LGT Beacon

Global macro and market review

November 8, 2017

Robust growth and diplomatic reengagement

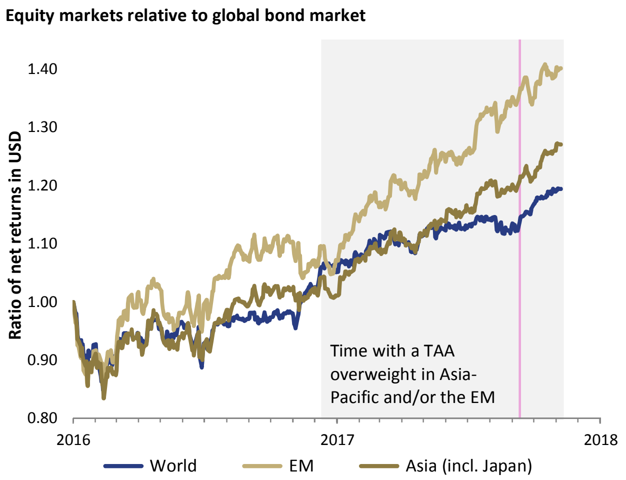
The global economy, corporate earnings and equities remain strong, while political events signal monetary policy continuity. Furthermore, after having solidified their domestic positions just days ahead of the US president's first tour of Asia, the leaders of China and Japan have moved to reengage diplomatically - and Asian markets continued to surge.

In this report, we offer a global macro update and communicate changes in our tactical asset allocation (TAA), as set following LGT Capital Partners' quarterly strategy review in September.

Overall, market-friendly developments have remained dominant since the last LGT Beacon and we are staying the course, maintaining an overweight in equities against an underweight in fixed income, with a tilt in favor of Asia (see TAA overview, page 5).

Graph 1

Equities have gained in momentum



Note: MSCI indices in USD for equities. JP Morgan index for bonds. Source: Bloomberg, LGT Capital Partners

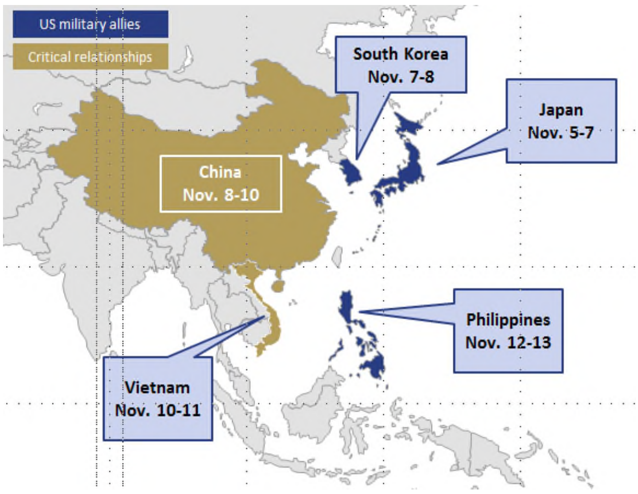
Geopolitical tensions defused

Geopolitical tensions have eased. In Europe, Spain has ousted the separatist regional administration of Catalonia to restore the constitutional order and prepare for early regional elections. But events in Asia may prove of greater global significance, as they concern critical security and regional relationships among major powers.

Specifically, the 19th Communist Party Congress in China and the 48th House of Representatives election in Japan strengthened the domestic standing of President Xi Jinping and Prime Minister Shinzo Abe, respectively. The former amassed personal powers unseen since Mao Zedong (see Special Topic). The latter comfortably defended a two-thirds majority for his coalition.

Graph 2

President Trump's Tour of East Asia



Source: The Guardian, LGT

Stronger regional leaders reengage

Following these processes and just days ahead of US President Donald Trump's first official tour of Asia (graph 1), China then agreed to end a more than year-long dispute with South Korea over Seoul's decision to allow the deployment of an advanced US missile defense system on its territory - a dispute that included unofficial economic sanctions against South Korean companies.

