

House View 2021 Outlook

The intelligence that guides our investment decisions

For today's investor



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House View

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

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

All aboard: from resilience to rapid recovery

There is little doubt that 2020 will go down in the history books as an extraordinary year. A deadly pandemic swept across the globe. Economies effectively shut down for an extended period to reduce the spread of the virus and limit the number of fatalities. That resulted in the largest decline in output since the Great Depression. However, while the first half of the year was punctuated by fear, that was quickly replaced by resilience and hope in the second half of the year. Resilience came from people rapidly adapting behaviours to the difficult circumstances, and hope from optimism that successful vaccines were being engineered. That hope was also founded on the rapid response of governments and central banks to both the medical and economic emergency. While perhaps not always perfect in terms of timing and execution, the support from the state for households and businesses was essential in preventing the debilitating economic effects of bankruptcy and unemployment. Governments correctly recognised that the cause of the crisis was not household or corporate excess, but a temporary shock caused by taking measures to contain the virus, and otherwise healthy, well-functioning businesses needed to be supported; household income should not be negatively impacted where workers were forced to sacrifice wages to contain the pandemic. The use of fiscal transfers, supported by central banks reducing interest rates to the effective lower bound and undertaking large-scale asset purchases, has facilitated a rapid economic recovery in the second half of 2020. In 2020 Q3 economies had recovered much of the decline in output over the preceding two quarters. Indeed, the bounce back in Q3 was better than we, and almost all, forecasters were expecting. As economies began re-opening, pent-up demand was released with consumer retail goods purchases rising well above pre-COVID-19 levels and services recovering in sectors where restrictions were less stringent. Interest rate sensitive areas, such as housing also saw a rapid increase in demand, and even companies began to ramp up investment again.

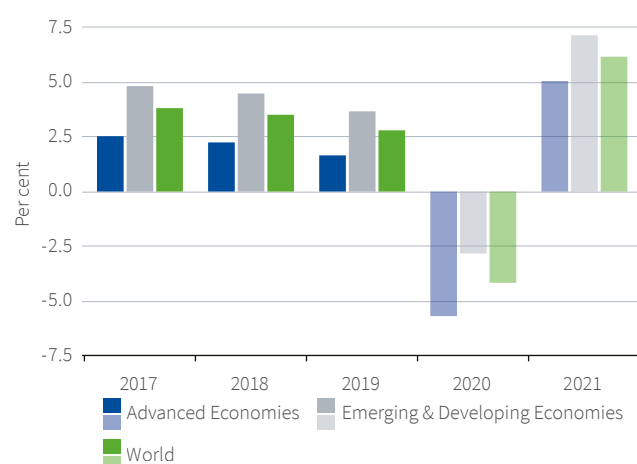
While hugely encouraging, the initial rebound in activity could only be sustained if there was an effective vaccine widely available for use. In early November, several pharmaceutical companies announced the results of their trials show that showed the vaccines to be highly effective. The success of these vaccine trials and the prospect of mass production and distribution starting in late Q4 is the game changer that society had been hoping for. The box on page 7 gives more detail on the next steps for vaccine distribution, but the hope now is for the majority of people in wealthier countries, as well as nearly all of the highly vulnerable sub-populations, to be vaccinated by the middle of 2021. The early and rapid roll-out of vaccines, alongside the high efficacy, is far better than anyone expected when the pandemic began. It dramatically reduces uncertainty about the outlook, allowing households and businesses to confidently plan for the future and draw down on some of the aggregate savings buffer accumulated in 2020. Moreover, it should raise demand expectations for businesses that have let inventories run down during the period of uncertainty, providing a further boost to near-

The global economy showed resilience through the COVID crisis of 2020, supported by extraordinary monetary and fiscal support

Roll-out of highly effective vaccines provides light at the end of the tunnel

Figure 1. Global GDP projections

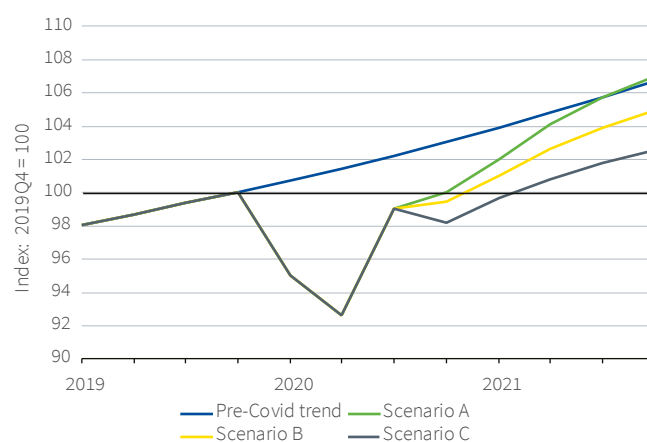
Strong growth recovery in 2021



Source: Aviva Investors, Macrobond as at 3 December 2020

Figure 2. Global growth scenarios

Scenario B remains our central case



Source: Aviva Investors, Macrobond as at 3 December 2020

term growth.

As a result we see a potent combination of economic drivers for 2021: 1) economies re-opening; 2) COVID-19 uncertainty largely removed; 3) pent-up demand for those activities forgone in 2020; 4) increased savings buffer to draw down; and 5) supportive monetary and fiscal policy. We have raised our growth expectations across all the major economies for 2021 to be somewhat above the current consensus. At the global level, we expect growth to be around 6¼ per cent in 2021, following a decline of around 4¼ per cent in 2020 (Figure 1). As a result, the level of global activity surpasses the pre-COVID-19 level by the end of 2021 Q1 (Figure 2). A significant factor in that is the earlier and more rapid recovery in China. Amongst the major developed economies, the pre-COVID level of activity is expected to be reached by the end of 2021.

Even as the global economy continues to recover through 2021, we expect monetary and fiscal policy to remain supportive. Central banks, led by the outcome of the Federal Reserve's framework review, are expected to delay any tightening in policy until spare capacity has been eliminated and inflation has moved above 2 per cent for a period (Figure 3). Governments have signalled that support for household incomes will remain in place for as long as necessary through 2021 while some restrictions on businesses operating remain in place. And looking beyond the pandemic, many governments are planning to increase spending on public infrastructure, as well as in other areas, to stimulate future growth (Figure 4), including a joint effort by EU countries that is widely viewed as increasing their economic and political unity.

There are both upside and downside risks to that growth outlook. On the upside, if households were to recycle more of their accumulated savings from 2020 (particularly large in the United States) then consumption may rise more rapidly. Similarly, business re-stocking and investment spending could rise more rapidly than anticipated given the low cost of financing. On the downside, the resurgence in COVID cases in the northern hemisphere autumn/winter and the associated restrictions on businesses will be a drag on activity in Q4 (albeit much less than earlier in the year) and could extend into Q1. It is also possible that a greater degree of long-term economic scarring could emerge as some of the business support measures are gradually wound back, leading to bankruptcies and defaults. Finally, distribution of vaccines may prove more difficult or less effective than expected, prolonging uncertainty.

While the prospects for growth in 2021 have improved, we do not expect inflation to rise materially over the next year. For most economies there will continue to be spare capacity throughout 2021, keeping inflationary pressures low. As that spare capacity is eliminated, and with monetary policy set to remain loose, we could start to see inflationary pressures building, albeit from a low starting point, in 2022.

One policy area that we expect to take on increasing economic and market significance in 2021 is climate change policy. With the delayed Glasgow COP26 conference due to take place in November, countries around the world are expected to implement further regulatory and tax changes to disincentivise CO₂ (and other greenhouse gas) emissions and incentivise clean

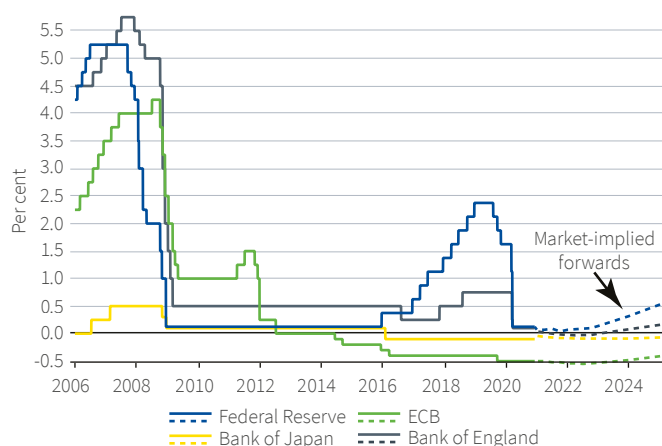
Global growth is expected to rebound sharply in 2021

Monetary and fiscal policy are expected to remain supportive

Large household savings buffers pose upside risks to consumption, but downside risks from a longer period of economic restrictions remain

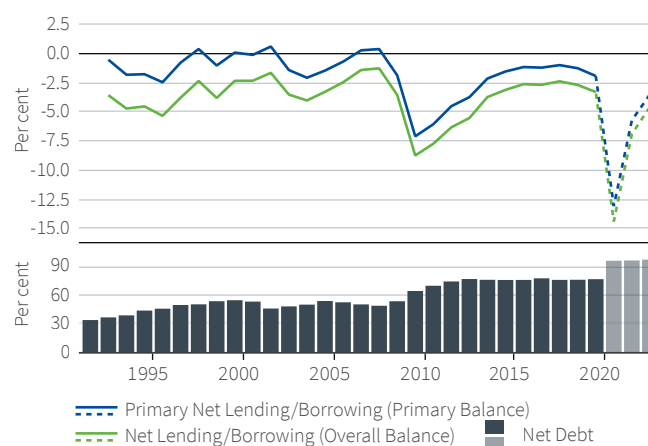
Inflation expected to remain subdued in 2021

Figure 3. Monetary policy to stay very loose



Source: Aviva Investors, Bloomberg, Macrobond as at 3 December 2020

Figure 4. Advanced economy government deficits and debt (%GDP)



Source: Aviva Investors, IMF, Macrobond as at 3 December 2020

energy solutions. In Europe, where the agenda is perhaps most clearly set out, there is potential for significant transitional impacts from changes in carbon taxes and other regulations. These could impact some economies (such as Germany) more than others (such as France). They will also impact certain businesses, requiring costly changes to practices. The new Biden administration in the United States is also likely to be more engaged on environmental regulation and international coordination. We see this as a key investment theme for 2021 and expand on it further on page 13.

With a rapid and robust recovery expected in 2021, in our asset allocation views we prefer to start the year with a moderate overweight to global equities (Figure 5). While multiples are already high, we expect prices will continue to be supported by the outlook for very strong corporate earnings growth in 2021; importantly, not just realised but expected earnings per share (EPS) are likely to rise. We see potential for the recent outperformance of “value” stocks to continue into 2021, as the economic recovery supports financials and travel and leisure sectors. With central banks set to keep policy rates at the effective lower bound in 2021, and maintaining quantitative easing (QE) programmes to monetize fiscal deficits, there is a limit to how much yields on shorter-maturity government bonds are likely to rise. That said, we do expect some steepening in yield curves as continuing fiscal support, alongside future growth and inflation expectations start to be priced into the market. With yields already so low by any historical standard, the benefit risk-free gilts bring from a portfolio construction perspective is also more limited. As such, we prefer to be modestly underweight duration, with a preference for UK, Italian, US and Australian government bonds over core Europe.

Both investment grade and high yield credit spreads have tightened significantly over 2020 H2, supported by central bank buying and increasing risk appetite. With spreads approaching their historical tights – Investment Grade offers just 100bps over Treasuries – the scope for material excess returns of corporate bonds is likely to be limited in 2021, but after a stellar 2020 H2, carry and rolldown will provide a more stable income. We prefer to be modestly overweight, with a preference for US and European investment grade and high yield over Asian and UK credit. In the emerging market (EM) space, we prefer hard currency debt, where spreads can tighten further on the back of the global recovery, with the high yield sovereigns more attractive. In the local currency space, a weaker US dollar would be supportive, but yields are already low by historical standards and balance sheet risks have become more elevated in some economies.

We expect a range of factors will see the US dollar decline further in 2021, with a preference to be overweight the euro and the yen. Those factors include the upswing in the global growth cycle, during which the US dollar has historically underperformed, the reduced geopolitical tensions coming from a Biden administration, expansionary fiscal policy in the United States (alongside very loose monetary policy) and finally expanding trade and budget deficits in the US. Moreover, we do not think the market has fully appreciated the long-term implications of the increased fiscal burden-sharing in Europe, which should support the currency as risk premia decline.

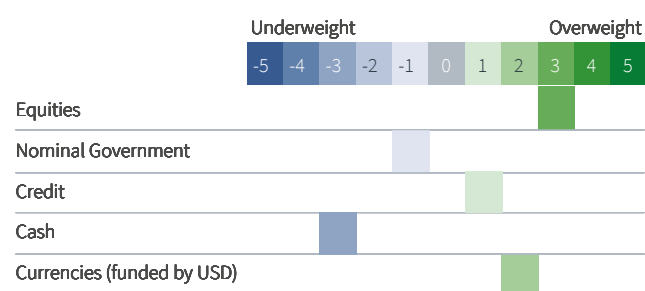
Policies to address climate change are expected to have greater economic and market impact

Our positive growth outlook means that we prefer to be overweight equities and modestly underweight duration

We prefer a small overweight in credit, with a preference for high-yield and EM hard currency

We expect the US dollar to weaken further in 2021

Figure 5. Asset allocation summary



Source: Aviva Investors, Macrobond as at 3 December 2020

COVID-19 vaccines

Perhaps the two elements of the COVID-19 crisis which have been most consistent have been the steadily depressing acceleration in the spread of global infections, and the continual ability of progress on vaccines to meet or beat consensus expectations.

Last quarter we viewed prospects as being ahead of expectations, with the likelihood of having a successful vaccine by the end of the year. We now approach 2021 with three vaccines already having proven efficacy and with a very high probability of several more to come over the first quarter. Not only that, but the two mRNA vaccines, representing the absolute cutting edge of vaccine technology, have proven incredibly effective in reducing symptomatic infections.

It is true that questions remain regarding the details of the 70 per cent efficacy announced by the Oxford vaccine study. However, this study, with greater depth of volunteer examination, offers the first indication that not only can vaccines reduce illness, but just as significantly they may materially reduce the spread of the virus. So, whilst the roll-out of the Oxford vaccine may be delayed by the need for further trials, the lessons learned only increase the expectations that the current Phase Three trials will result in further effective vaccines being found. This is not to say that the crisis is over, but rather to highlight that, from a position of uncertainty as to how we may be able to navigate the crisis, we now enter the well-defined logistical challenges of producing sufficient doses and then inoculating populations at speed. Whilst this will require a monumental effort, it is not quite as large as it may first appear. It is far from clear what proportion of populations are likely to be vaccinated given the extreme variations with which different cohorts experience the virus.

However, whatever number that turns out to be, governments will not wait for all to be vaccinated before relaxing restrictions. Once the most vulnerable are protected, we should expect to see easing, even whilst younger age groups continue to receive a vaccine. In the developed world this means in many countries it is not unreasonable to expect to see normality return over the course of the second quarter. Outside of the developed world it is less clear, with production likely to take longer to reach several countries. On the positive side though, these nations have far lower proportions of their populations in the higher risk categories and so programmes can achieve much in their early stages. So, whilst logistics are challenging, the most material outstanding question is not delivery, but is one that we won't have any clarity on for some time: the longevity of protection.

It will take some time before we see whether and how the efficacy of vaccines wanes over time. The evidence regarding natural infection is reassuring, with protection appearing to be long lasting for the vast majority. We will now have to wait and see the degree to which vaccines can match or even exceed this longevity. Whilst this uncertainty hangs over us, given the low level of mutation observed thus far, it is unlikely that the downside scenario is materially worse than the prospect of annual booster shots to revitalise population immunity levels.

Key investment themes and risks

Investment themes

- 1 Economic recovery
- 2 Monetary re-boot
- 3 Fiscal – from support to stimulus
- 4 European unity
- 5 Climate change
- 6 Strategic competition

Economic recovery

From a purely macroeconomic point of view, 2020 will go down as one of the strangest years ever. The COVID-19 crisis has resulted in the largest declines in GDP outside of periods of war or the Great Depression, the biggest economic revival ever (Figure 6) and the most remarkable monetary and fiscal policy responses since the 1930s. As the year comes to an end, there is still considerable uncertainty about both the path of the virus and regarding prospects for economies around the world. Although many nations are currently experiencing worrying second waves of virus infections – which are again being countered by explicit and specific containment measures which will hurt growth – we believe that economic recovery will still be a key theme throughout 2021 and well beyond. There are upside and downside risks to the outlook, a number of which we discuss below, but it is highly likely that next year will see some of the strongest annual growth rates for GDP in the last forty or fifty years. Our central scenario (which we have labelled B) envisions that global GDP will grow by in excess of 6 per cent in 2021, which would be comfortably the highest in the post-war period (Figure 7). The only reason that such an outcome is not being explicitly described as a boom or even a bubble is that it comes after the most extraordinary swings in GDP everywhere. Even in our downside scenario, GDP is expected to grow by around 5 per cent next year. In the more upbeat scenario, it reaches 8 per cent.

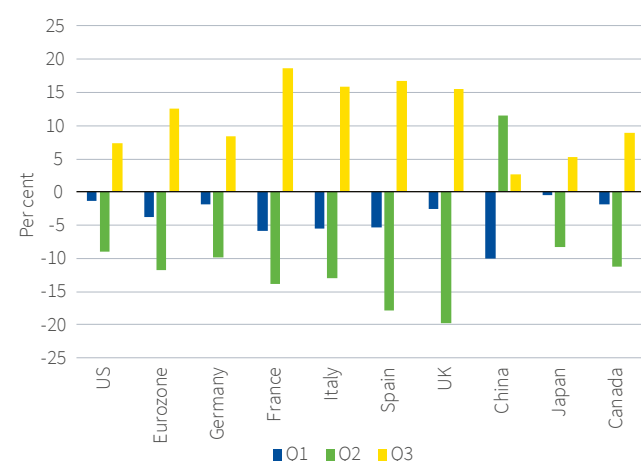
The exact form of the economic recovery that transpires will depend in substantial part on three things: the pattern of virus transmission and its impact in terms of case numbers, hospitalisation rates and mortality rate, the various policy reactions to those patterns and the manner and speed with which the assorted vaccines are disbursed. All can and will vary across different regions and countries, but it is highly likely that there will be much in common. Currently, many nations have been experiencing significant second waves of infection as it has become apparent that increased social interactions that followed earlier easings of restrictions on activities resulted in the infamous “R” number of the COVID-19 virus rising much

The global pandemic has led to some huge swings in GDP

Recovery in 2021 looks assured, but there will be bumps along the way

Figure 6. Wild swings in GDP growth in 2020

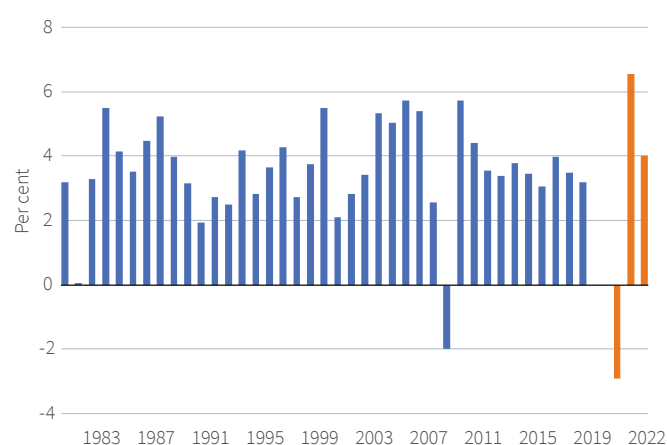
Quarterly GDP growth in 2020



Source: Aviva Investors, Macrobond as at 3 December 2020

Figure 7. Biggest fall, biggest rise in world GDP

Global GDP growth



Source: Aviva Investors, Macrobond as at 3 December 2020

more quickly than had been expected. The renewal of containment measures in October and November will cause further falls in GDP in Q4 of this year in many countries. But the impact is expected to be far less significant than in Q2 2020 because people and firms have learnt to adapt, the measures are more targeted and localised and many areas are much less affected – schools, universities, the construction sector and many manufacturing industries for example. GDP declines of perhaps 2 per cent to 4 per cent in Q4 are to be expected in affected countries.

