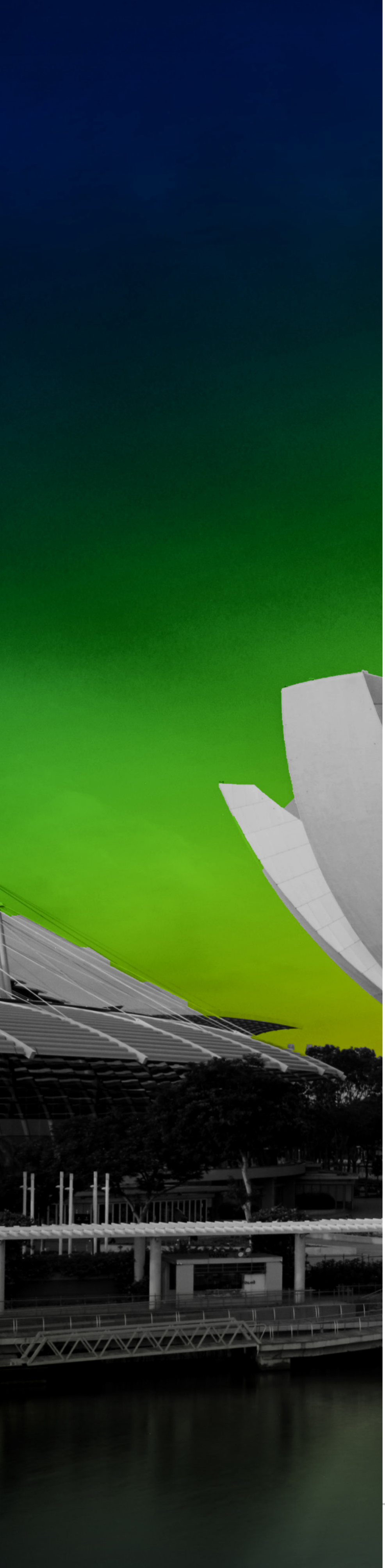
House View Q3 2021

The intelligence that guides our investment decisions

For today's investor

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 are encouraged to do so. The aim is to ensure 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 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

Beyond Covid – policy-led reflation

The global economy remains on track for a rapid and broad-based economic recovery from the Covid pandemic. Notwithstanding concerns around new variants of the virus, restrictions are generally being eased, as the vaccine roll-out progresses well, allowing economies to more fully re-open. Moreover, the tightening of restrictions in many countries earlier this year proved to be less economically damaging than feared, as governments, businesses and individuals found ways of limiting the number of jobs and industries impacted. At the same time, the extension of fiscal packages has ensured, household incomes have remained supported and that consumer demand has stayed robust. As a result, we have revised up our growth forecasts for 2021 to reflect the better start to the year than we expected, locking in the higher level of activity. Looking further ahead, our growth expectations remain strong for this year and next, somewhat above consensus across all the major regions. While there are risks on both sides of that outlook, we judge that the balance of risks to the growth outlook are to the upside, with still significant pent-up demand and excess household savings that could be deployed over-and-above our relatively conservative estimates.

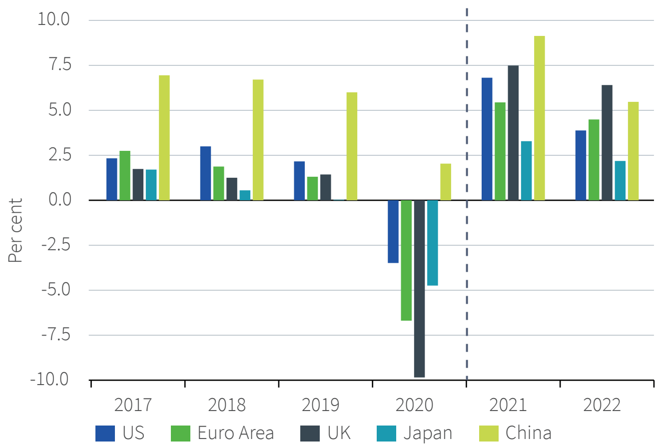
Rapid and broad-based recovery

We expect global growth of around 7 per cent in 2021, followed by 4½ per cent in 2022, with the level of activity rising above the pre-Covid level across all major economies at some point this year. Amongst the major economies, the quickest recoveries in activity have been in China, the United States and Canada, where the amount of policy support has been greatest. Recovery in Europe is expected to be a little behind those economies, but should see activity back to pre-Covid levels by 2021Q4. Our growth outlook for the major economies is shown in Figure 1. We expect the high point in quarter-on-quarter growth to be 2021Q2, when the impact of re-opening is likely to be largest, with a steady return to more normal quarterly growth rates by the end of 2022.

China and the United States have led the way

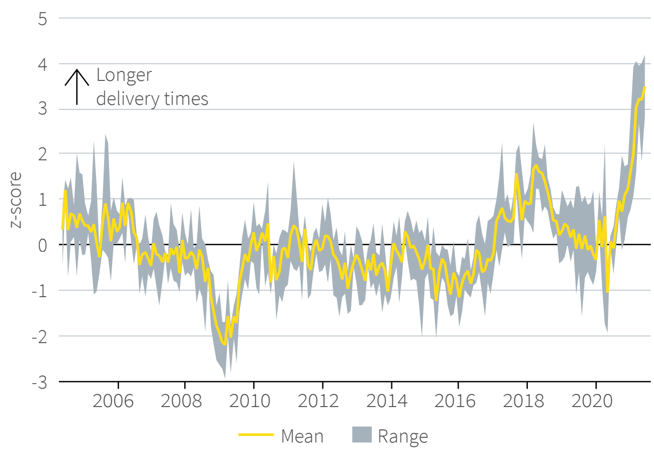
The role of both monetary and fiscal policy in supporting the recovery remains key. Monetary policy is expected to remain easy for some time, especially in those economies where inflation has been below the central bank target in the years before Covid (although, as discussed, below recent inflation outcomes have raised some questions). With the worst of the lockdowns likely behind us, the vast amount of support for household incomes through furlough and/or enhanced unemployment benefits can recede. That is not a fiscal tightening, but rather a natural consequence of these schemes having been designed to support incomes when needed given government restrictions on activity, but to then wind down when activity returns. But beyond the income support schemes, pro-cyclical fiscal policies are underway or planned across all the major economies. Many of these policies are focussed on the goals of meeting climate change targets and reducing economic inequality. As such, significant government

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



Source: Aviva Investors, Macrobond as at 28 June 2021

Figure 2. **US surveys of supplier delivery times**



Source: Aviva Investors, Macrobond as at 28 June 2021

infrastructure plans are already agreed in the Eurozone and United Kingdom, with the United States Congress expected to pass an even more sizeable (as share of GDP) infrastructure bill later this year. Some increases in corporate and high-income earners tax rates are also expected, but much of the revenue from these measures is expected to be directed to spending programmes for lower-income households.

Supply-chain bottlenecks are leading to higher inflation

There have been many aspects of the Covid-induced recession and subsequent recovery that have been unconventional. Unlike a more typical economic shock, where the hit to demand is the dominant factor, leading to increased spare capacity and lower inflation, the Covid shock has impacted both demand and supply. While that was clearly disinflationary in 2020, more recently the acceleration in demand (supported by excess savings and re-opening) has outstripped the available supply in some industries, creating so-called supply-chain "bottlenecks". That has put upward pressure on commodity prices, as well as further along the manufacturing supply chain and into some consumer goods. Part of that reflects the impact of lockdowns on production in 2020, resulting in insufficient inventories to meet the rise in demand. But part of it may also reflect the unexpected speed of recovery for many businesses. Business surveys indicate supplier delivery times will remain challenging over the next six months, suggesting that some bottlenecks may persist through to the end of 2021 (Figure 2). We expect elevated consumer price inflation to persist through to early 2022 (Figure 3), by which time the supply disruptions should be alleviated, with stronger employment and increased capacity. Moreover, the year-on-year change should fall back as it has been boosted by the unusually weak inflation outturns in 2020. Some may describe that outlook as one of transitory inflation. But rather than getting hung up on the description, we think it is more important to focus on the likely underlying inflationary pressures as we head into 2022 and the balance of risks to that outlook.

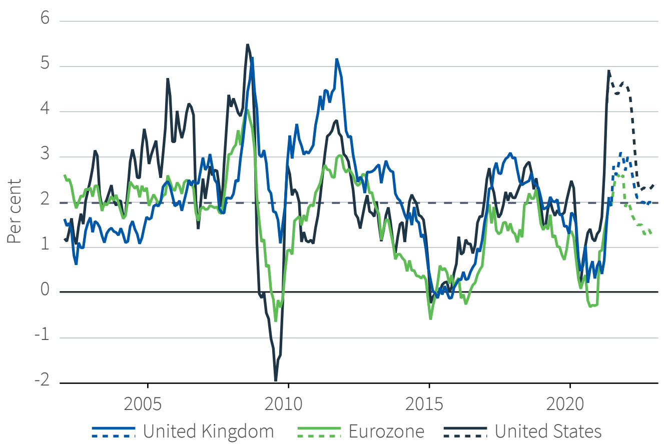
We think inflation will be higher than pre-Covid over the coming years

We think that underlying inflation pressures will be somewhat stronger in 2022 and 2023 than they were pre-Covid. That reflects our view of limited spare capacity, particularly in the United States, by early 2022. Alongside that, with wage growth (once adjusted for composition effects) remaining remarkably resilient through the Covid shock, and with inflation having been boosted by bottlenecks in 2021, we think there is greater potential for that limited spare capacity to drive wage demands and household and business inflation expectations higher. While in our central case that only leads to modestly higher underlying inflation compared to pre-Covid, we think the risks are tilted to the upside given our upside risk to demand and potentially greater pass-through into pricing.

