House View Q2 2022

The intelligence that guides our investment decisions

AVIVA INVESTORS

Contents

House View

The Aviva Investors House View document is a comprehensive compilation of views and analysis from the major investment teams.

The document is produced quarterly by our investment professionals and is overseen by the Investment Strategy team. We hold a House View Forum biannually at which the main issues and arguments are introduced, discussed and debated. The process by which the House View is constructed is a collaborative one – everyone will be aware of the main themes and key aspects of the outlook. All team members have the right to challenge and 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

A more uncertain world: economic and financial decoupling

The recent events in Ukraine serve to highlight the fragility of the global geopolitical and economic order. Russia's unprovoked attack on Ukraine has, first and foremost, resulted in a humanitarian crisis. Our thoughts are with those impacted. Russia's military actions have led to an unprecedented response by governments in the United States, Europe and elsewhere to impose financial and economic sanctions on individuals, companies and the Russian state. These sanctions will isolate Russia from the global economic system. As a major exporter of energy (oil and gas), metals and agriculture, the full or partial removal of Russia from those markets will also have a profound impact on the global economy for many years (Figure 1). Moreover, some countries such as China, who have not supported the imposition of sanctions, are expected to be drawn more closely to Russia in future, and drift further away from the West. While the war in Ukraine has acted as a catalyst for accelerating this global decoupling it is a trend that began many years ago. These are potentially tectonic shifts that could shape geopolitical, economic and financial market outcomes for decades. It is likely to usher in a period of greater uncertainty, increased economic and market volatility and more challenging asset allocation decisions.

Russia's invasion of Ukraine and the resulting economic sanctions are likely to have profound implications for the global economy for many years

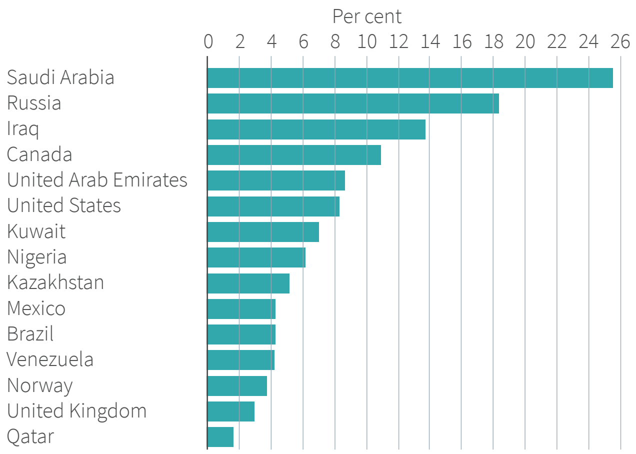
For investors, the more immediate uncertainty is around how the situation in Ukraine evolves from here. At the time of writing, the conflict had shown no signs of easing, with advances being resisted in many key towns and cities, but with ongoing Russian bombardment. Meanwhile, talks between Russian and Ukrainian officials continued to try to find a ceasefire and settlement agreement. As such, the range of possible outcomes over the coming weeks and months remains wide. A further escalation in the use of force from Russia could follow. Equally, a more protracted period of military stalemate may ensue, with depleted Russian forces struggling to make further inroads. Or it may be that peace talks can at least deliver a ceasefire to allow for a longer negotiated settlement. But even under the most optimistic scenario, we do not expect sanctions on Russia to be wound back quickly. Unlike the sanctions regime imposed on Iran, whereby clear goals were identified for sanctions to be lifted or eased, no such goals exist for Russian sanctions. On the other hand, should the conflict escalate, then we expect further sanctions to be enacted, including on oil, and over a longer-term horizon, potentially on gas as well.

Sanctions are unlikely to be eased, even in a settlement scenario, and would be expanded if the war escalated

As the second largest supplier of crude oil globally (after Saudi Arabia) and the fourth largest supplier of natural and liquified gas (and the largest to Europe), the threat of such sanctions will keep prices elevated. While "self-sanctioning" from Western companies taking delivery of Russian oil and other cargoes, as well as the recent European Commission announcement to reduce European reliance on Russian gas by up to two-thirds within the next 12 months (and

Energy prices expected to stay elevated, with risks to the upside

Figure 1. **Share of crude oil exports by country**



Source: Aviva Investors, Macrobond as at 24 March 2022

Figure 2. **European and US wholesale natural gas prices**

Source: Aviva Investors, Macrobond as at 24 March 2022

completely by 2027) is likely to add more upward pressure on prices (Figure 2). These additional global inflationary pressures come at a time when the strong global recovery from the COVID pandemic had already seen underlying inflation rising quickly, with shortages in global manufactured goods, and already elevated energy prices, contributing to multi-decade highs in both headline and core inflation.

Heading into 2022, we expected another year of well above trend growth across all the major economies. While the magnitude of the shock to global energy and other commodities is still evolving, we have marked down global growth this year by around 0.5 percentage points, to a little below 4 per cent. The impact of higher energy prices on household disposable income will be felt globally, but will be even more acute in the UK and Eurozone, where natural gas prices will be impacted by uncertainty of Russian supply. Moreover, income and activity will be affected more heavily in those economies that are net importers of oil and gas (again, amongst the larger advanced economies that would include the UK and Eurozone), while potentially being modestly beneficial to the larger net exporters (Canada and Australia amongst the advanced economies). However, even with the larger impact on the Eurozone, we still expect growth of around 2.5 per cent this year. There are risks on both sides of that projection, but they are skewed to the downside given the risk of higher energy prices. Growth projections for the major economies are shown in Figure 3.

Global growth expected to slow in 2022, but remain robust

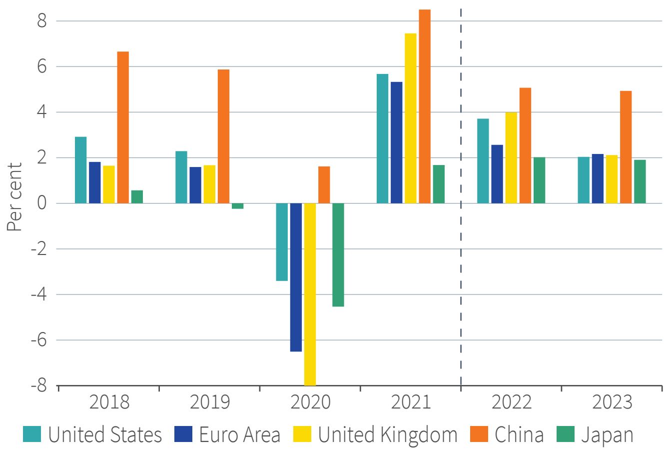
We have revised up our inflation outlook to reflect both the recent shock to energy prices, but also to reflect upside surprises in goods inflation that have persisted for longer than anticipated (Figure 4). In the Eurozone and the UK, inflation is expected to peak around 7 and 8 per cent, respectively, the highest rates in over 30 years. Around half of the year-on-year increase can be attributed to the direct contribution from energy prices. In our central scenario this contribution is expected to fall, reflecting the decline in futures contracts for oil and gas. However, there is an unusual amount of uncertainty given the war in Ukraine, with the risk of further upside surprises in oil and gas prices. In the United States, the peak in inflation is also expected to be around 8 per cent, but the contribution from energy is smaller, at around 2 percentage points. Inflationary pressures are more broad-based in the US, with both goods and services inflation ex-energy well above their average of recent decades, reflecting the strength of domestic demand, rising wage pressures and ongoing supply challenges.

Inflation is expected to remain higher for longer

With robust demand growth expected this year, even in the face of the energy shock, and inflation rates way above target for all the major central banks, we expect policy rates to rise markedly over the course of 2022 (Figure 5). At the forefront of that move will be the Federal Reserve (Fed), where we now expect policy rates to be around 2-2.5 per cent by the end of the year. That is a much faster pace of rate hikes than previously expected, reflecting some pull-forward from our expectations for 2023. It also reflects an expectation of the Fed now needing to tighten policy by enough to become outright restrictive, thereby slowing growth to below trend in 2023/24. We expect the policy rate to peak around 3.5 per cent, but the range

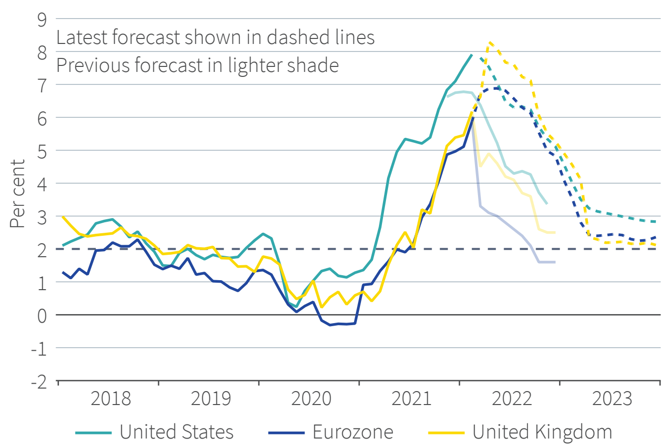
Monetary policy is expected to tighten materially in the United States this year, with others moving in the same direction. China and Japan the only majors not expected to tighten

Figure 3. **Major economy GDP growth projections: slowing, but not stalling**



Source: Aviva Investors, Macrobond as at 24 March 2022

Figure 4. **CPI inflation projections: higher for longer**



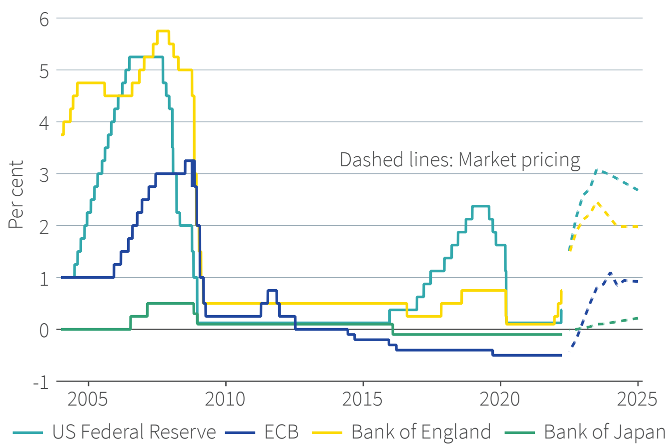
Source: Aviva Investors, Macrobond as at 24 March 2022

of possible outcomes is wide. In the Eurozone and the UK, a materially worse outlook in the trade-off between growth and inflation makes the monetary policy outlook even harder to assess. In both cases there will be a strong desire to ensure that high inflation rates do not become embedded in future wage and pricing decisions. But at the same time, the impact on national income from the energy shock is expected to be a material drag on growth this year. Overall, we continue to expect further rate increases from the ECB and BoE, but for those rate increases to be slower than the Fed.