The pattern thereafter is less obvious. The dynamics of the virus, containment measures and vaccines complicate the picture for 2021. It is already clear that renewed restrictions have worked – virus numbers have fallen again across Europe. But with the Christmas holiday period approaching, that could easily reverse again in December and January, obliging authorities to re-introduce such measures if indeed they had eased in the first place. It may be that countries choose instead to adopt a more cautious approach than in the spring and summer and maintain at least some restrictions throughout the winter months. The motivation to do this is enhanced by the knowledge that vaccine deployment programmes are imminent. As more of the population is vaccinated – especially key workers and the most vulnerable – then the COVID-19 dynamics switch again and worries about opening up economies reduce significantly. In practice, this will mean that the economic recovery – assured as it is in our view – could become more stretched out during 2021, rather than being concentrated in one single short period of time as it was in Q3 this year. Caution may mitigate against a “going for growth” attitude from Governments, but it is also important to remember that the earlier experience from lockdown did reveal a great deal of ingenuity from economic agents in terms of maintaining or returning to economic activities and also the practical reality of a sharper than expected rebound when conditions allow. The bottom line is that we expect robust growth everywhere during the course of 2021 (Figure 8). Economic recovery will be one of the dominant – and welcome – issues of the day.

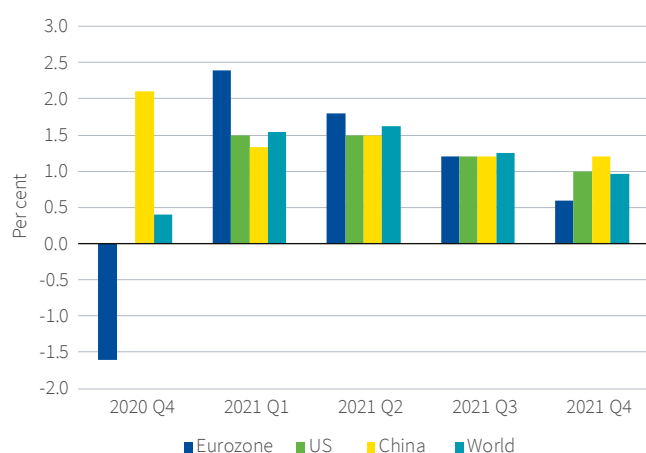
Renewed setbacks in Q4 and possibly early 2021, but growth should rebound thereafter

Monetary re-boot

Monetary policy has been through a number of different eras over the last century, often alternating between extended periods of calm and comparatively slow evolution and short periods of rapid change and sometimes blunt revolution. After the high-inflation 1970s and 1980s, many central banks were mandated to address the problem and their inflation-targeting aims and credentials were a key aspect of the period from the early 1990s to the mid-2000s that became known as the “Great Moderation” (Figure 9). Low, but positive inflation was generally achieved, on average, most of the time. Japan was a slight exception and provides an example, in the eyes of many, of what could happen if you let deflation take root. In the wake of the Global Financial Crisis, the same central banks became pivotal in providing a range of more unconventional monetary policy assistance, the most important of which was quantitative easing. These changes were not welcomed by all and were pronounced by some sceptics as sowing the seeds of future inflationary disasters and creating a drug-like

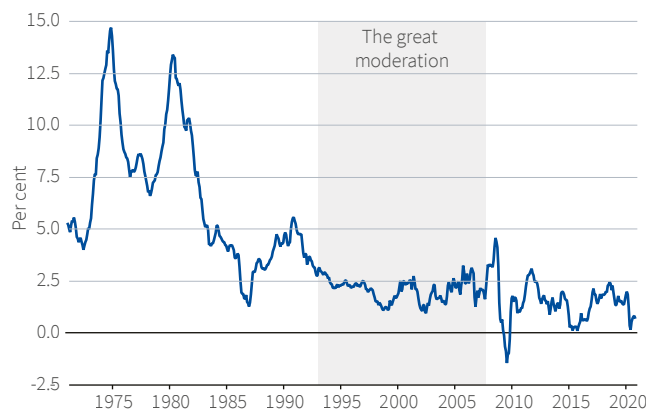
Low inflation has been more of a problem than high inflation, a contrast to earlier periods

Figure 8. After some Q4 setbacks, recovery should resume in 2021
Quarterly GDP growth projections



Source: Aviva Investors, Macrobond as at 3 December 2020

Figure 9. G7 CPI inflation is low but still positive
G7 countries: annual CPI inflation



Source: Aviva Investors, Macrobond as at 3 December 2020

dependency within some financial markets on continual monetary policy fixes. The latter accusation is still unproven, while the former has been largely discredited – at least so far.

We now seem to be entering another period of significant change for central banks and monetary policy in general. As we stated three months ago, they have been struggling with the challenge of seemingly ever-lower equilibrium or neutral real rates of interest for some years now (Figure 10). In addition to the specific requirements brought on by the two global crises since 2007 (three if you count the European sovereign debt crisis), many have argued that their over-zealous anti-inflation bias, alongside the trend lower in real rates, has led to them being constantly late in a game of policy catch-up, with rates never moving low enough to bring about the desired outcomes. Although the Fed in the US has not been the worst offender in terms of achieving a 2 per cent inflation target (Figure 11) – far from it in fact – it has been a pioneer in terms of introducing some new approaches to policy over the last year or so. Specifically, it has recently moved to an average inflation target (AIT) regime, whereby periods of below-target inflation can be explicitly followed by periods of above-target inflation.

In today's circumstances, this effectively means that, from the Fed's point of view, the US economy can be "run hot" in order to allow inflation to rise from present subdued rates (on average) so that the overall target is achieved on average rather than at every point in time. More generally, it has also invoked changes that mean it can be reactive rather than pre-emptive as far as inflation is concerned. Although it has moved more slowly, as is traditional, the ECB – which has been a serial inflation under-achiever – has hinted heavily that it will move in the same direction and will formally do so at the conclusion of its own strategic review next September. Other central banks around the world are likely to come under pressure to follow suit. The bottom line is that this monetary policy re-boot has the potential to change the inflation landscape for good. Of course, simply announcing a reformulation of inflation targets does not automatically make it more likely that you will achieve them. But it does add even further weight to the "lower for longer" thesis on monetary policy in what could in the end be a highly significant change in the ways that central banks around the world operate.

The "neutral" level of interest rates has fallen steadily

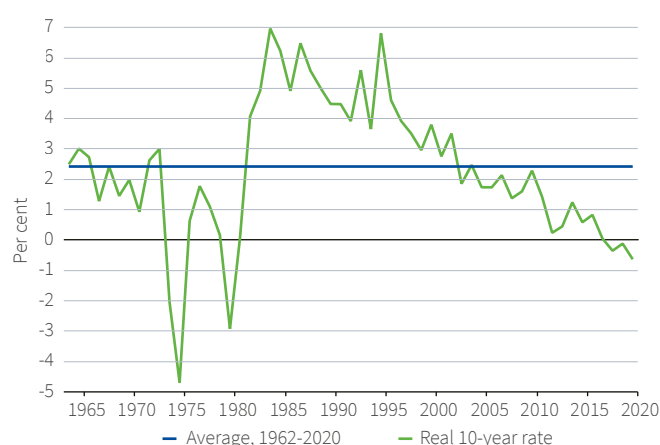
A new era for monetary policy beckons - led by the Fed in the US

Fiscal – from support to stimulus

Fiscal policy has come to the party in 2020. It had to. If it hadn't, it is certain that the economic impact of extended shutdowns of large swathes of economic activity during the year would have had far, far worse consequences. This is true whether we consider just the short-term direct impact of fiscal handouts or the longer-term protection that has been provided to many companies and individuals as governments attempt to nurture both so that they can return to normal activities when circumstances allow. The value of the latter course of action will only become apparent once economies re-open more fully and people can return to and resume their previous work. The principles are quite simple: shutdowns are necessary to stem

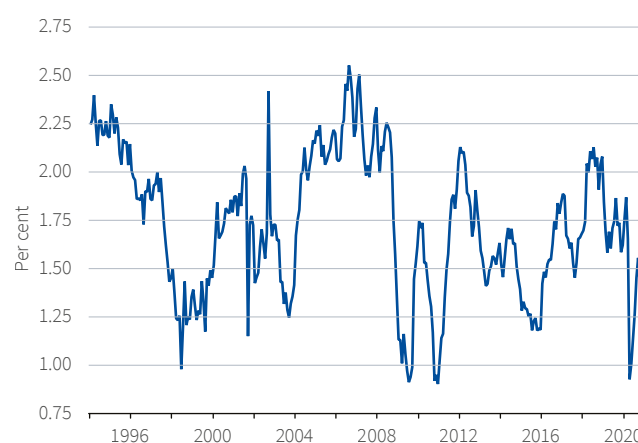
Loosening of fiscal policy in response to the crisis has been unprecedented and almost universal

Figure 10. Neutral real rate has been falling since the mid-80s
Crude estimate of 10-year real interest rate, G7



Source: Aviva Investors, Macrobond as at 3 December 2020

Figure 11. US core PCE inflation



Source: Aviva Investors, Macrobond as at 3 December 2020

the spread of the virus; organisations would quickly go bust and jobs would be lost forever if incomes that had previously been earned are not replaced; the government must step in to do just that, absorbing the risks that the private sector cannot until a time that they no longer require public sector financial life support. At the peak of the first wave of the crisis this year, over one quarter of the workforce in OECD countries was estimated to be participating in job retention schemes (Figure 12). In times of war, no questions are asked about the need for vast amounts of public sector spending, whatever the impact on budget deficits and public debt. Because of the COVID-19 crisis, the same should be true today. And by and large, it is. Deficits have soared higher (Figure 13) but there has been a general acceptance that this, and the resulting lurch higher in key public debt ratios, is the right thing to do. Indeed, that former bastion of fiscal rectitude, the IMF, has gone to great lengths to stress that one of the greatest risks to the global economy would be premature withdrawal of fiscal support.

Resurgent virus infections around large parts of the world imply that critical fiscal support, as described in the paragraph above, is going to be needed for some time yet. Renewed shutdowns mean that lost incomes will continue to need to be replaced if more adverse longer-term consequences (with many, many second-round effects) are to be avoided. There will be a time for a fiscal reckoning, but it is emphatically not now. Gradually, as first control over the virus is regained – we hope – and secondly as vaccine disbursement is rolled out more comprehensively, it will become appropriate for the blanket coverage of fiscal support to become more nuanced. At that stage it will be possible to modify fiscal programmes, adapting them to be more closely targeted. It will also be possible to monitor such expenses better. During the emergency phase of the pandemic, a “whatever it takes” approach was desirable – essential even. And since the virus is still with us, and is likely to be so for some time, it is right to defend and endorse that approach at those times. But the situation is evolving here too and as the recovery progresses, it will become more appropriate to shift from fiscal support to fiscal stimulus. A combination of both will be needed, but the balance is likely to change as the recovery progresses.

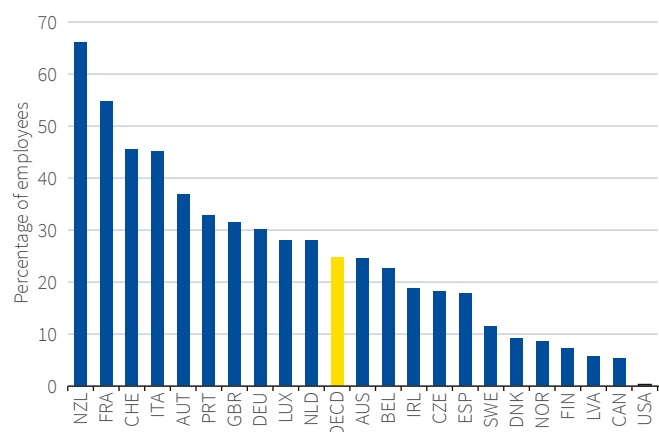
Both the IMF and the OECD have recently added their voices to the call for countries around the world to take advantage of the opportunity presented by the COVID-19 re-set to redefine the policy agenda for the future. There are several aspects to this, but they include climate change and green issues, a drive to reinvigorate world trade and multilateralism in the post-Trump era, the global digital and technology debate and public sector investment programmes more generally. On this last point, there is a powerful argument that governments around the world can help influence and underpin this recovery through public spending initiatives. Many are making the case that there can be no better time for governments to borrow long term, at exceptionally low rates, and to invest in public infrastructure projects that can support or boost potential growth in the future. These will include not simply traditional capital investment in transport and housing, but also in health

Fiscal support needed for some time yet, but there should be a shift towards stimulus

Premature withdrawal of fiscal support is acknowledged by many as a significant risk

Figure 12. Take-up of job retention schemes

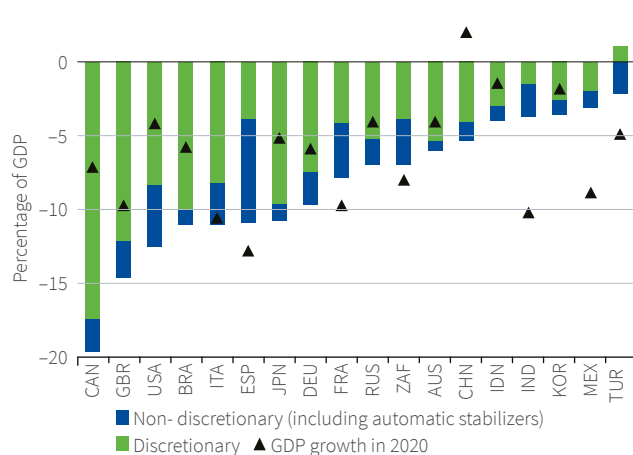
Participation in job retention schemes reached one-quarter of employees in OECD countries, and more than half in a few countries



Source: OECD

Figure 13. Fiscal deficits soared wider in 2020

Change in G20 deficits, 2020



Source: IMF, World Economic Outlook database; and IMF staff estimate,

care, education and digital and environmental infrastructure. In the post-COVID-19 world, it is difficult to argue against the idea that active fiscal policy has the potential to frame recovery and impact the future in a lasting and meaningful way.

European unity

The Eurozone has had a turbulent 20-year history and has not always made timely or coherent decisions. Shortly after the Global Financial Crisis (GFC), the Eurozone experienced its very own disaster in the form of the sovereign debt crisis. At the low point there was a genuine existential threat to the single currency project. It seemed inevitable that Greece would leave and most of the debate revolved around how many others would follow. In the end the Eurozone not only survived that crisis but used the despair which surrounded it as a catalyst for critical progress and change. The COVID-19 episode is now starting to look similar, bringing out at different times both the best and the worst of European politics. At the onset of the pandemic, it looked as if Italy – the epicentre of the first wave of the virus in Europe – might be left to deal with the consequences, effectively on its own. Some of the old familiar fracture lines centring on national responsibility and sovereignty seemed to be resurfacing. But as the indiscriminate nature of the virus became more apparent, member states swiftly regrouped and presented a coordinated and united front. As long as that solidarity can be maintained, improved unity among Eurozone member states can be one of the defining themes of the investment backdrop in coming years.

However, it would not be the Eurozone without some bumps along the way. The design and presentation of the Recovery and Resilience Fund in the summer was a key moment, if not quite the “Hamiltonian” one, as many had characterised it. Such a development would have been unthinkable ten years ago and illustrates the progress that has been made on the long journey to closer integration. The €750bn fund comprises both loans and grants (Figure 14) and although ostensibly temporary – its genesis was as an emergency facility which would allow financial assistance to get quickly to those most affected by the COVID-19 crisis – it contains within it ground-breaking elements such as common debt issuance and de facto large-scale transfers within the region. The latest spat with Poland and Hungary regarding commitments to “rule-of-law” standards risked delaying and diluting further progress, but a compromise seems to have been reached. Initiatives such as the Recovery Fund, which are pivotal to any meaningful transition towards greater fiscal and political integration, cannot afford to lose momentum. While there are clear dangers of further compromises and delays, we believe that the political will within Europe will eventually triumph.

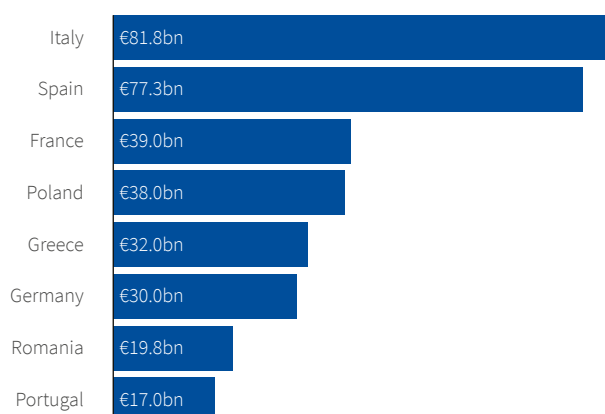
It is also worth noting that fears Brexit might result in growing tensions and disharmony among other EU members (those in the Eurozone in particular) have so far proved unfounded. Quite the opposite in fact: the battle with a common enemy has – like that with COVID-19 – seemed to bring them closer together. Helped by less capricious governments in Spain

The Eurozone has not always acted quickly or appropriately, especially in a crisis...

