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House View Q3 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. We hold a House View Forum biannually 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. All team members have 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

Prepare for the worst, hope for the best

The outlook for the global economy has deteriorated over recent months. Despite a somewhat more positive start to the year than expected, with growth in both the United States and the Eurozone surprising on the upside, the global manufacturing and trade outlook has worsened on fears of a protracted international trade conflict. We have, once again, revised down our growth expectations for 2019 and 2020, with no meaningful recovery expected over the next 18 months (Figure 1). This downward revision reflects expectations of slower growth across most regions and leaves us somewhat below the current consensus for this year and next. Looking across the major economies, only the United States is expected to deliver above-potential growth in 2019, with all the major economies at or below potential in 2020. As a result, the steady erosion of spare capacity that has happened globally over much of the past decade is expected to stall and even reverse a little. That is expected to ease wage and price pressures and bring a more accommodative monetary policy stance (Figure 2). In our central scenario, we expect the combination of looser monetary and fiscal policy will be enough to stave off a more serious downturn. Historically, global growth below around 2½ per cent was consistent with a recession. While we do not expect further deterioration of that size, the balance of risks to our outlook is judged to be to the downside.

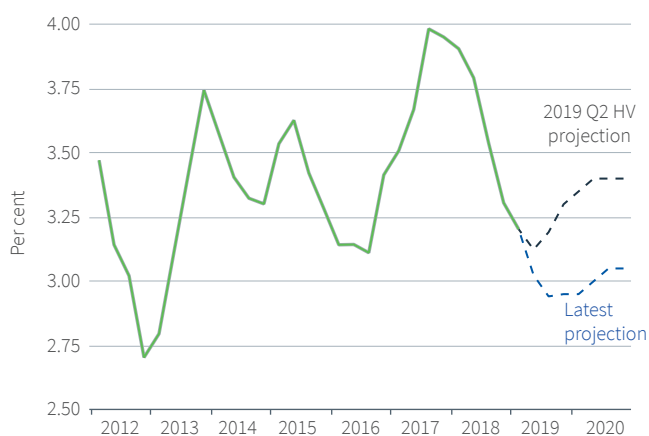
Early in 2019 it had looked as though trade tensions were easing, with a temporary truce between the US and China expected to lead to an agreement in around April or May for the US to ease tariffs and limit non-tariff restrictions. In return, China was expected to increase its purchases of US goods, tighten its protections around foreign firms’ intellectual property rights and further open up its market to foreign competition. However, on 5 May President Trump announced an immediate increase in existing tariff rates and a planned expansion of tariffs against all Chinese imports. That came after an apparent rejection of the draft trade agreement by the Chinese leadership. Around the same time, the US undertook restrictive actions against Chinese telecommunications company, Huawei, limiting its ability to deal with US companies or government bodies. These actions, once again, raised the stakes in the trade dispute that began in 2018 and reinforced the fears that the negative impact on business sentiment and investment already seen would persist for longer. Just a few weeks later, Trump then threatened tariffs against Mexico, the United States’ largest trading partner, over perceived inaction on border security. While that threat was later withdrawn, it was significant in moving the protectionist actions into a new sphere that was unrelated to real or perceived trading imbalances. While Presidents Trump and Xi agreed to a continuing dialogue at the G20 meeting at the end of June, we expect the US protectionist bias to remain in place throughout this Presidency and beyond, with regular flare-ups likely against a range of countries. That will weigh on growth by itself. However, should those flare-ups result in further actions, it could be enough to drive an already soft global economy into recession.

We expect tepid global growth in 2019 and 2020, with the risks tilted to the downside

Trade tensions have once again come to the fore and are expected to weigh on business spending

Figure 1. Global growth outlook (y/y)

We expect weaker business sentiment to weigh more heavily on growth



Source: Aviva Investors, Macrobond, as at 24 June 2019

Figure 2. Central banks are expected to ease policy

Market-based policy rate expectations

	Change in the last 3 months	Market pricing for next 2 years		Change in the last 3 months	Market pricing for next 2 years
USA	0	-103	CHN	0	43
EUR	0	-11	IND	-25	-48
JPN	0	-21	PRK	0	-55
GBR	0	-9	MEX	0	-142
CAN	0	-41	CZE	25	-67
CHR	0	-8	POL	0	-7
NOR	25	-25	ZAF	0	-24
SWE	0	-1			
AUS	-25	-61			
NZL	-25	-52			

Source: Aviva Investors, Macrobond, as at 24 June 2019

We expect major central banks to ease policy over the coming year

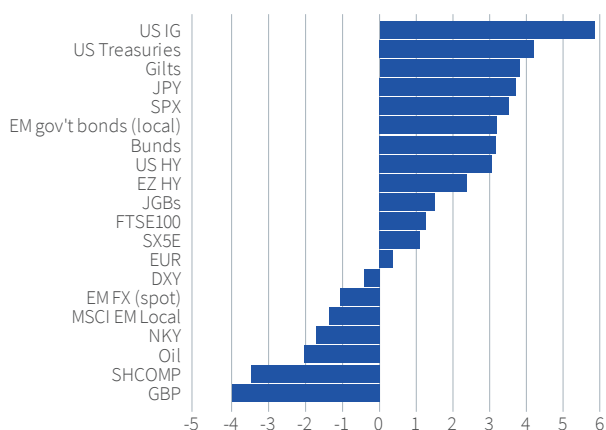
With inflationary pressures still muted – only in the US has inflation been close to the central bank target – the expected continuation of tepid, below potential, growth has resulted in a marked change in the outlook for monetary policy. In the US, the Federal Reserve has indicated that it is likely to cut rates this year, a far cry from its expectations of further increases just six months ago. The market has moved to price over 100bps of cuts over the next year. While we do not expect that much to be delivered in our central scenario (where the US remains a relative outperformer again this year), we do think it likely that rates will be cut this year. In the Eurozone, the prospect of further easing from the ECB is once again on the table. Despite the limited choices given the existing level of rates and rules around asset purchases, we expect that it will move policy rates more deeply negative and adjust the parameters on the asset purchase programme to allow further QE. Easier policy has already been forthcoming from the Reserve Banks of both Australia and New Zealand, which we also expect to continue. Meanwhile the combination of fiscal and credit easing in China has also broadened and been extended, reflecting the desire by authorities there to try to offset the impact of tariffs and slower global growth. More recently, those stimulus measures have included increased local government financing for infrastructure, a sign that the measures taken so far to boost household consumption and state-owned enterprises’ investment have fallen short of what was needed.

We prefer to be neutral on equities and modestly overweight credit and duration, reflecting our concern around downside global growth risks

The stimulus measures either taken or expected around the world have supported risky asset prices, despite the concerns about global growth prospects. Since the Q2 House View was published three months ago, government bonds, corporate credit and developed market equities (particularly in the US) have all seen positive returns (Figure 3). Given the strength of global equity market returns this year, and with valuations around their long-run averages, the scope for a sustained move higher at this point seems limited, even with policy support. Indeed, with the balance of risks to growth strongly tilted to the downside, we see the risk to equity returns to be similarly tilted to the downside. As a result, we have reduced our preference for equity risk to be broadly neutral (Figure 4). Combined with a modest preference for duration, our asset allocation view reflects our concern about the risks facing the global economy over the next year. In our central scenario, the global economy avoids recession, and therefore we expect a corporate default cycle would also be avoided. That should be a good environment for positive carry strategies and as such, we prefer to be modestly overweight credit, both in the corporate and emerging market hard currency space. While the most marked change in interest rate expectations in recent months has been in the US, we do not expect that to lead to a materially weaker period for the US dollar. With heightened risk aversion and positive carry, we expect the dollar to remain supported over the year ahead.

