Aviva Investors

House View

Q3 2024

Markets tug of war:
disinflation slows, political risks rise

AVIVA INVESTORS

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Executive summary

Markets tug of war: disinflation slows, political risks rise

- The “last mile” of disinflation is proving the toughest
- GDP growth is slowing slightly in the US and China, whilst improving in Europe
- Fiscal deficits are supporting growth but limiting the scope for rate cuts
- Political risks and geopolitical risks will continue to add uncertainty and generate market volatility
- We remain positive on equities: earnings are resilient and recession risks are low

In the first part of 2024, the consequences of central banks’ decisions to stop hiking in late-2023 are becoming clearer. Growth has stabilised, and fiscal stimulus remains a key support for growth, with industrial policy and security concerns important drivers. Although we see growth slowing very slightly, from 3 per cent last year to about 2.7 per cent this year, there is little slack in most economies, and labour markets remain tight in most emerging and developed markets.

While this “soft landing” should be a relief, as a “hard landing” and recessions were previously considered risks or even the consensus scenario, there is a trade-off: inflation convergence to targets has been stalling, as the “last mile” is proving the toughest in many economies. Monetary authorities restraining economic expansion are facing opposite fiscal impulses in their efforts to attain price stability, with markets sometimes helping and other times interfering.

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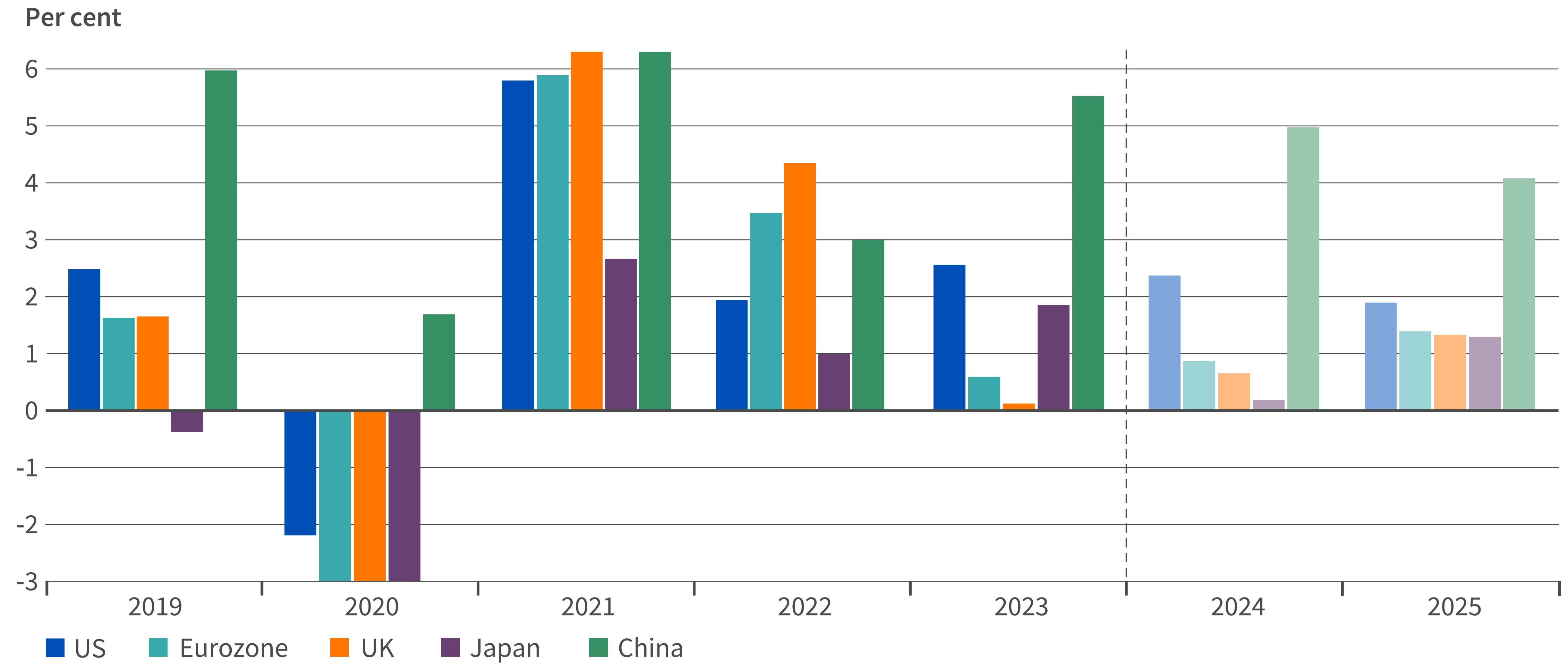
In the near term, growth continues to improve most rapidly in the euro area, led by the continued strength in the periphery (Spain, Italy) as Germany recovers from its recession; GDP will pick up to about a 1.5 per cent pace. In the US, the rebound after an inventory correction will probably wane, even with job creation and services remaining solid; growth should settle down towards 2 per cent after the recent 3 per cent above-potential pace. China came into the year growing at a nearly 6 per cent annualised pace, but front-loaded investments and exports are likely to give way to the drag from the property sector depression and weaker consumption, with growth slowing to around 5 per cent this year, and then to 4 per cent in the subsequent years. In Japan, it remains to be seen how much of a boost the yen will give exporters, while inflation, gradual rate hikes and a weak currency may cause some uncertainty for corporates, banks and households, but growth should stay around 1 per cent (Figure 1).

While sub-3 per cent growth used to be considered weak for the global economy, bringing inflation down from very high levels without inducing recessions or high unemployment should be considered a success story for policymakers and governments, to the extent their actions influenced the outcome. Energy markets, food and soft commodity prices supply chains all took time to adjust after the Covid and Russia invasion shocks, along with labour markets' recuperation. Fiscal policy has been prominent in cushioning the recession and bringing forward a V-shaped recovery, yet it has also contributed to the inflation problems of the past, present and future. Government deficits remain wide, and geopolitical concerns as well as a newfound enthusiasm for industrial policy and spending on the green transition make much public expenditure difficult to rein in. For emerging markets, there are questions about fiscal sustainability and creditworthiness, causing rate and FX pressures; even in developed markets, high rates will take a bite out of government budgets and burden businesses.

Figure 1. **Aviva Investors growth projections**



Source: Aviva Investors, Macrobond as at 30 June 2024.

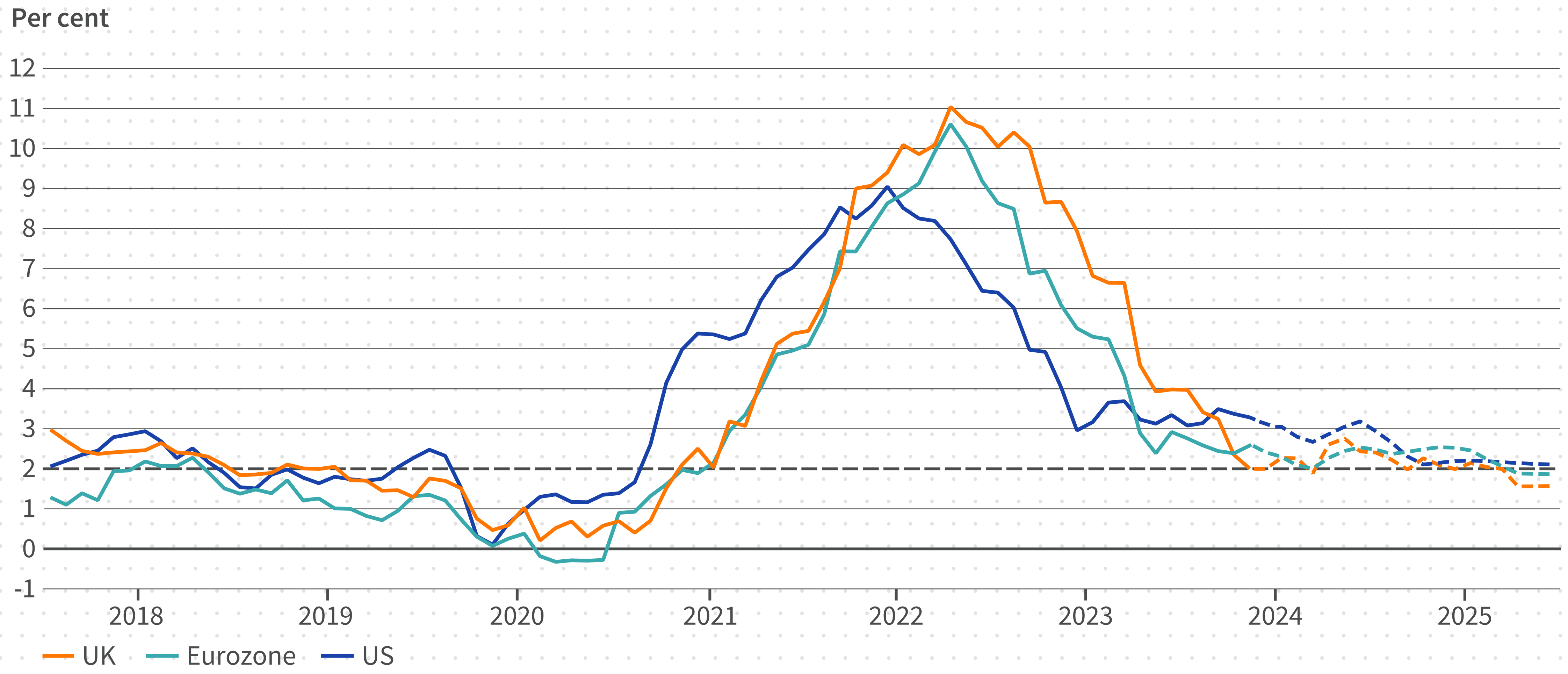
Energy markets, food and soft commodity prices supply chains all took time to adjust after the Covid and Russia invasion shocks, along with labour markets' recuperation

Questions about fiscal sustainability and creditworthiness are causing rate and FX pressures, particularly for emerging markets

There is little doubt that interest rates have been raised to levels that constrained growth and lessened inflation pressures in all major markets. The question now is: how restrictive are those rates, and for how long they will need to be kept in such territory? The evidence is mixed, and the risk identified in previous editions of the Aviva Investors House View, of disinflation slowing or reversing, has been realised. In the US, underlying inflation is just below 3 per cent, and will take another year and a half to get to 2 per cent, in our forecast; the situation is similar in the Eurozone, where inflation lately reaccelerated even though growth is much weaker (Figure 2). This has caused a large reassessment in fixed income markets YTD, with slower cuts to a higher terminal rate being priced in (Figure 3) – justifiably in our view.

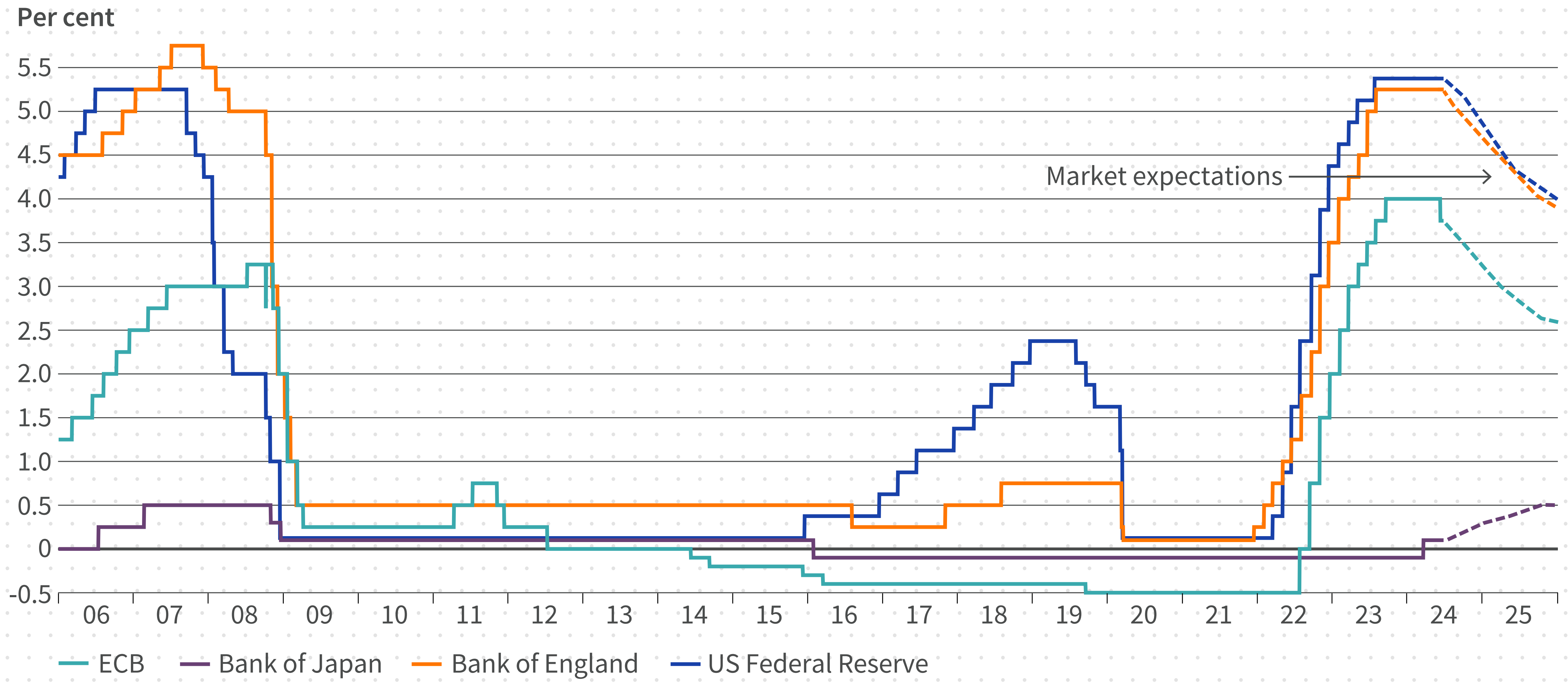
There is little doubt that interest rates have been raised to levels that constrained growth and lessened inflation pressures in all major markets

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



Source: Aviva Investors, Macrobond as at 30 June 2024.

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



Source: Aviva Investors, Macrobond as at 30 June 2024.

In a few countries inflation stayed more anchored and has enabled rate cuts to commence, especially where output and employment are less firm. In the past few months, Canada, Sweden and the European Central Bank (ECB) have joined Switzerland amongst the developed market central banks in lowering policy rates – but cautiously, without signalling aggressive cuts. The Bank of England (BoE) and the Federal Reserve (Fed) should follow suit in due course, but given the dynamics described above, they will do so cautiously too, reacting to the jobs, wage and CPI data rather than being proactive. There is downside risk for UK yields given more anaemic growth, and upside risk for US yields driven in part by the tech boom and wealth gains, but these will also depend on how post-election spending and tax programmes evolve in 2025. Emerging market central banks have also slowed down rate cutting cycles and are constrained, to some degree, by the Fed and continued dollar strength. Japan remains an outlier: the Bank of Japan (BoJ) is likely to hike rates faster than markets expect, and may continue to use quantitative easing (QE) to slow yield rises even as it intervenes to limit yen depreciation.

Turning to asset allocation (Figure 4, see also Figure 28), we see the current environment as neutral for government bonds generally, with their negative carry relative to cash, inverted yield curves, and positive correlation to risky assets making them poor diversifiers. Regionally, we favour the UK, and remain heavily underweight Japan. Credit spreads are quite tight, but upgrades and modest default rates mean that high yield can continue to post modest excess returns. We enter Q3 with a mildly bearish tactical bias on the US dollar, due to the spate of relatively weaker US data, but expect volatility and dollar strength to resume in the run-up to the US election. There is opportunity in the heterogeneity and volatility across emerging markets FX and external debt, particularly in higher yielding, lower-rated credits. We maintain our overweight equity allocation as fundamentals remain robust. We prefer developed markets and a remain tilted to quality stocks; including Japan and the US on a country level. While valuations are challenging in the US, growth continues to offer support. We still see a rebound opportunity in European stocks; however, political risks now add a new layer of uncertainty.

***Figure 4.* Asset allocation summary table**

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

Source: Aviva Investors, Macrobond as at 30 June 2024.