Central banks will welcome moderately higher inflation, delaying rate increases

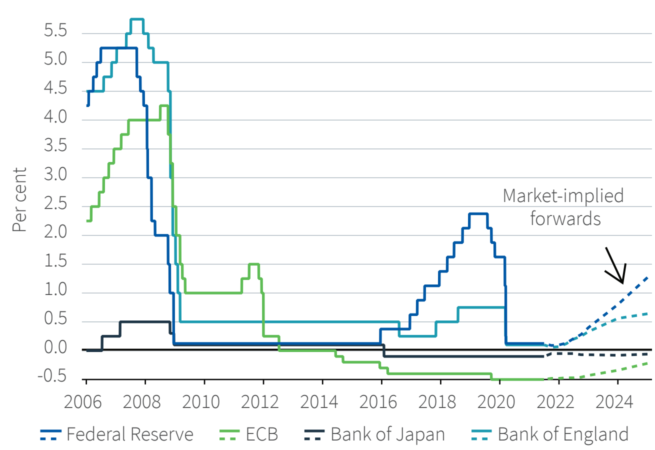
Despite the risks of higher inflation, we expect the major central banks to be willing to accommodate that in order to deliver a more robust recovery and a sustained increase in actual inflation and inflation expectations. The new framework adopted by the Federal Reserve in 2020, known as Flexible Average Inflation Targeting (FAIT), will require them to start raising interest rates only once inflation has been above 2 per cent for a period of time and full

Figure 3. **CPI inflation outlook**



Source: Aviva Investors, Macrobond as at 28 June 2021

Figure 4. **Monetary policy to stay loose**



Source: Aviva Investors, Macrobond as at 28 June 2021

employment has been reached. That does not mean they will be oblivious to the risks and may therefore signal lift-off somewhat earlier should the economic situation warrant it, but that they will wait until those criteria are met before moving. We expect that to be in 2023. The European Central Bank is due to announce the outcome of its own framework review later this year, whereby they are also expected to be more tolerant of somewhat higher inflation. However, with the Eurozone economy likely to take quite a lot longer than the US to eliminate spare capacity and create sustainably higher inflation, the prospect of rate rises is more remote. The Bank of England finds itself somewhere in between the two in terms of the expected speed of recovery and elimination of spare capacity, and has not had the same issue of inflation shortfalls over the past decade. In many emerging market economies, the hiking cycle has already begun, reflecting the impact of currency depreciation and producer prices on domestic inflationary pressures.

The combination of our global reflationary outlook, alongside supportive monetary and fiscal policy leads us to prefer to be overweight global equities. That is despite somewhat lofty valuations, reflecting our expectation of positive earnings surprises, rather than further multiple expansion. In terms of regions, we prefer to be slightly more overweight in the US and UK, with an underweight in 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.

Preference to be overweight equities

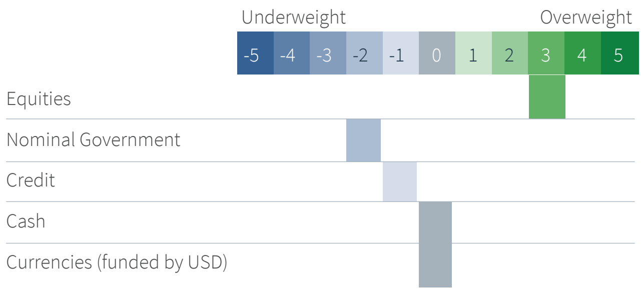
Government bond yields have moderated somewhat from their highs earlier in the year, possibly reflecting a combination of over-extended market positioning and some concern about the Federal Reserve raising rates too soon. Despite this, we continue to expect the growth and inflation backdrop to once again put upward pressure on yields, particularly as we see the Fed sticking to their FAIT framework. As such, we prefer to be somewhat underweight duration, mainly expressed through US Treasuries (figure 5). The upside from tighter credit spreads appears to be limited given the narrowing already seen, and therefore we also prefer to be slightly underweight investment grade and neutral in high yield. Finally, we have a neutral view on currencies (figure 6).

Modestly underweight duration and credit

Figure 5. **US 10-year nominal and real yields and breakeven inflation**

Source: Aviva Investors, Macrobond as at 28 June 2021

Figure 6. **Asset allocation summary**



Source: Aviva Investors, Macrobond as at 28 June 2021

Key investment themes and risks

Investment themes

1 Broad-based expansion
2 Fiscal – becoming pro-cyclical?
3 Monetary policy re-boot
4 Underlying inflation
5 Climate change
6 Global regulation and taxation
7 Global strategic competition

Broad-based expansion

The pattern of economic rebound from the COVID downturn in 2020 has been dictated by trends of the virus itself and by the related extent to which it has been possible for countries to ease lockdown restrictions. The adaptability of businesses and individuals in the face of those constraints has also been critical in defining the shape and strength of recovery. Essentially the ability of companies and households to get used to restrictions has meant that the impact on activity from the ebb and flow of restraint has been successively lower in each wave. Meanwhile, the successful roll-out of vaccination programmes has greatly reduced the threat from the virus. Although COVID is almost certain to be with us for some time – and there can of course be new variants in the future (see the risks section) – it should have less and less of an effect on economies.

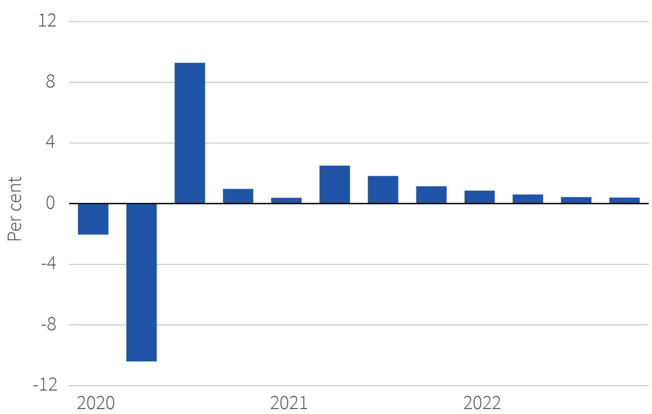
A broad-based recovery is currently underway

The impact on economies has been well-documented. Global GDP fell sharply in Q1 and Q2 last year, before staging a huge revival in Q3. As successive waves followed, activity slowed abruptly again in Q4 and Q1 this year – falling once more in a number of regions, although the gyrations have been much less extreme than during the initial wave (Figure 7). Variations in case numbers have also led to a greater disparity in experience between countries. But a more lasting recovery now looks to be underway – there is still the possibility of renewed restrictions if circumstances change, but with vaccination efforts progressing, any future disruptions should be minimal. However, as we have stressed on many occasions recently, just as this was no ordinary downturn, it will be no routine upswing either. There is no template from history to follow.

The impact of lockdown restrictions on economic growth has been progressively lower

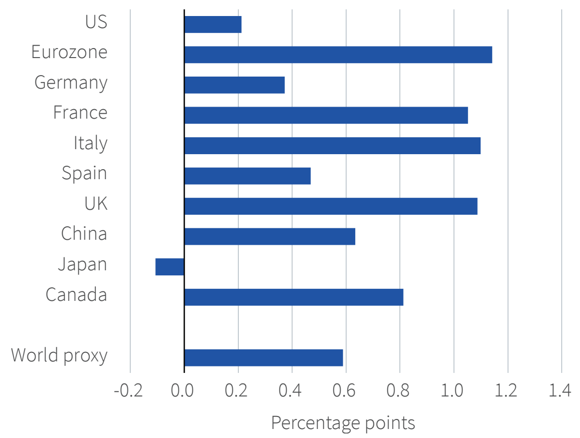
Some activities have rebounded swiftly. Households have quickly adapted to new ways of retail spending, with home deliveries replacing many shopping outings. Manufacturing production and construction activity have also recovered to close to "normal" levels. World trade flows have revived sharply too, although there has also been a post-Trump (remember

Figure 7. **G7 quarterly GDP growth, 2020-22**
Growth should be strong in Q2 this year but will slow thereafter



Source: Aviva Investors, Macrobond as at 28 June 2021

Figure 8. **Difference between Aviva Investors and consensus GDP growth forecasts**
Upside growth potential in 2021



Source: Aviva Investors, Macrobond as at 28 June 2021

the US-China induced trade spat?) rebound here as well. Other activities, those that involve or even require close social contact, will take longer to recover and some may be impacted for years or decades to come. But service activities are gradually returning, and many are expected to continue to do so over the rest of 2021 and beyond. The recovery is becoming more broad-based. The next 12 or 18 months will see a considerable amount of growth catch up with, in our view, upside risks (Figure 8). The exact pattern is more difficult to predict but we – like most forecasters – have spread it out over time as a base case. As a result, we have an historically strange pattern of strong growth that slows steadily from now until the end of 2022.

Fiscal – becoming pro-cyclical?

Fiscal policy has been crucial in providing financial support to businesses and households during the COVID pandemic. Measures had to be large, open-ended and immediate, and although there were some extraordinary moves in GDP, and also minor delays at the start, by and large that is what we got (Figure 9). As the IMF (and others) continue to insist, it is vital that fiscal backing is not withdrawn prematurely, but instead continues to support both individuals and companies as activities restart and people return to their jobs (or begin new ones). There will inevitably be considerable fragility that implies the need for ongoing support during such transitions. It will take time to get back to normal, and many organisations and individuals could be hampered by, for example, debts taken on during the pandemic.

Fiscal support has done most of the heavy lifting during the pandemic

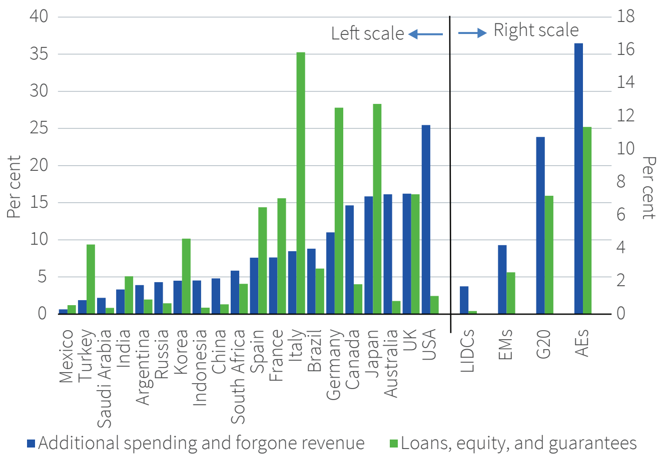
Many fiscal aggregates will improve automatically – and it is hoped quickly – as the various support schemes are withdrawn because they are no longer needed, or at least not to anything like the same extent. This process is already underway, but further progress should be made in the rest of this year and into 2022. This should not be mistaken for premeditated fiscal tightening or "austerity", even if some in the media choose to characterise it as such. It is simply the removal of emergency measures. As a result, public sector borrowing should fall back sharply from the 10% to 20% of GDP figures that were common in 2020 to something more like 5% to 10% this year and lower in subsequent years (Figure 10). It is estimated that the COVID pandemic will effectively add around 20% to public debt to GDP ratios in all of the major developed nations.

