House View 2020 Outlook

The intelligence that guides our investment decisions

For today's investor

AVIVA INVESTORS

Contents

House View

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

The document is produced quarterly by our investment professionals and is overseen by the Investment Strategy team. We hold a House View Forum biannually at which the main issues and arguments are introduced, discussed and debated. The process by which the House View is constructed is a collaborative one – everyone will be aware of the main themes and key aspects of the outlook. All team members have the right to challenge and 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

Risks recede – growth on a better trajectory

Having declined for the past 18 months, global growth is expected to reach a low point at the end of 2019, before gradually improving over the course of 2020 (Figure 1). While we do not expect growth to rise above potential through 2020, it does represent a somewhat better growth outlook than we had previously expected. That said, in the history of "mid-cycle" growth recoveries, it would be considered modest. But for asset markets, perhaps more significant than the improvement to the growth outlook is the view that the probability of a severe downturn or recession in 2020 has receded. That reflects a more constructive near-term view on the trade dispute between the United States and China. As we went to print, the text of a "Phase 1" deal between the US and China had been agreed by both sides. That included the US cancelling 15 per cent tariffs on about $150bn of Chinese goods that were due on 15 December and halving the tariff rate to 7.5 per cent on goods worth about $120bn that came into effect in September (while tariff of 25 per cent on around $250bn in Chinese imports remains in place). In exchange, the Chinese also cancelled tariffs that were due to be implemented on 15 December and agreed to substantially increase their imports of US agricultural, energy and other goods and services over the next two years, as well as tighten laws on technology transfer and intellectual property rights.

Global growth expected to recover in 2020, to a little below potential...

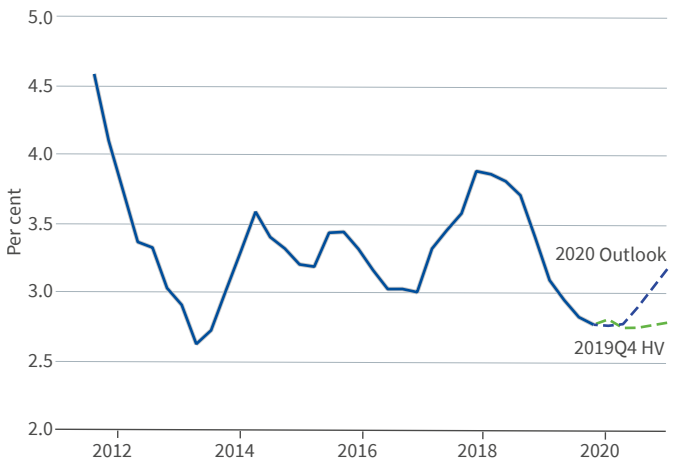
The agreement of a Phase 1 deal marks the first time that tariff rates have been reduced between the two economies since the dispute began in 2018. Should this abatement of the dispute persist, it is expected to improve sentiment globally, reversing the sharp slowing in business investment seen across many major economies. It should also prevent the past weakness in the manufacturing sector (which is very sensitive to developments in international trade) spreading more widely into the much larger services sector. However, as we saw through 2019, any truce in the trade war could prove to be fragile, with the potential for any number of factors related to the geopolitical and economic relationship a potential trigger for re-escalation. Moreover, we continue to expect strategic competition between China and the US will be an important factor in global economic developments for many years to come, irrespective of who occupies the White House.

...with downside risks from the trade war receding...

Alongside the recent de-escalation in trade tensions, 2019 saw a material easing in global financial conditions (Figure 2). With the Federal Reserve cutting interest rates by 75bp since July, and many other developed and emerging market central banks also easing policy, monetary conditions are back to their loosest in several years. Broader financial conditions have eased even more, with the decline in interest rate term premia, tightening in credit spreads and the rally in equity markets. That easing in financial conditions should boost global growth by around ¼-½ percentage point in 2020, offsetting some of the effect of the increase in tariffs

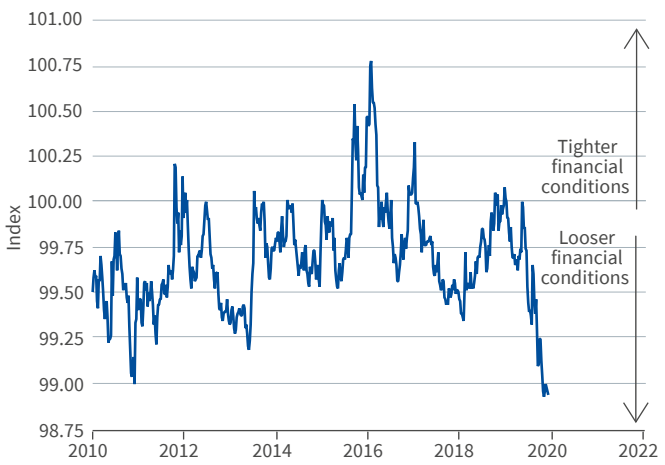
...while the easing in global financial conditions should support growth in 2020.

Figure 1. **Global growth outlook (y/y)**
We expect global growth to improve through 2020



Source: Aviva Investors, Macrobond as at 16 December 2019

Figure 2. **Global financial conditions**
Significant easing in conditions in 2019 will support growth in 2020



Source: Aviva Investors, Bloomberg, Macrobond as at 16 December 2019

during 2019. When taken alongside the smaller negative direct effect of tariffs on growth (given the cancellation of the December 2019 tariffs and the halving of those imposed in September 2019) and the expected improvement in sentiment from a more positive trajectory (talks are already being scheduled to start discussing Phase 2 of the US/China trade deal), we expect growth to pick up to a little below potential by the end of 2020.

Central banks are expected to be on hold in 2020, with an easing bias given muted inflation

With growth expected to remain below potential in 2020, inflationary pressures, which have been muted, should also remain contained. That makes it highly unlikely we will see the major central banks tightening policy during 2020. However, the likelihood there will be a further easing in policy is also limited, particularly for those economies that are close to their effective lower bound. In our central scenario we expect the Federal Reserve and other major central banks will be on hold in 2020, but with growth below potential, inflation below target and the risks remaining tilted to the downside, we expect most will maintain an easing bias. In some jurisdictions, such as Australia and New Zealand, we expect a further reduction in interest rates in 2020.

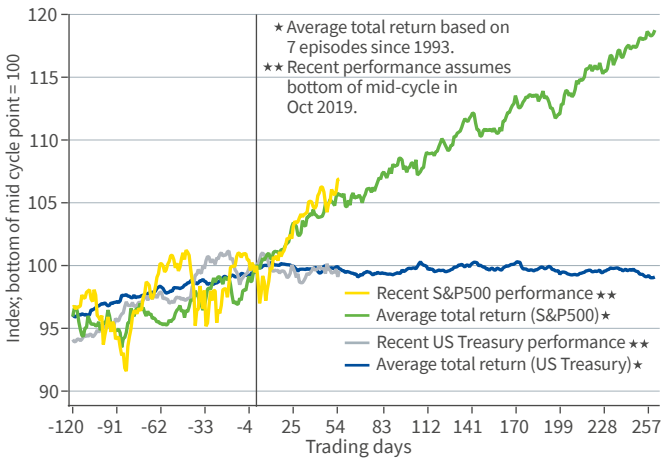
Given the more positive growth outlook, we prefer to be overweight global equities and neutral government bonds

With growth prospects improving and the downside risks from the trade dispute receding, we have a moderately positive outlook for risk assets in 2020. Analysis of mid-cycle recoveries (defined as non-recessionary growth slowdowns that subsequently reversed) since the 1990s shows that, on average, equity markets perform strongly in the growth recovery, while government bonds tend to mark time (Figure 3). That likely reflects the improved corporate earnings and sentiment associated with the better growth outlook, and the fact that central banks have not wanted to immediately choke off such a recovery with higher policy rates. That is similar to the environment that we expect to see in 2020, albeit with a somewhat less rapid improvement in growth compared to the historical average. At the asset class level, we prefer to be overweight global equities and (to a lesser extent) credit, with a broadly neutral view on government bonds (Figure 4).

We think stronger earnings growth, improved investor flows and modest re-rating should see decent equity returns in 2020

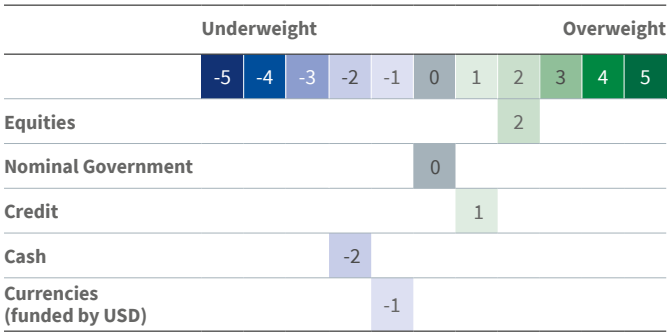
In terms of equity markets, while valuations at the broad country index level are generally around or above their long-run average, we see scope for those to move somewhat higher given the high equity risk premia implied by historically low discount rates. Moreover, equity funds have seen substantial outflows over the course of 2019 (Figure 5), with bond and money market funds seeing significant inflows. Some reversal of this in the early part of 2020, particularly from retail accounts, could be a material catalyst for a move higher in equities. In terms of fundamentals, we do not expect re-rating to do all the heavy lifting in 2020, with earnings growth expected to improve following a very weak 2019. Looking across the major regions we prefer to be overweight Japan, which should benefit from both the recent fiscal package and the fact that it remains one of the cheapest markets in the world. At the more thematic level, we think there are interesting opportunities both in tech and other sectors for businesses that are able

Figure 3. **Equity and bond performance in mid-cycle recoveries**



Source: Aviva Investors, Macrobond as at 16 December 2019

Figure 4. **Asset allocation summary**



Source: Aviva Investors as at 16 December 2019

to effectively incorporate the use of sophisticated data analytics into their business models. The shift to 5G mobile technology is also likely to produce winners and losers, with those that provide the components and services to telecoms companies arguably in a better position to grow revenues during the roll-out and launch of handsets.

We have a broadly neutral asset allocation view on government bonds. With the balance of risks still tilted to the downside, government bonds should remain an important part of a multi-asset portfolio, given their risk-reducing properties. That said, the sharp decline in yields during 2019 makes valuations challenging in many markets. We see US Treasury yields as offering relatively more attractive proposition at this stage, with a German bunds at the other end of the spectrum (Figure 6). We also prefer a slight overweight in Italian BTPs, which remain cheap compared to other European government bonds, and given the reduced near-term domestic and European political risk.

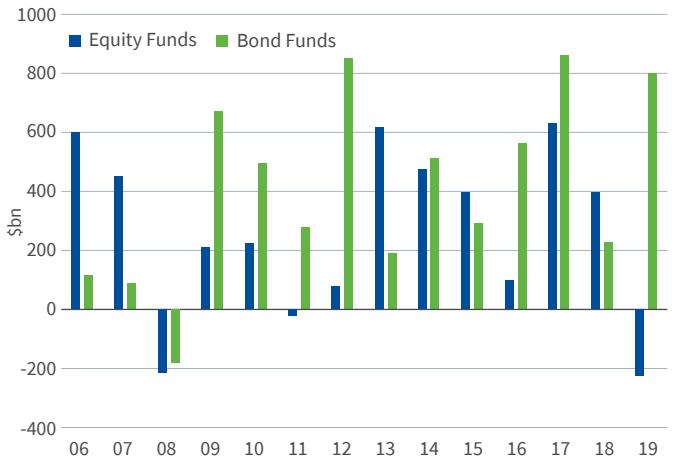
We have a broadly neutral view on government bonds, with a preference for US Treasuries

We have a broadly neutral view of developed market corporate credit, both high yield and investment grade. In both cases spreads are narrow by historical standards, supported by the relatively benign economic backdrop and easy monetary policy. Indeed, with the search for yield driven by negative interest rates in Europe, credit has been a major beneficiary in 2019. However, there has been increased differentiation, particularly in high-yield credit, with poorer credits materially underperforming. If growth improves as we expect, those risks should remain contained, but we do not expect to see much of a tightening in high-yield spreads in 2020. We prefer to be overweight emerging market debt – both hard and local currency. These asset classes are highly influenced by global factors. A more favourable global growth backdrop, alongside accommodative monetary policy in the US, as well as scope to ease policy further at home, should see decent returns in 2020.

We prefer a modest overweight in credit, with a preference for emerging market hard and local currency debt

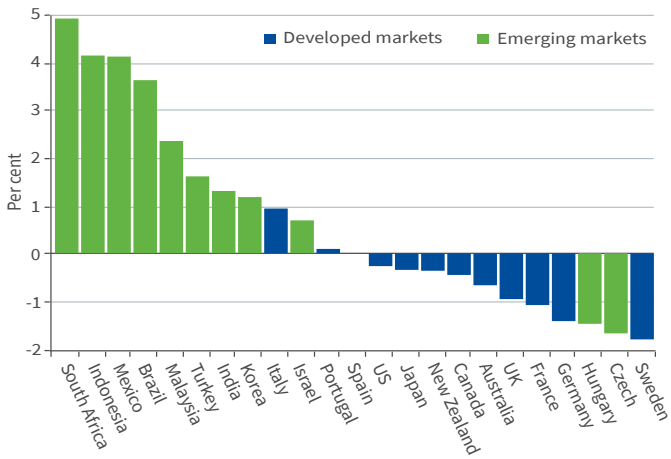
Finally, we prefer to be slightly overweight the US dollar, with a preference for long Japenese yen and short euro and Australian dollar. While the US dollar tends to underperform in an environment of improving global growth – particularly if that results in a narrower growth differential between the US and the rest of the world – we think that the potential for a relapse in geopolitical risks in 2020 favour a slightly more defensive currency allocation.

Figure 5. **Global mutual fund and ETF flows**
Significant equity fund outflows in 2019



Source: ICI, EPFR, EFAMA, Bloomberg, J.P. Morgan as at 16 December 2019. Based on global mutual fund and ETF data.

Figure 6. **Real 10y government bond yields**
Real yields calculated using current CPI inflation



Source: Aviva Investors, Macrobond as at 16 December 2019

Key investment themes and risks

Investment themes

1 Weak but recovering world growth
2 Lower for longer
3 Long-term strategic competition
4 Search for yield
5 US election

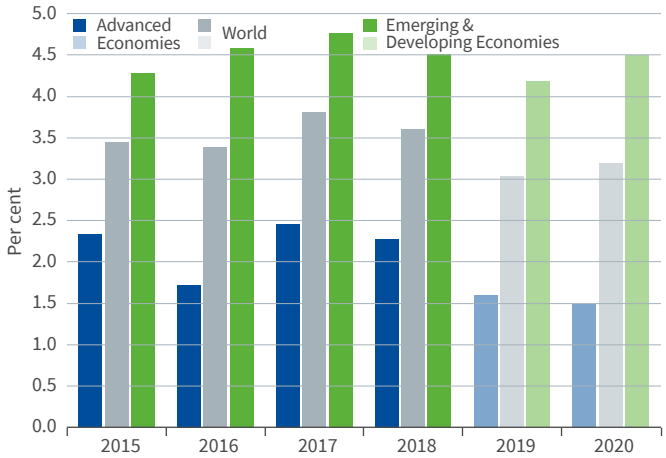
Weak but recovering world growth

1

Global growth has slowed from 4 per cent at the start of 2018 to a below-trend pace of around 2.8 per cent in the year to Q3 2019. China slowdown, previous tightening of monetary policy and a marked intensification of downside risks associated with escalating US-China dispute combined to drive the seemingly relentless downward momentum. As we highlighted three months ago, the risk of a global recession had become the most heightened for a decade. Such concerns remain, but they have moderated appreciably since that time as financial conditions have eased, tentative evidence has emerged that the deep manufacturing downturn may be coming to an end and there have been signs of more constructive developments in the trade dispute. The bottom line is that world growth appears to have stabilised in Q3 and although it is still too soon to signal an early return to above-trend world growth, the immediate outlook is a little brighter. World growth is now expected to increase gently to about 3.25 per cent by the end of 2020 (Figure 7), providing that trade tensions do not deteriorate again or evolve into a more damaging geo-political battle (see below). Neither can be ruled out, especially in a US election year.

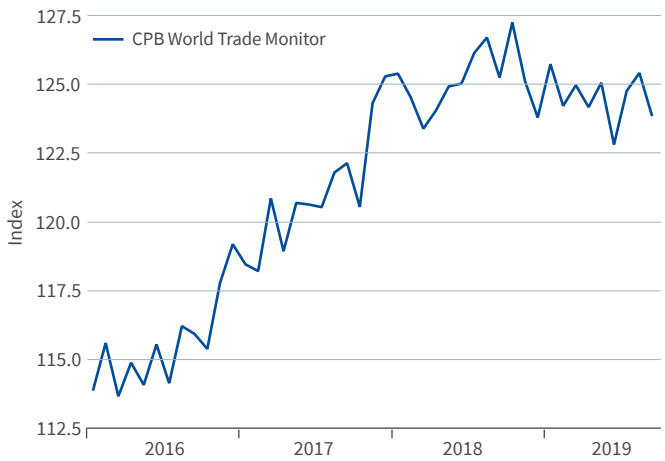
The stagnation in world trade flows only really became apparent about a year ago, but it has become more established since and shows no clear sign of recovery yet (Figure 8). Export order books around the world may have stopped weakening in several countries, but they have not yet revived sufficiently to argue for a marked increase in global trade. It is to be hoped that the combination of looser policy, a more enlightened approach to freer trade and a modest cyclical upswing in the industrial sector will lead to further improvements in 2020 and beyond. One of the more encouraging features of 2019 has been the very limited extent to which manufacturing and export weakness was transmitted to the more domestically-focussed service sectors around the world. Business investment, for example, has weakened rather than collapsed and labour markets remained robust. If the worst is really over for manufacturing, the point of greatest risk for such a transmission may have passed. Overall, the prospect is for a very modest recovery in global growth, with risks now slightly more balanced than three months ago.

Figure 7. **World GDP growth**
Growth picking up gently in 2020



Source: Aviva Investors, IMF, Macrobond as at 16 December 2019

Figure 8. **World trade volumes**
World trade flows have stagnated



Source: Aviva Investors, Macrobond as at 16 December 2019

Lower for longer

2

Global central banks reduced policy interest rates to unprecedentedly low levels in the wake of the Global Financial Crisis (GFC) and to below zero in many regions. They also embarked on a range of other unconventional monetary policy initiatives, many of which continue today. Interest rates across the maturity curve have fallen to historic lows in response. Central banks had signalled many times that, when the time eventually comes to tighten monetary policy once more, to use the Bank of England's apposite language, any future interest rate increases would be "to a limited extent and at a gradual pace". There is a temptation in much financial market commentary to assume that things mean-revert. In the case of policy interest rates around the world this means that there can be a tendency to assume that rate cuts in a downswing have to be fully reversed in the subsequent upswing. Following that rule-of-thumb over the last thirty years would have meant getting policy rate projections consistently wrong. In fact, peaks have got successively lower (Figure 9).

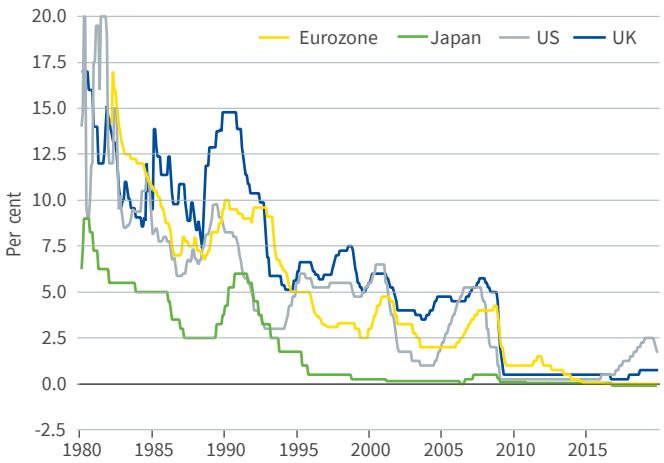
Estimates vary, but there is little doubt that neutral interest rates today are significantly lower than they have been in even the quite recent past (Figure 10). The recent US hiking cycle is a case in point, with the Federal Reserve having to raise their policy rate to a much lower level than previous cycles in order to achieve their goals. And in response to changing circumstances they have moved rates lower again in swift order. The ECB didn't even get as far as a first hike, before restarting asset purchases once more (and cutting rates further) as economic conditions deteriorated. The bottom line is that a "lower-for-longer" environment for interest rates is likely to persist for a number of years. In the present situation, the effective absence of inflation pressures alongside modest growth prospects at best, means that central banks are set to stay in accommodative mode for some time with a loosening bias, even if there is limited scope for additional stimulus. The next tightening cycle looks a while off.

Long-term strategic competition

3

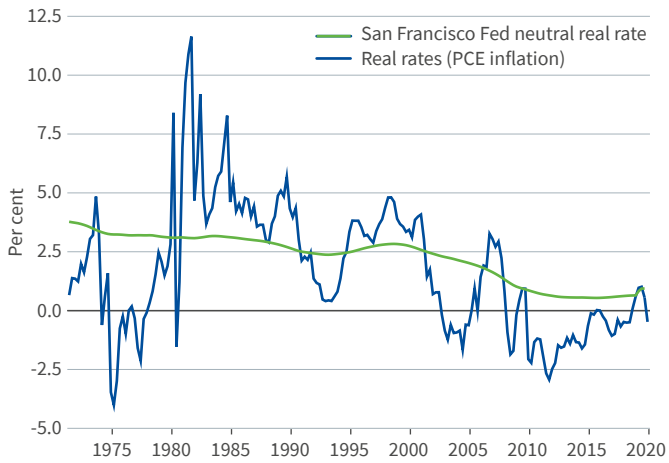
There have always been – and will always be – battles for supremacy between global superpowers in a variety of fields. One of the things that makes the current spat between the US and China special is the impulsive and capricious nature of those in power. On the one hand are Chinese leaders who are used to all-powerful state ownership as well as total control and deference; on the other is the combustible, populist and single-minded Mr Trump. There are a host of genuine grievances that can be levied against China in terms of unfair trading practices and intellectual property theft. The "normal" diplomatic channels for resolving such issues move far too slowly for the Trump administration and China has no qualms about playing the system, all too aware of its current and future position of importance on the world stage. The result was first a stalemate but then an eruption of conflict, starting in February last year with "global safeguard tariffs" on solar panels and washing machines, but swiftly escalating to tariffs on up to $550bn of Chinese goods and $185bn of US goods (Figure 11).

Figure 9. **Policy interest rates in the G4**
Policy rate peaks lower



Source: Aviva Investors, Macrobond as at 16 December 2019

Figure 10. **Neutral and actual real rates**
Equilibrium rate lower than in the past



Source: Aviva Investors, Macrobond as at 16 December 2019

The worst of the trade war could be over (although even that is not certain), and the recent "Phase 1" agreement reached between the US and China, along with the reduction of some existing tariff rates and postponement of others, points to the possibility of more constructive developments in 2020.

But while that may be enough to lift the mood, dilute the conflict and lead to a resumption of world trade growth, sparring between China and the US (and perhaps others) is almost certain to impact the global macro-economy and frame the investment backdrop for years to come. The US and the Soviet Union endured many decades of cold war regarding nuclear weapons but found an uncomfortable and occasionally precarious equilibrium. Billions were spent, but outright, lethal conflict was avoided. It is naïve to believe that US and China differences in areas such as trade, technology and international relations can be quickly resolved. But it is not unreasonable to think that some agreements can be reached over time and that pathways towards more harmonious trading arrangements and the greater inclusion of China in free market commerce can be sketched out. There are, however, many who do not share that ideal, believing instead in a more inward-looking future. Whatever happens, long-term strategic competition between China and the US will be here for a while.

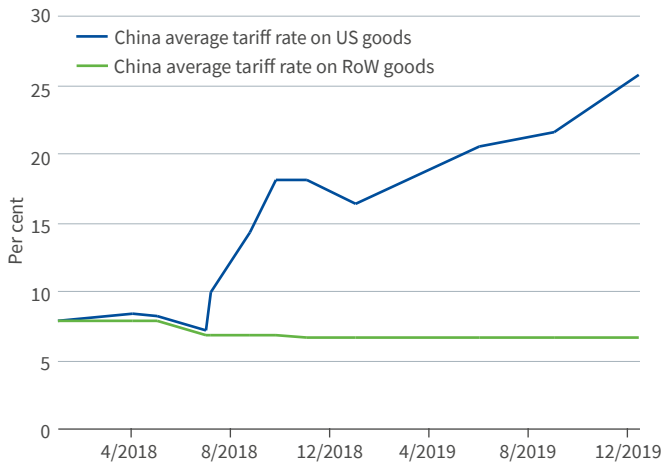
Search for yield

4

The influential Barclays Equity Gilt study compiles a history of real (and nominal) investment returns for different assets over the last century or more. Over the last 30 years – the period over which inflation has been tamed, more or less, at around 2 per cent – the average annual real return on equities has been 5.0 per cent. The equivalent for sovereign fixed income has been a little lower, at 4.5 per cent, while the average investment return on cash has been just 0.5 per cent (Figure 12). These numbers refer to UK financial assets, but virtually all longer-term studies for developed markets come up with similar figures. If investors have got used to, or rely on, these sorts of returns, or if they at least aspire to earn something like them, then the low level of yields that prevails today implies that there will be problems in the future. As yields have pushed lower in recent years, especially in the post-GFC period, generating an "adequate" income return has pushed many investors into a range of new and more exotic asset classes in a relentless hunt for yield. The capital gain implied by trend declines in yields has helped boost returns but that obviously cannot go on forever.

In a similar vein, the ever-lower level of interest rates has encouraged many economic agents – households, companies, financial institutions and governments – to take on much higher levels of debt (Figure 13). While it makes sense to take advantage of the low cost of borrowing where appropriate, there are concerns that the level of risk-taking among borrowers (or at least those in some regions or sectors) has been excessive. Such fears may not be realised until or unless interest rates eventually start to rise again, or until the economic backdrop becomes less favourable.

Figure 11. **China average tariff rates**



Source: Peterson Institute for International Economics as at 16 December 2019

Figure 12. **Financial asset returns over the longer term**

Real Investment returns, average p.a	UK equities	US equities	UK gilt	US T bond	UK cash	US cash
10 Years	5.8	10.4	2.7	2.0	-2.5	-1.5
20 Years	2.0	3.6	2.5	3.8	-0.1	-0.4
30 Years	3.9	7.0	4.6	5.2	0.4	0.8
50 Years	4.7	5.3	3.2	3.7	1.1	0.5
90 Years	4.9	6.5	1.3	2.5	0.7	0.4
2019 (est)	12.0	25.4	5.5	5.4	-1.2	-0.5
Current nominal yield	5.0	1.9	0.8	1.8	0.75	1.75

Source: Aviva Investors, Barclays, Bloomberg as at 16 December 2019

The bottom line is that the behaviours of both borrowers and savers are being acutely influenced by the low level of rates/yields today. Since there is no immediate likelihood of those rates moving significantly higher in the immediate future – a direct consequence of our first two themes – there is no reason to expect those behaviours to change soon. Some borrowers may take on too much debt and some investors may take on too many risks as they hunt for higher yields. Identifying such potential weak spots in advance will not be easy.

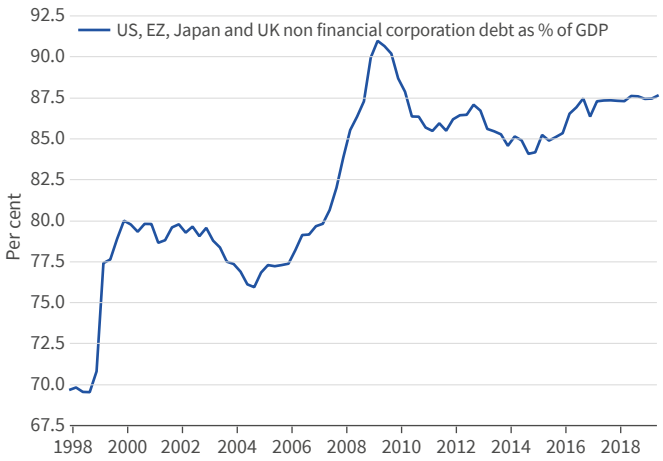
US election

5

US elections are protracted affairs so although the event itself does not take place until November 2020, the process will influence financial markets in the short term and economic prospects over a longer horizon. Those impacts will grow gradually over the year, starting from the primaries in February and March before building to the Democratic and Republican conventions in July and August and the election itself. Much of the focus will inevitably be on whether Trump can win a second term, but there is a lot more at stake: the Democrats will defend their majority in the House of Representatives (lower house) while attempting to take control of the Senate (upper house) where 34 of the 100 seats are up for election. At this stage Trump does not even know who his opponent will be (Figure 14), although that is not unusual this early in the process – four years ago he was a rank outsider for the Republican nomination. But the national (and international) mood will ebb and flow in response to polling trends and their perceived implications.

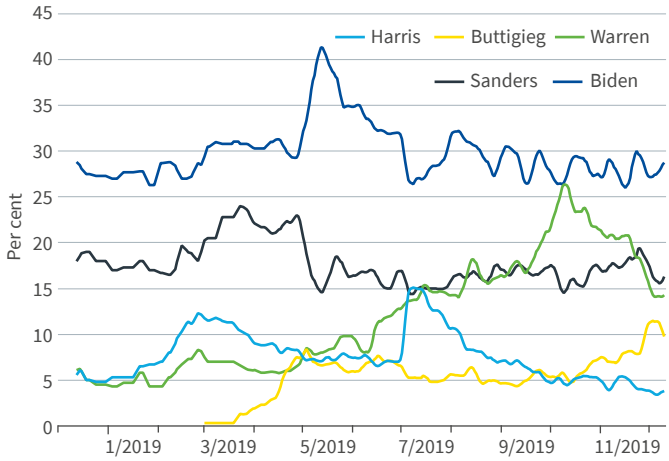
The Republican party is often considered to be the more (equity) market-friendly choice and Trump himself will be quick to point out the nearly 50 per cent rise in the US stock market over the last three years. Among the main Democratic contenders presently (this can change), the general perception is that there are two "progressive" candidates – Warren and Sanders and two "moderates" - Biden and Buttigieg. The nomenclature essentially intimates that the former have a bolder, more reformist agenda including higher taxes on the wealthy and greater regulation of big business, while the latter are considered to have a more restrained and conventional left-of-centre policy outlook. Sentiment in financial markets over the next twelve months will be influenced by which candidate looks most likely to take on Trump and by the perception of their chance of beating him. Currently the odds are slightly in favour of a Democratic win, but it is close, and it is very early days. Political events are a distracting sideshow in many regards, but it would be negligent not to consider this one as a potential driver of markets in 2020.

Figure 13. **Debt levels still high in some areas**



Source: Aviva Investors, Macrobond as at 16 December 2019

Figure 14. **Who will take on Trump?**
Democratic presidential nomination odds



Source: Aviva Investors, Realclear Politics, Macrobond as at 16 December 2019

Risks to the house view

De-globalisation accelerates

Further escalation cannot be ruled out

The highpoint for the globalisation trend that characterised much of the 1980s, 90s and 2000s is probably behind us (Figure 15), but it is widely hoped that the current stagnation of world trade is temporary, and that growth will resume during the course of 2020. But it is also plausible that the ongoing trade dispute reflects wider issues related to more insular attitudes towards free trade and openness between competing economies. The risk of a deepening and widening of trade tensions impacting many more nations including those of the trade-dependent Eurozone is very real. A ratcheting up of more narrow-minded protectionist attitudes could lead to a more permanent inertia in international trade flows as established global supply chains weaken or are replaced.

China policy glitch

China wobbles or policy stumbles should not be ruled out

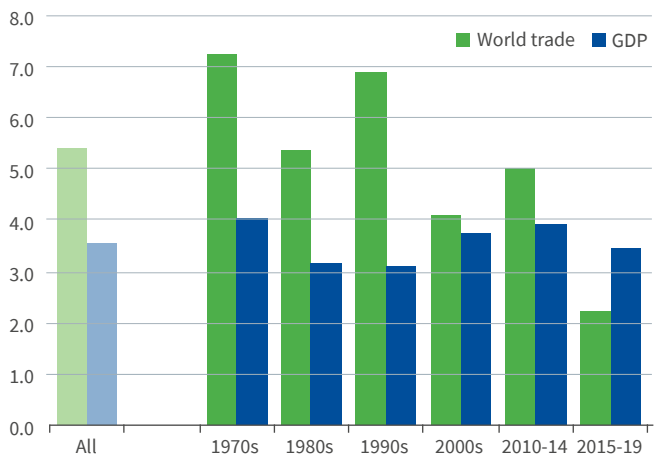
In response to its own economic issues and to the impact of global ones, China has invoked a range of policy stimulus measures. The majority of these have been domestically-focussed. Any knock-on effects to the wider global economy should therefore be limited. China's almost total control over most aspects of its system should give it a greater chance of success. Nevertheless, there is still a risk that policy initiatives do not succeed fully. China has plenty of ammunition at its disposal but is still learning how to use its policy weaponry effectively. It is rare that emerging economies transition without shocks along the way. The wobbles in 2015/16 were the most recent example (Figure 16). Although dealt with effectively in the end, there were significant global consequences at the time.

Liquidity challenges

Market liquidity still a major challenge in some areas

One of the unintended consequences of the GFC and its aftermath has been a marked reduction in liquidity in key markets. As a result of the imposition of a range of regulatory measures and restrictions, the coverage and depth of market-making has been compromised and diminished, adversely impacting the smooth functioning of such markets and leading to regular episodes of damaging illiquidity that can distort prices significantly. The authorities that have introduced such changes have done so with the laudable aim of preventing the more questionable activities that some financial institutions had indulged in. These contributed to the instability which characterised the GFC and led to, amongst other things, the collapse of Lehman Brothers and the freezing of key markets. There are risks that more markets could be adversely affected as regulations are imposed and as agents comply.

Figure 15. **Annual growth of world trade and world GDP**



Source: FactSet, CPB, OECD as at 16 December 2019

Figure 16. **Any China setback would impact elsewhere**

Source: Aviva Investors, Macrobond as at 16 December 2019

Brexit and European politics

The surprising UK election result and scale of the Conservative victory will determine Britain's direction of travel in 2020. It now seems inevitable that the UK will leave the EU at the end of January. But the risk of a hard exit has not disappeared. If the exact terms of future trading relationships cannot be finalised during 2020 (highly likely in our view), then an extension would seem to be the most sensible course of action. But in a painful repeat of the games of brinkmanship over the last three years it is possible that a cliff-edge exit on WTO terms could still happen at the end of 2020. More generally, Brexit is just the clearest example of the thrust of populism and discordant politics that has emerged in recent years (Figure 17). European discontent has lessened recently but could easily re-erupt: resistance to Macron's reforms, political change in Germany and renewed budgetary games in Italy are all genuine concerns.

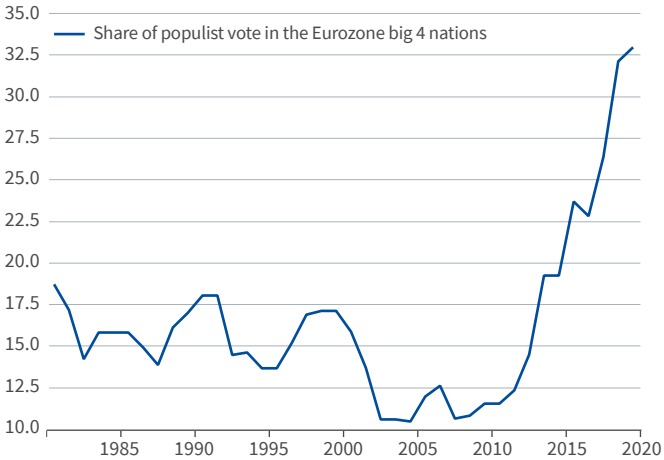
The politics of populism are having a significant impact

Fiscal activism

Public finances around the developed world spiralled out of control in the aftermath of the Global Financial Crisis (GFC). Deficits soared wider in 2009 and 2010 and public debts rose as percentage of GDP for many more years after that. After many years of fiscal retrenchment (austerity to some), Government budgetary positions are now in much better health. This development has led to demands for ambitious fiscal expansion packages to be implemented, with bold public investment programmes to take advantage of exceptionally low borrowing costs. While there is some merit in this line of reasoning, public deficits persist in most countries. So far, fiscal stimulus packages have been modest (Figure 18) but slightly growth-positive. (The US was an exception on modesty.) There is a risk that they become more explicitly expansionary, which could have potentially adverse effects on longer-term public finance sustainability.

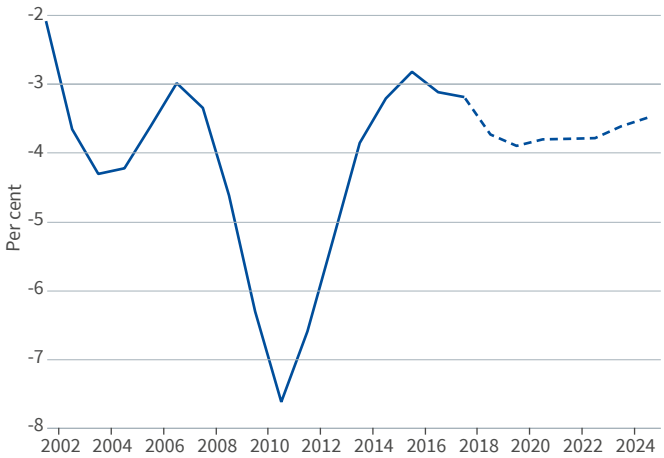
Calls for more ambitious fiscal projects are rising

Figure 17. **No sign yet of decline in populism**



Source: Aviva Investors, Macrobond as at 16 December 2019

Figure 18. **Planned fiscal expansions are modest**
G7 structural budget balance, per cent GDP and IMF forecasts



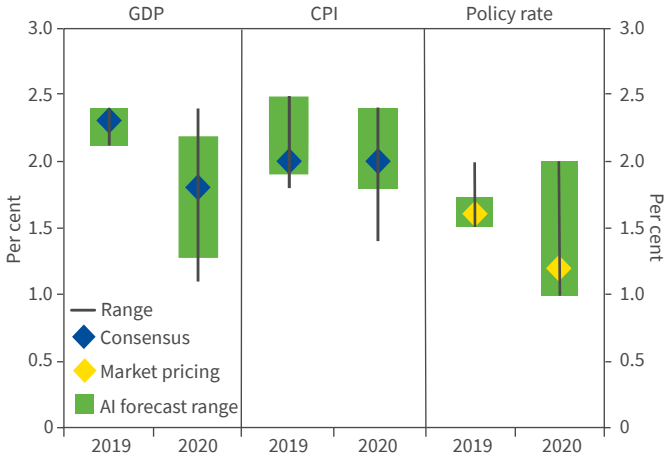
Source: Aviva Investors, Macrobond as at 16 December 2019

Macro forecasts charts and commentary

US

US growth is expected to moderate further in 2020, to around the long-run potential. That further slowing reflects the ongoing direct and indirect impact of tariffs imposed in the second half of 2019. The consumer remains relatively healthy, with robust balance sheet and favourable income prospects. Business investment is more challenged, however, given the trade uncertainty. While the announcement of a Phase 1 deal with China should ease concerns somewhat, risks remain tilted to the downside. With growth expected to be around potential, there should be limited upward pressure on core inflation. We expect the Federal Reserve to be on hold in 2020, but with a bias to further easing.

