Aviva Investors

House View
Q4 2024

And they're off! But how far will rate cuts go, and with what impact?

AVIVA INVESTORS

Contents

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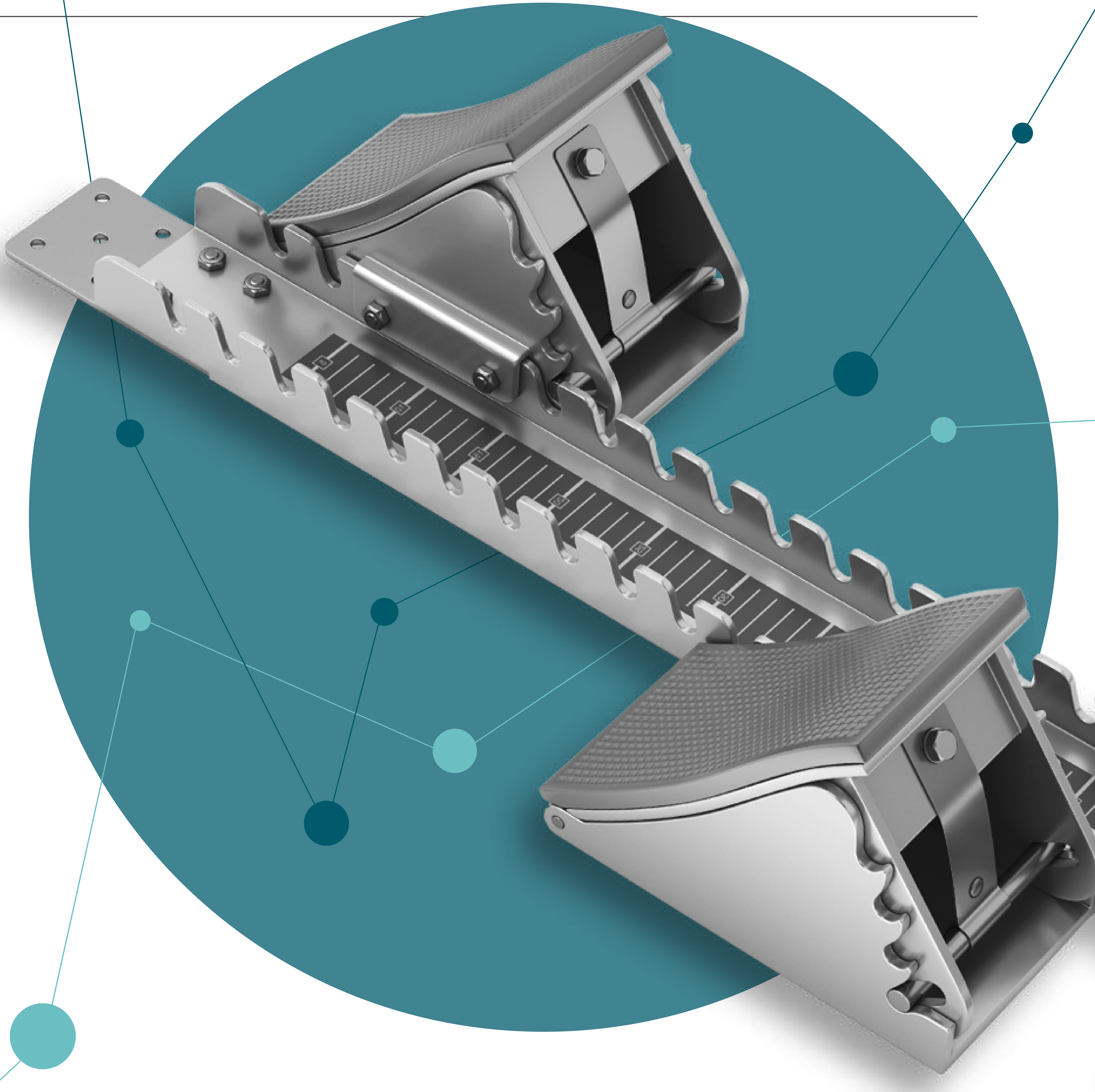
Executive summary

And they're off! But how far will rate cuts go, and with what impact?

- **Monetary restriction is being unwound, which will help complete a heterogeneous soft landing. Rate markets have already priced in fairly aggressive moves, leaving less room for bond and rate-sensitive equity sectors to outperform, but the dollar's weakness looks to remain.**
- **Growth has slowed; GDP will pick up slightly in Europe and Asia, and downshift from high rates in the US.**
- **Service sector inflation has been sticky, but underlying measures are slowly but surely approaching central banks' targets.**
- **Geopolitical risks and monetary adjustments have caused market turbulence, but without triggering systemic damage.**
- **China's economic problems and stimulus efforts, the US election, and the technology investment boom pose multifaceted upside and downside risks.**

Growth has held up as inflation and labour market pressures diminished, following the many disturbances of past years. The rate cutting gates opened earlier this year, but it was not until late in Q3 that the US Federal Reserve joined in, with an unusual 50 basis point reduction in the Fed Funds rate at September's meeting. Switzerland's SNB bolted out of the gates in March, and it, along with the ECB, Sweden's Riksbank, and Bank of Canada have cut multiple times. The Bank of England has taken it slow, while the RBA and several others have not yet seen fit to grease the wheels of financial conditions, even as growth has slowed everywhere. What are the reasons for this mostly synchronised but heterogeneous behaviour? How far and how fast will monetary easing run? And how much impact will lower rates have, if conditions are tight and economies slowing?

Many central banks have already commenced reducing their monetary restrictiveness



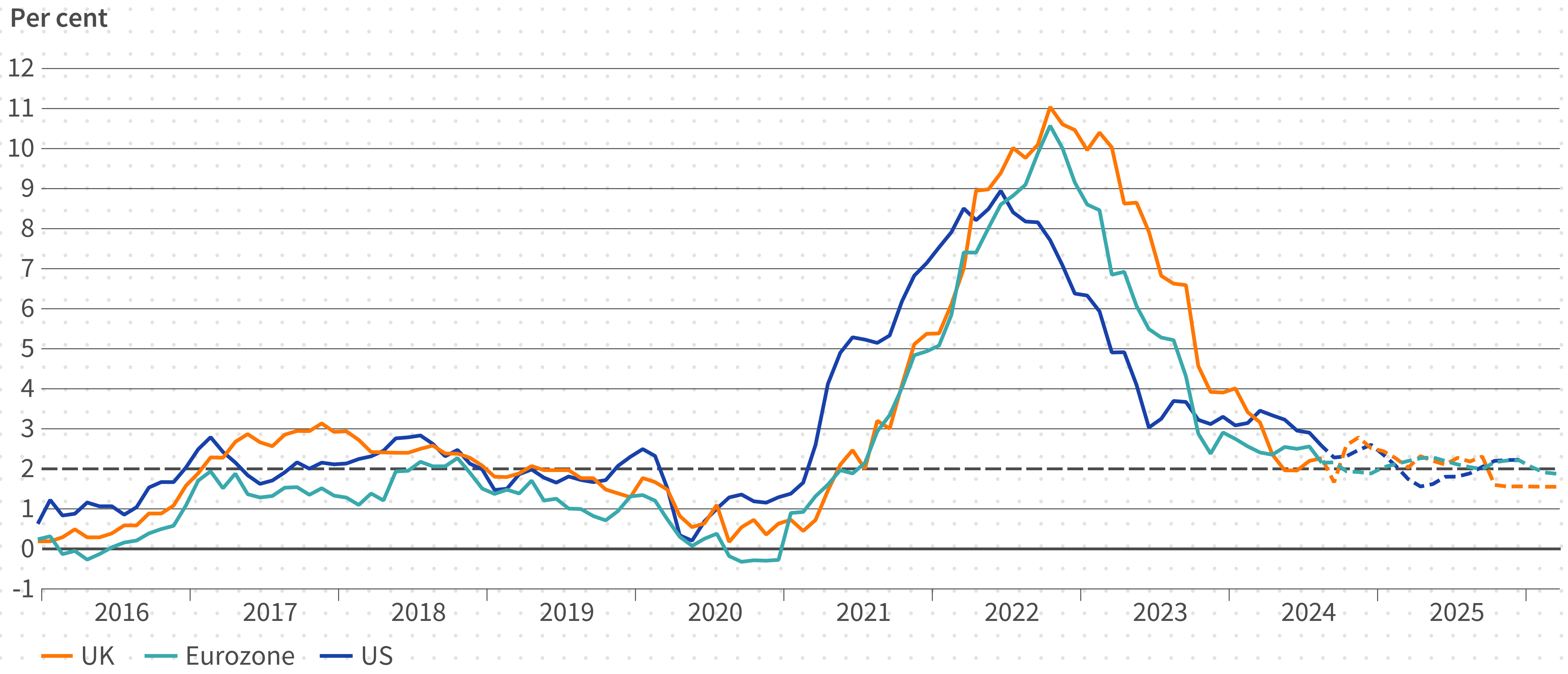
Most central banks are at pains to emphasise that they are data dependent

Most central banks are at pains to emphasise that they are data dependent. They – and pretty much everyone else – have been humbled in recent years by erroneous forecasts and broken models, as well as exogenous events that at times proved transitory, at times were anything but. The big shocks of Covid-19 and the Russian invasion of Ukraine, and all the disruptive consequences that followed, are finally fading, but policymakers are rightly cautious and careful; fiscal uncertainties and geopolitical tensions are also keeping them on alert. Importantly, developed markets' central banks are keeping rates restrictive, and it will take a while to get to neutral, while a negative shock will be needed for policy to become stimulative.

The determination of 'neutral' or r* is impossible, and will be debated endlessly – yet in practice, central banks will pause whenever they judge inflationary forces to be roughly in balance over coming quarters. It does seem that structural changes have shifted so that a return to zero and negative rates and too-low inflation is unlikely. Economies tend to not be in equilibrium very long anyway; if disinflation gathers pace cuts can go further; if the unobservable r* has shifted higher, we will see economies rev up after a more modest cutting cycle, that will then pause or even reverse. These are both risks into 2025 and beyond.

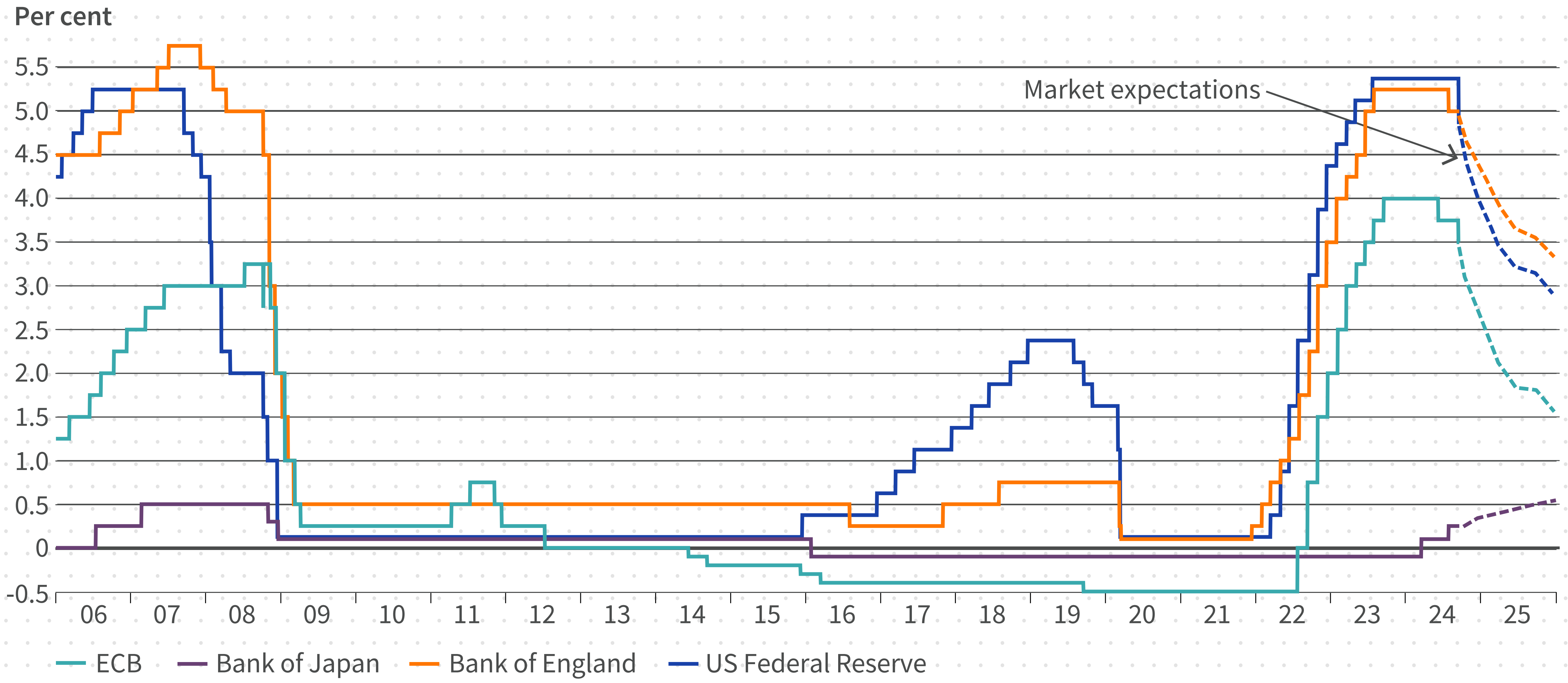
Lower growth and its impact on CPI and wages helped central banks to gain the required confidence to cut interest rates, in fairly synchronised fashion. Headline inflation is close to target in the US, the UK, and the Euro Area (Figure 1), even as many countries' core inflation and services prices are problematic and injecting restraint in central banks' actions. We see global growth falling from a 3.3 per cent gain last year to 3.1 per cent in 2024, and a similar rate of increase of 3.0 per cent next year – close to potential growth which itself might be downgraded. Real interest rates remain firmly positive for the time being, and this will continue to put downward pressure on investment and rate-sensitive sectors such as housing and credit-fuelled consumption. This backdrop will mean the Fed, the BoE, and the ECB will slash interest rates over the next year, as they become less restrictive, more growth sensitive, and feel their way towards neutral territory (Figure 2).

Figure 1. **Aviva Investors Consumer Price Index (CPI) inflation projections**



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

Figure 2. **Central bank policy rate expectations (market pricing)**

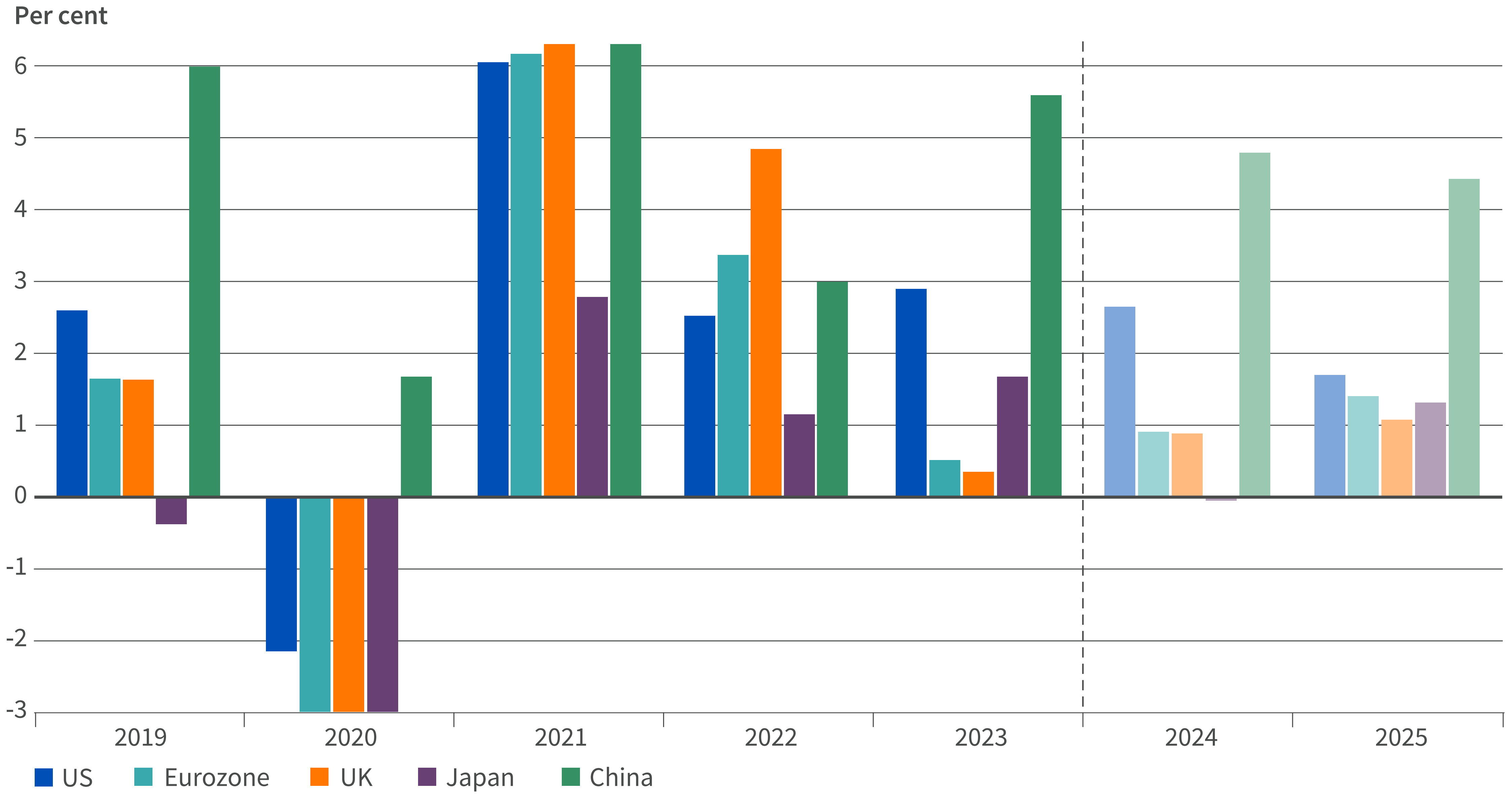


Source: Aviva Investors, Macrobond as at 30 September 2024.

