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# House View Q2 2019

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 our 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 pivot supports asset prices

According to the IMF, global growth was estimated to be 3.7 per cent in 2018, a similar rate of increase to that seen in 2017. When taken together, the past two years represent the strongest period of global growth since the start of the decade. However, the stability of calendar-year average growth masked a marked slowdown in sequential growth rates over the course of 2018. Across the G20 group of economies (which account for around 85 per cent of global output), quarterly annualised growth slowed from around 4 per cent at the end of 2017 to just over 3 per cent by the end of 2018. That slowdown reflected a weakening in global manufacturing and trade, with the earlier policy-driven tightening in credit conditions in China resulting in weaker external demand across the major trading nations in Europe and Asia. Our own "nowcast" estimate of global growth suggests a further slowing in 2019Q1 (Figure 1). A key question for global risk markets, which have rallied sharply this year following the sell-off in 2018Q4, is whether global growth reaches a cyclical low-point in the early part of 2019 and then turns up again, or whether the recent downturn portends something more serious.

Global growth slowed sharply over the course of 2018...

...key question for markets is when that slowdown comes to an end.

Our latest analysis of the major economies suggests global growth will slow this year by somewhat more than we had previously expected (Figure 2), to around 3.4 per cent. We have revised down growth expectations for the Eurozone the most, but more generally have revised growth down across the major economies. The deeper slowdown largely reflects developments in advanced economies, with calendar-year growth in the United States and the Eurozone expected to be around ¾ per cent lower in 2019, with particularly weak growth around the start of the year. Some of that reflects temporary factors, such as the impact of the government shutdown in the US and car production in Germany. But globally the impact of slower growth in China is expected to persist through to mid-2019. In the US, the fading boost from the fiscal expansion in 2018 also acts as somewhat of a drag on growth this year. While we have revised down our growth expectations for 2019, we continue to see only a modest risk of recession this year in the major economies. Recessions tend to result from a set of imbalances (eg household or corporate balance sheets) becoming too stretched, central banks raising rates aggressively (eg to choke off inflation) and/or some sort of exogenous shock (eg oil prices). We think the risk from the first two of those remains contained. We think that the most serious exogenous risk to the global economy is an inability for the Chinese authorities to shore up growth there.

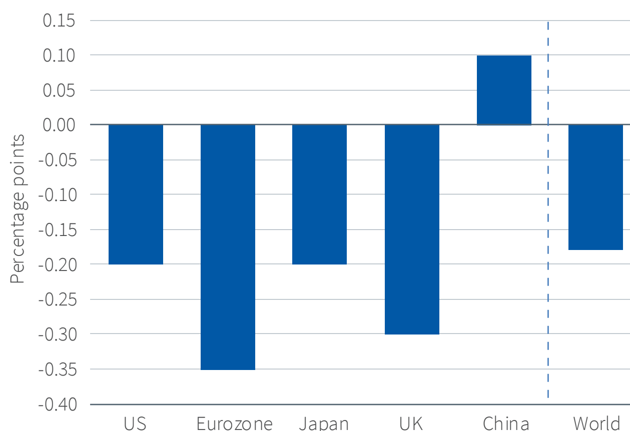
We expect a modest recovery in growth over the second half of 2019, leaving Calendar-year growth around trend.

While growth was above trend and rising in recent years, eroding spare capacity, wage growth was slow to respond. While wage growth moved higher across the major developed economies in 2018, that did not pass through into higher inflation. In the case of the US that might have been due to the improvement in productivity growth. Alternatively, it could just

*Figure 1.* **Global growth cycle**
Growth slowed through 2018

Source: Macrobond, as at 20 March 2019

*Figure 2.* **AI forecast revisions for major economies in 2019**
We have revised growth expectations down for 2019




Source: Macrobond, as at 20 March 2019

We expect continued modest upward pressure on wage growth and inflation.

reflect a more limited pass-through than in the past due to a range of structural factors. We remain of the view that inflation will rise steadily so long as growth remains above potential and the unemployment rate is very low.

In our central scenario we expect the global growth cycle to extend beyond this year, supported by a pause in the global monetary tightening. If growth does pick up in the way we expect, then we would not expect central banks to be at the start of an easing cycle. Indeed, it may still be the case that the Federal Reserve will need to consider raising rates again towards the end of 2019 or early 2020. This will, however, be contingent on higher inflation and not just growth.

We think the Fed is on pause, rather than at the start of a cutting cycle this year. But that requires a recovery in global growth and moderately higher inflation.

Meanwhile the ECB, which has yet to begin its rate hiking cycle, is now unlikely to begin that this year, but rather in 2020. However, if global growth does not stabilise and pick up over the course of this year, then the case for lower rates in the US would become stronger. If that were reflective of a global factor, then the scope for those central banks still at the effective lower bound, such as the ECB and Bank of Japan (BoJ), to ease further would be more constrained. It is in this scenario that we may expect to see increased use of fiscal policy to help manage the next downturn. As this House View went to print, financial markets were pricing in three rate cuts by the Federal Reserve over the next two years, arguably placing a material probability of recession, or at the very least a more significant slowdown in growth (Figure 3).

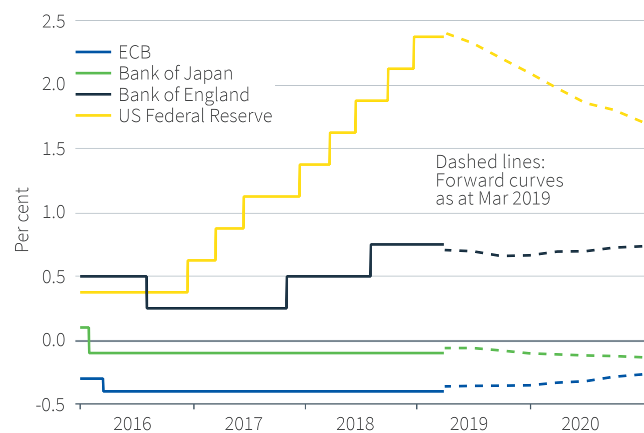
One reason that the Federal Reserve and other central banks may have changed their policy outlook so significantly over the last three months is the benign outlook for inflation. With the Fed's preferred measure of core inflation having been at or below 2 per cent for the past 10 years, and the Eurozone and Japan struggling to generate even that much inflation, central banks may try to manage policy in such a way as to generate a period of above-target inflation in order to ensure inflation expectations do not become de-anchored to the downside.

We prefer to be moderately overweight equities and credit, while being neutral on government bonds.

