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LGT Beacon
Global macro and market review
April 2023

Marketing material

Investment perspectives April 2023

- **Equities and credit markets have rebounded since the US bank failures, led by Europe and tech-sector shares**
- **The authorities' responses have reduced the risk of the banking sector issues spreading to other segments and regions**
- **The fundamental economic picture has only slightly improved, not as much as implied by the current rally**
- **Inflation remains too high for central banks to cut rates this year, weakening the main driver of the tech rally**
- **However, the bearish investors' position suggests that markets may continue to "climb the wall of worry" regardless**

Investment actions:
- **We are actively trading equities in this environment, using option strategies on European indices**
- **We keep ample cash reserves ranging from 5% to 7% to deploy them when opportunities arise**
- **We stay short duration and underweight public credit markets, as inverted yield curves still favor cash**

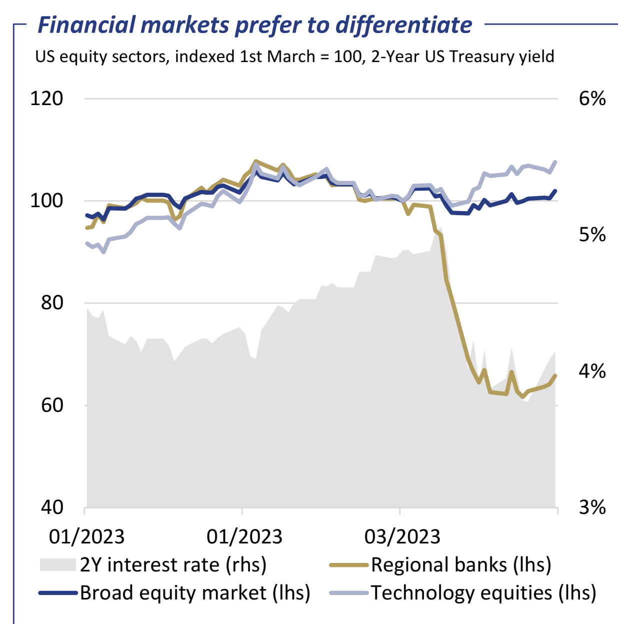
A credit crisis has been averted but risks to economic growth remain

Equity market indices have rebounded by 5.5% to 8.5% since the mid-March selloff, triggered by US regional bank runs, with technology and European stocks leading the advance. These gains reflect investors' relief that the banking industry's current problems will not spread to other sectors and regions. Additionally, hopes that the Federal Reserve will cut policy rates by the end of the year have boosted growth stocks and tech shares. The prospect of lower rates raises the present value of future earnings, which clearly buoyed the growth/tech segment.

European equities, in particular, seem to be benefiting more from the reopening of China than other regions. The geopolitical relationship between China and some European countries appears to be less strained when compared to the US and some of China's Asian neighbors. However, financial shares have clearly suffered over the past few weeks, especially US regional bank shares. This wide dispersion of returns between sectors is the main feature of the recent relief rally (graph 1).

While last month's fears about a global banking crisis spreading were overdone, the current optimism also appears somewhat stretched. At the same time, institutions currently hold historically high cash and low equity quotas and remain cautious about the economy. This bearish positioning means that continued gains in risk assets are possible beyond what may seem justified by fundamentals. As a result, we believe that counter-cyclical, opportunistic, and yet risk-conscious strategies are best-suited in such a market environment. We have been actively trading in and out of markets since March.

Graph 1



Equities are represented by MSCI equity indices for the US.
Source: LGT Capital Partners, Bloomberg

Active in European equities since the March selloff

We have actively traded in and out of European equities since the March bank failures, while carefully considering the macro risks. To limit our total equity exposure, we prefer to take positions using options and maintain a neutral overall stance at most. This tactical approach aligns with our fundamental assessment, which sees the recent investors' optimism as exaggerated, despite acknowledging that markets can rise on marginal good news when most investors are underinvested.

