Aviva Investors

House View Q2 2024

Policies coming into focus

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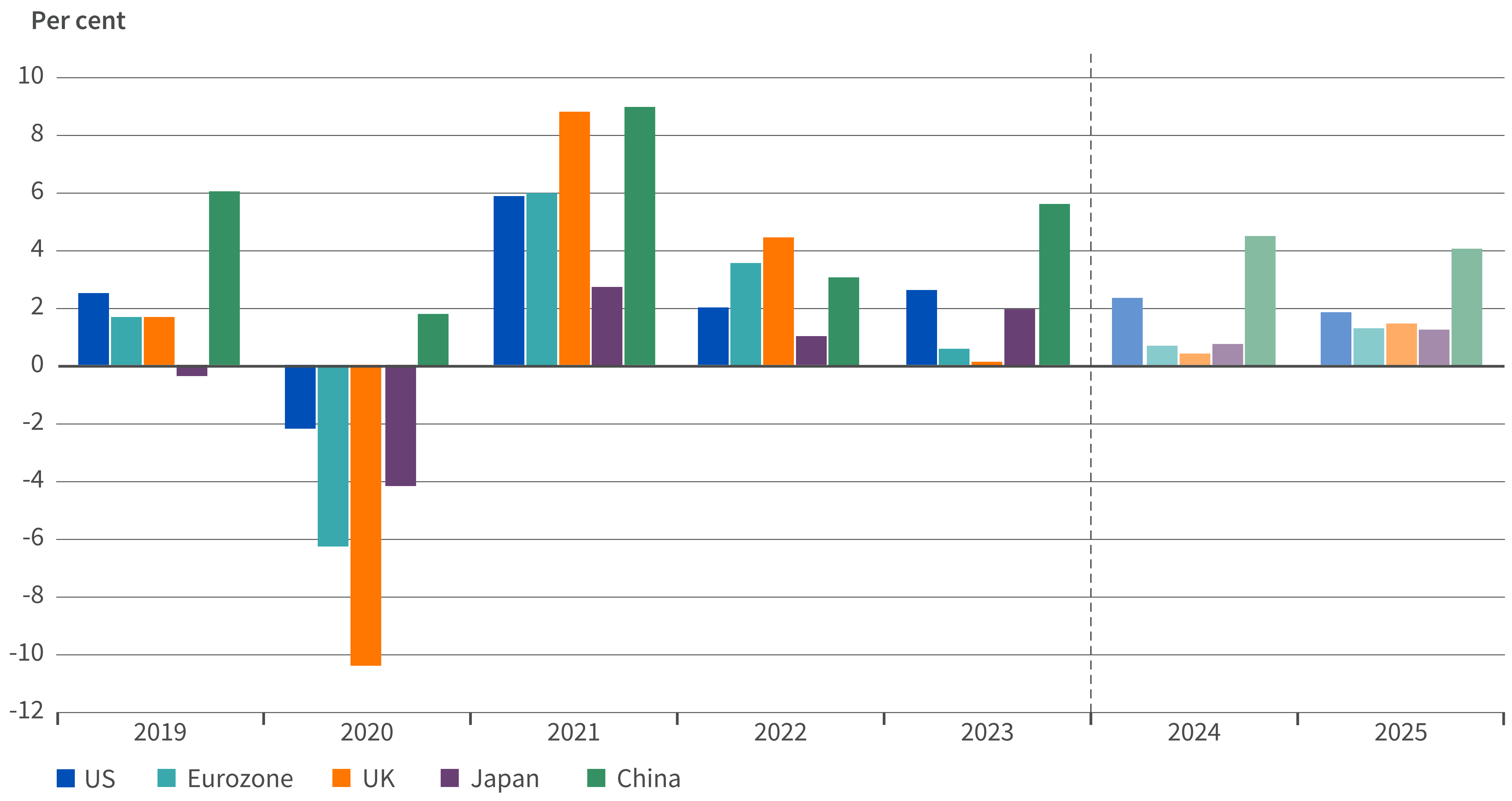
Executive summary

Policies coming into focus

The first quarter of 2024 has seen growth momentum maintained or moderately improve across most regions. For the US that has resulted in a better-than-expected start to the year, with both our own and consensus growth forecasts revised up for the year as a whole. While we still expect a slowing in growth compared to 2023, we now see it remaining somewhat above potential for another year (Figure 1). The US consumer remains in good shape, with real disposable income rising at a solid pace, driven by ongoing employment and wage gains and helped by the moderation in inflation. The corporate sector is also on an improving trajectory, with earnings growth improving and investment spending being supported by government policies.

Figure 1. **Aviva Investors growth projections**



Source: Aviva Investors, Macrobond as at 31 March 2024.

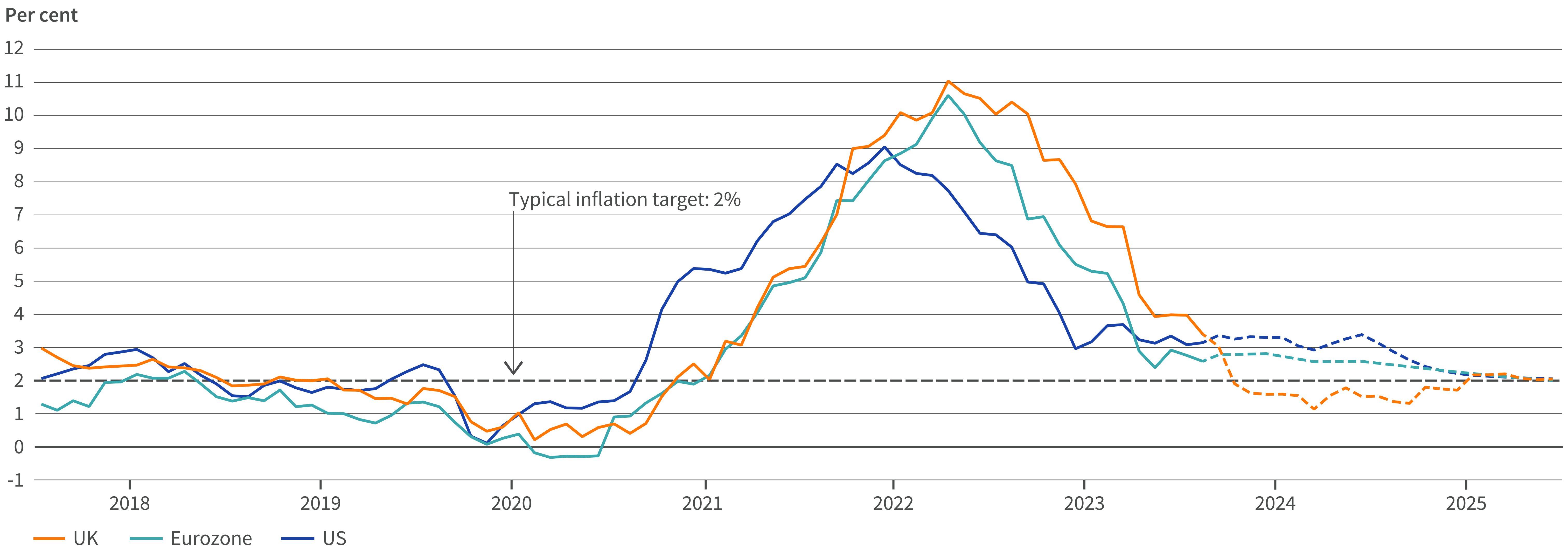
Past performance and forecasts are not a reliable indicator of future performance.

If our projections come to pass, it would be the softest ever growth landing to follow a globally synchronised and rapid tightening in monetary policy

Overall, we are expecting global growth of around 3 per cent in 2024. That is around 0.25 per cent better than we anticipated in our 2024 Outlook published at the start of the year, most of which can be attributed to the upward revisions to US and Chinese growth outlooks. We expect a similar global growth rate in 2025. If these projections come to pass, then it will be the softest ever growth landing to follow a globally synchronised and rapid tightening in monetary policy. Indeed, with Chinese growth likely to be structurally weaker than in the past, global growth of around 3-3¼ per cent is likely to become the norm across the cycle; similar to what we are expecting for the next two years.

Even in those regions where growth has stalled over the last 18 months, such as the Eurozone and the UK, labour markets remain surprisingly robust. Layoffs have remained low and job vacancies, while well down from the peak, are still high by historical standards. Businesses appear to have "hoarded" labour during this period, likely with an expectation that the growth slowdown would be sufficiently short-lived that they did not want to bear the cost of redundancy and new hiring. In the US, where growth has remained solid, the labour market has reflected that strength. Increased immigration and higher participation has come at the same time as only a small increase in the unemployment rate. While labour market conditions have remained relatively favourable, wage growth has slowed only moderately, rising by 4-6 per cent on an annual basis across the major economies. Even in Japan, which has experienced barely any increase for decades, the recent wage settlement round appears to be around 4-5 per cent. We expect some further easing in labour market conditions, and importantly a softening in nominal wage growth, but the risk remains of greater persistence.

Figure 2. **Aviva Investors Consumer Price Index (CPI) inflation projections**



Source: Aviva Investors, Macrobond as at 31 March 2024.

The disinflation experienced across the major economies throughout 2023 largely reflected the diminishing effect of energy and food prices, as well as an easing in pressures coming from global supply chains. Higher interest rates have had a restraining effect on demand that in turn has been a headwind to domestically generated inflation. However, the robust labour market and nominal demand – despite the tighter borrowing conditions – have kept service sector inflation elevated compared to the past decade. That has prevented headline inflation rates from returning to central bank targets of 2 per cent so far. In the US we expect that process will be further drawn-out, with a return to target (based on core personal consumption expenditures (PCE) inflation) expected in 2025, and with risks to the upside.

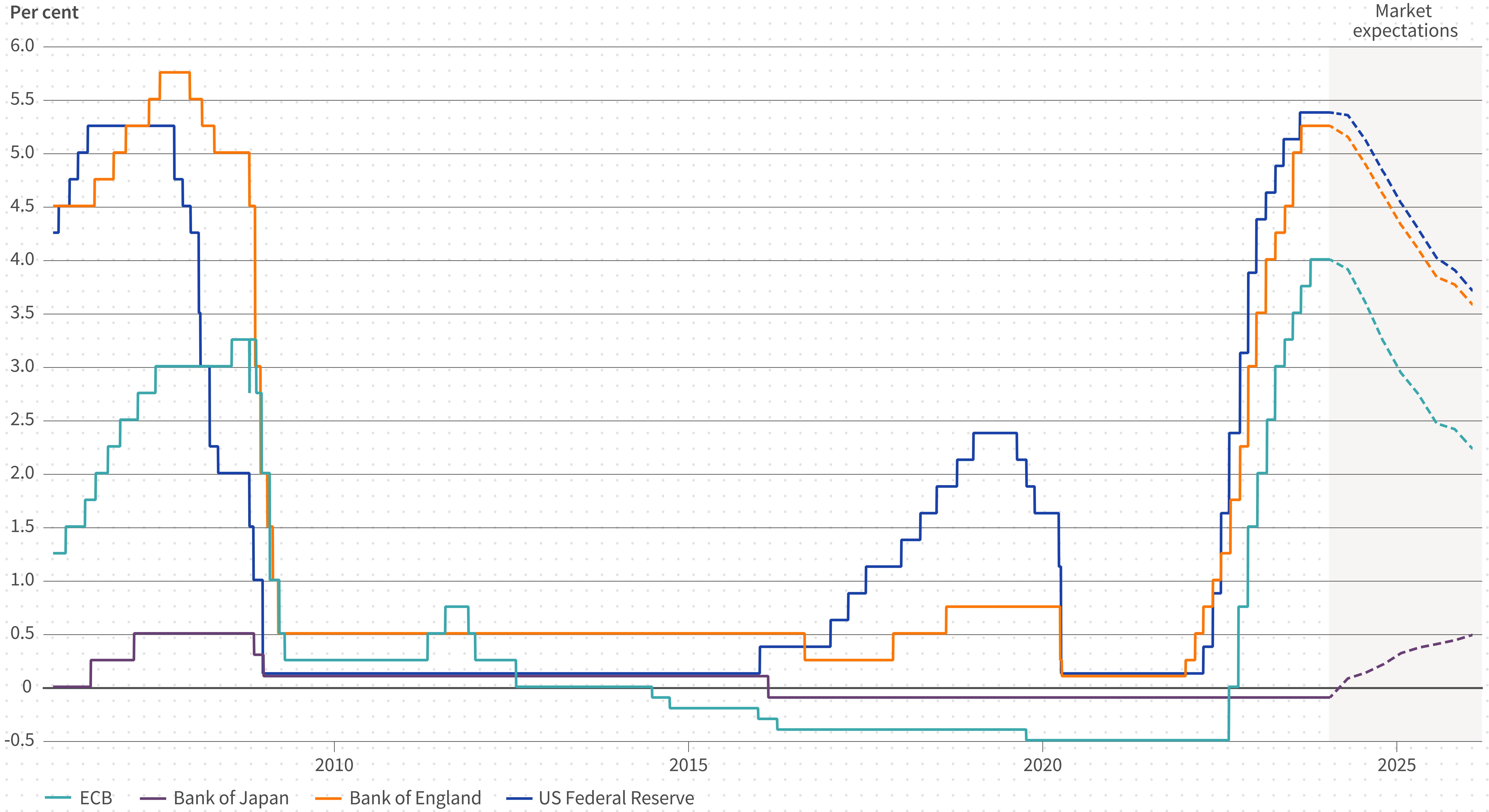
We are expecting global growth of around 3 per cent in 2024

In the Eurozone we also expect a relatively drawn-out return to target, but with more balanced risks. Meanwhile, in the UK we expect inflation to fall below 2 per cent in April, reflecting a decline in home energy prices, with inflation to rise back to only around 2 per cent in 2025, albeit with risks to the upside (Figure 2). Our views on underlying inflation continue to be informed by our measures of trimmed-mean and median inflation, which suggest the biggest challenge in returning inflation to 2 per cent amongst those majors lies in the US.

Given that outlook, we think that while rate cuts are indeed coming into focus, the pace is likely to be steady, rather than rapid (Figure 3). Since the start of the year the market has pushed back the likely timing of the first rate cut from the autumn to the summer and seen the terminal rate of the cycle revised higher. We agree with that direction of travel for the US and think we could see a further move that way. However, we think that pricing for the UK has been dragged along with the US, when in fact the economic backdrop looks quite different. Therefore, we think the Bank of England could cut rates sooner and more deeply than is currently priced. The European Central Bank has been fairly clear that it expects a first rate cut to materialise in June, but again we expect the pace of cuts to be at a roughly quarterly frequency thereafter. We expected the recent policy shift from the Bank of Japan to end yield-curve control (YCC) and raise the policy rate into positive territory, but expect further rate hikes to come slowly.

We think that while rate cuts are indeed coming into focus, the pace is likely to be steady, rather than rapid

Figure 3. **Central bank policy rates (2006-2025)**



Source: Aviva Investors, Macrobond as at 31 March 2024.

