



When policy tightens Signals from a non-systemic banking crisis

Core Offerings

Our latest view of markets and insights
into our latest strategic and tactical
asset allocation positions

April 2023



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When policy tightens

Signals from a non-systemic banking crisis

AN UPDATE FROM LGT CRESTONE'S CHIEF INVESTMENT OFFICER



Scott Haslem
Chief Investment Officer

"All will depend on just how bad the financial market strains become. Only a seer or a charlatan would say they knew."

Société Générale
March 2023

"We understand the US regional banks are lightly regulated compared to the US international banks and almost all other developed market banking systems."

Hasan Tevfik, MST Marquee
March 2023

Over the past month, we have witnessed intensifying strains within the global banking system. This is, without doubt, the most intense pressure of its kind since the 2008 GFC. Yet, there are only weak echoes to that time, reflecting strong evidence that most of the recent bank closures are idiosyncratic and not systemic in nature, and that the regulators are more adept than they were 15 years ago at swiftly mitigating contagion risks.

There are, however, still signals to be read and investment implications to be garnered. We are now witnessing the implications of very rapid monetary tightening. Something was always going to 'break'. In this month's letter, we explain why central banks would do well to recognise that there is now something to balance inflation risks, namely financial instability risks. We also discuss why the economic outlook has weakened, and why the peak in rates will likely be lower than where many had previously forecast, but that the need to grind out inflation pressures could still see monetary policy stay restrictive into 2024.

Idiosyncrasies dominate the recent demise of SVB, Credit Suisse and others

In most respects, the closures of Silicon Valley Bank (SVB), Signature Bank (SBNY) and Credit Suisse (CS) all reflect idiosyncrasies that are not indicative of broad-based global systemic issues. As BCA Research notes, "the three US failures so far all had anomalous elements and are therefore not a perfect read-through for their peers who are still among the living." Balance sheets, both corporate and banking, remain strong across Europe and the US, and deposits are largely a zero-sum game. Of course, banks will likely now need to compete more aggressively to secure their share of a smaller deposit pool, as deposits increasingly seek out the higher returns now on offer outside the deposit system.

Recent developments almost exclusively reflect issues of liquidity (and confidence in the case of CS), not issues of solvency. The actions of the Swiss National Bank, the European Central bank (ECB), as well as the US regulator's Bank Term Funding Program have, to date, mitigated near-term liquidity issues. The return of some calm to global financial markets suggests there is confidence that recent measures will be effective.

- SVB was essentially a boutique financial group servicing start-ups in the venture capital (VC) eco-system. A surge in capital raisings through 2020 and 2021 from their largely VC clients—appearing as deposits at SVB—were invested in secure, often longer-dated assets. However, interest rate risk went largely unhedged (in contrast to larger banks). As the combination of cash burn through 2022 and rising rates impacted their VC customers, they drew down their deposit balances. This ultimately required SVB to sell its 'safe' assets at losses, which was too great for the institution to absorb.
- SBNY was also a boutique financial group, servicing real estate developers and legal and other professional firms. According to BCA Research, the concentrated deposit base was largely uninsured and 20% was in crypto-related assets, thus "poised to bolt for the exits at the first sign of trouble...[and] given that nearly all the rest of the banking system has kept its distance from crypto, other banks' ability to function as going concerns is immune to its vicissitudes."
- CS had suffered a culmination of difficulties over recent years that led Swiss regulators to force a sale to UBS as public confidence waned and deposit outflow accelerated. Exposure to multi-billion dollar hedge fund losses in 2020 was followed by alleged mis-selling of higher-risk investments as low risk. Recent revelations in its annual report that there were "material weaknesses" in its internal financial controls and liquidity restrictions by other major banks ultimately led to its demise.

History argues for staying cautious near-term...the risk of financial flare-ups remains

The idiosyncratic nature of these events provides some comfort that a deepening of the recent global banking turmoil should not be our central case looking ahead. This is not only the collective wisdom of the 'nervous consensus' being evidenced across stabilising markets, but also from those analysts who were deeply embedded in financial markets through the Asian financial crisis, the GFC and then the European sovereign bond crisis.

It's hard to shake off that niggles in the back of one's mind that the full impact of recent events will take months, and possibly years, to show their full form.

Central banks would do well to recognise that there is now something to balance inflation risks, namely financial stability risk. Inflation risk now has a counterbalance.

"Financial conditions seem to have tightened, and probably by more than the traditional indexes say".

US Federal Reserve Chair Powell, March 2023

Of course, it's still hard to shake off that niggles in the back of one's mind that the full impact of recent developments will take months, and possibly years, to show their full form. The risk of financial flare-ups is likely to remain with investors for some time to come.

Monetary policy acts with a lag. We may only now—a year after key central banks started hiking—be starting to see the financial implications of central banks starting late, and moving policy rates rapidly higher, in one of the fastest rate-hiking cycles in 40 years. It was the inverted yield curve in mid-2006, the collapse of New Century REIT in April 2007, and then the woes of BNP Paribas in August 2007, Countrywide in January 2008, Bear Stearns in March 2008 that presaged the full force of the 2008 GFC that culminated in the collapse, or near collapse of Lehman Brothers, AIG, Freddie Mae, and Fannie Mac.

Now it's broken something...will monetary tightening pause?

While a deepening of the global banking turmoil is not our central case outlook for 2023, there are still signals to be read and investment implications to be garnered from recent developments, particularly around risks of further tightening and weakening risk appetite.

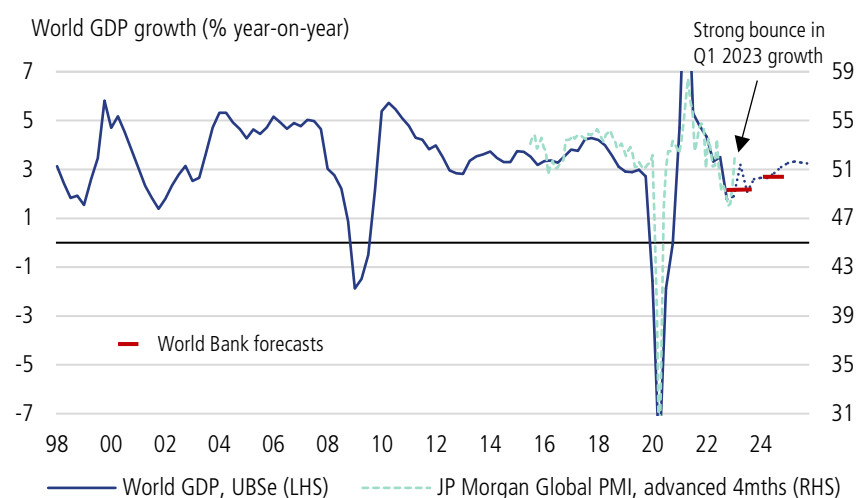
Firstly, despite the idiosyncratic nature of recent failures, history shows rapid monetary tightening eventually causes something to break. If it wasn't these firms, it would have been something else. Until now, the path of least regret for central banks was to ensure the risk that inflation became entrenched was mitigated, and a mild recession was a worthy price to pay. During February, prior to the banking turmoil, expectations for the peak of policy tightening were rising, with some forecasts for the US policy rate to rise above 6%, and the futures pricing for Australia moving over 4%.

But there is now something to balance inflation risks, namely financial instability risk. That is, the risk that the rapid pace of hikes has tightened financial conditions such that further 'breakages' will set in train more than a mild recession. Of course, the risk of hiking too little and inflation becoming entrenched has not gone away. It's just now balanced to some degree by the financial risks of overtightening, not previously evident.

Secondly, the economic and equity earnings outlook has also likely weakened in the wake of recent financial shocks, as risk appetite seems set to diminish. Firms' willingness to invest and grow – as well as the cost and availability of finance to fund this – and their capacity to carry workers during times of weaker activity, have inevitably fallen.

Indeed, recent weeks have seen central banks soften their increasingly hawkish tone through February. US Federal Reserve (Fed) Chair Powell noted, following its March meeting, that "financial conditions seem to have tightened, and probably by more than the traditional indexes say". Similarly, central banks in the UK, Australia and Europe all appear to have moved to be more data dependent in their latest meetings in March.

Worse macro still likely for 2023, but activity has bounced strongly in Q1



Source: UBS, FactSet, World Bank, LGT Crestone.

The challenge of improving growth and sticky inflation

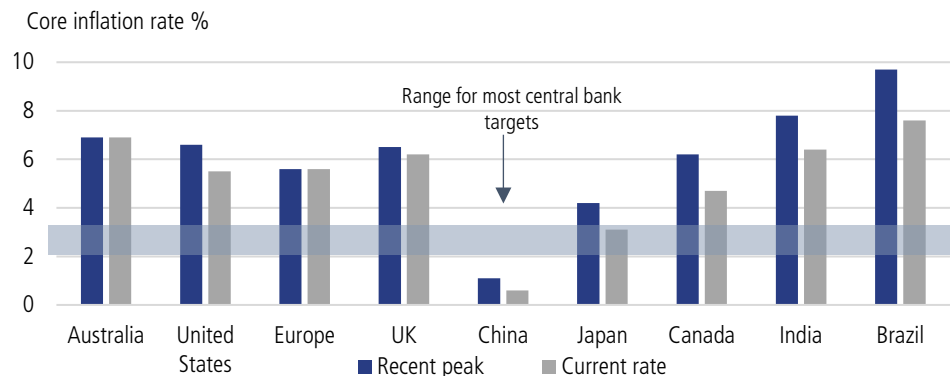
Interestingly, while financial conditions are likely to have tightened, activity across the global economy proved increasingly resilient in Q1. European industrial activity strengthened, the US jobs market remains tight, and China's activity rebounded.

As the first chart above reveals, global leading indicators of activity, namely composite purchasing manager indexes (PMIs) across manufacturing and services rebounded strongly in Q1, consistent with relatively strong global growth. This reflects a combination of easing supply-chain pressures (which are disinflationary) but also resilient consumer demand, with consumers working through their excess savings post pandemic (which is inflationary).

The resilience of consumer services demand is hampering the pace of moderation in core inflation. While it has eased, it has arguably proved stickier than central banks would likely have been hoping for. The second chart shows, core inflation rates remain well above central bank targets, and their moderation from peaks has been relatively gradual.

Core inflation remains close to its peak, well above most central bank targets

The resilience of consumer services demand is hampering the pace of moderation in core inflation. While it has eased, it has arguably proved stickier than central banks would likely have been hoping for.



Source: LGT Crestone, TradingEconomics.com

So, how should we incorporate recent developments into our portfolio views?

We are comfortable remaining modestly cautious in our tactical positioning...

...To be more constructive, we need to see signs of a faster decline in inflation and slower consumer spending that fosters a clearer pause in central bank tightening.