Figure 3. Lower bond yields boost safe and risky asset returns

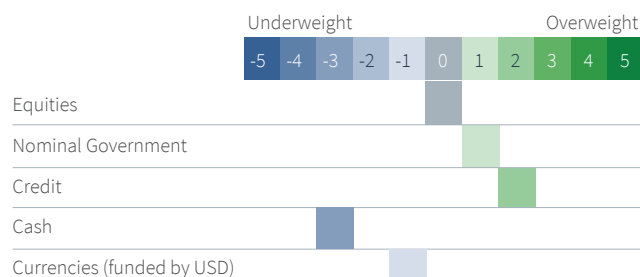
Macro asset market performance since 2019Q2 House View



Source: Aviva Investors, Macrobond, as at 24 June 2019

Figure 4. Asset allocation summary

Neutral equities, overweight credit



Source: Aviva Investors, Macrobond, as at 24 June 2019

Key investment themes and risks

Investment themes

- 1 Weak global growth
- 2 Monetary policy to be supportive
- 3 Trade war concerns linger
- 4 Fiscal activism
- 5 Volatility

Weak global growth

Global growth slowed sharply over the course of 2018, from well above potential to a little below. We expect growth to remain fairly soft through 2019 and into 2020 (Figure 5), as potential changes to trade and technology policy act as headwinds to business confidence. After an estimated increase of 3.6 per cent last year, we expect world GDP will increase by a little over 3 per cent this year. The slowdown has been slightly more marked in developed nations, but all countries have been affected. While our central case is for simply a continuation of modest growth, all of the risks look to be on the downside. That raises the probability of recession. However, the usual recessionary catalysts (such as major economic shocks, debt overhang and sharply rising interest rates) are not in place and therefore likely limit that danger. Instead, the main downside risks stem from a sharper contraction in global trade on the back of increasing economic and political tensions.

In the 25 years preceding the global financial crisis world trade volumes grew, on average, by between 6 and 7 per cent a year, comfortably above the average pace of global GDP growth of 3.5 to 4 per cent. This era of globalisation provided a major positive impulse to world economic growth over this period. That is now changing. In the future it is plausible that, overall, world trade grows more in line with the pace of global GDP. Moreover, as we describe below, in the shorter term it is likely that world trade grows more slowly than that as the impact of US-led trade disruptions is felt. This is almost certain to weigh on aggregate world GDP growth in coming years.

Monetary policy to be supportive

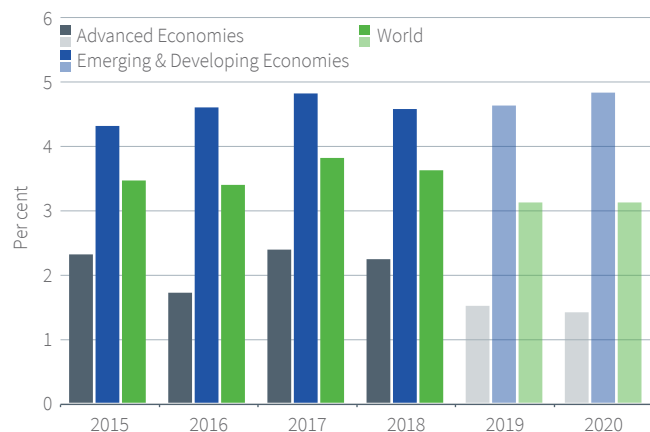
Just over a year ago, the major central banks appeared to be on a path to reduce monetary accommodation. The Fed was expected to raise rates steadily towards 3 per cent; the ECB had brought QE to an end and was signalling that Eurozone rates would move back into positive

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Figure 5. Global growth has slowed in 2019

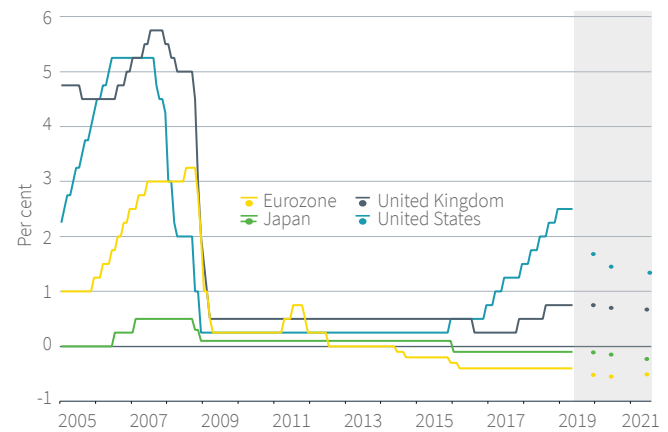
Widespread, but more marked in DM



Source: Aviva Investors, Macrobond, as at 24 June 2019

Figure 6. Markets now expect a strong easing bias

Policy rates in the major developed regions



Source: Aviva Investors, Macrobond, as at 24 June 2019

territory. Even the Bank of Japan was suggesting that its long period of ultra-loose policy would be ending. But now the combination of a weaker growth impulse, subdued inflation and heightened trade tensions has led to a significant reassessment of policy interest rate prospects (Figure 6). Central banks in the developed world have adopted a more dovish stance within their communications, a message that financial markets have received enthusiastically, pencilling in a material policy easing at the Fed over the next twelve months, as well as a renewed easing bias almost everywhere else.

In our central scenario we doubt that as much easing as is currently priced into markets will be delivered. However, given the risks to growth and inflation are heavily skewed to the downside, we do not see current market pricing of the mean outcome to be unreasonable. We expect that central banks will have little reason to remove their current easing bias (even if extensive easing is not delivered) over the next six to twelve months. Indeed, given the change of stance has already been reflected in lower market rates, there has already been a meaningful easing of financial conditions overall (Figure 7).

Trade war concerns linger

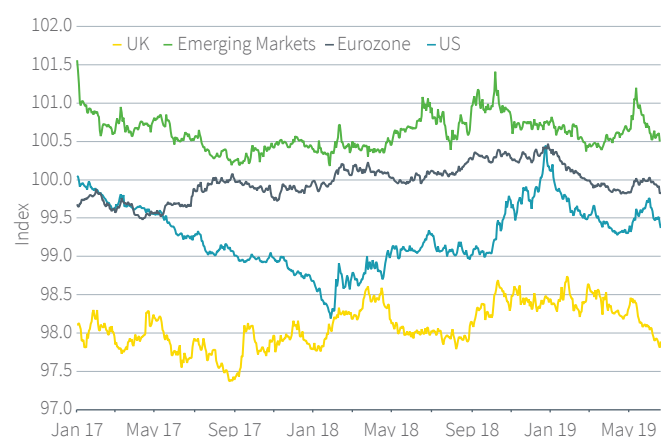
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Trade war concerns have hurt export sentiment and activity across the globe (Figure 8). What began as a Trump-inspired trade dispute between the US and China has seemingly turned into something far more serious. The Trump administration perceives tariffs and other restrictive measures as a key weapon to be used in defending US interests and, more provocatively, as a means of leverage for advancing parts of the “America First” agenda. Tariffs against Chinese goods may be a blunt instrument, but many of the US criticisms are legitimate, notably those relating to the theft of intellectual property and the lack of access to Chinese markets being granted to foreign companies. Although discussions foundered more recently, it did seem that the hard-line approach on tariffs being adopted by the US was bearing some fruit in terms of bringing China to the negotiation table.