The global "soft landing" is quite heterogeneous (Figure 3); the US is likely to grow faster than last year by a touch, clocking in a 2.6 per cent expansion, and India will grow at nearly a 7 per cent clip, according to consensus. Both have been steadily revised upward through the year, as most forecasts proved erroneously pessimistic. For next year, a lot will depend on the US election and its impact on taxes, spending, and regulation (see also Figure 7), as well as the ongoing artificial intelligence (AI) boom in investment. We expect growth in the Euro Area to reach around 1 per cent this year, and be just below 1.5 per cent in 2025, dragged down by Germany's woes while Spain and Greece outperform. The UK has found political stability but its new government has yet to implement tax, regulatory, and spending policies, while the BoE is awaiting for sticky services price inflation to abate after briefly achieving its 2.0 per cent headline CPI target. GDP has recently surprised positively, but the risks seem skewed to the downside. Japan's 2024 growth may print close to zero, but this has to do with some base effects from late 2023; underlying growth is a little over 1 per cent and that steady progress should be expected for 2025 as well – and enabling the BoJ to swim against the current and raise interest rates some more. Finally, despite recent stimulus measures, China is in a structural slowdown and after straining to get to 5 per cent growth this year might slow further to around 4 per cent next year.

For emerging markets, the soft landing is a relief, with a troughing in commodity prices and the apex of bond yields ushering in a more benign landscape, especially after the battering that markets took from various election results through the past year. Tariffs, sanctions, and trade restrictions remain a threat, especially if ex-President Trump is re-elected and follows through on some of his more extreme rhetoric. However, the macro backdrop is more supportive with a weaker dollar, lower rates, and many countries benefitting from better terms of trade; China's monetary easing and fiscal stimulus removes some downside risks. Positioning and sentiment are starting from very low levels, especially after the mid-year carry trade unwind, which crushed "carry" positions in EM, as well as Yen bears, Nikkei bulls, and vol sellers. While it validated our earlier concerns about market fragility, the episode came and went quickly, and without spiralling into anything traumatic.

Figure 3. **Aviva Investors growth projections**



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

China is in a structural slowdown and after straining to get to 5 per cent growth this year might slow further to around 4 per cent next year

Next year, US growth and market behaviour will depend on the US election and its impact on taxes, spending, and regulation, as well as the ongoing artificial intelligence (AI) boom

If recession fears were rising and corporate earnings suffering, rate cuts would not allay equity sentiment as monetary authorities would be "behind the curve", their efforts cancelled out by tightening financial conditions. At present, and in the medium term, we see growth largely stable, and importantly, credit spreads and lending conditions are steady too. Earnings have troughed and the tech boom, driven in large part by AI but accompanied by biotech, energy transition, electrification, and defence, are brightening the outlook. This keeps us constructive on equities, but with expected bouts of renewed volatility, we dial back our overweights, favouring the US's powerful growth drivers and Europe's compelling valuations (Figure 4). Government bond yields are lower, but have diversification benefits in case of growth fears intensifying, now that central banks are running free; the US and the UK are favoured for duration but Japan remains an underweight. Credit has been a steady performer and assuming spreads are rangebound, High Yield is preferred to Investment Grade, though both asset classes, as well as EM, are likely to turn in similar and decent risk-adjusted returns.

Figure 4. **Asset allocation summary table**

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

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

> ***Earnings have troughed and the tech boom, driven in large part by AI but accompanied by biotech, energy transition, electrification, and defence, are brightening the outlook***

Key investment themes and risks

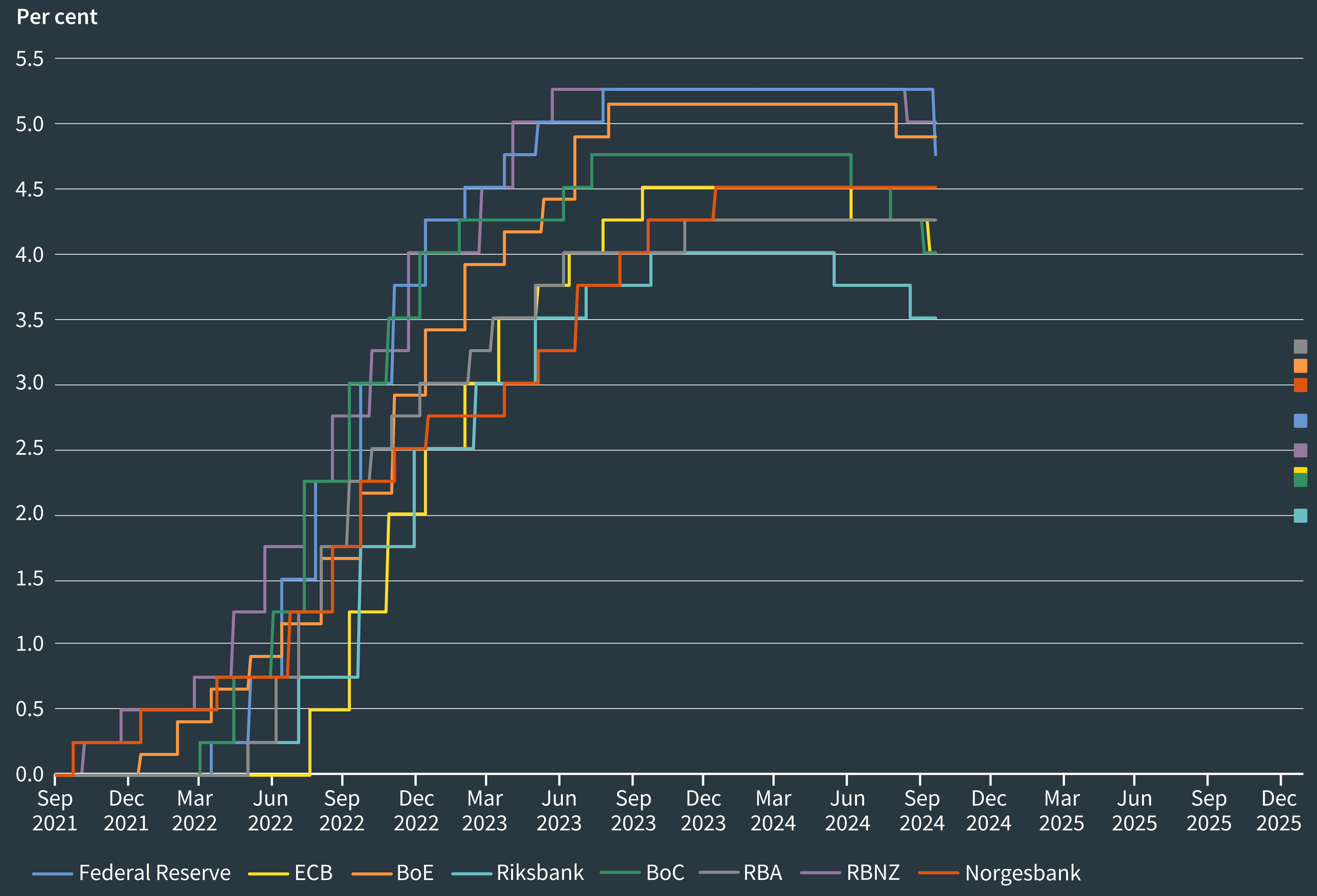
Investment themes

1	2	3	4
Synchronised cutting cycles	Soft landing; inflation risks receding	US election – too close to call, too important to ignore	The AI capex boom and monetising the technology

Synchronised cutting cycles

Most developed market central banks have begun cutting rates in recent months. Starting with the Swiss SNB in March and the Swedish Riksbank in May, followed by the ECB in June, we have seen the cutting cycle get underway in a relatively synchronised way (Figure 5). Increments have typically been 25bp, although the Federal Reserve stood out with an initial cut of 50bps in September. Looking back over the post-Covid hiking cycle, central banks were raising rates in sync during 2022 and 2023 as well, although the magnitude and pace of hikes did vary somewhat. The Fed started later than most, but hiked more aggressively, by over 5 percentage points, with others somewhere between 4 and 5 percentage points. Market expectations through to the end of 2025 suggest around 2-2.5 percentage points in cuts over that period, taking rates back to what many estimate to be around "neutral" in each economy. That is typically estimated to be in the range of 2-3.5 per cent. With inflation risks subsiding (see next theme) and labour markets more in balance, the case for bringing policy rates closer to neutral over the coming year appears more compelling. In our central scenario we see central banks delivering something close to what is priced into markets. However, there of course remains considerable uncertainty around the outlook – with the precise magnitude of easing likely to reflect the extent to which the labour market softens further from here. With central banks moving to cut rates before a material rise in unemployment, we expect a soft landing can be delivered (see next theme) and risk assets can be supported.

Figure 5. **Cumulative change in policy rates since September 2021** (squares based on market-implied pricing for end-2025)



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

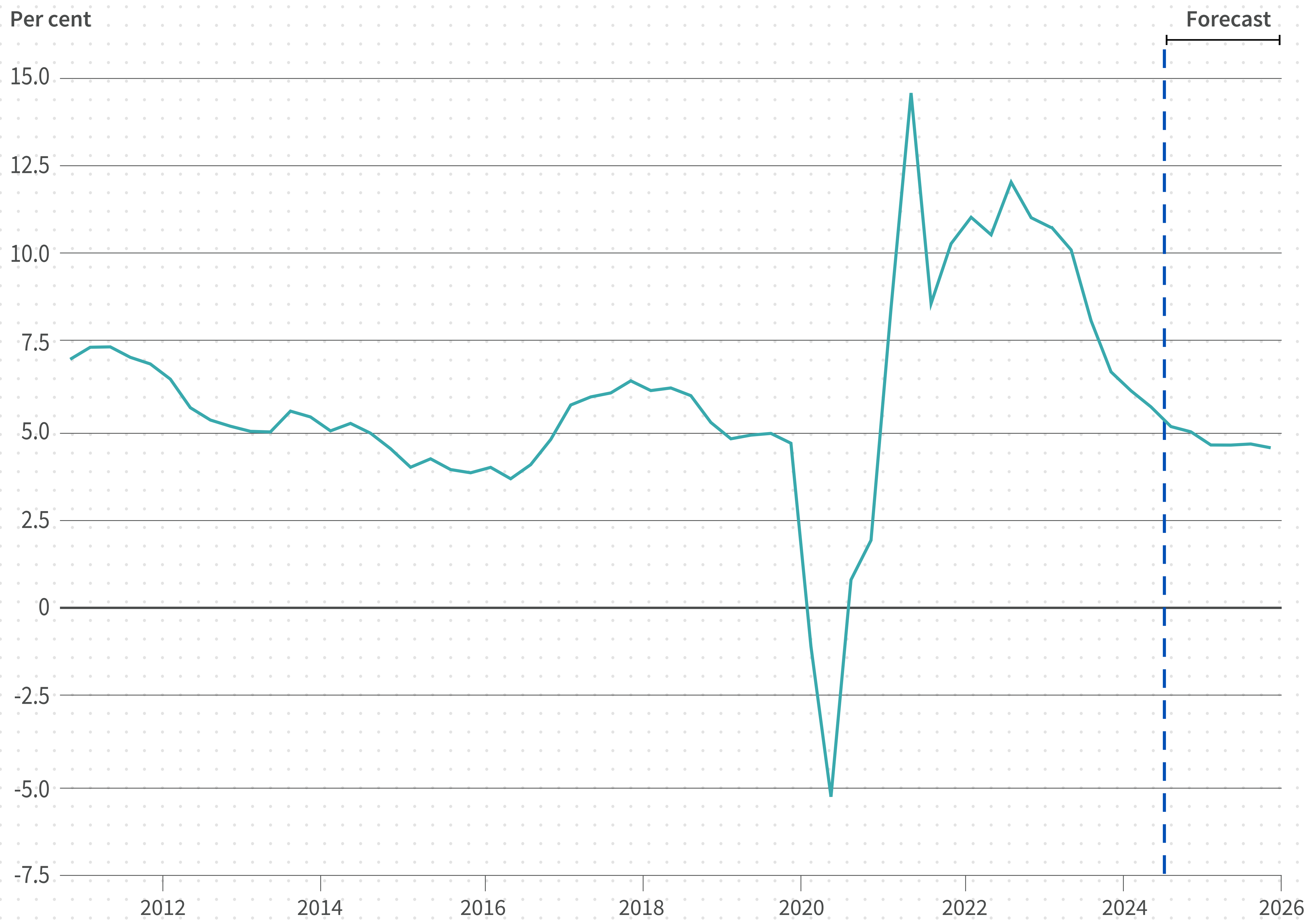
With central banks moving to cut rates before a material rise in unemployment, we expect a soft landing can be delivered

Soft landing; inflation risks receding

Ever since central banks started raising rates aggressively in 2022, there has been heightened concerns about those actions driving the global economy into recession. How would households and businesses cope with such a dramatic increase in financing costs? Wouldn't the desire to curtail excess demand and bring wage growth and inflation down lead to layoffs as businesses cut costs, driving the unemployment rate significantly higher? However, while interest rate sensitive sectors such as housing did cool significantly, as the months went by in 2023 it became evident that economies could withstand higher rates: slowing, but not falling off a cliff. In aggregate, balance sheets remained healthy and fiscal support remained a constant tailwind. With inflation risks now receding – headline inflation measures have fallen from close to or above double-digits to near central bank targets of 2 per cent – central banks have begun the process of removing restriction, as outlined above. Financial and credit conditions have eased in advance of those rate reductions, as the market has anticipated the cutting cycle, supporting activity and asset prices. As we look ahead to the remainder of 2024 and into 2025, we expect that easing in monetary policy will keep financial conditions loose and deliver a soft landing, with growth seen to be around potential or trend. When combined with the benign inflation outlook, we expect global *nominal* demand growth to slow to around 4.5 per cent in 2025 (Figure 6).

With inflation risks now receding – headline inflation measures have fallen from close to or above double-digits to near central bank targets of 2 per cent

Figure 6. **Global nominal GDP growth estimate**



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

US election – too close to call, too important to ignore

The US election on 5 November will see two very different candidates running for President. Former President Trump has run on a familiar policy platform to when he was President – lower taxes, higher tariffs, lower immigration, lower regulation (especially with regard to energy). Current Vice President Harris has a similar policy platform to President Biden – lower taxes for lower-income groups, higher taxes for higher-income groups, corporates making a larger contribution to the tax take and continued prioritisation of policies to support the ambition of net zero carbon emissions by 2050. At the time of writing, both the national polls and the polls for the key battle-ground states suggest a very tight outcome. It is simply too close to call. But the fulfilment of the policy agenda for each candidate is highly dependent on the outcome for both houses of Congress as well. In the past, the winning Presidential candidate has often been able to generate enough support for the party to carry both the Senate and the House of Representatives. This time around that looks to be somewhat easier in the case of a Trump victory than it does for Harris. The Democrats (who currently hold a 51-49 majority) are defending 23 Senate seats, several of which are in typically Republican-leaning states and where the Senator is retiring. On the other hand, Republicans are defending just 11 relatively safe seats in the Senate; meanwhile the House is also up for grabs by either party. Much of the policy agenda (Figure 7) for both Presidential candidates will require Congressional support. That is highly unlikely in a split Congress and may even be challenging in certain areas with a united Congress. Areas that can be pursued through executive order of the President are tariffs and regulations, two of Trump's top priorities. Should either candidate succeed with a united Congress, their policy proposals are likely to see the projected deficit widen further, from an already historically wide starting point.

If Trump pursued tariffs in the way he has indicated, that would be a very significant escalation from his first Presidency and would almost certainly result in retaliation from trading partners. If Harris pursued an increase in corporate tax rates, it would reverse much of the cuts that came in the Trump administration and could be a material headwind for US corporates. Beyond the fiscal implications of different policies, diametrically opposed views between Trump and Harris on climate change and related policies could be a significant factor in both domestic and global energy markets, as well as the geopolitics of the Paris Climate Agreement.

> ***At the time of writing, both the national polls and the polls for the key battle-ground states suggest a very tight outcome.***

Figure 7. **Key policy proposals from US presidential candidates**

Harris (Democrats)	**Trump** (Republicans)
Policies that increase the deficit	**Policies that increase the deficit**
• Extend expiring individual tax cuts for those earning under $400k	• Full extension of expiring individual tax cuts
• Expand child tax credits	• Exclude social security from taxation
• Expand earned income tax credit	• Cut corporate tax to 15 per cent from 21 per cent
• Enhanced subsidies for health insurance	• Increase defence and government infrastructure spending
• First homebuyer credit	• Increase child tax credit
• Remove tax on tips	• Remove tax on tips
Policies that reduce the deficit	**Policies that reduce the deficit**
• Raise corporation tax to 28 per cent from 21 per cent	• 10 per cent across-the-board tariffs and significantly higher rate on all Chinese imports
• Raise capital gains tax for high income earners	• Removal of subsidies for EVs

Source: Aviva Investors, as at 30 September 2024.