The sharp equity and credit market sell-off in 2018 Q4 has been quickly reversed at the start of 2019. That has come on the back of a pivot from the Federal Reserve and other central banks away from further rate hikes. With the hurdle to another pivot in the near-term high, we expect the current central bank rhetoric to remain in place well into the second half of the year. As a result, we think there is a window of opportunity for risk assets to continue to perform well. As such, at this time we prefer to be overweight equities, with a tilt towards the US over other markets (Figure 4). We expect the environment to be positive for carry strategies as well, and therefore prefer to be overweight emerging market local and hard currency bonds. However, we think that the window could close for one of two reasons. First, that the expected improvement in global growth does not come to pass (eg if the Chinese stimulus proves to be insufficient to raise growth there); or second that in coming to pass, it brings with it the realisation from central banks that policy is too accommodative, even while accepting a period of above-target inflation. At this time we think the balance of those risks is more heavily tilted to the former, and therefore prefer to be broadly neutral duration, an overweight in the US funded by underweights in Europe.

*Figure 3.* **Monetary policy re-set**

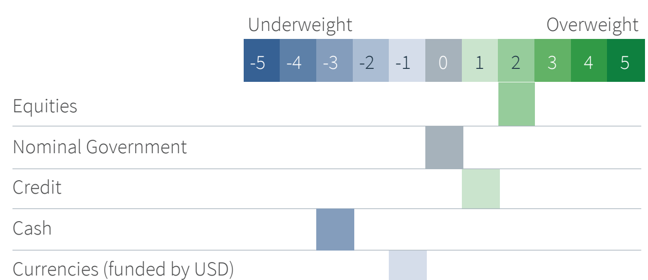
Markets now expect rate cuts in the US




Source: Macrobond, as at 20 March 2019

*Figure 4.* **Asset allocation summary**

Overweight equities, neutral Government bonds




Source: Aviva Investors, as at 20 March 2019



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# 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 2019 Forum we identified the following key themes:

1 Economic cycle extension
2 Monetary policy re-set
3 Trade truce
4 Brexit and European politics
5 Fiscal activism
6 Volatility

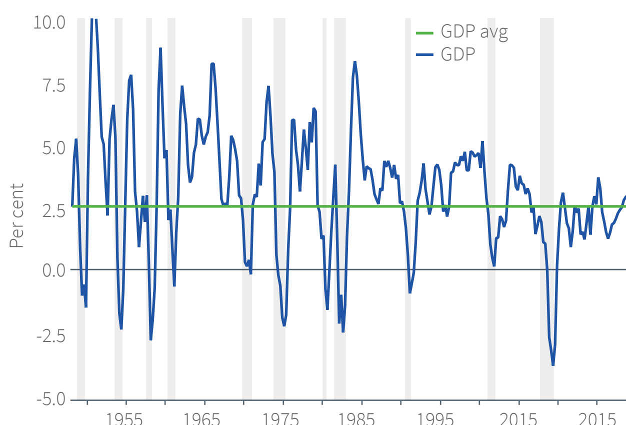
## Economic cycle extension

The current global economic expansion is already one of the longest in the post-war period. There have been some significant regional variations, but essentially it began in the second quarter of 2009, meaning it is now almost a decade long. Using the US as an example (as historically most global cycles reflected coincident regional and national cycles) the average length of upswing since 1945 has been just 5.5 years; if we confine ourselves to the period from the early 1980s, it has been 8.5 years (Figure 5). But there is no "natural" length. Cycles don't just die naturally of old age – they are typically killed off by economic imbalances, tighter policy or major shocks. The ultra-cautious approach to tightening being adopted by Central Banks (CBs) in the wake of the Global Financial Crisis, alongside reduced private sector imbalances and the absence of any serious inflation pressures, means that the current cycle may well be extended throughout 2019 and 2020, perhaps even longer.

1

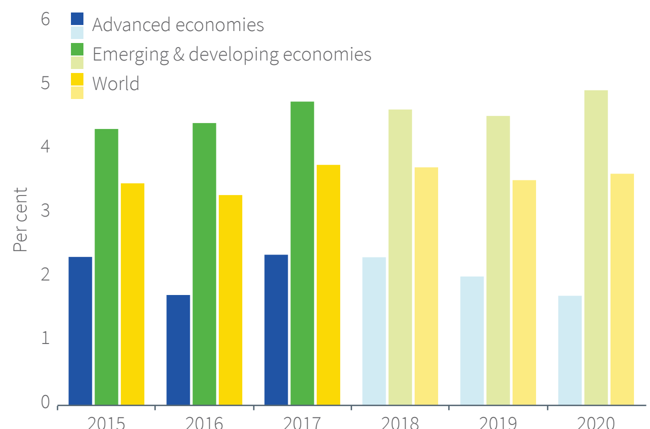
The fiscal boost to the US economy will fade this year, but growth looks set to remain satisfactory, while the troubling slowdown in Europe should first stabilise and then reverse modestly. If the stimulus that Chinese authorities are currently providing bears fruit, as we expect, then the growth impulse and momentum for the world should be sustained over the next couple of years (Figure 6). Eventually another downturn and/or recession will materialise, but it does not look imminent. Doubts about where the "new normal" is for neutral interest rates imply that CBs will continue to be extremely circumspect about tightening monetary

*Figure 5.* **US GDP growth and NBER recessions**




Source: Macrobond, National Bureau of Economic Research as at 20 March 2019

*Figure 6.* **Global growth and IMF forecasts**




Source: Macrobond, as at 20 March 2019

policy and while inflation remains contained (and in the absence of exogenous shocks), they will be right to act in this way. We will probably continue to see growth divergences, but overall the global economic cycle should extend for some time yet.

## Monetary policy re-set

2

Over the last three months policy makers across the developed world have put more weight on downside risks to both growth and inflation. A year ago, most had been either tightening monetary policy, or preparing the ground for doing so. Even those that had raised policy interest rates had been doing so at a historically slow pace. Although many have yet even to begin hiking, the re-assessment of risks has brought about a re-set for monetary policy as the next possible moves are considered. The removal of extreme levels of monetary accommodation will now take place at an even more gradual pace as a result. To the extent that the delivery of, or anticipation of, tighter policy was acting as a headwind for certain financial asset prices, the recent change to a more cautious approach has, and should continue to, provide support to those same assets.

Having raised US rates once a quarter throughout 2018, the Fed has signalled a pause, with patience being the main message now. Even if they were to return to additional modest hikes later in 2019 or in 2020 – something that markets do not believe is likely – concerns that the Fed might over-tighten have diminished significantly (Figure 7). Other Central Banks have also softened their stance on actual or expected policy tightening over the next few years, with most citing downside risks, either to their own or the global economy, as the justification. After three years of sequential upgrades to global growth projections, it is noteworthy that the last three or four months have seen modest downgrades from organisations such as the IMF and the OECD. These do not automatically mean a nasty downturn is coming, but they do indicate a change in trend that provides an evolving backdrop for financial markets.