...but has shown more encouraging signs of unity during the pandemic

Brexit has provided a common enemy for Europe

Figure 14. Grants directed to those most impacted by the virus
EU stimulus for members' economies



Source: European Commission, 2020

Figure 15. The Euro has appreciated since the start of the pandemic
Eurozone exchange rates



Source: Aviva Investors, Macrobond as at 3 December 2020

and Italy in recent years, the big 4 within Europe have become a more cohesive unit seeing greater agreements than differences compared to the past. The Franco-German axis, in particular, has seemed stronger and more coordinated. Whatever the exact reality in the corridors of European political power and within households across the region, there have been discernible moves in the direction of closer European unity in recent years and financial markets have, by and large, reflected that. The currency has strengthened in 2020 (Figure 15), and peripheral bond spreads have narrowed significantly. The GFC might have exposed the folly of no spread at all, but if greater cohesion lasts as we expect it to (and that should prove easier in a coordinated economic upswing) then European unity should strengthen too.

Climate change

It has been five years since the global community met in Paris to agree a plan to reduce greenhouse gas emissions and limit the increase in global average temperature to well below 2 °C above pre-industrial levels; and to pursue efforts to limit the increase to 1.5 °C. That agreement left each country/bloc to determine the extent to which they could reduce their own emissions (Figure 16) and the policy actions needed to deliver that outcome. But it did require signatories to communicate nationally determined contributions (NDCs) – targets for 2030 – at five yearly intervals. The intention was to ratchet up ambition over time and align actions with long-term visions (mid-century and beyond). Those longer-term strategies have taken centre stage in recent months, with a flurry of new net-zero announcements. As we look forward to 2021, and the Glasgow COP26 meeting, parties will once again convene to review and accelerate actions towards the goals of the Paris Agreement and the UN Framework Convention on Climate Change. Ahead of that meeting, we expect many more countries to strengthen their NDCs.

Plans and actions to deliver those 2030 commitments will follow, e.g. building on the 2019 Green Deal agenda, the EU is seeking to pass a range of new regulations in the first half of 2021. These include a significant expansion of the current Emissions Trading Scheme (ETS) to include more industries, as well as limiting the cap to further increase the price of carbon. European proposals also include a border carbon tax adjustment to reduce the risk of “carbon leakage” should the rest of the world not move at the same pace as the EU in raising the price of carbon – in effect creating a global carbon price for countries that trade with the EU. There are also a range of green investment initiatives that have received increased funding through the EU budget and the COVID Recovery and Resilience Fund. These funds will be used to develop new, green, technologies and to help with the transition away from carbon-intensive energy production and consumption.

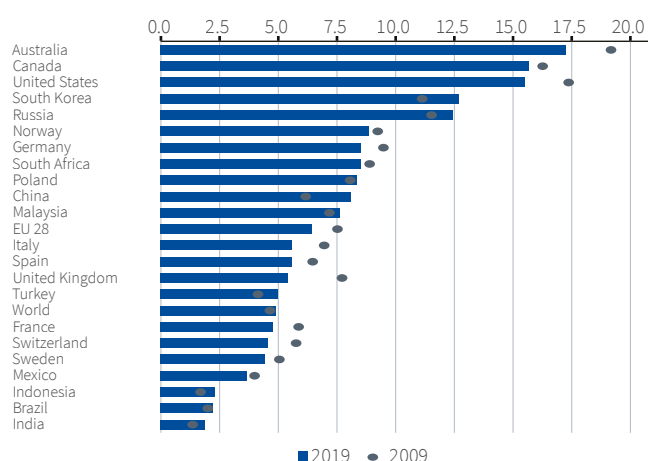
In the United States, the new Biden administration will bring the country back into the Paris Agreement and pursue a range of new initiatives to help deliver on that. Those are likely to include a range of new restrictions on emissions, but (assuming the Republicans hold on

Longer-term climate change goals are becoming increasingly important

Emissions Trading Scheme certain to be expanded

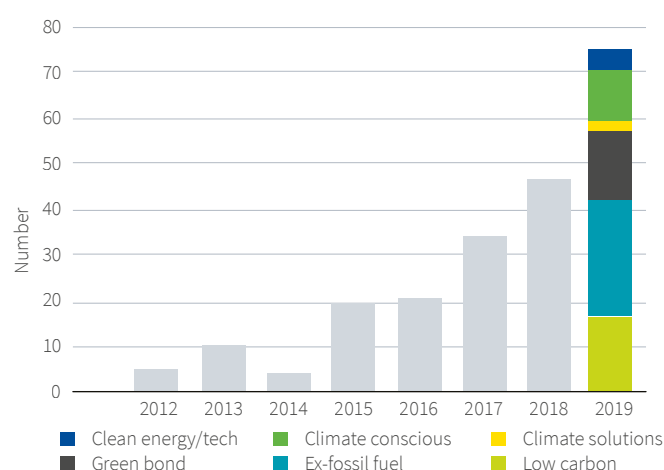
Figure 16. Per capita emission, fossil carbon dioxide (CO₂)

Metric tons of CO₂ equivalent



Source: Aviva Investors, Macrobond as at 3 December 2020

Figure 17. Number of launches of new ‘climate aware’ funds



Source: Morningstar as at 3 December 2020

to the Senate) are unlikely to extend to a national ETS or large subsidies for renewables. Meanwhile the UK government has also committed to a raft of policy measures to reduce carbon emissions, such as a commitment to improve building efficiency in homes and workplaces, a significant part of the country's annual carbon footprint. Key emerging market economies are also set to make important announcements. With the release of the next five-year plan in March, China will begin to set out how it intends to deliver its transformative pledge to reach net zero carbon emissions by 2060.

These policy measures, if introduced, are more wide-ranging and impactful than anything seen thus far. They will have profound implications for individual businesses, industries and countries. Those that are better placed to manage the transition impacts of these policies, through effective planning and deployment of capital, are likely to be relative beneficiaries. But there will clearly be some that will face a greater challenge than others, e.g., within the EU the annual per capita carbon emissions range from just 4.5 tons in Sweden to over 8.5 tons in Germany. Much of that difference reflects different sources of power generation (largely renewables vs significant coal and gas).

While at the company level, the Taskforce on Climate-related Financial Disclosures (TCFD) will require more transparency on the impact of corporate activities on, and by, climate change. Those who are best placed to manage the policy transition through their own footprint, as well as upstream and downstream activities, should be more attractive investment opportunities. Finally, the asset management industry is also undergoing regulatory and client-driven change, with increased focus on strategies and portfolios that are consistent with the targets in the Paris Agreement. We expect to see increased inflow into these strategies, which will also impact the price of the underlying building-blocks (Figure 17).

Strategic competition

There was a time before COVID-19 when financial markets worried about other things. Simmering hostility between China and the US as a result of the Trump trade war dominated sentiment for the two to three years preceding the pandemic (Figure 18). That long-running dispute had appeared to be coming to an end in the form of a Phase 1 trade deal, but the onset of the virus thwarted a clearer resolution. World trade flows have collapsed twice in the last 12 years, but have rebounded each time (Figure 19). With Trump now departing, rather reluctantly, hopes were expressed in some quarters that frozen international relationships can now thaw and be replaced by more constructive liaisons. However, it should not be assumed that a Biden White House will immediately be more conciliatory in its dealings with China. In many ways, the trade spat was really a symptom of broader trends between the two global superpowers and also of other geopolitical relationships beyond that main axis. It is not only

Some will face a greater challenge than others

The trade dispute may fade, but it is unlikely to be the end of hostility between China and the US, even with a Biden administration

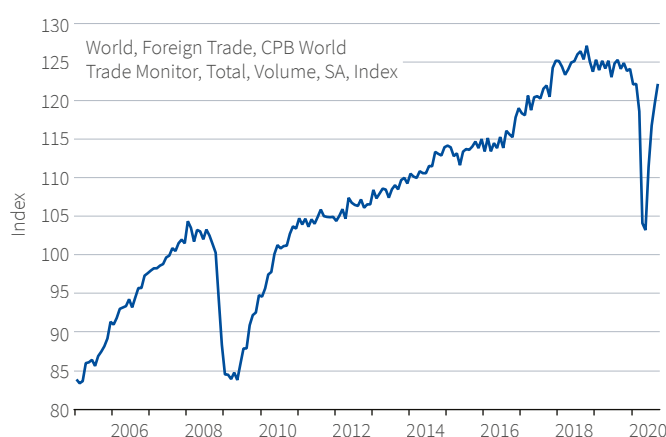
Figure 18. Bank of America Merrill Lynch Fund Manager survey

Table shows biggest tail risk in survey responses

March 2020 - present	COVID-19 pandemic
February 2020 - March 2020	US election result
March 2018 - January 2020	US-China trade war
July 2017 - February 2018	Quantitative tightening
May 2016 - June 2017	Political populism
August 2015 - April 2016	China "hard landing"
September 2014 - July 2015	Geopolitical crisis
July 2013 - August 2014	China "hard landing"
October 2012 - June 2013	US "fiscal cliff"
June 2011 - September 2012	Eurozone sovereign debt crisis

Source: Aviva Investors, Bank of America Merrill Lynch, as at 3 December 2020

Figure 19. CPB World Trade Monitor, Total, Volume, SA, Index



Source: Aviva Investors, Macrobond as at 3 December 2020

the US that is unsatisfied with the manner in which China is engaging with the rest of the world. But what is arguably more likely with the incoming Democratic administration is a return to more globally coordinated, multi-lateral approaches to international diplomacy.

Some of the more inward-looking opinions may have been hardened by the COVID-19 crisis, but it is hoped that as that moves into history and as recovery takes hold, attitudes will soften and become more constructive than confrontational. Even so, it seems inevitable that future years will still be characterised by strategic competition, largely related to China and the US, but also impacting many others. One key aspect is the race for technological global dominance. But really the heart of the matter relates to forced technology transfer, intellectual property theft and free market distortions. Beyond those specific issues lie others such as China's human rights violations, their influence in Hong Kong and Taiwan and the desire among other democracies that China complies more with international codes of practice that are broadly accepted everywhere else.

This is unlikely to be a smooth journey. As China's international influence has grown, it was always likely that they would challenge global standards and institutions and try to impose alternatives. Achieving technological self-sufficiency is one thing, but China has ambitions for much more and there is nothing wrong with that per se. However, if China is to succeed as an integrated global player, a balance will have to be found between their fundamentally different methods of operation and adherence to acceptable international codes of conduct in business and trade. Strategic competition between China, the US and others is likely to frame international relations and influence financial markets over the next decade or more.

Technology is likely to be a key area of potential conflict in the future

It is not just about China and the US

Risks

Balance sheet vulnerabilities

Generally speaking, financial crises and recessions – both in their origination and consequence – can be linked to balance sheet weaknesses in some part or parts of the economy. The COVID-19 experience has been a little different. Yes, some private sector balance sheets have weakened, but that has effectively been imposed on the sectors affected by measures put in place for sound medical reasons. The transfer of resource from public to private that has followed has relocated that “vulnerability” to the government sector and the legacy of it will be there for years – perhaps even decades – to come. In one very important sense, this is entirely appropriate – the public sector is far better equipped to cope with the consequences of the shock. History reveals many episodes of public debts spiralling higher (Figure 20), but most have corrected themselves or been corrected by subsequent actions. Granted, the processes by which that has happened have been many and varied.

The global pandemic has shown that, even with the extensive support of public funds, many corporate balance sheets around the world are bound to be more stretched after enforced shutdowns. There will inevitably be a delicate balancing act as funding schemes are withdrawn, which could expose the vulnerabilities of some. The fundamental health of public finances has taken a severe hit from the measures taken and those countries where there were already fiscal vulnerabilities, could be pushed closer to the edge (see below). Finally, several EM nations are seeing the now gruesomely familiar virus trends, but many will not have the financial resource or the political resolve to take steps that other, wealthier nations have been able to take. There is a risk that the COVID-19 experience reveals balance sheet weaknesses in specific countries that had until now remained hidden.

Digital regulation/taxation

Taxing and regulating international businesses have always been areas of extreme complexity and dispute. Increased globalisation in the post-war period has contributed to capital becoming exceptionally mobile internationally, able to respond quickly to differences in incentive structures around the world, especially in the areas of tax and regulation. Increasing digitalisation of large parts of our economies is now focusing the debate on these sectors and could have important ramifications in many areas. Change is happening fast, and policymakers are struggling to keep up. There is a danger of arbitrary, hurried or piecemeal approaches that could disrupt affected industries significantly. It is difficult to generalise as these areas are often characterised not only by abstruse levels of complexity, but also by sometimes abstract concepts and elusive definitions of activities or processes. Designing appropriate and workable solutions to tax and regulation is therefore not an easy task. Moreover, there is a risk that policymakers move away from sound principles on both because of a political expediency. What does seem clear is that organisations with a significant digital

Governments are better placed to cope with higher debt levels

Some EM nations may be less able to adopt fiscal flexibility

The digital revolution is throwing up complex problems regarding taxation and regulation

Figure 20. We've been here before – in some places

Historical patterns of general government debt



Source: IMF, Historical Public Debt Database; IMF, World Economic Outlook database; Maddison Database Project; and IMF staff calculations.

Figure 21. Monetary growth has picked up everywhere



Source: Aviva Investors, Macrobond as at 3 December 2020

or on-line presence will face heightened scrutiny and greater intervention from competition authorities. They will also be under growing pressure to comply with increasingly detailed consumer protection laws. Finally, there is the issue of national versus international initiatives. The OECD is attempting to coordinate an international approach, but has been hampered by not knowing the US stance until the new administration takes office. It is hoped that 2021 will see some meaningful and constructive progress. But there are many doubts. Is a global digital tax even possible – or could it be abandoned in the name of international competition? And could others follow France? Last year they imposed a 3 per cent levy applied on the revenues earned by international tech giants in France, but postponed collection while OECD negotiations took place. The lack of visible progress has led them to demand payments from this month.

Inflation

As we have already mentioned, in the wake of the GFC there were fears that inflation might make an alarming comeback. These worries, which proved unfounded then, betrayed a fundamental lack of understanding about the monetary transmission mechanism, failing to recognise that the additional money creation which resulted from QE programmes around the world was essentially replacing the usual means by which it was generated. The global banking system was, if not broken, severely compromised and the standard practice of credit creation was simply not happening. Today, although inflation is very low in most places, there are better theoretical grounds for believing that it could return over the longer term (Figure 21). There is still considerable debate on how monetary economics works in practice, but at the simplest level, a credible argument can be made that, when there is spare capacity, as there is today (and as there was in the wake of the GFC), stronger monetary growth impacts quantity variables more than price ones. Thus, in those circumstances, it helps contribute to stronger growth and the elimination of negative output gaps rather than results automatically in higher inflation. This is the aim of monetary stimulus today and with pre-COVID-19 levels of activity not expected to be regained until late 2021 or 2022, any inflationary impulse should be minimal until then. But beyond that, with monetary conditions so loose and central banks adopting a more relaxed approach to inflation, it is not unreasonable to imagine that inflation pressures might start to emerge. And if financial markets start to believe that is a plausible possibility, they may worry about it a bit more.

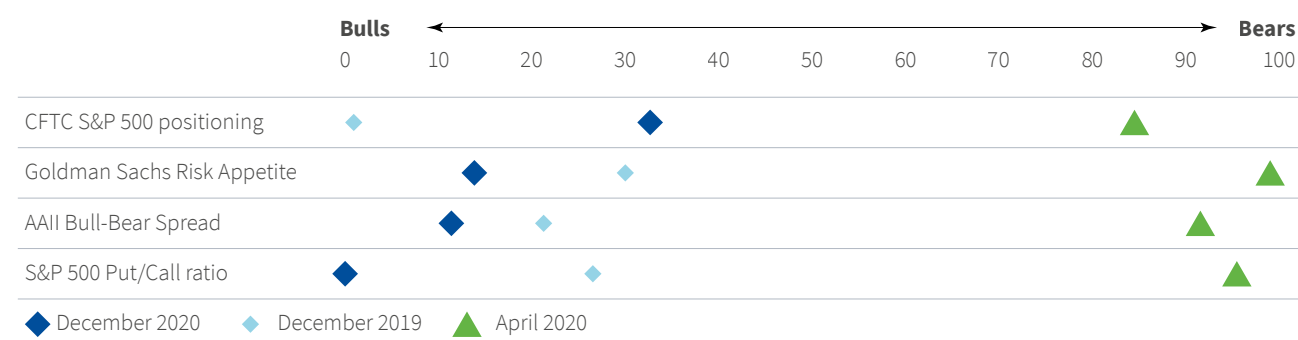
Low inflation is likely for some time; but longer term, it might yet make some sort of return

Pricing for perfection

We are optimistic about the ability of the global economy to recover from the COVID pandemic in 2021. Policy makers have been responsive to the crisis, supporting households and businesses. Those same households and businesses have shown themselves to be resilient to the circumstances and willing to adapt. While the news of a highly effective set of vaccines being ready for distribution in early 2021 suggests that uncertainty about the future should subside. Our central scenario for growth is above consensus across the major economies. However, we are conscious that the expectation for a rapid recovery in global growth in 2021 is almost unanimous amongst market participants. Similarly, expectations that a favourable

Is there a danger of another bout of “irrational exuberance”?

Figure 22. A number of metrics are pointing to a risk of setbacks



Source: Aviva Investors, Bloomberg, Macrobond as at 3 December 2020.

Table indicates when positioning becomes extreme >90% (extreme bearish positioning) or <10% (extreme bullish positioning)

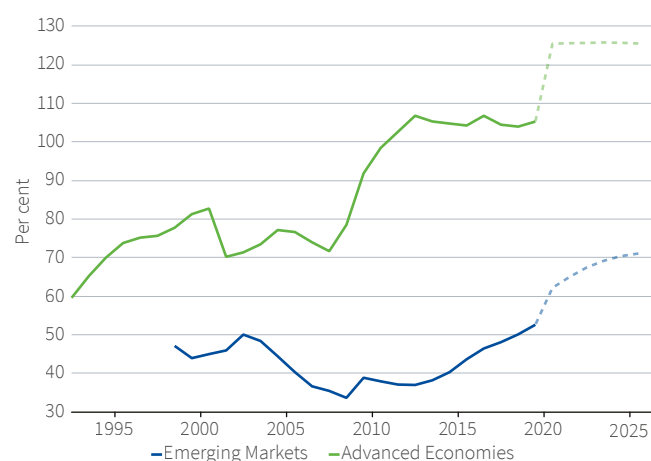
growth backdrop will support risk assets, including a rotation to cyclical and value stocks, as well as commodities, high yield credit, emerging market currencies and other cyclical asset prices are widely held. These expectations may have already been well discounted in some assets. In particular, the sharp move up in some risk assets in November 2020 suggests that the news on vaccine trials led to a rapid covering of short or underweight positions. There was also perhaps an element of fear of missing out in the pricing out of the pandemic downside risks. As such, some parts of the market may now be “priced for perfection”, when that outcome is rarely what eventuates, e.g., some parts of the equity growth sector, such as technology, look to be particularly expensive (Figure 22). But more generally, we observe that in recent years periods of market exuberance have often been followed by an extreme, but short-lived spike in volatility stemming from market corrections. The trigger for such corrections has been highly unpredictable.

