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Outlook remains uncertain and bifurcated

Marketing material

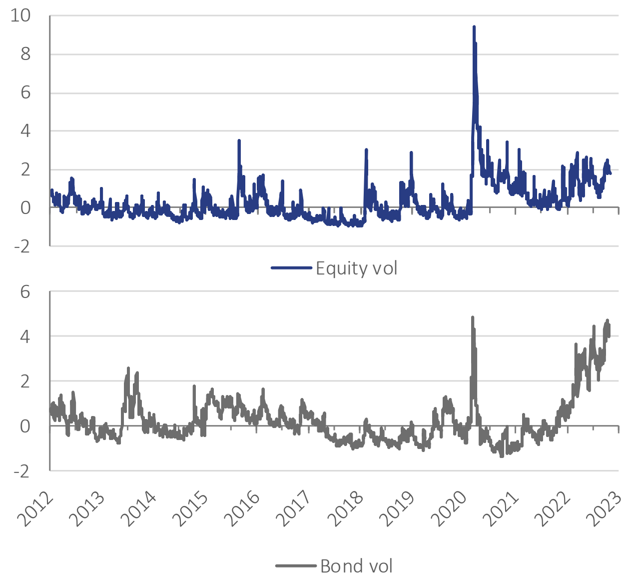
The transition from the third to the fourth quarter once again brought intense gyrations in various parts of the financial markets. While equity markets experienced unusually big intra-day swings, bond market volatility approached historic extremes. We used this volatile phase to trade the stock market and increase investment grade bonds, while maintaining our overall defensive tactical positioning.

Market review: volatility persists

After an already challenging first nine months, the transition from the third to the fourth quarter of 2022 brought intense gyrations in various parts of the financial markets. Equity markets experienced very unusual intraday swings, and bond market volatility even approached a new historic extreme (graph 1).

These developments reflect the uncertain economic outlook, in which many investors see an often shifting and wide range of possible outcomes. That said, risk assets, including equities and high yield credit, are now trading somewhat higher quarter-to-date, while safer bonds and most currencies trade lower.

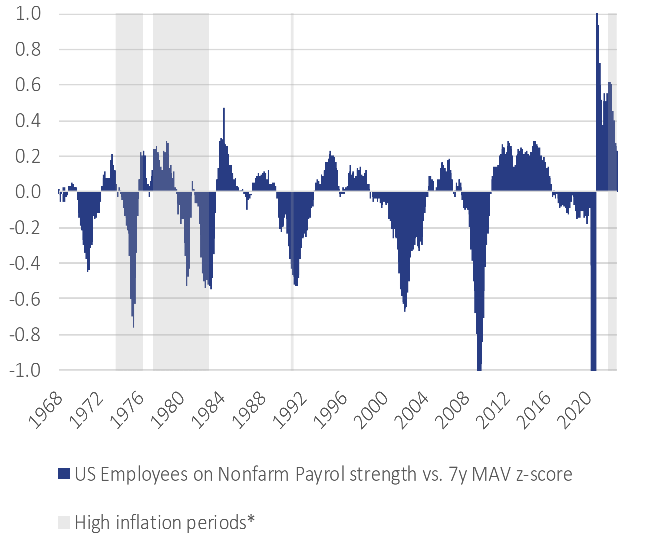
Graph 1
Volatility is high, especially in government bonds
Index moves shown in standard deviations from their mean



Chicago Board Options Exchange Volatility Index for equities. ICE BofA MOVE Index for bonds.
Source: Bloomberg, LGT Capital Partners

The main culprit for these sentiment convulsions was arguably not only the US Federal Reserve's hawkish policy bias, but also the US economy's relative robustness – because the latter is taken as *justifying* more and bigger rate hikes going forward. The US labor market, for instance, has been remarkably strong over the past couple of years by historical standards (graph 2). In that sense, the current situation starkly differs from the truly stagflationary 1970s, when job creation was much weaker.

