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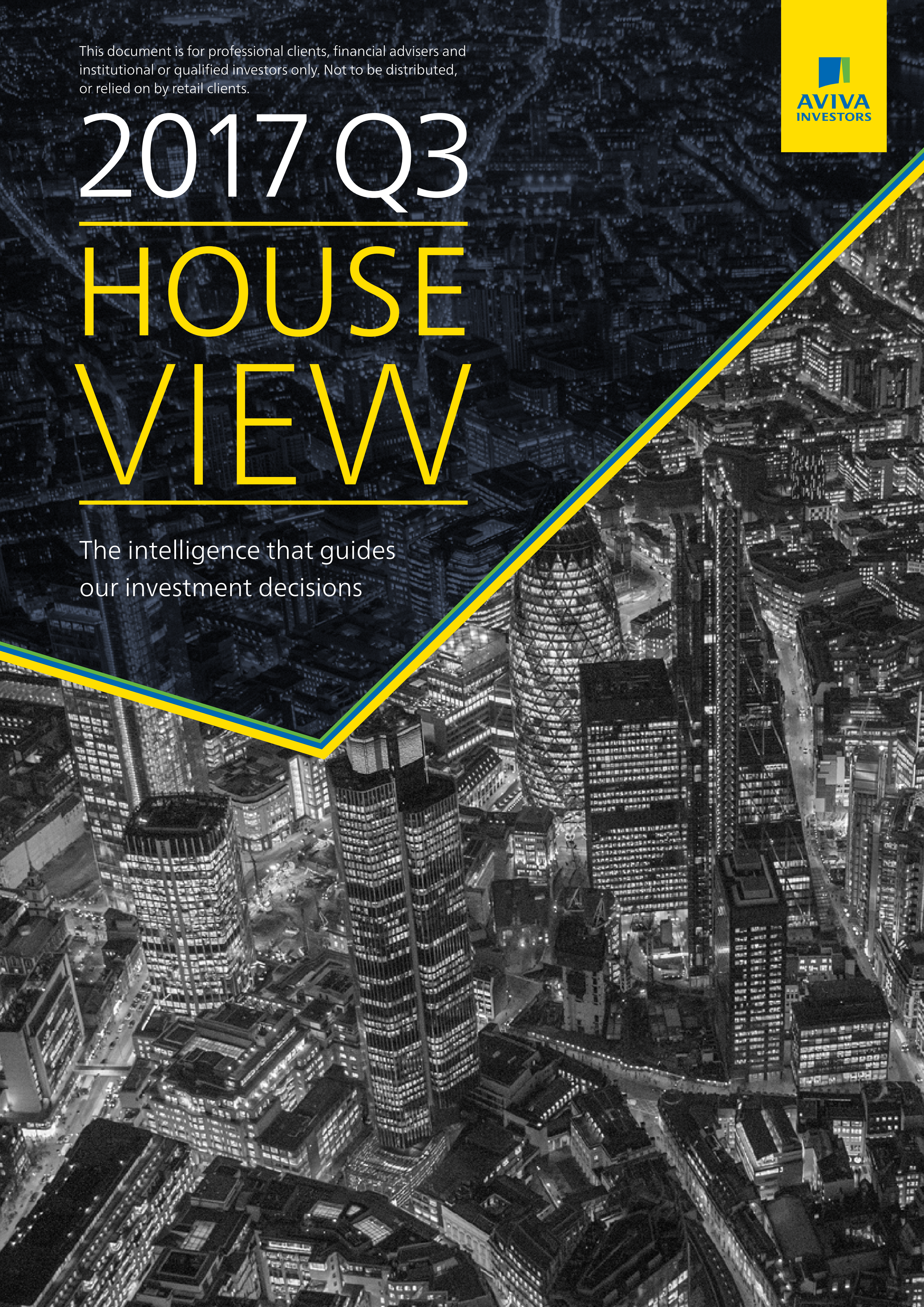
AVIVA INVESTORS

2017 Q3

HOUSE VIEW

The intelligence that guides our investment decisions



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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.

EXECUTIVE SUMMARY

FED UP - BUT THE MOOD IS IMPROVING

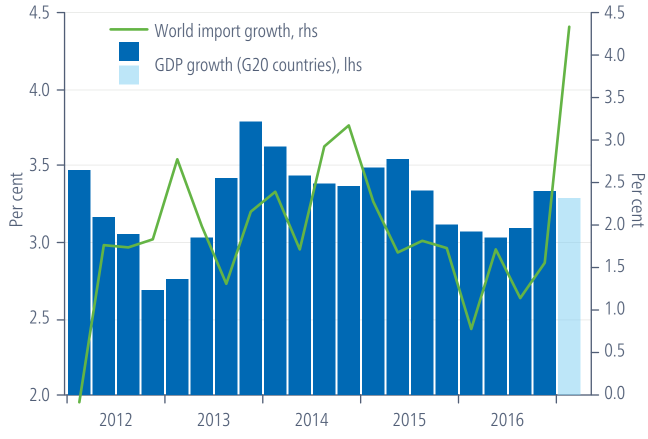
Over the course of 2016 H2 global growth accelerated, led by a broad-based recovery in industrial production. Policy support in China saw increased demand for raw materials, pushing up commodity prices, while the stabilisation in oil prices saw production recover in the United States (US). At the same time the Eurozone recovery picked up pace, encouragingly driven by domestic demand. The broad-based move saw growth for the G20 economies rise to over 3¼ per cent in Q4 (compared to a year ago). The improvement in global growth was followed by an even sharper pickup in global trade, with growth in imports in the year to 2017 Q1 rising at the fastest pace since 2011 (Figure 1). The pace of output and trade growth likely eased somewhat in Q1, with both China and the US slowing. We expect growth to rebound in the US in Q2, while China is expected to achieve their annual target of around 6.5 per cent this year. Most other major economies saw steady or improved growth in Q1, with the United Kingdom (UK) the major exception. Looking ahead, we continue to expect global growth of around 3.5 per cent this year, the fastest rate of increase since 2011. As ever, there are risks to that outlook. On the downside, the policy support in China may be withdrawn more quickly, weighing both on Chinese growth and emerging market economies more generally. On the upside, the recovery in the Eurozone may accelerate more rapidly, with survey evidence pointing to faster growth over the coming months. Overall we expect to see modestly above trend growth in the major economies (except the UK) this year and think the near-term global growth risks are broadly balanced.

Global growth set to be strongest since 2011

At the same time that global growth accelerated, measures of inflation also began rising (Figure 2). The rapid increase in CPI inflation reflected a stabilisation and subsequent increase in commodity prices during 2016. Core inflation remained low and stable in most major economies, with only the US seeing a steady move higher, albeit to a level still below the Federal Reserve's target. In recent months inflation has stabilised, and in some instances fallen back a little, again reflecting developments in commodity prices alongside stable core inflation. The decline in core inflation in the US has largely reflected a number of temporary factors and should reverse in mid-2018. That said, headline rates of inflation globally are expected to move steadily lower over the coming months as they converge on the somewhat lower rate of core inflation. While the risks of deflation remain much lower than in 2015/16, the risk of a rapid move higher in inflation from here also seems remote. We expect that with above-trend growth in the major economies this year, spare capacity will continue to be steadily eliminated, which should put

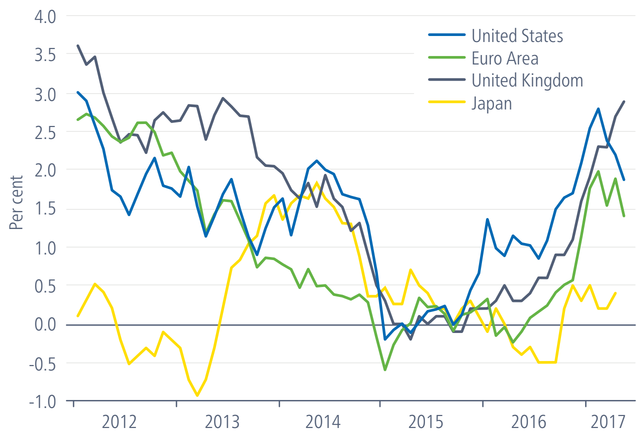
Outlook is for moderate inflation, with core rising steadily over the coming years

Figure 1: Global growth rebounds
Growth accompanied by improved international trade



Sources: Aviva Investors, CPB, IMF, Macrobond, as at 30 June 2017

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



Sources: Aviva Investors, Macrobond, as at 30 June 2017

modest upward pressure on wage growth and core inflation. We expect the US to be more advanced in that process than others, and as such expect the Federal Reserve to continue raising rates, once more in 2017 and three more times in 2018.

INVESTORS DOUBT GLOBAL REFLATION

Positive global activity and inflation surprises have recently reversed on improved expectations and some softer outturns

In the middle of 2016 the median forecast for near-term global growth was subdued. When growth began to accelerate in the second half, the market was taken by surprise. The Citigroup measure of data surprises showed that by early 2017 the positive growth surprises in both developed and emerging market economies were larger than at any time since 2010. At the same time, the positive surprise on inflation was even starker, reaching levels not seen since the oil price shock of 2008. The positive data surprises, alongside expectations of improved future growth and inflation (which were also at least partly driven by expectations of a boost to US and global growth from the policies proposed by President Trump) saw equity markets rally and fixed income sell off. However, as we progressed through the first half of 2017, with forecasts factoring in stronger growth and inflation, they have surprised to the downside. That has been most pronounced in the US (Figure 3).

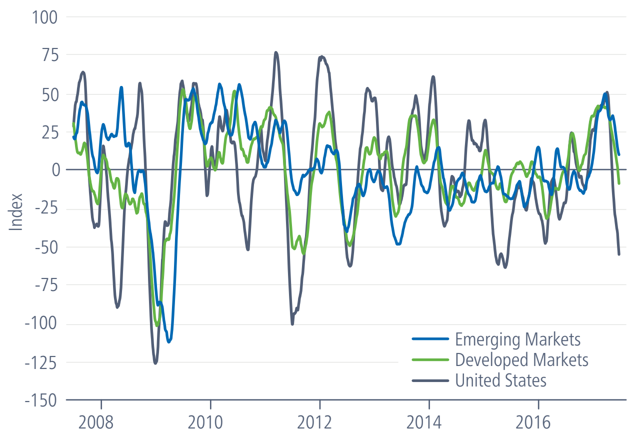
Yields on government bonds have declined in 2017, despite Fed rate hikes. Risks are tilted to higher rates ahead

The weaker than expected activity and inflation outturns have seen longer-term yields retrace (Figure 4), with lower breakeven inflation rates the main contributor. According to data compiled by JP Morgan, flows into bond funds are outpacing last year, and speculative long positions in US Treasuries are at all-time highs. That is despite a second hike in interest rates this year from the Fed, who raised the policy corridor to 1 -1.25 per cent in June, and indicated that they expect to raise rates once more in 2017 and three times in 2018. At the end of June the market had little more than one hike priced over the next three years. Alongside a continuation of rate hikes, the Fed have also indicated they will begin to slowly unwind their holdings of Treasuries and mortgage-backed securities later this year. We expect the benign global environment will continue to be supportive for government bonds, but see the risks tilted to the downside.

Global equity markets have performed strongly, with earnings expectations rising. European and emerging market equities the most attractive

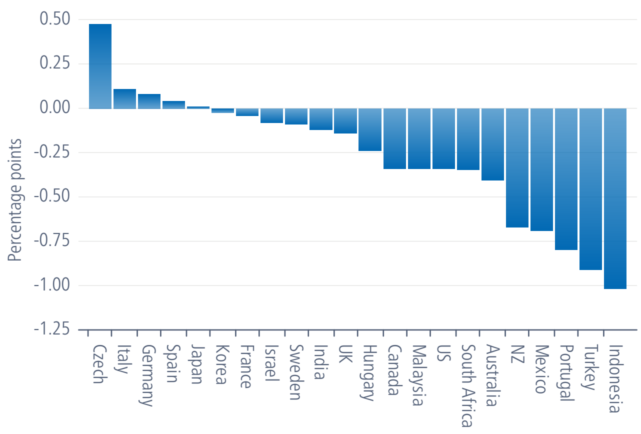
While the bond market has largely unwound much of the initial response to the global reflation theme that developed last year, global equity markets have reached new highs. Indeed, risk assets have performed strongly year-to-date, with emerging market equities leading the way, but closely followed by US and European equities (Figure 5). The rise in equity prices reflect both improved earnings growth, with double-digit year-over-year gains in all major developed markets in Q1, and a positive re-rating. The latter is particularly unusual in a midst of a rate hiking cycle

Figure 3: Data surprises
Positive data surprises have been reversed in recent months



Sources: Aviva Investors, Citigroup, Macrobond, as at 30 June 2017

Figure 4: Global sovereign bond market yields (change YTD)
Yields have mostly fallen this year



Sources: Aviva Investors, Macrobond, as at 30 June 2017

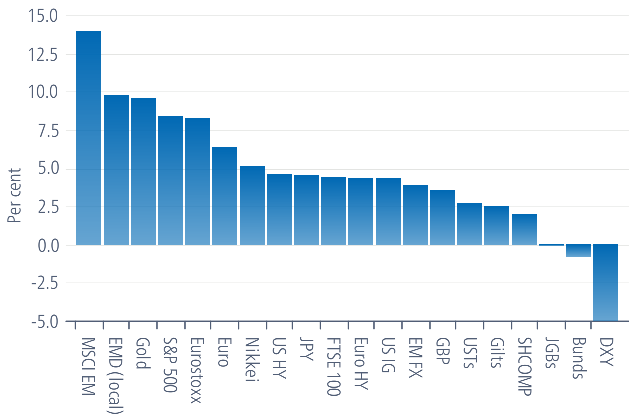
as we have in the US. We think that reflects the excess liquidity in financial markets from previous and current rounds of Quantitative Easing (QE) by central banks and the collapse in both implied and realised market volatility. European equities re-rated on the positive outcome of the French presidential election, but remain more attractive than the US on valuation basis. We also continue to favour emerging market equities on positive earnings outlook and relatively favourable valuation.

Global credit markets have also performed strongly over the past six months. That has reflected an improvement in fundamentals, but also more favourable technical, owing to strong demand from yield-sensitive buyers. With the further narrowing in spreads, credit has become relatively less attractive, with emerging market (EM) debt offering better opportunities. We expect local currency EM debt to continue to benefit from improving fundamentals and carry-supportive environment.

Credit markets have performed strongly on improved fundamentals and technicals. But looking ahead, emerging market debt likely to provide better risk-adjusted returns

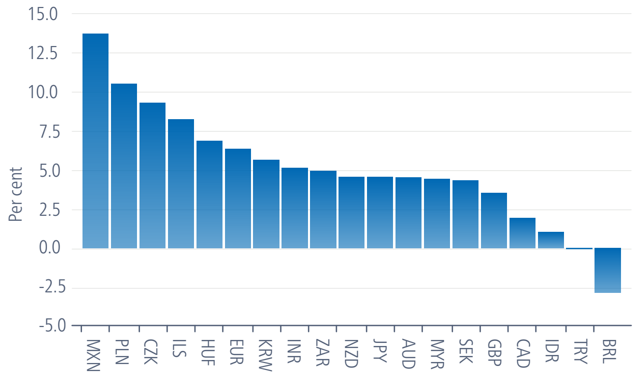
Following the strong performance of the dollar after the US election, this year has seen a reversal, with both EM and G10 currencies rising against the dollar (Figure 6). The most notable performer in recent months has been the euro, which was boosted by positive election outcomes in the Netherlands and France. While the US is the strongest economy, and the Fed is pushing ahead with rate hikes, the decline in the dollar likely reflects a combination of disappointment with the lack of delivery from the Trump administration and positive surprises elsewhere. We expect the dollar to be fairly range-bound in the near-term, with potential for the euro to move modestly higher, but the yen to weaken. We expect positive carry emerging market currencies to continue to perform well in a low volatility environment.

Figure 5: Global market performance YTD
Risk assets have outperformed risk-free



Sources: Aviva Investors, Bloomberg, Macrobond, as at 30 June 2017

Figure 6: Global (spot) currency performance vs US dollar (per cent change YTD)
US dollar weaker across the board



Sources: Aviva Investors, Macrobond, as at 30 June 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 June 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. Expectations of large-scale fiscal stimulus fade
5. Political prioritisation of national over collective interests
6. Opportunistic Chinese reform
7. Peak regulation

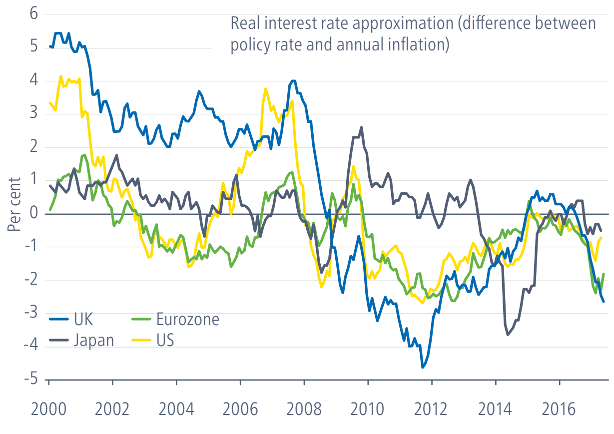
1

Turning point for global monetary policy in sight

After a remarkable decade for monetary policy, we have reached a significant turning point for central banks. With sustainable and broad-based growth entrenched and with the return of more convincingly-positive inflation, the slow removal of extreme stimulus is now becoming appropriate. The Federal Reserve has already raised rates four times. We expect a further hike this year and three more in 2018. This is still an extremely slow pace of tightening by historical standards. The Fed has signalled its intention to continue to raise rates gradually despite a couple of recent softer inflation prints. Financial markets do not believe that the Fed can deliver even this pace of tightening.

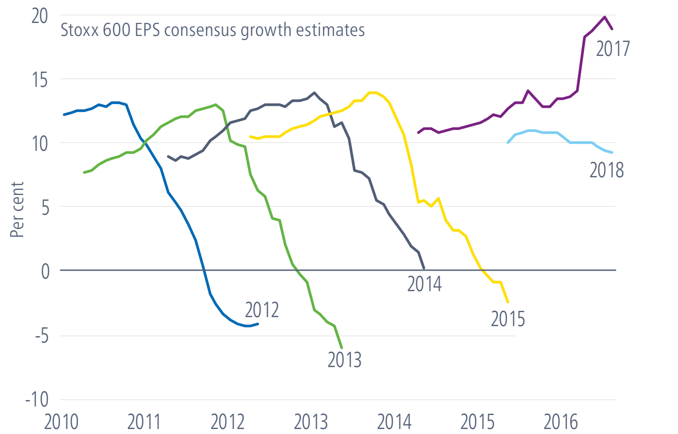
Elsewhere, we are at the end of the line for additional monetary stimulus and are shifting focus to the way in which central banks will exit their present radical stance. The Bank of Japan (BoJ) has indicated they are unlikely to do more, while the European Central Bank (EC) has tapered asset purchases and is publically discussing its exit strategy. Spare capacity in the region means there is plenty of scope for strong but non-inflationary growth, so they can proceed cautiously. Even

Figure 7: Policy rates to go up slowly
But real interest rates are still very low



Sources: Aviva Investors, Macrobond, as at 30 June 2017

Figure 8: Upside surprises for corporate earnings
After four years of disappointment, 2017 surprising to the upside



Sources: BofA Merrill Lynch Global Research, IBES, Datastream, as at 30 June 2017 in the UK, some policy-makers think interest rates should already be higher because of the inflation spike, despite mounting evidence of a growth slowdown. In passing it is worth noting that the return of low but positive inflation means that real policy rates – both actual and anticipated – are still extremely low (Figure 7).

Market outcomes to be increasingly determined by fundamental factors

2

It is generally accepted that QE (and ultra-low interest rates) boosted the prices of many financial assets significantly. Understandably, there are now worries in some quarters that the end of QE and eventual increase in policy interest rates will remove a key support to such assets and result in some disorderly falls. Fortunately, it looks as if asset prices are increasingly being determined by fundamental factors. This is another sign that the global economy is finally moving away from Financial Crisis mode as the outlook becomes brighter. However, that does not mean there will not be some bumps along the way.

Sovereign bond yields had fallen to historic lows because of the Global Financial Crisis (GFC) and the related collapse in GDP growth and inflation (and threat of deflation) and the plunge in policy interest rates. QE added to the downward pressure on yields. As all of these now reverse, yields will have to react. The latest signs are that they are reluctant to do so, largely because of scepticism over whether the recovery is sustainable. But if growth does continue and inflation returns, then central banks will become less accommodative. If the world is truly getting better, markets will have to reassess where the risk free rate is and what the equilibrium real interest rate should be. The latter was probably negative in the GFC, but is now moving higher again. Rising term premia are an inevitable consequence. Meanwhile, equities are responding more to fundamental influences such as earnings growth – as they have done in the recent upbeat earnings seasons for Q1 and Q2 this year (Figure 8).

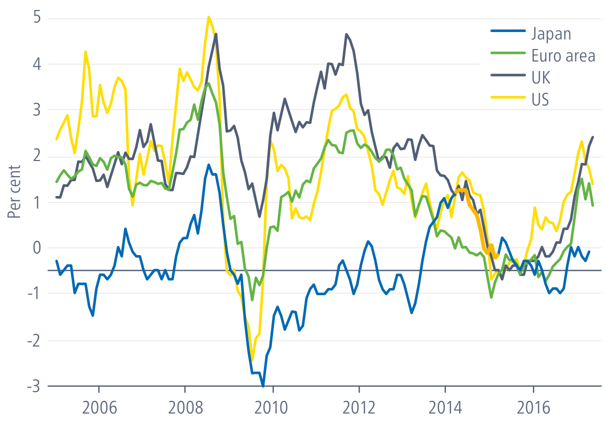
Expectations of sustained inflation

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 (Figure 9). Having risen back close to target in several countries, recent releases have shown modest declines in inflation , casting some doubt on the underlying trend. Inflation expectations, which had also recovered, have retreated in a similar manner, suggesting that markets are sceptical about policy makers' ability to reach inflation objectives (Figure 10). We continue to believe that sustainable, positive inflation is normal and that inflation rates will move back to target in most countries.

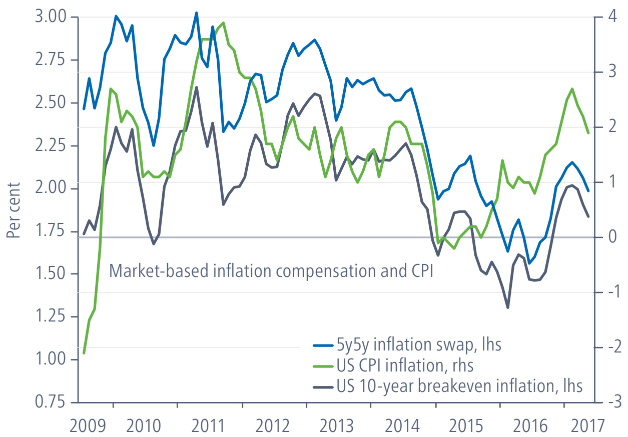
Recent increases in inflation have not been confined to developed economies – the trend has been seen in many emerging nations as well, including China, although

Figure 9: Inflation rising gradually
Headline inflation rates back towards "normal" levels



Sources: Aviva Investors, Macrobond, as at 30 June 2017

Figure 10: Markets sceptical on inflation
Breakeven inflation rates have dipped recently



Sources: Aviva Investors, Macrobond, as at 30 June 2017

the challenge that it has in large part been due to moves in energy and commodity prices is a legitimate one. Core CPI measures are still subdued in many areas, including Europe 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 Expectations of large-scale fiscal stimulus fade

Budget deficits spiralled higher in the GFC. Subsequently austerity measures restored a degree of fiscal discipline, but the legacy of high public debt is still with us. Despite this, there were hopes that governments around the world might take advantage of low interest rates and embark on expansionary fiscal policy to boost sluggish growth. Such hopes are now fading. In the US, the fiscal arena is just one area where the Trump administration has not delivered anything like the extent of change that had been presented during the campaign. It is still reasonable to assume there will some tax cuts and, perhaps, spending initiatives, but they are likely to take longer to be implemented and be on a smaller scale.

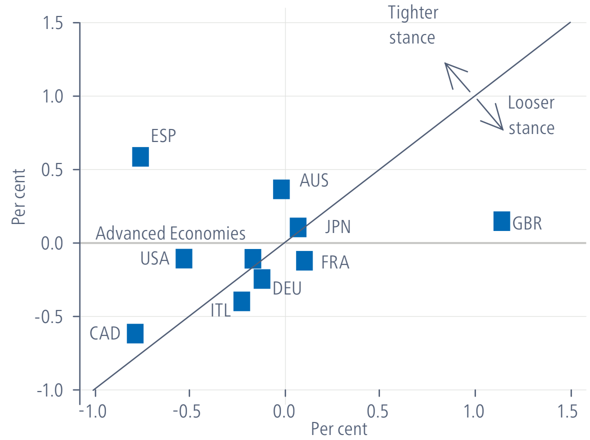
Elsewhere, a fiscal boost is possible in Japan, while in the Eurozone the cyclical upswing has reduced demands (and the need) for fiscal expansion. There is still quite a relaxed approach to deficit limits across the region despite many pushing against or exceeding the 3 per cent deficit limit (Figure 11). If this is adhered to, there is little scope for material fiscal easing overall. The political muddle in the UK suggests a reduced focus on austerity is probable. If growth weakens alarmingly, a fiscal boost should not be ruled out. Finally, China's fiscal deficit target for 2017 is 3 per cent of GDP, unchanged from last year. While they remain on track to achieve their GDP growth objective of 6.5 per cent, this stance is unlikely to change significantly.

5 Political prioritisation of national over collective interests

With Donald Trump as President of the US, the issue of national as opposed to collective interests is unlikely to slip from the headlines for very long. But the first six months of his reign have suggested that the more extreme versions of his populist agenda will be appreciably diluted. Others are being shelved or 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 a number of political hurdles have been cleared, notably in France, where the Macron government has been elected on a pro-reform agenda.

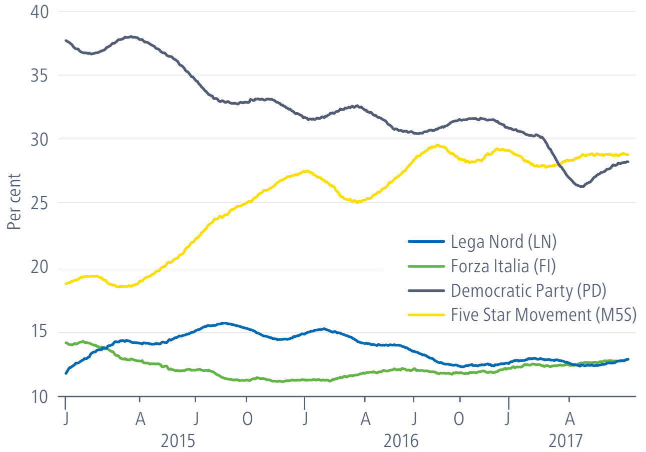
Key elections follow in Germany and Italy. Anxiety levels regarding nationalist and populist movements have retreated significantly, but they have not disappeared (Figure 12). The better economic backdrop as well as clearer signs of increased

Figure 11: Modest fiscal loosening expected
2016 saw boost; smaller stimulus in 2017, 2018



Sources: Aviva Investors, Macrobond, as at 30 June 2017

Figure 12: Five Star ahead in the Italian polls
Protest votes can destabilise Italian government



Sources: Aviva Investors, Macrobond, as at 30 June 2017

harmony between member states, should help prevent narrow-minded nationalism gaining much traction, but there is no room for complacency – in tougher times such worries could swiftly resurface. Finally, although the possibility of a "hard" Brexit may have fallen modestly, the messy election result – as well as the negotiations themselves – has the scope to provide further upsets in the UK and a drift towards greater self-interest.

Opportunistic Chinese reform

6

Policy stimulus in China ensured that growth worries in 2016 were unfounded. The Chinese economy is currently achieving or even exceeding its GDP growth target for 2017 (Figure 13). This has provided an opportunity for the Chinese authorities to take advantage of the benign economic backdrop and address concerns in other areas. In particular they may attempt to tackle excess leverage in key parts of the system and hence prevent the build up of bubbles and other debt-fuelled excesses. The risk is that they miscalculate the degree to which they can reduce leverage and cause a growth undershoot. Should that happen, policy would be swiftly reversed, especially with the key plenum this autumn on the horizon. Stability in the Chinese economy looks assured as long as they can retain control over capital outflows. The opaque nature of Chinese data means that it will be difficult to discern any early warning signs of slowdown.

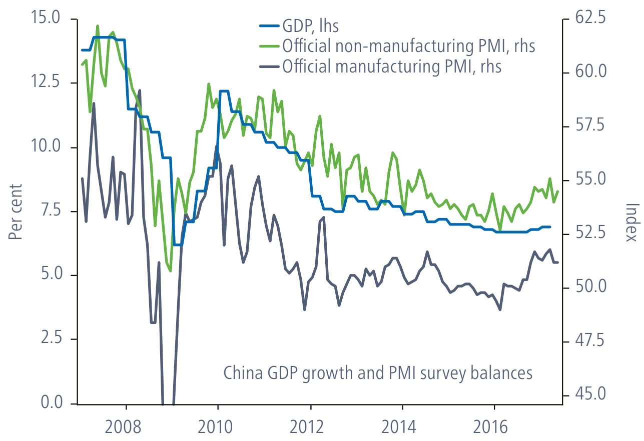
Peak regulation

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 can not 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. Trump may find it easier to push through initiatives in this area as most do not require legislative change. It remains to be seen whether other countries follow this lead. Across Europe there is less interest in a lighter regulatory touch, but there are some signs of a softening of their stance with regard to the final elements of Basel III which are expected to be phased in over the next two years. Lighter regulation could help offset some of the concerns regarding market liquidity.

Figure 13: China achieving 6.5 per cent growth target
Benign backdrop provides room to initiate reforms



Sources: Aviva Investors, Macrobond, as at 30 June 2017

RISKS TO THE HOUSE VIEW

ACCELERATION IN NATIONALIST AGENDA

Risks of trade restraint and protectionism still present

The risks of damaging trade protectionism measures and subsequent reprisals have reduced somewhat, partly because the Trump administration has back-tracked on a range of pre-election proposals and has been more conciliatory on some elements of international relations. But the theme of greater insularity is common to many nations and the risk of trade restraint is still present (Figure 14). If Trump does not get his way on domestic policy, he could easily return to this arena with the "America First" agenda. All accounts of the 1930s report the lasting damage caused by such an approach, but that doesn't mean we can't re-visit it. Brexit could have important and damaging trade ramifications.

SECULAR STAGNATION – LOW GROWTH, LOW RETURNS

Low growth still a concern, partly because of excess savings

Although global growth has continued to pick up slowly, it has not been entirely convincing (despite a very favourable policy backdrop). Any setbacks or pauses are inevitably going to be characterised by some as evidence that we are living in a secular, low-growth world. 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.

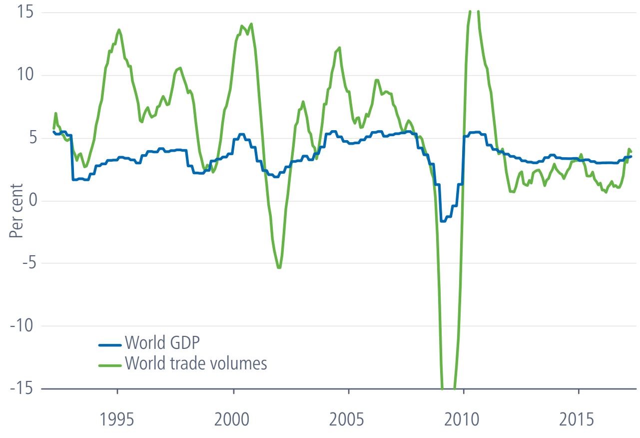
CHINA GROWTH SLOWDOWN

China's transition continues - rare for this to be a smooth process

China is becoming an increasingly important player on the world stage so any slowdown in growth will have global ramifications (Figure 15). This is different from the accepted and inevitable gradual reduction in China's potential pace of growth as a result of demographic change and economic development. As China transitions from an economy based on manufacturing and exports to one where services and consumption are the main drivers, there is always a risk of shocks, especially when activities are so tightly controlled by authorities who have little experience in such matters. There are well-documented imbalances in the Chinese economy and it is rare for a country to develop fully without bumps along the way.

Figure 14: World trade growth now matches world GDP growth

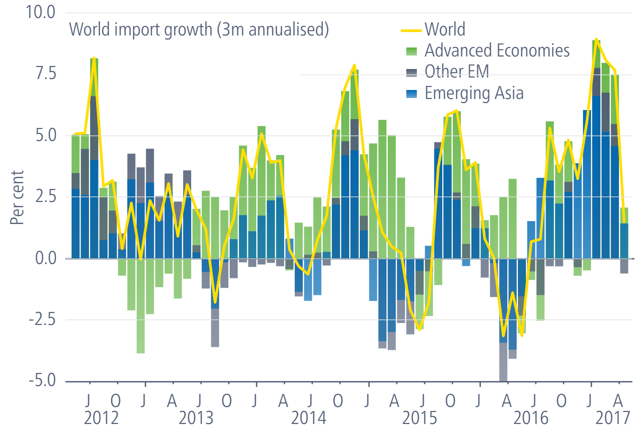
Greater protectionism would push it lower again, hurting all



Sources: Aviva Investors, Macrobond, as at 30 June 2017

Figure 15: Any China slowdown would impact global trade

Intra-Asian trade flows are very important



Sources: Aviva Investors, Macrobond, as at 30 June 2017

ACTIVE FED TIGHTENING

The latest inflation releases in the US have led some to believe that the Fed may be being too aggressive with its intended rate rises. Notwithstanding that the current hiking cycle is the slowest in the post-war period, the latest data may be little more than statistical noise in an upward trend. If inflation were to resume that trend, markets are ill-prepared for an environment where inflation is the main concern and where pressure grows for the Fed to accelerate its tightening schedule (Figure 16). This not implausible scenario could lead to some wrenching adjustments in sovereign bond and other financial markets.

