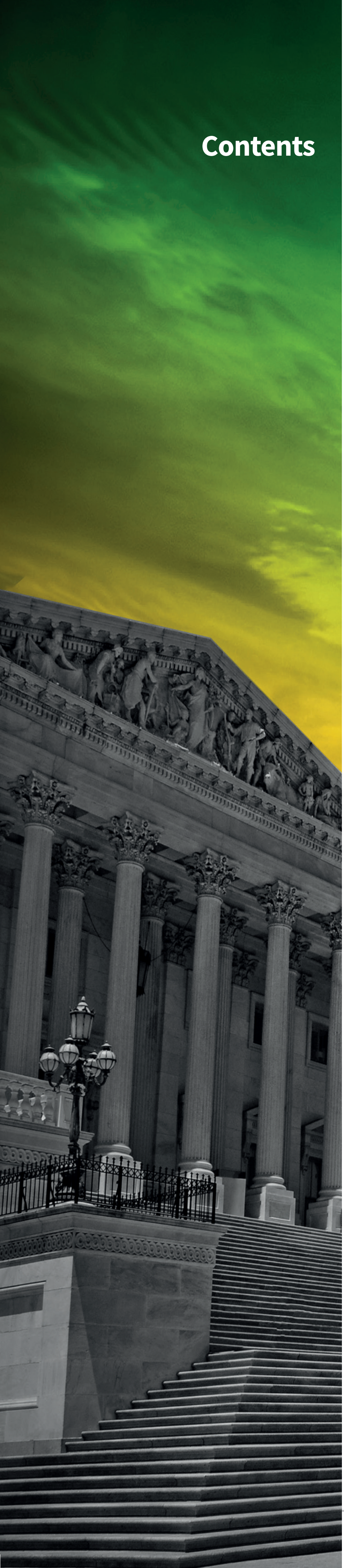
House View Q2 2021

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

This time really is different

Every recession is subtly different from the last. However, the events that led to the great recession of 2020 were unique, at least in modern times. A sudden stop in economic activity, imposed by governments around the world, to try to prevent the spread of the deadly COVID-19 virus. Just as the cause of the recession was unique, so has been the response from governments and central banks. Through large-scale fiscal transfers and central bank actions, households and businesses have been supported through the crisis and are in a position to emerge with their balance sheets largely intact. Indeed, so vast has been the fiscal response in some places, such as the United States, that aggregate household balance sheets are stronger than would have been the case without the crisis. The nature of the crisis has had a seismic effect on the way politicians and policymakers see their role in society. The Washington Consensus that emerged in the 1990s, already in the process of being dismantled by President Trump, has largely given way to highly interventionist demand management policies that have the potential to persist far beyond the crisis itself. If that turns out to be the case, then this time really is different.

Policy response to crisis means this time is different

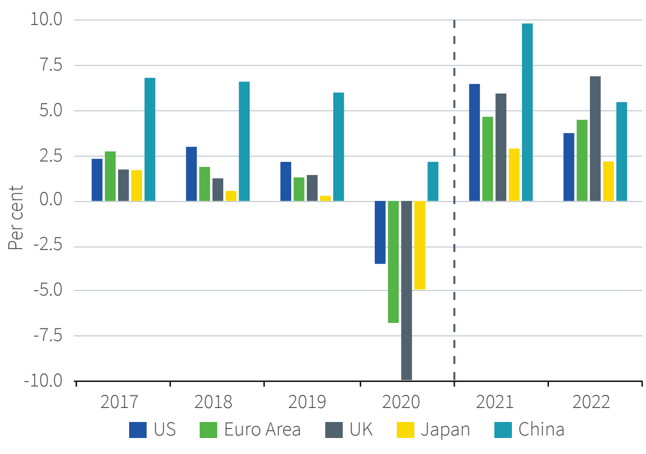
Alongside vast government support, households and businesses have also shown themselves to be more robust and adaptable to circumstances than perhaps was believed at the outset of the crisis. As a result, the range of sectors and businesses directly impacted by government restrictions on activity has steadily declined over time. Perhaps most notably, the manufacturing sector, which saw very steep declines in activity in the lockdown of 2020 Q2, has rebounded rapidly and continued to steadily expand through the more recent lockdowns. As a result, industrial production is already nearly back to pre-pandemic levels in many major economies. The ability of manufacturing companies to continue to operate effectively has ensured that the supply of goods has continued to grow, albeit at a slower pace than demand, in particular with retail goods spending well ahead of pre-pandemic levels in countries such as the United States where income support has been greatest.

Businesses have adapted and shown resilience

We have not changed our overall view on the potent combination of economic drivers for 2021, which lead us to an above-consensus outlook. Those factors remain: 1) economies reopening; 2) vaccine roll-out largely removing COVID uncertainty; 3) pent-up demand for those activities forgone in 2020; 4) increased savings buffer to draw down; and 5) supportive monetary and fiscal policy. However, we have adjusted our growth projections (Figure 1) to reflect some important developments in recent months. First, growth in 2020 Q4 was materially stronger than we expected across all major economies, with the impact of restrictions felt less harshly than anticipated. Second, a further tightening of restrictions in 2021 Q1, particularly in Europe, has led us to revise down our growth expectations for the quarter. The net of those two factors has left the level of global activity at the end of Q1 roughly in line with our prior expectations, with the weakness in Europe offset by strength in the US and China. However, as we look further into 2021 and 2022, we expect a somewhat faster pace of recovery than previously, with global activity reaching the pre-COVID trend by the end of 2021 (Figure 2). At the global level, we expect

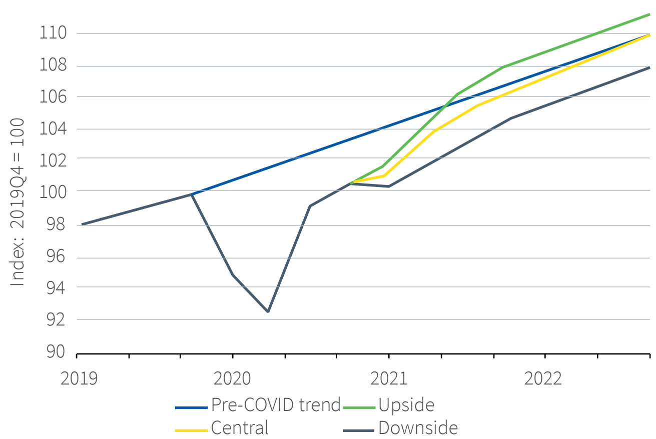
Strong global growth outlook, with risks to the upside

Figure 1. **Major economy GDP growth projections**



Source: Aviva Investors, Macrobond as at 26 March 2021

Figure 2. **Global growth scenarios**
Global GDP scenarios



Source: Aviva Investors, Macrobond as at 26 March 2021

growth to be around 7 per cent in 2021 and 4.5 per cent in 2022. We judge the growth risks to be tilted to the upside given the relatively conservative assumptions we have made about fiscal multipliers and release of excess household savings.

Inflation pressures low, but set to build

While spare capacity remains in most economies, underlying inflationary pressures are expected to be muted. That said, a variety of factors, such as energy prices, will impact on the year-on-year comparison for both headline and core measures of inflation over the course of 2021, pushing measured inflation temporarily above target in most major economies. Just how temporary that proves to be will depend on the pace of recovery. We expect spare capacity to be eliminated much more quickly than in the recovery from the global financial crisis of 2008. Indeed, in the US we expect the output gap to turn positive by the end of 2021, with the Eurozone to follow around a year later. That could put upward pressure on underlying inflation in 2022 and beyond, something that we think would be welcomed by central banks, so long as it was not excessive.

Policy to remain supportive for extended period

Indeed, even as the global economy continues to recover through 2021 and beyond, we expect monetary and fiscal policy to remain supportive. Central banks are expected to delay any tightening in policy until inflation has moved above 2 per cent for a period (Figure 3). And looking beyond the pandemic, many governments are planning to increase spending on public infrastructure, as well as in other areas, to stimulate future growth.

Downside risks include COVID mutations and greater economic scarring

The key themes and risks to the outlook are explored in more detail on pages 6 to 16. While we think the balance of risks are to the upside, there are undoubtedly downside risks as well, including the potential for COVID mutations that make existing vaccines less effective spreading more widely, as well as the potential for greater economic scarring than currently observed due to the vast range of support measures in place.

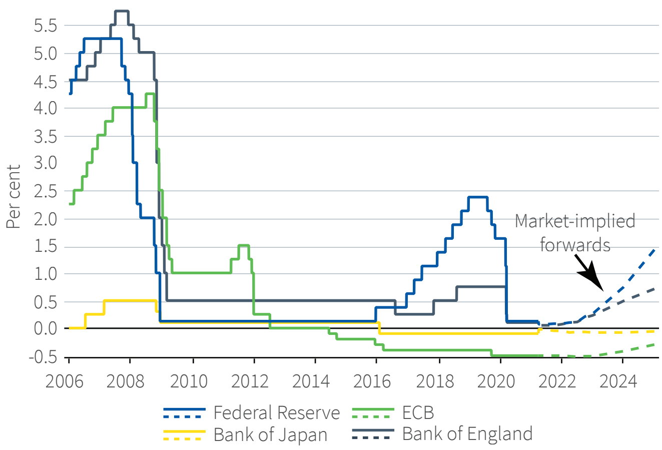
Preference to be overweight equities

Given our growth expectations for 2021 and 2022, as well as the balance of risks, we prefer to be overweight global equities (Figure 4). Looking across the major regions, we prefer to be slightly underweight emerging markets given they offer too little valuation cushion given the increased risks there of rising US bond yields, weaker local currencies and tighter domestic monetary policy. We prefer to be somewhat more overweight the US and UK markets, where domestic growth differentials, strong policy support and strengthening global trade should be supportive. Three months ago, we had expected “high growth” stocks to underperform and “value” and “cyclical” stocks to continue their recent outperformance, as we expected bond yields to continue rising. That has largely transpired, and we expect that trend to continue.

