AVIVA INVESTORS

Q2 2017 HOUSE VIEW

The intelligence that guides our investment decisions

CONTENTS

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 Aviva Investors investment professionals and is overseen by the Investment Strategy team. Each quarter we hold a House View Forum 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. Everyone has the right to challenge and all are encouraged to do so. The aim is to ensure that 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 all of the conclusions reached. No one can predict the future. But the contents of this report represent the best collective judgement of Aviva Investors on the current and future investment environment over the next two to three years.

EXECUTIVE SUMMARY

THE GLOBAL ECONOMY EDGES CLOSER TO NORMALIZATION

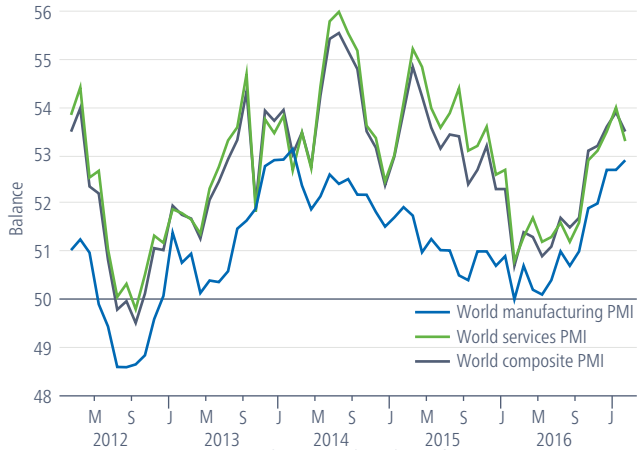
After a number of false starts, the global economy appeared to finally find a firmer footing in H2 2016. Nearly ten years after the onset of the global financial crisis, the deepest financial and economic crisis since the Great Depression of the 1930s, the scars left on the global economy may finally be fading. While progress is most clear in the United States, what has been encouraging about developments in recent months has been the synchronized and broad-based nature of the growth upswing. According to Markit Purchasing Managers' Index surveys (PMI), global manufacturing rose to near its strongest rate in over five years in February, with gains seen across both developed and emerging markets (Figure 1). The rapid improvement in global manufacturing is in stark contrast to H1 2016, when many feared global recession. The recovery in manufacturing has also been accompanied by a pickup in global trade volumes. Trade growth has been slower than global output growth for much of the past five years, a highly unusual situation. However, the most recent indicators suggest that trade growth is likely to rise above output growth in the coming months.

Synchronized and broad-based global growth upswing

While the manufacturing upturn has been particularly notable, the service sector has also seen gains, albeit they have been somewhat more muted. The rate of improvement has also been starker in survey-based measures than it has in the official or "hard" data. Looking ahead, we will be looking to see the hard data better reflect the survey evidence. If it does, as we expect, it should translate into global GDP growth of around 3.5% in 2017, the fastest rate of growth since 2011. Across the major developed market economies, we expect modestly above-trend growth for all but the UK. The rise in global growth has come at the same time as global inflation has risen to multi-year highs (Figure 2). Having risen modestly over H1 2016, Consumer Price Index inflation picked up more rapidly in the major developed economies in recent months. That pickup reflects a stabilization and subsequent increase in commodity prices during 2016. That saw the contribution to inflation from energy and food move from deeply negative to modestly positive. Core inflation, which removes energy and food price inflation, has risen moderately in the US, but has been low and stable in the Eurozone and Japan. With above-trend growth expected in the major economies this year, spare capacity will continue to be eliminated, which should put upward pressure on wage growth and core inflation.

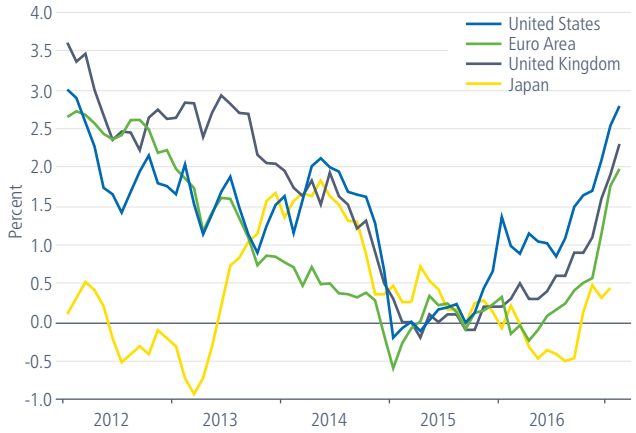
Rapid rise in headline inflation

Figure 1: Global economic activity
Global growth improved markedly in recent months



Sources: Aviva Investors, IHS Markit, Macrobond, as of 03/31/2017

Figure 2: CPI inflation
Multi-year high in the major economies



Sources: Aviva Investors, Macrobond, as of 03/31/2017

FUNDAMENTALS TO ONCE AGAIN DRIVE MARKETS

Monetary and fiscal policy to support growth in 2017, but a turning point may be in sight for global monetary policy

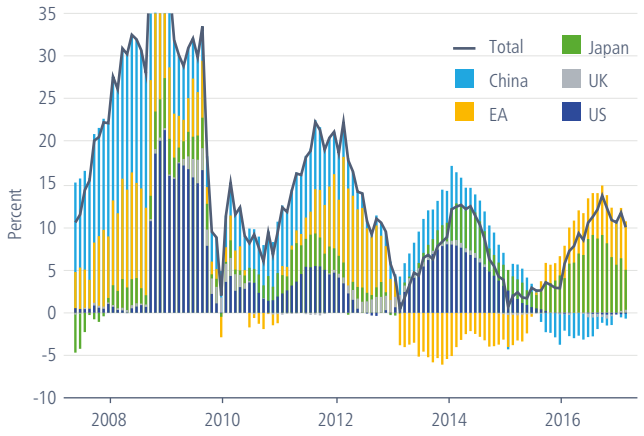
The post-crisis road to economic "normalization" has been a long one, and downside risks certainly remain. However, we think more than at any time in recent years the global economy is likely entering a sustained period of solid growth and moderate inflation. In part, that reflects the healing of private sector balance sheets over recent years. But importantly, we also expect that policy support will remain in place for some time. Monetary policy remains loose in all major economies, with the European Central Bank (ECB) and Bank of Japan (BoJ) expected to continue with quantitative easing (QE) policies throughout 2017. That will see the balance sheets of those central banks continue to grow, boosting global liquidity (Figure 3). With global policy rates also expected to remain low – only the Federal Reserve is expected to raise rates gradually this year – short-term real interest rates are set to remain negative. Alongside the monetary support, there has also been an increasing willingness to use fiscal policy. Perhaps most significantly, the fiscal boost in China during 2016 is expected to be maintained in 2017. It should continue to provide a material amount of support to Chinese growth, which in turn is supporting global commodity prices, manufacturing and trade. While the details of the anticipated tax and spending plan from the Trump administration are still to be revealed, we expect a package of tax cuts will be passed towards the end of this year. That will provide a further boost to US growth, albeit at a time when it is perhaps not entirely warranted. Nevertheless, it should also have positive spill-over effects to the rest of the world.