While yields have risen materially this year, reflecting the expectation that policy rates will need to rise significantly in order to address the inflation overshoot, we believe this process has further to go. With positive inflation surprises more likely, inflation risk premia need to be higher, while real rates need to also adjust to slow growth. As such, we prefer to be underweight duration (Figure 6). The higher-yield environment presents a more challenging outlook for equity markets. However, with growth expected to remain above trend this year – albeit slower than in 2021 – and corporate pricing power seemingly robust, we prefer to be modestly overweight equities in developed markets, with a more neutral view for emerging market equities. Recent spread widening in credit markets has provided an opportunity to move from a preferred underweight to neutral.

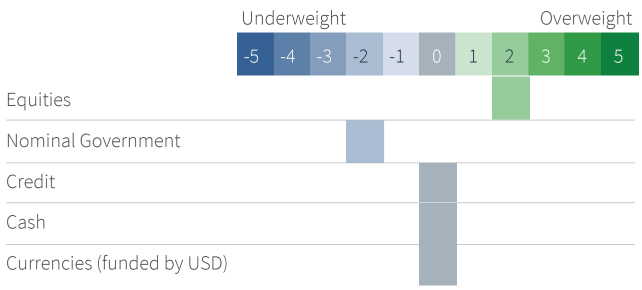
We prefer to be overweight equities and underweight duration

Figure 5. **Market expectation for policy rates: tighter policy required**



Source: Aviva Investors, Macrobond as at 24 March 2022

Figure 6. **Asset allocation summary**



Source: Aviva Investors, Macrobond as at 24 March 2022

Key investment themes and risks

Investment themes

1 Slowing growth
2 Inflation
3 Tighter monetary policy
4 Global economic and financial fragmentation
5 Commodity prices, energy security and decarbonisation

Slowing growth

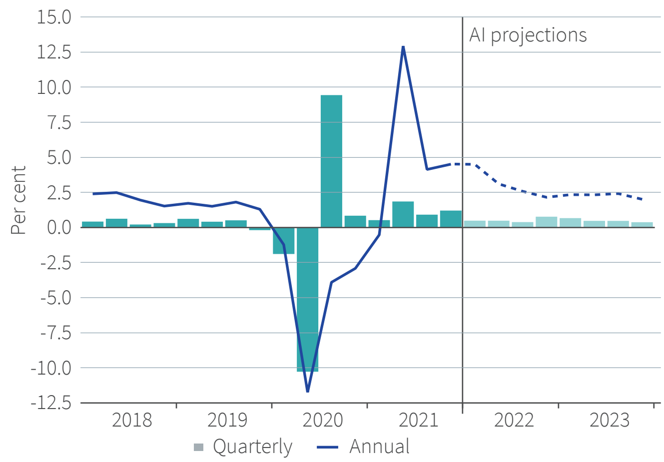
The COVID-19 pandemic led to wild swings in output and demand around the world as waves of infection were countered by enforced lockdowns or other, slightly more limited, containment measures. These alternated with swift rebounds as restrictions were lifted. Impressive adaptation by businesses and households meant that outbreaks had successively less overall impact, although the actual changes in GDP were still incredibly large by the standards of history. The virus is still with us, having its presence felt significantly in some regions, and the Omicron variant most recently led to limited further disruptions, albeit not as bad as had been feared. It had looked as if 2022 would finally see a smoother return to pre-COVID trends as economies reopened more fully (Figure 7). And although that remains the most likely eventual prospect in our central scenario, the path required to get there now looks less clear. The most obvious issue, of course, is the dreadful war in Ukraine which has roiled global sentiment and financial markets as well as greatly exacerbated the already-disruptive impact from energy – prices and supply. The outcome of the conflict is latently unpredictable.

Global growth had been recovering before the invasion of Ukraine

Even before the invasion, it had become increasingly appropriate to characterise the spike in energy (and some other commodity) prices as another major supplyside shock that would have a detrimental effect on underlying growth. The war has magnified that shock, but even if the impact fades as we expect, the longer-term hit to effective real incomes could well persist for a while. For energy importers, especially those who rely most directly on Russian supplies, the combination of sanctions and spiralling prices will slow growth, even while the post-COVID rebound continues. Europe is the most obvious instance, with large parts of the Eurozone closely integrated into Russian supply chains. It is plausible, therefore, that European economies experience a sharper slowdown in the middle quarters of 2022, before recovering once more later in the year (Figure 8). It is very hard to quantify the size of any such effect, especially when GDP data are still distorted by pandemic effects. But it is not unreasonable to postulate a stall in growth in Q2 and Q3 in Europe followed by another rebound, a similar pattern to the COVID experience. Other areas, the US for example, should be less impacted but higher energy prices and any war-related dent to sentiment could still slow growth moderately in coming quarters.

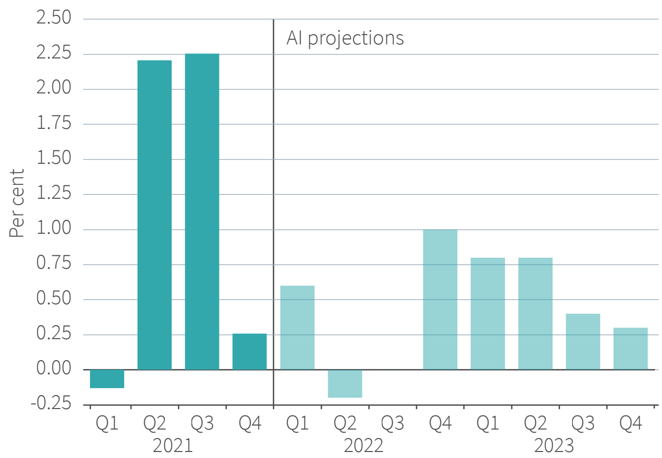
The war has boosted energy prices further and will hurt growth in some places

Figure 7. **G7 nations GDP growth**
Expected to slow but remain robust



Source: Aviva Investors, Macrobond as at 24 March 2022

Figure 8. **Eurozone GDP, quarterly growth**
European growth pause, but rebound is expected



Source: Aviva Investors, Macrobond as at 24 March 2022

Overall, most regions should still see above-trend rates of GDP growth in 2022 largely because of the earlier momentum. The post-pandemic catch-up will continue to be supported by reopening and by accumulated savings. However, greater challenges may emerge in 2023 as the reality of lower real income growth feeds through. The longer the spike in energy prices lasts, the greater will be that hit. Although we expect current exceptionally high inflation rates in Europe and the US to fall back later in 2022, for now they are already hurting real incomes significantly. The squeeze on households (and businesses) has been described as the most severe since the 1970s and 1980s and it is hard to argue with that reasoning. Moreover, even if inflation does decline, it is in our view unlikely to return any time soon to the 1 per cent to 2 per cent range that characterised much of the last two decades, implying that the pinch on real incomes will continue. If workers try and offset this through higher nominal wage increases, central banks are set to respond with more aggressive monetary tightening as they have warned (see below).

Higher inflation is causing a major squeeze on real household incomes

Inflation

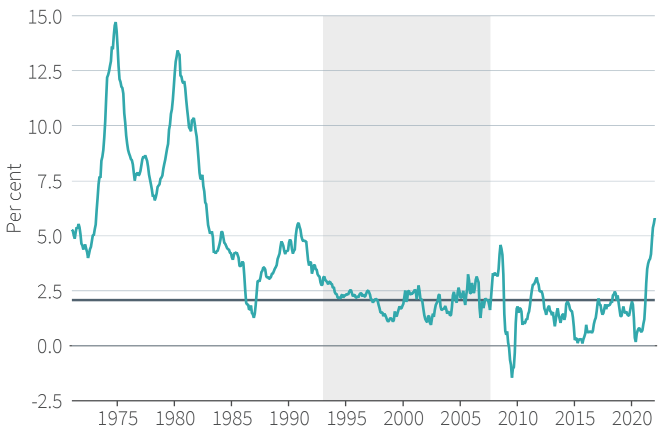
High and rising inflation has only actually been with us for a year (so far), but that has been long enough, and the spike extreme enough, to invalidate the usefulness of any debate about transitory versus permanent. Inflation is here and it is dangerous. It is having a significant impact on behaviours now and is generating a major squeeze on spending power (real incomes) that will be felt for some time yet. The shock of sharply higher inflation is all the more stark, coming as it has after an extended period of quiescence. Between 1992 and 2007 CPI inflation in the G7 averaged a whisker over 2 per cent (Figure 9). After the inflationary disasters of the 1970s and 1980s, this was an achievement for which central banks were quick to claim responsibility. And while there is some justification in that, there were a lot of other moving parts which contributed, including labour market and other structural reforms and the beneficial impact of globalisation and low-cost China. In the decade and a half which followed the Global Financial Crisis (GFC), inflation was more volatile, but actually averaged a little lower again (1.5 per cent) in the G7. It really has only been the last 12 months that have witnessed an apparent regime change.

