House View
Q4 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

Economic and financial market prospects brighten

Still searching for the new normal…but prospects have brightened

The global economy has proven to be more robust to the COVID-19 crisis than many anticipated. Following the unparalleled decline in the first half of the year, activity has bounced back sharply, as mobility restrictions have been eased and the pressures on hospital systems have remained low. While some restrictions remain in place in most countries, particularly following the recent increase in coronavirus case numbers in Europe, these are far removed from the strict "stay-at -home" orders earlier in the year. Caution on the part of most households and businesses, including the widespread adoption of face masks, hand-washing and social distancing, has undoubtedly helped in preventing the extremely rapid spread of the virus seen earlier in the year. But the combination of caution and restrictions on travel and hospitality continue to impede the recovery in those sectors. As such, until a vaccine is available, economies continue to search for the new "normal" that we described in our Q3 House View publication.

Central bank actions have reduced real interest rates and supported demand

Essential to the recovery in activity has been the vast amount of policy support – both monetary and fiscal. Developed market central banks have cut rates to their effective lower bound (or very near to it) and engaged in large-scale asset purchases. As in past episodes of quantitative easing (QE), those purchases have been primarily government bonds, but risk assets such as corporate bonds have also been purchased. Funding schemes have also been introduced to assist with bridge financing either through the banking system or direct to businesses. These measures both restored market functioning and provided a much-needed easing in financial conditions. Figure 1 shows that long-term real yields on government debt have fallen to historic lows. Perhaps even more significantly, governments pro-actively moved to support household incomes through the period of economic shutdown by supplementing the traditional automatic stabilisers. In many economies that came in the form of a wage subsidy or furlough scheme that kept employees attached to their employer by covering much of their wage bill, even if not working at all.

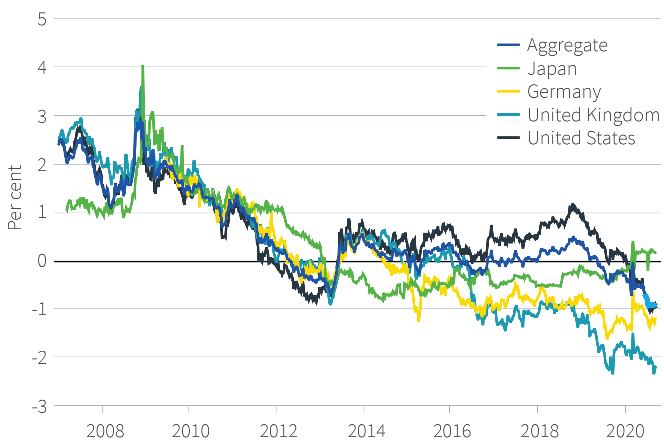
Fiscal policy has supported household income and provided bridge financing to businesses

Figure 2 shows that the decline in GDP would have been expected to have resulted in a very large decline in aggregate income. The impact on activity was several multiples of that seen in the 2008 financial crisis, but in the United Kingdom incomes fell by proportionally much less. In the United States, unemployment benefits were increased significantly, and one-off payments were made to all households. Actions there resulted in overall household income rising after the onset of the pandemic. These swift actions meant that governments, rather than households, carried much of the economic burden of the crisis. In so doing, private sector demand recovered quickly, with retail spending rising above pre-COVID levels in many economies in recent months.

Availability of an effective vaccine in early 2021 would accelerate the recovery, but risks remain if fiscal support is withdrawn too quickly

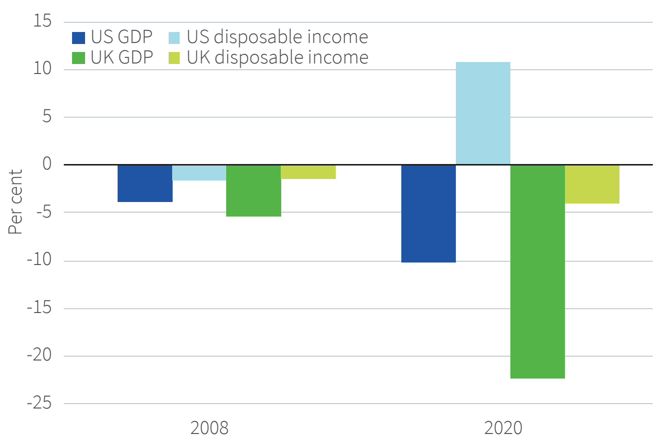
While the pace of the economic recovery has been encouraging, risks clearly remain. The recent increase in coronavirus cases in Europe and elsewhere has the potential to lead to more severe restrictions once again. If that were to occur, governments and central banks would once again be required to step in to support the economy. There is a risk that they might be less willing to do so again, although there appears to be little evidence of that for now. Perhaps a bigger risk is that the path to the new normal is somewhat slower from here and fiscal support is

Figure 1. **Real government bond yields (aggregate GDP-weighted)**
Central bank actions pushed real yields to new lows



Source: Aviva Investors, Macrobond, as at 1 October 2020

Figure 2. **Percentage change in disposable income and GDP**
Government policies supported household incomes



Source: Aviva Investors, Macrobond, as at 1 October 2020

The Federal Reserve has moved to an average inflation targeting regime, in an effort to boost inflation expectations. Others are likely to follow

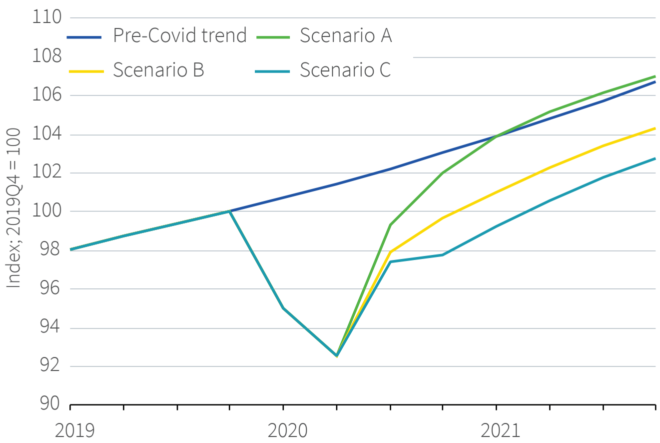
removed too quickly. On the upside, however, the timeline for a widely available and effective vaccine appears to be at the more optimistic end of the spectrum of views from earlier in the year. It is possible that more than one vaccine could be approved in Q4 and begin distribution in early 2021. While that roll-out process may take a year or more, it would remove much of the uncertainty that hangs over the service sector. Figure 3 shows our updated range of scenarios for economic activity through to the end of 2021. We put around a 60% probability on scenario B, which is little changed from our view three months ago. However, we now judge the downside (Scenario C) to be less severe than previously thought, with the prospect of another global economic lockdown like that seen earlier in the year much more remote. Meanwhile, there remains the potential for activity to return more quickly to the pre-COVID trend in the event of a rapidly deployed vaccine, alongside continued monetary and fiscal support (Scenario A). On pages 5-10 we review the key themes and risks to the outlook, including the much-anticipated US presidential election.

One of the most significant policy developments in the past three months came outside of the immediate response to the COVID crisis. In August the Federal Reserve delivered its much-anticipated policy framework review. The review, which began in 2018, was commissioned to address the challenge to the effectiveness of monetary policy from the era of very low "neutral" interest rates. The outcome was a decision to move away from a framework that ignored past deviations of inflation from target, to an average inflation targeting (AIT) regime that would try to make up for those past deviations. In effect, it would mean allowing inflation to run above the 2 per cent target for some time over the coming years, following several years of below-target inflation. Moreover, less emphasis would be put on removing accommodation as the labour market improved, but rather waiting until inflation was at or above target. The change in approach is likely to result in rates stay anchored at zero for even longer than previously anticipated – maybe for another 4-5 years. Over the longer term, it is also likely to mean somewhat higher and more variable inflation and more economic and market volatility. Other central banks are also pursuing reviews, with similar outcomes likely to be delivered over the next year or so. While the initial market reaction to this development has been muted so far, there is potential for this to be the most significant change in approach from central banks since the start of the inflation targeting era in the 1990s. When set alongside the renewed interest in fiscal policy, it could usher in a period of steeper interest rate curves, more volatile currencies and a rotation towards value stocks.

