AVIVA INVESTORS

House View Q3 2023

Late-cycle extension

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Contents

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Executive summary

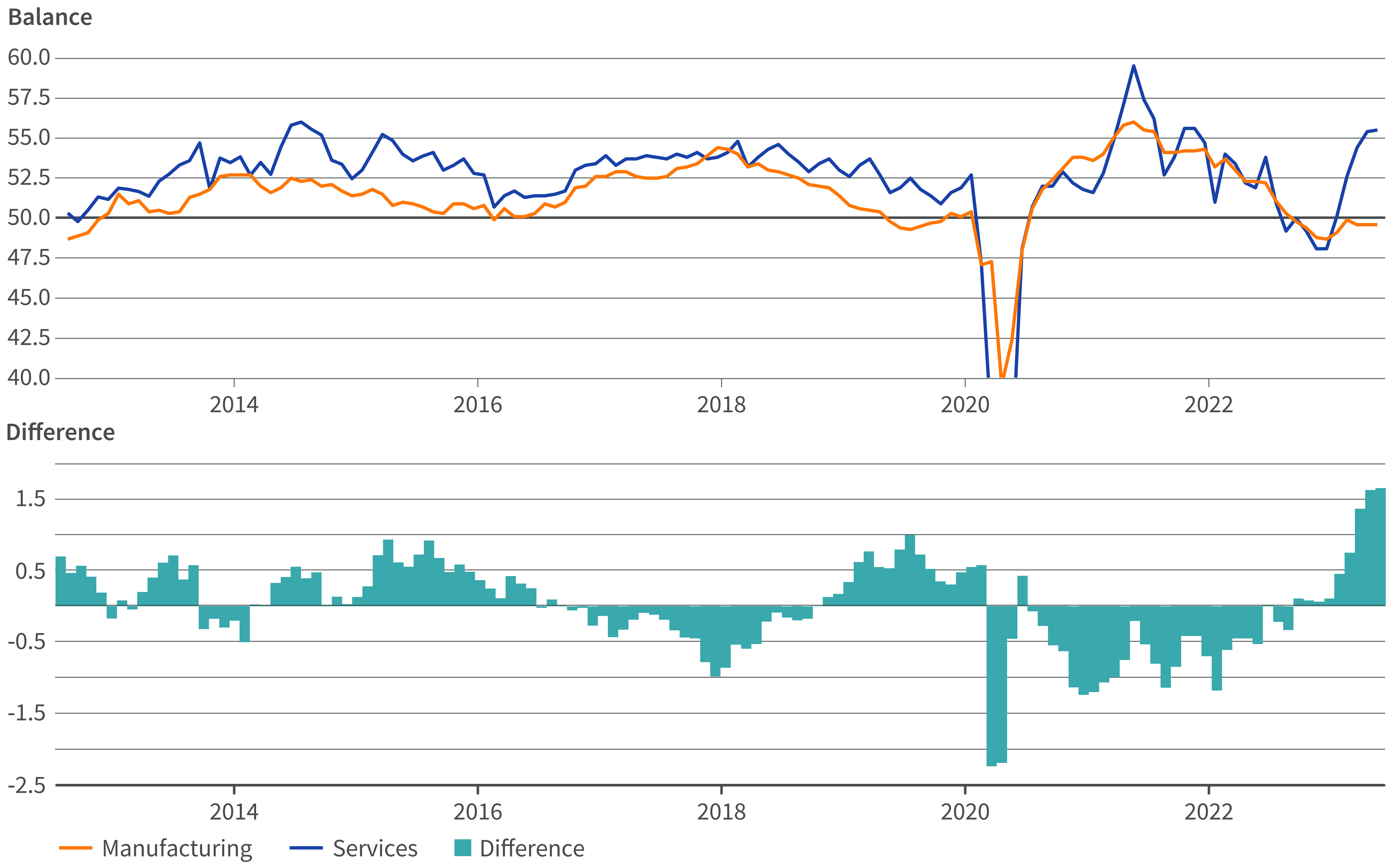
Late-cycle extension

The global economy has proven to be more robust than expected to the supply-side shocks that increased inflation and reduced disposable income. While growth has slowed, we have not seen any major economy enter recession. The most recent indicators of activity – such as the global PMIs – suggest that growth has actually improved in 2023H1, as energy prices have receded and sequential inflation rates have dropped. That improvement has come about through an acceleration in growth in the service sector, which continues to benefit from pent-up demand and some substitution away from goods, as well as tight labour markets that have boosted wages and incomes.

> *While growth has slowed, we have not seen any major economy enter recession*

Meanwhile, the manufacturing sector has remained weak, arguably in recession territory, as demand for consumer durables has softened (albeit from very a high level), China re-opening has stalled and the inventory cycle has turned less favourable. Indeed, the divergence between global services and manufacturing is currently at its greatest in the decade that such data is available (Figure 1).

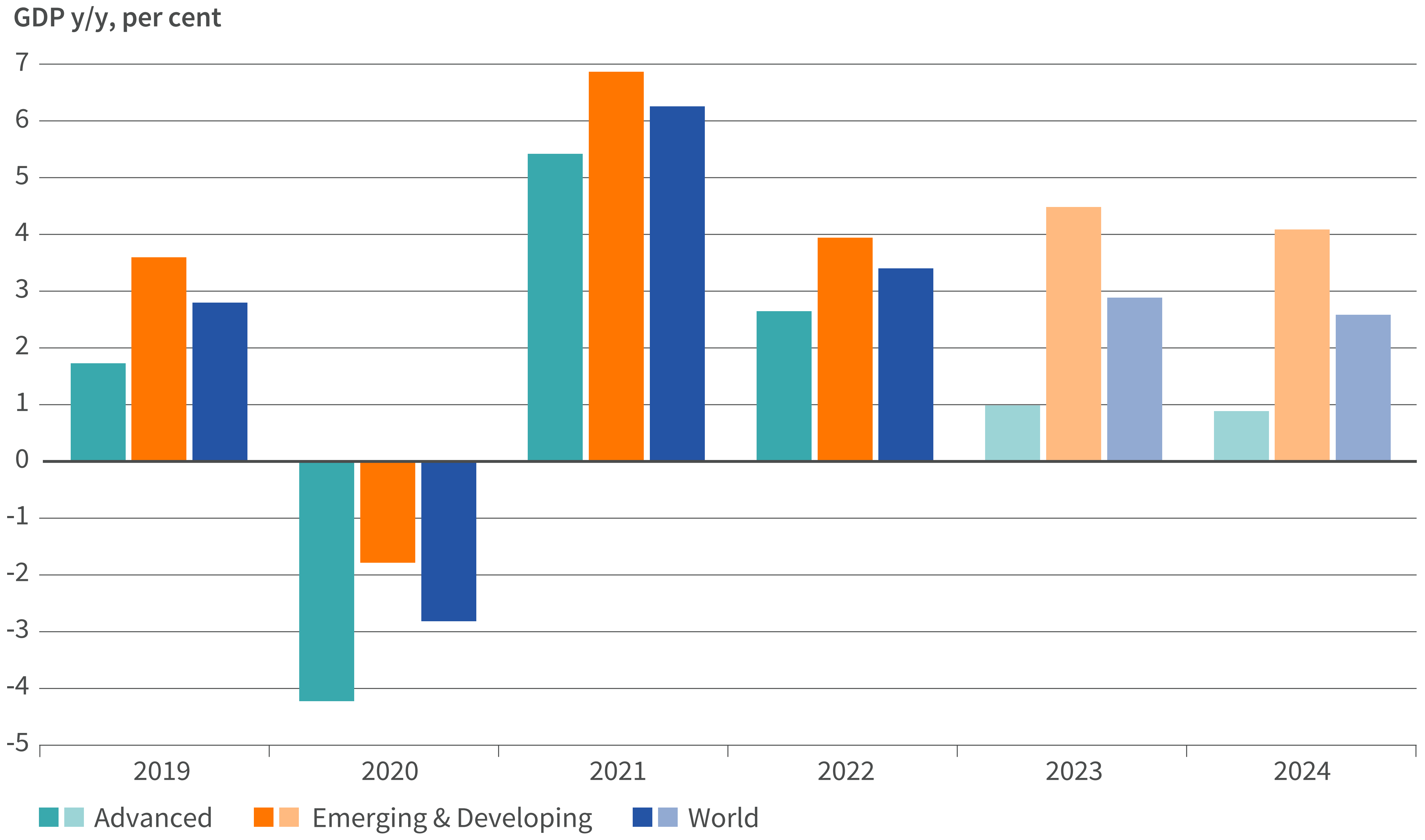
Figure 1. **Global PMIs: Manufacturing in recession, services strong**



Source: Aviva Investors, Macrobond as at 30 June 2023.

Looking ahead, we expect global growth of around 3 per cent this year and around 2¾ per cent in 2024 (Figure 2). That is well below the long-run trend rate of growth and reflects an expected weakness in the major developed market economies. In our central projection we see growth slowing to well below trend in the US over the next 6-9 months, with EZ and UK growth expected to remain below trend. Following the sharp bounce-back from Covid restrictions in Q1, we expect growth in China to also be materially weaker for the remainder of the year. The period of below-trend growth is expected to see a modest increase in unemployment rates across the major economies.

Figure 2. **Aviva Investors growth projections**



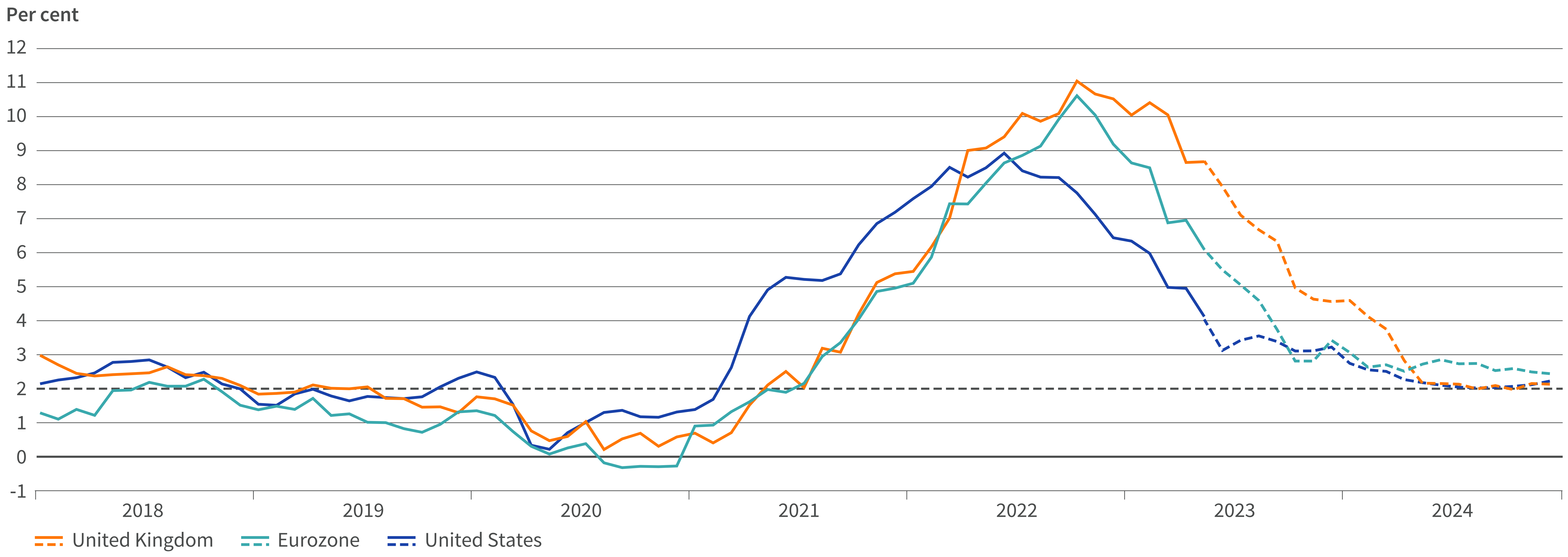
Source: Aviva Investors, Macrobond as at 30 June 2023.

We think that the medium-term balance of risks to the growth outlook are to the downside, with the probability of a deeper downturn that results in activity contracting and unemployment rising more materially as being close to 50 per cent. The pass-through of the rapid tightening in monetary policy over the last year is not yet complete. As mortgage holders refinance onto higher rates, the impact on household cashflow will become more acute. Alongside that, there has been some tightening in credit availability already, but we expect more to come as banks take a more prudent attitude towards new lending. While the events that led to the bank failures in the US in March have not spilled over into a broader banking problem, risks remain, particularly for those with large commercial real estate exposure. Finally, the excess savings that supported the post-Covid recovery in household consumption are unlikely to provide much ongoing support as they are likely exhausted (in real terms) for all but the higher income cohorts.

The fall in energy prices (oil prices are down around 25 per cent and European gas prices 75 per cent from their 2022 average) has resulted in headline CPI inflation starting to fall sharply. We expect headline inflation rates to continue to fall, as the contribution from energy turns negative. In addition, the pass-through of lower energy prices into fresh food and manufactured goods should also help to bring headline inflation down (Figure 3). However, while the energy effects dominate headline inflation rates, core inflation measures remain uncomfortably high.