Inflation has reached the highest rates for 40 years

Whatever the proximate cause – and there are many candidates (see below) – inflation-fighting central banks still have to deal with the issue. Monetary policy normalisation has been a long time coming. After the GFC a period of accommodative healing was required – only the US attempted to tighten meaningfully. Next came the Eurozone deflationary threat and finally the pandemic. High inflation – if it persists – implies very low real rates currently (Figure 10). But the tightening process has now finally begun in several jurisdictions. History books pronounce that inflation persistence in the 1970s was in significant part attributable to central banks doing too little, too late. Inflation pessimists fear that something similar may be happening today. We do not share quite such a pessimistic view, believing that inflation will fall back later this year and in 2023. But it would be seriously complacent not to acknowledge

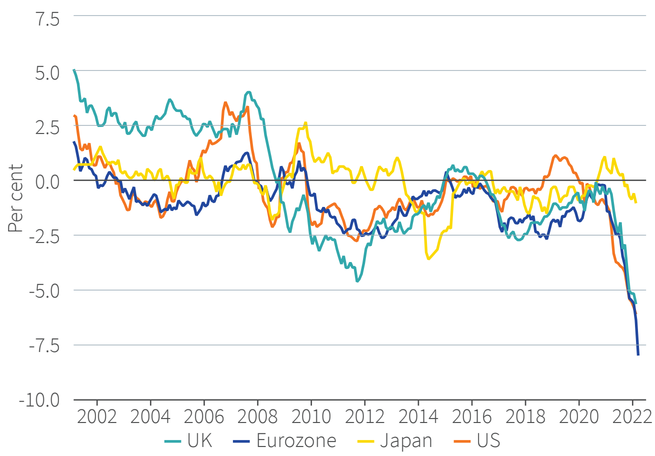
Overall financial conditions are still loose, but are expected to tighten over the next year

Figure 9. **G7 nations: annual CPI inflation**
Highest since 1982



Source: Aviva Investors, Macrobond as at 24 March 2022

Figure 10. **Real interest rate approximation**
High inflation means very low real rates



Source: Aviva Investors, Macrobond as at 24 March 2022

that the risks of a damaging inflation outbreak are probably greater now than at any time in the last 30 years at least. Arguably more important, even if some of the current drivers of higher prices do retreat or reverse, it is very likely that inflation will settle at rates significantly above the averages which have generally prevailed for the last 20 years. That would be a very different environment for both economies and financial markets, which could make for some grating adjustments.

Having said that, it is still important to recognise that there are at least two aspects of the present inflation impulse that are unusual and may not continue, irrespective of the monetary policy reaction. First, higher energy prices – recently exacerbated by events in Ukraine – account for much of the increase. For example, over half of the 5.9 per cent CPI inflation rate in the Eurozone is accounted for by energy alone (Figure 11). Undeniably a genuine price rise and major hit to households and businesses, it will only be sustained if energy prices continue to rise as they have over the last year. Not impossible, but unlikely, we would suggest. The average contribution to Eurozone inflation over the last 20 years has been 0.3 percentage points, a huge contrast to the present 3.2 percentage points. Secondly, the unique experience of post-pandemic reopening resulted in a wide range of imbalances between supply and demand that squeezed prices (mainly non-energy goods) sharply higher. The war may well add temporarily to such frictions for a while, but eventually supply will respond more completely, easing such pressures and restoring lower goods price inflation.

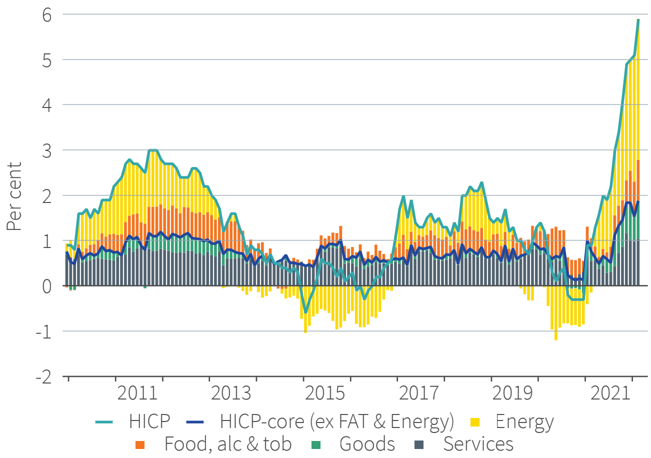
Inflation is still expected to fall back later this year and in 2023

Tighter monetary policy

In December we suggested that it was sensible and appropriate for financial markets to prepare for tighter monetary policy. The pandemic – and the Omicron variant in particular – was influencing the exact form of the exit route for global central banks from emergency policy settings, but in the absence of any "extraneous influences", we stated then that this would become more clearly the direction of travel. Three months on, there has obviously been an extreme such "event", but despite this, the actual and likely future path for monetary policy in most geographies seems clearer today and is far more aggressive than anticipated at the end of 2021. Policy interest rates are going up over the next two years, although the timing, pace and extent will vary across regions. Many emerging economies had not been able to afford the luxury of the "wait-and-see" approach adopted by most developed market central banks, as inflation rose in the wake of the pandemic. But now those developed market equivalents are following suit. In most cases, financial markets moved before they did, but now they are pretty much aligned. And what is expected is rather different from three months ago (Figure 12).

Market expectations of the tightening to come have adjusted significantly

Figure 11. **Eurozone: contributions to CPI inflation**
Broad-based increases, but energy the dominant component



Source: Aviva Investors, Macrobond as at 24 March 2022

Figure 12. **Policy rate expectations for end-2022**
After brief Ukraine dip, expectations have moved sharply higher

Source: Aviva Investors, Macrobond, Bloomberg as at 24 March 2022

In the middle of December last year, financial markets were discounting a Fed Funds rate at the end of 2022 of 0.75 per cent – a little under three 25 basis point hikes. The Fed has now achieved lift off and that expectation has risen to 2.5 per cent. An additional 50 basis points of tightening is expected in 2023 and the Fed's own dot-plot projections are now almost perfectly aligned with that forecast. The shift in the UK has been similar, with end-2022 expectations for the Bank rate now around 2 per cent, up from under 1 per cent three months ago. Recent moves in the Eurozone have been understandably more subdued, with markets shifting from an expected policy rate of -0.5 per cent (where it is currently) to just above 0 per cent most recently. Fed messaging has understandably been the most hawkish, with Powell and others acknowledging that it is probably inappropriate for them to be as relaxed about monetary tightening as they were in the last two hiking cycles. Specifically, near-term 50 basis point hikes are quite plausible in order to address the present inflation problem (Figure 13). The BoE is slightly more relaxed, but still expected to raise rates further in coming months. Meanwhile, a hike in the Eurozone may be a step too far for this year, but the ECB is content with the market view that higher rates – perhaps even to positive territory – are at least now on the forecast horizon.

The Fed is now expected to do a lot more

The timing of the ECB's actions may yet be influenced by events in Ukraine, but it is impossible to resist the conclusion that macro-economic conditions today warrant tighter monetary policy. Inflation is alarmingly high, underlying demand growth appears robust and the post-pandemic rebound looks secure. Central banks – and everyone else – may be uncertain about exactly where neutral or normal policy interest rates are. But they can be reasonably confident that they are well above present settings. Moreover, in the Fed's case, conviction is growing that they may need to go beyond neutral. Bond yields have risen sharply higher in anticipation (Figure 14). Absent major new shocks, tighter monetary policy looks inevitable in most places. For several places, this will be a major change from conditions which have prevailed since the GFC. This will be a headwind for economies and financial markets alike. It is a path that central banks will need to traverse both cautiously and determinedly.

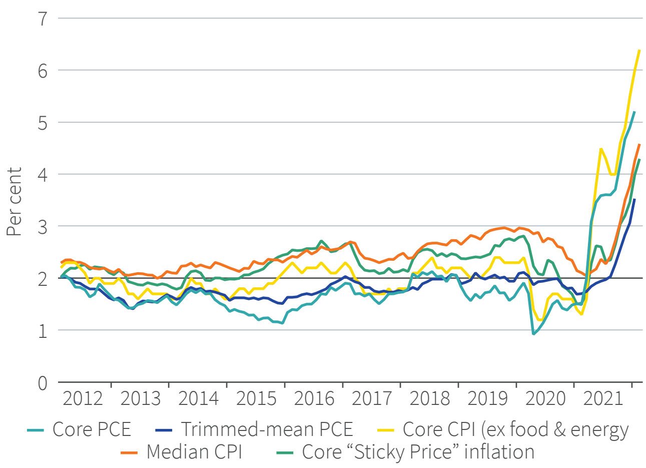
Tighter monetary policy is warranted in most places

Global economic and financial fragmentation

Well before the COVID pandemic and Russian invasion of Ukraine, the tide of globalisation which had swept the world between the 1970s and the 2000s, was already changing (Figure 15). Most economies in the world had continued to maintain close links, even in the face of global shocks such as 9/11, the Global Financial Crisis and the sovereign debt crisis in Europe. But momentum towards ever-closer integration was already slowing and several elements of economic, social, commercial and political theatre had started to resist that tide and move in different directions. In the past we have included aspects of these matters within our House View themes or risks under such headings as geopolitics, nationalism/populism

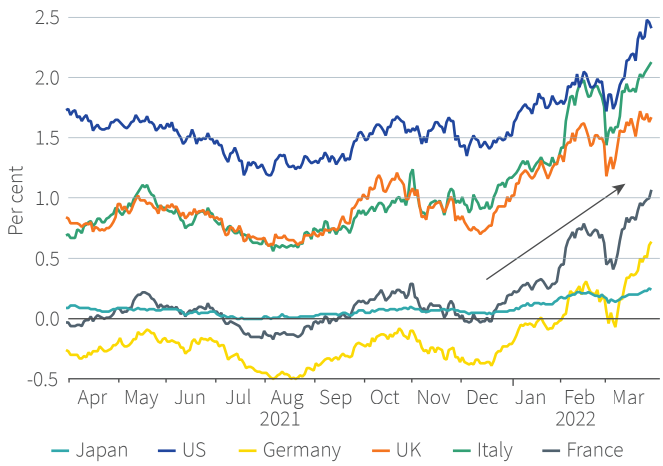
We may be entering a new era of global international relations

Figure 13. **US measures of core inflation**
However you measure it, US inflation is high and rising



Source: Aviva Investors, Macrobond as at 24 March 2022

Figure 14. **10-year sovereign bond yields**
Yields have moved up swiftly in early 2022



Source: Aviva Investors, Macrobond, Bloomberg as at 24 March 2022

and de-globalisation. Recent events have acted as a further accelerant to such change, so it now seems reasonable to group them under a single heading, even though it encompasses a diverse range of issues. It seems plausible that we are entering a new era (Figure 16).

