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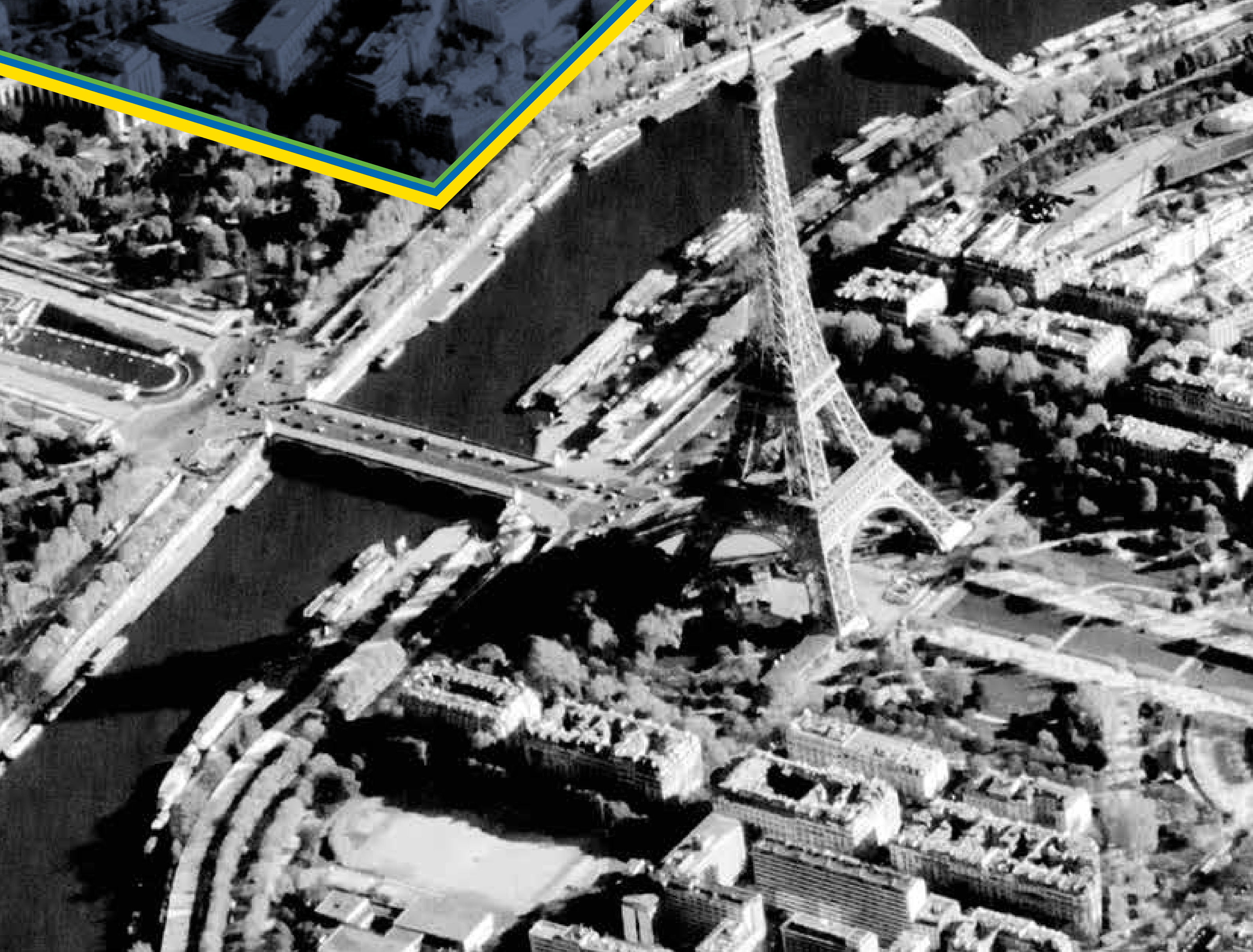
AVIVA INVESTORS

2017 Q2

HOUSE VIEW

The intelligence that guides our investment decisions



CONTENTS

HOUSE VIEW

The Aviva Investors House View document is a comprehensive compilation of views and analysis from the major investment teams.

The document is produced quarterly by Aviva Investors investment professionals and is overseen by the Investment Strategy team. Each quarter we hold a House View Forum at which the main issues and arguments are introduced, discussed and debated. The process by which the House View is constructed is a collaborative one – everyone will be aware of the main themes and key aspects of the outlook. Everyone has the right to challenge and all are encouraged to do so. The aim is to ensure that all contributors are fully aware of the thoughts of everyone else and that a broad consensus can be reached across the teams on the main aspects of the report.

The House View document serves two main purposes. First, its preparation provides a comprehensive and forward-looking framework for discussion among the investment teams. Secondly, it allows us to share our thinking and explain the reasons for our economic views and investment decisions to those whom they affect.

Not everyone will agree with all assumptions made and all of the conclusions reached. No-one can predict the future perfectly. But the contents of this report represent the best collective judgement of Aviva Investors on the current and future investment environment over the next two to three years.

EXECUTIVE SUMMARY

THE GLOBAL ECONOMY EDGES CLOSER TO NORMALISATION

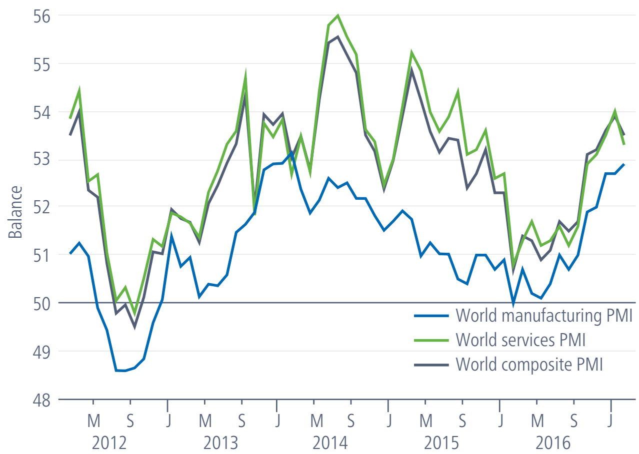
Synchronised and broad-based global growth upswing

After a number of false starts, the global economy appeared to finally find a firmer footing in the second half of 2016. Nearly ten years after the onset of the global financial crisis, the deepest financial and economic crisis since the great depression of the 1930s, the scars left on the global economy may finally be fading. While progress is most clear in the United States, what has been encouraging about developments in recent months has been the synchronised and broad-based nature of the growth upswing. According to Markit PMIs, global manufacturing rose to near its strongest rate in over five years in February, with gains seen across both developed and emerging markets (Figure 1). The rapid improvement in global manufacturing is in stark contrast to the first half of 2016, when many feared global recession. The recovery in manufacturing has also been accompanied by a pick-up in global trade volumes. Trade growth has been slower than global output growth for much of the past five years, a highly unusual situation. However, the most recent indicators suggest that trade growth is likely to rise above output growth in the coming months.

Rapid rise in headline inflation

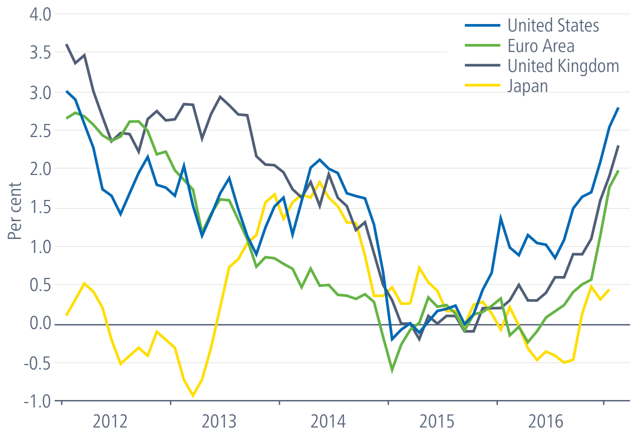
While the manufacturing upturn has been particularly notable, the service sector has also seen gains, albeit they have been somewhat more muted. The rate of improvement has also been starker in survey-based measures than it has in the official or 'hard' data. Looking ahead, we will be looking to see the hard data better reflect the survey evidence. If it does, as we expect, it should translate into global GDP growth of around 3.5 per cent in 2017, the fastest rate of growth since 2011. Across the major developed market economies we expect modestly above-trend growth for all but the UK. The rise in global growth has come at the same time as global inflation has risen to multi-year highs (Figure 2). Having risen modestly over the first half of 2016, CPI inflation picked up more rapidly in the major developed economies in recent months. That pickup reflects a stabilisation and subsequent increase in commodity prices during 2016. That saw the contribution to inflation from energy and food move from deeply negative to modestly positive. Core inflation, which removes energy and food price inflation, has risen moderately in the US, but has been low and stable in the euro zone and Japan. With above-trend growth expected in the major economies this year, spare capacity will continue to be eliminated, which should put upward pressure on wage growth and core inflation.

Figure 1: Global economic activity
Global growth improved markedly in recent months



Sources: Aviva Investors, IHS Markit, Macrobond, as at 31/03/2017

Figure 2: CPI inflation
Multi-year high in the major economies



Sources: Aviva Investors, Macrobond, as at 31/03/2017

FUNDAMENTALS TO ONCE AGAIN DRIVE MARKETS

Monetary and fiscal policy to support growth in 2017, but a turning point may be in sight for global monetary policy

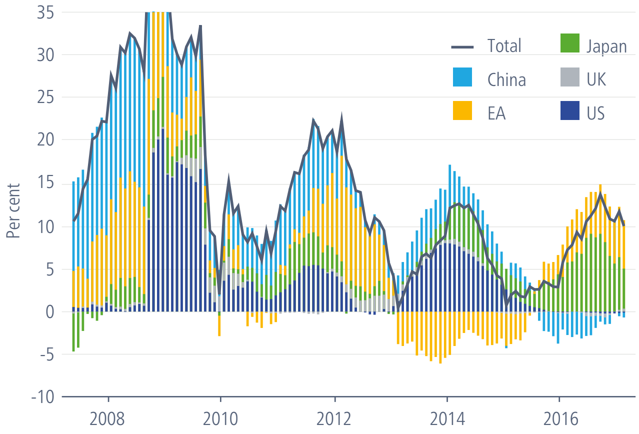
The post-crisis road to economic 'normalisation' has been a long one, and downside risks certainly remain. However, we think more than at any time in recent years the global economy is likely entering a sustained period of solid growth and moderate inflation. In part that reflects the healing of private sector balance sheets over recent years. But importantly we also expect that policy support will remain in place for some time. Monetary policy remains loose in all major economies, with the European Central Bank (ECB) and Bank of Japan (BoJ) expected to continue with Quantitative Easing (QE) policies throughout 2017. That will see the balance sheets of those central banks continue to grow, boosting global liquidity (Figure 3). With global policy rates also expected to remain low – only the Federal Reserve are expected to raise rates gradually this year – short-term real interest rates are set to remain negative. Alongside the monetary support, there has also been an increasing willingness to use fiscal policy. Perhaps most significantly, the fiscal boost in China during 2016 is expected to be maintained in 2017. It should continue to provide a material amount of support to Chinese growth, which in turn is supporting global commodity prices, manufacturing and trade. While the details of the anticipated tax and spending plan from the Trump administration are still to be revealed, we expect a package of tax cuts will be passed towards the end of this year. That will provide a further boost to US growth, albeit at a time when it is perhaps not entirely warranted. Nevertheless, it should also have positive spill-over effects to the rest of the world.

Risk assets have responded strongly to global upturn

We favour European and emerging market equities

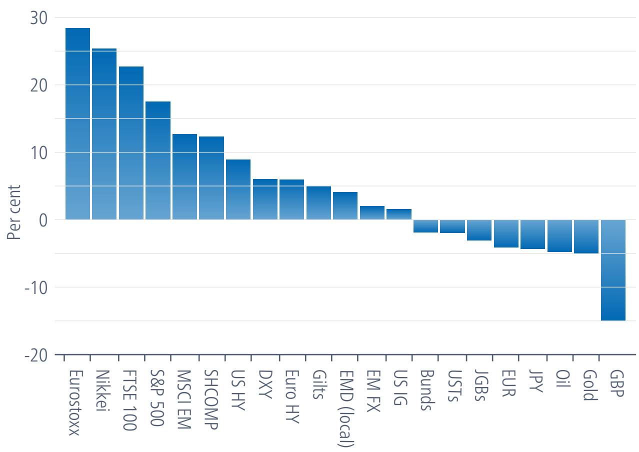
Global markets have responded to recent economic and political developments, with risk assets performing particularly well year-to-date. Looking back over the past nine months, a period over which we have expected that the world was moving into a more reflationary environment, global equity returns have been strong, led by Europe and Japan (Figure 4). Earnings growth in 2016 Q4 was the strongest in two years for developed market equities, and forward estimates have been revised higher. From a valuation perspective, Europe remains more attractive relative to the US, but the political risks in France and Italy may keep investors on the sidelines. In emerging markets, the pickup in global growth and inflation has provided an attractive backdrop for equity markets. Combined with the large valuation discount compared to developed markets, we expect emerging market equities to continue to outperform, but remain cognisant of the risks, in particular the sustainability of the Chinese credit boom. Global credit markets have also performed strongly over the past nine months, especially high yield markets. That has reflected a sharp improvement in performance by financials and other cyclicals. In the US credit spreads probably price too little risk now, and therefore risk

Figure 3: Growth in major central bank balance sheets
Global monetary policy still very accommodative



Sources: Sources: Aviva Investors, Macrobond, as at 31/03/2017

Figure 4: Global market performance since mid-2016
Risk assets have outperformed risk-free



Sources: Sources: Aviva Investors, Bloomberg, Macrobond, as at 31/03/2017 widening even with a positive growth backdrop. In Europe, the impact of ECB and Bank of England (BoE) purchases has left little upside on valuations.

At the other end of the returns spectrum, the reflationary environment has been negative for risk-free assets, with a negative return on government bonds of the major economies over the period. Those relative asset class moves represent a stark change from recent years, when both risk-free and assets have generally moved together. The rise in US government bond yields has reflected an increase in both real rates and market-based expectations of inflation. That increase in term premia (both real and inflation) has permeated across most of the world (Figure 5). While we expect bond yields in developed markets to move higher, supported by a stronger global economy and a gradual turn in monetary policy, there will likely need to be a new catalyst in the near-term to see yields move beyond what is priced into forward rate markets. That catalyst may be the Trump administration providing more clarity on the expected tax cuts. Or it could be a move higher in commodity prices driven by changes in either demand or supply conditions. But risks also lie in the other direction, most notably the increasing nationalist political agenda around the world and the potential for protectionist policies leading to a full-blown trade war. In emerging markets, the same risks dominate, however, the fundamental backdrop continues to be supportive. We think that the local currency debt markets are likely to outperform hard currency, with long-term valuations far more attractive in the former.

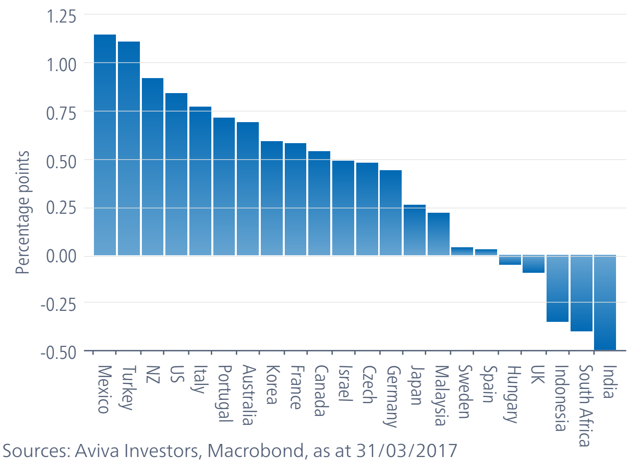
Duration remains challenging, although near-term probably needs a new catalyst for yields to move higher

Following the strong performance of the dollar after the US election, where it rose against all major currencies, this year has seen somewhat of a reversal (Figure 6). In particular, high yielding emerging market currencies have outperformed on the improvement in global growth and decline in broader market volatility. With the hopes of an early and large US fiscal stimulus waning, alongside a number of early mis-steps by the Trump administration, the support for the dollar has eased. That was despite an earlier than expected rate hike from Federal Reserve. With two more Fed hikes this year largely discounted in the market, the scope for further near-term dollar strength will likely depend on developments in other markets.

High-yielding currencies should outperform in low volatility environment

Figure 5: Global sovereign bond market yields (change since mid-2016)

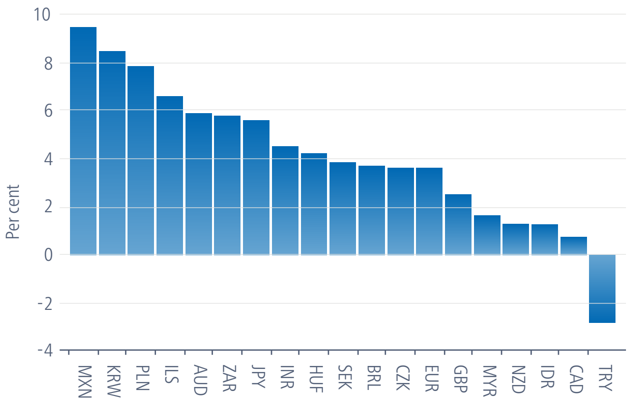
DM yields have moved higher, while EM have fallen



Sources: Aviva Investors, Macrobond, as at 31/03/2017

Figure 6: Global (spot) currency performance vs US dollar (per cent change since end-2016)

High-yielding currencies have outperformed



Sources: Aviva Investors, Macrobond, as at 31/03/2017

KEY INVESTMENT THEMES AND RISKS

INVESTMENT THEMES

The Aviva Investors House View Forum brings together senior investment professionals from across all markets and geographies on a quarterly basis to discuss the key themes that we think will drive financial markets over the next two or three years. In so doing, we aim to identify the key themes, how we would expect them to play out in our central scenario, and the balance of risks. We believe that this provides a valuable framework for investment decisions over that horizon. In the March 2017 Forum we identified the following key themes:

1. Turning point for global monetary policy in sight
2. Market outcomes to be increasingly determined by fundamental factors
3. Expectations of sustained inflation
4. Focus on willingness to use fiscal
5. Political prioritisation of national over collective interests
6. China growth stabilisation
7. Peak regulation

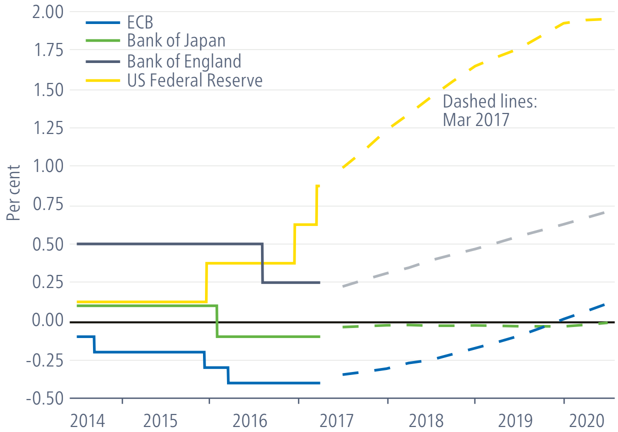
1

Turning point for global monetary policy in sight

The era of extraordinarily accommodative monetary policy across the world is – slowly – coming to an end (Figure 7). The Federal Reserve has already raised rates three times and we expect they will deliver two more hikes this year and a further three in 2018. More importantly, there has been growing acceptance by market participants that this is the appropriate response to economic developments. This is still an extremely slow pace of tightening by historical standards and the more plausible risk case is that more rather than less may be required, either because inflationary pressures increase more quickly or because fiscal stimulus adds to the pace of growth in the US.

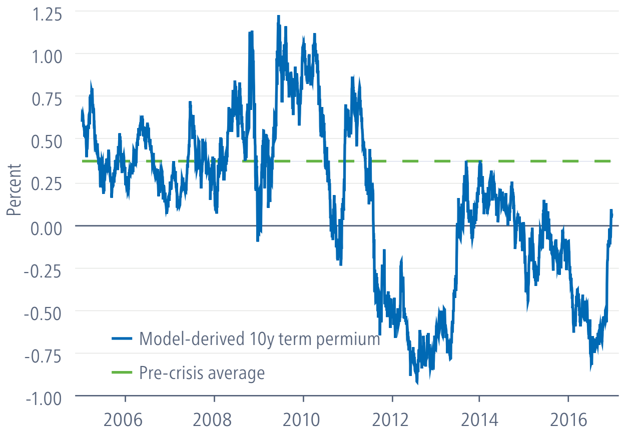
Arguably the more significant change recently has been the increasing belief that other Central Banks – the ECB and BoJ – have done as much as they can or should in terms of stimulatory monetary policy. They may now also be considering how to move away from the more radical elements of their policy stance – plotting their exit strategies from QE and negative interest rates. Neither is likely to be in any great hurry to act, but the very fact that such options are even being debated

Figure 7: Going up…eventually
Markets expect higher rates in most nations



Sources: Aviva Investors, Macrobond, as at 31/03/2017

Figure 8: Back to normal?
Fundamentals to drive asset prices again



Sources: Aviva Investors, Macrobond, as at 31/03/2017

represents a marked change from recent years. Inflation is now close to (or at) target in several countries and the deflationary threat has all but vanished. The return of inflation implies that real policy rates – both actual and anticipated – are still extremely low.

Market outcomes to be increasingly determined by fundamental factors 2

QE is regarded as a blunt monetary policy instrument by many, but one that has been necessary in extreme circumstances such as those experienced during and after the Global Financial Crisis (GFC). A key transmission mechanism of QE has been the boost to the prices of a range of financial assets and the associated suppression of volatility. The combination of this with the threat of deflation has pushed bond yields to exceptionally low levels by historical standards. As Central Banks now retreat from their asset purchase programmes, the distortion to risk assets will fade and asset prices will once again be determined more by fundamental factors. This transition is part of a more general return towards normality in economies and financial markets.

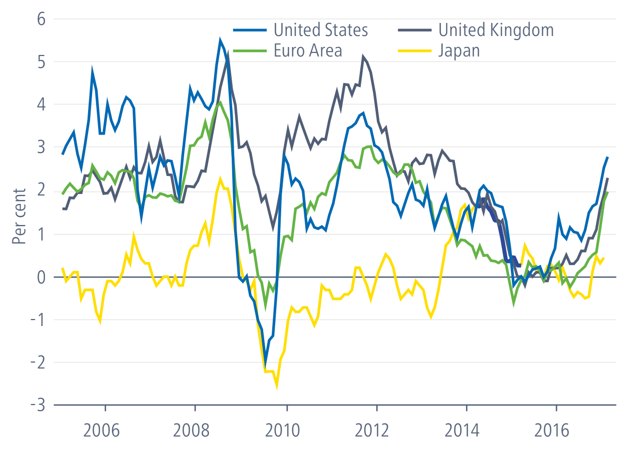
While QE was the dominant influence, correlations between asset prices rose markedly and the general market environment could often be accurately characterised as "risk on/risk off". As fundamental drivers reassert their importance, this will change again. In particular, markets will have to reassess what the risk-free rate is or should be (Figure 8). Most studies show that the theoretical equilibrium real rate was heavily negative following the GFC, but may now be inching back towards positive territory. This theme is closely related to two others. As we move away from the zero bound on policy rates (#1) and as it becomes more widely accepted that inflation has returned or is returning (#3).

Expectations of sustained inflation 3

In the wake of the financial crisis the threat of secular deflation felt very real. There is now a growing conviction that the danger has passed. Headline inflation is now at or close to target in the US, the Eurozone and the UK. It is still low in Japan, but is at least positive (Figure 9). Expectations of future inflation have also returned towards rates that prevailed pre-crisis when there was a widespread acceptance that Central Banks would achieve their inflation targets – generally around 2 per cent.

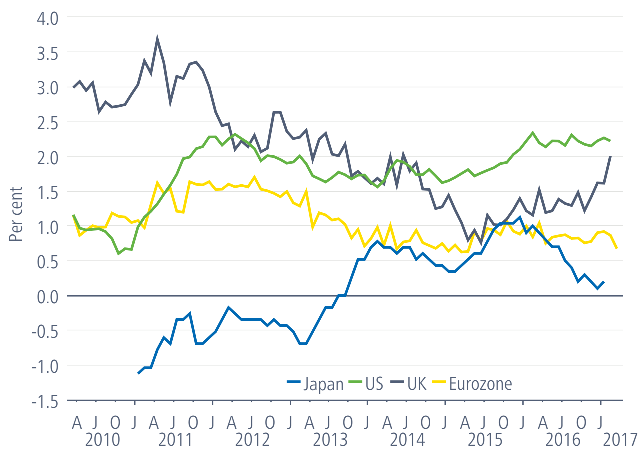
This may seem a small change, but it is an important one. As recently as the start of last year, the deflationary narrative dominated market dynamics, particularly bond markets. That is no longer the case. The rise in inflation has not been confined to developed economies – the trend has been seen in many emerging nations as well, including China. Part of the explanation has been the stabilisation and subsequent rise in energy and other commodity prices, but part has been more fundamental.

Figure 9: Inflation back to target
Headline inflation rates back at "normal" levels



Sources: Aviva Investors, Macrobond, as at 31/03/2017

Figure 10: Core inflation rates
Underlying inflation more subdued, but drifting up



Sources: Aviva Investors, Macrobond, as at 31/03/2017

Even so, "core" inflation rates (which exclude energy and food prices) remain more subdued, particularly in the Eurozone and Japan. The belief in the return of inflation is a key step on the road back to normality, but until or unless core inflation starts to drift higher too, there is good reason for central banks to tread carefully.

4

Focus on willingness to use fiscal

During the GFC almost all countries engaged in massive fiscal expansions, either through active policy decisions or as a result of automatic fiscal stabilisers. Subsequently it was generally accepted that fiscal discipline had to be re-imposed and that "austerity" was the appropriate course of action. Attitudes now seem to be changing again, despite high levels of public debt. Budget deficits are currently far lower than at the peak of the crisis, but are still high by historical standards. Yet it has become acceptable to propose and initiate looser fiscal policy as a means of stimulating growth. Although details are still sketchy, a fiscal boost in the US under Trump's administration is expected this year or next.

A new expansionary fiscal package is also plausible in Japan. Even in Europe, where fiscal prudence were the watchwords for many years, a more relaxed attitude towards fiscal expansion has prevailed (Figure 11). If deficits were to spiral higher again, this could change. But for the moment, fiscal policy seems more likely to add to growth than to limit it. The UK is a special case where any signs of a Brexit-related slowdown would probably be met with a fiscal boost. In China, the official budget deficit target of 3 per cent of GDP this year, alongside stimulus from other quasi-fiscal measures, suggest growth will be underpinned there to ensure they meet their GDP target of 6.5 per cent or more.

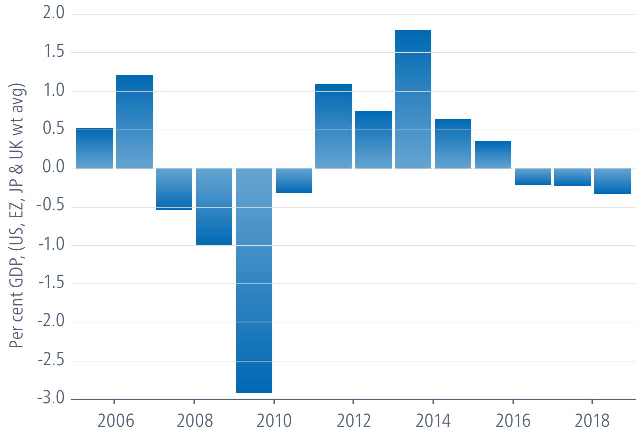
5

Political prioritisation of national over collective interests

With Donald Trump now installed as President of the US, the issue of the pursuit of national as opposed to collective interests is unlikely to slip from the headlines for very long. It is early days, but it seems plausible that some of the more extreme versions of his populist agenda will be appreciably diluted. Others might even be shelved and conveniently forgotten. Even so, nationalist themes are likely to feature extensively in public debate in the US and elsewhere over the next few years. In Europe we have seen the first important election this year – in the Netherlands – which saw the ruling centre-right party retain power. The far-right candidate did increase his share of the vote, but by much less than had been expected.

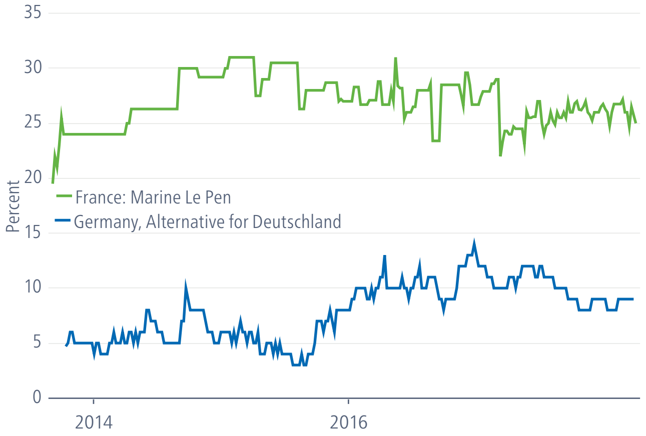
The focus in Europe has now shifted to France and, after that, Germany (Figure 12). Marine Le Pen is extremely unlikely to win in France, but she is almost certain to make it to the second round. The rise in nationalism/populism represents a small, but rising,

Figure 11: Small fiscal loosening expected
OECD projections show modest fiscal boost



Sources: Aviva Investors, Macrobond, as at 31/03/2017

Figure 12: Nationalism on the rise
Nationalist support is strong in France and has grown in Germany



Sources: Aviva Investors, Macrobond, as at 31/03/2017

threat to harmony in several nations. For example the present government in Italy may not last until the next scheduled election, and while opinion polls suggest the country would vote to remain in the EU and euro at present, the gap has narrowed. Self-interest is also certain to feature in a major way in the Brexit negotiations.

China growth stabilisation

6

Growth worries at the start of 2016 led China to introduce a range of credit and fiscal policy initiatives aimed at achieving their GDP growth target of 6.5 - 7 per cent. This was successful (growth was 6.7 per cent last year). Now their priorities seem to be shifting slightly again. They will not wish to put their growth target of 6.5 per cent or more at risk, but they do seem to be trying to tighten policy modestly at the margin, reining in the credit impulse and returning to the (slow) reform and economic transition agenda. As always, this process will be managed tightly, especially so this year as the authorities will strive for stability between now and the 13th National People's Congress in November.

Once the new leadership for the next five years is in place there will be greater freedom to concentrate on the economic agenda, but also – perhaps – to re-prioritise reform. On the sensitive currency issue, we anticipate that China will continue to manage a slow but steady depreciation of the renminbi, similar to the last two years (Figure 13). This issue is especially important in the context of relations with the US, and the previous Trump threat to label China a currency manipulator. Any moves towards greater global protectionism are also relevant here.

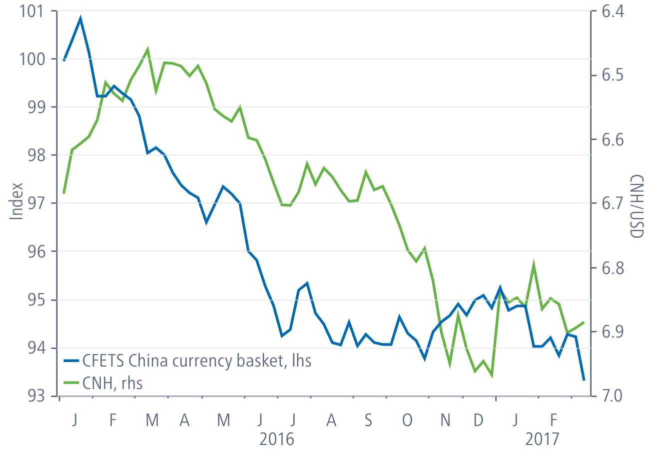
Peak regulation

7

The raft of greater financial regulatory requirements introduced over the last decade was an understandable response to the GFC. And doubtless they will have made the financial world a much safer one for investors and set in place an environment in which the worst excesses from that crisis cannot be repeated. Well-intended regulation can, however, sometimes result in excessive interference that prevents markets from functioning as they should. There is now a groundswell of opposition building against further regulation and even in some circles of reversing some parts of previous decrees.

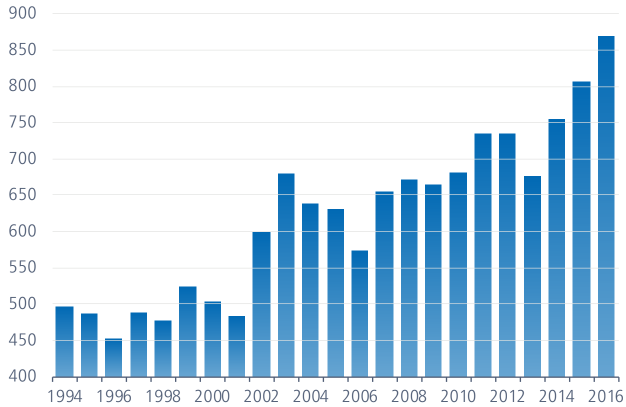
Reduced regulation is most likely in the US, where Trump's administration has a stated goal to ease the regulatory burden and free up institutions to allow them to operate more effectively in the future. It remains to be seen whether other countries follow this lead. Across Europe there is much less interest in a lighter regulatory touch, with the final elements of Basel III expected to be phased in over the next two years. Even so, the idea that we have passed the point of "peak regulation" seems increasingly likely.

Figure 13: China's managed depreciation
Continuation of two-year trend expected



Sources: Aviva Investors, Macrobond, as at 31/03/2017

Figure 14: Number of Securities and Exchange Commission enforcement actions
Doubled since the late 1990s - peaking now?



Sources: Securities and Exchange Commission, as at 31/03/2017

RISKS TO THE HOUSE VIEW

Acceleration in nationalist agenda

Ongoing growth in nationalist/ populist agendas

The election of Donald Trump has escalated the risks of greater trade protection and isolationist measures, but the trend towards more introspective nationalism was already there – Brexit, Italian referendum. The most immediate risks would seem to be in Europe, where there are key elections in 2017. The Dutch election passed relatively smoothly, with the far-right party improving its standing, but not enough to gain power. Focus now shifts to France and then Germany, although in many ways Italy looks the most vulnerable. In the extreme, greater nationalism could lead to another existential crisis for the Eurozone. A retreat from globalisation – in terms of both trade and capital flows – poses a material medium-term downside risk to global growth and would be especially damaging for small open economies, including several in the emerging market universe.

Secular stagnation - low growth, low returns

Is the equilibrium real interest rate negative?

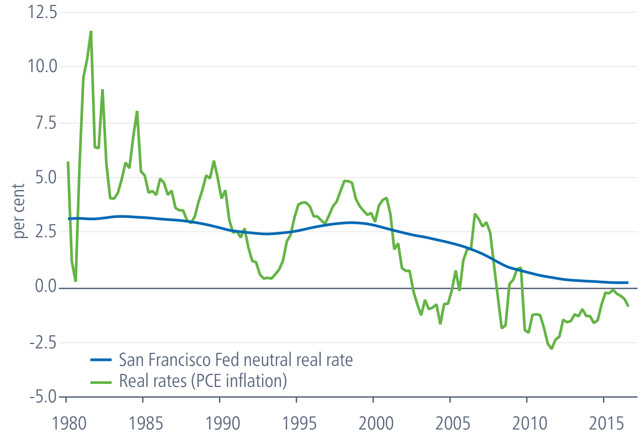
The decline in real rates could reflect a slide towards secular stagnation, a move that may have been accelerated by the financial crisis of 2008, although new technologies and demographic trends have also been key elements. Estimates of the current equilibrium real interest rate are around zero in economies such as the US, Eurozone and Japan, reflecting the excess supply of savings over investment globally. That implies that current policy rates may be far less stimulative than conventional analysis would suggest. If the potential for upside growth surprises is limited, risk asset pricing could struggle. And if the equilibrium rate is negative, nervousness about nominal rates below zero can prevent it being reached.

