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Tactical asset allocation Q4/2022

Marketing material

Inflation is still too high in most economies and geopolitical risks remain plentiful. The resulting uncertain and bifurcated outlook in turn causes frequent volatility spikes – an environment that favors well-diversified strategies and active management particularly well. After having sold toward the end of the recent rally to raise cash, we are now again seeking to redeploy some of that reserve liquidity back into the markets.

Brief review of the year thus far

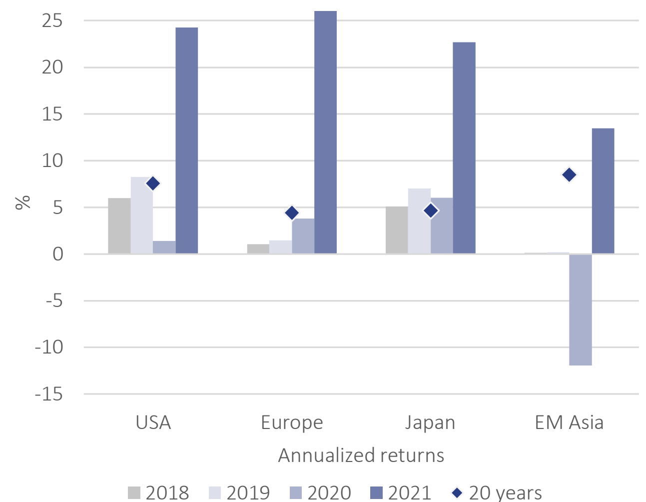
We entered the year with an increased Liquid Alternatives allocation, decided at the end of 2021, as well as tactical overweights in the US dollar, gold, and historically high cash reserves. Duration risk and credit were strongly underweighted, while we had just reduced equities to neutral.

After a long bull market and a quick post-COVID rebound, we had anticipated that this year could bring volatility spikes and require a better downside protection. From a fundamental macro viewpoint, inflation was rising and therefore monetary tightening was looming, just as geopolitical risks were on the rise as well. Hence, we broadened the above-mentioned defensive portfolio features, while scaling back our equity exposure somewhat.

In turn, these features allowed us to act more flexibly in this year's volatile markets. Thus, when markets were still selling off and sentiment was very negative between April and June, we began to selectively redeploy capital, drawing down about three quarters of our reserves to buy into various segments, including investment grade bonds, listed private equity, as well as in public stock markets. Vice versa, when the S&P 500 rallied by as much as 17% from mid-June to mid-August, we started to raise cash again, until it increased to more than 5% again – above the level at the start of the year.

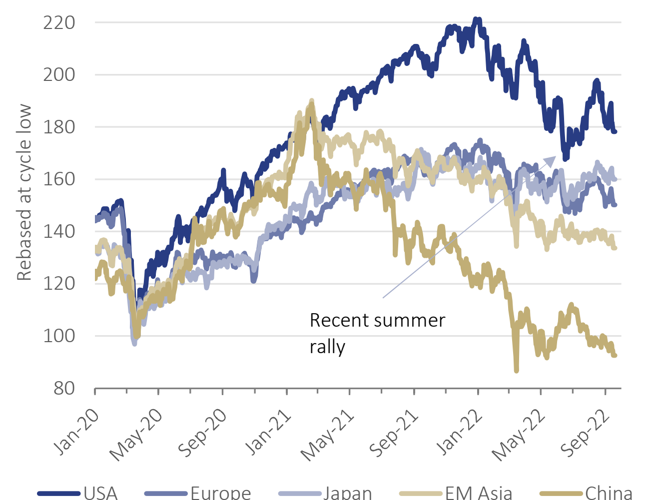
In the meantime, volatility has returned to markets, as the hopes that drove the summer rally – i.e., that monetary tightening would soon end – are being disappointed and fears of a nearing recession resurface. Our own macro assessment is less prone to such swings in sentiment and has changed little over the past few months. As a consequence, we are now inclined to redeploy some of our capital back into the markets. We remain convinced that an environment such as the current one requires an active and disciplined counter-cyclical approach based on a well-diversified multi-asset portfolio.

Graph 1
Annual returns of global equities
Based on MSCI net return indices, hedged in USD*



*EM Asia is unhedged in USD as efficient hedging is not possible; EM = emerging markets. Source: Bloomberg, LGT Capital Partners

Graph 2
Major stock market indices since 2020
Based on MSCI net return indices, hedged in USD



*EM Asia is unhedged in USD, see footnote of above graph. Source: Bloomberg, LGT Capital Partners

Outlook for the final quarter

The incoming macro data continue to corroborate the case that large parts of the world economy are mired in a stagflationary environment of low real output gains and high consumer price increases.