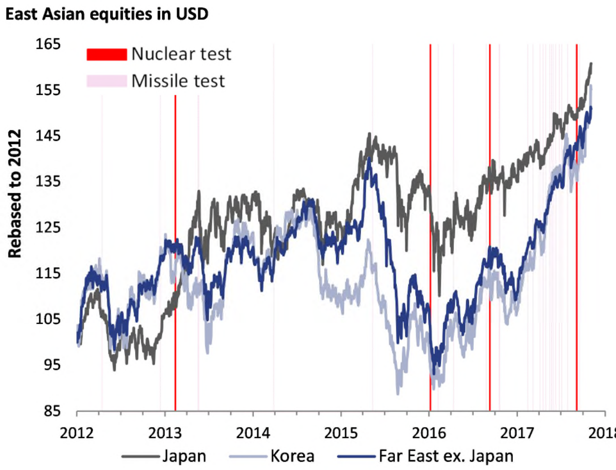
In addition, Beijing, Seoul and Tokyo have also reportedly agreed to revive their trilateral summits before the year's end. The last one had been called off after relations had soured due to current and historical issues, while South Korea was still reeling under its former president's impeachment and dismissal process.

In the meantime, all three countries have more stable and confident governments, while President Trump's visit is expected to signal continued US-engagement in Asia. At the same time, all three East Asian governments now seem to agree on one key point: regional matters cannot be left to the US alone.

In short, the recent saber-rattling surrounding the Korean peninsula has not led to an escalation, but was instead followed by the emergence of more confident and stable regional leaders - all of whom have moved to reengage diplomatically on issues on common interest.

Graph 3

Asia outperforms despite North Korean threats



Note: MSCI Japan, MSCI Korea and MSCI Far East excluding Japan. Source: Bloomberg, LGT Capital Partners

Unsurprisingly, Asia's equities continued to surge (graph 3), implying that a benign geopolitical outcome may not yet be fully priced in - which is remarkable, since that these markets have already been outperforming since North Korea began to sharply increase its nuclear and missile tests in early 2016 (partly in anticipation that Pyongyang's actions would ultimately lead to a pragmatic diplomatic solution).

Economic upswing maintains momentum

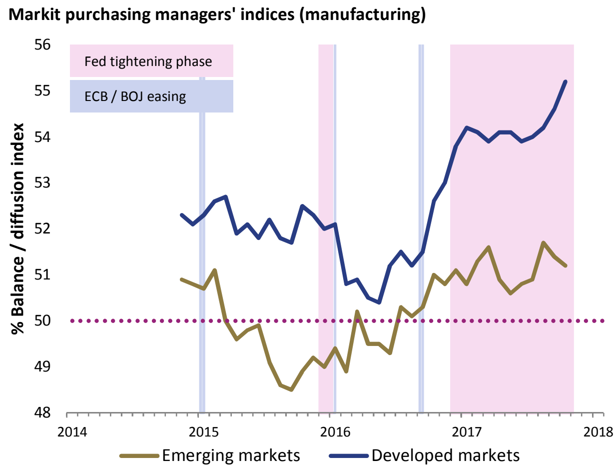
That said, it is important to repeat that these trends are primarily based on a global economic upswing, which has remained robust. Inflation expectations have recently normalized or moved toward the targeted levels, while the cyclical indicators continue to point to robust – and in some cases accelerating – economic growth.

For instance, the Atlanta Federal Reserve's real gross domestic product (GDP) forecasting index a few days ago signalled that US real growth will rise to an annualized rate of 4.5% in the current quarter, which would be far higher than the current consensus forecast of 2.2% as well as the 20-year average growth rate, also 2.2%.

The more reliable purchasing manager survey readings (graph 4) also mostly picked up again for the developed markets, or remained in positive territory in the case of the emerging markets.