China growth - hard landing

Chinese outlook will always be important for investors

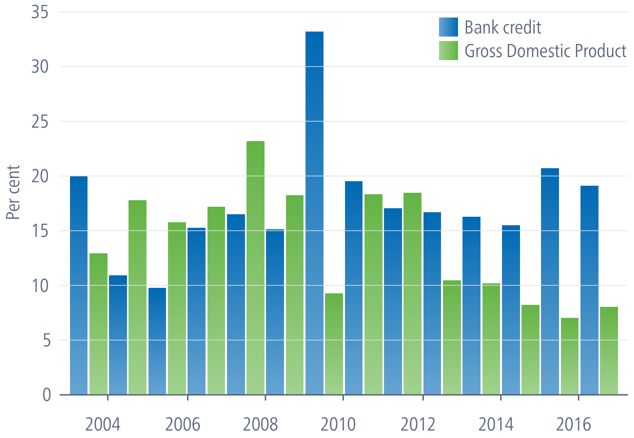
Growth has slowed in China in recent years, as the economy has matured and the process of transforming itself from one based on manufacturing, investment and exports towards one driven by services and consumption began. It will continue to slow in future years, a process that the authorities will want to manage carefully. 2016 was a year when growth was prioritised after the scare early in the year. China is now tightening policy modestly to help prevent any debt-fuelled excesses in parts of the economy. There is a risk that the authorities either become unable or unwilling to support growth further. While in the near-term we see them as being relatively low, medium-term risks have increased given the recent further increase in private sector debt. One consequence may be a sharper devaluation in the currency, weighing on global inflationary pressures. Commodity prices would also be likely to decline.

Figure 15: Secular stagnation
Estimates of neutral rate close to zero



Sources: Aviva Investors, Macrobond, as at 31/03/2017

Figure 16: China hard landing
Excessive credit growth?



Sources: Aviva Investors, Macrobond, as at 31/03/2017

Inflation acceleration - bond market rout

Headline inflation has risen sharply over the last six months, partly because of movements in energy and other commodity prices. So far, financial markets have adjusted to this with no sense of panic. But were that to change, a correction could swiftly become more alarming, raising the risk of a repeat of 2013's "taper tantrum" in terms of sovereign bond yields, or worse. Any perception of sustained inflation overshoots or a view that central banks are "behind the curve" would lead to a sharp sell-off in real rates and a spike in breakeven inflation rates. Significantly higher bond yields and a reassessment of the pace of central bank tightening would probably hit risk assets in general, boost the dollar and undermine emerging markets.

Has inflation been permanently tamed?

Debt de-leveraging vulnerabilities

After almost a decade of exceptionally low policy interest rates around the world, provision of credit to the private sector has expanded sharply in some economies (eg Canada, Australia, China and other emerging markets) while others – mainly those who saw a sharp increase in credit prior to the financial crisis – have de-leveraged (Figure 17). With global rates rising, albeit slowly so far, there is likely to be a renewed focus on which economies will be most vulnerable. Household balance sheets are particularly stretched in those which have experienced property booms, such as Canada and Australia. In the US, where overall the private sector has de-leveraged in the past decade, that reflects improving household balance sheets, with corporates taking on significantly more debt over that period. While rates remain low, the cost of servicing these debts will remain manageable. However, a surprise increase could uncover more serious problems.

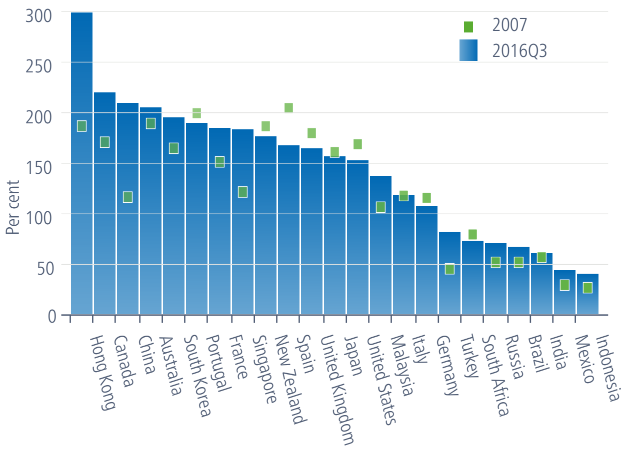
Debt levels are high around the world

Trade war: cycle of retaliatory trade protectionist actions

The most likely catalysts for a damaging cycle of protectionism and trade reprisals are initiatives from the Trump administration. These were widely mooted during his campaign and have been alluded to at various times since. So far, however, action has been limited and hopes have grown that some of the more damaging proposals have been either abandoned or tempered significantly. But this could change. US tax policy could be altered to materially favour domestic producers, while withdrawal from existing free trade agreements and increased use of tariffs and other trade barriers would reduce already-weak global trade growth. Retaliation against the US could follow, setting off a cycle of measures and counter-measures. World growth would suffer, with the adjustment falling more on export-orientated economies and companies. Inflation would probably rise too, at least initially, although the longer-term effect could be deflationary.

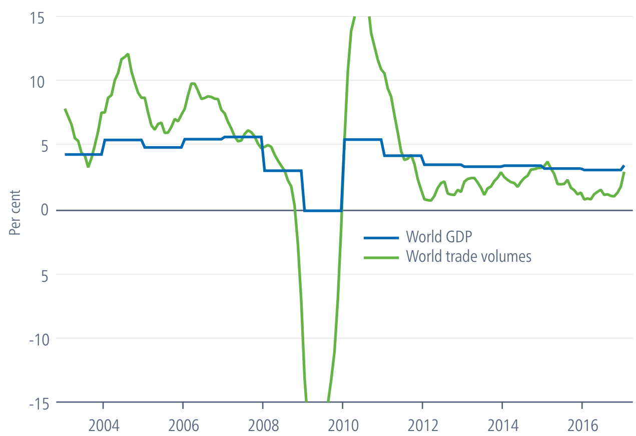
Moves toward greater protectionism would be damaging

Figure 17: Debt de-leveraging vulnerabilities
Private credit (% of GDP)



Sources: Aviva Investors, Macrobond, as at 31/03/2017

Figure 18: Trade war risk
Could restrictive measures curtail the recent recovery?

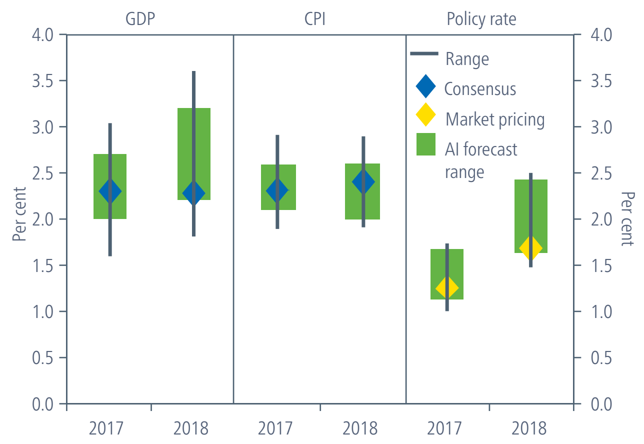


Sources: Aviva Investors, Macrobond, as at 31/03/2017

MACRO FORECASTS CHARTS AND COMMENTARY

Growth in the US has continued at a robust pace and this is expected to be maintained throughout 2017. With inflation rising steadily, the Fed has picked up the pace of monetary tightening and is expected to deliver three hikes in both this year and in 2018. A fiscal stimulus package is assumed, but this is anticipated to impact growth more next year than this. Encouragingly, Trump's administration has not, as yet, followed through on its more damaging policy proposals.

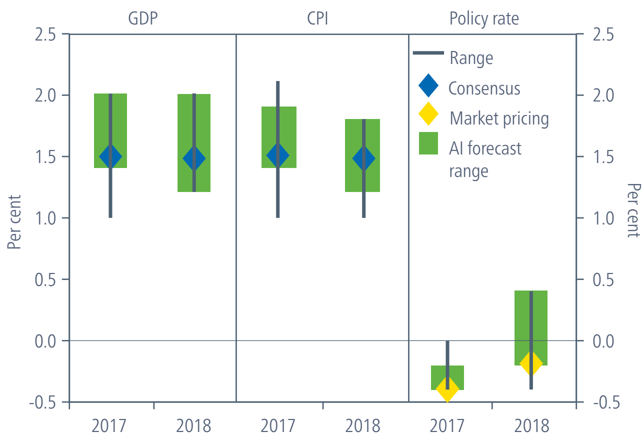
Figure 19: US



Source: Bloomberg, Aviva Investors, as at 31/03/2017

The Eurozone recovery looks as if it will broaden and strengthen in this year if surveys prove a reliable guide. There are still political hurdles to jump, underlying structural issues to address, and the thorny matter of closer integration to deal with. But 2017 has begun with sentiment high and a growing belief that this revival has legs. The ECB is relaxed for now, but with inflation back at target, they will be considering their exit strategy.

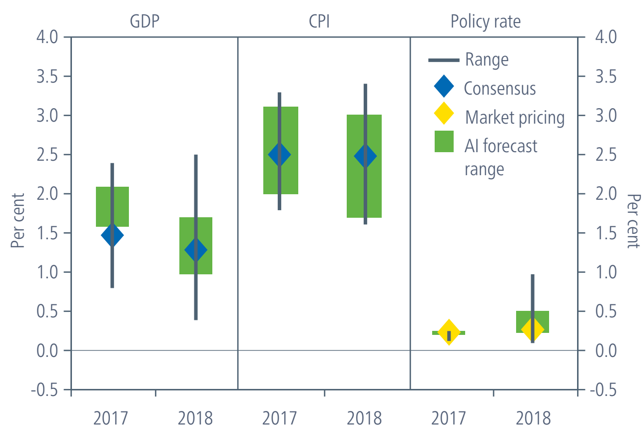
Figure 20: Eurozone



Source: Bloomberg, Aviva Investors, as at 31/03/2017

Macroeconomic resilience in the UK has continued over the last three months, but this looks set to be challenged during the course of 2017. Ongoing uncertainty related to Brexit has already impacted investment, while higher inflation will hurt real incomes and hence affect consumer spending later in the year. We continue to expect a slowdown this year, but if growth were to continue at or close to the recent pace, the Bank of England might have to react to higher inflation.

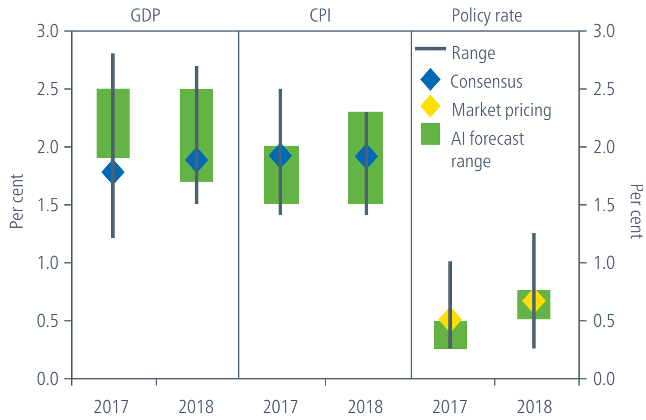
Figure 21: UK



Source: Bloomberg, Aviva Investors, as at 31/03/2017

GDP growth in Canada has gathered momentum in recent months, boosted by household spending and helped by the recovery in the oil price. But the hoped-for rebalancing towards business investment and non-energy exports is still largely absent. Better growth in her US neighbour will benefit Canada, but with core inflation still subdued, policy interest rates are likely to rise more slowly than in the US.

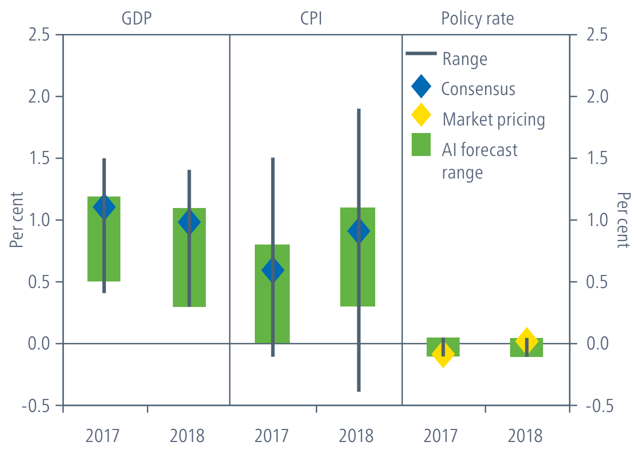
Figure 22: Canada



Source: Bloomberg, Aviva Investors, as at 31/03/2017

Any improvement in world trade flows will help Japan since exports are such an important component of GDP and domestic demand remains subdued. The weaker yen has also contributed in this area. A pick-up in wage growth, which would help boost consumer spending, has not yet happened but it remains an important goal for the Government. At least headline CPI inflation remains positive, if low. Another fiscal package during 2017 is widely expected.

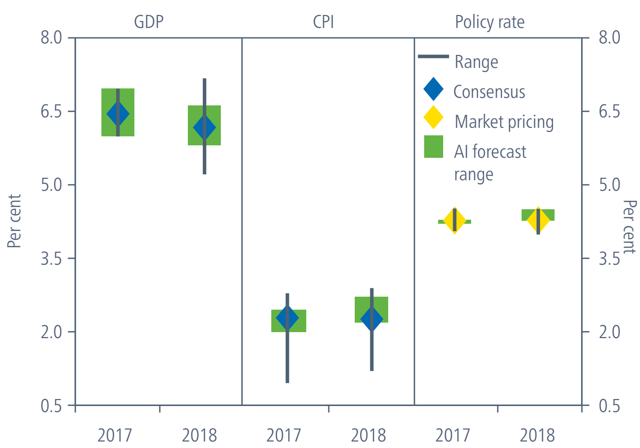
Figure 23: Japan



Source: Bloomberg, Aviva Investors, as at 31/03/2017

Helped by activist policies, China achieved its 6.5 per cent to 7.0 per cent growth target last year and looks set to reach this year's lower target of 6.5 per cent. This year the bias is for slightly tighter policy, but the main goal will be to ensure economic stability in the run-up to the plenum in November. Inflation has returned but is not a policy concern yet. The Chinese currency is likely to continue its recent slow depreciation. All eyes will be on trade – and other – relations with the US in 2017 and beyond.

Figure 24: China



Source: Bloomberg, Aviva Investors, as at 31/03/2017

GLOBAL MACRO OUTLOOK AND ASSET ALLOCATION

CLIMBING A WALL OF WORRY BUT NORMALISATION AHEAD

– Investors are climbing a wall of worry, slowly moving away from the deflation mind-set

– Crucial turning point in monetary policy ahead

– Equities are set to outperform, while duration faces challenges

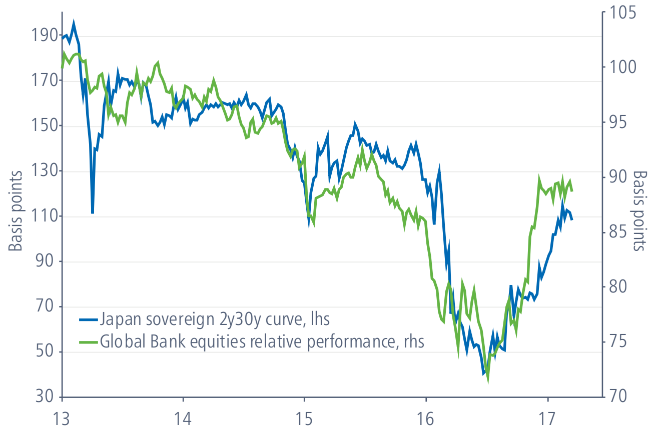
Investors are slowly pricing out deflation

Investors are climbing a wall of worry. A pretty high wall, but we think we are close to seeing the top of it. Fundamentals are improving, investors' mind-sets are slowly moving away from short-termism and political noise, and the focus is back on globally-improving economic newsflow. While we still consider it a downside risk to the outlook, we do not expect the global economy to head down the path of long-term secular stagnation. Beginning in the second half of last year, we think the market has finally started to price in a more positive global outlook, with fixed income markets in particular starting to move away from the mind-set of deflation that has dominated in recent years.

Turning point for global monetary policy is now in sight

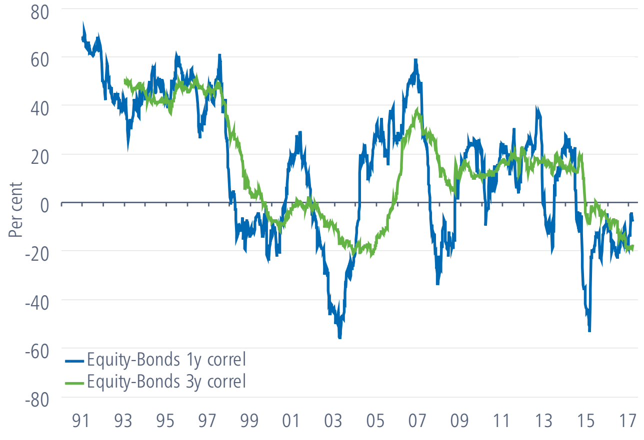
Indeed, there was an important inflection point around July last year (Figure 25). A synchronised global improvement in economic activity led to major moves in and across asset markets. As a result the major central banks have been obliged to acknowledge the improvement in growth and inflation prospects and start to consider exit strategies for some, or less gradual removal of accommodation for others. In the light of recent upbeat data, instead of adding to fear in global markets ("we still see downside risks"), monetary policy is now injecting confidence ("we see improvements in fundamentals"). As detailed in our economic outlook, we think the Federal Reserve will raise rates two more times this year, and that the ECB will start discussing exit options. Obviously this raises several questions for global markets. After all, many in the market have never seen a full tightening cycle in the United States. The Fed funds policy rate was anchored at 0 per cent to 0.25 per cent for seven years. The ECB rate is still negative and asset purchases are expected to continue at least until the end of the year. The Bank of Japan is also still pursuing a negative rate policy and is experimenting with "yield curve control". The turning point for global monetary policy is now in sight and is likely to impact global markets significantly, as fundamentals re-assert their influence.

Figure 25: Inflection point in markets last summer
Curve steepening and bank equities outperforming



Sources: Aviva Investors, Bloomberg, as at 31/03/2017

Figure 26: Regime change in correlations
Global equities vs global bonds rolling correlation



Sources: Aviva Investors, Bloomberg, as at 31/03/2017

Stronger global growth should translate into higher corporate earnings growth, while rising inflation supports term premia and represents a headwind for fixed income markets in the US and Europe. Keeping monetary policy so loose globally for years was justified, but it was inevitable that it would affect investor behaviour. This can be seen clearly in the asset allocation choices by investors in recent years, with very significant allocations into developed market fixed income at the expense of global equities and emerging market assets. While this has adjusted somewhat in recent months, there is still a long way to go. If there is a skew to our central view, it relates to upside risks for both growth and inflation. As a result we prefer owning equities to duration, with important differentiation to be made within each asset class across different geographies.

Equities to outperform duration, differentiation to be made within asset classes

The cross-correlation both between and within asset classes was distorted for much of the post-crisis period by central bank policies. However, as those policies have come to an end, correlations have begun to decline. Investors have to factor in higher dispersion within the equity space, but also within other asset classes. Figure 26 shows the correlation between equities and bond prices. The change in correlation regime coupled with a low volatility environment is a first step towards market normalisation. Indeed, the whole risk-on/risk-off approach with consistently high cross-asset correlations is not the historical norm. One might argue that asset prices have only just started to adjust to the idea that real rates might not stay so low forever. US markets are leading the way. For example, US 10-year breakevens at around 2 per cent are already close to historical norms.

Lower cross-asset correlations offer diversification potential

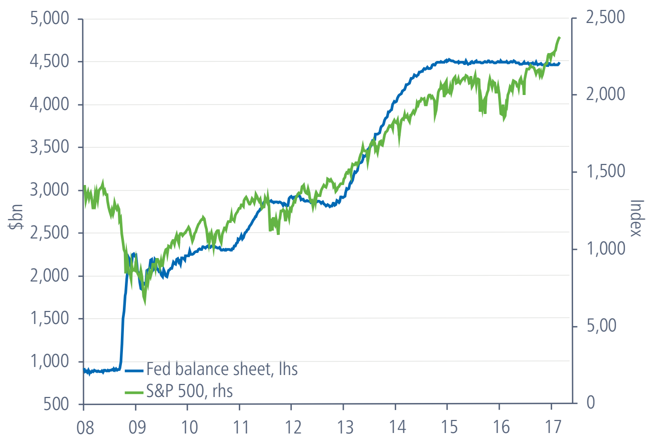
The view held by some commentators that Fed balance sheet expansion was the single driver of US equity markets seems not to hold anymore, as underlying earnings growth seems to have underpinned recent stock market advances (Figure 27). There was a case for saying that Quantitative Easing policies support multiple expansion as, for example, the low-yield environment persuaded companies to issue cheap debt and buy back stock. But looking forward we think equity prices will reflect an improved earnings outlook, based on stronger growth (Figure 28). And the potential for more active fiscal policy (especially tax cuts) should also support earnings and make the valuation adjustment quicker.

Earnings growth cycle to support equities going forward

We prefer a smaller allocation to US equities as we find the valuations provide a less attractive risk reward profile. Long-dated US Treasuries are now a more attractive proposition to reduce risk at portfolio level and provide balance. While we think there is still a case for higher yields in the US, the extent of the move higher in long-dated yields should provide protection if we were to be wrong in our central scenario. For example, if we were wrong on the reflation theme, or on our slightly more aggressive Federal Reserve path than what the market is currently pricing in,

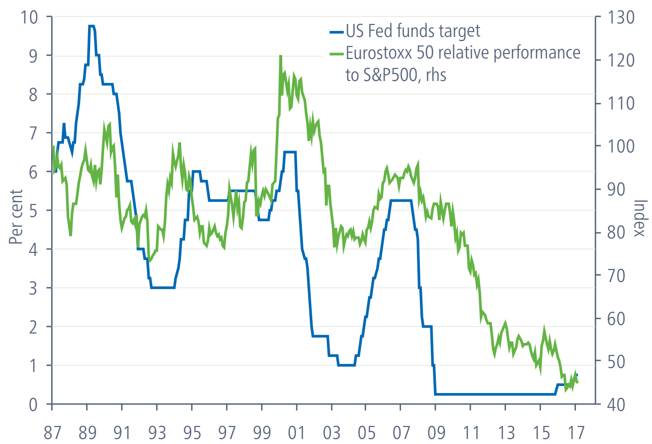
Long-dated US Treasuries offer protection as the equity risk premium normalises

Figure 27: S&P 500 to be supported by earnings, not balance sheet expansion anymore



Sources: Bloomberg Aviva Investors, as at 31/03/2017

Figure 28: We prefer European equities to US equities as the Fed is pursuing its tightening cycle



Sources: Datastream, Aviva Investors, as at 31/03/2017 then longer-dated Treasuries are likely to rally. Similarly, if we were wrong about the political outlook in Europe.

European equities are attractive

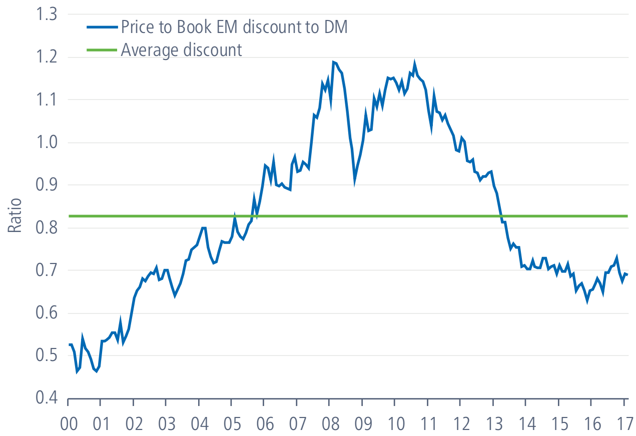
We take a somewhat different view in the Eurozone. We find equities still attractive in valuation terms (the weight of financial stocks certainly helps), while sovereign bonds and also credit markets are in our view offering poorer risk-reward profiles going forward. Indeed, given the ECB has probably reached maximum easing and is likely to be looking towards exit strategies later this year, as the underlying economy seems to be improving, we strongly prefer owning equities versus sovereign fixed income and credit in Europe. Indeed, depressed sentiment, international positioning, valuation, and potential for earnings re-rating mean we continue to strongly overweight European equities. We think European equities offer the best expected return on a one-year horizon, with risks on the volatility outlook. Our central view is that populist parties may increase their share of the vote, but will not win any major election in the Eurozone. Italy and France are the greatest risk to that outlook.

We think local currency debt offers better risk reward than hard currency in Emerging Markets

Emerging market debt and equities should both do well in our central view of the world. Our view on emerging markets assets began turning more positive at the end of 2015, and we continue to like both equities and, more selectively, bonds in the emerging market space. In particular, the idea that the Chinese economy does more of what we have seen in the last few quarters, i.e. prioritises and achieves stable growth, is a support for global emerging markets. At the same time, the fact that the Federal Reserve risks being somewhat behind the curve also means that we expect curve steepening without much dollar appreciation which is also positive for the asset class. We strongly prefer, on valuation grounds, having exposure to local debt (overweight) versus hard currency debt (strong underweight), and like EM equities (strong overweight) in general and Chinese equities in particular. Hard currency debt has become particularly expensive in our view.

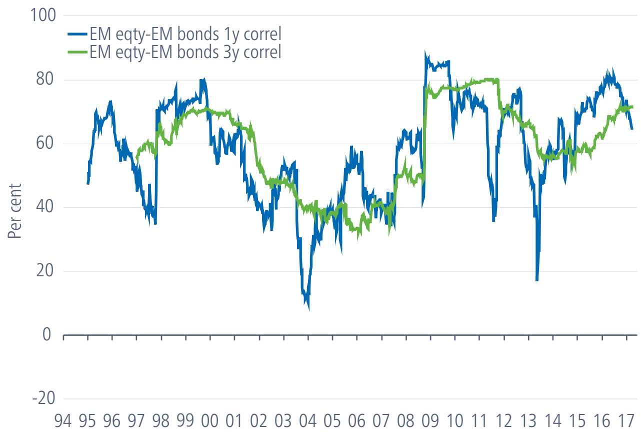
The United Kingdom outlook is obviously clouded by Brexit. If negotiations do not progress well, uncertainty could easily ramp higher again. We believe that much of the recent UK equity move is attributable to sterling depreciation. We see downside risks for both equity and bonds going forward and have an underweight stance and a neutral view on the currency.

Figure 29: EM equities still trading at a discount to DM equities



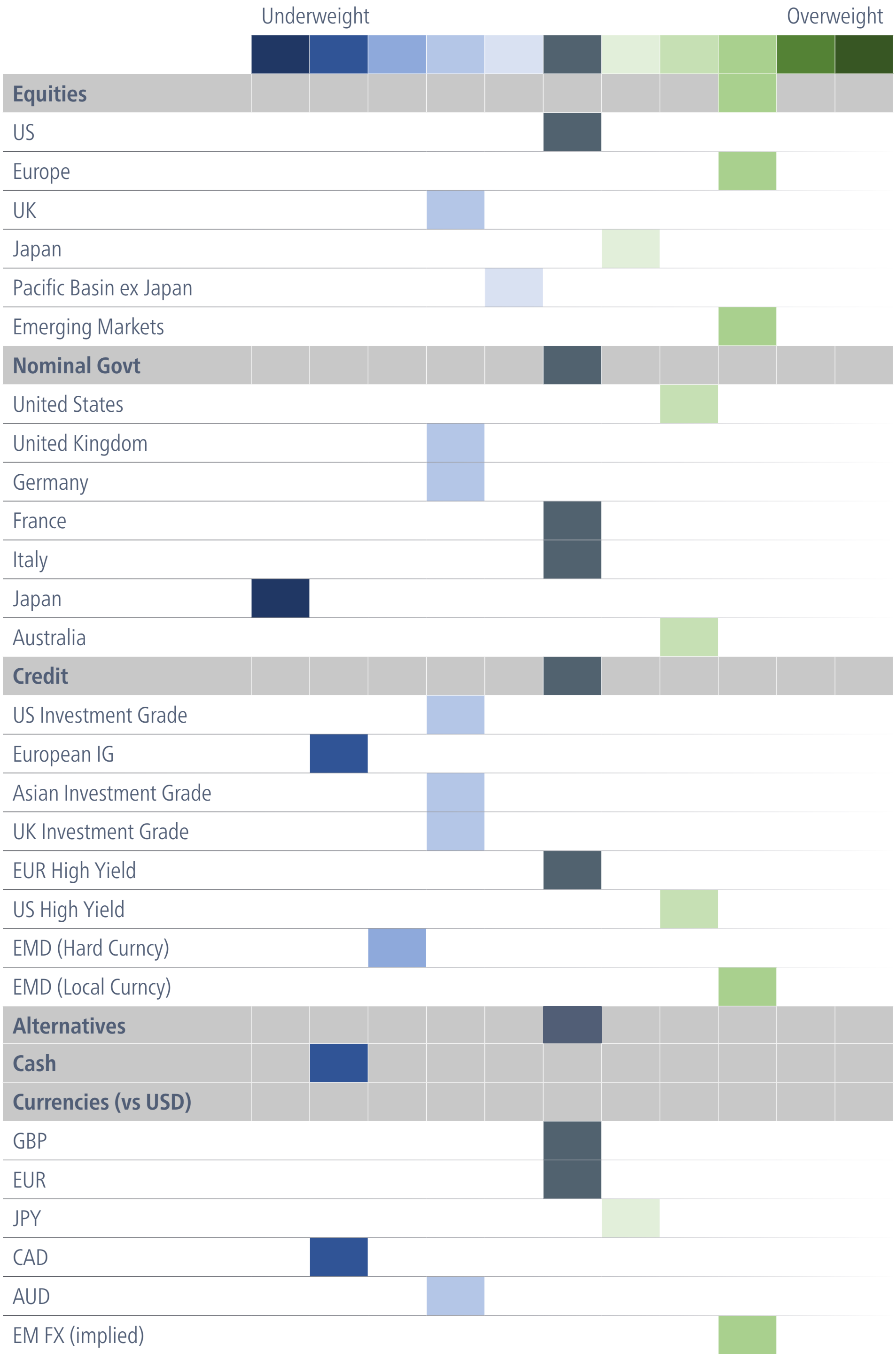
Sources: Bloomberg, MSCI, Aviva Investors, as at 31/03/2017

Figure 30: Correlation between EM equities and bonds recently weakened



Source: Bloomberg, MSCI, Aviva Investor. Correlation between MSCI EM and JP Morgan EMBI global total return index, as at 31/03/2017

Figure 31: Asset Allocation



Sources: Aviva Investors, as at 31/03/2017

> Overweight Equities, as fundamentals continue to improve

> Overweight US Treasuries at the long end for risk reduction

> Local currency debt preferred in EM

ESG INSIGHT

GENDER DIVERSITY – THE STATE OF PLAY

International Women's Day shines spotlight on systemic inequality

On March 8th 2017 the world marked International Women's Day, celebrating the political, social and economic contributions of women around the world. Significantly the day has also become a focal point to raise awareness of the ongoing systemic gender inequality that still exists within many strata of society. Despite a plethora of commitments and campaigns backed by governments, business leaders and prominent organisations, the World Economic Forum estimates that on current trends, the gender gap will not be closed until 2186.

Women on boards considered symbol of economic opportunities in the workforce

While gender inequality takes many different forms, in developed markets discrimination is most apparent in the imbalance of economic opportunities afforded to women. This includes unequal pay practices between men and woman and the existence of a glass ceiling restricting the pathway of women into senior management. Consequently, many of the high-profile initiatives supporting women's economic rights have centred on gender diversity within business, and in particular, the fair representation of female directors on corporate boards. The greater presence of female directors has been seen as both a proxy for practices across an organisation and also a catalyst for further progress and change.

Different jurisdictions have adopted a variety of approaches to help foster greater female representation within the boardroom. The most cited and controversial regulation was introduced in Norway in 2003 which obligated companies to appoint a minimum of 40 per cent female boards with the threat of dissolution if the target was not realised.

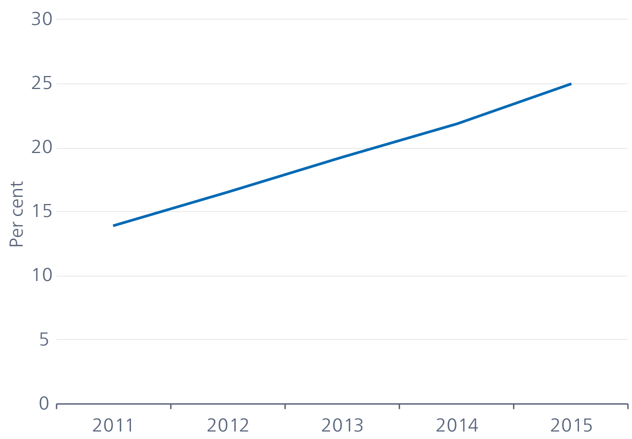
Emergence of quotas for female directors

Since that time, France and Germany have also introduced similar regulations requiring 40 per cent and 30 per cent mandatory quotas respectively (albeit without the punitive measures employed in Norway). Even India, a country that has traditionally scored poorly on women's rights, now requires all listed companies to appoint at least one female director. In contrast the UK has approached the problem through voluntary standards and reporting, targeting 33 per cent board representation by 2020. Importantly this was recently extended to apply to the executive pipeline as well.

Number of female directors has doubled over the last 5 years

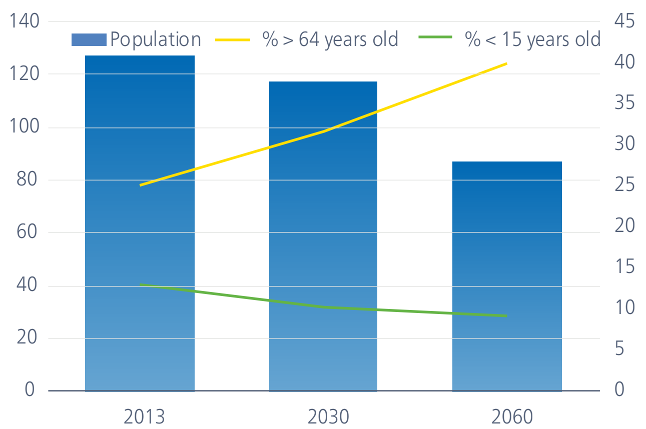
There is still considerable debate on the merits of mandatory versus voluntary quotas and how best to ensure an effective governance regime while guarding against "tokenism". Nevertheless, evidence suggests that there has been a steady improvement in board diversity under both approaches. Between 2011 and 2016

Figure 32: Proportion of women on STOXX 600 boards



Source: European Women on Boards, as at 31/03/2017

Figure 33: Shrinking and ageing Japan



Sources: Cabinet Office, MIC, MHLW, Japan National Institute of Population and Social Security Research, as at 31/03/2017 the percentage of woman on the boards of the largest 600 European companies doubled to 25 per cent (Figure 32). Similar trends can also be seen across most global markets where female representation at the board level now stands at approximately 15 per cent.