In a few countries inflation stayed more anchored and has enabled rate cuts to commence, especially where output and employment are less firm

Key investment themes and risks

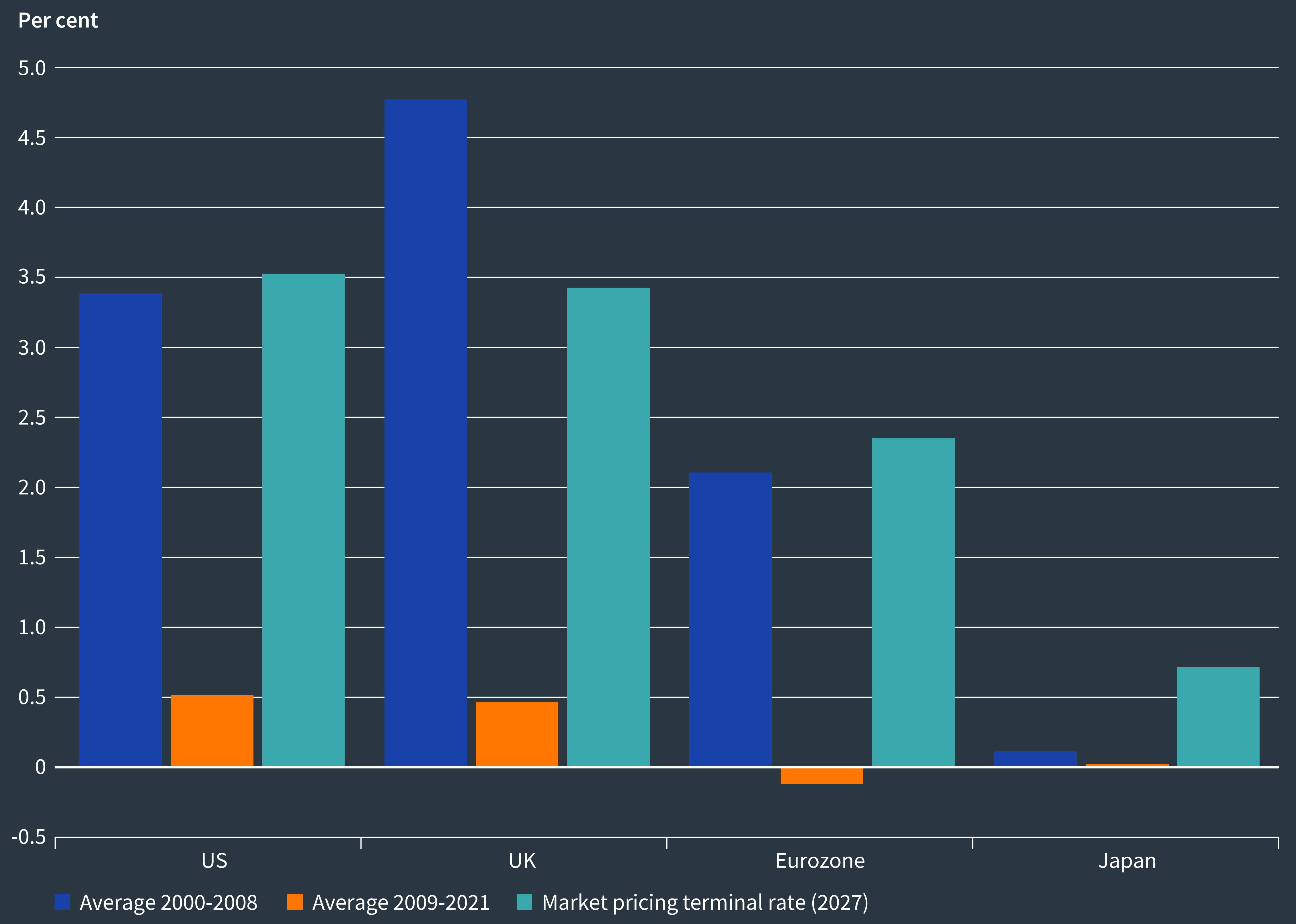
Investment themes

1	2	3	3
Limited rate cuts	**Fiscal support**	**Shifting power, evolving priorities**	**AI to the rescue?**

Limited rate cuts

Since the mid-1980s real interest rates have been on a steady decline. The drivers of that move lower may be difficult to estimate precisely, but are generally attributed to a combination of structural factors, including demographics, inequality, productivity growth, the relative price of capital and government debt. The decline in real rates came during a period in which inflation was also mostly low and stable, with few lasting supply shocks, but a number of large economic recessions. The global financial crisis (GFC) – the largest of those recessions – led to central banks cutting interest rates to close to or even below zero and undertaking large-scale QE. Lasting more than a decade, it seemed that both the secular and cyclical forces would act to keep nominal and real interest rates very low for the long term. However, just as the GFC seemed to coincide with a realisation of the secular factors pushing real rates lower, Covid and the ensuing recovery and inflation surge has coincided with a realisation that some of those secular forces may be changing. Shifting geopolitical priorities have led to increased protectionism, the drive to deliver on climate change objectives has changed the future savings/investment balance and a shift from private to public sector indebtedness reversed years of austerity, and the mass retirement wave of baby-boomers changed the demographic landscape. These supply-side factors could both increase the level and variability of nominal and real rates. We expect that alongside a somewhat softer, but still reasonably solid (albeit weaker) cyclical outlook, the market is right to expect limited rate cuts from major central banks over the next couple of years. That means something closer to the pre-GFC era of rates, rather than what was experienced over the past decade (Figure 5).

Figure 5. **Policy rates expected to decline only modestly in this cycle**



Source: Aviva Investors, Bloomberg, Macrobond as at 30 June 2024.

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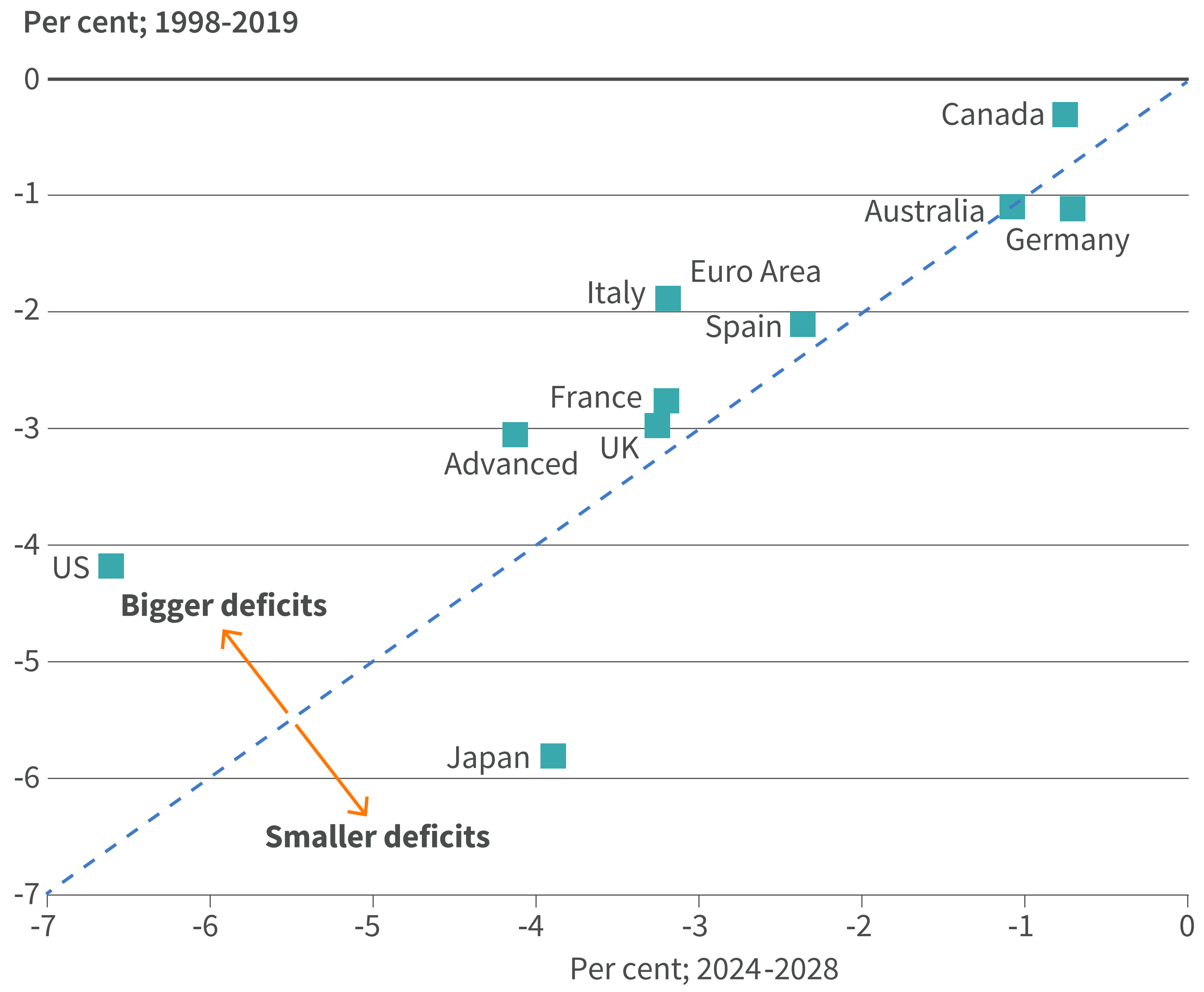
Fiscal support

The use of counter-cyclical fiscal policy during the pandemic proved highly effective in supporting the private sector through a period of lost activity and uncertainty. It was undoubtedly a key factor in the pace of recovery once economies re-opened and households could start spending and businesses start producing again. For governments that had been hesitant to engage in counter-cyclical fiscal support following the global drive for fiscal austerity in the post-GFC and Eurozone crisis years, this episode – which proved hugely popular with the electorate and failed to trigger an immediate adverse reaction in government bond markets – no doubt emboldened them to take a more activist approach to other shocks. An example of that was seen in the large energy price support packages unveiled across first Europe and then many other economies around the world in the wake of Russia's invasion of Ukraine. We expect governments will continue to provide powerful counter-cyclical support when required, well beyond the traditional automatic stabilisers. That marks a significant change in the role of fiscal policy compared to much of the last 40 years. It also changes the role of monetary policy, which has acted as the primary counter-cyclical tool over that period.

Alongside greater use of counter-cyclical fiscal policy, structural deficits are also expected to be wider over the coming decade, reflecting the range of longer-term priorities. Those include the cost of incentives and direct investment government investment in order to facilitate the transition to net zero carbon emissions, which are expected to be as much as 1 per cent of GDP a year for a decade. Governments are also looking at increased spending (or tax incentives) to enhance economic security, by encouraging more onshoring of technology and other key industries. Military spending is also structurally on the rise, as a more geopolitically unstable world starts to reverse the post-Cold War thinking around defence capabilities. The combination of counter-cyclical and structural fiscal over the years ahead will keep deficits wider than we have witnessed over the last 20 years (Figure 6).

Figure 6. **Fiscal deficits (as a per cent of GDP) are expected to be notably larger over the next five years than the prior 20 years**



Source: Aviva Investors, Macrobond as at 30 June 2024.

> ***The significant change in the role of fiscal policy changes the role of monetary policy, which has for decades acted as the primary counter-cyclical tool***

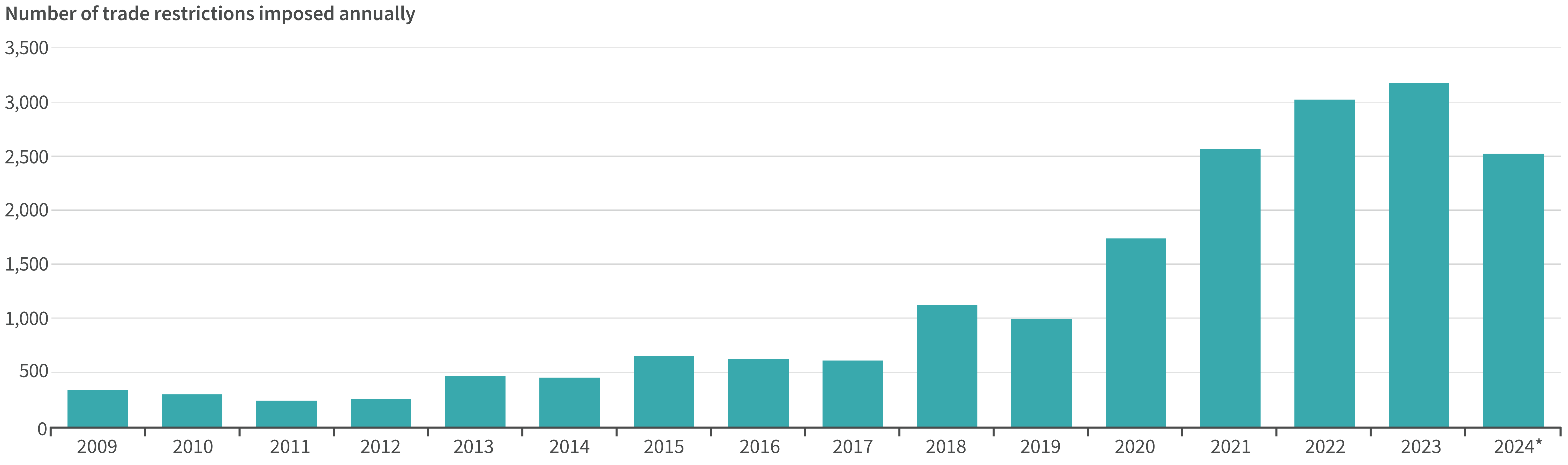
Shifting power, evolving priorities

Election outcomes this year are likely to prove highly consequential for domestic and foreign policies in the major economies. In many instances there is likely to be a change in government, with shifting power leading to a change in priorities. While we do not expect any retreat from industrial policies that have emerged in recent years, the focus may alter and evolve. In the recent European parliamentary elections, a shift to the right by voters across much of the EU has resulted in the centre-right/centre-left coalition holding, but with the far-right taking seats from the Liberals and the Greens, the influence the right has on policies will be notably increased. That is likely to lead to a slowing in the roll-out of policies aligned to the EU Green Deal championed by the previous parliament.

The US presidential election will have consequences for strategic competition and economic security. A Trump victory would likely see tariffs raised further

It is also likely to lead to a tougher approach to immigration across the bloc. The shift to the extremes was seen clearly in France, where subsequent snap national elections delivered a surprise with the Left coalition winning the largest number of seats in the Assembly (although not enough to form a majority government). The far-left party will take the lion's share of seats in the coalition. The far-right Rassemblement National (led by Marine Le Pen) also increased its number of seats, but finished third, removing any possibility of being part of the new government. The US presidential election hinges on personalities, with a multitude of domestic issues at play, while the international focus remains on strategic competition and economic security. A Trump victory would likely see tariffs raised further, targeting not only China, but other economies, including allies such as Europe. The use of tariffs and other harmful trade interventions has risen globally since the first round of Trump tariffs in 2018 (Figure 7). It would also likely see significant changes to energy policy, allowing greater permitting for fossil fuel extraction and removing or reducing subsidies on electric vehicles. A Democratic victory would provide more continuity in policy, and a divided Congress would also hamper the GOP's ambitious legislative agenda. In the UK, the Labour victory has the potential to provide some much-needed stability in government, following nearly a decade of turmoil kicked off by the Brexit vote in 2016. But it will be a government constrained in its spending by the fiscal rules and therefore looking for regulatory changes in planning and other areas to do the heavy lifting.

Figure 7. **Harmful trade interventions**



*2024 based on annualised figure for H1.
Source: Aviva Investors, Global Trade Alert as at 30 June 2024.

AI to the rescue?

Artificial intelligence (AI), specifically generative AI, offers the potential for a truly generational shift in technology. However, whilst AI has persistently been a focal point in markets, we are yet to see equivalent impacts upon the real economy. Adoption rates, on average, remain modest across industries in the US, whilst AI-related investments are yet to be visible in the national accounts data. We believe that AI's impacts, whilst still material, will be felt over the medium term – with automation the primary channel.

When it comes to the broader economy, the potential effects of AI boil down to one factor: productivity (output per hour worked). In short, a positive supply shock in the form of a productivity boost should be disinflationary and translate into stronger growth.

An AI-led productivity boost should mean greater growth and disinflation – yet experts disagree wildly on its extent

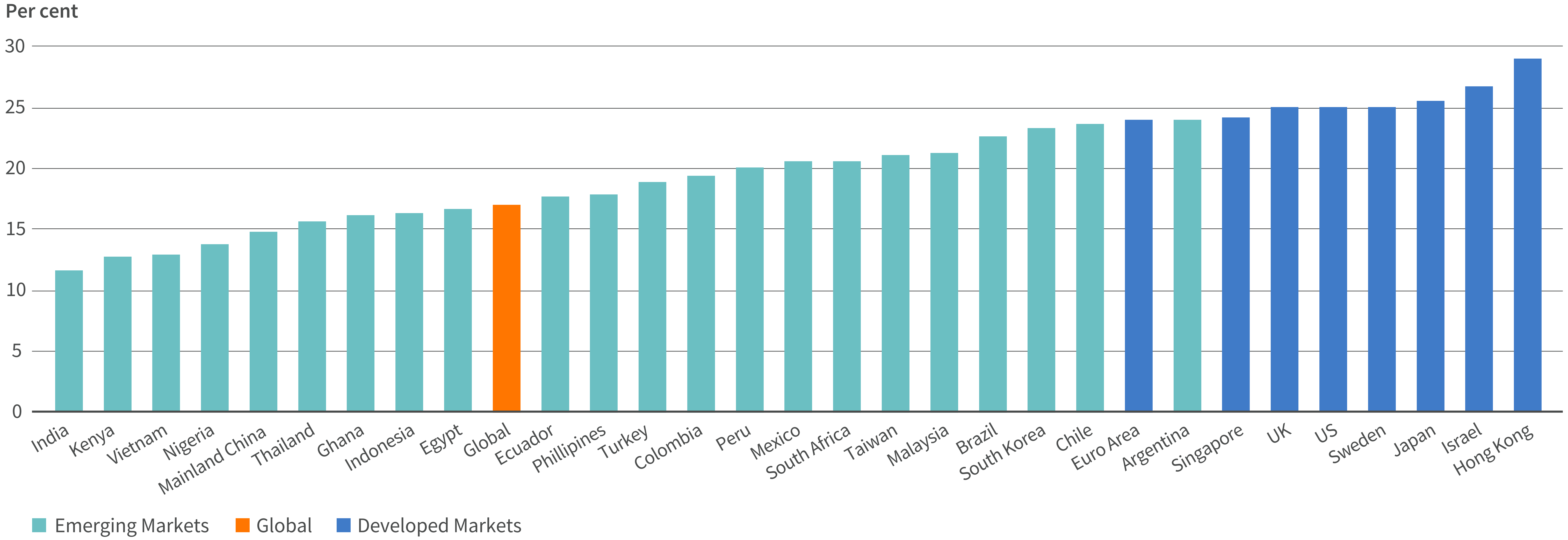
Indeed, many attribute the secular decline in yields of the past 20 years to that of diminishing potential – an AI-led productivity revival could help to reverse this. Moreover, a regime of both rising growth and rates arguably implies a more positive correlation between stock and bond returns, and as such may have significant implications for asset allocators in the future.

