AVIVA INVESTORS

HOUSE VIEW

2018 Q2

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

Fundamentals strong, but market risks rise

Global growth expectations revised up

In our 2018 Outlook we described our growth expectations for this year as being robust. Three months on, the fundamentals continue to point to a year of strong global growth, with fiscal stimulus in the United States adding to the growth dynamic. Indeed, the main change in our growth outlook for this year comes from an upward revision to the US, with more modest changes elsewhere (Figure 1). As such global growth is expected to be a little stronger than previously thought, at close to 4 per cent this year. Looking ahead to 2019, we expect a moderation in global growth to 3.7 per cent as the major economies slow modestly towards their long-run sustainable rates. However, with growth expected to remain well above trend in all major economies in 2018, labour markets should continue to tighten as spare capacity is eroded (Figure 2). That is expected to put upward pressure on wage growth and inflation. We have revised up our expectation for inflation in advanced economies to 2 per cent in 2018.

Federal Reserve expected to deliver more rate hikes

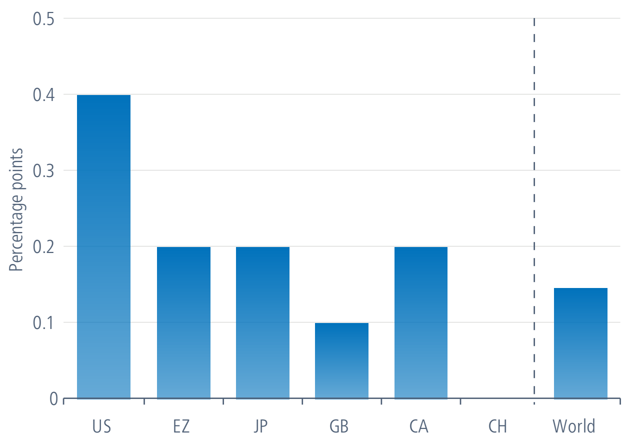
Given the growth and inflation outlook, we expect most central banks around the world to be biased towards tightening monetary policy. The Federal Reserve are furthest along that path, having raised rates to 1.5-1.75 per cent in March. We now expect a total of four rate hikes from them in 2018 and another four in 2019, taking the policy rate to over 3 per cent (Figure 3). That is a more rapid pace of rate increases than we had expected at the end of last year and reflects the combination of stronger-than-expected underlying growth momentum, the material boost from tax cuts and increased fiscal spending and the increased likelihood that inflation will overshoot the 2 per cent target in 2019. In the Eurozone we expect asset purchases to end in late 2018 (with a first rate hike in 2019), while in Japan we see the potential for the Bank of Japan reviewing its policy of yield curve control (YCC) if core inflation continues its recent steady rise to above 1 per cent. The outlook for the Bank of England remains highly dependent on developments in the Brexit negotiations, but the current balance of risks suggests at least one rate hike this year.

Era of cheap money draws to a close

We expect a sustained pickup in inflation will solidify expectations of tighter monetary policy

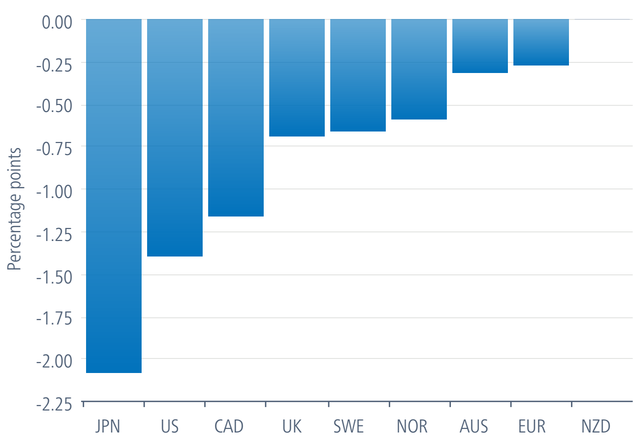
We expect that the shift to tighter monetary policy – both in terms of policy rates and central bank balance sheets – will be a key market theme in 2018, resulting in more volatility across asset classes, particularly as risk premia are re-priced to better reflect fundamentals. The expected tightening in monetary policy reflects our positive global growth outlook and our expectation that the rise in inflation to central bank targets will be sustained. As always, China will continue to play a pivotal role in global markets, particularly commodities. and therefore those countries that are heavily dependent

Figure 1: Global growth revisions
We have revised up our expectations for 2018



Sources: Aviva Investors, Macrobond, as at 31 March 2018

Figure 2: Tight labour markets
2018 year-end unemployment rate forecast less 2001-2007 average



Sources: Aviva Investors, Macrobond, as at 31 March 2018

on them. We expect that China will continue to pursue systematic reforms (such as deleveraging the corporate sector, reducing excess capacity in certain industries, improving environmental outcomes and tackling corruption), but will not let growth slip too far from their target of 6.5 per cent.

Of course there are always risks to the outlook. We have seen in the first few months of this year fears of rising protectionism and a global trade war stoked by the US seeking to impose tariffs on steel and aluminium and against a broad range of Chinese goods. While the scale of the tariffs will probably not be enough to have a material economic impact at the national, let alone global level, the sell-off in risk assets has demonstrated that the market is concerned about where any trade war may end. Outside of trade tensions, we think that the market continues to under-price the risk of central banks moving away from the post-crisis language of slow and gradual normalisation to something more active. Those risks are clearly greatest in the US. Alongside the prospect of rising rates globally, there are a range of countries and sectors that are highly leveraged and could become more challenged in that environment.

Market risks have risen with increased concerns about a global trade war

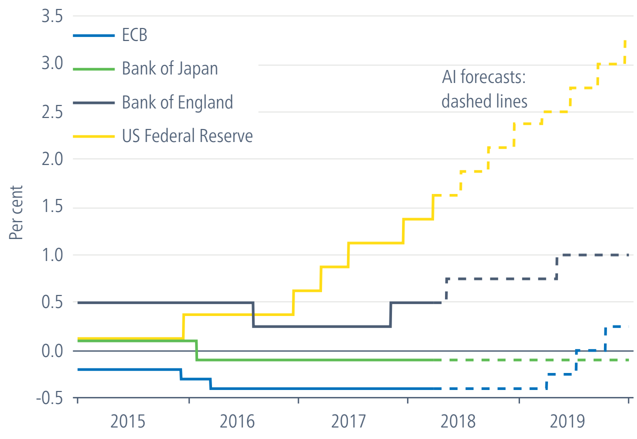
The start of 2018 has seen increased volatility in global markets. Strong returns in risk assets, such as equities, in January were rapidly reversed in February, with further declines seen in March (Figure 4). As a result, global equities were down around 5-10 per cent year-to-date, the worst quarterly performance since 2015. Despite these declines, we remain constructive on global risk assets due to strong economic fundamentals and the associated positive earning outlook. However we recognise the increased market risk – particularly given the magnitude of either explicit or implicit volatility selling products that have built up recent years.