Graph 2
Monthly total US non-farm payrolls (smoothed)
Standard deviation from the 7-year mean value



Smoothed by using six-month moving average value, cut-off at +/- 1 standard deviation. *High inflation defined as current year-on-year change in the Consumer Price Index exceeding 1 standard deviation from the seven-year mean value. Source: Bloomberg, LGT Capital Partners

Furthermore, and equally unnerving, the Fed's fast-paced withdrawal of US dollar liquidity is causing at least some cracks to appear in several areas of the global financial system. The recent turmoil in the UK bond market, or the extreme weakness of Japan's yen, and, to a lesser degree, China's yuan are good examples. These turbulences show that not every economy is able to absorb the tightening of US financial conditions without some unwanted repercussions – which at the very least complicates the work of the central banks, can lead to frequent volatility spikes, and hence ultimately weighs overall on risk appetite.

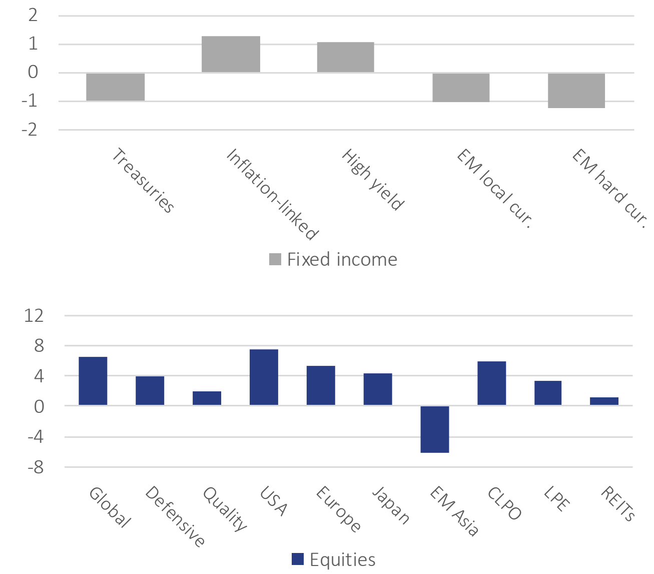
Still, it is also true that a path to a soft landing (i.e., a successful reduction of inflation without a major recession) remains open – at least in theory. In turn, this prospect occasionally triggers relief rallies – especially after investors have collectively moved to a too one-sidedly bearish mindset and positioning, as was the case recently, and probably still is the case today.

Hence, quarter-to-date, global equities were ultimately able to advance, with the MSCI World and S&P 500 gaining 6.6% and 7.6%, respectively, even as the US 10-year rate recently exceeded 4% for the first time since before the financial crisis of 2008, and the US dollar strengthened further. In terms of sectors, small- and mid-cap companies and quality stocks, as represented by our liquid private equity opportunities and quality strategies, were also among the outperformers (graph 3).

Graph 3

Performance of major market segments in our allocation

Quarter to date returns in %



Various reference indices used, i.e., Bloomberg Barclays indices for bonds and MSCI indices for equities, except for the internally managed special strategies, such as CLPO. CLPO invests in small- and medium-sized companies that are still partly owned by private equity investors. LPE is a listed private equity strategy. REITs are real estate investment trusts. Source: Bloomberg, LGT Capital Partners

By contrast, and notably, Chinese equities hit a new low, with the Hang Seng index down close to 10% quarter-to-date, while the mainland CSI 300 shed about 3.1%. In addition to purely domestic political and economic issues, China was also hit hard by new US measures that aim to deny Chinese businesses' access to the global semiconductor industry's supply and know-how chain, including human resources. Reports suggest that these measures will continue to expand to include other sectors, such as artificial intelligence.

Finally, commodity prices, are mixed, with natural gas down but crude oil up and industrial metals all over the place – which is also reflective of the uncertainty, as well as a price-finding regime that is distorted by geopolitical developments, rather than the usual economic supply/demand issues.

Concluding, we believe this type of market environment continues to favor an overall defensive positioning and a disciplined, rules-based active management approach in the context of a well-diversified portfolio.

Outlook for the coming months

When compared to the range of views driving markets at present, our assessment is more focused on the bigger picture and its more stable elements. It is hence rather binary in terms of what is most likely to happen (i.e., it will either be a "soft" or a "hard landing," see graph 4). At the same time, we acknowledge that sentiment will likely keep shifting more erratically for the foreseeable future.