Fiscal sustainability

The unprecedented assistance that was provided in response to the COVID-19 crisis was absolutely essential. And as experts everywhere are falling over themselves to emphasise, one of the most significant risks today would be the premature withdrawal of that support. But the measures taken are not without fiscal consequence, and that is something that has to be acknowledged and recognised. Budget deficits are expected to rise to 10 per cent, 15 per cent or even 20 per cent of GDP this year and although they are expected to narrow in coming years, the improvements pencilled in are relatively modest by historical standards and largely attributable to the anticipated strong growth in GDP rather than explicit fiscal tightening. Public debt in most countries will rise by up to 20 percentage points of GDP, perhaps even more (Figure 23). Ordinarily, the fiscal loosening implied by these headline numbers would have been met by clarion calls for austerity by the political right (although they wouldn't use that word these days). There is a reluctant acceptance that largesse has been vital. However, today's exceptional circumstances do not change the realities of fiscal sustainability over the longer run. And here not all countries are equal. Debt and deficit dynamics are reasonably well understood, with sustainability depending on the relationships between key numbers including the initial debt ratio, primary balance, the average rate of interest paid, the rate of GDP growth and the rate of inflation. Some countries are more vulnerable than others on the basis of these metrics (Figure 24). The recovery will help growth numbers and hopefully at least prevent inflation falling further, while re-opening of economies should mechanically lead to big declines in some items of public spending (furlough, support grants, etc.). Keeping borrowing rates low will be crucial and it is plausible that some nations – in both emerging and developed markets – could struggle. Recovery should allow governments to consider any required fiscal adjustments, but another danger, as before, is that some become over-enthusiastic about tightening and introduce fiscal cliffs.

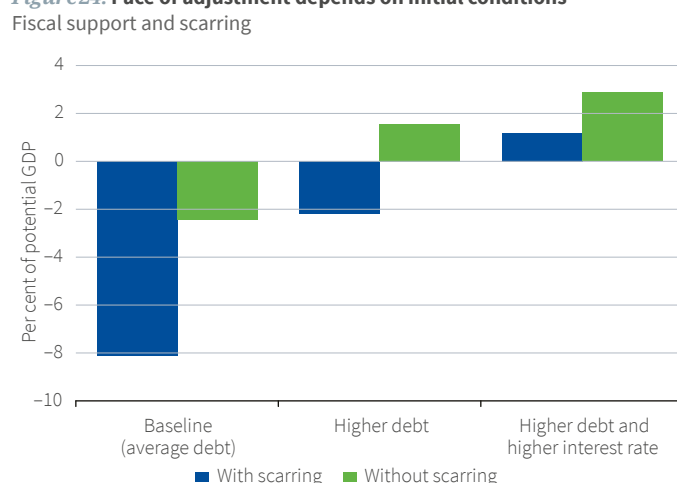
The legacy of the COVID-19 pandemic will impact public finance metrics for years to come

Figure 23. Gross debt, IMF fiscal monitor, estimate, per cent of GDP



Source: Aviva Investors, Macrobond as at 3 December 2020

Figure 24. Pace of adjustment depends on initial conditions



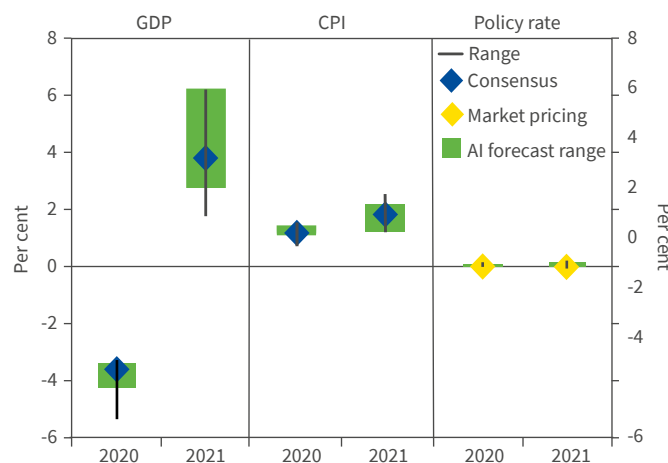
Source: Fournier 2019; and IMF staff estimates

Macro forecasts charts and commentary

US

The US economy bounced back more rapidly than expected following the period of COVID lockdown in 2020 H1. The level of activity was only around 3 per cent lower in Q3 than pre-COVID. Massive fiscal and monetary support provided the bridge that households and businesses needed to get through the worst of the economic crisis. With the roll-out of a highly effective vaccine to start in late 2020, the prospects for growth in 2021 are strong. Households have a savings buffer that they can potentially recycle back into the economy, and businesses need to re-stock depleted inventories. Pent-up demand for services should also drive consumption growth higher. That said, more fiscal support will be needed to bridge through the economic restrictions that will likely still be in place in early 2021. Meanwhile, monetary policy is set to remain highly accommodative for several years, with little near-term pressure on inflation.

Figure 25. US

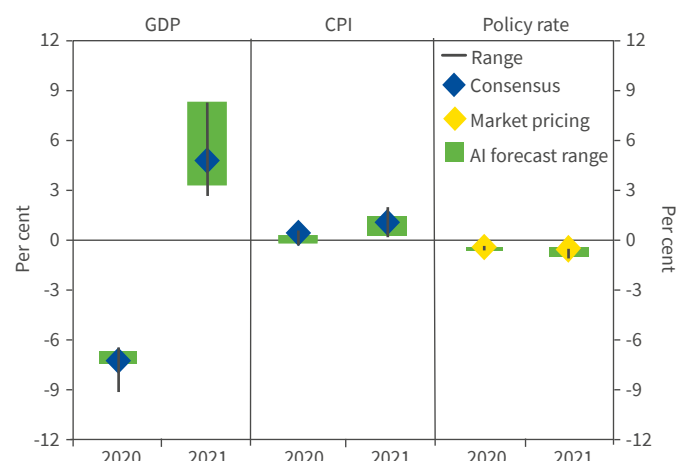


Source: Aviva Investors, Macrobond as at 3 December 2020

Eurozone

The immediate growth outlook for Europe is dominated by the second wave of virus infections and policy responses to those. After the strong rebound in activity over the summer, growth had already slowed before COVID trends compelled governments to reimpose restrictions. The latest measures are more targeted, and companies and households have become more adept at working round them (while still complying). The virus itself is also less of a shock than it was in the early part of the year and the eventual endgame is clearer. The bottom line is that the hit on growth in Q4 should be far less than in the spring, but it will still be negative. Thereafter, gradual re-opening will allow activities to resume although the earlier experience may make governments more cautious about the pace of easing (of containment measures), especially with effective vaccines on the horizon. Recovery during 2021 looks reasonably assured, but it may stretch out throughout the year. Ongoing policy support – fiscal and monetary – will therefore be needed for a while yet and looks set to be provided.

Figure 26. Eurozone

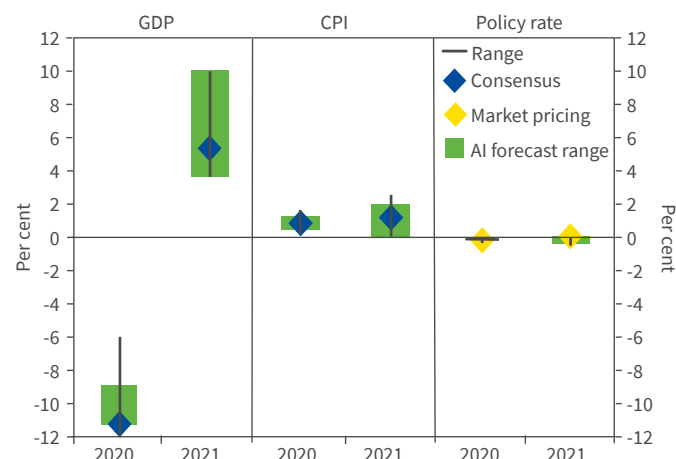


Source: Aviva Investors, Macrobond as at 3 December 2020

UK

The UK reacted slightly later than others to the onset of COVID-19 and as a result had to impose fiercer lockdown measures and keep them in place for longer. This experience highlights the importance of early and robust actions to control the virus, a lesson that should influence responses to any subsequent waves. The decline in UK GDP (in Q2) was therefore one of the largest among developed economies, although the peculiarities of national income accounting also explain some of the difference. As elsewhere, the strong rebound since May has now slowed and could reverse temporarily in Q4. Vaccine deployment has begun early, and while that will help in the long run, the shorter-term outlook is less good. The UK fiscal response has contrasted somewhat with that elsewhere: often late, minimal and provisional rather than open-ended. The winter months and early part of next year in particular are likely to see laboured growth, compounded by the idiosyncratic damage created by Brexit, whatever its exact form, although there are some upside risks thereafter. Additional policy support may be merited in early 2021.

Figure 27. UK



Source: Aviva Investors, Macrobond as at 3 December 2020

China

Successful containment of the coronavirus combined with aggressive fiscal and monetary support has boosted China's H2 GDP so that it is nearly back to its previous trend; sequential annualized growth of 5.5 per cent in 2021 is expected to lift annual GDP to 9 per cent above 2020's depressed level. Soaring exports and portfolio inflows mean the CNH should be kept under pressure to appreciate. CPI inflation should stay relatively low, at around 1 or 2 per cent.. We expect the policy mix to remain accommodative, but shift towards a more neutral stance. Authorities will look to rein in extremely fast credit growth with local government financing vehicle (LGFV) issuance used to fund infrastructure investment; worries about repayment continue to escalate. The Communist Party leadership will aim to decouple China from its technological and energy dependencies, as determined in the 5th Plenum. Achieving a peak in carbon emissions by 2030 is ambitious, and committing to net zero in 2060 means the coal plants being built today will need to be counteracted with large investments in low-carbon technology.

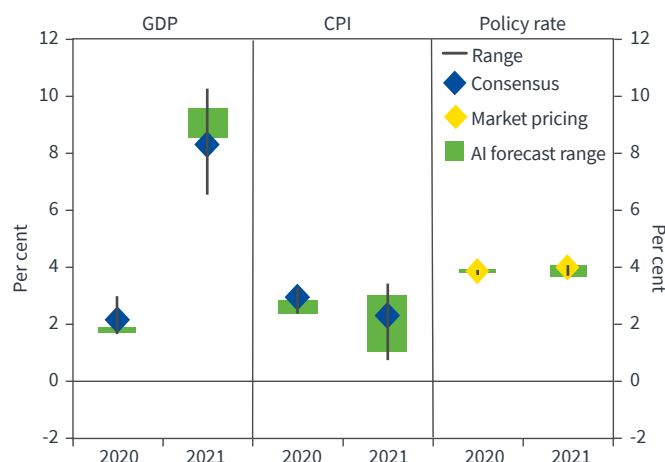
Japan

Japan's Covid recession was severe despite limited numbers of cases. The Q2 contraction of -7.9 per cent was a recession within a recession: the third consecutive negative reading, after the consumption tax hike set off a contraction in Q4-2019. The rebound in H2-2020 is unsurprising, but even with a supplementary budget recently announced by PM Suga, recovery will be incomplete. Output will end 2020 around 3 per cent below last year, and growth of 2 per cent means GDP will achieve pre-COVID levels in mid-2022 (an upgrade from our expectations before vaccine announcements). The BoJ is unlikely to do much besides monetize the fiscal deficit that has supported the recovery. With CPI around zero and inflation likely to stay anemic, real rates are too high and the Yen is under appreciation pressure – also thanks to strong exports and income. “Suganomics” is likely to be focused on administrative reform and regulatory improvements, as well as unlocking potential growth from digitization, in which Japan lags many G10 countries; reforming small banks and price caps on telcos could be damaging to those special interests.

Canada

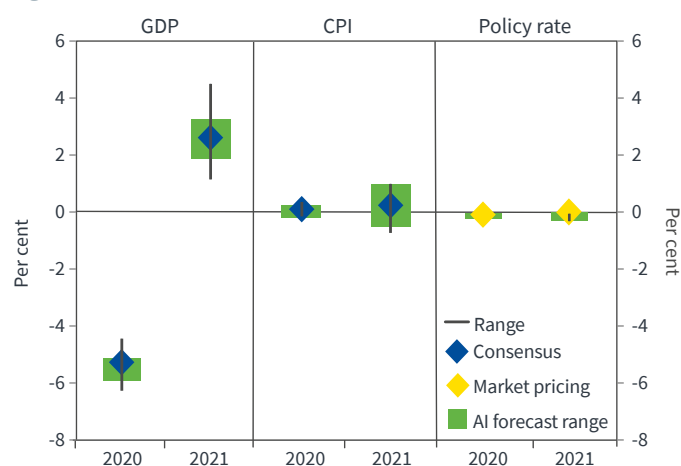
Canada has had the same GDP experience as many others during the COVID pandemic: steep declines in Q2, rebound in Q3 and slowing growth in recent months as case numbers rise again and restrictions are re-imposed. Virus trends in Canada are worrying and point to the need for further – or continued – containment measures in coming months which will impede growth further. The government has stepped in to provide critical income support and stands ready to continue to do so, while the Bank of Canada has increased its QE programme and issued clear guidance that policy will stay loose for longer, and could, if conditions warranted, be loosened further. Inflation is not really a significant policy concern at present but remains contained in any case. Any recovery in global trade flows will benefit open economies such as Canada, as will any bid to the oil price which has recovered to pre-COVID levels and should be supported by stronger global growth and the loose policy backdrop.

Figure 28. China



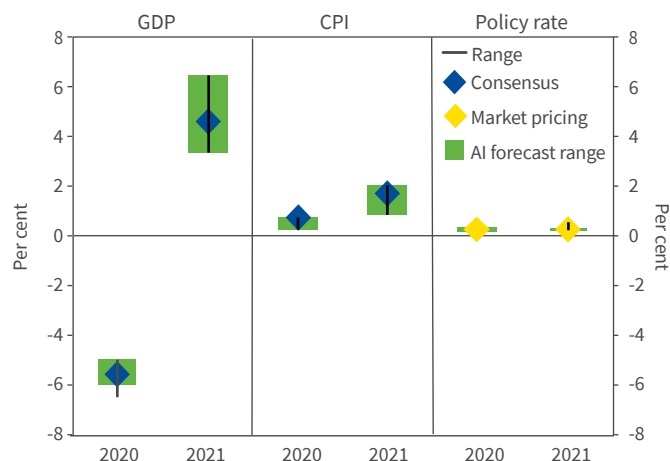
Source: Aviva Investors, Macrobond as at 3 December 2020

Figure 29. Japan



Source: Aviva Investors, Macrobond as at 3 December 2020

Figure 30. Canada



Source: Aviva Investors, Macrobond as at 3 December 2020

Global market outlook and asset allocation

- Raising our allocation to equities as uncertainty subsides and the outlook for earnings growth is positive
- Long-dated yields have limited scope to rise
- USD weakness theme is here to stay

In contrast to how the year began, its final innings has brought about a major reduction in economic and political uncertainty. The removal of two risk events, namely the potential for a seriously contested US presidential election and the possibility of COVID-19 vaccines with efficacy, provided substantial support for risk assets and has led us to upgrade our allocation to equities.

The discovery of a number of vaccines that are effective and safe brings into view the eventual end of the pandemic's most serious impact on economic life. So even though the path towards that outcome may be interrupted by renewed restrictions on mobility and economic activity, the market's tendency to "look through" near-term disruption when the longer – term outcome is more certain should prevail, in our view. We are therefore approaching any setbacks in risk assets as potential buying opportunities and accordingly leave sufficient risk budget to be able to act, should such opportunities arise.

The exit from the ongoing crisis, and with it the potential for profit growth, had always been expected to be swifter and more powerful than after previous recessions. However, upgrades to economic growth based on better than expected vaccine efficacy and distribution should lend further support to the earnings recovery. So should the cost cutting undertaken during the early stages of the crisis, since every unit of revenues earned is – at least initially – being met with a lower cost base. In equity jargon, such sensitivity of earnings to sales is labelled operational leverage. Operational leverage tends to be underestimated during recoveries, creating the potential for continued upside surprises in the quarters ahead.

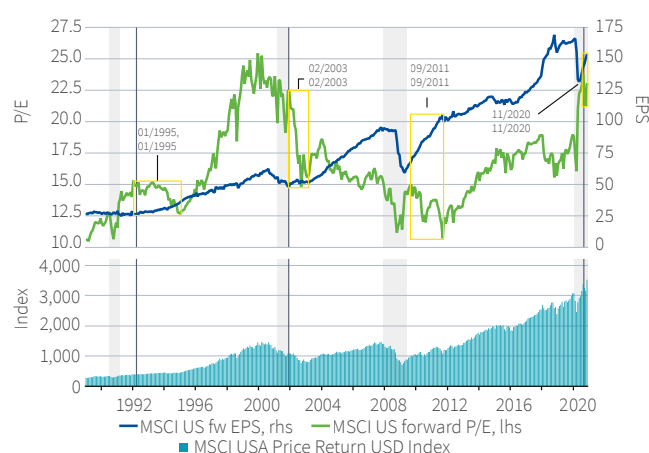
Studying the anatomy of post-recession interplays between multiples and earnings reveals that earnings tend to take over from P/Es in driving equity returns shortly after the end of a recession (Figure 31). Whilst this mechanically takes down the multiple, rising earnings are typically associated with rising prices (Figure 32), limiting the drop in P/Es. Should there be reason to upgrade earnings multiples, P/Es typically respond positively to such developments. We have already started to see this handover from multiples to earnings beginning sooner than it typically does. In fact, earnings started to rise and P/Es to stabilize during, as opposed to after, the recession. However, the nature of today's recession is also different in that it was caused by restrictions on businesses operating, and can hence be exited without as big a

The removal of uncertainty bodes well for risk assets

Subsiding risks are met with an economic and earnings recovery ahead

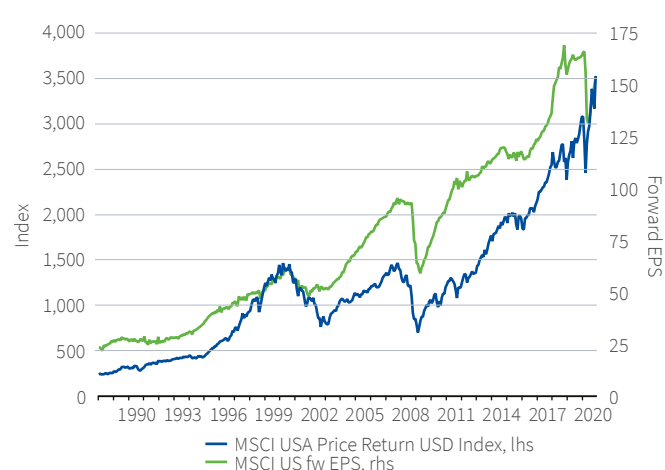
Earnings take over from valuation expansion

Figure 31. Handover from valuation to earnings expansion



Source: Aviva Investors, Macrobond as at 3 December 2020

Figure 32. Earnings and prices are well correlated



Source: Aviva Investors, Bloomberg, Macrobond as at 3 December 2020

hangover of indebtedness, bankruptcies, and credit tightening. Finally, the depth of earnings decline during the crisis should lead the way to a much greater and swifter return to earnings growth than historically observed. As Figure 33 shows, today's forward earnings, indexed to 100 at an ISM manufacturing trough during recessions, have rebounded more strongly than after past inflection points.