Modestly underweight duration and credit

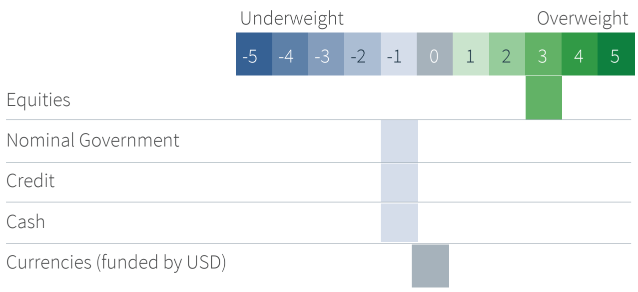
Government bond yields have risen in recent months, reflecting the brighter economic outlook and increased fiscal support, particularly in the US. We think that longer-term bond yields can rise further, albeit with central banks set to keep policy rates at the effective lower bound for some time, there remains a limit as to how far yields can rise. As such, we prefer to be modestly underweight duration. The upside from tighter credit spreads appears to be limited given the narrowing already seen, and therefore we also prefer to be slightly underweight. Finally, we are neutral on currencies, with the previous view of a broad-based weakening in the US dollar now more nuanced given the more rapid growth trajectory expected there now compared to other regions.

Figure 3. **Monetary policy to stay very loose**



Source: Aviva Investors, Macrobond as at 26 March 2021

Figure 4. **Asset allocation summary**



Source: Aviva Investors, Macrobond as at 26 March 2021

Key investment themes and risks

Investment themes

1 Rapid economic recovery
2 Fiscal fundamentals
3 Monetary policy reboot
4 Global strategic competition
5 Climate change policy
6 Digital regulation and taxation

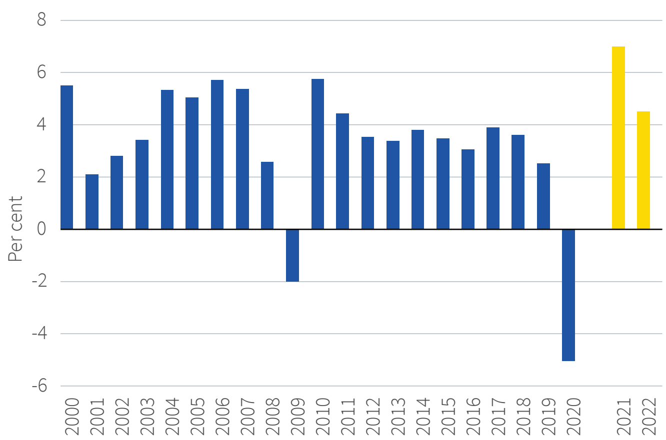
Rapid economic recovery

2020 will go down in history as the year of COVID. Because of the pandemic, last year will also have seen the steepest declines in GDP in the post-war period. There are still significant uncertainties and although 2021 is likely to be linked directly with the virus once more, the dominant feature of this year should be a strong and lasting economic recovery (Figure 5). The exact path to, and shape of, that recovery will be determined by transmission patterns of the virus itself (including variants) as well as by the extent of progress of the various vaccine programmes that are currently being undertaken around the world. Initial waves of the COVID virus a year ago had a similar impact in most developed nations, but subsequent waves have been more varied and there may well be some significant differences in the experience across countries going forward. Nevertheless, our central scenario envisages a globally coordinated economic upswing in 2021. In fact, despite renewed lockdown restrictions – which affected activity in some places in the last three months of 2020 and are likely to do so again in the first three months of this year – that revival is essentially already underway on a global basis. World GDP has grown each quarter since the middle of 2020, albeit at a slowing pace. But if economies reopen significantly, as we expect, then Q2 (especially) and Q3 this year should see some very rapid growth rates of GDP in the major nations (Figure 6). Several economies will regain pre-COVID levels of activity this year, including the US, while others should pass that mark early in 2022. On present trajectories and with continuing policy support, it is possible that a number of countries will return to pre-COVID trends by next year, something that seemed highly unlikely just three months ago. Forecasters have been upgrading growth projections in recent months, and we are no different, once again pushing our projections above consensus.

2021 should be a year of strong economic recovery

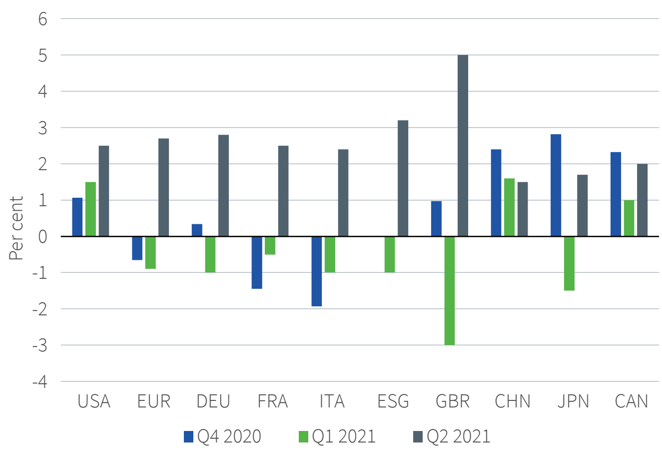
In our central scenario world GDP is projected to grow by almost 7 per cent in 2021 and a further 4.5 per cent the following year. Growth is also robust in each of the alternative

Figure 5. **2021 and 2022 should both see strong global growth**
Country variations, but pre-COVID trends could be regained next year



Source: Aviva Investors, Macrobond as at 26 March 2021

Figure 6. **Some areas of COVID-related weakness in Europe in Q4 & Q1**
Quarterly GDP growth, actual and projected



Source: Aviva Investors, Macrobond as at 26 March 2021

scenarios this year (and almost identical to the central case in 2022) reflecting diminishing uncertainty regarding the general macroeconomic outlook. The key to delivering this rapid pace of recovery is both the success of vaccine roll-out and subsequent reopening of economies, alongside continued fiscal and monetary support (see subsequent themes below). With large amounts of "excess" savings built up by households during the pandemic, there are risks to the upside (see risks section below for more). The backdrop of rapid global growth should continue to be supportive of risk assets in general, although there are likely to be important differences within asset classes, particularly as we expect longer-term interest rates to continue to move higher (see Market Outlook section for more details).

Pent-up demand and ongoing support suggests risks are to the upside

Fiscal fundamentals

The traditional fiscal orthodoxy that has dominated the last three decades has been called into question by events of recent years. The global pandemic has all but cemented the notion that the old rule book is no longer relevant in most places. The fiscal assistance that is still being provided during the COVID crisis is massive and unprecedented (Figure 7). It has also been essential, in our view, helping to avert a far more damaging catastrophe. The principles have so far been quite simple: shutdowns are necessary to stem transmission of the virus; organisations would quickly go bust and jobs would be lost forever if incomes that had previously been earned are not replaced; the government must step in to do just that, absorbing the risks that the private sector cannot until a time that they no longer require public sector financial life support.

Fiscal rulebooks have been rewritten during the pandemic

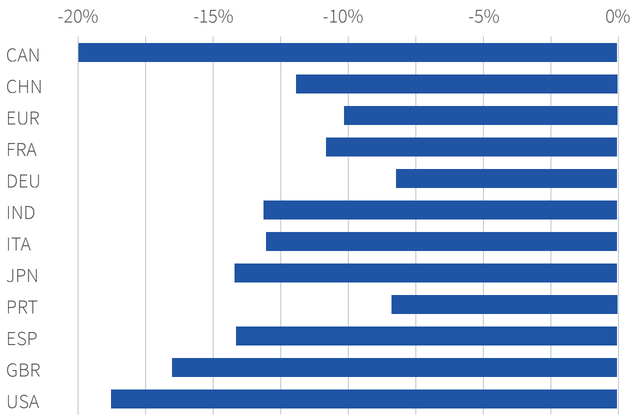
As the IMF and several other bodies have continually pointed out, one of the biggest risks to recovery is the premature withdrawal of fiscal support. Particularly in the light of what are now generally accepted as fiscal policy mistakes in the wake of the GFC, countries are more likely to err on the side of fiscal benevolence than in the past. OECD studies and forecasts show that many of its members will see public debt increase by 20 per cent of GDP or more over the next two years (Figure 8). In times past the priority for most governments would have been to reduce debt burdens as soon as possible by paring deficits or even trying to run surpluses. Rules of thumb about responsible metrics for public debts and deficits were an indication of the prominence of fiscal discipline. It continues to some extent in certain quarters, but in most places, fiscal policy is likely to be used for an extended period of time to support aggregate demand and to try to improve the supply-side as well.

Public debt will rise significantly as a per cent of GDP

The need for much of the direct fiscal support should diminish automatically. But countries are using the COVID reset, alongside the more enlightened attitudes towards fiscal policy, to rewrite the policy agenda. The US, for example, after passing the recent (COVID) stimulus programme, is quickly refocussing on a potentially huge and ambitious public spending package. Europe's fiscal response has not been as large as in the US, but has still been impressive, with the establishment of the Recovery Fund a very important step. But

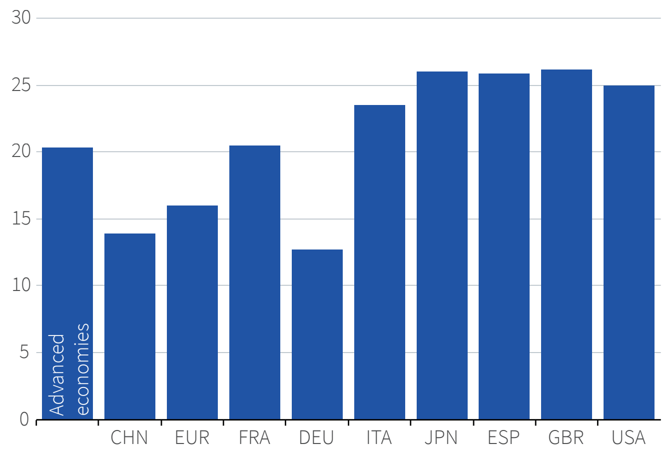
COVID reset is helping to redefine fiscal boundaries

Figure 7. **Public borrowing has soared in 2020 & will stay high in 2021**
Government borrowing as a per cent of GDP, 2020



Source: Aviva Investors, Macrobond as at 26 March 2021

Figure 8. **Public debt burdens have increased significantly**
IMF estimates for increase in public debt as a per cent of GDP in 2020/21



Source: Aviva Investors, Macrobond as at 26 March 2021

everywhere, traditional parameters and targets of fiscal policy are changing. In general, we seem to be evolving from support to stimulus. Some is reasonably conventional if overlooked for several decades – infrastructure expenditure for example, but even here there are important changes such as increased emphasis on the green agenda and digital revolution. But some is different: countries are adopting or considering fiscal initiatives in new arenas, reflecting novel societal objectives in areas such as climate, diversity and inequality. Of course, there are some overlaps with earlier initiatives, but there are new directions here too. Above all, fiscal tools seem to be reasserting themselves as key policy weapons, having lain in the doldrums for several decades.