Risk assets have responded strongly to global upturn

Global markets have responded to recent economic and political developments, with risk assets performing particularly well year-to-date. Looking back over the past nine months, a period over which we have expected that the world was moving into a more reflationary environment, global equity returns have been strong, led by Europe and Japan (Figure 4). Earnings growth in Q4 2016 was the strongest in two years for developed market equities, and forward estimates have been revised higher. From a valuation perspective, Europe remains more attractive relative to the US, but the political risks in France and Italy may keep investors on the sidelines. In emerging markets, the pickup in global growth and inflation has provided an attractive backdrop for equity markets. Combined with the large valuation discount compared to developed markets, we expect emerging market equities to continue to outperform, but remain congizant of the risks, in particular the sustainability of the Chinese credit boom. Global credit markets have also performed strongly over the past nine months, especially high yield markets. That has reflected a sharp improvement in performance

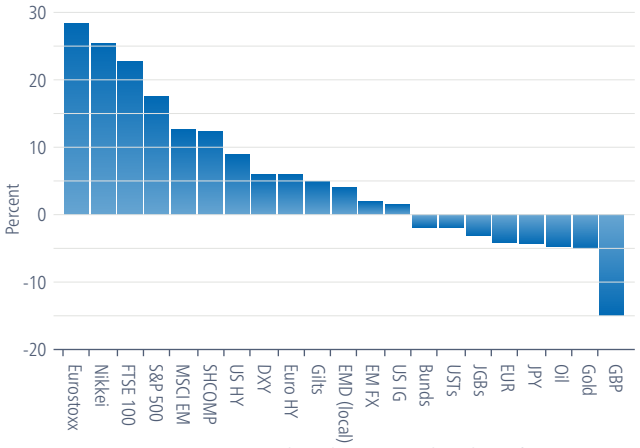
We favor European and emerging market equities

Figure 3: Growth in major central bank balance sheets
Global monetary policy still very accommodative



Sources: Sources: Aviva Investors, Macrobond, as of 03/31/2017

Figure 4: Global market performance since mid-2016
Risk assets have outperformed risk-free



Sources: Sources: Aviva Investors, Bloomberg, Macrobond, as of 03/31/2017

by financials and other cyclicals. In the US, credit spreads probably price too little risk now, and therefore risk widening even with a positive growth backdrop. In Europe, the impact of ECB and Bank of England (BoE) purchases has left little upside on valuations.

At the other end of the returns spectrum, the reflationary environment has been negative for risk-free assets, with a negative return on government bonds of the major economies over the period. Those relative asset class moves represent a stark change from recent years, when both risk and risk-free assets have generally moved together. The rise in US government bond yields has reflected an increase in both real rates and market-based expectations of inflation. That increase in term premia (both real and inflation) has permeated across most of the world (Figure 5). While we expect bond yields in developed markets to move higher, supported by a stronger global economy and a gradual turn in monetary policy, there will likely need to be a new catalyst in the near-term to see yields move beyond what is priced into forward rate markets. That catalyst may be the Trump administration providing more clarity on the expected tax cuts, or it could be a move higher in commodity prices driven by changes in either demand or supply conditions. But risks also lie in the other direction, most notably the increasing nationalist political agenda around the world and the potential for protectionist policies leading to a full-blown trade war. In emerging markets, the same risks dominate, but the fundamental backdrop continues to be supportive. We think that the local currency debt markets are likely to outperform hard currency, with long-term valuations far more attractive for the former.

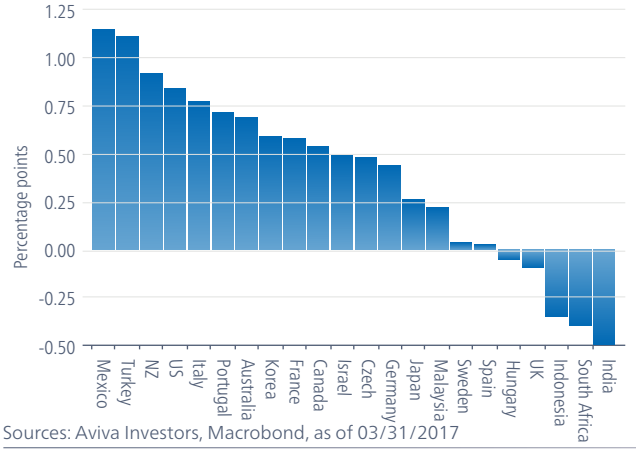
Duration remains challenging, although near-term probably needs a new catalyst for yields to move higher

Following the strong performance of the dollar after the US election, where it rose against all major currencies, this year has seen somewhat of a reversal (Figure 6). In particular, high yielding emerging market currencies have outperformed on the improvement in global growth and decline in broader market volatility. With the hopes of an early and large US fiscal stimulus waning, alongside a number of early missteps by the Trump administration, the support for the dollar has eased. That was despite an earlier than expected rate hike from the Federal Reserve. With two more Fed hikes this year largely discounted in the market, the scope for further near-term dollar strength will likely depend on developments in other markets.

High-yielding currencies should outperform in low volatility environment

Figure 5: Global sovereign bond market yields (change since mid-2016)

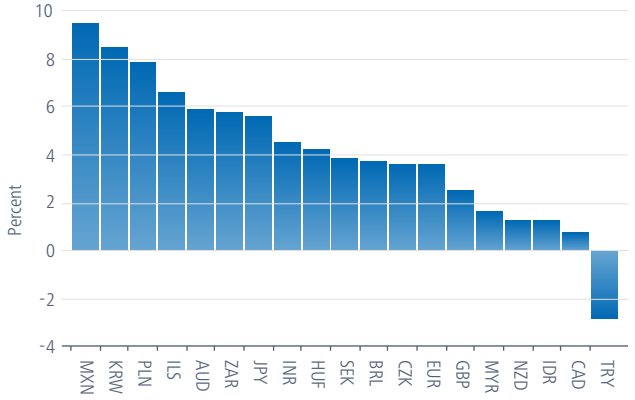
DM yields have moved higher, while EM have fallen



Sources: Aviva Investors, Macrobond, as of 03/31/2017

Figure 6: Global (spot) currency performance vs US dollar (percent change since end-2016)

High-yielding currencies have outperformed



Sources: Aviva Investors, Macrobond, as of 03/31/2017

KEY INVESTMENT THEMES AND RISKS

INVESTMENT THEMES

The Aviva Investors House View Forum brings together senior investment professionals from across all markets and geographies on a quarterly basis to discuss the key themes that we think will drive financial markets over the next two or three years. In so doing, we aim to identify the key themes, how we would expect them to play out in our central scenario, and the balance of risks. We believe that this provides a valuable framework for investment decisions over that horizon. In the March 2017 Forum, we identified the following key themes:

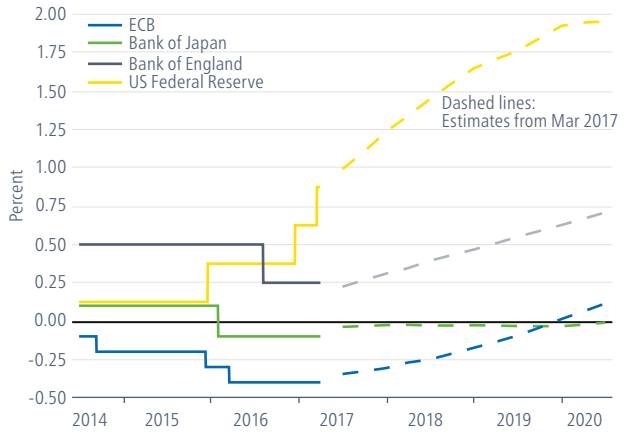
1. **Turning point for global monetary policy in sight**
2. **Market outcomes to be increasingly determined by fundamental factors**
3. **Expectations of sustained inflation**
4. **Focus on willingness to use fiscal policy**
5. **Political prioritization of national over collective interests**
6. **China growth stablization**
7. **Peak regulation**

1 Turning point for global monetary policy in sight

The era of extraordinarily accommodative monetary policy across the world is – slowly – coming to an end (Figure 7). The Federal Reserve has already raised rates three times since December 2015 and we expect they will deliver two more hikes this year and a further three in 2018. More importantly, there has been growing acceptance by market participants that this is the appropriate response to economic developments. This is still an extremely slow pace of tightening by historical standards and the more plausible risk case is that more rather than less may be required, either because inflationary pressures increase more quickly or because fiscal stimulus adds to the pace of growth in the US.

