LGT Capital Partners
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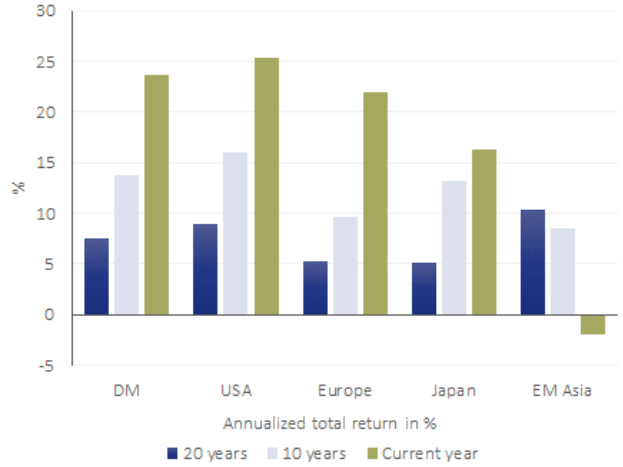
Constructive outlook, with some caveats

Marketing material

November saw another upside inflation surprise, which revived a spike in short- to medium-term inflation expectations. In the coming weeks, market participants may have to revisit the macro situation once again, and conclude that they need to bring forward their rate hike expectations. This could disrupt markets for a while, without ending the bull market.

Equities are on track to end the year with a strong gain. With the notable exception of Asia's emerging markets, all major indices are set to deliver total returns well above the past decades' norms (graph 1). The major developed markets have booked more than three times their 20-year annualized return thus far this year, led by Europe (which returned four times its 20-year annual norm) and followed by Japan and the US, with about three times each. Such strong deviations from the norm mandate a more cautious approach for the coming year.

Graph 1
Major equity index returns over the decades
(MSCI, annualized total return in local currency)

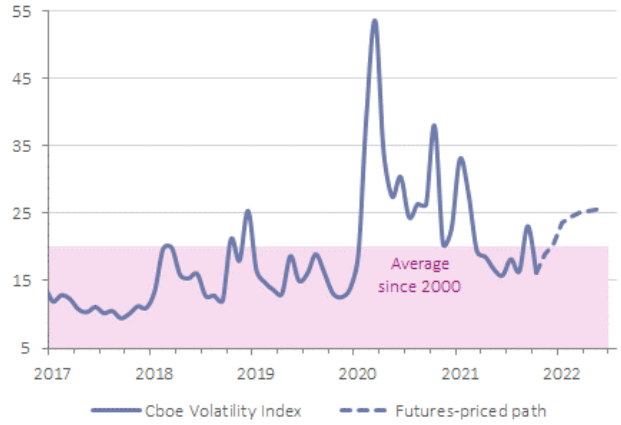


Source: Refinitiv, LGT Capital Partners

Expect choppier market action going forward

Over the past year, investors have (rightly) been relatively sanguine about the outlook – but that too is liable to change. In fact, investors are increasingly aware that equity market volatility will probably rise significantly from current levels, after plummeting since the initial COVID-19 shock in early 2020 (graph 2). That outlook is also consistent with broader macroeconomic trends: The global economy is just a year short of closing the gross domestic product (GDP) gap to the pre-pandemic trend.

Graph 2
Higher volatility priced in for the coming months
(Chicago Board Options Exchange volatility index, VIX)



Source: Bloomberg, LGT Capital Partners

At the current pace, the macro environment will thus start to look increasingly "mid to late cycle" as 2022 progresses. That kind of environment implies elevated macro and market volatility, strong but slowing growth, and inflation rates above central bank targets (but below current levels).

That said, we should restate that the factors favoring equities over most other asset classes in the coming year remain very much in place: monetary and fiscal policy is still clearly supportive, earnings growth is and will remain robust (the current consensus is too cautious, in our view), and market valuations on aggregate are certainly not extreme. In fact, thanks to stronger than expected corporate profit numbers, the forward price earnings ratio for the MSCI World All-Countries Index has declined from a peak value of 20.4 last September to about 18.2 at present. Lastly, the fact that expected volatility is already priced above average suggests that an uptick in actual volatility

is unlikely to catch investors off guard – implying limited impact on stock markets.

Nevertheless, over the longer term, equity market returns ultimately tend to track economic growth – and global growth momentum is clearly set to slow following last year's extremely rapid rebound from the sharp COVID-19 recession. Thus, overall equity market returns should also moderate accordingly over the coming months, while of course remaining in positive territory (graph 3).