Number of female directors has doubled over the last 5 years

While the progress to date is positive, the number of female directors still falls considerably short of being a meaningful reflection of the ratio of women in the workforce. Of even greater concern is that while the number of women on boards has doubled, the amount of female chief executives in Europe have remained broadly static at 3 per cent, indicating that the glass ceiling remains firmly intact. To really shatter this ceiling and accelerate the path to change, it is important that the narrative around gender diversity be expanded from a social obligation to an economic imperative.

WOMENOMICS – UNLOCKING JAPAN'S ECONOMIC POTENTIAL

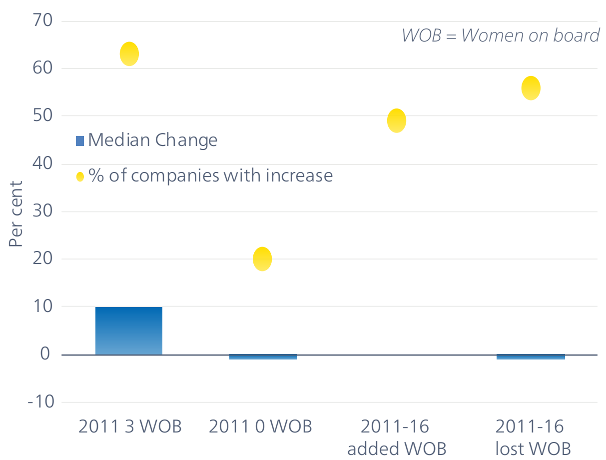
According to the Japanese Cabinet Office, Japan's total population is forecast to shrink by 30 per cent over the next 50 years (Figure 33). Japan's severe demographic headwinds mean that unless radical steps are taken quickly, the nation faces the risk of not only longer-term economic stagnation, but of economic contraction and lower standards of living.

A report published by Goldman Sachs projected that if Japan's female employment rate rose to match the level of their male counterparts, this would add another 7.1 million employees to the domestic workforce. Accordingly, Goldman Sachs estimated that this could boost Japan's absolute level of GDP by as much as 12.5 per cent. This fact was acknowledged by Prime Minister Abe at his landmark speech at the World Economic Forum in 2014, where he described the female labour force as the most under-utilised resource in the country.

Better utilisation of the female workforce could boost Japan's GDP by > 12 per cent

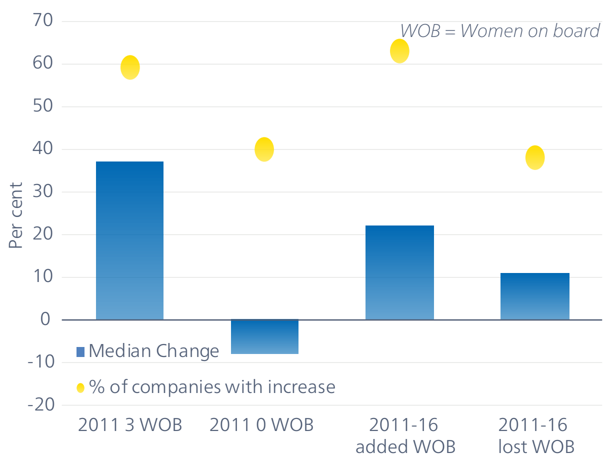
The Abe administration subsequently unveiled a series of policies and initiatives to encourage woman to re-enter the workforce. This culminated in the enactment of the Female Employment Promotion Legislation which requires large private and public sector companies in Japan to disclose gender diversity targets, accompanied by detailed action plans. The government intends to certify businesses that make and implement ambitious plans and reward them with preferential treatment in bidding for public orders.

Figure 34: Five-year return on equity (ROE) by number of women directors



Sources: MSCI ESG Research, as at 31/03/2017

Figure 35: Five-year earnings per share (EPS) by number of women directors



Sources: MSCI ESG Research, as at 31/03/2017

Japan ranks last for board diversity

Whilst it is still relatively early to judge, initial evidence points to limited progress in labour practices across the country. This can be most acutely observed in the boardroom where female directors represent only 3.5 per cent of the TOPIX Index, leading to Japan being ranked last behind Taiwan and South Korea in a global benchmark.

There are a number of actions that the government can focus on including reducing the estimated 30 per cent wage gap between men and women and removing the tax penalty for dual-income households. However, to truly unlock the 13 per cent of GDP potential represented by the latent female workforce, Japan must embark on the challenging task of tackling the deep-rooted cultural norms which represent the greatest barrier to change.

BETTER BOARDS & BETTER RETURNS

Over the last decade there has been a growing body of academic studies pointing to the financial benefits of corporations embracing gender diversity. This includes reports from McKinsey and Catalyst which found that companies with high female board representation perform well against various metrics including return on equity, capital and sales.

Companies with more women on boards generate superior returns and earnings growth

More recently MSCI published the results of a study of US listed companies over a five-year period. The research found that between 2011 and 2016, companies with at least three female board directors experienced median gains in Return on Equity (ROE) and Earnings per Share (EPS) of 10 per cent and 37 per cent respectively. In contrast, companies that began the period with no female directors experienced median changes of -1 per cent in ROE and -8 per cent in EPS (Figure 34, Figure 35). In separate but complementary research conducted by Morgan Stanley, companies that had more gender diverse boards were also found to exhibit lower levels of volatility.

Various studies have speculated on causality between diversity and observed financial performance, pointing to more effective and considered decision making, stronger risk management, lower staff turnover, and better engagement and relations with stakeholders. These observations are consistent with Aviva Investors' experience of direct engagement with over 600 portfolio companies annually as part of our ESG stewardship program.

CAPITAL MARKETS HOLD THE KEY TO CHANGE

Shareholders have begun holding companies accountable for diversity practices

The social and moral case in favour of equal opportunities for women in the modern workplace is incontrovertible. However, it is the financial case in favour of gender equality that may prove the most decisive catalyst for long-term change. This 'enlightened self-interest' has created a wave of activity within the investment industry. For example, we have seen the creation of gender-focused thematic funds and indices. Aviva Investors are also amongst a number of investors who have updated their voting policies to vote against director elections if boards fail to meet minimum diversity targets.

In volatile market environments investors will seek out high-quality companies that can generate superior risk-adjusted returns. Greater understanding of the relationship between diversity, quality and performance, should mobilise global capital into supporting social inclusion and gender equality, potentially serving as the tipping point in the delivery of a more sustainable, inclusive and equitable economic future.

RISK

What a difference a quarter can bring. As we entered 2017 investors fretted about the looming challenges and unknowns that faced the markets, and yet, somehow asset prices ground out new highs. Investors seemed to shake off their worries swiftly, volatility dropped and little seemed to bother the market for more than a brief moment. Elections in Holland restored investors' faith that the world order has not changed everywhere and that the apparent onward march of nationalistic politics might not be unstoppable.

Markets have remained very calm...

Have we entered another "goldilocks period"? Is this the long-awaited lift off for global rates, an entry point to the return of normality or is there something more ominous just around the corner? Perhaps investors have taken former Citi CEO Chuck Prince's most famous quote to heart:

"When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing".

While investors seemed to have wholeheartedly embraced the new world, there are still some signs that all might not be well. Nine months after the referendum decision, the phoney war is over and Britain has delivered its letter to Brussels. Donald Trump has stumbled at his first attempt at legislative change and yet standard measures of risk tell us the world is a safe place.

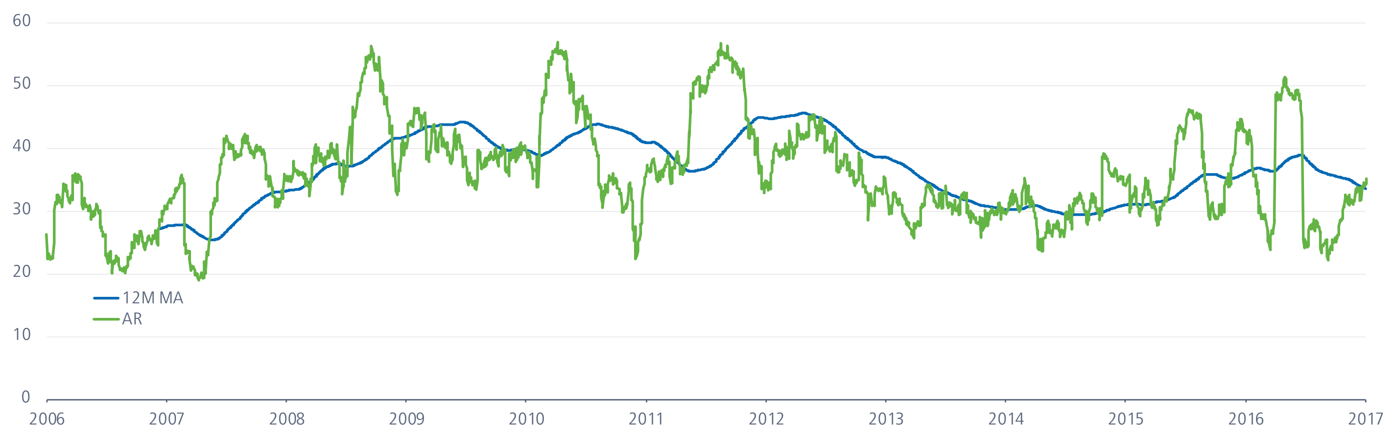
...but there are still many hurdles to jump

LOST IN THE POST?

At the EU gathers to celebrate it's sixtieth birthday in Rome there was one glaring omission from the guest list. Theresa May, the UK's Prime Minister, did not attend and instead used the time to compose perhaps the most important letter she is likely to write. Once delivered to the EU, Britain will begin along the formal path towards an unforced exit from the bloc. As the formal two-year process starts to unfold, markets will finally have an opportunity to establish whether the UK government has a viable plan for the economy's future or if the push for a hard Brexit beloved by some in Government will lead us over a cliff edge. While the tone from Europe has been polite and cordial, the stance is firm. This contrasts with the more abrasive tone emanating from some of the Brexiters in the UK. While markets have accepted a level of bluster before the talks, they may not be as sanguine if the official negotiations progress badly. There are many potential pitfalls in which talks can break down and markets might well wake up to a very different outcome than they are pricing in currently. Meanwhile, the UK Government will face pressure

Brexit negotiations have only just begun

Figure 36: Measure of systemic market risk



Sources: Aviva Investors, Bloomberg, Macrobond, as at 31/03/2017 from pro-remainers, pro-exiters and most likely a renewed push towards Scottish independence which all adds to the pressures on the process.

Figure 36 shows the absorption ratio of broad markets from 2007 onwards. The absorption ratio is a way to measure implied systemic risk and is one metric which can help demonstrate the interconnectedness of global financial markets. The higher the absorption ratio, the greater the level of systemic risk inherent in markets is perceived to be.

While we can see there have been periods of considerable strain in markets over the last decade, Brexit has yet to compare to other events such as the European debt crisis. The green line represents the rolling 60-day absorption ratio, while the blue line shows the 12-month moving average.

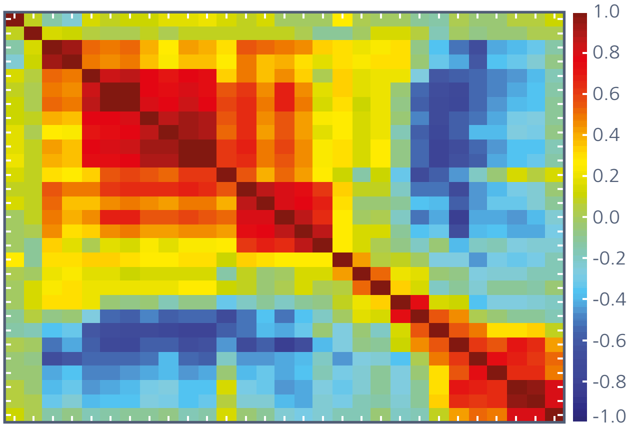
Currently this is not suggesting that markets are worried about the upcoming risks and indeed, if anything, are somewhat relaxed about the immediate future although the measure is rising, suggesting some nervousness. Should one side leave the table in Brexit negotiations and walk away, then it seems unlikely that market risks won't substantially increase and therefore risks remain to the downside rather than the up.

TRUMP'S FIRST THREE MONTHS

Trump has encountered some roadblocks to mooted changes

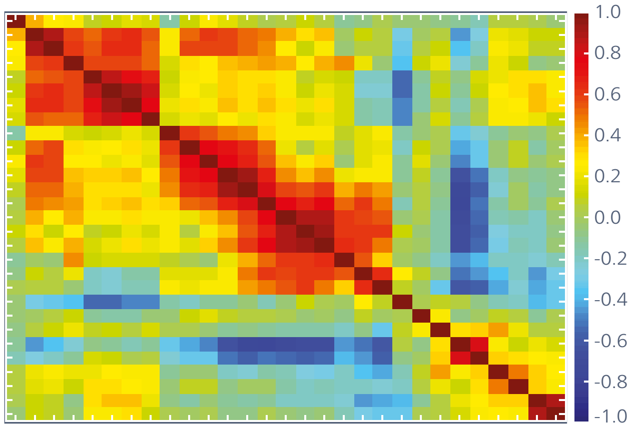
The first 100 days are thought to be defining periods for US presidencies, the term having been coined by Roosevelt in a 1933 radio address, and are thought to be the time when presidential power and influence are at their greatest. While President Obama had to deal with the fall-out of the Global Financial Crisis (GFC), President Trump has had the tailwinds of strong economic performance, rising inflation expectations, a buoyant stock market and a strong labour market. Coupled with both Houses being Republican-controlled, the stage seemed set for change. However, following the combination of seemingly being at loggerheads with the judiciary over the controversial travel ban, a hostile relationship with the mainstream press and an inability to agree a replacement for the Affordable Care Act, the fledgling administration is at risk of ending up bogged down inside its first 100 days. While traditionally of greater interest to individuals rather than to investors, many of the recent market moves have been motivated by elements of the promises within the Trump agenda. If these assumptions are questioned, then perhaps so too will be the market moves that have occurred since last November?

Figure 37: Correlation heatmap (June 2016)
High correlation environment (tending towards +/-1)



Sources: Bloomberg, Aviva Investors, as at 31/03/2017

Figure 38: Correlation heatmap (March 2017)
Lower correlation environment



Sources: Bloomberg, Aviva Investors, as at 31/03/2017

Across a Europe shocked by the Brexit result and the election of Donald Trump in the US, traditional political parties seemed to be fighting a wave of populist and nationalist driven agendas, often at odds with the last 30 years of political history. In the Netherlands, a country renowned for its liberal values and approaches, it seemed plausible that a controversial and populist agenda was about to claim another victory. However, in what many consider to be a surprise outcome, the more conventional parties have emerged victorious. Partly as a result, some of the concerns over unwelcome results in other European elections have faded. While undoubtedly there are risks from the upcoming French and perhaps, to a far lesser extent, the German elections, we judge these risks to be lower than they were at the start of the year.

Political event risks in Europe in 2017 and beyond

If and when these periods of fragility do arise, then it is important for investors to understand the impact that this may have on asset correlations. We have illustrated this dynamic in Figure 37 and Figure 38 which show the correlation of currencies, equity, commodity and bond markets to each other at the end of June and also the end of September. As we can see in the immediate aftermath of the Brexit vote, correlations became materially more polarised than they are now. This of course makes the search for true diversification more important as it is this which helps portfolios perform in both stressed and normal market conditions.

Correlations can change significantly at moments of heightened stress

PEAK REGULATION MAY HAVE BEEN REACHED

Since the GFC the global authorities have worked diligently and ceaselessly to opine over various new rules and approaches to remove risk from the markets and indeed the system. A huge quantity of new statutes and regulations have appeared from a wide number of regulators in recent years and these have inevitably necessitated large increases in compliance, legal and risk staff. However, since the US elections, the assumed pace of regulatory change has slowed and indeed many commentators have suggested there is a case that the regulatory burden might now start to diminish (for example, repeal of Dodd-Frank). While politicians might support this direction of travel, we don't believe that regulators will support such major changes across insurance, banking or asset management. Rather we believe the more likely outcome is that we will see a decline in the pace of new regulation alongside the removal of some more minor rules. Furthermore it is not clear that those being regulated are keen for a return to the former rule book, therefore perhaps we have witnessed a peak in the speed at which new rules are introduced. But anyone hoping for a return to the "laissez-faire" system that prevailed pre-crisis is likely to be very disappointed in the outcome.

ECONOMIC OUTLOOK

UNITED STATES: ALL EYES SHIFT TO THE FED

– Activity picked up in 2016H2 and looks set to remain robust

– Limited spare capacity set to increase wage and price inflation

– Much focus will be on delivery of fiscal stimulus, but Fed reaction will be increasingly important

SUMMARY

Financial headwinds to US economy have finally passed

The US economy is approaching the point at which the debilitating effects of financial crisis – a crisis that took place nearly a decade ago – have largely passed and a degree of normality has returned to the economic landscape. Progress has been steady rather than spectacular, as ongoing headwinds from the crisis, alongside global factors have weighed on the pace of recovery. However, by the end of 2016 a vast array of macroeconomic data showed how much the economy had strengthened.

Challenges remain, including weak productivity and investment growth

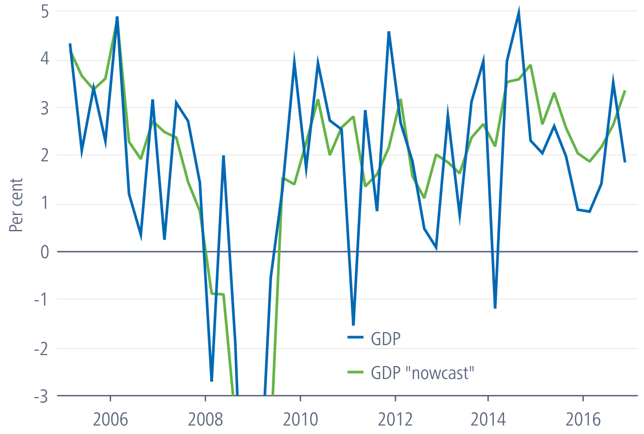
That is not to say that the US economy. Business investment (as a share of GDP) peaked two years ago, well below the pre-crisis level, and has shown only limited signs of improving since the energy sector stabilised. Corporate profits grew only modestly in 2016 and the fiscal position remained challenged. Participation in the labour market by prime-age workers, particularly men, is also well below the level implied by the pre-crisis trend. Inequality, as measured by household income distribution, worsened almost every year since 2000. It showed a small improvement in the latest available data, but inequality remains high in both a historical context and when compared to other countries.

Growth picture is robust

So while the economic picture was as positive as at any time in the past decade, it was not without its challenges. It was against this backdrop that President Trump took office in late January. Survey indicators for Q1 suggest that the economy has continued to grow robustly since the start of the year, although the hard data has been less effusive. Our estimate for growth in Q1, which is based on a range of survey indicators, suggests a figure of close to 4 per cent (Figure 39). However, approaches that put more weight on hard data suggest a more modest pace of increase.

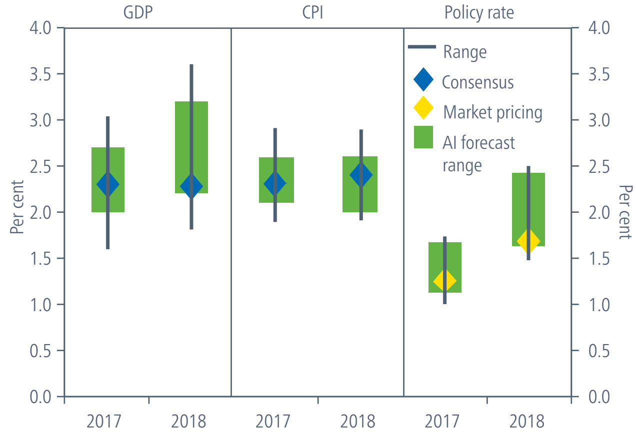
We expect that the direct boost to growth from new fiscal measures from the Trump administration will be small this year, as they are unlikely to be implemented until Q4. However, we do think that the increase in household and business

Figure 39: GDP growth and survey-based measure of growth
Growth picked up in 2016H2



Sources: Aviva Investors, Macrobond, as at 31/03/2017

Figure 40: US economic projections



Sources: Aviva Investors, Macrobond, as at 31/03/2017

optimism will deliver somewhat faster growth this year than would otherwise have been the case (Figure 40). We expect growth to pick up further in 2018 as the proposed tax cuts boost consumption and investment spending. That should put further modest upward pressure on inflation. Against this backdrop, policy rates remain close to their all-time lows, with the Fed having raised rates only once in 2016 and again in March. We expect that they will raise at least two more times this year, with the risks skewed to one more, rather than one fewer hikes. We expect another three rate increases in 2018. While that would mark a stark increase in the pace of rate hikes, it would still only be enough to bring short-term real rates back up to around zero.

Fed set to raise rates more quickly in 2017/18

RISING OPTIMISM

US growth accelerated beyond 2.5 per cent in 2016 H2, its fastest pace in two years, rising above the average rate of increase since the financial crisis and above potential supply growth of around 2 per cent. The pick up in growth reflected a faster pace of household consumption growth, alongside a turnaround in investment spending and inventory accumulation. The improvement in investment spending partly reflects the smaller drag from mining investment, as well as a modest rise in non-mining business investment. Looking ahead, a pick up in business investment will likely be necessary to sustain the above-trend rate of growth, with the additional benefit of increasing potential supply at the same time. Survey evidence is supportive of a revival in investment spending. Business sentiment has increased substantially in the past year, across a range of large and small business surveys. In some instances sentiment is a strong now as at any point since 2005 (Figure 41).

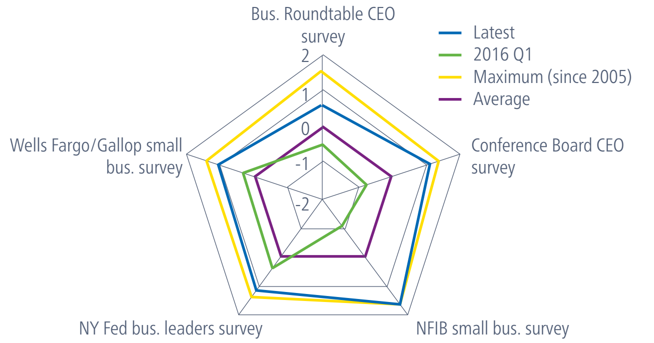
Business sentiment has risen sharply in recent months

The catalyst for the improvement in sentiment was the US election. In the Q1 House View, we described Trump's fiscal policy platform as likely to give US reflation – that is growth and inflation – a turbo-charge. That reflected our central view that the Congress would deliver a meaningful fiscal stimulus in the second half of 2017, worth around 0.5% of GDP, and Trump would not unilaterally raise tariffs in a way that would likely lead to retaliatory action. It seems that US businesses continue to expect a similar outcome, with reductions in regulatory burden adding to the optimism. That may be the catalyst for driving the "animal spirits" needed to boost investment spending, and is something we are monitoring particularly closely. Consumer sentiment has also responded positively, rising above the pre-crisis peak.

Increasing optimism has been seen across a range of sectors, boosted by hopes of lower taxes and reduced regulation

We continue to expect individual and corporate tax cuts to be delivered; however, we do not have as much clarity as we had hoped by this time. They may well be delayed into Q4 of this year or even 2018. Any additional spending on

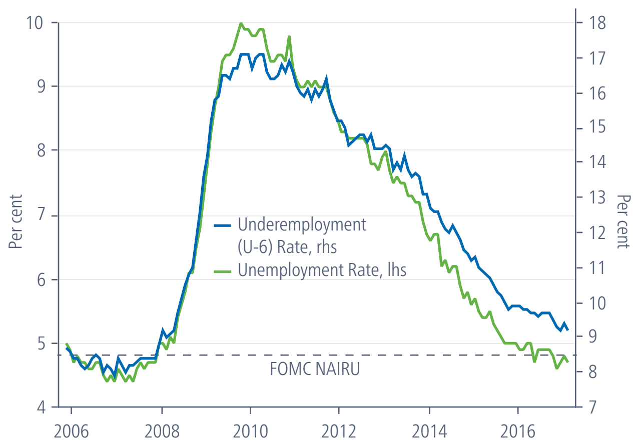
Figure 41: US business confidence[1]
Sentiment has risen sharply to near historic highs



Source: Aviva investors, Macrobond, as at 31/03/2017

1 Each survey has been normalised to have a mean of zero and standard deviation of one (since 2005). Each pentagon in the radar chart represents one standard deviation, with the long-run average at zero.

Figure 42: Unemployment and underemployment
Labour market extremely healthy



Sources: Aviva Investors, Macrobond, as at 31/03/2017

infrastructure seems even further down the road. However, on the other side of the ledger, President Trump has not taken any policy actions on trade protection, and has seemingly had a more positive initial dialogue with China than many had feared. That said, risks remain that a more protectionist set of policies could be pursued, which would be detrimental not only for the trading partners, but for the US as well.

Labour market to tighten further

The strength of the economy continues to show through in the labour market. The rise in monthly payrolls continues to be well above the "breakeven" rate needed to just keep the unemployment rate steady. The fact that it hasn't fallen more sharply reflects the recent rise in participation (Figure 42). We do not expect that rate of increase in participation can be sustained, and as such expect the unemployment rate to fall further, to around 4.5 per cent, over the course of 2017. However, the scope for the unemployment rate to fall much beyond that is limited, given the natural frictions in the labour market. Indeed, the number of unemployed per job vacancy is already below the pre-crisis trough, indicating the tightness of the labour market.

FOCUS SHIFTS TO THE FED

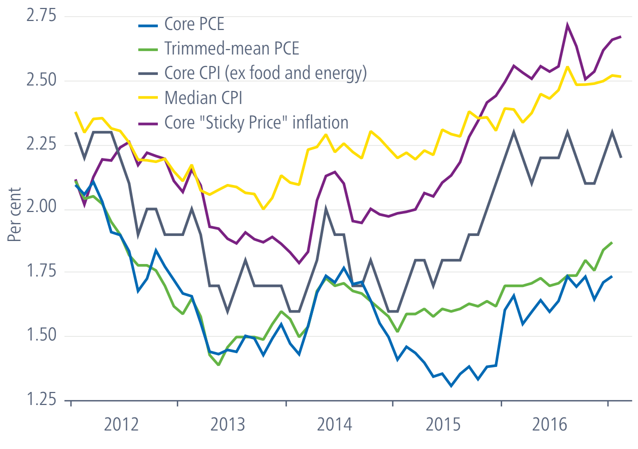
Inflation set to rise in 2017

Hourly wage growth picked up modestly over 2016, but reached the fastest pace of increase since 2009. With the labour market already close to full employment, minimal spare capacity within businesses and an expectation of continued robust economic growth, we think that wage growth will rise further over the coming year. That is expected to put further upward pressure on core inflation, pushing core PCE towards 2 per cent. Other approaches to measuring core inflation already show inflation above 2.5 per cent (Figure 43). While core inflation is expected to rise over 2017, headline inflation will initially fall back somewhat as the positive boost from energy prices subsides over the next few months.

Federal Reserve expected to raise rates three times in 2017 and 2018

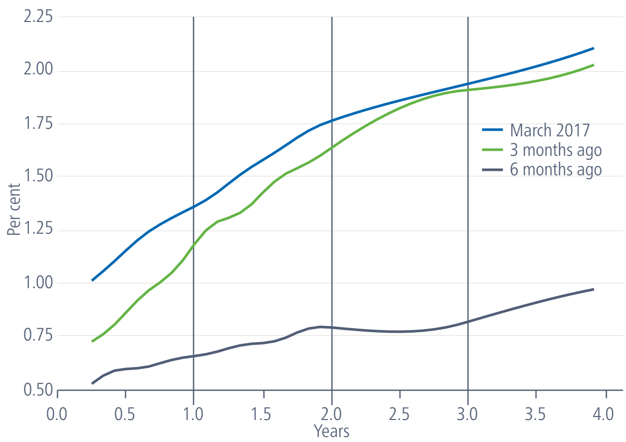
With the economy close to full employment and inflation nearing 2 per cent, the Federal Reserve raised rates in March for just the third time in this cycle. Despite raising the policy rate twice in the past three months, broader measures of financial conditions have actually softened over the period. That reflects a moderation in the strength of the dollar, rising equity prices, tighter credit spreads and little change in longer-term rates. If that were to persist, it would likely require the Fed to increase raise rates more quickly. We expect two more rate rises this year – which is broadly priced into the short-term rates market (Figure 44) – with a risk of three. We expect three more rate rises in 2018. That said, with Chair Yellen expected to retire in January 2018, there will be more uncertainty than usual about the future reaction function of the Fed.

Figure 43: Measures of core inflation
PCE to rise further in 2017



Sources: Aviva Investors, Macrobond, as at 31/03/2017

Figure 44: Market expectation of Federal Reserve policy rates
Market has re-priced sharply higher in the past six months



Sources: Aviva Investors, Macrobond, as at 31/03/2017

EUROZONE: PLANNING AN EXIT

– The four-year recovery should continue in 2017, despite political hurdles

– Headline inflation back at target; core still stubbornly low

– ECB in stimulus mode for now, but will be considering exit options

Could 2017 finally be the year that growth in the Eurozone surprises on the upside? The year has begun with a mood of optimism that, despite well-documented political hurdles this year, the cyclical revival that is already four years old and reasonably well-established, could strengthen this year. Although in a region of 19 countries there will inevitably be some areas of economic frailty at any one time, the feel at the start of 2017 is more upbeat than for many years. However, the consensus growth forecast is a relatively modest 1.6 per cent (and 1.5 per cent in 2018). This reflects both political event risk and the fact that the Eurozone has been a serial underachiever on growth since its inception in 2000. GDP has risen by a paltry 1.2 per cent a year on average since then (Figure 45), so it is understandable there is considerable scepticism that the region is suddenly on the launchpad heading for booming growth. There are known headwinds in the form of ageing/demographics and the unhurried pace of structural reform that impact the potential pace of growth. And in the background there are still many rumblings about the glacial rate of progress towards closer integration.

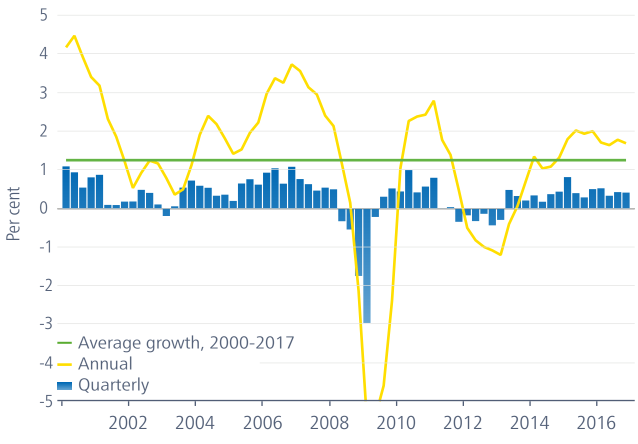
Growth optimism at the start of 2017

Perhaps some wish for too much. The Eurozone is not a fast-growth region. The trend pace is only about 1 per cent - perhaps even lower – so any GDP increase higher than that should be welcomed for now while there is spare capacity in the area. Estimates vary, but there is still ample room for non-inflationary growth in most of the major countries according to the OECD (Figure 46). The exception is Germany. But even there, the absence of any major inflationary threat (at least so far) is evidence that perhaps structural reforms there have improved the growth/inflation trade-off. Germany would doubtless argue that other nations should follow this lead more determinedly. Once the Eurozone output gap closes – and that looks possible by the end of this year or early in 2018 – growth will need to slow back to trend to prevent any build up of inflationary pressures.

There is still spare capacity in the Eurozone

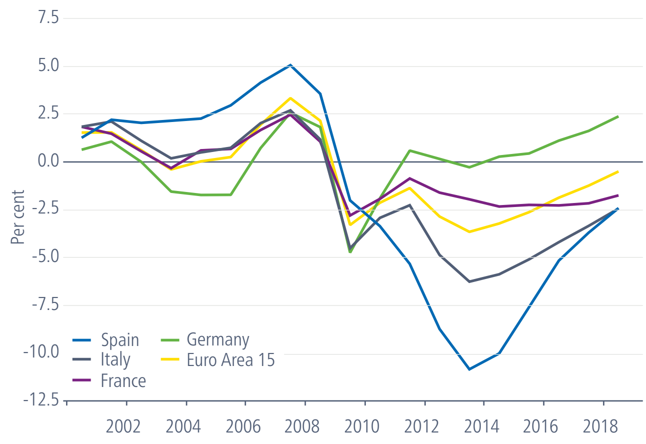
Although headline inflation has risen back to target, the core rate remains stubbornly low at just 0.9 per cent in February. The ECB expects the two to

Figure 45: Eurozone, GDP growth
Above-trend growth in recent years



Sources: Macrobond, as at 31/03/2017

Figure 46: Eurozone: OECD estimated output gaps
Spare capacity in many parts of Europe



Sources: Macrobond, as at 31/03/2017

Approaching the end of super-loose policy

converge over the next few years, but their forecasts have not always been accurate (Figure 47). Recently, they have rightly stressed that underlying inflation has to rise before they can be comfortable withdrawing the extreme policy stimulus that has prevailed for several years. But they are also right to be considering their exit strategy and sensible to be cautious about advertising such thinking – they have no desire to risk a repeat of the US 2013 "taper tantrum". Nevertheless, the very fact that the end is in sight is a long-awaited sign that things are really getting better and that the notion of a return to some form of normality is no longer far-fetched. And growth should be improving: monetary policy cannot really be any looser and with much less attention being played these days to the need for fiscal consolidation, the policy backdrop could hardly be any more conducive to better growth outcomes. Moreover, the cyclical revival will provide an environment in which it is easier to undertake reforms that will help over the longer-term. The Eurozone has not always taken advantage of such episodes.

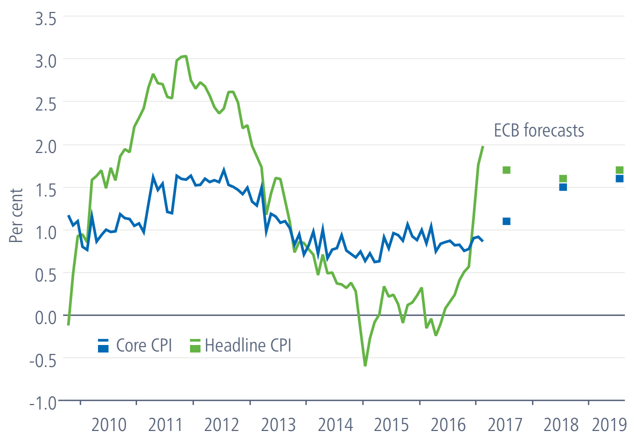
Growing belief in lasting upturn

One of the more encouraging aspects of the recent revival is that growth has been underpinned by better domestic demand rather than the more traditional driver of net exports (Figure 48). Less promisingly, it seems to have slowed a little in recent months. We expect another increase in GDP of around 1.7 per cent in 2017 (Figure 49). Whatever the exact growth outcome this year, the European recovery looks set to continue. And anything above 1 per cent will allow unemployment to fall further, boosting confidence and adding to the mounting belief that the Eurozone is not destined to struggle and stagnate endlessly. This being Europe, it could yet turn sour, but for now those strong sentiment readings are extremely valuable as they can become self-fulfilling, persuading both businesses and households to borrow and spend. Low interest rates have, of course, helped as well. The much-watched monthly PMI surveys have gone from strength to strength, with the latest readings consistent with faster growth than seen in 2016. National business surveys paint a similarly upbeat picture.