Transitions associated with these shifts suggest that the extended era of low inflation (too low much of the time) suppressed economic and market volatility and easy financial conditions may be coming to an end. This could result in supply shocks, such as those which have become more familiar in recent years, becoming as widespread as demand shocks. Their nature implies higher and more variable inflation but also the likely need for larger risk premia to compensate investors more appropriately. Comparisons with the two oil shocks of the 1970s are perhaps slightly overdramatic. But just as those hastened lasting changes in the world and led to difficult macro conditions – growth and inflation – today's circumstances will also catalyse change and have macro-economic consequences.

Supply shocks may become as widespread as demand shocks

Net zero and the energy transition (see below) form part of this new world – this will impact all sectors and geographies. Moves towards more reshoring will also contribute to greater fragmentation compared with the past and will mean reduced flexibility for global supply chains. In the wake of the GFC there were genuine fears over "Japanification" and the threat of deflation (especially in Europe). Central banks responded with an extended period of super-accommodation. Those days are now over. Just as globalisation was associated with low and falling inflation – even the outright threat of deflation – then the new environment must surely push the other way, obliging central banks to be more active and aggressive. In this world, higher inflation risk premia seem entirely reasonable.

Higher – and more volatile – inflation in the future seems likely

The Ukraine conflict has also refocused attention on high-level global geopolitics. While treading a fine diplomatic line, China has not distanced itself excessively from Russia. Whatever the resolution of the war, Russia is certain to be more isolated from the rest of the world, but their shared antipathy towards the US could yet lead to closer ties between them and China, with energy and commodity trade being the most obvious areas of potential common interest. It will hopefully be premature to conclude that the "peace dividend" has gone forever, but the quick response of Germany – almost doubling its defence spending to 2 per cent of GDP – is a clear indication of a major change of mood. The prospect of a "new world order" with divided spheres of influence is not unrealistic. China and Russia have a common rival in the form of the Western alliance and both are keen to ensure that the world is safe for autocracy.

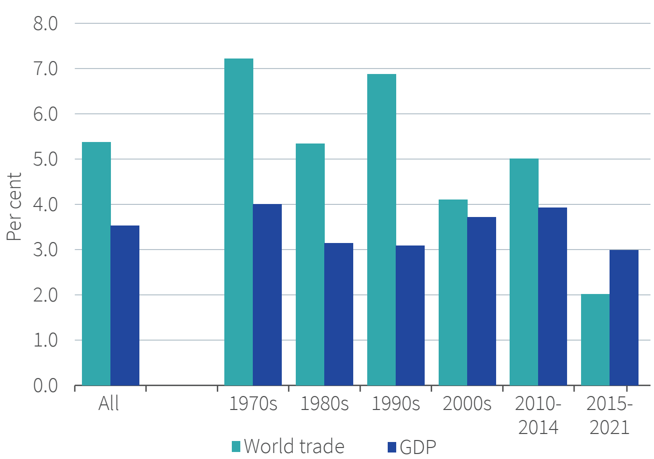
The global world order is evolving

Commodity prices, energy security and decarbonisation

The world's dependence on fossil fuel energy has been an uncomfortable truth for several decades, but at least momentum had been building in recent years towards the vital transition to renewables. The war in Ukraine has starkly exposed the duplicity of western nations who have relied heavily on imports of energy from Russia. Sanctions that have been swiftly

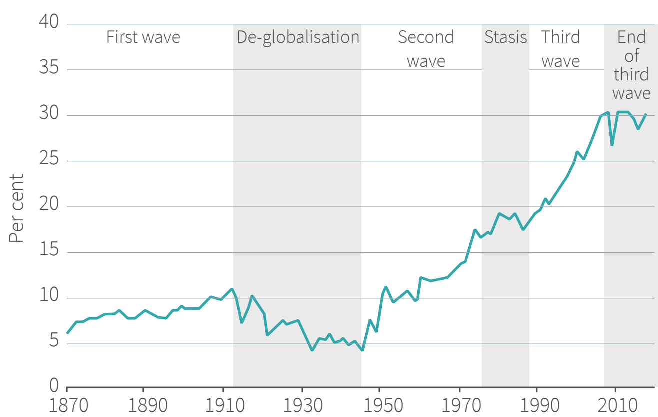
The war in Ukraine has refocused attention on energy usage

Figure 15. **Annual growth of world trade and world GDP**
World trade has grown more slowly than global GDP in recent years



Source: Aviva Investors, Macrobond as at 24 March 2022

Figure 16. **World exports as percentage of GDP**
Could we be entering a new de-globalisation era?



Source: Aviva Investors, Macrobond as at 24 March 2022

imposed have bypassed large parts of the energy complex for the short term, while cynics point out that the longer-term aspirations to replace Russian imports totally have something in common with well-documented ambitions to decarbonise. As ECB board member Isabel Schnabel put it in a recent speech: "today, our dependence on fossil energy sources is not only considered a peril to our planet, it is also increasingly seen as a threat to national security and our values of liberty, freedom and democracy".

Shorter term, the recent spike in energy prices (Figure 17) will have a major impact on households across the world and is being countered in many places by government actions to ease the pain. Much of expenditure on energy is effectively non-discretionary, but the huge increases in cost are creating a massive squeeze on living standards. Energy prices remain elevated and with the inflation impulse now expected to last for longer, these forces will be felt for some time yet. But it is possible that these longer-term drivers – climate change, energy transition and decarbonisation – also have an extended upward push to inflation.

The energy price spike is hurting households

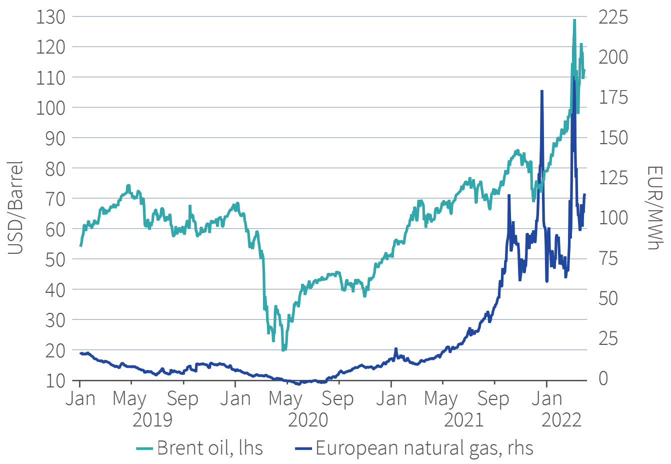
It is now inevitable that energy security will become a critically important policy aim for all nations in both a short and a longer-term context. Perversely, the Ukraine conflict and resulting sanctions may lead to a temporary increased reliance on some of the old, fossil fuel sources – and nuclear – as countries try and adapt to reduced Russian supplies. But it has also served to concentrate focus on the future. Later in the same speech, Schnabel states that investment in new technologies and facilities for renewable energy, including wind, water and solar, must be the way forward. And with costs of electricity from many renewables significantly lower than conventional power plants, households and businesses will eventually benefit from lower prices. This transition does not come for free, but it is a price worth paying, reflecting the twin goals of "safeguarding both our planet and our right to self-determination". The ECB estimates that the energy transformation will require a doubling of global annual investments (Figure 18). Some have gone as far as to describe such policies as the third pillar of macro (alongside monetary and fiscal). Correctly managed, the transition can be smoothed, and the growth-inflation mix maintained or even improved in time. But if it is uncoordinated, erratic or lacks credibility, it could have seriously adverse macro-economic consequences.

Energy transition should eventually lead to lower prices, but it will be far from costless getting there

Bluntly, events in Ukraine have drawn attention to, and perhaps accelerated momentum towards, energy transition. Navigating through this period will require solidarity and global political cooperation that will not necessarily be automatically forthcoming. It will also be a process that is almost certain to result in higher rates of inflation while it takes place. Both monetary and fiscal policies will need to recognise these trends and adapt dynamically to them, making sure that incentives to accelerate the green transition are not compromised or otherwise undermined.