Graph 3
Equity market returns and GDP growth
(Real GDP growth cutoff at +/- 10% YoY)

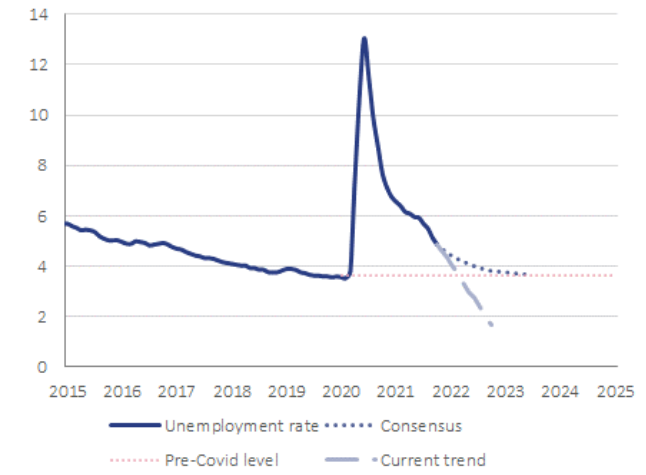
Source: Bloomberg, LGT Capital Partners

With this bigger picture in mind, we revisit the main recent economic developments, before summing up our current investment positioning.

Successful reflation on track

Earlier this month, the US inflation reading for October once again surprised on the upside, with a headline year-on-year gain of 6.2%, up from 5.4% in September. The core index rose 4.3%, up from 4.0%, and hence continues to hover around the highest levels since the early 1990s.

Graph 4
US unemployment rate: decline has accelerated
(% of work force)

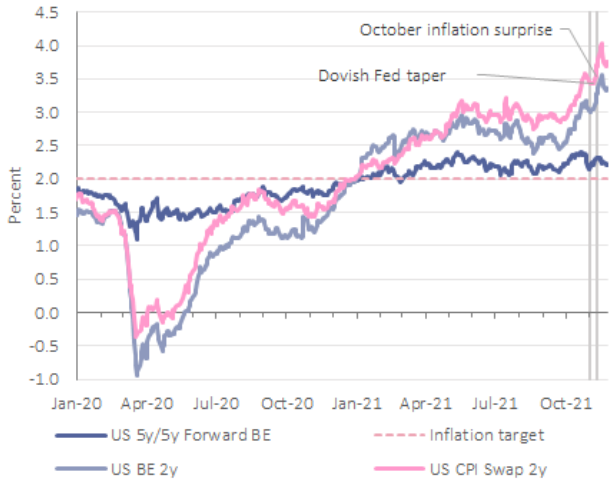


Source: Bloomberg, LGT Capital Partners

The inflation print came on the heels of robust labor market data published a few days earlier, which showed that the US private sector added more than 600,000 jobs in that same month – well ahead of the expected 420,000. In fact, the decline in the unemployment rate has accelerated markedly of late, while the consensus expects only a gradual fall toward pro-COVID-19 levels (graph 4).

Given the ongoing supply chain disruptions/repatriations and the still easy fiscal and monetary policy setting, this data in combination immediately revived a spike in short- to medium-term inflation expectations (graph 5).

Graph 5
Inflation expectations buoyant on the shorter end
(Based on traded inflation compensation instruments)



Source: Bloomberg, LGT Capital Partners

We must admit that both the cyclical as well as the supply side-driven price surges indeed appear to be somewhat higher than we had expected until recently.

Furthermore, the most recent COVID-19 infection wave in Europe has the potential to spread throughout the northern Hemisphere in the coming months, and hence also complicates the supply chain outlook, while arguably weakening the price pressures in the services sectors.