Graph 4

Markit business surveys



Source: Bloomberg, LGT Capital Partners

Central banks: prevalence of continuity

As far as the monetary policy is concerned, President Trump last week named Jerome Powell to succeed Janet Yellen at the helm of the Federal Reserve, showing a preference for pragmatic, data-dependent policy continuity. Powell is on the record as being rather disinclined to tighten policy in the absence of clear evidence of inflationary pressures. Some analysts thus view him as potentially more dovish than Yellen.

It is also worth adding that, following Abe's election victory last month, the monetary policy regime at the Bank of Japan is now even less likely to change than before, the outlook for China also remains encouraging (see Special Topic).

The risk of a hawkish policy error by one of the major central banks has thus decreased further, while current monetary conditions are just about right for most economies to generate broadly the desired moderate level of inflation, which is the ideal backdrop for sustained economic growth and hence stable corporate profit gains.

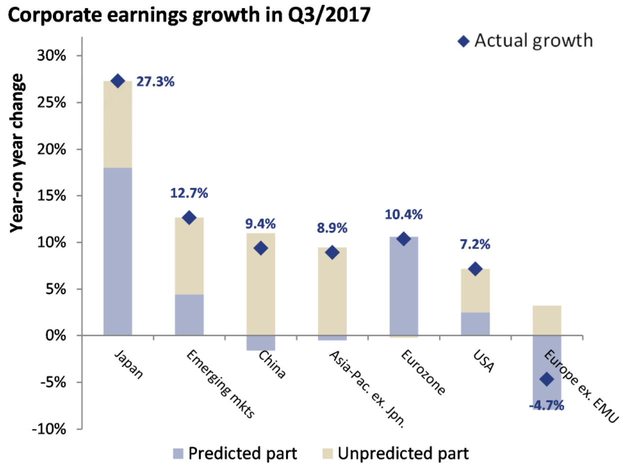
Earnings season: stronger than expected

To wrap up the global macro picture: the corporate reporting season for the third quarter of 2017 is now nearly complete. With about three-quarters of the world's major public companies having published results, earnings per share (EPS) are beating expectations in most regions. Actual growth is once again by far the highest in Japan, followed by the EM and Asia-Pacific. The surprises are the most positive in China, Asia-Pacific, and the EM (graph 5).

With regard to the surprises, it is worth highlighting that the consensus forecast a small drop in Chinese earnings, for example - but Chinese EPS actually rose by about 10%. In other words, the situation has fully reversed from a few years ago, when EM and Asian companies were expected to report very strong earnings but were consistently failing to meet these elevated forecasts for several years.

Graph 5

Earnings season results: earnings per share

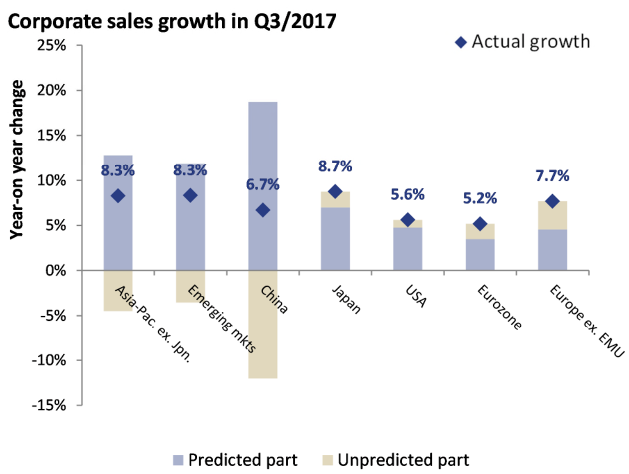


Note: S&P 500 for the US, EuroStoxx for the Eurozone, Topix 500 for Japan. The other results are based on MSCI indices. Source: Bloomberg, LGT Capital Partners

European results are mixed. Luckily, however, Eurozone growth is clearly positive and the drawdowns concentrated in just two segments - i.e. the German auto sector, which has been burdened by industry-specific issues, and the telecom sector, where deflationary pressures remain strongest. Earnings in aggregate declined only in non-euro Europe – but that too was driven by only a few sectors. The overall drop was also somewhat smaller than predicted by analysts on average.