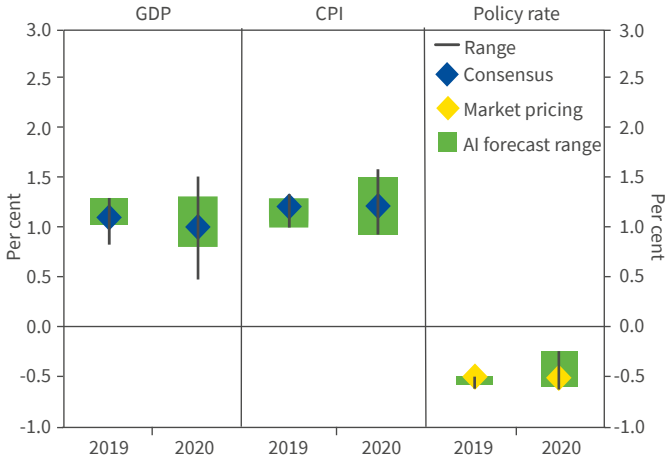
Figure 19. **US**



Eurozone

Eurozone growth has continued to disappoint in 2019, but at least it has remained positive. It is hoped that Q3 will prove the low point (+0.1 per cent q/q) and that GDP will revive gently in 2020 back towards the trend pace of between 1 and 1.5 per cent annualised. But that would probably require further positive progress on resolution (or at least reduction) of the trade dispute and a revival in world trade growth. The Eurozone nations – especially some of them – depend heavily on exports. Having said that, it is worthwhile noting that domestic demand across Europe continues to be resilient. On current trends, if trade simply stopped being a drag, growth overall would recover satisfactorily. With inflation still stuck at 1 per cent or so, and business sentiment still fragile, the current growth dynamic justifies the relaxed policy stance being adopted by the ECB.

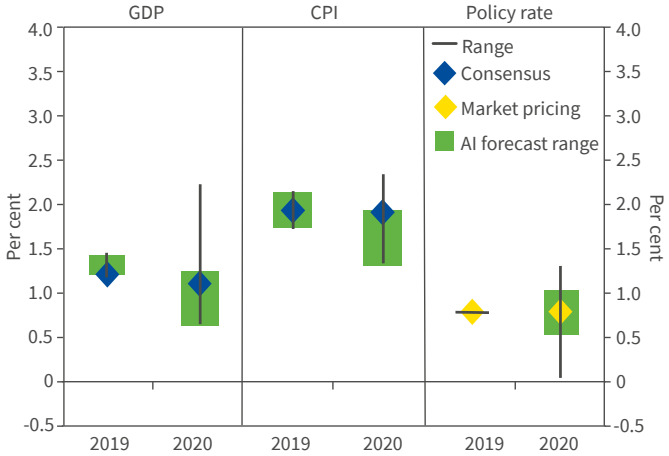
Figure 20. **Eurozone**



UK

Brexit continues to dominate all aspects of the UK's economic outlook. The decisive election result in favour of the Conservatives should clear a pathway to an exit from the EU at the end of January 2020 but will not remove all uncertainties. The spectre of another "cliff-edge" at the end of 2020 still hangs over Britain, as it seems unlikely that all of the details of the future trading relationship between the UK and the EU can be finalised quickly. An extension would be the logical next step but may be politically difficult. Meanwhile, growth in the UK remains weak and sentiment subdued. Risks are skewed to the downside and with inflation low and set to fall further, the Bank of England is unlikely to hike for some time. A post-election fiscal boost is probable but will not change the underlying picture much.

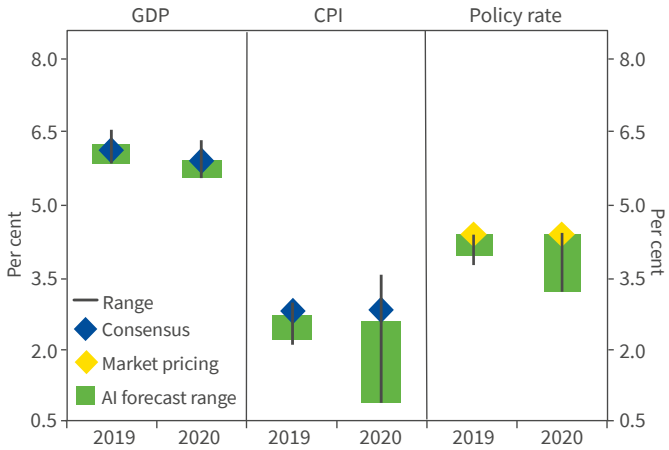
Figure 21. **UK**



China

A phase 1 trade deal with the US will avoid further damage, but existing tariffs will still require continued policy stimulus to put a floor under GDP growth. We expect total output to grow by less than 6 per cent in 2020, as existing leverage and debt concerns weigh on the corporate sector. CPI is elevated, with the Year of the Pig seeing pork prices lift inflation to nearly 5 per cent, but this should reverse during the new zodiac cycle: the year of the Rat should see gradual rate cuts and some CNY weakness on continued friction on the security, human rights, and technology fronts. The rest-of-the-world will benefit less than before from Chinese growth, as the state-directed economy focuses more on the domestic side and pursues import-substitution strategies.

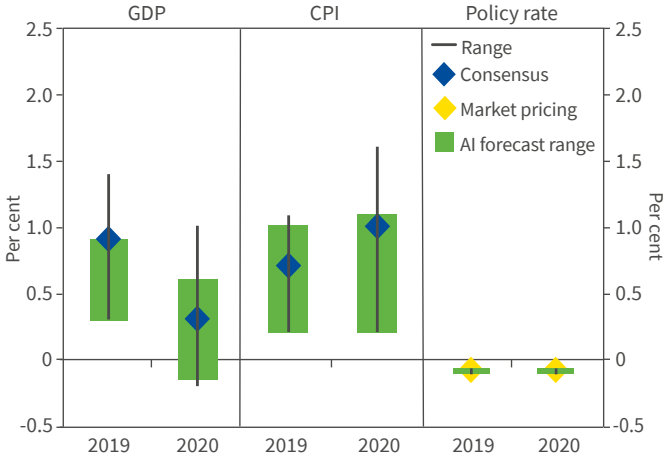
Figure 22. **China**



Japan

Export-sensitive Japan has been affected negatively by the global slowdown and negative trade growth. Q4 will look terrible after the consumption tax hike and October's damaging typhoon, but its impact should fade, and the government has added a slew of offsetting measures that should lift growth again, particularly around mid-2020, when the Tokyo Olympics will also boost tourism and consumption. However, even with a stabilising external sector, Japan's potential growth is limited by a declining population and productivity gains, while the BoJ is reluctant to use more firepower. Prices will be lifted by the tax, but both inflation and real incomes will benefit from free childcare – which can also help female participation and productivity. The recently unveiled fiscal package looks huge, but actual fiscal spending and investment is only a third of the headline number, and will be spread over four years.

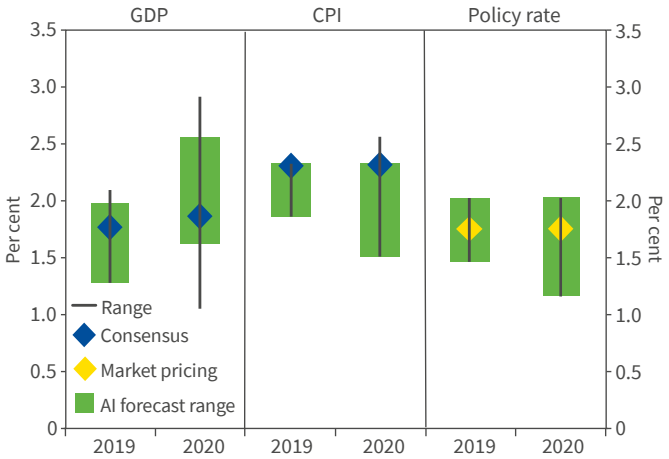
Figure 23. **Japan**



Canada

Growth continues to slow in line with expectations with the sharper contraction in Q3 2019 predominantly driven by a fall in net trade. Looking forward to 2020, growth is expected to remain near potential, however the outlook remains significantly tied to the broader trend in global growth and trade. Consumer spending continues to be the main contributor to growth, supported by a tight labour market and subsequent strong wage growth. A soft landing in the housing market is needed to support the economy, however the Bank of Canada (BoC) will be wary that this needs to be balanced against risks from high levels of household debt. Debt dynamics make the economy more sensitive to changes in policy, thus constraining the BoC desire to move rates. With inflation well anchored near 2% the BoC is likely to remain on hold and focus more on growth when making policy decisions. Given risks to the outlook remain on the downside, if monetary policy is to change the balance of probabilities are tilted towards cuts.

Figure 24. **Canada**



Global market outlook and asset allocation

- **Improving growth momentum and earnings lead us to prefer an overweight position in global equities**
- **We prefer to be broadly neutral on government bonds as central banks are likely on hold and term premia compressed**
- **We prefer to be slightly overweight credit, but a preference for emerging market debt**

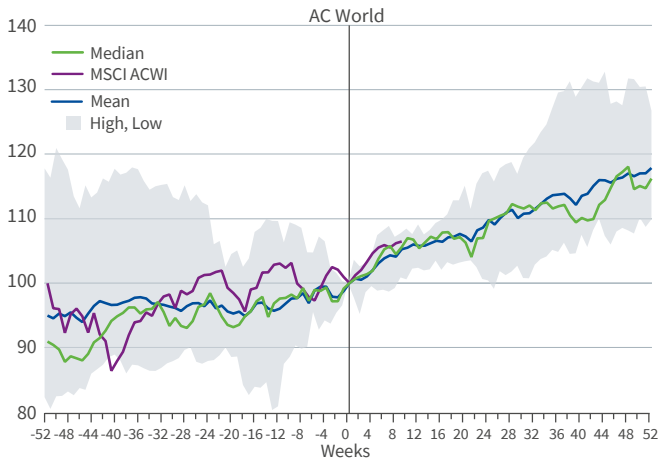
Overweight equities as global growth stabilizes, and recession fears abate

The year 2019 turned out to be one of a soft landing, thanks to the Federal Reserve's pivot in December 2018, its subsequent cumulative 75bps easing in the policy rate and central banks globally following with easier monetary policy. Whilst global economic growth continued to slow throughout the year, ahead-of-the-curve monetary easing led not only to lower discount rates, allowing for valuations to expand, but also mitigated the steepness of the growth slowdown and re-directed markets to focus on the subsequent stabilization and inflection of economic growth. Such mid-cycle inflection points have historically posed a very supportive backdrop for risky assets, leading to median MSCI AC World returns of approximately 15 per cent in the subsequent 12 months (Figure 25). The prospect of no further slowing in economic growth, together with a temporary de-escalation in the trade war between the US and China, allows market participants to price out what had been higher chances for a global recession than in any given year. Probability-weighted outcomes between a central and the downside scenario have shifted upwards, leading us to start the new year with a decisive pro-risk allocation.

Expect 2020 returns to be driven more evenly by valuations and earnings growth

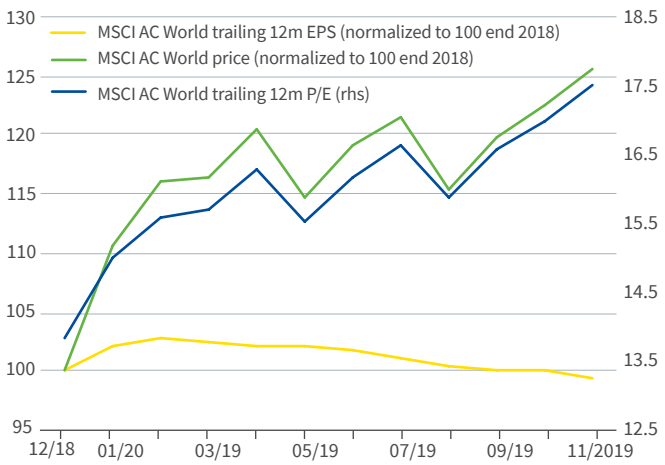
Whilst 2019 has been a year of valuation expansion rather than fundamental support to equities (Figure 26), we think 2020 is likely going to be a year of returns more evenly driven by fundamentals and expectations. For equities, that means we expect annual earnings growth, which had been roughly flat in year-on-year terms in 2019, to return into positive territory. As valuation proves to be a credible anchor for equity returns only over a very long time period, we think a further expansion amid lessening global risks and the hoped for pick up in growth materializing, could lead to additional multiple expansion in 2020; that is despite the current 12m trailing P/E of global equities already trading beyond their 10-year average. Over shorter-term horizons, we regard the strength of trend-following in markets themselves as a useful indicator for future prices, whereby the development of a meaningful trend is considered worth following, even if a rally/ sell-off might have taken current valuations above/ below historical averages. In this context, we view the current momentum in equity markets, as well as in the underlying macroeconomic data as strong enough to retain our overweight in equities.

Figure 25. **Distribution of returns in past mid-cycle recoveries**



Source: Bloomberg, Macrobond as at 16 December 2019

Figure 26. **Valuation expansion to drive equity returns rather than earnings growth**



Source: Aviva Investors, Macrobond as at 16 December 2019

Our tilt towards an increased pro-risk stance comes both from a larger allocation to equities and a reduction in our duration exposure.

The move in developed market bond yields has been broad-based and significant since the beginning of 2019, making the risk-return trade-off of holding the asset class less attractive.

The risk/return trade-off in being overweight government bonds has deteriorated

While rates have risen somewhat in Q4, most remain well below their end 2018 levels. In G10, only Norway and Sweden have seen front end rates rise versus the start of the year, whereas at the 10y point rates across all major regions have fallen and remain near the bottom of their long-term ranges. (Figure 27). With rates near historic lows, monetary policy in many G10 economies approaching the lower bound, and the worst of the economic slowdown behind us, the ability to see a comparable rally in 2020 is limited. That said, with many of the major central banks maintaining a more dovish bias and the growth pickup remaining moderate, rates are unlikely to move significantly higher either.

Yields pinned by central banks beings on hold

With front end rates pinned by monetary policy, we view the long end of the curve as the part that offers more protection, if downside risks were to materialize. Across regions, longer dated bonds in the US offer the most scope for compression. This is particularly stark versus the German 30y where the spread to the US 30y is near all-time highs (Figure 28).

Although probability-weighted risks to the outlook have shifted upwards, overall risks to the global economy remain to the downside. With this in mind, many investors will question to what extent duration positions can continue to be an effective risk hedge in 2020. Looking at the rolling correlation between global equities and US 10y rates versus the US manufacturing ISM, there does appear to be a cyclical relationship in the effectiveness of duration as a hedge to equities (Figure 29). This cyclical relationship suggests that, were we to see a further drawdown in global growth, the positive correlation between US 10y rates and global equities should strengthen.

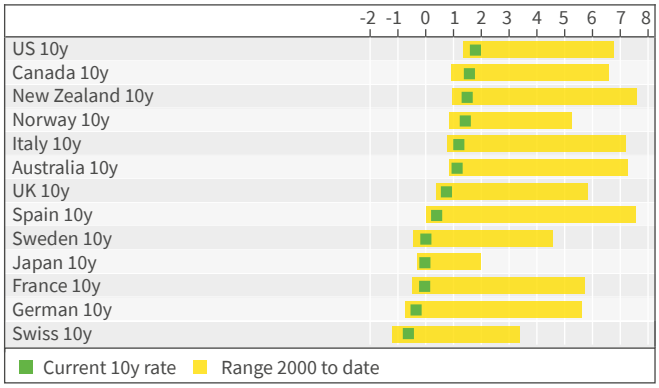
Portfolio protection remains essential in a world where the risks continue to be tilted to the downside

To balance protection to downside risks against our more favourable base case for the global economy we favour real rates over nominal. Particularly in the US, market pricing of inflation expectations look low in our opinion.

Taking these changes among asset classes on a headline level together, we are starting 2020 with a risk-on allocation, that is tilted towards equities rather than credit.

That said, we are shy of running the same level of risk we did throughout the early stages of 2019 owed to two main reasons: valuations reflect part of our envisioned inflection in global growth and secondly, we view the trade conflict among the US and China as unresolved despite the "Phase 1" deal and as being prone to setbacks. We are further well aware of the risks associated with the US presidential election towards the end of 2020, which, depending on the Democratic frontrunner and the final make-up of House and Senate, could pose a

Figure 27. **Current 10-year rates vs historic range**



Source: Aviva Investors, Macrobond as at 16 December 2019

Figure 28. **Yield differential between US and German 30y government bonds**

Source: Aviva Investors, Macrobond as at 16 December 2019

challenge for US equities in particular – largely owed to a threatened roll-back of the 2017 corporate tax cuts, increased tech and banking regulations, the potential for buyback taxation, an overhaul of the US health care system etc.

Bottoming global growth leads us to prefer more cyclical/value-oriented equity regions

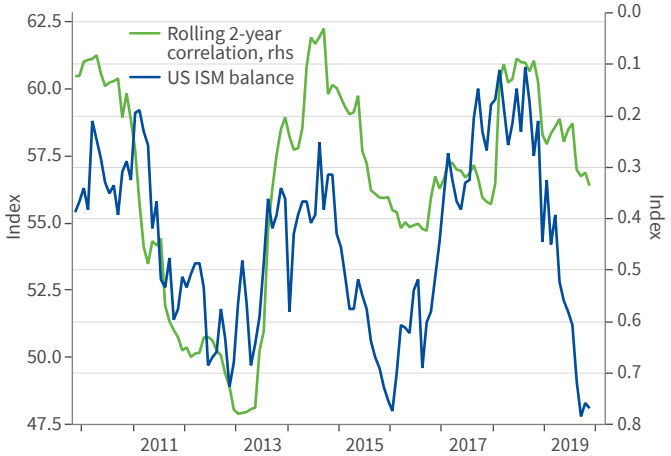
In terms of regional equity allocation, we favour Japanese equities, based on the premise that Japanese earnings growth, which comes off a very low base, is likely to refrain from falling further behind global EPS. Mitigating global recession fears, the closer we come to an inflection in growth and potential ceasefire in the US-China trade war, may further lead to a rotation out of bond proxies and to a re-coupling of Japanese equities to current USDJPY levels (Figure 30). Furthermore, Japanese equities enjoy a substantial discount relative to US equities, which should provide upside if positive catalysts materialize.

In government bond space, we retain our preference of the US over Germany and also prefer an overweight in Italian government bonds over German on the basis of the recent convergence trade to continue and Italian political risks to remain tame for now.

We have a neutral view on credit in developed markets given substantial spread tightening but remain overweight credits in emerging markets, particularly in local currency space, where we regard real yields as comparably attractive and see value in the FX component of the asset class. High yielding emerging market currencies are expected to outperform low yielders as the moderate pickup in global growth justifies current levels and allows currencies to remain stable and earn carry. Given local currency and particularly high yielding currencies are more sensitive to the global growth outlook any upside surprises in the growth outlook will be well captured by this asset class.

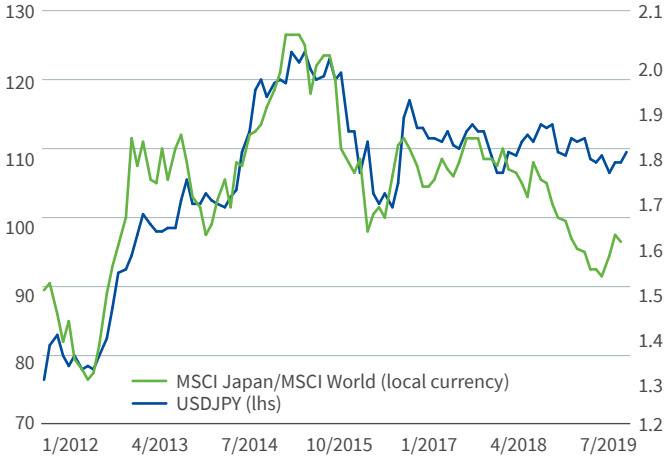
We are relatively neutral on the US dollar overall, but prefer a modest overweight in Japanese yen given the recent fiscal package announced there and the natural protection provided in risk-off episodes. We prefer an underweight in the euro, given it continues to provide attractive carry returns, with low volatility and re-newed asset purchases by the ECB. Finally, we also prefer a small underweight in the Australian dollar given likely further easing by the RBA in 2020.

Figure 29. **US ISM index and correlation between MSCI world index and US 10-year**



Source: Aviva Investors, Macrobond as at 16 December 2019

Figure 30. **Relationship between USDJPY and Japanese equities relative**



Source: Aviva Investors, Macrobond as at 16 December 2019

Figure 31. **Asset allocation**

	Underweight										Overweight
	-5	-4	-3	-2	-1	0	1	2	3	4	
Equities								2			
US						0					
Europe						0					
UK						0					
Japan							1				
Pacific Basin ex Japan						0					
Emerging Markets						0					
Nominal Govt						0					
United States								2			
United Kingdom						0					
Germany			-3								
France						0					
Italy							1				
Japan						0					
Canada							1				
Australia						0					
Credit							1				
US Investment Grade						0					
European Investment Grade						0					
Asian Investment Grade						0					
UK Investment Grade						0					
EUR High Yield						0					
US High Yield						0					
Emerging Govt (Hard Curncy)								2			
Emerging Govt (Local Curncy)									3		
Alternatives						0					
Cash				-2							
Currencies (vs USD)					-1						
GBP						0					
EUR					-1						
JPY							1				
CAD						0					
AUD					-1						
NOK						0					
EM FX						0					

The weights in the Asset Allocation table only apply to a model portfolio without mandate constraints. Our House View asset allocation provides a comprehensive and forward-looking framework for discussion among the investment teams.

Source: Aviva Investors, Macrobond as at 16 December 2019

ESG insight: Belt and Road

Since President Xi launched the *Belt and Road Initiative* (BRI) in late 2013, it has evolved into one of the most ambitious infrastructure policies ever conceived, leading to it being hailed as the "project of the century"[1]. The timescales, to 2049, and scope, spanning Eurasia and East Africa, seemingly justify that billing.

China's Belt and Road Initiative will reshape global value chains and trade

The belt and road respectively represent the initiative's land and sea components: the *Silk Road Economic Belt* and the *21st Century Maritime Silk Road* (Figure 32). Both evoke the romanticism of Marco Polo's adventures along the original Silk Road, a network of trade routes linking East and West, and harken back to a golden age in China's history.

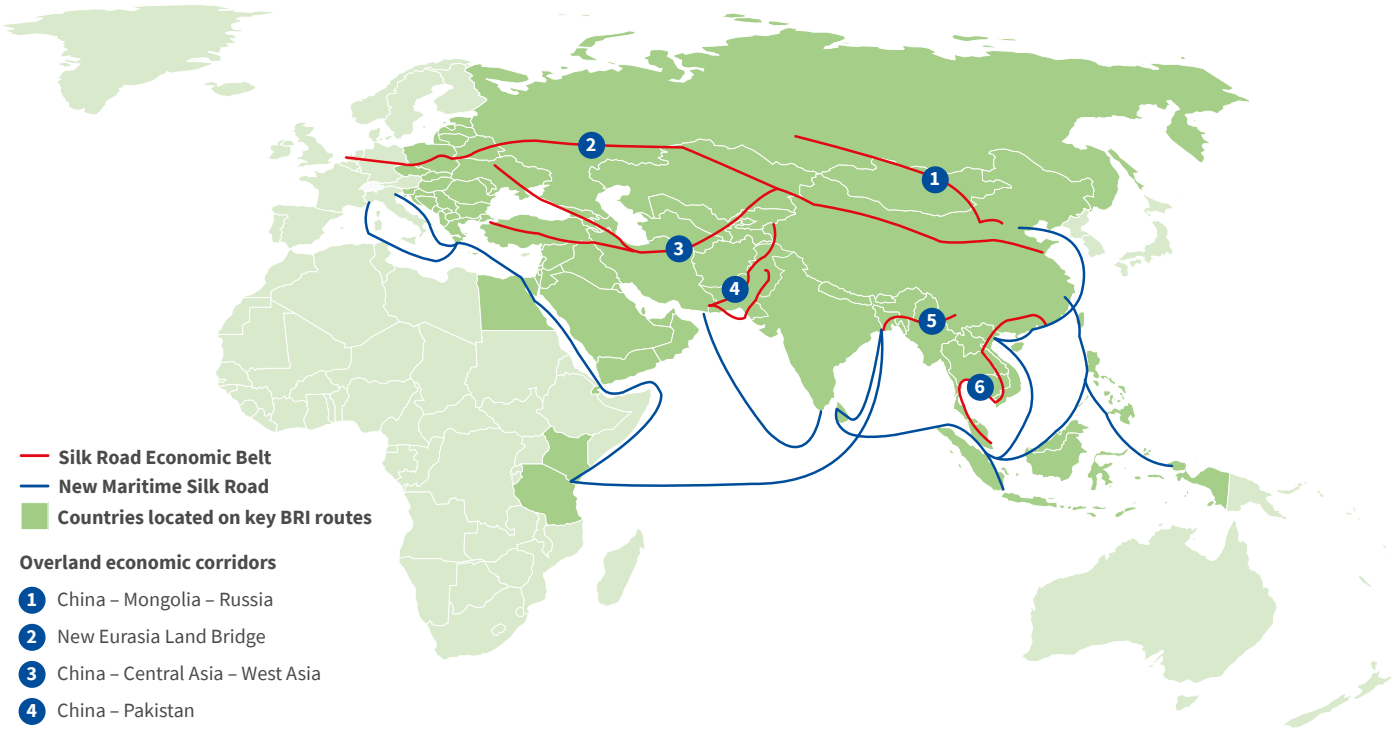
As China re-emerges as a leading global power, BRI embodies a shift towards a more active foreign policy, one where China shapes its external environment rather than merely adapting to it. By building a network of roads, ports and power stations, President Xi hopes to create a "community of shared destiny"[2]. This belies a transnational industrial policy in which new (Chinese-led) value chains are forged, markets for China's excess capacity are opened up and the supply of crucial imports is secured. Some observers see this as China embedding its hegemony and gaining asymmetric leverage over partner countries.

The Initiative could significantly boost global output and reduce extreme poverty over the coming decades

Others see BRI as simply a way for China to put its amassed foreign exchange reserves to productive use. With an annual infrastructure gap of $1.7trillion[3] in Asia and the global centre of economic gravity sitting east of the European Union[2], BRI appears a wholly rational strategy. It will also disproportionately benefit China's poorer western provinces like Xinjiang – closer to Europe than Beijing – by connecting them to global markets.

Whatever the motivation, BRI's impact could be seismic. At the upper end of estimates, it could boost global output by $7.1trillion per annum by 2040, amounting to 4.2 per cent of forecast GDP[4]. In addition, by 2030, BRI could increase global trade volumes by 1.7 per cent[5] and decrease the share of the world's population living in extreme poverty to 3.9 per cent[5], from a baseline forecast of 5.2 per cent[6].

Figure 32. **Countries on key Belt and Road Initiative routes**



Silk Road Economic Belt
New Maritime Silk Road
Countries located on key BRI routes

Overland economic corridors

1. China – Mongolia – Russia
2. New Eurasia Land Bridge
3. China – Central Asia – West Asia
4. China – Pakistan
5. Bangladesh – China – India – Myanmar
6. China – Indochina Peninsular

Source: Aviva Investors, World Bank as at 16 December 2019

Governance

Political scientist Bruno Maçães suggests BRI is best understood as a concept or process. Its structure is "vague and ductile"[2], encompassing an array of overlapping agencies, ministries, bureaus and state-owned enterprises (SOEs). Marshalling these actors is made all the more difficult by BRI's sheer scale.

BRI spans 138 partner countries, from Chile to Fiji, covering around one third of global GDP and two thirds of the population[5]. There are more than 1,300 official projects[5] – Egypt alone has 192 – and, while no official record exists, the American Enterprise Institute's investment tracker puts cumulative spend just shy of $700bn (Figure 33)[7]. To achieve its goals, outlays could exceed $4trillion by 2049[2].

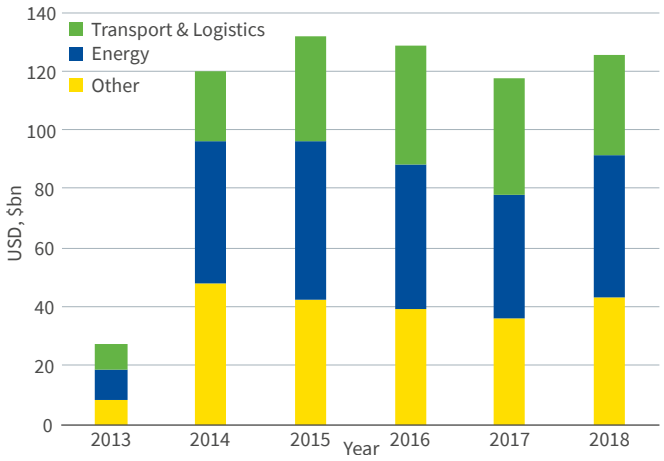
The provision of finance binds the colossal initiative together, giving Beijing a tool to provide direction in a quasi-shareholder fashion[2]. However, this approach means the details – project evaluation, lending terms and, crucially, standards – are left to SOEs and regional governments[8]. Chinese companies are simply required to abide by the host country's regulations[9]. In practice, this sets a low bar and allows various actors to devise projects that serve their own variegated interests, exposing a mismatch between the grand ambition for BRI and the institutional structures to support it[9].

This mismatch has resulted in the financing of unviable projects and left some partner countries saddled with unsustainable debt (Figure 34). The opaque, bilateral nature of deals has also facilitated corruption. The most conspicuous example is Sri Lanka's Hambantota port, situated on one of the busiest shipping lanes in the world – but just 250km from an already-thriving port in Colombo . Despite damning feasibility studies and Sri Lanka's ballooning debt, China provided financing of around $1.1billion[10].

Two years after opening, just 34 ships stopped at the port over the course of a year, compared with over 3,500 in Colombo[10]. As public opinion turned against the project, a series of fraudulent payments were made from the Chinese construction fund to the president's re-election campaign – an election he lost. Inevitable debt renegotiations followed and resulted in China taking a 99-year lease on the port and surrounding area. The debt-for-equity deal – not typical of BRI debt re-negotiations – erased $1bn[10] of debt but the port's militarily significant location meant the deal was met with cynicism by nearby India, the US and others.

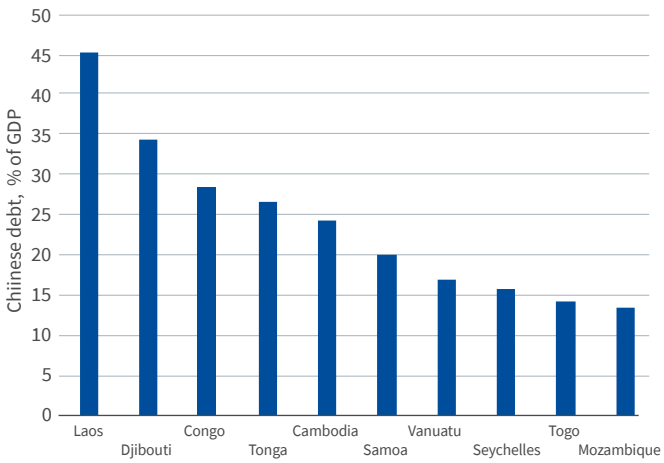
Governance shortcomings pave the way for poor project selection, unsustainable debt burdens and corruption

Figure 33. **AEI BRI spend, by sector**



Source: AEI as at 16 December 2019

Figure 34. **Debt to China as a per cent of GDP**



Source: Panel B, Lowy Institute as at 16 December 2019

Elsewhere, Djibouti's public external debt has doubled since receiving BRI funding equivalent to 75 per cent of GDP[11] while, in Bangladesh, a Chinese SOE attempted to bribe officials involved in a BRI project to upgrade a highway by stuffing $100,000 into a box of tea[10].

BRI will magnify China's already-asymmetric leverage over partner countries, expanding China's sphere of influence

Political corruption, enforced debt renegotiations and control over critical infrastructure also heighten the risk that China's partnerships with BRI countries descend into relations of dependency, exacerbated by China's economic heft. Given China aspires to form a BRI "community", it could use its leverage to sanction countries charting an independent path. In 2016, China closed a key border-crossing with Mongolia after the country hosted the Dalai Lama, for example[2]. By entrenching China's influence over swathes of Eurasia and Africa, BRI will strengthen China's standing in its strategic competition with the US, the ramifications of which will endure far beyond the ongoing trade war.

Social

If realised, the growth and poverty reduction opportunities stemming from BRI will be socially transformative for the countries involved. By 2030, 8 million people could be lifted from extreme poverty and 32 million from moderate poverty – Pakistan, Kenya and Tanzania are stand-out beneficiaries[6]. Growth is also forecast to be inclusive, with both skilled and unskilled workers gaining[6].

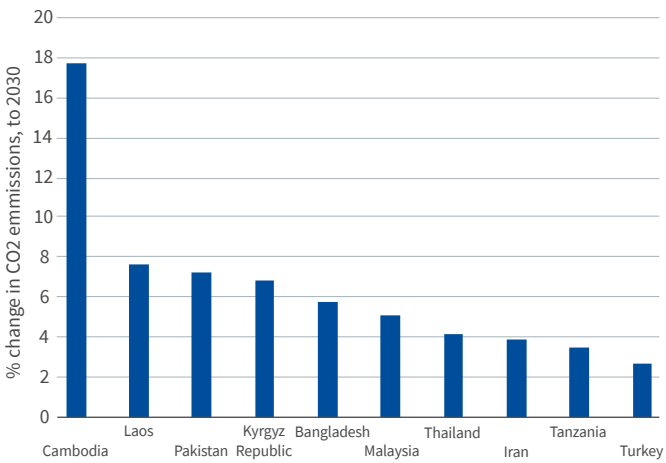
Transformative improvements in living standards could be marred by transitional costs

However, anticipated headline gains mask transitional impacts. For example, forecasts don't account for infrastructure expenditure which, for countries left heavily indebted, can lead to enforced austerity, to the detriment of social outcomes. Pakistan's recent BRI-induced IMF programme required the government to slash subsidies and commit to tax increases, leading to a national strike[12].

Moreover, political influence and opaque approach allows it to insist on the use of Chinese companies, limiting positive spillovers to local communities. Across all Chinese-funded infrastructure projects, 89 per cent of contractors were Chinese – compared with 29 per cent for projects funded by multilateral development banks[13].

Given most BRI investments are in developing countries, institutions and civil liberty protections tend to be weak. Public consultations on BRI projects are therefore limited or non-existent. In Laos, Chinese and government officials reportedly asked households to relocate without compensation to make way for a $6billion high-speed railway[14]. As one Pacific island official put it, China brings "the red flags, not the red tape"[15].

Figure 35. **Per cent increase in emissions as result of BRI**



Source: World Bank as at 16 December 2019

Environment

Infrastructure assets are built to last for decades, meaning BRI's legacy will stretch out far beyond its 2049 completion date. Alongside the fact countries in South and South East Asia, the Middle East and Africa are set to disproportionately bear the consequences of climate change[16], BRI presents both an opportunity and imperative to ensure new infrastructure is "green". Of the $1trillion clean energy investment opportunities identified in developing countries' *Nationally Determined Contributions*, central to the Paris Agreement, $430bn lie within BRI countries[17].

However, in BRI's first three years, more than 90 per cent of energy sector financing from Chinese SOEs and banks was in fossil fuels[17]. There are 13 coal plants planned for the China-Pakistan Economic Corridor alone[9] – Pakistan is the eighth most at risk country from climate change, globally[18].

Early BRI energy sector investments will lock in carbon-emitting fuel sources for decades

The transnational reorganisation of energy supply chains also helps shift emissions outside of China – by 2030, BRI is forecast to increase carbon emissions in countries along key BRI routes by 0.6 per cent, largely due to additional growth, but Chinese emissions will be unaffected[6]. Emissions in Cambodia could rise by 17 per cent[6] (Figure 35).

Beyond the energy sector, needing only to abide by host country standards precludes centralised emissions targets or environmental standards and means, in most cases, BRI infrastructure isn't green by default. This is despite the fact infrastructure compatible with full decarbonisation by the end of the century is not more expensive than more-polluting alternatives[19]. Relying on permissive host countries' standards also threatens biodiversity with planned BRI corridors overlapping with habitats of 39 critically endangered species[20].

"Crossing the river by feeling the stones"

China has acknowledged many of the ESG concerns that have characterised BRI's early years, most explicitly at the 2019 BRI Forum where President Xi promised to fight corruption, sought to quell accusations of "debt trap diplomacy" and set out a vision to improve BRI's green credentials. Since then, the remit of China's anti-corruption commission has been expanded to cover overseas investments[21], officials have begun informal work with the IMF on debt sustainability[22] and a slew of green initiatives have been launched[9].

China has taken tentative steps to address ESG concerns but initiatives are generally opaque and voluntary

The changing rhetoric and approach are cause for optimism. Particularly as, since 1978, reforms in China have tended to evolve incrementally and through experimentation[23] – Deng Xiaoping famously advocated "crossing the river by feeling the stones". But the next steps need to be more decisive. In practice, the new policies add little transparency and constitute only a shallow commitment to multilateralism. Prominent green initiatives, for example, are voluntary and many of the top BRI emitters are yet to sign-up[9]. Compelling SOEs to abide by China's domestic standards would be more consequential, particularly for environmental considerations, while genuine multilateral involvement – through the Paris Club, for example – would reduce the risk of undue Chinese leverage in debt renegotiations.

