House View Q4 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

Recession: a price worth paying?

Central banks need restrictive policy

The persistence of upside inflation surprises in 2022 has created a dynamic that has not been seen for decades. The combination of strong demand and weak supply has pushed headline inflation rates close to, or into, double digits across most of the world. The precise mix of demand or supply factors does differ by region. Europe has been most heavily impacted by the supply shock to energy markets that has resulted from the war in Ukraine. Whereas in the United States, the demand pressures have been a more important factor, with household consumption continuing to be supported by robust household balance sheets and rising wage growth. But whatever the underlying cause, the increase in inflation everywhere has led central banks to rapidly shift their policy stance into restrictive territory, abandoning the post-global financial crisis approach of gradually removing policy accommodation as economies recover. The focus has shifted almost exclusively to bringing inflation down to target, to avoid a sustained period of realised high inflation, with the objective of preventing a rise in longer-term inflation expectations amongst households and businesses. For central banks, credibility that has been hard-won over a long period is at risk of being lost quickly.

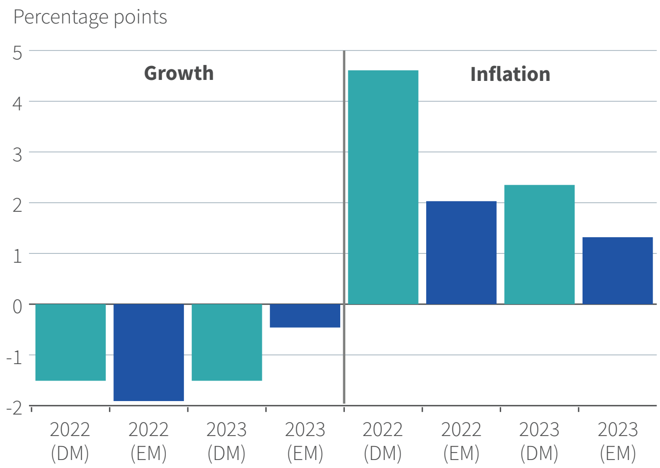
Growth and inflation trade-off expected to worsen further

The more singular focus of monetary policy on inflation is reflected in the expected worsening of trade-off between growth and inflation. Figure 1 shows the change in consensus expectations for both developed (DM) and emerging (EM) market calendar year growth and inflation since the start of this year. Growth projections, which were already expected to be on a slowing trend, have been revised down across both years and many regions. Meanwhile, inflation projections have been revised higher, reflecting both the surprises already seen this year, and the expected persistence of those shocks. This sets the global economy up for an extremely challenging period. Central banks are expected to tighten policy sufficiently to deliver positive real interest rates over the next few years. The extent to which households and businesses are able to manage materially higher real rates is difficult to assess. Central banks need to see enough of a slowdown in demand to ease underlying inflationary pressures. Too much tightening could push economies into recession, while too little could result in a more persistent inflation problem. At this stage we think the risk management decision for central banks will be more likely to result in the first of those two outcomes. As such, we expect growth in developed markets to be weak in 2023, with most experiencing some form of mild recession, characterised by little growth and rising unemployment. Growth in the emerging market economies is expected to be a little firmer, reflecting an improving situation in China. Overall, we expect global growth to slow to around 3 per cent in 2022 and 2¼ per cent in 2023 (Figure 2).

Fiscal policy is once again providing extraordinary support

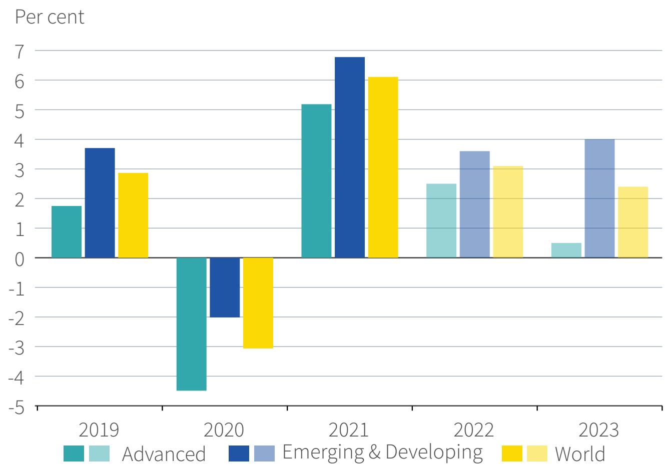
The depth of recession is expected to be shallow, reflecting the relative strength of private sector balance sheets. Unlike deep recessions of the past, we do not expect a sustained period of deleveraging to act as a serious continuing headwind to growth. However, the potential for further negative supply shocks, particularly from global energy markets tilts the balance of

Figure 1. **An expected worsening in the growth and inflation trade-off**
Change in consensus growth and inflation forecasts since the start of 2022



Source: Aviva Investors, Macrobond, Bloomberg as at 3 October 2022

Figure 2. **Global growth projections**
Recession the most likely outcome



Source: Aviva Investors, Macrobond as at 3 October 2022

risks to our central view to the downside. In response to the extraordinary increase in natural gas prices in Europe, governments across the region have taken significant fiscal actions. Many have moved to cap the increase in energy and electricity prices faced by consumers, absorbing that cost onto the government balance sheet. At current gas futures prices, the intervention might be worth upwards of 5-7 per cent of GDP. If that were to be the cost, it would exceed the direct support households and businesses in Europe received during COVID. While the financial support is understandable given the magnitude and cause of the shock, the fact that most governments have chosen not to be more targeted creates yet another challenge for central banks. In the first instance the price caps will reduce headline inflation compared to what it otherwise would have been, but over the medium-term they are likely to sustain demand and result in greater underlying inflationary pressures. Our central projection sees inflation ease back over 2023, but risks remain to the upside (Figure 3). Moreover, policies such as those recently announced by the government in the United Kingdom to introduce unfunded tax cuts, also come at an inopportune time. For the first time in recent memory, the fiscal accelerator is being used, while the monetary brake is applied at the same time. If handled poorly, this risks the type of systemic stress seen in the UK gilt market in late September, when the Bank of England was forced to intervene to stabilise the situation.

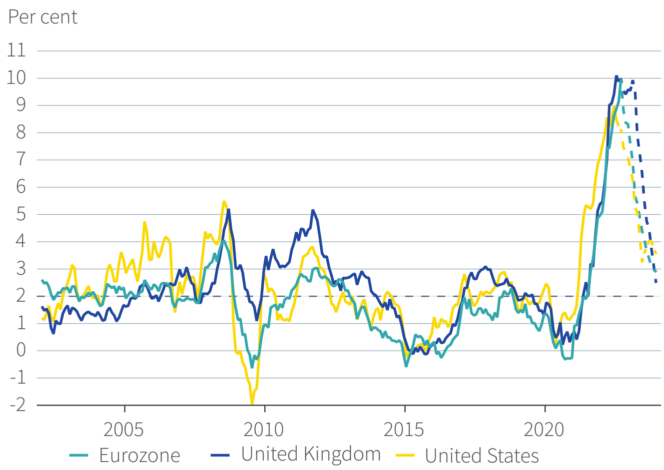
Asset markets will need to adjust to the new policy mix

We think the policy mix of greater use of fiscal and more active monetary policy will be far more common over the coming years than it was in the decade between the global financial crisis and COVID. That changing policy dynamic also comes at a time when three critical structural factors – deglobalisation, decarbonisation and demographics – are becoming more important drivers of the global economy. We think that the combination of these factors is likely to presage a period of increased economic and policy uncertainty, with greater variability and higher average level of interest rates. For asset markets that had become used to cheap money and unlimited liquidity, a period of adjustment will be necessary. That adjustment has begun, but we think will take some time to fully play out. That is not to say that there won't be investment opportunities created. Indeed, the increase in market volatility and shifting correlations can create more opportunities.

We prefer to be neutral equities, underweight duration and long dollars

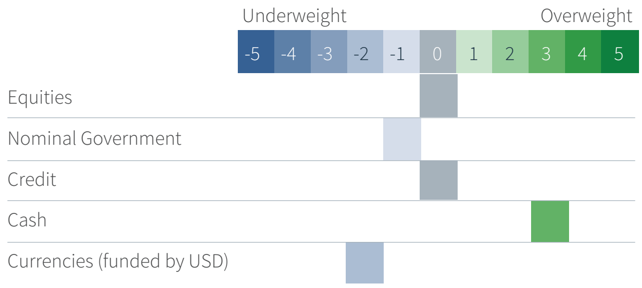
We have a preference to be modestly underweight duration, with upside inflation risks outweighing the downside recession risks (Figure 4). However, the tipping point between those two may well be coming closer. We prefer to be broadly neutral in equities, with the rise in real yields putting further pressure on multiples, while at the same time expecting to see downward revisions to earnings expectations in coming quarters. We have a mild preference for the UK over Europe given the relative exposure to energy and resources. We prefer to be neutral in credit, where we think pricing of high yield spreads is roughly fair in terms of recession risk, but with risks of further widening from here. On investment grade, the all-in yield on short-dated paper does make it relatively attractive. Finally, we prefer to be long the US dollar against a range of currencies, reflecting the weakening global growth environment and the strength of underlying inflation in the United States.

