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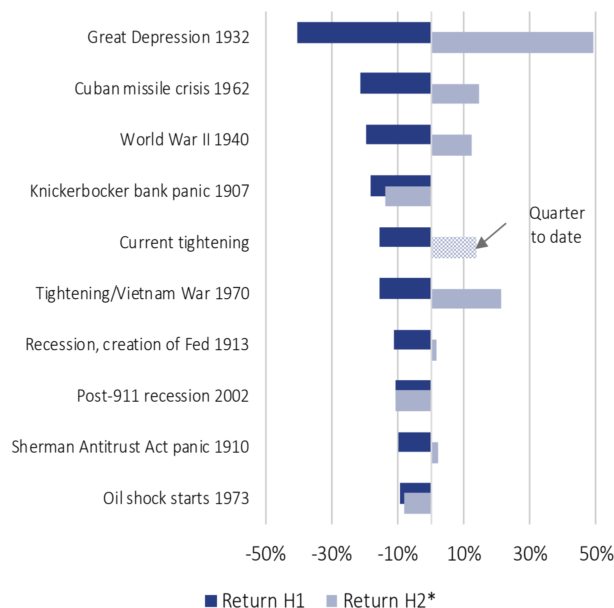
Uncertainty has peaked but macro risks continue to build

Marketing material

In line with our expectations, equities rebounded strongly in July. Commodity prices and interest rates are also off their yearly highs, softening inflationary pressures and fueling hopes that peak tightening is behind us. That said, while the uncertainty is fading, the overall macro picture has not yet improved meaningfully and we stick to our balanced strategy – i.e., one that is aware of the pitfalls but remains focused on opportunities.

Graph 1
Equity markets rebound in line with historical pattern
Total returns in USD since 1900



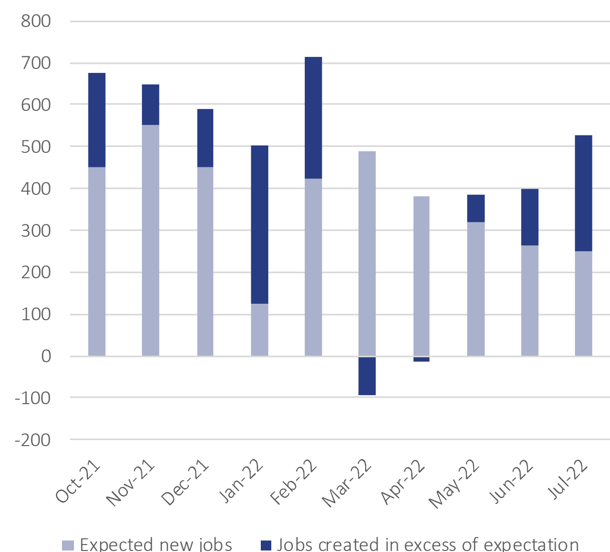
*Quarter to date return used for 2022, per Aug. 15, 2022.
Source: Prof. Robert Shiller, Bloomberg, LGT Capital Partners

Peak tightening hopes trigger recovery in risk taking

After one of the worst first stock market semesters in 122 years, the second half of the year started with a robust recovery. US equities have returned close to 14% quarter to date, in line with the historical pattern following big selloffs that price in major economic or geopolitical events (graph 1).

- While the global economy continued to weaken and inflation stayed high, the latest statistics showed that energy and other commodity-based inflation has started to fall, with pandemic-related price pressures retreating as well. Recent inflation readings were thus lower than expected, reaffirming many investors' hopes that inflation has indeed peaked and that the US Federal Reserve may soon relax its hawkish policy bias as a consequence.
- At the same time, a (much) stronger-than-expected US labor market (graph 2) indicated that falling real incomes and lockdown savings are motivating many people to seek work and that the economy is strong enough to supply those jobs – which suggests the opposite, i.e., that the Fed will have to keep tightening to fight inflation, as demand still exceeds the supply of goods and services.
- Finally, China continues to disappoint: Chinese equities have once again failed to participate in the global rebound (graph 3, page 2). Beijing's Covid-related self-isolationism, property sector issues, abrupt regulatory interventions into the private sector, as well as the tense geopolitics keep weighing on the second-largest economy, reducing its contribution to global growth.