Without decisive reform, the transition to and longevity of BRI's dividend is at risk. The community BRI creates may also contribute to the bifurcation of the global economy

Until ESG policies evolve further, the immediate implications are threefold. Firstly, though BRI partner countries can expect a growth dividend in the future, governance shortcomings will make for a turbulent transition for some. This will be particularly acute for countries where the costs of BRI projects, for government finances and for society, are felt long before the ensuing benefits. Secondly, failing to install infrastructure consistent with decarbonisation threatens the longevity of welfare gains, with many BRI countries set to bear the brunt of the consequences of climate change. Finally, and least concretely, greater interconnectedness and self-sufficiency within a BRI community that is increasingly susceptible to Chinese influence could contribute to the bifurcation of the global economy.

1 Xi Jinping, *Work Together to Build the Silk Road Economic Belt and The 21st Century Maritime Silk Road speech*, 2019
2 Bruno Maçães, Belt and Road: *A Chinese World Order*, 2018
3 ADB, *Meeting Asia's Infrastructure Needs*, 2017
4 Cebr, *From Silk Road to Silicon Road: How the BRI will transform the global economy*, 2019
5 HSBC, *Belt & Road: the global impact*, 2019
6 World Bank, the *BRI: Economic, Poverty and Environmental Impacts*, 2019
7 AIE, *China Global Investment Tracker*, accessed 2019
8 FT, *China needs to make BRI more transparent and predictable*, 2019
9 CSIS, *Chinese Multilateralism and the Promise of a Green Belt and Road*, 2019
10 NYT, *How China Got Sri Lanka to Cough Up a Port*, 2018
11 Downs and Becker, 2017; Downs et al, 2017 in CGDev, *Examining the Debt Implications of the BRI from a Policy Perspective*, 2018
12 FT, *Pakistan PM Imran Khan hit by strikes over IMF programme*, 2019
13 CSIS, *China's BRI: Five Years Later*, 2018
14 FT, *Laos's Belt and Road project sparks questions over China's ambitions*, 2019
15 FT, *China warned to reform its lending to indebted Pacific Islands*, 2019
16 JPM, *Climate Change: Emerging markets to carry the burden*, 2019
17 WRU, 2018 in FT, *China must calibrate overseas lending towards Paris climate goals*, 2018
18 Germanwatch, *Global Climate Risk Index 2019*, 2018
19 World Bank, *Beyond the Gap: how countries can afford the Infrastructure they need while protecting the planet*, 2019
20 WWF, *The BRI: WWF Recommendations and Spatial Analysis*, 2017
21 FT, *China to tackle corruption in Belt and Road projects*, 2019
22 FT, *China grapples with its BRI lending binge*, 2019
23 FT, *The BRI is short of 'Chinese Characteristics'*, 2019

Risk and portfolio construction: correlation complacency

2019 has seen strong market performance across most major asset classes. Developed global equities have produced double-digits returns and developed market bonds have also performed strongly. However, recently the bond / equity correlation has been trending more in line with its negative long-term average (Figure 36).

It would appear that 'normal service' has resumed between bonds and equities. In times of market stress, negative performance from equities can be cushioned by owning bonds, which are perceived as safe-haven assets. Perhaps the main example this year came in August, when the US unexpectedly announced it will move forward with tariffs on virtually all remaining imports from China. Equity markets fell, and bonds rallied.

This contrasts with last year, when solely relying on risk reduction from bonds would not have benefitted investors nearly as much. There were two examples of this in Q1 and Q4, where equity markets fell sharply, and bonds alone did not provide the desired offset. Whilst Trade Wars, China stimulus concerns and Brexit are still lingering in the background, market participants are becoming more accustomed to these risks and perhaps more complacent with this bond and equity interaction. These risks are not so dissimilar to last year and yet the market dynamic between these assets has been very different.

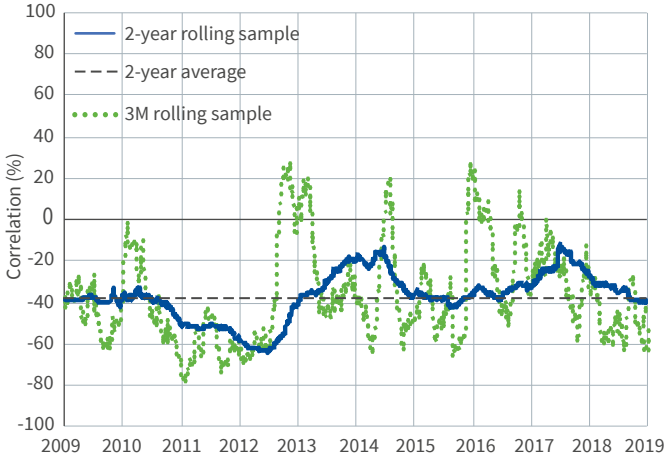
Normal service has resumed?

Balanced portfolios?

Cross asset correlation is a key component in building robust investment portfolios and can help portfolios achieve better outcomes through diversification. Central to many multi-asset portfolios is the equity-bond relationship, where one could rely on bonds being negatively correlated to equities and produce better risk-adjusted returns. The concept of simple 60/40 and risk parity portfolios have historically relied heavily on this bond/equity correlation.

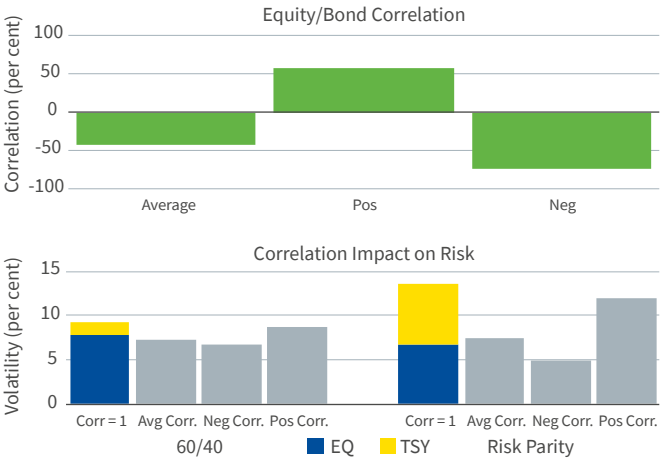
Over the past 10 years, the correlation between Equities (MSCI ACWI) and Bonds (US Treasuries) has been around -40 per cent. In addition, we calculated the correlation conditionally on the days when Equities and Bonds moved together and when they diverged. We can see that this relationship has been around60 per cent positively correlated and close to -70 per cent negatively correlated (Figure 37). There is essentially an asymmetry in this relationship in that it gives you more in the times when you need it, versus taking away less in the times when it is not working for you.

Figure 36. **Equity/Bond correlation**
Longer-term correlation shown to be negative where more variability seen in shorter term



Source: Bloomberg, Aviva Investors as at 16 December 2019

Figure 37. **Correlation impacts on Multi-asset portfolios**



Source: Bloomberg, Aviva Investors as at 16 December 2019

To illustrate how correlation can impact multi-asset portfolios, we constructed a simple 60/40 and risk parity portfolio using MSCI ACWI and US Treasuries. Applying these correlations to the 60/40 portfolio, we see that the equity risk dominates the portfolio with some diversification benefit coming from bonds when assuming a negative correlation. As a greater negative correlation is applied, the portfolio shows lower overall risk through a greater diversification benefit. However, where positive correlation is assumed, we see larger overall risk and less diversification benefit. What is important to note is that the changes here are marginal given the amount of risk coming from the equity component.

The main issue with a 60/40 portfolio is that it fails to consider the vast difference between equity and bond volatility (Figure 38). Risk Parity portfolios attempt to address this issue by sizing the equity and bond components in the portfolio to have equal volatility. If we apply the negative correlation, we see much larger diversification benefit in risk parity funds. However, the portfolio risk can be much larger if we assume the correlation to be positive. The change in risk is material given which correlation regime we are in.

These portfolios are highly reliant on the correlation between bonds and equities being negative and stable

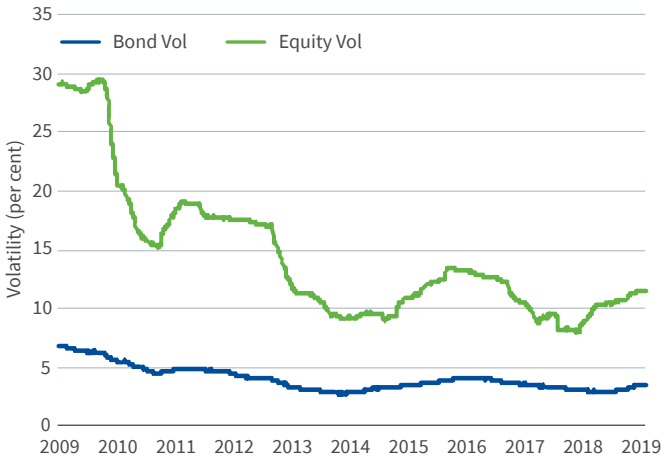
These portfolios are highly reliant on the correlation between bonds and equities being negative and stable. This characteristic is especially needed during periods of market stresses in order to protect capital. This makes basing a portfolio construction approach on assumed, or forecast, levels of correlation a difficult proposition.

What's more, where volatility is being used for sizing considerations, correlation changes can have a meaningful impact on the portfolios, overall risk levels. Unfortunately, correlation is far from stable and whilst we can expect the relationship to hold in many stress events, history has shown us that this is not always the case. In this situation the portfolio is especially vulnerable to drawdowns, as both equities and bonds are losing money. Looking at monthly returns where equity markets have fallen more than -2 per cent, there are several months when bond returns have been small or even negative. Thus, failing to provide enough risk mitigation (Figure 39).

Risk reducing outside of bonds

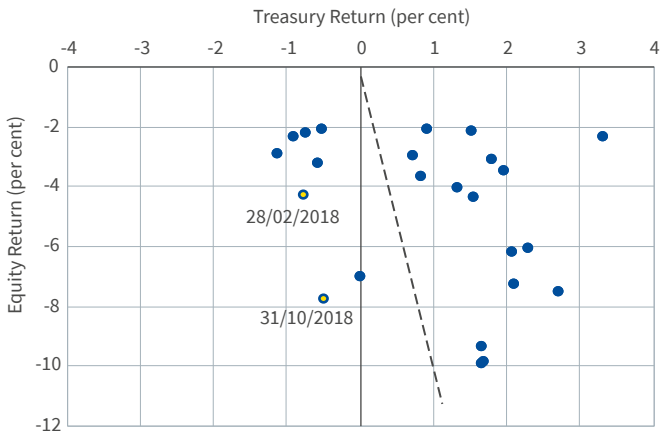
To complement the traditional long bond risk reducing strategy, investors can look for targeted risk reducing ideas with the intention to protect the portfolio against events perceived to be likely drivers of market stress. The ongoing trade disputes between China and US has seen the US Dollar versus Asian currencies (e.g. KRW, TWD, SGD) perform strongly over the course of this year. Countries with strong links to the Chinese economy and sensitivity to supply dynamics of China have seen their currency depreciate as trade tensions continue. The strategy exhibits persistent negative correlation to global equities and at times this is stronger than the equity bond correlation (Figure 40).

Figure 38. **Bond & Equity volatility**
2-year rolling volatility



Source: Bloomberg, Aviva Investors as at 16 December 2019

Figure 39. **Global Equity vs Treasury Bond Return**
Where equity returns are greater than -2 per cent



Source: Bloomberg, Aviva Investors as at 16 December 2019

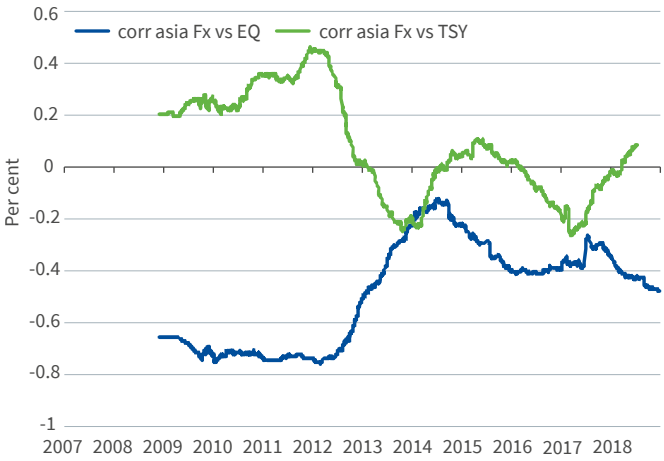
Another important property of the Asian currency strategy is that it is not consistently positively correlated with a long bond position (Figure 40). Diversifying a portfolio's risk reducing strategies is just as important as diversifying the growth part of it. The more diversified a portfolio's risk reducing strategies, the broader the set of scenarios where it will be able to protect the portfolio from drawdowns. Tilting the risk reducing part of a portfolio towards a set of stress events deemed more probable can help keep a portfolio better protected, whilst allowing for upside capture at the same time.

Modelling a Trade War scenario where we assume the US and China continue to impose tariffs on all imports, the global economy slows down with increasing inflationary pressure which in turn breaks the negative equity-bond correlation. This scenario assumes negative returns for equities and bonds for all countries, where the US Dollar strengthens relative to Yuan due to decreased demand for Yuan as bilateral trade diminishes. Both the 60/40 and Risk Parity funds are negatively impacted, but with the addition of a specific strategy designed to perform positively in this event we can offer additional protection on top of more traditional strategies (Figure 41).

Correlation, and the stability of this equity-bond dynamic is an important consideration in portfolio construction. Duration will continue to be an important tool for most portfolio managers in managing broad risks but understanding when this may not be as effective is crucial. Applying supplementary risk-reducing strategies which target the epicentre of a risk event can support a portfolio and enhance diversification in times of market stress.

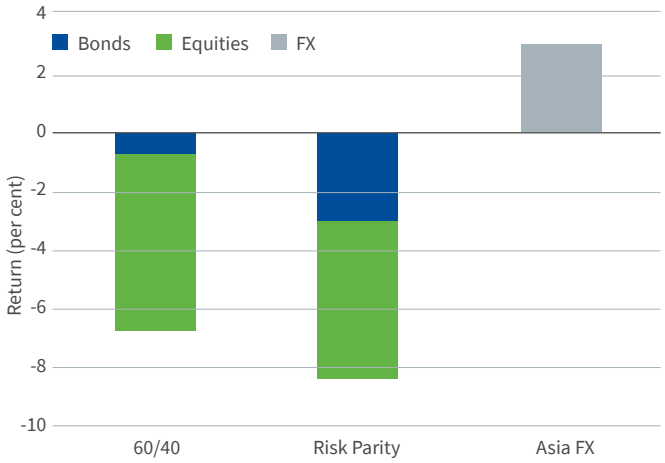
Correlation, and the stability of this equity-bond dynamic is an important consideration in portfolio construction

Figure 40. **Asia FX correlation vs Equities and Bonds**
2-year rolling correlation



Source: Bloomberg, Aviva Investors as at 16 December 2019

Figure 41. **Trade war stress test**
Impact on multi-asset funds and an alternative risk reducer



Source: MSCI Risk Manager as at 16 December 2019

Economic Outlook

United States: strong foundations, but significant risks

- **Growth to moderate further in 2020, but recession risk low**
- **Phase 1 trade deal with China a positive development, but risks remain**
- **Fed expected to be on hold, but with dovish bias**

Summary

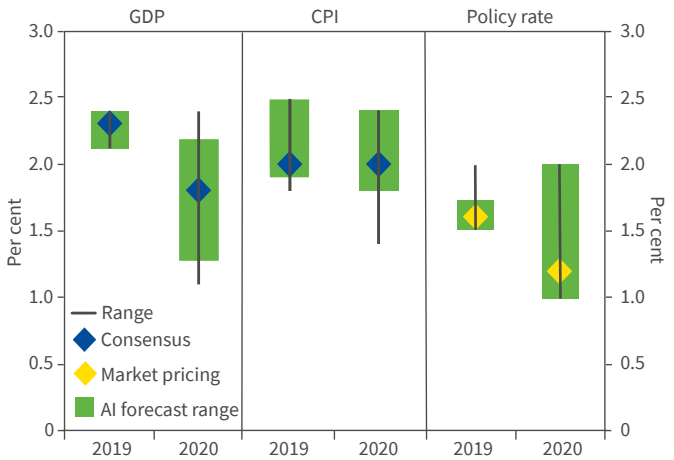
Growth slowed in 2019 as expected, with trade tensions weighing on business investment and trade

We expected 2019 to be a year of moderating, albeit above potential, growth in the United States. That has proved to be the case, with calendar year growth likely to be around 2.3 per cent in 2019, down from 2.9 per cent in 2018. That slowdown reflected a somewhat smaller contribution to growth from household spending and a more marked slowing in business investment. The slowdown in spending was anticipated given the waning boost of the personal and corporate tax cuts at the start of 2018, alongside the impact of tighter financial conditions associated with the interest rate increases by the Federal Reserve. However, as highlighted in our 2019 Outlook, the key risk to the US economy was an escalation of the simmering trade tensions with China. Those tensions boiled over throughout the course of 2019, resulting in the implementation of large-scale tariffs across a large proportion of Chinese imports to the US (and retaliatory actions from China against the US). The escalation in trade tensions materially impacted business confidence and was likely the major factor in the rapid slowing in business investment. In particular, manufacturing production and investment has been hit hardest given the direct impact on trade flows, but also the medium-term implications for global supply chains.

We expect growth to slow further to around potential in 2019

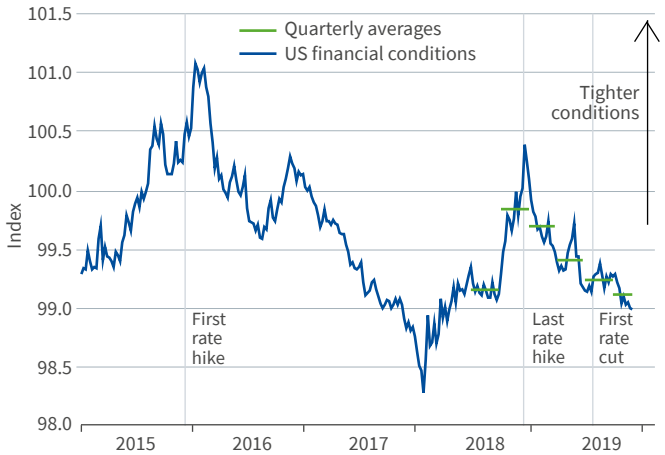
Looking ahead, we expect growth will slow somewhat further in 2020 (Figure 42), to around the long-run potential for the US. As we went to print, the text of a "Phase 1" deal between the US and China had been agreed by both sides. That included the US cancelling 15 per cent tariffs on about $150bn of Chinese goods that were due on 15 December and halving the tariff rate to 7.5 per cent on goods worth about $120bn that came into effect in September (while the tariff of 25 per cent on around $250bn in Chinese imports remains in place). In exchange, the Chinese also cancelled tariffs that were due to be implemented on 15 December and agreed to substantially increase their imports of US agricultural, energy and other goods and services over the next two years, as well as tighten laws on technology transfer and intellectual property rights. That ought to help a lift in business sentiment and a moderate recovery in investment spending. More broadly, growth should be supported by the material easing in financial conditions over 2019 (Figure 43). While we judge the growth outlook for 2020 to be somewhat better than previously expected, the risks remain tilted to the downside should there be renewed escalation in the trade and technology dispute between the US and China.

Figure 42. **US economic projections**
Further moderation in growth expected



Source: Bloomberg, Aviva Investors as at 16 December 2019

Figure 43. **Financial conditions**
Easier conditions to support economy in 2020



Source: Aviva Investors, Bloomberg, Goldman Sachs, Macrobond as at 16 December 2019

That should result in the Fed maintaining an easing bias, although we do not expect further rate cuts in 2020 in our central scenario. We see the prospect of rate hikes in 2020 as being remote, particularly with the Fed's review of monetary policy strategy (due to report by mid-2020) likely to provide some scope for the Fed to allow inflation to be above target for a period, following an extended period below target. On the broader policy front, the outcome of the Presidential election in November 2020 will undoubtedly be a focus with candidates from both the major parties looking at further fiscal stimulus in 2021.

We expect the Federal Reserve will be on hold in 2020, but with an easing bias

Consumer is healthy, but business needs policy uncertainty to lift

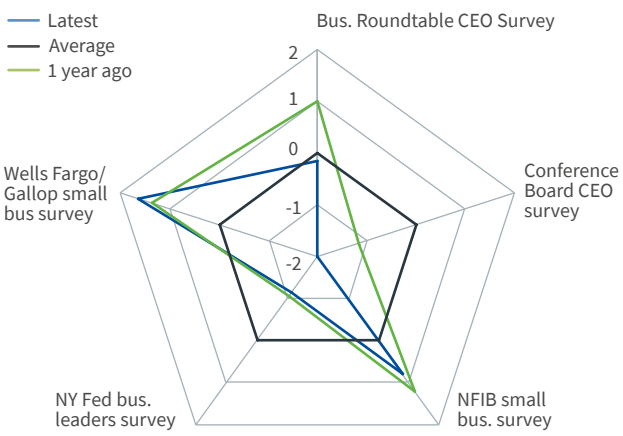
Household consumption growth slowed a little in 2018 to around 2.5 per cent, supported by continued strong growth in real household disposable income. Indeed, real disposable income has grown consistently at around 3 per cent for the past three years. That has reflected a combination of strong labour market growth, gradually rising wage growth and muted inflationary pressures. That underlying strength was further boosted by the personal income tax cuts in early 2018. Low mortgage interest rates and steadily declining household debt (as share of income) has also seen debt servicing costs fall to historic lows in 2019. Meanwhile, strong gains in financial assets in recent years have seen household net worth rise to a historic high of around 7 times annual income. A feature of the post-financial crisis period of the past decade has been that households have been running with a higher level of precautionary savings. The household saving rate is currently around 8 per cent, providing a greater cushion to any adverse income shocks that might come along, allowing consumption to be smoothed more effectively. With aggregate household balance sheets in a strong position, interest rates expected to stay low and the labour market to remain tight, the outlook for household consumption is for continued solid growth. However, the risks are tilted to the downside should tariffs be imposed on a wide range of consumer goods.

Household spending is expected to remain solid given healthy balance sheets and rising real disposable income

In President Trump's first year in office, business sentiment rose sharply to historic highs, as the plan for corporate tax cuts and reduced regulatory burden raised expectations. However, since the start of the trade dispute with China in 2018, business confidence has fallen back, with larger corporates becoming particularly concerned (Figure 44). On some survey measures, business confidence has recently fallen to historic lows. This collapse in confidence is consistent with measures of policy uncertainty rising sharply since the middle of 2018, particularly trade policy. The imposition of tariffs, tightening of inward foreign investment to the US and restrictions on technology exports and imports have led businesses to begin reassessing their global supply chains and ability to expand their business in China. The slowdown in global trade that has followed the trade dispute has also weighed directly on those engaged in export markets. The combination of an uncertain future costs base, potential need to change global supply chains and limits on international trade have resulted in stalling in business investment. Fed surveys of capital expenditure expectations

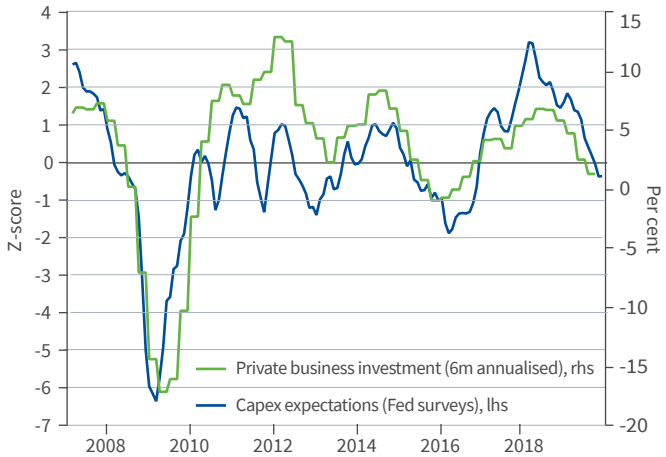
Business confidence has fallen sharply and requires a lifting of uncertainty on trade policy to encourage investment

Figure 44. **Business sentiment**
CEOs sentiment hit by trade war



Scale in standard deviations, with zero indicating series average.
Source: Aviva Investors, Macrobond as at 16 December 2019

Figure 45. **Business investment**
Uncertainty has weighed



Source: Aviva Investors, Macrobond as at 16 December 2019

remain subdued (Figure 45). While the recent decline in investment spending is not of a recessionary magnitude, it has been a material drag on growth in 2019. If the trade and technology uncertainty is lifted somewhat, as we expect, then confidence should improve, and investment should not be a further drag on growth in 2020. However, risks are to the downside should the trade war policy uncertainty return, and could be further impacted by the uncertainty of the outcome of the 2020 Presidential and Congressional elections.

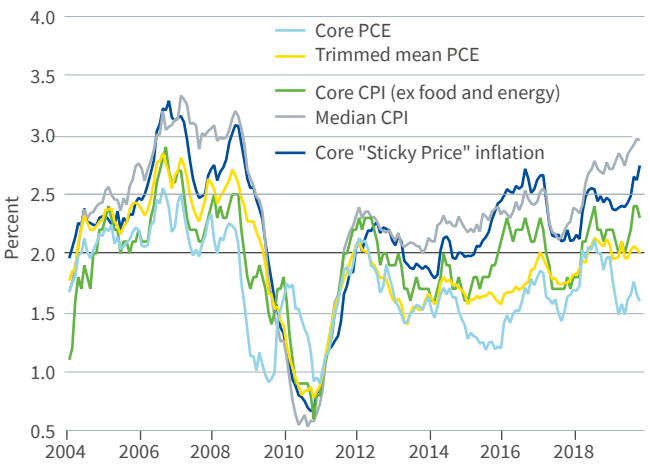
The remaining areas of final demand are likely to have more muted effects on overall GDP growth in 2020. Residential investment has already turned higher on lower financing costs and should provide a small boost to growth. Government spending is expected to be a little less supportive in 2020, following the boost to defence spending in 2019. The boost to growth from the build-up in goods-sector inventories at the start of 2019 has already been somewhat unwound, but there is likely to be a little more to come in 2020, acting as a small drag on growth in the first part of the year. Finally, while net trade is expected to be somewhat of a drag on growth, as was the case in 2019.

Wage pressures are likely to remain steady, with core inflation expected to be around 2 per cent

While growth slowed through 2019, it remained above the long-run potential rate of around 1¾ per cent, further eroding spare capacity and resulting in a decline in the unemployment rate to a 50-year low of 3.5 per cent. Despite this, the pickup wage growth seen during 2018 stalled at around 3-3.5 per cent in 2019. While that was similar to the average in the years prior to the financial crisis, it was a little softer than we had expected. Looking ahead, the scope for further increases in wage growth will likely be limited given the expected moderation in growth to around potential. That is likely to see unit labour costs remaining fairly contained at around 2 per cent, consistent with the Fed's inflation target.

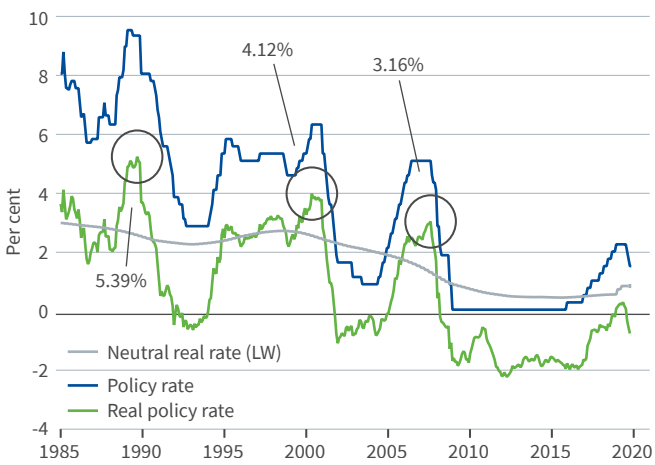
While wage growth was steady, core inflation measures generally moved a bit higher in 2019 (Figure 46). Perhaps most notable was the move up in median CPI inflation to 3 per cent. While many of these measures sit above the inflation target of 2 per cent, the Fed's preferred measure of core PCE inflation was somewhat below that during 2019 due to a number of volatile components dragging it down. The trimmed-mean measure, which strip out those temporary effects, has been close to 2 per cent. Looking ahead, we expect core PCE inflation to pick up to a little over 2 per cent during the early part of 2020 and remain around there for the remainder of the year. While in the past, that outlook might have led to the Fed beginning to talk about removing some accommodation, the review of monetary policy strategy due out in the summer is likely to recommend a more flexible approach to meeting the inflation target, focusing on the symmetry of outcomes. That would imply the Fed wanting to engineer a period of modestly above-target inflation for a period. As such, given the downside risks to growth and the likely appetite for a period of above-target inflation, we think the probability of rate hikes in 2020 is low. That would leave monetary policy in an accommodative position, with real rates well below the Fed's estimate of neutral (Figure 47).

Figure 46. **Core inflation around 2 per cent**
Range of core measures consistent with Fed target



Source: Aviva Investors, Macrobond as at 16 December 2019

Figure 47. **Policy rates, real rates and neutral**
Easing in 2019 leaves policy accommodative



Source: Aviva Investors, Macrobond as at 16 December 2019

Eurozone: external weakness trumps domestic resilience

- **Growth stabilised in Q3 but remains below trend; domestic demand is offsetting weak exports**
- **Cyclical weakness in manufacturing may be bottoming, but proper recovery needs trade improvements**
- **Low inflation implies accommodative stance from ECB for the foreseeable future**

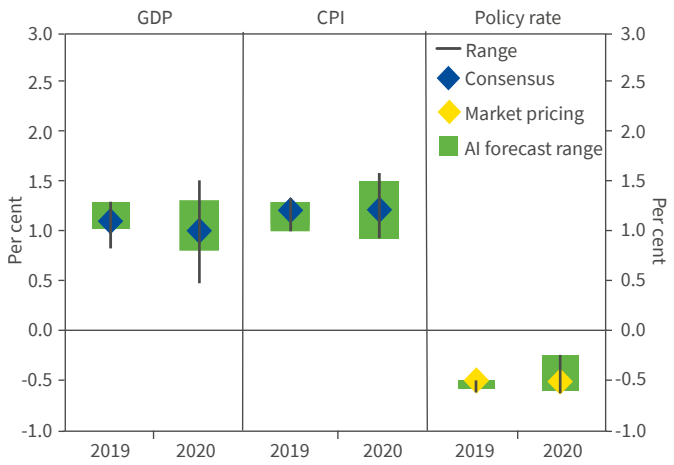
2019 has been yet another year of growth and inflation disappointments for the Eurozone. The external demand shock related to the ongoing trade dispute has been the dominant negative influence on activity levels, although idiosyncrasies within the autos industry have had a significant impact too. Weakness has therefore been concentrated in manufacturing and exports, with domestic demand and services providing a continued and valuable offset and ensuring that the economy has continued to grow overall. The average pace of growth in the last two quarters of 0.8 per cent annualised may be low, but it must be remembered that trend growth in the region is not that much higher (between 1 and 1.5 per cent). And that looks more likely to decrease than move higher in coming years unless productivity trends change dramatically. The bottom line is that while there is clearly room for improvement, the recent economic performance has been poor rather than disastrous – it doesn't require much of an acceleration to reach that trend pace. Given that most estimates suggest there is only limited spare capacity left in most of the region (unlike much of the post-GFC period), that would be all that is required today. The immediate problem is that there is little indication of any such pick-up in growth in the immediate future. Our central view is that GDP growth will average around 1 per cent next year (Figure 48).

Trend growth is low, but actual growth has been weaker still

Arguably, inflation frustrations have been even greater – they certainly have for the ECB with its explicit inflation-targeting mandate. In the post-crisis world (i.e., the last decade) headline inflation has averaged 1.4 per cent and core inflation just 1.2 per cent, both well below the 2 per cent target. Indeed, the core rate has never been higher than 1.7 per cent (Figure 49). In part this is entirely understandable since the negative output gap (alluded to above) which has prevailed since 2009 should mean a tendency for inflation to fall rather than rise. The ECB has – rightly – tried to offset this impulse with their extremely accommodative policy stance but even they have finally had to concede that the achievement of inflation "close to, but below, 2 per cent" is still some way off. They now assume that headline inflation will be lower,

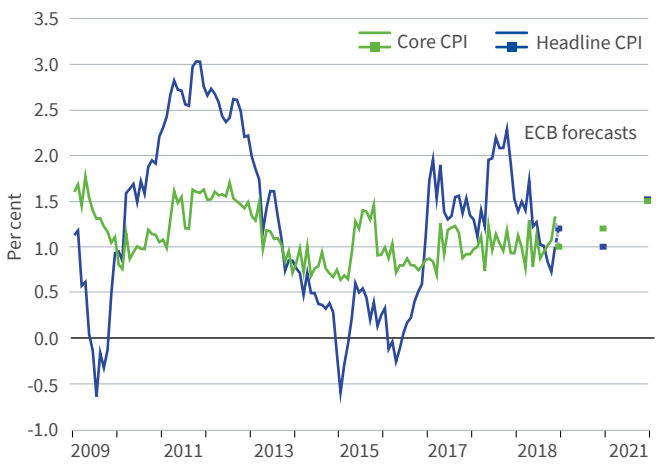
2 per cent inflation looks a long way off – policy to stay loose

Figure 48. **Eurozone: economic projections**



Source: Bloomberg, Aviva Investors as at 16 December 2019

Figure 49. **Eurozone: annual inflation rates**



Source: Aviva Investors, Macrobond as at 16 December 2019

on average, in 2020 than it was this year. The two-year ahead projection is always more of an aspiration than a forecast, but even that is only 1.5 per cent. If the core rate – which features more in ECB discussions these days – can reach that sort of pace by the end of next year, they will be satisfied (although they will never admit that). Furthermore, the bank has now explicitly linked any future monetary tightening directly to the inflation target. First, they state that key ECB rates will remain at present or lower levels until inflation "robustly converges" towards target and secondly that the asset purchase programme (APP) will only end just before the ECB first raises policy rates.

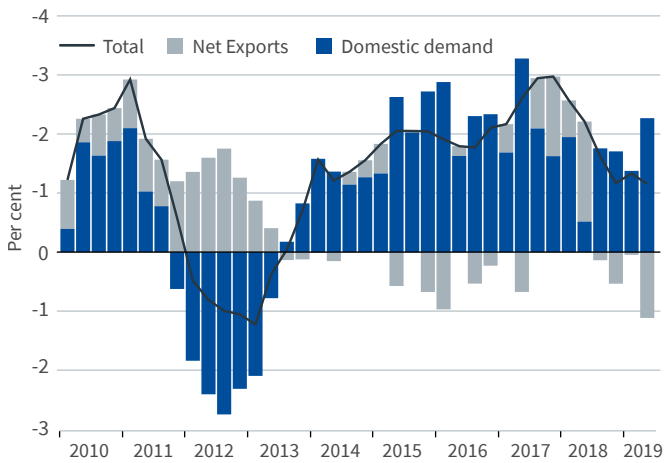
Domestic demand has actually been resilient

The simple mathematics of GDP expenditure components show that, in the year to Q3, domestic demand in the Eurozone expanded by a cheery 2.3 per cent, while net trade reduced growth by 1.1 percentage points (Figure 50). Even if some allowance is made for some "noise" in these data, it is abundantly clear that much of the Eurozone's weakness is accounted for by external factors. Partly because of the stimulus being provided by ultra-loose monetary policy, domestic demand is doing well. If the recent progress towards a constructive resolution of the trade dispute were to continue, and if autos production (very export-focussed) were to stabilise, then it is not hard to envisage a scenario where the contribution of net exports moves back to neutral rather than being a drag on growth. This effect alone would push annual GDP growth back up to 1.5 or even 2 per cent if the domestic impulse is unchanged. And that should lead to a gentle resumption of modest domestically generated inflation pressure. In these circumstances the ECB would find it much harder to justify either a continuation of asset purchases or maintenance of negative interest rates. Given the Eurozone's dismal record of false dawns, this scenario may seem far-fetched. Even if it were to materialise, it is undoubtedly still several quarters away and is far from certain. But it is not totally implausible. On current growth trends and inflation readings, their current relaxed policy stance is entirely appropriate, but these are the areas to watch in any assessment of the longer-term outlook for both growth and policy. In passing, it should also be noted that the argument in favour of bold and ambitious fiscal expansions (whether there is room or not) is less convincing when considered in this light.

Trade uncertainties are adversely impacting growth – short and long term

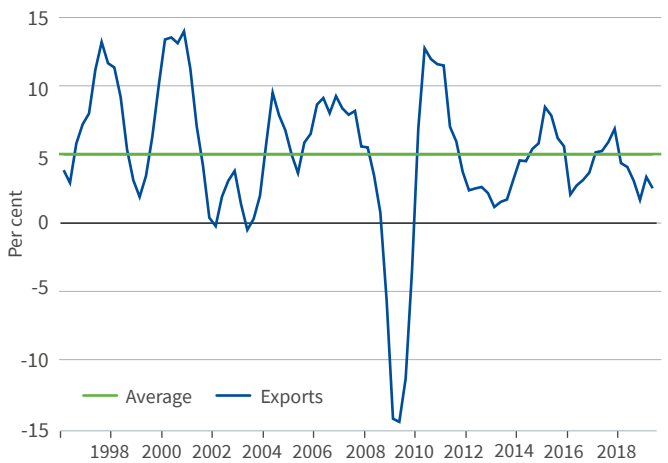
The stagnation of world trade flows in 2019 has hit the open economies of Europe hard, especially those most dependent on overseas demand for manufactured goods such as Italy and Germany. For the zone overall, exports are still rising – up by 2.5 per cent in the year to June (Figure 51). But that is less than half the average pace since the Euro's inception in 1999 and, if anything, it is still slowing. Export surveys continue to indicate that future demand is either weak or uncertain (or both). The lack of clarity over future trade policy from

Figure 50. **Eurozone: contributions to annual growth**



Source: Aviva Investors, Macrobond as at 16 December 2019

Figure 51. **Eurozone: annual export growth (growth and services)**



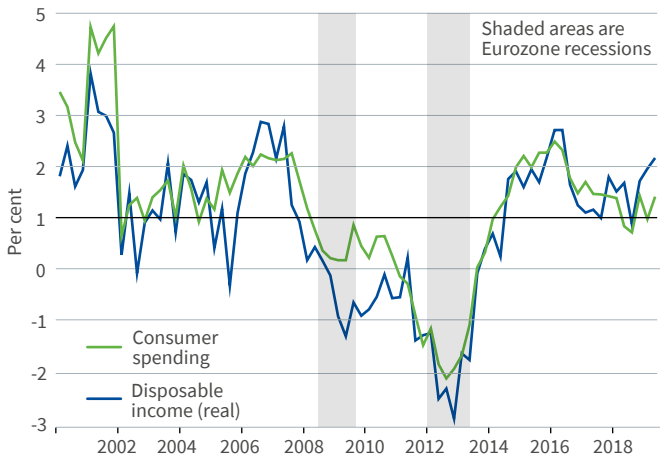
Source: Aviva Investors, Macrobond as at 16 December 2019

the US-China spat has created an environment of doubt that has been compounded, in the case of Europe, by Brexit-related uncertainty. It was generally the case in the past that world trade grew faster than world GDP. Any country or company that could successfully tap into that growth dynamic benefited from the "globalisation" trend. Although it is too alarmist and simplistic to describe the post-GFC world as one characterised by "de-globalisation", it is definitely a rather different place. As the OECD has recently pointed out, "the induced reallocation of activities across countries and adjustment to supply chains that results from persisting trade tensions is both a drag on demand and a source of weaker medium-term growth by reducing productivity and incentives to invest" (November 2019 Economic Outlook). Nevertheless, these developments also present the possibility of upside risks that would impact the Eurozone positively if further constructive solutions can be agreed on both China-US relations and Brexit.