At the same time, corporate profit growth is still resilient, owing to the high growth rate of nominal economic output. The latter is also helping to keep credit default rates in the developed markets near historic lows. However, this is countermanded by the fact that higher interest rates reduce the value of future earnings, and the continued tightening of financing conditions.

Furthermore, inflation rates remain stubbornly high, while many economic activity indicators continue to weaken – but this time without deterring central banks from swift and meaningful policy rate increases. That situation is not uniform, however. Japan is the exception among the G7, with its economy experiencing a domestic cyclical upswing, while the Bank of Japan is sticking to its near-zero rate policy, as domestic inflation dynamics are still subdued.

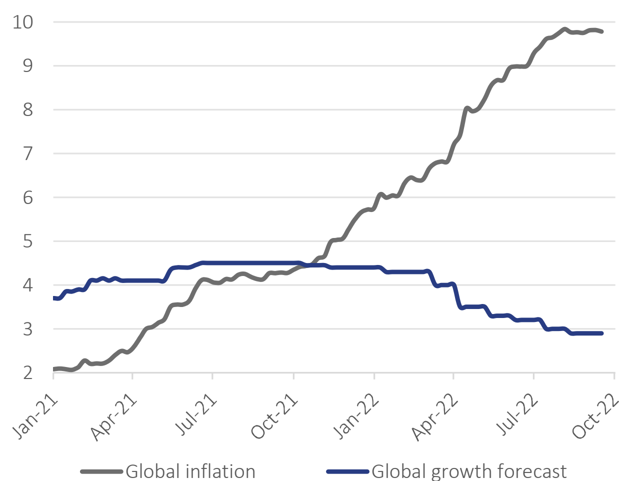
For most of the developed markets, the tightening cycle may still have some way to go, but it may already be more advanced in various emerging markets. In the emerging world, monetary and fiscal easing during the pandemic was much more modest than in the rich countries, while the tightening cycle set in earlier and more decisively.

The notable exception here is China, where authorities have started to ease macro policies somewhat to counter the economic drag from harsh COVID-measures, various regulatory interventions in the private sector, and a property market bust. More broadly speaking, the world's second-largest economy is facing the economic costs and reputational consequences of its domestic policies as well as geopolitically motivated potential exclusions from parts of the global capital and goods markets.

Graph 3

Expected economic growth and current inflation

Expected GDP* growth is for 2022



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

Portfolio positioning

Risk assets continue to be burdened by higher interest rates, excessive inflation, and fears of a coming recession. The intense market reaction to the August US inflation print, which came in only slightly above expectations, is a case in point, showing that investors remain susceptible to sudden sentiment shifts. However, market pricing of various financial assets also suggests that a so-called soft landing – i.e., bringing inflation under control without fully damaging the ability of the economy to recover quickly – remains possible as well.

Lower asset prices and higher earnings make valuations look attractive now, but that is largely due to a justified repricing to higher interest rates, i.e., discount rates. A recession is not implied by current valuations. Investors' sentiment and positioning, meanwhile, have turned outright bearish again – potentially signaling a contrarian buying opportunity for risk assets.

Overall, we concluded that a defensive tactical stance remains warranted. We thus remain positioned below neutral in duration and credit risk, as well as equities – the latter since we sold stocks toward the end of the brief summer rally. At the same time, we also believe that a counter-cyclical approach remains most appropriate in the current environment, which is marked by alternating risk sentiment and elevated policy uncertainty – and we decided to start redeploying some of the excess cash we had built up in August.

Specifically, we are slightly increasing Japanese equities from neutral to overweight. Japan has shown relative resilience, as many of the current economic and geopolitical headwinds are less acute for the country. The extremely weak and cheap yen, a lagged post-COVID upswing, subdued foreign investors' inflows, and undemanding valuations despite an already favorable relative performance year-to-date, further support the case for our tactical overweight. Meanwhile, we remain underweight Europe and Asian emerging markets, while US equities stay set at the neutral position. Following the increases in Japan, our cash now stands at 4% of our endowment, i.e., only slightly below the level at the start of the year.