Graph 2
Strength of US labor market continues to surprise
(Newly added monthly non-farm payrolls, in thousands)

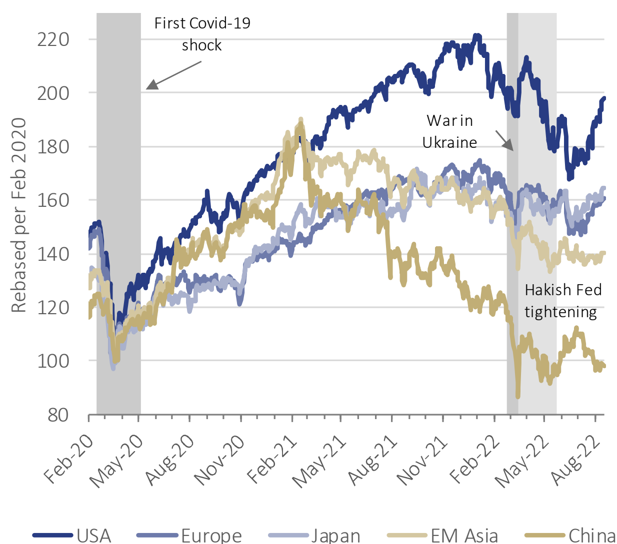


Source: Bloomberg, LGT Capital Partners

Graph 3

Equity markets recover but China fails to follow

(MSCI net return indices in USD, rebased to 100)



Source: Bloomberg, LGT Capital Partners

Measured confidence is reasonable but so is rational awareness of pitfalls

In short, the economic outlook remains bifurcated and the market environment uncertain, albeit perhaps to a lesser extent than last quarter when it comes to US inflation. With regards to the latter specifically, investors can now expect with some degree of confidence that annual price gains will indeed gradually continue to decline, although they will not fall to the targeted 2% rate anytime soon. That said, it is still unclear whether everything else will play out in a benign matter:

- Will the US economy indeed have a soft landing and avoid a true recession, i.e., a state in which consumer demand is below the economy's supply capacity, rather than excessive, as is the case today?
- Will Europe avoid an energy crisis and thus a widespread consumption rationing and/or production shutdowns this coming fall and winter?
- Will the war in Ukraine stay confined within the current conflict zones, and will Ukrainian grain and Russian energy supplies be allowed to continue – and be sufficient to avert food crises in low-income countries and industrial shutdowns in rich ones?
- Will the geopolitical tensions about Taiwan flare up again? Chinese forces effectively surrounded the island during recent military exercises, disrupting commercial shipping. Taiwan is a key global supplier of microchips, among other electronic and industrial goods.

Buy on weakness and sell on strength

With these pitfalls remaining visible in the horizon, we maintain a slightly defensive but balanced investment strategy. We welcome the relief rally in July-August, of course, as we had positioned our portfolios accordingly during the first half of the year. From April to June, we selectively bought into weak markets, adding investment grade bonds, US equities, as well as gold and Real Estate Investment Trusts, which are assets that offer some inflation-mitigating features.

Now that these counter-cyclical actions have paid off, mostly due to behavioral market patterns rather than meaningful changes in fundamentals, we are looking into reducing at least some of these positions again in due time. Beyond such active portfolio management measures, our macro view remains balanced, which translates into a broadly neutral tactical positioning, with a slight bias on the defensive side. The latter was most recently expressed when we increased quality equities at the expense of the broader global developed market exposure.

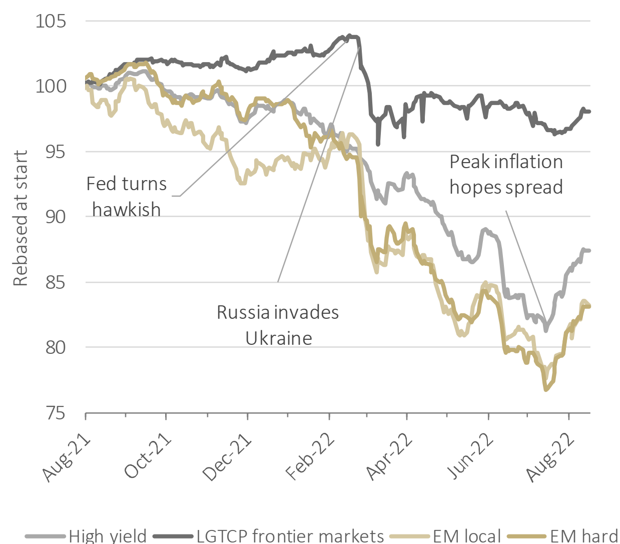
Special topic: how are frontier markets fairing in this challenging environment?