Overall, for policymakers, inflation risks must be balanced by financial risks, and the macro-outlook is arguably weaker. This should mean the path of least regret for central banks has shifted. The peak in policy is likely now lower than where some had forecast. The Reserve Bank of Australia (RBA) is now signalling a pause at 3.6%, below recent prior expectations of 4.35%. The Fed hiked 0.25% in mid-March against prior expectations of 0.50%, and its 'dot plot' now signals it may only have one final move, not multiple moves, to go.

Of course, the 'give-up' from recognising financial risks with a lower interest rate peak is that taming inflation may mean that central banks will keep these 'less high' policy rates at these levels for longer. Depending on how the data unfolds, policy rates may now only start coming down in early 2024, rather than mid to late 2023.

Reflecting this, we remain in the moderately 'risk-off' position we adopted on 22 February (see *Trimming risk—Resilient growth delays central bank pause*). At that time, strengthening growth was leading central banks to pivot more hawkishly as inflation rates were proving stickier than expected. Fortuitously, at this time, we closed our underweight to cash, moved underweight US equities and high-yield credit.

Although the pause in rate hikes now appears more in view, there is potential uncertainty associated with ongoing banking instability, likely additional tightening of financial conditions and its impact on growth, and still elevated equity earnings expectations. This leaves us comfortable remaining modestly cautious in our tactical positioning. Importantly, with a greater focus on valuation across all asset classes, we expect there to be increased variability in security and asset class performance. This is an environment where active management should add value to portfolios.

To be more constructive, we need to see signs of a faster decline in inflation and slower consumer spending that fosters a clearer pause in central bank tightening. Within equities, we need to see a further adjustment in earnings expectations that are more in line with margin and demand pressures that are expected through Q2.

Our latest views on positioning portfolios (and implementation)

Equities—Modestly underweight, favouring emerging markets and Australia

We moved underweight US equities in February and continue to see better value in some non-US markets, particularly Australia and emerging markets. The US position reflected the strong rally from December-February, which lifted valuations to relatively 'full-ish' levels (contrasting relatively attractive valuations in domestic and emerging market equities).

We expect there to be increased variability in security and asset class performance. This is an environment where active management should add value to portfolios.

Recent developments have seen us retain these positions, reflecting a range of tailwinds that argue for a more positive tilt and headwinds that argue for ongoing caution.

Tailwinds—We are now 17 months into an equity bear market (against an average of about a year), which means we are closer to finding a baseline from which markets can move sustainably higher. An approaching end to the central bank rate-hiking cycle is widely considered to be supportive as well. Other positive drivers remain in play, including peaking bond yields, China's re-opening, policy stimulus, and lower European gas prices that have improved the European growth outlook and somewhat eased global inflation risks.

Headwinds—Headwinds include falling economy-wide liquidity, tighter financial conditions, and the exhaustion of post-pandemic excess consumer savings, as jobs markets weaken, and interest costs rise. Equity valuations also appear elevated relative to the consensus macro outlook, while 'hoped-for' rate cuts look somewhat optimistic, given the current strength in underlying economies and sticky inflation. Either rates will be higher or earnings growth lower, with particular pressure on profit margins as labour costs move higher.

Fixed income—Maintain overweight, favouring government bonds and quality credit

In February, we added to short maturity (reducing duration) and moved underweight high-yield credit (where the risk of tighter financial conditions could weigh on certain segments of the market). While government bonds have already rallied significantly, they remain an attractive hedge against either a sharper-than-expected macro slowing or re-emergence of financial instability. Should disinflation accelerate and central banks confirm a peak in policy tightening, the option to move more neutral fixed income may present itself.

A recent area of interest for investors has been the **domestic bank hybrid market**. This follows decisions by regulators in Europe to fully write down CS Additional Tier 1 (AT1) capital hybrid securities to zero (while returning some capital to equity holders). While we have witnessed significant price volatility in European AT1 hybrids, the domestic major bank hybrid market has held up very well with limited price movement.

Importantly, domestic AT1 hybrids also differ in structure and receive a higher rating compared to offshore peers, with an investment-grade BBB- rating by S&P, which is much stronger than the CS hybrids' junk rating. If a bank failure requires a government bail-out, domestic bank hybrids convert into ordinary equity, diluting equity shareholders, rather than being written-off. Moreover, the Australian regulator may not need to fully convert all hybrids into bank equity (noting CS hybrids did not allow for any partial write-down).

Alternatives—Favouring hedge funds and real assets

While we don't tactically asset allocate alternatives, for those deploying capital, we continue to favour increasing allocations to hedge funds and real assets. For **hedge funds**, market volatility continues to provide a ripe hunting ground, where mispricing has created opportunities across asset classes. For **real assets**, we believe higher-grade commercial assets (where up-leasing and repositioning is viable) will outperform lower-grade assets. We also like infrastructure for its inflation protection characteristics and ability to capture strong thematics across the energy transition. **Private equity** is our least preferred alternatives class, albeit 2023 will be an attractive year to deploy new capital.

Cash—Scope for deployment in current market

In February, we closed our underweight to cash, signalling a more cautious tactical position. Still, for those deploying capital, we view the current environment as embodying less valuation risk across both equities and fixed income as was the case through much of the past few years. Equity multiples are no longer at historic highs, while the broad-based rise in interest rates has eased duration risk significantly.

Within fixed income, a very high portion of any portfolio could be deployed, in order to capture current relatively high yields, particularly across government bonds, investment grade credit and fixed rate short maturity (while a more cautious view on high-yield credit should be considered). For alternatives, a high portion of allocation into hedge funds and real assets (with a focus on infrastructure, and only moderate allocation to property) could be made, with an even more moderate deployment into undeployed private equity.

For equities, a range of 40-60% would be an appropriate deployment that reflects the tension between the age of the equity bear market (and being unexposed to a rally) and caution around current valuations that remain, at best, 'fair'. Allocations should favour non-US markets, with a tilt toward defensive versus cyclical exposures.

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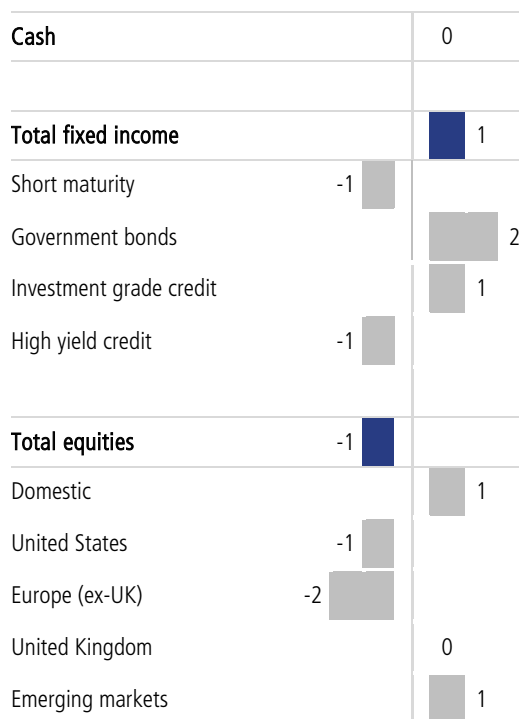
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What's driving our views

Tactical asset allocations (% weights)



Source: LGT Crestone Wealth Management. Units refer to the percentage point deviation from strategic asset allocations. Investment grade credit includes Australian listed hybrid securities.

No changes to our views...for now

Recent events such as the closure of Silicon Valley Bank and Signature Bank, as well as the sale of Credit Suisse, suggest we may now be seeing some of the implications of recent rate rises by central banks to try and curb inflation. Central banks must now consider both the risk of inflation and financial instability. As such, it is reasonable to expect that the peak in central bank interest rates is lower than previously expected.

Inflation volatility is likely to persist—Inflation is falling near term. But fading impacts of globalisation, structurally tight labour markets, and geo-political impacts on supply chains suggest less deflation and more inflation.

A return to 'normal' interest rates—Peaking inflation is likely to foster a near-term peak in central bank hikes. But stickier inflation than over the past two decades is likely to limit a return to near-zero interest rates.

Geo-political volatility likely to be enduring—Russia's invasion of Ukraine has ended a long period of benign globalisation. Ongoing decoupling of leading edge technology, political and trade alignment, as well as military and energy security, are all key potential drivers of growth and profits.

Diversification may matter more—In a world of heightened volatility and fewer long-cycle trends, it is important to maintain portfolio diversification, avoiding over-exposure to individual markets, sectors and other specific return drivers. Unlisted investments are likely to grow in favour.

Structural themes

The energy transition—As the world faces a trade-off between net-zero commitments, cost, and energy security, it is setting the scene for both old and new forms of energy to play a role.

Sustainable investing—As the world becomes more connected, it is also becoming more socially aware. The intersection of finance and sustainability will govern a reallocation of capital.

The search for income—The exit of "zero-bound interest rates" has resulted in a resetting of income expectations across all asset classes, from equities to fixed income, to income-generating alternative unlisted assets.

Deglobalisation—Brexit, trade wars, COVID-19, and Russia's invasion of Ukraine have up-ended a relatively harmonious world order, with impacts spanning geo-politics, military spend, supply chains and demographics.

	What we like	What we don't like
Equities	<ul style="list-style-type: none"> Companies with pricing power/resilient revenues Later-cycle defensive exposures in the consumer staples, telco and utilities sectors Emerging markets due to China re-opening, improving earnings and better valuation metrics 	<ul style="list-style-type: none"> Sub-market EPS growth companies, which are vulnerable to valuation headwinds S&P 500 companies, where valuations are now back above pre-COVID average valuations Continental Europe, where inflationary pressures suggest significant earnings headwinds
Fixed income	<ul style="list-style-type: none"> Green bonds and ESG-oriented strategies Fixed-rate three to five-year senior unsecured banks Fixed-rate Australian bank subordinated tier II 	<ul style="list-style-type: none"> Short maturity bonds with a preference for more duration in portfolios
Alternatives	<ul style="list-style-type: none"> Multi-strategy, credit-oriented and discretionary macro hedge funds High-grade, core-plus commercial real estate and infrastructure Private market and real assets exposed to the global energy transition 	<ul style="list-style-type: none"> Carbon-intensive assets with no transition plan Pre-IPO strategies Passive private market and/or real asset strategies Construction and/or junior real estate lending

Economic and asset class outlook

Economic outlook

Global economy



Over the past month, we have witnessed intensifying strains within the global financial system, with the collapse of several smaller US banks and the sale of Credit Suisse to UBS. This is without doubt the most intense pressure of this kind since the 2008 global financial crisis. There is much debate over the echoes to that time and the risk of ongoing financial instability. More certain is that financial conditions, as noted by Fed Chair Powell, will be tighter now than they were before these developments and global risk appetite will likely be dented. This suggests the peak in policy rates is now lower than many suspected a month or so ago.