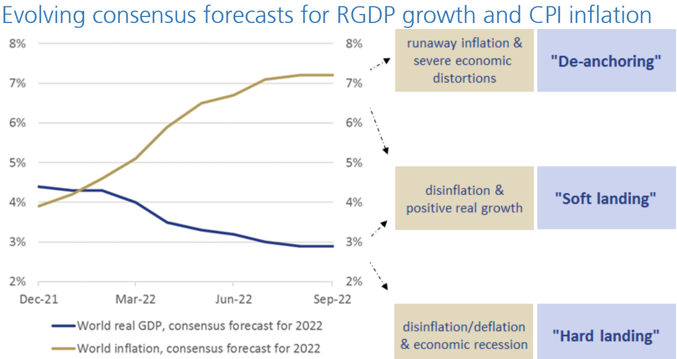
We believe the Fed will continue to tighten more aggressively than currently expected, as well as than most other central banks. This will support the US dollar and weigh on risk assets globally, due to the associated withdrawal of liquidity and rising debt-servicing costs. Simultaneously, as investors are generally positioned on the bearish side, occasionally in a very one-sided way, signs of declining inflation pressure, negative macro data surprises, and/or indications of an upcoming policy relaxation will continue to have the potential for meaningful, albeit rather short-lived rebounds in risk appetite.

That said, looking briefly into the next year and beyond, this policy will either succeed in bringing down inflation without causing a major recession, or fail and lead to a so-called hard landing, i.e., a meaningful recession (graph 4). The third possibility of a "de-anchoring" of long-term inflation expectations is not plausible at present in our view. Either way, inflation and interest rates are likely to stay at relatively high levels when compared to the norm of the past couple of decades.

Graph 4

A highly uncertain flight plan for 2023

Evolving consensus forecasts for RGDP growth and CPI inflation



RGDP = real gross domestic product. CPI = consumer price index.
Source: Bloomberg, LGT Capital Partners

Lastly, the global geopolitical environment has also changed significantly over the past few years. The various related tensions are likely to remain more entrenched in the aftermath of Russia's invasion of Ukraine, which will also have an impact on the longer-term macro environment. That impact is largely a restrictive one on the supply side, although potentially a more benign one on the demand side – at least in the economies that will remain open and continue to trade and invest in each other on friendly, interest-aligned terms.

Our longer-term, strategic asset allocation outlook is currently in discussion and will be finalized by end-year. In the meantime, we share our insight on key current issues and investment decisions, in the context of our defensive, yet flexible, investment strategy.

Fixed income has become fundamentally more attractive

Earlier this quarter, we decided to close our long-standing underweight in investment grade bonds, raising the allocation to a neutral position. In recent weeks, the gyrations in equity and fixed income markets have intensified noticeably, with the volatility in the government bond market reaching historic extremes.

In terms of level, the 10-year US Treasury yield exceeded the 4% threshold for the first time in 15 years, while real yields in the US jumped above 1.5%, marking a sharp rise from the -1.0% at the beginning of the year. Similar sharp rises in rates were observed in Europe, most notably so in the United Kingdom where the Bank of England already intervened with emergency liquidity injections to assure orderly markets.

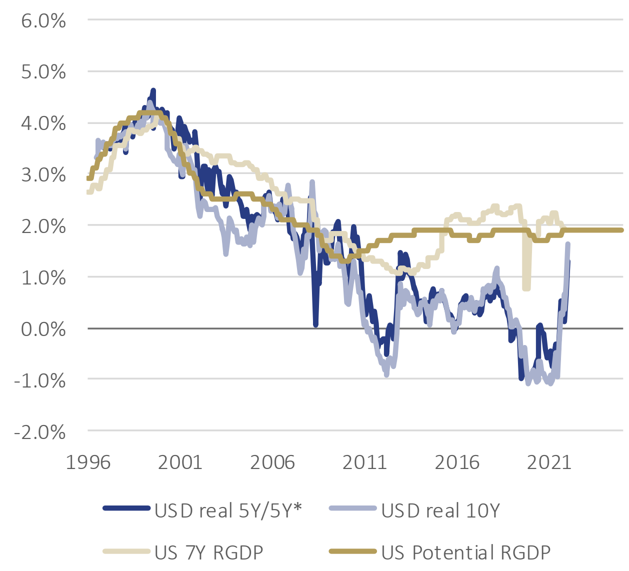
While neither the peak in inflation nor in the policy rates set by central banks can be assumed to certainly be behind us, we do believe that it may not be that far in the future. The macroeconomic data points toward a weakening of economies, which raises recession risks but on the positive side also provides some respite from fears of ever-higher interest rates.

