LGT Capital Partners
your partner for alternative investments

Reducing our fixed income underweight

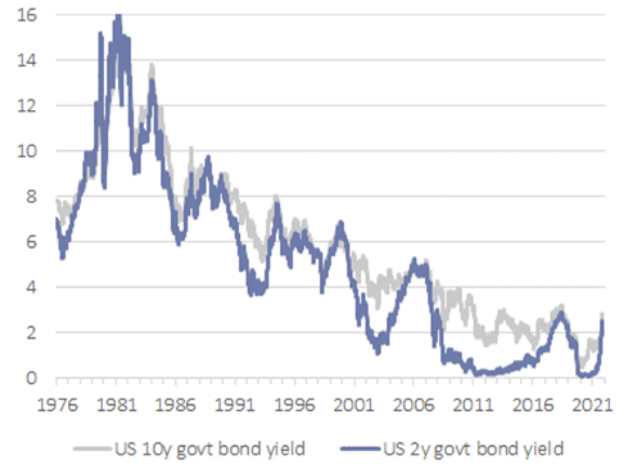
Marketing material

Following the recent surge in interest rates, we use some of our excess cash to trim our significant underweight in investment grade bonds. US policy makers have already adopted a bias in favor of an accelerated tightening and markets have started to react positively to even modest indications of peaking inflation, which leaves room for a rebound in the asset class.

The treasuries market had one of the worst quarters in decades, with the aggregate index of investment grade (IG) bonds down almost 10% year-to-date – an unusual move for the segment. For comparison, the MSCI Word equity index is down by a more moderate 5.8% since the start of the year.

The increases in US bond yields over the past three months were the biggest since the mid-1990s (graph 1) and came on the back of ever-higher readouts of inflation numbers, which forced investors to begin pricing in numerous rate hikes by central banks around the world. By now, the market is pricing two 50-basis-point-increases by June and some Fed officials are even suggesting 75-basis-point-moves.

Graph 1
Bond yields have surged in the first quarter
(US treasuries, yield to maturity in %)



Source: Bloomberg, LGT Capital Partners

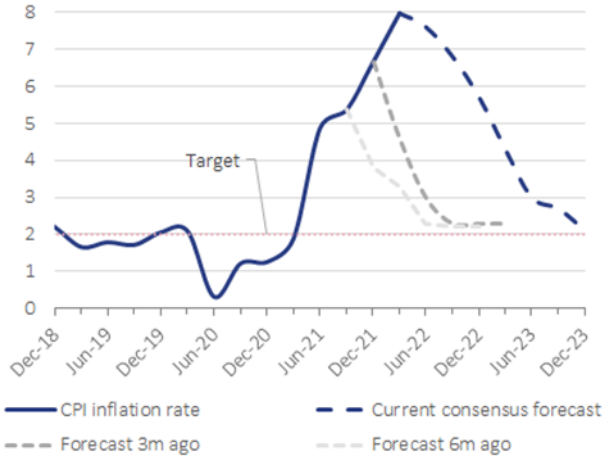
However, while the Federal Reserve is keen to show that it is eager to catch up with inflation dynamics of late, policy makers will also remain intent on keeping the economic recovery intact. Moreover, with a hawkish bias already priced in, any signs of abating price pressures would give central banks a reason to moderate, if not pause, the pace of policy tightening in the future.

Have we seen the peak in US inflation?

The latest inflation data for March, published on 12 April, gave us a first indication of how markets can react to even small hints of peaking price pressures under such circumstances. Specifically, the data showed that the year-on-year gain in the headline US consumer price index hit another multi-decade record of 8.5%, driven mainly by the spike in energy prices, but bond markets rallied in relief because the month-on-month rate in the core index simultaneously fell to 0.3% from 0.5%.

Such responses could become more frequent in coming months especially if inflation begins to moderate by the end of this quarter, as the consensus currently expects (graph 2).

