Tactical asset allocation for Q2/2021

Marketing material

The reflationary macro outlook remains intact, although investors have started to worry about the interest rate outlook and its potential impact in particular on the stretched parts of the market. Against this backdrop, we refrain from adding to our equity overweight at this point. Instead, we add exposure to emerging market debt and open a long NOK position.

In this report, we present our assessment and the current macro and market outlook following the latest quarterly asset allocation review last week. We also point out the resulting changes in our tactical positioning. In brief:

- The cyclical macroeconomic backdrop remains reflationary, driven by large government spending programs and a surge in private household savings; it is hence a generally favorable one for growth-sensitive assets
- In response to this robust reflationary outlook, which implies strong growth and normal inflation going forward, long-term US interest rates have also started to rise from extraordinarily depressed levels of late
- The latter creates short-term challenges for some segments of the markets, as the uneven and partly extreme nature of the past year's rally has also partly driven valuations to expensive levels and built up technical imbalances that may need to be corrected
- The most expensive parts of the markets are generally most sensitive to changes in the level of interest rates and technical corrections

Against this backdrop, we refrained from adding to our equity overweight for now. Instead, we trimmed investment grade credit in developed markets to buy more emerging market debt. We also opened a currency position that is in line with our broader reflationary economic assessment, by going long the Norwegian krone against the euro. Finally, we keep our tactical position in gold.

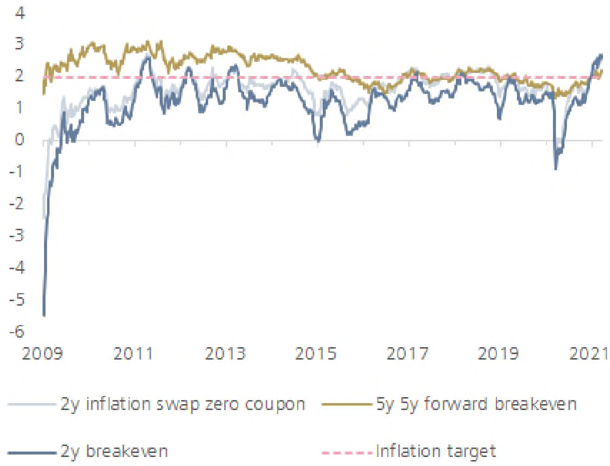
We will comment on these portfolio changes in more detail in the latter half of this repost. First, we should revisit the current macroeconomic situation once again.

Broader macro backdrop

The major event risks are behind us (US elections, Brexit, et al.) and the cyclical outlook is generally uplifting. We expect pent-up consumer demand and continued government stimulus programs to continue to fuel a rebound this year and into the next.

And while the fight against COVID-19 pandemic is facing occasional setbacks, financial markets have clearly shifted their attention and are less concerned about temporary delays in the reopening process. Instead, they have begun to ponder on inflation, interest rates and debt levels. Importantly, inflation expectations in the US have returned to exactly where they should be when the economy is recovering and they are also fully in line with the Federal Reserve's policy goals (graph 1).

Graph 1
USA: inflation expectations are back to normal
(Inflation compensation based on various debt instruments)



Source: Bloomberg, LGT Capital Partners

We agree with the Federal Reserve that the coming spike in consumer price indexes is driven by temporary factors, i.e. the base effects (crude oil has more than doubled year-over-year, temporary value-added tax suspensions are expiring, etc.) as well as temporary supply bottlenecks.

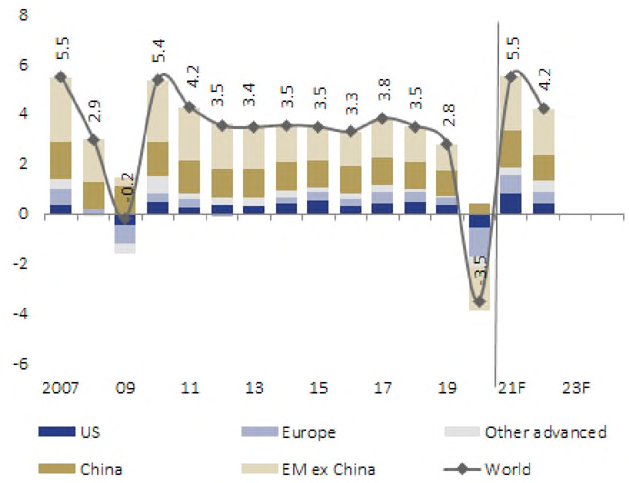
The larger question of long-term inflation that has now come to the fore is more important for the markets in our view. So far, the rise in bond yields and breakeven rates (i.e. future inflation as priced by the debt markets) is consistent with a long-awaited and lasting reflation – in other words, a favorable economic growth outlook with fairly normal underlying inflation pressures remains the most likely outcome over the medium term.

