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LGT Beacon
Global macro and market review
March 2023

Marketing material

Investment perspectives March 2023

- **Equities and especially bond market volatility surges, as US and European bank woes revive macro uncertainty**
- **Somewhat forgotten safe-haven assets such as gold or the JPY temporarily benefit due to the bank sector turmoil**
- **Still, the underlying cyclical outlook has slightly improved, as services in the West remain robust and China reopens**
- **Authorities have swiftly responded to address acute lack of confidence in the banking sector and liquidity issues**
- **We view today's banking sector issues as *not* systemic and are sceptical about the prospect for near-term rate cuts**

Investment actions:

- **After selling equities during the last rally, we now add exposure again – this time in favor of European markets**
- **We reduce duration further by selling investment grade bonds, as inverted yield curves favor cash**
- **We continue to hold ample cash reserves that allow us to act opportunistically in volatile markets**

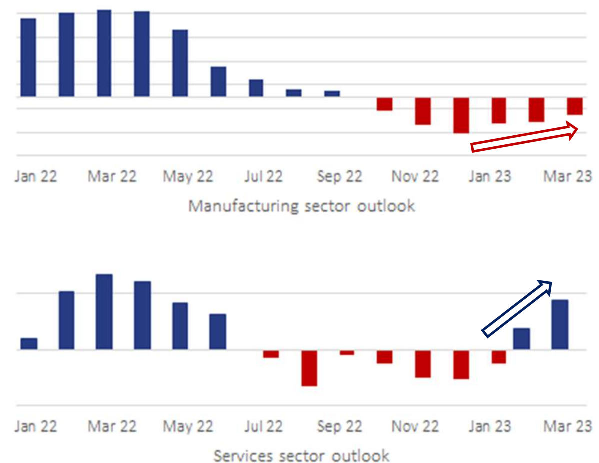
Late last week, our investment team concluded the quarterly tactical asset allocation review for the second quarter of 2023. In this report, we provide a brief summary of our views and positioning decisions resulting from that process.

Economic and (geo)political update: heterogenous, but better than before

The global economy continues to be highly heterogeneous – in parts booming or recovering (e.g., service sectors, China following its belated re-opening) and in other parts decelerating or even contracting (e.g., manufacturing, housing). All in all, the data still points toward the possibility that we are dealing with a slowdown rather than heading towards a protracted economic recession. At the margin, based on the business surveys around the globe, the cyclical growth outlook today is slightly less weak than it seemed three months ago. Shortly before the recent bank collapses, the services sectors in the major economies had returned to positive territory, while manufactuing appeared to have passed the low point as well (graph 1). The recovery in Chinese manufacturing is noteworthy as well (see purchasing manager data on page 6).

Inflation, although sticky in the services segment, continues to ease overall, which might pave the way for a pause in monetary tightening in due course. In that regard, the recent stress in pockets of the banking sector is likely acting as an additional tightening of credit conditions, as many financial institutions will now focus on their own funding and solvency whilst further restricting their lending to clients (graph 2, next page).

Graph 1
The cyclical outlook has improved this year
GDP-weighted index for the major developed economies*



*Major developed economies = USA, Eurozone, UK, Japan. The red columns indicate outlook is deterioriating, blue colums suggest outlook is improving. China isn't included because the relevant data for March is not available yet. The above indices are based on the S&P Global Markit purchasing managers' surveys. Source: Bloomberg, LGT Capital Partners

This at-the-margin negative growth impact notwithstanding, we are of the view that recent events are not a precursor to a wide-scale financial crisis like the banking collapse of 2008.

Graph 2

Broad based tightening of financial conditions

Banks will continue to further tighten the lending standards

The US C&I lending standards represent here the % of banks tightening lending standards for commercial and industrial loans to small firms. Source: Refinitiv, LGT Capital Partners

