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Risks to growth are similar but not uniform

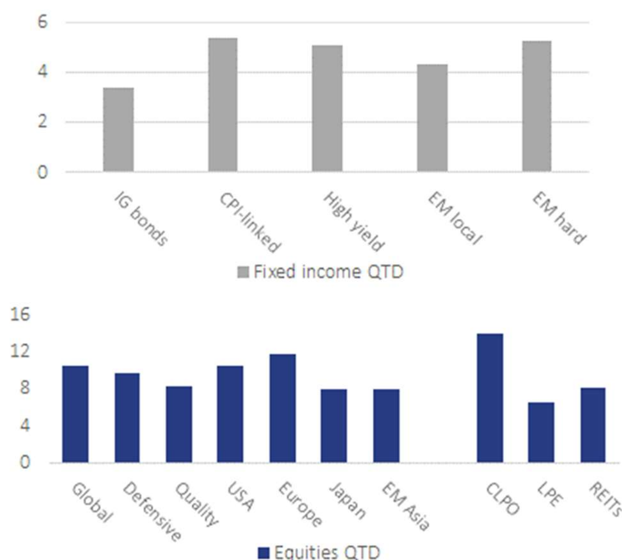
Marketing material

When investors' sentiment is one-sidedly bearish, even modestly positive news can lead to big relief rallies. This year's final quarter is hence shaping up as a risk-friendly one thus far. Notably, China has at last also joined the most recent global rebound. Nevertheless, a closer review of the situation shows that the outlook, while not uniform around the globe, remains challenging.

Market review: relief rally continues

The final quarter of 2022 is on track to potentially end on a positive note. Equity prices have generally kept advancing in recent weeks, while interest rates declined from their recent highs – which in turn bolstered riskier parts of the credit market. Notably, unlike during previous bear market rallies, China has at last joined the upswing as well. It is also worth noting that some of the less defensive elements in our allocation, like private equity-related parts of the public markets, also performed very well quarter-to-date (graph 1).

Graph 1
Performance of major market segments in our allocation
Quarter-to-date returns in %, per 21 Nov. 2022

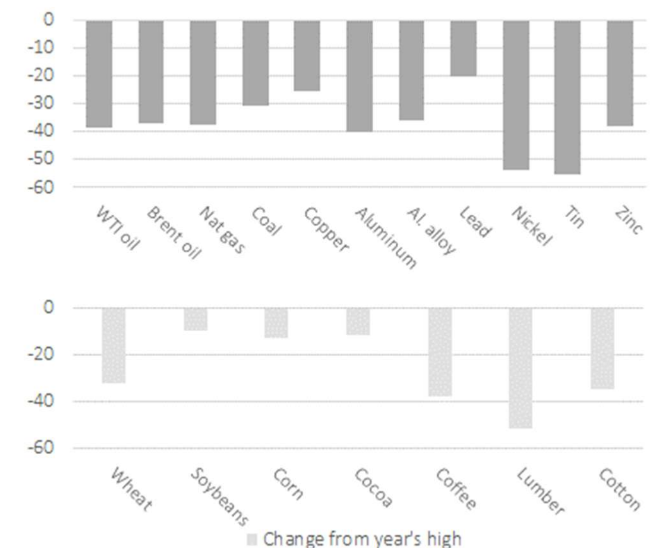


Reference indices used are the Bloomberg Barclays indices for bonds and MSCI indices for equities, except for the internally managed special strategies, such as CLPO. CLPO invests in small- and medium-sized companies that are still partly owned by private equity investors. LPE is a listed private equity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

If the quarter indeed ends up closing with such broad-based gains, it would be the first and only quarter to do so in 2022.

This current upswing was triggered by tentative signs that inflation may have indeed partly peaked. Firstly, global commodity prices are generally still trading well below their recent peaks (graph 2), while international supply chain pressures and the freight costs have also dropped markedly of late (graph 3).

