# House View Q2 2023

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

## Financial fragilities emerge

With interest rates having risen sharply and central bank balance sheets shrinking, the tide of global liquidity that has flooded the financial system for much of the past decade is receding. For those who have taken on too much leverage, relied too much on cheap and easy liquidity and became too exposed to duration (in the broadest sense), it will be a challenging time. Some business models will no longer be viable – particularly those that have little cash flow generation and instead are long on promises of future returns. Since the peak in equity markets in 2021, valuations on those companies have fallen sharply and some have failed. As we write this quarterly update, we have witnessed a bank run in the United States, and the failure of three medium-sized banks (each of which had close ties to more speculative parts of the economy). In Europe, Credit Suisse, one of the 30 so-called Global Systemically Important Banks (G-SIB), having been in a downsizing process for some time, saw a sudden collapse in confidence of depositors that resulted in a hurried government-facilitated take-over by fellow Swiss bank UBS.

Tighter monetary policy has revealed some vulnerabilities

Following a decade or more of near-zero interest rates and quantitative easing, it should not come as a great surprise that some were unprepared for a higher rates environment. But while there will undoubtedly be further failures, we remain of the view that overall non-financial private sector balance sheets are in good shape. Financial sector balance sheets are also far more robust than in the lead-up to the GFC, with regulators requiring much greater capital and liquidity buffers for banks; some important rules and "plumbing" improvements ought to stabilise "shadow banks" as well. However, confidence can evaporate quickly, and in a world of digital banking, deposits can run much more easily than in the past. We therefore remain cautious about the near term, with financial stability risks at the forefront of the mind. We expect central banks to use the full range of tools available to manage further liquidity issues.

Private balance sheets are healthy, but confidence can wane quickly

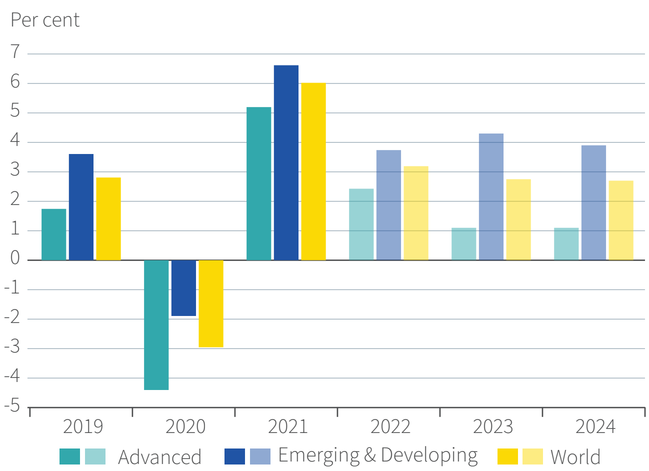
Away from the recent events in the banking system, it is because of the rapid recovery from Covid, aided by fiscal stimulus and the hit to supply, that central banks found themselves having to deal with excess demand and inflation way above target. The objective of raising rates is not to cause the sort of financial distress described above, but rather to temper demand across the economy in the short term, in order to ensure a sustainable long-term growth and inflation outcome.

Central banks are not trying to create distress – but that doesn't mean it can't happen

Indeed, despite the financial challenges faced from higher interest rates, growth has been more resilient than expected. Aided by a decline in energy prices, with a mild winter in the northern hemisphere helping to reduce demand for natural gas, growth appears to have picked up in early 2023. Alongside the rapid reopening in China following the lifting of Covid restrictions, global growth is likely to get off to a better start than expected this year. We had projected

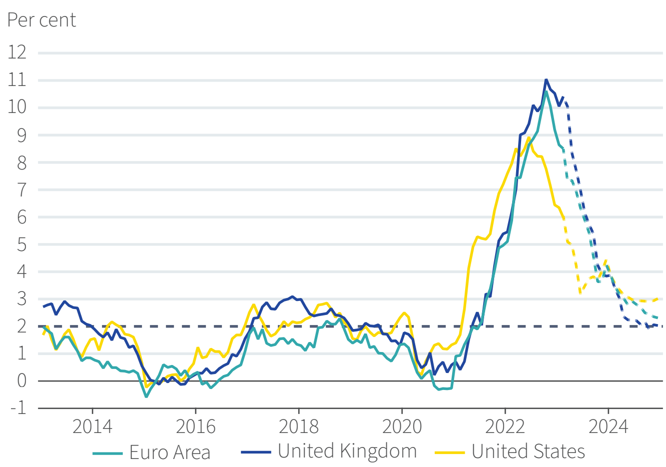
GDP growth has been resilient in early 2023

*Figure 1.* **Aviva Investors growth projections**




Source: Aviva Investors, Macrobond as at 23 March 2023

*Figure 2.* **Aviva Investors CPI inflation projections**




Source: Aviva Investors, Macrobond as at 23 March 2023

shallow recession in the Eurozone and United Kingdom to start around the end of 2022 and last into 2023. That now looks too pessimistic. In the United States we had expected growth to slow through 2023 with a shallow recession in H2. We have revised growth a little higher for this year, mainly due to the better start to the year, but still see a likely recession coming in late 2023 or early 2024.

Overall, our global growth projection for 2023 is 2¾ per cent, with a similar rate of growth expected in 2024 (Figure 1). We see the risks to this growth outlook as tilted to the downside. First, while it is too early to have any clear view on the impact of the regional banking issues in the US and the demise of Credit Suisse in Europe, there is potential for a greater tightening in credit conditions than expected. One particular area of concern for mid-sized banks in the US could be commercial real estate (CRE) exposure, which has grown significantly over recent years. Second, the war in Ukraine continues, with a new offensive likely in Spring; this could once again impact energy prices, especially the global LNG market for which Europe and Asia will fiercely compete. Finally, we can't rule out the possibility of a more severe bout of financial stress, particularly if confidence in the banking system weakens further. The main upside risk to growth could come from a re-energised China. While the property sector is expected to remain moribund, pent-up demand for household spending, especially on services may see growth comfortably beat the announced target of 5 per cent.

Growth risks remain to the downside this year and next

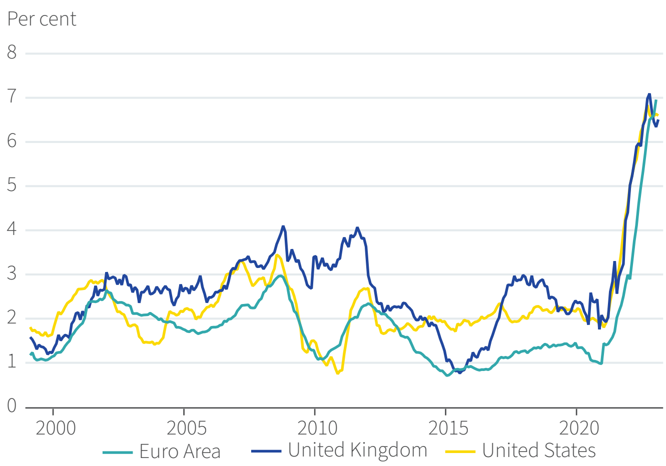
With oil and gas prices easing, alongside significant government subsidies for natural gas in Europe, the peak in headline inflation now looks to be well behind us (Figure 2). We assume that wholesale energy prices follow futures markets over the year ahead, which implies a further significant decline in the contribution of energy to headline inflation. By itself, that should subtract another 2-4 percentage points from headline inflation in the Eurozone and UK and around 2 percentage points in the US. While the developments in headline inflation are encouraging, the same can't be said for underlying or core measures. These remain uncomfortably high and sticky at around 6 per cent across the major economies. Current underlying inflation tends to be a better predictor of headline inflation in the subsequent 12-18 months, as it strips out a range of noisy elements that are less important for gauging medium-term pressures. We prefer to look at measures that "trim" the outlying components each month – an approach that central banks also tend to use (Figure 3).