Moreover, at current levels, investment grade bonds offer decent yields, and the chance to gain on a partial reversion of the hefty year-to-date moves. From a fundamental economic viewpoint, the current level of real interest rates is finally approaching reasonable levels – as they are now broadly in line with the potential economic growth rate (graph 5).

Graph 5

Real yields finally approach fundamental fair value

Real yields based on market-priced inflation expectations



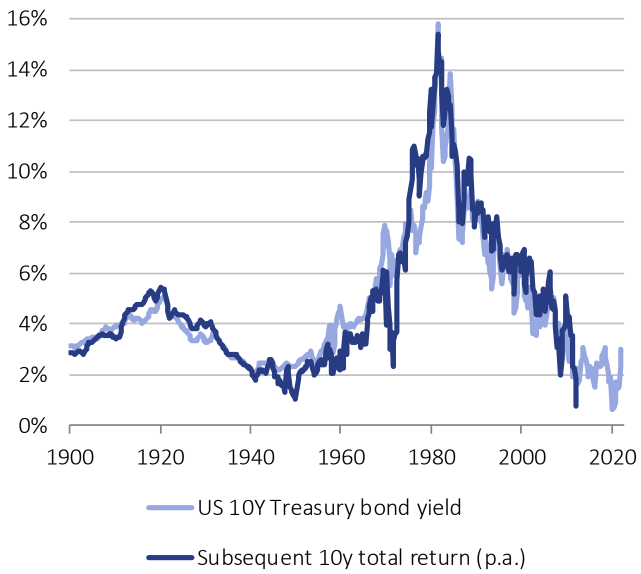
*10-year US bond yield minus 5 year/5year forward breakeven rate. RGDP = real gross domestic product.
Source: Refinitiv, LGT Capital Partners

If anything, real yields may by now be even above neutral, as many economists, including those at the Fed, argue that the pandemic may have lowered the potential growth rate from the generally assumed level of about 1.8%. The potential growth rate is theoretically equal to the so-called neutral interest rate, i.e., the rate that is neither restrictive nor stimulating economic activity. It is therefore a good proxy for the long-term fair value of government bonds. Given that long-term bond returns tend to track yields (graph 6), the risk-reward profile for the asset class has now improved, warranting an end to our pronounced underweight.

Graph 6

Bond returns track yields

10-year US treasuries, yield and annualized total returns



Source: Refinitiv, LGT Capital Partners

Finally, government bonds may coincidentally also regain some of their diversifying properties should markets and policymakers start shifting their focus from fighting inflation to supporting growth – in other words, bonds may provide some downside protection in a disinflationary scenario.

China's great leap downward

The Chinese Communist Party (CCP) concluded its 20th once-every-five-years national congress earlier this month, setting the basic policy parameters for the coming five years and selecting a new leadership for the country.

As expected by most accounts, party and state leader Xi Jinping cemented his supreme power. The new top leadership, which consist of seven members of the CCP Politburo's Standing Committee, now features Xi loyalists only. Moreover, several senior functionaries that international observers consider as more liberal and reform-minded were removed from key party organs or not appointed to new senior positions. The latter disappointed those investors and observers who had hoped that the personnel appointments will include at least some officials that they view as pragmatic, rather than ideological.

As far as the policy pronouncements are concerned, the congress confirmed the course that had become increasingly visible over the past few years. The party now puts a greater emphasis on state-led policies that prioritize broader national and social goals of a strategic and/or ideological nature, rather than simply creating conditions that support private economic activities for the purpose of general wealth creation and technological development. The later approach was arguably more prominent in the preceding decades. The language of the pronouncements also suggests that traditional Marxist-Leninist ideology seems to play a bigger role than in the past.

None of these developments were very surprising, however, as the writing has been on the wall for some time. The handling of the COVID-19 pandemic has shown that China is not inclined to alter course in response to international preferences or norms, or shy away from the potential socioeconomic costs of its policy choices.

The Chinese stock market has at least to some extent priced in a risk premium to reflect hard-to-assess political factors. Chinese equities have been very clearly underperforming the other major indices for about two years now (graph 7).