The current environment of easing uncertainty and very strong expected earnings growth is complemented by a symbiotic relationship between exceptionally easy monetary and fiscal policy. What's more, policy makers have indicated that easy policies will stay in place long into the future. For monetary policy to keep company refinancing costs low well into the recovery and for fiscal policy to move from support to outright stimulus (in a situation where a strong bounce back from COVID-induced lockdowns is anyhow expected) is a powerful alignment of drivers for risky assets. Explicitly, such policy support lends sustenance to top-line growth as well as margins; implicitly, it also supports sentiment as investors won't need to factor in an eventual return to tighter policies for an extended period of time.

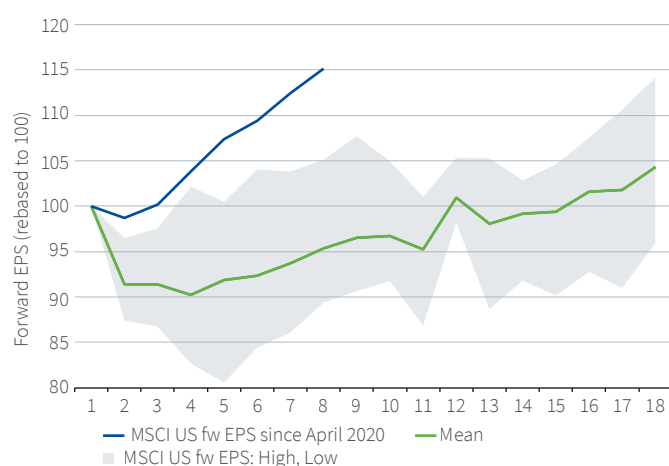
Taking stock at the end of the year, sovereign bonds exercised their defensive role well. By the end of November, the 10-year US benchmark bond index had recorded a 13 per cent gain year-to-date; a generic US all maturities Treasury index had returned 8 per cent. But even the deepest and most liquid market in the world, the US Treasury market, has experienced severe dislocations this year, only resolved when the Fed stepped in to restore market functioning. Short-end yields are anchored by the renewed commitment of central banks to keep rates at zero (or negative) for at least three years (as explicitly stated in the latest RBA statement or suggested by the Fed dot projections). But, what's the likelihood for long yields to compress further? We think the chances are fairly low, excluding a double-dip recession and/or a renewed wave of risk-off sentiment triggered by COVID-19 dynamics in early 2021. A cyclical recovery and strong policy accommodation in order to counter subdued inflationary pressures suggest we will see moderately higher yields and moderately steeper curves (Figure 34) and therefore are modestly underweight.

Importantly though, we don't see 2021 as the start of a structural bear market for fixed income just yet. Two opposite forces are at work: on the one hand there are the Federal Reserve's efforts to stimulate demand and stir inflationary pressures. On the other hand, there are nominal yields, which are capped by asset purchase programmes that aim to guarantee accommodative financial conditions. Taken together, as inflation normalizes – not least due to more supportive base effects in the first half of the year – we might see a continuation of the behaviour in rates we have experienced since the summer, where break-even inflation rises whilst real yields remain fairly low (Figure 35).

Monetary and fiscal policies to remain supportive of risk assets

An improved economic outlook limits the potential for long-dated yields to drop further, while the short end is anchored by central banks

Figure 33. Forward earnings typically rise sharply coming out of a recession



Source: Aviva Investors, Macrobond as at 3 December 2020

Figure 34. Yields curves should continue to steepen somewhat
US yield curve slopes



Source: Aviva Investors, Macrobond as at 3 December 2020

Our expectation of a limited rise in core yields means that a large share of Eurozone bonds should continue to trade at negative yield. At the end of November, this holds true for approximately 40 per cent of Eurozone sovereign bonds. In an environment of historically low yields, the hunt for yield and carry strategies is likely to remain in vogue in 2021. A technical argument reinforces our expectation, namely the fact that net bond issuances after ECB purchases are negative for Euro sovereign bonds in 2021. Needless to say, the expected return from these strategies is becoming thinner and they will also embed more risk. We expect positive returns from exposure to peripheral countries and from modest spread compression in the corporate bond space, where default rates should rise, albeit only modestly. Credit spreads are inching closer to pre-pandemic levels but could tighten a little further in the high-yield universe, driven by direct central banks' backstop, and a supportive supply/demand backdrop. That said, we favour only a modest overweight given the risk/reward trade-off for the asset class.

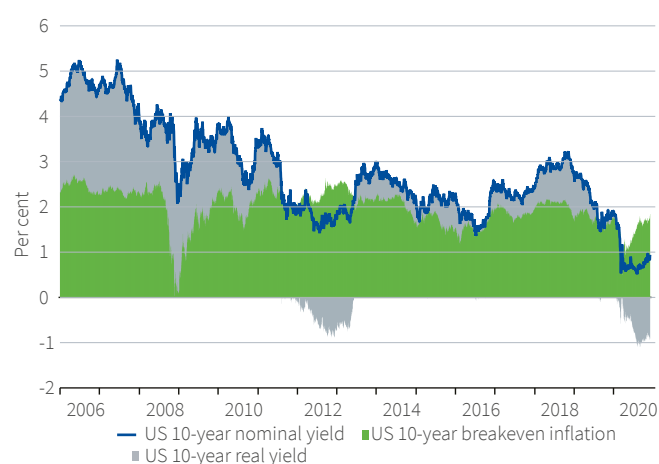
In our view, the dollar depreciation seen in 2020 – the dollar is over 10 per cent weaker against a basket of trade partners since the March highs – should be only the beginning of a prolonged lower dollar period. Several factors support this view: i) an improved risk picture, ii) solid global growth momentum in 2021, iii) very loose US monetary policy as inflation undershoots target levels, iv) ballooning deficit imbalances and valuations that point to the dollar being expensive against both developed and emerging market currencies. In the developed market space, the euro is also expected to benefit from structurally improved fundamentals and lower political risk premia (as a result of the Recovery Fund approval). In the near term, already elevated long positioning could be a headwind (Figure 36), and COVID-19 developments will matter as well, while real rate differentials still favour euro appreciation. The yen remains undervalued after decades of deflation and here too, skewed real yield differentials are still in favour of some further appreciation. As such, we prefer to be long euro and yen against dollars. The proportion of G10 FX moves explained by the USD stands currently at 75 per cent, while in the emerging market space it is only at 63 per cent, with a much lower average in 2020. The lower dominance of USD across the FX emerging space opens the door to more idiosyncratic opportunities, with decreased trade and tariff tensions also helping Asian currencies to appreciate, and commodities helping exporters' terms of trade.

Hunt for yield and carry strategies are still in vogue

Dollar weakening, euro in better shape

Figure 35. Rising break-evens meet subdued real yields

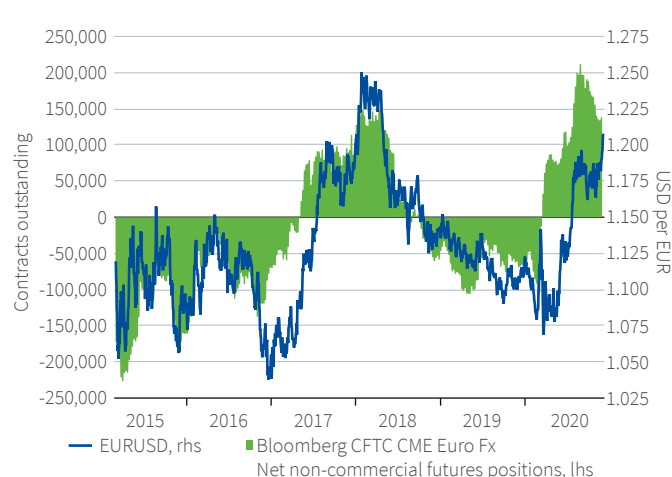
US 10-year nominal and real yields



Source: Aviva Investors, Macrobond as at 3 December 2020

Figure 36. The market is positioned for euro appreciation

EURUSD & CFTC positioning, post QE



Source: Aviva Investors, Macrobond as at 3 December 2020

Figure 37. Asset allocation

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

ESG insight: biodiversity loss

Nature is the foundation upon which our economies depend. Globally, we extract \$125 trillion in benefits from nature every year, but experts warn it is being destroyed at rates that will have significant repercussions for industries, countries and their populations¹. While acknowledged, these corporate and sovereign risks go largely unmeasured and unmanaged. That could change in 2021 as governments take steps to put a price on nature.

Rapid decline of natural resources

Biodiversity is defined as “the variability among living organisms from all sources including terrestrial, marine and other aquatic ecosystems and the ecological complexes of which they are a part”². Put simply, the nature around us. It is declining at a rapid rate; on average there was a 68 per cent decrease in species populations between 1970 and 2017 – for freshwater species, it was 84 per cent (Figure 38)³. The pace is so high that it has been called the 6th great extinction (Figure 39) as extinction rates are 100-1,000 of the normal background rates. The last was when the dinosaurs died out. The trend began at the same time as the industrial revolution⁴, driven by changes in land use, direct exploitation, pollution, invasive alien species and climate change – all factors linked to growing population, urbanisation and economic expansion.

Our dependency on nature is existential. It has been described through the concept of ‘planetary boundaries’ which examines nine system processes on which our societies depend (see Figure 40). If we exceed these boundaries, we won’t be able to sustain life. Two boundaries have been crossed, while others are in imminent danger⁵.

Physical risk from loss of nature

If biodiversity falls off a cliff, societies will suffer. There is a risk that what we get from nature today – ecosystem services – won’t be here tomorrow (Figure 41). Of the 18 categories of ‘ecosystem services’, 14 have shown a declining trend over the past 50 years, leaving our economies with fewer resources to draw on⁶. The value of these services has been estimated at \$125-140tn per year⁷ by the Intergovernmental Science-Policy Platform on Biodiversity and Ecosystem Services (IPBES)⁸. Its framework considers a broader category of value called Nature’s Contribution to People and estimates for example that the Great Barrier Reef contributes US\$ 5.7 billion annually to the Australian economy and supports 69,000 jobs.

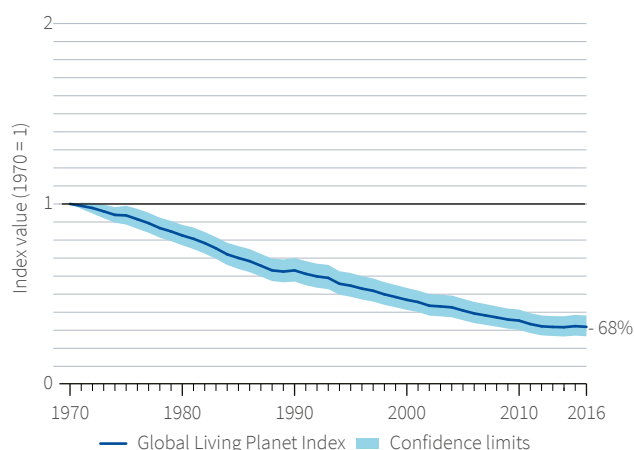
Biodiversity loss will also directly impact economies. Estimates of the direct economic value find that half (55 per cent) of global GDP, equal to \$41.7 trillion, is dependent on high-functioning biodiversity and ecosystem services⁹. The impact of biodiversity decline falls more immediately on sectors directly linked to natural resources. For example, due to

Average species numbers have dropped by 68 per cent since 1970

Nature provides us with an estimated \$135-140 trillion worth of ecosystem services per year - for free

Figure 38. Global Living Planet index, loss of species.

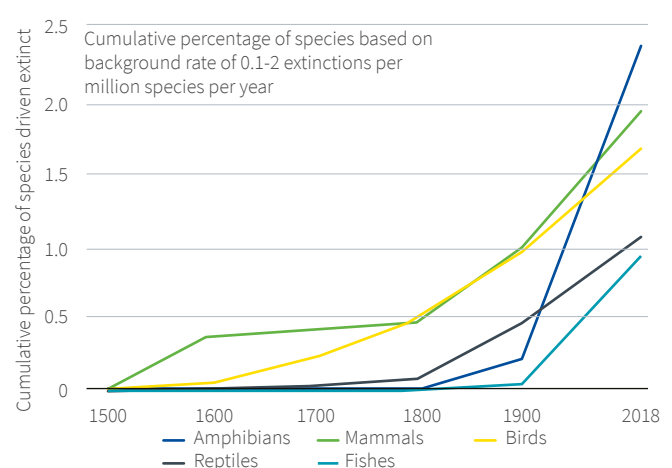
Range: -73% to -62%.



Source: Aviva Investors, WWF (2020) Living Planet Report

Figure 39. The 6th Great Extinction

Extinctions since 1500



Source: WWF (2020) Living Planet Report

decline of pollinators on which around 75 per cent of the world's food crops depend, sectors that stand to be adversely impacted are agricultural commodities, food producers and the pharmaceutical sector, whilst there are opportunities for new technology such as commercial pollination. In the US, farmers already paid c.\$320 million annually for commercial pollination services in 2017 due to decreasing natural pollination. There are also substantial indirect impacts. Global medical research is at risk with almost 50 per cent of prescription drugs based on plants. Multiple sectors rely on sustainable water supply across their supply chains: the garment and footwear sector is responsible for around 20 per cent of global wastewater use¹⁰.

At a sovereign level, the consequences will also be significant, but not equally spread (Figure 42). A fifth of countries are at high risk from ecosystem collapse as biodiversity declines¹¹, and among the top ten countries with fragile ecosystems and high GDP dependency on natural services are resource-rich developing countries with large agricultural sectors, such as Indonesia, Kenya, Nigeria, Pakistan and Vietnam. Diversified economies in Europe and America are also exposed through their supply chains.

Biodiversity risk remains largely unaccounted for

Despite these links, the ecosystem is unvalued in economic accounts and market prices. For example, unpriced natural capital consumed by primary production (agriculture, forestry, fisheries and mining) and primary processing sectors (including cement, steel, pulp and paper) has been valued at \$7.3 trillion¹². Even current models of climate risk fail to account for this loss. This makes it difficult for investors to assess investment implications of ever-diminishing resources.

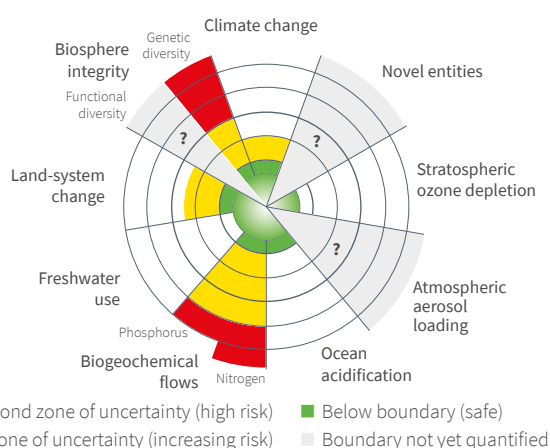
Moreover, unlike climate change, there is no simple quantifiable metric like GHG emissions to compare companies' reliance and impact on nature. Whilst some industries are apparent winners and losers, insufficient accounting and reporting on these risks could have unintended consequences, such as short or long-term risk mis-pricing, inadequate capital buffers, and potential for stranded assets along similar lines to the impact of climate change.

This information gap underpins a market failure, where economic incentives to conserve and sustainably use biodiversity remain weak. This is despite estimates of substantial economic opportunities from protecting nature. A nature positive transition could deliver \$10.1tn of annual business opportunities and 395 million jobs by 2030 compared to a business-as-usual scenario¹³. However, that transition is dependent on substantial changes across the economy, including a move from current consumption patterns to planet-compatible consumption, which depends on government intervention.

Unlike with climate change, there is no quantifiable metric like GHG emissions to compare companies' impacts on nature

Economic incentives to use nature sustainably remain weak

Figure 40. The 9 planetary boundaries and current impacts



Source: Stockholm Resilience Centre

Looming government action

Governments have to date acknowledged the problem, but not taken significant action. The Convention on Biological Diversity from 1992 was updated in 2010 with a set of 20 targets, but by 2020 not a single target had been met. Public finances remain misaligned, as biodiversity finance stands at \$78-91bn per year, whilst support that is potentially harmful to biodiversity is six times higher, around \$500bn¹⁴.

This could change in 2021 as governments meet to turn renewed ambitions into action at the global UN biodiversity conference (COP15¹⁵) taking place in Kunming, China, in May. The meeting is similar to the more well-known annual global meetings on climate change and it is expected that countries will agree a revised and stronger Convention on Biological Diversity (CBD). As a signal of increased intent, countries have already begun to make commitments. The EU has adopted a new biodiversity strategy which aims for 30 per cent of Europe's land and seas to become protected by 2030, to unlock at least €20 billion for spending on nature and dedicate 25 per cent of the EU budget to climate change, which includes action on biodiversity and nature-based solutions. The UK and European Commission called for clear, measurable targets that allow countries to hold each other to account.

Some countries and regions are already taking steps in the right direction. The EU has banned the use of neonicotinoids seed treatment on mass flowering crops and its new "Farm to Fork Strategy" includes targets to reduce use of pesticides by 50 per cent and fertilisers by 20 per cent. The strategy also aims to increase organic farming to reach 25 per cent of agricultural land and halve food waste per capita at retail and consumer levels by 2030. Canada, India and Spain have leveraged supportive packages and policies¹⁶. In the UK, the government has put forward a Global Resource Initiative which recommends placing a timber due diligence requirement on UK supply chains. Research into a potential "meat tax" is underway by think tanks and academics.

There are also initiatives in development to improve corporate disclosure of biodiversity risk¹⁷. In 2020, the Task Force for Nature Related Financial Disclosures (TNFD) was established following the success of its climate equivalent (TCFD) which has become a globally recognised, and in some countries mandatory, framework for climate-related financial risk reporting. Some companies are beginning to account for their biodiversity impact, using the limited metrics that exist to begin to build an understanding of the risks they face.

