Aviva Investors

House View 2024 Outlook

Navigating disinflation

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AVIVA INVESTORS

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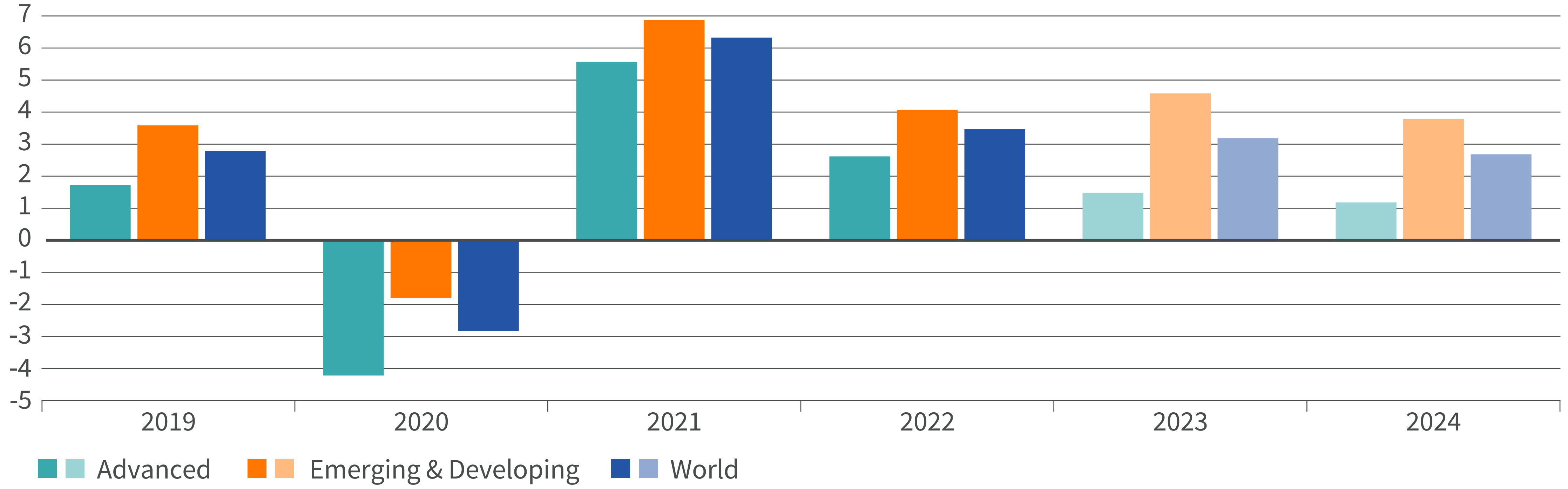
Executive summary

Navigating disinflation

The global economy avoided recession in 2023, despite the ongoing effects of tighter monetary policy and elevated energy prices. Much of that was down to the resilience of the US, which is now expected to have grown more quickly in 2023 than in 2022. Japan and China also picked up pace in 2023, as they emerged later than others from COVID restrictions. It was in the Eurozone and UK that growth stalled in 2023, with both only narrowly avoiding recession. As we look ahead to 2024, we expect growth will slow to below trend in the US – although our projection is somewhat stronger than consensus – with slowdown expected in China and Japan as well. We expect growth in the Eurozone and the UK to remain sluggish in 2024, as fiscal policy becomes a drag and the pass-through of higher policy rates into mortgages and corporate borrowing becomes a stronger headwind. Overall, we expect global growth of around 2.75 per cent in 2024, down from 3.25 per cent in 2023 (Figure 1). Once again, recession ought to be avoided, as rising real incomes should support household consumption, working to mitigate the impact of positive real interest rates. Overall, private sector balance sheets are not particularly stretched in the major economies and therefore the potential for a deleveraging-driven deep recession remains relatively low.

Figure 1. **Aviva Investors growth projections**

GDP y/y, per cent



Source: Aviva Investors, Macrobond as at 31 December 2023.

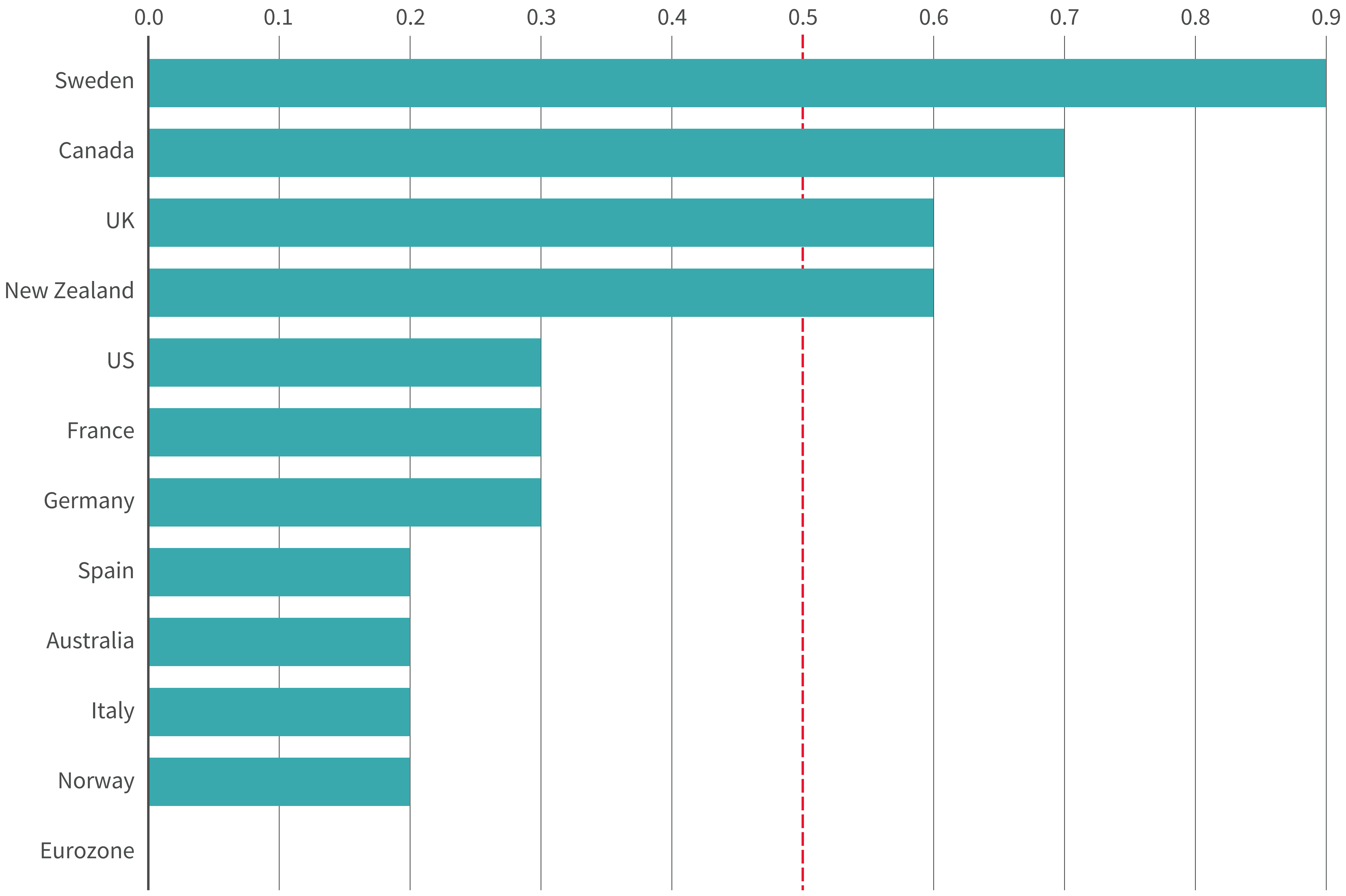
That said, it is important to recognise the balance of risks to the growth outlook, particularly as they are different by region. In the US, households have been somewhat insulated from rate rises by choosing not to move house or refinance off historically low rates. The collapse in housing transactions has negatively impacted new investment, but has seemingly had little impact on spending. The mortgage lock-in effect has the potential to add frictions to the labour market and slow growth. Eventually, more households will have to refinance. Similarly, larger US corporates termed out debt when rates were low and have therefore yet to face increased financing costs; this could impact profitability more heavily in 2024 and 2025. That said, with overall financial conditions little changed at the end of 2023 from where they were at the start of the year, the private sector will have had considerable time to adjust to conditions and may be well-placed to manage without negatively impacting spending. While the downside risk to growth is likely more powerful, the upside risk cannot be ignored.

The situation is somewhat different in the Eurozone and the UK, where the impact of refinancing costs is expected to be considerably more painful in 2024 (especially in the UK) and where the structural implications of higher energy prices are creating a difficult adjustment in the manufacturing sector. Both economies start from a weaker position than the US and the risks are more clearly tilted to the downside. In China the property-led deleveraging cycle likely has many years to play out, with the government expected to step in to remove the risk of a deeply damaging default cycle. However, the risk of a policy accident remains high and skews the growth risks there to the downside as well.

With growth expected to be subdued in 2024, the disinflation process that began in 2023 should continue, opening the door to rate cuts across the major central banks. The scope to shift from a tightening cycle in 2022/23 to an easing one in 2024 is only possible given the combination of the decline in inflation and the softening in the labour market. The labour market has weakened across most major economies this year, with the well-known Sahm indicator – based on rising unemployment rates – signalling a number of economies have already seen a material weakening (Figure 2).

Figure 2. **Labour markets have softened**

Sahm rule based on the change in the unemployment rate; a reading above 0.5pp indicates a labour market recession



Source: Aviva Investors, Macrobond as at 31 December 2023.

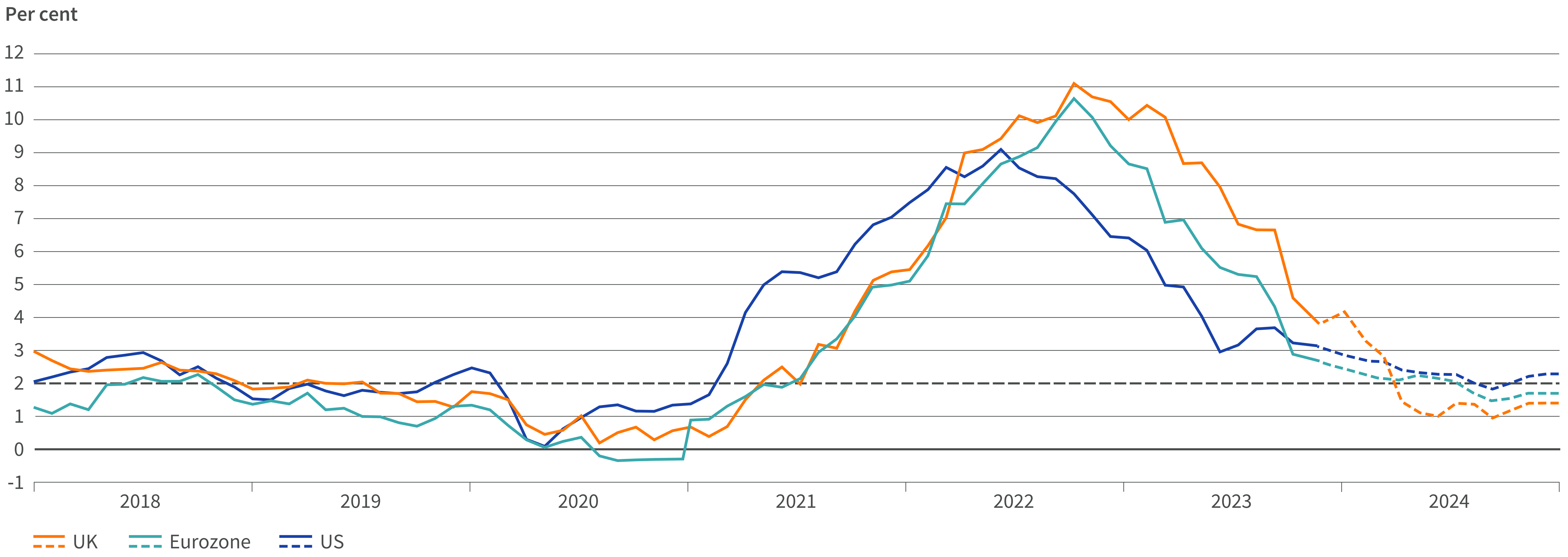
Alongside that, since the peak in late 2022, headline inflation rates have fallen significantly, as the impact of higher energy and food prices has subsided, and globally traded goods supply chains have normalised. To the extent that inflation remains above 2 per cent, this is almost entirely a reflection of domestically driven service sectors. Pricing in these sectors tends to be more impacted by the state of the labour market (wages are the largest input cost) and domestic demand conditions (which impact margins). Here progress has been somewhat slower, but the recent signs are more encouraging. In particular, recent figures for the Eurozone suggest a marked weakening in underlying inflation pressures. Developments in the US have also been encouraging, as wage growth has eased and productivity growth has improved, with core inflation also easing.