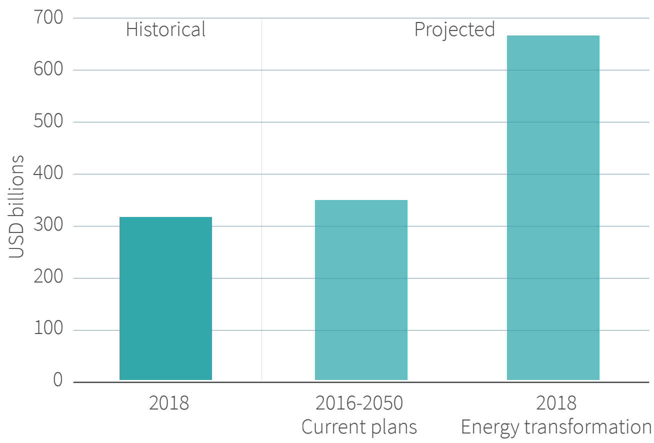
The green transition may lead to higher inflation

Figure 17. **Oil and natural gas prices**
Prices have risen sharply over the last year



Source: Aviva Investors, Macrobond as at 24 March 2022

Figure 18. **Actual and required global annual investment in energy**
Investment spending needs to double to fund transformation



Source: Aviva Investors, Macrobond as at 24 March 2022

Risks

Inflation outbreak

Against the backdrop of inflation rates that have not been seen for 20 or 30 years, it might seem perverse NOT to characterise recent outcomes as a serious outbreak of inflation. And in one sense, of course, they are. There has been a unique confluence of factors that have contrived to drive inflation sharply higher over the last year, many of which should fade or reverse in the future, helping to push inflation lower again. But the risk that high inflation becomes more engrained and self-perpetuating has not been higher at any time over the last 30 years. Two particular aspects worry us most. First, much of what has happened recently can (rightly) be described as supply shocks. But there have been a sequence of them, and an argument can be made that they are now more likely in the future. If supply overall is constrained on an ongoing basis, then demand growth may have to be more deliberately restricted by policy to address or prevent excessive inflation.

Worries that the inflation genie is out of the bottle are understandable

But the main worry is that the inflationary impulse broadens and widens as expectations adapt upwards to the higher inflationary backdrop, leading to a more widespread acceleration in inflation. The post-COVID landscape has confused interpretation here: as labour markets reopened, wage growth adjusted higher because of base effects and transient imbalances. Differentiating this effect from more conventional overheating (which would merit a more aggressive policy response) is difficult. Many indicators suggest that there are labour shortages in some areas. This is especially true in the US, where it can be reasonably argued that demand already exceeds supply potential. The UK is also experiencing higher wage growth, but such pressures seem more limited across much of the rest of Europe. If such wage trends were to deteriorate more generally – in a worst-case scenario leading to wage-price spirals – then Central Banks would have to move more quickly into restrictive territory.

Higher wage growth may oblige central banks to be more aggressive

Fiscal sustainability

The role and importance of fiscal policy has fluctuated over time and across countries. As attitudes to state intervention changed and after the inflationary disasters of the 1970s, it was largely usurped by monetary policy and relegated to deal mainly with distributional matters. With monetary policy believed to be approaching some limits, fiscal policy had already been making a bit of a comeback before COVID. But during the pandemic it was fiscal efforts which really did most of the heavy lifting, resulting in a renewed faith in its potential. Even so, there has always been a recognition that there are limits, with fiscal sustainability depending on well-known relationships between growth, inflation, interest rates, budget deficits and debt levels. There has been a distinct and welcome change in attitudes towards the effectiveness of fiscal policy in recent times, but the algebra still applies. There are risks that extra strains put on the public purse in some countries will push them onto unsustainable paths.

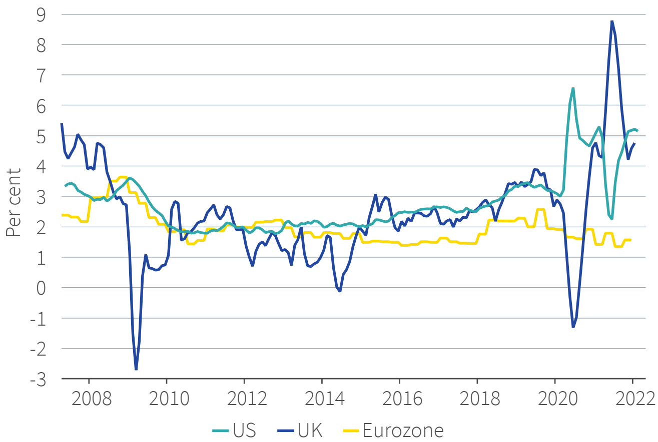
Fiscal policy has come back into fashion in recent years

Figure 19. **CPI inflation compared with decade averages**
Current inflation rates are extremely high compared with history

	1970s	1980s	1990s	2000s	2010s	Latest
US	7.1	5.6	3.0	2.6	1.8	**7.9**
Germany	4.9	2.9	2.3	1.6	1.3	**7.3**
Japan	9.3	2.7	1.2	-0.4	0.3	**0.9**
UK	12.0	6.5	3.3	1.9	2.2	**6.2**

Source: Aviva Investors, Macrobond as at 24 March 2022

Figure 20. **Wage trends in major nations**
Wage inflation has picked up sharply in the US and UK



Source: Aviva Investors, Macrobond as at 24 March 2022

Already it has become apparent that several emerging market economies do not have the luxury of engaging in the sort of fiscal largesse that their developed market contemporaries have been able to do, without serious consequences for their bond markets and currencies. Public borrowing and debt rose steeply during the pandemic and the impact of the war in Ukraine is almost certain to result in further calls on public spending. The limits for fiscal sustainability must therefore be significantly closer than they were for others now, or even more dependent on some of those key variables not moving out of acceptable ranges. As the IMF has pointed out, even with more enlightened approaches to policies, a credible medium-term fiscal framework will still be needed everywhere. COVID and now the war already meant that any equilibrium the world had achieved was fragile at best. It would not take much to change the delicate balance on fiscal sustainability for many countries.

There are still limits for fiscal sustainability

Global hard landing

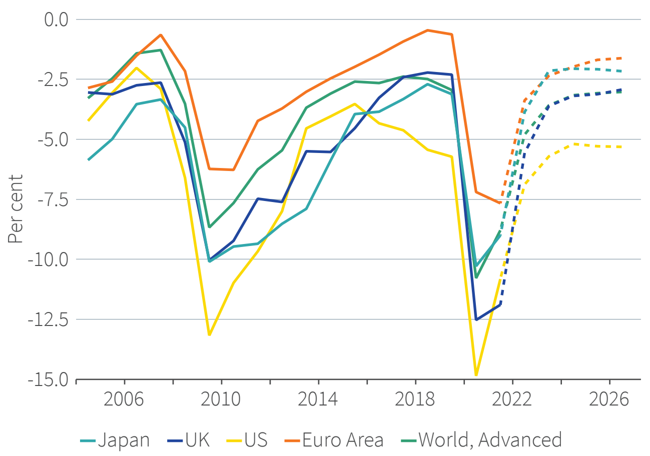
Economies have always moved in cycles. Downswings have generally been caused by significant shocks or policy errors. In the past the average length of cycle was much shorter, suggesting that there were either more shocks or more policy mistakes. There were also several episodes where inflation had got out of control as a result of an overheating economy (positive output gap) and where the central Bank had to raise interest rates to slow demand in order to choke inflation out of the system. There are several aspects of the current macro-economic environment that might lead to an observer highlighting recession risk: fragile economies, fractious global geopolitics, rising inflation and a severe commodity price spike and central banks raising rates. Keen observers of history will draw attention to the marked flattening of the yield curve that has happened in the last six months. Every US recession since the 1950s has been preceded by an inversion of the 2s/10s yield curve in the previous year (Figure 22).

There are several reasons to worry about a nastier downturn

The old warning that correlation is not the same thing as causation is relevant here and we are quite prepared to concede that we are closer to the next recession than we were three months ago. About three months closer in fact. However, it would also be complacent not to acknowledge the risk that a hard landing for some of the world's most important economies is possible. Granted, it would always be possible to have this as a risk in any economic outlook, but present circumstances are especially concerning. It is not difficult to outline a scenario where geo-political tensions escalate, energy and commodity prices ramp even higher, central banks tighten monetary policy aggressively because they perceive serious overheating risks and fiscal authorities feel unable to step in. It is quite possible that you would not need all of those ingredients – a selection could be sufficient to usher in a hard landing in 2023 or later.

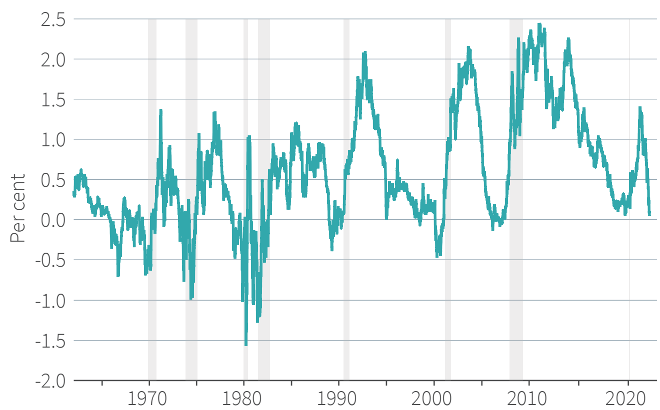
The risk of a hard landing is greater than it was three months ago

Figure 21. **Public borrowing as percentage of GDP – IMF Fiscal Monitor**
Small improvements, but Ukraine war may lead to further borrowing



Source: Aviva Investors, Macrobond as at 24 March 2022

Figure 22. **US yield curve, 10s – 2s spread**
Inversions have preceded previous US recessions



Source: Aviva Investors, Macrobond as at 24 March 2022

China policy mistake

China's policy-induced problems, including zero-COVID aims, and the ongoing property recession, are not yet fully played out. In March, renewed pressure on the economy and markets emerged from continued woes of real estate firms, a spate of Omicron outbreaks and lockdowns, and a new slew of tax and regulatory penalties for large tech firms. The Financial Stability and Development Committee responded by acknowledging the need to "boost the economy", to cease the regulatory harassment, and "actively introduce policies that benefit markets" while not letting COVID policy overly hamper growth by moving to a less strict "dynamic zero COVID policy".