Given the noticeable underperformance of China and some other emerging markets, today we take a closer look into a special emerging segment, the frontier markets. In light of the various challenges, our inhouse frontier strategy has held up exceptionally well so far this year (graph 4).

Graph 4

Frontier markets local currency bonds holding up well

(LGT Capital Partners frontier markets strategy and broad fixed income segments in USD)



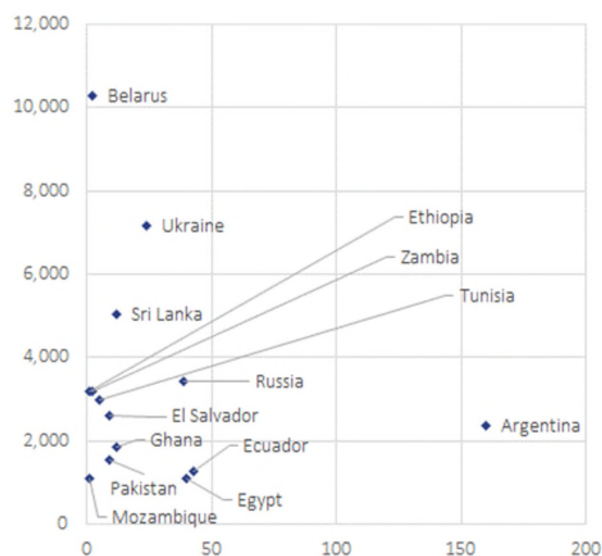
Source: Bloomberg, LGT Capital Partners

Over the course of this year, spreads of emerging market sovereign US dollar bonds over US Treasury yields have widened significantly, with around a third of the countries in the JP Morgan EMBI index now exceeding 1000 basis points, i.e., the threshold of debt distress (graph 5, next page).

Most of these sovereigns are frontier markets. In some cases, the challenging macro environment has also led to weaker currencies. Several economies find themselves in a particularly challenging position, as they face a deteriorating economic and fiscal outlook due to headwinds stemming from the US Federal Reserve's hawkish policy stance, the resulting strong US dollar, the war in Ukraine, and/or the subpar Chinese recovery.

Graph 5

EMBI spreads and hard currency frontier market bonds
(Basis points on y-axis, billion USD on x-axis)



Last available pricing for Russia and Belarus, as these countries' debt is excluded from the international bond indices.
Source: Refinitiv, JP Morgan, LGT Capital Partners

That said, as graph 4 shows, debt markets have started to stabilize somewhat recently, triggered by a decline in commodity prices and thus hopes that the global economy may have passed its inflation peak – hopes that were affirmed last week when the US inflation rate for July dropped by more than expected by the economist consensus, as energy and some other goods' prices fell.

Nevertheless, frontier markets are likely to continue to face difficulties. In some developing countries, food inflation is threatening to morph into an outright food crisis. High food and fertilizer prices increase food insecurity, while high fiscal deficits in the aftermath of the pandemic leave governments with less room to provide necessary relief. Most middle eastern countries, for instance, are highly dependent on grain imports, although the high crude prices are supporting the fiscal capabilities of the oil producers among them. Developing countries that are net food and energy importers, on the other hand, are set to face major socio-economic upheavals if prices remain on these elevated levels. The war has accentuated the situation because Russia and Ukraine are major exporters of food and fertilizers.

Countries such as Lebanon and Egypt are heavily dependent on Russian and Ukrainian supplies and are thus hit particularly hard. High food and/or energy prices tend to increase socio-political volatility. The last such crisis triggered the Arab Spring, which in turn later led to civil wars and military coups in some cases. The rise in commodity prices significantly raises import bills and further limits governments' abilities to provide relief, while aggressive interest rate hikes by central banks in developed economies make it more expensive to borrow from abroad.

A strong US dollar burdens the balance of payments and makes foreign debt service more difficult – this, as government balance sheets have already been weakened by the pandemic. Indeed, public debt-to-GDP ratios have surged in some of the frontier markets that had borrowed heavily in hard currency.