Figure 3. **CPI inflation projections**
Decline expected through 2023



Source: Aviva Investors, Macrobond as at 3 October 2022

Figure 4. **Asset allocation summary**



Source: Aviva Investors, Macrobond as at 3 October 2022

Key investment themes and risks

Investment themes

1. Monetary policy-induced recession
2. Inflation breakout
3. Fiscal backstops
4. Global fragmentation
5. Commodity prices, energy security and decarbonisation

Monetary policy-induced recession

Growth projections are still being revised lower

2023 GDP growth projections around the world continue to be revised lower (Figure 5). Aviva Investors now expect world growth of 2¼ per cent next year, down from 3 per cent just three months ago. Outright falls in global GDP are extremely rare – the COVID experience of 2020 was an exception (a decline of 2.6 per cent) – but anything below 2¼ per cent world growth is generally considered as bordering on global recession, so risks are clearly magnified. As we have highlighted previously, there are several well-documented elements of the current downswing which relate directly to the shock following Russia's invasion of Ukraine and the energy price hike and supply disruption which followed. Neither central banks nor governments can do much to prevent such supply-side impacts (although they can try to offset them), but if the shock fades or disappears, as is hoped, then so too will the negative effects. But as the OECD made clear in its updated September assessment of global prospects, "[a] key factor slowing global growth is the generalised tightening of monetary policy, driven by the greater-than-expected overshoot of inflation targets". In other words, part of the slowdown can be now attributed to central bank actions which have been – and are expected to remain – more aggressive than previously thought (Figure 6). Although they shy away from such language, some central banks probably now believe a downturn or recession is almost necessary in order to address the more fundamental rise in inflation than that driven by energy prices alone.

Recessions are now likely in Europe and UK, starting in Q4

Recessions are not inevitable (as they were, for example, during the pandemic). But they now look likely in several parts of the world (Figure 7). Although governments have strived to relieve the real economic distress from spiralling inflation for households and businesses through an array of fiscal assistance, that pain is still being felt and is being reflected in plunging sentiment and retrenchments in discretionary spending. The mood will be further affected by energy rationing over the winter months, should it be required (and worries about that even if it is not) and sharply higher borrowing costs. This will impact all businesses and households with debts,

Figure 5. **Growth projections revised steadily lower**
Consensus forecasts for global GDP growth

Source: Aviva Investors, Bloomberg, Macrobond as at 3 October 2022

Figure 6. **Rate expectations have ramped higher in the last two months**
Policy rate expectations for middle of 2023

Source: Aviva Investors, Macrobond as at 3 October 2022

most notably mortgage borrowers on variable rates or those who have to refinance. The huge uncertainties regarding the conflict in Ukraine, alongside prospects for inflation and interest rates are not a backdrop conducive to higher investment spending, while weaker labour markets – an inevitable consequence of slower growth – will hold back consumer spending.

Risks to growth in the short term appear skewed to the downside for the reasons outlined above. In addition, the more specific and localised worries in China, including the impact of zero-COVID policies, property market strains and possibly misguided policy responses are adding to those downside risks in a nation of increasing importance in the world and still a hugely significant global exporter and importer. It is important, however, not to get too gloomy. The next six months or so are going to be tough, but if inflation does start to fall back decisively, if fiscal policy remains sensibly supportive and – more speculatively – if some sort of resolution to the war in Ukraine becomes more plausible, then any recession could be both shallow and short-lived by historical comparison. In particular, there are far fewer global imbalances (either private or public) which require cathartic and painful adjustments that generally take place during recessions. Both household and corporate balance sheets are in good health by historical standards.

Risks to growth are skewed to the downside over the next six to nine months

Inflation breakout

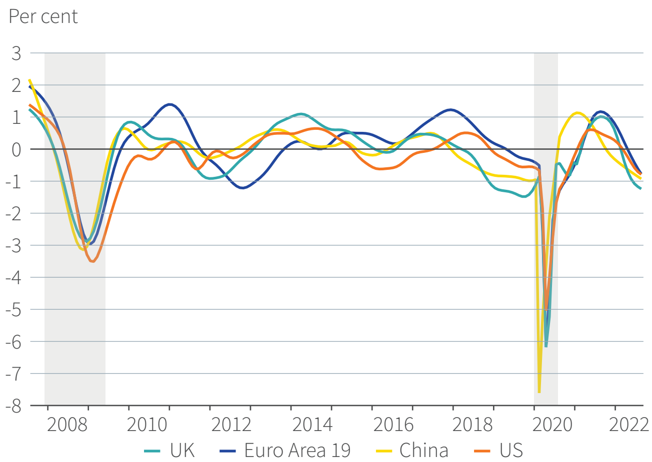
It remains to be seen whether history will judge that the present inflationary outbreak was the result of irresponsible monetary policy errors or of the unique confluence of an extraordinary range of factors, about which central banks could have done very little. In our view, it is likely to be a combination of the two. But the key point here is inflation was supposed to be yesterday's problem. We're all aware of the inflationary disasters of the 1960s, 1970s and 1980s. But harsh lessons had been learned and inflation as a severe macroeconomic problem seemed to have been beaten, partly because of a better understanding of the inflation generation process and partly because of the increased prevalence of inflation-fighting central banks. The period which became known as 'The Great Moderation' (basically 1992-2007) was characterised by low and stable inflation across most of the developed world (Figure 8). G7 CPI inflation averaged just a whisker above 2 per cent during this period. After the global financial crisis, there was a little more volatility and some more noticeable inflation spikes, but it always fell back quickly and actually spent more time below than above the typical central bank target of 2 per cent.

Policy-makers believed that inflation had been beaten...

Visually at least, the recent inflation experience represents a stark change to those patterns and prima facie evidence that something has gone very wrong and/or that policy mistakes have been made. Of course, we know that there are some specific reasons for the latest spike in inflation which relate to post-COVID supply chain disruptions and the conflict in Ukraine. These can be largely bracketed as supply-side shocks which central banks have to accommodate, but their influence should pass in time. As we have stated previously, we

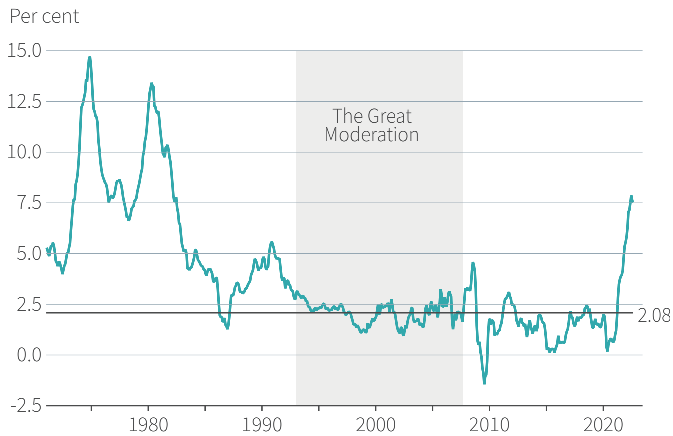
...but it is back now, boosted by both supply and demand factors

Figure 7. **Deeper cyclical downturns are now likely**
OECD composite leading indicators



Source: Aviva Investors, Macrobond as at 3 October 2022

Figure 8. **We thought inflation had been beaten**
G7 countries: annual CPI inflation



Source: Aviva Investors, Macrobond as at 3 October 2022

believe that any judgement on policy error is more likely to be applied to the long period of exceptionally loose monetary settings that existed between 2008 and 2020 than to the current episode of aggressive tightening. And that includes not just very low – even below-zero – policy rates, but also the array of unconventional policy instruments, collectively known as QE.

But the latest inflation upsurge is not all about energy prices and pandemic-related global supply imbalances. There are demand factors at work too. Figure 9 shows the inflation breakdown for the UK, but the picture is similar everywhere. And that means that central banks are right to respond forcefully to higher inflation. In many, perhaps even most, places, they now more firmly believe that they have to suppress the growth of demand to bring it into line with constrained supply to get the more fundamental underlying inflation impulse back under control. If that ushers in a period of weak - even negative - growth, then so be it. The clear lessons from the past are that the alternative would be worse: by not addressing the issue now, inflation would become even more engrained in behaviours and the eventual demand and output adjustment needed to bring it back to target would be even more painful. We believe that central bank efforts – and a reduction in those supply-side shocks – mean that inflation will fall back in 2023. But even if it does, it will be some time before policy-makers can relax and consider first a pause and then a reduction in policy rates.

Higher energy prices are a key part of the inflation impulse, but not the whole story

Fiscal backstops

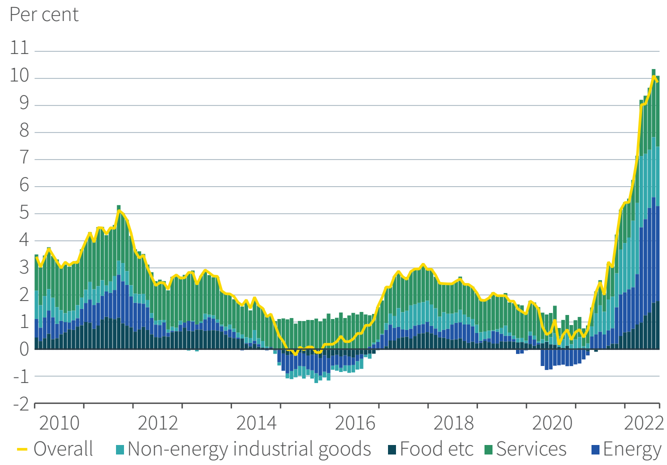
The role of fiscal policy as an active demand management tool has varied greatly over the decades. During its most influential periods, such as the New Deal of the 1930s, the post-WW2 recovery and the 1970s expansion of the social safety net (Figure 10), it has been a powerful force on growth and inflation. But for long periods it has largely been left to tackle other issues, such as redistribution. The emergence of fiscal rules in the 1990s arguably led to a smaller demand management role, handing that responsibility to central banks. Following the huge fiscal costs of global financial crisis, governments quickly moved to austerity measures to rein in deficits. The fiscal response to the COVID crisis appears to have emboldened governments to once again turn to fiscal policy for active demand management.