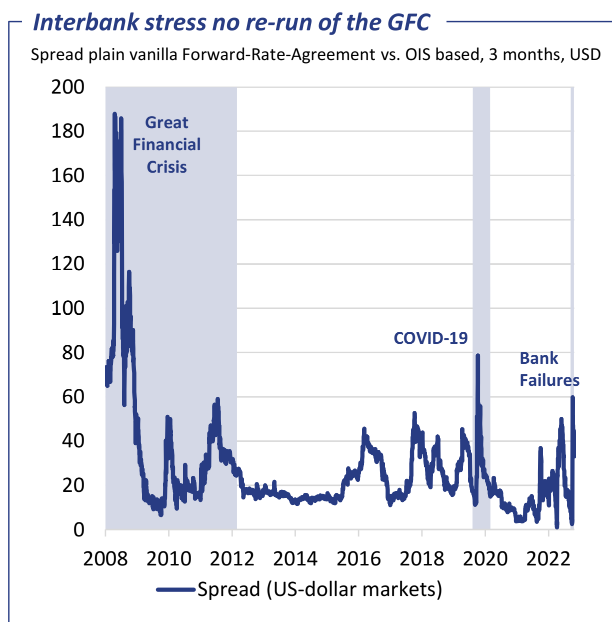
In mid-March, after the US regional bank failures caused a market overreaction, we increased our allocation to equities by writing puts on the Euro Stoxx index. We took profits on that position a few weeks later and recently reopened it with a slightly smaller increase in European exposure. As a result, our overall equity weight is currently somewhat below neutral. In a bearish scenario, the put position would increase our exposure to a neutral level, but with the benefit of having collected the option premium.

We remain very short duration and continue to hold ample cash reserves for any future buying opportunities.

Fundamental reasoning on the banking sector issues

In our view, the risk of a systemic crisis in the near term is relatively low. While there is significant stress in the interbank market system, the tensions are far from what we had seen during the Global Financial Crisis (graph 2). Moreover, the global economy is in slightly better shape than a few months ago, and the authorities' responses will limit the potential fallout of the recent bank failures.

Graph 2

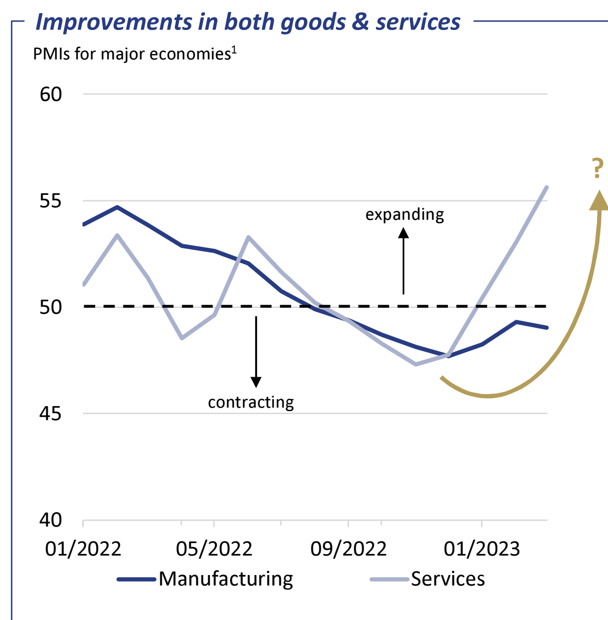


OIS = Overnight Index Swap spread, a measure of the market's expectation of the difference between the overnight indexed swap rate and the expected policy rate. A higher spread suggests stress in the system. Source: LGT Capital Partners, Refinitiv, Bloomberg

The problems faced by Credit Suisse were different in nature than those faced by US regional banks. European non-systemic banks have smaller market shares in lending than their US counterparts, are generally richer in tier 1 capital, and have deposits-to-assets ratios that provide a cushion against liquidity pressures. However, we do not consider the financial sector to be attractive at present due to higher funding costs on the liability side, lower long-term interest rates on the asset side, and competition from fintech companies. Tight monetary policies aimed at reducing demand and economic growth by raising the cost of capital ultimately limit credit growth, which is the sector's bread-and-butter business.