The altogether more alarming development was the initiative (since shelved it seems – but not before revealing elements of the Trump playbook) of using the threat of tariffs to try and achieve other, often unrelated, goals. Once Trump insisted that tariffs would be imposed on Mexico if it did not reduce illegal immigration to the US, they had become truly weaponised. Subsequent rumours of tariffs elsewhere if Trump did not get what he wanted in several different areas simply cemented the notion that intimidation and self-interest was now the modus operandi for the US. Although there have been periods more recently when these tensions, especially those between the US and China, have been de-escalated, it is very likely that this approach will resurface at regular intervals. Characterising this situation as a new “cold war” between the two nations may be a slight exaggeration, but the resemblance is compelling.

Figure 7. Financial conditions have eased recently

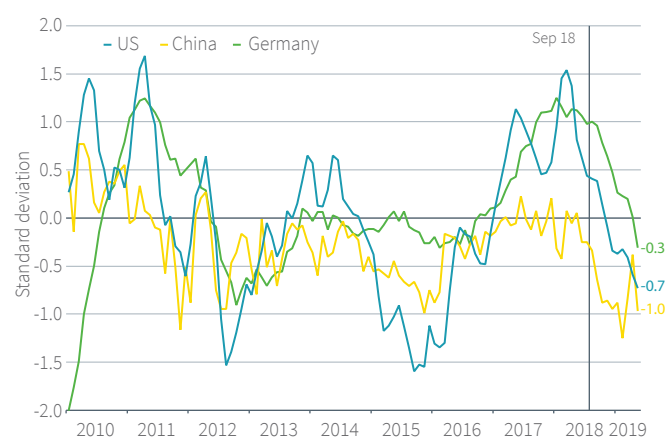
Goldman Sachs Financial Conditions Indices



Source: Aviva Investors, Macrobond, as at 24 June 2019

Figure 8. Export order books have been hit hard

New export orders (survey)



Source: Aviva Investors, Macrobond, as at 24 June 2019

Fiscal activism

After an extended period when fiscal policy in most countries has been a drag on growth, the next few years may witness a small positive contribution to overall GDP. In the wake of the Global Financial Crisis, public deficits and debts ballooned higher, necessitating a subsequent period of fiscal consolidation as public finances were restored to a sustainable footing. Although there are differences across nations, that period is now largely over, meaning that there is some scope for activist fiscal policy to boost growth modestly. The Trump administration’s tax and spending policies in 2018 were a standout example of this, but its initiatives are unlikely to be repeated in other countries and certainly not on the same scale. More recently, China has introduced fiscal measures to support growth and to offset the cyclical slowdown. The US enjoys the privilege of being the issuer of the world’s main reserve currency and while this is normally related to its current account balance, it applies to the fiscal balance too. Thus, Trump’s fiscal boost has widened the public deficit significantly, but the country has not been punished in the form of higher bond yields.

Many of the countries that make up the Eurozone have a more chequered fiscal history and financial markets can have long memories. Nevertheless, public finances have healed strikingly over the last six or seven years, creating some room for possible fiscal stimulus in Europe as well. Whether this is used and, if it is, whether it is used wisely, remains to be seen. But many Eurozone countries do plan to embark on mild fiscal expansion in 2019 and 2020 which should, at the margin, lift overall demand. However, the idea that any fiscal boost will simply pick up the policy baton and replace monetary stimulus as a key driver of growth is naïve. Public debt is still worryingly high in many countries (Germany is a notable exception) and this, together with sluggish growth and muted inflation pressures, means that the scope for fiscal expansion is very limited.

Volatility

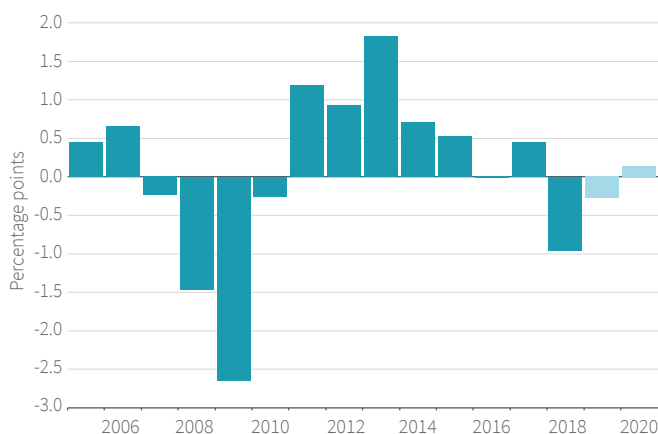
Recent years have been characterised by extended periods of relatively benign price moves, interspersed with episodes of relatively large asset price volatility across a range of financial assets. This pattern has been observed increasingly in different markets including equities, commodities and government 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.

However, risks to the global economy seem skewed predominantly to the downside at present, which will supply a ready number of catalysts for asset price volatility to persist. The about turn by the Fed this year in recognition of these risks has caused a wholesale repricing of interest rate expectations that lifted US rates volatility from the multi-decade lows experienced in 2018.

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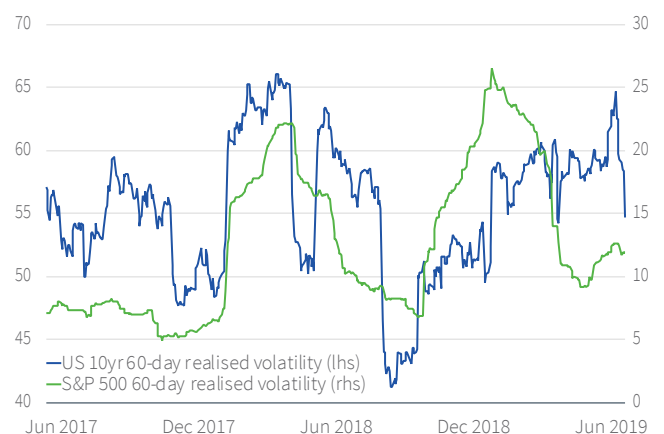
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Figure 9. Change in fiscal stance
% GDP (US, EZ, JP and UK wt avg)



Source: Aviva Investors, Macrobond, as at 24 June 2019

Figure 10. More volatility spikes plausible
US rates and equity volatility



Source: Aviva Investors, Macrobond, as at 24 June 2019

History shows that extremes in cross-asset volatility occur at the end 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.

Risks

China/US relationship deteriorates

Some elements of this risk are already contained in the central view, but there are further downside possibilities. The trade war theme has dominated investor sentiment for over a year (Figure 11). But the risk is that the dispute has opened the door to a wider set of conflicts between the US and China. Trump’s weaponization of the tariff threat in areas such as immigration sets a dangerous and worrying precedent. However, it would be wrong to conclude this is just another example of his belligerent methods. There is broad cross-party consensus in the US over protecting US corporate and national interests. The confrontation with Huawei is an indication of the blurred lines that have emerged between trade and national security. These could characterise China-US relations from now on as both sides employ a range of new restrictions and obstructions which could easily escalate into a tit-for-tat exchange of retaliatory measures across many areas.