China is facing a number of headwinds

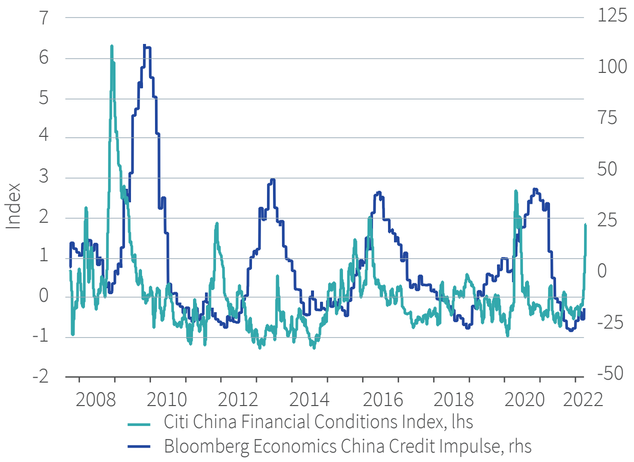
Credit was front-loaded in January but turned sharply down in February – China's credit impulse is only stabilising slowly and we will watch this critical indicator closely, along with the breakdown of fixed asset investment and how fiscal support materialises. Usually, such a tightening in financial condition has resulted in policymakers turning on the credit spigots (Figure 23), though leverage is now too high to risk a repeat binge. But just as these policy assurances reduce the risk of a disruptive scenario, the fallout from China's pledge of unlimited support for Russia and growing energy imports financing Putin's war machine raise the risk that Western sanctions are extended to China; the cost of energy is itself a headwind.

Policy is likely to remain supportive

In the shorter term, China's zero-COVID approach to the pandemic remains a problem. The lack of protection, from both previous infection and poor vaccines, obliges them to adopt lockdowns regularly. Although the authorities are allegedly adopting strategies to minimise economic disruptions, policies appear piecemeal and haphazard. Mistakes are likely and hits to economic activity certain. Overall, the ambitious 5.5 per cent growth target notwithstanding, a more severe downturn remains a real possibility (Figure 24).

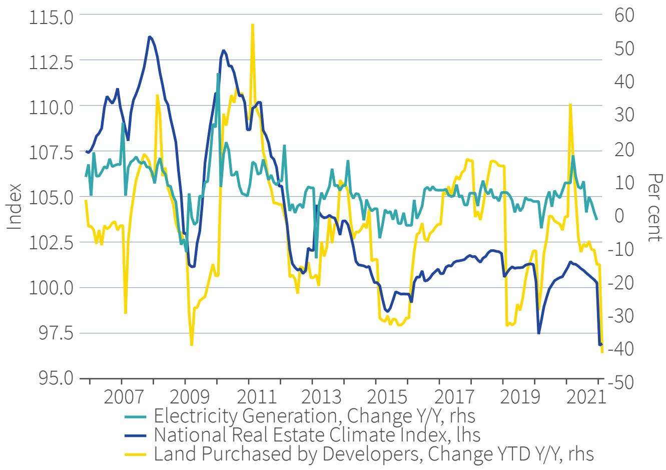
The 5.5 per cent growth target for this year looks ambitious

Figure 23. **A tightening in China's financial conditions typically induces a policy response**



Source: Aviva Investors, Macrobond as at 24 March 2022

Figure 24. **Real estate and power generation are flashing recession warning signs already**



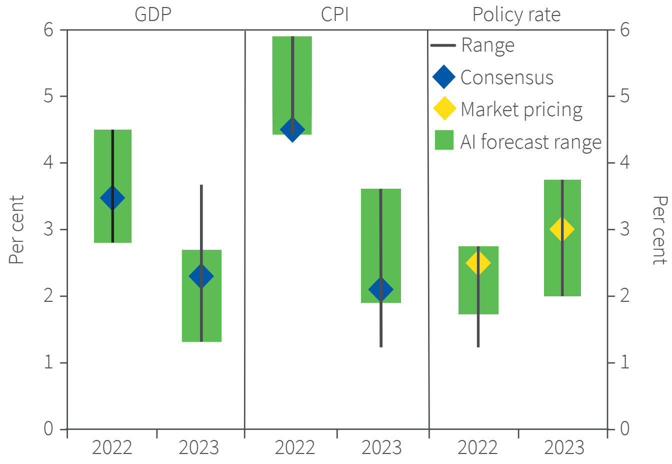
Source: China N.B.S, Aviva Investors, Macrobond as at 24 March 2022

Macro forecasts charts and commentary

US

We continue to expect growth in 2022 to be well above trend, at around 3.7 per cent, but have marked down our expectations somewhat to reflect the combination of higher oil prices acting as a drag on consumer spending, less fiscal spending than previously expected and a faster pace of monetary policy normalisation feeding through to the housing sector and consumer demand. Growth is expected to slow further in 2023 to around 2 per cent. More striking, however, we expect inflation to fall back more slowly, ending the year around 5 per cent, before easing further through 2023 to around 3 per cent. However, there is an unusual amount of uncertainty around those projections, with the balance of risks tilted to the upside in the near term. We expect the Federal Reserve to raise rates to around 3.5 per cent by mid-2023, reflecting the need for them to deliver positive real rates over the forecast horizon.

Figure 25. **US**

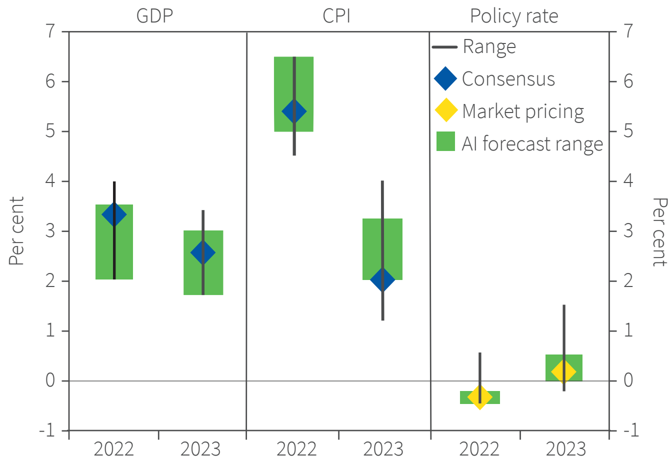


Source: Aviva Investors, Macrobond as at 24 March 2022

Eurozone

At the start of the year the main concern about European prospects was the potential for the Omicron variant – and reactions to it – to have an adverse effect on growth. In the event such fears dissipated quickly but were replaced by an altogether more alarming threat of war in Ukraine. How that is resolved is the great unknown, but already the conflict is having a major impact in many spheres. Any hit to growth is likely to be concentrated in Europe because of closer trade links and greater dependence on Russian energy. The scale of possible interruption to growth is impossible to assess, but we project a brief hiatus followed by a stronger recovery. Meanwhile, the war has exacerbated the inflation shock and may prolong supply side disruptions. This combination makes the ECB's task very difficult. We assume that they will stop asset purchases as scheduled this year, but may find it difficult to raise policy rates as quickly as financial markets project.

Figure 26. **Eurozone**

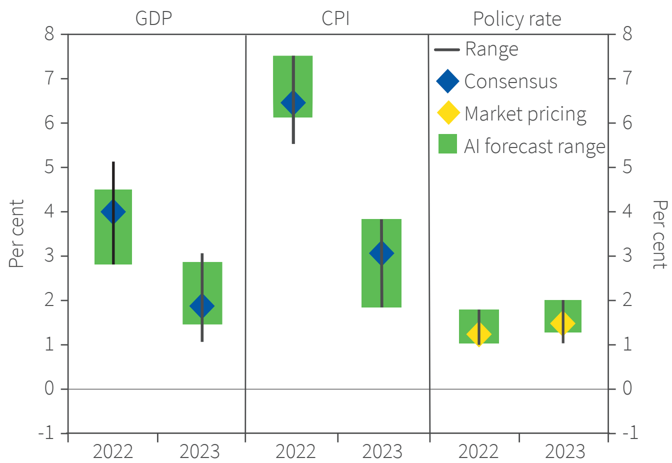


Source: Aviva Investors, Macrobond as at 24 March 2022

UK

There is still a reasonable amount of growth catch-up to take place as, we hope, the COVID pandemic fades into history. The war in Ukraine has the capacity to upset the immediate growth and inflation outlook but should have no lasting impact other than to reduce trade links with Russia and to re-think energy supply. The inflation impulse should fade later in the year and in 2023 but its impact is being felt now. Recently announced fiscal assistance will help offset some of the burden from spiralling energy prices and high inflation more generally, but will not be enough to prevent the largest real income squeeze on UK households since the 1950s. The Bank of England has raised rates to counter the inflation threat and, they hope, to help prevent more damaging second round effects. As the dust settles from COVID and events in Ukraine, the post-Brexit reality of slower-growth Britain may become more apparent.

Figure 27. **UK**

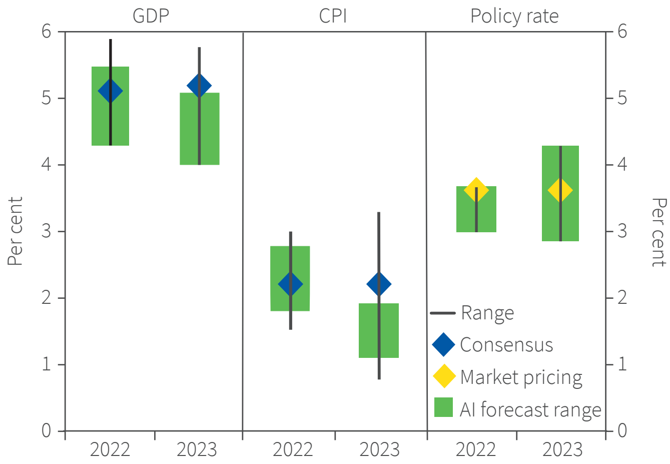


Source: Aviva Investors, Macrobond as at 24 March 2022

China

Ahead of the 20th Party Congress in October, China's policymakers are now focused on growth, cushioning the property market downturn, expanding infrastructure, and bringing to a close the damaging regulatory attacks on 'bad' activities and disorderly expansion of capital and powerful internet platforms. Exports and fixed asset investment in manufacturing are solid, but property development and private sector confidence remain weak. Authorities are loosening zero-COVID policy, and though disruptions and restrictions will continue to occur, the imminent arrival of mRNA vaccines and Omicron's less dangerous nature should continue the move away from strict containment, which has turned an initial health victory into a liability. China's increasing economic cooperation with Russia, and President Xi's pledge of support with "no limits" creates a renewed danger of sanctions and if not full decoupling, then increased financial and economic fragmentation between China and other countries that were already looking to diversify supply chains. Despite Fed hikes, China's slowdown and leverage problems suggest slow rate cuts will continue.