Graph 6

Earnings season results: sales



Source: Bloomberg, LGT Capital Partners

Top-line results - a better proxy for economic growth

Concluding, the results overall once again suggest that global economic momentum growth remains rather underappreciated in the major markets. The latter becomes evident if we look at corporate sales (top-line), rather than EPS (bottom line). Sales growth has a stronger, more direct relationship to nominal GDP – and regional differences are indeed less pronounced from that perspective (graph 6). At present, the top-line general growth rates are generally rather high at present.

END OF TAA-RELATED REPORT

Special Topic:

China: The 19th Congress of the Communist Party

On October 25, the 19th National Congress of the Chinese Communist Party (CCP) came to a conclusion. As China is a one-party state, this quinquennial congress essentially determines the country's political and economic course.

Most powerful leader in decades

As had been widely expected, many of President and Party General Secretary Xi Jinping's close allies have been promoted to the Politburo and its Standing Committee (PSC), the state's top-decision making body. This and the congress's decision to enshrine Xi's name next to his "thought" in the party constitution is representative of the fact that Xi has emerged as one of the most powerful Chinese leaders in years.

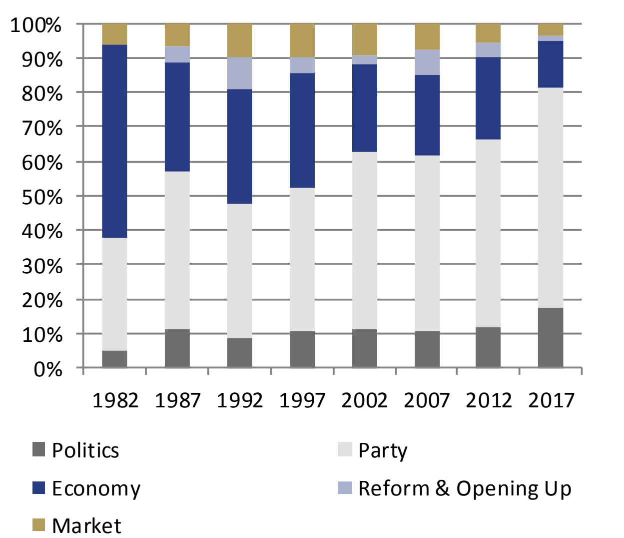
Also, by not anointing an evident successor, he broke with existing conventions, leaving the door open for himself to take over a third term in office in 2022.

A mixed bag

From an economic viewpoint, the outcome is a mixed bag. The consolidation of power around Xi will enable him to push ahead with the reform agenda, which, however, warrants a final say of the party over market forces in key areas. This is evident from the Party Congress Report, which focuses more on political achievements than on free-market reforms.

Graph 7

Relative share of key words in Party Congress Report



Source: Capital Economics, LGT Capital Partners

While it outlines a continuity of the party's 2013 reform blueprint (the focus is set on containing financial risk, encouraging innovation and increasing consumer spending), it also reveals a desire for strong state firms and for retaining state assets.

On the brighter side, the promotion of several officials from the more liberal party wing to the PSC could give future economic policy a somewhat reformist tilt.

It is also worth noting that Xi for the first time explicitly called for an improved coordination between fiscal and monetary policies. Hitherto, China's leader had only referred to fiscal-monetary coordination in an international context, during G20 and BRICS summits. This is an indication that the central bank would probably continue to provide sufficient support when needed, i.e. if/when regulatory or fiscal policy interventions burden growth too heavily.