With rate cuts likely across many economies this year, we see a supportive environment for risk assets (Figure 4). We entered the year preferring to be overweight equities, with a relative preference for the US and Japan over emerging markets. We continue to prefer those overweights and underweights, with only a slight downgrade in the UK to neutral and slight upgrade in Eurozone. Returns have been strong this year, and while we expected that on better earnings, it seems unlikely we will see a similar pace of equity market returns for the remainder of the year. Indeed, we think the risk of market ebullience breeding instability is growing. Therefore, we also prefer to be overweight government bonds to give balance to the asset allocation in the event of a risk event materialising.

A more elevated yield environment also makes for a more attractive risk/reward for fixed-income as we enter a cutting cycle. It also provides protection in an adverse market risk scenario. The preferred markets to be overweight are the UK and the Eurozone, with an underweight in Japan. We continue to prefer to be broadly neutral on corporate bonds, with the risk-reward somewhat better in high yield than investment grade given the stage of the cycle. Finally, we are broadly neutral on the US dollar against other major currencies.

Figure 4. **Asset allocation summary table**

	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$)						0					

Source: Aviva Investors, Macrobond as at 31 March 2024.

> ***Returns have been strong this year, and while we expected that on better earnings, it seems unlikely we will see a similar pace of equity market returns for the remainder of the year***

Key investment themes and risks

Investment themes

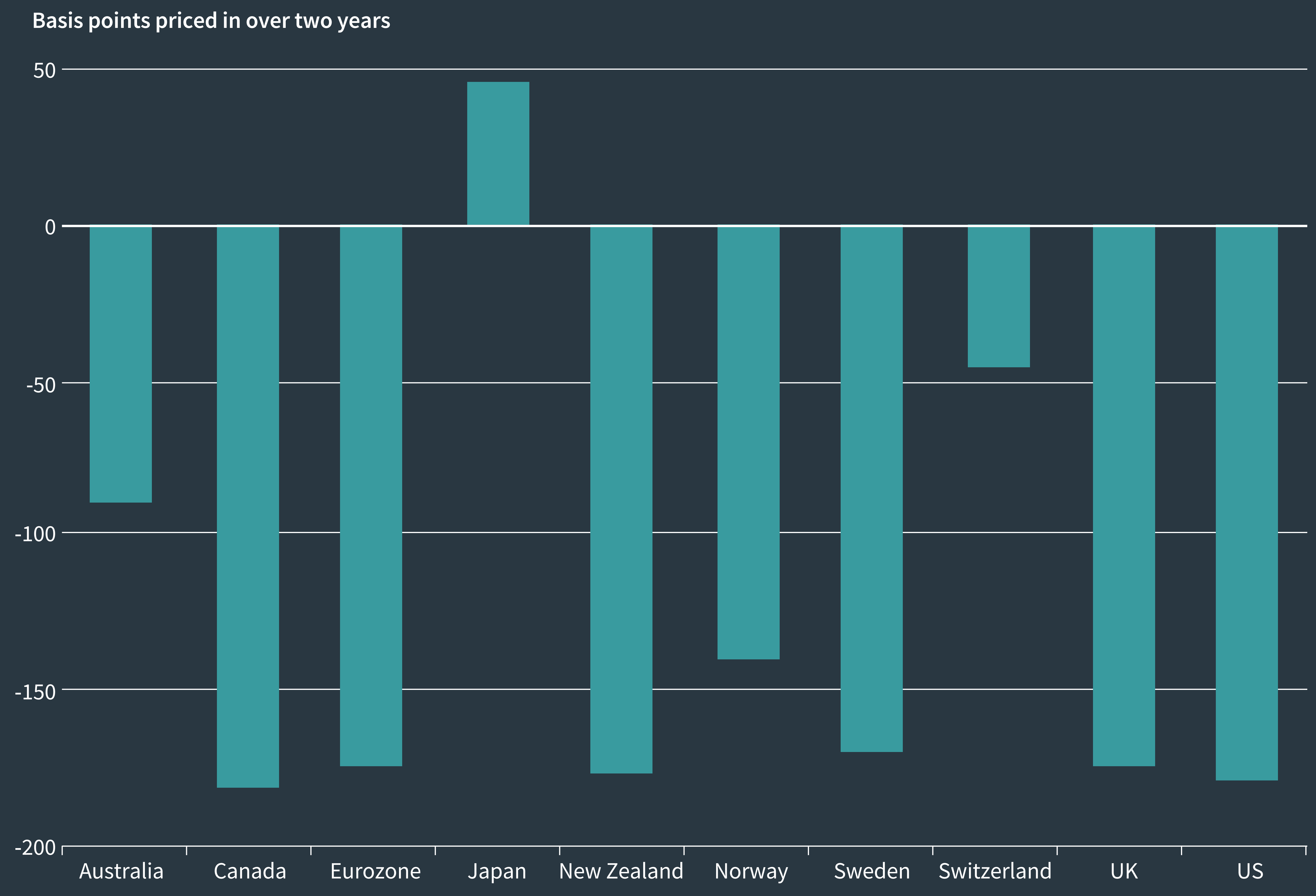
1 **Rate cuts coming, sooner or later**	2 **Geopolitical and political fragmentation**	3 **Industrial policy**

Rate cuts coming, sooner or later

The main market theme for 2024 remains rate cutting cycles by the Fed, ECB, BoE, and smaller developed market central banks (Figure 5). Doing so while inflation remains above target and labour markets remain tight is a risk, but so is leaving rates too high for too long, particularly for the Fed, with its explicit dual mandate that includes "maximum employment". Yet even for more single-minded inflation targeting monetary authorities, keeping rates restrictive with low growth involves trade-offs. Having kept rates too low for too long in 2021, continuing to fight the last battle and inducing a recession, or being blamed for it, would be an equally serious error.

Many emerging market central banks were also slow off the mark to raise interest rates, but responded to the inflationary shocks earlier, and often had to raise rates to much more onerous levels. As inflation fell and economic activity suffered, some policy rates were able to be cut, even as the Fed and others hiked. Yet recently the pace of EM cuts has become more varied, and monetary authorities more cautious. Developed markets will likewise need to take care, conscious of any reacceleration in price pressures (see risk section). Markets have priced in hundreds of basis points of rate cuts over the next couple of years – having pared back their overoptimism of Q4 2023 – but the way down is unlikely to be as continuous as in market pricing. The Swiss National Bank began the rate cuts in advanced economies in late March, but inflation there is only 1 per cent – for central banks with sticky inflation problems, rate reductions have already been delayed compared to what was once expected. Once they do begin, the so-called normalisation process could be prolonged, bumpy, and see divergences, with Europe and the UK likely to be somewhat ahead of the US, Canada, and Australia.

Figure 5. **"Low" expectations as many rate cuts are priced in across G10 markets**



Source: Aviva Investors, Bloomberg as at 31 March 2024.

The main market theme for 2024 remains rate cutting cycles by the Fed, ECB, BoE, and smaller developed market central banks

Geopolitical and political fragmentation: the centre isn't holding

This year is full of consequential elections, but the victors' impacts – not to mention market reactions – are not always easy to forecast even if one correctly predicts a given outcome. The approach of the House View is not to pretend to have a crystal ball but to try to clarify the trends as they take shape on a national or global level, and identify tailwinds or headwinds to policies and for sectors and asset classes.

Russia's invasion of Ukraine has been a wake-up call for much of the West. Mass immigration, refugee crises, humanitarian disasters and threats to borders have also upended domestic politics.

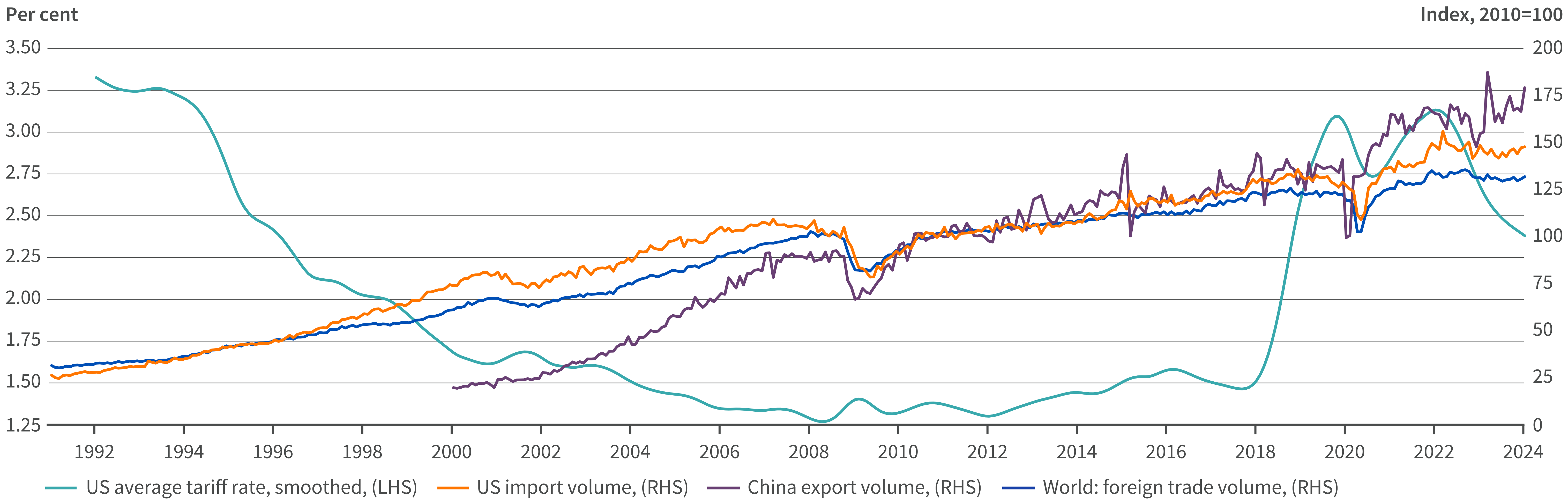
> *This year is full of consequential elections, but the victors' impacts – not to mention market reactions – are not always easy to forecast even if one correctly predicts a given outcome*

Finally, the climate agenda has been given new impetus as the energy crisis revealed the dependency of industry and consumers on carbon-based fuels – often produced in countries controlled by dictators or unelected autocrats with values that don't align with liberal democracy. While the measurable reality is still that we live in a richer, safer and healthier world than we once did, the stresses of geopolitics look very real indeed, and peaceful co-development is the historical exception rather than the rule.

Globalisation is still very much alive, as measured by trade flows and foreign direct investment (FDI) and portfolio investment – yet there are significant changes already underway (Figure 6).

Multinationals are adjusting their supply chains, diversifying away from China for a variety of reasons. Tariffs, sanctions and countersanctions have proliferated (as measured by the International Monetary Fund and others), as have domestic subsidies and governments' candid desires for dominance in high tech, energy and weaponry. There is a space race between the US and China, and technological decoupling is difficult to keep to a narrow, "high fence, small yard" boundary. Samuel Huntington's "Clash of Civilizations" analysis was not a prediction, but still seems to point correctly to the inevitable frictions of great powers rubbing shoulders in a globalised world.

Figure 6. **World trade volumes still near records, despite tariffs and sanctions**



Source: Aviva Investors, CPB World Trade Monitor, US Treasury, Census Bureau, Macrobond as at 31 March 2024.

Industrial policy: looking up and pushing forward

The tragedies of the Great Depression, WW2 and COVID had similar economic effects: they ended the preceding periods characterised by low growth and "liquidity traps" by forcing governments into major programmes of fiscal-monetary cooperation. While capitalist countries never really abandoned the idea that important projects could be done by governments, the ideological victory of free markets over communism made overt, aggressive industrial policies something of a taboo, associated with white elephants, corruption, and high-profile failures like Solyndra.

The aggressive nature of China's subsidies and technological aims, such as Made in China 2025, as well as the removal of fiscal shackles following the COVID largesse, has now made many developed markets' industrial policies explicit and muscular. China's "dual circulation" policy of subsidising investments continues, while the US has countered with the CHIPS Act, the Inflation Reduction Act, and a major infrastructure push. Europe's Next Generation EU (NGEU) funds also focus on tech and climate change, and Japan is investing in carbon reduction and defence. Will all this be an inflationary boondoggle?

While some waste is inevitable – and not exclusive to the public sector, as many private companies can vie for awards in fraud, failures and faulty decisions too – Harvard economist Dani Rodrik has studied industrial policy for over two decades and has some criteria that can help evaluate likelihood of success. There is no guaranteed recipe, but rather suggestions that policymakers should:

- Be single-minded and focused. Setting multiple objectives, e.g. promising job creation and innovation and green-transition and levelling up will probably miss many targets and tarnish the programme
- Embed businesses, local stakeholders and policy experts, rather than issuing top-down diktats; bureaucrats must interact and adjust to understand opportunities and flexibly respond to new information
- Not try to pick winners, but rather spread out bets à la venture capital, which means some companies are allowed to fail

These are some of the guidelines we anticipate will be useful to policymakers and investors as they look for opportunities and risks in this old-but-new interventionist landscape.

Industrial policies have become explicit and muscular, but will they also become inflationary boondoggles?