We are more constructive on risk assets, primarily through corporate credit. We expect a period of weakness in the US dollar

The brighter economic prospects, and even more importantly the receding downside risks from COVID-19, have led us to take a relatively neutral view on global equities (Figure 4), with relative valuations and cyclical recovery favouring Europe and Emerging Markets over the United States and Japan. We prefer to express more risk in credit markets, with overweight view in global high yields and US investment grade. While credit spreads have narrowed materially in recent months, high yield has potential to deliver further capital appreciation, while remaining supported by central banks should downside risks materialise. The decline in government bond yields has made them less attractive, particularly as an effective risk-reducing element. We prefer to be neutral overall, with overweights in the United States, Italy and Australia offset by underweights in core Europe. But perhaps the most significant asset allocation change has been in currencies. A long-held preference for US dollars has given way to what we believe could be a sustained decline in the dollar against G10 currencies. With a preference to be overweight euros and yen, we continue to be underweight sterling given ongoing risks from Brexit.

Figure 3. **Global activity scenarios**
Downside risks have receded



Source: Aviva Investors, Macrobond, as at 1 October 2020

Figure 4. **Asset allocation summary**

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

Source: Aviva Investors, Macrobond, as at 1 October 2020

Key investment themes and risks

Economic recovery

A very unusual recovery

This has not been a normal downturn; it will not be a normal recovery either. Around previous recessionary periods there has usually been considerable debate about whether a recession has begun, how long it might last and when it will end. It is often the case that it is only possible to calibrate these dates when looking back at each episode, sometimes after a number of years.

Strong growth in Q3, but path thereafter is less clear

This one is different. Its onset can be dated precisely, almost to the day. Although very deep, it has been mercifully short, and the start of the subsequent economic recovery is also easily identifiable. For most countries, the self-imposed downturn began in March 2020 and intensified in April, but then began to unwind from May onwards. We are now four months into a clearly defined economic revival. Q3 will see the strongest GDP growth rates in the post-war period (Figure 5). But the path of economies after that is less clear-cut. The virus is still with us, second waves of infection are happening and although there has been unprecedented policy support (see below), the true state of permanent loss is still not clear.

A double dip is a risk, but should be avoided

The last three months have seen the balance of probabilities around our global growth scenarios shift. In July, we assigned a 50% probability to our central view (B) with the remainder split roughly equally between the more optimistic A and the gloomier C scenarios. That latter case assumed the re-imposition of national lockdowns and a related secondary dip in activity levels. Although that is still possible, its likelihood has fallen as most nations seem to be dealing adequately with second waves by means of more localised and targeted measures. This has mechanically reduced the scale of GDP declines in 2020 and also the size of the rebound in 2021. The outlook is still uncertain and dependent in substantial part on the progression of the virus. Higher frequency indicators do show that the pace of economic revival has slowed in recent months and we are now entering the critical Northern Hemisphere winter, when the course of the pandemic – or reactions to it – could change significantly.

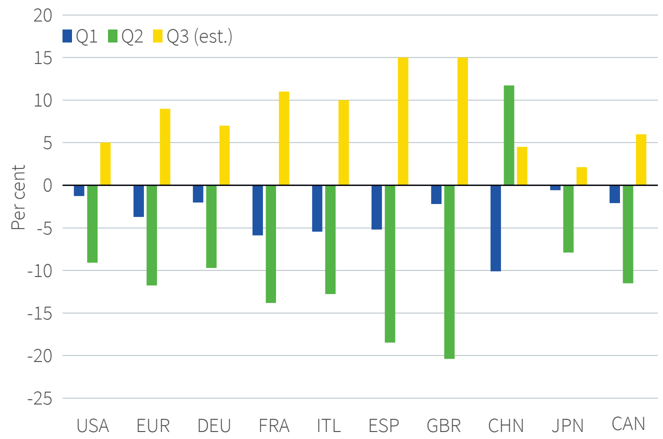
Some permanent losses are inevitable

Overall, we continue to believe that economies will carry on growing, but that it will not be until late next year or even some time in 2022 that pre-COVID levels of GDP will be reached. The OECD estimates that by the end of next year, world GDP will still be some 5% lower than it projected before the virus appeared (Figure 6). Beyond that, projections are more speculative, but it is to be hoped that, eventually, the pandemic's impact will fade steadily into history and "normal" growth dynamics and conduct can resume. Even in this case, it is a matter of some conjecture about how much this experience will have changed attitudes and underlying behaviours permanently. And it could take decades for public finances around the world to return to benchmarks that were previously considered prudent.

Monetary re-boot

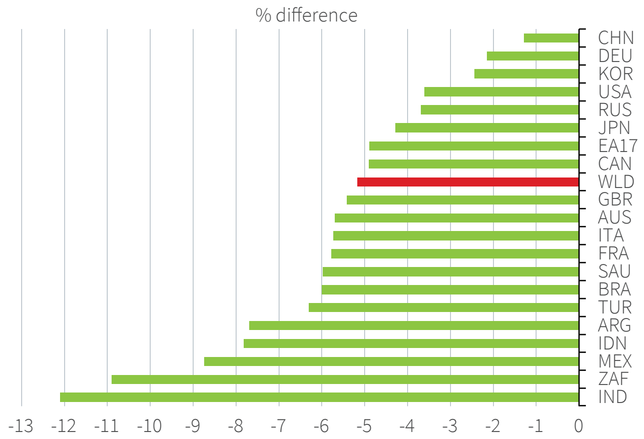
Central banks have spent much of the last decade grappling with the challenge of low and falling "neutral" real rates of interest. Those have been driven down by a range of structural factors and,

Figure 5. **Quarterly GDP growth in 2020**
Extraordinary swings in GDP in 2020



Source: Aviva Investors, Macrobond, as at 1 October 2020

Figure 6. **Change in OECD GDP projections (pre- and post-COVID)**
Growth shortfall more severe in some countries



Source: OECD, as at 1 October 2020

alongside inflation targets of usually around 2 per cent, have left central banks with very little space to move official rates lower. In other words, the distance to the effective lower bound (ELB) has been greatly reduced over time, leaving central banks with little choice but to engage in previously unconventional policies such as large-scale asset purchases, forward guidance, bank funding schemes and, in some cases, negative policy rates. Meanwhile, most developed market central banks have struggled to meet their mandates for much of the past decade, with inflation persistently sitting below target, generally 2 per cent (Figure 7). That carries the risk of inflation expectations becoming de-anchored to the downside and making it even more difficult to meet the mandate. As a result, many central banks had already begun reviews into their toolkit and their approach to monetary policy before the COVID-19 crisis hit.

Neutral interest rates have continued to push lower

The Federal Reserve announced the results of its review in August, moving to an average inflation target (AIT) framework, whereby it will seek to offset past deviations in inflation below/above target by pursuing above/below target inflation for some period. Moreover, it may not seek to tighten policy when the unemployment rate is approaching or even below its estimate of the natural rate, if it isn't accompanied by above-target inflation. These changes could have profound implications for both the way policy is set over the next decade or more, and similarly on economic and market outcomes. Other central banks, such as the ECB, are also undertaking similar reviews and we think are likely to arrive at similar conclusions. We believe that this could be the most significant shift in approach by central banks since the move to inflation targeting in the 1990s. The immediate implication is that policy rates will be kept low for even longer than would previously have been anticipated (Figure 8).