The fear that manufacturing weakness will spread more decisively to services remains relevant, but recent news has been mildly encouraging with surveys indicating that the trough for sentiment in the industrial sector may have passed. Meanwhile, strong labour markets have supported household incomes and boosted consumer spending (Figure 52), while overall investment expenditure has continued to rise despite the decline in business confidence over the last two years. Details on investment spending across Europe are sparse, but it would appear that weaker readings for the most visible elements of capital expenditure – traditional plant and equipment – have been more than offset by increases in construction and intellectual property (Figure 53). When higher discretionary public spending as a result of looser fiscal policy recently is added to the private components of domestic demand, it is easy to understand how overall activity has continued to expand. In the past, the Eurozone's over-reliance on export-orientated manufacturing might have meant an economy-wide recession given the size of the trade shock. Rebalancing towards domestic demand – whether deliberate or not – has helped Eurozone economies become more resilient. It is noteworthy that, at least so far, even the manufacturing powerhouses of Germany and Italy have avoided recession because of offsetting rises in domestic spending. However, any optimism should not be stretched too far: overall growth remains sluggish, unemployment has stopped falling and is close to most estimates of the natural rate and long-term demographics and poor productivity growth are all headwinds for the future.

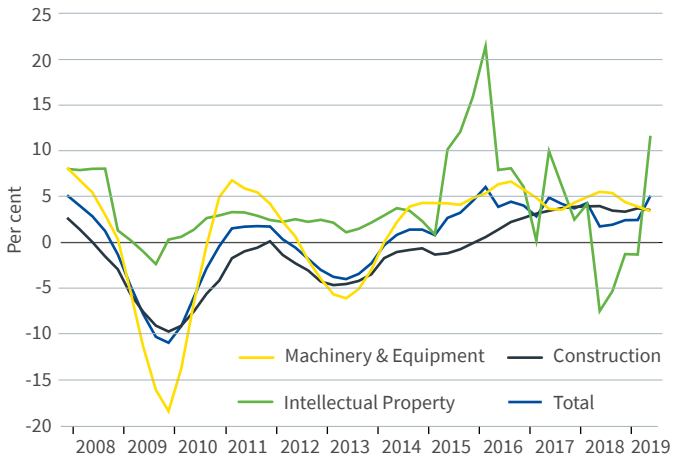
The Eurozone economy has become more balanced

Figure 52. **Eurozone: household income and spending, 3m MA, y/y %**



Source: Aviva Investors, Macrobond as at 16 December 2019

Figure 53. **Eurozone: main categories of investment, smoothed, y/y %**



Source: Aviva Investors, Macrobond as at 16 December 2019

UK: slow ahead

- **No deal risk has fallen, but Brexit-related worries are likely to continue for a while yet**
- **Growth is weak and sentiment is poor – part is a global trend, but part is UK in origin**
- **Reduction of election and Brexit uncertainties should help, but may not be game-changers**
- **Inflation is below target and will fall further: BoE has, rightly, become more dovish**

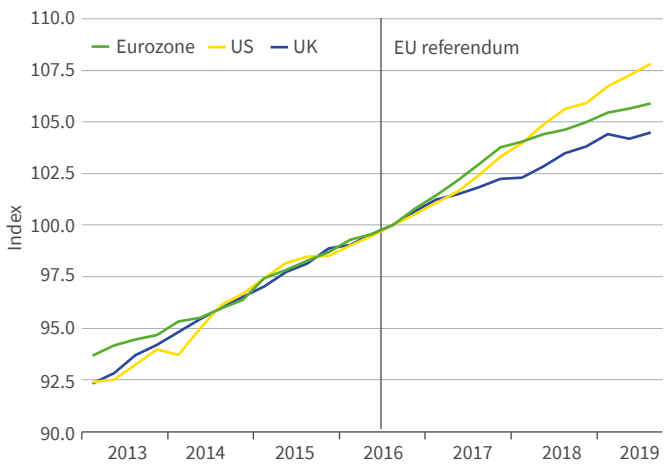
Brexit uncertainties unlikely to disappear soon

A year ago, Brexit-related uncertainties were stifling the UK economy and poisoning the mood. In 2018 we were just preparing for PM May's first "meaningful vote". In the event, she postponed it, setting in train the path that led inevitably to her eventual demise. Twelve months on, the personnel have changed, some progress has been made, but Brexit still dominates the UK outlook, and not in a good way. There is now, potentially, a clearer route to an exit from the EU at the end of January in the form of PM Johnson's deal which has been agreed by Parliament. The convincing Conservative victory makes a formal exit of the UK from the EU at the end of January 2020 inevitable, and has seemingly removed the possibility of any form of second vote. But even if we get clarity on formal "exit", the clouds of uncertainty will not suddenly lift. Leaving aside the long-term impact of Brexit (negative in our view, although most in Government would dispute that), there is the thorny issue of nailing down the exact form of the future relationship between the UK and the EU. Following the Tory win, we have been told there will be no extension of negotiations on this beyond the end of 2020, teeing up the very real possibility of another cliff-edge moment and de facto hard exit. We have been here before of course – some form of extension is perhaps more likely, despite the Government's hard-line stance. But the key point is that the joy of Brexit is set to be with us for some time yet.

UK has under-performed its peers since 2016

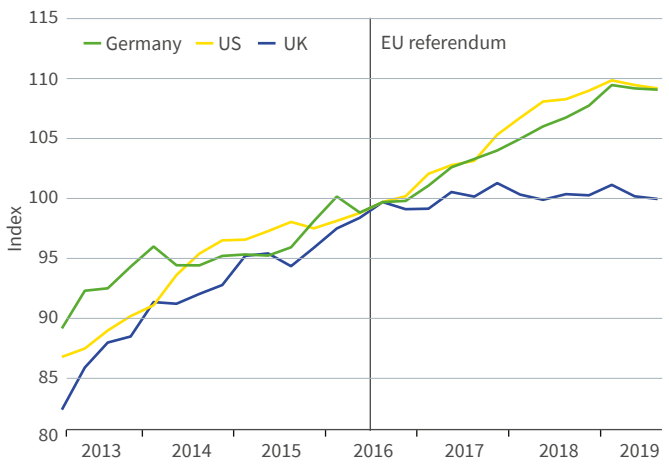
Since the 2016 referendum it is noticeable that the UK has underperformed its peers, having previously matched or exceeded them. In the three years to Q3 2016 the UK grew, on average by 2.3 per cent a year compared with 2.2 per cent and 1.4 per cent respectively for the US and the Eurozone. In the three years after the vote, the UK slowed to 1.6 per cent on average, the Eurozone picked up to 2.0 per cent and the US accelerated to 2.6 per cent (Figure 54). Brexit is an obvious candidate for the UK-specific root cause of slowdown, especially as it was weak or falling investment that has been the main explanation (Figure 55). This comparison actually

Figure 54. **GDP, July 2016 = 100**



Source: Aviva Investors, Macrobond as at 16 December 2019

Figure 55. **Aggregate investment, July 2016 = 100**



Source: Aviva Investors, Macrobond as at 16 December 2019

flatters the UK – business investment (half of the overall investment aggregate) has been weaker still, dropping in six of the last seven quarters. The Government tells us that a clean exit and swiftly-negotiated realignment could lead to a surge of previously pent-up investment expenditure, but it is fanciful to imagine that any such adjustment could be that smooth and that quick. It might take years. Current lead indicators of investment spending have continued to weaken while business sentiment remains fragile at best (Figure 56).

Household spending has supported UK growth so far

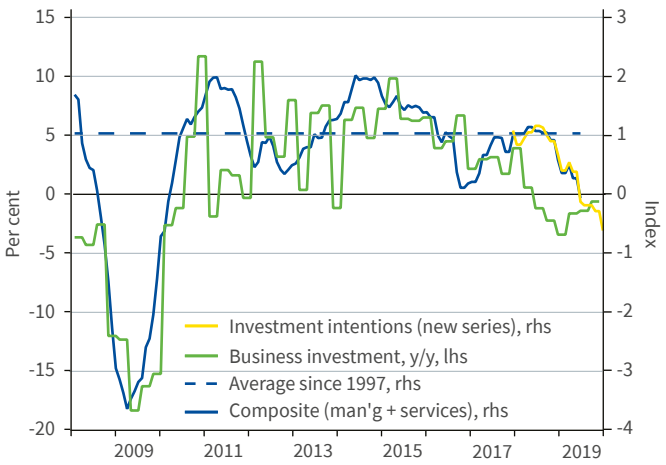
Until now household spending has been more resilient, supported by a surprisingly robust labour market which has boosted incomes. But here too clouds are gathering: employment surveys have softened (Figure 57), unemployment has stabilised or is even drifting a little higher and wage growth has slowed modestly. In the environment of uncertainty created by Brexit, consumer sentiment has dropped and the savings ratio, while still low, has risen, presumably underpinned by higher precautionary saving. Ever-reliable British consumers have been the lynchpin for growth since the Global Financial Crisis (Figure 58), but their contribution has already diminished in recent quarters as belts have been tightened and confidence has sapped. Any additional downside surprises in the jobs market would run the risk of growth stalling completely. UK GDP did bounce back in Q3 (+0.3 per cent) following the 0.2 per cent fall in Q2, but annual growth has now slipped to just 1 per cent, a little below most estimates of the trend pace and risks for the future would appear to be to the downside (Figure 59). Most indicators point to only a very modest expansion in Q4.

Moreover, as Figure 58 shows, what growth was achieved recently has been helped significantly by stronger public spending. Labour's election pledges, if they were to have been implemented, would have implied an alarming widening of the budget deficit and a major expansion of the state's role in the economy. They would have also begged important questions about longer-term fiscal sustainability. The Conservatives' more restrained alternative is also modestly expansionary, but their plans look miserly by comparison. That could change a little with the February 2020 Budget. Either way, public sector spending looks set to boost growth in coming years, a contrast to much of the past decade. In principle such a policy is defensible in the face of weak private demand, but the suspicion is that pre- and post-electoral sweeteners may have eclipsed sensible macro-economic policy.

UK exports have weakened despite lower pound

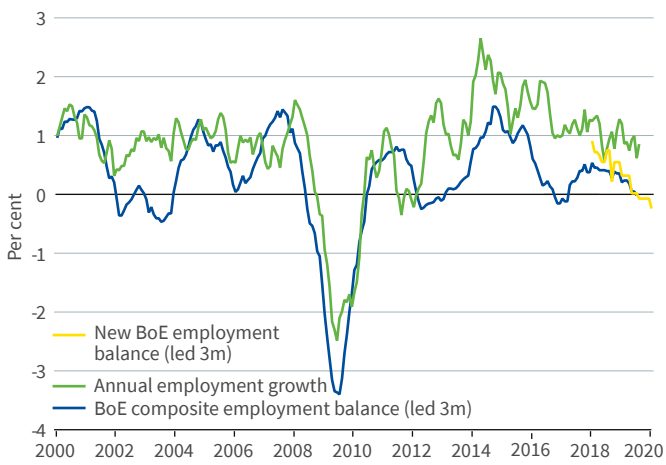
As far as external demand is concerned, any further constructive developments (total resolution looks too much to wish for) in the Sino-US trade dispute would help significantly by boosting world trade and export demand. UK export growth has averaged 5 per cent annually over the last 30 years but is currently around zero. The last time it was this weak was when our main trading partner – Europe – was in recession in 2012. Moreover, this has happened despite the depreciation of sterling since 2016. The UK would be helped by both a recovery in demand across the Eurozone and by a revival in world trade flows more generally. Neither, sadly, can be relied upon with any certainty.

Figure 56. **UK BoE investment intentions and business investment**



Source: Aviva Investors, Macrobond as at 16 December 2019

Figure 57. **UK jobs growth and employment intentions**



Source: Aviva Investors, Macrobond as at 16 December 2019

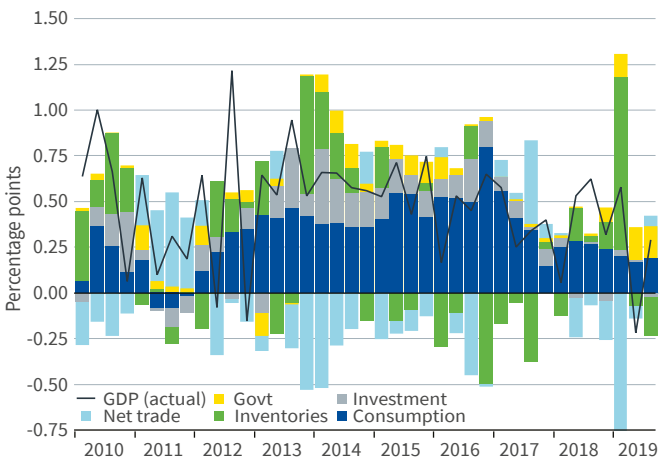
Inflation set to remain below target throughout 2020

Meanwhile, UK inflation has continued to decline, partly because of global factors – weaker world demand, lower energy prices – but partly because of lower domestically generated price pressures. With little immediate prospect of a return to above-trend growth, capacity buffers are unlikely to be encountered soon. As we suspected, the Bank of England's earlier worries about stubbornly high inflation have proved unfounded, and they have changed their stance markedly over the past year. Some on the MPC already think a policy rate cut is warranted. With inflation set to inch a little lower over the next six months, this line of reasoning is understandable. Concerns about Brexit downside, and the ongoing trade dispute argue for a relaxed monetary policy stance. But absent a further lurch down in growth – always possible – it may be enough to maintain UK rates at the current level for a while yet.

Long-term trend growth rate may fall further

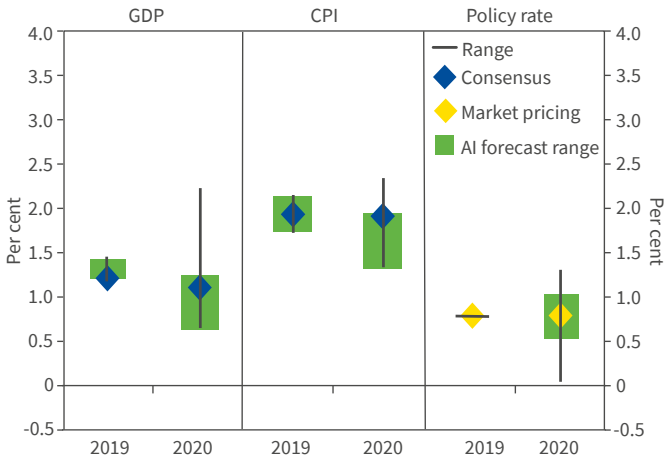
Economic outlooks typically concentrate on demand, but it is sometimes important to consider the supply-side too. Looking ahead, it is difficult to see the UK's longer-run growth prospects improving significantly in a post-Brexit world. Although the exact details about future immigration rules and regulations are yet to be determined, it is inevitable that our borders will be much less open to international labour movements than they were in the past. This area is currently providing a rich seam for academic research, but it seems entirely plausible to us that the influx of hard-working, well-qualified labour, from the EU and elsewhere, has contributed importantly to the UK's supply-side potential in recent decades. And this has happened across all levels of UK employment, from basic to highly-skilled. The future could be very different. Even if there were to be a more enlightened approach to immigration, the UK's reputation as an attractive destination for mobile, international labour may have been permanently damaged. When these trends are combined with those in the key areas of ageing and productivity, it is easy to paint a picture of much slower potential growth in future years. For example, productivity growth averaged 2.3 per cent in the 1970s, 1980s and 1990s. That dropped to 1.6 per cent in the 2000s and a paltry 0.5 per cent over the last decade. Perhaps the estimate for trend growth today of 1.5 per cent might become the high-water mark in future years.

Figure 58. **UK: contribution to GDP growth (qoq) 4Q MA**



Source: Aviva Investors, Macrobond as at 16 December 2019

Figure 59. **UK economic projections**



Source: Aviva Investors, Macrobond as at 16 December 2019

Japan: another year, another disappointment

- **Domestic growth continue to point to growth weakness**
- **Although front-loading of consumption during Q3 before the tax hike has exceeded expectations, GDP should not be followed by a steep decline given offsetting policies**
- **The BoJ is likely to keep its powder dry for the time being as fiscal policy steps in to stabilise growth; post-typhoon rebuilding and the 2020 Olympics should also support spending**

There has been little let-up in the growth slowdown that has been persistent since 2018, for which there are two main reasons: (i) Japan's structural demographic decline means a shrinking population is projected for coming decades, with an ageing population that requires spending but is less productive, and (ii) the global cyclical slowdown, to which Japan is highly sensitive. Internally, the risk after the consumption tax hike (much like a VAT, the levy was raised from 8 per cent to 10 per cent after two postponements) was a "retail hangover", and while some spending was clearly front-loaded, the overall impact is less negative than in 2014, thanks to offsetting measures taken by the government.

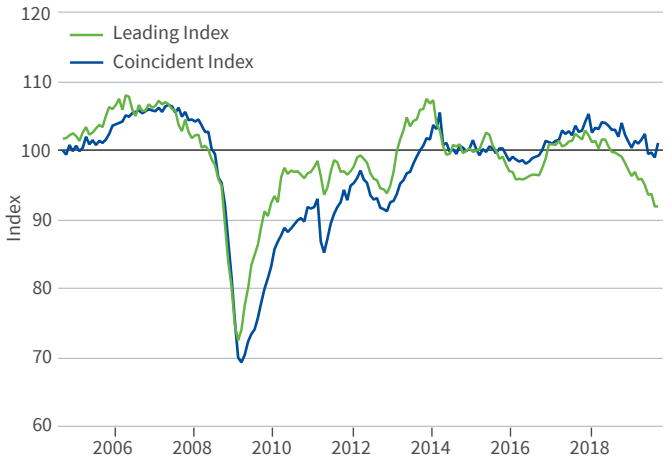
Survey indicators for both industrial activity and consumer confidence, are far below official forecasts, and point to industrial production – which had been falling at around -1 per cent y/y before October (Figure 60) – remaining in contraction for several more quarters, while households suffer from the tax-hike and front-running the higher prices. But we should expect a gradual recovery in mid to late 2020, with upside risk if government spending is effective.

A structural and cyclical slowdown are caused by the trade war and tax hike

The economy-wide leading index of the Cabinet Office's ESRI survey remains in trend decline, falling sharply in recent months (Figure 61). The first reading of the Q3 GDP report was a broad downside surprise. Inventories in particular were the weakest since Q3 2016 with a sharp decline in the stock of finished products – this was validated by what we now know was the pulling forward of demand ahead of the October consumption tax hike, similar in pattern to the 2014 tax hike. August and September retail sales were especially strong (+4.6 per cent and +7.2 per cent m/m respectively), but after this front-loading, we saw a 14.4 per cent m/m fall (!) in September. As in the 2014 experience, we expect a fairly quick stabilization this time around, and eventually inventories will need to be rebuilt. Not only is this tax smaller, but various measures have been taken to soften the blow to household finances. However, in 2014 it was really industrial production (IP) that went into a 2-year slump, and currently, IP has already been in what looks like an accelerated decline since late-2018. In short, we would not make much ado about the volatility in Q4-19 and Q1-20 economic data.

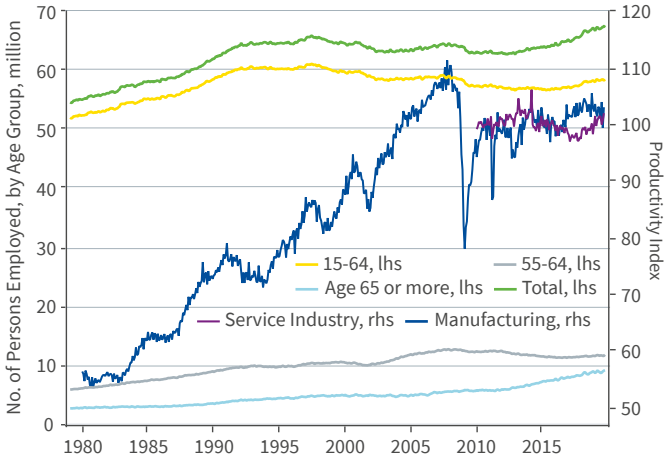
BoJ still has a bias towards easier monetary policy

Figure 60. **Survey indicators remain weak**



Source: Aviva Investors, Macrobond as at 16 December 2019

Figure 61. **Population productivity tug-of-war**



Source: Aviva Investors, Macrobond as at 16 December 2019

Q4 will be distorted by October's typhoon and the consumption tax increase

In October 2019, a tragic typhoon caused significant damage and loss of life, which also disrupted activity – thus some of the drop in that month was unrelated to the increased tax. While we are well aware of the "broken windows fallacy", rebuilding will result in a boost to output and investment as repairs are underway. Other "one-offs" include the 2020 Olympics, which will boost activity around July and August. Normally there is a drop-off after that, but the government will again probably be there to step in.

As in 2018, rebuilding after natural disasters is likely to boost growth temporarily

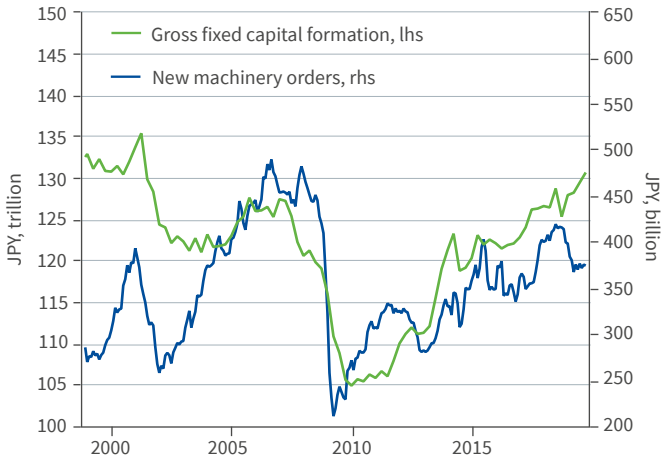
To avoid repeating the mistakes of 1997 and 2014, when tax hikes were blamed for economic woes that followed, numerous stimulus programs have been launched. Policymakers have encouraged cashless payments by providing small incentives to pay electronically at shops, introduced a tax allowance for cars and houses, raised infrastructure investment, and – importantly for raising productivity and encouraging female participation – provided additional spending for childcare and education. Furthermore, there will be significant fiscal loosening in 2020, amounting to 26 trillion yen ($236 billion, or 4.65 per cent of GDP), around half of which should be "new" spending. But the net boost is, sadly, even smaller, as some of the budgeted funds are loan guarantees or provisions to local governments, which do not result in output quickly, while other programmes have trouble being implemented due to labour or other constraints, and will be spread over more than one fiscal year. This means the fiscal deficit, which rose slightly to 3.5 per cent of GDP this year, will rise again, perhaps to over 4 per cent. As a sovereign nation borrowing in its own currency, with negative real interest rates and the central bank doing QE-infinity, this is not a worry, even at high levels of debt.

A fiscal boost is optically huge, but there's less than meets the eye

As has been consistently the case since 2018, net exports continue to be a drag on growth, although there have been interesting shifts in the composition of export growth. Services exports contracted reflecting the fall in inbound tourism from Korea amid the ongoing spat about war-time reparations. The continuation of this conflict remains a headwind to both Japanese and Korean economies, although at this point the restrictions on specific items does not have severe repercussions on a macro level. On the other hand, manufacturing exports have picked up, helped in part by a rise in shipments of tariff-sensitive categories such as semiconductors. Although encouraging, the risk here is that it's a temporary effect related to front-loading driven by the presumed tariff hike in December. Exports growth of semiconductors out of major exporters such as Japan has corresponded to a sequential improvement in China's imports of semiconductors.

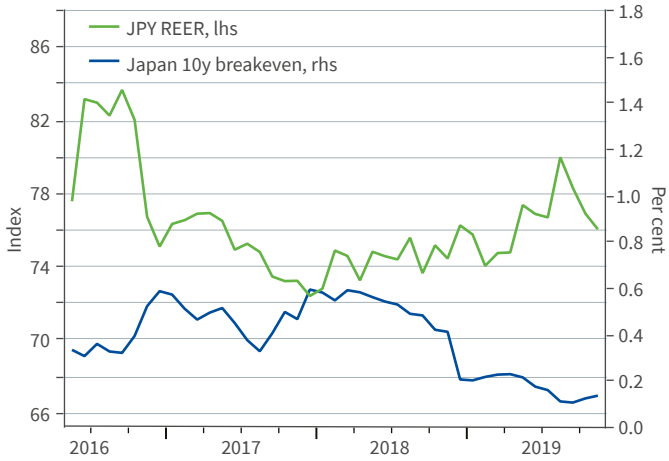
What is definitely a positive, however, is the resilience of capex in the face of the continuing industrial slump. In the past, a slump in machine tool orders growth has typically caused fixed capital formation growth to decline too. But that hasn't been the case this time (Figure 62). The structural rise in capex for labour substitution remains a major theme for Japan and is likely to cushion the ongoing slowdown. This relates to the ageing population – though for

Figure 62. **Capex has remained resilient**



Source: Aviva Investors, Macrobond as at 16 December 2019

Figure 63. **Inflation stuck near zero**



Source: Aviva Investors, Macrobond as at 16 December 2019

now the total labour force is still increasing, providing for the needs of current and future households and industry will require continued productivity gains (Figure 63), which are possible through investment in machines and technology. This in turn keeps costs low, limiting price pressures.

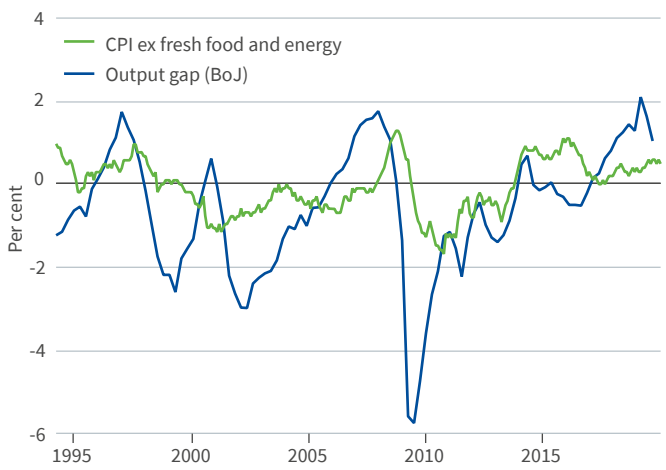
Inflation should remain low, as wage growth has remained sub-1 per cent despite the tight labour market (Figure 64). Reported CPI will, as in 2014, show the impact of the tax changes, but there are no other important price pressures to speak of – avoiding deflation in case of any further damage to the economy through trade wars or a strong yen will be the Bank of Japan's (BoJ) priority. By the end of next year, CPI should rise again from 2019's 0.5 per cent increase, but only slightly.

Despite shrinking Japanese and global trade, both imports and exports have fallen, leaving the balance of payments little changed. Trade deals with the EU and potentially the U.S., along with the TPP (which has an empty seat reserved for a post-Trump U.S.) belie the idea that the era of globalisation is dead: more nationalistic leaders suspicious of global institutions are instead pursuing bilateral FTAs. Though Japan's trade balance is around zero, investment returns and services provide a healthy current account surplus in excess of $100bn per year, while low inflation implies steady real devaluation; both of these forces point towards structural nominal yen appreciation (Figure 65).

Unlike 2014, price hikes from tax will be offset by free daycare – the impact on CPI will be small

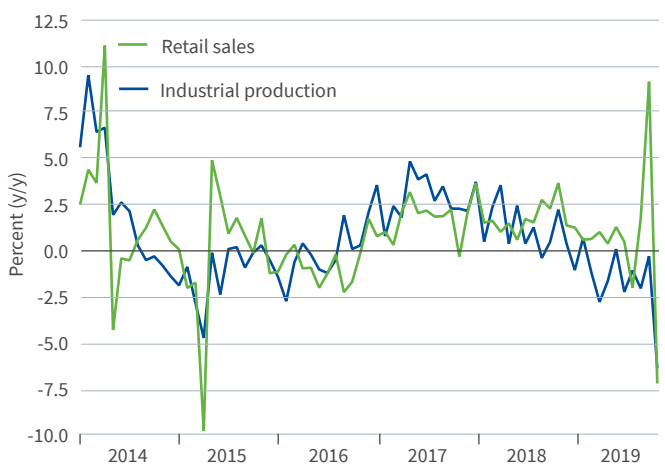
As for BoJ policy, although they have refrained from easing so far, it appears they are content for fiscal policy to take the lead for the moment. The fact that the yen hasn't strengthened much so far may also have played a role in delaying policy easing. Equally, governor Kuroda's recent language has been consistent with the notion that the BoJ will likely implement policy easing (possibly through a rate cut by 10 or 20bp) – but only in the event that growth disappoints or in case of a major negative development in the global economy. Wary of harming the banks by decreasing rates below the so-called "reversal rate", where negative interest rates begin to do more harm than good, the BoJ will stick with Yield Curve Control, using that tool to do what it can to finance government spending, perhaps even resorting to helicopter money. As it has for the past decades, Japan will be at the forefront of monetary experimentation.

Figure 64. **Output gap positive as per BoJ**



Source: Aviva Investors, Macrobond as at 16 December 2019

Figure 65. **Sales & production impacted by tax**



Source: Aviva Investors, Macrobond as at 16 December 2019

China: GDP growth to slip below 6 per cent in 2020

- **Beijing has the tools to contain China's slowing growth, but will restrain stimulus and keep a domestic focus**
- **A phase I trade deal will avoid even worse damage, but do little to mitigate the pain of implemented tariffs**
- **Slow rate cuts and liquidity will help finance SOE and LGFV credit, but are less beneficial to the private sector and property; expect gradual CNY weakness to continue despite elevated CPI**

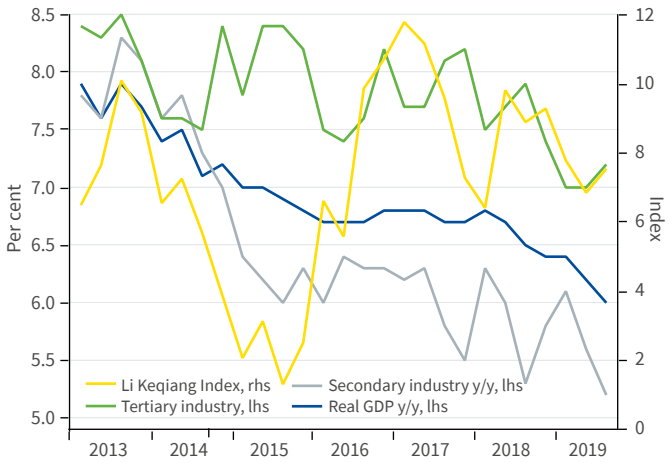
Despite the noise on the trade war front, China's growth trajectory is little changed: a gradual slowdown to below 6 per cent next year. Beyond that, there will be even slower expansion, but also a transition from the obsession with quantitative targets to quality-of-life issues, including environmental ones, as well as an attempt to be a leader on the global stage, from advanced technology to both hard and soft power.

With Q3 growth printing at 6.0 per cent y/y (Figure 66), and pain in industry and trade set to persist (Figure 67), policymakers will need to continue to be reactive to any negative developments in order to keep a floor on growth. Our expectation is that they are both willing and able to do so, continuing the broad set of stimulus measures used so far which has offset most of the negative impact on the economy caused by the global slowdown and U.S. tariffs. This time is different though, compared with 2009-10 and 2016, when property and infrastructure benefitted from a powerful, credit-fuelled stimulus that led to global reflation and spilled over into import demand from commodities to capital goods, significantly boosting global output. On the flip side, the leverage boost across all sectors now needs to be better controlled, and concern on financial stability limits Beijing's willingness to let banks and local governments run rampant in property and public spending. Corporate debt/GDP is finally beginning to come down, after reaching 136 per cent, but the augmented general government deficit is running at over 11 per cent, according to the IMF, and household borrowing is also increasing faster than the overall economy (Figure 68).

Worries over high debt and less bang for the buck constrain China's stimulus

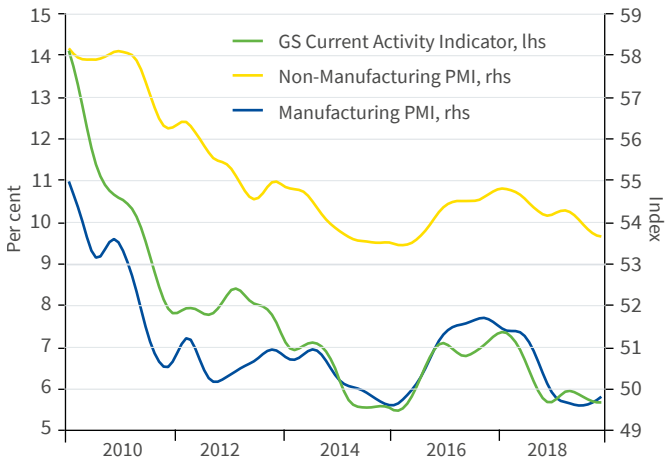
We expect nominal GDP will only be growing around 7 per cent next year, slightly slower than 7.5 per cent as of Q3 2019, and down from over 9 per cent in 2018, and nearly 11 per cent in 2017. This seems fast, but after decreasing in 2018, all-system aggregate financing has increased by 14.3 per cent; while some of this may be saved and used to replace maturing shadow-banking borrowings, which continue to decrease steadily, the total debt is still growing faster than the economy, at least measured by value-added output. In addition, this leverage does not seem to be achieving high "multipliers", for various reasons including (i) too much debt already incurred, (ii) damage from the previous deleveraging campaign, (iii) uncertainties

Figure 66. **Growth boost has faded**



Source: Aviva Investors, Macrobond as at 16 December 2019

Figure 67. **PMIs indicate weakening activity**



Source: Bloomberg, Markit, Goldman Sachs; Macrobond as at 16 December 2019

from the trade war, (iv) the negative confidence shock from Baosheng bank, and (v) fallout from official comments that seemed to threaten the private sector. Much of the infrastructure push has been decentralized, from "national" projects like high-speed trains, to less productive investments in 3rd and 4th tier cities that will suffer from depopulation, and much lending still flows to inefficient SOEs.

Overall, China is pursuing a careful and more modest stimulus, even with the RMB 1 trillion "pre-allocation" of local governments' special bond quotas, announced in late November and expected to be spent, at least in part, ahead of the March 2020 NPC when full programmes are unveiled. Infrastructure investment is much more restrained than earlier pushes, while tax cuts and other social programmes are aimed at lifting domestic consumption but are partly saved. Although the latest push is unlikely to be in time to save a weaker Q4, total social financing should be strong, as usual, in the first few months of 2020. Moreover, China is pursuing a strategy of import substitution, from petroleum refining to tech production, and while not always successful in meeting its ambitions, the goal is both to wean dependence from unreliable partners as well as to keep the current account from falling into deficit. An example of this is the recent order for the entire public sector to remove all foreign computer equipment within three years.

China is now pursuing an overt plan to substitute imports and continue to move up the value chain

This potential tech bifurcation shows that the so-called trade war is far deeper than the relatively superficial tariff punishment doled out by President Trump and his gang of mercantilists. Indeed, both the Democratic challengers, the bipartisan Congress, and the deep state, such as it is, are fairly unified in the need to confront China on the security and technology fronts, as well as its behaviour within the WTO and treatment of foreign firms, copyright enforcement, intellectual property, and subsidies. A phase one trade deal will barely scratch the surface and tensions will persist between China and the rest of the world, exacerbated by the situation in Hong Kong, Xinjiang, and Tibet.

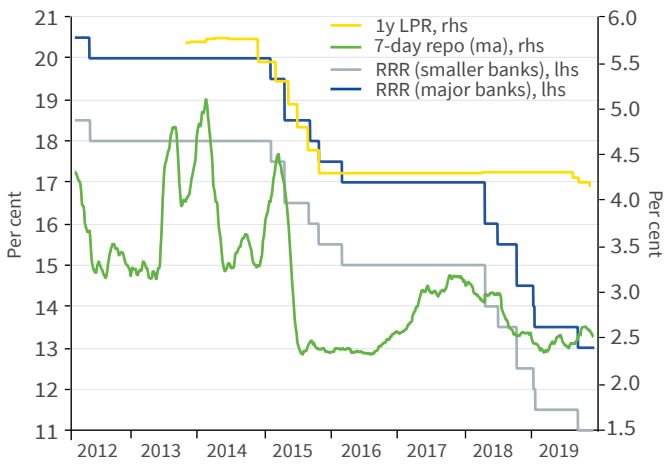
Long-term strategic competition between China and the West will continue

The prospect for GDP to print close to our earlier forecast of 6.1 per cent are good for 2019, but in 2020 growth is likely to fall below 6 per cent. Many forecasters had thought this was the floor in order to fulfil Hu Jintao's pledge to double GDP in the decade 2011-2020, but following the results of the economic census, lo and behold the growth of the previous eight years was revised up. While some of 2019's slowdown was trade related, a big part was automobile sales, which began H1-2019 by falling nearly 20 per cent. This was a hangover from 2016-18 subsidies, which boosted growth to 30 per cent y/y, front-loading several years of future sales. This hangover should wane, and October figures were "only" down 6 per cent y/y.

