Aviva Investors Q&A: House View Q4 2021

October 2021

With the release of Aviva Investors' House View Q4 2021, Michael Grady, head of investment strategy and chief economist, discusses the firm's current economic thinking and asset allocation views with Jennie Byun, multi-asset and macro investment director.

Jennie: In the Q3 House View, our growth expectations were relatively strong and above consensus across all major regions. How has that theme played out over the past quarter?

Michael: Following the unprecedented decline in activity in 2020, economies have recovered rapidly – much faster than any of us expected. This pace of recovery has seen some major economies, such as the United States, already surpass their pre-COVID level of activity, with others such as the euro zone and UK expected to reach that point by the end of 2021. These economies have regained their pre-crisis GDP within 18 months of the deepest recession on record. That compares with between three and seven years to return to the prior peak in activity following the global financial crisis of 2007-09.

Jennie: Can you quantify what the economic recovery outlook now looks like?

Michael: We have modestly downgraded our growth projection for 2021 and have instead pushed much of that lost activity into 2022, leaving the demand outlook the same from three months ago. As a result, we expect global growth of around 6.5 per cent in 2021 and around 4.75 per cent in 2022, with all the major economies' growth well above potential. The risks to that outlook, however, have become more balanced having been previously tilted to the upside.

Jennie: What are the drivers behind this more balanced outlook?

Michael: One factor has been the recent developments around market reform in China, which we see as weakening growth there. Another is the combination of manufacturing shutdowns, the speed of recovery in demand and the lingering effects of COVID restrictions in parts of Asia that has led to some growing pains. We've seen this become more evident over the summer as commodity, manufacturing and retail inventories have fallen sharply, resulting in longer supplier delivery times and significant upward pressure on producer prices. In addition to rising prices, the supply-chain problems have curtailed growth. Surprisingly for this early in the cycle, the supply challenges facing businesses appear to have gone beyond materials to also include labour.

Jennie: This leads to the key question around inflation – is it moving away from being transitory to becoming more permanent?

Michael: In our central scenario we think that much of the recent increase in inflation will prove transitory and will fall back in 2022 as economies reopen more fully. However, we think the risks to our central scenario are tilted to somewhat higher and more persistent inflation over the next 12 months. We have revised up our inflation outlook for this year and next, reflecting the temporary impact of supply constraints in 2021 and early 2022, but more robust underlying inflation through the course of 2022.

Jennie: When and how do you think central banks will respond?

Michael: Monetary policy has become more complicated, with a delicate balance needed in the face of supply constraints. However, with the recently revised mandates at the Federal Reserve and European Central Bank (ECB) in particular, they will likely remain accommodative, waiting to raise interest rates until much of the slack created by the pandemic is absorbed, and inflation is sustainable at around two per cent.

That would suggest a lift-off in rates in late 2022 or early 2023 in the United States, with the ECB likely to be at least a year or more after that. We expect the Bank of England to cease asset purchases at the end of 2021 and raise rates in Q2 2022.

Jennie: Has your shift in outlook changed your view on equity markets?

Michael: Going into the final quarter of the year, our asset allocation remains broadly pro-risk. Contrary to many market commentators, we do not see the year-to-date rally in global equity markets or the fact peak economic growth is behind us as reasons to significantly lighten up on our overweight equity positions and cyclical relative-value trades.

That said, transitioning into a mid-cycle environment comes hand-in-hand with lower outright equity returns than an early-cycle environment, and regional and sector leadership typically becomes more mixed; hence we have added more defensively oriented trades, such as US healthcare.

Jennie: Do you still maintain an underweight in credit?

Michael: Yes. High-yield and investment-grade corporate spreads have moved slightly wider over the past quarter, but the changes have been marginal and we continue to avoid the asset classes given spreads remain near their all-time tights. We expect this means giving up some carry as defaults and downgrades remain low, but the prospective returns are asymmetric on a medium-term basis and unfavourable relative to equities.

Jennie: What about our view on duration?

Michael: The Fed is expected to begin tapering QE purchases in late 2021, with the programme expected to end in mid-2022. In Canada and across Europe, monetary authorities have already begun to decrease the pace of asset purchases, with a few already raising interest rates, albeit slowly and to still very low levels. However, our downgrade to China's growth trajectory is one reason for a slightly lower US bond underweight; while policy easing in China will not be massive, it supports an overweight to Chinese government bonds.

Overall, our view is that growth and inflation risks will overcome a decelerating China, and that interest rates will rise above what is implied by the yield curve. Hence, we maintain a negative view on risk-free assets such as US Treasuries and UK Gilts, and expect steeper curves in the coming quarters to more than offset carry in global government bonds.

Jennie: Following a strong rebound in the first half of 2020, 2021 has been difficult for many emerging markets: is that trend likely to persist?

Michael: Many EM central banks have hiked rates, leading to large capital losses on rising yields. We are not underweight as the commodity cycle and global growth generally buoy the asset class, but from hereon in EM growth will increase imports, while weak portfolio flows and unstable politics, particularly in Latin America, make risk/reward uncompelling. Above all, the level of support from China's stimulus that helped emerging markets in past cycles is not expected to return for the foreseeable future.

Another factor at play is the fact many lower-income countries have not been able to extend vaccination programmes anywhere near as much as developed nations. On the whole, these contrasting choices between the developed and developing world, and between early adopters of reduced restrictions and those who stick with suppression, may lead to very different growth profiles as we move through the next 12-18 months. This will likely present investment opportunities for those who correctly identify the timing of changes, and clearly risks to those that don't.

View the latest version of the House View here.

Michael Grady

Head of Investment Strategy and Chief Economist

Joined investment industry: 1999

Joined Aviva Investors: 2015

Main responsibilities

Michael is Head of Investment Strategy and Chief Economist and is responsible for formulating our macro 'House View' and the risks to that view, as well as overseeing investment strategy for the AIMS funds. Since joining Aviva Investors as Senior Economist and Strategist, Michael has been responsible for monitoring and analysing global macroeconomic, market and policy developments.

Experience and qualifications

Prior to joining Aviva Investors, Michael was senior economist at COMAC Capital Llp, a global macro hedge fund, where he was responsible for the economic and market analysis used to inform the investment process. Prior to this, he spent a decade at the Bank of England in a variety of senior roles, latterly as a Senior Manager in the Markets Directorate. He began his career at the Australian Treasury.

Michael holds a BEc (Hons) from Macquarie University, Australia.

Jennie Byun

Multi-asset and Macro Investment Director

Joined investment industry: 2000

Joined Aviva Investors: 2018

Main responsibilities

Jennie is an investment director focusing on our multi-strategy capabilities. Based in London, she works closely with our portfolio managers to articulate their investment process, portfolio positioning and investment performance to clients and consultants around the world.

Experience and qualifications

Jennie began her career in emerging markets fixed income index research with JPMorgan NY, before relocating to London to help build the company's commodity index business. She then moved to the investment side as strategist and execution trader for a long-only multi-asset fund, covering the fixed income and commodity portfolios.

Jennie holds a B.S. in Management Science from Massachusetts Institute of Technology and an executive MBA from London Business School.

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243709 - 31/10/2022