Markets ill-prepared even for Fed's current pace of tightening

DEBT DE-LEVERAGING VULNERABILITIES

The low interest rates that have prevailed since the nadir of the GFC have, unsurprisingly, encouraged widespread borrowing that has taken debt to unprecedentedly high levels in many areas across the public and private sectors. As and when interest rates rise from these emergency levels, there are justifiable concerns that some holders of these liabilities will suffer and not be able to service their debts. The higher interest rates go, the greater the vulnerability. There are many potential areas of stress. US corporates, for example, have exceptionally high leverage by historical standards. Any pressures would be worse if the Fed had to tighten aggressively.

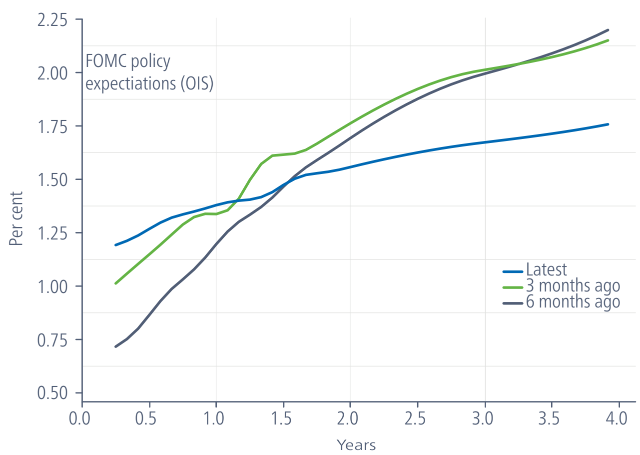
Debt levels high and interest rates are rising slowly

EUROPEAN CONVERGENCE

The political landscape in Europe is changing. Three months ago political worries dominated thinking. After the French election result, the pro-reform and relatively baggage-free Macron administration could represent the launch-pad to a fresh wave of pro-integration initiatives across the Eurozone. The key Franco-German axis has been revitalised and conditions could hardly be better for making further progress on European convergence and integration. Of course the key is in the delivery and the Eurozone has a chequered history here, but the encouraging election results and the unity shown in response to Brexit suggest that there are, for once, upside risks in the region (Figure 17).

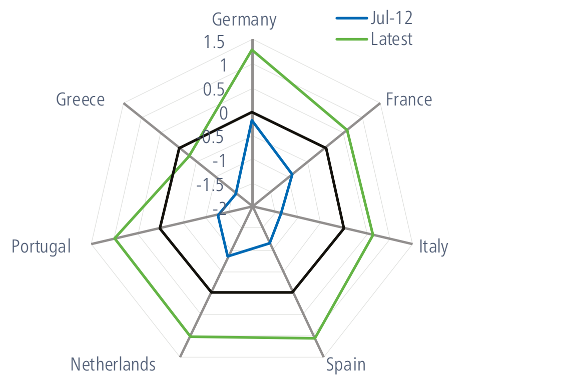
Upside risks to growth in the Eurozone?

Figure 16: Markets have reined back on rate expectations
A more aggressive Fed would be a shock to many



Sources: Aviva Investors, Macrobond, as at 30 June 2017

Figure 17: Eurozone business surveys very upbeat
Only Greece still subdued; all others doing well or very well



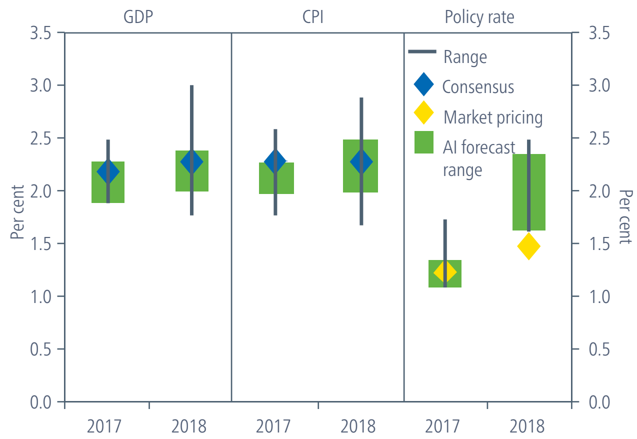
Sources: Aviva Investors, Macrobond, as at 30 June 2017

Each survey has been normalised to have a mean of zero and standard deviation of one (since 2000). Each septagon in the radar chart represents one standard deviation, with the long-run average at zero.

MACRO FORECASTS CHARTS AND COMMENTARY

We expect a return to solid growth in Q2 and beyond after yet another suspiciously-low reading for Q1. The US economy continues to look robust, with the labour market reporting steady jobs gains and ever-lower unemployment, while there are tentative signs of a recovery in business investment too. The recent weaker inflation prints should prove temporary, allowing the Fed to continue on its planned hiking schedule of one more rise this year and a further three in 2018. Financial markets are sceptical that they can deliver this much.

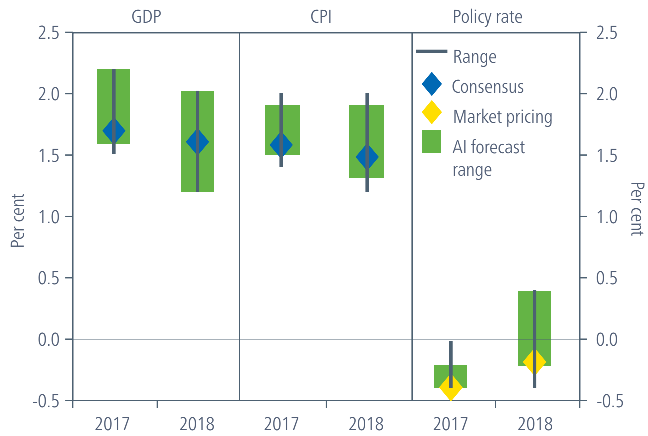
Figure 18: US



Source: Bloomberg, Aviva Investors, as at 30 June 2017

Political worries have diminished markedly in 2017 while the economic recovery has continued and, if anything, strengthened, led by domestic demand. Surveys continue to point to above-trend growth, although hard data has lagged slightly. The ECB is inching towards an exit from extreme policy stimulus but remains cautious, largely because of stubbornly subdued inflation. Tapering may be announced later this year, but rate hikes are a story for 2018.

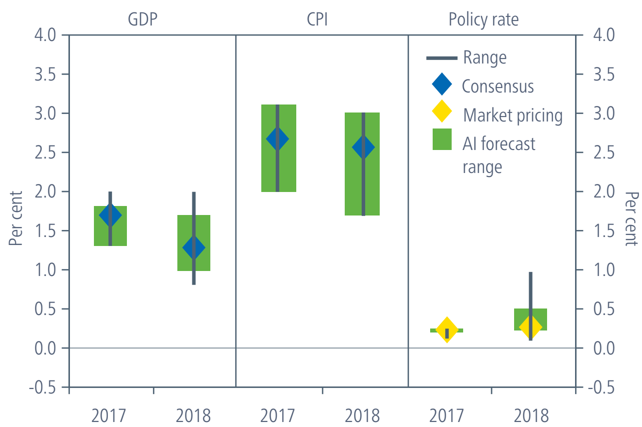
Figure 19: Eurozone



Source: Bloomberg, Aviva Investors, as at 30 June 2017

Having remained resilient in the year following the referendum result, some cracks are now starting to show in the UK economic outlook. Growth slowed alarmingly in Q1, led by weaker consumer spending as higher inflation hit real incomes. Q2 does not look much better according to reliable leading indicators. The unhappy mood is being compounded by the political mess of a hung parliament and the beginning of Brexit negotiations. Inflation may peak soon, but growth is slowing and the Bank of England (BoE) should resist calls for higher rates.

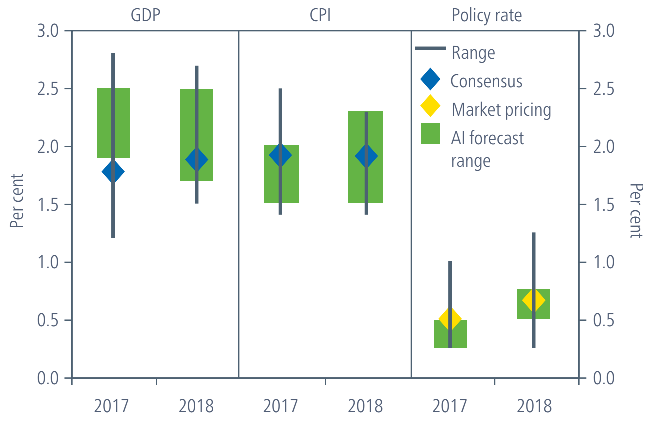
Figure 20: UK



Source: Bloomberg, Aviva Investors, as at 30 June 2017

Canada has revived swiftly following the earlier energy-related weakness, growing at an annualised pace of more than 3 per cent since the middle of last year. Growth has been led by household spending and has been partly funded by reductions in saving. This, together with growing evidence of an overheating housing market (e.g. Toronto), has led the Bank of Canada to adopt a more hawkish tone, clearly hinting at the likelihood of rate rises in the near future. On an underlying basis, however, inflationary pressure is quite muted.

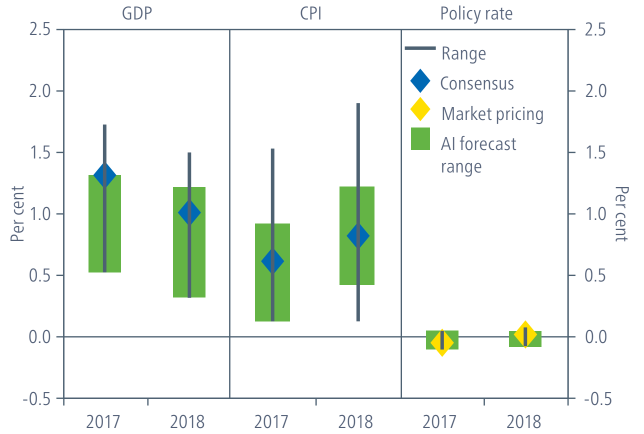
Figure 21: Canada



Source: Bloomberg, Aviva Investors, as at 30 June 2017

Growth remains lacklustre in Japan, but is at least positive. Exports have been a valuable contributor despite the stronger yen in the first half of this year. A weaker currency and/or a continued pick up in global trade flows would help, while a further modest fiscal boost should not be ruled out. It is estimated that the output gap has now closed, implying that above-trend growth should help push inflation a little higher. So far the perennial problem of weak wage growth has continued, supporting the view that low inflation will be an ongoing problem in Japan.

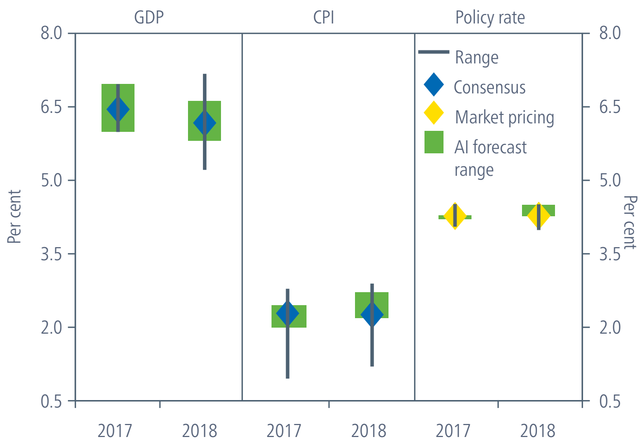
Figure 22: Japan



Source: Bloomberg, Aviva Investors, as at 30 June 2017

There has been no repeat of 2016's growth scare so far this year. China should comfortably achieve its growth target of 6.5 per cent in 2017 and the authorities may take advantage of the benign macroeconomic backdrop to embark on reforms in key areas as they attempt to resume China's transition to a more open, market economy. As long as there are no nasty shocks, external or internal, then this slow process can continue. For now, trade remains of critical importance, with strong demand from Europe and the US adding to vigorous intra-Asian flows.

Figure 23: China



Source: Bloomberg, Aviva Investors, as at 30 June 2017

GLOBAL MACRO OUTLOOK AND ASSET ALLOCATION

GEARING TO THE NEW NORMAL

– Sustained improvement in global growth and slowly rising inflation signal a turn in monetary policy

– Low volatility regime to persist, lower cross-asset correlation first step of market normalisation

– Duration is going to be challenged; Eurozone equities and emerging market local currency debt preferred assets

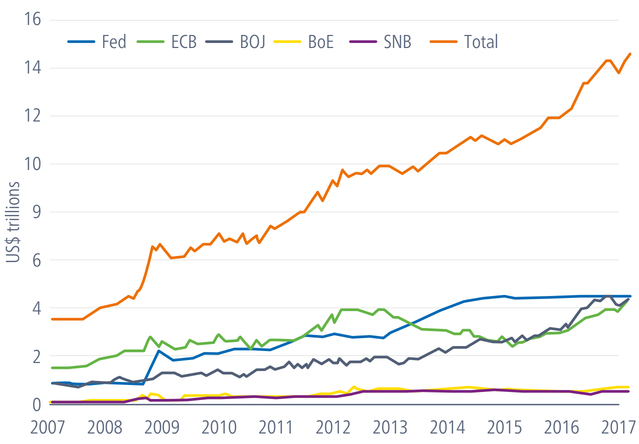
More hawkish tone from central banks

As the global expansion has become more broadly established and accepted, central banks have started to sound slightly more hawkish. The fundamental picture has indeed improved and we expect 3.5 per cent global GDP growth this year. Inflation has also been slowly rising. The example of Eurozone is striking, now growing above potential, with deflation fears gone and the ECB openly talking about exit strategy through further tapering and ultimately rate hikes. One area of monetary policy we think is important is balance sheet management. Major central banks are now running a staggering $14 trillion balance sheet (Figure 24). If the US Federal Reserve starts balance sheet reduction next quarter as we believe, the market should acknowledge that a major turning point in global monetary policy has been reached. It is worth noting that these developments are more synchronised than a few quarters ago, both in terms of fundamentals and monetary policy evolution. There will be different starting points and pace of change, but crucially the direction is now the same.

Financial stability affecting central bank policy too

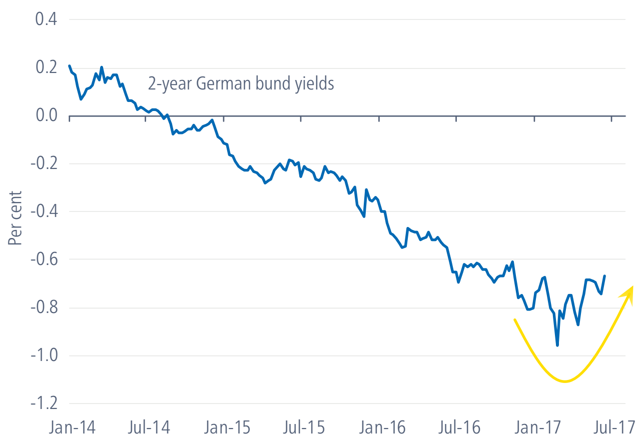
We continue to expect one more rate hike from the Federal Reserve this year as well as very gradual balance sheet reduction starting in the third quarter of this year. We think the Bank of Japan will remain on hold while the ECB is moving towards the exit, expected to announce further tapering this year and deliver rate hikes next (Figure 25). We also note that monetary policy hawkishness is not always driven by inflation as we see in Australia or Canada where financial stability concerns seem to take the lead. Even at the Bank of England, and against the Brexit backdrop, some are stressing the longer-term risks of keeping policy too loose and are arguing for higher interest rates now.

Figure 24: Central banks' ballooning balance sheets



Sources: Macrobond, Datastream, SNB & Aviva Investors, as at 30 June 2017

Figure 25: ECB talking exit strategy reflected in the short end



Sources: Aviva Investors, Bloomberg, as at 30 June 2017

The volatility regime remains suppressed across asset classes (Figure 26). However, it seems likely that volatility will remain muted during the rest of the year provided that our central scenario prevails. Part of the market normalisation theme is that tail risk events do not always trigger a correlated market response. It seems more feasible that volatility may appear in rates markets rather than equity markets because of this and given the upside risks that we feel there is to the Federal Reserve reaction function which isn't fully appreciated by the market.

Markets are slowly integrating the idea of normalisation

While market operators are focusing on the low volatility regime, we prefer to look at the correlation matrix. Significant changes are happening on this front. We highlighted in previous quarters the collapse in global cross asset correlations. We continue to look at the rise in return dispersion as a key part of the ongoing market normalisation process. While the equity to bond correlation has moved sharply lower, we also see signs of changing correlations within equities. One key example is the correlation of emerging market to developed market equities which has moved significantly (Figure 27).

Fundamentals matter again

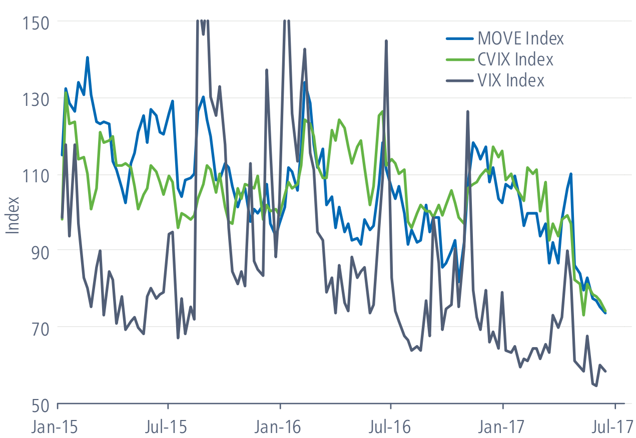
Looking forward, investors will have to pay much more attention to fundamentals as the impact of central bank stimulus fades. While it remains to be seen how individual central banks handle the process, it seems likely the majority – at least initially – will wish to remove monetary stimulus in a gradual fashion. This environment argues for retaining significant equity exposure. As fundamentals matter again, rising dispersion (i.e. lower correlations) also mean that asset allocation matters more than in the past in terms of alpha generation.

Higher term premia and steeper curves

Upward pressure on government bond yields from the improving macroeconomic backdrop will be further supported by the continuing withdrawal of purchases of such assets by central banks. Our central scenario points to higher term premia and steeper yield curves. European core sovereign bonds and Japanese bonds look the most expensive and we maintain our strong underweight position. We keep duration exposure in US treasuries to balance our aggressive positioning in equities. Should the volatility regime grind higher, rates volatility is likely to rise before equity volatility.

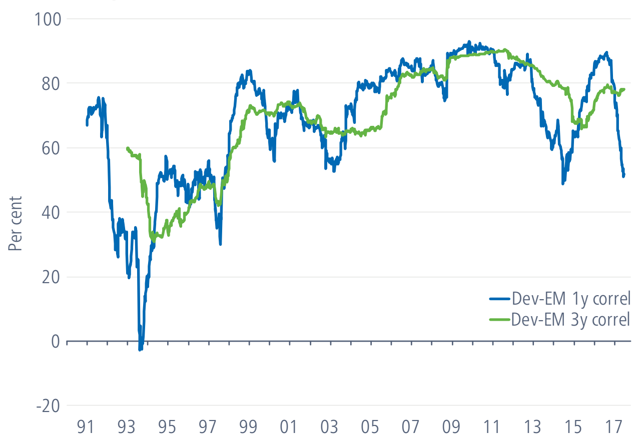
Corporate bonds may find it difficult to avoid the fallout from higher government bond yields, especially if volatility were to pick up in fixed income markets as global QE is withdrawn. Higher volatility is often accompanied by wider credit spreads. However, there are reasons to believe that spreads will not widen significantly and could even narrow because of supportive fundamental and technical factors. Supply looks set to shrink as the financial engineering of recent years begins to unwind (e.g. debt issuance to finance share buybacks). Meanwhile, faster economic growth should boost profits, in turn leading to a general strengthening of balance sheets and reduced default rates.

Figure 26: A low volatility regime across asset classes



Sources: Aviva Investors, Bloomberg, as at 30 June 2017

Figure 27: Correlation of EM equities vs Developed market equities



Sources: Aviva Investors, Bloomberg, as at 30 June 2017

It is quite striking to look at the implied correlation within European Credit versus the correlation within the European equity market. The former exhibits very low dispersion (i.e. high correlation) which might be a consequence of ECB QE (Figure 28). EM debt in local currency continues to look attractive and is preferred to hard currency EM bonds on valuation grounds. Gradual tightening from the Federal Reserve should not be a headwind as this is compensated by domestic improvements in EM. We continue to expect that while China could push the reform agenda opportunistically, growth will remain in line within the 3-year objective of 6.5 per cent. A China hard landing remains the key downside risk for the asset class, as is an aggressive Federal Reserve hiking much faster than expected.

Equities look more attractive than most sovereign bonds

While it seems certain bonds are going to struggle, equities could do better than many expect as QE is unwound. It looks as if the 'Great Rotation' may at long last be about to get under way. Although history suggests that equities tend to suffer once interest rates rise above four per cent, rates are currently so low that tighter monetary policy appears to present little threat. For the time being, the likely improvement in economic fundamentals should outweigh the impact of higher interest rates, leading to a growing number of investors switching out of bonds and into equities.

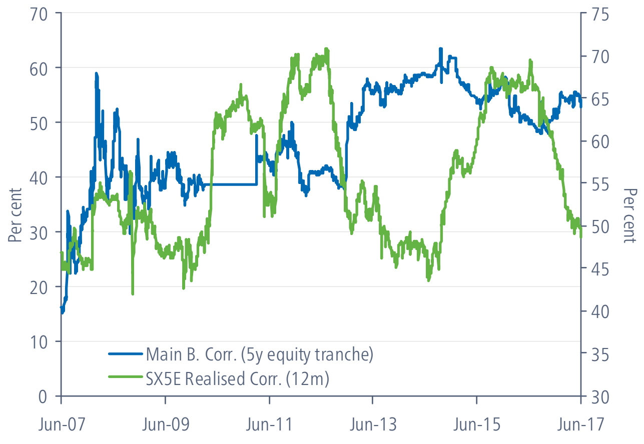
We upgrade Eurozone equities to maximum overweight given the earnings outlook, strength in the underlying economy and renewed political momentum in the Eurozone. We are also overweight EM equities as we still find valuations very attractive and the central scenario of a gradual tightening from the Federal Reserve to be benign for the asset class given its sensitivity to global growth. The first quarter earnings season has globally been very strong, suggesting that the improvement in the economy is real and lasting. Also, the upside risk of European convergence following the French election could lead to higher potential growth going forward. UK equities remain an underweight, as is sterling given the uncertainty of Brexit. Within sectors, we would expect growth and cyclical stocks to outperform income, reversing the trend of recent years. For example, we would expect financials to outperform broad equity markets, supported by rising yields (Figure 29).

The global monetary experiment of the last decade is coming to an end. Whereas in recent years it has been sufficient to focus on liquidity and technical factors, going forward it seems fundamentals will reassert themselves as we gear to market normalisation.

Gearing to the new normal

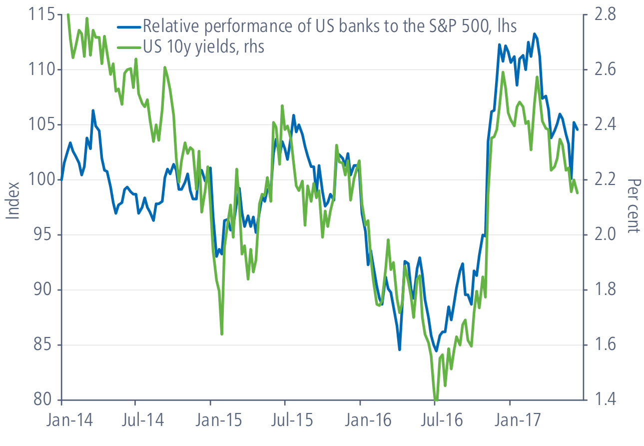
The 'risk-on, risk-off' approach that was dominant in the highly-correlated world of recent years is unlikely to prove as profitable in the future as the correlations between and within asset classes break down. Nevertheless, there should still be plenty of opportunities for investors who correctly assess fundamental factors, rather than merely rely on the actions of central banks.

Figure 28: Equities are pricing low intra-correlation vs credit



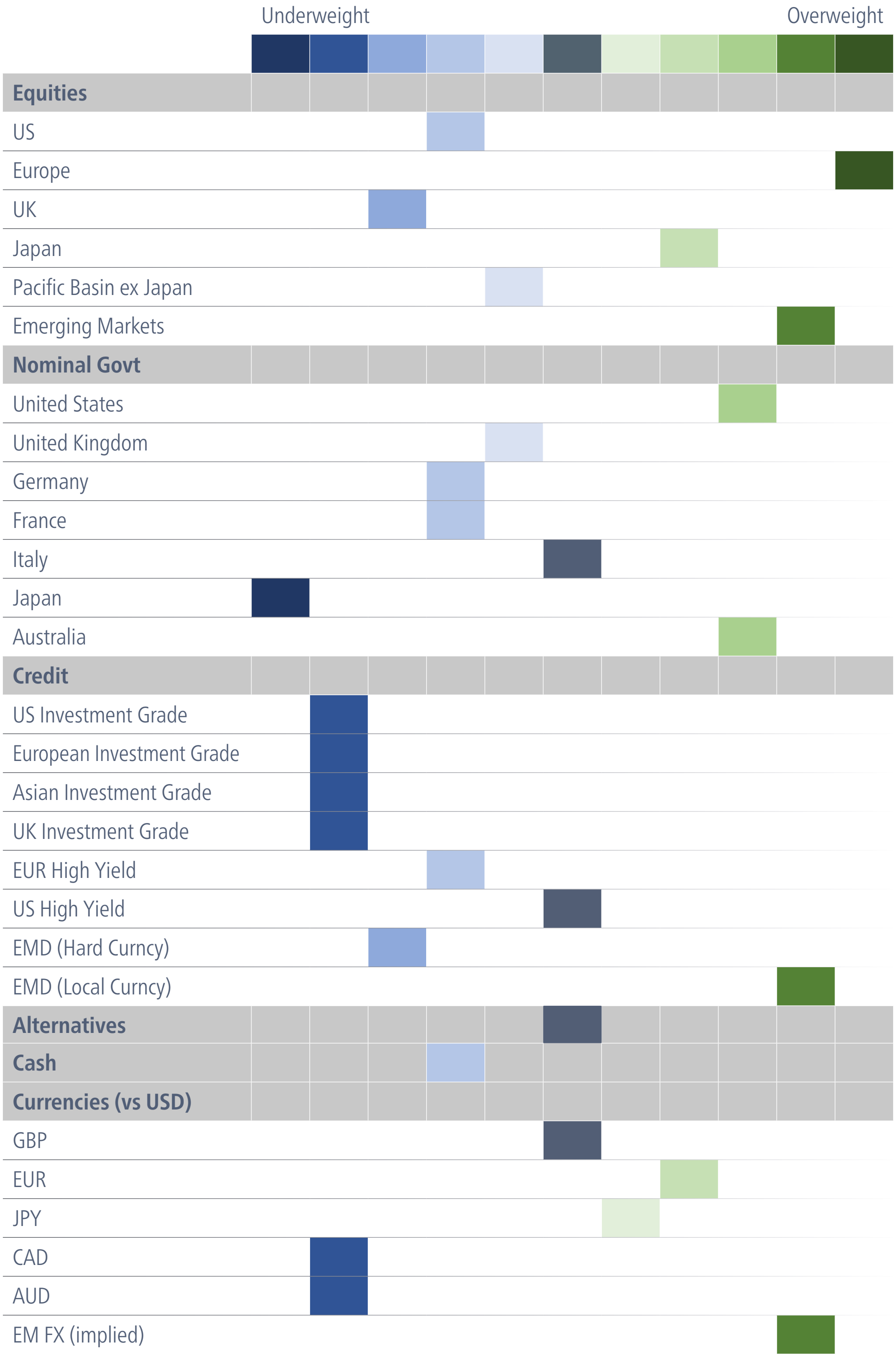
Sources: Aviva Investors, Bloomberg, Goldman Sachs, as at 30 June 2017

Figure 29: Financials should outperform the broad market as yields head higher



Sources: Aviva Investors, Bloomberg, as at 30 June 2017

Figure 30: Asset Allocation



Sources: Aviva Investors, as at 30 June 2017

ESG INSIGHT

CAN THE GLOBAL CLIMATE ACCORD SURVIVE WITHOUT THE UNITED STATES?

Retreating from the climate accord was a key campaign pledge

In an expected, but deeply disappointing move, President Trump fulfilled a long-standing campaign promise by announcing the withdrawal of the United States from the Paris Climate Accord. Under the mantra of 'America First', President Trump cited the detrimental impact that the Paris Agreement would have on US jobs, and the importance of wresting back sovereignty to protect US industry and trade.

Withdrawal will take a minimum of four years to come into effect

The drama surrounding the US decision will likely be enacted in slow motion as the terms of Article 28 of the Paris Accord means that the earliest possible withdrawal of the US will be November 2020 (coinciding with the next US presidential election). However, in the intervening period the US administration will be free to determine their energy and climate strategy as despite President Trump's protestations over the loss of sovereignty, the Paris Accord is a voluntary agreement, designed to shame rather than legally bind signatories into action.

US WITHDRAWAL IS SIGNIFICANT BUT NOT FATAL

The US is responsible for almost a third of the excess CO2 that is heating the planet

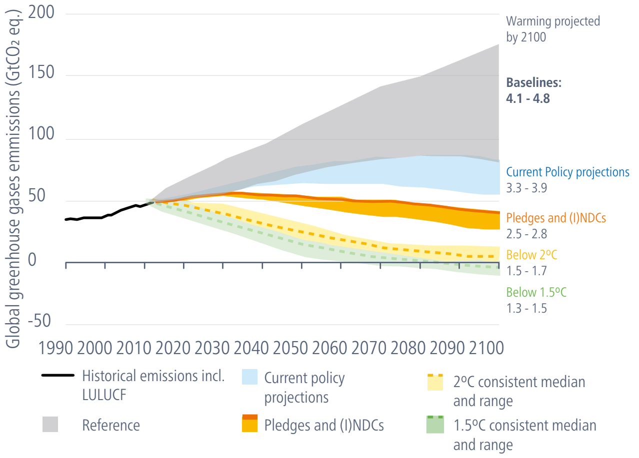
In 2015 the Obama administration was amongst the first five countries to submit a formal climate pledge, and its leadership was considered vital in encouraging the remaining 190 signatories to the Paris Accord to follow suit. As the world's second largest emitter of carbon, the reversal of policy commitments to reduce emissions by 26-28 per cent below 2005 levels is a devastating blow to the Paris objectives. However, beyond the US's own emissions and expected shortfall in contributions to the Green Climate Fund, the most significant impact may be on the diminished appetite of other countries to adopt more progressive reduction targets.

Existing global commitments will significantly overshoot the 2 degree target

According to the United Nations Framework Convention on Climate Change (UNFCCC), the aggregate of all climate pledges has the capacity to limit temperature rises to 2.7 degree Celsius at best, far exceeding the 'below 2 degree Celsius' objective (Figure 31). Therefore, the Paris Accord was fundamentally premised on the expectation that Nationally Determined Contributions (NDCs) would be significantly ratcheted up over time. However, the United States decision to join Syria and Nicaragua as the only countries outside of the Paris Accord, will possibly weaken the prospect of sufficient ratcheting of targets, particularly amongst developing countries.

Although the US decision is unquestionably a setback, there are four key factors which have the propensity to keep the global transition towards a low-carbon economy on track.

Figure 31: Projected CO_2 emissions under various policy scenarios



Source: Climate Action Tracker, as at 30 June 2017

Figure 32: Top 10 Global Emitters of CO_2

Rank	Country	Share of global CO_2 emissions
1	China	23.43%
2	US	14.69%
3	India	5.70%
4	Russian Federation	4.87%
5	Brazil	4.17%
6	Japan	3.61%
7	Indonesia	2.31%
8	Germany	2.23%
9	Korea	1.75%
10	Canada	1.57%

Sources: World Atlas (2017)

ALTERNATIVE POLITICAL LEADERSHIP

US-China leadership was crucial to how the Paris agreement originally took shape. The 2014 joint statement on climate change from Obama and Xi Jinping was considered a watershed moment. However, in the immediate aftermath of the US announcement, a new global leadership consisting of China and the EU appears primed to fill the political vacuum. The world's largest and third largest carbon emitters have reiterated their commitment to tackling climate change and importantly reaffirmed funding commitments and promises to bring forward new mid-century greenhouse gas reduction targets. Similar messages were also echoed by the individual members of the G7. Crucially, countries such as India, which had historically objected to the constraints of climate agreements due to their reliance on coal, have also committed to working 'above and beyond' their targets under the Paris Accord (Figure 32).

> China and the EU are positioned to fill the leadership vacuum

While these are positive developments, the formal joint statement between China and the EU was actually withheld due to an ongoing dispute pertaining to China's desire to be designated a 'market economy'. This episode served to emphasise that the pursuit of shorter-term national interests is not exclusively a US phenomenon, and will continue to cast a shadow over old and new climate alliances.

> Old divisions cast a shadow over new alliances

RISE OF NON-STATE ACTORS

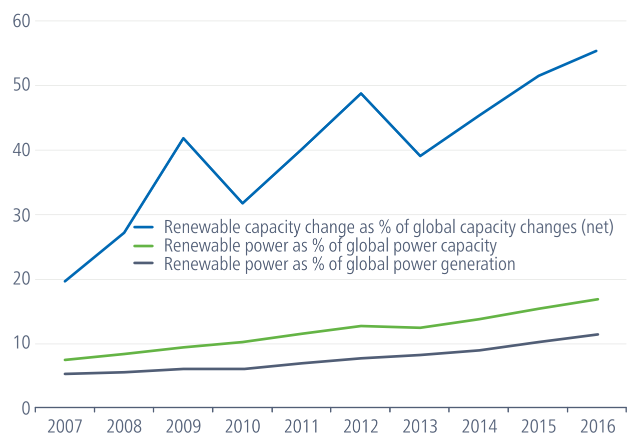
Climate change has proved to be one of the more divisive policy issues of the Trump administration with YouGov polls estimating more than 60 per cent of the American public were in favour of staying in the Agreement. Both before and after the formal presidential announcement, there has been an increasingly proactive and vocal support for the objectives of the Paris Agreement from non-state actors.