The 5.2 per cent Fixed-Asset Investment rate is now at a 20-year low – this is what rebalancing towards consumption looks like. Unfortunately, it is not an easy transition: Industrial Production continues to disappoint, and industrial profits, which tend to follow PPI, are now deep in negative territory. Putting it all together: median expectations for next year's GDP change have fallen from 6.2 per cent a few months ago to 5.85 per cent, but without a more meaningful resolution to the trade war with the US or a more synchronized global rebound, this looks more

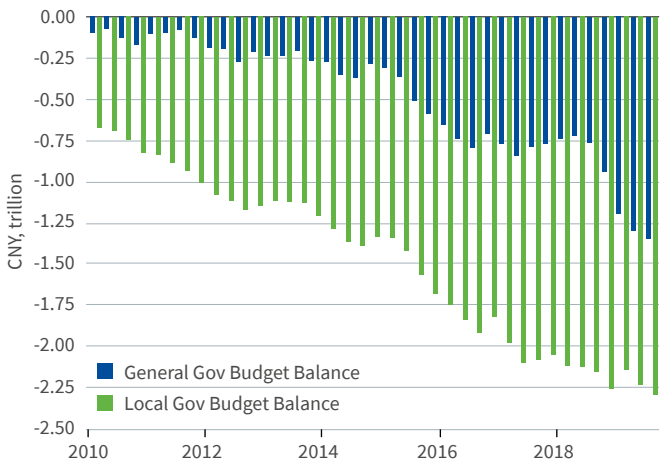
We see a further slowdown to below 6 per cent in 2020

Figure 68. **New benchmark LPR falling slowly**



Source: Aviva Investors, Macrobond as at 16 December 2019

Figure 69. **Fiscal stimulus reverses austerity**



Source: Aviva Investors, Macrobond as at 16 December 2019

like a best case. We lower our GDP forecast to 5.75 per cent y/y which is sufficient to meet the decade's growth target, but note downside risk, with the Goldman Sachs Current Activity Index recently printing 5.14 per cent, before rebounding to 6.15 per cent in November.

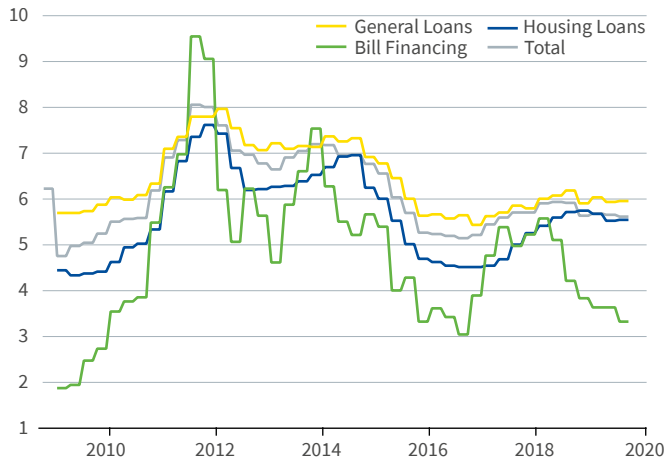
The PBOC has ample room to lower interest rates and RRR to provide liquidity, but it has chosen so far to do mainly the latter (Figure 68). This has kept the property sector stable, while the central and local governments can issue bonds and plough the proceeds into development and infrastructure, keeping the fiscal taps on (Figure 69); banks will finance SOEs and buy LGFV bonds, but the private sector will continue to find credit is tight (Figure 70). The Baosheng bank closure was a seminal event in 2019, and the repercussions to small banks' interbank funding lines has been long-lasting. That, in turn, has meant SMEs, the private businesses that have been the most dynamic part of China's economy, have faced a renewed challenge to get credit. This is an example of a China policy bungle that, going forward, we are more worried about in the next few years; overreacting to human rights concerns or forcing import substitution too quickly are other possibilities.

Worries over high debt and less bang for the buck constrain China's stimulus

Investment has always been the lynchpin for growth, but the SMEs are still suffering from the deleveraging campaign and decline in shadow banking; state-owned enterprises are keeping fixed asset investment from falling even faster. The augmented fiscal deficit is already over 12 per cent of GDP by some measures, and debt concerns will prevent profligacy: growth at all costs is a thing of the past. Two other constraints on monetary policy are the high CPI (mostly from pork prices in the Year of the Pig; these are likely to peak in early 2020 as supply has increased thanks to supply side response and subsidies) and risks of capital flight; thus we expect only gradual further reductions to RRR and across the spectrum of interest rates. This may be a policy mistake, as non-food CPI is just 1.0 per cent, while non-food PPI is -4.4 per cent (both around 3 per cent lower than their headline counterparts). The LPR rates may be cut more later on, if needed, after more lending is linked to them – the 1-year rate is used mainly for corporates, and the 5-year is the benchmark for mortgages. The 5bps cut to 7-day repo on 18th Nov was an important signal, but 5bps per month or every second month seems to be the pace, for now; yield curves should follow lower. This gradual loosening is consistent with allowing the renminbi to weaken, to stave off PPI deflation and boost competitiveness, with 7.40-7.50 our year-end forecast range.

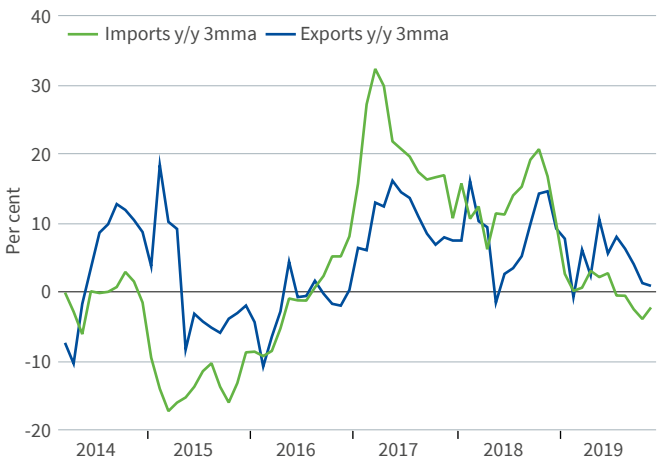
For the rest of the world, China's slowdown will mainly be felt via decreased imports (Figure 71), which will persist absent a big stimulus that includes both property and infrastructure. Global demand is tepid, meaning that both exports and FDI are subdued, while multinationals remain wary of expanding onshore operations. On the flip side, debt and ESG problems caused by Belt & Road Initiative lending (see additional section in this publication), and restrictive capital controls within China, or constraints placed by governments newly wary of China's reliability will limit outbound Chinese investment, which has previously benefitted growth, especially in poorer parts of the developed world.

Figure 70. **Loan rates (per cent) still elevated**



Source: Aviva Investors, Macrobond as at 16 December 2019

Figure 71. **Trade declines hurt global growth**



Source: Aviva Investors, Macrobond as at 16 December 2019

Australia: the newest member of the effective lower bound club

- **Another year of below potential growth expected in 2020, with a further increase in the unemployment rate**
- **Recovery in the housing market a complicating factor for the RBA, but unlikely to be sustained**
- **RBA expected to cut rates to the effective lower bound of 0.25 per cent in 2020**

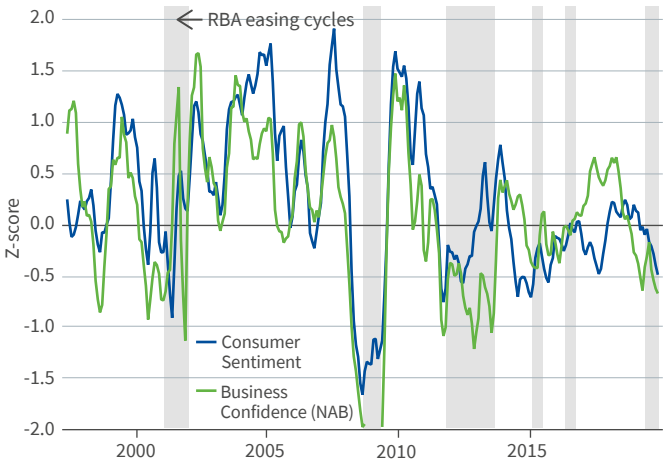
Summary

For several years we have had concerns about the structural imbalances in the Australian economy and the headwinds those would impose on it. The loss of international competitiveness during the mining boom years of the early 2010s required a lengthy period of low wage growth and/or materially lower exchange rate. Both of those have occurred, with annual wage growth running at 2.5 per cent or below over the past six years and the Australian dollar around 20 per cent weaker on a trade-weighted basis. While that has improved competitiveness, further adjustment is still required. It has also resulted in slower overall growth, low inflation and therefore the need for lower policy rates in order to try and achieve the RBA's inflation target. However, lower policy rates have only served to contribute to the other key imbalance, with household debt to income rising to over 180 per cent as house prices increases continued to run well ahead of inflation. In 2019 we expected those headwinds to persist, but saw the Royal Commission into financial services, and the associated tightening in credit conditions as a significant risk catalyst. In the event, the outcome of the Royal Commission was somewhat less impactful than feared, however, Australian banks acted ahead of its finalisation by tightening credit conditions for mortgage borrowers. In particular, taking into account more explicitly the ability to service the debt through greater disclosure on income and expenditures, as well as placing higher hurdles in stress conditions.

The slowdown in credit growth and housing transactions, as well as declines in house prices in the early part of 2019 set the scene for a more marked slowdown in growth than many anticipated. Household and business sentiment fell sharply (Figure 72). That ultimately led the RBA (who up until early 2019 had been indicating that the next rate move was likely to be higher) to reduce the policy rate by 75bps in the second half of 2019 to a historic low of 0.75 per cent. Looking ahead to 2020, we expect growth will improve somewhat, but will

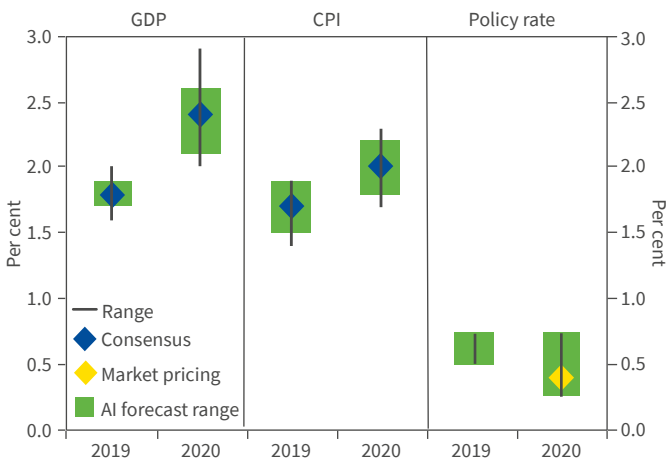
Growth should revive a little in 2020, but not enough to prevent further cuts from the RBA

Figure 72. **Consumer and business sentiment**
RBA likely to ease further unless sentiment improves



Source: Aviva Investors, Macrobond as at 16 December 2019

Figure 73. **Australia economic projections**



Source: Bloomberg, Aviva Investors as at 16 December 2019

remain below potential. That is likely to see the unemployment rate rise further and put downward pressure on already low wage growth and price inflation. As such, we expect the RBA will have to cut rates twice in 2020 to reach the unofficial lower bound of 0.25 per cent (Figure 73). We do not expect unconventional policies will be implemented, with the RBA reluctant to undertake QE. However, if the global downside risks were to materialise, it would likely force the RBA to take further action along those lines.

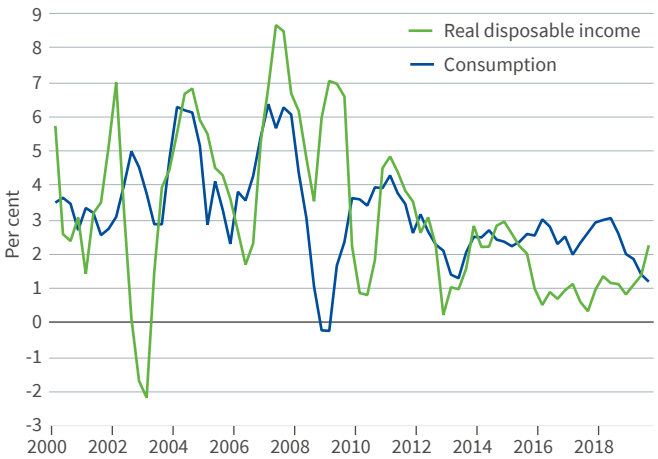
The vulnerable consumer

High debt levels and probable rises in unemployment will restrain household spending

The latest estimate for GDP growth in Q3 2019 was a q/q rise of just 0.4 per cent. While that was disappointing in itself, it masked an even weaker private final demand picture, which fell by 0.3 per cent on the quarter, marking the fifth consecutive quarter where it has either been flat or declined. Household consumption has slowed markedly over the past year (Figure 74), despite the recent boost to disposable income from tax cuts. The consumer remains vulnerable in Australia given the long-term headwind from the level of household debt, low saving rates and, more recently, from the concern of rising unemployment. Those concerns can be seen not only in low levels of consumer sentiment, but also in the apparent decision to save the recent income windfall from tax cuts and lower interest rates.

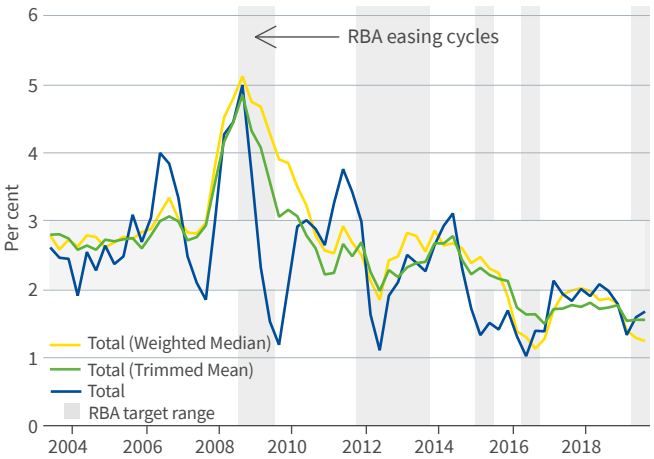
It is perhaps somewhat remarkable that in this environment the housing market has once again started to pick up, following the soft patch in 2018/19. In Sydney and Melbourne prices are once again rising at a rate that would only need to persist for another six months to take them back to all-time highs. That complicates the policy outlook for the RBA, particularly if it leads to a material increase in demand for credit. However, we do not think the recent improvement in housing is likely to persist given the underlying weakness in the broader economy. Indeed, while house prices may be rising again, dwellings investment is likely to be a material drag on growth in 2020. With the RBA's 2020 growth forecast looking too optimistic and inflation persistently below the target range (Figure 75) we expect another rate cut as early as February 2020.

Figure 74. **Household disposable income and consumption (y/y)**



Source: Aviva Investors, Macrobond as at 16 December 2019

Figure 75. **CPI inflation**
Extended period below the target range expected to continue



Source: Aviva Investors, Macrobond as at 16 December 2019

Canada: balancing act

- **Growth is expected to remain near potential, but global trends and the outlook for trade are critical.**
- **Consumer spending continues to be the main contributor to growth, supported by a strong labour market**
- **Debt dynamics make the economy more sensitive to changes in policy, thus constraining the BoC desire to move rates.**

After having declined sharply in the 2nd half of 2017 and into 2018, Canadian growth stabilised near potential in 2019, with full year growth forecast to be around 1.5 per cent. The slowdown in growth in Q3 2019 was in line with expectations and predominantly driven by weaker net trade, due to global trade uncertainty and lower non-energy commodity exports. Consumer spending continues to be the main contributor to growth (Figure 76), supported by a tight labour market and subsequent strong wage growth. The housing market also continues to play a dominant role in the growth outlook. Housing investment is a source of strength, backed by population growth and low mortgage rates. Investment spending was stronger than expected, notably in transportation equipment and engineering projects and will be watched closely going forward to determine if a renewed momentum in investment is emerging.

Growth has slowed in line with expectations

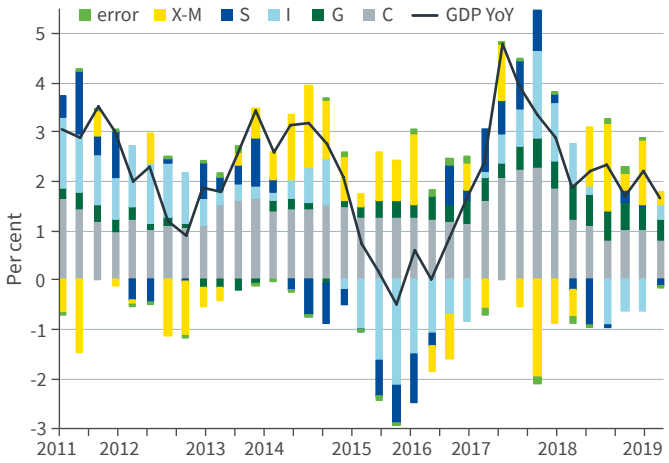
Looking forward to 2020, growth is expected to remain near potential however the outlook remains significantly tied to the broader trend in global growth. As an open economy, Canada remains highly sensitive to the outlook for the trade war between the US & China. Ongoing uncertainty around this trade relationship and subsequent supply chain disruptions has led to a significant slowing in global trade. While the risk of further escalation appears to have diminished recently, intensification in the future cannot be ruled out and continues to be the biggest risk to the outlook. (Figure 77).

The outlook remains significantly tied to the broader trend in global growth and trade

The housing market is expected to sustain growth in 2020, however it also represents the main domestic risk to the outlook. The housing market should be reinforced by population growth thanks to ongoing strong immigration. Canada is heading into its third year of targeted immigration at a rate roughly equivalent to 1 per cent annual population growth. On top of this, mortgage rates have fallen significantly as rates rallied globally. 5-year mortgage rates are now in line with levels from 5 years ago (Figure 78). As homeowners take advantage of falling mortgage rates, as well as moving into shorter term fixes, consumption is expected to rise. A soft landing in the housing market is needed to support the economy, however the Bank of Canada (BoC) will be wary that this benefit needs to be balanced against risks from high levels of household debt. Cutting policy rates could over stimulate the housing market and worsen debt dynamics such that the economy would suffer more if a recession were to hit.

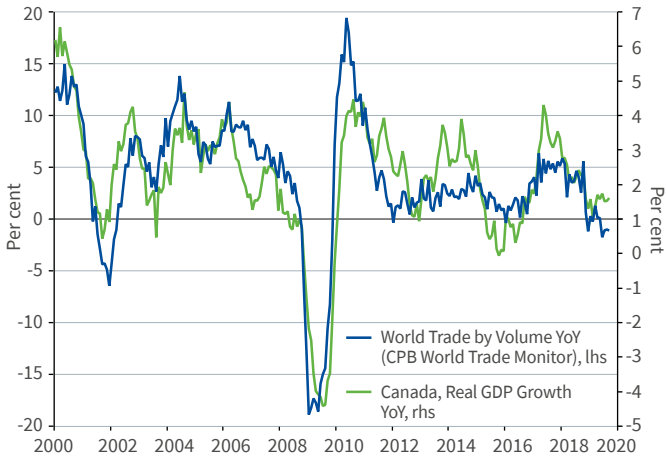
The housing market will support domestic growth; however you can have too much of a good thing

Figure 76. **Canada GDP yoy**



Source: Aviva Investors, Macrobond as at 10 December 2019

Figure 77. **Canadian economy highly sensitive to changes in global trade growth**



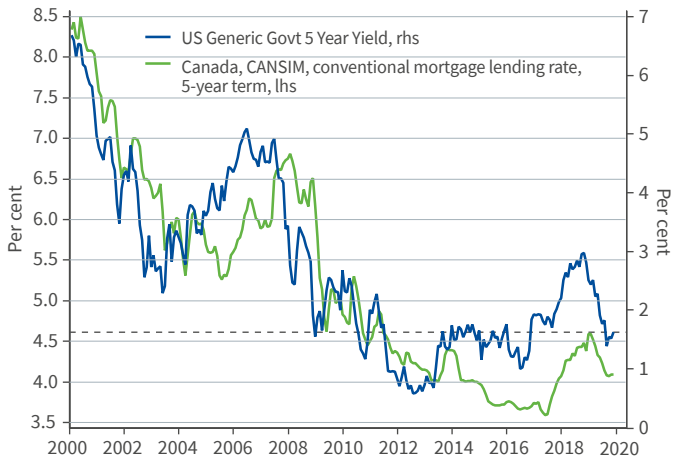
Source: Aviva Investors, Macrobond as at 10 December 2019

Debt dynamics make the economy more sensitive to changes in policy creating a delicate balancing act for the BoC

Debt-to-income levels are high and rising in Canada. The BoC has highlighted previously that this makes the Canadian economy more sensitive to changes in the policy rate, and this subsequently implies a more stable policy stance is preferable relative to other central banks. As the growth implications from the trade war became increasingly apparent through 2019, the FOMC pre-emptively cut rates by 75bp from 2.5 per cent to 1.75 per cent to support growth. Given the tight economic links between the US and Canada, many market participants speculated that the BoC would in turn lower its policy rate, however the BoC has kept rates unchanged since October 2018. Inflation is near target and backed by a tight labour market which is operating near full capacity, also in part because of the strong trend in immigration. The BoC also highlights that Canadian policy rates were lower to start with and therefore recent rate cuts in the US simply align policy rates in the two economies (Figure 79). Inflation is expected to remain near the 2 per cent target throughout 2020. With inflation well anchored the BoC is likely to focus more on the growth outlook when making policy decisions over the next year.

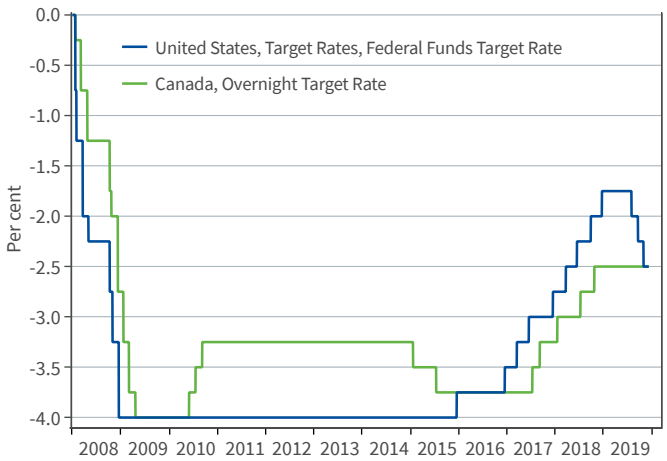
While risks to the outlook remain on the downside, the BoC will remain reluctant to move policy. However, if it were to change policy, the balance of probabilities is tilted towards cuts. Export growth should improve in 2020 as supply-side constraints in the oil sector lessen. However global factors will be the dominant influence. While trade war risks have lessened, they remain to the downside. Very weak results from the November labour force survey also suggest some unexpected deterioration in the labour market outlook. However, higher levels of household debt make pre-emptive rate cuts riskier for the Canadian economy than in the US. Currently, the Canadian economy is benefiting from lower global rates passing through to the domestic mortgage market. In addition, there are expectations of fiscal easing under the new Liberal minority government. For this reason, the BoC will likely remain on hold unless the domestic economy weakens more than its forecast suggests or the trade war escalates.

Figure 78. **Canadian mortgage rate market impacted by decline in global rates**



Source: Aviva Investors, Macrobond as at 10 December 2019

Figure 79. **Change in US & Canadian policy rates GFC**
From 31st Dec 2007: rates at 4.25%



Source: Aviva Investors, Macrobond as at 10 December 2019

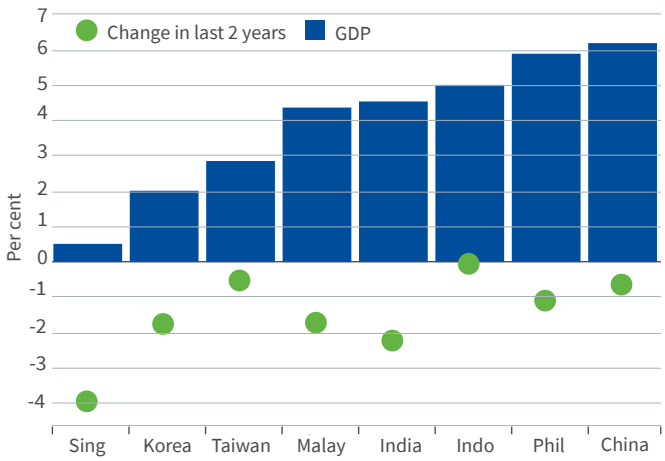
Asia ex-Japan: searching for the bottom

- **Though still a fast-growing region, there has been disruption from the US-China trade war**
- **Central Bank easing and fiscal loosening are important countercyclical measures**
- **The global tech cycle, and "reshoring" from China are upside risks**

Regional Themes: A year ago, trade tensions had damaged Asia's growth prospects, but hopes of a truce were an upside risk. Fast-forward a year, and things played out along the negative risk scenario: tariffs hit China hard, and important markets like memory chips were still bottoming out. The Fed cut rates, allowing many EM countries to follow suit, but the dollar remained strong, and China allowed two "mini-devals" which put additional pressure on exchange rates – though depreciation was surprisingly contained; Aviva Investors expected the latter two developments. Election risk was also weathered well, with populists Modi and Jokowi coasting to victory in India and Indonesia, respectively. GDP gains are lower than normal, but a slow recovery can improve as 5G investment grows, and assuming the Trade War does not materially worsen, (Figure 80).

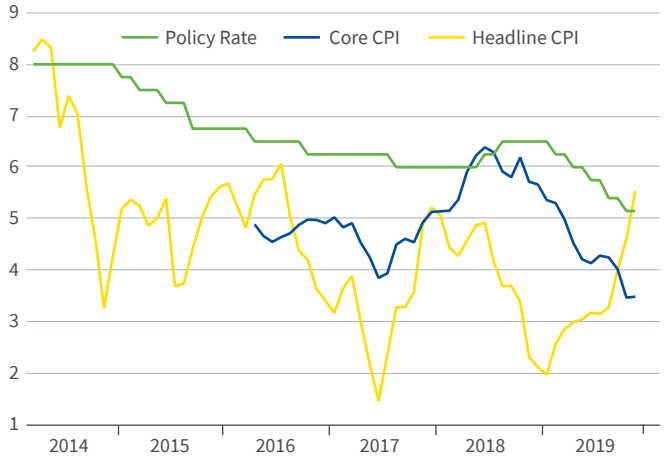
India: The Indian economy has slumped to the lowest growth rate since 2013 printing 4.5 per cent in Q3 data released at the end of 2019. The drivers of the slowdown are mainly domestic with the investment-led slowdown broadening into consumption which makes up close to 60 per cent GDP. The weakness in consumption has been driven by a credit crunch in the shadow banking sector alongside structural issues after a sustained fall in household savings and lower wages. The RBI has embarked on an extended easing cycle since the latter stages of 2018 and there is likely room for further rates cuts. The economy should begin to stabilise given the combination of monetary and fiscal easing that is underway with a modest rebound towards 6.5 per cent in FY21. Headline inflation has picked up, largely driven by vegetable prices, but core inflation is subdued suggesting that inflation backdrop won't stand in the way of easier policy by the RBI. (Figure 81). Indeed, inflation forecasts for FY21 are close to the RBI's 4 per cent target. Fiscal concerns remain elevated given the slippage relative to deficit targets which were exacerbated by corporate tax cuts to help revive the economy. The Rupee has been relatively stable, despite the challenges facing the economy, with underlying investment flows combined with a narrowing current account to provide support which has allowed the RBI to add FX reserves. The Indian economy faces several challenges and the ability for policy makers to navigate fiscal issues, weak growth and asset quality issues in the shadow banking sector will be critical for Indian asset prices.

Figure 80. **Asia remains a fast-growing region**



Source: Aviva Investors, Macrobond as at 16 December 2019

Figure 81. **India can cut rates more after food prices settle**



Source: Macrobond, Indian Ministry of Statistics as at 16 December 2019

Korea: The export-oriented nation will be happy to see the last of 2019, but 2020 may not be much better until trade tensions reverse – and they might not. Trade growth has been negative in 2019 and will again be negative next year, while unemployment rose marginally. The memory cycle is troughing, with investment in cloud and 5G being secular lifts, but which may not be strong enough until late-2020. This means growth will continue to be weak, in the 1.5-1.9 per cent range for the year, after a historically low 1.8 per cent estimated in 2019. Inflation is dormant at around 1 per cent, far below the BoK's target; having reversed 2018's policy error with two cuts this year, another two rate cuts should take policy rates to 0.75 per cent and help to weaken the KRW. One reason growth is being supported is the fiscal deficit, and the Finance Ministry has proposed a sizeable expansion of over 1 per cent of GDP; however, this needs Parliamentary approval and may be delayed by elections in April. As in many countries, political opposition to the president could continue by an obstructionist legislature, to the detriment of national interests.

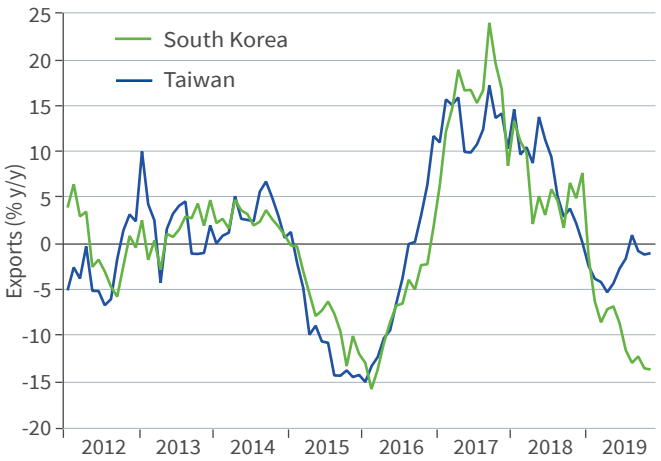
Taiwan is a beneficiary of "re-shoring" from China, but there are negatives as well

Taiwan: Following the HK riots, a pro-Beijing KMT will pose no threat to the incumbent in January elections, but that means continued tense relations with China. We expected shifts from the trade war to occur, and Taiwan has been the main example of this, with exports bucking the global trend (Figure 82); a favourable tech product mix helps as well. However, continued Chinese slowdown means this growth boost is unsustainable; inflation is low and the central bank may deliver a 12.5bps cut or two, especially if the Taiwan dollar remains relatively strong – it has appreciated against KRW and CNY in particular, losing competitiveness. Growth should decline slightly from the 2.6 per cent pace in 2018 and 2019; two-way risk is mainly around China-U.S. trade developments and the global chip cycle – the bust that began in early 2018 has still not bottomed. It is unclear if 2020 will bring the next tech boom, and China is struggling to displace its dependency on imports, though Taiwan remains far ahead in semiconductors and other speciality equipment.

Malaysia: Malaysia's growth is likely to remain subdued in 2020 – 4.2 per cent - which represents a modest slowing from 2019. An improvement in the external environment and infrastructure projects could provide support but are unlikely to offset the unwinding of the one-off tax rebates to households, which boosted consumption at the beginning of 2019. BNM cut rates by 25bps in 2019, and there is potential for to add another adjustment lower in the policy rate at the beginning of 2020, given the sluggish growth backdrop and limited inflationary pressures. Political dynamics could become increasingly fractious as rivals manoeuvre ahead of PM Mahathir's succession plans and will need to be closely monitored. Malaysian government bonds have been placed on review by a major index provider pending analysis of liquidity dynamics. An exclusion could trigger significant outflows although the domestic investor base can absorb foreign selling. A healthy current account surplus and attractive valuations should underpin the Ringgit.

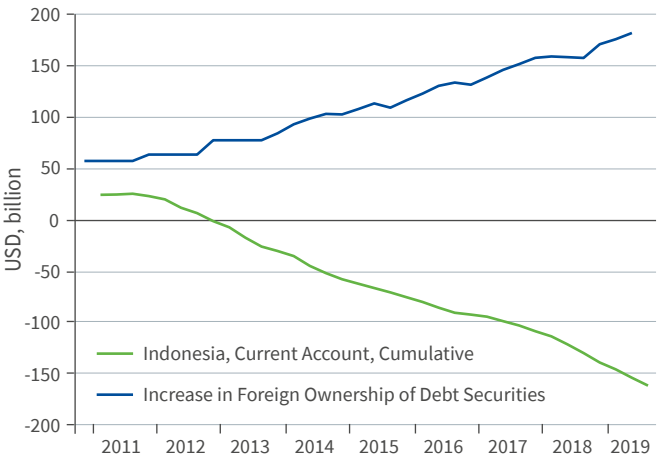
Indonesia: With President "Jokowi" Widodo's re-election and the appointment of his new cabinet, the focus will now shift to structural reforms aimed at boosting growth over the medium term.

Figure 82. **Taiwan's exports have outperformed**



Source: Macrobond; Taiwan Ministry of Finance, Korean Ministry of Trade as at 16 December 2019

Figure 83. **Portfolio flows fund Indonesia's deficit**



Source: Aviva Investors, Macrobond as at 16 December 2019

The priorities are likely to be fiscal reforms aimed at broadening the tax base, the streamlining of foreign investment and reviewing stringent labour market laws. Growth forecasts for 2020 are similar to last year – close to 5 per cent - while inflation should remain in the lower half of the BI's 2.5-4.5 per cent target range. A benign external environment should enable BI to support growth by easing policy further following up the 100bps of cuts in 2019. In the absence of stable long-term capital inflows, there is a constraint on the size of the current account deficit which will be a key input into the BI's reaction function. Indonesian government bonds are attractive to investors given the high real yields and decent fundamentals. Foreigners have added close to $12bn of bonds in 2019 taking ownership to 39 per cent but also making the market vulnerable to swings in investor risk appetite (Figure 83).

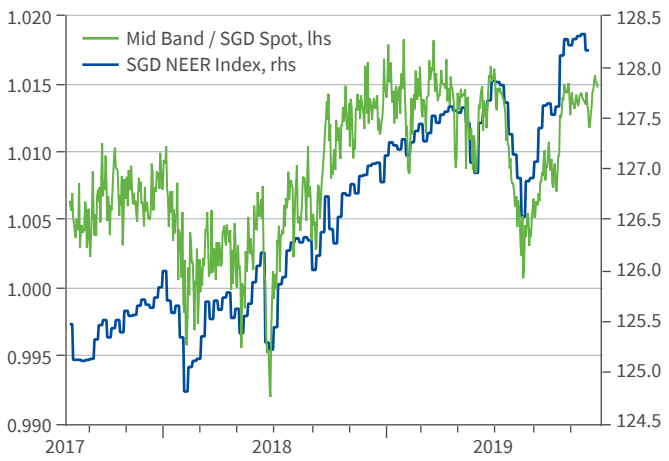
Rate cuts and a window of reform are potential positives for Indonesia

Singapore: Weak economic activity and low inflation were the key considerations for the MAS when it eased monetary policy in October. And, while there is likely to be some bounce back in growth, it will remain below potential at close to 1.5 per cent in 2020. With ongoing headwinds and modest inflation, we anticipate monetary and fiscal stimulus ahead of the next general election to support the economy. The MAS looks set to follow up the 50bps reduction in the NEER slope from last October with a further 50bps in April 2020, taking the slope to flat. The Singapore Dollar has been stubbornly strong when set against the domestic backdrop, but we believe a correction towards the mid-point is possible in coming months, as the market begins to price the potential for MAS policy adjustments (Figure 84).

Thailand: The combination of the delayed approval of the budget and weak exports, undermined by the external environment and Baht strength, have seen the economy end 2019 on a weak note. Growth looks set to rebound modestly in 2020 aided by the expected passing of the budget in January but remain subdued. Meanwhile, inflation is expected to be 1 per cent in 2020 which is in line with the lower range of the Bank of Thailand's 1-3 per cent target band. The still soft growth profile, aligned with the absence of inflationary pressures, should see the central bank ease policy further following the 50bps cuts during 2019. The Baht valuations appear expensive – the REER is 12 per cent above its long-term mean (Figure 85) which is only second behind the US Dollar - but the large currency account surplus and limited capital outflows point towards the currency being well-underpinned for the time being.

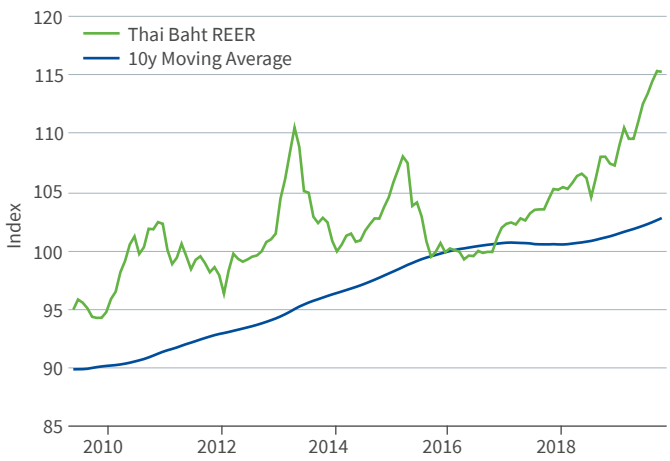
Philippines: Tight financial conditions and delays passing the budget saw growth slowdown in 2019. However, renewed government spending and private consumption aligned with easier financial conditions are expected to provide a fillip and boost growth back above 6 per cent in 2020. Fiscal spending related to the 'build, build, build' infrastructure programme should also support economic activity. The BSP cut policy rates by 75bps in 2019 and the reserve ratio requirement was decreased by 400bps, significantly easing banking system liquidity. While the rate cutting cycle is probably complete, a further easing of reserve requirements seems likely. Headline inflation is likely to increase back towards the mid-point of the BSP's 2-4 per cent inflation target band in the second half of 2020. The Peso will face headwinds from the widening current account deficit driven by the import of capital goods as infrastructure spending picks up.