Fiscal metrics should improve automatically during the economic recovery

But the fiscal landscape is not all about COVID. As we outlined in the last House View, there has also been a well-defined change in attitude towards fiscal policy. Perhaps we are not returning to the overt fiscal activism of the 1960s and 1970s everywhere, but in a number of places, fiscal policy seems to be stepping back into the limelight. COVID may have been a catalyst in this process. This has been most apparent in the US, previously thought to be the place least likely to embrace activist fiscal demand management policies over the last 30 years or so. If these trends continue, then it is right to consider an evolution from fiscal support to fiscal stimulus as a key part of the possible policy backdrop in coming years. Whatever

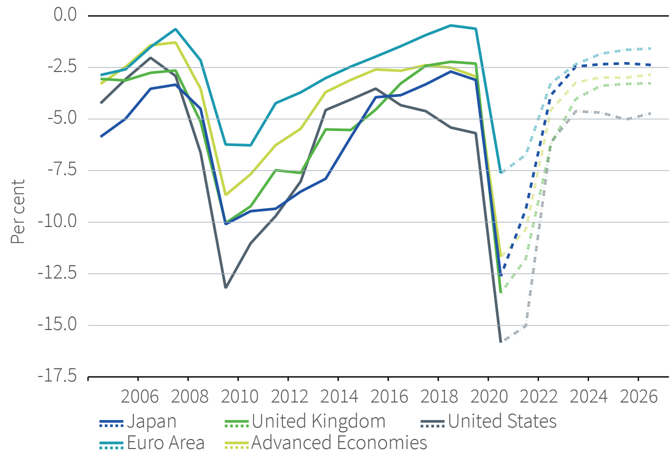
Fiscal activism is back in vogue, most notably in the US

Figure 9. **Size of fiscal support in response to COVID, % of GDP**
Extent and nature of support has varied across nations



Source: Aviva Investors, IMF, Macrobond as at 28 June 2021

Figure 10. **Public borrowing as % of GDP (IMF Fiscal Monitor)**
Deficits should shrink rapidly in 2022 and 2023



Source: Aviva Investors, IMF, Macrobond as at 28 June 2021 the micro-economic merits of the various Biden administration proposals, it is impossible to ignore the likely macro-economic impact in 2021, 2022 and beyond. Fiscal measures are now quite clearly adding to overall demand, to the extent that US GDP could easily exceed the pre-COVID path very soon. Stimulus packages are less grand elsewhere, but it does seem appropriate to accept that fiscal policy is back in vogue.

Monetary policy re-boot

For the major developed nations, the period between the early 1990s and the onset of the Global Financial Crisis (GFC) in 2007/8 has been described as the "Great Moderation". It was characterised by a marked reduction in the volatility of business cycle variations compared with post-war history. It is no coincidence, in our view, that this was also a time when most central banks (CBs) had adopted strict inflation targets – typically around 2%. And most achieved these targets, more or less (Figure 11). Between 1992 and 2007, the relevant inflation measure averaged precisely 2.0% in the US and UK and 2.2% in the Eurozone. Japan was the exception, averaging just 0.2%. Since 2008, inflation has generally been lower, especially in Europe and Japan, and that has contributed to a reassessment of monetary policy. This has been most radical in the US, where an explicit "flexible average inflation targeting" (FAIT) regime has recently been adopted by the Federal Reserve.

Central banks around the world, led by the Fed, are changing the way they interpret inflation-targeting

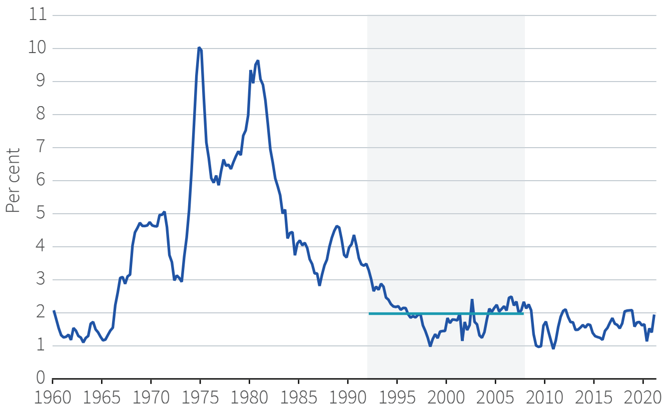
This monetary policy re-boot, as we have termed it, is a major change in the policy framework. Essentially it implies that, rather than automatically resisting any inflationary impulse – often in anticipation – the Central Bank will instead try to achieve an inflation target on average, over a longer time period. This implies a greater tolerance of higher inflation in the future. But as economies recover from the COVID experience and re-open, the new regime has immediately faced the challenge of some sharp upward moves in inflation. We believe that is wrong to believe that the Fed will swiftly backtrack in response. Instead we think they will use the flexibility of recent changes to hold back from responding to higher inflation outcomes (and forecasts) as they would almost certainly have had to do in the previous regime. Financial markets seem to have some faith in the new regime; so far, they pencil in only very modest policy rates rises over the next few years (Figure 12). In other words, the monetary re-boot remains firmly in place and will continue to frame the monetary policy backdrop around the developed world in years to come.

Recent inflation spikes have challenged the new thinking, but will not - in our view - lead to any backtracking

At present much of the attention on this issue is focussed on the Fed. It has also been in the US where the recent spike in inflation has been most marked. But others, including the ECB, the BoJ and the Bank of England have all edged in a similar direction. The ECB is set to report on its own strategic review this September, when it is expected to clarify and present an amended (and symmetric) inflation objective, alongside measures that shift it in the same direction as the Fed. Given the ECB's serial under-achievement in recent years, the guiding principle should be one which openly nurtures higher inflation. As has often been the case in Europe,

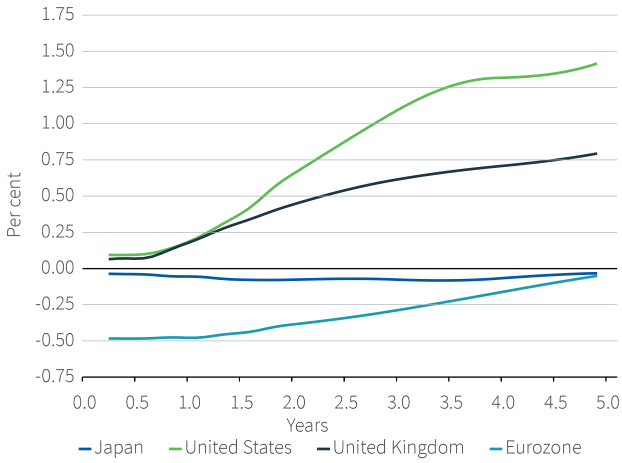
Arguably, looser policy settings are merited more in Japan and parts of Europe

Figure 11. **US core PCE inflation**
The Great Moderation



Source: Aviva Investors, Macrobond as at 28 June 2021

Figure 12. **Policy rate expectations in the major developed regions**
Markets expect only modest tightening over next 2/3 years



Source: Aviva Investors, Bloomberg, Macrobond as at 28 June 2021 change is more gradual – evolution rather than revolution, but steps in this direction should still be acknowledged as an important change.

Underlying inflation

Inflation has risen noticeably in recent months in many developed economies, leading to debate over how much of the recent increases are transitory and how much might be permanent (Figure 13). Headline rates are always buffeted around by “one-off” factors. But “core” rates have risen too, suggesting that there is something more fundamental happening. But care needs to be taken because of the extraordinary – unique even – times that we are living through. COVID has come after a lengthy period of “low” inflation and has coincided with a major reassessment of how inflation-fighting Central banks should conduct monetary policy (see policy re-boot theme above). This combination means that there are many moving parts to both the explanation of and the prospects for inflation. The present blend of elements makes it more likely than not that we will see modestly higher underlying inflation than we have perhaps got used to in recent years.

Modestly higher inflation is plausible, but much of current spike is likely to be transitory

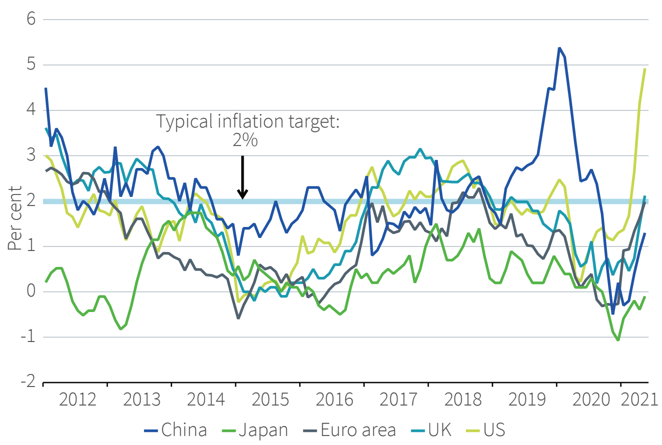
This should not necessarily be seen as an alarming development. Indeed, although it may bring about a shudder to those brought up in the inflationary 1970s and 1980s, a little bit of higher, positive inflation is deemed a “good thing” by many and is a stated ambition for at least some Central banks, especially those in Europe and Japan. The alternative of low, even negative inflation or outright deflation is a much more dangerous phenomenon and one that all Central Bankers wish to avoid. The pervasive deflationary impulse in Japan over the last several decades and the much shorter, but at the time very real, concern over the possibility of similar developments in the Eurozone in the wake of the sovereign debt crisis there has cast a pall over these economies, and has been a key part of the secular stagnation thesis that has coloured much recent thinking.

Deflation fears - quite prevalent not that long ago - would be a far bigger concern

There is today a potentially potent combination of factors that argue for higher inflation. They include the re-opening of economies, pent-up demand and excess savings and damage to parts of the supply-side of economies that may result in frictional mismatches or more lasting shortages and bottlenecks. In addition, current policy settings are loose and likely to remain supportive for some time, while Central banks are now adopting a more explicitly pro-inflation stance. Ultimately, underlying inflation trends will be determined by the balance between supply and demand, although some allowance needs to be made for temporary mismatches as economies restart after COVID. Our projections indicate that output gaps will close by the end of this year or in early 2022 (Figure 14). Policymakers should have time to react, but if growth has not slowed back to trend rates by then more action may need to be taken to make that happen. We do not believe that inflation will be a major policy problem, but it would be complacent not to recognise the risk (see below).

