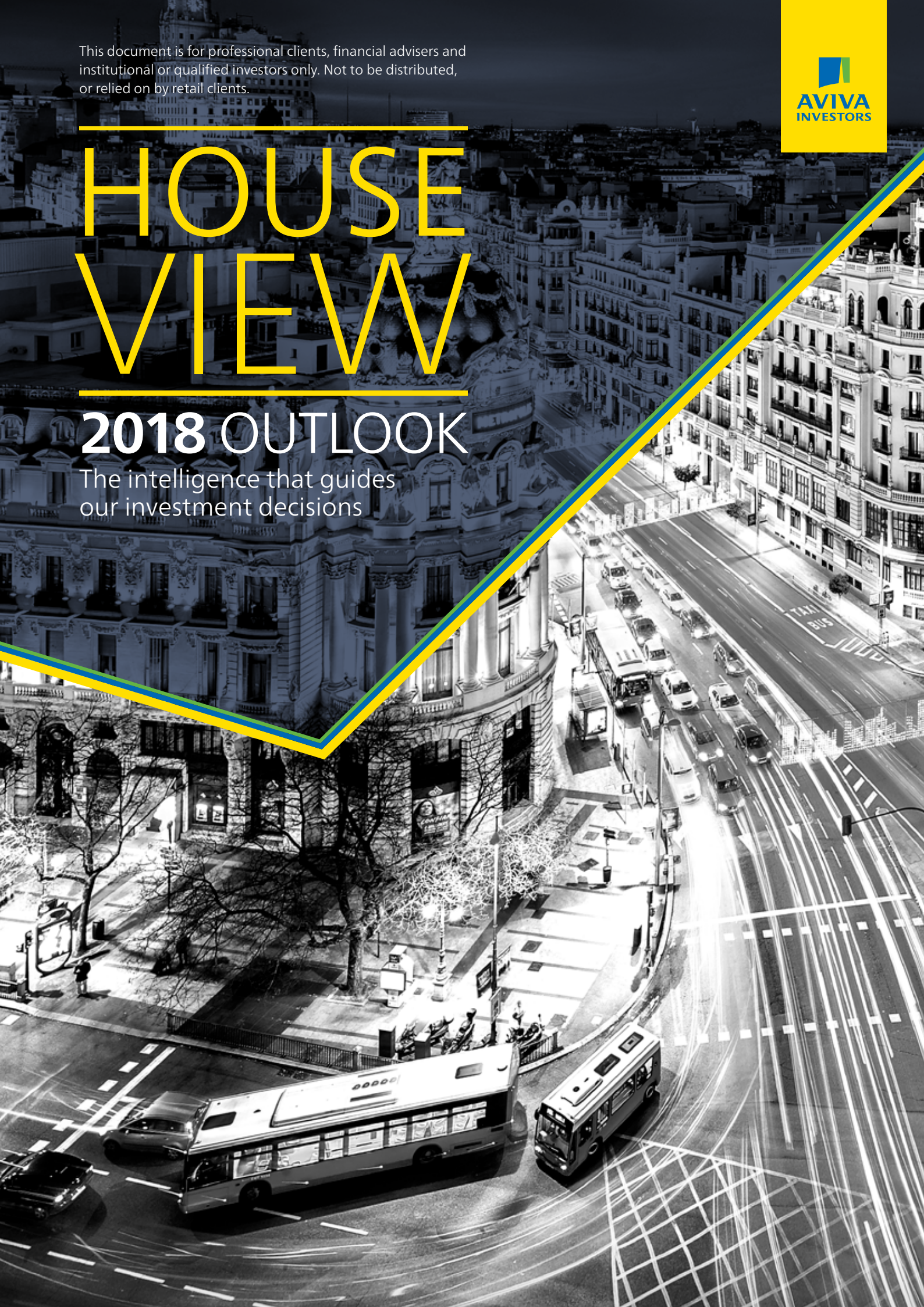
AVIVA INVESTORS

HOUSE VIEW

2018 OUTLOOK

The intelligence that guides our investment decisions



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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 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 perfectly. But the contents of this report represent the best collective judgement of Aviva Investors on the current and future investment environment.

EXECUTIVE SUMMARY

FIRING ON ALL CYLINDERS

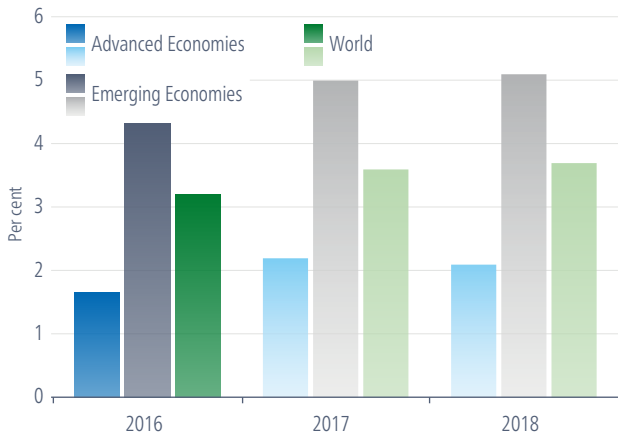
Our global growth outlook for 2018 is strong. The broad-based, synchronised upswing that began a year ago shows no signs of easing up, with above-trend growth expected to extend from the major G7 economies to the emerging markets in 2018. That should see global growth approach 4 per cent, the strongest since 2011 and consistent with a continued reduction in global slack, increased inflationary pressures and a geographical broadening in the removal of extremely accommodative monetary policy. As 2017 draws to a close, it is likely that global growth will finish the year well ahead of where consensus expectations were twelve months ago. That largely reflects much better growth than anticipated in the Eurozone, but also better outturns in Japan and China. It is also in spite of the US failing to deliver on President Trump's much-vaunted tax reform plans until the end of 2017. It would also be the first time since 2010 that global growth has surprised on the upside, with many forecasters, such as the IMF, raising their projections for 2018 (Figure 1). We have also raised our expectations for 2018, reflecting positive global consumer and business sentiment, limited private sector balance sheet risks and still easy financial conditions. We think the main upside risk is likely to come from the US (on greater-than-expected fiscal stimulus), and the main downside risk likely from a more rapid slowing in Chinese growth.

Global growth expected to improve further in 2018

We expect global consumer price inflation will be little changed in 2018 compared to 2017, with a modest rise in advanced economies offset by a similarly modest decline in emerging market economies (Figure 2). The rise in advanced economy inflation reflects a similar increase of around ¼ per cent across the major economies over the course of next year, with the United Kingdom the only exception. Those increases reflect the lagged effect of the reduction, and in some cases, elimination of spare capacity, that has seen wage growth rise steadily. A further steady rise is expected in 2018, with that imparting further modest upward pressure on inflation. In some economies, such as the US, the impetus for a somewhat larger increase in inflation may come from the potential non-linear effects of an extremely tight labour market. But structural headwinds make it unlikely for inflation to spike higher. Our growth and inflation outlook is consistent with a gradual removal of policy accommodation, with the Federal Reserve leading the way with further rate hikes, but with other central banks likely to move towards tighter, rather than looser policy. In the Eurozone we expect asset purchases to end in September and in Japan we see the potential for the Bank of Japan (BoJ) reviewing its policy of yield curve control (YCC) if core inflation rises above 1 per cent. The outlook for the Bank of England is highly dependent

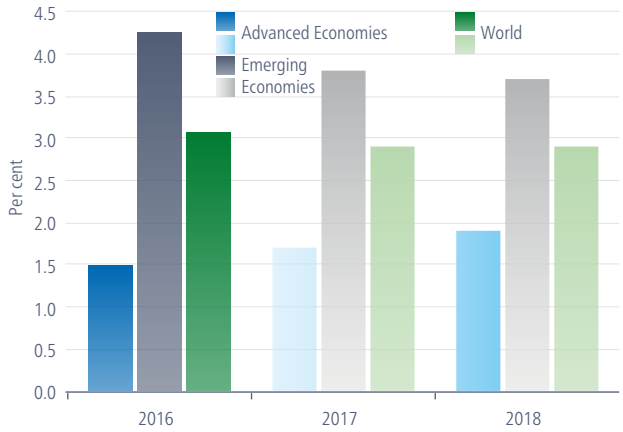
An expected steady increase in inflation suggests further removal of monetary policy accommodation

Figure 1: Global growth projections
Upside surprises in 2017 to be carried through into 2018



Sources: Aviva Investors, Macrobond, as at 1 December 2017

Figure 2: Global CPI inflation projections
Higher growth rates to be sustained



Sources: Aviva Investors, Macrobond, as at 1 December 2017

on developments in the Brexit negotiations next year, which have the potential to move policy in either direction. Elsewhere, there is potential for rate rises in Canada, Australia, New Zealand, Sweden and Norway in 2018.

Peak monetary stimulus is behind us

Global spare capacity is being eliminated

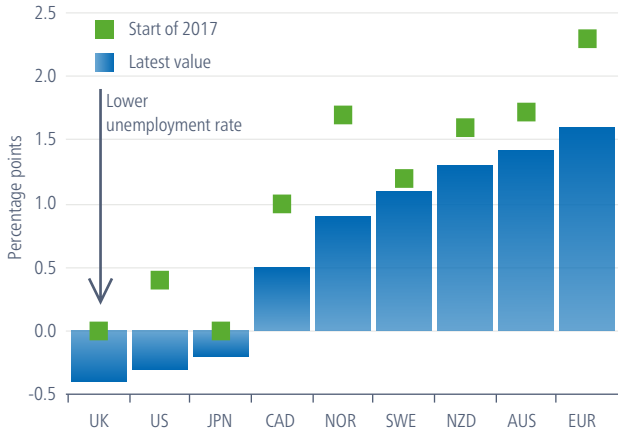
Over the course of 2017 above-trend growth across the major developed economies saw unemployment rates decline further. As a result, unemployment rates in some economies, such as the US, UK and Japan are now below the levels seen prior to the global financial crisis. Even allowing for the possibility that the equilibrium rate of unemployment may have fallen since 2007, these economies are likely to be very near to full employment (Figure 3). Other economies, such as the Eurozone, are further behind in their expansionary phase, and as such continue to have a reasonable degree of spare capacity. However, with a similar rate of above-trend growth expected next year, the Eurozone is likely to have relatively little spare capacity by the end of 2018. As the degree of spare capacity has been eroded, central banks have begun to embark on policy normalisation. The Federal Reserve is likely to have raised rates five times in this cycle by the end of 2017. Looking ahead, the market is currently pricing little more than one more hike in the US in 2019 and beyond, compared to another six increases currently expected by the Fed (Figure 4). We think the market is under-pricing the risk of further rate hikes over the coming year and beyond. Other markets look more fairly priced in terms of short-term rates, with little prospect of the European Central Bank (ECB) or the BoJ raising the short-term policy rate in 2018.

Global conditions supportive of risk assets, but duration more challenged

Risk assets expected to benefit from global economic outlook, with emerging market and European equities attractive

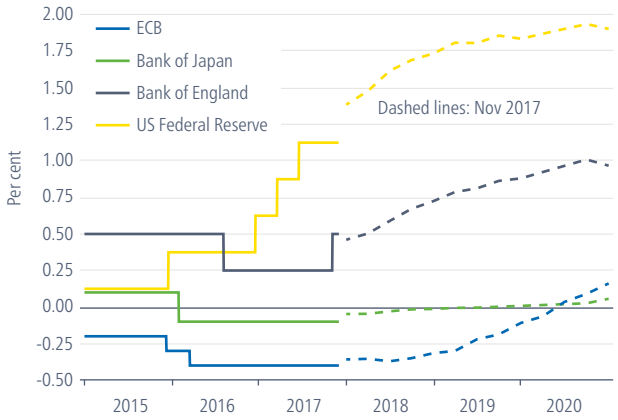
Expectations of stronger global growth and modestly higher inflation in 2018 provide the backdrop for a positive risk environment, just as they did in 2017 (Figure 5). Moreover, with the improvement in the global economy and the peak of monetary policy accommodation likely behind us, we would expect asset markets to be driven more by the underlying fundamentals than at any point in the past decade. In terms of equity markets, that should mean a focus on the earnings outlook, valuations and sector allocations is likely to be increasingly important. The correlation between stocks within equity indices declined sharply in 2017, consistent with company fundamentals driving returns, rather than external risk factors. That increased dispersion of returns has also been a contributory factor to the decline in overall equity index volatility. Looking to 2018, we think that amongst the main regions, emerging market equities should benefit most from the improving global growth outlook, while also standing to gain from relatively lower valuations. Amongst developed markets, we expect Eurozone equities to be supported by continued above-trend growth and receding political concerns. We also think that Japanese equities present a good opportunity in 2018, with the potential for strong corporate profitability and a potential sea-change in corporate and household inflation

Figure 3: Global slack is diminishing[1]
Unemployment rates are falling to pre-GFC trough



Sources: Aviva Investors, Macrobond, as at 1 December 2017
1. Difference with unemployment rate at the low point prior to 2008.

Figure 4: Global monetary policy rates
Market pricing slow pace of normalisation



Sources: Aviva Investors, Macrobond, as at 1 December 2017

expectations.

While we think that risk assets will be supported by economic growth, risk-free assets are more challenged. Arguably the most challenged is Eurozone government debt, where yields continue to be suppressed by ECB asset purchases. However, with a likely end to QE in September, we expect pressure on yields to start rising by the middle of 2018. Japanese government bonds are even more expensive, and could also be subject to a sell-off in 2018 if inflation rises above 1 per cent and the BoJ adjusts their target on YCC. If longer-term yields in these markets were to rise, then the pressure on global term premia would also increase, at a time when we expect the Federal Reserve to continue raising rates and reduce their balance sheet. Indeed, the liquidity and credit support globally from central bank balance sheets is likely to fall materially over the course of 2018 (Figure 6). That could be the catalyst for a normalisation in term premia and a more sustained rise in yields. However, there are likely to be some countervailing forces on yields, such as the demand for increased duration from Asia.

Global bond yields expected to rise, making duration a more challenging environment in 2018

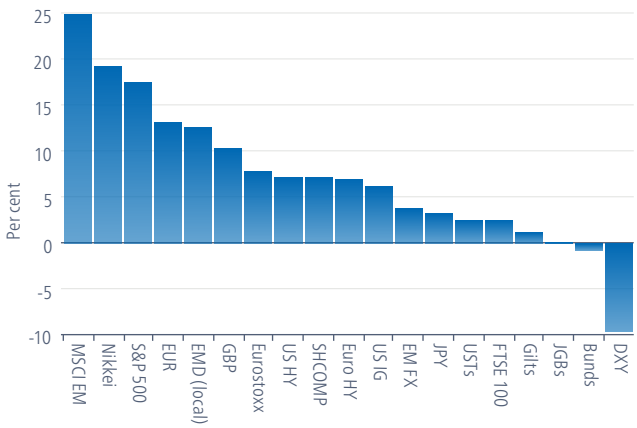
Investment grade corporate credit in both the US and Europe is also likely to be challenged in 2018 given the spread tightening seen over the past year and our views on the risk to duration. In Europe there is the added risk associated with the expected end of ECB purchases later in 2018. High yield credit is relatively more attractive given the potential for some further narrowing in spreads and the low probability of a material default cycle starting in 2018. Indeed default rates are expected to decline further over the next twelve months. The prospects for emerging market (EM) debt are also encouraging, with improved fundamentals and attractive valuations more than compensating for a rise in US rates. That said, recent months have seen heightened idiosyncratic risks, highlighting the potential for greater volatility across the EM debt spectrum, particularly with numerous elections taking place in 2018. A more cautious stance is warranted on EM hard currency (dollar-denominated) debt, where valuations look more stretched.

Strong global growth should see corporate defaults decline further and support high yield credit

Finally, we think that global reflation will continue to favour currencies that are under-valued on a longer-term basis. That means the US dollar's peak is likely behind us, absent a more aggressive move by the Federal Reserve to tighten policy. The main beneficiary of the benign global environment ought to be emerging market currencies, although as with EM debt, idiosyncratic factors will dominate in some instances. We see the better performance as likely to be in India and Indonesia, with South Africa and Turkey more challenged. We expect the major G10 currencies to be relatively range-bound in 2018, with the euro likely to perform a little better on stronger domestic factors. Sterling remains vulnerable to Brexit negotiations, but could equally outperform if it looks likely there will be a long transition period agreed.

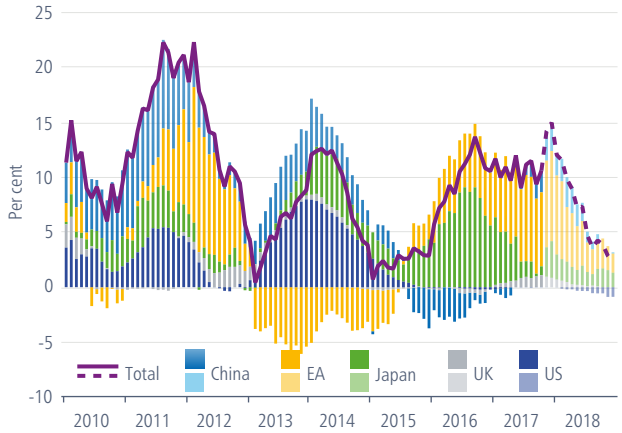
Under-valued currencies should benefit from global reflation

Figure 5: Global market performance 2017 YTD
Risk assets have outperformed risk-free



Sources: Aviva Investors, Bloomberg, Macrobond, as at 1 December 2017

Figure 6: Global quantitative boost is waning
Central bank balance sheets are set to rise less rapidly



Sources: Aviva Investors, Macrobond, as at 1 December 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 November 2017 Forum we identified the following key themes:

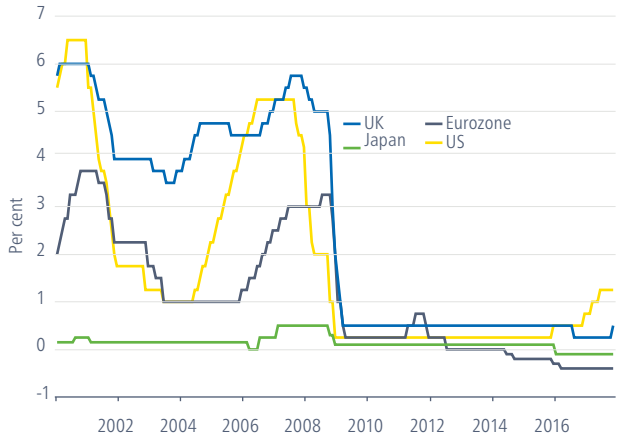
1. Turning point for global monetary policy in sight
2. Market outcomes to be increasingly determined by fundamental factors
3. Expectations of sustained inflation
4. Systematic Chinese reform
5. Peak financial regulation

1 TURNING POINT FOR GLOBAL MONETARY POLICY IN SIGHT

After almost a decade of extraordinary policy stimulus from global central banks, the sands are now shifting. We would contend that the extended period of exceptionally low – or even negative – interest rates (Figure 7), alongside the wide range of "unconventional" monetary initiatives, was essential to help prevent the financial crisis tipping the world economy into a reoccurrence of the Great Depression of the 1930s. Looking ahead to 2018 and beyond, monetary policy drivers for financial markets are set to be very different as the long return journey to more "normal" policy settings is undertaken. The return of trend GDP growth or better and the retreat of deflation fears mean higher interest rates are warranted or will be over the next few years.

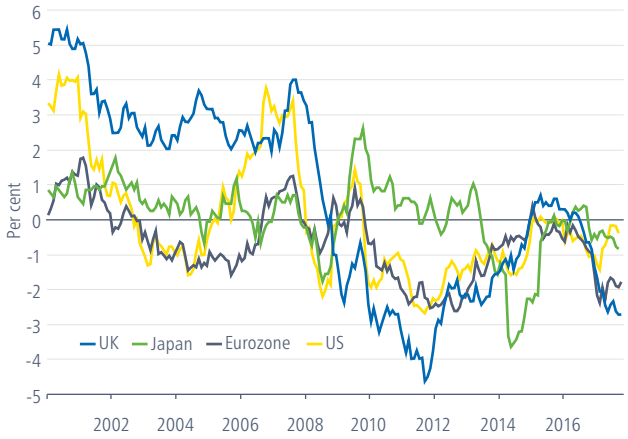
Post crisis, macroeconomic health was restored initially in the US, so it is no surprise that the Fed has been the first to tighten policy. It remains on a clearly signalled path towards higher interest rates, with one more expected this month and three more in 2018. But the progression will be slow – "limited and gradual" in Central Banker language. Moreover, other central banks are withdrawing their easing stance very cautiously and while we expect others to join the Fed in tightening

Figure 7: G4 policy interest rates
The only way is up



Sources: Aviva Investors, Macrobond, as at 1 December 2017

Figure 8: Real interest rate approximation
Difference between policy rate and annual inflation



Sources: Aviva Investors, Macrobond, as at 1 December 2017

on a two to three-year view, moves will be measured and very slow by historical standards. We do not expect a pronounced tightening of financial conditions over the next year or so and real interest rates are expected to remain low compared with history (Figure 8). All moves are contingent on a continuation of recent macro trends: ongoing robust GDP growth and a steady and sustained return of inflation to target.

MARKET OUTCOMES TO BE INCREASINGLY DETERMINED BY FUNDAMENTAL FACTORS

2

Part of the transmission mechanism for Quantitative Easing (QE) policies to the real economy was the boost they provided to financial asset prices. There are worries in some quarters that the withdrawal of asset purchase programmes around the world (actual or planned) will remove a vital support for risk assets. This is unduly pessimistic in our view – the Fed stopped buying assets three years ago and markets have not collapsed. Looking forward, the ECB is tapering its own purchases in 2018 and the BoJ may also buy at a reduced pace.

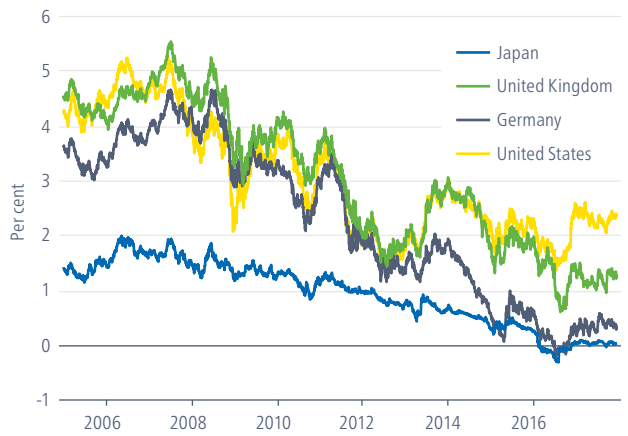
Although asset prices have benefitted from these programmes, markets are ultimately underpinned by fundamental drivers. These are already reasserting their influence and this can be expected to continue in 2018 and beyond as policy stimulus is withdrawn. Looked at in this light, the much-improved economic outlook and related earnings increases have supported equity markets in 2017 and should do so again, with some qualifications, next year. Sovereign bond yields, on the other hand, may have more of this transition (from policy support drivers to fundamentals) to make over the next few years, especially if we are right about the upbeat growth and inflation outlook (Figure 9). It is also plausible that there could be greater dispersion across fixed income markets as fundamentals reassert themselves, reflecting differing prospects, policy settings and economic conditions.

EXPECTATIONS OF SUSTAINED INFLATION

3

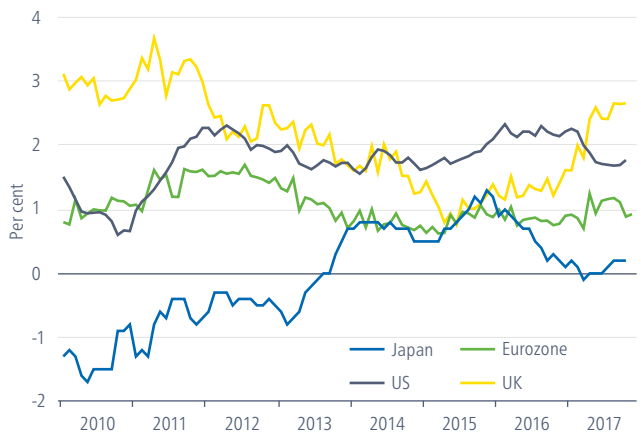
Fears of secular deflation in the developed world were prevalent during and after the financial crisis, but are now largely absent. However, CPI inflation rates remain generally below Central Bank targets (typically 2 per cent) (Figure 10). This latter feature has persuaded some commentators to argue that inflation will stay permanently too low and that policy, therefore, can remain loose indefinitely. Yet given the imbalance between supply and demand that opened up during the crisis, an extended period of low inflationary pressure was entirely understandable. But the long global expansion since 2009 means that the process of eliminating spare capacity is complete in some countries such as the US and getting much nearer

Figure 9: 10-year bond yields still look too low



Sources: Aviva Investors, Macrobond, as at 1 December 2017

Figure 10: Core inflation



Sources: Aviva Investors, Macrobond, as at 1 December 2017

in others, such as the Eurozone. Hence, inflation is expected to move higher on a sustained basis.

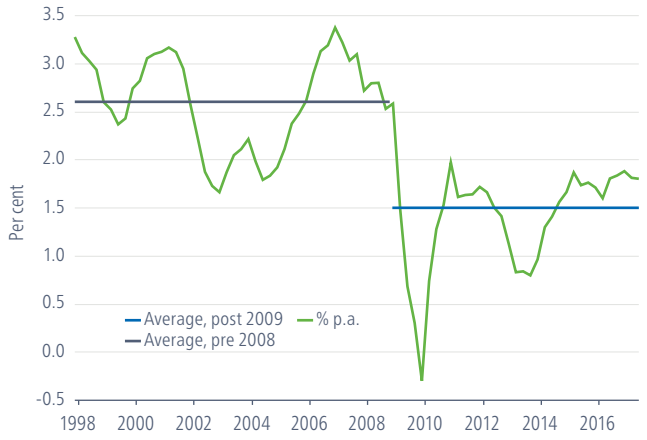
The evolution for inflation rates in 2017 was not totally convincing in directional terms, with both Europe and the US seeing some modest downside surprises. However, at least some of that was likely to be transitory. Wage inflation has also been subdued, with the G4 average pace still more than a full percentage point lower than the pre-crisis mean (Figure 11). One of the key themes that we believe will emerge in 2018 and 2019 is a clearer upward trajectory in inflation back to (or even slightly above) those 2 per cent target rates. If that is right, then expectations of sustained positive inflation will become more entrenched and the prevailing environment will distance itself even further from the dangerous deflation frontier and move more compellingly into low, positive inflation territory. Such a development would be an important element in the reappearance of more normal macro-economic conditions.

4 SYSTEMATIC CHINESE REFORM

After the growth scares of 2015, China has enjoyed two years of comparative calm, with GDP goals being achieved or even marginally exceeded (Figure 12). Perhaps more importantly, official growth targets appear to have been subtly downgraded in terms of Government priorities compared to earlier periods. Arguably, being a hostage to fortune where GDP objectives are concerned has been more of a hindrance to Chinese policy as well as to its transition and economic development ambitions. Hence although there are still growth targets implicit in China's longer-term aspirations, they are less front and centre than in the past. (Of course if there were a major downside shock, the Chinese authorities would almost certainly respond aggressively.) This greater flexibility of approach has allowed – and should continue to allow – China to pursue its reform agenda with greater alacrity and on a more systematic basis. Whether explicit or not, China will be aiming for somewhere between 6 per cent and 6.5 per cent growth in 2018.

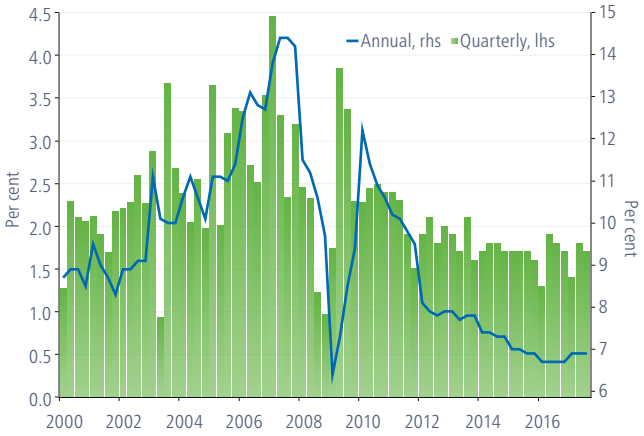
This was also the message that emerged clearly from the 19th Party Congress in October. As well as consolidating his power-base (which should provide greater stability), President Xi modified the economic policy focus in the years ahead, away from the emphasis on growth and towards supply-side reforms (including state-owned-enterprises), deleveraging and the longer-term transformation of China. While some elements of these initiatives will take years to implement and bear fruit, others will have an impact from now on and will help define key parts of the overall global macroeconomic backdrop in 2018 and 2019. The "One Belt One Road" set of initiatives in particular may well become increasingly important on

Figure 11: OECD G4 private sector wage growth, simple average
10-year bond yields still look too low



Sources: Aviva Investors, Macrobond, as at 1 December 2017

Figure 12: China: quarterly and annual GDP growth



Sources: Aviva Investors, Macrobond, as at 1 December 2017

the world stage. Although what China says and what it does can be very different things, it is an irony not lost on several commentators that China now sounds more amenable to free trade and open markets than Trump's America.

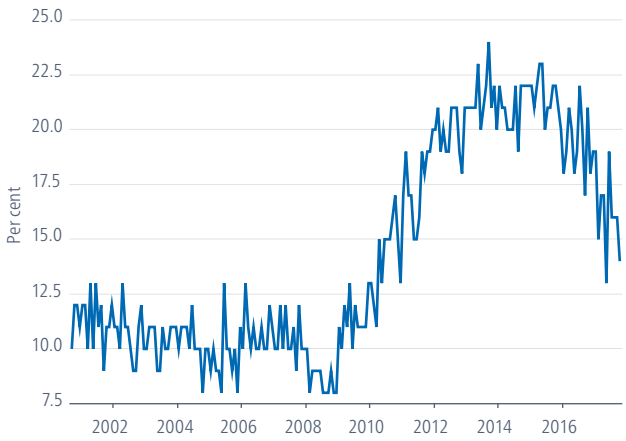
PEAK FINANCIAL REGULATION

5

After the inevitable raft of greater financial regulation in the wake of the Global Financial Crisis (GFC), the pace of introduction of additional measures has, just as inevitably, waned somewhat in recent years. This does not mean that we are about to experience a far looser regulatory environment in the near future, but rather that we have probably passed the peak in terms of additional initiatives being announced. Indeed, with the ostensibly market-friendly Mr Trump in the White House, there is even the possibility of a worthwhile reduction in the regulatory burden in some areas (Figure 13). It may take some time, and it has to be said that gauging US policy initiatives on the basis of Trump's twitter outbursts has not been the most reliable guide to subsequent events. But even a moderate bias towards an easier regulation tilt and less stringent rules would represent an important change to the operating environment for financial (and other) companies.

In Europe there has arguably been a greater acceptance of tighter regulation and less momentum behind any moves towards a lighter regulatory touch. But it is also generally accepted that a properly functioning banking system is vital. And in this context it is widely recognised that credit needs to be made available to reputable entities that wish to borrow if the Eurozone recovery is to continue. The latest indications are that credit conditions have eased considerably since the sovereign debt crisis and that lending has picked up. Although it is unlikely to be characterised as looser regulation, the European authorities will wish to ensure that credit continues to flow, without significant hindrance, to where it is needed. When there were more worries about the fundamental health of large parts of the European banking system, this was less of a priority – at such times solvency was more important than liquidity.

Figure 13: US NFIB survey: regulatory burden balance



Sources: Aviva Investors, Macrobond, as at 1 December 2017

RISKS TO THE HOUSE VIEW

NATIONALISM/POPULISM ON THE RISE AGAIN

Trade tensions have moderated in recent months, partly because of fewer histrionic outbursts from the Trump administration and partly because of the ongoing recovery in global trade volumes which has contributed importantly to a fall in protectionist rhetoric more widely. But increased nationalism ("America First") could easily resurface, especially if Trump doesn't get his own way on domestic policy. Moreover, the issue is still relevant in many other countries too. It is bubbling beneath the surface across swathes of Europe (AfD representation in fractured German parliament, Brexit aggravations, Italian elections), while the next year or so also sees a number of key elections within important emerging markets (Figure 14). Although it has also quietened down a little, recent episodes between the US and North Korea (and China to a lesser extent) highlight the scope for sudden eruption of conflicts and anxieties in this area.

LOW GROWTH, LOW INFLATION

Although there have been some gyrations in headline inflation rates since the crisis, on average it has remained low and below target in most geographies even while the recovery has continued over much of the last seven or eight years. The combination of a relatively sluggish expansion with continued low inflation has led some to conclude that this is now the normal state of affairs. Secular stagnation is one variant of this school of thought; supply-side weakness, including very low productivity growth, is another. The impact of technology on the capacity of companies to push through price increases is a third. The recent combination of growth and inflation has been low, but not exceptionally so (Figure 15). A low inflation, low growth environment that persists could permanently change the old policy rulebooks.

CHINA GROWTH SLOWDOWN

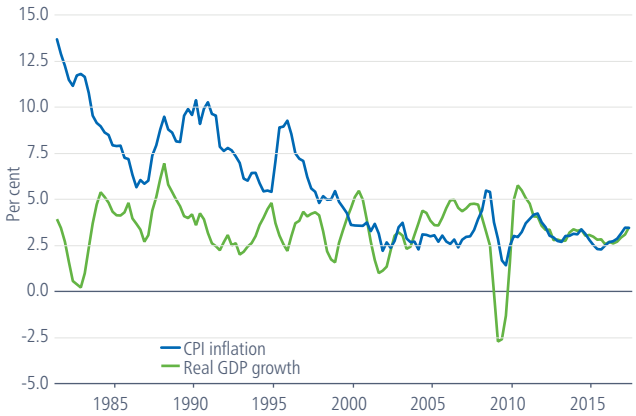
As in many other countries the trend GDP growth rate in China is slowing. But China's size and importance mean that both its growth rate and how the trend slowdown is managed will be watched very closely by financial markets and will have global ramifications. China is attempting to transition to a more open, service-based economy. But the combination of the inexperience of its policy-makers, their determination to micro-manage every detail of the economy and society, their ambitious long-term aspirations and the strange demographics as a result of the one-child policy means that the scope for upsets and mistakes is significant. There have already been previous episodes of China growth worries that have impacted global markets. A future slowdown could be either a result of transition shocks or could be brought about by policy mistakes. Either way, it would be foolish to ignore the risk of more shocks in the future.

Figure 14: Key EM general elections in 2018

Country	Date
Malaysia	August
Thailand	During year
Czech Rep	During year
Hungary	April
Russia	March
Slovenia	July
Brazil	October
Colombia	March
Costa Rica	February
Mexico	July
Paraguay	During year
Venezuela	December

Sources: Bloomberg, Aviva Investors

Figure 15: Nominal GDP growth on low side compared to history



Sources: Aviva Investors, Macrobond, as at 1 December 2017

ACTIVE CENTRAL BANK TIGHTENING

Financial markets continue to believe that the Fed will deliver nothing like its stated intention of seven 25 basis point hikes between now and the end of 2019. They also seem relaxed about the ECB's glacial journey towards the policy exit and the BoJ's almost permanent state of assistance provision. The Bank of England has raised rates once, but has hinted heavily that just two more 25 basis point hikes over the next three years is all that should be expected. Against this backdrop, the scope for upside surprises seems an obvious risk to consider. Many have argued that the Fed's last hiking cycle in 2004/6 (Figure 16) was "too slow" and contributed to many of the problems that came after. The current cycle is less than half that pace. It would not take much for markets to start to worry about upside inflation potential and the need for more active hiking from central banks. This would also threaten the low-volatility regime that has prevailed in recent years.