Sectors such as commercial real estate (CRE) and, in some cases, venture capital are most likely to feel the impact of these tighter credit conditions. Regional banks fund about 38% of the CRE market in the US, while start-ups are most susceptible to changes in risk aversion among lenders. This tightening of financial conditions has led us to remain cautious about the longer-term outlook for the economy. Nonetheless, the short-term outlook has brightened somewhat, with global manufacturing stabilizing and services remaining resilient, as shown in graph 3.

Graph 3

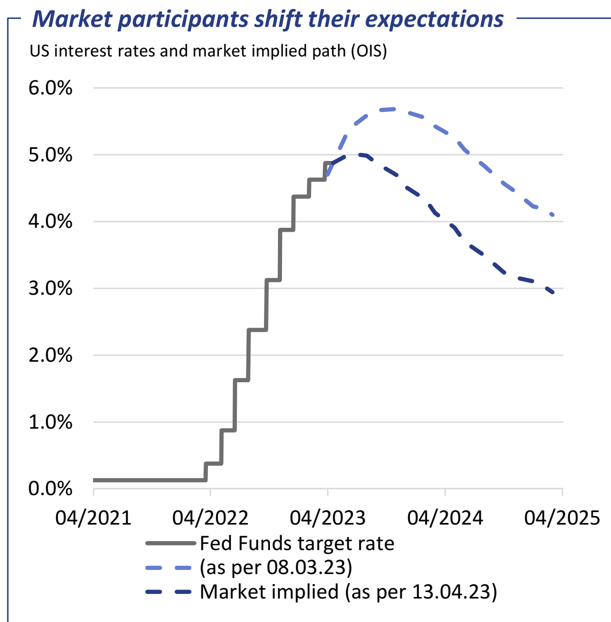


1 Purchasing manager indices based on S&P Global Markit. Major economies are represented by the US, Europe, UK, Japan, and China. The PMIs are weighted on GDP based on purchasing power parity as a share of the world of a single country. Source: LGT Capital Partners, Refinitiv

Current macro situation: not great, but not terrible

Since the March bank failures, investors have become more dovish about the monetary policy outlook, with the Fed funds rate level now expected to be up to 100 basis points lower than what was priced in shortly before the March bank runs (graph 4).

Graph 4



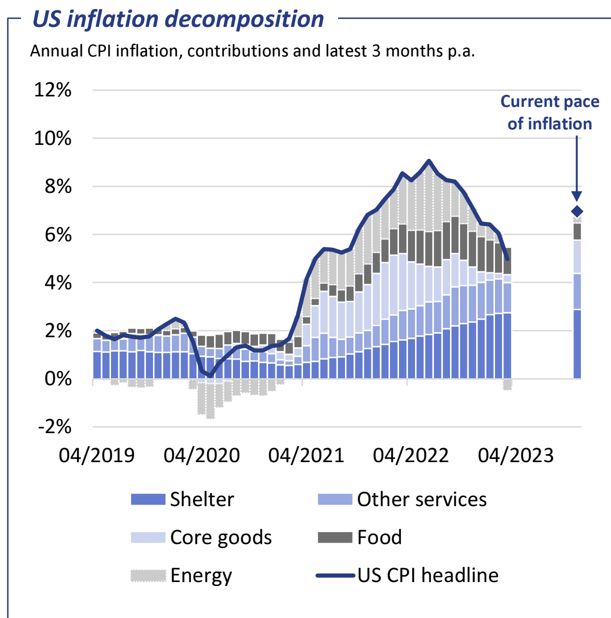
Market participants shift their expectations

US interest rates and market implied path (OIS)

Source: LGT Capital Partners, Refinitiv

Recent data supports the case for a more dovish rate outlook. US core consumer prices in March showed the slowest monthly rise since November. While the year-over-year core inflation rate remains high at 5.6%, the pace is moderating. Importantly, shelter inflation, which is the largest component of the core price index, declined last month, as market rents had predicted. Overall, we believe that core CPI inflation is on track to fall to the 3% to 4% range by the end of the year, which may lead to a pause in rate hikes after the Fed policy meeting in May.

