Tactical asset allocation for Q3/2021

Marketing material

Owing to their timely and generous macroeconomic policies and comparatively fast inoculation drives, most major economies are now reaping extraordinary cyclical upswings. At the same time, this bright outlook is now widely acknowledged, while inflation has appeared as potential spoilsport. We trim our risk exposure somewhat to account for this more nuanced situation.

Following the conclusion of LGT Capital Partners' quarterly tactical asset allocation review last week, today we provide a summary of our multi-asset portfolio investment strategy.

Economic recovery is in full swing, but everyone agrees on that by now

The global economic recovery is in full swing. Inoculation campaigns against COVID-19 are gaining traction and governments are gradually relaxing lockdown measures – albeit not without setbacks, as recent developments out of Asia and the United Kingdom show.

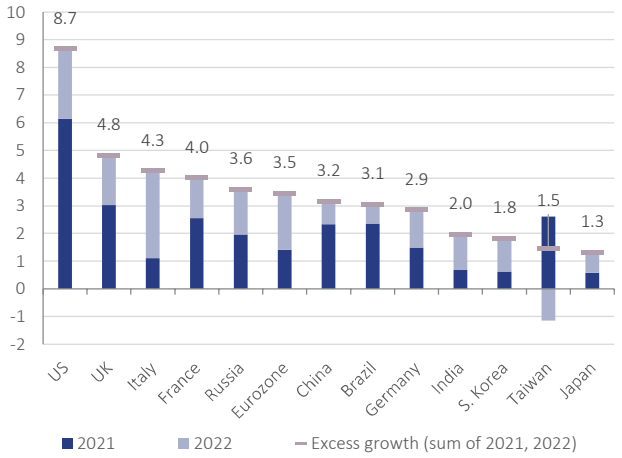
Regional disparities also exist in terms of economic developments: owing to the timely and generous monetary and fiscal responses to the outbreak of COVID-19 in 2020, the Western economies are showing remarkable momentum. In fact, most major economies are likely to grow significantly above potential this year and next, with the US set to outgrow them all by a big margin (graph 1).

For investors, the focus has long shifted to post-pandemic economics, and markets have generally remained upbeat, with inflation being the most debated topic currently. The performance of the broader markets generally reflects these themes, with asset classes and sectors that benefit from this reflationary rebound outperforming during most of this year (graph 2).

More recently, US consumer price indexes have spiked up, driven by base effects in energy, strong housing demand and bottlenecks in supply chains around the world. While these effects are transitory in nature, there is a possibility that the pre-pandemic low inflation environment may not return. Pent-up consumer demand in conjunction with large government spending on infrastructure and instrumental central banks could prove potent enough to support inflationary growth beyond this year and next.

A pivotal piece for an inflation regime-shift is the wage-price spiral, however, and the dynamics there are still tepid. Thus, for now, central banks are determined not to over-react and tighten monetary support prematurely. This means that they will roll back asset purchases and consider rate hikes only when economies can reach full employment.

Graph 1
Strong cyclical rebound in the West
(Cumulative excess growth* of GDP in 2021 and 2022)

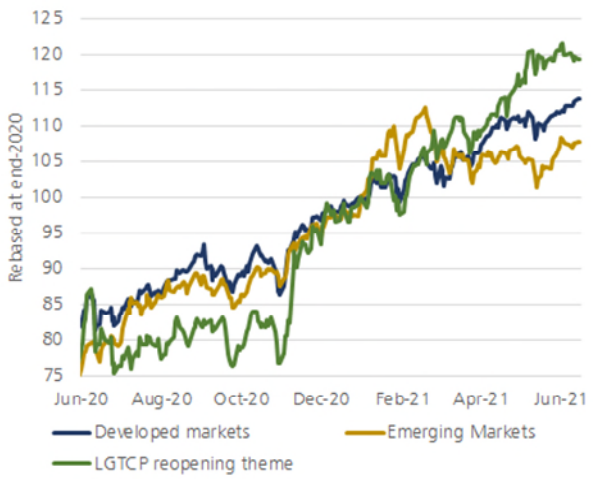


*Annual expected growth in gross domestic product that exceeds the estimated potential growth rate of the economy. Source: Bloomberg, LGT Capital Partners

The proposed global minimum tax rate will likely create costs for multinational firms, most notably the big tech companies. At the same time, unlike sudden and largely unexpected regulatory action, such as recently observed in China, the multilateral cooperative approach outlined by the G7 and their OECD partners significantly softens the immediate potential impact of the idea on markets. Ratification and implementation of a global tax will probably take years, after all, allowing for businesses and investors to prepare.

