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House View Q4 2019

The intelligence that guides our investment decisions

For today's investor

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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

All hands to the pump: central banks try to limit the damage from trade wars

Weak global growth expected to persist through 2020

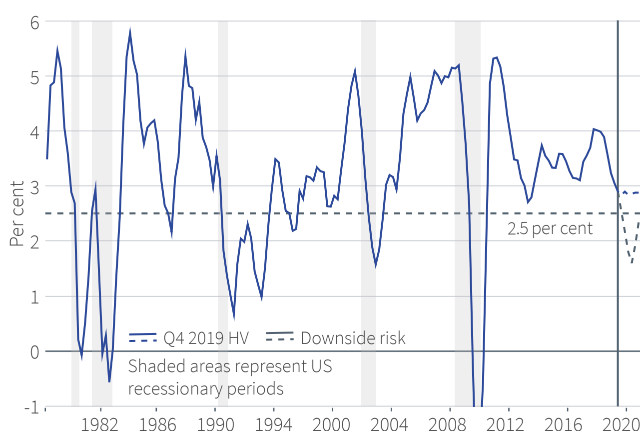
Global growth slowed to below 3 per cent (on an annual basis) in the middle of 2019, the weakest rate of increase since the Eurozone crisis of 2012. That slowdown, which began at the start of 2018, largely reflected a sharp deterioration in global manufacturing and trade, which in turn reflected a combination of factors, including: structural de-leveraging and slowdown in China, past monetary policy tightening in the US, the imposition of and uncertainty around tariff and non-tariff barriers between the US and China and policy changes related to auto emissions in Europe. There was a further escalation in the trade war between the US and China in August, when President Trump announced a broadening of tariffs to all Chinese goods. Following Chinese retaliation, the proposed tariff rates were then also increased across the board to an average of around 22 per cent. That, alongside weaker-than-expected growth outturns in the Eurozone, has led us to revise down our global growth expectations through to the end of 2020. We now expect growth to remain below 3 per cent over the next 18 months. That would represent the weakest sustained period for over a decade. We expect all major economies to be growing below potential in 2020, with unemployment likely to rise modestly and wage and inflation pressures set to remain muted. Given the uncertainty around how businesses and households will react to the imposition of further tariffs, as well as the use of non-tariff measures, we judge that the risks to growth are to the downside (Figure 1). Indeed, we put the probability of a mild global recession over the next 18 months at around one in three.

Trade and manufacturing sector already at recessionary levels

Aside from the global recessions of 2001 and 2008/09, growth in global export volumes has fallen to its weakest rate in the last 30 years. That reflects the impact on global supply chains of the key factors noted above. In particular, the imposition of tariffs from late 2018 accelerated the decline in export volumes globally as uncertainty rose and orders declined. The decline in orders led to a slowdown in industrial production, which is similarly weak (Figure 2). The impact of the shock to global trade has, unsurprisingly, been felt more strongly in those countries and regions in which trade plays a more important role. In particular, Japan and other parts of Asia, as well as Europe, have seen a sharper decline in growth as exports have become a material drag. International trade is a relatively smaller part of the US economy, but it has also seen a modest hit to overall growth via the trade channel. Perhaps more significant, however, has been the slowdown in business investment in the US and elsewhere as uncertainty has impacted spending decisions.

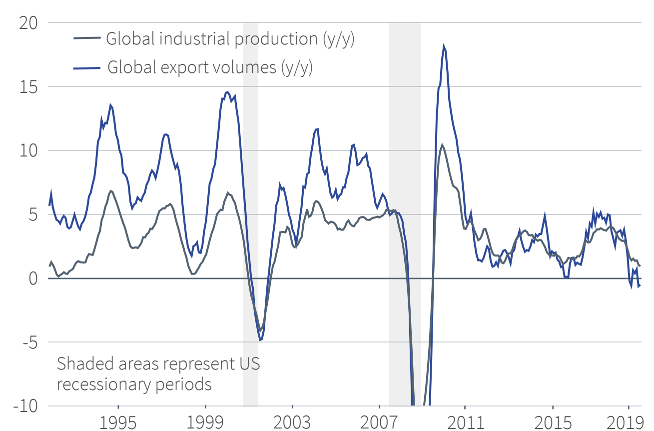
Thus far, the majority of the global slowdown can be attributed to trade and the associated manufacturing industries. While the manufacturing sector is a relatively small part of most economies – usually between 10-20 per cent – the magnitude of the changes in output can be large relative to other sectors. But if the downturn is contained to manufacturing alone, it is

Figure 1. **Global growth outlook (y/y)**
We expect global growth to remain weak, with risks to the downside



Source: Aviva Investors, Macrobond, as at 27 September 2019

Figure 2. **Global manufacturing and trade**
Trade wars have taken a toll on growth already



Source: Aviva Investors, Macrobond, as at 27 September 2019

Risks of global recession rest on whether the problems remain contained, or spread to the service sector

usually insufficient to cause a recession. Indeed, despite the slowdown, no major economies have experienced any material increase in overall unemployment so far. That reflects continued robust consumption growth, supported by real disposable income gains and solid household balance sheets. That has continued to support service sectors. Therefore, a key factor in determining whether the current slowdown turns into something more serious, or even recession, would be a broadening in the weakness beyond manufacturing. While the "hard" data has remained solid thus far, "soft" data such as surveys of service sector like the Purchasing Managers' Indices (PMI) have recently weakened as well, suggesting that the downside risk to growth may be more likely to materialise.

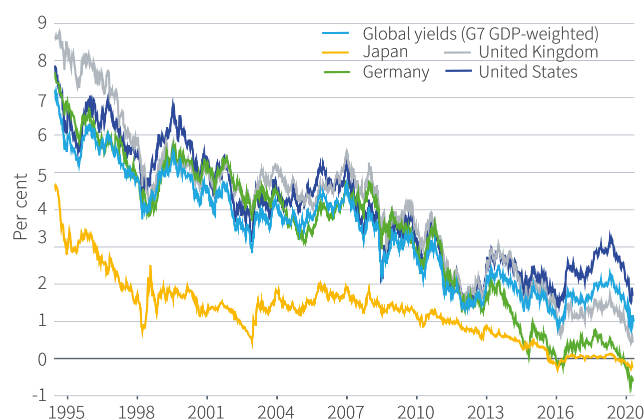
Central banks once again providing policy stimulus

Weaker growth prospects and low inflation have led many central banks to ease policy in recent months. The Federal Reserve reduced rates by 25bps in July and September, and several on the FOMC have indicated that they expect to ease policy further. The short-term US interest rates market currently prices in between another three or four rate cuts over the next year. We expect the Fed will cut rates once more this year and again next year, but given the downside risks do not see a material market mis-pricing. The European Central Bank (ECB) also eased policy in September, cutting policy rates by 10bps, taking them further into negative territory, re-starting asset purchases and making adjustments to its balance sheet operations to ease bank funding. The People's Bank of China (PBoC) has undertaken a range of policy easing measures as well in recent months, as have other central banks, such as the Reserve Bank of Australia and the Reserve Bank of New Zealand. All of this renewed monetary support has seen global risk-free rates fall sharply, with 10-year sovereign bond yields reaching new lows in many cases (Figure 3). While policy rates are at or near all-time lows in many economies, we see scope for further easing if necessary. Many are calling for an increased role for fiscal policy to stimulate economies, but we remain somewhat sceptical about the willingness of those best placed to ease fiscal policy, such as Germany.