Graph 4

Forward price-earnings ratios of global indices

Based on MSCI indices for the regions

Source: MSCI, Bloomberg, LGT Capital Partners

The case for the overweight in Japan

- Inflation remains subdued due to structural forces hence monetary policy is likely to stay easy
- Resulting (very) cheap yen creates an additional tailwind for corporate earnings and domestic investment
- Valuations near multi-decade lows, while earnings are growing and probably underestimated ("expectations management")
- Investors are markedly underinvested in Japan (multi-decade low allocations), leaving room for future inflows
- Technical and behavioral finance factors are constructive (e.g., relative strength throughout this crisis year)
- Energy problem is less acute, as reliance on Russia is low (<10% of supply), energy sourcing and production is diversified (currently, only 10 of 33 operable nuclear reactors are online), and fossil fuel inventories are high
- Japan could benefit from friend-shoring/re-shoring within the Western camp, especially given the undervalued yen

Due to a late reopening compared to the West, Japan's economy is still in an earlier phase of its recovery cycle, while the headwinds that currently plague other economies are (much) less acute. While import prices have risen, medium- to long-term expectations are still well below target, which allows the Bank of Japan to stick to its supportive monetary policy at a time when most other central banks are forced to tighten financial conditions even if it causes a recession.

The resulting interest rate differential between most currencies and the yen, which still yields near zero, has increased sharply, markedly weakening the yen. On a real effective exchange rate basis, the yen has plunged to its lowest level since 1971, i.e., when the yen was part of the Bretton Woods fixed exchange rate system.

Furthermore, the weak yen is not a major political or socioeconomic issue for Japan, as the country's households, businesses, and the state are net global asset owners, with the net international investment position amounting to about 70% of GDP. Hence, a cheap currency makes Japan's exports more competitive, bolsters the value of overseas assets as well as of the income they generate, and leads to an overall positive wealth effect.

The undervalued currency also supports domestic capital investment from an economic perspective, at a time of increased re-shoring and friend-shoring within the Western geopolitical camp, i.e., the emerging trend to repatriate supply chains, respectively to relocate them to friendly and/or allied countries. Given the changing geopolitical environment, it is now more likely than in the 1980s that the US will at least to some extent tolerate an undervalued yen for the purpose of balancing China and countering Russia.

Finally, while the Japanese equities have been outperforming steadily this year, foreign investors are still cautious about Japan. The percentage of investors who say they are overweight in Japan is still near a record low, with data going back 20 years. Similarly, the analyst consensus on Japanese earnings is not bullish, which makes upward revisions in the future more likely.

Concluding, currency risk should not be a concern for international investors because it can be fully hedged, while the extreme fundamental undervaluation of the yen limits the medium-term downside and provides an upside in the longer term, respectively. We always fully hedge our developed market currency risk as a matter of principle.

Graph 5

Inflation expectations for Japan

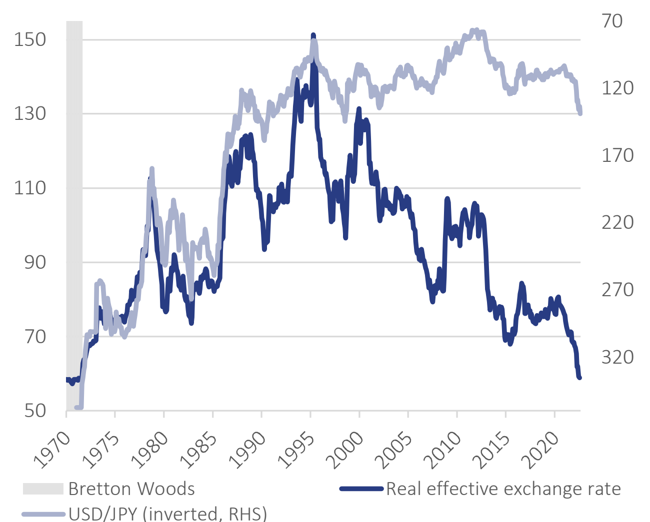
Based on traded inflation-compensation instruments

Source: Bloomberg, LGT Capital Partners

Graph 6

Japanese yen in a broader perspective

USD/JPY market rate and trade-weighted REER*



*REER = real effective exchange rate. It is used as a measure of the average prices of home manufactured goods relative to those of a country's major trading partners and is thus often referred to as competitiveness indicator.
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 global defensive and Japanese equities**
- **Fixed income: underweight, with high yield and investment grade bonds below neutral**
- **Alternatives: small overweight, resulting from a long position in gold**
- **Currencies: long position in the USD against the EUR and passive underweights in EM currencies**

	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					■	■	■ (partial)	
	EUR			■	■				
	CHF								
	GBP								
	Others				■ (partial)				