Graph 5



US inflation decomposition

Annual CPI inflation, contributions and latest 3 months p.a.

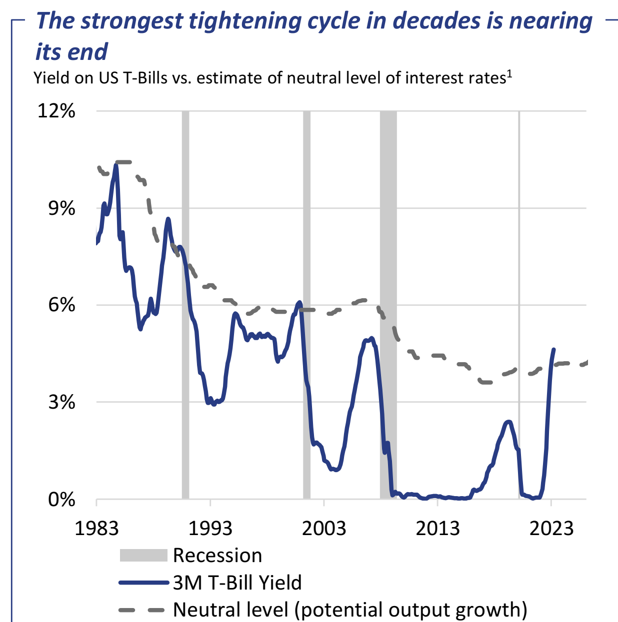
Source: LGT Capital Partners, Refinitiv

We have stated that the US economy might prove strong enough to avoid rate cuts in 2023, despite the recent banking troubles.

Participants at the March Fed meeting indicated that they would review incoming information regarding changes in credit conditions and credit flows as well as broader changes in financial conditions. Since that meeting, there have been mixed assessments of credit flows and financial conditions, with bank lending contracting sharply in the second half of March, but broad financial conditions easing (partly thanks to buoyant equity and credit markets). Credit issuance has also increased noticeably, as borrowers were able to tap into markets and find lenders. It remains to be seen whether bank lending will rebound in the coming weeks, but there may be one more 25 basis point rate hike at the next Fed meeting before an extended pause.

In the meantime, the narrative driving financial markets has shifted from good-news-is-bad-news to bad-news-is-good-news, and more recently to small-positive-surprises-are-great-news. This leaves us concerned about equities in the medium term. The hoped-for rate cuts would only occur in the event of an economic deterioration or even outright recessionary conditions, which would negatively impact corporate earnings. Thus, while the Fed's tightening cycle is coming to an end soon, refraining from further rate hikes is not the same as easing. Following the most aggressive tightening in decades, monetary policy has only recently entered restrictive territory (graph 6) and is likely to stay there for longer than markets are currently pricing in.

Graph 6



The strongest tightening cycle in decades is nearing its end

Yield on US T-Bills vs. estimate of neutral level of interest rates[1]

1 Neutral level of interest rates is assumed to be equal to potential output growth, measured as 10-year rolling median of annual nominal GDP growth.

Source: LGT Capital Partners, Refinitiv

We hence maintain an overall defensive general view on the macro outlook, although we always remain flexible with regard to tactical opportunities.