On geopolitics, markets have become more relaxed despite the fact that the strategic rivalry between China and the US evidently persists. Investors seem to have learned to live with a manageable level of tension overall, at least for now.

Graph 2
Broad equity market indices
(Rebased to 100 per end-2020)



MSCI indices used for global developed and emerging markets. The LGTCP reopening index is a proprietary index, based on 25 companies that we expect to benefit from the current reflationary reopening of the economy. Source: Bloomberg, LGT Capital Partners

Portfolio positioning: raising a bit of cash

Our tactical positioning remains tilted in favor of the global reflation idea, with bond duration held short and equities at a small overweight on aggregate. As long as real bond yields remain depressed and the economy expands, growth-sensitive assets should remain well bid, the occasional turbulence notwithstanding. In our view, current inflation dynamics reflect a stronger economy and demand for consumption and generally favor a risk-friendly overall stance.

A tail risk to this view would be a stagflationary turn, wherein central banks move to rein in de-anchored inflation expectations and hurting the real economy and rerating financial assets in the process.

While we believe the bull market remains generally intact, we decided to take some profit and raise a small cash position to account for the rise of these inflationary concerns among investors. The inflation topic admittedly has the potential to disrupt markets.

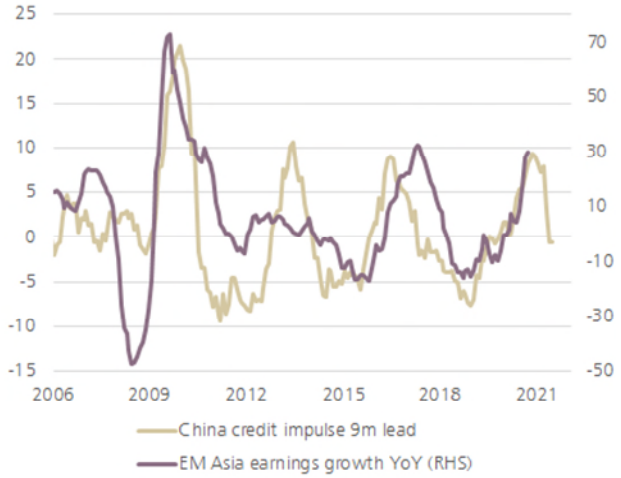
In addition, market valuations, investor sentiment and positioning indicators suggest that market participants may be close to fully pricing in these positive economic developments in many cases. The potential for even more positive surprises has probably diminished, at least for now. Going into the new quarter, we thus implement the following tactical positioning:

Equities: modest overweight maintained after reduction in emerging markets

We scale back emerging market equities (representing largely Asia) to neutral. The ongoing credit tightening bias in China is liable to continue to acts as a headwind.

The country's early emergence from the pandemic offered a tailwind for the region's corporate earnings last year, but this factor is going to abate going forward, as Chinese demand moderates incrementally from here (graph 3).

Graph 3
Chinese credit tightening will create headwinds
(Credit impulse, % of gross domestic product)



Source: Bloomberg, LGT Capital Partners

At the same time, spreading virus mutations combined with low vaccination rates have resulted in the renewed curtailment of economic activity in some Asian economies. We thus deem a neutral position more adequate. Developed markets remain modestly overweight, with Japan and Europe receiving the best overall assessment, based on their respective cyclical catch-up dynamics and relative valuations.

Fixed income: trimmed high yield credit further

In fixed income, we remain underweight sovereign and corporate debt and have now further reduced our exposure to high-yield credit. Elevated valuations and narrow risk premia following the recent gains in this segment provide a good exit point.