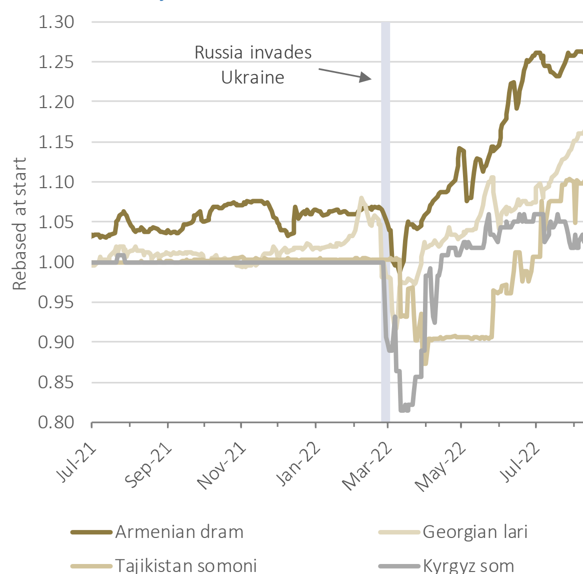
Investment outlook for frontier markets: selectivity is king

Despite these challenges, the outlook is not uniform for all frontier economies, as default risks and currency performance vary widely across the heterogenous universe. Oil producers such as Angola, Bahrain or Oman benefit from the high energy prices and are paying down large foreign currency debt. Others are suffering economic and social downturns – a recent example is Sri Lanka, which defaulted on its hard currency debt earlier this year.

Tunisia is also in a vulnerable position at present, in our view. Like Colombo, Tunis has suffered from political instability, low foreign exchange reserves, and a drop in hard currency earnings due to the Covid-19-related drop in tourism. Some African economies are also trading at levels that imply a high default probability. On the other hand, some ex-CIS countries are benefiting from the flow of people, capital and production out of Russia. Georgia, for example, has seen its currency appreciating strongly against the US dollar. The same holds for Armenia, Tajikistan or Kyrgyzstan.

Graph 6

Some post-Soviet currencies are stronger than the USD
(Price of currency unit in USD, rebased to 1 at start)



Source: Bloomberg, LGT Capital Partners

When it comes to debt restructurings, the composition of frontier markets' creditors has changed in the past decade. Debt relief used to be granted by a small array of creditors, mainly the G7 governments. However, today China and private investors are playing a more important role. When it comes to China, debt restructuring negotiations are more complex, as many lenders are typically involved – state banks, non-financial corporations, etc.

Moreover, Beijing tends to negotiate bilaterally, and in an opaque way. Individual terms are unknown and different lending policies as well as interests are involved when compared to G7 practices. China seems to be establishing a privileged lender status, which makes commercial lenders more reluctant to provide relief due to concerns that their financing could be

used to repay Chinese creditors, complicating debt restructuring for troubled countries further.

On a brighter note, investors are typically attracted to frontier economies due to the growth potential they offer. Indeed, these countries have been outgrowing the developed markets by about two percentage points per annum over the last 20 years and that is not likely to change going forward.

According to the forecasts of the International Monetary Fund (IMF), 28 of the 30 fastest-growing economies between 2022 and 2026 are considered frontier markets. Among them are many Sub-Saharan nations as well as various Southeast Asian countries like Bangladesh, Vietnam or Cambodia. Another advantage is that frontier markets are driven primarily by idiosyncratic developments (reform path, prudent fiscal and monetary policies), rather than global factors.

As a result, investors need to be very selective in their frontier engagements, to reflect the various opportunities and risks within the universe. This approach is the key in our own frontier strategy, which purely invests in local currency instruments in that region and has held up relatively well this year. Moreover, risk compensation in local currency markets is generally very attractive.

For example, while Pakistan has been in the headlines due to social unrest, the country's local currency securities at some point offered implied annualized yields of 60%, which compensates substantially for the depreciation risk. In addition, default risks of sovereigns that see their credit spreads at distressed levels are usually concerning US dollar bonds. Defaults or restructurings seldom involve local currency debt.

We should add that our inhouse frontier markets team strategy is well diversified across 35 countries, with major strategic long-term holdings in countries such as Uzbekistan, Kenya, Uganda, Uruguay or Armenia as well as positions in Georgia, Kazakhstan or Algeria, reflecting the positive trends in the ex-CIS region and/or countries that benefit as commodity producers/exporters.

Finally, in the LGT Group Endowment, or the Princely Strategy, the exposure to frontier markets is minimal at present, while the allocation we hold via an internal mandate is well-managed, in line with the above-described approach, and performing well. Thus, we do not expect the current market issues to impact our portfolio negatively. Neither is a general spill-over from the distressed cases to the broader financial markets likely, due to the small size of these economies and related debt markets.

Note: CIS = Community of Independent States, a group of countries of the former Union of Soviet Socialist Republics.