Yet there remains a considerable uncertainty over the size of this potential productivity boost. Over the 10 years following widespread adoption, Goldman Sachs (GS) estimates a c.1.5 per cent per annum upside to US productivity growth from AI (implying cumulative GDP gains of c.15 per cent).

Others offer far more conservative estimates – e.g., Acemoglu et al[1] estimate c. 1 per cent cumulative gains to productivity over a similar window. Unsurprisingly, differing assumptions account for the bulk of difference in productivity estimates. For instance, GS predicates its estimates on a view that c.25 per cent of full-time employment in developed markets can be automated by AI (Figure 8), whilst Acemoglu et al assume this to be closer to 5 per cent.

[1] The Simple Macroeconomics of AI | NBER

Figure 8. **Globally, 18 per cent of work could be automated by AI, with larger effects in DMs than EMs**



Source: Goldman Sachs Global Investment Research as at 31 December 2023.

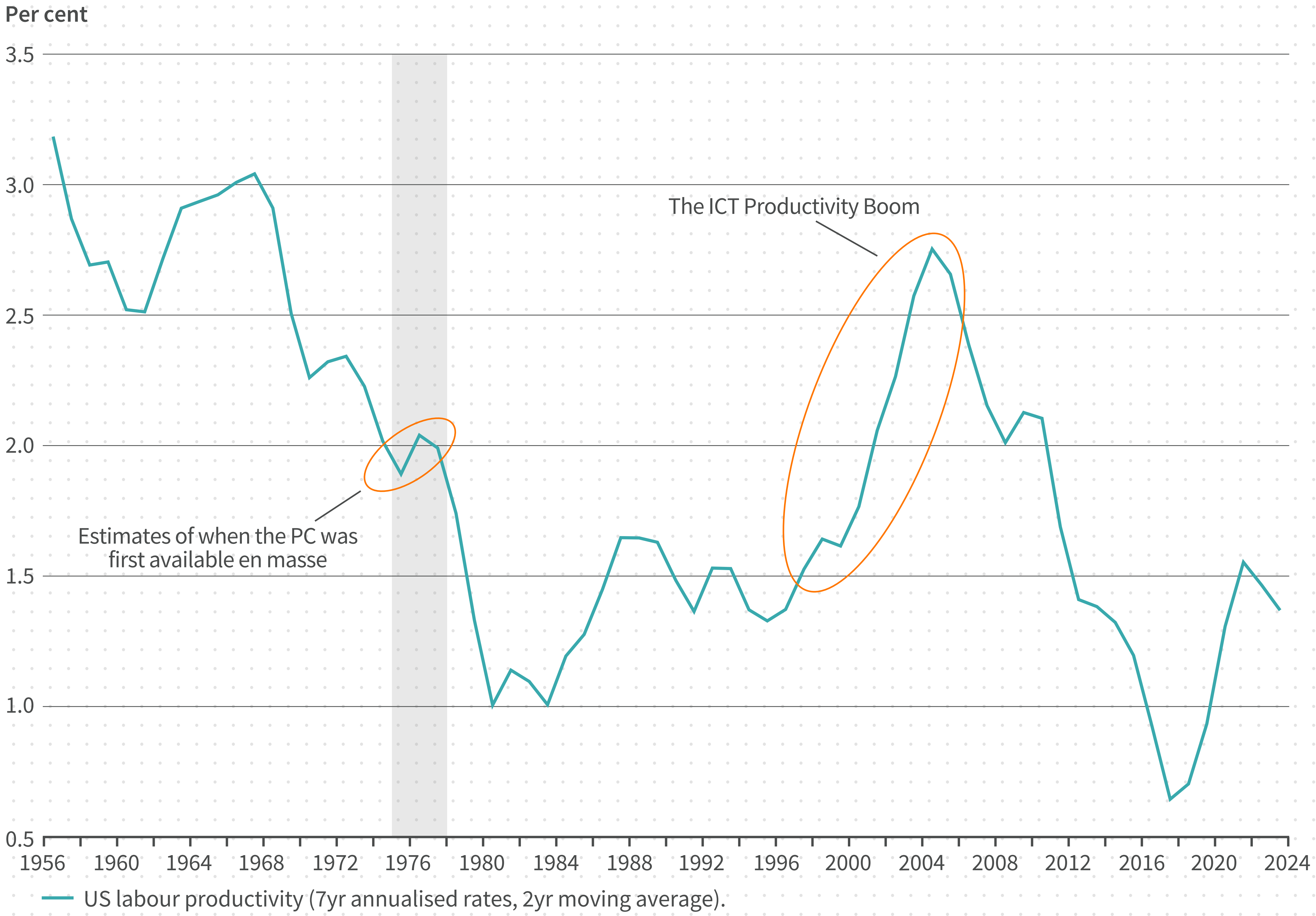
But will AI be as pervasive as some estimates suggest? Recent empirical studies and corporate anecdotes on AI usage, while impressive, focus on specific use cases that arguably involve "easy to learn"/ "linear" tasks. It is therefore hazardous to generalise these results – general knowledge work is far from linear, implying that productivity gains are perhaps more elusive than these studies may suggest.

Technological diffusion (i.e., the process by which knowledge/expertise can spread throughout an economy) will ultimately be critical for AI's ability to translate into aggregate productivity gains. Yet, over the past few decades it has been on a structural decline and, as markets become increasingly concentrated, this trend is unlikely to change any time soon – potentially imposing a ceiling on AI's productivity impacts.

One should be cognisant that productivity gains are difficult to measure ex ante. A study published by the St Louis Federal Reserve argues that although the PC was first made commercially available in the US in 1975, the impact on productivity is only visible in the late 90s (Figure 9). Whilst many believe that AI will fare differently, when looking at more recent technology advancements, there is mixed evidence to suggest that adoption time frames have improved. It took cloud computing around 12 years to reach "widespread adoption" (defined as c.50 per cent usage), whereas the smartphone got there in five. Will AI follow the former or the latter? Regardless, with history as a precedent, we are likely some years away from seeing the proposed economy-wide impacts of AI. Moreover, one must also consider the potentially negative welfare impacts from broader AI adoption, such as deepfakes and AI powered malware.

Will AI be as pervasive as some estimates suggest? Regardless, it will be some time until the broader economic impacts will be realised

Figure 9. **Diffusion of technological changes into overall labour productivity can take a long time**



Source: Aviva Investors, Macrobond as at 30 June 2024.

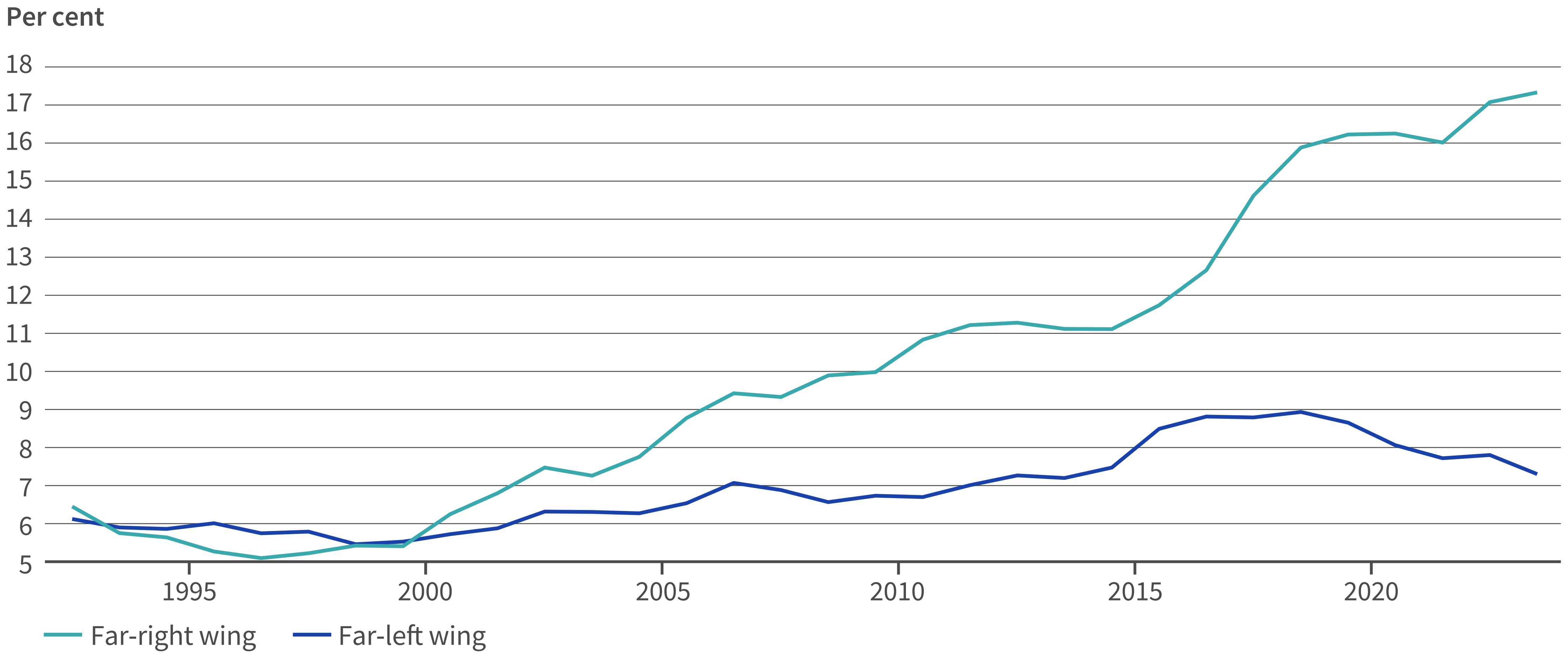
Risks

(Geo)political polarisation

The period of relative calm in national and international politics from the mid-1990s to the late 2000s has been disrupted over the last decade. Large parts of the electorate across western democracies have become disenfranchised, feeling left behind or excluded from the economic benefits that came from increased globalisation and drive for efficiency. That has led voters to look outside the traditional centre-left and centre-right political parties, as evidenced in the voting trend in Europe over the last decade (Figure 10). The rise in power of far-right (and to a lesser extent) far-left parties has not only brought them closer to – and in some cases into – power, but also changed the policies of parties in the centre. This shift matters not only for how countries are governed, but also for how it permeates through the economy and financial markets. Risks to the outlook can come from a number of angles – the policies pursued may be costly, the chances for policy mistakes are elevated, as are the risks of unintended consequences and the potential for geopolitical missteps increases the risk of greater fragmentation and even hot war scenarios.

A key focus over the next 12 months will be trade policy, with increasing use of tariffs and other harmful trade interventions across all major economies. These will be pursued under the guise of national or economic security considerations, but could worsen the growth outlook and increase inflation. Trade policy is likely to be used alongside industrial policies to influence supply chains and weaken strategic competitors. There are also associated risks to global capital flows, as trade policy is augmented by policies to restrict both inward and outward investment. How the countries that are impacted respond could lead to further escalation and a risk of a downward spiral of "beggar thy neighbour" policies. For some countries, including many in Europe, there is a risk of being squeezed from two sides due to reliance on both the US and China for investment, exports and imports – with the latter especially important given the need for Chinese manufactured goods, including solar panels and electric vehicles, to meet climate targets. These geopolitical developments will likely result in increased volatility and could be a catalyst for market corrections over the next year.

Figure 10. **Electoral outcomes across Europe up to 2023**



Source: Aviva Investors, Macrobond, Timbro as at 30 June 2024.

Geopolitical developments will likely result in increased volatility and could be a catalyst for market corrections over the next year

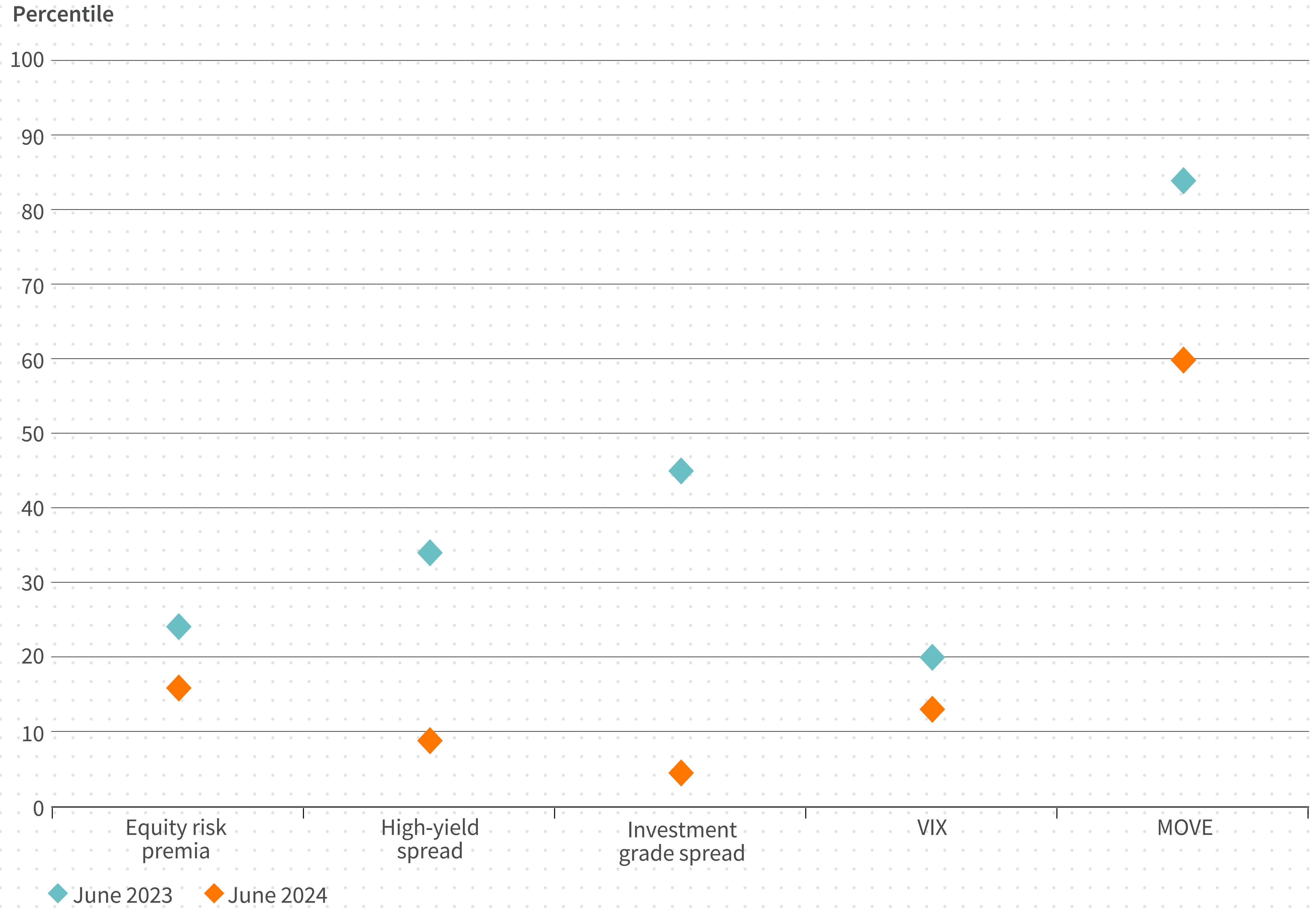
An unstable market equilibrium?

The inflation shock of 2022 resulted in a sharp increase in risk premia, as global bond markets re-priced for higher and more volatile yields. Both equities and corporate credit sold off as investors demanded more compensation for the level of risk taken. Fear of global recession in 2023 was high, especially after the failure of regional banks in the US as well as Credit Suisse in March. Neither a hard landing nor a financial meltdown ultimately came to pass, as economies proved to be more resilient than expected to the tighter monetary conditions. As concerns subsided, risk premia eased and volatility declined to within the second quartile (albeit with bond volatility still elevated). But since then equity markets have rallied – led by the Magnificent 7 tech stocks in the US – pushing valuations higher and the equity risk premia and volatility (as measured by the VIX) to around the 10th percentile of the range since 1998 (Figure 11).

Credit spreads have similarly compressed, with US investment grade particularly narrow by historical standards. These sort of compressed risk premia and low volatility states do not usually last. The risk of market correction intensifies, with the trigger potentially market-driven (e.g. the rapid sell-off in February 2018 that was amplified by market structure and instruments tied to volatility), economic or geopolitical.

> *...compressed risk premia and low volatility states do not usually last. The risk of market correction intensifies...*

Figure 11. **Measures of risk premia have compressed and are remarkably low**



Equity risk premium based on S&P500 forward earnings and 10 year treasury yields. High-yield investment grade spread are for US dollar Bloomberg indices based: VIX index represents expected volatility and S&P500; MOVE index measures US rates market volatility. Percentiles calculated from 1998, based on monthly moving average.

Source: Aviva Investors, Macrobond as at 30 June 2024.