Global risk assets expected to benefit from strong fundamentals, but duration to be more challenged

As such, we have modestly downgraded our expectations for equity markets this year. We favour European and emerging market equities where strong global growth, a benign outlook for the US dollar and relatively more attractive valuations should deliver outperformance.

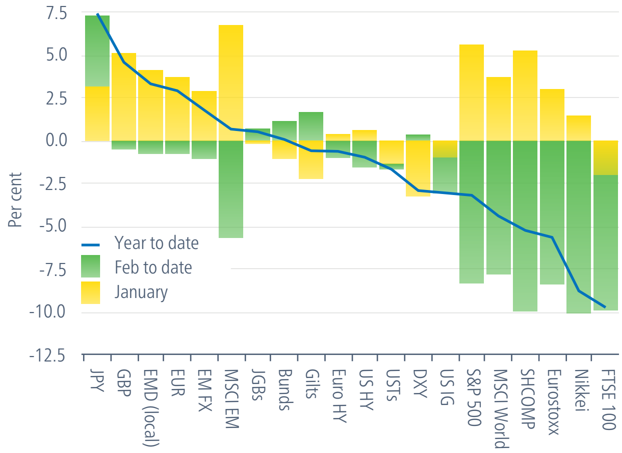
On the other hand we continue to expect risk-free assets to under-perform. It has been notable how weak performance has been in duration during the equity market sell-off this year. Over the past decade almost all periods of risk aversion have been met with a sharp rally in government bond markets. But with strong global growth, tightening labour markets, steadily rising inflation and the removal of monetary policy accommodation, yields have continued to move higher. We think that duration will remain challenged through 2018, with potential for policy changes later in the year from the European Central Bank and the Bank of Japan adding to rising global term premia.

Figure 3: Global monetary policy rates
We expect eight hikes in the US over the next 2 years



Sources: Aviva Investors, Macrobond, as at 31 March 2018

Figure 4: Global market performance 2018 YTD
Risk assets have underperformed YTD



Sources: Aviva Investors, Bloomberg, as at 31 March 2018

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 February 2018 Forum we identified the following key themes:

1. Tighter monetary policy across the world
2. Market outcomes to be increasingly determined by fundamental factors
3. Expectations of sustained inflation
4. Systematic Chinese reform
5. Peak financial regulation

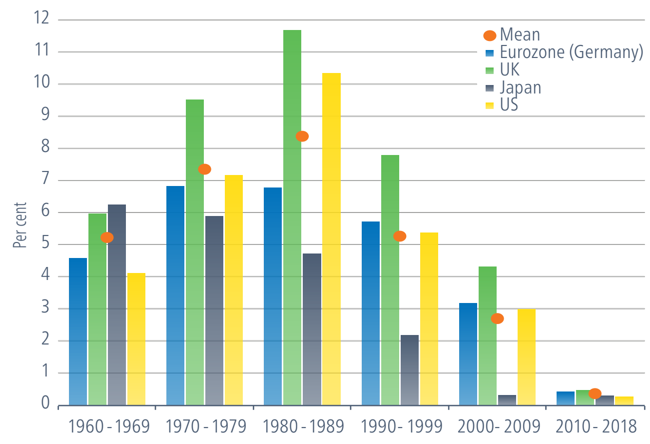
1

TIGHTER MONETARY POLICY ACROSS THE WORLD

The extreme levels of monetary policy stimulus that have persisted for almost a decade are now being slowly withdrawn (Figure 5). Although local conditions will determine the pace and extent of the required tightening, the overall theme will be common to all major developed economies over the next two or three years. It is a reflection of improved macroeconomic conditions and represents a gradual return to, or at least towards, normality in the post-crisis world. The final destination is still uncertain, but it should be characterised by steady growth, low, positive inflation and a more conventional policy interest rate. The monetary "life support" of a range of unconventional policy measures, vital during the crisis, is now no longer appropriate and is also being withdrawn. Their legacy, in terms of central bank balance sheets, however, will be with us for some time.

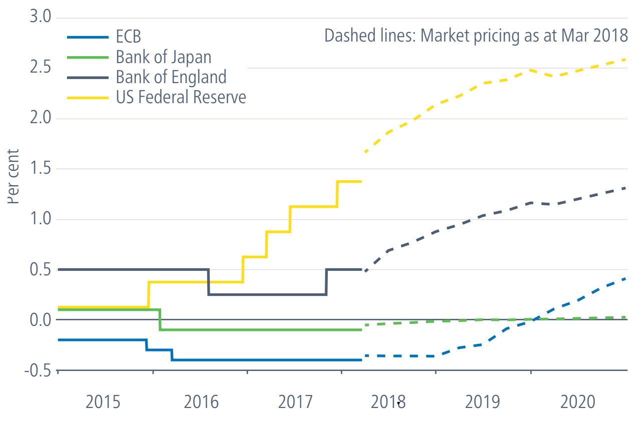
The US economy healed first, so the Fed was the first to tighten policy. We now expect four rate rises in each of 2018 and 2019 which will take the key Fed Funds rate back above 3 per cent. Financial markets expect a little less than that (Figure

Figure 5: Average policy interest rate by decade



Sources: Aviva Investors, Macrobond, as at 31 March 2018

Figure 6: Markets expect gently rising policy rates



Sources: Aviva Investors, Macrobond, as at 31 March 2018

6). While this is lower than rates that have typically prevailed in the past, it may be close to a "neutral rate". With inflation expected to remain well behaved, it would also be a positive real rate and should be associated with a modest tightening of overall financial conditions, something that has not accompanied the Fed tightening so far. Other central banks are expected to join the tightening cycle - the BoE this year and the ECB and BoJ in 2019, although any changes (of rates or unconventional policies) will be contingent on a continuation of favourable macroeconomic conditions.

2 MARKET OUTCOMES TO BE INCREASINGLY DETERMINED BY FUNDAMENTAL FACTORS

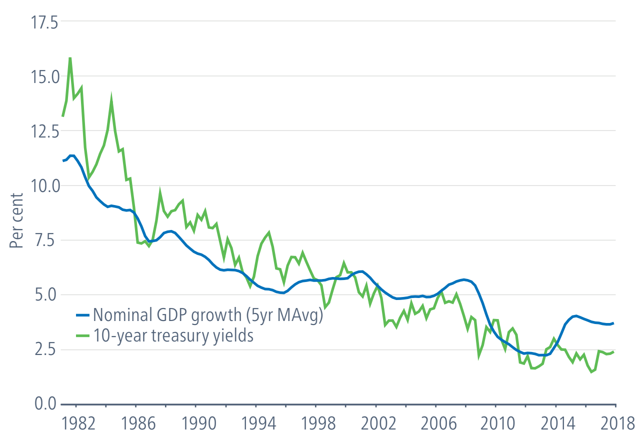
Over the long run the appropriate level of financial asset prices will be determined by fundamental drivers. Among the most important of these are the underlying pace of growth, the prevailing rate of inflation (Figure 7 & Figure 8) and the interest rate set by the central bank. During the financial crisis and in its aftermath there was great uncertainty about where all of these would settle and this contributed significantly to financial market turmoil. Many of the unconventional policies that were adopted over the last decade were intended to provide much-needed stability and, more contentiously for some, to support asset prices in general. For an extended period of time, many asset prices were underpinned more by the policy backdrop than traditional fundamental influences. As these policies are withdrawn, the direct support for asset prices that they supplied must necessarily diminish. But the reason policy is changing is because better macro-economic conditions have returned.