We prefer to be neutral on equities and modestly overweight duration and credit

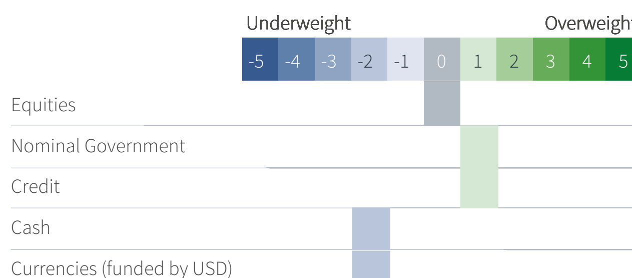
Having marked down our economic outlook and become increasingly concerned about the downside risks, it is perhaps unsurprising that we are cautious about the outlook for risk assets, with a neutral allocation to equities (Figure 4). While many equity markets are close to their all-time high, we think they are fragile and susceptible to further downside news on growth. We expect estimates for corporate earnings growth in 2020 will be revised lower, and with valuations already close to long-run averages, see limited scope for a sustained move higher. That said, if there was a permanent resolution to the trade war, something we currently put a very low probability on, it could be the catalyst for a re-rating, particularly for value stocks that have performed particularly poorly over the past 12 months. Our preference is for a modest overweight in duration, with the recent sharp rally sufficiently large for us to pare back our previous overweight view somewhat. Similarly, we continue to prefer a modest overweight in credit and emerging market debt, with both direct and indirect central bank support expected to mitigate the risks of a default cycle in our central case. We continue to prefer to be overweight US dollars due to heightened risk aversion.

Figure 3. **Sovereign bond yields**
Expectations of further monetary policy easing priced into rates markets



Source: Aviva Investors, Macrobond, as at 27 September 2019

Figure 4. **Asset allocation summary**
Neutral equities, modestly overweight duration and credit



Source: Aviva Investors, Macrobond, as at 27 September 2019

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Key investment themes and risks

Investment themes

1 Weak global growth
2 Dovish bias to monetary policy
3 Trade dispute continues
4 Fiscal activism returns
5 Volatility here to stay

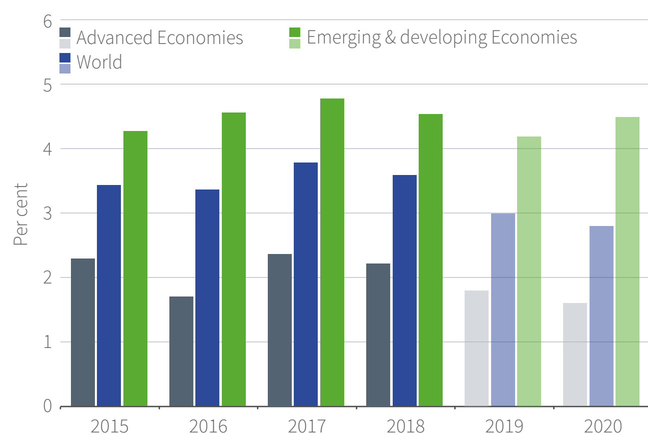
Weak global growth

1

The global growth slowdown has continued so far in 2019 and the outlook remains fragile and uncertain. The best that can be said is that it has not intensified dramatically on a global basis (although it has in a few key regions) in recent quarters. But with risks skewed to the downside and recession threat rising in some countries, it is entirely understandable that questions are being asked about the sustainability of the present economic expansion. World GDP is likely to increase by around 3 per cent in 2019 overall (Figure 5), which would be the lowest pace since the crisis year of 2009. In a longer historical context, only nine of the last 40 years have seen weaker global growth, so we are looking at a bottom quartile macro-economic performance in 2019. Moreover, on current momentum 2020 is likely to be even weaker, with aggregate growth slipping further to an annualised rate of 2.75 per cent or so. In calendar-year terms, all major regions are expected to slow in 2020, with even the previously resilient US slowing appreciably and to a below-trend pace.

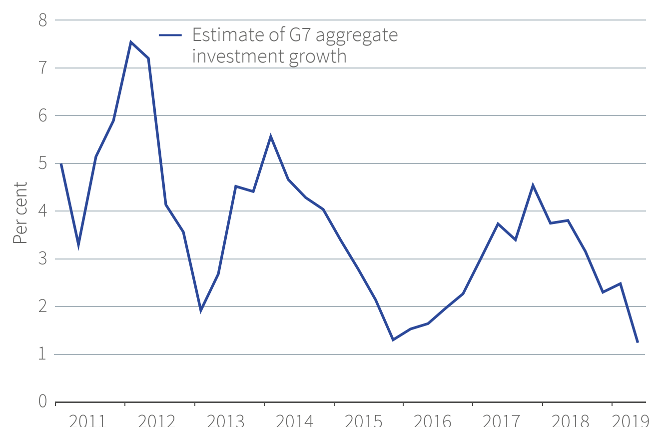
The main drivers for slower growth have been well documented: ongoing trade tensions and a widening of the arena of conflict between China and the US have weighed heavily on world trade and on global manufacturing which still dominates such flows. Global trade, which was growing at an annual pace of 5 per cent or more as recently as last October, is now stagnating and the malaise within industry is hurting those nations that depend most heavily on trade in manufactured goods. The worry is that the longer this goes on, the more likely it is that weakness will be passed on to domestic demand, which until now, has been extremely resilient. The channels by which any such transmission takes place are likely to be first, business sentiment, second, investment and finally, employment. Business surveys have already dipped in most nations, quite alarmingly in some cases and investment has slowed significantly too (Figure 6). But so far labour markets have generally been robust (or better) which has helped support household incomes and expenditure. Until or unless this final trend changes, or if consumer confidence were to suddenly plummet, the outlook remains one of low growth rather than no growth.

Figure 5. **Global growth continues to slow**
Could dip below 3 per cent next year



Source: Aviva Investors, Macrobond, as at 27 September 2019

Figure 6. **Investment growth has slipped**
As weak as 2015/2016 and still falling



Source: Aviva Investors, Macrobond, as at 27 September 2019

Dovish bias to monetary policy

2

In response to weaker growth, subdued (and in many cases, below-target) inflation and the threat from trade tensions and mounting protectionism, central banks around the world have adopted or re-adopted an increasingly accommodative monetary policy stance. After the extended period of ultra-loose policy that was implemented in the wake of the Global Financial Crisis (GFC) and maintained for years, the eventual moves towards normalisation may have seemed incredibly brief. (They never actually started in a number of jurisdictions.) But in fact, the recent US hiking cycle, for example, is one of the longest in history in terms of time (43 months), beating the previous one (2004-2007) by four months, and more than double the previous post-war average of 15 months. There is a lively debate about where the new "neutral" is in the post-crisis world and indeed whether it is even positive in several countries. But the key point is that central banks are back in stimulus mode almost everywhere and the main issue now is simply how far they will go (Figure 7). Financial markets are expecting a lot and while we agree that a dovish bias is appropriate in today's conditions, should downside risks ease, they may not need to (or want to) deliver quite as much as is currently priced in.