Figure 84. **MAS may weaken the Singapore Dollar**



Source: Aviva Investors, Macrobond; MAS, Goldman Sachs as at 16 December 2019

Figure 85. **The Thai Baht looks significantly overvalued**



Source: Aviva Investors, Macrobond; BIS, Bloomberg as at 16 December 2019

Latin America: in the crossfire

- **Risk premium on the rise as trust in political leadership drops**
- **Years of subdued growth reveal the structural problems**
- **Policy rates reaching their long-term constraints across the region**

The casualty of global slowdown

2019 was another year when growth disappointed across the region (Figure 86). External uncertainties, especially the trade war, have taken their toll on Latin American economies. China slowdown and trade war tensions have hit commodity-exporting countries disproportionately. Even Brazil, the most closed economy in the region, has suffered substantially. On top of the external backdrop, many countries have suffered some form of political shock, with Argentina's return of a Peronist administration being a prime example.

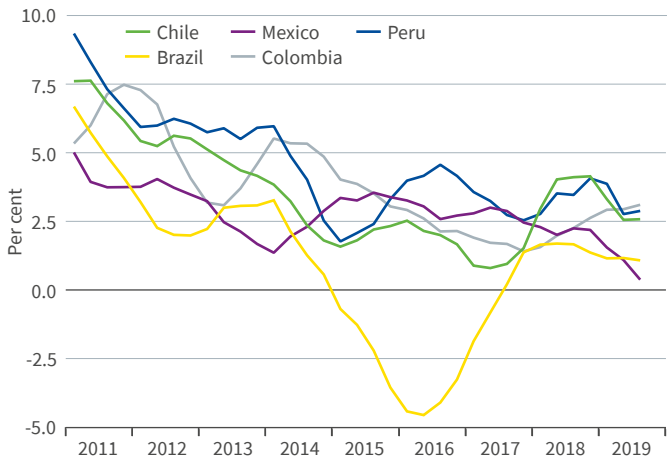
2020 is looking to be no easier for the region. Almost all countries are now struggling with domestic problems and political uncertainty is on the rise. After years of disappointing economic recovery, long-term structural imbalances are coming to the surface causing in many cases violent social protests. Unfortunately, most governments in the region have very limited space to accommodate demand for more social spending (Figure 87). Equally, central banks in the region have also seemed to hit the long-term constraints of expansionary monetary policies. Without a recovery in external demand and a further strengthening of institutional frameworks, it might be very hard for Latin American countries to escape the low-growth equilibrium.

Brazil: light at the end of the tunnel?

The outlook is not gloomy everywhere, however. In Brazil, despite consistent downward growth revisions, the stage is set for a modest but healthy recovery. After years of discussions and delays, the social security reform has been finally approved. That piece of legislation was essential to put public finances on a sustainable path in the long term. However, further efforts are still needed to reduce public spending and cut the red tape in the economy. Only by doing so can Brazil attract foreign investments and unleash economic potential. Other levers to support economic growth – monetary and fiscal policies – are very limited. The good news is that the economic administration led by Paulo Guedes presented a very ambitious reform agenda and, so far, it has support from major political parties.

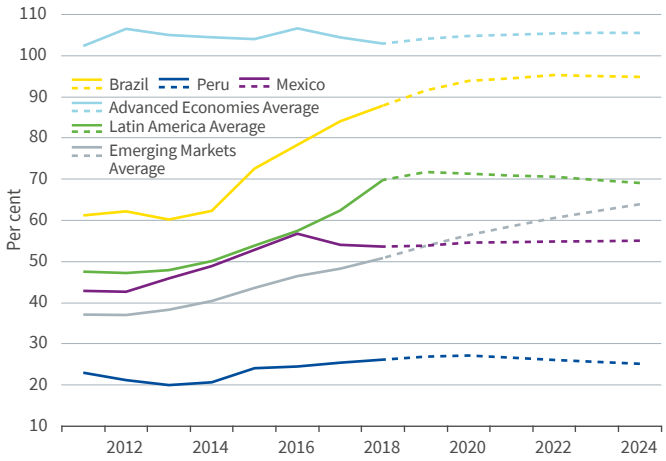
Obviously, there are major risks for Brazil going forward. Failing to deliver growth could cause Bolsonaro to lose his popularity and consequently put into question the economic agenda of Mr. Guedes. Brazil is also not immune to the social unrest going through Latin America currently, but we remain more optimistic.

Figure 86. **Latam GDP growth**



Source: Aviva Investors, Macrobond as at 16 December 2019

Figure 87. **Gross debt to GDP**



Source: Aviva Investors, Macrobond as at 16 December 2019

Mexico: how long will the honeymoon last?

The second biggest economy in Latin America – Mexico – has been avoiding major market turbulence in 2019. After initially disturbing foreign investors by the cancellation of the major airport project, President Obrador (AMLO) has proved to be very fiscally prudent. Yet, the external backdrop exacerbated by uncertainties around approval of USMCA, has led to a collapse in private investments (Figure 88). That is one of the biggest reasons for the large growth slowdown this year. It is also a key to next year's outlook. Without a revival in private investment, it will be extremely difficult for Mexico to escape from its low-growth equilibrium. There is also the unresolved problem of Pemex that will cast shadow on otherwise relatively healthy public finances. The longer the economic slowdown persists, the more likely AMLO's voters will challenge his policies. Will he remain fiscally prudent?

The Andean region is where political tensions have dramatically worsened the fundamental outlook. Firstly, there was a constitutional crisis in Peru which resulted in Congress's dissolution by President Vizcarra. There will be snap parliamentary elections in January 2020. The fragility of the current political backdrop and strong anti-establishment mood in society, mean that Peru is vulnerable to a further rise in the political risk premium. It comes also at a time when the economy continues to disappoint despite historically low interest rates.

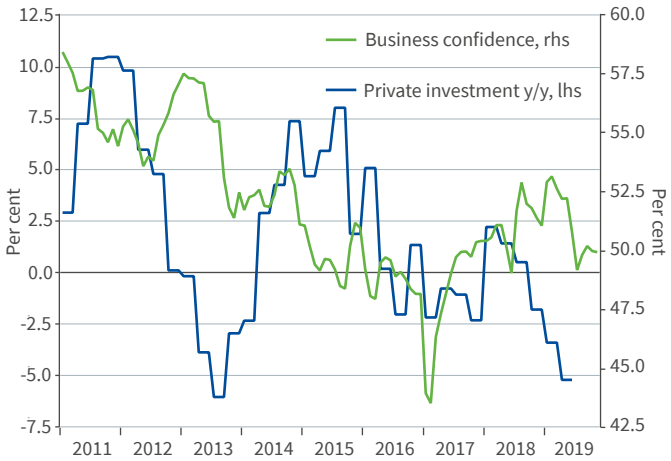
Chile: a tipping point

Following on from Peru, we have seen a dramatic eruption of social protests in Chile driven mainly by an outcry against income inequalities. After the initial confrontation, President Piñera backed down to social demands. There will be new laws enacted to improve income redistribution and the process to write a new constitution has been initiated. We expect some deterioration of fiscal fundamentals but Chile's starting point is healthy. What worries us more is whether authorities can restore social cohesion and rebuild investors' confidence (Figure 89). Heavy reliance on global demand for commodities and ultra-low policy rates make the country even more vulnerable to shifts in sentiment.

We have very similar outlook for Colombia where protests followed its southern neighbour. What makes it even worse is that Colombia does not have as much fiscal space to satisfy social demands. Although GDP growth was relatively good compared with the rest of the region, it came with a significant deterioration of the current account. That also makes the outlook for next year challenging, as the fiscal and monetary room to absorb further shocks is very limited.

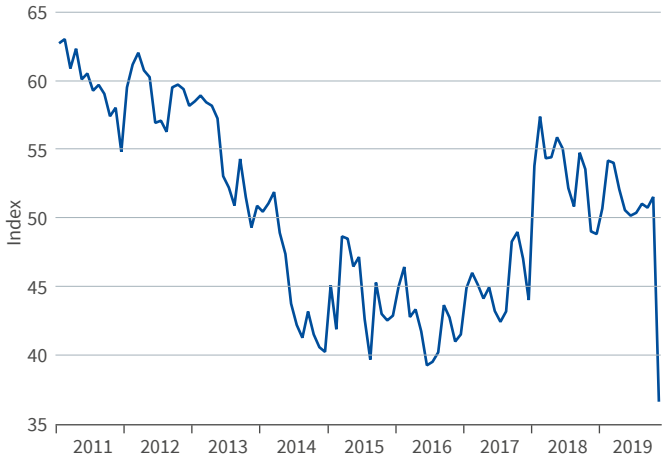
If there were not enough problems in the region, there will be another debt restructuring in Argentina. The discussions between the new administration, the IMF and bondholders will be very difficult. The outcome at this point is very uncertain.

Figure 88. **Mexico investment and business confidence**



Source: Aviva Investors, Macrobond as at 16 December 2019

Figure 89. **Chile economic expectations**



Source: Aviva Investors, Macrobond as at 16 December 2019

Central and Eastern Europe: a mixed picture

Russia – lower vulnerability, same structural problems

Modest growth expected, helped by loose fiscal and monetary policy

Russia has achieved the status of one of the most resilient emerging markets in 2019. Fundamental improvement over the last few years have been quite impressive. However, low vulnerability alone does not translate into better growth prospects. The economy has reached a low-growth equilibrium and, without structural reforms, we do not see much chances of switching into a higher gear. The main long-term problems include institutional weakness, poor public systems (most notably pension and health care) and the dire state of infrastructure, none of which have been resolved. On top of that, Russia has very poor demographics which will exert negative pressure on potential growth.

Notwithstanding the structural problems, we expect a modest recovery in growth thanks to more accommodative fiscal and monetary policy. Russia is one of the few countries which can afford looser fiscal policy. The central bank is also likely to keep easing monetary conditions further.

Fiscal rules implemented at the beginning of 2018 have successfully lowered the sensitivity of the ruble to oil swings (Figure 90). However, the price of that commodity remains the biggest risk factor for Russia's outlook. Further severe sanctions at this point seem unlikely but they can't be completely ruled out.

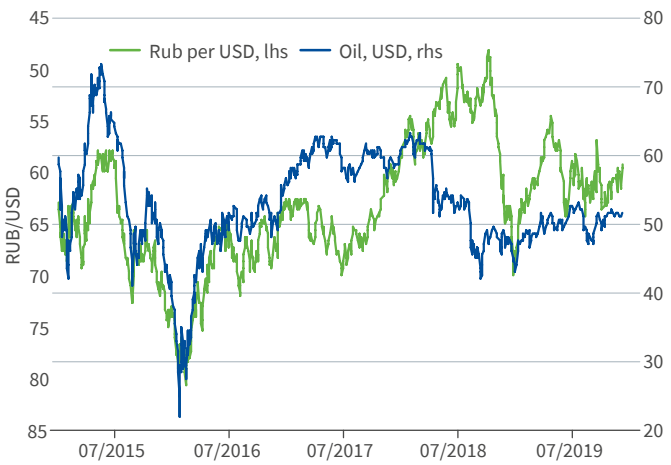
Turkey – at the mercy of global conditions

Turkey remains vulnerable and Erdogan confrontational

Turkey has experienced a recession in 2019, although it was less dramatic than some economists feared. There were also large improvements in some of the underlying structural imbalances. The current account gap has been closed. Banking and corporate sectors are going through healthy deleveraging and inflation pressure has subsided but remains at uncomfortably high level.

However, there are still many challenges ahead in 2020. Turkey needs to rebuild trust in its financial system and the credibility of institutions. Despite fundamental improvements there is still no sign of foreign investments coming back to Turkey. Moreover, even local households and corporates show a lack of confidence with more than 50 per cent of bank deposits being in foreign currency (Figure 91). The authorities need to address that problem and at the same time find a new model for growth. Because of the lacklustre recovery that we expect, as well as high unemployment, the authorities might be tempted to use tools they employed in the past, namely credit growth and expansionary monetary policy. Both would lead to Turkey being again very vulnerable in a scenario where global conditions turn less favourable for emerging markets. What makes the outlook for the next year even more complicated are geopolitical risks. The fact that Erdogan chose a much more confrontational approach towards the West increases the tensions and often drives the markets.

Figure 90. **Russia, RUB (FX spot) vs OIL, USD**



Source: Aviva Investors, Macrobond as at 16 December 2019

Figure 91. **Turkey: dollar deposits**

Source: Aviva Investors, Macrobond as at 16 December 2019

Decent growth in Central Europe, despite slowdown in the Eurozone

Growth in Central Europe (CE4) slowed down on average in 2019 but to a lesser extent than one might have expected, given the significant deceleration in Eurozone (Figure 92). Fast-growing real incomes and therefore households' spending have helped, as have expansionary fiscal policies in almost all countries in the region. Also, the slump in autos production hasn't quite hit vehicle output in Central Europe, the production hub for many European automakers. The outlook for 2020 is nevertheless for yet another gradual slowdown. Consumers will face less robust income growth and the governments are likely to be less generous than in the recent past. The lagged effect of the Eurozone slowdown and lower EU-financed investment will also play a role.

Growth to revive only slowly in 2020

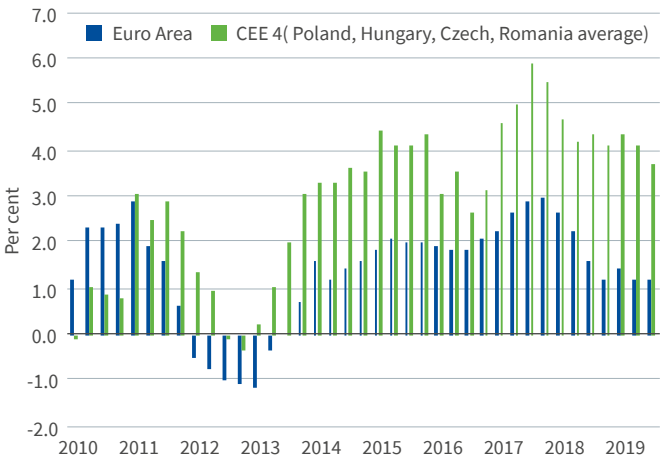
Higher inflation than rest of Europe should peak soon

Inflation has been on the rise for some time now and reached levels above inflation targets in most of the countries, driven primarily by rapidly rising labour costs (Figure 93). The scarcity of labour in general has also contributed, despite a large influx of migrant workers from former soviet republics. Services inflation has been particularly high, and this is where productivity has been clearly lagging nominal wages. It may be the long-forgotten Balassa-Samuelson effect at play, whereby the price level in economies adjusts upwards as economies move up in the value chain of the integrated global manufacturing sector. Central banks can do little about this. Even so, inflation should peak soon.

Inflation to peak soon

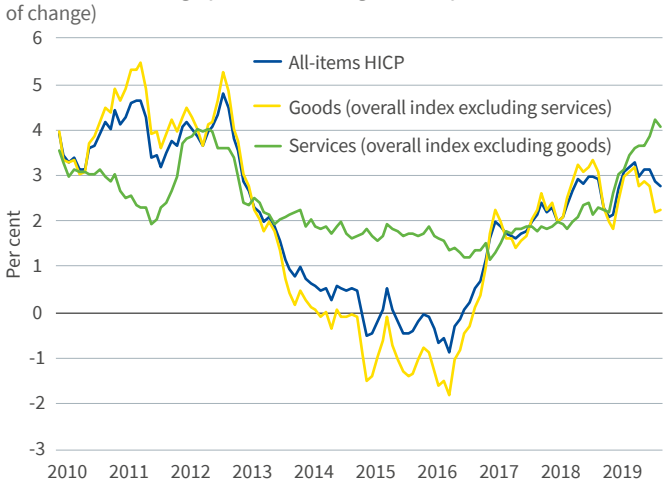
After years of above-potential growth, divergences appeared in terms of external and internal stability measures and very different sets of policies pursued by the regional central banks. **Hungary**, with the lowest rates in the region and a set of unconventional measures still in place, has conducted by far the most accommodative policies in the region and may be erring excessively on the dovish side, given the robust economic performance of the economy. But even so, Hungary has managed to build enough cushions: a balanced current account and low public sector deficit. As a result, it could easily sustain tighter monetary policy. In the **Czech Republic**, the central bank seems to be erring on the hawkish side. Expectations of a change in the monetary policy stance to a more accommodative one in the not-so-distant future are well grounded in our view. **Poland** has solid fundamentals but may face challenges on the fiscal front, although nothing is imminent. The central bank has steered a steady course, hasn't changed its policy for almost five years and pledges not to do so in the foreseeable future. We agree that it may not have to. **Romania** finds itself between rock and a hard place after a couple of years of irresponsible policies. Its ballooning fiscal and current account deficits, impotent monetary policy, slowing growth and election year ahead, all point to the situation getting worse there before it gets better. Longer term, we pin our hopes upon expected changes after the general elections to be held towards the end of 2020 and liberals winning majorities in parliament. Also, the European Commission is likely to impose an Excessive Deficit Procedure (EDP) on Romania some time in 2020 and force the government to take more meaningful measures to curb the fiscal deficit.

Figure 92. **Central and Eastern Europe: Real GDP growth year-on-year**



Source: Eurostat, Aviva Investors as at 16 December 2019

Figure 93. **Central and Eastern Europe: HICP inflation in CEE4**
(Poland, Czech, Hungary, Romania average, monthly data, annual rate of change)



Source: Eurostat, Aviva Investors as at 16 December 2019

Market Outlook

DM Equity: reasonable valuations, growing divergence

- **Headline valuation metrics are elevated but not alarming**
- **Increasing divergences between style factors and sectors creates mean reversion risks**
- **Stock selection opportunities arising from structural industry-level changes**

Global equities

Valuation metrics are at or near historic highs, but are not yet stretched given low interest rates

Global stock markets had a good year in 2019, with MSCI World delivering strong returns of over 20% at the time of writing, despite macro-economic and political concerns.

As always, headline valuation multiples are a reasonable starting point to consider the outlook for the next year.

At the time of writing, the MSCI World forward P/E ratio is at 16.5x, at the top end of the last 5-year range. It is not in itself alarming - market has been at these levels on multiple occasions in the past five years.

The EV/EBITDA metric, which accounts for financial leverage, is elevated at 11.1x representing 7-year highs, but does not look too stretched. This in part reflects companies' willingness to take on more debt given the cost of borrowing and market appetite for yield (Figure 94).

Compared to prevailing interest rates, the stock market represents "good value", with earnings yield at 6 per cent comparing favourably with a 1.8 per cent US 10-year Treasuries yield. This "yield premium" to Treasuries remains healthy and is not much different from where it has been over the past several years (Figure 95).

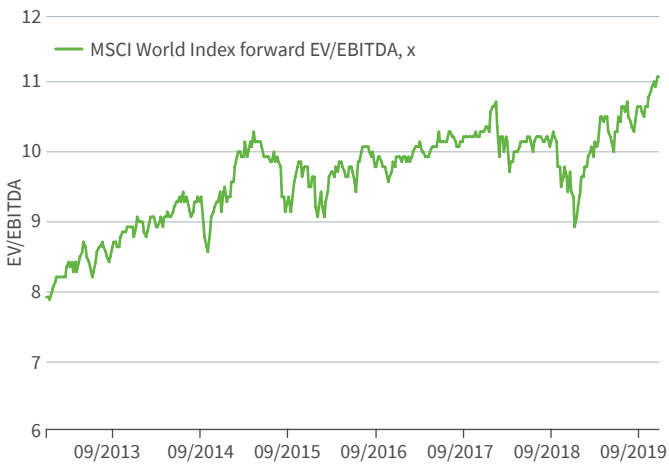
These simplistic headline metrics indicate somewhat elevated market valuation, but no immediate cause for concern. However, they hide increasing divergence within the market between sectors and style factors.

One of the more well-publicised phenomena is the valuation divergence between quality and value.

MSCI's own Quality and Value indices show that over 3 years, the Quality factor outperformed Value by a cumulative 30 per cent, with a substantial proportion of that occurring in 2019 (Figure 96).

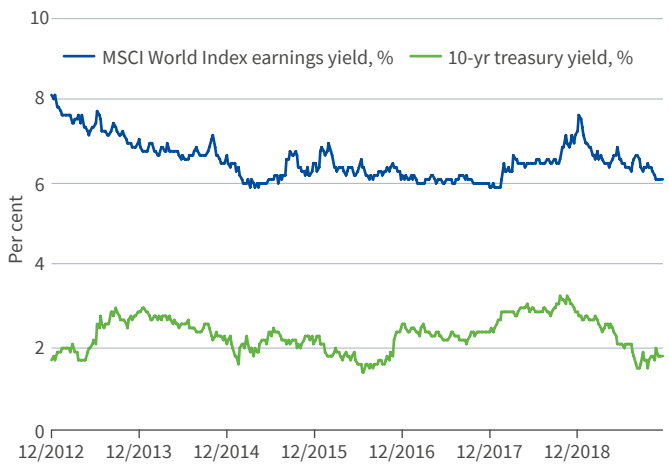
This performance divergence reflects both markets' preference for safety as well as value camp including some structurally challenged industries (e.g. energy as the world de-carbonises and the auto industry facing transition to EVs and shared mobility).

Figure 94. **MSCI World EV/EBITDA history**



Source: Bloomberg, Aviva Investors as at 16 December 2019

Figure 95. **MSCI World earnings yield vs Treasuries**



Source: Bloomberg, Aviva Investors as at 16 December 2019

A cleaner experiment is to look at the tech sector – which in general has a positive structural growth outlook. Within Tech, Software has strongly outperformed Semiconductors, in large part because Software enjoys a more predictable, less cyclical growth. The market's willingness to pay up for that through valuation multiples had substantially increased over the past 12-18 months (Figure 97, Figure 98).

This may result in significant sector and factor rotation risk and makes a more style-agnostic, bottom up approach key to delivering alpha in 2020.

Some of the areas where we are looking for opportunities in developed markets include the following:

1. Artificial intelligence, machine learning and data analytics are becoming mission critical in a range of sectors, not just tech

Companies that can evolve their business models through the use of data may be more likely to outperform. Advances in artificial intelligence, machine learning and data analytics give companies in many sectors more tools to monetise datasets. For those who currently sell data, offering additional services such as an analytics layer on top of the existing data can help customers apply the information more efficiently towards their business goals.

Data analytics go beyond tech sector hype and become mission critical for a range of "conventional" industries

Others may benefit from aggregating industry data to drive growth, efficiency and profitability. In the healthcare industry machine learning may help insurers improve outcomes by monitoring the impact of certain medical treatments over time and predicting patients' behaviour. Large-scale cost analysis can also be used to reduce healthcare spending.

2. The rollout of 5G mobile network will create winners and losers

The evolution of wireless technology has fuelled a host of new mobile applications and helped drive growth in areas such as video streaming. 5G, its next iteration, holds even bigger promises that will begin to take shape in 2020. IDC estimates that global 5G capex will reach US$26 billion in 2022 from US$528 million in 2018. Telecommunications providers will shoulder the bulk of that, but it remains unclear whether they can substantially gain from pricing advantages as a result.

5G roll-out is happening at scale, paid for by telecom industry, but creating opportunities for non-telecom players

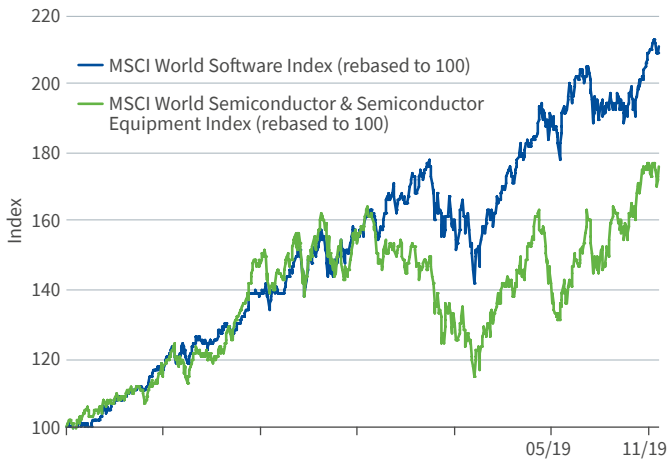
There is a lot of excitement around new industrial services associated with 5G, such as connected vehicles or internet of things, but these may accrue to industrial services and product providers, not the general telecom industry.

Some of those who provide the components and services to telecoms companies may be in a better position to grow revenues during both the rollout of 5G networks and the launch of 5G handsets and other connected devices.

Figure 96. **MSCI Quality vs MSCI Value**

Source: Bloomberg, Aviva Investors as at 16 December 2019

Figure 97. **Software vs semis performance**



Source: Bloomberg, Aviva Investors as at 16 December 2019

3. The imperative for pharmaceutical companies to control cost is increasingly at odds with their need to innovate

Instrument providers and outsources benefits from healthcare industry need to control pricing and costs but continue to innovate

Typically, pharmaceutical companies derive their pricing advantages from bringing new products to market as patents expire and the availability of generic equivalents limit pricing power. Luckily, medical scientific evolution has a lot of room to roam.

A clearer understanding of the human genome has created new targets to explore that cover a range of molecular classes, including proteins, peptide drugs, and gene and cell therapy that can provide more personalised treatments. However, these tend to come with hefty price tags and a far smaller consumer base. At least since 2010, average R&D costs have soared while average sales forecasts have continued to fall. It now costs an average of US$2.1 billion to bring a new drug to market.[1] R&D returns, however, dropped to about 1.9 per cent in 2018 compared to 10.1 per cent in 2010, according to Deloitte.

R&D in these new areas will continue to drive demand for new life sciences tools and laboratory supplies, benefiting the companies that provide those.

Meanwhile, pharmaceutical companies are under more pressure than ever to reduce costs. In the US, the largest healthcare market, 2020 presidential election will likely focus on healthcare costs. Pharmaceutical companies will need to improve cost efficiency while making sure they have a healthy drug pipeline. Outsourcing service providers that can reduce the cost of manufacturing or clinical trials for the industry stand to benefit from this change.

4. Global passenger air traffic growth coupled with rising climate change risks will support demand for new, more fuel-efficient aircraft

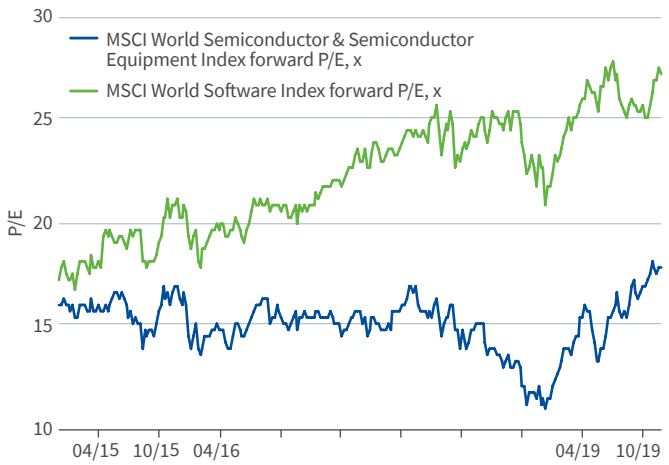
Growing air passenger traffic and environmental pressures support an already-benign aerospace cycle

Global passenger air traffic climbed by 6.5 per cent in 2018 and is expected to continue rising for the next 20 years. The number of passengers is expected to increase during this period by a compound annual growth rate of 3.5%.[2] While growth in developed markets is likely to continue, it is in emerging markets where much of increase is expected to occur.

This trend conflicts with rising climate change risks. Similar to efforts to cut emissions in the auto industry, governments, businesses and consumers are likely to put more pressure on airline companies and aircraft manufacturers to help reduce pollution from air travel. One obvious solution is to improve fuel efficiency. Only about ten per cent of the global short-haul aircraft fleet and about 20 per cent of the global long-haul aircraft fleet have been upgraded to the latest generation of aircrafts. These vary but can improve fuel efficiency by up to 20 per cent. If airlines increase the pace of fleet replacement, aircraft manufacturers and those providing the parts for them could benefit.

1 'Unlocking R&D productivity: Measuring the return from pharmaceutical innovation 2018,' Deloitte, 2018.
2 'IATA Forecast Predicts 8.2 billion Air Travelers in 2037', International Air Transport Association, 24 October 2018.

Figure 98. **Software vs semis valuation multiple**



Source: Bloomberg, Aviva Investors at 16 December 2019

EM Equity: foundations of a recovery

- **Trade war and macro uncertainty undermined confidence**
- **Corporate earnings bottoming out**
- **Diverging fortunes across sectors and companies**

2019 was a second consecutive disappointing year for global emerging market (GEM) equities. Although the asset class eked out reasonable gains in dollar terms it was again well behind most developed market equity indices. More positively, there are a number of companies performing well against this backdrop and there remains significant latent global investor demand for GEM assets, evidenced by the huge and successful Saudi Aramco IPO at the end of the year. Despite the plentiful macro noise which always complicates analysis of this asset class, we feel that we are at a point of inflection for the key driver, emerging market corporate earnings, which should contribute to a more positive performance in 2020.

GEM equities lagging in 2019 but some grounds for optimism

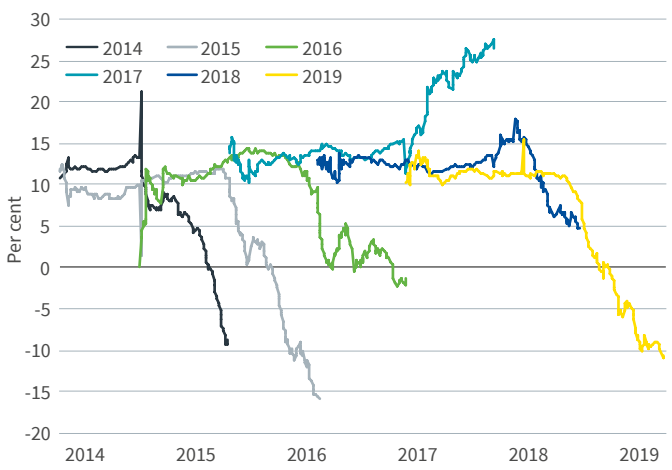
Continuing political tensions between the US and China have been the dominant political driver of GEM equity for the second successive year – the markets have been very sensitive to changes in tone of rhetoric from each side. This is not surprising given the importance of global free trade and the theory of comparative advantage to the emerging market growth story. It has not been purely a US-China issue; there was a period of political tension between Japan and Korea, which translated into policy measures restricting critical Japanese semiconductor material exports into the Korean memory chip industry. Although the full impact of a worst-case tariff outcome has not yet been reflected in corporate profits forecasts, the impact of uncertainty on business and consumer sentiment, particularly in China, has been a meaningful drag to earnings. Alongside the soft global growth environment and EM currency weakness, this has been another disappointing year for corporate earnings growth – expectations for 10 per cent growth at the start of the year were steadily eroded, and the likely outcome seems likely to be closer to -10 per cent in dollar terms as illustrated (Figure 99). The gap between corporate earnings growth in emerging markets and in developed markets has been sizeable; Figure 100 shows the extent of this over the last year and a half.

Trade war continues to unnerve investors in the asset class

Outside trade affairs it felt like macro policy has been broadly supportive of the asset class this year. The shift of the Fed to a more accommodative stance in late 2018 has been followed by rate cuts in a number of emerging markets including Korea, Indonesia and South Africa. Although Argentina has been slipping back from a pro-reform policy stance, we have seen more concrete signs of progress in one of the better performing markets, Brazil (Figure 101), where policy momentum is now feeding into improving economic growth, albeit alongside some major environmental concerns. On the whole we feel that most major emerging market economies are in reasonable shape with inflation and debt under control and fewer structural

Macro and micro policy generally supportive for emerging markets

Figure 99. **A further year of GEM corporate earnings downgrades**



Source: Bloomberg, MSCI, Aviva Investors at 16 December 2019

Figure 100. **Accumulating significant underperformance against global corporate earnings estimates:**

Source: Bloomberg, MSCI, Aviva Investors at 16 December 2019

imbalances than in the past. Although tariff uncertainties are an overhang, most emerging market companies are getting on with business and continuing to look for opportunities to deploy capital in promising markets.

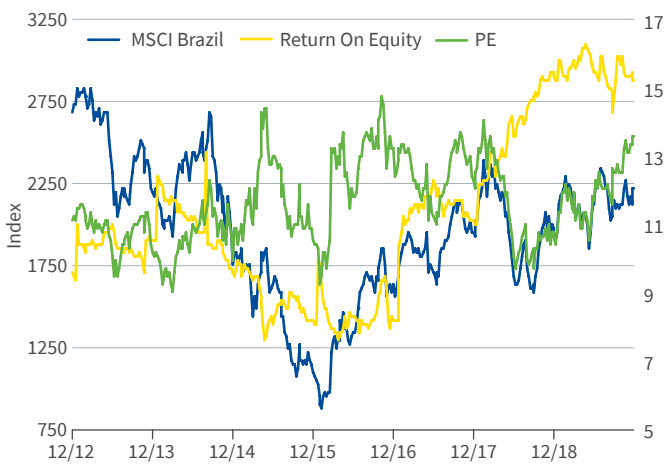
Big rebound in GEM technology stocks

Despite trade uncertainties, the performance of technology stocks roared back in 2019 after a very weak 2018. The rollout of 5G telecommunications infrastructure and handsets looks on course to be much quicker than initial expectations, with China's huge efforts to be on the cutting edge the main driver here. At the same time global server demand is now reaccelerating, driven by massive structural shifts towards cloud computing and artificial intelligence. One really interesting phenomenon we are noticing from our stock-specific research is the extent to which global supply chains are relocating in response to trade risks, both in tech and more generally across sectors. Regardless of the eventual outcome to tariff negotiations global companies are acting quickly to diminish risks in their supply chains. In many cases this involves sourcing more domestically and from neighbouring or allied countries, and we are actively searching for mid-cap stocks benefiting from this trend.

E-Commerce still a major force for change in emerging markets

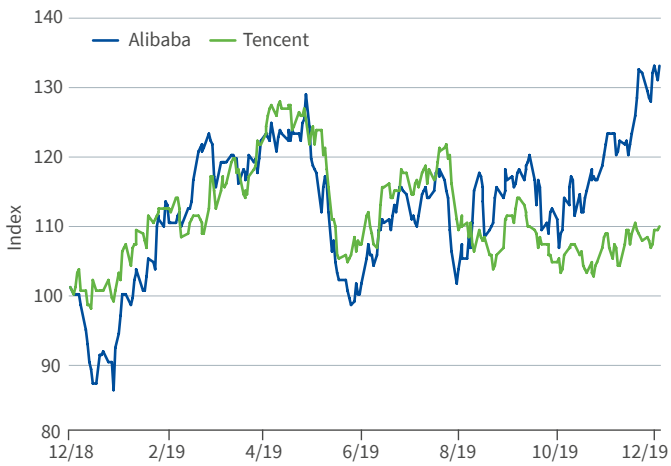
Against the improving technology background the four big Emerging Market tech stocks – Alibaba, Tencent, TSMC and Samsung Electronics – which have become the four biggest names in the MSCI EM index, are seeing quite different underlying earnings trends. While the Chinese e-commerce market goes from strength to strength, with Alibaba and its range of smaller competitors enjoying strong gross merchandise value growth and improving margins, the domestic gaming and online advertising markets have been more difficult. Tencent has seen a surprising erosion of its hitherto dominant social network share, with upstarts such as Bytedance with its popular TikTok app winning a lot of younger users. The share prices of these two Chinese internet giants have reflected this earnings divergence (Figure 102). In the semiconductor space Taiwanese foundry TSMC has furthered its competitive technological lead against global players such as Intel as we move into ever smaller 7nm and 5nm nodes. The remarkable job the company has done in grasping global technological leadership from Intel in logic chips is enabling it to take the lion's share cutting edge demand in 5G phones and high-performance computing. It is also one of the beneficiaries of the technology supply chain shift to Asia. In contrast Samsung Electronics has suffered major earnings erosion owing to its dependence on the more cyclical memory semiconductor markets and the difficulty of keeping up with TSMC in logic chips; we do however see scope for a significant recovery next year as DRAM prices bottom out and Samsung gains global share from Huawei in telecom infrastructure.

Figure 101. **Strong rebound in Brazil**



Source: MSCI, Aviva Investors, Bloomberg at 16 December 2019

Figure 102. **Alibaba v Tencent in 2019**



Source: MSCI, Aviva Investors, Bloomberg at 16 December 2019

It was a year where some of our more cyclical stock ideas struggled, with the materials sector in particular proving difficult in a weaker growth and trade environment. However we remain optimistic about certain underlying trends we are seeing. For example, the impact of IMO 2020, which sets new requirements on the environmental quality of fuel used by the global shipping fleet, seems set to transform profitability in Asian refining companies which have invested sufficiently in good quality new capacity. Equally, there will be more scope for shipping operators with efficient fleets to take advantage of their competitive advantage of a better cost base and gain share in some of the more buoyant Asian shipping routes.

Cyclical stocks underperforming

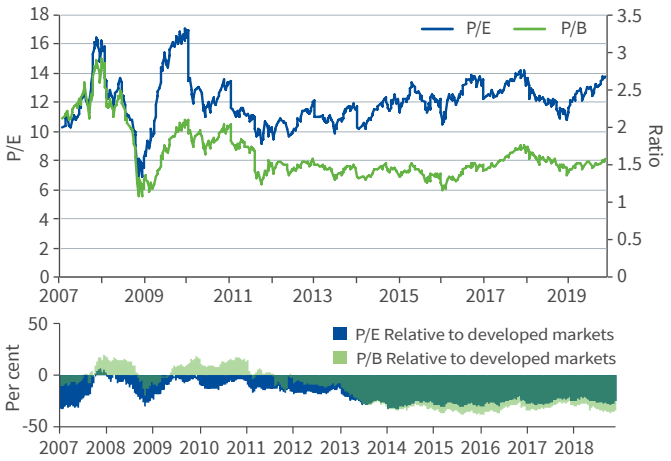
One intriguing factor of GEM equity has been the continuation of small cap underperformance through 2019 despite a less risk-averse tone to markets. It is particularly surprising when we look at the relative earnings performance of smaller quoted emerging market stocks, which have held up better than their larger counterparts. The consequence has been a de-rating to historic low relative valuation levels, suggesting that now is an attractive time to be considering small and mid-capitalisation companies.

Small capitalisation GEM stocks look extremely attractive

On the whole, despite their underperformance of global equity indices, emerging market equity valuations are slightly above long-term averages but lower than their developed counterparts (Figure 103). This reflects relatively weak GEM earnings dynamics as well as high valuations on developed market exchanges. An improvement in the relative performance of our asset class will require consistently better company earnings performance. The outlook here is looking more favourable for 2020 with the earnings cycle bottoming out, notably in the all-important technology sector, along with signs of structural improvement we are seeing in some areas. In GEM as elsewhere there has been a big factor divergence between styles, with momentum stocks outperforming value stocks dramatically leaving the valuation gap between the two at historically high levels. Figure 104 shows valuations in sectors such as consumer, health care and telecoms are well above long-term averages, in contrast to cyclical sectors such as industrials and materials. Timing of a reversion is hard to determine, but any sign of accelerating global growth could be the catalyst for a significant bounce in unloved value/cyclical stocks, and could remind investors of the benefits of a style agnostic investment philosophy.

