



# Principal Investor Perspectives Q2/2024



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### Brief summary

- Financial markets have been buoyed by a combination of positive economic surprises, expected cuts in interest rates and widespread technology optimism.
- For markets to achieve further gains, hard economic data and corporate earnings must follow through on that optimism, as the process of risk assets climbing the proverbial "wall of worry" has now largely run its course.
- While we generally subscribe to the benign economic outlook, we are also wary of the various lingering risks, ranging from volatile geopolitics to a scenario where monetary policy needs to stay restrictive for longer than anticipated.
- Higher interest rates have already taken their toll on economic sectors that are highly sensitive to changes in liquidity conditions and the availability of credit.
- Real estate is generally under pressure, but the US office market in particular is experiencing an unprecedented "full-employment recession" driven by structural supply-demand imbalances and acute financing stress.
- While we do not expect the malaise in commercial real estate to turn into a systemic credit crisis, we also do not see a swift end to the rebalancing process and therefore remain defensive and highly selective with new investments.
- In contrast, private credit is an asset class that is benefiting from secular tailwinds, and markets have already significantly repriced to reflect the higher interest rate environment and are now offering very attractive prospective returns on new commitments.
- As the private credit space is growing and evolving, we are opting for a combination of different sub-strategies to deliver a well-diversified credit allocation within our multi-asset and multi-alternatives portfolios.
- Our overall portfolio positioning is cautiously optimistic as we slightly overweight risk assets but do so in a relatively defensive manner.
- Besides private credit strategies, we currently see the most attractive investment opportunities in listed equities in Japan and global defensive styles, frontier emerging market debt, private equity secondary deals and systematic hedge funds that utilize new breakthrough technologies for their trading algorithms.

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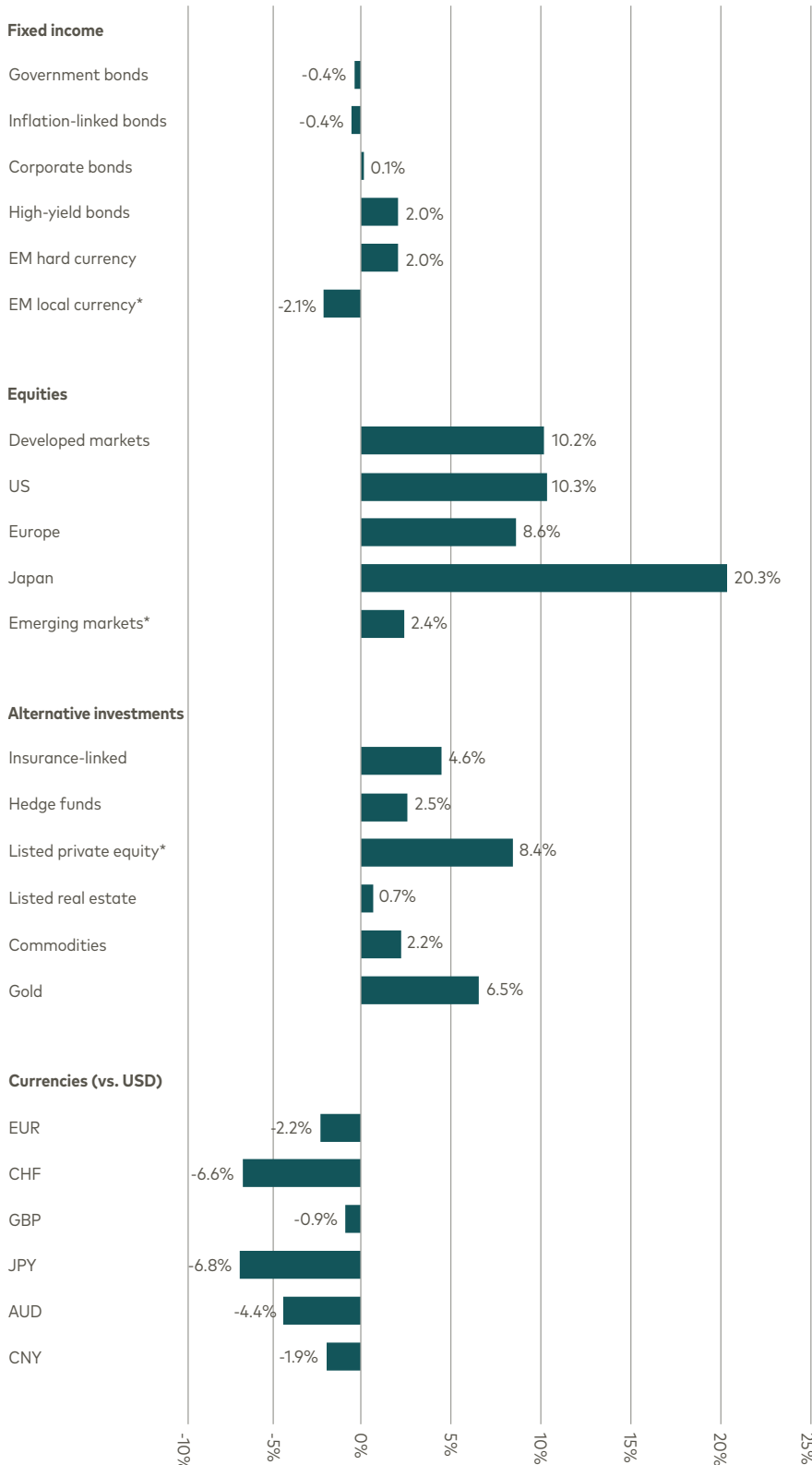
Economic Research