The UK has seen less progress, but recent wage and inflation data have also suggested a noticeable slowing. These developments are reflected in our inflation projections for 2024, which show inflation heading back towards 2 per cent, albeit declining more slowly than in 2023 (Figure 3). We see the risks to the inflation outlook to be broadly balanced in the US and to the downside in the Eurozone and the UK.

With policy rates in restrictive territory, the disinflationary process should allow for a recalibration of policy to something closer to neutral through the course of 2024. We think that the ECB can be the first to cut rates, possibly as soon as early Q2. We think that the Fed won't be too far behind, while the Bank of England could start cutting in Q3. Of course, the timing and extent of rate cuts will depend on how the risks evolve.

We expect a "soft-landing" disinflation that should only require a neutral policy stance, rather than an accommodative one. But even delivering that through 2024 would require 200-300bps of rate cuts depending on the economy. We continue to expect that the long-term interest rate environment will be very different to the post-GFC years, with neutral nominal rates around 2 to 3 per cent. But perhaps the most significant differentiator is Japan, where we expect the economic backdrop – in particular the inflation process – will allow for policy normalisation. That is expected to involve moving away from negative rates, through a series of increases to the policy rate, and formally ending yield-curve control (YCC). We expect that to begin in early 2024, ending decades of unconventional policies.

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



Source: Aviva Investors, Macrobond as at 31 December 2023.

With growth expected to be subdued in 2024, the disinflation process should continue, opening the door to rate cuts

Turning to our asset allocation views, the prospect of a benign disinflation that allows central banks to start loosening monetary policy ought to be a decent environment for risk assets. Indeed, we prefer to be overweight equities, although we are very conscious of the downside risks to nominal demand growth in 2024. In our central scenario we expect solid, if unspectacular, earnings to be the key for equity markets in 2024. While US valuations are already high, it has already been through an earnings “recession” in late 2022 / early 2023 driven by weaker margins, and now appears to be coming out the other side. That compares with Europe, where valuations are much lower, but where the earnings downturn has not yet materialised. Europe may escape an earnings recession but will face materially slower nominal demand next year, with elevated margins. Putting these together, we prefer a larger overweight in the US than Europe. We continue to see opportunity in Japanese equities, as the country finally emerges from decades of deflation and with significant corporate governance reforms. Our biggest change in terms of asset allocation views is on duration, where for the first time in three years we prefer to be overweight. That reflects our view that the rate hiking cycle has concluded, and rate cuts can follow in 2024. The balance of growth risks is likely skewed to the downside, while inflation risks are more muted, making duration more attractive – even with a downward-sloping yield curve. We prefer to be overweight UK and European government bonds, where the risks are greatest to the downside, while maintaining an underweight in Japanese government bonds as policy is normalised there. We prefer to be broadly neutral on corporate bonds, with the risk-reward somewhat better in high-yield than investment-grade given current spread levels and the stage of the cycle. Finally, we prefer to be modestly underweight the US Dollar, which remains expensive and tends to underperform in a growth convergence, global soft-landing scenario (Figure 4).

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 31 December 2023.

Key investment themes and risks

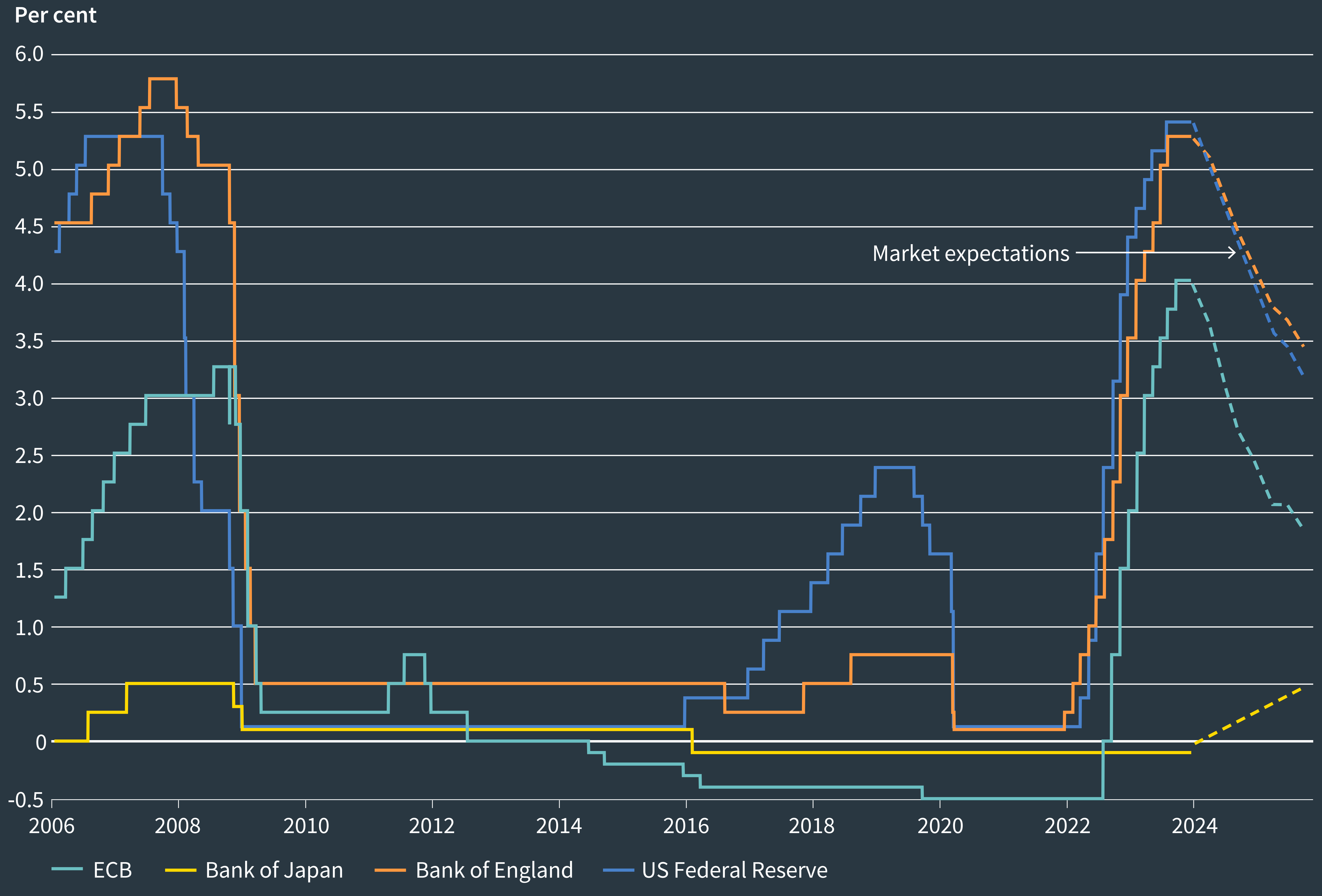
Investment themes

1	2	3
Rate cuts on the horizon	**Geopolitical tension and financial fragmentation**	**Intervention and Industrial policy**

Rate cuts on the horizon

The surge in inflation that began in 2021 led to the most aggressive rate hiking cycle since the 1970s. Policy rates were raised to levels not seen in over 15 years across Emerging Markets and Developed Markets alike. Tight monetary policy led to a material tightening in broader financial and credit conditions. The effect of rate increases, alongside easing supply pressures and lower commodity prices, saw inflation fall back sharply in 2023. As inflation fell back, real rates rose significantly, moving decisively above zero for the first time since the Global Financial Crisis of 2008. While the disinflation battle has not yet been completely won, with headline inflation rates in the major economies still some way above the 2 per cent target, the most recent monthly sequential rates suggest that y/y inflation may fall back more quickly to target than previously anticipated. That would allow central banks to ease the restrictive stance of policy in 2024 to deliver a real rate that is closer to neutral. Where growth is already below potential – such as in the Eurozone and the UK – an earlier than expected return to 2 per cent inflation would open the door to potentially earlier and deeper rate cuts. In the US, where inflation has fallen back despite growth being above potential, we expect rate cuts will be more limited in 2024. As noted in the section on risks, there are plausible alternative scenarios whereby recession could materialise in 2024, or where the disinflation process slows or even reverses. The former could see rates cut much more aggressively, while the latter could limit rate cuts to just a couple in 2024. Financial markets currently price around 150-200bps of rate cuts over the next two years (Figure 5).

Figure 5. **Market pricing rate cuts**



Source: Aviva Investors, Bloomberg, Macrobond as at 31 December 2023.

We expect the long-term interest rate environment will be very different to the post-GFC years

Geopolitical tension and financial fragmentation

The communique that followed the annual G7 meetings in May 2023 was significant for its inclusion of the following: "[to] *coordinate our approach to economic resilience and economic security that is based on diversifying and deepening partnerships and de-risking, not de-coupling*". Coordination is likely to come in the form of increased bilateral trade, investment and security deals between G7 economies and their close allies. Some refer to this as "friend-shoring", whereby trusted partners can, for example, agree on supply chain commitments for key goods and services. That could be in the form of key inputs, such as critical minerals, or in the manufacture of essential technology or healthcare goods.

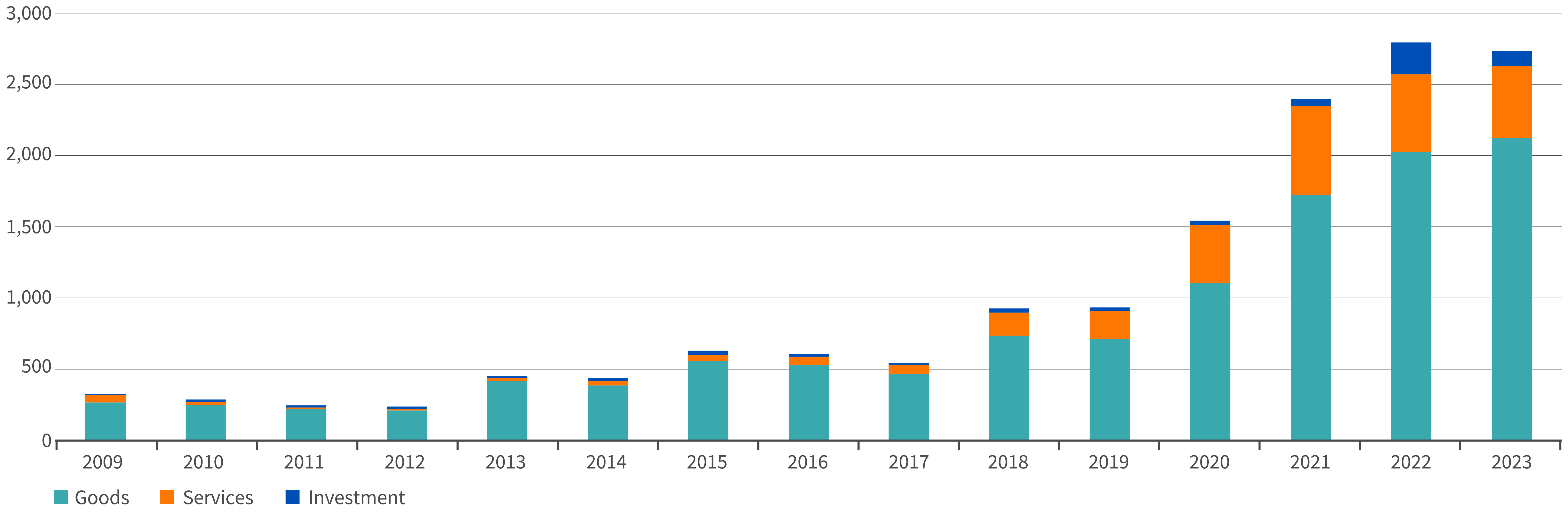
The objective is to remove or at least reduce the risk of relying on supply from a less trustworthy source. De-risking (rather than de-coupling) is the diplomatic way of saying that there is no desire to eliminate all trade with less trustworthy partners, but instead to remove reliance on them (again, through friend-shoring or re-shoring of production) and limit the capability they may have to develop technologies that could be against national security objectives. Much of this geopolitical tension and related fragmentation relates to the relationship between the US and its allies, and China and its allies (including Russia).

The recent summit between President Biden and President Xi suggested a modest improvement in relations, but we believe that to be short term and tactical, rather than changing the longer-term strategic ambition. One way in which fragmentation has manifested itself has been the sharp increase in harmful trade interventions in recent years (Figure 6).

Much of this geopolitical tension and related fragmentation relates to the relationship between the US and its allies, and China and its allies

Figure 6. **Explosion in harmful trade interventions**

Number of trade restrictions imposed annually worldwide



Source: Global Trade Alert as at 31 December 2023.