Fed has amended its mandate; other central banks may follow suit

Ongoing fiscal support

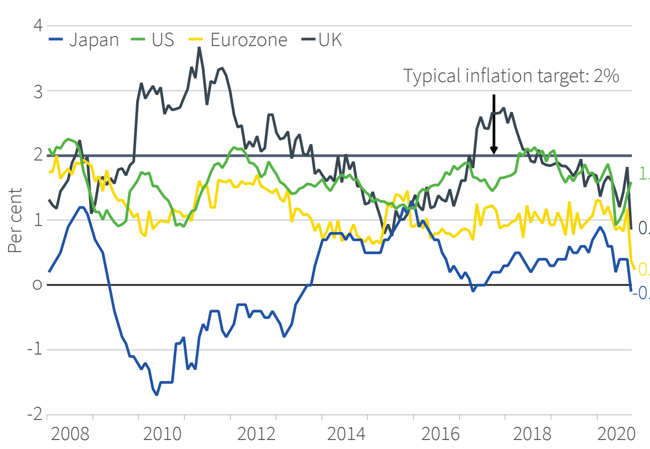
The initial aim of bold and ambitious fiscal programmes that were put in place in March and April this year was, broadly speaking, to substitute public funds for lost private incomes. It was all about support, not stimulus. Without this funding, many businesses would have failed quickly, and millions of jobs would have been lost permanently. As economies are now embarked on recovery, that balance is shifting. Clearly, there is a need for continued fiscal assistance to those impacted by the COVID-19 crisis. Although many activities have resumed, some have not and are unlikely to do so for some time. Individuals and businesses in this position will need ongoing bridging finance to tide them over until conditions allow them to restart. It is another invidious task to attempt to identify which operations are (or will be) viable in the future and those which should be permitted to fail. On labour markets, the approach should change from providing support to those who cannot work to assisting those who are returning to work – in other words to switch the focus to jobs from workers.

Huge fiscal assistance packages have been implemented

However, there is also now a growing desire in many countries for more activist fiscal stimulus to help sustain economic recovery. It is not universal – some on the political right are advocating a swifter reversal of fiscal largesse. But against the backdrop of continued uncertainty about the virus and significant economic fragility, support from public spending initiatives and encouragement from favourable tax incentives are generally considered valuable policy tools.

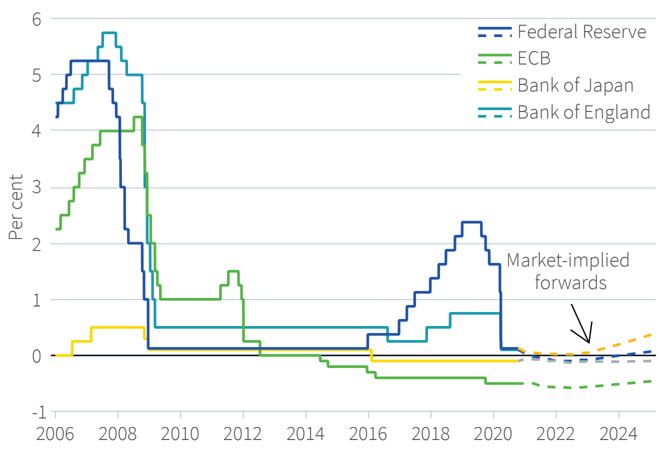
Fiscal help will be required for an extended period of time

Figure 7. **Core inflation in the major nations**
Inflation has undershot 2% targets regularly



Source: Aviva Investors, Macrobond, as at 1 October 2020

Figure 8. **Policy rates in major regions**
Back to the lower bound — and expected to stay there



Source: Aviva Investors, Macrobond, as at 1 October 2020

At the start of the crisis there was an understandable wish to distribute financial assistance quickly, almost indiscriminately. Now there can be more nuanced approaches, with more targeted fiscal programmes that can also be more closely monitored. Many are making the case that there can be no better time for Governments to borrow long term, at exceptionally low rates, and to invest in public infrastructure projects that can support or boost potential growth in the future. These will include not simply traditional capital investment in transport and housing, but also health care, education and digital and environmental infrastructure.

Public debt will rise significantly as a proportion of GDP, threatening fiscal sustainability in some cases

Most countries have already seen budget deficits soar higher, exceeding 10% of GDP in several and approaching 20% in others. Yet current circumstances have meant that the unprecedented deterioration in public finances has been accepted with barely a whisper of dissent. Government debt is likely to rise by between 10% and 20% of GDP over the next year or so almost everywhere (Figure 9), adding to burdens that were already considered onerous if not dangerous in many cases. Debt sustainability is not an immediate risk – especially when interest rates are so low – but debt burdens will have to be lowered eventually through a combination of growth, inflation and discretionary fiscal measures. This may well take decades rather than years.

Long-term strategic competition

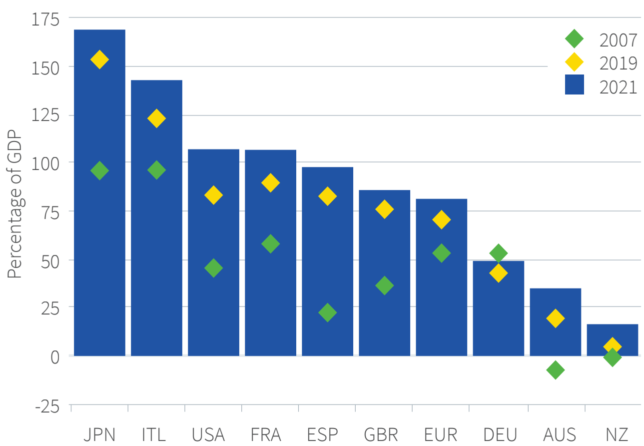
The trade dispute was a symptom of more a more general conflict

History is littered with examples of battles for supremacy between rival factions. Today the attention is primarily on the relationship between the US and China. The trade war that dominated market sentiment for almost two years (Figure 10) was one aspect of that, and it had seemed that some form of resolution had been reached just before the onset of the COVID-19 crisis in the form of a Phase 1 trade deal. The global pandemic has thwarted a clearer resolution, but the August compromise agreements between the two players indicated that there was still a route to a lasting reduction in the trade conflict.

China and the US may embark on a lengthy Cold War

In some ways, however, that is not the main story here, but is instead just one symptom of broader trends. And while those trends are heavily focussed on China and the US, they will also be influenced by the actions and attitudes of many other countries too. The status quo is being questioned more by a determined and ambitious China, a single-minded US president and changing attitudes to openness in many countries. Such attitudes have probably been hardened by the COVID episode which seems to have intensified the new Cold War between the US and China in particular, although it has also fuelled debates about international openness and free trade more widely too. Future years are likely to be characterised by increasing strategic competition, largely related to China and the US, but also impacting many others. One key aspect is the race for technological global dominance – the trade war is really morphing into this battleground now. China's trade surplus and alleged currency manipulations are part of it too. But really the heart of the matter relates to forced technology transfer, intellectual property theft and free market distortions. Beyond those specific issues lie others such as China's human rights violations, their influence in Hong Kong and Taiwan and the desire among other democracies that China complies more with international codes of practice that are broadly accepted everywhere else.

Figure 9. **Public sector net debt as % of GDP**
Big increases in public debt levels are inevitable



Source: Aviva Investors, IMF, Macrobond, as at 1 October 2020

Figure 10. **Bank of America Merrill Lynch Fund Manager survey**
Table shows biggest tail risk in survey responses

March 2018 - January 2020	US-China trade war
July 2017 - February 2018	Quantitative tightening
May 2016 - June 2017	Political populism
August 2015 - April 2016	China "hard landing"
September 2014 - July 2015	Geopolitical crisis
July 2013 - August 2014	China "hard landing"
October 2012 - June 2013	US "fiscal cliff"
June 2011 - September 2012	Eurozone sovereign debt crisis

Source: Aviva Investors, Bank of America Merrill Lynch, as at 1 October 2020

This is unlikely to be a smooth journey. As China's international influence has grown (Figure 11), it was always likely that they would challenge global standards and institutions and try to impose alternatives. Achieving technological self-sufficiency is one thing, but China has ambitions for much more and there is nothing wrong with that per se. However, if China is to succeed as an integrated global player, a balance will have to be found between their fundamentally different methods of operation and adherence to acceptable international codes of conduct in business and trade. Strategic competition between China, the US and others is likely to frame international relations and influence financial markets over the next decade or more.