At the same time, the fact that central banks have made it clear that they will err on the side of accommodation for a long while is also making investors nervous from time to time, because that creates the potential for sharper monetary policy reversals further down the road. This sword of Damocles could admittedly continue to fan the occasional volatility in financial markets going forward. The bigger point is that the current policy settings support a global economic growth outlook that is just too benign to be ignored. Real US gross domestic product is expected to reach levels last seen in the early 1980s, while global growth is also expected to come clearly above the past decade's average (graph 2).

Graph 2

Global economic growth

(Annual change in real GDP, IMF estimates)



GDP = gross domestic product. IMF = International Monetary Fund. Source: Refinitiv, LGT Capital Partners

The exact timeline of the return path to a more normal way of life and the tradition style of working remain hard to predict as it will depend on regional vaccine rollout progress and on easing of local restrictions.

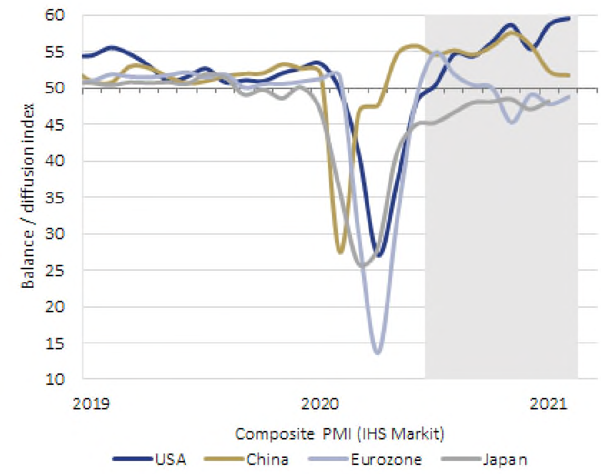
By and large, most large economies seem well on track for a reopening without major delays. The most recent readings of the composite purchasing managers' indices (which combine manufacturing and services sector surveys) show that the business outlooks in the US and China are well-anchored above the growth threshold at 50 points, while Europe and Japan remain on a more moderate, but nevertheless steady recovery path (graph 3).

Finally, the so-called lockdown indices, which estimate the levels of openness and the drag on each economy, also point out that, despite the occasional setbacks, most economies are closer to normal than to the restricted levels registered in the early phases of the pandemic (graph 4).

Graph 3

USA and China continue to lead recovery

(Composite purchasing managers' indices by IHS Markit)

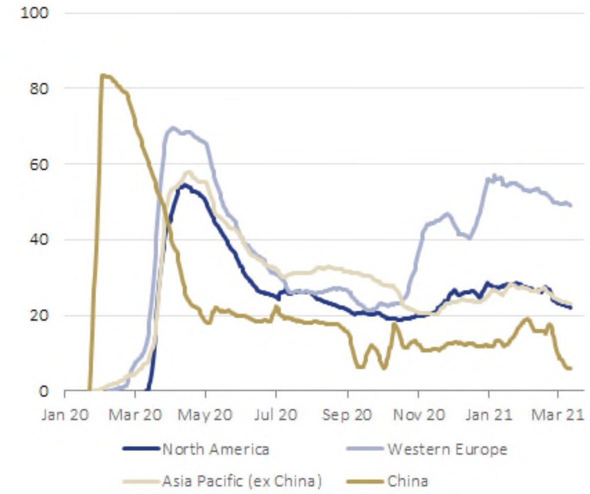


Source: Bloomberg, LGT Capital Partners

Graph 4

Gradual reopening of economies over time

(Goldman Sachs lockdown indices, 100 = full lockdown)



Source: Refinitiv, Goldman Sachs, LGT Capital Partners

Europe has been lagging in this regard for a while, largely due to policy choices that favor on/off restrictions on the services sectors, but the region is also moving in the right direction nevertheless. Intuitively, this process makes sense as the economy adapts to new ways of doing business over time. The bottom line is that the gradual global reopening thesis remains broadly intact.