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	-3.5%	-0.7%	-10.5%	-2.6%	0.6%
Global inflation linked bonds	USD	-7.2%	-5.5%	-22.5%	-3.6%	-1.0%
Investment grade corporate bonds	USD	-2.2%	-0.2%	-9.8%	-0.8%	1.1%
High yield bonds	USD	-3.1%	-0.5%	-15.6%	-1.7%	0.4%
Emerging markets, local currency*	USD	-3.6%	-1.1%	-15.5%	-6.2%	-3.5%
Emerging markets, hard currency*	USD	0.0%	0.0%	0.0%	0.0%	0.0%
Equities						
Global	USD	-7.2%	4.9%	-16.3%	8.0%	8.1%
Global defensive	USD	-6.2%	3.3%	-13.1%	1.6%	5.1%
North America	USD	-8.1%	5.7%	-18.7%	9.9%	10.2%
Europe	EUR	-5.7%	1.6%	-13.1%	3.0%	3.5%
Japan	JPY	-3.2%	5.5%	-2.5%	8.8%	5.8%
Emerging markets	USD	-5.6%	-4.8%	-21.5%	-0.1%	-0.8%
Alternative and real assets						
Listed private equity	USD	-8.3%	3.5%	-31.5%	7.1%	7.6%
Hedge funds	USD	0.8%	0.3%	-1.4%	5.3%	3.8%
Insurance linked securities (ILS)	USD	1.3%	1.6%	1.9%	5.0%	4.6%
Real estate investment trusts (REITs)	USD	-9.3%	2.6%	-21.3%	0.6%	4.5%
Gold	USD	-4.9%	-9.6%	-9.2%	3.5%	4.9%
Currencies (vs. rest of G10) [3]						
US dollar	USD	2.6%	4.4%	13.6%	2.8%	3.8%
Euro	EUR	2.0%	-1.3%	-1.7%	-1.0%	-0.4%
Swiss franc	CHF	1.5%	4.6%	6.4%	3.7%	3.6%
British pound	GBP	-1.6%	-3.6%	-6.2%	-0.8%	-0.1%
Japanese yen	JPY	-2.5%	-2.4%	-11.1%	-7.5%	-1.9%
Canadian dollar	CAD	0.0%	2.0%	7.3%	2.6%	2.0%
Norwegian krone	NOK	-2.3%	1.5%	-4.0%	-2.2%	-2.4%