Only in the last couple of months have we seen some modest relief in the US and Eurozone. That strength in underlying inflation reflects the ongoing tightness in labour markets, elevated wage inflation and companies being able to maintain their margins. There is evidence that margins are starting to compress, which should help to ease core inflation pressures. However, the period of below-trend growth and higher unemployment in our central projection will be required in order to deliver softer wage growth and ultimately lower underlying inflation pressures.

Figure 3. **Aviva Investors CPI inflation projections**



Source: Aviva Investors, Macrobond as at 30 June 2023.

Given the persistence in core inflation, albeit with some tentatively encouraging signs, we expect central banks to remain in restrictive territory for some time. We expect the Federal Reserve, ECB and Bank of England will reach 5.5 per cent, 4 per cent and 5.75 per cent, respectively.

We expect central banks to remain in restrictive territory for some time

The pass-through of the rapid tightening in monetary policy over the last year is not yet complete

The economic outlook remains one that could be described as late-cycle. Following the rapid growth recovery from Covid, the surge in inflation and the monetary policy response, the probability of recession remains elevated. But as we have seen this year, economies can prove more resilient than expected and therefore delay the end of the cycle. The late-cycle environment can persist for an extended period, as monetary policymakers search for the level of restrictive policy required to slow growth sufficiently to create spare capacity and ease inflation. But that search typically ends in over-tightening and recession.

This late-cycle dynamic can see equities outperform for longer than expected, but the turn can create material downside risk. Given that backdrop we prefer to be moderately overweight equities, balanced with an overweight in duration (Figure 4). We prefer to tilt equity overweight to US and Europe, with earnings outlooks being upgraded. However, we are somewhat more cautious on the US given the narrow base of recent performance. With credit spreads seen as roughly fair to expensive given the stage of the cycle, we prefer to be neutral.

> ***This late-cycle dynamic can see equities outperform for longer than expected, but the turn can create material downside risk***

Figure 4. **Asset allocation**

	Underweight										Overweight
	-5	-4	-3	-2	-1	0	1	2	3	4	5
Equities								2			
Government bonds								2			
Credit						0					
Cash							1				
Currencies (funded by USD)						0					

Source: Aviva Investors, Macrobond as at 30 June 2023.

Key investment themes and risks

Investment themes

1 **Inflation persistence and uncertainty**

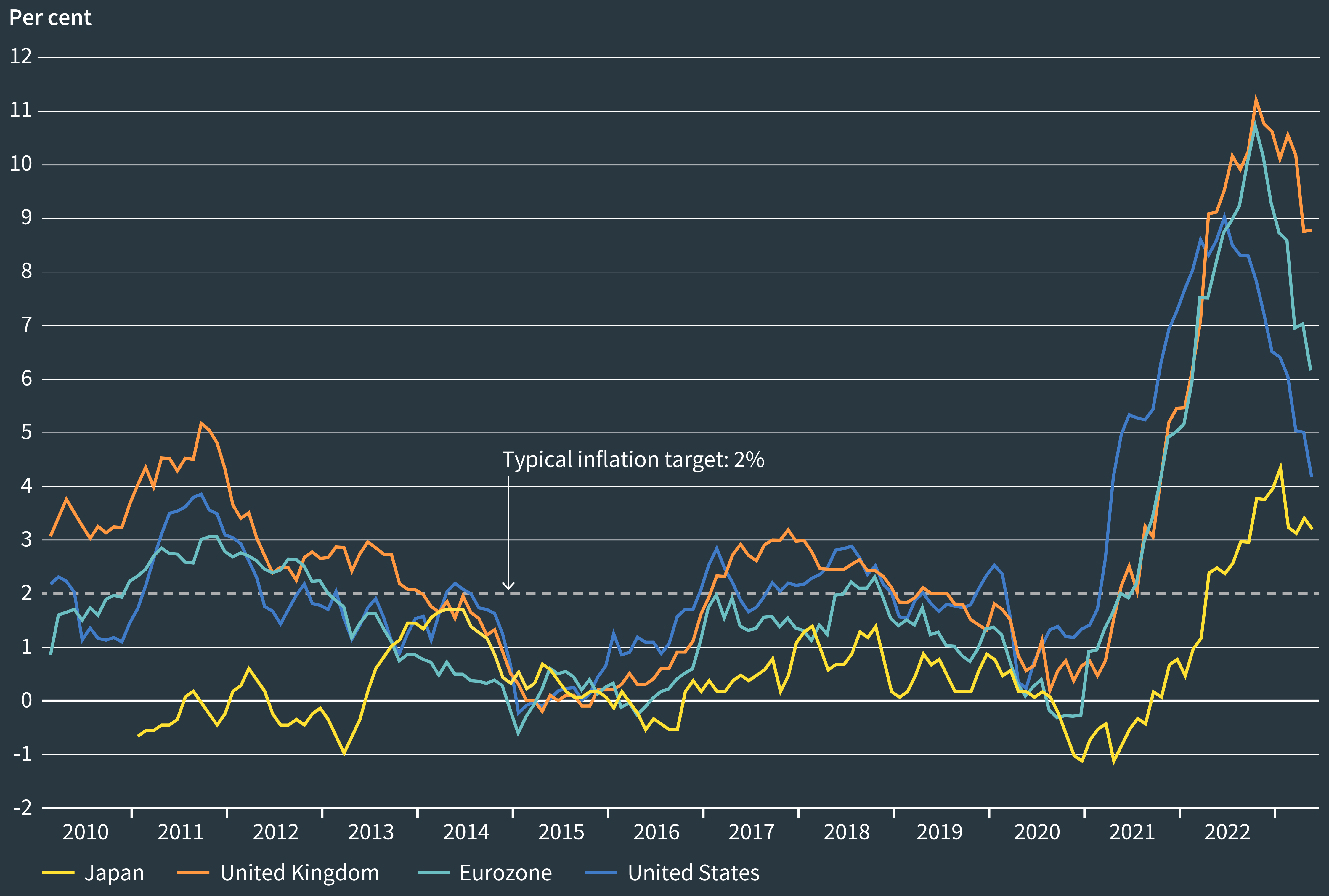
2 **Global fragmentation**

3 **Industrial policy programmes**

Inflation persistence and uncertainty

After an extended period of low inflation (the "great moderation" as it became known), the inflation experience of the last few years came as a major shock to everyone. A cocktail of supply- and demand-side factors combined to drive inflation to rates previously believed to have been left well behind. History will doubtless judge that excessively loose policy settings also contributed. But what matters now is dealing with the problem, returning inflation to target and doing so in a manner which creates the least damage in terms of output and demand. It is proving a challenging task for global central banks, but some progress is being made. The potent mix of adverse supply-side influences – global pandemic, international trade disruptions, energy shock – have all eased, leading to lower headline rates of inflation (Figure 5).

Figure 5. **Headline inflation in the major advanced economies**
Lower energy prices the main driver



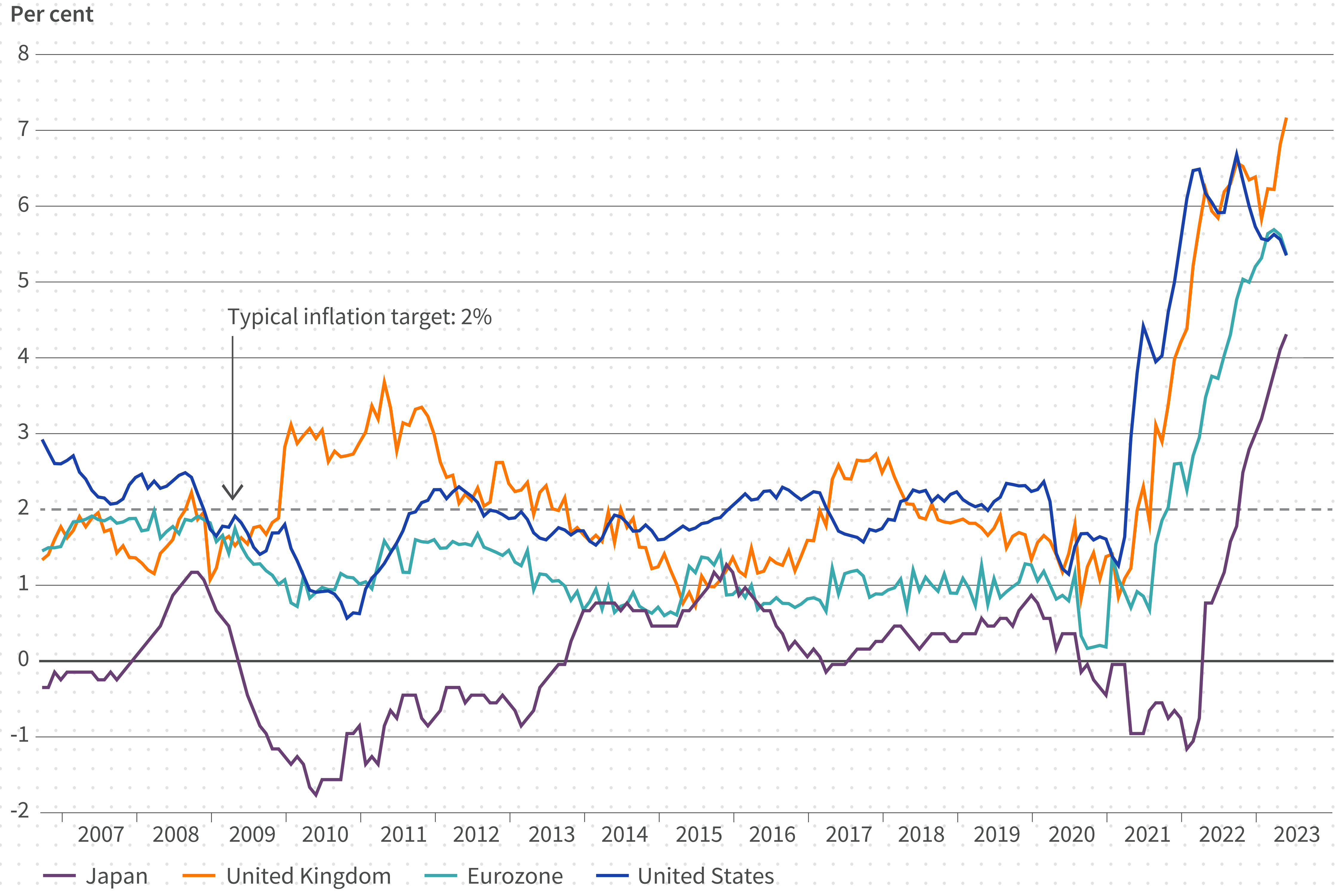
Source: Aviva Investors, Macrobond as at 30 June 2023.

The inflation experience of the last few years came as a major shock to everyone

Welcome as these developments are (and there is more to come before the end of 2023), attention has understandably switched to the stickier nature of core inflation rates (Figure 6). Until recently, there was a "common shock" element to the experience of almost all nations. Now some key divergences have appeared. Moreover, important as the supply-side drivers have been, it is becoming increasingly clear that demand factors are probably now the dominant influence on this underlying inflation impulse. Central banks – to varying degrees – all now recognise this and are tightening policy in order to suppress demand and regain control of inflation. It remains to be seen how much output and demand pain will be required to deliver this outcome, but monetary policymakers are mandated to deliver low inflation and if their determination means parts of the economy suffer, then so be it.

> ***Attention has understandably switched to the stickier nature of core inflation rates***

Figure 6. **Core inflation in the major advanced economies**
Proving far more difficult to shift



Source: Aviva Investors, Macrobond as at 30 June 2023.

Global fragmentation

We have included a de-globalisation or fragmentation theme in the House View for several quarters now and it seems likely that the wide range of factors which can be subsumed by the umbrella title will continue to frame global economics and politics for years to come. In one sense it is easy to define: a stall or reversal of the trends towards openness and closer integration which dominated from the mid-1970s until the late-2000s. But in another sense, it is a slippery subject area, encompassing a disparate collection of ideas, policies and attitudes which have evolved from a number of sources in the last two decades, perhaps longer.

Moreover, it has not been a linear progression – there have been many episodes of conflict and friction over the last 50 years (and much longer). But as the IMF and several other bodies have pointed out repeatedly, we now live in a more fractured world and an array of increasingly deep-rooted forces appear likely to push us further in the direction of self-interest, confrontation and argument. Sanctions, tariffs, and other restrictions or preferences are a reality and important investment considerations.