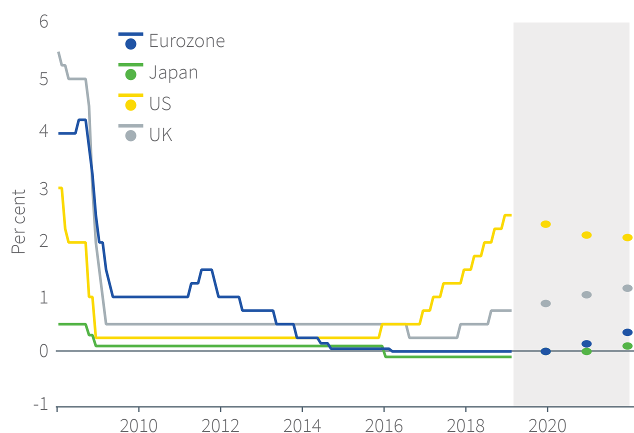
## Trade truce

3

Trade tensions, primarily focussed on the relationship between the US and China, dominated the investment landscape in 2018. In each of the twelve months to February 2019, the BAML survey of global fund managers showed this issue was the single most important investment risk for respondents. It was overtaken in March by China economic slowdown. The spectre of additional tariffs, a re-escalation of trade skirmishes or a re-focussing of Trump's ire to other areas or regions (see risks section below) are all still possible, but the toxic environment that prevailed throughout last year has improved significantly over the last couple of months. Trump will no doubt present any deal brokered with China as a major breakthrough due entirely to him.

Negotiations between China and the US have been constructive and made important progress on the legitimate grievances against Chinese trade practices related largely to protection of

*Figure 7.* **Policy interest rates in major nations, and market expectations**




Source: Macrobond, as at 20 March 2019

*Figure 8.* **World trade volumes, y/y, 3mma**

Source: Macrobond, as at 20 March 2019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intellectual property rights and improved access to their domestic markets. The ultimate proof is in changed behaviour rather than just promises, but the better mood is welcome. Tangible progress such as the postponement of the planned increase in tariffs is helpful and should facilitate a stabilisation or even an improvement in world trade growth, which slowed sharply last year (Figure 8). If the threat of ongoing trade disruptions has genuinely receded, then the global economic outlook would be enhanced significantly, especially for open trading nations such as most of Europe and Asia.

## Brexit and European politics

4

The cloud of Brexit has hung over Britain and, to a much lesser extent, Europe, for the last three years. It has contributed appreciably to markedly weaker growth in the UK and to the gloomier sentiment among both businesses and households. The negotiations between the UK and the EU have at times been farcical, with the UK making unreasonable demands and empty threats from an extremely weak bargaining position. This has been compounded by bitter infighting within the governing Conservative party and a hapless and divided Labour opposition. The resultant political scheming has ensured an almost total stalemate to what should have been the Brexit endgame. Even if some sort of deal is cobbled together, negotiations will continue for at least the next two years and are certain to influence the market, social and political mood over that timeframe and beyond.

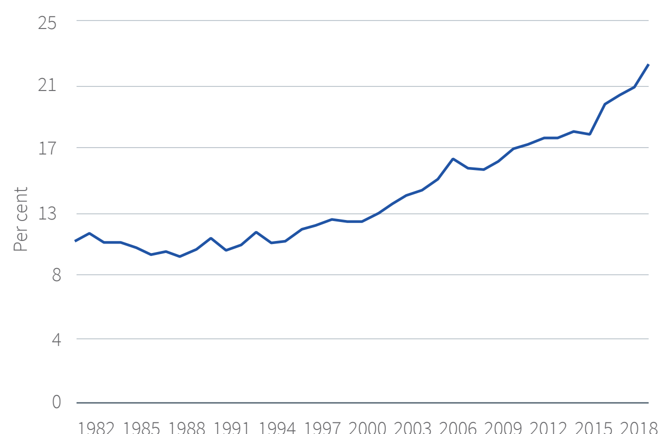
In one sense, Brexit is simply the most striking example of what can happen if populist movements are given the opportunity to voice their dissatisfaction. Support for such movements across Europe has grown steadily over the last 40 years (Figure 9). Deep-seated frustrations have simmered not far below the surface across Europe over the last ten years or more, erupting at times to wreak havoc on the status quo. The most recent example was Italy and its fiscal battle with the European Commission. The drivers of such discontents are wide and varied, but many have their roots in a belief that parts of society have not participated sufficiently in economic progress and development. Within the Eurozone, critical tensions remain between the central single currency collective and the individual nation states. With political/fiscal union still some way off, this theme will continue to impact Europe over future years. Frictions are more likely to emerge if there is another economic downturn.

## Fiscal activism

5

In the ongoing debate about austerity, it is often forgotten that in the aftermath of the Global Financial Crisis in 2008/9, fiscal policy provided a huge stimulus to all of the affected economies around the world. Part of this was a result of automatic fiscal stabilisers kicking in, exactly as they are supposed to do. But part was because of direct major tax and spending initiatives with the intent of offsetting at least some of the collapse in private demand by substantial boost in public demand. The legacy of these actions was a huge build up in

*Figure 9.* **Average share of votes for populist parties 1980-2018**




Source: Timbro, as at 1 January 2019

*Figure 10.* **G7 actual budget balance, percentage of GDP and IMF forecasts**

Source: Macrobond, as at 20 March 2019

public deficits and debt. Once economies were out of immediate danger, addressing these imbalances was unavoidable. Economic recovery helped in this process, but fiscal policy was a handbrake on growth for several years (Figure 10).

That lengthy period of healing means that public finances are now in far better health. Although debt remains high, it is generally affordable with low interest rates. Meanwhile, deficits have shrunk from peaks of up to 10 per cent of GDP or more, to 2 or 3 per cent in many countries and even surpluses in others. There is now room for fiscal stimulus. With monetary policy pushing against its limits, fiscal could be a viable alternative. The growth of populism and increased attention on inequality and other perceived social injustices has also contributed. The US acted first: Trump's tax and spending package boosted American economic growth significantly in 2018. China is another country which has recently adopted fiscal stimulus measures (Figure 11). Other nations may choose to follow, although perhaps not to such an extent. The recent experience in Italy is just one example. It is quite plausible that more activist fiscal policies will be invoked to enhance GDP growth over the next two or three years, especially if any cyclical slowdown materialises.

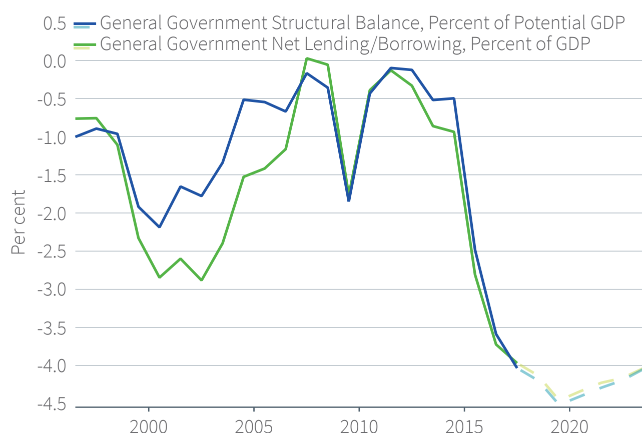
## Volatility

6

Cross asset volatility has itself shown a high degree of volatility over recent years, characterised by extended periods of relatively benign price moves, interspersed with episodes of relatively large asset price volatility. This pattern has been observed increasingly in different markets including equities, commodities and government bonds. Despite efforts by Central Bankers to extend the economic cycle, which we expect to be ultimately successful, we expect to see this pattern continue.