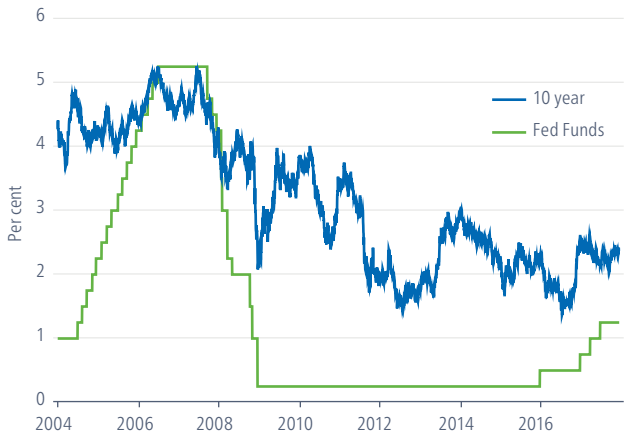
DEBT DE-LEVERAGING VULNERABILITIES

There is a widespread consensus now that, after a long period in the doldrums, the world has entered a period when policy interest rates will generally be rising. As monetary authorities have gone to great lengths to point out, rate hikes are likely to be "gradual and limited", especially compared to history. While that is some comfort, we should not be surprised that the exceptionally long phase of ultra-low interest rates has encouraged a wide range of borrowers to take on higher debts. As we shift slowly to a regime of higher interest rates, it is almost inevitable as interest rates now rise, even if the process is very slow, that some of those borrowers will be hurt by the financial burden of higher debt-servicing costs. De-leveraging among households, for example, has been different around the world (Figure 17).

EUROPEAN CONVERGENCE

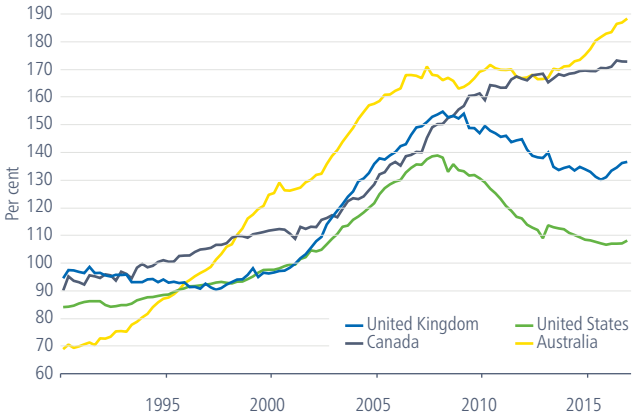
A year ago there were major worries about the possible direction of European politics. The prospect of major gains and increased representation for far-right parties dominated the political outlook for 2017. In the event, such worries proved largely unfounded and political unity (with a centrist flavour) has increased across the Eurozone, helped in part by a "common adversary" in the Brexit negotiations. Even the inconclusive German election result looks likely to result in another coalition with Merkel as leader once more, which should help the revitalised Franco-German alliance to work closely together on the next steps for the Euro project. Combined with the markedly better macroeconomic outlook, this set of conditions should enable important progress to be made on the aspiration of closer integration. Bold words are useful here, but they need now to be followed up with actions and these have been slow in coming. Nevertheless, the fact that the focus of this risk case is on the clear scope for upside surprises in Europe is good news in itself.

Figure 16: Current hiking cycle far slower than the last



Sources: Aviva Investors, Macrobond, as at 1 December 2017

Figure 17: Debt excesses possible in some areas
Ratio: Household debt to disposable income

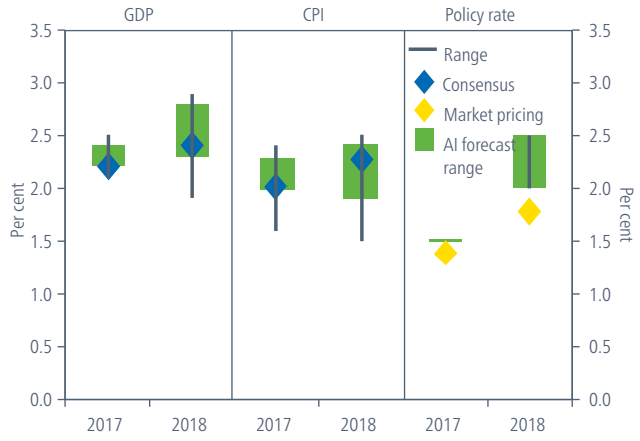


Sources: Aviva Investors, Macrobond, as at 1 December 2017

MACRO FORECASTS CHARTS AND COMMENTARY

The US economy picked up pace over the course of 2017. Looking ahead, we expect growth to be a little higher next year, with the mix a little more tilted towards investment. The period of softer inflation earlier in 2017 seems to have largely passed. Indeed there appear to be some nascent signs of a further modest pickup in inflation over the coming months. We expect the annual core CPI inflation rate to move back above 2 per cent by mid-2018.

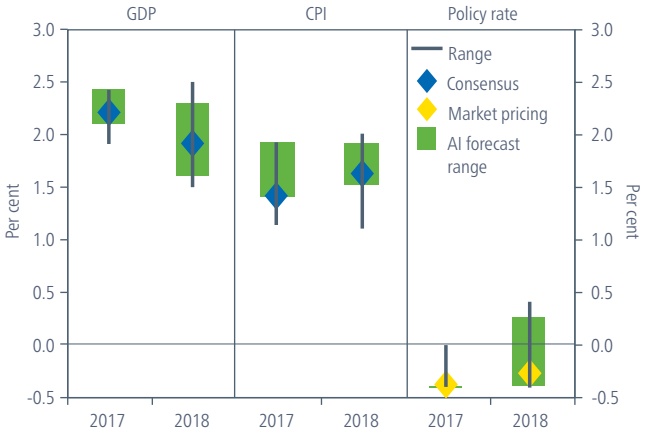
Figure 18: US



Source: Bloomberg, Aviva Investors, as at 1 December 2017

Eurozone business surveys and consumer sentiment readings continue to go from strength to strength, suggesting no imminent moderation in the present boom. Even so, GDP growth should slow a little next year, partly because of the 15 per cent rise in the euro exchange rate in 2017 and partly in anticipation of tighter policy eventually. The kicker from accelerating world trade growth is also likely to fade somewhat. But this is no bad thing – although inflation is subdued for now, the combination of well above-trend growth and super-loose monetary conditions cannot continue indefinitely.

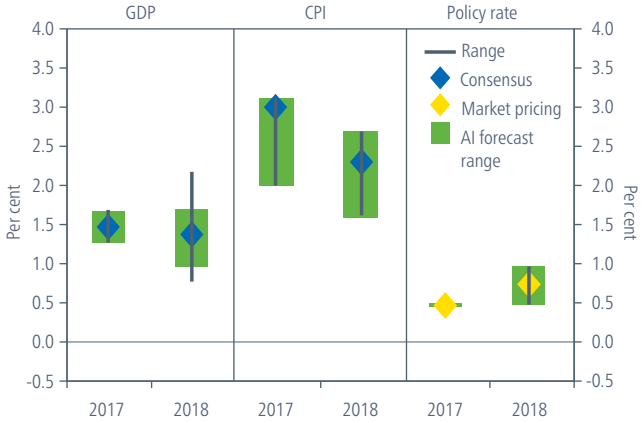
Figure 19: Eurozone



Source: Bloomberg, Aviva Investors, as at 1 December 2017

The reassessment of trend growth in the UK from 2 per cent to around 1.5 per cent represents a massive change to the UK's supply-side potential. After 10 years, GDP will now be almost 6 per cent lower than it would otherwise have been: effectively Britain would rather have "lost" three years of growth. Over the shorter term, current growth is sluggish, but at least positive. Some sentiment indicators – both business and households – are fragile and local downside risks are overshadowing the positives from the global upswing. It is not all Brexit-related, but that shadow looms large.

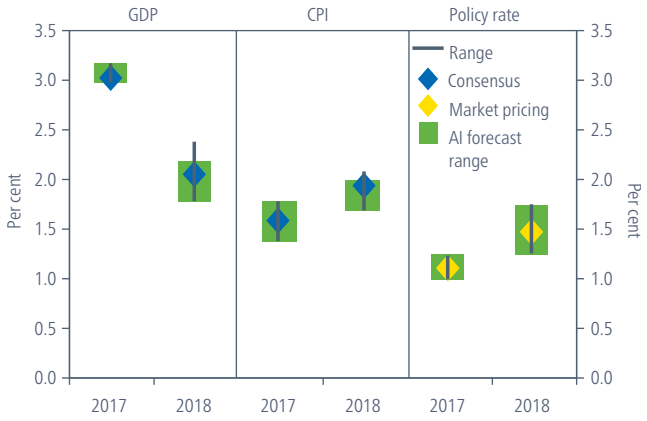
Figure 20: UK



Source: Bloomberg, Aviva Investors, as at 1 December 2017

Growth surprised to the upside in 2017, leading the Bank of Canada (BoC) to hike rates twice to 1 per cent. Looking forward to 2018 the rate of growth is expected to moderate to around 2 per cent from 3 per cent. Despite strong growth, inflation has remained below the target and although expected to pick up in 2018, the impact of rate hikes in 2017 and the appreciation of the Canadian dollar will be headwinds to a significant acceleration. The BoC is therefore expected to move more cautiously from here and in particular will be watching wage growth and household debt.

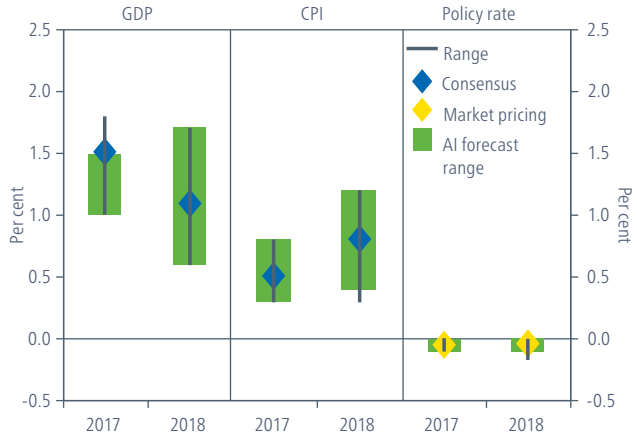
Figure 21: Canada



Source: Bloomberg, Aviva Investors, as at 1 December 2017

Amid a strong global growth backdrop, the Japanese economy remains in a good place. While Q3 GDP data showed moderation from Q2, survey data (Tankan indicators, PMIs) continues to suggest brisk expansion heading into 2018. While growth is expected to moderate slightly, reflecting the moderation in key trading partners such as China and the Eurozone, it is still likely to remain robust. Core inflation remains very weak for now, but is likely to pick up modestly as the effects of above-trend expansion and labour-market tightness begin to show themselves gradually.

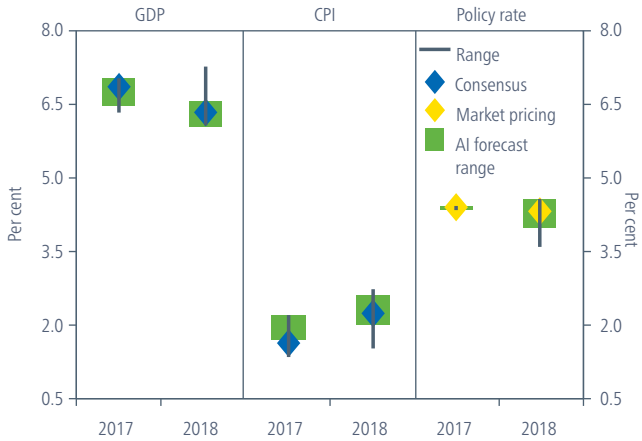
Figure 22: Japan



Source: Bloomberg, Aviva Investors, as at 1 December 2017

After a year that has seen Chinese growth defy predictions of a slowdown repeatedly, some signs of moderation are emerging as housing market activity continues to cool. But the impact on the wider cycle is likely to be much less pronounced than during 2015-16 as inventories are much lower than in the past. At the same time, wider activity indicators remain robust and survey indicators such as PMIs suggest that the expansion is likely to continue at a modestly slower pace next year. The policy environment is likely to remain broadly supportive as targeted easing mitigates the impact of the ongoing regulatory deleveraging.

Figure 23: China



Source: Bloomberg, Aviva Investors, as at 1 December 2017

GLOBAL MARKET OUTLOOK AND ASSET ALLOCATION

PEAK EASY POLICY IS BEHIND US

– Global growth is strong and accelerating, putting moderate upside risk on inflation

– Monetary policy now turning globally – peak easy policy is behind us

– Equities are not the most at risk – duration is; use credit to protect portfolios

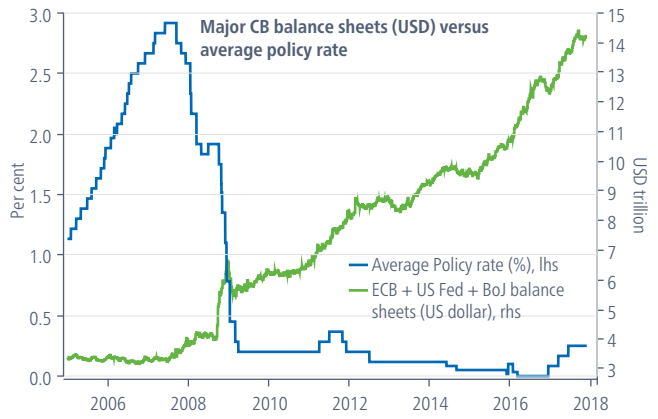
The Federal Reserve might not be alone next year…

The global policy environment is changing

One of the key themes we identified in the past few quarters was the turning point in monetary policy in developed markets. While this was very obvious in the United States as the Federal Reserve started to remove accommodation by hiking rates, it is important to note that peak accommodative policy in Japan and in the Eurozone is probably now behind us. Indeed, within our investment horizon, both the European Central Bank (ECB) and the Bank of Japan (BoJ) are likely to start reducing some of the extraordinary support they have provided, albeit very gradually. And this makes sense – we expect global growth to be in the region of 4 per cent in 2018, causing the global output gap to close more quickly. The pick up in underlying fundamentals has been particularly stark in the Eurozone, but also in Japan. And at the same time, the ECB and the BoJ are still running quantitative easing and negative rates policies. If we are right on our central scenario and inflation rises moderately next year, then markets might have to price in both central banks initiating exit from easy policies. All in all, peak monetary easing is behind us, and this could have significant consequences on financial markets (Figure 24).

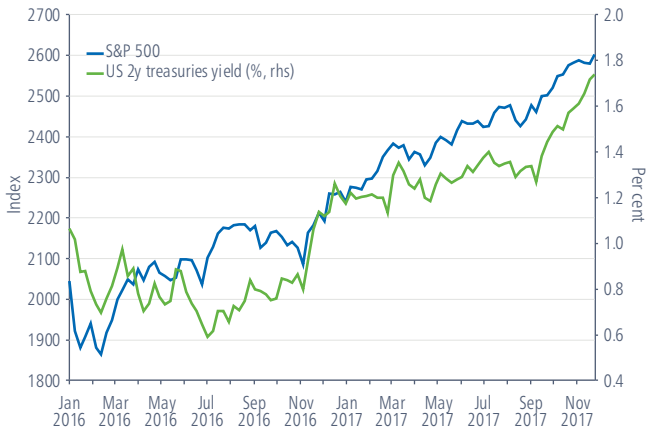
Rather than being concerned by the removal of extraordinary monetary policy accommodation, we think it should be welcomed. It is happening because the underlying economic background is strong enough to generate that change in stance. If we look at what is happening in the US for example, Federal Reserve policy is leading to higher yields in short-term government bonds. But this has been accompanied by higher equity prices as underlying earnings growth keeps improving (Figure 25). So the central bank is responding to an improving situation in the real economy. In 2018 we expect to see more movement in this direction.

Figure 24: Peak easy policy is behind us



Sources: Aviva Investors, Macrobond as at 1 December 2017

Figure 25: US Fed hikes priced in short-term yields at the same time as US equities advanced



Sources: Aviva Investors, Bloomberg as at 1 December 2017

Markets will be quick to respond once they sniff that change is coming. One example in 2017 was the move higher in the Euro exchange rate, ahead of the ECB announcing reduction in asset purchases. Hence, one of the key objectives for investors next year will be to build scenarios incorporating this turning point in monetary policy and identify underlying investment opportunities.

Markets will be quick to respond once they sniff change is coming

… cross-asset correlations normalising further, while volatility is too low

For much of the past decade, markets frequently moved up or down in response to external factors such as political risk or shifts in monetary policy, a phenomenon that has come to be known as 'risk-on, risk-off'. Investors moored in safe havens when the macroeconomic environment worsened, then paddled back towards riskier assets when the clouds cleared. But in equity markets at least, this dynamic has begun to change. Since the beginning of 2017, the correlation between stocks within major indices has dramatically broken down. Equity performance is increasingly a reflection of corporate strengths and weaknesses rather than extrinsic circumstances, a development that has big implications for investors.

We expect this to remain the case in 2018, and to move beyond equities and into fixed income markets. As we have highlighted in previous editions of the House View, while equity dispersion has risen sharply, fixed income dispersion is still rather low. This divergence is partly a function of the outsized impact of monetary stimulus on credit. By buying bonds and holding interest rates low, central banks spurred a flow of capital into riskier parts of the market, causing spreads to tighten. With the likely turn in monetary policy, this support could start to be removed in the coming year (Figure 26).

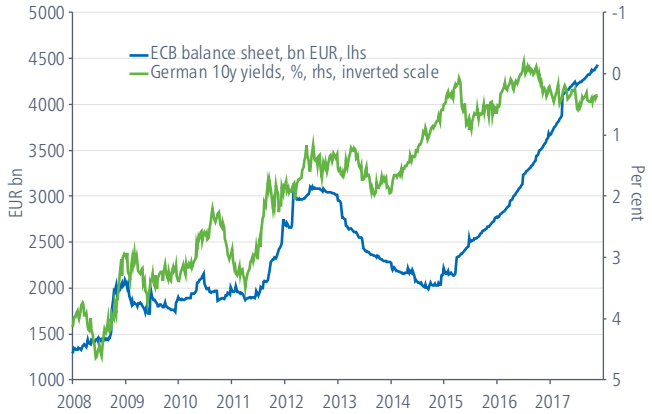
In addition to correlation, a key factor next year is likely to be asset market volatility. Across asset classes, volatility has been deeply suppressed this year – we think these historically-low levels of volatility are unlikely to persist, particularly in fixed income. Absent exogenous shocks and within our central scenario, we do not expect the volatility regime to spike higher – but to normalise to the cyclical position of the global economy.

Fundamentals in the driving seat…

With the beginning of the removal of extraordinary support from central banks, fundamentals are in the driving seat. In some asset classes, like equities or currencies, dispersion can be observed. Earnings growth outlooks and sector allocation matter again for equity allocations, while in the current market environment currencies tend to price early on changes in monetary policy (e.g. Euro response to the ECB) or structural changes (pound sterling and Brexit). Fixed income assets might respond more aggressively to a transition away from being driven by extraordinary monetary policy to being more fundamentally driven. This means that on top of a potentially higher volatility regime, higher dispersion within fixed income should also be expected.

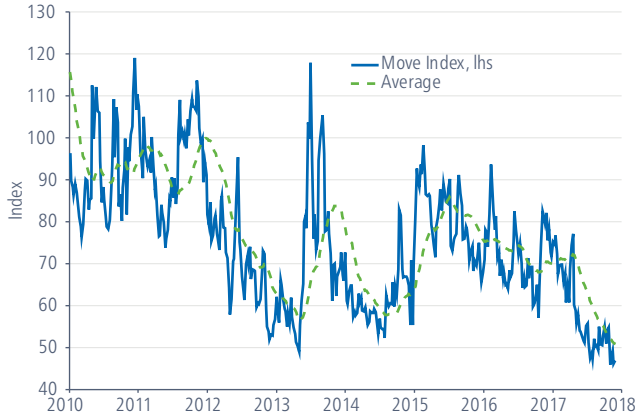
Fixed income to be more fundamentally driven next year

Figure 26: Monetary policy expansion has suppressed yields so far



Sources: Aviva Investors, Bloomberg as at 1 December 2017

Figure 27: Fixed Income volatility might not remain historically low in 2018



Sources: Aviva Investors, Bloomberg, MOVE index as at 1 December 2017

...we prefer equities to fixed income

We think next year duration is most at risk. Valuations remain very expensive in markets like Eurozone core fixed income, or Japanese fixed income – or even European corporate credit. While central bank policy has been a key driver for those assets, it is likely to change within our investment horizon. Given our outlook on global growth and on inflation, we think parts of the fixed income asset complex are mispriced when considering underlying fundamentals (Figure 27). In terms of portfolio construction, we continue to run most of our underweights in the fixed income space. The overarching idea underpinning our asset allocation thinking for the year to come is that when investing in a world where fundamentals are strong and peak monetary policy stimulus is behind us, equities should outperform fixed income, and that corporate credit exposure should be an underweight used to protect portfolios. This comes with caveats and specifics within each asset class.

Remain overweight equities through emerging markets exposure…

We prefer emerging markets within equities

We continue to be overweight equities. Within the equity complex, we prefer emerging market equities (maximum overweight). Fundamentals have been improving in emerging markets as well in terms of economic growth, but also in terms of earnings growth. The outlook from China is probably for slightly lower growth as it seeks to start implementing structural reforms, but this is in the context of a strong global growth backdrop (including in emerging markets), and still attractive relative valuations (Figure 28). We also remain overweight on emerging market local currency debt, as we think higher real yields and positive macro-economic developments do more than compensate for what we expect to be only a gradual tightening from the US Federal Reserve. We are, however, underweight on hard currency debt as we are concerned by expensive valuations.

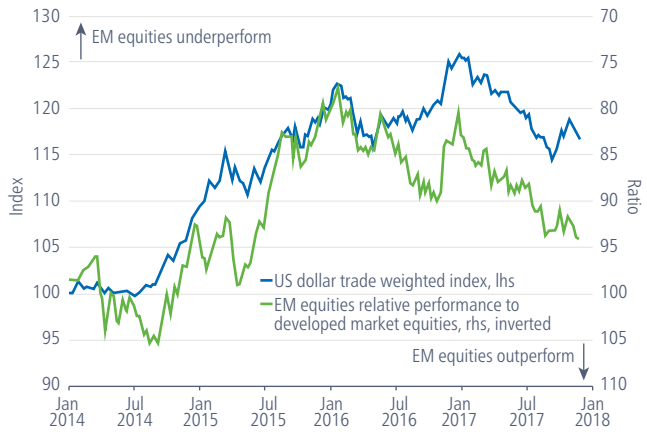
We continue to be overweight European equities, which we think are supported by fast improving macro environment in the Eurozone, but also receding political fears. We also increased our exposure to Japanese equities, as corporates are delivering on the earnings front, and the Japanese economy is showing signs of life. Given the starting point of monetary policy in both those geographies, we think gradual steps towards tighter policies should not derail equity markets. In contrast, we remain underweight on US equities, which we find much less attractive from a valuation point of view.

…and underweight duration

Underweight Japan and Eurozone bonds, overweight US Treasuries for protection

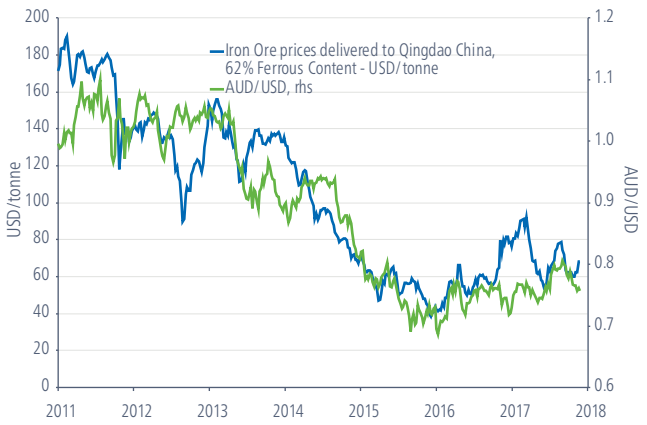
On the other side of the spectrum, we expect some fixed income markets to be under pressure next year. In particular, Eurozone core fixed income is trading on very expensive valuations. With the macro environment remaining strong and the ECB set to remove monetary support (through QE initially), we think the asset offers poor risk-reward. We are also underweight Japanese government bonds as yields are

Figure 28: Our expectations of a moderate US dollar environment should be supportive for EM equities



Sources: Aviva Investors, Bloomberg as at 1 December 2017

Figure 29: Australian dollar to protect portfolios should Chinese growth slow down sharply



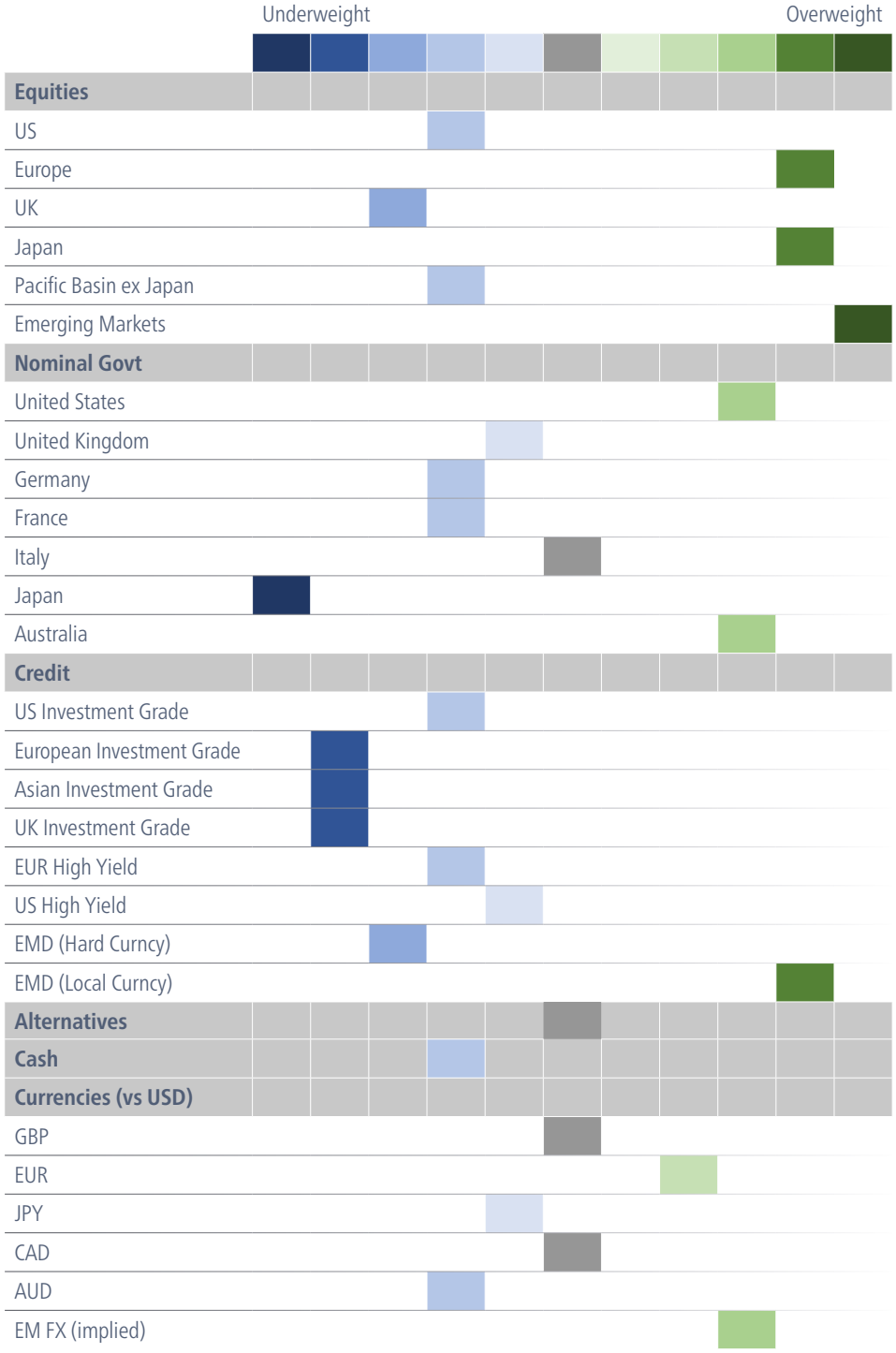
Sources: Aviva Investors, Bloomberg as at 1 December 2017

extremely low, and there is significant downside risk through a potential revision by the Bank of Japan of some of their policies like yield curve control.

We also find corporate credit in both Europe and United States to offer little expected return going forward (both are underweights), in absolute terms for Europe and relative to other markets in the equity space for US credit. European Credit in particular is threatened by the end of QE in the Eurozone.

In terms of portfolio construction, we maintain an overweight position on Treasuries at the long end of the curve to protect us should we be wrong in our central scenario. We also have a long position in Australian bonds to balance the risk we take in the emerging market space, as the former should do well in a risk scenario where Chinese growth slows sharply down (Figure 29).

Figure 30: Asset Allocation



Sources: Aviva Investors, as at 1 December 2017

ESG INSIGHT: THE MARCH OF THE MACHINES

Technology will disrupt traditional industries and labour markets

Startling images of convoys of driverless trucks, developments in drone-based delivery systems, and the deployment of Japanese 'Carebots' for the elderly, have served to ignite the imagination of a fully automated future. While the prospect of a dystopian world ruled by robots remains firmly within the realm of fiction, there is increasing anxiety over the real threat that automation presents to traditional industries and economies, and the implications for large swathes of the labour force.

Automation will increasingly impact white-collar roles

Automation can take many complex forms and encompasses a wide spectrum of technology from simple robotics to advanced artificial intelligence. However, at its most rudimentary level, it involves the minimising of human intervention in a process. This phenomenon is not new, having first emerged in the 19th Century with the mechanisation of the textile industry. Despite the protestations of the Luddite movement, the new technology dramatically reduced the cost of clothing, triggering a surge in demand, which ultimately quadrupled the number of jobs for weavers in the United States over the following 70 years.

However, the 'Fourth Industrial Revolution' is expected to have a more dramatic and pervasive impact on the labour market. Historically, automation had been focused on roles undertaken by low-skilled blue-collar workers, but due to advancements in technology, the scope of automation has now moved beyond the factory floor to any task involving repetitive actions. This includes routine aspects of financial and legal services and even the highly technical field of medical diagnostics.

POTENTIAL MAGNITUDE OF DISRUPTION

47 per cent of US jobs at risk of automation

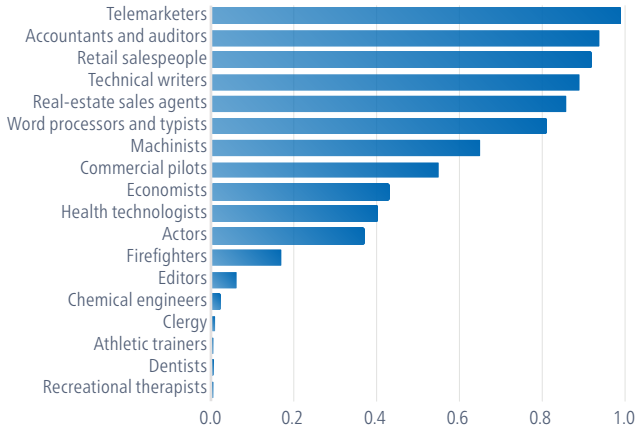
In 2013 Oxford University published a landmark paper exploring the susceptibility of different jobs to computerisation, estimating that 47 per cent of jobs in the US are at risk of being automated in the next 20 years . The study examined over 700 occupation types and calculated the probability of automation. Their research predicted that roles in telemarketing, accountancy and retail sales had more than a 90 per cent probability of being significantly disrupted by automation, while potentially more surprisingly, this number was above 40 per cent for health technologists and economists (Figure 31).

750,000 professional roles in the UK could be redundant by 2030

While the Oxford University report prompted a number of further studies with markedly lower estimates of 'jobs at risk', the projected numbers remain significant. A recent report by PWC, building on the earlier studies, predicted that 38 per cent and 30 per cent of jobs in the US and UK respectively will be at high risk of automation by the early 2030s . By mapping trends in technology, the repetitive

Figure 31: Catalogue of fears

Probability of computerisation of different occupations, 2013 (1 = certain)



Source: "The Future of Employment: How Susceptible are Jobs to Computerisation?", by C. Frey and M. Osborne (2013)

Figure 32: UK jobs at risk of automation

Employment shares, estimated proportion and total number of employees at potential high risk of automation for all UK industry sectors

Industry	Employment share (%)	Job automation (%)	Jobs at high risk (m)
Wholesale and retail trade	14.8	44.0	2.25
Manufacturing	7.6	46.4	1.22
Administrative and support services	8.4	37.4	1.09
Transportation and storage	4.9	56.4	0.95
Professional, scientific and technical	8.8	25.6	0.78
Human health and social work	12.4	17.0	0.73
Accommodation and food service	6.7	25.5	0.59
Construction	6.4	23.7	0.52
Public administration and defence	4.3	32.1	0.47
Information and communication	4.1	27.3	0.39
Financial and insurance	3.2	32.2	0.35
Education	8.7	8.5	0.26
Arts and entertainment	2.9	22.3	0.22
Other services	2.7	18.6	0.17
Real estate	1.7	28.2	0.16
Water, sewage and waste management	0.6	62.6	0.13
Agriculture, forestry and fishing	1.1	18.7	0.07
Electricity and gas supply	0.4	31.8	0.05
Mining and quarrying	0.2	23.1	0.01
Domestic personnel and self-subsistence	0.3	8.1	0.01

Sources: ONS for employment shares (2016); PwC estimates for last two columns using PIAAC data

nature of tasks across sectors, and their share of the economy, PWC projected over 10 million jobs in the UK will be at risk, including more than 750,000 jobs in professional and technical fields (Figure 32). Similar results were found when applying the PWC model to other OECD countries including Germany and Japan.

DECOUPLING OF GROWTH AND EMPLOYMENT

Technology, big data, artificial intelligence and robotics are expected to result in significant productivity gains – according to McKinsey this could add as much as 1.4 per cent to global GDP growth per annum. However, there are serious questions over whether automation will hasten the decoupling of economic growth and employment, particularly in segments of the economy which have historically relied on labour undertaking routine tasks. This phenomenon appears to have already taken grip in the US where employment involving routine cognitive and non-cognitive activities has remained broadly flat over the last 30 years . While these trends can be explained to some extent by the emergence of outsourcing, the increased prevalence of automation will likely see employment trends between routine and non-routine activities widen further.

> Jobs involving routine tasks have remained flat in the US over the past 30 years

Due to the nature of the roles likely to be most affected, the consequences of automation are expected to have a disproportionate impact on different groupings within society. The previously-cited PWC report projects that only 12 per cent of the 'jobs at risk' in the UK will affect workers with higher education, while the remaining 9 million job losses will come from workers with low or median education (Figure 33).

While the elimination of specific roles is inescapable, the net impact of automation on aggregate employment is a subject of considerable debate. David Autor, an economist at MIT, is a vocal proponent of the idea that automating a particular task increases the demand for human workers in related fields. Oft-cited examples include the evolution and growth of retail bank staff following the introduction of automated teller machines (ATMs), and the increased demand for paralegal work following the development of data analytics software which dramatically reduced the 'discovery period' for legal cases.

> Technology has potential to create more jobs than it replaces

However, there are concerns that the next phase of automation will be different, leading to permanent 'technological unemployment' rather than temporary displacement. These concerns are built upon a number of key factors including the heightened penetration of automation across all sectors, and the sheer pace of new technological developments and the shortened period to deployment. This will result in greater disruption with less time and opportunities for labour to react.