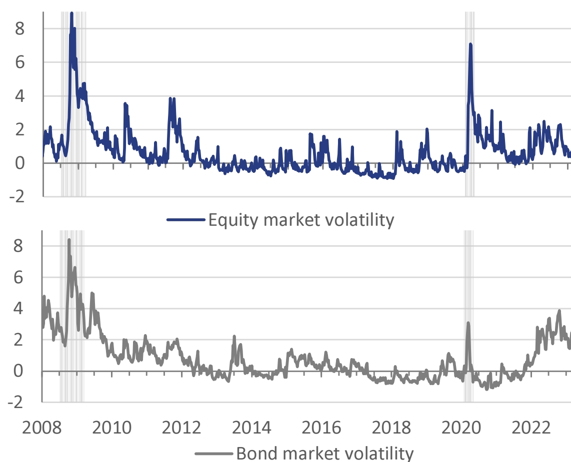
Back then, many banks had opaque structures and impaired assets on their balance sheets, with very little safety cushion against losses and write-downs. Today, banks are well-capitalized, better regulated, and hold more conservative and transparent credit books. The current crisis has so far largely been one of confidence-loss and liquidity-squeezes concerning particular firms and niche business models, rather than one of general distrust in financial institutions and their solvency.

Policymakers were also quick to react with generous liquidity programs and decisive ring-fencing measures to contain a wider spread. Lastly, markets have reacted rationally, i.e., punishing the directly affected securities, but refraining from broader-based sell-offs in unrelated risk assets.

Graph 3

A bigger problem for bonds than for equities

Equity and bond volatility indices, standard deviation from mean; grey areas mark major global crises



Source: Bloomberg, LGT Capital Partners

More broadly, the turmoil has been much more intense in the bond markets than in equities. Bonds saw the sharpest spike in volatility since the Global Financial Crisis of 2007/2008. By contrast, equity volatility remained below the post-COVID average (graph 3). We thus continue to view the outlook for equities as more attractive than for bonds, with the exception of course of cash – the latter being a consequence of the inverted yield curve (i.e., short-term interest rates are still higher than long-term interest rates).

Positioning: move toward neutral

In our base scenario we now assume that the global economic conditions will be less harsh than previously expected. Although the ongoing financial stress is souring investors' sentiment and lending standards are set to become stricter, we do not anticipate a financial crisis similar to 2007/2008.

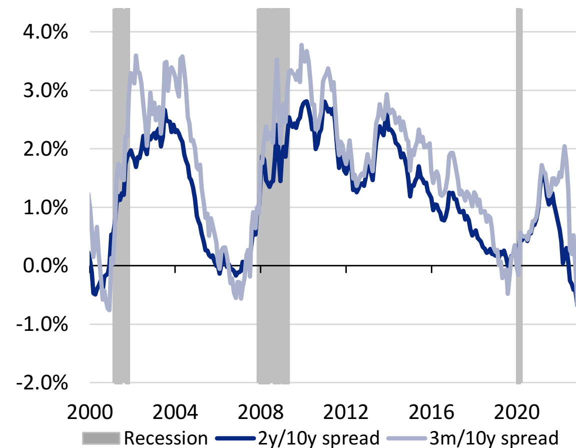
The economic data are painting an uneven picture, with some areas posting healthy figures, while others struggle more. Inflation is set to decline, but will remain above target levels. Growth on the other hand is positioned to slow. However, the deceleration will not be too severe, and some regions and sectors are recovering and may surprise to the upside. All things considered, the road ahead will be bumpy, but a hard landing can be avoided. In a less likely scenario, the economic status quo deteriorates further, as contagion risks increase and the loss of confidence intensifies leading to a significant slowdown.

The somewhat improved economic outlook, together with very bearish investors' sentiment and positioning, warrants a slightly less defensive tactical stance in our view. We implement this by selling put options on the Eurostoxx equity index. This raises our exposure to European equities and in the case of the option delta reaching one, would bring the regional weight back to the neutral position. Our overall equity beta (including the implemented value case in Listed Private Equity) is now close to the neutral position.

Graph 4

Inverted US yield curves

Do not bode well for the fixed income segment



Source: Refinitiv, LGT Capital Partners

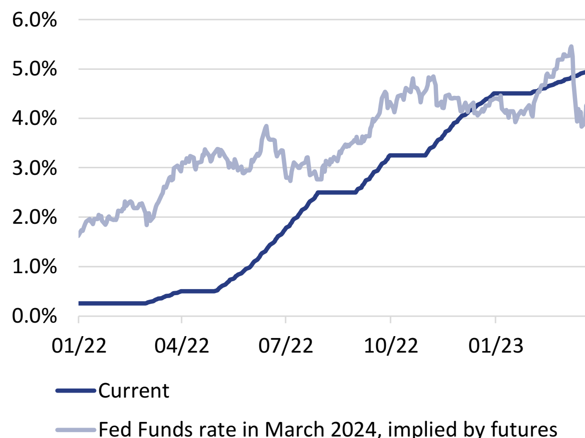
In fixed income, we increase our short duration call by selling an additional two percent of investment grade bonds. Yield curves are heavily inverted still, and we believe that expectations for immediate rate cuts will likely prove premature (graphs 4 and graph 5). Thus, long-dated bonds are at risk of repricing, if a recession can be avoided and central banks pause rather than cut short term rates. We currently have no active position in

currencies, and hold ample cash reserves for future buying opportunities.