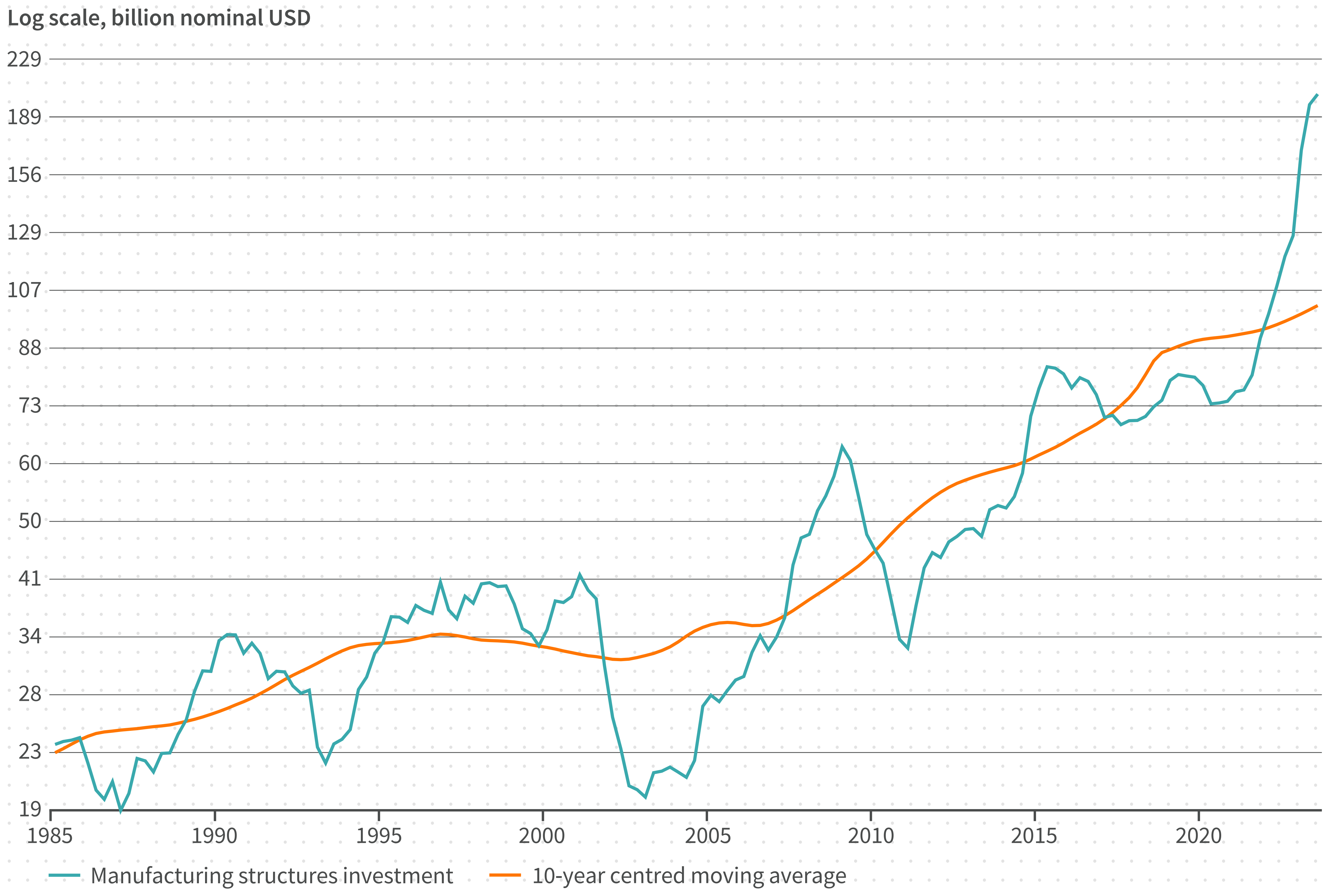
Intervention and industrial policy

With governments focused on long-term strategic objectives around national and economic security and reducing climate change, they have increasingly turned to various forms of intervention and industrial policy programmes. While these types of policies are not particularly ground-breaking, it is the scale and scope of them that is extraordinary this time around. From China's "dual circulation" policy of subsidising investment in technology (in particular semiconductors), to the US CHIPS Act (again focused on technology) and Inflation Reduction Act (focused on climate change policies), to Europe's Next Generation EU funds (tech and climate change) and Japan's recent initiatives (carbon reduction, defence) all the major economies are planning on spending vast sums or providing enormous tax breaks to deliver on these objectives. These policies could equate to 1 per cent of GDP every year for the next decade if fully utilised. These industrial policies may be trading off greater long-term efficiency and/or growth for the purpose of meeting other objectives.

Moreover, unless the subsidised investment fully crowds out alternative investment spending, then it may also create short-term excess demand challenges. Incentives created by the CHIPS Act have seen investment in manufacturing plants surge this year (Figure 7). The longevity of these policies may also create inflationary tailwinds for many years, supporting higher neutral interest rates. These policies also come with a significant fiscal cost that must be managed to ensure long-term sustainability.

These policies could equate to 1 per cent of GDP every year for the next decade if fully utilised

Figure 7. **US investment in manufacturing structures has boomed**



Source: Aviva Investors, Macrobond as at 31 December 2023.

All major economies are planning on spending vast sums or providing tax breaks to deliver on national and economic security and climate change objectives

Michael Grady
Head of Investment Strategy and Chief Economist

Risks

Slowdowns expose fragility, triggering instability

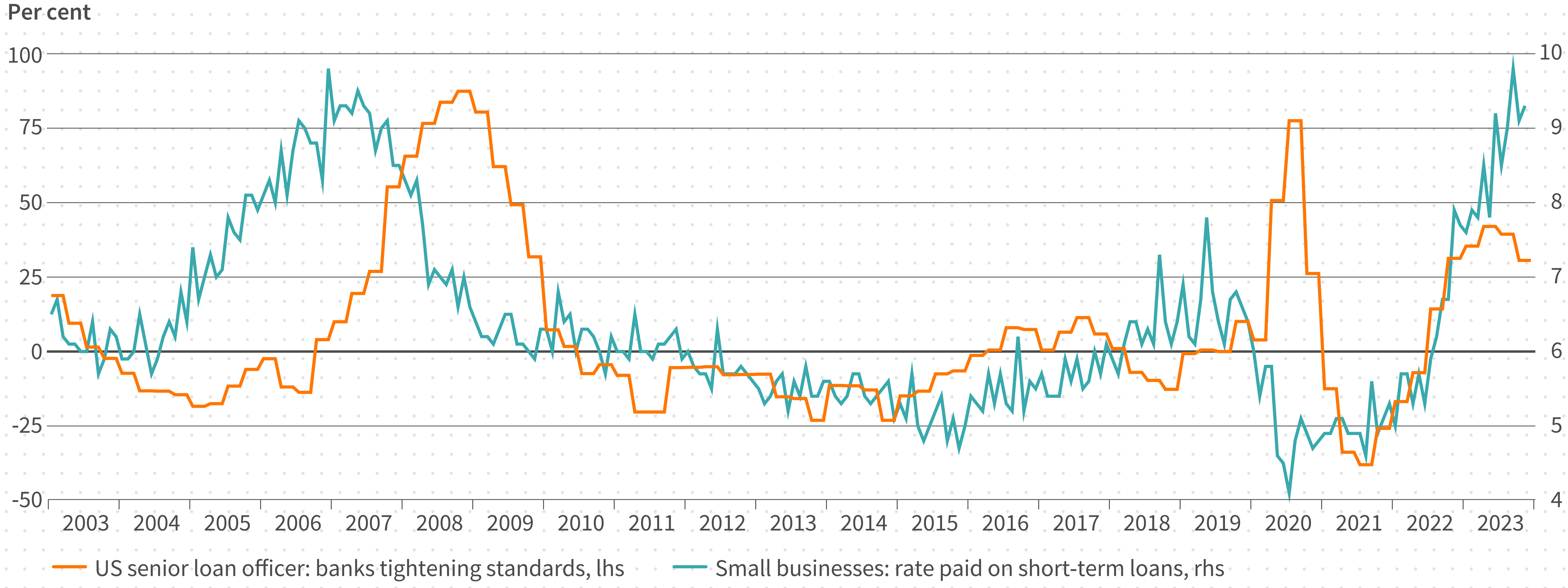
As inflation continues to fall, central banks are generally exercising caution. While acknowledging that rate cuts will be needed at some point to shift from restrictive to neutral, the fear of an inflation rebound is balanced against overtightening; this too is known and recognised. That doesn't make finding the balance easier, as even without more hikes, slowdowns can accelerate or recessions arrive without ringing a warning bell, or giving an inflation all-clear. In the meantime, ex-post real rates are rising.

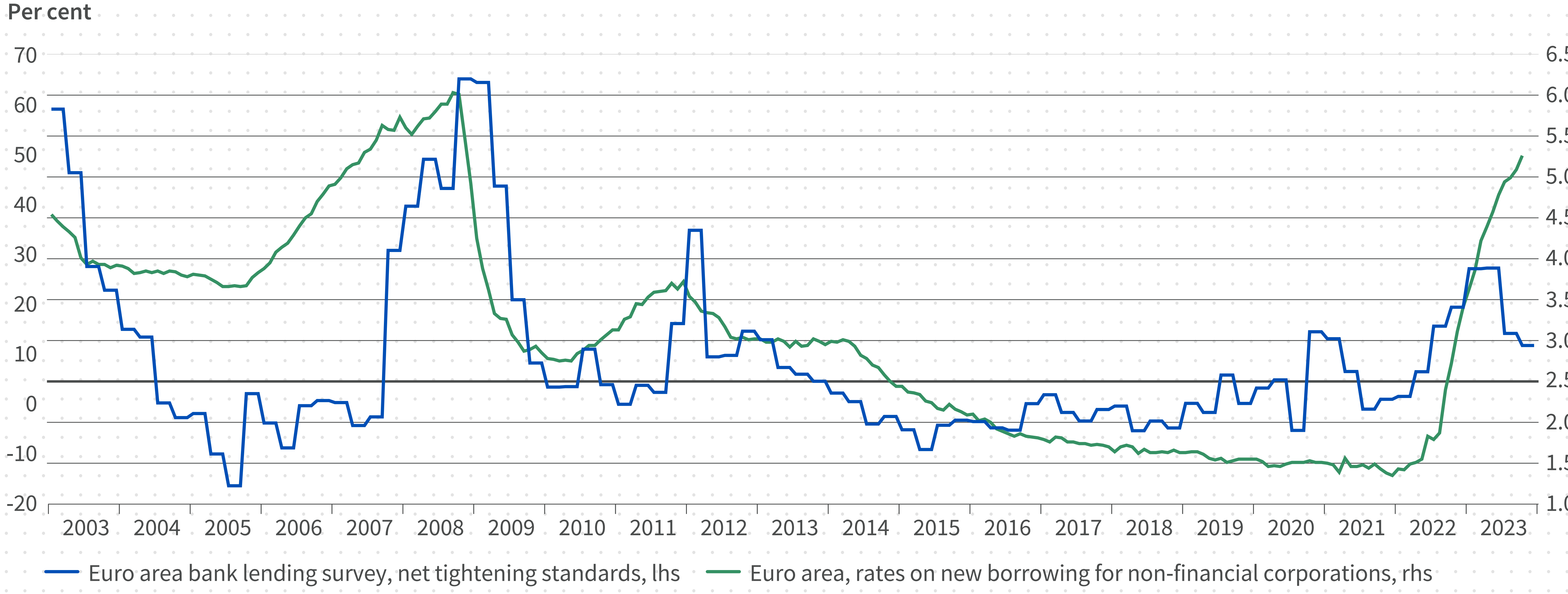
Where might vulnerabilities be exposed? We have already seen stress in leveraged areas of the economy such as commercial real estate (CRE), and that is likely to continue. Small businesses, unlike larger corporations, are more exposed to rising interest rates (Figure 8) and do not have the gigantic cash cushions and access to bond markets. Finally, weaker segments of the income distribution have run through their excess savings, and do not have capital gains to lean back on; should unemployment rise, their bargaining power for higher wages might also prove ephemeral. Emerging markets with large external debt, or fiscal and current account deficits to finance, have often proved brittle, although the least creditworthy have already defaulted in the current cycle.

These problems eventually wind up as non-performing loans for banks, who may then tighten credit pro-cyclically – though this has happened pre-emptively in many jurisdictions (Figure 8). With greater capital buffers, we do not expect this risk to set off a financial crisis, but it would be negative for risky assets and eventually prompt deeper rate cuts from central banks.

> *As inflation continues to fall, central banks are generally exercising caution*

Figure 8. **Smaller firms in particular face tighter lending conditions and incur higher borrowing rates**





Source: ECB, Federal Reserve, NFIB, Aviva Investors, Macrobond as at 31 December 2023.