Last year saw a clear change as the more customary drivers reasserted their influence on financial asset prices and we expect this to continue in 2018 and beyond. The return towards more "normal" monetary policy regimes around the world along with the restoration of an environment of low, positive inflation has already put some upward pressure on sovereign bond yields which had sunk to unprecedentedly low levels in recent years. This in turn may lead to adjustments in other financial markets. It is also plausible that there could be greater dispersion across fixed income markets as fundamentals reassert themselves, reflecting differing prospects, policy settings and economic conditions..

3 EXPECTATIONS OF SUSTAINED INFLATION

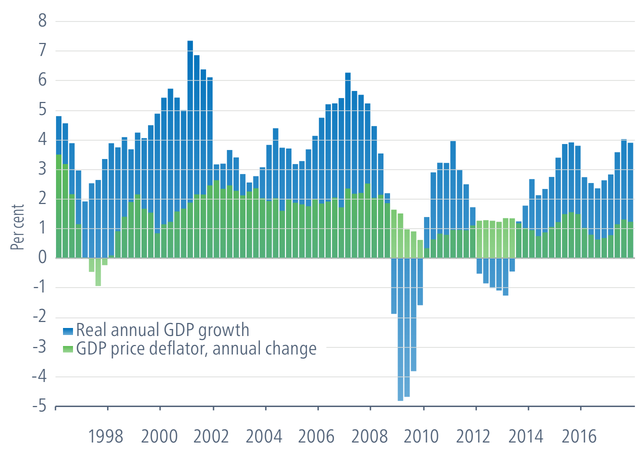
The period that became known as the "great moderation" (dates vary, but usually depicted as around mid-1990s-mid 2000s) was characterised by steady economic growth, low, stable inflation and a belief that boom and bust business cycles

Figure 7: United States: 10yr bond yields & nominal GDP



Sources: Aviva Investors, Macrobond, as at 31 March 2018

Figure 8: Eurozone: GDP growth - real & inflation



Sources: Aviva Investors, Macrobond, as at 31 March 2018

were a thing of the past. The rude awakening provided by the financial crisis understandably led to a significant reassessment. In particular, persistently low inflation and the very real threat of deflation led some to argue that inflation would now stay permanently low and that policy should, as a result, remain loose indefinitely. But the prevalence of low inflation since 2009 – even negative inflation – should not really have come as a surprise given the collapse of demand and resulting emergence of excess supply. Price pressures really should not re-emerge until that spare capacity has been used up.

We are now approaching that point globally – we may be past it in some geographies. The strong growth that we have seen in recent years is closing the gap between supply and demand and will in our view lead to a return of sustained low positive inflation in 2018 and 2019 that will converge on target rates (typically around 2 per cent). The US is most advanced in this process – it will take a little longer in the Eurozone and elsewhere. Wage inflation has also been subdued by historical standards, but this too should tick gently higher over the next few years. There was some evidence of higher inflation emerging last year, but it was not entirely convincing. It should become more clearly established this year and lead to an accompanying adjustment in inflation expectations (Figure 9 & Figure 10). Such a development would be an important element in the reappearance of more normal macro-economic conditions. A return to, and acceptance of, 2 per cent inflation would imply that a re-evaluation of yield curves and term premia could be appropriate.

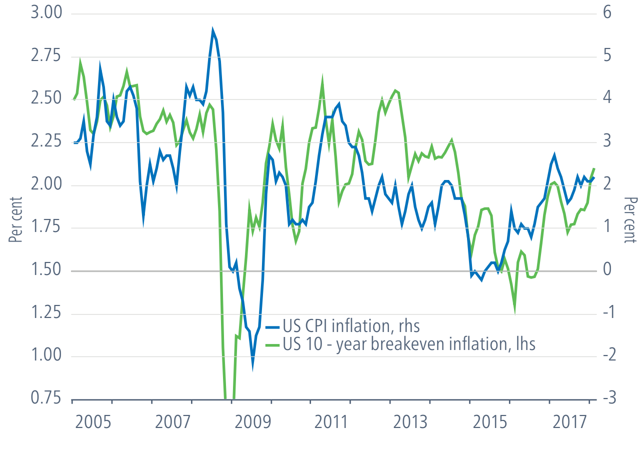
4

SYSTEMATIC CHINESE REFORM

One of the key messages from the 19th Communist Party Congress last October was a subtle modification of the economic policy focus away from an emphasis on growth targets and towards supply-side reforms (including state-owned enterprises or SOEs), deleveraging and the longer-term transformation of China (Figure 11). That message was reinforced more recently at the National People's Congress. There was a growth target for 2018 of 6.5 per cent (down from the 6.9 per cent achieved last year), but previous references to "striving for better" were absent. Targets for both the broad money aggregate (M2) and fixed asset investment were also dropped, supporting the view that a rigid adherence to the achievement of targets is no longer such a priority. This being Chinese data, it would be a surprise if targets were not reached.

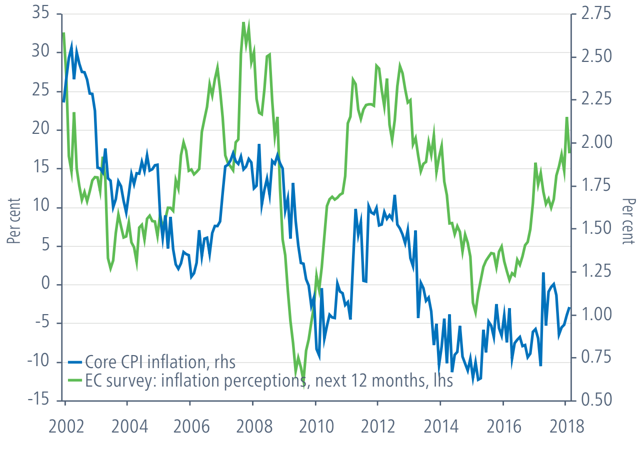
Arguably, being a hostage to fortune where GDP objectives are concerned has been more of a hindrance to Chinese policy as well as to its transition and economic development ambitions. The other major theme that has emerged has been

Figure 9: Market-based inflation compensation and CPI



Sources: Aviva Investors, Macrobond, as at 31 March 2018

Figure 10: Eurozone: core inflation and inflation expectations



Sources: Aviva Investors, Macrobond, as at 31 March 2018

President Xi's ongoing consolidation of his power-base. Far greater prominence has been given to Xi himself rather than the Party and the state, meaning that the foundations have been laid for a long stay in office, perhaps indefinitely, a clear change from earlier precedent. This change begs many questions about a return to dictatorship, benign or otherwise, but could also ensure greater stability and progress. Xi has associated himself indelibly with reform and transition. The combination of that aspiration and almost total power may help ensure that those reform goals can be achieved.