Can China and the US learn to co-exist?

European unity

The Eurozone has had a turbulent 20-year history and has not always made timely or coherent decisions. Shortly after the Global Financial Crisis, the Eurozone experienced its very own disaster – all of its own design – in the form of the sovereign debt crisis. At the low point there was a genuine existential threat to the single currency project. It seemed inevitable that Greece would leave and most of the debate revolved around how many others would follow. Not for the first time the Eurozone not only survived but used the despair of the crisis as a catalyst for critical progress and change. The COVID episode looks rather similar. After a brief spike of discord during the initial onset of the virus when it looked as if some of the old fracture lines would re-open, member states swiftly regrouped and presented a coordinated and united front.

European crises have sometimes led to progress on greater integration and unity

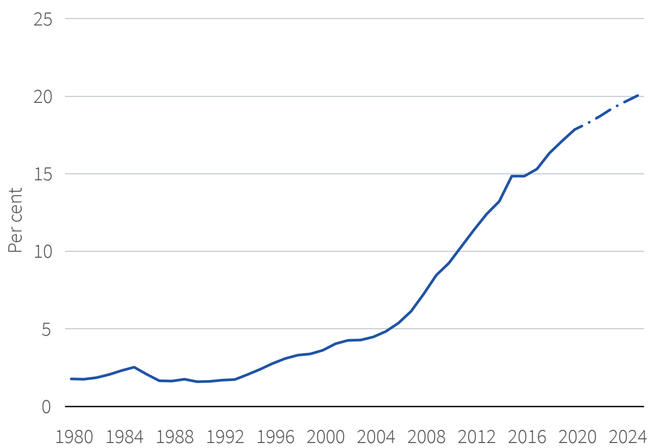
There will definitely still be some difficult times ahead, especially in the light of second waves of virus infection recently, but it now looks more likely than not that Eurozone nations will stand firm and be more closely aligned on a number of key issues. Perhaps most importantly of all, some significant steps have been taken in the direction of closer integration. Nowhere is this clearer than in the design and initial implementation of the "Recovery and Resilience Facility", as it was revealed in July. While in our view not the "Hamiltonian moment" that steers the Eurozone onto an inevitable path to full debt mutualisation, this was an important step in that direction. The €750 billion facility, comprising a mixture of loans and grants, contains within it elements of common debt issuance and large-scale transfers. There is still significant conditionality and it is ostensibly temporary – a direct response to the COVID crisis and a means by which financial assistance can go to where it is most needed. There are still many ideological differences and alternative points of view across the Eurozone (and EU) which may delay or alter disbursements or influence the governance of the fund. But it is still a key step towards creating the institutional framework necessary for a properly functioning single currency area.

The Recovery Fund is an important step towards a more unified Eurozone

The creation of the fund also suggests that political support for closer European integration is growing, even in areas where there was previously entrenched opposition. Of course, the European banking union is still only half built at best, but at least it is no longer fanciful to argue that the eventual destination is at least more clearly defined and identified. Greater unity should help support European risk assets in general (Figure 12) – including the Euro currency – and should ensure that peripheral bond spreads remain contained.

A long way to go, but the destination is more clearly defined

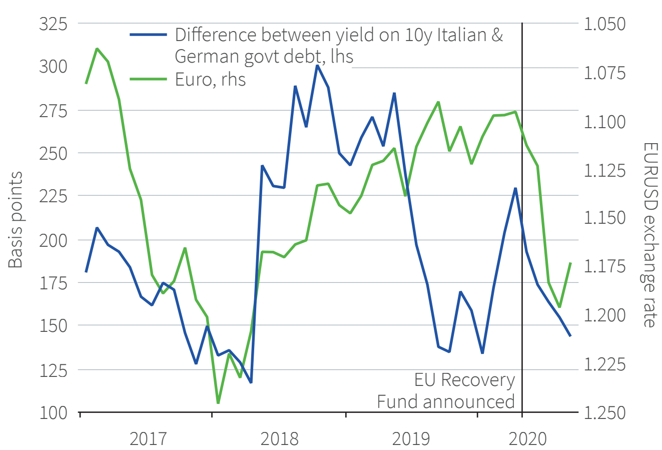
Figure 11. **China's share of global GDP, per cent**



Source: World Bank, Aviva Investors, Macrobond, as at 1 October 2020

Figure 12. **Euro risk assets have rallied**

Recovery Fund an important step to closer unity



Source: Aviva Investors, Macrobond, as at 1 October 2020

Risks

De-globalisation accelerates

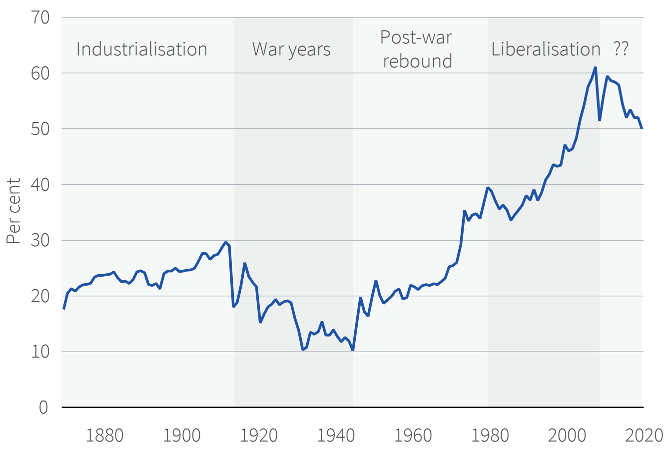
The global COVID pandemic has caused many countries to question the wisdom of global supply chains and economic inter-dependence more generally. It could therefore add to de-globalisation momentum that has become apparent since the Global Financial Crisis. There have arguably been four earlier eras for globalisation since the 1870s (Figure 13), but the last 70 years or so have seen sweeping trends towards greater openness, more free trade, international specialisation and global integration. World growth was generally strong and global poverty fell significantly. Since the GFC, world trade has expanded more slowly than world GDP. We do not expect a return to the damaging era of tit-for-tat protectionism of the 1930s but moves in that general direction have already taken place: China has turned inward, the US has embraced an "America First policy" and initiated a trade war. Even open Europe and Australia have become more sceptical. Fear can lead to insularity, so there are clear risks of further moves in this direction in the post-COVID world. De-globalisation could slow potential growth rates and lead to a reassessment of world equity valuations.

Fiscal cliffs

The huge fiscal assistance packages (Figure 14) that were introduced around the world in response the COVID-19 crisis were necessary to prevent a complete collapse in demand. Imposed shut-downs to activity would have resulted in a negative income shock that would have pushed economies into the second Great Depression. Instead the state stepped in to provide subsidy and absorb the risks that the private sector could not. But as economies restart and activities resume, that financial assistance will start to be withdrawn. Calibrating that will be no easy task. Some very unusual incentives structures have been established and it will be almost impossible to distinguish between deserving recipients and others. The key principles underlying the required fiscal largesse were that it was enormous, swiftly delivered and unconditional. Reversing that process means a clear risk of a premature withdrawal of support that risks stifling growth and doing lasting damage.