Lower energy prices are pushing headline inflation lower, but core measures are proving much stickier

These measures show that the strength of underlying inflation reflects a broad-based ability for companies to both pass on higher input costs and maintain (or even expand) margins. Wage growth across the major economies remains quite elevated, reflecting extremely tight labour markets – partly reflecting robust demand, but also reduced labour supply. Looking ahead, we expect the period of weaker growth and shallow recession to ease pressures in the labour market, with the unemployment rate expected to rise, and therefore to ease wage growth. That in turn is expected to reduce inflationary pressures, and is expected to coincide with a decline in margins. As such, we do expect underlying inflation to ease back throughout 2023 and 2024,

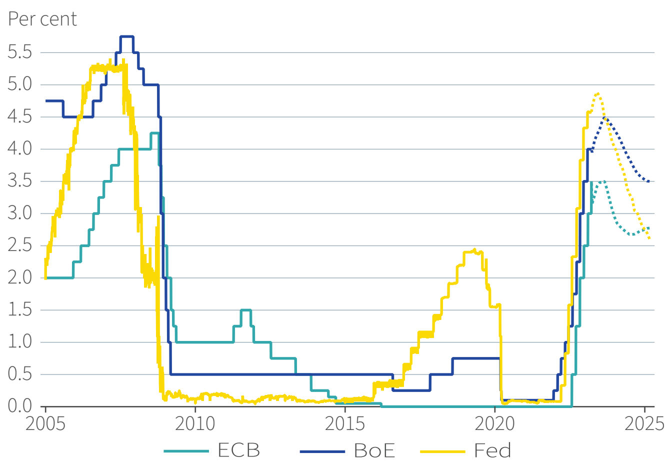
Core inflation should also fall back – albeit more slowly – but risks are to the upside

*Figure 3.* **Underlying inflation (trimmed-mean measures)**




Source: Aviva Investors, Macrobond as at 23 March 2023

*Figure 4.* **Policy rates and market-based expectations**




Source: Aviva Investors, Macrobond as at 23 March 2023

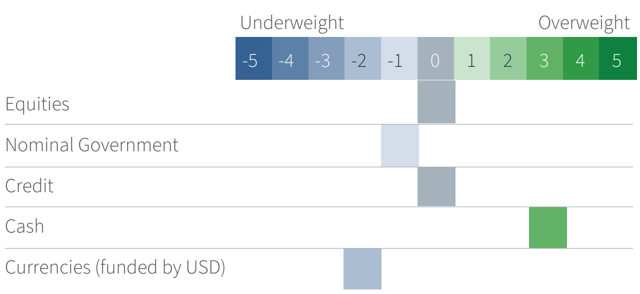
albeit somewhat sluggishly, towards 2 per cent. However, the uncertainty around that outlook is elevated, with potential for further near-term pressures from persistent wage growth and a modest rebound in global goods price inflation as Chinese demand rises. Further out, the risks are more balanced.

Central banks remain in generally hawkish mood, but the end of rate hikes could be close

The economic and financial market uncertainty created by recent events in the banking system is expected to leave central banks more watchful in the coming months. That means that the rapid rate hiking cycles that have been running for a year or more may be paused, or even come to an end (Figure 4). In our year-ahead Outlook published in December, we expected the Federal Reserve, ECB and Bank of England to reach the peak of the tightening cycle by the end of 2023 Q1, with rates of around 5 per cent, 3 per cent and 4 per cent, respectively. Now we have arrived there, we have seen those rate hikes delivered (with only the Bank of England having gone further to 4.25 per cent). If there is no further contagion across the banking system over the next 2-3 months, we think we may see some further rate increases around the middle of the year, as the inflation backdrop remains so challenging. However, if credit conditions are seen to be tightening sharply, then we will be at the end of the tightening cycle and the potential for rate cuts before the end of the year will increase. We will be closely monitoring information on bank lending and surveys on credit availability in particular.

That macro backdrop is one that we expect will result in continued financial market volatility. Uncertainty at turning points is always elevated, but the nature of this cycle is unique, extremely fast-paced and everchanging. We have no misgivings about not having any high-conviction tactical or structural asset class views, apart from keeping cash levels high. Equities and credit have repriced through 2022, but not to “buy” levels, especially ahead of a recession. Financial strains might eventually precipitate rate cuts, but for now inflation is keeping policymakers hawkish, and some cuts are already priced in, keeping us neutral on government bonds as well (Figure 5) – though yields may still push higher in Japan and core Europe. We are broadly neutral on the dollar, but the growth slowdown may still prove a challenge for EM FX; a more dovish BoE meanwhile could weaken sterling, even as it helps UK equities and gilts outperform.

*Figure 5.* **Asset allocation**




Source: Aviva Investors, Macrobond as at 23 March 2023

# Key investment themes and risks

## Investment themes

1 **Shallow recessions**
2 **Inflation persistence and uncertainty**
3 **Fiscal backstops**
4 **Global fragmentation**
5 **Energy security, commodities and decarbonisation**
6 **Changing market structures**

## Shallow recessions

Activity news over the last three months has generally surprised on the upside, leading to modest improvements in the growth outlook (Figure 6) and an increasing hope that even shallow recessions might be avoided this year. But recent concerns about vulnerabilities in parts of the banking sector challenge that momentum and are leading to a further negative reassessment. While we do not believe that we are witnessing a re-run of the 2008 financial crisis, the fact that we are even making those comparisons is worry enough: the banking model depends on the confidence of its depositors. For regulators, balancing contagion risk against moral hazard is never easy: while doubts about the resilience of banks endure, so too will risks of disorderly adjustments, weaker sentiment, slower growth and jittery financial markets. Any tightening in financial conditions that results will slow activity via the credit channel and could mean that requisite policy rate peaks are lower than previously thought. Our base case for the major central banks remains similar to that we outlined three months ago, although a lot has happened in the interim. Weak growth is the best that can be expected in most developed markets in 2023, with some regions still likely to experience modest recessions.

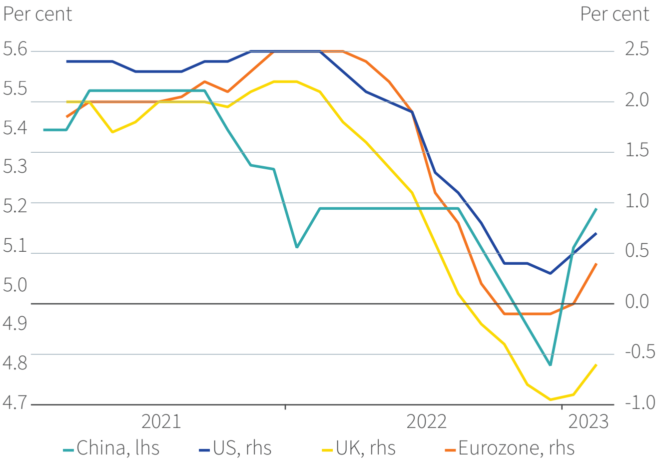
Although growth has been resilient, shallow recessions are still likely