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 are moderately underweight overall, tilted in favor of defensive strategies**
- **Fixed income is pronouncedly underweight, especially in investment grade bonds; EM bonds 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**

	Asset class	underweight		Tactical allocation versus SAA					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					■			
	Liquid alternatives								
	Insurance-linked securities								
	Real estate (REITs)								
	Gold								

	Currency[2]	----	---	--	-	+	++	+++	++++
Currencies	USD								
	EUR								
	CHF								
	GBP								
	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	-1.0%	-0.4%	2.5%	-3.7%	0.6%
Global inflation linked bonds	USD	0.6%	-0.6%	3.2%	-2.6%	-1.1%
Investment grade corporate bonds	USD	1.0%	0.2%	2.7%	-0.5%	2.1%
High yield bonds	USD	3.0%	0.6%	4.5%	3.1%	1.6%
Emerging markets, local currency	USD	3.6%	1.1%	5.5%	0.2%	-2.3%
Emerging markets, hard currency	USD	0.0%	0.0%	0.0%	0.0%	0.0%
Equities						
Global	USD	6.4%	6.1%	9.0%	14.0%	8.7%
Global defensive	USD	6.5%	4.0%	4.4%	6.4%	5.9%
North America	USD	6.3%	6.7%	8.7%	14.3%	10.1%
Europe	EUR	8.0%	5.2%	11.4%	14.8%	6.5%
Japan	JPY	5.4%	7.5%	9.2%	14.7%	5.9%
Emerging markets	USD	5.4%	-2.2%	5.1%	6.0%	-0.9%
Alternative and real assets						
Listed private equity	USD	9.2%	2.3%	8.5%	19.7%	8.8%
Hedge funds	USD	-1.0%	0.5%	0.5%	7.9%	3.3%
Insurance linked securities (ILS)	USD	1.6%	6.1%	6.3%	4.7%	3.9%
Real estate investment trusts (REITs)	USD	3.7%	-3.2%	1.8%	4.8%	4.4%
Gold	USD	0.7%	3.1%	9.3%	5.8%	8.2%
Currencies (vs. rest of G10) [2]						
US dollar	USD	-1.4%	1.0%	-0.1%	0.0%	2.8%
Euro	EUR	1.6%	2.4%	2.6%	0.3%	0.1%
Swiss franc	CHF	2.1%	3.4%	3.3%	2.8%	4.6%
British pound	GBP	1.2%	1.7%	3.4%	-0.1%	0.0%

