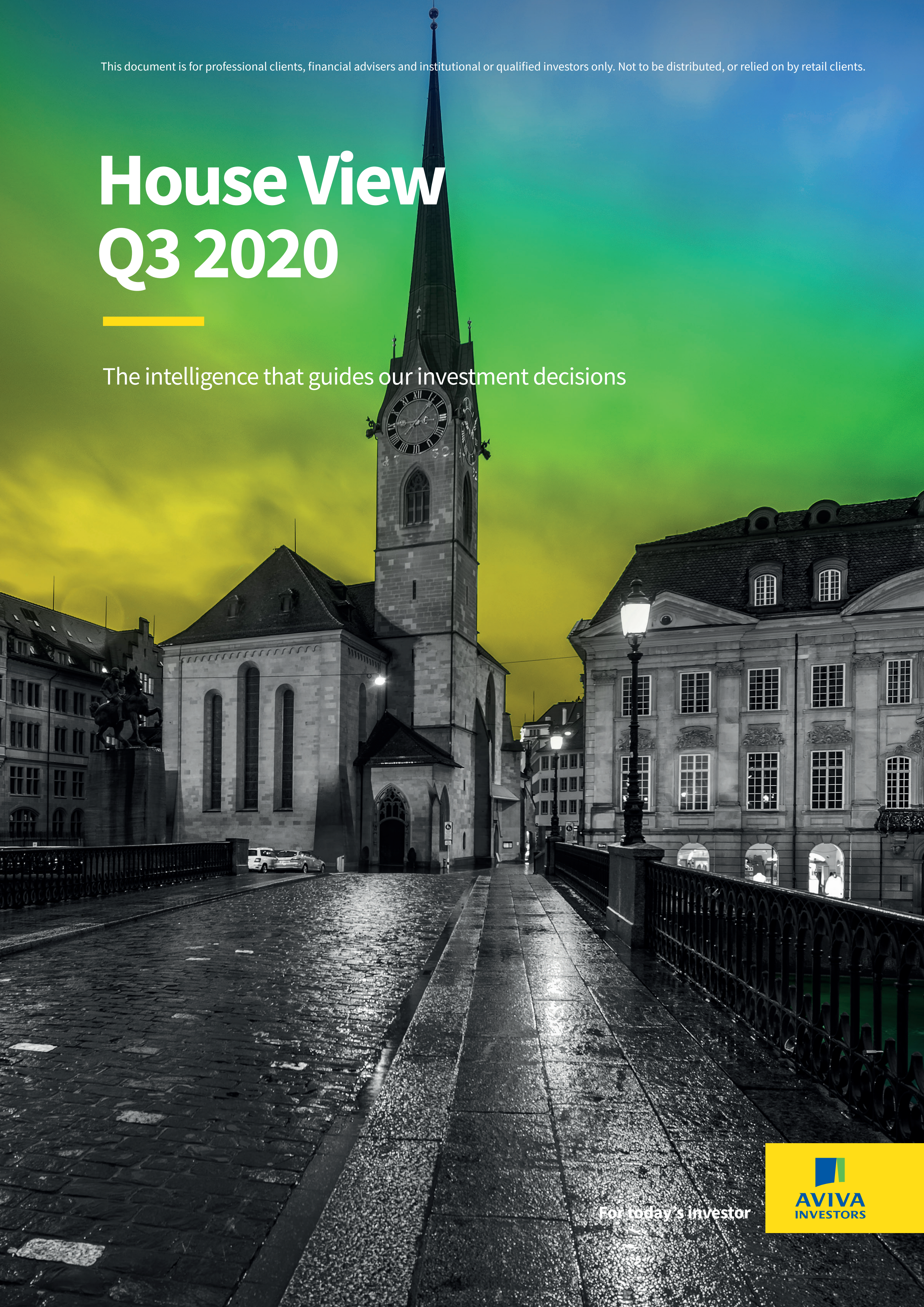
House View Q3 2020

The intelligence that guides our investment decisions



For today's investor

AVIVA INVESTORS

Contents

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

Finding the new "normal"

The COVID-19 pandemic continues to dominate the outlook for the global economy. Measures taken earlier in the year to lockdown most economies greatly helped to slow the spread of the virus and reduce the potential number of associated deaths. While effective in managing the healthcare crisis, those same measures had an immediate and debilitating impact on economic activity. Most economies are expected to see declines of between 10-25 per cent in activity in 2020 Q2. In order to support households and businesses through that, there has been an equally rapid and sizeable set of fiscal and monetary policy measures put in place. These measures have been primarily designed to support the income of households where individuals have either lost their job or have been furloughed. In addition, government loan guarantee schemes for businesses have been deployed to bridge the period in which revenues are severely impacted. At the same time, central banks through their asset purchases have acted to stabilise financial conditions and ensure no unnecessary tightening due to the additional government issuance that has accompanied the fiscal support. These policy measures have undoubtedly averted an even greater economic crisis.

Measures to avert a public health crisis have had significant impact on activity, with extensive fiscal and monetary policy support helping to bridge that decline in activity

As the spread of the virus slowed, most governments began in either May or June to remove some of the restrictions on economic activity. As anticipated, initial indicators for that period suggest a significant bounce-back in economic activity. That reflected both the ability of businesses to re-open and the pent-up demand on the part of households following the period of restricted spending. However, as we look ahead to the second half of 2020, a great deal of uncertainty remains around the likely path for economic activity.

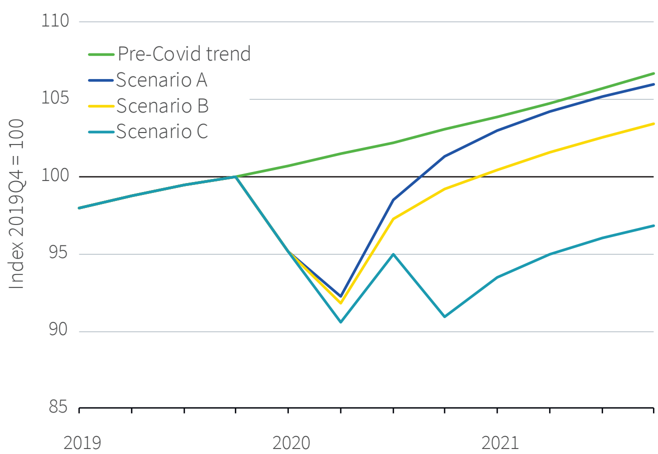
Economies have rebounded, but significant uncertainty remains around the outlook

First, the spread of the virus has slowed in most developed market economies but has been much less effectively managed in the emerging markets. Moreover, those developed market economies that experienced a more significant spread of the virus earlier in the year (such as Italy and the UK) are generally taking longer to remove restrictions and therefore experiencing a slower recovery. While some economies that re-opened before the number of new cases had materially fallen (such as the United States) are seeing a resurgence of new cases, putting at risk the ability for the economy to recover, or potentially leading to a further downturn. Box A on page 5 provides more detail of our current view on the outlook for the virus. Second, while the policy support has been vast, it is unclear how cautious households and businesses might be until, say, a vaccine is found. Fears about future outbreaks and the potential impact on jobs and demand may result in an increase in precautionary savings and a material reduction in investment spending. Third, there may also be a range of economic activities that are simply judged to be too risky to participate in (e.g. travel-related activities) for some time. While households may switch some of that expenditure to other goods or services, it may take some time for the economy to adjust to that new "normal". However, it is also possible that the spread of the virus slows through time, that better management of healthcare can minimise mortality rates and that recent promising signs that an effective vaccine could be ready sooner than originally anticipated bear fruit, allowing economies to return to normal. If that were to be the case, when set alongside the monetary and fiscal support, activity could quickly return to the pre-Covid trend.

Downside risks include further outbreaks, higher saving and changed behaviour until a vaccine is found

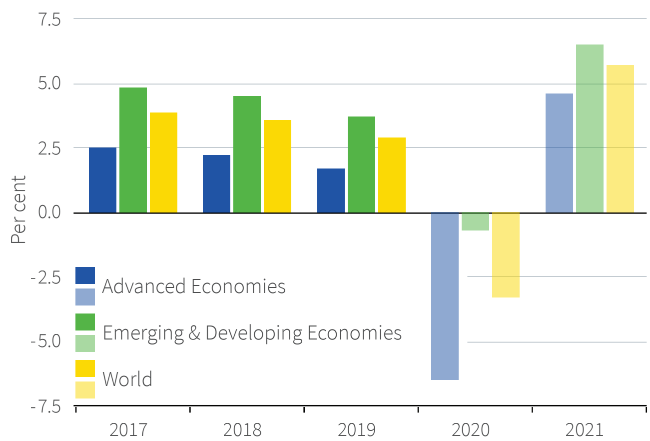
But there are possible upside surprises as well

Figure 1. **Uncertainty about the economic outlook remains elevated**
Scenarios for the level of global activity



Source: Aviva Investors, Macrobond, as at 25 June 2020

Figure 2. **Global growth projections based on Scenario B**



Source: Aviva Investors, Macrobond, as at 25 June 2020

Given the uncertainty, we have developed three scenarios, with the central one (scenario B) considered most likely

We have developed three economic scenarios that we think capture the range of possible outcomes over the next 18 months (Figure 1). Of these possibilities, we think that Scenario B is the most likely (i.e. with a probability of greater than 50 per cent), with a roughly equal view of the probability of Scenarios A and C. In our central scenario, we expect a fall in global growth of around 3.3 per cent in 2020 (the first calendar-year decline in the post-war period), followed by a rebound of around 5.7 per cent in 2021 (Figure 2).

