House View Q4 2021

The intelligence that guides our investment decisions

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

Growing pains – strong demand, constrained supply and elevated inflation

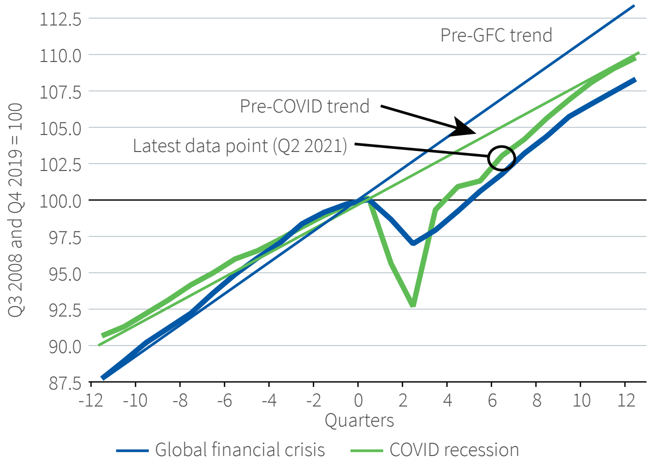
The course of economic recoveries and expansions never runs completely smoothly. Businesses need to adjust to the changing environment and are just as likely to be surprised by the strength of demand as by any unexpected weakness; still, the current global economic expansion is unique. Following the unprecedented decline in activity in 2020, economies have recovered rapidly – much more briskly than many forecasters, businesses or households had expected. Supported by extraordinary fiscal and monetary policy support and driven by a very rapid recovery in consumer demand, economies experienced a material shift in the mix of consumption, towards goods and away from services. The pace of recovery has seen some major economies, such as the United States, already surpass their pre-COVID recession level of activity, with others such as the Eurozone and United Kingdom expected to reach that point by the end of 2021. As a result, these economies have regained their pre-crisis GDP within around 18 months of the deepest recession on record. That compares with between 3 and 7 years to return to the prior peak in activity following the global financial crisis (GFC) of 2008. Moreover, we and many other forecasters expect economies to return to their pre-COVID trend path of activity by the end of 2022, something that most economies never achieved following the GFC (Figure 1).

Rapid recovery is expected to see economies return to pre-COVID trend by late 2022

However, the combination of manufacturing shutdowns in 2020, the speed of recovery in demand in 2020/21 and the lingering effects of COVID restrictions in parts of Asia (that have either pursued a zero-tolerance approach to infections or currently have low vaccination rates), has led to some growing pains. These have become more evident over the course of 2021, as commodity, manufacturing and retail inventories have fallen sharply, with production unable to keep pace with the level of demand. Figure 2 shows just how extreme those inventory issues have become, with both manufacturing and retail at historic extremes in the low level of inventories (relative to those desired). It is also a vastly different experience to the same point in the recovery from the GFC, when inventory levels were around average. The situation today reflects a range of factors, including: under-investment in the years preceding the COVID crisis; factory closures in H1 2020 and sporadically thereafter; final demand for goods well in excess of pre-COVID level of demand; and "just-in-time" inventory management. The decline in inventories has resulted in ever longer supplier delivery times, increased backlogs of work and significant upward pressure on producer prices. While the direct impact of higher energy prices has pushed consumer inflation up significantly, rising supply chain costs have also fed through into parts of the consumer basket. In addition to raising prices, the supply-chain problems have curtailed growth as well, as industries have essentially been unable to source certain components, such as semiconductor chips.

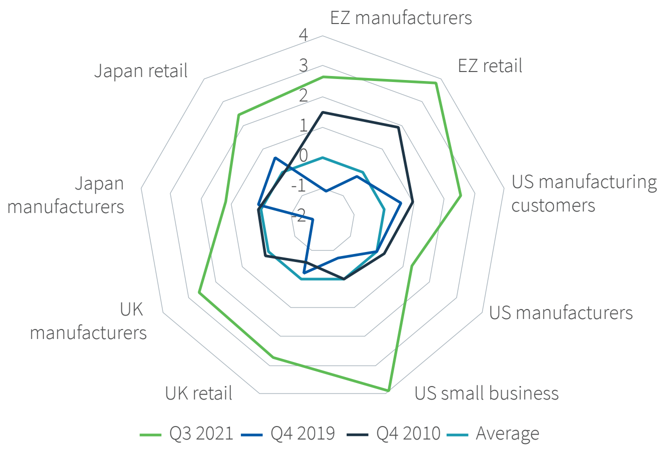
Goods supply chains are under strain from excess demand pressures, creating pockets of marked inflationary pressure

Figure 1. **Global activity: a recovery to pre-COVID trend, unlike the post-GFC experience**



Source: Aviva Investors, Macrobond as at 28 September 2021

Figure 2. **Surveys responses to level of inventories**
A larger number indicates lower inventory levels or greater inventory dissatisfaction; z-score



Source: Aviva Investors, Macrobond as at 28 September 2021

More recently, the supply challenges facing businesses appear to have gone beyond materials and intermediate inputs, to also include labour. Surveys of businesses in the United States, Eurozone and United Kingdom all indicate that they are having more difficulty sourcing labour than at any time in the past 30 years or more. That is also reflected in job openings, with vacancies at record highs. That is somewhat surprising given the number of people who left the labour market during the COVID crisis, alongside a still elevated unemployment rate. Perhaps the apparent labour shortage will resolve itself once some COVID-related support schemes, such as furlough and enhanced unemployment benefits are wound down. Or perhaps it will normalise as vaccination rates increase further and concerns around getting COVID subside, bringing people back into the labour market. However, if people have left the labour market permanently, then there is potential for wage pressures – which are already relatively high for this stage in the recovery – to increase further.

Surprisingly, labour shortages have also become an issue already in this recovery

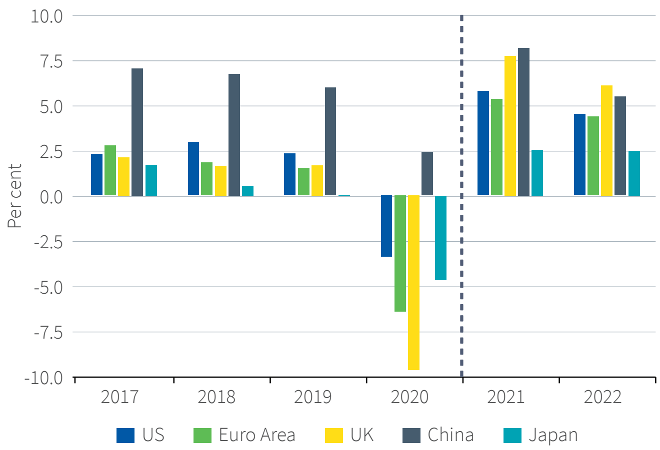
The confluence of strong demand, constrained supply and elevated inflation presents challenges for policymakers, particularly central banks that have dual mandates to support both full employment and deliver price stability. For now, the major central banks continue to expect the supply constraints to be only temporary in nature, and therefore the resulting increase in inflation to also be transitory. If that were the case, there would be no urgency to start removing policy accommodation. Rather, with recently revised mandates at the Federal Reserve and ECB in particular, they should wait to raise interest rates from the effective lower bound until much of the slack created by the COVID crisis is absorbed and inflation is sustainable around 2 per cent. That would suggest a lift-off in rates in late 2022 or early 2023 in the United States, with the ECB likely to be at least a year or more after that. However, recent comments from each of the Fed, ECB and Bank of England suggest some increasing concern about how persistent the supply constraints may be (in the face of still strong demand) and the potential for isolated increases in goods price inflation to become more widespread, feeding into wages and price-setting more broadly. In that case, interest rates could rise sooner and more quickly than anticipated.

Monetary policy has become more complicated, with a delicate balance needing to be found in the face of supply constraint

While we have modestly downgraded our growth projection for 2021, we have pushed much of that lost activity into 2022, leaving the demand outlook at the end of next year little changed from where we were three months ago. As a result, we expect global growth of around 6½ per cent in 2021 and around 4¾ per cent in 2022, with all the major economies growth well above potential (Figure 3). However, the risks to that outlook have become somewhat more balanced, having been previously tilted to the upside. One factor in that assessment has been recent developments in China, which we see as weakening growth there, and which are described in more detail in the themes and risks section. We have revised up our inflation outlook for this year and next, reflecting the temporary impact of supply constraints in 2021 and early 2022, but more robust underlying inflation through the course of 2022 (Figure 4). We judge the risks to the inflation outlook to be to the upside. We expect the Federal Reserve will begin tapering

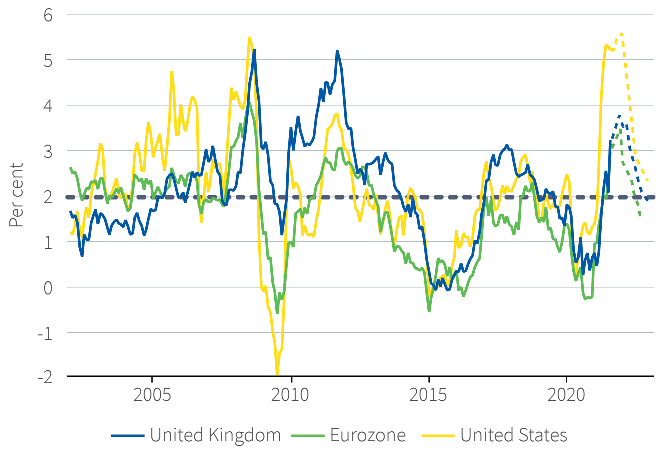
Inflation outlook has potential to bring earlier rate hikes from a number of central banks