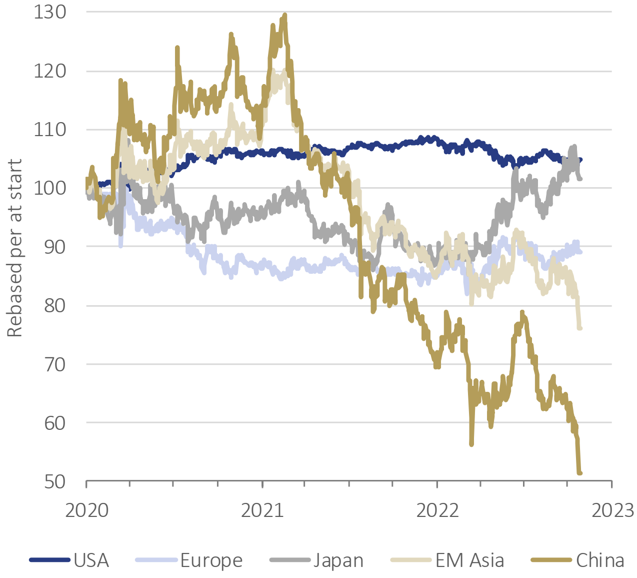
That said, domestic policy issues are not the only issues burdening the Chinese market and/or economic outlook at present. The country is at currently digesting a property market bust and an increasingly adverse international geopolitical environment – as highlighted by the most recent US decision to essentially deny Chinese companies access to the global supply chain for advanced semiconductors as well as the related technology and know-how, including human resources. Furthermore, it appears likely that the US and potentially other countries will continue to expand such measures to include other sectors as well.

From a cyclical viewpoint, the strengthened centralized authority could facilitate and speed up the implementation of macro policy measures designed to mitigate the de-leveraging of the property sector and thus support cyclical economic growth. COVID-19 related restrictions could also be eased going forward, which should have a positive impact on the economy as well. Furthermore, some parts of the Chinese economy will surely continue to grow over the longer-term as well, especially the sectors that are in alignment with the party's strategic priorities.

Graph 7

Chinese equities' great leap downward

Relative performance* of major equity market indices



*Return of the regional MSCI index vs. the MSCI World
Source: Bloomberg, LGT Capital Partners

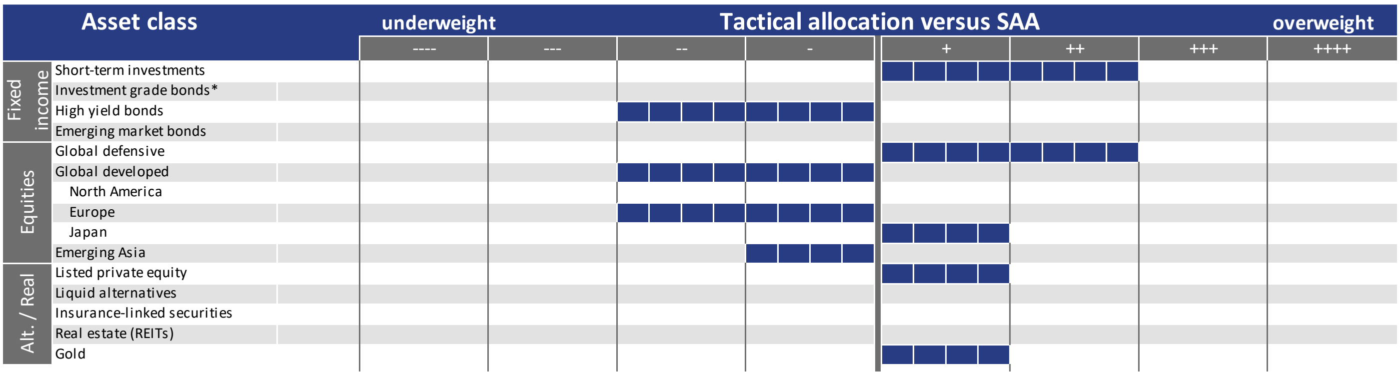
Concluding, in view of the broader economic and geopolitical background, the outcome of the 20th congress per se will not do much to restore the once-dominant confidence of international investors in the country's general economic prospects in the current, partly de-globalizing setting.