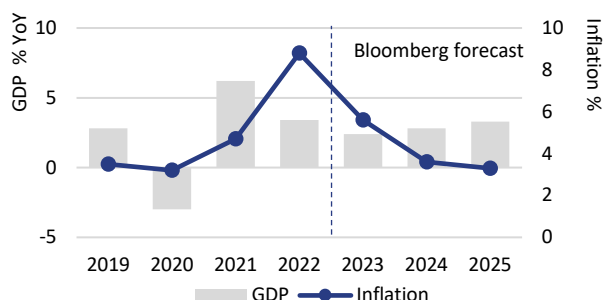
Balancing that, activity across the global economy has proved increasingly resilient over the past month. European industrial activity has strengthened, the US labour market remains tight, and China's domestic activity has rebounded. The resilience of consumer services demand has also hampered the pace of moderation in core inflation, which while easing, has arguably proved stickier and showed a less brisk pace of decline during Q1 than central banks and forecasters were anticipating.

Markets have largely removed further policy tightening in the wake of the banking turmoil. However, the return of some calm to financial markets suggests many central banks will deliver a final round of policy tightening during Q2 before pausing. Emerging market central banks, which began their tightening earlier, now appear on the cusp of a pause in Q1, while authorities in China have been cutting interest rates.

The near-term growth resilience, slower disinflation than anticipated, and uncertainty about further financial pressures are likely to see interest rates held 'less high' but for longer to ensure inflation risks are removed over time. This is raising questions as to whether the growth outlook for 2024 has darkened, and the lower prospect of a rebound will underpin reductions to growth forecasts over coming months.

Forecasts for the 2023 outlook have been revised higher. UBS lifted its forecast to 2.6% from around 2% earlier in the year and expects a pick-up to 2.8% in 2024. Société Générale (SG) has also added around 0.5% to its latest 2023 outlook across US, Europe, UK, and China under the banner of "recession must wait", but this is ahead of a forecast 2024 recession.

Global GDP growth and inflation



Source: Bloomberg as at March 2023.

Australia



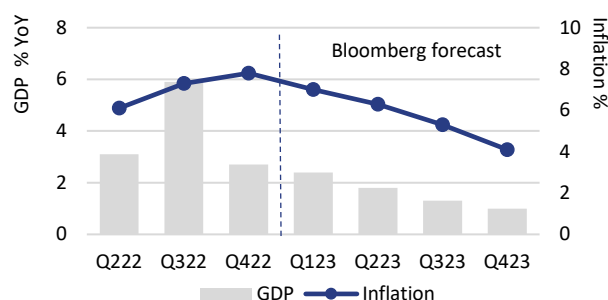
Recent data suggest the economy slowed noticeably in late 2022, with signs of a further loss of momentum through early 2023. Reflecting this, and after a brief period of hawkishness, the RBA once again signalled a near-term peak in policy rates. This was supported by some signs of easing price pressure during Q1. With consumer spending already slowing, ahead of rising housing interest costs in Q2, growth is expected to slow below trend into mid-2023. Still, China's re-opening and growth pick-up, some stabilising in the global growth backdrop, as well as the recent rebound in immigration, have added to confidence that Australia can avoid recession and outperform growth in other developed economies in 2023.

Growth in Q4 slowed to 0.5% from 0.7%, its weakest in a year. The annual pace eased from Q3's booming 5.9% to 2.7%, a near-trend rate of growth. There was broad-based slowing across consumer spending, housing investment and business capex, despite an acceleration in profit growth and wages. Early Q1 data remained mixed, with retail sales falling over the three months to February, but jobs growth jumping 64,500 after two prior falls. But, the unemployment rate has now been flat for eight months, new housing approvals have fallen sharply, and consumer sentiment is near record lows.

Importantly for the inflation outlook, wages growth continues to rise by less than expected, at 3.3% in Q4 2022, though concerns about an elevated minimum wage claim mid-year have risen. Inflation also eased in February, to 6.8% from December's higher-than-expected 8.4% pace. After pivoting more hawkish in February, flagging inflation as "way too high", the RBA signalled in March (after hiking to 3.6%), that it may pause in April to better assess the impact of tightening on the economy. Unsettled global financial markets have likely contributed to this. CBA and UBS have both recently lifted their terminal rate forecasts to 3.85%, with both expecting a pause in the rate cycle in April, ahead of a final hike in May.

After 3.7% growth in 2022, UBS expects Australia to avoid a recession in 2023, with the lagged impacts of the increase in rates slowing growth to 1.3% in 2023, while CBA forecasts a sharper slowing to 1.1%. UBS expects growth to recover modestly to a 1.6% pace in 2024.

Australian GDP growth and inflation



Source: Bloomberg as at March 2023.

Economic outlook

United States



Over the past month, there have been intensifying strains within the US banking system, with a number of regional banks being closed due to accelerating deposit outflow. While mostly idiosyncratic in nature (and non-systemic), this has led to significant market volatility and heightened uncertainty about the outlook. Actions by US regulators, including guaranteeing all deposits above insurance caps, appears to have stabilised the situation, reducing fears of contagion.

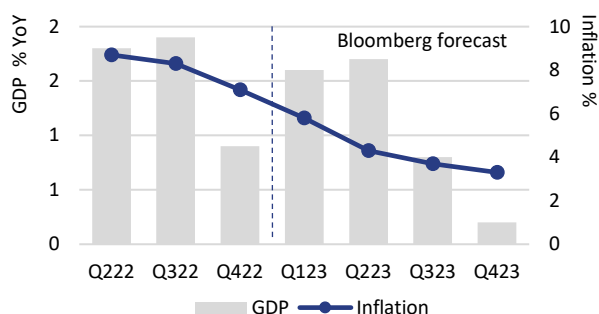
Elsewhere, data continue to suggest US activity stayed resilient early in 2023. Together with stickier-than-expected (services) inflation, this had heightened concerns of a more aggressive tightening cycle by the Fed. However, with signs that 2022's rate hikes are now tightening credit conditions, expectations are that we are nearing the peak in the US rate cycle. Risks of a recession are drifting into 2024.

Growth proved robust at 0.6% (2.6% annualised) in Q4 after a 0.8% rebound (3.2%) in Q3. Recent data have been relatively resilient. The US composite PMI has now risen to 53.3 in March, its fastest since May 2022. Retail sales retraced only 0.4% in February after January's 3.2% rebound. After January's bumper 504,000 new jobs print, there was a further strong 311,000 gain in February, albeit unemployment rose from 3.4% to 3.6%. Housing shows signs of troubling.

Price pressures continues to moderate, with inflation falling from 6.4% to 6.0% in February. But according to UBS, "progress on slowing monthly core CPI increases has stalled", with February's annual pace only edging lower from 5.6% to 5.5%. Rents, clothing, and airfares continue to pressure the monthly data. The Fed lifted rates by 0.25% in March to 5.00%, as expected. However, according to UBS, the Fed's "lack of desire" to assume more than one further hike in its 'dot plot' was more dovish than expected. UBS has now trimmed its rate peak from 5.50% to 5.25%.

After growth of 2.1% in 2022, UBS expects a sharp slowing to 0.8% in 2023 (and 0.4% in 2024). SG forecasts stronger growth in 2023 of 1.7% before a clearer slowing into recession in 2024, with growth of just 0.1%.

US GDP growth and inflation



Source: Bloomberg as at March 2023.

Europe



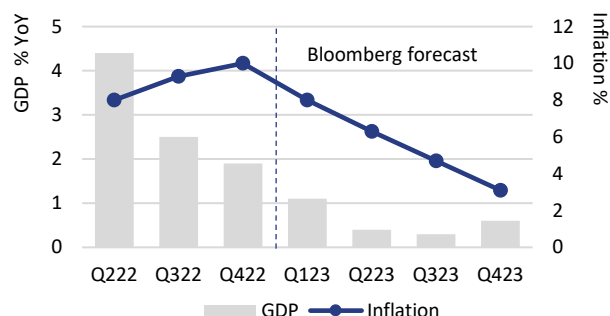
Europe's warmer-than-expected winter has increased the likelihood that the region can avoid recession in 2023 and 2024, albeit growth is still expected to be relatively tepid. Like the US, and in addition to the ongoing Russia-Ukraine war, the region has faced financial stability pressures over the past month, with Swiss regulators negotiating the takeover of Credit Suisse by UBS. Still elevated core inflation suggests the impact of tightening rates (likely to rise through to mid-year) is yet to be fully felt by European households and businesses.

Europe's Q4 economic growth beat again, printing flat against expectations for a small decline. The annual pace slowed further from 2.4% to 1.8%. March's PMI data added to an improving trend, jumping to 54.1 from 52.0. The jobs market was also tight, though unemployment has been unchanged at 6.7%, up slightly from a record low of 6.5% in October. While retail sales have been volatile, rising 0.3% in January (after -1.7%), annual growth remains steadily negative (near -2.5%). Industrial production rose 0.7% in January, after a gain of just 2.1% across all of 2021. According to SG, "this highlights the resilience of the industrial sector to the 2022 shocks: uncertainty due the war in Ukraine, high inputs inflation, ongoing supply disruptions and of course, the energy crisis."

Inflation edged lower in February from 8.6% to 8.5%, a slower pace of improvement than in prior months. Most worrying for the ECB is the rise in core inflation from 5.3% to 5.6% as prior energy price inflation shifts to food and other core items. Despite financial volatility, the ECB raised rates 0.50% in March, as it had committed, taking the deposit rate to 3.0%. However, according to SG, the ECB moved to be more data dependent. UBS expects a further final 0.25% hike in Q2, taking policy to 3.25% for the rest of 2023. However, SG expects the ECB to deliver another 1-4% by Q3 2023.

After growth of 3.5% in 2022, UBS expects a sharp slowing to 0.8% in 2023 (recently revised higher from 0.2%). SG expects higher growth of 1.2% in 2023, while CBA upgraded its growth outlook from -0.9% to -0.5% (and 1.0% in 2024).

European GDP growth and inflation



Source: Bloomberg as at March 2023.

Economic outlook

United Kingdom



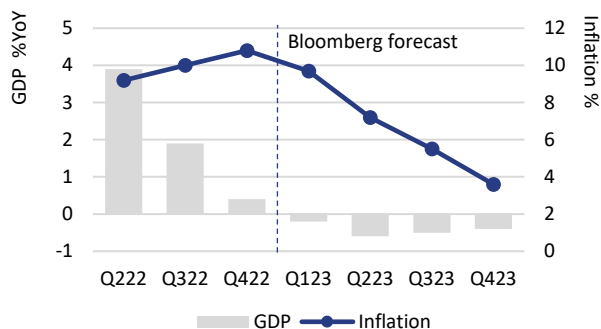
Recent data suggest underlying momentum in the UK economy remains weak in H1 2023. While the "UK economic performance has defied predictions of an inevitable recession in 2H22, it is less clear whether this can continue in 2023", according to SG, as elevated energy costs, rising inflation, and tighter monetary policy weigh on activity (including the key housing sector). Thus, the likelihood of recession in H1 2023 remains elevated and "households are in the throes of a triffecta of shocks (real income, energy, and interest rate shocks)", according to Longview Economics. This is likely to have been only partly mitigated by the Spring Budget, which featured larger-than-expected spending on energy support via the cancellation of a 20% increase due on 1 April (and spending worth 3.4% of output over the next five years).