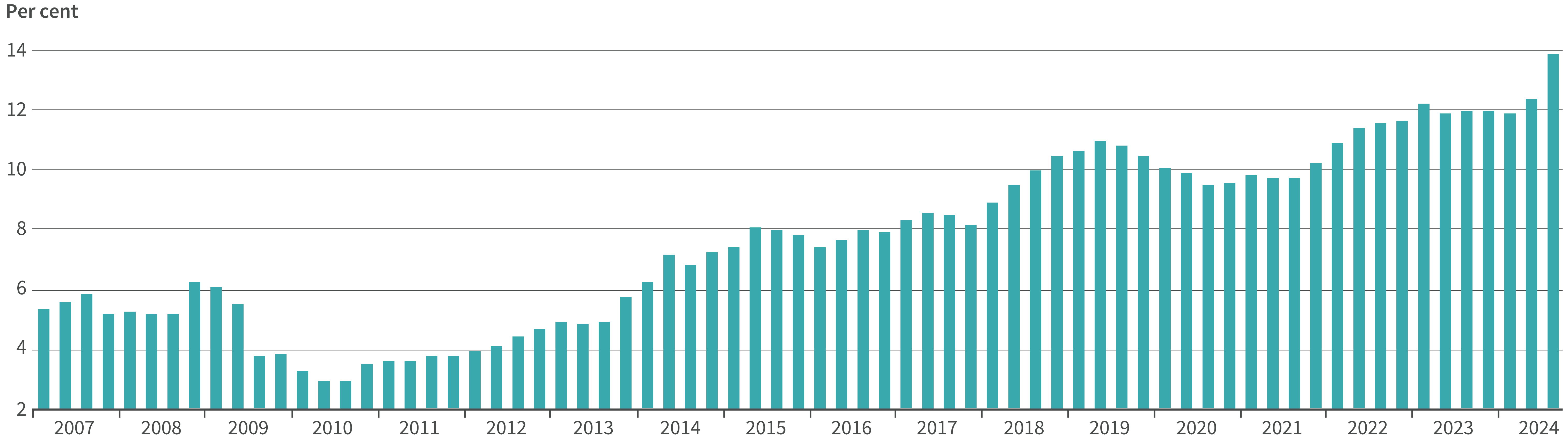
The AI capex boom and monetising the technology

In previous editions of the House View we have looked at the impact of artificial intelligence (AI) on productivity. But the prospects of profit gains from directly monetising AI continue to grow in importance for investors. To date, we have seen Mega-Cap tech names, so called "hyperscalers" and other businesses invest substantial amounts of capital (Figure 8). But despite that investment, return on investment (ROI) and clarity on the resulting use cases is still some way away. The path ahead may well split, with this relatively small group of very large of companies able to utilise their scale to reap the benefits of AI while those with more limited budgets are left behind. As of 2023, Amazon, Google, Microsoft and Meta accounted for more than 20 per cent of capex and R&D across the S&P 500. Their share of capex spend will likely only grow over the coming years.

Within that expenditure, there has been a clear tilt towards infrastructure, data centres and power-based structures that will support monetisation of AI technologies. Potential use cases for AI continue to expand. Iterations of chatbots that utilise generative AI have become synonymous with the technology in a short period of time and are already integrated into many businesses. However, it is still too early to make a full assessment of the productivity benefits, not least because the majority of AI plans are targeted towards automation rather than directly increasing labour productivity. While AI will struggle to meet the lofty expectations of the market we can already see early signs that, monetisation and revenue generation will follow. Although it is premature to make a full assessment, what we have seen so far does not suggest a "bubble" environment. In fact, initial anecdotal evidence suggests the opposite – for example Microsoft's rollout of Copilot already places it as one of the company's most successful product launches in its history. Despite the uncertainty around ROI, the message from corporates is one of increasing investment for the foreseeable future, perhaps as much for fear of missing out than for clear visibility on future returns. As ever, it will be the timeline for ROI that investors will be highly sensitive to when assessing both the economic and profitability implications. While prior tech cycles have typically begun with an overestimation of short-term returns and underestimation of the longer-term prospects, it is notable that the scale of upfront capex is much larger this time. Amongst the commitment by many firms and expected future returns, one should be cognisant of the magnitude of capital required to build out many of these AI capabilities.

The prospects of monetising developments in artificial intelligence (AI), continues to grow in importance for investors

Figure 8. **Aggregate Capex to Sales ratio for major AI investing corporates ("hyperscalers")**



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

Once again we have a highly consequential US election, with the outcome potentially leading us towards a global trade war

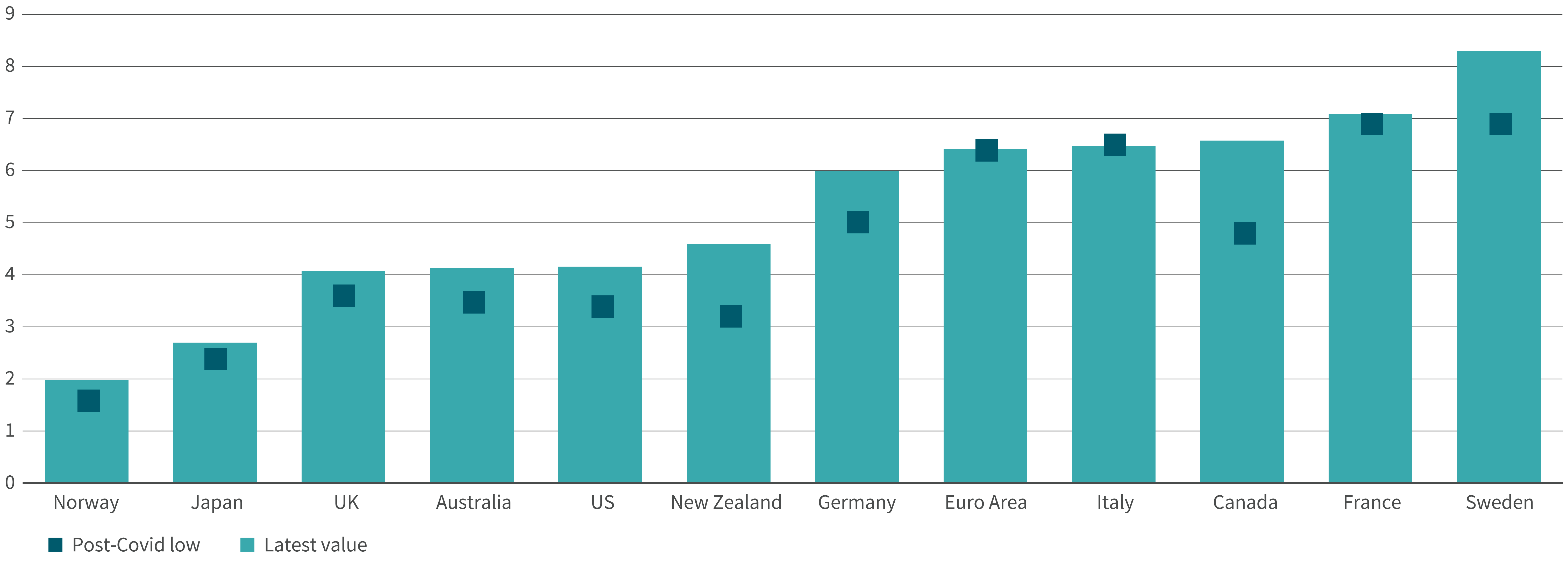
Michael Grady
Head of Investment Strategy and Chief Economist

Risks

Recession: central banks behind the curve

In our central scenario, we see the US and global economy delivering a soft landing when it comes to growth outcomes in the year ahead. However, we judge the risks to growth to be tilted to the downside, resulting in a more elevated risk of recession than is typically the case. Following the rapid and large increase in interest rates in much of the world, inflation has subsided and growth has slowed. As central banks have just started to ease restrictive policy, it may be that they have waited too long in an effort to ensure inflation stays sustainably near target. Unemployment is rising in most economies (Figure 9) and the lag between policy actions and their peak effect on the real economy is a year or more. Indeed, higher borrowing costs are still to fully feed through in some economies, such as the UK, where most mortgage holders only re-set every 2-5 years. If demand weakens sharply and unexpectedly then businesses may go from cutting back on hiring (as they have already done), to looking at layoffs to manage costs. That process could be exacerbated if the current lofty corporate earnings expectations for 2025 materially disappoint. Indeed, past interest rate cycles would suggest that this sort of outcome is more likely than not. With downside growth risks and potential for recession, the skew to policy rates is also to the downside. How risk assets perform will depend on the severity of any recession and the scope for monetary and/or fiscal policy to respond.

Figure 9. **Unemployment rates have risen from their post-Covid lows**



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

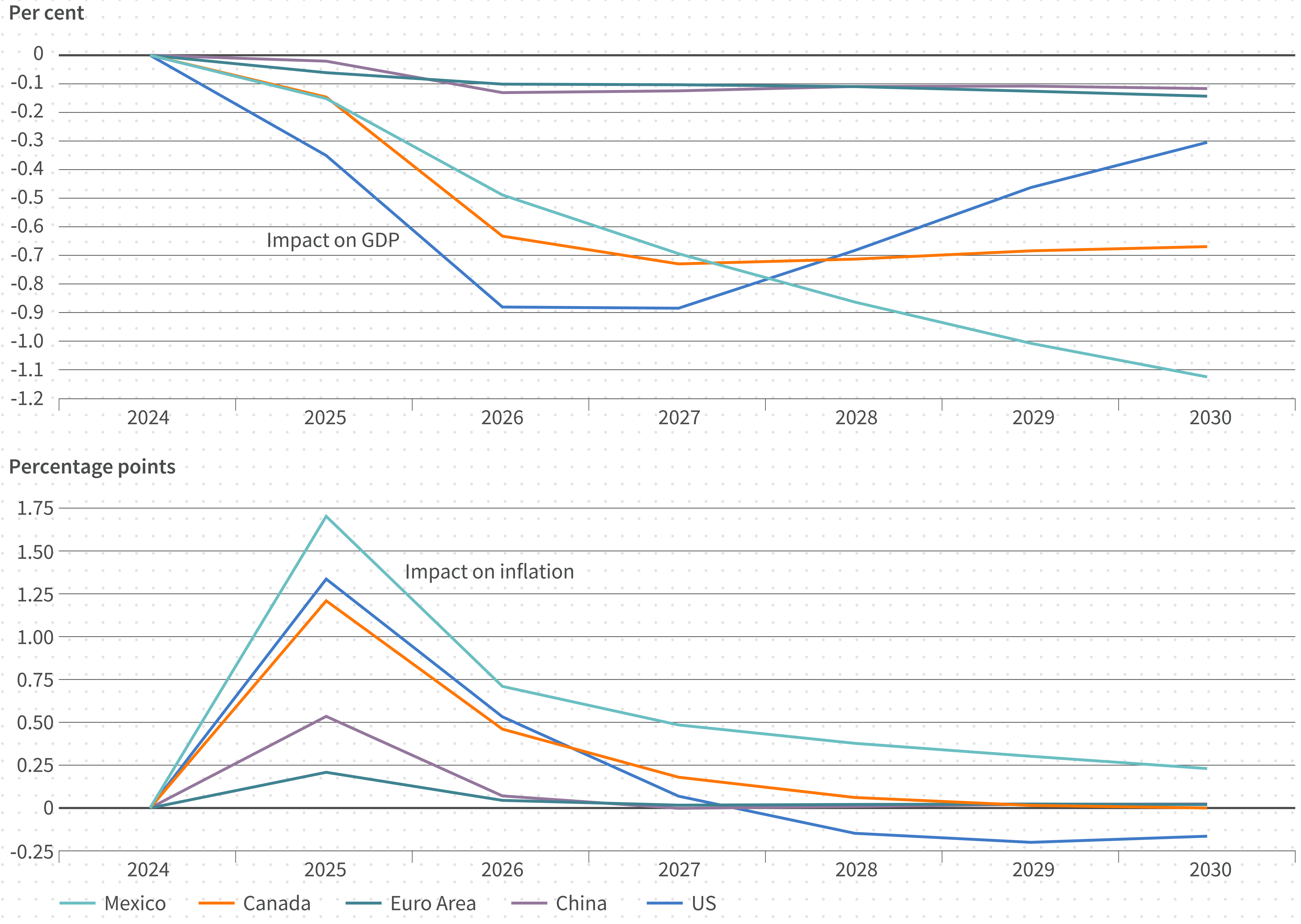
As central banks have just started to ease restrictive policy, it may be that they have waited too long in an effort to ensure inflation stays sustainably near target

Global trade war

We have highlighted in previous editions of the House View the growing use of tariffs and other harmful trade restrictions. Since 2017 there has been a six-fold increase in the number of harmful trade interventions each year according to the Global Trade Alert. The increase coincided with Trump's presidency, but far from slowing since he left office, this measure has continued to rise. With the real prospect of a second Trump presidency, 2025 may see a further escalation of tariffs and other restrictions. Trump has campaigned on a policy platform of across-the-board tariffs on all imports to the US, with additional exceptional tariffs on China. These measures could be taken without Congressional approval and would be far in excess of anything done during his first administration. It seems inconceivable that such actions would not be met with retaliatory measures from trading partners, further escalating the situation. On top of tariffs, it is likely that further inward and outward investment restrictions could also be utilised in areas deemed of importance for national security. If we saw such a set of policies evolve into a global trade war, there would be a significant cost to the global economy (Figure 10). While some trade may be diverted, it is likely to become increasingly difficult to engage beyond a small set of trusted allies. We expect global manufacturing would be hit hard in this scenario, with China most heavily impacted. Moreover, it would be a negative supply shock, with stagflationary effects.

Since 2017 there has been a six-fold increase in the number of harmful trade interventions each year according to the Global Trade Alert

Figure 10. **Estimated impact of the US imposing 10% across-the-board tariff, with other countries retaliating**



Source: Peterson Institute for International Economics (Working Paper 24-20).

Macro forecasts charts and commentary

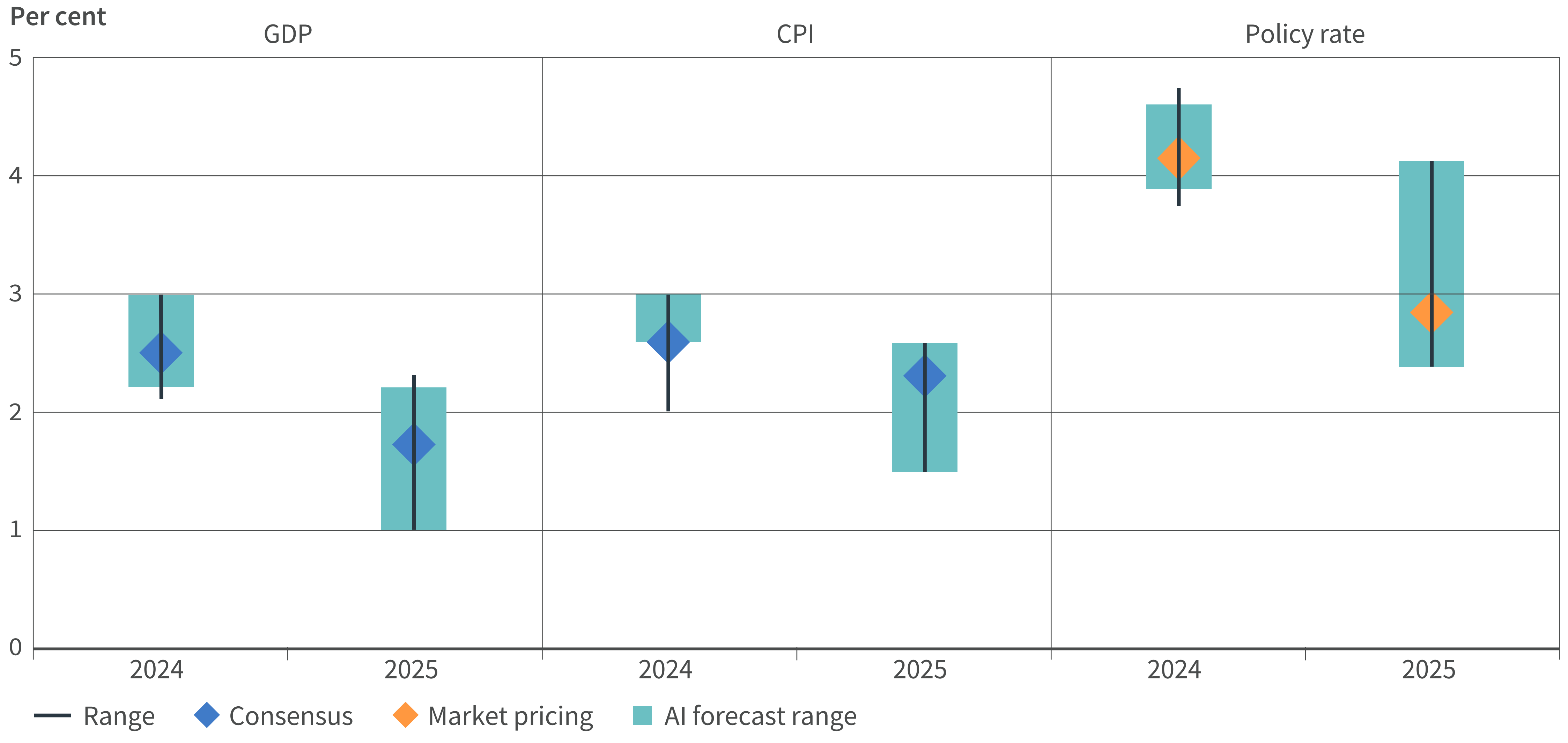
US

The Federal Reserve took the bold step of cutting rates by 50bps in September, marking the start of what is expected to be a sequence of rate cuts to bring policy back to more neutral territory. Exactly where neutral resides is, of course, uncertain. And therefore, the range of outcomes for policy rates in 2025 remains wide. But the direction of travel is clear, as is the intent of the Fed – it will act to try to deliver the softest of landings, so long as inflation remains on track to be around the 2 per cent target. We expect them to deliver another 150bps in easing through to mid-2025 before pausing, but place a non-trivial probability on them doing as much as 50bps more or less than that over that horizon (Figure 11).