> Labour force will require significant up-skilling to remain relevant

At this stage it is impossible to forecast with any certainty the net effects on aggregate employment levels, due to the unpredictability of evolving and newly emerging industries. However, substantive disruption to the existing labour market is

Figure 33: Breakdown of employees at risk of automation in the UK

Worker Characteristics	Employment share (%)	Job automation (%)	Jobs at high risk (m)
Gender			
Female	46	26	4.1
Male	54	35	6.3
Education			
Low education (GCSE level or lower)	19	46	3.0
Medium education	51	36	6.2
High education (graduates)	30	12	1.2

Sources: PwC estimates using PIAAC data as at 2016

Figure 34: Countries at risk of automation

Percentage of work activities that could be automated by adapting current technology

Africa		Asia/Australia		Europe		North America		South America	
KEN	51.9	JPN	55.7	CZE	52.2	MEX	51.8	PER	53.2
MAR	50.5	THA	54.6	TUR	50.4	CRI	51.7	COL	53.0
EGY	48.7	QAT	52.0	ITA	50.3	ATG	48.7	BRA	50.1
NGA	45.7	KOR	51.9	POL	49.5	CAN	47.0	CHL	48.9
ZAF	41.0	IDN	51.8	ESP	48.5	USA	45.8	ARG	48.2
		IND	51.8	DEU	47.9				
		MYS	51.4	GRC	47.8				
		CHN	51.2	AUT	47.4				
		RUS	50.3	SWZ	46.7				
		PHL	47.9	SWE	46.0				
		ARE	47.3	NLD	45.4				
		OMN	46.8	FRA	43.1				
		BHR	46.1	GBR	42.8				
		SAU	46.0	NOR	42.4				
		AUS	44.9						
		SGP	44.2						
		KWT	41.1						

Sources: McKinsey Global Institute, as at 2017

inevitable, and will require unprecedented levels of investment in 'up-skilling' of the labour force.

POLITICAL RAMIFICATIONS OF AUTOMATION

Governments must prioritise investment in education and training

The successful transition to more technology-driven economies will require political leadership that harnesses the full potential of automation while carefully managing the social upheaval caused by labour market disruption. Economies that will be better positioned to capitalise on the opportunities will be countries with higher standards of education, coupled with government budgets that are able to support the up-skilling of labour while managing costs associated with spikes in unemployment. This year's UK Budget contained several items focused on investments in technology-based education and retraining initiatives. We expect this to become a more prominent aspect of government spending going forward.

Marginalised workers could rekindle populist sentiments

Despite the long-term economic benefits of automation, the marginalisation of a subset of the workforce, unable or unwilling to upskill, is unavoidable. This has the potential to create the next phase of populism amongst affected countries, empowering opportunistic politicians to adopt obstructive regulations and policies with the goal of securing the support of a disenfranchised voter base. McKinsey estimates that government regulation and social attitudes could delay or accelerate the full impact of automation by up to 20 years.

LOOMING SHADOW OF CYBER-ATTACKS

Reliance on technology will expose governments and businesses to increased cyber-risks

Looking beyond the political and social instability that may be triggered by automation, the greatest emerging financial and business risk is posed by an increased vulnerability to cyber-attacks. Investment in cyber-security is increasing exponentially, with experts projecting that the $75 billion spent in 2015 will balloon to $170 billion by 2020 . However, despite the heightened level of awareness and defences, the world was rocked with consecutive ransomware attacks in 2017, temporarily crippling computer systems across nearly 100 countries. The potential financial significance of these types of attacks was highlighted in a report from Lloyd's of London which warned that a single serious cyber-attack could cost the global economy a staggering $120bn. Moreover, cyber-attacks are expected to play an increasingly prominent role in international conflict and warfare.

AUTOMATION MAY LEAD TO THE WIDENING OF THE WEALTH GAP

The Fourth Industrial Revolution will radically transform the existing economic landscape and cause significant disruption to the dynamics of the labour force. Automation will generate substantive productivity gains, but the extent to which subsections of the workforce share in the wealth creation will depend upon their ability to adapt and up-skill over time. However, in the short-to-medium term, technology-driven disruptions in employment may result in Silicon Valley becoming the next target of the '99 Per Cent'.

Automation may stifle growth opportunities in emerging markets

While developed countries at a macro level are expected to be net beneficiaries of the automation revolution, the long-term impacts on emerging economies is more uncertain. Although some countries with high numbers of tech-savvy graduates will be better positioned to capitalise on demand for more value-added professions, technological developments will fundamentally disrupt the traditional industrial pathway to growth for many emerging economies – an idea known as premature deindustrialisation (Figure 34). As lower-cost technologies enable businesses to 'on-shore' operations and supply chains, wage inflation and the rise of the middle class in some developing countries may begin to slow considerably earlier than expected.

RISK - WHAT'S ANOTHER YEAR?

In the first House View of 2017 we made a number of observations and predictions about what the year ahead would hold for the investment community. After what felt like a particularly bruising period for 'experts' in 2016, we started the year with some cautious optimism. One of our key risks was that of nationalism/populism, with elections across Europe posing significant risk to the fabric of the EU. In the end, and perhaps most significantly with the election of Macron in France and Merkel in Germany, Europe has steadied the ship.

> *"Prediction is very difficult, especially if it's about the future."*
> Niels Bohr, Nobel Laureate in Physics

Another topic we have discussed extensively was market volatility, or more precisely the lack of volatility, and whether that could continue. On the whole the calm has lasted throughout 2017 while headlines about the lack of volatility seemed to keep many nerves on edge. While levels of volatility continued to fall during the year, the fear about the lack of volatility anecdotally increased.

2018 ~ A YEAR OF PROMISE OR A YEAR TO FEAR?

Wise investors will always see the benefit of reflection on the past but the House View is a projection of the world as we see it in the future, so with this in mind we focus on some of the risks we perceive as potential issues over the next 12 months. Perhaps unsurprisingly, two prior themes will continue to resonate for investors: Brexit and the ongoing stagnation of volatility.

> *"You realize that our mistrust of the future makes it hard to give up the past."*
> Chuck Palahniuk

For the last 18 months a constant theme in the House View has been that politics matter for financial markets, just not all the time. Investors started 2017 worried and probably a bit confused; after all they had invested through a year of political tsunamis in 2016. In America a bombastic former reality TV star was President and promising to radically alter the landscape of the country and indeed the world, 140 characters at a time.

In Europe, the British had decided that 'leaving the band' to strike out on a solo career would be in their best interests. Investors obsessed about polls, absorbing each new data point with near obsessive behaviour. Sampling techniques and survey methodology knowledge became "de rigueur" in order to follow market changes.

We have often discussed the idea that markets misprice risk, and in the case of political risk it is because they believe that people behave rationally. However as behavioural economists will attest, people are often not rational nor are crowds logical, therefore is it surprising that an industry that places great weight on the power of quantitative analysis struggles to understand the human condition?

While continental Europe sailed calmly through its elections, the other protagonist in the Brexit process, the UK, called a surprise snap election. Pundits and observers assured all those who would listen that the Government would win a renewed mandate with a significantly enhanced majority on the back of a pledge to be both strong and stable.

Alas, this result proved to be anything like the initial predictions; post the election the UK now has a minority Tory government supported on a 'supply and confidence' basis by Northern Ireland's Democratic Unionist Party (DUP). Having staked her reputation on securing an enhanced majority with which to negotiate with the EU the terms of the UK's exit, the British PM's future is looking anything but strong and stable.

While it remains to be seen what the ultimate consequences of the vote will be on Brexit (hard, soft or indeed none) we believe that in all likelihood another election may be required. A weakened UK government will be forced to follow a more treacherous path between its own internal factions and the currently unified EU. In recent times the tone of the UK has been markedly softer. As a result our central scenario of likely outcomes has shifted to what could be described as bi-modal one, with the UK crashing out without any deal and the UK agreeing to a deal not dissimilar to what Canada has with the EU and perhaps a little more.

One risk case to this central scenario is the possibility that the perceived lack of unity within the UK generates the conditions which make a second referendum possible or indeed necessary. It is not entirely far-fetched to envisage a scenario where Brexit is indefinitely postponed. The central scenario of the House View and its associated risk scenario present significantly differing economic futures for the UK. All of which suggests that investors in the UK may well have many sleepless nights ahead as the drama of the next few years unfolds.

While in 2017 Europe averted a lurch to the right and the UK became significantly less stable, the US provided a third course. President Trump, fresh from his surprise 2016 victory, sought to embark quickly on a proposed legislative programme that was considered far-reaching if not universally popular. However, since his election the President's agenda has slowed if not outright stalled across much of his key policy planks. While administrations find change is easier to demand as a candidate than it is to deliver once elected, it seems that financial markets have learned not to hang on to every tweet and public pronouncement.

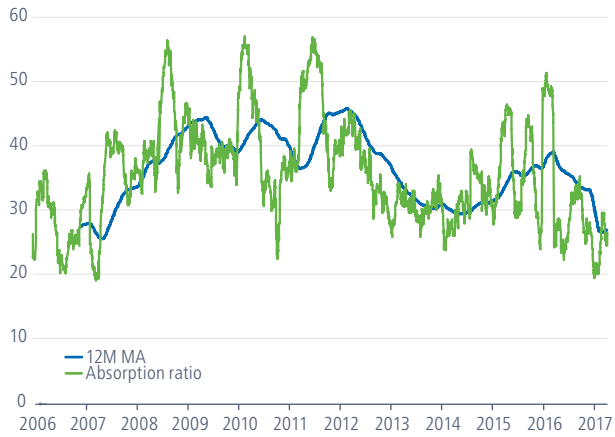
While political challenges remain a risk to investors, we believe that those risks are currently more localised, as in the case of Brexit for the UK, or not as significant as previous, as in the case of populism in Europe.

VOLATILITY, WHAT HAPPENS TO RISK WHEN VOLATILITY COLLAPSES?

As we examine the behaviour of markets in the period since the three main political upheavals in 2016, we observe an interesting phenomenon which we explore using the charts below. In Figure 35 we can see the absorption ratio of broad markets from 2006 onwards. The absorption ratio is a way to measure implied systemic risk and is one metric which can help demonstrate the interconnectedness of global financial markets. The higher the absorption ratio the greater the level of systemic risk inherent in markets is perceived to be. Bizarrely, despite the vast unknowns there has actually been a marked reduction in the perception of systemic risk. The green line represents the rolling 60-day absorption ratio, whereas the blue line shows the 12-month moving average.

While a simplistic interpretation might suggest that all is well in the world and that risks are well understood, controlled, managed and priced in, that could be drawing false comfort. A more likely explanation is that in the absence of any meaningful information the markets have simply chosen to ignore some of the potential long-term consequences.

Figure 35: Measure of systemic market risk



Sources: Aviva Investors, Bloomberg, Macrobond, as at 1 December 2017

Figure 36: Estimated market impacts

	Nationalist agenda	Low growth and inflation	China Slowdown	Fed Tightening	Debt Deleveraging	European Convergence
Equities (%age)						
MSCI World	-15%	-6%	-9%	-9%	-18%	12%
MSCI EM	-18%	-10%	-15%	-2%	-30%	29%
S&P 500	-13%	-10%	-7%	-8%	-10%	7%
Euro Stoxx 50	-27%	-11%	-12%	-2%	-26%	23%
Rates (bps)						
US 5 Year	-7	-67	-45	75	-42	34
US 10 Year	-34	-64	-58	60	-40	36
Credit (bps)						
CDX IG 5Y	53	18	7	13	89	-11
CDX HY 5Y	171	108	23	104	316	-74
FX (%age)						
EURUSD	-10%	10%	0%	-7%	-7%	15%
GBPUSD	-12%	2%	-5%	-7%	-16%	16%
USDJPY	-19%	-10%	-7%	4%	2%	-7%

Sources: MSCI, Aviva Investors as at 1 December 2017

STRESS TESTING AND THE RISKS TO HOUSE VIEW, A ROAD MAP OF DEALING WITH POTHOLES

The risks to the House View (pp. 12-13) set out where we think we are most likely to be wrong on the central view. These are the scenarios in which the world may turn out differently, and for which we think investors ought to be prepared.

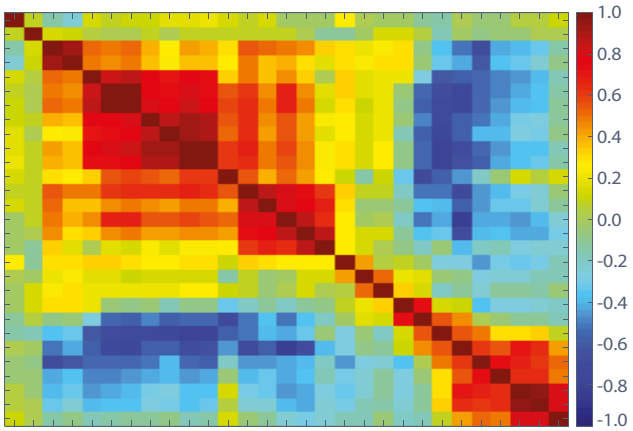
When considering investment mix or specific portfolios, investors are well served by not only thinking about a central scenario but also the events that can derail that vision of the world. When considering the impact of these alternative market outcomes understanding that they may not be independent of one another and indeed may overlap helps to establish a conceptual framework to work with. Furthermore it is helpful to consider the scale in which they may manifest. This flexible approach allows investors to understand the effects of various severities of risks to the central scenario and therefore the appropriateness and context of any risk reducing strategies that they may want to employ.

Not all risk events will trigger immediate corrective action as they may manifest themselves slowly at first and therefore not be easily identified as being underway. This slow motion unfolding of the risk is both an advantage and a challenge to investors. The longer the timeframe, the more likely portfolios can be restructured. Unfortunately, that gentle unfurling of market dynamics may also mean that investors do not recognise the effect until much damage has occurred to their portfolios.

Figure 36 provides some context around the potential outcomes we have identified as risks to the house view, as implied by moves on a correlated basis using five years of weekly data. These modelled impacts are, by the nature of all predictions, educated insights but by any scientific basis unreliable predictors. Instead we provide them as a possible first step in the process of considering plausible outcomes in some unknown future.

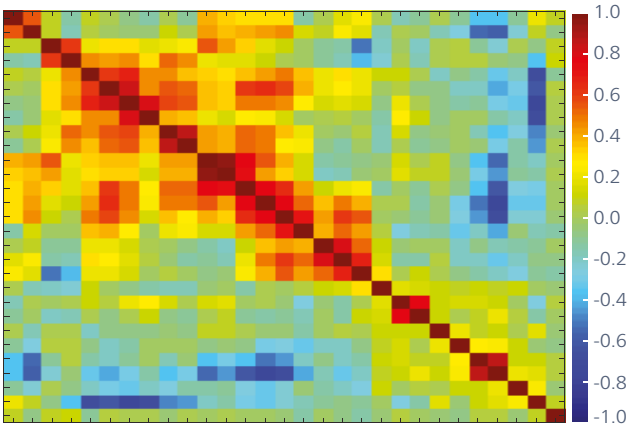
One significant insight gleaned from these implied estimates is that, given the current environment, small ripples in any market can cause potentially equally sized waves in other asset classes. This is of course further circumstantial evidence of suppressed volatility and synchronised market forces at play but it is also a sign that fragility occurring originating outside investors' immediate vision may have significant consequences. Therefore a stronger understanding of the time lines involved in the scenario unfolding allows investors to consider the urgency of corrective action. If and when periods of fragility do arise, it is important that investors understand the impact that this may have on asset correlations. This is illustrated in Figure 37 and 38 which show the correlation of currencies, equity, and commodity and bond markets to each other. As we can see, in the immediate aftermath of the Brexit vote assets correlations became materially more polarised than they are now. This of course makes the search for true diversification more important as it is this which helps portfolios perform in stressed and normal market conditions.

Figure 37: Correlation heatmap (June 2016)



Sources: Bloomberg, Aviva Investors, as at 31 March 2017

Figure 38: Correlation heatmap (November 2017)



Sources: Bloomberg, Aviva Investors, as at 1 December 2017

ECONOMIC OUTLOOK

UNITED STATES : GOING FROM STRENGTH TO STRENGTH

– 2018 expected to see robust growth and a tighter labour market

– Wage growth to pick up more convincingly, with inflation to head back to 2 per cent

– Fed to deliver 2-3 rate hikes in 2018

SUMMARY

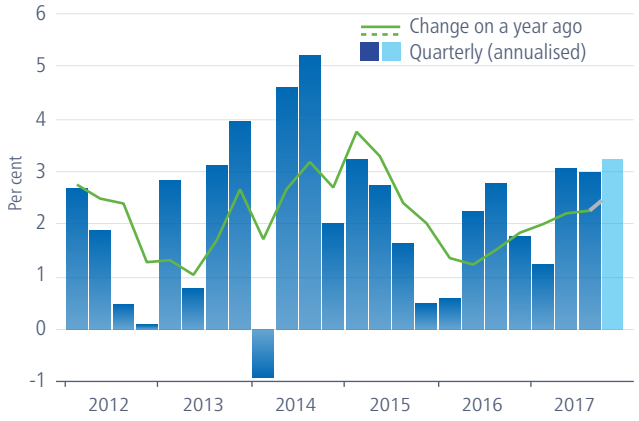
Above-trend growth in 2017 expected to continue in 2018

The US economy picked up pace over the course of 2017 (Figure 39), likely ending the year with three consecutive quarters of around 3 per cent annualised growth, the best run since the global financial crisis (GFC). Growth was supported by continued loose financial conditions, strong consumer and business sentiment, a recovery in the energy sector and improving global demand. Growth of around 3 per cent is well in excess of potential – estimated to be around 1¾-2 per cent – and has therefore continued to drive employment growth and push the unemployment rate down from 4.7 per cent at the start of the year to 4.1 per cent in October. That is lower than seen at any time in the lead-up to the GFC, with only a brief period in 2000 lower in the last 40 years. Broader measures of labour market slack, such as the Federal Reserve's weighted non-employment measure, are now also below their pre-crisis trough. Looking ahead, we expect sequential growth rates to moderate a slightly, but given the strong finish to 2017, we expect growth overall to be a little higher next year (Figure 40). The mix of growth should be a little more tilted towards investment. With growth expected to be above trend again in 2018, the unemployment rate is likely to fall to towards 3½ per cent.

Inflation is expected to move back towards 2 per cent in 2018

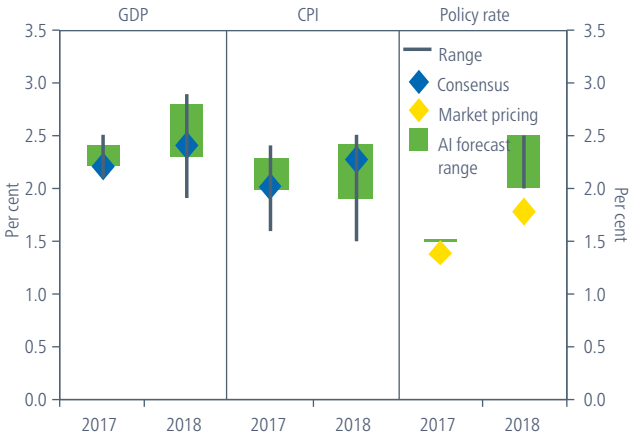
While there is little slack left in the labour market, nominal wage growth has risen only modestly in 2017. That may reflect both weak productivity growth and the very low rate of inflation in 2015/16. More recently productivity growth has improved, and alongside the higher rate of inflation and tighter labour market, should result in a pickup in nominal wage growth over 2018. The period of softer inflation earlier in 2017 seems to have largely passed, with the annualised rate of increase in recent months moving back up to around 2 per cent. Indeed there appear to be some nascent signs of a further modest pickup in inflation over the coming months, as stronger import prices feed through to goods price inflation. We expect the annual core CPI inflation rate to move back above 2 per cent by mid-2018 with core personal consumption expenditure (PCE) inflation also close to 2 per cent.

Figure 39: Robust GDP growth
Above-potential growth expected in Q4



Sources: Aviva investors, Macrobond, as at 1 December 2017

Figure 40: US economic projections



Sources: Aviva investors, Bloomberg, as at 1 December 2017

The gradual pace of Fed tightening in 2017 reflected the continued improvement in the economy and the need to withdraw the level of accommodation in place to ensure full employment and price stability was achieved in a sustainable manner. Looking ahead, we expect the Fed to raise rates two or three times in 2018, broadly in line with their expectations, with the risks tilted to more rather than fewer increases. While we expect inflation to move steadily back to target in 2018, we also expect that financial stability concerns will increasingly feature in the Fed's communication, particularly if broader financial conditions do not reflect the tightening in policy. The nomination of Jerome Powell as Chair should ensure policy continuity, but some uncertainty remains given the number of positions still to be filled on the Board of Governors.

Federal Reserve should raise rates two or three times in 2018 in order to keep the economy on track

Robust growth outlook, with inflation set to rise back to target

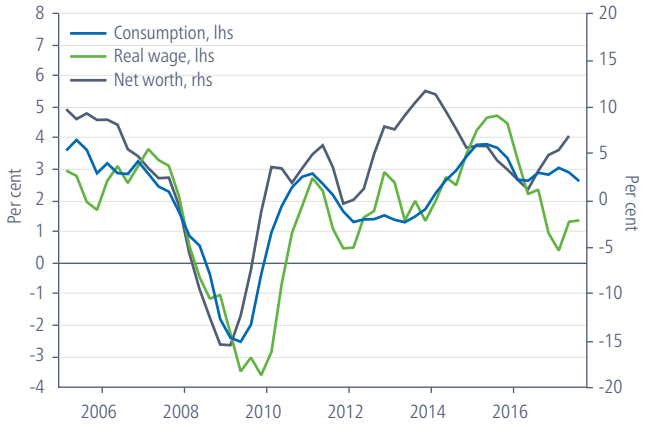
Household consumption continued to be the key contributor to GDP growth in 2017, although growth did slow a little compared to 2016. Real wage growth slowed in 2016, and remained subdued through 2017, acting as a headwind to consumption (Figure 41). However, robust gains in household wealth – boosted by strong returns in equities and steadily rising house prices – helped to provide some tailwind. As a result, the household saving rate remained low, at around 3-4 per cent, following the sharp decline in 2016. Looking ahead, we expect employment growth to ease a little, but for wage growth to pick up as the labour market tightens. The latter should outweigh the former, and with headline inflation expected to rise only modestly, real income growth should pick up over the course of 2018. That should support consumption growth, even allowing for a modest increase in the saving rate. In aggregate, household balance sheets are strong, with the gains in income and wealth outstripping the accumulation of debt. Indeed the ratio of household debt to income has been stable at around 107 per cent for the past two years, well below the pre-crisis peak of around 140 per cent.

Household consumption should be boosted by income and wealth gains in 2018

Following a difficult 2016, corporate profitability recovered in 2017, with stronger sales growth and stable margins, which according to Bloomberg, are expected to push earnings growth up to around 10 per cent. That would be the best annual earnings result since 2010. Alongside improved earnings, there was also a notable pick-up in investment spending over the course of 2017. Spending on equipment rose sharply, in part, driven by the recovery in the energy sector (which itself followed the rise in oil prices). Overall, business investment is expected to have grown by a similar rate in 2017 to that seen in 2014. The prospects for investment in 2018 are positive. Surveys of business sentiment rose sharply after the Presidential election in November 2016 and most remain well above their long-run average (Figure 42). Part of that likely reflects a general increase in optimism regarding the lessening in regulation and improved ease of doing business. It may also reflect hope of a lowering in corporate tax rates. At the time of writing, the US Congress

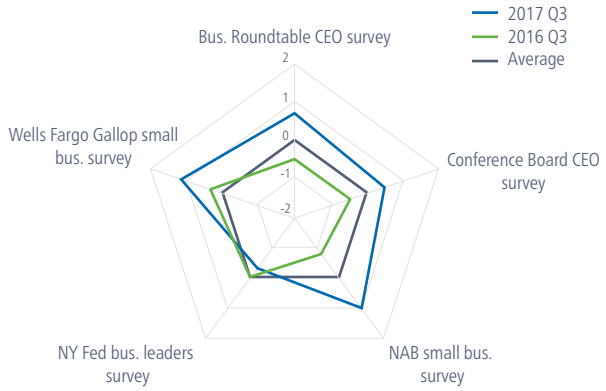
Stronger expected earnings growth and potential tax reform should boost investment in 2018

Figure 41: Household consumption, real wages and wealth (per cent change on a year ago)
Household fundamentals remain strong



Sources: Aviva investors, Macrobond, as at 1 December 2017

Figure 42: Business sentiment surveys
Sentiment remains buoyant



Sources: Aviva investors, Macrobond, as at 1 December 2017

was debating a bill that considered a number of changes to the corporate tax regime, including lowering the marginal rate, reducing interest deductibility and moving to a territorial system (where offshore profits would not be subject to tax by the US, even once repatriated). Should the tax package be signed into law, we expect it would give a further fillip to the corporate sector.

Wage growth should pick up in 2018 as the labour market tightens and productivity improves

Despite a further tightening in the labour market over 2017, to arguably the tightest it has been since the early 2000s, wage growth has only picked up modestly this year. Indeed, some indicators such as the Bureau of Labour Statistics average hourly wage measure, are likely to end the year with a smaller rate of increase than at the start of the year. Nominal wage growth is a result of the wage bargaining process, advancement and discretionary payments. The wage bargain is usually related to the tightness of the labour market and past rates of inflation. While there has been a further tightening, past low rates of inflation may still be restraining employees' expectations. Advancement and other discretionary payments tend to reflect changes in productivity growth, which has been weak in recent years. Given these developments, while wage growth has been weak, unit labour cost growth has been more robust, and largely consistent with inflation around 2 per cent. More recently we have seen inflation and productivity pick up, pushing down on unit labour cost growth. Looking ahead, we expect those factors to push wage growth higher in 2018, with unit labour cost growth rising at the same time.

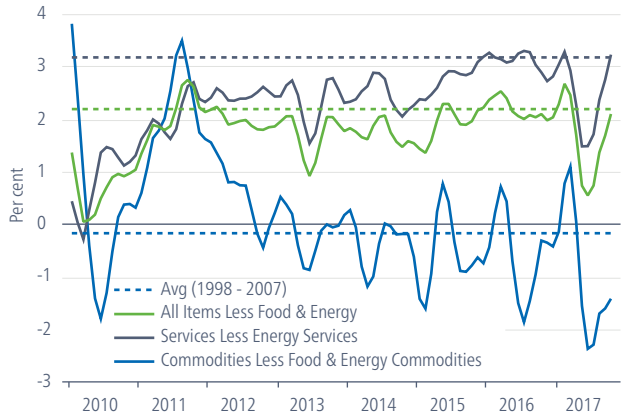
Core inflation should be back at 2 per cent by mid-2018

Inflation fell early in 2017, largely due to factors unrelated to broader economic conditions. For example, one-off reductions in the prices of mobile data services reduced inflation by around 0.2pp. Those one-off moves should prove transitory, and therefore should see the annual inflation rate pick up in early 2018 as those effects drop out. The evidence in recent months is supportive of that view, with the annualised rate of quarterly increase (which will no longer contain those effects) already back to the level seen in late 2016 (Figure 43). Core goods price inflation continues to be a headwind to overall inflation, although that headwind should lessen over the coming months as stronger imported consumer prices feed through to inflation. We expect core inflation to rise to around 2 per cent by mid-2018.

Economic conditions warrant two or three rate hikes in 2018

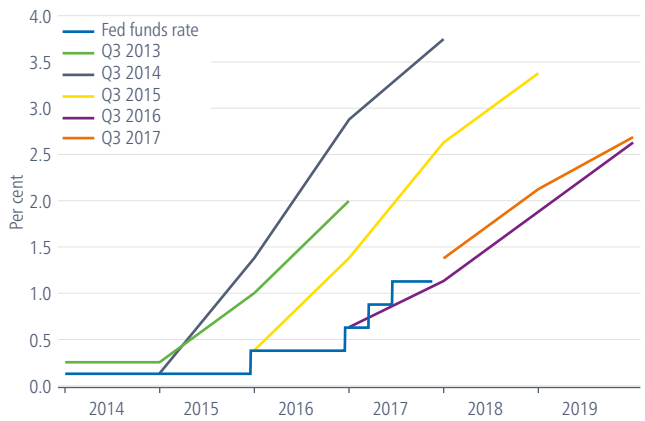
For the first time since the financial crisis, the Federal Reserve delivered on their central expectation of rate increases in 2017 (Figure 44). Despite that, the market continues to price fewer rate hikes over the coming years than the median Fed voter expects to deliver. We think that continued above-trend growth, tighter labour market, rising wage growth and inflation moving back to target will be sufficient for the Fed to continue on its current path of rate hikes. We expect that to result in two to three hikes in 2018 and a similar number in 2019. The unwind of the Fed's balance sheet will pick up pace in 2018, reaching the pre-announced monthly limit of $30 billion by Q4. We expect that will put some upward pressure on term premia and see some volatility return to the Treasury market.

Figure 43: Core inflation moving higher
Temporary factors weighing on inflation have largely unwound



Sources: Aviva investors, Macrobond, as at 1 December 2017

Figure 44: Fed rate hiking paths
Fed delivered what they expected to in 2017



Sources: Aviva investors, Macrobond, as at 1 December 2017

EUROZONE: CHALLENGING THE GLOOMY CONSENSUS

– The Eurozone is experiencing almost boom-like GDP growth conditions

– But inflation remains subdued, allowing the ECB to take their time

– Jobs are being generated and unemployment is falling rapidly

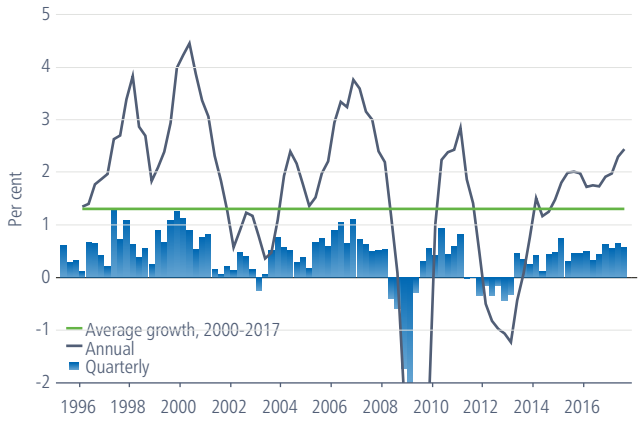
At the start of the year consensus forecasts for Eurozone GDP growth and CPI inflation were both 1.4 per cent. The inflation number (annual average) is likely to come in close to that and will finish the year at around that level. Growth, on the other hand, will beat that projection by some margin: 2017 should see the strongest GDP increase for a decade. Indeed annualised growth of around 2.5 per cent can rightly be described as boom-like conditions for the Eurozone where the generally accepted trend or potential pace of growth is perhaps a little above 1 per cent (Figure 45). Moreover, and just as important, growth has been broad-based with all 19 countries enjoying better fortunes: strong growth overall has been combined with the variability of those growth rates across the Eurozone's constituent nations at its lowest level ever. Leading indicators point to continued strong growth. Business and consumer sentiment is high (Figure 46), comparative political calm has been restored and money and credit growth are satisfactory.

Upside growth surprises, but inflation remains subdued

Ordinarily, such rapid GDP growth would be met with tighter monetary policy in order to prevent inflationary overheating. But these are still not ordinary times. After the twin shocks of the Global Financial Crisis and the Eurozone sovereign debt crunch, the associated GDP slump meant that all Eurozone nations were operating well below capacity. This in turn meant that policy settings could be comfortably set at ultra-easy levels in order to try and stimulate a recovery in demand. It took a while for such measures to gain traction as is frequently the case after financial crises. But the revival has been underway for four and a half years now and momentum is still good. The ECB has begun the journey back towards more normal policy settings – and took another step along this path recently – but while there is still a negative output gap, inflation pressures will be quiescent and the ECB believe they can afford to take their time. As financial markets move towards pricing in eventual tighter monetary conditions next year, the ECB will need to take care (to

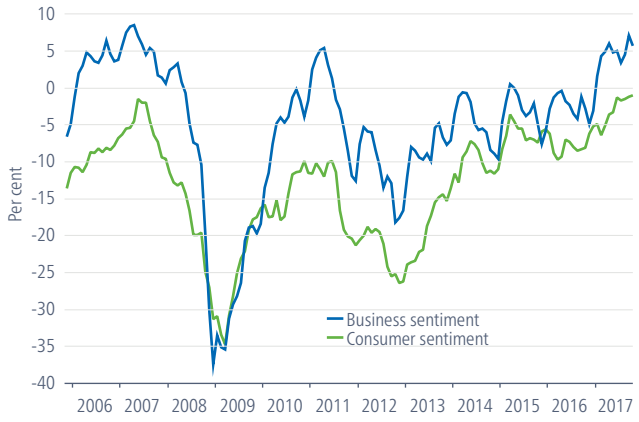
ECB takes baby steps towards policy normalisation

Figure 45: Eurozone expansion goes on
Year-on-year GDP growth



Source: Aviva Investors, Macrobond, as at 1 December 2017

Figure 46: No immediate slowdown likely
EC survey balances



Source: Aviva Investors, Macrobond, as at 1 December 2017

the extent that they can) to avert any bumpy transitions – they will be especially keen to avoid the risk of a European "taper tantrum" episode.

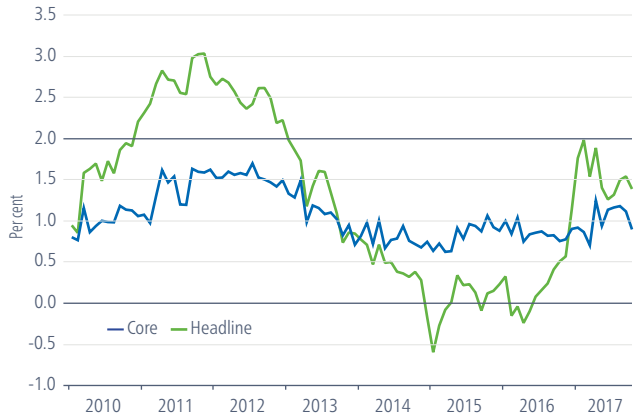
Low European inflation reflects ongoing presence of slack in the economy

Persistently low (and below-target) inflation has been a feature of the global economy during this recovery. But the Eurozone has experienced greater problems than many others. For a few years the threat of outright deflation was a very real one. Those fears have vanished now, but stubbornly low inflation is still very much with us and looks likely to stay for a while yet. Headline inflation did touch 2 per cent, briefly, but that was largely a result of a spike in oil and commodity prices at the end of 2016. Underlying inflation, as measured by "core" rates has been much more subdued (Figure 47). There were a few false dawns when it looked to be ticking higher, but the latest numbers have it dipping back below 1 per cent. Until these measures move more convincingly higher – and stay there – the ECB's policy stance is likely to remain relaxed. In one sense, low inflation in the Eurozone should not be any great surprise, reflecting as it does the shortfall between supply and demand that opened up during the two crises. This interpretation means that the ECB was right to keep policy loose and allow above-trend growth to continue – there was simply no urgency to tighten policy because of this gap. They have been absolutely right to "give growth a chance". But after four and a half years of consistent growth, this picture is now slowly changing. We do not know exactly where capacity limits are, especially in the light of the valuable labour market reforms that have been implemented in a number of countries across the Eurozone, but estimates suggest that, on current trends, the Eurozone will be back operating close to capacity by around this time next year (although there are always significant margins of error around such assessments). This implies that the ECB's anticipated timing of policy tightening can be defended as reasonable, even if the bias towards looser for longer is not without risks. Given the Eurozone's record on growth, inflation and policy changes, this stance probably makes good sense.