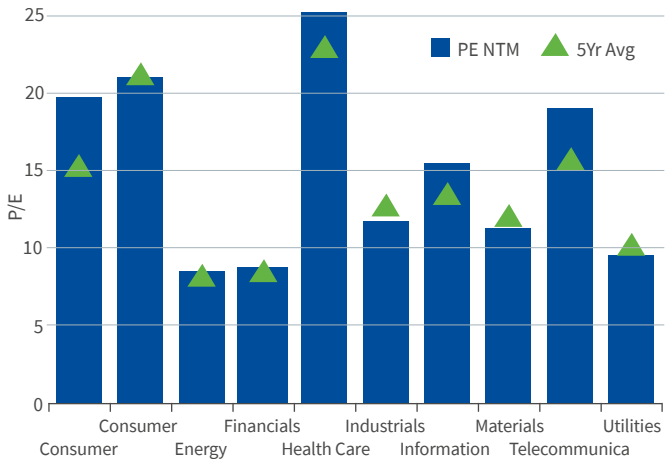
GEM Equity valuations relatively low, but style divergence is high

Figure 103. **Emerging market valuations slightly above long term average, but large discount to developed markets**



Source: Bloomberg, MSCI, Aviva Investors at 16 December 2019

Figure 104. **GEM sectoral valuation dispersion greater than normal**



Source: Bloomberg, MSCI, Aviva Investors at 16 December 2019

Rates: easy does it

- **Heightened risks meet easy money**
- **The global growth recovery likely to be modest by historical standards**
- **Low neutral rates imply rates will remain low by historical standards**

Overview

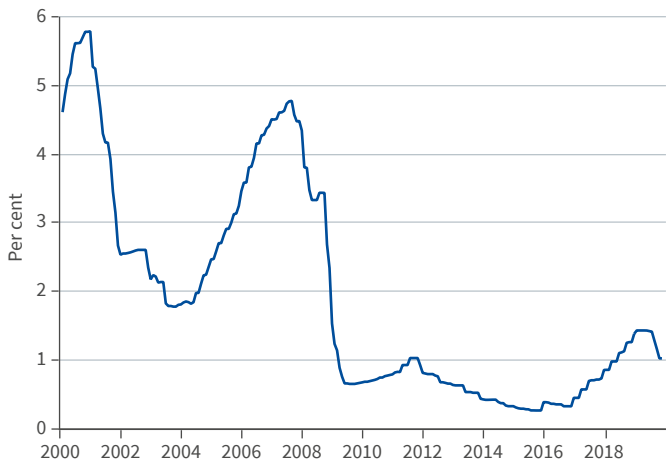
With global growth having slowed in 2019, we expect a period of stabilisation over the coming year, although any improvement will probably be modest compared with past recoveries, with risks still tilted to the downside. Developed market central banks either reversed course or re-started easing policy in 2019, helping to bring down developed market bond yields to multi-year, and in some countries, all-time, lows (Figure 105). This environment of accommodative monetary policy alongside muted inflationary pressures should continue to provide a supportive back drop for fixed income markets in the year ahead.

Developed market central banks to maintain accommodative stance

Monetary policy has continued to be the major form of countercyclical policy with Central Banks remaining ready to stimulate their respective economies should a more significant global slowdown occur, or economic conditions deviate meaningfully away from their respective mandate. Whilst calls for pro-active fiscal policy have grown during the latter stages of 2019, we expect that an aggressive use of such a stance will only be taken should a more meaningful growth slowdown occur leading to fiscal policy being reactive rather than pro-active. When fiscal policy is eventually loosened, we would see this working alongside monetary policy rather than a substitute. For now, we continue to expect that Central Banks will remain accommodative. This should be further supported by the Fed and ECB both conducting policy framework reviews this year where we expect to see a renewed focus on how to ensure monetary policy remains effective in a world of low interest rates. Should the downside risks materialise we would expect further easing. This may not only rely on cutting benchmark interest rates but also the use of quantitative easing and possibly, new non-traditional measures to stimulate the global economy.

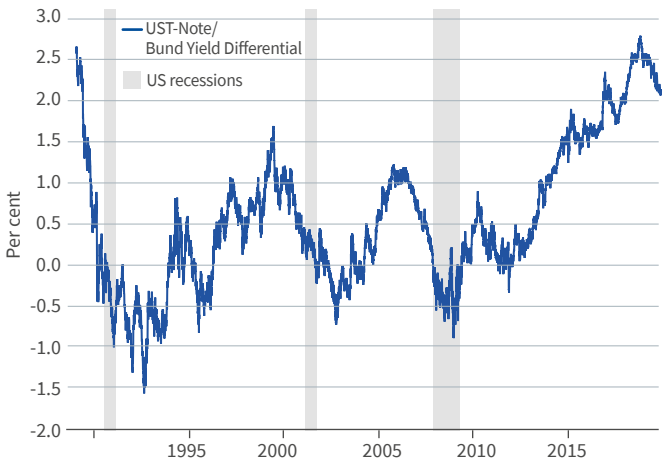
We expect that further flare-ups in the US-China trade and technology dispute, and the US presidential elections could serve as catalysts for further bouts of increased asset price volatility and risk aversion especially as we head into the second half of 2020.

Figure 105. **Accommodative monetary stance**
Global developed market GDP-weighted average policy rate



Source: Aviva Investors, Macrobond as at 16 December 2019

Figure 106. **US T-Note vs 10-year German Bund Yield Differential at 20-year highs**



Source: Aviva Investors, Macrobond as at 16 December 2019

Regional breakdown:

While the outlook for the global economy and global trade remains cloudy for 2020, in this uncertain environment we retain our constructive outlook for the US Treasury market with yields still offering an attractive opportunity. Given the risks are tilted to the downside, one potentially important theme in bond markets in 2020 could be a convergence of global bond yields. The spread of US Treasuries to other markets is close to 20-year highs. While we expect the Federal Reserve to be on hold, the next move in rates is more likely to be lower than higher. With the excess yield on offer around 210bps over German Bunds (Figure 106) we believe that a move higher in yields in Q1 2020 would likely be an opportunity to increase allocation to Treasuries. In addition to being allocated to US Treasuries, we also like yield curve strategies which look to benefit from a steepening of the term structure (Figure 107).

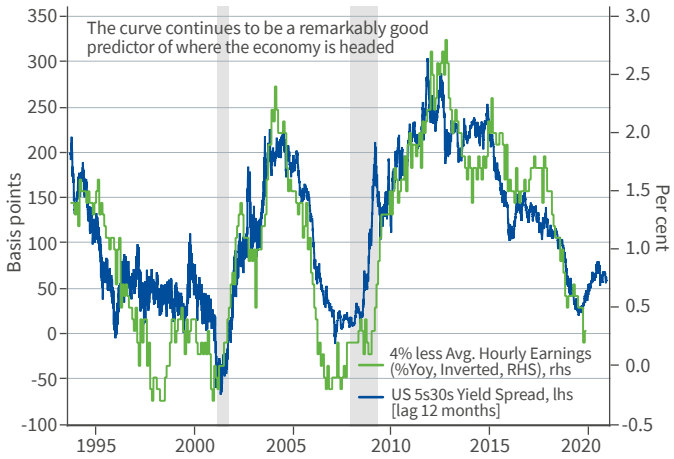
Sluggish growth and downside risks provide some support to duration

In the United Kingdom, 2019 has seen the political turbulence of Brexit remain at the forefront of the domestic focus. The recent trends in UK economic data point to headwinds for growth going forward with the UK economy set to become even more unbalanced in the years ahead. For 2020, Brexit developments and the terms on which the UK trades with its largest trading partner will be the key determinant of the growth and the investment outlook. While the Bank of England remains on-hold, the Monetary Policy Committee voted 7-2 to keep interest rates unchanged and this could well see a majority begin to move in favour of a cut in 2020 (Figure 108). In the context of a supportive environment for core fixed income strategies, we believe that nominal Gilt yields will remain relatively well supported. We also continue to recommend a structurally underweight bias towards UK break-even inflation rates recognising that UK inflation expectations have remained elevated (Figure 109) despite the slightly positive developments with respect to the Brexit process through the latter part of 2019.

UK break-even inflation rates look too high

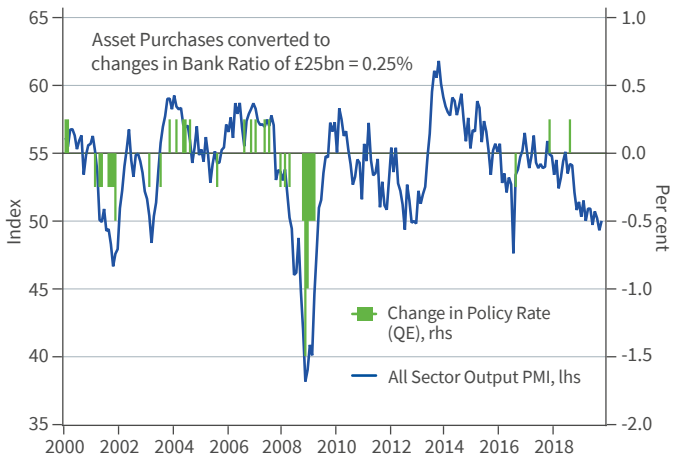
In Europe, we believe that European Sovereign bond yields will remain at or close to multi-year lows in core countries with European rates markets poised to defend the positive performance experienced in 2019. The outlook for the European fixed income market in 2020 will be heavily dependent on the global growth and inflation outlook although we continue to expect the European Central Bank will continue to be pro-active in supporting the economic expansion and European fixed income markets alike. With a large proportion of debt in the Eurozone currently trading with nominal negative yield, we expect the yield curve flattening experienced in 2019 to continue into 2020 as investors seek to allocate to high quality, liquid assets with positive yields, in both core- and semi-core markets (Figure 110).

Figure 107. **Fed Easing usually coincides with steeper yield curves**



Source: Aviva Investors, Macrobond as at 16 December 2019

Figure 108. **Composite UK Purchasing Managers Index consistent with BOE easing**



Source: Aviva Investors, Macrobond as at 16 December 2019

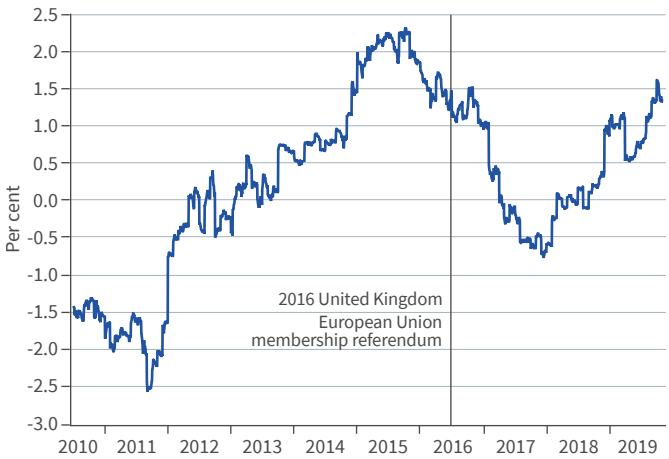
Bias towards easing in many places

Elsewhere, we continue to expect that the Bank of Japan will retain its bias towards making policy more accommodative with the potential for a cut in interest rates and with any further asset buying to be more concentrated in the front end. In Antipodean rates markets, we expect both the Reserve Bank of Australia and Reserve Bank of New Zealand will continue to leave the door open to further conventional and non-conventional monetary easing in 2020. In Australia, given the amount of leverage in the Australian household sector, tepid wage growth and an economy being more open to external trade, we see value in maintaining an allocation to Australian Government bond markets.

Summary:

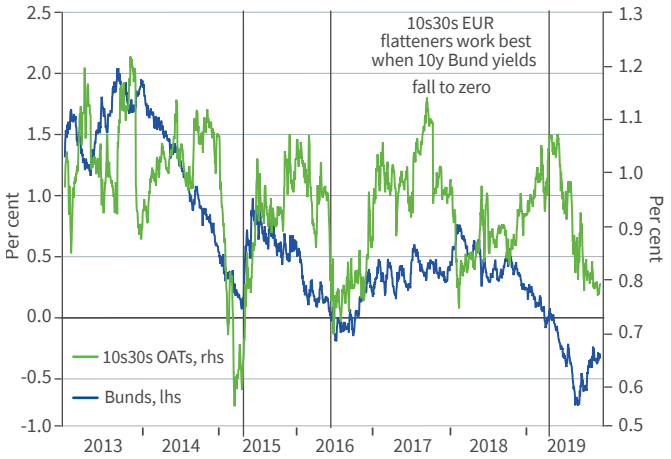
As we enter 2020, we are faced with continued uncertainty with regards to the growth outlook and the durability of any potential economic recovery. We expect geopolitical tensions to remain elevated and will continue to exert periods of influence and price volatility on capital markets. We believe an allocation to Government bonds remains important to help preserve capital at this stage in the business cycle. We see US Treasury yields offering relatively more valuation attractiveness as yields have more room to fall should global growth conditions deteriorate.

Figure 109. **UK inflation risk premium remains elevated**



Source: Aviva Investors, Macrobond as at 16 December 2019

Figure 110. **The hunt for yield should support the long end of core and semi-core yield curves in Europe**



Source: Aviva Investors, Macrobond as at 16 December 2019

Credit: QE extends the runway

- **Accommodative monetary policy provides support**
- **Geopolitical risks will create volatility**
- **Spreads nearing long-term equilibrium**

The outlook for global credit is positive although stretched valuations temper return forecasts leaving scope for only modest spread tightening. Our central scenario of weak but recovering growth and benign inflation, combined with accommodative monetary policy, is generally supportive for credit.

Positive outlook for global credit given accommodative monetary policy

A pivot towards supportive monetary policy in 2019 was the driving force behind exceptionally strong returns for global credit despite headwinds from trade wars, deteriorating fundamentals and fears of a global recession which caused bouts of volatility but not prolonged weakness. The quantum of negative yielding assets hit record highs and credit inflows resumed as investors turned once again to searching for yield. Interestingly, we did not see a traditional beta rally across all parts of the credit spectrum as evidenced by the stark decompression between BB and CCC high yield credits. This is symptomatic of the tug of war between deteriorating fundamentals and monetary stimulus.

Given its impact of restoring confidence in 2019, much hinges on the outlook for monetary policy in 2020 which we predict will remain supportive. Flows into credit should therefore continue and we envisage additional tailwinds from easing trade tensions causing a rebound in economic sentiment indicators allaying concerns of a global recession. However, with valuations so high, upside is limited, and there is much scope for volatility if our assumptions are challenged or if key risks were to materialise.

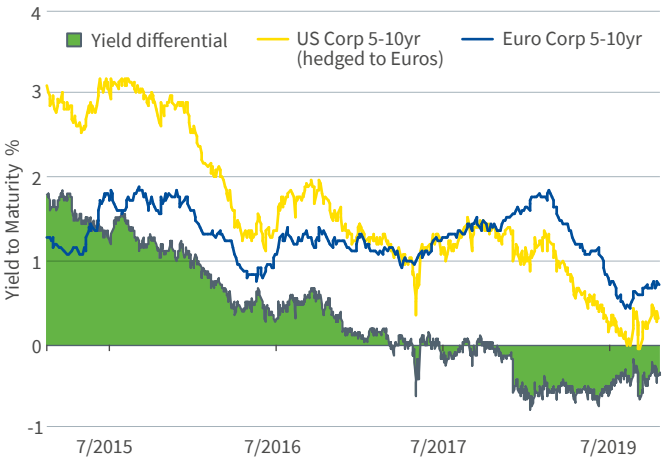
With regards to monetary policy, in Europe there is a risk that, despite being supportive, messaging becomes less clear as Lagarde establishes her leadership at the ECB and grapples with the growing calls for fiscal stimulus. With key European economies near stall speed and limited scope for additional monetary stimulus, the ECB has a fine line to tread.

Geopolitical risks threaten to cause volatility

Geopolitics and most notably US-China trade talks will be at the forefront of investors' minds. Although we think the worst may be over, China and the US are now engaged in long-term strategic competition and the various issues of contention will not be resolved overnight.

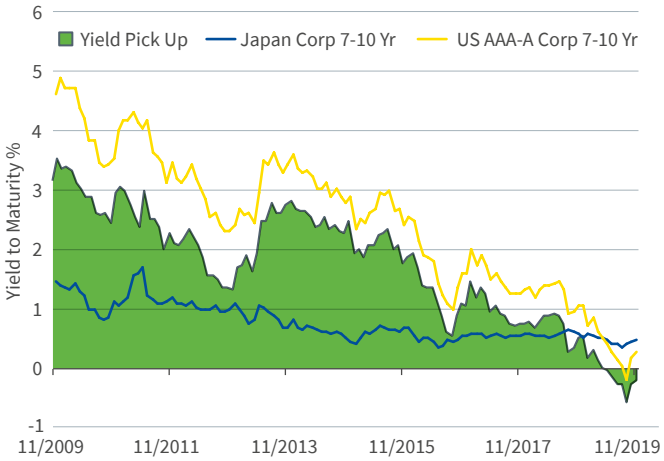
We are also entering an election year in the US and several prominent democratic candidates are not campaigning on a business-friendly platform which could have damaging effects on the profitability of certain US sectors such as healthcare and banking. Europe also has its own political challenges requiring careful navigation of Italian, Spanish and UK political developments.

Figure 111. **US credit no longer offers an attractive hedged pick up in yield for European investors**
Yield to Maturity of US vs European IG Credit



Source: Bank of America Merrill Lynch, Bloomberg as at 16 December 2019. US Yields hedged with 3m forwards.

Figure 112. **US credit no longer offers a hedged pick up in yield for Japanese investors**
Yield to Maturity of US vs Japan IG Credit



Source: Bank of America Merrill Lynch, Bloomberg as at 16 December 2019. US Yields hedged with 3m forwards.

QE has taken the lens away from corporate fundamentals for now

Finally, credit fundamentals should not be ignored. Market weakness in late 2018 seems a distant memory as QE took the lens away from corporate fundamentals and late cycle dynamics. However, debt levels remain elevated, covenants weak and US and European BBB credit markets are still multiple times the size of their respective high yield markets. QE extends the runway for dealing with these problems but there will come a time again when concerns mount.

In summary, whilst the conditions are positive for credit, our expected returns are modest given valuations and the scope for volatility. Diligent portfolio construction, disciplined security selection and active management of risks will be key to generating outperformance.

Investment Grade (IG) Credit

Demand and supply dynamics important in a truly global market

Within Global IG credit, Europe looks attractive given the open-ended support from ECB asset purchases, relative valuations and stronger fundamentals. Despite low yields, we expect hedging cost dynamics to continue steering global capital towards Euro IG credit. Whereas demand flowed abroad into US credit during the first Corporate Sector Purchase Programme (CSPP) in 2016, Figure 111 demonstrates that this is now unlikely as US credit no longer offers a pickup in yield after hedging costs.

We are aware that this has brought record supply from foreign issuers in 2019 which should continue, but factoring in redemptions and ECB purchases we still expect the supply /demand balance to be more supportive for European credit than in the US which has such a high proportion of foreign, and especially Asian, ownership and looks less attractive to foreign investors than in recent years as demonstrated in Figure 112.

Crowding into riskier assets

Limited options for matching inflation in Europe drives investors into riskier assets

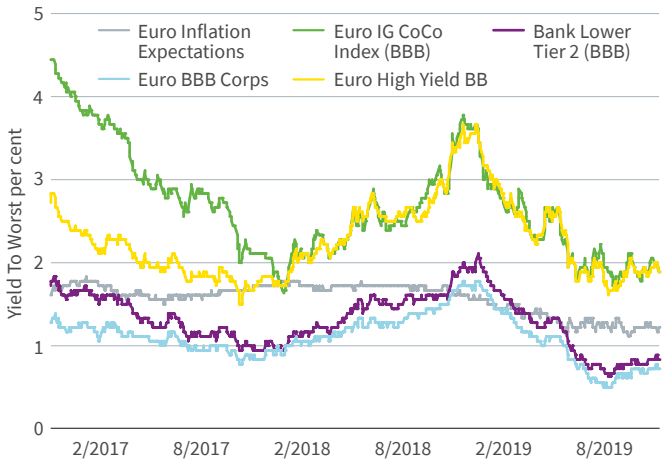
Whist eligible securities have outperformed since the announcement of CSPP II, there is scope for outperformance in 2020 from ineligible securities such as bank senior and subordinated debt, corporate hybrids and high yield. Given stretched valuations, shorter-dated subordinated instruments remain a slightly more defensive option for adding yield to investment grade portfolios.

Figure 113 demonstrates the challenge in achieving positive real returns in European IG and the need to crowd into smaller pools of higher-yielding assets. Contingent Convertibles (CoCos) are the only IG fixed income asset class yielding more than inflation and although scarce look attractive vs high yield given their higher rating and similar duration profile (Figure 114).

Fundamentals also favour European IG

Despite a firmer growth and earnings outlook, US credits are vulnerable from a fundamental perspective given higher debt levels. Some of the notably large and extended balance sheets have taken steps to deleverage since late 2018 such as GE and Anheuser-Busch but overall the supposed debt diet hasn't happened.

Figure 113. **Limited options for yield-starved investors**
Yields in Euro Credit vs Inflation Expectations



Source: Bank of America Merrill Lynch, Bloomberg as at 16 December 2019

Figure 114. **European Credit Index Characteristics**

		YTW (per cent)	OAS (Bps)	Duration	Size (Eur Bn)
Euro BBB Corps	BBB	0.72	125	5.1	1,295
Bank Lower Tier 2	BBB	0.83	140	4.2	114
Euro IG CoCo Index	BBB	1.86	236	3.1	18
Euro High Yield BB	BB	1.86	236	3.6	213
Euro High Yield B	B	4.38	488	2.6	70

Source: Bank of America Merrill Lynch, Bloomberg as at 16 December 2019

Looser monetary policy alleviates these problems via lower debt service costs as evidenced by high interest coverage ratios (Figure 115). However, even if GDP growth stabilises, earnings are likely to remain pressured as shrinking margins are likely to translate into cost-cutting measures and reduced investment. With earnings growth close to flat, organic deleveraging is difficult even if there is a willingness to do so. We prefer credits with levers to pull to reduce leverage in times of stress rather than relying on organic EBITDA growth in a late cycle.

Organic deleveraging will be difficult this late into the cycle

High Yield

High yield also performed exceptionally well in 2019 although dispersion between higher and lower quality bonds has increased with money pouring into BB credits driving their spreads near to the lows of the last decade. Conversely, spreads widened for the lowest quality credits due to global growth concerns and idiosyncratic loss of confidence in structurally challenged companies (Figure 116). Historically, dispersion this high has only been seen in recession or times of significant stress.

Looking to the year ahead, B valuations look more attractive than BB. Additionally, there are opportunities in lower quality names, although credit selection is vital given stretched balance sheets and the risk of default to structurally challenged business models. From a regional perspective, the outlook remains more favourable for US high yield given stronger investor demand, forecast-beating corporate earnings and relative valuations.

Asset-Backed Securities (ABS)

ABS issuance started 2019 slowly due the implementation of the new Simple, Transparent and Standardised (STS) regulations and the transition from LIBOR to SONIA, with issuers reluctant to issue first. The ensuing supply shortage drove spreads tighter setting the general tone for the year.

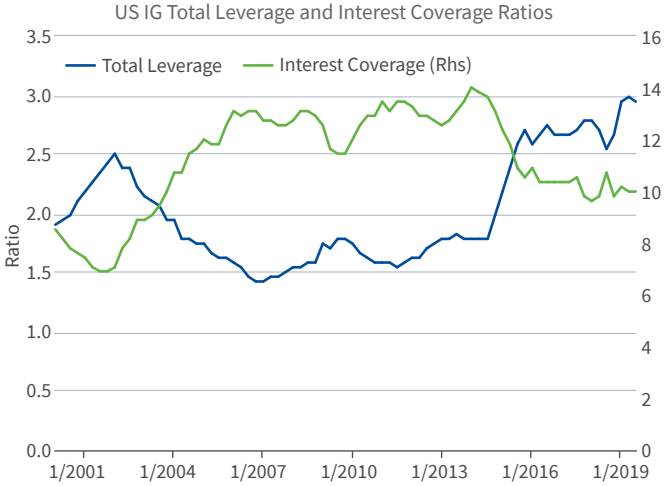
Spreads nearing what we think is a long-term equilibrium

However, towards the end of the year, UK primary issuance increased as banks started refinancing their funding rolling off with the Bank of England through the Term Funding Scheme (TFS). Banks not seen for some time are now back playing in the securitisation markets, seeking diversified funding. Spreads have therefore widened from levels seen during FLS and TFS and are nearing what we think is a long-term equilibrium where supply and demand are balanced. Spread moves in either direction should see demand and supply adjust appropriately seeing as many issuers can still fund elsewhere.

With unemployment bottoming and Brexit creating uncertainties, UK RMBS performance has likely hit the bottom and we can expect very marginal deterioration. However, with arrears and defaults close to 0 per cent for prime and near-prime mortgages, low loan-to-value ratios and high credit enhancement levels, any deterioration will be very well protected.

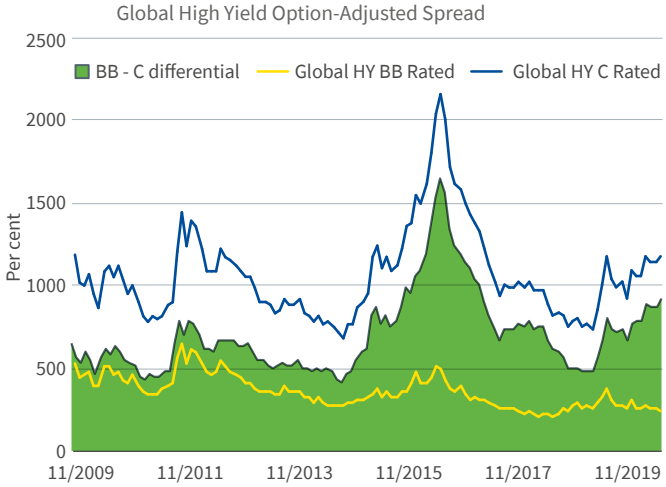
Auto sales remain weak in both the UK and the Eurozone. Our view is for the pace of new car sales to continue to decline, but at a slower pace, which will help support residual values. As such, the collateral should continue to weather the storm of any weakening macro outlook and hence we remain comfortable with auto-backed ABS.

Figure 115. **Monetary policy key to manageable debt service costs with leverage so high**
US IG Total Leverage and Interest Coverage Ratios



Source: Deutsche Bank as at 16 December 2019

Figure 116. **Dispersion between BB and C-rated Global High Yield increased significantly in 2019**
Global High Yield Option-Adjusted Spread



Source: Bank of America Merrill Lynch as at 16 December 2019

Emerging Market debt: a discerning asset class

A discerning approach is required as many country risks remain

The global trend for lower interest rates has provided tailwinds for emerging markets in 2019 and we expect emerging market debt (EMD) returns to continue to be supported by our lower-for-longer theme in the coming year. However, while overall returns in emerging market debt have been strong, the rise of political risk and situations in the likes of Argentina and Lebanon illustrate the need for investors to be discerning.

Major central banks will seemingly remain in a holding pattern as the global economy recovers but underlying challenges remain. The recent stability in economic data has removed some recessionary fears for EMD investors but, with a strong rebound unlikely, we feel a balance will be achieved between monetary policy and growth that is supportive for both fixed income classes and emerging market debt.

Both the Fed and the PBOC will continue to play an extremely important role in global markets and their actions have both a direct and indirect impact on emerging markets. Clearly US Treasuries and the US Dollar have a significant influence on asset class returns but any global provision of further liquidity and lowering of borrowing costs should create a more favourable backdrop for emerging market economies and continue to reduce the concern around external vulnerabilities that dominated in 2018.

The growth outlook will be a key determinant of total returns across EMD

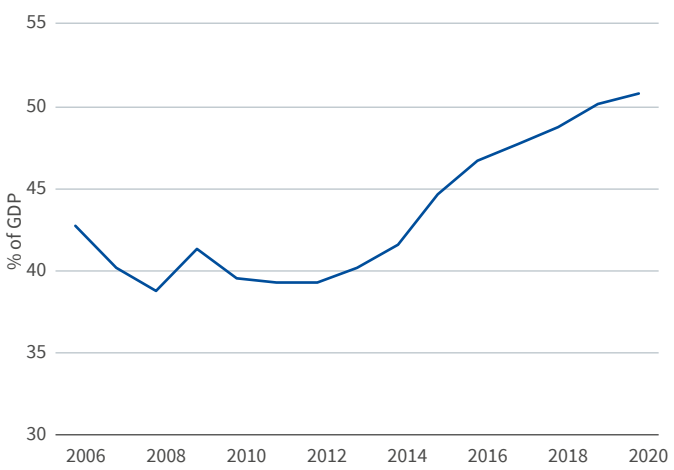
The ongoing trade negotiations between the US and China will likely have a significant impact on economic growth and EMD market performance in 2020. With the Phase 1 deal agreed, growth-sensitive assets should perform well, with emerging market currencies likely to prove particularly strong. In a more difficult macroeconomic environment, investors would gravitate towards economies with solid fundamentals, particularly those whose central banks have the scope to cut interest rates and where external vulnerabilities are more limited.

Very few idiosyncratic EM economies have the ability to generate significant growth domestically so the reliance on the global growth recovery will be a key determinant of EMD performance in 2020.

Hard currency

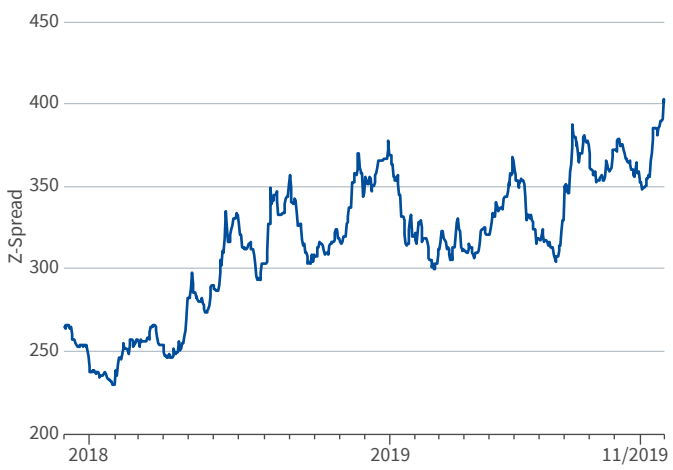
The sensitivity of hard currency assets to global macroeconomic factors has probably increased and therefore the outlook has to include more consideration of those factors than in 2019 (Figure 117). Throughout 2018, concerns about growing risks in emerging markets led to an increased premium which created attractive valuations for the universe as a whole but with growing importance of country selection given heightened idiosyncratic risks. The spread and yield of the asset class still appear attractive in the context of the macroeconomic environment we feel we are in. However, outsized returns are very unlikely, and it seems plausible that the index yields, which are currently just in excess of 5 per cent, are a good place to anchor return expectations.

Figure 117. **Debt to GDP - Rising trend**



Source: Bloomberg, Aviva Investors as at 16 December 2019

Figure 118. **HY (B) versus IG (BBB) Spread Differential**



Source: Bloomberg, Aviva Investors as at 16 December 2019

At present there are probably better opportunities within the high yield area of the universe. The spreads of investment grade assets have generally performed very well in recent years given their correlation with US Treasuries and the greater comfort with higher quality assets. This leaves the differential between investment grade and high yield showing attraction in the latter (Figure 118). However, within the high yield universe, there is a greater sensitivity to global growth and idiosyncratic factors both of which present downside risk. As a result, it is probably more prudent to focus on resilient high yield stories with stronger investment rationales that are underpinned by stable or improving credit metrics. These include positive reform momentum and policy space as well as strong domestic drivers of growth that provide a necessary cushion.

Hard currency still offers opportunities, but investors may be better compensated in the High Yield universe

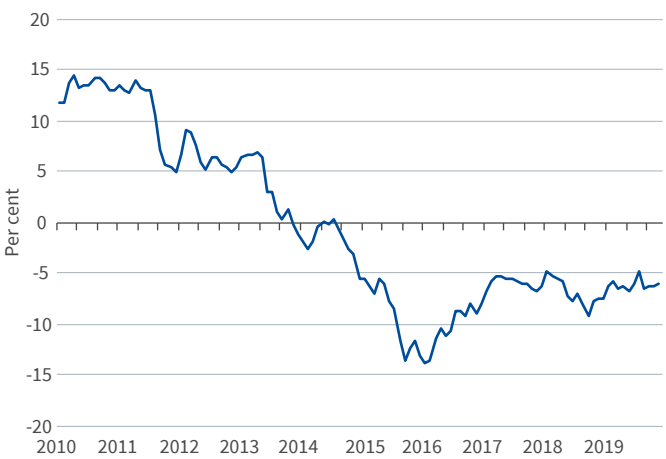
The election cycle presents a need for constant re-assessment. It will be crucial to monitor the situation in each country as the political weather can change quickly. Key votes in Ivory Coast and Ghana, for example, should be watched very carefully as these are two countries where economic policy has been reasonably supportive in recent years. Investors in Argentina are facing what could be a lengthy debt restructuring process following the election of Alberto Fernández in October, and are awaiting clarity on the main objectives of the restructuring, as well as the details of his wider economic programme and its implications for debt sustainability. A debt restructuring is also likely in Lebanon which is a highly-indebted country and is facing escalating protests and social issues given chronic economic pressures. The last time emerging market debt investors faced such a major restructuring was in Ukraine in 2014-15; now they could face two such events in the space of 12 months. This should focus minds on idiosyncratic risks despite a supportive environment for the asset class as a whole.

Local currency

The key considerations for local currency investors for the coming year are very much a continuation of the themes that have dominated this year, specifically the outlook for global growth and the evolution of trade-related narratives alongside geopolitical concerns. For lengthy periods in 2019, end-of-cycle and recessionary concerns have dominated investor appetite for the asset class and been the key driver of returns across the local currency universe. Whilst asset class returns have been healthy year-to-date, and particularly when compared to expectations at the start of the year, those positive returns have been dominated by duration rather than the more growth-sensitive currency portion of the investable universe and which in turn is partly behind relatively muted investor inflows when compared to hard currency.

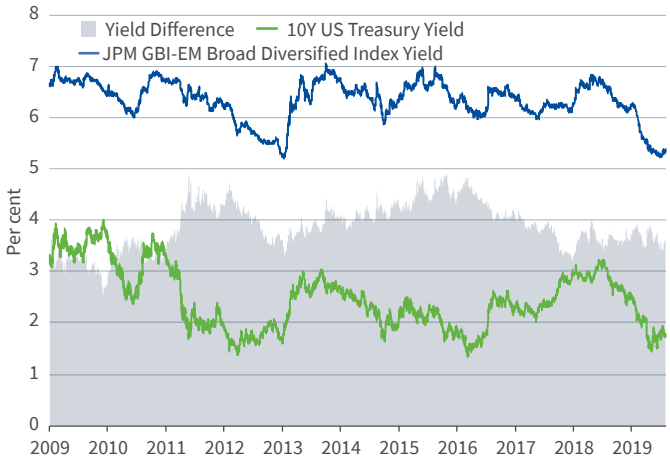
Solid returns in 2019; global growth a key determinant of total returns and investor appetite going forward

Figure 119. **GBI-EM Deviation from FX 'Fair Value'**



Source: Bloomberg, BIS, Aviva Investors as at 16 December 2019

Figure 120. **EM Local Currency Yields vs Treasuries**



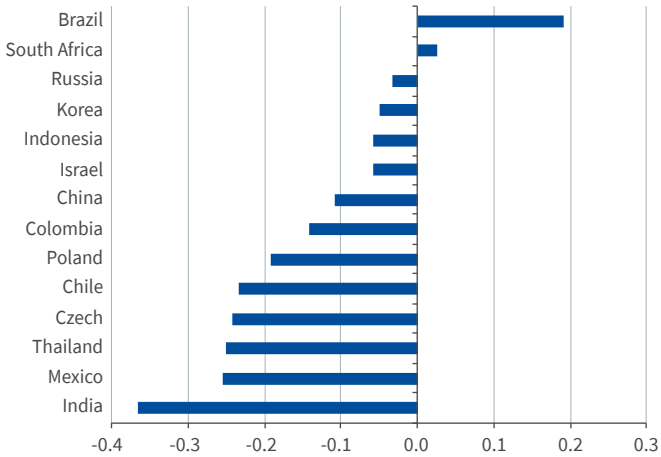
Source: Bloomberg, BIS, Aviva Investors as at 16 December 2019

Attractive valuations remain although that is largely concentrated in currencies rather than local currency bonds

Despite maintaining a reasonably rare fixed income combination of relatively high yields and compelling valuations, most of that valuation attractiveness at asset class level is a function of undervalued emerging market currencies rather than local currency bond markets (Figure 119 and Figure 120). The path of the US Dollar and concerns around global growth have provided headwinds to monetising the valuation opportunity in emerging market currencies for most of this year. However, there are now tentative signs of more growth stability. If this is right, the slowly improving outlook could provide the catalyst for greater opportunities and investor appetite for currency risk in the new year.

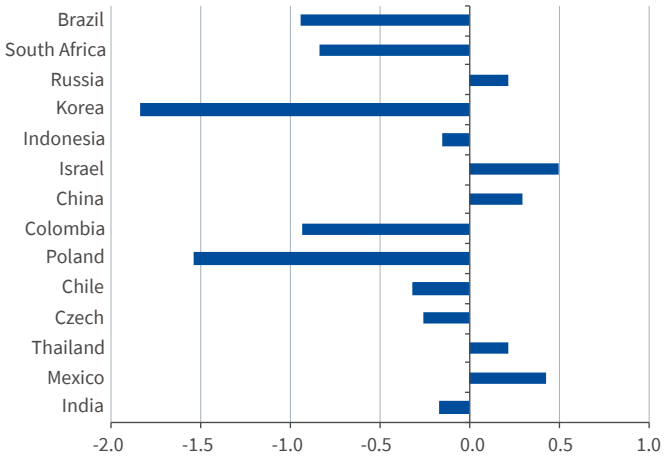
Whilst global growth metrics are showing signs of stabilisation and potentially a recovery, elevated real policy rates and a lack of inflationary concerns (Figure 121 and Figure 122) across core emerging market economies provide policy space for lower interest rates. This should provide some underpinning to large parts of the investable universe should it be required. Greater confidence in the growth picture together with a stable or lower US Dollar should unlock attractive total returns and allow investors to embrace those valuation opportunities within the asset class with greater conviction. But at this stage, the focus should be on markets that have strength in underlying fundamentals such as Brazil, Russia and Ukraine, or by exploring the growing opportunity set in local currency frontier markets.