Monetary policy reboot

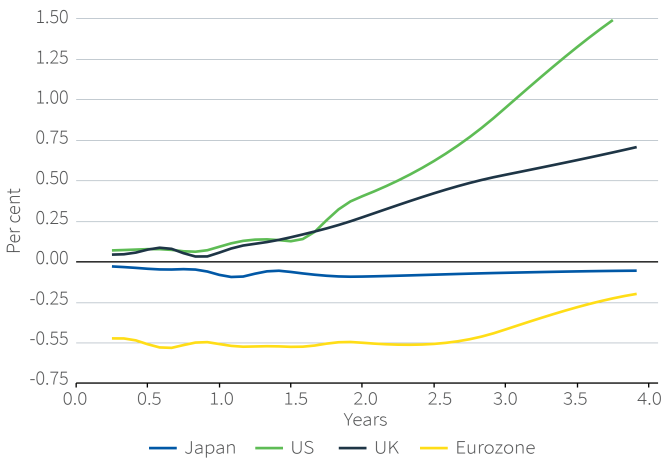
Central banks are signalling ongoing monetary policy support…

The largest central banks around the world appear all to be reading from a similar script, putting great emphasis on their intention to maintain extremely supportive monetary policy for an extended period of time. There is always room for some differences of interpretation in judging what exactly that means. Most central banks now seem keen to put greater stress on state-contingent landmarks, rather than rely solely on those which relate to time. Nevertheless, financial markets have continued to try and translate any forward guidance into date-specific deadlines. After any economic downturn there is always much conjecture about the appropriate timing for the first touch on the policy brakes, although it is usually a more appropriate metaphor to think in terms of lifting pressure gently from the accelerator. Given the extraordinary range and size of policy support measures – monetary, fiscal and other – put in place during the pandemic, that is especially true today. This has not been a "normal" cyclical downswing and it will not be a normal recovery phase either. The truly unique nature of present circumstances, along with the ongoing uncertainties about both the virus itself and the post-pandemic world that it has produced, mean that monetary policymakers everywhere will tread even more carefully than usual when they eventually start to exit from the extreme stimulus policy stance. Financial markets are just starting to query the exact timing, but have largely accepted that there will be minimal changes in the short run (Figure 9).

…and a markedly more pro-inflation stance

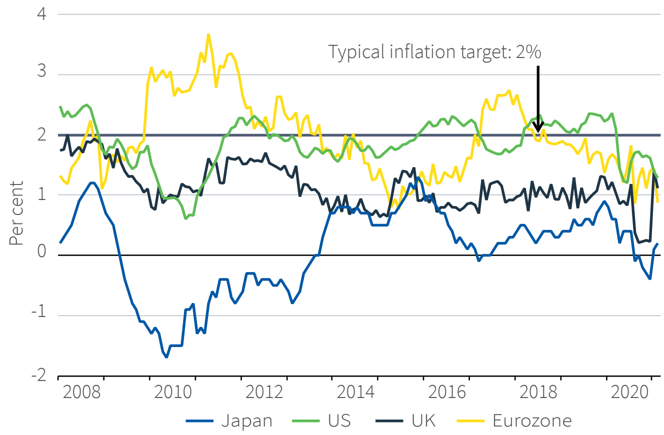
The timing (and eventual degree) of any decisions that are made in coming years will also be fundamentally influenced by the adoption – explicit or implicit – of a new monetary policy regime in many key geographies. The Federal Reserve (Fed) in the US has been at the forefront of these changes, unambiguously adopting an average inflation targeting (AIT) policy. Essentially, this will allow the Fed to balance inflation undershoots (more common recently) with intentional inflation overshoots. Other central banks have not yet been as bold, but are clearly moving in a similar direction – the ECB, for example, is expected to adopt something comparable at the conclusion of its strategic review in September this year. Arguably, it is other countries which have greater need for a more "pro-inflation" stance as it has been they, rather than the US, that have been least successful in achieving an inflation target (typically 2 per cent), often undershooting it by some margin in recent years (Figure 10). In our view, this

Figure 9. **Financial markets expect central banks to stay relaxed**
Policy rate expectations in the major developed regions (OIS)



Source: Aviva Investors, Macrobond as at 26 March 2021

Figure 10. **Inflation has largely been below target since the GFC**
Core inflation in the major nations



Source: Aviva Investors, Macrobond as at 26 March 2021

represents a major transformation in the way in which monetary policy is conducted, perhaps the most important since inflation targeting became the norm in the 1990s. While not yet certain, it could change the inflation and policy landscape fundamentally.

This monetary policy reboot, as we have termed it, effectively gives license to the holders of the key monetary policy levers (independent central banks) to "run economies hot", or at the very least hotter than they would have done in the recent past. Then, financial markets would have expected above-target inflation to have been met promptly by tighter monetary policy. They might even have tried to anticipate it. Now it is less clear, and the result is likely to be higher recorded inflation on average which, in turn, should probably be reflected in higher inflationary expectations. These have risen markedly since the middle of last year (Figure 11). We should point out that, in the light of the inflation experience of recent years, this does not automatically imply that dangerous risks are being taken with inflation. Rather it reflects the monetary policy regime attempting to keep up with modern circumstances. A cynic might point out that there have in the past been instances of monetary principles changing – late – to reflect the previous regime rather than the current one. That seems less likely in today's low-inflation world.

Inflation expectations have risen but remain contained by past standards

Global strategic competition

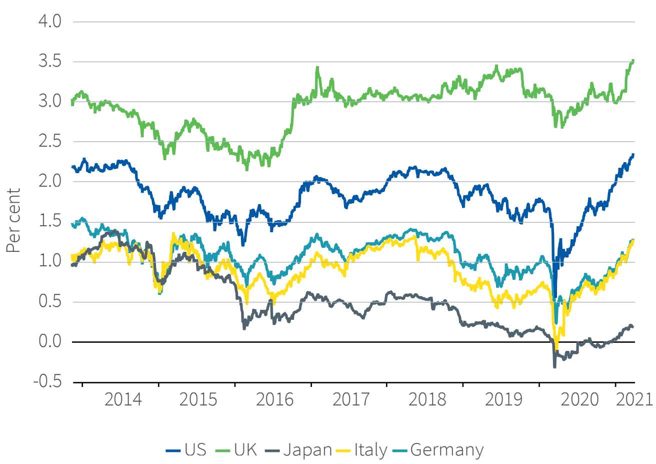
The Trump period in office was characterised by a confrontational approach on most issues. In the international arena, the final two years were largely defined by the deliberately combative attitude to relations with China. Tariffs were simply the weapon of choice. The justification underlying this embraced a number of well-documented grievances against China, including intellectual property theft, several other deeply questionable corporate practices as well as more general objections regarding their human rights record and methods employed to assert their economic and political might on the world stage. Hopes that the incoming Biden administration would lead immediately to a rapprochement and a more harmonious relationship between the two superpowers always looked far-fetched. As vice-president in the Obama administration, Biden had already contributed significantly to a hardening of attitudes towards China, including in his direct relationship with Xi as his opposite number. Although Trump, as always, put his own peculiar slant on things, arguably he was building on some of those foundations. Equally, while Biden and the Democrats were critical of many of Trump's ways, it now seems clear that there will be some continuity of effort in confronting China head-on as they attempt to at least shape the form of China's place in the new world order as the country becomes ever-more significant (Figure 12).

The change in US government has not led to any softening of approach with China

The first set-piece event between Chinese officials and those from the Biden administration in Alaska in March shocked people out of their comfort zone and injected a note of realism. There were some fiery public exchanges right from the start with both parties explicitly highlighting their perception of the other's shortcomings. Both were keen to assert their strength – to

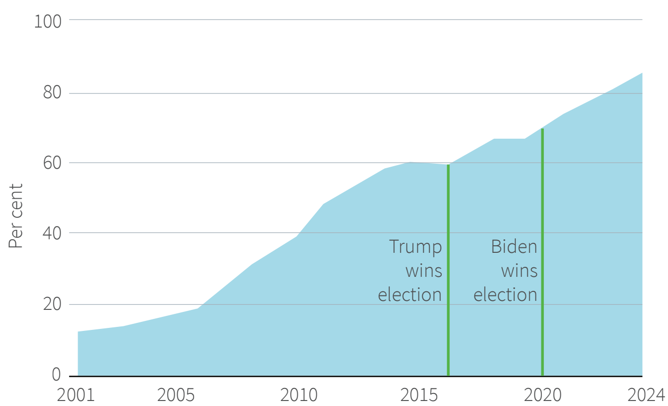
Tensions between the two superpowers are already apparent

Figure 11. **Breakeven inflation rates have risen, especially in the US**
10-year market breakeven inflation rates



Source: Aviva Investors, Macrobond as at 26 March 2021

Figure 12. **China is moving to top spot in the global GDP rankings**
China GDP as % of US GDP



Source: International Monetary Fund via Bloomberg Economics as at 16 March 2021 each other, to their home audiences and to other countries. There are echoes here of the old relationship between the two major nuclear superpowers in the 1970s and 1980s, when the US and the Soviet Union were engaged in the Cold War. Relations were often strained, there were many flashpoints in a variety of spheres, yet a form of co-existence and diplomacy was established. The comparison can only be stretched so far as it is now clear (although it was not so obvious at the time) that the Soviet Union was in decline, whereas China today is inexorably on its way up. But just as direct conflict was avoided in the past – even if sometimes quite narrowly – it is not unreasonable to conceive that China and the US will find a way of co-existing.