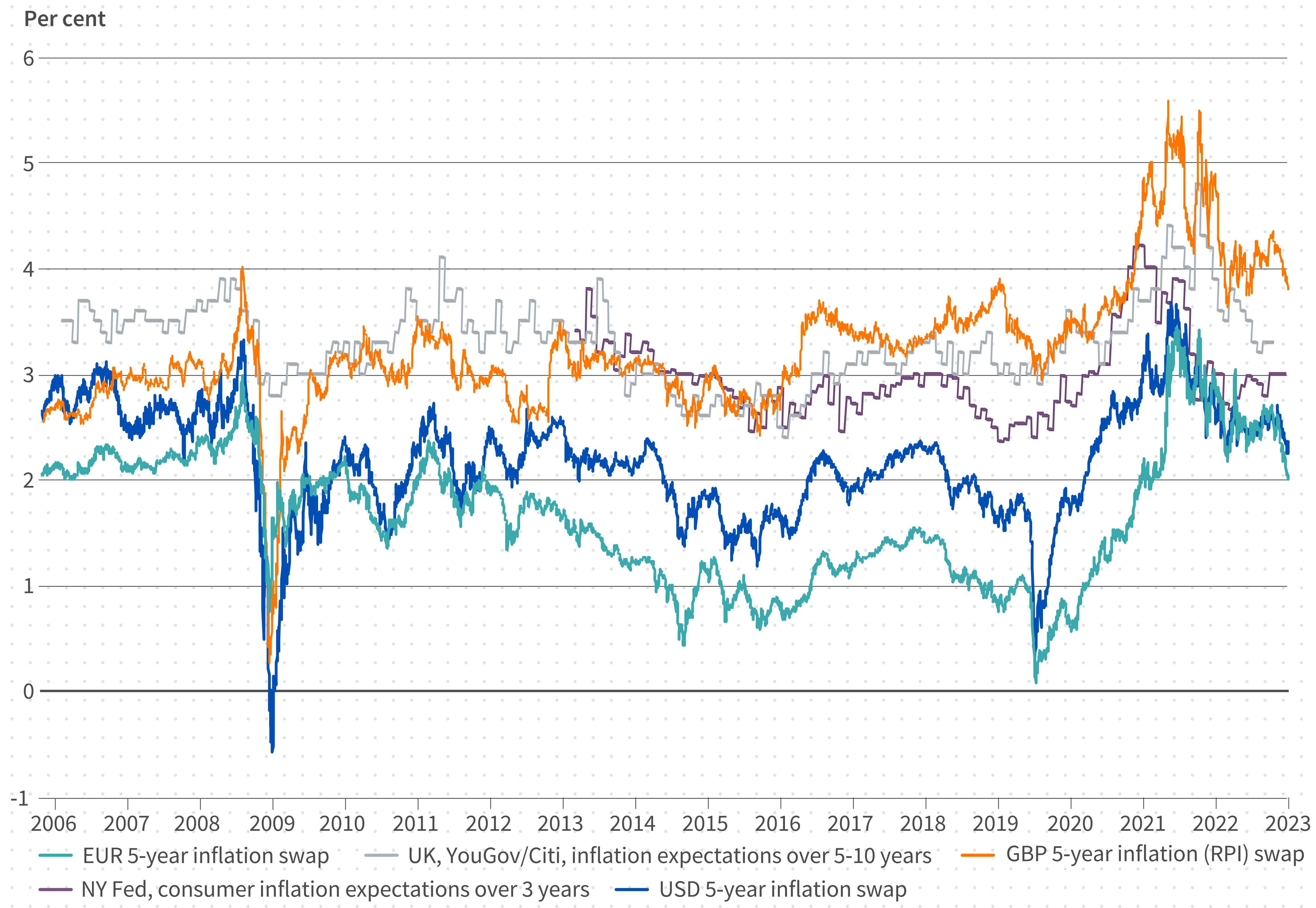
Disinflation slows or stops

Though not mutually exclusive in a stagflationary shock, this second risk is in some ways the polar opposite of Risk #1. Either because demand continues to be resilient, or due to renewed supply shocks, the disinflation that began in late 2022 could falter, leaving monthly inflation prints in the 0.2s and 0.3s. Price developments have hitherto developed in a slow, bumpy, but ultimately constructive fashion, but if they were stuck in a 2.75-3.5 per cent range, what then? (Figure 9). This is far enough away from 2 per cent targets, which many central banks stubbornly cling to as sacrosanct, to eventually necessitate action. This scenario might even begin with a few rate cuts in 2024, only to be revealed as a policy error that must be reversed, with additional hikes to boot.

Strikes and large wage settlements alongside increased fiscal spending, or an OPEC+ supply shock to punish allies of Ukraine, Israel and Taiwan, are two of the more obvious risks.

> ***This scenario might even begin with a few rate cuts in 2024, only to be revealed as a policy error that must be reversed, with additional hikes to boot***

Figure 9. **Medium-term inflation expectations**



Source: Bloomberg, Aviva Investors, Macrobond as at 31 December 2023.

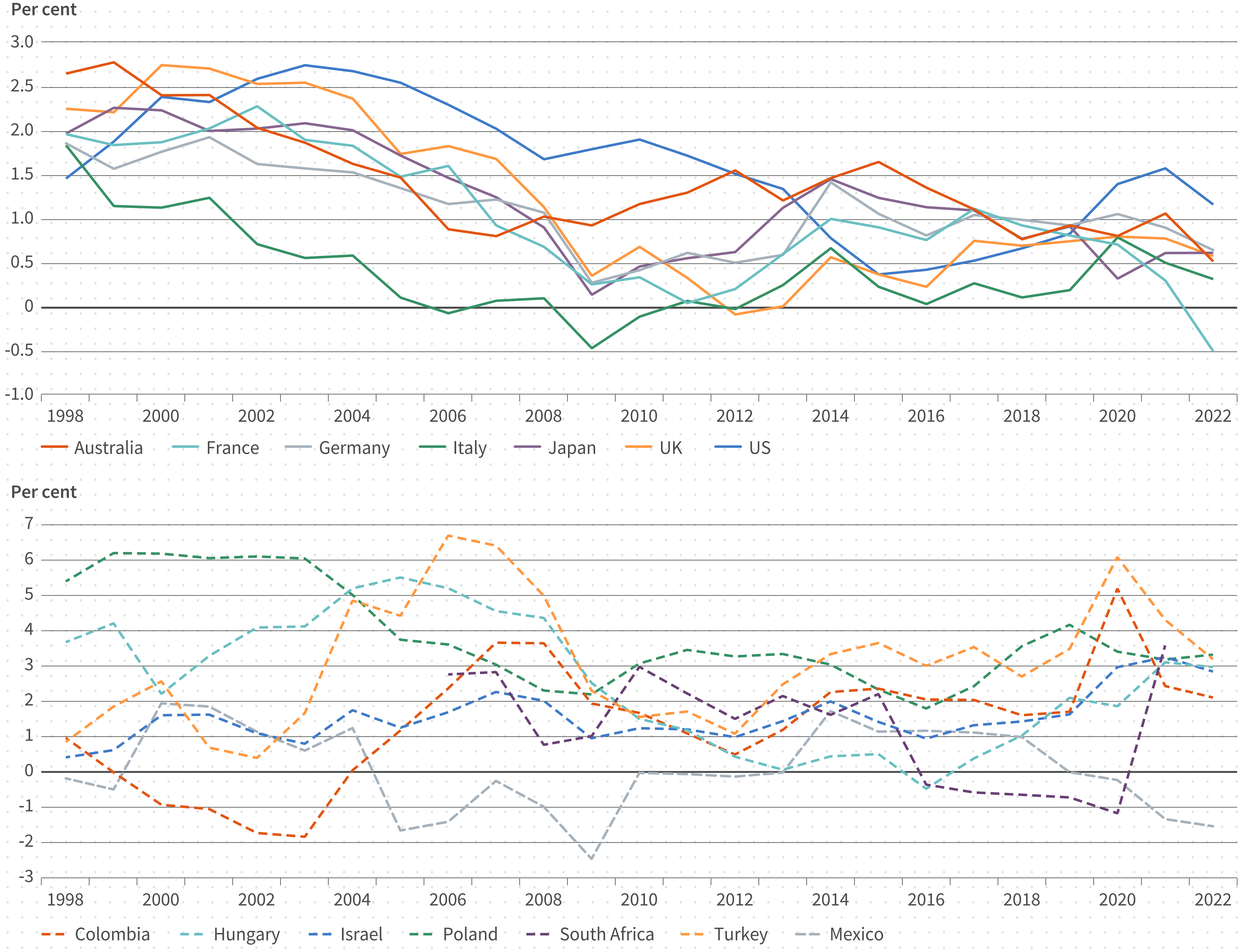
Productivity revival

Shortly after the pandemic, a curious thing happened: many countries found that GDP was bouncing back to its previous highs, even as the number of workers was far lower than pre-COVID. This productivity boom proved temporary: once constraints were removed and labour markets normalised, measured productivity (GDP per total hours worked) declined again, cyclically (Figure 10). This simple measure of productivity is arithmetically correct, but masks underlying improvements in total factor productivity, whether due to capital deepening, or innovation that enables greater output with the same or fewer inputs, moving the production frontier up.

During and after the COVID period, there were structural changes, not least the embrace of videoconferencing and remote working, and commitment (particularly in the US, EU, and Japan) to infrastructure and energy investment. Looking forward, it is hard not to be optimistic about advances in technology such as AI, gene editing, advanced materials and nanotechnology, and of course, vaccines and other medical advances. China has multiple political and growth issues, but there are also upside risks, and the government's explicit goal is to thwart sanctions and trade wars, and move to the forefront of next generation technologies. Success in EVs, batteries and solar panels (even if there are some booms and busts along the way), are a case in point.

These developments will take time to show up in trend growth, but – if they pan out as hoped – eventually should benefit growth numbers, even in the laggards. Some of the gains will not show up in GDP at all, but replace or displace existing products, or just improve quality of life, and so be "lost" to consumer surplus as dangerous jobs or diseases are eliminated, continuing the rapid upward arc of human progress since the industrial revolution.

Figure 10. **US productivity may have turned a corner, and EM productivity has remained high**



Source: Aviva Investors, Macrobond as at 31 December 2023.