Eurozone natural rates of unemployment lower than the past

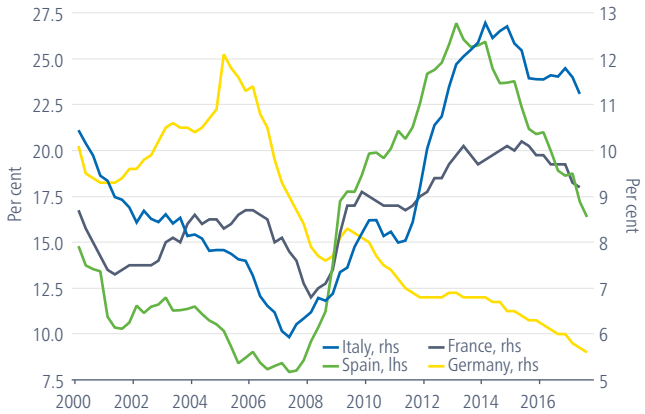
Nowhere has the better news within Europe been clearer than in labour markets. Unemployment rates (outside of Germany) may still be "high" by international standards, but they have been falling for almost four years now, a clear indication of above-trend growth and economic resilience (Figure 48). For the area overall, the rate is now 8.9 per cent. Estimates of the natural rate vary, but a figure of between 7.5 per cent and 8 per cent looks about right. Again on current trends, that could be reached by the end of 2018. Germany has reaped rewards for its structural reforms in earlier years in the current expansion, seeing only a small and temporary rise in unemployment during the crisis, before jobs growth swiftly resumed. Their unemployment rate of 5.6 per cent now compares favourably with others internationally and represents a benchmark for others in Europe to aspire to. It will

Figure 47: Inflation remains subdued
CPI inflation rates, y/y



Source: Aviva Investors, Macrobond, as at 1 December 2017

Figure 48: Unemployment rates are tumbling
Unemployment rates



Source: Aviva Investors, Macrobond, as at 1 December 2017

not happen quickly and there are some idiosyncrasies of the German labour market model that argue for a much lower "natural" rate.

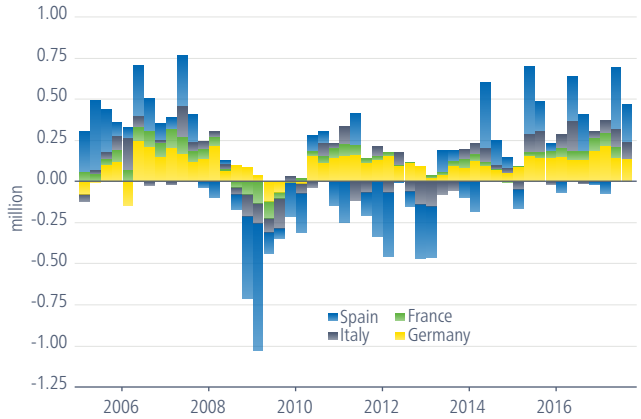
In the past, the Eurozone has often struggled to generate jobs. It has also frequently looked a relative failure compared with the more dynamic US economy. For example, during the initial stage of recovery following the Global Financial crisis (2010-2013 inclusive) the US generated 8 million new jobs. Over the same period the Eurozone employment total was unchanged. By contrast, since the start of 2014 the US aggregate has risen by an additional 10 million, but this time the Eurozone has almost kept pace with nearly 9 million net new jobs. Drilling a little deeper, Germany has seen a jobs rise of 1.9 million, reflecting the success of the German industrial machine. Spain has seen an increase of 2.1 million, as part of the vast jobs losses of 2009-2013 has been reversed (Figure 49). Increases in France and Italy have been positive, albeit slightly less convincing, but that may reflect both earlier job hoarding, at least on a relative basis, as well as the related impact of more recent labour market reforms.

Impressive net jobs generation in the last four years

Looking forward (Figure 50), short-term growth momentum is good, but a slight moderation in 2018 would arguably be welcome as demand closes in on supply buffers. The cyclical boost from global trade and the industrial cycle is likely to fade modestly over the next two years, while the stronger Euro will also have some impact. Domestic demand should continue to benefit from labour market improvements, while higher inflation next year – if it materialises – will crimp real incomes marginally. One slight cloud on the horizon is the potential fragility of a future German coalition government. Any potential dilution of German involvement in the Eurozone integration process (and Brexit negotiations) would be an unwelcome development at this stage.

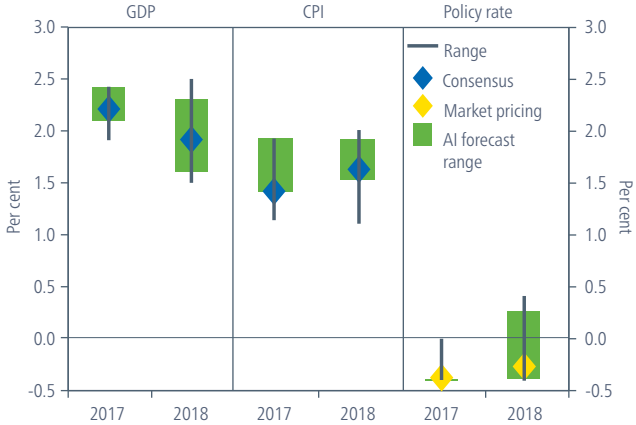
Modestly slower growth and higher inflation in prospect

Figure 49: 9mn new jobs in last four years
Quarterly change in employment



Source: Aviva Investors, Macrobond, as at 1 December 2017

Figure 50: Eurozone economic projections



Source: Aviva Investors, Bloomberg, as at 1 December 2017

UK - BUCKING THE GLOBAL TREND

– Demand sluggish but supply weaker still according to Bank of England

– Inflation close to peak – how fast will it fall in 2018?

– Home-grown downside risks could yet overshadow favourable global backdrop in 2018

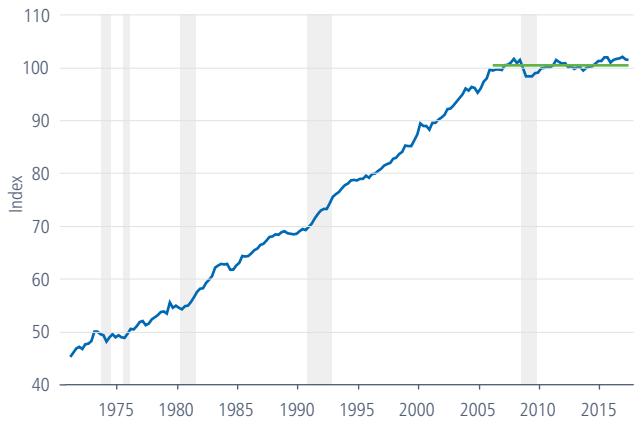
Demand growth sluggish but still outpacing supply increases

The Bank of England had stated (several times) over the summer that UK policy rates might have to go up more than markets had been anticipating. They duly delivered the first UK rate rise for more than a decade in November, reversing the "emergency" rate cut in the wake of the referendum last year. Since the financial crisis, on previous occasions when inflation spiked above the 2 per cent CPI target, the Bank had been prepared to "look through" the overshoot and keep rates on hold. Not this time. The change of approach was justified by the Bank through their much gloomier assessment of the UK's supply-side potential. Hence, although demand growth has slowed more or less as they had expected, it was still judged to be above the growth of supply, so slack in the economy was being used up. Markets now expect two more hikes by the end of 2019 and the Bank has abandoned its earlier warnings about complacency, indicating that they too believe that judgement to be reasonable. Although the Bank stressed that their supply-side re-assessment was linked to the decade-long disappointments of the UK's productivity record (Figure 51), they also stated explicitly that lower trend growth was being compounded by Brexit-related concerns and uncertainties. By adopting this standpoint, Governor Carney may be risking the wrath of Jacob Rees-Mogg and the Eurosceptic Tory right, but it looks perfectly sensible to us.

UK households rein in spending; jobs growth slowing

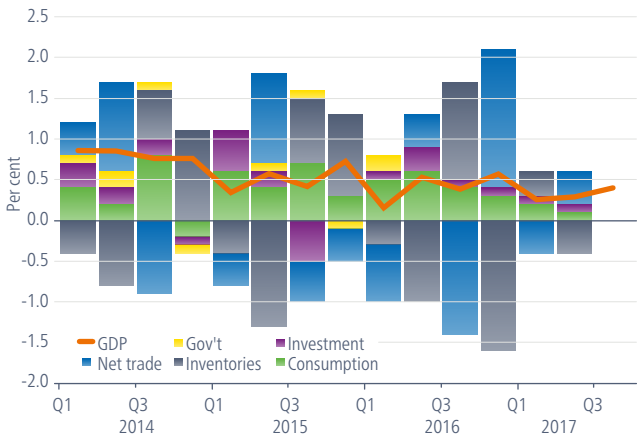
Official data shows that UK GDP growth rebounded somewhat in Q3 – to 0.4 per cent from 0.3 per cent in each of the previous two quarters. But growth overall is running at just 1.5 per cent (annual rate) at best and has now been slowing for almost three years. Even the relatively optimistic Bank of England assumes no meaningful pick up from here for the next three years. Before the referendum they were consistently projecting UK growth of 2.5 per cent a year or more. A more sanguine analysis today might reasonably conclude that downside risks continue to predominate. The composition of UK growth recently (Figure 52) shows a very clear and significant slowdown in consumer spending growth, no contribution

Figure 51: Decade-long supply-side weakness
UK productivity, output per hour worked



Source: Aviva Investors, Macrobond, as at 1 December 2017

Figure 52: Consumption still slowing
UK contribution to quarterly GDP growth, per cent



Source: Aviva Investors, Macrobond, as at 1 December 2017

from government and a modest positive addition from investment. The impact of net trade has been volatile, trendless and tiny in the last year (and zero in both the last two and the last three). Given the noticeable pick up in global trade alongside the fall in the pound since the summer of 2016, this last pattern is especially disappointing. Household spending trends have been understandable in the face of the significant income squeeze from higher inflation and subdued wage growth. Moreover, one surprising recent trend has been that employment growth has held up well, providing some support to household incomes. However, the latest labour market report was considerably weaker. If companies did, collectively, decide to reduce hiring in the future, consumption could easily remain fragile or weaken further. It is noteworthy that other indicators of consumers' willingness to spend – retail surveys, car sales, sentiment readings (even the health of housing markets) have all flashed some amber warnings recently (Figure 53).

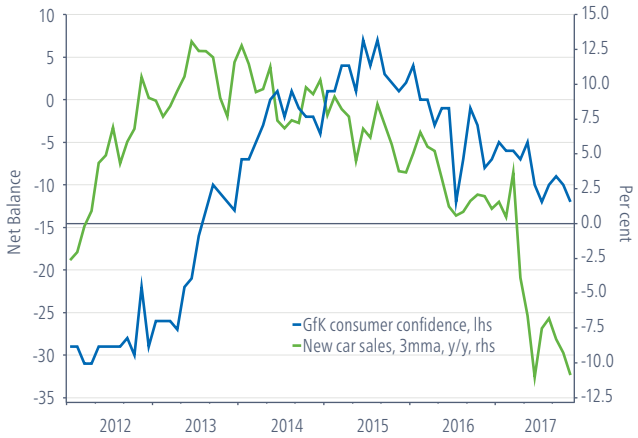
One of the comparatively better outcomes recently has been that business investment has not collapsed in the face of Brexit-related uncertainties. Granted it has not been that strong either, but this component of demand has seen some wild swings in the past driven by, amongst other things, the famous "animal spirits" of business people. As there is still so much doubt about the nature of the UK's future relationship with the EU (and others), it would have been no great surprise to see greater weakness as at least some businesses chose instead to put investment projects on hold until the outlook became clearer. In the past there have been several occasions when business investment fell by 5 per cent or 10 per cent, largely because of worries about the future. Of course this could yet happen, especially if Brexit negotiations go badly, but so far at least, this element of demand has held up reasonably well (Figure 54). It is possible that whatever the political backdrop, the closer proximity of capacity buffers has persuaded some businesses to increase investment spending. It is also true that corporate borrowing costs are still extremely low by past standards. Nevertheless, it would be naïve to assume that there are no downside risks to this most volatile part of GDP.

Business investment has held up so far, but is still vulnerable

The UK's prospects over the next few years (and well beyond) are still deeply coloured by Brexit and the deal that is struck (or not) with the EU. The spectre of a "cliff edge" departure from the EU in March 2019 remains a possibility despite the indisputable fact that it is in both parties' interests to reach a compromise. Our central view is that a deal will be reached, but it would be wrong to disregard the downside scenario. The main initial adverse macro-economic consequence of a "no deal" outcome would be the disruption to trade as we revert to WTO rules and

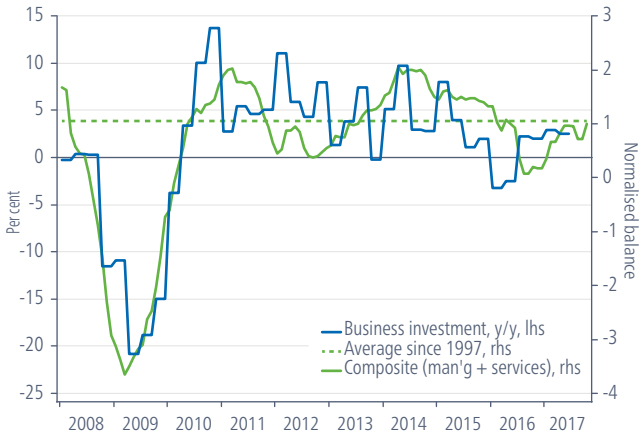
A Brexit deal should be found, but risks remain, especially regarding trade

Figure 53: Weak car sales and sliding sentiment
UK new car sales and consumer sentiment



Source: Aviva Investors, Macrobond, as at 1 December 2017

Figure 54: Business investment holding up
UK BoE investment intentions and business investment



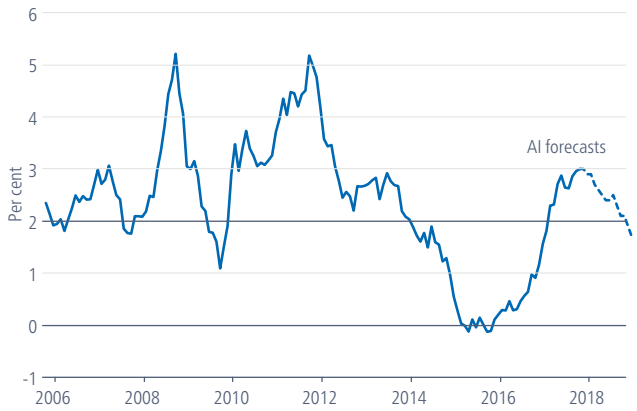
Source: Aviva Investors, Macrobond, as at 1 December 2017

regulations. Frankly it beggars belief that many pro-Brexit groups and individuals deny that there is any possibility of damaging disruptions. By contrast a number of respected forecasting groups have suggested that the level of UK GDP could easily be 1 per cent lower in both 2019 and 2020. As we are currently only growing at about a 1.5 per cent pace, that reduction would put the UK economy dangerously close to stall speed.

Inflation close to peak and should fall in 2018

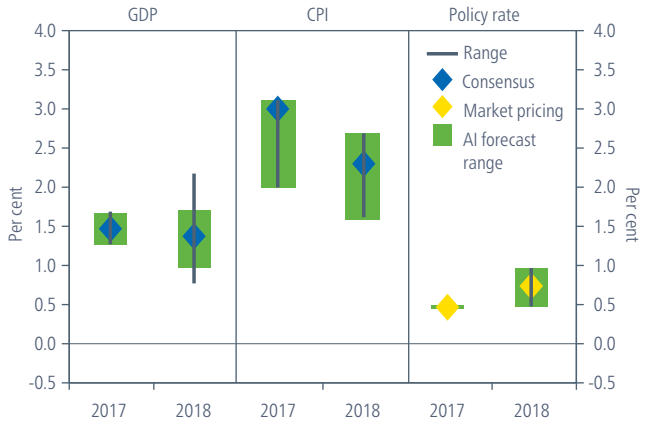
Meanwhile inflation is probably at or very close to a peak and 2018 should see steady declines (Figure 55). Inflation elsewhere has been quite subdued in 2017, so the UK's experience of above-target readings has been unique among the major nations and can be attributed largely to the steep fall in the exchange rate after the referendum. That impact is still being felt but it should gradually fade over the coming twelve months. The speed at which it does so will be one of the factors that will help determine whether or not the Bank of England raises policy rates again in 2018. One of the more important developments now is what happens to wage inflation. The low productivity story argues for weak wage growth and that is what we have seen recently – running at between 2 per cent and 2.5 per cent. But if the Bank is right about there being less slack in the economy, and that is the case in the labour market too, then wages may get bid up because of labour shortages. What happens here could be pivotal. It is not implausible that Britain sees a combination of falling consumer price inflation, muted growth and continued Brexit anxieties. That does not look like an environment in which rates need to go up quickly if at all. In such circumstances, it might be a little harsh to call the recent hike a policy mistake, but another increase would surely heighten that risk. Conversely, if growth holds up and inflation falls only slowly – as the Bank of England expects – then another hike in the spring would be likely. Overall, we continue to believe that downside risks to the UK outlook are significant. Growth is expected to remain relatively modest, inflation should fall meaningfully and policy rates will not need to move much higher at this stage (Figure 56).

Figure 55: How fast will inflation fall in 2018?
UK CPI inflation, y/y, per cent



Source: Aviva Investors, Macrobond, as at 1 December 2017

Figure 56: UK economic projections
Modest growth, lower inflation



Source: Aviva Investors, Bloomberg, as at 1 December 2017

JAPAN: ABE VICTORY REJUVENATES THE ABENOMICS TRADE

– The decisive election victory by Abe in the snap election ensures policy continuity for now

– Despite reasonable growth, inflation is too modest for any major shift of monetary policy

– Continued growth to cause only modest pick-up in inflation as wages remain weak

The recent snap general election victory has provided PM Shinzo Abe with a strong mandate for policy continuity. The size of the win makes it clear why – apart from the ruling coalition holding on to a two-thirds majority, the Liberal Democratic Party (LDP) itself secured nearly 60 per cent of the seats. The election result makes it likely that Abe will be re-elected in the LDP presidential election in September next year, which in turn implies that he will likely be PM until September 2021. The market response appears to endorse this prospect of policy continuity – Japanese equities have risen to fresh 20-year highs. And such is the strength of market sentiment that for the first time in several years local stocks haven't appeared to have needed the propulsion of a significantly weaker yen (Figure 57).

Abe's decisive re-election at the snap general election ensures policy continuity

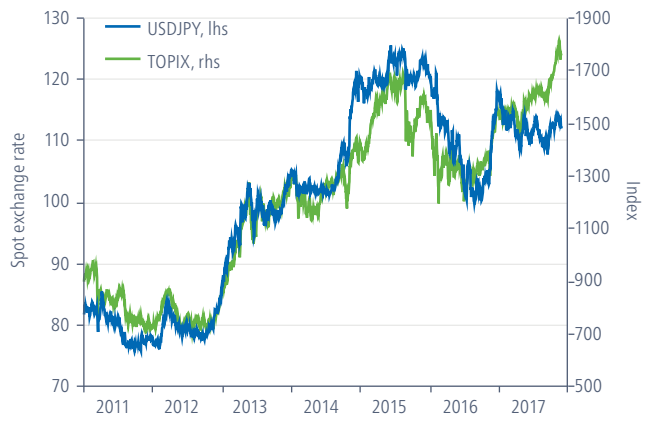
In terms of policy initiatives, a consumption tax hike from 8 per cent to 10 per cent is likely to come into effect in October 2019. However, PM Abe wants to divert part (JPY 2 trillion of the JPY 5 trillion) of the additional tax revenues from servicing debt to spending on human resource initiatives such as free early education. Future initiatives aimed at raising productivity and capital expenditure are likely to be an important focus of policy in the coming years.

VAT hike likely to come into effect in 2019

One key issue highlighted during the snap general election, partly as a result of the surge in Tokyo Mayor Yuriko Koike's popularity, was the huge corporate cash pile in Japan and especially the link with weak wage growth. Corporate profits have surged as a proportion of GDP in recent years (Figure 58) and corporate retained earnings have gone up by some 40 per cent over the last five years. A combination of rising corporate profits, lacklustre wage growth and weak capital expenditure against the backdrop of colossal stock of corporate cash is generating a political backlash. Koike's activism on this front is likely to encourage the re-elected Abe administration to adopt policy measures that will address these concerns. In fact,

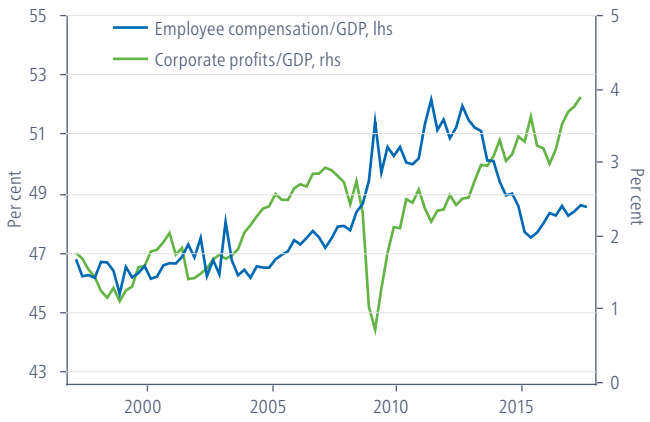
Opposition parties' campaign success on idle corporate cash pile likely to lead to some activism by the re-elected Abe administration

Figure 57: Equities powered by optimism



Sources: Aviva Investors, Macrobond, as at 1 December 2017

Figure 58: Corporate profits soaring



Sources: Aviva Investors, Macrobond, as at 1 December 2017

Abe has already talked of higher wage growth as being the "will of the people". It's quite unlikely that Japan will impose a tax on retained earnings. A more likely course of action is the government issuing guidelines for corporate cash holdings and putting pressure on companies to reduce their cash piles through more capital expenditure and particularly higher wages which have grown at a frustratingly slow pace in recent years.

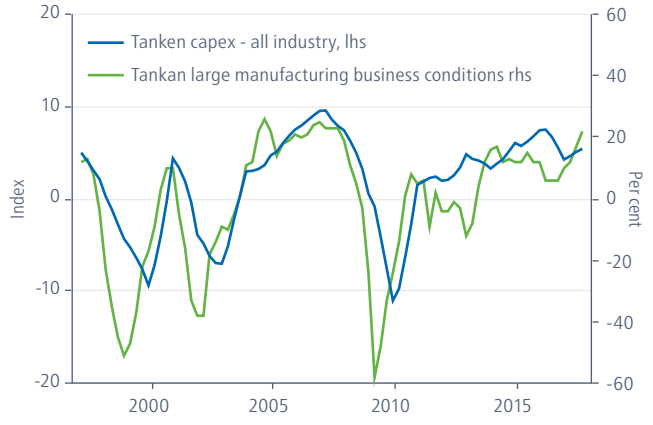
The detail of the Q3 GDP report is at odds with high-frequency indicators

In terms of the business cycle, after a strong Q2 report, the initial release of the Q3 report was disappointing. While Q2 GDP growth was powered by domestic consumption and investment, both recorded negative growth for Q3. The 1.4 per cent annualised growth seems to have been supported entirely by inventories and net exports. Here, two points are worth making (i) initial GDP prints have been quite unreliable in the past and are liable to sizeable revisions and (ii) the contraction in domestic demand is at odds with survey evidence that has suggested that the strong Q2 momentum likely continued into Q3. The Tankan surveys on business conditions and outlook surprised mostly to the upside during Q3 and the outlook for capital expenditure remains positive (Figure 59). PMIs have also come in strong in recent months. So, we would not be surprised to see significant upward revisions to the Q3 report. Even if the domestic demand weakness is confirmed by subsequent revised GDP prints, this is likely to be temporary, as employment growth remains strong and consumer sentiment upbeat.

Despite better growth and a tight labour market, inflation is nowhere near the BoJ's 2 per cent target

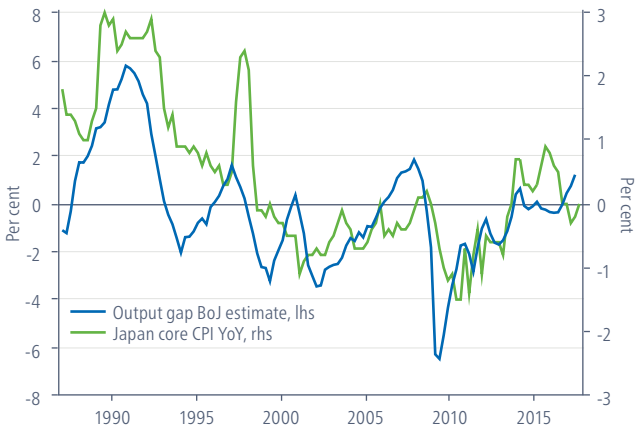
On monetary policy too, the decisive re-election of Abe ensures policy continuity for the time being. At the most recent monetary policy meeting, the BoJ lowered its inflation outlook for 2017 and 2018, whilst maintaining the timeline for achieving the 2 per cent target by 2019. More significantly, Governor Kuroda has decisively acted to quell speculation about an exit from the yield-curve control policy. Inflation remains further from the Bank of Japan's (BoJ) 2 per cent target than at any time during the last two years, even though economic activity has improved. Most estimates of Japanese trend growth put it below 1 per cent, so clearly the economy has been growing above potential this year. Both the Cabinet Office and the BoJ have estimated the output gap to be positive since Q4 2016. The unemployment rate has continued to fall during Q3 and is at the lowest level since 1994, while the job offer-to-applicant ratio, a more reliable measure of labour-market tightness, is at the highest level since 1974. And yet, core inflation remains exceptionally weak, which underscores how far the inflation-activity trade-off, the so-called Phillips curve, has worsened for Japan.

Figure 59: GDP growth unlikely to drop too sharply



Sources: Aviva Investors, Macrobond, as at 1 December 2017

Figure 60: Inflation to pick up modestly



Sources: Aviva Investors, Macrobond, as at 1 December 2017

The main issue with Japan's inflation is not growth but wages. Wage setting has been persistently very cautious given low inflation. And this has generated the negative spiral effect of low inflation expectations which surveys and market indicators suggest have not been lifted so far by aggressive policy easing. In theory, the pressure on wages should be upward, especially if growth is sustained next year, likely on the back of a pick-up in capital expenditure which in turn should be helped by the strong surge in corporate profitability (Figure 59). However, in practice, the follow-through of a tight labour market in the form of higher wages is likely to be exceptionally slow given structural shifts in labour-market dynamics, such as more part-time job creation as more retirees and women have entered the labour force.

Key issue for BoJ's target is not growth, it's wages which have remained stubbornly stagnant

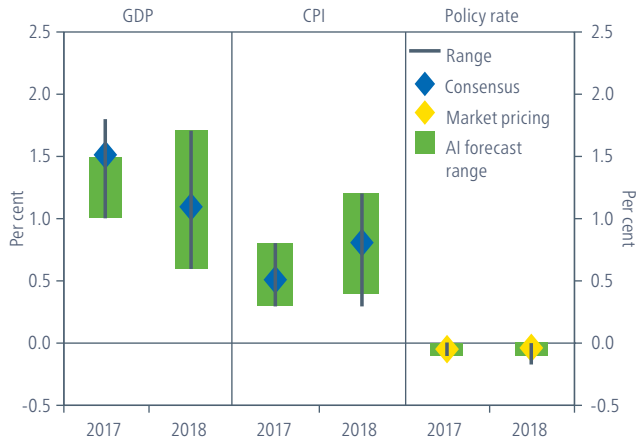
Despite reasonable above-trend growth, which should bring inflation gradually above the current 0 per cent rate (Figure 60), risks over 2018 still lie to the downside. Apart from the effect of the structural issues discussed above (weak wage growth, flat Phillips curve, etc.), another factor this time round is Japanese companies' likely caution in increasing prices and wages as they passed through higher import costs in 2014 and 2015 and therefore increased their prices quite substantially. Given the rise in corporate profits, they may well be tempted to absorb any fresh increases in imported goods' costs. This behaviour could soften the pass through of yen depreciation to core inflation. Secondly, we do not see growth accelerating next year as much as it has done this year (Figure 6259), that would argue for inflation pressures remaining modest.

Growth should generate modest inflation in 2018, but risks lie to the downside

Therefore, despite the relatively strong growth performance this year, inflation is likely to stay front and centre of the BoJ's policymaking. Unlike in many other economies with ultra-accommodative monetary policies, asset prices in Japan have not recorded lofty valuations in recent years (Figure 6160) and there is little risk of financial overheating judging by the financial conditions indices published in BoJ's October Financial System Report. Hence, financial stability concerns are unlikely to deter the BoJ in pursuing its inflation target through open-ended yield-curve control (YCC).

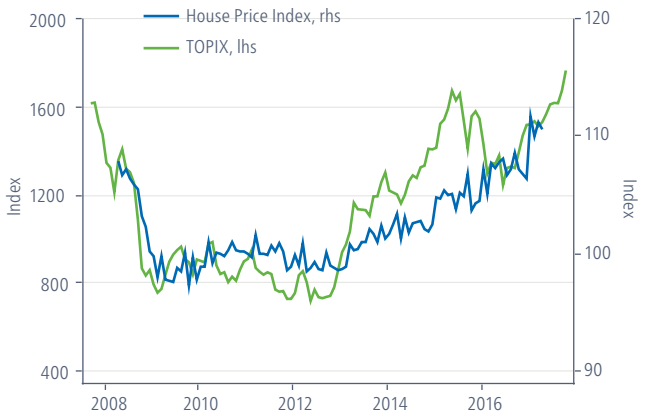
Financial overheating no deterrent to BoJ's policy easing continuing next year

Figure 61: Core inflation continues to be determined by the yen



Sources: Consensus Economics, Bloomberg, Aviva Investors as at 1 December 2017

Figure 62: Asset valuations not lofty



Sources: Aviva Investors, Macrobond, as at 1 December 2017

CHINA: POLICY CONTINUITY FOR NOW WITH FOCUS ON MANAGING GROWTH MODERATION

– Lack of major surprises at the Party Congress implies policy continuity for now

– Domestic and global reflation likely to blunt the impact of financial deleveraging

– Housing slowdown poses challenges though investment response likely to be contained

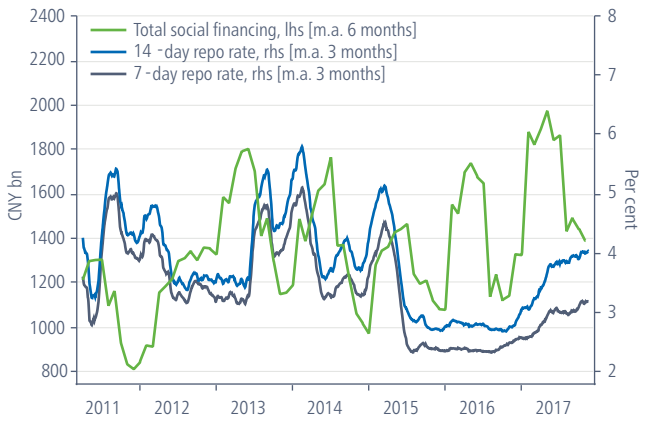
For the most part, the Party Congress has brought more continuity than change

The just concluded 19th Party Congress was as much notable for what it did not bring – any major shift of policy emphasis – as for what it did. What that means is that we are likely to see a degree of policy continuity. There will likely be a continued emphasis on greater regulation of shadow-banking entities and on encouraging broader deleveraging through measures such as tighter wholesale funding. Equally, policy will still be pro-active in adapting to changing economic dynamics, especially if economic activity slows too sharply. This is, for example, seen in how the pace of wholesale tightening through higher repo rates has moderated in recent months (Figure 63), after funding rates rose sharply late last year, causing, among other things, a sharp sell-off in the local bond market.

Despite deleveraging and a slight shift in policy priorities, growth should still be strong in 2018

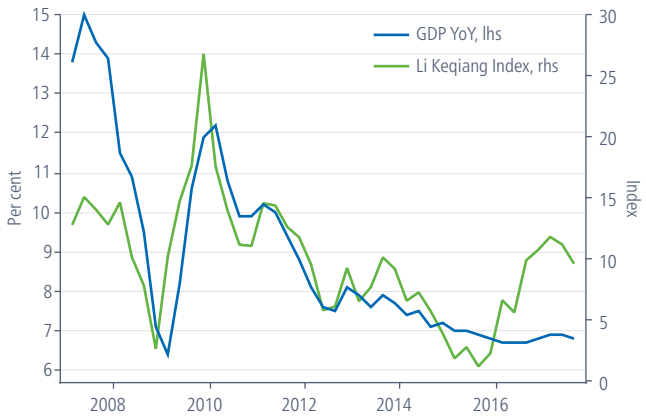
One key theme from the Party Congress is the likely shift away from quantitative growth targets to broader measures of national welfare including environmental protection, poverty reduction programmes and provision of social safety nets. While policymakers may be more flexible on the 6.5 per cent growth target, they are unlikely to veer very far from it. A sharp slowdown in growth is socially disruptive and highly unlikely. We believe growth will moderate in 2018 in line with what we have seen this year. Policymakers will alleviate the impact of tighter funding at a broad level through targeted relief for distressed institutions via measures such as Required Reserve Ratio (RRR) cuts. The smooth nature of official GDP figures is likely to persist in relation to more responsive indicators such as the Li Keqiang index that uses more readily available statistics like loans, electricity consumption and rail freight activity (Figure 64). Even so, we see headline GDP growth in the 6 per cent-6.5 per cent range over 2018 (Figure 65), as the impact of deleveraging throughout 2017 begins to appear in official GDP data.

Figure 63: Wholesale tightening moderating



Sources: Aviva Investors, Macrobond, as at 1 December 2017

Figure 64: GDP growth unlikely to slow much



Sources: Aviva Investors, Macrobond, as at 1 December 2017

Cyclically, there are a few qualified positives for the Chinese economy, despite the impact of regulatory deleveraging. Firstly, while the growth in house prices has moderated sharply in recent months, up until now, the slowdown in price growth has not affected investment activity in the real estate sector (Figure 66). A key factor has been the fact that a significant chunk of sales in recent years has been on account of a reduction in unsold inventories that had grown significantly during the slowdown of 2014-15. Strong housing market activity, in turn, has supported domestic demand, given the sensitivity of the Chinese business cycle to developments in the real estate sector. We are conscious that the sharp slowdown in house price growth this year can turn into a headwind, especially if price declines become a drag on investment activity next year, with obvious implications for wider economic growth. Housing sales have weakened and this trend is likely to continue. Mortgage lending growth has declined recently and local authorities have been taking measures to slow down activity. So, a likely drop in sales is a clear headwind for growth. However, given that housing inventories are low, the growth in real estate starts and investment is unlikely to suffer as much as during previous housing-market slowdowns. But housing will, on balance, be more a source of headwind than an upside surprise over 2018.

Impact of housing slowdown on investment and construction likely to be moderate thanks to the nature of the housing inventory cycle

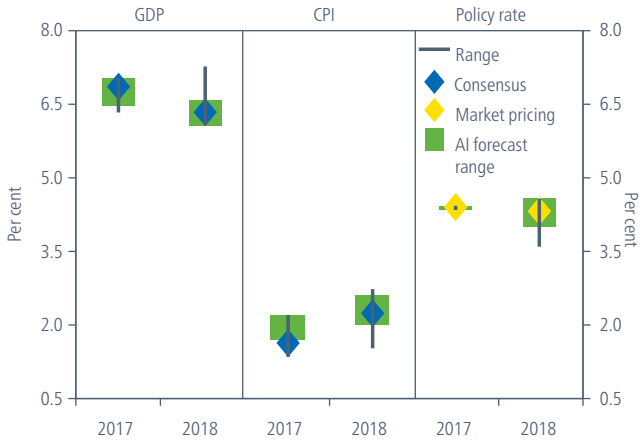
Secondly, policy measures aimed at reducing overcapacity coupled with strong investment activity in the real estate sector led to a steady rise in producer price inflation (PPI). Corporate profitability has improved as both PPI and commodity prices rose. This is not only good news for state-owned enterprises (SOEs), but also for banks' asset quality, given recent worries about the extent of non-performing loans. Moreover, this is positive for the local equity markets which should boost sentiment further.