Other major market themes include renewed strategic competition between the US and China and the upcoming US elections

While much of the focus remains on the ongoing impact of COVID-19, we have also identified several other important themes that we expect will drive economic and market outcomes such as strategic competition between the US and China and the upcoming US elections. In addition, we have identified a number of downside risks, including the potential fiscal cliff that may follow from the recent COVID-19 support measures, the balance-sheet vulnerabilities that have increased as a result of the crisis, as well as potential upside risks such as improved European political and economic unity and emerging inflation. More details on these key themes and risks can be found on pages 6-12.

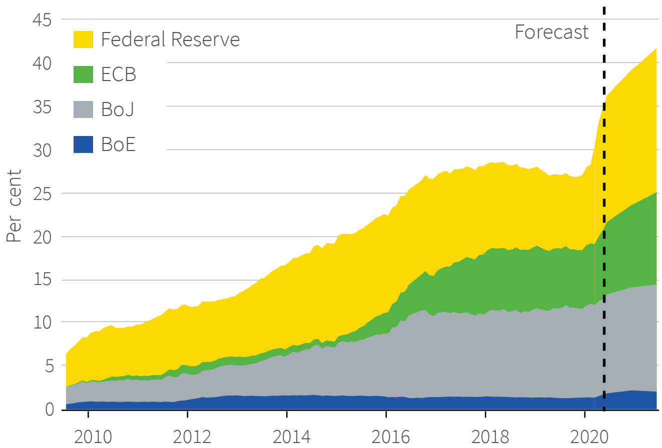
Risky assets have recovered from the sharp sell-off in March, while risk-free rates have hit all-time lows across the world

While risk assets initially reacted very negatively to developments in the COVID-19 crisis, there has been a sharp rebound in equity indices, which across the major regions at the end of June were down only 5-10 per cent year-to-date. With the deep downward revision to the corporate earnings outlook for 2020, that has resulted in some 12-month forward price/earnings valuations reaching multi-decade highs. Looking at earnings expectations for future years, a rapid recovery is expected, and perhaps has led some investors to “look through” the deeply negative earnings impact felt in 2020. In addition, some companies and sectors are seen to benefit from the changes that have come from COVID-19, such as the more rapid adoption of technology across a range of activities. Credit spreads have also narrowed significantly from their widest point in March, although remain elevated compared to the pre-Covid period. The recovery in risk assets is also likely to be a function of both the direct and indirect support from central banks. Purchases of government bonds (Figure 3) have helped to suppress risk-free yields, while purchases of risky assets, such as investment grade, and even high-yield, credit has supported those assets. This support likely also has an indirect impact on other asset classes as liquidity makes its way through the system and private investors are pushed out along the risk spectrum.

Given current valuations and the balance of risks, we prefer to be somewhat underweight global equities, moderately overweight investment grade credit and modestly overweight US government debt

Given the combination of stretched valuations and the elevated risks to the economic outlook from the COVID-19 crisis, we prefer to be modestly underweight global equities (Figure 4). With somewhat more attractive valuations, and direct support from central bank purchases, we prefer to be moderately overweight credit, with a preference for US and European investment grade. We have a more neutral view on high yield and emerging market debt. In terms of duration, we prefer to be modestly overweight, with a preference for the US, where there remains some scope for further decline in yields, with an underweight in core European markets. We also prefer a modest overweight to Italy, with the recent developments around the European Recovery Fund and other European fiscal and borrowing measures helping to solidify the solidarity of the bloc. Finally, within currencies we have a preference to be overweight the euro against the pound given the positive fiscal developments noted above, while at the same time the UK continues to find negotiations on a Brexit deal challenging. More details on our market outlook and asset allocation views can be found on pages 15-18.

Figure 3. **Central bank balance sheet expansion**
Asset purchases of big 4 central banks as a share of aggregated nominal GDP (USD)



Source: Aviva Investors, Macrobond, as at 25 June 2020

Figure 4. **Asset allocation summary**

	Underweight										Overweight
	-5	-4	-3	-2	-1	0	1	2	3	4	5
Equities				-2							
Nominal Government							1				
Credit									3		
Cash				-2							
Currencies (funded by USD)						0					

Source: Aviva Investors, Macrobond, as at 25 June 2020

Box A: COVID-19 – where to from here?

One of the challenges of trying to make market assessments at the present is the uncertainty around how the COVID-19 pandemic will progress.

When the last House View was published, comparatively little was known about COVID-19. As we enter the second half of the year, many questions remain to be answered; however, the degree of uncertainty is several orders of magnitude lower. Lessons learnt have been both positive and negative as the true nature of the virus has not followed either of the wings of the distribution of outcomes that seemed possible three months ago. On balance, the news has been positive despite daily confirmed infections currently being at their highest. The largest positive is that despite doubts, the virus is containable with focus and determination.

As the last House View was published there was considerable concern that without the adherence to rule available to an authoritarian regime, once high local transmission became established the best that could be hoped for would be a flattening of the infection curve. These fears have been allayed by the actions of governments across Europe which have not only implemented lockdowns but have maintained their resolve to continue them until virus levels were suppressed to very low levels. So far, the tentative steps of reopening economies have not resulted in uncontrollable infections as ramped up testing, infection tracing and improved treatment protocols have been sufficient to contain spikes in infection. Many parts of Asia such as South Korea and Taiwan are most advanced on this reopening, offering an example to follow for those parts of the world which have more recently started this process. Part of this achievement must be put down to changes in behaviour globally as populations have adapted to infection risk. Across the world we now see estimates of R (the reproduction number, or the average number of people one infected person will transmit the disease to) in a fairly tight band of between 0.5 and 1.5 despite very differing policies. This reduces the threat of sudden breakouts materially from the environment of the first quarter where R was in the region of 3-5 in many countries and delays of action of only a few days could see infection levels double or more.

It has not been all positive news though. The US had appeared to be following the pattern of many European nations in acting to suppress infection levels which had reached crisis levels in the North East of the country. However, after initial success, we have seen a split in policy with many states reopening swiftly and without following the reopening guidance that the White House Covid task force had laid out. This has resulted in a renewed rise in infections with several states of particular concern. The lower levels of R we now see delay the arrival of crisis, but if current trends remain in place, several states will approach limits of hospital capacity over the coming months with several states in the south appearing high risk.

There is significant resistance to the idea of reinstituting lockdown measures, but at this point we have no experience of the effectiveness of other policies when relied upon at high levels of infection. Should the level of excess death start to accelerate towards levels seen in NY state in early Q2, without effective action from authorities the impact on society is unclear. Given successes elsewhere it would appear unlikely that infection levels beyond the capacity of the health system to treat will be acceptable on an ongoing basis in any developed country. What we would expect though is that responses will be far more localised from here and national lockdowns are unlikely to be favoured. Outside of the US the main concern is emerging economies. It appears that the cost of failing to contain infection at the point of initial introduction carries a greater cost for emerging countries who struggle with the fiscal strength and infrastructural framework required to implement extended lockdowns. This has seen much of South America, India, Pakistan and others with high and growing levels of infection, with governments appearing powerless to control the spread.

Key investment themes and risks

Ongoing impact of COVID-19

Lockdowns have created huge distortions to macro data

The near- and longer-term impact of the COVID-19 crisis, and society's response to it, is expected to continue to have a major impact on economic outcomes, investor sentiment and financial market reactions. Box A on page 5 gives our latest thoughts on the possible evolution of the virus itself and how governments may respond from here. Experiences have varied across countries, largely related to the spread of the virus and the timings and extent of policy reactions to it (Figure 5). The broad characterisation for countries other than China (where it all happened earlier) is of a significant hit to GDP in March, a collapse in activity in April and the beginnings of a recovery in May. June and the second half of the year should see further marked rebounds in growth. Figure 6 uses monthly UK GDP data simply as an example of the patterns we are likely to see. Many activity series will look similar to this, but note that in levels terms, we are still well below the pre-COVID-19 starting point at the end of the year.