> A majority of the American public is supportive of the Paris Accord

The most prominent initiative at the State level was the formation of The United States Climate Alliance, a coalition between the governors of New York, California and Washington State committing to cut greenhouse gases and lead a state-level initiative to support the Paris Agreement. The three states alone represent more than 20 per cent of US gross domestic product.

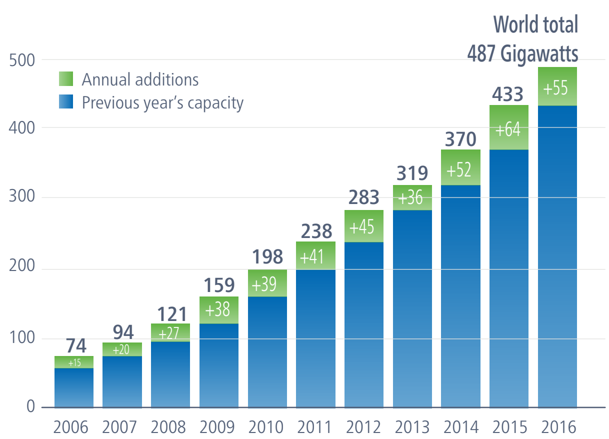
At the grassroots level, the determination of many within the US to remain on the path towards decarbonisation was most palpably captured through the launch of the "We Are Still In" initiative, who claim to represent $6.2 trillion of the US economy. The initiative brought together over a thousand mayors, businesses, investors, and academic institutions who have pledged to continue to fight climate change and intend to formally report emissions targets and progress to the United Nations on a voluntary basis.

Figure 33: Growth in Renewable Energy Capacity



Sources: Bloomberg New Energy Finance/UNEP Global Trends in Renewable Energy Investment 2017

Figure 34: Expansion in Wind Power Capacity



Sources: REN21 Renewables 2017 Global Status Report

62 per cent of shareholders demanded Exxon begins annual reporting of climate risks

In May institutional investors also heralded a landmark moment when the New York Times reported that 62 per cent of ExxonMobil shareholders voted to require the world's largest oil and gas company to report on the impacts of climate change on its business (up from 38 per cent support in 2016). The majority shareholder vote, which followed similar results at Occidental Petroleum and PPL, Pennsylvania's largest utility, is another indication that the investment community is taking stronger action to embed climate risk into their capital allocation and investment processes.

CHANGING ECONOMICS OF RENEWABLES

Renewables account for half of new global power generation capacity

Global renewable power generation capacity rose by 9 per cent in 2016, a 400 per cent increase from the start of the century. For the second year in a row, renewable energy now accounts for more than half of new power generation capacity added worldwide (Figure 33 and Figure 34). This explosive industry growth has been bankrolled by the tax payer, most notably in Germany, where generous state subsidies have inflated renewables in the German energy mix from 9 per cent of the total to 32 per cent over the last 12 years. Beyond Germany, there are an estimated 145 countries that provide direct policy support for the renewables industry, nearly triple the number in 2004. Therefore, fiscal commitments by governments have been, and continue to be, essential in facilitating the energy transition.

Dong Energy shows that renewables can already be commercially viable without subsidies

However, the heavy state-funded investment in technology has yielded a dramatic fall in prices coupled with a marked increase in efficiency. Since 2009 the costs of wind turbines and solar panels have fallen by 30 per cent and 80 per cent respectively according to the Financial Times. According to a recent McKinsey report, by 2025 the cost of renewables will become competitive with the marginal cost of fossil fuels in most regions, lifting the share of renewables in global power generation from 4 per cent today to 36 per cent in 2035. Notably, we are already starting to see this take effect in certain regions. Earlier this year, Dong Energy successfully bid in auction to build two new unsubsidised wind farms, funded exclusively from market prices.

With the US solar industry now employing more than double the amount of workers than the coal sector, irrespective of federal policy reversals, the future strength of the US economy will likely be inextricably linked with the continued growth of the domestic renewables industry.

TECHNOLOGY RATHER THAN POLITICS MAY HOLD THE KEY

President Trump's withdrawal from the Paris Accord naturally raised questions on the viability of a global climate treaty that lacked the US's backing. However, the speed, strength and breadth of support and commitments from state and non-state actors have ensured that the global climate accord remains intact and credible. Nevertheless, President Trump's decision has given fuel to the politics of national interests, and will likely further complicate future inter-governmental negotiations.

While global political leadership is central to the battle against climate change, dramatic advancements in technology may ultimately prove to be the decisive factor in hastening the world's transition towards a lower-carbon economy.

RISK: A GAME OF TWO HALVES

When commentators run out of words to describe a rapid but sustained change in the rhythm and tempo of a football game they often reach for this infamous cliché. Nonetheless what is true in sports can be true for the broader world as well. At the onset of 2017 investors appeared to have the weight of the world on their shoulders; would the UK be able to continue to defy gravity? Could America's new President deliver against his words and tweets? Would Europe be swept away by a rising tide of hard right politics?

However, as summer approaches, what worried investors six months ago seems almost irrelevant now, indeed perhaps even a little quaint. As 2017 moves from its first to second half we look forward as to what might keep investors awake on their sun loungers, bar the increased expenses from a weak pound.

– Politics: from learning to live with Trump to Brexit may not mean Brexit.

– Volatility: what happens to risk when volatility collapses?

FROM THE ART OF THE DEAL TO DEAL OR NO DEAL! LEARNING TO LIVE WITH TRUMP AND BREXIT MAY NOT MEAN BREXIT.

> *"But the thought of being a lunatic did not greatly trouble him; the horror was that he might also be wrong."*
>
> ~ George Orwell, 1984

For the last 18 months a constant theme of the risk section in the House View has been that, for markets, politics do matter, just not all the time. Investors started 2017 worried and probably a bit confused. After all, they had invested through a year of political tsunamis in 2016. In America a bombastic former reality TV star was President and promising to radically alter the landscape of the country and indeed the world, 140 characters at a time.

In Europe, the British had decided that 'leaving the band' to strike out on a solo career would be in their best interests. Would 2017 present continued uncertainty or would the political landscape revert to its prior state?

Early tests lay ahead: could the tides that swept away the previous certainties breach the Dutch election dykes and would the French embrace a new love of the far right? Investors obsessed about polls, absorbing each new data point with near obsessive behaviour. Sampling techniques and survey methodology knowledge became popular in order to follow market changes.

> Financial markets often mis-price risk

Since the first risk section of the House View, we have discussed the idea that markets often mis-price risk and in the case of political risk it is because they believe that people behave rationally, always. However as behavioural economists will attest, people are often not rational and crowds are not always logical. Therefore is it surprising that an industry that places great weight on the power of quantitative analysis struggles to understand the human condition?

While continental Europe sailed calmly through its elections, the other protagonist in the Brexit process, the UK, called a surprise snap election. Pundits and observers assured all those who would listen that the Government would win a renewed mandate with a significantly enhanced majority on the back of a pledge to be both strong and stable.

Alas, this result proved to be nothing like the initial predictions. After the election the UK now has a minority Tory government supported on a "confidence and supply" basis by Northern Ireland's Democratic Unionist Party (DUP). Having staked her reputation on securing an enhanced majority with which to negotiate with the EU the terms of the UK's exit, the British PM's future is looking anything but strong and stable.

The type of Brexit and its consequences still largely unknown

While it remains to be seen what the ultimate consequences of the vote will be on Brexit (hard, soft or indeed none) we accept that another election may be required. A weakened UK government will be forced to follow a more treacherous path between its own internal factions and the currently unified EU. In the immediate aftermath of the election result, the tone of many senior cabinet members has been markedly softer. As a result our central scenario of likely outcomes has shifted to what could be described as bi-modal one, with the UK crashing out without any deal and the UK agreeing to a deal not dissimilar to that which Norway has with the EU.

One risk case to this central scenario is the possibility that the perceived lack of unity within the UK generates the conditions which make a second referendum possible or indeed necessary. In such a scenario we cannot rule out the possibility of an option to reversing course not being a potential outcome. Both the central scenario of the House View and its associated risk scenario present significantly differing economic futures for the UK. All of which suggests that investors in the UK may well have many sleepless nights ahead as the drama of the next few years unfolds.

Trump is still a wild card

While in the first half of 2017 Europe averted a lurch to the right and the UK became significantly less stable, the US followed a third course. President Trump, fresh from his surprise 2016 victory, sought to embark quickly on a proposed legislative program that was considered far-reaching if not universally popular. However, since his election, the President's agenda has slowed if not stalled across much of his key policy proposals. While administrations find change is easier to demand as a candidate than it is to deliver once elected, it seems that financial markets have learned not to hang on every tweet and public pronouncement. However, the risk remains that many of the post November assumptions turn into disappointments.

While political challenges remain a risk to investors, we believe that those risks are currently more localised, as in the case of Brexit for the UK, or not as significant as before, as in the case of populism in Europe. There are, as always, some events to monitor from the growing political difficulties of PM Abe in Japan through to the Italian elections later this year or next. However, to date, these have not caused market fragility to rise.

Figure 35: Measure of systemic market risk

Sources: Aviva Investors, Bloomberg, Macrobond, as at 30 June 2017

VOLATILITY: WHAT HAPPENS TO RISK WHEN VOLATILITY COLLAPSES?

As we examine the behaviour of markets in the period since the three main political upheavals in 2016, we observe an interesting phenomena which we explore using the charts below. In Figure 35 we can see 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.

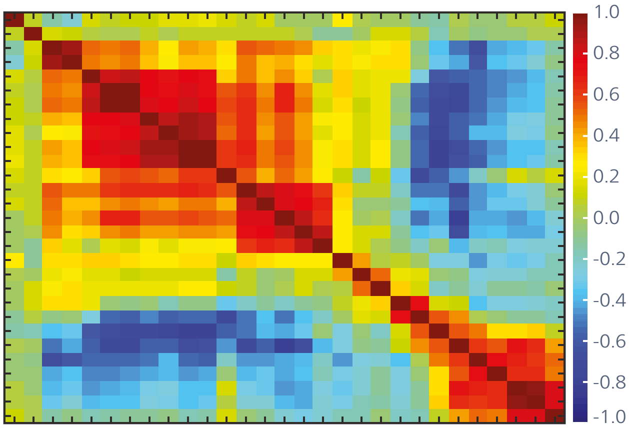
While we can see there have been periods of considerable strain in the markets over the last decade, Brexit has had a smaller and more transitory effect to date than might have been expected. Despite the great uncertainties regarding President Trump's likely policies, the absorption ratio is still low by the standards of the last ten years and well below the spikes associated with major risk events in the past. This indicates markedly lower perceptions of systemic risk. The green line represents the rolling 60 days absorption ratio, whereas the blue line shows the 12-month moving average.

> Despite many shocks, perceptions of systemic risk are still very low

While a simplistic interpretation might suggest that all is well in the world and that risks are well understood, controlled, managed and priced in, that could be drawing false comfort. A more likely explanation is that in the absence of any meaningful information, the markets have simply chosen to ignore some of the potential long-term consequences.

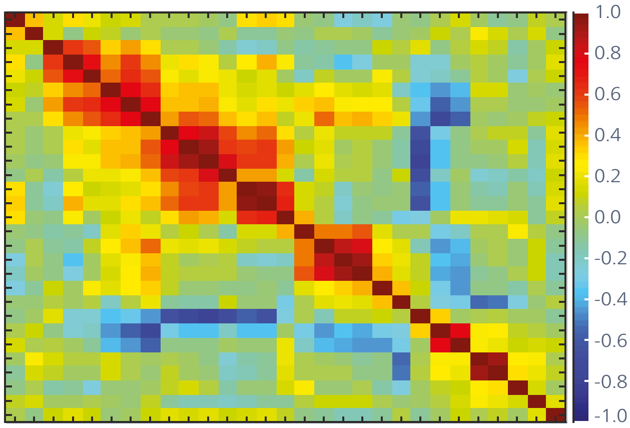
If and when these periods of fragility do arise then it is important that investors understand the impacts that this may have on asset correlations. We can illustrate this dynamic by looking at Figure 36 and Figure 37 which show the correlation of currencies, equity, and commodity and bond markets to each other towards the end of June this year and twelve months ago. As we can see in the immediate aftermath of the Brexit vote, assets correlations became materially more polarised than they are now. This of course makes the search for true diversification more important as it is only this which can help portfolios perform in both stressed and normal market conditions.

Figure 36: Correlation heatmap (June 2016)
High correlation environment (tending towards +/-1)



Sources: Bloomberg, Aviva Investors, as at 30 June 2017

Figure 37: Correlation heatmap (June 2017)
Lower correlation environment



Sources: Bloomberg, Aviva Investors, as at 30 June 2017

ECONOMIC OUTLOOK

UNITED STATES: FED PUSHES ON WITH NORMALISATION

– H1 growth expected to be above potential, as investment picks up

– Wage growth key over the next twelve months

– Fed looking to deliver 3 rate hikes this year and begin balance sheet unwind

SUMMARY

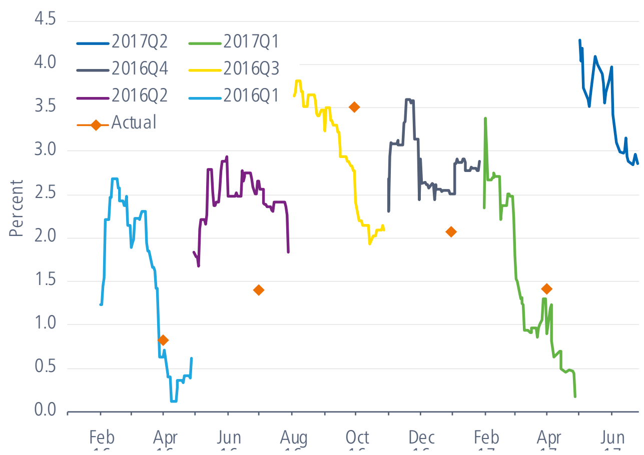
GDP growth set to pick up in 2017 Q2 following a soft Q1

At the end of 2017 Q2, the US economy was in its strongest position at any time since the global financial crisis. While the initial estimates of growth for Q1 were somewhat disappointing, with annualised GDP growth of 1.4 per cent, that reflected a number of transitory factors that are expected to reverse in the second quarter. Indeed, the latest Atlanta Fed GDP 'nowcast' – an approach that uses more timely high frequency data to estimate GDP growth – is consistent with annualised growth of around 3 per cent for Q2 (Figure 38). That would imply growth in the first half of 2017 was around 2 per cent, somewhat faster than potential growth. With growth running above potential, there have been further gains in employment, with the average increase in monthly payrolls over the last six months around 160k. While that is somewhat of a moderation from 2015 and 2016, it is still well ahead of the pace needed to push the unemployment rate lower. In May the unemployment rate reached a new post-crisis low of 4.3 per cent, while the broader measure of underemployment (which includes those who are marginally attached as they are not currently looking for a job, but would like one and have looked at some time in the past year) also reached a new low.

Wage growth has so far not picked up as much as expected

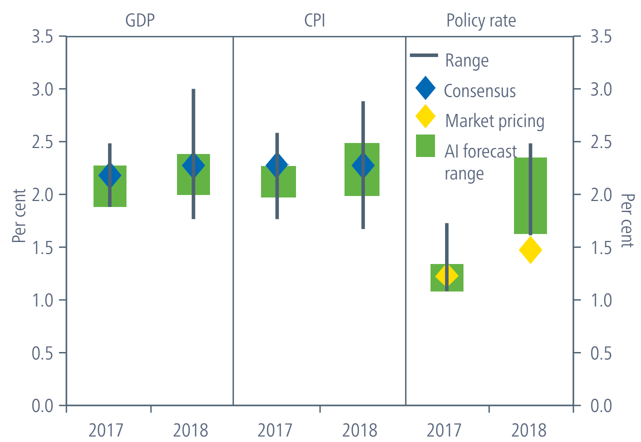
While the cumulative improvement in activity and employment over recent years has eliminated much of the slack in the economy, wage growth has risen only modestly. The most commonly-cited hourly wage growth measure for the private sector rose by 2.5 per cent in May, compared to a year earlier. While that reflected a modest acceleration from the average post-crisis increase of 2 per cent, it was down from 2.9 per cent at the end of 2016. Wage growth is arguably around 0.5-1 per cent below what you might expect in a relatively tight labour market. We expect wage growth to pick up over the coming year, but a failure to do so would question either the tightness of the labour market or the ability of workers to bargain for higher wages.

Figure 38: Atlanta Fed 'GDPnow' estimate
Growth expected to pick up in Q2



Sources: Aviva investors, Macrobond, as at 30 June 2017

Figure 39: US economic projections



Sources: Aviva investors, Macrobond, as at 30 June 2017

The rate of increase in headline inflation eased in recent months as the positive contribution from energy price inflation fell. Core inflation also slowed in recent months, in large part reflecting some one-off factors that will reduce the rate of increase compared to a year earlier by around 0.2-0.3 per cent until early next year. We expect inflation to pickup in 2018 towards the Federal Reserve's 2 per cent target (Figure 39). We expect the Fed to raise rates once more in 2017 and three times in 2018 and expect that the recently announced balance sheet run-off will start in September.

Fed looks to hike 3 times in 2017 and 2018

CONDITIONS IN PLACE FOR FURTHER FED HIKES

Household consumption growth slowed in Q1, reflecting both unusual weather conditions and the timing of tax refunds, but also reflecting a slowdown in the growth of real disposable income (Figure 40). While wage and employment growth was little changed, higher inflation acted as a drag. However, the underlying fundamentals remain strong for households. Net wealth reached a new high as a percentage of disposable income in Q1 and measures of consumer confidence remain well above the long-run average. Real disposable income growth should improve over the coming year, with continued gains in employment and as wage growth picks up more quickly than inflation.

Household fundamentals strong and supportive of consumption growth

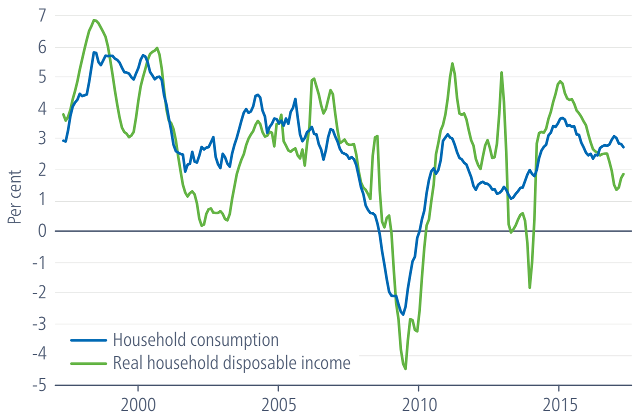
Arguably the most notable part the Q1 GDP report was the sharp improvement in business investment. Following upward revisions to the initial estimate, the contribution of investment to quarterly growth was the largest in over five years, with both mining and non-mining rising (Figure 41). Business investment has been a drag on growth for much of the past two years and a return to above average rates of growth will be necessary to sustain growth over the longer term. Business surveys suggest that optimism remains high, despite the tribulations of the Trump administration, and should be supportive of a further improvement in the investment outlook. While the outlook remains positive, it is worth noting the increased leverage in the corporate sector in recent years. While much of that leverage has reflected balance sheet engineering (e.g. issuing debt to buy back equity) rather than funding new investment, it has the potential to leave businesses more exposed to an economic or policy shock that leads to materially higher interest rates.

Business investment to be a key driver over the coming years

With wage growth rising only modestly, and inflation easing recently (Figure 42), there has been rising scepticism amongst market participants that the Fed can deliver on both the pace and ultimate level of interest rates implied by their forecast. Indeed, the market-implied path for Fed policy over the remainder of 2017 and through to the end of 2018 is for between one and two rate hikes. That

Figure 40: Household consumption and real disposable income

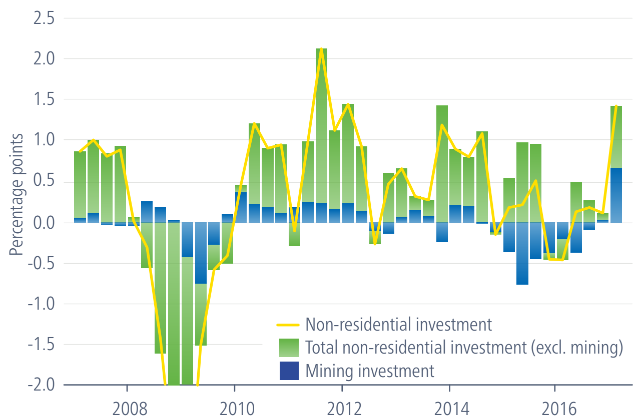
Household fundamentals remain strong



Sources: Aviva investors, Macrobond, as at 30 June 2017

Figure 41: Business investment

Signs of a resurgence?



Sources: Aviva investors, Macrobond, as at 30 June 2017

would leave real rates deeply negative for the foreseeable future and compares with the median voter on the Federal Open Market Committee (FOMC), who expects four rate hikes over the period, and a gradual reduction in the degree of policy accommodation. When considering the appropriate policy stance, it can be informative to look at previous episodes. In 2004 the Fed embarked on a long series of rate hikes, raising the policy rate by 25bp each meeting for the following two years. Policy rates rose from 1 per cent to 5.25 per cent. That is more than twice as fast as the Fed expects to raise rates over the next two years, and around four times faster than the implied by market pricing.

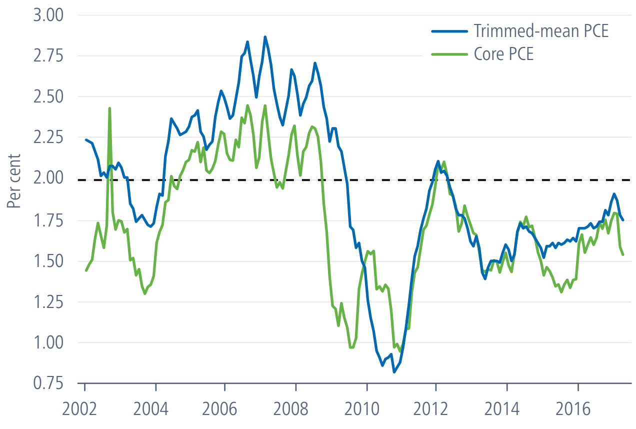
Labour market tighter today than in the early part of the 2004 hiking cycle

Figure 43 shows a range of key macro indicators. Each has been "normalised" such that a value of zero would be broadly consistent with an economy operating at full employment and with inflation at target. Following three rate hikes in the 2004 cycle, business and consumer sentiment was strong, but unemployment was still above the equilibrium unemployment rate, wage growth was well below normal, as was core inflation. At the end of June this year there was a similar picture. Sentiment was even more elevated, unemployment was below the equilibrium, wage growth was outpacing what was seen in 2004, but inflation was a little further away from target. Despite eleven further rate hikes in 2004 and 2005, the labour market continued to tighten, wage growth accelerated and core inflation rose above target. While there are undoubtedly differences in the economic environment today to that which prevailed in the mid-2000s, it is nonetheless worth remembering that the Fed hiking cycle began with similarly restrained wage growth and inflation, which subsequently accelerated rapidly despite a succession of rate increases.

Modest fiscal boost to come in late 2017 or early 2018

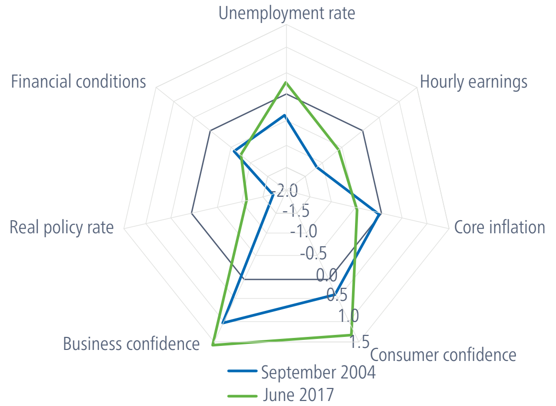
Looking ahead, we expect the Fed will raise rates once more in 2017 and three times in 2018 as the economy continues to show robust growth, with steadily rising wage growth and inflation. However, there is a risk that the labour market has already tightened to the extent that wage growth accelerates in a manner similar to the mid-2000s. That would likely require a faster pace of rate hikes than the Fed currently envision. Equally, there is a risk that more of those not in the labour force could be drawn back in, limiting the tightening in the labour market, or that the ability to bargain for higher wages is much weaker than in the past. On balance we think the former is the greater risk, particularly with broader financial conditions looser today than when the Fed began hiking rates. Moreover, we continue to expect a modest fiscal boost from tax cuts and infrastructure spending to be passed by the Congress late this year or early 2018. In addition to rate hikes, we expect that the steady reduction in the Fed's balance sheet will begin in September this year.

Figure 42: Core inflation
Recent move lower driven by one-off factors



Sources: Aviva investors, Macrobond, as at 30 June 2017

Figure 43: Key macro indicators
Similarities between now and 2004 hiking cycle



Sources: Aviva investors, Macrobond, as at 30 June 2017

EUROZONE: BETTER ALL THE TIME

– The Eurozone's recovery is ongoing, encouragingly supported more by domestic demand

– The ECB is not yet convinced that inflation is on a sustained upward trend towards 2 per cent

– Greater political stability and renewed efforts at closer integration will help

The Eurozone upswing has gathered strength in 2017, with GDP rising by an upwardly-revised 0.6 per cent in Q1 to stand 1.9 per cent higher than a year ago. In the post-GFC world (32 quarters now), annual growth has only exceeded that rate on five occasions. With leading indicators and survey balances resolutely upbeat, Q2 could even improve on the Q1 reading. If this is right, the Eurozone could rightly be described as experiencing almost boom-like conditions, all the more so since the trend pace is only around 1 per cent. Given the amount of stimulus that has been provided to the region since 2008, it would have been disappointing not to see solid growth, but the Eurozone has been to some dark places over the last decade, so it is heartening to see it enjoy better fortunes (Figure 44).

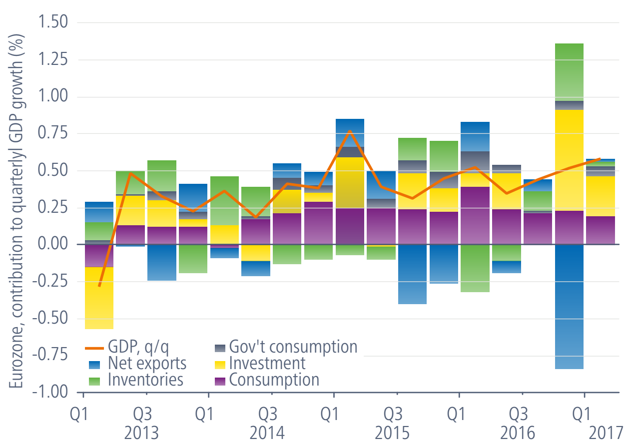
Activity and sentiment pick up further across the Eurozone…

We highlighted three months ago that there were a number of political hurdles to jump, but here too the news could scarcely have been better so far. President Macron in France was convincingly elected in the run-off against Marine Le Pen and has established a large majority in the subsequent parliamentary election. Moreover, he has done so with a bold reform agenda, and while the proof is always in the pudding in terms of delivery on such goals, the positive momentum for France and the Eurozone integration process more generally – including constructive developments of the critical Franco-German axis – could hardly be any better. So, conditions are ripe for the next steps of the project – Governments must now take advantage of them and deliver. There is still the German election and, possibly, an Italian vote to get through, but anxiety levels about results have understandably subsided.

In "ordinary" economic circumstances (remember them?), these conditions would warrant at least a discussion of monetary tightening from the present extreme stimulus stance of negative policy interest rates. The justification would be to control the boom and prevent inflation rising alarmingly. But there are good reasons for proceeding cautiously, as the ECB has been keen to point out. The key

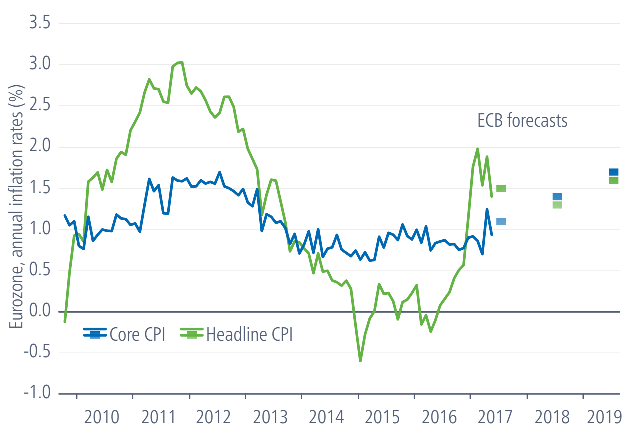
…but inflation remains subdued, allowing ECB to stay relaxed

Figure 44: Strong growth led by domestic demand
Consumption steady, investment rising



Sources: Aviva investors, Macrobond, as at 30 June 2017

Figure 45: Underlying inflation pressure still weak
ECB expects only modest increases



Sources: Aviva investors, Macrobond, as at 30 June 2017

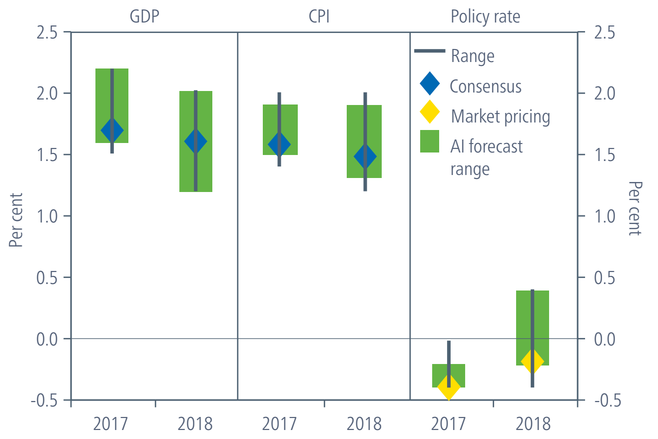
issue is that after the GFC and the Eurozone's very own sovereign debt crisis, there is still plenty of room for non-inflationary growth. Even in the cyclically-advanced USA, inflation has been slow to return. In the Eurozone, where deflation was the more likely threat as recently as 2015/16, it has been slower still. Core inflation is still stubbornly low, below 1 per cent, and it is clear that the ECB wants to see a more convincing upward drift before they commit to tighter policy (Figure 45). That will only happen when output gaps are closed. Yes, there are differences between individual countries, but as the ECB regularly reminds us, they set policy for the region overall and on that basis, there is still spare capacity that can be re-absorbed back into productive use by allowing and encouraging above-trend growth. A loose policy stance is therefore still merited. Granted, there would be rumblings if inflation were to appear in some countries that were running hot, but so far that has not been the case. This description of the Eurozone helps to explain and validate the ECB's relaxed approach to policy. But the punchbowl cannot remain on auto-refill for ever and it is clear that they are preparing their exit strategy. Asset purchases have been pared back already and further tapering is expected later this year or early next. Gradual rate rises will follow as long as the macroeconomic backdrop remains robust (Figure 46).

Eurozone has generated 8mn new jobs since 2013

One of the most welcome aspects of the Eurozone recovery in recent quarters has been that it has been domestic demand rather than net exports that has done most of the work (Figure 47). Consumer spending is "only" growing by around 1.5 per cent a year, but that is perfectly adequate for the Eurozone given its underlying demographics. Developments in the labour market have helped: the Eurozone lost just under 3mn jobs during the GFC (compared with nearly 9mn in the US), regained them by 2011 and then lost almost 4mn during its own crisis. But since the start of 2013 the area has generated nearly 8mn net new jobs (Figure 48). The unemployment rate has fallen from a peak of 12.1 per cent to 9.3 per cent in April this year. Of course this is still "high" by the standards of several other developed nations, but it is moving in the right direction and is doing so without any emergence of wage pressures so far. Estimates of the natural rate of unemployment in the Eurozone vary, but it is hoped that some of the much-vaunted structural reforms in labour markets have brought it down to perhaps 8 per cent or so. If that is right, the region can probably afford another year of 2 per cent plus GDP growth before wage pressures start to emerge. Individual country labour markets have different degrees of tightness, but so far, wages have been well-behaved. Were that to change, the ECB would face a trickier task.

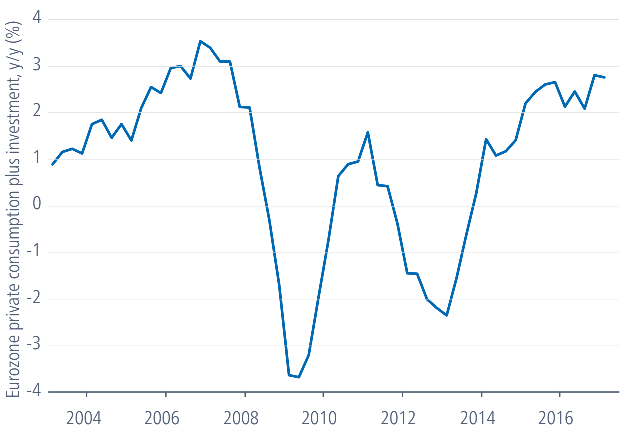
Investment spending, meanwhile, rose by 6 per cent in the year to Q1, the highest since the GFC and in line with other periods when the Eurozone economy was

Figure 46: Better macro outcomes
ECB relaxed on policy stance



Sources: Bloomberg, Aviva Investors, as at 30 June 2017

Figure 47: Demand growth back to pre-crisis level
Private demand doing much better



Sources: Macrobond, as at 30 June 2017

doing well. Unfortunately, investment data across Europe is generally of poor quality so it is difficult to assess exactly which categories of spending are advancing most. Having said that, business and industrial surveys show that construction activity has strengthened noticeably and also that Eurozone companies are very upbeat about future demand (Figure 49). This, combined with very low borrowing costs, is stimulating firms to borrow and invest. Finally, although an element of fiscal restraint is still being encouraged, public sector capital spending (in part related to the ongoing Juncker plan) is probably growing quite strongly. As long as "animal spirits" in the Eurozone remain robust, there is little reason to see this changing much in the near future.

