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HOUSE VIEW

2018 Q3

The intelligence that guides
our investment decisions

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HOUSE VIEW

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

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

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

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

EXECUTIVE SUMMARY

America First: the United States holds the key to the global outlook

The global dominance of the US has declined in recent decades, but it is currently leading the global growth cycle.

As the largest economy in the world, the United States has long been the most dominant player in global economic, military, political and financial market developments. Indeed, since the end of the Second World War, the President of the United States has been known as the “leader of the free world” and the US dollar the global reserve currency. However, since the accession of China into the World Trade Organisation in 2001 and the recovery of emerging market economies from various financial crises in the 1980s and 90s, the US has fallen in relative economic importance (Figure 1). Indeed, in the raw commodities sphere, China has been responsible for nearly all the global demand growth for the past two decades. While their economic supremacy has waned, the US has continued to benefit from the “exorbitant privilege” of issuing the global reserve currency and being the home to the biggest and deepest global capital markets. Having led the world into the global financial crisis of 2008, the US has also led the recovery, albeit in a disappointingly slow and uneven way for much of the past decade. However, the US economy is now in the strongest position it has been since 2008, and on many measures stronger than in the decade leading up to the financial crisis. With growth expected to be well above potential again in 2018 (helped by a significant boost from tax cuts and fiscal spending), spare capacity is set to diminish further and inflation is expected to remain above target. As such, we expect that the Federal Reserve will continue raising rates at the pace of 25bps per quarter through to the end of 2019.

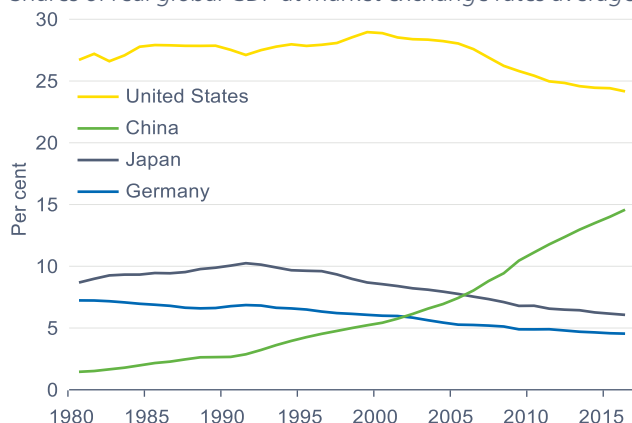
Near-term we expect to see increased policy divergence between the Federal Reserve and other major central banks.

Strong economic growth in the US ought to drive global growth in 2018 to its fastest pace of increase since 2011. That should be a good environment for global risk assets, such as equities, but tighter monetary policy in the US will also have important ramifications both domestically and in the rest of the world. In the near-term, it is likely to mean greater divergence in monetary policy between the US and rest of the developed market economies (Figure 2). That is likely to have important implications for global term premia and the value of the dollar. It is also likely to put increasing strain on those households, businesses and countries that have borrowed heavily in US dollars. However, the most important driver of global markets over the remainder of 2018 may not be US economic developments, but rather politics. President Trump has taken the view that the relative decline in US economic supremacy needs to be stopped and indeed reversed. He sees that primarily through the lens of trade and the desire to reduce the US trade deficit. His proposed solution has been to threaten and then impose tariffs – albeit so far not to the point of being economically significant at the national, let alone global level. But his desire to break down the multi-lateral global agreements of the post-war era and replace them with new bilateral deals that better favour the US, the increased use of sanctions and restrictions on foreign investment could

Protectionist policies have become the biggest threat to the global outlook.

Figure 1: United States remains the largest economy in the world

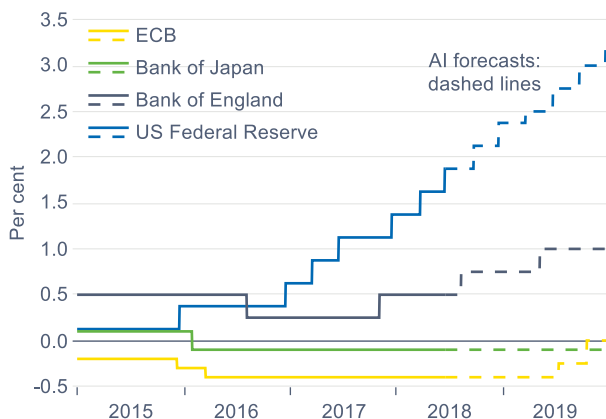
Shares of real global GDP at market exchange rates average



Sources: Aviva Investors, Macrobond, as at 30 June 2018

Figure 2: Near-term monetary policy divergence

All major central banks expected to tighten policy over next two years



Sources: Aviva Investors, Macrobond, as at 30 June 2018

have serious ramifications for markets in the near-term and beyond. Perhaps more than ever, the outlook for global markets is in the hands of the United States. Whatever form the “America First” policy takes, it is likely to be a disruptive factor for at least the next two years.

Central scenario remains positive, but downside risks intensify

Growth slowed in the major developed market economies in 2018 Q1 (Figure 3). According to the OECD, GDP growth amongst the G7 economies slowed to an annualised pace of 1.3 per cent, down from 2.3 per cent in 2017 Q4. While the slowdown was broad-based across the majors, we do not think it signals a fundamental slowdown. Indeed, in each of the major economies there were one-off factors (including unseasonably cold and snowy weather) that should largely reverse in Q2. Outside the G7, growth was steady in Q1. As such, when looking ahead to growth over 2018 as a whole we continue to expect global growth close to 4 per cent, with growth in the US, Eurozone and Japan all expected to be above potential this year and next. We therefore also expect to see further declines in unemployment rates and upward pressure on wage growth and inflation. The US is, of course, more advanced in the cycle and therefore we expect monetary policy to tighten, becoming modestly restrictive during 2019. We have marked down our growth expectations for the Eurozone modestly this year, and given recent announcements from the ECB expect the first rate rise to now come in the second half of 2019. Despite good growth, and a somewhat better spring wage round this year, inflationary pressures remain muted in Japan and we have therefore also pushed back our expectations for any adjustment to yield-curve control (YCC) until 2019. The outlook for the UK remains clouded by Brexit uncertainty. The recent moderation in growth, fairly rapid decline in inflation and the uncertainty regarding the outcome of the Withdrawal Agreement should mean that the Bank of England will be slow to raise rates, with just one hike expected later this year. Finally, Chinese growth was a little better than we expected in Q1, but has shown some signs of slowing more recently. We expect growth this year to be around 6.3 per cent, with modest easing in reserve requirements to more than offset higher policy rates.