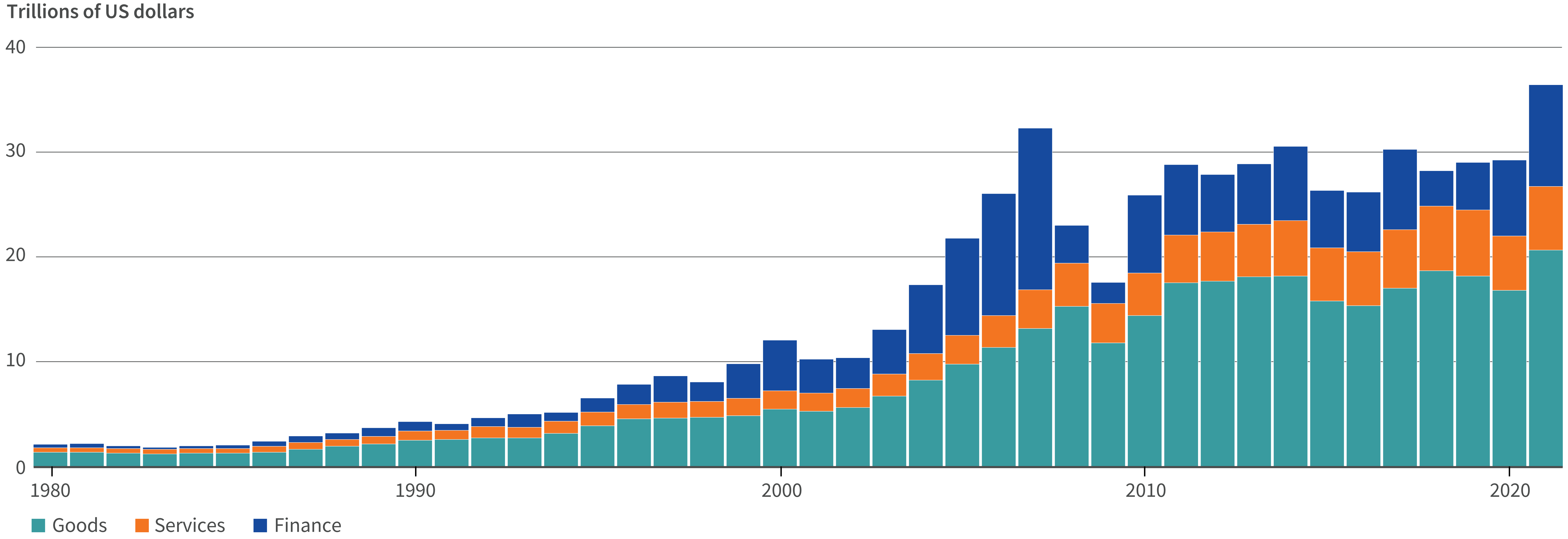
Populism, free trade restrictions, reduced openness and constrained immigration are all examples of greater scepticism towards the benefits of globalisation. And it is abundantly clear that growth in global flows of goods, services and capital (Figure 7) have reached some sort of hiatus. The same is probably true of key elements of migration flows, but purely economic drivers here are difficult to disaggregate from others, including refugee movements and other displacements.

Globalisation was not without blemish – not all benefited and it may have contributed to greater inequality in some places. But the overwhelming evidence is that benefits far outweighed any costs. The obvious danger is that moves in this direction will result in long-term losses for all, or nearly all. A recent compilation of research into the possible impact from geo-economic and trade fragmentation generated estimates (over the long run) of between 2 per cent and 12 per cent of global GDP.

Globalisation was not without blemish – not all benefited and it may have contributed to greater inequality in some places

Figure 7. **Global flows of goods, services and finance**

Very different patterns since the GFC



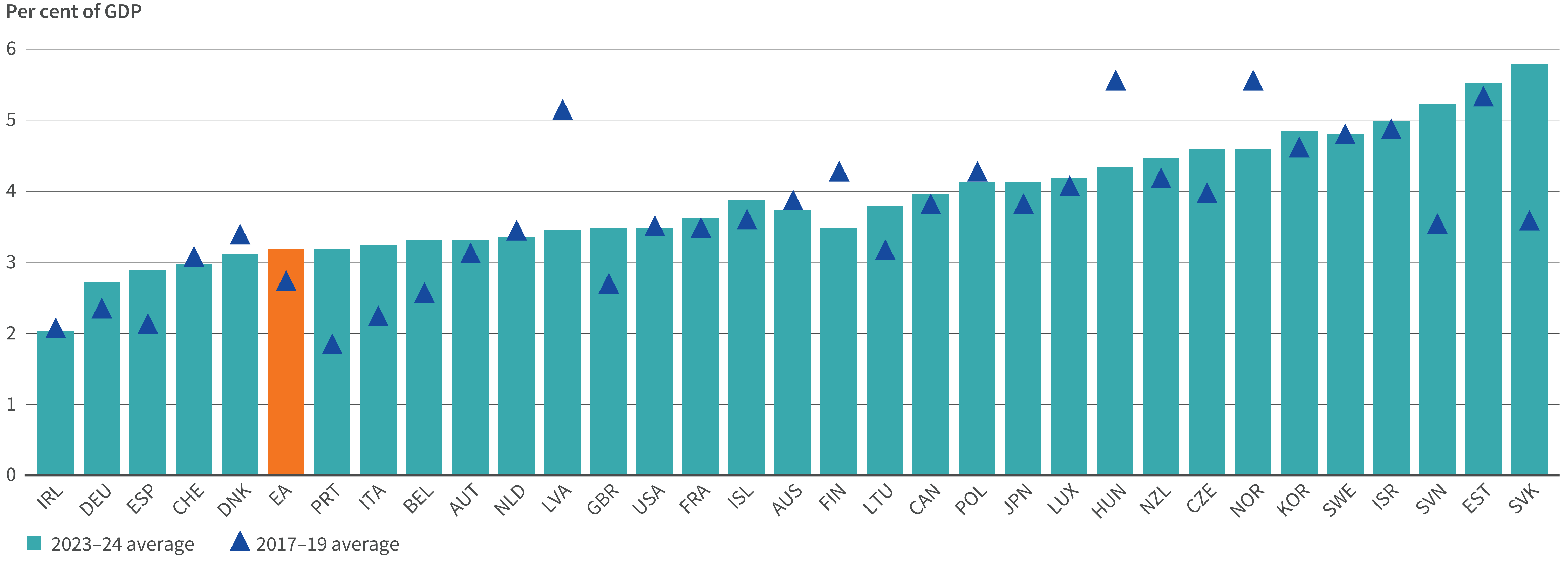
Note: The figure shows exports only. Source: IMF balance of payments, World Bank, global trade alert (2022), and IMF staff calculations as at 30 June 2023.

Industrial policy programmes

As we have stressed in previous House Views, fiscal policy in general has come back into fashion in recent years. But it is also worth noting that one particular sphere of government intervention (or influence) – industrial policy – also seems to be staging a comeback. In general terms, such efforts aim to support or encourage industries that are considered to be strategically important or are involved in areas where public interest is focussed. In specific terms, there is a huge range of industries which are – or will be – affected by these initiatives, so it is difficult to generalise. But one thing is clear: these are long-term structural policies. They may well involve higher public investment in key areas – this is already being seen in many countries (Figure 8). But they are not cyclical, demand management policies. They may impact growth or its composition a little, but they are primarily a means of laying the groundwork or influencing the chosen parameters for how certain industries will operate in the future. In simple terms, it is more likely to be about tax reductions, subsidies and impacting incentives rather than massive spending programmes.

Industrial policy seems to be staging a comeback

Figure 8. **Public investment is projected to increase in most countries**



Source: OECD economic outlook 113 database; and OECD calculations as at 30 June 2023.

There are many different drivers for this renaissance, including (but not confined to) a response to the growing importance (and attitudes) of China, increased emphasis on security of supply in several areas, attempts to make real progress on climate change and the development and advancement of new technologies. The Chips Act and Inflation Reduction Act in the US can be seen in this light, as can several elements of the repurposing of the NGEU programme and REpowerEU plan in Europe. Energy stability and safeguarding key commodity production are central imperatives.

Many of these initiatives were adopted in the wake of the pandemic and were in the first instance related to post-COVID recovery programmes. But they are now taking on a life of their own and are very likely to frame the global environment in which commerce and trade take place in the future. They may be a source of frictions between some countries or regions, with some fearing a return to protectionism and unfair state aid and support for national champions, but most simply reflect the new direction for some government priorities and their attempts to set the agenda.

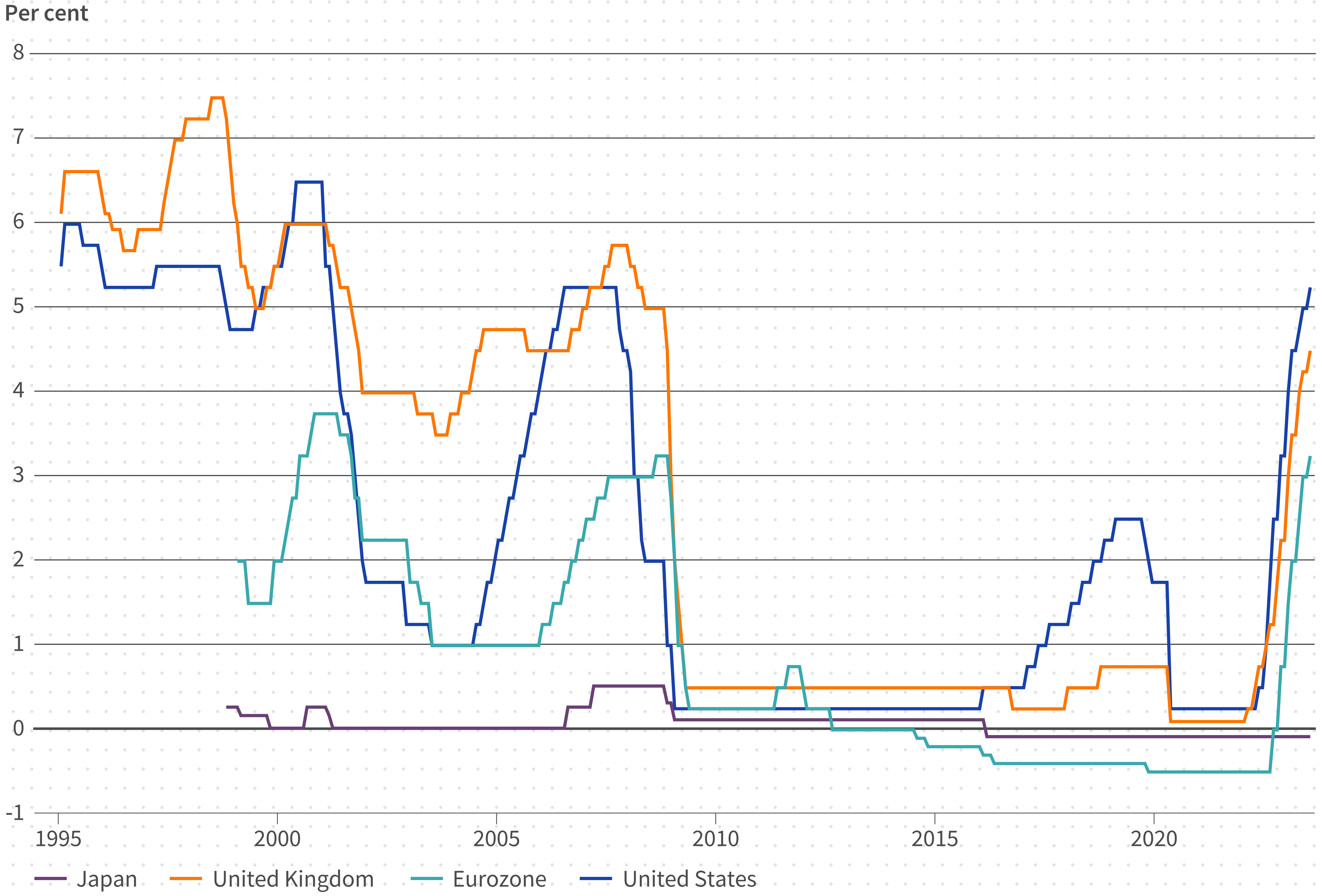
Risks

Global hard landing

In March there were understandable fears that a mini-crisis in parts of the banking sector might lead to a more generalised credit crunch resulting in a global hard landing. Although such concerns did tighten overall financial conditions via the credit channel, we said at the time that a systemic banking crisis was extremely unlikely and any sort of repeat of the 2008 disasters even more far-fetched. Three months on that feels like the right judgement, although it would be complacent to ignore the possibility that there could yet be some further banking jitters, especially in an environment of rising interest rates. More generally, there is always a risk that one or more central banks induce a nastier downturn than they had been anticipating as they tighten policy in the attempt to control runaway inflation. Given the exceptionally loose policy settings which have prevailed for much of the last 15 years (Figure 9), that risk is particularly elevated at present. Bluntly, many companies, individuals and institutions will have little or no experience of policy rates being tightened, especially at the pace at which that is happening today.

They are, unsurprisingly, not very vocal at expressing the following view, but the three key central banks which are currently hiking rates aggressively – the Fed, the ECB and the Bank of England – are all doing so in order to slow demand deliberately. As they do so, the danger of tightening policy too much is ever-present. As every economics textbook memorably states, monetary policy has long and variable lags. The full impact of earlier tightening has yet to be fully felt, but it is little wonder that some of the more interest rate sensitive areas – property, business investment – are creaking. And, of course, if inflation proves even stickier, a downturn or recession could be what is effectively needed in order for it to fall back convincingly. This is not our central view, but it is a disquieting risk. And it should not automatically be characterised as a policy mistake – in their eyes, it could be a price worth paying.

Figure 9. **Policy rates in the major developed regions**



Source: Aviva Investors, Macrobond as at 30 June 2023.