Through the lens of output growth, the US economy remains in a healthy situation. Over the first nine months of the year annualised growth is estimated to be running around 2.5 per cent – above potential. Personal consumption remains the key driver, with solid real income growth continuing to support spending. Business investment growth has also contributed, supported by both policy measures to incentivise tech and green investment, as well as from the nascent boom in AI-driven capex. However, through the lens of the labour market, the US economy has looked less robust. Employment gains have been minimal this year, especially in the context of the rapid increase in immigration. That has led to a rise in the unemployment rate and a risk that the decline in hiring could broaden. Arithmetically, this situation has resulted in a rapid increase in labour productivity growth, which seems unlikely to persist. We expect that to be resolved through a combination of softer GDP growth and moderately better employment growth.

The inflation backdrop has improved in recent months, suggesting that it is more sustainably moving back towards 2 per cent. That said, services inflation remains high and sticky, with the better outcomes driven more by very soft core goods inflation. We expect the moderation in wage growth seen thus far will continue through 2024 and 2025 and help to ease service sector inflation. Lastly, the outcome of the election in November remains unclear, with Harris and Trump polling similarly in the key battle-ground states. Just as importantly, the outcome of the House and, to a lesser extent the Senate, also remains unclear. A clean sweep for either the Democrats or the Republicans will be far more meaningful for the economy and financial markets than a divided government.

Figure 11. **US**



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

The Federal Reserve took the bold step of cutting rates by 50bps in September

Eurozone

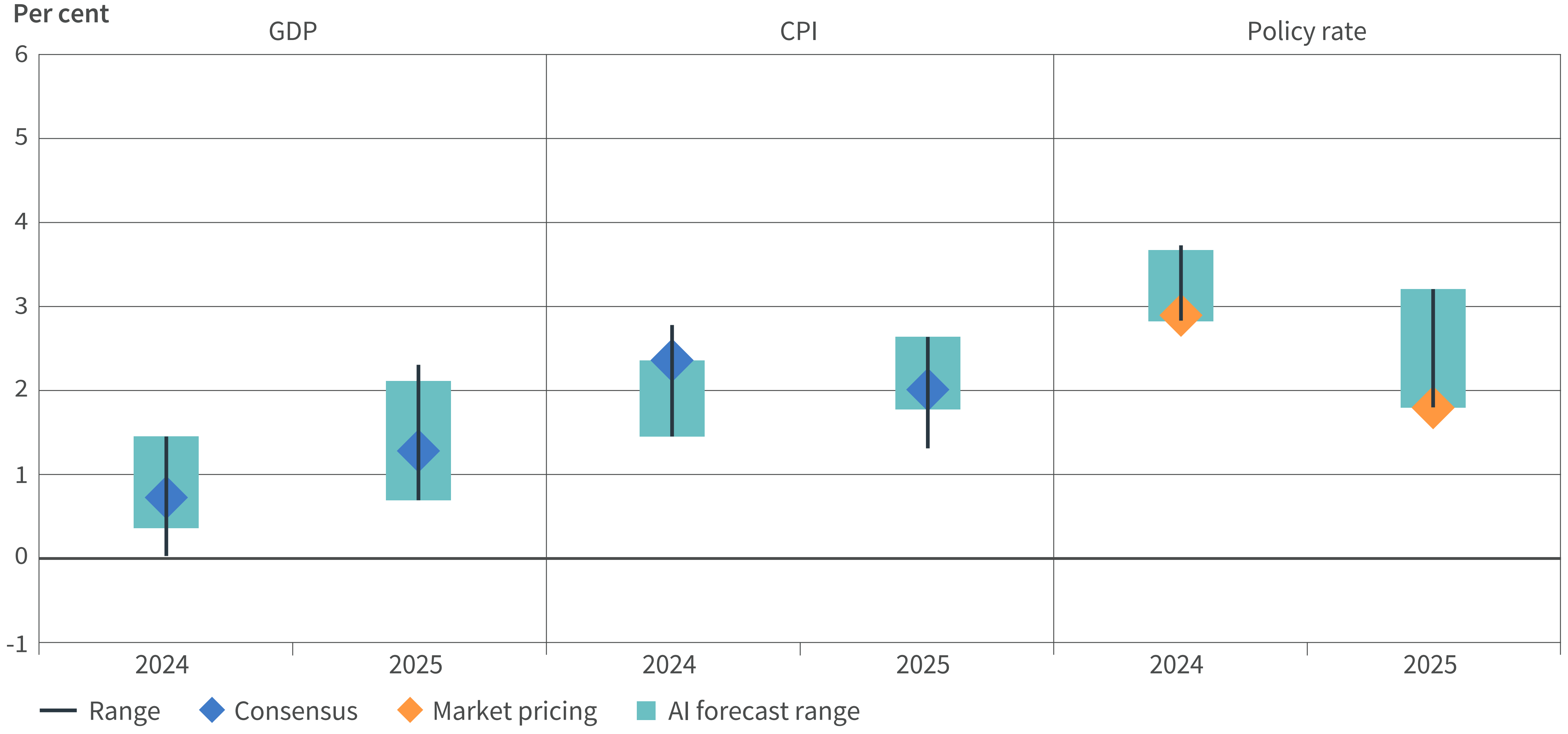
In 1H24, Eurozone growth surprised somewhat to the upside, with real GDP rising 1 per cent (1H24, annualised), not far away from the average of 1.4 per cent between 2010 and 2019. Main drivers have been net trade and household consumption (the latter mostly in 1Q). The recovery has been led by the periphery, while Germany has remained in stagnation. High frequency surveys have recently deteriorated, but we believe this is not reflective of underlying weakness but rather due to the earlier rise in political risk premia (France's elections), negative summer seasonality and the July/August market turmoil. The sharp repricing in rates higher during spring might have also played a role in consumption being curtailed and savings increased.

We expect the material improvement in real incomes, monetary policy easing and the accumulation of a sizeable buffer stock of savings (15 per cent of disposable income, the highest in the Eurozone history outside of the COVID period) to underpin consumer sentiment and spending; alongside evidence of more corporate appetite for borrowing and declines in lending standards. All this should sustain decent economic activity. We maintain our real GDP growth forecasts at 0.9 per cent for 2024 and 1.4 per cent for 2025. At the same time, we see inflation falling closer to target by 2024-end (see Figure 12).

On monetary policy, we see the ECB cutting one more time this year (to 3.25 per cent). While there is a high risk of two more cuts in 2024, we do not share the market's view for a terminal rate below 2 per cent. Our expectation is for rates to bottom around 2.25 per cent-2.5 per cent in addition to a likely pickup in consumption. We think the reduction in budget deficits will be slow (EZ budget balance is expected to rise from -3.5 per cent to -2.3 per cent of GDP by 2027) which would justify a higher real rate than has been the norm in the pre-COVID period.

Finally, a word on the long-awaited Draghi report: the recommendations revolve around a bold new industrial strategy for Europe with new joint EU debt issuance and substantial increase in public spending amounting to 5 per cent of GDP per annum. Although the report is not the first to raise the issues of low productivity growth, lack of competitiveness, over-regulation and the requirement to meet climate targets among others, it does give a very forceful view on the need for public investment to spearhead investment revival via common debt issuance. While its findings and suggestions do not bind members states to adopt them, the recommendations are coming from someone who carries credibility among EU circles. It remains to be seen if and to what extend these proposals will become part of a formal political framework.

Figure 12. **Eurozone**



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

Risks to our rather constructive view (vs consensus) on Eurozone growth include: (a) the outcome of the US elections and potential increase in international trade barriers; (b) French politics and impact on (broader) sentiment in case of heightened frictions between France and Brussels on the budgetary adjustment required due to the economy being under the Excessive Deficit Programme; other political events next year, including the 2025 German elections; and unforeseen shocks (including increases in energy prices) in which case the ECB will be forced to ease more; (c) recent deterioration in activity being more fundamental than we think and consumption failing to pick up.

While the Euro Area's activity indicators have softened, underlying growth factors remain healthy and household consumption should pick up modestly to sustain growth

UK

UK growth has defied expectations this year, rising by 0.7 per cent QoQ in 1Q and 0.5 per cent in 2Q. However, the bulk of the increase has been driven by growth in gross fixed capital formation (although investment as a percentage of GDP still lags compared to other G7 economies) and government spending. Real household consumption grew only modestly so far in 2024, and it is virtually unchanged since the pre-COVID period. Momentum in headline growth and investment has led us to increase our 2024 real GDP growth forecast to 1.0 per cent but we have kept the 2025 projection unchanged at 1.1 per cent. At the same time, inflation has fallen to near the BoE's target and despite an upcoming temporary uptick in the autumn (see Figure 13) due to the increase in the Ofgem price cap, CPI should remain anchored around the 2 per cent level.

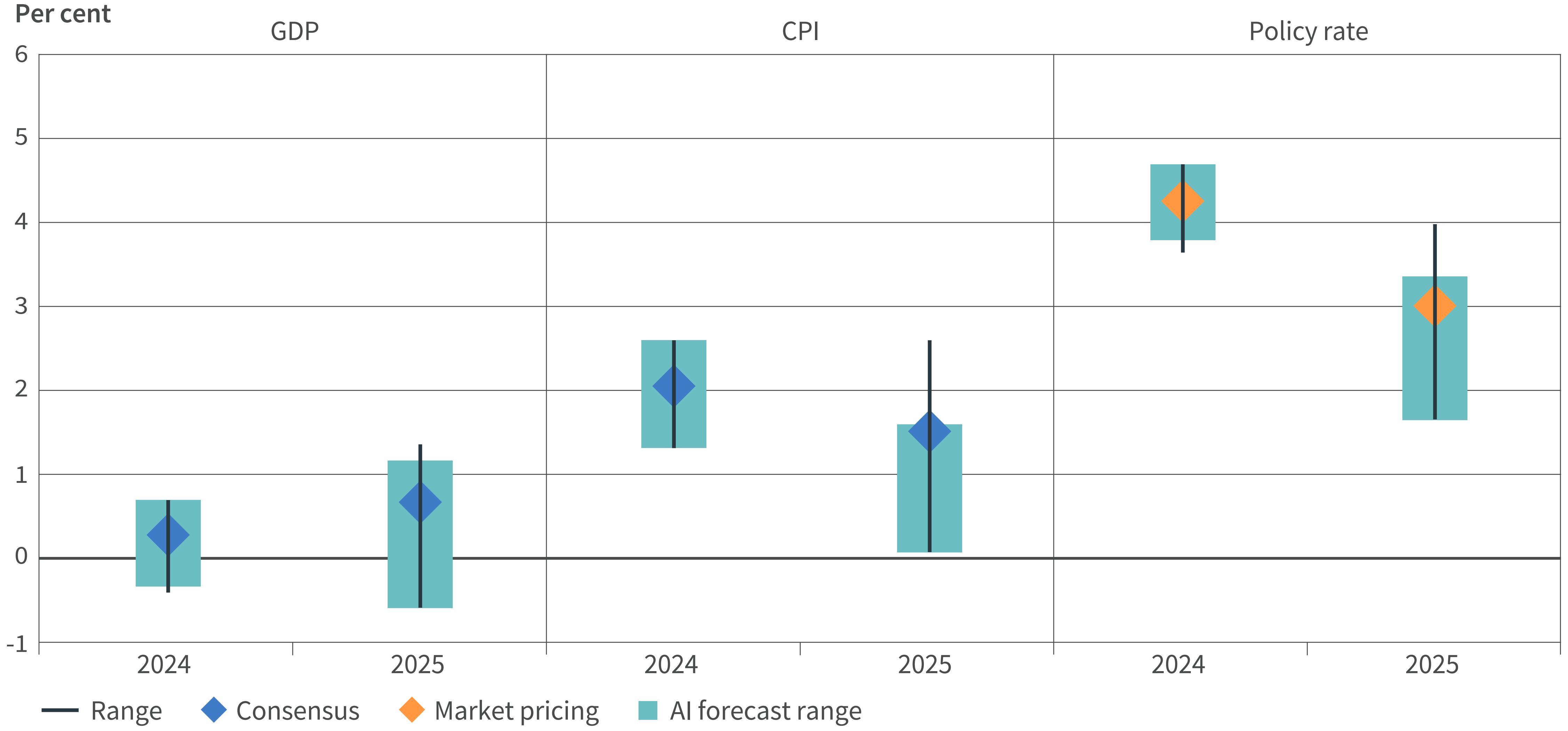
Although the broader economy has so far fared better than we expected, we remain sceptical: consumer spending is persistently lacklustre and, in contrast to the eurozone, effective mortgage rates and mortgage servicing costs will keep increasing, even as the Bank of England reduces the policy rate.

As a result, we expect one to two more rate cuts this year and the terminal rate at 3.0 per cent, lower than market's expectations. Fiscal policy is set to tighten, albeit marginally over the next few years (budget balance is forecasted to change from -4.3 per cent of GDP to -3 per cent by 2027). We do not expect the government to renege on pre-election promises over income tax and national insurance, but other taxes may have to rise to ensure medium term fiscal targets are respected. On balance, we do not think the October budget announcements will result in any "fireworks".

That said, the emergence of a stable government with a very wide majority seems to have instilled some positive sentiment amongst investors. If carried forward, this should help sustain growth in investment and GDP. On the flip side, UK-EU negotiations appear to have started on the wrong footing. EU hardliners want to make an aggressive easing in youth mobility rules a precondition for the creation of a broader negotiating package, something that the UK government seeks to avoid. It is still very early to anticipate any results; should progress come to pass, this would be a net positive for the UK economy's medium-term structural growth.

In our view, risks to our growth/inflation outlook are skewed dovishly due to subdued consumption growth. If the BoE delays policy easing even more then the economy would decelerate quite notably, something that would suggest faster and deeper rate cuts later.

Figure 13. **UK**



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

A good first half of the year for aggregate GDP, but household consumption remains subdued; the BoE will likely cut rates more and faster than markets expect

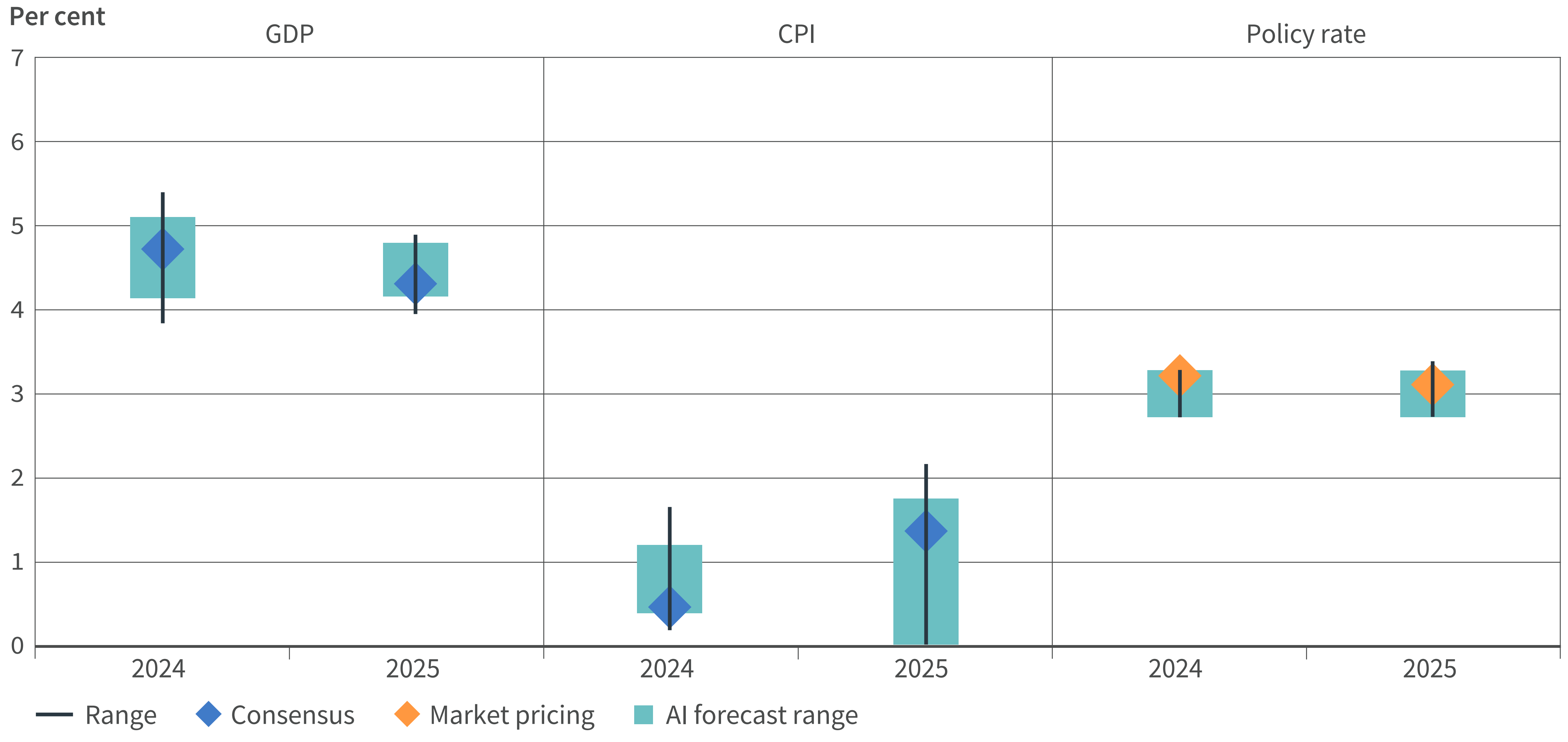
China

China's output this year has slowed, as we expected, and it is now getting late for any policy boosts to have a meaningful impact this year, though the measures announced in late September will lift activity into 2025 and reduce risks of a downward spiral of debt and deflation problems. The growth objective of "around 5 per cent" is vague enough that a result that rounds up could still be interpreted as a successful delivery, even if it is far from a resounding success. At this point, growth coming in slightly below that level seems likely, while further slowing in coming years towards 4 per cent remains our high likelihood base case (Figure 14). The positives are industry overall, led by exports and manufacturing – the aggressive overproduction of the latter is being sent abroad, and causing trade frictions and (broadly valid) accusations of subsidies and unfair competition. On the investment side, state-led infrastructure is still supporting activity, while both SOEs and private firms are expanding capacity in everything from power grids to solar panels, from EVs to coal-burning plants, and from steel factories to "lighthouses" supporting the Fourth Industrial Revolution.