The risk of an even slower pace of disinflation cannot be dismissed, which would imply higher rates for (even) longer

Michael Grady
Head of Investment Strategy and Chief Economist

Risks

Disinflation slows or reverses, catching central banks off guard

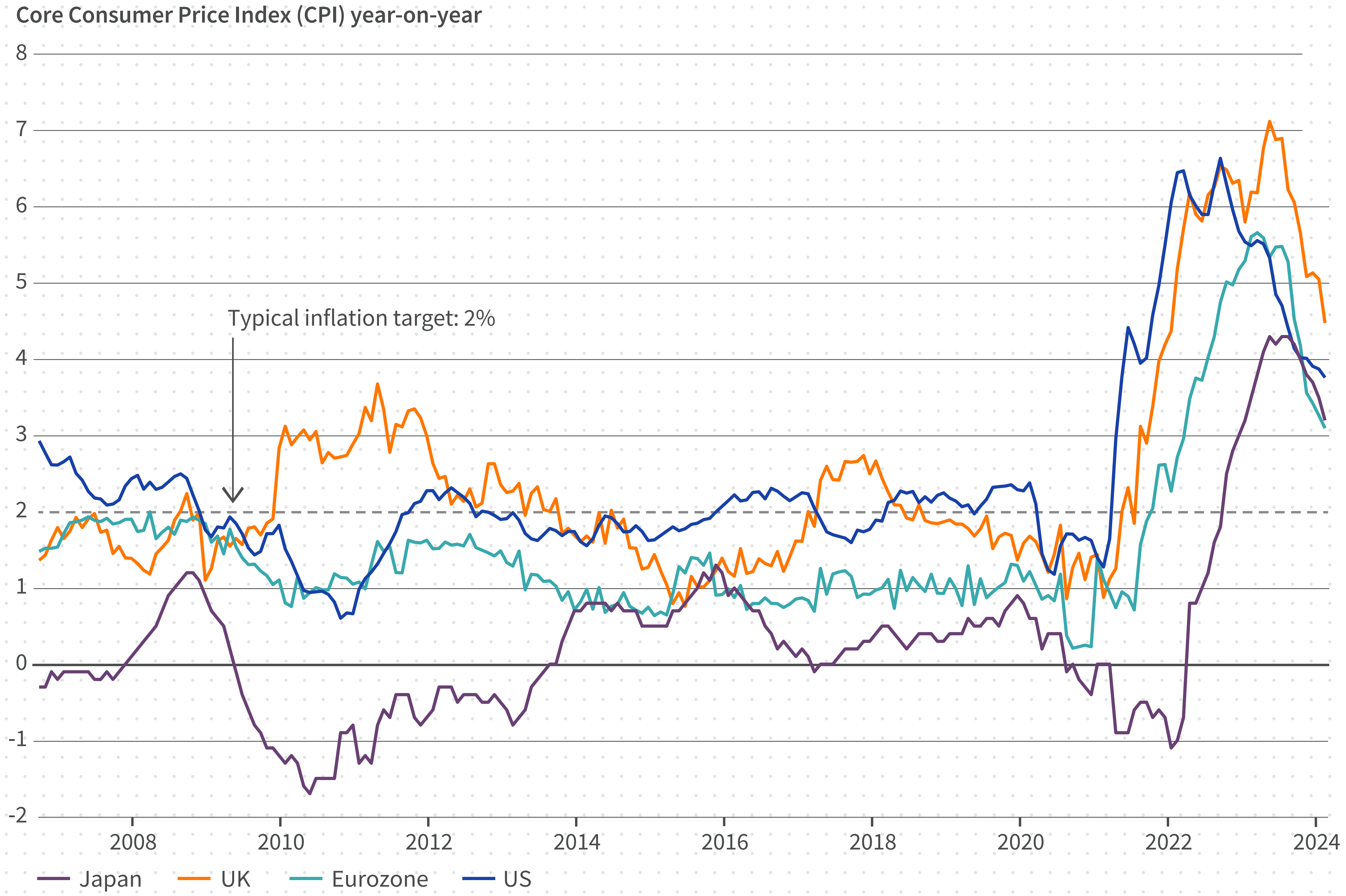
Disinflation began in late 2022, and while central bank tightening has played an important role, "Team Transitory" is still trumpeting that the bulk of inflation's rise and fall was down to supply-side shocks in energy, labour markets and supply chains. Yet, in most developed countries core inflation has fallen later, and recently more slowly, than headline measures; services prices in particular remain elevated and historically have been linked to tight labour markets and wages (Figure 7).

In late 2023, rates rose sharply and central bankers used that as an excuse to cease and desist from further hikes – but since then financial conditions have loosened considerably on many measures, as equity and even some property prices have risen in many areas. These carry their own dangers but wealth effects can spur consumption and inflation as confidence multiplies.

If rate cuts and fiscal stimulus result in inflation and expectations getting stuck in a 2.75-3.5 per cent range, it will eventually necessitate action: either a long delay or pause in cuts, or even, after a few rate cuts in 2024, the realisation that this was a policy error that must be reversed, with hikes back on the table. Inflation might also come back from supply rather than demand: Strikes and large wage settlements, sanctions, counter-sanctions, and tariffs, or an OPEC+ supply shock to punish allies of Ukraine, Israel and Taiwan, are some of the risks.

> ***If inflation gets stuck in a 2.75-3.50% range, it will eventually necessitate action***

Figure 7. **Inflation is in the "last mile" but the mission is not accomplished**



Source: Aviva Investors, BLS, Eurostat, Japan Statistics Bureau ONS, Macrobond as at 31 March 2024.

Non-artificial productivity gains

Declining productivity growth has long burdened many industries and been perceived as a policy challenge to be rectified for many countries' workforces. With the emergence of artificial intelligence (AI), new verticals and support to unlock workers' potential may have materialised; the optimism, at any rate, shows little signs of slowing down. AI may be the solution to raising output per hour and underlying measures of productivity. Following the pandemic, research has intensified in the search to identify the greatest beneficiaries and productivity's trajectory, with progression categorised into phases or steps.

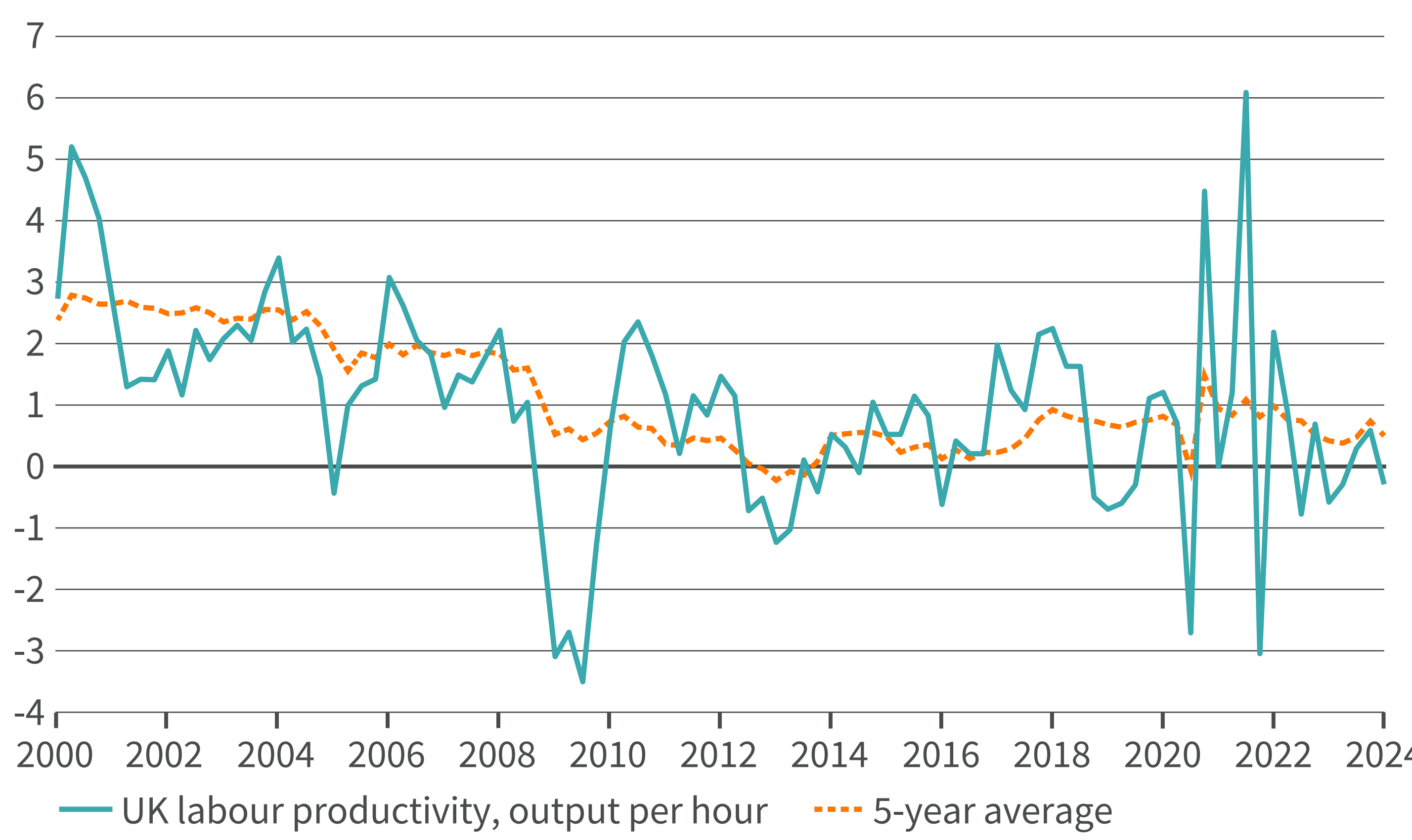
At present, we are at the most elementary stage whereby generic language tools (ChatGPT, Google Bard/Gemini etc.) are being incorporated, reinvented and encouraged into workflows. Following this, we are likely to see an uptake of customised models with an ability to harness company data and eventually function with autonomy, acting as supplementary agents. The broad-based efficiency gains are likely to materialise from 2025 onwards as companies more formally adopt AI tools. The UK, like many other economies, has had productivity trending lower for over two decades (Figure 8) as manufacturing has taken a smaller share of gross domestic product (GDP); for service-based economies like the US or UK gains centred around those sectors, which are 60-70 per cent of the economy, will be crucial to sustaining productivity growth at the aggregate level.

On a sector level, the benefits are not expected to be equally dispersed. At the forefront, software & services and commercial & professional services are observed to be the leaders in monetising and benefitting from AI and related innovations (Figure 9), and that is reflected in market pricing.

Labour-intensive sectors appear more exposed, and the proportion of a workforce poised to benefit will vary substantially depending on structural elements. Despite fears, many jobs and mediocre workers will be enhanced, not eliminated, with the use of AI. Corporations' focus is on efficiency lowering costs, and industry analysts are enthusiastic about those companies with the largest proportions of wage bills exposed to AI automation. Of course, the new tools must be acquired and deployed successfully, as with any technology. Some companies and countries will be more adaptable, or more lucky, than others. Undoubtedly, these developments will take time to materialise in GDP figures, and there are valid concerns about job displacement and automation, whilst concerns about protecting traditional industries are likely to remain. Finally, AI is not the "only game in town"; we remain excited by innovations in gene editing, advanced materials and nanotechnology, medical advances, energy production and decarbonisation, and the rapid fall in the costs of space launches.

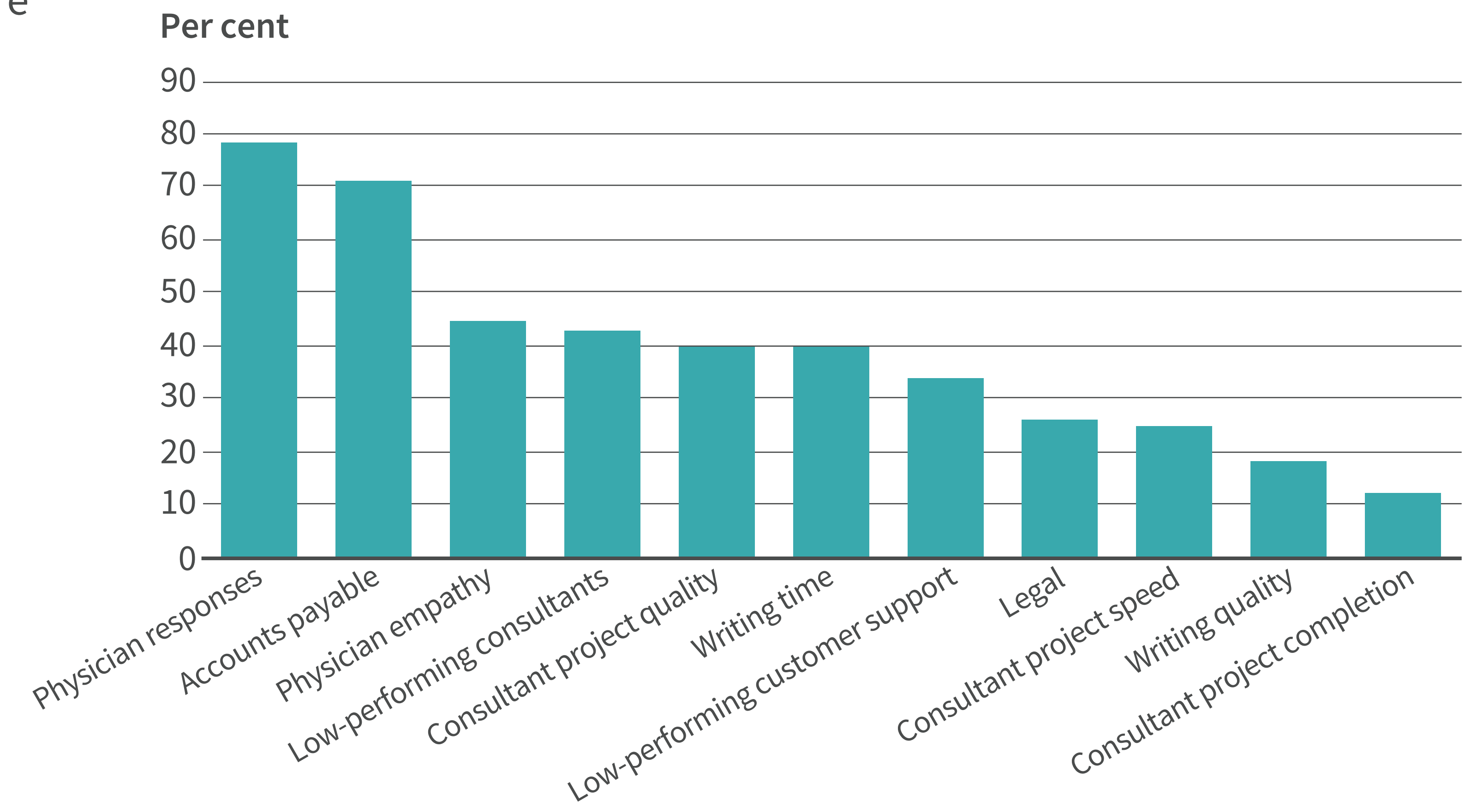
Gains centred around services will be crucial to sustaining productivity growth at the aggregate level

Figure 8. **Low productivity growth is in need of new impulses**



Source: ONS, Aviva Investors, Macrobond as at 31 March 2024.

Figure 9. **Efficiency gains from AI**



Source: Aviva Investors, Morgan Stanley, academic literature as at 31 March 2024.