Entrenched inflation (wage/price spirals)

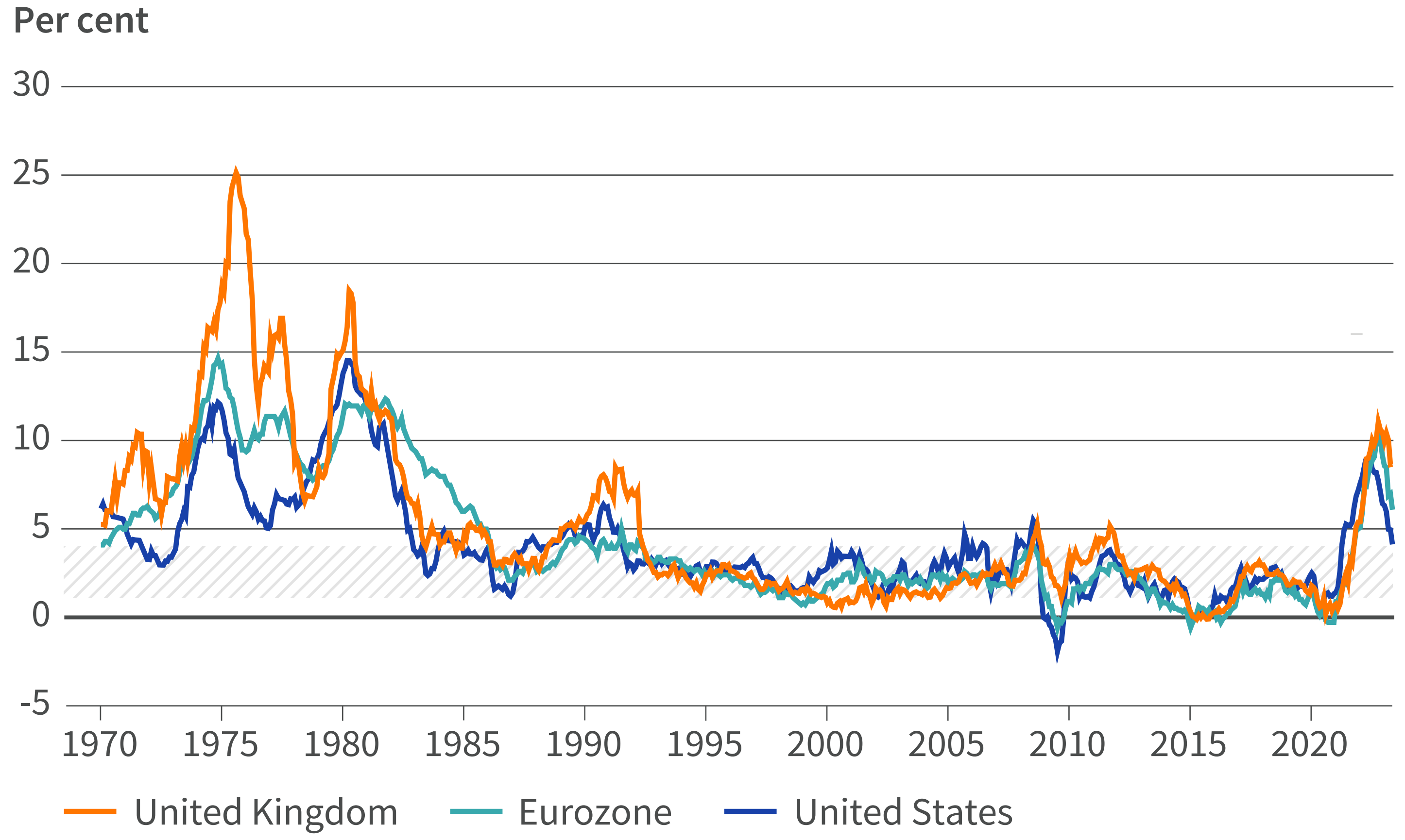
In open, free markets, changes in the price level (inflation, in other words) are always determined by the interaction of supply and demand. After the inflationary disasters of the 1970s and 1980s, governments and policymakers around the developed world regrouped and adopted new, more disciplined regimens aimed at eradicating inflation. It was a far from painless transition, but by the end of the 1990s the inflationary environment seemed to have been transformed fundamentally. Inflation settled, on average, at low and stable rates, typically around 2 per cent. And it was expected to stay there. This "great moderation" as it became known, was challenged briefly during the GFC, but came to a grinding halt in the post-pandemic period, when headline rates of inflation soared to rates believed to have been consigned to history (Figure 10).

Initially, it was widely supposed that the inflation spikes were largely driven by adverse supply-side developments. But it quickly became apparent that demand-side factors had become more important, partly assisted by the extended period of ultra-stimulative policy settings. Central banks are now effectively playing catch-up. But as those earlier experiences amply demonstrated, once the inflationary cat is out of the bag, it can be difficult to recapture control. Once inflation becomes accepted as the "normal" way of things (i.e., entrenched), then it is a far more dangerous beast. Most importantly, if price increases become matched with (or linked to) wage rises, the risk of the emergence of more damaging wage price spirals is heightened. Some would – with some justification – argue that we are already seeing elements of this in places, but there is plenty of scope for this to become much worse (Figure 11). Central banks are determined to prevent such outbreaks, but success is not guaranteed.

If price increases become matched with (or linked to) wage rises, the risk of the emergence of more damaging wage price spirals is heightened

Figure 10. **Headline CPI inflation**

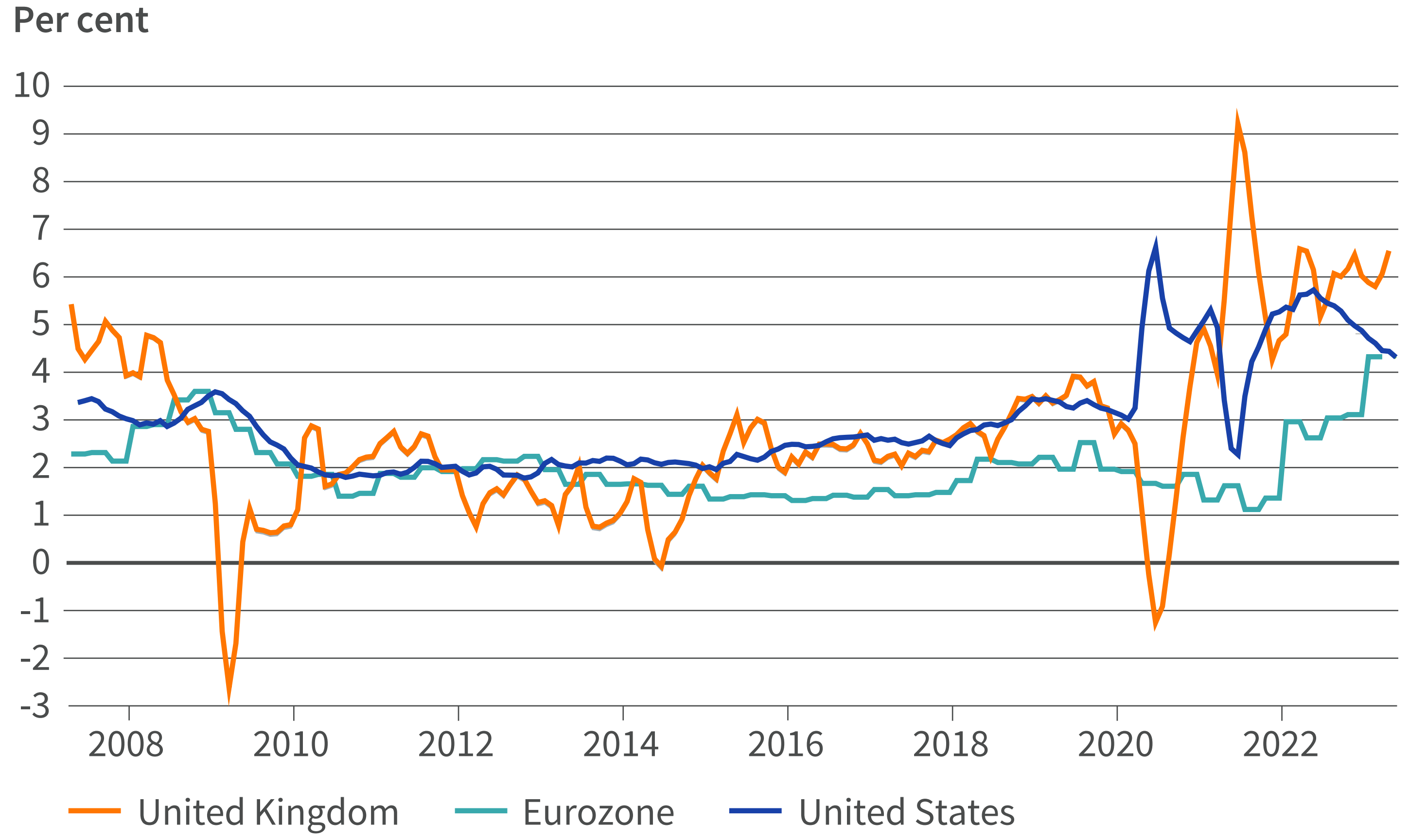
Overall inflation rates broke out in 2021



Source: Aviva Investors, Macrobond as at 30 June 2023.

Figure 11. **Wage trends in the major nations**

Distorted by COVID, but too high everywhere



Source: Aviva Investors, Macrobond as at 30 June 2023.

Fiscal sustainability

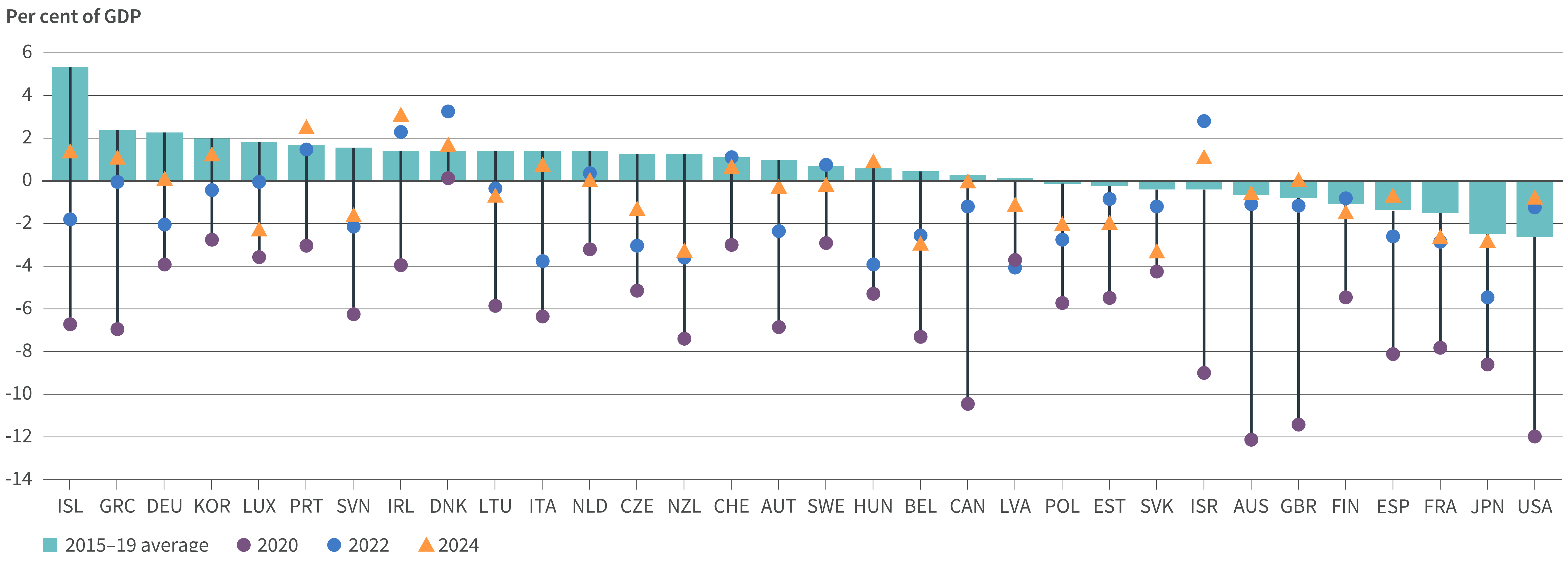
The relative importance of fiscal policy has ebbed and flowed in dimensions of both time and place (geographical regions) over the years, but it has enjoyed something of an almost universal renaissance since the aftermath of the GFC. As we have stressed before, the occasions of the pandemic and the more recent energy shock have clearly demonstrated how critical fiscal support can be in an economic crisis. Perhaps the painful experience of austerity in the wake of the GFC, much of which is now considered excessive at best, futile and self-defeating at worst, provided a valuable lesson. There is certainly a far more enlightened approach to fiscal policy than there was in the fairly recent past. The "science" of fiscal sustainability metrics has also been revisited, even while the reality of the well-known algebra relating to fiscal aggregates remains unchanged. Essentially, there are limits to the combinations of growth, inflation, debt, interest rate and budget balance which are viable. Thankfully, there is an element of "art" as well – if borrowing rates don't spiral too high (what is too high?) and some heed is paid to fiscal pragmatism, then sustainability today may be different to what it was in the past.

However, and also a point we have stressed many times before, this does not mean that there is a fiscal "free lunch". Weaker growth, higher rates and lower inflation will all restrain the ability of governments to embark on expansionary fiscal programmes in the future, whatever their wider merits. Budgetary indiscipline can also hurt in other ways as the UK's desperate experience last autumn showed only too clearly.

For some countries, especially several emerging economies, the reality is that any perception of fiscal irresponsibility will probably be punished by financial markets, and even those countries where investor trust holds firm and who have the luxury of financing debts in a currency they can print, there are limits.

It has been noteworthy that agencies such as the IMF (but others too) have used the end of the pandemic and the worst of the energy shock to return to calls for fiscal prudence to address the sustainability issue. Some consolidation is expected in coming years, but many primary budget balances in 2024 are projected to be well below pre-pandemic levels (Figure 12).