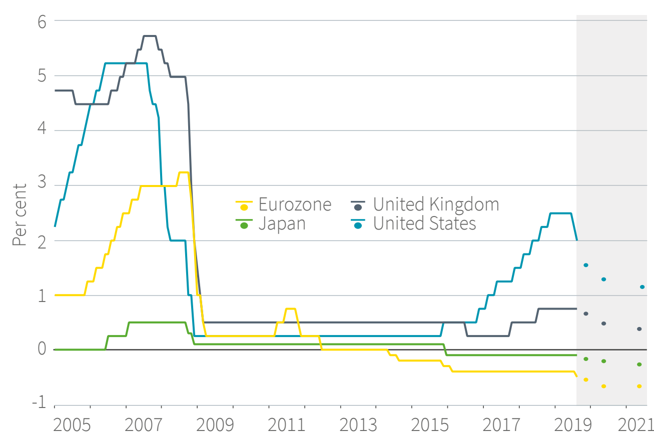
Nevertheless, in our central scenario the dovish bias is likely to remain over the next year or more. In common with earlier cycles it may be that financial imbalances have built up in some areas, but what is missing in the current experience is any sign of more generalised overheating. In the past, such episodes have been characterised by rising inflation pressures to which central banks have been obliged to respond, often killing off the economic upswing. The absence of such pressures today provides the monetary authorities with almost total freedom to react to growth concerns and downside risks and that is what they are doing. Until growth revives and/or risks dissipate (and assuming inflation stays well behaved), they will be comfortable in adopting such an approach.

Trade dispute continues

3

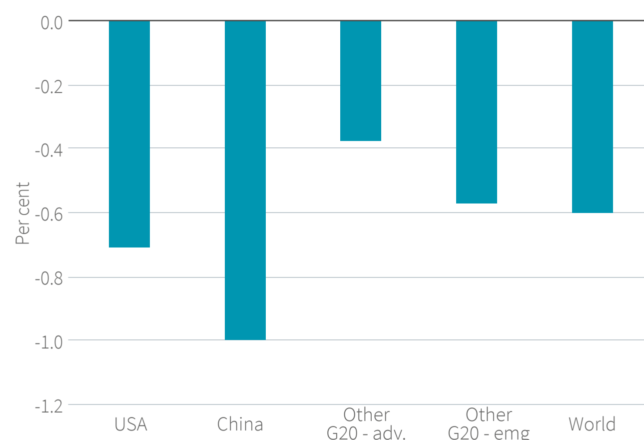
The trade war between the US and China will continue to frame the investment landscape for the foreseeable future. As has been the case since it began, there will be intermittent shifts of mood – both up and down – with periods of calm interspersed with a ratcheting up of tensions as Trump and others pursue the America First agenda and China responds. Before condemning the Trump administration totally, it needs to be acknowledged that some of their grievances with China are legitimate, especially with regard to intellectual property theft and access to China's markets. But weaponizing tariffs and the like sets a dangerous and worrying precedent. Moreover, the risk of such measures spreading to other nations and eventually resulting in an all-out, tit-for-tat and damaging trade war is one that is already impacting business sentiment and financial markets, even if it were never to materialise fully.

Figure 7. **Bias to easing in the major nations**
Markets expect further cuts everywhere



Source: Aviva Investors, Macrobond, as at 27 September 2019

Figure 8. **Adverse impact from US-China tariffs 1**
Hit to GDP (difference from base)



Source: OECD, Aviva Investors, Macrobond, as at 27 September 2019

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Financial markets will be susceptible to "headline" or "tweet" risk, but our central view is one where there is continued tension and intermittent escalation rather than resolution. Our base case also assumes that the planned (announced) additional tariffs are implemented in full. In addition to the direct impact on trade flows, the uncertainty about trade policy, which has recently reached a new all-time high, is hindering cross-border investment and disrupting supply chains which will harm medium-term growth prospects. More immediately, the bilateral tariffs introduced by China and the US since the start of 2018 will reduce global growth by about 0.6 percentage points by 2020/21 (Figure 8) according to analysis undertaken by the OECD, with much of that hit coming from lower business investment (Figure 9). In the event that trade tensions ease, global growth could be stronger, but the most likely scenario is one where uncertainty persists and that this in itself will be sufficient to hurt growth.

Fiscal activism returns

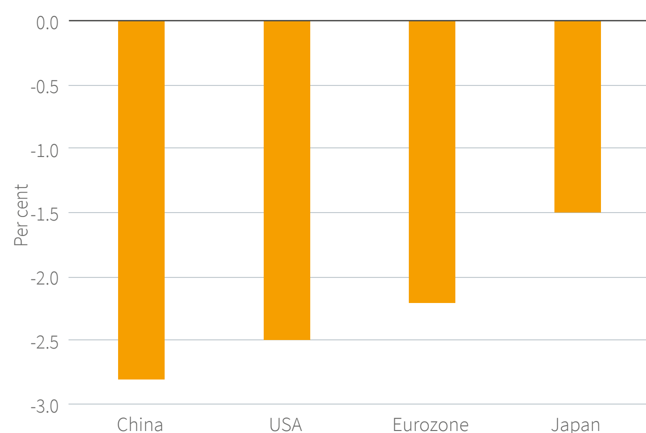
4

Whether monetary policy has reached its "natural" limit or not, the marginal return to additional measures is almost certainly lower than it was. With public finances now restored to health in most countries, pressure on fiscal authorities to provide policy assistance where possible (and prudent) is building. It has even been suggested that the arbiters of the fiscal purse should pick up the policy baton from their monetary equivalents. In the era of independent central banks, policy boundaries were generally respected. Today the edges are more blurred, the latest example being the ECB stating explicitly that the time was right for fiscal authorities to share the burden in the provision of policy stimulus.

Both the IMF and the OECD have been unusually vocal recently in their support of such initiatives, with the latter stating that "exceptionally low interest rates provide an opportunity to invest in infrastructure that supports near-term demand and offers (long-term growth) benefits for the future". While a return to the large-scale Keynesian fiscal interventionism of the 1960s and 1970s is highly unlikely, fiscal policy is set to provide a small boost to growth in coming years, which is a marked change from successive years of fiscal retrenchment. If the downturn were to become more severe, the healthier state of fiscal aggregates means that there is now greater scope in some places for public demand to step in to support growth.

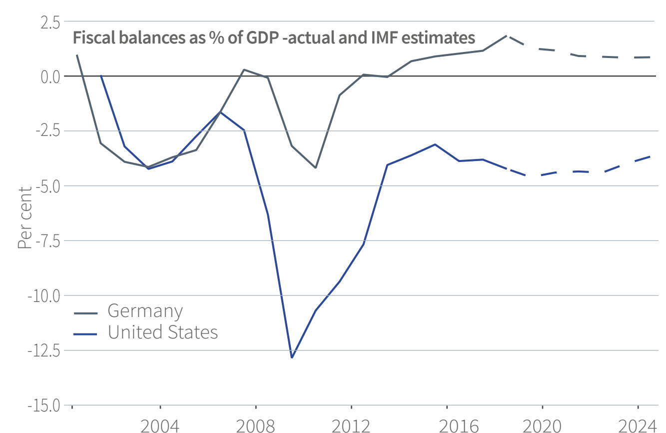
However, caution is warranted in any assessment of the room for fiscal expansion. Despite the improvements in recent years, vulnerabilities remain in many countries. After Trump's fiscal largesse in 2017/18, the US budget deficit is approaching 5 per cent of GDP with the economy now slowing – there is very limited capacity for any repeat. Meanwhile in Germany there is ample scope for fiscal stimulus, but little desire to embark on such policies (Figure 10). For most of the rest of Europe there is no such room given high public debt levels. Our central view is that fiscal policy can deliver a valuable lift to aggregate demand in many countries in future years but that it will not be a game-changer.