Growth was flat in Q4, after -0.2% in Q3, helping the UK narrowly avoid a technical 'winter' recession, albeit annual growth eased to a nearly stalled 0.4% from 1.9%. The UK's PMI edged back in March from 53.1 to 52.2. Some early 2023 data has improved, with retail sales jumping 1.2% in February after January's 0.9% rebound. While the labour remains tight overall, CBA believes there are "signs of loosening".

Price pressures remain significant, rebounding in February from 10.1% to 10.4%, ending three months of declines. But after lifting rates by 0.25% in March to 4.25%, the Bank of England (BoE), according to CBA, "sound like they are ready to pause their tightening cycle with further rate rises required only if there was 'evidence of more persistent pressures'". Governor Bailey noted in his late March speech that inflation was much too high but "expected to fall steeply". Both UBS and CBA view the BoE as very close the end of its tightening cycle, with UBS viewing the peak to be the current 4.25% rate.

After growth of 4.0% in 2022, both UBS and SG expect growth to fall by 0.4% in 2023. For 2024, growth is expected to rebound modestly, with UBS forecasting 0.6% (unchanged) and SG forecasting 1.0% (revised higher from just 0.3%).

UK GDP growth and inflation



Source: Bloomberg as at March 2023.

Japan



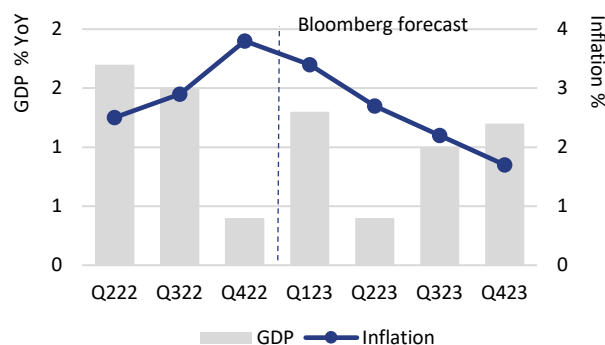
In contrast to other key advanced economies, Japan looks on track to deliver steady, if not somewhat modest, growth over the next couple of years. The economy's re-opening is widely viewed as the main support for growth in the year ahead. Recent developments have been broadly offsetting, with global impacts of emerging financial instability in the US and Europe (adding to the headwind of a slower global economy) counterbalanced by a strong spring wage negotiation round and easing inflation pressures. Focus over the coming month is on new Bank of Japan (BoJ) Governor Ueda, who starts in April, and whether this leads to a more restrictive policy stance.

Growth in Q4 was revised to show no rebound (0.0%) after an unexpected 0.3% contraction in Q3, with the annual pace slowing to just 0.4%. Growth is expected to pick up in Q1, with Japan's February PMI revised higher to 51.9 (from 51.1 in February). According to BCA Research, "Japan's Economy Watchers Survey suggests that businesses are becoming less pessimistic about the economic outlook". Mixed consumer trends continue (given still subdued wages growth), with retail sales rebounding 1.9% in January (after December's 1.1% decline). Unemployment fell further to 2.4% in January.

Core inflation surprised weaker in February, falling from 4.4% to 3.4%, led lower by energy prices (due to the Government's subsidy program). According to UBS, "signs of a significant acceleration in service prices" remains absent. According to BCA Research, "a sustained economic improvement and more pronounced domestic price pressures are needed to nudge the BoJ towards a less accommodative stance", though the BoJ's 'yield curve control' policy, which has become unsustainable, will be a focus as the new BoJ governor Ueda commences his term during April.

After growth of 1.0% in 2022, UBS expects a modestly better pace of growth of 1.3% in 2023 (and 1.2% in 2024). SG forecasts 1.3% in 2023 but 0.9% in 2024, with the latter recently trimmed from 1.3%.

Japanese GDP growth and inflation



Source: Bloomberg as at March 2023.

Economic outlook

China



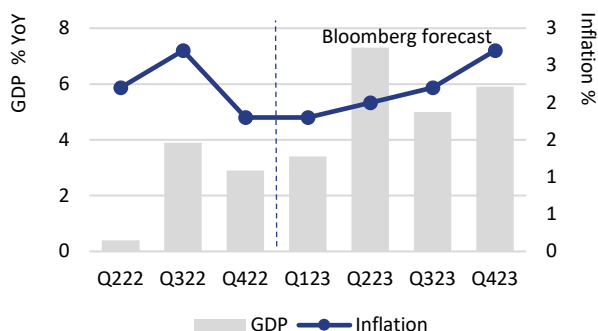
China's recovery stalled in Q4, as renewed COVID outbreaks weighed on consumer spending and property activity remained historically weak. However, recently released data for early 2023 confirm a significant rebound in activity as COVID-zero restrictions were removed. While the key National People's Congress in early March set a lower-than-expected growth target of "around 5%", clear signs of accelerating consumer activity, tentative signs of stabilisation in the property sector, together with additional policy stimulus, have led to upward revisions to the growth outlook to well above 5% for 2023.

Output in China slowed by less than expected in Q4, albeit largely stalling in the quarter, with annual growth easing to 2.9% from Q3's 4.0% pace. Looking ahead, China's expected pick-up in growth contrasts a typically slowing growth trend in other major economies. However, relative to prior cycles, this is likely to be a more consumption-led recovery, with a more "L-shaped property recovery" according to UBS. This suggests less commodity support from China across 2023-24.

Recent data confirms a strengthening of domestic activity through January and February. Retail sales rebounded from -1.8% to 3.5%, while property activities bottomed out with sales from -32% to -4% year-on-year, and new starts rebounded more visibly than expected from -44% to -9%. The improvement of property investment also underpinned overall fixed asset investment. In February, credit growth beat expectations again, accelerating from 9.3% to 9.9%, underpinned by stronger corporate and consumer loans. The authorities also unexpectedly eased monetary policy in mid-March, lowering the Reserve Ratio Requirement for banks by 0.25%, the third cut in interest rates since the start of 2022.

China's growth dropped from 8.4% to 3.0% in 2022. But in contrast to most other economies, growth is expected to reaccelerate in 2023 and 2024. UBS recently upgraded its 2023 growth outlook from 4.9% to 5.4%, with a similar 5.2% pace seen for 2024. SG has raised its 2023 forecast from 4.8% to 5.8%, with 2024 seen slowing modestly to 4.8%.

Chinese GDP growth and inflation



Source: Bloomberg as at March 2023.

Emerging markets

After a H2 2022 rebound in activity led by Asia, the emerging market region is expected to recover moderately during 2023, as Asian growth strengthens and emerging Europe stabilises. China's accelerated re-opening provides further support, with SG viewing this as a "game-changer" for Asia. Inflation broadened beyond food and energy, underpinning some late-cycle tightening by a number of central banks in March. UBS recently upgraded its outlook for Hong Kong and Thailand: "The resumption of cross-border travel is the foremost channel through which Asian economies benefit."

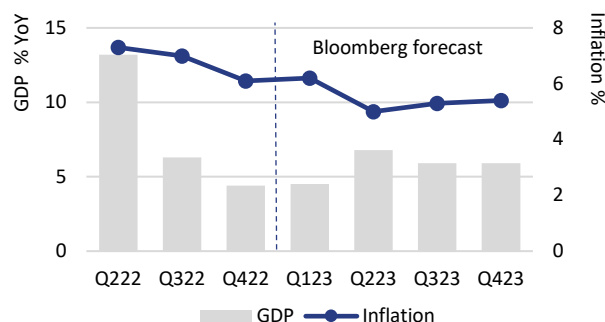
Growth in India fell 0.8% in Q4 after flat growth in Q3, with the annual pace slowing from 6.3% to 4.4%. While consumer spending was supported by re-opening, tight monetary policy is weighing on purchasing power as accumulated pandemic savings are being depleted. Looking ahead, with interest rates near their peak, SG believes India is "well positioned to emerge as an important driver of global growth" in 2023 and 2024.

With inflation nearing its peak, or passing it in some regions, there was a divergence in central bank actions during March. Some delivered near-final rate hikes, but more central banks moved 'on hold'. In Asia, rates rose further in Singapore, Hong Kong, India, Taiwan, and the Philippines, but held steady in Thailand, South Korea, Malaysia, and Indonesia.

For Latin America, the key headwind will be the slowing global economy impacting external demand for exports. UBS expects growth to slow from 3.6% in 2022 to 1.1% in 2023. In Brazil, fiscal policy has been tightened amid peak central bank rates. Q4 quarterly growth fell by -0.2% from 0.3%, adding to expectations that interest rates will be cut in H2 2023. For emerging Europe, a downturn in consumer spending is one of the main drivers of an expected slowdown in growth in 2023.

After 4.0% in 2022, UBS expects a similar pace of growth of 3.9% for 2023 (was 3.8%) before a modest acceleration to 4.3% in 2024. Growth in emerging Europe is expected to slow to 1.0% for 2023, after 3.1% in 2022.

India GDP growth and inflation



Source: Bloomberg as at March 2023.

Asset class outlook

Short maturity and government bonds

Position: Underweight short maturity, overweight government bonds

Key points

- Central banks are likely to pause hiking rates as the crisis in the financial sector slows growth data.
- Global bond yields have fallen, as markets price lower terminal rates in H2 2023.
- We expect rate volatility to remain elevated in Q2 2023, reflecting the risk of inflation data and a slowdown in economic growth.

Short maturity—The onset of a number of US bank failures has sparked fears of a looming credit crunch. A substantial rally in Treasuries saw the two-year yield fall from its 5.00% high earlier in March to a low of 3.75%. This whipsaw shift in sentiment will likely continue, but as time passes and the risk of further contagion in US regional banks subsides, central banks will still maintain their focus on inflation and whether the recent turmoil is likely to slow growth considerably. The Fed increased rates by 25 basis points (bps) at its March meeting. It is likely the terminal peak in rates is near and the RBA will hold at lower-than-anticipated levels for longer and be guided by future inflation and growth data. The minutes of its March meeting showed the RBA is likely to pause its policy tightening cycle next month, given the cash rate of 3.60% is already restrictive and the economic outlook is uncertain.

We are underweight short-maturity debt to help protect against rising interest rates. While the market will likely remain volatile at the front end of the curve, it is our 6–12-month view that global overnight fund rates will fall and we, therefore, recommend adding duration. The recent market turmoil is likely to tighten lending liquidity and slow economic growth, and as inflation was already showing signs of falling, we do expect central banks to ease until later in H2 2023.

Government bonds—Our base case is that bond yields are likely to fall over the next six to 12 months as growth decelerates because of tighter financial conditions, elevated energy costs, and general macro uncertainty. The 10-year Treasury yield, now around 3.5%, is pricing in rate cuts and fears are growing of an imminent recession, which is characteristically seen in the inversion of the yield curve. Given the balance of risks between high inflation and slowing growth, we believe the asset class presents an attractive asymmetric return prospect. Bond yields may remain volatile in the short term as markets will be influenced by macro data, but we see any rise in bond yields as a buying opportunity. Above-target inflation numbers are likely to reverse and drop quickly enough for central banks to take out insurance against a recession, predicting lower energy prices, a weaker labour market, and ultimately lower cash rates. Government bonds are our most preferred sector within fixed income.