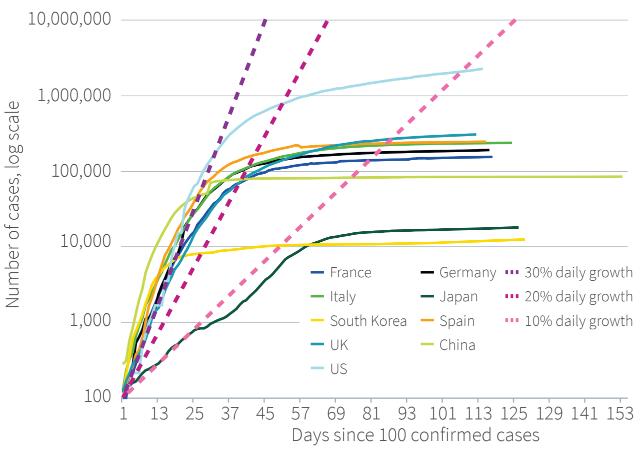
Q3 GDP should rebound significantly following collapses in Q2

In terms of the more conventional quarterly GDP numbers, this sort of pattern implies a fall in GDP of between 1 per cent and 5 per cent in Q1 (these data are now known but may yet be revised), before an estimated decline of 6 per cent and 18 per cent in Q2. These sorts of numbers are simply unprecedented, easily the largest declines since the Great Depression and quite possibly ever. Uniquely, the collapses in output and demand are almost entirely self-inflicted, a direct result of the lockdown measures imposed by Government. As those are now being eased, we will witness a resurgence in GDP on a scale that will also be without precedence. Q3 is likely to witness quarterly increases in GDP of between 5 per cent and 15 per cent in the major developed nations. While any such rebound is, of course, welcome, it needs to be emphasised that these sorts of numbers will not be sufficient to return GDP to its pre-virus level. In our central case, that is not expected until the second half of 2021 at the earliest.

Pace of recovery is not certain

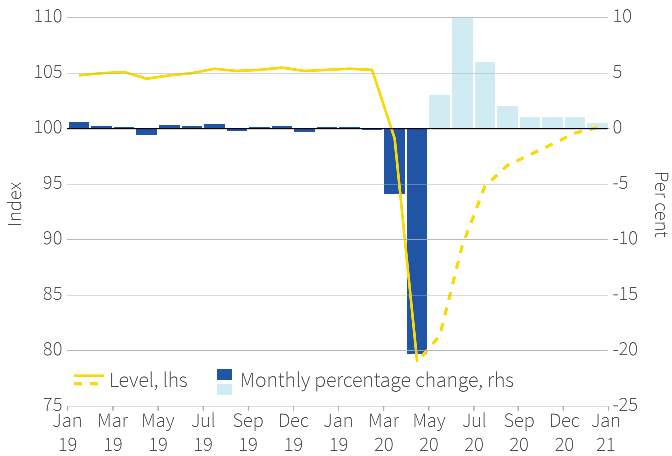
Moreover, the extent of recovery is not assured. It will depend critically on at least three factors. First, the extent to which lockdowns are eased and/or re-imposed going forward. This in turn will depend on the progress of the disease itself, as well as the political backdrop. While it remains under control, it makes good sense to relax restrictions on activity. But there are already warning signs about possible second waves or renewed up-ticks in infections. Second, despite the enormous efforts of monetary and fiscal authorities, it seems likely that there will be some long-term damage from the sudden halt in economic activity through increased long-term unemployment and business closures. Finally, attitudes and behaviours have probably changed because of the virus. In the longer term, this could mean lasting changes in the way firms operate and in the manner in which households work and spend. But in the shorter term, it could well imply greater caution and slower recoveries. With risky asset markets appearing to price in a relatively optimistic scenario, there is potential for some disappointment later in the year.

Figure 5. **COVID curves have flattened**
Confirmed cases are still rising, but more slowly



Source: Aviva Investors, Macrobond, as at 25 June 2020

Figure 6. **Moves in monthly activity data are unprecedented**
But it will take a longer time for normal service to be resumed



Source: Aviva Investors, Macrobond, as at 25 June 2020

Substantial policy support

In response to the virus, monetary and fiscal policy have both been loosened substantially. The rationale for this has been two-fold: first, to provide ongoing support for companies and individuals to allow them to survive during lockdown. Secondly, to deliver policy stimulus to help activities recover quickly as restrictions on activity are lifted. Arguably, the first has been of far greater importance during this crisis. Without state support and funding, many businesses would simply have failed, and many jobs would have been lost permanently. Fiscal support, in the form of a host of "contingent liability" support packages has tried to provide a form of bridging finance to companies and individuals as the public sector absorbs risks that the private sector cannot in current circumstances. Unwinding this support when the time comes will be no easy matter.

Unprecedented scale of fiscal and monetary policy response

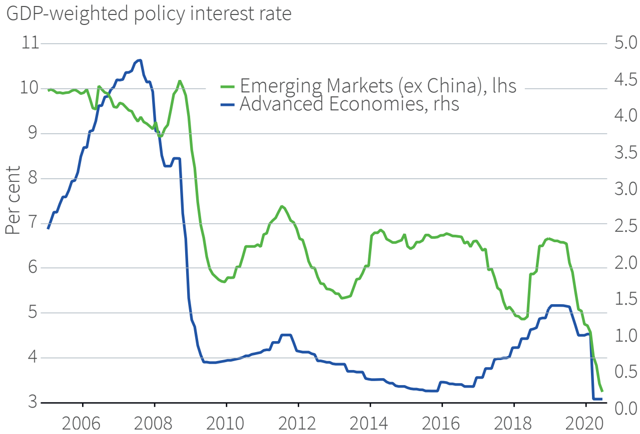
In this era of independent central banks, it has been quite normal for monetary and fiscal policies to work to entirely separate agendas. Both should respond to the needs of the economy, but that assessment may well be different for a government and for an inflation-targeting central bank. But in the current episode, it has been vital that the two policy elements at least act in tandem, if not in full coordination. Different countries or regions have approached this issue in different ways. In most cases there is a close correspondence between the additional debt issuance planned by Government and the additional purchases planned by the central bank. It may not be monetary financing of deficits per se, but it does not look that different. In the particular case of the Eurozone, we have seen a combination of bold initiatives – prompt European Central bank (ECB) actions and the EU Recovery Fund for example, but also the now familiar complications emanating from divergent views from member states about the appropriate policy actions, leading to deadlock and stasis. In terms of monetary policy, interest rates have been kept at or taken back to the effective lower bound in most countries, or to new lows in some cases (Figure 7). Asset purchase programmes have been restarted and a wide range of measures have been introduced to provide liquidity and ensure that commercial banks are part of the solution to a crisis, rather than being the cause of one as they were in 2008/9.

Interest rates back to the effective lower bound....

Fiscal policy has also been loosened substantially, with budget deficits set to soar in 2020 and, perhaps, 2021 as well. The many measures introduced will inevitably lead to significantly higher ratios of public debt to GDP in short order. In some cases, this may lead to justifiable questions about longer-term fiscal sustainability, but for now such actions are critical to avert economic disaster (Figure 8). It is also vital for borrowing costs to be kept as low as possible, given the additional debt that is being taken on by the public sector. The key point is that the next year or two are virtually certain to be characterised by continued policy support. There may be pressure to ease back on fiscal measures before monetary ones (see the Risks section), but it seems highly likely that policy interest rates will remain close to the lower bound for some time yet, while central bank balance sheets will grow rapidly. During the global financial crisis, there was considerable debate about whether such "unconventional" policies were appropriate or not. This time around, they seem universally acceptable.

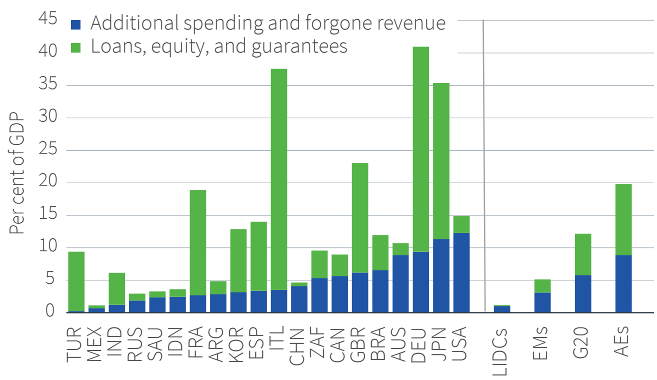
...and budget deficits and debts are set to soar higher

Figure 7. **Policy rates are back at the effective lower bound**
Close to zero in developed markets, new lows in emerging nations



Source: Aviva Investors, Macrobond, as at 25 June 2020

Figure 8. **Size of fiscal response has been enormous**
Much support takes the form of contingent liabilities



Source: National authorities; and IMF staff estimates, as at 12 June 2020. AEs = advanced economies; EMs = emerging markets; G20 = group of twenty; LIDCs = low-income developing countrie.