While the central scenario remains a positive one, the downside risks have undoubtedly intensified. In particular the trade tensions between the US and the rest of the world have recently escalated into trade skirmishes, in particular between the US and China. The risk is that it progresses into full-scale trade war, threatening to reverse the progress made in lowering trade barriers over the past 25 years (Figure 4). At the time of publication the US had imposed new tariffs on steel and aluminium imports from Canada, Mexico and the EU. They had also announced, but not yet imposed, tariffs on \$34bn of Chinese goods. But much more significantly, they have threatened tariffs on as much as \$400bn in Chinese goods, almost the entire value of US goods imports from China, should the Chinese retaliate with tariffs of their own. Moreover, they have also suggested investigating the imposition of new tariffs on

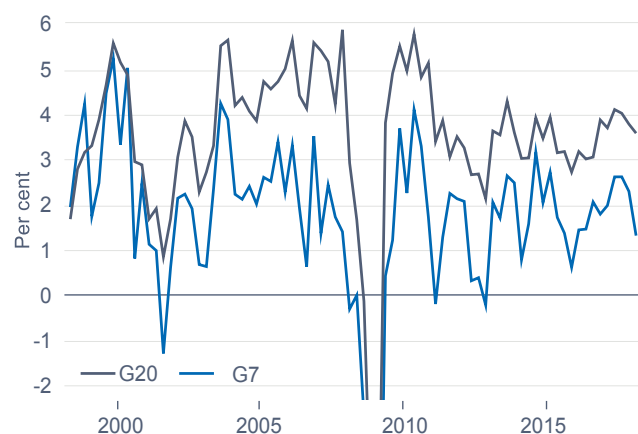
We expect the slowdown in growth in Q1 to prove temporary.

We expect the Federal Reserve to raise rates another six times by the end of 2019, but see less prospect of the ECB or BoJ moving before mid-2019.

Trade tensions have escalated in recent months, as the US threatened tariffs against a wide range of goods.

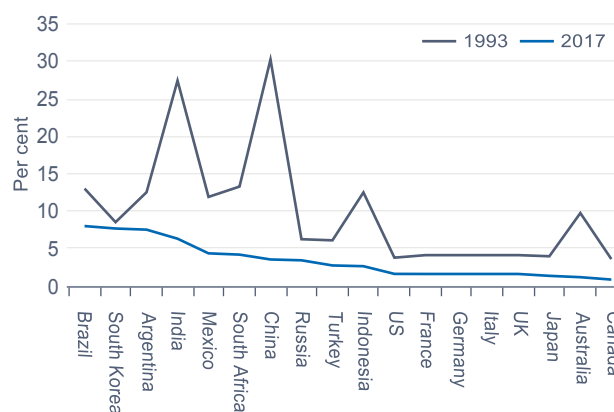
Figure 3: Major economies saw growth slow in Q1

We think temporary factors explain much of the slowdown in annualised GDP growth



Sources: Aviva Investors, Macrobond, as at 30 June 2018

Figure 4: Average tariff rates have fallen over the past 20 years



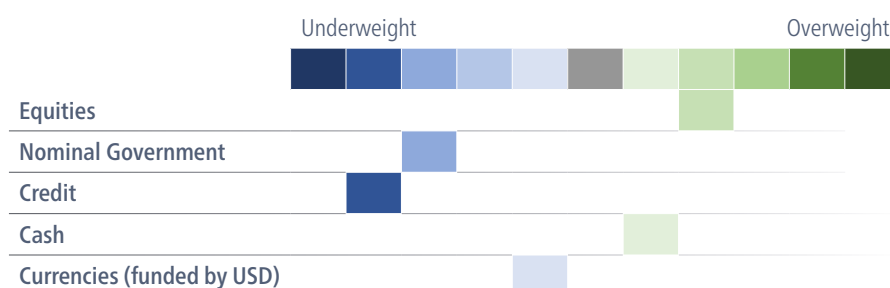
Sources: Aviva Investors, Macrobond, as at 30 June 2018

automobile imports, which are worth close to \$200bn. While these threats may prove to be part of a negotiation that ultimately results in minimal imposition of new tariffs, the risk has intensified that the Chinese walk away from the negotiating table. If tariffs were imposed on goods valued at over half a trillion dollars, the economic impact would be meaningful, not least as it would imply that retaliatory tariffs had also been imposed in China and elsewhere. Such a scenario would undoubtedly see growth expectations revised down sharply in economies with large export sectors, including China, Japan, Emerging Asia and the Eurozone. Beyond tariffs, the US is also seeking to reduce inward investment from China (and potentially others) in technology sectors, as well as restricting exports of technology to China. If imposed in a wide-reaching way, these restrictions could also have major ramifications for global trade.

We remain constructive on risk assets, but have marked down our equity and emerging market expectations, while raising our US dollar view.

Given our central scenario, we remain constructive on global risk assets, but recognise the increased market risk. We have adjusted down our expectations for equity returns, in particular for those with more trade and US dollar sensitivity, including Eurozone, Japanese and Emerging Market equities, while we have adjusted up our US equity expectations. We continue to expect risk-free assets to under-perform, with short duration views across the major developed markets. With tighter global dollar funding conditions and less attractive valuations, we have reduced our expectation for emerging market local debt and currencies. More broadly we see continued upside in the US dollar over the near-term, although have a more neutral view over a longer horizon.

Figure 5: Summary of asset allocation view



KEY INVESTMENT THEMES AND RISKS

INVESTMENT THEMES

The Aviva Investors House View Forum brings together senior investment professionals from across all markets and geographies on a quarterly basis to discuss the key themes that we think will drive financial markets over the next two or three years. In so doing, we aim to identify the key themes, how we would expect them to play out in our central scenario, and the balance of risks. We believe that this provides a valuable framework for investment decisions over that horizon. In the May 2018 Forum we identified the following key themes:

- 1 Robust global growth
- 2 Sustained inflation
- 3 Trade tensions
- 4 Higher interest rates around the world
- 5 Markets adapt to the post-QE world
- 6 Expected end of the ultra-low volatility era

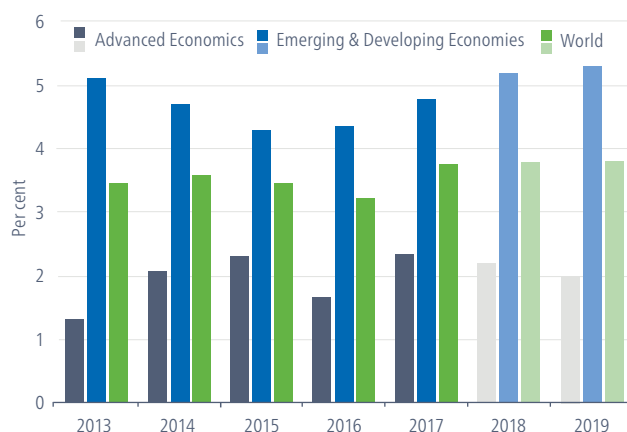
ROBUST GLOBAL GROWTH

World GDP is estimated to have grown by 3.8 per cent last year, the strongest outturn since 2011. We expect growth this year to be a touch higher, pushing towards 4 per cent and 2019 should see something similar, even while monetary stimulus is slowly withdrawn. AI's projections are slightly above consensus numbers. Moreover, growth has become increasingly widespread, with almost all nations benefitting from the cyclical global upswing (Figure 6). Advanced nations should see GDP expand by around 2.2 per cent, while for emerging and developing nations the figure should be close to 5 per cent. A decade after the Global Financial Crisis (GFC), the world is finally expanding at a pace comparable to the average seen between 1960 and 2007.