COP15 is likely to produce stronger targets for conservation of land and seas, and scaling up of investment in conservation, sustainable use and restoration. Unlike the last targets set in 2010, it is likely that some of the new targets will be more specifically aimed at business, in addition to governments. We also expect to see efforts to put a price on biodiversity loss, through reforms of subsidies harmful to biodiversity, greater focus on internalising the externalities

Subsidies harmful to nature are 6x larger than financial support for biodiversity

Clear, measurable targets are needed

The EU is aiming for a 50 per cent reduction in pesticide use

We expect to see a greater focus on putting a price on biodiversity loss

Figure 41. Ecosystem services

Type of value	Examples of ecosystem services	Geographical scale of benefits		
		Local	Regional	Global
Direct use	Food (e.g. fisheries and aquaculture)	✓	✓	✓
	Fuel (e.g. timber)	✓	✓	
	Water	✓	✓	
	Natural products (e.g. sand, pearls and diatomaceous earth)	✓	✓	✓
	Genetic and pharmaceutical products	✓	✓	✓
Indirect use	Atmospheric composition, carbon sequestration and climate regulation			✓
	Shoreline stabilisation/erosion control	✓	✓	
	Natural hazard protection (e.g. from storms, hurricanes and floods)	✓	✓	
	Pollution buffering and water quality	✓	✓	
	Recreation and tourism	✓	✓	✓
Option values	Potential for future use of the above	✓	✓	✓
Non-use values	Cultural and spiritual values, existence and bequest values, e.g. associated with habitat for Species	✓	✓	✓

Source: OECD (2019) "Biodiversity: Finance and the Economic and Business Case for Action"

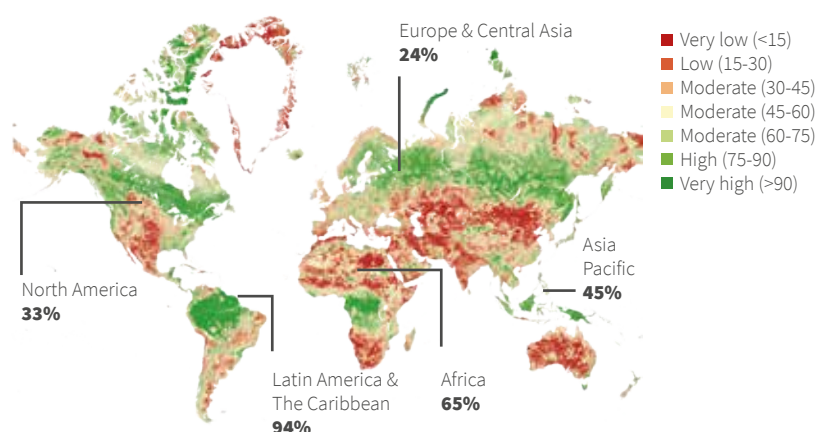
via starting a debate on resource taxes, and increased economic incentives for biodiversity preservation and restoration. Negotiators at the World Trade Organisation are working on finalising a two-decade attempt to reach consensus on curbing government subsidies, roughly \$22bn, that encourage unsustainable fishing. Companies and governments are likely to commit to being 'nature positive' and achieve 'biodiversity net gain'. Reforestation, as well as peatland and wetland restoration, are the dominant offset solutions, so we expect to see growth in these activities which are key solutions to climate change too.

As we enter 2021, the COP15 meeting in Kunming is slated to do for biodiversity what the Paris Agreement did for Climate Change. Companies and their investors may not be able to take nature for granted for much longer.

We expect to see a growth in reforestation, as well as peatland and wetland restoration, as 'offsetting' solutions

- 1 The IPBES Global Assessment Report on Biodiversity and Ecosystem Services (2019) compiled by 145 expert authors from 50 countries over the past three years, with inputs from another 310 contributing authors, based on the review of 15,000 scientific and government sources.
- 2 IPBES Glossary.
- 3 WWF (2020) Living Planet. Tracks numbers of species mammals, birds, fish, reptiles and amphibians.
- 4 IPBES (2020) Workshop on Biodiversity and Pandemics
- 5 Steffen et al (2015) 'Planetary Boundaries: Guiding Human Development on a Changing Planet', Science.
- 6 Intergovernmental Science-Policy Platform on Biodiversity and Ecosystem Service (IPBES).
- 7 OECD (2019) 'Biodiversity: Finance and the Economic and Business Case for Action'.
- 8 IBEPs, which is similar to the International Panel on Climate Change, is a group of 145 expert authors from 50 countries over the past three years, with inputs from another 310 contributing authors, based on the review of 15,000 scientific and government sources.
- 9 SwissRe Biodiversity and Ecosystem Services (BES) 2020.
- 10 UNECE (2018), 'Fashion is an environmental and social emergency, but can also drive progress towards the Sustainable Development Goals'.
- 11 SwissRe Institute Biodiversity and Ecosystem Services (BES) 2020.
- 12 Natural Capital Coalition, 2001.
- 13 World Economic Forum (2020): the future of nature and businesses.
- 14 OECD (2020): A comprehensive Overview of Global Biodiversity Finance.
- 15 COP stands for Conference of Parties to the agreement.
- 16 Vivid Economics Greenness of Stimulus Index (2020).
- 17 See the Finance for Biodiversity Pledge, www.financeforbiodiversity.org. Also the French initiative to improve biodiversity data available to fund managers <https://www.ipe.com/news/asset-managers-progress-biodiversity-impact-measurement-plan/10047972.article>.

Figure 42. The distribution of dependencies of economies on biodiversity and ecosystem services



Source: WWF Global Living Index, Swiss Re Institute and multiple data sources

Risk and portfolio construction: the risk of perceived safety

The events over the past year have been dramatic. Accustomed concerns that occupy investors' minds have been completely overshadowed by the global Coronavirus pandemic. The COVID-19 pandemic produced a severe market correction on par with many historical stress events and will take its place alongside a whole host of other downside stress tests run across the financial industry. Perhaps even more surprising was the rate of recovery. With the risks to the upside presenting a different challenge in portfolio management.

Initially impacting emerging markets, the crisis quickly spread to developed markets and saw a peak to trough move of -34 per cent in global equities. This resulted in a large de-grossing from risk assets, with a reduction of risk allocation to equities and credit. Historically safe-haven assets such as US Treasuries could not escape the market turmoil with a brief period where market liquidity seized up. This was remedied by the central banks stepping in with support/stimulus measures and leading to a strong rally in credit and equities.

Risk limits are designed to protect portfolios against excessive drawdowns and enhance long-term portfolio performance. However, they may potentially hamper performance if the market subsequently rebounds sharply whilst the risk limit is reducing market exposure. Furthermore, the requirement to de-risk a portfolio following a drawdown presents a missed opportunity. The portfolio cannot capitalise on picking up undervalued assets or fully participating in the recovery.

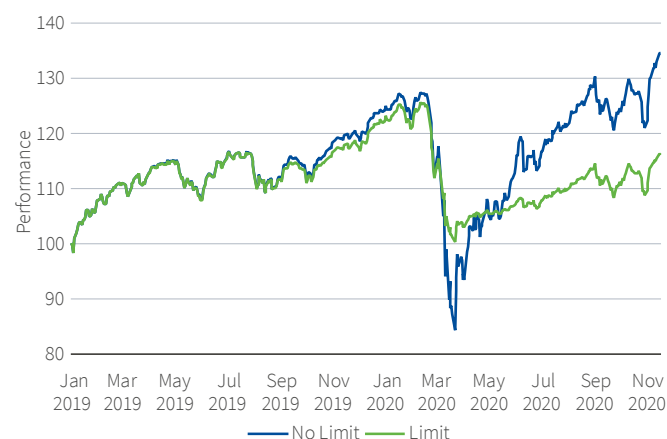
De-grossing vs diversifying

There are many ways to de-risk a portfolio but for simplicity we look at the following two ways to manage the portfolio risk limit:

- (a) De-gross: decrease market exposure to reduce excess portfolio volatility.
- (b) Diversify: use uncorrelated or negatively correlated positions to manage total portfolio volatility.

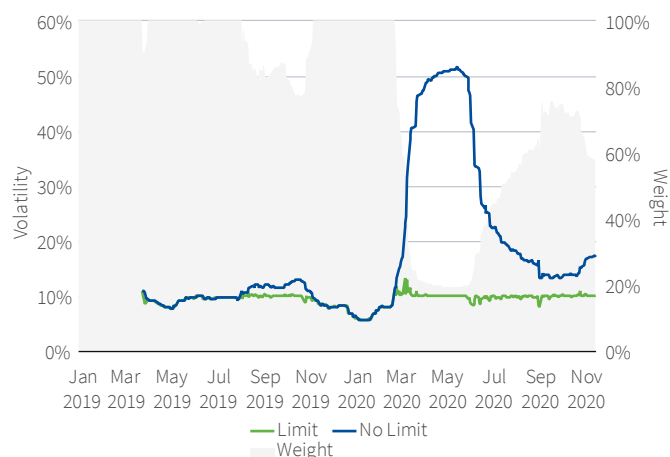
Figure 43 & Figure 44 show that adhering to a strict risk limit reduces the level of drawdown. However, it also highlights the problem of de-grossing at the bottom and not fully participating on the upside capture until volatility has subsided. This mechanism would be more effective if the recovery had not been so rapid. Figure 45 & Figure 46 show one can achieve a better risk-adjusted return by employing diversification with a simple portfolio of equities and bonds, but as we noted last year it is heavily reliant on correlation relationships remaining stable.

Figure 43. De-grossing performance



Source: Aviva Investors, Bloomberg as at 3 December 2020

Figure 44. Risk vs. exposure



Source: Aviva Investors, Bloomberg as at 3 December 2020

With bond yields continuing to decline to lower levels, this relationship could be increasingly challenged and the effectiveness of duration in stressed scenarios is potentially weaker. In addition, if bonds begin to sell off as they did in March, this will also present a problem for rear view looking risk models. As always, does the past really give us a good handle on the interaction between asset classes going forward?

Challenges in finding risk-reducers

We need to think more broadly in terms of finding strategies to help manage the portfolio risk. By employing less correlated or negatively correlated ideas across the portfolio, a reduction in risk can be achieved. However, this may not be achieved using the same investments as in previous periods of history. US dollars have conventionally been viewed as a safe-haven asset but not all dollar FX crosses are the same. USDJPY showed mixed risk-reducing properties in March this year, working well initially but it struggled later and is displaying much weaker correlation presently. In contrast AUDJPY shows a consistently strong negative correlation to risky assets. This can present a different problem as it can act as a drag on portfolio performance.

The correlation heatmap in Figure 47 further illustrates a range of risk-reducing ideas against MSCI ACWI over the past 2 years. The correlation of some risk-reducing strategies are more consistent than others. As these relationships are dynamic, allocating to a broad range of these strategies is crucial to making sure the portfolio will be resilient to market shocks.

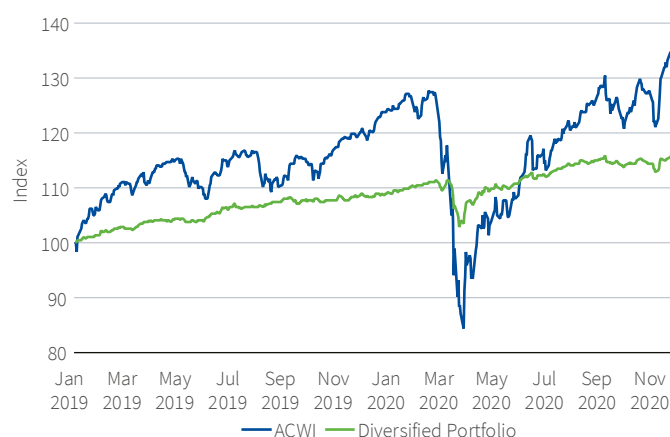
Is it all the same?

The commonality of the risk-reducing ideas is also to be considered. Is false comfort being drawn from several risk-mitigating ideas which are all essentially acting in the same way? We try to address this problem using cluster analysis, whereby we algorithmically categorise these ideas to see which strategies are displaying similar properties.

The analysis shown in Figure 48 uses a hierarchical clustering technique to group strategies into similar types as determined by the algorithm. The vertical axis represents dissimilarity between clusters and horizontal lines represent clusters. We observe the following groupings (1) Duration, (2) Asian / JPY FX, (3) DM FX and (4) Equity RelativeValue and lastly (5) Global Equities completely separated from the rest.

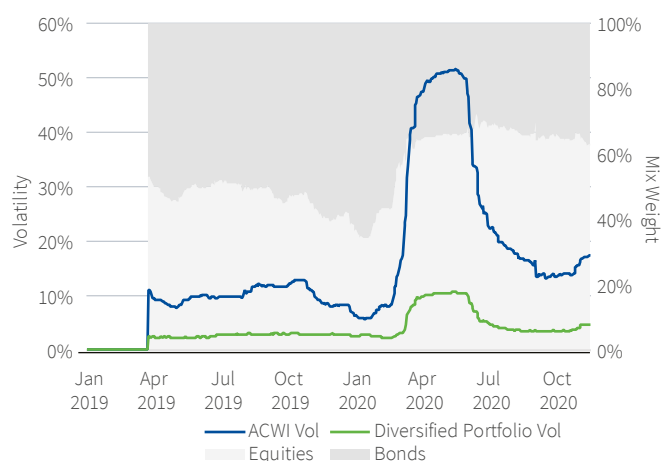
By picking risk reducers from several of the relevant clusters, an investor can construct a more robust portfolio that is less reliant on a single correlation outcome. However, it should also be noted that not all types of diversification are equal. If an investor's starting point is to hold US treasuries as a risk reducer, then an additional allocation to duration in a different region results in better diversification than an allocation to a different maturity within the US. Moreover, superior diversification can be achieved when allocating to multiple asset classes, hence suggesting that a flexible approach can lead to better outcomes.

Figure 45. Diversified portfolio performance



Source: Aviva Investors, Bloomberg as at 3 December 2020

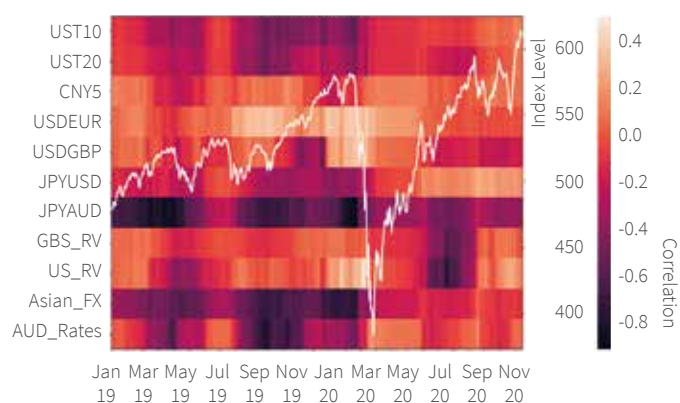
Figure 46. Risk mix



Source: Aviva Investors, Bloomberg as at 3 December 2020

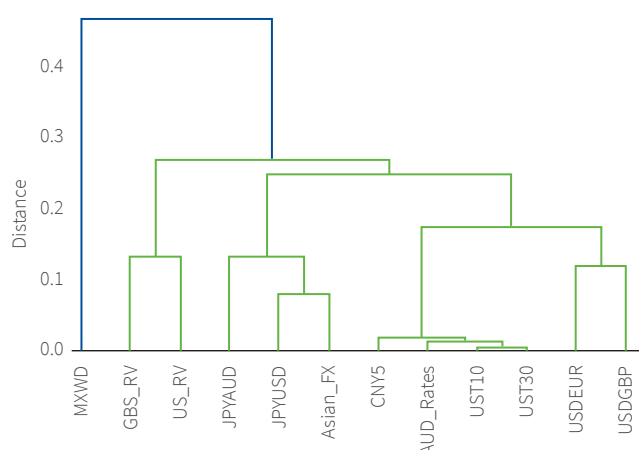
Risk limits can offer a degree of comfort for investors, but they should also be considered for their potential to limit the upside after a large market event. Not being fully invested is taking a view which can be detrimental in a positive market environment. Diversification provides a method for staying invested and potentially achieving a better risk adjusted return. Diversification requires constant scrutiny of correlation. Stability and similarity of risk-reducing strategies also present an ever-decreasing set of traditional opportunities for investors to shield their investments from equity market drawdowns. However, with thorough portfolio construction techniques, informed diversification decisions will be key to managing long-term performance.

Figure 47. MSCI ACWI vs risk reducers correlation CORR heat map



Source: Bloomberg, Aviva Investors as at 3 December 2020

Figure 48. Risk-reducing cluster dendrogram



Source: Bloomberg, Aviva Investors as at 3 December 2020

Economic Outlook



United States: no ordinary recession, no ordinary recovery

- Economy expected to recover strongly in 2021, supported by monetary and fiscal policy
- Growth supported by robust household balance sheets, alongside a significant inventory re-build
- Inflation to remain subdued, albeit with a temporarily rise above 2% in late 2021Q1 due to base effects

Summary

The US economy has been remarkably resilient to the impact of the COVID-19 pandemic. While it was deeply impacted by forced closures in Q2, the rebound that followed re-openings in Q3 was more rapid than the most optimistic expectations. As a result, the level of activity was only around 3 per cent lower in Q3 than it was pre-COVID-19, an extraordinarily rapid bounce-back from the decline of over 10 per cent in the first half of the year. With COVID-19 infections rising again in Q4, and restrictions being imposed once again, it is likely that growth will stall for a period. However, we expect that to be short-lived, particularly given the expected distribution of highly effective vaccines starting in December. The ability of the economy to bounce back so quickly likely reflects both the vast amount of fiscal and monetary policy support given in 2020, alongside the flexibility of households and businesses to adapt their lives to social distancing and other measures.