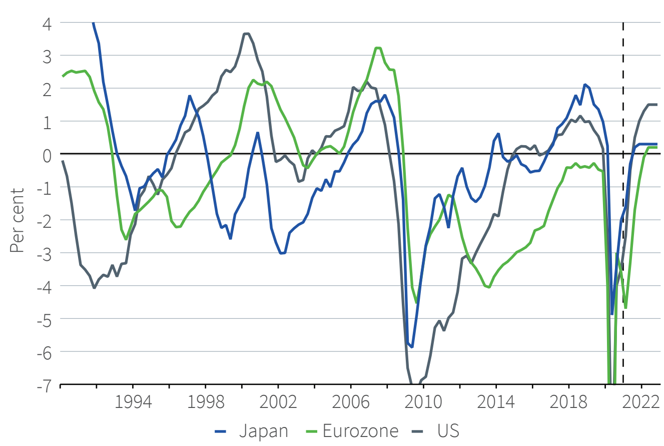
Ultimately, inflation will - as always - be determined by the balance between supply and demand

Figure 13. **Headline CPI inflation in the major regions**
Above-target inflation has been a rarity in recent years



Source: Aviva Investors, Macrobond as at 28 June 2021

Figure 14. **Output gap projections**
All should have closed by the end of 2022



Source: Aviva Investors, Macrobond as at 28 June 2021

Climate change

The G7 summit in Cornwall in June laid bare many truths about progress, or the lack of it, in key areas of climate change policy, with frustrations from a number of developing and emerging economies coming to the surface regarding the $100bn commitment outlined in the Paris Agreement. Many expressed their irritation at the very limited steps taken so far, with a clear suggestion that developed nations – who after all are ultimately responsible for much of the current crisis – are not facing up to their responsibilities, honouring their laudable commitments and delivering the finance that can actually start to make the required changes happen.

Developed nations have supplied great words on climate change, but need to follow up with deeds

Attention will now move on to the G20 finance summit later in July, pre-COP meetings in Milan in September and the full G20 meeting in October, before COP26 itself in Glasgow in November. As always, the devil is in the detail. The G7 communique at the end of the Cornwall summit contained several climate-related goals, including further detail on net-zero commitments, ambitions to reduce or eliminate public funding support (such as subsidies) for coal and other polluting activities, support for moving towards mandatory disclosures based on TCFD, the Task Force on Climate-related Financial Disclosures, which aims to improve and increase clear and accurate reporting on climate-related financial information. Commitment to the $100bn climate finance for developing countries is one thing, but much more detail on actual delivery is urgently needed. Finally, the communique referred explicitly to the need for an "optimal use of a range of policy levers to price carbon". Since the last House View was published, the European carbon price, for example, has risen from around €40/tonne to well over €50 (Figure 15).

There are a number of key set-piece events over the coming four months

There are essentially four goals at COP26. First, mitigation – to secure global agreement to deliver net zero emissions by 2050, thereby helping to ensure that global temperature increases are restricted to 1.5 degC by 2100. 2030 nationally determined contributions (NDCs) will have to align with these two objectives. Far more progress has been made on this than the remaining three goals. Second, adaptation – to make real progress on dealing with the impacts of climate change that are already occurring. Third, to mobilise the $100bn of annual climate change finance to low- and middle-income countries meaningfully. Fourth, collaboration – finalise the detailed operational rules of the Paris Agreement by creating fully-functioning carbon markets and establish practical climate change cooperation between governments, businesses and civil society.

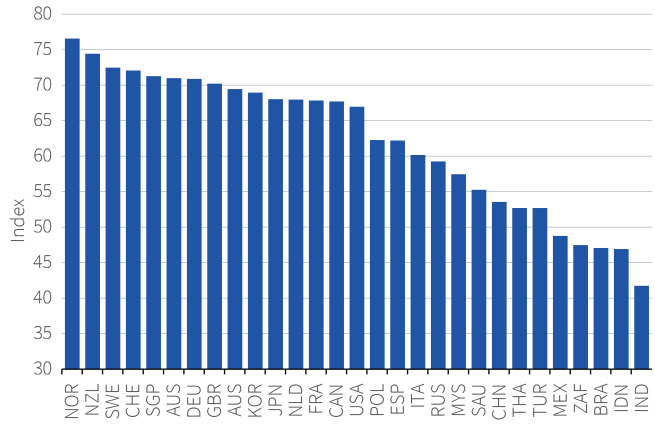
COP26 has multiple goals

The Notre Dame University Global Adaptation Initiative (ND-GAIN) uses data from multiple indicators to rank countries based upon their vulnerability to climate change and their readiness to successfully adapt (Figure 16). A higher number is "better", with Norway and New Zealand currently at the top of those rankings.

Figure 15. **EU trading: indicative carbon price**
Has risen sharply in 2021, but probably has further to go

Source: Aviva Investors, Macrobond as at 28 June 2021

Figure 16. **Latest ND-GAIN index values**
Higher numbers signify countries that are adapting to climate change better



Source: Aviva Investors, Macrobond as at 28 June 2021

Global regulation and taxation

Taxing and regulating international businesses have always been areas of extreme complexity and dispute. Increased globalisation has contributed to capital becoming exceptionally mobile internationally, able to respond quickly to differences in tax and regulation incentive structures around the world. These trends have been compounded by the increasing digitalisation of commerce. As tax and legal authorities have attempted to keep up, rushed and piecemeal legislation and rules have been put in place, often in a haphazard manner. There is now growing momentum behind efforts to establish an international consensus-based solution to prevent the proliferation of such uncoordinated unilateral measures. If successful, this should also help avert a worldwide "race to the bottom" on tax and regulation.

Capital is still becoming increasingly mobile, with digitalisation adding further layers of difficulty

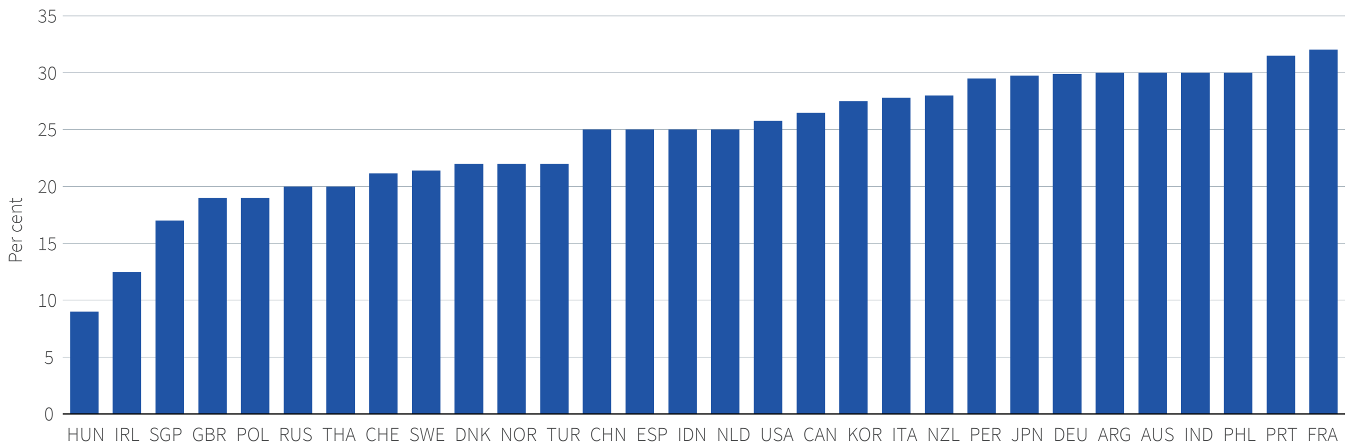
Those efforts have been led by the OECD who, after wide-ranging discussions with relevant nations spanning several years, were able to announce an historic international agreement on global tax reform at the G7 meeting in Cornwall. This focussed on an "ambitious two pillar global solution to tackle the tax challenges arising from an increasingly globalised and digital global economy." (G7 communique, 5th June 2021.) Under Pillar One, the largest and most profitable multinationals will be obliged to pay tax in countries where they operate, rather than solely where they have their headquarters. Under Pillar Two, the G7 also reached agreement on the principle of a minimum global corporation tax rate of 15%. There is less disparity between national tax rates than there was, but it is still significant (Figure 17). There is also still a wide gulf between theory and implementation. And it may still take several years to establish the necessary organisational infrastructure and systems to complete the task. But the direction of travel is now clear, and agreement of the basic principles of global tax and regulation architecture for the future is a vital foundation step. These initiatives will frame the multinational operating environment for years to come.

Important progress has been made recently, but still a gulf between theory and implementation

These latest developments are actually only a part of a range of issues that the OECD have been looking at in recent years under the banner headline of "base erosion and profit shifting" or BEPS. These comprise tax planning strategies used by multinationals to exploit gaps and loopholes in international tax rules. As the OECD points out, developing countries' greater reliance on corporate income tax means that they may be losing out from BEPS disproportionately. It is estimated to cost between $100bn and $240bn annually in lost revenue globally. The EU has good reason to wish to expedite change quickly since the region has some of the largest and most generous welfare systems in the world, and financing them is no small task. Unsurprising, therefore, that European governments have concentrated attention on companies, especially large ones which have flourished with the abrupt shift to an on-line world. Internationally coordinated efforts are the benchmark, but it is also possible that the EU (for example) embarks on additional or more stringent measures.

Several developing nations depend disproportionately on corporation tax revenues

Figure 17. **OECD estimates of corporation tax rates**
Still significant differences across nations



Source: Aviva Investors, Macrobond, OECD as at 28 June 2021

Global strategic competition

This theme evolved from the trade war conflict between the US and China that was initiated under the Trump administration, to encompass the broader area of medium-term strategic competition between major nations in a number of areas. The main proponents are the same, but others are becoming more involved. Trade sanctions in the form of tariffs are still in place and these will doubtless be used as bargaining chips during future negotiations between the relevant countries. It seems reasonable to assume that relations will be less overtly confrontational than they were under Trump, but the notion that there would be an immediate rapprochement under President Biden was always unlikely. In the previous House View, we had characterised the Sino-US relationship as likely to exhibit at least some similarities to the cold war relationship of the US and Russia in the 1980s. Now, as then, there will be moments of heightened tension. But that need not prevent some form of workable co-existence becoming established.