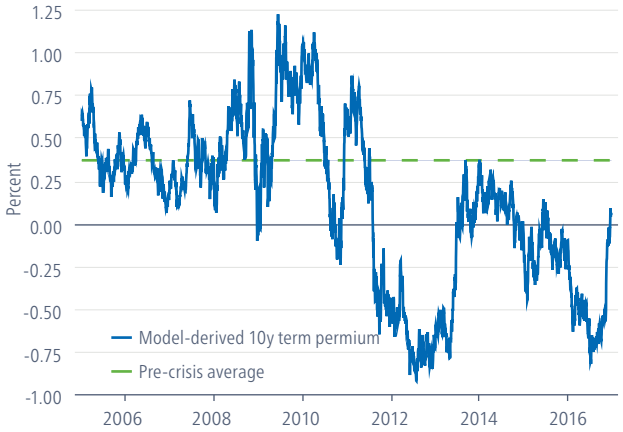
Arguably the more significant change recently has been the increasing belief that other central banks – the ECB and BoJ – have done as much as they can or should in terms of stimulatory monetary policy. They may now also be considering how to move away from the more radical elements of their policy stance – plotting their exit strategies from QE and negative interest rates. Neither is likely to be in any great hurry to act, but the very fact that such options are even being debated represents a marked change

Figure 7: Going up…eventually
Markets expect higher rates in most nations



Sources: Aviva Investors, Macrobond, as of 03/31/2017

Figure 8: Back to normal?
Fundamentals to drive asset prices again



Sources: Aviva Investors, Macrobond, as of 03/31/2017

from recent years. Inflation is now close to (or at) target in several countries and the deflationary threat has all but vanished. The return of inflation implies that real policy rates – both actual and anticipated – are still extremely low.

Market outcomes to be increasingly determined by fundamental factors

2

QE is regarded as a blunt monetary policy instrument by many market participants, but one that has been necessary in extreme circumstances such as those experienced during and after the 2008 Global Financial Crisis (GFC). A key transmission mechanism of QE has been the boost to the prices of a range of financial assets and the associated suppression of volatility. The combination of this with the threat of deflation has pushed bond yields to exceptionally low levels by historical standards. As global central banks now retreat from their asset purchase programs, the distortion to risk assets will fade and asset prices will once again be determined more by fundamental factors. This transition is part of a more general return towards normality in economies and financial markets.

While QE was the dominant influence, correlations between asset prices rose markedly and the general market environment could often be accurately characterised as "risk on/risk off". As fundamental drivers reassert their importance, this will change again. In particular, markets will have to reassess what the risk-free rate is or should be (Figure 8). Most studies show that the theoretical equilibrium real rate was heavily negative following the GFC, but may now be inching back towards positive territory. This theme is closely related to two others. As we move away from the zero bound on policy rates (#1); and the greater acceptance that inflation has returned or is returning (#3).

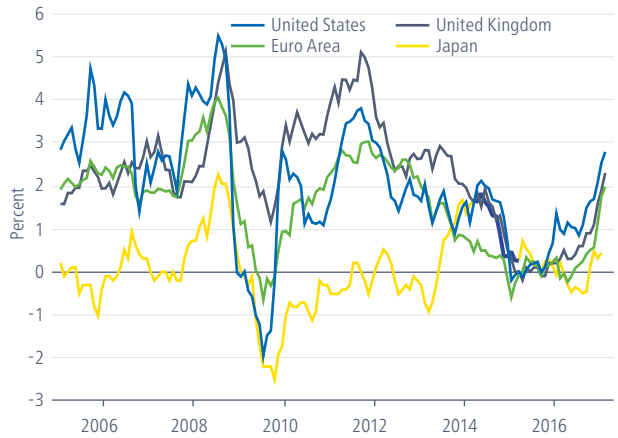
Expectations of sustained inflation

3

In the wake of the financial crisis, the threat of secular deflation felt very real. There is now a growing conviction that the danger has passed. Headline inflation is now at or close to target in the US, the Eurozone and the UK. It is still low in Japan, but is at least positive (Figure 9). Expectations of future inflation have also returned to pre-crisis rates when there was a widespread acceptance that global central banks would achieve their inflation targets – generally around 2%.

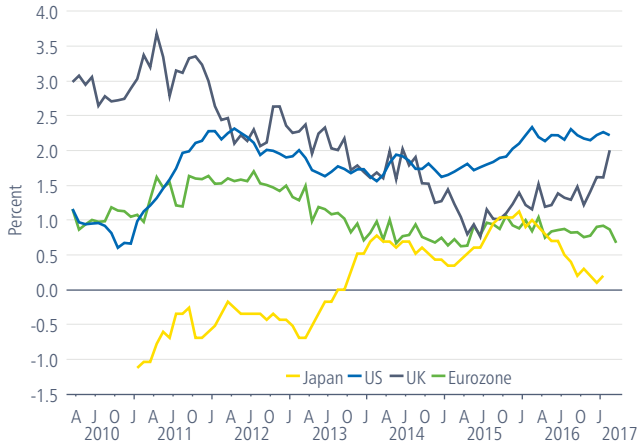
This may seem a small change, but it is an important one. As recently as the start of last year, the deflationary narrative dominated market dynamics, particularly bond markets. That is no longer the case. The rise in inflation has not been confined to developed economies – the trend has been seen in many emerging nations as well, including China. Part of the explanation has been the stabilization and subsequent rise in energy and other commodity prices, but part has been more fundamental. Even so, "core" inflation

Figure 9: Inflation back to target
Headline inflation rates back at "normal" levels



Sources: Aviva Investors, Macrobond, as of 03/31/2017

Figure 10: Core inflation rates
Underlying inflation more subdued, but drifting up



Sources: Aviva Investors, Macrobond, as of 03/31/2017

rates (which exclude energy and food prices) remain more subdued, particularly in the Eurozone and Japan. The belief in the return of inflation is a key step on the road back to normality, but until or unless core inflation starts to drift higher too, there is good reason for global central banks to tread carefully.

4 Focus on willingness to use fiscal policy

During the GFC, almost all countries engaged in massive fiscal expansions, either through active policy decisions or as a result of automatic fiscal stabilizers. Subsequently, it was generally accepted that fiscal discipline had to be re-imposed and that "austerity" was the appropriate course of action. Attitudes now seem to be changing again, despite high levels of public debt. Budget deficits are currently far lower than at the peak of the crisis, but are still high by historical standards. Yet it has become acceptable to propose and initiate looser fiscal policy as a means of stimulating growth. Although details are still sketchy, a fiscal boost in the US under Trump's administration is expected this year or next.

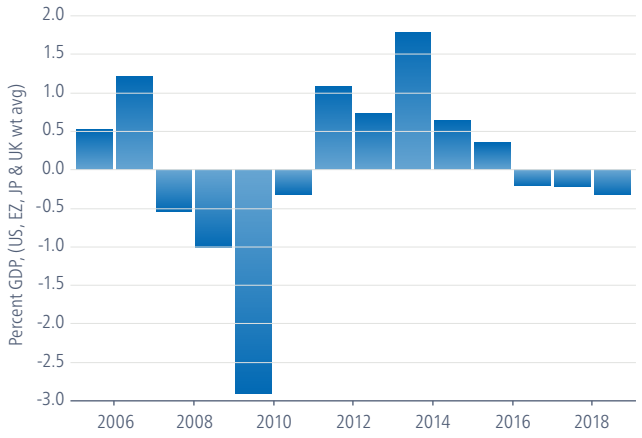
A new expansionary fiscal package is also plausible in Japan. Even in Europe, where fiscal prudence were the watchwords for many years, a more relaxed attitude towards fiscal expansion has prevailed (Figure 11). If deficits were to spiral higher again, this could change. But for the moment, fiscal policy seems more likely to add to growth than to limit it. The UK is a special case, where any signs of a Brexit-related slowdown would probably be met with a fiscal boost. In China, the official budget deficit target of 3% of GDP this year, alongside stimulus from other quasi-fiscal measures, suggest growth will be underpinned there to ensure they meet their GDP target of 6.5% or more.