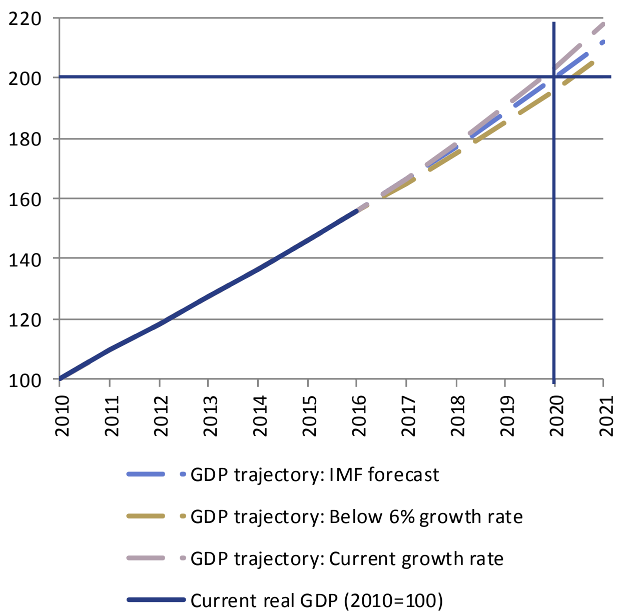
More details on the near-term economic policy objective from the new leadership can be expected toward the end of the year at the annual Central Economic Work Conference.

Slower, more balanced growth ahead

By and large, a more moderate economic momentum should be expected. The government needs a growth rate between 6-6.5% to achieve its goal of doubling gross domestic product (GDP) by 2020, which is below the current growth rate of 6.8%. Therefore, it could allow growth to grind somewhat lower. As reemphasized during the congress, the authorities are increasingly focused on the quality and not the quantity of growth. In fact, in his opening speech Xi refrained from explicitly mentioning the intention of doubling GDP, instead he envisioned a modern socialist country by 2035 and leading influence on the world stage by 2050.

Graph 8

GDP trajectory according to various assumptions



Source: Thomson Reuters, LGT Capital Partners

Going forward, a less supportive fiscal policy stance and a further slowing in credit activity are likely, while efforts to make growth more sustainable i.e. reduce overcapacity and increase environmental protection, will continue.

As growth has been unexpectedly strong this year, which is partially attributable to the desire of holding the congress amid stable business conditions, and partially to the rebound in global trade and strong external demand, the government is in a rather comfortable position to move ahead fast with painful structural reforms.

Retention of power remains first priority

However, while growth may in fact become somewhat more volatile henceforth, it is unlikely to slip below 6%, as this level would call the party's capabilities into question. Although Xi is in a position of unprecedented sway, at the end of the day, his thought on "Socialism with Chinese Characteristic for a New Era" is first and foremost about fostering China's strength. This means that while economic reforms will in fact be a top priority over the next five years, the party's retention of power will remain the paramount one.