Portfolio positioning

Overall, the bright economic growth outlook and lingering central bank support bode well for risk assets. The rise in yields has thus far only led to a rotation of sectors and styles and not to a general pushback in risk appetite.

We suspect that the inflection point of long-term interest rates becoming more damaging (exit from risk assets, forced deleveraging, fears of runaway inflation) lies much higher still and that the reflation trade can thus continue.

A more immediate caveat comes in the form of ebullient investors. Sentiment and positioning indicators all tell the tale of prevailing bullishness – often a contrarian indicator for the short-term. This likely means that the path ahead could become bumpier, at least until some of the excess optimism has waned. However, any market drawdowns could also be short-lived and/or shallow, considering the flood of liquidity likely to join an intact bull market.

Our tactical positioning hence remains largely unchanged and is set to capture the benefits of global reflation. We note here that we had recently added positions in global equities that we expect will benefit from this ongoing process of economic normalization.

We also maintain an underweight in bond duration and a small overweight in equities and, as mentioned, added exposure to emerging market debt and the Norwegian krone. Gold serves both as a diversifier for (geopolitical) event risks and as a preferred store of value should inflation expectations uncouple.

In more details, we implement the following tactical positioning going into the new quarter:

Equities: moderate overweight in favor of broad global indices

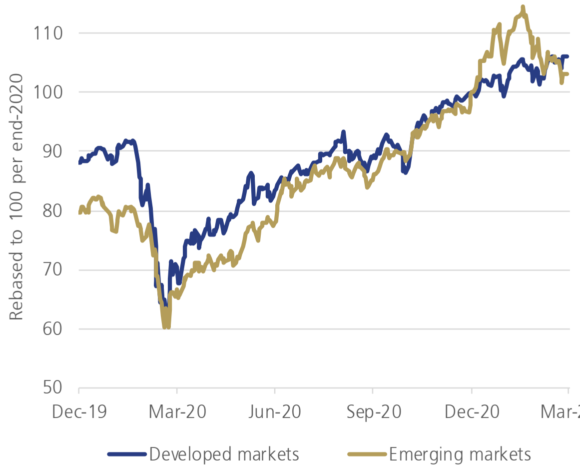
Equities are kept at a small overweight. Both developed market equities and emerging market assets remain slightly overweight to benefit from the strong, albeit staggered economic recovery around the globe.

Japan has received the most favorable assessment among equity regions on the grounds of relative valuation and cyclical exposure, however, we refrain from a separate active weight at this time and prefer to allocate to Japan within global equities. The global developed and emerging markets (EM) indices capture the current environment quite well in our view (graph 5). The developed markets (DM) perform well in a less volatile manner, while the EM show more potential for a rebound following the recent correction.

Graphs 5

Equities: staying the course

(MSCI net total return indices in local currency*)



*Hedged in the case of developed market equities. Source: Bloomberg, LGT Capital Partners

We should add that an important aspect of the current adjustment process in markets is the continuation of the so-called rotation trade, i.e. the shift away from the relatively small number stocks that had rallied strongly last year.

We believe this may continue for a while as investors begin to redeploy capital to the segments of the financial markets that are more reasonably valued as they had been left behind when investors were not expecting a V-shaped economic rebound.

Finally, our strategic allocation is well-positioned overall to benefit from this process due to its composition, which includes allocations to Real Estate Investment Trusts, or REITs. We are hence comfortable with staying the course.

Bonds: trim interest rate risk and add EM exposure

In fixed income, we added to emerging market debt in local currency. Many emerging market currencies are fundamentally cheap and hence attractive, especially versus the US dollar, which we expect to remain rather weak over the medium term. And although spreads have tightened already, they still offer an attractive carry in many EMs versus most DM base currencies – especially following the recent, comparatively pronounced, correction (graph 6).