The risk-return profile for defensive, higher-quality segments of the fixed income market remains appealing, given the all-in yields on offer and the expected transition from inflation risks to growth risks. Within this context, we prefer high grade and investment grade bonds.

Investment grade and high yield credit

Position: Overweight investment grade and underweight high yield credit

Key points

- Domestic subordinated Tier II debt is our most preferred segment within investment grade credit.
- Investment grade credit spreads are stable as outright yields attract demand.
- We prefer investment grade credit over high yield, where the latter is vulnerable to an increase in default risk.

Investment grade credit—With bond yields falling, investment grade credit spreads have risen slightly but financial sector spreads have been contained. Domestically, with the three-month Bank Bill Swap index (BBSW) now around 3.65% and a steeper swap curve at the front end, we recommend investing in fixed rate assets around the three to five-year part of the curve. Senior unsecured bank spreads have remained elevated at around BBSW+110bps, offering a yield to maturity of 4.60% for five years. We expect issuance to remain high in both subordinated Tier II and senior unsecured, which should keep spreads elevated. We see this as an investment opportunity, particularly in Tier II, as outright yields are offering attractive returns of around 6.00%.

Domestically, we have seen a widening of AT1 hybrids but not to the same degree as in Europe. The structure of AT1 securities differs depending on jurisdiction. In Australia, hybrids are first converted into equity and are not written down to zero. Domestic hybrids have only widened around 25bps from BBSW +275bps to BBSW +300bps. Retail investors continue to retain strong exposure to bank hybrids, given their safe-haven status. On a risk-adjusted basis, our preference is subordinated Tier II over AT1 hybrids.

High yield credit—The culmination of outright yields of around 8.00% has led to high yield spreads stabilising. However, we remain cautious about the high yield market and expect a widening of spreads in coming months. This is consistent with less supportive liquidity conditions, an increase in defaults to a more normalised level, and high yield spreads coming under further pressure from a tightening of financial conditions.

Tactically, before we become more positive on the broader high yield market, we need to see further evidence that inflation is coming under control, which will provide confirmation that central banks do not need to hike as aggressively as anticipated and that any recession will be relatively mild or avoided.

Yields for US and European high yield debt of around 8.0% provide a level of protection against falling prices. With a large part of the investment universe now trading at a discount to par, there are select opportunities available for investors. Our preference is to be higher up the credit quality curve in investment grade credit.

Asset class outlook

Domestic equities

Position: Overweight

Key points

- Domestic equities fell 1.1% in March, significantly underperforming global equities. Cyclical sectors bore the brunt of the sell-off, with real estate (-7%), financials (-5%) and energy (-5%) the worst performers.
- Expectations for RBA rate increases changed markedly in March, with investors now pricing in a rate cut by August. At the start of the month, investors were pricing in more than four hikes, suggesting a peak of 4.35% versus the current 3.6% peak.

Somewhat surprisingly, the domestic equity market has lagged global peers year-to-date. This has occurred despite China's re-opening and stronger Q1 activity. It now means that the S&P/ASX 200 is trading on a 12-month forward price/earnings (P/E) ratio of 13.5x. Over the past 10 years, this ranks in the bottom fifth percentile of valuations. Since the GFC, this level of valuation would rank in the bottom 30% of valuation readings. Its 12-month forward free cash flow yield is now 6.3%. While this is not quite at the same levels we witnessed last year, it is attractive relative to the past decade.

The relative underperformance of domestic equities since the collapse of Silicon Valley Bank is more likely a reflection of higher wholesale funding costs and deposit competition, leading to pressure on net interest margins, rather than systemic liquidity challenges within the financial sector.

Australia's growth is likely to slow sharply through 2023 as swift tightening from the RBA dampens housing market turnover and prices (consensus estimates GDP to grow 1.8% in 2023 from 3.7% in 2022, and to rise 1.6% in 2024). Higher debt servicing costs and negative wealth spill overs should weigh on consumer spending. However, the rapid rebound in immigration should provide a buffer and help cap wage pressures. Coupled with stabilising energy prices, investors are starting to position for the possibility that the RBA will soon end its tightening cycle. In fact, the market believes we have already arrived at peak rates and is forecasting one to two rate cuts by the end of the year.

In terms of earnings, analysts have been consistent in their small cuts to forward earnings estimates. This downward skew to consensus revisions is clearly observable for both financial years 2023 and 2024 and reflects an analyst community that sees an economy past its peak but still growing. Cuts to earnings estimates through the February results period have taken about 0.7% off financial year 2023 earnings per share (EPS) growth (now 6.6% year-on-year versus 7.3% year-on-year one month ago). The travel, resource contracting and insurance sectors appear to be areas of strength, and there are ongoing signs of resilience within autos and discretionary retailers. In contrast, food producers, builders and real estate-exposed stocks suggest that domestic pressures remain.

International equities

Position: Underweight Europe and the US, neutral UK and overweight emerging markets

Key points

- In March, global equity markets rose 2.8%. Emerging markets gave back some of their earlier gains following China's emergence from COVID-zero.
- Cyclical sectors fell in March, with financials (-8%), energy (-2%) and real estate (-3%) all sharply lower.
- Offsetting these declines were strong performances from traditional defensive sectors, such as communication services (9%), IT (10%) and consumer staples (+5%).

Some of the factors that have thus far supported equity markets (peaking bond yields, China re-opening, lower energy prices) have already been adequately reflected in equity market pricing. Going forward, falling money supply, tighter lending standards, the repricing of credit spreads, and the exhaustion of excess consumer savings will likely be headwinds. Thus far, corporate earnings have been resilient, but this will be challenged going forward. Profit margins are at record levels, currently much higher than pre-COVID, and pricing power is likely to deteriorate from here (given the fading inflationary tailwind). As investors shift their focus to fundamentals (i.e., earnings), they will likely remain wary of other potential risk-off events that could arise, such as the US debt ceiling, and Bank of Japan monetary policy.

Most analysts do not see the failure of Silicon Valley Bank or the issues that confronted Credit Suisse as a systemic risk. This is especially the case now there appears to be a de-facto guarantee on all deposits and President Biden's commitment to do "whatever is needed" to protect deposits. The Forward Rate Agreements/Overnight Index Swap spread is a signal of stress and has widened sharply, but remains lower than GFC and COVID highs. Additionally, senior banks' credit default swap spreads in Europe and the US do not signal major stress, though these spreads have widened of late. More importantly, the decision to write down Credit Suisse's AT1 bonds, while valuing its equity at CHF 3 billion, is likely to lead to an increase in wholesale funding costs for the banking sector.

Both UBS and Credit Suisse remain cautious on global equities, anticipating that the already tightening lending standards will only worsen, due to recent stresses in the banking system. Deposit guarantees will focus retail investors on the high risk-free cash yields, or the low equity risk premium on offer. Earnings downgrades should accelerate in Q2 and persist through Q4. UBS sees the S&P 500's 2023 EPS at \$198 (consensus is \$220). European EPS is forecast to be EUR 32 (consensus is EUR 36). P/E multiples for the S&P 500 and Stoxx 600 are expected to fall between now and late Q2/early Q3 from 18x to 15x and from 13x to 12x, respectively. This is when markets are expected to bottom, although it is worth noting that UBS and Credit Suisse expect markets to trough much lower than current levels.

Asset class outlook

Currencies

Key points

- Increased risk aversion and persistent inflation concerns have been the focus for currency markets.
- A peak in Fed policy has paved the way for broader US dollar weakness into H2 2023.

The USD index has been on a steady decline since reaching a peak of 114 in Q4 2022. It continued to weaken throughout March after the Fed indicated that rate increases are nearing an end. Importantly, a higher 'dot plot' did not emerge at the latest Fed meeting, and updated projections point to a peak rate of 5.1%, which is unchanged from December. This suggests that most officials expect only one more rate hike ahead. Additionally, the recent collapse of Silicon Valley Bank and the ensuing stress in the US banking system have seen rate hike expectations reduce significantly. The US dollar's direction is likely to be conditioned by how long the Fed keeps rates in restrictive territory. In the near term, given the counter-cyclical nature of the US dollar, further downside may be somewhat limited, due to an increase in safe-haven flows. Sentiment should change in a more meaningful way once the Fed transitions to a cutting cycle. Fed Chair Powell noted that officials do not expect any rate cuts in 2023, but the market has currently priced the start of a cutting cycle from Q3.

The Australian dollar fell back below USD 0.67 in March as perceptions of global risks deteriorated and the RBA adopted a more dovish tone. The latest minutes revealed that the RBA is considering a pause to its policy tightening in April, since interest rate settings are already restrictive, and the economic outlook has become incrementally more uncertain. Interest rate differentials between Australia and the US could easily become more of a headwind, given that Fed officials expect at least one more rate hike, and do not anticipate the cutting cycle to start until 2024. For end-2023, CBA expects the Australian dollar to remain around its current level and targets USD 0.68, while UBS expects it to lift to USD 0.75 by year-end on a weaker US dollar outlook.

The euro has been on a steady comeback since falling to a 20-year low in Q3 2022. In March, it rose further to USD 1.08. The outlook for the euro has improved recently after a surprisingly warm winter across the region saw natural gas prices plummet, reversing the negative terms of trade shock that had been so bearish for the currency. The ECB also delivered a 50bps hike in March. It indicated that December's hawkish pivot remains on track, with the bank likely to keep the policy rate higher until late 2024. This should eventually lead to some compression in Europe/US interest rate differentials. UBS expects that the euro will continue to strengthen towards USD 1.15 for end-2023, while CBA targets USD 1.08.

Commodities

Key points

- The near-term demand outlook for commodities remains uncertain, as the market considers the prospect of slowing global growth and increased supply in some areas.
- Production is beginning to outpace demand in many areas, and prices of most commodities are still experiencing steady declines.

Oil prices fell to a 15-month low intra-month, reaching USD 70 per barrel (bbl) as concerns rose around the stability of the global banking system. However, these fears eased towards the end of the month and prices climbed back toward USD 78 bbl. Oil markets will continue to face several supply and demand factors in the months ahead. Expectations that the Fed is reaching the end of its rate hiking cycle, and the downtrend seen in the US dollar since October, have been supportive of prices. Additionally, China remains one of the top oil importers, and the rapid re-opening of its economy should boost energy demand. However, global recession concerns are mounting in other regions. Meanwhile, the supply-side response has been quite muted, and the European Union's embargo on Russian oil and associated sanctions have been less restrictive than initially envisaged, with Russian production remaining resilient to date. Both CBA and UBS expect prices to average USD 90 bbl for end-2023.