The risk of unintended consequences and the potential for geopolitical missteps increases the likelihood of greater fragmentation and even hot war scenarios

Michael Grady
Head of Investment Strategy and Chief Economist

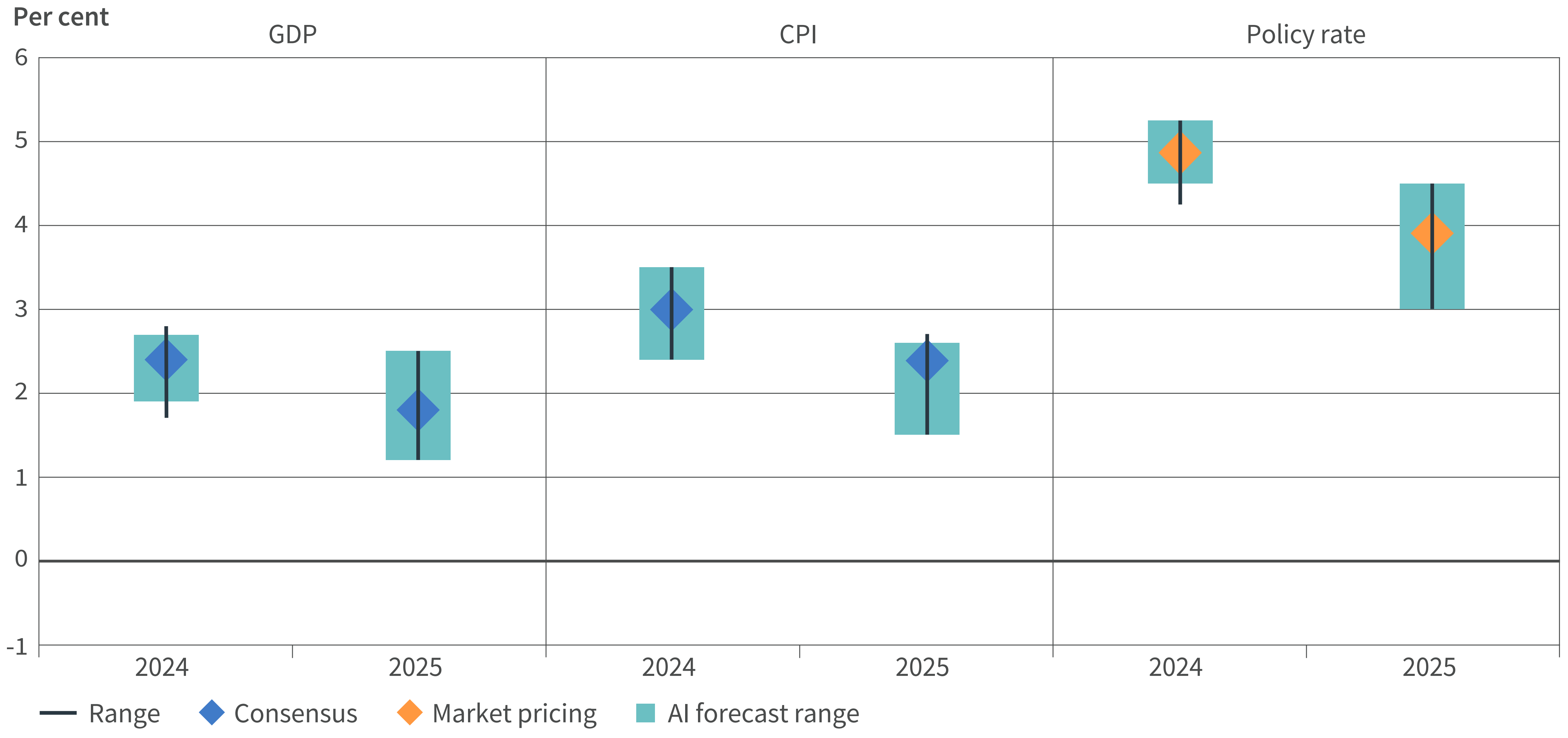
Macro forecast charts and commentary

US

Growth slowed in the US in Q1, falling below potential for the first time in two years. However, whilst headline GDP growth softened, final domestic demand growth remained strong, growing at over 2.5 per cent annualised rate. The continued underlying strength of demand reflects the ongoing robust growth in real household disposable income, improving corporate profitability and increasing investment in areas related to technology and green transition. We expect growth to slow moderately through 2024, with annual growth of around 2.2 per cent expected, down from 2.5 per cent in 2023. We expect a further moderation to below 2 per cent in 2025. The slowing in growth reflects the ongoing impact of restrictive monetary policy and little additional impulse from fiscal policy. Of course, looking into 2025 there is greater uncertainty given the US election in November could see some important policy shifts (see sections on Key Themes and Risks) should the Republicans win the Presidency and take Congress. With growth only expected to slow modestly, the labour market is expected to remain solid and underlying inflationary pressures – especially in services – are expected to moderate only slowly. We expect core PCE inflation (the measure preferred by the Fed) to remain around 2.75-3 per cent through to the end of 2024, before slowly moving back towards 2 per cent in 2025. We expect the Fed will have enough evidence of that path to undertake a first rate cut near the end of 2024, with three or four cuts of 25 basis points expected in 2025. We see the risks to that outlook to be fewer, rather than more cuts (Figure 12).

We expect the Fed will have enough evidence to undertake a first rate cut near the end of 2024, with three or four cuts expected in 2025.

Figure 12. **US**



Note: GDP calendar year growth; Consumer Price Index (CPI) Q4/Q4; Policy Rate Q4.
Source: Aviva Investors, Bloomberg as at 30 June 2024.

Eurozone

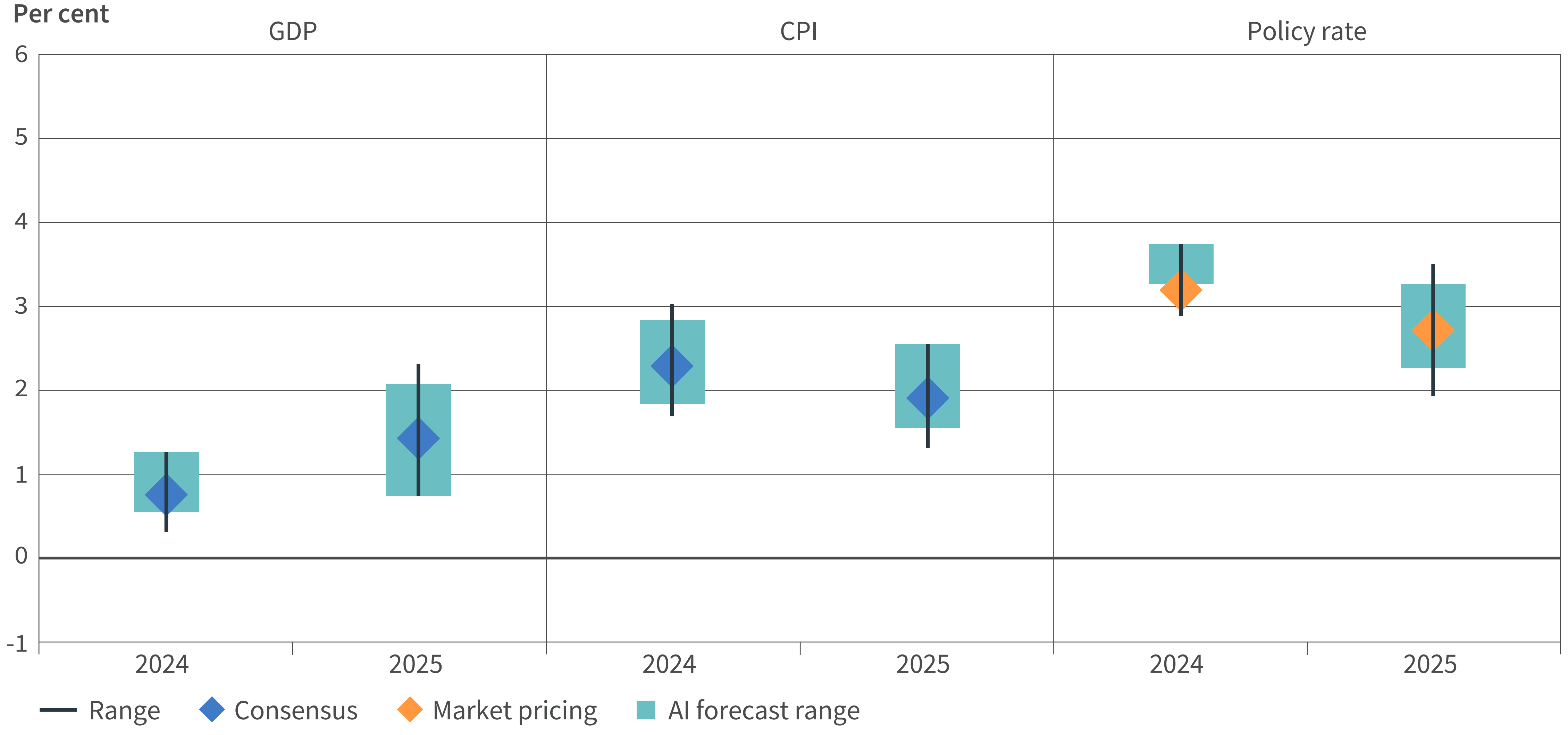
Eurozone activity started the year on a stronger-than-expected tone, with GDP rising 0.3 per cent QoQ in the first quarter, driven by final consumption expenditure and net exports. More importantly, recent high frequency surveys continue to point to an ongoing rebound, supported by increased real disposable income. We upgrade our GDP forecast for 2024 to 0.9 per cent; and see inflation ending the year around 2.3 per cent, while in our base case the ECB will cut rates to between 3.25 per cent-3.5 per cent this year, with a terminal rate around 2.75 per cent-3 per cent (see Figure 13). We see real activity subject to upside risks, absent any political turbulence.

On the economic front, the Eurozone is currently undergoing a modest boom, notwithstanding the recent political setback: real disposable incomes are rising as wage growth is high and inflation is falling; monetary policy is past its peak-impact, especially now that the ECB has eased policy and the composite cost of borrowing is declining; and China's industrial recovery – though far from impressive – is adding at the margin via the trade channel. Fiscal consolidation will remain a drag, but this is likely to be smaller than originally expected: fiscal deficit will decrease by c.0.5 per cent (of GDP) – still meaningful but a smaller reduction relative to what the IMF projects for the US and the UK. NextGenerationEU (NGEU) disbursements will also cushion part of fiscal consolidation.

All this is complicating monetary policy. Despite the June cut, rates are still restrictive, suggesting that progress on disinflation and (very likely) slower wage growth will keep pointing towards the need for easier policy further out. However, real demand is picking up – corroborated by the widespread strengthening in high frequency surveys – as real disposable income rises, and German activity seems to be bottoming out. Effectively, the initial stage of the recovery, which was almost exclusively led by the European South, is spreading further (less so in France) making it more robust. In turn, this could slow the disinflation process. We see even odds between one and two more cuts by the ECB this year and a likely terminal rate between 2.75 per cent to 3 per cent, higher than the market expects. The reduction in interest rates in June and further NGEU disbursements pose some upside risks to our economic activity forecasts.

However, political developments could derail the recovery, via decision bottlenecks and policy paralysis that would dampen sentiment and growth. Of immediate concern is the French election result, which has increased uncertainty over the economy's fiscal trajectory, especially now that France is put under the Excessive Deficit Procedure (EDP) by the European Commission. Aside from near-term potential political disruptions, our main worry is that the EU could find itself without a united and coherent German-Franco front that pushes a decisive political agenda centred around reduced regulation to improve competitiveness, infrastructure spending, productivity growth and more progress on capital union.

Figure 13. **Eurozone**



Note: GDP calendar year growth; Consumer Price Index (CPI) Q4/Q4; Policy Rate Q4.
Source: Aviva Investors, Bloomberg as at 30 June 2024.

Alongside France, the German coalition is falling behind in popularity while the far-right's appeal is rising. This complicates near-term decision making on topical issues and increases uncertainty ahead of the planned 2025 elections. The rise of populism and extremism are also concerning. That said, there could be a silver lining: we believe that the prior example of the last decade makes it likely that extreme political functions opt to soften their stance when elected in positions of responsibility (the Meloni government in Italy is a case in point) and avoid confrontation with EU fiscal rules; hence, we do not subscribe to redenomination risks. That said, there is certainly an element of policy cohesion (or lack thereof) and paralysis risk which poses downside risks to foreseeable euro area activity.

Economic activity is rebounding as real disposable incomes and sentiment improve; however, political developments pose a major risk to our positive euro area outlook

UK

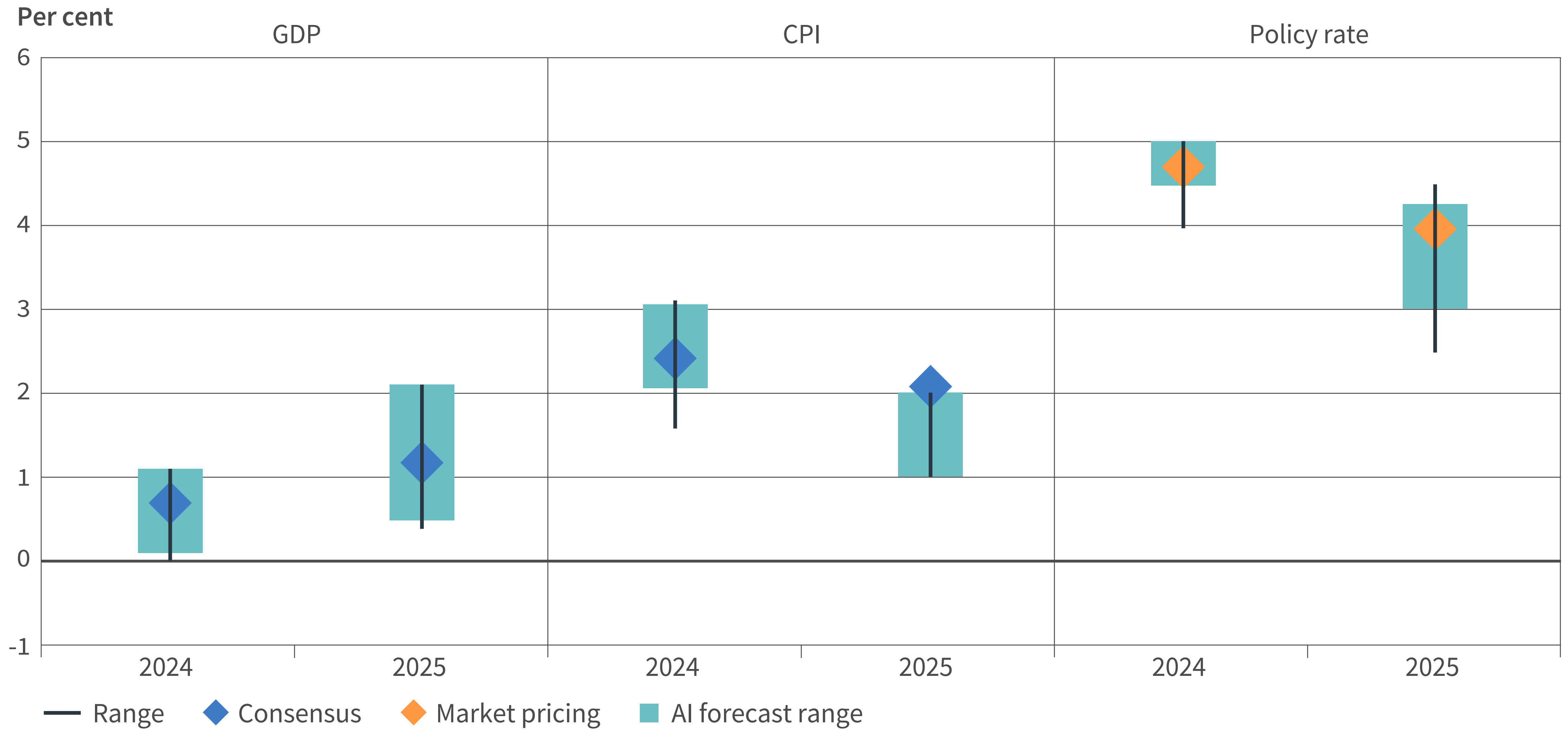
UK growth surprised to the upside in Q1 24, following a year of stagnation. This was down to investment rebounding after declining notably in the first three quarters of 2023. We have revised somewhat higher our 2024 GDP growth projection to 0.6/0.7 per cent (from 0.3 per cent; see Figure 14) to account for recent momentum; however, lacklustre household spending means that growth will remain anaemic until monetary policy becomes less restrictive. And while inflation has fallen closer to target, recent stickiness in services inflation and slower progress on wage growth mean that the BoE may be able to ease policy by only 50bps this year (now our base case). In turn, this suggests that growth will slow in H2 24, prompting the central bank to cut more aggressively in 2025.

Stagnating consumption growth has been our main concern for the UK economy and there has been little evidence so far to suggest otherwise: real household consumption expenditure barely grew in Q1 24 and remains some 2 per cent below its pre-pandemic level. At the same time, effective mortgage rates keep rising, suggesting ongoing pressure on household finances.

Headline inflation has fallen to target – in part thanks to the reduction in the energy price cap. We expect further deceleration below the 2 per cent level before rising somewhat above target by the end of the year. In parallel, the labour market continues to loosen with market tightness now at pre-2020 levels and wage growth decelerating, albeit more slowly than expected. We believe that slower-than-expected progress towards the inflation target is more backward looking, and wage growth stickiness likely reflects the rise in the national minimum wage; consequently, languishing consumption should weigh on inflation over the rest of this year and the next. We expect the BoE to ease monetary policy only modestly this year but accelerate cuts into 2025.

The result of the UK election is likely to induce some sentiment stability given reduced uncertainty and a stable government. At the same time, the change of leadership should not impact the fiscal trajectory, at least over the next year or so, given Labour's pledge to stick to the debt reduction target. Consequently, the UK is set for a fiscal tightening of around 1.5 per cent of GDP in 2024 and another 0.5 per cent in 2025. Nonetheless, the increase in budget deficit during the pandemic years is likely to maintain bond supply high and fiscal deficits will remain in place for a number of years.

Figure 14. **UK**



Note: GDP calendar year growth; Consumer Price Index (CPI) Q4/Q4; Policy Rate Q4.
Source: Aviva Investors, Bloomberg as at 30 June 2024.

At the same time, steps to rebuild some of the (trade) ties with the EU should be seen as positive, both in terms of output and price growth. Nonetheless, the path to restoring growth passes through higher investment, stronger productivity growth and addressing skill mis-matches in the labour market: these require well-thought-out structural reforms and careful implementation aimed at raising private investment confidence.