Fiscal policy was more important in the past, but monetary policy became the dominant force in the 1990s...

During the pandemic, it was fiscal policy which essentially did most of the heavy lifting, providing vast, immediate and open-ended assistance which, it is generally judged, prevented the onset of the second Great Depression, but added significantly to public debt burdens (Figure 11). Monetary policy was (and is) far from impotent, but the focus has changed again. To be fair, the tide had already been shifting: liberal Europe was already focussing on more active fiscal interventions, the UK had learned to love fiscal again and Japan was providing the clearest illustration how old guidelines on 'safe' levels for public deficits and debts were changing. Even the previously fiscally conservative US was embarking on huge tax-cutting and public spending programmes. Those old rules of thumb were swiftly abandoned.

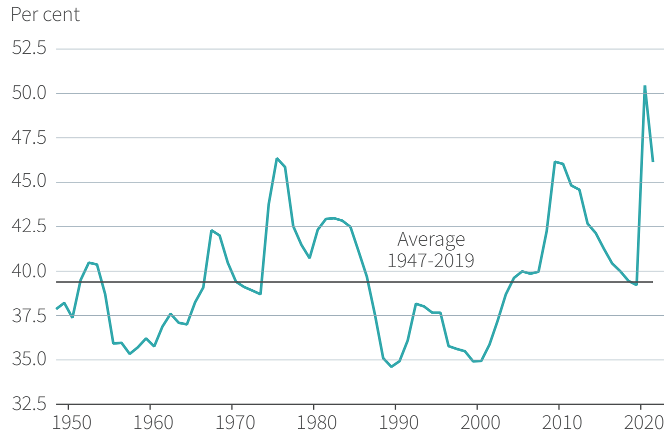
...but that may now be changing again

Figure 9. **Inflation has become markedly more broad-based**
Contributions to UK CPI inflation



Source: Aviva Investors, Macrobond as at 3 October 2022

Figure 10. **Is fiscal dominance making a comeback?**
UK government spending as per cent of GDP



Source: Aviva Investors, Macrobond as at 3 October 2022

The key point is that in a growing number of countries we now seem to be at a point where the marginal policy instrument of choice for providing stimulus is fiscal not monetary. The various energy support packages across Europe are a case in point (Figure 12). Many of these numbers are comparable to the direct assistance provided during the pandemic. Gone are the days when the main ambition of fiscal policy was to exercise 'prudence', keep deficits contained (generally 3 per cent of GDP or less) and public debt sustainable (typically 60 per cent to 70 per cent of GDP as an arbitrary upper limit). The COVID experience has convinced many that expansionary fiscal policy can be actively pursued without as much need to worry too much about adverse financial market reactions. In the fairly recent past, any perception of fiscal profligacy might well have been met with scepticism, unhelpful market reactions and crowding out of private sector spending. That said, it remains the case that the guidelines for longer-term fiscal sustainability have not been abandoned completely (see risks section). They are simply being interpreted in a rather different and arguably more enlightened manner. But just as there were limits to monetary policy, there will be confines for fiscal policy too. The recent experience in the UK with their September 'fiscal event' has demonstrated the pre-eminence of fiscal initiatives today but has also highlighted that measures considered inappropriate or misguided cannot just be adopted freely. Judgements will still be made, whether by private agents and financial markets, central banks or august bodies such as the IMF. All will have consequences.

The energy crisis is being countered by extensive fiscal programmes

Global fragmentation

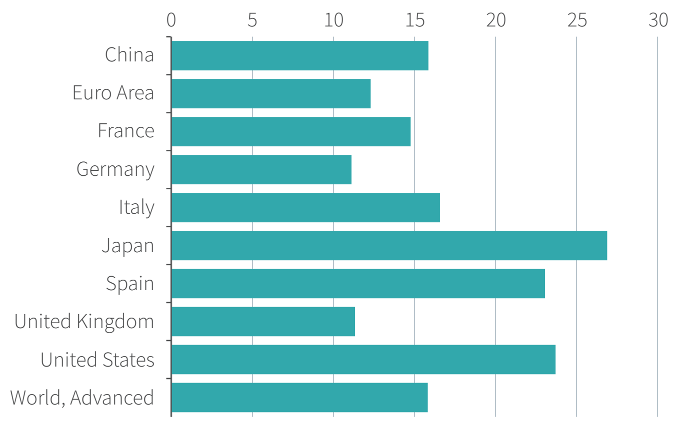
As we have stressed in previous House Views, momentum in global integration had already been slowing noticeably in recent years after decades of continuous increases. In the three decades from the mid-1970s, the world became steadily more closely connected and many seemed to benefit (Figure 13). Openness, free trade, specialisation, technology transfer, shared knowledge. These were all illustrations of the international attitudes to trade and development. It would be naïve to suggest that there was no self-interest – of course there was. But those driving forces were contained within a globally accepted ideology that encouraged cooperation and shared goals. This coincided with the enlargement of middle classes across many nations. But since 2008, governments, companies and people have wrestled with a global financial crisis, an existential Eurozone disaster, growing revolt against open borders, Trump's trade war and a global pandemic and now a war on European soil. Attitudes have already changed, and they are likely to alter further in coming years.

Has globalisation slowed, changed in nature or is it reversing?

These changes were probably underway well before 2008 – there had already been an increase in greater self-interest, in nationalism and a reaction towards wealth and income inequalities that had been getting wider for many years. But in the wake of the global financial crisis, attitudes hardened and became much more visible. They showed themselves in many different ways including right-wing and other 'populist' parties across Europe and moves towards greater independence, autonomy and self-determination in many different

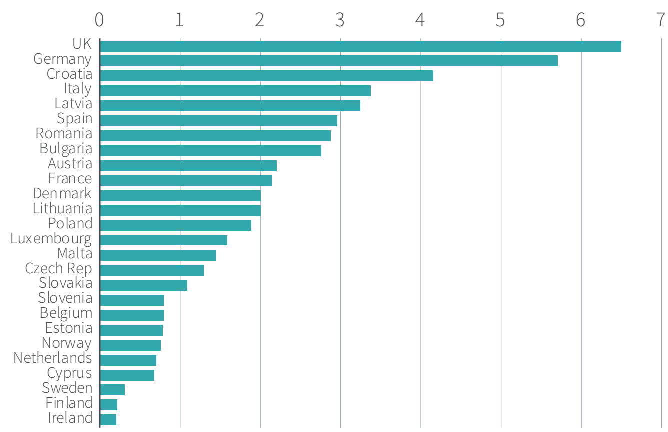
Attitudes continue to shift towards greater autonomy and self-determination

Figure 11. **Public debt rose significantly during pandemic**
IMF estimates for increase in public debt as a per cent of GDP (2019-21)



Source: Aviva Investors, IMF, Macrobond as at 3 October 2022

Figure 12. **Support to help households has been extensive**
(allocated funding, Sep '21 - Sep '22, % of GDP)



Source: Aviva Investors, Bruegel, Macrobond as at 3 October 2022 arenas. Brexit was another sign. The set-in-stone political system in the US prevented sudden transitions there, but even so, similar trends were visible: first the Tea Party, then more of lurch to the right, then Trump. Attitudes towards free trade have shifted, advanced technologies inspire fear as well as admiration and large elements of the middle classes feel squeezed and poorly treated. On a broader scale, we seem to be witnessing geopolitical fractures between the West and Russia and between the US and China. These trends look as if they will frame the next 10 or 20 years.

Three months ago, we suggested that globalisation based on efficiency was yesterday's story. Today, we seem to be evolving towards interactions based more on security. It seems inevitable that there will be moves towards home-shoring and a more just-in-case approach to inventories (rather than just-in-time). To the extent that globalisation was a key part of the emergence of low inflation in the 1980s, 1990s and 2000s, any reversal may support a generally higher inflation impulse around the world. If supply shocks do now become as common as demand shocks, then inflation is also likely to be more volatile, meaning that investors may demand higher risk premia to compensate.

From just-in-time to just-in-case

Meanwhile, politics continues to move with these times. Italy has recently elected an unashamedly far-right government (Figure 14). The main governing party has tried to re-position itself but has its roots in the fascism of Mussolini. The realities of social democracy in the Eurozone today mean that the new government is highly unlikely to make too many extremist demands, but their agenda will concentrate on areas which reflect their base: immigration, self-governance, increased access to the Recovery Fund. It is unlikely that the new administration will repeat the mistakes of Salvini and pick a fight with the EU. But some clashes in time look entirely plausible. Closer to home, the shambles in UK politics is also a result of these shifting sands: a right-wing agenda and drive to supply-side reforms has precipitated a mini crisis that could yet become a maxi one.