Inflation still likely to moderate over the coming year

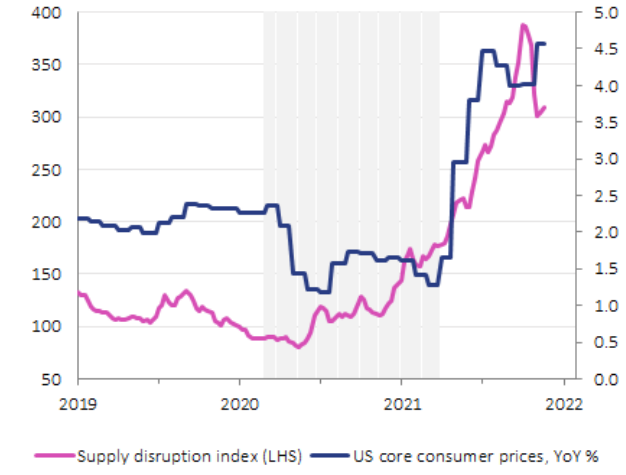
In sum, we believe the overall case for a gradual easing of current price pressures remains intact. For one thing, the biggest drivers of the recent supply disruptions have already started to ease markedly.

The supply disruption index, which we use as a proxy of these supply chain issues, has started to decline sharply over the past few weeks. If that retreat continues, inflation readings should also moderate going forward (graph 6, next page).

Graph 6

Global supply disruptions and US core inflation

(Shaded area: height of international lockdowns)



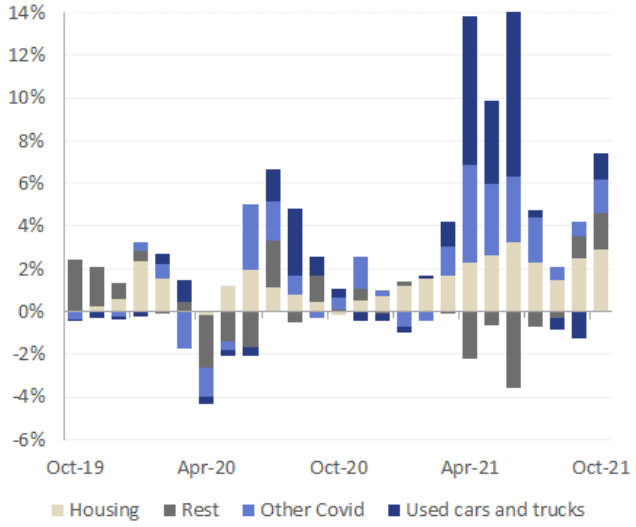
Supply disruption index: Baltic dry index, containerized freight costs, European natural gas, Chinese coal and DRAM microchip prices
Source: Bloomberg, LGT Capital Partners

The easing of the post-pandemic reopening-related inflationary pressures is also visible if we break down the consumer price index into its components (graph 7).

Graph 7

Contributors to this year's US inflation surge

(Core CPI*, annualized month-on-month change)



*Consumer price index less food and energy. Source: Bloomberg, LGT Capital Partners

Admittedly, housing costs and some other cyclical price pressures are now coming into effect as well, substituting the COVID-elements. However, as the reopening-related items are likely to not only moderate but arguably even see outright price declines, as already briefly observed during last year's summer, the net impact should contain inflation, and ultimately pull it lower again.

Meanwhile, oil prices seem to have stabilized on high levels after the recent surge, suggesting that base effects will likely drive fuel price inflation lower over the next twelve months, which should ultimately also be reflected in headline inflation rates.

In addition, the Federal Reserve has also adjusted its policy toward scaling back monetary stimulus and could further adjust the stance to the hawkish side, as and when needed. For example, if dynamics in the US labor market continue to surprise to the upside, then a more hawkish tilt would become increasingly palatable for financial markets.

Employment improving, but not yet on target

Recent employment trends have indeed been promising. If we define significant progress as recovering 75% of pre-COVID employment levels, then such progress has been achieved in roughly 70% of all labor market indicators that we track.

While these dynamics are a clear testimony to the health of the US labor market recovery, unemployment remains still high among ethnic minorities. At the same time, labor market participation is also still subdued with uninspiring dynamics. While a fast recovery on that front would ultimately pivot the Fed into earlier policy normalization, current data is still more consistent with a gradual approach to policy normalization.

The Fed will thus most likely continue its patient approach and be hesitant to raise interest rates as aggressively as currently priced in by financial markets participants.

The chances of a regulatory push at the Fed are rising

Meanwhile, on 22 November, President Joe Biden stuck to the playbook of most previous administrations by reappointing the sitting Fed chair – i.e. he nominated Jerome "Jay" Powell for a second term. This decision confirms the existing policy trajectory at the Fed.

That said, the nomination of Lael Brainard as vice chair could carry more weight for financial markets, at least over time. The economist, who has already served seven years as a Fed governor, is known for defending the post-global financial crisis regulatory apparatus and for opposing votes to relax restrictions on the largest and most important financial institutions.