The trade dispute was part of a wider issue of strategic competition and geo-political difference

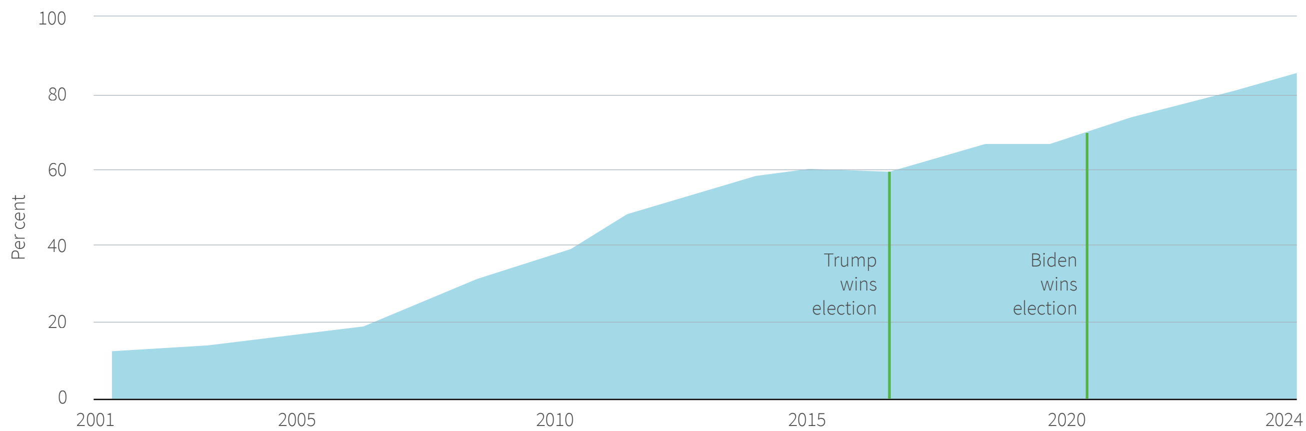
Political experts from Columbia University have suggested that the cold war analogy should not be stretched too far. After all, China and the US are not engaged in ideological struggles to win the hearts and minds of third countries, neither is leading alliances that could foster war or nuclear conflict, and the world is very different today. Even so, it seems plausible that US-China (and indeed World-China) strategic competition may assume some ideological dimensions that will have to result in an effective agreement to differ. One of the key differences is that China today is experiencing an inexorable rise in the global rankings that is expected to continue (Figure 18). The Soviet Union in the 1980s was in decline. China will, presumably, continue to embrace a model of authoritarian state-led capitalism – rather than "conventional" open-market democracy. But there must be room for some for compromises and movement towards abiding with a rules-based international order. These sorts of issues are likely to frame international diplomacy in the future. They may not disrupt or upset the global balance – and financial markets – as much as some of Trump's more controversial initiatives, for example. But they are not unimportant. Positive progress in some of these areas would enhance the overall outlook; stalemates and non-resolution would cloud prospects.

There will always be differences between China and the US (and others), but that should not prevent compromises being reached

It is to be hoped that all sides will see the value in reaching solutions where differences exist, even where it proves impossible to bridge known gaps. There are clear risks for less than optimal resolutions: China has strengthened its cooperation with Russia and has signed a strategic partnership with Iran, but it is obviously doing so for its own ends – not to foster revolution and political uprising. Hacking operations have, unfortunately, become well-established, and it is widely suspected that both Russia and China have made use of cyberspace to spread on-line disinformation which aims to destabilise western democracies. There can be conflict and difference – even on a protracted basis – over national values and geo-political and economic interests. But there is still room for more harmonious co-existence which must, in the end, be in all parties' interests.

China will doubtless be forthright in pursuing its own goals, but peaceful co-existence should suit all

Figure 18. **China is moving to top spot in the global GDP rankings**
China GDP as % of US GDP



Source: Aviva Investors, Macrobond as at 28 June 2021

Risks

Damaging inflation

At the simplest level, inflation is determined by the balance of supply and demand and by whether Central banks accommodate any inflation impulse or not. For now, all continue to stress their belief that higher inflation is transitory. Sovereign bond markets appear to agree: yields have risen a little but are still low (Figure 19). The risk is that inflation is not benign, transitory and desirable. Instead it reflects excess demand, meaning inflation will continue to rise (or at the very least remain uncomfortably high) and that it will become embedded in expectations. In this case, damaging second round effects – wage bargaining behaviour for example – will start to become more visible and Central banks will be obliged to react, possibly quite aggressively.

If inflation proves more persistent, central banks will have to respond...

If this is what happens, then at some point, bond markets will have to react. Monetary tightening of this nature will help usher in the next economic downturn in order to suppress demand and squeeze inflationary pressure back out of the system. A good old-fashioned, if modest (we hope), overheating episode. The shock of this sort of event would be all the greater for coming after an extended period of below-target inflation which has led to a cosy acceptance that such episodes are a thing of the past (Figure 20). Any return to inflation, even if minor compared to earlier instances, would be deeply damaging. Household and business optimism would weaken and the hard-won belief in Central banks' ability to achieve low and stable inflation would be shredded.

...and sovereign bond markets will become less sanguine

Fiscal sustainability

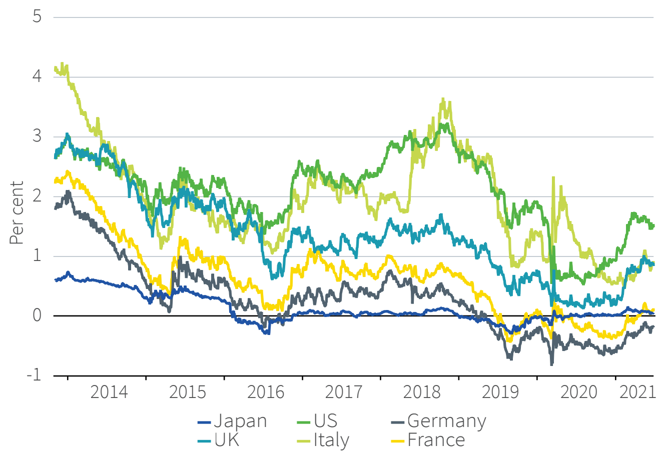
The algebra of fiscal sustainability is well understood, with key relationships between variables including the rate of economic growth, pace of inflation, initial public debt ratio, primary budget balance and rate of interest. The COVID episode has resulted in yawning budget deficits and has added significantly to public sector debt burdens (Figure 21). At the start of the pandemic, there were worries that those countries which already had delicate fiscal balances might be swiftly pushed onto explosive and unsustainable public debt. While that remains a threat, the worst fears seem to have diminished, largely because growth has resumed, inflation is low but positive and borrowing rates, although a little higher, have remained historically very low. Real rates have stayed historically very low too, despite subdued inflation (Figure 22). There has been greater tolerance of higher borrowing in current circumstances and a recognition that perhaps debt and deficit ratios should be seen in a context other than simplistic comparisons to annual GDP.

Fiscal largesse has been welcomed, but the algebra of fiscal sustainability hasn't gone away

However, not all countries are equal. Some developed economies were already on the cusp of sustainability before the COVID pandemic and therefore remain vulnerable to any sudden changes in circumstances. More fundamentally perhaps, several emerging market

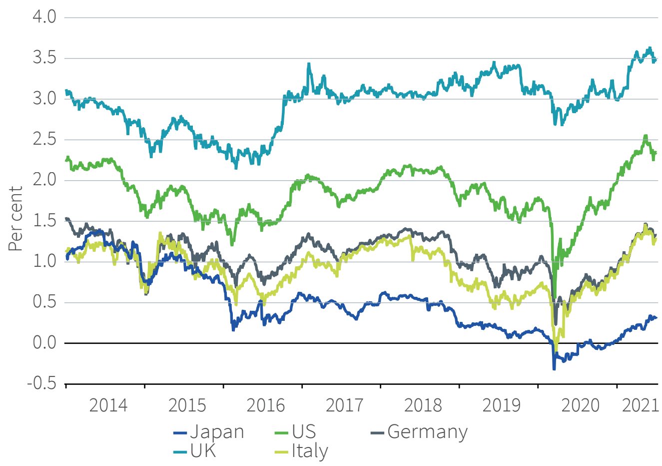
Some developing countries may feel the pinch more

Figure 19. **10-year sovereign bond yields**
Offer no protection against a big rise in inflation



Source: Aviva Investors, Macrobond as at 28 June 2021

Figure 20. **10-year breakeven inflation rates**
Expectations have risen, but remain reasonably contained



Source: Aviva Investors, Macrobond as at 28 June 2021

(EM) economies do not have the luxury of being able to take on extra borrowing and/or debt without potentially damaging consequences for their bond markets and currencies. Sharp movements in either can quickly push such countries onto unsustainable paths and severely curtail market access. Knowledge of these possibilities has meant that most have not increased debt burdens anything like as much as the major developed countries. But deficits have still widened sharply in the face of COVID and vulnerabilities have increased. The IMF has been notably more relaxed about the fiscal situation in all countries, but still recognises that a credible medium-term fiscal framework will be needed in many emerging markets.

Long-term scarring

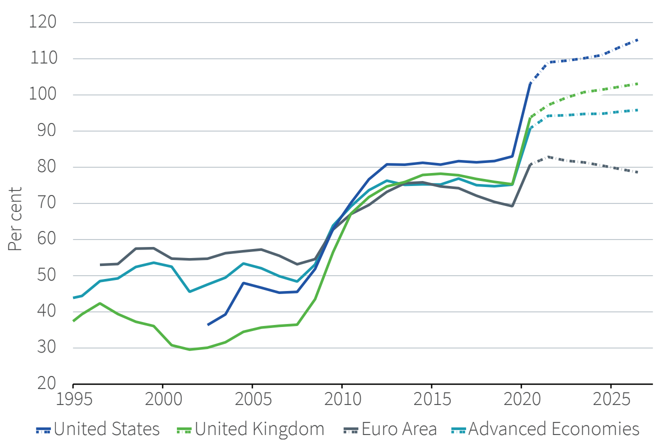
The massive amount of assistance that has been provided during the COVID crisis aims to support companies and individuals financially so that both can resume commercial activities when circumstances allow. Sadly, it is inevitable that not all will survive. The extent of this damage will only actually become apparent when the various schemes are withdrawn, a process that has only just begun but which will become far more advanced in the second half of the year and into next. There is always a continuous long-term process of business creation and destruction. But COVID will have exaggerated this. 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 rise. It already has (Figure 23) but the likely true extent has been hidden by the various support schemes. GDP may be permanently lower than it would otherwise have been. As in many other areas, this is totally new ground – there is no precedent, so we can only estimate the possible extent.