Business and consumer sentiment is strong

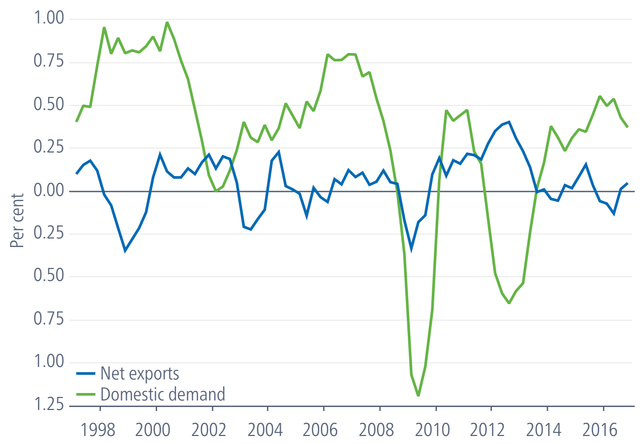
Meanwhile, consumer confidence levels are a world away from the troughs seen in the Global Financial Crisis and again in 2011/13. If the surveys (business and consumer) prove a reliable guide, then growth should move meaningfully higher in the first half of 2017. So far the hard data has been less impressive and it is fair to ask whether survey balances are overstating prospects. The Eurozone has moved decisively away from stagnation and deflation in recent years and given the very real threat of implosion at one stage and the long history of disappointments, it is quite understandable that optimism has surged once it became apparent that the cliff edge had been avoided. That confidence now needs to feed through into actions and spending over a sustained period. It all looks promising at present, and is moving in the right direction. But some caution is still warranted.

Figure 47: Eurozone, annual inflation rates
ECB expects headline and core inflation to converge



Sources: Macrobond, as at 31/03/2017

Figure 48: Eurozone, contributions to GDP growth 4Q MA
Domestic demand has been main driver



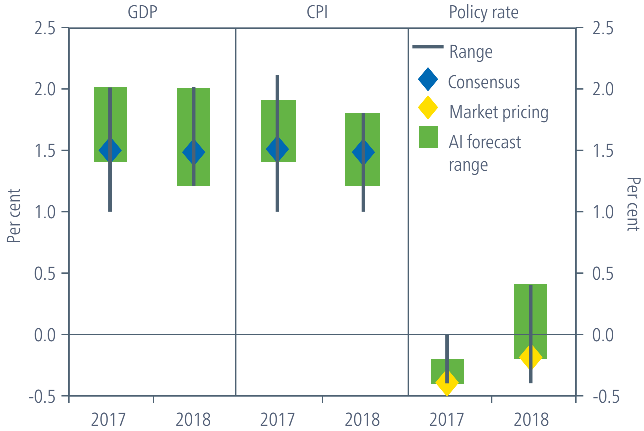
Sources: Macrobond, as at 31/03/2017

The ECB clearly thinks in a similar way. Prospects for both ongoing growth and rising inflation are good, but until they establish themselves definitively, the ECB is happy to maintain a relaxed approach. Underlying inflation now holds the key to any assessment of likely monetary policy actions and their timing. As long as core inflation ticks slowly higher throughout 2017, we believe that the ECB will try and manage expectations towards a tapering in early 2018 and eventual rate increases.

Underlying inflation pressures still modest – ECB relaxed

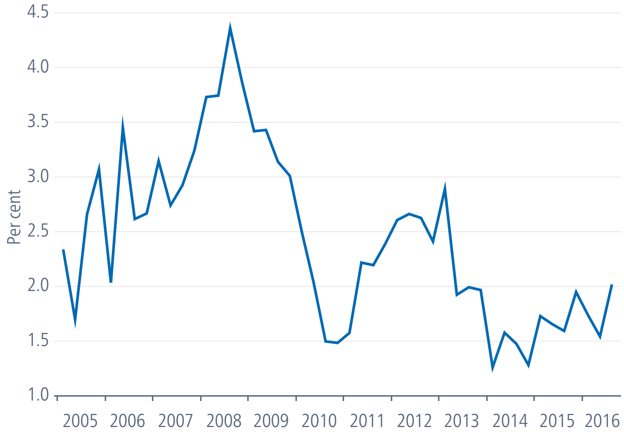
It is not out of the question that they move the deposit rate up from the present -0.4 per cent before ending QE, since many are uncomfortable with negative rates. If so, their guidance will probably have to change this year. One of the factors that may guide them is wage developments. In the past President Draghi's predecessors had occasion to worry about the possibility of "wage-price spirals", partly as a result of Europe's dysfunctional labour markets. Although there is still plenty of room for improvement, progress has been made. European wage data is notoriously flaky, but a proxy can be constructed by subtracting the growth in hours worked from the growth of the aggregate wage compensation bill. The result is shown in Figure 50. Cyclical movements in wages are easy to discern, but the latest upswing has been very modest. Even if trend productivity growth is only 1 per cent, as we believe, the current subdued pace of wage growth – around 2 per cent – is consistent with a 1 per cent rate of increase of unit labour costs, probably the best measure of underlying inflationary pressure. Unsurprisingly, this is in line with core inflation.

Figure 49: Aviva Investors macro forecasts
The outlook is improving steadily



Source: Bloomberg, Aviva Investors, as at 31/03/2017

Figure 50: Eurozone wage growth proxy
Wage pressures still subdued



Source: Macrobond, as at 31/03/2017

UK: THERE MAY BE TROUBLE AHEAD…

– The resilience of the UK economy post-referendum has been maintained in recent months

– But inflation has risen noticeably and will head higher in the rest of the year

– Uncertainty will remain an unhelpful backdrop for the foreseeable future

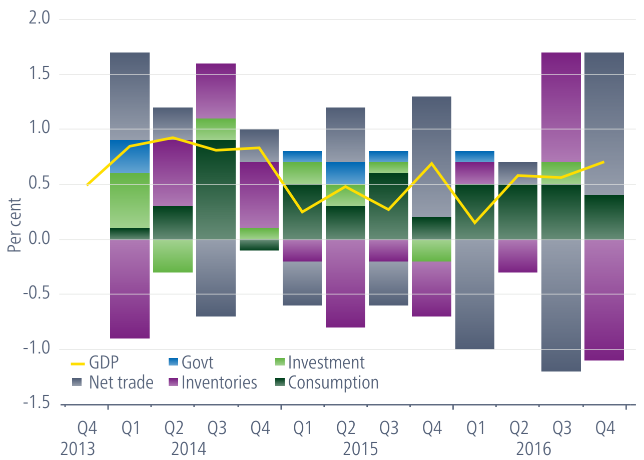
UK economy very resilient since Brexit vote

The resilience of the UK economy in the nine months since the EU referendum must reflect one of two things. Either the doomsayers were wrong and the economy can comfortably absorb the ramifications of the Brexit decision – perhaps even thrive outside of the EU - or any adverse consequences resulting from that choice will only become apparent over a significantly longer period of time. We lean towards the second explanation and continue to worry that Brexit will not be painless. However, we must concede that the performance of the UK since June last year gives pause for thought. Certainly initial fears of a stall in activity by the end of last year have proved misplaced – the UK economy grew by 0.6 per cent in Q3 and 0.7 per cent in Q4 (Figure 51). There was a sharp rebound in sentiment indicators after the initial shock, and the only lasting impact has been the steep decline in sterling exchange rates. However, there are several reasons for caution. In explaining why demand has held up so far, account must be taken of the cut in policy interest rates, the re-start of QE, the relaxation of macro-prudential policies, support from fiscal policy, the recovery in global demand and the competitive boost from the currency depreciation. Yes, the UK economy has been robust, but it has received quite a bit of help.

Uncertainty has already hit some investment spending

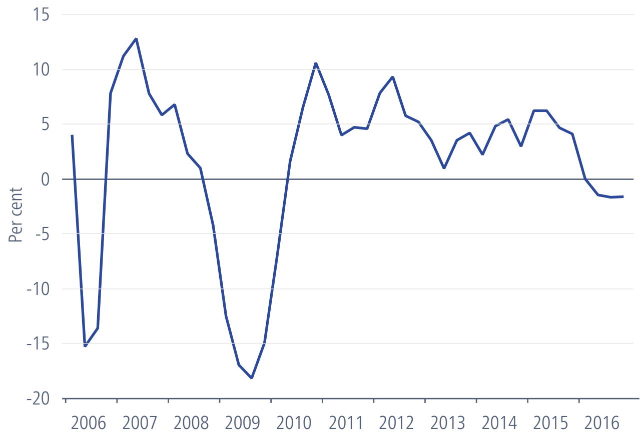
Looking ahead, there is still legitimate cause for concern. Two years of potentially fraught negotiations on the terms of our exit from, and the nature of our future relationship with, the EU does not look like a backdrop that is particularly helpful to expansionary investment programmes and hiring initiatives. The uncertainty associated with Brexit has already led to small declines in business investment. Granted these have been nothing like the magnitude of those seen during major downturns (1981, 1991, 2009), but the weakness does indicate a vulnerability that could intensify if that uncertainty is not resolved (Figure 52). It is often forgotten that up to half of investment is construction-related and although such activity has also weakened over the last few years, it has not collapsed (Figure 53).

Figure 51: UK: contribuition of GDP growth (qoq)
Growth robust in H2 2017



Source: Macrobond, as at 31/03/2017

Figure 52: UK business investment growth, y/y, %



Source: Macrobond, as at 31/03/2017

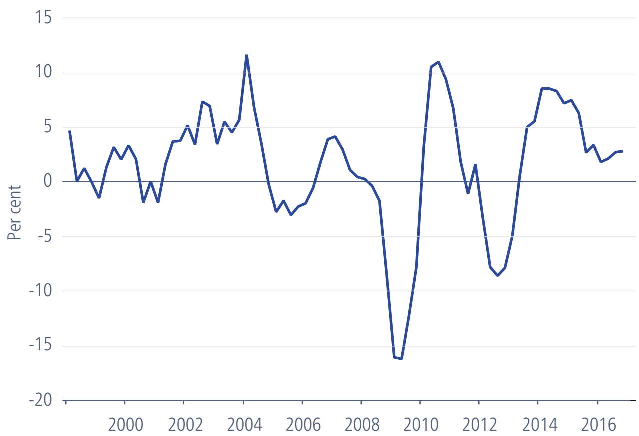
By their very nature, most construction activities have a very long gestation period, so changes in sentiment take a long time to feed through into actual activity. Infrastructure projects are often measured in decades, but even housing developments can easily take a number of years. What is happening today usually reflects decisions made several years ago, meaning that supply and demand can often become mismatched. A useful guide to trends over the next 12-24 months is provided by order books among construction firms. The latest data (Figure 54) show a slow and steady recovery since the financial crisis, but levels are still generally well below those that have prevailed in previous decades. When account is taken of the rise in the UK's population over this period, it is easy to argue that construction is not really as strong as might have been hoped. The latest national accounts data shows that construction represents about 6 per cent of total GDP, but as is well-known it can have a big influence at key turning points in the economic cycle. It is impossible to summarise such a complex sector in just a few words here. Overall, the picture seems to be one where there is some gentle positive momentum in the sector, but it does not look about to boom and boost GDP significantly in coming years.

Construction activity has been robust recently

Consumer spending accounted for almost two-thirds of UK GDP last year and grew in volume terms by 3.1 per cent, providing a major impetus to growth overall, as it has done for much of the last two years. Any assessment of the UK's prospects in 2017 and 2018 must therefore include a view on consumption trends. All economic research shows that these will be driven primarily by what happens to real incomes and wealth. The latter (both financial and housing) have held up very well in recent years, so income trends are probably the key. And the worry here is that higher inflation will inevitably hit real incomes, just as it did in 2009 and 2011/12, and with similar consequences. The fall in sterling since the Brexit vote has boosted import prices significantly as the UK is such an open economy, adding to the upward pressure from the normalisation of energy and commodity prices. CPI inflation was zero a year ago, is 2.3 per cent today and almost certain to touch or exceed 3 per cent before the end of 2017. With wage growth stuck at around 2.5 per cent (and jobs growth slowing), that is a significant adverse hit to real incomes. In the usual fashion, UK households are likely to respond to this development rather than alter their behaviour in advance. The Bank of England, for example, assumes that household spending will slow materially over the course of 2017, even while the savings ratio – helped by lower borrowing costs – falls from 5.75 per cent in 2016 to 3.25 per cent by 2019. Annual growth of consumption will slow to 2 per cent this year and just 1 per cent in 2018 according to them.

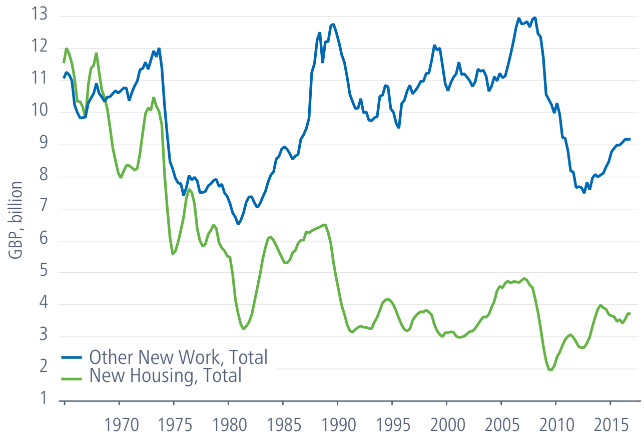
Real incomes will be hit by higher inflation…

Figure 53: UK construction output, y/y%
Activity solid, without being strong



Source: Macrobond, as at 31/03/2017

Figure 54: UK, construction orders, volume, 4Q MA
Orders OK for now, but these change slowly



Source: Macrobond, as at 31/03/2017

...just as it was in 2009 and 2011

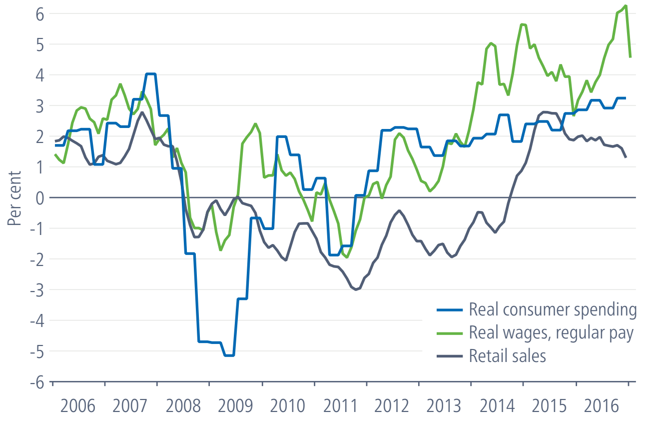
This sort of outcome would mirror the experiences referred to above (2009 and 2011/12) when inflation spikes reduced real wages and were associated with, or followed by, marked slowdowns in consumer spending (Figure 55). The unprecedented period of real income squeeze – from 2008 to 2014 – was really what austerity was all about and was accompanied by very poor consumer sentiment, double-dip fears and calls on the Government to ease households' pain. If our forecasts and those of the Bank of England are right, it will not be such a painful event on this occasion, but it will still feel pretty grim by comparison with the last 2 years. It is still very early days for this adjustment, but recent retail spending figures for the UK have already shown some weakness, although admittedly this has come after a very strong run.

A more difficult time ahead for the UK

Overall then, we expect inflation to rise and growth to slow materially but not disastrously over the next year (Figure 56). On the face of it the Bank of England may face a policy dilemma in such circumstances – raise rates to address higher inflation, or keep policy loose to support growth. Our view is that, as in the recent past, they will lean towards the latter and "look through" higher inflation. This is hardly a great insight – they have more or less told us this and it is the policy playbook that they have used before. But if growth were to surprise on the upside, this would need to be reassessed. After the referendum result last June we had feared a far worse slowdown, but the UK economy has proved remarkably resilient. The next year could be one where some Brexit realities are revealed, now that Article 50 has been triggered and once formal negotiations begin. If this all happens against the background of a weakening economy, it will be a more difficult period for Britain.

Figure 55: UK consumption, retail sales and wages, 3m MA, y/y %

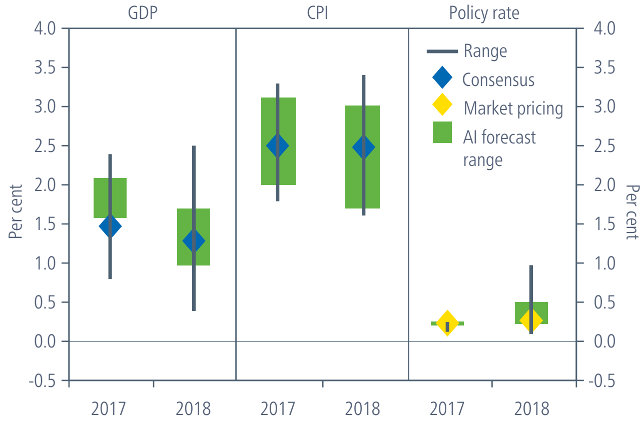
Another squeeze on real incomes looks imminent



Source: Macrobond, as at 31/03/2017

Figure 56: Slower growth, higher inflation

Weaker growth, higher inflation



Sources: Bloomberg, Aviva Investors, as at 31/03/2017

JAPAN: EXPORTS SUPPORTIVE BUT WAGES WILL DISAPPOINT

– Exports continue to be the key source of support for the Japanese economy

– Recovery in global growth will support Japan even as wage growth disappoints

– BoJ to keep yield curve control in place as inflation expectations remain elusive

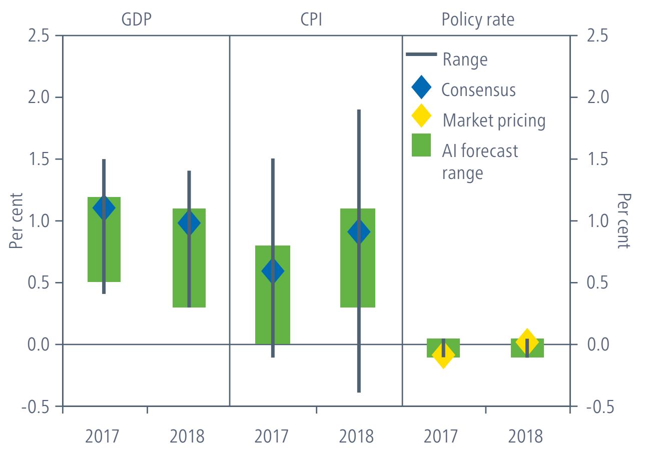
Over 2016, the Japanese economy expanded at an upwardly revised rate of 1.6 per cent, a modest acceleration from the 1.2 per cent expansion recorded over 2015. This is also faster than plausible estimates of the potential growth rate of the economy. The main driver of growth was an increase in exports (Figure 58). In contrast, consumer spending rose only modestly and public investment was a drag on growth. Both could be improved with an expansionary fiscal package. We expect a supplementary package to be announced later in the year, with an eye to elections in 2018. Abe has already secured an extension to his leadership of the LDP, and continues to enjoy strong popular support. In the meantime, the economy will continue to need a weak yen (JPY) in order to maintain the boost from export growth as global trade growth enters its next phase of expansion with reflation broadening out. We have modestly upgraded our forecast range for 2017 GDP growth (Figure 57).

World trade growth likely to remain supportive of Japan's economic cycle

Last quarter we noted that the export contribution was seemingly high due to several one-off factors including shipments of smartphones. However, the trend now looks more sustainable. Global trade in general is improving and the JPY real effective exchange rate declined further in Q4, helping to support exports (Figure 59). The yen peaked at almost 119 against the dollar in December, but has subsequently strengthened somewhat. While monthly trade data can be volatile, Japanese exports of general machinery shot up to 7.4 per cent in January after declining 0.3 per cent in December as the global economy picked up pace. If capital investment continues to improve globally, then exports could continue to boost growth further (Figure 60). Bank of Japan research suggests that sectoral variations in export performance could complicate the picture for economy-wide

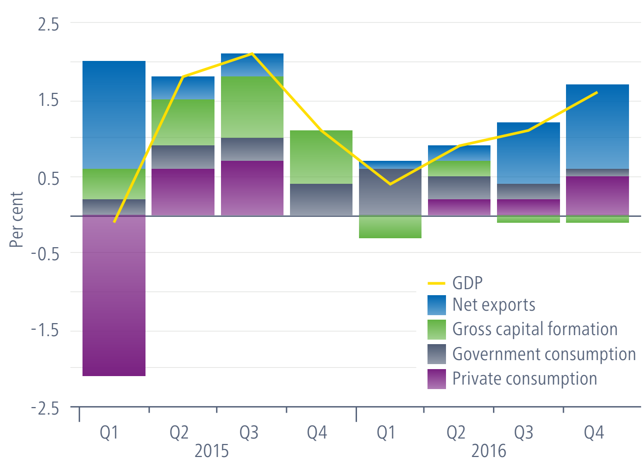
Yen weakness supportive of export growth and global reflation boosts them further

Figure 57: Japanese economic projections



Sources: Consensus Economics, Bloomberg, Aviva Investors, as at 31/03/2017

Figure 58: Exports continue to be a key driver of growth
Contributions to GDP



Sources: Aviva Investors, Macrobond, as at 31/03/2017

export growth somewhat. However, on balance, we expect the propulsion from global growth to be strong enough to allow the positive momentum in exports to continue this year.

We expect growth to continue to be low but positive, keeping core inflation (CPI less food and energy) at relatively subdued levels despite the boost from yen weakness since the US presidential election. The recent rise in oil prices will push headline CPI inflation higher and some of this may feed through to the core rate (Figure 61). The BoJ still believes that they can reach their inflation target around fiscal 2018. Some members of the BoJ have expressed concern that wage growth will stay sluggish this year, with a potentially disappointing round of wage negotiations in the spring. But a potential change in minimum wage legislation for part-time and flexible workers could be a catalyst to broader wage gains.

Indicators of labour market tightness still doing little to push wage inflation higher

As has been the case throughout the Japanese quest for inflation, without a pick-up in wage inflation, the BoJ's inflation target will likely remain elusive especially since inflation expectations are low and have actually declined on market measures after surging in the wake of the initial Abenomics policy impulse in 2012-13. On the data side, many labour market indicators have continued to signal a very tight labour market. But with inflation expectations remaining structurally depressed, labour market tightness continues to fail to stoke wage growth. The OECD estimates that the Japanese economy already had a positive output gap last year which could rise further this year with modest growth. And yet, average rates of inflation have remained very depressed (Figure 62). While core inflation has picked up in recent months, a sustained increase remains challenging.

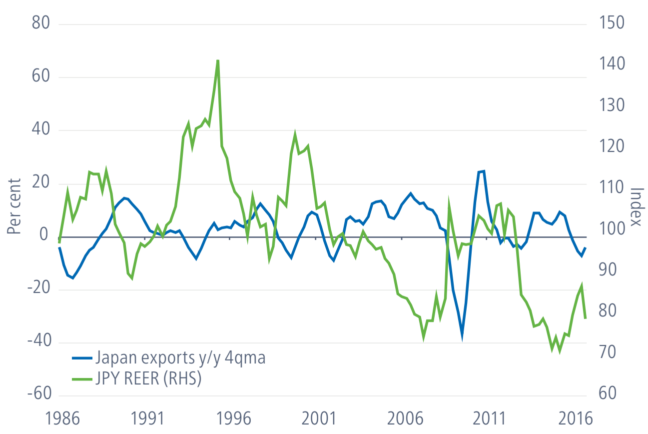
From the BoJ's perspective, inflation expectations are a key

From the BoJ's perspective, the key driver is a rise in inflation expectations, which would eventually lead to higher wage gains and a virtuous cycle through higher consumer spending and more demand driven inflation. Until this is delivered we do not expect that the BoJ will raise its target for the 10-year Japanese government bond (JGB) yield under the new yield-curve control (YCC) programme.

BoJ can benefit from a better communication strategy

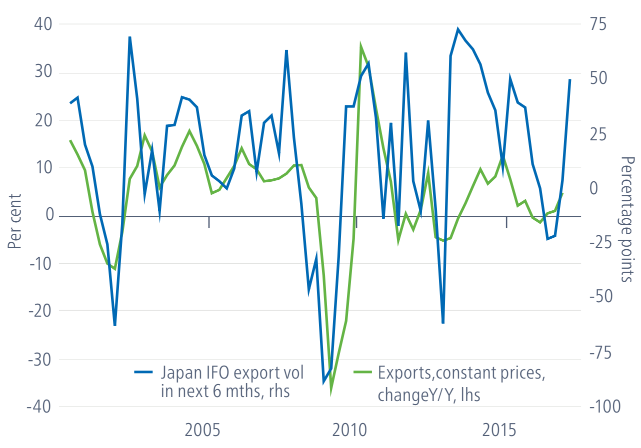
The BoJ's strategy can be thought of as leveraging policy exposure to global developments. In an environment of global reflation, higher global yields ought to push the yen weaker, re-enforcing the reflationary impulse in the Japanese economy through stronger net exports and dearer imports. However, they would do well to improve their communication strategy. By failing to drop their reference to an JPY80trn quantitative purchase target despite moving to a long-end rate target, they have sown some confusion in the global investor community. Given the scarcity of JGBs, it's perfectly natural for the BoJ to credibly hit their ~0 per cent

Figure 59: JPY weakness remains supportive for exports



Sources: Aviva Investors, Bloomberg, as at 31/03/2017

Figure 60: Japan exports on a positive trajectory



Sources: Aviva Investors, Macrobond, as at 31/03/2017

target in the 10-year JGB with fewer purchases of JGBs than the original JPY80trn quantitative target. Indeed, the quantity of their purchases is currently estimated to be running at an annualised rate of JPY65trn. However, by maintaining formal references to the original JPY80trn quantity target, the BoJ have given rise to a needless discussion on "QE tapering". The reality is that quantitative easing, in the strict sense of the term, ended the moment the Bank of Japan moved to a price target based on the 10-year JGB yield.

It is possible that if the BoJ drops reference to the JPY80trn target and clarifies that they are buying less JGBs then there is some volatility with a brief snap rise in JGB yields and the yen. But any move would likely be accompanied by the offer of unlimited intervention in the JGB market to ensure yields remain near zero. Once the new framework is clarified, it is likely that markets will focus on using the yen as a funding currency for reflationary investment positions globally, helping the BoJ creep towards their elusive 2 per cent inflation target.

Figure 61: Core inflation remains low but rising food and fuel prices putting pressure on headline inflation

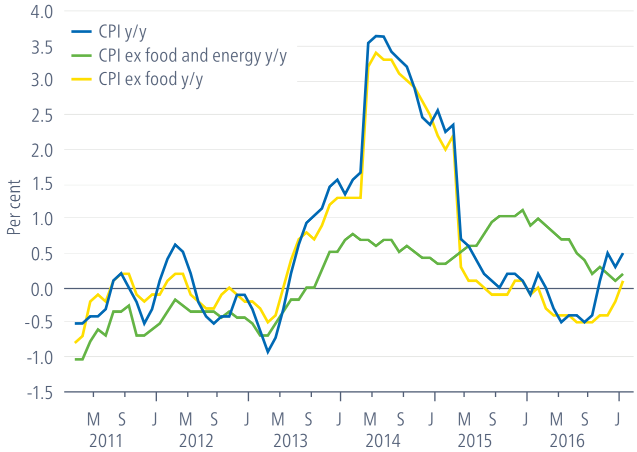
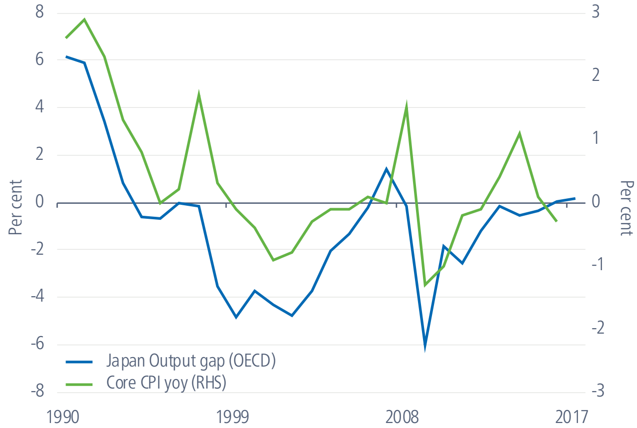


Figure 62: Could a positive output gap stoke inflation finally?



Sources: Aviva Investors, Bloomberg, as at 31/03/2017

CHINA: WAITING FOR AUTUMN

– Authorities will focus on neutral monetary policy and looser fiscal policy for 2017

– Growth target is set at around 6.5 per cent vs. 6.5-7 per cent

– Stability will be the main theme ahead of the 19th Party Congress in the autumn

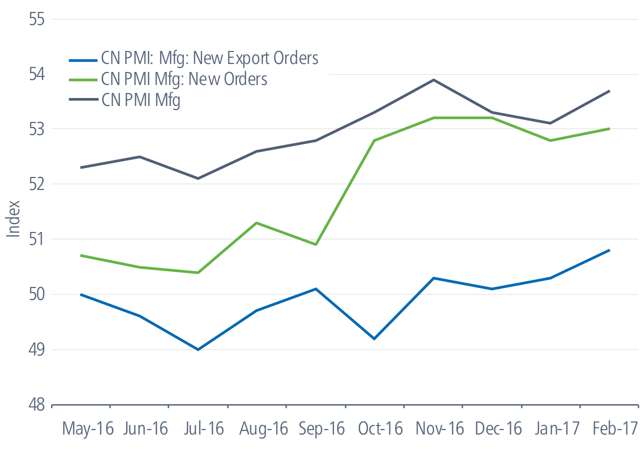
2017 growth target is "around 6.5 per cent''

Policymakers in China achieved their growth target of 6.7 per cent in 2016 and this stable growth trend is likely to continue, albeit at a modestly slower pace. The National People's Congress (NPC), which took place the first week of March, set the growth target for 2017 at "around 6.5 per cent", slightly lower than the 6.5-7 per cent target in 2016. But the government will "aim to do better in practice". The other targets for M2, Total Social Financing (TSF), inflation and the fiscal deficit were generally in line with expectations. This year's NPC meeting was expected to be uneventful. The real focus is on the 19th Party Congress in November which means that authorities would like to maintain stability over the next seven months. Therefore, we expect the status quo to remain and fiscal policy to be a more important driver of growth. The key shift this year is on monetary policy where policy is now prudent and neutral rather than accommodative, in order to contain financial risks.

The economy is starting off the year on a strong note

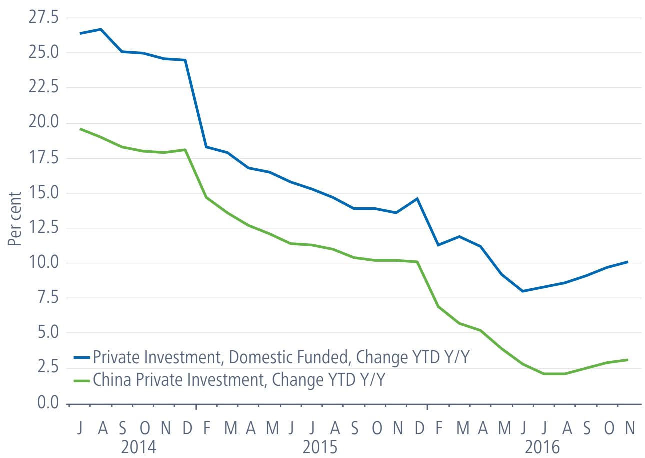
Policymakers are hoping for stability this year, and they will likely achieve this. Most important, economic trends are favourable. Leading indicators such as the PMIs have pointed to a more robust economy (Figure 63). Activity data since the start of the year have been strong. While there are always distortions from the Chinese New Year, forward-looking indicators like new orders and new export orders depict a positive outlook for the economy. In addition, growth remains supported by fiscal policy. At the NPC, they announced a 3 per cent fiscal deficit target, but they have recently shown that this is flexible. In 2016 the pre-adjusted (without accounting for fiscal savings) fiscal deficit was 3.8 per cent. Something similar is expected this year. Also, issuance of local government revenue bonds will be nearly 1.1 per cent of GDP this year compared with 0.6 per cent in 2016. One important difference in this year's fiscal policy is that the government plans to cut taxes and reduce fees on private businesses to stimulate investment (Figure 64). They are even providing more tax incentives for small and medium-sized businesses. Such measures are crucial for long-term sustainable growth.

Figure 63: China manufacturing PMI surveys
All components have risen over last year



Sources: CEIC, Aviva Investors, as at 31/03/2017

Figure 64: China private investment
Growth rate has stopped falling



Sources: Aviva Investors, Macrobond, as at 31/03/2017

While growth is the priority, reforms are still on the table. The government has pledged to reduce steel production and coal mining capacity further. A special fund will be allocated for workers affected by job cuts in these industries. The government continues to advocate mixed ownership for State-owned Enterprises (SoE) reforms in a number of industries and they will continue to support deleveraging through securitisation and debt-to-equity swaps. In the housing market, policies have been differentiated for Tier 1 and 2 vs. Tier 3 and 4 cities. The former are encouraged to increase supply of residential land and better regulate development and sales activity to ease some of the price pressures. The latter will focus on de-stocking. Local governments will be asked to provide basic housing, targeted towards migrant workers who cannot afford private residences. Also, financial sector reforms continue to be a priority. The NPC discussed the need to monitor stability risks, related to non-performing assets, defaults, shadow banking and internet finance. Much of this has already started with China's Macro Prudential (MPA) system, but expanding its oversight will be crucial.

Reforms will resume albeit at a very slow pace

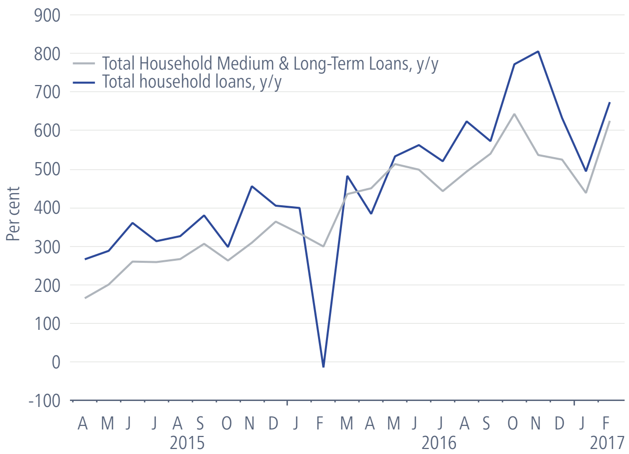
As for monetary policy, the move to a neutral stance is no surprise. The People's Bank of China (PBoC) revealed in its Q3 monetary policy report on 8 November that it needs to prevent financial risks rather than sustain growth. Since late last year, they have tightened policy through open market operations and marginally increased the medium and standing lending facility rates. They cut the reserve requirement ratio (RRR) ahead of Chinese New Year because of tighter liquidity conditions around this time of year, but they made it very clear that this was temporary. The PBoC will continue to tighten monetary conditions through every other channel except policy rates. The Deputy Governor of the PBoC reportedly said that he sees no need for a rate hike or RRR cut at this current juncture. The concern is that the economy may be too fragile for rate hikes even though inflation is creeping higher and capital outflows persist. Talks of a RRR cut were circulating onshore in January because 2nd and 3rd tier banks needed more liquidity. Given the number of fragilities in the economy, particularly in the credit markets, we believe that they will use other tools to tighten monetary conditions. The record loan growth in January was a worry for the authorities but January is often a strong month. The rise in property prices has been a key concern for policymakers. Mortgages continue to grow at a very rapid pace (Figure 65) and property prices (Figure 66) remain robust despite the house price restrictions imposed late last year. Authorities will clamp down on the potential risks to the economy without impeding the growth momentum.