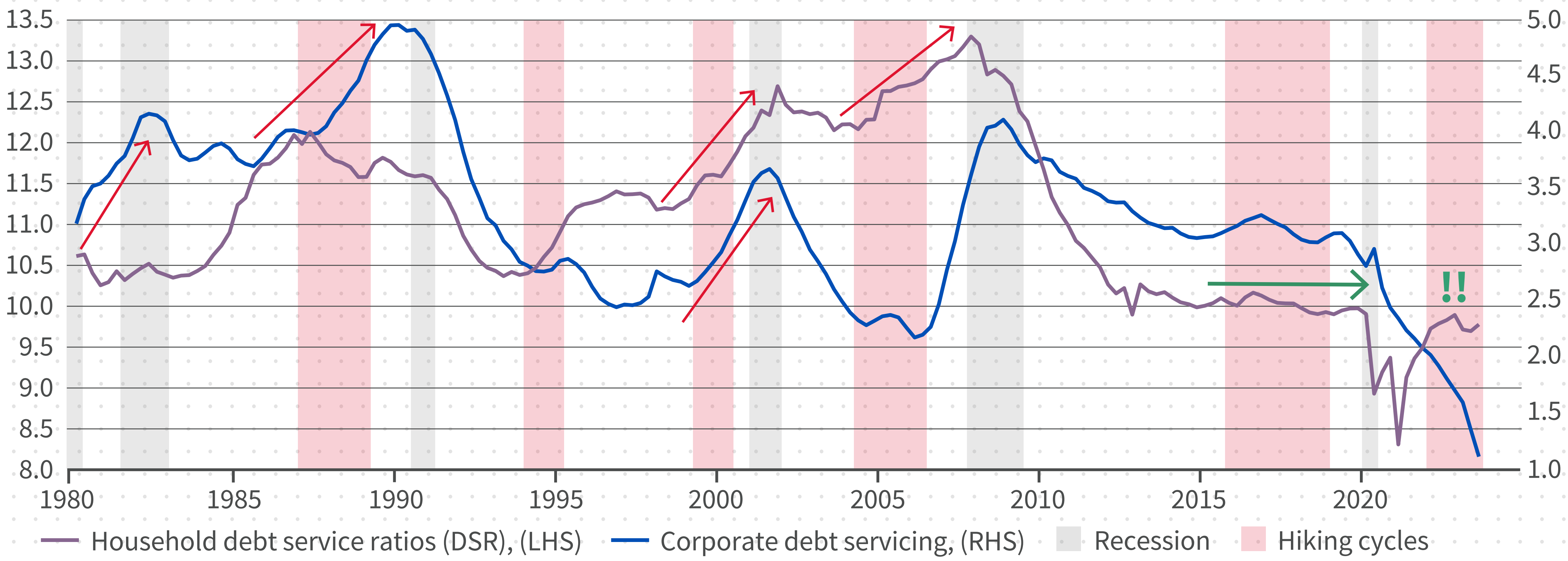
Market ebullience breeds instability

The experiences of the 1990s' dot-com/TMT bubble and 1980s' LBO buyout boom taught many observers and market participants that rapid build-up in corporate debt can turn booms into busts. The 2008 Global Financial Crisis likewise was a credit boom of epic proportions, driven mainly by households' irrational exuberance about housing, and private commercial banks and non-bank financials' (a.k.a. investment 'banks') frenzied leverage and risk taking. As is often the case, governments and taxpayers were left holding the bag. The latest bail-outs of citizens and corporates were the huge monetised fiscal sprees following COVID and the energy supply shocks in 2020-22. Despite the recent rate hikes, a decade of prior deleveraging means that debt service is not likely to be a problem for most households or firms (Figure 10) – though of course some will still face hardship, and small businesses in Europe and North America, as well as more fragile emerging markets, are vulnerable.

This government splurge has in part stimulated industrial policies, and may trigger Risk #1 (inflation redux) and/or Risk #2 (productivity surge) in due course. Thanks to a combination of saving and capital gains, a huge amount of nominal and real wealth has also been created very quickly (Figure 11); in the past that has, on occasion, proved ephemeral. In our markets outlook section we discuss why equity market performance seems well-founded, supported by both macro and micro drivers. Yet it may turn into overheating and eventual meltdown, especially as structures such as volatility selling proliferate – the "Snowball" derivative implosion in Chinese equity markets is an example, although in that case deteriorating fundamentals arguably played a role, too.

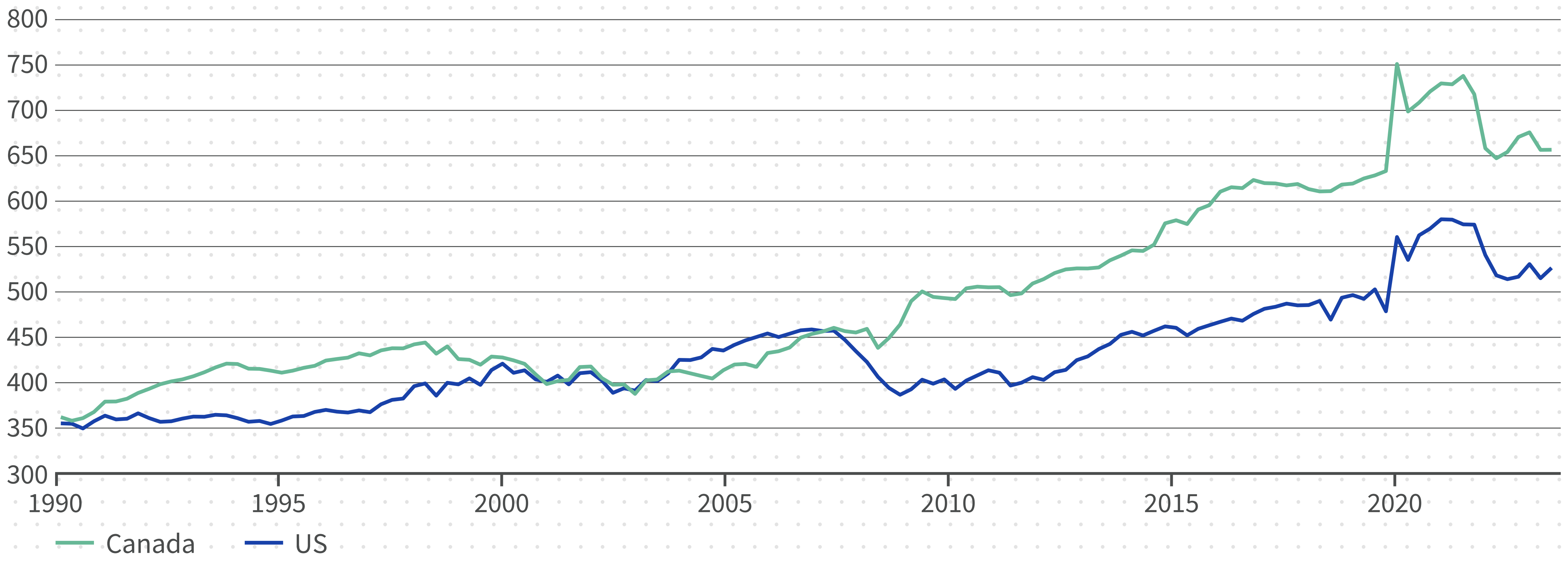
Debt service is not likely to be a problem for most households or firms... and equity market performance seems well-founded

Figure 10. **Household and corporate debt service doesn't look threatening**



Source: Aviva Investors, BEA, Federal Reserve, Macrobond as at 31 March 2024.

Figure 11. **Household net wealth in North America is high and rising**



Source: Aviva Investors, BEA, Federal Reserve, Macrobond as at 31 March 2024.

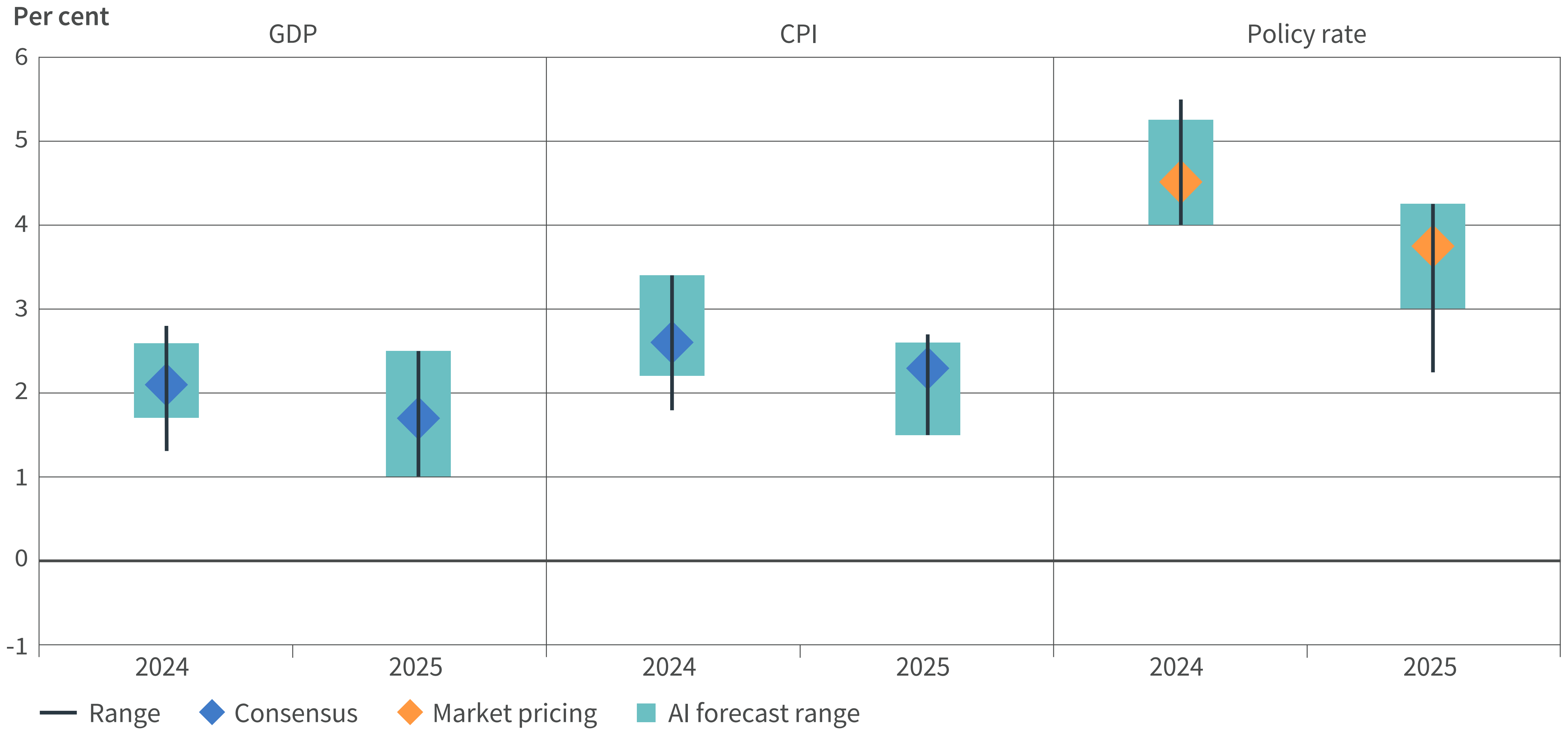
Macro forecasts charts and commentary

US

Activity continues to expand at an above-trend pace in the US, with recent improvements in the supply-side of the economy allowing for a faster pace of expansion without a reduction in spare capacity or further tightening in the labour market. Faster productivity growth and increased labour force participation are unlikely to be sustained throughout 2024, which we think will see growth slow somewhat to around 2.25 per cent this year. We expect a further easing in 2025 to around 1.75 per cent. The soft landing should see the labour market continue to perform well, and therefore deliver only a moderate further decline in inflation this year and next, converging on the Fed target of 2 per cent. We expect the Fed will begin the process of normalising policy rates in the summer but expect that process to be slower than has been the case in previous rate-cutting cycles given the growth and inflation mix. We think the risks lie to the upside relative to market pricing of around 150bps in rate cuts over the next 18 months (Figure 12).

> ***We expect the Fed will begin the process of normalising policy rates in the summer but expect that process to be slower than has been the case in previous rate-cutting cycles given the growth and inflation mix***

Figure 12. **US**



Note: GDP calendar year growth; Consumer Price Index (CPI) Q4/Q4; Policy Rate Q4.
Source: Aviva Investors, Bloomberg as at 31 March 2024.

Eurozone

Eurozone GDP grew by a muted 0.4 per cent in 2023, as the region grappled with tight monetary policy which curtailed consumption, credit creation and business investment. However, early 2024 has seen surveys bottoming out. For 2024, we expect GDP to grow by 0.7 per cent (higher than the consensus of 0.5 per cent) and disinflation to continue (Figure 13). We anticipate the ECB will likely cut rates to around 3.25 per cent by the end of the year, and reduce them further in 2025, which should allow growth to pick up. On balance, we expect slow but slightly above-consensus economic performance.

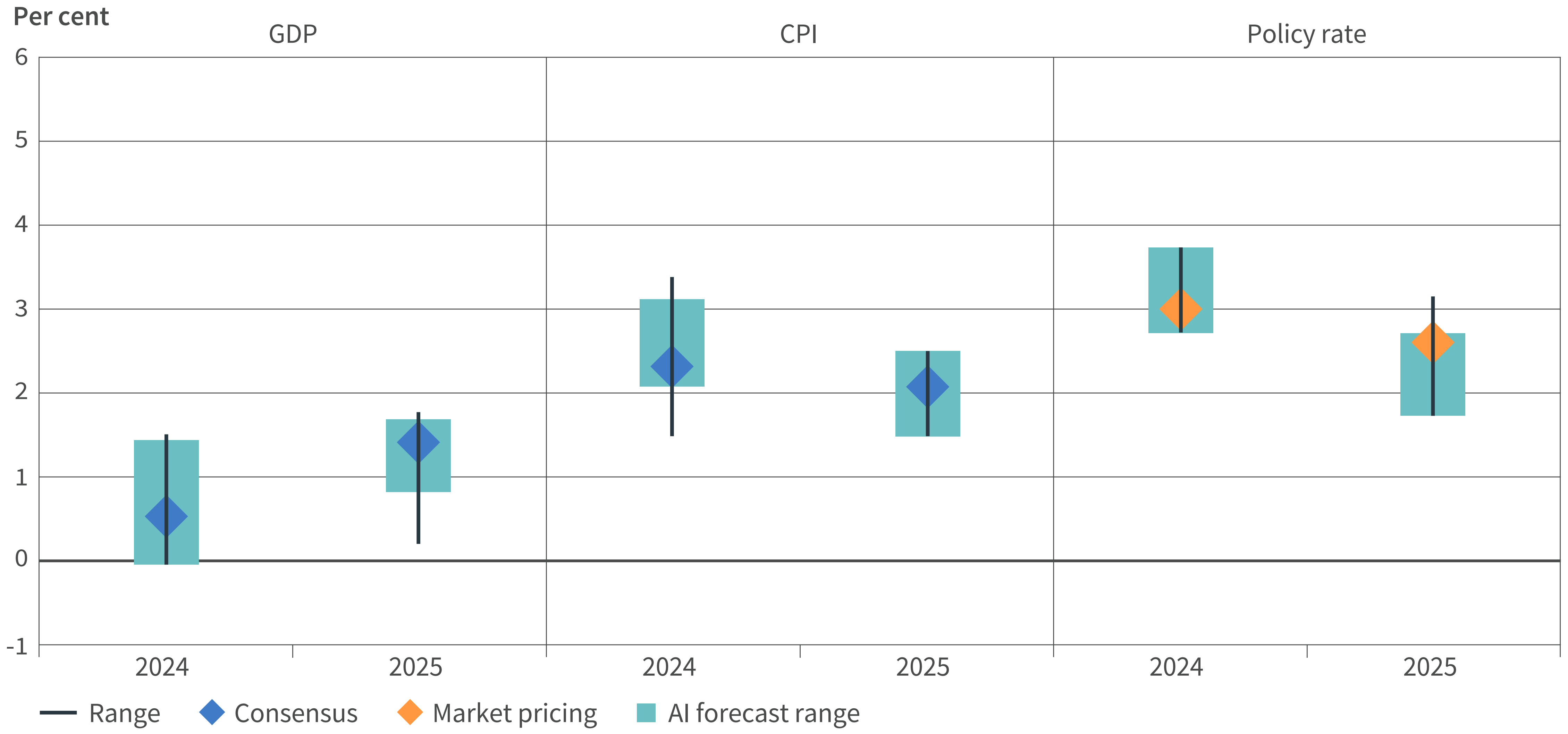
Policy tightening is now past maximum-impact: effective mortgage rates and borrowing costs for non-financial firms have peaked and are now declining. While manufacturing is still struggling, high frequency data illustrate that the trough is behind us and the services sector has improved, albeit from low levels.