The property depression continues to spread its misery beyond the housing and development sector itself; consumers' wealth and confidence is damaged and that has made retail sales and other spending grow at 3.4 per cent y/y, less than half the pre-Covid rate. The reality of protectionist measures in the EU and the US and threat of further measures also hurts confidence, as does the continued punishment and purging by a heavy-handed authoritarian government.

The combination of the above factors, as well as a shrinking, ageing population, has several additional macroeconomic outcomes. First, import growth is well below exports, which leads to trade surpluses of $1 trillion or more annually (similar to the US's goods deficit, coincidentally) as firms export their excess production. With surplus savings and no need to accelerate already high investment, China is seeing a mix of capital flight, negative FDI, and hoarding of exporters' dollars abroad, where they have a chance to earn higher returns or at least dodge confiscation. The result is a very large increase in the Net International Investment Position, which has more than doubled from the 2015 Foreign Exchange Crisis to $3 trillion, and a currency under pressure to weaken despite the positive current account (only 1.3 per cent of GDP). Second, the weak demand and excess supply is, just as we expect from Econ 101, disinflationary: core CPI is stuck close to zero and PPI remains negative, even though food prices might cause some temporary jumps. This dynamic should continue, even with US rate cuts that will probably reduce pressure on USDCNY and spur on PBoC rate cuts.

Figure 14. **China**



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

Much will depend on the winner of the US election and trade policies adopted in 2025, but even under a more benign outcome, it is likely that the Americans will be joined by most of Europe and parts of APAC in ever-escalating targeted restrictions. This is ostensibly to limit China's technological advancement in certain key areas (cutting-edge semiconductors, military hardware), as well as punishment of certain firms for human rights and aiding and abetting Russian, Iranian and North Korean aggression. But it also is protectionist, and a response to China's own obsession with self-sufficiency and independence if not dominance of key production components and supply chains.

China is seeing a mix of capital flight, negative FDI, and hoarding of exporters' dollars abroad. The long-awaited stimulus will moderate the downward spiral

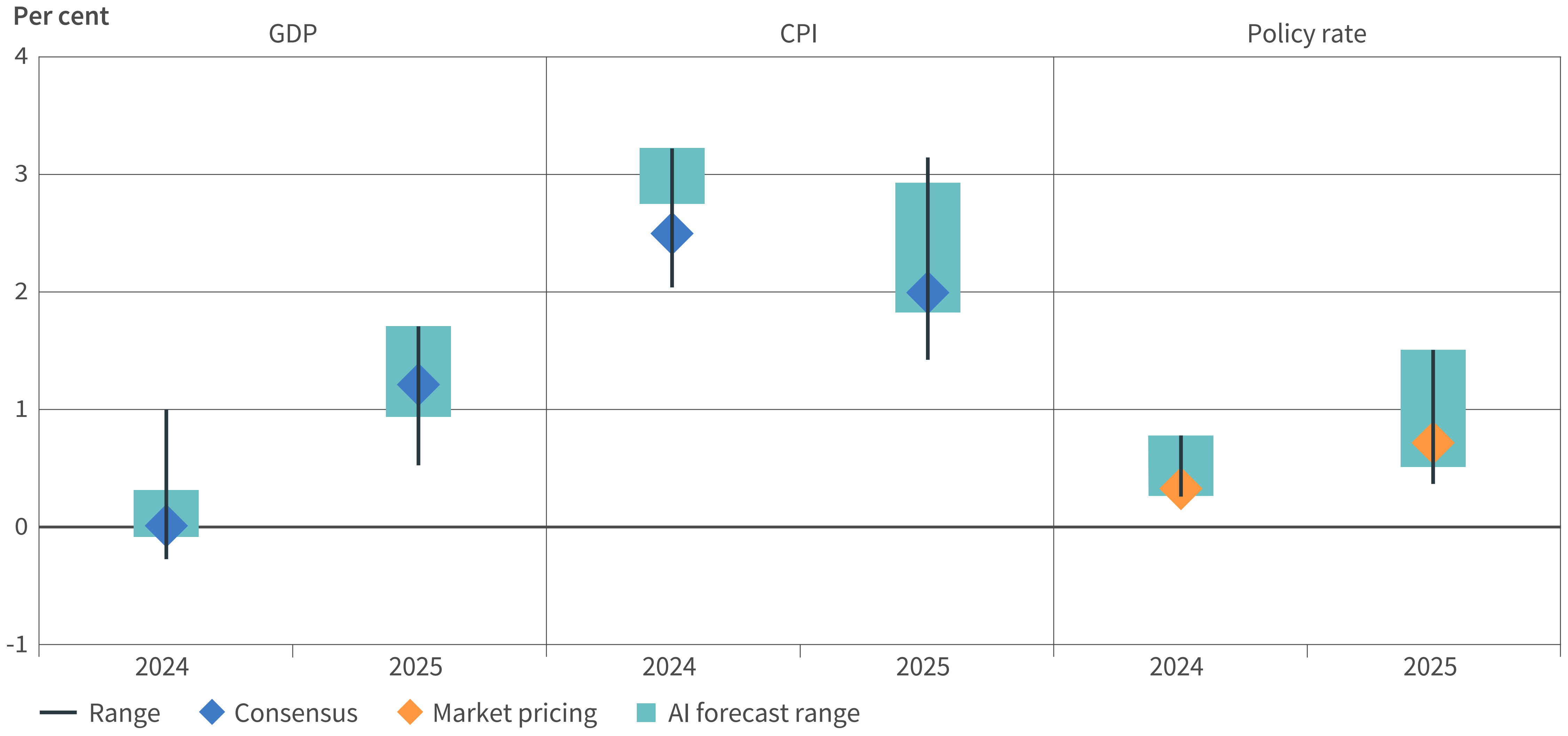
Japan

Japan has exited the era of negative rates in April, when its entire yield curve shifted above zero; in July a further rate hike by the BoJ and beginning of QE tapering put the monetary regime further on the path to normalcy. Despite the gradualness of the approach, which had taken the yen to extremely weak levels, markets were taken by surprise as BoJ Governor Ueda all but promised further hikes. We expect more hikes than the market is pricing, with rates heading toward 1.5-2.0 per cent, which is probably close to neutral given low growth potential and the rather dire demographic outlook. The carry trade, which used yen to fund everything from US assets to the Mexican Peso, unwound rapidly, and took the exchange rate from ¥160 to ¥140. That was back to the levels at the beginning of 2024, when markets mistakenly priced a Fed easing cycle; this time, the Fed has delivered. What will the markets do as Japanese rates march ever higher? The last hiking cycles were long ago, and are few and far between, but suggest further yen strength – though the main drivers are arguably not domestic, but rather global risk factors and the Fed's cutting and hiking cycles.

Aside from these developments, there is not much that has changed, with wage growth and consumption holding up amidst weather disruptions; looking through the quarterly noise, GDP growth should stay comfortably above 1 per cent and inflation sustainably above 2 per cent. Base effects and other temporary factors like subsidies may cause CPI to jump around, but the BoJ is likely to look through that if they see that firms are able to pass through costs and maintain margins. Along with corporate reforms and government efforts on modernisation and digitisation, this in turn should support investment and equities. Exports to China and the EU continue to decline, but demand elsewhere has held up, while lower energy prices have helped the terms of trade.

A Kishida government has passed the reins to the new LDP leader, but we do not expect drastic change under new Prime Minister Shigeru Ishiba as the party has a year to go before general elections are called, and it makes sense for the ruling party to try to consolidate popularity. This probably means additional fiscal spending and supplementary budgets, which even with price-suppressing subsidies, should increase bond supply and not dissuade the BoJ from small, steady, well-telegraphed hikes – marching to its own drummer as most of the world's central banks are taking off in the opposite direction (Figure 15).

Figure 15. **Japan**



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

Japan has exited the era of negative rates in April, when its entire yield curve shifted above zero

Canada

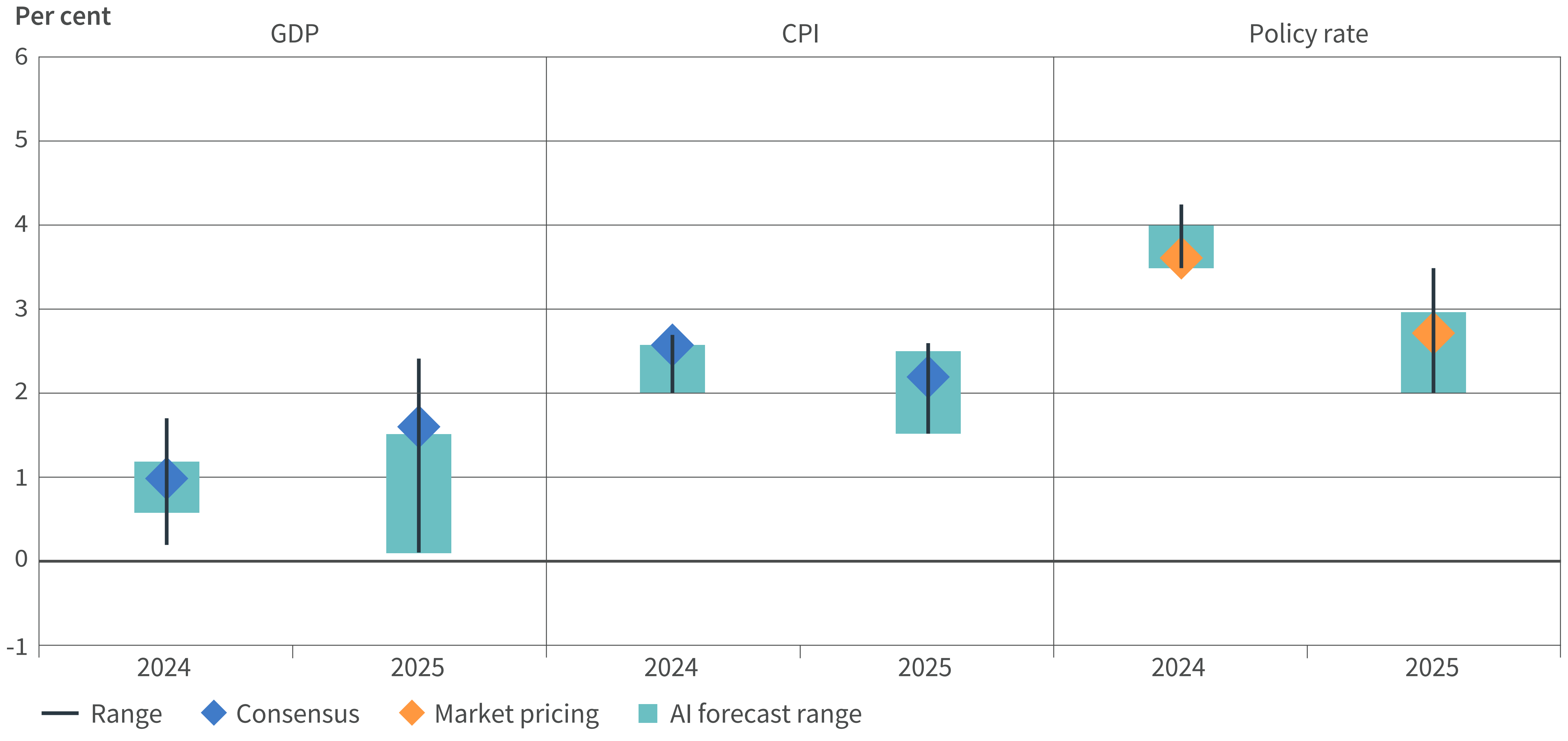
Since May's upside surprise, headline inflation has consistently undershot consensus estimates, and is now below the BoC's 2 per cent target at 1.95 per cent YoY as of August. Indeed, the BoC's "preferred measures", designed to better reflect underlying price pressures (CPI trimmed mean and median), continue to demonstrate a clear downward trajectory, with the two averaging 2.35 per cent YoY in August. However, services inflation remains sticky (4.6 per cent YoY in August) as wage growth and shelter inflation remain elevated. Yet as of September's meeting, the BoC opted to lower its policy rate by 25 basis points for the third consecutive time. This arguably reveals the dovish reaction function of the BoC and a shifting of the narrative towards growth.

On the surface one might take comfort from Q2's GDP release, which came in ahead of both consensus and the BoC's own expectations. However, this was largely due to government spending and private investment, as household consumption slowed markedly – rising only 0.6 per cent QoQ. What is more concerning, however, is that Canadian GDP per capita has now been persistently contracting for a whole year. This demonstrates the reliance that Canadian growth has had upon population growth this cycle, which is expected to slow henceforth, and is now a pressing concern for policymakers as labour productivity remains lacklustre. So much so, that the per capita argument has been one of the main concerns cited by the BoC in justifying their decisions to ease policy.

As mentioned earlier, services inflation has remained persistent. This largely pertains to the shelter component, contributing well over two thirds of headline inflation owing to elevated mortgage interest costs. We would expect for the contribution of this category to continue to diminish, as it has been since June, reflecting the BoC's looser policy stance. The stubbornness of wage growth has been surprising, given the slowdown seen in the labour market and in wider activity. However, more forward-looking surveys on wage growth still give us belief that the past loosening seen in the labour market will weigh more clearly upon wage growth in the coming quarters.

Household mortgage debt service ratios have continued to rise this quarter, as have business bankruptcies, with the former now well above its pre-pandemic levels. Debt service ratios represents one of the more traditional mechanisms of monetary policy transmission into the real economy. Its continued rise throughout 2024 indicates that policy is still at work in Canada- providing greater urgency for the BoC to dial back restrictiveness. Ultimately, we believe that inflation risks are receding whilst downside risks to growth are becoming increasingly prevalent. As such we expect further easing of policy from the BoC in both 2024 and 2025 (Figure 16).