The complex relationship between the two nations is of course the most important in the world today. But in some ways, it is simply the biggest example of the global strategic competition that looks set to shape international relations – political and economic – in coming years. It is not just about China and the US. Most recently the EU has imposed sanctions targeting the China elite in protest over alleged human rights abuses. That these actions have been supported by the UK, the US and Canada illustrates that – in contrast to much of the Trump era – there may be more of a multilateral approach to future relations with China. China has not held back from defending its own position with colourful and forceful language, but this is often how international diplomacy works. It is to be hoped that a more coordinated approach from Western democracies will help the transition of China proceed more smoothly and in a manner that is more in line with international conventions and practices. How global political influence settles will be critical, but also crucially important in the world of commerce, will be technology and the digital domain.

Global strategic competition is likely to be a feature of international diplomacy in future years

Climate change policy

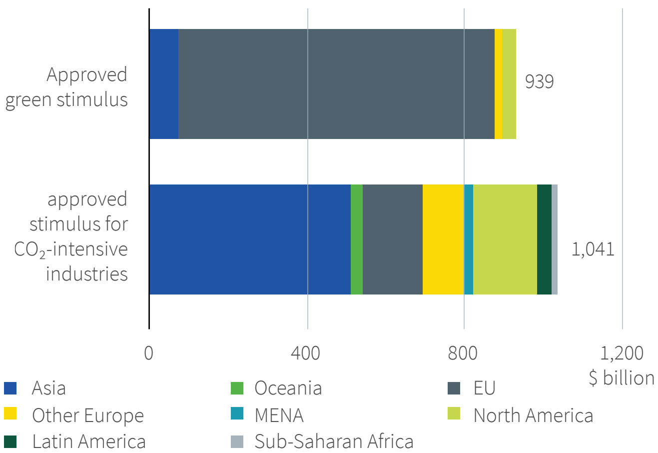
The COVID reset has presented an opportunity for many countries and supra-national organisations to reframe the debate over climate change policies (and several other issues too) as they attempt to define more precisely the agenda for progress. Bodies such as the IMF and OECD have made very deliberate efforts to highlight the importance of countries redoubling their efforts on climate change mitigation as economies recover following the pandemic.

Climate change is being put at the top of many policy agendas

This will inevitably be a multi-year, perhaps even multi-decade task. But change needs to start as early as possible. The pick-up in momentum behind the green agenda in general and climate change in particular that began last year has continued in early 2021 and suggests that some meaningful policy initiatives will be introduced this year. It is widely hoped – expected even – that public policy in these areas will help inspire a genuine "build back better" approach, but there is clearly a way to go. Bloomberg estimates that of the $13 trn of government support and stimulus so far pledged under COVID-related initiatives, just under $1 trn (7 per cent) has been directed to schemes aimed at reducing greenhouse gas emissions

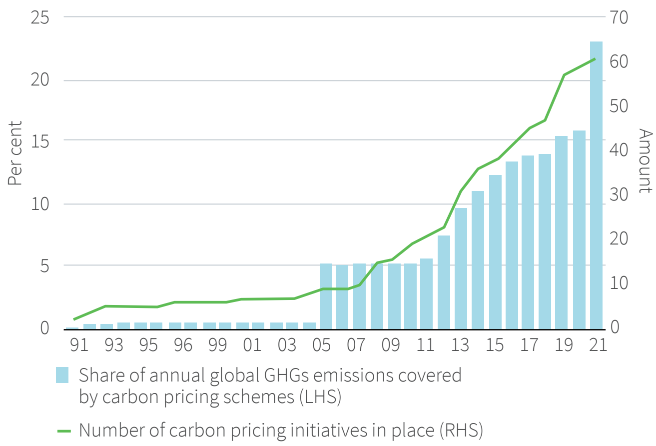
Many "build back better" approaches will have a climate change element

Figure 13. **EU is a key driver of the green agenda**
COVID-19 stimulus approved ($bn)



Source: Governments, media reports, BloombergNEF as at 26 March 2021

Figure 14. **Number of carbon pricing schemes has tripled**
Share of global GHG emissions covered by carbon pricing initiatives



Source: World Bank, "Carbon pricing dashboard," accessed 22 January 2021 or aiding climate adaptation, less than the total dedicated to carbon-intensive sectors (Figure 13). By contrast, very little if any of the stimulus after the GFC could be classified as green. China's recent five year plan was especially disappointing, revealing no additional commitments to reducing their reliance on coal.

The key set-piece events coming up that should push forward on climate change policies are the climate leaders' summit in April, the G7 meeting in June and finally COP26 in Glasgow in November. But things are already changing quickly. The number of carbon pricing systems (taxes or emissions trading schemes, ETS) has tripled over the last decade, covering almost a quarter of global greenhouse gas emissions (Figure 14). In this year alone Carbon ETSs are up 30 per cent and are expected to continue to increase. Carbon prices are rising too: in Europe it has moved above €40/tonne in 2021 having fluctuated around €20 to €25 over the last three years (Figure 15). The most important recent development has been the launch of China's ETS. Although initially aimed at encouraging power plants to document and record emissions, rather than constrain them, the very fact that China is engaging in such schemes is reassuring and something that can be built on in the future.

COP26 this autumn will be a key event

Many other nations have committed to net zero targets by mid-century, together amounting to more than 65 per cent of emissions and 70 per cent of the global economy. Another crucial recent change, in the wake of their election, has been the US rejoining the global effort. The appointment of John Kerry as special climate envoy has raised the prospects for a greater role of climate diplomacy between nations, most importantly, the US, China and Europe. But it will not be smooth sailing. Many subjects will need to be addressed at the international level including the thorny issues of international carbon markets and border adjustment mechanisms – aimed at levelling the international playing field on carbon prices.

Post-Trump US is likely to be far more involved

Climate change policies are fundamentally changing the relative attraction of different types of commercial activities. Costs will rise in many of the most polluting sectors, energy efficiency drives will become more common and the public sector will benefit from fiscal revenues and be expected to foster innovation and contribute directly via a range of energy, transport, buildings and water infrastructure investments. Green projects, for example, are at the heart of the European Commission's €1.85bn recovery plan (Figure 16). The transition to a low carbon world can be shaped by public policy. But ultimately it will be private sector decisions and actions that change the landscape. Among the more obvious areas are electric vehicles, energy-efficient buildings, and green finance.

Public sector infrastructure likely to lean towards green projects

Digital regulation and taxation

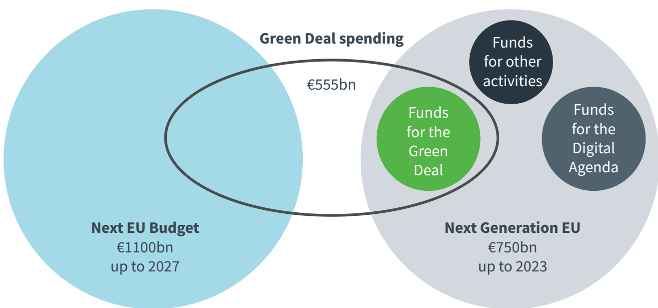
The increasing digitalisation of business is leading to ongoing reform of national and international rules relating to tax and regulation. While attempts are being made to reach some sort of international consensus, a number of countries are looking at the possibility of unilateral actions instead or as well. There is a tension between establishing a unified and

International efforts on a unified approach to digital tax and regulation

Figure 15. **Carbon price has risen significantly in 2021**
EU trading: indicative carbon price

Source: Aviva Investors, Macrobond as at 26 March 2021

Figure 16. **Recovery fund to boost green agenda**
30 per cent of overall funds directed towards climate change



Source: Baker Mackenzie as at 26 March 2021 consistent set of internationally acceptable guidelines and allowing national champions to flourish in a fair and competitive manner. Although these issues affect all areas of commerce, they are especially convoluted in the digital arena. Taxing and regulating international businesses have always been areas of extreme complexity and dispute. Increased globalisation in the post-war period has contributed to capital becoming exceptionally mobile internationally, able to respond quickly to differences in incentive structures around the world, especially to different tax and regulation regimes.

Now the debate is focussing on impacted sectors and this could have important ramifications for those and many other connected areas. Change is happening fast, and policymakers are struggling to keep up. There is a danger of arbitrary, hurried or piecemeal approaches that could disrupt affected industries significantly. Moreover, there is also a risk that policymakers move away from sound principles because of political expediency. What does seem clear is that organisations with a significant digital or on-line presence will face heightened scrutiny and greater intervention from competition authorities. They will also be under growing pressure to comply with increasingly detailed consumer protection laws.

Companies with a large digital presence set to face greater scrutiny

The international effort has been centred on the OECD, where momentum behind efforts to establish a meaningful agreement on a digital tax has picked up significantly this year, largely because the new US administration is now more fully committed and involved. Perhaps as importantly, key players outside of the OECD (India and China) have also signalled a willingness to comply with any solution negotiated at the OECD forum. Confidence is growing that an understanding could be reached (in principle) by the summer. A number of issues are outstanding in both Pillar I (redistribution of tax revenue) and Pillar II (increased revenue from minimum taxation). For example, on Pillar I, the US will push for a broader scope so as to capture more companies than just the large US tech firms. Europe by contrast seems to favour a more limited scope, which would shield many of their national tech champions. Preliminary estimates from the OECD are that their proposals could increase global corporate income tax (CIT) revenues by between $50bn and $80bn (Figure 17). But the key point is that compromises seem to be within reach and both the US and EU see advantages in getting a deal done. If a global solution is found, the EU intends to follow up with an independent EU scheme that is consistent with the global agreement. If negotiations at the global level fail, the EU intends to push ahead with its own scheme, which, in this scenario, would stand a good chance of being adopted and implemented. Individual member states have already begun to impose their own schemes. Last year France imposed a 3 per cent levy applied on the revenues earned in France by international tech giants.

OECD is at the centre of the international effort

It is difficult to generalise on digital tax and regulation as these areas are often characterised not only by abstruse levels of complexity, but also by abstract concepts and elusive definitions of activities or processes. Designing appropriate and workable solutions to tax and regulation is therefore not an easy task. But for the first time in a while, there may be some workable solutions within reach.