PBoC will maintain a neutral and prudent stance

The shift to a neutral and prudent monetary policy stance will help keep inflation in check. In recent months, both CPI and PPI have been rising (Figure 67). In February PPI inflation climbed to a 7-year high of 7.8 per cent although the pace of increase

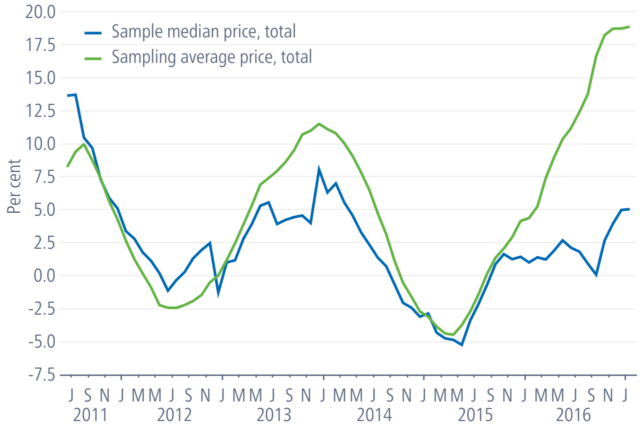
PPI continues to rise but CPI is well below the PBoC's target

Figure 65: Household loans rising despite restrictions
China PMI: New orders vs new export orders vs overall PMI



Sources: Macrobond, as at 31/03/2017

Figure 66: House prices while high are stabilising thanks to macroprudential measures
Property prices getting bubbly again



Sources: Macrobond, as at 31/03/2017

has slowed. Prices of major commodities in coal, petroleum and ferrous and non-ferrous metal industries are the main culprits. Meanwhile, CPI gains slowed in February as Chinese New Year effects dissipated. The main thing is that core CPI remains around 2 per cent so far this year which will ease the PBoC's concerns.

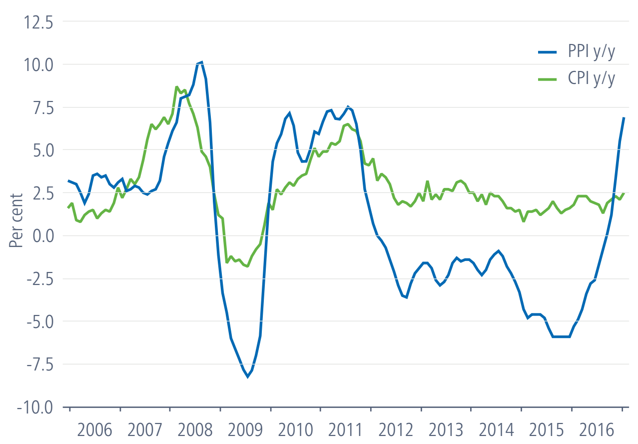
Capital controls remain firmly in place

As part of their monetary stance, the PBoC will continue to allow the currency to depreciate at a very slow pace. The work report from the NPC noted that China "will adhere to the exchange rate's market-oriented reform direction, and maintain the RMB's stable position in the global monetary system". This statement implies less management of the currency by authorities via a sharp one-off depreciation for example, but we will see more two-way volatility. RMB could continue to average a 4-6 per cent annual depreciation against the USD. Managing the RMB against the basket is likely to be more important than against the USD. Onshore expectations of currency depreciation have led to significant capital outflows over the past year which has resulted in increased capital controls. Capital controls seem to be the only solution at this point since they cannot hike rates or allow the currency to appreciate at the expense of the economy. Foreign exchange reserves fell nearly $230bn between January 2016 and February 2017. Therefore, capital controls will remain tight. So far, moral suasion and window guidance have mitigated the outflows through more of the formal channels.

The 19th party Congress is most important agenda item for the government this year, but the threat of trade protectionism may be a disruption

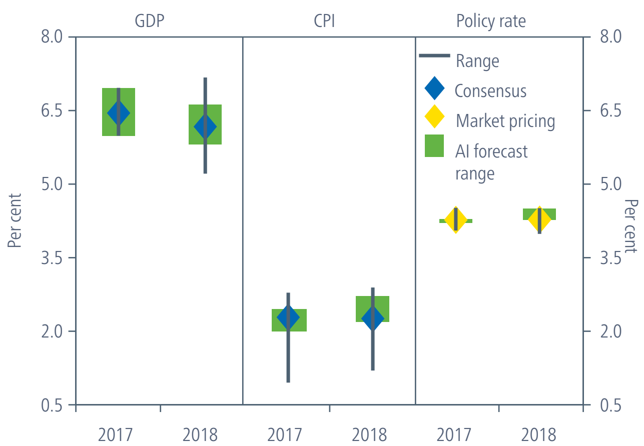
With growth likely to stay on track (Figure 68), the authorities will continue to focus on the 19th Party Congress which will be held in autumn 2017. Five of the seven Politburo Standing committee (PSC) members are expected to retire, which means there will be a reshuffle in the leadership. Based on precedence, the party will highlight its ideological slogan and framework and provide some indication of succession. For President Xi to pass his agenda, growth will need to remain stable. However, there are some lingering risks including Trump protectionism and financial risks via the credit markets. On trade protectionism the good news is that the Trump administration recently softened its tone on China. Any tariffs on China would be harmful to both countries. Recent data shows that trade with the US made up about 14 per cent of China's total trade while trade with China comprised about 16 per cent of US total trade. Unlike the other Asian countries that shifted their focus to the Chinese market, the US is still the second largest trading partner for China while China is the largest for the US. To appease the US, the Trump administration may slap tariffs on certain goods as they have done in the past (steel products and tyres), but this is really only a continuation or modest extension of existing anti-dumping cases This should avoid a full-blown trade war. China has already noted that they would retaliate by making it difficult for US companies to do business in China. Many companies would be reluctant to move from China given its large expansive market.

Figure 67: Chinese inflation
Both PPI and CPI inflation are rising



Sources: Macrobond, as at 31/03/2017

Figure 68: Aviva Investors macro forecasts
Stable growth and gently rising inflation



Sources: Macrobond, as at 31/03/2017

AUSTRALIA: CONFLICTING SIGNALS

– National income boosted by higher commodity prices

– Domestic rebalancing continues, with risks to the downside

– RBA likely on hold in 2017

SUMMARY

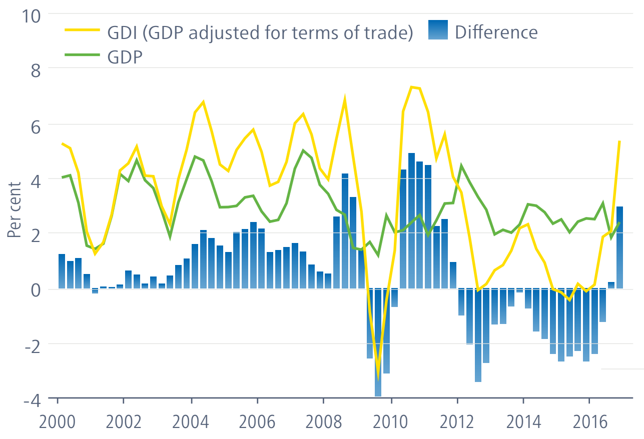
The rise in global commodity prices in 2016 Q4 delivered a sharp boost to Australia's terms of trade and national income (Figure 69). The rise in income came at the same time as real GDP growth bounced back, rising by 1.1 per cent in Q4, after a surprising decline in Q3. The recovery in commodity prices followed a synchronised improvement in global growth that began around the middle of 2016. Supported by easy global monetary policy and more expansionary fiscal policy – notably in China – the global manufacturing cycle turned markedly stronger. We expect the global reflationary environment to be sustained through 2017, which should support a more positive growth outlook for Australia. The transition out of the mining boom and subsequent investment bust has also been aided by significantly lower interest rates and a weaker currency. While growth has been supported by those developments, low interest rates have also had less desirable implications for financial stability. The ratio of household debt to income is amongst the highest in the world (Figure 70), reflecting the rapid rise in house prices.

Terms of trade have boosted real income growth as global growth has picked up

This poses a policy challenge for the Reserve Bank of Australia (RBA), which is faced with a complex set of conditions. On the one hand some of the domestic headwinds are fading (as the fall in mining investment comes to an end), global conditions are improving and house prices are starting to pick up again in major cities. That could argue for a reduction in the current accommodative policy stance. On the other hand, the recent decline in housing approvals could presage a rapid weakening in the housing market. When viewed alongside the longer-term structural adjustment of household balance sheets and international competitiveness that may require continued accommodative policy. Indeed, wage growth has been subdued and inflation is expected to be below target for some time. We expect that over the next year the authorities will look to pursue macroprudential policies to slow the housing market, in an effort to avoid raising rates.

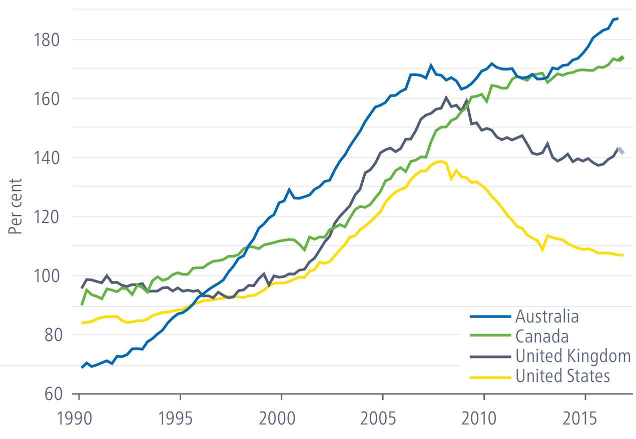
Conflicting policy pressures make RBA outlook challenging

Figure 69: GDP and GDI growth (yoy)
National income boosted by rising commodity prices



Sources: Aviva Investors, Macrobond, as at 31/03/2017

Figure 70: Household debt to income
Australian household balance sheets look stretched



Sources: Aviva Investors, Macrobond, as at 31/03/2017

EXTERNAL BOOST MEETS DOMESTIC REBALANCING

Some headwinds to growth are abating, but households may find it difficult to keep up the pace of spending

The rebound in GDP growth in 2016 Q4 was accompanied by the fastest pace of final domestic demand growth (compared to a year earlier) in four years. Domestic demand had been suppressed over that period by the decline in business investment, as the earlier boost to growth from mining investment unwound. That headwind to growth is coming to an end, while household consumption has remained fairly robust throughout. At the same time business and consumer sentiment have risen to around their long-run average levels. Meanwhile net trade, which has been an important contributor to growth in recent years, is expected to continue to contribute with both mining and service sector export growth expected to remain robust. Looking ahead, the latest capex survey suggests that non-mining business investment recovery looks to be fairly muted this year. The outlook for real disposable income also looks to be moderate at best, which would require households to continue drawing down on their savings to support consumption growth. That may prove challenging, with the household saving ratio already having fallen from 10 per cent to 5 per cent in the past 4 years. The extent to which households are prepared to run savings down further (they averaged close to zero through much of the 2000s) is likely to depend upon any further improvement in the terms of trade and developments in the housing market.

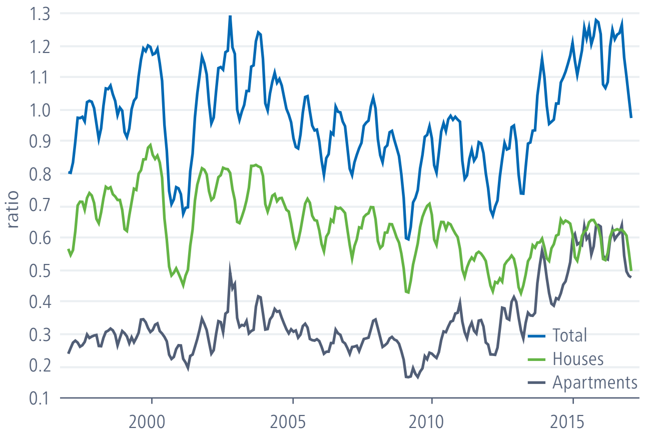
Housing set to contribute to growth in 2017, but then become a meaningful drag in 2018. Low rates continue to support rapid price appreciation

Dwelling investment has been driven by apartment building in recent years (Figure 71). That is set to continue in 2017, given the lag between permits being issued and construction being completed. However, we expect a material drag on growth in 2018, with permits already falling and set to decline further. While the apartment market is likely to see excess supply in coming years, supply conditions for houses are relatively tight. Combined with low interest rates and increased economic optimism, this has seen house price increases accelerate again in Sydney and Melbourne, where prices are between 10-20 per cent higher on a year earlier.

Wage and price inflation to remain muted and the RBA to sit on their hands this year

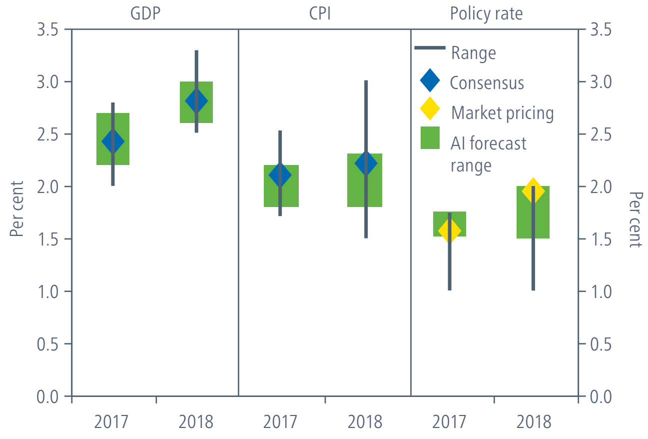
The labour market has softened somewhat in recent months, with both unemployment rising and participation falling. Domestic wage pressures remain subdued, with the wage cost index reaching a new low of 1.9 per cent in Q4 (compared to a year ago). Subdued wage pressure has kept unit labour cost growth down, putting little upward pressure on inflation. Looking ahead, we expect inflation will only slowly rise back up to the middle of the RBA target range of 2-3 per cent (Figure 72).

Figure 71: Per capita housing permits (annualised)
Apartment sector set to decline sharply



Sources: Aviva Investors, Macrobond, as at 31/03/2017

Figure 72: Australian economic projections



Sources: Aviva Investors, Macrobond, as at 31/03/2017

CANADA: GROWTH FIRMING BUT RISKS REMAIN

- Growth gathering momentum, supported by household spending and rebound in oil prices
- Rotation story remains absent; non-residential investment spending lacklustre
- Excess leverage continues to be a concern; consumers vulnerable to any interest rate shock

The Canadian economy showed signs of strength towards the end of 2016, with growth conditions starting to firm. Most recent economic data surprised to the upside as the resources sector rebounded. Real GDP ended the year on a stronger than expected note, with the economy growing at a 2.6 per cent annualized pace in the fourth quarter and 2 per cent on a year-on-year basis. While household spending remains the main pillar of growth, the rebound in oil prices helped net exports to contribute positively and increased government spending supported domestic demand to some extent (Figure 73). On the other hand, business confidence remains weak with investment spending, in particular non-residential construction, still a drag on growth. The most recent annual non-residential capital and repair expenditures survey for 2017 was soft. Although investment intentions were up, it was only a modest increase suggesting that business spending won't be a major driver this year. This outlook challenges the central bank's rotation thesis which relies on business investment and exports to drive the economy forward. Given that the trade relationship between Canada and the US is one of the most important for Canadian exporters, any potential changes to the current NAFTA agreement could have negative ramifications. Furthermore, lowering US corporate tax rates has the potential to shift investment spending away from Canada.

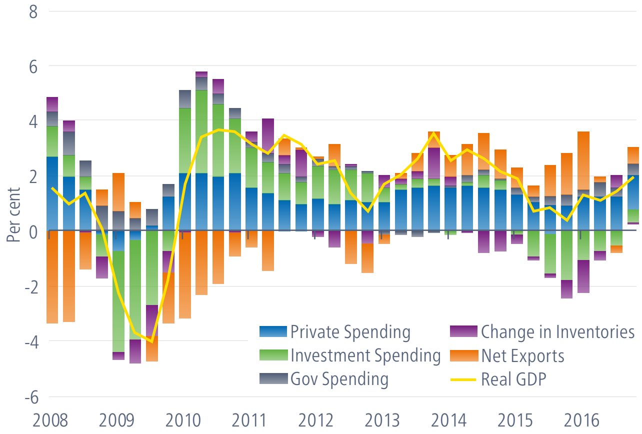
Rebound in oil prices supporting growth

Non-Residential investment spending remains weak

When it comes to monetary policy, the central bank stayed on the side-lines since the last rate cut in July 2015 while maintaining a dovish stance. The recent rise in global and Canadian yields wasn't welcomed given the economic slack in the Canada. We expect the "wait-and-see" mode to persist going forward, given the significant uncertainties on the trade side and weak inflationary pressures.

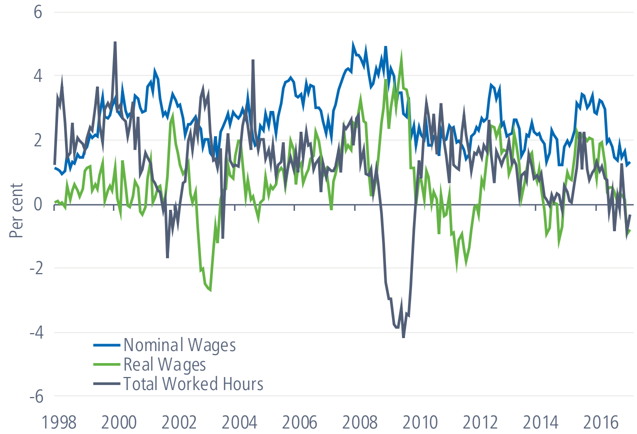
Central bank remains in "wait-and-see" mode

Figure 73: GDP decomposition: Private spending remains the main engine of growth



Sources: Aviva Investors, Datastream, as at 31/03/2017

Figure 74: Wage growth weakening and total hours worked contracting



Sources: Aviva Investors, Datastream, as at 31/03/2017

FASTER US GROWTH MIXED WITH HIGHER OIL PRICES SHOULD SUPPORT CANADA

US demand combined with higher oil prices are tailwinds for Canada

Faster growth in the US combined with higher oil prices are positive to Canada's economic activity and macro outlook. This has been reflected in the recent economic activity data, in particular the increase in headline job creation. The Canadian economy added more jobs on a 6-month rolling basis than it has in nearly 10 years. Although employment growth looks healthy, wage growth remains soft. Nominal wage growth has decelerated rapidly, from a peak of 3 per cent to 1.3 per cent. Real wages and total hours worked are contracting, a far from constructive development for the Canadian consumer (Figure 73). Bottom line, Canadians are working fewer hours and for less in real terms than they were a year ago. We continue to believe that a sustainable growth outlook for Canada is reliant on the revival of its non-energy export sector to support business investment going forward. So far the much needed rotation has not happened. Real non-energy exports are still contracting despite the pick-up in US demand.

Real non-energy exports still contracting

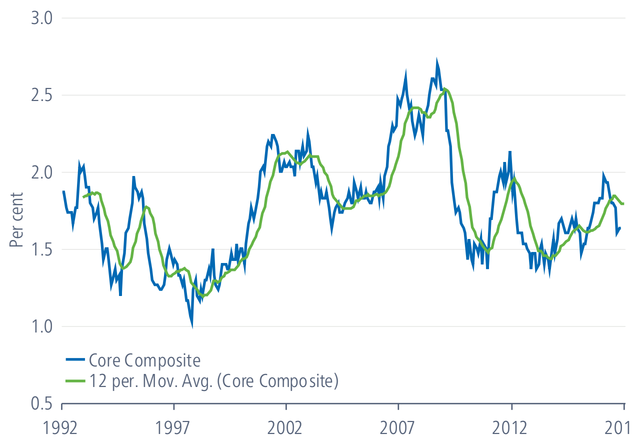
Inflationary pressures remain weak

On the inflation front, the sharp rebound in oil prices led to an increase in headline inflation not just in Canada but globally. While headline CPI was much stronger than expected, the core inflation trend remains on the weak side. The Bank of Canada's core inflation measures are still below target, at 1.5 per cent on average (Figure 75), down from a peak of 2 per cent. This suggests that the Canadian economy continues to run with excess capacity.

Credit excesses make consumers very vulnerable to interest rates increases

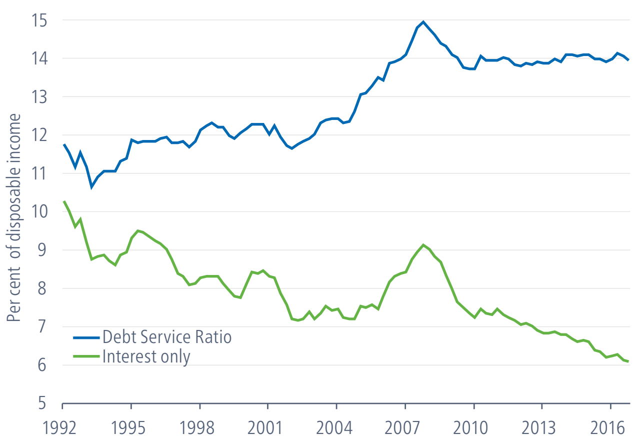
Although Canada is enjoying a cyclical rebound, long-term structural issues remain. The build-up of housing and credit excesses will limit the country's economic growth in our opinion. Despite the rapid decrease in the interest-only household debt service ratio, the overall ratio remained flat (Figure 76). This suggests that Canadians are still taking advantage of lower rates to increase leverage, primarily mortgages. This makes Canadian consumers very vulnerable to any major reversal in interest rates and threatens Canada's financial stability.

Figure 75: Inflationary pressures remain weak



Sources: Aviva Investors, Datastream, as at 31/03/2017

Figure 76: Canada debt burden remains very high despite falling interest rates



Sources: Aviva Investors, Datastream, as at 31/03/2017

ASIA EX-JAPAN: FACING HURDLES NOT ROADBLOCKS

- Global pick up provides a lift to Asian economies
- Better growth and higher inflation likely to keep central banks in the region on hold
- Trump protectionist policy is a key uncertainty for the region especially in Northeast Asia

SUMMARY

Benefiting from the improving industrial cycle

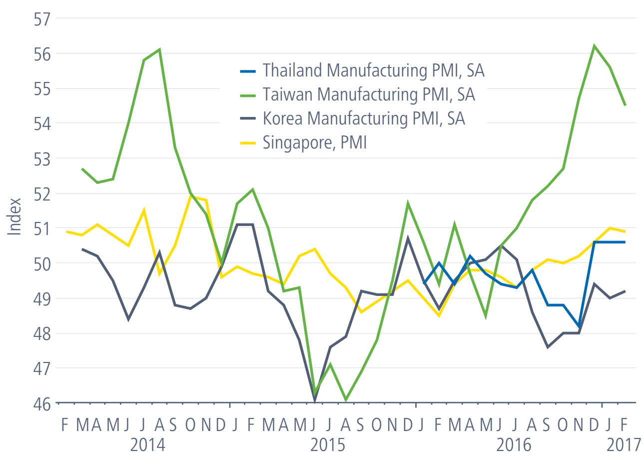
Several dominant global themes are surfacing in Asia ex-Japan. Global excess capacity is shrinking, showing up in an industrial pick-up and reflation across the region (Figure 77). Exports in particular are making a comeback, partly helped by rising prices and partly by declining inventories, meaning that a restocking cycle is imminent. An inventory rebound is already underway in China. For example, Singapore's Q3 GDP reading was poor but that changed with a Q4 manufacturing rebound. Likewise in Korea where exports and industrial production have bounced back this year. However, this doesn't mean that the region is out of the woods just yet. We need evidence of a meaningful rise in export volumes rather than just prices (Figure 78). Moreover, the threat of trade protectionism looms large. Consumption in the region remains largely subdued and there is little evidence of a rebound. However, a turn in the industrial cycle has mitigated investor concerns.

Rising inflation to keep monetary policy in neutral gear

Given these modest improvements, central banks will likely move to a more neutral policy stance as inflation rises (Figure 79). This will be a relief as monetary policy in Thailand, Korea, and Taiwan had arguably reached its limits. The Banks of Thailand and Korea were trying to balance weak growth and inflation with record high household debt. The Monetary Authority of Singapore (MAS) had already shifted to a neutral bias. However, central banks in the region still face challenges. The likes of the MAS and the Hong Kong Monetary Authority (HKMA) are tied to Fed policy. Their economies cannot weather significantly higher rates at this point in the cycle.

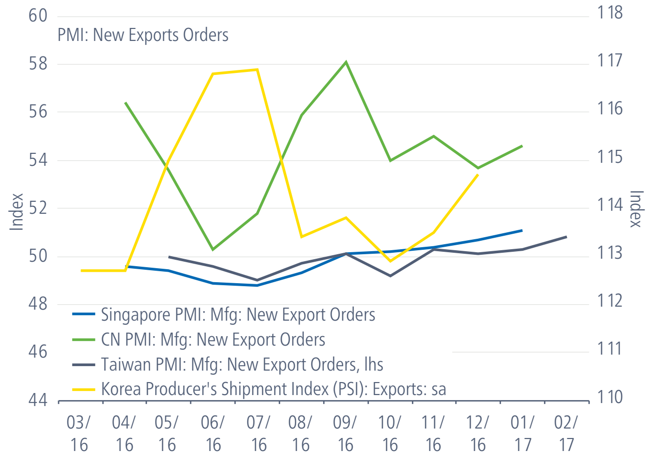
Politics continues to cloud the outlook for some economies. In Korea, the Supreme Court unanimously voted to uphold the decision to impeach President Park. Elections will have to take place within 60 days of the final ruling which is by May 9. A successor is still unclear. North Korea continues to test missiles. In addition, the early deployment of THAAD (an anti-missile system provided by the US to Korea

Figure 77: Growth in the region is holding up relatively well



Sources: Aviva Investors, Macrobond, as at 31/03/2017

Figure 78: There are some signs that export volumes are improving



Sources: Aviva Investors, Macrobond, as at 31/03/2017

Political risk poses a threat to growth

which the Chinese perceive as a means to spy on them) by the Korean government is leading to a deterioration in Sino-Korean relations. China has already barred certain exports from Korea and banned tour groups from vacations in Korea. The estimated impact of this travel ban on the Korean economy could be as much as -0.3/-0.4 per cent of GDP. In Thailand the military government has once again postponed elections from the end of 2017 to sometime in 2018. In Malaysia, the government panicked during the emerging market sell-off in November after the US elections and tightened restrictions on the use of the foreign exchange non-deliverables market to prevent capital outflows. The result was deterioration in investor confidence. Elections are expected sometime this year.

RBI will only cut if growth significantly disappoints

Meanwhile in India, President Modi faces more local elections after the wins in Uttar Pradesh boosted his standing in the upper house of parliament. The implementation of goods and services tax (GST) this year also poses risks. However, growth has surprised to the upside, defying expectations of Q4 weakness due to de-monetisation. After delivering cumulative rate cuts totalling 175bps since January 2015, the RBI surprised the markets by shifting to a neutral stance, as in their view, the impact of de-monetisation was temporary and core inflation remained high. The economy would now need to falter considerably for the RBI to cut. With the Fed expected to hike twice more this year, the RBI would be reluctant to avoid any local market volatility.

Indonesia needs more investment spending for growth

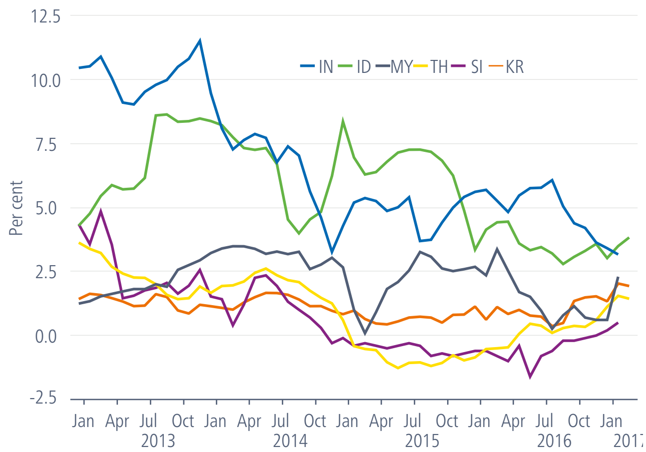
Indonesia continues to operate below potential. Exports have picked up with commodity prices. The government continues to embrace reforms, cutting electricity subsidies recently which will mean inflation rises temporarily. Investment projects were cut back last year, but this year they will need to be executed for a meaningful recovery. The Bank Indonesia (BI) is likely to cut if growth fails to improve. They have room to ease, but they would want to wait until later in the year given the impact of electricity prices on inflation. A potential ratings upgrade could give Indonesian assets a boost. While both Indonesia and India have made strides towards reforms, they remain sensitive to higher global funding costs.

FOCUS ON PROTECTIONISM – MORE OF A NORTHEAST ASIA PROBLEM THAN SOUTHEAST ASIA

Threat of trade protectionism is very real for this region

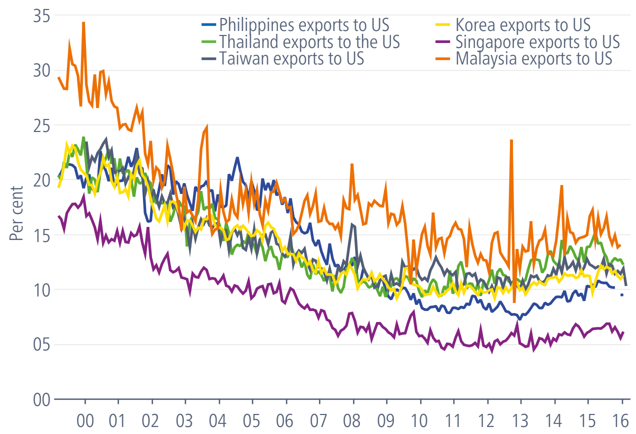
Singapore, Taiwan, Hong Kong, Korea, Thailand and Malaysia are all small open economies, and so the threat of protectionism is very real. Korea and Taiwan in particular are most vulnerable and listed on the US Treasury's currency watch list. The countries have significant bilateral trade surpluses with the US. As offenders they could be targeted as a means to setting an example to China without engaging in a trade war with China. Also, Peter Navarro, the White House trade

Figure 79: The recent pickup in inflation should ease some pressure of the central banks



Sources: Aviva Investors, Macrobond, as at 31/03/2017

Figure 80: AXJ has become less dependent on the US in terms of exports



Sources: Aviva Investors, Macrobond, as at 31/03/2017

advisor named Vietnam, Korea, Taiwan, India, China as countries that account for the "lion's share of the deficit problem".

While the share of exports to the US has declined in recent years, it is still important for Korea and Taiwan (Figure 80). The US accounts for about 15 per cent of Korea's total exports which is half of what it exports to China. They export mostly intermediate goods to China and final goods to the US including technology products like semiconductors. Also the number of anti-dumping measures targeting Korea tripled from 2005 to 2015. Korea is one of two countries (the other is Singapore) in the region that has a bilateral free trade agreement with the US. As part of Trump's platform, he promised to renegotiate some of these bilateral agreements to get a better deal. In the case of Taiwan, the US accounts for 12 per cent of total exports which is about 6 per cent of GDP. Taiwanese manufacturers mostly produce in China and send these goods to the US which means that they would be affected if Trump slaps a tariff on China.

Korea and Taiwan would suffer the most from US protectionist threat

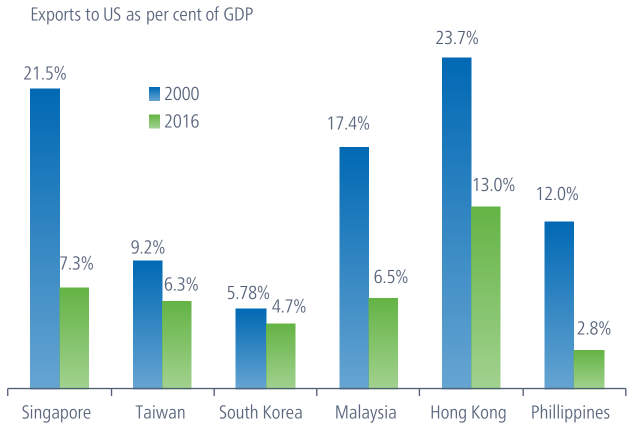
While these two countries are particularly vulnerable to the threat of protectionism, the region as a whole will likely be able to withstand such a threat. Firstly, the region has been dealing with weak exports for the past few years which meant that the focus shifted to domestic sources of growth i.e. investment and domestic demand. The Philippines, Indonesia, India are all more dependent on domestic sources of demand. Even Malaysia has seen a stronger contribution to growth from investment and consumption over the last few years than net exports. Second, as previously mentioned, their share of exports to the US has declined in recent years (Figure 81). During the Global Financial Crisis, intraregional trade became much more important. China is now the more dominant trading partner. Third, while the region is an important part of the electronics supply chain in particular, final export demand to the US which accounts for the supply chain is actually small. The countries most exposed in this regard are Singapore (8 per cent of GDP), Taiwan (7 per cent of GDP) and Malaysia (6 per cent of GDP) (Figure 82). While the latest data is from 2011, the contribution to GDP has declined since 2008. Singapore may be exposed but they have the fiscal firepower to withstand any impact on the economy.

AXJ has become more dependent on domestic sources of growth in recent years

The potential detachment from the US on trade will embolden China and the region to focus on intraregional trade. With the US officially out of the Trans-Pacific partnership (TPP), China's Regional Comprehensive Economic Partnership (RCEP) will likely take centre stage. The agreement includes the 10 ASEAN countries plus Australia, China, India, Japan, New Zealand and Korea.