Germany will continue to be a drag to Eurozone growth in H1 24 (in part due to subdued manufacturing activity and in part due to lack of Chinese impulses) but the historically "weak south" is offsetting part of the impact. This resilience has been mainly driven by the deployment of NGEU and because in several countries, the share of outright home-ownership is relatively high, insulating households from higher interest rates. Over 2024-2026, NGEU funded public investment is likely to be material.

As disinflation continues, real incomes should receive some further reprieve, while savings should offer enhanced buffers (now at 14 per cent of disposable income).

Overall, growth will be slow by historic standards, reflecting the overall fiscal tightening expected in the coming years (and despite NGEU dispersement). This, alongside continuing disinflation, should open the door to ECB rate cuts in the summer of this year. That said, the "last mile" may be more difficult as there may be still some wage growth pressure and services inflation in the pipeline.

Figure 13. **Eurozone**



Note: GDP calendar year growth; Consumer Price Index (CPI) Q4/Q4; Policy Rate Q4.
Source: Aviva Investors, Bloomberg as at 31 March 2024.

While manufacturing is still struggling, high frequency data illustrate that the trough is behind us and the services sector has improved, albeit from low levels

UK

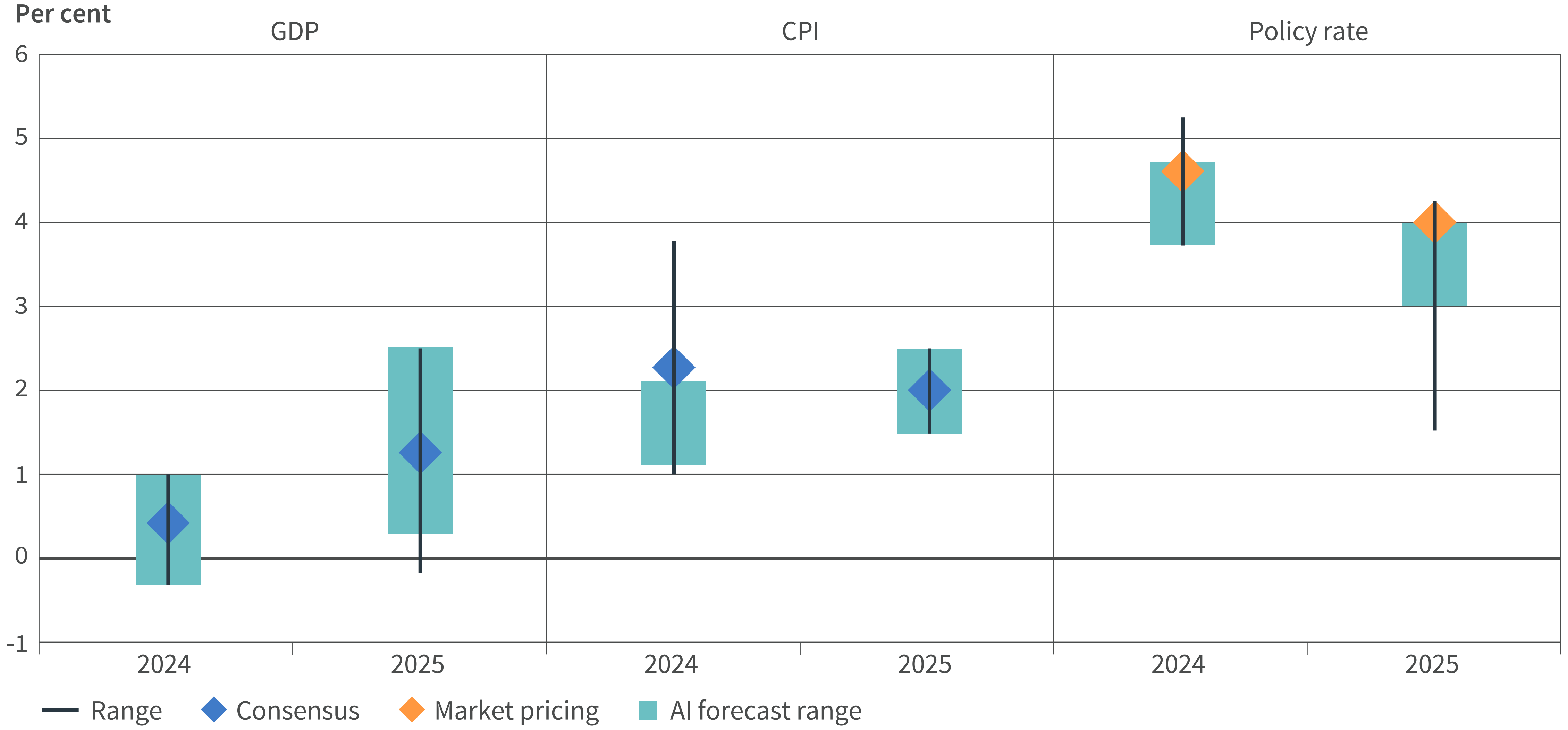
The UK has experienced even slower growth in 2023 than most expected, with GDP barely rising by 0.1 per cent as sizeable monetary policy tightening and tighter fiscal finances weighed on consumption and investment growth. In 2024, the UK economy is likely to experience another year of growth stagnation as policy tightening is yet to reach its peak-impact: we expect GDP to grow by just 0.3 per cent, slightly lower than consensus expectation of 0.4 per cent (Figure 14). While wage growth remains high, it will keep moderating and maintain the theme of disinflation at play. That should allow the BoE to start easing monetary policy this year. This alongside further easing next year should help GDP growth to pick up to around 1.4 per cent in 2025.

The reduction in the energy price cap in April – and potentially in July – will lead to headline inflation falling below the 2 per cent inflation target, before rising somewhat. Nonetheless, we expect it to be below 2 per cent at the end of the year. We anticipate the BoE will cut the policy rate to around 4.25 per cent by end-2024; that is more than the market currently expects.

While the labour market remains tight, the UK is yet to experience the full impact of higher borrowing costs. The effective mortgage rate on the stock of outstanding mortgages stands at only 3.4 per cent, a result driven by the sharp increase in the uptake of fixed rate mortgages just before and right after the onset of the pandemic. We expect with housing-related debt service will keep rising, even as the BoE cuts rates. Parliamentary elections could add to uncertainty later this year. Eventually, we anticipate the labour conditions to continue to normalise, and unemployment to increase modestly.

The Spring budget will do little to support growth (it is estimated to contribute around 0.1 per cent to annual growth) and the fiscal stance should not be expected to become more growth-friendly as the government adheres to self-imposed fiscal stability. Moreover, the structural issues of skill mismatches in the jobs' market and low investment (the lowest as a share of GDP, amongst the major advanced economies) remain impediments to any productivity improvements. The rise in Brexit-related costs will continue to pose additional headwinds.

Figure 14. **UK**



Note: GDP calendar year growth; Consumer Price Index (CPI) Q4/Q4; Policy Rate Q4.
Source: Aviva Investors, Bloomberg as at 31 March 2024.

In 2024, the UK economy is likely to experience another year of growth stagnation as policy tightening is yet to reach its peak-impact

China

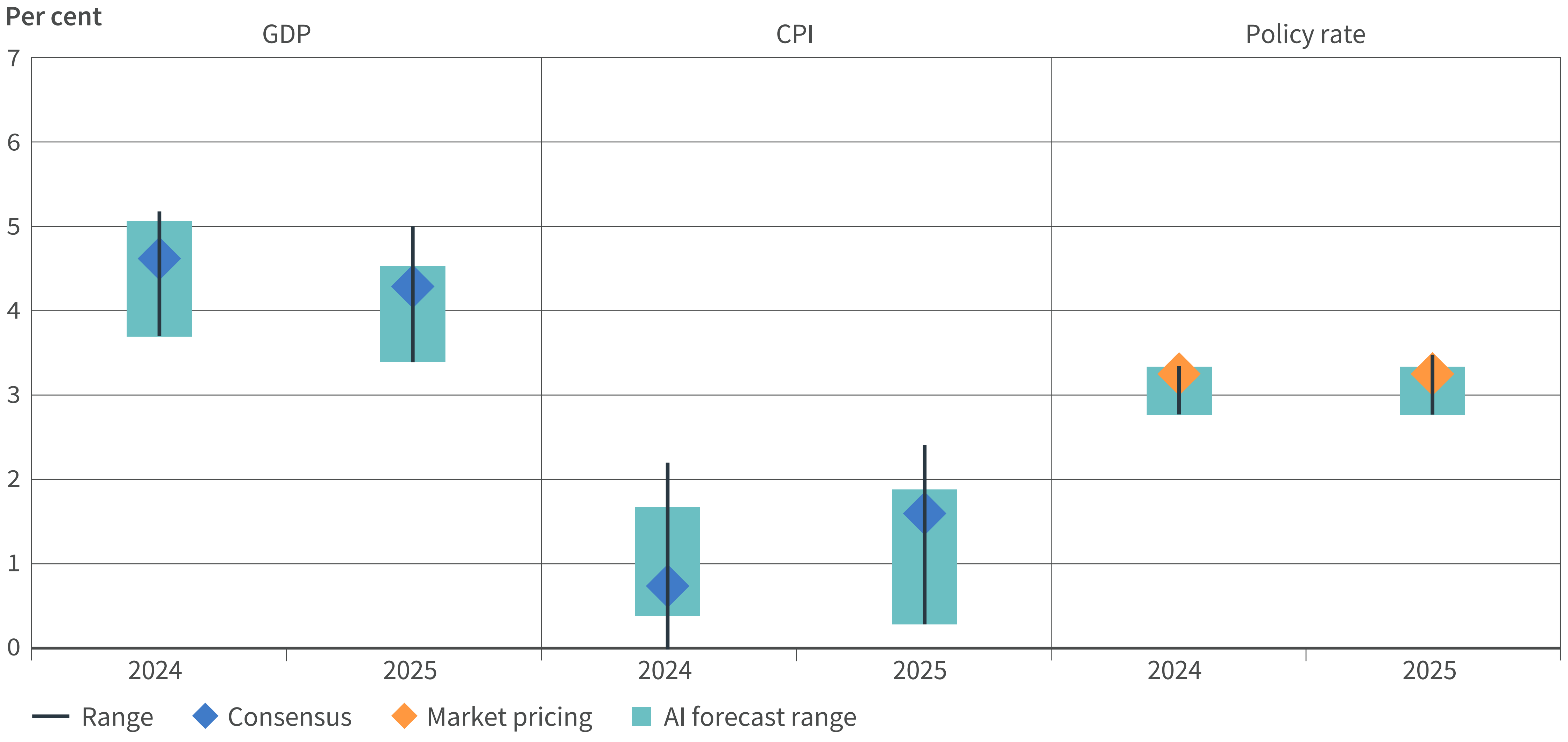
Thanks to infrastructure investment, strong manufacturing and robust exports, GDP growth in 2023 cleared the easy 5 per cent goal with room to spare. The strong finish to the year and front-loaded stimulus leads us to upgrade growth in output this year to an expected 4.5 per cent (Figure 15), within the target range of the "around 5 per cent" announced by Premier Li Qiang in the annual NPC meeting. Unlike the rebound from the 2022 disaster, achieving 5 per cent growth for the $18 trillion economy is a tall order this time around, and growth will continue to trend lower in years ahead.

China's economy and society will suffer from 5 "D"s: demographics, debt, decoupling (a.k.a. de-risking to be charitable), deflation and stern Xi Jinping dogma. An ageing population and declining prime-age labour force has more in common with richer countries in Europe or North Asia than fast-growing EMs, and is a drag on growth. Debt and deflation are a toxic combination; we expect CPI inflation of under 1 per cent, and PPI inflation close to zero. Obsession with currency stability and competitiveness limits aggressive rate cuts or QE – though credit easing and liquidity provisions are the main tools preferred by the People's Bank of China, and the key one-year Loan Prime Rate will probably get cut towards 3 per cent, especially once the Fed delivers some rate reductions. Currency stability will be maintained, but despite the huge trade surplus, there is likely to be a bias towards exchange rate weakness, even before potential trade and tariff threats re-emerge in 2025.

Geopolitical tension is set to persist and intensify, so that even if globalisation isn't thrown into reverse, access to new export markets in certain sensitive goods and services, as well as to imports, investments and knowledge may become more difficult. Finally, crackdowns on personal behaviour during COVID, regulatory clampdowns on various areas in the private sector, and a long-running, apparently never-ending campaign against corruption against the public sector and those with whom it conducts business are all intended to realign society and the economy with what the Communist Party of China deems to be the national interests.

There has recently been more attention paid to the economy, with more than lip service being paid to making sure property projects are delivered or converted into public housing, and subsidies to upgrade for autos and appliances. These will have some positive impact, and reduce downside risks. However, the negative sentiment among domestic investors, and foreign investors, affecting FDI and international portfolio flows, is likely to prevail.

Figure 15. **China**



Note: GDP calendar year growth; Consumer Price Index (CPI) Q4/Q4; Policy Rate Q4.
Source: Aviva Investors, Bloomberg as at 31 March 2024.