At the same time, we keep our exposure to emerging market debt with a preference for local currency securities. We do expect government bonds yield to, more or less gradually, climb up from their historically low levels, while credit spreads continue to look unattractive to us, particularly for non-investment grade corporate bonds.

By contrast, we continue to see the EM debt space as offering a better proposition, due to adequate real interest rate differentials and undervalued currencies leaving room for potential foreign exchange gains versus the G10.

Graph 4

Norwegian krone trending higher

(Price of EUR in NOK, and broad NOK-Index* price in USD)

*Bloomberg Correlation-Weighted Currency Index for the NOK against the other G10 currencies. Source: Bloomberg, LGT Capital Partners

Currencies and Alternatives: Staying long NOK and gold

In currencies, we retain our position in the Norwegian krone versus the euro and leave our holdings in gold unchanged. The currency pair trade offers another way to gain exposure to the reflation theme, as energy prices often drive the crosses in the Norwegian krone. Furthermore, Norway's central bank has already adopted a tightening bias on the back of a humming economy.

Gold has bounced off the double bottom formed earlier this year. Low, if not negative, real interest rates, a relatively weak US dollar and investors' inclination to hedge against inflation should also continue to support the metal.

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 Endowment, or Princely Strategy, for 2021.

- **Equities: tactical overweight in developed markets, with an emphasis on reflationary/reopening theme**
- **Fixed income: underweight, with a preference for emerging markets bonds (in local currency)**
- **Alternatives and currencies: active position in gold and NOK vs. EUR and a small passive overweight in EM currencies**

	Asset class	SAA 2021	underweight ----	---	--	-	Tactical allocation versus SAA +	++	+++	++++ overweight
Fixed income	Short-term investments	0.0%					■	■		
	Investment grade bonds*	23.0%	■	■	■	■				
	High yield bonds	5.0%			■	■				
	Emerging market bonds	7.0%					■			
Equities	Global defensive	7.5%								
	Global developed	26.5%					■			
	North America	OW								
	Europe	OW								
	Japan	OW								
	Asia-Pacific	OW								
	Emeging markets	5.0%								
Alt. / Real	Listed private equity	5.0%								
	Liquid alternatives	13.0%								
	Insurance-linked securities	6.0%								
	Real estate (REITs)	5.0%								
	Gold	0.0%					■	■	■	

	Currency[2]	SAA	----	---	--	-	+	++	+++	++++
Currencies	USD	88.0%				■				
	EUR	0.0%			■	■				
	CHF	0.0%								
	NOK	0.0%					■	■		
	Others	12.0%					■			

Reference portfolio: LGT GIM Balanced (USD). The TAA is valid for all similar portfolios but 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 markets