Long-term strategic competition

Tensions between China and the US are still bubbling away

The relentless trend towards closer integration of the global economy, that had dominated much of the post-war period, has changed over the last decade or so. Since the Global Financial Crisis, more questions are being asked about whether all aspects of globalisation are beneficial and whether a more inward-looking, potentially more uncompromising approach might be better. The main focus currently is on relations between the two largest global superpowers – China and the US – but the issue is broader than that, touching on areas such as populism in Europe, Brexit, re-shoring, international institutions and world trade flows. There have always been battles for supremacy between countries in a range of fields, and purportedly healthy competition across international borders. But the status quo is now being questioned more and more, boosted by a determined China, a single-minded US president and changing attitudes to openness in many countries. If anything, the COVID-19 crisis has intensified the "cold war" between China and the US (and may have hardened attitudes elsewhere too). It has certainly given it another dimension. Prior to it, there had been some significant, if stuttering, progress towards a phase 1 deal that seemed to have partially defused trade war concerns. But hostilities have resumed, with President Trump making political capital where possible by referring to the Chinese virus and accusing China of not taking adequate steps to control the disease or to be honest about its origins. Although lip service is paid to the building of bridges and the forging of new relations between the two countries, both parties have more self-interested ambitions.

Constructive resolutions to differences are possible, but far from inevitable

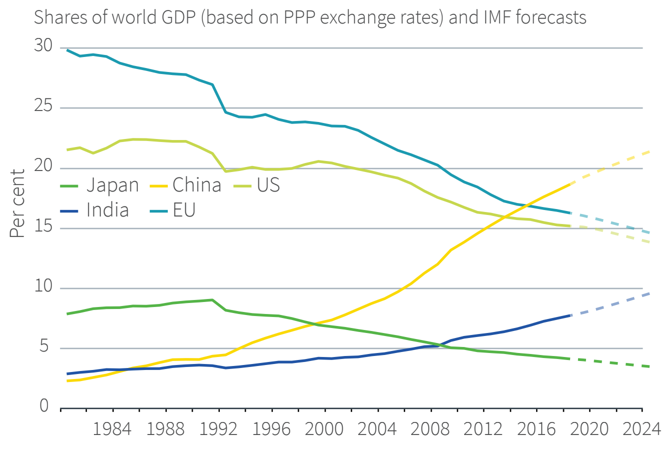
Coming years are likely to be characterised by increasing strategic competition, largely related to Sino-US dealings, but quite possibly including several other nations as well. As we stated at the start of the year, it would be naïve to believe that US and China differences in areas such as trade, technology and international relations can be quickly resolved. But it is not unreasonable to think that some agreements can be reached over time and that pathways towards more harmonious trading arrangements and the greater inclusion of China in free market commerce can be sketched out. However, such a congenial outcome is far from inevitable and many believe instead that a more antagonistic positioning is more likely. How this pans out over the next few years will help frame the boundaries of the new world order and will be a key driver of both economies and financial markets.

There are many areas of potential dispute between China and the rest of the world

There are many critical aspects to this theme. They include the future treatment of China technology firms (Huawei perhaps the most important), China's relations and influence in both Taiwan and Hong Kong, any initiatives aimed at addressing China's human rights violations and any issues relating to the virus itself including the COVID-19 Accountability Act in the US. One key dimension will be how the US election result drives the form of the future relationship between China and the US. More generally, nations other than the US are likely to play a more significant role in determining the free market constraints within which China will be permitted to operate. This is not an attempt to dictate separate rules to control China, but rather to ensure that it is brought into line with internationally accepted rules and practices.

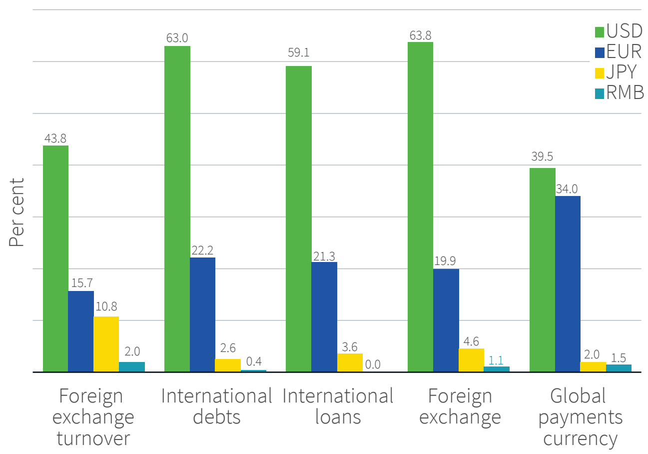
Figure 9. **The world is changing**

US is shrinking in relative importance, while China is growing



Source: Aviva Investors, Macrobond, as at 25 June 2020

Figure 10. **Share of USD and other currencies in the International Monetary System**



Source: Eichengreen and Xia (2018)

US election

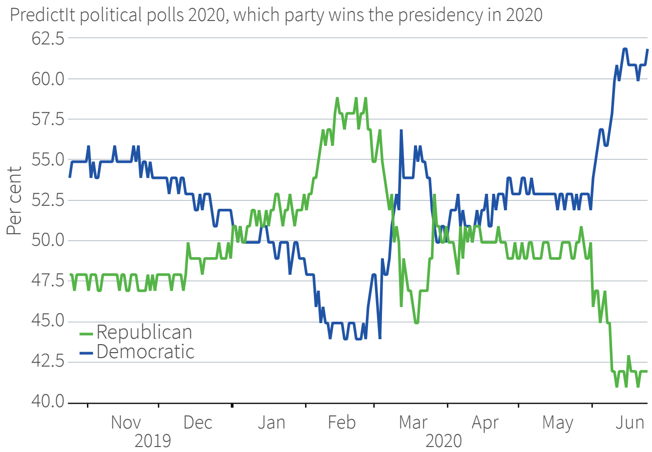
With five months to go until election day (3rd November), polling data in the US has shifted significantly in favour of the Democratic candidate Joe Biden. Just four months ago, Trump's chances of a second term looked better than ever. His impeachment trial ended in an easy acquittal, his approval rating was as high as those that saw both Obama and the younger Bush re-elected, the economy was doing well and the divisive Bernie Sanders was riding high in the democratic primaries. The plunge in Trump's fortunes has been attributed to a combination of the remarkable resurgence of the generally well-regarded Biden, the inept handling of the COVID-19 crisis, the immense damage to the economy resulting from lockdown measures (rising unemployment, collapsing GDP) and a liberal surge in the wake of the George Floyd killing and rise of the Black Lives Matter movement (Figure 11). Despite this, there is still a battle to be fought and much can change between now and November. Arguably, one of the more important developments will be the impact of any recovery of American GDP in Q3 and beyond. Bill Clinton's chief strategist famously quipped in the 1992 election campaign (when Bush senior was unseated), "it's the economy, stupid", judging that economic weakness would persuade voters to shift their loyalties. But if the economy does revive, will voters respond to that positive momentum or to the disasters of recession, lower stock prices and the highest unemployment rate since the Great Depression? It is hardly surprising that the single-minded Donald Trump is keen to get the US economy re-started as soon as possible.

Polling trends in the US have changed significantly over the last four months

As we pointed out at the end of 2019, the Republican party is generally believed to be the more market-friendly choice, but the selection of the "moderate" Biden over the "progressive" Sanders or Elizabeth Warren has removed a substantial part of the tail risk from a more radical, reformist agenda after a Democrat victory. There had previously been understandable fears over higher wealth and income taxes, greater regulation of business and even the break-up of some corporate empires. If the Democrats were to win, there may be some smaller biases in those directions, but perhaps not enough to roil financial markets unduly. Nevertheless, there is still a battle to be fought and Trump is unlikely to go quietly. If he continues to trail in the polls, he may take extreme steps himself. Whatever happens, the US election is likely to become an increasingly important driver of markets in the run-up to the event itself and in its immediate aftermath: will we be looking at how Trump will try and fashion his legacy, or at the post-Trump era? Could the Democrats take control of both the House and the Senate (Figure 12)? There are many, many aspects to this issue, but one of the more interesting (linking back to another of our themes) would be the US-China geopolitical relationship. China might be happy with the way that Trump has disrupted internationally coordinated diplomatic efforts to tame them, but less keen on the collapse of the global trading order that has materialised. On the other hand, a Democratic administration might be even tougher on China, and include their questionable human rights record. Moreover, Biden's team might be more effective. It is not clear who China might prefer.

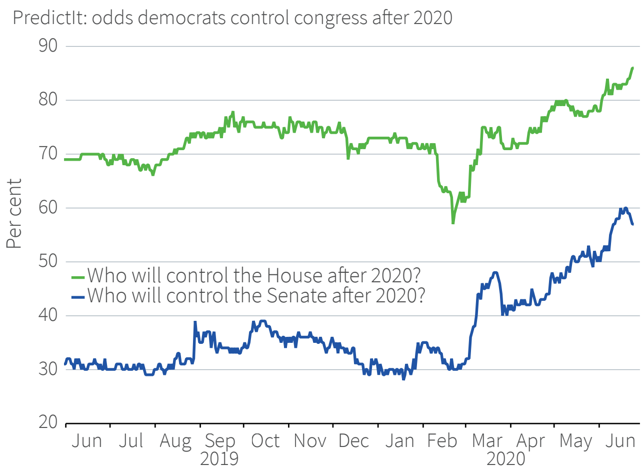
A Democratic agenda may not be as radical as previously feared, but is still unlikely to be as business-friendly

Figure 11. **Big change in Trump's polling since February**
Biden is now convincingly in front



Source: Aviva Investors, Macrobond, as at 25 June 2020

Figure 12. **Democrats could make a clean sweep**
They expected to control the House; the Senate now looks possible too



Source: Aviva Investors, Macrobond, as at 25 June 2020

Risks

Downside

De-globalisation accelerates

Greater insularity from several nations is plausible

The “golden era” of globalisation may be behind us (Figure 13), but the world economy is still expected to engage in mutually beneficial trade and to practice international specialisation. However, a downside risk is that a drive towards de-globalisation, that began for many nations in the wake of the GFC, intensifies after the COVID-19 crisis. The Trump tariffs represented a key step in this direction, but there were already rumblings of heightened nationalism and protectionism in other countries too. Compounding these trends, the virus has exposed some of the vulnerabilities from global supply chains and encouraged some nations to reconsider their international strategies. A return to the damaging “beggar-thy-neighbour” policies of the 1930s is unlikely, but a wave of more inward-looking policies seems quite plausible. A hard Brexit is just one possible example of this type of development.