Figure 28. **China**

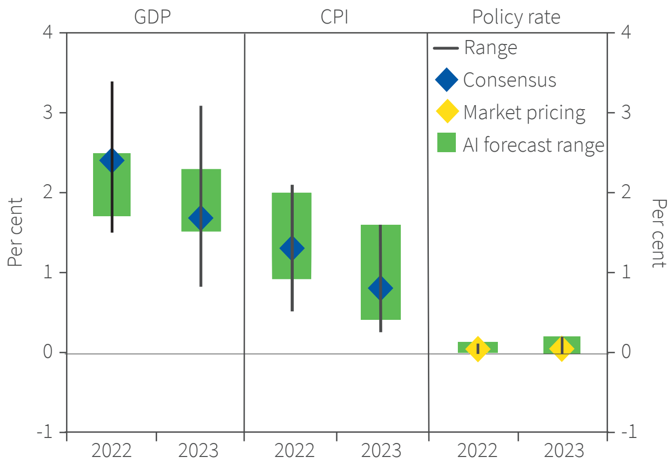


Source: Aviva Investors, Macrobond as at 24 March 2022

Japan

Omicron's spread and low booster rates instigated a "quasi state of emergency" across large parts of Japan, damaging confidence and early-2022 growth. Those curbs are ending, but weak demand (including government spending) was revealed in downwardly revised Q4 data, just as new headwinds from high energy prices emerge. We anticipate a modest rebound in coming quarters, but have revised down the GDP path, and maintain that growth will fall to sub-1 per cent unless fiscal stimulus and a weak yen combine with accelerated reforms. The BoJ will ignore 2 per cent inflation caused by oil prices and a weak yen, as these are temporary adjustments and not a reason to raise rates – slowing export growth, worse terms of trade, and fast-widening rate differentials as other central banks rev up hiking make the yen ripe for further depreciation. There will be hard decisions on geopolitics that affect the economy: how to deal with the Sakhalin oil/gas development in Russia, and whether to follow Germany's lead in rearming for defence purposes, which may require constitutional change to Article 9 and would have consequential fiscal impact.

Figure 29. **Japan**

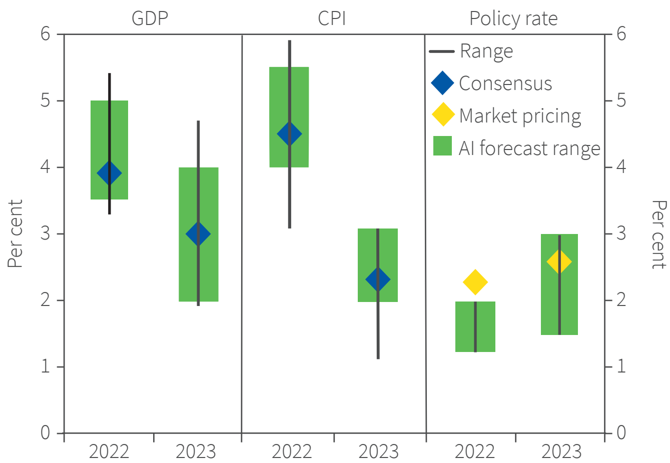


Source: Aviva Investors, Macrobond as at 24 March 2022

Canada

Extraordinary policy stimulus will continue to be removed in 2022 as the economy recovers further. New COVID variants present a risk to the outlook and may delay normalisation. Growth in the service sector remains strong while the goods market continues to be impacted by COVID-related supply issues. Predicting the level of maximum sustainable employment and the relationship between labour market conditions and inflation are two key questions for the central bank. Anticipating the persistence of inflation pressures will be fundamental in determining the pace and terminal rate for monetary policy tightening. The extension of COVID-related inflation pressures against potential drags to growth from prolonged COVID mitigation policy will be a difficult balancing act for central banks. However, the BoC is expected to begin raising rates in mid-2022.

Figure 30. **Canada**



Source: Aviva Investors, Macrobond as at 24 March 2022

Global market outlook and asset allocation

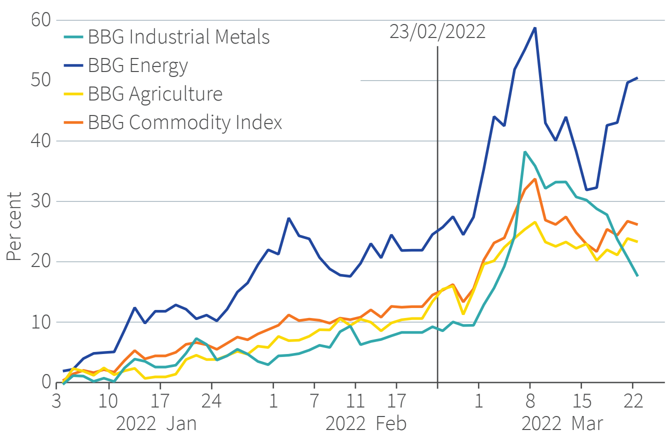
- **The war in Ukraine has led to a price/supply commodity shock, worsening the growth-inflation mix**
- **Central banks' focus on the latter not only supports government bond underweights, but impacts all asset classes**
- **Higher rates affect equity sectoral and regional performance, but are not reasons to be negative (yet)**
- **Valuations in emerging markets (EM) and Chinese policy support mean negative fundamentals are less mispriced**
- **Similarly, credit spreads have adjusted and now provide better risk-reward profile**

In the three months since we published our 2022 Outlook we have been reminded – for the third year in a row – of the sagacious Yogi Berra's warning: "It's tough to make predictions, especially about the future." The market outlook continues to be coloured by the war in Ukraine and our assumptions could change rapidly. And yet, for all the horrors and surprises of late, the main themes of the House View and its investment implications remain intact. Inflation is still a dominant theme, exacerbated by the commodities supply shock – existing demand and COVID-related supply issues have only been aggravated. We anticipated central banks would take further steps to remove accommodation, while growth was projected to slow from high rates; those trends have also intensified, while China's internal redirection and reaction to the spread of COVID have proven impactful – and problematic. Our strongest market conviction remains that yields continue to move higher, and while equities have weathered the storm, their elevated volatility warrants a more modest overweight.

Commodities were expected to trend higher through 2022 given depleted inventories, ongoing supply constraints and a pickup in demand. The outbreak of war between Russia and Ukraine accelerated the move, leading to rapid increases in the prices of oil, gas, metals and wheat which are more directly affected by the conflict (Figure 31). The war has brought energy security into sharp focus in the West and led to the European Commission publishing their RePower EU plan on 8th March. The plan aims to cut Europe's imports of Russian gas by two-thirds by the end of 2022, an ambitious goal. Longer term, the Commission wants to totally phase out dependency on Russian gas, oil and coal by 2027. These policies will have significant ramifications for commodity prices. Even if there is a settlement between Ukraine and Russia, it is now highly unlikely that plans to diversify away from Russian energy supply will be reversed. Robust growth, ongoing supply side issues, increased levels of uncertainty and policies around energy security will likely keep commodity prices elevated through

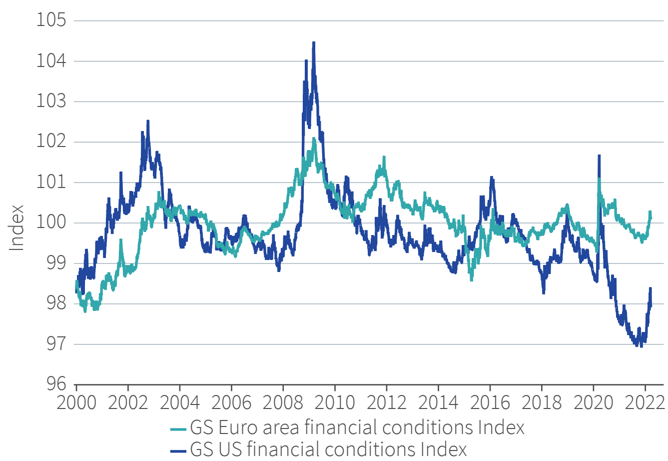
Commodity prices to remain elevated, but their pass through to inflation to decline through 2022

Figure 31. **War in Ukraine has pushed commodity prices higher**
Commodities YTD per cent performance



Source: Aviva Investors, Macrobond, Bloomberg as at 24 March 2022

Figure 32. **Financial conditions in the US remain relatively loose**
US & European financial conditions



Source: Aviva Investors, Macrobond, Bloomberg as at 24 March 2022

2022 and beyond. That said, if commodity prices stabilise even at high levels the direct pass through to inflation will decline rapidly through 2022 thanks to base effects, with the energy contribution to inflation falling to near zero by the end of the year.

Central banks' policy responses to higher inflation and the subsequent implications for economies will be key for markets over our investment horizon. Even before the acceleration in commodity prices, rising inflation meant central banks were either starting or discussing monetary policy tightening. While the war in Ukraine has increased economic and financial uncertainty particularly in Europe, policymakers have been consistent in their focus on inflation and have guided that policy normalisation remains the key priority. This is unsurprising given risks to the inflation outlook are firmly skewed to the upside. The longer supply side shocks persist, the greater the probability that they have second round effects and feed through into wage growth.

