June 12, 2018

Tactical asset allocation for Q3/2018

Global economic growth is firm but set to moderate just as a number of factors, including the prospect of rising trade barriers, begin to underpin inflation outlook. In the context of our constructive, but defensively-titled strategy, we make several adjustments to further align our portfolios with our macro outlook and improve their longer-term risk-return profile.

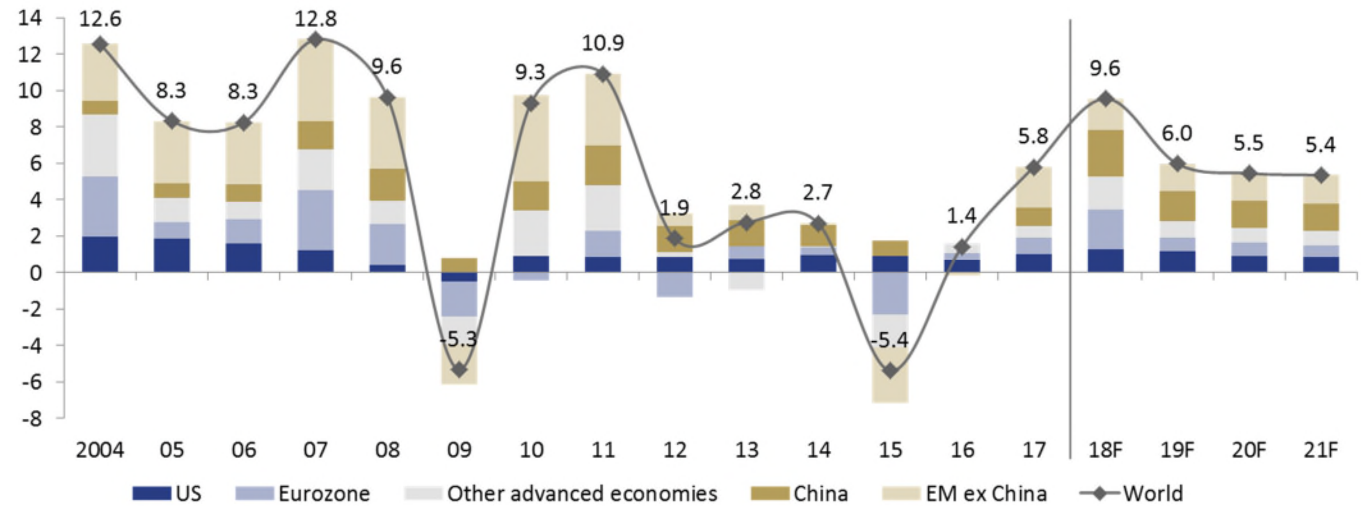
We have moderated our macro outlook somewhat, owing to the impact of higher US interest rates and the typical late-cycle inflationary factors. The remarkable rebound that followed on the heels of the commodity crash of 2014/2015 was always expected to start tapering out (graph 1). In addition, however, Washington's strong-armed trade policies have hardened recently, risking a backlash from rivals and allies alike. This creates new uncertainties that can trigger volatility and undermine a possible rebound in momentum in equity markets. In economic terms, rising trade barriers tend to lead to higher prices.

In Europe, the recent and rather laborious formation of a new Italian government with a mandate to curb immigration and boost social spending could revive political tensions within the eurozone, sap confidence in Italy's fiscal health and its reform capacity, and hence weigh on markets as well.

Graph 1

Global growth is strong but set to peak this year

(Nominal GDP in USD, % YoY, IMF forecast)



GDP = gross domestic product, YoY = year-on-year change
Source: LGT Capital Partners, Bloomberg, International Monetary Fund (IMF)

In the emerging markets (EM), rising US interest rates, a strong US dollar (USD), and the associated potential scarcity of USD liquidity, combined with the rise in energy prices, have led to rather indiscriminate selloffs recently. A wide range of markets with distinct, country-specific political and economic issues were impacted, ranging from Argentina to Turkey and Malaysia, forcing some central banks to hike interest rates to stem the capital flight. Although a lasting fallout should ultimately be limited only to the most fragile economies, i.e. those with their fiscal and current account balances in the red and weak institutions, general volatility may persist going forward, as several elections are due in the coming months (e.g. in Turkey, Brazil, Mexico).