Businesses are happy to borrow and spend

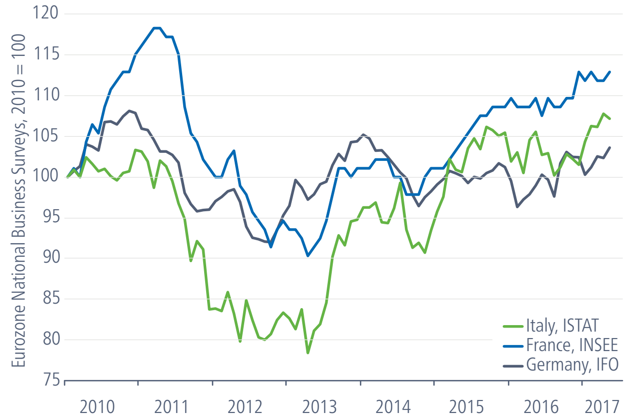
While it is right to be more optimistic about Eurozone prospects than for many years, some words of caution are still warranted. The thorny tasks of much closer fiscal integration, of full debt-burden sharing and of political unity have yet to be achieved. The path to those ends looks clearer than it has for a long time and most participants seem determined to progress down it. There does appear to be a determination to complete the project, but it has been a painfully slow process and lots remains to be done. It would be surprising if there were not some further bumps along the way.

Political worries have diminished; enhanced integration must come next

Figure 48: Jobs growth still picking up
Unemployment still has further to fall

Sources: Macrobond, as at 30 June 2017

Figure 49: Business sentiment is strong
Animal spirits continue to recover



Sources: Macrobond, as at 30 June 2017

UK: FROM BAD TO WORSE

– More signs of slowing growth in the UK, led by weaker consumer spending

– Inflation still rising, hurting real incomes – should peak in Q3/Q4

– Exports have not risen as much as hoped; investment hasn't weakened as much as feared

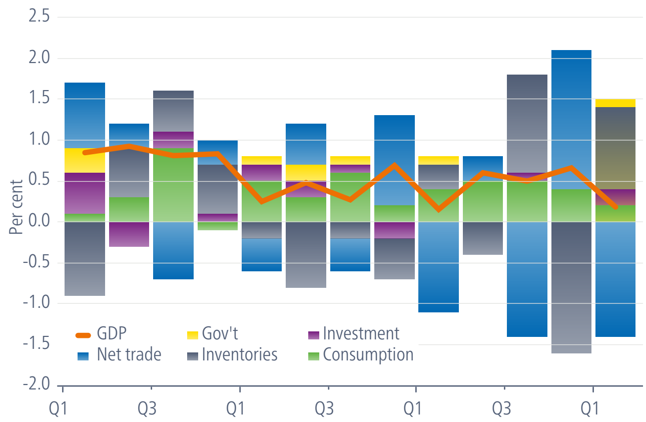
Political shambles adds to economic woes

The last three months have not been a good time for the UK. Prime Minister May's attempt to take advantage of a massive lead in the polls backfired disastrously, resulting in a hung parliament that will do nothing to stabilise the Government as had been intended. For this to happen when the harsh reality of just how difficult Brexit negotiations will be is becoming more apparent, simply adds to the vulnerability. And of course this is compounded by the UK's weak bargaining position in those talks. Moreover, cracks are starting to appear regarding economic prospects for the country: growth has slowed sharply (Figure 50), inflation has risen markedly (Figure 51) and sentiment has slipped. Although many continue to insist that Brexit will be relatively painless and in the UK's long-term interest, evidence is mounting that this will not be the case. In our view, it is impossible to construct a coherent or plausible economic scenario where the UK is better off outside of the EU.

Consumer slowdown now clear-cut with more to come

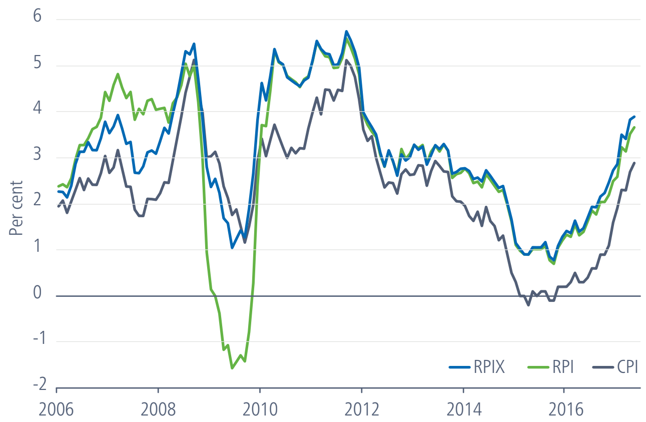
The slump in GDP growth to just 0.2 per cent in Q1 is disturbing, but not unexpected. It is also extremely unlikely to be the end of bad news on the economy. Reliable leading indicators suggest no improvement in Q2, with some pointing to even worse than that. UK GDP data has become quite volatile in recent years, especially in regards to the composition of growth which often gets revised extensively. Perhaps the most significant aspect of the Q1 breakdown was the noticeable slowdown in consumer spending to 0.3 per cent, the slowest for more than two years. Consumption is always the mainstay of economic growth (typically 60 per cent to 70 per cent of total spending) and this has been particularly true in the aftermath of the Global Financial Crisis (GFC). Since 2008 it has grown, on average, at an annual rate of 2.5 per cent; in the last two years it has been closer to 3.0 per cent, so the slowdown at the start of 2017 is notable and concerning.

Figure 50: Growth slowed significantly in Q1
Consumer spending slowdown has further to run



Source: Aviva Investors, Macrobond, as at 30 June 2017

Figure 51: Inflation has picked up sharply
CPI inflation should peak in Q3/Q4 at over 3 per cent



Source: Aviva Investors, Macrobond, as at 30 June 2017

Furthermore, weaker household spending looks set to be with us for a while yet: in Q2 so far we have seen weaker car registrations, further slowing in the housing market and some poor retail sales data. More anecdotally, a number of high-profile UK companies have signalled a noticeable turnaround in spending patterns over the last three months.

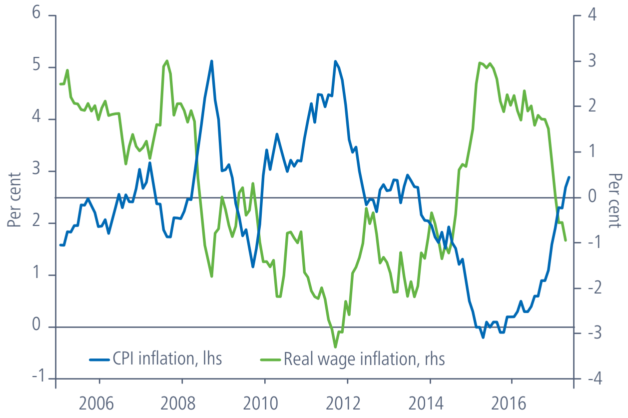
Higher inflation causing pronounced real income squeeze

The main explanation for the change in spending patterns is not hard to find: households are feeling the pinch from higher inflation which is hitting real incomes. In simple terms, a year ago wage growth was running at 2.7 per cent and CPI inflation at just 0.3 per cent. The implied real wage growth of 2.4 per cent was ample to support ongoing robust increases in spending. Today wage growth has fallen to 1.7 per cent, while inflation has jumped to 2.9 per cent, implying a significant real wage squeeze (Figure 52). And as in previous recent episodes of inflation spikes, consumers have reacted to the hit rather than changing behaviour in advance. It is noteworthy that, in purely mathematical terms, strong spending growth recently has been financed largely by a steep decline in the savings ratio to an all-time low (Figure 53). As long as consumers are confident about the future, lower savings can be defended. But if the future is uncertain, such a course of action begins to look unwise. More importantly, it can only be done once – savings cannot fall for ever. Although the majority of households voted for Brexit, many might now be re-assessing their opinion regarding its consequences and if so, they will rein in spending and increase precautionary saving. Looking ahead, these factors point to continued weak of consumer spending increases this year and next.

Hoped-for export revival has been disappointing

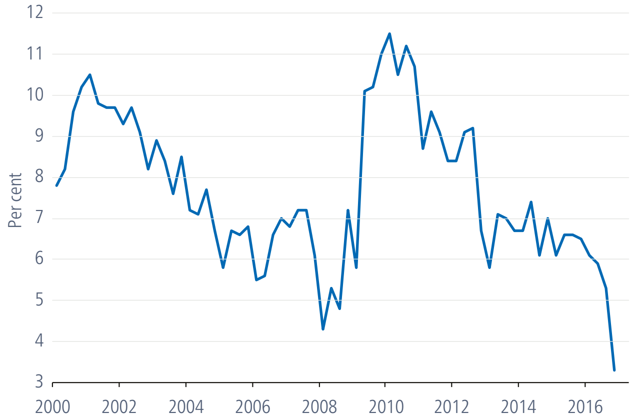
The small increase in business investment in Q1 was encouraging – there had been fears that Brexit-related worries would impact such spending meaningfully. But although investment intentions are much better than in the immediate aftermath of the referendum, it is still far too early to sound the all clear. The additional uncertainty after the General Election, along with the dawning recognition that Brexit negotiations may not go as well as our Government has stated, provides plenty of reasons for companies to act cautiously. In any event this category of spending is susceptible to any adverse changes in sentiment. The other disappointing aspect of the Q1 GDP report was the large negative contribution from net exports. It had been hoped that the steep drop in sterling exchange rates would stimulate exports and import substitution, but this has not yet happened on a scale of any consequence (Figure 54). One possibility is that UK exporters have taken advantage of the pound's decline to increase margins rather than to improve market share and export volumes. This may help explain why export surveys have

Figure 52: Real income squeeze is hurting households
Back into negative territory



Source: Aviva Investors, Macrobond, as at 30 June 2017

Figure 53: Spending financed by slump in saving ratio
Little or no scope for a repeat of this



Source: Aviva Investors, Macrobond, as at 30 June 2017 remained comparatively upbeat even in the face of disappointing export growth. In one sense it doesn't matter that much, as higher corporate profits will help insulate the UK economy from some of the chill winds of downturn elsewhere.

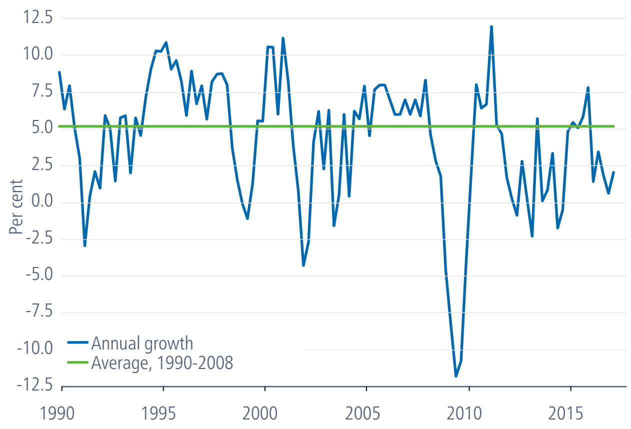
CPI inflation to peak above 3 per cent in Q3/Q4

The sharp rise in inflation over the last year is mainly a result of the depreciation of sterling and much of the impact has now fed through. Nevertheless, we expect it to move a little higher, peaking at a little above 3 per cent in Q3/Q4 this year. Thereafter, it should fall back steadily, especially if growth does indeed slow as much as we believe. Three months ago, we highlighted that if the UK economy remained resilient as inflation climbed, then the Bank of England would face a dilemma on policy – cut rates to support growth, or raise them to choke off inflation. We said then that we believed the Bank would look through higher inflation (which should prove transient). Given the growing evidence of a slowdown, that seems even more likely now, making it rather bewildering that two more on the Monetary Policy Committee (MPC) voted for a hike at the most recent policy meeting. We continue to think that the UK will not raise interest rates until any growth scare has clearly passed. With Brexit negotiations having only just begun, that looks a long way off.

Difficult times ahead for the UK economy

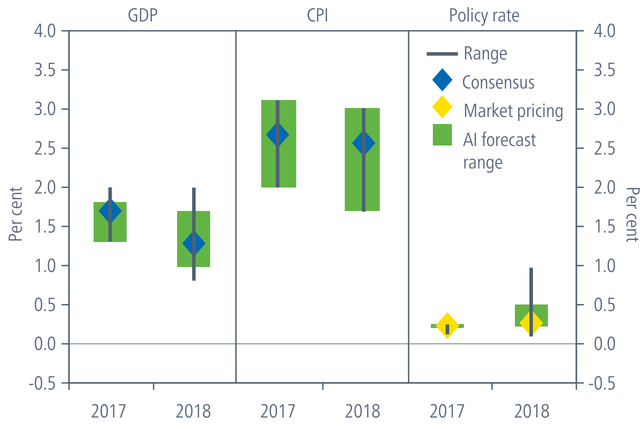
Finally, if growth does stay weak, pressure will grow for the Government to pursue more expansionary fiscal policy. Whether "austerity" was an accurate description of the official stance in the years following the GFC, the UK's public finances are in far better shape today. The deficit is now only a little over 2 per cent of GDP (down from a peak of 10 per cent), suggesting that there is scope for fiscal support, should the need arise, without generating any major threat to fiscal sustainability over the longer term. Overall, the next year or two is likely to be quite a tough time for the UK economy (Figure 55). Messy politics combined with strained international relations and economic weakness is an unhappy and unwelcome cocktail.

Figure 54: Exports growing, but not as much as hoped
Competitive boost disappointing in growth terms



Source: Aviva Investors, Macrobond, as at 30 June 2017

Figure 55: Tough years ahead for the UK
Weaker growth, higher inflation, low rates



Sources: Bloomberg, Aviva Investors, as at 30 June 2017

JAPAN: NEEDS REFLATION OR A WEAKER YEN

- Bank of Japan (BoJ) forecasts suggest that the inflation target will remain elusive until at least 2019, meaning the current policy stance will be maintained for the foreseeable future
- Global reflation unwind poses a threat to BoJ's objectives while wage growth remains lacklustre
- Exports and yen weakness remain the best hope for growth, helped by government spending

Growth remains lacklustre in Japan, with GDP rising by 0.3 per cent in Q1 to stand just 1.3 per cent higher than a year ago. Annual growth in Q4 was 1.6 per cent. As during Q4 last year, export growth was a positive contributor, despite yen strength over the quarter. Private consumption also contributed positively, growing by 0.3 per cent in Q1 having been static in Q4. On the investment side, government investment declined and private investment slowed sharply, albeit from very elevated rates of growth in the previous quarter (Figure 56).

Going forward, we expect the positive contribution of net exports to be maintained, although a slight moderation in indicators of global trade create some downside risks to our view. However, a pick up in long-end yields outside of Japan and the resultant yen weakness should blunt the impact.

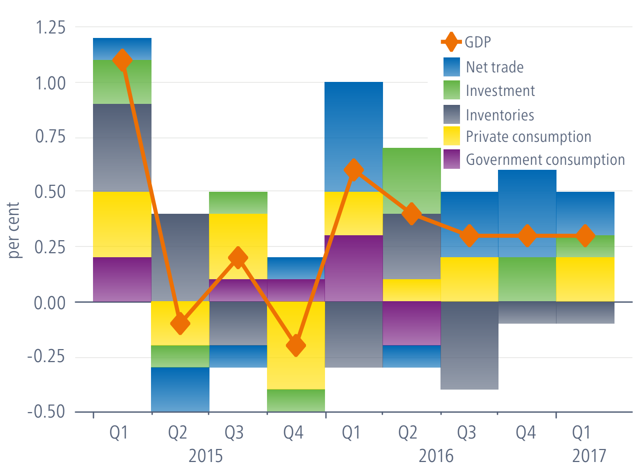
Weaker yen should help net exports to continue to boost growth

Further yen weakness will be instrumental in boosting private investment spending which has remained uninspiring despite non-financial corporate profit margins being close to cyclical highs.

Government spending is also expected to turn more supportive. Infrastructure spending is set to rise and demand is likely to be supported by cash hand-outs which should mitigate the impact of the unpromising spring negotiations and continued poor wage growth. Over the course of 2017, we expect growth to be in the 1.0-1.3 per cent range, with policy support at every level continuing to play a critical role (Figure 57).

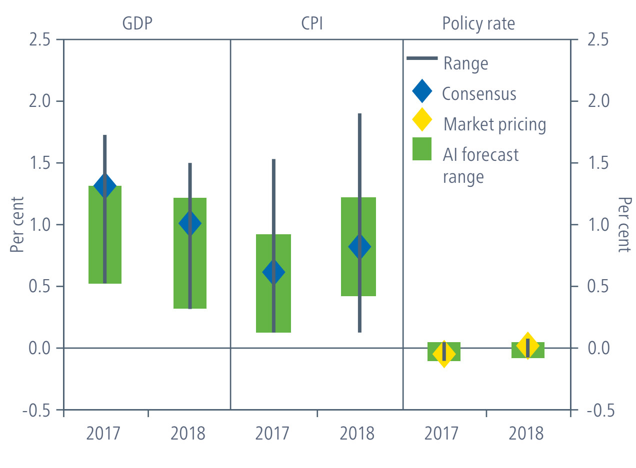
Over the course of 2017, we expect growth to be in the 1.0 -1.3 per cent range

Figure 56: Japan QoQ growth contributions



Sources: Aviva Investors, Macrobond, as at 30 June 2017

Figure 57: Japan economic forecasts



Sources: Consensus Economics, Bloomberg, Aviva Investors, as at 30 June 2017

Although headline inflation has picked up from the mid-2016 lows, the pick up has been weaker than the BoJ had expected.

In April headline inflation rose to 0.4 per cent ticking up from 0.2 per cent in March. The improvement was driven by a pickup in food and energy prices and subsequently core inflation (ex food) remained at 0.3 per cent while inflation excluding food and energy continued its trend lower since the start of the year.

The pickup in inflation has been weaker than the BoJ expected

Despite recent soft data, the BoJ has maintained its projection for rising core inflation and continues to expect that CPI inflation will tend towards its 2 per cent target. The BoJ forecasts see inflation firming mainly on the back of a closing in the output gap and a rise in medium to long term inflation expectations.

Wage growth has been unresponsive to labour market tightness

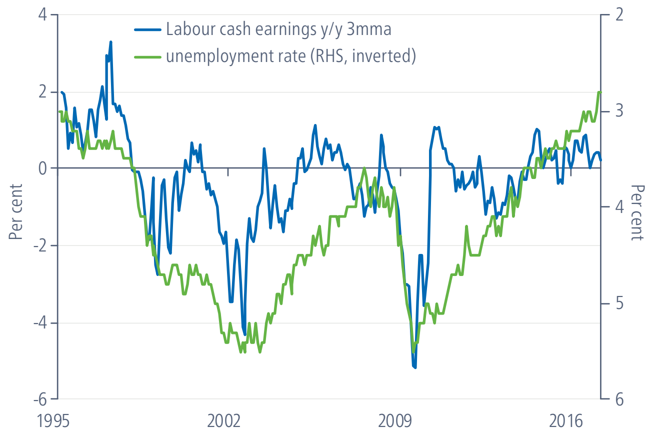
That said, the BoJ acknowledges that medium to long term inflation expectations have remained subdued. Weak inflation expectations will not be helped by the discouraging spring wage negotiations, where Japan's largest corporates offered a smaller wage rise than last year. Yet again there has been disappointment on the wage-growth front with the Shunto negotiations producing little in the way of tangible gains. Structural factors, such as rising participation of old-age workers and women, continue to keep wage growth depressed despite the labour market being historically tight (Figure 58). Poor wage growth also poses a problem for the ongoing cyclical recovery, which over Q1 was supported by a pick-up in household spending. If wage growth fizzles out yet again, then household spending will come under pressure (Figure 59).

The BoJ believe the output gap is currently around 0 per cent and expect the gap to become positive going forward (Figure 60). The tightening labour market is evident in the active job openings-to-applicants ratio approaching peak levels and the unemployment rate declining below 2 per cent. There is evidence that the tight labour market is having a more significant impact on wage growth of part time workers who can be more responsive to labour market conditions. However the lack of wage growth in the broader economy highlights that if wage growth is to come through, it will be very gradual. This helps the BoJ justify maintaining their current policy stance for the foreseeable future.

A lack of wage growth has helped the BoJ fend off questions about an exit policy

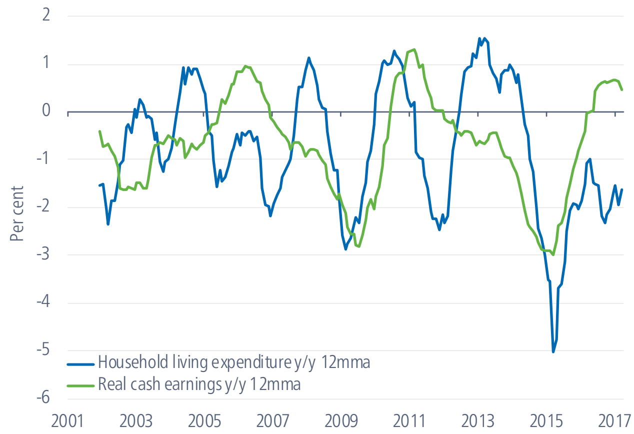
The recently published forecasts of the BoJ board have the median projection for core inflation at 1.9 per cent by 2019. The implication is clear – there is little prospect of any shift in the monetary-policy stance in the foreseeable future. In a way, a projected undershoot out to 2019 enables Governor Kuroda to fend off repeated questions about the BoJ exit policy that he faces from the press. While these questions may stem from legitimate concerns about the BoJ taking

Figure 58: Japanese wages have recently been insensitive to labour-market tightness



Sources: Aviva Investors, Bloomberg, as at 30 June 2017

Figure 59: Wage growth needed to sustain household spending



Sources: Aviva Investors, Bloomberg, as at 30 June 2017

large losses on its Japanese Government Bonds holdings in the event that the inflation target is achieved, the BoJ's bigger priority is the inflation target itself and accordingly they will be keen to discourage any discussion of an exit strategy.

Additionally the BoJ is about to lose two main voices of internal dissent to its current policy. Takehiro Sato and Takahide Kiuchi, who leave the Bank on July 23rd, were seen as the last remaining hawks on the BoJ board. Their replacements, nominated by Prime Minister Shinzo Abe, are expected to fully support the current stance of aggressive monetary easing and could therefore diminish the likelihood of an early exit to quantitative easing.

So while speculation about an exit strategy is clearly premature, concerns about the limitations of the BoJ's policy arsenal are not.

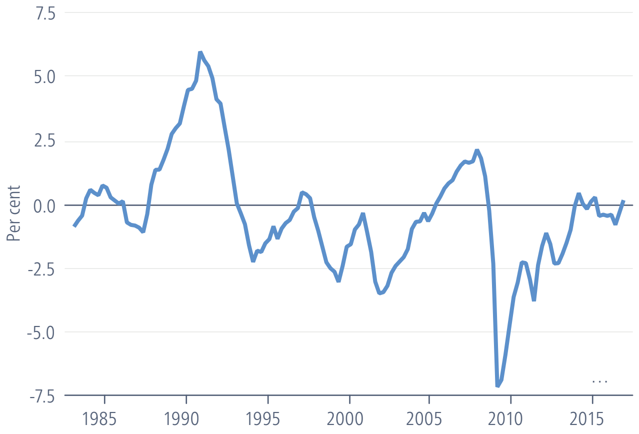
While speculation about an exit strategy is clearly premature, concerns about the limitations of the BoJ's policy arsenal are not

At the June policy meeting the BoJ was more upbeat on the growth outlook but reiterated the ongoing need for monetary policy accommodation to support inflation. As expected the BoJ maintained its policy stance across the board and we expect them to maintain this stance at least until the end of 2017. At the press conference, questions regarding the bank's ongoing financial health dominated. Kuroda has pushed back on discussions of an exit strategy given the bank is still far from achieving its 2 per cent inflation target and it is therefore impossible to predict what the economic environment will be at that time.

In the face of global risks that threaten to push the yen higher, there is little the BoJ can do to boost core inflation which continues to be determined largely by the yen real effective exchange rate (Figure 61). And the yen has strengthened so far in 2017, following closely the path dictated by the US Treasury yields which have dipped on political risks in the United States surrounding President Donald Trump. We see the US political turmoil as temporary, which should boost long-end Treasury yields and help weaken the yen afresh.

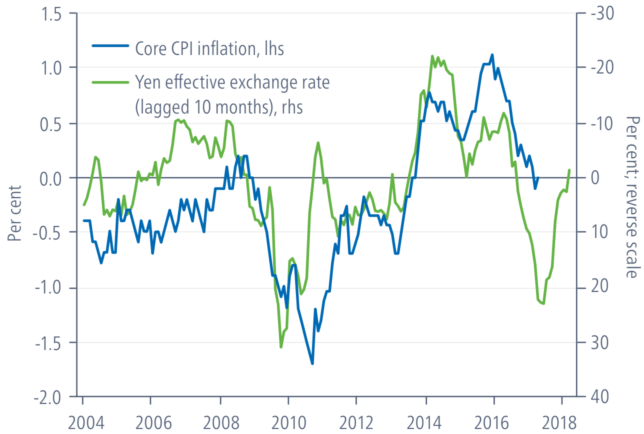
Core inflation continues to be largely determined by the yen real effective exchange rate

Figure 60: Japan output gap



Sources: Aviva Investors, Macrobond, as at 30 June 2017

Figure 61: Core inflation continues to be determined by the yen



Sources: Aviva Investors, Macrobond, as at 30 June 2017

CHINA: POLICY MIX CRITICAL

– Deleveraging to continue but not at expense of growth; policy response to soften

– Fiscal support to moderate but unlikely to be removed until private sector is more resilient

– Reforms on multiple fronts in the lead up to Party Congress

Some developments, such as Caixin-official PMI divergence, remind us of 2015

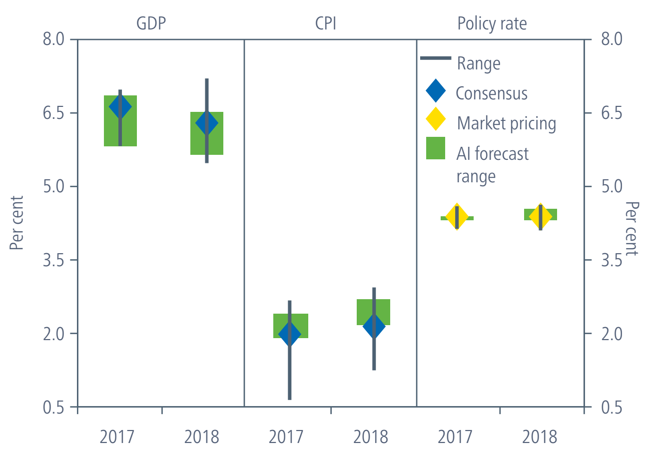
After exceptionally strong growth recently, we expect some moderation in the coming quarters. However, we continue to see a managed slowdown. The policy response, fiscal and monetary, is likely to be recalibrated to limit hard-landing risks. In terms of the headline activity indicators, while growth has inevitably moderated, there is greater resilience in indicators such as retail sales and industrial production than during previous episodes when policy was tightened. Some developments remind us of the early build-up to the 2015 slowdown – a clear divergence has opened up between the official manufacturing PMI and the Caixin PMI with the former showing much better growth than the latter (Figure 63). However, this could be because larger firms, that dominate the official index, have access to a wider range of funding sources and they are the main beneficiaries of fiscal measures. Similarly, the decline in the price of iron ore isn't necessarily an indication of a broad-based slowdown as other industrial metals prices, such as copper, have been far more resilient.

Growth is likely to slow further, but there is unlikely to be a hard landing

On the balance of evidence, we do not see a repeat of the sharp slowdown from 2011-15. We regard the authorities' commitment to maintaining growth close to 6.5% as credible, though we recognise that uncertainty may be higher and accordingly have a wide spread of growth outcomes around that average (Figure 62). Consumption and services have remained more resilient than manufacturing (Figure 64), which bodes well for the structural rebalancing objective. But even in terms of investment spending, there has been a pattern of the public component of fixed asset investment (FAI) growth coming to the rescue when the headline FAI has been dragged down by the private slowdown. Hence, for the time being, fiscal policy will keep growth ticking at a manageable pace.

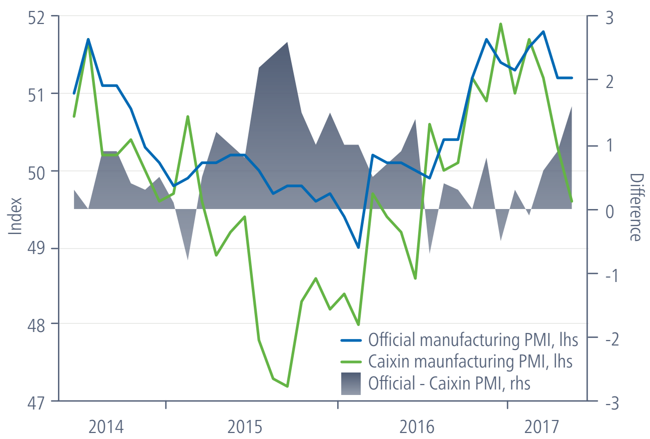
In the lead up to the party Congress in November, the key focus of investors will be on risks surrounding regulatory deleveraging (Figure 65) and the trajectory of fiscal policy which has been instrumental in spurring growth since early 2016. The authorities, notably the relatively hawkish China Bank Regulatory Commission,

Figure 62: Growth likely to average around 6.5% in 2017



Sources: Aviva Investors, Bloomberg, as at 30 June 2017

Figure 63: Caixin slowing more than official PMI



Sources: Aviva Investors, Macrobond, as at 30 June 2017

view the growth surge of recent months as an opportunity to push through deleveraging, especially in the shadow banking sector where credit has been intermediated through increasingly ill-regulated and opaque mechanisms, e.g. wealth management products involving non-bank financial institutions and securities firms as channel firms. A particular focus for the authorities in recent months has been the activity surrounding entrusted structures that allow banks to circumvent regulatory restrictions on investment in conventional assets such as equities and real estate. The authorities clearly view the involvement of the banking sector in speculative activities as destabilising and will probably continue to clamp down on the newer forms of shadow-banking intermediation which have evolved in recent months to avoid regulatory scrutiny.

The authorities are likely to continue to clamp down on ill-regulated shadow banking structures

The regulatory deleveraging has meant that People's Bank of China's (PBoC) balance sheet has shrunk by some CNY1.1trn during Jan-Mar 2017 and repo rates have risen gently (Figure 66). This has had repercussions for a wide range of economic participants including small/medium-sized banks, bond investors and the housing market. However, we believe the policy response will likely be recalibrated to avoid a significant economic slowdown and credit-market stresses. Judging by the relatively dovish Q1 monetary policy report, the PBoC's response in particular is likely to slow down to allow the economy to stabilise.

Policy response likely to be recalibrate to avoid hard-landing risks

The authorities are keen to differentiate between financial and monetary deleveraging, the former being a matter primarily for the wholesale markets where easy funding until last year has given rise to vulnerabilities in some sections of the economy (small/medium sized banks, non-bank financial institutions, some SOEs, etc). Financial deleveraging is likely to be encouraged. But PBoC in particular is likely to minimise monetary deleveraging, i.e. spending retrenchment in the real economy, especially the housing market, in the wake of tighter funding. To this end, it's a positive sign that policy response is being tailored through a combination of wholesale tightening along with liquidity provision further out on the maturity spectrum through the medium-lending facility.

The authorities want to encourage financial deleveraging, but not monetary deleveraging

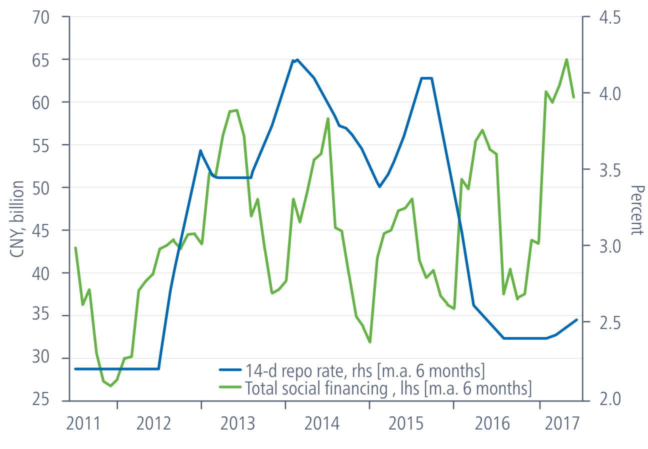
The housing market is where there remain considerable downside risks. While activity has evidently softened with price gains in 1st tier cities moderating significantly from the middle of last year (from annualised rate above 30 per cent to below 12 per cent now), supply indicators such as new starts suggest that excess supply could again become a problem (Figure 67). Hence, policy will need to be particularly carefully calibrated in order to avoid fresh stresses in the housing market. Encouragingly, the latest data shows that the price growth moderation of recent months is generating a supply response which should prevent a deeper slowdown.

Housing market will be a key focus in terms of risks to the household sector

Figure 64: Consumption, services stronger than manufacturing

Sources: Aviva Investors, Macrobond, as at 30 June 2017

Figure 65: Policy trying to rein in excess credit growth



Sources: Aviva Investors, Macrobond, as at 30 June 2017

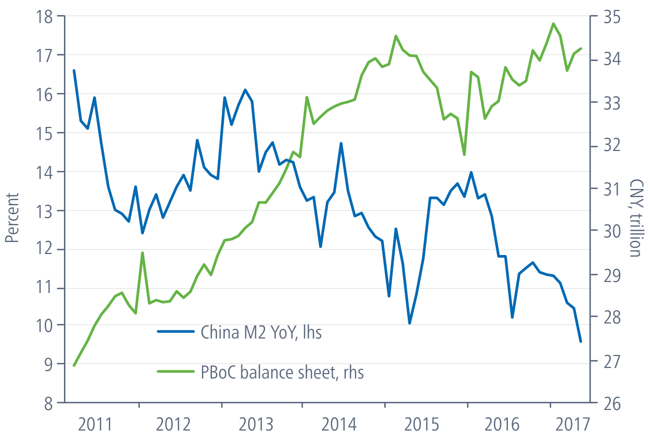
External demand backdrop has been supportive and is likely to remain benign

One big positive for the Chinese cycle in recent months has been the strength of external demand. While exports to final-demand destinations such as Europe and the US have been strong, intra-Asia trade has been an increasingly important part of China's trade and has been a key contributor to export growth. At the same time, import growth has been exceptionally strong in recent months which reflects the strength of domestic demand.