5

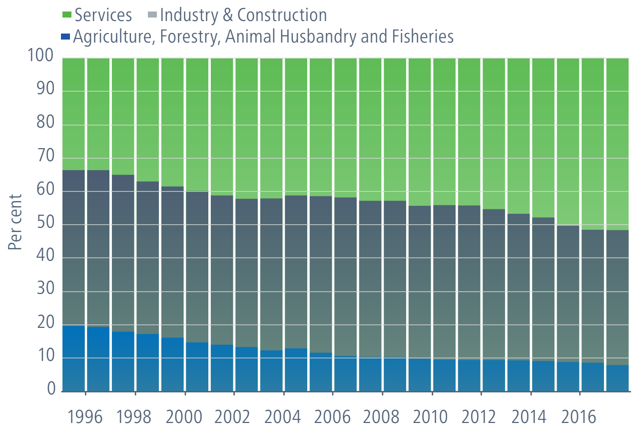
PEAK FINANCIAL REGULATION

After the inevitable raft of greater financial regulation in the wake of the Global Financial Crisis (GFC), the pace of introduction of additional measures has, just as inevitably, waned somewhat in recent years. This does not mean that we are about to experience a far looser regulatory environment in the near future, but rather that we have probably passed the peak in terms of additional initiatives being announced. Indeed, with the ostensibly market-friendly Mr Trump in the White House, there is even the possibility of a worthwhile reduction in the regulatory burden in some areas. His rollback on rules may not be as dramatic as portrayed in the campaign, but it does now look as if the key Dodd-Frank legislation will be relaxed significantly. The mooted changes in the definition of a "systemically important" bank would remove the need for 25 of the 38 largest banks in the country to comply.

Despite claims that regulation would be removed, arguably the more significant change is the large reduction in the number of new rules (Figure 12).

In Europe there has perhaps been a greater acceptance of tighter regulation and less momentum behind any moves towards a lighter regulatory touch. But it is also generally accepted that a properly functioning banking system is vital. And in this context it is widely recognised that credit needs to be made available to reputable entities that wish to borrow if the Eurozone recovery is to continue. The latest indications are that credit conditions have eased considerably since the sovereign debt crisis and that lending has picked up. Although it is unlikely to be characterised as looser regulation, the European authorities will wish to ensure that credit continues to flow, without significant hindrance, to where it is needed. When there were more worries about the fundamental health of large parts of the European banking system, this was less of a priority – at such times solvency was more important than liquidity.

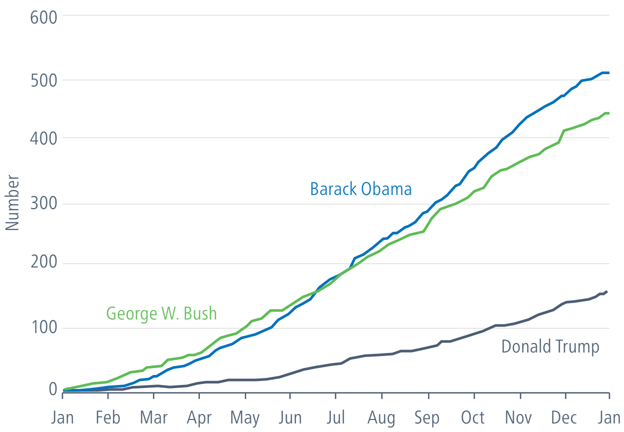
Figure 11: China output decomposition



Sources: Aviva Investors, Macrobond, as at 31 March 2018

Figure 12: Trump's regulatory blockage

Trump White House has approved far fewer major regulation in his first year than either Bush or Obama



Sources: Office of Information and Regulatory Affairs

RISKS TO THE HOUSE VIEW

PROTECTIONISM AND TRADE CONFLICTS

Trade tensions are significantly higher

Three months ago we welcomed the fact that global trade tensions had moderated. That may have been a false dawn. Perhaps we should not be surprised, given the stress that the Trump team placed on the issue during the election campaign, that protectionism is very much back on the agenda following the provocative imposition of US tariffs and reciprocal measures from China. The risk of a more damaging trade war or wars is clearly evident, threatening global trade (Figure 13). The potentially disruptive risks of nationalism and populism continue to bubble beneath the surface in many arenas including European elections, Trump policy and Brexit negotiations. They may yet resurface more alarmingly, especially if economic fortunes change for the worse.

CHINA GROWTH SLOWDOWN

China's secular slowdown needs to be carefully managed

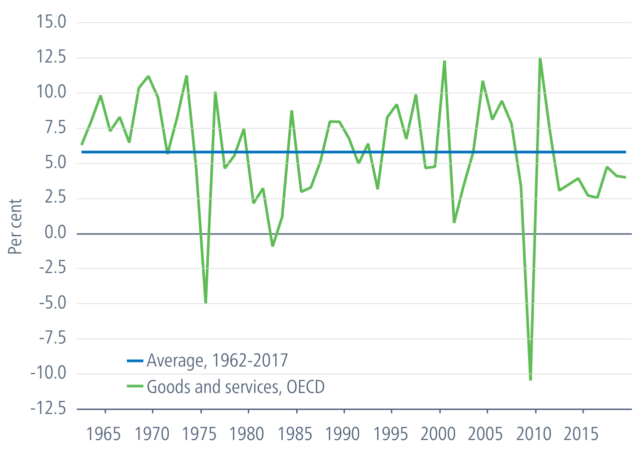
The trend rate of GDP growth in China is slowing, as it is in many countries (Figure 14). But China's size and importance mean that both its growth rate and how the trend slowdown is managed will have ramifications for both financial markets and the global macroeconomic outlook. China is attempting to transition to a more open, service-based economy. But the combination of the inexperience of its policy-makers, their determination to micro-manage every detail of the economy and society, their ambitious long-term aspirations and China's strange demographics means that the scope for upsets and mistakes is significant. There have already been previous episodes of China growth worries that have rattled global markets. An unnecessary slowdown could be brought about either by a transition shock or as a result of policy mistakes. Either way, it would be foolish to ignore the risk of more shocks in the future.

CENTRAL BANKS TRY TO SLOW GROWTH

Central banks might have to try and change behaviour

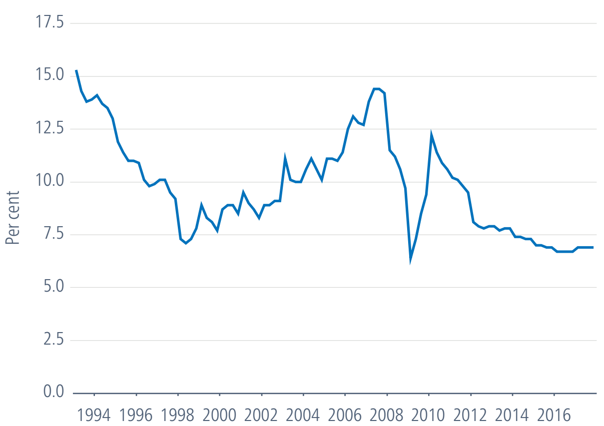
Tightening cycles have barely begun in some places but so far central banks (CBs) have merely been "leaning into the wind" and it has been noteworthy that overall financial conditions are looser today then when the Fed first raised interest rates in December 2015. The favourable policy backdrop has finally resulted in a marked pick up in global growth. The "gradual and limited" playbook of CBs today is generally well understood. But this would change dramatically if they instead determined that they needed to slow growth deliberately – to actively tighten financial conditions – perhaps to ward off inflationary pressures. The pace of tightening has until now been easily the slowest in the post-war period (Figure 15). A simple reversion to an "average" rate of hiking would change the financial market environment profoundly.