After a number of false starts since 2008, it is now generally accepted that positive economic growth is the normal state of affairs, even if the sustainable pace of that growth may well slow in future years as a consequence of demographic change and, more debatably, weaker productivity growth. If growth continues and the crisis drifts

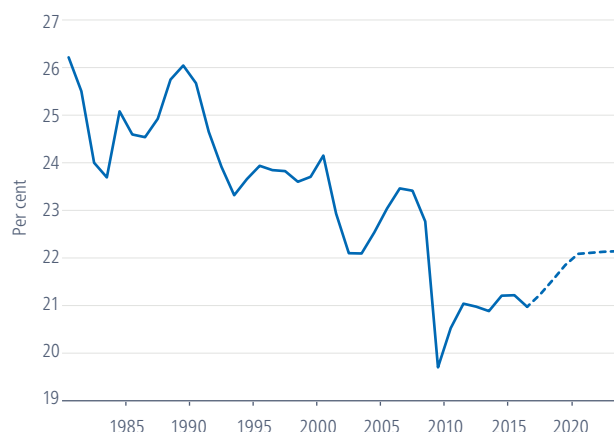
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Figure 6: GDP growth: outcomes and AI forecasts



Sources: Aviva Investors, Macrobond, as at 30 June 2018

Figure 7: Advanced Economies, investment as % of GDP



Sources: Aviva Investors, Macrobond IMF, as at 30 June 2018

back into history, some of the legacies of that episode will fade further, allowing policy settings to begin (or continue) their slow journey back towards “normality”. As conviction in an ongoing expansion has grown, it has been noticeable that investment spending has made an increasing contribution (Figure 7). This bodes well for future growth and, perhaps, for productivity improvements. In and of itself, the strong growth backdrop should be a helpful one for risk assets.

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SUSTAINED INFLATION

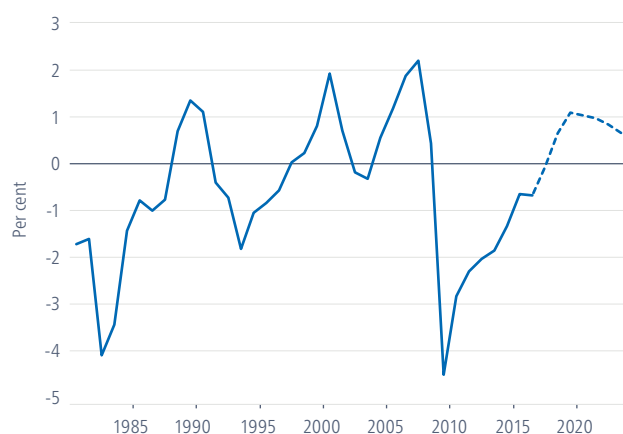
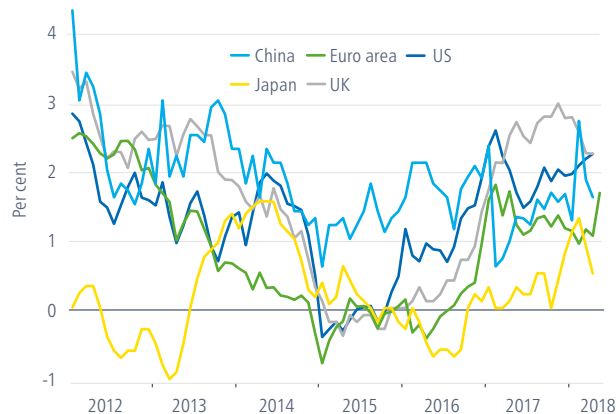
During the GFC and in its aftermath there were genuine worries that deflation was a clear and present danger. As economies have recovered and reabsorbed idle factors of production (labour and capital) back into use, such fears have abated. It comes as no surprise to us that this has taken a long time: underlying inflation is fundamentally a consequence of demand pressures on supply capacity. The conditions of excess supply that have prevailed over much of the last ten years imply an absence of inflationary pressure. That is now changing as demand has recovered and output gaps (the difference between supply and demand) have narrowed or even closed completely in some cases (Figure 8).

With above-trend growth set to continue in 2018 and 2019 too, inflation should make a more determined return towards levels more in line with Central Bank target rates, typically about 2 per cent. Some countries – the US for example – look already to be at or possibly even beyond this point because their cycle is more advanced. But sustained, positive inflation is likely to be a theme that will characterise the investment backdrop for the next couple of years at least. In tandem, inflation expectations should become more embedded at rates compatible with those inflation targets. Indeed this is already happening in several countries (Figure 9). It is worth noting that inflation has returned least convincingly in those nations where the recovery after the GFC took longer to establish itself (Eurozone, Japan).

3

TRADE TENSIONS

As he attempts to deliver on “America First” campaign promises, President Trump has looked to radically change the terms on which the US engages in global trade. From withdrawing from the Trans-Pacific Partnership to renegotiating NAFTA and targeting steel and aluminium imports, the US has more recently moved on China through a threat to impose tariffs on a wide range of goods in response to alleged theft of intellectual property. Investigations have also been opened into the auto industry and potential for tariffs there as well. Whether these latest threats prove to be part of a negotiating strategy that will ultimately deliver concessions from China or rather lead to widespread

Figure 8: IMF estimate of G7 output gap**Figure 9: Headline inflation in the major economies, %**

tariffs being imposed by both parties (and potentially others) in a tit-for-tat trade war remains to be seen (and is reflected in our key risks).

But even if a more positive outcome is achieved, the path to get there is likely to be difficult. For that reason, we expect it to remain at the forefront of investors' minds over the year ahead. Adding to the challenge for markets is that there is little doubt that Trump is playing to his home crowd, with one eye on the November mid-term elections. The tariffs issue polls very well with the domestic audience. But as the recent US - North Korea summit demonstrated, Trump can turn from insult to deal very quickly.

HIGHER INTEREST RATES AROUND THE WORLD

The extraordinary period of extreme policy stimulus that has existed around the world since 2009 is coming to an end (Figure 10). During the period that became known as the "great moderation" (steady growth, low and stable inflation), the idea that policy interest rates would go to zero or below and that Central Banks (CBs) would engage in massive purchases of Government Bonds would have been considered far-fetched to the point of being preposterous. But that is what happened, and while opinion still remains divided about whether it was the right thing to do, we believe that these extreme actions were necessary in the circumstances. Whether such deeds helped bring about the return of both growth and inflation or not, the fact that both are back with us means that CBs are right to be withdrawing monetary stimulus. They are also sensible to tread carefully while doing so.

The timing of tighter policy will vary depending on conditions in individual countries or regions. An estimated \$12 trillion of QE assistance has been provided so far (Figure 11). The US has already halted asset purchases (and reinvestment) and raised the Fed funds rate six times. We expect a further two hikes this year and an additional four in 2019. The next few years will see more follow their lead as policy interest rates very slowly move back towards (but probably not to) rates that have prevailed, on average, in the recent past. The Eurozone has reduced the pace of asset purchases and plans to halt altogether this year before raising rates in 2019. The situations in Japan and the UK are more problematic because of the special contexts of serial macroeconomic disappointments and Brexit respectively. But over our two- to three-year horizon an upward bias to monetary policy is likely.