Figure 17. **Overview of global tax revenue effects from the proposals**
Estimates based on illustrative assumptions on the design and parameters of Pillar One and Pillar Two

Estimated global tax revenue gains		In % of global CIT revenues	In USD billion
Pillar One		0.2%-0.5%	5-12
Pillar Two	Direct revenue gains	0.9%-1.7%	23-42
	Additional gains from reduced profit shifting	0.8%-1.1%	19-28
	Total Pillar Two	1.7%-2.8%	42-70
Total Pillar One and Pillar Two		**1.9%-3.2%**	**47-81**
US Global Intangible Low Tax Income (GILTI) regime		0.4%-0.8%	9-21
Total, including GILTI		**2.3%-4.0%**	**56-102**

Source: OECD as at 26 March 2021

Risks

Excessive inflation/boom (bust)

Headline inflation rates can and have always been buffeted around by one-off factors. Energy price spikes and collapses have been regular offenders, and these will have a notable impact again in 2021. Food and house prices, mortgage rates and tax changes have also been important in the past. But unless these usually transient drivers lead to significant second round effects – altering behaviours and expectations – they are often more noise than signal. Underlying inflation is more fundamental, reflecting instead the balance between supply and demand in a true macro-economic sense. In market economies, excess demand leads to rising inflation and vice versa. Given the experience of the last 20 or 30 years in most developed economies, this fascination with inflation may seem like a mania-like obsession to many. But before that, inflation had been the main adversary, leaving a trail of economic loss in its wake (Figure 18). It was these disasters that led directly to greater independence for central banks and to inflation targeting regimes. By and large, history will judge this to have been a successful endeavour.

Inflation was the main macro-economic enemy in the past

But it is possible that this success – alongside the impact of the virus episode (and before that the Global Financial Crisis) – might have led to a degree of complacency about inflation as yesterday's enemy. It is widely accepted that there are significant negative output gaps today (Figure 19) – excess supply in other words – and that is, as it always is, a deflationary impulse for as long as it remains in place. But they are only ever estimated and there is a risk that anticipated strong post-COVID recoveries lead to a resurgence of demand, pushing it above supply. There is a potentially rich combination of factors lining up which could move inflation unexpectedly higher: policymakers are explicitly adopting an increasingly pro-inflation stance, monetary and fiscal policy is in maximum stimulus mode and suppressed spending could return more rapidly. In addition, the supply-side of economies may have suffered permanent damage from the pandemic, coming on top of mounting evidence of long-term secular demographic trends that could weaken supply capacity. We may not see a return to the inflationary booms of the past. But even a modest reappearance could force grating policy-induced bust. The market implications of this are discussed further in the Market Outlook section on page 19.

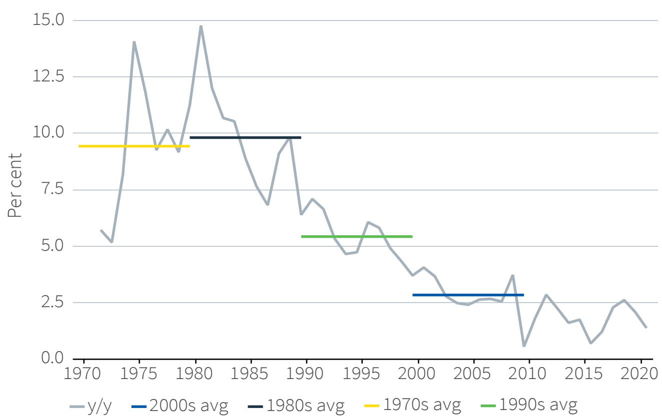
Is there a danger of complacency regarding a return of inflation?

Fiscal sustainability

The COVID crisis has resulted in sharply higher budget deficits around the world. As economies recover, those deficits will narrow automatically, but not before public debt burdens rise considerably. In most places, a more relaxed stance is being adopted towards these increases and to fiscal largesse in general. Debt and deficit dynamics are reasonably well understood, with sustainability depending on the relationships between key numbers

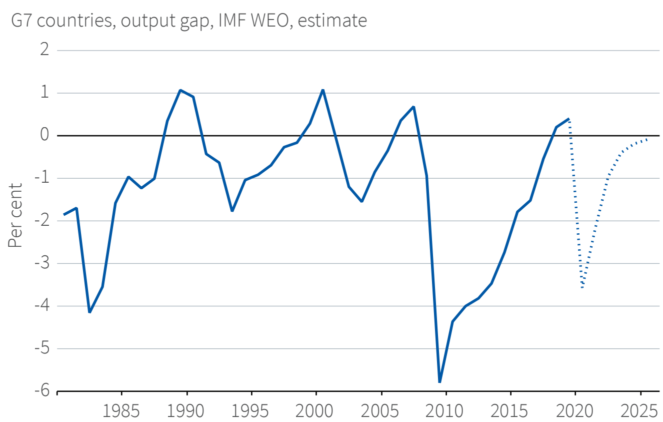
Higher public debt burdens will be more onerous for some

Figure 18. **Inflation was the main macro problem in the past**
But the long secular decline is probably over



Source: Aviva Investors, Macrobond as at 26 March 2021

Figure 19. **G7 countries, output gap, IMF WEO, estimate**
Currently negative, but could close fast



Source: Aviva Investors, Macrobond as at 26 March 2021

including the initial debt ratio, primary balance, the average rate of interest paid, the rate of GDP growth and the rate of inflation. These allow for a multiplicity of possible equilibria consistent with sustainability. Among the most important is the rate of interest, meaning that the recent rise in sovereign bond yields has led to some questions being asked about whether additional debts are manageable (Figure 20). Another key variable is inflation: a higher rate might appeal to some as means by which to erode the real value of higher debts. But any such development would presumably push interest rates up too, potentially to unaffordable levels.

Amended conventions are probably appropriate today, but the fiscal algebra still has to work. And even with attitudes (and markets) changing, this may prove more of a challenge to some countries than others. It is a cold truth that those nations with more delicate fiscal balances to begin with, or those with less secure reputations, are more vulnerable – changes in key metrics could push them onto unsustainable paths quickly. High debt levels can be managed – Japan has shown that. But low, or negative, bond yields have helped enormously too and not every country will be able to rely on them. Many emerging market economies have no such luxury, so financial markets effectively impose some form of fiscal discipline on them. If they choose to – or are forced to – run deficits that are considered excessive, they will be punished. Even some developed markets can fall victim to such dynamics – it wasn't that long ago that Italy looked to be at risk of a fiscal disaster (Figure 21). Any increased risk premium demanded by markets can quickly push countries onto an unsustainable fiscal path. The COVID crisis should pass, but there is a risk of some fiscal glitches in its wake.

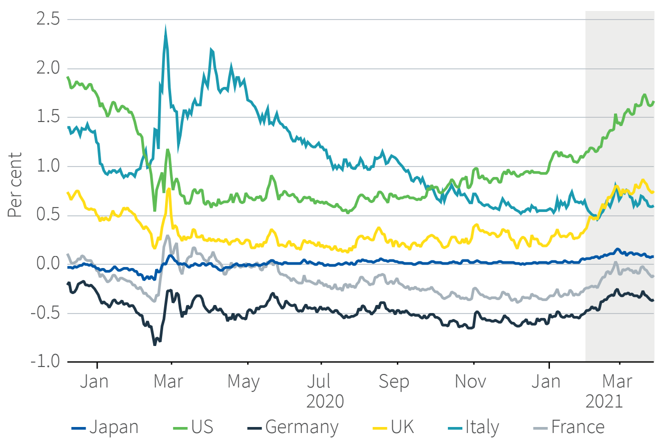
Low borrowing costs help, but the balance is delicate in many countries

Pricing for perfection

We remain optimistic about the ability of the global economy to recover from the COVID pandemic in 2021. Policymakers have been responsive to the crisis, supporting households and businesses. Those same households and businesses shown considerable resourcefulness in adapting to abnormal circumstances, limiting the extent of the negative hit from lockdowns. The suite of effective vaccines currently being deployed are increasing visibility about the future and argue for a marked reduction in uncertainty. Our central scenario for growth is still above consensus across the major economies. However, we are conscious that the expectation for a rapid recovery in global growth in 2021 is almost unanimous amongst market participants. Similarly, expectations that a favourable growth backdrop will support risk assets, including a rotation to cyclical and value stocks, as well as commodities, high yield credit, emerging market currencies and other cyclical asset prices, are widely held. These expectations may have already been well discounted in some assets. The succession of encouraging news about effective vaccines last November led to significant rallies in many risk assets, reflecting the growing belief that a path to the end of the pandemic had become much clearer. The setbacks over the winter have, so far at least, resulted in only fairly modest corrections in quite a narrow range of markets. As a result, some parts of the market may still

Financial markets appear keen to look forward to a brighter future

Figure 20. **Recent rise in bond yields raises borrowing costs**
10-year sovereign bond yields



Source: Aviva Investors, Macrobond as at 26 March 2021

Figure 21. **Fiscal risk rose sharply in Italy in 2018/19**
Italy 10-year yield spread over Germany

Source: Aviva Investors, Macrobond as at 26 March 2021

be effectively "priced for perfection", when that outcome is rarely what actually happens. Many financial assets still appear expensive on conventional valuation criteria when there is still at least some doubt about the exact path from here. More generally, in recent years periods of market exuberance have often been followed by an extreme, but short-lived spike in volatility stemming from market corrections. The trigger for such corrections has been highly unpredictable, but any emerging evidence of possible overheating in the recovery phase is a possible candidate.

Longer-term scarring

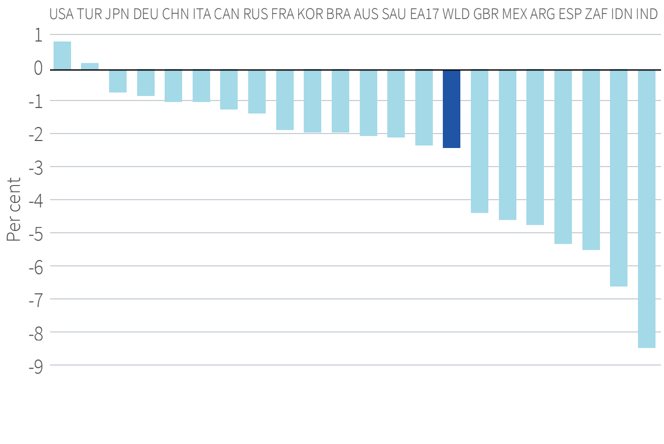
The extraordinary and unprecedented range and amount of policy assistance that has been put in place during the COVID crisis has, in our view, averted an even more damaging downturn and one which could quickly have become self-perpetuating. Among the most important has been the array of direct support measures, such as furlough payments and grants to companies who have not been able to operate as normal. Collectively, these represent massive financial transfers from the public sector to the private to replace otherwise lost incomes or revenues and to allow some corporations to continue to meet costs that would otherwise swiftly have pushed them into bankruptcy. But putting large swathes of the economy into, effectively, suspended animation, is not riskless. Eventually, economies will re-open fully and the various support schemes will be gradually withdrawn. It is only at that time that the extent of any permanent damage will become apparent. It is a sad truth that although Government schemes aim to tide people and companies over until better times return, not all will be able to do so. Some firms will go under, others will reduce the scope and size of their operations. Some jobs will not be there to return to, and unemployment will, inevitably, rise. GDP may be permanently lower than it would otherwise have been (Figure 22).