Household consumption remains anaemic; the BoE is likely to ease policy in H2 24 and accelerate the cutting cycle into 2025

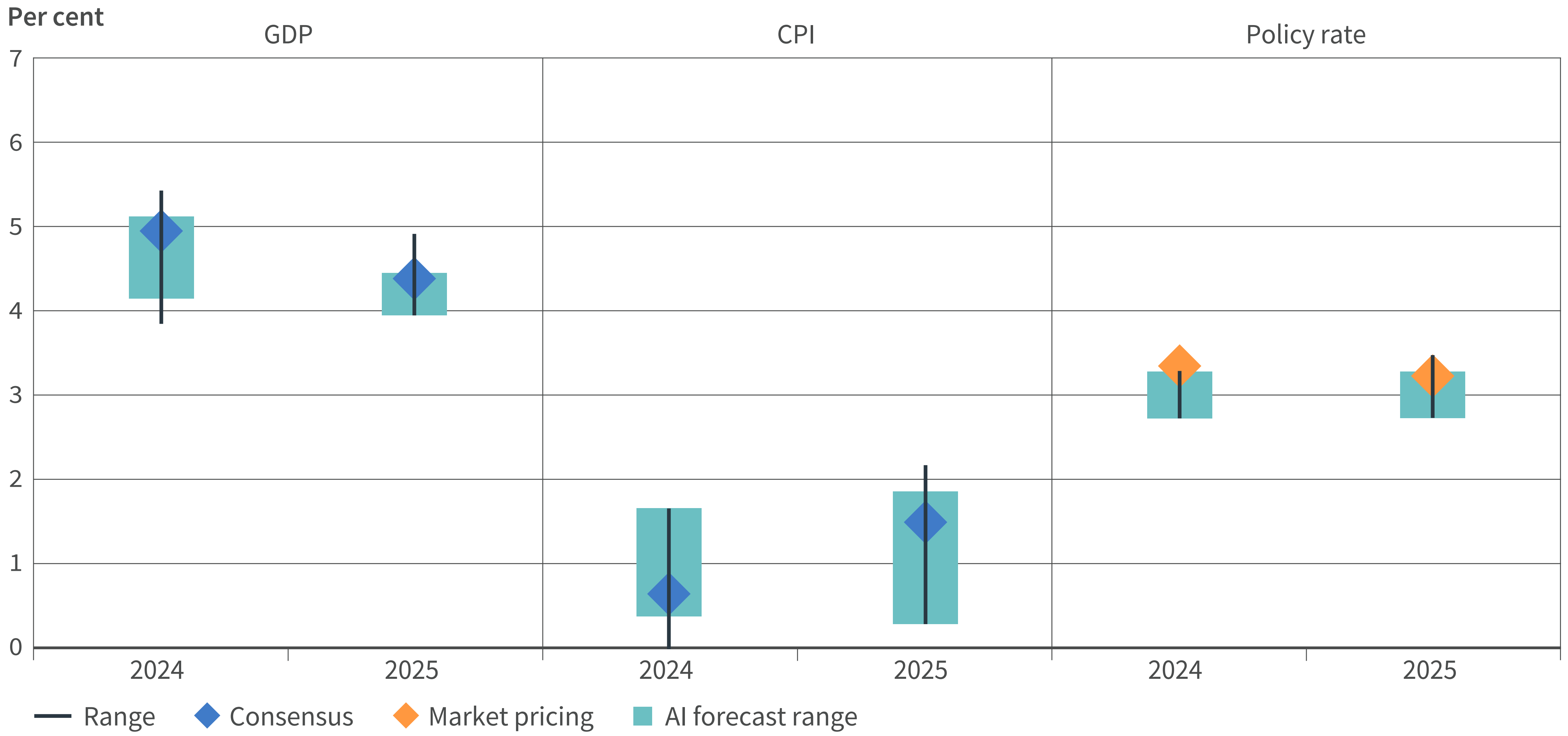
China

China's output this year is expected to slow slightly, as industrial production and exports remain strong. GDP should be close to the "around 5 per cent" target range announced by Premier Li Qiang in the annual NPC meeting, despite the hangover from the property depression, which will continue to depress investment and consumption for many years. Growth will continue to trend lower in years ahead (Figure 15), particularly if protectionist measures in the EU and the US take a toll. However the biggest challenges are internal.

The Five "D"s of demographics, debt, decoupling/deglobalisation, deflation and stern Xi Jinping dogma remain in place. With an ageing population that is declining by 2 million per year and barely any immigration, the labour force continues to shrink and will be a drag on growth and demand, while putting pressure on the state due to spiralling dependency ratios. Deflation is damaging to highly indebted households and corporates, increasing their burden in real terms, even as the People's Bank of China keeps repo rates close to 2 per cent, and cut the LPR to around 3 per cent. With CPI around zero and PPI negative due to overproduction in manufacturing, real rates are simply too high. Obsession with currency stability and competitiveness limits aggressive rate cuts or QE. Despite the huge trade surplus, there is likely to be a bias towards CNY weakness as capital outflows are immense too, even before potential trade and tariff threats reemerge in 2025.

Whatever the outcome of the US election, trade and geopolitical tensions are set to increase, and tariffs, sanctions, and China's countermeasures are likely to escalate too. The US, EU and UK are all concerned about China's alleged malfeasance and overproduction, and worried about unfair competition from solar panels to EVs, and security problems from TikTok to 5G and other tech equipment; closer neighbours such as Japan, Korea, Australia and the Philippines are managing an increasingly fraught relationship. Taiwan looms large but is set to remain constructively ambiguous, while China's alliance with Russia has further damaged its relationships with the West. Finally, while underplayed by many economic analysts, President Xi's autocratic rule and emphasis on security and CCP dominance is arguably negative for private business confidence and hence productive investment; SOEs continue to be as highly subsidised as they are inefficient allocators of capital.

Figure 15. **China**



Note: GDP calendar year growth; Consumer Price Index (CPI) Q4/Q4; Policy Rate Q4.
Source: Aviva Investors, Bloomberg as at 30 June 2024.

Growth will continue to trend lower in years ahead, particularly if protectionist measures in the EU and the US take a toll

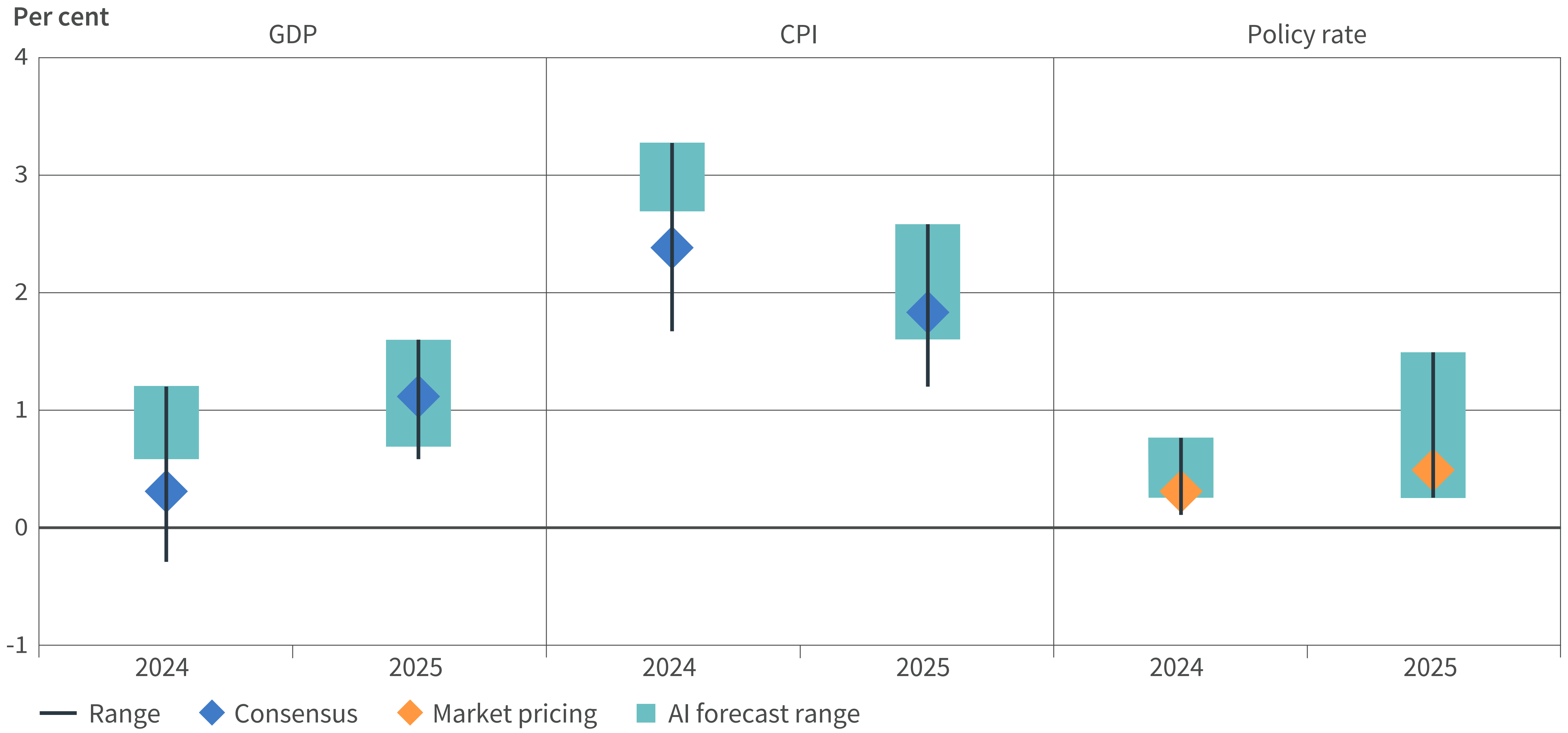
Japan

The focus for Japan will be on BoJ policy and the currency in the second half of the year. Intervention in foreign exchange has again proved ineffectual, but has delayed the urgency for rate hikes as inflation abated slightly, and the JPY stayed below ¥160. Pressures have re-emerged on the yen, and domestic removal of subsidies has pushed inflation back towards 3 per cent, with wages also growing enough to make such gains sustainable if firms have pricing power. Rapid rate hikes or huge selloffs in JGBs are unlikely – QE will always remain an option to stem volatility – but having exited negative rates and signalled a large tapering of QE soon, we expect that the path for yields is steadily higher. JGB yields should, over time, exceed market pricing and will be unlikely to be stemmed by lifers or other locals, who have no appetite to catch a falling market even if it isn't a "falling knife". As with SVB in the US there will be some strains for banks, insurers, and those firms with FX exposure as rates rise, but these are offset by the positive impacts of exiting from chronic deflation and the decades-long liquidity trap, in our view.

Growth remains solid, albeit noisy, and production and manufacturing should turn up with the global cycle bottoming; exports and tourism should also help GDP increase at a 1 per cent rate or faster in the medium term, although 2024's growth may be close to zero after a strong 2023 (Figure 16). The unemployment rate is very low and participation rates high, explaining the wage pressure and sustaining demand for services in spite of a rapidly falling and ageing population. The government has set out plans for a medium-term consolidation, but is vague and unambitious, and has been sharply criticised by the IMF, which wants tax rises to lower debt/GDP. This is unlikely ahead of a leadership election and an eventual general election, which must be held before November 2025.

Production and manufacturing should turn up with the global cycle bottoming; exports and tourism should also help GDP increase at a 1 per cent rate or faster in the medium term

Figure 16. **Japan**



Note: GDP calendar year growth; Consumer Price Index (CPI) Q4/Q4; Policy Rate Q4.
Source: Aviva Investors, Bloomberg as at 30 June 2024.

Canada

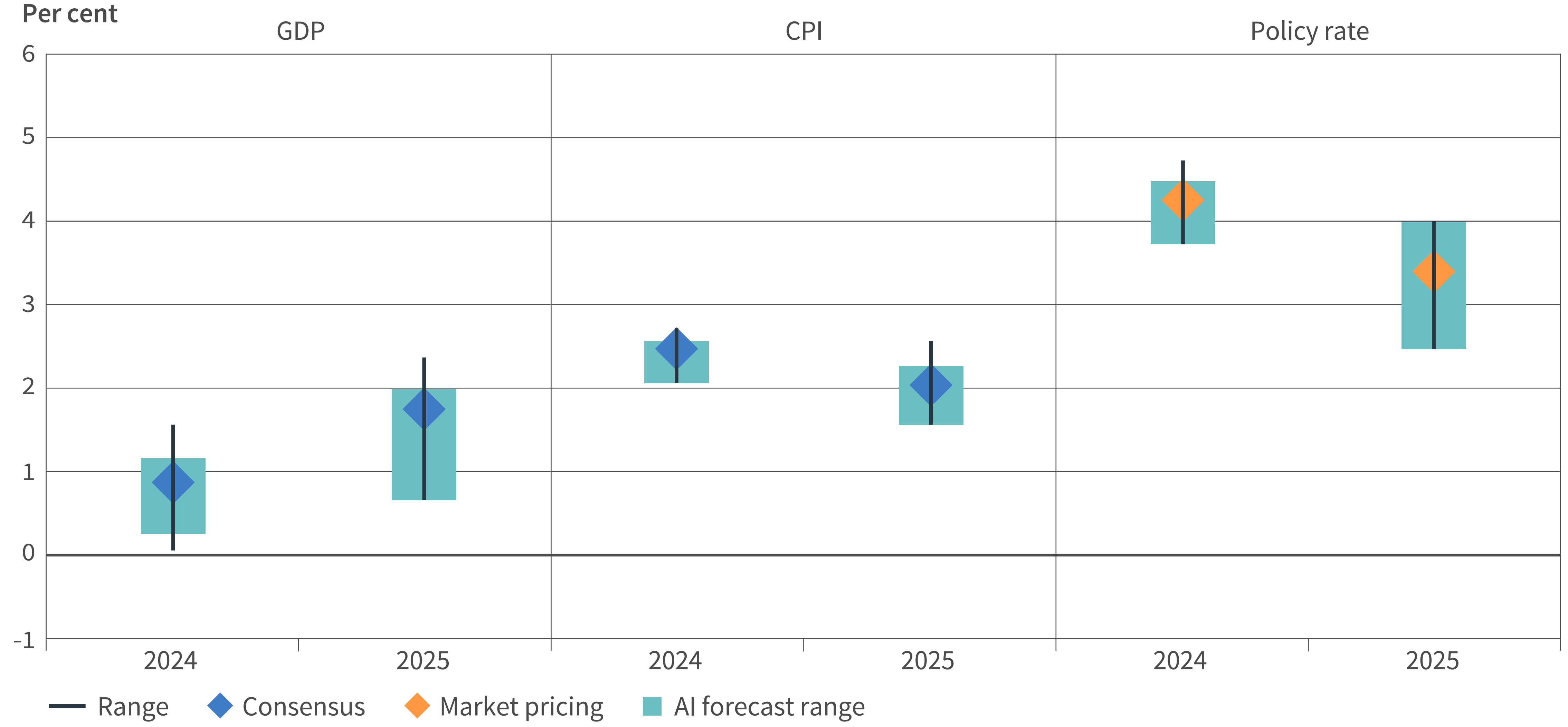
In the first four months of 2024, inflation in Canada has consistently surprised to the downside, printing at a monthly rate compliant with that of the Bank of Canada's target. After having been on hold for nearly 11 months, the BoC lowered its policy rate to 4.75 per cent in June, with the governing council signalled a cautious but growing belief in the current disinflationary trend. Whilst the broad-based nature of May's upside surprise in inflation has given some cause for concern, we believe the case for continued disinflation is still intact.

The labour market has continued to loosen. Some measures of tightness are now below pre-pandemic levels whilst the unemployment rate has now risen over 1.1 percentage points to 6.13 per cent since January 2023. Whilst it may be a gradual process, this labour market slack will weigh upon wages and the domestic, "stickier" services inflation components. Moreover, inflation expectations have continued to recede, which should dampen concerns regarding the potential for feedback loops arising from stubbornly high wage growth.

Real GDP growth during Q1 2024 in Canada was 1.7 per cent Q/Q. Whilst an improvement upon 2023's lacklustre pace, this was below both consensus's and the BoC's own projections, with the latter determining that the economy was a state of "excess supply" as of the first quarter. Moreover, given the elevated levels of both household debt relative to incomes and the interest rates households face on new loans, the ongoing mortgage reset represents a sizeable downside growth risk.

Monetary policy, as always, acts with a lag – today's inflation reflects yesterday's growth. Thus, Canada's economy being in excess supply as recently as the first quarter, whilst broad inflation expectations remain broadly anchored, reassures us that the BoC can continue to ease policy in an orderly fashion (Figure 17), without forsaking the progress made on inflation.

Figure 17. **Canada**



Note: GDP calendar year growth; Consumer Price Index (CPI) Q4/Q4; Policy Rate Q4.
Source: Aviva Investors, Bloomberg as at 30 June 2024.