MARKETS ADAPT TO THE POST-QE WORLD

Higher policy interest rates are appropriate in a world where growth and inflation have been restored. But in addition to the specifics of tighter monetary policy, financial markets will now also have to get used to the absence of Quantitative Easing (QE). Stressing this difference is not semantic; QE has had huge impacts on the prices of

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Figure 10: Policy interest rates in major economies

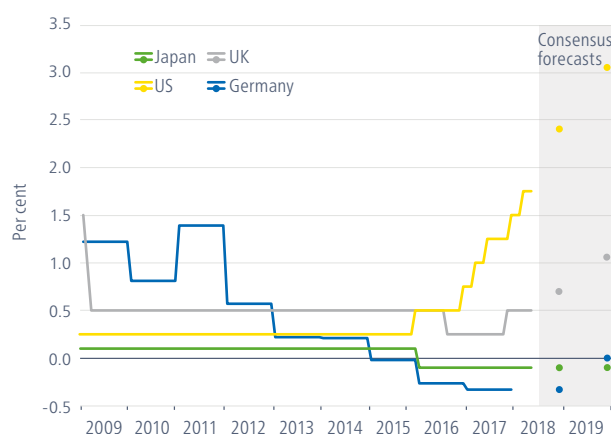


Figure 11: Year-on-year change in CB Balance Sheets
Federal Reserve, BoE, ECB and BoJ



financial assets since it was first introduced in 2009 and this continues to today. Indeed, current policy from both the European Central Bank (ECB) and the Bank of Japan (BoJ) is still having direct (some might say distorting) effects on asset prices. The transmission mechanism for QE is poorly understood, but a substantive part was exactly that – to boost asset prices and help generate beneficial wealth effects and portfolio substitutions.

Financial markets will now have to adapt to a world without such an influence (or at the very least, on a much-reduced scale). To some extent they have already started to do so – part of the explanation for higher sovereign bond yields in 2018 (Figure 12), for example, is that CB buying is much lower today. The policy was intended, again in part, to suppress yields, so the absence of QE implies that they will now have to find their own level. But there will be knock on effects to all financial assets as institutional investors rebalance portfolios to better reflect market conditions free from what some have termed the artificial stimulus of QE.

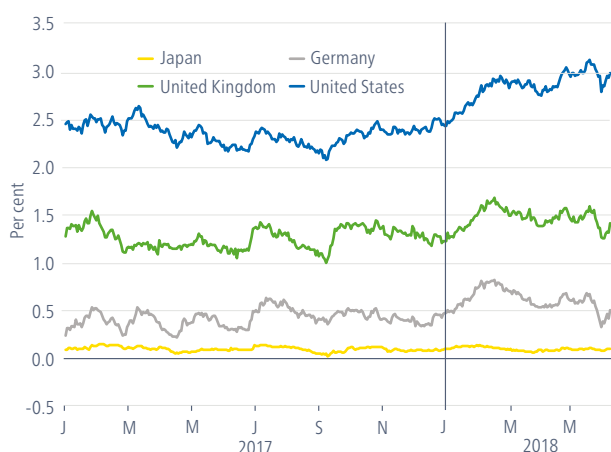
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EXPECTED END OF THE ULTRA-LOW VOLATILITY ERA

2017 saw a collapse in cross-asset volatility to historically very depressed levels. Although periods of low asset price volatility are common during times of economic expansion, those experienced last year were exceptional in both level and breadth of assets affected (Figure 13). Whilst we see no evidence of a notable slowing in global growth, which is the usual prerequisite for a structural and sustained elevation in cross-asset volatility, there are a number of reasons why we anticipate higher levels than those seen last year.

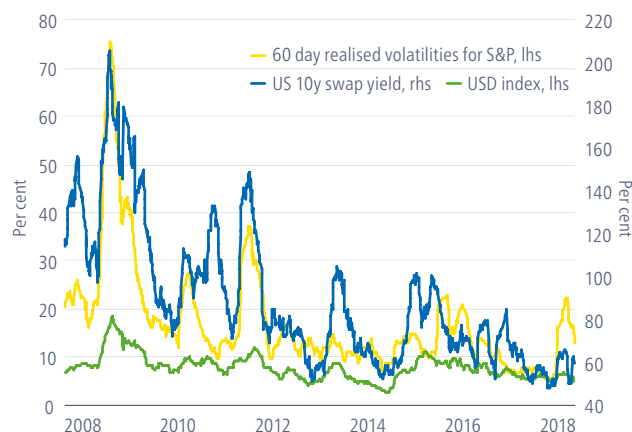
The accommodative investment environment that was engineered by low policy rates, QE programmes and central bank communication have all had a profound effect on the suppression of volatility. As interest rates rise in response to more sustained inflation, this volatility suppression is also being wound down. The US is further through its economic cycle than other global economies and the tightening in policy rates that are appropriate to it will continue to have a variety of knock-on effects to other economies across the world. This has been acutely seen so far this year in certain Emerging Market countries, such as Argentina and Turkey, which have witnessed extreme levels in currency and rates volatility. As the US continues to tighten, this is likely to keep volatility higher than levels that investors have grown accustomed to over previous quarters. Even in core asset markets we expect that ultra-low levels of volatility reached last year will not be retested. This is a natural process over time and one that might occur, potentially (perhaps on a lower scale), even if the cycle were to show no sign of slowing.

Figure 12: 10-year sovereign yields since early 2017



Sources: Aviva Investors, Macrobond, as at 30 June 2018

Figure 13: Volatility set to rise



Sources: Aviva Investors, Bloomberg, as at 30 June 2018

RISKS TO THE HOUSE VIEW

PROTECTIONISM AND TRADE CONFLICTS

The risk of damaging trade disruptions, largely as a consequence of President Trump's actions on tariffs, remains significant. Like many of his initiatives, it is difficult to establish how sincere and determined he is on any announced actions. But his recent restatement of tariffs on steel and aluminium is a signal that further trade skirmishes are plausible – reciprocal actions from China and/or Europe seem likely. Trump's latest announcements were met with universal condemnation around the world, but it sometimes appears that this merely encourages him. The pick-up in world trade growth in the last two years (Figure 14) has been a pivotal part of the economic recovery that is now threatened by these initiatives. More generally, populism and inward-looking nationalism continue to influence politics in many areas.

Only skirmishes so far, but risk of trade war is elevated

CHINA GROWTH SLOWDOWN

Although annual GDP growth in China has been remarkably stable at between 6.7 per cent and 7.0 per cent over the last three years, the underlying pace of potential growth continues to slow (Figure 15). The growth target for 2018 is 6.5 per cent and that is likely to be achieved with some comfort. But in future years it is going to be lower. That is inevitable, but how the process is managed is critical, as are the cyclical influences around the longer-term structural trend. No country has been through the transition from emerging to developed economy without bumps along the way. China's policy-makers are inexperienced and determined to micro-manage every detail of the economy and society. Mistakes will be made. China is now a major world player and any growth concerns or policy errors have the capacity to rattle world markets.

China's inevitable slowdown must be managed carefully

HIGHER INFLATION MAKES THE FED MORE ACTIVIST

Overall financial conditions in the US are looser today than when the Fed first raised rates in December 2015. They have at least tightened so far in 2018. Headline CPI inflation has reached 2.5 per cent and core is now above 2 per cent. Both are expected to move higher. Were the Fed to start to get more nervous about inflation, either because of these trends or those in the labour market, then their playbook could change to one that attempts to slow growth more deliberately to choke off inflationary pressures. In such circumstances, they might decide they had to move above neutral, possibly quite quickly. A change to more than four rate rises in a year would be a significant alteration of the Fed stance and expectations regarding its actions.