Figure 13: Global export growth



Sources: Bloomberg, Aviva Investors, as at 31 March 2018

Figure 14: China GDP growth



Sources: Aviva Investors, Macrobond, as at 31 March 2018

DEBT SERVICING VULNERABILITIES

The long period of exceptionally low interest rates encouraged greater borrowing, just as it was intended to do. Debt levels around the world have risen as households, companies and governments all borrowed more. As interest rates now rise, even if they do so only very slowly, it is inevitable that the costs of servicing those debts will increase and that the debt burden will become incrementally more onerous. Credit conditions, as gauged by loan covenants, have eased significantly in some areas (Figure 16). How different debtors cope with these changes will help determine the resilience of the recovery. We do not anticipate that borrowing costs will get even close to rates that prevailed in the past, but history is littered with examples of borrowers who hadn't realised they were overextended until rates rose. Gearing is undoubtedly higher today in some areas. As interest rates now rise gently, there are obvious risks that such vulnerabilities will be exposed.

Higher interest rates will hurt debtors

EUROPEAN CONVERGENCE

2017 was a good year for the Eurozone. It saw the strongest growth for a decade and an expansion that was extremely broad-based. Differential growth rates have in the past been a source of tension between member nations. In addition, the French and German elections passed without too much drama and resulted (eventually in the German case) in governments that should be able to take further steps on the path to closer integration. The recent Italian election has been a little bit of a setback and it remains to be seen whether any sort of government can be formed. But it should not go unnoticed that all three elections featured significant support for nationalist and populist movements. Meanwhile, clear, definitive progress towards fiscal and political union is still painfully slow. This scenario is an upside risk for Europe, but looks as distant as ever, perhaps more so than three months ago.

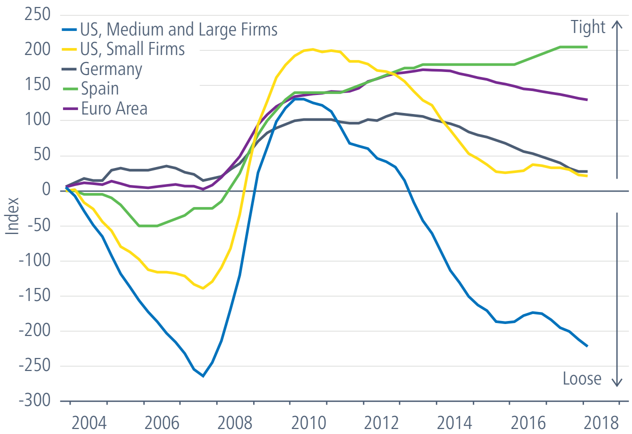
Closer integration would change Eurozone dynamics

Figure 15: Previous CB hiking cycles (1970-2018)

	Average Increase (bps)	Time (m)
US	550	16
Germany	390	20
Japan	360	10
UK	484	16
Average	446	16

Sources: Aviva Investors, Macrobond, as at 31 March 2018

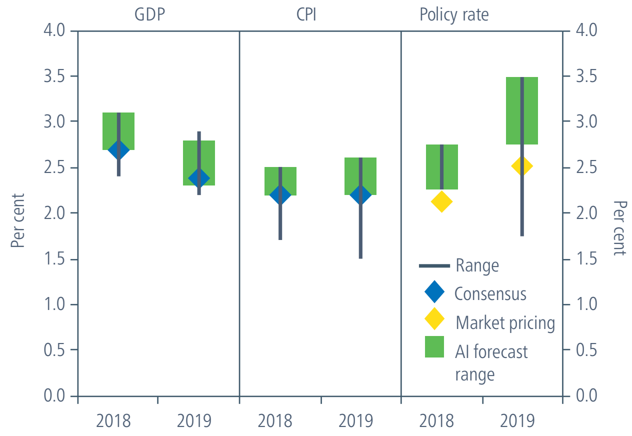
Figure 16: Survey balance of corporate credit conditions (loan covenants)



Sources: Aviva Investors, Macrobond, as at 31 March 2018

MACRO FORECAST CHARTS AND COMMENTARY

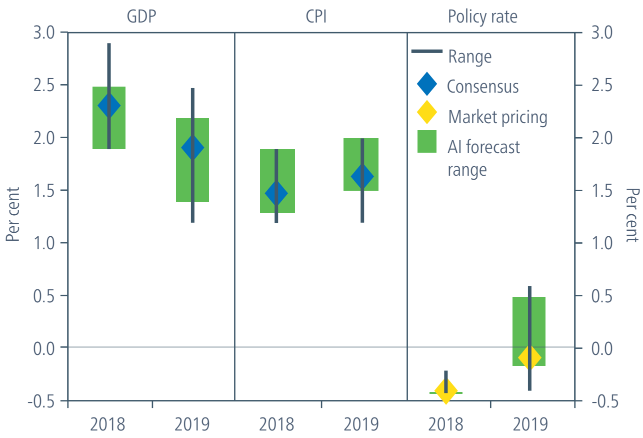
Figure 17: US



Source: Bloomberg, Aviva Investors, as at 31 March 2018

Strong underlying growth dynamics at the end of 2017 received a further boost with the passage of household and corporate tax cuts at the end of last year and a boost to government spending. Together those fiscal measures are likely to add between 0.5-1 per cent to growth this year and only marginally less in 2019. As such we have revised up our growth estimates this year and next, and remain above consensus. With stronger growth and a further tightening of the labour market, we expect core inflation to move back to the 2 per cent target by the middle of 2018 and to be above that in 2019. We expect the Federal Reserve will deliver four rate rises in each of 2018 and 2019.