Fiscal cliffs

Worries about fiscal sustainability could lead to sudden changes in policy stance

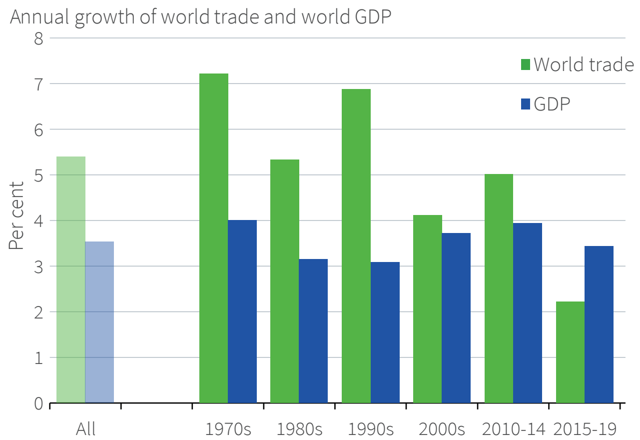
Huge packages have been put in place around the world to support companies and individuals during the lockdown periods so that they can return to normal activity as and when restrictions are lifted. The scale of this fiscal largesse is unprecedented and is already leading to soaring budget deficits. To give just one example, public sector net borrowing in the UK totalled £48bn in the financial year ending in March this year. It then amounted to an additional £48bn in April alone and a further £54bn in May. The OECD estimates that the budget deficits will soar (Figure 14) and the average increase in public debt because of the crisis will be 18 per cent of GDP (more if there is a second wave). As lockdowns are eased, political pressure is already growing in some quarters to start to address this through the removal of fiscal support (e.g. in the UK the planned reduction of the employee furlough support scheme, and in the US the planned reduction or elimination of the boost to unemployment benefits enacted in late March). While the drive towards austerity that came in the post-GFC period seems unlikely this time around, too rapid removal of support measures could result in a nasty negative demand shock.

Balance sheet vulnerabilities

Corporate and public sector balance sheets will feel the strain

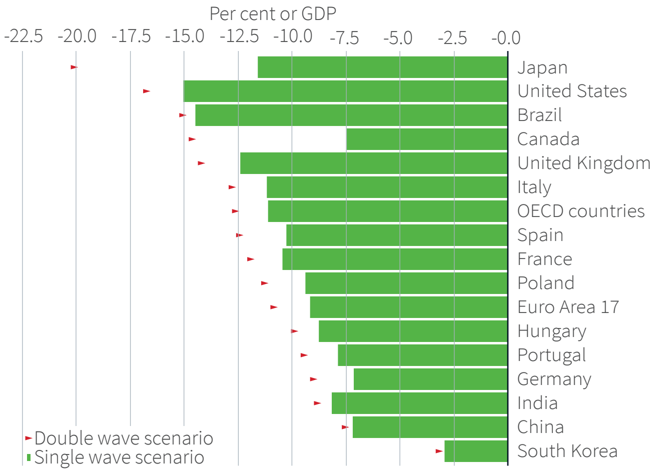
Generally speaking, financial crises and recessions – both in their origination and consequence – can be linked to balance sheet weaknesses in some part or parts of the economy. There are a number of candidates in the present episode, but as Warren Buffet famously said, it is only when the tide goes out that you discover who’s been swimming naked. Even with the support of public funds, corporate balance sheets around the world are bound to be more stretched after enforced shutdowns and there will be a delicate balancing act as funding schemes are withdrawn, which could expose the vulnerabilities of some. The fundamental health of public finances has taken a severe hit from the measures taken and those countries where there were already fiscal

Figure 13. **World trade has been growing more slowly than world GDP…**
…a sharp contrast to much of the post-war period



Source: FactSet, CPB, OECD, as at 25 June 2020

Figure 14. **Public sector deficits will widen sharply**
Debt sustainability in some countries will come into question



Source: OECD, as at 25 June 2020

vulnerabilities, may be pushed over the edge. Finally, several EM nations are seeing worrying virus trends, but do not have the resource or the resolve to take steps that other, wealthier nations have been able to take. There is a risk that the COVID-19 experience reveals balance sheet weaknesses in specific countries. In its June Economic Outlook, the OECD runs some stress tests on corporations in a number of geographies (Figure 15).

The end of US exceptionalism

The US has long prided itself as the wealthiest, strongest and most scientifically advanced nation in the world. Yet it leads the world in terms of both confirmed cases of the COVID-19 virus and of related deaths. They are widely believed to have mis-handled the virus badly. It is rather fanciful to leap from these facts to a more general conclusion that the US position in the global hierarchy is evolving. But when considered in parallel with the many Trump policy whirlwinds over the last four years, entrenched inequality and the emergence of more radical political factions on both the left and the right, it is a question that is now being asked more often. In terms of the attack of the Covid virus, the US has been shown to have much in common with all other nations. Attitudes are changing: fewer and fewer Americans agree with the idea that they stand above other countries. And the image of the US has fallen in the eyes of several other nations. The hegemony of the US may be dwindling and that would create a very different geopolitical backdrop for economies and markets.

Nature of American primacy seems to be evolving

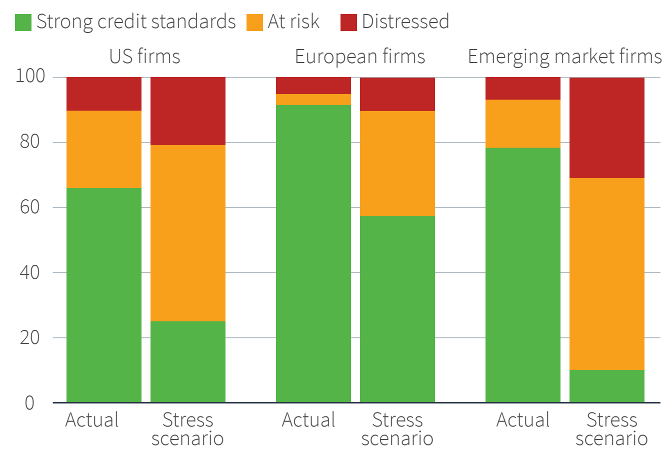
Upside

COVID-19 uncertainty clears

Amid all the many and entirely justified concerns about the virus and the damage created by lockdowns, it should not be forgotten that there are upside possibilities to the resolution of this episode. The transmission of the disease has been successfully reduced by the measures put in place (Figure 16) and we are already starting to see the clear beginnings of strong activity upswings in many countries. If the measures put in place to protect and nurture firms and workers during the pause have been successful, then perhaps lasting damage can be avoided. Conviction can then grow that the virus has been defeated and that things can go back to normal. If a vaccine can be discovered and distributed – a latently unpredictable development, but one that should not be ignored – then the swift removal of COVID-19 uncertainty could become self-reinforcing and lead to a post -virus boom. Far-fetched as this might seem at times, it could lead to a pressing re-assessment of policy settings.

