Aviva Investors

House View Q4 2023

Approaching the summit

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AVIVA INVESTORS

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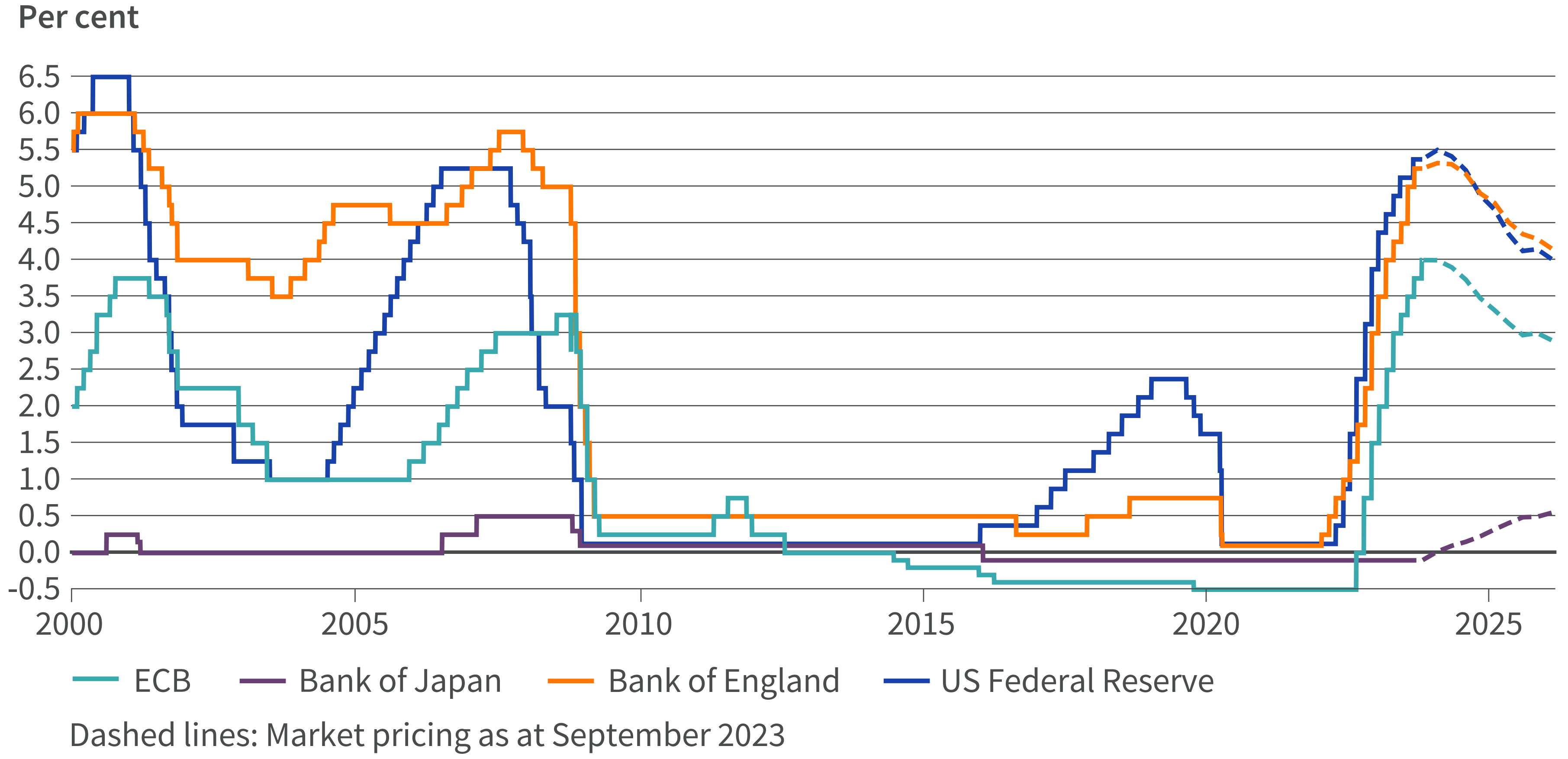
Executive summary

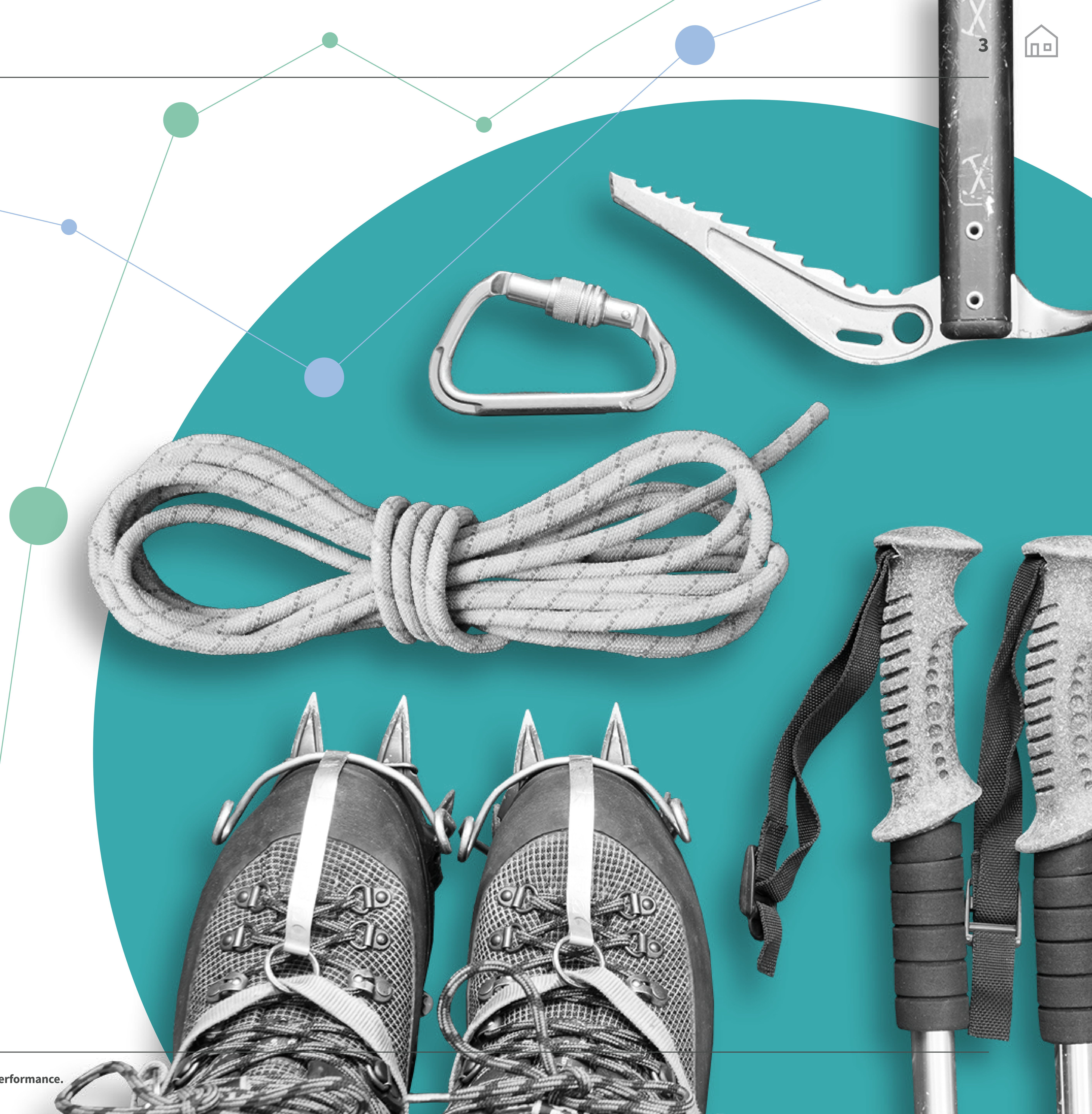
Approaching the summit

Central banks have raised policy rates sharply over the last 18 months. From the post-Covid lows of around zero, all the major central banks (except for the Bank of Japan and the Peoples Bank of China), have delivered the most aggressive tightening cycle since the 1970s. At the end of September, the Federal Reserve (Fed), ECB and Bank of England (BoE) had raised rates to 5.25-5.5 per cent, 4 per cent and 5.25 per cent, respectively (Figure 1). In the case of the ECB, that was the highest policy rate since the inception of the euro, while in the case of the Fed and BoE, it was the highest since 2001 and 2008, respectively. The tightening in policy rates followed the largest inflation shock in a generation, reflecting a combination of positive demand and negative supply factors across commodities, manufactured goods and services. We think that the policy rate cycle is approaching the peak in those major economies, although near-term risks remain tilted to higher rates.

Figure 1. **Major central bank policy rates**

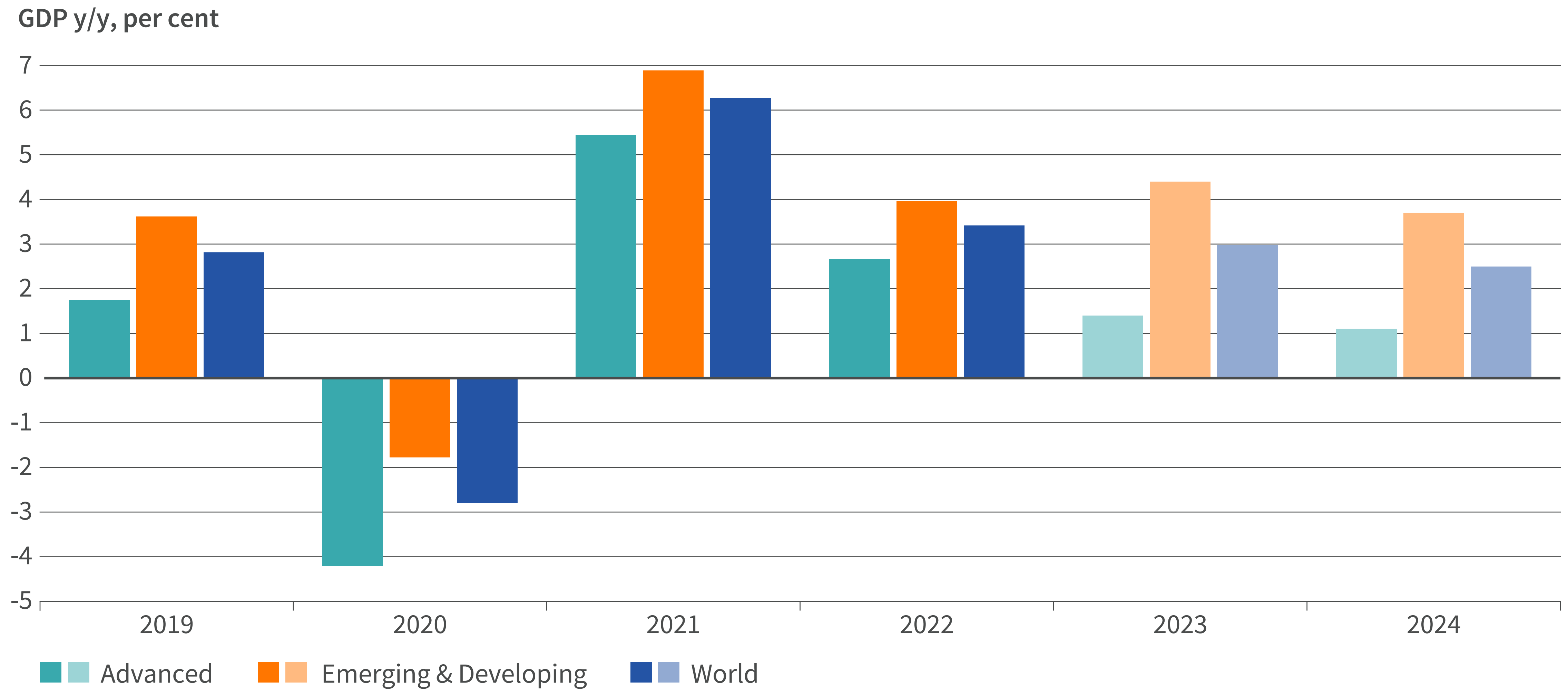


Source: Aviva Investors, Macrobond as at 30 September 2023.



The pass-through of changes in monetary policy to the real economy and inflation depends on many factors. Precisely how much interest rates need to rise to bring inflation back to target over a roughly two year horizon is difficult to judge. At a minimum, one would expect to have to deliver a positive real interest rate. But just how positive will depend on the short-term neutral (or natural) interest rate – the rate at which the economy is in a stable price equilibrium. That rate is not observable, so must be inferred. Setting aside temporary price-level shocks, one would usually need to observe a period of below-trend economic growth to follow from a period of restrictive monetary policy, to create economic slack and weigh down on inflationary pressures. We expect growth to be below trend in developed markets in 2024 (Figure 2), with global growth slowing from 3 per cent in 2023 to 2½ per cent in 2024. But there are have been some important regional differences to consider.

Figure 2. **Aviva Investors' growth projections**



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

We expect growth to be below trend in developed markets in 2024

In the case of the Eurozone and the UK, growth has indeed been below trend for the past 12 months. The combination of the impact of higher energy prices on household real disposable income, as well as the building effect of higher interest rates has weighed on household consumption. In fact, if household balance sheets had not been in decent shape (aided significantly by fiscal transfers), both economies would likely have gone into recession. Looking ahead, the effect of the 2022 energy shock has largely worked its way through, and subject to any further material supply disruptions should not be much of a drag on spending. However, the full effect of higher interest rates will take some more time to come through.

The prevalence of fixed-rate mortgage deals and termed-out corporate debt has meant that the usual negative cash flow effects from higher interest rates have been slower to materialise than in the past. But those effects will continue to build over the next six to 12 months and will weigh on consumption, and residential and business investment spending. However, with no material balance sheet adjustment required, deep recession is expected to be avoided.