Extremes in cross-asset volatility occur at the ends of economic expansions when growth begins to slow meaningfully. Equity volatility is generally the first to exhibit persistently higher levels of volatility at such times, but historically also shows increasing levels of volatility in the second half of expansions. Whilst we think the current cycle will persist for some years to come, the structure of markets has changed considerably since the Global Financial Crisis and the predominance of non-discretionary flows and share buyback programmes are frequently the marginal buying forces. These have helped to perpetuate upside market moves whilst limiting the volatility exhibited, which is further reinforced by increasingly large waves of short-dated option selling as risk-taking sentiment coalesces. Such forces help to provide significant downward pressure on volatility, which becomes self reinforcing as the low volatility period progresses. The market impact of crowded position de-risking and closing out of short volatility positions has recently been accentuated by the dearth in trading liquidity, contributing to spikes in volatility that are large in comparison to the conditions that preceded them. We feel this pattern of long periods of low volatility interspersed with significant spikes will continue (Figure 12).

*Figure 11.* **China, IMF WEO, estimate**




Source: Macrobond, as at 20 March 2019

*Figure 12.* **S&P 500 30-day realised volatility**

Source: Macrobond, as at 20 March 2019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## Risks to the house view

### China stimulus fails

China appears to be embarking on its own version of Mario Draghi's "whatever it takes" approach to policy intervention. In the face of evidence that growth in China was slowing more than the authorities were prepared to accept (Figure 13), China has provided extensive monetary and fiscal stimulus. But it is still possible that their efforts fail and that a negative Chinese growth shock permeates around the world. Another variant is that stimulus inflates dangerous asset bubbles rather than the real economy and condemns the country to some even more grating adjustments in the future.

Will the world catch a cold if China sneezes?

### Fed has moved too far

In the post-financial crisis world there has been considerable debate about the neutral or equilibrium level of policy interest rates. There is general acceptance that it is significantly lower than the past (Figure 14). It probably also varies across different countries. US interest rates have been raised eight times since December 2015, but are still very low by historical standards. Nevertheless, it is not impossible that they have already moved above neutral, but that the resulting slowdown has been masked by the fiscal sugar-rush. As that now fades, US growth could slow alarmingly, pushing the economy to the brink of recession and obliging the Fed to backtrack swiftly and provide renewed stimulus.

The Fed may already have moved above the new neutral

### Upside inflation surprise

The period of Fed hikes until the middle of 2018 was, in general, accompanied by gently rising inflationary pressure. Wage inflation continues to tick slowly higher (Figure 15), but CPI inflation dipped in the second half of last year, helping fuel the debate over whether the Fed should pause. With unemployment still well below most estimates of the natural rate, cost-push pressures could re-emerge more conspicuously, leading to higher core and headline inflation and compelling the Fed to raise interest rates more sharply. A return to "old-fashioned" inflationary overheating may seem far-fetched to some, but there is a risk that the earlier deflationary threat has led to a degree of inflation complacency.

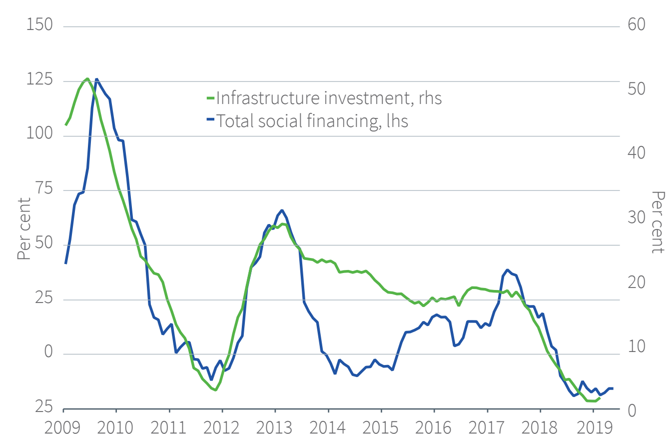
Return of inflation would oblige the Fed to tighten

### Debt servicing strains

No-one should be surprised that ultra-low interest rates around the world have encouraged greater borrowing. That is exactly what they were intended to do. Equally inevitable, as we move slowly away from the backdrop of extreme stimulus, was the revelation of where debt build up had been "excessive". Although there has been extensive deleveraging in some areas, it is no surprise that certain businesses and households (perhaps even some governments) may have taken on too much debt and that these vulnerabilities are only now being exposed. The example of the Australian housing market (Figure 16) might just be the first to appear, but these episodes usually throw up surprises.

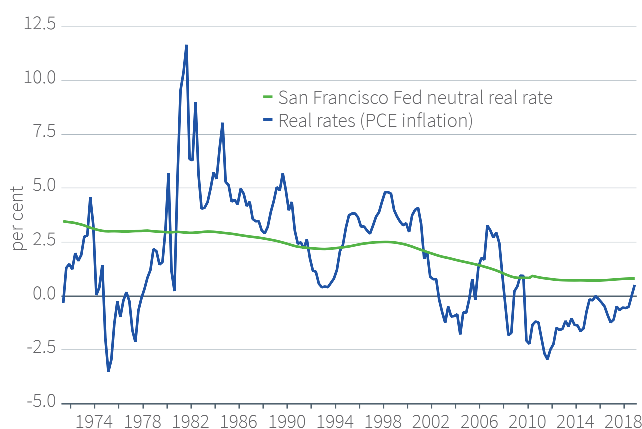
Excessive debt can build up insidiously

*Figure 13.* **China: infrastructure and social financing have slowed**




Source: Macrobond, as at 20 March 2019

*Figure 14.* **Neutral and actual real rates**




Source: Macrobond, as at 20 March 2019

## Trade dispute turns to Europe

Trump turns on Europe

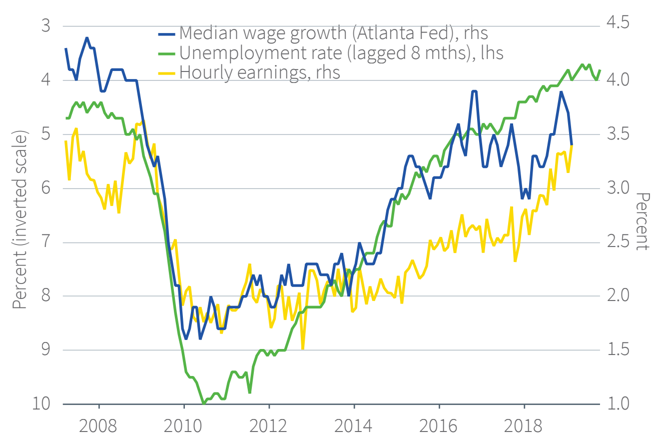
There is a danger that Trump's interpretation of the extended trade spat between the US and China last year is that bullying works. If so, his administration may turn its sights towards Europe. The autos sector is the main focus of attention. In the middle of 2018, Trump threatened (via a tweet) to put 20 per cent tariffs on European auto imports. His stance contrasted with the more conciliatory approach adopted by others in Government and he subsequently seems to have abandoned such ambitions. But his latent unpredictability means the issue should not be disregarded. It may be low probability, but the impact would be enormous, perhaps ushering in greater protectionism around the world.