Any lasting damage from pandemic lockdowns will only become as support is withdrawn

Using the UK as an example, the Office for Budget Responsibility (OBR) has estimated that GDP could be 2% lower indefinitely because of such effects. That would be an immense permanent economic loss. Moreover, it is not a binary issue – whether there is a job to resume or a company to restart. The COVID experience is widely expected to have altered some behaviours profoundly, especially in areas characterised by close social contact. 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. Less hours may be made available to workers in such an environment, even if only temporarily. All these factors imply lower incomes, spending and output. Even if resources can be re-deployed elsewhere, transitions will not be painless. If permanent damage is worse than feared, the supply-side hit to economies could have damaging knock-on impacts on long-term growth.

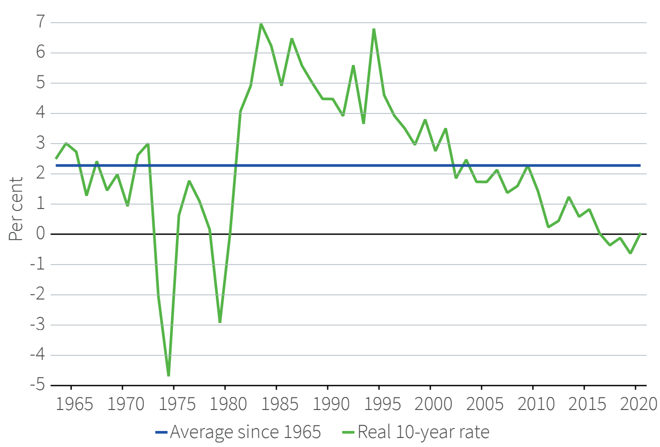
The COVID experience may have a lasting impact on the ways in which many activities take place

Figure 21. **Net public debt as % of GDP and IMF forecasts**
COVID has added 10% to 20% of GDP to public debt



Source: Aviva Investors, Macrobond as at 28 June 2021

Figure 22. **Estimate of G7 real interest rate**
Low real rates ease fiscal burden enormously



Source: Aviva Investors, Macrobond as at 28 June 2021

COVID mutations

The last three months have brought mixed news on the COVID front, with greater hurdles to tackle in the shorter term, but perhaps increasing confidence in the slightly longer term. The recent dynamics of virus variation have shown how quickly they can develop and become dominant. So far, existing vaccines have proved effective against new variants and that remains the central view. But given the uncertainties, it would be complacent to ignore the possibility that something more dangerous and damaging emerges, obliging authorities to once again impose restrictions and usher in another economic setback.

Unless the virus is eradicated, new variants will continue to emerge

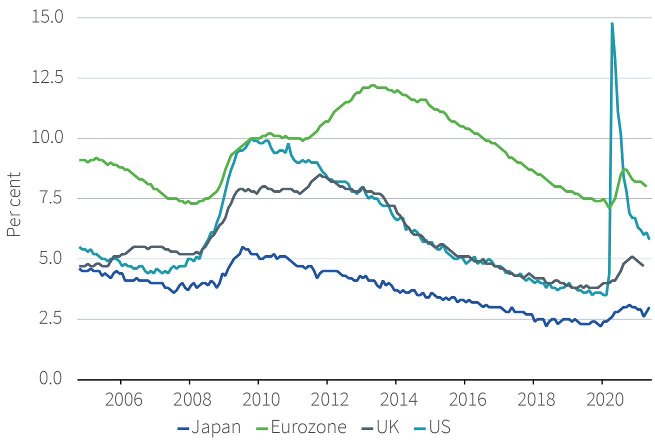
The recent experience of the Delta variant of the virus has for the first time combined faster transmission with a material impact on the effectiveness of vaccines. Thankfully at this point it seems that the reduction in efficacy is a delay to protection rather than significantly less eventual protection. Prior to this variant, the level of protection of a first dose of vaccine had been beyond initial expectations. The most recent news is that the efficacy of that first dose of protection has been significantly reduced. This has the impact of delaying the population level benefits of high levels of immunity even for those vaccine programmes which are relatively advanced. The damage is further exacerbated by the higher levels of transmission, which mean that countries which had previously been able to contain the pandemic with a high degree of success are now struggling, with many countries (particularly in South East Asia, Figure 24) recently suffering their largest waves of infection.

So far, existing vaccines are proving effective, but transmission patterns can change quickly

Longer term, the evidence that existing vaccines retain strong efficacy after the second dose increases confidence that science can remain ahead of the pace of mutations. Not only do we have multiple vaccines which are currently effective, but we already have evidence that relatively soon we will have an additional cushion against further mutations. Recent studies have shown that third doses, mixing the vaccines for the two doses and also new updated vaccines (specifically targeting the beta variant) all have a material impact on increasing the quality and quantity of antibodies. Although this evidence suggests that scientific progress will allow us to remain on top of COVID dynamics, it is still sensible to consider the risk of a worse outcome.

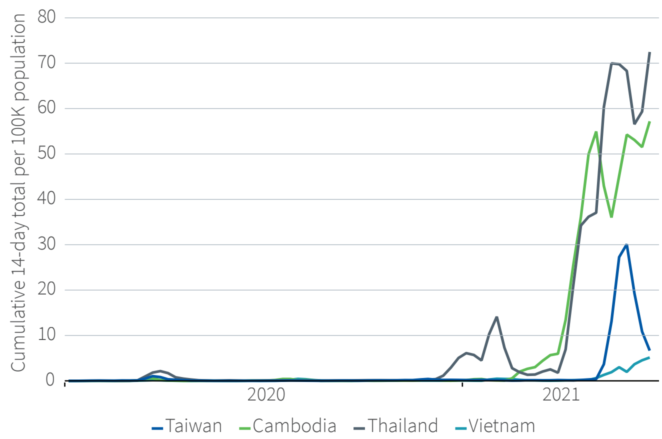
Ongoing vaccinations, including booster shots, are set to become part of our routines

Figure 23. **Unemployment rates in the major nations**
Furlough has hidden unemployment and underemployment



Source: Aviva Investors, Macrobond as at 28 June 2021

Figure 24. **New waves in south-east Asia**
Latest trends illustrate the dangers of renewed infections



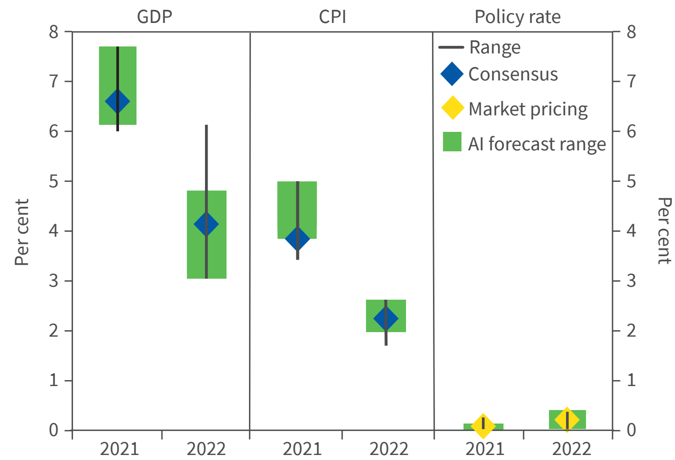
Source: Aviva Investors, Macrobond as at 28 June 2021

Macro forecasts charts and commentary

US

The US economy expanded rapidly in 2021H1, as the successful roll-out of vaccines allowed those in front-line roles to return to work as the economy continued to re-open. We expect the peak growth impact of re-opening to be in 2021Q2, with growth easing back over the subsequent quarters, albeit still above trend through to the end of 2022. The fiscal support packages in late 2020 and early 2021 have supported household income and should continue to drive strong consumption growth through this year. With strong demand and some capacity constraints, businesses are also expected to increase their investment in capital goods and inventories. A further large fiscal package – perhaps in the range of $2-3 trillion – is expected later this year to boost public infrastructure and support lower-income households through a range of measures. Supply-chain bottlenecks have pushed inflation up in some industries this year, and that may continue through to the end of 2021. Underlying inflationary pressures are also likely to rise somewhat, as the labour market tightens, and inflation expectations rise. In our central case, we expect the Fed to accommodate the increase in inflation for a period, with a first rate hike in 2023. However, with the risks to growth and inflation tilted to the upside, the Fed may need to move earlier if those were to materialise.

Figure 25. **US**

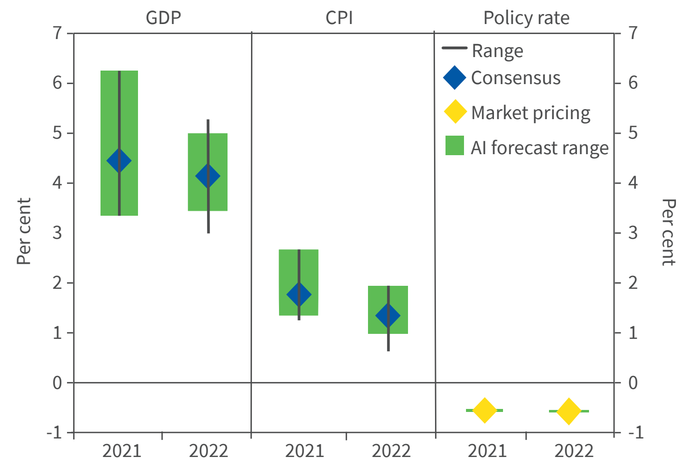


Source: Aviva Investors, Macrobond as at 28 June 2021

Eurozone

The outlook for the Eurozone is brighter than three months ago. At that time, the region was experiencing an alarming new wave of case numbers and had made an unimpressive start to vaccination programmes. Even so, we had anticipated that the impact of lockdowns would be much less than previously and that a rebound would materialise in Q2. Both judgements proved correct. Moreover, the Eurozone has since reversed infection trends convincingly and improved greatly on its vaccination efforts. As a result, we have upgraded our growth projections for all of the major European nations and the region overall. GDP fell by “only” 0.3% in the first quarter, despite comprehensive lockdowns. It is now expected to grow by between 2% and 3% in both Q2 and Q3, before slowing at the turn of the year. Inflation is currently close to target and is expected to move higher by the end of 2021. The ECB – along with fiscal authorities everywhere – is set to remain in supportive mode this year and next, even if the debate switches now to when to lift the foot off the policy accelerator.