Figure 3. **Major economy GDP growth projections**



Source: Aviva Investors, Macrobond as at 28 September 2021

Figure 4. **CPI inflation projections: expected to fall back towards target in 2022**



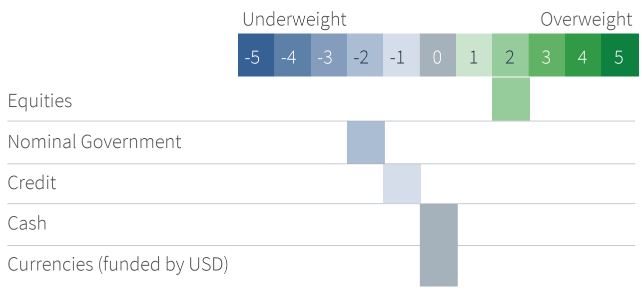
Source: Aviva Investors, Macrobond as at 28 September 2021

asset purchases in December, with an end to purchases by mid-2022. In our central scenario we expect a first rate hike from the Fed in Q4 2022. We expect the Bank of England to cease asset purchases at the end of 2021 and raise rates in Q2 2022, while the ECB is expected to end the COVID-related asset purchases (PEPP) in March 2022 and modestly expand/extend the pre-existing Asset Purchase Programme.

Going into the final quarter of the year, our asset allocation remains broadly pro-risk (Figure 5). We continue to be modestly overweight global equities, albeit we have scaled that overweight back a little given the growing pains economies are now experiencing, which could impact sales and margins. We have also tilted to a mix of more defensive sector exposures (such as healthcare) in addition to existing cyclical sectors (such as energy and industrials). We also remain modestly underweight duration, but again have scaled our positioning back. Credit spreads have widened a little in the last few months, but remain relatively tight and as such we continue to see corporate credit as less attractive than equities.

We prefer to be overweight equities and underweight duration

Figure 5. **Asset allocation summary**



Source: Aviva Investors, Macrobond as at 28 September 2021

Key investment themes and risks

Investment themes

1 Above-trend growth
2 Higher inflation
3 Ongoing policy support
4 Climate change policies
5 Living with COVID-19
6 New China

Above-trend growth

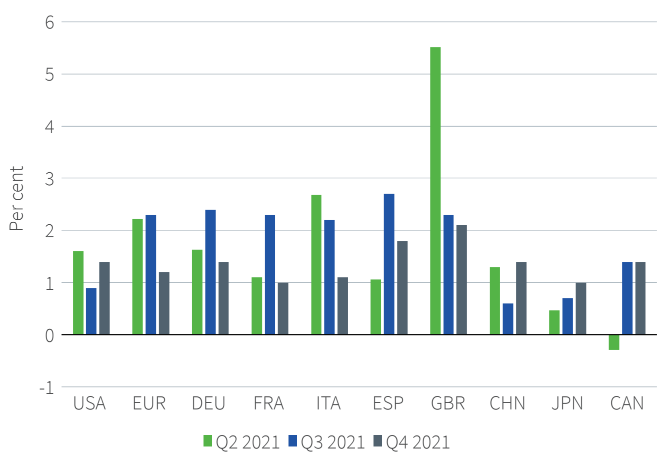
The path of economic growth during the COVID pandemic almost merits its own nomenclature. The usual words – expansion, contraction, recovery – convey meanings rooted in historical experience and "normal" cycles. This time really has been different. A slump used to mean GDP dropping by 2% in a quarter; but it fell by 10%, 15% even 20% in some places in Q2 last year. A rebound of 2% would have been called a surge in growth; we saw quarterly increases of between 15% and 20% in Q3 2020. The recent experience has been more restrained. But 1% or 2% growth in a quarter is still very strong (Figure 6). After the setbacks at the start of the year (global growth estimated at just +0.4% in Q1), GDP rebounded again – perhaps +1.6% in Q2. The Q3 outcome may be a little weaker because of concerns about the Delta mutation, but it will still be above the (estimated) trend rate of perhaps 0.8%. And Q4 should see similar. These sorts of outcomes mean we will see annual GDP growth of 5%, 6%, even 7% in the major developed economies in 2021 and only a little lower next year (Figure 7). In normal times, these would indicate unsustainable booms. But in present circumstances they represent economic revival and post-COVID catch-up. We expect to see the major regions grow by around 6% or 7% between now and the end of 2022. The exact distribution of that growth will depend on the dynamics of COVID, including vaccination efforts, but it should be heavily weighted to the second half of this year.

This time really has been different

This pattern means growth will be slowing in 2022. That is what we are projecting, with quarterly GDP growth converging to around the trend pace by the end of next year. Slowdowns always give financial markets something to worry about – do they mean the next downturn is looming? Is another stall or recession likely? We believe that the answer to both of those questions is "no". Rather, this pattern of strong, but slowing growth, is simply a reflection of post-COVID dynamics. There are legitimate questions to ask about whether all – or some – economies return fully to the post-pandemic trend in terms of GDP. But a sustained economic recovery over the rest of this year, throughout 2022 and quite possibly well beyond, looks the most plausible outcome. Strong growth in this instance does not necessarily imply the build up

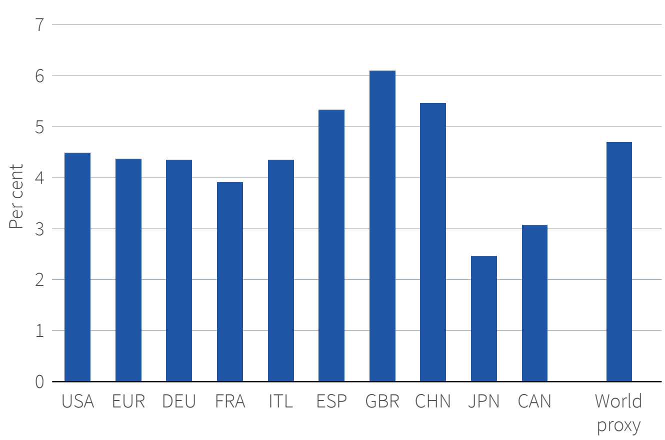
Strong, but slowing growth expected between now and the end of 2022

Figure 6. **Quarterly GDP growth: actual and projected**
Activity has rebounded strongly in 2021



Source: Aviva Investors, Macrobond as at 28 September 2021

Figure 7. **Aviva Investors 2022 GDP projections**
Post-COVID catch-up points to another boom year



Source: Aviva Investors, Macrobond as at 28 September 2021

of excesses that require monetary and fiscal policy brakes to be applied hard. It will eventually become appropriate to tighten policy and move away from emergency settings (see below). But in our view policymakers have plenty of time to respond. For now, optimism in a robust and lasting economic recovery in, we hope, a post-COVID era, looks justified.

Higher inflation

In economic upswings there are often frictional imbalances between demand and supply: demand revives, while supply initially struggles to keep up, resulting in upward price pressures. Subsequently, supply recovers and the transient inflation impulse fades. The COVID downturn and rebound have been on a scale barely imaginable, so in one sense it is no great surprise that this has led to rising inflationary pressures in some sectors. Nevertheless, there is considerable debate over how much of recent increases is temporary and how much may be more permanent. Headline rates of inflation have certainly been boosted by special factors and base effects. Energy prices, for example, tumbled at the start of the pandemic but have risen steeply since. It is very likely that this contribution to higher inflation will fall in coming quarters. Changes in indirect taxes have also impacted and distorted headline rates of inflation. But underlying or core rates have risen too, indicating that something more fundamental may be happening (Figure 8). Moreover, even if demand-supply imbalances are largely transient, the special circumstances around COVID mean that they may last for longer than normal. And the longer they do, the greater the danger that they become more entrenched and lead to more damaging (and lasting) second round effects.

Supply-demand imbalances are not unusual during upswings...

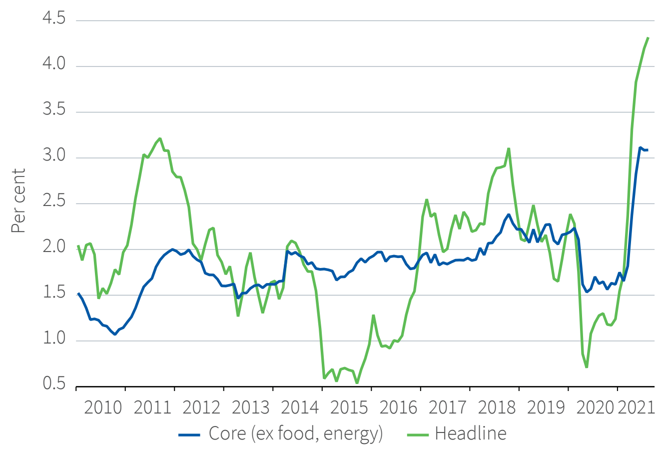
It is very clear that shortages of certain goods or components have emerged and that transportation costs have surged higher as economies have reopened and trade has resumed. The OECD estimates that higher commodity prices and global shipping costs are currently adding 1.5% to G20 CPI inflation (around 3.5% at present) and they expect such components to remain elevated into 2022. If these "supply chain" influences endure they may feed through more permanently and lead to a more enduring inflation impulse. Related to this, and arguably more worrying, has been the emergence of shortages in parts of the labour market resulting in pockets of higher wage inflation (Figure 9). These are very different from the last cycle and may also be transient, but many indicators suggest demand for labour is currently very strong. Labour costs are the key driver of underlying inflation pressure.