# Review of the past quarter

## Bonds and equities no longer in lockstep

### Market performance (index returns, gross, USD hedged)

● Q1 2024



\* Asset classes are not currency hedged.

Data as of 31 March 2024. Past performance is not a guarantee, nor an indication of current or future performance.

Source: LGT Capital Partners, Refinitiv, Bloomberg

### Credit achieves small gains

Unlike the previous two years, the most recent quarter was characterized by a dispersion between fixed income and equity returns. As expectations around policy rate cuts were pared back on stronger-than-expected economic data, fixed income asset classes faced headwinds in the form of rising yields. Credit spreads tightened further in view of generally positive risk sentiment, however, aiding returns on high-yield bonds and emerging market debt in US dollar.

### Equity market rally broadened

Equity markets added to the rally that began in earnest in October of last year. The mega caps in the US tech sector continued to pull indexes higher, but the market rally broadened out this year, engulfing more regions and sectors. Even emerging markets, an equity region long weighed down by China's structural challenges, improved its performance, albeit from a low base.

### Mixed alternatives, stronger US dollar

The picture was mixed in alternative investment classes on the back of renewed but differentiated risk appetite. Real estate lagged behind, while listed private equity, cat bonds and gold thrived. Commodities and hedge funds posted positive numbers on a top level. In currencies, the US dollar strengthened against most crosses, as the US economy continued to impress, especially compared to other slow-growing major economies.

# Macro and market perspectives

## Are markets still climbing the "wall of worry"?

- Financial markets that are climbing "the wall of worry" are running low on oxygen
- The fundamental outlook is positive but enduring risks should not be ignored
- Our portfolio positioning is broadly balanced and takes advantage of several absolute and relative value opportunities

### The pricing-out of pessimism has run its course

Lingering inflation concerns, recession fears, credit crunches and even brutal wars and conflicts – the world has certainly not had any shortage of palpable worries and real dangers. And yet, financial market conditions have been remarkably benign, with many indexes reaching new highs and risk premia narrowing in the process. In part, markets have been climbing the proverbial "wall of worry". After a dismal investment year in 2022, many investors had adopted overly pessimistic views and defensive portfolio positionings. As those worst-case scenarios did not

materialize, investors abandoned the sidelines and reengaged. This process has now largely run its course, as sentiment and positioning data currently suggests. The "pain-trade" factor may therefore no longer serve as a significant tailwind for future performance.

### Plenty to worry about

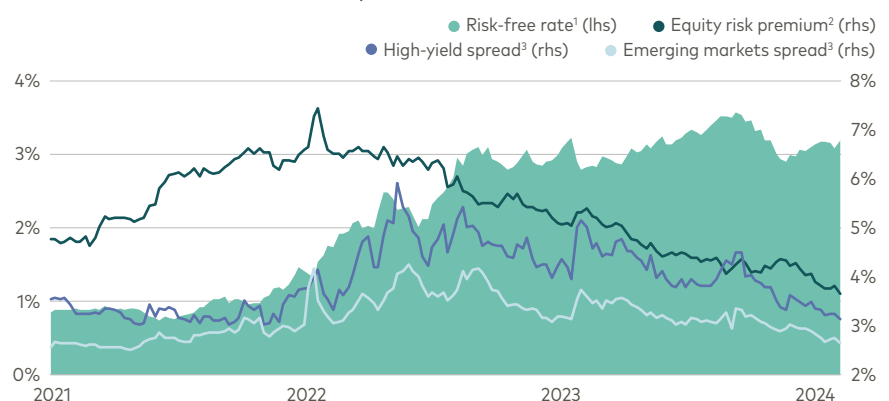
Biggest tail risks as seen by global fund managers:

1. Higher inflation
2. Geopolitics
3. Economic hard landing
4. US election
5. Systemic credit event
6. China banking crisis

Source: BofA Fund Manager Survey

### Against the odds

Risk free rate<sup>1</sup> and market risk premia<sup>2,3</sup>



<sup>1</sup>Yield to maturity on government bonds world index

<sup>2</sup>Equity risk premium is difference between the earnings yield of world equities and the 10Y real government bond yields

<sup>3</sup>Option-adjusted spreads on high-yield bonds and emerging markets hard currency debt indexes

Source: Refinitiv, Bloomberg, LGT Capital Partners

## Optimistic fundamental outlook

What we increasingly need to see now is the real economy following through to justify rosy asset pricing. There is already broad consensus about a "soft landing", meaning that economic growth is expected to pick up again after the current slowdown – in Europe and elsewhere around the world. By the same token, corporate earnings in developed markets are projected to grow by around 6% this year and by more than 10% in 2025, supported by rising nominal GDPs, robust profit margins and technology optimism.

## Risks are not to be neglected

Although economies and markets have proven to be surprisingly resilient, we also see risks to the prevailing optimistic outlook. First,

technology optimism may have gotten ahead of itself, as the wide adoption and full diffusion of AI-applications will take time. The promised boost in productivity supporting inflation-free growth may thus only materialize much later. Second, the world is experiencing the effects of China's structural challenges, domestic political divisions and volatile geopolitics – all of which are major issues that need time to rebalance and remain a source of uncertainty or even shocks. And third, interest rates are being held higher for longer than anticipated. In fact, market participants have already started to pare back their easing expectations as central banks have guided towards later and fewer rate cuts. The importance of this point may well be underestimated since the effects of restrictive monetary policy may come with considerable time lags and could thus spell more pain down the road.

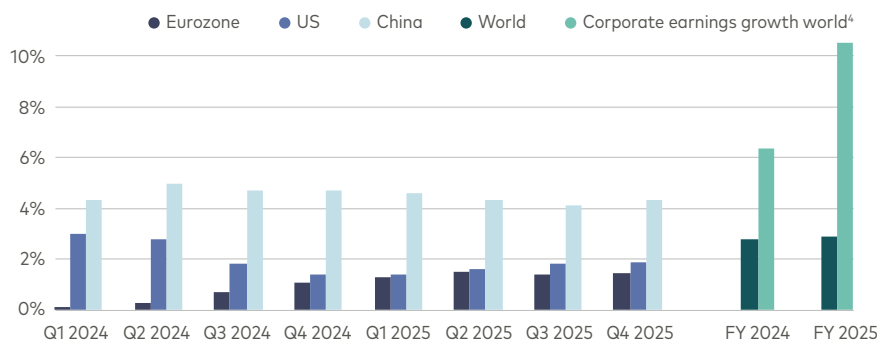
We have already seen brake marks in various sectors of the economy, most notably in real estate markets (see next section).

## Cautiously optimistic with select investment opportunities

In this environment, we believe a broadly balanced asset allocation to be most appropriate (see chapter on positioning). However, we also see various value-buying and pair-trading opportunities. The next two sections elaborate on two asset classes that have been shaken by higher interest rates. In private credit, we are increasing our commitments on the back of very attractive deal pricing dynamics and secular tailwinds for the asset class. In real estate, we are taking a more defensive stance, as the troubled US office market has yet to find a new equilibrium.

### Soft-landing, then high-flying?

Expected growth rates for real GDP and corporate earnings



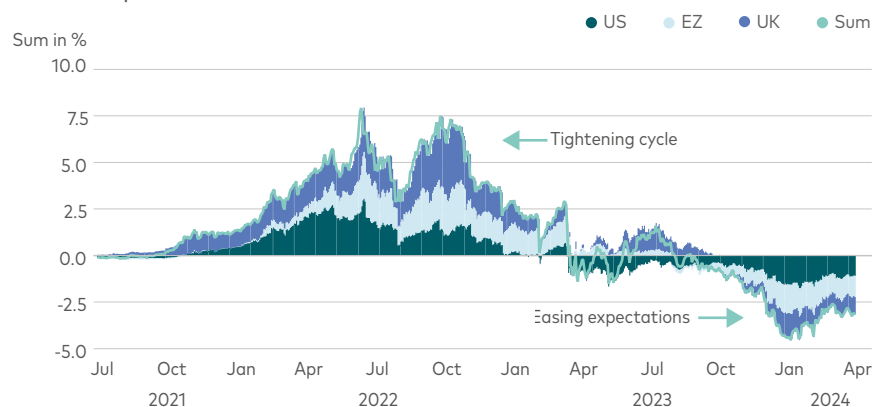
Consensus estimates for real GDP growth rates (YoY%)