Figure 26. **Eurozone**

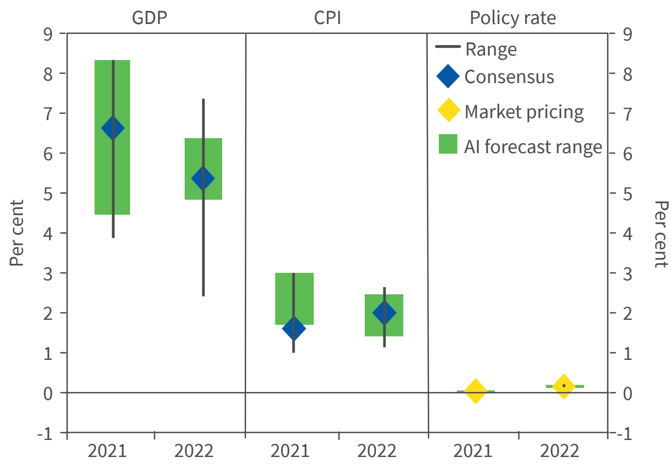


Source: Aviva Investors, Macrobond as at 28 June 2021

UK

As feared, UK GDP fell again in the first quarter as restrictions on activity were reimposed in the light of the vicious new wave of virus infections in Q4 and Q1. As elsewhere, the hit from lockdown measures was nothing like as damaging as it was a year ago, another illustration that firms and individuals have adapted to COVID conditions successfully after the initial shock. Output fell by 1.6% in the first three months of the year. But the UK may well see the strongest rebound in the G7 in Q2 as the economy re-opened – growth of 5% or more in the quarter is to be expected. Although another wave of infections is currently underway, led by the Delta variant, with the most vulnerable groups fully vaccinated there have been minimal repercussions so far in terms of hospitalisations and deaths. As long as this continues, re-opening should continue and there will be no need for renewed restrictions. Inflation has pushed higher and may rise further from here but should be falling next year. The Bank of England, like other Central banks, has signalled it believes the impulse will be transitory and that they do not need to respond to it.

Figure 27. **UK**

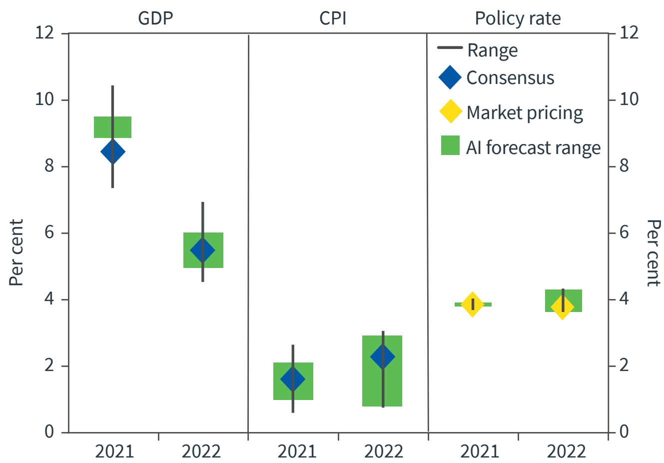


Source: Aviva Investors, Macrobond as at 28 June 2021

China

As opposed to direct funding for consumers and the unemployed, as most DM and many EM countries did, China provided credit-fueled stimulus to banks and firms, with infrastructure and property supporting the economy. Exports continue to boom (+28% y/y in May, with imports continuing to rise even faster, at a sizzling +51% y/y) and are continuing to benefit from COVID restrictions elsewhere. There are clear signs now that policymakers are successfully containing leverage, with credit growth slowing and aggregate measures showing a negative impulse. This is feeding through to activity, with industrial production slowing from an 8% annual pace to around 6.5% between Q1 and Q2. The hope is that this can be slowed while retail sales and consumption pick up as the economy normalises, converging to a 5.5-6.0% real growth rate. Inflation is a problem, driven by commodities that lifted PPI to 9%; CPI is lower, at 1.3%, but is flattered by falling pork prices. Authorities have taken actions to ease speculation and price spikes, but are unlikely to hike rates; the currency has appreciated already but is likely to be kept stable. The Sino-US relationship remains fraught, but the focus has shifted from trade to human rights, technology and military influence.

Figure 28. **China**

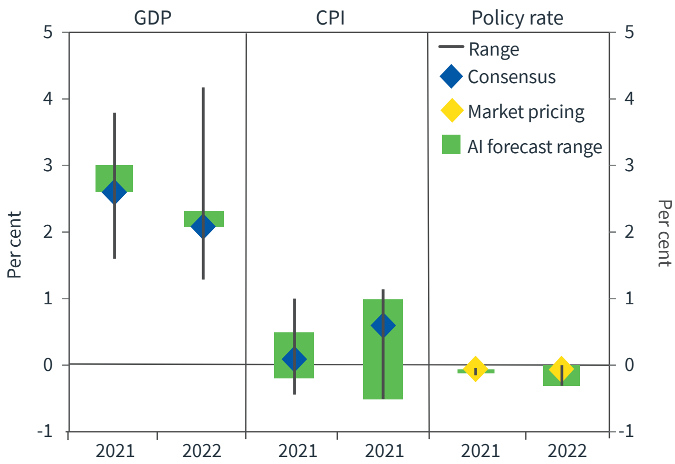


Source: Aviva Investors, Macrobond as at 28 June 2021

Japan

We still expect Japan to attain pre-crisis GDP levels by the end of 2021, but the beginning of the year has disappointed our raised expectations. Exports are just below where they were in Q4 2019 and are growing rapidly in response to global demand. Industrial production is already above pre-pandemic levels, along with consumption of durable goods. Three supplementary budgets have kept fiscal spending robust. As restrictions ebb in Q2/Q3, the Tokyo Olympics should help activity, but Japanese consumers have shown an unwillingness to spend, and continue to accumulate large savings. Overall consumption remains only partially recovered, with services spending nearly 20% lower than pre-COVID. Because of this weak demand, and as Japan remains a "pursued economy", with better investment returns in most sectors available externally, capital expenditure will remain weak. The BoJ is monetising fiscal expenditure and continues to fail to achieve much more than zero inflation. Political scandals are an ongoing hurdle, but PM Suga should at some point – post-Olympics, and after slow vaccinations eventually catch up to other rich countries – seek a fresh mandate in snap elections, which could remove uncertainty and help both domestic investment and FDI.

Figure 29. **Japan**

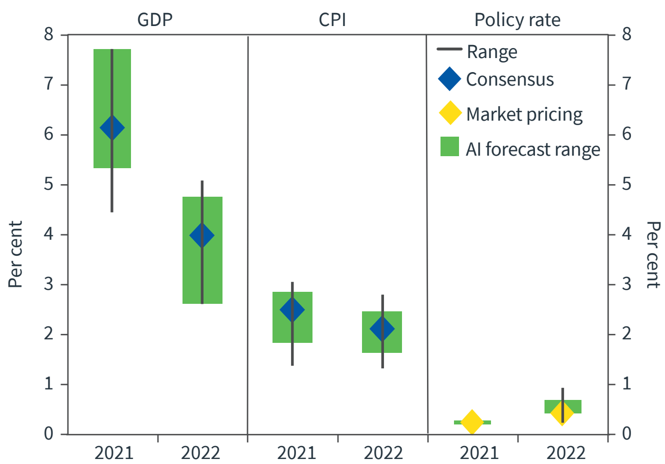


Source: Aviva Investors, Macrobond as at 28 June 2021

Canada

Like its larger US neighbour, Canada saw growth slow rather than turn negative (as in most of Europe) in the first three months of 2021. But as case numbers fell back again and the economy re-opened, growth has rebounded strongly in Q2 and momentum looks to be carrying through to Q3 as well. The Canadian economy could grow by as much as 7% this year. As elsewhere, growth has also become more balanced, with service activities reviving robustly. Canada has also benefited from the twin kickers of successively higher oil prices and the global revival in trade flows, including commodities in particular. Inflation has shifted higher too, although not to the same extent as in the US. The Bank of Canada has already signalled a further taper of its asset purchases later this summer and may stop entirely by the end of the year. Policy rate increases still look unlikely until much later next year, but some hawkish comment has led markets to price in between two and three hikes by the end of 2022.

Figure 30. **Canada**



Source: Aviva Investors, Macrobond as at 28 June 2021

Global market outlook and asset allocation

- **Re-opening of the global economy has the potential to create a virtuous cycle for growth, supporting companies' earnings, wages, employment and investment**
- **Inflation is not entirely transitory, meaning QE and low rates will be less necessary in coming quarters**
- **Tapering and tightening make policy less loose, but not restrictive – especially with fiscal policy accommodative**
- **Climate goals and higher taxes are also possibly inflationary, and may prove challenging for certain sectors**

The key House View themes of strong growth, procyclical fiscal support, and expansionary monetary policy persist. They are joined by a new subject that interacts with them, and impacts all asset classes: inflation, which, together with more challenging valuations (high P/Es, tight spreads, elevated commodity prices) creates a trickier investment environment. Growth should slowly decelerate from here, and even after central banks have recalibrated their targets, QE is on the way out and rate hikes are beginning to come into focus – in several major emerging markets, they have already started in earnest.

Strong growth has pushed some central banks to reduce easy monetary policy

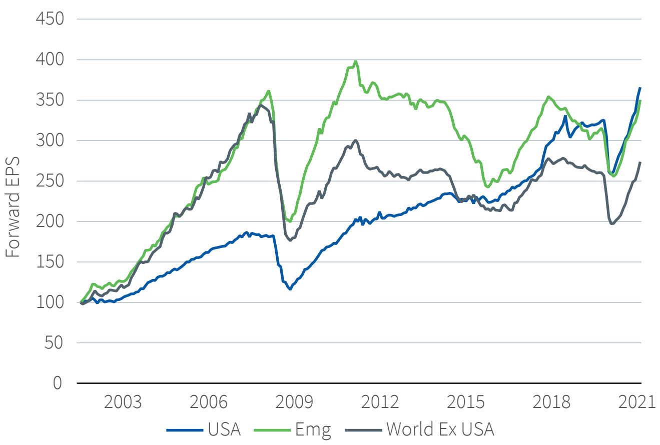
Policy is still promoting a stronger expansion, even if the "delta" is not as large, and the surprises relative to expectations of new programmes is smaller. We still expect the US to implement a large infrastructure package in H2, the benefits of which outweigh any tax hikes and reregulation; additional tax cuts and redistribution may also provide an offset to declining older stimulus. Similarly, the EU is now funding itself via NextgenEU bonds which will be deployed via the Recovery Fund over coming years, and Japan has expanded its fiscal thrust with supplementary budgets as it prepares for its delayed Olympics. Austerity: RIP and good riddance! Well, not quite: China's credit impulse has rolled over as property and infrastructure lending slows, and many Emerging markets have less policy space to continue fiscal profligacy; EM finance ministers must find a way to tighten budgets and consolidate deficits even as damage from COVID persists.