Graph 5

Interest rates and implied path (futures)

Market participants are pricing a lot of rate cuts in



Source: Refinitiv, LGT Capital Partners

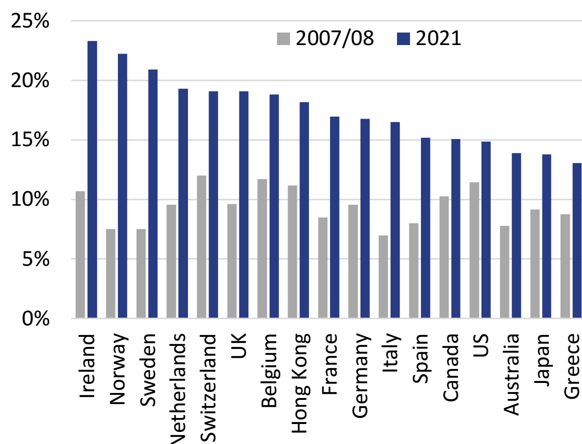
Our view on the recent banking sector turmoil

Following recent bank failures (Silicon Valley Bank, Signature Bank, Credit Suisse), bond yields declined sharply, and equities suffered considerable losses both in the US and in Europe, while safe-haven assets recorded inflows. In the meantime, the US Federal Reserve (Fed), along with regulators and the Treasury Department, as well as the relevant European authorities, have taken steps to avert this turmoil turning into a potential banking crisis. All major central banks have by now also installed expanded US dollar swap programs to avoid any liquidity crunches.

Graph 6

Global banks are in a better shape than 2007/2008

Tier 1 Capital (as % of risk-weighted assets)



Source: Refinitiv, International Monetary Fund, LGT Capital Partners

The Fed has also adopted a slightly more cautious stance, further relaxing its rate-hiking campaign by raising its policy rate by 25 basis points on 22 March – instead of by 50 basis points, as was widely expected prior to the US bank seizures, and by 75 basis points at each meeting last year.

While some collateral damage may arise from these recent developments and policy actions, ranging from disgruntled stakeholders of Credit Suisse to a potentially greater tolerance for higher inflation in the future, the measures broadly address the most urgent issues from a macro viewpoint.

Today's banking industry issues differ from those of 2007/2008. Then, the main problem was that banks had assets of dubious quality on their balance sheets, while the current crisis is one of confidence and liquidity, driven by deposit outflows. As such, central banks should be able to solve the crisis by fulfilling their role of lender of last resort. Moreover, on both sides of the Atlantic, banks are well capitalized and have above-average liquidity buffers. As such, this is not a systemic banking crisis.

Nevertheless, there are potential implications for the wider economy and the monetary policy outlook. The past year's quick rate hikes are increasingly causing strains in the financial system, and risks to financial stability have risen. The central banks' fight against inflation has become more difficult, as they now must also take financial stability into account.

Still, we doubt that the Fed's policy will shift toward cutting policy rates soon, as suggested by rates markets. Rather, recent data shows that inflation is still running too hot. The tightening cycle is thus probably not over yet, although in case of doubt, central banks may settle for a less rapid decline in inflation, in exchange for more financial stability. At the margin, this raises longer-term inflation risks.

Moreover, the banking problems will weigh on growth. Smaller US regional banks will turn more cautious and curtail their lending to preserve liquidity. Some of this may be absorbed by larger banks, but credit growth will still decline, arguably reducing US GDP growth by about half a percentage point. While this must be seen in the context of an overall resilient economy, where growth is still running above its potential rate, the risk of a credit crunch has risen recently.

Finally, banks in both Europe and the US will have to raise deposit rates closer to money market levels to attract or keep client money, and/or increase funding of expanded deposit insurance programs, which will weigh on their profitability.