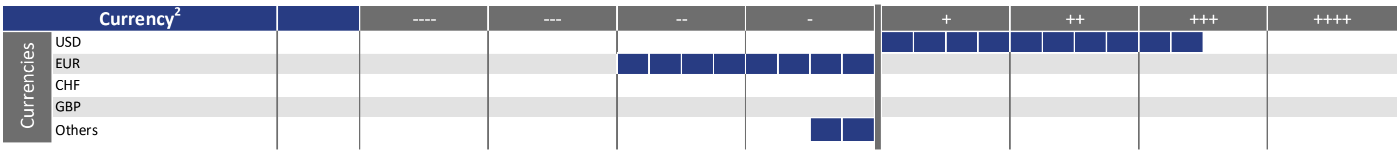
END OF REPORT

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: neutral overall duration, tilted in favor investment grade and EM bonds**
- **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**





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	-2.2%	-6.6%	-13.5%	-3.8%	0.0%
Global inflation linked bonds	USD	1.2%	-9.9%	-25.6%	-4.8%	-1.6%
Investment grade corporate bonds	USD	-2.1%	-5.6%	-12.9%	-2.2%	0.4%
High yield bonds	USD	-1.2%	-5.1%	-18.5%	-3.0%	-0.4%
Emerging markets, local currency*	USD	-3.3%	-4.7%	-20.0%	-8.5%	-3.9%
Emerging markets, hard currency*	USD	0.0%	0.0%	0.0%	0.0%	0.0%
Equities						
Global	USD	2.5%	-3.9%	-18.0%	7.0%	7.2%
Global defensive	USD	0.2%	-5.2%	-15.8%	0.5%	4.2%
North America	USD	2.7%	-4.2%	-20.6%	8.9%	9.2%
Europe	EUR	3.3%	-4.0%	-13.8%	2.3%	2.9%
Japan	JPY	-0.7%	-2.5%	-4.5%	7.1%	4.2%
Emerging markets	USD	-6.9%	-14.0%	-29.9%	-4.4%	-3.1%
Alternative and real assets						
Listed private equity	USD	5.5%	-9.9%	-34.5%	5.7%	6.3%
Hedge funds	USD	-2.1%	0.6%	-3.3%	4.5%	3.2%
Insurance linked securities (ILS)	USD	-9.9%	-8.0%	-8.0%	0.9%	2.2%
Real estate investment trusts (REITs)	USD	-7.9%	-18.2%	-32.2%	-4.8%	1.7%
Gold	USD	2.3%	-3.5%	-9.3%	3.3%	5.4%
Currencies (vs. rest of G10) [3]						
US dollar	USD	-1.0%	6.0%	15.8%	3.5%	3.5%
Euro	EUR	2.2%	3.0%	0.0%	-0.5%	-0.3%
Swiss franc	CHF	-2.5%	2.4%	5.2%	3.5%	3.4%
British pound	GBP	5.4%	0.6%	-3.4%	-0.6%	0.3%
Japanese yen	JPY	-4.3%	-2.8%	-12.3%	-7.6%	-2.3%
Canadian dollar	CAD	-1.2%	-0.6%	6.6%	1.9%	2.1%
Norwegian krone	NOK	1.5%	-0.3%	-3.5%	-1.1%	-2.3%