...but the COVID experience has been unique

In our central scenario we think that much of the recent increase in inflation will be transitory and will fall back in 2022 as economies reopen more fully. Central banks in most developed markets share this view and are using it to justify maintaining their relaxed stance on monetary policy. Recent changes to their inflation mandates and operating frameworks have made this easier and imply that they will allow (even encourage) inflation. Even so, they may not be able to ignore the latest inflation trends completely, especially if financial markets start to fret more about them or if they become more fully reflected in measures of

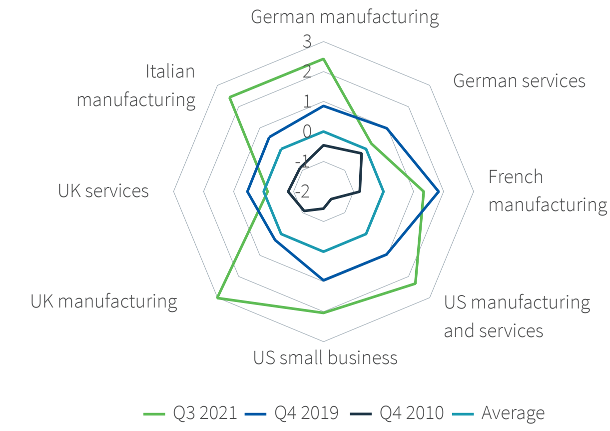
Inflation should fall back next year as supply recovers

Figure 8. **OECD CPI inflation**
Both headline and core inflation have risen sharply



Source: Aviva Investors, Macrobond as at 28 September 2021

Figure 9. **Labour shortages at record highs**
Unusual to emerge so forcefully this early in the upswing



Source: Aviva Investors, Macrobond as at 28 September 2021

inflation expectations. We continue to believe that the risks to our central scenario are tilted to somewhat higher and more persistent inflation outturns over the next 12 months.

Ongoing policy support

In other circumstances it might be deemed appropriate to respond to the combination of strong recovery and rising inflation with a touch on the fiscal and/or monetary policy brakes, or at the very least, lifting the foot off the policy accelerator. But in the current environment, ongoing policy support may still be required to help ensure a complete and lasting global recovery. There are at least three aspects to this. First, governments need to deploy vaccination efforts as quickly as possible, including programmes of booster shots as we go into the Northern Hemisphere winter. Wealthier nations will also need to drive stronger international efforts to assist lower-income countries. Secondly, monetary policy will need to remain supportive until durable progress is made towards longer-term objectives and far more economic stability is restored. As discussed above, this may well require "looking through" a period of higher recorded inflation. This does not mean that initial steps towards normalisation should not be made – crisis settings are probably no longer needed. But any actions, at least in advanced economies, will be signalled clearly and introduced slowly.

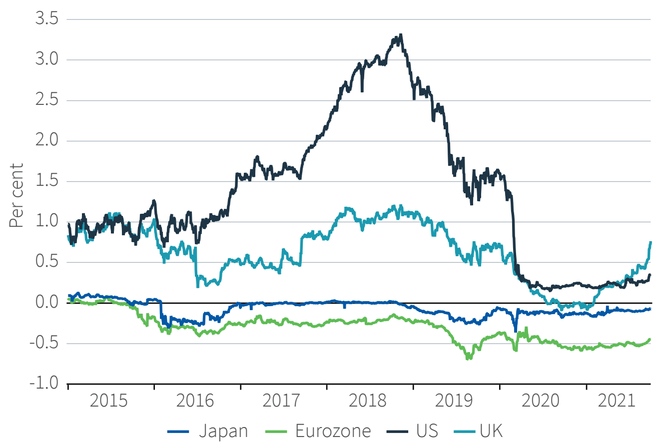
Even if COVID worries are receding, support will be needed for a while yet...

For central banks this implies sequential steps starting with removal of emergency measures, followed by stabilisation of balance sheets and reductions of asset purchases and finally, higher interest rates. Some emerging markets will not have the luxury of such a relaxed timetable. The first policy rate rise in the larger developed markets will probably not be required until next year, although policymakers and markets are now a little less certain of this than a few months back (Figure 10). Finally, fiscal support will only be withdrawn as the need for it subsides. Fiscal policy has done much of the "heavy lifting" during the pandemic and has been critical in ensuring that mothballed sectors have been able to restart with minimal permanent damage or losses (Figure 11). Even the once fiscally conservative IMF has been more relaxed than usual: "[a]ny moderation in fiscal spending in 2022 should come from contingent reductions in crisis-related spending as the economy strengthens and vaccination coverage expands, rather than substantial discretionary consolidation measures". Many of the support packages (e.g. furlough) will fall away naturally as activity restarts. It is important to acknowledge that people and businesses will require ongoing support during the transition back to normal or to the new normal.

...and should be withdrawn cautiously

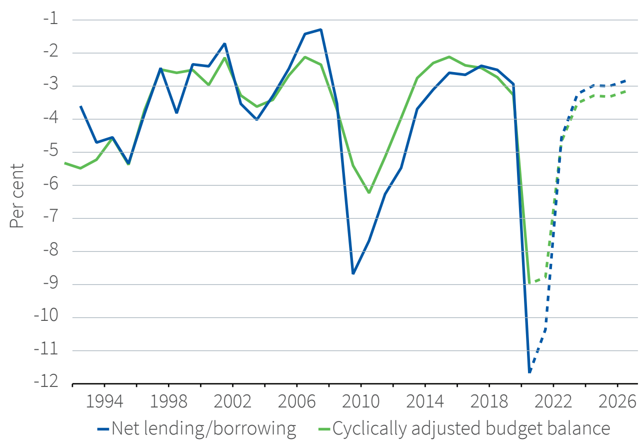
Overall, both fiscal and monetary policy are expected to remain supportive over the next year or two. Unless there are new setbacks, no major additional stimulus packages should be needed, so it is not unreasonable to characterise a longer-term mild tightening policy bias. There may well be a greater role for the state in many areas – and this is perhaps most marked in the US (in terms of change rather than level), but this is not a sea change towards acceptance and adoption of Modern Monetary Theory (MMT).

Figure 10. **Interest rate expectations (1 year ahead)**
Markets beginning to look ahead to possible tightening



Source: Aviva Investors, Macrobond as at 28 September 2021

Figure 11. **Fiscal balances, advanced economies**
Budget deficits have soared, but should correct without "austerity"



Source: Aviva Investors, Macrobond as at 28 September 2021

Climate change policies

Decades of procrastination mean that original ambitions for carbon-intensive economies to gradually reduce their dependence on fossil fuels and emissions of greenhouse gases are now increasingly irrelevant. Instead, it has become apparent that the required changes are far more likely to be abrupt. Recent estimates from the Intergovernmental Panel on Climate Change (IPCC) at the United Nations have shown that emergency action is required to have any chance of limiting potentially catastrophic climate disruption. These realities are now being recognised more widely and are being translated into plans for quicker transitions to carbon neutrality (Figure 12). The International Energy Agency (IEA) recently reported that countries representing 70% of global emissions and GDP have committed to reaching net zero emissions by 2050 or 2060 (Figure 13). Further announcements and declarations are to be expected in the run-up to COP26 as well as during and after that event. The official judgement on progress – or the lack of it – with regard to the Paris agreement will also be revealed.

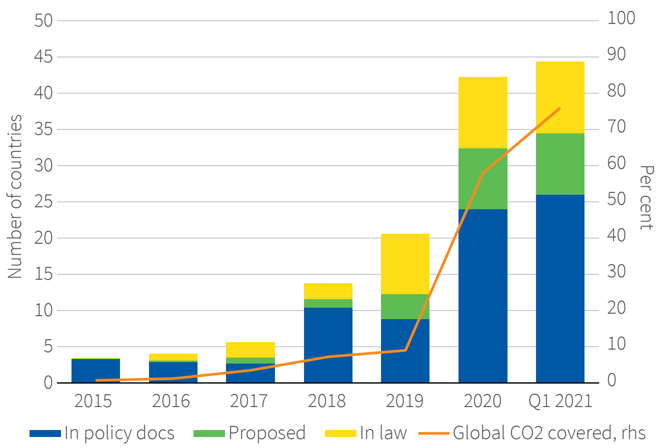
Any hopes of achieving net zero emissions by 2050 requires wide-ranging change

There is still considerable distance between aspiration and delivery on climate change initiatives, but it does seem as if some momentum is now building behind such policies. But if even a fraction of the proposals currently being discussed are introduced in coming years, it seems inevitable that climate change policies will have significant macroeconomic consequences across a wide range of different spheres. A number of countries in Europe have been especially vocal in pioneering real progress on climate change. The European Commission recently announced plans to cut emissions by 55% by 2030 (compared with 1990) instead of the previously legislated 40%. They hope to overhaul energy legislation, broaden the scope of the carbon trading scheme, introduce new technical standards and push through minimum carbon taxation at the national level. Not all such initiatives will survive negotiations between member states, but the new agenda is consistent with stated ambitions of governments so pressure can only grow to align actions with words. Overall, it is reasonable to expect wide-ranging changes for energy, transport and housing as well as more generally for manufacturing, agriculture and services.