## Liquidity challenges

Smoothly functioning markets rely on liquidity

10 years on from the collapse of Lehman Brothers, financial authorities around the world have put in place a range of regulatory requirements that aim to ensure such an event cannot happen again. While all such intentions are entirely laudable of course, there is a danger of creating negative and unwanted consequences. The prevention of some of the more esoteric investment bank practices may have the unintended (but largely inevitable) consequence of removing key market makers and thereby reducing liquidity and compromising the smooth operation of crucial markets. There are risks that more markets will be adversely impacted as regulations are introduced and as agents comply.

*Figure 15.* **US wage growth**




Source: Macrobond, as at 20 March 2019

*Figure 16.* **Australia, median house prices, Sydney**

Source: Macrobond, as at 20 March 2019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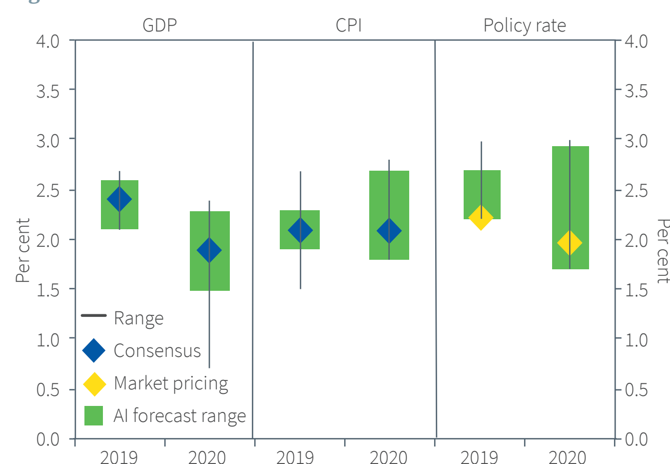
# Macro forecast charts and commentary

## US

Growth is expected to slow below trend in Q1, due to the direct effects from the government shutdown and the impact on consumer and business sentiment of the decline in asset prices in Q4. However, we expect that slowdown to be temporary, with modestly above-trend growth for the remainder of the year. Overall, that implies a slowdown in annual growth compared to 2018, with a further slowing expected in 2020. We do not expect a recession this year or next. Inflationary pressures are expected to remain moderate, and we now expect the Fed to remain on hold for a period, although do not rule out the potential for another hike. This view stands in stark contrast to current market pricing.

*Figure 17.* **US**

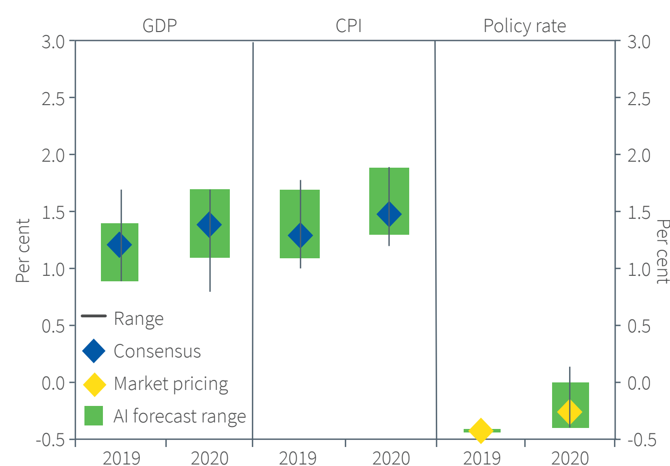



Source: Bloomberg, Aviva Investors, as at 20 March 2019

## Eurozone

Last year saw successive growth disappointments in the Eurozone, with annual GDP growth slowing to just 1.1 percent from 2.7 per cent a year earlier. The early part of 2019 continued in the same vein, although more recent data suggest that the worst could be over, demand should revive gently over the rest of the year. The slowdown at the end of 2018 was probably exaggerated by a cluster of one-off, adverse impacts, most of which should unwind. More fundamentally, weaker growth was almost entirely due to a big fall in trade flows – domestic demand held up reasonably well. If China stabilises and global trade tensions recede, net exports should recover. But the slowdown has lasted for long enough for the ECB to react, pushing out rate hikes until 2020. A return to the stellar growth rates of 2017 is unlikely, but a resumption of trend growth or slightly better by the second half is plausible, given strong jobs markets and healthy corporate finances. What is more of a worry is the continued weakness of inflation. Underlying measures need to drift higher in 2019.

*Figure 18.* **Eurozone**

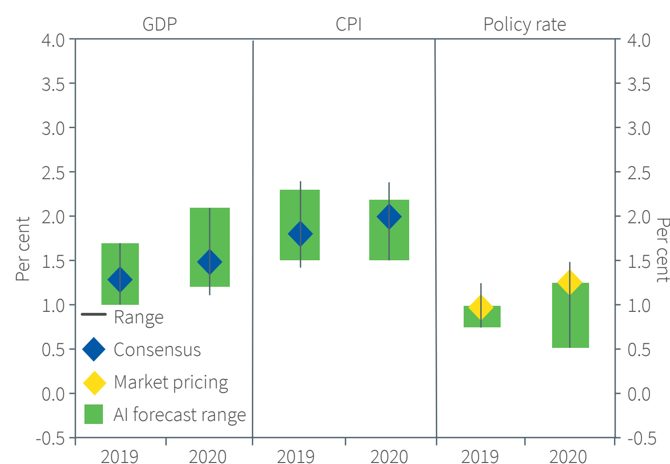



Source: Bloomberg, Aviva Investors, as at 20 March 2019

## UK

Brexit has, once again, dominated the political and financial market backdrop in the UK over the last three months. The British Parliament has comprehensively rejected PM May's Withdrawal Agreement twice (at the time of writing) and a no deal exit is still possible, if not likely. In the meantime, growth has remained sluggish with the chronic weakness of business investment almost certainly attributable to Brexit-related uncertainty. Consumer spending has held up better, helped by a rise in wage growth and puzzlingly strong increases in employment. With output growth weakening further in Q4 (+0.2 per cent in the quarter, 1.3 per cent over the year), productivity growth has turned negative again. If the labour market were to turn – and a number of surveys suggest it could do so – the outlook could quickly darken further. The Bank of England continues to adopt a slightly hawkish stance, but their ability to raise UK rates may be further compromised by subdued inflation, which is now back below target.