Figure 12. **Public investment is projected to increase in most countries**



Source: OECD economic outlook 113 database; and OECD calculations as at 30 June 2023.

Once inflation becomes accepted as the "normal" way of things, then it is a far more dangerous beast

Stewart Robertson
Senior Economist
(UK and Europe)

Macro forecasts charts and commentary

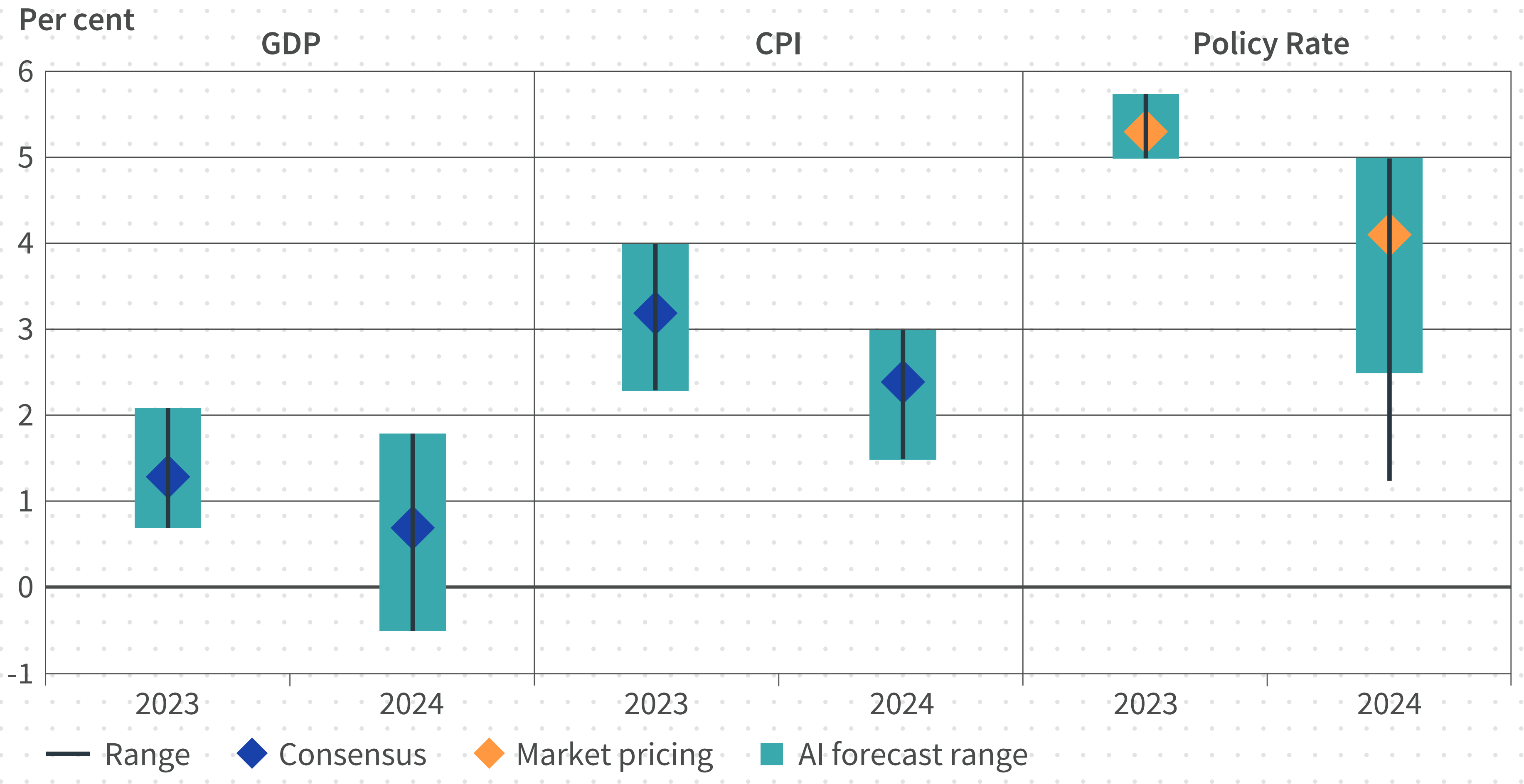
United States

The problems in the small and mid-sized US banks that emerged in March seem to have largely passed. Credit conditions appear to have tightened somewhat, but not excessively. As such, growth has been sustained through H1, with consumer spending remaining robust, supported by continued strong gains in employment. While headline inflation has fallen – largely as expected – due to energy prices, core measures of inflation have only eased modestly so far. As a result, the Federal Reserve has raised rates further and we expect at least another 25bps in this cycle. With underlying inflation set to only recede slowly through H2, we expect the Fed to then stay on hold for some time. Recession risk remains elevated given the tightening in monetary policy, but there appear few imminent signs. We expect a period of below-trend growth over the next year or so to result in a modest increase in the unemployment rate and underlying inflation moving towards 2 per cent (Figure 13).

Eurozone

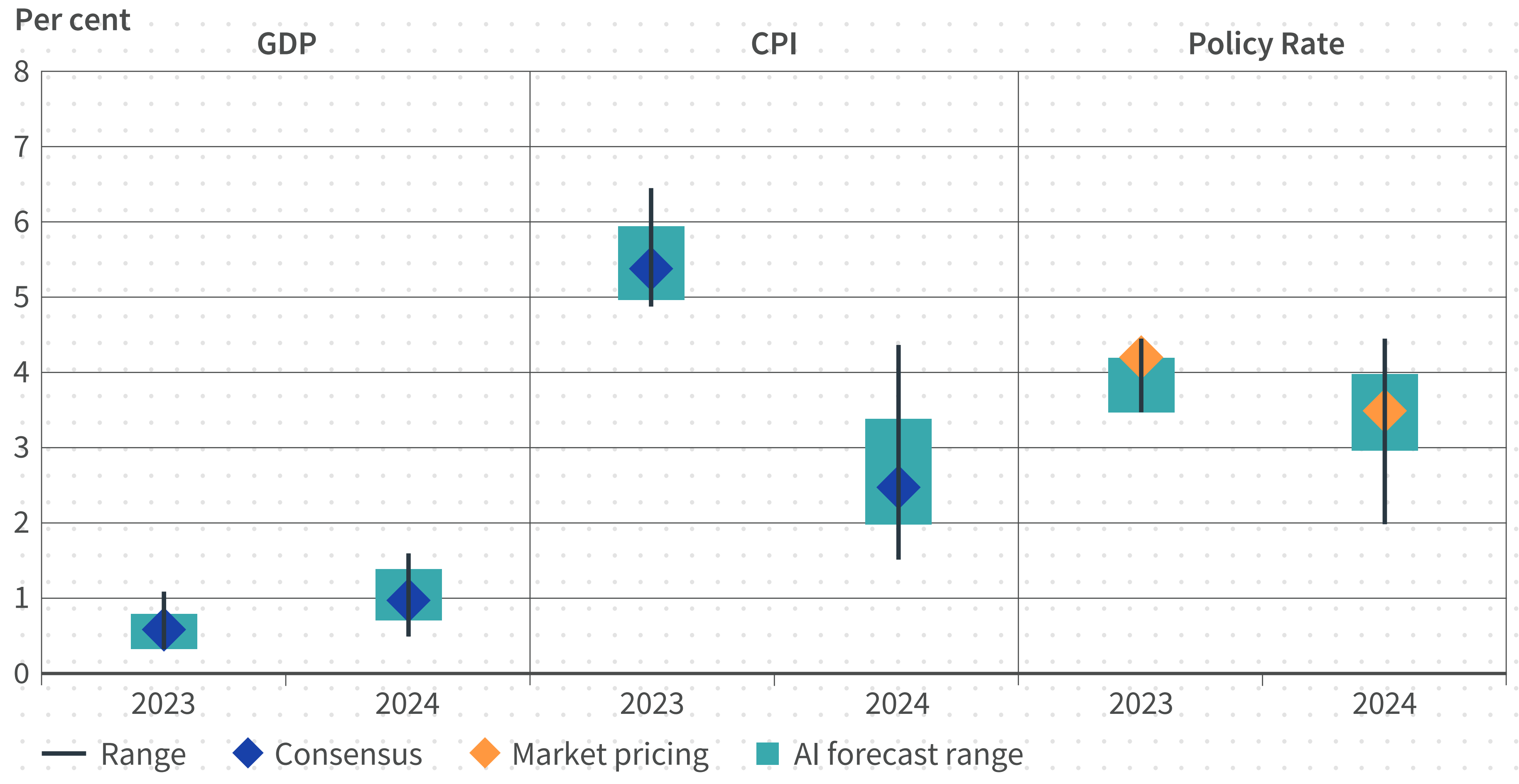
The Eurozone experienced modest declines in GDP in Q4 last year and Q1 2023 (-0.1 per cent in each), thereby satisfying the definition of a technical recession, just. But it didn't really feel like a recession. With the full impact of earlier monetary tightening still to be felt and the ECB still in hiking mode, there is always the risk of weaker activity numbers later this year or in 2024. But, overall, recession fears have declined over the last three months, a view supported by less concern about the conflict in Ukraine and helped by much lower energy prices. Headline inflation is now falling back, and we expect further declines – including in the core rate – over the next year or so. The ECB is likely to hike a little further, but the peak is close. If inflation does fall back as we expect, then policy rates can be cut back from the current restrictive level, probably in 2024 (Figure 14).

Figure 13. **United States**



Source: Bloomberg, Aviva Investors as at 30 June 2023.

Figure 14. **Eurozone**

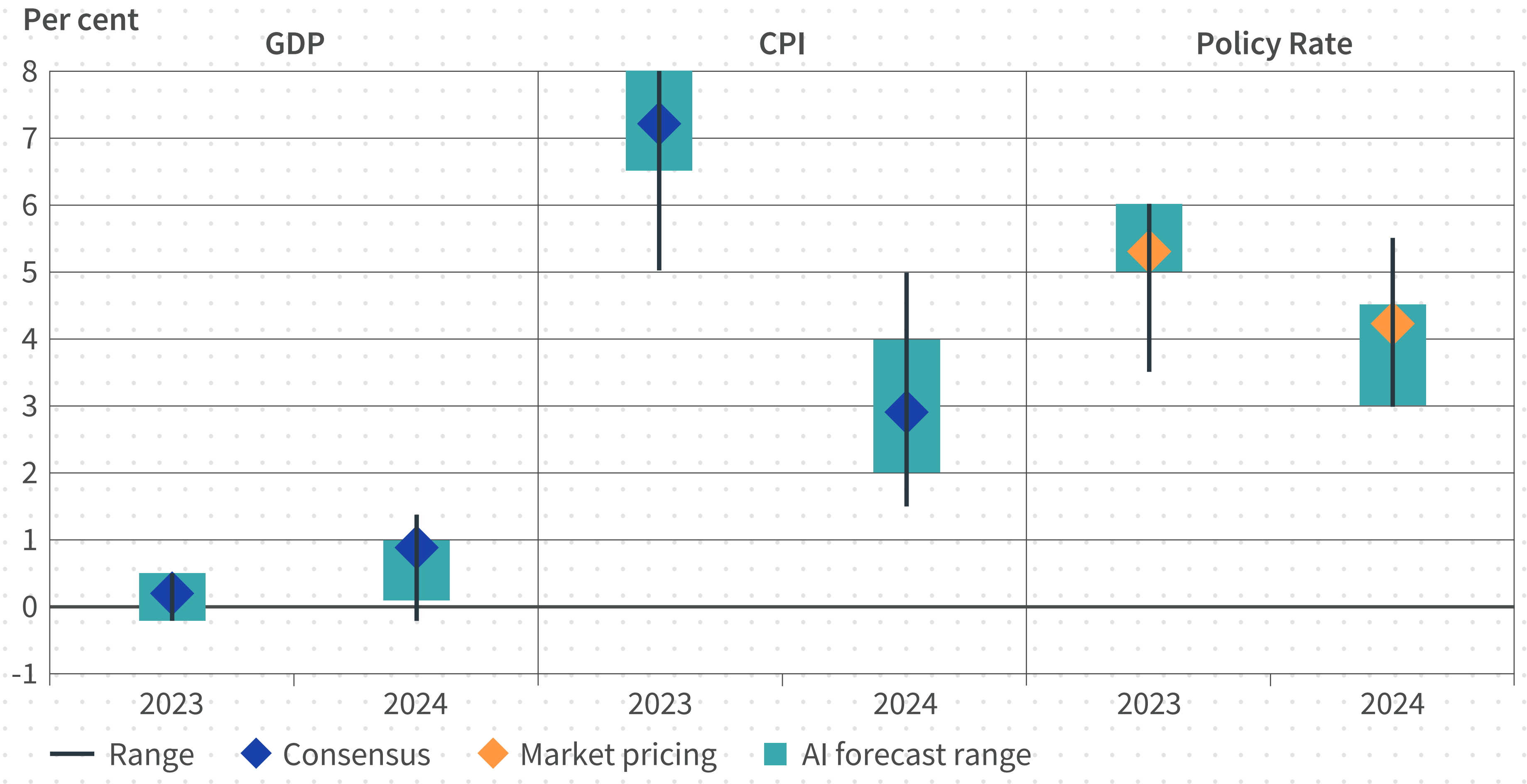


Source: Bloomberg, Aviva Investors as at 30 June 2023.