China-US relationship likely to stay strained

China stimulus fails

In response to slowdown concerns, China has embarked on a wide-ranging combination of monetary and fiscal stimulus (Figure 12). Our central view is that these measures will be successful, but it is quite possible that they are not and that instead a negative China growth scare permeates across the globe. This would be especially damaging if it happened at the same time as any trade shock, but is largely independent of that since the stimulus is primarily intended to boost domestic demand rather than export trade. The Chinese authorities have plenty of ammunition at their disposal. If present measures were deemed not to be working sufficiently, it is highly likely that they would do more, in their own version of “whatever it takes”.

Chinese policy measures may not work as well as hoped

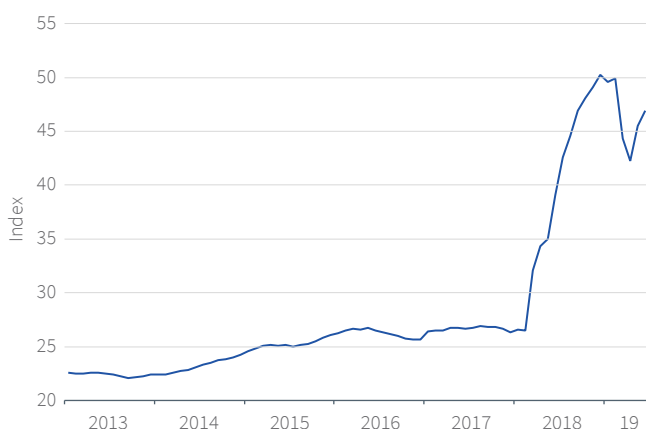
Global recession

For the first time since the Eurozone sovereign crisis, global recession risk appears to be heightened. Growth has stuttered recently, the export-orientated manufacturing sector has experienced a marked downdraft (Figure 13) and the threat of trade disruptions, protectionism and a more insular pursuit of nationalistic agendas means that there is plenty to worry about. The “new normal” for monetary policy makers implies greater uncertainty about where neutral or equilibrium rates are compared with the past. It is possible that the modest tightening we have seen so far is sufficient to bring about another downturn.

Recession risk heightened, led by manufacturing

Figure 11. Tariff threat had retreated but is back again

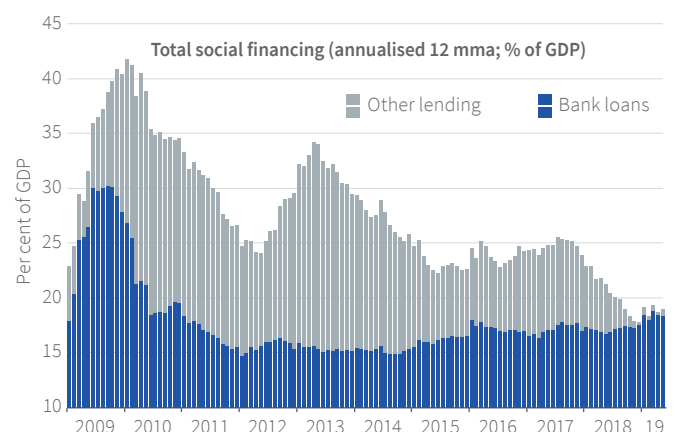
United States, Google mentions of tariff



Source: Aviva Investors, Macrobond, as at 24 June 2019

Figure 12. China’s monetary stimulus

China has halted earlier tightening



Source: Aviva Investors, Macrobond, as at 24 June 2019

Era of low rates may have encouraged excessive borrowing

Debt servicing strains

Historically very low interest rates over the last decade have encouraged greater borrowing from households, corporations and governments, just as they were intended to do. The exit from the era of extreme policy stimulus is going to be unhurried and limited in the sense that rates are highly unlikely to even approach the peaks of earlier cycles. Nevertheless, it is almost inevitable that some agents will have taken on excessive debts and that these vulnerabilities will be uncovered as we very slowly move back to a more “normal” policy backdrop. All cycles are different and there are often surprising revelations of where debt build ups have happened, but some possible candidates can already be identified. Although there has been extensive deleveraging in some areas, in others there has been only very limited adjustment (Figure 14).

Liquidity challenges

Smoothly functioning markets rely on liquidity

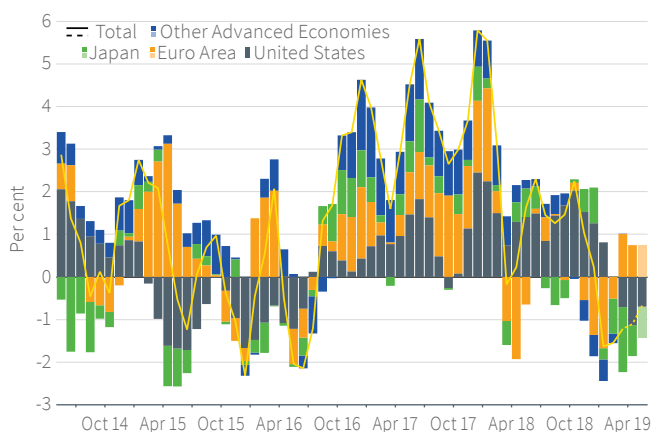
One of the unintended consequences of the Global Financial Crisis (GFC) and its aftermath has been a marked reduction in liquidity in key markets. As a result of the imposition of a range of regulatory measures and restrictions, the coverage and depth of market-making has been compromised and diminished, adversely impacting the smooth functioning of such markets and leading to regular episodes of damaging illiquidity that can distort prices significantly. The authorities that have introduced such changes have done so with the laudable aim of preventing the more questionable activities that some financial institutions had indulged in. These contributed to the instability which characterised the GFC and led to, amongst other things, the collapse of Lehman Brothers and the freezing of key markets. There are risks that more markets could be adversely affected as regulations are imposed and as agents comply.

Brexit/European politics

Populism and discordant politics becoming the norm

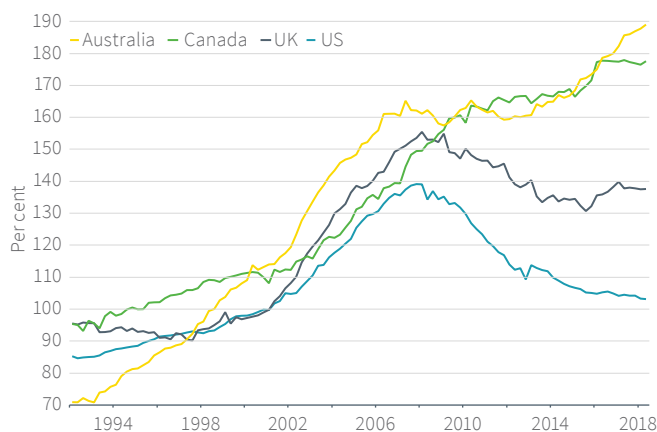
The ongoing Brexit process has contributed meaningfully to weaker growth in Britain and to gloomier sentiment among households and businesses. The impact on the rest of Europe has been less significant, but there is still scope for a greater hit, especially in the event of a no-deal exit from the EU. Beyond Europe, the Brexit process has progressively less relevance for economies and markets, although it is still a minor irritant in some cases. More generally, Brexit is just one example of the thrust of populism and discordant politics which has taken root in Europe (and elsewhere) in recent years. It is still possible that such frictions could erupt again – more likely if there were another economic downturn – with Italy perhaps the most plausible setting.