<sup>4</sup> Earnings growth estimates for listed developed markets equities

Source: Bloomberg, LGT Capital Partners

### Paring the pivot

Sum of expected rate hikes/cuts in the next 12 months



Source: Macrobond, LGT Capital Partners

# Spotlight

## Pressure points in commercial real estate

- As an interest-rate sensitive sector, real estate markets have weakened across the board
- The office space market is facing a crisis on an unprecedented scale – especially in the US
- As physical stocks, debt levels and market values rebalance, stress lingers but appears contained
- Our investment focus is on marked-down quality assets in non-office sectors

### Cooling what was once hot

Real estate is one of the more interest-rate sensitive areas of the economy. It is therefore no surprise that the sector has broadly come under pressure lately. In property segments that have previously run hot – driven by a mix of upbeat fundamentals, the hunt for yield and speculative behavior – the reversal in prices and slowdown of activity may even be welcomed. Housing markets in boom areas or logistics properties around major hubs are just two examples. But that does not apply to the office sector, where there is now real cause for concern as the challenging situation owed to the structural shift towards hybrid working models is being exacerbated by higher financing costs. This is most acute in the US and is, to a lesser degree, also an issue for Europe and Asia.

### Office properties in an idiosyncratic crisis

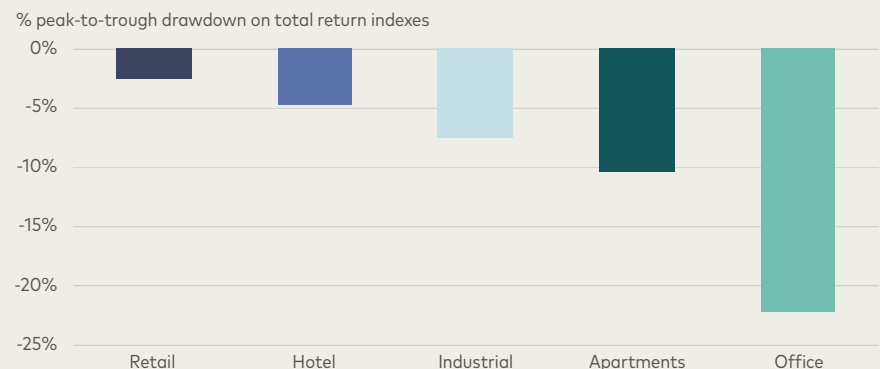
Looking at the US office market, vacancy rates are at record highs even though the economy is near to full employment and office jobs are plentiful. This is a novel contradiction with a well-known cause: The ability of employees to work efficiently from home and their reluctance to commute to the office every day has led to an acute overhang of office space. Unlike in previous, employment-led downturns, this is also affecting prime office space, although older buildings in less attractive locations continue to experience higher vacancy rates and are more at risk of obsolescence.

### Lingering stress in loans is probably not systemic

Although these challenges are global in nature, they are most

### Commercial real estate in correction mode

Drawdowns in real estate sectors, all for the US



Source: Macrobond, LGT Capital Partners

visible in the US, where the values of office buildings have been marked down by around 30% since reaching their peak in early 2022. That figure represents a national average, however, with many individual properties experiencing even steeper devaluations. Consequently, many debt-financed office properties may now have untenable loan-to-value (LTV) ratios. Fortunately, lenders have so far been willing to work with borrowers as long as they are able to service their debt at current market rates. The numbers of foreclosures and distressed sales are therefore still limited, but they may begin to