The negative sentiment among domestic investors, and foreign investors, affecting FDI and international portfolio flows, is likely to prevail

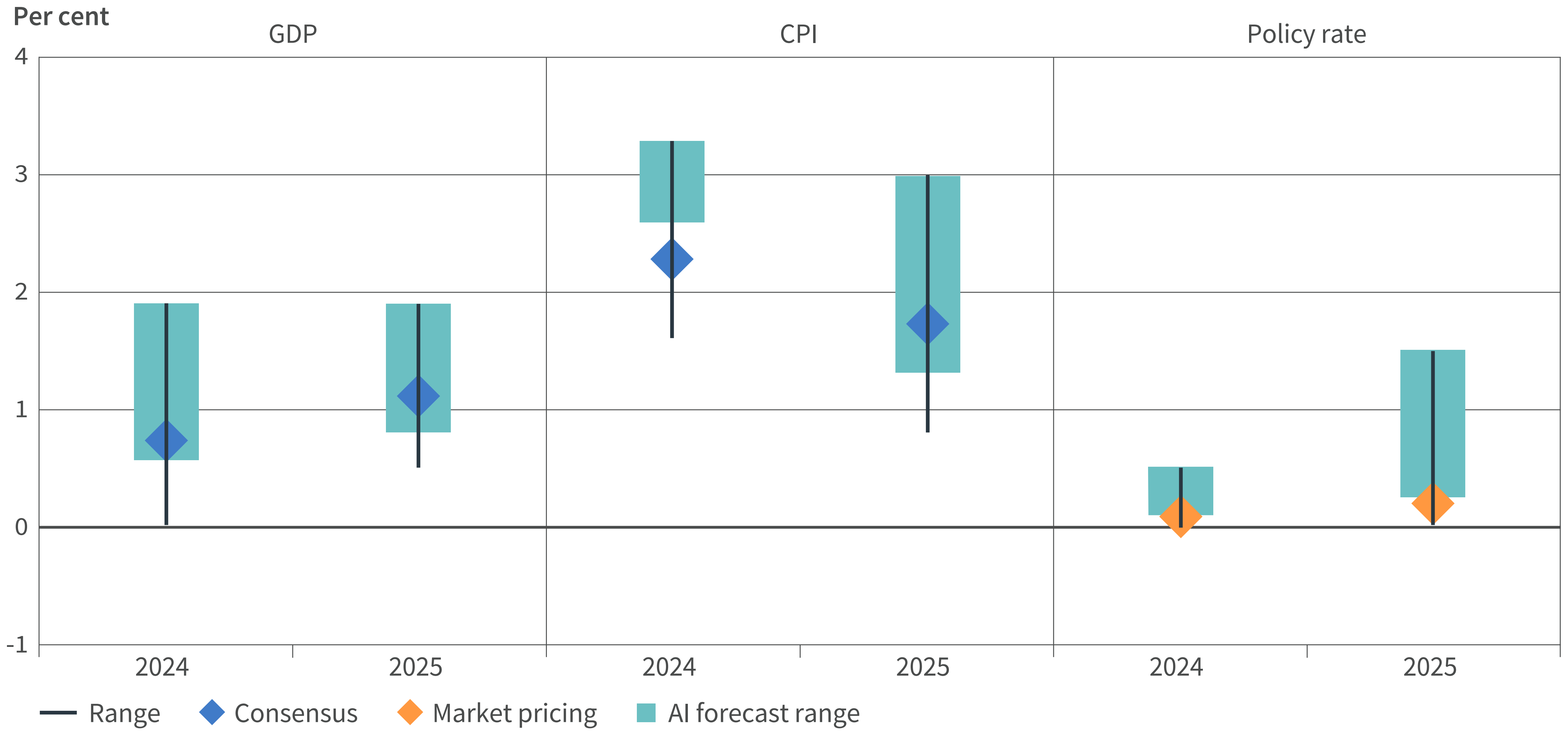
Japan

Having observed the Shunto wage negotiations, which delivered worker pay rises in excess of 5 per cent, and with core inflation close to 3 per cent and expected to remain at (or above) 2 per cent sustainably, the criteria for monetary tightening was finally met. After over a decade of truly extraordinary and unconventional monetary policy the BoJ scrapped yield curve control, ceased buying ETFs, and raised rates by 10-20bps, out of negative territory. Governor Kazuo Ueda has emphasised maintaining supportive monetary policy and reserves the right to buy bonds (QE) whenever deemed necessary, so rapid rate hikes or sharp selloffs in JGBs are unlikely. But the path for yields is, in all likelihood, steadily higher.

Growth remains solid even though the quarterly profile is somewhat erratic; underlying GDP should expand at around 1 per cent or more, driven by fiscal stimulus, investment and exports, with consumption providing upside risk and the weak yen encouraging domestic consumption and repatriation of foreign income (Figure 16). The output gap is mostly if not entirely closed (according to BoJ and the IMF), hence growth should revert to trend, and faster expansion is inflationary. The yen and JGBs ought to remain underperformers, which is the desired de facto policy path. Elections seem to have been deferred, as supplementary budgets have failed to enhance Prime Minister Fumio Kishida's popularity, while his party's standing has been marred by fundraising scandals.

Governor Ueda has emphasised maintaining supportive monetary policy and reserves the right to buy bonds (QE) whenever deemed necessary, so rapid rate hikes or sharp selloffs in JGBs are unlikely

Figure 16. **Japan**



Note: GDP calendar year growth; Consumer Price Index (CPI) Q4/Q4; Policy Rate Q4.
Source: Aviva Investors, Bloomberg as at 31 March 2024.

Canada

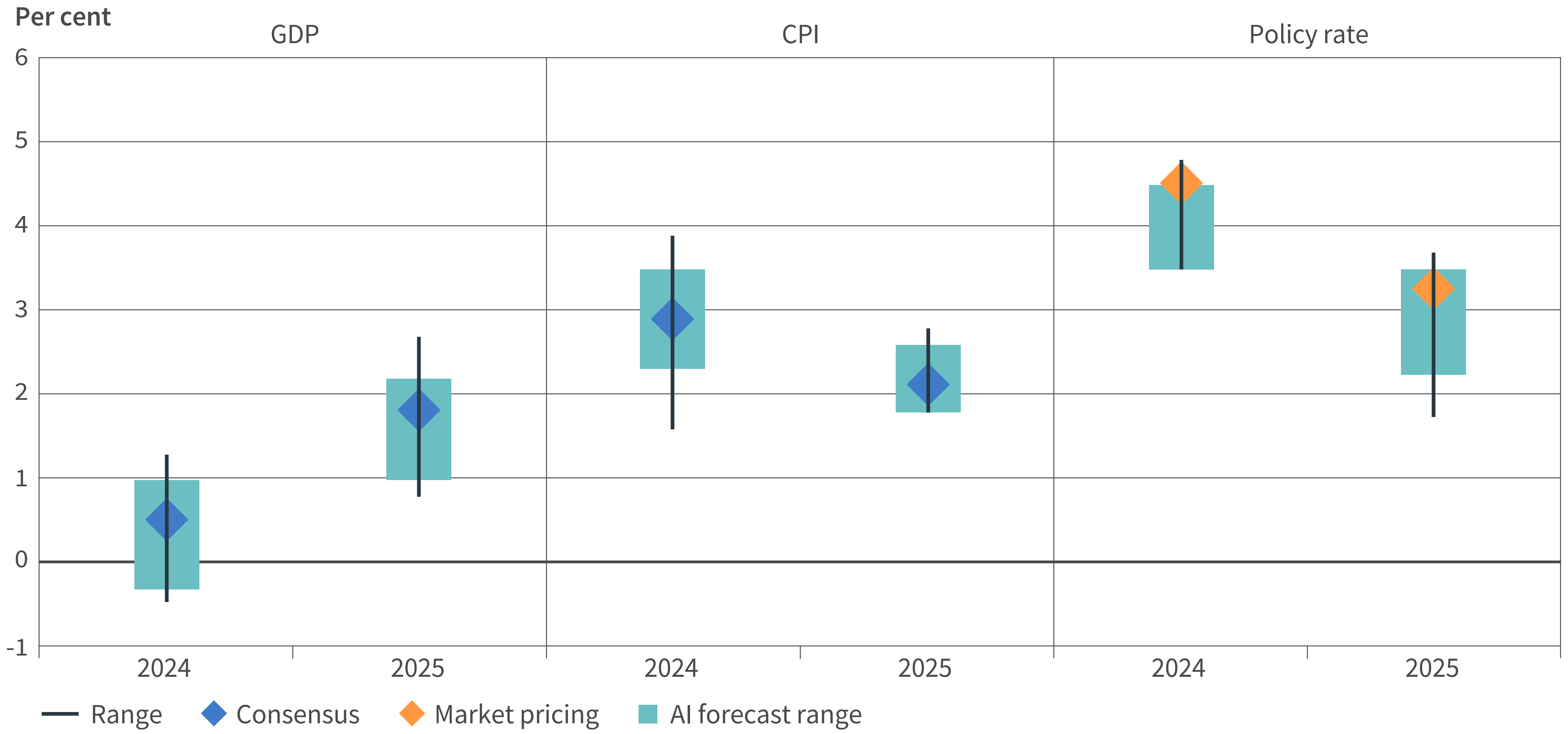
On an annualised basis, GDP grew 1 per cent in the final quarter of 2023, confirming a year of below potential growth in Canada. The first half of 2024 beckons more of the same: a tepid economic expansion ahead of a possible rebound in the latter stages of the year.

Although no longer increasing at the rapid rate seen in the first half of 2023, debt service ratios remain near all-time highs (15 per cent), thus continuing to pose a downside risk to consumption. Whilst we have likely moved beyond "peak restrictiveness" in financial conditions, we still expect for the effects of past tightening to continue to weigh upon activity and price setting within the economy. Indeed, despite mixed employment reports in 2024, Canadian labour markets now appear to have cooled significantly, which should lower wage growth as the year progresses.

2024 has seen welcome progress on inflation; as of February, headline CPI is now 2.8 per cent whilst the average of the Bank of Canada's own "preferred" core measures stands at 2.2 per cent (three-month annualised). However, much of the heavy lifting is owed to goods (1.2 per cent y/y), as services remains the laggard (4.2 per cent y/y). We expect this to change as wage growth moderates. Shelter inflation has continued to be the main contributor, representing a near third of February's headline inflation, and remains a meaningful upside risk to the inflation outlook given the structural housing issues that Canada faces.

Whilst the disinflation process is clear to see, the level of both wage growth and inflation expectations remains too high. More progress is needed on these fronts for the BoC to achieve full confidence in returning inflation to target. Noting the effects of rising economic slack, which continue to weigh upon price setting, we are confident that this will be achieved sooner rather than later. We expect the BoC to begin easing in June, with risks to both growth and inflation to the downside (Figure 17).

Figure 17. **Canada**



Note: GDP calendar year growth; Consumer Price Index (CPI) Q4/Q4; Policy Rate Q4.
Source: Aviva Investors, Bloomberg as at 31 March 2024.

Despite mixed employment reports in 2024, Canadian labour markets now appear to have cooled significantly, which should lower wage growth as the year progresses

Global market outlook and asset allocation

Signs that the pace of disinflation is slowing have prompted markets to re-price central bank rates higher.

But today's equity valuations are not driven by yields, but by growth expectations.

Market concentration is not a clear signal of downside risk for equities as a whole – the biggest risk is a change in leadership.

Long duration positions can provide a portfolio hedge at current yield levels, with preference for the UK and Eurozone.

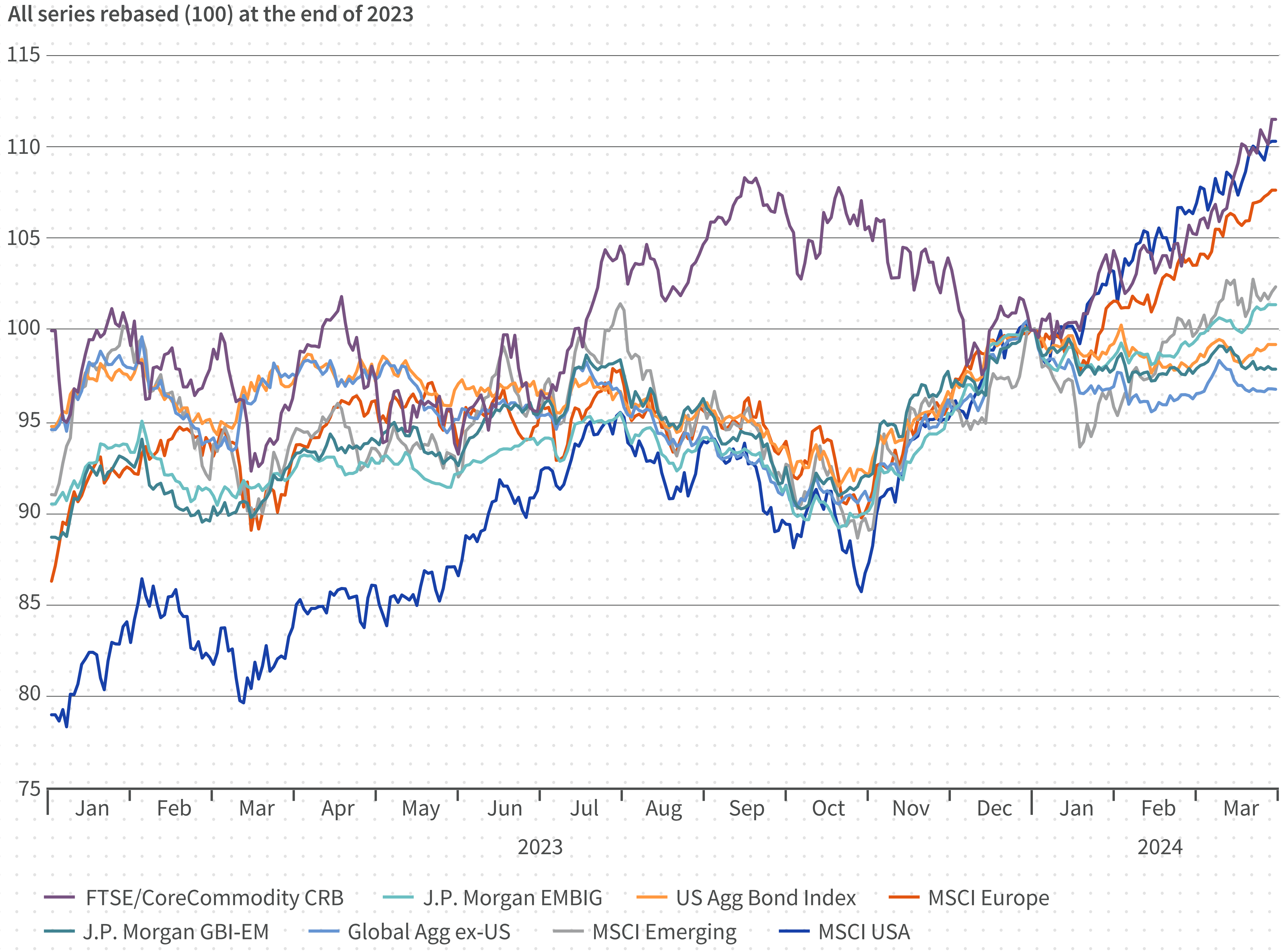
Global market outlook

The beginning of 2024 has seen risk assets powering ahead while bond yields – in contrast to previous correlations – surged and curves flattened (Figure 18). The latter has been the result of signs that the pace of disinflation is slowing, prompting markets to re-price central bank rates higher; however, equities and corporate bonds have performed much better than some market participants might have expected due to still robust underlying economic activity and corporate earnings, particularly in the US.

However, regional performance could rotate as non-US equities regain lost ground. In fixed income the theme of disinflation and monetary policy easing remains in play, albeit from more realistic levels/expectations; however, we favour differentiation across regions, still expecting US economic dynamics to hold up well but the UK to underperform and the BoE to cut by more than anticipated. In credit, the small but steady grind towards tighter spreads is likely to continue in this soft-landing scenario. Finally, in FX, we see USD's overvaluation as modest by historic standards and justified on the basis of US exceptionalism; sustained dollar depreciation would only materialise if US growth falters and/or rest of world growth expectations are re-rated higher.