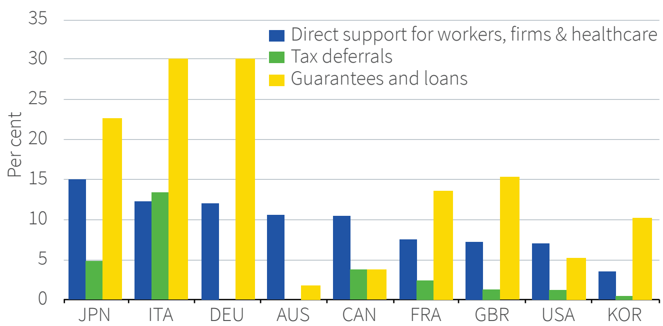
The OECD, in the past generally a bastion of fiscal cautiousness, recently advocated ongoing fiscal support to sustain incomes and minimise the scarring effects of the pandemic. In their words, there is a "clear need for state contingent policy support that can evolve as the recovery progresses". This view is probably coloured by the experience after the Global Financial Crisis when there was a perception that untimely attempts to restore fiscal prudence led directly to weaker growth, slower recoveries and lasting damage. The as yet unresolved fourth US fiscal package may yet lead to a growth hiccup in the fourth quarter or in early 2021, while the transition in the UK from the Furlough scheme to the Job Support scheme at the end of October also risks withdrawing too much support too soon. More traditional social democratic approaches across much of Europe (in terms of ongoing labour support schemes) should allow for a smoother transition. Either way, as the OECD also recognises, fiscal support will eventually

Figure 13. **Four major globalisation eras in history**
Trade openness index: world exports plus imports divided by global GDP



Source: Our World in Data, Aviva Investors estimates

Figure 14. **Substantial fiscal support has been announced since the pandemic began**
Official estimates of fiscal support, % of 2019 GDP



Note: Countries are ordered by the scale of support with a direct budget impact. The figure shows official estimates, when available, of financial help included in emergency packages announced in selected advanced economies in response to the Covid-19 crisis, as of 14 September 2020. In many cases, they are highly uncertain due to an unknown duration of the crisis and take-up of various programmes by the private sector, and may not be fully comparable across countries
Source: OECD calculation based on official estimates

have to be reined in, but the priority must be to ensure that recoveries are robust enough to allow for such adjustments. The downside risk is that Governments get this timing wrong.

End of US exceptionalism

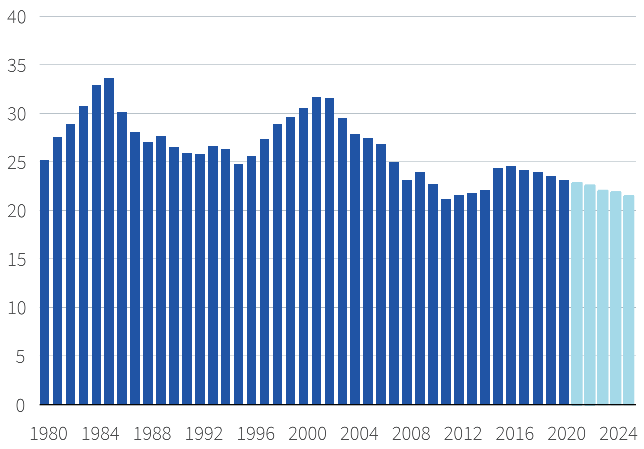
The US is still easily the most important and influential global superpower and will undoubtedly be a key – even the key – player in the arenas of politics and economics in coming decades (Figure 15). But that does not prevent change and evolution, and the hegemony of America may now start to become more challenged. This does not just relate to China's inexorable ascent, although that is part of the story, but also to a changing set of relationships among many other countries.

In 2010 a poll by Gallup reported that 80% of Americans agreed with the statement "The United States has a unique character because of its history and Constitution that sets it apart from other nations as the greatest in the world". Most countries exhibit aspects of national pride that is rooted in the first part of that description, but not all would jump to the conclusion reached in the second part. The post-war period has seen other episodes when there has been debate about the possible end of US exceptionalism. These include the end of the Cold War, the aftermath of the Vietnam War, the Watergate scandal and the Global Financial crisis. Each time the US has, as other countries did in the past, evolved and moved on, but it has always retained a position of critical importance in the world order. It may well do so again in the future, but it is still legitimate to question whether the US position in the global hierarchy is now changing once more. If US exceptionalism is retreating, then that would imply a very different backdrop for global financial markets. At the extreme, could the "exorbitant privilege" of the US dollar become more challenged?

US election

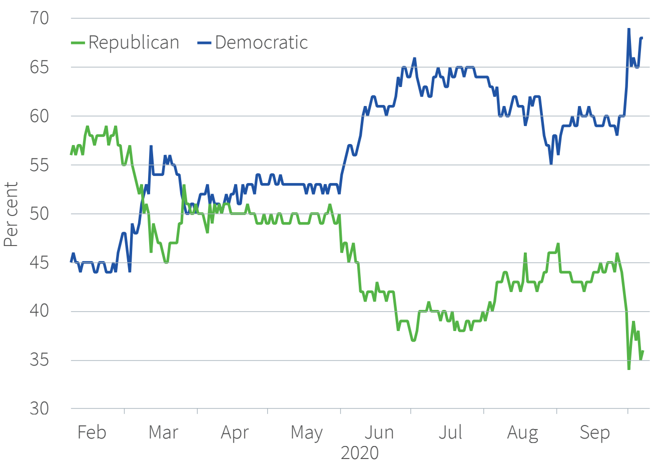
With only a few weeks to go until the election, Vice President Joe Biden and the Democrats have retained a comfortable lead over President Donald Trump and the Republicans in both national and key swing state polls (Figure 16). But nothing is certain, the mood can change, and sentiment could shift quickly in the light of economic developments, the path of the virus itself and Trump's policy stance in a number of possible fields in the short time that is left. There is also the risk of a contested result as there was in 2000, perhaps regardless of whether the officially called result is close or not. Trump and others have already been trying to instil doubts in the legitimacy of any Democratic victory, ostensibly on the back of potential voting irregularities that few others seem concerned about. In broad terms a Democratic win (especially if Biden wins together with a House and Senate majority) would be expected to lead to a significant fiscal package aimed at providing support in the current economic environment, but also for longer-term priorities, such as the green agenda. It would also likely be somewhat less favourable in terms of regulatory requirements on big business. On the other hand, a second term for Trump would likely see a further ramping up in tensions with China (and potentially other countries) and a limited domestic agenda given the likely Congressional outcome.

Figure 15. **US share of global GDP, per cent**
US has seen a slow but steady decline over the last 40 years



Source: World Bank, Aviva Investors, Macrobond, as at 1 October 2020

Figure 16. **Predictit Political Polls 2020, percentage chance of winning**
Biden and the Democrats are well ahead



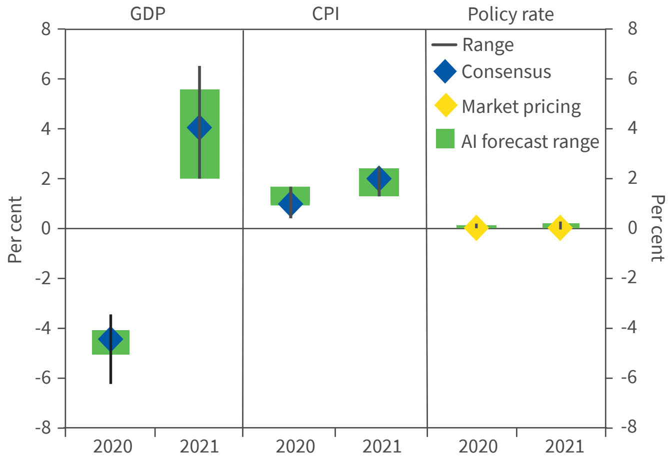
Source: Aviva Investors, Macrobond, as at 1 October 2020

Macro forecasts: charts and commentary

US

Despite the resurgence of COVID-19 cases in the summer, and associated restrictions on mobility, the US economy remains on track for recovery from the slump in 2020H1. In aggregate, the income support provided to households has, so far, more than offset the negative impact of job losses. Meanwhile the easing in monetary policy has materially reduced borrowing costs, supporting consumer spending and the housing market. While much of the ongoing additional income support for households expired at the end of July, there remains an expectation of further significant fiscal stimulus before the end of the year, irrespective of the election outcome. The prospect of a Democratic clean sweep across the presidential and congressional elections would likely further boost fiscal spending. Alongside the changes to the Federal Reserve's inflation targeting regime, prospects for a strong recovery in 2021 look to have improved. As ever, the timing and magnitude of that recovery will partly depend on the availability and widespread use of a COVID-19 vaccine.