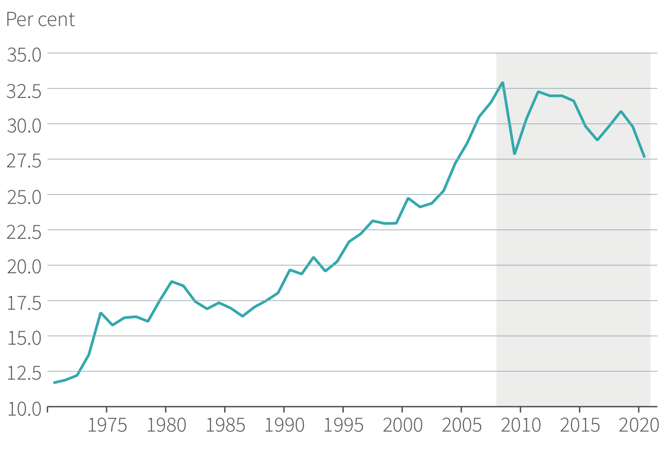
Both national politics and geo-politics are getting messier

Commodity prices, energy security and decarbonisation

Russia's ongoing restrictions of natural gas flows to Europe have continued to support prices at levels far above those which prevailed before their invasion of Ukraine. Of course, their actions are all related to the complex dynamics of the new 'cold war' and will influence the parameters of the post-conflict landscape. Any such settlement does not appear an imminent development. Nevertheless, some things will never be the same again. One certainty is that Europe – and others – will reduce their reliance on Russian energy as soon as they can. Russia is only too well aware of this and is determined to maximise the time-limited leverage that they have. As the International Energy Agency's (IEA) Director of Energy Markets and Security recently stated, "The outlook for gas markets remains clouded, not least because of Russia's reckless and unpredictable conduct, which has shattered its reputation as a reliable supplier. But all the signs point to markets remaining very tight well into 2023". More generally, commodity prices are still high by the standards of recent years, but have very clearly come off the boil in 2022 as growth prospects have been revised lower (Figure 15).

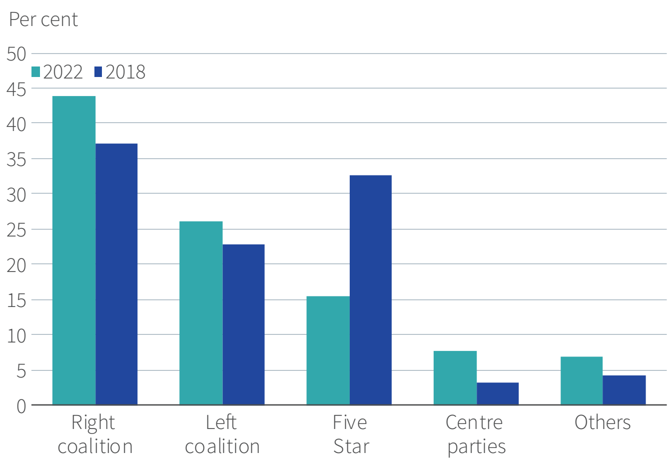
Energy markets are likely to stay distorted for a while yet

Figure 13. **Trade openness has stopped increasing since the GFC**
World exports as per cent of world GDP



Source: Aviva Investors, Macrobond estimates as at 3 October 2022

Figure 14. **A further lurch to the right in Italy**
Italian election results



Source: Source: BBC, Wikipedia, Aviva Investors estimates as at 3 October 2022

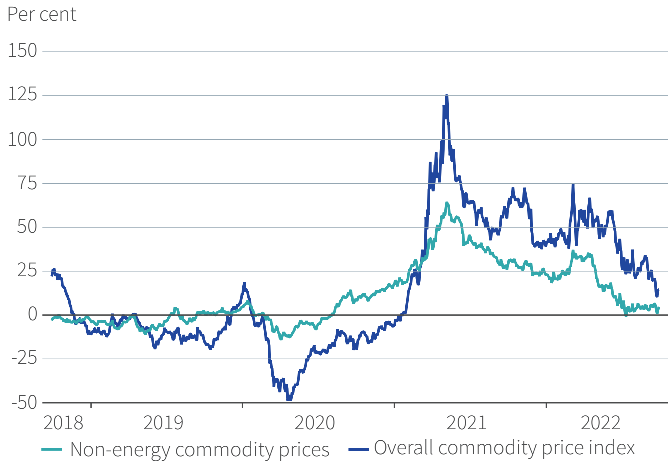
The current experience has also injected greater uncertainty into longer-term prospects for natural gas where its use had been expected to increase as it replaced other high-emission fossil fuels. Europe has attempted to offset at least some of the impact of reduced Russian supplies by alternative sources such as Norway, as well as boosting LNG imports significantly. At the end of September, it is estimated that EU storage facilities were almost 90 per cent full (Figure 16). The IEA further concluded that if Russian supplies remain frozen and, in the absence of demand reductions, EU gas storage would be less than 20 per cent full by February as long as LNG supplies continue. This would imply a significant risk of supply disruptions if the late winter is especially cold. Moreover, even if they get through this winter relatively unscathed, rebuilding inventory to safe levels in 2023 will be a major task. In other words, while medium-term dependence on Russian gas supplies declines, the impact of deliberately restricted supplies will be felt for a while yet. The drive towards cleaner forms of energy will continue. But it may be interrupted by more pressing short-term considerations which leans on other sources, including dirtier fossil fuels and nuclear.

The conflict in Ukraine and its aftermath have been a setback to energy transition

The current energy shock does bear some comparison to the twin crises in the 1970s. Those events inflicted short-term pain but led to far-reaching changes to the energy industry that were in the end beneficial. Longer-term aspirations for green energy are appealing and, we hope, realistic. But they will not inevitably be achieved. Governments are being pulled both ways – ease and speed the transition but keep prices low. They will not all do the right thing. Some may prioritise short-term relief through increased fossil fuel production or distorting subsidies, potentially exacerbating the climate crisis. The green transition remains a laudable ambition. Recent events may both help and hinder, but care needs to be taken to ensure that macroeconomic policy adapts dynamically to present circumstances and continues to smooth the path to cleaner energy and less pollution.

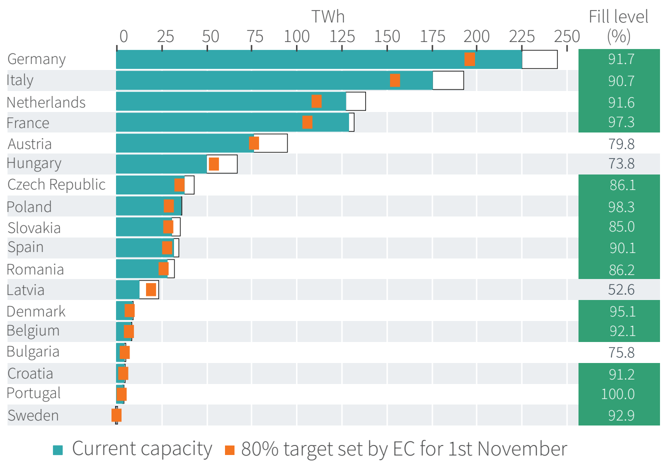
Different times, but some relevance of comparisons to the 1970s

Figure 15. **Commodity spike has cooled**
Commodity price inflation



Source: Aviva Investors, Macrobond as at 3 October 2022

Figure 16. **Gas inventories are high for now**
Natural gas inventory in Europe



Source: Gas Infrastructure Europe (GIE) as at 3 October 2022

Risks

Inflation problems spread

With headline inflation rates of close to 10 per cent in most of the developed world, and core inflation rates two to three times above target, it is difficult not to characterise the current experience as a disaster. And in the context of the last 30 or 40 years it is, even though, as we described in the earlier themes section, there are a number of unique factors driving inflation higher. Many – even most – of these should reduce or reverse over the coming 12 months or more, pushing inflation down again. If that happens, then there is a chance that this inflation crisis will pass. But this needs to start happening now, or the problem could easily start getting worse in far more damaging ways. Both headline and core inflation rates moved decisively above the 2 per cent mark in the spring and summer of last year (a little later in Europe and Japan – Figure 17. Since then, of course, both have risen relentlessly and even if they are peaking now (not entirely certain), they are all far too high for comfort. The key point is that high and rising inflation has now been around for long enough to have a permanent impact. That is what central banks are worried about.

Inflation has now been around for long enough to have a more damaging and lasting impact

The key relationship is that between prices and wages. In the past, wage increases followed price inflation spikes much more immediately, leading to destructive wage-price spirals. High inflation became expected and built into wage bargaining processes. Today that link is more tenuous because of the reduced power of collective labour, but more fundamentally because the hard-won inflation successes since the 1980s became reflected in inflationary expectations which, with minor exceptions, became anchored at or very close to official inflation targets. The longer that high inflation continues – whatever the root cause or causes – the greater the risk of those anchors being lost. For now, most measures of expectations are cashing in on the credibility that had previously been established and are remaining contained. But unless actual inflation measures do now start to fall back, that faith will fade. Some small cracks are already appearing in the form of expectations edging higher. But they are nothing like as high as actual inflation rates today (Figure 18). If those widen again and form the basis of successful higher wage demands and other second round effects, then the inflation problem will broaden, deepen and endure.