Graph 2
Change in prices of hard and soft commodities
Price difference in % from 52-week high, per 21 Nov. 2022



Source: Bloomberg, LGT Capital Partners

Secondly, when the latest US inflation data, for October, showed that the annual price increases were smaller than expected, markets rallied. Looking at the bigger picture, the data show that inflation has only partly peaked (mainly in the goods segments) and that core inflation remains rather sticky. In short, the overall inflation problem is not resolved yet. Nevertheless, this moderately positive news was enough to revive hopes of a soft landing of the economy next year, at least in the US.

Thirdly, the Chinese government has communicated a gradual relaxation of its strict Zero Covid policy, along with macro policy

measures that make large-scale, cascading bankruptcies in its over-levered property sector unlikely the coming year – by essentially ordering banks to refinance most due loans to the broader sector for another year. Arguably, these decisions could usher in better conditions for a more normal and lasting cyclical recovery going forward. However, that too is only moderately positive news, as the overall debt-deflationary property overhang remains in place and will take time to digest.

Graph 3

Freight costs and supply chain pressures plummet

Indices rebased at the start of 2020

Source: Bloomberg, LGT Capital Partners

Fourthly, relatively good news also emerged in international politics. Most importantly, US President Joe Biden met with his Chinese counterpart Xi Jinping at the sidelines of the G20 summit, and both leaders agreed to tentatively reengage diplomatically to avoid an escalation of their existing tensions.

Finally, the US mid-term Congressional election results did not produce a strong shift in favor of the more divisive Republican candidates, while the G20 and COP27 summits also produced good news at the margin. The common thread of these events is that a more cooperative, compromise-oriented mindset is potentially taking root – against the background of the ongoing war in Ukraine, that would arguably reduce a further increase in international tensions.

The bottom line is that the current relief rally is not based on clearly game-changing news in either the economic or political spheres. And while recent developments were good enough relative to the bearish investors' sentiment, it remains to be seen how things play out in the coming months.

Outlook is not uniform, but remains challenging

Looking ahead, economic challenges remain in place in the coming months. Firstly, most of the good economic news are essentially limited to the US – and even those are still tentative and represent a double-edged sword. While US growth at present is stabilizing around its potential growth rate, which also means that the Federal Reserve might be forced to increase interest rates further than is currently expected, to engineer a deep recession that eradicates inflation. Moreover, even if the Fed pauses, the cumulated effect of this year's significant rate increases should also become more visible going into next year.

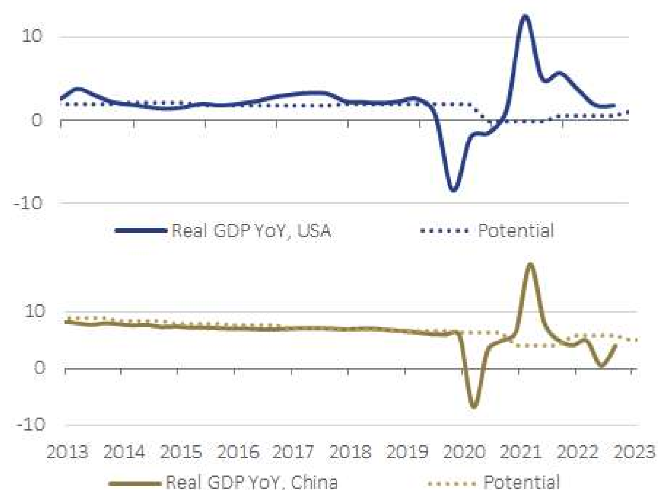
Looking at China, cyclical growth has bounced back noticeably in the last quarter from near zero, but the economy's is still performance well below potential, which in turn has been steadily declining for many years even without the Zero Covid policy and the property market problems. Moreover, the debt-deflationary overhang is likely to remain in place because the Chinese government's recent liquidity support measures for the broader property sector do not and cannot resolve the underlying issue quickly – that is, the need to write-off unrecoverable debt and malinvestment in the system in the longer term.

A true and sustained recovery is unlikely as long as the Zero Covid policy is not removed – which is not the case yet –, the country has largely digested its property bust, and its businesses and capital markets are able to interact with counterparts from other economies with less political or regulatory friction. In the foreseeable future, none of these points are likely to fully return to the ideal situation that China enjoyed during most of the past decade.