In the United States, growth has been more robust than anticipated this year and is expected to remain above trend through to the end of the year. We expect to see a period of below trend growth next year, but do not have a recession in our central scenario. While the housing market has contracted in the face of higher interest rates, consumer spending has remained robust and business investment has been supported by government industrial policies to promote technology re-shoring and net zero targets. The fact that growth has remained strong suggests that real rates have not been high enough. As inflation has come down this year, real rates have moved into positive territory, but are likely to need to stay there for an extended period.

The use of industrial policies (see page 11) across the major developed markets was a key investment theme we identified earlier this year. The scale of direct spending and/or subsidy is significant over the next five to ten years. While it should not be seen as a large cyclical growth boost, these policies are expected to provide a consistent tailwind to activity. That should eventually result in increased supply potential, but the demand effects will outweigh the supply effects in the near term. That will keep capacity tighter than would have otherwise been the case, as we do not expect the support to completely crowd out other investment. It is one of the factors informing our view that underlying inflationary pressures will be stronger than in the past decade and interest rates will be higher.

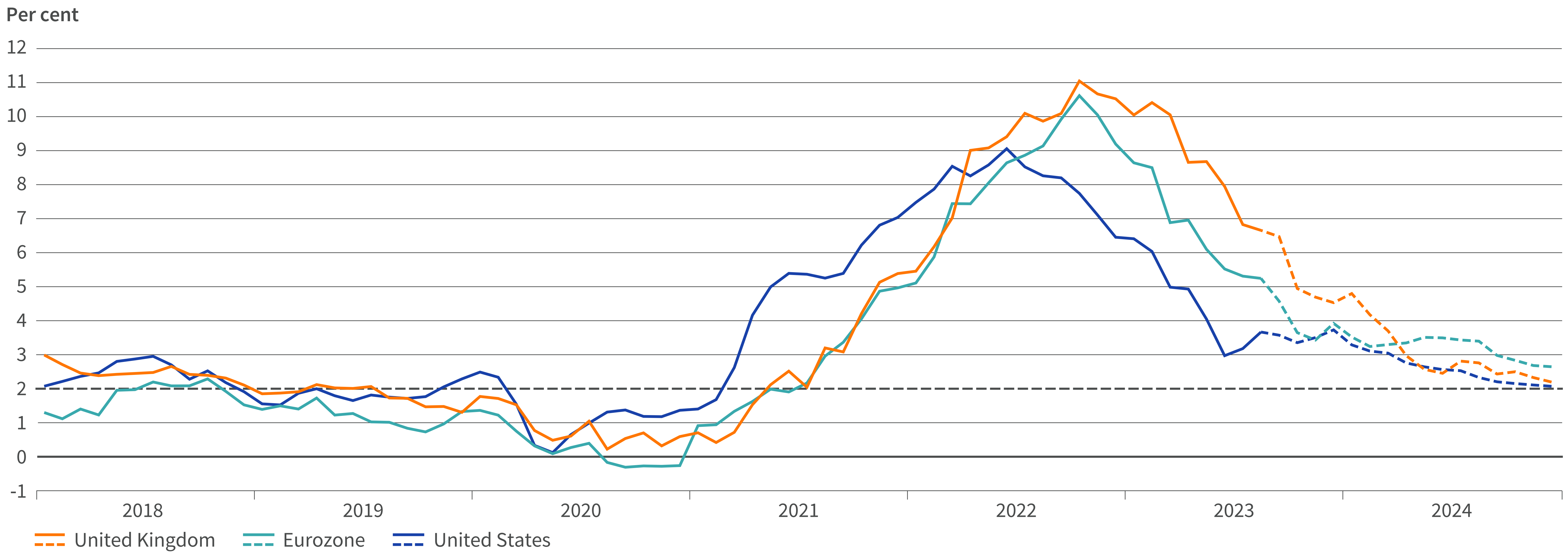
Emerging market economies have traditionally been more active in pursuing industrial policies in the past. China would be a prime example. While we expect that they will continue to strategically support certain industries, especially in the technology field, we expect less support to come for property and infrastructure than in the past two decades. The debt overhang that has been created will need to be addressed over a long period of restructuring and is expected to result in notably slower growth in China over the next decade.

Headline rates of inflation have fallen this year, as we anticipated, with the contribution from energy pulling inflation down. The softness in global manufacturing activity, as well as the pass-through of lower energy prices, has also seen consumer goods inflation ease. In Europe, the contribution from food, which has been unusually strong due to energy costs and supply shortages in certain fresh foods, is also set to fall back further.

These are all encouraging signs for a normalisation in inflation rates. However, core inflation measures remain elevated due to ongoing pressures in the service sector. We expect these pressures to ease only gradually over the next year, leaving both headline and core inflation measures above – albeit much closer to – central bank targets by the end of 2024 (Figure 3). We see the risks tilted to the upside over the next six months, with energy prices potentially contributing positively once again, wage growth potentially remaining even more sticky and firms' margins stabilising or even rising.

Headline rates of inflation have fallen this year, as we anticipated, with the contribution from energy pulling inflation down

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



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

We prefer to be overweight equities and underweight government bonds

Turning to our asset allocation views (Figure 4), we prefer to be overweight equities, with earnings growth likely to be near the bottom, and therefore providing some upside into 2024. That said, we remain conscious of the risk of a sharper move higher in yields. Within the regions, we prefer to be fairly evenly overweight the majors, with underweights in emerging markets and Asia ex-Japan given the weaker growth outlook for China. In fixed income we prefer to be underweight government bonds. Given our view on the balance of inflation risks, this helps to fund the equity overweight and protects against further bear steepening. The underweights are focused on the US, where growth remains strongest, and Japan, where we continue to expect further policy tightening. Overweights are focused on the UK and Germany, where growth is weak and inflation slowing rapidly, as well as Australia, where the curve is much flatter than elsewhere. We prefer to be overall neutral credit, but within that overweight high-yield versus underweight investment grade. High-yield credit spreads are still stuck somewhere between recession and cycle-extension. We think the latter wins out for now, particularly with limited funding needs next year. Finally, we are modestly overweight US dollars, with US growth outperformance expected to put the euro, sterling and EM currencies under some pressure.

Within equities, we prefer developed markets over emerging markets

Figure 4. **Asset allocation**

	Underweight										Overweight
	-5	-4	-3	-2	-1	0	1	2	3	4	5
Equities									3		
Government bonds				-2							
Credit						0					
Cash						0					
Currencies (versus US$)					-1						

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

Key investment themes and risks

Investment themes

1	2	3
Approaching peak policy rates	**Global fragmentation**	**Industrial policy programmes**

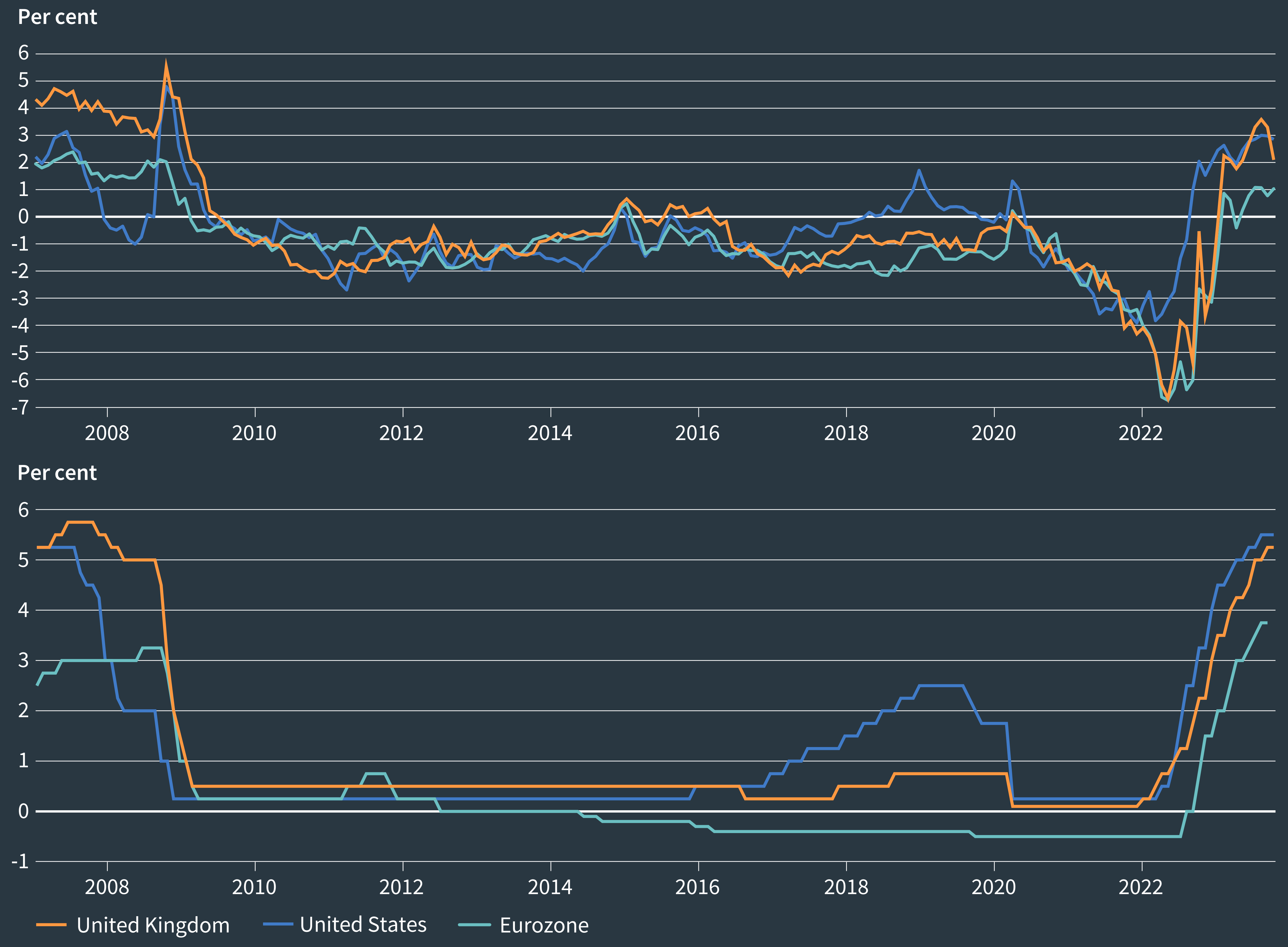
Approaching peak policy rates

Since late 2021, the major developed market central banks have aggressively raised policy rates in an effort to curb excess demand and bring inflation back towards their 2 per cent target. The speed and magnitude of the rate increases over the last two years has only been seen before in the 1970s. However, the starting point in nominal terms was clearly very different this time. Policy rates were cut to effective lower bound (close to zero) in the aftermath of the Covid shock and are now at a similar level to before the 2007/08 global financial crisis. The move in real interest rates has been even more significant, with market-implied real rates expected to be around 2 per cent in the US and UK, the highest in over a decade (Figure 5). By most estimates, this level of real rates ought to be sufficiently restrictive to slow growth to below trend and ease underlying inflation pressures. However, the precise level of real rates needed to deliver that outcome can only be observed after the fact. We think that central banks have likely done enough, but there remains an upside risk in the near term that modestly more tightening may be required. Hence, we think we are approaching peak policy rates. But to deliver enough of an easing in spare capacity, we expect that policy rates will need to stay elevated through 2024. In our central scenario, it may be that rates could be cut in 2024H2 if inflation falls back in the way we expect.

Figure 5. **Policy tightening**

Top figure: Real interest rates (1y OIS less 1y inflation swaps; UK adjusted for RPI-CPI wedge)

Bottom figure: policy rates



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

Market-implied real rates in the US and UK are expected to be the highest in over a decade