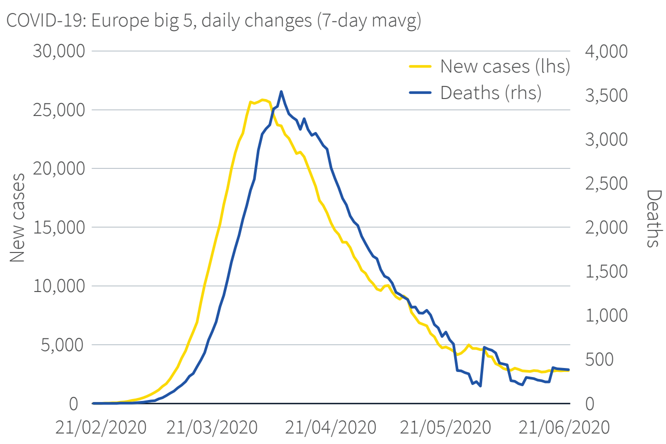
There are upside possibilities to an exit the COVID-19 world

Figure 15. **Corporate balance sheets to come under severe strain**
Some EM countries may be especially vulnerable



Source: OECD, as at 25 June 2020

Figure 16. **The spread of the virus has slowed dramatically**
Significant country variations, but peak has passed



Source: Aviva Investors, Macrobond, as at 25 June 2020

Crises can - sometimes - lead to better outcomes as people pull together

European unity

The Eurozone has had a turbulent 20-year history, with episodes characterised by serious policy errors and major differences of doctrinal opinion and basic values mixed up with periods of great advancement. The ECB has been a key component and, ultimately, backstop to the slow grind towards closer fiscal and political integration that is the eventual goal. If unity is, as some suggest, borne out of crisis and difficulty, then the single currency project must stand a good chance of success. After some significant wobbles at the beginning of the COVID crisis, when it briefly looked as if some old fracture-lines would re-open, member states have stood firm and together in facing down the disease and presenting a reasonably coherent and coordinated approach to dealing with it. There will still be some difficult times ahead, but It is possible that Eurozone countries will come out of this crisis more closely aligned and with renewed dynamism to achieve their ambitious goal of creating an entity that looks more like a united state of Europe.

Could inflation make a comeback if the COVID crisis eases?

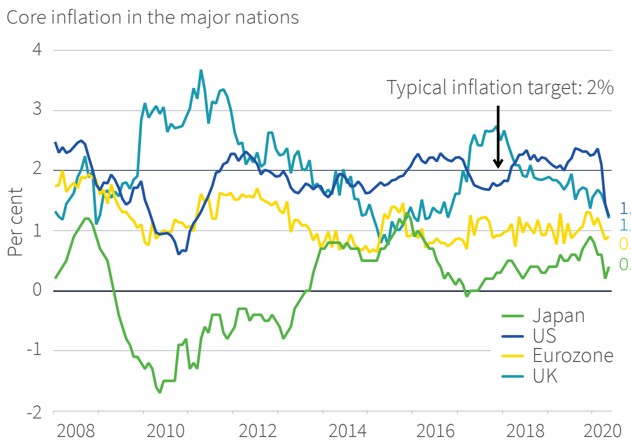
Emergence of inflation

During the GFC, many voiced concerns that the extreme policy stimulus being provided would result inevitably in runaway inflation. That view was wrong then, largely because of a fundamental misunderstanding of the monetary transmission mechanism. On that occasion, a hobbled banking system meant that money was not being "created" in the usual (credit creation) manner. QE programmes replaced such activities and underlying monetary growth did not change much. This time around, there are more legitimate concerns regarding possible inflationary consequences of "de facto" monetary financing of (much larger) budget deficits. Added to this, possible disruptions to global supply chains could compound any supply-demand imbalances and push inflation higher. Core inflation has generally been below target since the GFC (Figure 18). By and large, central banks know how to deal with rising inflation, but they may face the dilemma of choking off demand before recovery has become assured.

Figure 17. **Eurozone has seen many swings in growth since its formation**
COVID-19 experience may bring member states closer together

Source: Aviva Investors, Macrobond, as at 25 June 2020

Figure 18. **Core inflation has generally been subdued since GFC**
But if it rose sharply in wake of Covid, central banks may have to respond



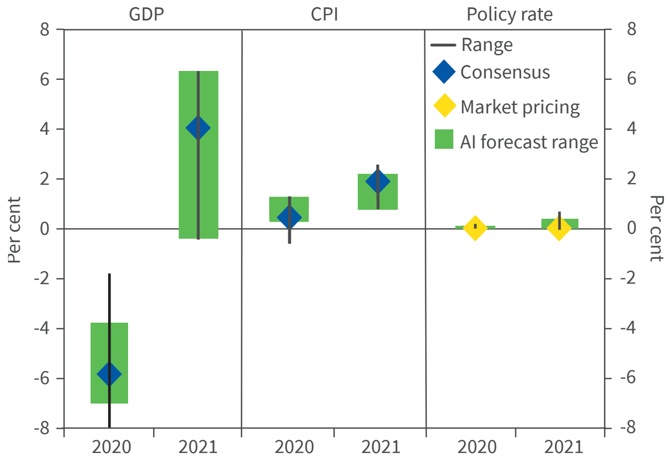
Source: Aviva Investors, Macrobond, as at 25 June 2020

Macro forecasts: charts and commentary

US

The United States went into the Covid crisis in better economic shape than most. There were no serious internal imbalances and the uncertainty around the external situation had reduced following the Phase 1 trade deal with China. As such, most expected the US to be better-placed to deal with the economic fall-out of Covid. To some extent that remains the case. However, we have lowered our growth forecast for 2020 and think there is increased uncertainty around the recovery. Those changes reflect two things: 1) the larger-than-anticipated impact of the stay-at-home orders in place in March and April; 2) the resurgence in Covid cases in June following the rapid easing of restrictions. While the fiscal and monetary policy response has been effective in helping households and businesses bridge the initial period of lockdown, that support is set to expire in the coming months. We believe it will need to be extended and expanded to ensure a robust recovery follows. Adding further uncertainty is the upcoming presidential and congressional election, which could see a material change in economic policy should the Democrats take control.

Figure 19. **US**

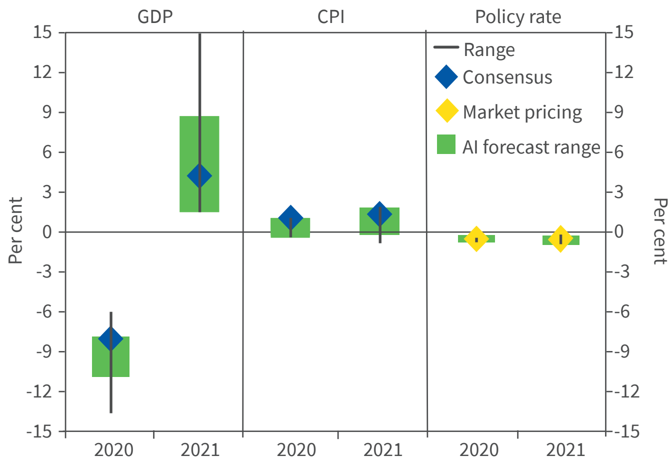


Source: Bloomberg, Macrobond as at 25 June 2020.

Eurozone

There is still considerable uncertainty about both the ongoing control of the virus and also regarding the nature and extent of economic recovery as economies slowly re-open. In medical terms, the lockdowns have been successful in most European nations, severely slowing the transmission of the disease and preventing a far worse health crisis. The resulting slump in economic activity seems to have reached a trough in April and May has witnessed the first signs of a rebound which should continue in June and the second half of the year. The experience varies a little by country, but the broad pattern is the same: GDP declines in Q2 will be enormous, but Q3 should see a strong recovery. The many monetary and fiscal policy measures that have been adopted will remain in place for some time, although the focus will shift from support to stimulus. The Eurozone has stumbled a little in terms of a coordinated fiscal response, but some progress has now been made. The ECB, as ever, stands ready to support where necessary.

Figure 20. **Eurozone**

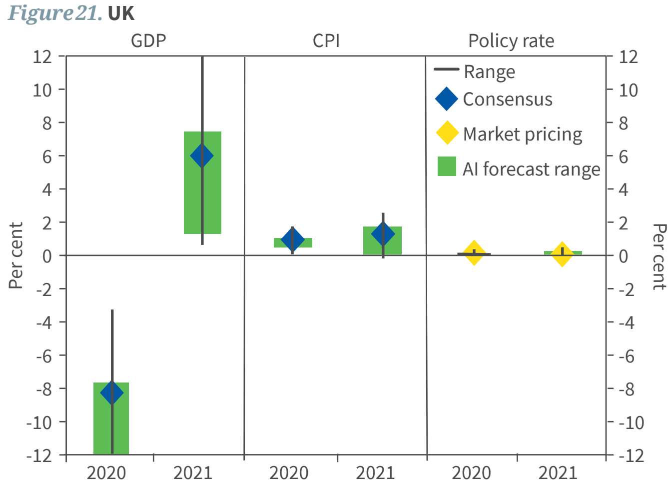


Source: Bloomberg, Macrobond as at 25 June 2020.

UK

GDP growth numbers for 2020 and 2021 will probably be unique from a historical perspective, seeing both the largest annual decline (2020) and biggest annual increase (2021) ever. The UK lockdown began slightly later than elsewhere in Europe, so the output drop in Q1 was fractionally less than elsewhere. But the collapse in Q2 will be comparable and may well approach 20 per cent. The steep and unprecedented fall will, in substantial part, reverse in Q3 as activities resume while restrictions are gradually eased. Even so, it will not be until well into next year – and perhaps considerably later – that activity will return to pre-Covid levels. Policy stimulus is set to remain in place for some time, although there will be some pressure to rein back on fiscal policy support packages as soon as possible. The extent of lasting damage to businesses and households (unemployment) will only become apparent with time. The UK also faces the additional uncertainty related to the end-year Brexit transition deadline which has the capacity to add another unwelcome shock.