Figure 16. **Canada**



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

> ***Inflation risks are receding whilst downside risks to growth are becoming increasingly prevalent***

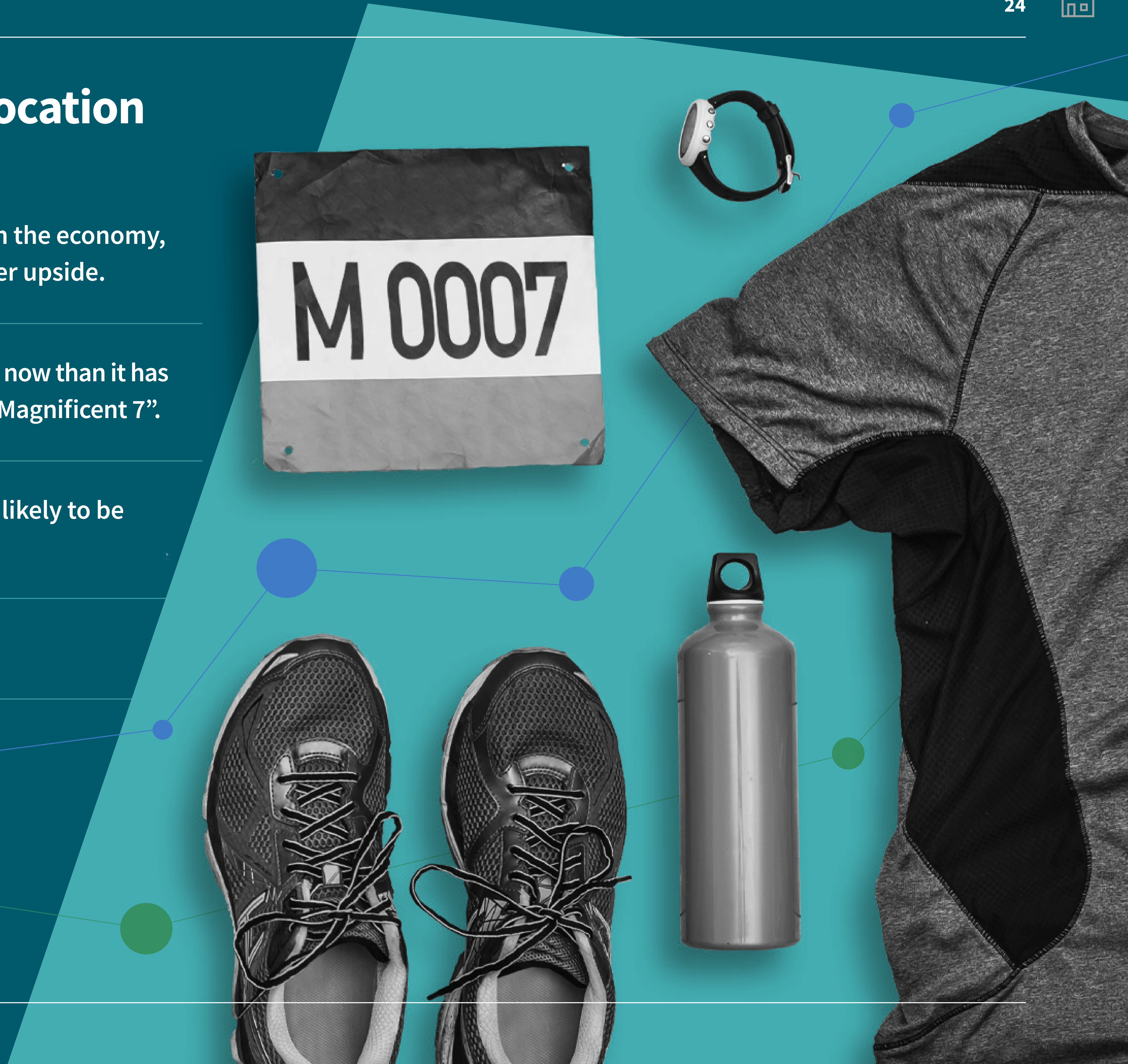
Global market outlook and asset allocation

We remain constructive on equities. There is enough support from the economy, structural drivers and expectations of lower rates to sustain further upside.

In many ways, the case for US equities in particular appears stronger now than it has been, as earnings have broadened and are less dependent on the “Magnificent 7”.

Easing cycles have started, but key to us is that terminal rates are likely to be materially higher compared to the pre-COVID period.

We still see room for USD weakness to extend further.



Global market outlook

In the third quarter, most risk assets experienced significant volatility through July and August. Global equities quickly rebounded and are now back at all-time highs as fundamentals remained supportive. The recovery was largely driven by US equities, but European equities are also trading back at similar levels to May/June and EM equities have rallied to the highest levels since 2022 following the China stimulus announcements. Commodities have also rallied following the news from China but are still below the highs reached in May. A noteworthy characteristic of the July correction was the return of a negative correlation between bonds and equities. Bonds fulfilled their diversification role in July and moved higher while risk assets were pressured. However, that negative correlation period might prove to be short lived if economic data continues to support a soft landing scenario. In the bounce back from that July correction, bonds and equities already resumed the positive correlation seen in recent years with both moving higher together. In FX, the USDJPY has now seen two months of sharp downside and is c.8.0 per cent lower than in early July. The Euro has also rallied against the dollar over the quarter, currently trading at c.1.10 and c. 3.0 per cent above the lows at the end of June.

> *The recovery was largely driven by US equities, but European equities are also trading back at similar levels to May/June*

Looking into the fourth quarter of the year:

- We remain constructive in equities. As we highlighted in previous House Views, we expect a more moderate pace of equity gains and more volatility, with bull-market corrections such as the July one becoming more frequent. But there is enough support from the economy, structural drivers, and expectations of lower rates to drive continued upside in equities for longer. We reiterate that growth has been and still is the driver of the equity rally. On that point, corporate profit growth remains robust, with a high degree of visibility on future earnings and profit margins continue to show resilience. While that background is in place, the core of the investment case for equities remains solid.
- Across regions the key question revolves around US leadership and if it continues despite challenging valuations or if the broadening of equity markets will favour regions outside the US. In many ways, the case for a continuation of US leadership appears stronger now than it has been throughout the year as earnings growth has broadened out and almost all sectors of the US market are now growing, reducing the dependence on Magnificent 7 earnings. In addition, visibility on those earnings has improved and growth for 2025 continues to be upgraded.
- The case for European equities is more complex. Although European earnings are recovering; the structural outlook for European stocks remains challenging. So, the window of opportunity for Europe to catch up to the US is short. Over the last several months political risk, continued geopolitical turbulence, headwinds from China exposure and other factors prevented European equities from taking advantage of that cyclical chance to outperform. This has consumed much of that short window of opportunity. The window is still open and the recently announced stimulus from China could remove one of the headwinds for Europe, but the bullish case for European equities gets harder with each passing day.
- The Fed, the ECB and the BoE have now all started their easing cycles, but terminal rates are likely to be materially higher compared to the pre-COVID period. We see the amount of Fed cuts priced in by markets as broadly fair – but there are risks in both directions. We think the ECB will end up cutting by a little less than market expectations, while we maintain the view that the BoE will be forced to deliver faster and deeper cuts next year. In contrast, the BoJ will continue to tighten policy.
- We maintain our preference for curve steepeners, although acknowledge that forwards have moved ahead of spot already. We see value in receiving UK rates given our belief the BoE will cut more than expected. While in Japan, we are of the view that the BoJ will tighten policy more than what is priced.
- We highlighted in our previous House View that the environment suggested USD depreciation and this has largely played out in Q3. Going forward, we still see room for the USD weakness to extend further. Some of the catalysts we are watching that could lead to a bottoming out of the USD are: (1) an increase in trade barriers post the US election; (2) global growth decelerating and US growth outperforming global growth again; (3) higher rates volatility. On the flip side, what appears to be a change in signalling by Chinese policies towards more orchestrated and bigger support for the economy could amplify USD downside via a rerating higher of global growth/trade expectations – if confirmed.

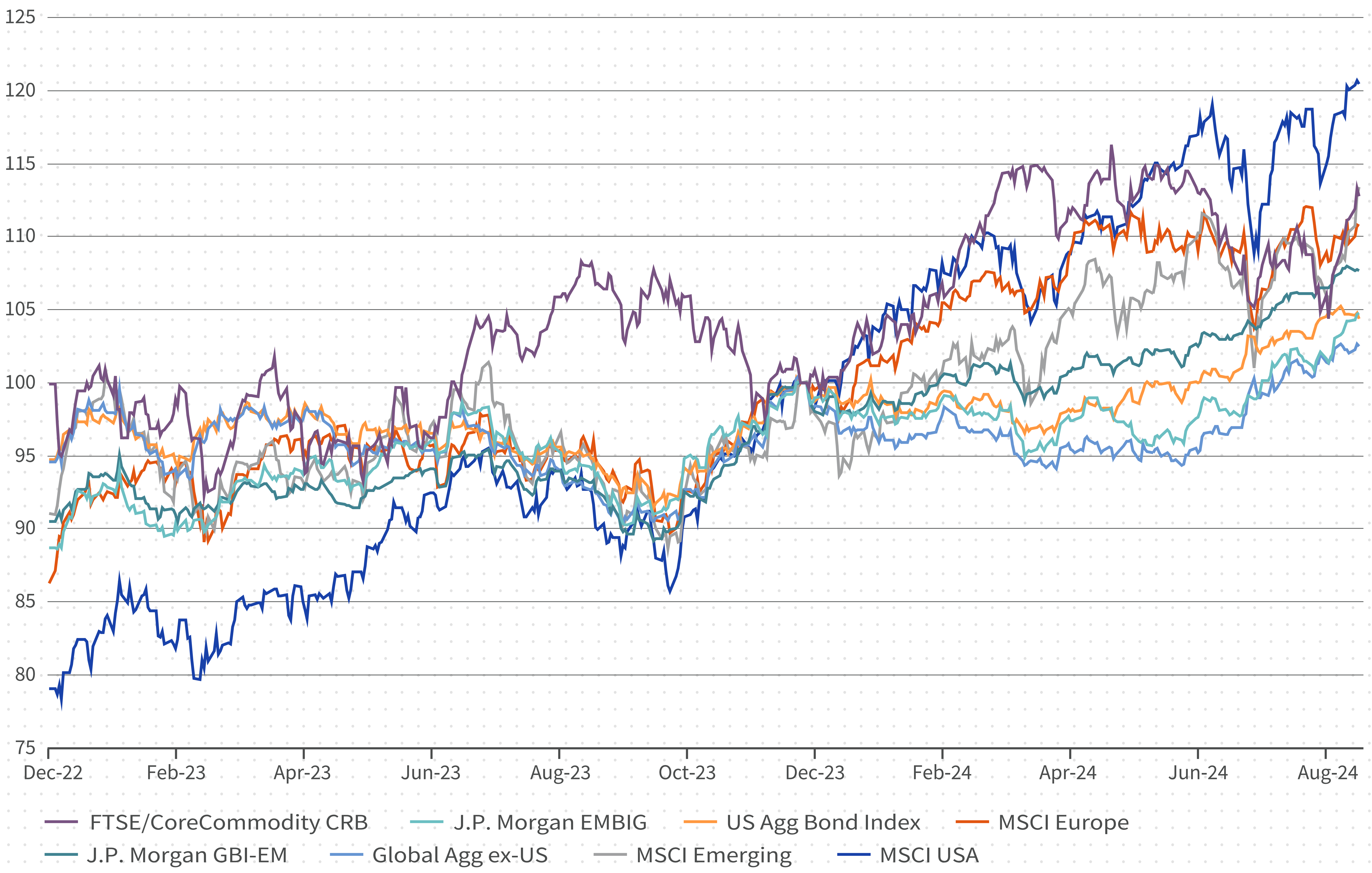
- Credit has been one of the lower volatility asset classes of late, as strong fundamentals make corporates less sensitive to macro risks, and supply has been and should be easily absorbed, especially as rates decline and yield curves disinvert. Both investment grade and high yield spreads are relatively low but offer decent risk-adjusted carry as long as recession is avoided, and have stayed rangebound. European spreads are a good 10-15 per cent wider than US counterparts on average, but that seems fair given the sector-specific downturns and political risks.

As always, there are several risks to these views: disinflation can slow again (or stop) or we could see further pressure on US activity, raising recessionary odds. The recent weak European PMIs could be the presage for disappointment in European growth. China's industrial, housing and monetary policies will also remain of focus. The recent stimulus announcements have given a temporary boost to the Chinese equity market, but but for the impact on the overall economy to be very significant, the announcements so far would need to be followed by fiscal action in order to generate a broader and sustained domestic boost. (Figure 17)

Both investment grade and high yield spreads are relatively low but offering decent risk-adjusted carry as long as recession is avoided, and have stayed rangebound

Figure 17. **Total return across a range of assets**

All series rebased (100) at the end of 2023



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

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

Equities: The times they are a changing – why we see the need to reassess how we look at equities

For over two years now most equity investors have been thinking of the market in terms of the risk of an economic hard landing vs a soft landing. And this dichotomy has remained top of mind despite the fact that the economy, especially in the US, has remained resilient.

We also need to consider that during this period the earnings cycle has been on a different timeline than the rate cycle. In every rate cycle since the late 60s, the Fed would reach peak rates while earnings were still rising (in part driven by inflation). Corporate earnings would only peak and go into contraction, at the earliest, three months after the Fed reached peak rates (in the late 60s and late 80s cycles) and, at the latest, 11 months after (in the mid-2000s cycle). From that peak, earnings would start contracting and the first rate cut would tend to happen during that contraction period. Those rate cuts would then support growth and earnings would soon bottom out and start expanding again. That is the "normal" picture of synchronised inflation/rate/earnings cycles.

In the current cycle, however, the moment when earnings peaked and went into contraction was in Q2 2022, over a year before the Fed reached peak rates. Subsequently, earnings already bottomed out and went back into a new period of growth over a year ago – around the same time the Fed was reaching peak rates. So, for the listed market at least (and of course, it is worth emphasising, the listed equity market is not the economy), corporates' reported profits already went through a contraction and back into expansion.

That contraction in US equity market earnings from mid-2022 to mid-2023 was concentrated in the big-tech space but was material, constituting an "earnings recession" of a magnitude similar to that seen in inflationary recessions of the 60s and 70s – S&P 500 earnings fell by ~13 per cent between 2022 and 2023, the same amount they fell in the late 60s cycle.

> ***We no longer see the dichotomy of soft vs hard landing as the best way to frame equity market dynamics***

One pushback to the above rationale is that equity markets are disconnected from the economy and hence negative equity performance is needed so they "reconnect". We would argue that, in fact, the earnings cycle is much more aligned with the inflation cycle than the Fed rate cycle has been. Suggesting it is Fed rates and not earnings that might be "out of sync".

All in all, this timing mismatch led to a market in two minds. At times late-cycle sectors such as Pharma and Utilities led. But, more often than not, early-cycle sectors drove the market higher, such as Semiconductors, some parts of Industrials, Construction and Banks.

Going forward, we need to reassess the way we look at equity markets to adapt to those changing times and odd timings. We don't see the simple dichotomy of soft vs hard landing as the best way to frame equity market dynamics. That in no way means the risk of a recession should be disregarded, that risk is not imminent in our view but over the medium term it is present. What it does suggest is that to frame that recession risk as natural follow-up to the central banks' rate cycle is no longer adding value to the understanding of equity markets.

To us the key questions that leads to a better understanding of equity markets from here are: first, how the cyclical sectors that exhibited an early cycle behaviour will progress as we head into a more mature earnings cycle, with more limited margin expansion? Second, how will the behaviour of the rate sensitive section of the market which has been in line with a late cycle (Utilities, Real Estate, etc.) evolve as the Fed continues to cut rates.

Those are the main forces we see driving equity markets at the moment: in one corner, a group of cyclical sectors which delivered operating leverage and margin expansion heading into a softer but resilient economic environment. While in the opposite corner, a group of rate sensitive defensive sectors which already delivered a fair amount of re-rating in the past few months heading into the crux of the Fed rate cut cycle.

The conclusion to us is that on balance this should be supportive for equity markets. The pace of gains is expected to be slower than in recent quarters; in line with the slower pace of US economic growth. But equities, and especially cyclical sectors, should find enough support in the economy and in structural drivers such as artificial intelligence. In addition, headwinds to some of the cyclical sectors are either behind us (such as the industrial destocking cycle) or should be resolved soon (such as election uncertainty in the US). As for the rate sensitive defensive cohort, while the leadership of the past few months is unlikely to continue (save in the event of a significant negative growth shock) lower rates should still provide support.

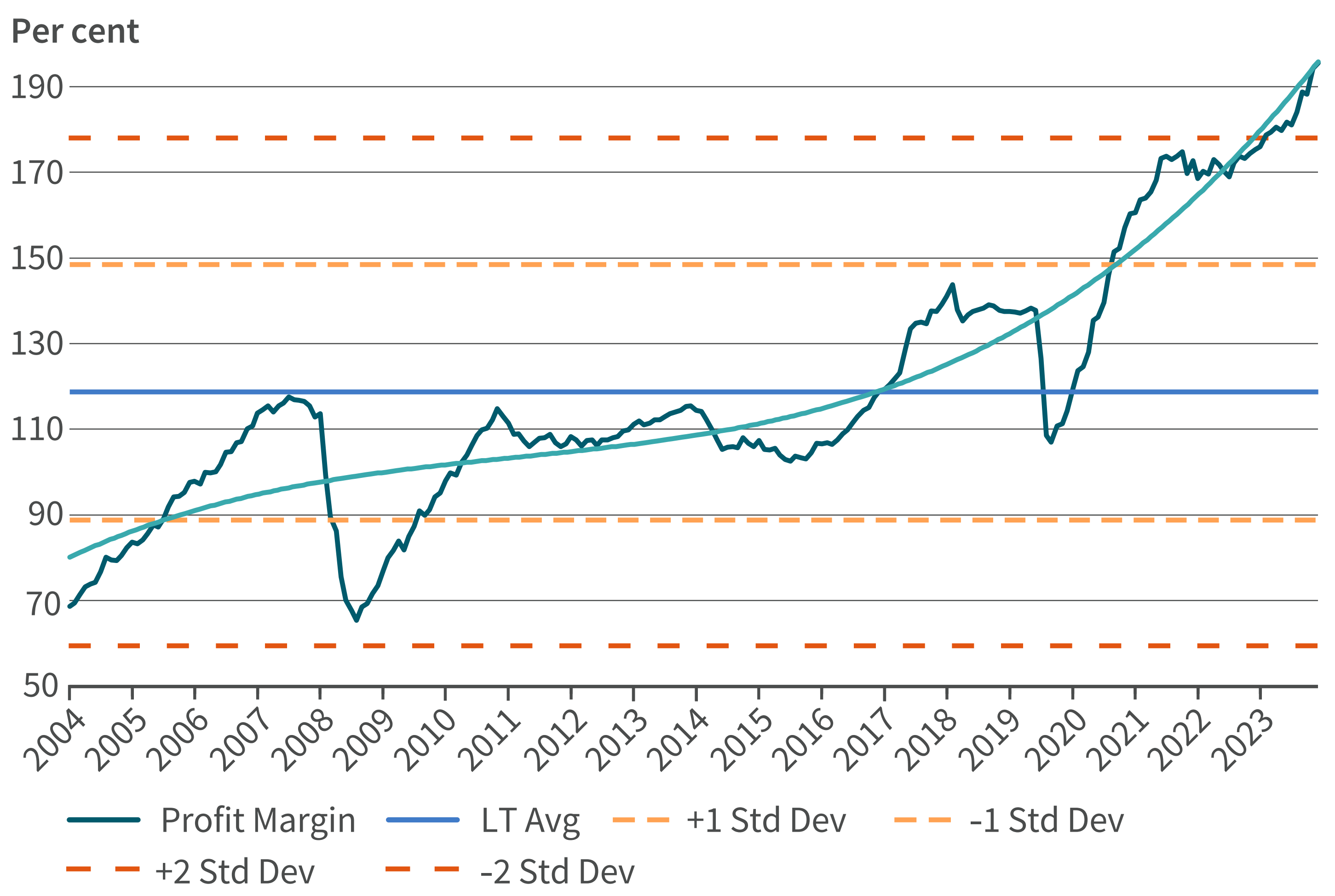
Back to the start: "Eventful" price action meets "boring" fundamentals

The past three months saw significant price action, but "boring" fundamentals. And as the adage goes in markets: "boring is good" (Figure 18 and Figure 19). The volatility experienced over the summer has left equity markets largely where they started before the July correction. Meanwhile, under the surface, fundamentals remain robust. Earnings continue to show the resilience we expected, so do profit margins. We remain of the view that the key driver of the equity rally is growth. Hence, we reiterate: a backdrop of resilient but decelerating economic growth is likely to translate into a continuation of the equity upside but at a slower pace.