Global fragmentation

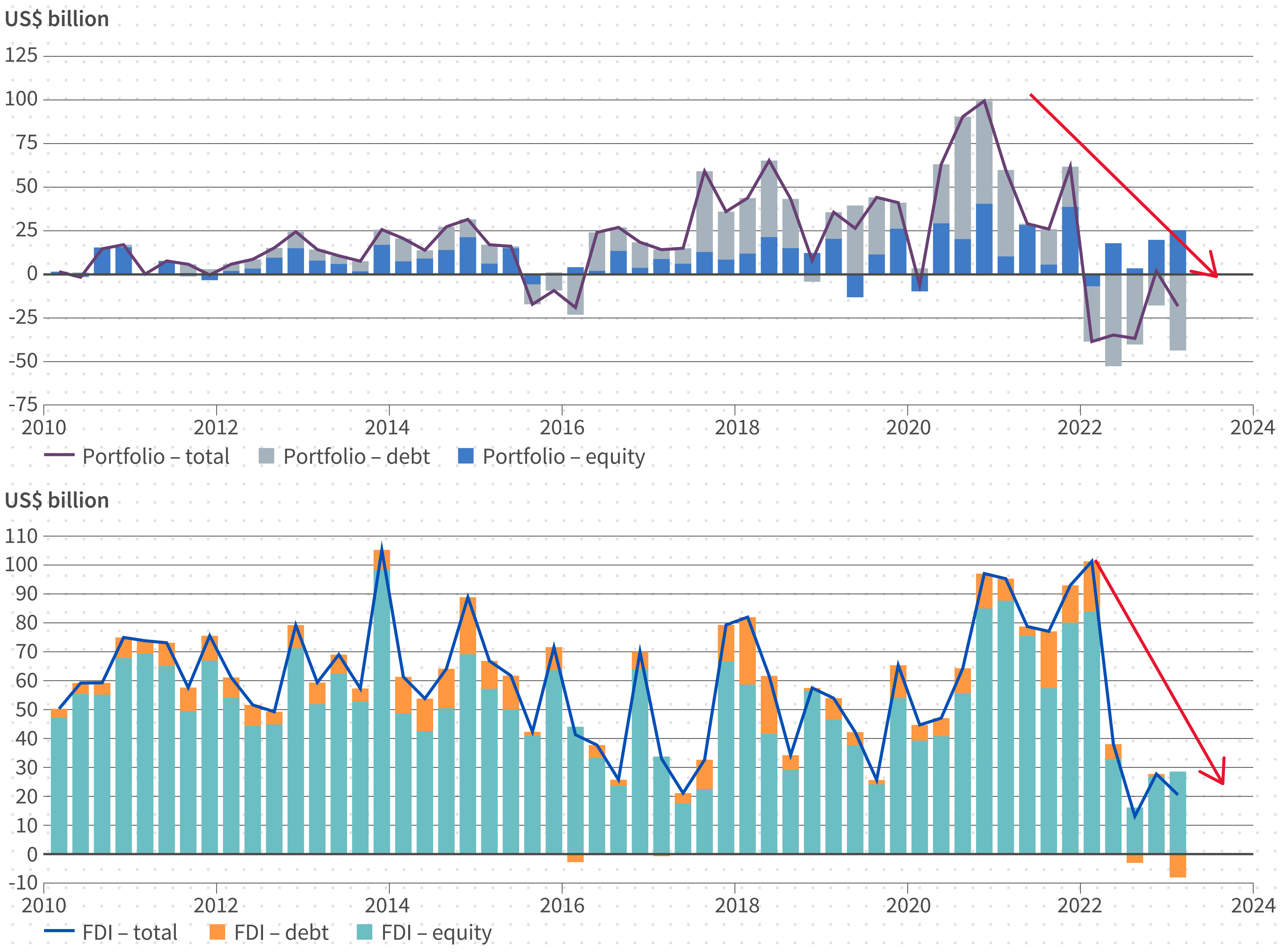
Geopolitical tensions show little sign of easing. Relations between the US and China may have improved a little in recent months, with visits to China from senior members of the US administration, including Treasury Secretary Yellen and Secretary of State Blinken, but the desire to decouple remains intense. In August, President Biden issued an Executive Order that prohibits or requires notification of certain types of outbound investments in advanced technologies and products. In particular, it highlights semiconductors, quantum technologies and artificial intelligence, with China targets as a country of particular concern. This follows the restriction on exports of similar high-tech components to China in the interests of national security. The rising tensions between the US and China over recent years has already had a noticeable impact on cross-border capital flows. Foreign direct investment (FDI) inflows to China have slowed dramatically over the past year, to the weakest level since records began in 2005 (Figure 6). Similarly, portfolio inflows have gone into reverse with significant outflows from Chinese debt securities. Net FDI and portfolio flows have also turned deeply negative in Russia since the outbreak of war in the Ukraine, with sanctions leading to a rapid withdrawal of capital. We expect cross-border capital flows to continue to be impacted by these and other global geopolitical tensions, including the recent breakout of violence in Gaza and Israel. That poses a potential macro-financial stability risk, particularly for emerging markets. It also reduces international risk diversification opportunities and likely increases the costs of production as national security concerns dominate efficiency and low-cost supply chains.

> ***We expect cross-border capital flows to continue to be impacted by these and other global geopolitical tensions***

Figure 6. **Chinese financial inflows**

Top figure. Net Portfolio inflows

Bottom figure. Net Foreign Direct Investment inflows



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

Industrial policy programmes

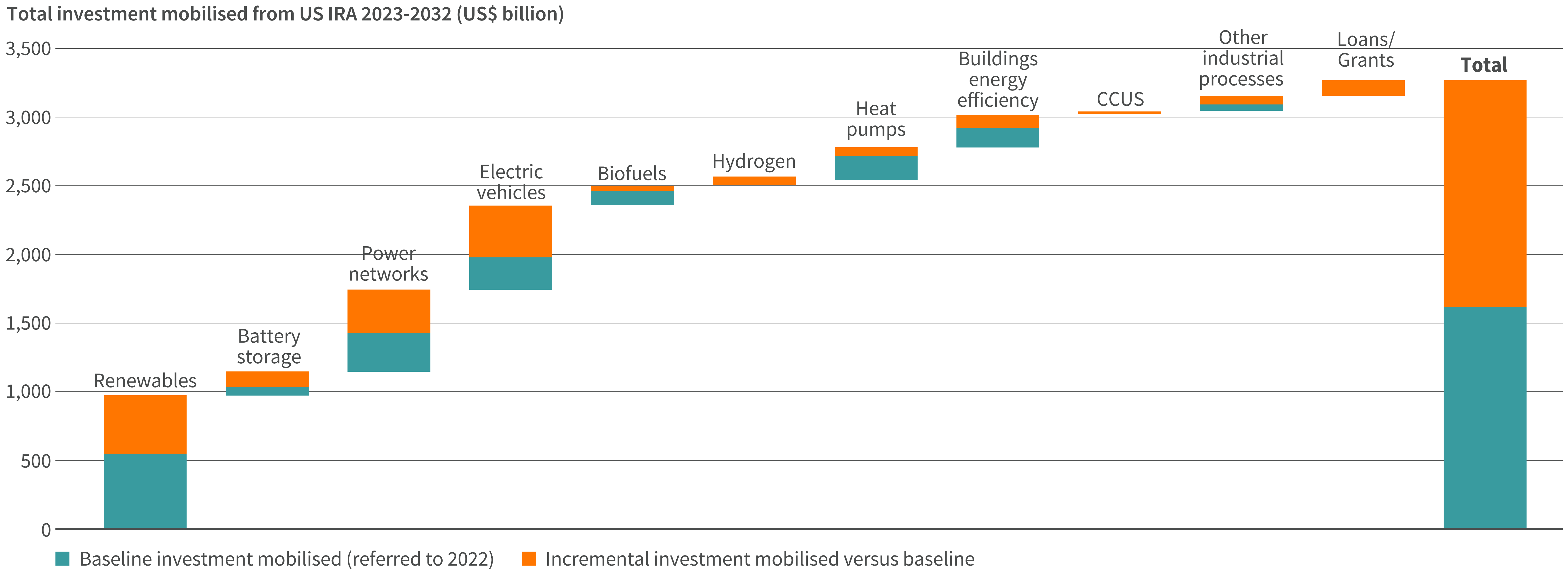
The renewed interest in industrial policies has come on the back of two tectonic shifts in the global economy. First, as noted above, global fragmentation will manifest itself in greater self-reliance in certain key areas. The United States and European Union have been clear that they want to have the capability to be self-reliant for certain aspects of the technology supply chain. In particular, bringing onshore the capacity to produce high-end semi-conductor chips, as well as strengthening other areas of technology. In the US, the CHIPS Act will provide tax breaks and subsidies worth around $280bn to incentivise investment in semi-conductor manufacturing, while at the same time requiring recipients to cease expanding similar operations in China. Second, the shift to renewable energy and electrification required by Net Zero targets requires enormous investment over coming decades. The US Inflation Reduction Act provides tax breaks and subsidies for investment in renewable energy and electrification. These incentives could unlock over $2 trillion in investment over the next decade (Figure 7). In Europe, only around one-fifth of the Next Generation EU funds (which are a combination of grants and loans worth 5 per cent of Eurozone GDP to primarily develop renewable energy and electrification) have been spent so far, with the remainder to be dispersed over the next four years. Meanwhile Germany has created its own Climate Fund (KTF) that will allocate €212bn (5 per cent of German GDP) to green transition projects over the next five years. These industrial policies create important trade-offs. By supporting "national champions" or particular industries for the purpose of security and self-sufficiency, governments may be trading off greater long-term efficiency and/or growth.

Moreover, unless the subsidised investment fully crowds out alternative investment spending, then it may also create short-term excess demand challenges, creating an inflationary tailwind. These policies also come with a significant fiscal cost that must be managed to ensure long-term sustainability. In our mind, these factors are likely to be important drivers of yields, both due to central bank reaction to ongoing inflationary pressures, as well as longer-term funding needs for government.

The US Inflation Reduction Act provides tax breaks and subsidies for investment in renewable energy and electrification

Figure 7. **Estimated incremental investment mobilised by the Inflation Reduction Act**

Cumulative investment relative to 2022 level



Source: Goldman Sachs Global Investment Research as at 30 September 2023.

Most climbers know the statistics: 80 per cent of accidents happen on the way down

Michael Grady
Head of Investment Strategy and Chief Economist

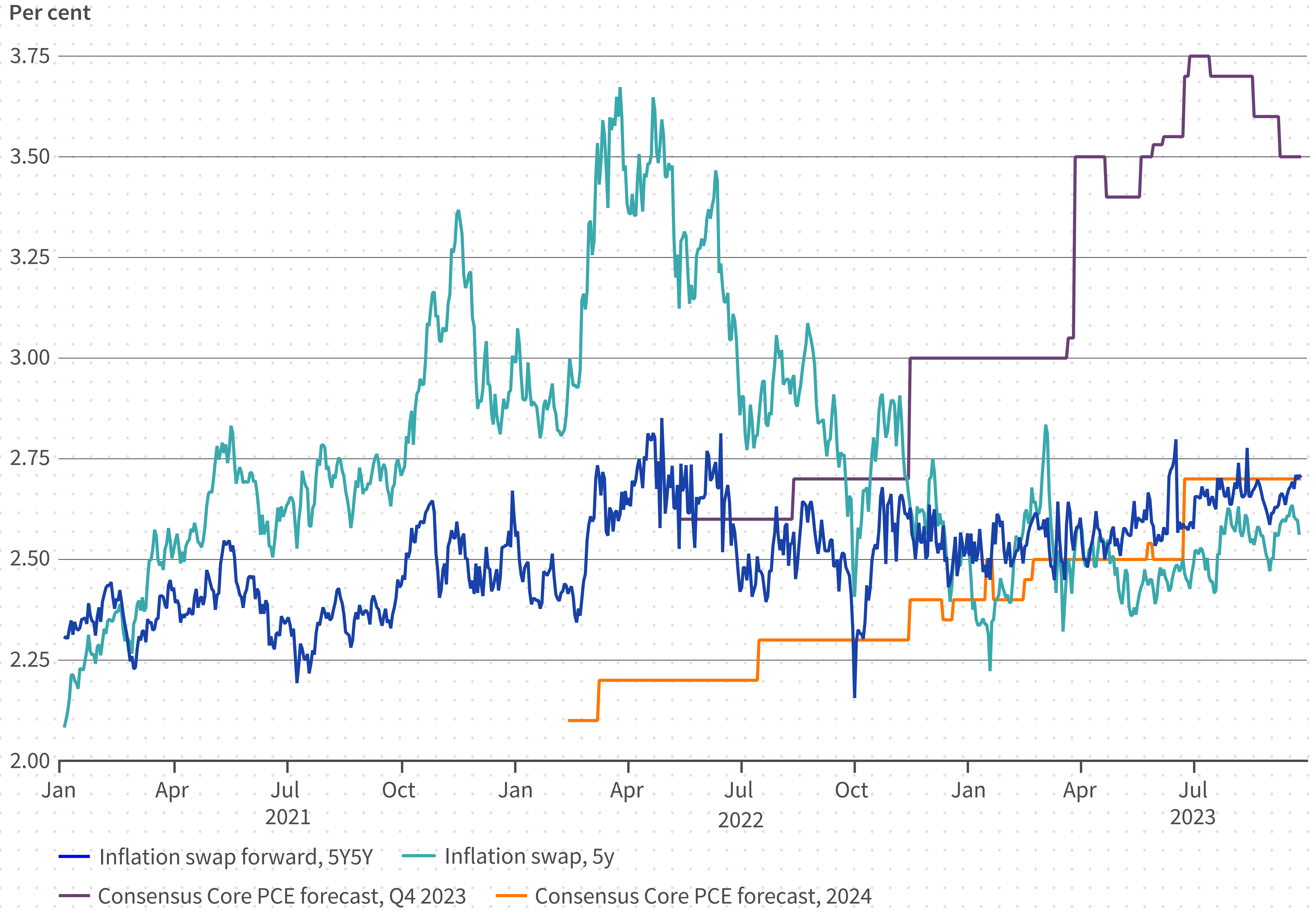
Risks

Delayed policy pass-through

Although Russia's brutal invasion and contemptible energy supply shock provides a valid excuse for many central banks being "behind the curve" on fighting inflation, the truth is that by early 2022 they should have known better. Many Emerging Markets had already had their wake-up call, and had realised that tentative, small rate hikes were inadequate. Eventually, most Developed Market monetary authorities followed suit and raised interest rates fairly aggressively. In the months ahead, policymakers need to descend the mountain. Most climbers know the statistics: 80 per cent of accidents happen on the way down. The same arguably holds true for monetary policy. Economists appreciate that inflation itself is unpopular but harmless, but *getting rid* of inflation means some combination of weakening demand, lower wage pressures, or excess capacity. In other words, real variables must move from solid to soft, and that can be damaging.

In calibrating their future rate cuts, New York Fed President John Williams and others have argued that seeing inflation come down and real rates rising will create space for lower nominal rates – otherwise, policy would become increasingly restrictive when the need for that was reduced. In the messy real world, getting the timing and sizing right to ensure a soft landing will be very difficult. Even if they don't raise rates just before a major recession (as the ECB did under Trichet multiple times) or repeat the ill-advised BoJ rate hike that Ueda voted for in 2000, the idea that central banks have the fine-tuning tools and foresight to engineer a "soft landing" is laughable. We should all hope for it, but it will take luck as well as skill to not "boil the frog". Forecasts of inflation have actually been climbing for 2024 and for the medium term, as central banks have become cautious of over-tightening, and growth has surprised in its resilience (Figure 8). That will keep the Fed and others careful in loosening policy, especially after their inaccurate forecasts have proven even further off the mark than usual. Whether through further hikes or "high for longer", the risk is that central banks, once again, fall behind the curve, with signs and momentum reversed from 2021-22, and inflation and/or growth surprise to the low side.

Figure 8. **US Inflation expectations rising near term, but still well-anchored long term**



Source: Bloomberg, Aviva Investors, Macrobond as at 30 September 2023.