United Kingdom

Over the last three years there has been a great deal of commonality about macroeconomic outcomes in different countries. There were, of course, some divergences of experience, but the “common shock” element of events meant that there was much more similarity than difference. That period may now be ending for the UK, where recent months have seen some more alarming developments. Headline inflation in the UK is falling, albeit more slowly than elsewhere. But far more worryingly, core inflation is not, and wage pressures also are not receding as hoped. The message must be that demand is still too strong relative to supply and needs to be suppressed by tighter monetary policy. The Bank of England has responded and is willing to tolerate weak activity outcomes if that is what is needed to regain control over inflation. Markets now expect a rate peak of just over 6 per cent. The short-term growth outlook is therefore pretty bleak, with recession risk greater in the UK than elsewhere (Figure 15).

Figure 15. **United Kingdom**

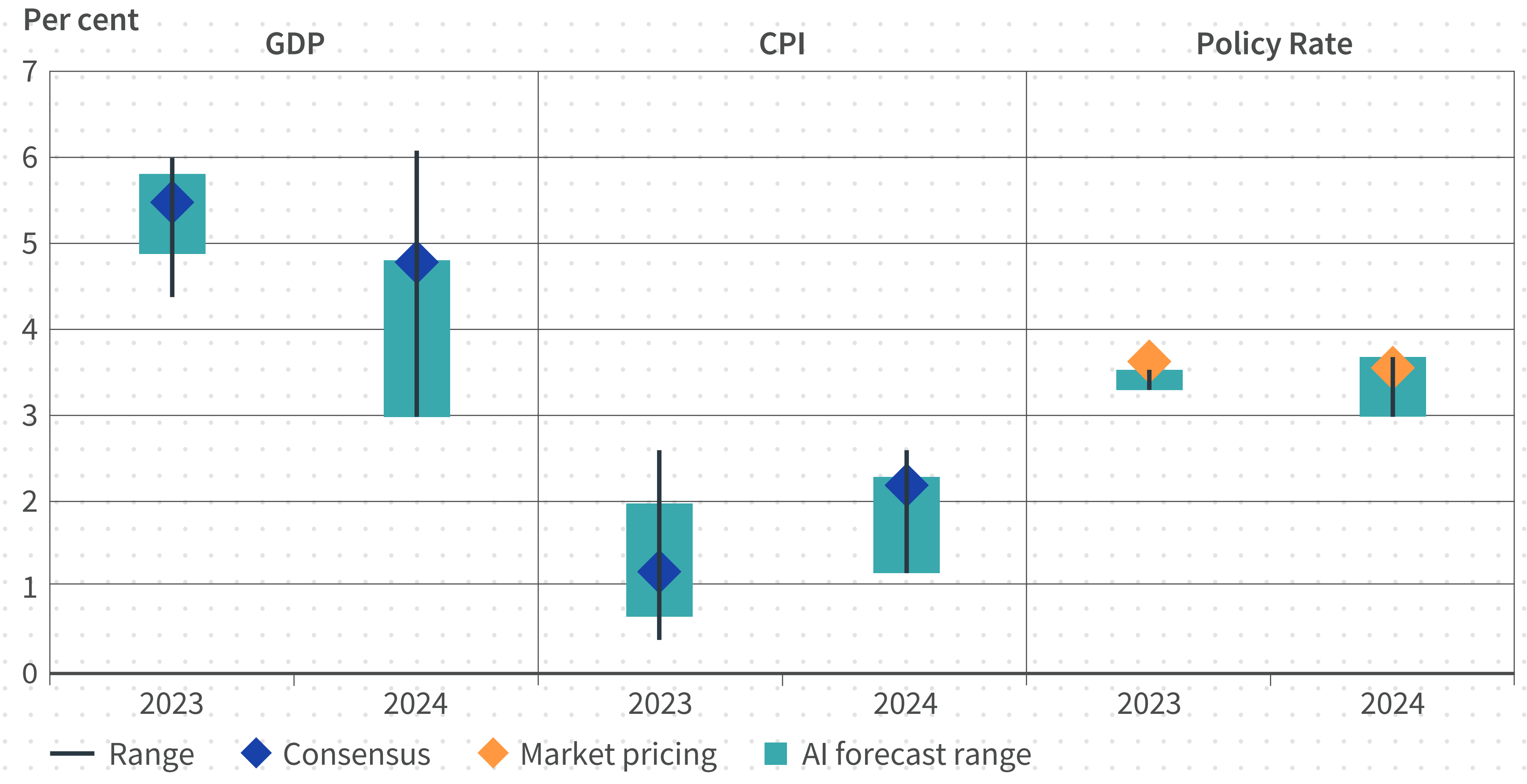


Source: Bloomberg, Aviva Investors as at 30 June 2023.

China

China’s reopening led to a rebound in Q1 growth (+2.2 per cent q/q), but a global manufacturing decline and domestic pessimism has not sustained that momentum. The weakness in the property sector is still dampening sentiment, causing negative wealth effects on consumption and lower investment. Local government cashflows are also impacted and LGFV indebtedness constrains funding. Demographics are also a near-term and longer-term headwind; trend growth is falling to 4 per cent or less. This weakness in demand, coupled with overcapacity in manufactures, is reflected in low inflation (CPI near zero, PPI in deep deflation) and falling firm profits – and coupled with high savings rates results in a gigantic current account surplus. Exporters are keeping funds offshore and dollar carry trades are in vogue, and tolerated by the PBoC, which is cutting rates in small increments, and so inducing modest currency weakness. Authorities are wary of large stimulus, but will unveil modest support measures for property and once again lean on infrastructure to prevent growth from slumping too far (Figure 16).

Figure 16. **China**

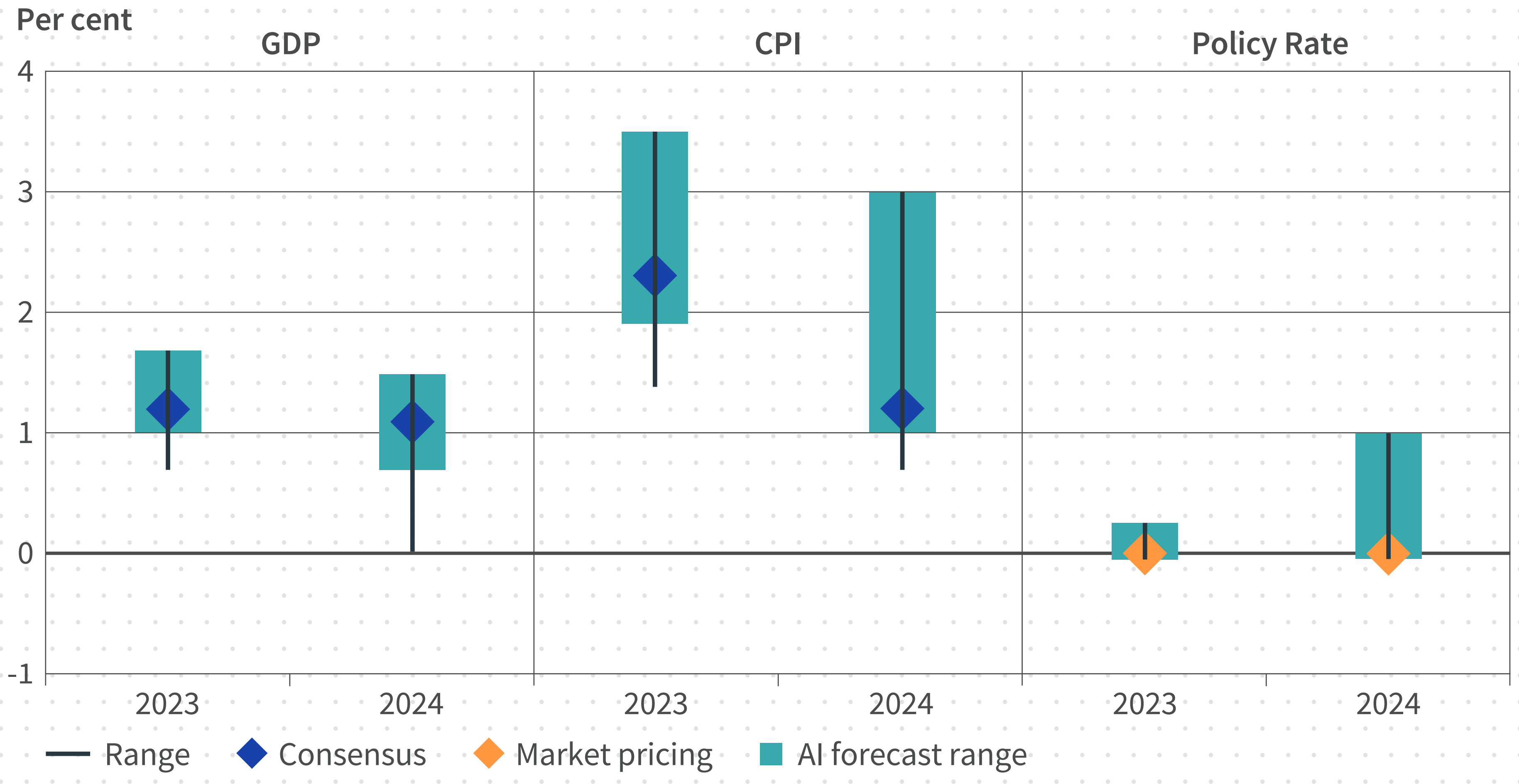


Source: Bloomberg, Aviva Investors as at 30 June 2023.

Japan

The distribution for outcomes for Japan's GDP, inflation and interest rates are all skewed to the upside in the forecast horizon, even as growth and some price pressures are diminishing slightly. The reopening momentum is fading and commodity prices have come down. Yet import costs continue to be passed through to output prices, and strong wages and tight labour markets should support demand, while yen weakness is set to persist as the BoJ keeps burying its head deeper in the sand. Inflation has been running well above 3 per cent for many months, and is unlikely to drop back below 2 per cent as the central bank forecasts. Yield curve control (YCC) may have been kept too long, as Kuroda and his successor Ueda both seem ultra-cautious and politically influenced, suggesting that FX weakness or unpopularity of inflation may spur its abandonment. Rate hikes may follow, but the BoJ will be circumspect due to its past hawkish policy errors, risking falling behind the curve should inflation pressures persist and a global hard landing not materialise (Figure 17).

Figure 17. **Japan**

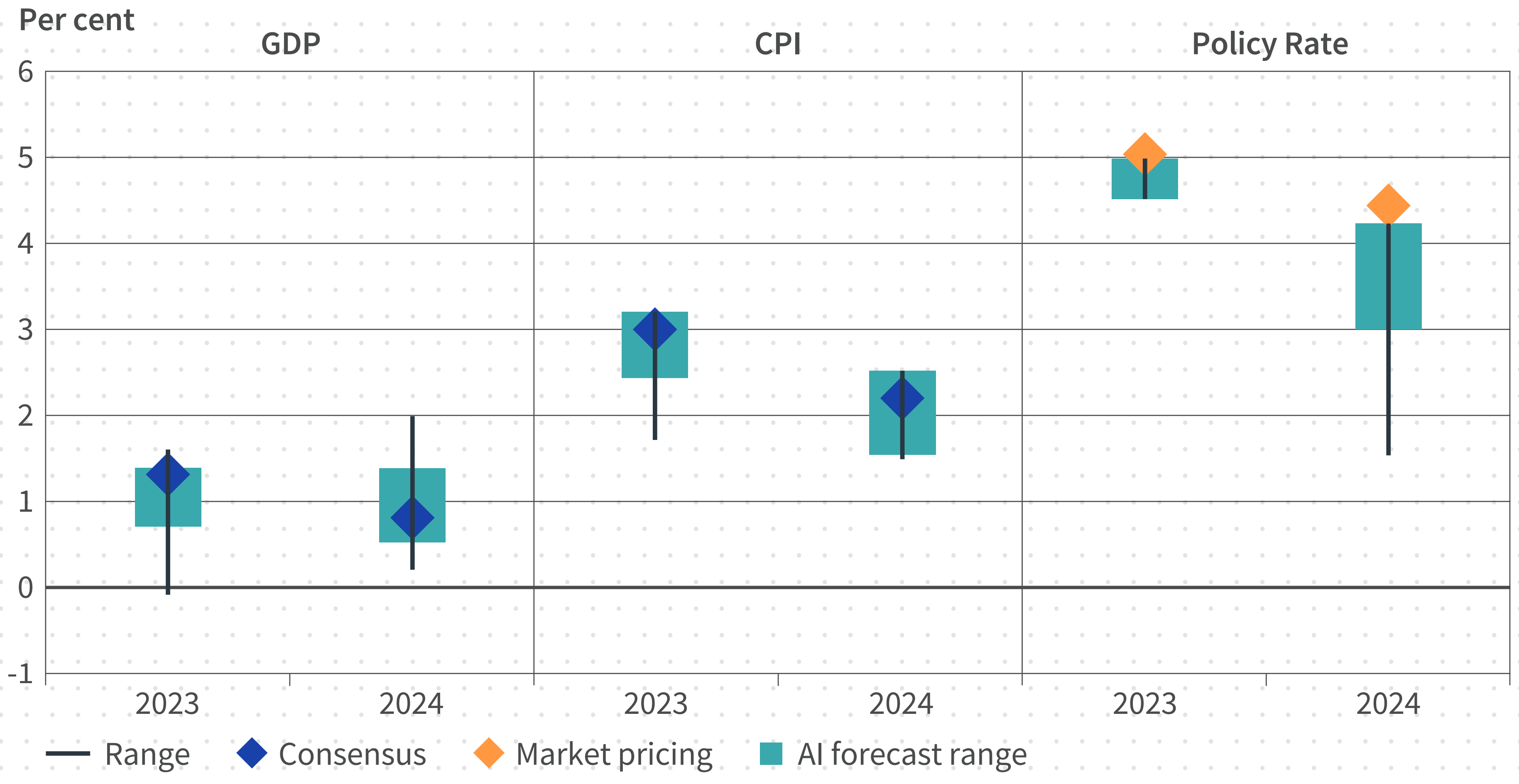


Source: Bloomberg, Aviva Investors as at 30 June 2023.