*Figure 19.* **UK**




Source: Bloomberg, Aviva Investors, as at 20 March 2019

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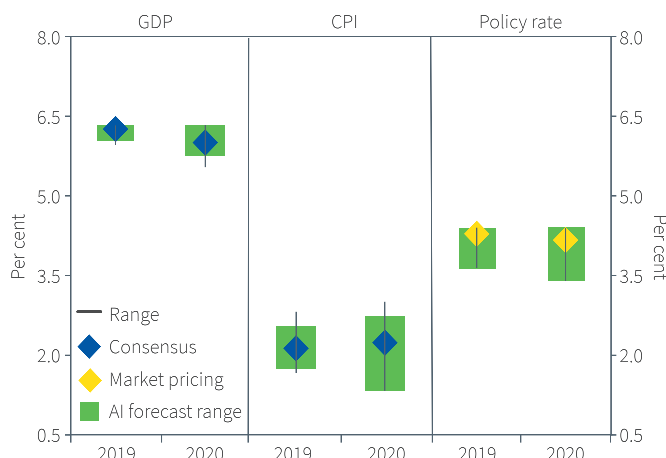
## China

Beijing has moved from an effort to rein in credit growth to more of an emphasis on "slowing down the slowdown". Fiscal and monetary stimulus is being applied, after quarterly growth came in at just 1.5 per cent at the end of 2018. Inflation has fallen sharply and low PPI usually translates into margin pressure for corporates. The impact of tariffs has been felt and will persist in 2019 even as further increases have been deferred, as Xi and Trump work with their negotiators to sign a deal that will, if successful, decrease the tariffs in exchange for market access, better protections for foreign investors, and specific promises to import more US goods. Despite a balanced current account, the Chinese currency should remain broadly stable as portfolio inflows follow index inclusion.

*Figure 20.* **China**

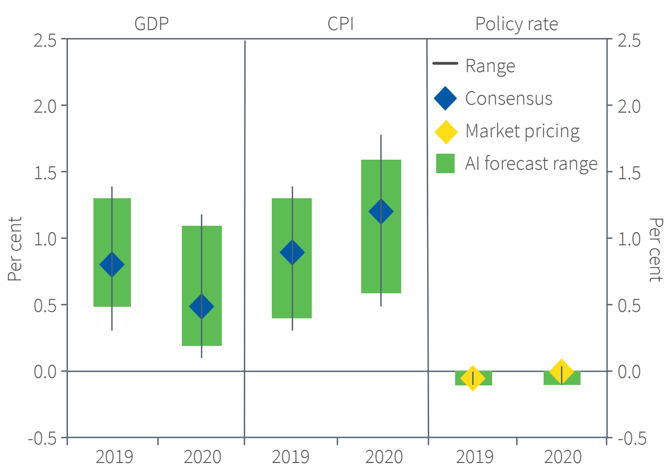



Source: Bloomberg, Aviva Investors, as at 20 March 2019

## Japan

Japan is likely to experience a non-linear growth trajectory. In the early part of the year, domestic demand is likely to offset to an extent the damage from external demand weakness, driven by front-loading of spending before the consumption tax hike and some help from fiscal measures. In Q4, domestic demand is likely to weaken once the consumption tax hike kicks in. But by then, the external demand outlook should be less challenging, as the effects of dovish policy turns by the Fed and ECB, China's policy stimulus and lower trade tensions help world trade volumes recover. Meanwhile, the outlook for inflation looks very benign. In a low-growth environment, it is unlikely that the Bank of Japan will launch any new policy experiments to help the yield curve steepen. Much will depend on the outlook for the yen, which has remained on the defensive with a recovery in risk appetite but could strengthen if the Fed stays on a lengthy hold.

*Figure 21.* **Japan**

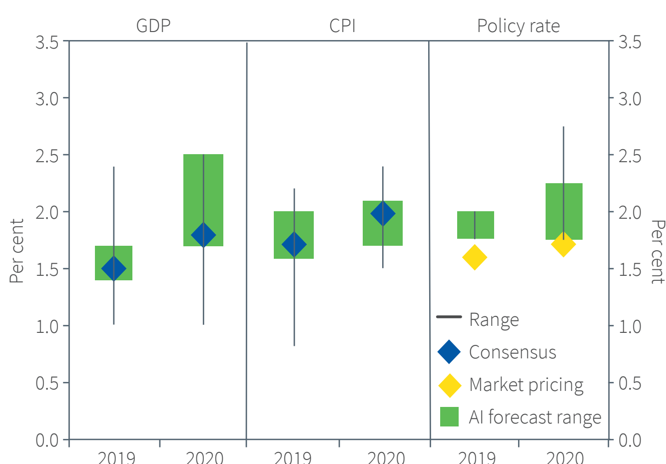



Source: Bloomberg, Aviva Investors, as at 20 March 2019

## Canada

While a slowdown in Canadian growth in late 2018 and early 2019 was anticipated, the decline has been sharper and broader than expected. Looking ahead this implies that growth in early 2019 will be slower than the Bank of Canada's (BoC) forecast from their January monetary policy report. At the same time, macro concerns around US-China trade policy have impacted global confidence and economic activity. The combination of weaker than expected domestic growth and a disappointing global backdrop has led to the BoC to take a more cautious stance to monetary policy tightening and therefore we expect rates to be kept on hold for now. On the inflation front, the headline rate has fallen due to lower fuel prices, but core inflation measures remain near target. Going forward, price pressures will be muted by the slower growth outlook. In particular, the BoC will be watching household spending closely to guide expectations about domestically driven growth and inflation pressures.

*Figure 22.* **Canada**




Source: Bloomberg, Aviva Investors, as at 20 March 2019

# Global market outlook and asset allocation

## Finding safe harbours

- **Market reaction to disappointing growth triggered a shift in stance from the Fed**
- **As better data ease recession concerns, this prolongation provides a window of opportunity for risk assets, particularly emerging markets.**
- **The success or failure of Chinese stimulus will have significant ramifications for global growth**
- **Vol of Vol has risen and this makes liquidity concerns even more notable**

The change in Fed tone will extend the economic cycle in our view

The most significant change to our house view over the last quarter has been around our expectations for further monetary policy normalisation from the Fed. While we expect the Fed to remain data-dependent, disappointing growth data and subsequent market reaction means Fed normalisation is now largely complete. US GDP continues to expand above potential, increasing wage growth and spurring capex spending. Yet inflation remains quiescent. Whereas we spent most of 2018 positioned for rate hikes and inflation, we don't think that dynamic will repeat; in addition to signalling a long pause in raising rates, the Fed has said it will cease shrinking its balance sheet in September.