Figure 17. **US**

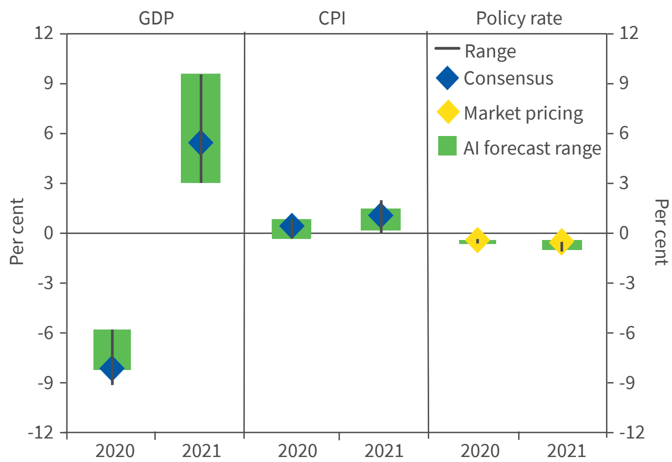


Source: Aviva Investors, Macrobond, as at 1 October 2020

Eurozone

Eurozone activity rebounded sharply as economies re-opened in May and June. Some spending – retail sales for example – has returned to previous levels, as households have found alternative ways to shop. But others – consumption of services that are associated with social interaction as well as investment – are still 10% or more below previous highs. Second waves of the virus, especially severe in France and Spain, are hurting sentiment and highlight downside risks to recovery. It is hoped that renewed national lockdowns can be avoided and that looks a reasonable assumption, but there is considerable uncertainty. The ECB has signalled ongoing policy support and may yet deliver additional stimulus in the form of more QE. Fiscal assistance packages have also been extended as Europe has shown a more enlightened approach to support than some other nations. Inflation has moved into negative territory, but this is largely due to a combination of one-off effects. Even so, it is expected to stay low in coming years. The ECB will face growing pressure to follow the Fed and review and amend its inflation-targeting mandate.

Figure 18. **Eurozone**

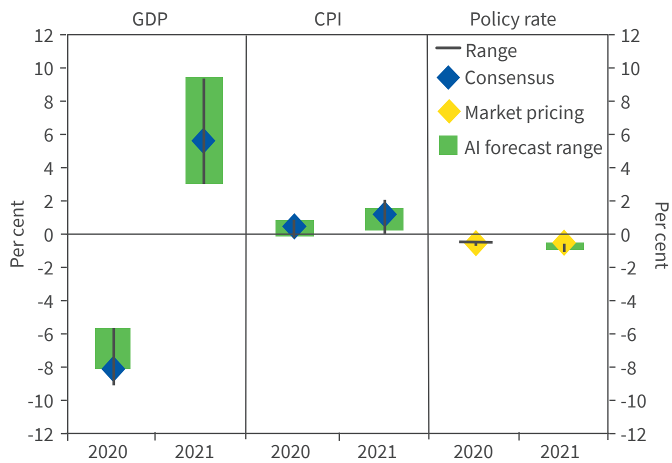


Source: Aviva Investors, Macrobond, as at 1 October 2020

UK

The UK saw one of the largest declines in GDP in Q2 (-20.4%) compared to its peers. But the strange growth patterns are the same everywhere. Q3 will see some extraordinarily large gains, reflecting the re-opening of economies that began in May but continued over the summer months. GDP could increase by 15% or more in the quarter. But that is all history now. It is what happens in Q4 and Q1 that really matters and the prospects there are mixed. A second wave of virus infections have been followed by localised restrictions on activity and more recently by a modest but significant tightening of required conduct among the population. More importantly, worries about the resurgence of the virus – especially over the autumn and winter months – may well restrain demand and activity. As a result, pre-COVID levels of GDP are unlikely to be restored until late 2021 or 2022. The additional headwinds of planned fiscal retrenchment (policy may have to change here) and Brexit add to downside risks in the UK. Further stimulus from the Bank of England is possible.

Figure 19. **UK**

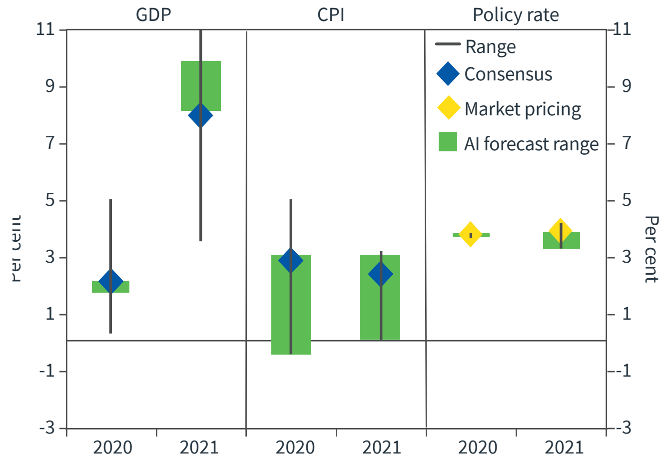


Source: Aviva Investors, Macrobond, as at 1 October 2020

China

China is already achieving levels of economic activity that exceed the pre-COVID period in many sectors. This is led by exports (+9.5% y/y in dollar terms in August), fuelled by demand for healthcare and some catch-up after H1 disruptions, but Industrial production was +5.6% y/y in that month, and even retail sales, which have lagged, edged into positive territory. The credit-driven fiscal and monetary stimulus is past its peak, but will support manufacturing, consumers and investment. Beyond near-term recovery, the state will aim to decouple China from its technological and energy dependencies; the details of top-down plans will be unveiled in October's 5-Year Plan. Inflation continues to be weak, CPI + PPI averaging close to zero, and core CPI under 1%, as the recovery is not yet robust enough to cause demand pressure, and unemployment and the output gap are yet to fall back to normal. With debt levels high, the PBOC will keep monetary policy loose, but has effectively raised yields by 75-100bps since the lows in Q2 and is likely to lower them only incrementally to ease corporate financing needs.

Figure 20. **China**

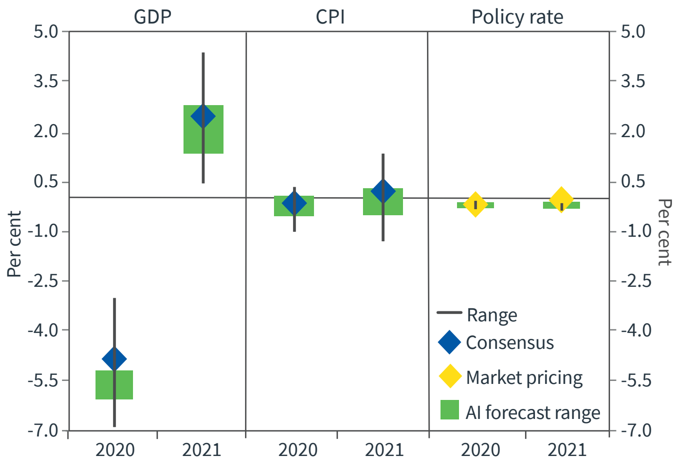


Source: Aviva Investors, Macrobond, as at 1 October 2020

Japan

Japan's COVIDrecession and rebound are slightly out-of-sync with the rest of the world, as the lockdowns happened slightly later. The Q2 contraction of -7.9% was a recession within a recession: the third consecutive negative reading, after the consumption tax hike set off a contraction in Q4-2019. A large rebound in Q3 is unsurprising, but even with a new fiscal stimulus package likely as one of the first moves for the new administration of PM Suga, recovery will be incomplete for years: we see economic output achieving pre-COVID levels only in late 2022. CPI has slipped back to around zero, but "Suganomics" is likely to be focussed on administrative reform and regulatory improvements – some of these are major but will probably not be the kind of sea change inaugurated by former PM Abe. The BoJ is unlikely to ease significantly, but will keep rates only slightly in negative territory; of course QE will continue to monetise the deficit used to support the weak economy, but the BoJ has been unable to prevent the real rate of interest from rising.