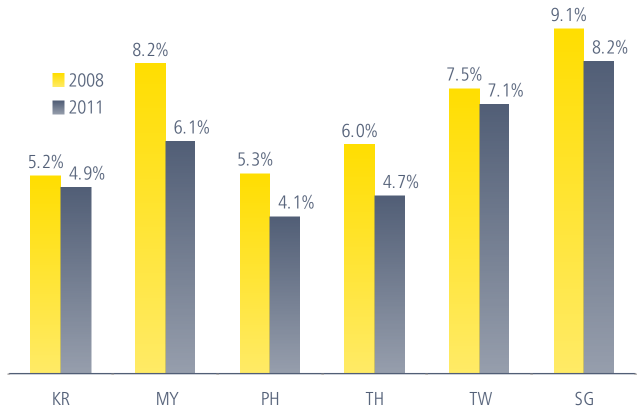
"America First" policy may lead to more intraregional trade cooperation

Figure 81: Exports to the US have become less important for AXJ economies



Sources: Aviva Investors, Macrobond, as at 31/03/2017

Figure 82: Trade to the US has declined even when accounting for the supply chain
Origin of value added in final demand, per cent of GDP



Sources: Aviva Investors, Macrobond, as at 31/03/2017

LATIN AMERICA: LACKING CONFIDENCE

– Political risks on the rise again

– Declining confidence to weigh on growth

– Slow growth and lower inflation

Corruption headlines continue to depress confidence across the region

2016 marked an important turning point for Latin America. Reforms in Argentina and Brazil and a positive election outcome in Peru point to a shift away from the populist past. Unfortunately, this year the region has yet again been shaken by new reports of political corruption linked to the ongoing Odebrecht investigation. The stream of negative news pushed confidence measures lower across the region (Figure 83) and highlights the bumpy path that lies ahead. Focusing on the headlines misses the bigger picture though and there are still plenty of positives across the region with declining inflation supporting lower policy rates across several countries and stable commodities and currencies pointing to a better growth outlook ahead. Additionally, key reforms may be delayed, but do not yet look likely to be derailed, suggesting room for ongoing improvement across the region.

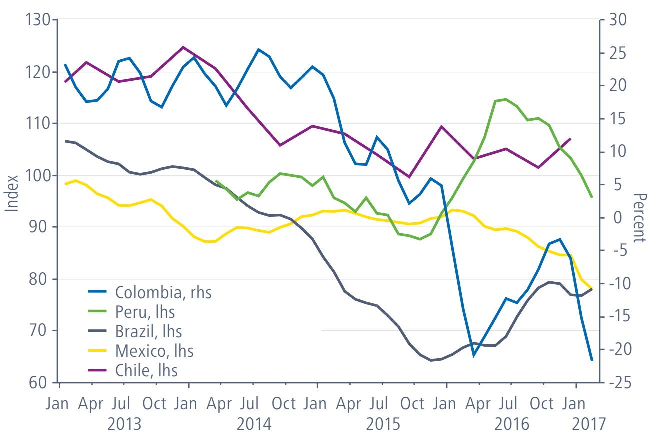
Lower inflation should allow Brazil's central bank to accelerate the easing cycle

In Brazil, exiting the worst recession on record is proving to be more challenging than expected. Q4 GDP data surprised to the downside again – declining 0.9 per cent – placing real GDP at the same level as in 2010. Private consumption has declined for eight consecutive quarters and, given the continued rise in unemployment to a cycle-high of 12.6 per cent, is unlikely to provide of boost to growth in the near term. Investment also continues to disappoint but there may be room for a bit more optimism here. Prices are declining rapidly in response to weak domestic demand. At 4.8 per cent, headline inflation is just above the central bank midpoint target and year-ahead inflation expectations remain anchored. This should allow the central bank to accelerate the easing cycle in coming months and suggests stabilizing investment. While the central bank certainly welcomes lower inflation, political risk remains elevated (Figure 84). With corruption investigations ongoing, and contentious pension reforms ahead, the risk is for disappointing economic performance to continue.

Outlook for Mexico still hinges on US policy decisions

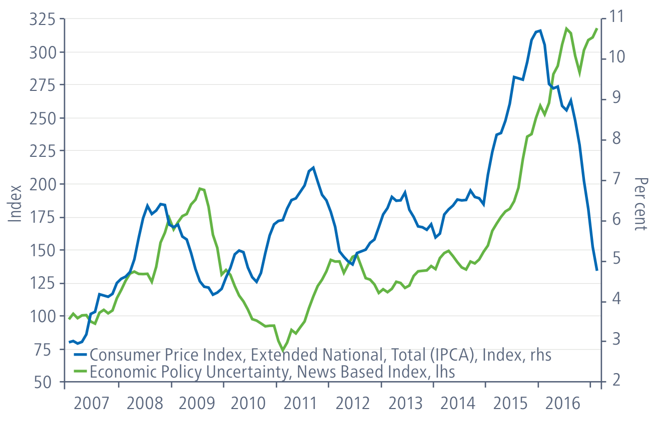
Mexico remains caught in a balancing act between internal and external developments. While the externals—specifically US fiscal and trades policies—captured most of the headlines over the past several months, the domestic economy remained relatively resilient, finishing the year with a 2.4 per cent growth rate and the unemployment near multi-decade lows, at 3.5 per cent.

Figure 83: Consumer confidence
Declining again in most countries



Sources: Aviva Investors, Macrobond, as at 31/03/2017

Figure 84: Will stabilizing inflation in Brazil lead to reduced uncertainty?
Lower inflation, higher uncertainty



Sources: Aviva Investors, Macrobond, as at 31/03/2017

More recently it looks like the balance is shifting slightly. Protectionist policies from the US have yet to materialize and the administration's top trade advisor recently advocated joining with Mexico to create a trade "powerhouse." On the other hand, the domestic outlook is more concerning with uncertainty depressing consumer confidence and indicating a slowdown in consumption ahead (Figure 85). Additionally, inflation has accelerated with both core and headline rates above 4 per cent, driven by currency depreciation and a recent increase in energy prices. Looking ahead, an economic slowdown would impede higher inflation in coming months and allow the central bank to end the tightening cycle at a rate near 7 per cent. However the outlook is unlikely to materially improve until there is more clarity on US policies.

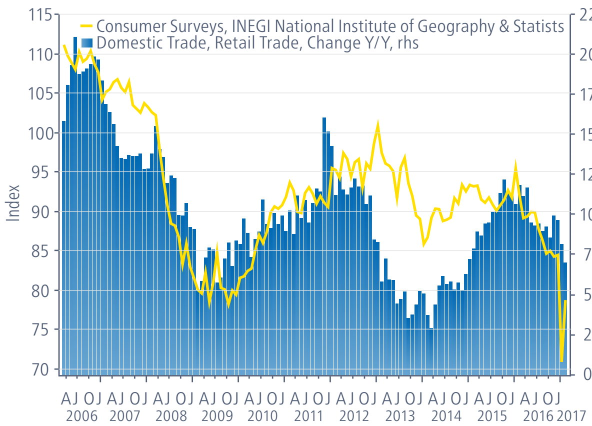
Improving global outlook to support the copper-producing region

As small open economies, both Peru and Chile stand to benefit from an anticipated pick up in global growth; however, the outlook for Peru remains more promising. Stable currencies and sluggish domestic demand have pressured inflation lower in both countries allowing the central bank in Chile to ease policy to 3 per cent and the Peruvian central bank to adopt a more dovish bias (Figure 86). With growth near cycle lows at 0.5 per cent y/y in Chile, cuts should provide support to the economy while in Peru easier monetary policy comes alongside a positive fiscal impulse, enhancing the positive outlook. On the downside, recent corruption scandals in Peru have weighed on confidence and uncertainty around upcoming elections in Chile has contributed to weak domestic demand. With the expectation that both of these issues will be resolved successfully, the outlook for both Chile and Peru is positive, aided by pro-cyclical monetary and fiscal policies.

Passage of fiscal reform bill stabilises the outlook for Colombia

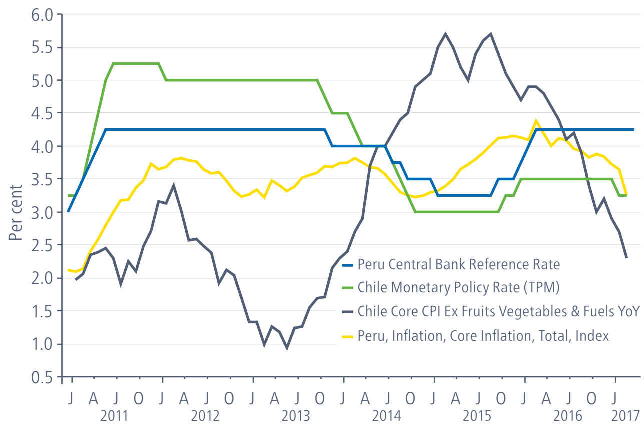
Risks have abated somewhat in Colombia in the recent quarter leaving the outlook more balanced. The rebound in oil prices has supported the trade balance and the current account deficit has improved by 3 per cent of GDP over the past year. In addition the passage of structural tax reform points to a stabilizing fiscal balance in the year ahead. While consumer activity remains sluggish with retail sales declining 2.2 per cent y/y recently, inflation is now about 4 per cent below the 2016 and points to stabilizing confidence in coming months. The central bank will continue easing policy towards 5 per cent and recently announced fiscal stimulus along with ongoing 4G infrastructure spending should support the growth outlook going forward.

Figure 85: Consumer confidence and retail sales
Sentiment likely to hit consumer spending



Sources: Aviva Investors, Macrobond, as at 31/03/2017

Figure 86: Core CPI inflation and policy rates
Lower inflation provides room to ease



Sources: Aviva Investors, Macrobond, as at 31/03/2017

CENTRAL EUROPE: ON THE VERGE OF OVERHEATING?

– Still very positive outlook for economies in the region, helped by improved external environment and robust consumption

– Central Banks more likely to let economies run hot before they hike rates

– Lower political risk but adverse French or German election results may weigh on sentiment

The fundamental backdrop has improved further in Central and Eastern Europe (CEE): expansionary fiscal policy employed in most of the countries in the region has borne fruit in the form of stronger consumer spending. Add improvements in investment spending, driven by the resumed flow of EU subsidies and fairly positive developments in the Eurozone, the major export market, and you end up with expectations of very solid growth this year and next. All the economies, including the Balkan laggards, Slovenia, Croatia and Serbia, are forecast to expand close to or above 3 per cent in 2017. Romania and Hungary are likely to be the top performers and these are the countries where the fiscal impulse has been the strongest.

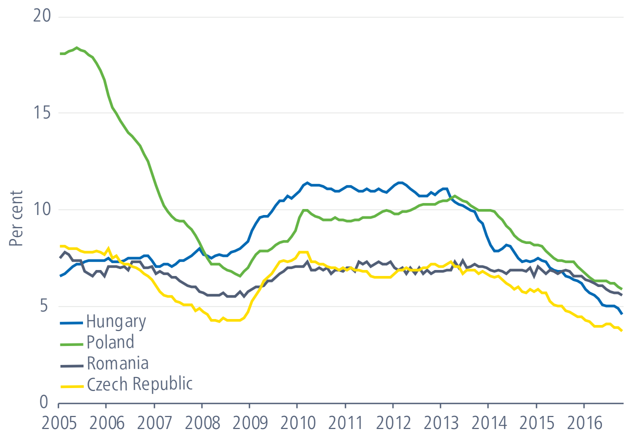
CEE labour markets becoming ever tighter

Labour markets in the region continue to get tighter: official unemployment fell to a record low in 20 years in almost all the countries last year (Figure 87). A record 30 per cent of companies cite shortages of labour as a major constraint on output growth, up from 5 per cent in 2010. The problem is particularly pronounced in Hungary, the Czech Republic and Slovakia while in Poland it has been partially mitigated by strong influx of labour from Ukraine. Wages are clearly on the rise.

Headline inflation on the rise, watch the core

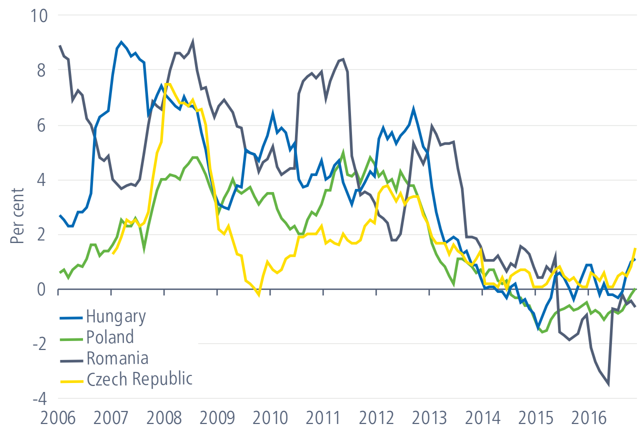
Headline inflation in the CEE countries has risen significantly from recent lows and is much closer to central banks' targets (Figure 88). It is almost entirely due to the rise of commodity prices and strong base effects, while core measures remain largely subdued (Figure 89). Thus far productivity growth in the region has outpaced nominal wage increases , especially in the manufacturing sector, but this can change soon if wage growth accelerates as expected (Figure 90).

Figure 87: CEE4 unemployment rate



Sources: Eurostat, as at 31/03/2017

Figure 88: CEE4 HICP inflation



Sources: Eurostat, as at 31/03/2017

Relaxed Central Banks

Cental banks do not look as if they will stand in the way of this solid economic expansion: although it may seem that the central banks have more reasons to at least guide the market toward a removal of some of the monetary stimulus now in place, they continue to play down any signs of inflationary pressures in the economies. They need to see core inflation rising towards target levels before they take any action and certainly prefer to err on the dovish side. This adds up to expectations that none of the central banks are very likely to raise rates this year. The Czech National Bank may abandon the FX floor in the second half of 2017 and there might be some minor reduction of excess liquidity in interbank markets by the Hungarian or Romanian central banks. But don't count on the central banks to be the first to ring the "inflation" alarm bell.

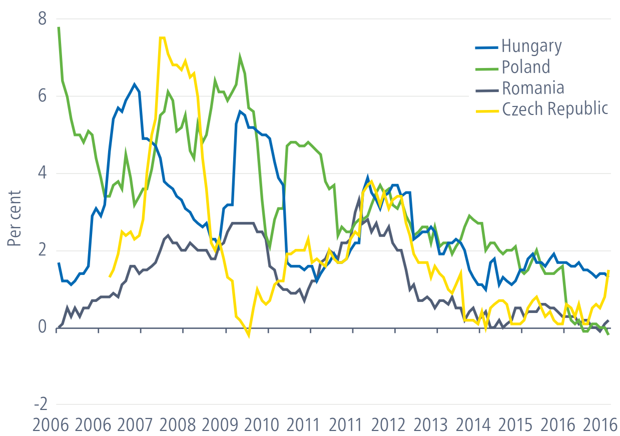
CEE competitive internationally

Real effective exchange rates (deflated by unit labour costs) suggest that the region remains competitive internationally. Current accounts remain balanced or in surplus, with exception of Serbia and Romania. While in Serbia improvement is expected, in Romania it may be an early sign of overheating in the economy. Despite increased government spending in most of the countries in the region, fiscal metrics are likely to improve further in 2017 and 2018, again with exception of Romania, and Poland. But the risk of breaching the EU 3 per cent threshold is small in Poland, albeit somewhat higher in Romania.

Political risks have come down

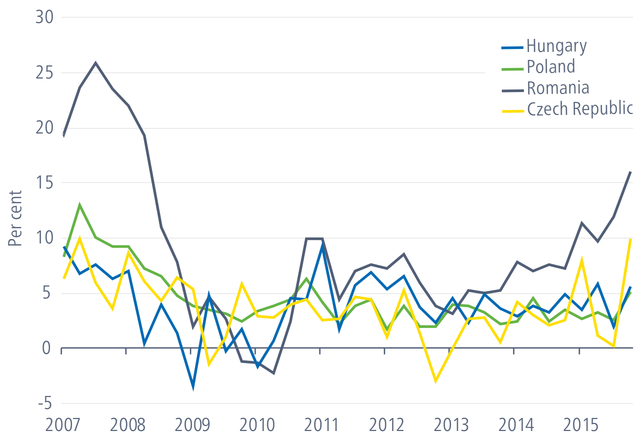
Idiosyncratic political risks in the region have come down as the major parliamentary elections are behind us and none of them brought as unexpected and game-changing results as in Poland in 2015. The most recent one in Romania hasn't changed the political landscape. The better than expected results of the PSD party may result in slightly more populist and expansionary policies implemented by the new government. The Czech elections in October this year should prove a non-event. Politics will not entirely come off the radar screens: any shift in European politics toward a more anti-EU and nationalist agenda such as in upcoming elections in France and Germany, may potentially result in much higher risk premiums across the region. Equally, if the "two-speed EU" idea finds its way into mainstream European politics, it could weigh on the perception of CEE region stability.

Figure 89: CEE4 CORE HICP inflation



Sources: Eurostat, as at 31/03/2017

Figure 90: Nominal wages growth, annual



Sources: Eurostat, as at 31/03/2017

MARKET OUTLOOK

DM EQUITY: EARNINGS RECOVERY CONTINUES

- Q4 earnings were the strongest in two years for developed markets
- Earnings revisions also showing positive momentum
- Reflation trade that dominated markets last year has struggled this year
- Valuations in Europe remain more attractive relative to the US, but heightened political risk remains a concern

SUMMARY

Earnings momentum continues to grow across developed markets (US, Europe and Japan), with all regions posting impressive year-over-year growth in Q4. Looking ahead, we have also seen a positive trajectory for earnings revisions which should bode well for this upward earnings trend to continue. From a valuation perspective, Europe would appear more attractive than the US, though we would caveat this with the political uncertainty of upcoming elections in a number of European countries this year (France and Germany) which may mean that some investors remain on the sidelines.

2017 has so far seen a cooling off of the reflation trade that dominated equity markets in the latter half of 2016, with more defensive sectors such as consumer staples and healthcare performing relatively well. Energy has been the main laggard so far year-to-date, as markets question the sustainability of the announced OPEC cuts to production and data indicates crude inventories continue to build in the US.

EARNINGS SEASON STRONG ACROSS DEVELOPED MARKETS

Earnings momentum has been strong across developed markets

With the majority of companies having reported Q4 results across the US, Europe and Japan, the main takeaway is that we have seen a continuation of the upward trend in earnings that we saw in the previous quarter (Figures 91-93). Europe and Japan in particular posted impressive double-digit growth year-over-year; indeed this is the first time in six quarters that European and Japanese earnings growth

Figure 91: US Q4' 16 Earnings Summary

	% reported	% cos beating EPS estimates	% yoy EPS growth	% cos beating sales estimates	% yoy sales growth
S&P500	**94%**	**73%**	**5%**	**53%**	**5%**
Energy	100%	65%	-9%	71%	3%
Materials	100%	68%	4%	48%	4%
Industrials	97%	68%	-4%	54%	2%
Discretionary	85%	70%	3%	48%	8%
Staples	84%	65%	5%	39%	3%
Healthcare	97%	84%	5%	53%	5%
Financials	100%	80%	6%	53%	6%
IT	88%	91%	10%	72%	6%
Telecoms	100%	20%	0%	20%	-2%
Utilities	100%	39%	9%	25%	9%
Real Estate	100%	76%	11%	55%	4%

Sources: Bloomberg, JPMorgan, excluding outliers, one-offs, as at 2nd March 2017

Figure 92: Eurozone Q4'16 reporting season

	% reported	% cos beating EPS estimates	% yoy EPS growth	% cos beating sales estimates	% yoy sales growth
DJ Stoxx 600	**80%**	**52%**	**11%**	**63%**	**3%**
Energy	87%	42%	-5%	54%	8%
Materials	82%	56%	11%	69%	8%
Industrials	76%	58%	19%	51%	2%
Discretionary	78%	47%	10%	58%	3%
Staples	81%	54%	6%	54%	8%
Healthcare	97%	56%	15%	66%	7%
Financials	89%	55%	14%	85%	-6%
IT	92%	41%	1%	67%	3%
Telecoms	67%	40%	5%	54%	5%
Utilities	56%	25%	11%	38%	-3%
Real Estate	42%	67%	8%	40%	48%

Sources: Bloomberg, JPMorgan, as at 2nd March 2017 has exceeded that for US companies. Earnings revisions ratios (the ratio of analysts' upgrading their earnings forecasts relative to those downgrading) are also looking stronger in Japan and Europe, where we are actually seeing net upgrades. It's worth noting we are also seeing an improvement in earnings revisions, with 2017 growth expectations being revised higher compared to where they were at the start of the year.

EUROPEAN EQUITY VALUATIONS VS US

European equities have materially underperformed US equities for an extended period, now stretching to 2008. In total US companies have outperformed their European peers by nearly 100 per cent in USD terms. A large proportion of this outperformance can be explained by the much stronger earnings backdrop in the US – looking at forward EPS (earnings per share), the US has recovered much faster from the prior recession, with European company earnings having virtually stagnated over the past six years (Figure 94).

> European companies have materially underperformed their US counterparts in USD terms since 2008

In terms of profit margins, we've also seen a large gap open up between the two regions, with European companies substantially less profitable than their US counterparts (Figure 95). The issue here appears to be less about costs and more about pricing power. The relatively weak demand environment combined with deflationary pressures has meant European corporates have faced a significant squeeze on their ability to push through price increases. We are seeing some signs of improvement here, with the demand outlook improving and inflation coming back into the Eurozone economy – indeed companies such as Schneider Electric (one of the large European industrial players) have pointed towards a better pricing environment of late. Even a relatively small uplift in margins combined with further top-line growth would be enough to drive a meaningful acceleration in earnings.

> There is a large gap in profit margins between European and US companies

Contrast this with the US, where there are some signs that margins are getting squeezed, with rising wage costs starting to have an impact – whilst we expect demand to remain robust, there does seem to be more opportunity for European companies to boost margins than for those in the US.

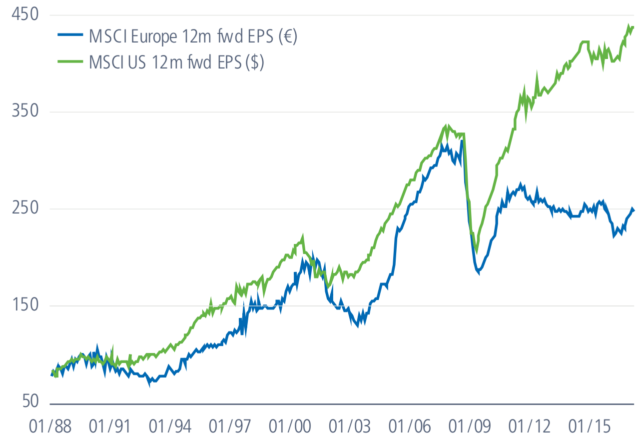
Given the positive earnings momentum and the current valuation discount, one might rightly question why we have not been seeing more positive flows into European stocks. When analysing the cumulative weekly flows into a range of regional mutual funds and ETFs, European flows have largely been flat since the start of the year – political uncertainty seems to be the primary reason for investors staying on the sidelines, with upcoming elections in the France and Germany leaving many reluctant to allocate any significant new capital. The US, by contrast,

Figure 93: Japan Q4'16 reporting season

	% reported	% cos beating EPS estimates	% yoy EPS growth	% cos beating sales estimates	% yoy sales growth
Topix	**98%**	**69%**	**13%**	**45%**	**-2%**
Energy	100%	100%	-	63%	-2%
Materials	99%	81%	61%	43%	-3%
Industrials	98%	70%	21%	45%	-4%
Discretionary	96%	68%	-15%	47%	-3%
Staples	96%	68%	10%	33%	0%
Healthcare	100%	82%	11%	40%	-4%
Financials	100%	69%	14%	68%	0%
IT	98%	67%	16%	48%	-3%
Telecoms	89%	25%	-1%	40%	-1%
Utilities	95%	47%	-8%	20%	-7%
Real Estate	100%	70%	24%	44%	13%

Sources: Bloomberg, JPMorgan, as at 2nd March 2017

Figure 94: MSCI Europe vs MSCI US 12 month forward earnings per share (EPS)



Sources: BofA Merrill Lynch Global Research, Datastream, MSCI, IBES, as at 31/03/2017 has seen continued inflows, albeit not at the aggressive pace we saw in the immediate aftermath of the Trump election victory.

REFLATION TRADE COOLING OFF?

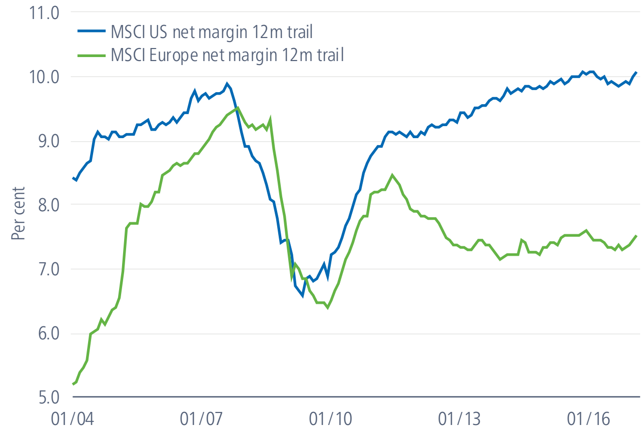
The reflation trade which dominated equity markets last year has struggled of late

One of the major drivers of equity markets during 2016 was the so-called "reflation trade" as investors rotated into cyclical sectors that they felt would benefit more from increased inflation and growth expectations and away from higher quality defensive stocks. This can be seen in Figure 96, which shows the relative performance of European and US cyclicals vs defensives. The Trump election victory accelerated the rotation that had begun in July last year, though year-to-date the momentum has somewhat stalled, with sectors such as consumer staples and healthcare actually outperforming the broader market. The energy sector has been the main negative drag, with recent data indicating crude inventory levels have been building in the US and some doubts over whether the announced cuts to production from OPEC will be maintained.

CONCLUSION

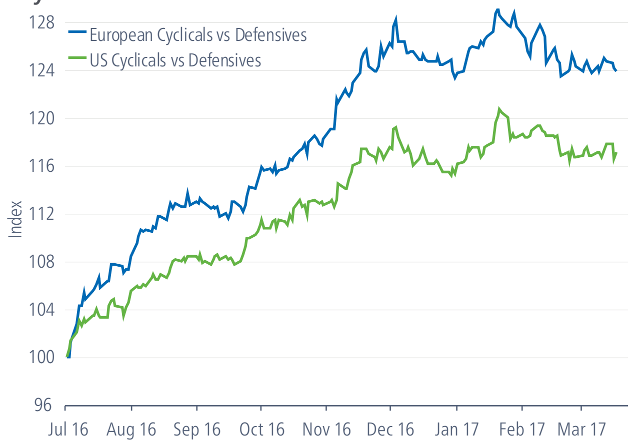
The strong earnings momentum we are seeing across developed markets should be seen as a positive for equities – this combined with an improving macro outlook should provide support to markets, although valuations are already reflecting this positive tone to a large extent. From a valuation perspective Europe provides an interesting opportunity set for global investors over the longer term, provided they are willing to absorb some of the political risks that will likely dominate headlines over the coming months.

Figure 95: MSCI Europe vs MSCI US 12 month trailing net margin



Source: BofA Merrill Lynch Global Research, Datastream, MSCI, IBES, as at 31/03/2017

Figure 96: Europe and US Cyclicals vs defensives since July 2016



Sources: BofA Merrill Lynch Global Research, Datastream, MSCI, IBES, as at 31/03/2017

EM EQUITY: CREDIT TO THE CHINESE

– A strong start to the year for emerging market equities

– Corporate earnings continue to recover

– Global politics remains a risk

SUMMARY

The recovery in emerging markets has reasserted itself after a pause in the fourth quarter of 2016. The coincident recovery in global growth and a pick up in inflation have created an attractive backdrop for emerging markets and underlying corporate earnings. The significant valuation discount of emerging markets to developed markets remains excessive, particularly in an environment of resilient near-term growth.

EMERGING MARKET EQUITY PERFORMANCE

2016 was a strong year for emerging market equities, as they gained just under 12 per cent on a total return basis in US dollars (Figure 97). After a period of consolidation in equity prices in the fourth quarter, this rally in emerging market equity prices has continued with a further 9 per cent gain to mid-March. As we have highlighted in the past, this positive return should be put in the context of prior years. The MSCI Emerging Markets Index was launched in 1988, and since then the average positive year has returned just over 40 per cent. With this in mind, the question rapidly focuses on the foundations of the recovery and its sustainability. For this we believe we need to look at valuations, the economic backdrop and, finally, politics.

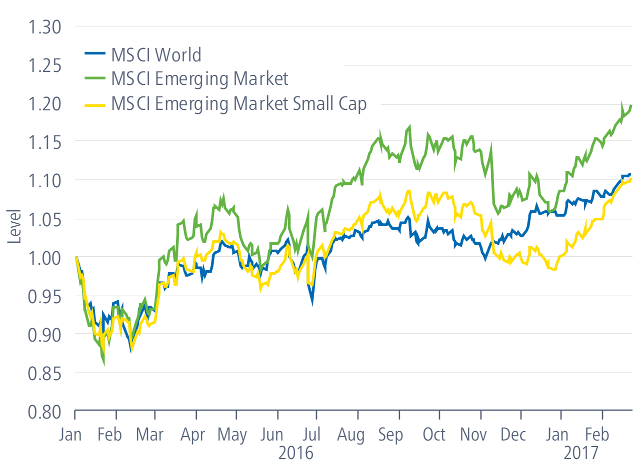
Emerging market equities are showing sustained momentum

ABSOLUTE AND RELATIVE VALUATIONS

We have consistently highlighted that emerging market equities are materially undervalued. Compared to developed market equities since 2014, (and for this we use the MSCI World Index), they have consistently traded at a near 30 per cent discount (Figure 98). The recent recovery in emerging markets has been coincident with a recovery in earnings expectations that has outstripped that of developed markets. This means that an expectation of a reduction in the discount in valuation has not materialised. To put that in context, over the past 6 months expectations for 2017 earnings for developed markets have increased by 7 per cent, whilst for emerging markets that increase has been 12.5 per cent. Over that same period, developed markets have outperformed emerging markets by 1.3 per cent, further opening up the valuation gap.

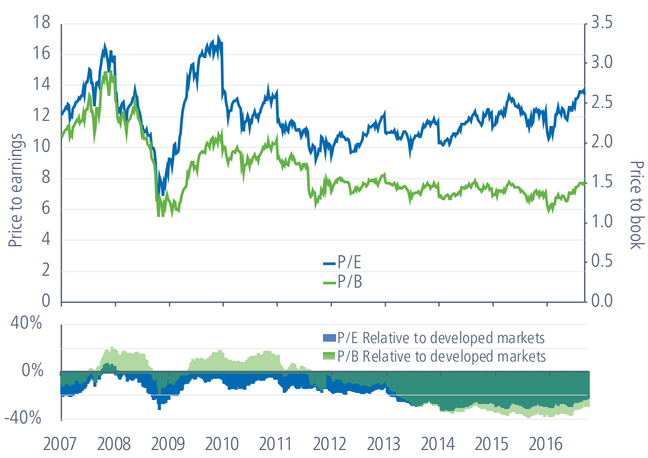
The valuation discount to developed markets remains excessive

Figure 97: MSCI Emerging Market Performance



Sources: MSCI & Bloomberg, as at 31/03/2017

Figure 98: EM valuation, historic and vs DM



Sources: MSCI & Bloomberg, as at 31/03/2017

The valuation of emerging markets compared to their recent history is perhaps one of the weakest links in this argument. They currently trade on 12 times next year's earnings. This compares unfavourably with a 10-year average of 11 times and a 5-year average not far off that mark. However, developed markets trade at a 22 per cent premium to their 10-year average. But when we scratch beneath the surface, the picture is very different: developed markets, for example, trade on 16.7 times earnings, have a return on equity of 10.15 per cent and a yield of 2.5 per cent. Emerging markets have a similar but better return on equity of 10.6 per cent, a higher expected yield of 2.7 per cent and still trade on only 12 times earnings.

Earnings expectations for emerging markets are improving and remain modest

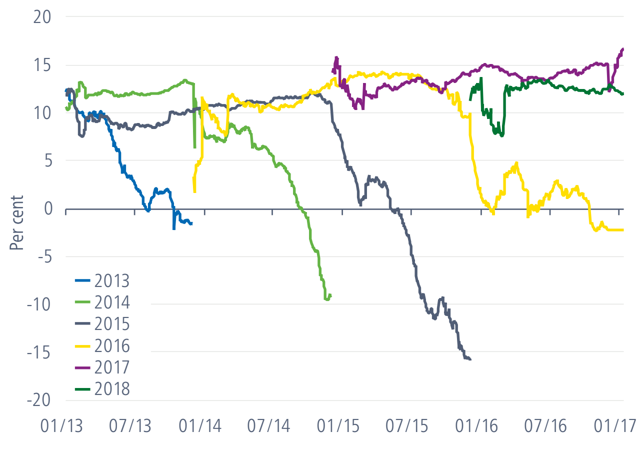
The earnings expectations for emerging markets (Figure 99), on which all these valuations assumptions are built, remain depressed. To put this in context, we can look at historic earnings for emerging markets. What becomes very clear is that 2016 earnings were less than 10 per cent ahead of those which were achieved in 2009 as the impact of the global financial crisis was felt across all markets. The 15 per cent growth in earnings expected for this year looks comparatively modest compared to the rebound of over 40 per cent we experienced in 2010. Should we take our lead from the ever-moving feast of analyst forecasts, clearly expectations for emerging market earnings are rising. This should be highly supportive of sentiment, valuations and, of course, equity prices.

ECONOMIC MOMENTUM

Growth in emerging markets is stronger than anticipated

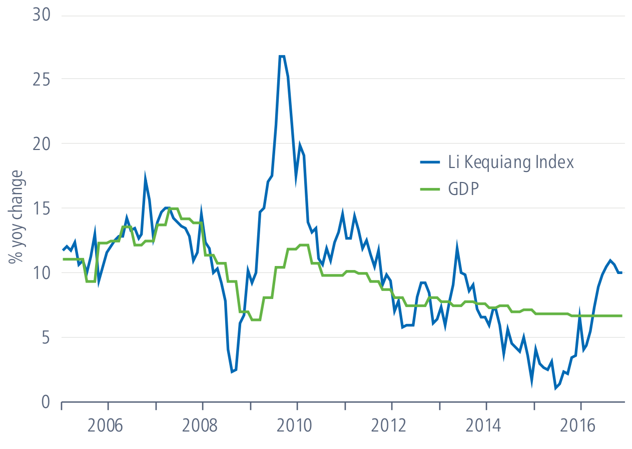
The improvement in expectations and corporate earnings across emerging markets is clearly supported by an improvement in the economic backdrop. Countries such as Brazil and Russia, both of which experienced significant recessions over the past two years, have passed an inflection point. More important though is the clear change of priority in China. In the lead up to the Chinese domestic equity market correction in 2015 there was a focus on reform. This was embodied in the anti-corruption push and targeted reductions in capacity and consolidation across the iron ore, coal and steel sectors. The cost of this, combined with the deceleration in credit growth, was, in our view, an unreported slowdown in GDP. In early 2016 growth clearly became the priority, credit growth re-accelerated and both property and infrastructure projects were rapidly approved. The Li Keqiang index (Figure 100), often derided as measuring only the historic drivers of Chinese economic activity, subsequently re-accelerated and has remained strong, suggesting that Chinese growth could even be running faster than the fastidiously reported 6.5 per cent to 7 per cent target range.

Figure 99: Emerging market earnings expectations



Source: Bloomberg, as at 31/03/2017

Figure 100: Li Kequiang Index vs GDP



Sources: Bloomberg, National Bureau of Statistics of China, as at 31/03/2017

The importance of China and the strength of its growth cannot be under-estimated for emerging markets. Commodity prices have recovered strongly as Chinese demand has increased. This recovery in Chinese demand, combined with historically-loose global monetary policy, has been rapidly transmitted through to corporates in emerging markets. It is no coincidence that the emerging market Markit PMI (Figure 101), a measure of the health of the manufacturing sector, has recovered dramatically from the lows in late 2015 and early 2016.