Figure 21. **UK**

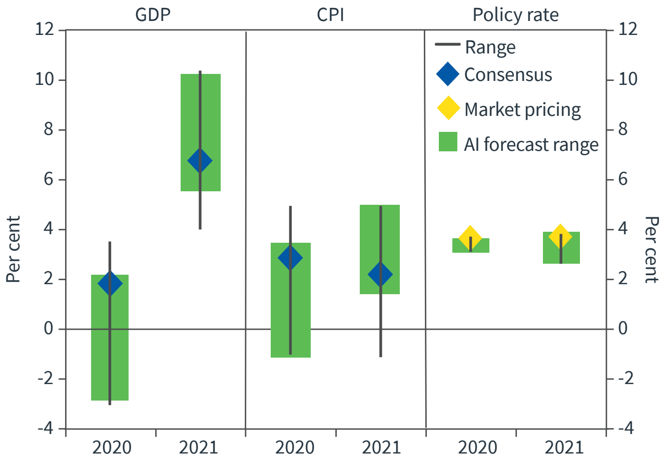


Source: Bloomberg, Macrobond as at 25 June 2020.

China

China is "first in, first out" with respect to the COVID-19 shock. The 10 per cent quarterly contraction in Q1 fully reversed in Q2, but the weakness in the rest of the world, and continuing problems with full reopening, mean that GDP will slow from there, and not resume its pre-crisis trajectory. That said, we revise our expectations for output growth for the full year 2020 to around 2 per cent y/y, with Q4/Q4 up around 5 per cent. There are two-sided risks, but this is due more to the virus and the global situation, rather than things under Beijing's control: fiscal and monetary policy are loosened but not to the degree they were in 2009 or 2016. The PBOC is in a rate-cutting cycle, but a gradual one, as inflation has come down and PPI has moved deeper into negative territory. Rather, the central bank's focus is on ensuring adequate liquidity via RRR-cuts and other measures to absorb heavy local government bond and corporate issuance. The FX is stable with a weakening bias.

Figure 22. **China**

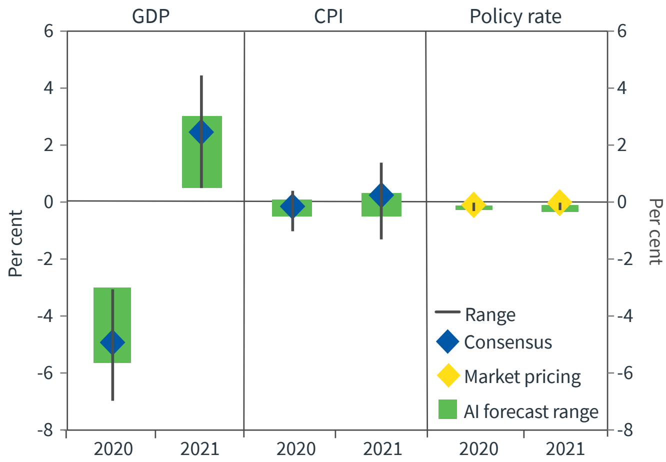


Source: Bloomberg, Macrobond as at 25 June 2020.

Japan

Already almost in a recession due to a tax hike in Q4-2019, Japan hit bottom in Q2 2020, with GDP about 8 per cent lower than the year before. A drawn-out recovery looms, as monetary policy is constrained with the entire yield curve out to 10 years at zero or below. However, thanks to Fed swap lines the BoJ has been able to stem the strong yen, though the path of least resistance is still appreciation until global growth picks up; there is disinflationary pressure but not yet outright deflation. So far, the government has expanded fiscal policy by more than 10 per cent, with handouts to businesses large and small as well as individuals. A slew of subsidies and potentially forgiveable loans add to the support – and distortions – in the economy. Deficits cannot grow faster than the economy forever, yet as long as inflation stays positive, and growth returns to positive territory (someday) then negative real rates means that a larger debt "burden" makes debt dynamics more sustainable!

Figure 23. **Japan**

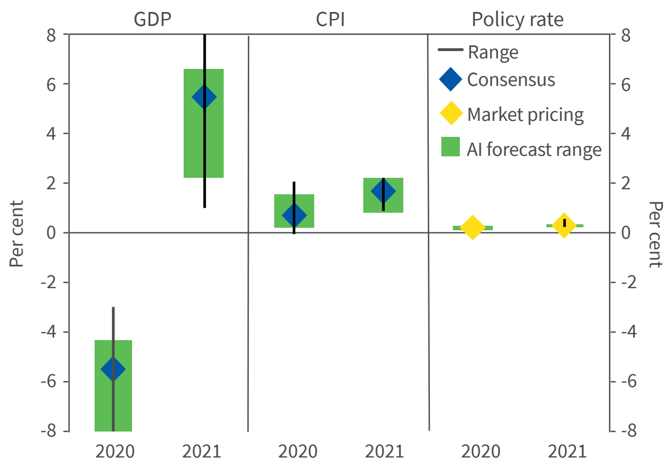


Source: Bloomberg, Macrobond as at 25 June 2020.

Canada

Growth is expected to rebound strongly in Q3, albeit from a low base, as the economy starts to reopen. Focus will now turn to the pace and breadth of the recovery. The recently extended government support package has lessened the shock to household incomes and laid the foundations for recovery. Going forward, expectations are for an initial period of rapid jobs growth and higher spending thanks to pent-up demand, followed by a more gradual pace of recovery as confidence is restored. If supply recovers quicker than demand, significant downward pressure on inflation may result. The new Bank of Canada Governor, Tiff Macklem, has reiterated that the inflation target remains in place. With policy rates at the effective lower bound, further monetary stimulus has been delivered via QE: the bank has committed to buy at least $5 billion of Canadian government bonds a week until recovery is assured. As the bank is reluctant to impose negative rates, any requirement for additional easing is likely to come from adjustments to the QE programme.

Figure 24. **Canada**



Source: Bloomberg, Macrobond as at 25 June 2020.

Global market outlook and asset allocation

Unprecedented recovery in risky assets

Risky assets have delivered a striking recovery from their March lows, in some cases reversing much of the historic decline seen in February and early March. Many equity indices are not far from where they began the year, and while credit spreads remain more elevated than in recent years, they have tightened significantly. Meanwhile currencies that traditionally have been negatively correlated to global growth have embarked on a weakening path. The vast amount of monetary and fiscal policy support, alongside the rebound in economic activity that has followed the easing of lockdowns, has seen risky assets de-couple from fundamentals.

It appears that most risky assets are pricing a relatively rapid return to pre-Covid levels of activity, with the hope that a combination of fiscal stimulus and central banks being assumed to keep policy rates at the effective lower bound for many years to come, provide sufficient support. However, our central economic scenario is somewhat less optimistic than what appears to be priced in. Moreover, valuations, which — even in the absence of further price gains and following consensus' more positive stance on the earnings trajectory – are screening as unattractive. Finally, the jury is still out on whether the COVID-19 crisis will merge into a corporate solvency crisis. With this backdrop, we prefer to be underweight global equities. However, acknowledging that the global economy has entered an economic recovery phase and taking advantage of a number of themes that have emerged in response to the COVID-19 crisis, we prefer to be overweight more defensive risk assets, such as global investment grade credit and Italian government bonds.

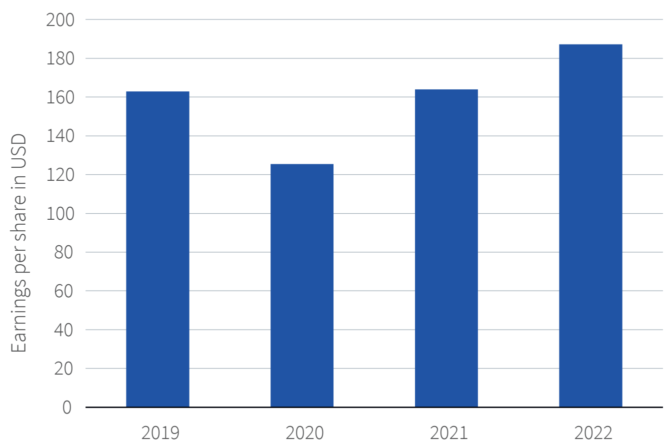
Equity market valuations approaching all-time highs

Equity market valuations across a range of regions are on course to approach previous peaks as earnings continue to deteriorate (Figure 25). Whilst price/earnings multiples typically start rising at some point during recessions, as the market starts to price a recovery well ahead of an eventual turn in earnings, the current dynamics concern us for several reasons. First, the de-rating going into this recession has been shallow relative to the magnitude of the economic and earnings downturn, i.e. the starting point from which multiples have recovered has been comparably high (Figure 25). Secondly, the earnings trajectory envisioned by consensus would be atypical for those normally experienced during recessions and recoveries, particularly for one of this magnitude: the decline understates the drop in GDP while the recovery would be very swift and strong, implying a return to end 2019 earnings by end 2021 (Figure 26). Lastly, incorporating even these optimistic earnings expectations, an adjustment towards longer term average valuations, assuming unchanged index levels, would only occur several years from now. To summarize, already high valuations that are prone to rise further and are built upon an optimistic outlook for earnings, do suggest that sensitivity to any potential negative news is high.