Graph 2
US consumer price inflation finally peaking?
(Year-on-year change in the consumer price index)



Source: Bloomberg, LGT Capital Partners

Allocating cash to investment grade bonds

Following the steep rise in interest rates since early March, we deem it likely that the inflation readings of the coming months could support at least a partial retracement of last quarters' big increase in bond yields.

Furthermore, markets have already priced in aggressive interest rate hikes and various surveys suggest that multi-asset investors are now heavily underweight or even short government bonds and duration risk.

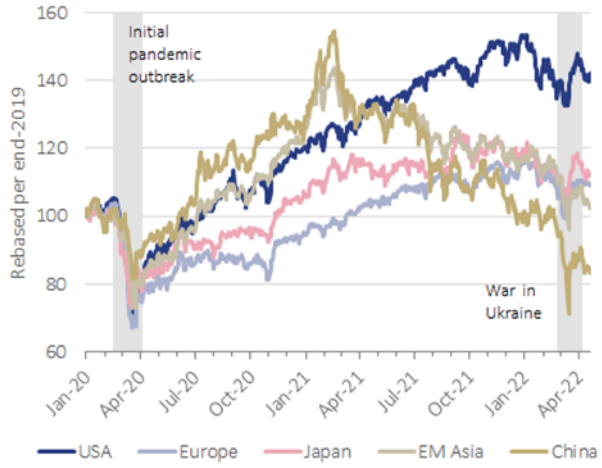
We therefore decided to reduce our long-standing pronounced underweight in fixed income from -6% to -4% relative to our neutral strategic quota, by shifting some of our cash reserves to buy into an internally managed global investment grade bonds strategy.

From a more practical viewpoint, government bond yields of close to 3% are sufficiently attractive when compared to holding high levels of cash, which still yields near zero. Beyond this purchase, our tactical positions are unchanged and still rather defensive – i.e., we still hold an ample amount of cash (4.5%) and are ready to deploy it on any future tactical opportunities.

Near-term economic situation has not changed much

The macro outlook also remains largely unchanged compared to our last monthly report and is broadly in line with the current performance patterns of the equity markets indices – which highlight the relative strength of the US (graph 3).

Graph 3
Performance of major equity markets
(MSCI net return indices in USD, hedged for all DM)



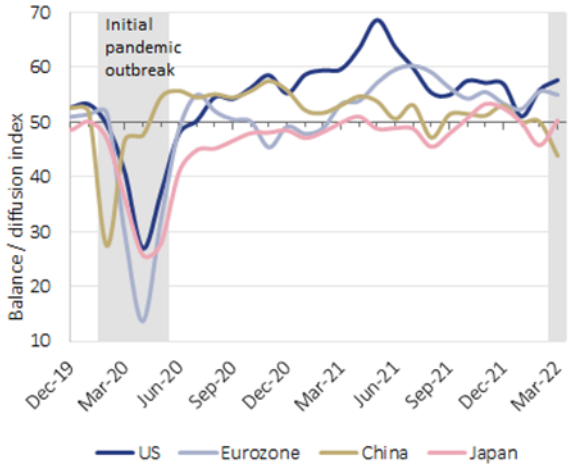
DM = developed markets
Source: Bloomberg, LGT Capital Partners

The stagflationary risks to the global macro outlook remain in place, but the potential consequences are not exactly the same for all regions. The US economy in particular has been standing out positively and continues to perform above expectations in general – i.e., both in terms of the incoming top-down macro data as well as the bottom-up corporate earnings reports.

For instance, with about 10% of the S&P 500 members having reported their results, about 8 in 10 companies are still clearly beating the consensus expectation.

Furthermore, the purchasing managers' indices for the US not only remain comfortably above recessionary levels, but have actually also ticked up further in March – both in the services as well as the manufacturing industries, resulting in an overall rise in the composite index (graph 4). By contrast, China has fallen back below 50, which indicates a retrenchment of expected business activity. Since the start of the Russian invasion of Ukraine in late February, Europe's outlook is also weakening, albeit from a high level. Finally, Japan is about to return to growth, recovering from the imposed COVID-19-related restrictions of last November.