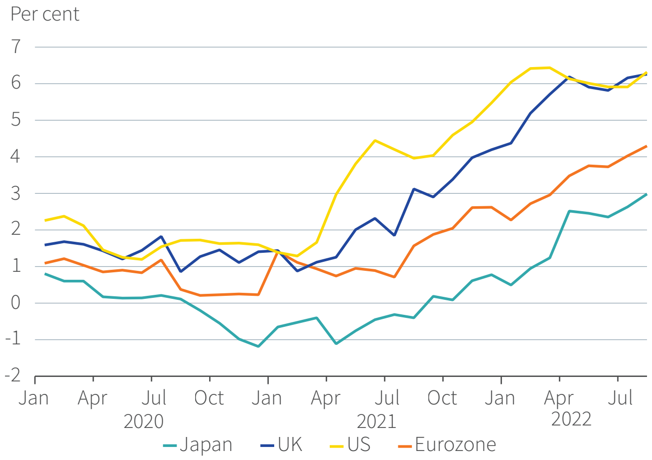
Central banks are especially worried about higher wage inflation

Global hard landing

There is no official textbook definition of an economic ‘hard landing’, but most believe that they would recognise one. It may be easier to characterise the ‘soft landing’ alternative, which is generally considered to be the successful transition from a bubbly, potentially overheating economy to a slower but more sustainable pace via a nudge or two on the policy brakes. The less palatable alternative is of a more jarring adjustment, requiring painfully tighter policy settings and bringing about big drops in sentiment and retrenchments in activity. Sometimes these are necessary; sometimes they can happen by accident. Moreover, there are both

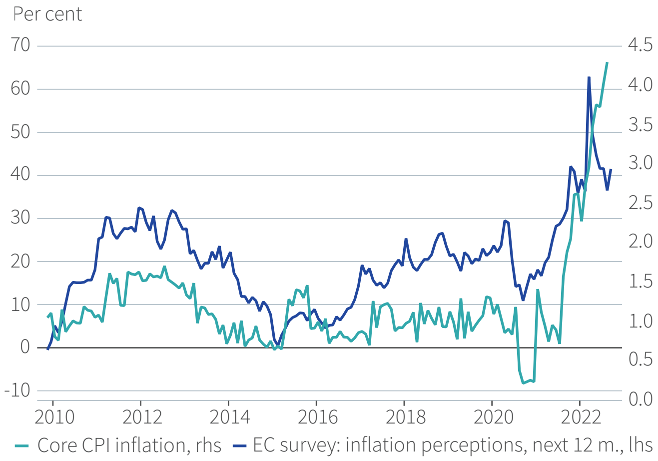
Hard landing risks continue to move higher

Figure 17. **Core inflation high and rising**
Core inflation, y/y per cent



Source: Aviva Investors, Macrobond as at 3 October 2022

Figure 18. **Inflation expectations are still reasonably contained**
Eurozone: core inflation and inflation expectations



Source: Aviva Investors, Macrobond as at 3 October 2022

supply-side and demand-side elements to this fine-tuning. Finally, they can be driven by changes in either fiscal and monetary policies, which are often motivated by very different considerations and can pull in different directions. In the last three months, the risks of a hard landing have risen again, and you can persuasively argue that some elements have already materialised: it is clear that parts of the world (Europe, primarily) are already experiencing a difficult adjustment to the energy price and supply shock, while others (China et al) are still coping with disruption related to COVID policy (Figure 19).

The dynamic which has added to the hard landing risk more forcefully since the summer, has been the increasingly more hawkish stance adopted by global central banks in the face of persistent and broad-based inflation. This evolution, magnified by market expectations, has increased the chances of a hard landing being brought about by the ‘tough love’ of dealing with the inflation problem now, rather than run the risk of an even worse problem further down the line. In other words, as central banks attempt to suppress demand growth, they increase the chances of the downturn gathering its own momentum. Any intensification of supply shocks (for example, a harsh winter and additional Russian supply restrictions) over this period would add to this risk. Three months ago, we talked down the idea that parts of the world almost “needed” a downturn in order to deal with inflation. Today, that element of inflation risk is higher and so too, therefore, is the possibility of a harder landing. The Bank of England was already projecting marked increases in unemployment (Figure 20). The Fed has recently moved more in this direction. It is still true that the world economy does not have anything like scale of vulnerability from over-leveraged private balance sheets and under-capitalised banks which have characterised previous recessions, and that means that any downswing could, in theory, be short-lived. But that is far from certain.

There is now far more discussion about whether downturns are actually required in order to regain control over inflation

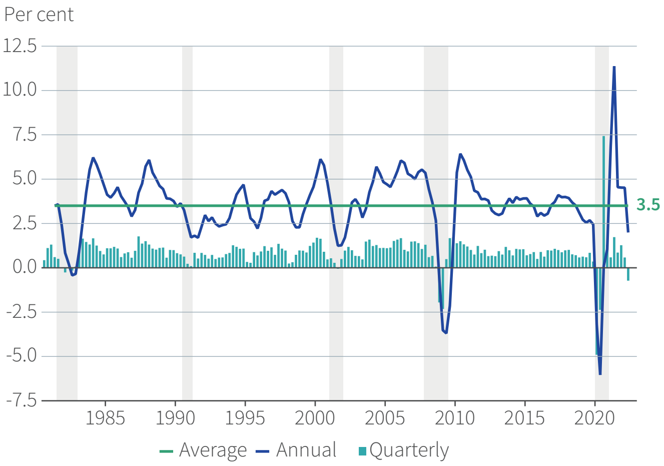
Fiscal sustainability

Fiscal policy was already moving towards the ascendency before the pandemic, but the COVID experience really accelerated that journey. In response to that crisis, it had to be vast, immediate and open-ended. And by and large, it was. As countries now struggle with the impact of the energy price shock and the cost-of-living crisis, fiscal initiatives to provide support and protection are once again front and centre. These are undoubtedly merited, but the reaction to them reveals very different attitudes to issues of fiscal sustainability than those which prevailed for decades. There is now a more widespread acceptance that changes to tax and spending aggregates, often on a massive scale, are the appropriate policy response to challenging circumstances, such as those which exist today. However, there is still a danger that the high regard in which fast and flexible fiscal programmes are held now obscures some of the realities of their longer-term consequences.

Greater acceptance of fiscal policy does not mean the rules of sustainability have been rewritten

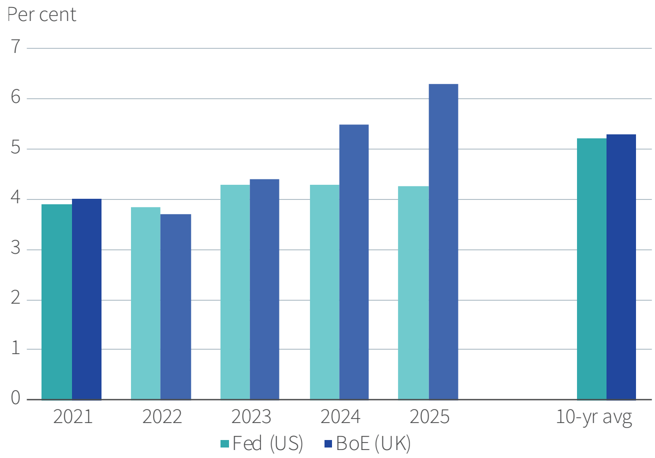
Bluntly, the rules of fiscal sustainability have not been rewritten. The algebra of prudence is reasonably straightforward even if it does involve several variables. But perhaps the key relationship is between the real rate of interest which governments pay on their debt and the

Figure 19. **Global growth has already slowed sharply**
Estimates of global GDP growth



Source: Aviva Investors, Macrobond as at 3 October 2022

Figure 20. **The Fed and Bank of England project higher unemployment**
Central bank projection for unemployment rate



Source: Aviva Investors, Macrobond as at 3 October 2022

growth rate of the economy. During COVID, and in its aftermath, the former fell well below the latter which helped generate ample room for fiscal latitude. Since then, high inflation has also helped the arithmetic. But growth is now slowing, inflation may have peaked and should fall significantly next year and beyond whilst interest rates are rising quite rapidly. Public sector debt is now more than 100 per cent of GDP in most G7 nations (Figure 21). It would not take a lot for the fiscal maths to put countries on an unsustainable path. Japan may provide some visual comfort, but can other nations expect to keep borrowing rates close to zero? Unsurprisingly, the IMF recently acknowledged that while fiscal support in the face of the energy shock was warranted, it "should be temporary, concentrated on the most vulnerable, preserve incentives to reduce energy consumption and be withdrawn as energy price pressures wane".

Higher interest rates, lower inflation and weaker growth all reduce the room for fiscal largesse

China rebound

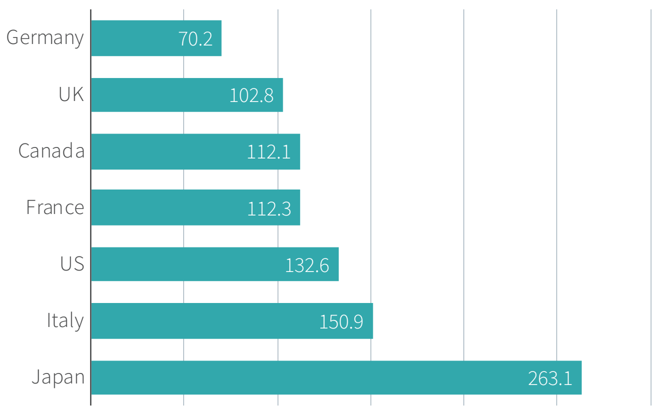
China's economy is at a weak point as Xi's second term draws to a close, with policy errors destroying the promises of 'stability' and the 5.5 per cent growth target missed for the second time in three years. While our base case is that the damage is difficult to reverse, there are several 'known unknowns' that also point to potential upside risks. The first and arguably most important is Zero-COVID Policy (ZCP) which has been modified but is still exerting a severe negative influence through 2022, as lockdowns move from city to city and sharply curtail activity. After admitting in May that the economic situation was "worse than in 2020", Premier Li Keqiang rolled out policies that were touted as "more forceful" than two years ago – but the dampened confidence caused by lockdowns means many transmission mechanisms are broken. If China exits ZCP, even in a bumpy fashion with some health issues and reversals, it could unleash some pent-up demand and vastly improve confidence, though the rebound will not be as big as after Western economies reopened from extremely depressed levels.