Canada

Since December 2022 there had been steady disinflation, accompanied by a clear slowdown in domestic demand in Canada. However, April's upside surprises in growth and inflation, accompanied by stabilisation in house prices, led the BoC to surprise markets by ending their hiatus with a June 25bp hike. Despite May's numbers showing further disinflation, core measures remain unacceptably high and are proving to be stickier than anticipated. However, June also saw the unemployment rate rise for the first time since 2020, with firms reporting lower shortages in labour. This perhaps indicates further disinflation to come, as the surge in migration (to which the reacceleration in domestic demand could be attributed to) at the start of the year helps to loosen Canada's labour market. We expect for the BoC to keep its policy rate at 4.75 per cent throughout 2023 as unemployment rises and the disinflationary process continues; with a view to start cutting rates by mid-2024 with inflation back at target over the same horizon. Nevertheless, risks to both growth and inflation remain to the upside (Figure 18).

Figure 18. **Canada**



Source: Bloomberg, Aviva Investors as at 30 June 2023.

Global market outlook and asset allocation

Reduced near-term recession risk and persistent underlying inflation pressure has led to additional rounds of rate hikes, and markets are arguably over-optimistic on the pace of cuts over the next 1-2 years.

Asset Allocation is positive on equity and credit markets from a tactical basis.

We anticipate reducing risky asset exposure as recessions materialise, but many longer-term factors in our House View themes are potentially positive.

The latter part of the year should see many emerging market central banks delivering expected cuts; we are constructive on EM duration and FX, but cautious on EM equities.

A medium-term decline in the US dollar's exchange rate has probably begun.

A busy first half has seen inflation rear up, then recede, but not fade away

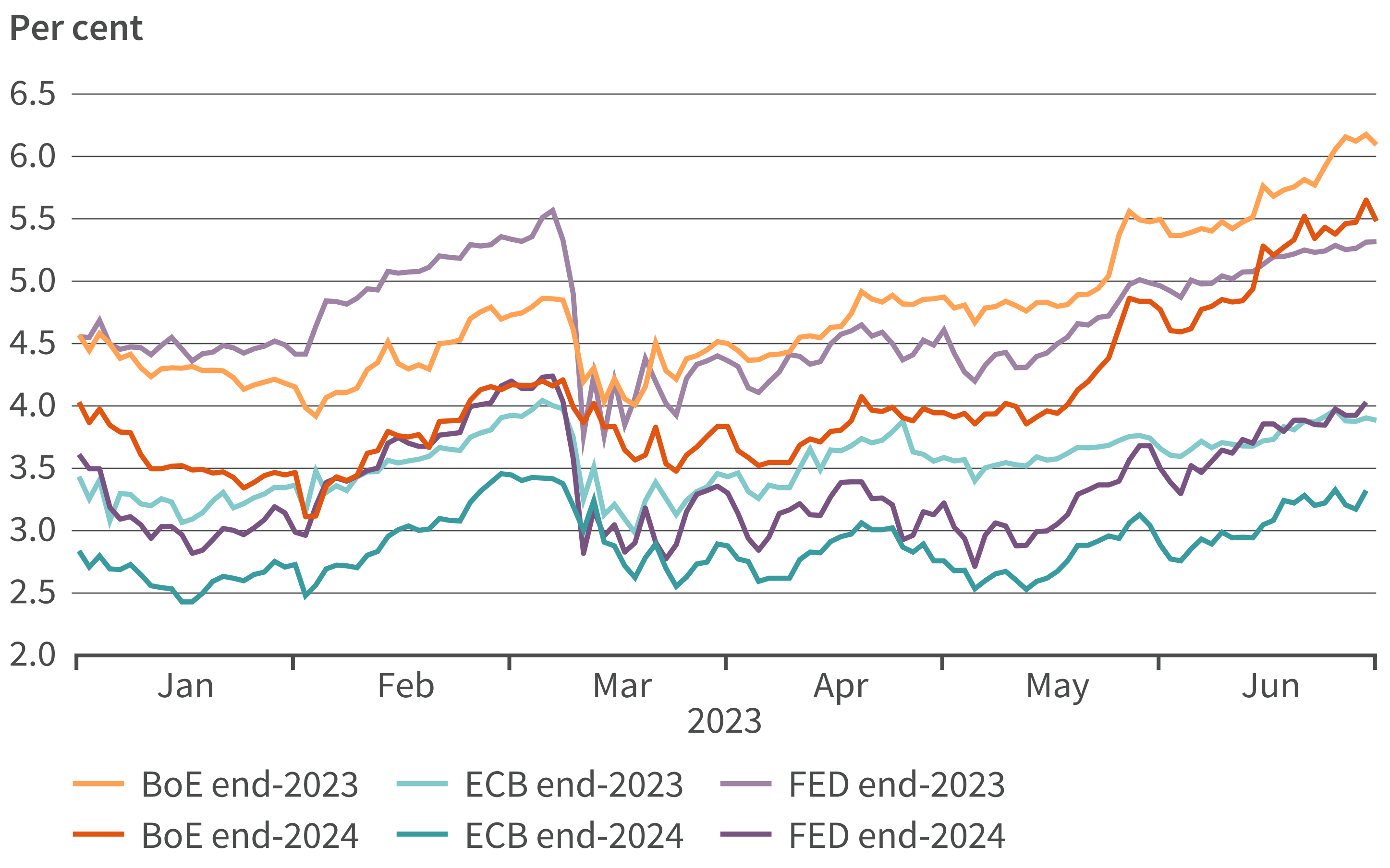
As we often tell young people, life is about the journey, not just the destination. The same goes for markets: even with a recession looming, the path that gets us there, investor positioning, changing expectations about outcomes and tail risks, and heterogeneity across sectors, geographies and asset classes is what drives prices. A busy first half has seen inflation rear up, then recede, but not fade away, while perception of recession risk ebbed, jumped, and waned. Despite a manufacturing downturn that normally precedes a broader slump, GDP growth and markets have held in well. In contrast to 2022 and Q1, an additional few rounds of rate hikes have not resulted in a broad risk-off environment or a strong dollar. In the second half of 2023, disinflation will continue to unfold, but markets still seem overoptimistic that it will be fast, and facilitate fairly rapid rate cuts in both EM and DM over the next 12-18 months (Figure 19 and 20), along with the "soft landing" that enables a rise in earnings to support equity valuations and credit.

Having overcome fast rate hikes, a potential energy crisis and a prospective financial catastrophe, the global economy looks to have stabilised and inflation has peaked, even if it's a long way from policymakers' targets. Earnings beat somewhat lowered expectations, and defaults are rising slowly, while disappointing Chinese growth is leading to stimulus hopes. This, coupled with positioning that is building from low levels, makes us positive on equity and credit markets from a tactical basis, but neutral-to-negative medium term; we anticipate reducing risky asset exposure, potentially a lot, as recessions materialise and if we judge that hard landing risk is going to increase.

> ***In contrast to 2022 and Q1, an additional few rounds of rate hikes have not resulted in a broad risk-off environment or a strong dollar***

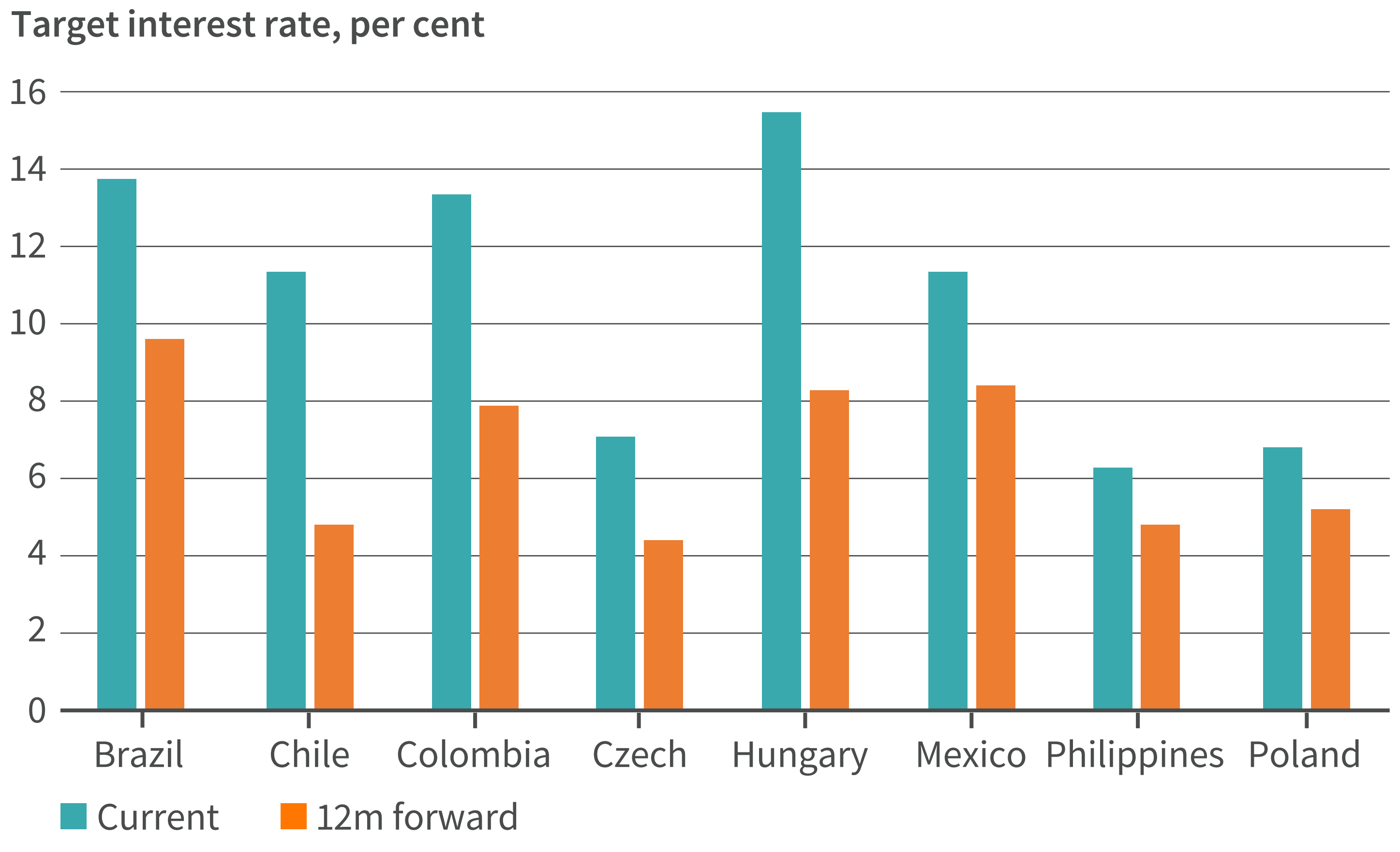
Most equity markets are up in the 10-20 per cent range YTD, with tech companies fuelling the Nasdaq and loose monetary policy propelling Japan to around 30 per cent increases, while disappointing UK and China are in the doldrums. This heterogeneity is mirrored in the dispersion across sectors (Figure 21), with the most interest-rate sensitive sectors continuing to underperform, but positive growth surprises and ability of many firms to pass through input cost increases to maintain margins powering most indices to renewed strength. As inflation recedes, real rates will too, but oligopolies and firms with strong brands may even increase margins. Perceptions of the probability of a hard landing have decreased, which has been reflected in the decline of implied equity volume, credit spreads, and cross-sector and intrasector correlations. With VIX and IG and HY credit spreads approaching their tightest levels in 18-21 months, it is also hard to be very constructive on these factors driving equities higher.