Graph 4

Cyclical versus potential output of the economy

Change in real GDP, year-on-year in %



Current potential GDP estimates by Bloomberg Economics. Source: Bloomberg, LGT Capital Partners

One the other hand, we cannot exclude a soft landing in the US either – i.e., that the hitherto US monetary tightening was just about the right dosage and that the inflation rate will continue to retreat toward 2% per year even without further tightening. An argument can be made that goods and labor supply issues resolve themselves naturally, while the pent-up post-pandemic demand for services also reverts to normal just in time. It might also be that Chinese authorities will fully abandon Zero Covid faster than anyone expects at present. Those paths to a soft landing are thus still possible. But a single month's worth of weaker-than-expected US inflation readings and Chinese policy pronouncements do not suffice to make that call.

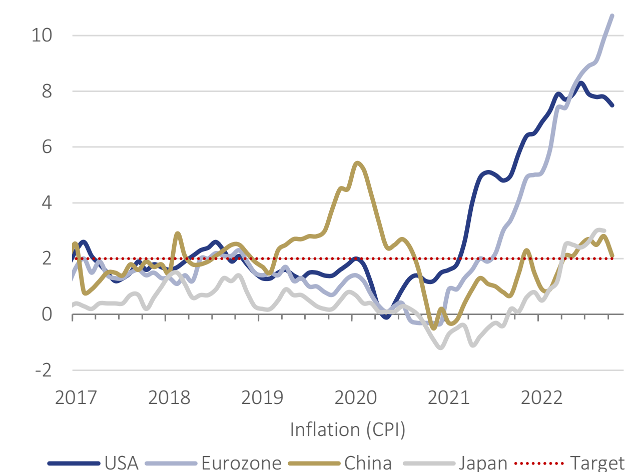
When all is said and done, while headline inflation seems to have peaked in the US, it is still climbing steadily in Europe, while China and Japan are each in their own distinct situation that makes domestic inflationary pressures much less acute

(graph 5). All three largest economic regions will continue to face economic headwinds, be it from the monetary side or due to other factors and limitations.

Graph 5

Inflation remains a challenge, albeit to varying degrees

Annual change in consumer price index, in %



Source: Bloomberg, LGT Capital Partners

Positioning: increase allocation to high yield credit

Overall, we keep our slightly defensive but flexible tactical positioning in place and focus on the overall risk exposure of the portfolio. In this context, it is worth noting again that the tactical positioning is measured against our strategic allocation, which includes a substantial weight of liquid alternatives, the quota which we raised at the end of last year in anticipation of more difficult markets. That strategic increase of strategies that mitigate the downside, along with our initially significant overweight in cash, has worked as intended this year, allowing us to keep a slightly higher tactical allocation to equities (i.e., broadly neutral) than we would have otherwise.

That said, over the past year, interest rates have risen significantly, and long-term government bond yields have started to come off their recent high of late, as the peak in policy rate-increases is becoming more visible on the horizon. Moreover, real interest rates have risen substantially this year (graph 6). In the US, they are now broadly corresponding to the potential economic growth rate, which means that valuations are now fair based on economic fundamentals.

This development makes fixed income generally more attractive as an asset class and hence we have been gradually reducing our underweight in this segment over the past year. Specifically, after largely avoiding them for most of the past decade, we increased our allocation to investment grade bonds in two steps, in April and October, back to neutral.

Graph 6

Real 10-year interest rates in major developed markets

Based on long-term inflation compensation instruments

Source: Bloomberg, LGT Capital Partners

In the meantime, more recently a slew of more upbeat economic and political news has somewhat revived investors' appetite for risk assets. Among these were the October US inflation print, which came in less hot than anticipated, China's tentative loosening of its COVID-19 policies and measures to support its ailing property market, and a potential thawing of US-China relations during the G20 meeting.

At the margin, the outlook for risk assets has slightly improved, as have the prospects for fixed income, and we decided to incrementally add to risk in our portfolios by reducing our underweight in high yield bonds, further bringing our overall underweight in fixed income closer to neutral. Spreads in the high yield segment are now at very attractive levels, even after accounting for higher defaults due to the economic slowdown and higher level of interest rates next year. Furthermore, borrowers hold elevated cash balances that act as a safety buffer and reduce issuance needs, mitigating the impact of reduced prospective earnings expectations due to the macroeconomic outlook.