After surging more than 70% since November, iron ore weakened in March, falling below USD 130 per tonne (p/t). China remains the key driver, where its recent economic growth target of 'around 5%' disappointed expectations. Additionally, concerns that policymakers in China will intervene in iron ore markets drove a further fall in prices after the National Development and Reform Commission issued warnings on price gauging and hoarding. China's plan to reportedly reduce steel output again this year also looms as another downside risk to iron ore prices. China's steel output fell approximately 3% in 2021 and 2% in 2022. The plan to reduce China's steel output in 2023 is linked to reducing carbon emissions from China's steel sector and is expected to limit price upside. UBS expects that prices will continue to trend down to USD 103 p/t for end-2023 and USD 85 p/t for end-2024, with long-term prices settling around USD 60 p/t.

Base metal prices have lifted since November, reflective of more positive sentiment following China policymakers' abandonment of the country's restrictive COVID-zero policy. Optimism that the Fed is nearing the end of its rate-hiking cycle and a weaker US dollar have also been supportive of prices. Longer term, de-carbonisation trends are bullish for most metal and mineral demand profiles as the world transitions away from fossil fuels. Nickel, copper, aluminium, and lithium graphite all face significant under-supply, which should support prices over the longer term.

Asset allocation views

Strategic asset allocation views

Why do we believe in strategic asset allocation?

We believe that the central component of successful long-term performance is a well-constructed strategic asset allocation. Empirical evidence suggests that a disciplined strategic asset allocation (SAA) is responsible for around 80% of overall investment performance over the long term¹. Diversification plays a critical role within SAA. By diversifying your portfolio among assets that have dissimilar return behaviour, lower overall portfolio risk can be achieved, and your portfolio can be better insulated during major market downswings.

Why do we advocate SAAs to our clients?

We believe that SAAs encourage a disciplined approach to investment decision-making and help to remove emotion from these decisions. A thoughtfully designed SAA provides a long-term policy anchor for clients. Over the long term, we believe clients are best served by identifying the risk they can bear, then adjusting their return expectations accordingly. Return expectations may be anchored unrealistically. However, risk tolerance tends to remain more consistent throughout the cycle.

Why strategic asset allocation?

Strategic asset allocation is an important part of portfolio construction as it structures your portfolio at the asset class level to match your specific objectives and risk tolerance.

Furthermore, history has shown that a disciplined strategic asset allocation is responsible for around 80% of overall investment performance over the long term.

Strategic asset allocations in models

	Yield (%)	Balanced (%)	Growth (%)	Endowment (%)
Cash	3	3	3	3
Fixed income	53	35	17	14
Short maturity	8	6	3	3
Government bonds	32	15	7	5
Investment grade credit	11	11	4	4
High yield credit	2	3	3	2
Equities	24	42	60	38
Domestic	12	19	28	11
United States	6	11	16	13
Europe (ex-UK)	3	4	5	4
United Kingdom	2	3	4	3
Emerging markets	1	5	7	7
Alternatives	20	20	20	45
Hedge funds	6	6	5	14
Private markets	7	7	9	17
Real assets	7	7	6	14

Source: LGT Crestone Wealth Management. Investment grade credit includes Australian listed hybrid securities.

¹ Ibbotson, Roger G., and Paul D. Kaplan. 2000. Does Asset Allocation Policy Explain 40, 90, or 100 Percent of Performance? Financial Analysts Journal, vol. 56, no. 1 (January/February).

Active portfolio weights and tactical asset allocation views

Our current tactical asset allocation views

While we remain constructive on markets relative to 2022, we now expect the period of potential market volatility to extend beyond mid-2023. Recent events such as the closure of Silicon Valley Bank and Signature Bank, as well as the sale of Credit Suisse, suggest we may now be seeing some of the implications of recent rate rises by central banks to try and curb inflation. Central banks must now consider both the risk of inflation and financial instability. As such, it is reasonable to expect that the peak in central bank interest rates is lower than previously expected. Our view of 'worse macro, better (or less bad) markets' remains the right call for 2023.

Why tactical asset allocation?

Tactical asset allocations have a six to 12-month investment horizon and are reviewed monthly. They can be considered an interim strategy where the aim is to provide a smoother investment journey without altering the end goal.

Cash

We recently moved to a neutral cash position, from underweight, reflecting a reduction in risk appetite and the recent significant move higher in central bank policy rates.

Fixed income

At the asset class level, we remain overweight. At a sub-asset class level, we are overweight investment grade credit and government bonds and slightly underweight high yield credit. These changes provide a clearer reflection of our preference for investment grade (higher quality) credit over high yield, where tighter financial conditions are likely to lead to a rise in default rates.

Alternatives

We favour increasing allocations to hedge funds and real assets, with deployed private equity least preferred.

Equities

We remain underweight equities and continue to prefer some better valued non-US markets. We're underweight the US and Europe ex-UK due to a weaker earnings outlook. While Europe has avoided a potential energy crisis (helped by a warmer winter,) persistently higher inflation has not helped. We retain an overweight to domestic equities and emerging markets due to attractive valuations (on a relative basis) in Australia and China, as well as the potential for tailwinds associated with China's re-opening and stronger activity.

Active portfolio weights and active tactical asset allocation tilts

	Active tilt	Yield (%)	Balanced (%)	Growth (%)	Endowment (%)
Cash	0	3	3	3	3
Fixed income	1	54	36	18	15
Short maturity	-1	7	5	2	2
Government bonds	2	34	17	9	7
Investment grade credit	1	12	12	5	5
High yield credit	-1	1	2	2	1
Equities	-1	23	41	59	37
Domestic	1	13	20	29	12
United States	-1	5	10	15	12
Europe (ex-UK)	-2	1	2	3	2
United Kingdom	0	2	3	4	3
Emerging markets	1	2	6	8	8
Alternatives	--	20	20	20	45



Decreased weight this month



Increased weight this month

Source: LGT Crestone Wealth Management. Investment grade credit includes Australian listed hybrid securities.

Our view on fixed income

Short maturity

We are underweight short maturity. We favour a more balanced position in duration-related bonds and credit securities, as aggressive monetary policies from central banks have sufficiently repriced bond yields. Our base case is that central banks will be required to ease monetary policy in late 2023 (or early 2024), making a duration play in fixed rate outperform floating rate over time.

Government bonds

We are overweight government bonds. With expectations of further central bank rate hikes over coming months largely priced into markets (both domestically and offshore) and yields elevated, we remain overweight government bonds. Although it is difficult to forecast the absolute peak, government bonds have largely absorbed the aggressive rate hiking cycle (which we expect to peak during Q2 2023).

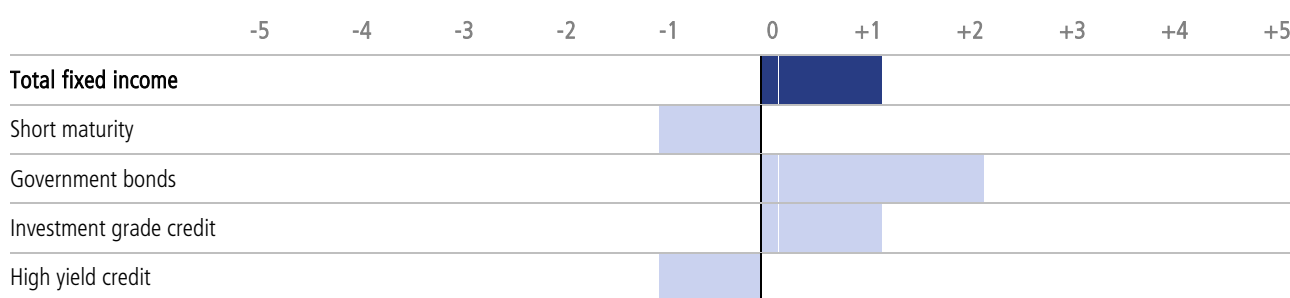
Investment grade credit

We are overweight investment grade credit. Investment grade credit spreads have moved closer to fair value, and we have now moved overweight. We are comforted by higher outright yields. Helped by a wider swap curve, they now provide a reasonable cushion to any further spread widening.

High yield credit

We are underweight high yield credit. With central banks remaining hawkish, high yield credit spreads will be vulnerable. We believe spreads have not widened sufficiently enough to compensate for the higher funding costs, liquidity premium, and for a potential acceleration in defaults as interest rates rise more than initially anticipated and an expected material slowing in the global economy unfolds.

Active fixed income weights (%)—We are overweight fixed income



Fixed income market summary

Fixed income indices	Current	One month ago
Australian iTraxx	90.53	86.50
Australian 3-year yield	2.94%	3.60%
Australian 10-year yield	3.30%	3.85%
Australian 3/10-year spread	34.3 bps	24.3 bps
Australian/US 10-year spread	-17.3 bps	-6.0 bps
US 10-year Bond	3.47%	3.91%
German 10-year Bund	2.29%	2.65%
UK 10-year Gilt	3.49%	3.83%
Markit CDX North America Investment-Grade Index	75.9 bps	75.4 bps
Markit iTraxx Europe Main Index	84.4	79.6
Markit iTraxx Europe Crossover Index	436.4	413.7
SPX Volatility Index (VIX)	18.7	20.4

Source: LGT Crestone Wealth Management, Bloomberg as at 31 March 2023. Pricing based on UBS Global Research. Active fixed income weights sourced from LGT Crestone Wealth Management. Units refer to the percentage point deviation from strategic asset allocation.

Our view on equities

Domestic equities

We are overweight domestic equities. The 12-month forward P/E for the S&P/ASX 200 is 13.5x, which features in the bottom 5% of valuations over the past decade. With its leverage to a re-opening in China, a likely near-term pause in policy tightening, and a dividend yield almost twice that of the MSCI World index, Australia remains an overweight.

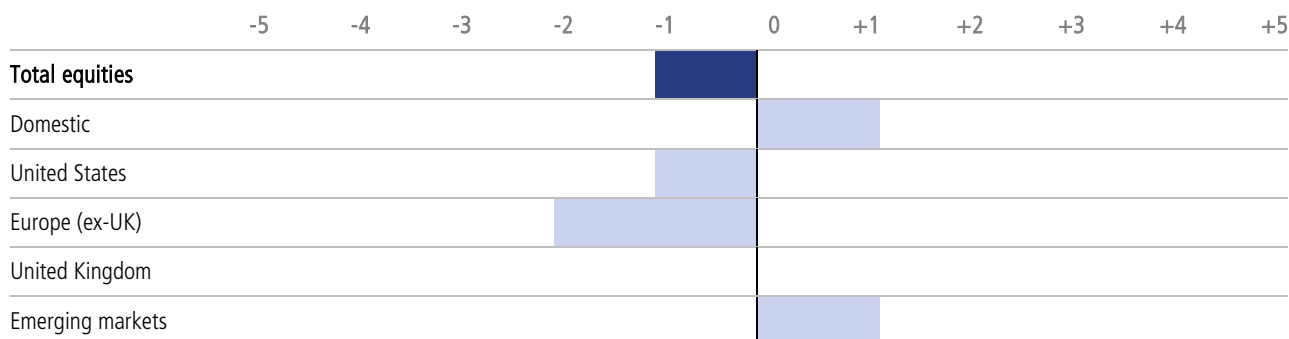
US equities

We are underweight US equities. The deposit flight from the US banking system, and recalibration from small to large banks, threaten to further tighten lending standards. In turn, this is likely to add further pressure to corporate earnings. UBS sees the S&P 500's 2023 EPS at \$198 versus consensus' EPS of \$220, a likely near-term headwind to performance.