Figure 19. **Rate paths have moved back up, and rate cuts pushed further out**



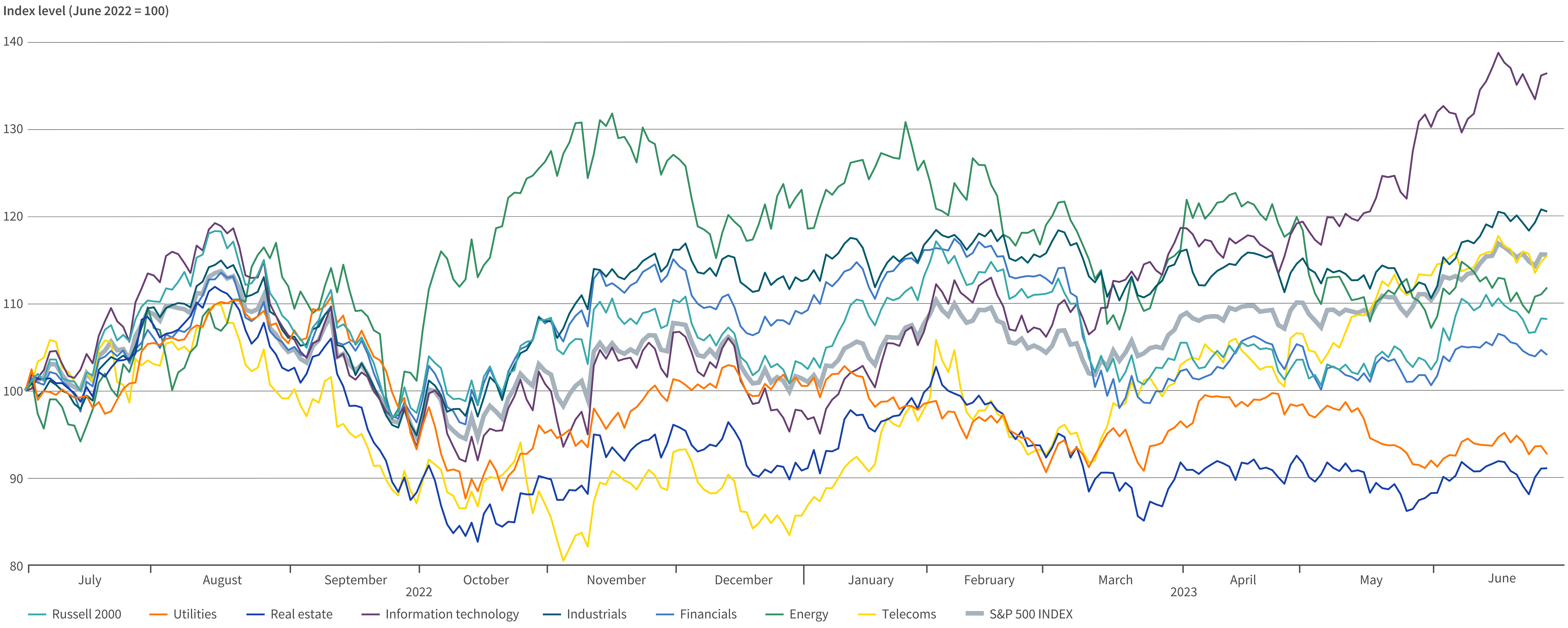
Source: Bloomberg, Aviva Investors as at 30 June 2023.

Figure 20. **Markets imply large rate cuts across many Emerging Markets**



Source: Aviva Investors, Macrobond as at 30 June 2023.

Figure 21. **Equity returns reflect high real rates and tech optimism**

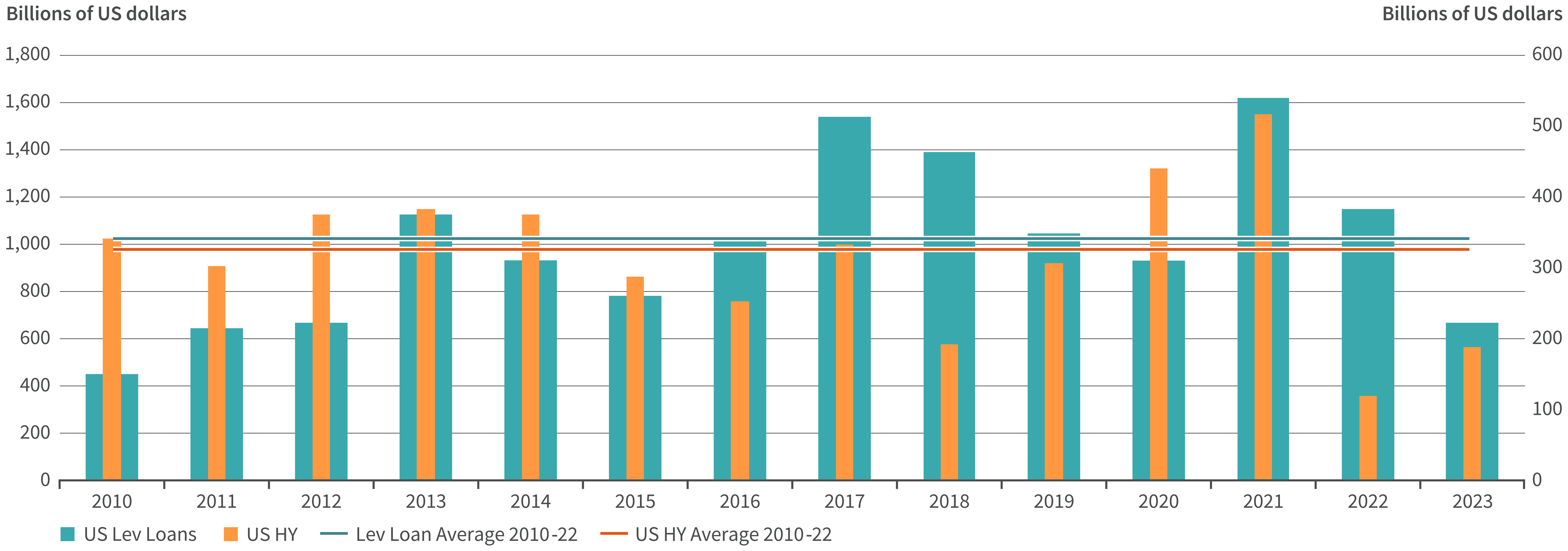


Source: Aviva Investors, Macrobond as at 30 June 2023.

However, some longer-term factors are potentially positive: the House View theme we label Industrial Policy involves programmes that are beginning to unleash a stream of investment incentives and tax breaks. The hope of policymakers and NGOs is that these will usher in an era of decarbonisation and green energy, improved infrastructure, and resilience in supply chains. The hope of shareholders and executives is a gravy train of profits as governments pick winners (and by exclusions, determine losers as well). Global fragmentation, as explained in our Themes and Risks section, means lower growth as efficiency and speed are traded off for resilience and lower risk. But that also means less competition and extra earnings, particularly for chips and dual-use technologies, as well as the defence sector. A rapid transition to a low carbon future is energy intensive, decreases investment in key oil and gas production that will be needed for decades, and will require huge amounts of metals and rare earths (which are also metals, and often not particularly rare, just difficult or expensive to get at). Commodities have performed poorly as the industrial cycle and Chinese growth slow, but the long-term prognosis seems auspicious. Finally, Tech is pricey to be sure, but Artificial Intelligence promises to be as revolutionary as the internet, and the latter part of the monetary tightening cycle has failed to lift long-end yields that previously hurt the sector's returns; central banks signal cuts, while not imminent, aren't too far away.

Although most developed market central banks will at long last achieve their "terminal rate" for this hiking cycle sometime in the H2, we have learned that a pause may still be followed by some additional hawkish fine-tuning (Figure 19). Rate markets were in a state of panic after Credit Suisse and SVB failed, with post-GFC trauma evident in pricing in huge rate cuts and spiking banking sector CDS – most of that has now been reversed, and cutting cycles have been pushed (still optimistically!) into 2024. In contrast, Emerging Markets saw rates go up 6-9 months earlier, and the latter part of this year should see many delivering on cuts that are priced into bond markets; we are constructive on EM duration and FX, as large carry and positive real rates will attract flows despite how much is already anticipated by markets (Figure 20). Many of the weakest links in EM have already defaulted or are priced for recovery/restructuring, though fiscal sustainability is still a risk worth noting – especially if recessions hit while interest rates are still restrictive.

Figure 22. **Creditors have turned parsimonious, but huge prior issuance and technical are supporting markets**



Source: Bloomberg, Aviva Investors; 2023 based in YTD issuance, annualised, as at 27 June 2023.

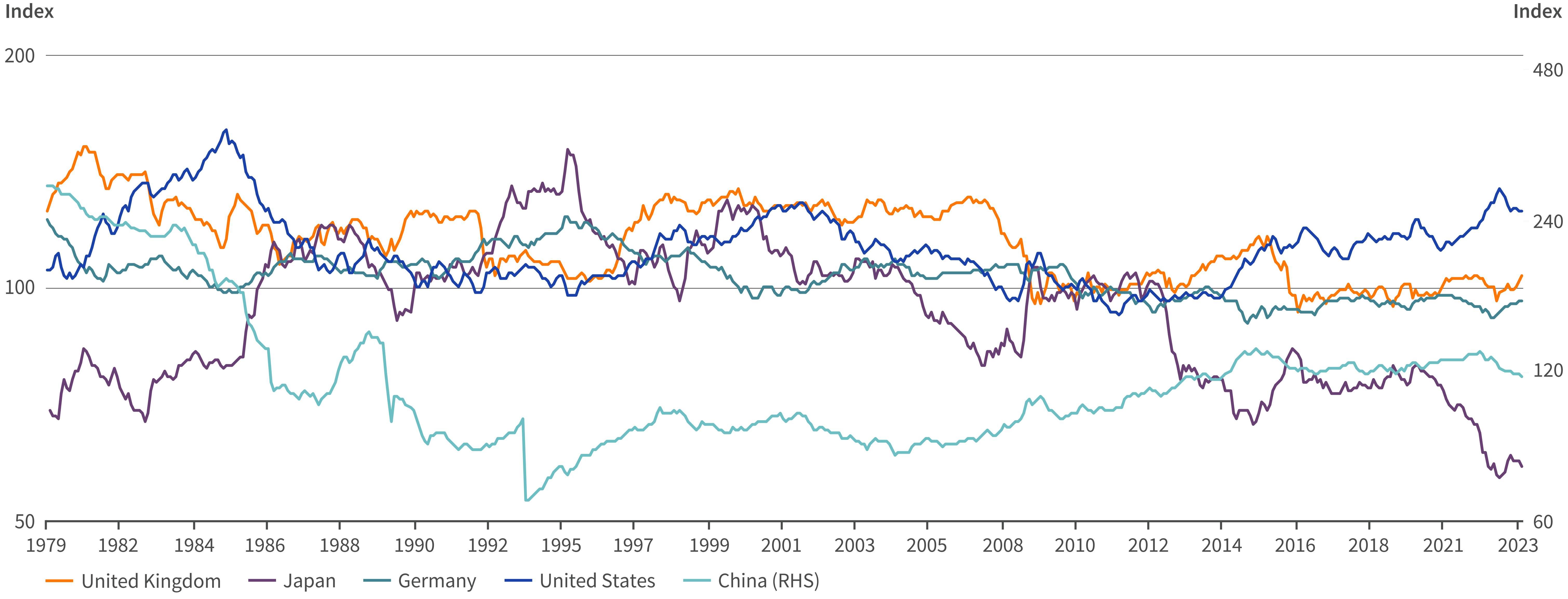
Industrial Policy is beginning to unleash investment incentives and tax breaks

A few quarters ago, with a meaningful energy shock and large growth downgrades, we (and markets) expected a slew of fallen angels and a spate of non-payments to damage corporate credit. In fact, this bad outcome did not come to pass aside from the handful of bank failures and a few idiosyncratic stories, and creditworthiness has been broadly stable even as bankruptcies and defaults have ticked up. Flows from reinvestments and inflows thanks to higher yields are also supportive of corporate credit markets, while technicals are helpful too: huge issuance termed out debt in the past few years of ultra-low bond yields, but now supply has dropped off significantly (Figure 22). There is no impending maturity wall, though refinancings will pick up in 2024-25, which may prove to be the real testing ground, if a recession is delayed until that time period.

As we wrote three months ago, a medium-term decline in the dollar has arguably already begun, but the delay in reaching terminal US rates, along with hikes elsewhere, has kept the greenback rangebound against other most currencies. The lowest yielders in G10, such as SEK, NOK and JPY have been pushed ever weaker, and CNY is likewise being used as a funding currency and risk hedge, with the PBOC one of the only major central banks cutting rates. However, in real terms, it is still close to its strongest level since the post-1994 30-year globalisation boom began, and slow growth, monetary easing and capital outflows may outweigh the structural, stable trade surplus. Likewise, the yen is on a weakening trend and at the mercy of when other central banks reverse their tightening cycles, though a shift in the BoJ's YCC or negative rate policy ought to provide temporary support. The eventual dollar depreciation will take many years to play out (Figure 23), and for now we remain negative on the yen, and positive on EM. In Emerging Markets, rate cuts go hand-in-hand with currency appreciation, and given the huge carry, should not be slowed too much by central banks removing some restriction in the second half of the year. Clearly, though, it is LatAm and high-yielding CEEMEA that have and will benefit most, while Asian FX is dragged down by the trend weakness in yen and renminbi.

The yen is on a weakening trend and at the mercy of when other central banks reverse their tightening cycles

Figure 23. **Real effective exchange rates are often highly unstable and trends last years or decades**



Source: Bloomberg, BIS, Aviva Investors as at 30 June 2023.

Figure 24. **Asset Allocation**

	Underweight										Overweight
	-5	-4	-3	-2	-1	0	1	2	3	4	5
Equities								2			
US							1				
Europe								2			
UK						0					
Japan							1				
Pacific Basin ex Japan						0					
Emerging Markets					-1						
Government bonds								2			
United States								2			
United Kingdom							1				
Germany						0					
France						0					
Italy						0					
Japan					-1						
Canada						0					
Australia						0					

	Underweight										Overweight
	-5	-4	-3	-2	-1	0	1	2	3	4	5
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)							1				
Alternatives						0					
Cash								2			
Currencies (versus USD)						0					
GBP						0					
EUR						0					
JPY						0					
CAD						0					
AUD						0					
EM FX							1				

Note: 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 30 June 2023.

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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.

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382323 – 31/07/2024