Figure 9. **Adverse impact from US-China tariffs 2**
Business investment hit most (difference from base)



Source: OECD, Aviva Investors, Macrobond, as at 27 September 2019

Figure 10. **All countries are not equal**
The scope for fiscal easing varies enormously



Source: Aviva Investors, Macrobond, as at 27 September 2019

5

Volatility here to stay

Recent years have been characterised by extended periods of relatively benign price moves in financial markets, interspersed with episodes of relatively large asset price moves. 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. We expect to see this pattern continue.

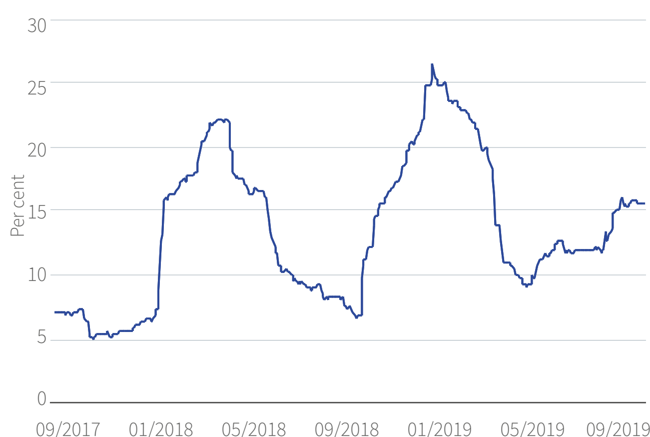
History shows that extremes in cross-asset volatility occur at the ends of economic expansions when growth begins to slow meaningfully. Yield volatility is currently exhibiting levels more consistent with historical norms, having spent the last few years at historically very depressed levels (Figure 11). Equity volatility is generally the first to exhibit persistently higher levels towards the end of the economic cycle, but historically also shows increasing levels of volatility in the second half of expansions (Figure 12). Since we are likely well beyond the midpoint of the current global expansion, we expect volatility to continue to be an episodic feature of equity markets. Furthermore, 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. Conversely, the market impact of crowded position de-risking and closing out of short volatility positions has been accentuated by the dearth in trading liquidity over recent history, 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, provided that global growth does not fall significantly further below potential.

However, since risks to the global economy seem skewed predominantly to the downside at present, there are already a number of catalysts for asset price volatility to persist. Were growth to deteriorate further, cross asset volatility will likely remain at more consistently elevated level across the board.

Figure 11. **US 10-year 60-day realised volatility**

Source: Aviva Investors, Macrobond, as at 27 September 2019

Figure 12. **S&P 500 60-day realised volatility**



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Risks

Trade war deepens and goes global

As before, elements of this risk are contained in our central view, but in reality it is a continuum of possibilities of which there are many at the adverse (risky) end. What began as a "simple" trade dispute between the US and China has already mutated into a more generalised geopolitical clash between those nations that could easily become more severe and also spill over into new areas. Other bilateral US-China relationships could become affected, including currency wars, services trade (including tourism and foreign students) as well as more specific corporate restrictions, such as those initially applied to Huawei. The wider this scope becomes, the more detrimental the likely impact on global growth from both direct and indirect effects (Figure 13). In addition, the conflict could spread to other countries: the spectre of tariffs still hangs over Europe and Japanese autos, for example. Escalation, sometimes on a whim, is a risk that is likely to be here throughout 2020.

Further escalation in the trade war very likely

China stimulus fails

It may seem unfair to single out China – policy stimulus could fail anywhere after all – but there are reasons. China is employing a range of policy instruments (not just rates) to provide stimulus, including monetary (Figure 14), fiscal, as well as imposed rules and guidance via national and local government. Required longer-term structural adjustment and the importance of China to the global economy – think back to the concerns in 2015/16 – mean that it merits its own risk. Simply put, if stimulus worked everywhere else, but not in China, the world economy would still be affected. China has plenty of ammunition at its disposal but is still learning how to use its policy weaponry effectively. Recent measures have generally been domestically focused and should help offset weakness in the external sector related to the trade dispute.

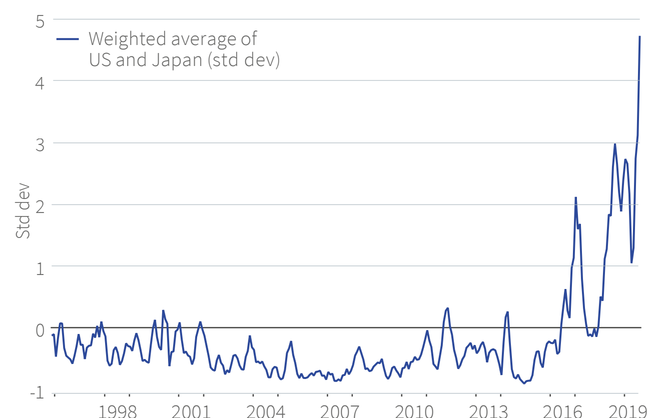
China is still learning how to use its policy weapons

Global recession

In the last 40 years global growth has dipped below 2.5 per cent seven times. On four of those occasions, what followed could legitimately be described as a "global recession". Today world growth has slowed to under 3 per cent from more than 4 per cent not very long ago and momentum is still poor, so it is no surprise that recession threat is heightened (Figure 15). The fragility of the global economy is being met by additional policy accommodation, but it would not take much more bad news to push the world into a more serious downswing. A global recession is not inevitable (although some countries may experience one), but the main concern is that chronic weakness within manufacturing and trade migrates to services and domestic demand. Even if borrowing rates stayed low or moved lower still, a global recession would also expose vulnerabilities in over-indebted sectors.

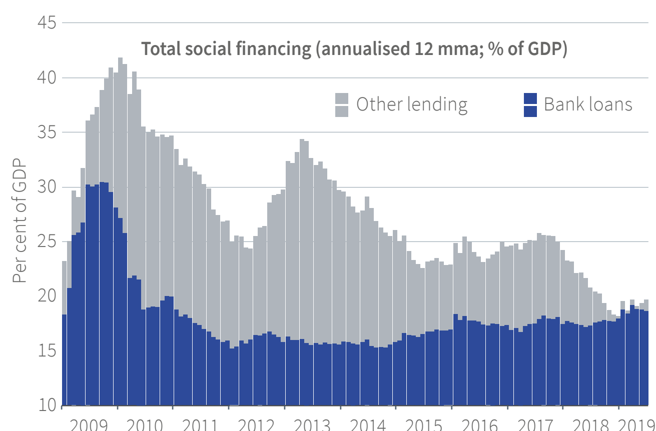
Recession not inevitable, but dangers most elevated for a decade

Figure 13. **Trade policy uncertainty in unprecedented territory**
Has only become a major issue since Trump was elected



Source: Aviva Investors, Macrobond, as at 27 September 2019

Figure 14. **China stimulus rising once more**
Earlier tightening is now being reversed



Source: Aviva Investors, Macrobond, as at 27 September 2019

Liquidity challenges

Ample market liquidity may be a thing of the past

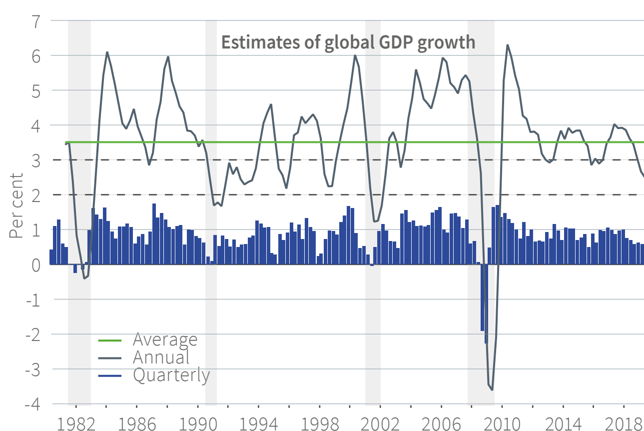
One of the unintended consequences of the GFC and its aftermath has been a marked reduction in liquidity in key markets. As a result of the imposition of a range of regulatory measures and restrictions, the coverage and depth of market-making has been compromised and diminished, adversely impacting the 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 and European politics