Looking at the recent few months, while on the surface the market went back to where it was beforehand, the July correction led to a significant change in sector leadership in the market. That is in contrast to the equity market correction we saw in April which did not change the sector composition of the rally. In the US, Utilities and Real Estate have both moved up double digits in the period since the start of the correction in mid-July. In the same period the Tech sector moved lower by just over 6 per cent (Figure 20).

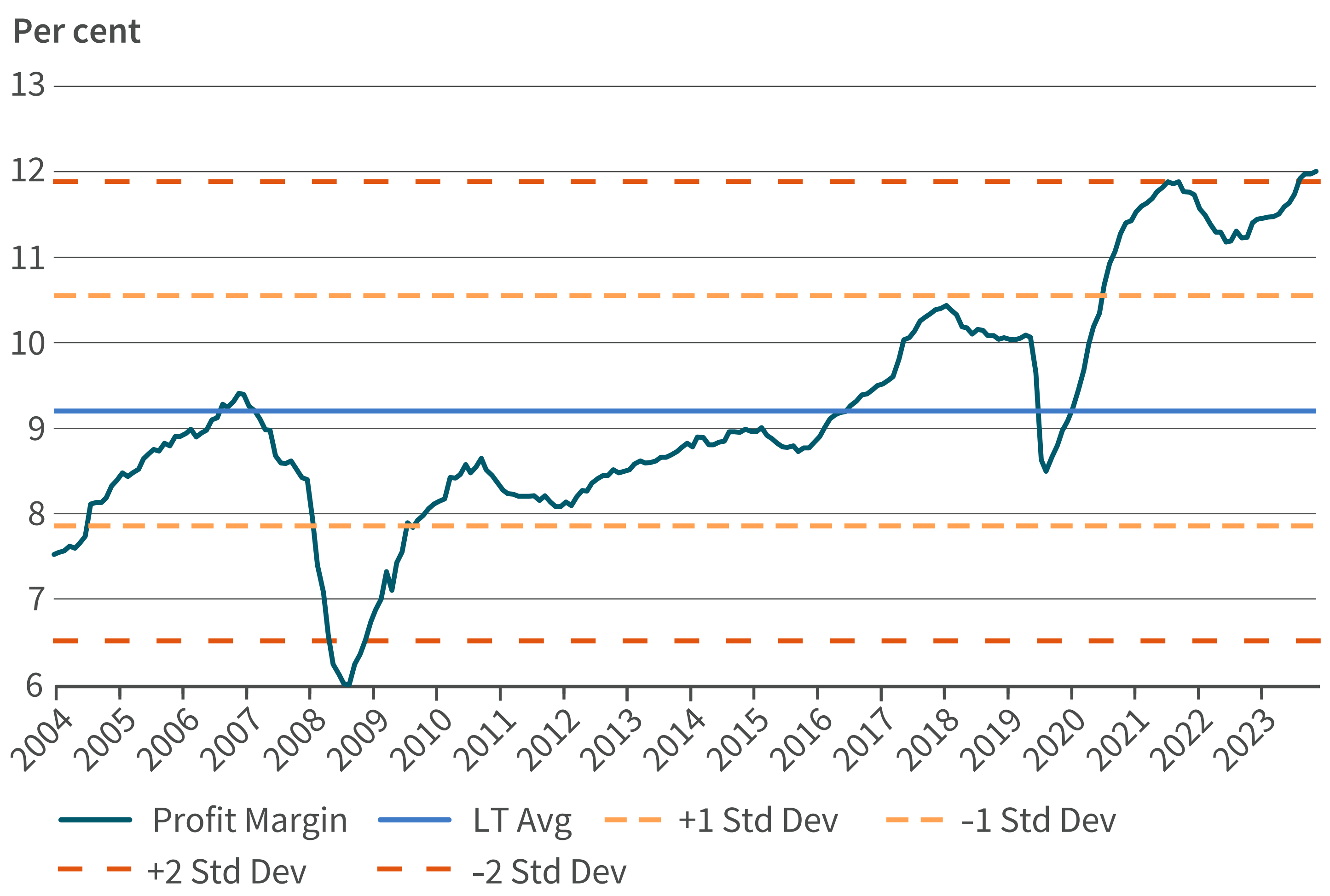
> *Earnings continue to show the resilience we expected, so do profit margins*

Figure 18. **MSCI World Profits – smooth sailing in fundamentals**



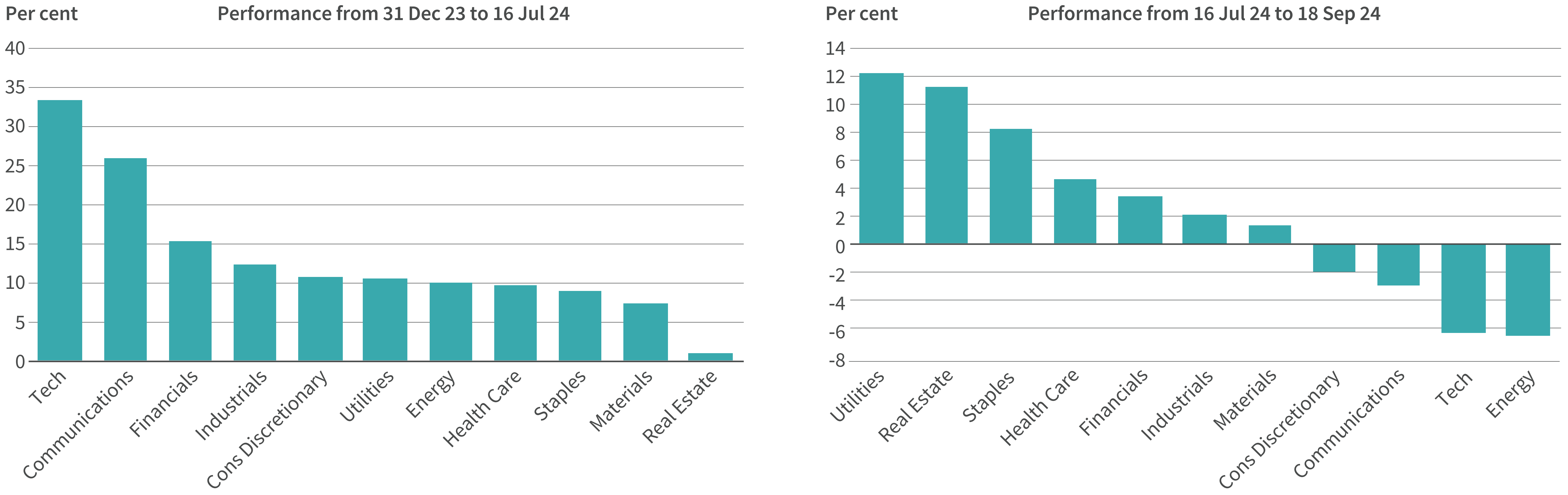
Source: Aviva Investors, Refinitiv Workspace as at 30 September 2024.

Figure 19. **MSCI World Margins – margins remain resilient**



Source: Aviva Investors, Refinitiv Workspace as at 30 September 2024.

Figure 20. **Sector performance changed after the July market correction**



Source: Aviva Investors, Refinitiv Workspace as at 30 September 2024.

Prior to the July correction, Tech was by far the best performing sector while Real Estate was the worst, followed by Materials and Staples. Utilities is now broadly in line with Tech as the two best performers this year and Real Estate is now ahead of Energy, Materials and Consumer Discretionary. Staples also moved up significantly and is now broadly in line with the S&P year-to-date.

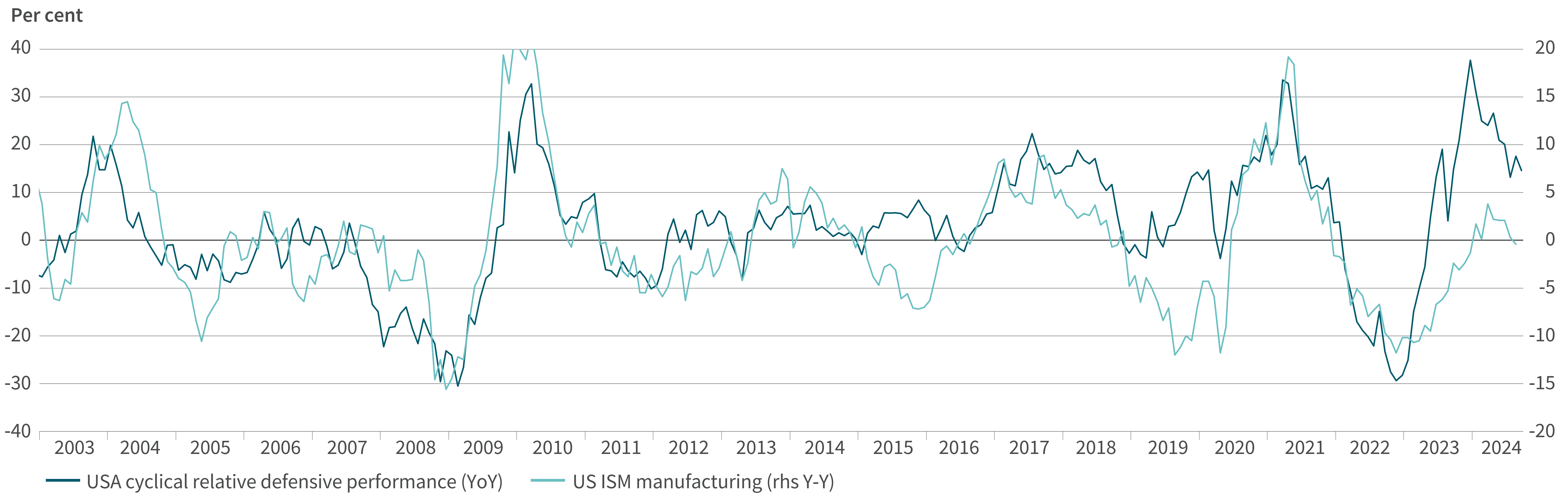
It is important to highlight that the trends in cyclical vs defensive performance are moving in line with the trends in business surveys (e.g. ISM), as is the historical norm. There has not been any significant period since the Covid shock in which cyclical vs defensive performance and ISM were moving in different directions. What is surprising is the magnitude of the movement, not the direction (Figure 21). Cyclicals outperformed defensives at a much faster pace in 2023 and early 2024 than the ISM trends would suggest – but those ISM trends still suggested cyclical outperformance. Many factors contributed to the magnitude of the cyclical run; bouncing back from a historical low in line with the trough of the global financial crisis, the reopening of economies following the Covid lockdowns and artificial intelligence.

We see opportunities across a range of sectors such as Industrials, Technology, Financials, Consumer sectors and Real Estate

Going forward, the magnitude of that differential is likely to slowly fade as base effects fall out of the comparative periods, but it is unlikely to reverse unless the artificial intelligence driver also reverses and/or the economy goes into recession. On the other hand, if ISMs resume upside trends, there is no clear reason why the defensive outperformance should continue – at least not at the current pace. Referring back to the key forces at the centre of equity markets we described above: the environment suggests a more balanced positioning. Outcomes are more binary, growth is somewhat slower, rates are moving lower. The early cycle behaviour in some cyclicals should start to mature. The late cycle behaviour in some rate sensitive defensives should move into its conclusion.

This all points to opportunities in both cyclical and defensive. Cyclicals that have further support, either structural via artificial intelligence or fiscal stimulus, or cyclical through the end of the industrial de-stocking cycle, or the end of election uncertainty, should do well. On the other hand, some defensive sectors should still have room for multiple expansion as rates move lower and the earnings growth gap to cyclicals narrows. We see opportunities across a range of sectors such as Industrials, Technology, Financials, consumer sectors and Real Estate.

Figure 21. **Cyclical vs Defensive performance and ISMs – a gap in magnitude but the direction remains the same**



Source: Aviva Investors, Refinitiv Workspace as at 30 September 2024.

Rates: The cutting cycle has begun but how far will it go?

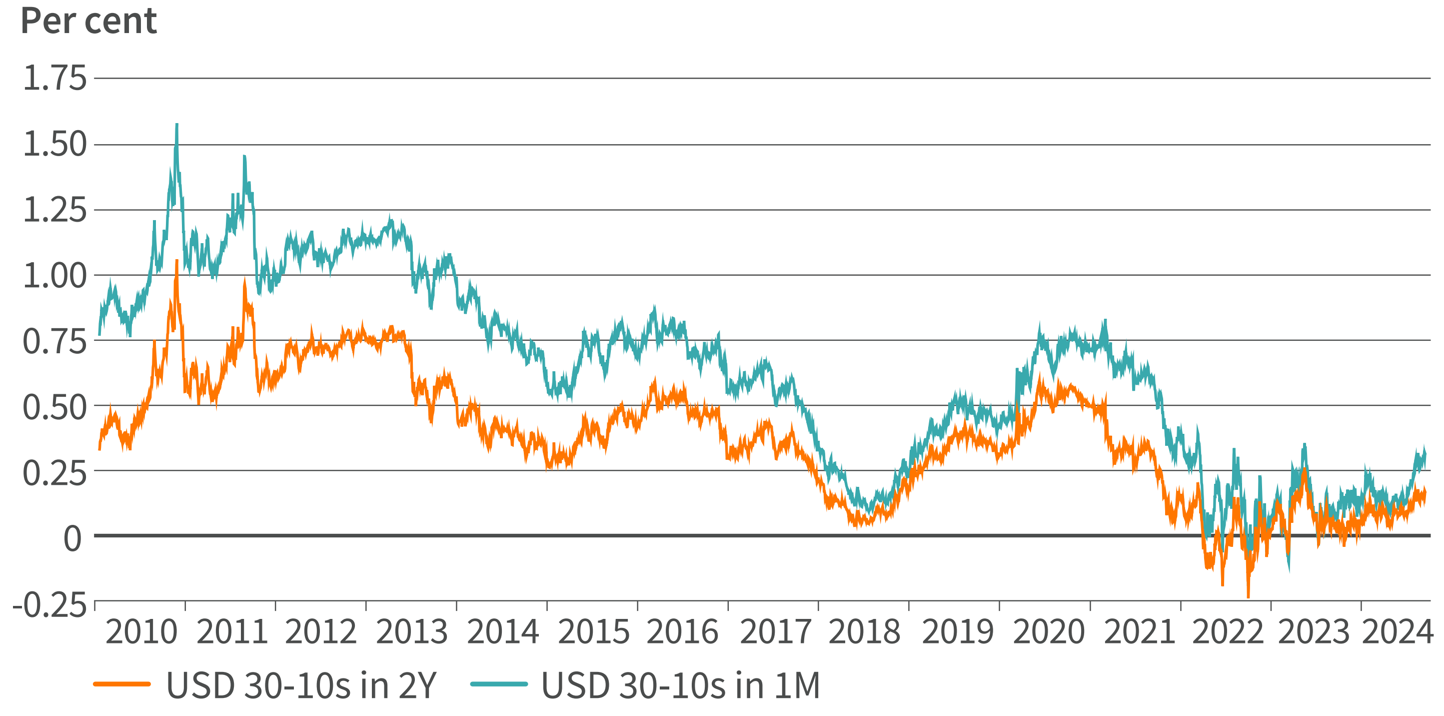
The severe rates repricing during 3Q24 surprised us somewhat – as discussed in our 3Q24 House View, we were expecting a lower rates' range but no significant declines. What transpired was a broad based bond rally led by the shorter end of the curve, due to (1) a revival in the disinflation theme and (2) further loosening in the US labour market: in the US, 2Y yields fell by c.115bps and 10Y yields by c.65bps, ending years of yield curve inversion. Somewhat more more modest declines were seen in the Eurozone and the UK, while Japanese yields stayed relatively unchanged, pulled in opposite directions: the BoJ tightening policy against the global decline in yields.