		1 month	3 months	Year to date	3 years, p.a.[1]	5 years, p.a.[1]
Fixed Income						
Global government bonds	USD	0.9%	0.5%	-2.6%	4.4%	2.7%
Global inflation linked bonds	USD	0.5%	1.7%	2.1%	4.1%	3.4%
Investment grade corporate bonds	USD	0.7%	1.6%	-0.6%	6.1%	4.0%
High yield bonds	USD	1.0%	2.7%	2.7%	7.2%	7.4%
Emerging markets [2]	USD	1.2%	3.5%	-1.4%	5.6%	4.8%
Equities						
Global	USD	2.9%	7.0%	13.4%	13.7%	15.0%
Global defensive	USD	2.0%	6.9%	7.7%	9.9%	9.4%
North America	USD	2.3%	7.3%	13.3%	17.0%	17.1%
Europe	EUR	3.9%	8.7%	15.9%	7.4%	10.6%
Japan	JPY	5.4%	1.1%	10.6%	6.8%	12.4%
Emerging markets	USD	5.6%	2.7%	7.5%	9.9%	14.1%
Alternative and real assets						
Listed private equity	USD	6.3%	16.9%	32.0%	20.5%	20.0%
Hedge funds	USD	0.9%	3.9%	6.5%	5.4%	5.4%
Insurance linked securities (ILS)	USD	0.1%	1.4%	1.7%	3.7%	3.8%
Real estate investment trusts (REITs)	USD	7.5%	14.1%	20.7%	12.3%	7.8%
Gold	USD	-0.4%	7.4%	-2.0%	13.3%	7.8%
Currencies (vs. rest of G10) [3]						
US dollar	USD	0.5%	-1.2%	-0.2%	-1.4%	-0.5%
Euro	EUR	0.3%	0.9%	-1.0%	0.2%	1.2%
Swiss franc	CHF	0.8%	2.0%	-1.8%	2.5%	1.1%
Japanese yen	JPY	-0.2%	-2.2%	-7.0%	-1.2%	-1.7%
Australian dollar	AUD	-0.6%	-1.9%	-0.1%	-0.1%	0.5%
Norwegian krone	NOK	-1.0%	0.7%	3.0%	-2.2%	-0.4%
British pound	GBP	0.6%	0.6%	3.4%	0.9%	-0.6%
Canadian dollar	CAD	-0.2%	1.2%	4.8%	1.6%	0.9%
Chinese yuan (vs. USD)	CNY	0.7%	1.5%	1.8%	0.1%	0.5%

[1] Annualized return [2] Equal-weighted hard and local currency total return indices [3] Bloomberg correlation-weighted currency indices of a currency versus its nine major counterparts, except for the CNY (shown against the USD).| Source: Bloomberg

Economic and corporate fundamentals

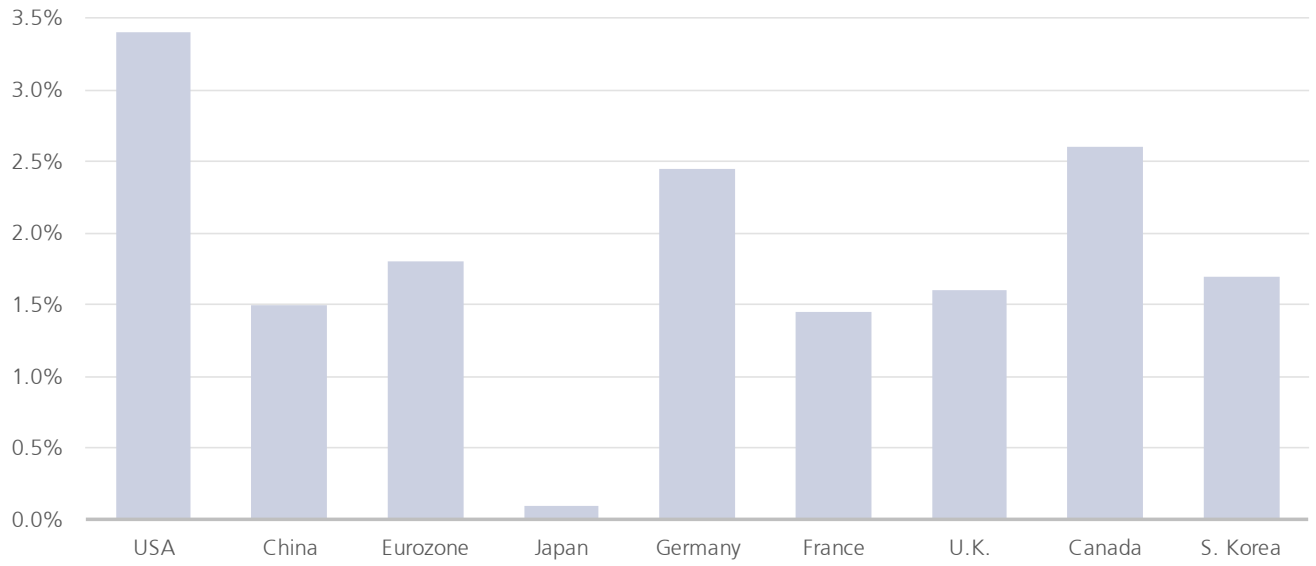
		USA	China	Eurozone	Japan	Germany	France	U.K.	Canada	S. Korea
Gross domestic product (GDP)										
Nominal, this year[1]	bn USD	22,675	16,642	14,584	5,378	4,319	2,938	3,125	1,883	1,807
Per Capita, purchasing power parity[1]	USD, PPP	65,254	18,931	40,965	44,585	56,956	49,492	47,089	51,713	47,027
Real growth this year[1]	Consensus	6.6%	8.5%	4.3%	2.6%	3.4%	5.8%	6.4%	6.2%	3.9%
Real growth next year[1]	Consensus	4.1%	5.5%	4.2%	2.3%	4.2%	4.0%	5.5%	4.0%	2.9%
Real growth current quarter	Annualized	6.4%	2.4%	-1.3%	-3.9%	-1.8%	-0.1%	-1.5%	5.6%	1.7%
Unemployment this year	Consensus	5.5%	3.8%	8.3%	2.9%	5.9%	8.4%	5.2%	7.5%	4.0%
Inflation this year	Consensus	3.4%	1.5%	1.8%	0.1%	2.5%	1.5%	1.6%	2.6%	1.7%
Purchasing manager index (comp.) [2]	Neutral: 50	68.7	53.8	57.1	48.8	56.2	59.4	65.6	57.0	53.7
Structural budget balance/GDP	IMF	-12.9%	-9.0%	-4.6%	-8.5%	-4.0%	-5.2%	-5.0%	-6.7%	-2.4%
Gross government debt/GDP	IMF	132.8%	69.6%	98.2%	256.5%	70.3%	115.2%	107.1%	116.3%	53.2%
Current account balance/GDP	IMF	-3.9%	1.6%	2.8%	3.6%	7.6%	-2.1%	-3.9%	-0.8%	4.2%
International currency reserves	bn USD	43.4	3,221.8	417.3	1,300.4	37.1	53.4	130.9	71.1	439.3
Govt bond yield 2yr [3]	% p.a.	0.16%	2.73%	-0.60%	-0.10%	-0.67%	-0.66%	0.08%	0.32%	1.23%
Govt bond yield 10yr [3]	% p.a.	1.50%	3.14%	0.06%	0.05%	-0.23%	0.14%	0.76%	1.38%	2.08%
Main policy interest rate [4]	% p.a.	0.25%	4.35%	0.00%	-0.10%	0.00%	0.00%	0.10%	0.25%	0.50%