Fed could respond more aggressively to higher inflation

Figure 14: World GDP and trade growth, year-on-year

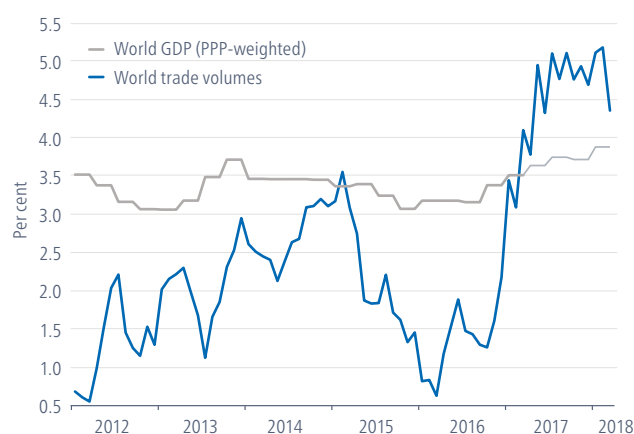
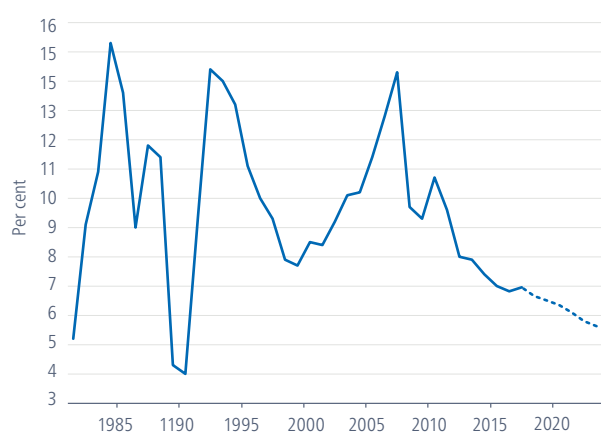


Figure 15: China annual GDP growth and IMF forecast



Too little, too late from the Fed?**FED TIGHTENING FALLS BEHIND THE CURVE**

This is a subtle variation of the previous risk. In this instance the Fed instead ignores potential inflation risk and sticks to the “slow and gradual” approach on interest rates. Growth momentum would be maintained or increased and both inflation and financial stability risks would intensify considerably. As the US economy began more visibly to overheat and the recognition of a policy error grew, the Fed would have to change course, hike aggressively and thereby usher in a sharp downturn. Previous downturns have all been preceded by hiking cycles (Figure 16). This scenario would almost certainly be associated with some jarring adjustments in financial markets.

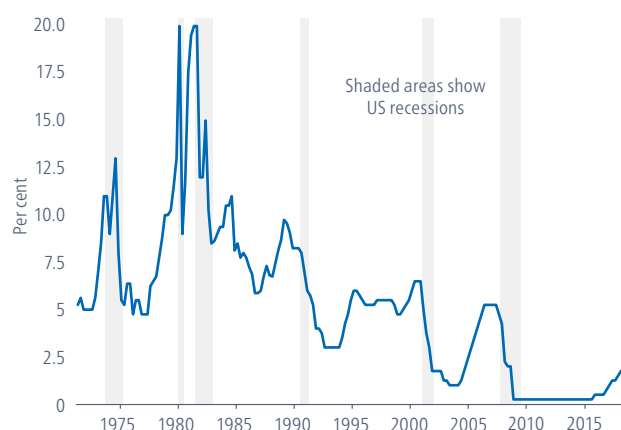
Higher rates will expose vulnerable debtors**DEBT SERVICING STRAINS**

We have now had a decade of exceptionally, historically low interest rates, a period long enough to have influenced behaviour meaningfully. This extended period may also have led borrowers in some areas making judgements about what represents a “normal” interest rate and debt servicing obligation. As interest rates now rise, there are risks that the vulnerability of such groups is exposed. Low interest rates have undoubtedly encouraged greater borrowing and debt levels in several areas are markedly higher. We would highlight specifically concerns for certain US corporates, Emerging Markets that rely on US dollar funding and peripheral G10 property markets. The most indebted Governments should also not be ignored. US corporate debt as a proportion of GDP, for example, has returned to all-time highs (Figure 17).

Liquidity problems may be more prevalent in the post-crisis world**LIQUIDITY CHALLENGES**

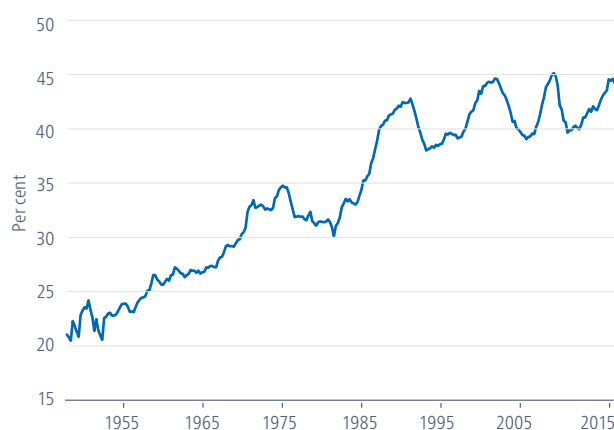
The authorities have introduced a raft of new regulatory requirements since the GFC. The indirect impact of some of these measures has become more apparent in recent years. For instance, new capital rules have seen banks retreat from certain risk-taking activities. That has resulted in sharply reduced levels of liquidity in some markets, particularly in certain areas of fixed income, such as high-yield debt. If these influences intensified or if regulation became more invasive, liquidity in key markets could become more profoundly compromised. This, potentially, would make it appreciably riskier to invest in these asset classes than was previously the case.

Figure 16: Earlier US expansions have been ended by tighter policy



Sources: Aviva Investors, Macrobond, as at 30 June 2018

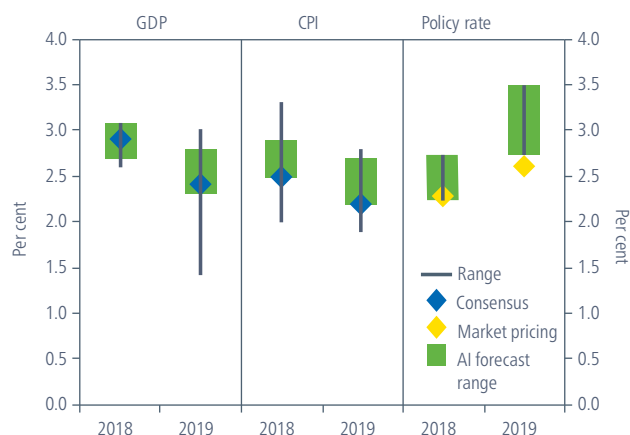
Figure 17: US: Nonfinancial corporate debt as % of GDP



Sources: Aviva Investors, Macrobond, as at 30 June 2018

MACRO FORECAST CHARTS AND COMMENTARY

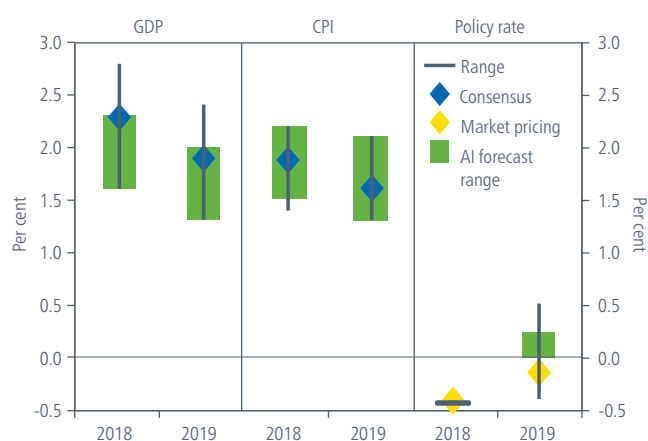
Figure 18: US



Source: Bloomberg, Aviva Investors, as at 30 June 2018

Modestly softer growth in 2018 Q1 should prove temporary, with a strong bounce-back expected in Q2. Overall growth is expected to be close to 3 per cent this year. Headline inflation is expected to remain above 2 per cent this year as underlying inflation strengthens and as energy continues to contribute. We expect the Federal Reserve will deliver four rate rises in each of 2018 and 2019.