Baseline scenario: moderating growth

To be clear, our baseline scenario remains quite positive, with most major economies continuing to expand near or above potential - as is typical this late in the cycle.

Some major markets, including the US, could very well deliver more upside surprises in the coming months. In most EM, which are in an earlier stage of their cyclical upswing, the underlying fundamentals also remain benign, and most countries are more capable of managing their policy challenges better than during previous US monetary tightening phases. Nevertheless, the business surveys have begun to point to a slowing economic growth going forward (graph 2).

Graph 2

Business surveys point to a cyclical peak

(Balance/diffusion index for PMI, lhs; annualized real GDP growth, % QoQ, rhs)

QoQ = quarter-on-quarter change, annualized
Source: LGT Capital Partners, Bloomberg, Markit

Risk scenario: stagflationary tendencies

The potential problem is that inflation pressures may not retreat in tandem, as is normally the case during such slowdowns.

Revived domestic demand, rising capital spending, and (in some cases very) tight labor markets create cyclical wage pressures and other capacity constraints. These forces could conspire with potentially higher energy prices and the prospect of rising international import tariffs, and underpin price gains in goods and services. The latest EM currency depreciations also boost local stagflationary forces, although there are extreme differences from region to region (graph 3).

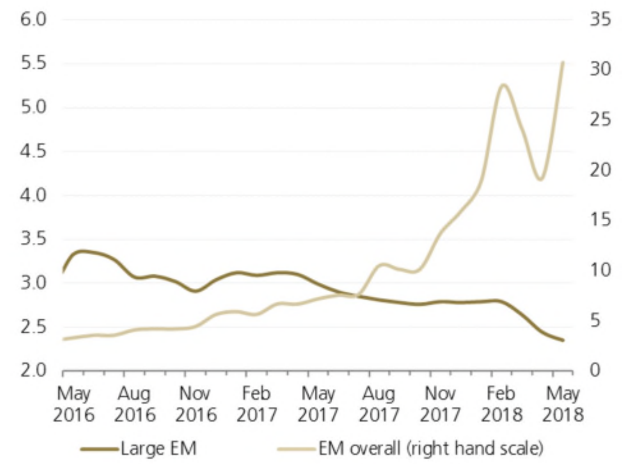
While that prospect may still sound quite benign from an economic viewpoint, it creates challenges for investors – because it means that the goldilocks situation of profitable, non-inflationary growth may be coming to an end.

Hence, in our alternative – and less likely – risk scenario, we expect the stagflationary element to become dominant, envisioning a global economy that offers less real growth, with significantly higher inflation rates.

Graph 3

Inflation outlook for the emerging markets

(Median of economists' forecasts for 2018, % YoY)



Large EM = Russia, India, China, South Africa. Forecasts weighted by nominal GDP in USD. Source: LGT Capital Partners, Bloomberg

Investment positioning: changes in our fixed income and equity allocations

In broad terms, our tactical asset allocation (TAA), i.e. our strategy for the coming three to six months, continues to combine a measured overweight in equities with a pronounced underweight in bonds, and a relatively short portfolio duration. We also hold on to ample liquidity reserves for tactical opportunities that may arise during volatile market phases. Still, we make the following changes to fine-tune the risk-return profile of our portfolios, and bring our strategy in line with our updated views on the economy and the markets:

- **Buy inflation-linked bonds** – based on our views on inflationary risks and the segment's modest but stable relative trends
- **Buy EM hard-currency bonds** – an opportunistic action: economic fundamentals and security valuations remain or have become more attractive; and risk is adequately priced following the recent EM selloffs
- **Sell commodity producers' equities** – a strategic-level decision: the sector's strong rally over the past couple of years has closed the once large undervaluation gap that had emerged after the last commodity bear market, while the long-term outlook for commodity prices is less clear
- **Buy the broader equity markets, with a preference for developed markets and defensively-managed strategies** – this move redistributes the proceeds from the sale of commodity equities, and is in line with our longer-term portfolio construction considerations
- **Sell equities in Asia-Pacific excluding Japan** – the technical picture has deteriorated somewhat and the region is most exposed to the risk of increasing trade protectionism
- **Close the position in favor of the Norwegian krone (NOK) against the Australian dollar (AUD)** – this tactical trade has not worked out, and our conviction no longer holds

With these changes, our overall equity market exposure (i.e. including our positions in the alternative assets segment) has declined somewhat, while the fixed income quota has modestly risen. The cash element remains very high, but has also dropped slightly. In foreign exchange, except for our passive overweight in EM currencies versus of the base currency of each portfolio, we undertake no active positions from a TAA viewpoint.

Fixed income: buying inflation-linked bonds and EM local currency debt

The overall fixed income quota is now somewhat less underweight, with duration kept below neutral (relative to our strategic asset allocation, SAA). The segments are positioned as follows (change from the previous quarter in brackets):

- **Short-term investments:** strong overweight (reduced)
- **Global government bonds:** underweight (unchanged)
- **Global inflation-linked bonds:** small underweight (reduced)
- **Investment grade corporates:** underweight (unchanged)
- **High yield bonds:** underweight (unchanged)
- **EM bonds:** overweight (increased)

The quota in inflation-linked bonds has risen closer to neutral in line with our adjusted inflation outlook. However, we note that we do not expect an extreme upsurge in inflation. Rather, we believe that current late-cyclical economic dynamics, aided by political developments, are making it easier for most major economies to hit, moderately exceed, or remain slightly above the respective inflation rate targets.

Graph 4

Inflation-linkers: modest but stable outperformance

(Total return vs. sovereign bonds, rebased)

Total return indices: Bloomberg Barclays LGT Custom Weighted Inflation-Linked Index, Bloomberg Barclays Intermediate Corporate Index, ICE BofAML Global High Yield Constrained Index. The performance is shown relative to the benchmark J.P. Morgan Hedged USD GBI Global Bond Index for global government bonds. Source: LGT Capital Partners, Bloomberg

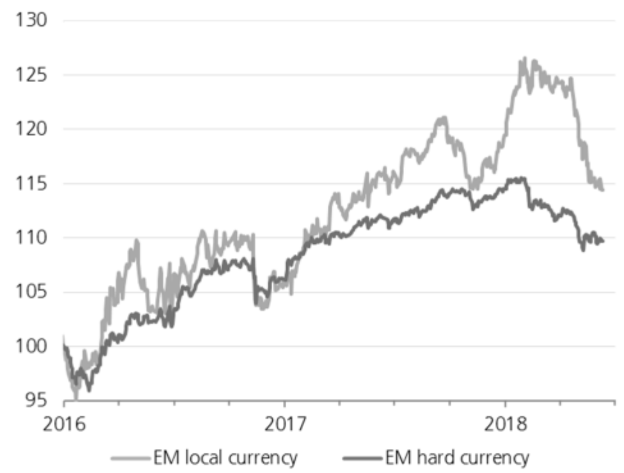
The overweight in EM bonds is the combined result of a reduced underweight in EM hard-currency bonds, and an unchanged overweight in EM local-currency bonds. The EM space remains our only overweight in the fixed income segment.

Even though US base rates are likely to continue to gradually rise, the recent EM selloff has rendered the risk premia, or spreads, sufficiently attractive in our view. In addition to the extra yields offered, EM currencies have also depreciated to attractive levels in many cases, while economic fundamentals remain positive.