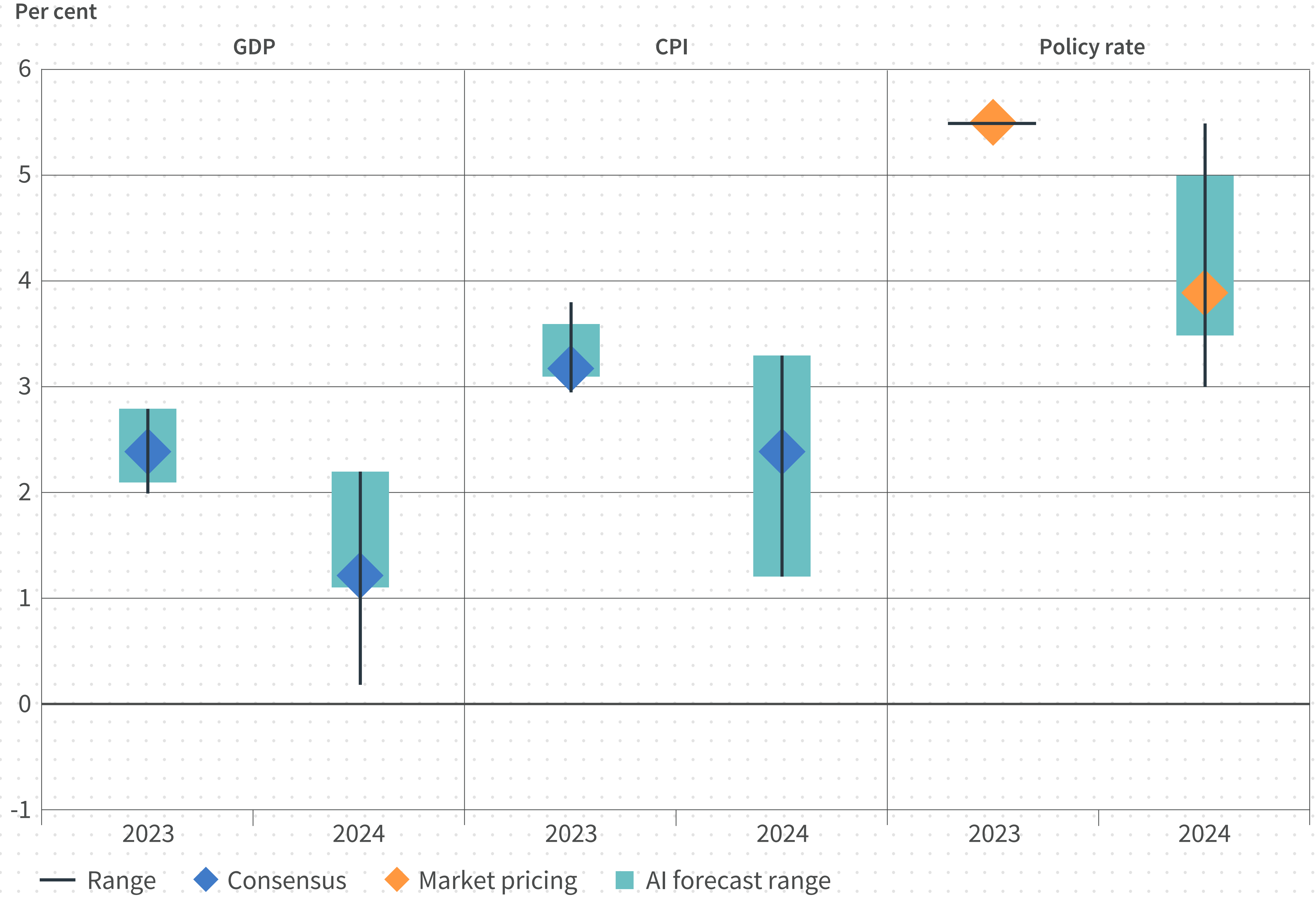
Macro forecasts charts and commentary

US

The US has experienced disinflation throughout 2023, despite another year of solid growth. Indeed, not only did the much-vaunted recession fail to arrive, but growth was above potential throughout the year. While the labour market softened a little, most of the adjustment came through reduced vacancies and hours worked. Employment growth remained solid, as did wage growth, albeit it slowed through the course of the year. The strength of spending likely reflected a sharp deterioration in the cyclically-adjusted fiscal balance, driven by weaker tax receipts. Subsidies for investment in climate change and national security priorities also helped. We expect growth will slow in 2024, but only to around potential. There is likely to be a modest headwind from fiscal policy; this marks a big change from 2023, and the full effect of higher real rates should also slow spending. That said, there is little spare capacity and the recent easing in broader financial conditions means that there are risks in both directions on growth. Core inflation has already fallen sharply from the post-COVID peak and should ease back closer to 2 per cent through 2024. However, there remain upside risks to the inflation outlook given the limited spare capacity. We expect the Federal Reserve ought to be able to ease policy in 2024, keeping realised real rates positive but not wanting them to rise further. But we think that market expectations of cuts next year are overdone (Figure 11).

Core inflation has already fallen sharply from the post-COVID peak and should ease back closer to 2 per cent through 2024

Figure 11. **US**



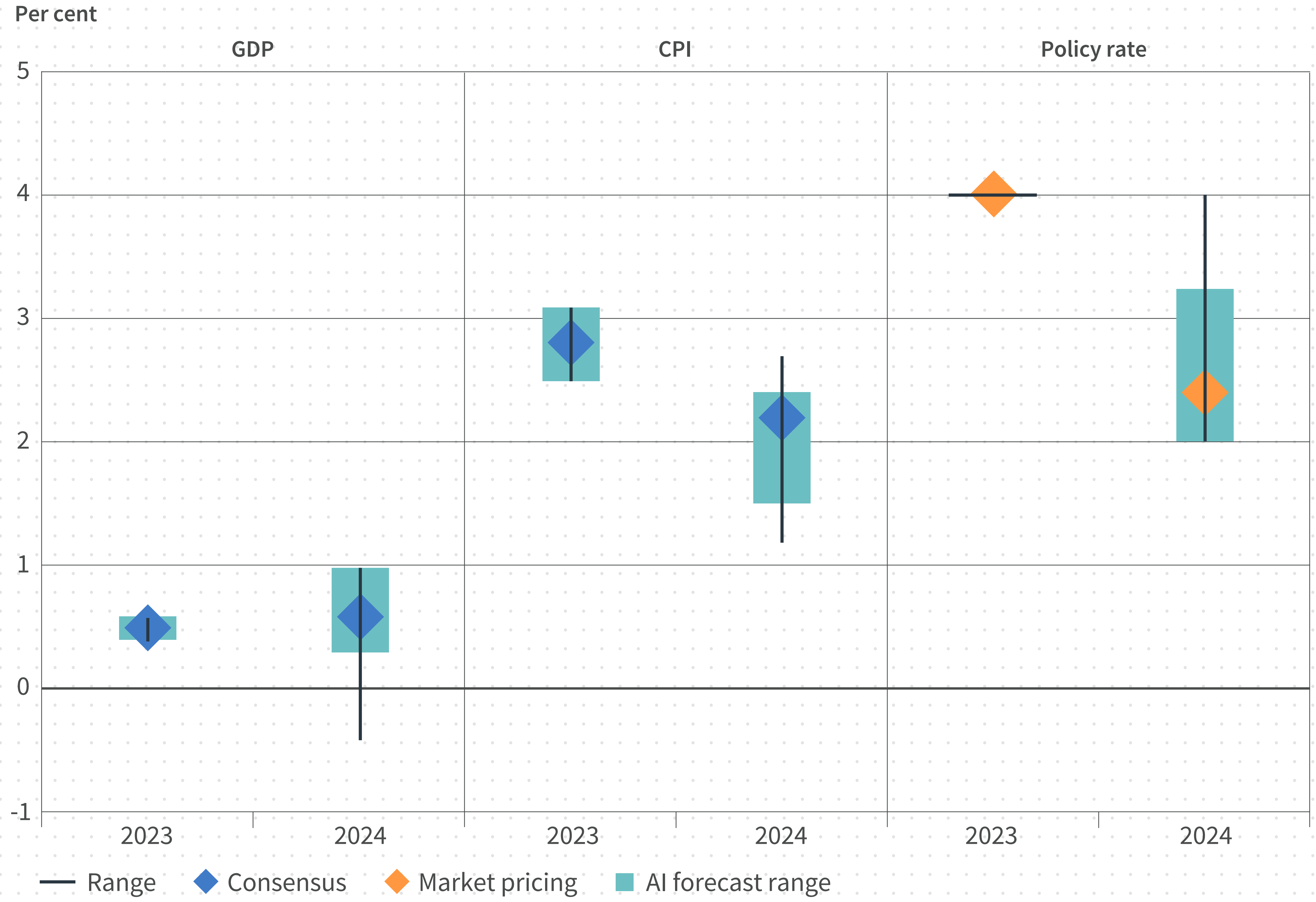
Source: Bloomberg, Aviva Investors as at 31 December 2023.
GDP calendar year growth; CPI Q4/Q4; Policy Rate Q4.

Eurozone

The Eurozone economy has barely registered any growth in 2023. While that reflected surprising resilience in H1 to the energy shock, activity has since faltered, despite the retreat in gas prices. Tight monetary policy has slowed credit creation, impacting consumer spending and investment – especially on the residential side. Alongside that, the structural impact of persistently high gas prices on industrial production has seen the German economy approach technical recession for the past year. We expect 2024 to be another year of muted growth, with the full impact of higher rates still feeding through the economy in H1, with growth only gradually picking up in H2 as real household disposable income growth improves. While the long-term fiscal support for climate transition and national security remains in place, government spending is likely to be a marked drag on growth in 2024 following the recent German Constitutional Court ruling. Inflation has fallen faster than expected in recent months, and while there will be some reversal of that due to the unwind of energy support packages, we expect core inflation to fall back to target in 2024. That opens up the prospect for the ECB to cut rates more sharply, with a widening output gap and limited prospect of underlying inflation accelerating in the near term. We expect the ECB will look to bring policy rates back to around 2 per cent over the next 18 months (Figure 12).

> *We expect 2024 to be another year of muted growth, with the full impact of higher rates still feeding through the economy in H1*

Figure 12. **Eurozone**



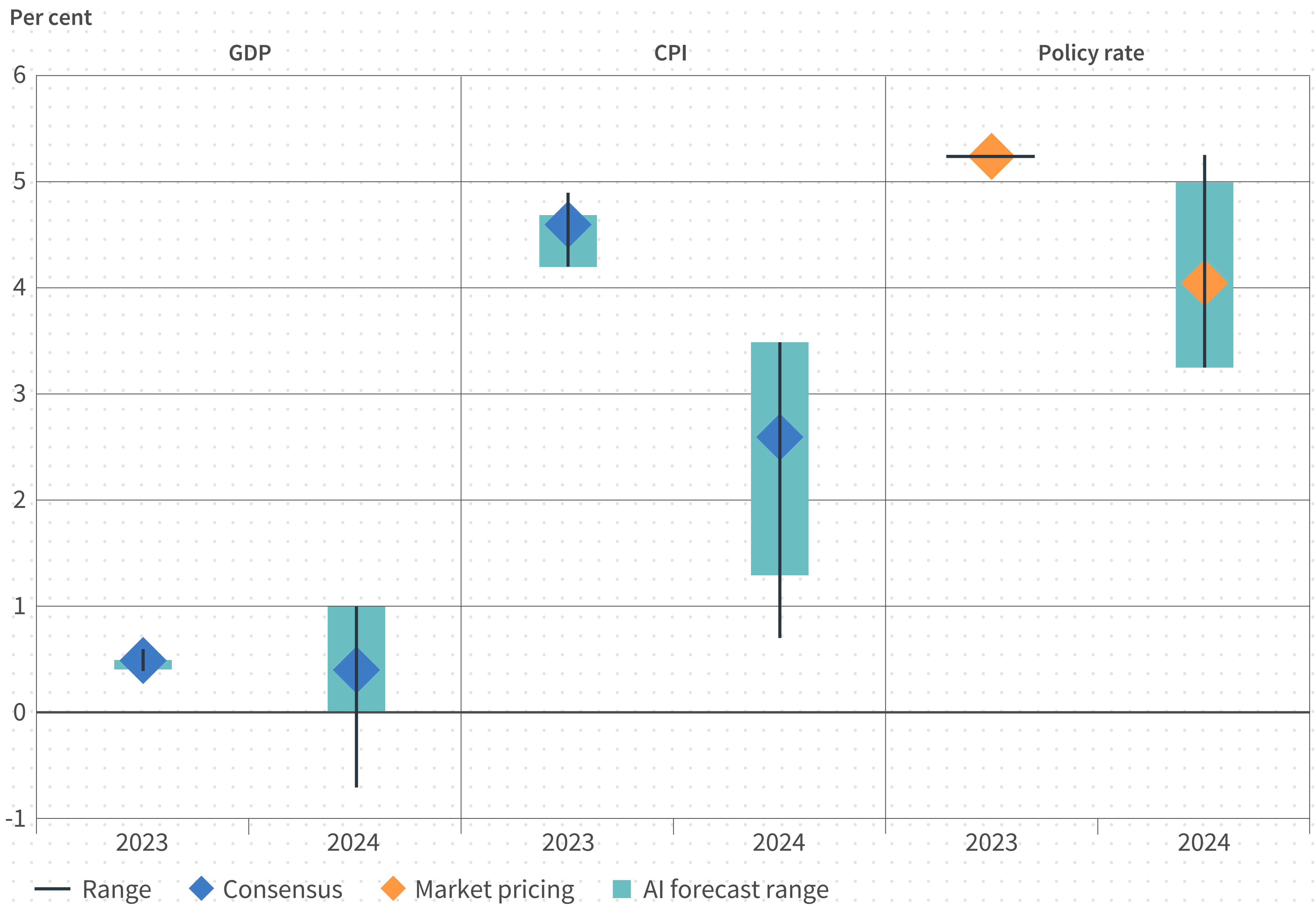
Source: Bloomberg, Aviva Investors as at 31 December 2023.
GDP calendar year growth; CPI Q4/Q4; Policy Rate Q4.

UK

2023 has proved a weaker year for the UK relative to its developed market peers. We expect something similar in 2024, with positive, but below potential growth, at around 0.5 per cent. An accumulation of negative supply shocks in recent years has left the UK's labour market structurally damaged, with increased levels of skill mismatches likely raising the equilibrium unemployment rate and increased rates of long-term illness impacting inactivity. Meanwhile, the weakness in demand has meant that the modest improvement in labour market participation recently has resulted in a notable increase in the unemployment rate, as job creation has failed to keep pace with the growing labour force. The impact of monetary policy tightening is expected to continue to build through 2024, as the most interest-rate sensitive sectors refinance onto higher rates. Indeed, we think two-thirds of mortgages are yet to reset to the new rates environment. The recent progress on inflation has been more encouraging, although much ground still needs to be travelled to bring it back to target. The outcomes of the pay settlements round in Q1 2024 could be crucial in providing more clarity on underlying inflation trends. We expect inflation to continue to decline in 2024, as food and core goods inflation drop back further. With core services expected to be more persistent, we do not see headline inflation back to 2 per cent until 2025. We expect the Bank of England will be in a position to ease policy around the middle of 2024, with an increasing amount of spare capacity and inflation getting close to target sufficient to move the policy rate back towards neutral (Figure 13).

> ***The recent progress on inflation has been more encouraging, although much ground still needs to be travelled to bring it back to target***

Figure 13. **UK**



Source: Bloomberg, Aviva Investors as at 31 December 2023.
GDP calendar year growth; CPI Q4/Q4; Policy Rate Q4.