Figure 21. **Japan**

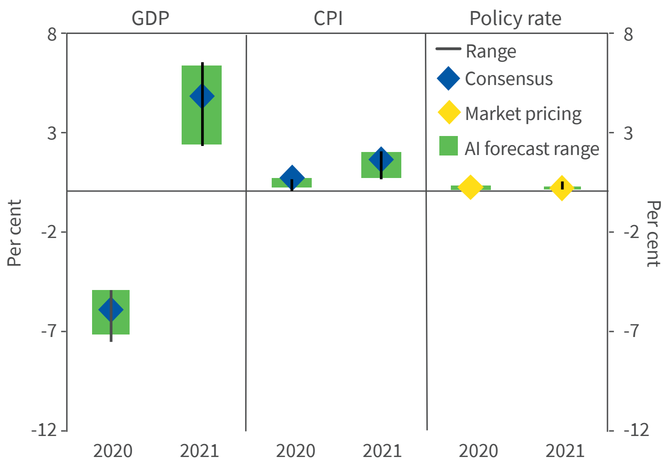


Source: Aviva Investors, Macrobond, as at 1 October 2020

Canada

The strong growth rebound expected in Q3 has materialised and looks faster than was anticipated. Looking ahead, the strong growth of the reopening phase is expected to be followed by a slow and choppy recuperation phase that will remain largely determined by the path of the virus and the subsequent policy response. Given the uncertainty around the economic outlook, the Bank of Canada (BoC) is expected to remain dovish, keeping rates at 0.25% and continuing the asset purchase programme until the recovery is well underway. The BoC continue to stress a "sustainable 2% inflation target" and there is potential that the BoC looks to implement an average inflation target similar to the Federal Reserve. Fiscal policy remains supportive with September's Throne speech outlining several ambitious proposals, with the government declaring it would support people and businesses affected by the crisis "as long as it lasts, whatever it takes". These announcements, including the extension of the wage subsidy programme (CEWS), will be followed by a fiscal update and projections in Q4. The outlook for fiscal policy, therefore, remains one of expansion over the medium term.

Figure 22. **Canada**



Source: Aviva Investors, Macrobond, as at 1 October 2020

Global market outlook and asset allocation

The global economy improved rapidly from its partial paralysis in early Q2, when lockdowns meant that activity in certain sectors dropped to almost zero. The fast recovery meant that recent monthly changes are huge, and prospects for continued advances are enhanced by optimism that mass vaccinations will make normal activity possible once again. The extreme pessimism in H1 has abated, and expectations for earnings have begun to improve, albeit from depressed levels (Figure 23). In normal times, such "fundamental" changes would justify gains in risk assets, but the level of earnings and the trajectory of expectations matter too. This is why we think there has been a "decoupling" of equity prices from their short-term earnings fundamentals: even with forward (2021) earnings dropping 20 per cent in the US and more elsewhere, equity index levels have fallen much less, or even gained year-to-date in China and the US, leaving traditional valuation multiples elevated (Figure 24).

Equities and credit: driven by recovery hopes and government intervention

This does not make equity prices irrationally exuberant, because a more powerful force than fundamentals has intervened: governments have come to the rescue of firms and workers, allowing consumer spending to avoid a crash, and central banks have also come to the rescue of banks and markets, lowering the term structure of yield curves (more on fixed income below). This upside was highlighted in our last quarterly, and as we do not expect either of these two main themes of our house view to let up, risk assets such as equities and credit will remain supported, as long as downside possibilities such as fiscal cliffs are avoided and assuming that the global economy is, however erratically, continuing to heal into 2021.

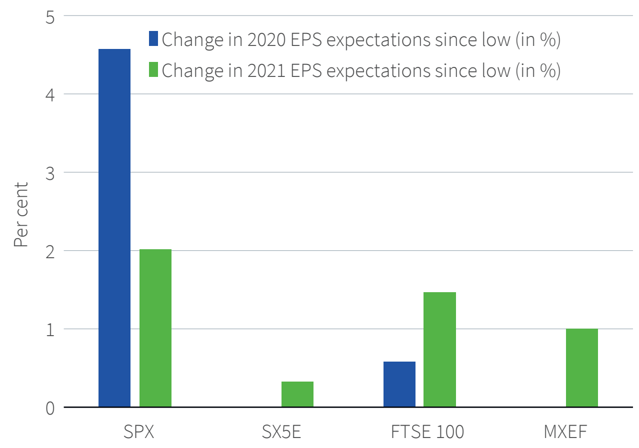
Governments and central banks have come to the rescue, overwhelming fundamentals

This also means that, to a large degree, risks to the outlook and how they feed into earnings and capital flows do matter, and we have seen that impact in the past few months: the US Congress's incapacity to agree on a Phase 4 fiscal deal, potential vaccine delays, and above all a COVID-19 second wave slowing down the re-opening of economies have meant that the ebullience of equity markets in July and August took a serious knock when these reality checks manifested themselves. Valuations outside the US, Japan and China are more supportive and arguably provide some cushion; moreover, in several markets the earnings outlook for 2021 has bottomed out and begun to improve.

The uncertainty around the economic outlook and risks to our house view will cause two-way equity volatility

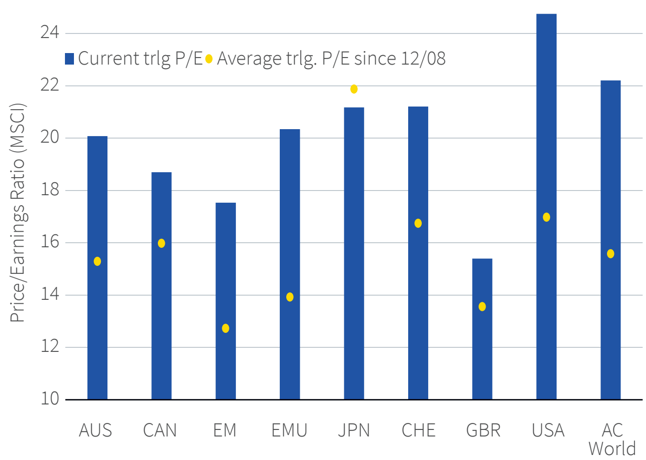
In credit markets, the blow to earnings has been too much for many leveraged companies, with bankruptcies and downgrades rife across retail, energy, travel and leisure. Those defaults and credit deterioration were accompanied by spread widening and forced selling, but what was expected in Q1 was worse than what transpired in Q2 and Q3, and is now mostly in the rear-view mirror. Banks will be affected but benefit from regulatory forbearance and central bank largesse mentioned above, while corporates are benefitting from low interest rates and in many cases direct purchases as their bonds are included in asset purchase programmes. Valuations have compressed – from a spread of 1087bps at their peak for US High Yield and 401bps for US Investment Grade, to 547bps and 139bps respectively – but these are still 40-60% higher than where they were pre-crisis. Despite record issuance, these asset classes remain attractive

Figure 23. **US earnings have been upgraded faster than other regions**



Source: ThomsonReuters Datastream; Aviva Investors, as at 1 October 2020

Figure 24. **Equity indices' multiples are very elevated**



Source: ThomsonReuters Datastream; Aviva Investors, as at 1 October 2020

COVID-19 shock led central banks to cut rates to lower bound, where they will remain for an extended period

This led to yield compression both on a cross country basis and across the curve; rates' ability to rally from here is more limited

Loose monetary and fiscal policy provides more scope for the market to price in upside inflation pressures

AIT framework could lead to more volatile swings in economic cycles and feed into measures of risk premium

and we prefer the risk/reward they offer compared to equities. EM Hard Currency debt, where the spread of 410bps is comprised of IG and HY both well wide of corporate counterparts, has likewise already suffered from defaults of some of the weakest credits, and remains an overweight, though landmines must still be avoided.

As the significant economic impact of COVID-19 became apparent, central banks around the world eased monetary policy, cutting rates and initiating or expanding quantitative easing (QE) programmes to support their economies and aid the functioning of global banking and financial systems. With developed market central banks having used significant firepower and unlikely to do dramatically more, additional policy support will need to come via the fiscal channel, while policy rates remain at the lower bound for an extended period.