[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

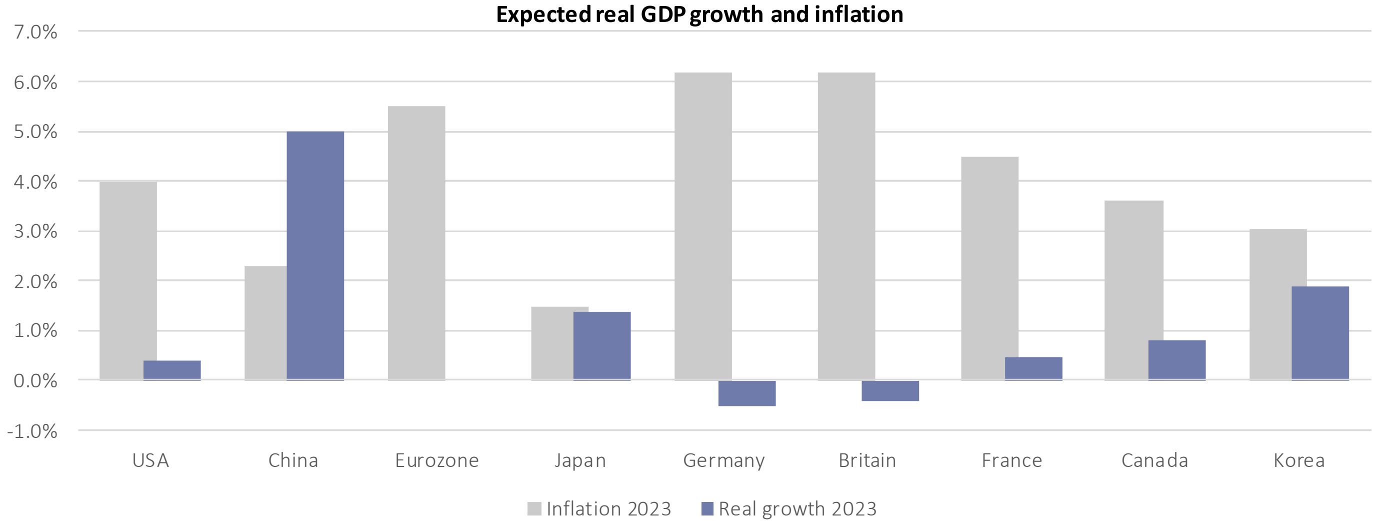
		USA	China	Eurozone	Japan	Germany	Britain	France	Canada	Korea
Gross domestic product (GDP)										
Nominal, this year[1]	bn USD	26'185	21'643	14'224	4'366	4'120	3'479	2'807	2'327	1'792
Per Capita, purchasing power parity[1]	USD, PPP	78'422	23'038	40'965	51'594	65'865	57'822	58'421	59'872	56'694
Real growth 2023	Consensus	0.4%	5.0%	0.0%	1.4%	-0.5%	-0.4%	0.5%	0.8%	1.9%
Real growth 2024	Consensus	1.4%	5.0%	1.6%	1.1%	1.6%	1.2%	1.7%	1.9%	2.4%
Real growth current quarter	Consensus	1.2%	4.5%	0.6%	1.1%	0.5%	0.1%	0.8%	1.1%	2.3%
Unemployment 2023	Consensus	4.7%	4.0%	7.1%	2.4%	5.5%	4.8%	7.6%	6.2%	3.5%
Inflation 2023	Consensus	4.0%	2.3%	5.5%	1.5%	6.2%	6.2%	4.5%	3.6%	3.1%
Inflation 2024	Consensus	2.5%	2.2%	2.1%	0.8%	2.5%	2.6%	2.1%	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	34	3'029	537	1'121	36	98	52	81	413
Govt bond yield 2yr [3]	% p.a.	4.4%	2.0%	2.0%	0.0%	2.0%	3.3%	2.0%	4.1%	4.4%
Govt bond yield 10yr [3]	% p.a.	4.1%	2.7%	2.2%	0.3%	2.2%	3.6%	2.7%	3.5%	4.3%
Main policy interest rate *	% p.a.	3.3%	4.4%	1.3%	-0.1%	1.3%	2.3%	1.3%	2.5%	3.0%
Spread 10y-2y treasury yield	Basis points	-33.2	67.0	21.8	26.7	21.1	29.0	72.6	-65.5	-1.5

[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	40'636	13'483	7'020	4'818	1'823	2'533	2'469	2'560	1'392
Growth in earnings per share, estimated (MSCI)										
12 months forward / trailing 12 montl	Consensus	16.0%	2.4%	29.5%	23.9%	28.2%	35.4%	55.1%	7.9%	-13.5%
Next fy / 12m fwd	Consensus	2.7%	2.8%	1.0%	0.8%	1.8%	-0.1%	0.3%	0.5%	-1.3%
Growth in revenue per share, estimated (MSCI)										
12m fwd / trail 12m	Consensus	6.3%	3.2%	5.6%	8.9%	5.6%	11.9%	28.3%	7.4%	2.7%
Next fy / 12m fwd	Consensus	1.4%	2.0%	0.5%	0.4%	0.8%	0.3%	0.3%	5.7%	0.6%
Valuations (MSCI)										
Price-Earnings Ratio (est 12m fwd)	Consensus	16.5	8.3	10.7	11.8	9.5	10.8	8.8	11.1	9.3
Price-Sales Ratio (est 12m fwd)	Consensus	2.2	0.7	0.9	0.9	0.7	1.0	1.0	1.6	0.6
Dividend yield	Consensus	1.7	3.2	3.8	2.7	4.2	3.5	4.5	3.4	2.6

** China market cap includes Hong Kong | Source: Bloomberg Data per: 25.10.2022

Expected real GDP growth and inflation



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