Progressive Democrats in the Biden administration had thus hoped for her to be nominated in Powell's stead, and have suggested that she would have put more emphasis on issues like climate change and economic inclusion.

In any case, as vice chair, pending Senate confirmation, Brainard will still carry significant weight as the role prepares the intellectual ground for changes in policy and signals shifts to financial market participants. Hence, investors should be prepared to see the newly appointed vice chair lead more debates on banking regulation, the economic and policy aspects of climate change, as well digital central bank currencies.

While the alignment on monetary policy between the two officials will be welcomed by most investors, many market participants will be less happy about the potential for a renewed regulatory push. Discontent could grow further as three more seats at the Fed are currently vacant and to be filled by the Biden administration. Among them the position of vice chair for supervision.

In our view, given the market's verdict on the Fed's reflationary policy response to the pandemic shock, keeping Powell is less disruptive than replacing him with a candidate that enjoys partisan support with a specific group of Democrats – and hence the reappointment should be seen as positive for markets.

At the same time, on a higher level, Brainard's promotion is also in line with the global trend toward big government, regulation, and climate action. These are topics we had already highlighted in our annual outlook, and which are not per se directionally negative for the macro and market outlook in our view, although they clearly have consequences for asset allocation, e.g. with respect to de-carbonization of investment portfolios.

Conclusion: stay the course

Our base case for next year and beyond is as constructive as before. We still expect the global economy to reflate successfully, and hence corporate profitability to be sufficiently strong to favor investments in equities over other asset classes, in particular bonds.

Moreover, given seasonal patterns, we might very well see equities rally into the year-end. After all, while this year's gains are bigger than usual, the trading path as such is very much in line with historical patterns (graph 8).

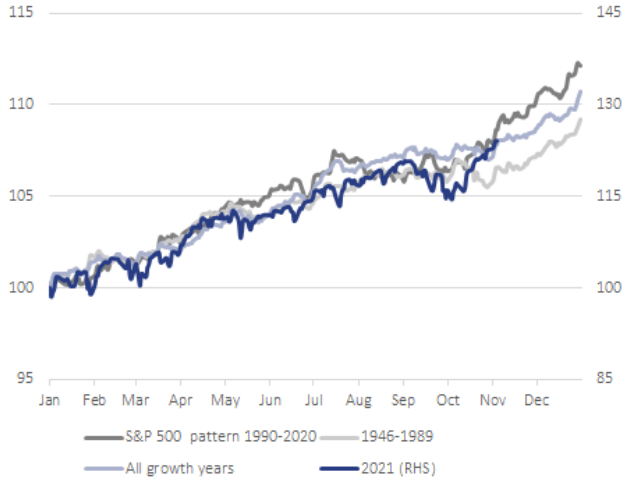
However, the special nature of the COVID-related developments and the recent data suggest that the risk/reward mix is becoming more balanced. The reappearance of broader, though still comparatively modest, lockdown policies in Europe, adds another element of uncertainty.

While we still expect inflation rates to fall over the next twelve months and policy makers to ultimately pursue a relatively patient approach to rate normalization, the risk that market participants will continue to price in additional rate hikes is elevated in the short term given the upward skew observed in inflation dynamics. Markets could thus prove choppier than current sentiment and history suggests.

Graph 8

S&P 500 in 2021 compared to historical patterns

(Rebased at start of year each period)



Source: Bloomberg, LGT Capital Partners

Against this backdrop, we stick to our only slight overweight in equities, combined with a significant underweight in duration, an elevated cash reserve, as well as a hedging position in gold for the time being. At the same time, in view of the more balanced overall outlook, we would be more inclined to adjust our risk exposure downward rather than upward at this stage.