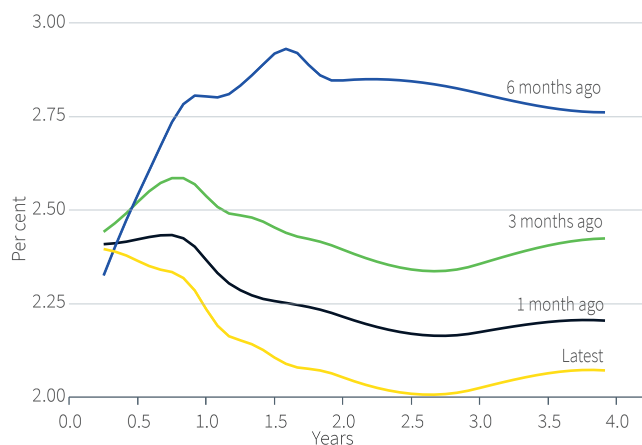
On the other hand, the ECB is nowhere near this point, having recently signalled it has no plans to raise rates this year. Meanwhile the BoJ is conducting QE-infinity. This has resulted in a shift to our duration view: even though we think the Fed may have one hike left in this cycle after the current pause, we currently prefer to have a neutral allocation to bonds. This is because we see a US slowdown continuing beyond 2019, with growth having peaked in mid-2018, and Europe and Asia are experiencing a more entrenched deceleration. At this point in the cycle, with 2-year USD swap rates moving from 0.5 per cent to over 3 per cent before the recent move back to 2.5 per cent, the big move up in rates is over (for now), and US Treasuries have revived their role as an important defensive diversification tool.

The outlook for risk assets is linked to the success of the Chinese stimulus programme

China stimulus and its subsequent success in stabilising Chinese growth at around 6 per cent remains critical to supporting risk assets more broadly, but is not yet enough to spark global reflation as it did in 2017; we expect trade tensions to ease but some permanent damage to growth has been done, and risks remain.

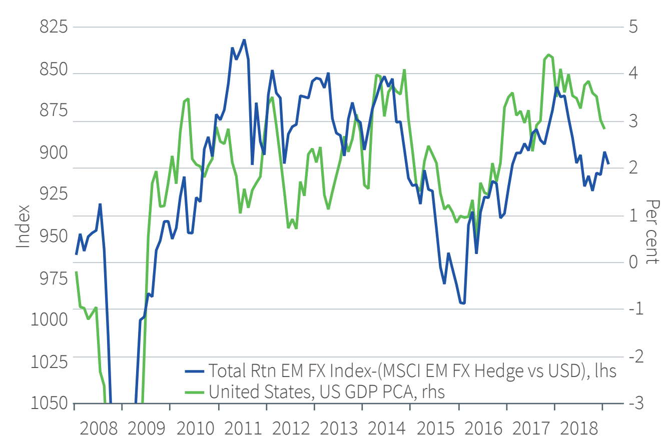
With developed market central banks taking a more dovish tone, the risk that restrictive monetary policy impedes growth and pushes economies towards recession is significantly diminished (Figure 23). We believe this creates a window of opportunity in which risk assets can deliver attractive returns. Indeed, risk assets such as emerging market equities and currencies have performed well in Q1 19 for this reason. For this constructive environment to remain intact, it is important that the growth slowdown in major countries stabilise,

*Figure 23.* **Market expectations of FOMC policy (OIS) have repriced dramatically since Q4 2018**




Source: Macrobond, Bloomberg, as at 20 March 2019

*Figure 24.* **EM FX performs well in environments of stronger US growth**




Source: Macrobond, Bloomberg, as at 20 March 2019

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particularly in China. Several stimulus measures from China and some tentative positive turns in the data support our view that global growth will remain above potential and extend the cycle. To take advantage of this period of relative calm, we prefer high yielding emerging markets where there is potential for both rates and currency to outperform, and therefore we increased our allocation to EM credit in both hard and local currency.

Emerging markets will benefit from the window of opportunity that has opened as the risk of restrictive monetary policy lessens

While the USD has weakened versus emerging market currencies since the start of the year, the extent that this trend continues will likely depend on whether the slowdown in US growth bottoms. Historically EM currencies offer an attractive return profile verses the US dollar when the American economy is expanding (Figure 24).

That said, political risks remain high, with many emerging market economies due to have elections in 2019. While volatility will surely be lower as central banks support markets and growth stabilises, changes to the regulatory environment and market structure mean we are likely to see more shocks within what otherwise appears to be a lower volatility environment. With the stability of volatility falling, factors such as liquidity and sensitivity to global "risk-off" moves will remain important when selecting which emerging markets to invest in.

Yet the market remains fragile with the volatility spiking

The extent that growth stabilises and remains above potential will also be important in driving return expectations for developed market currencies. We maintain our preference to be short the Australian dollar given further downside risks to growth driven by weaker household consumption and the outlook for wages. As markets price in an increased probability of a more dovish Australian central bank, the 2-year rate differential to the US suggests that the Australian currency has room to weaken further (Figure 25).

For developed market currencies, growth is key

The Q4 earnings season showed that corporations (particularly in the US) are still able to generate plentiful revenues and profits, even as margins are no longer expanding as they could early in the recovery. In addition, earnings per share (EPS) are growing, albeit at a slower pace than in early 2018 (Figure 26). Debt has risen but interest coverage is ample and will remain so, absent a sharper economic decline. The rapid fall and subsequent rebound in markets leaves valuations fairly valued in the US, but this remains our preferred region as Europe and much of Asia have weaker fundamentals. Despite our base case of above-trend growth and reduced risk from restrictive monetary policy, there is not much scope for a strong positive bounce in growth or earnings, and low inflation is partly a reflection of a lack of pricing power (Figure 27).

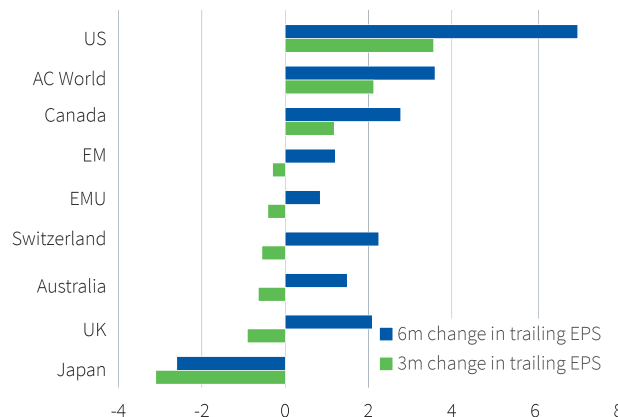
Within equities, valuations look fair and we expect gains to be in line with slower but resilient earnings growth

We thus remain moderately positive on equities, expecting gains in line with this slower, but resilient, earnings growth, helped by dividends and buybacks. The divergence between US growth and the rest of the world, with emerging markets underperforming, was one of the main drivers of EM equity and currency underperformance. However, that gap began to close late in the year as the US "caught down", and we expect EM to perform positively going forward. In Europe forward multiples are lower than in Japan and the US but risks are higher, growth is lower, and catalysts to change that are missing. Japan has more upside potential, with a calendar stacked with stimulus from royal and sporting events, and firms that stand to benefit from a rebound in global trade.