Extraordinary measures have tried to protect large swathes of the economy

The extent of this damage is unknown but could be significant. Using the UK as an example, the Office for Budget Responsibility (OBR) has estimated that GDP could be 2 per cent lower indefinitely because of such effects. That is an immense permanent economic loss, if it proves accurate. Moreover, it is not a binary issue – whether there is a job to resume or a company to restart. There is a range of possible outcomes, even in individual cases. The COVID experience is widely expected to have altered some behaviours profoundly, especially in areas characterised by close social contact. Again using the UK as an example, the pattern of furlough has varied considerably across different sectors (Figure 23). It may take far longer, for example, for international or business travel to return to "normal"; working practices may have changed permanently, meaning less need for as much office space or public transport and lower demand for any attendant services. Fewer hours may be made available to workers in such an environment, even if only temporarily. All these factors will imply lower incomes, reduced spending and lower output. Even if resources can be redeployed in other areas, transitions are not frictionless and not painless. If permanent damage is worse than feared, the supply-side hit to economies could have damaging knock-on impacts on long-term growth.

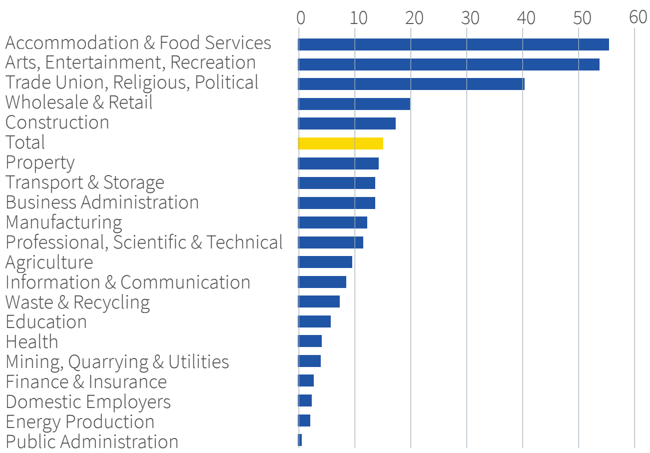
The extent of any lasting damage will not be known until support is withdrawn

Figure 22. **There will be some lasting damage from COVID**
Estimated GDP in Q4 2022 compared with Nov 2019 projection



Source: OECD Economic Outlook database; and OECD calculations as at 26 March 2021

Figure 23. **Furlough has varied considerably across sectors**
Percentage of UK jobs furloughed by industry, February 2021



Source: Aviva Investors, Macrobond as at 26 March 2021

COVID mutations

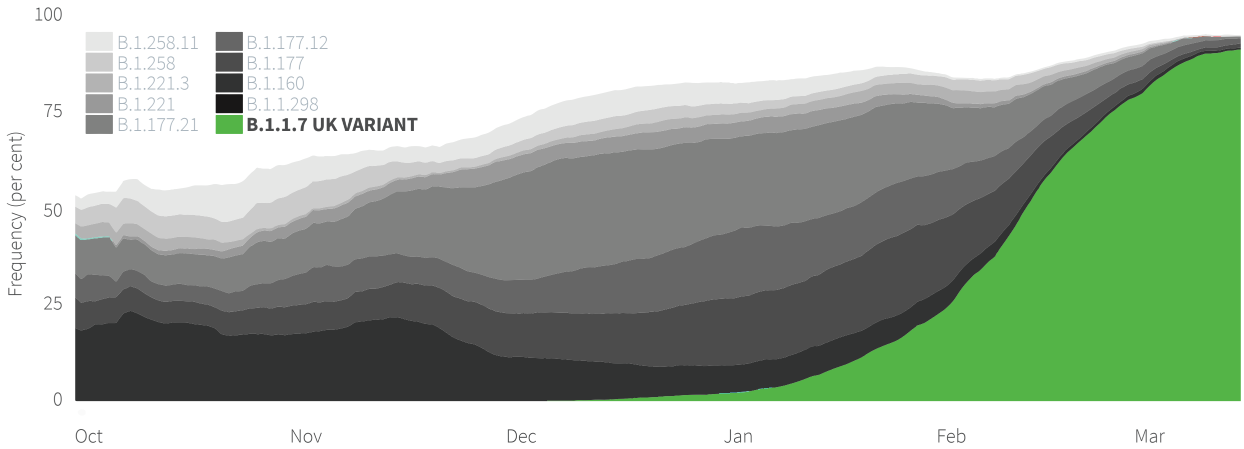
Mitigation of the spread of COVID-19 both within and across nations around the world has been complicated by the emergence of a number of variants of the virus. Virus mutations are inevitable – it is what viruses do – and had been widely expected. However, the speed of the arrival of variants which potentially undermine vaccines has come as a surprise to many experts in the field who previously had been reassured by the slow pace of mutation. Figure 24 shows an example of mutation dynamics of the virus in Denmark, as that country has undertaken much more detailed genome sequencing than many others. The chart shows just how quickly the UK variant (B.1.1.7) became the dominant one for newly confirmed cases once it was first established last December. The other grey bands show earlier more minor variants of the original virus. The trial data so far is limited, but the most recent vaccines to report their results have been able to compare efficacy between regions where different variants are dominant. The picture these studies paint is mixed. Whilst there have been material falls in the protection against symptomatic infection, the protection so far against severe illness appears less impacted. Given the relatively low proportion of infections which develop severe illness, the statistical power of these limited number of observations isn't enough to give complete confidence. This raises the prospect of vaccination programme being extended further with either third doses or maybe booster shots with updated vaccines a strong possibility in the European autumn.

Mutations are complicating the task of controlling the spread

When thinking about the potential for further mutation, the convergent evolution currently being observed, with many of the mutations which are causing concern occurring independently around the world, does suggest though that this race against viral evolution won't be as challenging forever. These common patterns suggest the strongest advantages that single mutations can confer have been seen and evasion of updated vaccines would be a slower process. While far more is now understood about virus mutations and their possible consequences, it is obviously a constantly changing environment. Despite increased awareness and monitoring, it is quite plausible that the emergence of mutations – including of potentially more dangerous variants – could oblige authorities to impose more stringent lockdown restrictions or to retain containment measures for longer than originally planned. Any such development would prolong and deepen the economic hit, oblige governments to provide ongoing fiscal support and increase further risks of permanent scarring. The economic recovery would be slower, weaker and less certain.

Virus variants may result in delays in reopening economies

Figure 24. **Mutation dynamics change very quickly**
The UK-originated variant is now dominant in Denmark, for example



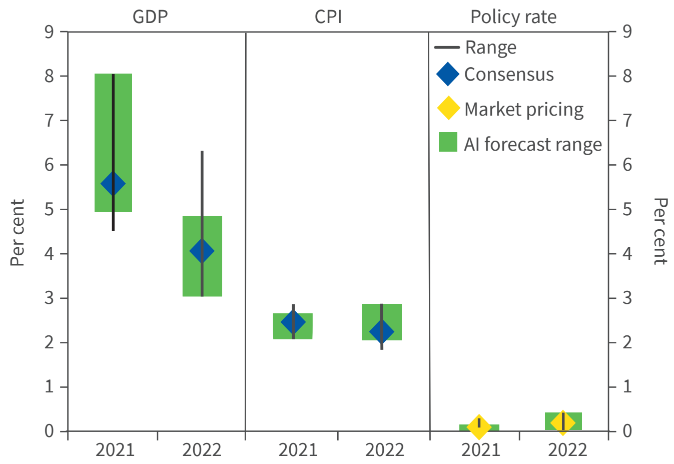
Source: Aviva Investors, Macrobond as at 26 March 2021

Macro forecasts charts and commentary

US

In our 2021 Outlook we expected an above-consensus, rapid growth recovery in the United States. We have seen further positive news over the past three months, with stronger-than-anticipated activity during 2020 Q4 and the start of 2021 Q1, rapid vaccine roll-out and, most importantly, the passage of another very large fiscal support package (worth nearly 10 per cent of GDP). This combination of factors has led us to revise up the central estimate of our growth expectations for 2021 to 6.5 per cent, with risks tilted to the upside. In particular, we continue to make the conservative assumption that only around 15 per cent of household excess savings are drawn down in 2021, with the risk that this could be materially higher. We have also revised our inflation outlook modestly higher, reflecting a more rapid elimination of spare capacity and a more positive outlook for the housing market. Despite these changes, we do not expect the Federal Reserve to raise interest rates before 2023.