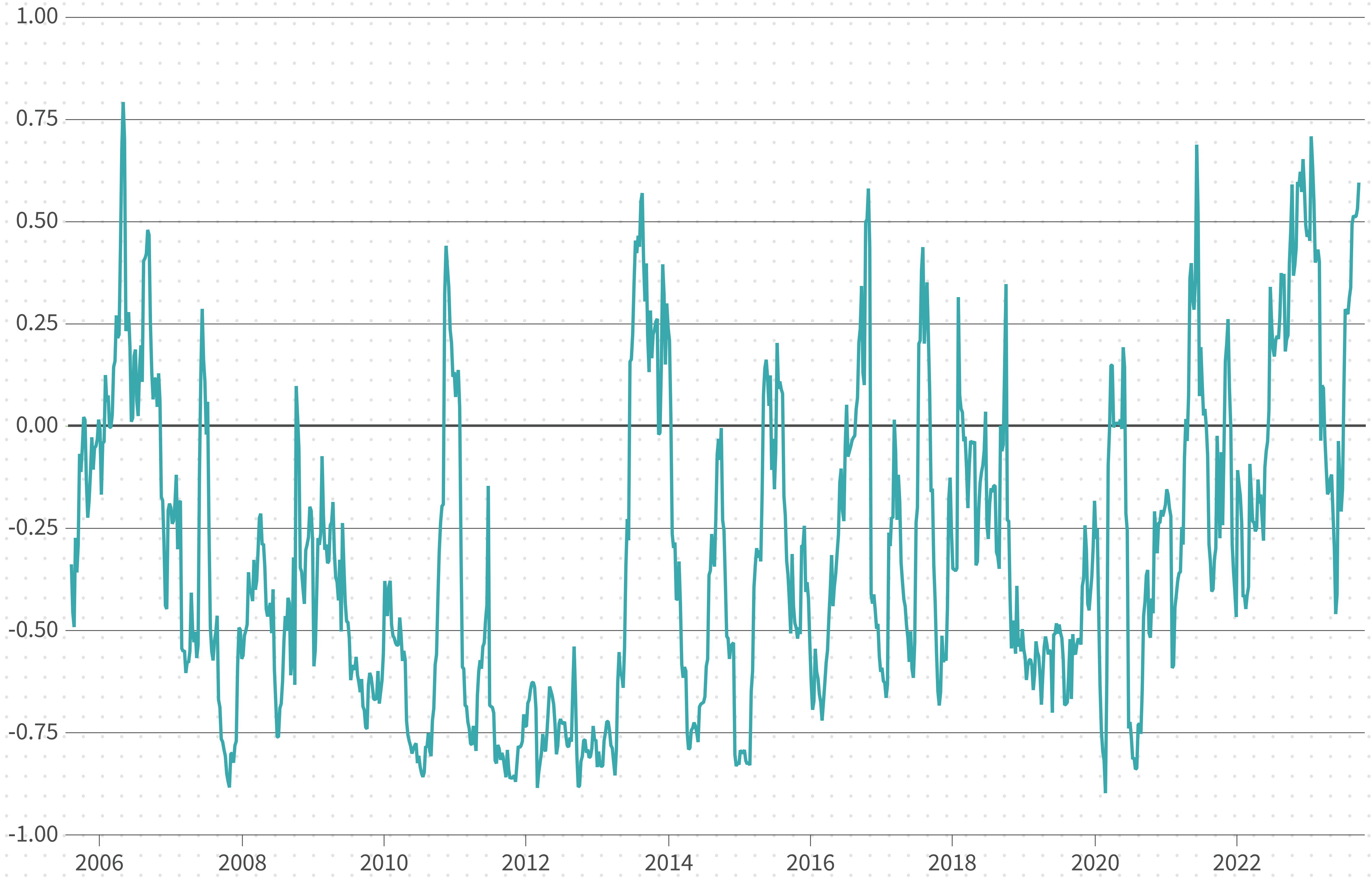
Inflation re-acceleration

Part of what makes risk #1 so probable and poignant is the existence of another possibility: that even after an unprecedented campaign to stem price rises, demand proves more resilient than expected, or supply constraints re-emerge. In other words, just as we have been celebrating "peak inflation" since late 2022 (first headline, then, finally, core measures more recently), we may soon be lamenting the "disinflation dip". The worst outcome for policymakers would be a stagflationary situation of weak growth but too little tempering of prices, and/or de-anchoring of expectations. Strikes and large wage settlements alongside fiscal spending in the run-up to elections, and Putin's despicable diplomatic display of using energy and food production and blockades to punish the coalition of countries helping Ukraine, are two of the more obvious risks.

The outcome might not be as dire, of course. The disinflation process is noisy and uneven, and we have had several false dawns since 2020, with a set of good datapoints followed by disappointing ones. The market reaction to such let-downs, e.g. in Sept/Oct 2022, or Jan/Feb 2023, was not very palatable. Moreover, the correlation between "risk-free" government bonds and "risky" assets such as credit and equities has not returned to low or negative values that prevailed through much of the post-GFC period, enhancing balanced funds and risk-parity approaches (Figure 9). After a brief worry about growth and financial distress in Q2, which saw bonds rally as equities tumbled, we have reverted to a focus on inflation and central banks' "higher for longer" mantra, with higher rates and steeper curves causing sell-offs through Q3-2023, particularly in August and September.

Figure 9. **Treasury and Equity returns positively correlated, as inflation and rate fears dominate**

Correlation between returns on US equities and government debt; three month rolling window, weekly returns changes



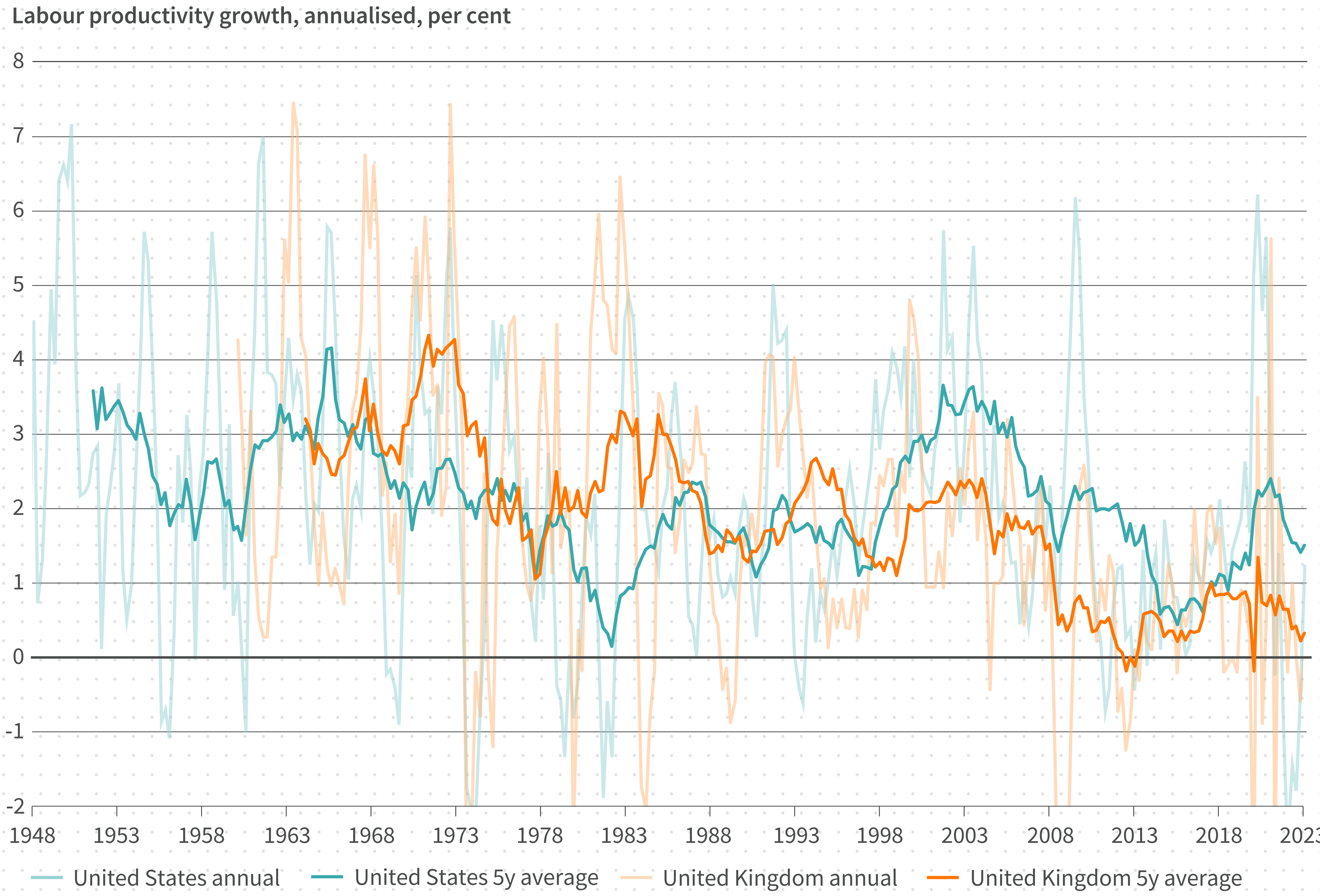
Source: Bloomberg, Aviva Investors, Macrobond as at 30 September 2023.

Productivity revival

Since the Global Financial Crisis ushered in a "New Normal" decade of low growth and low rates, worries have spread that the world was undergoing Japanification. Aging populations, indebted public and private sectors, growing inequality, lack of investment and a dearth of innovation were supposed to sow the seeds of "secular stagnation". The argument had its merits and was backed by data, and hotly debated by economists such as Piketty, Gordon, Summers, and others. Yet, just as two decades or so earlier, when the computer revolution was visible everywhere but in the statistics, it now appears that peak pessimism might have coincided with a turning point.

Since the mid-2010s, productivity seems to have turned upwards in the US, as the negative shocks of the property bubble, financial meltdown, and Eurozone crisis faded. It even improved in the UK, after half a century of trending mostly down. From a longer-term perspective, productivity does appear to come in waves that are longer than typical business cycles, driven by technology, globalization, demographics, and public and private adaptation and implementation of knowledge (Figure 10). The post-war boom of the 1950s and 60s, the oil crisis and inflation mess of the late 70s and 80s, a modest Peace Dividend improvement in the 90s, and the tech & globalization surge of late 90s and Aughts are the primary ebbs and flows. The optimism around AI is reminiscent of the dot-com bubble in some respects, but the market is nowhere near such extremes, in our view, and is complemented by major advances in materials, biotech, big data, and of course energy production, from shale gas and oil and carbon capture, to "sustainable" alternatives.

Figure 10. **Productivity is noisy, but fluctuates between high and low periods over decades**



Source: BLS, ONS, Macrobond, Aviva Investors (NB: Output per worker used in UK from 1960-70) as at 30 September 2023.

Macro forecasts charts and commentary

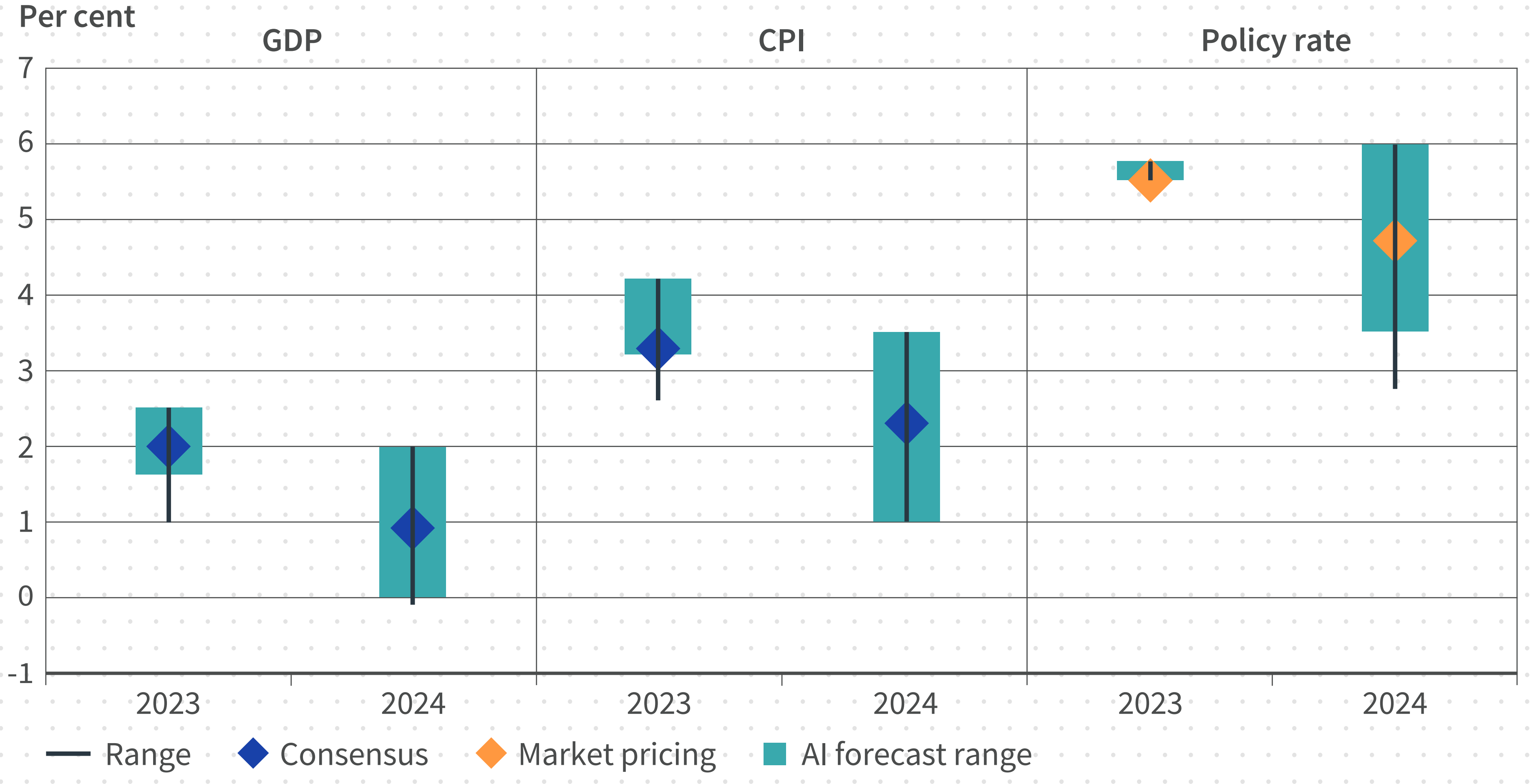
United States

Activity in the US has surprised on the upside this year. We were expecting a period of barely any growth in H2, while consensus views were even weaker. It appears that the economy will have grown above potential for the past four quarters and shows no sign of slowing materially into the end of this year. Consumer spending continues to be robust, supported by the employment and wage backdrop and strong balance sheets. That is despite the increase in interest rates and the impact on mortgage rates – which have risen to over 7.5 per cent, the highest in nearly 25 years. While that has clearly impacted the housing market, with a sharp decline in transactions and new investment, broader impacts have been limited thus far. We expect the tightening in credit conditions to weigh further on growth next year, but we do not have a recession in our central scenario. We expect the recent easing in labour market pressures to continue and for inflation to slow further as well. But to deliver this outcome, we expect the Fed to keep policy in restrictive territory throughout 2024. (Figure 11).