Figure 13. Manufacturing downturn has been severe
DM industrial production growth (3m annualised)



Source: Aviva Investors, Macrobond, as at 24 June 2019

Figure 14. Not all households have reduced debt levels
Ratio of household debt to disposable income



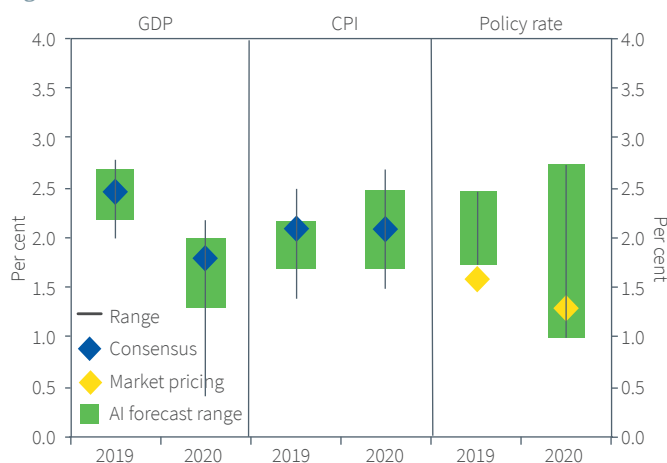
Source: Aviva Investors, Macrobond, as at 24 June 2019

Macro forecast charts and commentary

US

Annualised growth in the US is expected to be around 2.5 per cent in 2019H1, down from over 3 per cent a year ago. That slowdown reflects not only the waning boost from tax cuts and increased government spending, but also the weaker global backdrop and headwinds from the ongoing trade dispute with China. Looking ahead, we expect growth to slow further over the next 18 months, with weak business spending the main driver of that, but for the US to avoid recession. Despite the lack of domestic imbalances – household and corporate balance sheets are not stretched – the risks are tilted to the downside due to the risk of an intensification of the trade dispute with China and others. This will put little upward pressure on inflation, which remains low, and therefore makes it more likely that the Federal Reserve will ease policy rates over the rest of 2019.

Figure 15. US

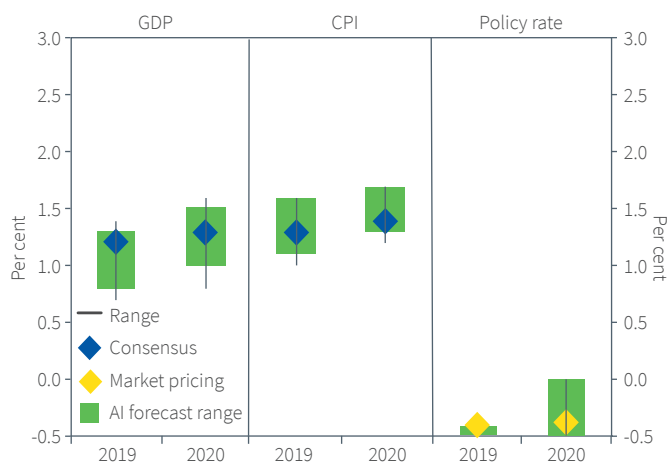


Source: Aviva Investors, Macrobond, as at 24 June 2019

Eurozone

Growth surprised modestly to the upside in the first quarter as resilient domestic demand continued to offset external weakness. Although forward-looking surveys have improved a little from their Q1 base, they are still only consistent with slightly below-trend growth. Moreover, the hard data is pointing clearly to a weaker Q2. The bottom line is that Eurozone growth is still weak overall, and the threat of further global trade disruption is weighing heavily on the outlook for the region. In addition, rumbling discontent in Italy has the capacity to disrupt once more. With inflation showing no sign of moving to target in the near term, the ECB has turned dovish again. If conditions don't improve soon, the pressure for additional stimulus will become irresistible. We expect modest gains in both growth and inflation, but this is far from certain: all the risks look to be to the downside.

Figure 16. Eurozone

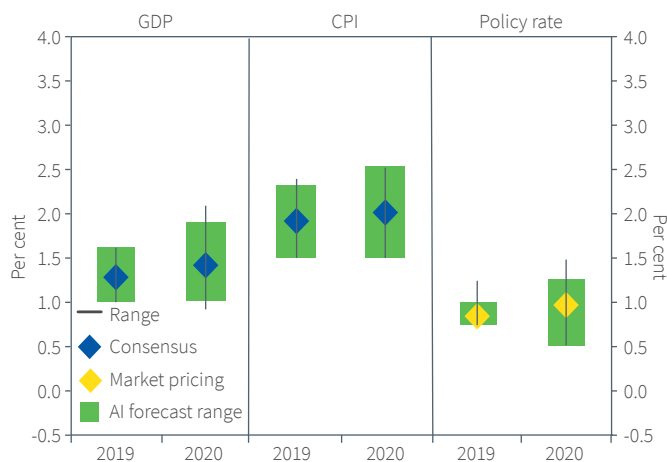


Source: Aviva Investors, Macrobond, as at 24 June 2019

UK

The Brexit cloud still dominates the UK outlook and now has the additional dimension of a new Prime Minister who could be far more hard-line on deal-making. The risk of a no-deal exit has risen significantly and despite protestations from the likely new camp that such an outcome would be manageable for the economy, we believe it would have a significant adverse impact. Uncertainty will therefore continue and is likely to hold back business investment just as it has done over the last year and a half. It is also noteworthy that employment surveys have weakened as well more recently. Until now, robust jobs growth has helped support household incomes and consumer spending growth, offsetting weaknesses elsewhere. GDP growth is likely to stall in Q2 after the inventory boost in Q1 and inflation may well dip back below 2 per cent. In this environment, Bank of England relative hawkishness looks a little odd, especially in light of the recent change in tone from other central banks.

Figure 17. UK



Source: Aviva Investors, Macrobond, as at 24 June 2019

China

The impact of trade tensions has weighed on Chinese growth over the last year, culminating in the 1.4 per cent quarterly rise in GDP in Q1. This was the lowest pace of growth since Q1 2016 when there were also significant concerns about a China slowdown. Now, as then, the Chinese authorities have responded with a combination of policy stimulus comprising lower rates, a boost to the credit impulse and fiscal loosening. The spectre of a damaging tit-for-tat with the US looms large, but these measures do mean there is a good chance of achieving the lower end of this year's 6.0-6.5 per cent GDP growth target. The fiscal stimulus is more geared to the local economy this time around, so positive spillovers to the rest of the world will be smaller. Re-escalation of the trade war is the dominant risk, but any signs of constructive resolution between China and the US, something that both sides claim to want, should be welcomed globally.