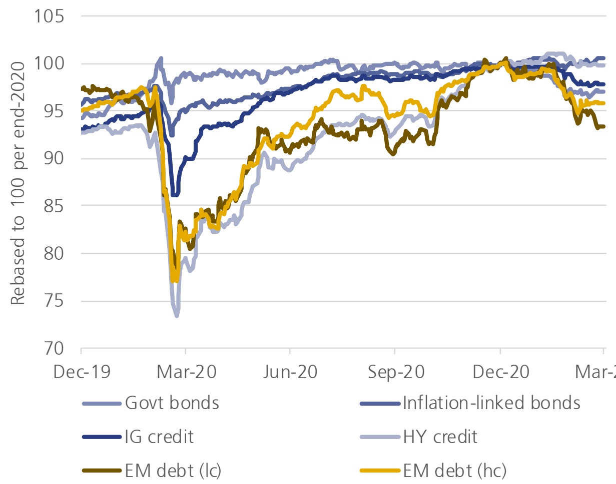
The asset class should also be able to digest gradual increases in treasury yields, particularly if the latter occur on the prospects of improving growth.

Moreover, local inflation rates are structurally lower and external balances relatively solid which allows many EM central banks to operate with some leeway with regards to low policy rates. The recent price pullback combined with the solidifying rebound in global business and trade activity has thus created a promising point of entry into this growth sensitive asset class in our view.

Graph 6

Credit: EM local currency debt most attractive now

(Total return indices by Bloomberg Barclays)



Source: Bloomberg, LGT Capital Partners

High-yield and investment-grade corporate credit, meanwhile, are kept underweight on very tight spread levels and slowly rising base rates. Within our allocation to government bonds, inflation-linked issues continue to command a significant allocation.

Currencies: adding NOK vs. EUR

In currencies, we initiate a position in the Norwegian krone versus the euro. The Norges Bank seems to be one of the first central banks to have adopted a tightening bias on the back of the strong cyclical outlook, aided by rise in crude oil prices.

The euro on the other hand, is expected to be held back by its negative interest rate policy of the European Central Bank for the foreseeable future. Thus, Norway is bound to see both a rising yield carry and a rising current account differential relative to the Eurozone. In addition, the growth differential between the two economic blocks is also set to expand in favor of Norway given less stringent pandemic restrictions and surging energy demand.

Graph 7

Euro versus Norwegian krone

(Price of EUR in NOK)

Source: Bloomberg, LGT Capital Partners

Gold: keeping the position for now

The long-term investment case for gold remains intact in our view, although the precious metal has not benefited from the rise in inflation expectations in recent months. Somewhat higher nominal rates and the end of the decline in real interest rates represent expectations of "good" and "expected" inflation, rather than an unexpected surge. This has led investors to shun safe-haven assets recently, opting to seek exposure to asset that benefit from a rebounding economy.

We intend to monitor technical support levels closely in coming weeks and revisit the case for this tactical position.

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 and adjusted in the interim if necessary; it shows our current positioning versus the strategic allocation (SAA) of the LGT Endowment, or Princely Strategy, for 2021. The regional weights for equities result from the quota in global developed markets.

- **Equities: moderate tactical overweight in both developed and emerging markets, with no active emphasis on regions**
- **Fixed income: underweight, with the preference shifting in favor of emerging markets in local currency**
- **Alternatives and currencies: new active position in NOK vs. EUR and a passive overweight in EM vs. USD**