Some momentum has built up, but actions are needed now

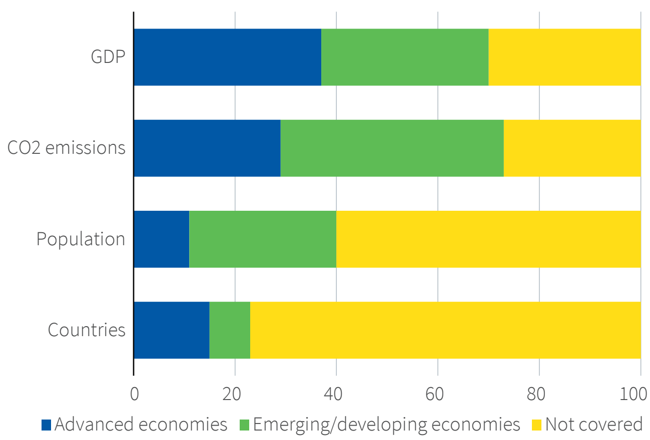
Any moves toward more definitive actions in coming years are bound to have immediate economic implications. Some capital equipment will lose economic value, some industrial plants may have to shut down, some employees will have to be redeployed, investment will have to increase in certain areas and parts of the capital stock may need to be repaired, rebuilt or modified. Often these steps have been characterised as a sort of "benign endeavour" rather than as essential, but potentially disruptive, steps that may have meaningful impacts at a macroeconomic level. Some have even compared decarbonisation to the supply-side oil shocks of the 1970s. That is probably too extreme, but the next decade could well see short-run hits as the required adjustments are made.

Figure 12. **Number of national net zero pledges and share of global CO2 emissions covered**



Source: International Energy Agency as at 28 September 2021

Figure 13. **Coverage of announced national net zero pledges**



Source: International Energy Agency as at 28 September 2021

Living with COVID-19

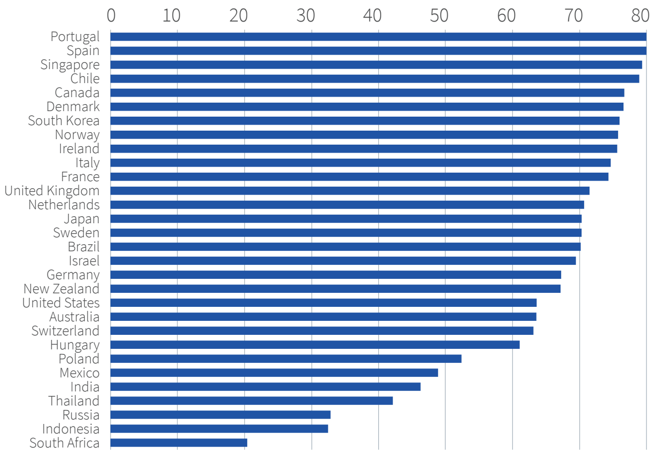
Over the next few years, it is very unlikely that the COVID virus will be eradicated. But its impact on economic activity around the world should become trivial compared to the experience of 2020-21. This transition may not be entirely smooth, or quite so painless in some countries or regions, but the direction of travel and ultimate destination now seem clear. The COVID pandemic has been a truly extraordinary event, the legacy of which will be with us for decades. It is estimated that there have been 230 million cases worldwide and nearly 5 million deaths. Both of these numbers will, sadly, increase, but it seems very clear that we are now moving to a new stage of the COVID episode. For comparison, the Spanish 'flu pandemic of 1918-1920 is believed to have resulted in around 50 million deaths, with high mortality in people 20-40 years old. People and businesses have adapted successfully to the existence of the virus and vaccination programmes (Figure 14) have totally changed the dynamics of the pandemic and its economic impact. Initially it was hoped that the virus would be contained close to its point of origin, but it swiftly became apparent that this was not going to happen. The spread in early 2020 quickly became explosive (Figure 15) and countries had to react, imposing stringent lockdown restrictions to contain the virus.

COVID will still be with us for some time

If COVID evolves from a pandemic to an endemic phenomenon, as we expect, then the world will have to get used to living with the existence of the virus in a similar way that it does with the regular episodes of 'flu which hit us every year. After all, they too are easily communicable and occasionally deadly, and the world does not stop for them. But even if this is true, the ability of countries to adapt will vary depending on their experience so far. It is now clear that containment of infection levels requires both high levels of immunity from initial vaccination and also from infection itself. The deployment of booster shots may mean other nations have to wait a longer for vaccine supplies. Meanwhile, countries which had been successful in suppressing the virus initially (such as Australia and New Zealand) will have to accept that a transition to containment must imply a materially higher burden on health systems and greater fatalities than experienced thus far if they are to reopen as Europe and the US have done and accept COVID in its endemic state. These contrasting choices between the developed and developing world and between early adopters of reduced restrictions and those who stick with suppression may lead to different growth profiles as we move through the next 12-18 months and will present investment opportunities for those who correctly identify the timing of changes. But for most developed nations, the next few years should see an environment where the COVID virus is still present, but increasingly unimportant from a macroeconomic point of view.

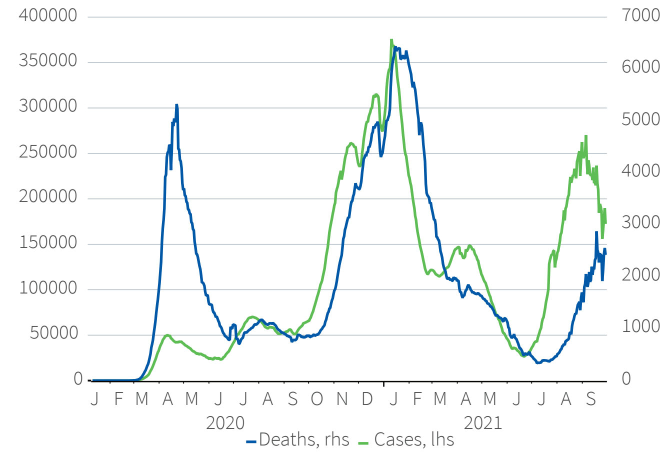
From pandemic to endemic – regional experiences may vary

Figure 14. **Percentage of population vaccinated (first dose)**
EM nations are far less advanced in vaccination efforts



Source: Aviva Investors, Macrobond as at 28 September 2021

Figure 15. **G7 COVID-19 cases and deaths, daily change, 7-day mavg**
Case numbers are falling; death rates are lower



Source: Aviva Investors, Macrobond as at 28 September 2021

New China

China's economic development path is unique

China, the world's second largest economy and biggest "engine" of economic growth for decades, is in the midst of a major shift in its priorities. In the near term, the burst of credit to cope with COVID has been far smaller than earlier expansions (Figure 16), and this impacts our global growth forecasts, but the longer-term change is even more important. The directives come from the very top, and our interpretation of how the main philosophical goals of the 19th Party Congress (2017) and 14th Five Year Plan (March 2021) should be interpreted are based around (a) Regulatory Rectification, and (b) Common Prosperity. What these vague and general phrases mean has been much discussed and may change over time, but there are clear shifts away from sustainability and urbanization and towards market reform and ideological and cultural issues. We think these modifications will include:

Self-reliance

- Aiming for **self-reliance**, with the internal part of the so-called dual circulation economy promoting consumption and local production. Investing in technology that grows domestic supply chains will be a priority. Sectors that are seen as antithetical to these goals may face regulatory hurdles and political opposition.

Quality of growth rather than quantity

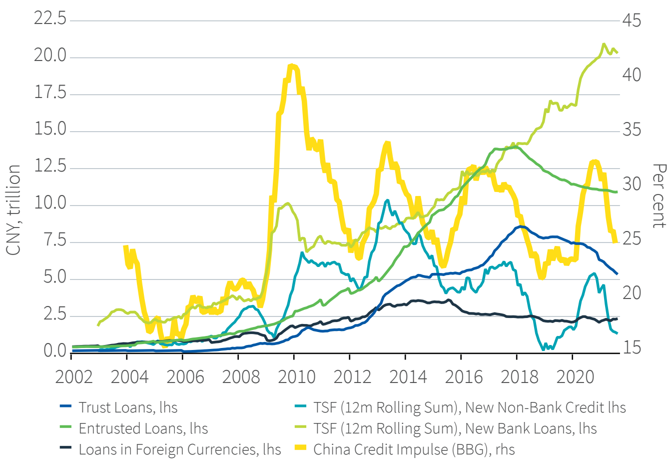
- **High-quality development** rather than merely high growth, led by investments that raise living standards and expand clean energy generation. Infrastructure and capital-intensive manufacturing will not be stopped, but SOEs will upgrade to become more efficient and less polluting. On the flip side, there will be taxes and transfers that are painful for those sectors that have grown dominant, limits on "negative" activity (e.g. gaming, online tutors, celebrity influencers) and higher property taxes.

Controlling risk

- **Risk reduction**: especially in financial risks, i.e. leverage, forced simplification of conglomerates straddling banking or fintech, curbing monopoly or other power that encroaches on CCP dominance, and – the hot topic since the Evergrande collapse began – reducing property speculation that re-emerged after the 2010-14 boom paused for a few years. Reining in "disorderly expansion of capital" encompasses debt ratios, dependence on foreign capital, and market dominance that, by increasing inequality, runs counter to shared affluence. After years of debt accumulation (Figure 17) this will not be an easy process.