Graph 4
Composite purchasing managers' indices
(Developed economies still in expansionary territory)



The composite indices combine the results of the manufacturing and services sector surveys.
Source: Bloomberg, LGT Capital Partners

US economy best placed to cope with the monetary tightening

The US economy owes its current relative strength to the ample excess household savings built up during the pandemic, rising wages amid tight labor markets, and a demographic tailwind resulting from the mass retirement of the baby-boomer generation – all of which are factors that will in principle support consumer spending going forward.

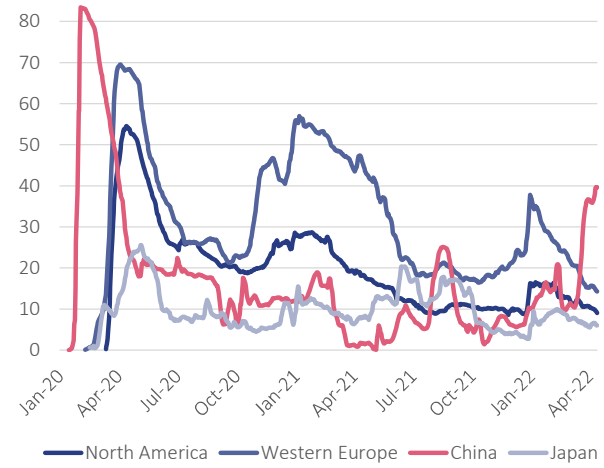
In other words, it is an overheated economy – and hence relatively well positioned to absorb the coming monetary tightening without entering a recession – i.e., achieve a so-called "soft landing". That is to say, while the inflation outlook is more uncertain than a few months ago due to the war in Ukraine as well as the current COVID-19-related lockdown wave in China, the US economy is still in a relatively good position to cope with these additional supply shocks.

By comparison, the war-related risks in particular are unfortunately more pronounced in Europe, where some economies, notably Germany, are arguably already in stagflation. Unlike the US, which is in essence self-sufficient in energy and food, Europe is highly reliant on Russian fossil fuel imports and has

no quickly available alternative energy sources. The geographic proximity to the war and the humanitarian catastrophe may also have a more direct impact, e.g., on consumer and business sentiment.

Finally, Asia-Pacific faces a mixed situation, albeit for different reasons. The biggest headwind stems from the most recent COVID-19 lockdowns of some Chinese cities, most notably of Shanghai. Their negative impact is evident in the jump in the effective lockdown index for China (graph 5), which will also disrupt global supply chains beyond the country as well.

Graph 5
COVID-19 effective lockdown indices* for major regions
(7-day moving average of index value)



*These indices measure the intensity of mandatory and voluntary virus control efforts and estimate their impact on the economy.
Source: Goldman Sachs, LGT Capital Partners

Japan, on the other hand, finds itself in a more benign situation. Firstly, with a delay of several months when compared to the West, it has just recently started to reopen the economy from the restrictions imposed due to the Omicron variant of COVID-19. Moreover, and perhaps more importantly, Japan's core inflation rate (nationwide consumer price index excluding food and energy) was still very close to a 40-year low of -1.8% in February, meaning that the Japanese monetary policy outlook is likely to remain far more relaxed than in any of the other developed markets, which in turn will tend to weaken the yen.

This constellation is a net positive for the Japanese economy – because the country's households, companies, and state entities are net holders of income-generating overseas assets, while broader domestic consumer prices are stable because of the deeply entrenched deflationary forces in the domestic economy.

As a reminder, we are slightly overweight the US, neutral in Japan, while Europe and emerging Asia are held below neutral, resulting in an overall underweight quota in equities (excluding our position in real estate investment trusts, which serves as a real asset proxy in our liquid multi-asset funds).