## Inflation persistence and uncertainty

Until usurped by worries about the banks, stubbornly high inflation (alongside the related hawkishness of central banks) was the dominant theme driving markets and economic commentary. Now relegated to second place in investors' list of concerns, it is important to remember that the issue is still there and remains relevant. Lower energy prices are now helping push inflation down and further declines are certain in coming months. By our estimates, these alone should shave between 2 and 4 percentage points off headline inflation by the end of the year. While that is welcome and will help ease the real income squeeze, concerns had already moved to underlying inflation (Figure 7) , services prices and (tight)

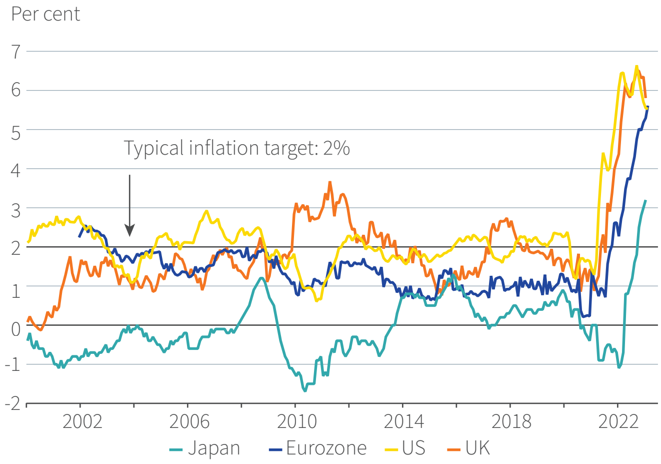
Core inflation is still stubbornly, and worryingly, high

*Figure 6.* **Consensus growth forecasts for 2023**
Modest upgrades welcome after relentless downgrades in 2022




Source: Aviva Investors, Macrobond as at 23 March 2023

*Figure 7.* **Core inflation in the major nations**
Underlying inflation has not yet peaked in some places




Source: Aviva Investors, Macrobond as at 23 March 2023

labour markets, all of which tend to exhibit a more worrying “stickiness”. As we stressed three months ago, inflation trends are always determined by the interaction of supply and demand. Supply disruptions have been a critical part of such dynamics in recent years (COVID, global trade, energy shock, labour supply), but demand is probably the key driver now. Central banks, in general, still feel that they need to suppress demand in order to regain control over inflation. And if that doesn’t work as they would like, then they will do more or keep rates in restrictive territory for longer, providing that underlying conditions allow them to do so.

## Fiscal backstops

Fiscal policy was already coming back into favour in the years before COVID, but the unprecedented fiscal assistance required and provided during the pandemic, followed by the many major government responses to the energy shock, have added significantly to that momentum. Alongside a more broad-minded approach to acceptable or “prudent” deficit and debt benchmarks, this has led to a growing acceptance that more activist fiscal initiatives are useful and appropriate policy tools. This does not mean that such expansionist policies can be pursued indiscriminately (see also risks section below), but it does mean that any assessment of the macroeconomic outlook must take more explicit account of fiscal as well as monetary policy. Companies (including financial institutions) and households now expect fiscal measures to be a customary part of the environment. The latest important examples of this are the Inflation Reduction Act (IRA) in the US and European responses to that – several of which are still being formulated. Higher military spending is also set to add the overall idea of more public sector demand becoming the norm. There are many strands to the IRA, but those relating to subsidies for clean energy are getting most attention (Figure 8). While laudable in its intentions, there are dangers that frictions to trade flows are introduced (some deliberately – think China) and that competitiveness is reduced.

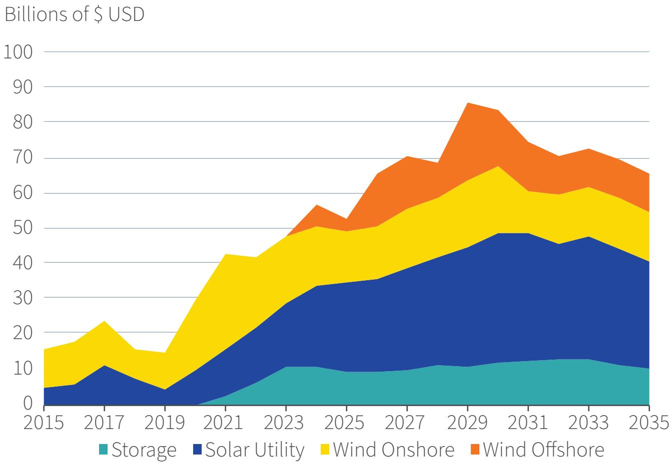
Fiscal policy is back in favour in many places, helped in part by the green transition agenda

## Global fragmentation

At the World Economic Forum in Davos earlier this year the IMF highlighted that geo-political tensions are making it more difficult to address a number of vital global issues. The shift towards a new “Cold War” of rival economic blocs risks reversing many of the earlier gains from greater global integration. While urging nations not to squander the peace and cooperation dividends which have made billions of people wealthier, healthier and better educated, the IMF did acknowledge that not everyone has benefited: dislocations from trade and technological change have harmed some, while public support for openness is on the wane in many countries. Since the GFC, and accelerated more recently by the pandemic and the war in Ukraine, cross-border flows of goods and capital have levelled off. Countries have always placed some restrictions on trade in goods, services and assets for legitimate economic and national security considerations (Figure 9). But the danger is that increased focus on security and ensuring resilient supply chains could result in more damaging self-

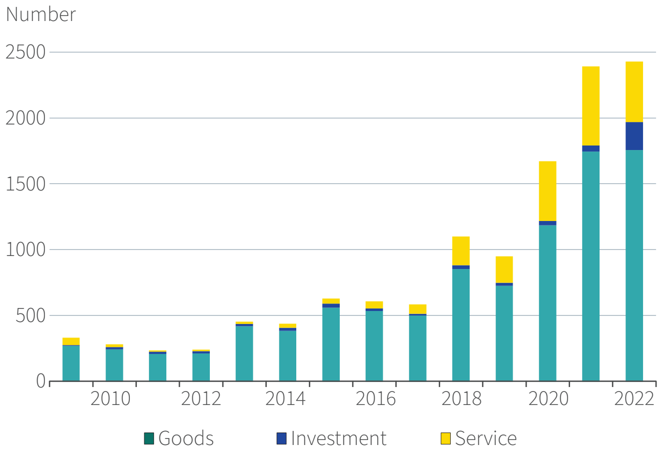
The trend towards ever-greater globalisation is over; the dangers from a reversal are significant

*Figure 8.* **Projected US renewable energy investment under the IRA**
Cleaner energy is a very important part of the act




Source: Wood Mackenzie as at 23 March 2023

*Figure 9.* **Trade restrictions imposed (number)**
Restrictions have risen as global integration has slowed or reversed




Source: IMF as at 23 March 2023

interest and lead to self-defeating reciprocal measures from others. The world has definitely moved in this direction, with some justification, but it is important to find an appropriate balance. The IMF estimates that the cost of such "geo-economic fragmentation" ranges from around 1 to 7 per cent of global output (spread over many years). More worryingly, they also suggest there could be further longer-term detrimental effects from reduced migration and capital flows, lower technology sharing and a general decline in international cooperation.

## Energy security, commodities and decarbonisation

There is a danger that the capacity of a major event – war in Ukraine – to shock, diminishes over time. But that conflict is ongoing, even if there appears to be a stalemate for now. There is every chance that Spring offensives, by either Russia, Ukraine or both, change the landscape again in coming months. The war has focused attention on energy security in the short term and has led to sharply lower dependence of large swathes of Europe on Russian supplies in an impressively short space of time. That, combined with the mild winter, has meant that shortages have been rare, and that rationing has thankfully not been necessary. Prices have dropped significantly as a result (Figure 10), although they remain high by historical standards. The conflict also led to spikes in several other commodity prices, all of which have retreated since. In the short term, scrabbling for alternative energy supply led to renewed use of fossil fuels to fill the gap. But over the longer term, exactly the reverse is likely to be true, with the Russian invasion acting as a catalyst for energy transition and faster decarbonisation.