China

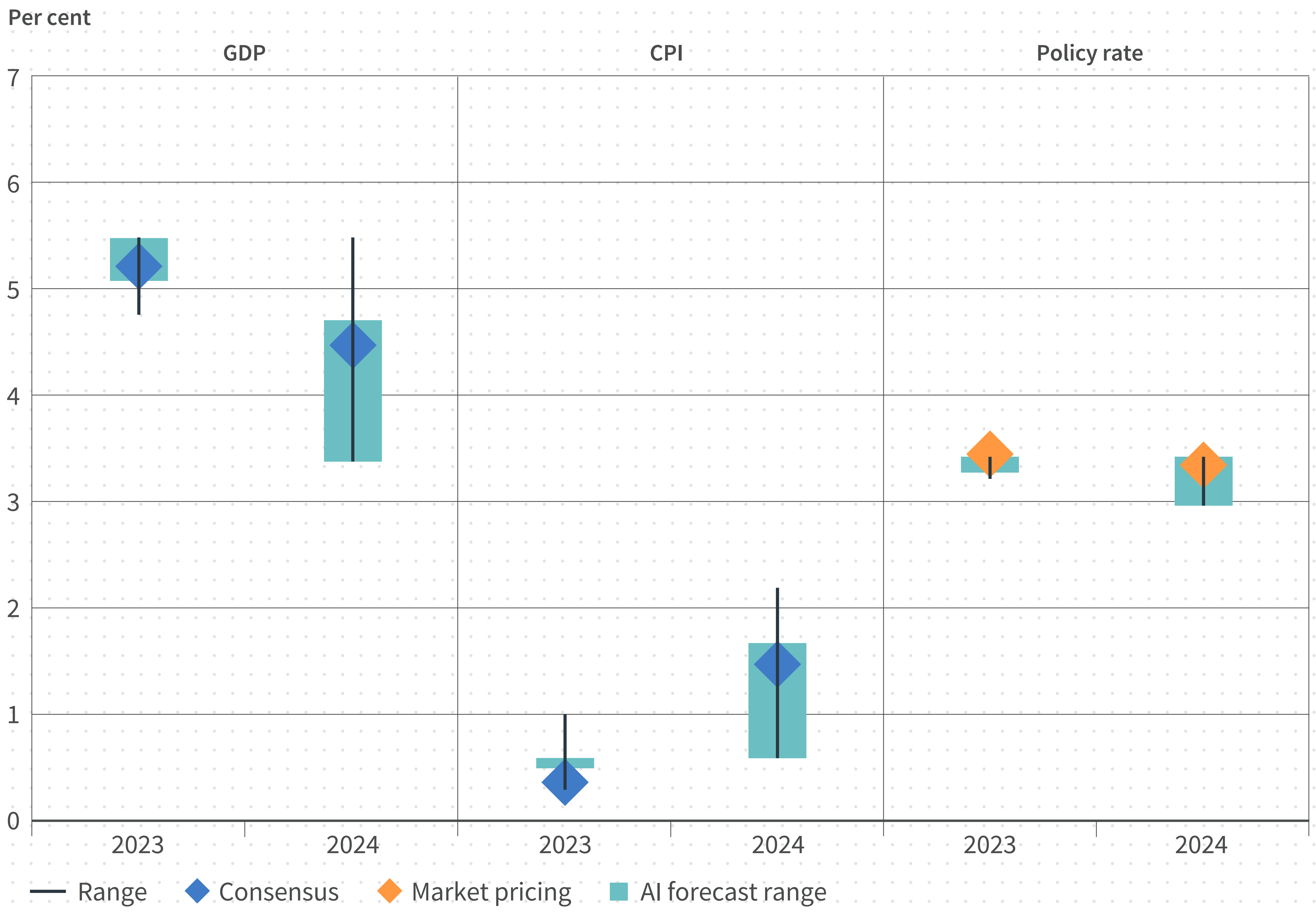
GDP growth is on track to exceed the low bar of 5 per cent set by Beijing after all, with programmes being rolled out to support weak companies and boost manufacturing. Dual circulation and mercantilism remain pillars of Xi's plan to dominate new economy sectors and reduce vulnerability in case of geopolitical conflict. This is increasing global fragmentation as non-aligned countries react to their supply overdependence, with portfolio flows and FDI fleeing alongside domestic capital flight.

Confidence remains weak in most areas across China, with the property market still in a depression and dealing with a large debt overhang. Non-performing loans at banks are being papered over, but wealth destruction is still occurring in the bond market, from the issuers themselves to local government financing vehicles, and losses are affecting trusts and wealth management products. The lack of tax and land sale revenue at local governments has also led to payroll and supplier delays or non-payments, and is damaging consumption and investment. The combination of these factors has intensified the mistrust of the government's erratic policymaking under President Xi, especially during and after COVID. This includes anti-corruption meted out selectively, harsh regulation targeted to align sectors with national priorities, and ideological dogmatism deepening ties between the CCP and private sector.

Inflation remains close to zero, and PPI in particular correlates well with corporate profits, which bodes ill for China's corporates. Fiscal policy has been loosened and monetary policy and liquidity is supportive, but this stimulus prevents worsening in the economy, rather than promoting a self-sustaining expansion. Policymakers are focused on stability, and are wary of allowing too much CNY weakness. We expect this to persist into 2024, and see a structural slowdown that is faster than consensus, despite the bright spots mentioned earlier (Figure 14).

Policymakers are focused on stability, but face weak confidence and a structural slowdown

Figure 14. **China**



Source: Bloomberg, Aviva Investors as at 31 December 2023.
GDP calendar year growth; CPI Q4/Q4; Policy Rate Q4.

Japan

The U-shaped post-COVID recovery is largely complete in Japan, and fiscal spending alongside real wages turning the corner into positive territory should sustain the expansion. Q3 was marred by inventory correction, and quarterly data looks soft mainly because of the big jump in activity in Q1 – we expect growth should trend to 1-1.5 per cent, well above population growth and ahead of consensus. Key to that are the *Shunto* wage negotiations, and whether small and medium enterprises feel the need and have the ability to raise salaries as well. The government's economic plans focus on green and digital transformations; delivering that should combine with businesses' strong profitability and the weak yen to boost investment. The global growth slowdown and election risk, as well as the world's worst demographic profile, are the main short- and medium-term drags.

Some of the fiscal deficit is incurred from subsidies, which boost consumption but also repress inflation, as was the case in Europe, China, and many Emerging Markets. CPI should still be around the 2 per cent target on a sustained basis, in part as subsidies abate, allowing for gradual rate hikes which are needed to steady the yen, even if other central banks cut in 2024. Yield curve control policy is effectively dead, but the BoJ is well within its rights to intervene in the government bond market or the yen or JPY market to dampen volatility. There is no risk of fiscal crisis, but large issuance amidst rising rates and no credible consolidation on the deficit front, while real and nominal growth is relatively low, suggest prolonged yen weakness is a structural phenomenon, though the exchange rate can appreciate if the ECB or Fed cut quickly (Figure 15).

> ***The global growth slowdown and election risk, as well as the world's worst demographic profile, are the main short- and medium-term drags***

Figure 15. **Japan**

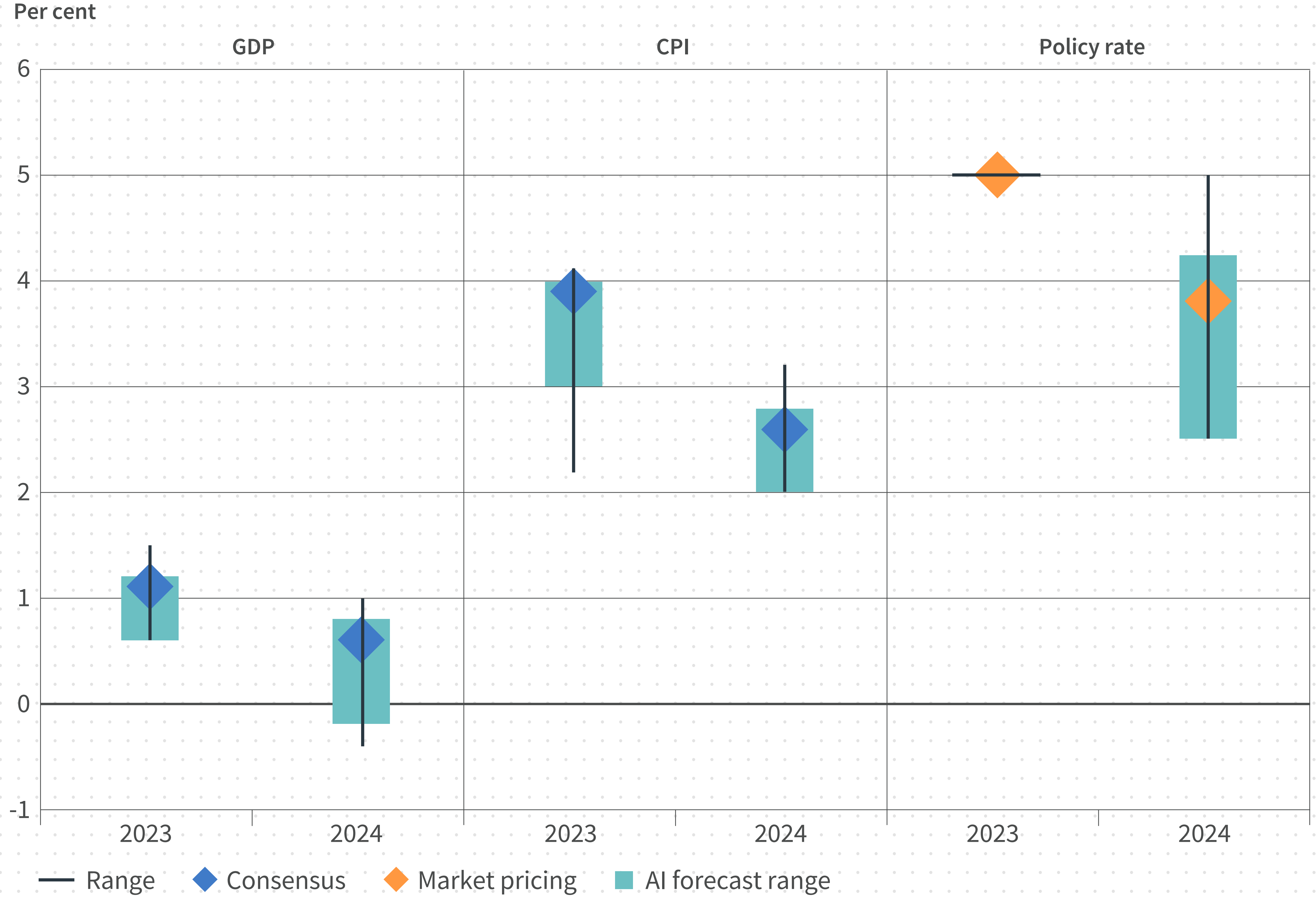
Source: Bloomberg, Aviva Investors as at 31 December 2023.
GDP calendar year growth; CPI Q4/Q4; Policy Rate Q4.

Canada

Canada will likely end 2023 with stagnant, below potential growth as headline inflation declines to around 3 per cent. Higher levels of leverage have rendered Canada far more sensitive to monetary policy than other developed economies, with 2023 seeing both Canadian corporates and households' debt service ratios rise sharply to near all-time highs. Only the structural housing shortages amidst a rebound in demand, due to the migration surge earlier in 2023, have stabilised the housing market in the face of tight policy. This poses a potential financial stability risk, which we expect to weigh considerably on the BoC's reaction function in 2024. That said, much of the "excess savings" accumulated during the pandemic remain, which should help to limit downside growth risks. On the inflation side, the rapid rise in mortgage interest costs have contributed materially to headline inflation in 2023, but should switch to a headwind to inflation in 2024. Despite "sticky" services inflation and persistent wage growth both above 4 per cent, in recent months the Canadian labour market has loosened considerably. However, near-term inflation expectations have also remained elevated, prompting the BoC to voice concerns over potential "feedback loops" between wages and prices. These concerns should fade as the labour market continues to slacken. Indeed, firms are already cutting back on both their hiring and pricing intentions. Hence, the conditions for cuts may be fulfilled sooner rather than later as the drag on growth from monetary policy peaks in early 2024. We expect the BoC to cut rates in Q2 2024, with both growth and inflation risks to the downside (Figure 16).

We expect the BoC to cut rates in Q2 2024, with both growth and inflation risks to the downside

Figure 16. **Canada**



Source: Bloomberg, Aviva Investors as at 31 December 2023.
GDP calendar year growth; CPI Q4/Q4; Policy Rate Q4.