> ***Whilst the broad-based nature of May's upside surprise in inflation has given some cause for concern, we believe the case for continued disinflation is still intact***

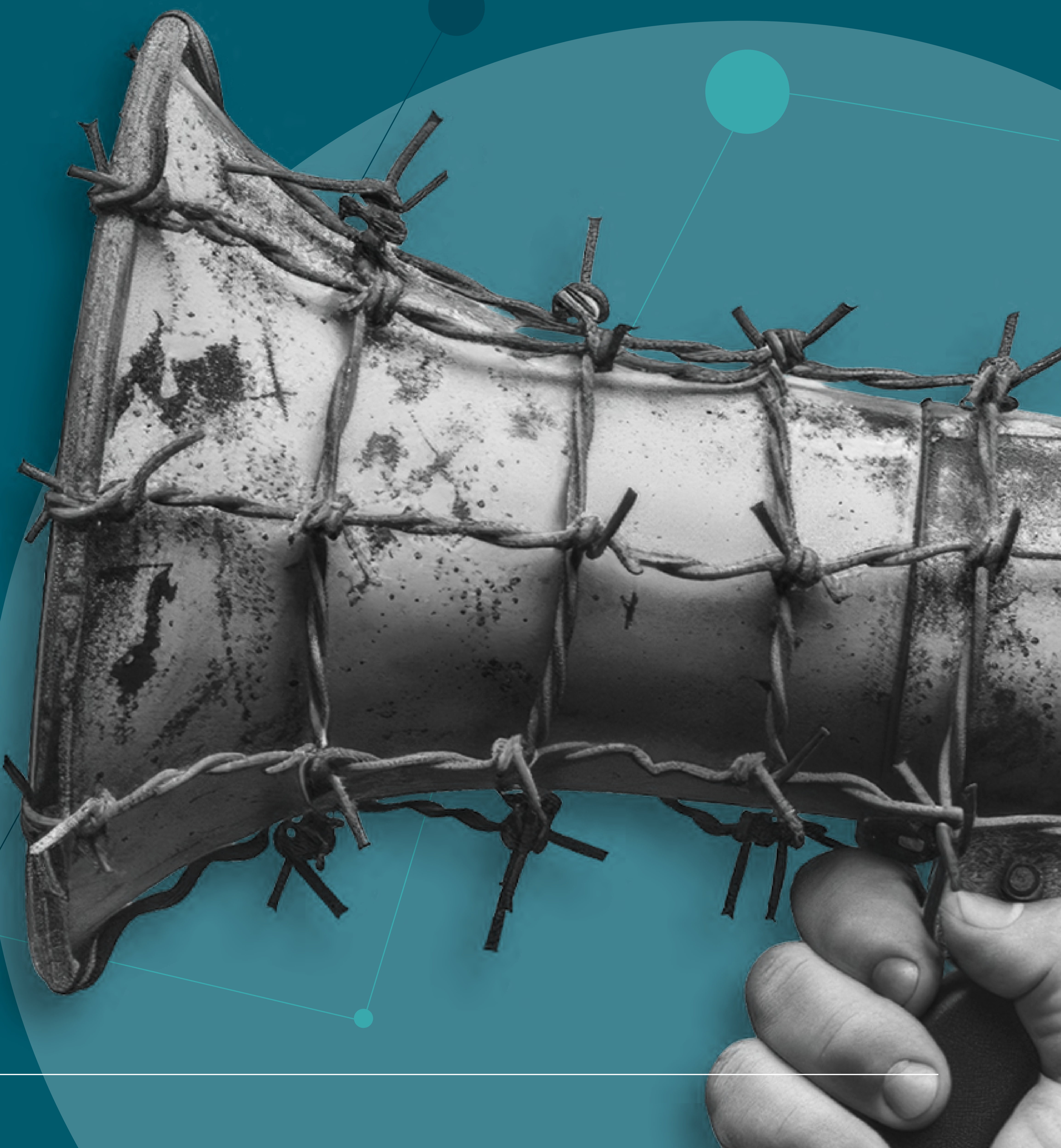
Global market outlook and asset allocation

We remain constructive in equities, but the pace of gains is likely to moderate.

Disinflation remains at play but pace has slowed, suggesting yields will trade at only slightly lower ranges; yield curves should steepen; absent political disturbance EUR spreads have room to widen.

Investment grade and high-yield spreads should remain at tight levels but the path to excess returns is narrower.

We have turned somewhat USD-bearish, but later, in the run-up to the US elections, risks are skewed to dollar strength resuming due to potential rhetoric on increased trade barriers.



Global market outlook

In the second quarter, most major asset classes continued their prior quarter trend amidst resilient economic growth: global equities started the quarter with a c.5 per cent correction in April but quickly resumed an upwards trend. Europe started the quarter outperforming during the market correction but reversed sharply after the French election announcement to end the quarter as a significant underperformer. In EM we saw a similar trend, outperformance in April followed by a reversal in the last two months (Figure 18). Despite wide ranges in yields due to an initial inflation scare that waned later in the quarter, bond prices finished Q2 with relatively small changes relative to Q1; credit spreads widened slightly but remain near two-year tights. Commodities rose further, led higher by metal prices due to resilient global activity. The trade-weighted USD appreciated but almost exclusively due to continued and large yen depreciation.

In the second quarter, most major asset classes continued their prior quarter trend amidst resilient economic growth

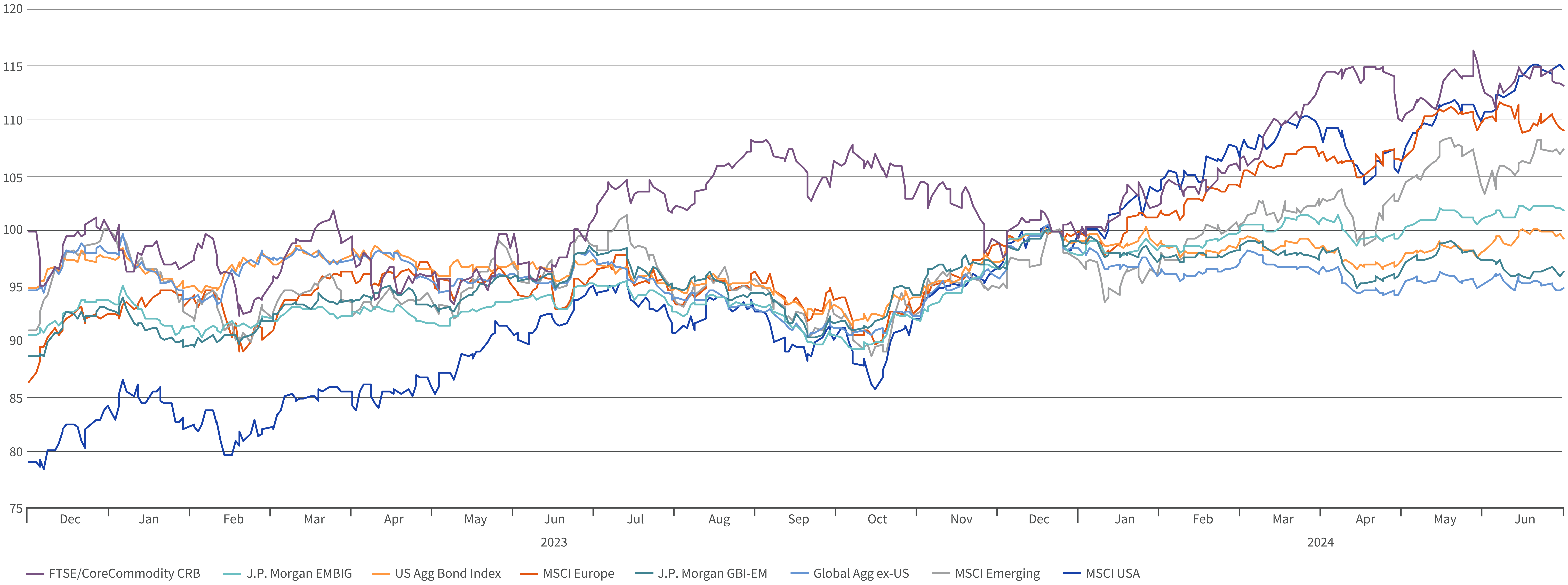
Looking into the third quarter of the year:

- We remain constructive in equities. The pace of equity gains is likely to moderate from here, in line with the US economy slowing, but US and global growth are still resilient. As we highlighted before, growth has been the driver of the equity rally, not rate cuts. Hence the key is that corporate earnings growth remains robust and profit margins continue to show resilience. While that is the case, the core of the investment case for equities remains in place.
- Across regions the central question is whether US leadership can continue despite challenging valuations or if the broadening of equity markets will accelerate and favour regions outside the US. European growth is recovering and after sharp downgrades in late 2023, European earnings have bounced back and are now getting upgrades. This suggests a catch up to US performance; however, political turbulence has added risk premia and uncertainty to European markets and unless that uncertainty is reduced/resolved European equities could miss the cyclical opportunity to regain lost ground relative to the US.
- The disinflation theme remains at play but has slowed, suggesting that yields will trade only slightly lower but still within ranges: absent political disturbances, we think it likely that European government spreads (mostly vs the UK and, less so, vs the US) could widen due to the European cyclical recovery. Curves should steepen.
- Both investment grade and high-yield spreads should remain at tight levels, supported by lower supply in Q3 compared to previous years, and credit metrics that are stable or improving. Defaults and downgrades are at around average levels and likely to stay low, as financial conditions are not particularly tight and have steadied.
- Finally, we have turned somewhat bearish on the USD due to evidence that the US economy is slowing at a time when Europe is recovering. However, later in the run up to the US elections, risks are skewed to dollar upside, due to potential rhetoric on increased trade frictions.

As always, there are several risks to these views: disinflation can slow further (or stop) sending rates higher for (even) longer; this could put more pressure on US activity and global growth, resulting in higher volatility (which is still very low) and risk asset weakness. In addition, our constructive European view could be seriously challenged if political risks flare up due to populist and proliferate fiscal policies, causing political paralysis in the EU and disrupting (or even reversing) the cyclical recovery. China's industrial, housing and monetary policies will also remain of focus, given spillovers to international politics and world trade.

Figure 18. **Most major asset trends continued in Q2 24**

All series rebased (100) at the end of 2023



Source: Aviva Investors, Macrobond as at 30 June 2024.

Equities: Central investment case remains in place, but expect pace to moderate

Global equities are up almost 30 per cent since the lows of October last year. While we expect the pace of gains to slow from here, in line with the slowdown in the US economic growth described above, we remain constructive on equities. Earnings continue to show resilience and PMIs provide further support. We reiterate that the equities rally is being driven by growth, rather than rates, in our view. Hence, resilient but decelerating growth is likely to translate into a continuation of the upside trend but at a slower pace.

The rates-driven correction in April proved to be temporary, in line with our expectations and by and large markets have behaved in line with our positive equity view this year. What has challenged our view has been the regional breakdown of performance. European stocks outperformed their US counterparts by c.8 per cent between late January and late April but European outperformance has reversed sharply since the European parliament elections and the announcement of snap elections in France. European stocks are now down c.6 per cent relative to the US year to date.

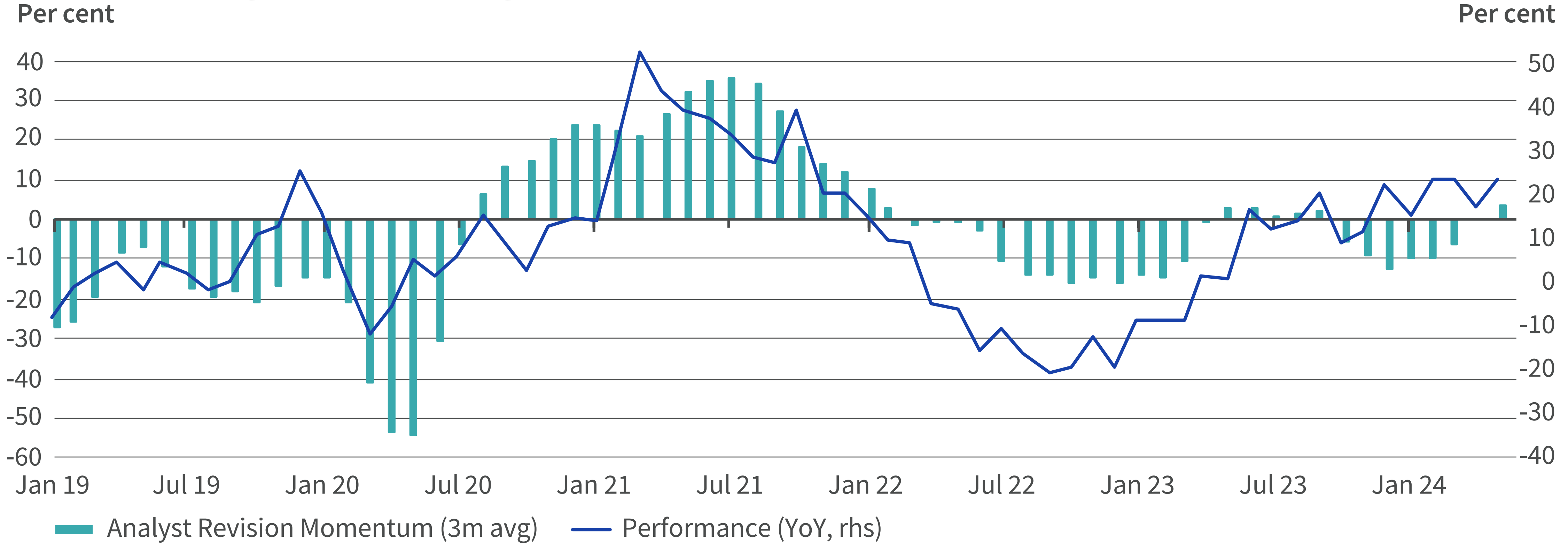
Going forward, the base case remains for equities to show upside. Yet across many regions, the level of uncertainty has increased. While on balance the base case is for Europe to regain lost ground as politically driven volatility decreases; it is also clear that European risk has risen and will likely stay elevated. Outcomes are more binary now, with a greater number of political "unknown unknowns" adding to European stock volatility and risk-premia. In Asia, geopolitical flare-ups continue, and the US election may eventually have market implications.

Bull market correction gives way to continuation

After a c.5 per cent correction in April, equity markets largely resumed trend. The MSCI World Index made new highs by mid-May and is now up c.8 per cent since the April lows.

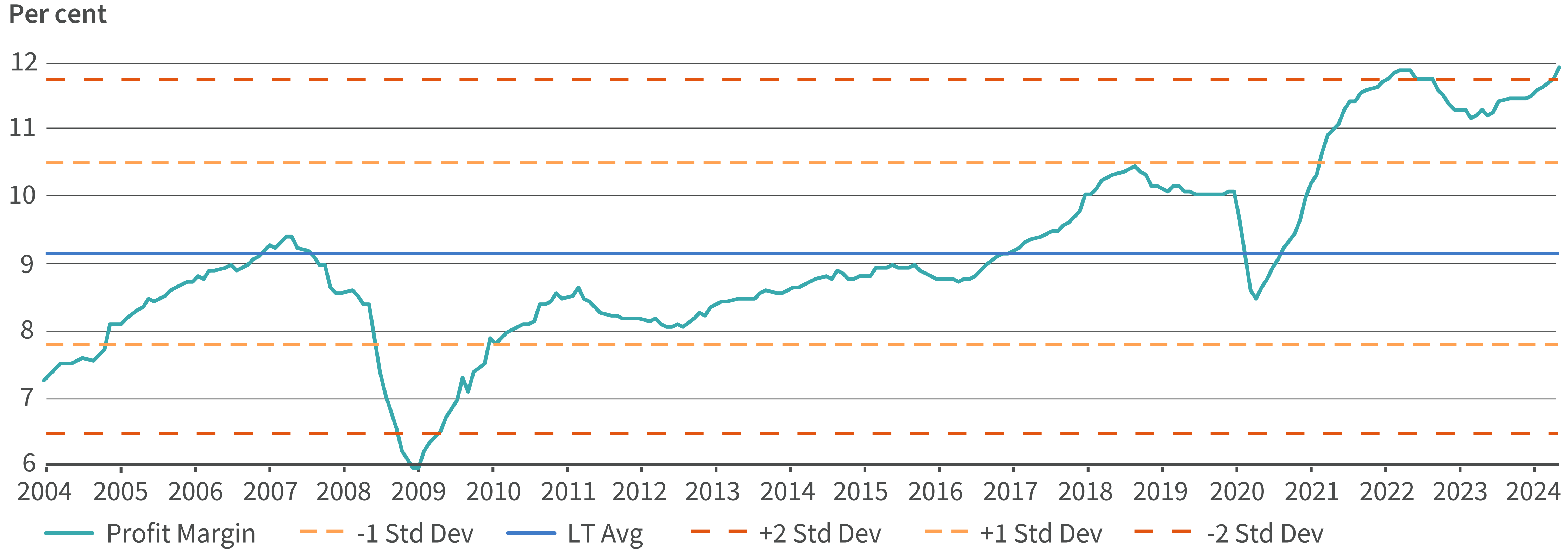
While the catalyst for the April correction was largely yields (10y treasury yields jumped c.45bps in the first half of April), the resumption of trend has been led mainly by growth and fundamentals. Earnings continued to trend higher, analyst revisions moved from downgrades to upgrades in May and June (Figure 19) and margins continued to expand, recovering back to the highs of 2022 again (Figure 20).

Figure 19. **MSCI World Analyst Revisions vs Performance – Analysts shifted from downgrading MSCI World earnings up to April to upgrades since May 2024**



Source: Aviva Investors, Refinitiv as at 30 June 2024.