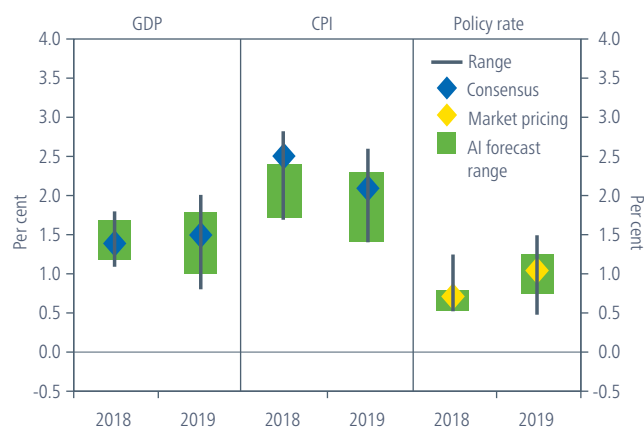
Figure 19: Eurozone



Source: Bloomberg, Aviva Investors, as at 30 June 2018

The growth slowdown in Q1 warrants some attention, but was probably necessary. 2018 will still see above-trend growth and there is far less slack remaining. Inflation is returning, slowly, but a continuation of 3 per cent annualised growth could have led to unwelcome overheating. The ECB has, unusually for them, provided very clear guidance on their policy intentions: asset purchases will stop at the end of 2018, while policy rates are not expected to rise until the second half of next year. Higher energy prices have boosted headline inflation. The Eurozone now needs to see core inflation move closer to 2 per cent than 1 per cent.

Figure 20: UK

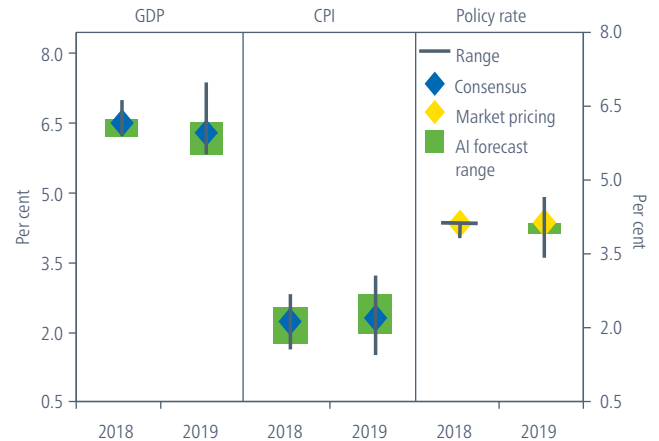


Source: Bloomberg, Aviva Investors, as at 30 June 2018

The UK continues to be a growth laggard among developed nations. Paltry growth of just 0.2 per cent in Q1 may have been partly weather-related, but Q2 does not look to have seen much improvement (or payback). With inflation also falling faster than the Bank of England had expected, the pressure for early rate rises has diminished. The Bank has stressed that supply potential is now only growing at around 1.5 per cent a year. But demand is struggling even to match that. If growth does not recover, or if Brexit uncertainties continue or worsen, the Bank may postpone again. The labour market has, surprisingly, remained robust, although strong jobs growth may be more a reflection of a gloomy productivity story.

China's start to the year has been strong with growth surprising to the upside, though the most recent data on credit and fixed investment point to the risk that a slowdown is underway. While growth is likely to slow further, policymakers have clearly recalibrated their strategy towards deleveraging as seen in lower wholesale funding rates and three RRR cuts. Trade war risks pose further downside risks, but policymakers may well act to stimulate domestic demand to offset the growth impact through policy easing. CPI inflation has stabilised slightly below 2 per cent, which allows the PBoC space to shore up activity if needed.

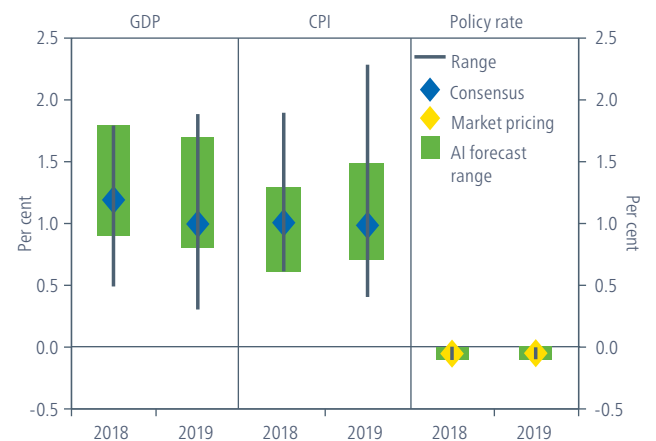
Figure 21: China



Source: Bloomberg, Aviva Investors, as at 30 June 2018

Growth has stumbled during Q1 with domestic demand faltering after contributing strongly to GDP last year. But temporary factors such as weather have been the major driving force behind the loss of momentum, though clear risks have emerged from US protectionism. Having said that, survey data has continued to present a picture of a reasonably strong business outlook and consumer confidence. While wage growth has shown some signs of a modest pick-up, the spring wage negotiations were largely disappointing, keeping inflation at subdued levels and ensuring BoJ policy continuity.

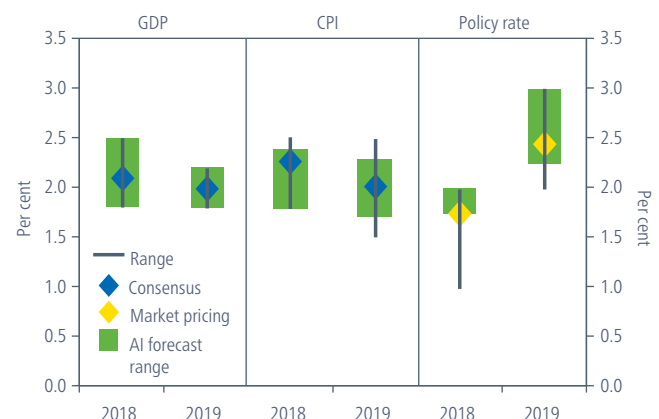
Figure 22: Japan



Source: Bloomberg, Aviva Investors, as at 30 June 2018

While growth continues to moderate it has been well underpinned by consumption and investment. Overall therefore, activity in the Q1 was slightly stronger than the BoC forecast and the economy continues to operate close to capacity. Consumption should support growth given the solid improvement in wage growth. Core inflation measures have increased to around 2 per cent. Going forward pressures remain to the upside. Year to date the BoC has hiked rates by 25bp and another 2 hikes are expected by market participants before year end. A higher rate environment will likely alter the composition of growth going forward with a declining contribution from household spending and more from investment and exports on the back of higher oil prices.