Finally, base rates are expected to stabilize in the not-too-distant future, or at least slow their ascent on signs that we may have passed peak inflation. The elevated running yield makes this credit segment also more attractive versus many other asset classes that rely on capital appreciation.

The increase in our high yield allocation further reduces the cash position in our endowment, which is now only at a small overweight level, compared to a record level at the start of the year.

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 of 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**

Tactical allocation versus SAA (underweight … overweight)

	Asset class	----	---	--	-	+	++	+++	++++
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	1.9%	-3.8%	-11.1%	-2.8%	0.4%
Global inflation linked bonds	USD	7.5%	-6.6%	-22.0%	-3.0%	-1.0%
Investment grade corporate bonds	USD	3.1%	-2.7%	-10.2%	-1.3%	1.0%
High yield bonds	USD	5.1%	-2.1%	-14.8%	-1.5%	0.7%
Emerging markets, local currency	USD	5.1%	-1.8%	-15.0%	-6.3%	-2.6%
Emerging markets, hard currency	USD	0.0%	0.0%	0.0%	0.0%	0.0%
Equities						
Global	USD	6.3%	-4.3%	-13.7%	8.0%	8.0%
Global defensive	USD	8.2%	-2.8%	-10.1%	2.5%	5.3%
North America	USD	5.8%	-6.0%	-16.9%	9.5%	9.8%
Europe	EUR	9.0%	0.5%	-7.4%	4.5%	4.3%
Japan	JPY	5.0%	-0.8%	-0.1%	7.9%	4.9%
Emerging markets	USD	9.1%	-5.5%	-21.5%	-1.1%	-1.6%
Alternative and real assets						
Listed private equity	USD	15.9%	-3.1%	-27.6%	8.8%	8.9%
Hedge funds	USD	1.1%	-0.2%	-2.4%	4.6%	3.3%
Insurance linked securities (ILS)	USD	3.4%	-5.5%	-4.9%	2.0%	2.8%
Real estate investment trusts (REITs)	USD	11.0%	-13.3%	-24.8%	-0.6%	3.1%
Gold	USD	5.3%	0.6%	-4.5%	6.0%	6.4%
Currencies (vs. rest of G10) [2]						
US dollar	USD	-4.1%	1.1%	11.9%	2.4%	2.7%
Euro	EUR	0.5%	3.9%	0.1%	-0.4%	-0.3%
Swiss franc	CHF	0.6%	1.6%	6.4%	3.8%	3.5%
British pound	GBP	1.0%	1.2%	-3.6%	-0.9%	0.1%
Japanese yen	JPY	1.3%	-1.8%	-10.4%	-7.0%	-2.3%
Canadian dollar	CAD	-2.3%	-2.4%	4.8%	2.0%	1.6%
Norwegian krone	NOK	-1.0%	-3.5%	-5.2%	-1.8%	-2.3%