Energy prices have, thankfully fallen back; but the Ukraine war has re-focused attention on the energy and commodity complex

## Changing market structures

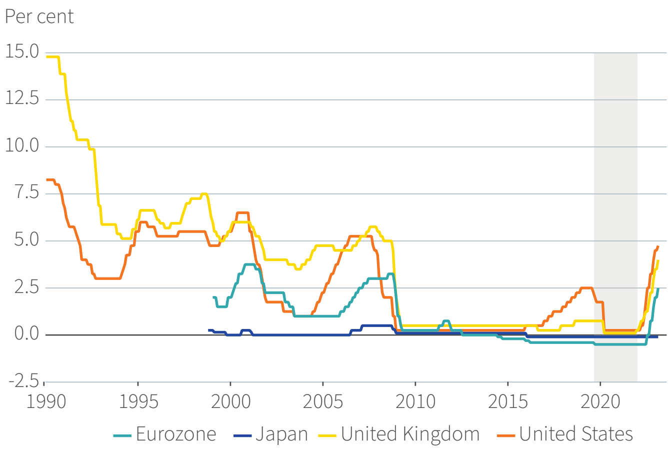
The recent experience among US regional banks serves as a reminder of Warren Buffet's famous aphorism that it is "[o]nly when the tide goes out that you discover who's been swimming naked". It is not right to assert that central banks simply raise interest rates until something breaks, but it is true that higher interest rates hurt and expose weakness and vulnerabilities, especially in areas where complacency may have bred recklessness. After 14 years of ultra-accommodative monetary policy (Figure 11) and suppressed financial market volatility, it was inevitable that the rapid shift to aggressively tight monetary policy would produce some jarring adjustments as agents everywhere attempt to adapt to the new world. The return of inflation – even if it proves transient – argues for higher interest rates for a while yet. Policy rates are undoubtedly above neutral now – that is deliberate and necessary. They will be able to return to neutral or even below only if inflation does retreat in the next year or two. But it is very unlikely that we will go back to the era of zero or negative rates any time soon. The key point is that if this broad assessment is correct, financial markets (as well as many other markets) have to adapt to higher rates, and this is not always smooth: there may be further casualties or collateral damage along the way. In addition, there may be grating changes to previously accepted relationships: between bonds and equities for example.

Financial markets – and others – have to adapt to higher rates. Early signs suggest the transition may not be smooth

*Figure 10.* **European natural gas price (€/MW hour)**
Prices are back below pre-invasion levels


Source: Aviva Investors, Macrobond as at 23 March 2023

*Figure 11.* **Policy rates in the major developed regions**
Policy was loose for a long time




Source: Aviva Investors, Macrobond as at 23 March 2023

# Risks

## Global hard landing

Recent issues in parts of the banking sector have raised the unwelcome prospect of a more generalised "credit crunch". If this were to materialise, it would emphatically increase the risk of a nasty global hard landing. We do not believe that there is, or will be, a more comprehensive banking crisis, although uncomfortable echoes of the 2008 experience mean that even such a small risk should rightly feature as a downside scenario. There could yet be some further banking hiccups in coming weeks and months, but a systemic disaster is, in our view highly unlikely. However, as we stressed three months ago, there are always downside risks anyway when central banks are tightening monetary policy: their explicit aim is to deliberately slow demand growth to address the inflation problem. The risk they move too far, or too fast, is ever-present. Moreover, even if we are right that worries about the banking sector dissipate and that a full-blown credit crisis does not emerge, there is a good chance that some things have changed for good. Or at least for a while. It is very likely that banks will tighten lending criteria in the wake of recent events and that, as a result, overall financial conditions (Figure 12) tighten further, slowing growth. This may help central banks in their fight against inflation, but if it is "excessive", then high inflation – not a problem in 2008 – could prevent them from being able to respond with radical policy loosening.

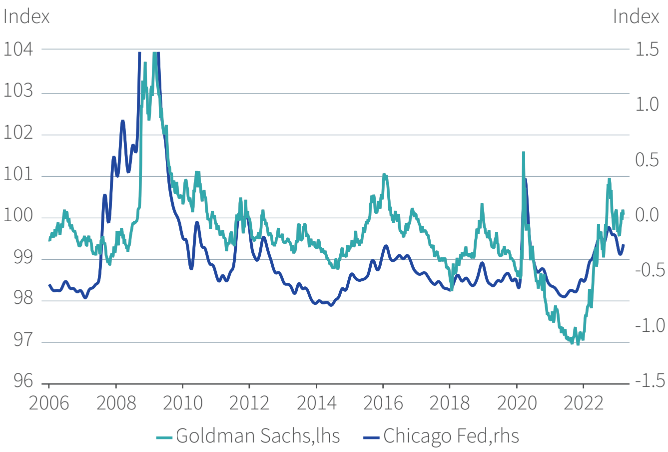
Banking wobbles have increased the risk of a credit crisis and a global hard landing

## More entrenched inflation

Many would argue that high inflation is already "entrenched". After all, headline CPI inflation has been above 2 per cent (the typical target) since July 2021 in the Eurozone, May 2021 in the UK and March 2021 in the US (Figure 13). Surely that is long enough for people to begin to believe that high inflation is back for good. The latest readings have been totally out of line with the experience since the early 1990s and hark back alarmingly to the inflationary disasters of the period before that. Then, inflation was very much entrenched and featured repeatedly in the wage-price dynamics of the day. The evidence today is more mixed, reflecting: either a belief that has been a selection of "one-off" factors which have boosted inflation; And/or a touching faith in the ability of still-credible central banks to return inflation to (or at least close to) target in a reasonably short space of time. There is some truth in both of these (Figure 14), but the risk is that unless inflation falls back quickly, those beliefs will become more challenged. So far there has been no major break-out. Wage inflation has moved higher, but it does not yet suit the description of a "spiral" and may be partly attributable to post-COVID distortions. More encouragingly, inflation expectations are almost all anchored at levels pretty close to inflation targets. The longer high inflation hangs about, the greater the danger of these trends changing for the worse.