5 Political prioritization of national over collective interests

With Donald Trump now installed as president of the US, the issue of the pursuit of national as opposed to collective interests is unlikely to slip from the headlines for very long. It is early days, but it seems plausible that some of the more extreme versions of his populist agenda will be appreciably diluted. Others might even be shelved and conveniently forgotten. Even so, nationalist themes are likely to feature extensively in public debate in the US and elsewhere over the next few years. In Europe, the first important election this year – in the Netherlands – saw the ruling center-right party retain power. The far-right candidate did increase his share of the vote, but by much less than had been expected.

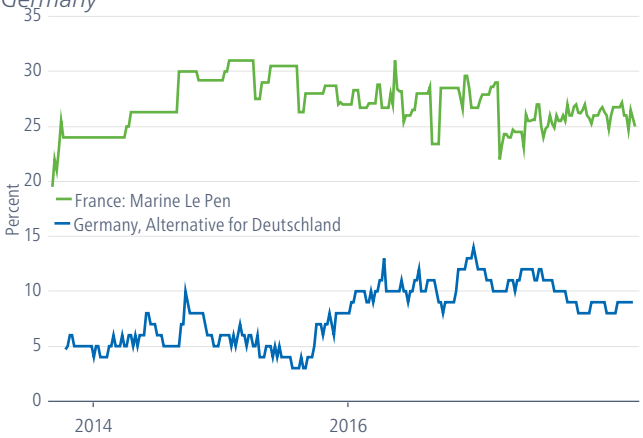
The focus in Europe has now shifted to France and, after that, Germany (Figure 12). In the French presidential election, populist candidate Marine Le Pen is almost certain to make it to the second round of voting, according to recent polls, but it is extremely unlikely

Figure 11: Small fiscal loosening expected
OECD projections show modest fiscal boost



Sources: Aviva Investors, Macrobond, as of 03/31/2017

Figure 12: Nationalism on the rise
Nationalist support is strong in France and has grown in Germany



Sources: Aviva Investors, Macrobond, as of 03/31/2017

she will win. The rise in nationalism/populism represents a small but growing, threat to harmony in several nations. For example, the present government in Italy may not last until the next scheduled election, and while opinion polls suggest the country would vote to remain in the EU and with the euro currency at present, the gap has narrowed. Self-interest is also certain to feature in a major way in the Brexit negotiations.

China growth stabilization

6

Growth worries at the start of 2016 led China to introduce a range of credit and fiscal policy initiatives aimed at achieving their GDP growth target of 6.5%-7%. This was successful (growth was 6.7% last year). Now their priorities seem to be shifting slightly again. They will not wish to put their growth target of 6.5% or more at risk, but they do seem to be trying to tighten policy modestly at the margin, reining in the credit impulse and returning to the (slow) reform and economic transition agenda. As always, this process will be managed tightly, especially so this year as the authorities will strive for stability between now and the 13th National People's Congress in November.

Once the new leadership for the next five years is in place, there will be greater freedom to concentrate on the economic agenda, but also perhaps to reprioritize reform. On the sensitive currency issue, we anticipate that China will continue to manage a slow but steady depreciation of the renminbi, similar to the last two years (Figure 13). This issue is especially important in the context of relations with the US, and the previous Trump threat to label China a currency manipulator. Any moves towards greater global protectionism are also relevant here.

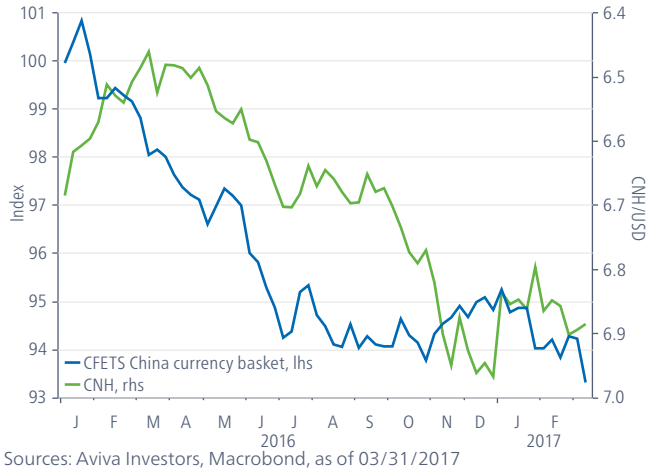
Peak regulation

7

The raft of greater financial regulatory requirements introduced over the last decade was an understandable response to the GFC. It is highly probable they will have made the financial world a much safer one for investors and set in place an environment in which the worst excesses from that crisis cannot be repeated. Well-intended regulation can, however, sometimes result in excessive interference that prevents markets from functioning as they should. There is now a groundswell of opposition building against further regulation, and even in some circles of reversing some parts of previous decrees.

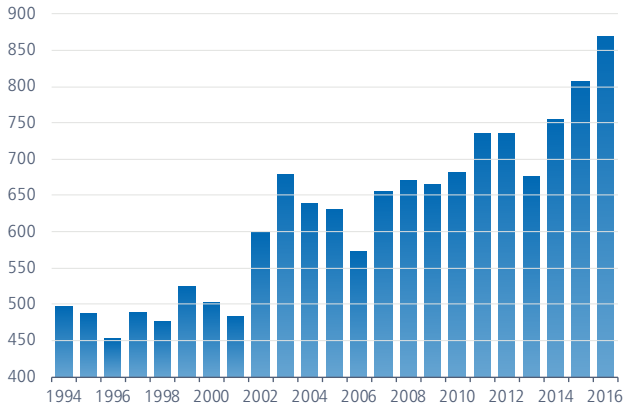
Reduced regulation is most likely in the US, where Trump's administration has a stated goal to ease the regulatory burden and free up institutions to allow them to operate more effectively in the future. It remains to be seen whether other countries follow this lead. Across Europe, there is much less interest in a lighter regulatory touch, with the final elements of Basel III expected to be phased in over the next two years. Even so, the idea that we have passed the point of "peak regulation" seems increasingly likely.

Figure 13: China's managed depreciation
Continuation of two-year trend expected



Sources: Aviva Investors, Macrobond, as of 03/31/2017

Figure 14: Number of Securities and Exchange Commission enforcement actions
Doubled since the late 1990s - peaking now?



Sources: Securities and Exchange Commission, as of 03/31/2017

RISKS TO THE HOUSE VIEW

Acceleration in nationalist agenda

Ongoing growth in nationalist/ populist agendas

The election of Donald Trump has escalated the risks of greater trade protection and isolationist measures, but the global trend towards more introspective nationalism was already there (e.g., Brexit, Italian referendum.) The most immediate risks would seem to be in Europe, where there are key elections in 2017. The Dutch election passed relatively smoothly, with the far-right party improving its standing, but not enough to gain power. Focus now shifts to France and then Germany, although in many ways Italy looks the most vulnerable. In the extreme, greater nationalism could lead to another existential crisis for the Eurozone. A retreat from globalization, in terms of both trade and capital flows, poses a material medium-term downside risk to global growth and would be especially damaging for small open economies, including several in the emerging market universe.

Secular stagnation: low growth, low returns

Is the equilibrium real interest rate negative?

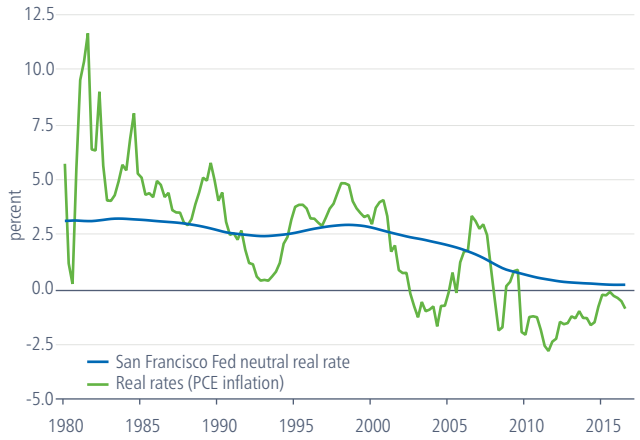
The decline in real rates could reflect a slide towards secular stagnation, a move that may have been accelerated by the financial crisis of 2008, although new technologies and demographic trends have also been key elements. Estimates of the current equilibrium real interest rate are around zero in economies such as the US, Eurozone and Japan, reflecting the excess supply of savings over investment globally. That implies that current policy rates may be far less stimulative than conventional analysis would suggest. If the potential for upside growth surprises is limited, risk asset pricing could struggle. And if the equilibrium rate is negative, nervousness about nominal rates below zero can prevent it being reached.