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

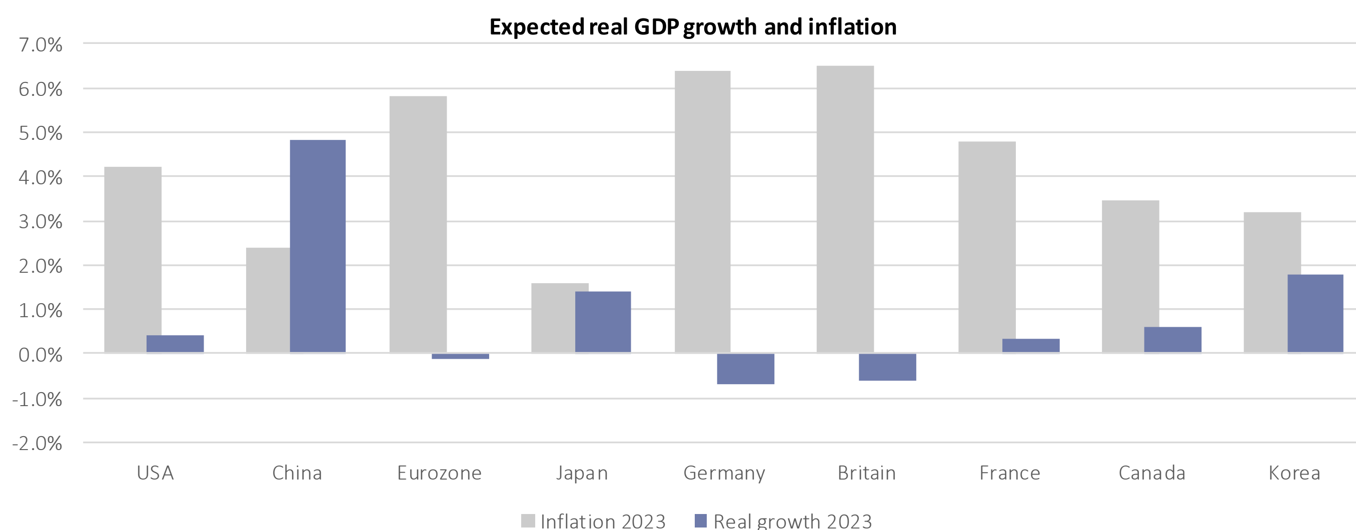
Economic and corporate fundamentals

		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%	4.8%	-0.1%	1.4%	-0.7%	-0.6%	0.3%	0.6%	1.8%
Real growth 2024	Consensus	1.3%	4.9%	1.5%	1.1%	1.3%	1.1%	1.2%	1.7%	2.5%
Real growth current quarter	Consensus	1.0%	4.4%	0.3%	1.1%	0.2%	-0.6%	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%	3.5%
Inflation 2023	Consensus	4.2%	2.4%	5.8%	1.6%	6.4%	6.5%	4.8%	3.5%	3.2%
Inflation 2024	Consensus	2.5%	2.1%	2.1%	1.0%	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	33	3,052	531	1,078	37	102	51	81	394
Govt bond yield 2yr[3]	% p.a.	4.5%	2.3%	2.1%	0.0%	2.1%	3.2%	2.0%	4.0%	4.0%
Govt bond yield 10yr[3]	% p.a.	3.8%	2.8%	2.0%	0.3%	2.0%	3.2%	2.5%	3.1%	3.8%
Main policy interest rate[4]	% p.a.	4.0%	4.4%	2.0%	-0.1%	2.0%	3.0%	2.0%	2.5%	3.0%
Spread 10y-2y treasury yield	Basis points	-72.1	52.3	-9.2	26.9	-10.0	6.0	47.1	-85.4	-24.9

[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	42,620	14,723	8,088	5,314	2,121	2,856	2,830	2,759	1,639
Growth in earnings per share, estimated (MSCI)										
12 months forward / trailing 12 montl	Consensus	12.3%	2.5%	24.7%	13.6%	25.0%	32.3%	44.2%	3.5%	-13.6%
Next fy / 12m fwd	Consensus	2.3%	1.9%	0.5%	0.5%	1.1%	-0.1%	0.1%	1.6%	-1.6%
Growth in revenue per share, estimated (MSCI)										
12m fwd / trail 12m	Consensus	3.5%	5.0%	2.0%	4.5%	2.4%	7.1%	16.9%	8.3%	-0.4%
Next fy / 12m fwd	Consensus	1.1%	1.3%	0.4%	0.2%	0.7%	0.3%	0.4%	1.3%	0.3%
Valuations (MSCI)										
Price-Earnings Ratio (est 12m fwd)	Consensus	17.5	10.0	11.6	12.5	10.8	11.9	9.5	12.0	11.2
Price-Sales Ratio (est 12m fwd)	Consensus	2.3	0.9	1.0	0.9	0.7	1.1	1.1	1.7	0.7
Dividend yield	Consensus	1.6	2.6	3.5	2.6	3.8	3.2	4.2	3.2	2.4

* China market cap includes Hong Kong | Source: Bloomberg — Data per: 21.11.2022



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