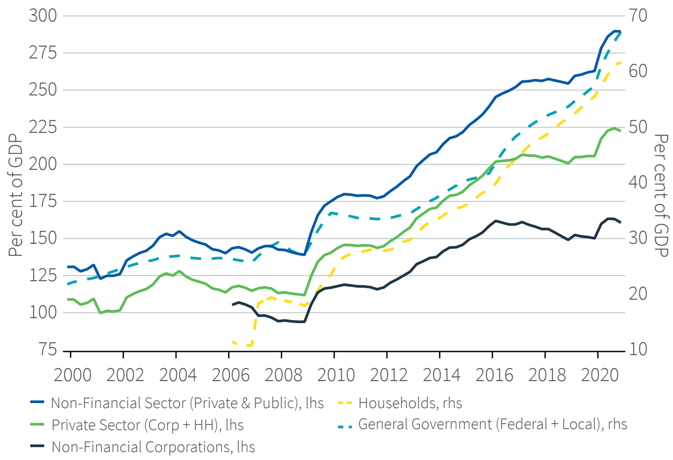
For the past year our House Views contained the theme of Strategic Competition, which included the trade war, geopolitical tensions between China and its neighbours, and risks of decoupling. That thesis is not defunct, but is increasingly shifting to technology, ideology, and global rule-setting, and is part of China's outward reorientation from an emerging market export powerhouse based on cheap labour and debt-driven investment to a more sustainable, middle-income, consumption-driven technology leader – Korea and Japan being role models in this respect. A slower-growth China aiming to substitute imports and dominate sectors will have spillovers to other countries via trade and capital flows, while China's internal model will impact markets as it continues to try to open up, attract foreign capital, and integrate into global markets.

Figure 16. **Credit impulse attenuated as shadow banking quelled**
China, social financing, CNY



Source: Aviva Investors, Macrobond as at 28 September 2021

Figure 17. **High and growing debt presents large financial risks**
Debt-to-GDP by sector (per cent of GDP)



Source: Aviva Investors, Macrobond as at 28 September 2021

Risks

Inflation outbreak

Concerns about the current inflationary impulse being more lasting have risen in recent months. Although parts of the supply-demand imbalance should fade as economies reopen, as should the energy price impact, there are fears that some supply-side weaknesses may be more persistent, leading to more serious and lasting price pressures. There are particular worries about parts of the labour market, where pockets of severe shortage, leading to noticeable wage rises, have appeared. Economies and financial markets are presently drawing considerable comfort that central banks will "look through" high inflation and keep policy looser for longer. If that assessment were to change because of stubbornly high inflation – in other words, the view that monetary authorities have to react to worrisome inflation takes root – then the landscape for both the growth outlook and for markets changes considerably.

If inflation proves more stubborn, central banks may have to react

If central banks choose to raise policy rates earlier and by more than had been anticipated, then bond markets will have to react, pushing yields higher. At present they offer little protection against higher inflation (Figure 18). It has been a long time since a "conventional" overheating episode; after an extended period of below-target inflation, it would represent a meaningful shock, even if it were modest by historical standards. For economies, monetary tightening would weaken demand and lead to slower growth to help drive inflation back down. If output gaps had in fact moved significantly into positive territory, then a period of below-trend growth would be warranted. That would be a very different environment to that which has prevailed for much of the last decade or more. In extremis, an inflationary episode could challenge the hard-won belief that central banks had defeated the high inflation problems of the past. Stubbornly high inflation may well be more of an issue for emerging market economies, some of which have already responded to its threat.

Longer-term bond yields offer little protection against higher inflation

Fiscal sustainability

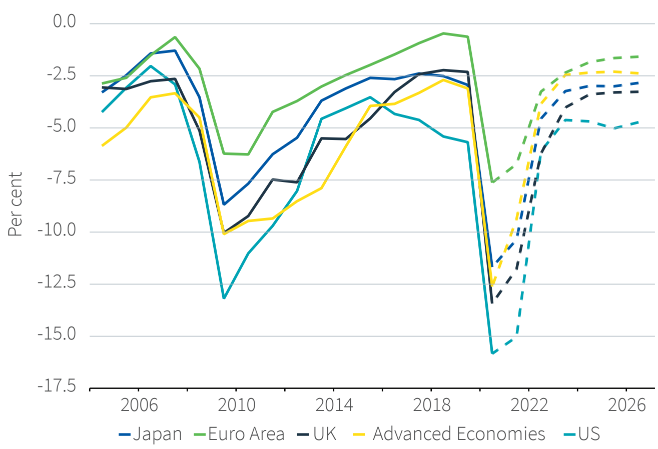
The algebra of fiscal sustainability is well understood, with key relationships between variables including the rate of economic growth, pace of inflation, initial public debt ratio, primary budget balance and rate of interest. The COVID episode has resulted in yawning budget deficits (Figure 19) and has added significantly to public sector debt burdens. 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 still quite subdued and borrowing rates – in particular real rates – have remained historically very low. 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.

COVID-related spending has led to big increases in public borrowing

Figure 18. **Bond yields have risen a little in EMs, but near lows in DMs**
Long-term interest rate estimates

Source: Aviva Investors, Macrobond as at 28 September 2021

Figure 19. **Public borrowing as a per cent of GDP**
Deficits have soared but should narrow automatically



Source: Aviva Investors, Macrobond as at 28 September 2021

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. In contrast, several emerging market 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/or currencies. Sharp movements in either can quickly push such countries onto untenable paths and severely curtail market access. Knowledge of these possibilities has meant that most have not increased debt burdens as much as the major developed countries (Figure 20). But government deficits have still widened sharply, and vulnerabilities have increased, especially as EM yields have risen. 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 EMs.

Some countries are more vulnerable than others

Longer-term scarring

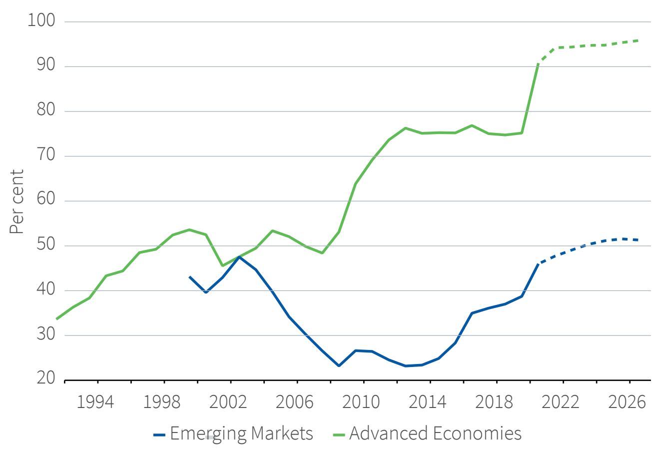
The vast amount of assistance that has been provided during the COVID crisis aims to support companies and individuals financially so that both can resume commercial activities as circumstances allow. The extent of the underlying damage will only become apparent when the various schemes are withdrawn, a process that has only just begun but which will become 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; 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 – the likely true extent of which has been hidden by various support schemes – will rise. 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.

The effects of mothballing businesses and workers are unknown

The latest signs have been encouraging – unemployment has been falling fast for many quarters (Figure 21) – but it would be premature to conclude that labour markets will fully heal. Moreover, it is not a binary issue – whether there is a job to return to 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. Fewer 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 redeployed elsewhere, transitions will not be painless or immediate. If permanent damage is worse than feared, the supply-side hit to economies could have damaging knock-on impacts on long-term growth.

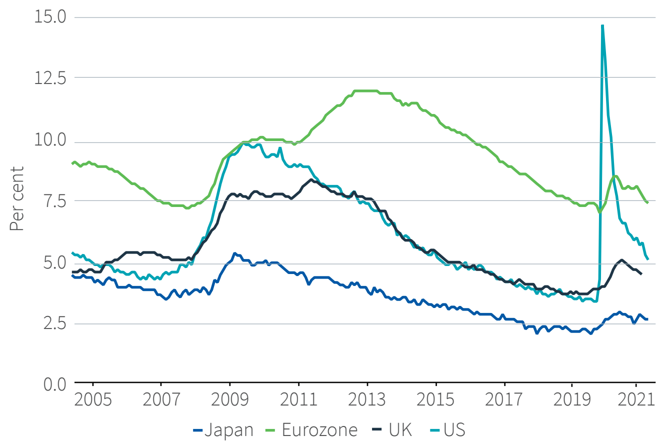
There will be lasting changes as a result of COVID

Figure 20. **Net public debt as % of GDP**
DM ratios are higher, but vulnerability could be greater in EMs



Source: Aviva Investors, Macrobond as at 28 September 2021

Figure 21. **Unemployment rates**
Jumped most in the US but have fallen back everywhere



Source: Aviva Investors, Macrobond as at 28 September 2021

COVID variants

Although the more transmissible Delta variant still dominates the dynamics of COVID (and there may yet be other troubling mutations), impressive vaccination efforts as well as the longevity of the pandemic itself, mean that it is appropriate to adopt a more hopeful outlook on the progression of the virus from this point. A year ago, there was far more uncertainty – and no known vaccines – but now it is neither overly optimistic nor complacent to accept the idea that vaccinations do work, and that booster shots over the Northern Hemisphere winter will reinforce favourable global trends for case numbers and complications. Different country experiences have also revealed what can and cannot be done in the face of COVID. First, the distribution of vaccines has been far from uniform around the world. Many lower income countries have not been able to extend vaccination programmes anything like as much as developed nations. They will need ongoing assistance in vaccine provision and distribution. Moreover, while the virus exists anywhere, it is a potential threat to everywhere, both in its current form and in any future mutations.

