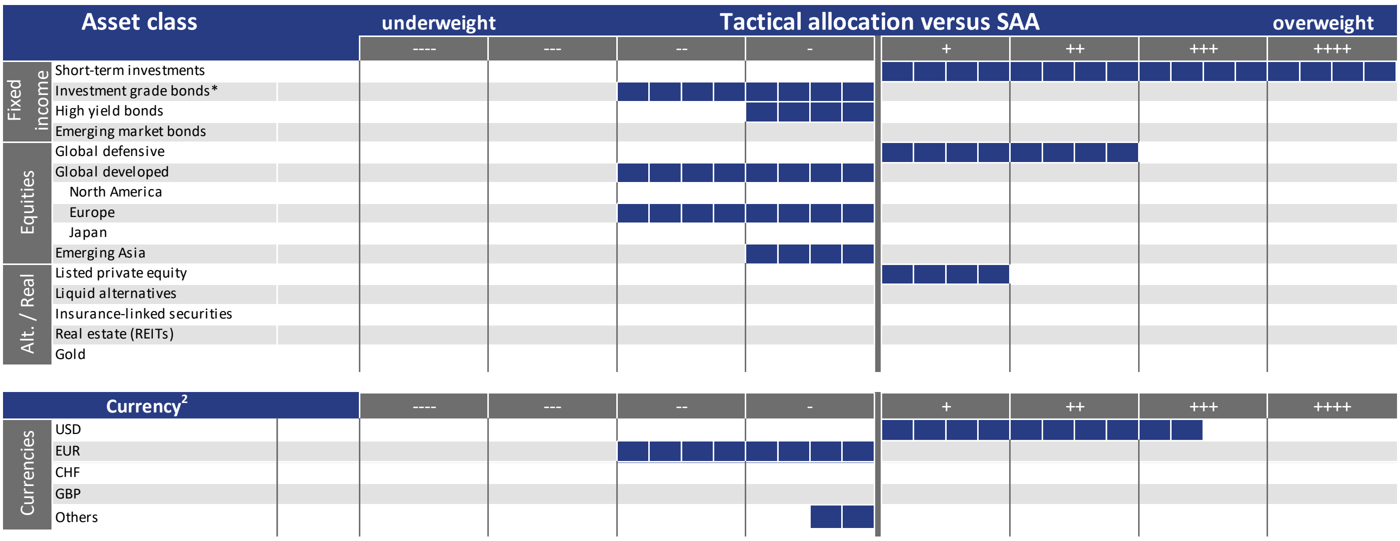
Hence, we have been shifting weight from the equity to the debt side in private markets as well of late. Among the manager additions of the past quarter (graph 5), we thus find three specialized private debt managers, along with two equity managers that focus on small and middle market buyouts, an area where we certainly see a widening opportunity set in the current environment.

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: clearly underweight, tilted in favor of global defensive and to a lesser extent US and Japan**
- **Fixed income: underweight, titled in favor of emerging markets and high yield**
- **Alternatives: small overweight, resulting from position in Listed Private Equity**
- **Currencies: long position in the USD against the EUR and passive underweights in EM currencies**
- **Significantly increased cash position (5%)**



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	1.7%	-0.1%	-10.1%	-2.3%	0.5%
Global inflation linked bonds	USD	1.8%	1.5%	-21.1%	-3.0%	-0.9%
Investment grade corporate bonds	USD	1.9%	0.7%	-9.0%	-1.0%	1.2%
High yield bonds	USD	3.6%	2.4%	-12.5%	-1.2%	1.1%
Emerging markets, local currency	USD	2.0%	0.6%	-13.2%	-6.0%	-2.3%
Emerging markets, hard currency	USD	0.0%	0.0%	0.0%	0.0%	0.0%
Equities						
Global	USD	0.1%	1.8%	-13.2%	7.5%	7.7%
Global defensive	USD	2.9%	4.3%	-8.2%	3.0%	5.4%
North America	USD	-0.3%	1.2%	-16.4%	8.9%	9.5%
Europe	EUR	1.1%	4.4%	-6.8%	4.2%	4.3%
Japan	JPY	-1.4%	-0.7%	-0.7%	6.6%	4.3%
Emerging markets	USD	3.2%	-1.3%	-19.6%	-1.6%	-0.6%
Alternative and real assets						
Listed private equity	USD	-6.4%	0.6%	-28.9%	6.8%	8.3%
Hedge funds	USD	1.0%	-0.2%	-2.4%	4.6%	3.3%
Insurance linked securities (ILS)	USD	0.2%	-5.3%	-3.8%	2.3%	2.9%
Real estate investment trusts (REITs)	USD	-0.2%	-6.3%	-23.7%	0.5%	3.3%
Gold	USD	0.8%	4.9%	-2.4%	6.5%	7.3%
Currencies (vs. rest of G10) [2]						
US dollar	USD	-1.1%	-3.1%	9.4%	2.1%	2.3%
Euro	EUR	1.0%	3.2%	0.6%	0.1%	-0.3%
Swiss franc	CHF	-0.4%	-0.1%	6.5%	4.0%	3.5%
British pound	GBP	3.0%	4.3%	-1.8%	-1.0%	0.3%
Japanese yen	JPY	-0.2%	2.4%	-10.3%	-6.3%	-2.2%
Canadian dollar	CAD	-3.9%	-6.7%	0.7%	0.8%	0.9%
Norwegian krone	NOK	-1.6%	-1.5%	-4.5%	-1.6%	-1.7%