Graph 5

EM bonds: buying the significant dip in prices

(Total return vs. sovereign bonds, rebased)



Total return indices: J.P. Morgan EMBI Global Diversified Composite for hard-currency EM bonds, J.P. Morgan GBI-EM Global Diversified Unhedged USD for local currency EM bonds. The performance is shown relative to the benchmark J.P. Morgan Hedged USD GBI Global Bond Index for global government bonds. Source: LGT Capital Partners, Bloomberg

Equities: redistributing proceeds from selling commodity producers' equities

The overall equity exposure has declined somewhat, due to the closure of the commodity producers' equities position, but remains modestly above the strategic neutral quota. The regional allocation is now as follows:

- **Global defensive equities:** modest overweight (increased)
- **North America:** modest overweight (increased)
- **Europe:** small overweight (increased)
- **Japan:** small overweight (unchanged)
- **Asia-Pacific ex Japan:** marginal overweight (reduced)
- **EM:** modest overweight (unchanged)

The new weights result almost exclusively from our decision to sell the commodity producers' equities position, which we explain further on in this report. Nevertheless, with our broader strategic asset allocation (SAA) in mind, these redistributions reflect a slight preference for more established and less volatile markets in general and the US in particular. Defensive equities are securities from various sectors that are less volatile than the overall market on average over the longer term.

Graph 6

Equities: broader bull market remains intact

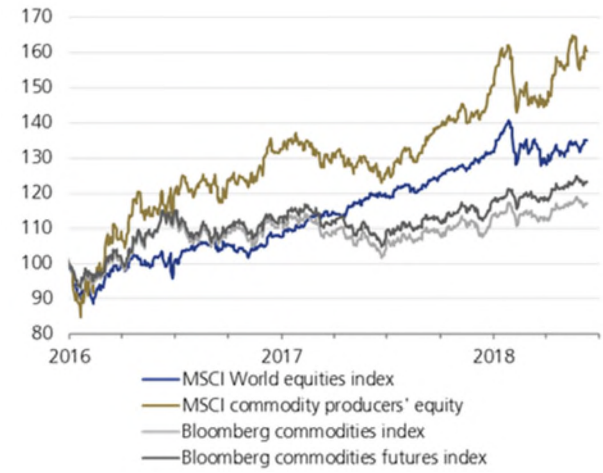
(MSCI total return indices, rebased)

Source: LGT Capital Partners, Bloomberg

Graph 7

Commodity equities: not value case anymore

(MSCI total return indices, rebased)



Source: LGT Capital Partners, Bloomberg

Separately, we have also cut our equity allocation to Asia-Pacific excluding Japan to marginally above neutral, primarily due to a weaker technical picture, and because the region's economic outlook is more sensitive to changes in the international trade and supply chain system. The overweight in Japan remains unchanged.

Real assets: closing commodities producers' equities position

In the real assets segment, we have gone from neutral to an underweight, due to the complete closing of the mentioned commodity equities position:

- **Commodity producers' equities:** position closed, zero
- **Real estate investment trusts:** neutral (unchanged)
- **Infrastructure:** neutral (unchanged)

The decision to sell commodity equities was taken with broader strategic and portfolio considerations in mind. We had identified the sector as a value case following the severe commodity slump that lasted until early 2016. At the time, we had chosen to shift our SAA position in commodities from the futures markets into resource company stocks, which offered a more attractive way to gain the desired exposure to this segment of our SAA.

Over the past two years, the sector has indeed materially outperformed the physical commodity markets (represented by an index of commodity futures contracts), as expected. However, commodity producers'equities have not outperformed the broader global equity markets in a meaningful way when adjusted for the volatility (graph 7). Commodity producers' equities hence offer a less attractive risk/return profile that the broader equity markets – i.e. the sector is rather volatile and delivers lower returns per unit of risk over time. This is unlikely to change going forward. Meanwhile, the extreme valuation discount has faded, and our scenario-based revised expected returns for resource equities are now lower than for equities in general.