Global market outlook and asset allocation

A large portion of the inflation shock proved transitory, and 2024 will likely see Developed Market central banks join many Emerging Markets in cutting rates

Risks are two-sided for both growth and inflation, and hence for equities and government bonds

The US Dollar is expensive, and Fed cuts alongside slower US growth are expected to be negative for the currency. Upside in rates is highest for EMs with high real rates and strong growth

For FX and credit, the Fed's actions hold the key to sustaining Q4's momentum, and it is more likely to be positive than for risk-free bonds

After an awful 2022 for most asset classes, 2023 has been a treacherous but rewarding journey, with numerous landmines to avoid. Most fixed income indices dipped into negative territory several times throughout the year, and equity markets also managed to come close to having two bear markets within the same year. Ultimately, US growth exceptionalism, easing inflation and reaching the summit of rate hikes for most monetary authorities, allowed for a Q4 "everything rally" that has left equities and bond benchmarks positive in the US, Europe, and Emerging Markets (Figure 17).

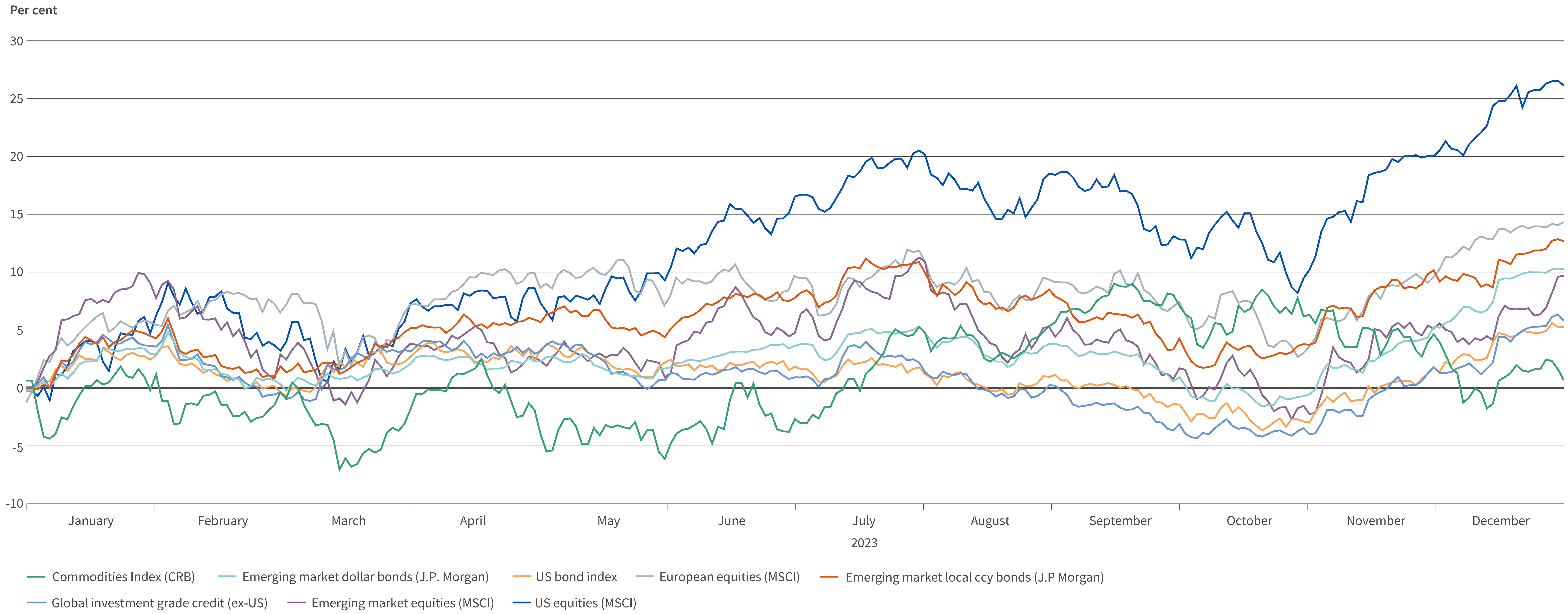
The next year is likely to have a number of twists and turns as well, and though yields are high, bond markets will have a tough time beating cash, in our central scenario – mainly because fairly aggressive rate cuts have now been priced into the front end of many curves, and some term premium has recently disappeared from longer maturities. Credit spreads are in neutral territory. For equity markets, much hinges on macroeconomic outcomes as well as the evolution of margins and earnings, and we remain broadly constructive. Risks for all of these are two-sided, and which risk materialises or disappears may well be the most important development for investors.

Next year will see rate cuts that have begun in Emerging Markets spread to Developed Markets, but not necessarily more than is already priced in

Inflation proved transitory, albeit later than expected and thanks in some part to rate hikes that slowed growth and depressed certain sectors. At least as important has been the normalisation of many supply chains and labour markets, as detailed in the accompanying sections. For fixed income markets, this means that the restrictive monetary policy that has been in place since early 2023 can, in all likelihood, ease off. Next year will see rate cuts that have begun in Emerging Markets spread to Developed Markets, but not necessarily more than is already priced in. This will steepen most curves, but this is not so much a prediction as stating the obvious and confirming what is priced in: in the US the 2s10s has troughed at -100bp, but is already priced to go to +70bp in two years' time. The easy money has been made on this movement already, and it will outperform meaningfully only in a sharp downturn accompanied by rate cuts.

The other side of the coin is that underlying inflation dynamics – from demand for services, which is driven by tight labour markets – have not entirely disappeared. After the first few rate cuts, credit restraints may improve, financial conditions should loosen, asset prices typically do well. This could force central banks to hold off on further "calibration", moving nominal rates lower alongside disinflation, or even reverse it in late 2024 or 2025. Holding bonds is a negative carry trade, and performance relies on continually more cuts being priced in, and/or momentum as term premium comes down. There is, ostensibly, room for real rates to come down – however, if we are now permanently out of the deflationary, too-low inflation, lower-for-longer regime that prevailed from 2009-2021, then the higher real rate environment of 1990-2008 may be the appropriate range to consider.

Figure 17. **2023 has been volatile, but produced positive total returns for most asset classes**



Source: Bloomberg, MSCI, JPMorgan; Aviva Investors as at 31 December 2023.

For FX and credit, the Fed's actions hold the key to sustaining Q4's momentum, and it is more likely to be positive than for risk-free bonds. Rate cuts outside of recession and a steeper yield curve are strongly associated with tighter credit spreads – though for high yield bonds, a 4 to 5 per cent default rate in the US, and more anaemic growth in Europe, suggests less room for compression compared to a year ago. Likewise, EM investment grade is expensive. But for Investment Grade in developed markets, spreads are in the middle area of the 2013-23 range; carry and roll provide a better cushion here, and decent risk-adjusted excess returns.

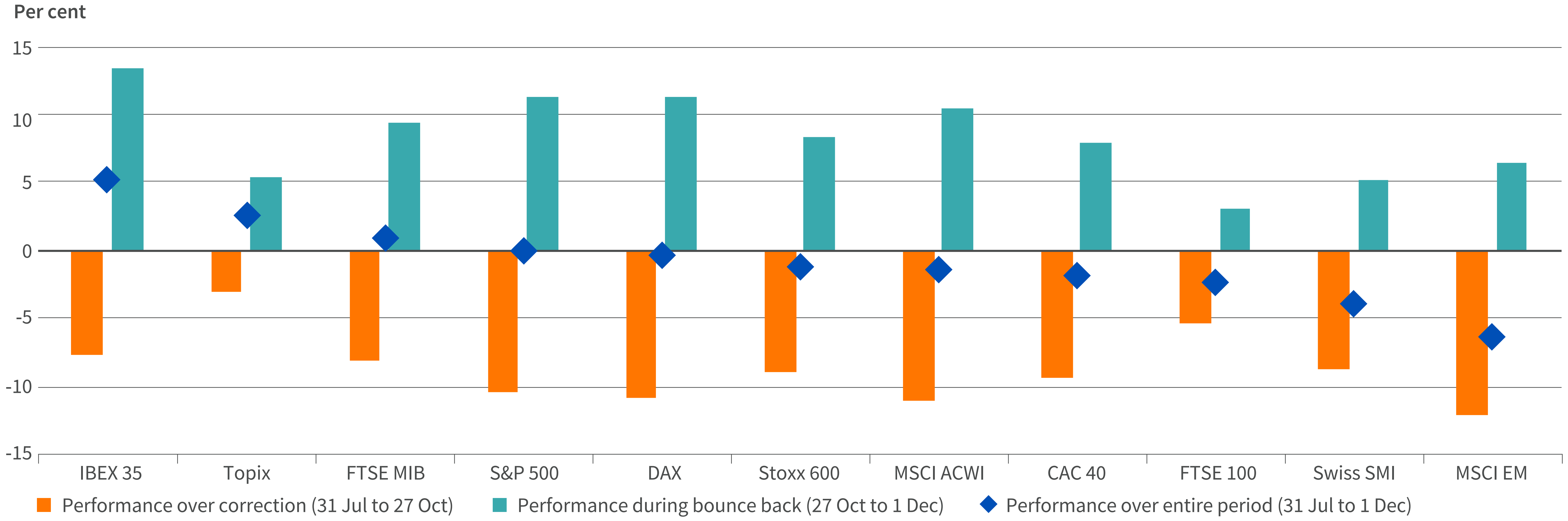
Bullish steepening is also empirically linked to a weaker USD, and the overvaluation of the dollar is still significant even if we award it a premium for high carry and "exceptionalism". Higher growth, high-yielding currencies (e.g. BRL, INR, PLN) should do well; CNY ought to underperform, as will countries that cut rates too far and too fast. Most EMs are being prudent, and we expect inflows to GBI-EM should benefit from bond performance and FX appreciation, particularly against USD.

Election risk will come into focus, eventually, in particular in the US. Event risk may rise as a shift in policies approaches, with two-way risk: the protectionism and tax cuts that would probably be delivered would be dollar positive, though interference with the Fed could lead to inflation and a USD selloff. Unlike 2017-19, though, fiscal profligacy and higher rates could punish other asset classes, as assuming the Fed maintains independence, its tolerance for inflation is diametrically opposite to the Yellen-Powell era pre-COVID.

Equity markets went through a significant correction between August and late October, with the MSCI All-Country World Index down close to 11 per cent from the peak on the 31st July to the trough on the 27th October. That was followed by a very sharp bounce, in which global equities recovered almost all those losses during the month of November and the S&P 500 made new highs for the year by the 1st of December. To put the bounce into perspective, the performance from October 28th through to December 1st in the S&P 500 is in the 98.8th percentile of performance in periods of the same length since 1963.

After this volatile four-month period, the S&P 500 and most non-US equity indices ended up broadly where they began in late July. But there has been some divergence across regions (see Figure 18). Japanese equities were the most resilient on the way down (falling only 2.9 per cent) but they also bounced back less than most (the Topix was the 3rd weakest in the bounce back period, only behind the UK and Emerging Markets). Spanish equities stood out on the bounce back, going up almost 14 per cent, and were also relatively resilient on the way down. This makes the IBEX the best performer over the entire period. Emerging markets were the weakest on the way down and also had an underwhelming bounceback; making the MSCI EM the weakest performer over the entire period.

Figure 18. **Performance of equity indices during equity correction and bounceback**



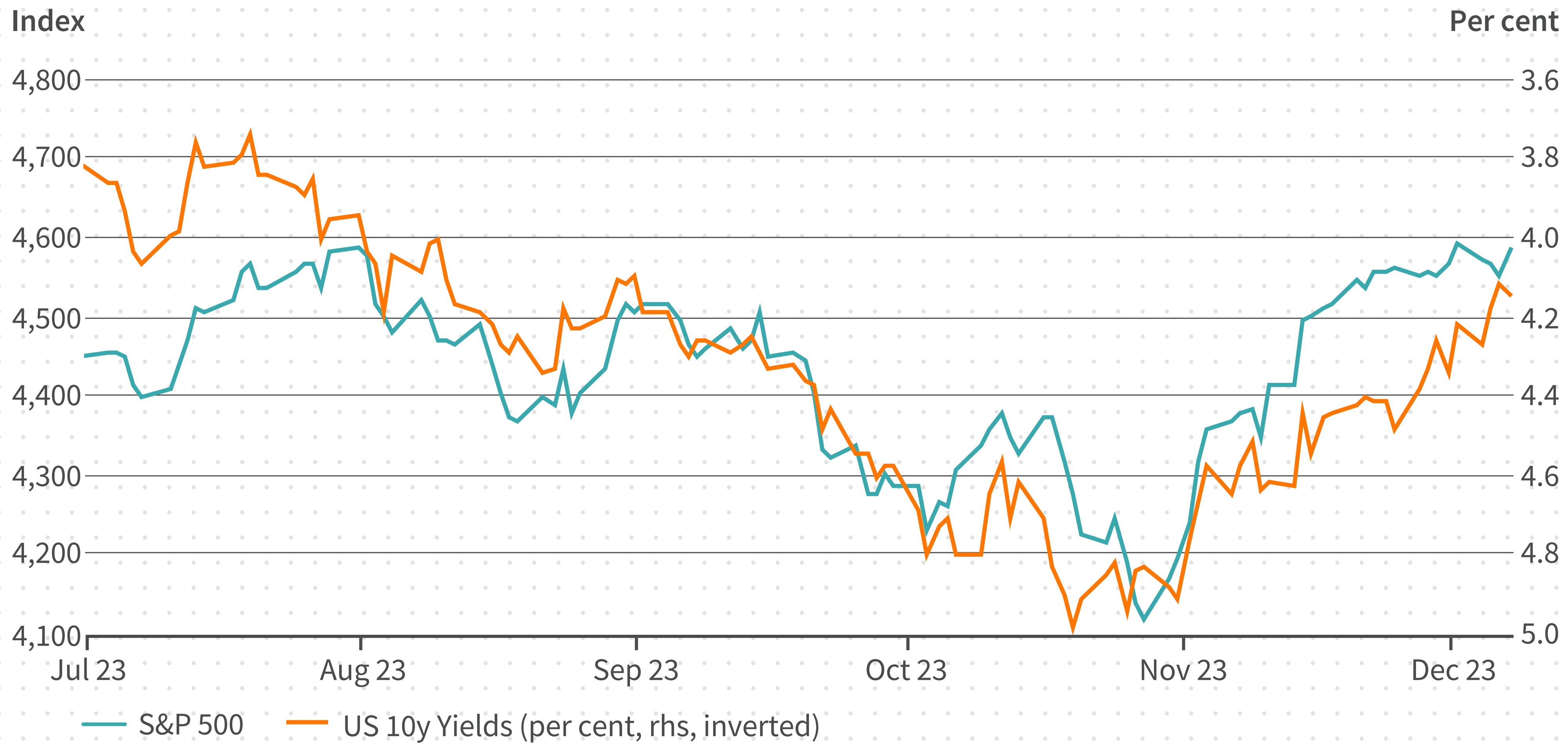
Source: LSEG DataStream as at 31 December 2023.