Strong corporate profitability and better bank asset quality are further boosts to activity

Thirdly, both fiscal and monetary policies are unlikely to tighten significantly. Despite the gradual pick-up in wholesale funding rates in recent months, real interest rates are not especially high. Moreover, regulatory deleveraging is more targeted at interbank lending activity with the intention of curbing excesses in the shadow-banking sectors. Bank lending to non-financial firms has actually accelerated in recent months. In its Q3 Quarterly Report on Monetary Policy, the PBoC has stressed the need to maintain a dual-pillar monetary policy, with conventional policy targeting growth and inflation while macro-prudential policy addressing financial-stability risks. This framework means that PBoC may not need to tighten policy through conventional instruments in the wake of rate hikes by the Fed. It also means that the central bank can act to maintain liquidity for banks' on-balance sheet lending. Hence, the policy environment is consistent with an expectation of a modest growth slowdown.

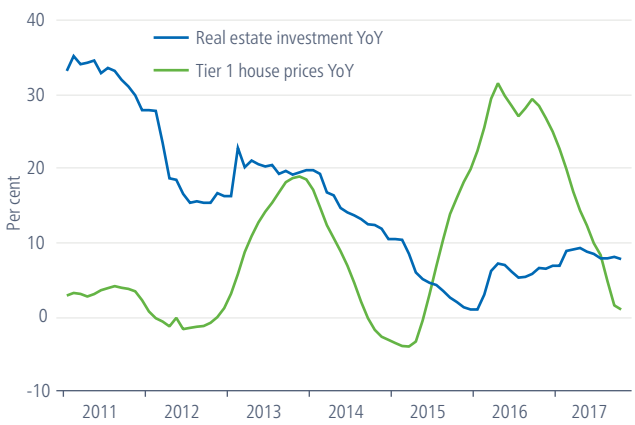
Policy is unlikely to be disruptive despite deleveraging

Figure 65: Growth likely to be in 6%-6.5% range in 2018



Sources: Aviva Investors, Macrobond, as at 1 December 2017

Figure 66: Real estate investment still strong



Sources: Aviva Investors, Macrobond, as at 1 December 2017

External environment is supportive with strong broad-based global growth

Finally, the global environment remains quite supportive with external demand strong. We expect some moderation in global growth, which means that the boost from the external environment may be smaller in 2018 than in 2017. The US dollar weakness in 2017 provided a boost to global manufacturing in general and emerging markets in particular, with many of whom China has important trading relationships. The renminbi, which has been a key index of financial stability in China, has been relatively stable despite the repricing in dollar rates since September. On the year, it's actually stronger against the dollar. Going forward, there could be limited risk for further repricing higher in USD rates, but the impact on renminbi is likely to be contained as this is unlikely to trigger capital outflows.

There is still much uncertainty around the longer-term in China regarding President Xi Jinping's approach to governance based on ever-greater centralisation. Of particular concern is the reform of SOEs. Given that SOEs account for more than a third of GDP and a fifth of total employment, SOE reforms such as overcapacity reduction, deleveraging and general efficiency enhancement are key to unlocking future growth. There has been some progress in areas such as capacity reduction, but the scale of the challenge remains huge. Eventually, SOEs can become a long-term drag on growth (Figure 67), underscoring the need for credible progress on reforms. In this context, the progress on "one belt one road" (OBOR) is of particular interest, as one of the objectives of the project is to use SOE overcapacity for the infrastructure projects in the OBOR region where China is likely to have strategic interests.

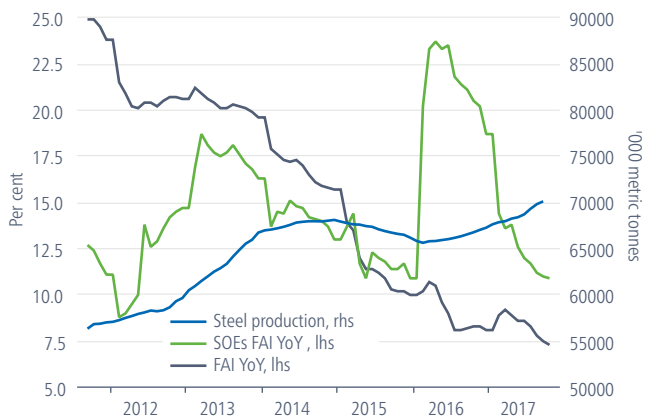
Deep, fundamental reforms still needed to maintain long-term growth

Also promising are new initiatives such as removal of restrictions on foreign ownership of Chinese financial institutions, which resulted from the latest meeting between Presidents Xi and Trump. China plans to raise ownership limits on security firms, fund managers, commercial banks and life insurance companies. This is by far the most significant instance of liberalising Chinese financial industry, which has been beset with long-running problems relating to asset quality and poor business models.

The tide has continued to turn on capital flows

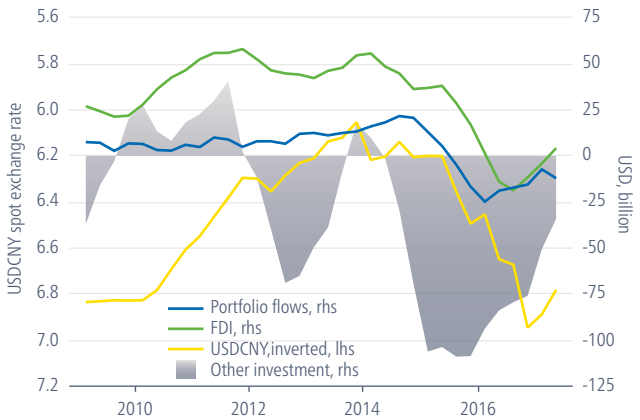
On the balance of payments front, the improvement in capital flows has continued for yet another quarter, as a combination of capital controls and a stable to stronger yuan has reduced the incentive for Chinese residents to hold US dollar denominated securities (Figure 68). While portfolio outflows have continued, they are unlikely to be financially destabilising. There have been equity outflows through the Connect mechanisms, which operate through exchanges on mainland China, so the proceeds of any share sales in the Hong Kong market return, by default, to the mainland.

Figure 67: Investment growth moderating



Sources: Aviva Investors, Macrobond, as at 1 December 2017

Figure 68: Capital flows recovering



Sources: Aviva Investors, Macrobond, as at 1 December 2017

AUSTRALIA: HOLDING PATTERN

– Domestic headwinds battle with global tailwinds

– Moderate growth and low inflation expected in 2018

– RBA on hold for now

SUMMARY

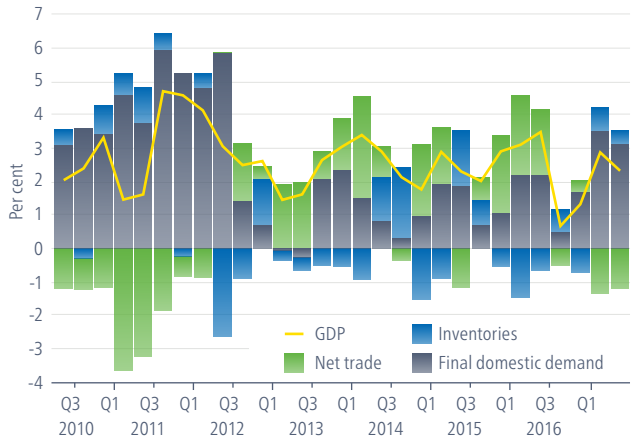
As a small, open economy with a vast natural endowment, Australia's economic fortunes have historically been tied to developments in the rest of the world. The rise of China in the 2000s boosted demand for commodities and saw prices increase rapidly. The mining investment boom that followed (alongside a protected banking system) ensured that Australia was one of the few developed economies to get through the global financial crisis without suffering a recession. The peak in the mining investment cycle was reached in 2013, after which Australia entered a difficult transition period, where mining investment fell from nearly 10 per cent of GDP to around 3 per cent currently. That adjustment is now largely complete and has not resulted in a recession or even a deep slowdown. While consumer demand remained robust and a weaker currency helped boosted net trade, the economy was able to grow, albeit somewhat more slowly (Figure 69). But the economic challenges left by the preceding boom will probably continue to be felt for many years to come. The manufacturing sector was hollowed out due to lack of competitiveness and households took on ever more debt as house prices rose rapidly. Moreover, faltering consumer confidence has increased concerns about job security and impacted wage bargaining, while increased competition has put pressure on business margins. These factors will act as a headwind to growth in 2018 and beyond.

Domestic headwinds such as heavy indebtedness and lack of competitiveness are expected to restrain growth

However, while households have come under increasing balance sheet and real income pressures, some service sectors have benefitted from weaker currency and increased foreign demand. In particular, education and tourism have grown strongly. Also, as the volume of mining exports is expected to rise significantly in the coming years as projects come to fruition. Finally, non-mining business investment has shown some signs of improvement recently, supported by low interest rates and stronger foreign demand. All these factors mean that growth is expected to be stronger in 2018 (Figure 70). However, wage growth is expected to remain subdued, with slack remaining in the labour market, and inflation is expected to rise only modestly, to the bottom of the Reserve Bank of Australia's (RBA) target range. As such we expect the holding pattern for the RBA to remain in place over much of the coming year, with the risks tilted to a first rate hike in eight years.

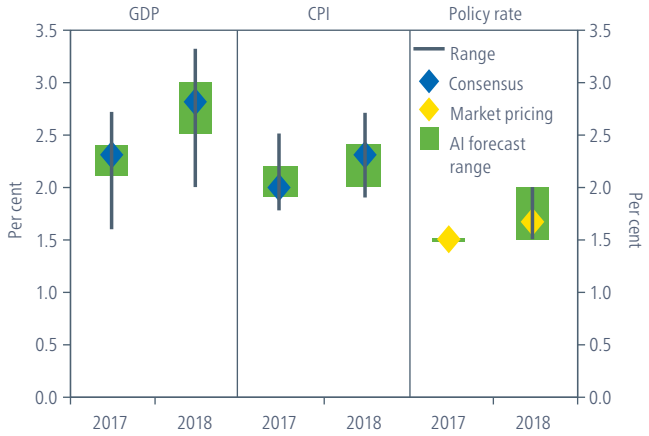
Foreign tailwinds, from stronger global demand, increased mining exports and a weaker Australian dollar will provide a boost

Figure 69: Contributions to GDP growth (6mth annualised)
Domestic demand rebounds as net trade shrinks



Sources: Aviva Investors, Macrobond, as at 1 December 2017

Figure 70: Australian economic projections



Sources: Aviva Investors, Bloomberg, as at 1 December 2017

MODERATE GROWTH MAINTAINED, WITH INFLATION TO REMAIN LOW

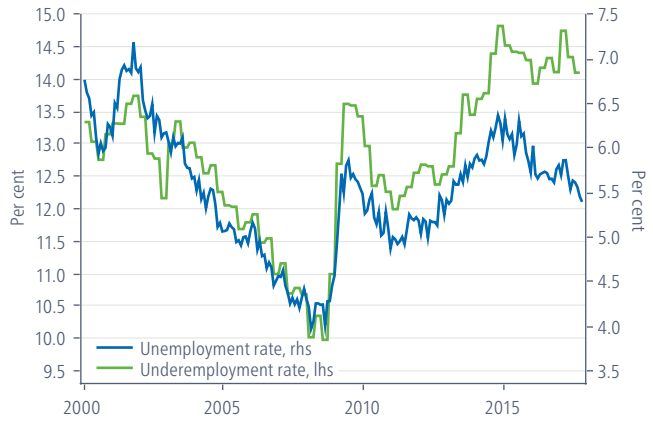
Wage growth and inflation are expected to remain modest in 2018

The rebound in commodity prices in 2016 and early 2017 helped to boost gross domestic income in Australia, at a time when GDP growth was actually slowing. That boost to national income helped to offset the weakness of wages and therefore support household consumption growth. In fact through the first half of 2017, real household disposable income was unchanged on a year ago, while consumption grew at around 2½ per cent. That meant that despite the boost to overall income from commodity prices, the household saving ratio fell to a nine-year low. That decline, alongside the continued rise in household indebtedness is likely to see household consumption growth ease in the second half of 2017. While GDP growth slowed in 2017, employment growth has accelerated, pushing the unemployment rate below 5½ per cent (Figure 71). The pickup in jobs growth has been seen across household services and construction, and has improved in those states that had been most impacted by the decline in mining investment. However, while employment growth has been strong, it has not resulted in much of a decline in the underemployment rate. That suggests there is more slack in the labour market than appears to be the case. That slack, alongside increased concerns around job insecurity and changes in the composition of employment have resulted in very weak wage growth. Annual growth in average earnings per hour rose by only 1 per cent through 2017. Weak wage growth and low productivity growth mean that cost pressures remain weak. That in turn puts little upward pressure on inflation, which remains below the RBA target range. Looking to 2018, the labour market is likely to tighten a little more, with some improvement in wage growth likely to follow, but not enough to see inflation move materially higher.

The housing market is slowing, which will be welcomed so long as it does not fall too fast in 2018

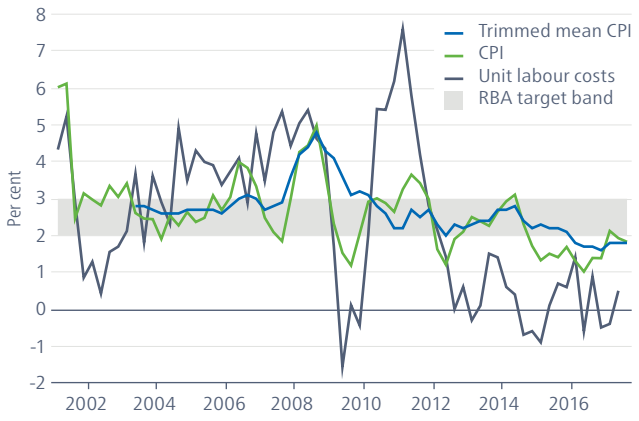
Meanwhile the housing market remains a key risk to the outlook. More recently there has been a cooling in house prices in Sydney, while with the exception of Melbourne, other major cities have also seen limited increases this year. Part of the slowing reflects the arrival of new supply onto the market, something that may see apartment prices decline more sharply in some cities. More generally the slowdown probably also reflects the impact of macroprudential measures to reduce the amount of lending to investors and those who take out interest-only loans. With household balance sheets stretched, the housing market risk represents a delicate balance for policy makers. While a rekindling of activity from low interest rates would not be welcomed, nor would a rapid and large decline in activity and prices. Absent an external trigger, it remains unlikely that the housing market will enter a downward spiral of its own accord.

Figure 71: Unemployment falling, but slack remains
Underemployment remains elevated, as people want to work more hours



Sources: Aviva Investors, Macrobond, as at 1 December 2017

Figure 72: Measures of CPI inflation and unit labour costs



Sources: Aviva Investors, Macrobond, as at 1 December 2017

CANADA: KEEPING PACE WITH POTENTIAL

- Excess capacity in the Canadian economy has been diminished more quickly than expected. The pace of growth is expected to moderate to around its trend rate
- Inflation pressures should be held back by recent rate hikes and a stronger currency. The BoC will remain cautious on any further tightening of monetary policy
- In particular the BoC will be watching excess capacity in the labour market (where gains in productivity have held back wage growth) and household responsiveness to rate hikes

Growth surprised to the upside in the first half of the year driven by strong consumer spending, a broad-based expansion in business investment and a surge in energy exports. The robust growth has reduced excess capacity more quickly than had been expected by economists and the Bank of Canada (BoC). The BoC now believes the output gap to be broadly closed, estimating it to be between -0.5 and 0.5 per cent.

Growth surprised to the upside in the first half of 2017

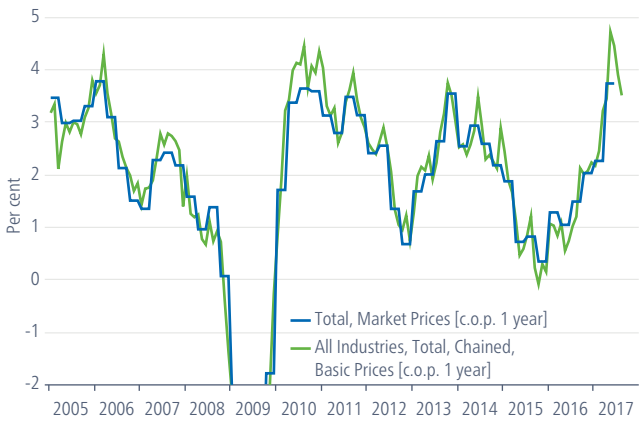
Looking forward the pace of growth is expected to moderate slightly from the currently very strong level. This view has been supported by weaker GDP numbers in August which saw a contraction in manufacturing detract from the pace of growth (Figure 73). That said consumption is expected to remain strong, supported by a high level of consumer confidence and so the economy will remain at, or close to full capacity.

The pace of growth is expected to moderate but the economy will remain at or close to full capacity

Despite strong growth inflation has remained below the 2 per cent target and undershot expectations (Figure 74). Earlier in the year headline inflation had been hampered by falling energy prices. However, more recently Hurricane Harvey's disruption of refining capacity boosted energy prices is estimated to have contributed 0.2 per cent to annual inflation in September. Additionally the drag from food inflation has dissipated. This combined with firming pressures in the labour market paints a constructive picture in Canada. However, rate hikes and currency strength will prevent any excessive acceleration in inflation.

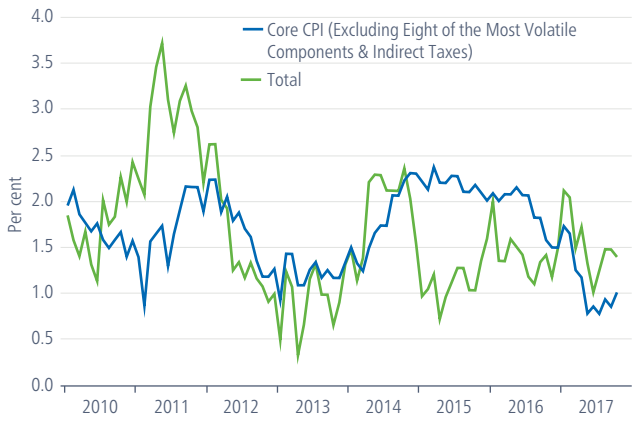
Inflation has remained below target but should now rise. Rate hikes and currency appreciation will temper any increase

Figure 73: Gross domestic product, constant prices, chained, CAD



Sources: Aviva Investors, Macrobond, as at 1 December 2017

Figure 74: Consumer price index, SA yoy



Sources: Aviva Investors, Macrobond, as at 1 December 2017

An improving outlook led to rate hikes but policy likely to be more cautious from here

The expectation of a gradual normalisation of inflation towards the target led the BoC to hike rates twice this year in July and September. However the latest Monetary Policy Report following the October meeting where the BoC maintained rates at 1 per cent highlighted the fact that the bank expects monetary policy to move more cautiously from here. In particular the BoC emphasised continued excess capacity, soft wage growth and household debt.

Excess capacity is diminishing however gains in productivity have held back wage growth

Compensation per hour worked remains below its historical average and unit labour cost has been falling, recently turning negative as labour productivity has outstripped wage growth (Figure 75). Labour market slack has held back wage growth and although the impacts of faster productivity growth are now thought to be dissipating, other factors such as displaced workers in the high paying oil and gas industry taking lower paid jobs explains some of the slower wage growth. Going forward, these impacts are anticipated to moderate however the BoC will remain cautious while waiting for confirmation of firming wage growth. The recent move higher in oil prices presents an upside risk to the inflation outlook in Canada. If oil prices are to move sustainably higher this will also feed though into inflation directly and indirectly via a boost to the oil and gas industry.

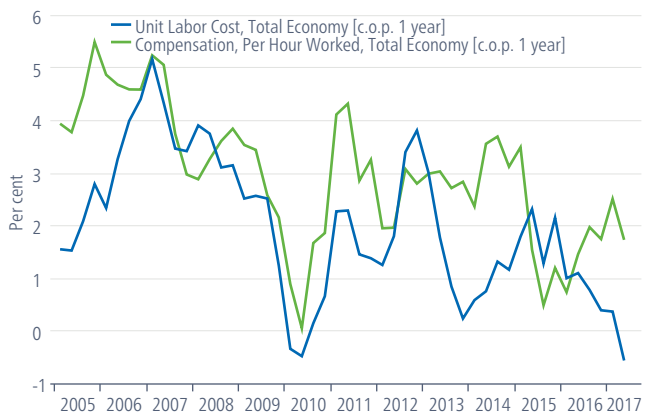
Household responsiveness to rate hikes is an element of uncertainty that may make the BoC more cautious in its approach in 2018

The level of household debt has also been a source of concern for the Canadian economy over the last few years. Macroprudential measures targeting the housing market have led to modest declines in housing starts and some deceleration in house prices. Nevertheless household debt to disposable income is very high at 170 per cent and presents a problem to the central bank as they hike rates. The high levels of household debt will likely make households more responsive to rate hikes than they have been in the past. Household responsiveness to rate hikes is an element of uncertainty that will make the BoC more cautious in its approach in 2018.

Renegotiation of the North American Free Trade Agreement (NAFTA) will remain a key political risk in 2018

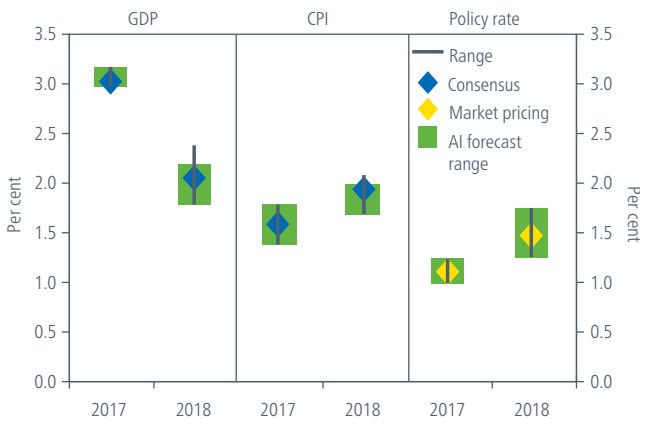
Renegotiation of the North American Free Trade Agreement (NAFTA) will remain a key political risk in 2018 and could provide some volatility in markets. While the economic outlook is improving the BoC will remain cautious until excess capacity in the labour market is diminished and wage growth firms. The strengthening Canadian dollar will limit any acceleration in inflation in the near term. That said higher oil prices provide potential for an upside surprise and a faster pace of rate hikes.

Figure 75: Productivity, costs & hours worked, SA, index



Sources: Aviva Investors, Macrobond, as at 1 December 2017

Figure 76: Canadian economic projections



Sources: Aviva Investors, Bloomberg, as at 1 December 2017

ASIA EX-JAPAN: SINGING TO A DIFFERENT TUNE

– Growth in 2018 is likely to remain firm thanks to the strong global backdrop

– Central banks in Korea and Malaysia are gearing up for a hike

– India and Indonesia are likely to disappoint on the growth front

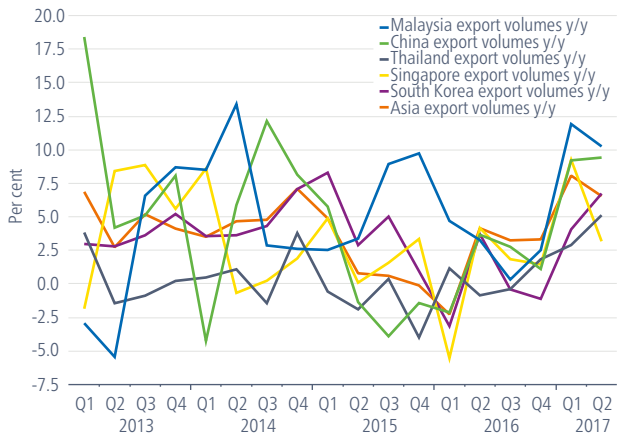
SUMMARY

The IMF forecasts global growth for 2018 to reach 3.7 per cent thanks to improvements in trade, investment and consumer confidence. Against this robust global backdrop, we expect positive growth momentum in the region to continue. For now, the key beneficiaries are the export demand driven economies of Singapore, Korea, Malaysia and Taiwan (Figure 77). Countries more dependent on domestic demand such as India and Indonesia are still growing below potential. However, they have implemented a number of structural reforms (e.g. subsidy reform, implementation of Goods and Services Tax (GST), demonetisation) that have hindered growth in the short term but should be beneficial in the medium term. While growth is on a firmer footing in most countries, the key challenge heading into 2018 for policymakers will be monetary policy. Inflation across the region remains low even though growth has improved. Central bankers in Malaysia, Korea, and Singapore have signalled a more hawkish stance. However, managing low inflation and higher growth will be a challenging balancing act in the region.

Export-driven economies well supported by the improved global backdrop

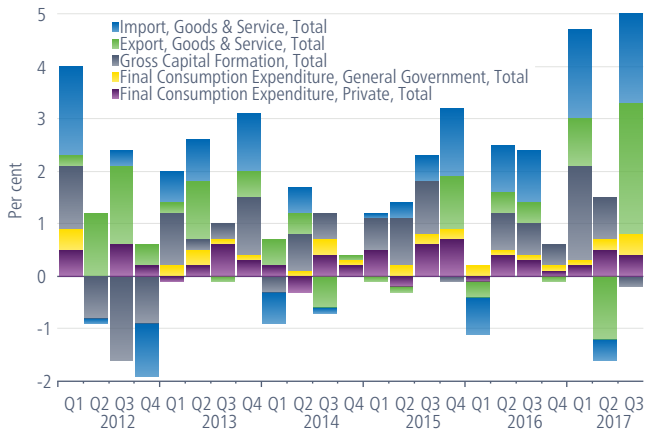
In Asia, the rising star this year has been Korea. GDP growth is likely to come in above 3 per cent this year for the first time since 2014. The technology sector (semiconductors in particular) has led export strength. While the external sector has been the key driver of growth (Figure 78), consumption and investment have also improved. A strong global backdrop should keep the domestic sector well supported headed into 2018. In addition, the government is looking to hike the minimum wage by 16 per cent to Korean Won (KRW) 7,530 in 2018 and to at least KRW 10,000 by 2020. However, the government will need to provide support to small businesses which they look ready to do. In a June survey by the Korea Federation of Small and Medium Enterprises (SMEs), about 90 per cent

Figure 77: Exports have been very supportive for Asia
Export volumes in Korea in particular are up significantly



Source: Aviva Investors, Macrobond, as at 1 December 2017

Figure 78: Exports have been the key driver of growth for Korea
Semiconductors account for 15% of exports



Source: Aviva Investors, Macrobond, as at 1 December 2017

of companies want raises kept below 5 per cent a year. If it is increased to KRW 10,000 over the next three years, 55 per cent said it might lead to their bankruptcy. Another positive heading into 2018 is improved relations with China. The two countries have agreed to end their standoff over the deployment of the Terminal High Altitude Area Defense (THAAD) system at the end of October. This row disrupted trade and business relations. It cost the Korean economy an estimated $6.5bn in lost revenue and shaved 0.4 percentage points off the Bank of Korea's 2017 GDP forecast.

Malaysia also beat expectations, expanding at the fastest pace in three years in Q3. Growth has been broad-based in 2017, but export and investment were the key drivers of growth. Heading into 2018, investment remains supported by a number of projects in the pipeline. Also growth will be supported by increased social spending ahead of the elections. However the economy faces some headwinds: higher inflation and high levels of household debt. As such, we expect consumption growth to slow next year.

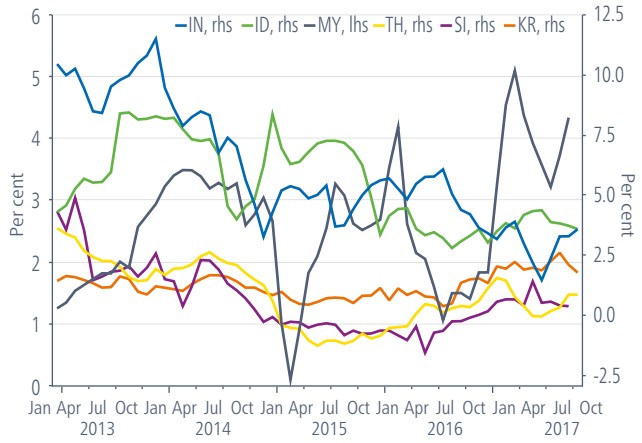
Central banks looking to tighten policy

With growth improving, central banks in Korea, Singapore, and Malaysia have shifted their stance. The Bank of Korea's (BoK) recent hawkishness has led the market to price three rate hikes over the next twelve months. However, this may be a bit overdone given that inflation remains low and continues to move lower. The more likely scenario is that the Bank of Korea hikes once and then pauses until it sees significant improvement in inflation. Governor Lee's term ends in April and so he may want to start the hiking cycle before he leaves. As for Singapore, the market is looking for a potential change from neutral back to a gradual appreciation bias at the April meeting. However, the Monetary Authority of Singapore (MAS)'s reaction function is very much data dependent. Inflation remains low and much of the work has already been done for them since the currency has appreciated nearly 6.5 per cent against the US dollar year-to-date. In Malaysia, the central bank took a more hawkish stance at the November meeting, prompting the market to price in a hike as soon as January. In Malaysia's case, inflation is creeping higher (Figure 79). However, The Central Bank of Malaysia (BNM) will have to hike gradually given high household debt levels.

Fear of inflation will keep RBI on hold

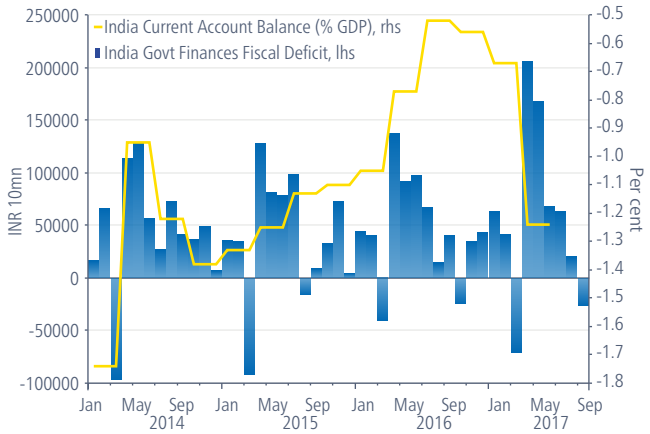
Meanwhile India and Indonesia are facing different challenges. In India, concerns over fiscal, current account, and growth slippages in 2017 have led investors to reassess India's growth story (Figure 80). Growth has suffered from the impact of demonetisation and the implementation of the GST. The fiscal deficit target of 3.2 per cent of GDP is likely to be breached; the question is by how much. Despite these recent setbacks, Moody's upgraded India to two notches above investment grade

Figure 79: Inflation remains benign across most of Asia
Inflation in Malaysia has been creeping higher



Source: Aviva Investors, Macrobond, as at 1 December 2017

Figure 80: Short-term concerns over India public finances
In the long term, India's finances should improve



Source: Aviva Investors, Macrobond, as at 1 December 2017

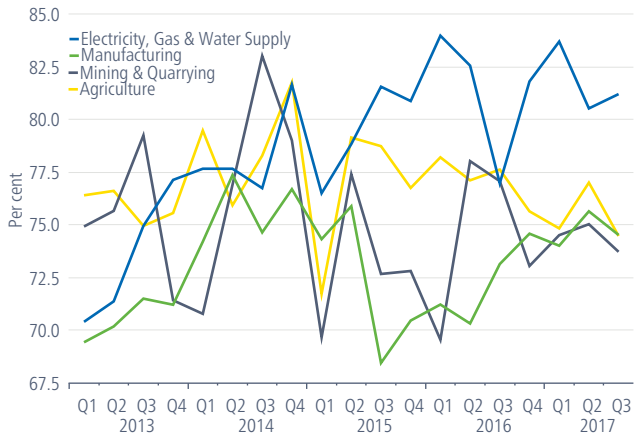
because of its progress on structural reforms. We too expect growth to pick up as the kinks of the GST are fine-tuned and the economy responds to the much-needed bank recapitalisation that was announced in Q4 2017. The recapitalisation of the state-owned banks should reignite investment. In addition, stalled investment projects are set to move ahead in Q4 and into 2018. These are likely to be pushed ahead of India's state legislative assembly elections in 2018. While growth may be weak, the market is currently pricing in a small hike over the next 12 months. Concerns over inflation are increasing. The drop in inflation over the last few years in India can be attributed to a combination of structural reforms on the supply side and excess spare capacity. The Reserve Bank of India (RBI) expressed its concern over the rise in inflation expectations at its October meeting and took on a more hawkish tone on inflation. Therefore, we expect the RBI to stand pat since inflation is likely to stay within its target of 4 per cent +/-2 per cent.

Growth in Indonesia continues to disappoint. The recent drivers of growth have been the manufacturing and retail trade sectors, and exports have improved. But the key engine of growth, domestic consumption, remains weak. The Bank of Indonesia (BI) has cut rates twice this year but that has failed to give a much needed jolt to the economy. Government spending on infrastructure has fallen short of its promises. However, Q3 growth showed some signs of a recovery. Investment and exports were strong and government spending added to growth after contracting in Q2. Social spending, energy subsidies and the disbursement of funds to villages should provide some support for consumption in 2018. However, the country is not out of the woods just yet and expect growth to remain below potential (Figure 81). In the meantime, with inflation subdued and the currency stable, the BI could cut again if growth weakens further.

The dynamics of the current account becomes important for Thailand and the Philippines

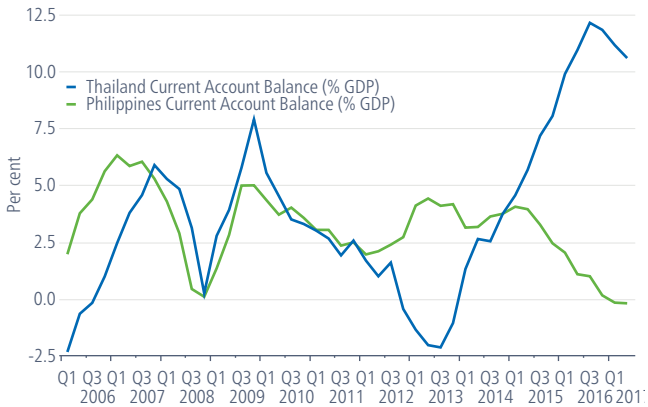
While there are distinct differences in performance in the region between export-oriented and domestic demand-driven economies, there is also another theme in the region: the notable decline in the current account surplus in the Philippines and the sharp current account accumulation in Thailand (Figure 82). For the Philippines, the current account deficit is mainly the result of fiscal and infrastructure spending. The Philippines needs to import most of the equipment for these projects. But the current account is unlikely to improve with more projects in the pipeline and now that oil prices have crept higher. While the current account balance has declined, the focus on much-needed infrastructure investment is a long-term positive. Meanwhile, the surge in Thailand's current account surplus is due to the opposite problem. Imports have declined dramatically thanks to weak domestic demand and the government has failed to deliver on its ambitious infrastructure project plans. The military pledged to hold elections in November 2018. Elections have been repeatedly postponed. We expect Thailand to continue to muddle through.