The risk of an even slower pace of disinflation cannot be dismissed, which would imply higher rates for (even) longer; on its own, that would pressure risk assets via tighter financial conditions and reduced margins. However, to the extent that growth does not deteriorate materially, equities and credit should hold up, notwithstanding near-term corrections. The worst-case scenario would be one in which disinflation slows further or stops and growth impulses decline substantially: this is a low likelihood event but if it materialises it would ripple through sharp increases in volatility, lower risk asset valuations and a notably stronger dollar.

Figure 18. **Strong risk asset performance in 2024 despite higher yields**



Source: Aviva Investors, Macrobond as at 31 March 2024.

Equities: Concentrate!

A key concern among equity investors is the issue of high concentration, especially in the US market. The largest 10 stocks in the S&P 500 (i.e. 2 per cent of the number of stocks) currently account for almost a third of the market cap of the entire index (Figure 19). This is a level of concentration not seen in almost 100 years. To find a level that matches the current concentration we must go back to 1932, amidst the Great Depression.

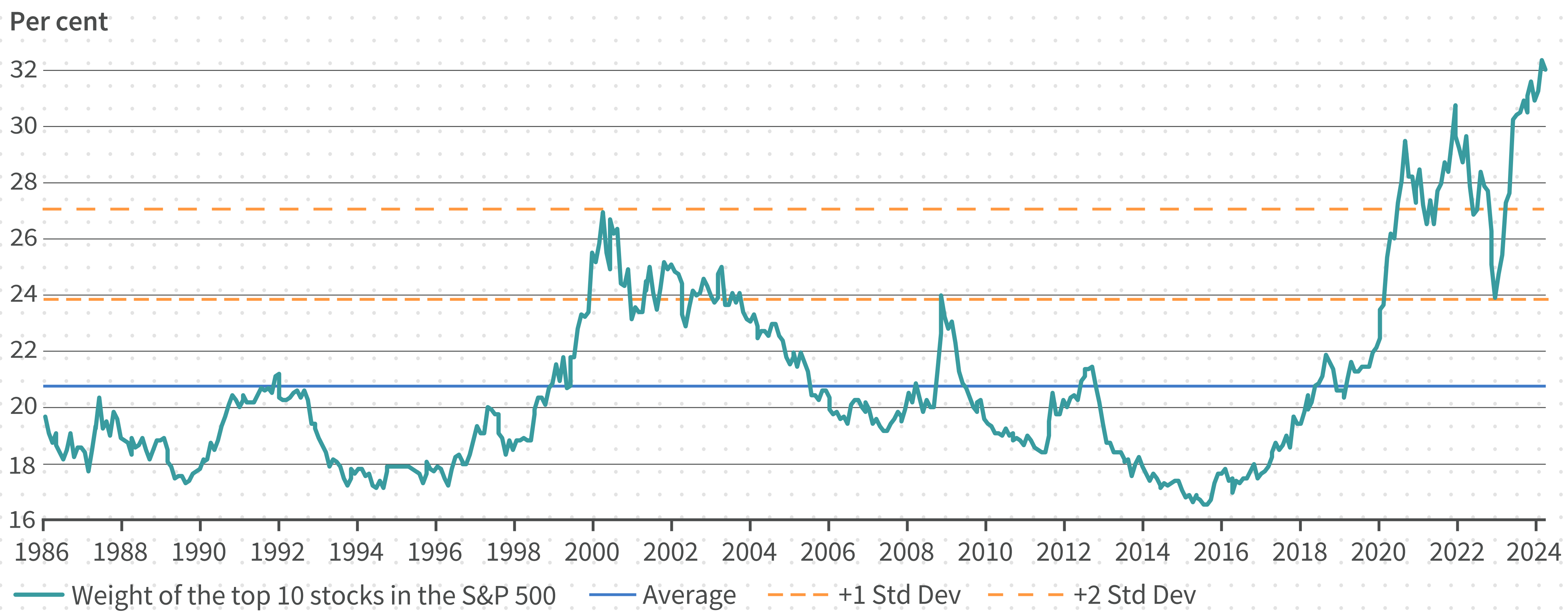
The extreme concentration leads to fears of an equity market bubble. However, it is important to highlight that high concentration per se is not a signal of downside risk for equities. The aforementioned 1932 period when concentration peaked at similar levels to today was followed by a sharp market rally where the S&P 500 went up 146 per cent in the 12 months from June 1932 to June 1933 and more than quadrupled over the following five years until its peak ahead of the 1937 recession.

Focusing on more recent periods, it is clear that the high level of concentration in 2000 coincided with the dot-com bubble and was followed by a sharp market downturn. However, other peaks in equity market concentration such as 2009 and 2020 were followed by strong equity rallies. All these past instances of high market concentration were different in a number of ways to today, but taken as a whole they point to the issue of concentration not being a clear indication of downside risk.

In addition to the concentration issue, valuations are often cited as a cause for concern. However, we would argue that today's elevated valuations are not driven by yields primarily, but by growth expectations. While P/Es and yields moved broadly in line between 2017 and 2022, valuations decoupled from yields in the second half of 2022 and have not reconnected since (Figure 20).

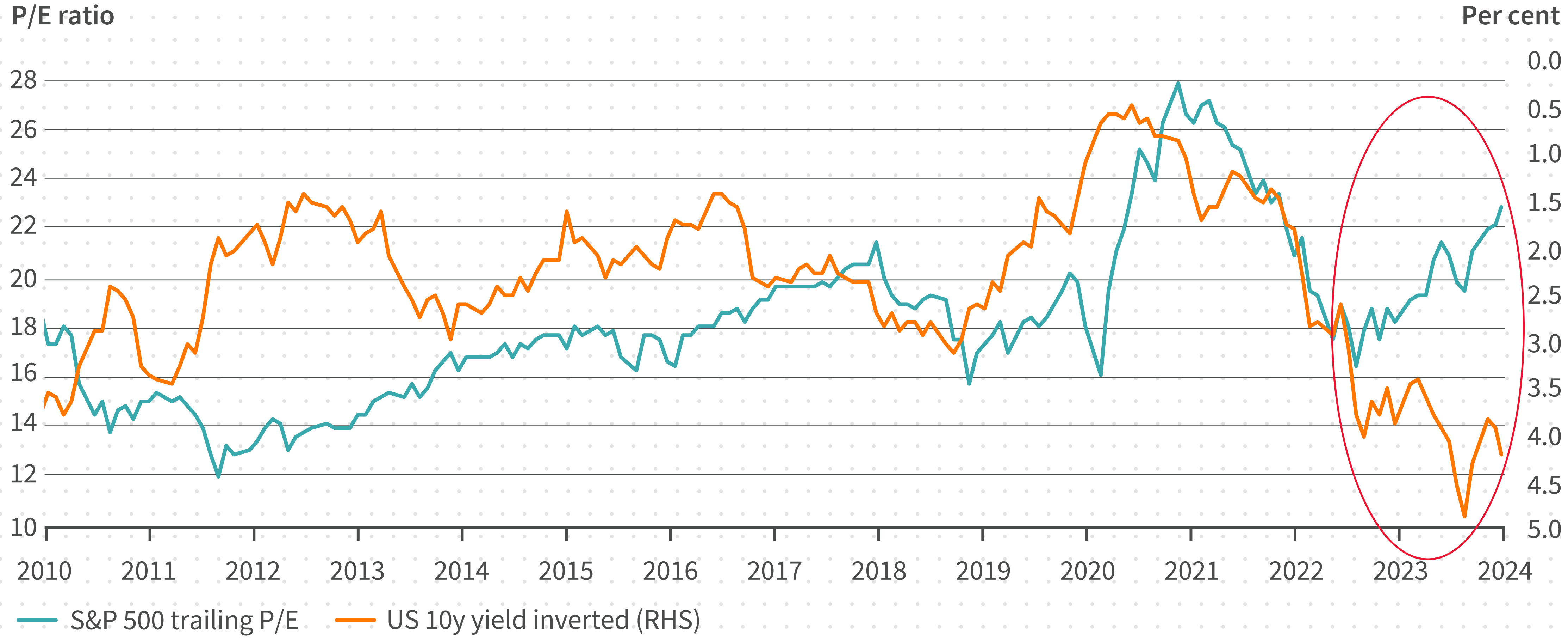
Instead, it appears to be the sharp spike in growth expectations that has driven valuations up (Figure 21). Long-term growth expectations for the S&P 500 have jumped from just under 10 per cent in the middle of 2023 to circa 16 per cent in recent months. Outside of the COVID lockdown period, this is the fastest increase in long-term growth expectations since the data begins in the 1980s. There can be legitimate concerns about whether those expectations (much of it driven by AI) will be fulfilled. But if P/Es in isolation look extended, in relation to growth the market pricing appears rational. Another way to illustrate the same is to look at PEG (P/E to growth ratios), which today are broadly in line with long-term averages.

Figure 19. **Market concentration at historical highs**



Source: Aviva Investors, LSEG DataStream as at 31 March 2024.

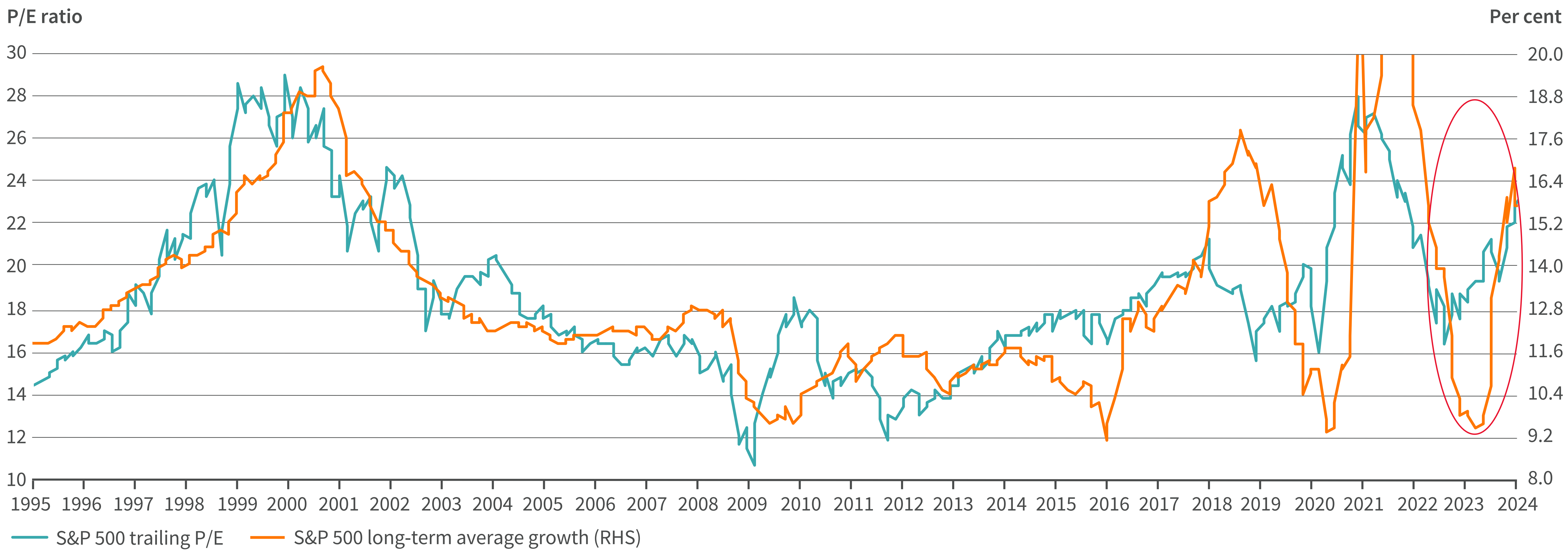
Figure 20. **Equity valuations decoupled from yields**



Source: Aviva Investors, LSEG DataStream as at 31 March 2024.

So, in our view, the risk for equities is not so much an overall equity market bubble, but a risk of "broadening", or change in leadership. Both the issues of concentration and elevated valuations are particularly US equity issues and not of other regions. All in all, this points to a significant risk of the US losing its market leadership in favour of European and Japanese equities going forward. While Japanese equities have outperformed the S&P through most of last year and continue to do so in 2024 year to date, European equities underperformed through most of 2023. However, this is showing signs of changing now. The SX5E has marginally outperformed the S&P 500 year to date and the data surprises suggest Europe has a window of opportunity to recover some lost ground to the US. Europe appears to be moving past a weak cyclical point with many companies raising guidance in the most recent earnings season and suggesting the remainder of the year could see better growth. While in the US, positive economic data surprises seem to be coming off the strong highs of the second half of 2023. Often relative data surprises go hand in hand with relative outperformance in Europe versus US (Figure 21).

Figure 21. **P/Es moving in line with growth expectations**



Source: Aviva Investors, LSEG DataStream as at 31 March 2024.

All in all, this points to a significant risk of the US losing its market leadership in favour of European and Japanese equities going forward

Rates: differentiation matters

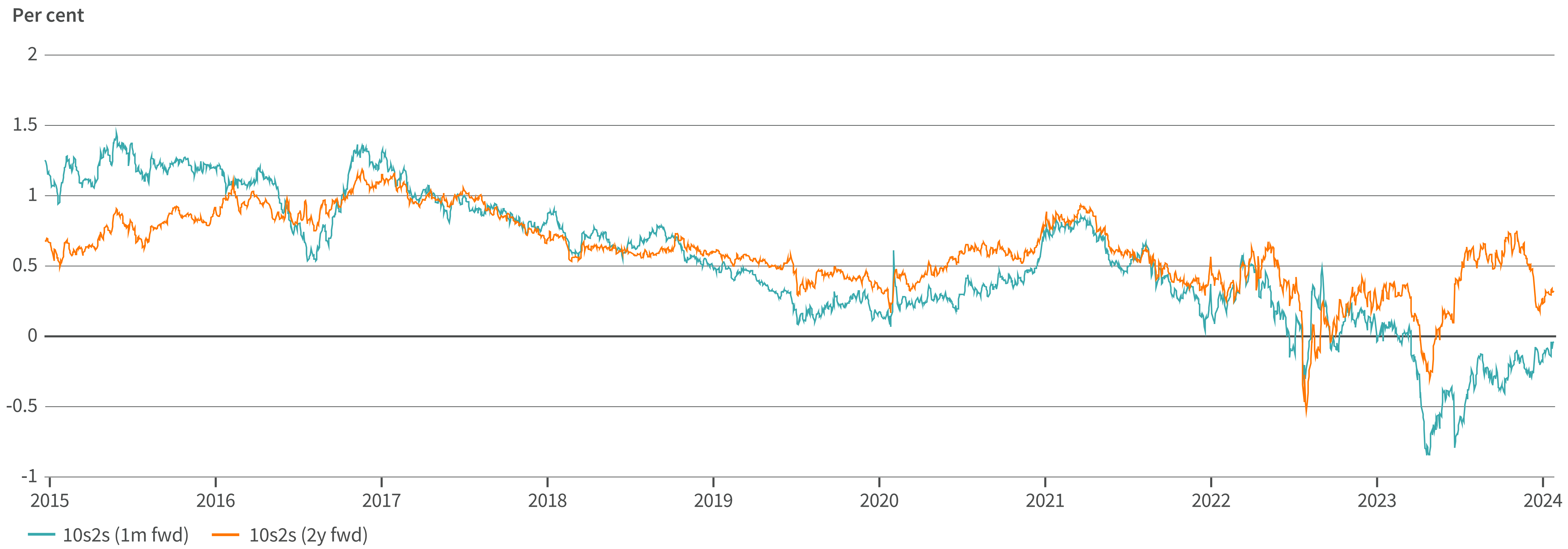
In our last outlook we made two points: first, that bond markets will have a tough time to beat cash due to the fairly aggressive monetary policy easing that was priced at the time; second, that easy money on curve steepening – a historically favourite trade at the onset of policy rate cuts – had been already made and ongoing performance was warranted only in a sharp slowdown scenario which forces central banks into steep rate reductions.