All major central banks (Fed, ECB, BoE) have now started their easing cycles. In summary, we see the c.200bps of Fed cuts priced as broadly fair – but there are risks in both directions – as the Fed navigates towards a soft landing. We think the ECB will end up cutting by a little less than market expectations, while we maintain the view that the BoE will be forced to deliver faster and deeper cuts next year. In contrast, the BoJ will continue to tighten policy. However, it is important to highlight that terminal rates are likely to be materially higher compared to the pre-COVID period.

Our assessment is based on the following three principles:

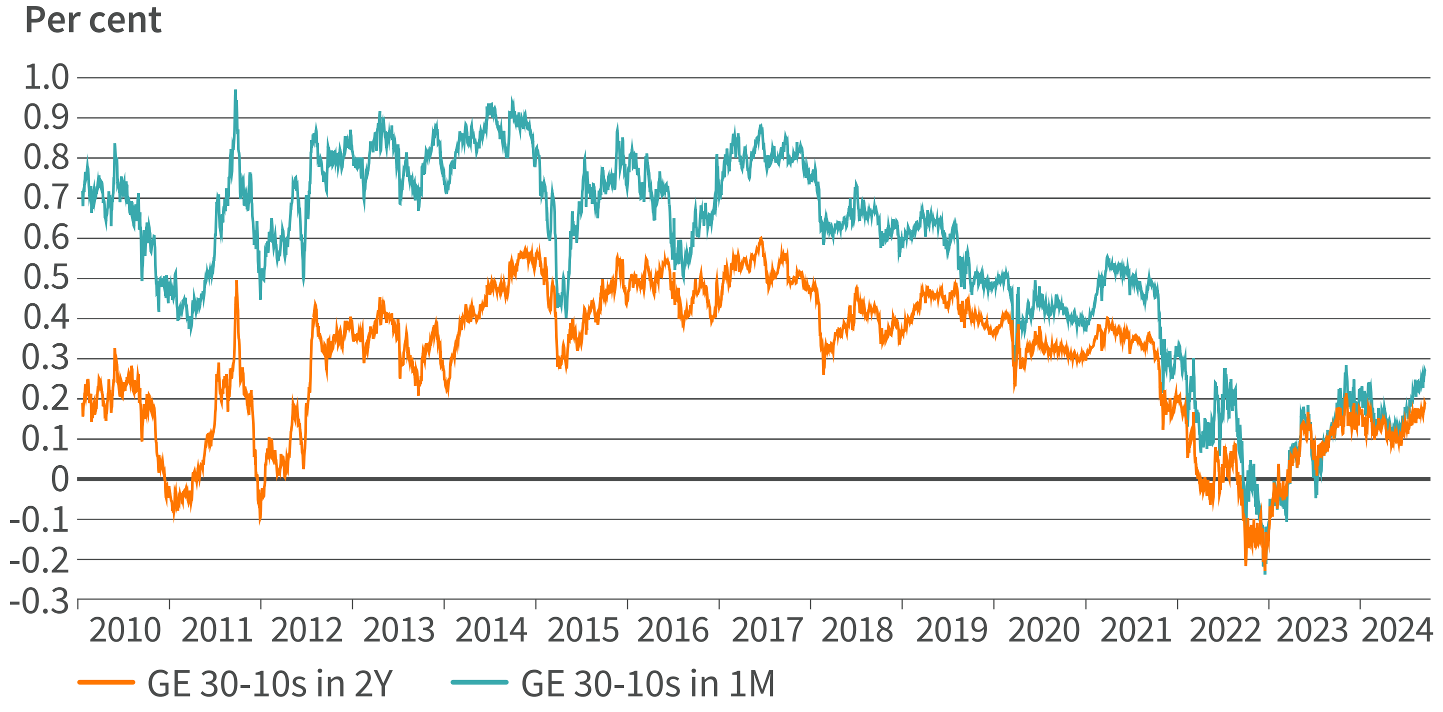
1. **In our view, the US economy has slowed, and the labour market has come broadly into balance.** However, the economy does not appear to be on the precipice of a recession, with all usual indicators (e.g. real spending/income, employment, industrial production and soft surveys) not flashing any alarming signals.
2. **Despite what several headlines would have you believe, market pricing of rates is not reflective of recessionary fears:** during the previous recessions post-1990, the Fed cut interest rates by an average of 500bps i.e. twice as much as current pricing.
3. **We consider the current pricing as broadly fair, although there are risks on both sides, the skew is greater to the more downside.** More specifically:
   a. There are asymmetric risks to US yields: on one hand, a soft landing scenario is now priced so its validation will only see limited upside to yields, even if the Fed don't have to deliver all the cuts priced; on the other hand, there is more ample room for yields to fall if recessionary fears flare up, due to accelerated deterioration in the labour market: rates pricing would move closer to that of Fed reaction in prior recessions.
   b. We maintain preference for curve steepeners, although acknowledge that forwards have moved ahead of spot already. This requires patience and choosing tactically the entry points. We prefer 10s30s in the US and core Europe (see Figure 22 and 23).
   c. Outside the US, we continue to see value in receiving UK rates: we believe the Bank of England will deliver faster and deeper rate cuts than currently priced, owning to consumption fragility; in that sense, the shorter end of the curve is more attractive, also because longer yields are likely to continue incorporating risk premia relating to fiscal developments and structural Brexit issues. In Europe, things are slightly more complicated: fundamentally, we think that the risk lies to upside in yields but acknowledge that recent survey data have been disappointing and have yet to bottom out; any improvement in sentiment indicators should be considered a catalyst to initiate payers at the short end.

Figure 22. **US rates curve expected to steepen...**



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

Figure 23. **...and core Europe**



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

   d. In Japan, we remain of the view that the BoJ will be forced to tighten policy more than the 25bps of hikes that the market has priced until 2025-end: headline inflation dynamics continue to show upside pressure, nominal cash earnings are growing annually at more than 3.5 per cent (the highest since the early 1990s) and real earnings are growing again, despite inflation being higher than 2 per cent.

Despite what several headlines would have you believe, market pricing of rates is not reflective of recessionary fears

FX: Q4 to see further dollar weakness

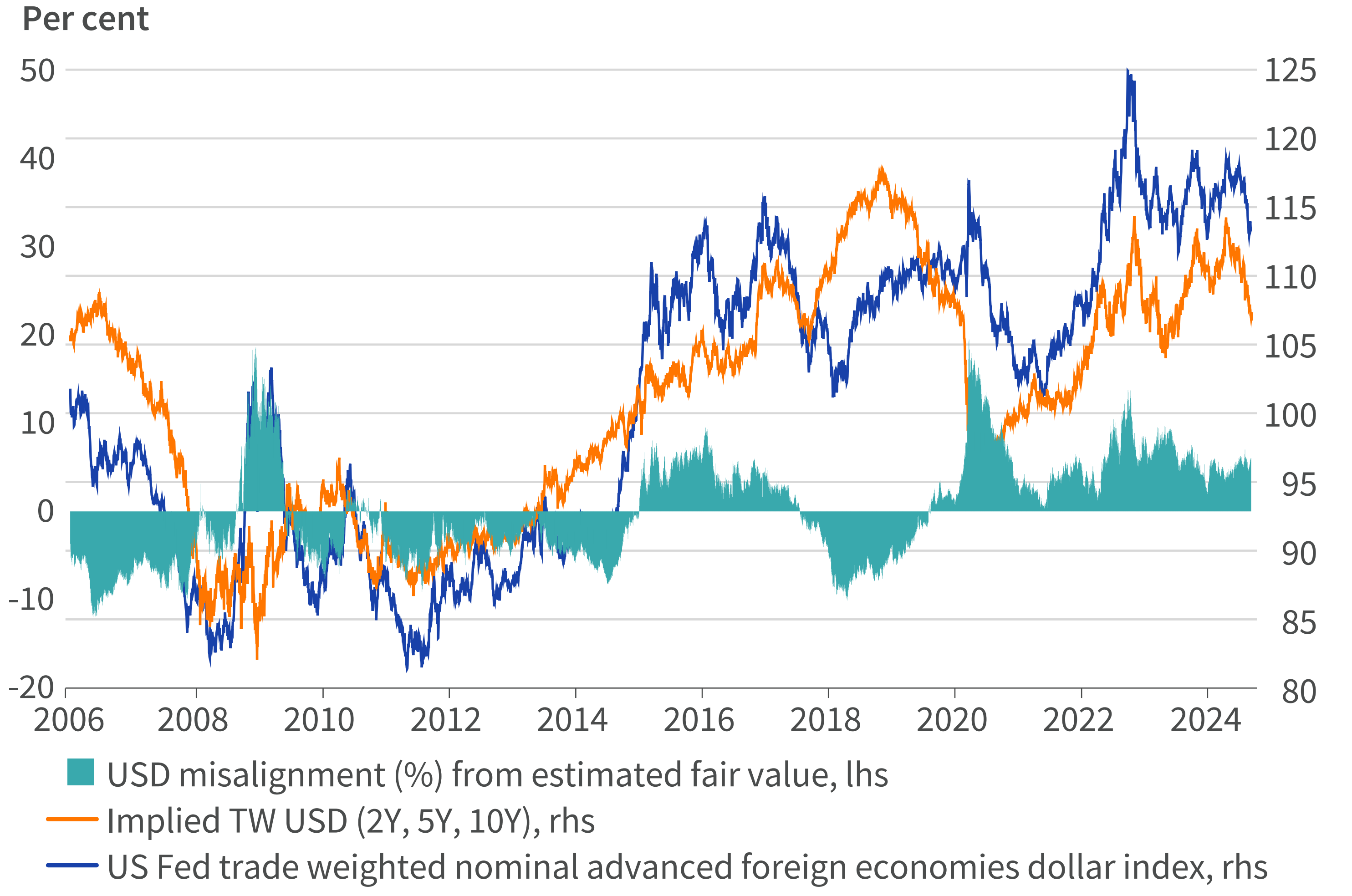
In our last House View we argued that resilient but slowing US growth together with US dollar overvaluation suggested that USD weakness was likely to continue, while the euro could extend its gains. Q3 has largely played out along these lines, with the Trade-weighted (TW) USD index down by c.4 per cent and EURUSD appreciating by more than 4 per cent. The stellar performer was the JPY (USDJPY down by 11 per cent QoQ) driven by a significant repricing of more Fed easing, BoJ's tighter monetary policy and the July/August flare up in risk aversion. GBP was also stronger across the board, despite the BoE cutting rates in August, as so far easing expectations have remained relatively modest (vis a vis other major central banks). Emerging market (EM) foreign exchange (FX) performance was rather mixed, with dollar weakness supporting mostly EEMEA (Eastern Europe, Middle East and Africa) and select Asian currencies but failing to provide support to high carry/beta LatAm FX.

In our view there is room for USD to depreciate further, especially since recent China policy announcements will result in a re-rating higher of global growth expectations. Namely: (1) fundamentally, the TW USD remains overvalued relative to TW yield differentials, by c.6 per cent (see Figure 24); (2) Fed pricing (c.200bps of cuts through the end of 2025) extended significantly over the summer but is not pointing to recession (which historically has resulted in c.500bps of Fed easing) (see Figure 25); this means that risks are asymmetric i.e. limited repricing higher of rates in a soft landing scenario vs more scope for repricing rates lower in a recessionary one; (3) as far as EUR and the ECB are concerned, we still believe that the market pricing c.1.75 per cent terminal rate appears aggressive and euro rates have room to reprice higher and hence the euro to appreciate; (4) the combination of US growth slowing, Fed cutting rates and rest of world (RoW) growth holding up (or, in fact, doing better than previously expected due to China measures) has empirically been negative for the dollar; (5) GBP should remain supported in the near term, but face headwinds later, when the market (finally!) reprices rates lower – however, UK-EU relations are likely to be a decisive factor for sterling over the medium term, with any potential lowering of trade/immigration barriers providing structural support ; (6) JPY remains a very tough call, not least because it is difficult for expected spot returns to trump the negative carry; we hold no strong view here but expect JPY appreciation over a long period of time with periods of increased volatility; (7) assuming RoW growth holds up as we expect, FX carry should make some headways but we still believe that most of the carry-gains have already been realised.

In our view there is room for USD to depreciate further

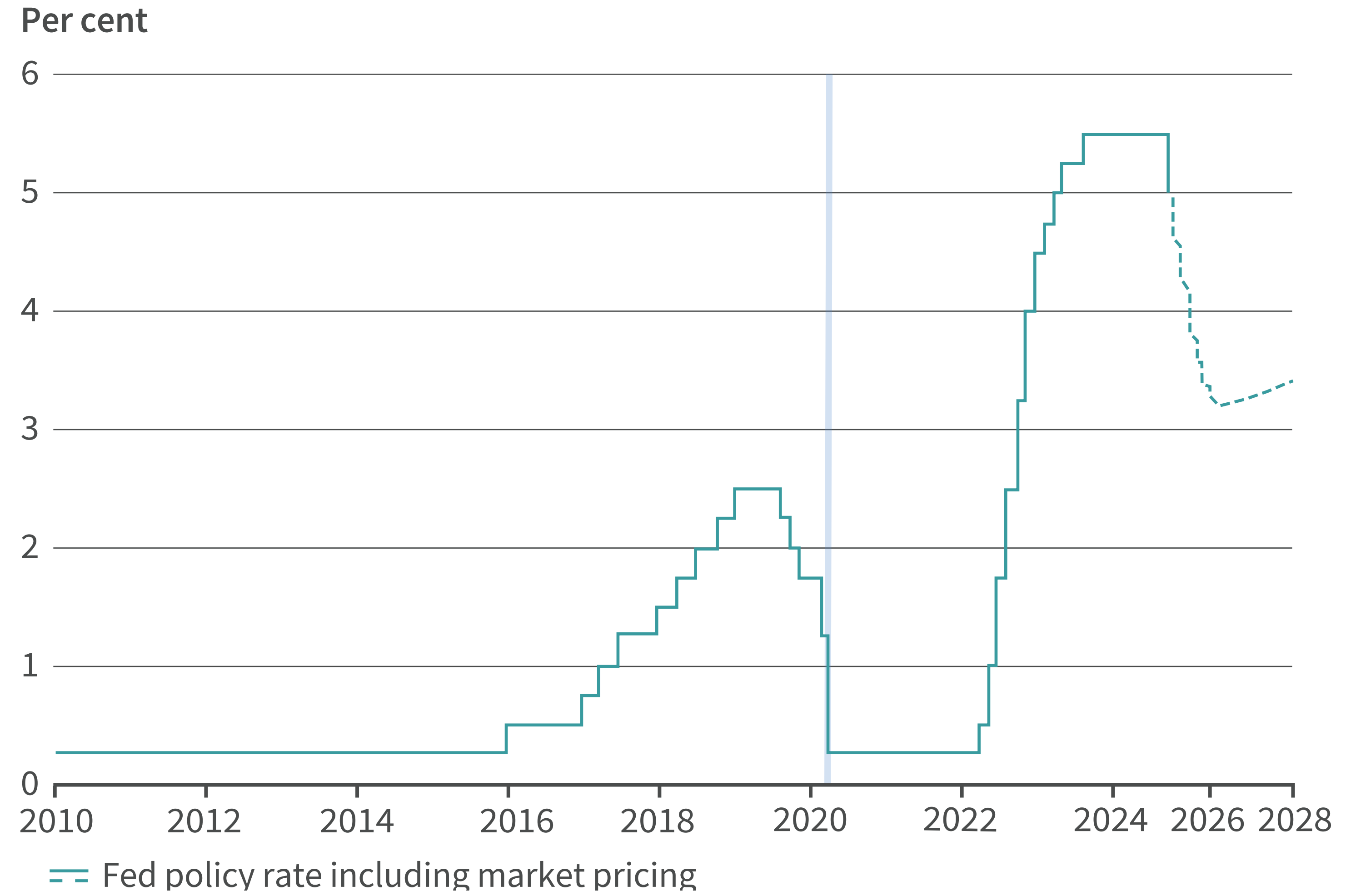
However, there are pathways through which the dollar manages to bottom out and appreciate again: (1) the US election outcome triggers an increase in trade barriers, dampening global growth and trade and spurring flight to safety; (2) global/eurozone growth decelerates (including due to China slowing further); (3) US growth starting to outperform global growth again prompting the Fed to deliver meaningfully less tightening; (4) higher rates volatility, which has historically been supportive of the dollar.

Figure 24. Trade-weighted USD remains overvalued



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

Figure 25. Current market Fed pricing nowhere near recession territory



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

Figure 26. **Asset allocation**

	Underweight										Overweight
	-5	-4	-3	-2	-1	0	1	2	3	4	5
Equities							1				
US								2			
Europe							1				
UK						0					
Japan						0					
Pacific Basin ex-Japan						0					
Emerging Markets						0					
Government bonds							1				
US								2			
UK								2			
Eurozone						0					
Japan					-1						
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				-2							
Currencies (versus US$)						0					
GBP						0					
EUR						0					
JPY							1				
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 September 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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