Zero-COVID policies continue to hurt growth in China...

Another huge benefit of reopening will be tourism, both for China's domestic hospitality sector (Figure 22), but also the rest of the world, which will again have millions of visitors spending money at restaurants and hotels, losing money at casinos, and buying various entertainment services. A second possible upside is that the effort to stabilise the property sector works better than in other real estate busts, in the UK and US for example, where 20-30 per cent declines in house price indices and collapses in housing starts were followed by L-shaped recoveries that took 5-6 years to regain an upward trajectory. China is helped thus far by GDP that is still growing, prices that haven't collapsed, a smaller supply overhang, and well-capitalised banks that have avoided a crisis despite widespread developer distress. Finally, the political cycle is perhaps underestimated, but has probably acted as a constraint on SOEs and local governments, which are afraid of mistakes and corruption probes ahead of possibilities for career advancement. Following October's Party Conference and the March 2023 implementation at the National People's Congress, more aggressive investment projects may be deployed, and if this happens (a big if) the private sector may also see a more pro-business stance by the ruling party, after years of harsh new rules and insecurity.

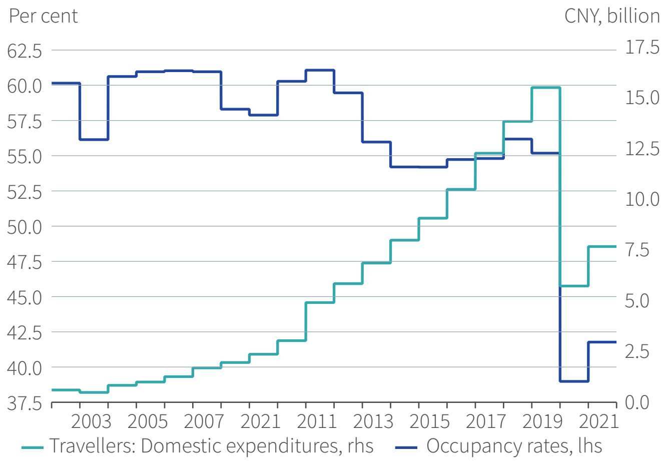
...but other initiatives are boosting growth possibilities

Figure 21. **Public debts now worryingly high in most places**
Central government debt as a per cent of GDP in the G7



Source: Aviva Investors, Bloomberg, Macrobond, IMF as at 3 October 2022

Figure 22. **Tourism is still being hit hard**
Tourism data



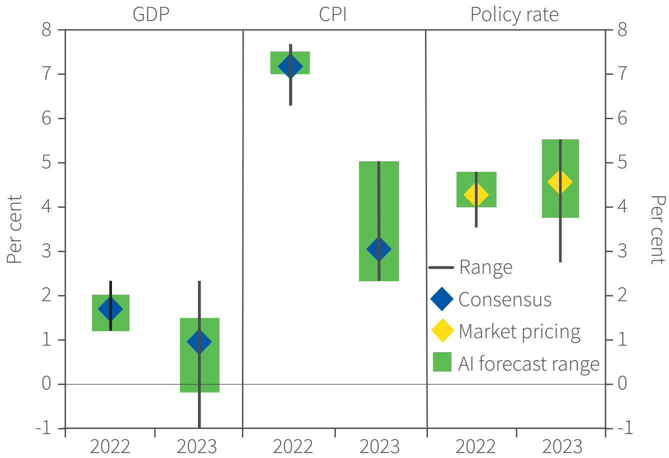
Source: Aviva Investors, Macrobond as at 3 October 2022

Macro forecasts charts and commentary

US

Despite the reported decline in GDP in 2022H1, the US economy appeared to remain fairly robust. A range of survey data, as well as readings from the labour market suggest that demand was still strong and that there was very little spare capacity in the economy. Inflation rose further, with core measures reaching around 6 per cent, as core services such as housing rose strongly. The ongoing strength of core inflation reflects the tight labour market, with wages rising at between 5-6 per cent and companies being able to maintain high profit margins. The Federal Reserve has moved swiftly to raise the policy rate into restrictive territory, with further rate hikes expected. We think that tightening in policy will slow demand through 2023, with the US likely experiencing a mild recession. That should ease inflationary pressures, although not enough to bring inflation back to target by the end of 2023.

Figure 23. **US**

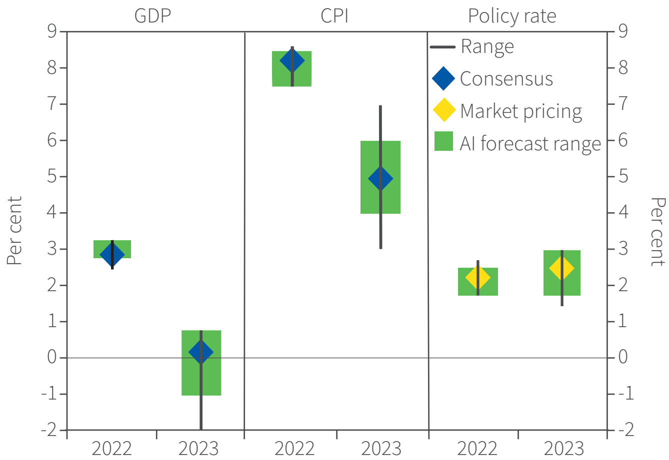


Source: Aviva Investors, Macrobond as at 3 October 2022

Eurozone

Growth prospects continue to be revised lower, while inflation is still showing no signs yet of retreating meaningfully. The energy shock is already having a major impact on activity, real incomes and sentiment and may on its own be sufficient to push some of the major economies and the region overall into recession over the winter quarters. In addition, the ECB has joined the growing group of central banks asserting that a slowdown in demand is necessary to address the underlying inflation issue. Their messaging has changed noticeably over the last three months and financial markets have reacted accordingly. Fiscal policy initiatives can help offset some of the immediate pain but cannot and should not prevent some difficult adjustments to changed circumstances. Inflation should fall back next year, and demand stabilise, but the ECB looks set to hike to between 2 per cent and 3 per cent – they have said they, like the Fed, need to move into restrictive territory.

Figure 24. **Eurozone**

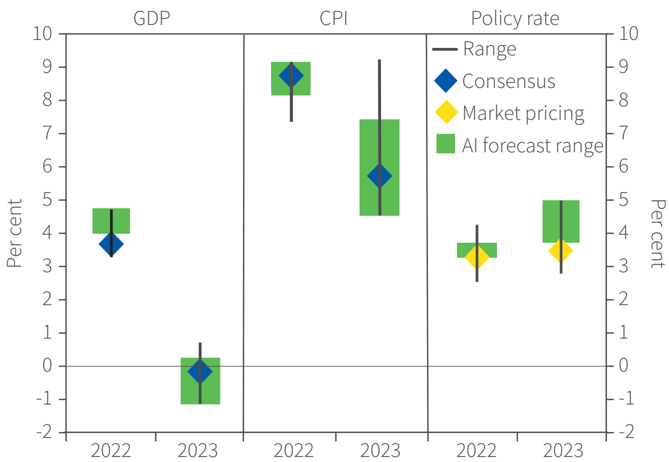


Source: Aviva Investors, Macrobond as at 3 October 2022

UK

Disastrous domestic politics and poor economic outcomes have blighted the UK in recent years. Some of the drivers have been common to several other nations, but others have been entirely of their own making. After the traumas of Brexit and the pandemic came the instability of the Johnson administration. Any hopes for a return to comparative calm under new PM Liz Truss have been swiftly dashed by some woeful misjudgements on new policy initiatives. These have been greeted with financial market turmoil and rewarded with a sudden 33-point deficit in the polls. A year ago, the ruling Conservatives were 8 points ahead. The immediate outlook is grim, with recession likely to be accompanied by stubbornly high inflation – even with the energy price cap – and more rate hikes from a hawkish Bank of England. As elsewhere, inflation should fall back in 2023. But if fiscal policy is loosened 'excessively', the monetary stance may have to remain tougher for longer.