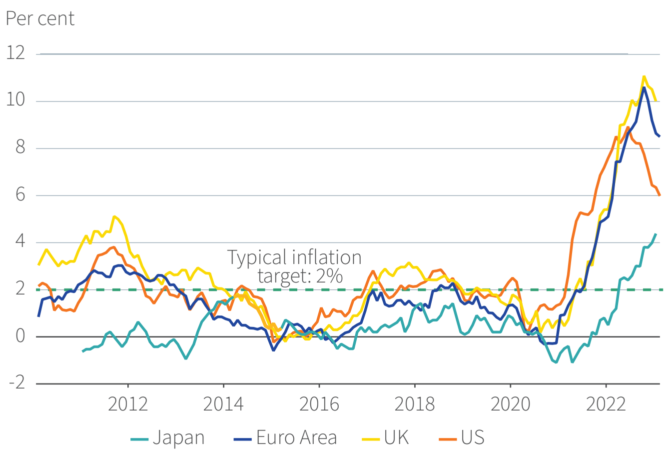
The main worry is that high inflation feeds through to wages

*Figure 12.* **US indices of financial conditions**
Tighter overall conditions may slow growth




Source: Aviva Investors, Macrobond as at 23 March 2023

*Figure 13.* **Headline inflation in the major nations**
Japan excepted, inflation has been above 2 per cent for almost two years



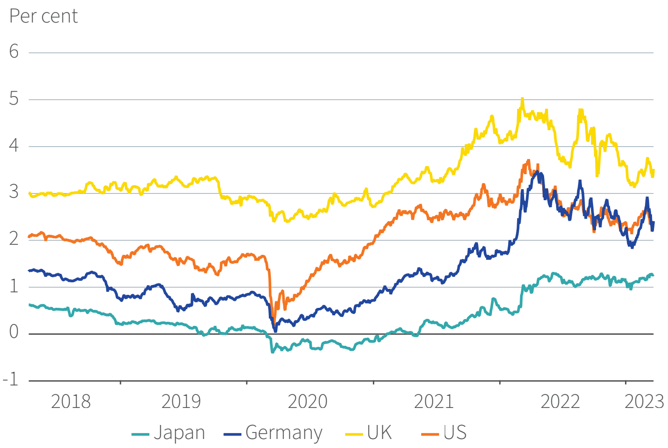

Source: Aviva Investors, Macrobond as at 23 March 2023

## Fiscal sustainability

As we have outlined previously, the algebra of fiscal sustainability is well understood and still applies. Intricate relationships between interest rates, economic growth, inflation and primary budget balances place constraints on what is viable for fiscal policy. Weaker growth, higher rates and lower inflation will all restrain the ability of governments to embark on expansionary fiscal programmes in the immediate future, whatever their wider merits. As well as the "science" of sustainability metrics, there is room for some "art" in terms of flexibility and longer-term interpretations of what is appropriate and prudent. Hard-line adherence to rules-of-thumb (3 per cent of GDP deficits, 60 per cent debt-to-GDP ratios) has given way to softer, more flexible guidelines. The lessons from the GFC, the pandemic and the energy shock are that fiscal policy is a valuable, even essential tool, which can provide both targeted support as well as play a wider role in demand management. Nevertheless, as the UK's hapless experience last Autumn showed, there is still no "free lunch" and projected public debt levels give cause for concern (Figure 15). With a clear nod towards longer-term sustainability, the OECD recently acknowledged that energy-related fiscal assistance had been crucial, but that there was now a case for withdrawing broad, unconditional support and replacing it with more targeted measures. In a similar vein, the European Commission is renewing efforts to bring back fiscal guidance for member states, without returning to the incoherent strictures of the Stability and Growth Pact.

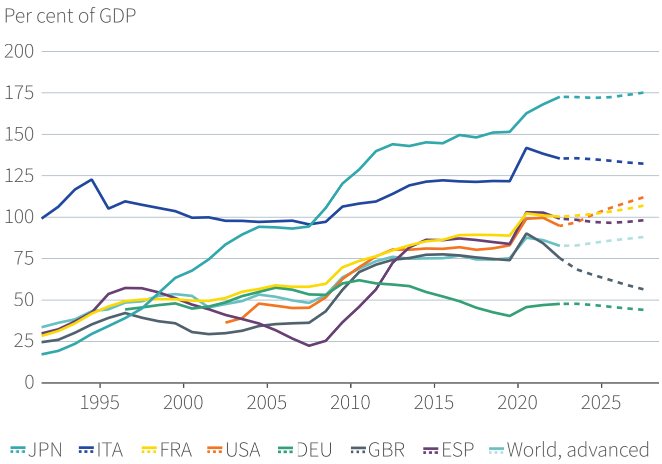
The rules of fiscal sustainability have not been abandoned, but more flexible interpretations are possible

*Figure 14.* **5-year breakeven inflation rates**
Breakevens have fallen back in the last 18 months




Source: Aviva Investors, Macrobond as at 23 March 2023

*Figure 15.* **IMF estimates for net public debt as % of GDP**
Debt burdens are projected to rise in many countries



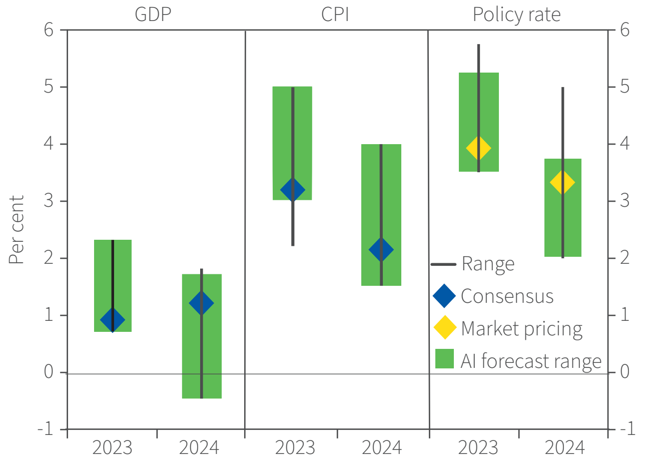

Source: Aviva Investors, Macrobond as at 23 March 2023

# Macro forecasts charts and commentary

## US

Activity has remained resilient in the first quarter of 2023, leading us to revise up our growth expectations somewhat for this year. However, the outlook has become more clouded by the recent problems in the mid-sized banking sector and the potential for that to spill over into a material tightening in credit conditions. We continue to expect the US will experience a shallow recession in late 2023 or early 2024. Underlying inflation has also proved to be sticky, with little sign of any cooling yet. However, we expect as growth slows and unemployment rises a little, that inflation pressures will ease, albeit remain above target throughout 2023. We think the Federal Reserve is likely to pause in May, but could subsequently hike again if credit conditions have not materially deteriorated. The anticipated shallow recession and decline in inflation is expected to result in rate cuts in 2024, as policy is brought back towards neutral.

*Figure 16.* **US**

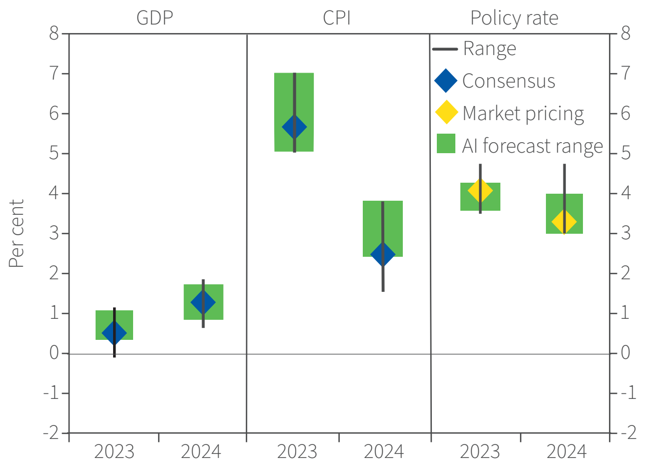



Source: Aviva Investors, Macrobond as at 23 March 2023

## Eurozone

Eurozone activity numbers have been better than feared over the winter. On the supply-side, mild weather has tempered the impact of the energy shock considerably. On the demand-side, the reopening of China and resumption of global trade flows have boosted Eurozone exports. However, domestic demand growth remains subdued and with the ECB continuing to hike rates to address the inflation problem (and high inflation itself hurting both households and companies), the outlook is still for low or even zero or negative GDP growth at times this year. Recession risk has reduced, but is still present, although any downturns are expected to be shallow and short-lived. Even as supply shocks fade (and the energy one could easily return) the impact from weaker demand as a result of tighter monetary policy could increase. Lags between higher rates are famously "long and variable" and the first ECB hike was only last July.