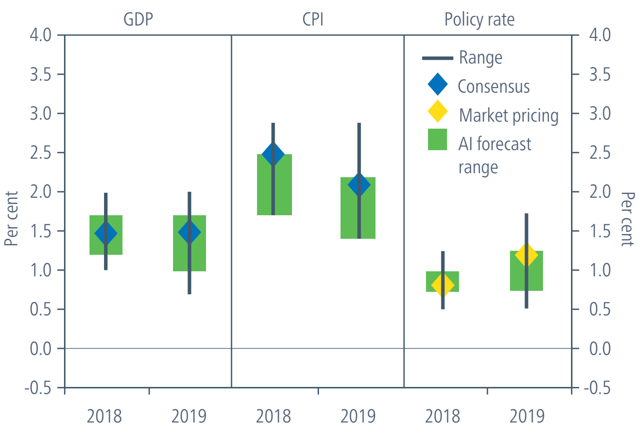
Figure 18: Eurozone



Source: Bloomberg, Aviva Investors, as at 31 March 2018

Sentiment across the Eurozone has slipped slightly from recent peaks, but remains upbeat and argues for another year of above-trend growth in 2019. A small moderation in growth would be welcome, as there is much less spare capacity now remaining and trend growth is estimated at only a little above 1 per cent. With inflation still subdued and only expected to rise slowly back towards target, the ECB will withdraw extreme stimulus very gradually. Asset purchases should halt this year, while modest policy rate increases are more likely to come next year rather than this.

Figure 19: UK

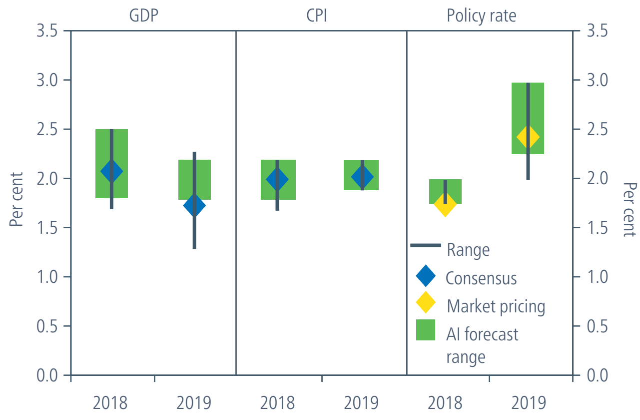


Source: Bloomberg, Aviva Investors, as at 31 March 2018

The UK outlook continues to be dominated by Brexit negotiations with risks still tilted to the downside. The modest pace of current growth (around 1.5 per cent annualised) is in line with the lower growth rate of supply-side potential that is now generally accepted. As a result, the Bank of England believes a modest tightening bias is appropriate. However, if inflation falls further in 2018, as we expect, that view could be reassessed, especially if growth were to weaken. Prospects are not calamitous, but with low rates, a weaker currency and a favourable global backdrop, the UK should be doing better.

Growth surprised on the upside in 2017 and labour market slack was absorbed more quickly than expected. Going forward, growth is expected to slow. High levels of debt in the economy and a stretched housing market mean that consumption and investment will contribute less to growth this year as the impact of higher interest rates and new mortgage guidelines take effect. NAFTA also presents a source of uncertainty and will weigh on the outlook. That said, growth remains above potential and wage pressures are clearly coming though. Risks remain on the more hawkish side, with an additional hike likely later in the year.

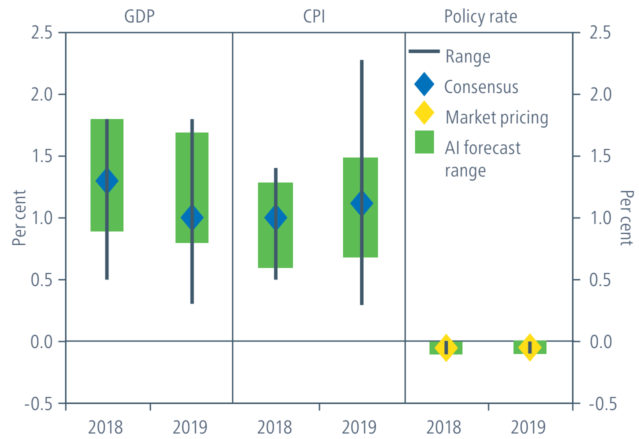
Figure 20: Canada



Source: Bloomberg, Aviva Investors, as at 31 March 2018

Strong upside growth surprises in 2017, fuelled by domestic demand, suggest significant momentum into 2018. With the global cycle strong, net exports are likely to contribute positively. Surveys and corporate profitability point to a strong investment outlook. Upside surprises to 1.8 per cent yoy growth are likely. Inflation should grind higher gradually, but will probably fall short of the 2 per cent target by 2019. With the yen rising against the US dollar recently, the stakes are high for the BoJ to tailor its message carefully to a market nervous about a shift in policy, which could have large implications for inflation expectations and in turn the central bank's inflation target.

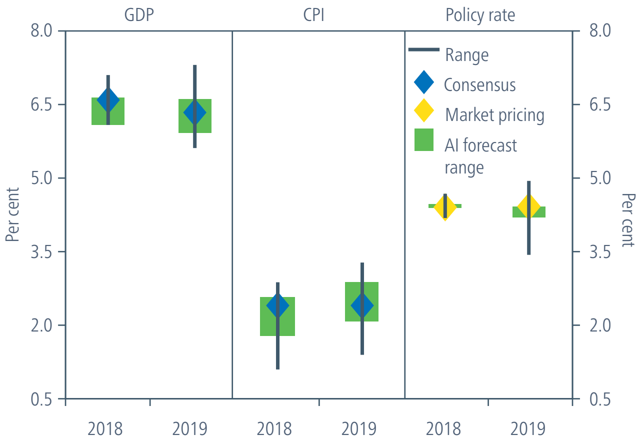
Figure 21: Japan



Source: Bloomberg, Aviva Investors, as at 31 March 2018

Now that President Xi Jinping has consolidated power, policymakers will re-focus on reforms. At the top of the agenda is financial stability which means deleveraging will continue and growth will slow. However, the 6.5 per cent target will likely be achieved at the start of the president's 'third term'. The lower fiscal deficit target (2.6 per cent vs. 3 per cent) looks achievable if they cut infrastructure spending. While a policy mistake is still the main risk for China, escalation of trade tensions between the US and China could also pose a threat to growth. Inflation remains benign which means the PBoC will maintain its neutral policy stance. We expect the currency will also remain stable.

Figure 22: China



Source: Bloomberg, Aviva Investors, as at 31 March 2018

GLOBAL MARKET OUTLOOK AND ASSET ALLOCATION

HIGHER VOLATILITY REGIME A SIGN OF NORMALISATION

– Global growth is supportive, putting moderate upside risks on inflation

– With peak easy monetary policy behind us, markets are resuming the ability to price risks

– Duration is the most threatened asset class

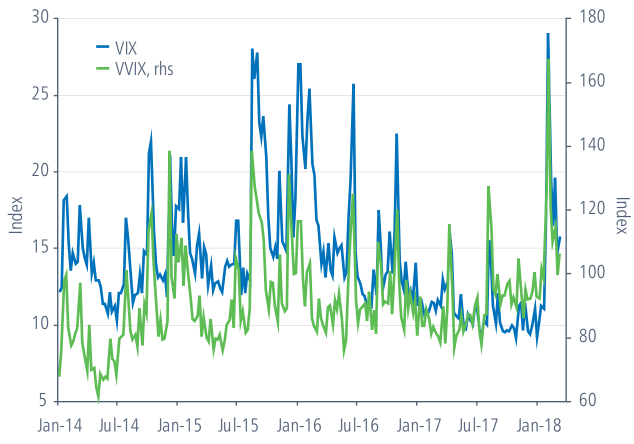
Higher volatility regime become a reality…