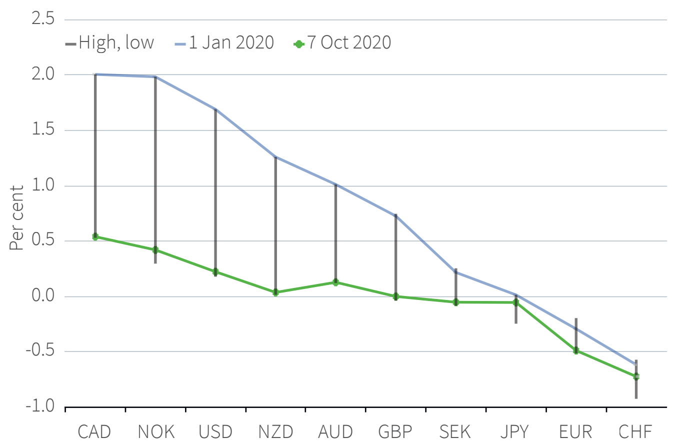
This has led to a significant yield compression of front-end rates such that the dispersion in rates across economies has contracted (Figure 25). Unsurprisingly yield compression has been largest in economies where rates were high on a relative basis going into the crisis. Most impactful for the market was the reaction function of the Federal Reserve, which cut rates by 150bps and restarted QE, and recently altered its framework to accommodate the new average inflation targeting (AIT) mandate. This shift in goalposts implies front-end rates will remain pinned at the effective lower bound for even longer and has brought rates across the curve to historic lows. At current levels, the ability of US government bonds to offer risk-reducing diversification in multi asset portfolios is more limited.

While the ability of nominal rates to rally from here looks constrained, real yields look comparatively more attractive (TIPS and other inflation-linked bonds), even at record lows of around -1% for the US year bond. Since the GFC, inflation has struggled to reach central bank targets; going forward the combination of loose monetary policy and fiscal support provides more scope for upside inflation pressures. Additionally, the AIT framework means that when inflation does rise above target the economy will be allowed to run "hot" for a period to compensate for consistent undershooting. Longer-term inflation risk premia could rise to accommodate both recession risk and subsequent boom phase, but in any case, higher expected future inflation implies even lower real yields now.

With central banks less likely to look through exogenous shocks, more dramatic swings in economic outlooks and subsequent monetary reaction functions, higher volatility in fundamentals could feed through into market volatility and broader measures of risk premium. As such, taking views on governments' curve structure will likely provide opportunities over our investment horizon.

Large fiscal deficits across the world might normally mean higher and steeper yield curves, and/or bond yields widening to swaps, but for now central banks are keeping rate volatility subdued.

Figure 25. **G10 2-year swap rate compression year-to-date**



Source: Aviva Investors, Macrobond, as of 29 September 2020

Figure 26. **MSCI EMFX YoY vs global growth nowcast**

Source: Aviva Investors, Macrobond, as of 29 September 2020

US dollar depreciation has been a significant trend in markets over the last few months. Looking ahead the key question will be to what extent this trend can continue. Historically, changes in USD have had a countercyclical relationship to global growth, with USD appreciating as growth falls and vice versa (Figure 26). It is unsurprising, therefore, that USD would depreciate once growth bottomed and we moved into a more risk-friendly environment. But there are several other longer-term factors that could continue to support the recent decline. The yield compression and equity outperformance discussed above has considerably weakened the relative attractiveness of USD assets and generates questions over the sustainability of US exceptionalism. Yield compression has also meaningfully reduced the cost of hedging for foreign holdings of USD assets (Figure 27).

USD depreciation trend has scope to extend so long as the growth trajectory remains positive

As economies recover from the shock of COVID-19, differences in fiscal policy response and the easing of restrictions could open up relative value opportunities, particularly where market pricing does not reflect divergent paths. In Europe, the coronavirus crisis has accelerated progress towards fiscal integration with the development of the European Recovery Fund. The combination of more bearish USD drivers described above with a more positive outlook for Europe supported the rally in EURUSD. The theme of European Unity in our House View points to scope for further upside should the outlook for growth improve and the investment in the European project bears fruit.

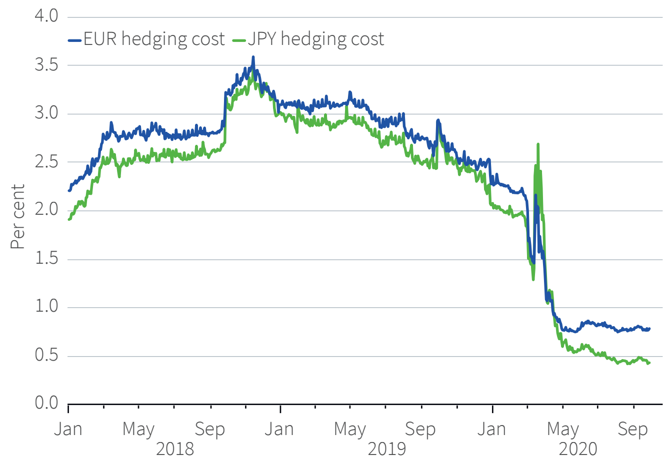
Differences in COVID recovery paths could open up relative value opportunities

While the USD has been the dominant driver of trends in G10 FX, emerging market (EM) currencies' appreciation vs USD has been more mixed. A weaker flow picture for emerging market assets has hampered EM FX performance. Typically, the DM / EM growth differential has been a good indicator of capital flows into EM. Current forecasts suggest a weaker relative backdrop for EM (both including and excluding China) for the second half of 2020 and the first half of 2021, before improving in EM's favour in the second half of 2021. The market is likely to seek confirmation of this improving growth backdrop – especially the impact on exports to China as it embarks on its next Five Year Plan – and diminishing risks for the global economy before it is willing to allocate significant resources to this asset class. Because of the record low yields in EM FX and EM Local Governments overall (Figure 27), we are therefore selective in EM fixed income markets, even with the weak dollar backdrop. We are choosing exposure based on high-carry, steep-yield curves, or valuations that scan as attractive relative to stable or improving fundamentals, such as Mexico, but generally prefer hard currency exposure.

Emerging market assets have struggled; we remain selective on opportunities

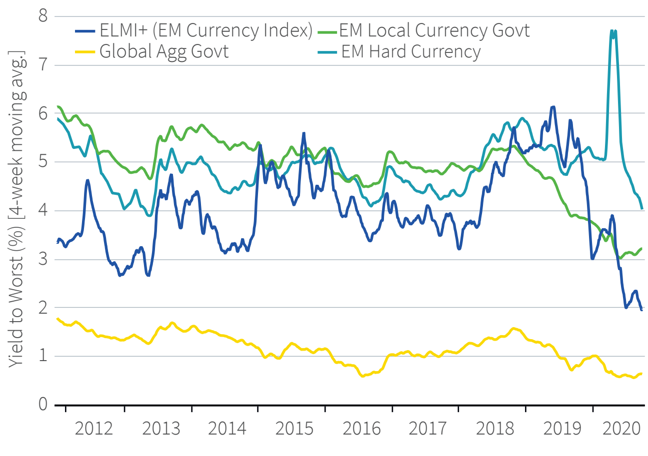
In terms of our asset allocation (Figure 28) credit remains a preferred growth asset with increased appetite for high yield. We have become less bearish on equities; defensive positioning has begun to pay off recently but there is a recognition that from here positive news around a vaccine could generate upside momentum. We retain our small positive bias for government bonds. With rates globally pinned near the lower bound, we look for relative value opportunities that exploit divergences between expected recovery paths and market pricing. Our conviction in Italian government bond spreads has increased given positive political developments and gradual progress on Eurozone integration. In FX we prefer to be overall short USD.

Figure 27. **Cost of selling USD fwd (3m fwd points, annualised rate)**



Source: Aviva Investors, Macrobond, as of 29 September 2020

Figure 28. **Emerging market dollar bond yields have remained relatively high**



Source: Bloomberg/Barclays, JPMorgan: Avia Investors, Macrobond as at 29 September 2020

Figure 29. **Asset allocation**

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