Figure 20. **MSCI World Profit Margins – Back to the highs**



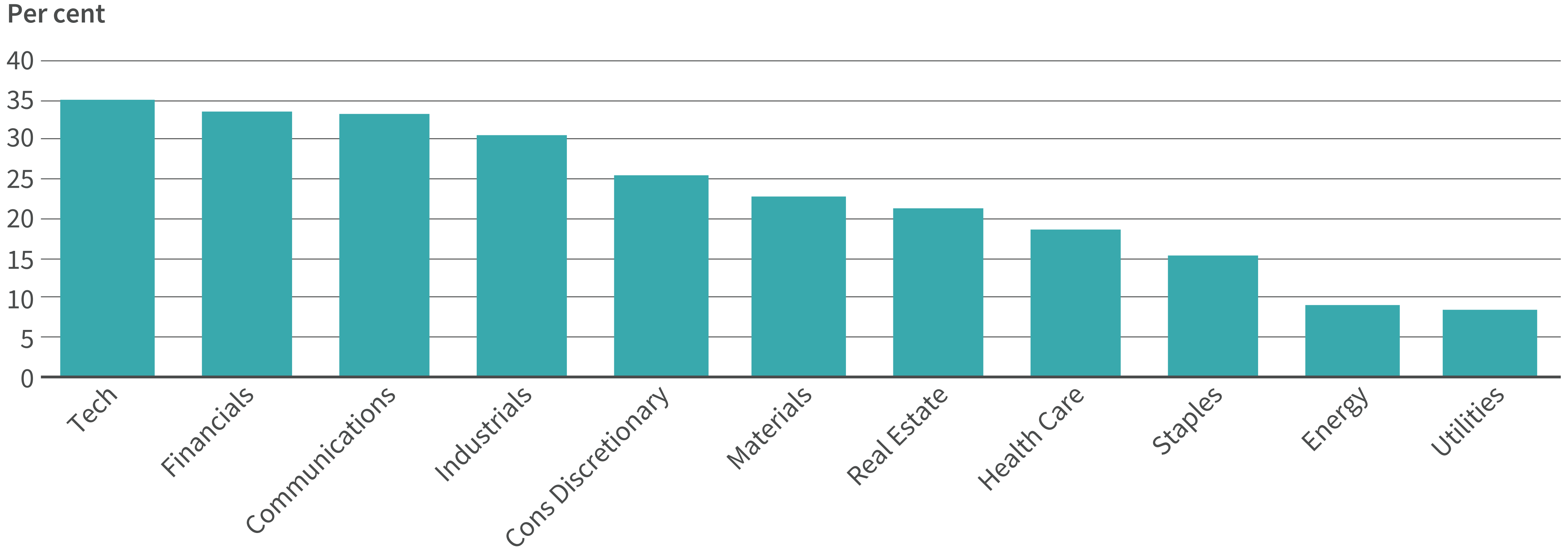
Source: Aviva Investors, Refinitiv as at 30 June 2024.

The composition of the rally after the bull market correction is also similar to the period before the correction. Tech leads in both periods (Figure 21 and Figure 21), while Communications firms (which include "Magnificent 7" names such as Alphabet and Meta) are also among the key contributors to performance in both periods. Commodities (especially Energy) and defensives broadly seem to lag. The key differences appear to be Industrials and Financials, which were leaders in the period up to the correction and are now lagging since the correction.

Going forward, we remain constructive on equities and see further upside, just at a slower pace. Across regions, we maintain a preference for the developed markets over emerging markets and maintain overweights in the US, Europe and Japan. We continue to see opportunities in European equities, although outcomes are more binary and driven largely by political risk. And across sectors we maintain a preference for cyclicals with a few defensive hedges such as Utilities and Pharma. We see key opportunities precisely in some of the sectors highlighted above which were leaders prior to the correction but have so far lagged since, such as Banks and Industrials.

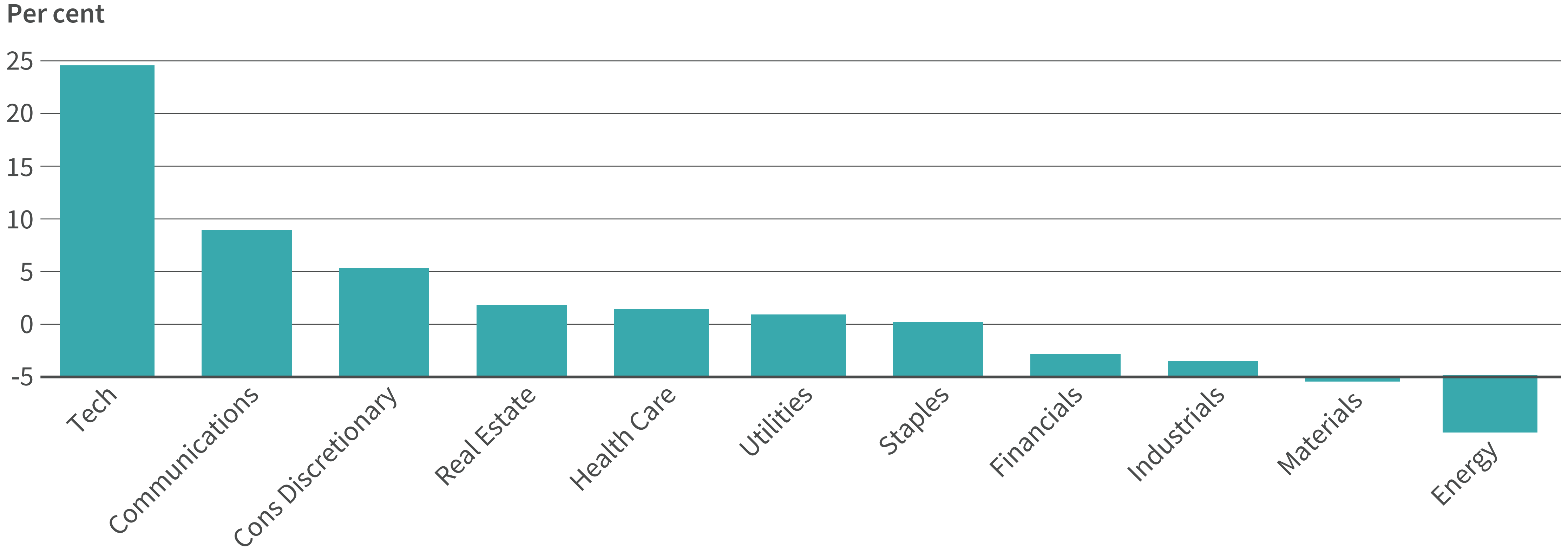
> ***Across regions, we maintain a preference for the developed markets over emerging markets and maintain overweights in the US, Europe and Japan***

Figure 21. **Performance pre-April correction (27 Oct 23 to 21 Mar 24)**



Source: Aviva Investors, Refinitiv as at 30 June 2024.

Figure 22. **Performance post-April correction (19 Apr 24 to 01 Jul 24)**



Source: Aviva Investors, Refinitiv as at 30 June 2024.

Rates: Slightly lower ranges but no imminent large decline in yields; absent political disturbances, euro rates have room to widen

Q2 was a rollercoaster quarter for rates: initial disappointing inflation readings (mostly in the US, Australia and to a lesser extent in the UK) precipitated a repricing in rates/yields higher, with US10Y yield hitting 4.73 per cent in April; however, a late-quarter revival in the disinflation theme triggered a renewed leg lower in yields, with the US10Y ending the period at 4.4 per cent. Similar patterns were seen in other DM yields, with the only notable exception Japan, as the 10Y rose above 1 per cent, for the first time since 2012. The US curve (10-2s) ended the quarter at similar levels to March, while curves in the euro area and the UK marginally steepened.

Our assessment is that the disinflation process remains at play but has appreciably slowed during 2024; and while central banks will ease policy (at varying degrees) as labour markets loosen and unemployment rises, rates are likely to end up being meaningfully higher than pre-Covid levels. Wage growth in G3 economies is cooling but at a pace somewhat slower consistent with price stability. Although this likely reflects lagged responses to prior inflation (mostly relevant in the euro area), central banks cannot afford the risk of de-anchoring inflation expectations.

The Fed will likely begin its cutting cycle this year but there is a risk it will find it challenging to deliver the easing that the market has priced (c.150bps by 2025-end). The economy is slowing, but payroll gains remain robust; this may mean that markets price out the “US exceptionalism” premium but does not necessarily imply an aggressive cutting cycle. The BoE is rapidly approaching its first rate cut and we feel it will ease more than markets expect while the ECB, having cut rates in June, is likely to proceed more cautiously than priced due to pipeline wage growth pressure and a cyclical recovery in activity.

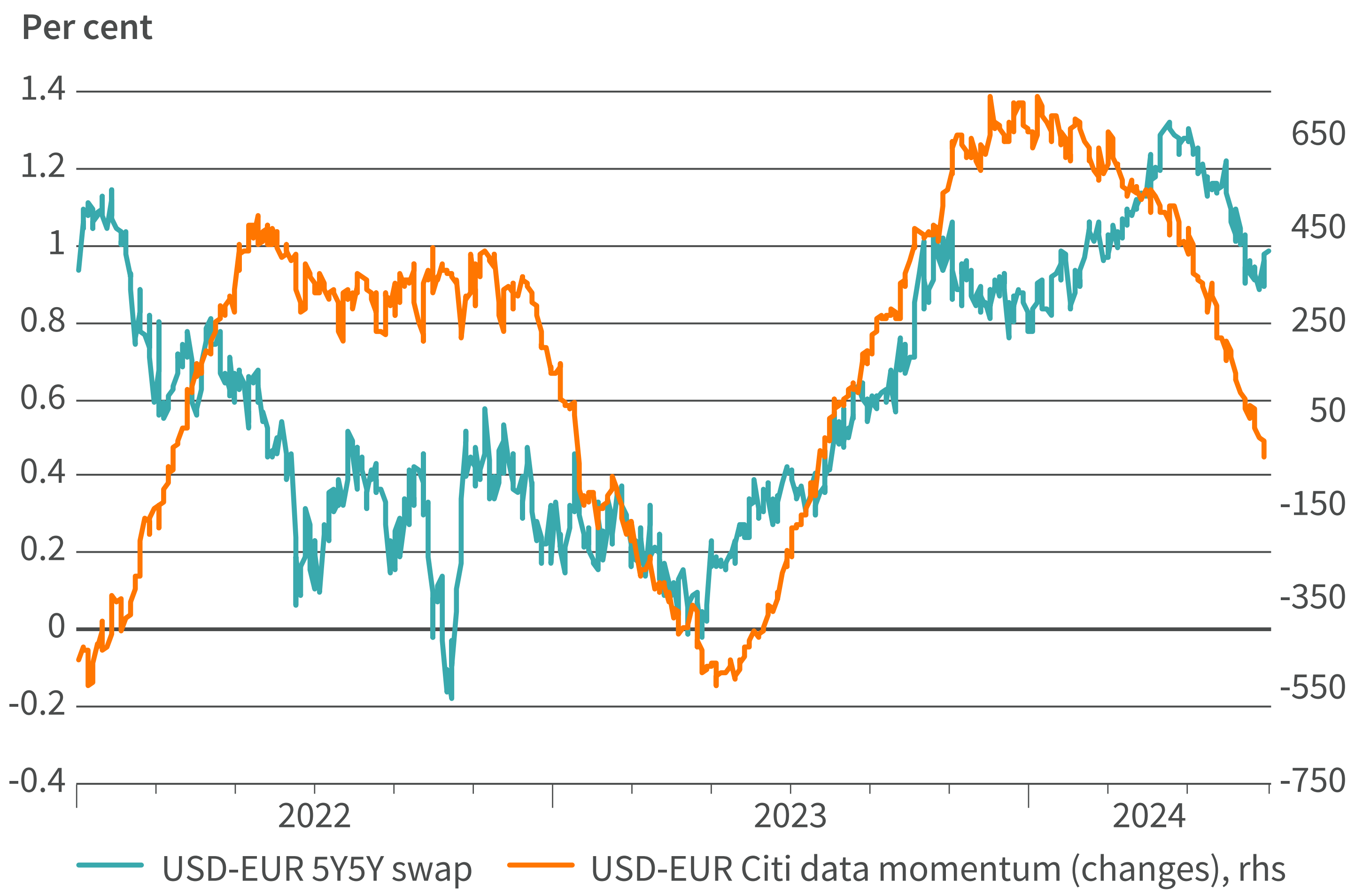
More specifically, we see four themes playing out in DM for the remainder of the year:

1. **Longer term yields, mostly in the US, trading in a (slightly) lower range:** the range is likely to be lower on account of the US growth slowdown but, equally, longer term yields should maintain a strong anchoring due to still healthy global growth and high fiscal deficits (at a time of near-full employment). There are two-sided risks to this view: a more abrupt slowdown or a US recession would weigh on yields and support bond prices; US elections and the possibility of higher budget deficits would, in contrast, propel yields higher; even stickier wage growth/inflation would have a similar impact, though this would be more evident at the short end of the curve.
2. **Several yield/swap spreads in G3 appear to either defy reasonable historical ranges and/or relative economic dynamics:** Despite the recent rebound in euro area activity, EUR-GBP 5Y5Y swap spreads are very low: over the last 15 years or so, only 2 per cent of “observations” have traded below current levels (see figures Figure 23 and Figure 24). There are technical reasons for the steeper UK curves (reduced LDI activity and insurance companies’ buy-out programmes) but we think there is value in being underweight 5Y Europe and overweight 5Y UK, given the economic trajectories and relative monetary policy outlook we expect. At the same time, and while we do not foresee an imminent US recession, we think relative economic dynamics are supportive of US-EUR swap spreads to compress further (e.g. in 5Y5Y). The clear risk to these views relates to political developments in Europe (France and, later, Germany) and risk premia; another risk is more persistence in US inflation (including US election risk and high fiscal deficit) and/or weakness in Eurozone price growth.
3. **We still expect yield curves to steepen:** in the US, this process was interrupted in the last few months as short-end rates/yields repriced higher due to sticky inflation. However, market pricing is more pragmatic now, hence curve developments should be more aligned with historical precedents of activity slowdown and the Fed cutting rates; that said, this may be a bumpy trade. UK curve steepening also looks more interesting now, as spot and forward curves have been closing the big divergence seen in late 2023 and early 2024. The BoE starting its easing cycle in the next couple of months should act as a catalyst for the curve to steepen further. We expect curves to steepen in the euro area as well.
4. **Finally, we maintain the view that Japanese bonds are expensive:** inflation in Japan seems to have turned the corner, as wage growth is likely to trigger a more sustainable push to price growth. BoJ rhetoric is moving along the same lines, and the central bank is likely to announce QT soon and hike interest rates further out. That said, this is very likely a gradual process and requires patience. Aside from inflation risks to this view, the decade-long mindset around deflation could delay tightening; recent BoJ communication, however, suggests that this is a low-likelihood event.

Our assessment is that the disinflation process remains at play but has appreciably slowed during 2024

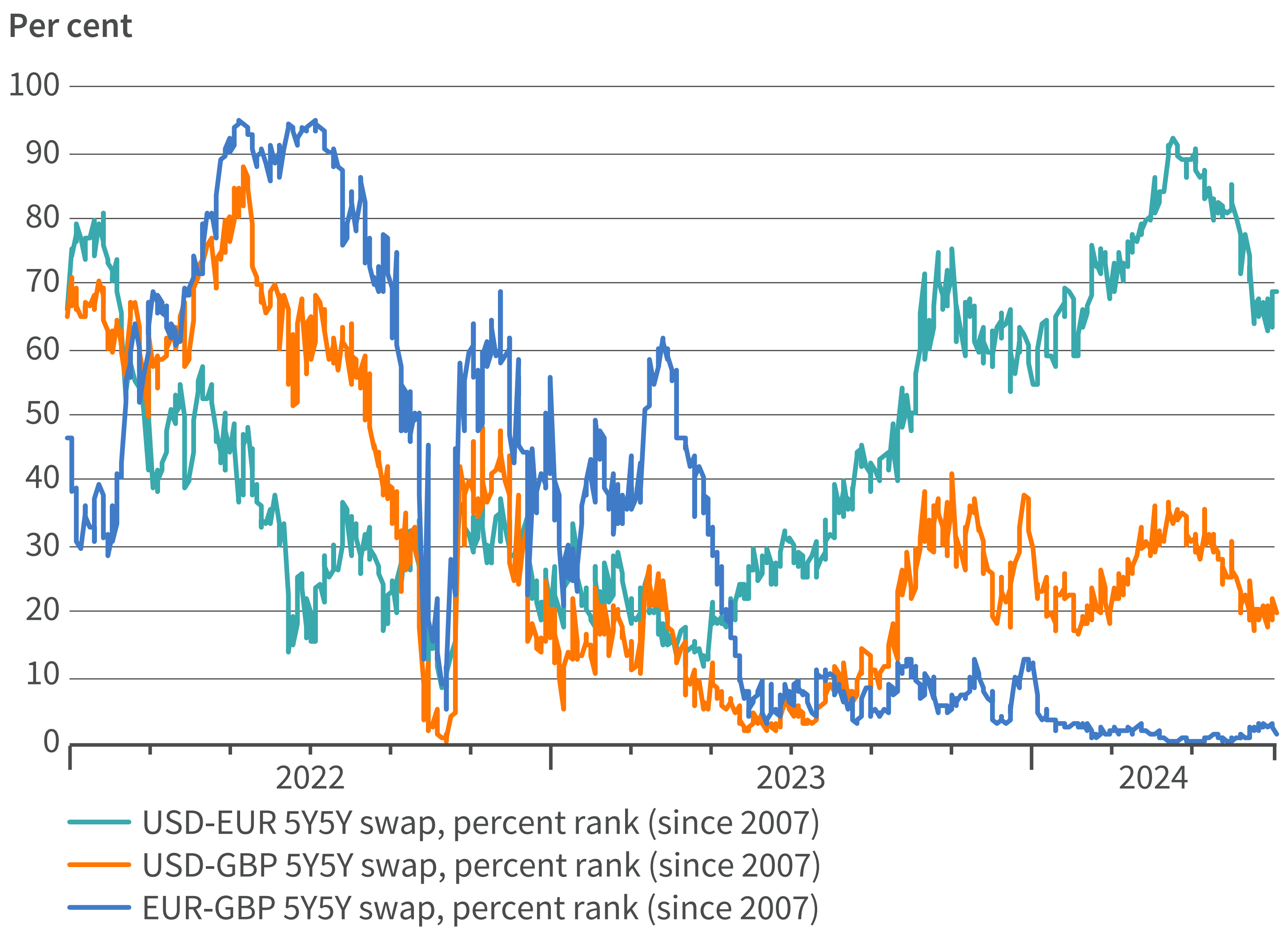
As in developed markets, fiscal worries, election risks and slowing of disinflation has led to some volatility across emerging market bonds (and currencies). EM central banks remain in rate-cutting mode, but have slowed the pace and grown more cautious, especially where currency pressures have emerged (e.g. South Africa, Indonesia, Brazil). Some may soon go on hold, if not already. The carry unwind through Q2 was exacerbated by the election outcome in Mexico, and belated reaction to lack of commitment on deficit reduction in Brazil and Indonesia. While yields remain far higher than in DM across all regions, inflation is higher too, with labour markets tight and FX still prone to depreciation. As always, there is plenty of heterogeneity; India remains an attractive destination for capital with fast growth and index inclusion, and Prime Minister Modi may be more pragmatic after his election humbling; likewise, the ANC's loss of its majority in South Africa has resulted in a compromise with the more centrist opposition, leaving the feared populists and Marxists out in the cold. Looming over all of EM is the US election; under a Trump 2.0 outcome there could be huge tariffs on China, whose economy continues to struggle to generate growth, and which in turn has kept yields low – along with outflows pressuring the CNY. We expect that stress to build into year end, though certain countries like India, Turkey and Mexico could end up being beneficiaries of fragmentation and trade war/s – if they play their cards right (Figures Figure 23 and Figure 24).