In terms of the industry outlook, on the back of the mentioned rebound in commodity prices and the typical late-cycle dynamics, the sector's cost- and capital-budgeting discipline may start to fade going forward, eroding returns to shareholders.

As for the inflation-protecting properties of the asset class, we expect the link between economic activity and commodity prices to be weaker in the current growth cycle. Technological innovation has rendered economies generally less resource-intensive, while the supply-side has become more flexible, especially in the energy sector – due primarily to the rise of the US shale oil and gas industry. Demand for base metals for construction and engineering, meanwhile, is likely to stay rather moderate when compared to a decade ago, when the US was going through a housing boom, and China was in an earlier phase of its infrastructure build-up.

Our investment committee has therefore decided to close the SAA position in commodity producers'equities, and redistribute the quota in the mentioned broader equity markets. However, we continue to be invested in the commodity segment either directly or indirectly, with the exact sector allocations being generally left to be handled at the discretion of the respective managers, within the agreed investment approaches.

Formally, the SAA change will be instituted at end of year, as part of our annual SAA review process. However, we decided to start implementing this shift in stages over the coming months and therefore show the change with immediate effect.

To conclude the broader alternative investments segment: we made no changes in Listed Private Equity (underweight), hedge funds (neutral) and insurance-linked securities (neutral).

Currencies: no new active positions

We close our Norwegian krone (NOK) position against the Australian dollar (AUD) with a small loss. Contrary to our initial expectations, the NOK did not benefit from the recent surge in crude oil prices. In addition, dovish expectations have prevailed regarding Norway's monetary policy outlook. Should the European Central Bank decide to extend its monetary stimulus, Norges Bank would also be inclined to postpone any rate hikes. Conversely, the macro figures out of Australia surprised on the positive side recently. In short, our conviction in the trade no longer holds.

We have also decided not to open any new active positions, as we lack strong convictions at present, given the more fluid and volatile market conditions.

Lastly, we maintain a passive overweight in EM currencies, resulting from our active positions in respective equity and bond markets. By design, this overweight reduces the weight of base currency of the portfolio, i.e. the USD in the case of our model portfolio, as shown on the following page.

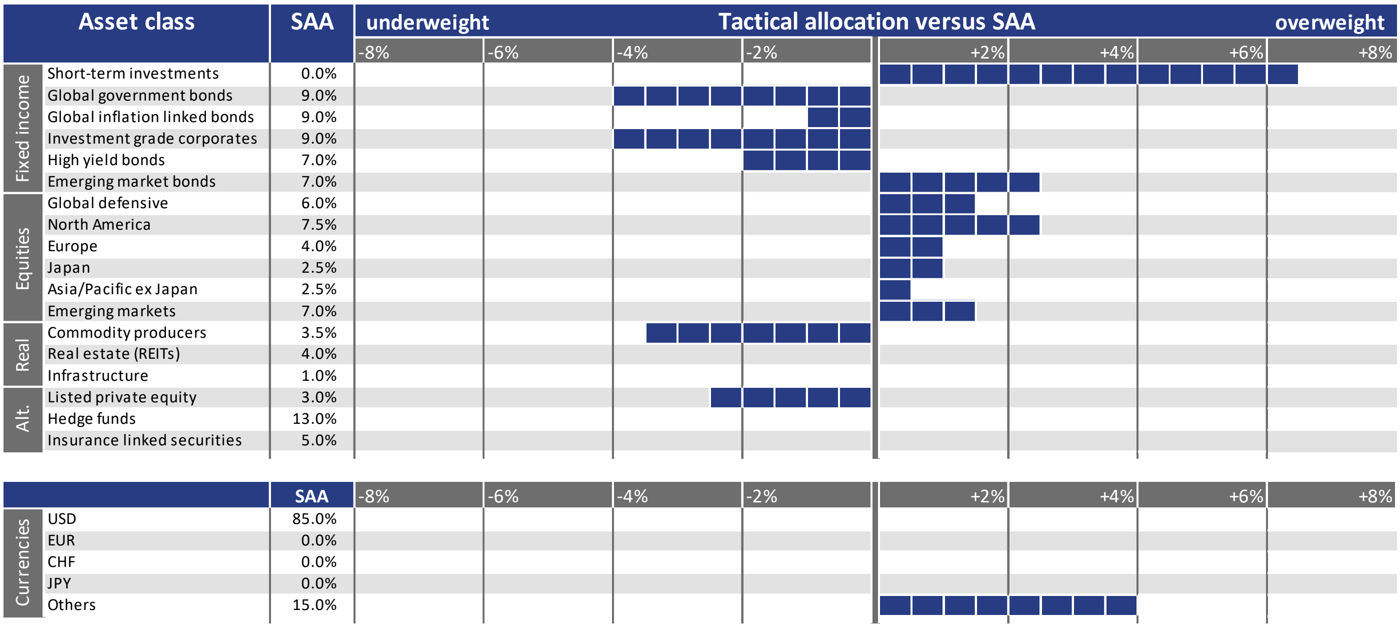
The next LGT Beacon will be published in mid-July and update readers and investors on any changes in our macro house view and/or our tactical positioning in financial markets.