Corporate earnings season for Q1/2022

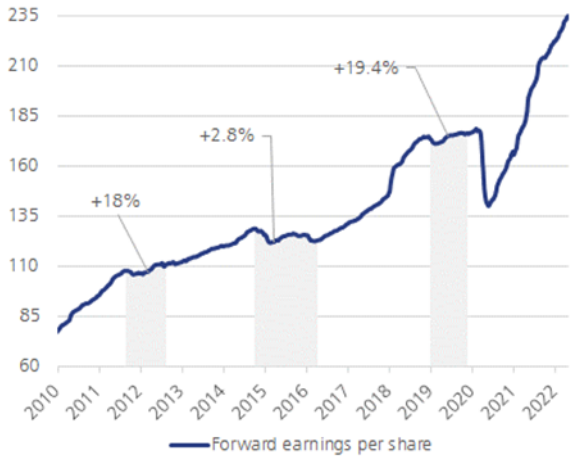
The US corporate earnings season for the first quarter of 2022 has begun on a rather positive note. With about 10% of the S&P 500 members having reported results, about eight in ten companies are surpassing the beating the consensus, compared to average value of 72% over the past 15 years. That said, the outlook is rather uncertain, as a majority of companies are revising their guidance numbers lower, citing labor shortages, price pressures, and supply chain risks – as they have been doing for a couple of quarters now.

Looking ahead, it is worth considering the big picture: profit growth is likely to slow from the very high level of the past couple of years. Earnings per share might even decline quarter-on-quarter if the uncertainties fully materialize, and that warrants some caution in positioning until visibility improves.

However, following the historically extreme surge in earnings during the rebound from the COVID-19 shock, a consolidation is only natural. Moreover, such natural consolidation phases of slow or flat growth have not coincided with bear markets in equities – on the contrary, the S&P 500 continued to gain during the last three such phases since 2010 (graph 6).

Thus, we do believe our measured overweight in US equities remains appropriate for now and the earnings season seems set to prove good enough to provide sufficient support in the coming weeks.

Graph 6
MSCI USA companies' earnings per share in USD
(Annotations show index returns during consolidation phases in grey)



Source: Bloomberg, LGT Capital Partners

END OF REPORT

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	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	3.2%	5.0%	2.8%	2.2%	2.2%	3.9%	3.2%	3.9%	2.9%
Real growth next year[1]	Consensus	2.1%	5.2%	2.4%	1.8%	2.8%	1.7%	2.1%	2.8%	2.6%
Real growth current quarter	Annualized	6.9%	5.3%	1.2%	4.6%	-0.3%	1.3%	0.7%	6.7%	1.2%
Unemployment this year	Consensus	3.6%	3.9%	6.9%	2.7%	5.0%	4.0%	7.3%	5.5%	3.6%
Inflation this year	Consensus	6.9%	2.2%	6.5%	1.5%	6.1%	7.0%	4.4%	4.9%	3.4%
Inflation next year	Consensus	3.0%	2.3%	2.3%	0.8%	2.6%	3.3%	2.2%	2.5%	2.0%
Purchasing manager index (comp.) [2]	Neutral: 50	58	44	55	50	55	55	55	59	51
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	38.1	3,188.0	560.9	1,226.2	38.0	123.1	53.4	75.4	437.0
Govt bond yield 2yr [3]	% p.a.	2.57%	2.19%	0.61%	-0.05%	0.04%	1.55%	0.03%	2.52%	2.85%
Govt bond yield 10yr [3]	% p.a.	2.90%	2.82%	1.56%	0.25%	0.87%	1.93%	1.34%	2.82%	3.30%
Main policy interest rate [4]	% p.a.	0.50%	4.35%	0.00%	-0.10%	0.00%	0.75%	0.00%	0.25%	1.50%
Spread 10y-2y treasury yield	Basis points	33.6	62.5	94.4	29.9	83.7	37.6	130.8	30.4	45.5