Populism and messy politics are having an impact

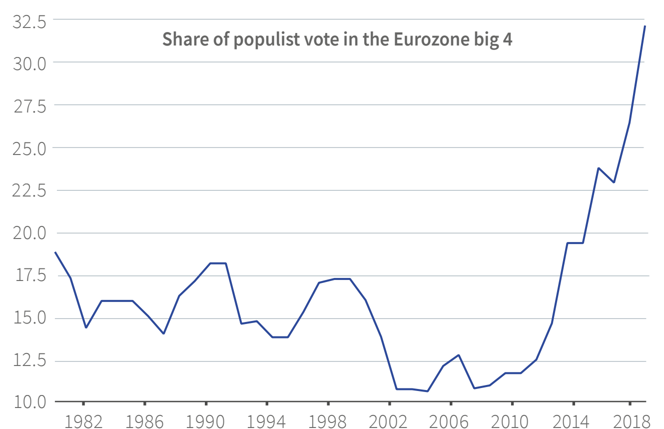
The change of leadership in Britain has altered Brexit dynamics, but not the fundamental issue of stalemate with the EU. Initially the hard-line approach adopted by PM Johnson had raised the probability of a No-Deal exit, but the subsequent political logjam and passing of the Benn Act has probably reduced it again. Nevertheless, the risk remains and is, it should not be forgotten, the default. The uncertainty of the outcome has impacted sentiment and activity in the UK already, but the threat of more turmoil and contagion is very real. A No-Deal exit would be even more damaging and would hurt Europe too. More generally, Brexit is just the most pressing example of the thrust of populism and discordant politics that has emerged in recent years (Figure 16). But there are others: Italy still looks vulnerable, while the possibility of disruptive election results in Spain and Germany is a genuine threat.

Figure 15. **Global growth has slowed significantly**
Threat of recession (shaded areas for the US) has risen



Source: Aviva Investors, Macrobond, as at 27 September 2019

Figure 16. **Populism is popular**
After the GFC, politics in Europe has splintered



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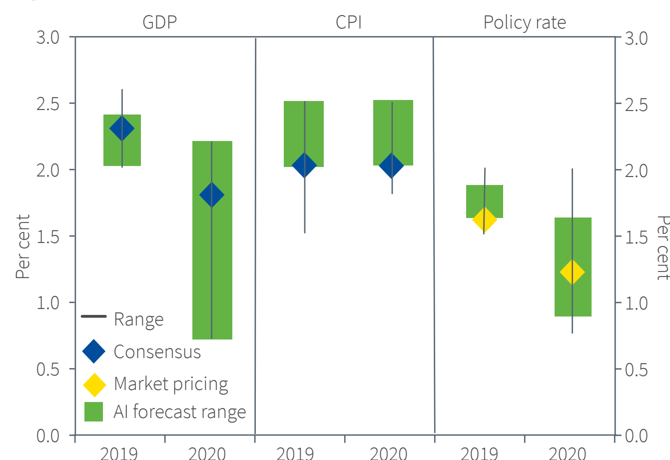
Macro forecast charts and commentary

US

The US economy has slowed through 2019 as the global weakness in manufacturing and trade has spread. That weakness follows the further escalation of the economic conflict between the US and China. It has been accompanied by higher inventories, reduced capital expenditure plans and slower employment growth – consistent with a negative demand and confidence shock. However, the consumer has been resilient, with strong disposable income growth supporting consumption and the non-manufacturing sectors. Looking ahead, the extent of the slowdown will be a function of the trade war, the response of the Federal Reserve and the resilience of the consumer. We expect the Fed to cut rates once more in 2019 and again in 2020. We do not expect a recession, but see the risks tilted in that direction.

Figure 17. **US**

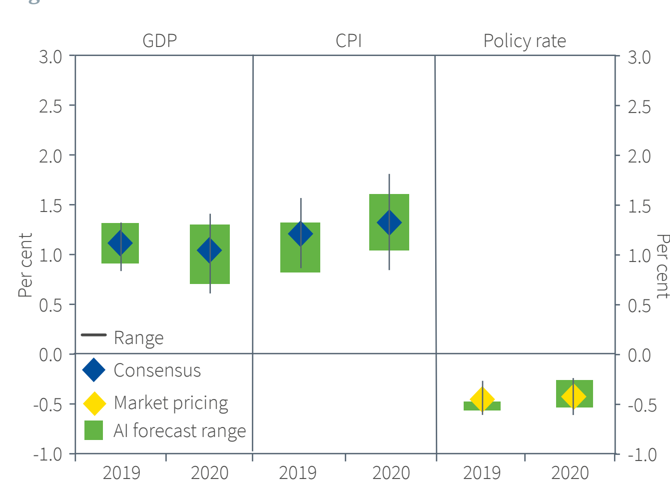


Source: Aviva Investors, Macrobond, as at 27 September 2019

Eurozone

After the upside surprise in Q1, Eurozone GDP growth slowed sharply in Q2 to a below-trend pace and there are no signs of any noticeable pick up in Q3. The malaise in the manufacturing sector has got incrementally worse, largely because of the slump in global trade which has hurt exports. More worryingly, there are limited signs that weakness is being transmitted to the more domestically focused service sector which, until now, has remained reassuringly resilient. In contrast to many businesses, households are still reasonably upbeat, while some money and credit indicators have improved modestly. Nevertheless, the additional stimulus promised by the ECB is warranted, especially as inflation – to which they have now directly linked monetary policy – is still troublingly low. Fiscal policy should also lift demand at the margin, but is unlikely to be a game-changer.

Figure 18. **Eurozone**

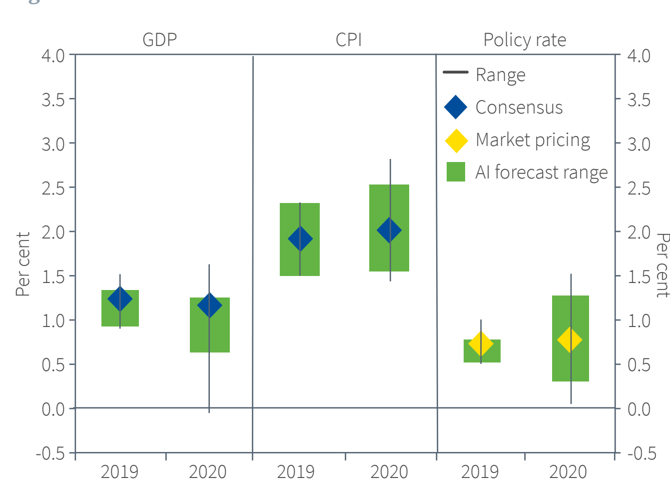


Source: Aviva Investors, Macrobond, as at 27 September 2019

UK

The drop in GDP seen in Q2 may not be repeated in Q3, but growth in the UK remains worryingly weak. Alongside the headwinds to exports from the recent stagnation in world trade, sentiment at home is being hurt by the Brexit turmoil. Unsurprisingly, this combination has already impacted business investment as companies have held back on discretionary capital spending because of the uncertainty. Such expenditure may not have collapsed, but it has dipped in five of the last six quarters and looks set to fall further. If employment growth also slows, or even reverses, as some surveys suggest (especially in the event of a No Deal exit), then growth could slow much more. Binary Brexit outcomes make it difficult to forecast macro variables as they are so path dependent.