Figure 23: Canada



Source: Bloomberg, Aviva Investors, as at 30 June 2018

GLOBAL MARKET OUTLOOK AND ASSET ALLOCATION

GEARING TO A HIGHER VOLATILITY REGIME

- Strong global growth will continue to support risk assets
- Underweight duration as inflation pressures finally appear
- We expect a higher volatility regime, with market structure fragilities an increasing risk

The global economic backdrop – current and expected – remains supportive for risk-sensitive assets. As ongoing above-trend growth reduces the amount of remaining slack in the economy, inflationary pressures are finally beginning to build, taking inflation back towards central bank targets.

Unwinding a decade of experimental monetary policy

Fundamental weaknesses to be revealed

It is entirely appropriate that this combination of robust growth and rising inflation is now leading to changes in policy. The withdrawal of monetary accommodation is one of our major themes and has the potential to impact asset prices significantly. As central banks remove liquidity from the system, fundamental weaknesses across asset classes and regions that have previously been masked by abundant money are becoming more exposed (Figure 24). We have already begun to see some of these fragilities in certain emerging markets where reliance on external or internal financing is comparably high. Brazil and Turkey are prime examples. Whilst each has its idiosyncratic dynamics playing out and policy responses certainly differ, the commonality is one whereby tightening US dollar liquidity is leading to less generous capital flows into emerging markets.

More selective on Emerging Markets (EM)

Many emerging markets have benefitted greatly from the era of cheap money and have enjoyed significant inflows, driven in part by the search for higher yields. As yields elsewhere rise and the opportunity cost of investing in safer asset classes diminishes, the return on EM assets will look less favourable, particularly in economies where there has been a lack of political and structural reforms. In order to stem capital outflows, several EM central banks have intervened in one way or another. Turkey has raised policy rates aggressively (Figure 25), while Brazil has relied more on the use of foreign exchange intervention. We continue to expect greater dispersion not only across EM asset classes

Figure 24: Year-on-year change in global CB Balance Sheets and EM FX

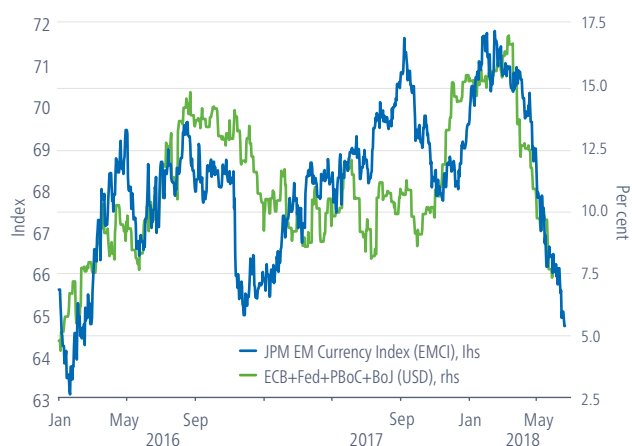
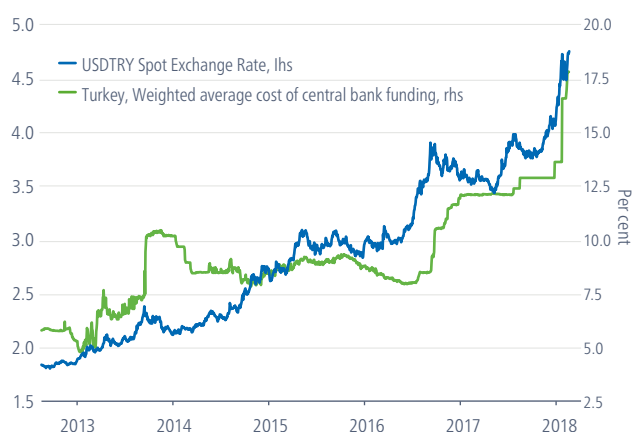


Figure 25: Turkish currency and average CB policy rate



but also within asset classes more broadly. In terms of investments, this means we like to be more selective in our EM exposures, be that in equities or in fixed income.

A higher cross-asset volatility regime

As monetary accommodation is removed and fundamentals increasingly drive markets, volatility, both in terms of the variability of asset prices and as an asset class in its own right, will be impacted. A strong global growth environment is often associated with periods of structurally low cross-asset volatility. Looking forward, we expect that growth will remain strong in 2018. However, we also believe that cross-asset volatility will be sustainably higher than the depressed levels of 2017, which was notable not only for its level, but also for the range of assets it influenced. While a robust growth environment should temper any rise in volatility, the days of ultra-low volatility are probably behind us.

Days of ultra-low volatility behind us

Figure 26 shows the significant jump higher in both US rates volatility and US equity volatility at the start of the year. The sell off in equities and subsequent increase in volatility was driven by a concern that US monetary policy accommodation would be removed faster than the market had initially anticipated. Perhaps as importantly, tighter US policy has ramifications well beyond its own market. The spike in US equity volatility seen earlier this year generated a broader rise in equity volatility as markets moved in sympathy with the US. Likewise, we believe that higher US rates will foster higher rate volatility across the asset class.

Weaker market structure, headline risk rising

The move higher in equity volatility was exacerbated and prolonged by a change in market structure, whereby losses on short volatility trading strategies intensified equity selling. Alterations in market structure are evident in other asset classes also. This changing market structure can create liquidity vacuums when the market needs it most and therefore can exaggerate market fragilities.

Structural changes in the market increase risks

Adding another layer of complexity in navigating markets is the political newsflow, one way or another nationalistic in nature. Whilst we must not dismiss the risks that emanate from trade frictions between the US and other regions, nor those from attempts to break away from a set of common institutions and rules with the latest episode unfolding in Italy as we write, we rather view these developments as volatility events that are to be weathered so as long as they do not derail the global recovery. It's against this backdrop of more political headlines that we would not be surprised to experience more frequent volatility spikes, if not "mini-crashes", as central bank support is slowly fading, forcing investors and global markets to regain the ability to price underlying risks across asset classes.

Figure 26: Equity and rates volatility

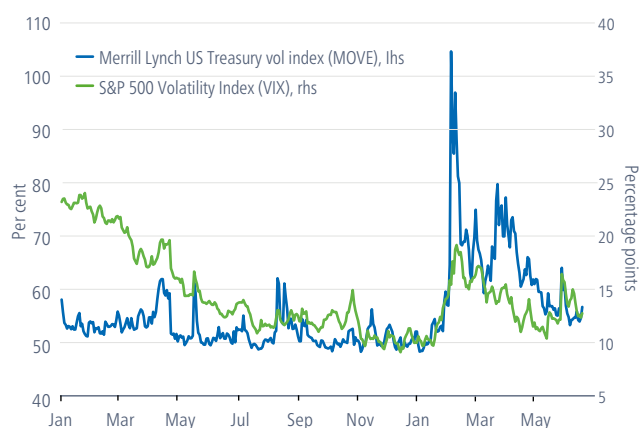
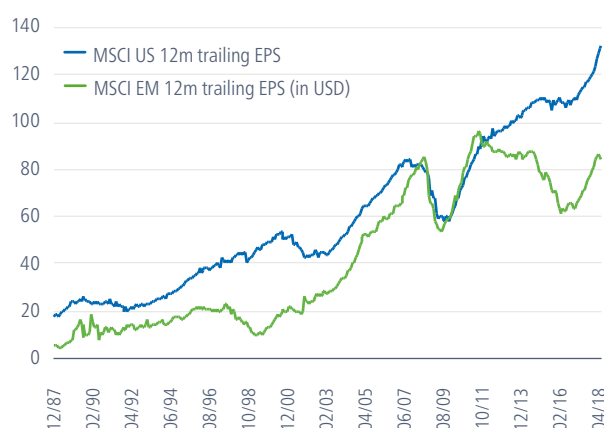


Figure 27: Equity earnings in US and emerging markets



Underweight duration across geographies

We remain underweight duration

We position our portfolios accordingly by remaining short duration across large parts of the fixed income universe and have tactically reduced our equity overweight. Yields are expected to move higher particularly in the US, where monetary policy is furthest removed from being accommodative. However, as output and employment gaps narrow in other regions as well, we expect yields globally to broadly follow suit.