China growth: hard landing

Chinese outlook will always be important for investors

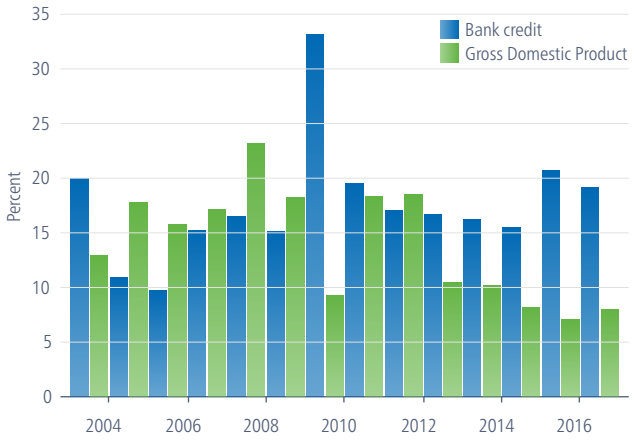
Growth has slowed in China in recent years, as the economy has matured and began the process of transforming itself from one based on manufacturing, investment and exports towards one driven by services and consumption. It should continue to slow in future years, a process that the authorities will want to manage carefully. 2016 was a year when growth was prioritized after the scare early in the year. China is now tightening policy modestly to help prevent any debt-fuelled excesses in parts of the economy. There is a risk that the authorities either become unable or unwilling to support growth further. While in the near-term we see them as being relatively low, medium-term risks have increased given the recent further increase in private sector debt. One consequence may be a sharper devaluation in the currency, weighing on global inflationary pressures. Commodity prices would also be likely to decline.

Figure 15: Secular stagnation
Estimates of neutral rate close to zero



Sources: Aviva Investors, Macrobond, as of 03/31/2017

Figure 16: China hard landing
Excessive credit growth?



Sources: Aviva Investors, Macrobond, as of 03/31/2017

Inflation acceleration: bond market rout

Headline inflation has risen sharply over the last six months, partly because of movements in energy and other commodity prices. So far, financial markets have adjusted to this with no sense of panic. But were that to change, a correction could swiftly become more alarming, raising the risk of a repeat of 2013's "taper tantrum" in terms of sovereign bond yields, or worse. Any perception of sustained inflation overshoots or a view that global central banks are "behind the curve" would lead to a sharp sell-off in real rates and a spike in breakeven inflation rates. Significantly higher bond yields and a reassessment of the pace of central bank tightening would probably hit risk assets in general, boost the dollar and undermine emerging markets.

Has inflation been permanently tamed?

Debt de-leveraging vulnerabilities

After almost a decade of exceptionally low policy interest rates around the world, provision of credit to the private sector has expanded sharply in some economies (e.g., Canada, Australia, China and other emerging markets) while others – mainly those who saw a sharp increase in credit prior to the financial crisis – have de-leveraged (Figure 17). With global rates rising, albeit slowly so far, there is likely to be a renewed focus on which economies will be most vulnerable. Household balance sheets are particularly stretched in those countries which have experienced property booms, such as Canada and Australia. In the US, where overall the private sector has de-leveraged in the past decade, but that reflects improving household balance sheets, with corporations taking on significantly more debt over that period. While rates remain low, the cost of servicing these debts will remain manageable. However, a surprise increase could uncover more serious problems.

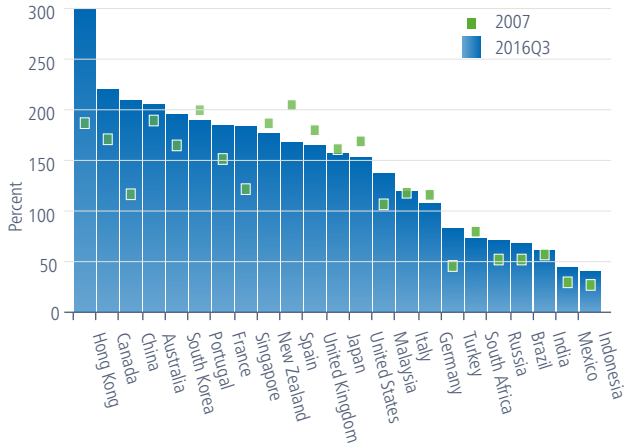
Debt levels are high around the world

Trade war: cycle of retaliatory trade protectionist actions

The most likely catalysts for a damaging cycle of protectionism and trade reprisals are initiatives from the Trump administration. These were widely mooted during his campaign and have been alluded to at various times since. So far, however, action has been limited and hopes have grown that some of the more damaging proposals have been either abandoned or tempered significantly. But this could change. US tax policy could be altered to materially favor domestic producers, while withdrawal from existing free trade agreements and increased use of tariffs and other trade barriers would reduce already-weak global trade growth. Retaliation against the US could follow, setting off a cycle of measures and counter-measures. World growth would suffer, with the adjustment falling more on export-orientated economies and companies. Inflation would probably rise too, at least initially, although the longer-term effect could be deflationary.

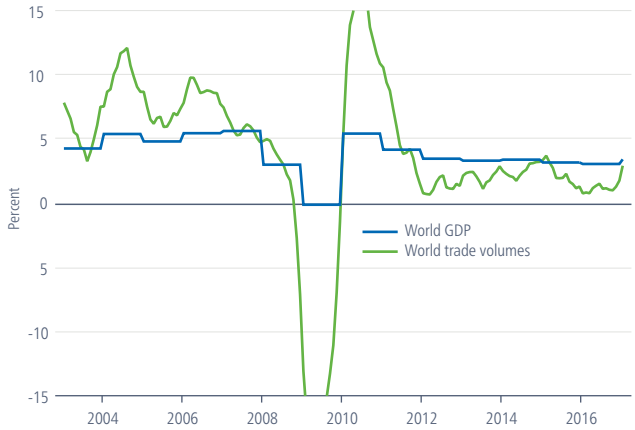
Moves toward greater protectionism would be damaging

Figure 17: Debt de-leveraging vulnerabilities
Private credit (% of GDP)



Sources: Aviva Investors, Macrobond, as of 03/31/2017

Figure 18: Trade war risk
Could restrictive measures curtail the recent recovery?

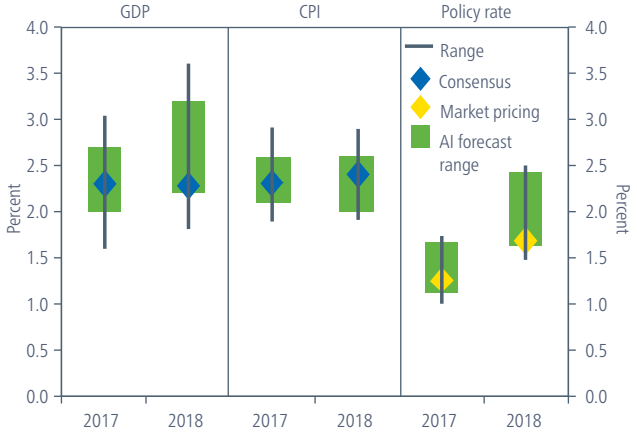


Sources: Aviva Investors, Macrobond, as of 03/31/2017

MACRO FORECASTS CHARTS AND COMMENTARY

Growth in the US has continued at a robust pace and this is expected to be maintained throughout 2017. With inflation rising steadily, the Fed has picked up the pace of monetary tightening and is expected to deliver three hikes in both this year and in 2018. A fiscal stimulus package is assumed, but this is anticipated to impact growth more next year than this. Encouragingly, Trump's administration has not, as yet, followed through on its more damaging policy proposals.