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

Economic and corporate fundamentals

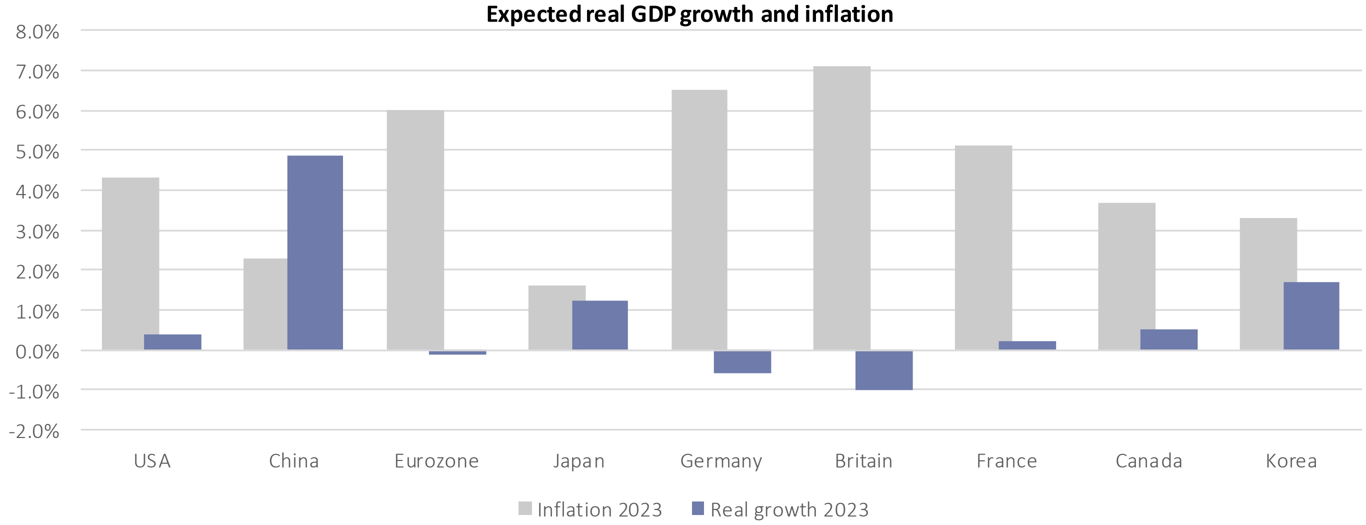
		USA	China	Eurozone	Japan	Germany	Britain	France	Canada	Korea
Gross domestic product (GDP)										
Nominal, this year[1]	bn USD	26,185	21,643	14,224	4,366	4,120	3,479	2,807	2,327	1,792
Per Capita, purchasing power parity[1]	USD, PPP	78,422	23,038	40,965	51,594	65,865	57,822	58,421	59,872	56,694
Real growth 2023	Consensus	0.4%	4.9%	-0.1%	1.3%	-0.6%	-1.0%	0.2%	0.5%	1.7%
Real growth 2024	Consensus	1.4%	4.8%	1.4%	1.1%	1.3%	0.9%	1.1%	1.6%	2.3%
Real growth current quarter	Consensus	1.0%	4.4%	0.3%	1.2%	0.2%	-0.8%	0.7%	1.2%	2.3%
Unemployment 2023	Consensus	4.7%	4.0%	7.1%	2.4%	5.5%	4.7%	7.6%	6.2%	3.4%
Inflation 2023	Consensus	4.3%	2.3%	6.0%	1.6%	6.5%	7.1%	5.1%	3.7%	3.3%
Inflation 2024	Consensus	2.6%	2.2%	2.2%	1.0%	2.6%	2.5%	2.2%	2.1%	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	33	3,117	535	1,105	37	108	51	79	391
Govt bond yield 2yr[3]	% p.a.	4.4%	2.4%	2.2%	0.0%	2.2%	3.5%	2.2%	3.9%	3.8%
Govt bond yield 10yr[3]	% p.a.	3.6%	2.9%	1.9%	0.3%	1.9%	3.2%	2.4%	2.9%	3.4%
Main policy interest rate[4]	% p.a.	4.0%	4.4%	2.0%	-0.1%	2.0%	3.0%	2.0%	2.5%	3.3%
Spread 10y-2y treasury yield	Basis points	-77.1	51.4	-25.8	26.8	-26.7	-26.4	23.4	-96.2	-36.7

[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	42,102	15,542	8,267	5,383	2,142	2,972	2,917	2,717	1,633
Growth in earnings per share, estimated (MSCI)										
12 months forward / trailing 12 montl	Consensus	12.2%	3.5%	23.6%	13.6%	14.5%	31.4%	39.4%	1.0%	-15.5%
Next fy / 12m fwd	Consensus	2.1%	1.0%	0.4%	0.5%	1.0%	0.0%	0.2%	1.7%	-0.8%
Growth in revenue per share, estimated (MSCI)										
12m fwd / trail 12m	Consensus	3.4%	6.7%	2.8%	5.7%	4.9%	6.5%	14.2%	6.0%	-0.1%
Next fy / 12m fwd	Consensus	0.9%	0.7%	0.2%	0.2%	0.4%	0.1%	0.3%	0.9%	0.1%
Valuations (MSCI)										
Price-Earnings Ratio (est 12m fwd)	Consensus	17.6	10.7	11.7	12.4	10.7	12.1	9.9	12.3	11.3
Price-Sales Ratio (est 12m fwd)	Consensus	2.3	0.9	1.0	0.9	0.8	1.2	1.2	1.7	0.7
Dividend yield	Consensus	1.6	2.4	3.5	2.6	3.8	3.2	4.1	3.3	2.5

* China market cap includes Hong Kong | Source: Bloomberg Data per: 13.12.2022

Expected real GDP growth and inflation



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