[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

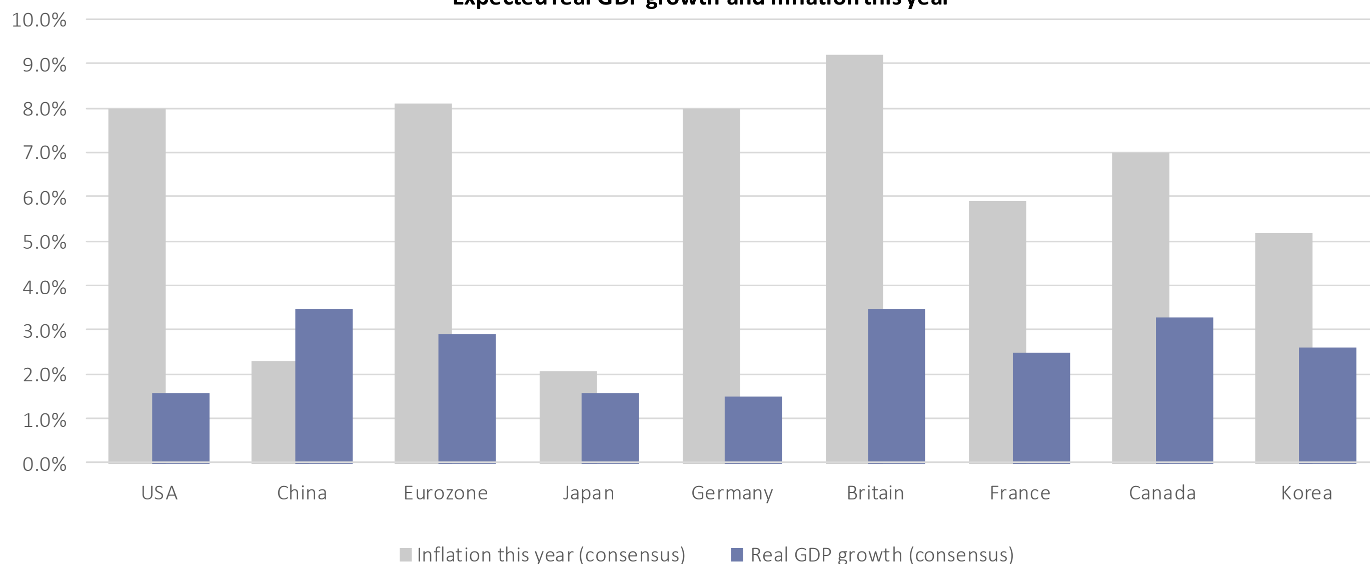
Economic and corporate fundamentals

		USA	China	Eurozone	Japan	Germany	Britain	France	Canada	Korea
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	1'805
Per Capita, purchasing power parity[1]	USD, PPP	76'027	21'364	40'965	48'814	63'271	55'301	56'036	57'812	53'051
Real growth this year[1]	Consensus	1.6%	3.5%	2.9%	1.6%	1.5%	3.5%	2.5%	3.3%	2.6%
Real growth next year[1]	Consensus	0.9%	5.2%	0.3%	1.5%	-0.1%	-0.1%	0.5%	1.2%	2.0%
Real growth current quarter	Consensus	1.3%	5.1%	0.3%	1.1%	0.2%	0.0%	0.6%	1.6%	2.0%
Unemployment this year	Consensus	3.7%	4.1%	6.8%	2.6%	5.3%	3.9%	7.3%	5.3%	3.1%
Inflation this year	Consensus	8.0%	2.3%	8.1%	2.1%	8.0%	9.2%	5.9%	7.0%	5.2%
Inflation next year	Consensus	3.7%	2.3%	4.8%	1.3%	5.2%	6.6%	4.0%	3.6%	3.0%
Purchasing manager index[2]	Neutral: 50	44.6	53	48.9	49.4	46.9	47.3	50.6	48.7	47.6
Structural budget balance/GDP	IMF	-5.3%	-7.0%	-3.5%	-7.3%	-2.0%	-4.4%	-5.3%	-2.3%	-1.3%
Gross government debt/GDP	IMF	125.6%	77.8%	95.2%	262.5%	70.9%	87.8%	112.6%	101.8%	52.0%
Current account balance/GDP	IMF	-3.5%	1.1%	1.8%	2.4%	5.9%	-5.5%	-1.8%	1.1%	2.2%
International currency reserves	bn USD	34	3'055	543	1'173	37	108	52	81	415
Govt bond yield 2yr[3]	% p.a.	3.9%	2.0%	1.6%	-0.1%	1.6%	3.1%	1.4%	3.8%	3.9%
Govt bond yield 10yr[3]	% p.a.	3.4%	2.7%	1.8%	0.3%	1.8%	3.1%	2.3%	3.1%	3.8%
Main policy interest rate ?	% p.a.	2.5%	4.4%	1.3%	-0.1%	1.3%	1.8%	1.3%	1.0%	2.5%
Spread 10y-2y treasury yield	Basis points	-41.8	62.5	21.7	32.4	21.0	-0.3	88.9	-64.6	-11.6

[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	Korea
Exchange capitalization*	bn USD	42'131	14'933	7'224	5'144	1'805	2'685	2'531	2'720	1'554
Growth in earnings per share, estimated (MSCI)										
12 months forward / trailing 12 montl	Consensus	17.3%	5.7%	28.2%	23.4%	27.1%	34.9%	56.8%	8.6%	-4.6%
Next fy / 12m fwd	Consensus	2.9%	4.4%	1.1%	1.5%	1.4%	-0.1%	0.5%	0.7%	-0.2%
Growth in revenue per share, estimated (MSCI)										
12m fwd / trail 12m	Consensus	6.7%	8.1%	6.9%	8.7%	6.4%	10.9%	29.1%	10.4%	3.3%
Next fy / 12m fwd	Consensus	1.4%	3.0%	0.3%	0.6%	-0.2%	0.5%	0.0%	1.4%	1.1%
Valuations (MSCI)										
Price-Earnings Ratio (est 12m fwd)	Consensus	16.6	10.3	10.8	12.2	9.4	10.8	8.8	11.3	8.9
Price-Sales Ratio (est 12m fwd)	Consensus	2.2	0.9	0.9	0.9	0.7	1.1	1.1	1.6	0.7
Dividend yield	Consensus	1.6	2.6	3.7	2.6	4.2	3.4	4.4	3.3	2.5

* China market cap includes Hong Kong | Source: Bloomberg Data per: 19.09.2022



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