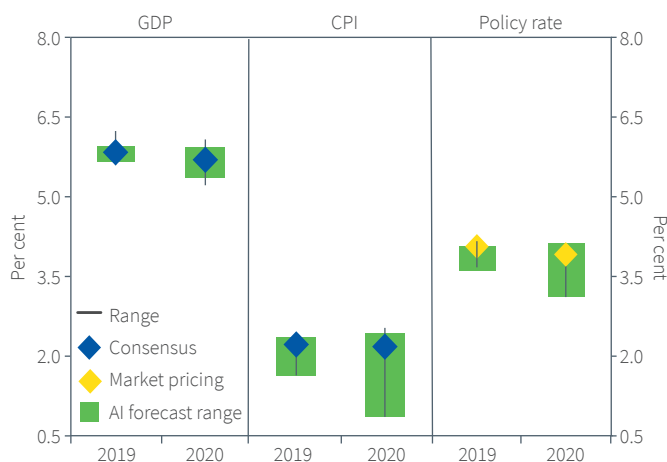
Japan

Continuing external headwinds and their possible transmission into weaker domestic demand raises recession concerns, although recession risk for now does not look high, given mitigating factors such as structural capex and countervailing measures for the consumption tax hike later in the year. Despite the logistical issues involved in abandoning the tax hike, it may still not be a done deal, as tracking estimates show overall growth slowing afresh. Q1 GDP was an upside surprise, but underlying detail was weak, as growth was largely driven by inventory accumulation and imports dropping by more than exports. Looking ahead, consumer confidence has declined sharply which might mean downside risks for consumption demand too. Meanwhile, the bar for further BoJ policy easing remains high, although slowdown risks, persistently weak inflation and possible yen strength given Fed dovishness could change the BoJ's stance, starting with a further strengthening of forward guidance.

Canada

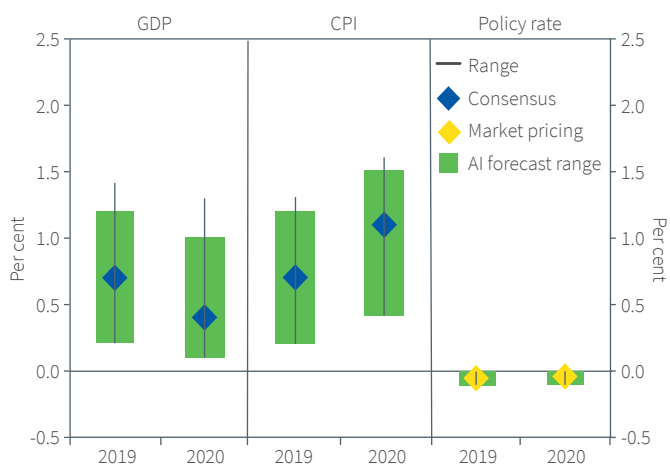
Canadian growth continued to slow through the first half of 2019 with broad-based weakness in exports and investment. While the contribution from consumption strengthened, the downside surprise in growth has led to downward revisions to 2019 growth forecasts. The outlook remains predominantly driven by external factors. Volatility in the oil market has held back investment while rising uncertainty and weaker global demand have subdued exports. Increased tariffs and the ongoing uncertainty around trade policies will impede global growth. The Bank of Canada (BoC) estimates the drag on global growth has increased to 0.4 per cent by the end of 2021, amplifying a broader structural slowdown. While the growth outlook is vulnerable to external shocks, inflation remains near the 2 per cent target and surprised to the upside in May, suggesting there is less slack in the labour market than previously estimated and that price pressures are firming. This creates a dilemma for the BoC, despite accommodative policy; further disruptions to the global outlook will likely tilt them to a more dovish stance.

Figure 18. China



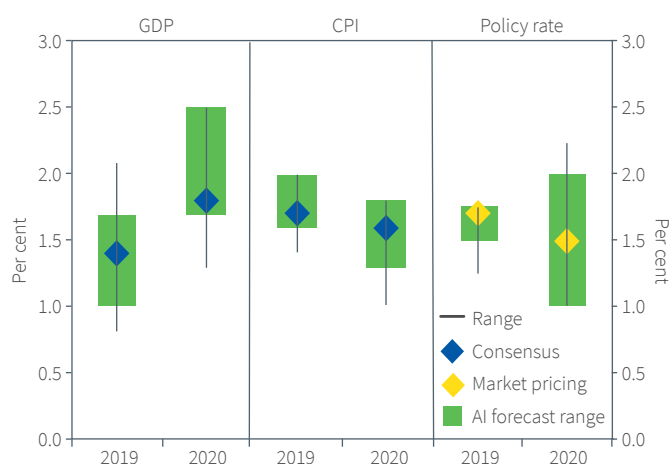
Source: Aviva Investors, Macrobond, as at 24 June 2019

Figure 19. Japan



Source: Aviva Investors, Macrobond, as at 24 June 2019

Figure 20. Canada



Source: Aviva Investors, Macrobond, as at 24 June 2019

Global market outlook and asset allocation

Positioning for a further slowdown

- Disappointing growth and increased risks lead us to downgrade risky assets
- Government bonds are less attractive but are valid assets for hedging purposes
- Risk-reward favours credit over equities
- Stay long US assets

Growth outlook has deteriorated; Central Banks are quick to react

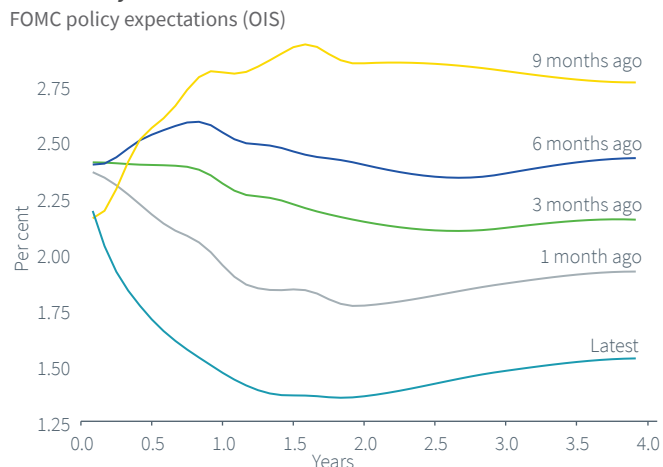
Having started the year with a decisively risk-on view in equities, we have now scaled back our preference for the asset class, taking our overall allocation closer to a neutral position. This change should be seen in the context of the strong performance in global equity markets so far this year, and at a time when a recovery in economic growth remains elusive but would be needed to support a fundamentally driven move higher in risky assets. At the same time, the downside risk from a trade dispute escalation between the US and China delaying the growth recovery further have risen and are, in our view, not fully appreciated by markets. As a result, we have downgraded our view on equities. Combined with a modest preference for duration, the portfolio now reflects what we regard as more acute downside economic and market risks. Among risky assets, we prefer credit, specifically High Yield and Emerging Markets hard currency, over equities. The US remains our preferred equity market, balanced by an underweight position in EM.

Slowing growth and rising risks have prompted central banks to respond, with nearly all giving clearly dovish forward guidance or commencing rate cuts. Global bond markets have reacted accordingly and, in the case of the United States, are priced for a reversal of the 2018 rate hikes. With the speed and magnitude of central bank support having become clearer in recent weeks, any easing of economic tensions between the US and China or signs of a global growth stabilisation would lead us to re-consider our asset allocation stance and favour a more positive risk allocation.

The year-to-date rally in equities is to be seen in the context of oversold levels in Q4 2018. Markets at that time de-coupled from economic fundamentals, not least due to an intensifying standoff between the US and China in trade matters and fears of tighter monetary conditions. Amid continued positive earnings growth during that sell-off period, valuations adjusted to reflect significant discounts. When the Fed offered support by refraining from further policy rate increases, the tone between the US and China eased and the feared US earnings recession in the first half of 2019 was averted, markets rallied back towards long-term average multiples.