While the virus persists, further variants are likely

Secondly, countries which adopted a zero-COVID policy, such as Australia and New Zealand (Figure 22), are now facing difficult choices. With experience, many countries have changed their approach to better reflect the realities of virus transmission. It may well be the case that a number of countries in south-east Asia as well as China will have to adopt a similar change in strategy. Different countries also have culturally different parameters which influence the approaches which have been adopted. Overall, although we believe it is right to embrace a brighter prospect for the post-COVID future, there are still clear risks over the next year or two related to further outbreaks and virus variants.

There are now significant variations in COVID experience

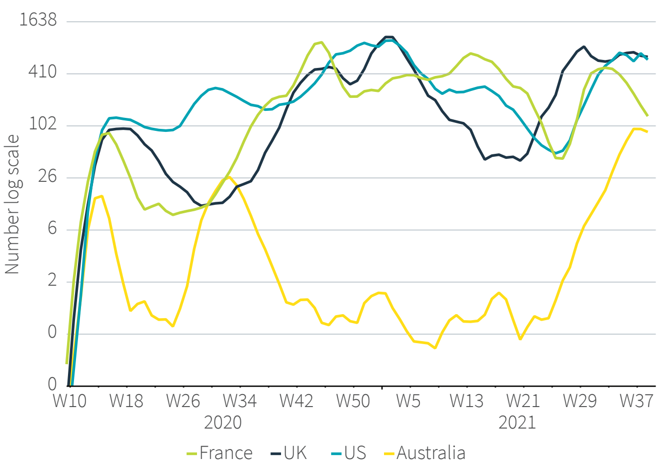
China slowdown/policy mistake

The growing importance of China on the world stage means that the impact of any slowdown there – whether unavoidable or as a result of a policy mistake or mistakes – will have a significant impact on the global outlook. Recent history shows that it is incredibly rare for developing nations to transition to wealthier status without experiencing some damaging shocks along the way.

Economic development is rarely a smooth journey

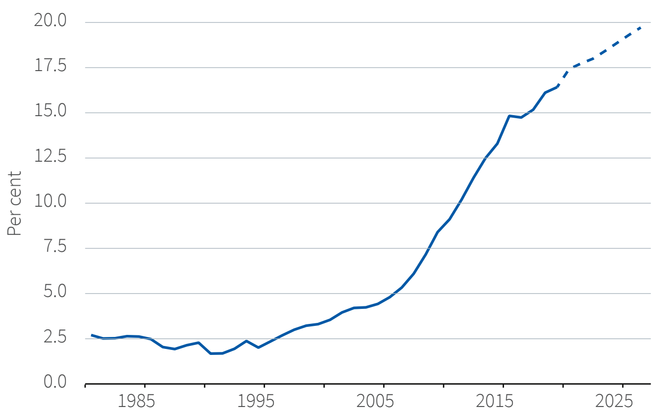
China is treading a distinctly different path in terms of economic development and participation in global politics and commerce (see themes earlier). And it will continue to be very forthright in its pursuit of strategies to achieve its longer-term goals. Such transitions are never easy and policy mistakes should probably be expected. It is possible that China has already or is already making such errors. Its share of world GDP is now approaching 20% (Figure 23), so any slowdown in China will have global ramifications. As the authorities there seem determined to push ahead with bold and ambitious plans to cement their position in the world hierarchy, it seems sensible to recognise the risk of a discrete China slowdown.

Figure 22. **COVID cases, 14-day total per 100K**
Pattern of case numbers very different in some places



Source: Aviva Investors, Macrobond as at 28 September 2021

Figure 23. **China % of world GDP**
China's relative importance still increasing



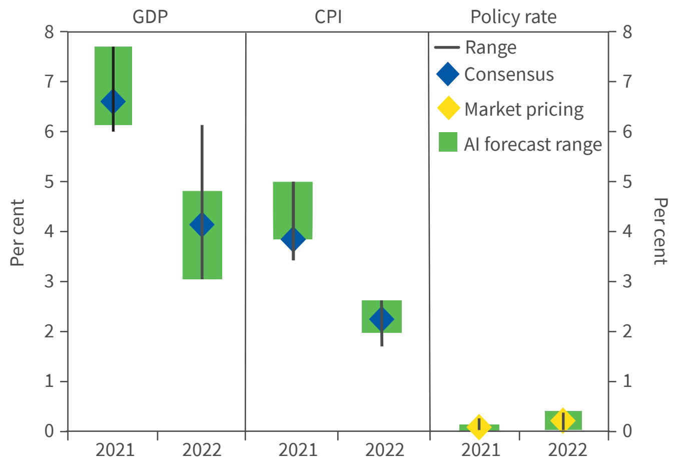
Source: Aviva Investors, Macrobond as at 28 September 2021

Macro forecasts charts and commentary

US

The US economy expanded somewhat less rapidly than expected in Q2, as the impact of the Delta variant led to a slowdown in service sector activity. That likely extended into the start of Q3, but with cases once again falling and vaccination rates rising we expect that lost activity will be recovered in Q4 and 2022 Q1. The labour market has continued to strengthen and is on course for the unemployment rate to fall below the pre-Covid historic low in 2022. Looking further ahead, the expansion should be further supported by the expected passage through Congress of a large public infrastructure package, alongside a range of income redistribution policies, in Q4 2021. Perhaps the most challenging aspect faced by the economy in the near-term is the supply-chain disruption that has led to elevated inflation in a number of specific areas. We expect that to be transitory, but the risk of a more protracted period of elevated inflation has risen. As a result, the Federal Reserve may need to bring forward the first rate hike into 2022, a little earlier than we had previously anticipated.

Figure 24. **US**

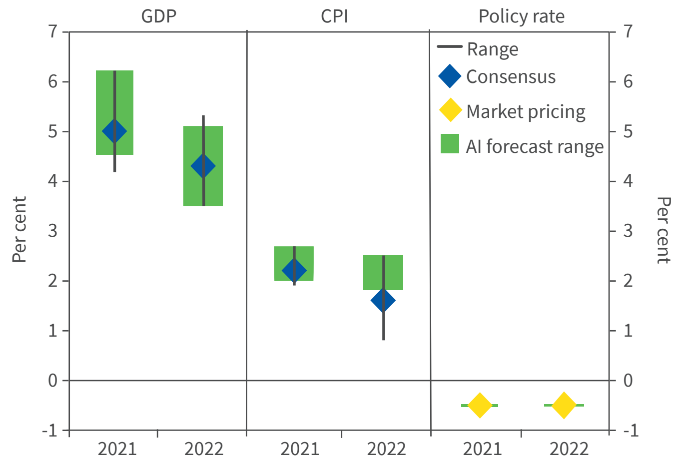


Source: Aviva Investors, Macrobond as at 28 September 2021

Eurozone

In customary fashion, the Eurozone managed to manufacture two (technical) recessions from the COVID crisis, where most nations experienced only one. Activity recovered sharply in Q2 and is expected to record further robust increases in the second half of the year. We expect ongoing above-trend growth (albeit at a successively lower pace) to be maintained throughout 2022 as the post-pandemic catch up continues. Our latest projections indicate that the level of GDP by the end of 2022 will be very close to where it would have been if the pre-COVID trend had been sustained. Given the scale of the shock, that would be a remarkable achievement and one that suggests minimal lasting damage. This is a far more optimistic outlook than those which have prevailed over much of the last year and a half. Although inflation has spiked higher, the ECB, like other Central Banks, is expected to "look through" higher readings, which it considers will be transient. QE will come to an end, but the first rate hike still looks a long way off.

Figure 25. **Eurozone**

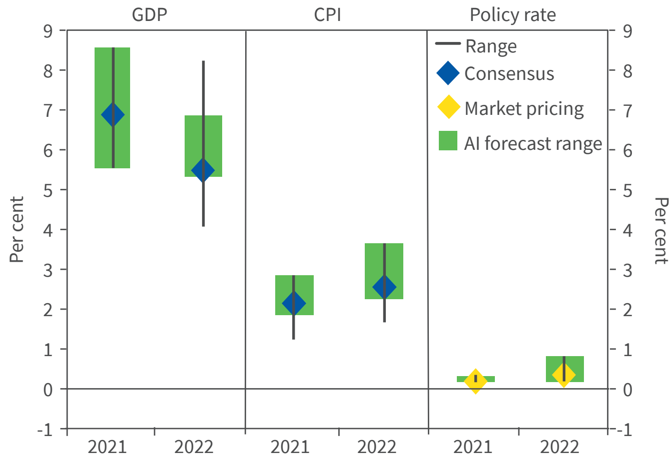


Source: Aviva Investors, Macrobond as at 28 September 2021

UK

The 1.6% fall in GDP in Q1 was a little less than feared, a reflection of the now well-defined trend around the world of COVID restrictions having much less of an adverse impact on activity than they did in 2020. The resilience and adaptability of households and businesses has been impressive and beneficial. Moreover, UK GDP rebounded very strongly in Q2, rising by 4.8%. Although growth is expected to slow in the second half of the year, robust quarterly rises of 2% or more are expected, which would take GDP back to its pre-pandemic level by the end of the year. Attention has now turned to inflation which has risen sharply and is likely to push higher still. With supply-demand imbalances more intense in Britain because of Brexit adjustments, inflationary pressure here could be more stubborn. The Bank of England has acknowledged this with a more hawkish stance and financial markets have responded by pencilling in earlier rate rises. While this is clearly a risk, we continue to believe that the BoE will be patient – they believe most of the inflation impulse will be temporary.