Eurozone

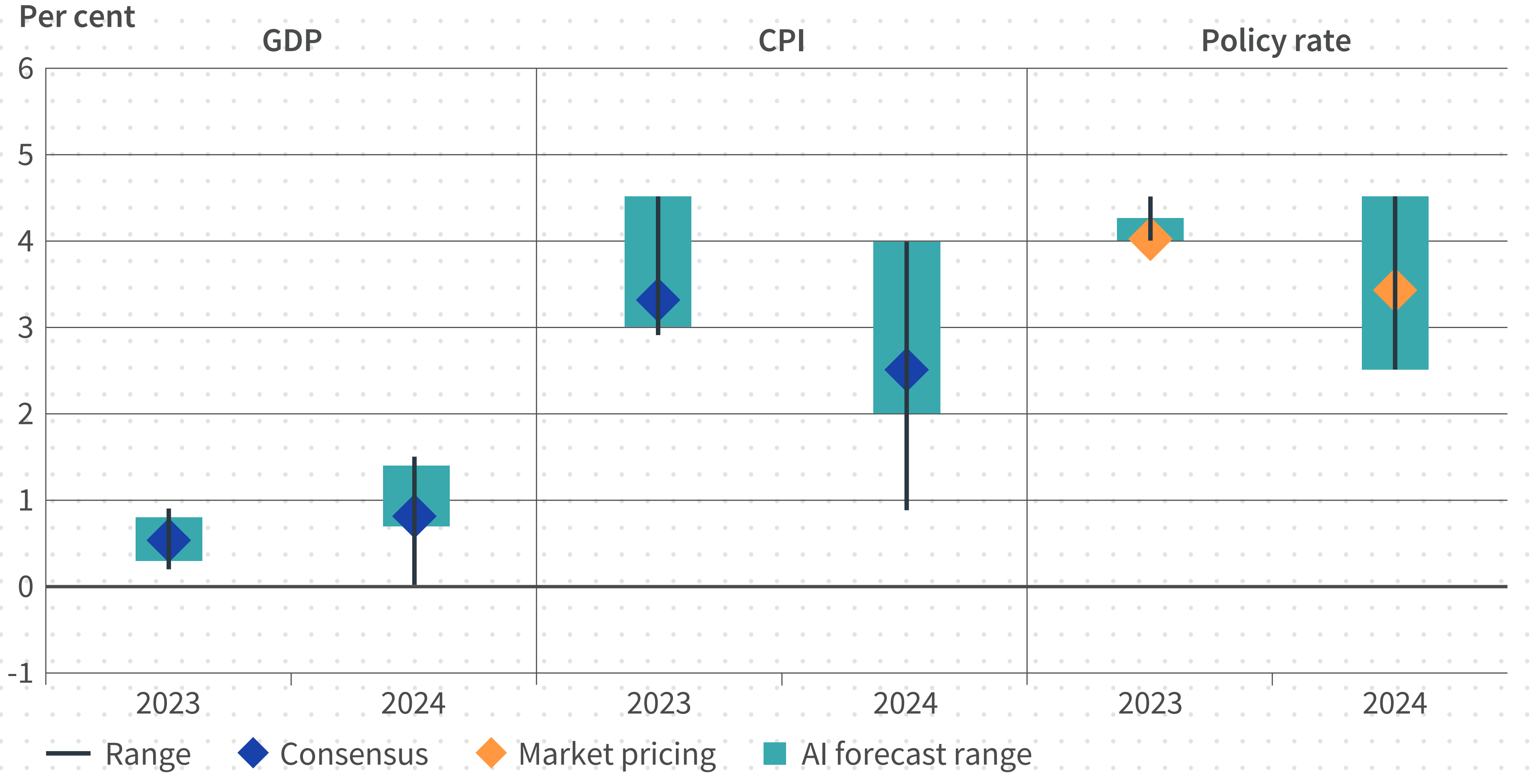
Activity broadly stagnated in the Eurozone in 2023H1, as the global manufacturing cycle weakened appreciably, and the service sector also softened. The ECB has delivered 450bps in rate hikes, the most since the inception of the euro, and the transmission of those increases into borrowing rates and lending volumes has been forceful. Both housing and business investment have been weak and consumer spending has softened. However, recession has been avoided thus far. With wage growth expected to remain around 4-5 per cent over the next year, the expected decline in inflation should boost real incomes and support a recovery in consumer spending. With the increase in energy prices in 2022 dropping out of the annual inflation measure through this year, we expect headline inflation to fall to around 3.5 per cent by the end of the year, but underlying inflation to be somewhat more persistent. We think that the ECB is likely at or near the end of the hiking cycle, but is likely to have limited scope to reduce rates next year (Figure 12).

Figure 11. **United States**



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

Figure 12. **Eurozone**



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

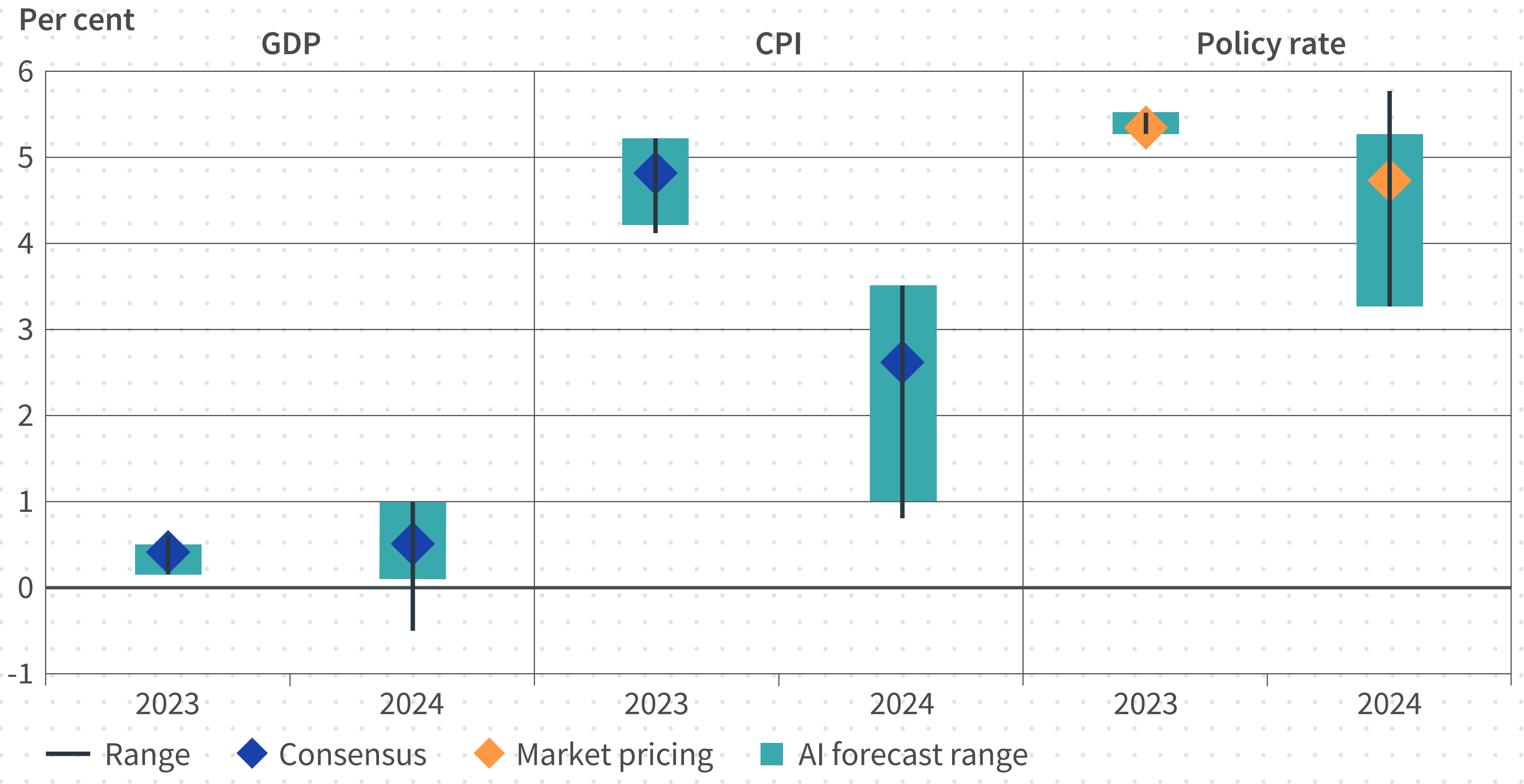
United Kingdom

Activity has been persistently weak in the UK over the last 18 months. The most recent survey data suggest that weakness is likely to persist through to the end of the year. Indeed, we expect quarterly annualised growth will have averaged around 0.4 per cent through to Q4 2023. That is well below potential growth and reflects both the impact of the energy price shock in 2022 and the transmission of higher interest rates on the real economy. We expect that the full effect of higher policy rates will only be felt by mid-2024 as fixed-rate mortgages re-set to higher levels. Despite weak activity, the labour market has remained tight, with labour supply still a concern. That said, the unemployment rate has moved higher in recent months and is expected to continue to steadily rise. That should ease wage pressures, although there has been almost no sign of that so far. The 2024 pay settlements round will be crucial to determining the degree of slowing in wage growth next year. Inflation has fallen back as expected, as the contribution from energy has subsided. We expect food and core goods price inflation to ease further over the next year, while services are likely to be stickier. However, we expect inflation to be close to 2 per cent by the end of 2024, with no further rate hikes likely from the Bank of England (Figure 13).

China

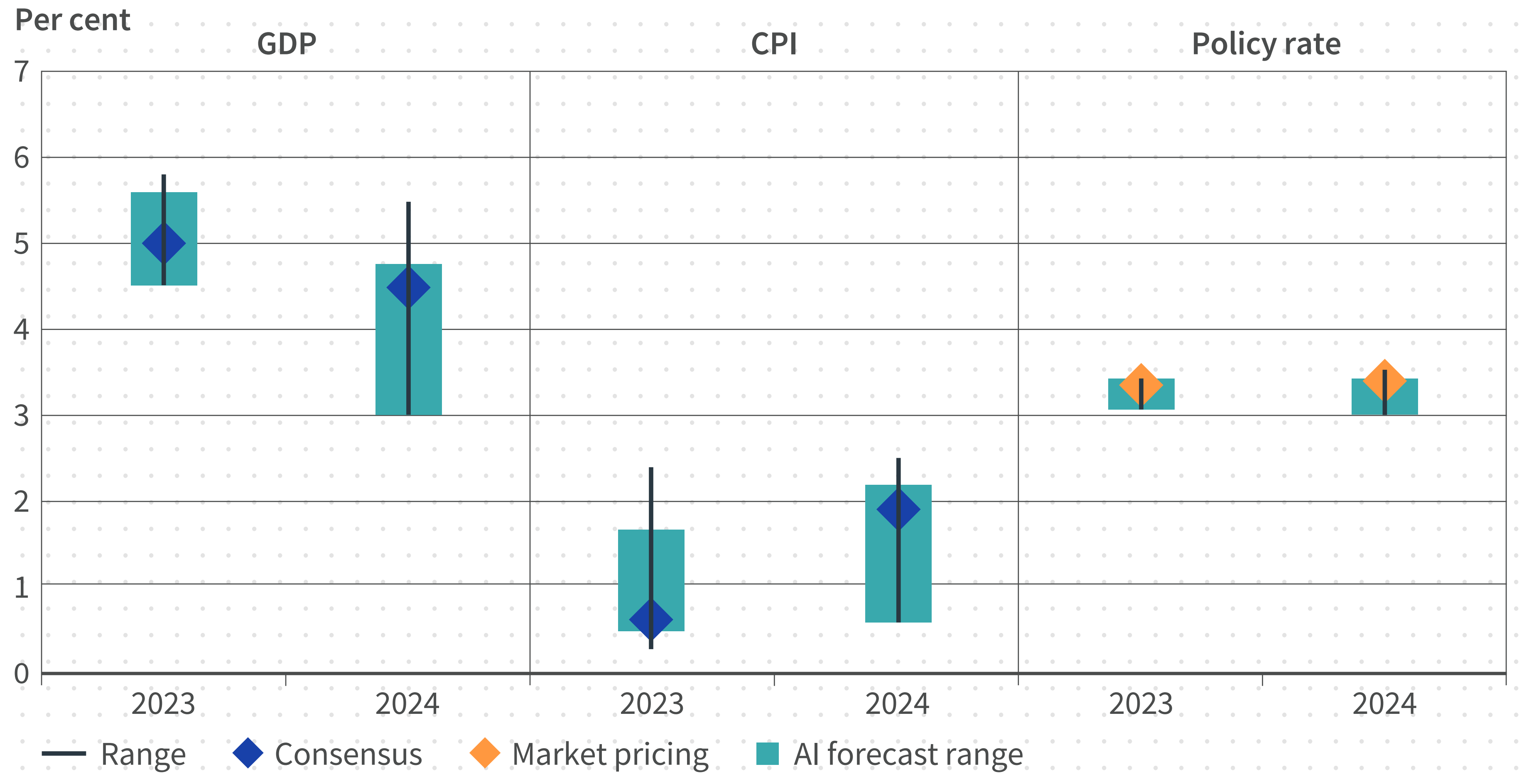
Negative spillovers from the property depression, which is set to last for many years, have dampened consumer sentiment and the ability to continue to boost infrastructure via leveraged investment. Households are less confident and there is fear of falling prices, as inflation overall has turned negative (average of 0 per cent CPI and -3 per cent PPI). Land sales that raised revenues for local government are curtailed: this impacts their ability to fund projects, to pay salaries and suppliers, and above all the capability to service debt to LGFVs. The central government will need to clean up using debt swaps, supported by PBoC liquidity. Demographics are a chronic headwind; trend growth is falling to 4 per cent or less. Exporters are keeping funds offshore and dollar carry trades are behind capital outflows, inducing currency weakness. Authorities are wary of large stimulus, and have unveiled modest support measures, disappointing growth bulls who refuse to hear Xi's message: national security and ensuring his and the Party's dominance is paramount, not the old unsustainable growth model (Figure 14).