*Figure 17.* **Eurozone**

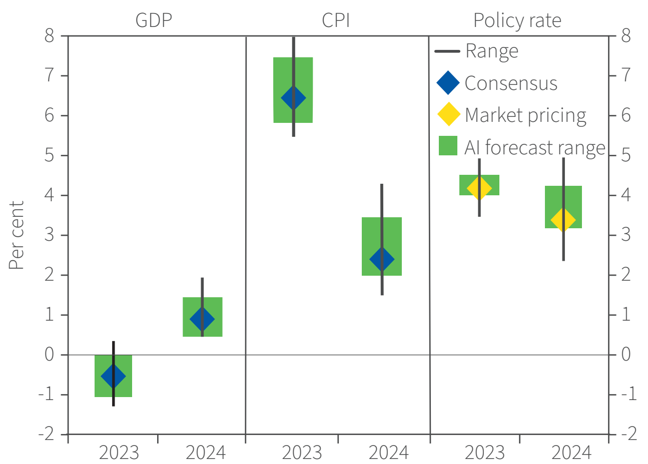



Source: Aviva Investors, Macrobond as at 23 March 2023

## UK

Two of the supply shocks (global supply chains and energy prices) have eased, but two others more specific to the UK remain – the economic realities of Brexit and low labour force participation remain. Stubbornly high inflation means the Bank of England retains a hawkish bias, even in the face of banking jitters, and that will restrain demand this year and next. Overall, the growth outlook is slightly less grim than three months ago, but it is still poor. After a modest contraction this year, the return to growth in 2024 is expected to be weak at best. Headline inflation is now falling and that will continue. But underlying pressures are more persistent, arguing against an early reversal to the rate hikes of the last year. The tough love should work, implying a return of core inflation towards target in 2024 and an eventual relaxation of monetary policy from a restrictive stance. Growth risks still look to the downside and inflation to the upside.

*Figure 18.* **UK**

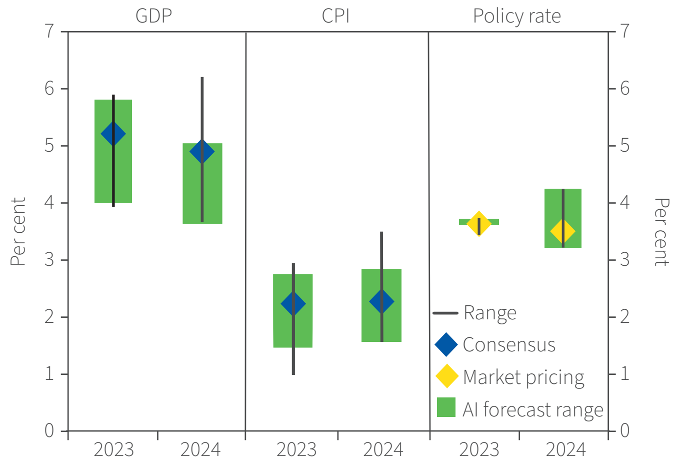



Source: Aviva Investors, Macrobond as at 23 March 2023

## China

Growth is picking up after the end of Covid restrictions. Disastrous activity numbers will provide easy y/y comps and that could mean that GDP prints closer to 6 per cent than the government's "around 5.0 per cent" soft target, but trend growth is slowing toward 4.0 per cent. There is a palpable shift towards promoting growth, with less emphasis on regulation and deleveraging. Yet the focus on social control, Common Prosperity, and self-sufficiency will dominate economic concerns in Xi's third term. The alignment with Putin gives China dominance in the "anti-western" geopolitical grouping, and some cheap energy and commodities, but at a cost: FDI and portfolio flows will stay weak, and the EU, the UK and Japan have joined the US in reappraising their trade relationships. Low inflation after the long COVID period should keep the PBoC on hold, with open market operations and RRR adjustments sufficient to keep CNY stable while onshore liquidity stabilises credit growth.

*Figure 19.* **China**

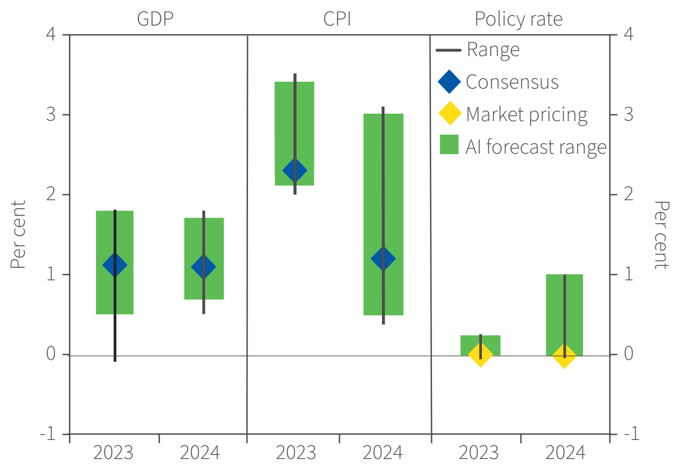



Source: Aviva Investors, Macrobond as at 23 March 2023

## Japan

Q4 data disappointed yet again, but Japan is not actually in recession – similar to the US a year ago, higher inventories have boosted GDP. In fact, both household and public consumption accelerated, and exports did well even before China's reopening; Japan's Q4 Gross National Income rose over 4 per cent annualised. Recent PMIs indicate a bifurcated economy, led by services, with industry weaker. The shunto wage round looks like a regime change, with union wages rising well above 3 per cent; although this will help sustain inflation, the central bank fears a return to disinflation, and has kept up its unconventional loose monetary policy of negative interest rates and Yield Curve Control (YCC). BoJ Governor Kuroda tweaked the policy in December, but the yield curve and JGB market are more dysfunctional than ever, and the yen would be far weaker if not for the US banking woes. The new BoJ head, Kazuo Ueda, takes the helm in April and is expected to scrap YCC, though rate hikes will likely come later.

*Figure 20.* **Japan**

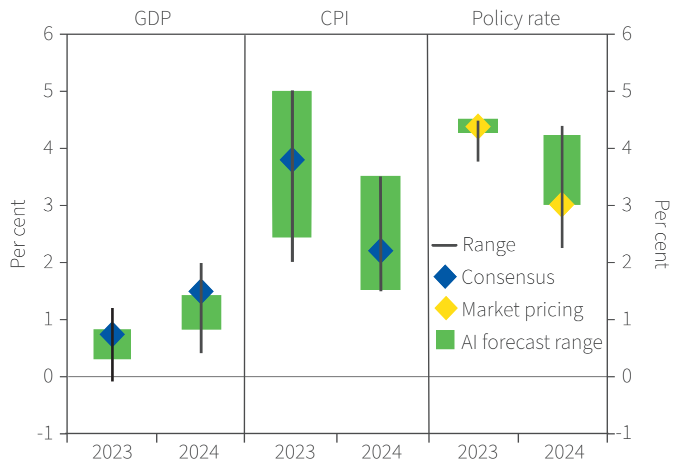



Source: Aviva Investors, Macrobond as at 23 March 2023

## Canada

Could Canada's experience provide some sort of template for others? The Bank of Canada (BoC) raised rates aggressively in 2022 in the face of what it saw (early) as an inflation problem. The policy rate reached 4.5 per cent in January this year and the economy has responded: growth has slowed to around zero. From a peak of over 8 per cent, headline CPI inflation is now close to 5 per cent and falling and core measures are dipping too. In March the BoC was able to declare a "conditional pause" in their hiking cycle as they wait to confirm that the impact of previous tightening will be sufficient to return inflation to their 2 per cent target. They stand ready to act again if not, but the likelihood is that a peak has been reached. Growth should pick up modestly this year and inflation should continue to fall. Longer term, Canada's potential growth will be helped by rapid population increases: growth of 2.7 per cent last year was almost all due to inward migration, which is being actively encouraged by government.