Figure 25. **US**

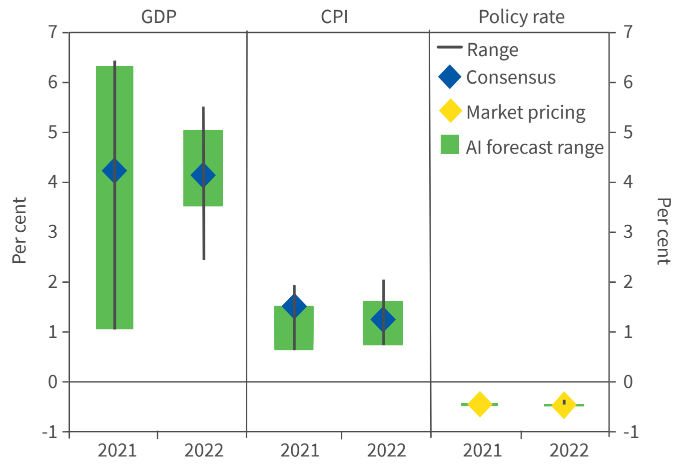


Source: Aviva Investors, Macrobond as at 26 March 2021

Eurozone

Despite renewed lockdown measures since Christmas, the big three Eurozone nations are currently experiencing a worrying third wave of COVID-19 infections. This is being countered by extensions to existing containment measures – and more may yet be needed – which will affect the timing and extent of the economic recovery that is still expected this year. Some encouragement can be taken from the experience in Q4 when restrictions on activity did not have as large an impact on output and demand as had been feared. Small declines in GDP are anticipated for the first quarter of 2021, but Q2 and beyond should still see a strong rebound as long as economies are able to reopen. The other cloud on the horizon for Europe is the unimpressive progress which has been made on vaccination programmes in the region. These have seen a number of organisational setbacks as well as some barely credible official adjudications about the vaccines themselves which may also contribute to a delayed recovery. Fiscal and monetary policy will remain supportive and underlying inflation is expected to stay contained.

Figure 26. **Eurozone**

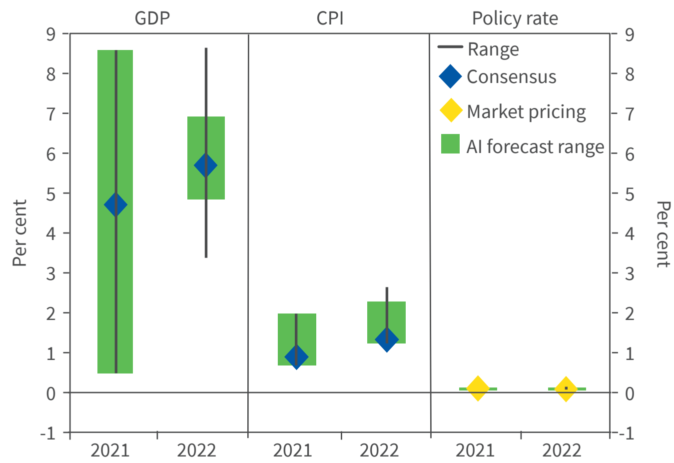


Source: Aviva Investors, Macrobond as at 26 March 2021

UK

The renewed national lockdown imposed in early January is likely to result in a small fall in GDP in the first quarter, although fears of something similar in Q4 proved misplaced as the economy showed greater resilience than expected. While doubts and uncertainties remain, the UK's outstanding progress on vaccinations since December – nearly half of the population have now received their first shot – has boosted sentiment and should allow for reopening of the economy as scheduled and usher in a convincing rebound in activity in Q2 and beyond. The UK is now set to regain its pre-COVID level of output a year from now and should grow strongly this year and next, as long as control of the virus is maintained. One concern for the future is the potentially overzealous plans of the British government to tighten fiscal policy in future years. Their position stands out by comparison to almost everywhere else in the developed world, where more relaxed approaches are being adopted.

Figure 27. **UK**

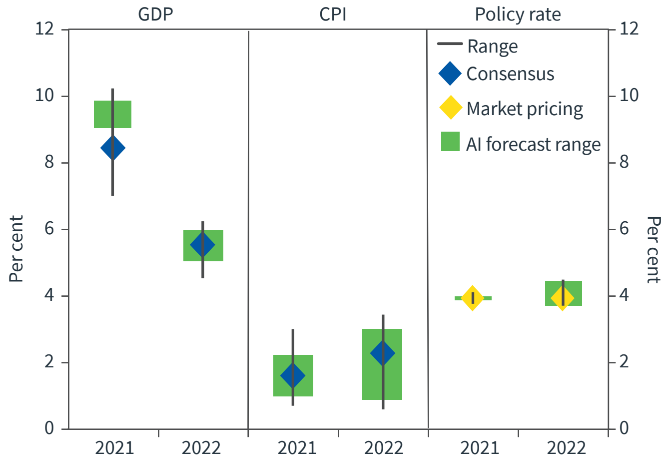


Source: Aviva Investors, Macrobond as at 26 March 2021

China

China's economy is growing at a 6 per cent annual pace in 2021, which is expected to lift annual GDP to nearly 10 per cent above 2020's depressed level. Low inflation should keep the PBOC stance loose, with a bias to move to neutral if needed to contain leverage or financial speculation. The five year plan unveiled at the National People's Congress indicates continuity, but was disappointing for those looking for more clarity, particularly around climate change goals. The Communist Party leadership will aim to decouple China from its technological and energy dependencies, as determined in the 5th Plenum, and has added food and financial security to these aims. Achieving a peak in carbon emissions by 2030 is ambitious, but aggressive investment in low-carbon power generation will continue. The tensions with the new US administration mean that a rapid reversal of tariffs is unlikely, but will depend on positive engagement on areas of common interest – such as climate, North Korea, and COVID-19 – as well as Western actions on human rights, Hong Kong, Taiwan, and Chinese economic and political malfeasance.

Figure 28. **China**

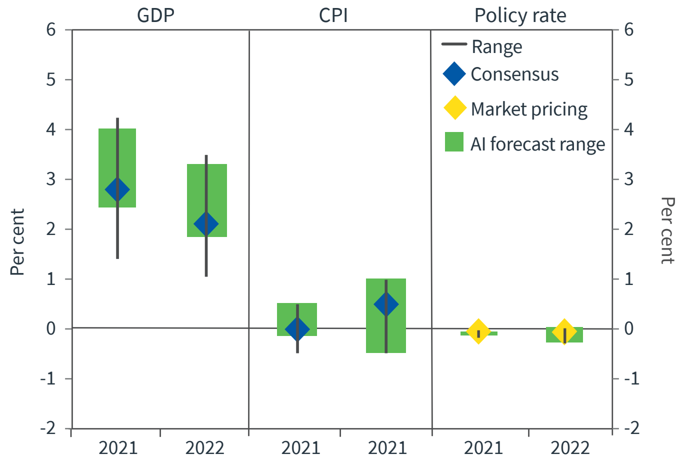


Source: Aviva Investors, Macrobond as at 26 March 2021

Japan

Japan should attain pre-crisis GDP levels by the end of 2021, with growth close to 3 per cent, yet another upgrade compared to the last quarter (and with upside risks). This is driven by public consumption thanks to fiscal spending which will remain supportive of growth, even as the deficit shrinks; private consumption and finally investment will rebound in upcoming quarters, but gradually. The state of emergency will enable lockdown restrictions to ebb in Q2, and the Tokyo Olympics will take place but with domestic audiences only in person. The BoJ has recently tweaked its intervention policies but the song remains the same: monetizing the fiscal expenditure and not doing anything much about very low inflation, which should remain close to zero. "Suganomics" includes administrative reform, regulatory improvements, and digitization, but the relatively new PM is dogged by recent scandals. He may seek a fresh mandate in snap elections, which would be positive in removing uncertainty and helping both domestic investment and FDI.

Figure 29. **Japan**

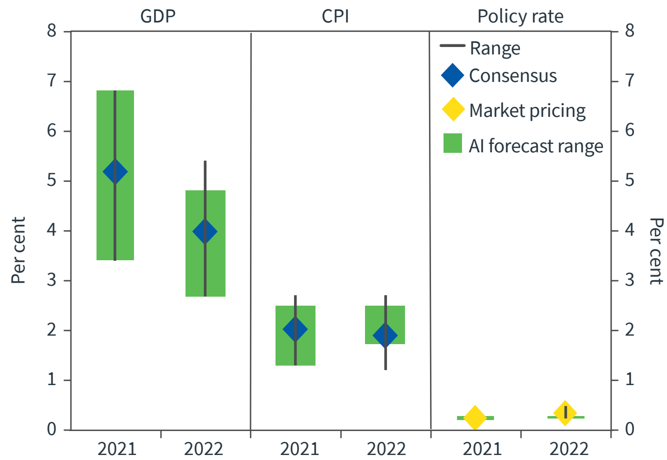


Source: Aviva Investors, Macrobond as at 26 March 2021

Canada

In common with many other economies, Canada enjoyed a far better Q4 than had been feared as case numbers rose steeply and new restrictions were imposed. GDP rose by a further 2.3 per cent after the outsized jump (of 8.9 per cent) in Q3 as the economy proved more resilient than expected. Canada is also being helped both by the strong growth (actual and prospective) in the US and by the rebound in the oil price which has boosted the commodity sector. Growth is expected to be slightly lower – but still positive – in Q1 this year but should then pick up again in Q2 and Q3. Restrictions were partly lifted in February and further easing is expected, although the recent tick up in case numbers warrants attention. As elsewhere, the exact pattern of recovery will be dictated by the path of the virus and by the vaccination programmes currently underway. GDP growth could exceed 6 per cent this year and while the BoC may consider tapering its asset purchases later this year if the revival pans out as we have suggested, it is in no rush to raise interest rates.

Figure 30. **Canada**



Source: Aviva Investors, Macrobond as at 26 March 2021

Global market outlook and asset allocation

- **Aggressively procyclical fiscal and monetary policy create a new investment paradigm**
- **Long-dated yields will stay under pressure as growth and inflation accelerate**
- **Equities are likely to weather the yield pick-up, even if the risk of temporary setbacks has risen**
- **Emerging market assets are vulnerable as real rates continue to rise**

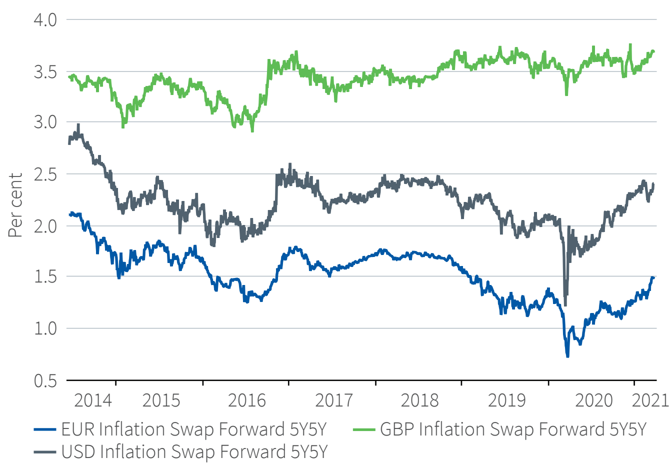
Our above-consensus view on economic growth has been given a further boost by the US's newly united federal government, its passage of a $1.9 trillion support package to stimulate the economy, and further plans for a huge infrastructure package. Government support in the UK, the EU, Japan and China is also sizeable, and the rejection of the post-GFC austerity mistake means that this newly found fiscal generosity will persist into the expansion phase. At the same time, central banks have made it clear that they won't be the ones interrupting the cyclical recovery, given their commitment to achieve — or even temporarily overshoot — inflation targets, and a more explicit aim to engineer employment gains that permeate through all parts of society. This procyclical shift of both fiscal and monetary policy has implications for the interplay between asset classes.