Figure 13. **United Kingdom**



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

Figure 14. **China**

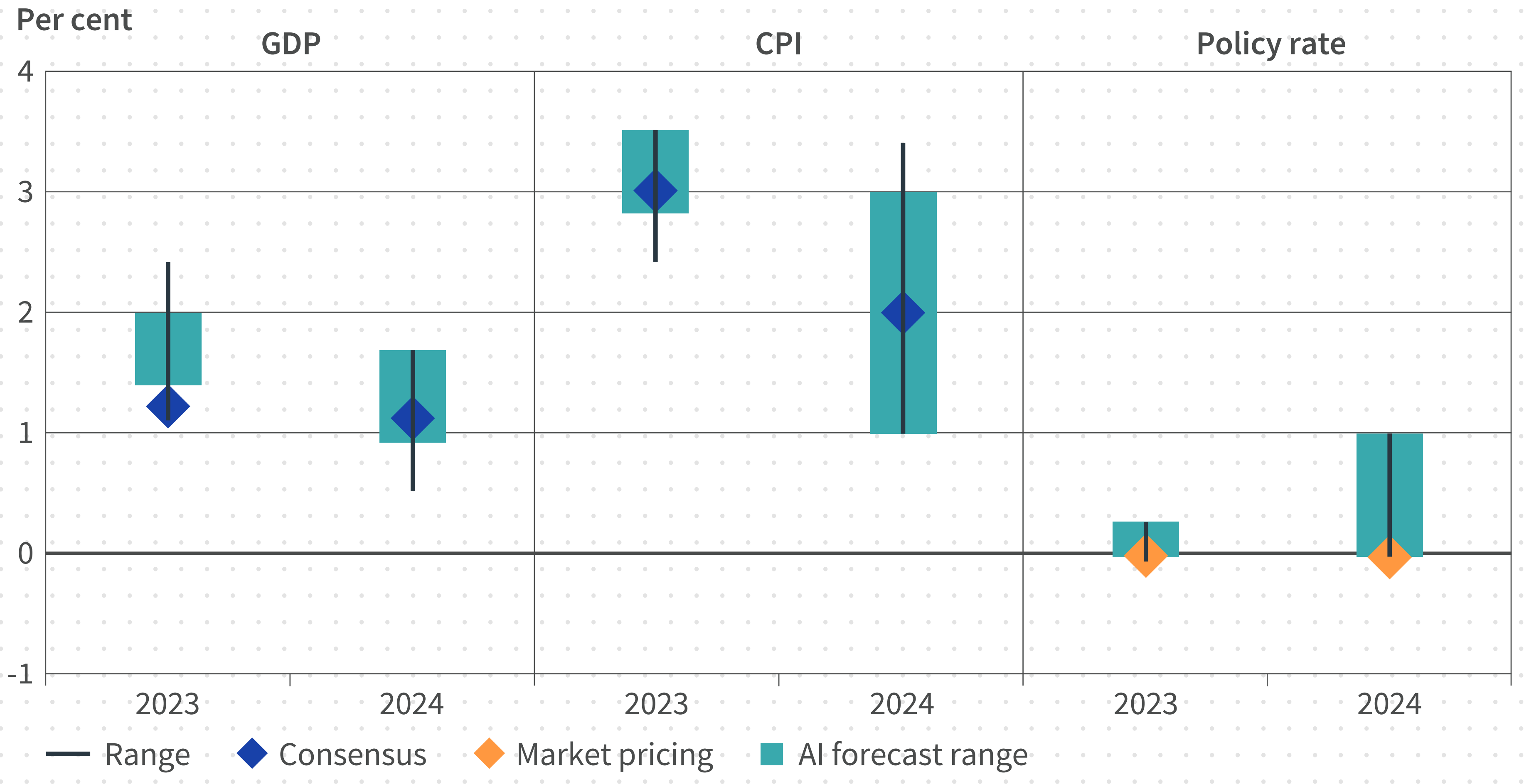


Source: Bloomberg, Aviva Investors as at 30 September 2023.

Japan

Japan is entering what could be a "virtuous" cycle: strong wages and tight labour markets support demand, and both force and enable firms to raise prices, while yen weakness is set to persist, boosting tourism and reinforcing import cost pressures. The BoJ has tweaked YCC but is in no rush to do so again or to lift rates out of negative territory – though rate hikes will likely come in 2024. 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. The weak exchange rate reflects structural changes, but is a boost for exporters, while domestic equities and businesses overall are becoming more investor-friendly as well as spending on capex, helped by government incentives in areas such as energy transition and defence (Figure 15).

Figure 15. **Japan**

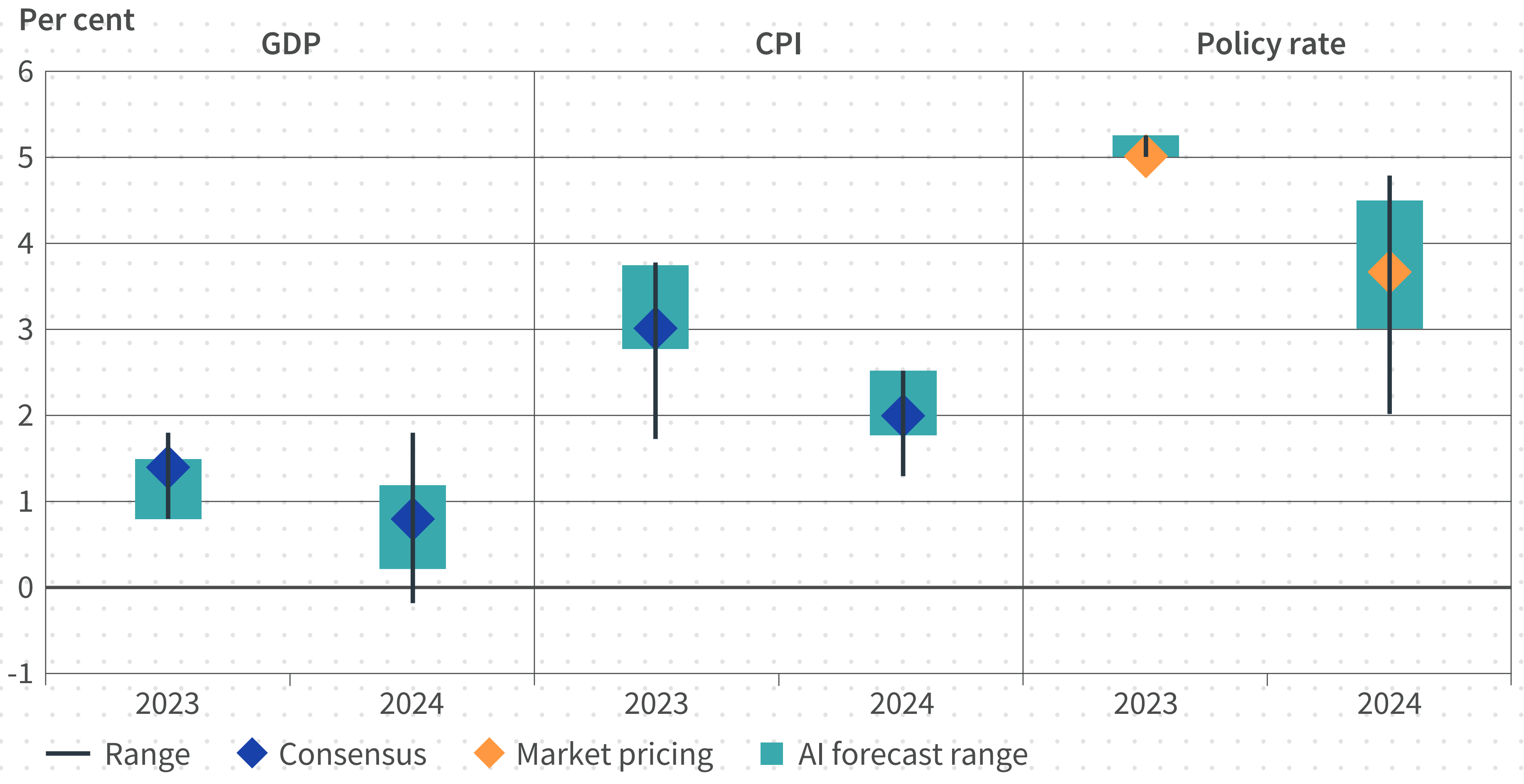


Source: Bloomberg, Aviva Investors as at 30 September 2023.

Canada

Canada's output gap has likely peaked, with a clear bottoming in the unemployment rate and a surprising contraction of growth in Q2. Domestic demand had also decelerated, proving that this contraction was more than just a reflection of a slowdown in the global economy. Despite this, recent upside surprises to retail sales and inflation have given cause for concern. On a 3m annualised basis, the average of the BoC's two preferred core measures (CPI Trimmed Mean and Median) are now growing at their fastest pace since July 2022. This, combined with increasingly persistent wage growth (recently rising to 5.2 per cent) and a resurgence in housing activity, does question whether further hikes are warranted. However, as the BoC themselves have consistently communicated, monetary policy acts with a lag. We feel that there is further tightening to be felt, in addition to there already being early signs of localised household stress. We believe that the BoC will continue their conditional pause, as the effects of tightening continue to be felt across the economy, with a view to cut rates by Q2 2024. However, if core inflation and wage growth continue to surprise to the upside, or the Fed extends their hiking cycle, there will be considerable pressure on the BoC to hike once more before year end (Figure 16).

Figure 16. **Canada**



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

Global market outlook and asset allocation

Rate cuts for major central banks are not yet in focus, and expectations for lower rates have been pushed back.

Central Bank asset sales and loose fiscal policies, together with growth resilience, will continue to lift yields and steepen curves.

US economic outperformance supports continued dollar strength, particularly against lower-yielding European and Asian currencies.

Equities can weather some rise in yields, as long as EPS have turned a corner.

Cycle extension has greatly benefitted corporate credit, though a high yield "maturity wall" looms in 2025-27.

Inflation has ebbed everywhere, but is generally far above targets despite large rate hikes

Moving into the second half of 2023, we have seen fracturing and divergence in markets and economies as the common shocks of 2020-2022 fade away, and paths begin to separate. Inflation has ebbed everywhere, but is generally far above targets despite large rate hikes. Surprisingly, the slowdown thus far has been relatively painless: labour markets are strong and are supporting spending, along with loose fiscal stances. At one end of the spectrum, the US, India, and oil exporters such as Norway and the GCC are resilient and have only shown modest reactions to tighter monetary policy (e.g. housing and commercial real estate), while China and Japan are at the opposite end, with accommodative policies that give a green light to further depreciation and inflation. In the middle, many central banks are in the latter stages of their hiking cycles, possibly finished but open to fine-tuning with a few more lashes of tight money, and a few (Hungary, Poland, Brazil, Chile) that have seen faster disinflation and very high rates – and political pressure – beginning cutting cycles, with a wary eye on FX rates.