Monetary policy tightening and the subsequent implications for economies will be key for markets over our investment horizon

Near-term price shocks mask any potential structural break in the inflation regime towards higher baseline inflation. As discussed above changes in policy around energy security are likely to be long-lasting. De-globalisation of supply chains, climate change, decarbonisation and central banks who are actively targeting higher inflation levels bias us towards structurally higher inflation going forward.

Risks to the inflation outlook remain to the upside, financial conditions need to tighten

The impact of higher inflation will be more apparent in economies such as the US, where growth is strong and labour markets are tight. Interestingly, while US financial conditions have tightened from the lows seen earlier this year, they remain very loose both by historical standards and on a relative basis (Figure 32). Central banks need to see financial conditions tighten significantly from here if they are to bring inflation sustainably back to target.

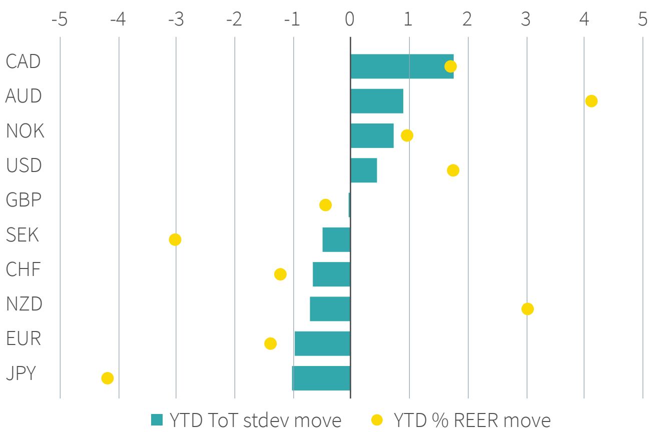
The degree of financial tightening required will depend on the extent inflation returns to target as supply side shocks abate. If underlying inflation dynamics return to the post GFC - pre-COVID era, then required central bank tightening will be more limited and inflation will decline quickly once supply side shocks fade. On the other hand, if higher inflation becomes more embedded in the economy, then it will be difficult for central banks to get inflation sustainably to target while growth remains above trend, even if the peak year-on-year rates are reached in coming months.

With risks to inflation to the upside, nominal yields are expected to rise further from current levels. While curves have flattened significantly as the market priced in tighter monetary policy, that process is likely to have further to play out as we proceed through the hiking cycle, arguing for underweight or short duration to be focused more on the front end of the curve.

Rates to move higher, position underweights in short-dated tenors

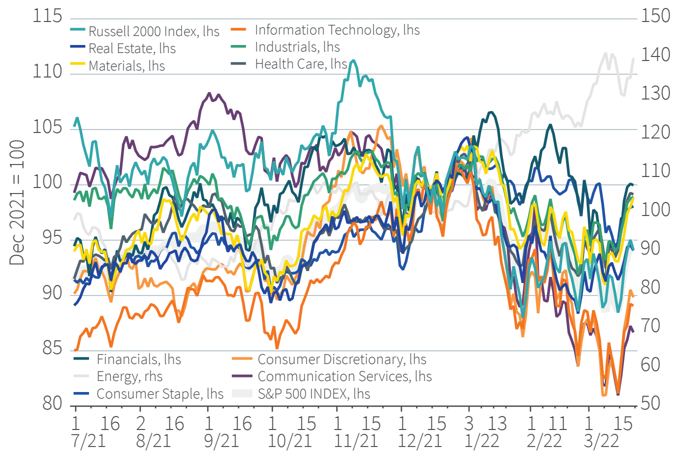
The implications for breakevens and real yields are more complex as these markets reflect not only central banks' actions, but also their ramifications on the economy. Supply shocks are still masking the underlying inflationary environment and which of the structural inflation environments we are in, will likely differ across economies.

Figure 33. **FX moves driven by terms of trade shocks and relative monetary policy**
YTD standardised change in Citi ToT & per cent REER move



Source: Aviva Investors, Macrobond as at 24 March 2022

Figure 34. **Very large sector dispersion in equities, reversing earlier trends**
S&P 500 sector GICS level 1 breakdown



Source: Aviva Investors, Macrobond, Bloomberg as at 24 March 2022

Over the medium term real rates need to move higher. Whether we reach higher real yields via declining inflation or via more aggressive monetary tightening remains to be seen, but in most cases it is likely to be some of both. If the inflation baseline has indeed moved higher then real yields may struggle to move higher near term and may even move lower initially.

Despite the dramatic events and increased market volatility we have seen in 2022 the US dollar, the traditional currency of safety in uncertain times, has strengthened by less than 2 per cent in real effective terms. The Japanese yen, also traditionally a safe haven in times of stress, has depreciated more than 6 per cent year-to-date. Across the G10 currencies, those whose economies are linked to energy prices and have seen a positive terms of trade shock (Figure 33) have appreciated this year. These moves highlight that the themes of commodity price strength and monetary policy reaction functions have returned as key drivers for currency markets, following reduced sensitivity throughout 2021. The large and extended period over which we project the terms of trade shock to persist suggests increased appreciation pressure on currencies which benefit from exports and higher rates going forward.

Russia's invasion factored in; maintain equity O/W (for now)

Supply shocks such as the global pandemic and its aftermath, compounded recently by the war in Ukraine, created a challenging environment for equities. They now also face an additional significant headwind in the form of a tightening cycle from global central banks. The Ukraine war and the sanctions which have followed have the capacity to introduce new disruptions, so far concentrated in Europe and emerging markets. Violent reactions to geopolitical events are not unusual for equity markets, and panic can present opportunistic entry levels if fundamentals are still supportive. Medium-term growth prospects are still reasonable as post-COVID reopening eases supply side disruptions and benefits services and tourism; rates are rising in an orderly fashion and companies report satisfactory pricing power: that supports maintaining modest overweight exposure to equities overall.

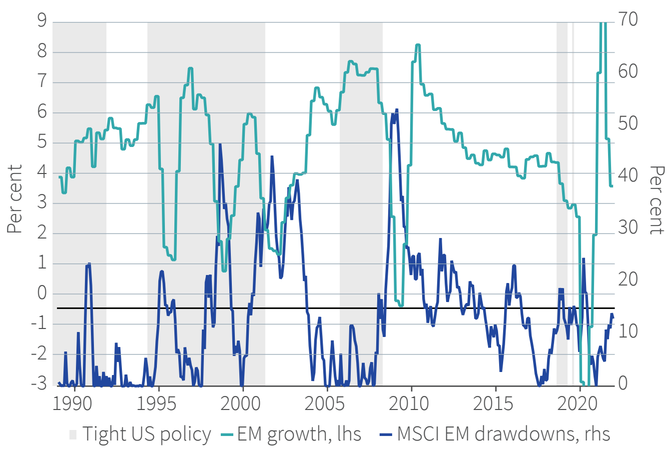
Turbulence for Tech and EM assets to continue, but with some bright spots

Under the hood, in both Europe and the US, higher real rates are a challenge to high valuations in tech and other growth sectors, while rising interest rates and commodities favour banks, energy, and materials. The divergence between sectors is stark (Figure 34), and the trends have further to run. For emerging markets, we move to neutral as China's promises to support growth and to a less strict COVID policy remove some downside. Developed market policy normalization and the potential economic/financial decoupling are headwinds for EM asset classes, with the shift to restrictive territory often causing major drawdowns (Figure 35). Latin America – Brazil in particular – and the Middle East, as well as ASEAN markets are notable exceptions, thanks to similar terms of trade trends mentioned above.

Corporate credit is more attractively priced after recent widening of spreads

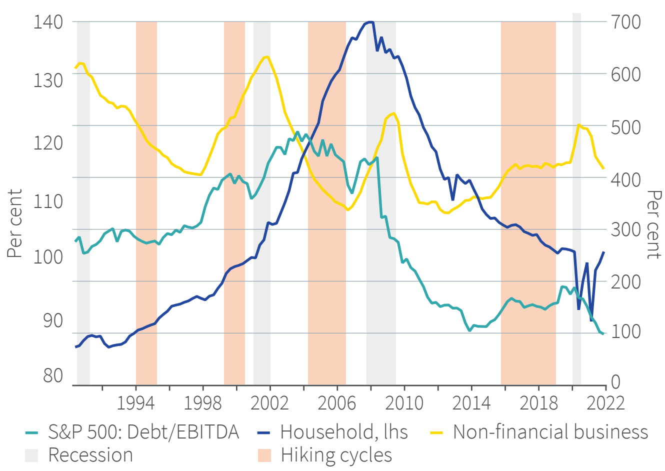
Corporate credit has been volatile, and the relatively low spread levels of 2021 adjusted sharply higher; fundamentals are not deteriorating at this early stage of the business cycle. The improved risk-reward, and corporate and household balance sheets being in good shape (Figure 36), warrant a modification to our asset allocation. Across investment grand and high yield, we move from our long-standing credit underweight to neutral.

Figure 35. **EM equities are volatile during Fed hiking cycles**
MSCI EM local drawdowns and tight Fed policy



Source: FRB, FRB -NY, FRB -Dallas; Aviva Investors, Macrobond, Bloomberg as at 24 March 2022

Figure 36. **U.S. Household and Corporate balance sheets in good shape**
US: household and corporate debt to income



Source: Aviva Investors, Macrobond, Bloomberg as at 24 March 2022

Figure 37. **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						0					
Nominal Govt				-2							
United States			-3								
United Kingdom					-1						
Germany					-1						
France					-1						
Italy					-1						
Japan					-1						
Canada						0					
Australia							1				
Credit											
US Investment Grade						0					
European Investment Grade						0					
Asian Investment Grade						0					
UK Investment Grade						0					
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 24 March 2022

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