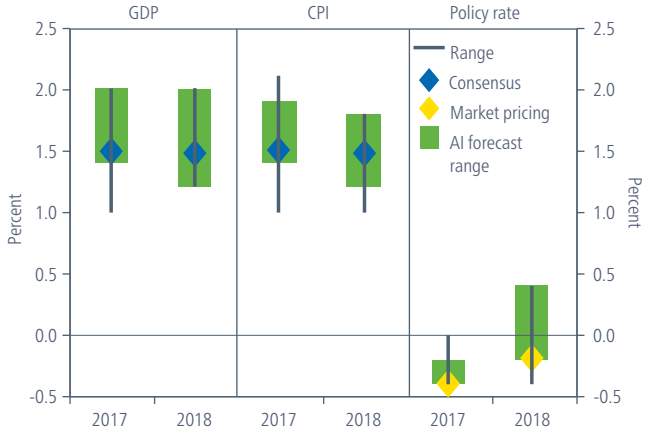
Figure 19: US



Source: Bloomberg, Aviva Investors, as of 03/31/2017

The Eurozone recovery looks as if it will broaden and strengthen in this year if surveys prove a reliable guide. There are still political hurdles to jump, underlying structural issues to address, and the thorny matter of closer integration to deal with. But 2017 has begun with sentiment high and a growing belief that this revival has legs. ECB monetary policy is relaxed for now, but with inflation back at target, they will be considering their exit strategy.

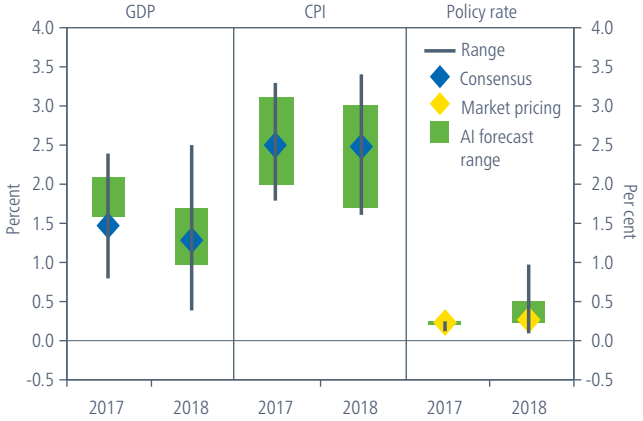
Figure 20: Eurozone



Source: Bloomberg, Aviva Investors, as of 03/31/2017

Macroeconomic resilience in the UK has continued over the last three months, but this looks set to be challenged during the course of 2017. Ongoing uncertainty related to Brexit has already impacted investment, while higher inflation will hurt real incomes and hence affect consumer spending later in the year. We continue to expect a slowdown this year, but if growth were to continue at or close to the recent pace, the Bank of England might have to react to higher inflation.

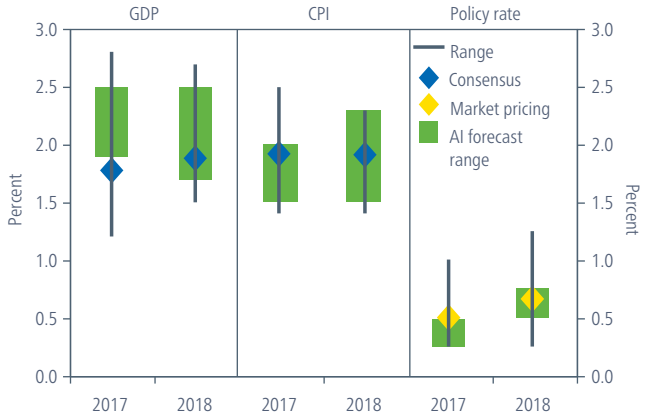
Figure 21: UK



Source: Bloomberg, Aviva Investors, as of 03/31/2017

GDP growth in Canada has gathered momentum in recent months, boosted by household spending and helped by the recovery in the oil price. But the hoped-for rebalancing towards business investment and non-energy exports is still largely absent. Better growth in her US neighbor will benefit Canada, but with core inflation still subdued, policy interest rates are likely to rise more slowly than in the US.

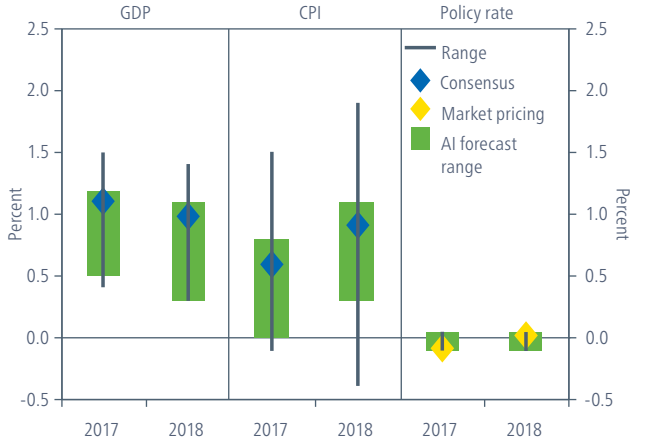
Figure 22: Canada



Source: Bloomberg, Aviva Investors, as of 03/31/2017

Any improvement in world trade flows will help Japan since exports are such an important component of GDP and domestic demand remains subdued. The weaker yen has also contributed in this area. A pickup in wage growth, which would help boost consumer spending, has not yet happened but it remains an important goal for the government. At least headline CPI inflation remains positive, if low. Another fiscal package during 2017 is widely expected.

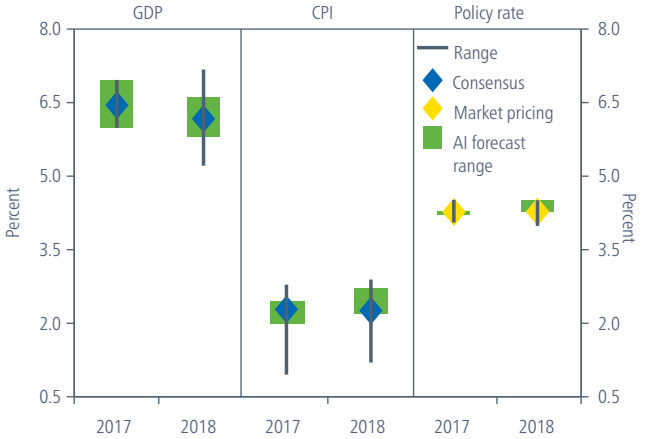
Figure 23: Japan



Source: Bloomberg, Aviva Investors, as of 03/31/2017

Helped by activist policies, China achieved its 6.5%-7.0% growth target last year and looks set to reach this year's lower target of 6.5%. This year the bias is for slightly tighter policy, but the main goal will be to ensure economic stability in the run-up to the plenum in November. Inflation has returned but is not a policy concern yet. The Chinese currency is likely to continue its recent slow depreciation. All eyes will be on trade – and other – relations with the US in 2017 and beyond.

Figure 24: China



Source: Bloomberg, Aviva Investors, as of 03/31/2017

GLOBAL MACRO OUTLOOK AND ASSET ALLOCATION

CLIMBING A WALL OF WORRY BUT NORMALIZATION AHEAD

– Investors are climbing a wall of worry, slowly moving away from the deflation mindset

– Crucial turning point in monetary policy ahead

– Equities are set to outperform, while fixed income faces challenges

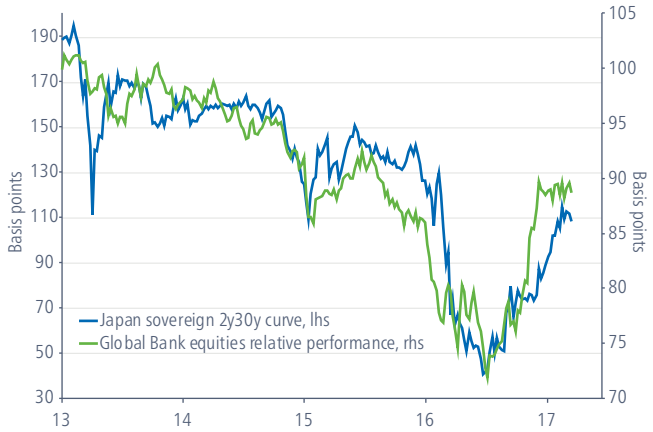
Investors are slowly pricing out deflation

Investors are climbing a wall of worry. A pretty high wall, but we think we are close to seeing the top of it. Fundamentals are improving, investors appear to be slowly moving away from short-termism and political noise, and the focus is back on globally-improving economic newsflow. While we still consider it a downside risk to the outlook, we do not expect the global economy to head down the path of long-term secular stagnation. Beginning in the second half of last year, we think the market has finally started to price in a more positive global outlook, with fixed income markets in particular starting to move away from the mindset of deflation that has dominated in recent years.