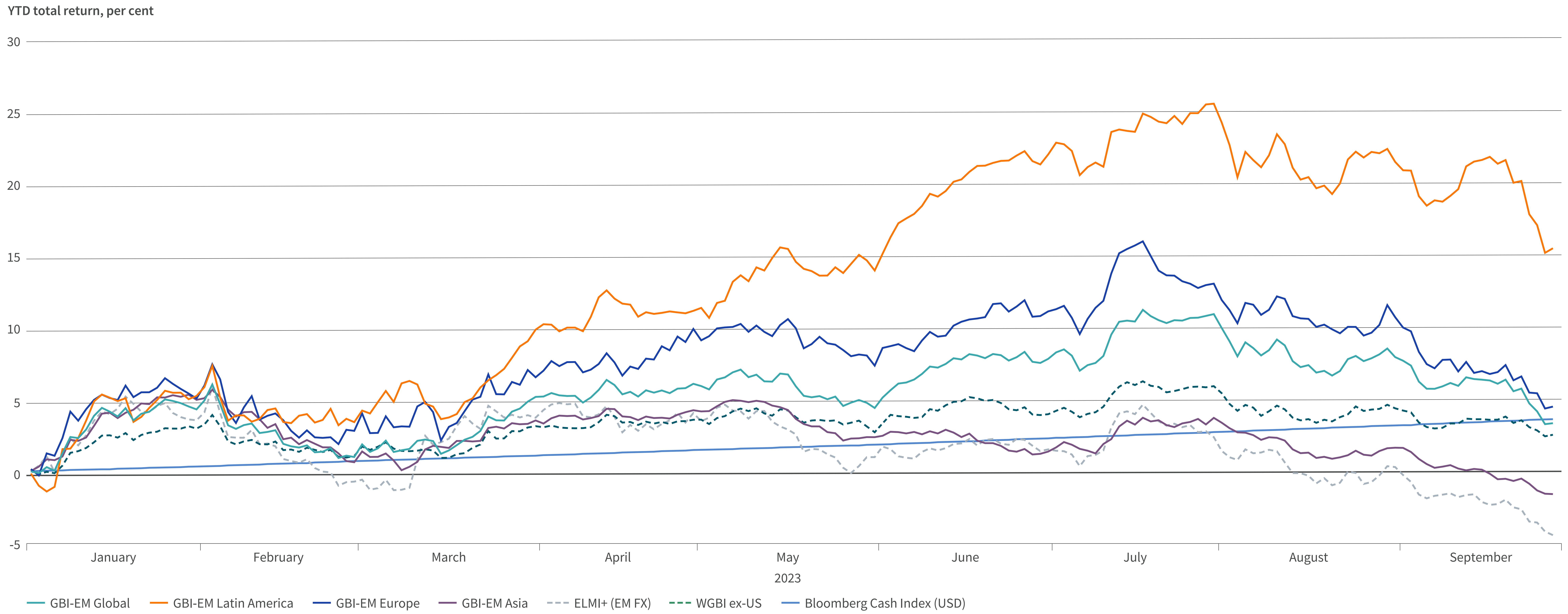
The Fed remains *primus inter pares* among major central banks, but the weaker economic data in Europe, as well as different mortgage market structure, suggests that the ECB, BoE, and smaller regional banks may not need to raise rates much more, though they are likely to persist with QT and dismiss it has meaningful impact. But rate cuts are a different matter, and will need to see an unhappy confluence of weaker growth, and loosened labour markets and lower inflation readings as well as forward expectations. The confluence of sticky inflation and wage gains despite output decelerating, alongside fiscal spending on infrastructure, defence, and energy transformation alongside household wealth gains despite property markets facing hurdles, has finally sunk into bond markets, it seems. Yield curves have steepened on supply risks and the growing cumulative impact of QT, which adds duration risk back into the market. Simultaneously, some of the expected future rate cuts have been removed: the terminal rate is higher and the neutral or "natural" rate is too, even after inflation converges back towards central bank targets.

Yield curves have steepened on supply risks and the growing cumulative impact of QT, which adds duration risk back into the market

This means that Q3 has been another poor quarter for bond markets, with the US leading losses across most DM geographies, and even the front-end underperforming cash. The UK has been a notable outperformer as inflation finally settled down, and emerging markets have been mixed: a huge rally on built-up expectations of cutting cycles has been partially unwound, contaminated by the global bearish steepening in yields, and a stronger dollar. We expect these trends to continue, as the US and select EM economies (India, Mexico, Taiwan) have outperformed expectations. Bond markets are somewhat safer for allocators in the Eurozone and the UK, given economic weakness, as well as in Canada and Australia, where curves are flatter. We still expect Japan to eventually tackle inflation through higher rates, and thus maintain an aversion to JGBs across the curve.

These relative yield movements, along with China's malaise and commodity swings that favour oil producers like the US, are the main drivers for the 6 per cent jump in the dollar off of recent lows, breaking a nine month long weakening run. Our medium-term view on the greenback's overvaluation remains, but it seems hard for the yen, euro, pound or scandies to rally substantially in the current environment. The PBoC's rate cuts will make it a challenge for CNY to not trend down too, and that will drag down parts of the Asia FX complex. However, the high carry in EM – particularly Brazil, Mexico, Chile, and Colombia – makes up for a lot of negatives, and against a basket of G10 currencies EM Local Currencies are holding their own in total return space, though aggressive rate cutters (CLP, PLN) are being put in the penalty box. That has seen EM FX outperform G10 bonds YTD, with huge LatAm gains making up for Asia's underperformance, and CEEMEA in the middle (Figure 17). While positioning might be stretched and cause some volatility, this sort of differentiation makes sense and seems likely to continue.

Figure 17. **Higher yields and proximity to US have helped LatAm FX outperform; Asia FX lagged due to low yields and proximity to China**



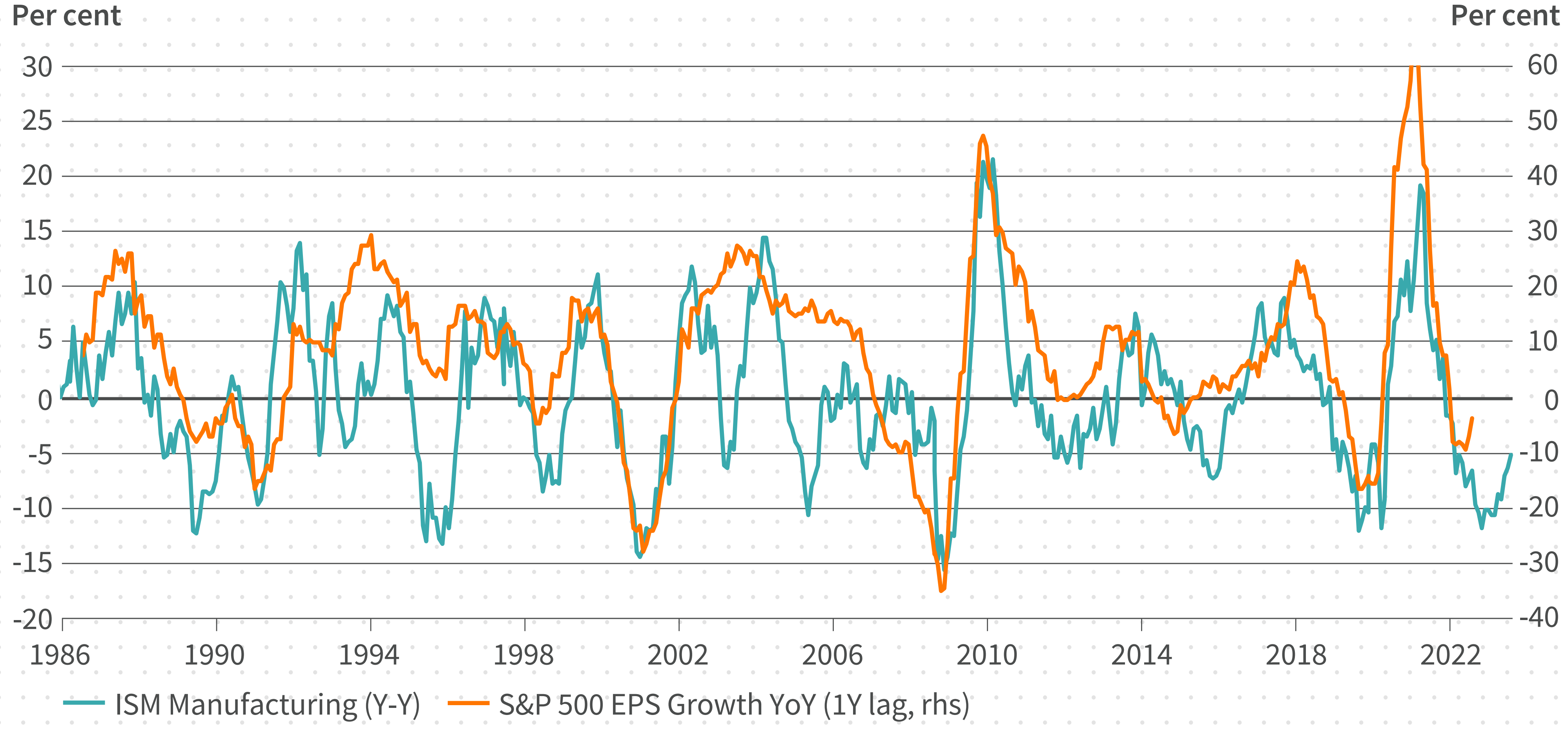
Source: Citi, JPMorgan, Bloomberg, Aviva Investors, Macrobond as at 30 September 2023.

Equity Markets have experienced a correction in August and September with the MSCI All-Country World Index down just over 7 per cent from the peak on 31st July. Japanese equities have been the best performers in the correction (Topix is down just over 2 per cent in USD for the same period) while EM equities were the weakest performers (down nearly 10 per cent in USD). A key driver of this correction has been the sharp movement in yields. With US 10y yields rising c55bps since the end of July – and over 100bp since the Q2 lows – this has forced some reassessment of equity valuations. However, valuations seem more at risk in the US where P/E ratios are currently at a near 20 per cent premium to their 20y historical average, driven by a relatively small number of components of the US market. Meanwhile, outside of the US, equities tend to offer relatively low valuations with Europe and Japan offering meaningful discounts to their 20y average P/E ratios and UK equities trading at a c.16 per cent discount.

In our view, despite the sharp move in yields having been a recent negative catalyst, earnings will be the key driver of how far we go in this equity correction. And here economic data gives us a puzzle: "soft" survey data suggest earnings should have fallen more than what we have seen so far and point to significant further downside ahead (Figure 18). "Hard" data, on the other hand, has been in line with EPS growth and points to the earnings trough being behind us and a potential recovery ahead (Figure 19), which our internal earnings model corroborates. Finally, the earnings numbers themselves already hint at a turning point with the August and September EPS coming in slightly above the July level in the US.

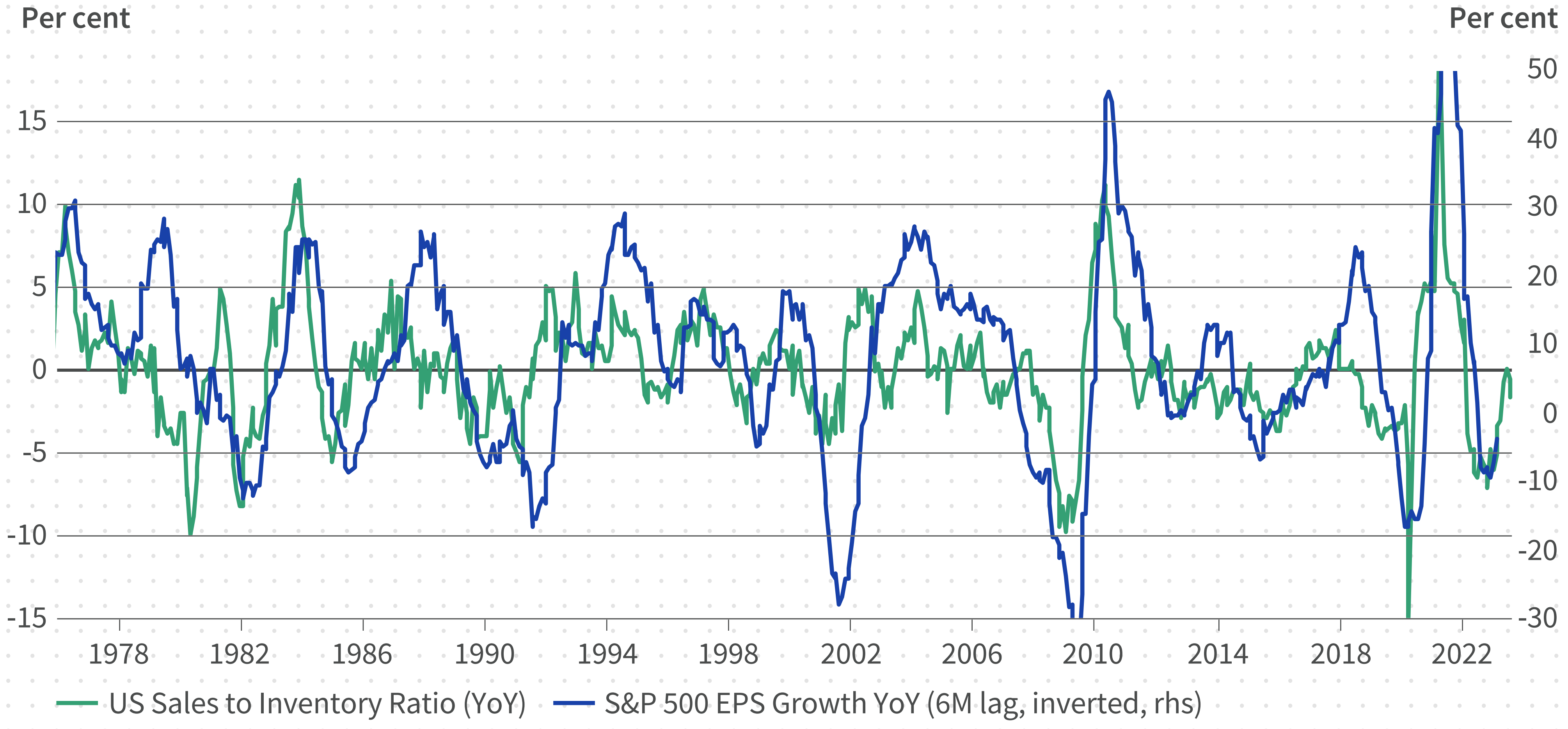
> ***"Soft" survey data suggest earnings should have fallen more than what we have seen so far and point to significant further downside ahead***

Figure 18. **US earnings appear to have undershoot changes in ISM**



Source: Refinitiv DataStream, Aviva Investors as at 30 September 2023.