Figure 81: The Indonesian economy is operating below potential
Capacity utilisation in different industries is weak



Source: Aviva Investors, Macrobond, as at 1 December 2017

Figure 82: Current account in Thailand and the Philippines
Improved in Thailand, deteriorated in Philippines



Source: Aviva Investors, Macrobond, as at 1 December 2017

LATIN AMERICA: CAST YOUR BALLOT

– Cyclical rebound & broadening recovery

– Lower inflation, lower policy rates

– Key elections in Brazil, Colombia, & Mexico

The light at the end of tunnel could still be a train

Latin America enters 2018 with a far better outlook than in recent years. The macroeconomic adjustment to lower commodity prices is largely over, inflation has stabilized and interest rates have declined, growth is accelerating, and current accounts have improved markedly over the past year. While Latin America should also continue to benefit from a pick up in global growth in 2018, key risks remain. Additional fiscal consolidation is required to limit increases in debt ratios and could act as somewhat of a headwind to growth. Uncertainty over presidential elections in Mexico, Brazil, and Colombia are likely to restrain investment as well. Finally, the region faces external risks from China's deleveraging strategy and from potential trade restrictions from the US. Despite the risks, the 2018 outlook for Latin America is the best it has been in several years.

Political approval ratings lower than real interest rates

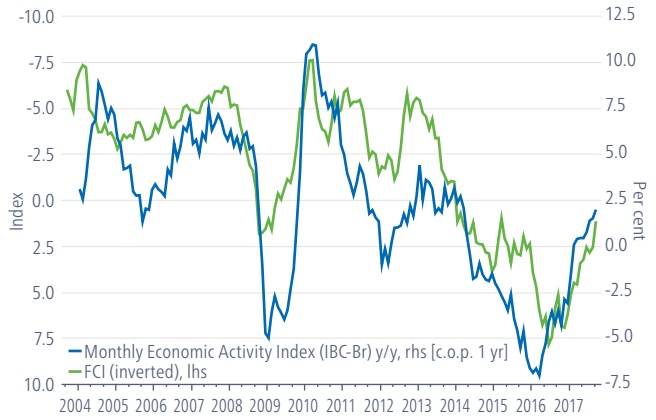
Accelerating growth in Brazil should be the main boost to the region in 2018. After sub-one per cent growth in 2017, GDP should advance at a 2.5 per cent to 3 per cent rate in 2018. Inflation near all-time low levels and an improving labour market will aid a rebound in household consumption. Additionally, after three consecutive years in negative territory increases in business sentiment combined with depleted inventory levels are pointing towards positive contributions from private investment. The central bank is likely to ease policy rates to 7 per cent or slightly lower providing an additional boost to the economy via easier financial conditions (Figure 83). Despite the positive backdrop, political risks loom large. The current administration has struggled to pass key pension reforms and the wide-open 2018 presidential election race creates additional uncertainty. So while the near-term outlook is positive, political outcomes will determine how sustainable the rebound is.

Clowns to the left of me, jokers to the right

Growth in Mexico continues to be resilient albeit disappointing. After a remarkable run, consumption is likely to slow due to declining real wage growth and credit growth decelerating from lofty levels (Figure 84). Additionally, uncertainty around NAFTA negotiations and the 2018 presidential elections are not supportive for investment. On the upside, a weak currency combined with global economic strength should support export growth in the high single digits. A rebound in US industrial activity also bodes well for Mexican manufacturing and should

Figure 83: Financial conditions should support growth in Brazil in 2018

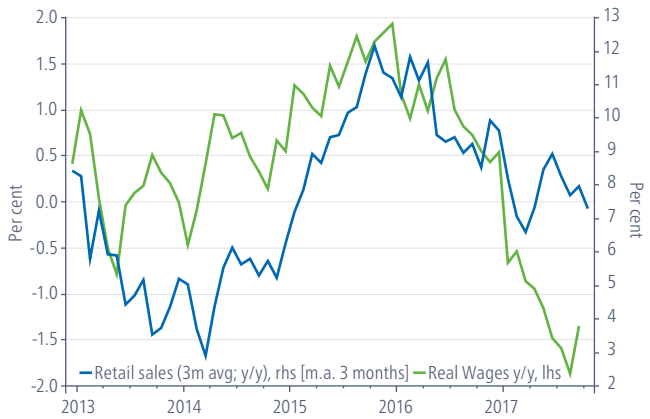
Financial conditions & economic activity



Sources: Aviva Investors, Macrobond, as at 1 December 2017

Figure 84: Mexico consumption to slow in coming months

Real wage growth & spending



Sources: Aviva Investors, Macrobond, as at 1 December 2017

keep growth in the 2 per cent range for the coming year. Inflation should decline towards 4 per cent by mid-year. However, the central bank will be slow to ease policy given aforementioned trade and election risks. In sum, the solid outlook and lack of macro imbalances should allow the economy to navigate 2018 event risks.

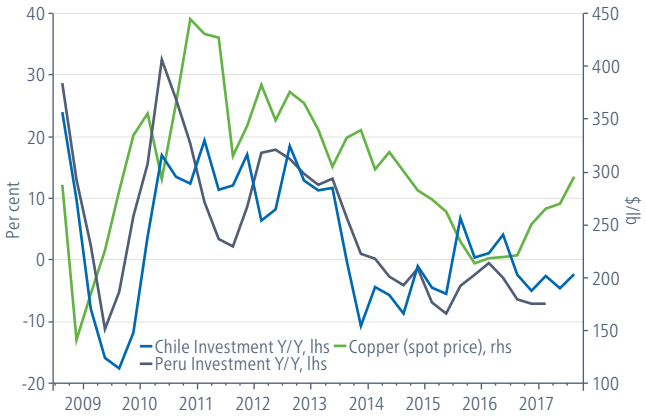
Dr. Copper to the rescue

After a disappointing 2017, growth should accelerate in the region's copper producers thanks largely to buoyant copper prices. Growth in Chile is projected to increase by a full percentage point towards 2.5 per cent while Peru is likely to lead the region with growth approaching 4 per cent year on year. Both economies benefit from improved confidence measures, a pickup in export growth, lower inflation, and easing financial conditions. The biggest improvement though should come from a resumption of investment after several years of declines (Figure 85). With solid economic fundamentals and elections wrapping up by the end of this year, the outlook for 2018 is positive for both Peru and Chile.

Oil's well that ends well

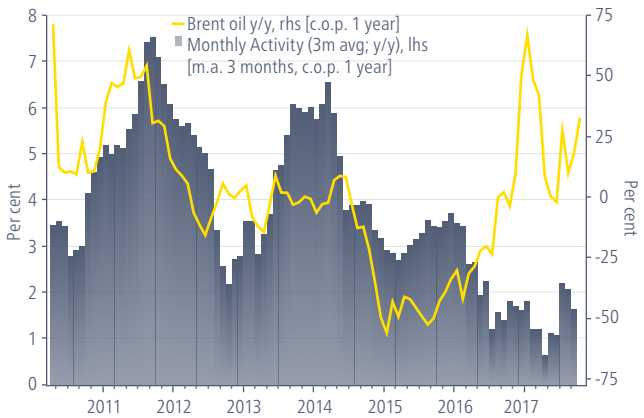
Colombia remains the most challenged economy in the region in 2018. Despite higher oil prices and an improved global environment, 2017 GDP is likely to finish below 2 per cent for the full year (Figure 86). Growth should improve slightly in 2018 aided by infrastructure spending and lower inflation along with easier central bank policy. However a weak growth outlook and declining oil production will keep pressure on the fiscal deficit which could result in another round of tax hikes. Additionally, polls for the 2018 presidential election continue to favour the leftist *Movimiento Progresistas* party. In addition to fiscal risks, Colombia's current account remains at almost 4 per cent of GDP, making it one of the most vulnerable among developing economies and suggesting the year ahead will be challenging.

Figure 85: Improving investment outlook in Chile & Peru
Copper & investment



Sources: Aviva Investors, Macrobond, as at 1 December 2017

Figure 86: Limited benefit from higher oil prices in Colombia
GDP & oil



Sources: Aviva Investors, Macrobond, as at 1 December 2017

CENTRAL EUROPE: IN FULL CYCLICAL UPSWING

– Central and Eastern European (CEE) economies delivered against already high expectations; some signs of overheating more visible now

– Fundamentals improving in Russia, but significantly higher growth long term depends on political willingness to reform the economy

– Missed opportunities in Turkey: once again at the centre of financial worries in emerging markets

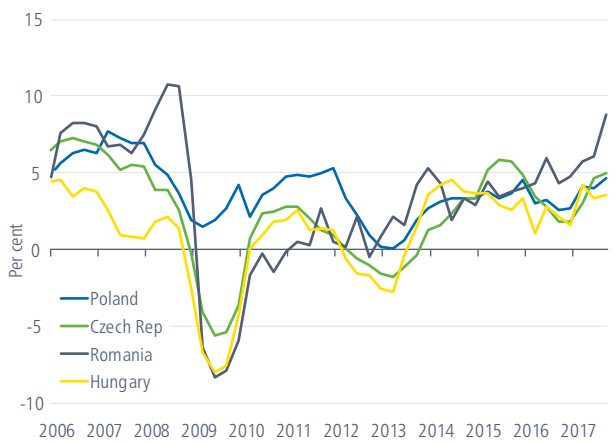
Growth in Central Europe surprises on the upside, again

Growth in Central Europe continues at a very brisk pace, supported by both external factors, namely a very healthy growth rate in developed Europe, and almost universally expansionary fiscal and monetary policy. By all measures, most of the countries in Central Europe have seen growth above potential rates (Figure 87) for some time now and output gaps have been closed. Unemployment rates have hit historical lows and wage growth has reached levels last seen before the financial crisis. Having said that, inflation is picking up only gradually and is still well below where it might have been expected to be given the strength of the cyclical upswing (Figure 88). Some of the regional central banks have just started to reduce the scale of monetary stimulus, namely the Czech and Romanian ones; others, in Poland, Croatia and Serbia, are still a long way from hiking rates. Hungary still looks likely to add to monetary stimulus. Irrespective of the specific actions the banks are taking or not taking, in general, policy makers in the region remain dovish and the risk of inflation overshooting in the medium term in CE countries is not trivial.

NBP is not in a hurry to hike rates…

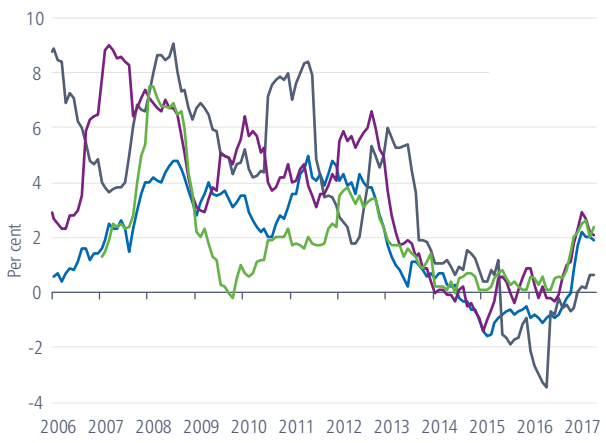
Poland is on track for above 4 per cent growth in 2017, well above market predictions at the start of the year. Prospects for next year have also improved considerably. The social spending spree that the Law and Justice Government embarked on is one factor, but fixed investment does seem to be picking up, on the back of resumed flow of structural funds from EU. Wages are also picking up but the growth rate, around 6.6 per cent for the last couple of months, remains well below the Central European average (Figure 89). The significant influx of labour, primarily from Ukraine, has eased somewhat the pressure in the labour market. Core inflation is likely to pick up from the current rate of just 0.8 per cent, but only

Figure 87: CEE4 Real GDP (% yoy)



Source: Bloomberg, as at 1 December 2017

Figure 88: CEE4 HICP inflation (% yoy)



Source: Eurostat as at 1 December 2017

gradually and the National Bank of Poland (NBP) should not be under pressure to start hiking rates before the end of 2018. Rifts between Poland and the European Commission over Rules of Law in the country have reached a plateau and should not have an immediate negative impact on the economy or on financing costs in international markets.

The Hungarian economy continues to grow at a decent 3.7 per cent pace year to date, driven by private consumption and distinctly robust investment growth. These drivers are expected to continue into next year. Unemployment at 4 per cent and wage growth at 13 per cent point to very tight labour market (Figure 90). The Government will likely continue with fairly expansionary fiscal policy, at least until the next parliamentary elections and the central bank has only just decided to add mortgage bond purchases to the already extensive tool of unconventional measures already in place. Headline inflation and core inflation both hover around 2.5 per cent recently (having risen from 0 and 1 per cent respectively in mid-2016), but still comfortably below the National Bank of Hungary target. The NBH is in a position to continue to target EURHUF and longer-term yields as the hefty current account surplus gives it a lot of leeway, and as long as inflation is not a problem.

NBH is about to increase the scale of monetary easing

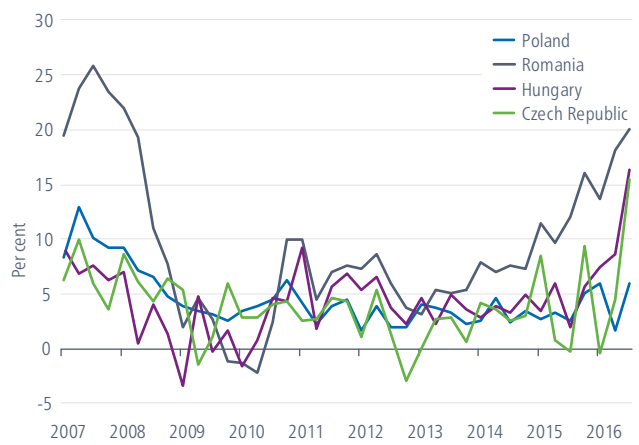
Czech and Romanian economic growth has accelerated well beyond market expectations in recent quarters and central banks in both countries have started to tighten. The Czech case seems to be a textbook one: a fairly balanced economy in an advanced stage of the economic cycle and a forward-looking central bank hiking rates. The Romanian case looks to be an example of an overheated economy with the central bank behind the curve.

Czech and Romanian Central Banks started to tighten

The main theme in Russia this year is disinflation. CPI inflation continues to surprise on the downside relative to both central bank forecasts as well as market participants and is already significantly below the central bank's target (Figure 91). To some extent that can be explained by temporary factors – a good agricultural harvest and the strong ruble – but the mix of tight monetary policy and prudent fiscal policy have also helped. Lower inflation has allowed central bank to steadily cut rates. Expectations are for at least another 100bps of cuts as real rates are still one of the highest in emerging markets. Russia has also improved considerably in terms of external vulnerabilities and has started to clean up the banking sector which is a significant positive. Growth this year finally picked up and further recovery is expected but, without structural reforms, it is unlikely Russia can grow above 2 per cent. Health care, the pension system, corruption and administration are the main weaknesses that authorities should tackle. Yet, it is unlikely that any changes will happen before next year's presidential elections (March 2018). It is widely expected that Putin will win the next elections but there is no visibility on

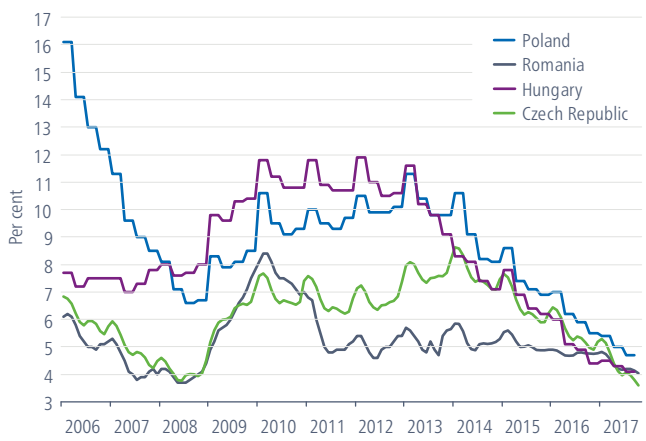
Fundamentals improved, but structural reforms badly needed…

Figure 89: Nominal wages growth (% yoy, quarterly)



Source: Bloomberg, as at 1 December 2017

Figure 90: Unemployment rates



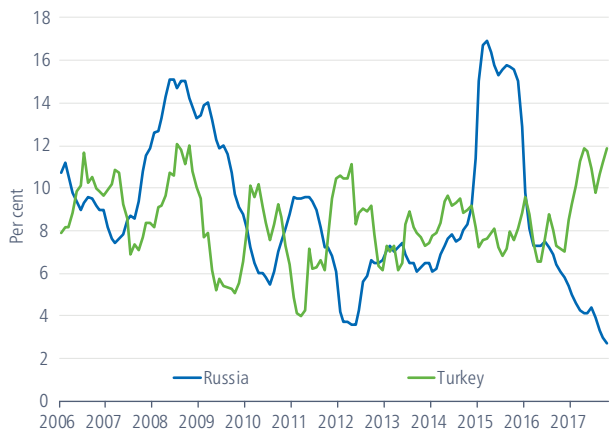
Source: Aviva Investors, Macrobond as at 1 December 2017

his economic and political agenda for the next term. Also worth keeping in mind is that the US Congress is still assessing the extension of sanctions against Russia which is the biggest risk for Russian assets currently.

As bad as it gets

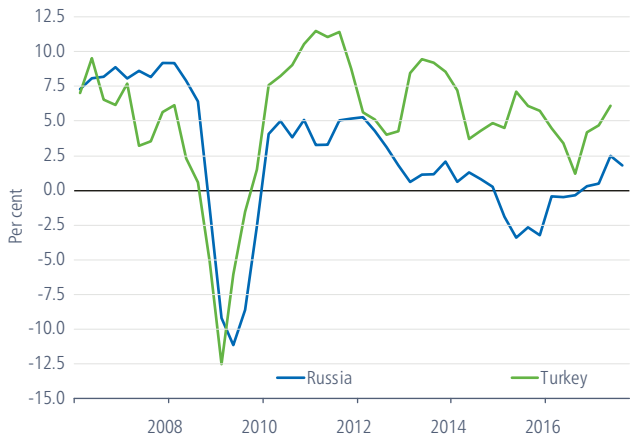
Turkey this year is the worst performing emerging market and for very good reason. Inflation has clearly run out of control, reaching double digits in recent months. Some fall in prices is expected at the beginning of 2018 but it will be purely explained by base effects. The long-term core inflation outlook has dramatically deteriorated. The Turkish authorities have missed a very good opportunity this year to tackle some of the underlying structural problems of the economy and have instead decided to boost GDP growth by supporting more credit creation. The consensus for growth next year is 3.6%, significantly lower than the average over the past decade (Figure 92). The central bank was forced to tighten monetary policy significantly to prevent the lira from depreciating alarmingly. Yet, that was not enough to keep inflation under control and further tightening is expected. To make the situation even worse, the Turkish authorities are conducting a very aggressive foreign policy which led to a deterioration of relations with the main trading partners in the West – Germany and the US. The ongoing purge against supporters of the Gulenist movement have not helped the investment climate either. On the positive side, Turkey maintains a cautious stance in terms of fiscal policy which should keep the debt-to-GDP ratio at a relatively low level.

Figure 91: CPI inflation in Russia and Turkey (% yoy)



Source: Bloomberg, as at 1 December 2017

Figure 92: GDP, annual growth



Source: Aviva Investors, Macrobond as at 1 December 2017

MARKET OUTLOOK

DM EQUITY: EARNINGS DRIVING MARKETS BUT SOME CLOUDS ON THE HORIZON

- Remain on track for double-digit earnings growth across all developed regions in 2017
- Technology stocks have led the way in terms of performance
- US tax reform could provide further boost but little expectation priced in
- Leverage remains an area of focus, with signs of some balance sheet stress

SUMMARY

Global equities have continued their upward trajectory this year, with corporate earnings continuing to underpin the rally. Cyclical sectors (in particular technology stocks) have been the main driver as the global economy gains traction. Equity markets in the US, Eurozone and Japan all remain on course for double-digit earnings growth this year. Against this positive backdrop there are some areas of concern, notably increasing levels of leverage in corporates.

EARNINGS MOMENTUM REMAINS STRONG ACROSS ALL DEVELOPED REGIONS

Q3 saw a continuation of the earnings momentum from prior quarters

The past quarter has seen a continuation of the earnings recovery that began in the latter half of 2016 (Figure 93, Figure 94, Figure 95). Q3 earnings across all developed regions exceeded consensus expectations, with Japan in particular the stand-out, delivering 16 per cent year-over-year growth. Top-line growth remained robust, with 5-6 per cent growth in US/Europe and 8 per cent in Japan. The main driver has been the synchronised recovery in global economic growth, which has helped drive earnings revisions upwards. Currency movements did have an impact, with US multi-nationals faring better than more domestic-focused names thanks to the weakness in the dollar. Conversely the strength of the euro had a negative impact on some European companies, particularly export-related names. Margins have remained robust, though there are some signs of wage pressures beginning to have some effect in certain areas of the US such as retailers and homebuilders. Importantly, there have been more optimistic signs from companies that they are

Figure 93: US Q3' 17 Earnings Summary

	% reported	% cos beating EPS estimates	% yoy EPS growth	% cos beating sales estimates	% yoy sales growth
S&P500	**87%**	**76%**	**6%**	**66%**	**5%**
Energy	97%	74%	137%	71%	17%
Materials	100%	72%	11%	80%	9%
Industrials	93%	79%	-1%	66%	6%
Discretionary	66%	74%	0%	58%	2%
Staples	73%	79%	4%	63%	5%
Healthcare	94%	78%	7%	62%	5%
Financials	100%	76%	-9%	76%	2%
IT	75%	92%	21%	80%	10%
Telecoms	100%	33%	-2%	33%	-1%
Utilities	100%	50%	-4%	29%	-3%
Real Estate	100%	76%	8%	70%	4%

Sources: Bloomberg, JPMorgan, excluding outliers, one-offs, as at 1 December 2017

Figure 94: Eurozone Q3 '17 reporting season

	% reported	% cos beating EPS estimates	% yoy EPS growth	% cos beating sales estimates	% yoy sales growth
DJ Stoxx 600	**83%**	**54%**	**9%**	**47%**	**6%**
Energy	100%	53%	54%	53%	21%
Materials	85%	50%	17%	53%	5%
Industrials	88%	45%	6%	39%	4%
Discretionary	80%	40%	14%	59%	7%
Staples	86%	38%	6%	27%	0%
Healthcare	94%	60%	1%	27%	0%
Financials	79%	69%	2%	57%	2%
IT	85%	69%	18%	55%	3%
Telecoms	71%	67%	6%	33%	-1%
Utilities	75%	44%	4%	54%	3%
Real Estate	38%	0%	21%	100%	3%

Sources: Bloomberg, JPMorgan, as at 1 December 2017

looking to increase levels of investment spending going forward, which would certainly be welcome given relatively muted levels of investment previously. Looking ahead to 2018, we expect robust earnings growth to continue, supported by the positive global macro backdrop. In terms of valuations, it's worth noting that European and Japanese equities still trade at a discount to their US counterparts.

TECHNOLOGY STOCKS LEADING THE WAY

From a sector perspective, cyclicals have been the main driver, with technology, energy and materials sectors performing well across all regions. Indeed the technology sector has been the standout performer this year, up 35 per cent globally (Figure 97). Only two sectors are in negative territory, telecoms and energy. Telecoms stocks have remained under pressure as competition intensifies and attempts at consolidation have come under pressure from regulators on both sides of the Atlantic. Energy stocks were weighed down by low oil prices in the first half of the year, though the rebound we have seen since June has given a boost to the sector.

> Technology stocks have been leading the market this year

US TAX REFORM - A POTENTIAL GAME-CHANGER IN 2018?

There has been a lot of focus on the proposed tax plans from both the US House and the Senate and potential implications for corporates. Whilst there remains uncertainty about what the final bill will look like there are elements that could provide a significant boost for earnings and also have implications for corporate balance sheets. Whilst the proposed changes to individual taxes should be net positive for consumption, the reduction in corporate tax rate to 20 per cent would provide a more meaningful boost to earnings. Domestic companies with high effective tax rates would see the most benefit, which from a sector perspective would be telecoms, financials and consumer discretionary names. We don't expect companies to retain all the benefit of a lower tax rate as some will likely get competed away or passed on to end consumers, particularly in industries with less pricing power.

> Tax reform does not appear to be priced in to US equities

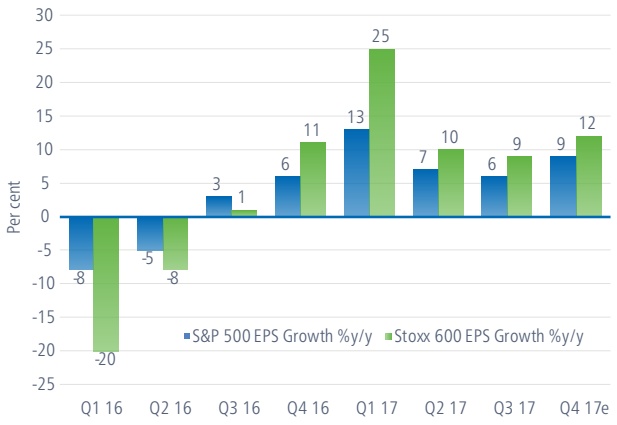
The one-time lower repatriation tax could see a large amount of the roughly $1.2 trillion held in cash overseas by US corporates being brought back onshore; a high proportion of this is held by technology and health care companies, and we would expect a large amount of this cash will be used for share buybacks.

Figure 95: Japan Q3'17 reporting season

	% reported	% cos beating EPS estimates	% yoy EPS growth	% cos beating sales estimates	% yoy sales growth
Topix	**73%**	**62%**	**16%**	**62%**	**8%**
Energy	64%	67%	52%	25%	11%
Materials	75%	71%	24%	63%	15%
Industrials	73%	61%	35%	64%	7%
Discretionary	74%	56%	12%	61%	8%
Staples	81%	62%	6%	62%	5%
Healthcare	81%	56%	14%	56%	5%
Financials	44%	75%	6%	64%	9%
IT	78%	71%	9%	68%	13%
Telecoms	67%	33%	-5%	40%	1%
Utilities	100%	54%	0%	40%	9%
Real Estate	71%	33%	-1%	39%	3%

Sources: Bloomberg, JPMorgan, excluding one-offs, as at 1 December 2017

Figure 96: Quarterly Year-over-Year EPS growth for US and Europe, with Q4 forecasts



Sources: Thomson Reuters, IBES, Bloomberg, JPMorgan, as at 1 December 2017

The proposed cap on the deductibility of interest expense would also likely lead to companies deciding to deploy some of the repatriated cash to pay down debt. In terms of how much of this is priced into US equities, it would appear very little at this stage. Judging by the performance of companies with higher tax rates (which have lagged the overall market this year), there appears to be a lot of scepticism from a market perspective in terms of whether tax reform does get passed.

LEVERAGE IN FOCUS

There are increasing concerns over levels of leverage

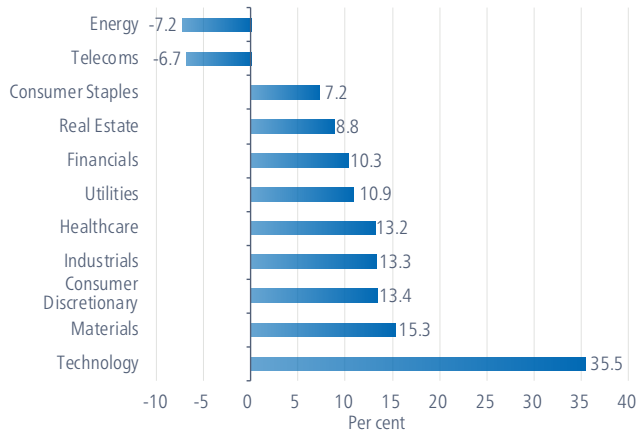
US small-caps are significantly more levered than large-caps

With earnings continuing to deliver versus market expectations and the macro backdrop remaining relatively benign, the outlook for equity markets remains positive. There are however some indicators that should make investors more cautious going forward. We have seen levels of leverage increase steadily over the past few years, with the record low interest rate environment encouraging corporates to extend their balance sheets. In the US we have seen increasing levels of debt-fuelled share buybacks, although this has moderated somewhat this year. Leverage has increased significantly more for small-caps vs large-caps in the US (Figure 98). Whilst the Fed has clearly signalled the pace of rate hikes will be gradual, there is likely to be more pressure on companies with highly geared balance sheets going forward.

CONCLUSION

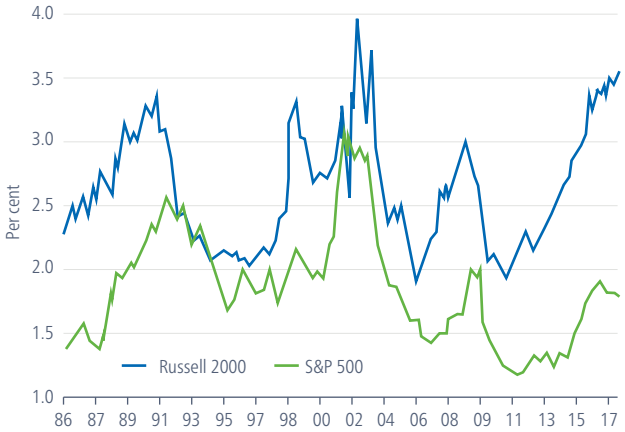
The rally in global equities this year has been underpinned by the strength in corporate earnings, along with an improving global macro backdrop. Whilst we expect the momentum in earnings to continue to provide support for equity markets going forward there are reasons for investors to adopt a more cautious approach. The low-interest rate environment has led to increased levels of leverage, and with signs central banks are looking to withdraw stimulus and/or increase interest rates, companies with stretched balance sheets may come under increasing pressure.

Figure 97: MSCI World (Developed Markets) sector performance year to date



Sources: Datastream, MSCI, reported in local currency, as at 1 December 2017

Figure 98: Net Debt to EBITDA (ex-financials) of small caps vs large caps in the US



Sources: FactSet, BofA Merrill Lynch US Equity & US Quant Strategy as at 1 December 2017

EM EQUITY: CONCENTRATING RETURNS

– Corporate earnings continue to grow

– Valuations remain reasonable

– Returns are increasingly concentrated

SUMMARY

The recovery in emerging market equities continued throughout 2017 supported by a backdrop of strong global growth and only moderate tightening of monetary conditions. GDP growth continues to meet or beat expectations across the board and underlying corporate earnings continue to grow. The significant valuation discount of emerging markets to developed markets remains excessive, particularly in an environment of resilient growth.

EMERGING MARKET EQUITY PERFORMANCE

Emerging market equities are showing sustained momentum

Emerging market equities have now performed strongly for the last two years. The full year 12 per cent gain in 2016 masked the strength of the recovery from the March lows of near 30 per cent. 2017 has been a continuation of the move experienced from March 2016. Emerging market equities are, if anything, gathering momentum. As at mid-November emerging market equities have gained 34 per cent year to date in USD terms (Figure 99).

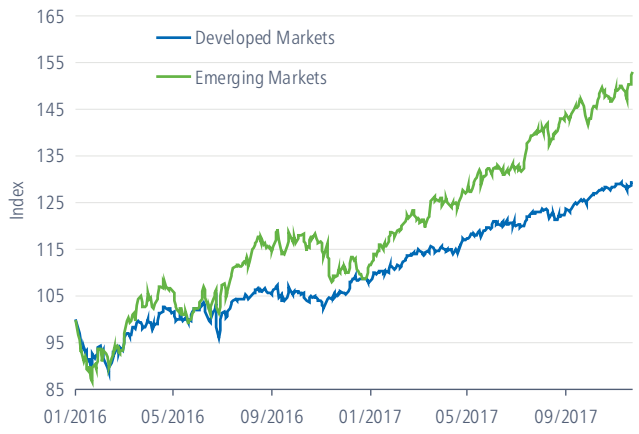
Year to date equity performance is strong but not exceptional

We have highlighted before that emerging markets have a history of delivering their returns in large doses. Since the MSCI Emerging Markets Index was launched in 1988, the average positive year has returned just over 40 per cent. With just over a month to go until the year end, a 40 per cent return target for the year does appear within the realms of the possible.

Returns have been concentrated in two sectors

If the performance from emerging markets this year has not been exceptional in its size, then it has been in its delivery. On a regional basis there has been a material divergence between Asia and both Latin America and Emerging Europe, the Middle East and Africa. Asia having gained over 40 per cent in US dollar terms, more than double that of either of the other regions (Figure 100). Of more interest, perhaps even of concern, is the fact that within Asia, only two sectors have outperformed. The two outperforming sectors are real estate and information technology, both of which have returned over 70 per cent whilst no other sectors have come close to the 40 per cent return of the regional index. This level of concentration lends an element of instability to an otherwise indomitable rally.

Figure 99: EM vs DM performance



Sources: Bloomberg as at 1 December 2017

Figure 100: Regional performance

Sources: Bloomberg as at 1 December 2017

ABSOLUTE AND RELATIVE VALUATIONS

The valuation discount to developed markets remains excessive

The strength of the move in emerging market equities has done nothing to address the high and persistent discount emerging markets trade at relative to developed markets. The performance of emerging markets has been coincident with a strong rebound in corporate earnings expectations. This recovery in earnings growth, after a slow start in 2016, has now far outstripped that of developed markets. As a result, since 2014 emerging market equities have consistently traded at a material discount to developed market (Figure 101). The discount to developed markets has been oscillating around the 30 per cent level on both a price to book and price to earnings basis. Now is no different.

Emerging equity valuations are moving higher

Despite the strength of the earnings recovery, the strength of the move in emerging market equity prices has affected their valuation. The absolute valuation for emerging markets (Figure 101) compared to their history has started to gradually creep higher. They currently trade on 14.1x next year's earnings; this is now the wrong side of the historical averages. Such a valuation does not compare favourably with a 5-year average of 11.1x and a 10-year average of 11.2x. When looked at in a global context, this move is less worrying. US equities, for example, also trade on a 25 per cent premium to their 10-year average. As a stand-alone asset class, emerging markets are generating a return on equity of over 10 per cent, a yield of 2.2 per cent and are trading on only 14x earnings. In this context they remain moderately priced compared to their current fundamentals.

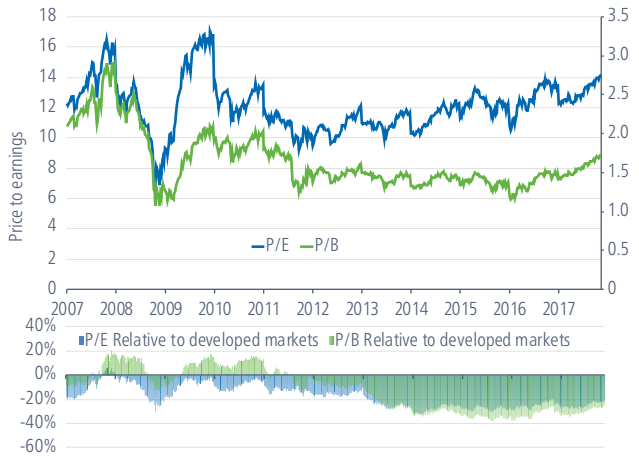
Earnings expectations for emerging markets appear reasonable

Despite the pace of the rally moving valuations higher, earnings expectations do continue to improve and remain supportive for emerging markets. The rebound in emerging market corporate earnings has far outstripped that witnessed in developed markets (Figure 102). The scale of this recovery cannot be looked at in isolation. Firstly, emerging market earnings have been under pressure since 2013 and remain 10 per cent below that level. This certainly cannot be said for other equity markets. The S&P 500 for example has earnings expectations at all-time highs. In 2016, emerging market earnings expectations bottomed only 10 per cent away from that which was achieved at the depths of the global financial crisis in 2009. This also helps put the pace of the recovery in perspective. In 2010, following the financial crisis, emerging market earnings grew by over 40 per cent from the prior year. For 2017 earnings are now on track to deliver approximately 30 per cent growth year on year (Figure 5). This may superficially appear high but remains credible considering the supportive backdrop and the low starting point. For 2018 emerging markets are expected to achieve low teens earnings growth which will more than underpin their current valuation.