Figure 121. **3m change in 2020 growth forecast, per cent**



Source: Aviva Investors, Bloomberg as at 16 December 2019

Figure 122. **Inflation forecast relative to Central Bank target, per cent**



Source: Aviva Investors, Bloomberg as at 16 December 2019

Currencies: one $ size does not fit all

- **Improving growth outlook, but not strong enough to create broad-based bearish USD environment**
- **Short EUR offers attractive carry relative to vol; EM fx should benefit from better growth outlook**
- **Geopolitical risks still to the downside, helping moves into more defensive currencies**

While 2017 and 2018 saw significant broad-based swings in the US Dollar (USD), 2019 has stood out for its lack of clear USD regime. Figure 123 shows the proportion of co-movement in G10 FX that can be explained by movements in USD, (where USD movement is defined as the first principal component in a 3m rolling Principal component analysis (PCA) of G10 currencies). When more than 75 per cent of co-movement in G10 can be explained by moves in the USD we define this as a USD dominant regime. This framework is useful as it highlights that, in 2019, investors treated all USD crosses equal at their peril.

Are we in a broad-based USD bullish or bearish environment? …. Neither

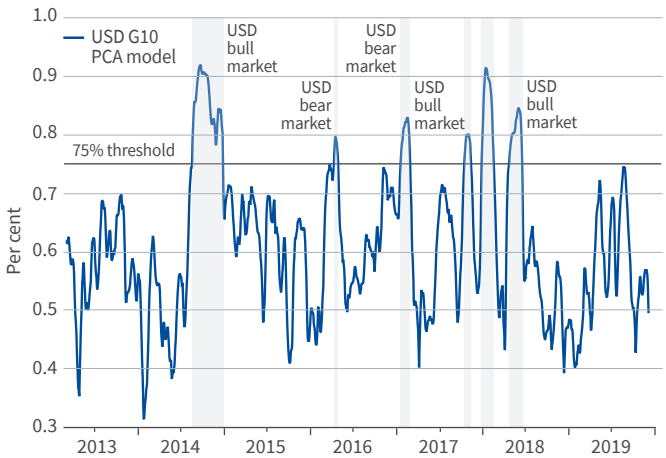
Currently, the proportion of co-movement in G10 currencies explained by moves in USD is low and therefore even within G10, trends verses the USD are divergent. Figure 124 shows the 1-year rolling correlation of G10 currencies to an equally weighted basket of USD vs G10. Both the yen (JPY) and swiss franc (CHF) stand out for their more defensive properties, with both performing well in risk off periods in 2019. At the same time neither currency has materially changed in valuation terms over the year. Year-to-date (YTD) the change in real effective exchange rate (REER) for both currencies has been less than 1 per cent and therefore valuation should not prevent these currencies being an effective hedge in portfolios going forward. The pound (GBP) was also driven by idiosyncratic risks and traded away from broader G10 moves throughout the year as the outlook for a Brexit deal evolved.

Even within G10 currencies trends have been divergent

The extent that these currencies continue to be driven by risk-on – risk-off factors depends mainly on the outlook for drivers of risk sentiment. In 2019 risk-off periods were predominantly driven by geopolitical risks such as the trade war and Brexit. As 2019 draws to a close the outlook appears to be improving. However, we expect geopolitical risks will continue to be a theme in 2020. Even if further escalation in trade tensions can be averted, we expect hostilities between the US and China to continue as both compete for strategic dominance in technology & international relations. In addition, the US election will be a new driver of risk sentiment to add into the mix for 2020. Therefore, trends in risk-on – risk-off are likely to continue to determine moves in JPY & CHF while trends in GBP will remain heavily reliant on Brexit developments.

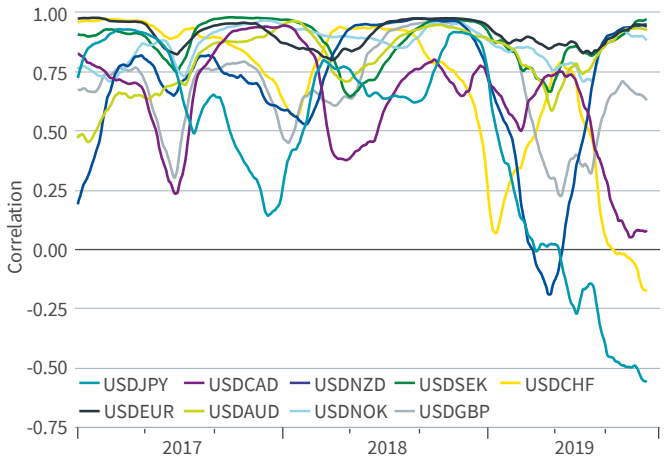
Geopolitical risk will continue to drive divergences within G10 currencies

Figure 123. **USD dominant regimes (75% threshold on PCA highlighted)**



Source: Aviva Investors, Macrobond as at 16 December 2019

Figure 124. **1 year rolling correlation of FX to USD in levels space**



Source: Bloomberg, Macrobond as at 16 December 2019

EUR continues to offer attractive carry relative to its volatility

The most interesting thing about the euro (EUR) over 2019 is how uninteresting it has been. EURUSD moves have been highly correlated to broader USD trends and realised volatility of EURUSD is at the very bottom of 2000 to date range and lower than all other DM currencies in our scan (Figure 125). Concurrently, investors have been able to pick up a substantial carry by shorting EUR through 2019. As the Fed pivoted towards a more dovish stance, US rate differentials to Europe have fallen and therefore the carry available in short EUR positions has also fallen from near 3.5 per cent per annum (pa) to nearer 2.5 per cent pa (Figure 126). Despite the decline in carry, very low levels of volatility in the EUR means carry relative to volatility remains attractive and rivals that of many traditionally high-yielding emerging market currencies.

Our outlook for the global economy should be supportive for carry trades

Growth is set to pick up slowly from below to above 3 per cent over the next two years and while monetary policy will remain accommodative for some time, scope for additional stimulus is now more limited. This should provide a good backdrop for carry trades as rate differentials remain broadly steady and moderating downside risks allow for more stable risk sentiment. With most of the Fed's cutting cycle behind us and European rates going nowhere anytime soon, EUR will remain an attractive short from a carry perspective. On the long side, EM should benefit from an improved growth outlook.

High-yielding emerging market currencies perform well in cyclical upturns

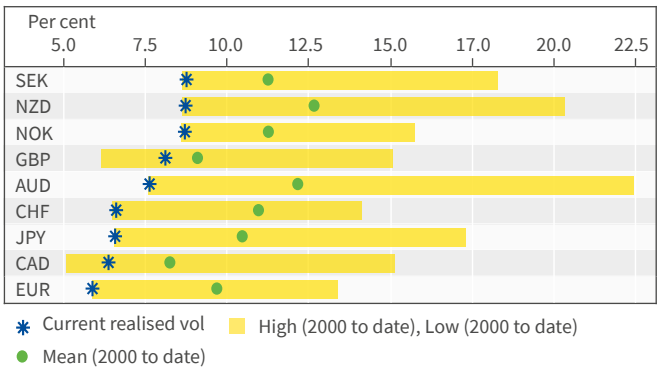
USD verses Emerging Market FX (EM FX) on a carry-adjusted basis has historically had a strong relationship to the global growth cycle. Figure 127 shows Aviva Investors' global growth nowcast versus the year-on-year (yoy) change in a broad basket of high-yielding EM FX verses the USD. USD tends to depreciate yoy versus EM FX when global economic growth is accelerating and appreciate yoy when global growth declines. This relationship is particularly pronounced when using a basket of high yielders rather than a broader range of EM currencies.

Our global economic outlook would imply a pickup in the nowcast to around -1. This model shows that, in line with other risk assets, EM FX has begun to price in a turn in the global growth cycle. In spot terms EM FX levels have been unchanged year to date (YTD) however base effects have driven the year-on-year return higher throughout 2019. For current levels of EM FX to be justified we need to see our base case of a turn in the hard data materialise. Looking forward and assuming our base case plays out, we expect EM FX to remain range bound with trends in appreciation / depreciation driven by broader trends in risk sentiment.

With growth picking up only slowly carry will dominate total returns for emerging market currencies

Limited moves in spot EM FX over 2020 does not equate to limited return expectations,however. It's important to remember that even if spot levels stay flat YTD this can still lead to significant returns in high-yielding EM FX. Indeed, YTD performance of high-yielding EM currencies is down around 80bps in spot terms but up around 4 per cent in carry-adjusted terms (Figure 128).

Figure 125. **FX realised volatility low and EUR vol lowest**
Annualised realised volatility based on weekly wages



Source: Aviva Investors, Macrobond as at 16 December 2019

Figure 126. **3m annualised carry on long EUR position**

Source: Aviva Investors, Macrobond as at 16 December 2019

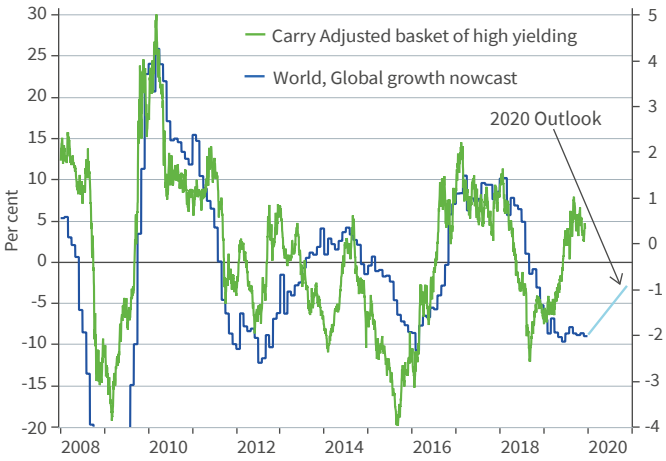
A lower volatility environment provides the right backdrop for investors to benefit from carry trades in EM. If our base case for global growth materialises and political risks abate this will provide a supportive environment for EMFX with carry playing an important role for total returns.

The cyclical upswing that we are assuming is welcome, but not remarkable. One upside risk to our outlook comes from the possibility of a more substantial fiscal expansion than we have in our base line. Global growth would be boosted higher if fiscal policy were to become explicitly expansionary rather than just a small positive kicker. The sensitivity of EM FX to the global growth cycle combined with low valuations, gives EM FX significant scope to rally and capture market pricing of upside growth risks. If global growth accelerates significantly this will likely generate a broader based USD bear market across G10 currencies also.

Downside risks continue to dominate however, being more numerous and more significant to global growth should they materialise. The trade war between the US and China is yet to be fully resolved and tensions between these two large nations will continue. If de-globalisation accelerates and the protectionist mindset spreads, global trade would slow further. China's policy response to a sharper contraction in growth than planned has thus far seemed to successfully smooth the growth trajectory. Should China's policy response fail to stabilise growth sufficiently, global growth would falter, and EM FX would suffer while defensive currencies such as the JPY would strengthen. Overall, therefore, whilst we expect EM FX to perform via carry, we are cognisant of choosing our carry trades carefully and minimising, where possible, exposure to idiosyncratic risks which could create underperformance in a world where the downside risks materialise.

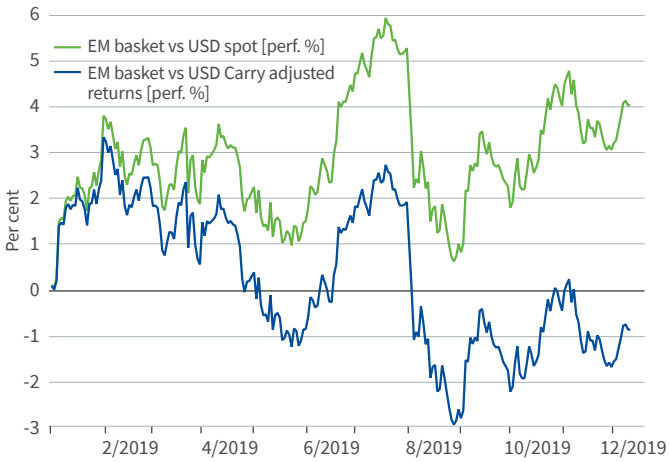
Risks remain to the downside; emerging market currencies are the most vulnerable to downside shocks

Figure 127. **EMFX vs USD relationship to the global growth outlook**



Source: Aviva Investors, Macrobond as at 16 December 2019

Figure 128. **EM FX YTD performance**
Trend in spot has been broadly flat, positive return driven by carry



Source: Bloomberg, Macrobond as at 16 December 2019

Real estate: cycle extended

Lower interest rates supporting the cycle

Opportunities in European real estate are being shaped by expectations of a lower for longer interest rate environment and growing downside risks to the growth outlook (Figure 129 & Figure 130). While pricing in prime markets looks particularly high by historical standards, we believe most markets in Europe look attractive on a risk-adjusted basis, given the favourable relative pricing implied by very low government bond yields. Generally, the logistics and office markets look more attractive than the retail sector.

Talent is key driver of growth

We are concentrating on key locations with clusters of talent and value-adding economic activity, and firms able to leverage agglomeration effects. Paris stands out as a magnet for global talent; Stockholm, Berlin, Amsterdam and Copenhagen have world-renowned clusters in digital and biotech fields, while Munich, Frankfurt and Dublin compete globally with vibrant activity in financial, automotive, ICT, media, cultural and creative industries and engineering sectors.

Structural change driving logistics

Most Continental European logistics markets have been boosted by the transition to e-tailing, but the stand-outs appear to be the Randstad, Paris and Copenhagen. Strong occupier markets are likely to drive office performance in Paris, where development constraints suggest scope for sustained rental growth. Prospects in Copenhagen, some German cities, Amsterdam and Lyon also look positive. While there has been less re-pricing of retail assets than in the UK, we expect it to emerge in non-core locations and would only have appetite for strong assets in the best locations.

ESG growing influence

Looking ahead, we expect more investors to be asking what their real estate allocations can achieve beyond financial returns. Investors are increasingly concerned about the environmental, social and governance (ESG) impact of their investments and are searching for opportunities to improve Europe's infrastructure and deliver a societal benefit. Adopting a long-term, direct owner mindset is critical.

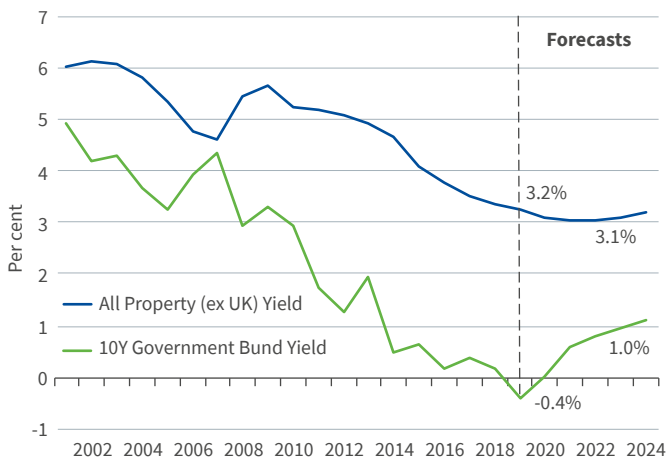
Political uncertainty clouding UK

As with continental Europe, pricing in the UK is elevated by historical standards for many prime markets, however we still feel that the UK property market is attractive on a risk-adjusted basis. Although the uncertain political environment and impacts of Brexit also need to be navigated. Nevertheless, real estate continues to offer attractive illiquidity premia for investors seeking sustainable income for cash flow and liability-matching (Figure 131).

Real estate becoming more operational

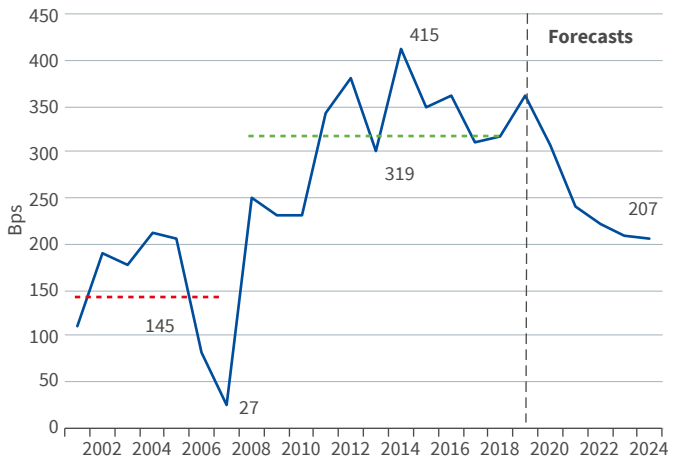
We expect property owners to have to work harder to sustain income as lease lengths fall and occupiers require greater flexibility. For example, in the office environment, the shift towards flexible working space is likely to mean that underlying rental income streams reflect changes in market rents more quickly. This implies that rental income streams will be more volatile than in the past, closer to that of market rents.

Figure 129. **Europe (ex UK) All Property vs 10y German Bund**



Source: Aviva Investors, Macrobond as at 16 December 2019

Figure 130. **Spread between Europe (ex UK) All Property and 10y German Bund**



Source: Aviva Investors, Macrobond as at 16 December 2019

With this in mind, we have a more positive outlook for locations with robust long-term demand. Overall, the logistics and office markets look more attractive than the retail sector. Broadly, London and south-east logistics look well placed as they are supported by tight supply dynamics. Central London, Cambridge and Manchester office markets also look to have the most growth opportunities. The repricing of retail assets is further advanced in the UK, but value is yet to emerge in our view, given the scale of the structural challenges the sector faces.

Opportunities for growth in supply constrained markets

Looking ahead, as the property and economic cycle slows, there may be opportunities in long income real estate. Historically, inflation has and likely will beat open market rents and current relative pricing remains in line with historical norms. In addition, depreciation and maintenance costs continue to impact returns as yields are so low in many traditional sectors.

Long income real estate attractive

Private Debt

The private debt market remained active in 2019 thanks to a heavy flow of refinancing. M&A and real asset transaction activity was more subdued than in 2018: with most PPP programmes winding down, greenfield infrastructure volumes were down, and new investments directed at renewable (onshore and offshore), rolling stock and data infrastructure. Property sales volume were also down.

Institutional investors' appetite for private debt continues to grow, while the ECB has, increased deposit rates, helping banks impacted by negative rates. Market competition has been intense for loans in well-liked sectors such as prime property and renewables, compressing margins. In some of these sectors, illiquidity premia are elusive (Figure 132).

Illiquidity premium trend

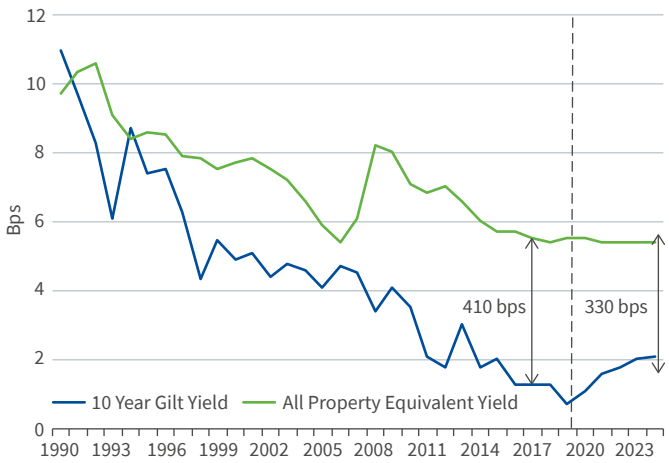
Higher illiquidity premium can be found in complex, structured loans. A risk premium is also available in new sectors emerging to support the digital transition and low carbon agendas, for example data infrastructure and infrastructure corporates. Such credits are secured by resilient cash flows and offer a lower risk profile than high yield bonds – albeit at typically lower spreads. For commercial mortgage, we favour secondary assets in prime locations, as well as low leverage debt to prime retail destinations, to exploit opportunities left by investors exiting the sector.

Value in complexity and innovation

Shorter duration loans, and loans to mid market, are expected to provide more attractive returns than longer-term institutional fixed rate debt, particularly in Europe where many loans benefit from Euribor floor. However, investors should be selective on risk. While near term recession concerns seem to be receding, the rate of loan default is likely to increase from its current low level. Senior secured debt backed by infrastructure and real estate is well positioned to withstand a downturn. In the non investment grade space, a diversified portfolio construction is needed to reap the benefit of this asset class.

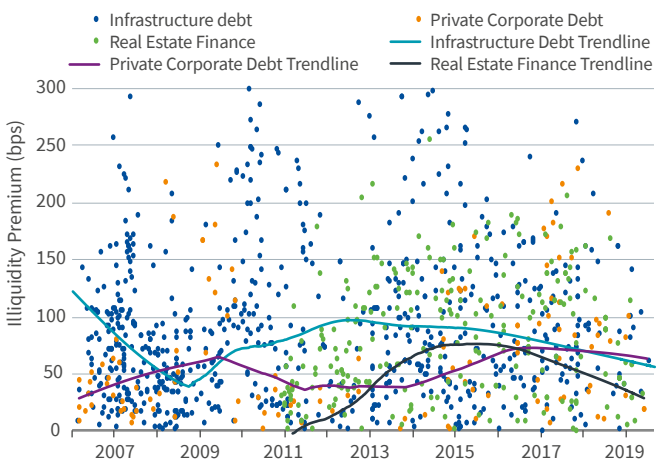
Mid market loans are attractive but should be diversified

Figure 131. **10y Gilt vs. All Property Yield**



Source: : Thomson Reuters Datastream, Aviva Investors as at 16 December 2019

Figure 132. **Trends in Illiquidity Premia**



Source: Aviva Investors, Macrobond as at 16 December 2019

Infrastructure

Turning to Infrastructure equity, forward looking total returns have drifted downwards, as competition for assets has increased (Figure 133). Nonetheless, the premium over government bonds provided by the asset class remains attractive in consideration of its low economic sensitivity.

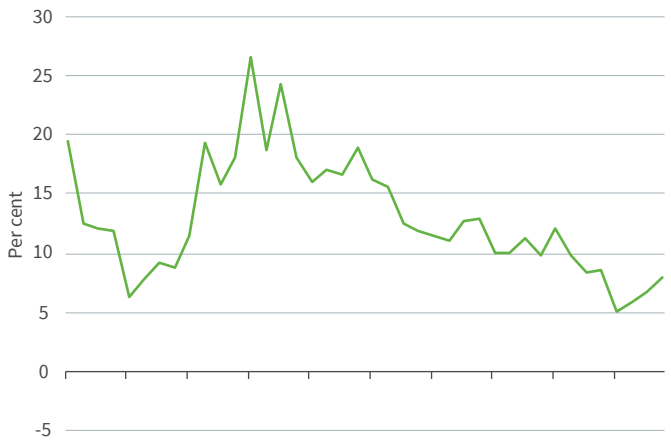
Renewables dominate European infrastructure activity

Renewables remains the most active sector across Europe, representing two-thirds of transactions in 2019. The availability of renewable subsidies has decreased as technology costs have fallen, but in some countries subsidy-free projects are being supported by long-term corporate power purchase agreements (PPAs). Across Europe, decarbonisation targets necessitate further investment, but in some instances there is a lack of policy to support it; we expect further clarity in 2020.

Greenfield opportunities in energy from waste and digital infrastructure

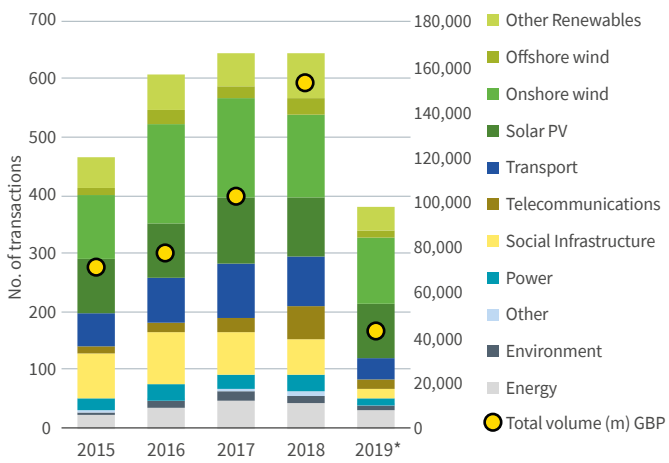
Greenfield infrastructure investment decreased in 2019 (Figure 134), but the need for new infrastructure remains acute: the EIB estimates that investment needs to double to over €500bn per annum to support EU policies. Energy from waste and digital infrastructure are two sectors with prevalent greenfield opportunities where investors can be well-rewarded for taking on construction risk. Demand for energy from waste is underpinned by the significant shortage of waste processing infrastructure across many European countries and desire to divert waste from landfill. Rapidly increasing demand for data from both households and businesses around the world is fuelling demand for fibre networks, datacentres and cell towers.

Figure 133. **Developed market infrastructure equity – trailing 12m total returns**



Source: EDHECinfra, Aviva Investors as at 16 December 2019

Figure 134. **European infrastructure transactions excluding refinancing**



Source: Inframation, Aviva Investors as at 16 December 2019

Cross asset volatility

Summary

As global growth is projected to stay weak through 2020, we expect liquidity, as measured by natural market depth, to become the main driver of episodic high volatility against a rising, but low ambient level of volatility.

Historically, extremes in cross-asset volatility occur at the ends of economic expansions. In this late cycle, low-yielding environment, there may well be more instances of crowding into momentum and convergence premia strategies, and it is likely that, as asset values reconnect with fundamentals, there will be an increase in the frequency and sharpness of market corrections.

This is probably part of a necessary market adjustment process at this stage in the cycle as participants learn to meaningfully price in for risk from externalities.

Markets are characterised by low levels of ambient volatility with episodic bursts higher

A lot more of the same?

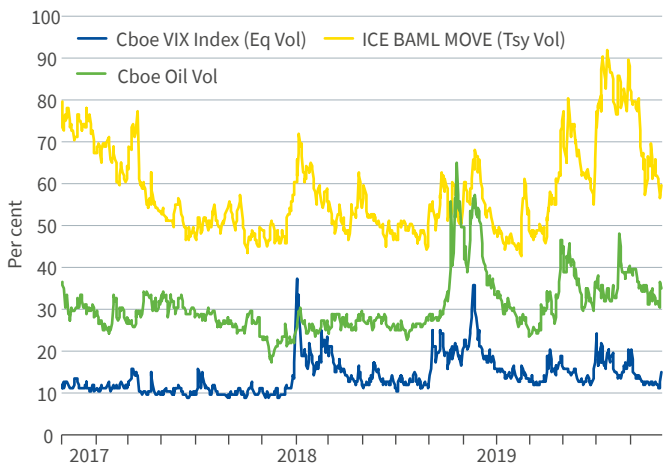
Recent years have been characterised by extended periods of relatively benign price moves in financial markets, interspersed with episodes of relatively large asset price moves. This pattern has been observed increasingly in different markets including equities, commodities and government bonds despite efforts by Central Bankers to extend the economic cycle (Figure 135). This pattern is expected to continue.

Dips on growth fears are likely to be bought

History shows that extremes in cross-asset volatility occur at the ends of economic expansions when growth begins to slow meaningfully. The turn higher in yield volatility that occurred in Q3 2019 has faded, but this period provides a good illustration of the conditions that are expected to continue throughout 2020. With central banks expressing a willingness to stimulate, and with the room to do so, there is good reason to expect rates to stay lower for longer. As risky assets are effectively taken out of circulation it is natural for investors to demand less compensation for risk and this should see yield volatility continue to be suppressed through next year. However, any sign of inflationary pressure would probably result in a rapid pickup in volatility as participants become increasingly sensitive to the risk of meaningful downside.

Corporate credit term-structures are still relatively steep, indicating continuing healthy supply (Figure 136). Central banks switching back to expansion of their balance sheets has helped dampen volatility and has seen some liquidity premium repriced out of credit markets. The European Central Bank is buying the credit market directly, which reduces the tail risk in Europe versus the US. Slow, but non-recessionary growth, muted inflation and a dovish tilt to monetary policy should be helpful for credit markets. This increases the likelihood that credit volatility remains low.

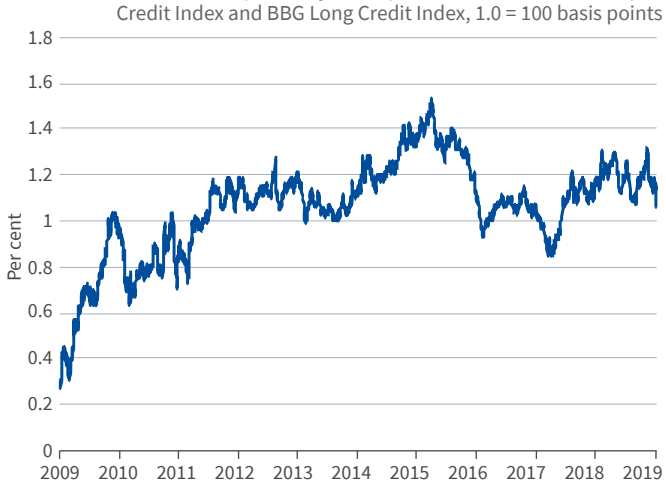
Figure 135. **30-day implied volatility over the past 3 years**



Source: Bloomberg as at 16 December 2019

Figure 136. **Credit curves are steep**

Difference in option-adjusted spread between the BBG 1-3yr Credit Index and BBG Long Credit Index, 1.0 = 100 basis points



Source: Bloomberg as at 16 December 2019

Credit markets have been relatively calm (Figure 137). The risk of bouts of volatility may come from growth scares, which may reappear regularly over the next couple of years. Divergent data across regions and sectors, alongside political risks as we head into or towards elections in many countries are potential catalysts. Given the generally supportive environment for credit that we are in, it is to be expected that these dips will be bought.

Market structure has changed considerably since the GFC

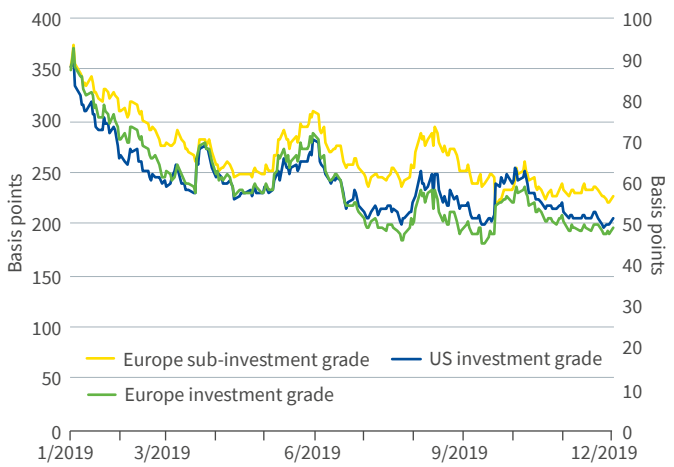
Equity volatility is generally the first to exhibit persistently higher levels towards the end of the economic cycle, but history also shows increasing levels of volatility in the second half of expansions. Since we are likely well beyond the midpoint of the current global expansion, we expect volatility to continue to be an episodic feature of equity markets. Furthermore, the structure of markets has changed considerably since the Global Financial Crisis and the predominance of non-discretionary flows and share buyback programmes are frequently the marginal buying forces. These have helped to perpetuate upside market moves, whilst limiting the volatility exhibited, which is further reinforced by increasingly large waves of short-dated option selling as risk-taking sentiment coalesces. Such forces help to provide significant downward pressure on volatility, which becomes self-reinforcing as the low-volatility period progresses.

Crowded position-taking amid lower available liquidity exacerbates volatility spikes

While there is a top-down low-volatility feedback loop, at a microstructure level it is like that a build-up of forces that can catalyse short sharp bouts of higher volatility will be observed. Yield starvation has driven many investors into liquidity momentum trades, such as via passive investing, or into simply outright shorting of implied volatility (Figure 138). Factor convergence strategies such as growth versus value – have seen phenomenal demand, and there has been an accompanying explosion in interest for alternative risk premium strategies that seek to capture factor premiums through systematic trading patterns. Investor crowding and competition for yield in these strategies has introduced instability to the persistence and prominence of returns. The ensuing overlapping of risk has also effectively reduced the heterogeneity of market activity. In other words, many investors are positioned in optically diverse strategies. However, the speed of the increase in correlation of these strategies to each other, especially during risk-off periods, is high. This is exacerbated by much reduced available liquidity on the bid-ask in the marketplace and the reduction in market-maker provided liquidity and arbitrage activity that came with increased regulatory cost post the GFC.

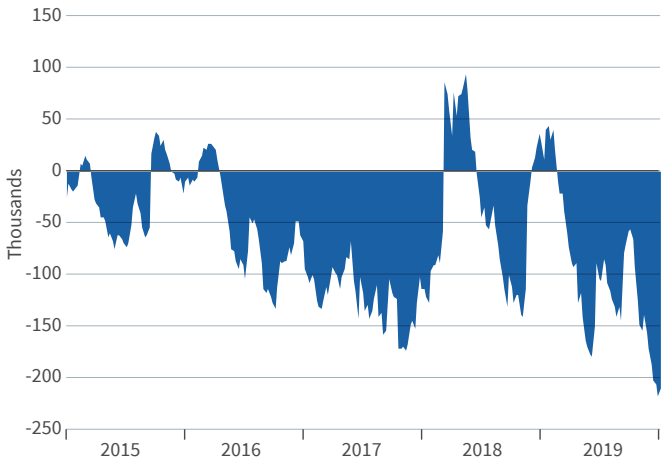
This means the market impact of crowded position de-risking and closing out of short volatility positions is sharp and significant, and this is contributing to periodic spikes in volatility. This feature is expected to continue in 2020. An unusual facet of these spikes in volatility is the speed at which they dissipate. Just as realised volatility could rise because many investors may be exiting their positions via a smaller liquidity window, the stabilising effect of market participants trained by central bank activity to buy-the-dip has a strong normalising influence. The effect of this is that although bouts of volatility may become more frequent, they are typically over before investors can act.

Figure 137. **US & European index spreads**



Source: Bloomberg as at 16 December 2019

Figure 138. **CFTC Cboe volatility short positions at elevated levels to history**



Source: Bloomberg as at 16 December 2019

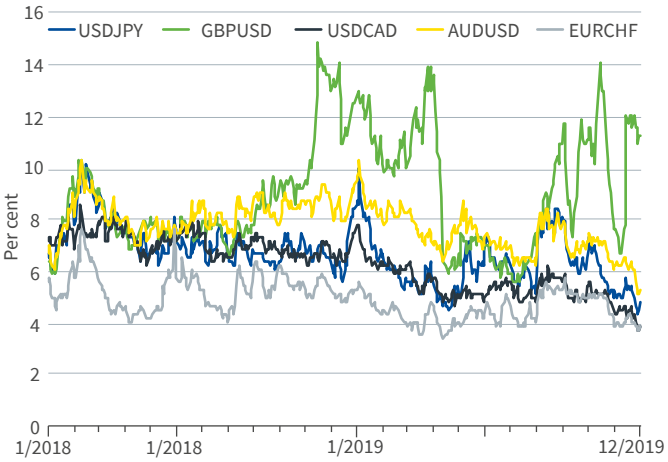
Longer-dated implied volatility levels feel well supported at historically suppressed levels. Coupled with a low-volatility feedback loop, steep term-structures are expected to continue, though with volatile front ends likely to be another feature of 2020. Reduced premium to downside risk is a prevailing trend that could reverse as we go through the next year. Market participants are attaching risk premium to known events, whether their effects are understood or not. The level of that premium is currently low. Markets are not pricing for unknown externalities – the 'unknown' unknowns; tail event pricing has largely come out.

Aside from pairs experiencing political risk, FX markets have also been experiencing an ever-decreasing ambient level of implied volatility (Figure 139). This is perhaps not as surprising, given lower levels of volatility premium in the asset class to begin with, and the prevalence of volatility sellers trying to capture that premium for yield. Tightening interest-rate differentials as global monetary policy rates converge and a consistent pull towards ever-lower realised volatility levels are exerting a significant dampening influence on term-structures (Figure 140). Like equities, term-structures are steep, but anchored at extremely low levels of implied volatility going out several years. Therefore, carry strategies dominate this asset class. Other risk premia strategies such as momentum and EM carry have also seen a significant allocation in the past year – these too have a suppressing effect on volatility.

FX implied volatility term-structures are steep, no surprise given realised volatility

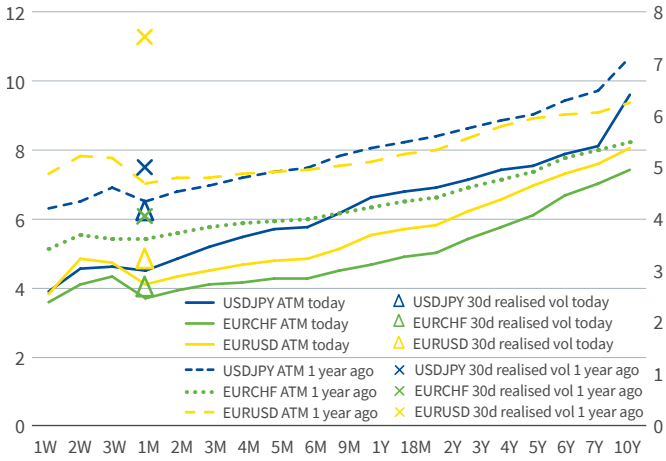
This term-structure in a low-yielding, late cycle environment is underpinned by a belief that central banks have the ability and capacity to continue to support the economy. A dovish tilt to monetary policy throughout 2020 is to be expected and therefore, a continuation of this term-structure dynamic is also likely. Should inflationary pressures rise to the fore, or we see signs of a more aggressive growth slowdown, then a higher ambient level of implied volatility across assets will be merited.

Figure 139. **1 month implied volatility**



Source: Bloomberg as at 16 December 2019

Figure 140. **ATM implied volatility term-structures at end Nov 2019 vs 1 year prior**



Source: Bloomberg as at 16 December 2019

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