*Figure 21.* **Canada**




Source: Aviva Investors, Macrobond as at 23 March 2023

# Global market outlook and asset allocation

- **The tension between high inflation and slowing growth now has financial sector instability added into the mix.**
- **Central banks are determined to keep rates restrictive but are now close to their terminal rates, resulting in inverted yield curves, credit stress, and extreme volatility in fixed income.**
- **Equity markets remain on the expensive side, but are helped by earnings holding up and lower long-term yields.**
- **The dollar has tended to rally on growth and inflation surprises, but has declined as rate cuts and disinflation become more probable.**
- **A Fed pause and end to outflows, along with China's recovery, may help EM investors weather mild Developed Market recessions.**

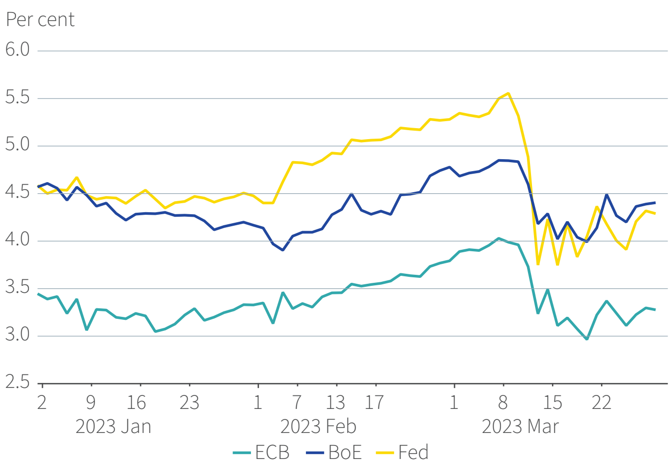
Goldilocks....followed by three bears

Recession risks seemingly receded early in 2023, initially helping risk assets resume their Q4-22 rally. Disinflation was helped by lower commodity prices and warm weather, reducing the sting of the energy shock, which alongside China's early reopening from Covid-boosted global growth prospects while lowering terminal rate expectations for central banks. Goldilocks! Then came three bears: tight labour markets led to persistent "too-hot" job growth and wages, repricing Fed and ECB paths; "too-firm" inflation prints (across Japan, Europe and North America in particular) extended the fixed-income selloff but still saw credit performing well; finally a torrid two weeks of "too-fast" deposit outflows, bank failures and rescues flipped correlations and sent yields tumbling. Oil, equities and credit were all trampled, though not to the extent seen last autumn. In the US, the UK and Euro Area, the extent of further hikes is now in question, and cutting cycles have been priced in (Figure 22).

Rates and credit may ultimately drive other markets

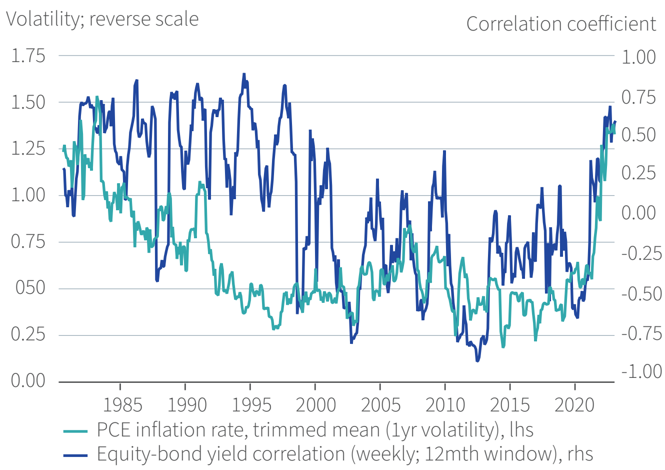
Going forward, we believe that rates and credit will ultimately drive other markets. Current sturdy growth and inflation dynamics have pushed back recession calls, which makes it difficult for monetary policy to ease from restrictive, near term. Indeed, many central banks are worried about what the House View terms "entrenched inflation risk" more than they are a "hard landing". Our last HV noted that we see equity-bond correlation changing back from an inflation/monetary policy driven environment to one that is more focused on growth and recession risks (Figure 23). What often determines correlations across asset classes is temporary extreme volatility in "common factors". The high uncertainty and variability of inflation has made monetary policy extremely sensitive to current data, and when this is the case, bad news is good news for bonds and equities alike, and vice versa.

*Figure 22.* **Rate paths have become highly uncertain**
Policy rate expectations for end of 2023




Source: Bloomberg, Aviva Investors, Macrobond as at 23 March 2023

*Figure 23.* **As inflation settles down, expect more growth sensitivity**




Source: Aviva Investors, Macrobond as at 23 March 2023

This could be changing. An incipient credit tightening, and the risk of "credit crunch" is seen by policymakers as tantamount to several rate hikes: this also makes risk-free government bonds a more attractive investment, even with yields below cash rates in many regions. There are still two-sided risks in case inflation fails to come down much and growth/credit risks abate, but the asymmetry is growing to the downside for yields. The trillion dollar question is, will this be good for stocks and corporates, and high-yielding EM FX? Once the recession we expect in the US approaches, inverted curves will steepen, perhaps violently if unemployment increases and defaults accelerate quickly. This seems unlikely in the next few months, but volatility is set to be with us for the foreseeable future. Japan may be an exception: its steeper yield curve is underpinned by commitment to zero rates, and while correlation to other G10 markets has grown, its yield curve should re-steepen when YCC is abandoned under the new BoJ governor.

Recent events could tighten overall financial conditions

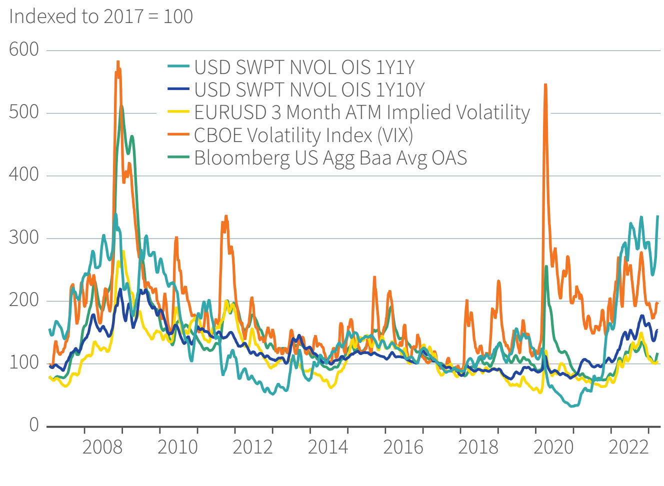
In any case, the conventional wisdom of 2022, that a "pivot" or pause at whatever terminal rate is deemed sufficient to get the "fairy tale ending" of a soft landing and disinflation has, like many of Grimms' stories, come to a horrid end. Interest rate volatility (particularly in short-end rates) had trended down, but then spiked to unprecedented levels (Figure 24). So far this has not propagated fully to equities or credit, though measures such as VIX or credit spreads are showing some modest signs of strain. Earnings and credit ratings have on the whole avoided large downgrades.