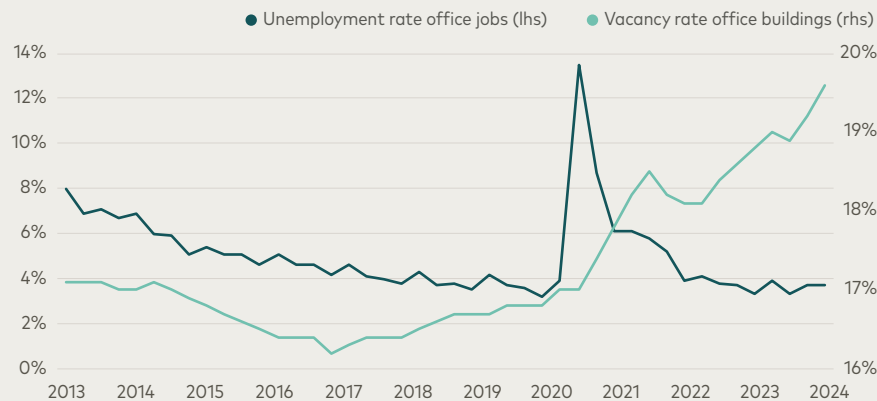
increase as pressures persist and office markets around the world try to find a new equilibrium. From a macro-perspective, another major financial crisis appears unlikely since financial institutions are today generally on a more solid footing and policymakers are quick to step in and avoid contagion, should exposed banks begin to wobble. In addition, the total volume of outstanding commercial real estate loans may be large in absolute terms, but when viewed in relative terms and in comparison to housing mortgages, fears of another Great Financial Crisis (GFC) seem unwarranted.

## Investment opportunities under development

Investment markets have been very slow over the past couple of years, with significantly reduced levels of transaction and deal activity in commercial real estate. While the dislocation in office markets will potentially create very attractive investment opportunities down the road, we are taking a more defensive stance for now. Our focus is on sectors with still solid fundamentals and on quality assets that hit the market at marked-down prices. We currently see such opportunities in the residential, logistics and light industrials sectors, among others.

### A full-employment office recession

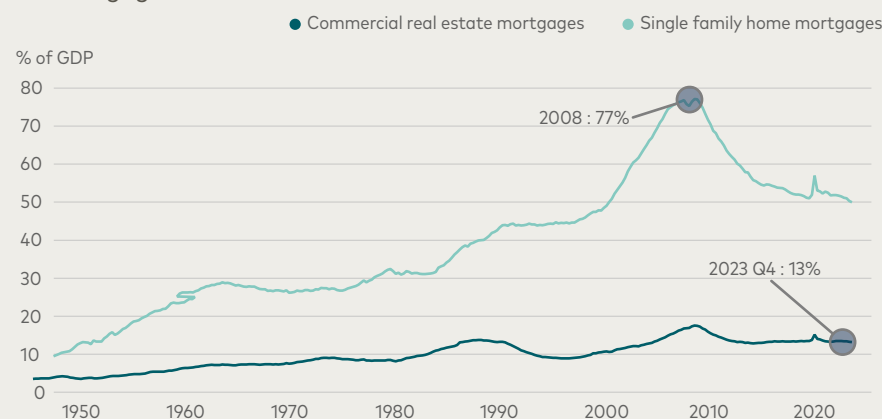
Unemployment and vacancy rates in the US office sector



Source: Refinitiv, LGT Capital Partners

### Not on the verge of another GFC

US mortgages relative to GDP



Source: Macrobond, LGT Capital Partners

# Principal insight

## How we invest in private credit

### A fast-growing asset class with unique features

The private credit market has grown from around USD 900 billion in 2020 to approximately USD 1.7 trillion in 2023 and is expected to reach an estimated USD 2.3 trillion by 2027, according to research firm Preqin<sup>1</sup>. Today, the asset class encompasses a broad universe of sub-strategies with different risk/return profiles. A significant driver of its growth is the ongoing retrenchment of banks from certain lending activities. In addition, unlike standard bank loans, private credit can be customized to match borrowers' needs and it typically offers them pricing certainty and speed of execution. Investors are attracted by the higher yields and lower volatility of this asset class compared to comparable exposures in liquid credit markets.

### From senior direct lending to specialty finance

In general, we believe that combining different credit sub-strategies creates a more resilient portfolio and enhances the overall risk/return profile. In the current market environment, we also see NAV lending as particularly attractive within the context of specialty finance. Demand for these types of loans is driven by the large amount of unrealized NAV in private equity funds (approximately USD 1.8 trillion) and the need for additional capital for accretive add-on acquisitions. Lenders are able to generate low double-digit returns with NAV-based loans that typically have a loan-to-value ratio of 20% or lower.

In addition, there is strong market demand for strategies that support banks in reducing their risk-weighted assets, including significant risk transfer transactions (SRTs) and the acquisition of portfolios of non-performing loans (NPLs). As banks face increasing capital charges while the universe of potential buyers is (still) relatively limited, these transactions benefit from attractive spreads on top of elevated base rates.