MARKET DISPERSION

Despite the attractive backdrop we have outlined for emerging markets in the prior paragraphs, there is one growing risk we believe needs to be addressed. The

Figure 101: EM valuation, historic and vs DM



Sources: Bloomberg as at 1 December 2017

Figure 102: EM vs DM earnings expectations

Sources: Bloomberg as at 1 December 2017

concentration of the rally in Asia and within two sectors cannot be overlooked as a market risk. Geographically the rally has been concentrated in China where the MSCI China index has gained just under 60 per cent. We can however delve down deeper and see that within China the returns have been dominated by real estate (up 100 per cent year to date) and technology (up 110 per cent year to date). Figure 104 shows two of the big contributors to these phenomenal returns.

Chinese real estate performance appears unsustainable

The Chinese real estate sector has been a concern to investors over much of the past decade in various ways. A leading real estate company such as China Evergrande Group (Figure 104) is structured such that its equity listing is only a tiny visible portion of its capital structure. According to Bloomberg, its reported total debt currently stands at $100bn after various capital raising exercises. This is clearly backed by property assets but, as far as we can tell, very little else. Their reported gross profit in 2016 was under $10bn and by our calculations it has not been materially free-cash-flow positive in the past decade. The 19th National Congress of the Communist Party this year provided a strong indication that there would be a greater focus on the quality of growth within China, and within that our interpretation is greater awareness of financial stability. There have also been clear moves to control the rapid appreciation in the property market experienced over the last two years. Neither of these two factors are in our view supportive of further sustained equity market performance from this sector.

Valuations in the technology sector are high but so is their potential

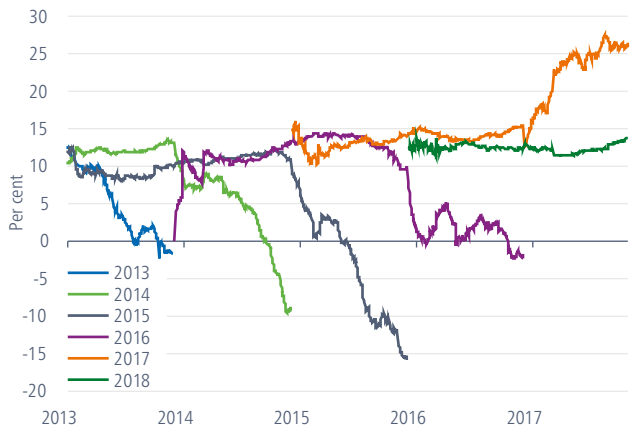
Information technology is much harder to reach a judgement on. The main drivers of performance within that sector are new technology companies such as Tencent (see Figure 104), Alibaba and Baidu. Together they have accounted for over 50 per cent of the total return year to date in China. Without doubt these companies have potential, their appreciation has been backed by strong earnings growth and a vision for the future. Their valuations have moved materially higher, Tencent for example now trades on 51x 2017 expected earnings having started the year on 32x. However near-term earnings expectations have not historically been an accurate predictor of near-term returns within the technology sector.

Though it may not be possible to predict what might derail their current performance, both Alibaba and Tencent now have a combined market cap of $1trillion. This makes their scale and their dominance as a source of returns a concern for investors in emerging market equities.

CONCLUSION

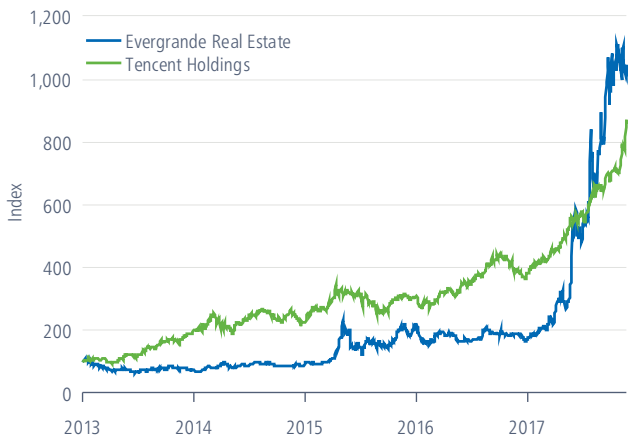
The rally in emerging market equities over the past two years has been backed by the strong foundations of recovering global growth, strong corporate earnings growth and low valuation. We are concerned that the returns within emerging market equities have become increasingly concentrated in a few core companies. We believe the foundations on which this recovery has been built remain in place for the near future and should continue to be supportive of emerging market equities.

Figure 103: EM earnings expectations



Sources: Bloomberg Best estimates as at 1 December 2017

Figure 104: Evergrande & Tencent



Sources: Bloomberg as at 1 December 2017

RATES: TIGHTENING THE SCREW…

– Tighter policy remains the dominant theme

– Valuations are challenging

– Idiosyncratic risks remain

THEMES

2017 held true to our thesis of a broad-range trade prevailing in core rates markets

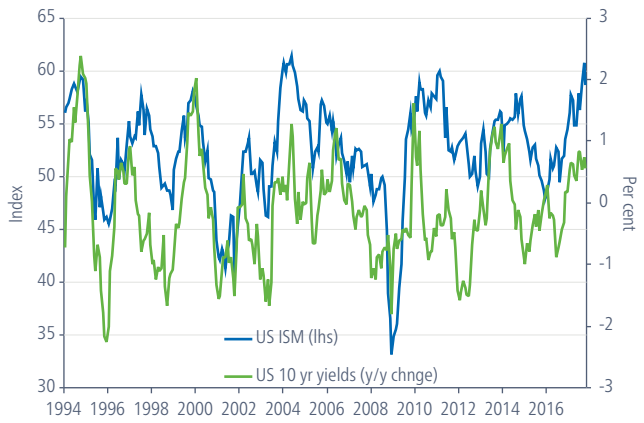
As we head towards the end of 2017 we reflect on the fact that core developed market yields have remained locked in ranges that have prevailed all year. This performance was in contrast to the reflationary macro bias as technical considerations meant it failed to result in significantly higher yields. The key macro driver behind this has been the absence of meaningful inflationary pressures with a number of one-off factors limiting the full on normalisation in prevailing inflation rates. Meanwhile a number of structural forces have been supporting demand for core markets (such as ongoing QE in Europe and Japan and policy uncertainty in the US) while risk assets rallied robustly driven by a hunt for returns, forging onwards to higher and higher valuations. The re-emergence of geopolitical risk (N. Korea, Middle East) likewise served to provide some safe haven support.

The global set up is challenged by a lack of spare capacity

So what can we expect for 2018? No doubt the global economy is heading into 2018 in robust form with growth globally looking strong. Indeed the pace of growth in 2018 looks likely to be at least as strong as was seen in 2017. This focuses attention on whether or not rising inflation can continue to surprise markets by its absence. Certainly with higher oil prices and shrinking or non existent output gaps, the policy framework is very much in flight path mode at the US Federal Reserve. Despite a change at the helm, we continue to expect a slow pace of rate hikes (in line with the dot plots) and ongoing balance reduction. Meanwhile we know already that the ECB will be providing less and less in the way of asset purchases into Q3 while post election, the outlook in Japan should be for YCC (yield curve control) to continue from the BoJ assuming the leadership by Kuroda remains constant. In other words, the broad framework of tighter monetary policy is not greatly changed from 2017 with the notable exception that globally spare capacity is now much lower than it was at the start of 2017 (see Figure 105).

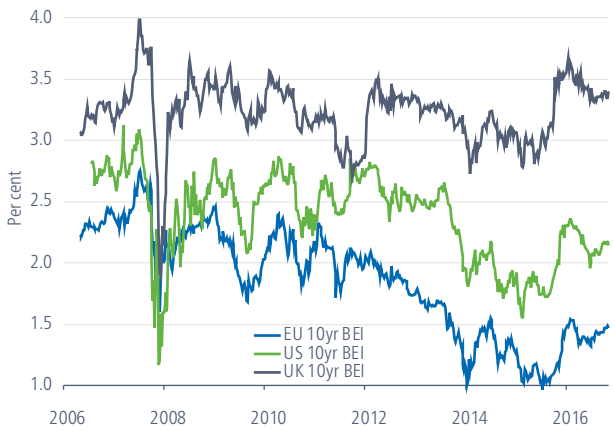
Given our belief that it is only a matter of time that growth can continue at this pace without inflation materialising, the bias has to be towards moderately higher yields over 2018. The caveat to this is that a degree of structural demand for core

Figure 105: US 10yr yields vs ISM



Sources: Bloomberg, as at 1 December 2017

Figure 106: Breakeven inflation rates are subdued



Sources: Bloomberg, as at 1 December 2017

assets remains in place and on going reserve creation by Asian central banks will remain a factor lessening the potential bearishness for fixed income markets. As such our overall bearish view will be tempered by some supporting factors. Key to the balance is how policy makers are responding to higher global growth and inflationary risks. By tightening despite current inflation being below target inflationary expectations should remain contained. The risk of course is that policy makers do not respond sufficiently robustly to an upside surprise and thereby inflation expectations become unhinged. In this scenario we could see both higher realised inflation and ultimately more aggressive policy tightening from the major central banks (see Figure 106).

Bond yields likely to match their forwards

A NEW REALITY…..

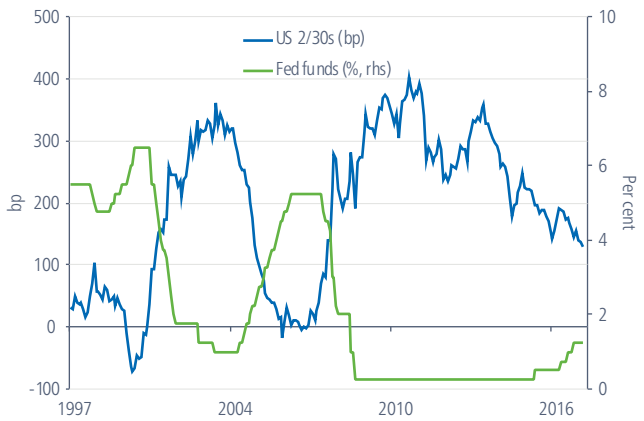
Much about the outlook for US Treasuries depends on the outcome of policy maker decisions in the US and notably the prospective tax reforms that are running through the legislative process at the timing of writing. The key here is really the scale of the package and how much of a stimulus it provides to a US economy that is already running close to full tilt. As of the latest reports it seems likely that whatever is agreed will be enough to marginally move the needle on US growth and equally will result in higher issuance in terms of deficit funding. However, as long as a Powell-led FOMC continue to keep the path to higher rates in place (and unwind their balance sheet) then inflation expectations should not spike out of control. The notable flattening of the US curve over the past few months highlights the terminal rate for the FOMC will not be as high as in prior cycles but provides some opportunities in terms of potential re-steepening risks as supply and additional fiscal stimulus kick in. One risk scenario we find increasing probability of is for the cycle to 'mature' more in line with the second half of the 1990s where a muted rate hike cycle saw a sustained number of years where only minor fine tuning was seen in terms of policy rates and the curve held in a range at low levels (see Figure 107).

We could be heading for a 1990s style cycle

Meanwhile the outlook in Europe and Japan is still notably different from the US in that the policy makers are still providing support for economic activity in the form of expansionary monetary policy, albeit at a lesser pace. Certainly with strong growth in Europe, it is clear we are approaching the end game with respect to QE in 2018 but rate hikes look unlikely until 2019 and thereby the process of 'normalisation' in the European term structure is likely to be slow at best. The case for higher yields is convincing based on current valuations but with the ECB inflation target still elusive on a 3-year horizon, the negative carry of being short European assets makes holding this position look expensive. We prefer yield curve steepeners as a positive carry way to express these risks. In Japan we may see some

Higher European yields may be negated by the cost of carry

Figure 107: US curve heading for 1990s model?



Sources: Bloomberg, as at 1 December 2017

Figure 108: JGB curve set to steepen

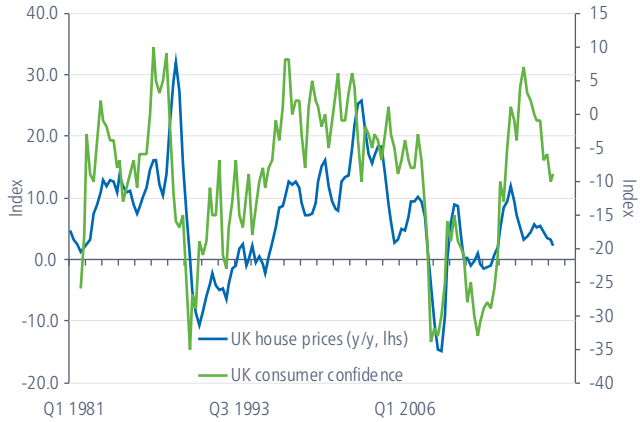
Sources: Bloomberg, as at 1 December 2017

adjustment to YCC as the year progresses but the policy is likely to remain in place and thereby this is a key major market where we would expect some steepening pressure to be dominant over the course of 2018 (see Figure 108).

UK market prices a mid point between binary outcomes

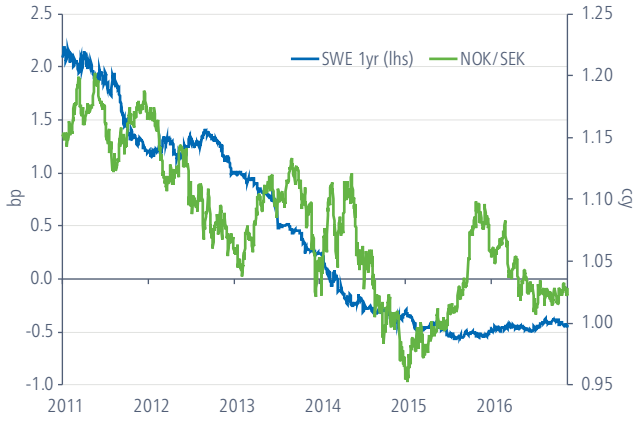
Elsewhere in developed markets we face a lot of ongoing uncertainty especially in the UK market which as yet has little clarity on the binary outcomes with respect to Brexit (Figure 109). A 'no deal' outcome would likely see yields fall sharply across the curve and the Monetary Policy Committee compelled to respond with monetary easing. Conversely a 'good deal' could see much higher yields and a stronger currency as the worse effects of no deal are eliminated. This remains a difficult scenario for the market to price and thereby we remain priced mid point for two relatively extreme outcomes. Other themes we like heading into 2018 are to look where hawkish expectations are overly priced into the front end of yields curves where we expect the central banks to be reticent to hike rates such as in Australia and in Sweden.(Figure 110).

Figure 109: UK fundamentals weakening ahead of BREXIT outcome



Sources: Bloomberg, as at 1 December 2017

Figure 110: Swedish rates suppressed



Sources: Bloomberg, as at 1 December 2017

CREDIT: WATCHING FOR THE TURNING POINT

– US high yield experiences a small correction

– But technicals are likely to remain supportive

– US tax reform adds upside risk for credit markets

GLOBAL HY SELLOFF

High yield (HY) markets have been at the centre of credit investors' interest during the first half of November as spreads widened by 42 basis points (bps). Looking closer, the sell-off was more pronounced in the Pan-European high yield market (+60bps option-adjusted spread) than the US high yield market (+40bps OAS). The correction has been driven by a variety of factors: idiosyncratic credit problems, higher than expected new issue supply and worries about US tax reform. However, even after the recent sell off, the global high yield market is only 11 basis points wide of the previous cycle tights set in 2014.

Are spreads too tight?

However, market composition is continuously changing and the average credit quality of the market has improved over the last three years. The ratings curve BBs/CCC has steepened with lower-rated bonds still trading much wider compared to 2014. The reason valuations can be justified is that fundamental credit quality trends remain accommodative with positive earnings before interest, tax, depreciation and amortization (EBITDA) growth, steady leverage, and strong interest coverage.

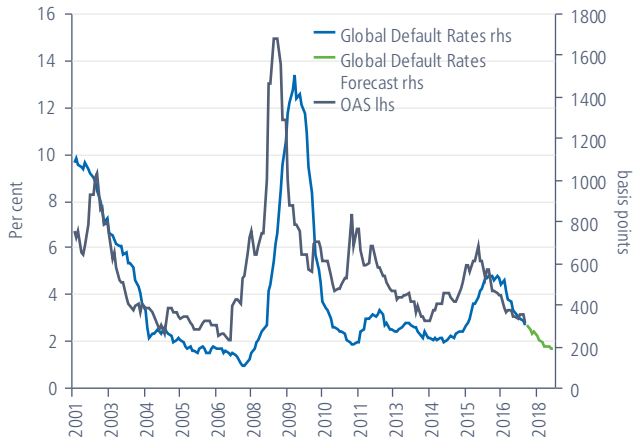
Market composition change should be considered before analyzing spreads levels over time

While we believe we are clearly late in the credit cycle, we note that, historically, credit spreads have demonstrated the ability to stay at truncated levels for extended periods of time. Moody's expects default rates to decline to 1.7 per cent over the next 12 months, compared to the long-term historical average of 4.2 per cent (Figure 111). With this backdrop, we do not find enough evidence to support significant spread widening going forward.

A solid high yield fundamental backdrop

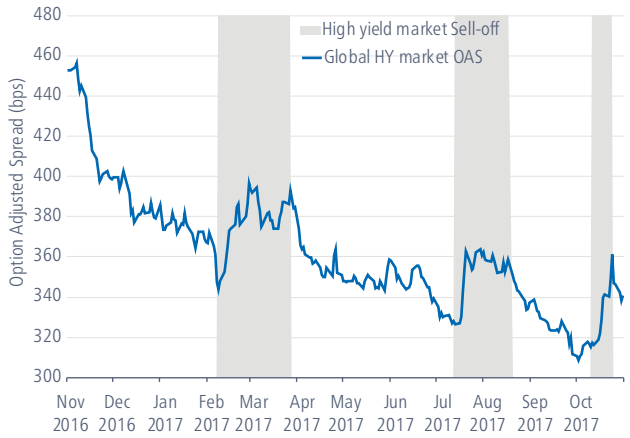
Bouts of volatility understandably bring worries about a larger market correction. Figure 112 shows that it is important to keep the perspective that this was the third occurrence of at least a 35 basis points spread widening just in 2017. We see this as fresh air for HY investors, allowing for more opportunity within a tightly-priced market. We still expect positive total return of low single digits over the next 12 months.

Figure 111: High yield default rates



Source: Moody's, Bloomberg, as at 1 December 2017

Figure 112: High yield corporate spreads



Source: Bloomberg, as at 1 December 2017

TECHNICALS

Technicals remain the key driver of credit spreads

Overwhelmingly strong technicals have kept such sell-offs very muted. The global economy has moved into a new phase of synchronised growth, but output gaps still remain in some regions and below-target inflation has kept central banks tilted towards dovish policy. This 'goldilocks' scenario for risk assets has been characterised by a collapse in volatility across risk assets and credit spreads have fallen in sympathy. Given the countercyclical nature of monetary policy, we believe this scenario is unlikely to persist in the long term, but over shorter time periods the technical picture remains robust. Figure 113 shows the expected glide path of central bank QE; purchases are set to continue in the near term, but the technical picture could start to turn in 2H 2018.

The picture remains robust for now, but watch for the turning point

The market is still significantly discounting the Fed's commitment to raising interest rates in line with their forward guidance, but credit markets should be able to withstand a gradual rise in short-term rates. Any upside surprise to the inflation outlook, however, could cause credit investors to grow fearful of a more active Fed.

But as policy normalises, fundamentals will reassert

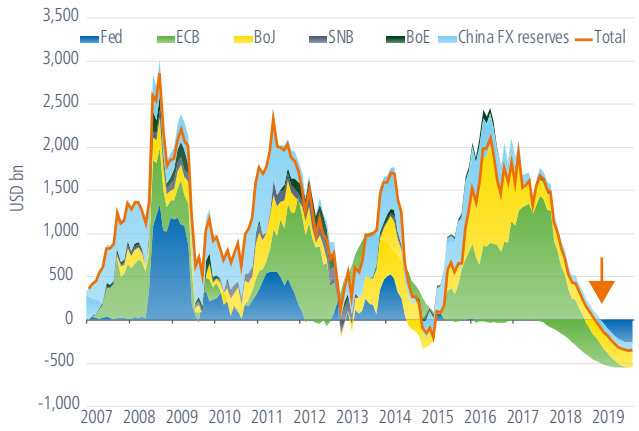
The ECB delivered a dovish surprise in their latest policy meeting, tapering QE purchases but reaffirming their commitment to keep interest rates in negative territory for an extended period. With European deposit rates at -40bps for the foreseeable future, investors are increasingly crowded into riskier assets and credit markets are the most obvious beneficiary. Finally the BoJ's commitment to yield curve control (keeping the 10yr rate pinned at 0bps) was increased after Abe's victory in the Japanese election. With Japanese government bonds offering meagre returns, investors are forced to find yield in international assets that have a pick-up over treasuries. Again, credit is a sweet spot. Figure 114 shows the dearth of high yielding assets in the fixed income space and highlights how low rates have kept credit spreads supported. We are probably past the point of peak liquidity, which warrants a defensive allocation to credit risk, but in the short term central banks keep technicals well pinned.

TAX REFORM

US tax reform: a tailwind for US Credit

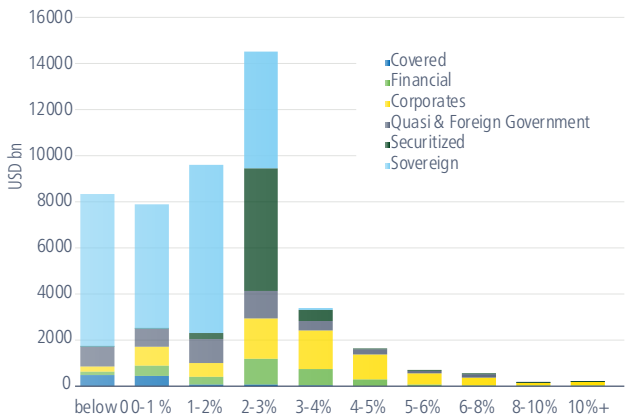
We have previously written about a number of downside risks to credit markets but as we head into 2018, we actually face an upside risk from US tax reform. There are three key aspects of US tax reform that will be important drivers of credit performance in 2018; a reduction in the rate of corporation tax to 20 per cent; a limit on interest deductibility; and a temporary deduction in the tax paid on repatriated earnings. It remains unclear whether reform efforts will be successful and investors are approaching the subject with a healthy dose of scepticism. This

Figure 113: QE flows set to turn negative in 2019



Sources: BofA Merrill Lynch Global Research, Bloomber, BoE, ECB, as at 1 December 2017

Figure 114: High yielding assets are in short supply



Sources: ICE BofA Merrill Lynch Global Bond Indices, Global fixed-income GFIM index, as at 1 December 2017

can be seen in the weak performance of the USD, the flattening of the US yield curve and the lack of outperformance of equity sectors that currently have a high tax burden. Figure 115 shows the underperformance of Goldman Sachs' "high tax" equities basket for example. Given the net effect of these policies could result in a structural reduction in US corporate leverage, successful implementation could mean significant upside risk for US credit and therefore tax reform warrants close attention.

The most fundamental aspect of the tax package is a reduction in the headline tax rate. Not only would this increase the profitability of US corporates, it would also lower the tax 'shield' that companies receive when issuing bonds. Figure 116 shows the long-term relationship between leverage and tax rates, pointing to a possible 25 per cent deleveraging in the future. Recent tax proposals also include a plan to limit the amount of interest that companies can deduct from their tax bill. This would put an implicit cap on the amount of leverage that US corporates should target in order to achieve an optimal balance sheet structure.

US companies may start to change the way they think about debt financing

The third important aspect of the tax package is the repatriation of foreign earnings. Estimates of the size of offshore cash typically range between $1tn-3tn. The majority of this cash is held by companies in the tech and pharma sectors; two sectors that have been significant contributors to US bond supply in recent years in order to finance M&A and share buybacks. If they were granted access to this cash overseas, US supply could fall meaningfully.

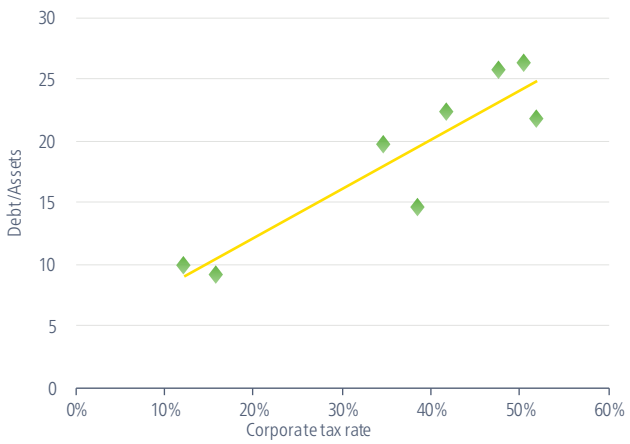
As credit investors we are watching for structural changes in bond issuance

Aside from the cyclical benefits of tax cuts, we are also looking out for some key aspects of tax reform that could lead to a structural change in how companies think about bond issuance versus other forms of financing. The market is likely under-pricing the significance of this shift as we head into 2018.

Figure 115: High tax stocks have underperformed this year

Sources: Goldman Sachs, Aviva Investors as at 17 November 2017

Figure 116: Lower taxes could mean long term deleveraging



Sources: "A Century of Capital Structure. The Leveraging of Corporate America", December 2012

EMERGING MARKET DEBT: SELECTIVE OPPORTUNITIES

Continued structural underpinning for the asset class

Although the macro-economic backdrop remains supportive for emerging market (EM) Debt, the last few months has seen a correction in local currency returns and heightened idiosyncratic risks provide some challenge to the bullish sentiment towards EM. Indications that investors have taken a more cautious approach into year-end should not divert attention from the continued structural underpinning for the asset class. However, numerous sources of idiosyncratic risks will provide the potential for intra-EM volatility and will likely make careful asset selection important over the coming months.

Most valuation metrics continue to favour local markets, which should benefit the most from the duration and carry-supportive environment. In hard currency markets the relative value comparison has to be broadened across global credit markets to find valuation attraction but upside appears more limited.

EM LOCAL CURRENCY

EM local currency bonds returns have corrected lower since September after strong gains in preceding months. A rebound in the US Dollar, aligned with optimism on tax reform and increasing expectations for higher policy rates, coincided with a number of idiosyncratic events across EM economies. However, we believe that the backdrop remains positive for local currency emerging debt and the recent pullback presents an opportunity for an asset class with unchallenging valuations and attractive yields (Figure 117 & Figure 118).

Synchronous growth pickup aligned with ample liquidity to support EM local bonds

The macro backdrop continues to be supportive for EM local bonds and is underpinned by the most synchronous pickup in growth expectations, for both emerging and developed economies, since the global financial crisis. Notably, the growth differential between EM and DM economies is moving in EM's favour which is typically associated with capital flows towards emerging economies. Meanwhile global liquidity remains ample which fuels investor risk appetite and contributes to demand for higher-yielding assets like emerging market debt.

The cyclical fundamental outlook for EM economies is improving in aggregate. Growth forecasts have been revised higher consistently through 2017 for a broad range of countries. Meanwhile, inflation expectations continue to be subdued – forecasts for end 2018 are below the midpoint of central bank targets for the majority. However there are a few exceptions – some of the more structurally vulnerable economies are exhibiting signs of stress. Budgetary and political

Figure 117: GBI-EM Deviation from FX 'Fair Value' [USD]

Sources: JP Morgan, Bloomberg, as at 1 December 2017

Figure 118: EM Local Yield - US 10y

Sources: JP Morgan, Bloomberg, as at 1 December 2017

concerns remain elevated in South Africa, while inflationary pressures and geopolitics are weighing on local assets in Turkey (Figure 119).

As we progress into 2018, election risks will be a key consideration for many EM countries. Elections can create uncertainty about the continuity of policy and economic reform alongside potential for less fiscal prudence. The key elections which have potential to create volatility in local markets are the elective conference in South Africa next month followed by presidential votes in Mexico and Brazil in July and October 2018 respectively. It is too early to gauge the impact on local markets but is something that will warrant close monitoring as policies and candidates become clear in coming months.

Stable fundamentals but rising election risk as we move into 2018

The technical backdrop for local currency bonds continues to be supportive. Cross-border appetite for EM assets has been strong this year after weak flows the preceding two years. There has been an increased appetite for local currency assets amongst emerging debt flows but it is still roughly half that of going into hard currency funds. We anticipate continued demand for EM debt given the growth and yield differentials relative to developed markets and the structural underweight towards EM debt in investors' portfolios (Figure 121).

Valuations are attractive in local markets and this is mainly driven by the currency component. Although there has been some recovery since 2015, EM currencies in aggregate are below long-term averages in inflation-adjusted terms, and we see scope for this to correct, underpinning EM local returns in the medium term. Meanwhile yield spreads between EM local and US Treasuries are close to long-term averages in nominal and real terms, providing a buffer against potential currency volatility.

Investors' allocations are likely to continue aided by attractive valuations

EM HARD CURRENCY

As expected the drivers of the strong inflows supporting EM hard currency assets did not fade during the third quarter of 2017. The global macro backdrop of healthy global growth, contained inflation pressures and a likely cautious approach to withdrawing stimulus by policy makers should support investor sentiment towards EM in the coming months. Therefore the outlook for the next quarter is constructive even while spreads appear expensive.

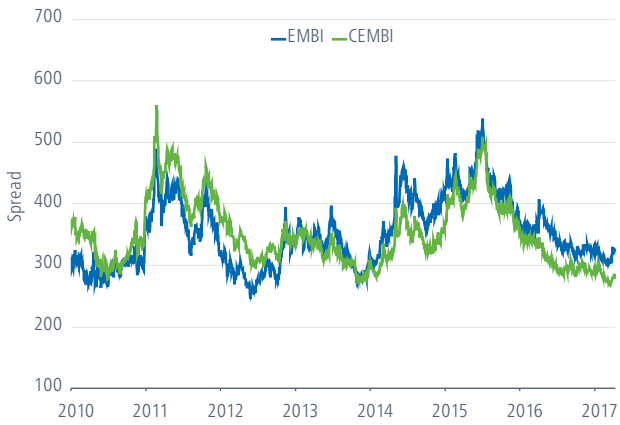
We face the challenge of a macroeconomic backdrop supportive of further inflows into the asset class, but a risk/reward balance that looks increasingly unappealing. The rally in EM hard currency assets has become increasingly indiscriminate and after the spread tightening experienced over the course of the year valuations naturally look more stretched across the universe (Figure 120).

The rally has become increasingly indiscriminate

Figure 119: EM Growth Forecasts Tracking Higher [GBI-EM]

Sources: JP Morgan, Bloomberg, Aviva Investors, as at 1 December 2017

Figure 120: EM Hard Currency Spreads



Sources: JP Morgan, Bloomberg, Aviva Investors as at 1 December 2017

Risks remain focused on changes in monetary policy but gradual policy normalisation is not a problem for emerging market economies given lower external vulnerabilities and an improved policy mix. However, when looking at hard currency assets specifically, we remain wary that a positive correlation with US Treasuries (UST) could still appear. At best a significant move higher in UST yields would challenge total returns because of the limited spread cushion now on offer in many parts of the universe.

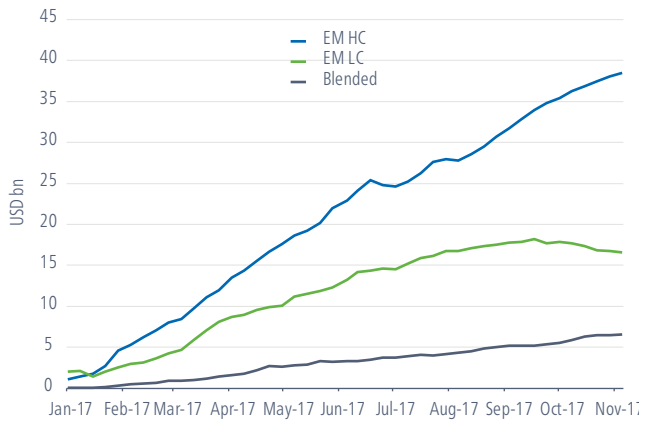
Hard currency assets will offer attraction in a global credit context

Elevated valuations and low volatility raise questions about the adequate pricing of risk. As a result a cautious stance is warranted from a headline risk perspective. However, in a period of extended stability for credit spreads Emerging Market hard currency assets will offer attraction in a global credit context and the current environment has the potential to be sustained (Figure 122).

Focus on positions with robust fundamental rationales and sustainable sources of return

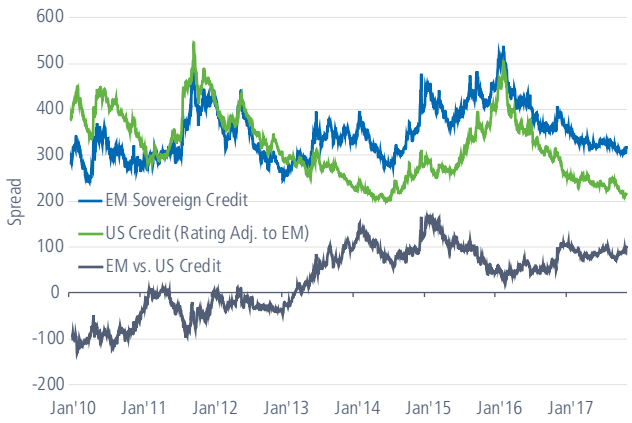
It would be unjustified to position too defensively at this stage, but attention must be paid to the perceived poor risk/reward profile. The focus should be on positions that offer value based on robust fundamental rationales whilst having the ability to provide sustainable sources of return. Overweight positions in mid to high yielders with more defensive characteristics and/or a better fundamental value proposition such as Ukraine, Russia and Egypt look to offer better value. Quasi-sovereign exposure also looks appealing as it provides an attractive mix of spread alongside improving fundamentals. In several countries relative value may be found in specific major corporate names compared with the sovereign as well as a broader global credit peer group. There may also be some benefit in reducing exposure to some sovereign high yielders that have had strong momentum and that have benefitted excessively from the broad based rally (for example, Sub-Saharan African credit).

Figure 121: EM Fixed Income Inflows



Source: Aviva Investors as at 1 December 2017

Figure 122: EM Sovereign Credit vs. US Credit (Rating Adj.)



Sources: Morgan Stanley, Bloomberg, as at 1 December 2017

CURRENCIES: REFLATION KEEPS FX VALUE ATTRACTIVE

– Limited USD boost from rates repricing suggests peak dollar likely behind us

– ECB's sensitivities likely to keep euro gains capped against the greenback

– Quality EM carry stories to likely weather the changing global environment much better

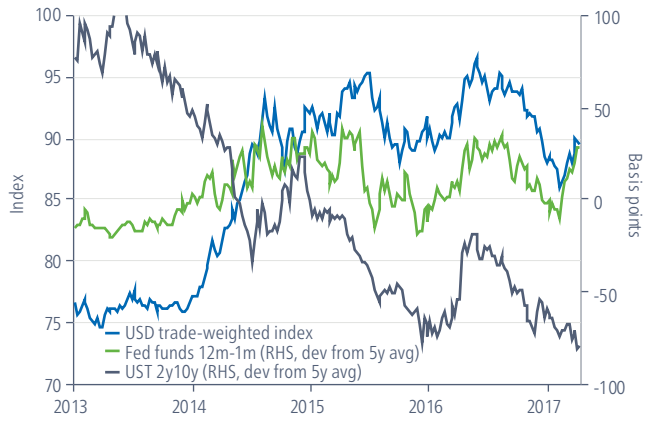
Since early September, the US dollar has been boosted by a combination of expectations of US tax cuts and repricing higher in short-end USD rates as markets have moved to price in a December rate hike by the Fed. Apart from policy, strong growth acceleration during the second half of the year has put a floor under the dollar, which fell rather sharply during the second and third quarters against G10 majors. Looking ahead, for now, we do not see any persuasive signs to suggest that the dollar will break out higher significantly. The behaviour of rates repricing provides some useful hints. After the election of Donald Trump in November last year, dollar strength was accompanied by yield-curve steepening at both the short and long ends, as stimulus expectations boosted expectations of both near-term policy normalisation and medium-term inflation (Figure 123). However, since September, the Treasury yield curve has continued to flatten further, even as dollar money-market curves have steepened, suggesting that markets do not see tax reform measures as a sustained boost to long-term inflation expectations. A degree of scepticism is no doubt fuelled by the Trump administration's inability to score a single legislative victory in the first 10 months in office, despite the Republicans controlling both the White House and Congress. Hence, significant further dollar upside does not look straightforward.