Turning point for global monetary policy is now in sight

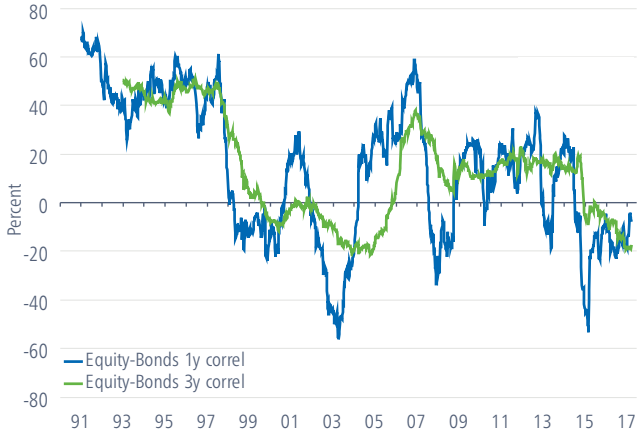
Indeed, there was an important inflection point around July last year (Figure 25). A synchronized global improvement in economic activity led to major moves in and across asset markets. As a result, the major central banks have been obliged to acknowledge the improvement in growth and inflation prospects. Some have started to consider exit strategies for their quantitative easing programs, while other look to begin the gradual removal of monetary accommodation. In the light of recent upbeat data, instead of adding to fear in global markets ("we still see downside risks"), monetary policy is now injecting confidence ("we see improvements in fundamentals"). As detailed in our economic outlook, we think the Federal Reserve will raise rates two more times this year, and that the ECB will start discussing QE exit options. This raises several questions for global markets. The Fed funds policy rate was anchored at 0-0.25% for seven years. The ECB rate is still negative and asset purchases are expected to continue at least until the end of the year. The Bank of Japan is also still pursuing a negative rate policy and is experimenting with "yield curve control". The turning point for global monetary policy is now in sight and is likely to impact global markets significantly, as fundamentals re-assert their influence.

Figure 25: Inflection point in markets last summer
Curve steepening and bank equities outperforming



Sources: Aviva Investors, Bloomberg, as of 03/31/2017

Figure 26: Regime change in correlations
Global equities vs global bonds rolling correlation



Sources: Aviva Investors, Bloomberg, as of 03/31/2017

Stronger global growth should translate into higher corporate earnings growth, while rising inflation supports term premia and represents a headwind for fixed income markets in the US and Europe. Keeping monetary policy so loose globally for years was justified, but it was inevitable that it would affect investor behavior. This can be seen clearly in the asset allocation choices by investors in recent years, with very significant allocations into developed market fixed income at the expense of global equities and emerging market assets. While this has adjusted somewhat in recent months, there is still a long way to go. If there is a skew to our central view, it relates to upside risks for both growth and inflation. As a result, we prefer owning equities to fixed income, with important differentiation to be made within each asset class across different geographies.

Equities to outperform duration, differentiation to be made within asset classes

The cross-correlation both between and within asset classes was distorted for much of the post-crisis period by central bank policies. However, as those policies have come to an end, correlations have begun to decline. Investors have to factor in higher dispersion within the equity space, but also within other asset classes. Figure 26 shows the correlation between equities and bond prices. The change in correlation regime coupled with a low volatility environment, is a first step towards market normalization. Indeed, the whole risk-on/risk-off approach with consistently high cross-asset correlations is not the historical norm. One might argue that asset prices have only just started to adjust to the idea that real rates might not stay so low forever. US markets are leading the way. For example, US 10-year breakevens at around 2% are already close to historical norms.

Lower cross-asset correlations offer diversification potential

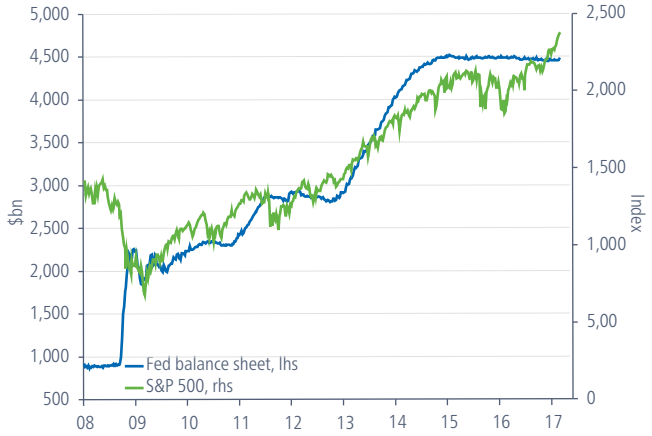
The view held by some commentators that Fed balance sheet expansion was the single driver of US equity markets seems not to hold anymore, as underlying earnings growth seems to have underpinned recent stock market advances (Figure 27). There was a case for saying that quantitative easing policies support multiple expansion as, for example, the low-yield environment persuaded companies to issue cheap debt and buy back stock. But looking forward, we think equity prices are likely reflect an improved earnings outlook, based on stronger growth (Figure 28). And the potential for more active fiscal policy (especially tax cuts) should also support earnings and make the valuation adjustment quicker.

Earnings growth cycle to support equities going forward

We prefer a smaller allocation to US equities as we find the valuations provide a less attractive risk-reward profile. Long-dated US Treasuries are now a more attractive proposition to reduce risk at portfolio level and provide balance. While we think there is still a case for higher yields in the US, the extent of the move higher in long-dated yields should provide protection if we were to be wrong in our central scenario. For example, if we were wrong on the reflation theme, on our slightly more aggressive Federal

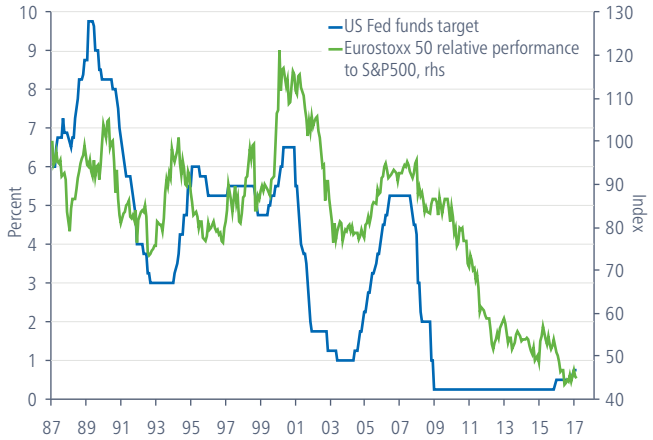
Long-dated US Treasuries offer protection as the equity risk premium normalizes

Figure 27: S&P 500 to be supported by earnings, not balance sheet expansion anymore



Sources: Bloomberg Aviva Investors, as of 03/31/2017

Figure 28: We prefer European equities to US equities as the Fed is pursuing its tightening cycle



Sources: Datastream, Aviva Investors, as of 03/31/2017

Reserve path than what the market is currently pricing in, then longer-dated Treasuries are likely to rally. Similarly, if we were wrong about the political outlook in Europe.