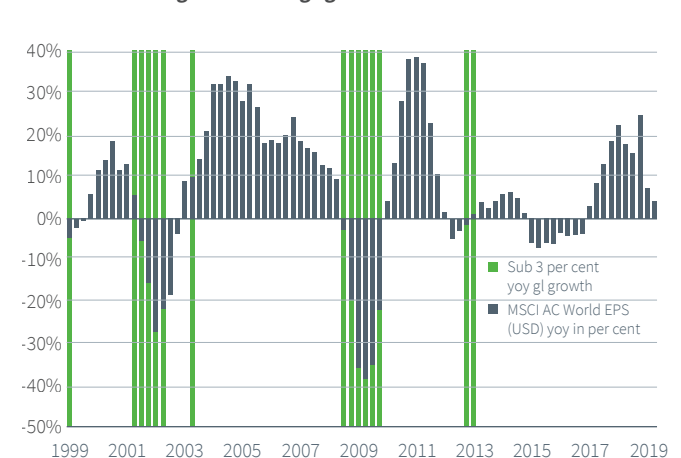
In our view, the probability-weighted outlook for equity risk has turned less favourable. This is

Figure 21. Market expectations for policy rates have shifted dramatically



Source: Macrobond, Bloomberg, as at 24 June 2019

Figure 22. Sub 3 per cent global growth rates have historically coincided with negative earnings growth



Source: Macrobond, Refinitiv Datastream, as at end May 2019

because global equities have returned to close to their record highs at a time when earnings growth is meagre, and when the multiple is already reflecting a discount rate that incorporates a cumulative 100bps expected rate cut in the US by end-2020 (Figure 21). We think the trade standoff between the US and China will prove to be a deeper-rooted conflict, and that economic growth is continuing to slow into H2. Incorporating our global growth outlook into our assessment for the asset class, it is notable that historically, periods during which global growth fell below 3 per cent in year-on-year terms were associated with negative earnings growth 80 per cent of the time (since the late 1990s (Figure 22)). Our central expectation for global growth is for a stabilization at, or just below, 3 per cent. As we don't anticipate a deterioration in growth beyond these levels, and therefore see the global economy escaping recession, a prolonged period of negative earnings growth might be circumvented. However, given the comparably high expectations built in for earnings growth in 2020 (Figure 23), we do envision chances for disappointment relative to actual earnings delivery to be meaningful.

China's efforts to stabilise growth remain critical for commodities and the global economy. Beijing's credit tightening of 2018 has been reversed, income tax cuts are supporting retail sales, and PMIs rebounded in Q1 before easing back a bit in Q2. However, with the US/China trade conflict persisting and broadening to other countries, confidence has again been rattled and industry is still slowing (Figure 24). Having realised the benefits of better liquidity conditions in the G10, and with less spill-over outside China compared with past infrastructure and property booms, we have shifted to an underweight view on Emerging Market (EM) equities. The underweight is offset by an overweight view on US equities, with US earnings expected to continue to outperform EM. A positive earnings growth differential in favour of the US has historically most often led to positive performance of such trade (Figure 25).

Another reason to remain cautious on EM equities is our outlook for EM currencies (against the US dollar). We have preferred a short basket of low-beta Asian currencies to hedge against a downturn in global growth and/or an escalation of the trade dispute for more than a year now. This underweight view in EM currencies is against a long USD position, which we think is not only attractive in terms of carry but also because it stands out as a beneficiary of slowing global growth and growth divergence (Figure 26). Moreover, periods of illiquidity in USD funding markets as well as the periodic spikes in risk aversion are likely to contribute to USD strength, along with other "safe havens" such as JPY and CHF.

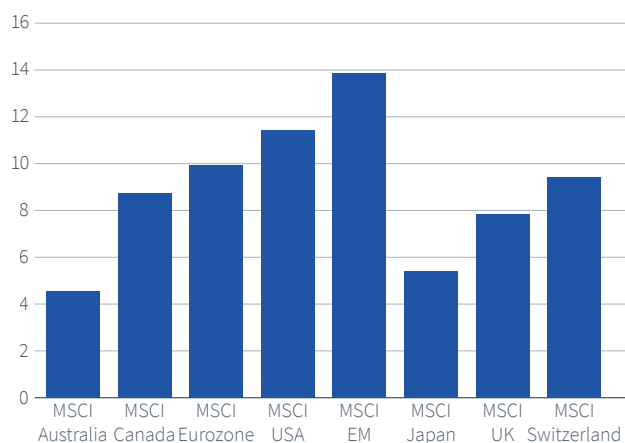
Conversely, we maintain our preference to be short euros and the Australian dollar. Both should underperform in a global growth environment that continues to weaken and where trade disputes remain an ongoing theme. While in theory, the Fed can cut more than the ECB or RBA, we are wary to adopt the recent market narrative that this will drive sustainable dollar weakness. This is for two reasons: (i) aggressive Fed cuts are already priced into the curve, and (ii) the current economic situation in the US doesn't call for as strong a policy response as in the Eurozone and Australia.

Regional tilt: long US vs Emerging Market equities

For developed currencies, a tug-of-war between growth, valuation and rate drivers

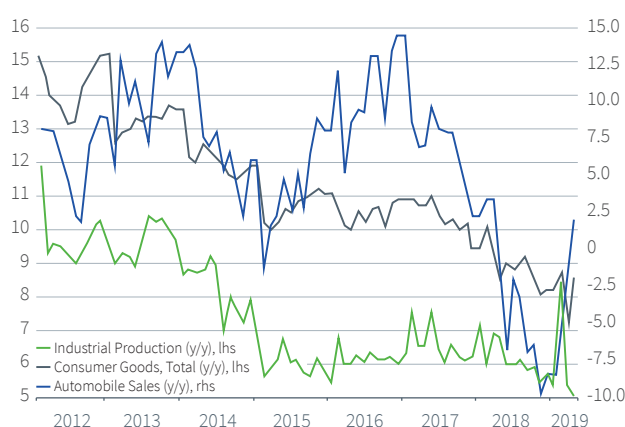
Figure 23. High expectations for earnings growth in 2020

Consensus expected EPS growth for 2020 in per cent



Source: Refinitiv Datastream as at 16. June 2019

Figure 24. Chinese growth indicators are stabilising, but remain fragile



Source: China NBS, Aviva Investors, Macrobond, as at 24 June 2019

Government bonds remain supported, despite low yields

Across developed markets, risk-free 10-year bond yields have dropped between low double-digit figures (Japan) and up to 100 bps (Australia) year-to-date. In Q1, when recession fears faded, risk assets outperformed bonds, but with the global manufacturing PMI dipping below 50 in recent months, bond yields have fallen dramatically again: the global treasury benchmark's average yield dropped from 1.17 per cent to under 1 per cent following Mario Draghi's speech at Sintra in June. Despite lower coupons and paltry rolldown, risk-free assets remain an important diversifier. While shorter-dated bonds are useful for funding, especially in Japan and Europe, moving further out on the maturity and credit spectrum is appealing; this is not a mere reach for yield, but is supported by business cycle dynamics and relative pricing.