Fundamentals are back in the driving seat

Three months ago we discussed the idea that peak policy easing was behind us and that a higher volatility regime lay ahead. Our central scenario remains one of strong global growth, leading to modestly stronger inflation pressures. In that context, the direction of travel for the main G10 central banks is biased towards tighter policy. One consequence of this view that we have highlighted in previous quarters (in hindsight probably a bit early) is that fundamentals should be back in the driving seat and that the low volatility regime will come under pressure (Figure 23). The return of fundamental drivers is impacting different asset classes in alternative ways and at a different pace. But while we have seen a lot of dispersion in equity markets, fixed income assets have shown far less. This is unlikely to continue, especially as we expect the ECB to halt asset purchases this year and the Bank of Japan to potentially modify their yield curve control policy in the second half of this year or in 2019. This comes on top of an expected four rate hikes from the Fed this year and a further four in 2019.

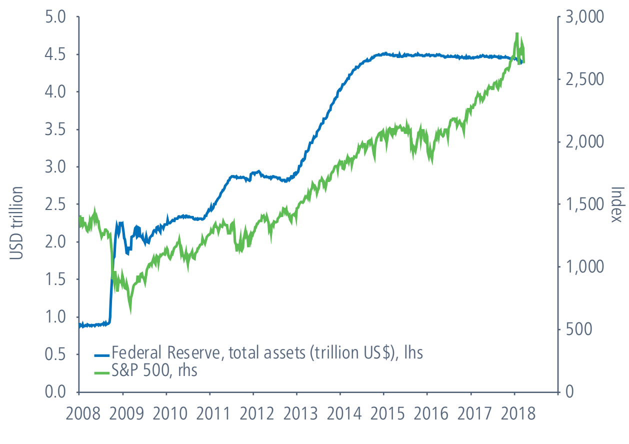
More dispersion on average and across asset classes is likely to be the new norm, and in this world investors may wish to be more granular and active than was the case in the quantitative easing era. We are clearly progressing along the road of normalisation and leaving behind a decade of almost zero interest rates policy and excess liquidity (Figure 24). It is not surprising that it is taking time for global markets to adjust to the new state of affairs. Although such adjustments are not always smooth, fundamentally it should be regarded as a positive development. The robust growth backdrop, which is expected to continue, is helping markets to stand on their own two feet again.

Figure 23: Equity volatility regime to remain higher than last few quarters



Sources: Aviva Investors, Bloomberg as at 31 March 2018

Figure 24: Federal Reserve support is fading



Sources: Aviva Investors, Bloomberg as at 31 March 2018

…but the market can stand on its own two feet

We remain generally constructive on global equity markets. But expectations of a higher volatility regime lead us to favour a small reduction in equity exposure, while still remaining overweight. Indeed, an alternative way of positioning for strong growth, the return of inflation and the changed monetary policy stance is to be aggressively underweight duration in developed markets.

A higher volatility regime is arguably a good thing for global markets. What was less healthy was the almost uninterrupted rise in equity markets accompanied by extremely low volatility. We now think that global markets have regained some ability to price risk. Again there is some differentiation to be made across asset classes. In the past few years, foreign exchange markets in general have been more successful in pricing in the main macro-economic developments.

Higher volatility regime not necessarily a bad thing

In that context the US dollar depreciation over the past year or so is interesting. While the monetary policy differential between the US and the rest of the world argues in favour of a stronger dollar, global markets are factoring in the rest of the world catching-up (signalling the turn in monetary policy in the UK, Japan and the Eurozone) and other factors such as concerns around fiscal discipline in the US. We continue to look at currencies as providing risk-reducing positions which should protect portfolios should we be wrong in our central scenario. We find being short the Australian dollar an attractive position, since it provides protection in a number of scenarios (Figure 25). Being long the Japanese Yen also works well in a number of downside scenarios, and interestingly it is likely that future policy from the Bank of Japan will be supportive of the Yen, a marked contrast to much of the last few years.

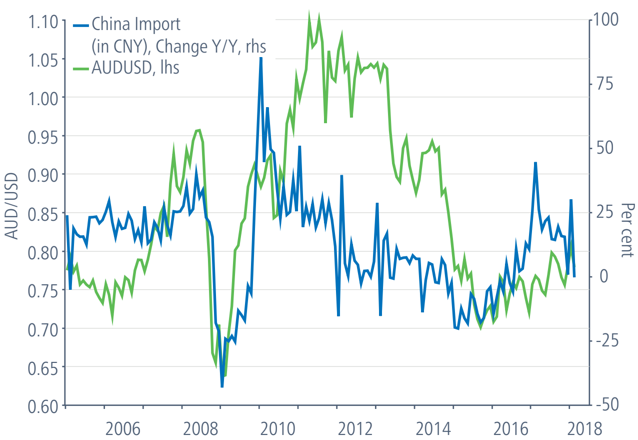
We prefer emerging markets exposure…

Emerging markets remain our preferred area, both in equities and local currency debt. The environment of strong growth and, crucially, a benign dollar, alongside still supportive valuations, mean that emerging market assets continue to look attractive. We still prefer local currency debt to hard currency debt on valuation grounds, however as we reduce exposure further in developed market fixed income, we upgrade hard currency debt from underweight to neutral.

We remain constructive on equities

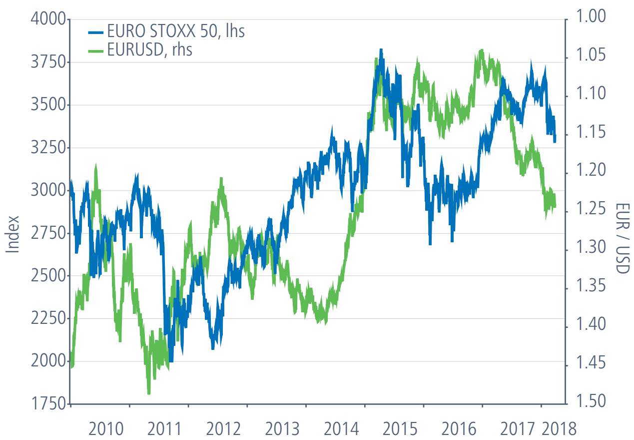
We have neutralised our underweight on US equity markets as we expect earnings growth to remain strong, with share buy-backs potentially giving more support to the market. As a result, we have rebalanced our exposure in other markets and reducing slightly our European and Japanese exposure. One potential headwind

Figure 25: Short AUD a hedge against softer global trade outlook or weaker China



Sources: Aviva Investors, Macrobond, Bloomberg as at 31 March 2018

Figure 26: Euro strength could be a headwind for European equities



Sources: Aviva Investors, Macrobond, Bloomberg as at 31 March 2018 for both these markets going forward could be the currency, as the environment in terms of monetary policy is supportive for both the euro and the Japanese Yen (Figure 26). Sector wise, we continue to like global financials as an expression of our reflation views, also helped by lower sensitivity to currency moves than the broad market. We remain underweight UK equities as uncertainty around Brexit still makes the risk-reward balance unattractive.