Figure 23. **EUR spreads have room to widen vs the US...**



Source: Aviva Investors, Bloomberg as at 30 June 2024.

Figure 24. **...and vs the UK**



Source: Aviva Investors, Bloomberg as at 30 June 2024.

While yields remain far higher than in DM across all regions, inflation is higher too, with labour markets tight and FX still prone to depreciation

Credit: Narrow spreads, narrow path to excess returns

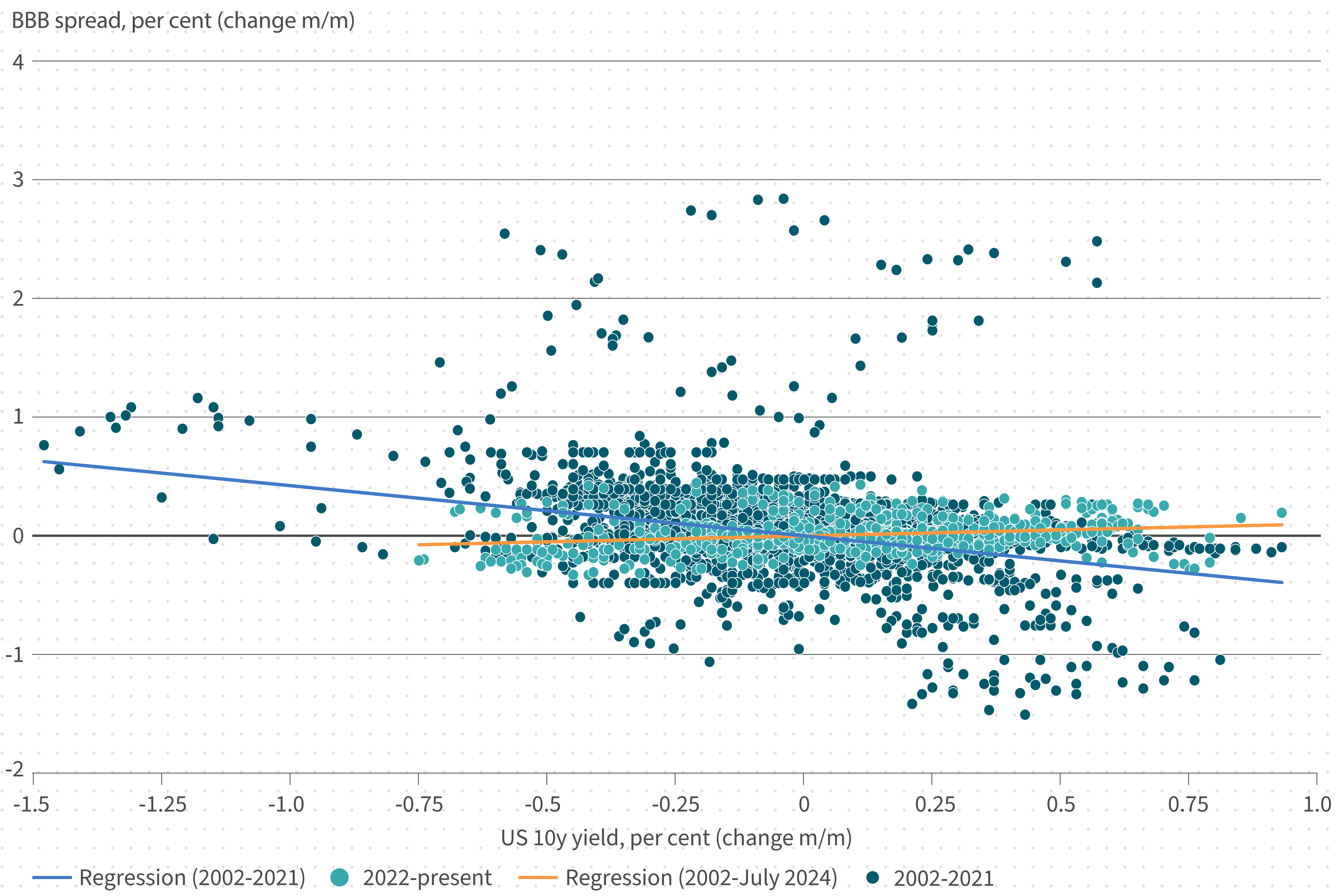
A combination of modestly tight monetary policy, very loose fiscal policy, and slow but solid growth continues to be a firm backdrop for credit in both Europe and the US, across most of the credit spectrum. As with equities, an earnings recovery is occurring even as the US slows, while in Europe rate cuts have already begun, which should help inflows. But a stable environment does not imply a compelling risk-adjusted return, because spreads are already rather tight.

Investment Grade (IG) yields of 3.8 per cent in euros and 5.5 per cent in dollars, with spreads only around 100bp over risk-free government bonds, are a challenge when cash and money markets give similar if not higher yields. H1 saw spreads tighten and then widen back slightly, in part as US, European and geopolitical risks have risen. After a 2-3 per cent expected annual default rate, High-yield spreads in the 300-350bp range will generate modest excess returns, and suffer less spread and rate volatility than IG, as long as hard landing risks are modest. Further pre-emptive rate cuts across the G10 would provide upside, easing financial conditions and improving risk appetite.

As with equities, the relationship between yields and bond spreads has shifted notably in recent years, although the future behaviour is unpredictable and not yet stable (Figure 25); this suggests a surge in yields, caused perhaps by China-US tariffs or other inflation surprises, or fiscal deficits crowding out other borrowers, are the main market risks, rather than credit fundamentals.

Further pre-emptive rate cuts across the G10 would provide upside, easing financial conditions and improving risk appetite

Figure 25. **The relationship between Treasury yields and credit spreads has changed**



Source: Aviva Investors, Bloomberg/Barclays, Macrobond as at 30 June 2024.

FX: pricing out of US exceptionalism?

Q2 was a mixed quarter for the US dollar: the Bloomberg USD index rose 1.9 per cent QoQ, but this was purely the result of further and substantial JPY depreciation. Bar the Yen and the Canadian dollar, the rest of the G10 complex either appreciated or managed to stay relatively unchanged against the USD. At the same time, EM currencies & carry FX trades performed poorly on average, although this was down to a number of idiosyncratic stories (e.g. in Brazil and Mexico) that more than offset the dollar factor.

In our last House View, we argued that we did not hold a bearish USD view while highlighting that the main risk/s to this related to US activity slowing and/or global growth being rerated higher. We still expect resilient US growth, but the economy is now slowing, while Eurozone growth is undergoing a cyclical recovery. With the Fed priced more fairly now for the next 12 months or so, and the trade-weighted USD overvalued by 5.5 per cent by our estimates (relative to global yield differentials – see Figure 26) we think dollar weakness can continue.

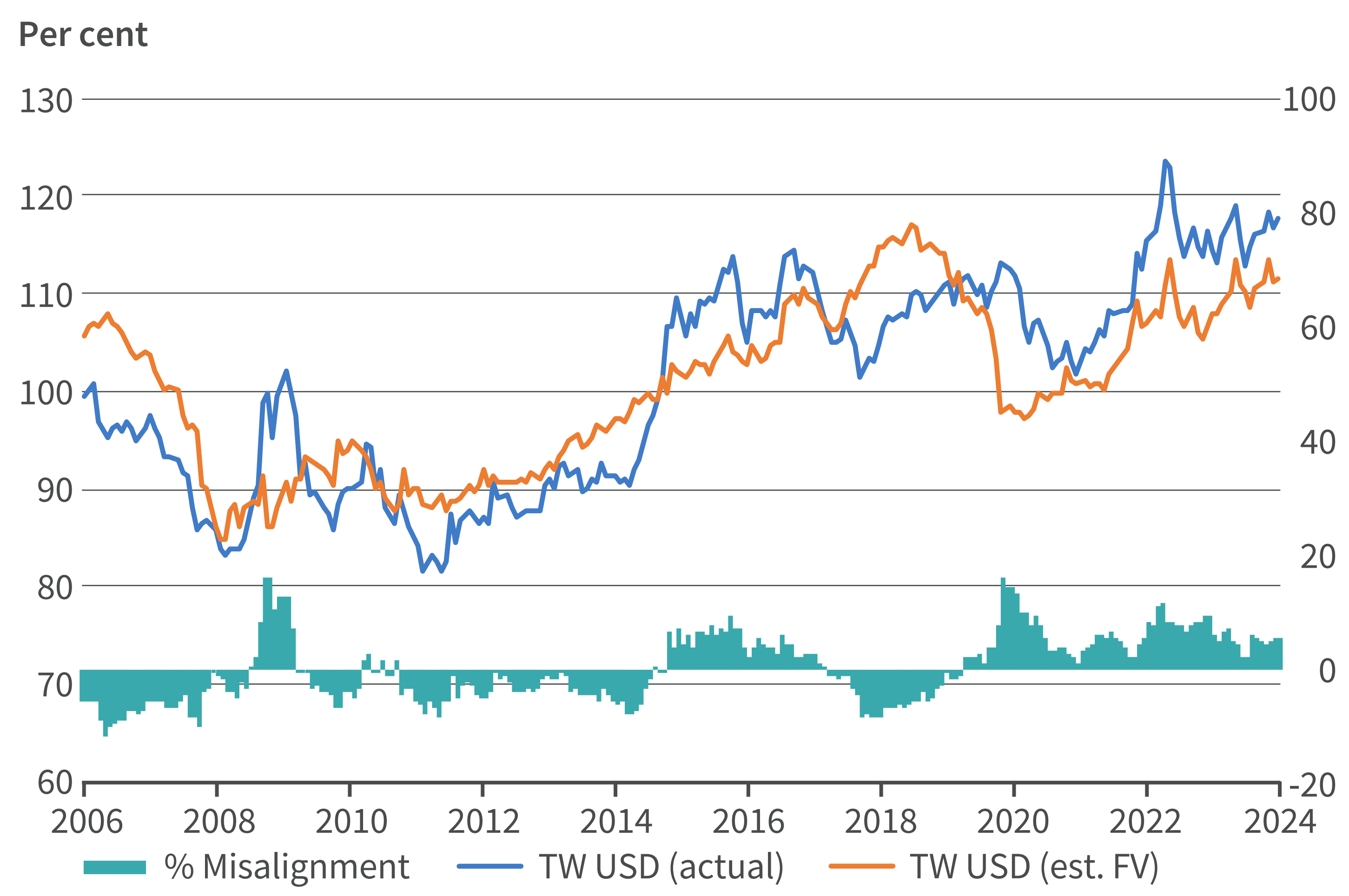
> *We still expect resilient US growth, but the economy is now slowing, while Eurozone growth is undergoing a cyclical recovery*

More specifically: (1) we believe the euro can extend the Apr-May gains on favourable cyclical dynamics; (2) GBP could benefit from a strong and stable government and USD weakness (see Figure 27) but the BoE signalling a more aggressive monetary policy easing might offset some or all of these tailwinds; (3) commodity currencies could still make some headway against the USD but gains might be capped due to the lack of fresh global growth impulses; (4) EM carry is likely to remain mixed on account of strong idiosyncratic stories that could keep obscuring the dollar-beta: among the high-carry complex our preference remains for Indian rupee as political uncertainty is past its peak, foreign flows should pick up (in part due to the inclusion of bonds in the GBI-EM index) and the currency remaining one of the most attractive carry-to-vol across FX. Finally, we have some bias for JPY appreciation, as we expect BoJ tightening (at a gradual pace) and further rises in longer term JPY yields; however, unfavourable carry will remain a strong headwind, making yen adjustment higher a gradual and, at times, choppy process.

That being said, dollar downside could be challenged later in the run-up to the US elections, depending on opinion polls and, crucially, on rhetoric around global trade and fiscal policies. Expectations of increased trade barriers could trigger the re-pricing lower of global growth and support the dollar via haven flows; similarly, expectations of even wider US fiscal deficits could trigger higher inflation expectations and higher US yields.

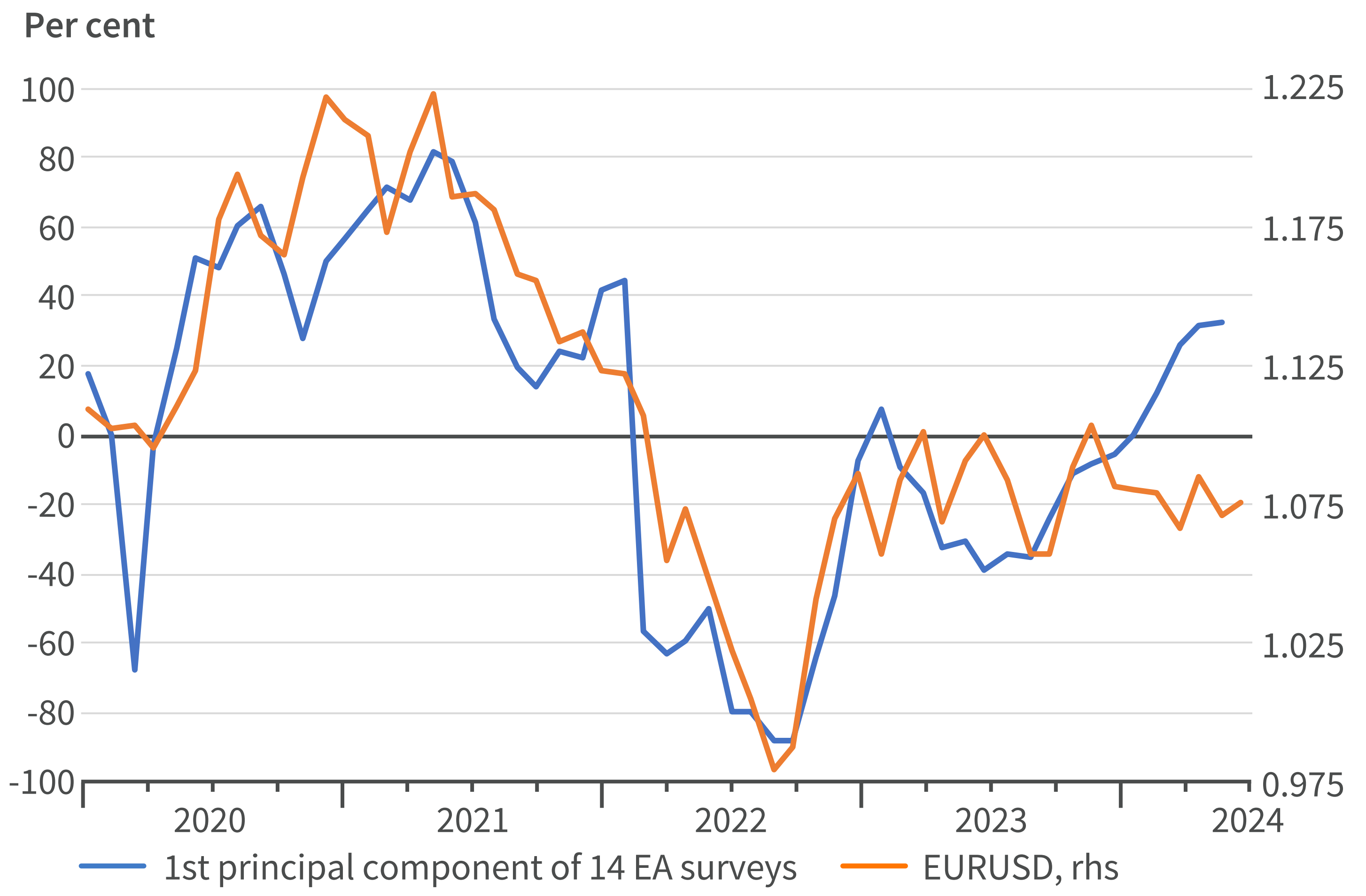
Lastly, the main risk to our positive euro view relates to political developments: France's national assembly election result avoided an outright majority of extreme policies but has raised fiscal risks at a time when the economy will have to comply with Excessive Deficit Procedure rules.

Figure 26. **Trade-Weighted USD overvalued by c.5 per cent**



Source: Aviva Investors, Bloomberg, Macrobond as at 30 June 2024.

Figure 27. **Euro area cyclical recovery a tailwind for the euro**



Source: Aviva Investors, Bloomberg, Macrobond as at 30 June 2024.

Figure 28. **Asset allocation**

Underweight ← → Overweight

	-5	-4	-3	-2	-1	0	1	2	3	4	5
Equities									3		
US									3		
Europe									3		
UK						0					
Japan								2			
Pacific Basin ex-Japan			-3								
Emerging Markets			-3								
Government bonds						0					
US						0					
UK								2			
Eurozone						0					
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			-3								
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 30 June 2024.

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

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

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

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