Rates repricing has helped the dollar higher, though markets seem to doubt the durability of the repricing

Having said that, while still moderately expensive, dollar valuations are less extreme after the 6.5 per cent decline in the USD trade-weighted index, though in terms of the cross section of valuations, it still ranks on the rich side (Figure 124). More importantly, the combination of a strong cyclical resurgence in the US and strong currency appreciation in exchange-rate sensitive places like the Euro area is likely to mean that the broad dollar index varies within a range rather than rise or fall in a sustained trend.

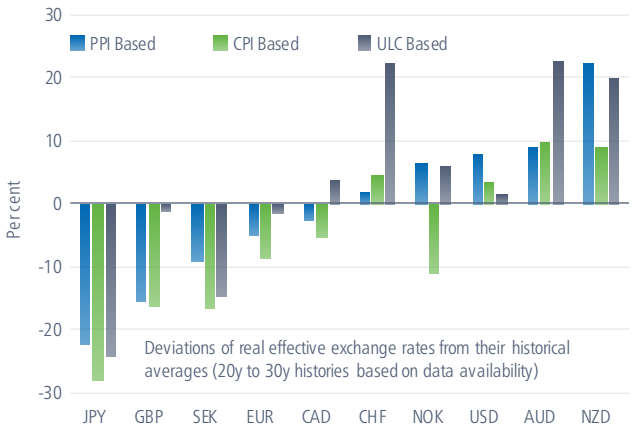
Dollar valuations are less expensive than at the start of the year

Figure 123: Rates repricing boosting USD



Sources: Aviva Investors, Bloomberg, as at 1 December 2017

Figure 124: USD still on the rich end



Sources: Aviva Investors, Bloomberg, as at 1 December 2017

Further euro strength is likely to make the ECB uncomfortable and generate a policy response

EURUSD has strong cyclical momentum behind it, in addition to the fact that the relative core-inflation trajectory, a historical predictor of nominal rates differential, has moved in favour of the euro this year, even as nominal rates have failed to respond (Figure 125). FX markets are not constrained in the same way as rates markets are by non-standard monetary policy and have been responding to the relative pick-up in the Euro Area's core inflation. However, further upside in EURUSD is likely to be limited now, given that US growth momentum is on a par with that in the Euro Area and the ECB has already shown signs that the rise in the euro is probably making them uncomfortable – Mario Draghi's dovish tapering announcement at the October policy meeting was probably as much aimed at the euro as at ensuring that the ongoing expansion continues steadily.

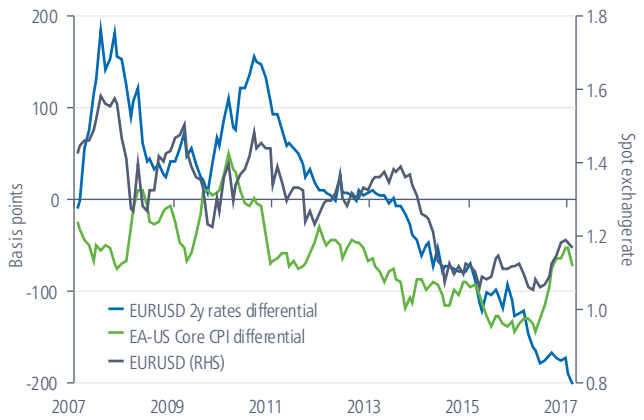
Yen-equity correlation has been weaker, but it's unlikely to be a regime change

Elsewhere in G10 FX, it's notable that USDJPY barely responded to both the repricing higher in USD yields and especially the break higher in Japanese equities with Shinzo Abe's strong victory in the recent snap general election. The correlation between Japanese equities and USDJPY had been moderating even before the election result powered the equity market to the highest levels since 1994 (Figure 126). Given signs of strong domestic growth in Japan this year, it may be tempting to conclude that the negative correlation between the yen and equities has broken down. That would be quite premature, as a slow pick-up in wage growth means that a significant part of reflation in Japan will rely on the yen staying at fundamentally cheap levels. Equally, valuations are in large part responsible for the lack of a strong response in the yen to shifts in yields and equities – it is still the cheapest currency in G10 FX. Finally in the G10 space, the outlook for sterling remains clouded by Brexit negotiations and economic uncertainty. The recent increase in policy rates by the Bank of England gave some support to the currency, but the potential range of outcomes over the next year remains very wide and largely dependant on whether the UK secures a positive transition agreement with the EU.

EM FX less vulnerable now than in past instances of USD rates repricing

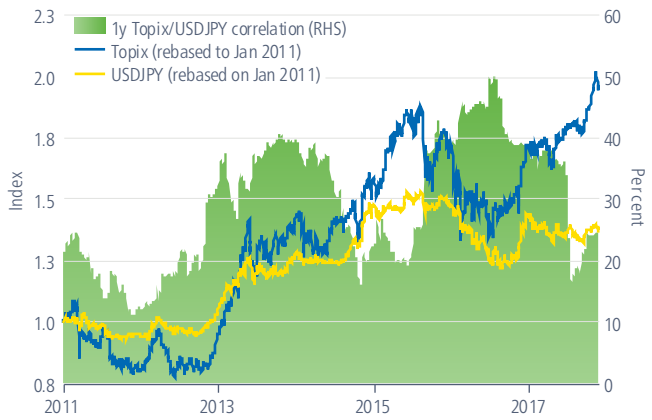
EM FX has particularly been in the firing line from the repricing in USD rates since early September. However, there are notable differences from past such repricing episodes. During late 2014 and early 2015, a 50-bp steepening in the Fed-funds futures curve corresponded to a more than 15 per cent decline in the JP Morgan EM currency index. In contrast, the decline was a far more moderate 3 per cent at the time of the US presidential election last year, while since September this year, the EM FX index has lost around 4 per cent, which equates roughly to a 5 per cent decline for a 50bp steepening in the USD money-markets curves (Figure 127). What's also noteworthy about this mini sell-off is how concentrated the declines have been in three currencies – the Turkish lira, South African rand and Mexican

Figure 125: FX not constrained like rates



Sources: Aviva Investors, Bloomberg, as at 1 December 2017

Figure 126: Topix correlation with USDJPY lower



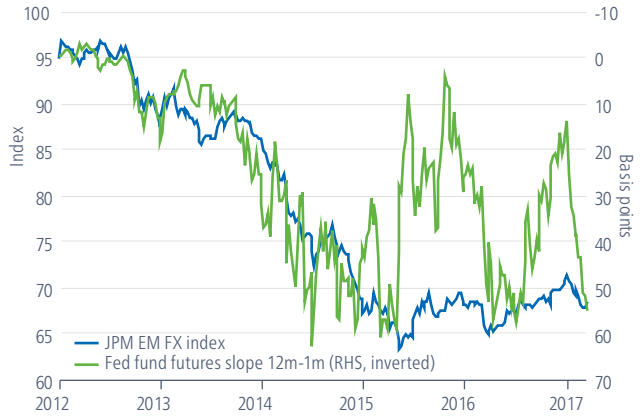
Sources: Aviva Investors, Bloomberg, as at 1 December 2017

peso – where there has been a rise in specific risks: diplomatic spats and higher inflation for Turkey, fiscal slippage and risk of further ratings downgrades for South Africa and NAFTA renegotiation and presidential elections for Mexico. But the wider EM FX landscape continues to look resilient.

Quality EM FX carry stories such as the Indian rupee (INR) and Indonesia rupiah (IDR) are likely to remain attractive sources of risk-adjusted yield pick-up over G10 low-yielders. INR has recently been boosted by a string of positive developments, including a bank recapitalisation programme, a new infrastructure programme, a 30-point jump in World Bank's Ease of Doing Business ranking and most recently an unexpected credit-ratings upgrade by Moody's. These positives have gone some way towards countering the headwinds from higher dollar rates and worries about fiscal slippage in the lead-up to the 2019 general election. The local equity market has been bolstered by a return of overseas investors (Figure 128), which has taken the pressure off the rupee. Like INR, IDR too has had only a modest adjustment lower. As growth recovers in both India and Indonesia and prospects for further policy easing diminish, both INR and IDR should remain attractive to global investors.

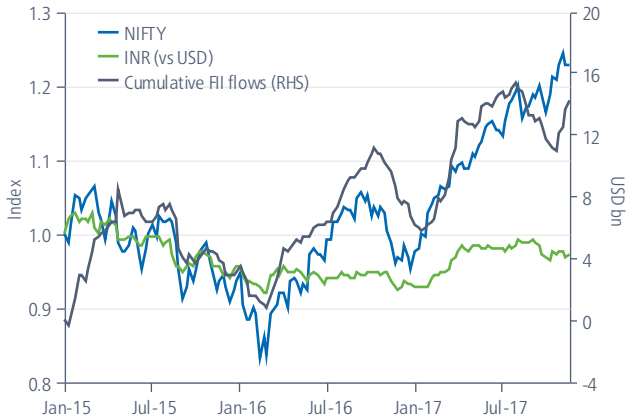
Quality EM carry stories like INR and IDR remain attractive

Figure 127: EM FX less vulnerable than before



Sources: Aviva Investors, Bloomberg, as at 1 December 2017

Figure 128: INR remains a quality carry play



Sources: Aviva Investors, Bloomberg, as at 1 December 2017

REAL ESTATE: PEAKING

GLOBAL

Limited room for further yield compression

The global real estate pricing cycle is nearing an end. The pace of yield compression in most markets has decelerated further, and room for further manoeuvre is limited due to eroded property premiums.

US and UK more advanced in the investment cycle

Markets that have led the recovery, namely in the US, are seeing an increasingly widespread cap rate expansion. Yet the impact on capital values has been minimal thus far, with rental growth offsetting yield impact. The UK has also seen corrections in pricing. While this is partly Brexit related, it has long been acknowledged that the cycle was at an advanced stage.

Over the next two years limited capital growth will continue to contribute to performance for European, Australian and Japanese markets, which lead our short term forecasts (Figure 129). However, we expect gradual normalisation in yield levels to impact medium-term performance in these markets.

Logistics to outperform other sectors

Our forecast returns for all regions are front-loaded. Logistics have the strongest outlook by sector, given the favourable structural themes underpinning global demand and relatively higher level of yield available.

UNITED STATES

Increasing supply puts pressure on rental growth

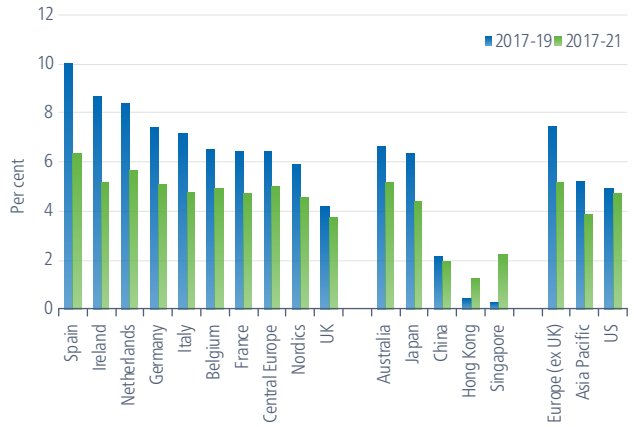
The return of development has been putting downward pressure on rental growth in offices since end-2015, with Q3 2017 seeing just 1.6 per cent of growth (compared to 2.9 per cent in Q4 2016)[1]. Apartment rental growth has also been slowing for some time now and retail has seen a moderation in the last four quarters. Meanwhile, logistics rental growth continues to run at over 6 per cent year-on-year.[2]

The CoStar Price Index for US Metro Areas increased in Q3 by 13.2 per cent y/y for prime industrials, 8.2 per cent for offices, 7.8 per cent for retail and 10.5 per cent for multifamily (Figure 130)[3].

Cap rates are beginning to move out

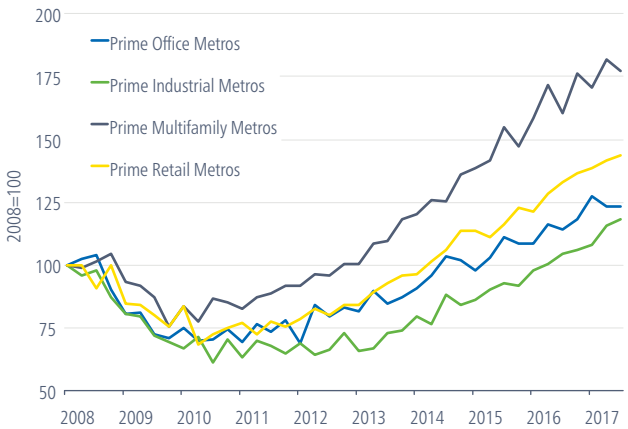
There is some evidence that cap rate compression for this cycle is near the end. CoStar data suggests that while a few markets compressed slightly in the first half of 2017, most markets expanded slightly (Figure 131). As such, the national office cap rate appears to have bottomed out with Q2 2017 registering a third consecutive quarter of stabilization at 5.7 per cent. This figure masks large

Figure 129: All property forecast total returns (pa %)*



Source: Aviva Investors, as at 1 December 2017
*Prime market returns for Asia Pacific and Europe; average market returns for the US

Figure 130: CoStar Price Index for US Metro Areas



Source: CoStar, as at November 2017

variations at the market level. Markets such as Austin or Reno have seen yields expand while Minneapolis further compressed in H1 by around 20 bps.[4]

EUROPE

Prime European office markets continue to see improvements in occupier demand, which coupled with limited development resulted in ongoing declines in vacancy rates. Vacancy in the office sector is now close to the level last seen at the last peak of the cycle (7.9 per cent in Q3 2017 compared to 7.2 per cent in 2008). Solid rental growth continues to be seen across the region (+ 3.1 per cent y/y for all sectors in EU-15 in Q3) (Figure 132)[5].

A healthy occupier market

Although pockets of development continue to emerge, supply pipelines remain sustainable for the region overall. There is a risk that the supply response gathers momentum as the availability of development financing and the economics of office development improve.

Development is sustainable, for now

Investor demand is holding up, with transactional levels in 2016Q4-2017Q3 up by 22.8 per cent compared to the previous four quarters, leading to further sharp yield compression.[6]

We expect one more year of good returns before the market softens as yields bottom out. The spread to the German bund yield is anticipated to return to its long-term average by 2019, halting further yield compression (Figure 133). The current advanced point in the investment cycle means that hardly any markets look attractive on a risk-adjusted basis over the medium term.

Value eroded due to ultra low yields

UK

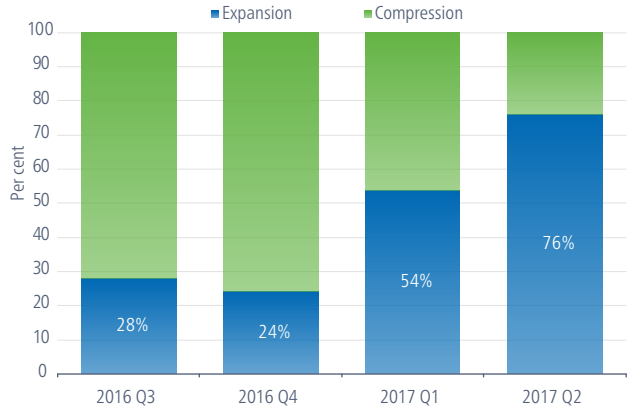
The political and economic risks facing the UK still do not appear to be appropriately reflected in direct real estate valuations. The share of the market that looks appropriately priced for total return mandates has shrunk noticeably over the course of 2017.

No meaningful pricing adjustment

We continue to expect a slowdown in rental growth amid a weak economic growth backdrop, with occupiers delaying decision-making and negotiating hard on any new lettings. The challenge facing weaker parts of the retail sector is particularly acute, while the disconnect between pricing and the outlook for fundamentals is most evident in Central London offices. In this market overseas investors continue to support pricing at the top end, despite evident weakness in the occupational market. A wave of new development completions over the next 18 months looks set to coincide with low levels of occupier demand, with Brexit threatening to compromise financial services firms' access to the European single market.

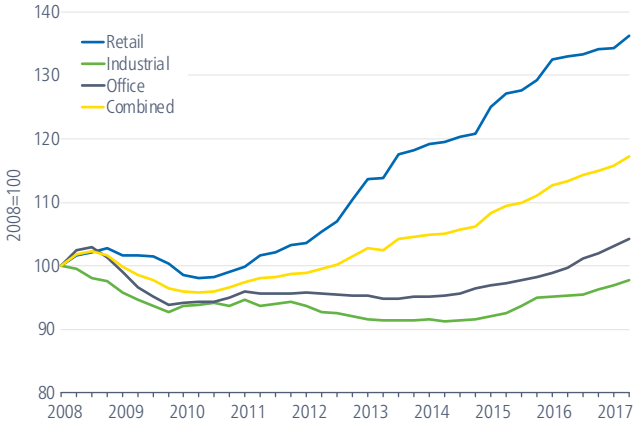
Worsening outlook for rents

Figure 131: QoQ cap rate movement, 54 CoStar office markets



Source: CoStar, as at November 2017

Figure 132: Eurozone Prime Rent Index



Source: CBRE, as at November 2017

The likelihood of a severe correction still appears low, however. This cycle lacks a debt bubble, whilst yield-driven investor demand for real estate looks set to remain robust in the short term in what remains a very low interest rate environment.

ASIA PACIFIC

A mixed occupier picture

The performance of Asia Pacific occupier markets continues to vary. Sydney Central Business District (CBD) and Melbourne offices recorded double-digit y/y growth in net rents for the third consecutive quarter in Q3 while Hong Kong CBD net office rents grew by 6.4 per cent. Elsewhere, rental growth has been muted or negative (Figure 134). Perth offices and Singapore retail saw the sharpest declines in Q3.[7]

Investor demand remains universally solid

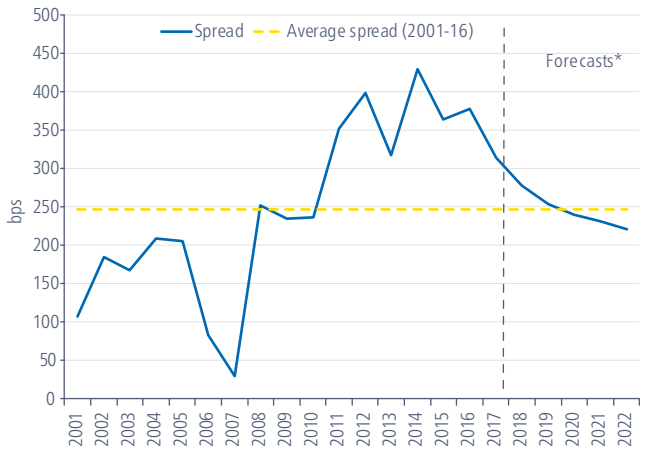
International funds continue to acquire core assets in the region, with direct commercial real estate investment up by 14 per cent y/y in H1 2017[8]. The increase was driven by South Korea and Japan, while activity was stable in Australia, Hong Kong and Singapore. Cross-border investment volumes remained high in H1, accounting for 30 per cent of the total[9]. India, China and Australia have been the most active markets for non-Asia Pacific investors.

Severe correction unlikely

As a result of sustained investor demand yields remained flat or continued to compress, even in markets with weak occupier fundamentals. Gradual monetary tightening is however expected to place upward pressure on yields in due course.

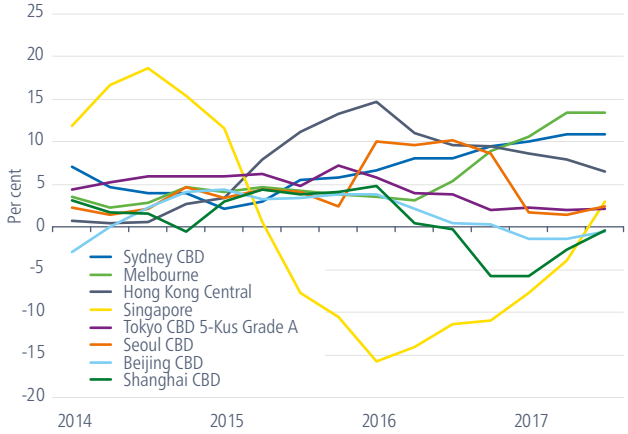
1. CoStar, November 2017
2. CoStar, November 2017
3. Macrobond, CoStar, November 2017
4. CoStar, November 2017
5. CBRE, November 2017
6. CBRE, November 2017
7. JLL, November 2017
8. JLL, November 2017
9. JLL, November 2017

Figure 133: Spread between Europe (ex UK) All Prime Property and 10y German Bund



Source: Aviva Investors, Macrobond, PMA, November 2017

Figure 134: Annual rental growth in Asia Pacific office markets



Sources: JLL as at November 2017

CROSS ASSET VOLATILITY: A SEASON IN PURGATORY

– Realised volatility continues to grind lower but implied is not universally cheap

– Low volatility environments can breed instability; could there be a "Minsky Moment" in 2018?

SUMMARY

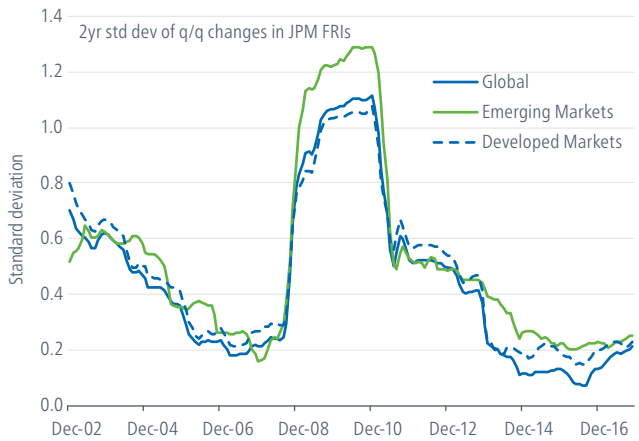
Volatility continues to intrigue and confound both market participants and commentators, drifting lower in both realised and implied space across asset classes. Any spikes tend to be short lived with the asset class exhibiting a mean-reverting character as opposed to the more normal clustering that we have observed in the past. On such occasions, when volatility spiked it tended to stay elevated for some weeks or months leading to the observation that rather than buy low sell high, it was often more profitable with volatility to sell low and buy high. However, for the last year or so the opposite has been the case, with every spike quickly reverting back to the low mean. Whether this has been driven by a "buy the dip" mentality, a hunt for yield or algorithmic trading, it is hard to say, but it is a clear and present characteristic that we observe.

Volatility remains low and is now more likely to mean revert than to cluster which is unusual

In our previous House Views we have noted that economic volatility was low and that in general, during these periods, realised volatility tends also to be low or at least not above average levels. Figure 135 shows that this continues to be the case. However, realised volatility is at well below average levels so there is more going on here than simply low economic volatility. One observation we can make, looking at Figure 136, is that the correlation between stocks is also at extreme lows. This means that on any given day, more often than not, stocks are moving in different directions to each other. For example, in a high correlation world if Vodafone goes up you would be confident that Rio Tinto might also be up on the day. In today's world, it is more likely than not it would instead be down or flat. This dispersion in stock returns on a daily basis mechanically lowers the realised volatility of the index. Low correlation/high dispersion is again a function of a market that is trading more on stock fundamentals than, say, central bank policy and it does therefore fit with our return to fundamentals driving markets theme. However, the absolute level is lower than we would expect and suggests there are additional drivers.

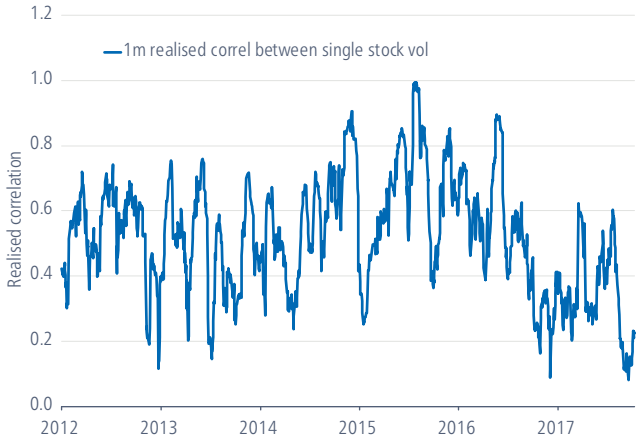
Economic volatility remains low as seen by the variation in economic forecasts, stock correlations are also low but this does not explain current levels

Figure 135: The dispersion of economic forecasts is extremely low which is indicative of low economic volatility



Source: JP Morgan as at 1 December 2017

Figure 136: Realised correlation is at or close to five year lows, leading to low realised index volatility



Source: Soc Gen as at 1 December 2017

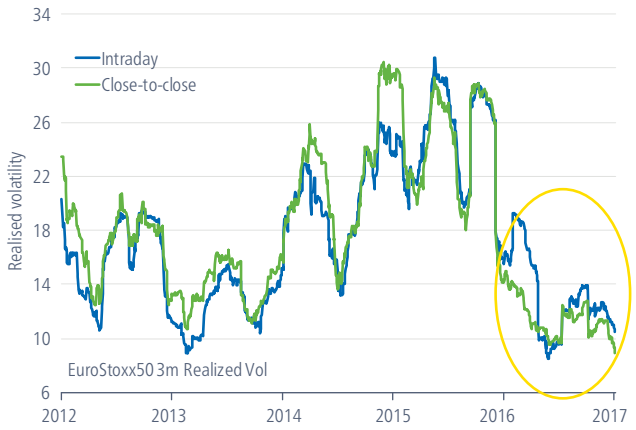
The "hunt for yield" continues to fuel demand for structured products on equities, the hedging of these products could be another driver of the low volatility environment

One of those is the ongoing hunt for yield. With global yields remaining stubbornly low, investors have turned increasingly to structured products and outright short-volatility strategies across equities and rates. Within equities, structured products are moving from index products to single stock or sector underlyings. When a bank sells a product like this to an investor, they are typically left with a long position in volatility, a long position in dividends and a sensitivity that means they tend to sell the stock when it increases in value and buy it back when it falls. This "hedging" further dampens volatility through an outright supply of implied volatility to the market. But in addition this buying and selling in the opposite direction to market moves (which occurs on market close) depresses the close-to-close volatility which is the main measure of realised volatility. It's a relatively recent phenomenon as can be seen from Figure 137. There is a similar effect going on in fixed income markets as some sophisticated funds sell options on interest rates for yield and Asian insurance companies issue bonds (Formosa bonds) that supply long-dated volatility to rates markets and depress the prices of longer-dated options.

Longer-dated volatility is closer to average levels in equity but still very low in FX leading to both risks and opportunities

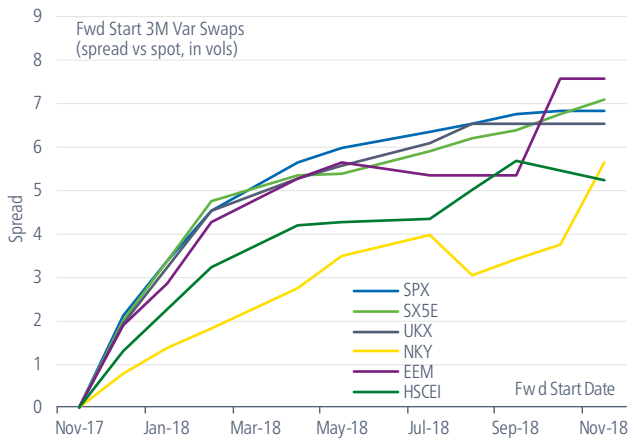
It is important to remember that volatility markets, like interest rate and commodity markets, trade at different time points and therefore have a price curve. The shape of these curves, as seen in Figure 138 and Figure 139, is quite revealing at the moment because while short-dated equity volatility is low, longer-dated volatility is closer to the average level that we would expect. It is interesting that this is not really the case in FX volatility. As seen in Figure 140 this means that for a longer-term investor, buying medium-term equity volatility is actually expensive, as over time and in the absence of shocks it converges to the very low spot volatility. Conversely there are opportunities to buy longer-dated FX options as the curves are very flat here. The shape of the equity curve partially explains the explosion in the growth of short strategies that sell medium-term volatility. The most well known of these is the short VIX strategy which, at its most basic, involves selling a 2-month or 3-month future and earning the roll down between this and the next month and then repeating. Clearly the steeper the curve, the higher the return. The size of these positions and the very low level of spot VIX has the potential to precipitate a volatility event in itself. Essentially, were we to see a large one-day move on the S&P 500 of the order of 3 per cent, a vast amount of VIX futures would need to be bought to rebalance the position. This could lead to a negative feedback loop where short covering sends volatility higher and precipitates more short covering. This has happened in the past on Black Monday in October 1987 when a wave of selling, linked in part to a product called "portfolio insurance", saw the FTSE 100 index fall almost 30 per cent in one day.

Figure 137: Normally volatility measured from close to close is higher than that measured at other time points recently this has changed.



Source: Soc Gen as at 1 December 2017

Figure 138: Equity Volatility curves are very steep with 1yr levels close to 7 points above spot

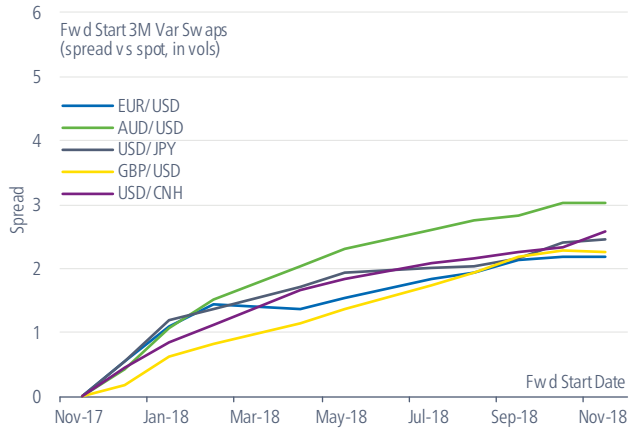


Source: JP Morgan as at 1 December 2017

We should note that this is unlikely today for two reasons. The first is that modern indices all include some forms of circuit breaker which halts all trading after certain levels are breached. This time out is designed to allow the market to return to some form of equilibrium. If enough circuit breakers are hit the market can even shut completely for the day. Secondly, given the very low realised volatility, a one-day move of -3 per cent or less is extremely unlikely as can be seen in Figure 140. However, markets do not always follow statistics and there are signs from the US options markets that some investors are positioning for a collapse in markets by buying short-dated put opens that are struck 10-20 per cent below market levels. These positions represent billions of dollars of potential exposure. They are so significant that the price of protection in US equities now looks expensive relative to the price of options on a rising market. This means that, for every one of these 6-month puts sold, an investor can buy up to 10 call options, which is close to the 99th percentile over the last 10 years. So while low volatility is seen by some as a quagmire or a blanket hanging over the market, it is certainly presenting some interesting opportunities while also holding the potential to be in part its own catalyst in the next market meltdown. A continuing drop off in QE liquidity and a market with some extreme positioning could set the scene for some surprises in 2018. Whether we emerge from purgatory into heaven or hell remains to be seen, but at this point in time it's worth thinking about how to position for both.

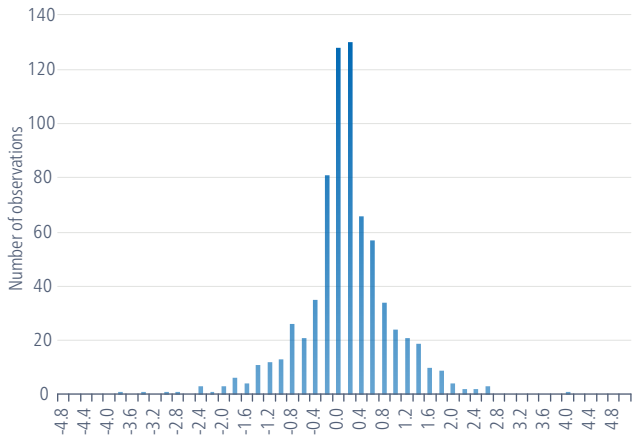
While the risks of a portfolio protection style sell off are low, there are catalysts on the horizon that could see volatility move higher in 2018; equally we can see the drivers of low volatility persist. Investors should consider how to position for both scenarios

Figure 139: FX volatility is on the other hand a lot more consistent as you move out the curve



Source: JP Morgan as at 1 December 2017

Figure 140: The distribution of returns on the S&P 500 over the last 2 years is clustered around -0.5% - + 0.5%



Source: Bloomberg, as at 1 December 2017

NOTES

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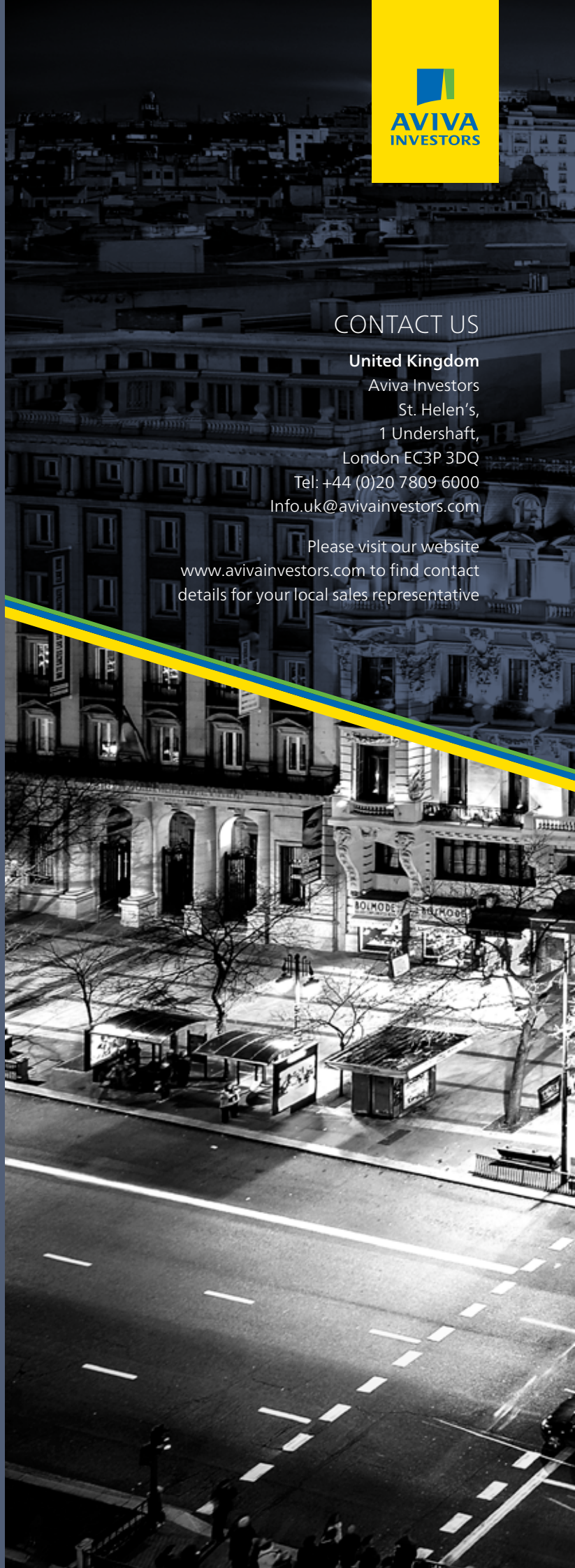

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