Yuan stability keeping capital outflows from turning destabilising

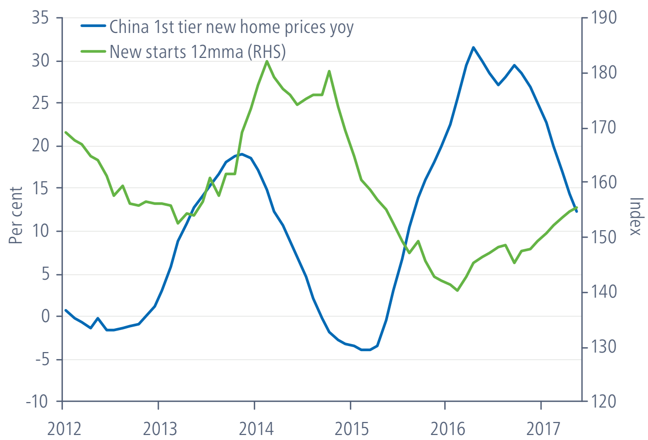
Capital outflows have moderated with FX reserves bottoming out around $3trn. Outflows in recent months have been largely due to Chinese residents' acquiring assets overseas rather than the large carry-trade unwind of 2015. We don't see such asset-allocation driven outflows to be as destabilising as those associated with carry unwinds. Even so, the authorities are likely to remain sensitive to the matter – they have maintained the USD/CNY exchange rate in a 6.80-6.90 range for much of this year, mindful of the fact that a weakening exchange rate in itself can be a powerful trigger for outflows. While the yuan has been relatively stable against the dollar, it has been weakening on the CEFETs or trade-weighted basket. So while psychologically for capital outflows the USD/CNY rate matters more, for the wider impact on the economy, it's the trade-weighted yuan index that is key. Another development that supports this interpretation of PBoC policy is their introduction of a counter-cyclical adjustment to the USD/CNY fixing, which is essentially designed to lean against the trend in the onshore exchange rate and prevent overshoots which the central bank views as destabilising. Hence, we would expect relative stability in the USD/CNY rate in the coming months.

Figure 66: PBoC balance sheet shrank during Q1



Sources: Aviva Investors, Bloomberg, as at 30 June 2017

Figure 67: Housing - rising supply amid falling prices



Sources: Aviva Investors, Bloomberg, as at 30 June 2017

AUSTRALIA: LOWFLATION TO PERSIST

– Terms of trade boost set to wane

– Domestic rebalancing points to downside risks to growth

– Reserve Bank of Australia (RBA) on hold in 2017

SUMMARY

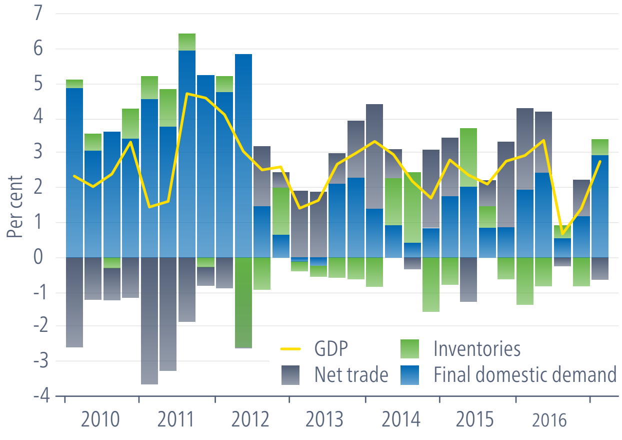
Australia enjoyed a significant boost to gross domestic income in the year to 2017 Q1, as higher commodity prices fed through into a nearly 25 per cent improvement in the terms of trade (the ratio of the price of exports to imports). Indeed, while GDP growth in the year to Q1 slowed to just 1.7 per cent, the weakest rate of increase since 2009, domestic income grew by nearly 6½ per cent. The improvement in the terms of trade also pushed the trade balance to its largest surplus since 1973 and moved the current account deficit to its narrowest since the mid-1970s. If these conditions were to persist, the tailwind would be greatly beneficial to an economy still going through a long adjustment phase. However, more recently the price of those commodities that Australia exports have fallen back. For example the price of iron ore, which makes up around 20 per cent of Australian goods exports, has fallen around 40 per cent from its peak in Q1. Estimates by Citigroup suggest that around one-third of the improvement in the terms of trade seen in 2016 has reversed in recent months.

The boost from higher commodity prices already waning

With support from the terms of trade support likely waning, the domestic economy will need to take up the slack. Final domestic demand has strengthened in recent quarters as the drag from falling mining investment slowed (Figure 68). At the same time household consumption growth has remained reasonably solid, despite a slower pace of growth in real disposable income (Figure 69). As a result the household saving ratio fell to its lowest level since the financial crisis. With wage growth slowing further over recent months, and household balance sheets strained by heavy indebtedness, it is unlikely that consumption growth will be maintained at the recent pace. With inflation below the Reserve Bank's target range, and expected to remain below for some time, the RBA continues to be faced with a difficult trade-off between supporting domestic demand through easier policy, but not fuelling a further increase in housing market activity. We expect they will maintain the current policy rate over the next year, with further reliance on macroprudential policies to slow the housing market.

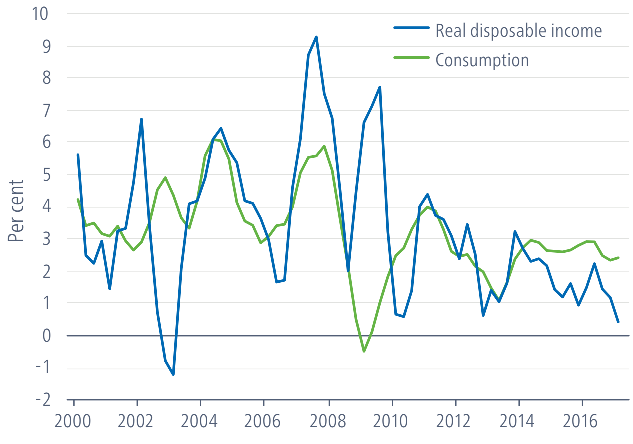
Consumption growth has been outpacing income

Figure 68: Contributions to GDP growth (6mth annualised)
Domestic demand rebounds as net trade shrinks



Sources: Aviva Investors, Macrobond, as at 30 June 2017

Figure 69: Household consumption and disposable income
Households are being squeezed by slow wage growth



Sources: Aviva Investors, Macrobond, as at 30 June 2017

LOW INFLATION MEANS LOW RATES FOR LONGER

Domestic demand likely to be soft, with greater reliance on foreign trade

A central theme for the Australian economy in recent years has been the transition from mining-led growth to non-mining sectors. Following a boom in mining investment during the second half of the 2000s, there was a precipitous decline starting in 2013. That adjustment is nearing its completion, and therefore will no longer be a drag on growth. However, non-mining investment has not as yet taken the baton. The latest capex survey suggests that non-mining investment will be muted in the coming years as well. With consumer spending under pressure from weak wage growth and no appetite for looser fiscal policy, the outlook for domestic demand is muted. Moreover, the contribution from housing investment is also set to wane in the coming years, as a glut of apartments in the major cities reach completion. Perhaps more than ever, the economy will be reliant on external forces. Net trade should benefit from the large LNG projects coming online (boosting GDP growth materially in 2018), but the pace of growth in China and the Asian region will be just as important to the outlook.

Housing market risks require more macroprudential measures

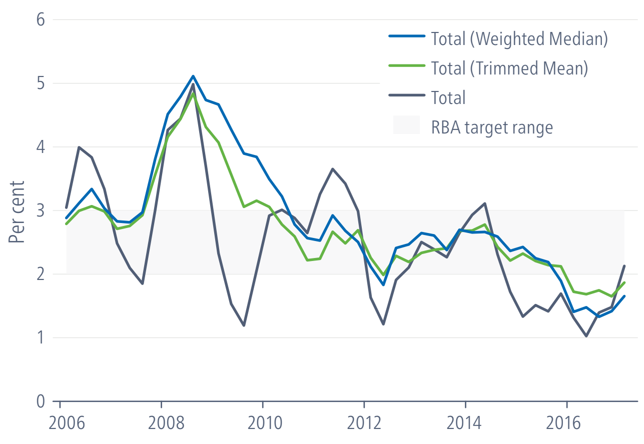
Domestically the housing market has once again picked up pace in 2017 in the major cities. According to RP Data/CoreLogic, house prices are up 50 per cent over the past 5 years. Debt levels have risen accordingly and, in the event of a major correction, represent a significant risk to the outlook. In response, the authorities have pursued tighter macroprudential policies in order to rein in lending to property investors and "interest-only" borrowers. These measures have curtailed lending to these segments of the mortgage market, which should help to slow the pace of turnover and price increases. Moreover, through the course of the past two years only around half the reduction in official interest rates have been passed on to mortgages, as the banks have increased their spreads on the back of tougher capital requirements. These efforts are designed to slow the housing market while at the same time allowing the RBA to keep policy rates low.

RBA expected maintain current rates as inflation is set to remain low

The need for low rates has been reinforced by the weakness of wage growth and inflation (Figure 70). Despite some reduction in unemployment, broader measures of underemployment remain elevated. Wage growth fell to a new low of 1.9 per cent in Q1 and unit labour costs have been falling over the past six months. Alongside muted cost pressures, the retail sector is under increasing pressure to lower margins as competition from low-cost competitors abroad intensifies. These factors are likely to see core inflation continue to undershoot the RBA target over the coming year (Figure 71).

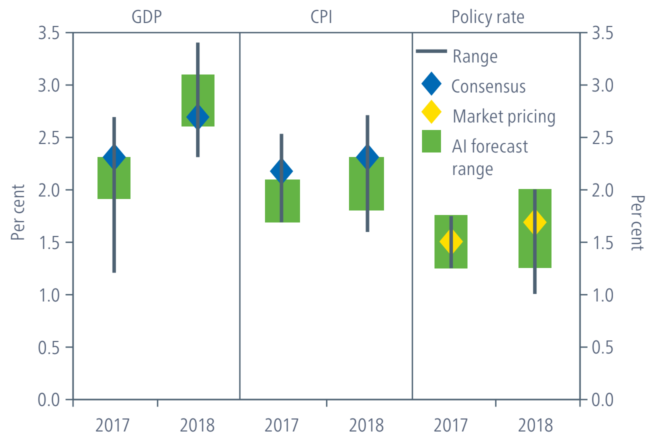
Figure 70: Measures of CPI inflation

Core measures below target



Sources: Aviva Investors, Macrobond, as at 30 June 2017

Figure 71: Australian economic projections



Sources: Aviva Investors, Macrobond, as at 30 June 2017

CANADA: IT'S NOT SUSTAINABLE

– Fastest growing economy in the G10 universe led by household spending and residential investment

– Inflationary pressures remain non-existent

– Housing crisis! What housing crisis?

The Canadian economy continues to surprise on the upside. First quarter GDP growth put Canada as the fastest growing economy in the g-10 universe. The economy grew by 3.7 per cent annualised (Figure 72). Looking at the details, household spending and residential investment were the main drivers, with consumption spending growing at an annualised pace of 4.5 per cent and residential investment spending rising by 15 per cent on the same basis. Positive signs are emerging from the business community and are worth highlighting. Although investment intentions remain low by historical standards, the most recent business outlook survey showed a marginal improvement. The energy soft patch is now behind us as Canadian energy firms have adjusted well to the current lower oil price. We don't expect a rapid acceleration in investment spending but it shouldn't be a drag on the economy anymore. The external sector remains very disappointing. The Canadian current account deficit remains very wide and has not shown any sign of improvement despite the large depreciation of the currency since 2011 (Figure 73). Given that 20 per cent of the Canadian economy and 15 per cent of its total employment are linked to US exports, NAFTA negotiations represent a significant worry to the sustainability of the Canadian growth model and the long-term goal of rebalancing the economy away from energy and housing.

Fastest growing economy in the G10 universe…

…driven by household spending and construction

NAFTA negotiations remain a risk

MONETARY POLICY SURPRISE

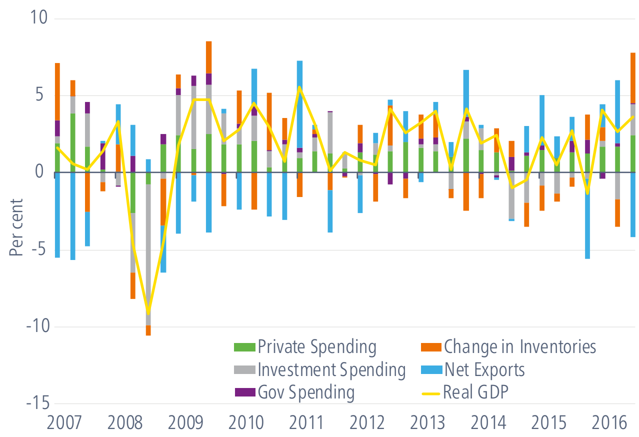
The central bank took comfort from the recent broad-based improvement in economic activity and surprised many with a more hawkish tilt to their monetary policy stance. Expectations are for the central bank to undo the 2 insurance rates cut it made during the oil shock in 2015 (January and July).

Hawkish surprise from Bank of Canada

IS IT SUSTAINABLE? WE DON'T THINK SO

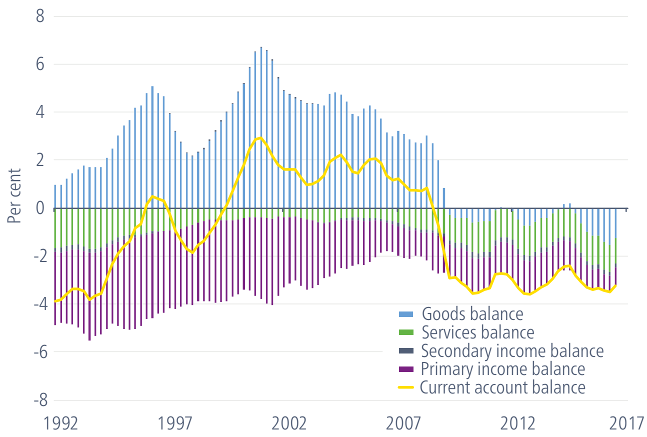
Although economic momentum has strengthened of late, the main question is whether it is sustainable and whether Canada can grow above potential going

Figure 72: GDP decomposition: Private spending remains the main engine of growth



Sources: Aviva Investors, Datastream, as at 30 June 2017

Figure 73: Current Account Balance Decomposition (% GDP)



Sources: Aviva Investors, Datastream, as at 30 June 2017

Spending funded using additional debt

forward. We believe that this recent pick up in growth is not sustainable at this pace. The country's economic activity will remain restrained until Canada deals with its imbalances. The spending spree continues to be funded by debt. The sharp drop in the household savings ratio, from 5.3 per cent in Q4 of 2016 to 4.3 per cent in the first quarter of this year, suggests that this expansion cannot continue with wage growth decelerating significantly in nominal terms and contracting in real terms. Savings-funded consumption is not a sustainable source of spending going forward.

Non-energy exports remain very weak.

Moreover, non-energy exports remain very weak. So far the depreciation of the currency, combined with the pick up in US economic activity, has not been enough to help Canadian exporters in a convincing way. Volumes remain low and are weakening. The slowdown in the US car market is a serious risk for Canada and its car industry. Autos account for the 2nd largest proportion of Canadian exports after energy.

Where is inflation?

Inflation remains weak and continues to trend lower. Headline CPI remains below target but most importantly all three core CPI measures are well below the 2 per cent level (Figure 74). Excess capacity remains and the output gap is still negative despite robust job creation in the last 6 to 12 months. Most of the job creation took place in the construction sector. With housing activity expected to slow on the back of the recent round of macro-prudential measures, we think jobs growth will decelerate in the coming quarters.

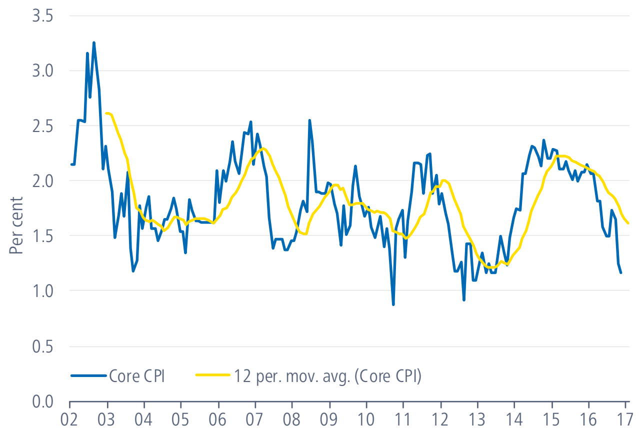
HOUSING AND CREDIT

Housing crisis! What housing crisis?

Consumers vulnerable to higher borrowing costs

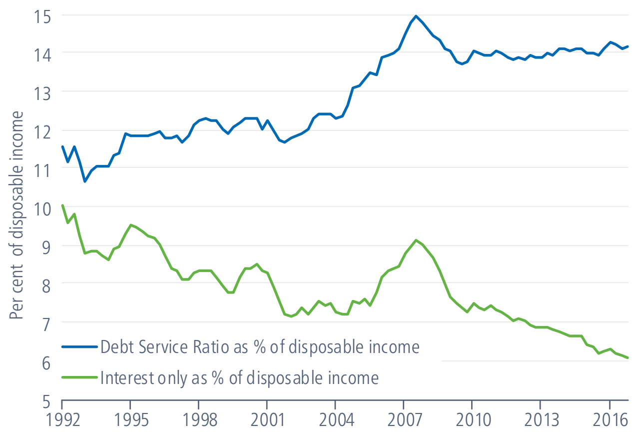
The outlook for Canadian housing remains front and centre. Although the Home Capital Group liquidity issue is now perceived as an idiosyncratic event, Canadian housing market and excessive credit in the system are showing some signs of cracks. House prices in Toronto were up more than 4 per cent in April alone, and up almost 30 per cent in the last 12 months. Household debt as a percentage of disposable income continues to rise, driven by growth in mortgages and home equity lines of credits (HELOCs). These imbalances were highlighted in the most recent financial stability report. Macro-prudential measures implemented in the fall started to be felt and we think that higher borrowing costs will only make consumers more vulnerable to an income squeeze and a deleveraging cycle. Despite all-time low debt service cost ratios, total payments including principal are at all-time high (Figure 75).

Figure 74: Inflationary pressures remain weak



Sources: Aviva Investors, Datastream, as at 30 June 2017

Figure 75: Canada debt burden remains very high despite falling interest rates



Sources: Aviva Investors, Datastream, as at 30 June 2017

ASIA EX-JAPAN: RIDING HIGH ON ROBUST TRADE GROWTH

- Moderate but robust world trade growth bodes well for export-oriented EM Asia
- Diminishing risks of protectionism remove uncertainty hanging over Korea and Taiwan
- Domestic demand stories (India, Indonesia) likely to remain positive

SUMMARY

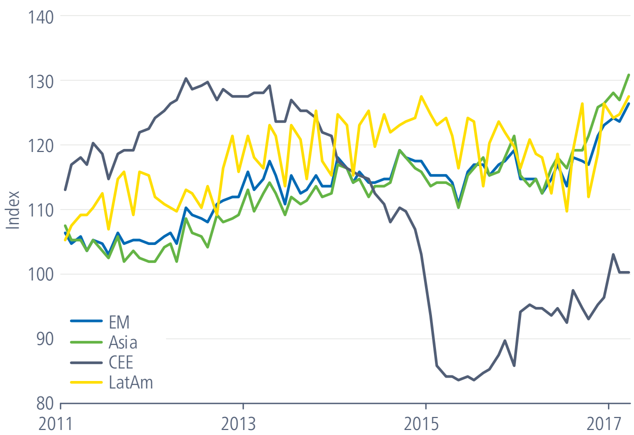
If there is one theme that is central to the fortunes of the Asia ex-Japan region, it is the resurgence of world trade growth since early 2016. While trade growth measures may have peaked during Q1, they are likely to remain healthy over the coming quarters. Figure 76 shows that trade growth for EM Asia is, by some margin, the fastest among the major EM regions. GDP growth in the most export-oriented economies has stabilised owing in large part to the boost from external demand (Figure 77), taking the pressure off central banks in economies such as Korea, Taiwan and Thailand where monetary policy had arguably reached its limits. With the positive impulse from global trade likely to continue in the near term, deflationary risks have mostly vanished, paving the way for more neutral monetary policy stances.

For regional central banks tied to Fed policy, such as the Monetary Authority of Singapore (MAS) and the Hong Kong Monetary Authority (HKMA), the moderation in US inflation in recent months could potentially mean that the Fed tightens policy at a gentler rate, allowing them to see the growth improvement of recent quarters entrenched.

The other risk for the region is the ongoing growth moderation in China, which could weigh on the wider region given the ever-increasing trade linkages with China. However, we expect the Chinese authorities to smooth the path to a lower growth trajectory which should minimise the sort of destabilising effects of a slowdown seen during 2015. Moreover, exports to key markets for finished goods, especially the US and Europe, have remained resilient and are likely to continue to support growth in the region.

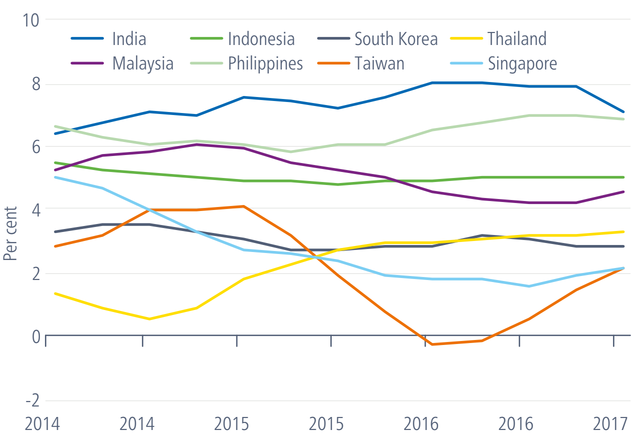
Robust world trade growth likely to continue to support strong growth in EM Asia

Figure 76: Asia strongest on trade growth indices



Sources: Aviva Investors, CPB Netherlands Bureau for econonimic policy analysis

Figure 77: Real GDP growth stabilising



Sources: Aviva Investors, Bloomberg, as at 30 June 2017

Diminishing near-term risks of protectionism to boost North Asian exporters

Also from a global-risk angle, risks of protectionism in the form of punitive US tariffs have diminished given the disarray that the Trump administration currently finds itself in. This takes away the major source of uncertainty hanging over regional economies such as Korea and Taiwan which have large bilateral trade surpluses with the US and have been on the US Treasury's current watch list. The risk that the two North Asian exporters would be targeted to set an example for China had already diminished materially after the meeting between Presidents Trump and Xi. But now the US political establishment has far more important matters to attend to (fall-out from James Comey's firing and President Trump being investigated for obstruction of justice). This should boost North Asia further after trade and industrial growth have recovered handsomely in recent quarters (Figure 78).

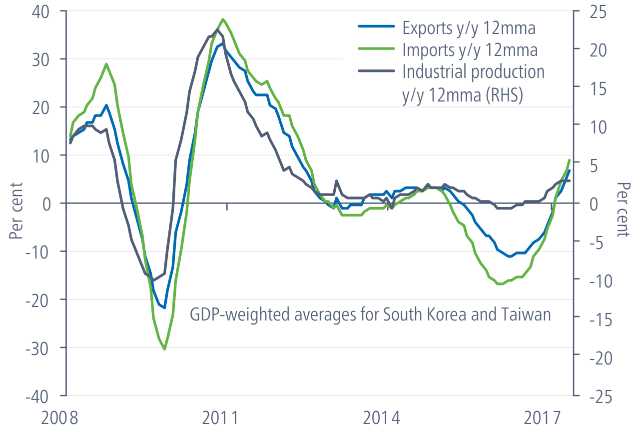
Among other export-oriented economies, Malaysia and Thailand should benefit from deleveraging in recent years, as rates of debt growth have dropped below the rates of nominal GDP growth. This is in contrast to Korea and Singapore where high household indebtedness continues to act as a drag on overall growth, preventing the boost from export growth from translating into a wider cyclical upswing.

Malaysia has multiple sources of cyclical boosts

Malaysia in particular looks set to enjoy a continuation of the recent cyclical rebound. First, the recovery in exports is not entirely due to the rebound in commodity prices (rubber, oil) but also due to non-commodity exports (especially electronics). The large depreciation of the ringgit in recent years has enhanced competitiveness and bodes well for non-commodity exports in the coming quarters(Figure 79). Finally, while parliament is due to be dissolved by June 2018, there is speculation about early elections. Historically, both household spending and the government deficit have tended to rise in the lead up to elections. Hence, there are good reasons for pre-election spending to become a source of a further cyclical boost.

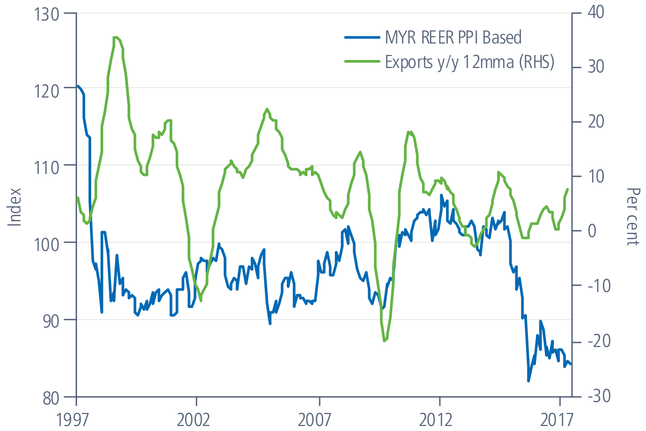
Domestic-demand driven Asian stories continue to look attractive despite some concerns about stretched asset-price valuations. Starting with India, while Q1 GDP surprised to the downside, likely because of the negative impact of the demonetisation reform last year manifesting itself with a lag, growth should recover in the coming quarters. Inflation as measured by the consumer price index has declined to an all-time low while the current account remains nearly in balance (Figure 80), which could allow the Reserve Bank of India to ease policy, though up until now the central bank has shown remarkable conservatism, partly for credibility reasons. However, at the most recent meeting, the MPC cut its inflation forecast for FY18 by 125bps, likely paving the way for a less hawkish policy stance.

Figure 78: Strong trade-led recovery in North Asia



Sources: Aviva Investors, Bloomberg, as at 30 June 2017

Figure 79: Cheap MYR to boost Malaysia's exports



Sources: Aviva Investors, Bloomberg, as at 30 June 2017

One near-term risk comes from the implementation of the goods and services tax (GST) which the government passed in April and wishes to implement from July. Consumption growth could slow down during the implementation phase. Historical evidence suggests that the slowdown in activity from indirect taxes has been short lived and growth tends to return to trend levels quickly. However, for India the disruption could persist longer given the scale of implementation and the size of its informal sector.

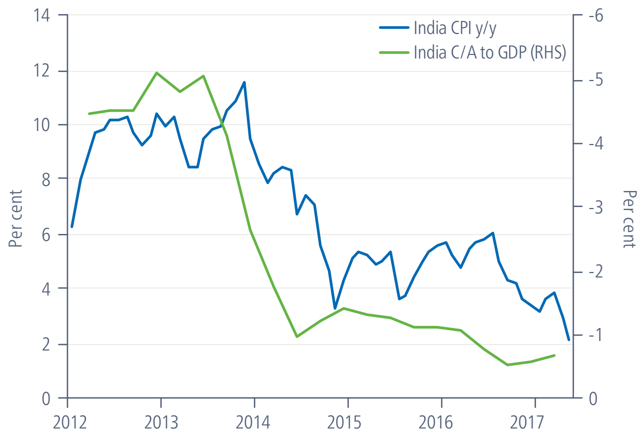
GST implementation poses near-term risks for India, but the cycle remains in Goldilocks

Indonesia got a further boost to its standing after S&P upgraded it to investment grade. While this was an act of catch-up with other major ratings agencies, it has served to validate international investors biases, resulting in a further rise in capital inflows (Figure 81). Indonesia is one of the highest-yielding investment grade emerging markets globally.

The main worry about Indonesia in recent months has been about a possible fiscal cliff as the budget deficit cannot rise above a statutory 3 per cent of GDP. The weak revenue growth over 2016 threatened to force harsh fiscal cuts during 2017 owing to the statutory deficit limit. However, government revenue receipts have picked up, partially as a result of a tax amnesty programme allowing fiscal policy to turn supportive again as state capital expenditure rebounded in March. Going forward, a greater shift in the mix of state spending towards infrastructure is likely to be positive both cyclically and for trend growth as it generates favourable multiplier effects. Secondly, while private sector demand momentum has stuttered in recent months, export growth has been robust. The expected rebound in state infrastructure investment should "crowd in" private-sector investment demand too, shoring up growth further.

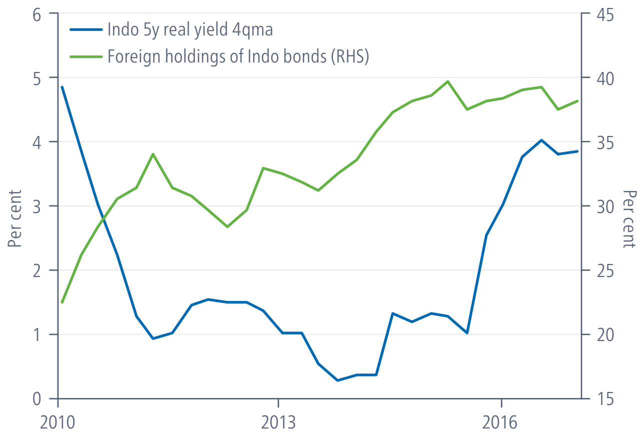
Receding fiscal-cliff worries to boost Indonesia cyclically, after the favourable ratings upgrade

Figure 80: India's C/A deficit and inflation at multi-year lows



Sources: Aviva Investors, Bloomberg, as at 30 June 2017

Figure 81: Rising Indo real yields attractive for foreign investors



Sources: Aviva Investors, Bloomberg, Asia Development Bank as at 30 June 2017

LATIN AMERICA: ROLE REVERSAL

– Political risks remain elevated

– Low growth keeps pressure on fiscal outlook

– Shifting outlooks across the region

Economic fortunes shifting across the region

While Latin America has made positive strides over the past year on many fronts, recent developments are a reminder that the transition is still in progress. Market darlings of Brazil, Peru, and Colombia have faced setbacks recently. In Brazil, President Temer has been implicated in a bribery scandal, putting much-needed pension reform at risk. In Peru, President Kuczynski has had limited success in navigating majority congressional opposition and in Colombia, sub-par growth and declining oil prices have many suggesting another VAT increase is the only option to avoid a downgrade. On the flipside, the outlook in Mexico and Chile is improving as the US administration has shown willingness to negotiate with trade partners and early polling results in Chile are supportive for market-friendly candidate Piñera. The improved growth outlook in Chile and Mexico means they have joined the Latin America disinflationary trend, suggest shifting outlooks across the region.

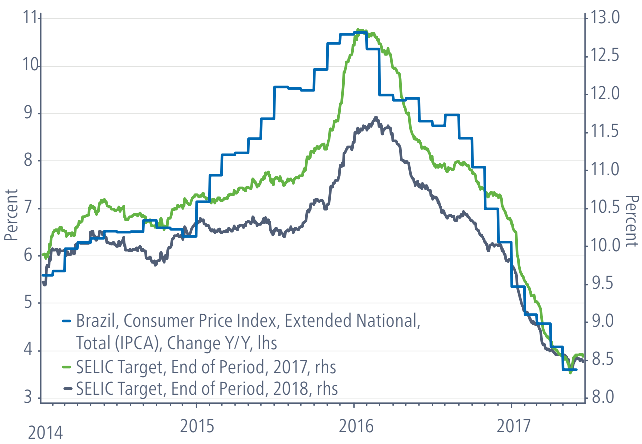
Political risks should not derail easing cycle

After eight consecutive quarters of decline, GDP growth in Brazil recently broke into positive territory, expanding at a one per cent rate in the first quarter. However, leaked audio seemingly implicating President Temer in corruption scandal will be a headwind to passing key pension reform and has the potential to reverse recent increases in confidence measures. The silver lining is that the weak economic outlook continues to pressure inflation lower and should allow the central bank to continue to cut rates from the current 10.25 per cent rate to the mid-eight per cent range as the year progresses (Figure 82). An additional positive is Brazil's improved external position—the current account deficit at 1.25 per cent of GDP is the best in the post-crisis period and the trade balance continues to surpass expectations. That said, political uncertainties suggest the risks remain to the downside.

Is the worst behind Mexico?

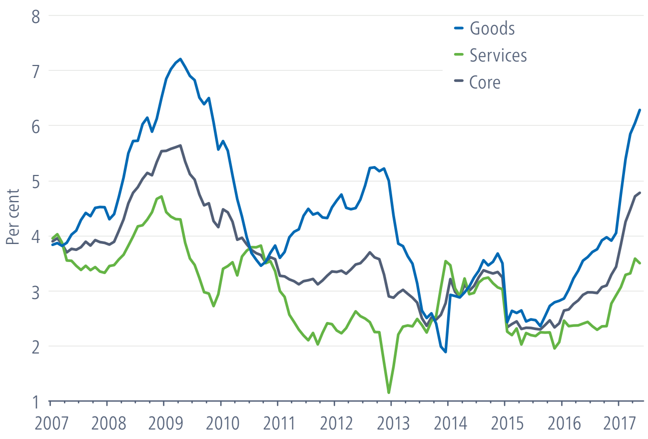
Mexico continues to defy expectations with growth remaining stable and the US administration abstaining from protectionist measures to this point. Led by solid private consumption growth of 3.1 per cent y/y, activity remains stable, although uncertainties around US policies and the lagged impacts of monetary tightening are expected to weigh on activity as the year progresses. In particular, investment— flat on a y/y basis—is likely to restrain growth, leading to forecasts of sub-two per cent growth for the remainder of the year. This should help contain

Figure 82: Lower inflation supports BCB easing cycle



Sources: Aviva Investors, Macrobond, as at 30 June 2017

Figure 83: Mexico CPI inflation to slow in coming months



Sources: Aviva Investors, Macrobond, as at 30 June 2017

inflation which has continued to exceed expectations and is currently above six per cent for the first time in the post-crisis period (Figure 83). While US policy actions remain a key risk, it looks likely that Mexico will continue to outperform worst case scenarios.