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

	Currency[2]	SAA	Tactical allocation versus SAA (---- / --- / -- / - / + / ++ / +++ / ++++)
Currencies	USD	88.0%	--
Currencies	EUR	0.0%	--
Currencies	CHF	0.0%	
Currencies	NOK	0.0%	++
Currencies	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	0.1%	-2.7%	-2.9%	4.4%	3.1%
Global inflation linked bonds	USD	1.0%	0.7%	0.6%	3.9%	3.3%
Investment grade corporate bonds	USD	-1.0%	-2.0%	-2.1%	5.5%	4.1%
High yield bonds	USD	-0.7%	0.0%	-0.2%	5.9%	7.8%
Emerging markets[2]	USD	-1.9%	-5.1%	-5.4%	1.8%	4.5%
Equities						
Global	USD	4.1%	6.3%	6.1%	13.3%	13.4%
Global defensive	USD	5.4%	2.2%	1.7%	8.5%	8.5%
North America	USD	3.7%	6.2%	5.5%	16.4%	15.8%
Europe	EUR	5.6%	6.0%	7.0%	6.6%	8.2%
Japan	JPY	5.4%	8.5%	9.3%	8.1%	9.7%
Emerging markets	USD	-2.2%	3.5%	1.6%	6.3%	12.5%
Alternative and real assets						
Listed private equity	USD	5.3%	12.4%	12.1%	15.6%	16.1%
Hedge funds	USD	2.9%	6.1%	3.2%	4.3%	5.4%
Insurance linked securities (ILS)	USD	0.8%	0.8%	0.7%	3.9%	4.0%
Real estate investment trusts (REITs)	USD	6.3%	8.4%	7.0%	8.7%	5.7%
Gold	USD	-0.7%	-8.8%	-9.7%	8.9%	6.6%
Currencies (vs. rest of G10)[3]						
US dollar	USD	1.6%	2.0%	2.4%	0.9%	0.0%
Euro	EUR	-1.2%	-2.4%	-1.7%	-0.7%	0.9%
Swiss franc	CHF	-2.0%	-4.5%	-4.0%	1.6%	0.7%
Japanese yen	JPY	-1.7%	-4.4%	-4.3%	-0.3%	0.6%
Australian dollar	AUD	0.6%	2.5%	1.6%	0.7%	0.0%
Norwegian krone	NOK	3.4%	3.2%	3.1%	-2.2%	-0.4%
British pound	GBP	0.3%	4.3%	3.3%	0.2%	-1.0%
Canadian dollar	CAD	2.9%	4.1%	3.6%	1.7%	0.8%
Chinese yuan (vs. USD)	CNY	-1.1%	0.1%	-0.3%	-1.2%	-0.1%