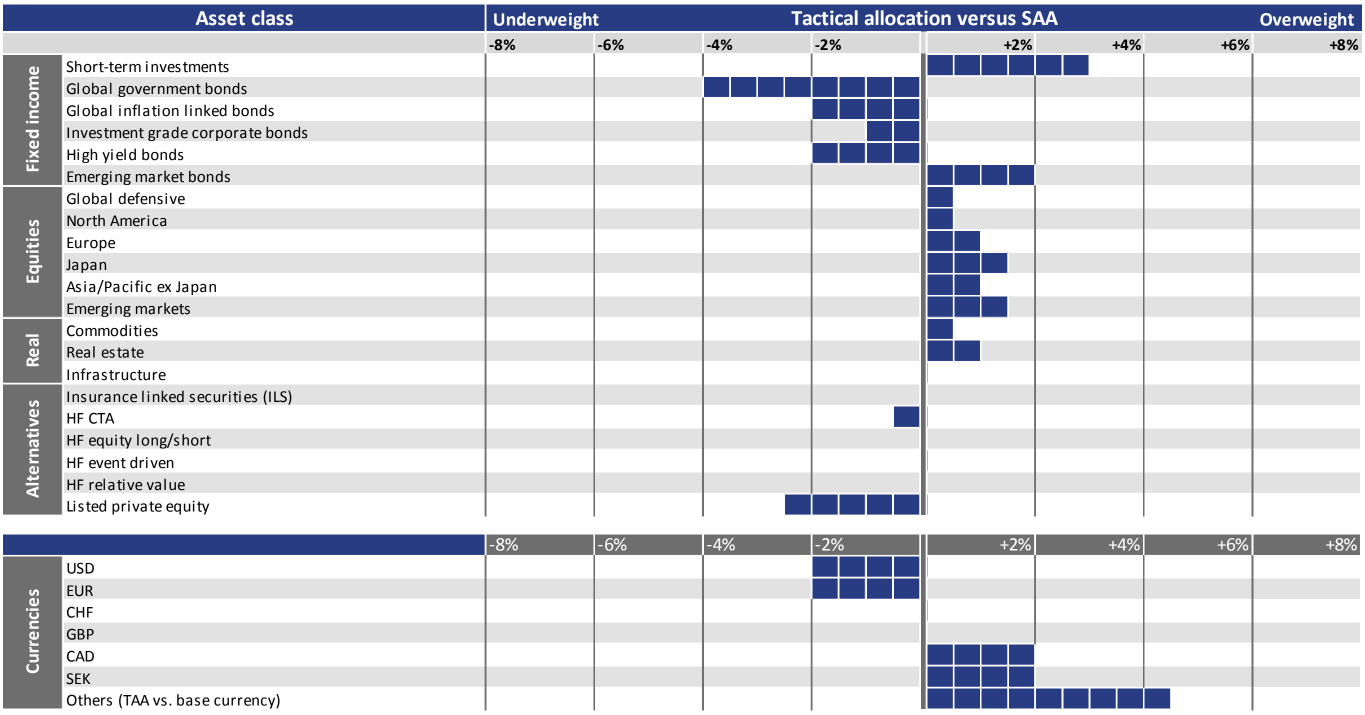
Barring a major policy mistake, the strongest effect from China's transition to a consumption-based economy thus continues to be felt in commodity-exporting emerging markets and Australia, while service imports such as tourism and education are likely to hold up due to their consumption-related nature. Investors can continue to take solace in the fact that a hard landing of the Chinese economy will be avoided at all costs and that the gradual nature of economic transition in China should not derail the rebound in global activity.

END

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

Our tactical asset allocation (TAA, i.e. positions versus our neutral strategic quotas) is set following a quarterly scoring process, and reviewed monthly. Further trades can and are regularly implemented to capture short-term market movements in between these meetings, without signifying a change in our views. Our current TAA (set on Sept 8, 2017) can be summarized as follows:

- **Overweight in equities, with a tilt in favor of Asia resulting from positions in the Asia-Pacific, the EM, and Japan**
- **Underweight in fixed income, strongly in favor of EM against the developed sovereign and credit markets**
- **Real and alternative assets: REITs preferred over commodity and infrastructure stocks, listed private equity avoided**
- **Currencies: SEK and CAD preferred over EUR and USD; EM and Asia-Pacific currencies are passively overweight**



The above shown model portfolio is based on the LGT GIM Balanced (USD) portfolio, managed by LGT Capital Partners. Currency risk in developed markets is always fully hedged in our portfolios as a matter of policy.