Figure 19. **UK**



Source: Aviva Investors, Macrobond, as at 27 September 2019

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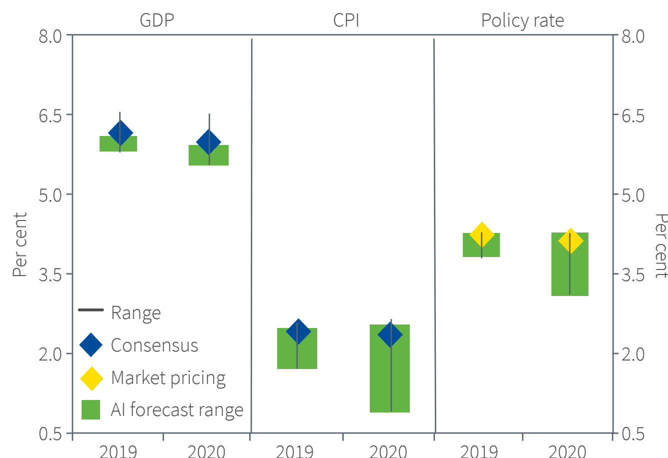
China

Policymakers have reacted to the imposition of increased tariffs and the global slowdown with renewed fiscal stimulus and liquidity measures. Growth is still moderating towards 6.0 per cent going into 2020, and trade will continue to be a drag. The USDCNY exchange rate was allowed to depreciate 6 per cent, to above 7.0; this will cushion the trade war's impact for exporters but also weaken Chinese demand for the rest of the world's goods. For now, Chinese authorities have refrained from aggressive monetary measures, but have begun to cut the new LPR rate slowly while continuing RRR cuts; similarly, a big, leverage-fuelled infrastructure binge or property boom is not on the cards. A minor trade deal is a possibility, but full de-escalation is extremely unlikely given political constraints in both Beijing and Washington; this will crimp investment and business sentiment, and negative PPI inflation is an inauspicious omen for industrial profits, which will follow suit.

Figure 20. **China**

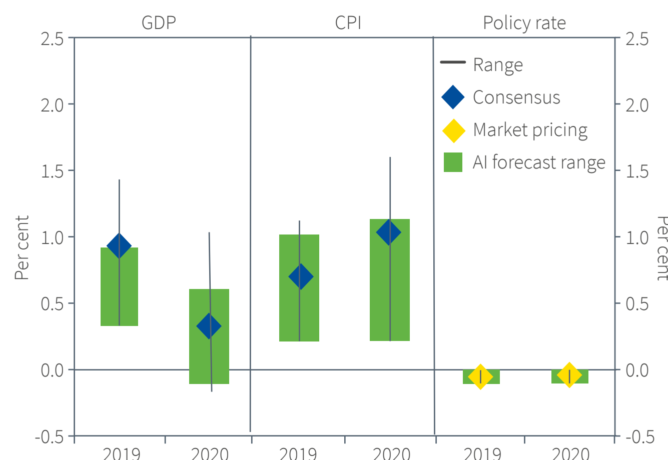


Source: Aviva Investors, Macrobond, as at 27 September 2019

Japan

With weakness in world trade persisting and the Abe administration pressing ahead with the consumption tax hike, the risks of a deeper downturn in Japanese growth have risen materially. Although tax-offsetting fiscal measures and likely policy easing by the BoJ could mitigate the downside to some extent, domestic policy response may struggle to prevent yen strength in the event of a significant sell-off in global risk assets. From a policy perspective, the BoJ has a difficult choice between cutting rates and inflicting pain on banks and not cutting rates and risking an even deeper recession. They will likely choose the former. But increasingly, as in the wider world, fiscal policy may have to play a bigger role in response to the unfolding downturn. Growth is now seen at 0.6 per cent in 2019 and at 0.2 per cent in 2020, both below consensus.

Figure 21. **Japan**

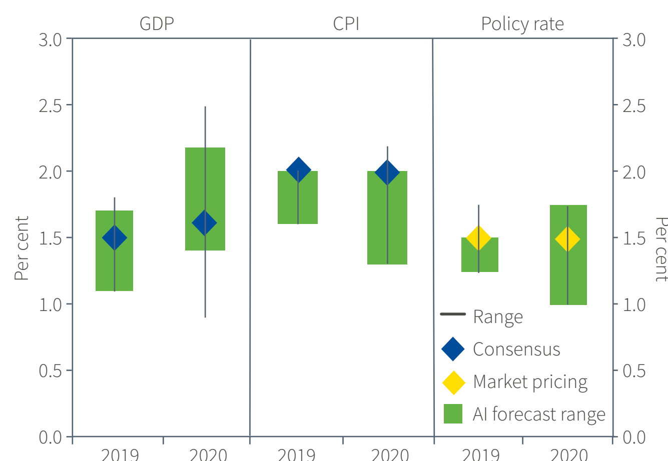


Source: Aviva Investors, Macrobond, as at 27 September 2019

Canada

The outsized 0.9 per cent rise in GDP in Q2 was largely due to a surge in exports that will not be repeated – the boost was attributable to temporary factors in the energy sector. Domestic demand actually shrank modestly as investment fell (the fourth decline in five quarters) and inventory levels were drawn down. With stock levels still high relative to output and business sentiment weaker, neither is set to pick up significantly. Consumption remains well supported by a robust labour market for now, but domestic vulnerabilities associated with high debt levels and a softening house market have grown. Stagnating global trade is hurting Canada, while any weakening in their US neighbour will also have a significant impact. The Bank of Canada is maintaining a neutral bias at present but has explicitly highlighted the growing downside risks.

Figure 22. **Canada**



Source: Aviva Investors, Macrobond, as at 27 September 2019

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Global market outlook and asset allocation

Positioning for a further slowdown

- Equity and corporate credit: EM duration to beat equities
- Developed FX – growth, policy and liquidity prop up USD
- Government bonds – positive US, Australia, and EM Local

Late-cycle, not (yet) end-cycle

Slowing growth, trade conflict, and policy responses drive our asset allocation

The market implications of our House View lead us to position portfolios conservatively, retaining a preference for duration (particularly in the US, Australia, and Canada) and the US dollar. We maintain a neutral view on equities, preferring exposure to credit and emerging market bonds. This is because global growth, having peaked in Q4 2017, continues to slow, although in the past few months the pace of deterioration has decreased. High-frequency signals (e.g. the ratio of copper to gold, orders-to-inventories, and OECD Composite Leading Indicators, shown in Figure 23) suggest no let up in the broader trend. While trade talks have resumed, risks of renewed US-China tension remain high; other conflicts, such as the Japan-Korea spat and clashes between the US and EU, also bear watching. The outlook for world trade is negative, as shown by the recent European PMIs and Korean exports. The silver lining for asset markets is a global easing cycle, with central banks across developed and emerging markets slashing rates and supporting our constructive view on bonds.