Rates volatility has spiked higher in recent months

For credit markets, the restrictiveness of monetary policy could perhaps be weathered alongside sluggish growth, but it has now become apparent that smaller/regional banks will continue to tighten credit conditions. This will be felt particularly in SME and CRE lending, and larger banks and borrowers will also feel the pinch. There have been many attempts to chart the Senior Loan Officer (SLO) survey results alongside credit spreads and default rates, but the truth is that the scale chosen matters a lot, and that the lead time from such tightening to a recession is quite variable and not always predictive (Figure 25). For now, relatively stable equity behaviour (e.g. VIX and realised volatility) and measures of bond market functioning (e.g. the NY Fed's Corporate Bond Market Distress Index) help explain why both IG and HY spreads are still far from recession levels. If we are correct in our analysis that recessions are a likely result of rate hikes later this year or early in 2024, then spreads and defaults will eventually revisit new cycle highs, and current sub-20 VIX levels will prove to be absurdly low. Energy and geopolitical shocks, and increased term premia as the new market paradigm reveals fragilities are also part of the landscape. EM Credits have proven relatively resilient (Figure 25), and although they are still being buffeted by the global environment, the past spate of Chinese property defaults and frontier market distress haves left CEMBI and EMBIG at around 400bp OAS, which provides a cushion against a challenging outlook.

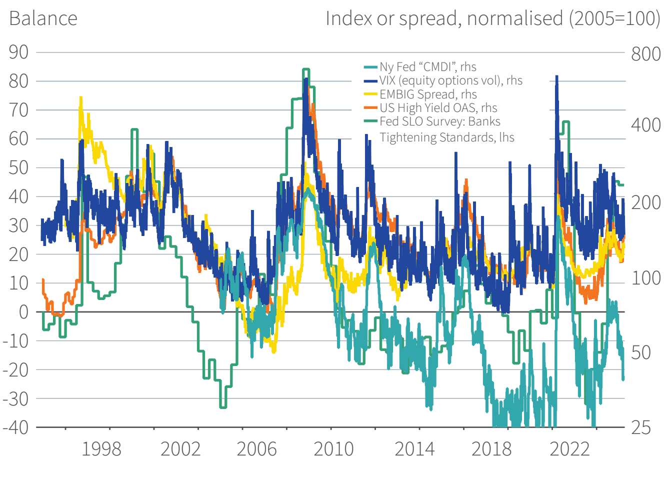
Economic downturns would lead to more defaults and wider credit spreads

*Figure 24.* **Not a common shock: volatility across asset classes**




Source: Bloomberg, Aviva Investors, Macrobond as at 23 March 2023

*Figure 25.* **EM (GBI-EM yields and EMBIG spreads)**




Source: Aviva Investors, Macrobond as at 23 March 2023

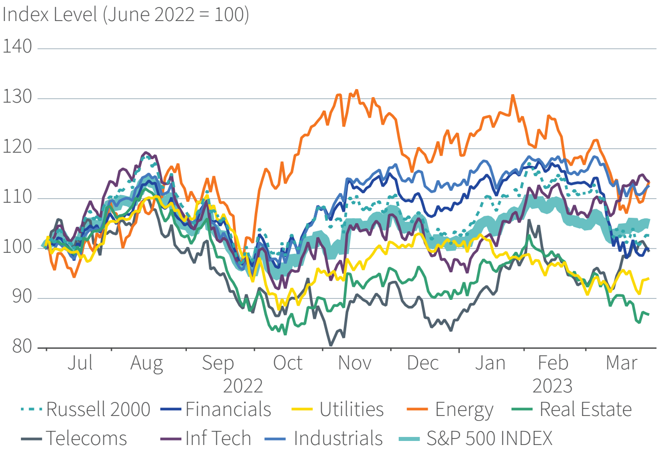
An approaching recession and rising risks would argue for caution or even underweights in equity markets. Yet global equities had gained 20 per cent since their October 2022 nadir, and gave up only a small part of the year-to-date gains since February. Equities have weathered inflation surprises, hawkish central banks, and stress in real estate and the financial sector. Realised volatility continues to decline, and the financial market volatility, and worries in Europe and the US about banks, REITs and CRE is reflected in aggressive central banks closer to pausing, and lowered projected terminal rates. Valuations have come down from 2022's excessive levels, but are not extremely cheap either; taking all this into consideration we have no qualms to stay with a neutral outlook on equities. To be more constructive, we would need to see lower earnings forecasts and multiples, and/or see growth turning the corner. The UK is expected to benefit despite its weaker growth outlook, as a more dovish BoE helps underpin P/Es through low real rates. There is also relatively wide dispersion, as interest rate sensitive sectors have underperformed significantly. Lower rates may help growth and tech temporarily, but a downturn will surely weigh on firms exposed to cyclical forces, and provides scope for relative value between sectors (Figure 26).

Equities have weathered much bad news, helped by lower rate hike expectations

We continue to expect a more meaningful medium-term decline in the dollar to take hold as the Fed pauses its rate hike cycle more definitively – indeed, the DXY index has already retreated 10 per cent from its 2022 peak as hikes slowed, coupled with more aggressive rate hiking continuing elsewhere (or in the case of many EM, higher rates already achieved in 2021-22). Emerging market currencies are benefitting from the perceived imminent ending of G10 rate hikes, and the higher rates that their central banks have implemented to fight inflation and FX pressures (Figure 27). Outflows have persisted but that has been met with central bank intervention; high carry and Chinese demand from imports and tourism should help stabilise the asset class after 2022's grim series of unfortunate events.

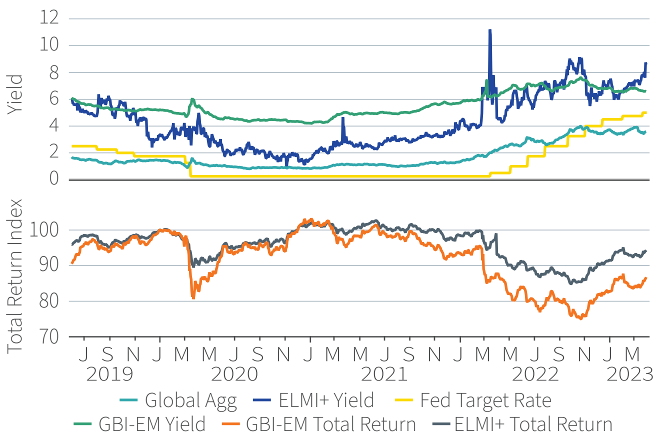
The US dollar may weaken if a Fed peak becomes anticipated

*Figure 26.* **Equity returns reflect rate sensitivities**
S&P 500 sector GICS level 1 breakdown




Source: Aviva Investors, Macrobond as at 23 March 2023

*Figure 27.* **EM Local Bonds and Currencies have built significant carry cushion against the dollar and euro**




Source: Aviva Investors, Macrobond as at 23 March 2023

*Figure 28.* **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 | | | | | | 0 | | | | | |
| United Kingdom | | | | | | | 1 | | | | |
| Germany | | | | | -1 | | | | | | |
| France | | | | | | 0 | | | | | |
| Italy | | | | | | 0 | | | | | |
| Japan | | | | | -1 | | | | | | |
| Canada | | | | | | 0 | | | | | |
| Australia | | | | | | 0 | | | | | |
| **Credit** | | | | | | 0 | | | | | |
| 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** | | | | | | | | | | 4 | |
| **Currencies (vs USD)** | | | | -2 | | | | | | | |
| GBP | | | | -2 | | | | | | | |
| 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 23 March 2023

# Contact us

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

**www.avivainvestors.com**



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