END OF REPORT

LGT Capital Partners: tactical asset allocation for a balanced model portfolio in USD

Our tactical asset allocation (TAA, positions versus neutral strategic quotas) is set every quarter with a time horizon of three to six months and reviewed monthly, as well as ad-hoc, when needed. Further action may be implemented for purely technical reasons at any time. The current TAA was last revised on June 8, 2018.

- **Moderate overweight in equities, large underweight in fixed income (except for EM debt), very high cash reserves**
- **Real/alternative assets: generally underweight (in sum)**
- **Currencies: no active positions, passive overweight mainly in EM relative to base currency**



The TAA positions shown are based on the LGT GIM Balanced (USD) strategy managed by LGT Capital Partners AG. The TAA can be transferred to similar portfolios as a general rule, but investment restrictions or liquidity considerations may lead to deviations in implementation. In currencies, "others" represents indirect exposures resulting from over-/underweights of unhedged positions in markets, against a portfolio's base currency; the effective position of the base currency may thus deviate from the direct tactical position shown above.

Performance of relevant markets

		1 month	3 months	Year to date	3 years, p.a.[1]	5 years, p.a.[1]
Fixed Income						
Global government bonds	USD	-0.3%	0.2%	-0.4%	2.6%	3.0%
Global inflation linked bonds	USD	0.5%	1.2%	0.5%	2.3%	1.4%
Investment grade corporate bonds	USD	0.2%	0.0%	-1.8%	2.2%	2.4%
High yield bonds	USD	-0.5%	-1.2%	-1.0%	5.4%	4.8%
Emerging market bonds	USD	-1.5%	-4.0%	-4.6%	4.3%	2.7%
Equities						
Global defensive	USD	0.8%	0.3%	0.5%	8.7%	9.7%
North America	USD	2.0%	0.4%	4.4%	10.6%	12.3%
Europe	EUR	-2.0%	3.1%	0.5%	4.6%	8.5%
Japan	JPY	-0.7%	4.6%	-1.1%	3.2%	10.9%
Asia/Pacific ex. Japan	USD	0.1%	-0.9%	1.4%	8.8%	8.4%
Emerging markets	USD	-2.3%	-5.4%	-1.2%	7.6%	6.0%
Real assets						
Commodities (commodity producers' equities)	USD	-0.1%	11.6%	6.7%	5.9%	2.4%
Real estate (real estate investment trusts, or REITs)	USD	1.1%	5.7%	0.6%	5.8%	6.9%
Infrastructure (master limited partnerships, or MLPs)	USD	3.8%	5.6%	1.8%	-6.7%	-3.0%
Alternatives						
Insurance linked securities (ILS)	USD	0.6%	1.7%	3.4%	4.7%	5.5%
HF CTA	USD	-3.2%	-2.3%	-5.3%	-2.1%	1.8%
HF equity long/short	USD	1.6%	1.4%	2.3%	4.9%	5.7%
HF event driven	USD	1.7%	1.5%	2.1%	4.1%	4.6%
HF relative value	USD	0.9%	1.5%	2.1%	3.7%	4.2%
Listed private equity	USD	0.7%	-0.5%	1.9%	8.4%	10.8%
Currencies [2]						
US dollar	USD	0.3%	3.4%	1.5%	0.9%	3.7%
Euro	EUR	-0.9%	-1.2%	-0.3%	2.7%	1.0%
Swiss franc	CHF	1.9%	-0.6%	0.2%	-1.1%	2.3%
Norwegian krona	NOK	-0.2%	-0.4%	3.7%	-0.1%	-3.6%
Australian dollar	AUD	1.3%	-0.1%	-1.4%	0.2%	-1.1%
Japanese yen	JPY	-0.3%	0.1%	4.2%	5.3%	0.7%