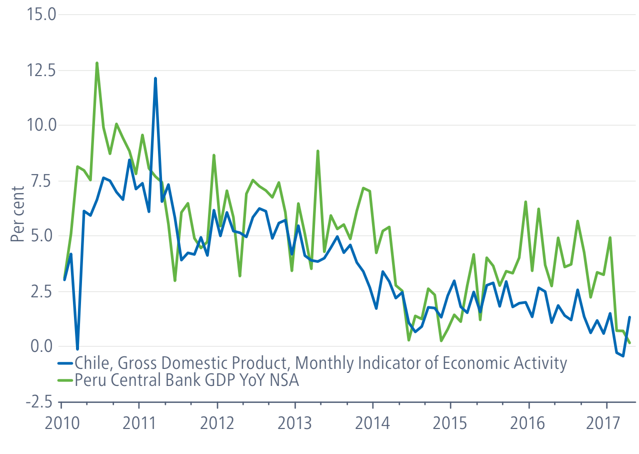
Time for Chile to outperform Peru

While both Chile and Peru continue to adjust to lower copper prices (Figure 84), the outlook for Peru was more upbeat largely as a result of last year's election outcome. Recent political setbacks suggest the Peruvian economy might not rebound from the first quarter near-zero activity as quickly as previously believed. Meanwhile, Chile appears to be bottoming from the recent growth malaise with leading indicators like money growth (+9.5 per cent y/y) and steepening yield curves are discounting an improved growth outlook. A resumption of industrial activity after mining strikes drove production down 20 per cent y/y in Q1 and an election-driven boost in confidence and investment also support a more positive outlook. The medium outlook for Peru is still more favourable owing to ample fiscal space and a capacity for the central bank to cut rates further. However, the upcoming quarter may be more favourable for Chile.

Fiscal challenges remain in Colombia

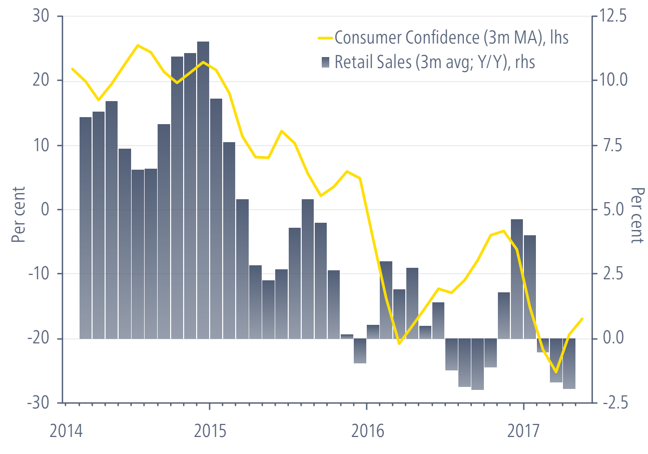
Fundamental concerns are on the rise in Colombia again. The growth outlook continues to deteriorate with retail sales declining by 2 per cent and industrial production plummeting by 6.8 per cent in the year to April. Low growth, combined with oil prices below the government's estimated $48/bbl breakeven, are putting the focus back on the fiscal outlook. With limited room to cut spending, the government may need to increase VAT again to close the 1.1 per cent primary deficit. This, in turn, will keep confidence depressed, extending the record streak of 16 consecutive months in negative territory (Figure 85). While the central bank has suggested 100 basis points of easing ahead, core CPI has become sticky above 5 per cent and may spoil the central bank's plans. Indeed if portfolio flows begin to reverse as fundamentals deteriorate Colombia's dreaded twin deficits could be a theme for the second half of this year.

Figure 84: Role reversal in region's copper producers



Sources: Aviva Investors, Macrobond, as at 30 June 2017

Figure 85: Weak confidence weighs on Colombian economic outlook



Sources: Aviva Investors, Macrobond, as at 30 June 2017

CENTRAL EUROPE: FUNDAMENTAL BACKDROP IMPROVING

– Central European (CE) economies in a strong cyclical upswing but CE central banks still very slow to reduce ample monetary policy accommodation

– In Russia, the short-term outlook has brightened, but long-term challenges remain

– In Turkey, a window of ill-defined political stability opens, which hopefully allows the government to focus on structural problems

Consensus growth forecast for Central Europe upped, after very strong Q1 2017

Economic activity has improved further in Central Europe. GDP growth in Q1 2017 surprised to the upside in almost all economies in the region and by a wide margin in many (Figure 86). As well as the already robust private consumption, the rebound of investment spending was quicker and stronger than many expected. Encouragingly, spending that was financed out of EU budget provision increased, but so too did private investment expenditure. As a result consensus growth estimates have been further increased for this year and next close to 4 per cent on average across the CE region. Growth moderated somewhat in Bulgaria, where ongoing political turmoil weighs on business sentiment and investment spending, and Croatia. In both countries the slowdown should prove only transitory.

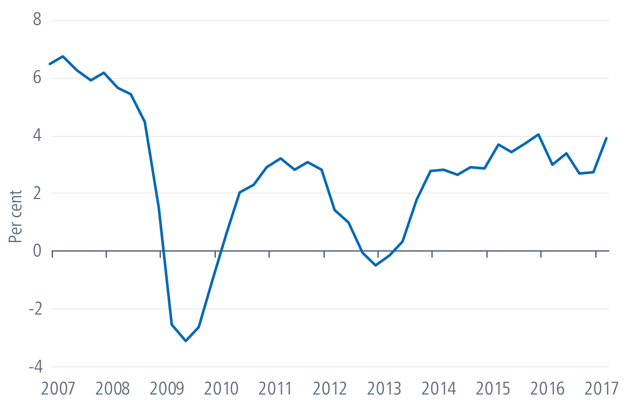
Very expansionary fiscal policy seems likely to continue

Meanwhile, governments in CE countries have continued with very expansionary fiscal policy, as promised to their political constituents. The scale of fiscal stimulus may increase further in Hungary and the Czech Republic ahead of parliamentary elections. While this may push balanced budget further into the distance, it should not, on the other hand, lead to any breaches of the 3 per cent Maastricht threshold in any of the CE countries with exception of Romania. In Croatia and Serbia, the fiscal impulse has been much more muted as the International Monetary Fund (IMF) has continued to exert pressure on these countries to carry on with fiscal adjustment.

CE central banks want to see sustainably higher core inflation before they move

Despite the strong economic picture, CE central banks are seemingly nowhere near to starting any meaningful monetary tightening. Very tight labour markets, close to zero or already closed output gaps, haven't yet showed up in higher core inflation readings, which universally remain comfortably below inflation targets. Only in the case of the Romanian and Czech central bank's inflation projections, core inflation

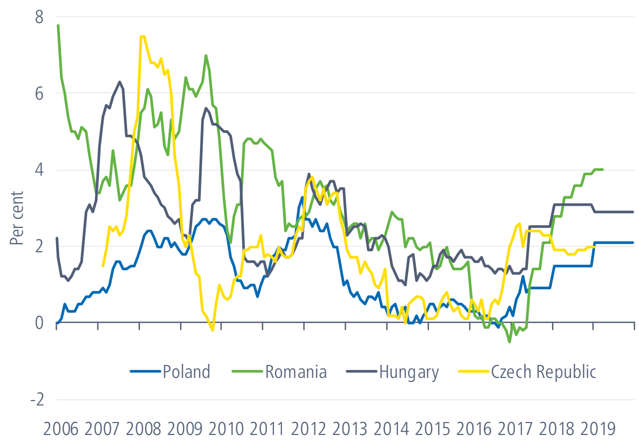
Figure 86: Central Europe Real GDP (weighted average*)



Source: Bloomberg, as at 30 June 2017

* GDP weighted average of Poland, Czech Republic, Romania, Hungary, Croatia, Slovenia, Serbia, Bulgaria

Figure 87: CEE4 CORE HICP inflation & national banks' core CPI forecast



Sources: Eurostat, National Central Banks inflation projections rises to slightly above target within the banks' forecast horizon (Figure 87). The Czech bank may still hike rates towards the end of 2017, but the Romanian one continues to downplay any signs of inflationary pressures. Polish and the Hungarian central banks envision their first hikes in 2019 or beyond. Clearly the policymakers in Central Europe prefer running the risk of falling behind the curve to that of acting prematurely.

The outlook for Russia has improved considerably in 2017. Economic growth has finally picked up and is expected to reach around 1 per cent this year, finally leaving behind the economic consequences of sanctions imposed after the conflicts in the Crimea and Ukraine (Figure 88). Better growth has been accompanied by a large fall in inflation which finally reached central bank's target. It is a sign that the very orthodox and restrictive monetary policy conducted by central bank has paid off. It also enabled it to start a gradual easing cycle. The government has attempted to limit Ruble sensitivity to oil prices by the introduction of new fiscal initiatives. That together with supportive external environment and high real yields led to strong Ruble appreciation this year.

Yet, despite the ongoing improvement in the main economic aggregates Russia still struggles with structural issues which limit potential growth (currently estimated at around 1.5 per cent). There are some advisory teams working on structural reform plans but it is unlikely any major reform will be implemented before the presidential elections in March 2018. Without restructuring of administration and pension systems and in the absence of any attempt to tackle corruption, it is hard to see Russia maintaining growth momentum next year. It will be also interesting to see if the government sticks to its ambitious fiscal plans ahead of elections.

Russia readies for reforms but implementation uncertain and so too the longer term growth prospects

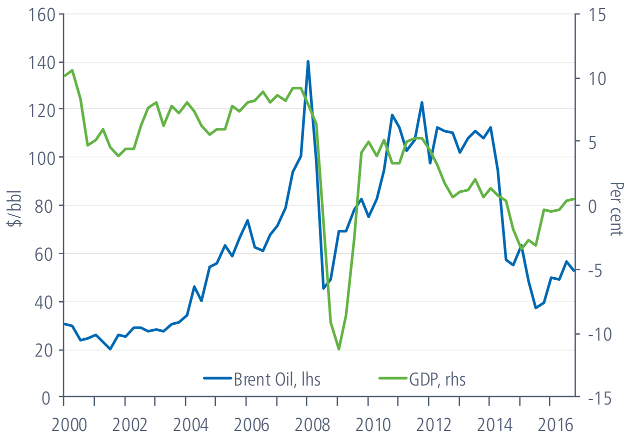
The economic situation in Turkey has stabilized and the outlook improved slightly with political uncertainties receding after results of the April referendum. Despite questionable long-term implications, the result of the referendum brought some political stability and hopefully will allow the authorities to focus on structural problems within the Turkish economy. Growth in Q1 surprised to the upside but it was mainly driven by private consumption and was helped by a fiscal boost equal to 2 per cent of GDP.

After the referendum, the Government will have the chance to focus on economic agenda

Thanks to the favourable global environment and tight monetary conditions, inflation should gradually ease but will stay in double-digits for most of 2017. There is still concern that core inflation might become sticky and remain at elevated levels for prolonged time.

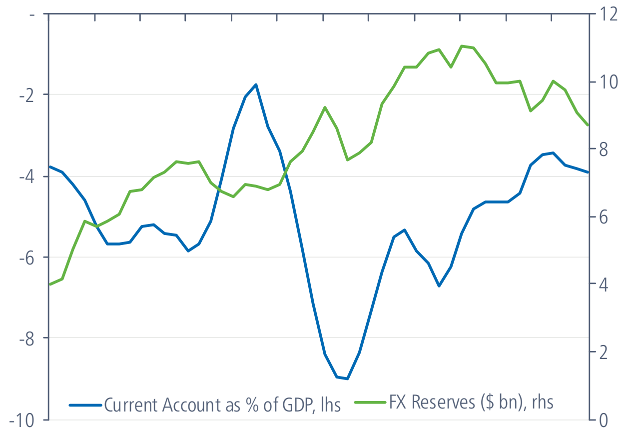
External financing remains the biggest risk for Turkey and the recent widening of the current account deficit and declining levels of foreign exchange reserves can only add to existing worries (Figure 89). Having said that, public debt is still comparatively low as a proportion of GDP.

Figure 88: Russia Real GDP (per cent YoY, quarterly) and Brent Oil ($/brl)



Source: Bloomberg, as at 30 June 2017

Figure 89: Turkey current account and foreign exchange reserves



Source: Bloomberg, as at 30 June 2017

MARKET OUTLOOK

DM EQUITY: EARNINGS AND M&A THE MAIN DRIVERS

– Q1 earnings were the best in nearly seven years for developed markets

– All major regions delivered double-digit earnings growth

– Earnings recovery has been broad-based across sectors

– M&A activity remains strong, although risks remain to deals completing

SUMMARY

The recent Q1 earnings season has seen a continuation of the uptrend we have seen from the prior two quarters. All developed markets posted double-digit year-over-year gains, reflecting the best growth we have seen in nearly seven years. Japan was the standout performer, with Europe and the US also posting solid gains. Importantly the earnings momentum was fairly broad-based across sectors, and also was accompanied by impressive revenue growth on the top-line. The quarter also saw notable M&A activity, with US companies continuing to focus their attention on cross-border transactions with Europe in particular.

EARNINGS CONTINUE TO POWER AHEAD – EUROPE AND JAPAN LEADING THE WAY

Q1 earnings growth was the highest figure in nearly seven years

The past quarter has seen a continuation of the upwards earnings momentum in developed markets, with all major regions posting impressive gains. Japan reported year-on-year EPS growth of 28 per cent, with Europe coming in at 23 per cent and the US at 14 per cent (Figure 90, Figure 91 & Figure 92). Overall this would be the strongest quarter of growth in nearly seven years; encouragingly top-line numbers were also healthy, with 10 per cent sales growth in Europe, just ahead of the other regions. There was also fairly broad-based strength across sectors, with 10 of 11 sectors recording positive growth in both Europe and the US. We have seen a significant rebound in earnings since the second quarter of last year (Figure 93), and expectations are for this to continue in the next quarter, albeit at a more moderate pace. For the majority of regions FY 2017 growth expectations remain ahead of where they were at the beginning of the year.

Figure 90: US Q1' 17 Earnings Summary

	% reported	% cos beating EPS estimates	% yoy EPS growth	% cos beating sales estimates	% yoy sales growth
S&P500	**89%**	**78%**	**14%**	**64%**	**8%**
Energy	100%	76%	-	74%	31%
Materials	100%	84%	20%	84%	9%
Industrials	97%	81%	0%	80%	4%
Discretionary	74%	82%	8%	55%	12%
Staples	75%	63%	4%	44%	2%
Healthcare	92%	80%	5%	70%	6%
Financials	100%	82%	18%	63%	10%
IT	72%	88%	20%	65%	9%
Telecoms	100%	25%	-5%	25%	-5%
Utilities	100%	71%	4%	46%	7%
Real Estate	100%	60%	6%	55%	3%

Sources: Bloomberg, JPMorgan, excluding outliers, one-offs, as at 18/05/2017

Figure 91: Eurozone Q1'17 reporting season

	% reported	% cos beating EPS estimates	% yoy EPS growth	% cos beating sales estimates	% yoy sales growth
DJ Stoxx 600	**97%**	**65%**	**23**	**77**	**10%**
Energy	100%	82%	128%	67%	40%
Materials	100%	53%	23%	76%	11%
Industrials	99%	63%	17%	83%	7%
Discretionary	95%	62%	15%	79%	10%
Staples	97%	60%	9%	74%	8%
Healthcare	97%	70%	13%	77%	9%
Financials	96%	79%	21%	82%	2%
IT	100%	57%	17%	85%	5%
Telecoms	100%	43%	3%	58%	2%
Utilities	100%	58%	-8%	79%	5%
Real Estate	86%	43%	1%	50%	37%

Sources: Bloomberg, JPMorgan, as at 18/05/2017

REASONS FOR OPTIMISM IN EUROPE

In the previous quarterly view, we highlighted the valuation differentials that suggested reasons for potential outperformance of European equities vs their US counterparts. Clearly another important factor has been the resurgence in earnings for European companies, with the upward trajectory in earnings revisions also cause for optimism. In the last three months there have been significant upgrades for European companies, with only Japan seeing more upgrades relative to downgrades in terms of developed regions. Indeed EPS growth expectations for 2017 in Europe have been rising steadily for the past 8 months now, currently standing at 18.9 per cent. This is a marked contrast to the previous 5 years, where we have seen cumulative downgrades in the region of 10 per cent every year (Figure 94).

We are seeing positive earnings revisions in Japan and Europe in particular

Leading indicators would also suggest that this momentum is sustainable; there is a relatively strong historic relationship between business surveys such as the ISM and PMIs and EPS growth (Figure 95). The recent bounce we have witnessed in both survey indicators should bode well in terms of achieving the elevated consensus expectations.

We have also started to see signs of margin expansion coming through - this has been one of the primary reasons European corporates had lagged their US counterparts since the global financial crisis. One of the main drivers for this has been the increase in inflation expectations which has helped provide some pricing power which had been largely absent in the prior deflationary cycle. Industries with higher operating leverage have also been benefitting from an improvement in top-line growth. From a flow perspective, we have seen recent inflows into European equities continue as the political risk has receded to some extent with the victory for Emmanuel Macron in the French presidential election bolstering investor confidence.

M&A IN FOCUS

M&A activity so far this year has remained healthy, with a number of deals announced across a range of sectors. Interestingly we have seen a number of proposed cross-border transactions, with US companies increasingly looking to acquire European counterparts. This reflects the positive corporate momentum we have been seeing in Europe, which combined with the valuation discount relative to US equities and increased political stability has spurred US corporates into action. With balance sheets remaining in healthy shape and interest rates near record lows we would expect activity to remain strong.

There has been more focus on cross-border M&A between US and Europe

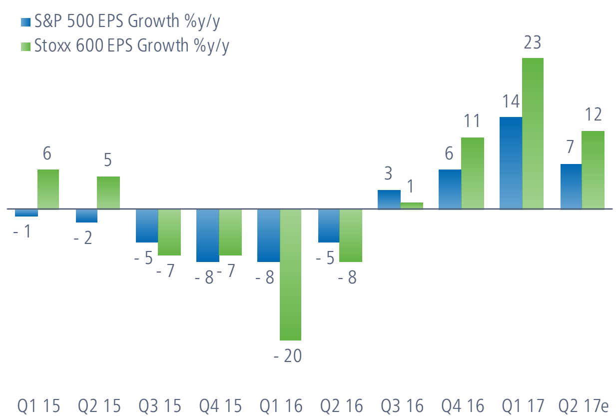
Figure 92: Japan Q1'17 reporting season

	% reported	% cos beating EPS estimates	% yoy EPS growth	% cos beating sales estimates	% yoy sales growth
Topix	**98%**	**56%**	**28%**	**54%**	**4%**
Energy	100%	75%	-	50%	19%
Materials	100%	77%	121%	70%	5%
Industrials	99%	47%	24%	56%	3%
Discretionary	97%	56%	16%	49%	4%
Staples	97%	54%	15%	43%	3%
Healthcare	100%	50%	3%	40%	-1%
Financials	100%	47%	-10%	70%	1%
IT	97%	58%	39%	59%	8%
Telecoms	100%	75%	-3%	40%	0%
Utilities	100%	57%	-25%	67%	-2%
Real Estate	96%	56%	12%	54%	8%

Sources: Bloomberg, JPMorgan, excluding one-offs, as at 18/05/2017

Figure 93: Year-over-Year EPS growth for US and Europe

Expectations are for growth in Q2 earnings as well, albeit not at the levels we saw in Q1



Sources: Bloomberg, JPMorgan, Thomson Reuters, as at 30 June 2017

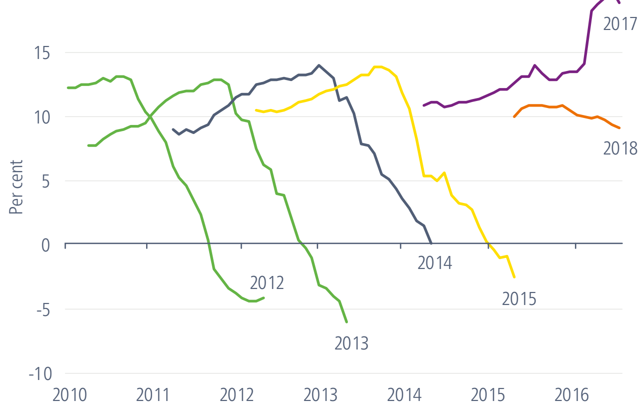
The one caveat for investors would be the associated risk with certain transactions - we have observed a number of high-profile proposed deals falling through this year. Kraft-Heinz's failed bid for Unilever was the main example of this in the first quarter, and we saw US chemcials giant PPG finally pull out of its proposed bid for Dutch counterpart Akzo Nobel (after having three separate bids rejected) at the beginning of June. This in itself raised some governance issues, with many Akzo investors frustrated at the lack of engagement from the board of the company with PPG. Many other proposed deals also face regulatory scrutiny, with regulatory bodies under pressure to demonstrate the deals are in the best interests of consumers rather than the companies themselves.

CONCLUSION

There has been an ongoing debate of late regarding so-called 'hard' and 'soft' data points in developed markets. Whilst some of the 'hard' macro indicators have certainly lagged, from what has been observed in business surveys and sentiment indicators, from a corporate perspective, the 'hard' datapoint of earnings has given cause for optimism. The fact that we are seeing earnings revisions being upgraded (in contrast to prior years where we have seen sharp downgrades) should also provide some comfort that this momentum is sustainable. The improving corporate momentum can also be seen in the robust levels of M&A activity, with US companies increasingly shifting focus to overseas acquisitions. Investors should be wary though of proposed deals falling through, with regulators scrutinising deals ever more closely.

Figure 94: EPS growth expectations for Stoxx 600

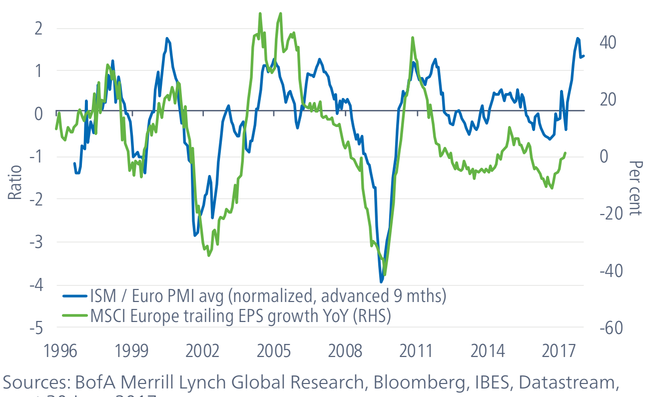
2017 is set to buck the trend of earnings estimates being downgraded as the year progresses



Sources: BofA Merrill Lynch Global Research, IBES, Datastream, as at 30 June 2017

Figure 95: Europe business surveys and MSCI Europe EPS growth

There is a strong relationship between business surveys and EPS growth in Europe



Sources: BofA Merrill Lynch Global Research, Bloomberg, IBES, Datastream, as at 30 June 2017

EM EQUITY: GROWING EXPECTATION

– Corporate earnings are growing at an accelerated rate

– Valuations remain cheap

– The bull market continues

SUMMARY

The recovery in emerging markets continued through the 2nd quarter against a supportive backdrop of solid global growth. GDP growth is meeting or beating expectations across the board and underlying corporate earnings continue to strengthen. 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

Emerging market equities may have performed strongly in 2016, gaining just under 12 per cent on a total return basis in US dollars. This has however been only the warm up for 2017 where by the end of May they were up 17 per cent on a comparable basis and show little sign of losing momentum. As we highlighted last quarter, emerging markets have a history of delivering their returns in large numbers.

Emerging market equities are showing sustained momentum

Since the MSCI Emerging Markets Index was launched in 1988, the average positive year has returned just over 40 per cent. This is the third strongest start to the year for emerging market equities in the past 20 years. To put this in context, the two years which saw stronger starts were 1999, when equity markets were in the grip of a technology bubble, and 2009 as we broke away from the global financial crisis with unprecedented monetary stimulus. Certainly we are not in the first few months emerging from any form of crisis, so the question to ask ourselves is whether we are in the grips of an asset class bubble.

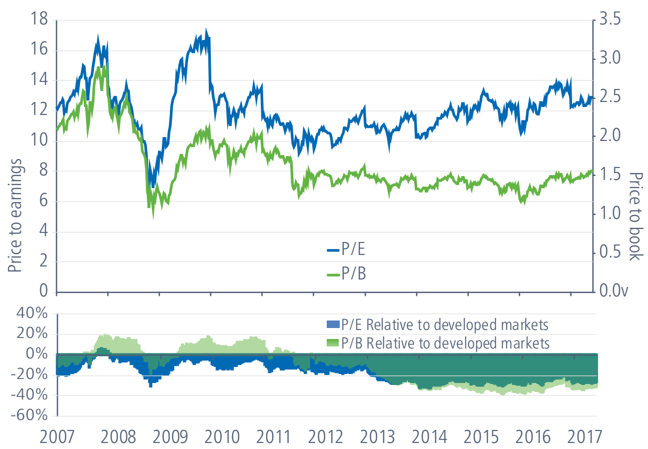
Year-to-date equity performance has been exceptional

ABSOLUTE AND RELATIVE VALUATIONS

Talk of bubbles brings us conveniently to the valuation for emerging market equities. We have consistently highlighted that emerging market equities look materially undervalued. Despite the recent strong emerging market equity performance, this has in no way changed. The performance of emerging markets has been co-incident with a strong rebound in corporate earnings expectations. This recovery in earnings growth has outstripped that of developed markets. As a result, since 2014 emerging market equities have consistently traded at an

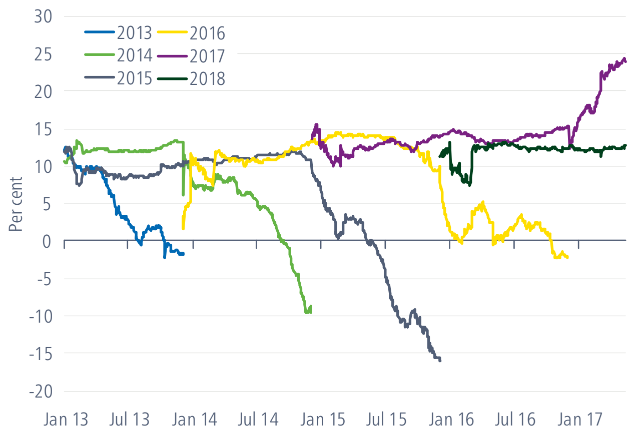
The valuation discount to developed markets remains excessive

Figure 96: EM valuation, historic and vs DM



Sources: MSCI & Bloomberg, as at 30 June 2017

Figure 97: Emerging market earnings expectations



Sources: MSCI & Bloomberg, as at 30 June 2017 approximate 30 per cent discount to developed markets (Figure 96). This is on both price-to-book and price-to-earnings. Now is no different and it is a discount that we believe that is unjustifiable.

Emerging equity valuations remain cheap

The absolute valuation for emerging markets (Figure 96) compared to recent history is also supportive of the fact that they remain undervalued. They currently trade on 12.1 times next year's earnings; this may be on the wrong side of the historical averages but does not compare too unfavourably with a 5-year average of 11.2x and a 10-year average of 11.1 times. This is very different to the near 25 per cent premium US equities trade at compared to their 10-year average. Generating a return on equity of over 10 per cent, a yield of 2.6 per cent and trading on 12x earnings, there is no conclusion that can be drawn other than that emerging market equities remain exceptionally cheap compared to their current fundamentals.

Earnings expectations for emerging markets are high

Earnings expectations continue to remain supportive for emerging markets (Figure 97). Firstly, emerging market earnings have been under pressure since 2013 and remain nearly 15 per cent below that level despite a material recovery in expectations since the lows of the last two years. This certainly cannot be said for other equity markets. The S&P 500 currently has earnings expectations at all-time highs. For 2016 for example, emerging market earnings expectations were less than 10 per cent ahead of that which was achieved at the depths of the global financial crisis in 2009. This also helps puts the pace of the recovery in perspective. In 2010, following the financial crisis, emerging market earnings grew by over 40 per cent from the prior year. Expectations for 2017 earnings growth at between 20-25 per cent therefore seem high, but remain credible considering the supportive backdrop.

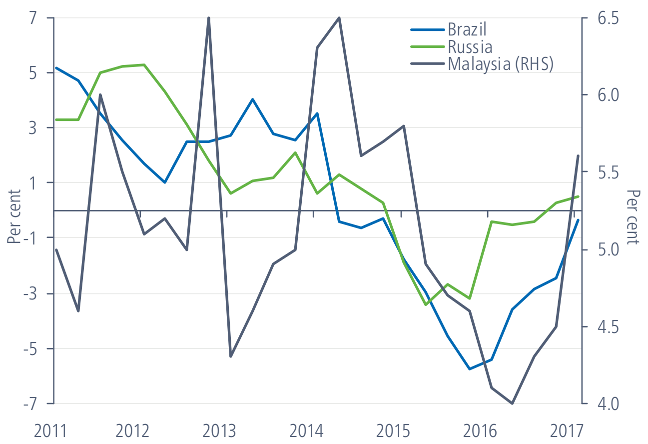
ECONOMIC MOMENTUM

Domestic growth in Emerging Market has recovered

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 clearly passed an inflection point and are both now pointing towards economic expansion (Figure 98). Malaysia for example has seen a similar dynamic where its GDP growth decelerated from 6.5 per cent in 2014 to below 4 per cent. Government policy has adjusted to accommodate for lower commodity prices and tax receipts. The recovery in commodity prices and trade has resulted in a faster and stronger rebound than originally anticipated. This is all good news and firmly underpins the strength of the recovery.

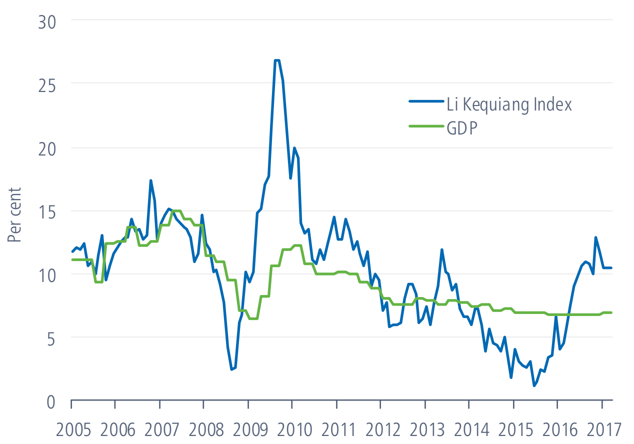
China remains the most important economy and equity market within emerging markets. The focus on reform that was so prevalent in the build up to the equity market correction in 2015 was embodied in the anti-corruption push and targeted

Figure 98: EM GDP growth recovery



Source: Bloomberg, as at 30 June 2017

Figure 99: Li Kequiang Index vs GDP



Sources: Bloomberg & national bureau of statistics, as at 30 June 2017 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 became the priority, credit growth re-accelerated and both property and infrastructure projects were rapidly approved. The Li Keqiang index (Figure 99), 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.

China's excessive credit growth is a mid term risk

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 100), a measure of the health of the manufacturing sector, has recovered dramatically from the lows in late 2015 and is continuing to recover.

Manufacturing activity remains resilient

There is never a silver lining without a cloud, however. The strength of the recovery in growth in China has, in our view, been significantly stronger than anticipated by either the Chinese authorities or investors alike. The over-shoot of the Li Keqiang index is a good indication of the strength of not only the contraction in growth but also the strength of the recovery. Xi Xinping made a clear statement in late April that "safeguarding financial security is a strategic and fundamental matter for China's social and economic development". This in our view marks the first sign that China may be moving away from a policy focused almost solely on prioritising growth to one that is more balanced and potentially sustainable. The outcome of such a move would be a deceleration in credit growth and a subsequent slow down in the current recovery.

China changing priorities

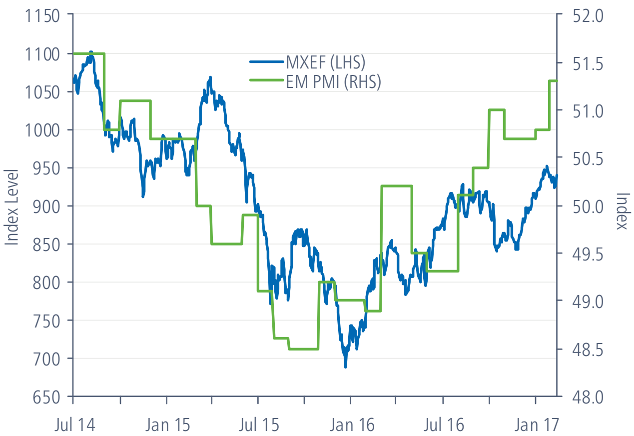
The Citi Economic Surprise Index, which measures investor expectations of economic growth (Figure 101), shows the timing of the de-prioritisation of growth is co-incident with investors' expectations catching up with market growth. Slowing growth combined with overly optimistic expectations has the risk of adding a little turbulence to an otherwise smooth ride.