[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

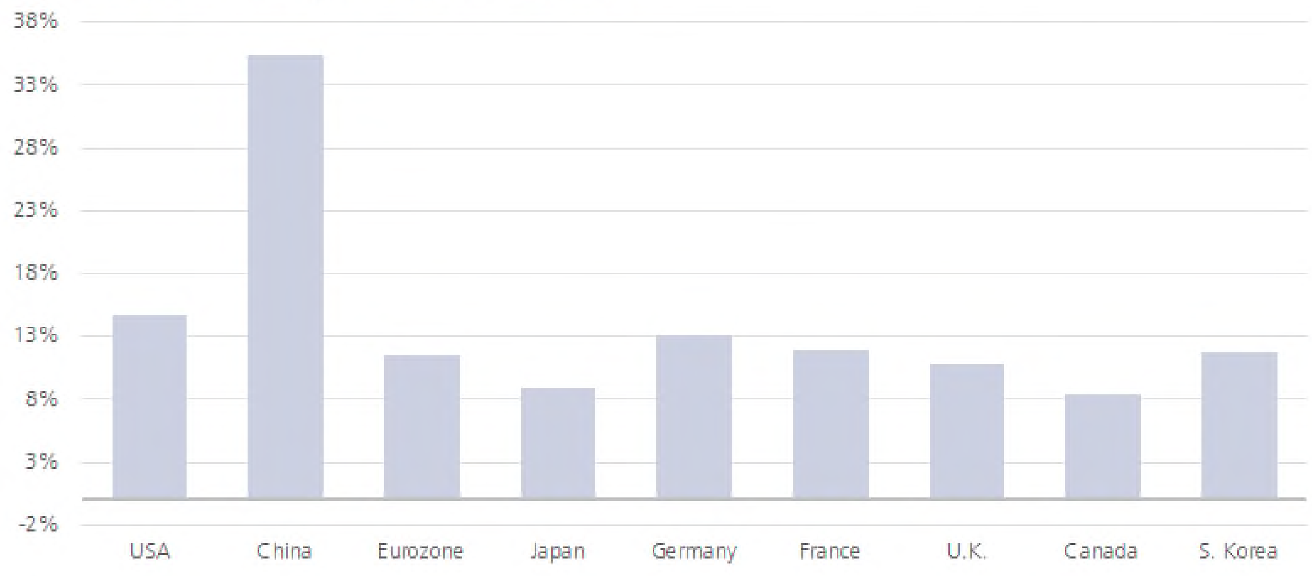
		USA	China	Eurozone	Japan	Germany	France	U.K.	Canada	S. Korea
Gross domestic product (GDP)										
Nominal, this year[1]	bn USD	21'922	16'493	14'545	5'103	4'318	2'918	2'856	1'763	1'674
Per Capita, purchasing power parity[1]	USD, PPP	65'254	18'983	40'965	43'709	57'081	49'124	47'693	50'596	46'534
Real growth this year[1]	Consensu	5.7%	8.5%	4.2%	2.8%	3.4%	5.7%	4.7%	5.4%	3.4%
Real growth next year[1]	Consensu	4.0%	5.5%	4.2%	2.1%	4.1%	4.0%	5.7%	4.0%	2.8%
Real growth current quarter	Annualize	4.3%	10.8%	-2.6%	11.7%	0.3%	-1.4%	1.0%	9.6%	1.2%
Unemployment this year	Consensu	5.6%	3.8%	8.6%	3.0%	5.9%	9.3%	6.0%	7.8%	4.0%
Inflation this year	Consensu	2.4%	1.6%	1.5%	0.0%	2.0%	1.2%	1.6%	2.0%	1.2%
Purchasing manager index (comp.) [2]	Neutral:	59.1	51.7	52.5	48.3	56.8	58.8	57.9	54.8	55.3
Structural budget balance/GDP	IMF	-7.6%	-10.9%	-3.1%	-5.6%	-1.8%	-4.0%	-6.4%	-7.9%	-1.0%
Gross government debt/GDP	IMF	133.6%	66.5%	100.0%	264.0%	72.2%	118.6%	111.5%	115.0%	52.2%
Current account balance/GDP	IMF	-2.1%	0.7%	2.4%	3.2%	6.8%	-1.8%	-3.8%	-2.4%	3.4%
International currency reserves	bn USD	43.1	3'205.0	420.9	1'300.6	37.9	54.2	132.4	72.9	430.1
Govt bond yield 2yr [3]	% p.a.	0.14%	2.74%	-0.66%	-0.14%	-0.71%	-0.66%	0.07%	0.22%	1.05%
Govt bond yield 10yr [3]	% p.a.	1.69%	3.19%	-0.18%	0.08%	-0.32%	-0.07%	0.79%	1.51%	1.98%
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	45'582	9'295	17'576	7'007	2'640	826	3'454	690	2'015
Growth in earnings per share, estimated (MSCI)										
12 months forward / trailing 12 month	Consensu	38.6%	34.3%	226.6%	39.3%	211.7%	252.4%	488.8%	59.0%	67.8%
Next fy / 12m fwd	Consensu	14.0%	15.3%	17.9%	22.1%	16.4%	18.1%	12.6%	8.4%	22.7%
Growth in revenue per share, estimated (MSCI)										
12m fwd / trail 12m	Consensu	14.8%	35.4%	11.5%	8.9%	13.1%	11.8%	10.8%	8.4%	11.7%
Next fy / 12m fwd	Consensu	6.4%	12.9%	4.5%	7.4%	4.6%	4.7%	4.4%	5.4%	7.5%
Valuations (MSCI)										
Price-Earnings Ratio (est 12m fwd)	Consensu	23.4	16.3	18.4	21.0	16.5	19.0	14.0	16.0	14.1
Price-Sales Ratio (est 12m fwd)	Consensu	2.8	1.8	1.3	1.1	1.0	1.4	1.2	2.0	1.0
Dividend yield	Consensu	1.5%	1.6%	2.7%	1.9%	2.6%	2.7%	4.0%	2.9%	1.7%

* China market cap includes Hong Kong | Source: Bloomberg Data per: 30.03.2021

Expected revenue per share growth 12 months forward



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