European (ex-UK) equities

We are underweight European (ex-UK) equities. China's dramatic shift in its zero-COVID policy has resulted in a strong activity rebound. This coincided with a sharp fall in European gas prices, which has helped Eurozone PMIs rise five points since November and underpinned equity gains. But the lagged impact of ECB hikes is likely to pressure earnings from here.

Active equity weights (%)—We are underweight equities



Equity market summary

Region	Index	Latest price	Consensus 1 yr		Next year P/E ¹	Next year D/Y ²
			Target	Upside		
Australia	S&P ASX 200	7,177.8	7,766.7	8.2%	14.2	4.31%
New Zealand	S&P NZ 50	11,884.5	12,803.8	7.7%	30.3	3.01%
United States	S&P 500	4,109.3	4,614.8	12.3%	17.0	1.71%
Europe	Euro Stoxx	457.2	527.2	15.3%	11.9	3.44%
United Kingdom	FTSE 100	7,631.7	9,067.4	18.8%	10.3	4.19%
China	CSI 300	3,272.9	3,903.1	19.3%	11.0	2.93%
Japan	Nikkei 225	28,041.5	32,414.5	15.6%	15.0	2.28%
India	Sensex	58,991.5	70,492.7	19.5%	19.3	1.49%

Source: Bloomberg. Data as at 31 March 2023; 1 P/E = Price to earnings ratio; 2 D/Y = Dividend yield. Active equity weights sourced from LGT Crestone Wealth Management. Units refer to the percentage point deviation from strategic asset allocation.

Our view on alternatives

Hedge funds

Low beta hedge fund strategies are preferred, but credit is now also looking attractive. Market volatility continues to provide a ripe hunting ground for hedge funds, where mis-pricing has created opportunities across asset classes for skilled managers. Heightened macro-economic and geo-political uncertainty is also presenting attractive opportunities for discretionary macro strategies, while idiosyncratic credit strategies should provide increasingly attractive risk-adjusted return opportunities in 2023. We are, therefore, focusing on satellite exposures in those areas, alongside diversified multi-strategy solutions that can take advantage of the wider investment universe.

Private markets

Last year's re-calibration should present an attractive deployment opportunity for private equity and venture in 2023.

While private equity is least preferred on a relative risk-adjusted basis when compared to other alternative assets, we believe 2023 will be an attractive year to deploy new capital. 2022 served as a re-calibration with regards to private market valuations, particularly within the venture and growth sectors. As such, entry valuations are readjusting meaningfully, while secondary (fund) market activity is beginning to pick up. We recommend maintaining exposures to private equity and venture capital, albeit investors should consider new primary and secondary fund commitment structures, rather than growing exposures in evergreen strategies where they may already be fully invested.

Private debt looks increasingly attractive as yields reset higher on the back of interest rate increases. If investors do not compromise on credit quality and cater for increased debt servicing costs, private debt should be attractive due to wider spreads, credit protections relative to public market equivalents, and their typically floating rate structures. We prefer direct lending versus broadly syndicated strategies, as loan terms can be negotiated directly, offering greater protection to the end investor. We also prefer corporate and sponsor-backed transactions relative to real estate lending strategies that are often heavily focussed on construction, a sector exposed to supply-chain disruption, contractor risk and rising rates.

Real assets

We favour core-plus, high-quality real estate. Notwithstanding some anticipated valuation softness, real estate continues to be one of our favoured asset classes within alternatives, but we see a meaningful dichotomy across different assets, sectors, and investment approaches. We prefer high-grade commercial assets where there is some ability to add value through up-leasing, repositioning, or marking rents to market, for example. When in the right assets, these initiatives can and have been able to offset valuation declines, arising from interest rate increases. We also like high-quality, overseas, multi-family accommodation. This can benefit during periods of higher inflation, as shorter lease terms allow rents to mark to market more often. In addition, firms that have prudently put in place longer-term debt facilities at attractive rates, and those that have been conservative with prior long-term discount rate assumptions, are likely to provide a superior experience for investors.

Infrastructure is our most favoured sub-asset class. Infrastructure can provide more defensively positioned core assets on long-term, typically inflation-linked contracts. This can provide both a defensive ballast and inflation protection, both of which are in high demand currently. With most COVID-19 related travel restrictions likely behind us, volume-based transport-related assets, such as airports, and contracted assets should play a key role in diversified portfolios. Further, we see attractive investment opportunities focussed on energy transition.

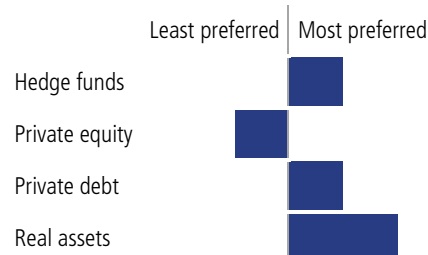
Our most preferred and least preferred exposures—We continue to favour core real assets and private debt, while maintaining private equity and low-beta hedge funds exposures

What we like

- Multi-strategy, credit-oriented and discretionary macro hedge funds
- Domestic private debt and asset-backed securities (excluding real estate)
- High-grade, core-plus commercial real estate and infrastructure
- Private market and real assets exposed to the global energy transition

What we don't like

- Passive private market and/or real asset strategies
- Pre-IPO strategies
- Construction and/or junior lending within real estate
- Carbon-intensive assets and industries with no transition plan



Direct equity

Recommendations: Domestic equities—Best sector ideas

Objective of this list

The objective is to identify the best business models or best in breed by GICs Industry Group for longer-term investors. While we also overlay valuation, companies are included based on anticipated three to five-year performance. When analysing companies to add to the list, some metrics we consider are:

- **Profitability measures**—Return on net operating assets, return on invested capital, free cashflow and return on equity
- **Liquidity and leverage**—Net debt to equity, Altman Z-score, net debt to earnings before interest, tax, depreciation and amortisation (EBITDA)
- **Efficiency**—Capital expenditure to sales
- **Valuation**—Price/earnings ratio, price/book ratio, enterprise value to sales and EBITDA, private equity screens

Code	Company	Sector	Market price	Consensus upside	P/E 1yr fwd (x)	Dividend yield	ROIC	ROE	1yr EPS growth	MSCI ESG rating
REA*	REA Group	Com. Services	\$138.03	-10%	48.0	1.2%	30%	27%	21.2%	AA
ALL	Aristocrat Leisure	Cons Discret	\$37.20	14%	19.7	1.7%	22%	19%	8.0%	AA
TLC	Lottery Corp	Cons Discret	\$5.12	1%	30.8	3.1%	22%	128%	7.8%	AA
MTS	Metcash	Cons Staples	\$3.85	17%	12.4	5.7%	21%	28%	-3.9%	AAA
ALD	Ampol	Energy	\$30.49	19%	11.0	6.2%	16%	18%	-2.8%	AA
MQG	Macquarie Group	Financials	\$175.66	15%	14.1	3.9%	na	16%	-5.4%	AA
IAG	Insurance Australia Group	Financials	\$4.69	10%	21.5	3.3%	na	10%	68.8%	AA
RMD	ResMed	Health Care	\$32.39	13%	33.7	0.5%	28%	25%	8.2%	A
CSL	CSL	Health Care	\$288.30	16%	36.2	0.8%	15%	17%	28.4%	A
MND	Monadelphous Group	Industrials	\$12.55	4%	23.0	3.8%	na	13%	22.4%	AA
ALU	Altium	IT	\$38.08	5%	51.1	1.2%	34%	23%	25.3%	AA
XRO*	Xero	IT	\$89.42	9%	593.9	0.0%	3%	3%	453.4%	AA
IGO	IGO	Materials	\$12.77	19%	6.3	3.0%	24%	37%	-1.7%	AA
JHX	James Hardie Industries	Materials	\$31.83	14%	15.5	0.2%	39%	40%	-10.3%	AA
GMG	Goodman Group	Real Estate	\$18.79	18%	20.1	1.6%	10%	10%	10.8%	AA
ORG	Origin Energy	Utilities	\$8.29	-3%	34.0	4.0%	8%	4%	89.8%	A

Source: UBS Global Research, Bloomberg Analyst consensus and MSCI Research. Data as at 31 March 2023. ESG is environmental, social and corporate governance. * Added this month.

Trade opportunities

Please note the following opportunities may not fully satisfy metrics for the above table.

ResMed (RMD)—Buy. As major sleep apnoea competitor Philips falls to GFC and Eurozone crisis lows (~75%), the product recall that will limit its ability to sell its products, and may negatively impact customers' longer-term perception, paves the way for RMD to take permanent market share.

Xero Limited (XRO)—Buy. XRO's software should be viewed largely as non-discretionary, and its Software as a Service (SaaS) delivery mode gives the company the ability to pass on price increases at regular intervals, with little to no churn. A 15% reduction in workforce (700 - 800) roles has been announced, which will aid profitability and free cash flow.

REA Group (ALU)—Buy. REA is one of the highest quality companies globally. Although housing finance is already experiencing its biggest contraction since the GFC, history suggests that this should trough some two to three months after the end of the tightening cycle, which leads house prices by two to three months.