Concluding, we expect interest rates to remain high for longer than currently priced into financial markets, and lending conditions to tighten over the course of the coming quarters. Central banks may adopt a wait-and-see stance, which means they might have to resume tightening campaigns later. It is difficult to reverse increasingly entrenched inflation without causing economic harm. Thus, while markets may occasionally rally as worst-case outcomes are being avoided, the current macro regime is likely to remain challenging from an asset allocation perspective.

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, lilted in favor of global defensive equity strategies and non-US markets**
- **Fixed income: pronounced underweight – especially in investment grade bonds – while EM bonds are kept at neutral**
- **Alternatives: small overweight resulting from the position in Listed Private Equity**
- **Currencies and cash: neutral in currencies exposures and significant cash reserves (5%)**

	Asset class	underweight				Tactical allocation			overweight
		----	---	--	-	+	++	+++	++++
Fixed income	Short-term investments					■	■	■	■
	Investment grade bonds*	■	■	■	■				
	High yield bonds				■				
	Emerging market bonds								
Equities	Global defensive					■	■		
	Global developed			■	■				
	North America				■				
	Europe								
	Japan								
	Emerging Asia								
Alt. / Real	Listed private equity					■			
	Hedge funds								
	Insurance-linked securities								
	Real estate (REITs)								
	Gold								

	Currency[1]	----	---	--	-	+	++	+++	++++
Currencies	USD								
	EUR								
	CHF								
	JPY								
	AUD								
	NOK								
	Others								

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	2.6%	2.9%	3.0%	-3.6%	0.7%
Global inflation linked bonds	USD	3.4%	3.7%	3.4%	-2.3%	-1.2%
Investment grade corporate bonds	USD	1.5%	2.1%	2.0%	0.9%	1.9%
High yield bonds	USD	-0.4%	2.1%	2.0%	4.4%	1.3%
Emerging markets, local currency	USD	2.4%	3.9%	3.5%	0.2%	-2.7%
Emerging markets, hard currency	USD	0.0%	0.0%	0.0%	0.0%	0.0%
Equities						
Global	USD	-0.8%	5.0%	4.0%	16.1%	8.5%
Global defensive	USD	1.7%	0.2%	-0.1%	7.9%	5.4%
North America	USD	-0.1%	5.4%	3.9%	17.4%	9.9%
Europe	EUR	-2.9%	4.9%	5.4%	14.9%	6.1%
Japan	JPY	-1.6%	2.8%	3.7%	12.9%	5.4%
Emerging markets	USD	0.2%	0.7%	1.1%	7.1%	-1.3%
Alternative and real assets						
Listed private equity	USD	-7.9%	4.6%	3.2%	20.0%	8.3%
Hedge funds	USD	-0.4%	1.3%	1.6%	5.3%	3.4%
Insurance linked securities (ILS)	USD	1.5%	5.3%	5.0%	4.4%	3.7%
Real estate investment trusts (REITs)	USD	-6.4%	-2.4%	-3.4%	6.3%	3.1%
Gold	USD	7.3%	8.7%	7.5%	6.4%	8.2%
Currencies (vs. rest of G10) [2]						
US dollar	USD	-1.3%	-0.3%	0.5%	0.2%	2.8%
Euro	EUR	1.2%	1.8%	1.7%	-0.9%	-0.1%
Swiss franc	CHF	2.0%	1.4%	1.7%	1.7%	3.8%
British pound	GBP	1.4%	2.4%	2.6%	-0.2%	-0.2%