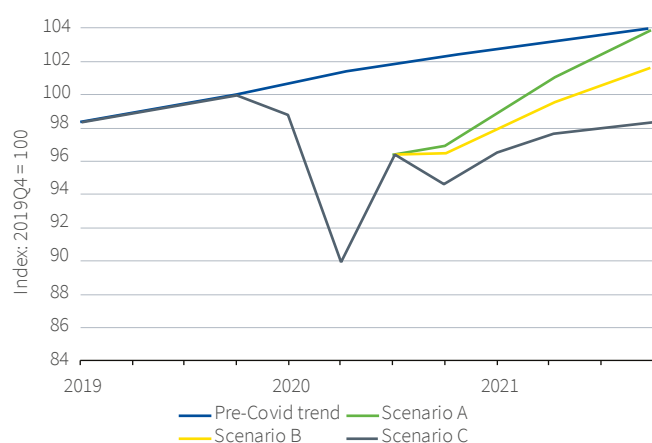
On the fiscal side, households have been well supported. As a result, household incomes (in aggregate) rose by more than would have been the case had the COVID-19 pandemic never occurred. With production and spending constrained by lockdown measures, personal savings have increased materially this year, to the tune of around \$1.2 trillion more than would have otherwise been the case. That provides a buffer for households that could be utilised as uncertainty around the outlook recedes. Moreover, that support could be further enhanced with the expected passage of a “Phase IV” fiscal package by early 2021. The size of such a package is expected to be up to another \$1 trillion, and could continue to support household incomes, as well as provide ongoing benefits to small businesses and state and local government. The combination of these factors presents a meaningful upside risk to personal spending in 2021, as pent-up demand for hospitality, travel and leisure activities that have been forgone in 2020 is released. In addition to the fiscal support, the Federal Reserve reduced interest rates to zero and undertook large-scale asset purchases of US treasuries and mortgage-backed securities, as well as introducing new purchase programmes for corporate debt and loans. These actions reduced borrowing costs and eased financial conditions, supporting interest rate sensitive areas such as housing and consumer durables.

US economy has rebounded quickly from the COVID shock

Fiscal support for household income has been key to the recovery

Figure 49. US GDP scenarios

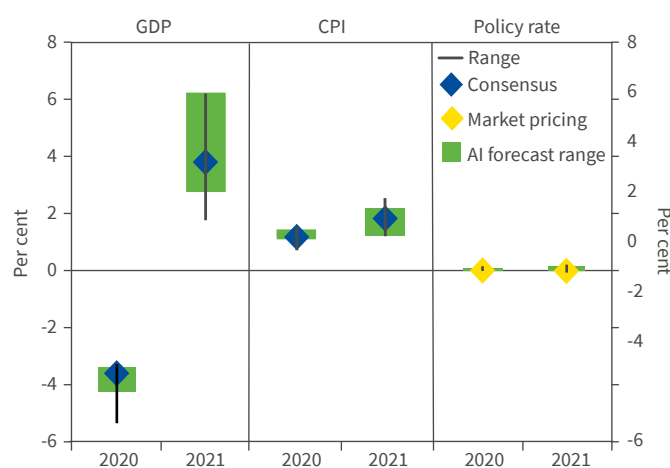
A rapid recovery expected in 2021



Source: Aviva Investors, Macrobond as at 3 December 2020

Figure 50. US economic projections

Aviva Investors is above consensus on US growth in 2021



Source: Aviva Investors, Bloomberg as at 3 December 2020

Looking ahead, we expect GDP to recover to its pre-COVID-19 level by 2021 Q2 and to make up further ground on the pre-COVID-19 trend in the second half of 2021, growing by around 4¾ per cent on an annual basis (Figure 49). As noted, the risk to the upside is if consumer spending accelerates more quickly if the buffer stock of savings is recirculated back into the economy. On the downside, there is a risk that the economic scarring from the crisis is worse than we expect, with an increase in longer-term unemployed. We see little in the way of near-term inflationary pressures (absent some positive base effects in Q2) but see some potential for inflation to surprise on the upside in 2022 and beyond. That view is supported by the new Federal Reserve framework of Average Inflation Targeting (AIT), which will delay any lift-off in rates until inflation has risen above 2 per cent and is expected to sustainably remain at target (Figure 50).

While a Biden administration is expected to be more stable in its policy approach than that experienced under Trump, many of the more ambitious policy areas are likely to be limited if they do not get control of the Senate (our central expectation).

No ordinary recession, no ordinary recovery

When the United States entered recession in March 2020, it did not follow a period of economic excess. The usual causes of past recessions, such as excesses leverage and balance sheet overhang in either the household or corporate sector were not present. Nor were high interest rates. Indeed, the US economy had been through a challenging 2019, slowed by the impact of the trade dispute with China. Instead, this was a health crisis that led to a self-imposed shut-down of economic activity in order to save lives. As such, this was no ordinary recession. Not only was it unusual in the way in which it came about, but also because of the severity. Output declined at the fastest pace since the Great Depression. The unemployment rate soared to nearly 15 per cent, from a 50-year low of just 3.5 per cent. Fear and uncertainty about both the immediate danger from COVID-19, as well as the implications of a virus that may never be contained (other than by reaching so-called herd immunity), created the potential for a historic long-term economic decline. However, two powerful and rapid responses were enough to stabilise the spread of the virus and underpin household and business balance sheets and confidence. First was the actions of government and citizens to limit physical interactions and take other precautions while a vaccine could be developed. Second was the vast monetary and fiscal support that transferred much of the economic risk today from households to government. This was most clearly seen in the income support packages provided to all households, and particularly to those impacted by job losses. The support payments ensured that, in aggregate, household incomes not only didn't fall in 2020, but actually rose by more than would otherwise have been the case (Figure 51).

While consumption on services was constrained by social distancing, households were able to substitute spending into goods. In October 2020 consumer goods spending (in real terms) was nearly 9 per cent higher than at the end of 2019 (nearly three times the average annual increase over the past decade). Although it should be noted that the earlier sharp decline in

We expect growth of 4 3/4% in 2021, with inflation to remain subdued

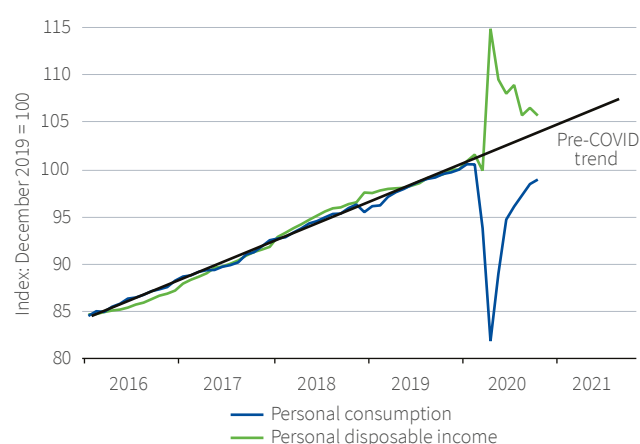
Biden presidency to provide stability, but ambitions likely curtailed by the Senate

Recession not caused by financial imbalances

Vaccine roll-out and large savings buffer to support consumer-led recovery

Figure 51. Household income and spending

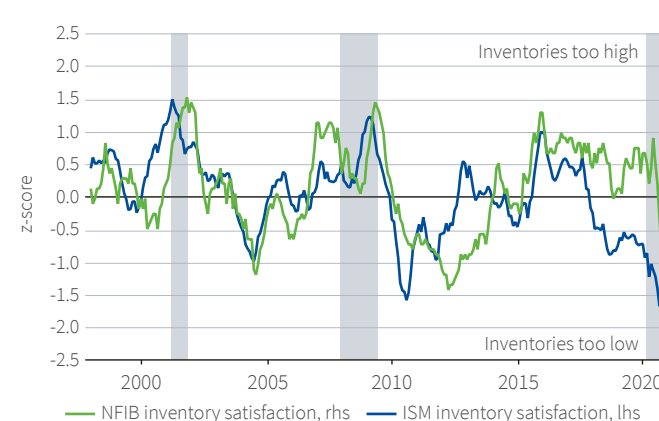
Higher income to support consumption



Source: Aviva Investors, Macrobond as at 3 December 2020

Figure 52. Business inventories

Unexpected demand will require significant re-stocking



ISM is weighted average of manufacturing and non-manufacturing surveys. Series are 6-month moving averages

Source: Aviva Investors, Macrobond as at 3 December 2020

goods spending will likely result in similar growth in 2020 (as a whole) as in the past decade. That compared to spending on services which was around 7 per cent lower in October compared to the end of 2019. Looking ahead, we expect the vaccine roll-out will result in more rapid re-opening of services from 2021 Q2, with significant pent-up demand. Alongside that, some of the buffer of around \$1.2 trillion in savings accumulated in 2020 could be recycled back into the economy, providing a further boost. We are expecting a recovery in consumer demand that is more rapid than any previous recession.

Businesses have also been supported, both directly through loan schemes and grants, and indirectly through the support of household income. But they have also been surprised by the pace of economic recovery in 2020 H2. A combination of that unexpected demand, alongside production shutdowns earlier in the year, has resulted in inventory levels falling to their lowest on record relative to desired levels (Figure 52). That is typically the case well after recessions have passed, but again serves to demonstrate the unusual pace of recovery this time around. Just bringing inventory levels back up to what is desired should result in a material contribution to GDP in 2021. Encouragingly business investment intentions have also recovered quickly, suggesting capex spending will recover sharply as well.

While the fiscal support in 2020 has been vital in breaking the usual adverse feedback loop from incomes to spending, the majority of those programmes will have come to an end by the end of the year. Further fiscal support is likely to be needed in the nearterm, and the recent election victory for President-elect Biden should see a further package of up to \$1 trillion on support in by 2021. While the Democrats kept control of the House, the outcome of the Senate will not be known until January when two run-offs occur in Georgia. If the Republicans hold on to just one of those seats, then they will continue to hold the balance of power in the Senate, therefore limiting the Democratic legislative agenda (at least until the 2022 mid-terms). That is our central expectation and would make a much larger fiscal package very unlikely to pass Congress. However, a more significant fiscal question may be beyond the immediate COVID crisis, looking to the next 4 years. There are increasing calls from organisations such as the IMF, as well as respected past policymakers for governments to engage in more expansionary fiscal policy over the coming years. In particular, focusing on public infrastructure and other potentially productivity-enhancing measures. That could result in a sustained period of cyclically-adjusted deficits (Figure 53), although again this might be limited in the US if the Republicans maintain control of the Senate.

What seems less in question is the outlook for monetary policy (Figure 54). The new framework adopted by the Federal Reserve should see them hold back from tightening policy for an extended period, even in the face of a very rapid recovery. They have been clear in stating that they will put less weight on the reduction in spare capacity and more on inflation outcomes – which they will want to be above the 2 per cent target for a period. The combination of loose fiscal and monetary policy over the next few years could be the impetus for inflation to move sustainably higher, and ultimately for the Fed to tighten policy more quickly.

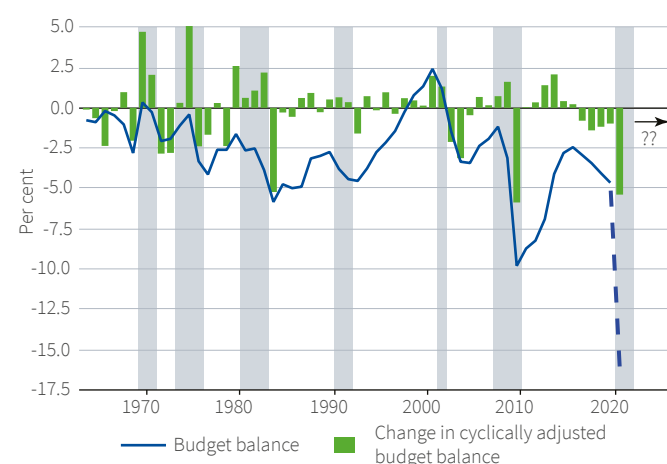
Low inventory levels will need to be re-built

Further fiscal support expected

Fed expected to keep interest rates low for several years

Figure 53. Budget deficits may become the norm

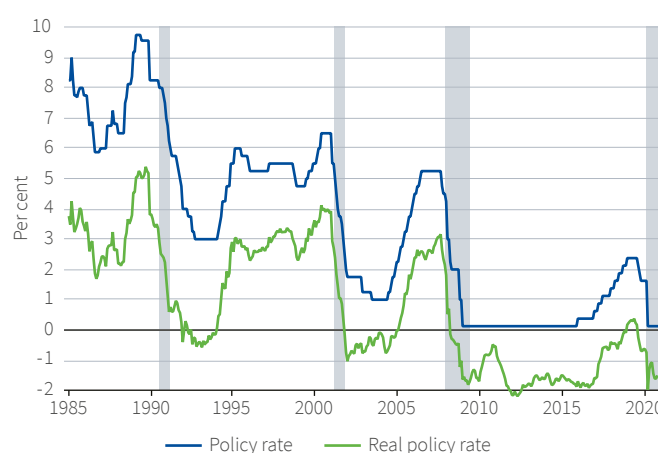
Deficits set to continue for several years



Source: Aviva Investors, Macrobond as at 3 December 2020

Figure 54. Policy rates and real rates

Monetary conditions to remain very easy



Source: Aviva Investors, Macrobond as at 3 December 2020

Eurozone: maybe this time

- Growth to rebound strongly in 2021 even in the face of ongoing containment measures
- Policy support will remain in place; fiscal to move from support to stimulus
- Unlike a decade ago, Europe can become more united in the wake of a major crisis

It now seems ironic that the tone of the Aviva Investors 2020 outlook, published exactly a year ago, highlighted the possibility of better growth outcomes. 12 months on, the world has changed in ways that could not possibly have been foreseen. Yet our 2021 outlook has an optimistic bias once again, even if the grounds for holding those opinions are a little different. The COVID-19 pandemic has blighted almost every country of the world in 2020 and the legacy of the experience will be with us for years to come. But the development of effective vaccines means that it is now possible to foresee an eventual end to virus disruptions. Europe has experienced a similar pattern to many other nations this year, with unprecedented collapses in GDP being followed by equally sharp rebounds as economies re-opened over the summer (Figure 55). Resurgences of virus infections (Figure 56) have obliged Governments to reinstate restrictions in recent months which will probably lead to further declines in GDP in the fourth quarter before 2021 sees a lasting revival in growth, the widespread disbursement of vaccines and, eventually, a return to some semblance of normality.

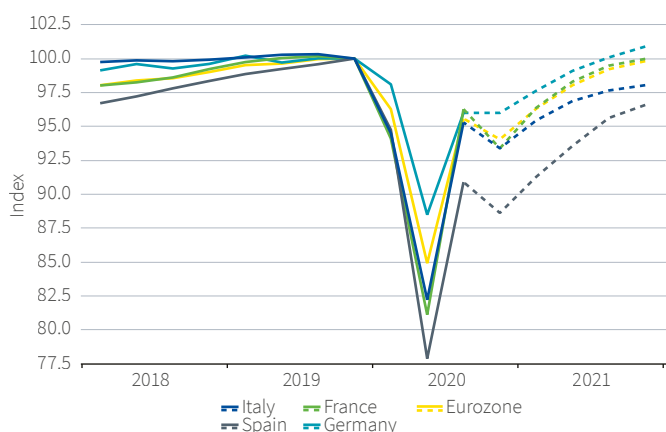
The extraordinary nature of this crisis along with its unprecedented impact on economies means that conventional analysis of macroeconomic variables is almost meaningless. Desperate times have, quite rightly, led to measures that might in normal times be characterised as desperate, but which in today's unique circumstances have not only been entirely appropriate but have arguably been essential in ensuring that self-inflicted downturns did not become far more damaging depressions. For the second time in a little over a decade, policymakers have had to respond to an extraordinary situation with imaginative and visionary actions. Thankfully, this time around the key players in European policy circles have responded far more quickly than in 2008 (or 2011). Subject to a successful transition in terms of the virus itself, that more enlightened and timely approach means there is less risk today of a stuttering recovery or of a secondary crisis borne out of half-hearted attempts at dealing with the first.

2021 should be a year of healing and recovery

Figure 55. GDP has rebounded strongly

But pre-COVID levels unlikely to be reached until end of 2021

Gross Domestic Product, 2019 Q4 = 100

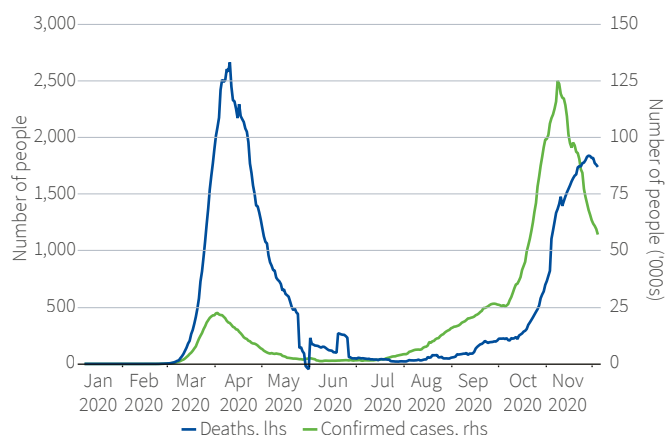


Source: Aviva Investors, Macrobond as at 3 December 2020

Figure 56. Europe has seen a resurgence of the virus

But renewed containment measures are working

Eurozone Big 4, change in COVID cases and deaths, 7-day mavg



Source: Aviva Investors, Macrobond as at 3 December 2020

The first downturn did not impact all sectors or countries evenly (Figure 57). Households soon found new ways to maintain and then increase retail spending, but construction and manufacturing are still some 5 per cent below pre-COVID levels. On the plus side, both look as if they can be sustained, more or less, in the second downswing, meaning that the hit to GDP should be markedly less than in the spring. In both instances, however, other service activities – many of which rely on close social contact – are the main areas that have suffered. Several have yet to re-open meaningfully after the first shutdowns. The extent of declines in activity has been directly related to the stringency and duration of containment measures put in place which has varied across Europe (Figure 58). There may be some more subtle variations in growth experiences during the second dip as countries adopt slightly different measures. Several aspects of the experience earlier this year are worthy of note as they offer insight into similarities and differences that may emerge during and after the second wave of virus infections. First, the initial shock from the pandemic (and reactions to it) was all-encompassing: uncertainty and fear meant that all activities were impacted significantly. Second, activities which rely extensively (or totally) on social interaction were, unsurprisingly, hit hardest by lockdown. Third, as restrictions were eased (too quickly as it turned out), activity rebounded faster than expected. And finally, people and companies demonstrated considerable resilience and adaptability, first coping with the strange circumstances and then quickly finding ways of working with or around the new conditions and regulations.

The re-imposition of restrictions will hurt GDP growth in Q4 across Europe and although it is quite apparent that the measures work – case numbers declined steadily once more – it is also clear that governments are going to be more cautious in relaxing the latest rules. Lessons have been learnt, people and companies have adapted to operating in lockdown and vaccines are on the horizon. All these factors imply that recovery in 2021 may stretch over several quarters rather than be concentrated in one as it was first time around (Figure 59). But it is important to stress that there are upside possibilities here too – the short-term hit to activity will not last and should quickly reverse next year. With the policy backdrop still extremely stimulative and set to remain so, the economic recovery story that should dominate 2021 could also see positive growth surprises.