[1] IMF estimates, per capita data for Eurozone per 2019, rest per current year [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	France	U.K.	Canada	S. Korea
Exchange capitalization*	bn USD	49,036	10,394	18,844	6,928	2,891	1,066	3,734	788	2,252
Growth in earnings per share, estimated (MSCI)										
12 months forward / trailing 12 month	Consensus	31.5%	-17.8%	128.2%	22.3%	113.3%	180.0%	265.3%	31.5%	60.3%
Next fy / 12m fwd	Consensus	10.8%	17.4%	13.8%	11.5%	12.4%	13.9%	6.2%	4.3%	9.2%
Growth in revenue per share, estimated (MSCI)										
12m fwd / trail 12m	Consensus	14.2%	37.3%	12.1%	11.3%	11.8%	12.7%	14.6%	5.0%	11.2%
Next fy / 12m fwd	Consensus	6.4%	15.3%	4.6%	3.8%	5.2%	4.1%	2.4%	4.2%	7.9%
Valuations (MSCI)										
Price-Earnings Ratio (est 12m fwd)	Consensus	23.0	16.7	18.4	16.8	16.0	19.6	13.5	16.3	12.4
Price-Sales Ratio (est 12m fwd)	Consensus	3.0	1.3	1.4	1.1	1.1	1.5	1.3	2.2	1.1
Dividend yield	Consensus	1.4%	1.6%	2.6%	2.1%	2.6%	2.4%	3.9%	2.6%	1.7%

* China market cap includes Hong Kong | Source: Bloomberg Data per: 16.06.2021

Expected annual inflation rate for 2021 (Consensus)



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