Figure 26. **UK**

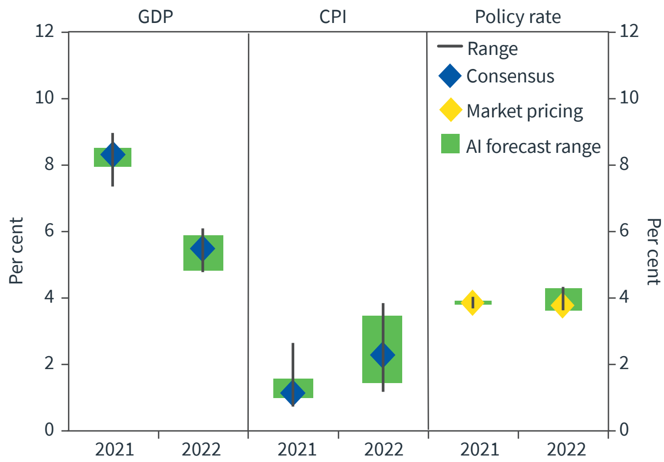


Source: Aviva Investors, Macrobond as at 28 September 2021

China

China's growth hit some major speed bumps in Q3. The government's zero-covid policy is harsher than most countries, and despite disseminating 2 trillion vaccines, there does not appear to be acceptance that Covid is endemic. Meanwhile, exports are very strong, soaring to around 25% above pre-crisis levels. However, industrial production and fixed asset investment are slowing while consumption has still not fully recovered; limits on coal-fired power and dirty metal output to meet carbon goals, while demand for electricity has soared, is also causing pricing and growth problems that are not unique to China. What is new are the aggressive new policies towards certain sectors that are not aligned with President Xi's longer-term agenda.Containment of leverage is slowing credit growth, but has become disruptive as several large property firms implode. Beijing is expected to counteract the slowdown with fiscal, but it also needs to contain contagion to the financial and property sectors. Rising inflation and the desire to deleverage and decrease financial risks should keep the PBoC from large scale easing, but the central bank will retain an easing bias and ample liquidity provision.

Figure 27. **China**

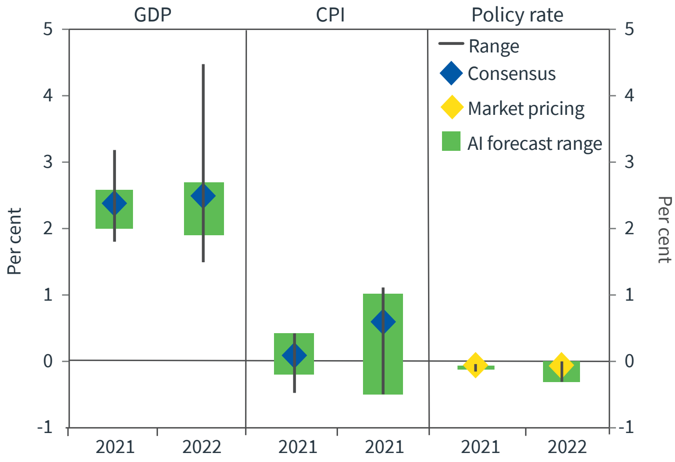


Source: Aviva Investors, Macrobond as at 28 September 2021

Japan

After Fumio Kishida prevailed in the LDP election, continuity should prevail when he becomes the Prime Minister, following the Lower House elections later this year. Reform and raising productivity are likely to play second fiddle to recovering from the coronavirus restrictions, with income redistribution via tax hikes, tax breaks, and fiscal stimulus being the government's likely main focus. Growth has been held up by exports and investment, and a return to more normal conditions should help consumers start to spend more in Q4 and into 2022; by the end of next year pre-crisis GDP should be attained with around 3% annual growth; after that catch-up, growth will fall to 1% or less and investment will still flow out rather than in. Headline CPI may be boosted by energy and food prices temporarily, but the longer-term trend is near zero; this will allow the BoJ to monetize fiscal deficits with QE purchases, negative rates, and yield curve control; divergence with global growth and monetary policies should weaken the yen marginally, but strong balance of payments and returns on external assets may act as an offset.

Figure 28. **Japan**

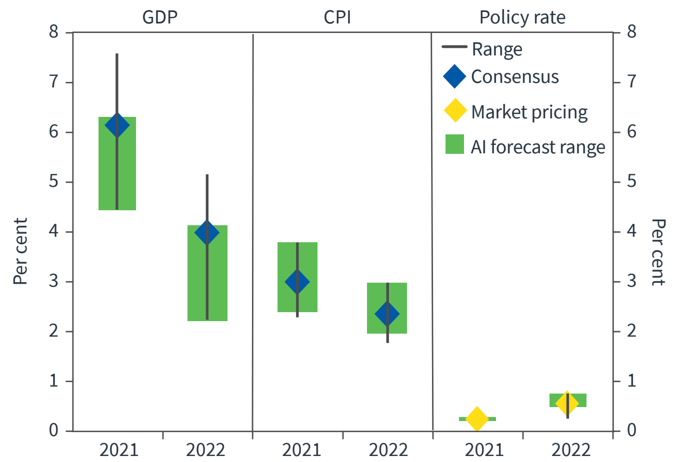


Source: Aviva Investors, Macrobond as at 28 September 2021

Canada

Uniquely among the G7 nations, Canada experienced a dip in GDP in Q2, although the small decline (-0.3%) needs to be seen alongside the strong increases previously. July numbers remained fragile, but survey readings have picked up subsequently, so Q3 overall should see a rise in activity that will more than offset the Q2 fall. With the US set to remain strong, oil and commodities doing well and global trade continuing to revive, Canadian growth should be well supported. As elsewhere, the Bank of Canada is presenting a fairly relaxed stance against the backdrop of higher inflation. Even so, they have signalled a willingness to tighten policy a little more quickly or earlier than other DM Central Banks and have already reined in asset purchases significantly. Financial markets are currently discounting two rate hikes from the BoC over the next year. The snap General Election called by President Trudeau passed with virtually no change in either voting patterns or representation.There will be a similar minority Government to the one that has existed for the last two and half years. Discretionary fiscal policy is unlikely to change.

Figure 29. **Canada**



Source: Aviva Investors, Macrobond as at 28 September 2021

Global market outlook and asset allocation

- **The economic cycle is not over, and neither is the positive environment for risk assets**
- **However, a mid-cycle environment warrants defensive asset allocation adjustments**
- **China's property-led slowdown and slew of enforcement measures is a headwind for "reflation" trades, including G10 rates and EM currencies, but inflation remains a key theme**
- **Upside risks to growth and inflation warrant a negative view on risk free assets as central banks prepare for tightening**

Going into the final quarter of the year, our asset allocation remains broadly pro-risk oriented. Contrary to many market commentators, we regard neither the year-to-date rally in global equity markets nor the fact that peak economic growth is behind us as a reason to significantly lighten up on our overweight equity positions and cyclical relative value trades. That said, transitioning into a mid-cycle environment comes hand-in-hand with lower outright equity returns than an early-cycle environment, and regional and sector leadership typically becomes more mixed; hence we add somewhat more defensively oriented trades. Further, we reduce our short duration exposure in acknowledgement that being underweight government bonds beyond shorter time horizons is betting against risk-premia embedded in this asset class and that also here, moving out of an early-cycle macro environment makes being short duration less asymmetric than before.

Maintaining a pro-risk allocation at this point in the economic cycle

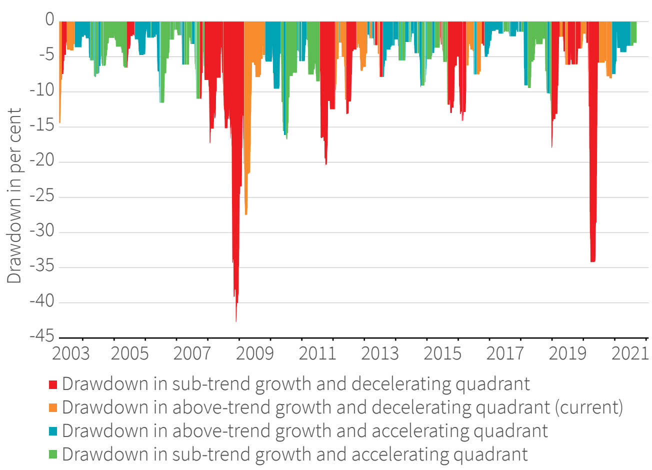
Drawing equity market implications from our economic outlook, we note two findings: first, growth is now firmly decelerating on a trend basis and second, our outlook is no longer significantly more positive relative to other economic forecasters.

In addressing the first finding, we look at global equity market returns through the lens of a four-quadrant economic growth framework, differentiating between accelerating and decelerating growth, above and below trend. Figure 30 shows the evolution of these quadrants alongside the MSCI World Index. The amber shaded parts of the time series reflect the growth quadrant we are currently in through history. Whilst by far not the most attractive quadrant in terms of risk-reward, we judge the current early phase of this environment with a contextual 3-month mean return of approximately 2-3% as sufficiently attractive to remain tactically invested in equities. Notwithstanding a relatively positive fundamental outlook, equity markets can draw down at any time and a correction of around 10% is possible (Figure 31).