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

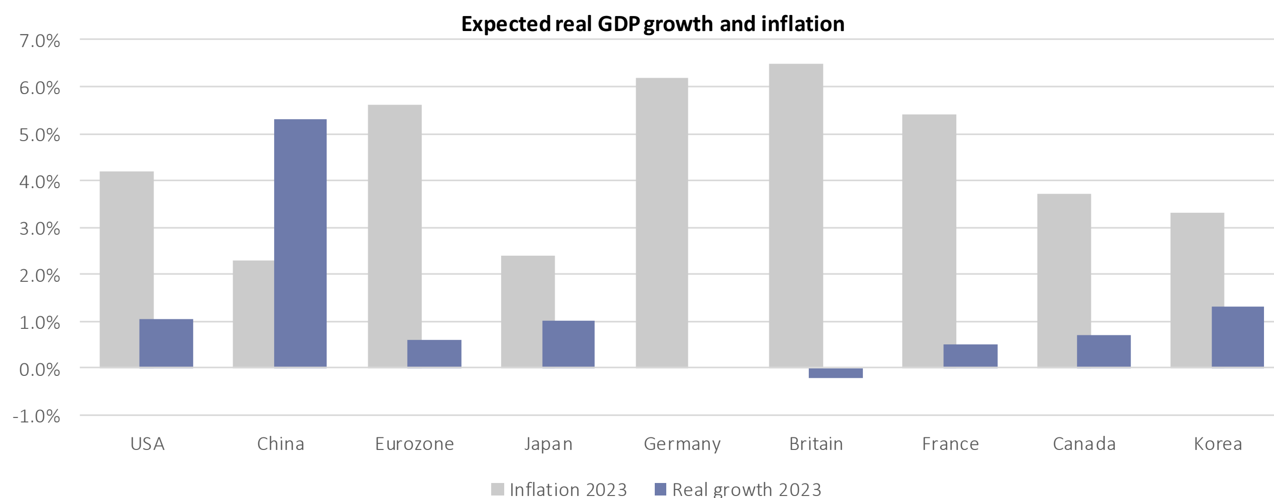
Economic and corporate fundamentals

		USA	China	Eurozone	Japan	Germany	Britain	France	Canada	Korea
Gross domestic product (GDP)										
Nominal, this year[1]	bn USD	26,855	19,374	15,071	4,410	4,309	3,159	2,923	2,090	1,722
Per Capita, purchasing power parity[1]	USD, PPP	80,035	23,382	40,965	51,809	66,132	56,471	58,828	60,177	56,706
Real growth 2023	Consensus	1.1%	5.3%	0.6%	1.0%	0.0%	-0.2%	0.5%	0.7%	1.3%
Real growth 2024	Consensus	1.0%	5.0%	1.1%	1.1%	1.0%	0.9%	1.0%	1.3%	2.2%
Real growth current quarter	Consensus	0.2%	5.8%	0.5%	0.9%	0.5%	-0.1%	0.6%	0.7%	2.3%
Unemployment 2023	Consensus	4.6%	4.1%	6.9%	2.4%	5.3%	4.5%	7.5%	6.1%	3.3%
Inflation 2023	Consensus	4.2%	2.3%	5.6%	2.4%	6.2%	6.5%	5.4%	3.7%	3.3%
Inflation 2024	Consensus	2.6%	2.3%	2.5%	1.3%	2.7%	2.4%	2.6%	2.2%	2.0%
Purchasing manager index[2]	Neutral=50									
Structural budget balance/GDP	IMF	-6.6%	-6.4%	-3.1%	-6.4%	-3.2%	-4.3%	-4.6%	-0.5%	0.2%
Gross government debt/GDP	IMF	122.2%	82.4%	89.8%	258.2%	67.2%	106.2%	111.4%	105.1%	55.3%
Current account balance/GDP	IMF	-2.7%	1.4%	0.6%	3.0%	4.7%	-5.2%	-1.2%	-1.1%	2.2%
International currency reserves	bn USD	37	3,184	537	1,129	36	105	28	82	401
Govt bond yield 2yr[3]	% p.a.	4.2%	2.4%	2.9%	0.0%	2.9%	3.7%	3.0%	3.9%	3.3%
Govt bond yield 10yr[3]	% p.a.	3.6%	2.8%	2.5%	0.5%	2.5%	3.7%	3.0%	3.1%	3.4%
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	-62.6	44.6	-42.9	51.7	-43.4	5.6	0.5	-80.2	0.5

[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	44,134	16,775	9,425	5,708	2,485	3,109	3,391	2,867	1,812
Growth in earnings per share, estimated (MSCI)										
12 months forward / trailing 12 montl	Consensus	1.7%	17.6%	1.4%	16.5%	3.5%	-4.2%	-7.5%	-0.5%	-26.1%
Next fy / 12m fwd	Consensus	7.0%	9.7%	5.5%	4.8%	7.7%	4.9%	1.2%	5.3%	36.3%
Growth in revenue per share, estimated (MSCI)										
12m fwd / trail 12m	Consensus	2.8%	4.9%	1.1%	2.6%	3.1%	1.1%	1.6%	9.7%	2.2%
Next fy / 12m fwd	Consensus	3.1%	6.0%	1.7%	2.9%	2.1%	1.8%	-0.3%	3.9%	5.3%
Valuations (MSCI)										
Price-Earnings Ratio (est 12m fwd)	Consensus	18.7	10.7	12.8	13.5	11.5	14.0	10.8	12.9	14.3
Price-Sales Ratio (est 12m fwd)	Consensus	2.3	1.1	1.1	0.9	0.8	1.3	1.2	1.7	0.8
Dividend yield	Consensus	1.7	2.4	3.3	2.6	3.4	3.0	4.2	3.4	2.3

* China market cap includes Hong Kong | Source: Bloomberg Data per: 19.04.2023



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