Q1 24 has broadly justified these views. Following the brutal decline in interest rates in Q4, bonds have come under significant pressure this year with US2Y and US10Y yields rising by around 45bps, driven by central bank rates re-pricing higher on the back of a slower pace of disinflation and robust data in the US; yields in the UK and core Europe have behaved similarly. Importantly, curves have flattened or have failed to extend their Q4 23 steepening.

That being said, the theme of central banks' easing has not disappeared: policies remain restrictive with ongoing pass-through to the real economies, fiscal impulses waning (depending on jurisdiction) and weaker aggregate demand putting pressure on inflation. Rather, global monetary policies have been re-priced and this now offers new and attractive opportunities but with differentiation across regions.

We judge that the market being positioned for roughly three rate cuts by the Fed this year is broadly a fair assessment given the combination of inflation and growth outlook. At the same time, we find that four cuts by the ECB may be stretching the tolerance of the central bank as there is still wage growth pressure in the pipeline and monetary policy tightening is past its maximum impact; BoE priced for three rate cuts this year is low in our view given our weak economic outlook (we expect four 25bps decreases).

Figure 22. **Forward UK curves have flattened considerably this year**



Source: Aviva Investors, Macrobond as at 31 March 2024.

In contrast, the BoJ's landmark shift to end the negative interest rate policy era and abandon its explicit yield curve control does not necessarily herald the start of a steep hiking cycle; however, with wage growth set to reach c.5.5 per cent for the first time in more than three decades and 10Y yields at a historic misalignment with core inflation trend, we see room for rates to re-price higher, albeit at a gradual pace. Many emerging markets are on the opposite end of the spectrum: rates have been high for long enough to prompt meaningful disinflation, and rate cutting cycles have already begun in much of Latin America and Central and Eastern Europe – often at a pace of 50bp per cut or more. As with developed markets, though, a terrific late-2023 rally has left many yield curves pricing in a lot in the medium-term, and this high hurdle – along with the uncertainty of the timing and pace of advanced economy rate cuts – may delay the resumption of positive performance for local currency EM bonds, which turned in a slightly negative performance in Q1.

As such, we favour the short end of the curve in the UK and maintain the view that relative value trades e.g. UK versus US are attractive, also as a way to reduce outright bets on the monetary policy cutting cycle; in our view, Japanese bonds remain expensive but we caution that generating returns from underweights is likely to be a slow-burner, as past decades of deflation are deeply ingrained in the BoJ's mindset and prevent it from a quick normalisation of policy.

Given the moves this year, there is scope for curve steepening to re-ignite, and the UK appears to be the most attractive: for example, spot 10-2 yield curve is now at around -13bps, 1M fwd at -4bps and this is now priced to rise to 30bps in two years, a substantial decline since end-2023 when it was priced at c.75bps (Figure 22).

Credit: small but steady grind tighter

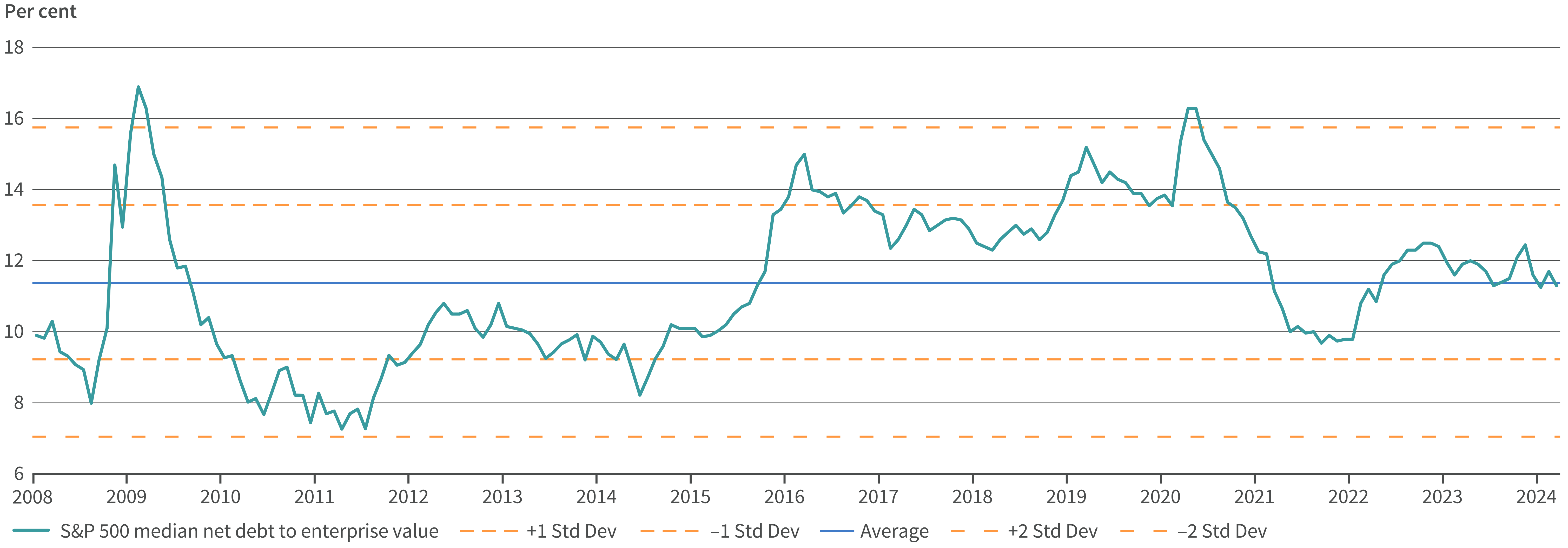
If the economic "soft-landing" indeed proves to be the outcome, it is difficult to see a scenario in which spreads widen materially in the near to medium term. It would likely take a significant economic or geopolitical shock for that to happen. The recent stream of central bank meetings also appears to be marginally supportive for credit: the Federal Open Market Committee meeting, above all, with its overall dovish tone, led to some steepening of the Treasury curve and boosted demand for credit.

On the other hand, spread valuations are unattractive and buyers appear reluctant to take on further positions. Put together this suggests a continued grind tighter for spreads.

In both high yield and investment grade, spreads compressed in recent periods and we are now at the bottom decile of the post-GFC range.

Fundamentals also remain supportive with relatively modest leverage on most balance sheets; the median S&P 500 company is carrying a c.11 per cent net debt to enterprise value (Figure 23). In addition, the earnings season just passed delivered results ahead of forecasts for both the overall market and for high yield companies. This provides further support for the view of a small but continued grind towards tighter spreads.

Figure 23. **Listed corporates are carrying relatively modest leverage**



Source: Aviva Investors, LSEG DataStream as at 31 March 2024.

> *If the economic "soft-landing" indeed proves to be the outcome, it is difficult to see a scenario in which spreads widen materially in the near to medium term*

FX: does US exceptionalism justify USD overvaluation?

Q1 24 has seen a reversal of the Q4 23 dollar trend, mostly in G10 FX, with the dollar recouping around half of its previous quarter losses, for two reasons: first, the repricing of the Fed rate higher (by nearly +90bps) and, second, the absence of growth impulses outside the US which has worked to bring US-exceptionalism back to the forefront (Figure 24).

For the remainder of 2024 we do not hold a bearish view on the dollar and stress that Fed easing cycles have not been historically USD-negative unless accompanied by a re-rating higher of the RoW-US growth expectation differential, something which we are yet to see any signs of.

The dollar is expensive but not significantly so: our estimates based on trade-weighted yield differentials suggest that the trade-weighted USD (versus advanced economies) is overvalued by c.4 per cent which (1) is not a very wide valuation gap; and (2) can be justified on grounds of US exceptionalism: the last few years the dollar has persistently traded higher than what yield differentials would suggest, largely due to the mix of outperformance of domestic growth as well as increased uncertainties and vulnerabilities in the rest of the world (Figure 24).

A re-election of a Trump administration appears to pose upside risks to the dollar – although there are plenty of unknowns – via the threat of trade barriers and increased de-globalisation

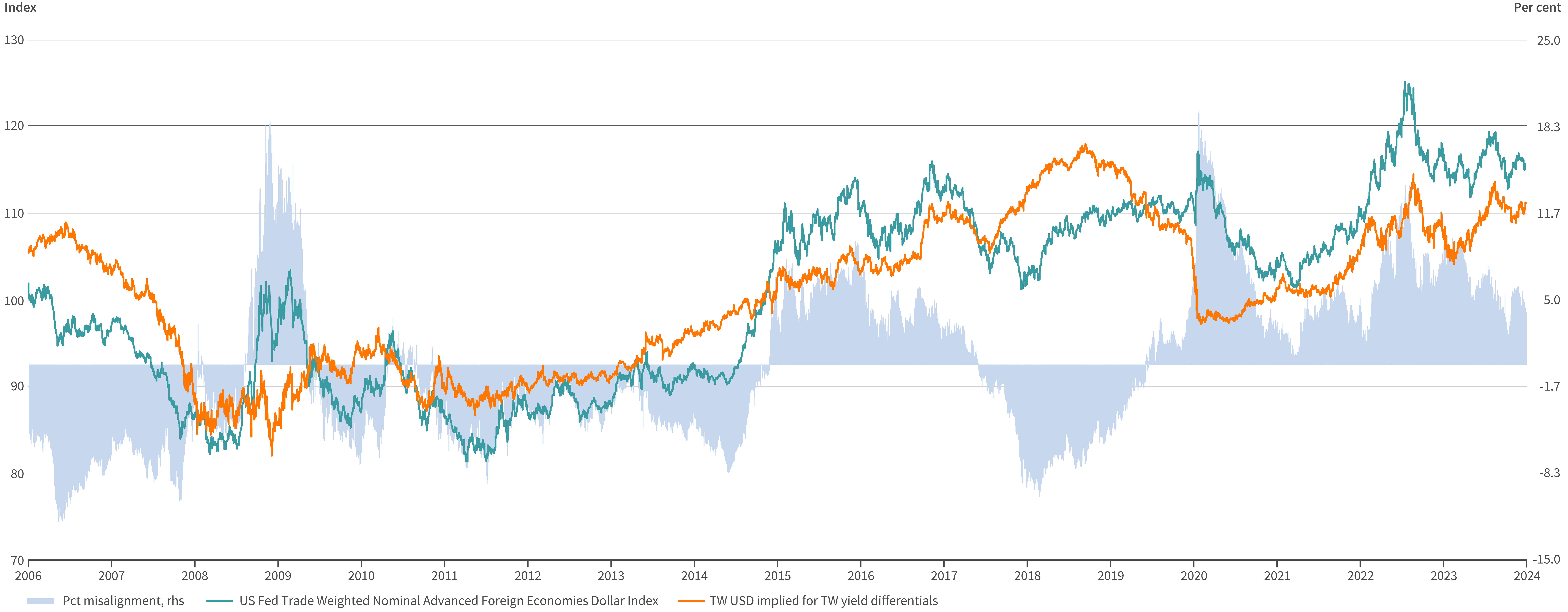
In our base case that envisages global growth slowing but the US achieving a soft landing and likely outperforming other major economies, the dollar is poised for some further upside, especially against low yielders, such as the CHF (JPY is a far more difficult call given its ongoing undervaluation and the BoJ wild card). Carry should continue to perform (including in EM e.g. MXN, BRL, INR): EM central banks are in the midst of their easing cycle (at varying degrees) but terminal rates should remain sufficiently high and, assuming risk appetite holds up well, carry trade performance should extend further. That said, we think a large chunk of carry profits has already been made and momentum is likely to wane.

Based on our views on the Fed, the ECB and the BoE, we expect EURUSD to remain range-bound, and GBPUSD to come under some depreciating pressure. We also have a bearish view on the Swiss franc as inflation has decelerated more than expected and the currency remains too high in real terms.

A re-election of a Trump administration appears to pose upside risks to the dollar – although there are plenty of unknowns – via the threat of trade barriers and increased de-globalisation.

We think the dollar would come under pressure if (1) US growth undershoots expectations while global growth does not disappoint; this would prompt the Fed to cut by more than expected vis à vis other central banks; and (2) global growth is re-rated higher due to a pickup in Chinese activity and/or Eurozone growth surprising on the upside.

Figure 24. **US exceptionalism has sustained dollar overvaluation**



Source: Aviva Investors, Bloomberg, MSCI, JPMorgan as at 31 March 2024.

Figure 25. **Asset allocation**

	Underweight										Overweight
	-5	-4	-3	-2	-1	0	1	2	3	4	5
Equities									3		
US									3		
Europe								2			
UK						0					
Japan									3		
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$)						0					
GBP						0					
EUR						0					
JPY						0					
AUD						0					
EM FX						0					

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 March 2024.

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House View Q2 2024

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House View

The Aviva Investors House View document is a comprehensive compilation of views and analysis from the major investment teams.

The document is produced quarterly by our investment professionals and is overseen by the Investment Strategy team. We hold a House View Forum biannually at which the main issues and arguments are introduced, discussed and debated. The process by which the House View is constructed is a collaborative one – everyone will be aware of the main themes and key aspects of the outlook. All team members have the right to challenge and are encouraged to do so. The aim is to ensure all contributors are fully aware of the thoughts of everyone else and that a broad consensus can be reached across the teams on the main aspects of the report.

The House View document serves two main purposes. First, its preparation provides a comprehensive and forward-looking framework for discussion among the investment teams. Secondly, it allows us to share our thinking and explain the reasons for our economic views and investment decisions to those whom they affect.

Not everyone will agree with all assumptions made and of the conclusions reached. No one can predict the future perfectly. But the contents of this report represent the best collective judgement of Aviva Investors on the current and future investment environment.

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