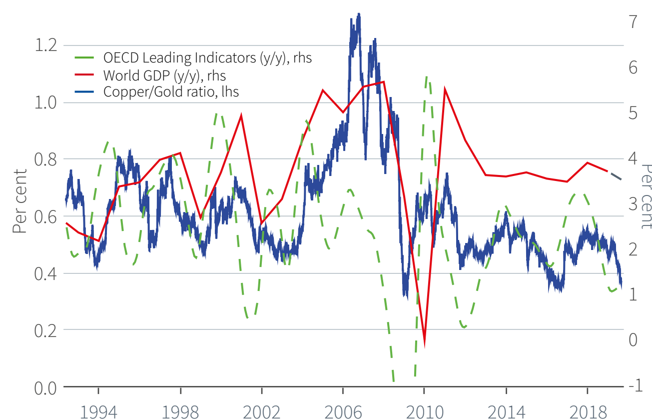
In the US, apart from the weakness in manufacturing, there has been sequential moderation in non-manufacturing growth. Moreover, national accounts data revisions were substantial, showing corporate profits from the National Income and Product Accounts recording zero growth since 2014. This means equity and credit markets are vulnerable to a drop in corporate earnings and other shocks, despite these markets' resilience to the downgrades throughout 2019.

Equity and corporate credit: selection in a declining environment

US equities to outperform EM; credit can perform well despite stagnating EPS

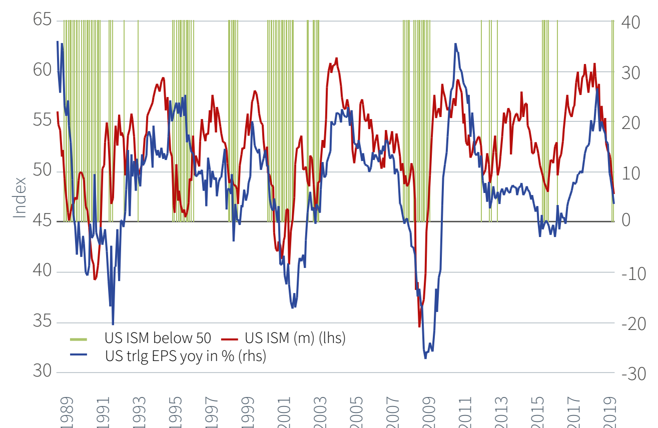
The weakness in overall earnings growth (Figure 24) and the outright negative earnings in EM keeps us neutral on global equities: valuations are "cheap" for good reason, and expectations for double-digit growth in 2020 across almost all regions are challenging, and likely to be downgraded. We overweight the US over EM, given that the outperformance of US corporates' EPS has been a good barometer for EM underperformance (Figure 25); Japan's vulnerability to China and its own weak internal growth justifies an underweight there. Given that our House View is that a global recession is neither imminent nor inevitable, we prefer to take exposure to some risky assets via corporate credit, with slight exposure to US and Euro Investment Grade and High Yield. We've upgraded Euro credit due to ECB policy that is supportive of

Figure 23. **Copper/gold ratio and global growth**



Source: Aviva Investors, Macrobond, as at 27 September 2019

Figure 24. **Weak ISM associated with falling earnings**



Source: Macrobond, Refinitiv Datastream, as at 27 September 2019

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spreads (including direct purchases through the APP), and we think bank CoCo/AT1s offer good fundamentals and a spread pickup to non-financials. However, we've downgraded US HY a notch – solely on the back of strong performance year-to-date. We expect a low default rate to continue, but spreads have come in from a peak of 537bps in January to around 370bps.

Emerging market spreads and duration are also attractive

In contrast to our wariness on emerging market equities and cautiousness on currency (see below), we have a strong preference for external credit and local duration: EMBIG spreads of 350bps are similar to HY for a "split-rated" asset class, and still far from the overvalued sub-300 spreads reached in 2013, 2014, and early-2018. Moreover, the adjustment to current accounts and weaker currencies has enabled many central banks to reverse their 2018 hikes: many are in the middle of extended easing cycles that have not yet ended, and can lead to continued bullish steepening. Duration plays we favour include China, Indonesia, and Mexico.

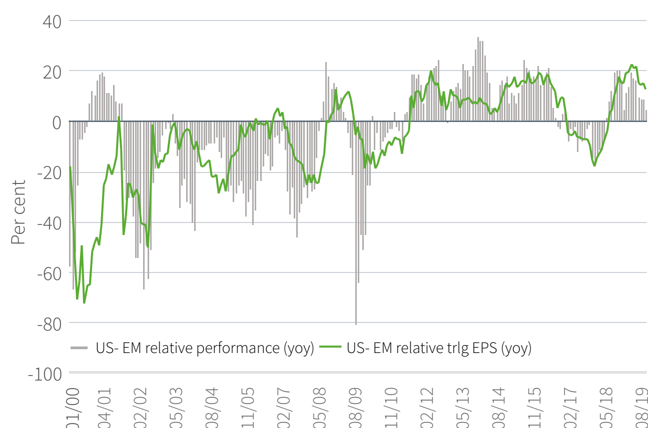
Global equity markets ended Q3 with a large "factor reversal": sizeable equity positions had been accumulated over many years in factor-driven themes such as value versus growth, cyclical versus defensive, low versus high momentum and to a lesser extent smaller versus larger market capitalisation stocks. After generating steady positive returns for long periods, these tilts had become stalwarts of many quant and hedge funds. Growth stocks have consistently outperformed value stocks since before the GFC – the longest such period since the 1970s. The resulting reversal has been quite violent in some areas of the equity market, with the "one year price momentum" factor exhibiting its two largest negative daily returns since 1984 at the start of September and many other factors recording multiple daily standard deviation moves. The proximate cause seems to have been a slight brightening of the global economic outlook and the sharp rise in yields that followed, after the strong rally in global bonds year-to-date. Continued reversal of many of these themes will likely require further support from higher rates backed by more robust economic growth, which is not consistent with our current House View. Whether in bonds or equities, we will take note of heavy positioning in "consensus" views.

Developed FX – growth, policy and liquidity issues prop up the US dollar

USD and JPY should outperform trade-sensitive EUR and "commodity" currencies

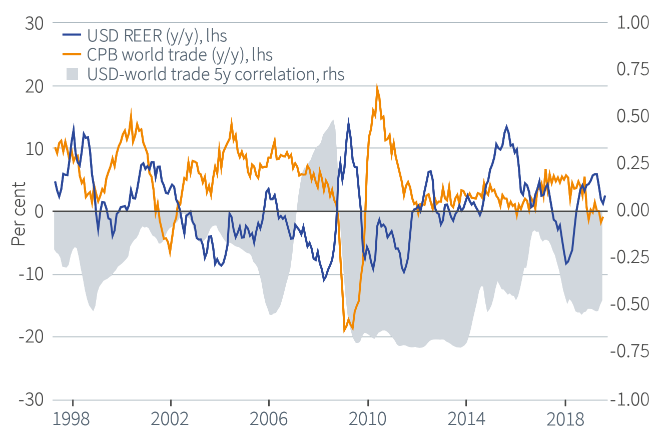
The multiple global risks have continued to have an outsized impact on non-US economies. Recently, domestic US data (housing market, non-manufacturing activity indicators) have surprised to the upside, with few signs of stabilisation in much of the rest of the world. This is the core reason why Aviva Investors' outlook for the US dollar remains bullish – periods of weak global trade growth have historically come alongside a strong US dollar, and so far this episode has been no different (Figure 26). From a policy perspective, the relative monetary-policy outlook (the Fed versus the rest) is USD supportive, even as high US rates have more room to decrease. The ECB has embarked on another round of QE to accompany a rate cut, while the PBoC has cautiously eased policy via RRR cuts. If the extent of policy easing priced into USD money markets proves excessive, this would push the dollar higher.