As we highlighted in the previous House View, a key driver of this correction has been the sharp movement in yields. The trajectory of the S&P 500 over the period is a mirror image of the trajectory of US ten-year yields (see Figure 19), bringing home the positive correlation between bonds and equities, and the lack of diversification available in balanced funds and "60-40" approaches.

Another point we highlighted previously is how, despite yields being the catalyst for the recent volatility, it is earnings which will be the key driver of equities into 2024: the US market has little room for valuations to go higher. And on this front, on top of the US economic data having been buoyant, so far profits appear to be supportive (see Figure 20). The US has gone through an earnings downturn earlier than other geographies, beginning in 2022, which was mainly margin driven. It now appears to have come out on the other side of it and earnings have been growing again in recent months. Europe poses more of a question as it seems to have "escaped" the earnings downturn relatively unscathed so far; margins in Europe remain in line with the 2022 highs. European earnings have tended to follow the US; a move in US earnings is normally replicated in Europe with a delay of one or two quarters. The question now is this: is Europe overdue a period of negative earnings growth, or have European earnings proved to be more resilient in a downturn this time? If that resilience is proven, it will be a rare event but one that should not be completely unexpected. This is because that early US earnings downturn was driven by big technology firms, a sector that has little presence or read-across for European earnings.

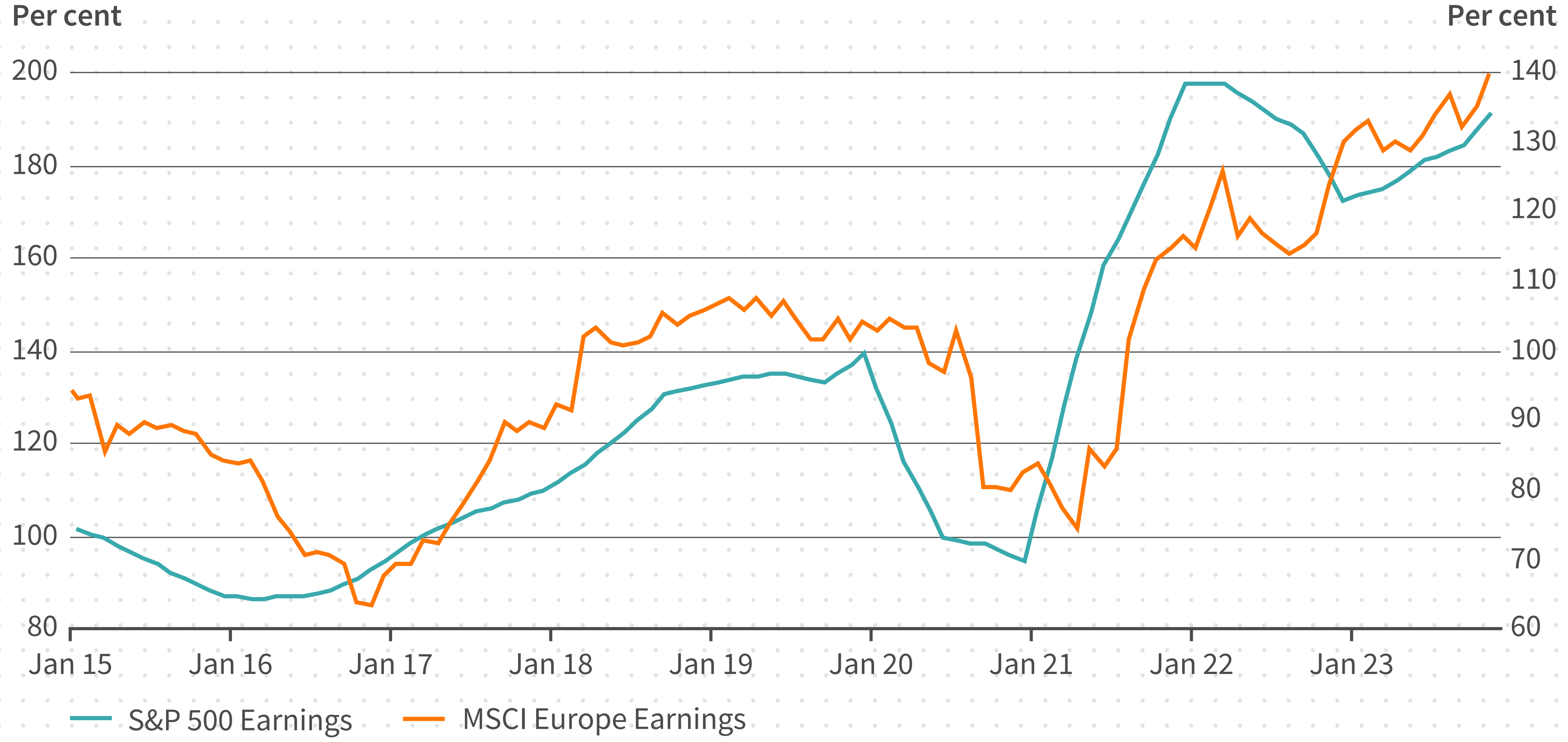
> ***The question now is this: is Europe overdue a period of negative earnings growth, or have European earnings proved to be more resilient in a downturn this time?***

Figure 19. **S&P 500 vs US 10y yields**



Source: LSEG DataStream as at 31 December 2023.

Figure 20. **US and European Earnings per share**

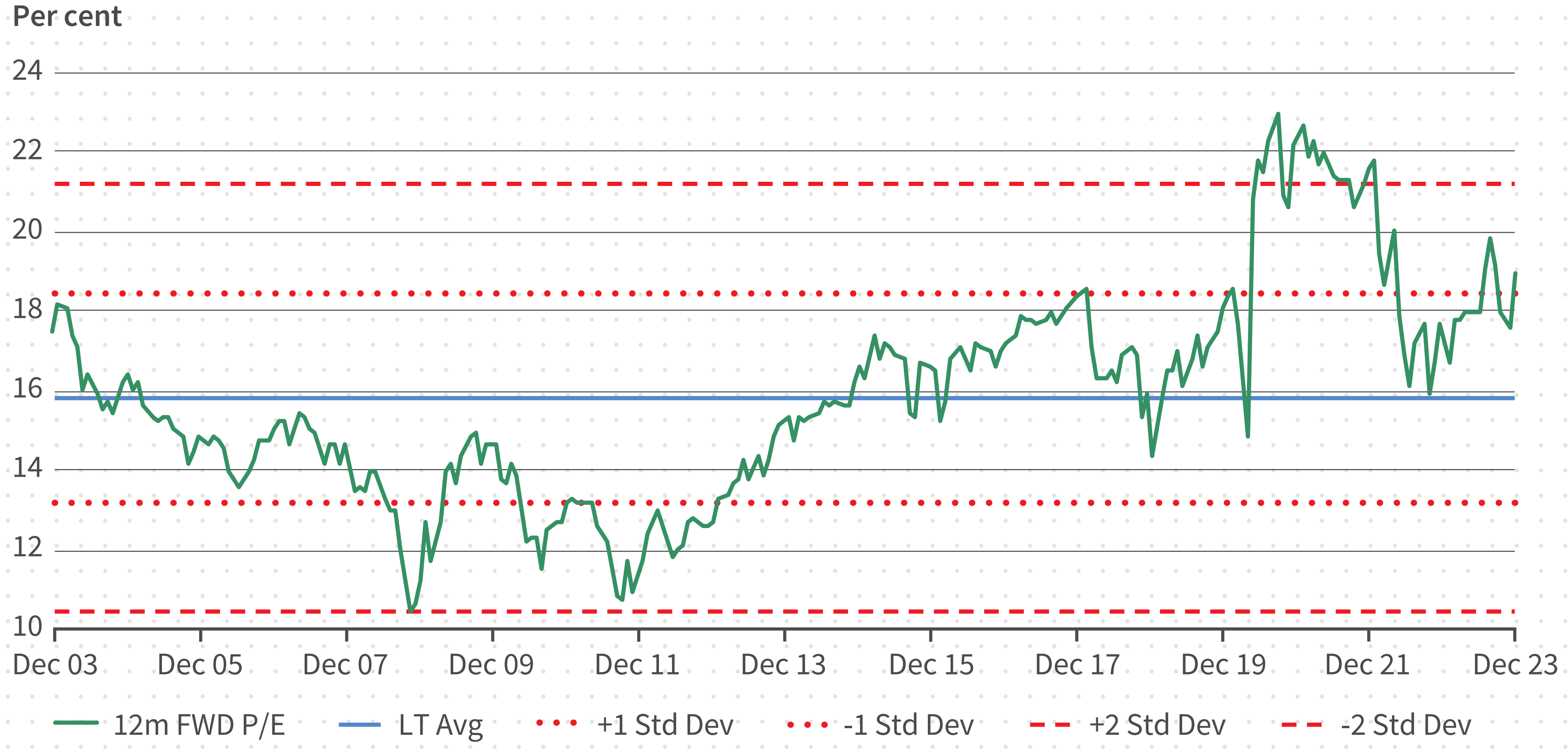


Source: LSEG DataStream, S&P Global, MSCI as at 31 December 2023.

If we indeed have seen the peak of rates and the trough of earnings, this suggests a positive scenario for equities going forward. This is only complicated by valuations, especially when thinking about allocation decisions across regions. While there is better visibility over earnings growth going forward in the US, valuations pose a challenge, as they already appear to discount a robust earnings environment in the US. P/E ratios are at c19x. In the last 20 years this ratio has only been higher during the COVID lockdown period (see Figure 21). So, it seems unlikely the US equity market can see significant re-rating in 2024 and returns will depend mainly on EPS growth alone. In Europe, on the other hand, while there are many more questions around how much earnings can grow in 2024, valuations are much less demanding. P/E ratios are below long-term average (see Figure 22) and already price in a weaker growth environment and/or greater downside risk. This allows potential upside for European valuations and reduces the dependence on EPS growth for equity returns in the region.

> ***If we indeed have seen the peak of rates and the trough of earnings, this suggests a positive scenario for equities going forward***

Figure 21. **S&P 500 P/E**



Source: LSEG DataStream as at 31 December 2023.

Figure 22. **MSCI Europe P/E**

Source: LSEG DataStream, MSCI as at 31 December 2023.

Figure 23. **Asset allocation**

Underweight ← → Overweight

	-5	-4	-3	-2	-1	0	1	2	3	4	5
Equities									3		
US									3		
Europe							1				
UK							1				
Japan								2			
Pacific Basin ex Japan			-3								
Emerging Markets			-3								
Government bonds								2			
US						0					
UK								2			
Eurozone								2			
Japan		-4									
Australia						0					

Underweight ← → Overweight

	-5	-4	-3	-2	-1	0	1	2	3	4	5
Credit						0					
US Investment Grade					-1						
European Investment Grade					-1						
UK Investment Grade						0					
EUR High Yield								2			
US High Yield								2			
Emerging Govt (Hard Currency)						0					
Emerging Govt (Local Currency)						0					
Cash						0					
Currencies (versus US$)							1				
GBP							1				
EUR							1				
JPY							1				
AUD							1				
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 31 December 2023.

WEBCAST

House View 2024 Outlook

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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.

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