[1] Annualized returns [2] Currencies are represented by Bloomberg's correlation-weighted indices (BCWI), which measure a currency against the remaining ten other major freely convertible currencies, to show the broader strength / weakness of a currency.

Economic and corporate fundamentals

Macro fundamentals		USA	Eurozone	China	Japan	Germany	Britain	Brazil	Russia	Switzerl.
Gross domestic product (GDP)										
- nominal	bn USD	19,391	12,607	12,015	4,872	3,685	2,625	2,055	1,527	679
- nominal, per capita 2017[1]	USD, PPP	59,501	38,322	16,660	42,832	50,425	44,118	15,603	27,834	61,422
- expected real growth for 2017	Consensus	2.3%	2.5%	6.9%	1.6%	2.5%	1.7%	1.0%	1.5%	1.0%
- expected real growth for 2018	Consensus	2.8%	2.3%	6.5%	1.2%	2.3%	1.4%	2.5%	1.8%	2.1%
- real growth in most recent quarter[2]	q/q annualized	2.2%	1.6%	5.7%	-0.6%	1.2%	0.4%	1.6%	-2.3%	2.4%
Unemployment rate[3]		3.8%	8.5%	3.9%	2.5%	5.2%	4.2%	8.2%	4.9%	2.6%
Inflation, core rate (CPI)	y/y	1.8%	1.1%	1.9%	0.1%	1.4%	2.1%	2.9%	2.0%	0.4%
Purchasing manager indices (comp.)	Neutral = 50	56.6	54.1	52.3	51.7	53.4	54.5	49.7	53.4	62.4
Structural budget balance/GDP 2017	IMF	-4.6%	-0.6%	-4.0%	-4.0%	0.9%	-2.3%	-6.4%	-1.4%	0.2%
Gross government debt/GDP 2017	IMF	108%	87%	48%	236%	64%	87%	84%	17%	43%
Current account balance/GDP 2017	IMF	-2.4%	3.5%	1.4%	4.0%	8.0%	-4.1%	-0.5%	2.6%	9.3%
International currency reserves	bn USD	43	278	3,111	1,193	37	124	185	376	813
Govt bond yield 2yr[4]	p.a.	2.52%	-0.46%	3.30%	-0.13%	-0.63%	0.78%	9.34%	7.57%	-0.74%
Govt bond yield 10yr[4]	p.a.	2.96%	0.71%	3.74%	0.05%	0.47%	1.43%	9.78%	8.10%	0.05%
Main policy interest rate[5]	p.a.	1.75%	0.00%	4.35%	-0.10%	0.00%	0.50%	6.50%	7.25%	-0.75%