Figure 25. **EM equities outperformance follows relative earnings**



Source: Aviva Investors, Macrobond, as at 27 September 2019

Figure 26. **US and world trade volumes**



Source: Aviva Investors, Macrobond, as at 27 September 2019

Thirdly, the recent funding-market stresses, if not contained effectively, could also spur dollar appreciation. Despite the two rate cuts by the Fed, the erosion of the dollar's yield advantage has not been large, especially in volatility-adjusted terms.

Among G10 majors, the euro is likely to depreciate once a post-ECB positioning clear-out is behind us. Apart from policy divergence, European data is showing limited signs of the slowdown bottoming. Risk of a recession in Germany remains high as manufacturing slumps. The yen, on the other hand, will likely be a regional and global outperformer as sentiment deteriorates into year-end and due to escalating geopolitical issues such as Saudi-Iran tensions and Brexit. By the same token, the Australian dollar, Asian currencies such as the Korean won, and trade-sensitive EM currencies are likely to be underperformers.

Government bonds – mini tantrum episodes unlikely to change outlook

Government bonds remain a bulwark, "mini-tantrums" notwithstanding

The challenging global growth backdrop means that any "mini-tantrum" sell-off in government bonds will be ephemeral. The decline in long-end yields since the end of July resulted in excessive positioning, but the subsequent retracement proved short-lived. In recent years, it has often been seen that when anticipation of a QE announcement is high, bonds tend to rally aggressively in the lead-up to the QE (the "rumour") but sell off briefly after the "fact" of the programme. While fiscal support for economies is an important theme of our House View, it is moderating a slowdown rather than sparking a renewed reflationary expansion as in 2017-18, and so fiscal pressure on bond yields or term premia is minor – though in many cases we observe swaps are outperforming cash bonds.

Indeed, bonds yields of major government bond markets have been pinned down by low growth, and indicators such as the global manufacturing PMI continue to show signs of contraction (Figure 27). Forward-looking indicators of the global industrial cycle, such as China's credit programmes, do not point to an imminent recovery in manufacturing PMIs.

There have been recent worries about a spike in US inflation, with core inflation rising to the highest level since 2007 in year-on-year terms. However, core inflation has historically tended to track the path of growth with a lag of 18 months to two years. With growth moderating, it is unlikely that core inflation will surprise to the upside for too long. All in all, it remains a supportive environment for bonds, despite their low yields.

Figure 27. **US Treasury yields and global manufacturing PMI**

Source: Aviva Investors, Macrobond, as at 27 September 2019

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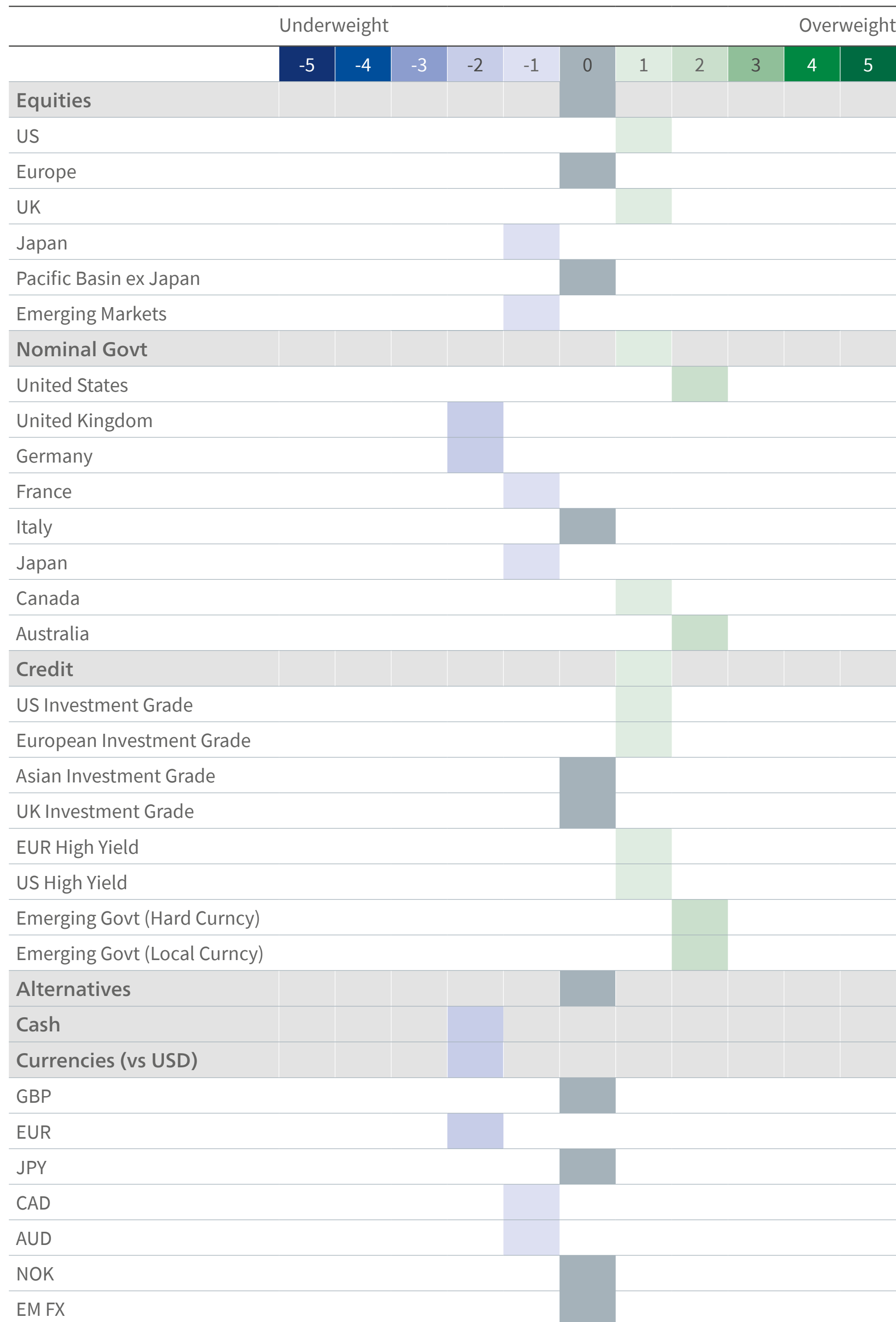
Figure 28. **Asset allocation**



	Underweight										Overweight
	-5	-4	-3	-2	-1	0	1	2	3	4	5
Equities						■					
US							■				
Europe						■					
UK							■				
Japan					■						
Pacific Basin ex Japan						■					
Emerging Markets					■						
Nominal Govt							■				
United States								■			
United Kingdom				■							
Germany				■							
France					■						
Italy						■					
Japan					■						
Canada							■				
Australia								■			
Credit							■				
US Investment Grade							■				
European Investment Grade							■				
Asian Investment Grade						■					
UK Investment Grade						■					
EUR High Yield							■				
US High Yield							■				
Emerging Govt (Hard Curncy)								■			
Emerging Govt (Local Curncy)								■			
Alternatives						■					
Cash				■							
Currencies (vs USD)				■							
GBP						■					
EUR				■							
JPY						■					
CAD					■						
AUD					■						
NOK						■					
EM FX						■					

Source: Aviva Investors, 27 September 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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