European equities are attractive

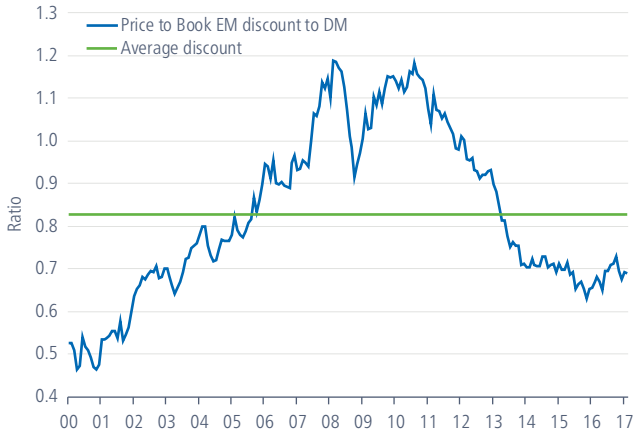
We take a somewhat different view in the Eurozone. We find equities still attractive in valuation terms (the weight of financial stocks certainly helps), while sovereign bonds and also credit markets are in our view offering poorer risk-reward profiles going forward. Indeed, given the ECB has probably reached maximum easing and is likely to be looking towards exit strategies later this year, as the underlying economy seems to be improving, we strongly prefer owning equities versus sovereign fixed income and credit in Europe. Indeed, depressed sentiment, international positioning, valuation, and potential for earnings re-rating mean we continue to strongly overweight European equities. We think European equities offer the best expected return on a one-year horizon, with risks on the volatility outlook. Our central view is that populist parties may increase their share of the vote, but will not win any major election in the Eurozone. Italy and France are the greatest risk to that outlook.

We think local currency debt offers better risk reward than hard currency in emerging markets

Emerging market debt and equities should both do well in our central view of the world. Our view on emerging markets assets began turning more positive at the end of 2015, and we continue to like both equities and, more selectively, bonds in the emerging market space. In particular, the idea that the Chinese economy does more of what we have seen in the last few quarters, (i.e. prioritises and achieves stable growth), is a support for global emerging markets. At the same time, the fact that the Federal Reserve risks being somewhat behind the curve also means that we expect curve steepening without much dollar appreciation, which is also positive for the asset class. We strongly prefer, on valuation grounds, having exposure to local debt (overweight) versus hard currency debt (strong underweight), and like EM equities (strong overweight) in general and Chinese equities in particular. Hard currency debt has become particularly expensive in our view.

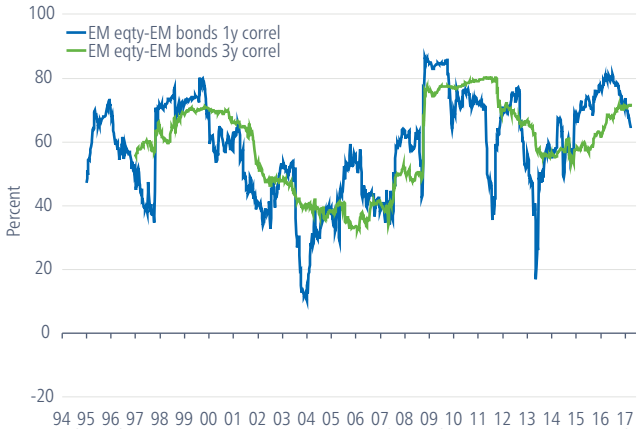
The United Kingdom outlook is obviously clouded by Brexit. If negotiations do not progress well, uncertainty could easily ramp higher again. We believe that much of the recent UK equity move is attributable to sterling depreciation. We see downside risks for both equity and bonds going forward and have an underweight stance and a neutral view on the currency.

Figure 29: EM equities still trading at a discount to DM equities



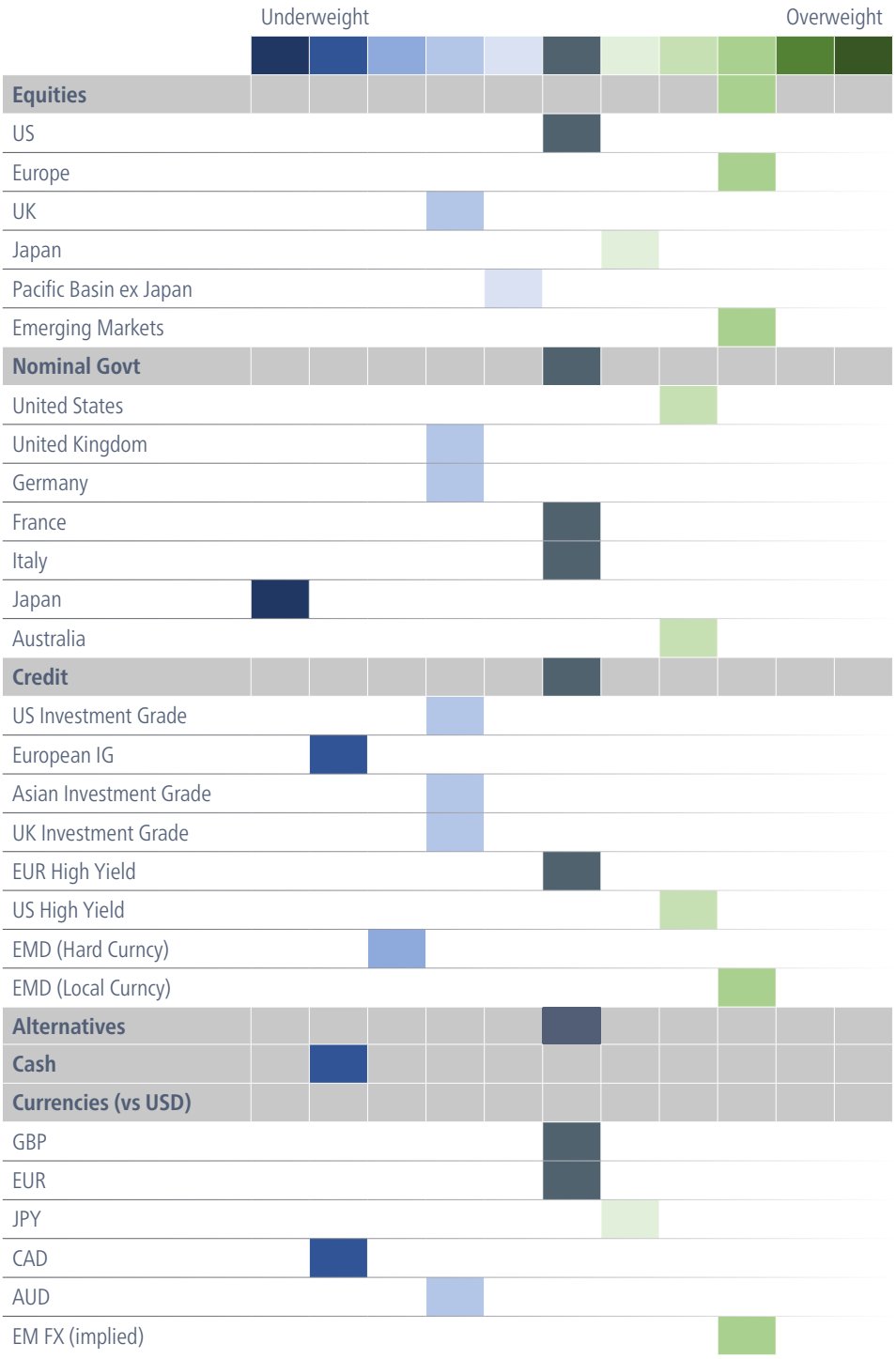
Sources: Bloomberg, MSCI, Aviva Investors, as of 03/31/2017

Figure 30: Correlation between EM equities and bonds recently weakened



Source: Bloomberg, MSCI, Aviva Investor. Correlation between MSCI EM and JP Morgan EMBI global total return index, as of 03/31/2017

Figure 31: Asset Allocation



Overweight equities, as fundamentals continue to improve

Overweight US Treasuries at the long end for risk reduction

Local currency debt preferred in emerging markets

Sources: Aviva Investors, as of 03/31/2017

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