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%	0.8%	2.2%	3.1%	3.2%
Global inflation linked bonds	USD	0.6%	0.9%	1.9%	2.0%	1.1%
Investment grade corporate bonds	USD	0.3%	0.5%	4.1%	3.1%	2.7%
High yield bonds	USD	0.2%	1.2%	9.5%	5.4%	6.0%
Emerging market bonds	USD	-0.5%	0.6%	9.5%	4.3%	2.8%
Equities						
Global defensive	USD	0.7%	2.1%	13.8%	9.2%	11.2%
North America	USD	1.6%	4.8%	16.9%	9.4%	14.0%
Europe	EUR	1.7%	3.7%	14.6%	9.5%	11.3%
Japan	JPY	6.4%	10.2%	18.4%	10.0%	20.5%
Asia/Pacific ex. Japan	USD	3.5%	5.5%	33.6%	8.3%	7.4%
Emerging markets	USD	2.6%	5.6%	33.7%	7.1%	4.8%
Real assets						
Commodities (commodity producers' equities)	USD	4.2%	9.4%	8.3%	-1.1%	0.2%
Real estate (real estate investment trusts, or REITs)	USD	0.4%	0.3%	7.8%	5.2%	7.3%
Infrastructure (master limited partnerships, or MLPs)	USD	-3.8%	-4.4%	-8.0%	-12.6%	-1.1%
Alternatives						
Insurance linked securities (ILS)	USD	1.7%	-3.9%	-1.3%	3.4%	6.2%
HF CTA	USD	4.7%	4.6%	2.2%	2.1%	2.9%
HF equity long/short	USD	1.5%	3.6%	9.7%	4.6%	6.3%
HF event driven	USD	1.1%	1.9%	5.9%	3.6%	5.9%
HF relative value	USD	0.4%	1.3%	4.0%	3.4%	5.0%
Listed private equity	USD	-0.7%	0.7%	23.2%	11.1%	14.7%
Currencies [2]						
US dollar	USD	1.5%	2.3%	-5.4%	3.7%	4.2%
Euro	EUR	0.3%	0.4%	5.4%	1.0%	2.0%
Swiss franc	CHF	-0.7%	-0.7%	-3.4%	2.4%	2.9%
Canadian dollar	CAD	-0.2%	1.9%	0.5%	-0.7%	-1.3%
Swedish krona	SEK	-2.3%	-1.1%	3.4%	-1.1%	-0.9%
Japanese yen	JPY	0.1%	-1.1%	-2.8%	3.8%	-3.7%