Figure 25. **US forward multiples have expanded rapidly**

Source: Refinitiv Datastream, as of 19 June 2020

Figure 26. **Expectations for an EPS recovery by end 2021**
Consensus' EPS expectations for the S&P 500



Source: Refinitiv Datastream, as of 18 June 2020

The risks to our outlook

While we are cautious on global equities at this juncture, there is an upside risk to our assessment. It is possible that valuations could remain elevated – and even rise further – compared to the past, on the back of monetary policy expectations having raised net present values by lowering the risk-free rate. Another upside risk would be a stronger cyclical recovery than currently anticipated, with activity following closer to our Scenario A (outlined in the Executive Summary), whilst central banks continue to keep rates at historically low levels.

However, there are also downside risks. Some of the longer-term consequences of the COVID-19 crisis tilt the outlook for equities to the downside. Corporates are likely to leave the crisis with a much higher level of indebtedness (Figure 27), curtailing both the potential to engage in growth opportunities and to maintain, let alone raise, payouts. Holding ample inventory in case supply chains fail and pressure to attain self-sufficiency in producing critical goods will require companies to spend on capex and to run less efficient and optimized production, leading to margin pressure. Moreover, it is not yet decided how governments are going to restore public balance sheets but raising taxes on corporates or individuals remains an option and would lead to pressure on bottom- and top-line, respectively.

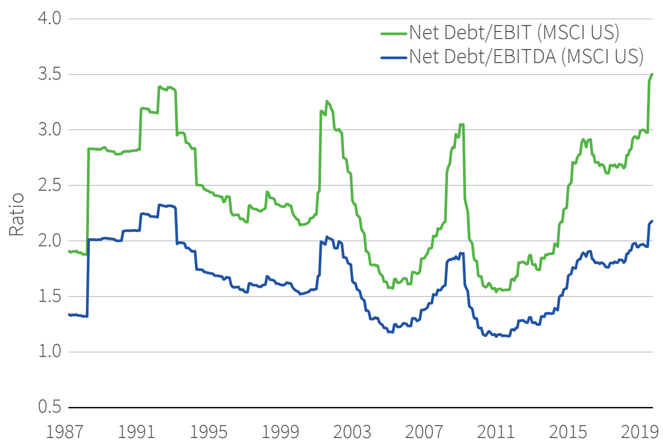
Sovereign yields are capped by central banks

At the other end of the risk spectrum, we prefer to be overweight government bonds. Yields have been well anchored at low levels, not least owed to significant central bank purchases. We expect duration to remain attractive and term premia to stay compressed given ever growing monetary and fiscal cooperation considering the need to finance government deficits. Should the macroeconomic environment turn more adverse again and/or should the Fed decide to introduce Yield Curve Control later in the year, bonds could still offer decent returns despite low yield levels currently. There is little doubt that central banks will continue to support the economy during this uncertain recovery phase via the existing toolkit, and possibly by doing more should the necessity arise. The Fed has implicitly announced a floor to its QE purchases and does have the flexibility to ratchet up purchases if need be. The ECB has recently increased the firepower of the Pandemic Emergency Purchase Programme (PEPP) to a total of €1,350 billion, extended the programme's horizon and added re-investments. The Bank of Japan has strengthened its monetary policy to support the government's actions and the BoE has added to its programmes as well. With central banks showing the willingness to absorb public and private debt issuance, we regard lower for longer as a valid ongoing theme.

Credit spreads have re-tightened significantly

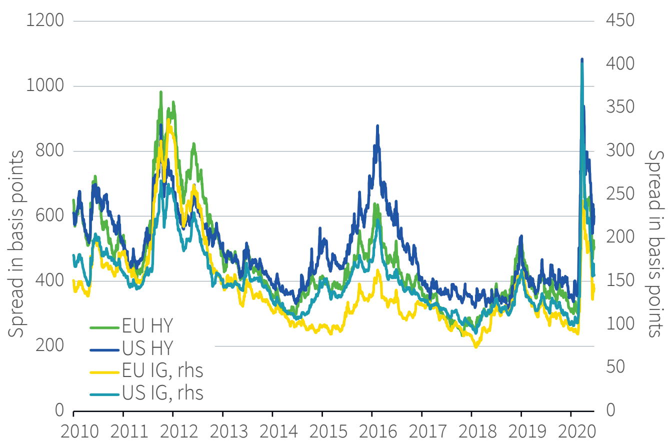
After having experienced tremendous dislocations on the back of very poor liquidity in March, credit market conditions have improved, as evidenced by significant spread compression (Figure 28). The retracement of approximately 70 per cent of previous spread widening can largely be attributed to technical factors, predominantly direct central bank purchases of credit instruments. Credit fundamentals outside of financing costs, however, have deteriorated significantly in response to the COVID-19 crisis. Consequently, rating agencies have pushed through large amounts of rating downgrades. Selecting quality names is even more important in a context where nearly 50 per cent of global investment grade (IG) indices are now BBB-rated (Figure 29). Further, the Fed's decision to include fallen angels and high-yield ETFs in its programme has also contributed to an increase of US issuance in the BB-rated sector.

Figure 27. **Corporate indebtedness is on the rise**



Source: Refinitiv Datastream, as of end May 2020

Figure 28. **Credit spreads supported by policy backup**
US & EU credit - OAS



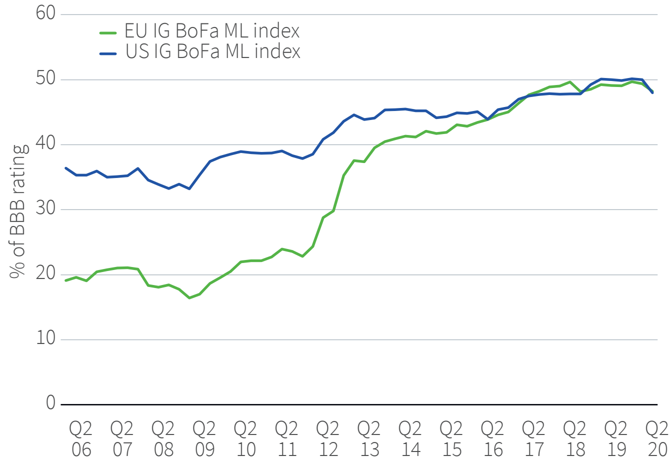
Source: Refinitiv Datastream, as of 21 June 2020

Adding risk selectively

As such, we prefer to be selectively overweight credit. US investment grade credit is our preferred choice, but we also have a preference for Italian government bonds (BTPs). The latter follows positive developments for European political risk, namely the potential for a Next Generation EU plan. We regard BTPs as the most direct beneficiary of further steps towards European fiscal integration. In addition, ECB support and lighter supply pressure over the summer may induce further spread tightening. Over the medium term, however, we think the usual risks to a common European policy framework remain in place and the beginning of the budget process may start to lay bare fault lines. Moreover, rating risk might become an important factor once again in the latter part of the year.

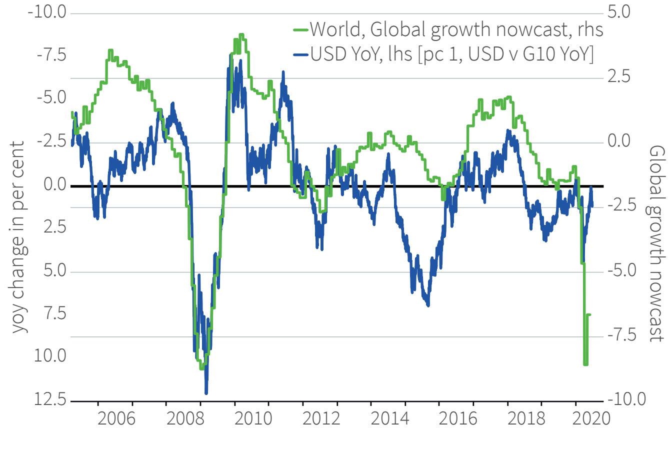
Within FX, we have a relatively neutral view on the US dollar at this time. Absent independent shocks to risk sentiment, the dollar tends to perform inversely with global growth (Figure 30). Given the recovery expected in Q3, the dollar's relationship to growth would suggest limited appreciation potential from here. Among other factors, politics and the outcome of the US election in November could potentially affect performance negatively over the coming months. Across other currencies, we have a preference to be underweight sterling and overweight the euro. The latter is currently better positioned in terms of political risk and is experiencing a quicker exit from lockdown economics than the UK.

Figure 29. **Deterioration of quality in IG credit**
Quality of IG universe



Source: Refinitiv Datastream, as of 21 June 2020

Figure 30. **US dollar tends to depreciate when growth resumes**
USD v G10 YoY (PC1) vs Global growth



Source: Aviva Investors, Macrobond, as at 25 June 2020

Figure 31. **Asset allocation**

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

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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