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: slight tactical overweight tilted in favor of the developed markets**
- **Fixed income: underweight, with a preference for emerging markets bonds issued in local currencies**
- **Alternatives and currencies: moderate position in gold combined with a passive overweight in EM currencies**

	Asset class	SAA 2021	underweight ----	---	--	-	+	++	+++	++++ 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	0.6%	-1.4%	-2.3%	4.5%	3.2%
Global inflation linked bonds	USD	0.2%	1.3%	5.1%	5.0%	3.8%
Investment grade corporate bonds	USD	-0.3%	-1.5%	-1.5%	5.6%	3.9%
High yield bonds	USD	-0.8%	-1.5%	0.7%	7.0%	6.1%
Emerging markets [2]	USD	-1.4%	-3.0%	-5.8%	4.3%	3.9%
Equities						
Global	USD	2.5%	4.1%	23.1%	19.3%	15.0%
Global defensive	USD	0.3%	-1.2%	11.0%	10.8%	10.5%
North America	USD	2.5%	4.4%	24.8%	23.1%	17.8%
Europe	EUR	2.6%	2.5%	21.9%	12.2%	9.7%
Japan	JPY	2.7%	8.2%	16.1%	11.3%	9.8%
Emerging markets	USD	-2.4%	2.4%	-0.5%	11.7%	10.6%
Alternative and real assets						
Listed private equity	USD	2.5%	10.5%	56.6%	30.8%	22.3%
Hedge funds	USD	0.8%	1.2%	7.5%	6.7%	5.0%
Insurance linked securities (ILS)	USD	0.3%	1.4%	4.3%	4.6%	3.5%
Real estate investment trusts (REITs)	USD	0.1%	1.9%	26.3%	13.0%	10.5%
Gold	USD	0.0%	0.1%	-4.8%	13.9%	8.7%
Currencies (vs. rest of G10) [3]						
US dollar	USD	3.5%	2.0%	5.6%	-0.3%	-0.5%
Euro	EUR	-0.5%	-2.9%	-3.7%	-0.7%	0.9%
Swiss franc	CHF	1.4%	-0.4%	-0.3%	2.2%	1.4%
Japanese yen	JPY	2.0%	-3.2%	-6.3%	-1.0%	-1.0%
Australian dollar	AUD	-0.4%	2.1%	-1.6%	-0.4%	-1.0%
Norwegian krone	NOK	-4.2%	1.5%	0.7%	-1.8%	-1.4%
British pound	GBP	0.4%	-0.8%	3.2%	1.3%	1.1%
Canadian dollar	CAD	0.3%	1.4%	5.7%	1.2%	0.8%
Chinese yuan (vs. USD)	CNY	0.2%	1.6%	2.0%	2.7%	1.5%