### The dichotomy of higher interest rates

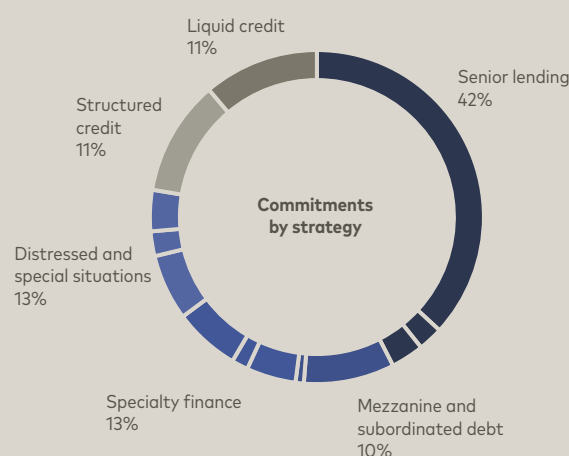
The current global economic and geopolitical backdrop, with its many uncertainties and higher interest rates, has led to the tightening of the supply of available capital.

As a consequence, private credit has become ever more important as a flexible and bespoke financing option for borrowers, while private credit investors benefit from its elevated return profile. The downside of higher interest rates is the impact they have on the cash flows of the underlying (corporate) borrowers. We address this aspect by focusing on sizeable and resilient companies that are achieving healthy growth and exhibit strong margins and high free cash flow generation.

### How we invest for the LGT Endowment

Within the LGT Endowment's target allocation of 8% for private credit, we favor diversification across multiple sub-strategies, with a geographical focus on North America and Europe. In these regions, we are leveraging our extensive network of relationships developed over more than two decades of private markets investing. An important building block of our investments in private credit is senior direct lending due to its attractive, contractual cash yield. However, we also strategically pursue compelling risk-adjusted opportunities by investing in niche credit sub-strategies, such as the above-mentioned NAV lending or SRTs. This diversified strategy aligns with our overarching commitment to prudently growing portfolios while effectively managing risk.

### The LGT Endowment's global private credit portfolio<sup>2</sup>



<sup>2</sup> Quotas refer to the share within the private credit allocation. Data as of 30 September 2023  
Source: LGT Capital Partners

<sup>1</sup> The future of alternatives in 2027, Preqin, October 2023

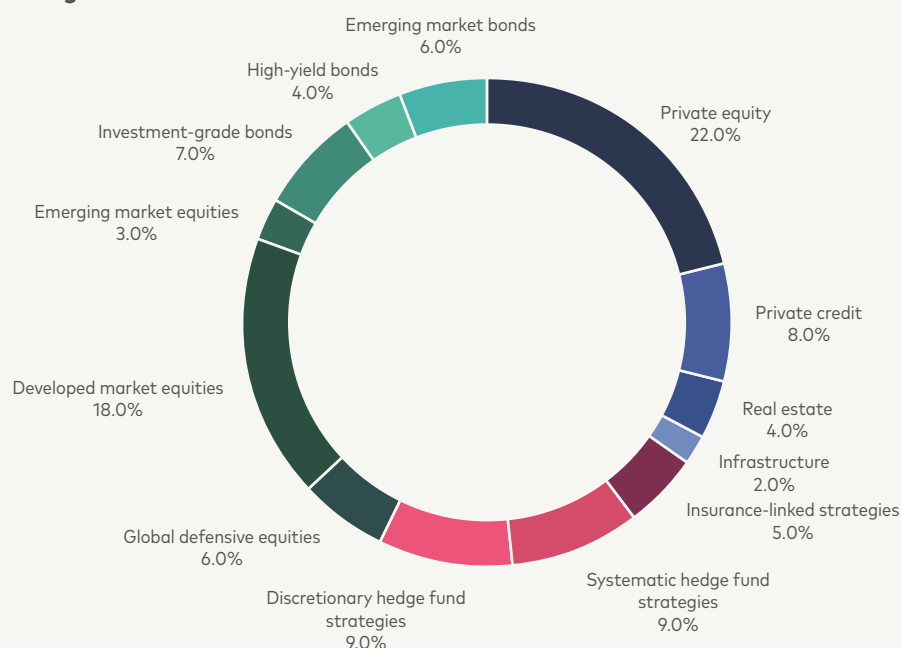


# Portfolio positioning

## Long-term allocation and current focus areas

LGT Capital Partners has been investing on behalf of the Princely Family of Liechtenstein and the clients of LGT Bank since 1998. Our flagship fund, the LGT Endowment (or Princely Strategy), is an unconstrained portfolio that combines global opportunities in traditional, alternative, and private market investments. Today, it has become one of the largest funds of its kind in Europe and its assets under management include substantial sums of capital from LGT's sole shareholder and from key investment professionals at LGT Capital Partners. This drives the strong alignment of interests between the firm's owner, our investment team and our investors.