The end of COVID restrictions, household savings and fiscal spending will power demand

We had previously been cautious on duration, given expectations of a successful reflation of economies through reopening and policies, with an eventual slow normalization in real rates. Aviva's Q1 2021 House View noted that "the risk case is that the recovery gathers pace far quicker than we expect, which could see inflation moving higher sooner"; this elevated inflation scenario remains just a risk, but expectations of its likelihood are increasing, justifiably. With manufacturing PMIs in the high 50s and prospects that services will join the party soon, as they already have begun to in the US, we maintain our bearishness on longer-dated bonds. Shorter maturity yields will remain low as, outside of EM, most central banks will refrain from hiking for a while and avoid the mistakes they made in 2010-11's premature hawkishness (in the case of the ECB, RBA and Riksbank) and to live up to amended objectives (in the case of the Fed). Either translates, if successful, into steeper curves, as the short end of the government bond curve remains lower for longer, while the long end starts to reflect a faster and higher pick-up in policy rates to be commenced at a later point in time. This dynamic is only beginning to be reflected and not yet fully appreciated.

The monetary policy reset means policy rates stay low until inflation picks up, but then rise more quickly

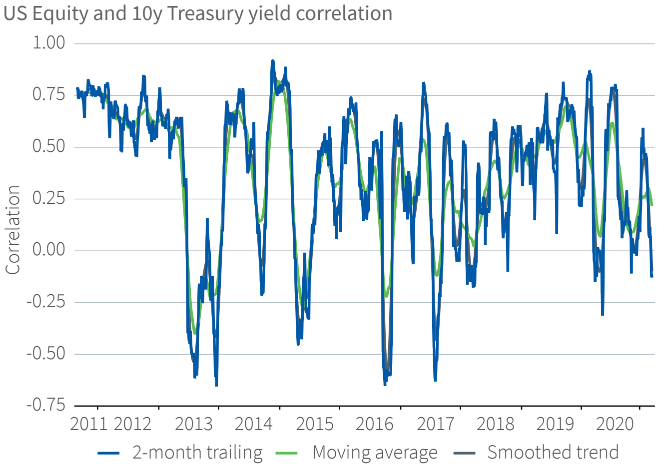
Figure 31. **Inflation expectations have risen to above pre-crisis levels**



Source: Aviva Investors, Macrobond as at 26 March 2021

Figure 32. **Bond-equity correlations flipped on fears of tapering and rate hikes**

US Equity and 10y Treasury yield correlation



Source: Aviva Investors, Macrobond as at 26 March 2021

In the early stage of the recovery, inflation expectations were very low, and the yield curve was suppressed by quantitative easing. This meant that as reflation expectations rose, breakeven inflation (the difference between nominal and inflation-linked securities' yields) went higher, sending real yields lower: a very positive development for risk assets. Now that inflation expectations are closer to targets and stickier, with 5yx5y inflation swaps above pre-crisis levels in the US, UK, and Eurozone (Figure 31), further rises in yields are starting to result in higher real rates too: a mix of rate hike expectations and rebuilding of term premia. This is a marked change in the financial environment.

Real rates are catching up to breakeven rates

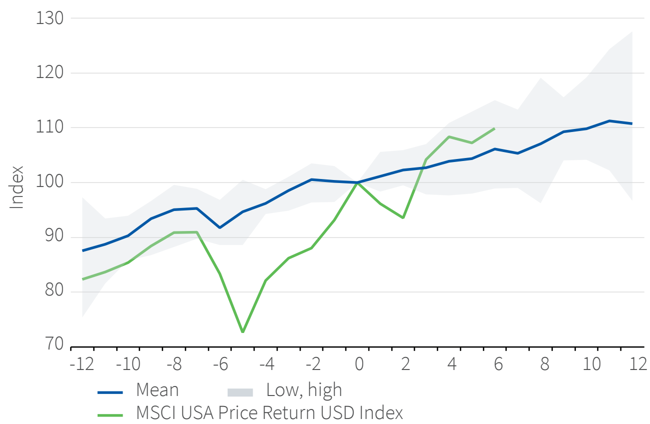
Once the risk-off period during the 2020 crisis was quashed, the main reflation and recovery trends were lower real interest rates, higher breakevens, a weaker dollar, and rising earnings expectations driving equity prices higher and spreads tighter. The outlook for 2021 is more complex. During times when yields rise or fall sharply, which is often during shifts in monetary policy or expectations of central bank action, the normal "risk-on, risk-off" positive correlation of bond yields and risky assets like equities flips (Figure 32). This phase is usually temporary, but we are currently in such a period and expect this to remain the case until the timing of tapering and rate hikes is clarified – then, the monetary policy reset theme will again be more supportive for equity prices. These short-term negative correlations between yields and equities are a headwind, but do not materially shift our asset class outlook on duration (negative) and equities (positive) from the Q1 2021 House View, as over longer time periods higher yields go hand-in-hand with equity bull markets.

The most positive environment for equities, characterised by rising breakeven yields but falling real yields, is arguably behind us. Equity returns should slow from here but remain positive as real rate pressures on valuations are balanced by a bright outlook for earnings. Hence, we maintain our overweight stance on the asset class. This notion is reinforced by history: Figure 33 shows that median US equity returns remained positive over the 6-12 months after previous real rates troughs, whilst Figure 34 shows that average positive weekly equity market returns have slowed in a regime of rising breakeven and real rates compared to one of falling real rates and rising breakeven rates. Steeper curves in combination with a positive cyclical outlook leads us to maintain our cyclical equity exposure in Energy and Industrials. Regionally, we are downgrading EM equities from overweight to underweight: EM equities offer (too) little compensation in terms of earnings growth and FX yield for the risk embedded in the asset class at a time when monetary policy starts to tighten (actual in EM and prospective in DM) and concerns over asset prices and regulation in EM are elevated. Strong past inflows into EM and the region being a consensus overweight suggests that there is little margin for disappointment. Market perception on EM, as captured by pairwise momentum indicators, is starting to turn, which in itself has provided a useful signal for pair's investment environment.

The environment for equities remains positive, even if we expect returns to rise less rapidly going forward

Figure 33. **Equity returns after real rate troughs**

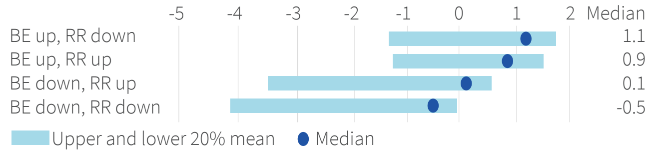
MSCI US Index around previous real rate troughs (normalised at zero for respective troughs, monthly data)



Note: Real rate trough observations are 03/2004, 11/2012, 01/2015, 07/2016, 08/2020
Source: Aviva Investors, Macrobond as at 26 March 2021

Figure 34. **Positive but lower median equity returns as real rates join rising breakeven rates**

Weekly performance of SPX (in per cent) in different BE & real rate regimes (since 2012)



Source: Aviva Investors, Macrobond as at 26 March 2021

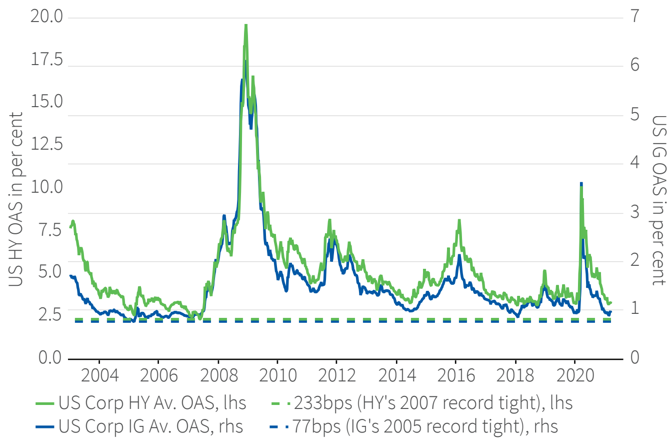
Corporate credit spreads are extremely tight, particularly in Investment Grade, where the index's OAS trades below 100bps in both the US and Europe (Figure 35). This offers barely any scope for capital gains even should we reach the pre-2008 credit bubble records; moreover, issuers have taken advantage of the low yield environment and termed out maturities (Figure 36), saddling investors with more risk and lower total returns, guaranteed. We shift to underweight after a year of stellar performance that went from extremely distressed levels of cheapness to modest overvaluation. We maintain a neutral stance on High Yield, where spreads in the low-300s are supported by central bank corporate bond purchases and expected low default rates. The past year has seen around 5 per cent of junk bonds default, with some delayed restructurings and bankruptcies that will come this year already "in the price" and are slightly more attractive in the current environment.

We are further closing our overweight on EM credit, noting that duration is playing an unusually large part in total returns, and that the emerging rate hiking cycle in EMs — which began in earnest in March with Brazil, Russia and Turkey all raising rates more than expected — probably has some way to run before the carry picture becomes compelling.

Within FX, we are closing our short USD bias. We foresee the strength of the US economy in comparison to rest of world to at least pause the pressure that low US real rates and a general risk-on environment had previously exerted on the dollar.

Credit: the risk-return trade-off has turned asymmetrically negative

Figure 35. **Credit spreads at pre-pandemic lows offer asymmetric returns**



Source: Aviva Investors, Macrobond as at 26 March 2021

Figure 36. **Corporates' average duration has grown, increasing risk for the asset class**

Source: Aviva Investors, Macrobond as at 26 March 2021

Figure 37. **Asset allocation**

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

Source: Aviva Investors, Macrobond as at 26 March 2021

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