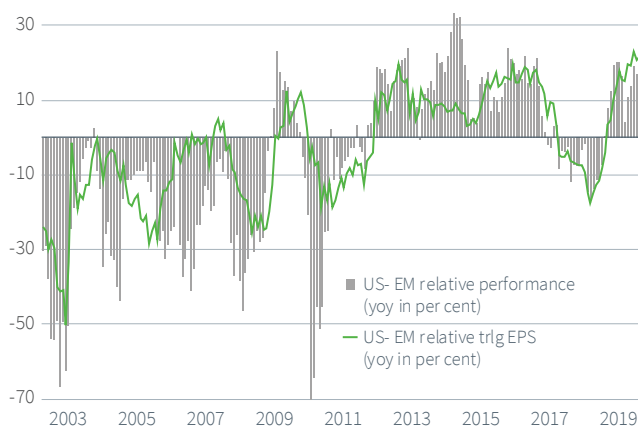
Corporate and EM credit have repriced more than equities

While US equities are near all-time highs, and European stocks are only a couple of percent lower than 2018 highs, spreads on corporate bonds and hard-currency EM sovereign debt are now far more attractive than the extremely tight levels of early/mid-2018. In particular, Europe and US HY spreads around 100bps above their 2018 tight, offer compelling carry and rolldown, with a still sparse default rate. We don't expect to revisit recent lows in spreads as fundamental credit metrics have deteriorated, but a grind lower is likely as monetary and fiscal stimulus gets us through the soft patch. We find EM sovereign dollar spreads appealing overall too, with a spread of around 370bps and steep credit curves offering good compensation for a "split-rated" asset class that compares well with triple-B corporates at approximately 150bps and double-Bs at 250bps over Treasuries.

Risks to current positioning

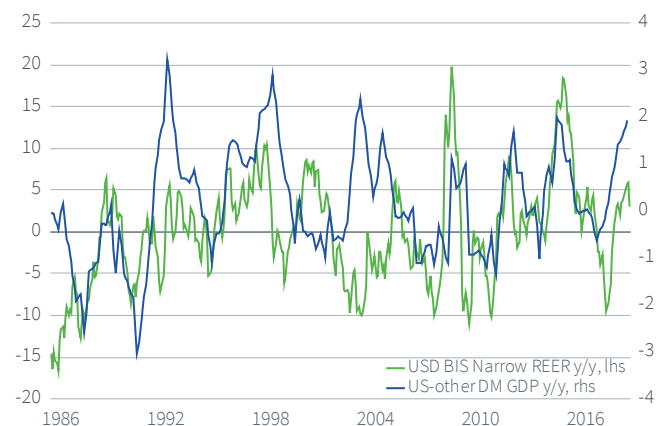
Though our asset allocation overall is conservative, we should note that there are still important risks to consider. Should the Fed not deliver on rate cuts that it signalled are likely in the June FOMC meeting, global yields could reprice meaningfully, even in the absence of hikes. Moreover, if a lasting trade détente is reached with China, and EU auto tariffs and "No Deal" Brexit are avoided, we could see pent-up demand and investment accelerate, lifting inflation and growth, with yields and risk assets in their wake. A relatively defensive portfolio would then suffer a mix of opportunity cost (from being close to neutral overall) and some losses (EM underweight and duration), even as US equities and global HY and EM would make gains. On the downside, should growth deteriorate, and trade wars become damaging and disruptive, long duration positions may only partially protect losses in credit markets and global equities.

Figure 25. Positive US over EM earnings growth usually coincides with relative US outperformance



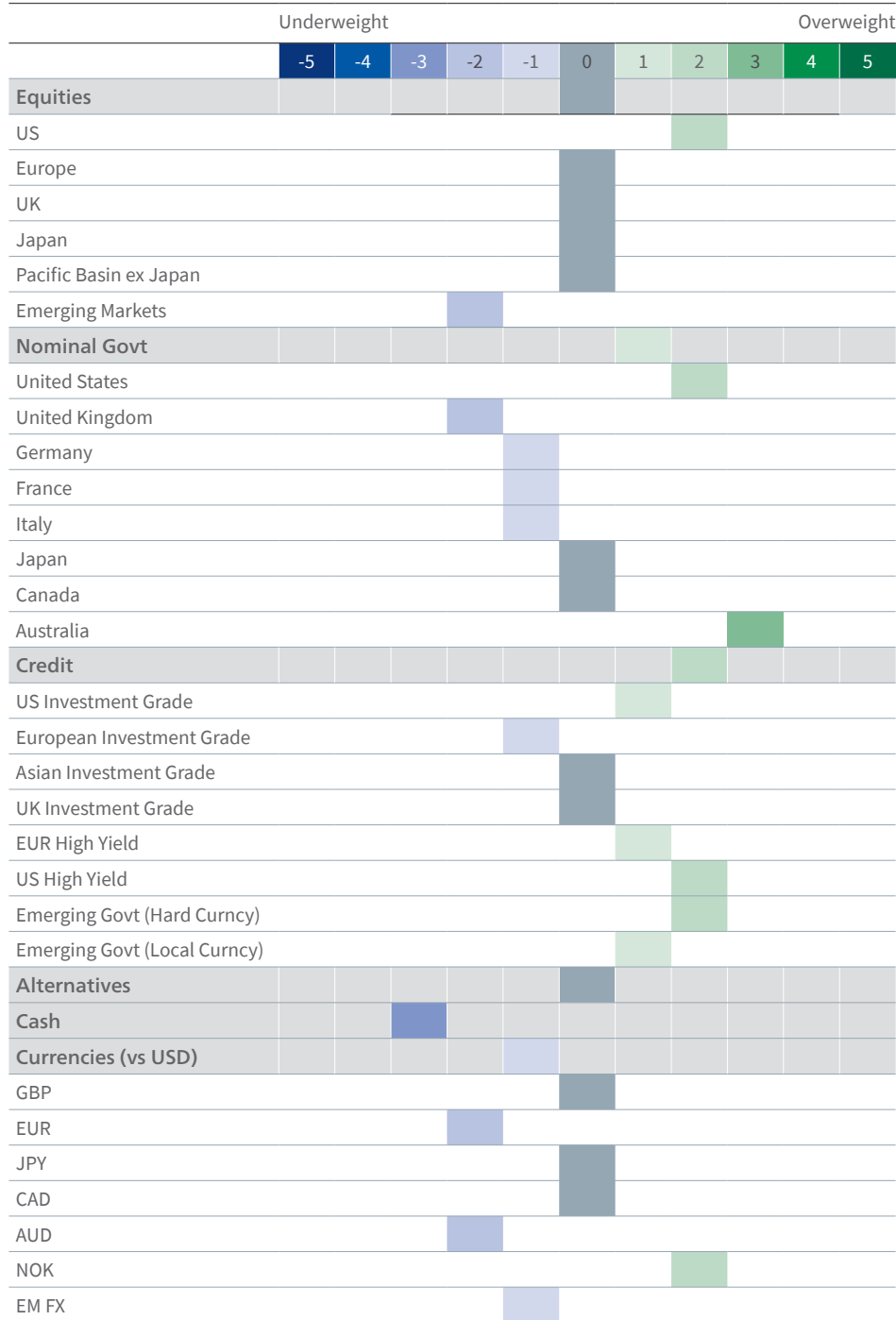
Source: Refinitiv Datastream, as of end May 2019

Figure 26. USD benefits from growth differentials



Source: Aviva Investors, Macrobond, as at 24 June 2019

Figure 27. Asset allocation



Source: Aviva Investors, as at 24 June 2019

The weights in the Asset Allocation table only apply to a model portfolio without mandate constraints.

Our House View asset allocation provides a comprehensive and forward-looking framework for discussion among the investment teams.

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