**Long-term asset allocation of the LGT Endowment<sup>1</sup>**



### Cautiously optimistic positioning in liquid markets

Our current portfolio positioning can best be described as cautiously optimistic. We believe that the benign economic outlook and strong market metrics warrant a slight overweight in risk assets. However, we are implementing this view in a defensive manner. In listed equities, our focus is on developed markets and on strategies with the potential to mitigate downside risk, such as Minimum Variance and Sustainable Quality.

In fixed income, we underweight bonds, keep duration short and

retain a curve-steepening trade that banks on the normalization of the inverted yield curves in US treasury markets. At present, we do not see sufficient risk/reward ratios in G10 currencies to implement a pair trade, but we do like emerging market debt in local currencies. Frontier markets, in particular, offer an attractive combination of much higher yields and exposure to a basket of volatile but undervalued currencies.

### Select opportunities in private markets

In private markets, we have increased our target allocation to private credit strategies on an opportunity set that we

deem highly attractive (see chapter on Principal insight). In private equity, we are pacing our commitments in a steady but conservative manner and are looking to add to them opportunistically through co-investments and secondary deals. We are also considering selected deals in repriced real estate assets and in infrastructure segments with secular tailwinds.

Meanwhile, hedge funds and insurance-linked strategies continue to be a source of uncorrelated returns and we regard the current market environment as very conducive to these cash-plus asset classes and flexible trading strategies.

<sup>1</sup> Please note that the sum of all asset classes amounts to 103%. This includes a leverage of 3%. In addition, the portfolio holds a 3% allocation to the dynamic protection strategy, which is an overlay strategy and is thus not added to the overall sum of assets allocated. The quotas above represent the long-term, strategic asset allocation. The actual, invested asset allocation can deviate considerably from these numbers for tactical and portfolio management reasons.


Source: LGT Capital Partners

## Overview of focus areas and tactical positioning per major asset class

Private equity	<ul style="list-style-type: none"><li>• Small- and middle-market buyouts among the most robust in generally muted private equity deal environment</li><li>• Steady commitment pace to capture future vintages and increased flexibility through dynamic secondaries market</li><li>• Balanced allocation between Europe and US and select add-ons, including top regional managers in Asia</li></ul>		
Private credit	<ul style="list-style-type: none"><li>• Increased commitments on the back of attractive pricings and potentially large pipeline of refinancing opportunities</li><li>• Focus is on unitranche senior direct lending that currently offers double-digit gross return profiles</li><li>• Diversifying into growing areas, such as NAV loans, private credit CLOs and risk transfer transactions (SRTs) from banks</li></ul>		
Real assets	<ul style="list-style-type: none"><li>• Underweight in REITs and core real estate as many sectors remain challenged, most notably the US office sector</li><li>• Focus on selected deals with attractive entry prices and strong fundamentals in residential, logistics and light industrial</li><li>• Infrastructure investments in energy transition, digitalization, healthcare and education with very promising outlook</li></ul>		
Insurance-linked	<ul style="list-style-type: none"><li>• «Harder» market environment with higher return momentum on the back of the increased event activity in the past</li><li>• We reduce frequency covers and low attaching layers, to re-focus on single, extreme catastrophe events</li><li>• Strategic portfolio increase in private ILS transactions, as pricing for cat bonds has started to slightly soften in Q1</li></ul>		
Hedge funds	<ul style="list-style-type: none"><li>• Uncorrelated and low beta hedge fund strategies present unique source of return in today’s market environment</li><li>• On the systematic side, the focus is on quant equity utilizing machine learning algorithms and quant macro strategies</li><li>• Discretionary sector-focused equity long/short and convertible bond arbitrage strategies are in focus for pure alpha</li></ul>		
Public equity	<ul style="list-style-type: none"><li>• Slight overall equity overweight on benign economic outlook and strong market metrics</li><li>• Focus is on developed market equities, defensive equity styles and Japan</li><li>• Underweight in Asian emerging markets as China continues to struggle to rebalance its economy, companies produce lackluster results and heightened political risks persist</li></ul>	Defensive	+2%
		Developed	+2%
		Emerging	-1%
Fixed income	<ul style="list-style-type: none"><li>• Investment-grade bonds are underweight and duration is slightly below benchmark on lingering upward pressures on long-term yields</li><li>• High-yield bonds with positive fundamentals but tight credit spreads; neutral allocation</li><li>• Focus is on extra returns from high-yielding local frontier market debt; issuers with resilient public finances and undervalued currencies</li></ul>	IGB	-3%
		High yield	=
		EMD	+1%
Currency and overlays	<ul style="list-style-type: none"><li>• No currency pair trade in place</li><li>• Yield curve-steepening trade remains active (short 10Y/long 2Y US Treasury futures)</li><li>• Currently no cash position as portfolio is fully invested</li></ul>	FX	=
		Curve	+2%
		Cash	0%