Figure 19. **Sales-to-Inventory ratio has been in line with EPS growth and points to stabilisation**



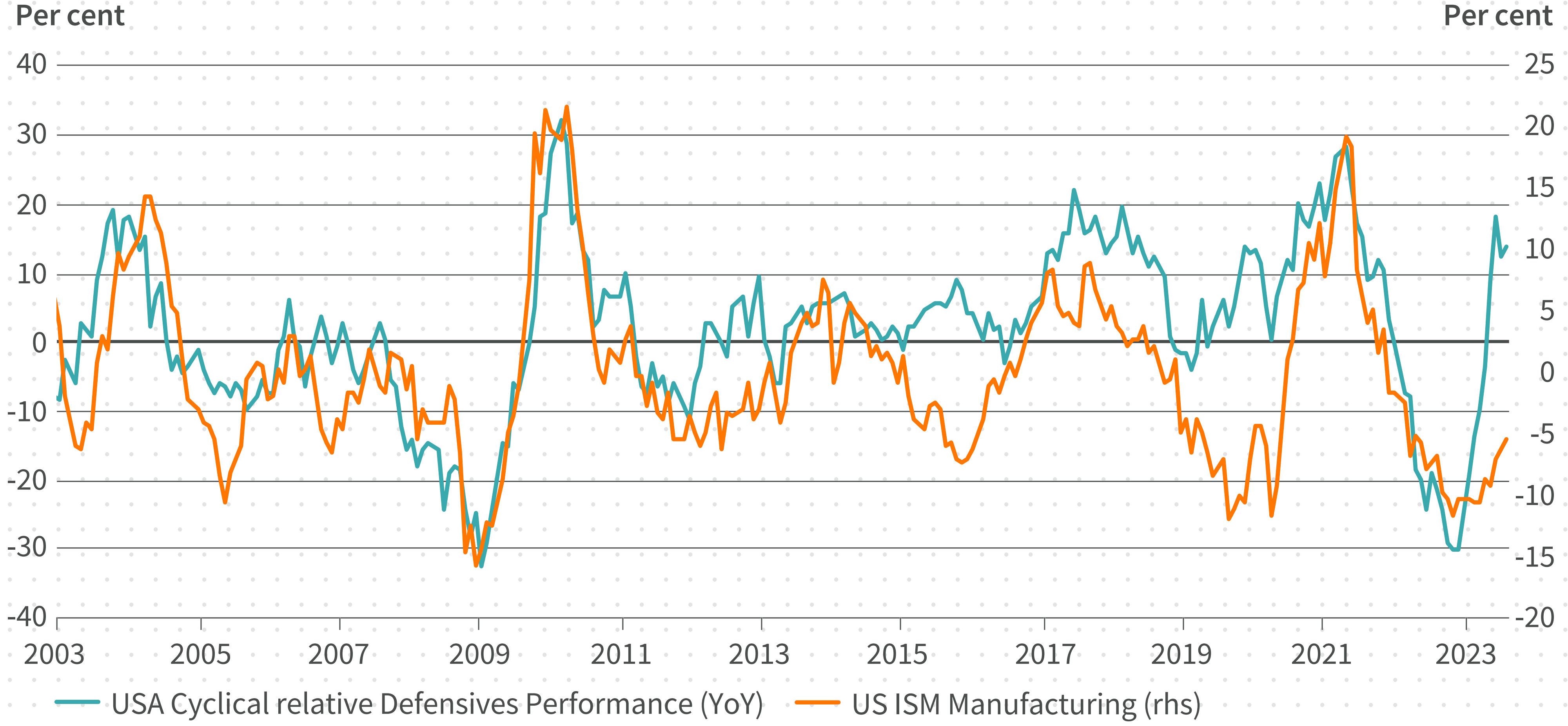
Source: Refinitiv DataStream, Aviva Investors as at 30 September 2023.

All in all, this suggests to us a benign scenario for equities. If actual and forecasted EPS improve from here, the movement in equity markets should remain what it has been so far – a correction, rather than a sharp reversal. This should by no means suggest complacency. First, there are risks, as equities are probably "equipped" to deal with a rise in US 10y yields to around the 5 per cent level at a gradual pace. If, however, yields climb above 5 per cent rapidly, the risk, especially for richly valued stocks, becomes very substantial.

Second, we see reason to be cautious in the positioning within equity markets even if, as we believe, the Q3 market correction does not have much longer to run. That is because the dynamics within the market – especially the performance of Cyclical vs Defensive sectors (Figures 20 and 21) – has been in line with an economy which is growing strongly, instead of the reality of an economy which has weakened less than most forecasts expected it to. We believe that Defensive sectors will go through a period of "catching up" to Cyclicals and to the reality of a weakening economy and we favour those sectors in our current equity allocation.

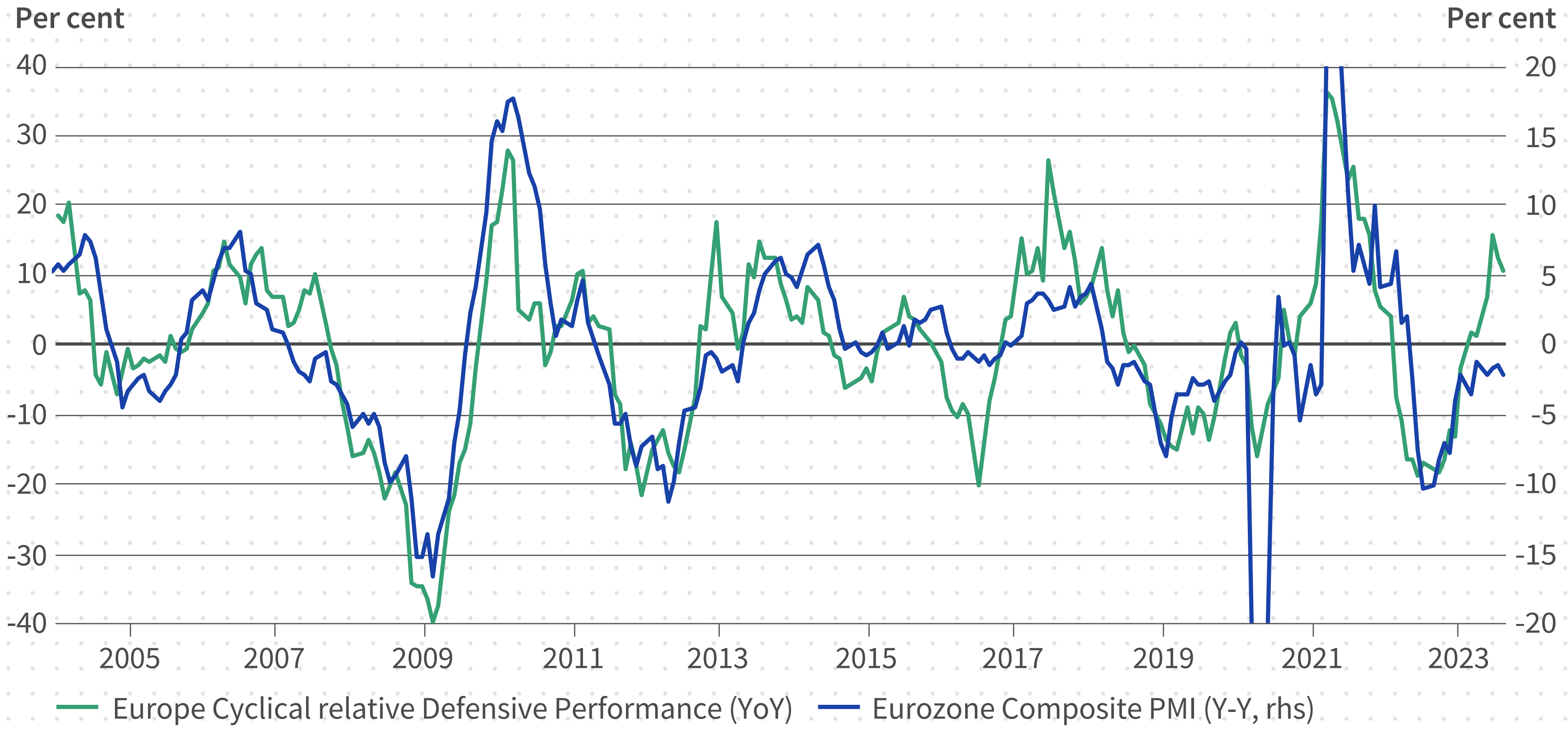
> ***We believe that Defensive sectors will go through a period of "catching up" to Cyclicals and to the reality of a weakening economy***

Figure 20. **US Cyclicals outperformance over Defensives is consistent with strong expansions, not a slowdown**



Source: Refinitiv DataStream, Aviva Investors as at 30 September 2023.

Figure 21. **European Cyclicals are less stretched, but also not in sync with economic fundamentals**

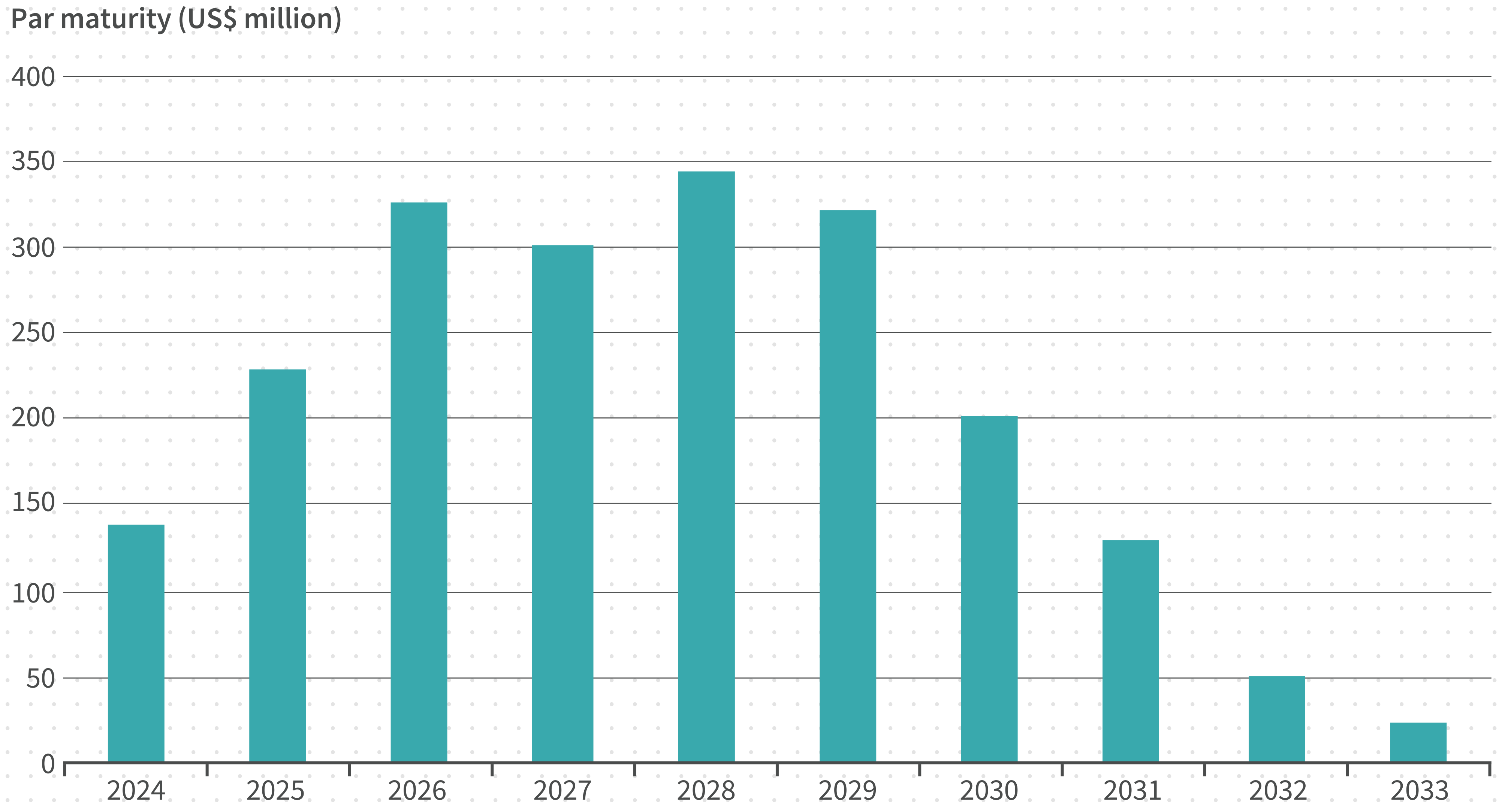


Source: Refinitiv DataStream, Aviva Investors as at 30 September 2023.

For corporate credit markets, the "good news is bad news" mantra hasn't applied, thankfully. While IG total returns are about flat YTD, they have massively outperformed similar long-maturity government bonds, as spreads have tightened modestly with recession fears ebbing and after weathering the SVB mini-shock. For High Yield, defaults have risen (to around 4-5 per cent), though many of those counted in the statistics are orderly restructurings – a far cry from the 5-cent recoveries of some previous recessions. The cycle extension has compressed spreads, and both US and European HY have trounced most other fixed-income asset classes, and even equities on a risk-adjusted basis. In the previous House View, we gave credit to the low issuance for improved technicals; looking forward, global HY also benefits from low refinancing needs… at present. Figure 22 shows the maturity profile for sub-investment grade corporates, and while the next year will be more challenging, the 5-7 year bonds issued en masse in the post-Covid period create a "maturity wall" in 2026-8. Larger companies and higher rated companies are so cash rich, it is unsurprising that rate hikes are not feeding through to financial conditions. Given IG and HY spreads are not at the tighter end of their historical range, absent a recession, the asset class should continue delivering solid returns, though not as stellar as when recession risks abated as in the past year.

> ***Larger companies and higher rated companies are so cash rich, it is unsurprising that rate hikes are not feeding through to financial conditions***

Figure 22. **Global HY's maturity wall builds in 2025, and becomes a real challenge from 2026-29**



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

Asset Allocation Table: the table overleaf (Figure 23) reflects the discussion above, with cycle extension supporting moderate net exposure to equities, selectively, eschewing growth-challenged regions. Government bonds where yields are high and disinflation progressing are also becoming more attractive, though rising term premium may continue to steepen curves. High Yield is preferred over Investment Grade, with a mild preference for being long USD.

For illustrative purposes and subject to change. Not intended to be an investment recommendation.

Figure 23. **Asset Allocation**

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

	Underweight										Overweight
	-5	-4	-3	-2	-1	0	1	2	3	4	5
Credit						0					
US Investment Grade					-1						
European Investment Grade					-1						
Asian Investment Grade					-1						
UK Investment Grade						0					
EUR High Yield								2			
US High Yield								2			
Emerging Govt (Hard Currency)							1				
Emerging Govt (Local Currency)				-2							
Alternatives						0					
Cash						0					
Currencies (versus US$)					-1						
GBP					-1						
EUR					-1						
JPY						0					
CAD						0					
AUD						0					
EM FX				-2							

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 September 2023.

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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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