China's near-term policies help underpin the recovery

We cannot mention China and the strength of its economic recovery without highlighting the over-hanging risk associated with its excessive and sustained credit growth. However, in the near term this should not detract from their positive contribution to growth. In our view, China's near closed capital account and the upcoming national party congress in the fourth quarter makes this a mid – rather than short-term risk to emerging market equities. We therefore believe investors should be aware of the risks but still take advantage of the current strong support to earnings growth that Chinese policies provide in the near term.

China's excessive credit growth is a mid-term risk

POLITICS

The political backdrop for emerging markets is perhaps the aspect that has received most attention recently. While there are still specific issues with domestic politics in some emerging markets, these are outweighed by those major players - China, Brazil and India - where the news is more positive.

Emerging market politics are not centre stage

Unusually of more concern is the impact of developed market politics (Figure 102). While the uncertainties around upcoming European elections are unlikely to have any more lasting impact in emerging markets than the initial reaction to the Brexit vote, the US is more of an issue.

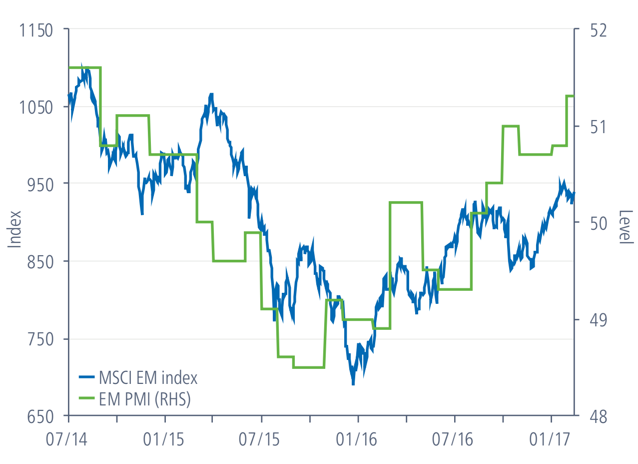
The potential destabilising effect of an introduction of trade tariffs and the cancellation or renegotiation of agreements such as NAFTA remains a concern, though one that we hope will be tempered by the knowledge that the integrated nature of global supply chains means punitive tariffs would not leave the US unscathed.

Developed market politics are a clear risk

CONCLUSION

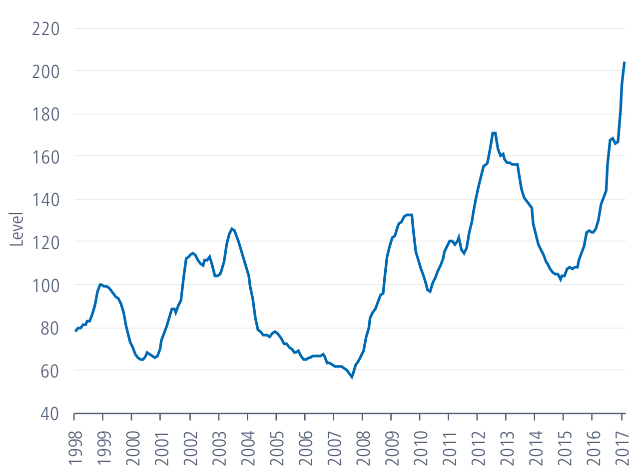
The strong start to 2017 for emerging market equities has the foundations to continue in the near term. Corporate earnings are benefiting from a recovery in global growth. We remain concerned over the sustainability of Chinese credit growth but acknowledge that the authorities' policies are highly supportive of both Chinese and emerging market growth. Valuations remain excessively cheap in both absolute and relative terms. While emerging markets behave, the main risk has now become the unpredictable political backdrop in developed markets.

Figure 101: Emerging market PMIs



Sources: MSCI, Bloomberg, Markit, as at 31/03/2017

Figure 102: Global policy uncertainty index



Source: Macrobond, as at 31/03/2017

RATES: CONFLICTS ABOUND

– Policy emphasis swings back to monetary

– Uncertainty doesn't make reality

– Risk remains elevated

THEMES

The policy burden shifts back to monetary

Many of the risks driving bond market sentiment that came to the fore at the start of this year remain unresolved. We are yet to see a complete fiscal plan from the new US administration; political risks remain, even with the uneventful passing of the first major hurdle, namely the Dutch general election (where centrists effectively retain control). However, there has been a re-focusing of attention on monetary policy, notably with the US Federal Reserve moving in line with their 2017 forecasts, whilst the improved economic performance in the euro area has raised thoughts about how and when a withdrawal from extraordinary measures will begin. Once again, monetary rather than fiscal policy seems to have taken centre stage as the driving factor for bond markets (Figure 103).

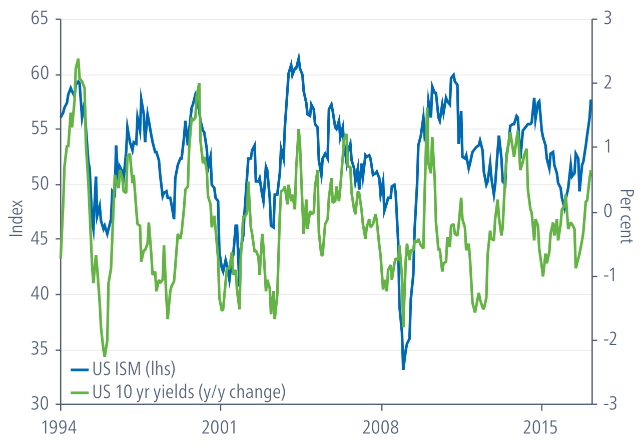
Risk-adjusted returns cloud the outlook

Set against this backdrop the bond markets were broadly range-bound in Q1 in terms of duration and curve slope. It seems to be that the strong consensus towards a number of key themes, such as fiscal stimulus and upside inflationary pressures leading to steeper curves, was all challenged, at least in terms of the timing. At the same time, other market drivers, such as commodity prices, actually weakened over the quarter after a strong performance into the end of last year. The stand-out performance in terms of asset classes has been at the riskier end of the spectrum (equities, credit spreads, etc.) which have seen strong positive moves (Figure 104).

Inflation base effects will see real rates rise

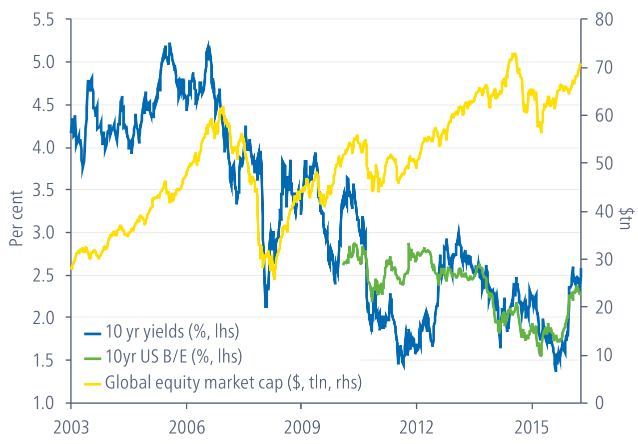
Nonetheless it is worth reiterating that the current macro upswing globally remains broadly intact. US growth remains robust and given the additional impetus on the fiscal side from China seen last year, the likelihood is that global growth will have a decent tailwind for the next few months at least. That should keep the focus on monetary policy more skewed towards the removal of support rather than any additions. However, one additional market driver could be the down shift in base effects from the oil price which will be dropping out of most inflation indices over the next few months. This will certainly lessen any concerns about inflationary risk getting out of control but equally could foster concerns in certain parts of the globe (e.g. EZ and Japan) that less meaningful progress in creating sustained inflation has occurred.

Figure 103: US ISM vs yoy change 10yr yields



Source: Bloomberg, as at 31/03/2017

Figure 104: Risk vs Risk free



Source: Bloomberg, as at 31/03/2017

ALL THAT GLITTERS…

The outlook for duration globally is by no means consistent. Given we face tighter policy in the US and potentially a long run in before any fiscal stimulus is forthcoming, in the context of softer inflation prints and no real wage pressures, it is hard to construct a strongly bearish view on the outlook for longer-term rates. Equally, even though data has been improving in Europe, they are a long way from achieving their policy objectives and will remain a dominant flow in terms of their bond buying programme. Much the same is true in Japan where the YCC policy from the BoJ is hugely pro-cyclical and could see buying actually increased if yields move too far away from their 0 per cent target. In short, we will need to see a significant fresh catalyst emerge to move rates markets beyond what is priced into the forwards even in the context of an improved macro back drop. Equally the risk of a negative event such as a material risk-off episode could spark some significant duration buying and challenge the lower bound of prevailing ranges (Figure 105).

Duration likely to be range bound and risks are symmetrical

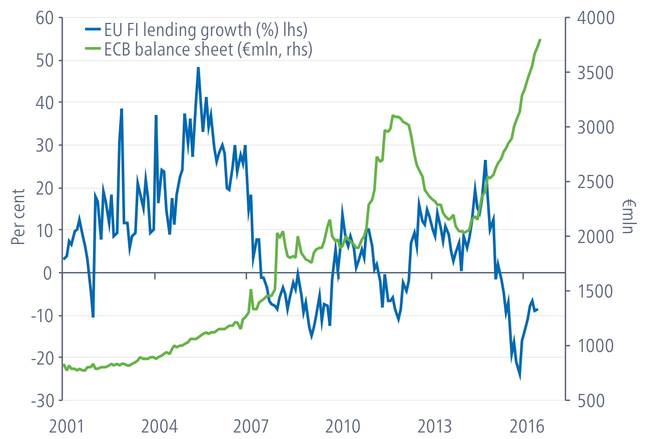
Certainly if one looks to other developed markets there are clearer long duration catalysts than in the main markets, with both Canada and New Zealand offering attractive risk-adjusted returns at this point in time. Harder to call is the outlook for yield curves as these have been less convincingly trending than many forecast with a steepening bias (driven by higher inflation premia and higher term premia) not panning out as expected. Indeed it has been in the front end of curves where steepening has been most evident and we expect this to continue as the primary risks that lie on the horizon will be challenged by policy makers continuing to suppress the front end of the curve via ZIRP/NIRP. We also believe some of the best opportunities will be in the cross-market space over coming quarters as the divergence not only in monetary policy but likewise in terms of sensitivity to dominant thematics (such as commodity price trends) could present some strong cross-market opportunities both in terms of embedding carry into a total return portfolio but likewise driven by underlying macro divergences.

Front end steepening and cross market plays look best

Inflation markets have been a rich seam for investment in recent quarters due primarily to the success in creating some reflationary pressures by super-accommodative monetary policies combined with a recovery in commodity prices and especially energy prices. This has forced breakeven inflation rates globally to recover sharply with the UK leading the pack (as BREXIT-related currency effects came to the fore) whilst US breakevens have moved back to be only a little below long-term averages. In Europe there is still some way to go before the implied expectations for inflation hit the ECB target. The reality is that in most cases, inflationary expectations have been normalised but it is only with aggressive further stimulus that they are likely to ratchet higher once again. As such, rather than focus on breakevens at this point, we would be more focused on real yields and their potential to move notably in the face of declining inflation base effects and a range-bound duration outlook (Figure 106).

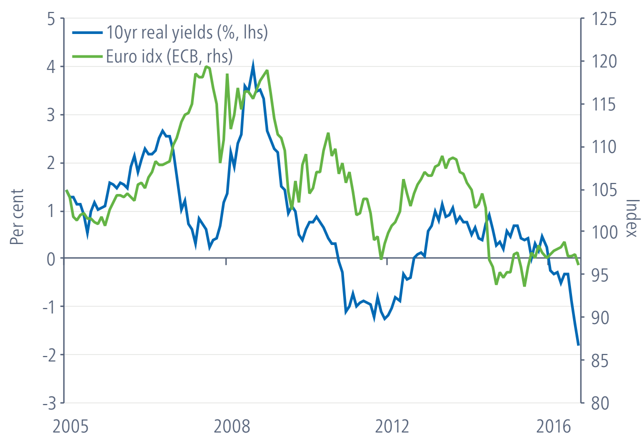
Real yields potentially have favourable dynamics

Figure 105: Central bank balance sheets still expanding



Source: Bloomberg, as at 31/03/2017

Figure 106: EU effective exchange rate vs real yields



Source: Bloomberg, as at 31/03/2017

CREDIT: ON BORROWED TIME

SUMMARY

Credit spreads pricing in an extension of the credit cycle

Credit markets have continued their strong performance so far this year, especially in high yield and higher beta areas of investment grade such as financials and cyclicals. In the US, the strong performance has been driven by the expectation of improving fundamentals as the political landscape looks increasingly supportive for corporate profitability. A better growth outlook, fiscal expansion and softer regulations in the banking sector will assist the transition from supportive monetary policy to tightening conditions; however, we believe the risk of one or all of these outcomes not materialising is greater than current spread levels suggest. While policy in the US may successfully extend the credit cycle further into the future, as corporates deal with a higher-yielding environment at a time of elevated balance sheet leverage, the risk of a more disorderly unwind is growing.

The low volatility backdrop may soon come to an end

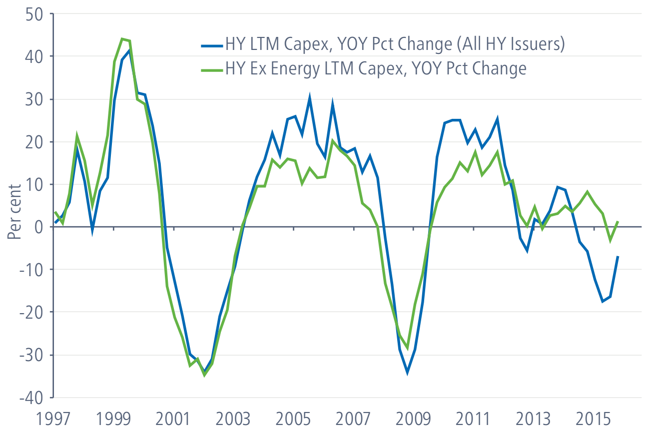
In Europe, although underperforming US credit year-to-date, the ECB's corporate sector purchase programme (CSPP) continues to support spreads so far this year, with long-dated credit and high yield outperforming against a backdrop of subdued volatility. This narrative remains intact for now as the programme remains in place. However, the heavy impact of central bank support from the ECB and the BoE has left very little upside on valuations especially during a time of political uncertainty. European credit spreads have underperformed the US market in recent months and we expect this to continue.

STABLE FUNDAMENTALS FOR NOW

Trump has triggered a late cycle upswing

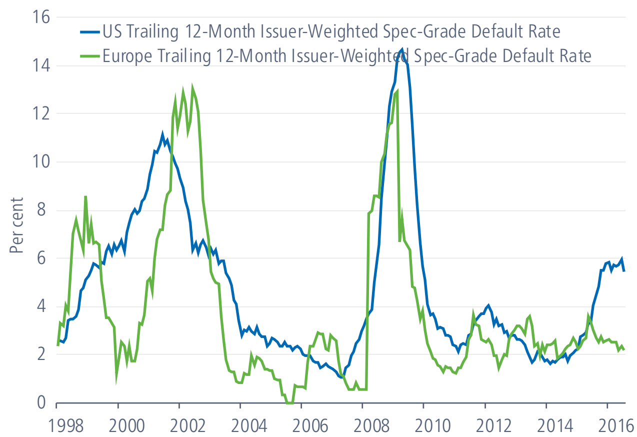
In the US weak global growth has meant corporates have struggled to grow revenues and earnings. Corporates have in the main responded to this, and the very low interest rates at which they can fund, with large-scale mergers and acquisitions or share buybacks. This has generally resulted in higher gross debt levels within companies, but continued weak levels of investment. The recent election victory of Donald Trump, and the growing potential for business-friendly tax initiatives and infrastructure spending, have triggered improved sentiment across the US economy. We are already seeing signs of a pick up in capital expenditure as illustrated in Figure 107, but the revival of "animal spirits" is likely to encourage this even further and promote a late-cycle upswing in growth whilst also raising concerns of a gradual credit deterioration trend. The US high yield market continues to be the best performing asset class within credit markets, however is still heavily dependent on the energy sector. With the oil price at current low levels, this sector will probably remain in the spotlight and, default rates are higher than European high yield (Figure 108).

Figure 107: Year-on-year changes in capex by US HY firms (with and without the energy sector)



Sources: Bank of America, as at 31/03/2017

Figure 108: Trailing 12-month HY Default Rates in Europe and the US



Sources: Bank of America, as at 31/03/2017

Despite the low-yield environment in Europe, corporates have maintained their financial discipline. Heavy supply periods since the start of ECB corporate purchase program (CSPP) have mostly been driven by refinancing rather than a meaningful re-leveraging trend, while capex and share buyback programmes remain subdued given the political backdrop. Once the election dust settles, improving earnings trends and better economic data could support spreads as central bank support wanes, but it is unlikely to deliver exceptional excess returns given how little value is offered at current levels and the potential for debt-fuelled investment picking up.

European corporates are behaving more conservatively

CORPORATE BOND PURCHASES COMING TO AN END?

It has been a year since central banks became involved in credit markets in a meaningful way. The impact on increased supply and spread tightening was witnessed immediately as shown in Figure 109, while in more recent months, investors rebalancing into higher yielding parts of the market such as Financials have contributed to greater compression of high beta to low beta. A steeper yield curve environment has also helped financial spreads perform while the corporate sector (non-financials) has leaked wider on tapering fears. We still believe the overriding policy support will remain a long-standing positive technical feature of the market for years to come, however in the shorter term, central bankers are becoming more aware of the market distortions created by ultra-loose monetary policy and as we move out of this policy phase, the likelihood of realising higher volatility increases.

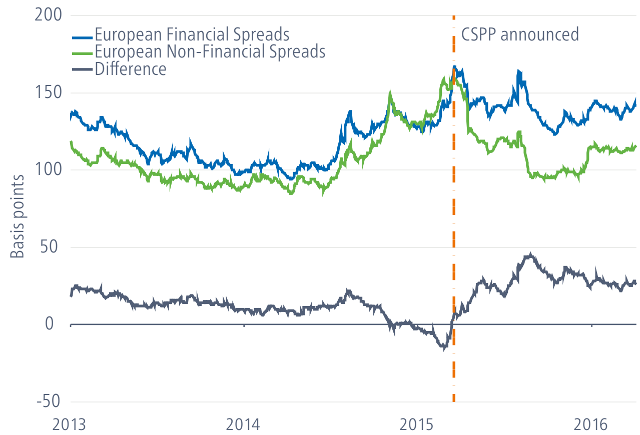
Support from central banks will remain a favourable dynamic for a while yet

A noteworthy development of recent months has been the move wider in European swap spreads, as investors fearing the rise in political risks are driving bunds lower and swaps higher, while at the same time the pressure on short-dated bund yields is very strong as the ECB increases its government debt buying below the deposit rate. As shown in Figure 110, this development has yet to meaningfully impact credit spreads, but if swaps remain elevated, the increasing unattractiveness of European credit on a swaps basis will become a concern.

In terms of supply, primary market levels continue to be healthy with a record-breaking issuance month in January being well-absorbed by cash on the sidelines and an increased appetite from non-traditional credit investors. We expect supply levels to remain robust, particularly in the US, given rising M&A activity as well as potential capex increases. However, uncertainties related to corporate tax reform and particularly interest tax deductibility pose a possible dampener on issuance over the coming quarters.

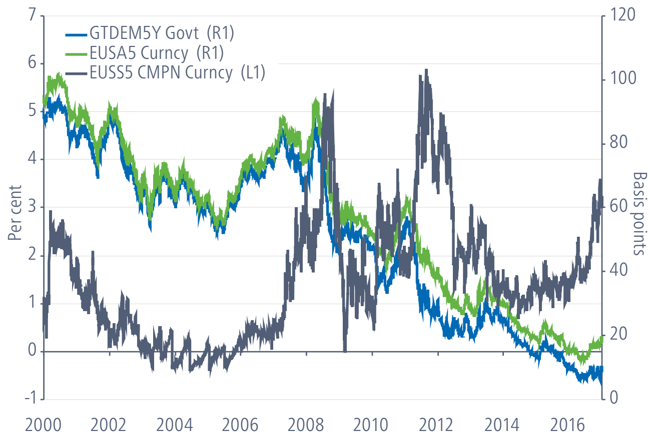
Five-year swaps spreads are historically high

Figure 109: European Credit Spreads, Financials versus Non-Financials



Sources: Bloomberg, as at 31/03/2017

Figure 110: 5-year Bund, Euro Swaps & Swap Spreads



Sources: Bloomberg, as at 31/03/2017

Investment grade is offering greater premium than high yield

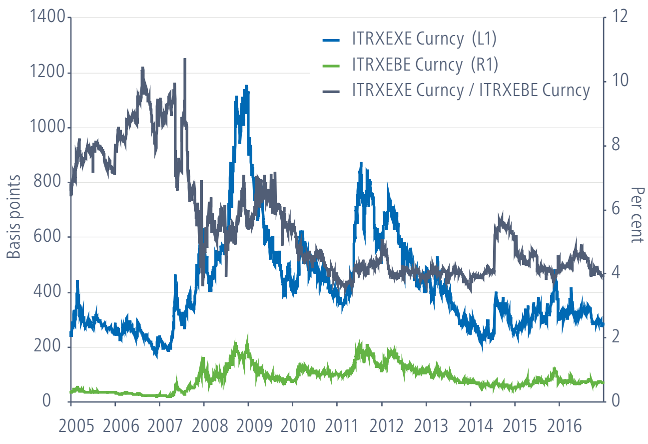
INVESTMENT GRADE STILL OFFERS THE BEST RISK/REWARD

When looking at absolute valuation metrics versus historical ranges, the risk/reward of high beta credit looks increasingly unattractive at these levels – see Figure 111. When considering the different rating buckets with High Yield CCCs are trading at higher absolute spread level than in 2014, although they are now facing higher default rates, meaning that excess compensation is actually lower than it was when spreads hit the 5-year lows. BB- and B- rated credits are also trading tighter than their 2014 levels on this metric. Conversely, Investment Grade credit offers a greater premium versus history and has scope to outperform as the primary beneficiary of potential US tax reform.

CONCLUSION

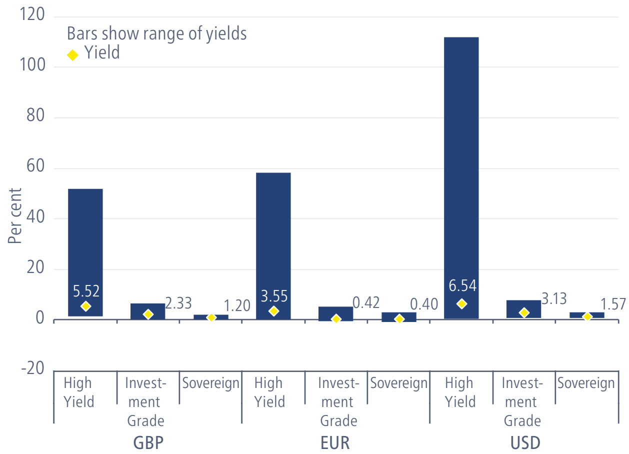
Credit spreads are currently pricing in considerable improvements in the economic backdrop especially in the US, while in Europe, the removal of Central Bank support that has been such a key driver of the current low volatility environment, is causing very little concern for investors at current levels. Clearly although sentiment is improving in the US we are not convinced that this will be matched by improving credit-worthiness, especially as corporates will be facing tighter financial conditions from a relatively highly-geared standpoint. In Europe, the fundamental picture is more stable, yet technical support from the ECB and BoE is gradually being removed. Figure 112 shows that despite the low levels of yields at the index level, numerous opportunities are still available from a stock-picking perspective, especially in High Yield. As a result a more selective investment approach is warranted, since the credit cycle appears to be increasingly running on borrowed time.

Figure 111: Spreads of iTraxx Main versus Crossover indices



Sources: Bloomberg, as at 31/03/2017

Figure 112: Developed Market Fixed Income Index Yields and Spread distributions



Source: Bloomberg, as at 31/12/2016

EMERGING MARKET DEBT: EXTERNAL RISKS

As emerging market economies look ahead toward the remainder of 2017 they do so with the tailwind of an ongoing global reflationary impulse and a notable pick up in investor appetite, set against the ongoing potential for greater challenges from the external environment. At the start of the year we highlighted an improving fundamental backdrop for developing economies which has continued to evolve in a positive fashion, especially when viewed through the lens of improving terms of trade and commodity prices as well as economic survey data. Whilst there is good reason to believe that the survey data will translate into hard data in the coming months, as always it remains important to differentiate and determine where investors are well compensated for risks across countries and asset markets within the broad emerging market debt (EMD) universe. Once again risks to the asset class seem focused on the external environment and particularly around US monetary and trade policies, though our central House View scenario suggests an environment where US real rates should not represent a major risk to EMD in the coming quarters and that any change in US trade policy direction will be relatively contained and narrow in its focus.

> Risks to the asset class seem focused on the external environment and particularly around US monetary and trade policies

We believe that this environment should remain particularly supportive of local currency markets and we retain a preference for local currency over hard currency. Our rationale remains consistent with the view that we see long-term valuation attractiveness and supportive terms of trade improvements best represented within emerging market currencies and local bond markets. The ongoing move higher in commodity markets, which is largely attributable to infrastructure-related stimulus in China and which we expect is likely to remain supportive of associated assets, has led to a notable rally in EMFX following the sell off after the US election. As a result, the local currency universe has outperformed its hard currency equivalent so far this year, despite the fact that the latter has seen very significant investor inflows over the same period. Whilst we believe there are attractive bottom up investment opportunities within the hard currency universe and investor inflows have been particularly supportive (Figure 113), the relative valuation argument that we discuss in more detail below is not as compelling as local currency or indeed when compared to global credit spreads.

EM LOCAL CURRENCY BONDS

EM local currency bonds have made a strong start to the year – up 4 per cent in US Dollar terms – as concerns about US policy risks have continued to fade and the impulse from the cyclical upturn in the global economy underpinned commodity prices. Local markets have remained well underpinned despite the increasing

Figure 113: YTD flows into EM debt funds

USD mn	EM HC	EM LC	Blended	Total
21-Dec-16	-503	-1,068	223	-1,348
28-Dec-16	42	-207	-34	-199
04-Jan-17	345	1,648	-44	1,949
11-Jan-17	766	393	132	1,291
18-Nov-17	332	105	-27	410
25-Jan-17	289	-699	36	-374
01-Feb-17	1,025	625	10	1,660
08-Jan-17	1,822	461	222	2,505
15-Feb-17	722	415	162	1,299
22-Feb-17	951	184	86	1,221
				8,414

Sources: EPFR, Aviva Investors, as at 31/03/2017

Figure 114: GBI-EM Deviation from FX 'Fair Value' [USD]

Sources: Aviva Investors, Bloomberg, as at 31/03/2017

EM Local markets can withstand limited rate hikes

probability of rate hikes by the US Federal Reserve over the course of this year. This will be the key risk to monitor in coming months – EM local markets can likely withstand rate hikes associated with increased global activity but a more aggressive policy stance, while not our central scenario, would present a larger challenge.

Valuations in local markets remain attractive, primarily driven by currencies

Valuations in local markets remain attractive. This is primarily driven by currencies which remain significantly below long-term fair value estimates, notwithstanding the recovery that has been playing out over the past year. Using the countries within the JPM global diversified index, we observe that real effective exchange rates are on average 10 per cent below their long-term means (Figure 114). Meanwhile, EM local yield spreads to core government markets have continued to narrow from the multi-year highs seen at the start of 2016 (Figure 115). This is a trend which we expect will continue but spreads remain elevated over longer time frames and offer a buffer in the case of increased currency volatility.

The fundamental outlook has improved across emerging economies

The fundamental outlook has improved across emerging economies with activity data beating expectations in the latter stages of last year. But the pickup in sentiment indicators hasn't translated through to a broader improvement in growth expectations for this year. And growth differentials to developed economies have lost some of the upward momentum which has been in place since the start of 2016 (Figure 116). Inflation expectations are divergent across EM with Latin America inflation expectations declining compared with a modest increase across Eastern Europe and Asia. The scope for further monetary easing is largely confined to South America while stable policy settings are likely elsewhere.

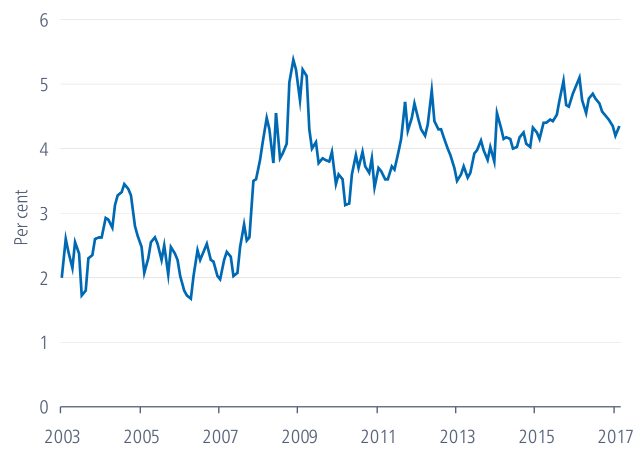
Cross-border appetite for emerging debt has recovered strongly from the outflows seen after the US election. This is a trend that we expect to persist, given recent asset class performance, although the ability of EM economies to gain further traction on growth will be an important driver also. Although investor positioning data is not widely available, our sense is the challenging period from 2013-16 has left investors structurally underweight emerging debt and should provide a supportive underpinning over the medium to longer term. Portfolio positioning favours the higher-yielding countries with improving fundamentals in, for example, Indonesia and Peru.

EMERGING MARKET HARD CURRENCY DEBT

We now view hard currency spreads as expensive

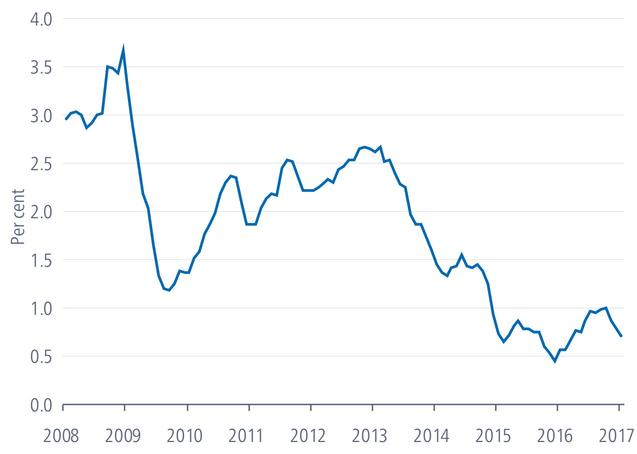
At the end of last year our view changed to reflect a more cautious approach as we felt the supportive external environment was facing a number of challenges that were not correctly reflected in headline spread levels. Over the last quarter improving global growth, a continuation of the broader EM recovery, low rate

Figure 115: EM yield differential to UST



Sources: Aviva Investors, Bloomberg, as at 31/03/2017

Figure 116: EM - DM Growth forecast differentials



Sources: Aviva Investors, Bloomberg, as at 31/03/2017

volatility and yield attraction has led to inflows into the asset class. This has driven spreads in hard currency assets to levels that we now view as expensive (Figure 117).

We continue to see external risks to emerging markets. The apparent comfort with hard currency assets at levels that offer such a poor risk-reward profile is a concern in itself. We feel the EM premium has been removed during the spread tightening experienced this quarter and now believe any subsequent movement will be aligned with the beta of the asset class relative to global credit. This reduced relative value attraction should slow inflows from the recent pace.

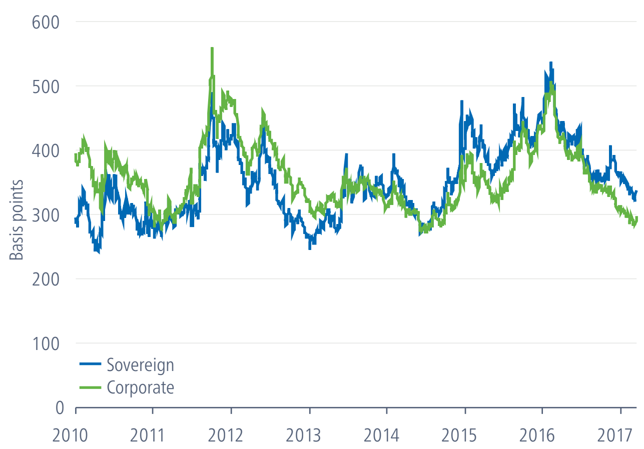
US monetary policy, and in particular rising real rates, will remain a key risk to monitor over the coming months. Spreads have been absorbing the 100bp+ move in UST yields since mid-2016 (Figure 118), more than offsetting the rise in rates through spread tightening. Although a negative correlation is historically normal, given the long-held fears around the removal of extraordinary policy, as evidenced by the reaction in the taper tantrum in 2013, this time has been surprisingly normal. We remain wary that a positive correlation could still appear as market expectations have moved to more seriously consider an accelerated rate hike. At best a significant move higher in US Treasury yields would challenge total returns because of the limited spread cushion now on offer.

> US monetary policy will remain a key risk to monitor over the coming months

At this point we believe risk-reward is poor and believe that a cautious stance is warranted as several potential catalysts for a correction remain. Within hard currency funds we feel positive, although sustainable returns will need to be driven by a greater focus on security selection. We continue to believe that low spread assets have moved below levels that are justified by fundamental quality. Assets with a greater spread cushion and stable or improving outlooks look more attractive. This could result in a focus towards Latin American sovereign and quasi-sovereign issuers where return expectations look more favourable.

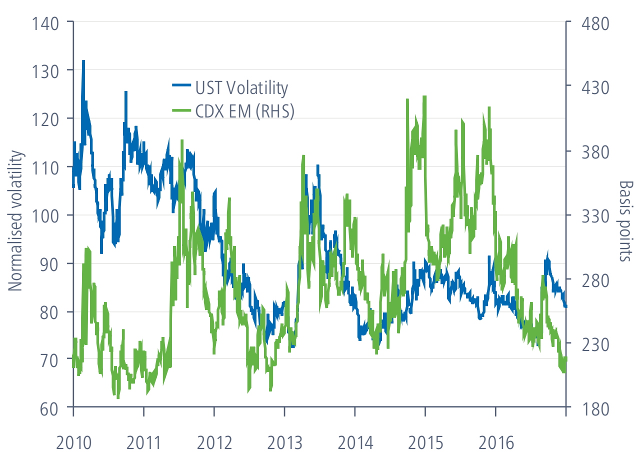
> Maintain a cautious stance overall with a greater focus on security selection

Figure 117: EM Hard Currency Spreads



Sources: Aviva Investors, Bloomberg, JP Morgan, as at 31/03/2017

Figure 118: EM Spread vs UST Volatility



Sources: Aviva Investors, Citi Velocity, as at 31/03/2017

CURRENCIES: REFLATION ALTERS BALANCE OF RISKS

– Macro momentum and hawkish policy to keep the dollar supported despite rich valuations

– With reflation going global, commodity currencies benefit from a terms-of-trade boost

– Subtle ECB policy shift helps EUR short term; JPY to remain the main funding currency

Dollar has taken a breather as markets re-assess the initial assumptions about Trump

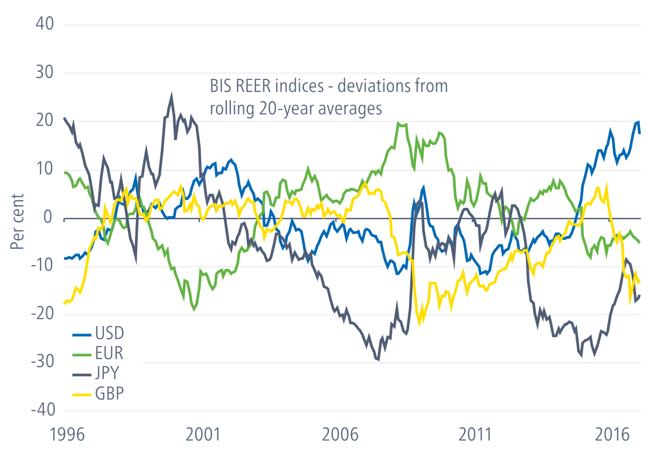
While late last year the US dollar was turbo-charged by Donald Trump's victory, more recently it has struggled to break higher despite the favourable repricing of the FOMC's policy path. Valuations may be part of the explanation as the dollar screens quite rich on several valuation metrics (Figure 119). In addition a lot of optimism built on expectations of Trump's future policies appears to be already in the price. With the poor handling of some early policy initiatives and a lukewarm reception from the White House to Congressional measures such as the border-adjustment tax, regarded by some as dollar positive, currency markets have perhaps begun to question the initial response to Trump. A pick up in global reflation is another factor that may be limiting further USD gains, as it threatens to cut into the dollar's yield advantage over its peers.