… while duration is a strong underweight

Prefer duration in Australia

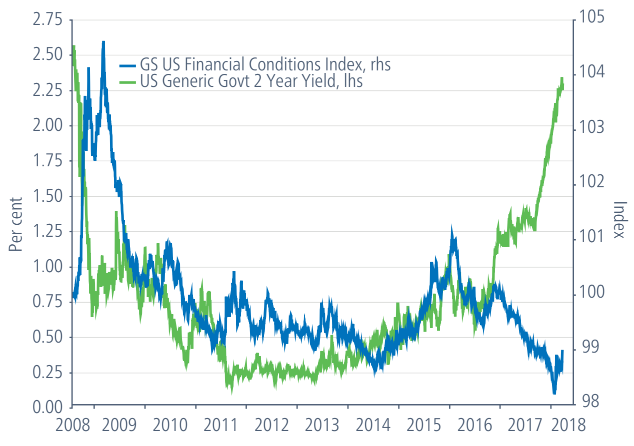
The key element underpinning our asset allocation view lies in our view on duration. We note that although bond yields have risen, overall financial conditions remain loose (Figure 27). We think duration should be an aggressive underweight both in the sovereign and credit space in most developed markets. The most acute threats for duration lie in Japan and the Eurozone for sovereign bonds, while we see US Treasuries as neutral at best. We continue to use duration in Australia as a risk reducing position which should do well if we are wrong in our central economic scenario. The domestic situation in Australia, with rising risks around the housing market, is also a key driver of this position (and of our short Australian dollar position). Corporate credit remains a strong underweight. As spreads remain relatively tight, we find the asset class offers little expected return going forward, most notably in the US and in Europe.

One step closer to normalisation

Emerging markets our preferred market

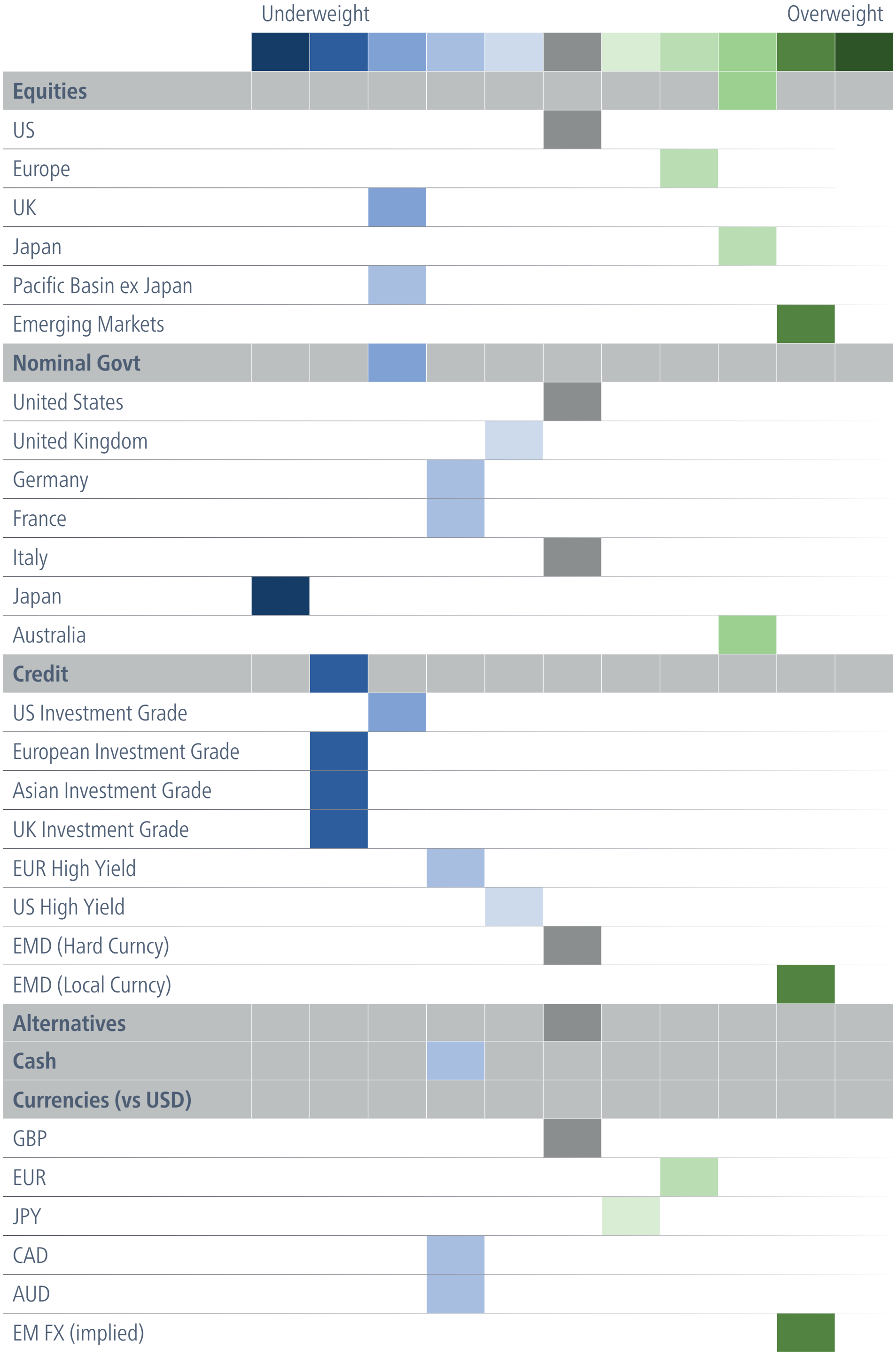
While global markets are still climbing a wall of worry (the most recent contributor being the trade policy initatives coming out of the White House), the longer term anchor of our central scenario is a world of strong growth and modest inflation pressures. Markets are taking more steps towards normalisation as we slowly exit from the decade-long experience of experimental monetary policy. The euro and yen currencies are likely to take the batton from the US dollar as appreciating currencies. This favours taking exposure in emerging markets, and being underweight duration. In many ways, risk scenarios seem to be more and more centered around debt markets, be it fiscal discipline both at sovereign and corporate levels, debt deleveraging, active central bank tightening or higher volatility regimes.

Figure 27: Financial conditions remain loose, despite rising yields



Sources: Aviva Investors, Macrobond, Bloomberg as at 31 March 2018

Figure 28: Asset Allocation



Sources: Aviva Investors, as at 31 March 2018

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Important information

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CONTACT US

United Kingdom
Aviva Investors
St. Helen's,
1 Undershaft,
London EC3P 3DQ
Tel: +44 (0)20 7809 6000
Info.uk@avivainvestors.com

Please visit our website www.avivainvestors.com to find contact details for your local sales representative