Figure 25. **UK**

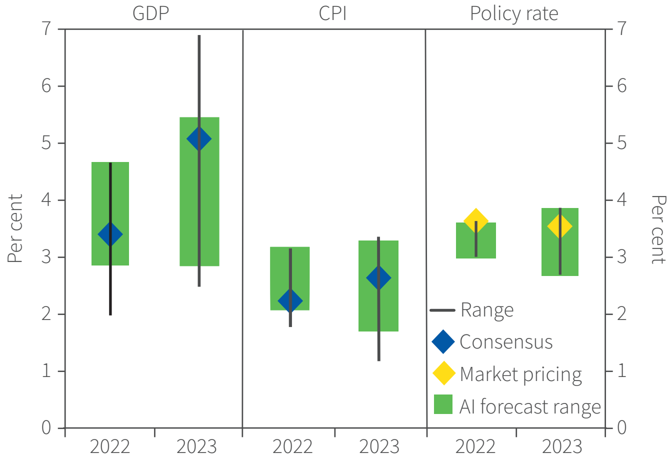


Source: Aviva Investors, Macrobond as at 3 October 2022

China

The property market damage continues to be a major drag on spending and local government revenues; it has been exacerbated by the rolling lockdowns to impose the Zero-COVID Policy (ZCP). A Q3 rebound after Q2's -2.6 per cent growth is likely, after the disastrous shutdown of Shanghai ended, but predicting the path ahead is fraught. Gradual reopening may cause a COVID wave that is met with renewed lockdowns, but eventually abandonment of ZCP in Q2 will lift 2023 GDP. After the October Party Congress, political fear and paralysis should ebb, but the focus on social control, Common Prosperity, deleveraging and de-risking, and self-sufficiency will dominate economic concerns in Xi's third term. Weak demand is keeping core CPI under 1 per cent, and the PBoC is focused on liquidity provision and modest rate cuts; the 'dirty float' will probably adjust to around 7.50-7.80 per dollar.

Figure 26. **China**

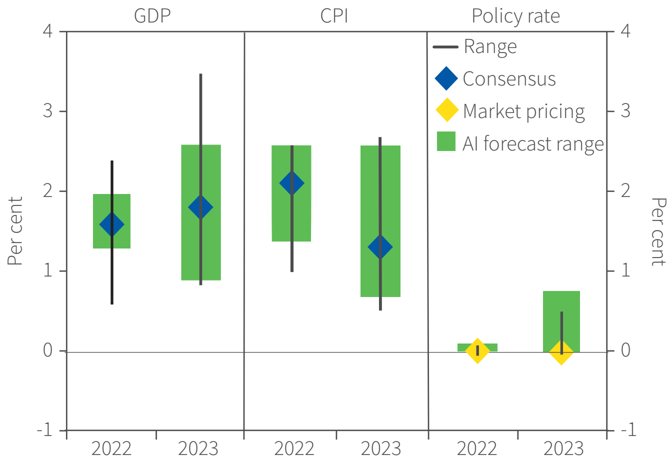


Source: Aviva Investors, Macrobond as at 3 October 2022

Japan

Japan's reopening is continuing slowly, and GDP is still below its pre-pandemic level. Sub-2 per cent growth is dampened by the very gradual removal of COVID restrictions, and the drag from net exports. Authorities are not yet confident that inflation is durably at or above 2 per cent . The weak yen will help this, and while the currency is already at historical lows on an REER basis, the structural changes in Japan's economy over decades, the terms-of-trade shock over the past couple of years, and the BoJ's divergence with other G10 monetary authorities justifies multi-decade lows. The extreme weakness in the yen has been met by unilateral JPY intervention; this is probably futile but indicates the government will likely, eventually, direct the BoJ to abandon its adherence to Yield Curve Control and possibly negative interest rates.

Figure 27. **Japan**

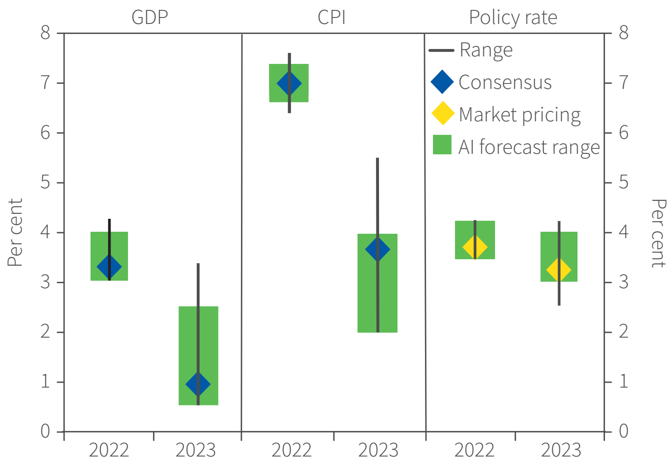


Source: Aviva Investors, Macrobond as at 3 October 2022

Canada

Unusually, the Canadian economy continued to grow robustly in the first half of 2022, even while its much larger neighbour apparently shrank. Part of the reason for the difference was that Canada benefited from surging commodity prices. Looking ahead, however, growth is expected to slow significantly as high inflation squeezes real incomes and as a response to one of the most aggressive hiking cycles ever by the Bank of Canada in the last six months. They may not be 'ahead of the curve', but they might be closer than others. At this stage, a recession does not look imminent, but one cannot be ruled out for 2023, especially if the US economy softens as we expect. As elsewhere, inflation remains the main macroeconomic problem, but should fall back next year. Canada has more limited trade connections with nations impacted by the war in Ukraine and is, of course, a major energy exporter.

Figure 28. **Canada**



Source: Aviva Investors, Macrobond as at 3 October 2022

Global market outlook and asset allocation

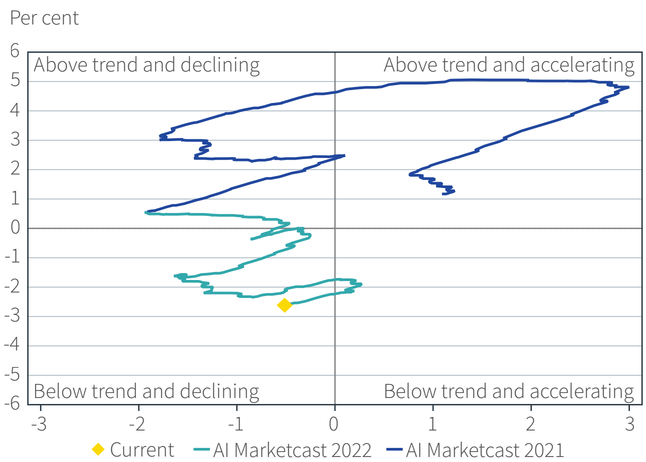
- **Inflation broadening amidst aggressive central bank tightening remains the dominant dual theme, with direct impact on rates and strong influence on risk assets**
- **Governments' more proactive approach to fiscal support, in response to energy price shocks, may reduce economic volatility relative to no support, yet increases the risks of policy mistakes**
- **Commodity prices and global fragmentation are a combined terms-of-trade and confidence shock, boosting the dollar but also creating relative winners and losers in FX**

The deteriorating macro environment creates a challenging outlook for credit and equity markets, with outcomes skewed toward downside scenarios; these risks are somewhat mitigated by the strong fiscal response, which may have its own set of unintended negative consequences. Central banks are determined to bring inflation to heel, having mostly abandoned the idea of soft landings and normalisation. Policies will be tight, and in some cases will induce recessions; this is in part a reaction to overly easy fiscal-monetary policy mixes during the strong post-COVID rebound as well as Russia's invasion of Ukraine and the impact on commodities, and the concomitant global fragmentation and supply chain issues that continue to impact price pressures. Yield curves have adjusted significantly as we are now in the intermediate stages of an aggressive synchronised global hiking cycle, with some laggards and a few already reaching terminal rates. This tightening in financial conditions is exacerbating the growth slowdown, but this is a feature, not a bug: stock and bond markets are under stress from both factors, and the dollar remains supported too. Eventually, this combination will lead to slack emerging, and central banks will be able to take their heavy feet off the brake pedal – but not yet.

Bringing inflation to heel means further economic slowdown and market stress

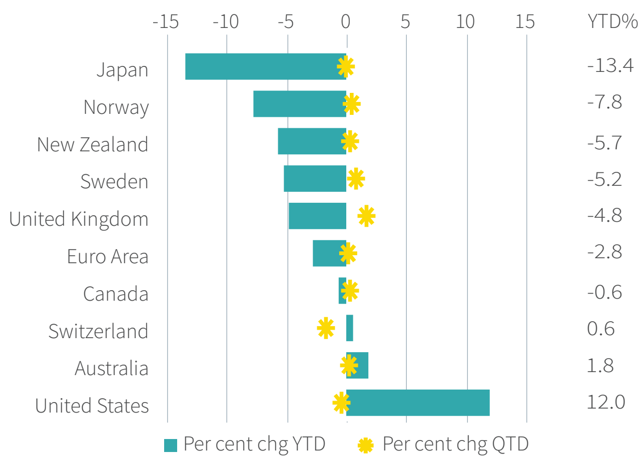
Despite ongoing strength in inflation, the economic cycle is now firmly in the below-trend and declining quadrant of the growth cycle and the market pricing is broadly consistent with this view (Figure 29). While fiscal policy is attempting to push back on the negative impact of rising energy prices, it will only partly mitigate the growth slowdown: below-trend growth is needed to moderate inflation. In economies such as the US where the energy impact is smaller and the economy more robust, the slowdown will need to be instigated by the central bank. Market pricing of the growth cycle usually moves a little ahead of the economic cycle given economic data is released with a lag and investors look to the future. Are we close to a point where the negative trend ends, and the market can start to price in incremental improvement

Figure 29. **Aviva Investors market implied pricing of global growth**



Source: Aviva Investors, Macrobond as at 3 October 2022

Figure 30. **JP Morgan real effective exchange rate changes in 2022**



Source: Aviva Investors, Macrobond as at 3 October 2022

in the growth outlook? Much has changed over the last few years, but some lessons shouldn't be given up too easily – don't fight the central banks. Bear market rallies may occur but for as long as central banks are actively tightening to slow economies, the market will struggle to sustainably price an improving outlook for growth and the current risk-off environment for growth-sensitive assets will persist.