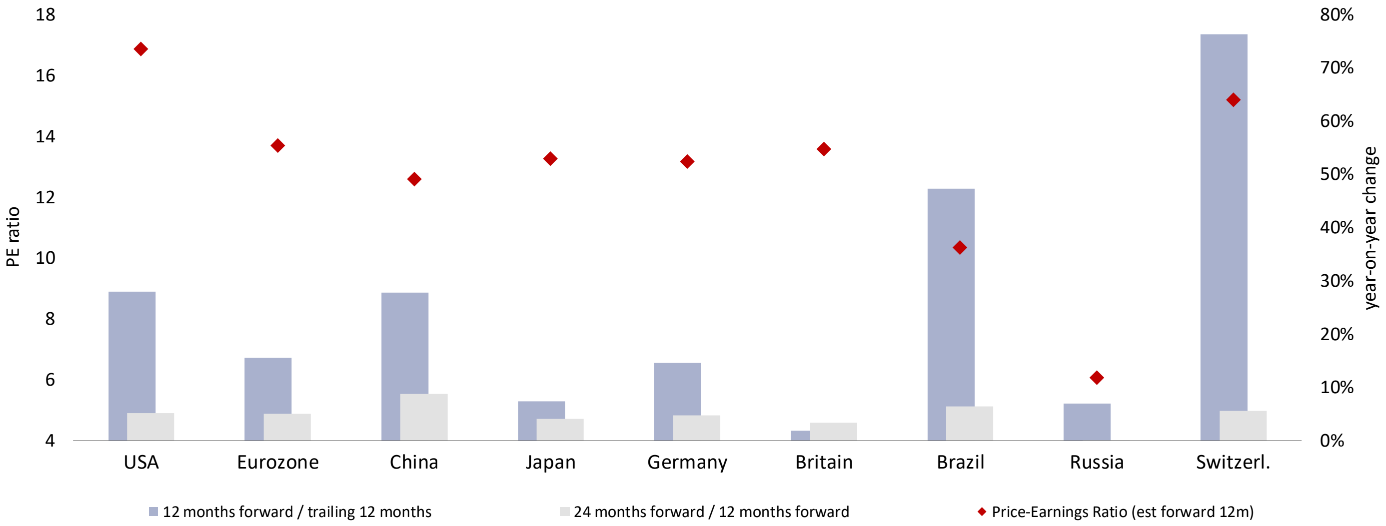
[1]IMF estimates. [2]annualized, most recent qtr. [3]PRC ex. migrant workers. [4]Currency swap rates for China and Brazil, closest ESM or EFSF bonds for Eurozone. [5]Max target rate for Fed, middle of the target range for SNB

Corporate fundamentals		USA	Eurozone	China	Japan	Germany	Britain	Brazil	Russia	Switzerl.
Exchange capitalization*	bn USD	30,911	8,261	13,054	6,396	2,392	3,800	764	597	1,593
Growth in earnings per share, estimated (MSCI)										
12 months forward / trailing 12 months	Consensus	28.0%	15.6%	27.9%	7.5%	14.7%	1.9%	47.4%	7.1%	76.4%
24 months forward / 12 months forward	Consensus	5.2%	5.0%	8.8%	4.1%	4.8%	3.5%	6.5%	0.1%	5.7%
Growth in revenue per share, estimated (MSCI)										
12 months forward / trailing 12 months	Consensus	5.1%	3.4%	12.9%	2.8%	3.2%	2.5%	6.2%	2.6%	4.4%
24 months forward / 12 months forward	Consensus	5.2%	2.6%	11.4%	3.0%	3.4%	1.5%	6.6%	3.3%	2.0%
Valuation metrics (MSCI)										
Price-Earnings Ratio (est forward 12m)	Consensus	16.9	13.7	12.6	13.3	13.2	13.6	10.4	6.1	15.2
Price-Sales Ratio (est forward 12m)	Consensus	2.1	1.1	1.5	0.9	0.9	1.2	1.3	0.8	1.9
Dividend yield	Consensus	1.0%	3.3%	2.1%	2.2%	3.0%	4.3%	4.1%	8.1%	3.6%

*Includes Hong Kong. Source: Bloomberg

Current equity market valuations and earnings growth expectations

(Implied growth based on Bloomberg BEst Estimates for the next 12 to 24 months)



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