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

Economic and corporate fundamentals

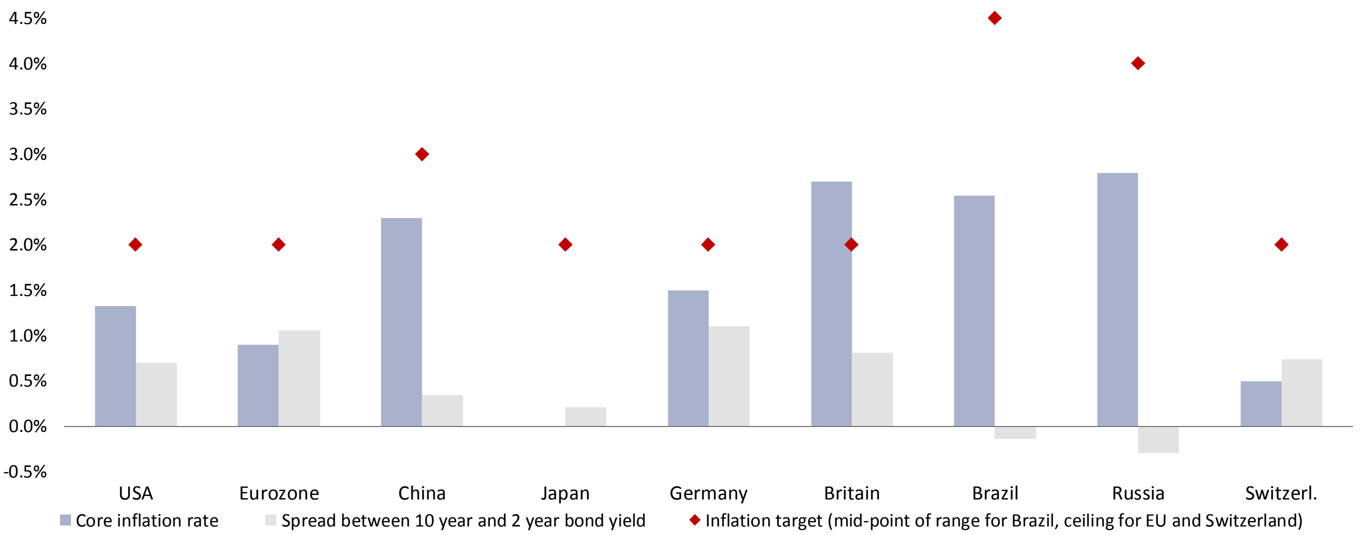
Macro fundamentals		USA	Eurozone	China	Japan	Germany	Britain	Brazil	Russia	Switzerl.
Gross domestic product (GDP)										
- nominal	bn USD	19,362	12,526	11,938	4,884	3,652	2,565	2,081	1,469	681
- nominal, per capita 2017[1]	USD, PPP	59,495	38,322	16,624	42,659	50,206	43,620	15,500	27,900	61,360
- expected real growth for 2017	Consensus	2.2%	2.2%	6.8%	1.5%	2.1%	1.5%	0.7%	1.8%	0.9%
- expected real growth for 2018	Consensus	2.4%	1.8%	6.4%	1.1%	1.8%	1.3%	2.4%	1.8%	1.7%
- real growth in most recent quarter[2]	q/q annualized	3.0%	2.4%	7.0%	2.5%	2.4%	1.6%	1.0%	-2.3%	1.2%
Unemployment rate[3]		4.1%	8.9%	4.0%	2.8%	5.6%	4.3%	8.2%	5.0%	3.1%
Inflation, core rate (CPI)	y/y	1.3%	0.9%	2.3%	0.0%	1.5%	2.7%	2.5%	2.8%	0.5%
Purchasing manager indices (comp.)	Neutral = 50	55.2	56.0	51.0	53.4	56.6	55.8	49.5	53.2	62.0
Structural budget balance/GDP 2017	IMF	-4.4%	-0.9%	-3.8%	-4.0%	0.3%	-2.8%	-7.8%	-2.0%	0.2%
Gross government debt/GDP 2017	IMF	108%	91%	48%	240%	65%	89%	83%	17%	43%
Current account balance/GDP 2017	IMF	-2.4%	3.1%	1.4%	3.6%	8.1%	-3.6%	-1.4%	2.8%	9.9%
International currency reserves	bn USD	42	264	3,109	1,203	38	118	185	351	795
Govt bond yield 2yr[4]	p.a.	1.62%	-0.57%	3.72%	-0.18%	-0.76%	0.45%	8.31%	8.13%	-0.85%
Govt bond yield 10yr[4]	p.a.	2.33%	0.49%	4.06%	0.03%	0.34%	1.26%	8.18%	7.84%	-0.10%
Main policy interest rate[5]	p.a.	1.25%	0.00%	4.35%	-0.10%	0.00%	0.50%	7.50%	8.25%	-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	28,673	8,327	12,897	6,149	2,421	3,657	884	583	1,742
Growth in earnings per share, estimated (MSCI)										
Next fiscal year / current fiscal year	Consensus	10.5%	9.4%	14.8%	3.1%	10.5%	6.3%	11.7%	12.6%	13.9%
FY year after next / next FY	Consensus	10.3%	9.0%	14.9%	8.4%	7.9%	7.6%	18.4%	6.4%	9.4%
Growth in revenue per share, estimated (MSCI)										
Next fiscal year / current fiscal year	Consensus	4.8%	3.5%	12.1%	2.3%	3.1%	4.0%	5.2%	6.1%	3.5%
FY year after next / next FY	Consensus	4.9%	1.7%	12.0%	1.8%	3.5%	4.1%	7.3%	6.5%	3.5%
Valuation metrics (MSCI)										
Price-Earnings Ratio (est forward 12m)	Consensus	19.7	16.1	15.4	15.2	15.5	15.3	14.3	7.4	19.5
Price-Sales Ratio (est forward 12m)	Consensus	2.1	1.2	1.8	0.9	1.0	1.3	1.6	0.9	2.2
Dividend yield	Consensus	1.0%	3.0%	2.0%	2.0%	2.7%	4.2%	2.8%	5.2%	3.1%

*Includes Hong Kong. Source: Bloomberg.

Current inflation rates remain below target and yield curves imply little upward pressure



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