# Appendix

## Economic data and market fundamentals

Economic fundamentals <sup>1</sup>		World	USA	China	Eurozone	Japan	U.K.
Nominal GDP (USD bn)	2024	70'720	27'967	18'560	16'320	4'286	3'588
Real GDP growth (%YoY)	2024	2.8%	2.2%	4.6%	0.5%	0.7%	0.3%
	2025	3.0%	1.7%	4.3%	1.3%	1.1%	1.2%
Inflation (CPI, %YoY)	2024	-	2.9%	0.8%	2.4%	2.3%	2.5%
	2025	-	2.4%	1.7%	2.1%	1.7%	2.1%
Leading indicator	latest	52.3	52.1	52.7	50.3	51.7	52.8
(PMI Composite)	last -6M						
Gross government debt	2024	-	127%	87%	88%	252%	106%
Structural budget balance	2024	-	-8%	-7%	-2%	-4%	-2%
Current account balance	2024	-	-3%	1%	1%	4%	-4%
Short-term rate	Policy rate	-	5.5%	4.4%	4.5%	-0.1%	5.3%
	Deposit rate (3M)		5.4%	3.6%	3.9%	0.0%	5.3%
Government bond yield	2Y	-	4.6%	1.9%	2.9%	0.2%	4.2%
	10Y	-	4.3%	2.3%	2.4%	0.8%	4.0%
Implied inflation (CPI Swaps)	Next 10Y	-	2.6%	-	2.4%	1.5%	3.7%
FX valuation (REER) <sup>2</sup>	latest	-	9.4%	-6.7%	2.8%	-24.5%	5.8%

Public equities		World	USA	China	Eurozone	Japan	EM Asia <sup>3</sup>
Market capitalization (USD bn)	latest	71'261	45'114	1'828	5'817	3'927	5'690
Sales growth (%YoY)	next 12M	4%	7%	10%	2%	3%	9%
Earnings growth (%YoY)	next 12M	8%	12%	15%	1%	3%	27%
Valuation (P/E)	next 12M	18.3	21.8	9.5	14.1	17.0	13.4
Cash flow multiple (EV/EBITDA)	last 12M	11.9	14.3	10.5	10.1	6.1	10.5
Earnings yield	next 12M	4.9%	3.9%	8.7%	6.8%	5.7%	5.9%
Dividend yield	last 12M	1.9%	1.4%	2.8%	2.8%	1.9%	2.2%

Private equity		North America		Europe		Global	
Entry valuation (EV/EBITDA)	2023	14.2x		10.8x		12.5x	
EBITDA growth (% p.a.)	last 3Y	11.9%		9.2%		10.5%	
Discount to NAV (for listed PE)	latest	-		-		-17.5%	

Credit markets		US corporate bonds	US high-yield bonds	US leveraged loans	US middle market loans	EM sovereign USD bonds	EM sovereign local bonds
Yield	latest	5.4%	7.8%	9.2%	10.7%	7.8%	6.3%
Credit spreads (in bps)	latest	90	312	436	714	336	-
Modified duration (in years)	latest	7.2	3.7	-	-	6.6	5.0

<sup>1</sup> Economic fundamentals are based on IMF forecasts and Bloomberg consensus estimates. Government debt, budget balance and current account all in %GDP.

<sup>2</sup> Based on current difference to the 10-year average of the real effective exchange rate (REER).

<sup>3</sup> EM Asia consists of Greater China, India, South Korea and Southeast Asian countries.

Sources: Bloomberg, Refinitiv, Pitchbook, LGT Capital Partners; data retrieved on 5 April 2024.

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