Figure 30. **Evolution of economic growth quadrants along MSCI World**

Source: Aviva Investors, Macrobond, Bloomberg as at 28 September 2021

Figure 31. **MSCI World drawdowns across economic growth quadrants**



Source: Aviva Investors, Macrobond, Bloomberg as at 28 September 2021

Knowing which growth quadrant one is in and following a simple investment strategy, remaining long the equity market in all quadrants bar the one during which growth is sub-trend and decelerating, has led to smooth and market-beating returns (Figure 32).

In contrast, following an investment strategy that incorporates "consensus" thinking on growth, whereby we incorporate revisions and surprises to growth, respectively, leads to less positive and more erratic strategy returns than using actual real-time growth.

Based on this read-through from economic growth to equity markets, so long as our growth outlook remains above trend, being invested should pay off.

The current environment warrants remaining invested and buying-the-dips

We supplement a fundamentally driven view on equities with quantitative risk-taking signals. These are aimed at capturing behavioural biases which exist among investors and identifying market regimes. Both frameworks, fundamental and quantitative, arrive at the same message of signalling a positive environment for risky assets; while still supportive, technical indicators have weakened somewhat as well.

The main risk to our view comes from higher government bond yields that are entirely driven by higher real rates, for example a swift re-pricing of monetary policy combined with disinflation. However, so long as real rates remain negative (Figure 33), the economic cycle remains favourable, and our quantitative signals indicate risk-on, we anticipate being buyers of potential equity market drawdowns.

Moving up the quality spectrum in equity relative value space

Within our equity allocation, we have added an overweight in US Health Care versus the broader market. This trade is testament to our acknowledgement of investors' greater appreciation of higher quality and more defensive sectors during mid-cycle transitions. We further regard the Health Care sector as one of the cheaper sectors of that nature and one that is positively geared towards rising real rates. It is further a sector with positive longer-term earnings growth potential given higher health care spent in light of changing demographics and signs of a favourable innovation cycle.

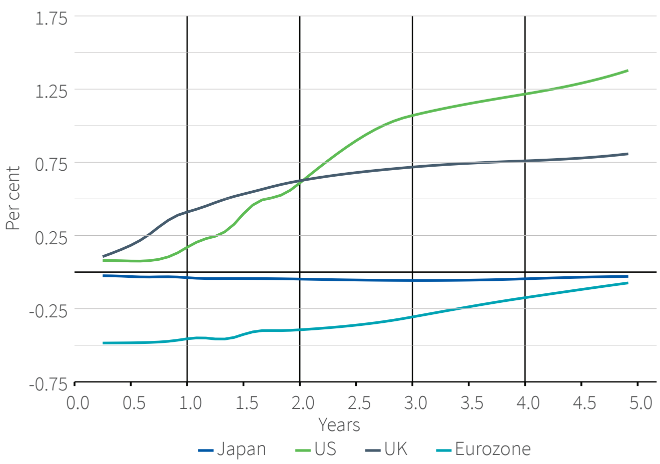
We have closed our preference for US versus EM equities following strong outperformance by the former, driven by the Chinese regulation of the Tech sector and broader common prosperity agenda, which involves redistribution policies away from capital. From here, and in light of adjusted relative valuations and premia built back into EM FX, a narrowing gap in the US-EM growth differential and potential for Chinese monetary and fiscal stimulus, we take a neutral view on the pair – despite the very real possibility of shareholder policies becoming even less friendly.

After a formidable rebound in H2 2020, 2021 has been difficult for local currency emerging markets. Perhaps surprisingly, the carry from the higher yields mentioned above has meant that the JPMorgan ELMI+ FX index has slightly outperformed G10 currencies YTD. The GBI-EM local bond index has taken large capital losses on rising yields, as EM central banks have hiked

Figure 32. **Investment strategy payouts**

Source: Aviva Investors, Macrobond, Bloomberg as at 28 September 2021

Figure 33. **Policy rate expectations**



Source: Aviva Investors, Macrobond as at 28 September 2021

rates – in some cases aggressively and in almost all cases ahead of expectations (Figure 34), causing bond curves to bear steepen. We are not underweight as the commodity cycle and global growth generally buoy the asset class, but from here on EM growth will increase imports, while weak portfolio flows and unstable politics (particularly in Latin America) makes risk/reward uncompelling. Above all, the support from China's stimulus that helped emerging markets in past cycles is not expected to return for the foreseeable future (Figure 35).

Local EM bonds and currencies have performed poorly as central banks quickly turn less dovish

Since 2017, China has de-emphasized, but not abandoned, GDP growth as a target, but throughout 2018-20 policymakers had to balance deleveraging efforts against Trump's ill-advised trade war and the global crisis wrought by COVID. Now that those struggles have been successful – at the cost of larger inequality, pollution, and even higher leverage and financial vulnerabilities – a multi-pronged policy-induced slowdown has emerged (see House View Themes for more details). Our downgrade to China's growth trajectory is one reason for a slightly lower US bond underweight; in contrast policy easing in China will not be massive, but supports an overweight to Chinese government bonds.

China's slowdown raises risks, and leads us to trim underweight US bond allocation

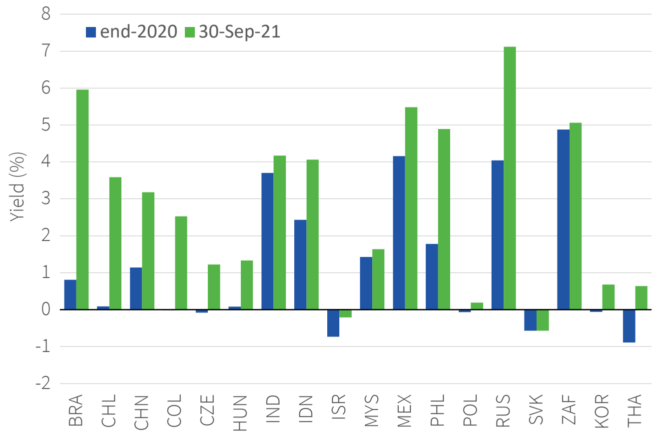
The Fed is expected to begin tapering QE purchases in late 2021, with the programme ending (for now) in mid-2022. Conditions for a Fed Funds lift-off, including full employment and PCE inflation sustainably above 2.0% are likely to be met around the end of 2022; while some hikes are priced in (Figure 34), the path of rates is well below what the median FOMC member expects as a likely scenario, with a terminal rate of just 2%, far below the 2.5-2.75% longer-term projection. Elsewhere, in Canada and across Europe, monetary authorities have already begun to decrease the pace of asset purchases, with a few already raising interest rates, albeit slowly and to still very low levels. With inflation pressures building, markets need to balance the probability of central banks' eventually needing to tighten above neutral against the medium-term probability of another recession – and a return to zero rates and more QE – in the years ahead. The flattening of G4 yield curves in Q2-Q3 has been one of the biggest surprises of the year for us, and is an overreaction to the delayed reopening caused by the Delta variant as well as the impact of QE and global demand for safe assets. Our judgement is that growth and inflation risks will overcome a decelerating China, and that interest rates will rise above what is implied by the yield curve. Hence, we maintain a negative view on risk free assets such as US Treasuries and UK Gilts, and expect steeper curves in coming quarters to more than offset carry in global government bond indices.

Central bank tightening comes into focus

As for credit, both High Yield and Investment Grade corporate spreads are slightly wider over the past quarter, but the changes have been marginal and we continue to avoid the asset classes given spreads remain near their all-time tights. We expect this means giving up some carry as defaults and downgrades remain low, but the prospective returns are asymmetric on a medium-term basis and unfavourable relative to equities.

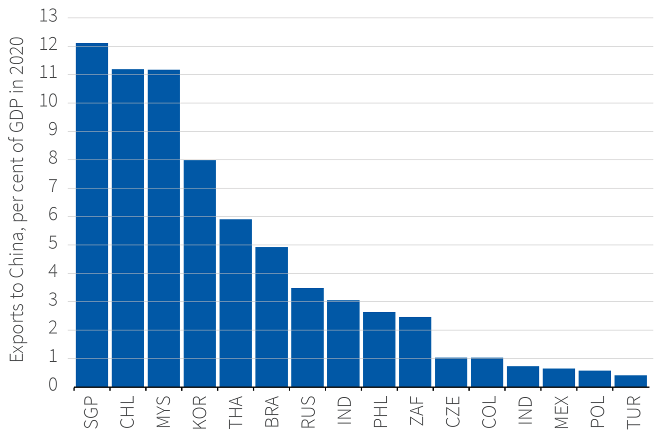
Credit spreads remain suppressed

Figure 34. **Emerging Market yields have risen**



Source: JPMorgan ELMI+, Aviva Investors, Macrobond as at 30 September 2021

Figure 35. **Emerging Market growth and FX is sensitive to China**



Source: Aviva Investors, Macrobond as at 28 September 2021

Figure36. **Asset allocation**

	Underweight										Overweight
	-5	-4	-3	-2	-1	0	1	2	3	4	5
Equities								2			
US								2			
Europe								2			
UK								2			
Japan								2			
Pacific Basin ex Japan								2			
Emerging markets								2			
Nominal Govt				-2							
United States				-2							
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					-1						

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 September 2021

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