Expectations are catching up with reality

CONCLUSION

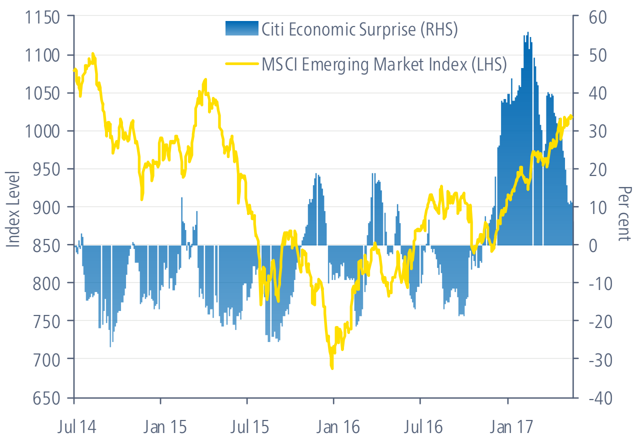
The strong first half of 2017 for emerging market equities was built on firm foundations and should continue in the near term. There are initial signs that investor expectations for economic growth are starting to catch up with the strength of the recovery. Corporate earnings, however, are still benefiting from this recovery in global growth and valuations remain excessively cheap in both absolute and relative terms.

Figure 100: Emerging market PMI's



Sources: Bloomberg & MSCI, as at 30 June 2017

Figure 101: Citi Economic Surprise Indicator



Sources: Bloomberg & MSCI & Citigroup, as at 30 June 2017

RATES: SUMMER LOVING...

– Policy focus remains uncertain

– Benign global scenario continues to support fixed income

– Tail risk is growing

THEMES

Q2 was something of a anti consensus move

The second quarter saw the rates market reverse much of the global reflationary impetus, with nominal yields declining across the G7, as breakeven rates eased back and yield curves flattened. This move was driven partly by the unwind of positions built up in expectation of a significant fiscal impulse in the US, leading to a resurgence in inflationary risks globally. Alongside that commodity prices eased back in the face of some reduced stimulus in China, as officials there tightened policy in order to address financial stability risks created by increased leverage. In short, it was something of a consensus breaking move in terms of price action (Figure 102).

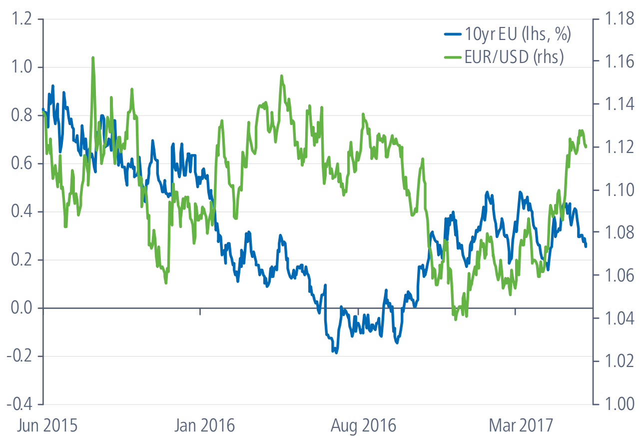
Inflation is simply not self sustaining yet

So are we set to see yields decline further in the near term? The macroeconomic backdrop does not support lower yields. Solid growth performance in the US continues (with the unemployment rate hitting cycle lows below 4.5 per cent), while in the euro area growth has surprised on the upside, albeit supported by significant policy easing by the ECB. That said, the broader context is not singularly negative for fixed income. As we highlighted previously, it will be hard for yields to beat their forward projections without a new catalyst. While globally inflation has risen from record lows, there remains little sign of it moving materially higher from here. The decline in commodity prices this year has weighed on inflation more than many expected and indeed, this looks likely to continue to be the case into year end. In the euro area, the ECB have continued to make the point that they do not yet see a self-sustaining move in underlying inflation towards their target. On this basis, the range trade for rates markets seems likely to hold in the second half (Figure 103).

Tail risks have risen

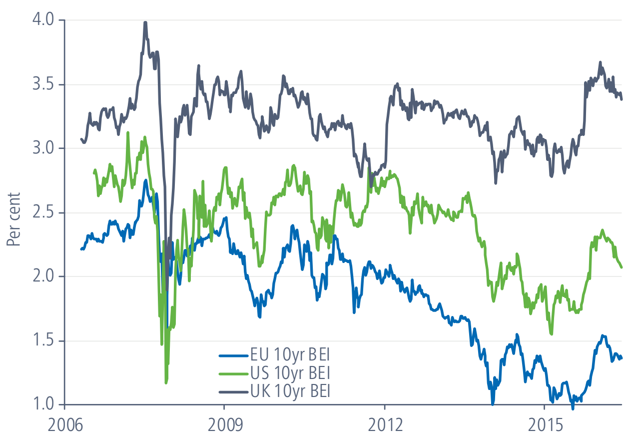
The benign environment for fixed income has supported an ongoing hunt for returns in credit and emerging market debt and has led to a significant compression in spreads. That in itself is not a surprise as the backdrop of relatively benign macro conditions should be broadly beneficial to these asset classes, but equally, having seen such a degree of spread compression, the tail risk in

Figure 102: EUR/USD vs 10yr Bund yields



Source: Bloomberg, as at 30 June 2017

Figure 103: US, EU and UK 10yr breakeven inflation rates



Source: Bloomberg, as at 30 June 2017

the markets overall has clearly risen. That increased risk has also helped increase demand for safer government bond markets. That in turn opens the risk of a more disorderly unwind if those risks were to materialise. However, in the absence of tighter financial conditions, it is not obvious that there is a catalyst at this point in time.

PICKING UP PENNIES…

We think the likelihood is that yields remain somewhat locked within recent ranges. The potential exception to this could be UK gilts which face not only ongoing political and Brexit risk but likewise are facing a marked slowdown in economic activity, at the same time as seeing inflation move higher. We would expect the MPC to look through the move higher in inflation, but there could be some support for relative Gilt outperformance over the medium term (Figure 104).

Gilts may be set to outperform

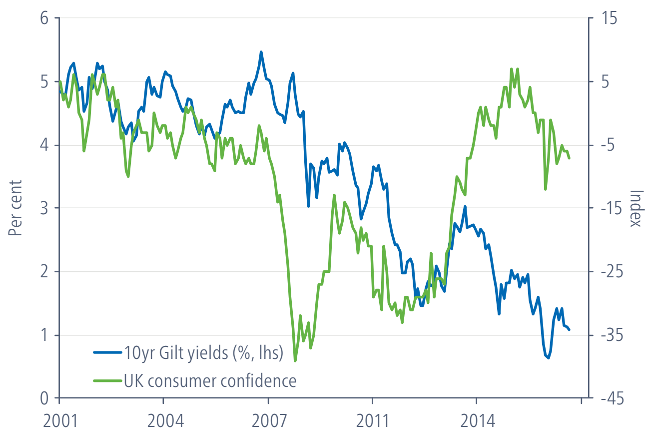
At the start of this year we had a strong bias towards steeper yield curves on the expectation that markets would price in greater inflation and term premia. Curves are steeper than a year ago, but the absence of significant fiscal policy initiatives in the US and the reversal in commodity prices, have resulted in a more nuanced story. In part that nuance has followed from the yield hunt driving investment strategies and forcing investors out the term structure. Indeed, the risks for the long end of yield curves may have receded given the benign global backdrop, and the risk is if anything shifting to the front end of the yield curves. As such our steepening bias is more focused on the front end of the US curve now and we would actually look for return driven flattening in the long end of the European curve and likewise in Australian and New Zealand curves (Figure 105).

More and more risk towards flattening in global curves

Breakeven inflation rates have eased back in recent months. With underlying inflation pressures still muted, there is currently little support for a strong upside risk to breakeven inflation. Indeed, unless one can find idiosyncratic support for ones perceived inflation risks then much would depend on the outlook for commodity prices. Medium term we believe US breakevens will recover but from lower levels than currently on offer whilst in Europe, we remain a long way off generating sustained inflationary pressure.

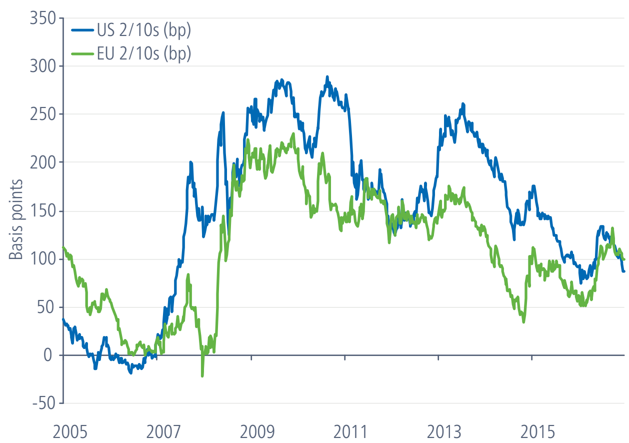
Breakevens have further to fall before they are a buy

Figure 104: UK consumer confidence vs 10yr Gilt yields



Sources: GfK, Bloomberg, as at 30 June 2017

Figure 105: US & EU 2/10s curves



Source: Bloomberg, as at 30 June 2017

CREDIT: RUNNING LATE BUT ROOM TO RUN

- Central banks continue to support global credit markets, but the rate regime is changing
- Fundamentals have improved while technicals are still supportive and dominate
- Political risks in Europe and in the US could heighten credit volatility

SUMMARY

Credit markets remained firm in Q2 and H1 despite already tight valuations with high beta cohorts of the market outperforming, including high yield and BBBs within investment grade. Most segments of the market have posted positive excess returns. In the US, the strong performance has been driven by improvement in fundamentals but more so by positive technicals owing to strong demand from yield-sensitive buyers with the latter a particularly dominant theme for investment grade.

The credit cycle is running late but there is some room to run given positive technicals

An important shift since the beginning of the year is an increasingly challenged political landscape in the US, in which expectations of fiscal stimulus delivery have largely reset lower, though credit markets have not fully priced this in by most measures, including tighter spreads relative to pre-election levels as well as persistently low credit volatility (Figure 106 and Figure 107). Thus, expectations for significant out-performance are low, though we do believe this extended credit cycle has some legs left given the positive technical backdrop.

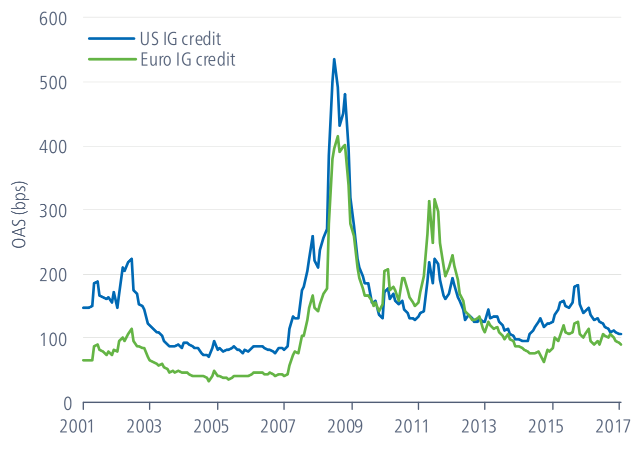
The CSPP unwind will be a slow and orderly one

In Europe, accommodative central bank policy, most notably the ECB's corporate sector purchase program (CSPP) has supported credit spreads so far this year and European credit has outperformed US year-to-date in excess returns. While the pace of central bank buying is decelerating, the credit purchase program is holding up well and we believe the eventual unwind will be a slow and orderly one, especially with the ECB closely monitoring subdued inflation. Still, with limited upside against a backdrop of potential tapering, we expect modest room for performance.

TECHNICALS – STRUCTURAL TAILWINDS

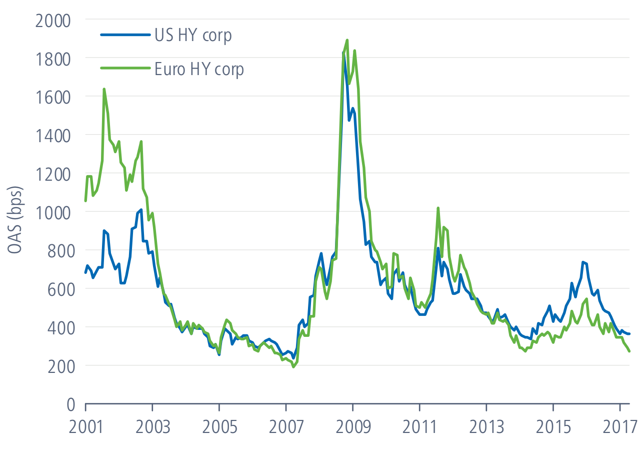
The reach for yield has been a key driver of spread compression, particularly for USD investment grade credit year-to-date and we expect this to continue. All-in

Figure 106: Investment grade credit spreads



Source: Bloomberg, as at 30 June 2017

Figure 107: High yield corporate spreads



Source: Bloomberg, as at 30 June 2017

yields in US corporates generally remain higher than elsewhere in the global fixed income context despite some fluctuation in hedging costs back to local currencies. Many investors believe Treasury yields will rise faster than other government bonds, which helps set the stage for spread compression in credit, benefitting from increased demand by the marginal foreign buyer. Leveraged credit has also benefited from the reach for yield as evidenced by strong net flows to loans (Figure 108). Additionally, pension funded status has improved, particularly from gains in equity markets, which provides a structural tailwind for credit from increased asset allocation into the asset class.

Tailwinds too exist from the supply perspective – while USD investment grade credit has seen a heavy amount of new issuance so far this year, with many issuers taking advantage of low rates and the move tighter in spreads, we expect reduced supply in the second half of the year. Issuance has been front-loaded, in addition to subdued M&A-related issuance that is well off the peaks reached in past years (Figure 109).

Tailwinds from yield-sensitive buyers and lower supply

A key focus in Europe is the corporate sector purchase program and the changing pace of QE. In early Q2, expectations were set for the ECB to start tapering purchases in both the government bond and the corporate program proportionally; however, this has recently shifted as the proportion of corporate purchases has trended higher. That, coupled with subdued inflation data recently, makes us believe the eventual unwind will be a slow and orderly one.

FUNDAMENTALS – IMPROVEMENT IN LEVERAGE AND EARNINGS

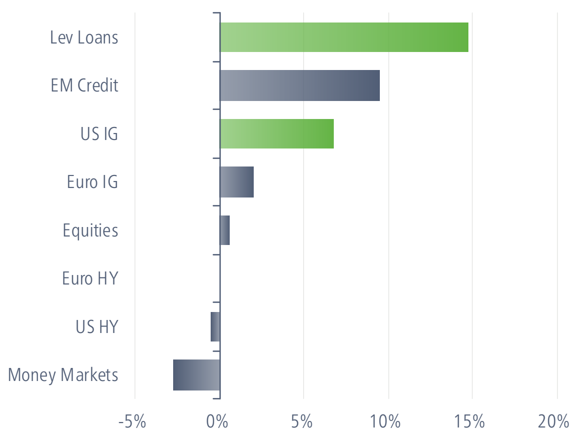
In the US, fundamentals have seen improvement over the past quarters – most notably in revenues and earnings with investment grade seeing low single-digit increases and high yield seeing low double-digit increases. Profit margins have seen modest gains in prior quarters and stand at the highs post-GFC for both investment grade and high yield. We continue to expect modest improvement in coming quarters, from the generally strong economic backdrop as well as from robust M&A in prior years that is becoming accretive.

Leverage has stabilised and seen modest improvement, though absolute levels do stand near post-GFC highs for both investment grade and high yield. Interest coverage has declined since 2013 for both investment grade and high yield, but has also stabilised in the past quarters and absolute levels remain comfortable, which is particularly important for high yield (Figure 110).

As it relates to default rates, high yield default rates have trended lower, running well below its long-run average and importantly, expectations are for a further decline in default rates (Figure 111).

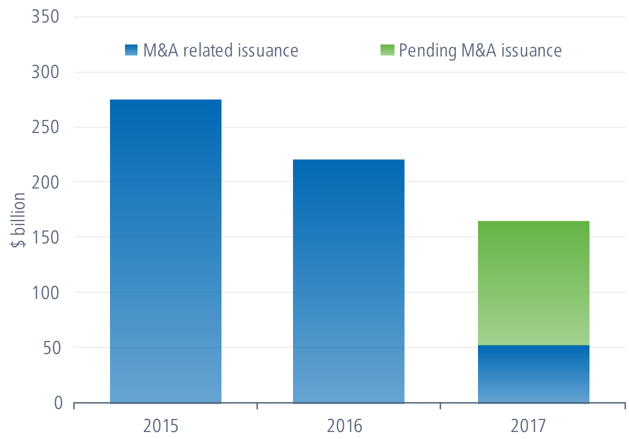
More earnings growth and lower default rates

Figure 108: IG and loans have particularly seen strong inflows - net flows YTD as % of market



Sources: Wells Fargo, EPFR, as at 16/06/2017

Figure 109: Reduced M&A issuance is a tailwind for IG



Sources: JPM, Dealogic, as at 31/05/2017

SO WHAT ARE THE RISKS? MOSTLY POLITICAL

Credit markets have demonstrated resilience so far this year despite a number of risk factors both credit market specific and not, including large supply volumes, lower oil prices, lack of progress on tax and regulation reform in the US, election risk in the UK, and EM risk flare-up.

At this juncture, political risks are the key ones that could derail the positive sentiment and heighten volatility in credit markets in our view, as opposed to fundamental. In the US, the budget for fiscal 2018 and the debt ceiling issues are focus points in Q3 as well as a potential government shutdown. Negative findings from FBI investigations regarding collusion in the Trump administration would also be detrimental, particularly if the developments significantly delay or stop progress on the fiscal agenda.

Risks outside of credit are more likely to derail sentiment than ones specific to credit markets

In Europe, while the outcome of the French elections has removed some uncertainty, political risks remain elevated with the elections in Italy a potential source of volatility. Other sources that may induce a risk-off environment are geopolitical in nature, including headlines out of North Korea or the Middle East, and more generally, hard economic data not converging with the soft confidence data over time.

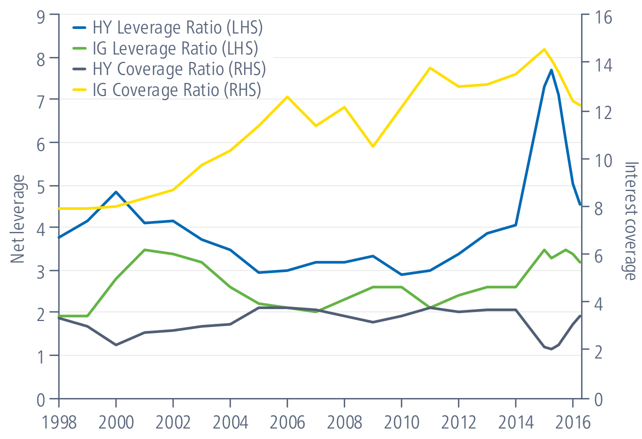
PUTTING IT ALL TOGETHER IN THE CONTEXT OF VALUATIONS

Credit spreads have been grinding tighter so far this year, whether in investment grade or high yield. In the US, investment grade credit spreads are approximately 30 bps away from all-time tights and approximately 15 bps away from post-GFC tights in 2014. Accounting for the structural and fundamental differences in the landscape, such as a larger proportion of BBBs, longer duration, and higher leverage that may impede spreads today from reaching the all-time tights, we do think spreads can test the more recent tights given the positive technicals and improvement in fundamentals. As spread dispersion within credit is low, we view taking on idiosyncratic risk in high conviction ideas as appropriate.

Appropriate taking on idiosyncratic risk as spread dispersion is low

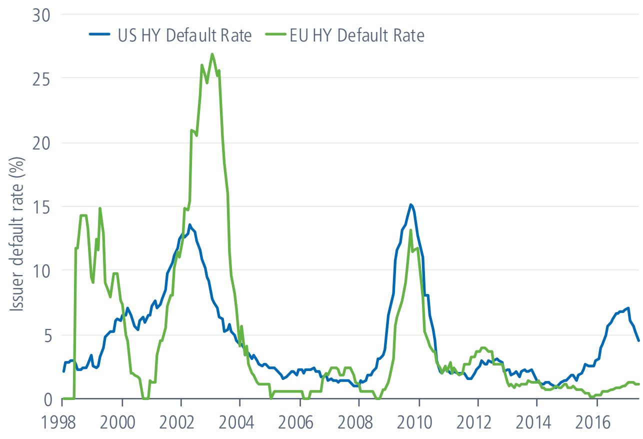
In high yield, while valuations are not particularly appealing either – global high yield spreads 20 bps away from 2014 tights and 140 bps away from all-time – we also expect the combination of strong technical factors and low default rate expectations to drive spreads tighter over the medium term with idiosyncratic risk taking and owning convexity key. Thus, while the credit cycle is running late, we do see the cycle as having more room to run.

Figure 110: Stabilisation in leverage and interest coverage for IG & HY



Sources: BofA-ML, Barclays, as at 08/06/2017

Figure 111: Declining and low default rates support HY



Sources: BofA-ML, Moody's, as at 31/05/2017

EMERGING MARKET DEBT: CARRY ON THROUGH THE SUMMER

The strong asset price performance in emerging market (EM) debt since the beginning of 2017 has been driven by a continuation of supportive global monetary policy and abundant liquidity. Alongside this has been the easing of market concerns about the policy initiatives of the Trump administration that introduced fear around higher US rates and greater protectionism.

The push factors of the global environment have led emerging market debt portfolio inflows to reach $42bn year to date, already matching the total inflows registered in 2016 (Figure 112). These factors show no sign of fading and the asset class remains well supported by stable fundamentals meaning justification is provided by the pull factors but idiosyncratic risks remain across the universe.

Local currency markets should benefit most from the duration and carry-supportive environment. In hard currency markets the relative value comparison has to be broadened across global credit markets to find valuation attraction but upside appears more limited.

EM LOCAL CURRENCY

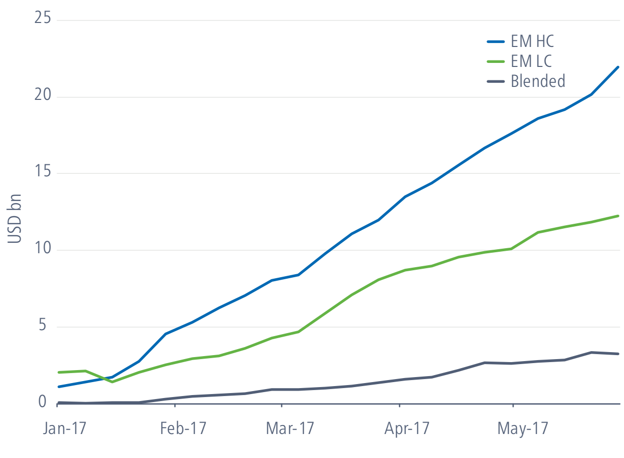
EM local currency bonds continue to post impressive returns – 11 per cent year to date in US Dollar terms – with yields on a declining trend and currencies remaining well underpinned. Investors' desire for income, set against a backdrop of still abundant liquidity across financial markets and low levels of macro volatility, is providing support. Gradual policy normalisation by the US Federal Reserve is unlikely to unsettle local markets, which still benefit from attractive valuations and yields. There is no reason to expect these trends to change significantly in coming quarters. Activity indicators in China suggest some modest slowing, aligned with the deleveraging process, but the Renminbi is stable and capital outflows have slowed. Our central scenario of a managed slowdown is unlikely to present a risk to the low macro-volatility backdrop. Consensus overweight positioning is likely the biggest near-term risk alongside uncertainty about central bank balance sheet adjustments later in the year.

> Gradual policy normalisation by the Fed unlikely to unsettle local markets

Despite the recent gains, valuations in EM local markets remain attractive. Emerging currencies, as represented as a weighted average of the countries in the widely followed JPM benchmark, are below their long term means in real terms, leaving room for further gains in coming months (Figure 113). Meanwhile

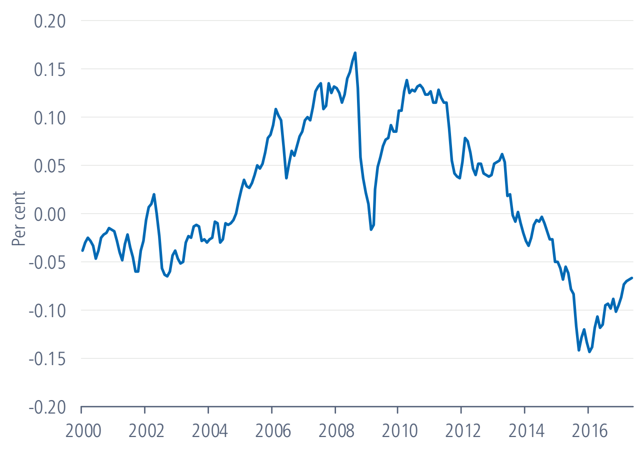
> Despite the recent gains, valuations in EM local markets remain attractive

Figure 112: EM Fixed Income Inflows



Source: Aviva Investors, as at 30 June 2017

Figure 113: GBI-EM Deviation from FX 'Fair Value' [USD]



Sources: Bloomberg, Aviva Investors, as at 30 June 2017

the yield spread between local bonds and core markets remains elevated, both in real and nominal terms, providing a buffer against currency volatility (Figure 114). Fundamentals across EM economies are broadly stable. Consensus economic growth forecasts have tracked marginally higher since the start of the year and inflation expectations are within the central bank target band for the majority of EM economies (Figure 115). Nearly all central banks are likely to leave policy rates on hold for now with inflation pressures muted. Indeed, easier monetary policy is confined to the high yielding markets where inflation is declining like Brazil and Russia.

Market positioning surveys suggest that dedicated investors have the largest overweight for a number of years

Investor demand continues to be strong as evidenced by mutual fund and cross-border investment flows which are tracking at the strongest pace since 2013. The higher yielding markets with an improving fundamental backdrop like India and Indonesia continue to attract the largest inflows. Market positioning surveys suggest that dedicated investors have the largest overweight for a number of years which presents a potential risk. But appetite from cross-over investors has picked up substantially from recent years, which likely reflects the relative attractiveness of the asset class, and the desire to decrease a structurally underweight exposure. Portfolio positioning continues to be focused on countries with improving fundamentals and attractive valuations such as Mexico, Peru and Indonesia while the Malaysian and Turkish currencies also offer attractive valuations.

Market positioning surveys suggest that dedicated investors have the largest overweight for a number of years.

EM HARD CURRENCY

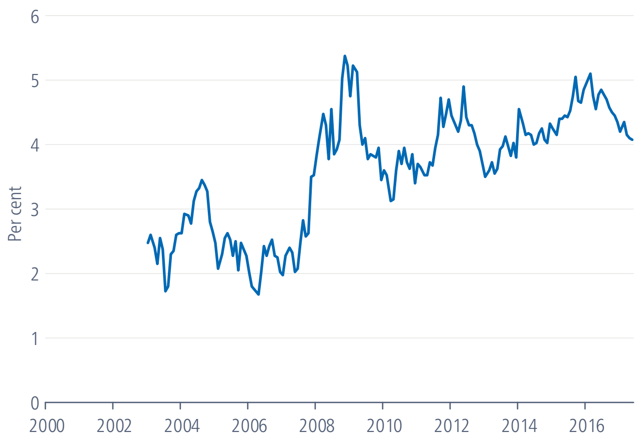
The drivers of the strong inflows supporting EM hard currency assets show no signs of fading. Therefore the outlook for the next quarter is constructive even while spreads look a little stretched (Figure 116).

A cautious stance from investors is warranted

Macro-economic push factors continue to provide the foundation for the inflows while stable fundamentals provide comfort from a bottom up perspective. Valuations are no longer a support and we continue to believe that risk reward is poor and current investor positioning less supportive than in recent months. The tapering of developed market central bank asset purchases and already low volatility are among the key risks as we look beyond the coming quarter.

However, in a period of extended stability for credit spreads emerging market hard currency assets will offer attraction in a global credit context and the current environment has the potential to be sustained.

Figure 114: EM Local Yield - US 10y



Sources: Bloomberg, Aviva Investors, as at 30 June 2017

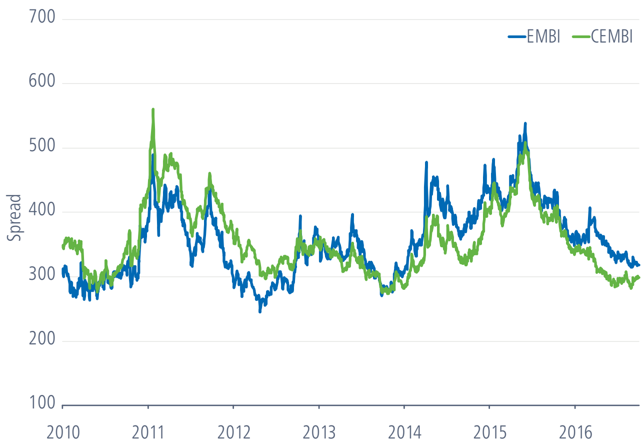
Figure 115: EM Growth Forecasts Tracking Higher [GBI-EM]

Sources: Bloomberg, Aviva Investors, as at 30 June 2017

Over the past decade the larger emerging market debt constituents have been able to issue a far greater share of their debt in local currency (Figure 117). This reduces external vulnerabilities and improves the resilience to external shocks for these countries. This has to be considered alongside the growing importance of frontier markets (next generation EM) that do not benefit from this dynamic as they are mostly reliant on external borrowing. However, for these countries the International Monetary Fund (IMF) is hugely important as a lender of last resort and guardian of more disciplined policy. The need for a programme is clearly not a credit positive but it does prevent credit events, provide a ceiling for bond yields and put countries on the right future path. This ultimately supports long-term returns in the asset class especially when compared to a global credit peer group. An isolated comparison of EM debt and a current preference for local currency assets can potentially lead to an under-appreciation of the attraction of hard currency assets.

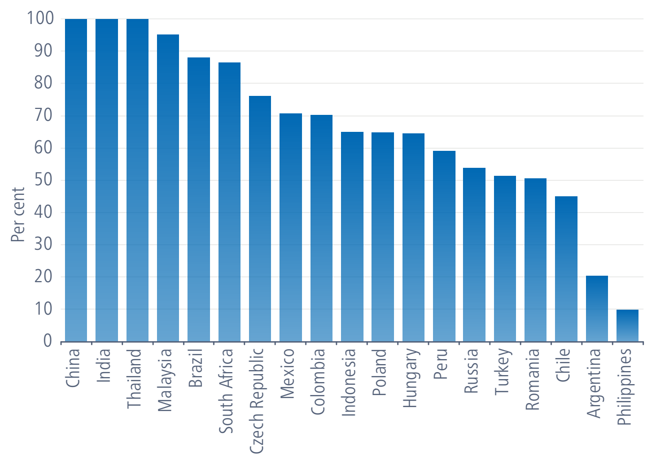
Long term returns vs global credit are supported by structural positives

Figure 116: EM Hard Currency Spreads



Sources: JP Morgan, Bloomberg, Aviva Investors, as at 30/06.2017

Figure 117: Local Currency Debt as % of Total Sovereign Debt



Source: JP Morgan, Aviva Investors, as at 30 June 2017

CURRENCIES: DIFFERENTIATION AMID GLOBAL REFLATION

– Despite US strength, rich valuations continue to prevent the dollar from having much upside

– Markets see a case for policy repricing in other markets given growth momentum

– Select EM currencies remain in prime position to benefit further from global growth

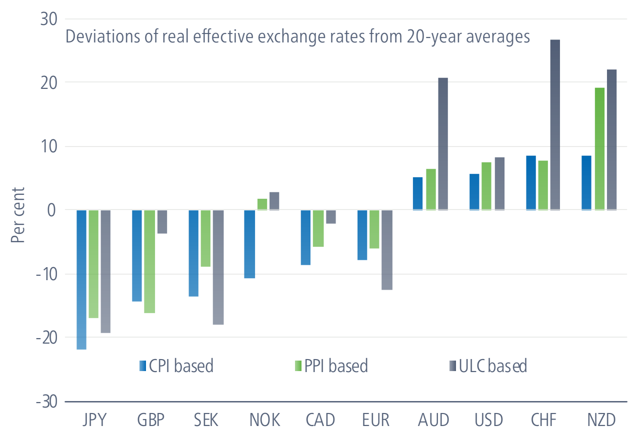
US political uncertainty weighing on the dollar, though solid growth remains a source of support

Since the December rate hike, the FOMC has tightened policy twice more and confirmed their intention to reduce the size of the Fed's balance sheet, starting later this year. Yet the US dollar has declined by more than 5 per cent against both G10 majors and higher-yielding EM currencies. This has resulted from a combination of disappointment with Trump in the US and an improvement in FX-relevant fundamental impulses in other major markets. Political uncertainty in the US, especially as it relates to the future of President Donald Trump himself, could be a risk for the dollar for the coming months as it threatens at least the timing of the fiscal boost that still relatively elevated dollar valuations seem to be allowing for. The dollar remains among the expensive G10 currencies on a range of different valuation measures (Figure 118). We expect the dollar to be helped by a cyclical acceleration after the soft patch in Q1, which was probably due to temporary factors.

Gentle reflationary re-pricing is underway in other markets, giving rise to differentiation

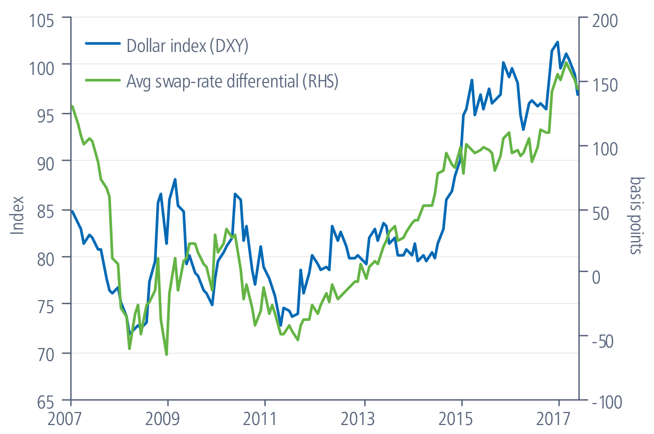
In terms of conventional associations, the dollar is tracking in a downward direction the average nominal-yield differential relative to peers after overshooting to the topside in recent years (Figure 119 where the yield differential is an average of 2-year, 5-year and 10-year differentials). The recent loss of the dollar's yield advantage is not entirely a consequence of US specific factors – the US 2-year swap rate is at the same level as at the time of the dollar's December 2016 high. And yet the dollar index (DXY) 2-year rate differential has declined modestly since that time. This suggests that a short-end re-pricing in other major markets is also an important driver. Another potential risk for the dollar is that this re-pricing happens at a faster rate in other markets, given the sharp divergence of nominal rates differentials from nominal GDP growth differentials (Figure 120).