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

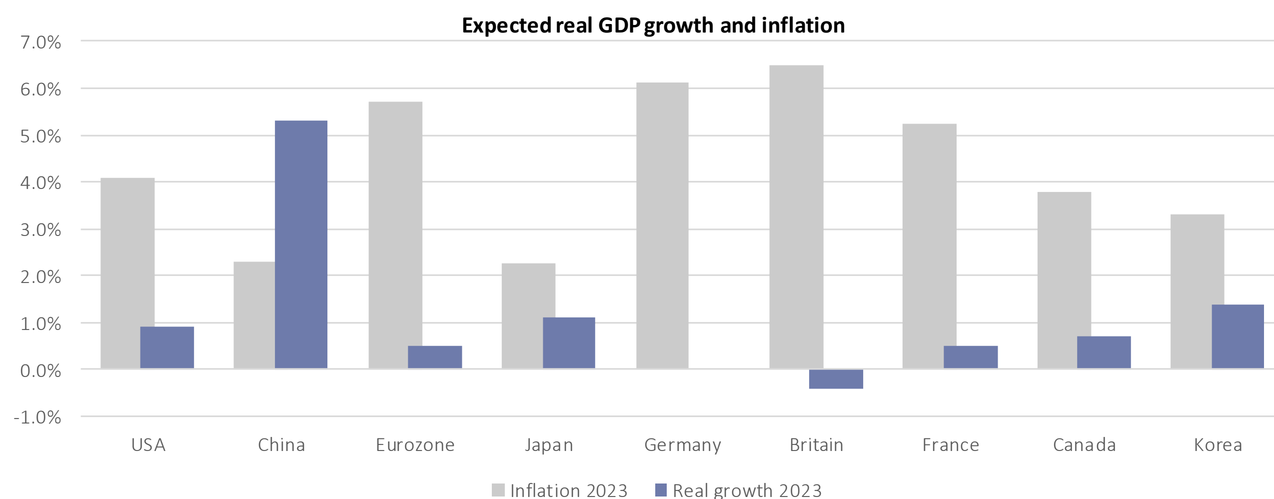
Economic and corporate fundamentals

		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	0.9%	5.3%	0.5%	1.1%	0.0%	-0.4%	0.5%	0.7%	1.4%
Real growth 2024	Consensus	1.2%	5.0%	1.2%	1.1%	1.2%	0.9%	1.1%	1.5%	2.3%
Real growth current quarter	Consensus	0.7%	5.9%	0.6%	1.0%	0.4%	-0.4%	0.4%	1.0%	2.3%
Unemployment 2023	Consensus	4.6%	4.0%	6.9%	2.4%	5.2%	4.6%	7.6%	6.1%	3.5%
Inflation 2023	Consensus	4.1%	2.3%	5.7%	2.3%	6.1%	6.5%	5.3%	3.8%	3.3%
Inflation 2024	Consensus	2.5%	2.3%	2.4%	1.2%	2.6%	2.4%	2.4%	2.2%	2.0%
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	3,133	537	1,102	36	103	28	81	406
Govt bond yield 2yr[3]	% p.a.	3.9%	2.4%	2.5%	-0.1%	2.5%	3.3%	2.6%	3.6%	3.3%
Govt bond yield 10yr[3]	% p.a.	3.5%	2.9%	2.2%	0.3%	2.2%	3.4%	2.7%	2.9%	3.3%
Main policy interest rate[4]	% p.a.	5.0%	4.4%	3.5%	-0.1%	3.5%	4.3%	3.5%	2.5%	3.5%
Spread 10y-2y treasury yield	Basis points	-43.0	49.1	-29.4	39.7	-30.1	5.5	12.5	-71.2	-5.2

[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	42,292	16,172	8,820	5,614	2,329	2,899	3,142	2,685	1,718
Growth in earnings per share, estimated (MSCI)										
12 months forward / trailing 12 montl	Consensus	1.7%	28.7%	0.1%	16.7%	1.8%	-3.8%	-7.5%	-0.5%	-26.0%
Next fy / 12m fwd	Consensus	7.7%	-3.7%	5.3%	5.0%	8.2%	4.6%	0.7%	5.2%	37.8%
Growth in revenue per share, estimated (MSCI)										
12m fwd / trail 12m	Consensus	2.6%	19.2%	0.3%	2.3%	2.0%	1.4%	4.0%	7.6%	1.6%
Next fy / 12m fwd	Consensus	3.5%	-2.5%	1.7%	3.3%	2.8%	1.8%	-1.0%	2.5%	5.6%
Valuations (MSCI)										
Price-Earnings Ratio (est 12m fwd)	Consensus	17.9	10.4	12.2	12.9	11.1	13.0	10.0	12.2	13.4
Price-Sales Ratio (est 12m fwd)	Consensus	2.2	1.1	1.1	0.9	0.8	1.2	1.1	1.6	0.7
Dividend yield	Consensus	1.7	2.4	3.5	2.7	3.6	3.2	4.4	3.6	2.4

* China market cap includes Hong Kong | Source: Bloomberg   Data per: 28.03.2023



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