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 our global defensive allocation and US equities**
- **Fixed income: underweight, with high yield and investment grade bonds below neutral**
- **Alternatives: overweight, resulting from net long positions in REITs, LPE and gold**
- **Currencies: long position in the USD against the EUR and passive underweights in EM currencies**

	Asset class	SAA	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	n.a.					■■■■			
	Europe	n.a.			■■■■	■■■■				
	Japan	n.a.								
	Emerging Asia	5.0%				■■■■				
Alt. / Real	Listed private equity	5.0%					■■■■			
	Liquid alternatives	15.0%								
	Insurance-linked securities	4.0%								
	Real estate (REITs)	5.0%					■■■■			
	Gold	n.a.					■■■■	■■■■	■■■■	

	Currency[2]	SAA	----	---	--	-	+	++	+++	++++
Currencies	USD	90.0%					■■■■	■■■■	■■	
	EUR	0.0%			■■■■	■■■■				
	CHF	0.0%								
	NOK	0.0%								
	Others	10.0%				■■				

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

Fixed Income		1 month	3 months	Year-to-date	3 years, annualized[1]	5 years, annualized[1]
Global government bonds	USD	1.0%	0.1%	-7.1%	-1.9%	1.4%
Global inflation linked bonds	USD	4.1%	-4.4%	-15.2%	-0.8%	1.1%
Investment grade corporate bonds	USD	1.7%	1.0%	-6.9%	0.1%	1.8%
High yield bonds	USD	6.1%	0.9%	-11.5%	0.4%	1.7%
Emerging markets, local currency*	USD	6.3%	2.9%	-11.9%	-4.5%	-2.1%
Emerging markets, hard currency*	USD	0.0%	0.0%	0.0%	0.0%	0.0%
Equities						
Global	USD	10.0%	6.1%	-8.6%	12.9%	10.3%
Global defensive	USD	5.6%	3.4%	-6.9%	4.7%	6.7%
North America	USD	11.7%	7.5%	-10.0%	15.3%	12.9%
Europe	EUR	6.1%	1.3%	-7.3%	7.1%	4.9%
Japan	JPY	5.1%	6.6%	0.3%	13.0%	7.1%
Emerging markets	USD	5.9%	2.3%	-15.8%	3.9%	1.5%
Alternative and real assets						
Listed private equity	USD	14.9%	4.8%	-21.7%	14.7%	11.0%
Hedge funds	USD	1.4%	-1.3%	-2.5%	4.7%	3.6%
Insurance linked securities (ILS)	USD	0.6%	0.1%	0.5%	4.6%	3.2%
Real estate investment trusts (REITs)	USD	10.8%	6.5%	-10.9%	5.5%	7.2%
Gold	USD	4.2%	-2.4%	-2.7%	5.6%	6.8%
Currencies (vs. rest of G10) [3]						
US dollar	USD	-2.3%	0.5%	8.8%	1.3%	2.5%
Euro	EUR	-1.5%	-2.5%	-4.0%	-1.9%	-0.8%
Swiss franc	CHF	1.2%	7.0%	4.5%	2.6%	3.0%
British pound	GBP	-0.5%	-2.0%	-4.4%	1.0%	1.0%
Japanese yen	JPY	1.9%	-3.1%	-7.7%	-6.8%	-1.7%