At the same time, cyclical momentum in the US economy remains strong – the ISM surveys are well above 55, jobs growth is accelerating and this time with meaningful wage growth. And the fact that this acceleration is occurring close to full employment is likely to keep monetary policy on a relatively hawkish path. While this would be normally supportive of further strength in the greenback (Figure 120), excessive appreciation from current relatively elevated levels could influence FOMC thinking. On balance, the bar for a dollar break-out is likely higher. Equally, it's unlikely that the multi-year upswing in the greenback that began in 2011 will be unwound anytime soon.

Reflation going global means terms-of-trade boosts to commodity currencies

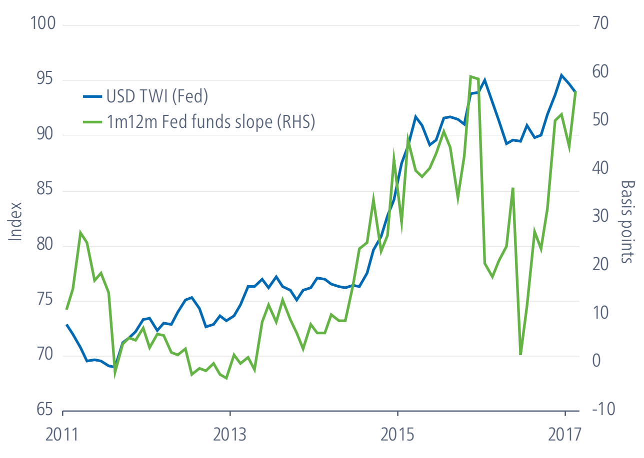
An important theme in global FX over recent months is that reflation has become more global. Steady recoveries in major economic blocs, helped in part by strong fiscal stimulus in China last year and continued monetary stimulus in the Euro area and Japan, have pushed commodity prices higher boosting the terms of trade of many EM and DM commodity currencies (Figure 121). The sharp rise in industrial

Figure 119: Dollar expensive relative to peers



Sources: Aviva Investors, Bloomberg, as at 31/03/2017

Figure 120: Policy repricing boosting USD



Sources: Aviva Investors, Bloomberg, as at 31/03/2017

metals in anticipation of a Trump infrastructure spending programme and the support of crude oil prices in the wake of the OPEC deal have further provided support to this improvement that was underway throughout 2016 as world trade growth picked up. The result has been that several EM currencies (Brazilian real, South African rand, Russian rouble, Chilean peso) have strongly outperformed the dollar despite higher US yields in recent months. Cheap EM valuations have been a supportive factor, but the main propulsion has come from an improving global growth outlook (Figure 122).

Within developed market currencies, the Australian and Canadian dollars have failed to benefit from terms-of-trade improvements as domestic cycles have remained weak, partly due to structural reasons. Fundamental valuations aren't expensive, but they aren't especially cheap either. On balance, residual value may be somewhat greater in EM currencies that are leveraged to global growth but not directly vulnerable to a surge in Trump's protectionist instincts – notable examples are Brazilian real and South African rand, especially the real since Brazil is a relatively closed EM economy and has a trade deficit with the US.

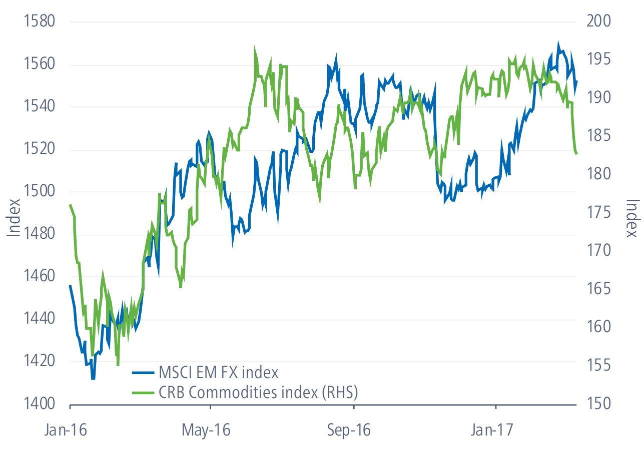
Weak domestic cycles mean DM commodity currencies fail to benefit from commodity surge

Among the low-yielding majors, the euro has held steady against the opposing forces of increased interest rate divergence with the US on one hand and political risk on the other. Looking ahead, if the recent cyclical upswing in the euro area is sustained and political risks pass, there may be scope for the euro to head higher. While the ECB continues to indicate that they are comfortable with the current policy stance, the improving macroeconomic backdrop has allowed the belief of a sustained recovery to gain traction. In such circumstances, it would be irresponsible for the Central Bank not to be considering their exit strategy. The modest upgrades to their projections in March and nuanced changes to the language used support this view. We continue to believe that policy changes are more likely next year than this, but they could be signalled earlier. With core inflation still very low and flatlining, the boost to the euro from these developments may not necessarily be sustainable. A lot will now depend on the path of core inflation. A steady increase in the coming months will be a validation of the euro bulls' case. However, for now the jury is out. From a valuations standpoint, a case can be made that both euro rates and consequently the single currency itself are depressed relative to reasonable fundamental anchors (Figure 123). However, the challenge to the valuation thesis comes from the ECB's possible inability to lower monetary accommodation by enough to impress the markets.

Upside in EUR requires a boost from core inflation which could take longer than markets expect

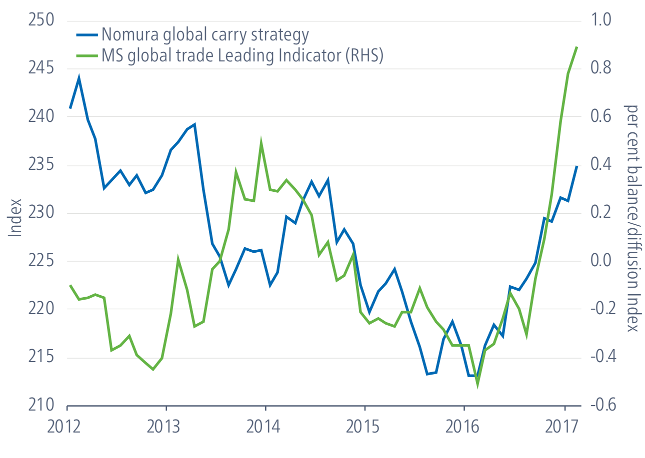
Amidst this global reflationary backdrop, the yen is likely to remain the main funding currency in global FX, as the Bank of Japan persists with maintaining a tight lid on JGB yields. While core inflation in Japan nudged modestly above

Figure 121: EM FX boosted by commodities



Sources: Aviva Investors, Bloomberg, as at 31/03/2017

Figure 122: FX carry revived by global reflation



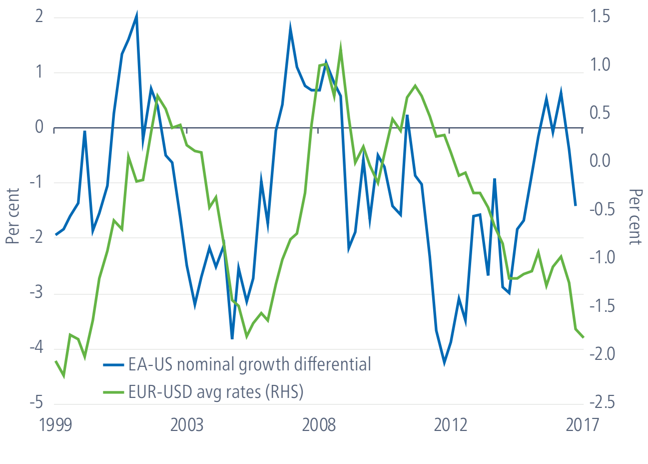
Sources: Aviva Investors, Bloomberg, as at 31/03/2017

zero, it's still a long way from the BoJ's 2 per cent target. Governor Kuroda's term ends at the end of 2018. It is possible he could be re-appointed, but by his own admission the BoJ are unlikely to reach their target by then. Therefore, it's hard to see them changing course before then, especially if global reflation and further yield divergence can deliver the exchange-rate depreciation that remains crucial to achieving inflation given lack of any signs of domestic wage growth.

Sterling weakness is largely Brexit-related

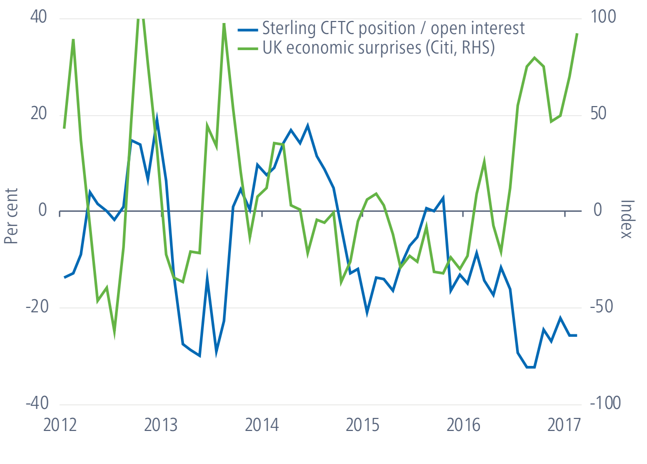
Finally, sterling is likely to continue to face elevated levels of idiosyncratic risk despite valuations being near historical lows, recent economic performance above expectations and no large-scale capital outflows (Figure 124). The pound may stay at cheap levels for a while, but it's unclear that a significant further downward adjustment is needed. The net international investment position has been positive since Q2 last year and improved further as the currency has fallen. The current account deficit is likely to shrink as well as the primary income balance tends to be sensitive to exchange rate moves. These factors should give some support to the currency. However, with Brexit negotiations only set to begin in the coming months, the outlook remains clouded.

Figure 123: EUR rates advantage should be higher?



Sources: Aviva Investors, Bloomberg, as at 31/03/2017

Figure 124: Markets have ignored UK macro data



Sources: Aviva Investors, Bloomberg, as at 31/03/2017

REAL ESTATE: DRY POWDER PILING UP HIGH

GLOBAL

Based solely on reported transaction data, it would seem that global investment activity has already passed its zenith for this cycle. Jones Lang LaSalle (JLL) data suggests that full year 2016 volumes amounted to $661bn, a 6 per cent decline on 2015. This follows on from the stable level of investment activity seen in 2015 after a period of strong acceleration (Figure 125).

Global investment volumes appear to have peaked

Despite a lower level of overall volumes for 2016, there was evidence of a rebound in investor momentum towards the final quarter. Much of the pullback in activity came in H1 2016, whereas fourth quarter volumes were more or less on par with 2015 figures. This suggests investor sentiment was relatively unperturbed by political shocks, however we expect these factors to weigh on decision making throughout the course of this year.

The level of dry powder in closed-end private funds has reached a record high, estimated at $237bn at the end of 2016. A further $11bn has been raised since the start of the year according to Preqin (Figure 126). Difficulty in productively deploying this capital partly explains the recent slowing in investment volumes. We expect competition for assets to continue this year, with fewer markets looking attractively priced than twelve months ago. Global growth indicators need to be watched closely, particularly in relation to underwriting rental growth assumptions.

But capital raising continues at a rapid pace

UNITED STATES

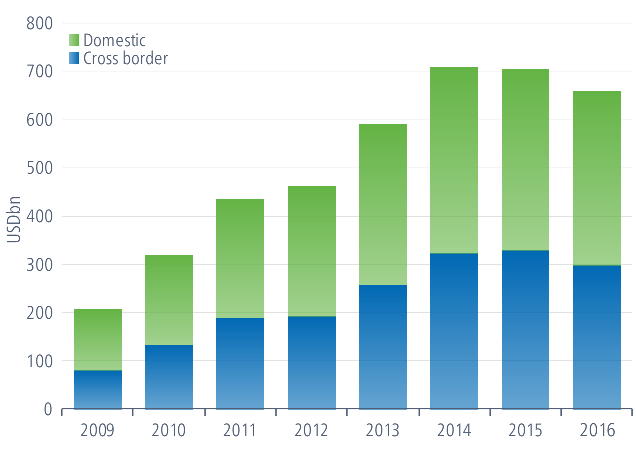
Occupier markets in the US remain resilient for the most part. The national office occupancy rate stood at a business-cycle high at the end of the fourth quarter (89.6 per cent) according to CoStar, within 0.2 per cent of its 2006 peak. Growing signs of construction activity are indicative of the current strength of the office market. However, a tightening of lending standards could curb the acceleration of construction activity. Recent data suggests that loan origination volumes were flat over 2016, and tighter lending standards are constraining land sales.

US construction activity picking up, but lending more stringent

Investment activity has slowed since reaching its peak in 2015, which can be attributed to a lack of product. One positive sign is that the diversity of buyers in the market remains high. The majority of private capital raised thus far in 2017 is set to target North American markets.

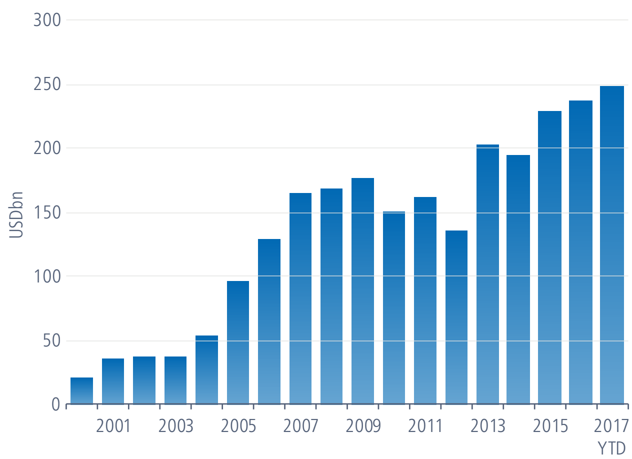
2016 marked another year of strong performance in the logistics sector. Demand has outpaced growth in the wider economy as reconfigurations of supply chains to

Figure 125: Global investment volumes



Source: JLL, as at 31/03/2017

Figure 126: Dry Powder - Closed-End Private Real Estate Funds



Source: Preqin, as at 31/03/2017

accommodate e-commerce have driven appetite for modern space. Looking to the year ahead, rental growth expectations are waning as supply fundamentals begin to catch up with demand.

A second round bankruptcy filing for American Apparel towards the end of 2016 symbolises the ongoing polarisation occurring within the retail sector. Prime retail maintains its appeal to occupiers seeking platforms to showcase their products and services, but weaker retail schemes look increasingly vulnerable (Figure 127).

UNITED KINGDOM

UK real estate saw a recovery in transaction volumes and modest capital growth over the final quarter of 2016. However the market faces a number of headwinds which we expect to hamper both liquidity and performance going forward.

Central London offices most at risk from Brexit

The best part of the rental cycle is behind us, and although GDP projections have been revised up, we do expect political and economic uncertainty to weigh on occupier market conditions. That said, supply of prime stock appears to be broadly in balance with demand in most markets, with the current cycle having generated only modest levels of development. Higher quality assets are likely to outperform if and when vacancy rates do increase.

Rising inflation looks set to drag on real wage growth this year, hampering the strength of the consumer economy and impacting the retail sector in particular. Thereafter, Brexit creates specific risks for central London offices (Figure 129).

EUROPE (EX UK)

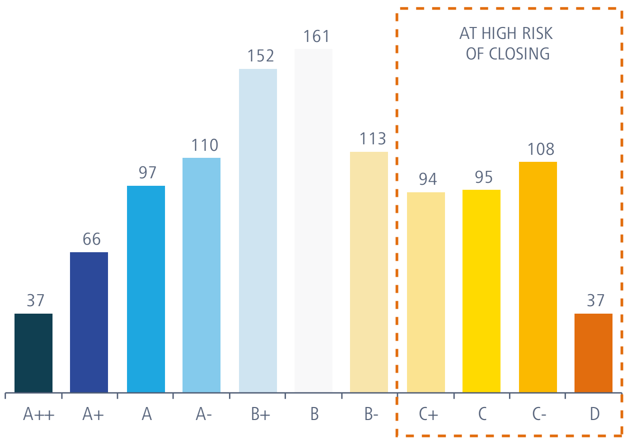
Limited development (Figure 129) and rising occupier demand are driving rental growth across the European real estate market. This, combined with a wide spread in yields over government bonds, continues to entice investors to the asset class.

We forecast total returns on prime European commercial real estate of 5-6 per cent per annum over the next three years and 4-5 per cent per annum over the next five years. Our forecasts are frontloaded, reflecting an erosion of relative value, assuming bond yields begin to normalise between now and 2020. Moreover, a gentle rebound in supply is projected for a number of markets in 2019, which should result in slower rental growth.

Political risk a key factor for European real estate in 2017

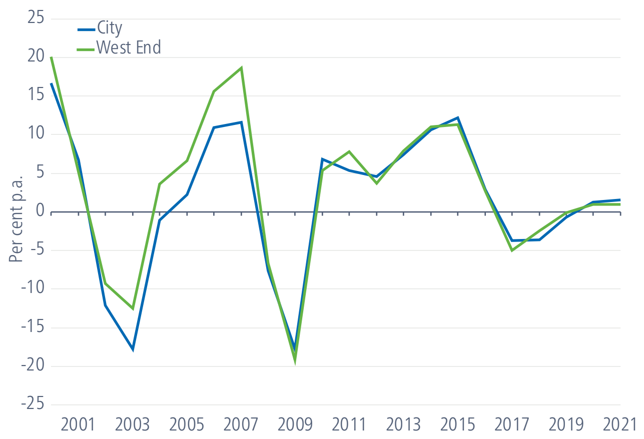
A series of important political events is clouding the outlook for the sector. Political risk has provided some benefits to investors in European real estate after the UK's EU membership vote: core European bond yields fell, thus making real estate relatively more attractive. However, the risk of a populist-led government and a

Figure 127: Number of US malls by rating



Sources: Green Street Advisors, as at 31/03/2017

Figure 128: Rental value growth



Sources: IPD Annual Digest, 2000-2015; AI house-view Q1 2017, 2016-2021.

potential membership referendum in one of the core Eurozone economies is of a different order to Brexit. The probability of such an event is extremely low but its implications would be damaging for Europe's economy and its real estate market.

ASIA PACIFIC

Leasing activity in Asia ended the year as it started: mixed fortunes determined by local market forces. The strongest rental growth over the last year was in the Sydney (+22 per cent) and Melbourne office markets (+13 per cent). Conversely, prime Singapore office rents saw double-digit movement in the opposite direction, posting 11 per cent rental declines over the year. Rental recovery forecasts are at risk of being pushed back if headwinds such as trade barriers materialise over coming months.

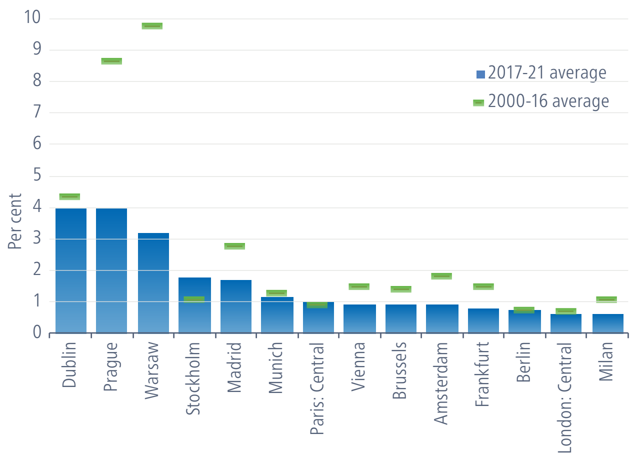
Sydney carrying positive rental growth into 2017

Expectations of further yield compression in Japanese markets have been pared down following a stabilisation of pricing. Yield spreads between Tokyo and other cities are likely to narrow as investors focus their attention on the next level of top tier markets. There is also growing evidence of Japanese investors looking beyond their domestic market in order to achieve higher returns.

Weak occupier markets and an expectation of gradual outward yield movement build a weak case for entry into Hong Kong at the present time. Tightening from the US Federal Reserve is expected to exert pressure on cap rates given the close historical relationship (Figure 130).

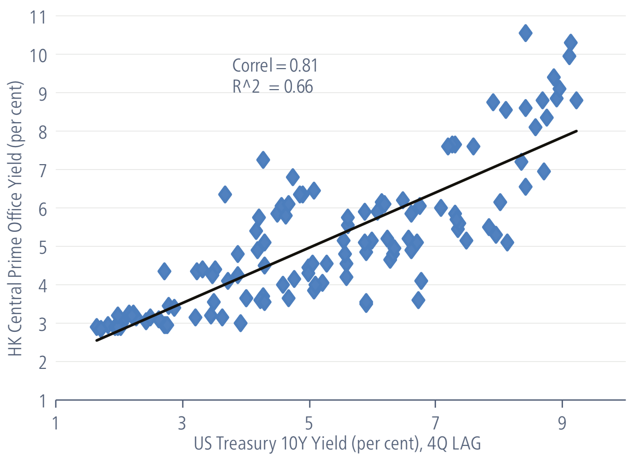
Bucking the global trend, investment volumes in Asia Pacific rose by 5 per cent from their 2015 level to $130bn. Cross-border purchasers accounted for more than a third of total investment volumes. A rush of deals towards the end of the year saw volumes increase by 21 per cent year-on-year in the fourth quarter, with record activity in China bolstering the numbers.

Figure 129: Office development estimates
(net additions as % of stock)



Sources: Property Market Analytics, as at 31/03/2017

Figure 130: US rates vs Hong Kong Offices, 1987Q1-2016Q4



Sources: Aviva Investors, as at 31/03/2017

CROSS ASSET VOLATILITY: GLOBAL EQUITY VOLATILITY HITS MULTI-YEAR LOWS

– Macro, technical and behavioural factors all combine to exert pressure on equity vol

– FX vols remain elevated on a relative historical basis

SUMMARY

S&P 500 60-day realised volatility sank to 6.4 per cent in March – the lowest level since 1995

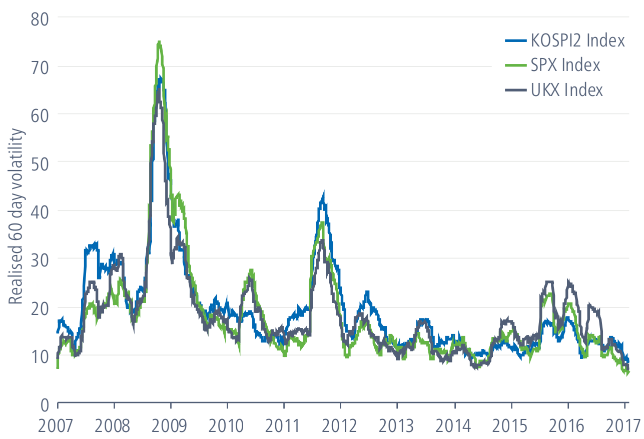
Equity market volatility subsided around the world as S&P 500 60-day realised volatility sank to 6.4 per cent in March – the lowest level since 1995 – which equates to an average daily move of just 0.4 per cent on the index throughout the 60 consecutive trading days extending back to mid-December. Elsewhere, Eurostoxx and FTSE indices recorded their lowest level of 60-day realised volatility since the Global Financial Crisis (GFC), whilst the Shanghai Composite saw its lowest since 1992 and the South Korean Kospi 200 its lowest ever (Figure 131).

EQUITY VOLATILITY HAS FALLEN AGAIN

Realised volatility also moderated on global sovereign bond yields during the first quarter as the effect of the sharp re-pricing out of the deflationary mind-set from bond markets began to fade. Developed market corporate bond yield volatility followed suit, soothed by the favourably benign risk sentiment that buoyed equity markets. However, whereas equity markets were breaking record-low levels of volatility, bond yield volatility generally only dipped to second quartile relative to their last five years of history. The exception was the Chinese corporate high grade sector where realised yield volatility climbed to its 90th percentile over the last five years.

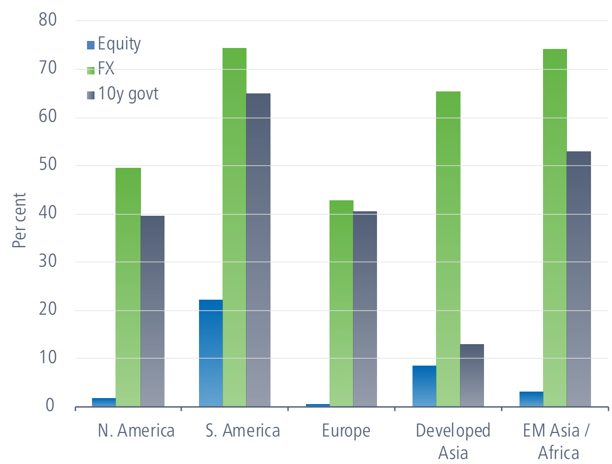
USD FX realised volatility has remained reasonably elevated relative to its five-year history so far this year. Although on the whole less affected than yield volatilities to the pricing out of deflationary outcomes from asset markets, volatility on specific crosses such as the Mexican peso receded from extreme levels. Renminbi volatility rose as the depreciation versus the dollar that had characterised most of last year reversed in the first quarter of 2017.

Figure 131: 60-day volatility on South Korean, US and UK stock indices



Source: Bloomberg, as at 31/03/2017

Figure 132: Cross asset percentiles of 60-day volatility by region



Source: Bloomberg, as at 31/03/2017

Equity market volatility around the world sank in the first few months of 2017. In Asia the Shanghai Composite fell to its lowest 60-day realised volatility since 1992, whilst the Kospi 200 in South Korea sank to its lowest on record. In Europe the FTSE and Eurostoxx recorded their lowest 60-day realised volatilities since the global financial crisis, whilst in the US, S&P 500 volatility fell to its lowest since 1995 and on the Nasdaq Composite since 1989. This was not a widely-predicted outcome at the start of the year, although with hindsight much of the determining factors were already in place.

The collapse of US equity realised volatility can be attributed to the confluence of a number of factors, both macro and technical, and this (as is traditionally the case) exerted an outsized calming influence on the volatility of other global equity indices. Firstly, much of last year was characterised by a stable and increasingly positive global growth outlook and this has continued into 2017. Importantly, the recognition that China had changed focus early last year to support growth through enhanced credit expansion removed one of the perceived tail risks to global equity investing that had most concerned market participants. Then followed the election of Trump and the potential fiscal loosening his election represents, which increased the upside case for the already brightening recovery in the US and accelerated the pricing out of the deflationary mind-set that had gripped parts of the market for so long.

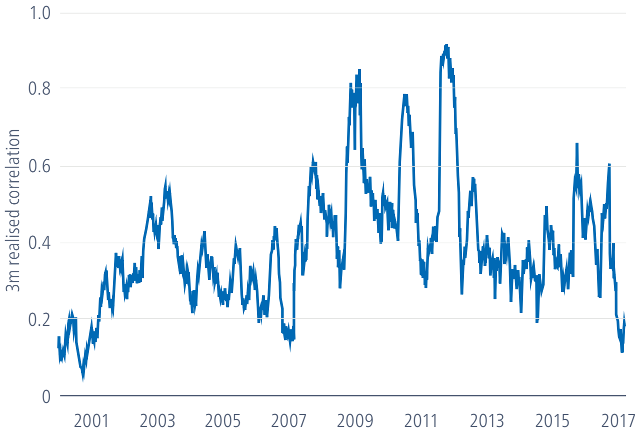
The collapse of US equity realised volatility can be attributed to the confluence of a number of factors, both macro and technical

As well as providing a further strong narrative for equity investment in the US, this also prompted a sharp market rotation that created a collapse in sector correlations, as investors quickly shifted out of defensive and "bond proxy" equities and into pro-cyclical sectors. By mid-February three-month realised correlation on the S&P 500 had fallen to its lowest level since the dot-com bubble burst at the beginning of the millennium (Figure 133). It was this that caused the final death knell to realised volatility, since although the index was steadily appreciating, it was unable to move violently in any direction whilst the individual stocks that constituted it were exhibiting such extreme levels of dispersion.

By mid-February three-month realised correlation on the S&P 500 had fallen to its lowest level since the dot-com bubble burst at the beginning of the millennium

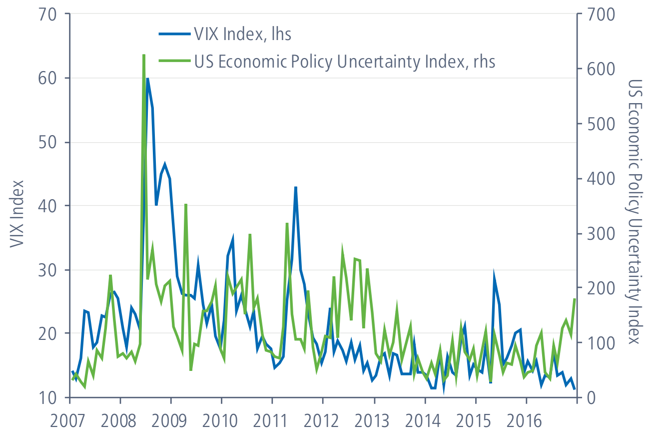
There are also more nuanced factors potentially at play that may have also contributed to such low levels of volatility. Among them is the investor psychology that has arguably taken hold, whereby such a prolonged period of decent positive low volatility returns such as those we have witnessed on the S&P 500 becomes ingrained in market behaviour. As the Sharpe Ratio steadily grows, it perpetuates the "buy the dip" mentality that was so successfully first instilled by successive Fed QE programmes over recent years. This can be evidenced at the moment by decomposing equity market returns into up and down daily returns. Doing so shows a lower two-month realised volatility and correlation on down days as

Figure 133: S&P 500 3m realised correlation



Source: Barcaplive, as at 31/03/2017

Figure 134: Economic Policy Uncertainty Index vs VIX



Source: Bloomberg, as at 31/03/2017

opposed to up days, suggesting that investors have been using the relatively fewer days of market weakness to add to favoured single stock exposures.

Can the low volatility backdrop continue throughout 2017?

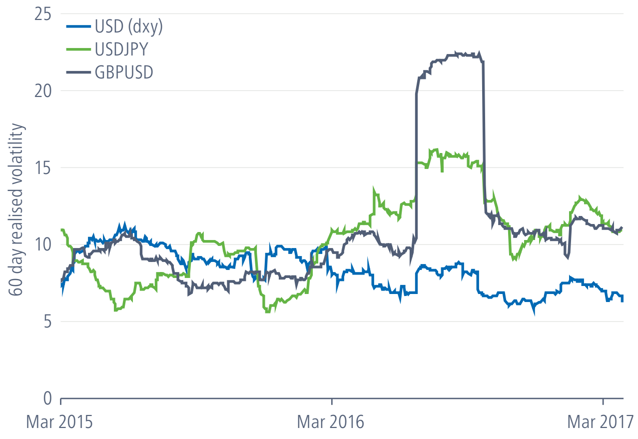
As we look towards Q2, the burning question is whether such depressed levels of equity volatility are here to stay. It seems possible that, absent any exogenous "black swan" shocks and as long as the growth outlook remains positive and the "Trumpflation" narrative remains intact, the status quo can endure. This is given weight by the additional fuel that is potentially available to sustain the equity rally if our central case House View were to play out - i.e. that the strengthening US economy will support the rotation from bonds to equities over the near term. However, with US equity markets at increasingly high valuations on an historic basis, a rising discount rate and still a large amount of uncertainty over the details of the fiscal policy that has driven sentiment to elevated levels (Figure 134), it would be far too early to suggest that such low levels of volatility can be maintained for several quarters ahead. Indeed with the cost of insurance so low in certain areas and payoffs increasingly asymmetric, it is looking prudent to own some regardless.

Comparatively however, and still caveated with the same positive growth outlook, it seems feasible that US rates volatility might rise before US equity volatility in quarters ahead under our central House View scenario. Although short-dated realised volatility is not as historically depressed as with equities, a macro backdrop supportive of the reallocation of bonds into equities is likely to deliver greater rates volatility against a backdrop of higher yields and steepening curves. Central banks in Europe and Japan are expected to remain accommodative throughout the next few quarters however, which will contain yield volatilities in these regions and especially so in Japan where we expect Yield Curve Control (YCC) to be maintained. Without these ongoing ECB and BOJ programmes the up-side risks to yield volatilities would be amplified.

Caveated with the same positive growth outlook, it seems feasible that US rates volatility might rise before US equity volatility

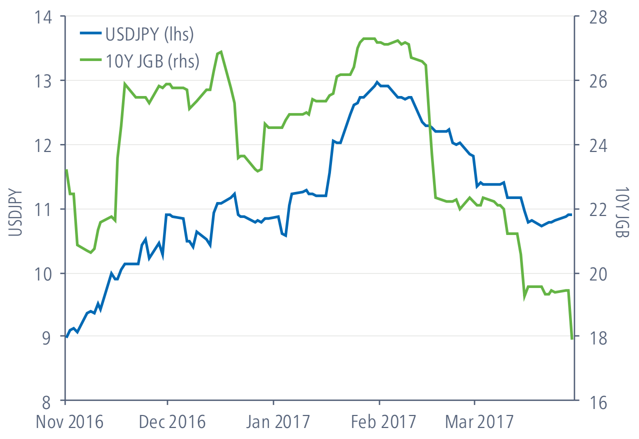
FX volatility remains reasonably elevated relative to equities and bonds and also to its five-year history. The political calendar in Europe this year has kept Euro option premiums higher than others and, although not our central case, has the ability to produce outsized volatility if market-unfriendly parties begin polling better in France or Germany in months ahead. Yen volatility has remained elevated on certain crosses since the currency has become the main outlet of market moves in light of YCC. Volatility in the sterling/dollar exchange rate has remained elevated all year relative to its pre-referendum level and this is likely to remain the case looking forward, now that Article 50 has been triggered and as the market works through the future implications of this momentous event. (Figure 135, Figure 136)

Figure 135: Broad USD volatility versus USDJPY and GBPUSD



Source: Bloomberg, as at 31/03/2017

Figure 136: 10y JGB 60 day realised yield volatility versus USDJPY 60 day realised volatility



Source: Bloomberg, as at 31/03/2017

NOTES

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