[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

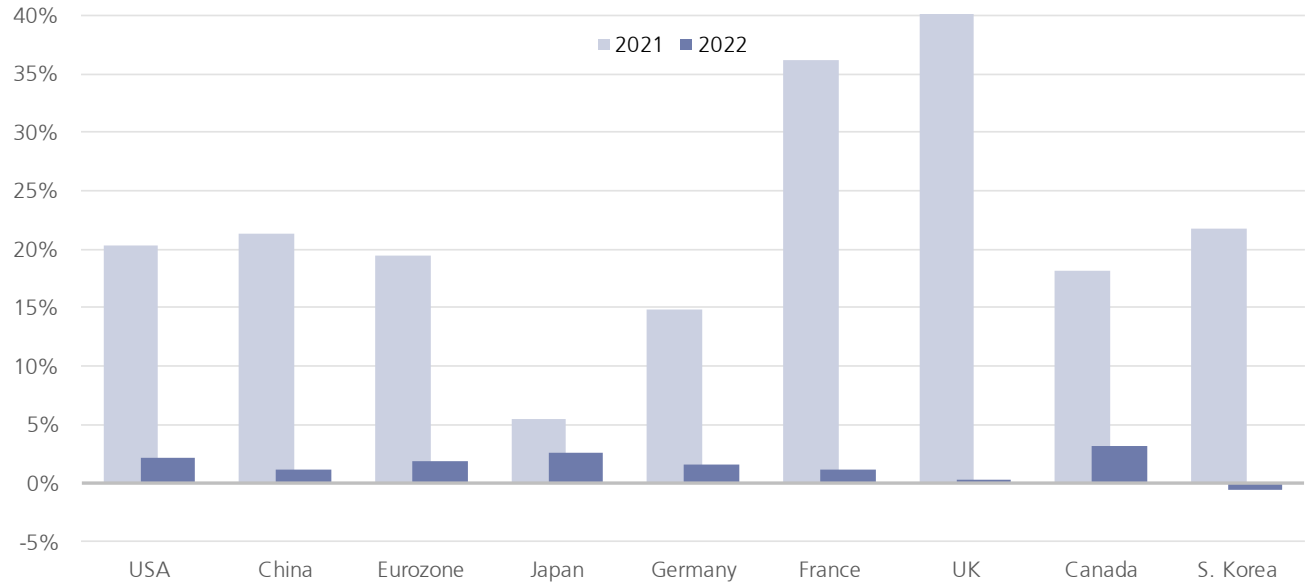
		USA	China	Eurozone	Japan	Germany	France	UK	Canada	S. Korea
Gross domestic product (GDP)										
Nominal, this year[1]	bn USD	22,940	16,863	14,518	5,103	4,230	2,940	3,108	2,016	1,824
Per Capita, purchasing power parity[1]	USD, PPP	69,375	19,090	40,965	44,935	58,150	50,876	48,693	53,089	48,309
Real growth this year[1]	Consensus	5.5%	8.0%	5.1%	2.1%	2.8%	6.7%	7.0%	5.0%	4.0%
Real growth next year[1]	Consensus	3.9%	5.4%	4.2%	2.6%	4.3%	4.0%	5.0%	4.0%	3.0%
Real growth current quarter	Annualized	2.0%	0.8%	9.3%	-3.0%	1.8%	3.0%	1.3%	-1.1%	0.3%
Unemployment this year	Consensus	5.4%	3.9%	7.8%	2.8%	5.7%	8.0%	4.8%	7.5%	3.7%
Inflation this year	Consensus	4.5%	1.0%	2.4%	-0.2%	3.0%	2.0%	2.4%	3.3%	2.2%
Inflation next year	Consensus	3.7%	2.2%	2.2%	0.7%	2.4%	1.9%	3.5%	2.9%	1.7%
Purchasing manager index (comp.) [2]	Neutral: 50	58	52	54	51	52	54	58	58	50
Structural budget balance/GDP	IMF	-8.8%	-6.9%	-5.9%	-8.0%	-5.7%	-7.5%	-5.6%	-6.6%	-2.5%
Gross government debt/GDP	IMF	133.3%	68.9%	98.9%	256.9%	72.5%	115.8%	108.5%	109.9%	51.3%
Current account balance/GDP	IMF	-3.5%	1.6%	2.6%	3.5%	6.8%	-1.7%	-3.4%	0.5%	4.5%
International currency reserves	bn USD	41.2	3,217.6	563.1	1,278.4	37.2	54.6	126.0	77.9	439.2
Govt bond yield 2yr [3]	% p.a.	0.63%	2.49%	-0.58%	-0.13%	-0.75%	-0.81%	0.53%	1.04%	1.97%
Govt bond yield 10yr [3]	% p.a.	1.63%	2.91%	-0.01%	0.08%	-0.29%	0.07%	0.93%	1.76%	2.42%
Main policy interest rate [4]	% p.a.	0.25%	4.35%	0.00%	-0.10%	0.00%	0.00%	0.10%	0.25%	0.75%

[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	Eurozone	China	Japan	Germany	France	UK	Canada	S. Korea
Exchange capitalization*	bn USD	53,982	10,181	18,989	6,840	2,762	776	3,570	797	2,279
Growth in earnings per share, estimated (MSCI)										
12 months forward / trailing 12 months	Consensus	20.3%	21.3%	19.4%	5.5%	14.8%	36.1%	43.6%	18.1%	21.8%
Next fy / 12m fwd	Consensus	2.2%	1.2%	1.8%	2.6%	1.6%	1.1%	0.3%	3.2%	-0.5%
Growth in revenue per share, estimated (MSCI)										
12m fwd / trail 12m	Consensus	9.7%	3.7%	19.8%	7.2%	7.4%	6.0%	10.4%	1.8%	5.0%
Next fy / 12m fwd	Consensus	1.5%	0.7%	1.5%	1.3%	0.8%	0.7%	0.6%	1.6%	0.8%
Valuations (MSCI)										
Price-Earnings Ratio (est 12m fwd)	Consensus	21.9	15.7	13.2	14.8	13.7	16.2	11.8	15.1	10.8
Price-Sales Ratio (est 12m fwd)	Consensus	3.0	1.4	1.3	1.1	1.0	1.5	1.3	2.2	0.9
Dividend yield	Consensus	1.3%	2.7%	1.9%	2.1%	2.7%	2.5%	4.2%	2.6%	1.8%

* China market cap includes Hong Kong | Source: Bloomberg Data per: 23.11.2021

Expected corporate earnings growth rates



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