A slowing growth environment has historically been supportive for the US dollar and this most recent period has been no exception. Rising rates and a superior growth outlook in the US relative to other developed market (DM) economies has also supported dollar appreciation. The dollar has appreciated nearly 7 per cent in real effective terms over the last quarter, taking the year-to-date change to over 12 per cent (Figure 30) and the level to the highest seen since November 1985. It is unsurprising then, that investors are questioning how much further this trend can run. With the outlook for the dollar so tightly tied to the rates and risk outlook, the current environment of dollar strength is expected to continue for as long as the Fed's active tightening stance persists. The recent tightening in financial conditions has been sharp (Figure 31) with all the drivers moving in the same direction: rates rising, credit spreads widening, equities falling and the dollar appreciating. Only when the trend in inflation is clearly reversed will central banks look for looser financial conditions.

Slower global growth, Fed hawkishness and 'US exceptionalism' support the US dollar

Aside from the broad trend of dollar strength, currencies with less hawkish central banks and deteriorating terms-of-trade have been more at risk, e.g. sterling, yen, won and yuan; a handful of emerging markets also have wide trade deficits and problematic fiscal metrics. However, many EM currencies benefit from high commodity prices, and have raised interest rates to quell inflation and stabilise exchange rates – as such, EM FX may outperform many G10 currencies, especially when carry is taken into consideration, even as the USD remains 'king'.

It goes somewhat against the grain for central banks to be actively seeking to tighten financial conditions further in a 'below trend and declining' growth environment. This time it's different. With central banks actively trying to create a growth slowdown, rather than reacting to one, the relationship between fixed income and risk assets has flipped. Over the last 20 years the growth cycle and growth-sensitive assets have driven rates; now rates are in the driving seat. Figure 32 shows the rolling correlation between US treasury return and US equities which has now turned positive. In the bottom panel we split correlation according to the return environment for equities and we can see that not only has the correlation turned positive, but it is more positive in periods of declining equity markets.

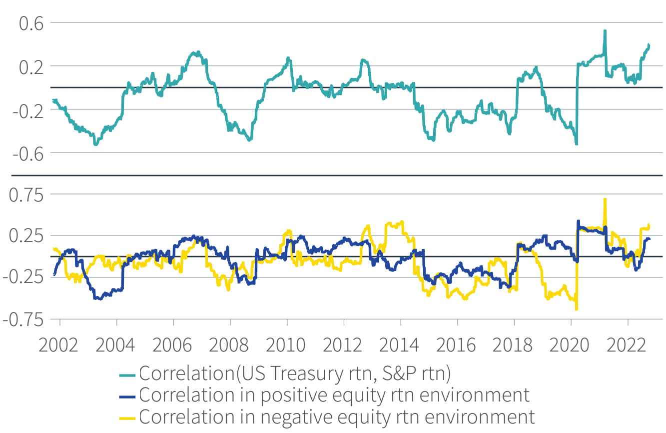
Central banks will not look to defend markets, reversing bond-equity correlations: government bonds don't effectively reduce portfolio volatility

Looking forward there is no doubt that central banks are closer to the end of their hiking cycles than the beginning. Real yields may yet need to move higher still to sustainably bring inflation back under control, and the reliance on current inflation as an indicator for when the job is done makes it more likely than not that the more aggressive central banks overtighten.

Figure 31. **US financial conditions**

Source: Aviva Investors, Macrobond as at 3 October 2022

Figure 32. **US Treasury total return corr to SPXT**
Wkly chgs, 1y rolling window



Source: Aviva Investors, Macrobond as at 3 October 2022

Given current levels of yields in major economies, the outlook for fixed income from here over the longer term is likely positive but timing entry will be tricky and highly sensitive to depth and breadth of inflationary pressures.

With so much of the outlook determined by inflation and the subsequent policy response, it is unsurprising that market volatility has been elevated. As we have seen in the UK in late September, fiscal policy has the potential to have very significant ramifications for market pricing and monetary policy decisions. Divergences in fiscal policy could create opportunities for relative value plays going forward. Playing these divergences will also help reduce the need to perfectly time the rotation from short to long bonds.

Fiscal policy complicates matters, for bond markets and for monetary authorities dedicated to reining in inflation

Slowing and below-trend growth alongside the absence of any meaningful 'central bank puts', rising real rates, and heightened uncertainty due to geopolitical risks have resulted in a challenging environment for equities. Our view is that this negative environment is likely to persist over the next six months. Moreover, despite being able to pass on many input and labour costs, earnings per share (EPS) estimates continue to trend down (Figure 33). As our title suggests, the bottom will likely be reached only when PMIs and leading indicators durably improve from low levels, inflation and employment soften enough to allow central banks to assuage rather than induce "pain", as Jay Powell terms it. That said, on a structural, multi-year view, equities are likely to produce positive, perhaps even excess-to-cash returns, as long as a deep recession or financial crisis is avoided.

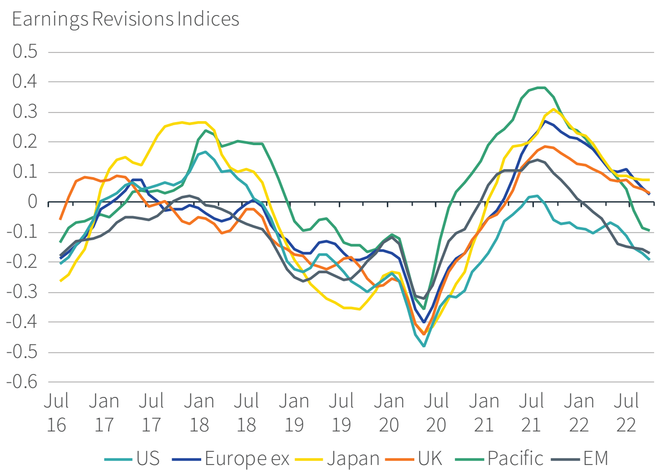
Equities continue to bounce downward in volatile fashion, as fundamentals worsen

A similar logic applies to corporate bond spreads: they are strongly correlated to the shape of yield curves (a proxy for monetary stances), as well as real yields, commodities and growth. None of these are supportive, and unlikely to change near-term. Inverted yield curves and restrictiveness in lending, as well as capital markets that have sporadically shut down, usually portend a rise in High Yield defaults (Figure 34). There are good reasons to be hopeful that coming recessions will avoid the huge, multiyear spikes in defaults seen in the GFC and dot-com crash, but credit deterioration leads us to expect some further HY underperformance of cash. Junk spreads usually peak around 1000bps as a recession of unknown duration and magnitude hits and we anticipate further spread-widening relative to investment grade (IG), where shorter duration bonds should be better at holding their value.

The coming default cycle may prove to be mild, but has barely started (outside of China)

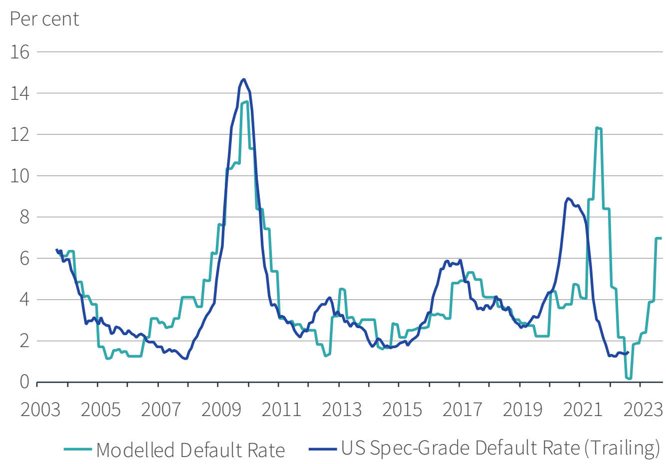
The asset allocation table applies the above considerations to further reduce equity exposure, which has been steadily reduced from +3 during the reopening period of 2020-21, and now sits at zero, with Europe underperforming. Government bonds and HY are underweights, with IG and higher grade EM, along with cash and (hedged) UK equities preferred, alongside a heavy long dollar overlay.

Figure 33. **Equity earnings trends are heading downhill rapidly**
(Avg of 3, 6, 12m changes)



Sources: Thompson/Reuters DataStream, MSCI, Aviva Investors as at 3 October 2022

Figure 34. **US HY default rate regression model**
Annual default rate



Source: Bloomberg, Federal Reserve, Moody's; Aviva Investors as at 3 October 2022

Figure 35. **Asset allocation**

	Underweight										Overweight
	-5	-4	-3	-2	-1	0	1	2	3	4	5
Equities						0					
US						0					
Europe					-1						
UK							1				
Japan						0					
Pacific Basin ex Japan						0					
Emerging Markets						0					
Nominal Govt					-1						
United States					-1						
United Kingdom						0					
Germany						0					
France						0					
Italy					-1						
Japan					-1						
Canada						0					
Australia						0					
Credit						0					
US Investment Grade							1				
European Investment Grade							1				
Asian Investment Grade						0					
UK Investment Grade					-1						
EUR High Yield					-1						
US High Yield					-1						
Emerging Govt (Hard Currency)							1				
Emerging Govt (Local Currency)						0					
Alternatives						0					
Cash									3		
Currencies (vs USD)				-2							
GBP				-2							
EUR				-2							
JPY					-1						
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 as at 3 October 2022

Contact us

Aviva Investors
St Helen's, 1 Undershaft
London EC3P 3DQ
+44 (0)20 7809 6000

www.avivainvestors.com

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