Advanced economies maintain expansionary fiscal policy; EMs are less able to do so

As the global economy moves from healing its wounds to a more robust expansion, and with scope for further gains from equity markets, credit products should perform decently too. Almost 18 months since the onset of the COVID crisis, the recovery is well underway in both economies and asset prices, meaning additional gains will be less vigorous: earnings usually

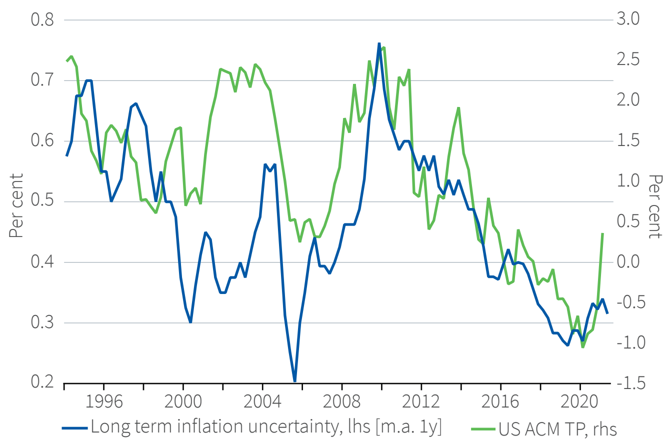
Rising earnings can drive equities even higher, led by energy and financials

Figure 31. **Forward earnings are rising robustly across equity markets**
MSCI 12 months forward earnings per share
(rebased to 100 in January 2002)



Source: Aviva Investors, Macrobond as at 28 June 2021

Figure 32. **Lower inflation uncertainty has been a key driver**
US term premia (10y) and inflation uncertainty



Source: Aviva Investors, Macrobond as at 28 June 2021

lead equities at a more mature phase of the business cycle, with high multiples staying flat or even decreasing gently, absent a bubble. We maintain our highest conviction asset allocation views in equities, where even though stock markets are at or near record levels, further gains are in order especially in energy (where consensus needs to catch up) and financials that benefit from earnings growth and still rising expectations (Figure 31).

There are other thematic, medium and long-term beneficiaries of this unusual "business cycle"; our climate change regulation thesis is complex, and includes recipients of decarbonisation largesse companies that improve energy efficiency, or legacy players reaping bumper profits of past investments in commodities as future investment is curtailed. The strategic competition between China and the United States has morphed from a myopic focus on trade deficits into an arms race of investment in current and future technology while punishing anyone on "our team" who is too much help to "their team"; we want to make sure our investments can benefit from such tailwinds, but not get caught offside and be penalised.

Regulation and politics can drive less cyclical, opportunistic investments

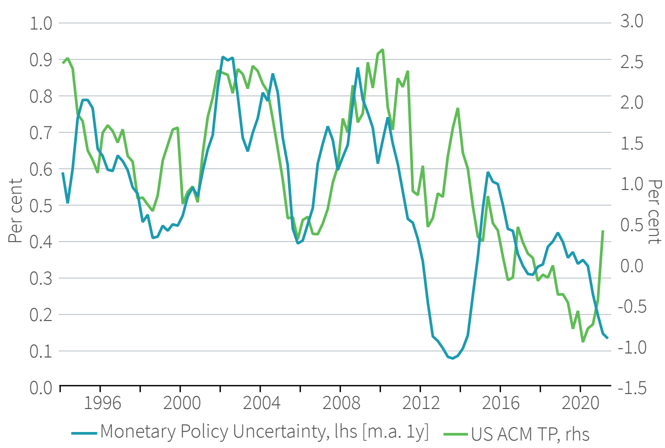
Credit spreads have not been tighter than they are now since the Global Financial Crisis – and before that were grossly overvalued – so excess return from investment grade and high yield credit will come from this limited carry and rolling down somewhat steep credit curves. This may not suffice to offset losses from the interest rate duration, especially for the longer-dated maturities, although they should still outperform government bonds. Eventually, should a slowdown raise the risk of a recession, or a global shock materialise, spread widening can unravel many quarters' worth of excess returns as well. Even though we don't see such a negative event on the investment horizon, we continue to recommend underweights in investment grade, and are keeping a neutral stance towards high yield and hard currency EM (which benefit more from global growth and upgrades).

We see limited scope for corporate credit spreads to tighten much further

We do see inflation as a dominant theme for markets; coupled with the base effects on energy prices, upward pressures are building up as a mix of supply constraints intersect with accelerated demand caused by rapid post-COVID reopening. Such a combination does not have any historical precedent. Although this does not describe a "supply shock" since the capacity for output is not reduced, it will take some time for the supply to overcome current limitations and match the demand; this means that inflation should be transitory, although in our minds transitory means at least for the rest of this year. In the United States, where the output gap will soon turn positive, the risks are skewed to the upside, because demand pressures might further feed the underlying inflationary impulse. In such a context, potentially higher inflation and monetary policy uncertainty attached to a more outcome-based Fed guidance should be the key drivers of higher bond term premia (Figure 32 & Figure 33). As a market implication we underweight nominal government bonds, and in particular US long-dated bonds, where the retracement lower in US yields since March has created a short opportunity. US treasury yields are expected to move higher as the FOMC is gearing up to start

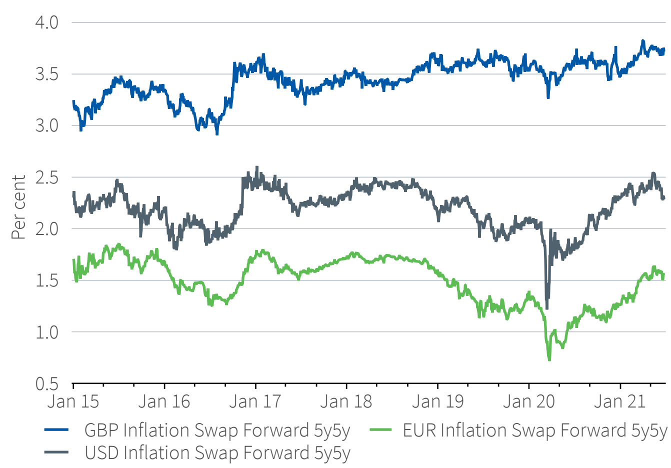
Rising inflation fears can push bond yields higher via the "term premium"

Figure 33. **Lower monetary policy uncertainty has contributed too**
US term premia (10y) and monetary policy uncertainty



Source: Aviva Investors, Macrobond as at 28 June 2021

Figure 34. **Inflation expectations have risen from the depths of the crisis**
5y5y swap fwd



Source: Aviva Investors, Macrobond as at 28 June 2021

reducing its super-loose monetary policy, and those periods usually see higher yields across the curve. The move could be led by a move higher in FOMC median long-run rate projections (terminal Fed Funds rate) but also by a rise in term premia in anticipation of QE tapering.

Real yields should rise from here, but slowly

From the trough of 2020, break-even inflation rates for many markets are materially higher (Figure 34), while real yields are barely above their recent lows. We think that low real yields in the near term are supported by Fed, ECB and BoE policy. A material negative carry (caused by the current high inflation prints) is an additional technical factor not supportive of a short position in TIPS. Nevertheless, later this year, when we expect the Fed will have reached a consensus on tapering QE purchases, it will mean that substantial progress in the real economy has been achieved, and some reopening price jumps will be behind us. Moreover, our main scenario foresees for this and next year US growth in line with pre-COVID trend. We do not see real yields going back immediately to pre-COVID levels, but gentle upward pressure on the average level of long-term real yields looks more likely than declines from current levels. As we discussed in the last House View, this is not usually a bad environment as long as inflation expectations are not falling, even if no longer as marvellous as the policy-supportive reflation of late 2020 and Q1 2021.

Within the FX space, the USD dollar outlook is more uncertain. The broad-based growth environment, a higher US twin deficit looking forward and the elevated valuation of the dollar are the main factors that would point to further dollar weakness in the long term (Figure 35).

Commodity prices and higher rates may support currencies such as the Canadian dollar and Norwegian krone

Year to date, the USD has appreciated by roughly 3% vs the major world developed countries' currencies (DXY index), and it has appreciated during March and June when the markets have cast doubts on the ultra-loose Fed policy stance. Although continued QE and zero rate policy from the Federal Reserve will limit the extent of dollar appreciation in 2021, the near-term direction might be conditioned by the macro data volatility and markets' doubts on the strength of their commitment to Average Inflation Targeting. Finally, the performance of USD tends to be less broad-based and more mixed across currencies in the case of rising real yields, hence pushing for more differentiation across high and low-yield currencies. In this environment we prefer to buy commodity currencies, such as CAD and NOK. We believe that the global recovery environment and the higher commodity prices tend to favour the outperformance of commody currencies, which exhibit a positive correlation with both global growth and oil. Moreover, both the Bank of Canada and the Norgesbank have recently revised up their economic projections, and have been the first two developed market Central banks to tune their communication for future normalisation of monetary policy. In Canada, the rate lift-off is now expected to happen sometime in the second half of 2022 (brought forward from 2023); in Norway the lift-off date has been brought forward from December to September of this year. In emerging markets, currencies got a reprieve in Q2 as G10 yields retreated, but are sensitive to rising US nominal and real yields. As a result, EM central banks are raising rates already (e.g. Brazil, Czech Republic, Hungary, Mexico, Russia, Turkey) and many more will have to normalise policy in H2, adding to the challenges for EM local debt and equity (Figure 36).

Figure 35. **The real, trade-weighted dollar remains at relatively strong levels**
JP Morgan CPI REER - percentage deviation from 20y average

Source: Aviva Investors, Macrobond as at 28 June 2021

Figure 36. **Rising yields in 2021 have caused losses in EM local debt markets**

Source: Aviva Investors, Macrobond as at 28 June 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				-2							
United States			-3								
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						0					
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 28 June 2021

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