[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	48,256	16,339	8,695	5,591	2,279	3,396	2,944	3,301	1,986
Growth in earnings per share, estimated (MSCI)										
12 months forward / trailing 12 montl	Consensus	23.3%	16.5%	15.5%	8.3%	22.6%	23.4%	42.3%	30.2%	14.7%
Next fy / 12m fwd	Consensus	5.7%	5.6%	11.3%	3.5%	5.7%	3.4%	0.5%	2.3%	9.0%
Growth in revenue per share, estimated (MSCI)										
12m fwd / trail 12m	Consensus	9.7%	8.8%	16.3%	7.5%	5.9%	16.9%	13.5%	2.6%	6.8%
Next fy / 12m fwd	Consensus	3.5%	2.2%	7.1%	2.2%	2.8%	1.4%	-1.7%	1.3%	4.1%
Valuations (MSCI)										
Price-Earnings Ratio (est 12m fwd)	Consensus	19.39	12.76	10.17	12.39	11.19	13.07	10.90	13.43	9.48
Price-Sales Ratio (est 12m fwd)	Consensus	2.63	1.10	0.92	0.93	0.85	1.17	1.27	2.10	0.80
Dividend yield	Consensus	1.41	3.26	2.62	2.62	3.56	3.04	4.07	2.77	2.11

* China market cap includes Hong Kong | Source: Bloomberg

Data per: 20.04.2022

Strategic scenario landscape

Our strategic asset allocation (SAA) is based on a set of macro scenarios that are reviewed annually and adjusted or changed if necessary toward the end of each year. Below we provide an overview of the current scenarios and comment on the changes as they emerged compared to the previous year's observations.

	Baseline (high prob.)	Alternative scenarios (medium probability)			Outlier scenarios (low probability)			
2022	**Reflationary expansion**	**"Muddling through"**	**Competitive prosperity**	**Inclusive capitalism**	**Monetary debasement**	**Global protectionism**	**Deflationary depression**	**Climate distortions**
	Coordinated monetary/fiscal easing succeeds in reflating the global economy	Elevated economic volatility due to interplay between politics, the real economy and financial markets	Bipolar world order fosters race for technological and economic supremacy	Big governments apply hefty regulation, taxes and transfers to make liberal capitalism more inclusive	Loss of confidence in fiat money leads to runaway inflation	Nationalistic and protectionist policies reverse the globalization process	Debt defaults, deflation and recessions dominate	Physical damage triggers late, but strong policy response and raises transition costs

Changes

Reclassification

- Reflationary policy regime of monetary-financed fiscal spending will prevail and policymakers will resort to it whenever necessary to prop up the economy
- Pent-up consumer spending and business investment/capex have the potential to make the expansion more self-sustained
- Policymakers are unlikely to prematurely reduce their multi-layered stimulus measures

Adjustments and reclassification

- The pushback against the winners of pro-corporate policies, globalization and the digital economy has increased and public focus has shifted towards social justice
- Policymakers aim for a more equitable and socially acceptable sharing of economic gains in order to make neoliberal capitalism more inclusive

Reclassification

- Revival of the transatlantic alliance and G7-multilateralism has significantly reduced the probability of a global protectionism scenario
- Widening rift between China and the West more likely to feed "competitive prosperity"