*Figure 25.* **Rate differentials between the US and Australia support a weaker AUD view**

Source: Refinitiv Datastream, as at 28 February 2019

*Figure 26.* **Earnings are growing, albeit at a slower pace**




Source: Macrobond, as at 20 March 2019

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Credit has performed well year-to-date and we expect further value to be unlocked in the current period of stability

Credit spreads have performed very well year-to-date in both Europe and the US, recovering most of the widening of Q4 2018 across both investment grade (IG) and high yield (HY). However, the levels remain above their average of the past two years. As with other asset classes, the current environment seems supportive to unlock some of that value and deliver positive carry and rolldown even in a stable situation. The main risk is credit deterioration, with leverage very high, driven by capex, M&A, and shareholder-friendly buybacks; this is reflected in lower interest-coverage ratios even with overall yields still quite low. However, the downdraft in inflation and economic growth has not been too severe, even though it has been enough to put central banks on the sidelines: this is being reflected in rates and FX volatility being subdued. This usually pushes credit spreads lower too, and we have upgraded our views on the asset class; we expect BBB-rated companies to utilize this window of calm to shore up their finances, but our constructive view is contingent on recession risk remaining low in the US and Eurozone.

Utilities and Retail have well-telegraphed debt and revenue problems, but elsewhere EBITDA remains healthy (+9.2 per cent y/y; +4.3 per cent y/y excluding commodities, according to JPMorgan) and profit margins stellar (Figure 28). These healthy fundamentals are unlikely to remain intact in a severe downturn and we expect to be adversely impacted if Chinese growth fails to stabilize; the build-up of debt in the non-financial corporate sector is, of course, itself a contributor to two of our risk scenarios: debt-service strains and bouts of compromised liquidity.

*Figure 27.* **Global Equities price a bottoming in global growth slowdown**

Source: Macrobond, Bloomberg, as at 20 March 2019

*Figure 28.* **Corporate profitability supports credit**

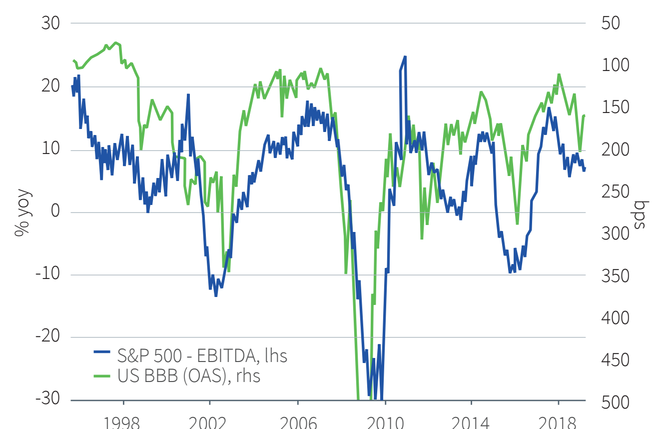


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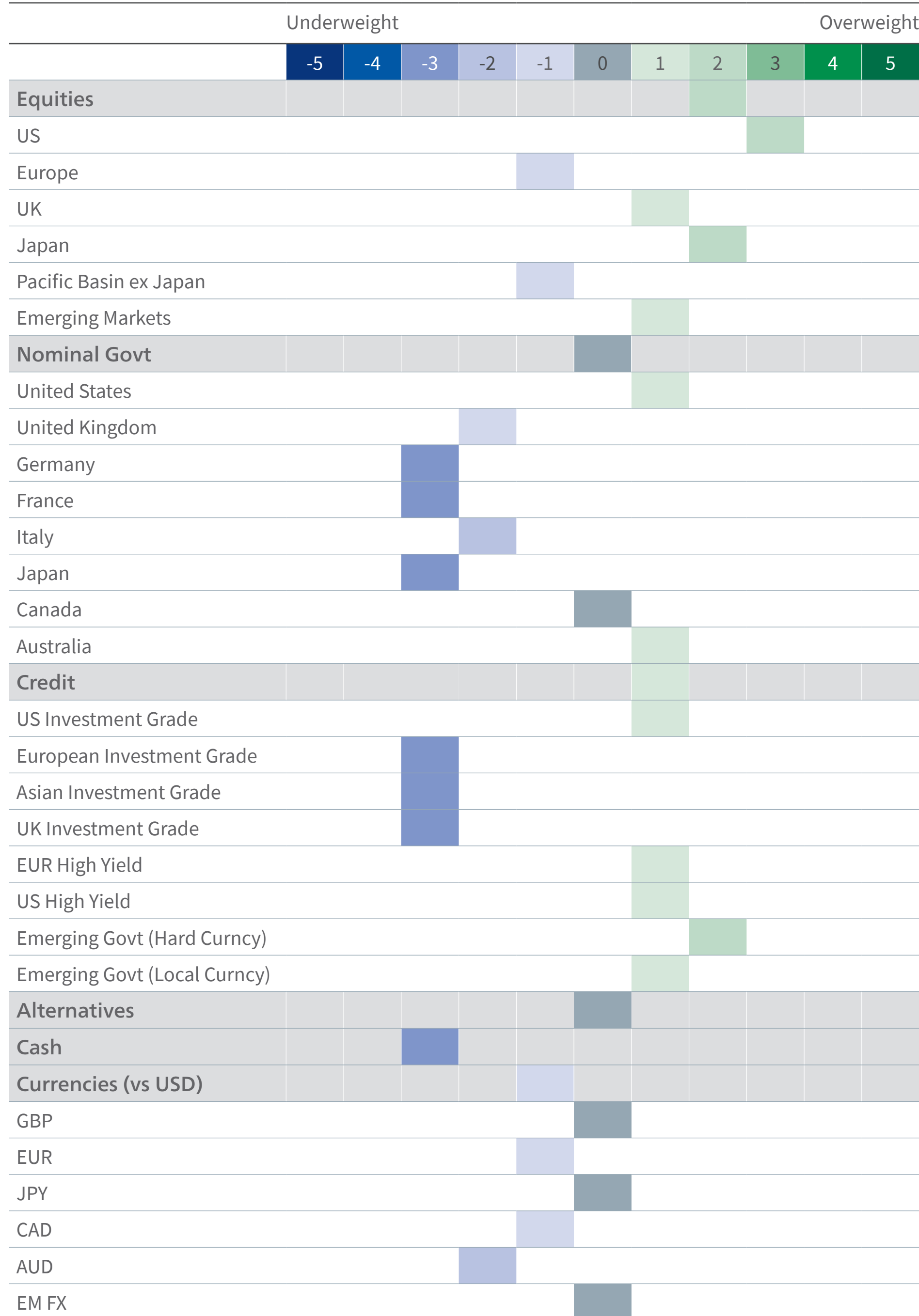
*Figure 29.* **Asset allocation**




Source: Aviva Investors, as at 20 March 2019

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