Recommendations: Domestic equities—Sustainable income

Objective of this list

This objective is to generate 'sustainable income' over time. Historically, companies that grow their dividends consistently can offer superior long-term performance. While we also overlay valuation, companies are included based on anticipated three to five-year performance. When analysing companies to add to this list, some metrics we consider are:

- **Profitability measures**—Return on assets, cashflow, return on invested capital and return on equity
- **Liquidity and leverage**—Net debt to equity
- **Efficiency**—Change in revenue, EBITDA and margins
- **Management signalling**—Dividend growth and pay-out ratios

Code	Company	Sector	Market price	Consensus upside	P/E 1yr fwd (x)	P/B 1yr fwd (x)	Franking	Grossed up yield	1yr DPS growth	MSCI ESG rating
IAG	Insurance Australia Group	Financials	\$4.69	10.3%	12.7	1.77	30%	3.3%	75.0%	AA
MQG	Macquarie Group Ltd	Financials	\$175.66	14.6%	14.9	2.07	40%	3.9%	-0.5%	AA
WBC	Westpac Banking Corp	Financials	\$21.66	9.9%	10.3	1.07	100%	6.5%	5.1%	A
QBE	QBE Insurance Group Ltd	Financials	\$14.59	15.5%	8.9	1.61	10%	3.5%	15.2%	AA
COL	Coles Group Ltd	Cons Staples	\$18.02	1.4%	22.0	7.14	100%	3.6%	2.1%	AA
MTS	Metcash Ltd	Cons Staples	\$3.85	16.9%	12.9	3.45	100%	5.7%	-4.1%	AAA
SGR	Star Entertainment Grp	Cons Discret	\$1.43	10.4%	30.4	0.68	100%	0.0%	na	BBB
TAH	Tabcorp Holdings Ltd	Cons Discret	\$1.00	13.2%	25.5	0.85	100%	2.0%	10.0%	AA
TLS	Telstra Corp Ltd	Com. Services	\$4.22	11.7%	23.2	3.22	100%	4.0%	4.7%	AA
NEC	Nine Entertainment Co	Com. Services	\$1.97	28.7%	11.0	1.76	0%	5.9%	5.1%	AA
RMD	ResMed Inc	Health Care	\$32.39	12.9%	31.2	8.61	100%	0.5%	-7.9%	A
PME	Pro Medicus Ltd	Health Care	\$63.87	-7.0%	92.7	57.05	100%	0.4%	22.9%	BBB
REP	RAM Essential Services	Real Estate	\$0.73	28.6%	12.3	1.34	0%	8.0%	1.7%	na
SGP	Stockland	Real Estate	\$3.98	1.8%	12.9	0.92	0%	6.8%	-3.3%	AAA
IRE	IRESS Ltd	IT	\$9.92	5.1%	24.3	4.14	0%	4.5%	1.1%	AA
DBI	Dalrymple Bay Infra.	Industrials	\$2.68	-0.3%	14.6	1.15	0%	7.7%	5.3%	na
ALX	Atlas Arteria Ltd	Industrials	\$6.29	3.8%	15.2	0.93	0%	6.0%	9.1%	AA
ORG	Origin Energy Ltd	Utilities	\$8.29	-2.6%	17.9	1.65	100%	4.0%	4.2%	A
ALD	Ampol Ltd	Energy	\$30.49	19.3%	11.3	2.00	100%	6.2%	-1.5%	AA
BPT*	Beach Energy	Energy	\$1.42	28.4%	5.7	na	100%	3.0%	100.0%	AA
BHP	BHP Group Ltd	Materials	\$47.23	3.7%	11.0	3.75	100%	4.5%	-8.4%	A
AMC	Amcor PLC	Materials	\$16.69	0.7%	13.8	na	0%	2.9%	2.7%	AA

Source: UBS Global Research, Bloomberg Analyst consensus and MSCI Research. Data as at 31 March 2023. ESG is environmental, social and corporate governance. *Added this month.

Trade opportunities

Please note the following opportunities may not fully satisfy metrics for the above table.

QBE Insurance (QBE)—Buy. The premium rate environment is now more positive than it has been for a decade. Combined with the benefits of higher investment portfolio yields due to higher interest rates, QBE stands to be a significant outperformer in 2023. In absolute terms, the stock's P/E of less than 9x is two standard deviations from its long-term average.

Beach Energy (BPT)—Buy. Based on the outlook for gas pricing, peak capex in financial year 2023/24, and production growth that is greater than 20%, Beach Energy is expected to generate around AUD 850 million in free cash flow from financial year 2025. This should lead to a free cash flow yield of almost 30% and a dividend yield of over 8%.

Ampol (ALD)—Buy. ALD is trading at 9.6x 2023 earnings, a 37% discount to its historical average of 15.3x and largely in line with global peers, which are at 9.7x. The business is now structurally better positioned and recent weakness presents a buying opportunity.

Recommendations: International equities—Best sector ideas

Objective of this list

The objective is to provide a list of large-cap international companies across sectors with sustainable business models that generate compounding returns on investment and capital over the longer term. While we also overlay valuation, companies are included based on anticipated three to five-year performance. When analysing companies to add to the list, some metrics we consider are:

- **Profitability measures**—Return on net operating assets, return on invested capital, free cashflow and return on equity
- **Liquidity and leverage**—Net debt to equity, Altman Z-score, net debt to EBITDA
- **Efficiency**—Capital expenditure to sales
- **Valuation**—Price/earnings ratio, price/book ratio, enterprise value to sales and EBITDA, private equity screens

Code	Company	Sector	Base CCY	Market price	Consensus upside (%)	P/E 1yr fwd (x)	Yield (%)	Market cap (USD bn)	MSCI ESG rating
LSEG LN	London Stock Exchange	Financials	GBP	7868.00	17.6	20.0	1.6	53,772	AA
LLOY LN	Lloyds Banking Group PLC	Financials	GBP	47.68	38.0	6.1	6.5	39,195	AA
WFC US	Wells Fargo & Co	Financials	USD	37.38	40.5	7.1	4.1	141,188	BB
2318 HK	Ping An Insurance Group	Financials	HKD	51.10	41.4	5.2	5.8	120,344	A
939 HK	China Construction Bank	Financials	HKD	5.09	28.2	3.1	8.4	164,181	A
2330 TT	Taiwan Semiconductor	IT	TWD	533.00	17.3	13.0	2.4	453,374	AAA
MA US	Mastercard Inc	IT	USD	363.41	17.1	25.1	0.7	346,418	AA
ASML NA	ASML Holding	IT	EUR	625.20	14.6	27.2	1.2	273,944	AAA
GOOGL US	Alphabet Inc	Comm Services	USD	103.73	22.4	15.5	0.0	1,330,201	BBB
UMG NA	Universal Music Group NV	Comm Services	EUR	23.31	13.3	24.6	2.3	45,956	AA
DIS US	Walt Disney Co/The	Comm Services	USD	100.13	26.9	18.5	1.1	182,920	A
9988 HK	Alibaba Group Holding Ltd	Cons Discret	HKD	100.40	43.1	11.7	0.0	264,752	BBB
NKE US	NIKE Inc	Cons Discret	USD	122.64	10.9	30.7	1.2	190,161	BBB
SBUX US	Starbucks Corp	Cons Discret	USD	104.13	7.4	25.7	2.2	119,677	A
ABNB US	Airbnb Inc	Cons Discret	USD	124.40	13.8	28.6	0.0	79,682	BB
RACE IM	Ferrari NV	Cons Discret	EUR	249.30	3.2	35.0	1.0	49,435	BB
BA US	Boeing Co/The	Industrials	USD	212.43	8.1	38.7	0.9	127,283	BBB
DSV DC	DSV A/S	Industrials	DKK	1326.50	5.0	21.5	0.5	42,391	AA
MSFT US	Microsoft Corp	IT	USD	288.30	2.6	26.8	1.0	2,146,049	AAA
ILMN US	Illumina Inc	Health Care	USD	232.55	1.4	72.2	0.0	36,743	AA
NOVOB DC	Novo Nordisk A/S	Health Care	DKK	1085.80	-4.3	29.7	1.6	361,252	AAA
ISRG US	Intuitive Surgical Inc	Health Care	USD	255.47	5.4	41.7	0.0	89,480	A
EL US	Estee Lauder Cos Inc/The	Cons Staples	USD	246.46	18.0	33.7	1.2	88,040	A
COST US	Costco Wholesale Corp	Cons Staples	USD	496.87	8.4	31.8	0.9	220,354	A
288 HK	WH Group Ltd	Cons Staples	HKD	4.68	55.2	5.5	0.9	7,649	BBB
SHW US	Sherwin-Williams Co/The	Materials	USD	224.77	10.5	22.8	1.2	58,090	A
SHELL NA	Shell PLC	Energy	EUR	26.49	27.8	6.1	4.9	197,333	AA
EQIX US	Equinix Inc	Real Estate	USD	721.04	8.3	71.8	2.0	66,873	AA
ORSTED DC	Orsted AS	Utilities	DKK	583.40	24.7	28.1	2.6	35,788	AAA
Average Yield:							1.9%		

Source: UBS Global Research, Bloomberg Analyst consensus and MSCI Research. Data as at 31 March 2023. ESG is environmental, social and corporate governance.

Recommendations: Thematic investing—The circular economy

Objective of this list

Thematic investing is an approach which focuses on predicting long-term trends rather than specific companies or sectors. As it is also often associated with secular forces, this means it can provide investors with exposure to themes that are expected to grow at rates above economic growth over the longer term. Thematic investing is best suited to longer-term investors and those looking for opportunities beyond the comparatively smaller investment universe that exists in Australia. Some key themes that investors are exploring include:

- Climate change
- Cryptocurrency and blockchain
- Demographics
- Electric vehicles
- Healthcare and genomics
- Inflation
- Metaverse
- Security and safety
- Supply chain disruption
- Sustainable investing

The circular economy—Select exposures

The circular economy is an economic system that aims to reduce waste, minimise resource consumption, and increase efficiency. Here are some examples of global stocks that are exposed to the thematic of the circular economy.

Code	Company	Sector	Base CCY	Market price	Consensus upside (%)	P/E 1yr fwd (x)	Yield 22E (%)	Market cap (USD bn)	MSCI ESG rating
WM US	Waste Management	Industrials	USD	\$163.17	2.2	24.4	1.8	66,372	A
TSLA US	Tesla	Consumer Disc.	USD	\$207.46	0.3	36.9	0.0	656,425	A
ECL US	Ecolab	Materials	USD	\$165.53	3.3	28.9	1.4	47,121	AAA
VIE FP	Veolia Environment	Utilities	EUR	\$28.40	14.0	13.0	5.2	22,057	A
ALB US	Albemarle	Materials	USD	\$221.04	44.6	7.8	0.7	25,928	BBB
PHG SW	Koninklijke Philips	Health Care	CHF	\$48.00	-69.0	35.8	1.8	46,714	BB
JCI US	Johnson Controls	Industrials	USD	\$60.22	18.7	15.1	2.6	41,384	AAA
NESTE FH	Neste Oyj	Energy	EUR	\$45.43	21.4	14.8	3.3	37,982	AAA
DD US	DuPont de Nemours	Materials	USD	\$71.77	19.2	16.4	2.2	32,895	A
SIE GY	Siemens	Industrials	EUR	\$149.26	15.1	14.7	3.2	129,785	AA
SU FP	Schneider Electric	Industrials	EUR	\$153.68	9.6	18.2	2.4	95,392	AAA

Source: UBS Global Research, Bloomberg Analyst consensus and MSCI Research. Data as at 31 March 2023. ESG is environmental, social and corporate governance.

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Contact us

LGT Crestone Wealth Management Limited

ABN 50 005 311 937
AFS Licence No. 231127

info@lgtcrestone.com.au
lgtcrestone.com.au

Adelaide

Level 26, Westpac House
91 King William Street
Adelaide SA 5000

+61 8 8403 9400

Brisbane

Level 18, Riverside Centre
123 Eagle Street
Brisbane QLD 4000

+61 7 3918 3600

Melbourne

Level 17
101 Collins Street
Melbourne VIC 3000

+61 3 9245 6000

Sydney

Level 32, Chifley Tower
2 Chifley Square
Sydney NSW 2000

+61 2 8422 5500