Performance of markets

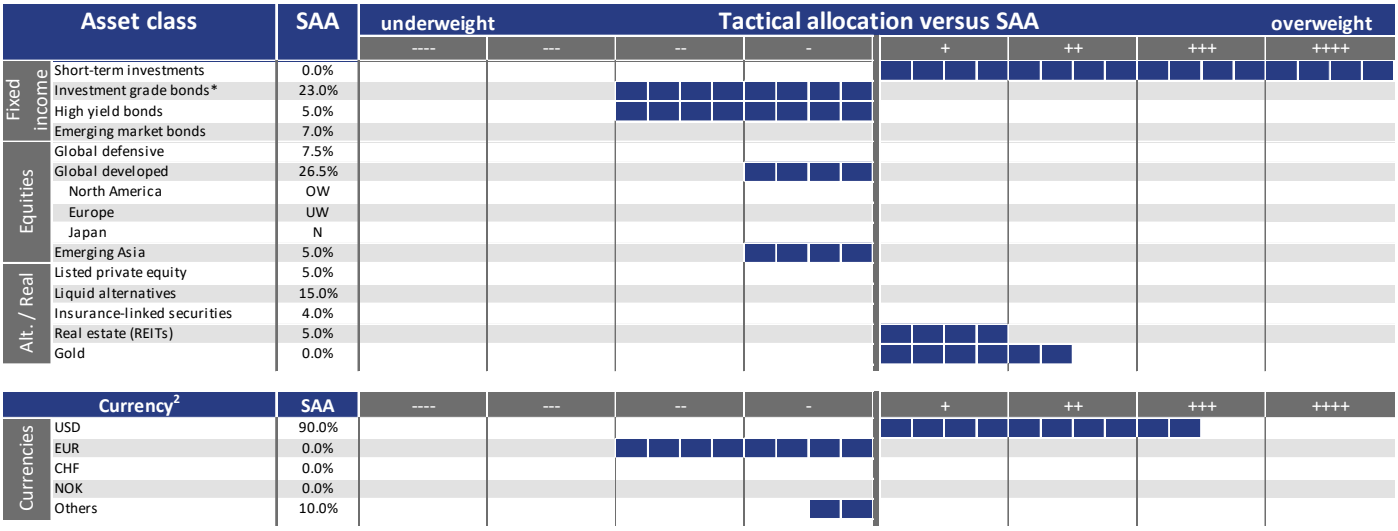
		1 month	3 months	Year to date	3 years, p.a.[1]	5 years, p.a.[1]
Fixed Income						
Global government bonds	USD	-3.4%	-5.7%	-7.1%	0.5%	1.5%
Global inflation linked bonds	USD	-1.7%	0.4%	-0.8%	4.1%	3.3%
Investment grade corporate bonds	USD	-3.0%	-6.1%	-7.6%	1.4%	2.0%
High yield bonds	USD	-1.7%	-7.2%	-8.3%	1.9%	3.2%
Emerging markets, local currency*	USD	-1.6%	-9.0%	-8.9%	-2.4%	-0.5%
Emerging markets, hard currency*	USD	0.0%	0.0%	0.0%	0.0%	0.0%
Equities						
Global	USD	0.1%	-1.1%	-5.8%	13.5%	12.1%
Global defensive	USD	1.6%	1.8%	-3.0%	8.4%	8.7%
North America	USD	0.0%	-0.3%	-6.3%	16.7%	14.9%
Europe	EUR	0.4%	-4.8%	-5.4%	6.7%	6.3%
Japan	JPY	0.6%	-1.7%	-4.2%	8.5%	7.9%
Emerging markets	USD	-2.2%	-12.3%	-10.6%	2.4%	5.1%
Alternative and real assets						
Listed private equity	USD	-2.1%	-7.9%	-14.4%	19.5%	15.2%
Hedge funds	USD	1.4%	-0.5%	-0.5%	6.2%	4.4%
Insurance linked securities (ILS)	USD	0.0%	0.4%	0.5%	5.0%	3.5%
Real estate investment trusts (REITs)	USD	4.7%	5.1%	-4.0%	11.0%	9.1%
Gold	USD	0.6%	5.8%	6.4%	15.1%	8.7%
Currencies (vs. rest of G10) [3]						
US dollar	USD	1.5%	2.4%	2.7%	0.2%	0.2%
Euro	EUR	-0.8%	-2.4%	-2.6%	-1.2%	0.5%
Swiss franc	CHF	-0.6%	-1.4%	-1.6%	2.7%	1.4%
British pound	GBP	0.1%	-2.4%	-1.5%	0.2%	0.6%

[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

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, for 2022.

- **Equities: overall underweight with a bearish positioning in Europe and emerging Asia**
- **Fixed income is underweight due to our positioning in investment grade and high yield bonds**
- **Alternatives and currencies: long positions in gold and the USD against the EUR, underweight in EM currencies**



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.

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