More specifically, we made the following asset allocation changes this quarter: we reduced our equity exposure marginally and funded this adjustment by increasing our cash allocation. Our underweight in government bonds remains unchanged. Within equities, we have reduced our exposure to more cyclical regions. The change is largely reflected through a neutral exposure to EM equities, having been our highest conviction overweight previously. Realised and expected tighter US liquidity conditions, alongside less favourable valuations and the prospect of less strong earnings growth make EM materially less attractive (Figure 27). At the same time, we have increased our exposure to UK equities from underweight to neutral and move to an overweight stance in US equities. The main motivation to take up UK equities lay in the broad-based valuation advantage, alongside improved future earnings prospects – helped by higher oil prices in the commodities sector and a fall in sterling. Within government bonds, we added US to our suite of short duration positions on the back of recent curve flattening and have reduced the short duration on core Eurozone bonds slightly. Our conviction in near-term Bank of Japan tightening has diminished; hence we have moved our maximum underweight position in Japanese bonds up a little. In terms of currencies, the portfolio has moved from being roughly neutral US dollar to slightly overweight. At the same time, we have positioned for a somewhat weaker euro, unchanged Japanese yen and a reduced degree of depreciation in the Australian dollar. As a result of a much less pronounced overweight in EM local currency debt and EM equities, our implied overweight in EM FX has diminished.

We remain positive on the outlook

Cautiously optimistic

Global bond yields declined significantly in the wake of the Global Financial Crisis, helped significantly by ultra-low policy rates and unconventional monetary policy stimulus. As Central Banks reverse some of these measures, it should come as no surprise that volatility has picked up and that bond yields have come under some upward pressure.

As our central economic scenario remains one of sustained, robust growth, with little prospect of recession in the next 12 months, we maintain our cautiously optimistic outlook and are positioned accordingly (Figure 28).

Figure 28: Equity returns prior to US recessions

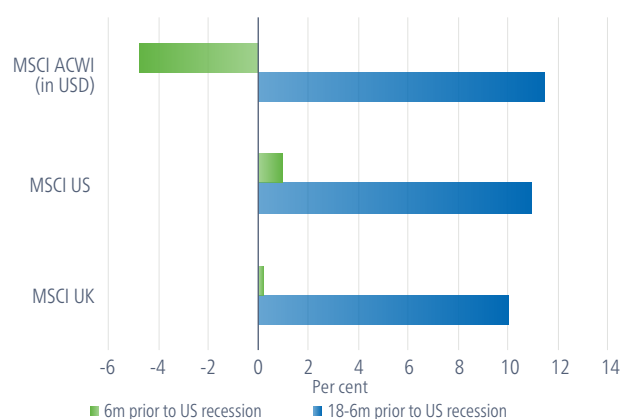
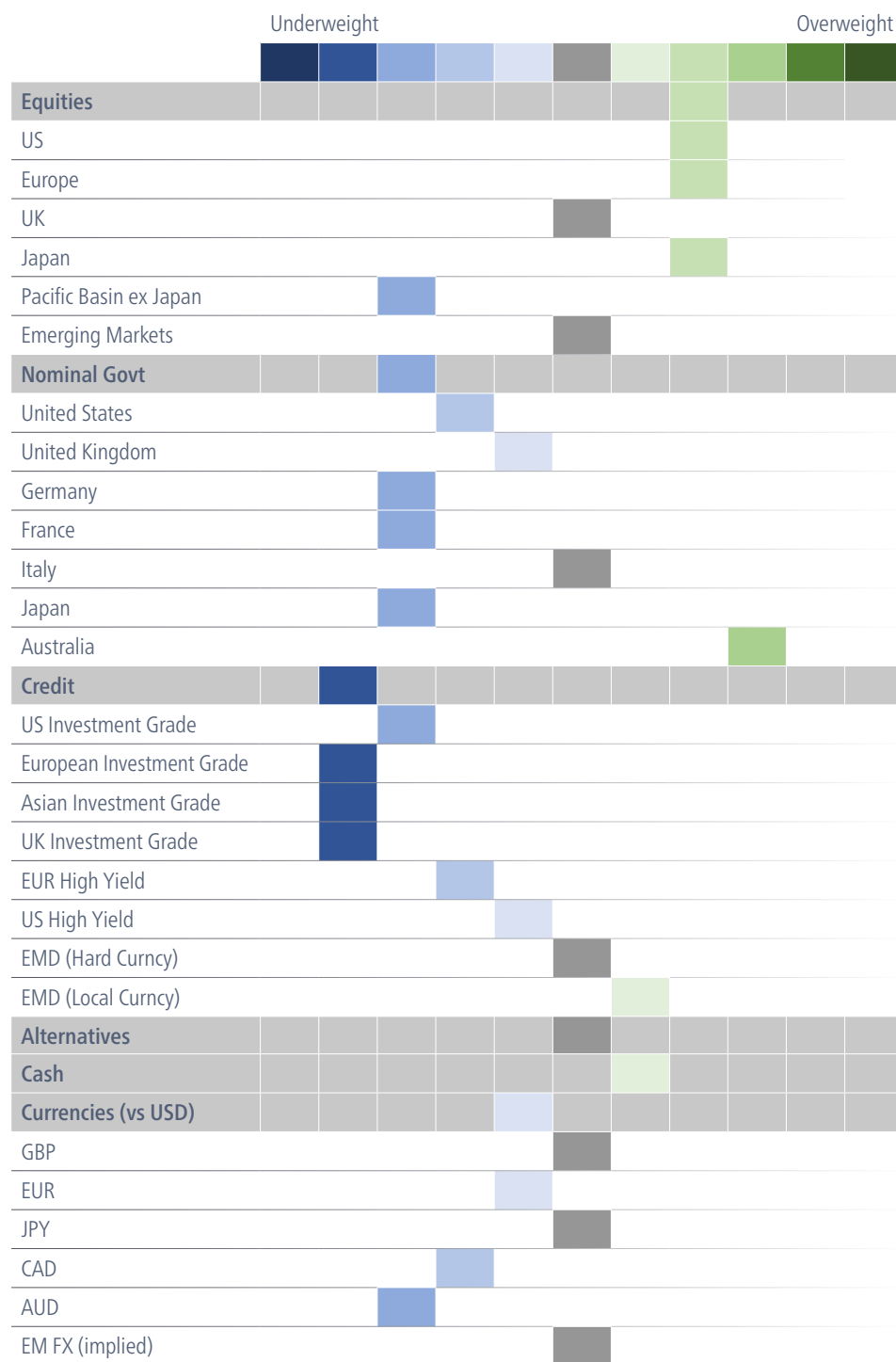


Figure 29: Asset Allocation



Sources: Aviva Investors, as at 30 June 2018

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