Figure 118: Dollar remains among the richest in G10



Sources: Aviva Investors, Bloomberg, as at 30 June 2017

Figure 119: Dollar tracking rates differentials closely



Sources: Aviva Investors, Bloomberg, as at 30 June 2017

The euro is an example of such reflationary re-pricing where short-end rates appear to have bottomed out since the middle of last year. Another clear sign is the changing dynamic correlation between the single currency and equity markets (Figure 121). Given the outperformance of European equities since the end of February, this suggests that markets are increasingly of the view that European growth and growth assets can withstand a less fundamentally-cheap euro. So, long euro has behaved like a reflation trade in recent months. The challenge to this view, however, could come from the ECB's ultra-cautious risk-management approach to policy, which was evident in the modest downgrade to their inflation forecasts at the June policy meeting. Hence, we struggle to see any significant further upside for the European single currency from current levels around 1.12 against dollar.

> The ECB is likely to act to prevent further significant gains in the euro

The outlook for sterling has been further muddied by the recent snap general election that has left no single party with a clear majority. The sterling positive arguments include still very cheap valuations and the possibility of a softer Brexit and at least a proper transition arrangement beyond the two-year negotiation timeline. However, the negative arguments stem from political instability and possible cyclical weakness if uncertainty begins to affect investment and consumption spending in a significant way. Complicating matters further is the recent split on the Bank of England Monetary Policy Committee (MPC) where three members voted for a hike given the rise in inflation. On balance, volatility is likely to rise and remain high given these conflicting signals.

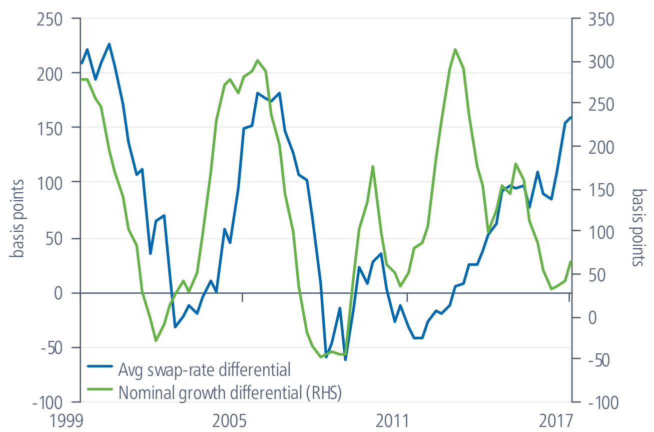
> The inconclusive UK election has muddied the waters for sterling further

The yen has strengthened as global yields have declined. Also, there has been speculation about the Bank of Japan's (BoJ) exit strategy. Discomfort about the likelihood of large BoJ balance-sheet losses if the inflation target is reached has helped fuel this speculation. However, short of abandoning the 2 per cent inflation target, it's hard to imagine how the BoJ can encourage any exit speculation. Hence, the yield-curve control policy is likely to remain in place for the foreseeable future, which should deliver a weaker yen if global long-end yields rise later in the year (Figure 122).

> BoJ yield-curve control is likely to push yen lower as global yields rise in H2 2017

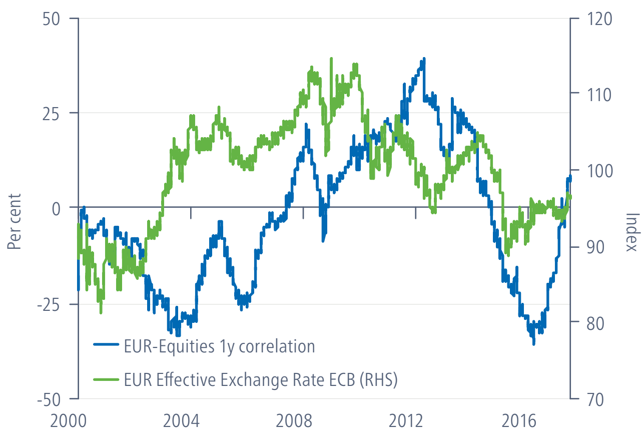
EM FX continues to be attractive from a valuation normalisation perspective, as we expect only a modest slowdown in global trade growth from the elevated rates seen in Q1 and with China likely to have a managed slowdown in the coming months. Several EM currencies, including the Indian rupee (INR), Indonesia rupiah (IDR), Turkish lira (TRY) and the South African rand (ZAR), have also enjoyed a boost to their terms of trade (Figure 123). A decline in political instability is positive for the lira which continues to provide the largest carry in global EM. Inflation is likely to decline in the coming months boosting real yields and attracting further portfolio inflows into the local bond and equity markets.

Figure 120: Dollar's yield advantage too high



Sources: Aviva Investors, Bloomberg, as at 30 June 2017

Figure 121: Euro correlation with equities positive now



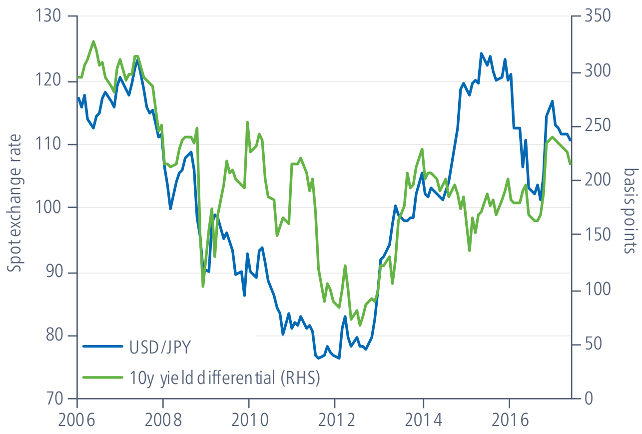
Sources: Aviva Investors, Bloomberg, as at 30 June 2017

The Mexican peso has already returned to levels prevailing before the US presidential election, as risks of Trump's protectionist measures have steadily declined. However, the peso is still among the cheapest currencies globally and as such contains a large risk premium. Inflation is likely to have peaked now and should decline beginning July-August. Currently, Mexican Bonos are the highest-yielding investment-grade local-currency debt market. A fall in inflation will attract portfolio inflows and boost the peso.

EM continues to provide fundamentally attractive sources of carry

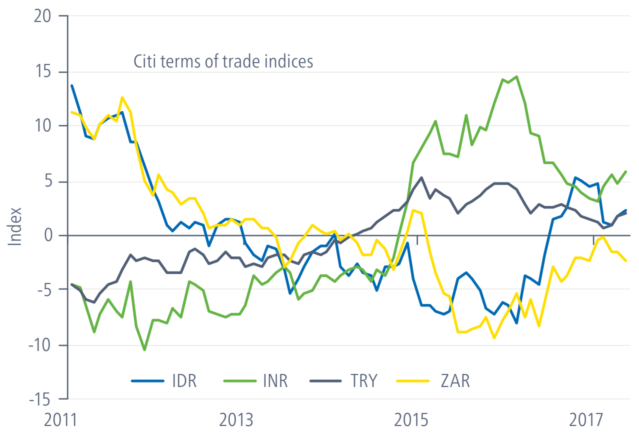
The Indian rupee continues to look attractive with inflation declining to all-time lows while the Reserve Bank of India continues to maintain a relatively hawkish stance. The high real yields and the strengthened political hand of the reform-oriented Prime Minister Modi should keep the rupee's place as an attractive source of risk-adjusted carry secure in global EM, despite the downside growth risks coming from the implementation of reforms such as the goods and services tax later this year.

Figure 122: JPY to weaken as yields rise



Sources: Aviva Investors, Bloomberg, as at 30 June 2017

Figure 123: Terms of trade improving for select EM



Sources: Aviva Investors, Bloomberg, as at 30 June 2017

REAL ESTATE: INCOME GROWTH TO DRIVE RETURNS

GLOBAL

Global real estate investment declined in the opening quarter of 2017, by 9 per cent year-on-year in US dollar terms, but remained above the 10-year average. Performance varied substantially by region, with the Americas down 16.5 per cent, the UK down 17.7 per cent, Asia Pacific up by 7.2 per cent and EMEA (ex UK) up by 11.5 per cent, according to CBRE.

Global investment continues to slow

We anticipate that continental Europe will continue to attract high levels of investment and generate higher returns than other regions over the short term due to particularly attractive relative pricing, combined with an occupier market recovery (Figure 124).

Europe to outperform

Investment demand remains robust in Australia and Japan, where relative pricing is also coupled with a positive rental outlook. It also remains unabated in other Asian markets despite a highly challenging occupier picture. Across the commercial real estate market, value is increasingly difficult to find for investors with absolute returns as capital growth is on the wane. Investors should focus on those locations where supply-and-demand dynamics are fostering income growth.

Asian markets targeted by international capital despite weak fundamentals

UNITED STATES

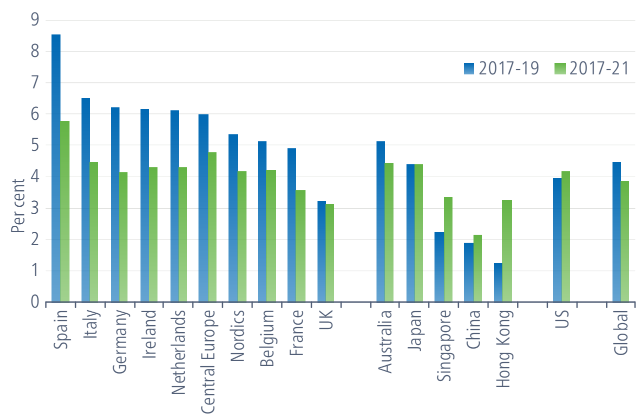
Occupier demand in the US remains resilient. However, the return of development has led to a modest slowdown in rental growth in offices and retail – from 3 per cent in 2016 to a mid-2 per cent range in Q1 2017. Meanwhile, competition for quality logistical space remains fierce, with national rental growth above 7 per cent year-on-year for the fifth consecutive quarter.

Logistics rally continues

There is some evidence of cap rates beginning to move out. CoStar data suggests that more than half of national office markets experienced yield expansion in the first quarter of 2017 (Figure 125). The national office cap rate appears to have bottomed out in 2016 Q3, with Q1 2017 registering a second consecutive quarter of outward yield shift at the national level. The modest increase in the national cap rate (+4bps over the past six months) masks large variations at the market level. Markets such as San Jose and San Francisco have seen stronger corrections in pricing, given the historically low cap rates and less bullish occupier outlook.

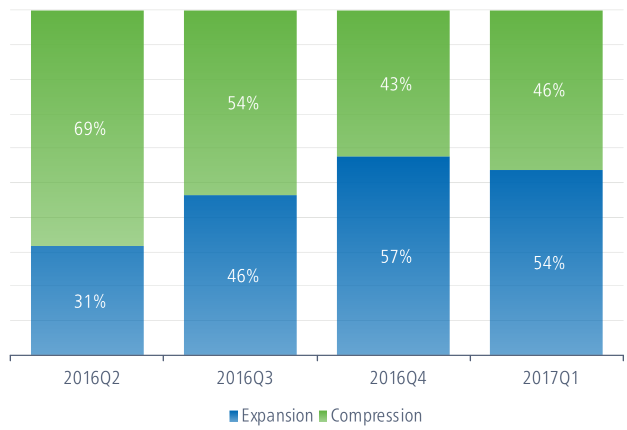
Correction in pricing spreads

Figure 124: All-sector total return forecasts, %pa*



Source: Aviva Investors, as at 30 June 2017
*Weighted average of forecast total returns for prime office, industrial and high street retail for European and Asian markets; Weighted average of forecast total returns for all market retail, office, industrial and apartments sectors for the US.

Figure 125: US: QoQ cap rate movement, 54 CoStar office markets



Source: CoStar, as at 30 June 2017

Malls hit hardest

The Green Street Commercial Property Price Index decreased by half a percent in May. Over the past year, the index has risen only 1 per cent, as higher cap rates have offset growing rental income (Figure 126). Breaking down the index, the mall sector has shown the most marked deterioration, with capital values falling by 5 per cent in the past three months. Office values have generally kept stable over the same period.

EUROPE

Sound fundamentals in offices

Prime European office markets continued to see solid improvements in occupier demand in Q1 which, combined with limited development, resulted in a sharp fall in the vacancy rate (to 8 per cent for EU-15) and further rental growth (+4.9 per cent y/y for EU-15 ex-UK).

Slowdown in high end retail

Consumer confidence in the euro area has continued its upward trend, reaching its highest level since 2007 in May 2017, well above the long-term average. Despite this favourable context, EU-15 (ex-UK) prime high street retail rents started to slow down in Q1, rising by only 1.4 per cent y/y and underperforming the office and industrial markets. This followed a period of very strong growth in 2011-16 (Figure 127).

Development returns to parts of the logistics market

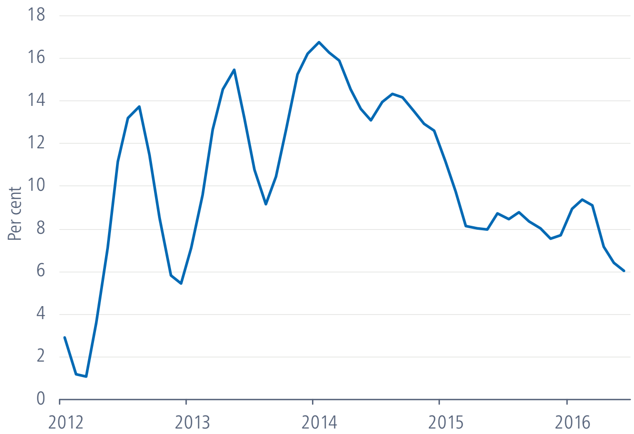
The Eurozone industrial sector appears to be growing robustly, with industrial production up by 1.9 per cent y/y in March and Markit Eurozone Manufacturing PMI indicating robust expansion. Improvements in manufacturing combined with ongoing growth of ecommerce resulted in ongoing solid occupier demand for prime industrial space. Nevertheless, average prime industrial rental growth in EU-15 (ex-UK) slowed in Q1 to 1.9 per cent y/y according to CBRE as development returned to some markets.

Value is becoming scarce

Strong investor demand has driven up competition for the best assets; year-on-year all-sector transaction activity in Europe (excluding the UK) increased by 12 per cent in the first quarter of 2017, according to CBRE. This led to further yield compression to new all-time lows in all the three main sectors; prime office yields now stand at 3.95 per cent, retail – 3.43 per cent and industrial – 5.85 per cent, according to CBRE.

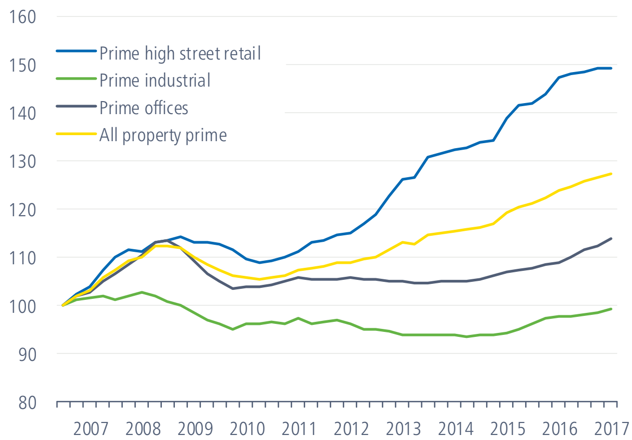
While there remain attractive opportunities in European real estate – and the asset class still offers a healthy spread over fixed income – good value is increasingly difficult to find. Our pricing analysis suggests investors will need to become more discerning in their choice of assets, especially if they are looking to meet nominal return requirements (Figure 128).

Figure 126: US: Investment Grade Commercial Property Price Index, 3MMA %YOY



Source: CoStar, as at 30 June 2017

Figure 127: Eurozone Prime Rent Index



Source: CBRE, as at 30 June 2017

UK

We continue to expect that economic headwinds will affect UK real estate performance over the remainder of 2017 and beyond, despite pricing to date remaining remarkably unaffected by the uncertain outlook. The short term impact on rental growth will be most acute in the more structurally-challenged parts of the retail sector. Thereafter, central London's office market looks exposed with some occupiers expected to make pre-emptive moves to relocate some job functions into the remaining EU before the onset of 'Brexit'.

Parts of the retail sector and central London offices most exposed to Brexit

However, with occupier markets generally in good health, and supply of stock in most markets broadly in balance with demand, we do not anticipate substantial declines in diversified investors' income streams. The investment market is likely to soften as rental growth slows, so we do expect returns prospects to remain moderate in the near term with some further capital declines likely. However, yield-driven investor demand for real estate remains robust, driven by a loose monetary policy.

Significant rental declines unlikely in the near term

ASIA PACIFIC

Mixed fortunes determined by local market forces continue to characterise the Asia Pacific occupier markets. In Australia, grade A office rental growth reached an impressive 28.9 per cent y/y in Sydney and 14.8 per cent y/y in Melbourne in Q1 2017, according to Jones Lang Lasalle (JLL). Hong Kong central business district offices also saw rents increase in Q1, by 9.1 per cent y/y. Elsewhere in the region, rental growth has been muted or negative, with Hong Kong retail and Perth offices seeing the sharpest declines in rental levels. The outlook for Seoul retail deteriorated since last quarter due to the Chinese moratorium on tourism trips to South Korea.

Occupier markets are a mixed bag…

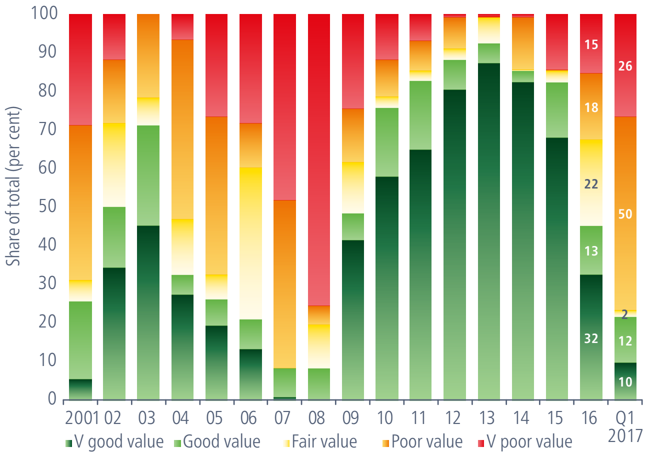
International funds continue to acquire core assets in the region. Offshore investors remained active in Australia, with cross-border buyers continuing to outpace cross-border sellers. A seemingly insatiable appetite from Chinese investors, motivated by portfolio diversification objectives, continues to play a key role in regional investment markets. The first quarter of 2017 saw record-setting acquisitions of development sites in both Singapore and Hong Kong, backed by Chinese capital.

… but investment demand remains robust across the region

As a result, even in markets with weak occupier fundamentals, yields continued to compress (Figure 129). A higher financing burden from gradual monetary tightening is, however, expected to place upward pressure on yields in due course.

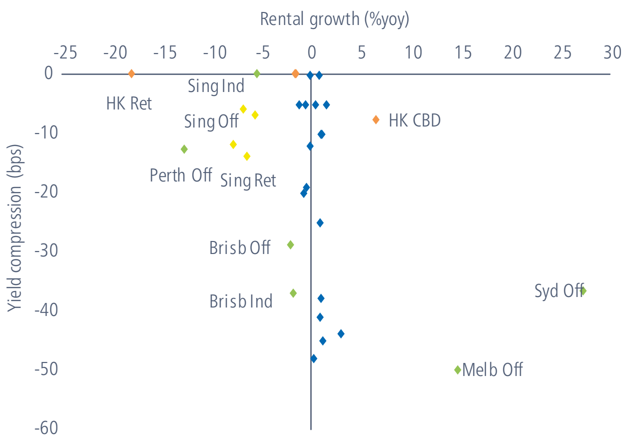
Yields likely to decompress in due course

Figure 128: Europe (ex UK) under/over pricing analysis, by market size



Sources: Aviva Investors, as at 30 June 2017

Figure 129: Capital and occupier market decoupling in Asia Pacific, Q1 2017



Sources: Aviva Investors, as at 30 June 2017

CROSS ASSET VOLATILITY: ONGOING MODERATION

– Volatility continues to moderate across all asset classes

– Isolated political risks cause localised pockets of volatility around the globe

SUMMARY

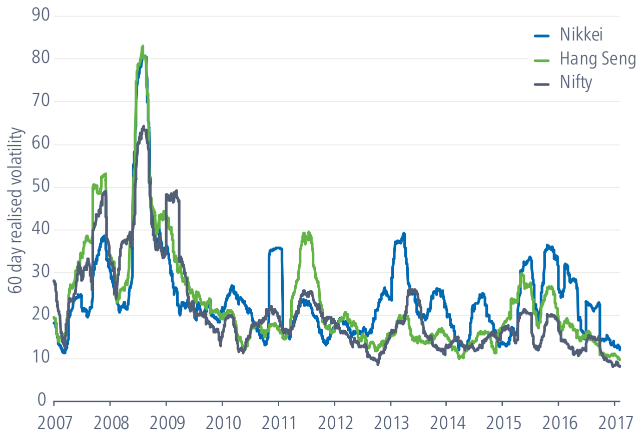
Nikkei, Hang Seng and India's NIFTY index recorded new lows in 60-day realised volatility

Volatility across many global equity markets lifted off the multi-year (and in some cases multi-decade) lows that were experienced in the first quarter of this year. However, a handful of large Asian indices including Nikkei, Hang Seng and India's NIFTY index recorded new lows in 60-day realised volatility (Figure 130). Whereas Nikkei and Hang Seng recorded their least volatile periods since the GFC, NIFTY recorded its lowest since the index was launched in 1990. Again it was isolated political events that were responsible for the larger equity market moves, with the CAC, Eurostoxx and the Brazilian IBOV indices recording year-to-date highs in volatility.

Sovereign 10y yield volatility continued to moderate across nearly all major markets throughout Q2, receding further from the highs experienced around the end of last year when the 'secular stagnation' mindset was so sharply priced out of markets. Yield volatility across developed and most emerging markets now are comfortably first quartile in terms of their five-year histories. A similar picture is seen across high grade credit indices, whilst US High Yield volatility remained somewhat elevated.

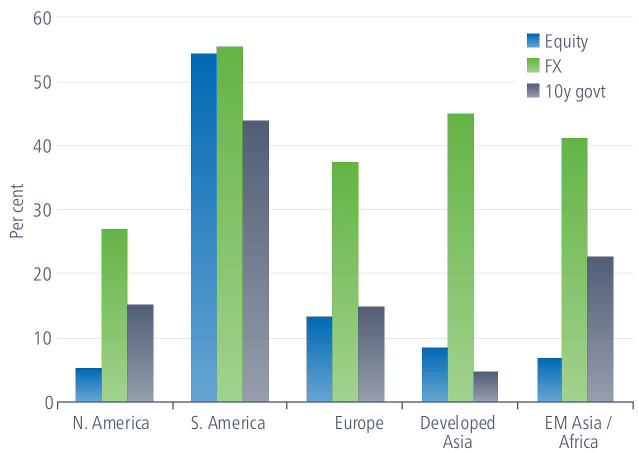
FX volatility also generally receded throughout the quarter, barring isolated political events that had a direct effect on sterling and the Brazilian real. On a five-year history FX volatility remains the most elevated of the major asset classes, sitting largely in the third quartile (Figure 131), although some EM pairs remain more elevated than others.

Figure 130: 60-day realised volatility for Nikkei, Hang Seng and Nifty



Source: Bloomberg, as at 30 June 2017

Figure 131: Cross asset percentiles of 60-day volatility by region within a 5y history



Source: Bloomberg, as at 30 June 2017

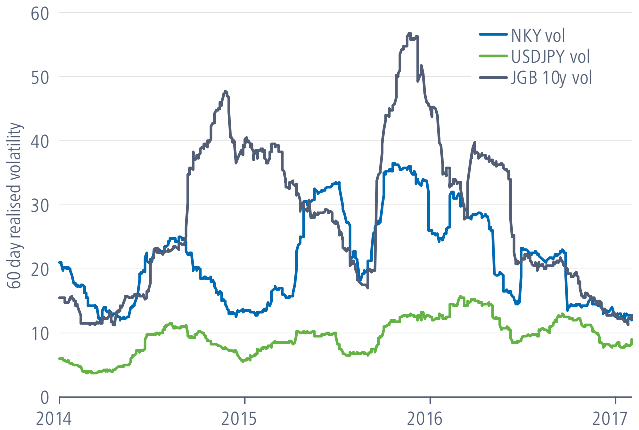
Many of the themes from Q1 continued into Q2 – a general moderation of asset price volatility continued, some new record lows in equity volatility were recorded and isolated political events created pockets of more elevated volatility in localised markets. Our previous Cross Asset Volatility piece argued that low volatility was likely to endure for coming quarters as long as the global growth outlook remained positive, and this proved to be the case during Q2. Benign macroeconomic conditions continued to engineer a favourable outlook for global investment, which combined with the continued liquidity provision from central banks, helped pacify asset price volatility and perpetuate the 'buy the dip' mentality that still remains intact across risk markets.

Equity volatility lifted gently from the multi-period lows experienced by a number of indices in Q1, buoyed in the US by the small uptick from multi-decade lows in stock correlations and also in Europe by increased investment flow around the French and UK elections. Asian equity volatility continued to moderate however, with new multi-year lows recorded on some indices. Japan's Nikkei reached its lowest 60-day realised volatility since 2007, Hong Kong's Hang Seng since 2005 and India's Nifty reached its lowest volatility since the index was launched in 1990. Political risk remained the main idiosyncratic driver of volatility in Brazil as the IBOV index surged to a twelve-month high in response to further damning evidence emerging against Temer in the ongoing corruption scandal engulfing the Brazilian government.

> Japan's Nikkei reached its lowest 60-day realised volatility since 2007

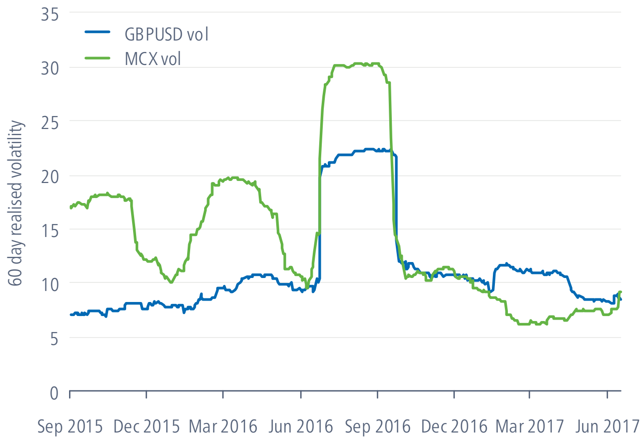
Whereas equity volatility continues to behave in a particularly subdued fashion, FX volatility remains more elevated by historical standards. This is creating unusually tight spreads between the volatility of some equity indices and the base currency in which they are expressed. Particularly apparent is the example of Japan, where against the continued crush in equity realised volatility and the BOJ policy of Yield Curve Control which is artificially reducing volatility of 10y JGBs, the only remaining outlet of price volatility remains the currency (Figure 132). Equally noteworthy is the UK, where even the predominantly domestically-focussed FTSE midcap index (MCX) has displayed historically-low volatility following the referendum, whilst cable volatility has remained relatively elevated and reactive to political developments. This has created the highly unusual situation whereby although the two currently trade with very similar levels of realised volatility, GBP/USD has actually traded with higher levels throughout most of this year (Figure 133). Elsewhere, the riskier nature of some EM currencies was highlighted again during Q2, as the Real slumped over 8 per cent in one day against the US dollar, causing one month realised volatility to hit its highest level since the GFC.

Figure 132: 60-day realised volatility for Nikkei, USDJPY and 10y JGB yields



Source: Bloomberg, as at 30 June 2017

Figure 133: 60-day realised volatility of MCX vs GBPUSD



Source: Bloomberg, as at 30 June 2017

Euro 10y swaps recorded their most involatile 60 trading days on record

Volatility across sovereign rates continued to moderate too. Yield volatility on 10y sterling swaps fell to post-GFC lows, whilst Euro 10y swaps recorded their most involatile 60 trading days on record. However, against this ongoing moderation, isolated political risks again caused ongoing pockets of localised volatility. South African sovereign 10y yield volatility was elevated during Q2 as President Zuma's sacking of finance minister Pravin Gordhan rattled investors and then Moody's cut their debt to its lowest investment grade rating. Credit indices exhibited differentiation across the quarter based upon their risk characteristics. High grade indices globally saw volatility moderate further throughout the quarter and remain comfortably within their lowest quartile relative to their five year history, whilst US High Yield indices saw a modest increase in yield volatility and remain in their second or third quartile.

History shows that higher policy rates do not necessarily lead to higher volatility

Looking ahead we estimate that the current situation can endure for several months into the future, as we suggested in our publication last quarter. Low volatility periods usually persist in equity markets in the mid cycle of an economic expansion, such as those that occurred between 1993 and 1995 or between 2004 and 2006. During these periods the macroeconomic picture is improving and this in itself is sufficient for investment flows to move along the risk spectrum, thereby pacifying equity volatility. As we have alluded to many times over recent editions also, the nullifying of the riskier end of the investment spectrum is usually sufficient to reduce volatility across the whole of the risk spectrum. It is important to note also that throughout both of these low volatility periods during the last two decades, the Fed was hiking the policy rate. History does not therefore favour the argument that an increase in benchmark rates alone is sufficient to dislodge us from the current low volatility regime – indeed volatility levels remained very low throughout both of these hiking cycles and even bottomed months after the last hiking cycle was completed.

Markets will have to get used to reduced liquidity support from central banks

However, there are several extraordinary aspects about the current cycle, aside even from its length. One of which of course is the amount of liquidity still being created by central banks – notably the BOJ and ECB. QE has been a panacea for risk assets since the GFC and by extension for low volatility. The withdrawal and tapering of this by the ECB, should it go ahead as expected next year, is one question mark that might concern investors. Even though the US successfully tapered theirs without too much of an issue aside from the initial Taper Tantrum, the baton was quickly picked up by the ECB in terms of provider of ongoing liquidity following the Jackson Hole meeting in January 2015. Consequently, since one of the tacit objectives of these near-concurrent QE programmes was to push investment flows along the risk spectrum (and that a number of equity market valuation measures suggest it has been successful), to an extent the asset price inflation and associated volatility compression has arguably already happened. It is therefore not entirely clear what the volatility regime will look like when this liquidity provision stops. A further concern on the horizon that could arguably raise the background level of volatility is the quantum of economic growth that China will settle into after the Party Congress in November. The probability of a China slowdown was one of the greatest perceived tail risk events for equity investors throughout the last few years, and whilst not at all our central scenario, there will likely be a wider spread of growth outcomes around the average expectation.

However, it seems likely to us that volatility will remain muted during Q3 provided that our central scenario prevails, the continuing US growth outlook remains intact and there are no exogenous 'black swan' shocks. It seems more feasible that volatility may appear in rates markets than equity markets given these caveats and given the upside risks we feel there is to the Fed's reaction function which maybe isn't fully appreciated by the market.

NOTES

Important information

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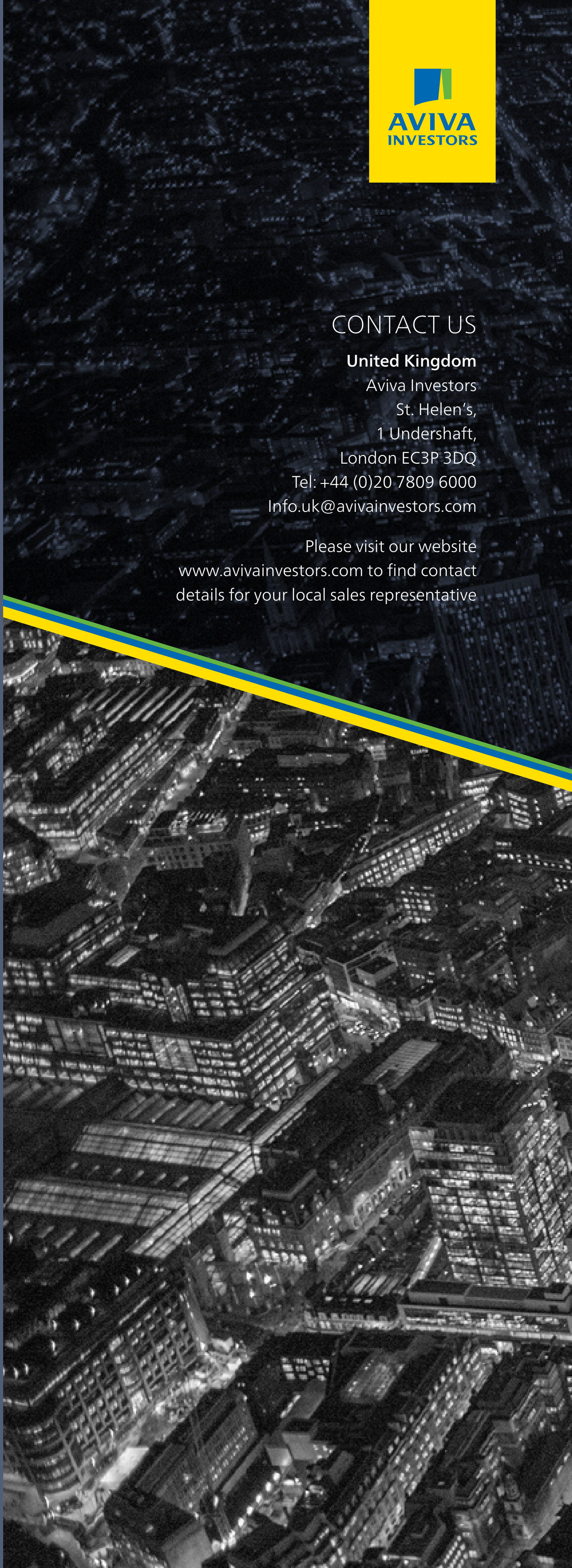

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