[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

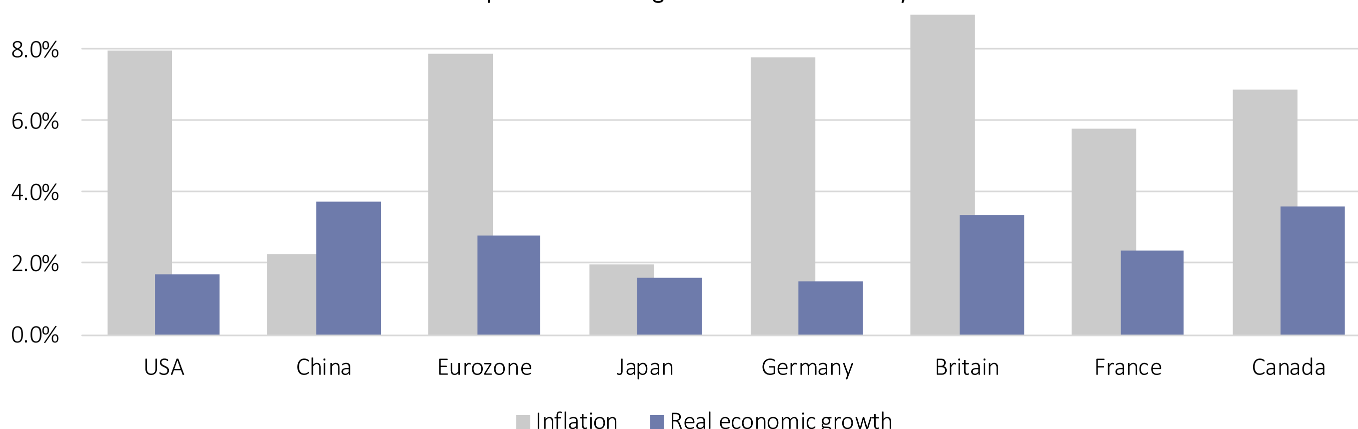
		USA	China	Eurozone	Japan	Germany	Britain	France	Canada
Gross domestic product (GDP)									
Nominal, this year[1]	bn USD	25'347	19'912	14'493	4'912	4'257	3'376	2'937	2'221
Per Capita, purchasing power parity[1]	USD, PPP	76'027	21'364	40'965	48'814	63'271	55'301	56'036	57'812
Real growth this year[1]	Consensus	1.7%	3.8%	2.8%	1.6%	1.5%	3.4%	2.4%	3.6%
Real growth next year[1]	Consensus	1.1%	5.3%	0.8%	1.6%	0.8%	0.5%	1.1%	1.6%
Real growth current quarter	Consensus	1.4%	5.2%	1.0%	0.9%	1.0%	0.5%	1.1%	1.5%
Unemployment this year	Consensus	3.7%	4.1%	6.8%	2.6%	5.1%	3.9%	7.3%	5.3%
Inflation this year	Consensus	8.0%	2.3%	7.9%	2.0%	7.8%	9.0%	5.8%	6.9%
Inflation next year	Consensus	3.7%	2.3%	4.1%	1.4%	4.5%	5.9%	3.5%	3.5%
Purchasing manager index[2]	Neutral: 50	47.7	54	49.9	50.2	48.1	52.1	49.5	52.5
Structural budget balance/GDP	IMF	-5.3%	-7.0%	-3.5%	-7.3%	-2.0%	-4.4%	-5.3%	-2.3%
Gross government debt/GDP	IMF	125.6%	77.8%	95.2%	262.5%	70.9%	87.8%	112.6%	101.8%
Current account balance/GDP	IMF	-3.5%	1.1%	1.8%	2.4%	5.9%	-5.5%	-1.8%	1.1%
International currency reserves	bn USD	35	3'104	540	1'203	37	108	52	79
Govt bond yield 2yr [3]	% p.a.	3.3%	2.0%	0.7%	-0.1%	0.7%	2.4%	0.5%	3.3%
Govt bond yield 10yr [3]	% p.a.	2.9%	2.6%	1.1%	0.2%	1.1%	2.2%	1.6%	2.8%
Main policy interest rate ?	% p.a.	2.5%	4.4%	0.5%	-0.1%	0.5%	1.8%	0.5%	1.0%
Spread 10y-2y treasury yield	Basis points	-43.0	57.3	37.4	27.9	36.9	-12.8	108.4	-56.8

[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
Exchange capitalization*	bn USD	46'795	16'228	7'966	5'607	2'023	2'992	2'792	2'930
Growth in earnings per share, estimated (MSCI)									
12 months forward / trailing 12m	Consensus	17.7%	6.0%	23.7%	22.4%	22.7%	31.7%	49.2%	6.6%
Next fy / 12m fwd	Consensus	3.2%	5.8%	1.2%	2.9%	1.5%	-0.3%	-0.3%	0.6%
Growth in revenue per share, estimated (MSCI)									
12m fwd / trail 12m	Consensus	7.0%	10.3%	5.9%	7.7%	5.1%	9.6%	22.6%	5.1%
Next fy / 12m fwd	Consensus	1.6%	3.9%	0.5%	0.7%	0.9%	0.5%	-0.7%	4.9%
Valuations (MSCI)									
Price-Earnings Ratio (est 12m fwd)	Consensus	18.6	10.6	11.8	12.8	10.3	12.2	9.8	12.0
Price-Sales Ratio (est 12m fwd)	Consensus	2.5	0.9	1.0	0.9	0.8	1.2	1.2	1.8
Dividend yield	Consensus	1.5	2.5	3.4	2.5	3.8	3.1	4.0	3.1

* China market cap includes Hong Kong | Source: Bloomberg — Data per: 17.08.2022

Expected real GDP growth and inflation this year



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