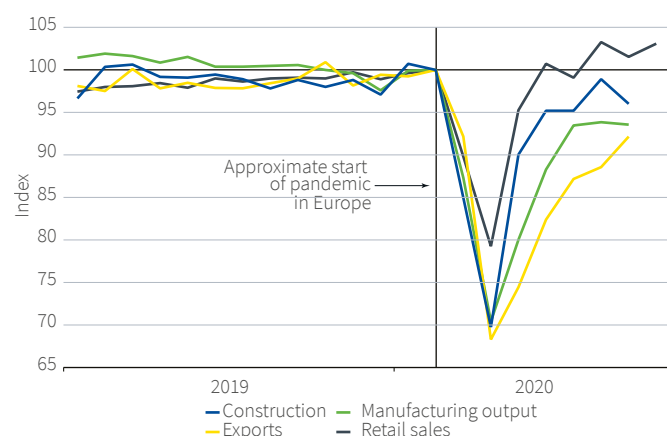
The ECB has increased its asset purchases, signalled that it will provide additional support in December and stands ready to do more if required. But it is the approach to fiscal policy which has changed most in the Eurozone. The pandemic required a response that was enormous, open-ended and immediate. And Europe delivered. The general intent is to tide the private sector over by providing a transfer of income to offset that lost from private entities not being able to trade normally. When conditions permit, such operations can recommence, and public funding assistance can be withdrawn. To facilitate this process, the Eurozone's archaic fiscal rules have been suspended, perhaps for good. Most importantly, the single currency area has set up the Next Generation EU Recovery Fund, comprising a mix of loans and grants

Economic activity that relies on close social contact has been hardest hit

Fiscal and monetary policy will remain very expansionary, with a number of new weapons

Figure 57. Some activities have recovered better than others

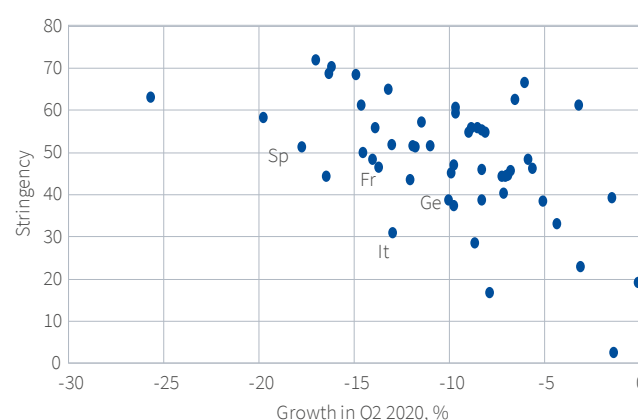
Retail spending habits have evolved quickly
Euro zone 19, SA, Jan 2019 = 100



Source: Aviva Investors, Macrobond as at 3 December 2020

Figure 58. Falls in GDP related to stringency

Extent of restrictions varied across countries
GDP growth in Q2 and stringency of restrictions



Source: OECD as at 3 December 2020

amounting to €750bn in total. It wouldn't be Europe without a few glitches in the delivery of the new mechanism, but this is an important building block in the drive towards closer integration. More immediately, it provides a conduit through which financial assistance can be directed to those member states most affected by the pandemic. The more enlightened approaches that underpin these initiatives, as well as fiscal policy more generally, have helped sovereign spreads in the Eurozone narrow significantly. Finally, while there is a recognition that fiscal sustainability needs to be monitored carefully, there is also an almost universal acknowledgement that now is not the time for overt fiscal consolidation.

GDP should recover steadily in 2021 and beyond, but it may be hampered by a recurrent need for containment measures before vaccine deployment is sufficiently advanced. As economies re-open and move off public sector life support, the true extent of lasting damage – or scarring – will become more apparent. There will be some permanent losses – business failures and higher unemployment. But governments can try to alleviate as much as possible and help facilitate the transition towards new jobs and new ways of doing business. As the OECD stressed eloquently, the COVID-19 experience provides an opportunity for a strategic re-set that can be used to reinvigorate global collaboration and cooperation in a number of spheres. Arguably the most important is climate change. Europe is, by international standards, well advanced on many parts of the green agenda and has the capacity to be an influential voice on the global stage. Public sector investment and regulation can promote resource reallocation including building energy efficiency, lower pollution initiatives and electric vehicles. “Green bonds” may be a step too far at present, but the fact that they are even being discussed highlights the direction of travel very clearly. Other principles are greater free trade, internationally coordinated approaches to taxation of the digital economy and an overall bias back towards multilateralism in place of some of the nationalistic or unilateral styles that have dominated geopolitics in recent years.

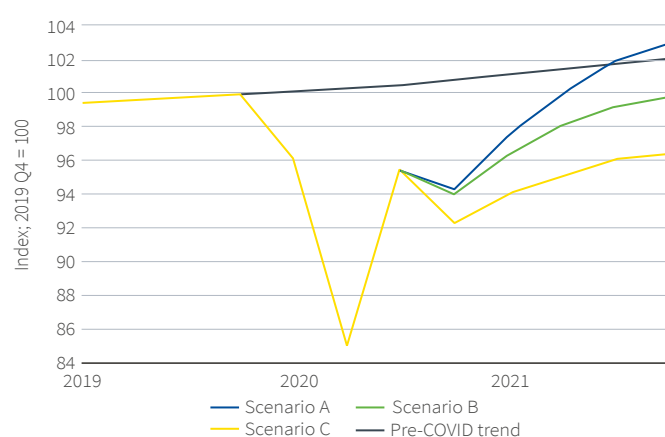
From a strictly macro-economic point of view, 2021 looks likely to be a year of strong growth and low inflation for the Eurozone (Figure 60). The latter has been a perennial problem for the Eurozone, and the COVID episode has been, in the first instance, an additional deflationary impulse. As output gaps close and the full extent of any supply-side damage is revealed, the true inflation picture will emerge. It is possible that, at that point, the monetary boost that has been provided on such a vast scale in recent years might plausibly gain some traction on prices rather than quantities. In addition, in its strategic review due next September, the ECB is likely to modify its inflation objective to one that will permit higher inflation on average. A high inflation issue in Europe looks a long way off for now, but even small steps in that direction following a robust economic recovery should be regarded as encouraging, rather than as any sort of a problem.

Green agenda likely to be key component of recovery drive

Deflationary worries are understandable, but should pass

Figure 59. GDP to recover strongly

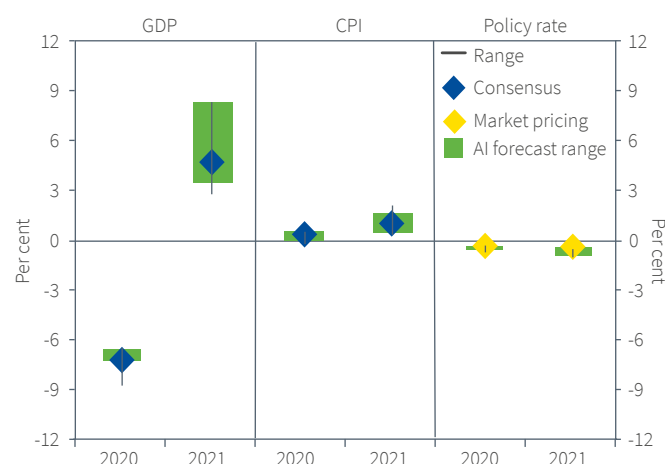
Hopefully the Q4 dip will be the last for a while
Eurozone GDP scenarios



Source: Aviva Investors, Macrobond as at 3 December 2020

Figure 60. 2021 should be a good year

Strong growth, low inflation, loose policy



Source: Aviva Investors, Macrobond as at 3 December 2020

UK: better growth, but Brexit drag

- Vaccine disbursement will allow the UK to participate in the global recovery in 2021
- But ongoing fiscal and monetary policy support needed for a while yet
- Brexit, whatever its form, is an unwelcome additional hit to a fragile economy

The impact of the COVID-19 virus across the world has been both universal and indiscriminate, with the only major differences in pattern (other than luck) relating to pandemic responses and the fiscal and monetary policy reactions. The UK has been affected, like every other major nation, and is now experiencing a second wave of infections (Figure 61). Renewed restrictions on activity, initially at a local level but then nationally too, are having the desired effect – cases have stabilised and are now falling steadily. Crucially, second waves have not resulted in dangerous levels of strain being placed on hospital capacity and COVID-19 occupancy is now falling again. Nevertheless, these patterns illustrate the sensitivity of virus transmission to prevailing conditions. Current containment measures are also, unfortunately, having the undesired but entirely predictable effect of weakening the economy again. GDP is now expected to slide lower in Q4 before returning to growth – hopefully at a robust pace (Q3 showed how rebounds can be surprisingly swift) – in 2021. However, there are at least three areas where the UK's experience has its own unique aspects. First, the UK was late in reacting to the onset of the virus initially. This has resulted in the highest death toll in Europe and implied the need for a more severe (and longer) lock-down in the spring. This, in turn, has meant both greater immediate damage to the economy (Figure 62) than elsewhere and has heightened the risk of permanent scarring.

Secondly, the UK's fiscal reaction to the crisis has been slower than it might have been. It has also been reluctant. Many European neighbours responded with powerful and almost immediate “whatever it takes” messages to the extraordinary circumstances of COVID-19 – providing instantaneous reassurances of financial support to those (firms and workers) who were not able to undertake their usual activities. The UK has instead been more reactive than pre-emptive in many of its fiscal initiatives. Although it has offered substantial support in many areas in the end, delays could prove critical in environments where many companies operate with extremely short cash-flow reserves. Moreover, the impact on sentiment should not be overlooked – if agents have little faith that the Government stands ready to

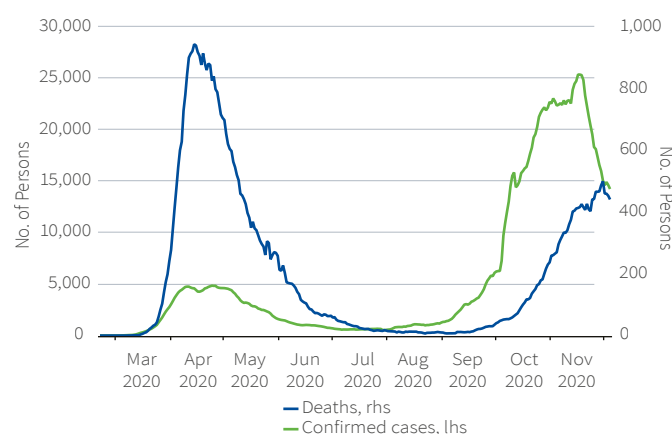
Additional GDP hit in Q4 as a result of renewed containment measures

Fiscal reticence in the UK – better late than never

Figure 61. The second wave is now waning

But further outbreaks are still possible

COVID-19 cases and deaths, daily change, 7-day mavg

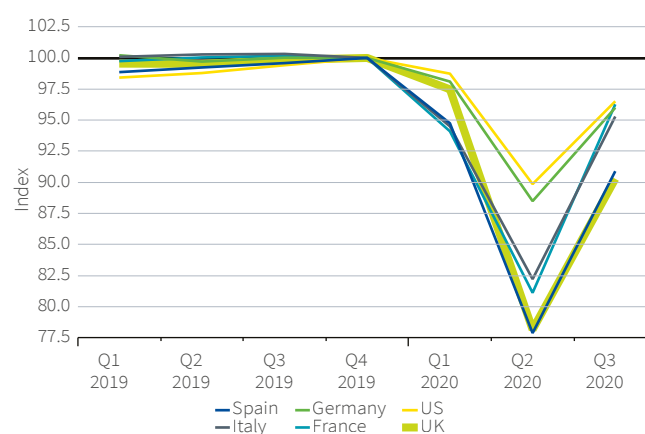


Source: Aviva Investors, Macrobond as at 3 December 2020

Figure 62. UK harder hit than European neighbours

GDP still some 10% below pre-crisis level

2019 Q4=100



Source: Aviva Investors, Macrobond as at 3 December 2020

protect them, they will retrench sooner and build up precautionary savings if they are able. This impacts households and companies – especially SMEs – alike, producing potentially damaging second-round effects on growth.

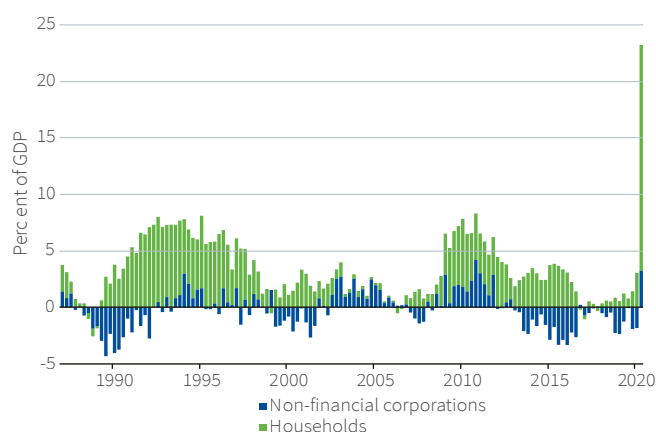
Household savings are generally well understood conceptually, but corporate saving is important too, especially at key cyclical turning points. If companies are uncertain about the future, they will automatically tend to hold back on longer-term investment and hiring programmes until the fog clears. This boosts their savings and hurts the income of others. Over the last 30 years or so, a measure of “financial savings” of the corporate and household sector combined has averaged just under 3 per cent of GDP. At the end of Q2 this year, it had spiked to more than 20 per cent (Figure 63). A great deal of this probably represents pent-up demand that will return. But it can also reflect precautionary behaviour by anxious firms and individuals. In today’s exceptionally fraught circumstances, many companies are effectively being instructed not to do business – at least for a while. If the Government does not bridge the financing gap that is a logical consequence of doing so – or leaves the impression that any such support will soon be withdrawn – then further retrenchment is the obvious course of action. There are many on the right of the ruling Conservative party that even now are alarmed with the current fiscal “profligacy” and would like to remove support as soon as possible, even as virtually every authority is at pains to highlight the dangers of doing so.

Thirdly, compounding these UK-specific stresses, is perhaps the biggest of them all. Four and a half years after the referendum, the reality of Brexit is now almost upon us. And in time-honoured fashion, we do not yet know the exact form of the future relationship. Our base case is that a “skinny” deal will be agreed (to the tightest of deadlines), but that is scant comfort. Whatever the outcome (deal or no deal), the Brexit transition on 1st January 2021 will still be an immense shock to an already-fragile UK economy. The government’s own figures show that the economic hit from a “no deal” outcome would amount to over 7½ per cent of GDP after 15 years – 0.5 per cent a year, on average, for an economy that may be growing at a trend pace of just 1.25 per cent. But even the “deal” scenario encompasses an estimated hit to GDP of almost 5 per cent over that period (Figure 64). Perhaps we shouldn’t be surprised, but whatever benefits Brexit might bring, economic well-being does not seem to have been part of it – we will be worse off. The additional impact of Brexit – whether messy or not – could hardly have come at worse time. A more pragmatic Government might have considered a delay or extended transition, but this one has too much political capital tied up in “getting Brexit done”. The analysis above relates to the longer-term impact of Brexit. But there is also the initial shock from the new era that begins on 1st January next year – whatever its form. It is a huge and unprecedented change: many nations have tried to become more closely linked on matters of trade. Never before has a country so explicitly attempted to become more detached. The Bank of England estimated that, even in the event of a reasonably comprehensive Free Trade Agreement (FTA), the UK economy could be hit to the tune of 1 per cent of GDP in Q1 simply as a result of the transition to a new regime.

Figure 63. Financial saving has spiked higher

Pent-up demand or precautionary saving?

Corporate and household financial saving, as per cent of GDP



Source: Aviva Investors, Macrobond as at 3 December 2020

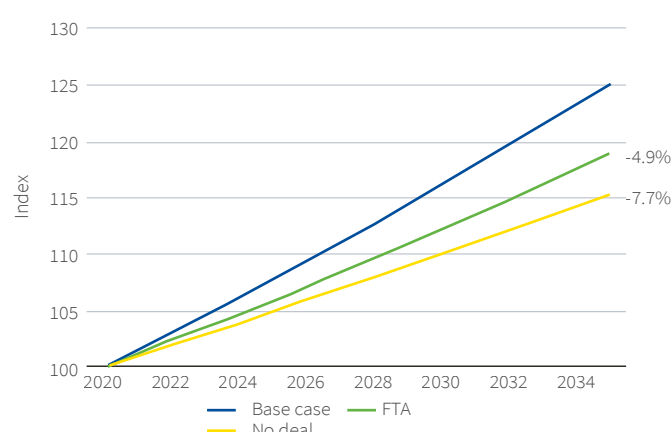
Savings spike – pent-up demand or indication of caution?

“Getting Brexit Done” will cost the UK in the long term

Figure 64. Bad or very bad?

UK worse off economically under any Brexit

GDP scenarios



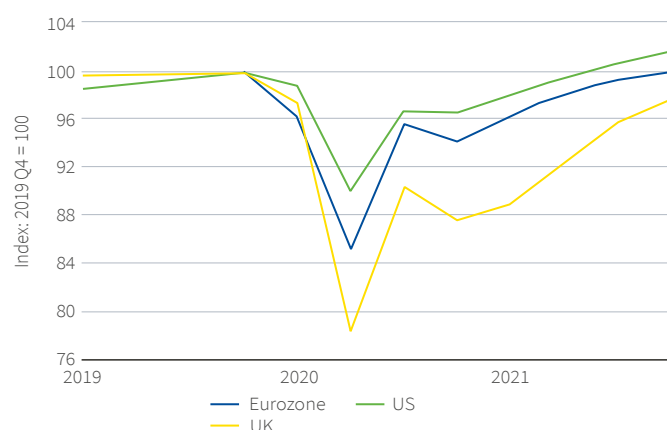
Source: Aviva Investors, Macrobond as at 3 December 2020

In these circumstances, there are legitimate grounds for believing that the Bank of England may provide additional monetary policy support early in 2021. They have reacted to Brexit concerns before. A cut to zero for the policy interest rate is possible and a number of spokespeople have been at pains to indicate that negative rates are a potential tool in the Bank's armoury. For now we believe that any such move will be resisted, but additional "non-conventional" policy assistance in the form of increased asset purchases or other more targeted support is quite plausible, especially if the Brexit transition is bumpy. Nevertheless, the UK could continue its recent experience of underperformance for a while yet (Figure 65).

It may not be until well into 2022 that the pre-COVID-19 level of GDP in the UK is reached again, well behind the timings for most of its peers. In common with other nations, it will not be until activity returns – more or less – to normal, that the true extent of permanent damage as a result of the COVID-19 crisis becomes apparent. In the UK's case, the Office for Budgetary Responsibility (OBR) has estimated that output remains permanently 3 per cent below its pre-crisis trajectory in its central case and 6 per cent below in its downside scenario (Figure 66). Both represent huge losses even though they each assume a smooth transition on Brexit. Overall then, the UK will still benefit from the expected coordinated global upswing in 2021 and as vaccines eventually push the COVID-19 crisis into history. But there is still plenty to worry about.

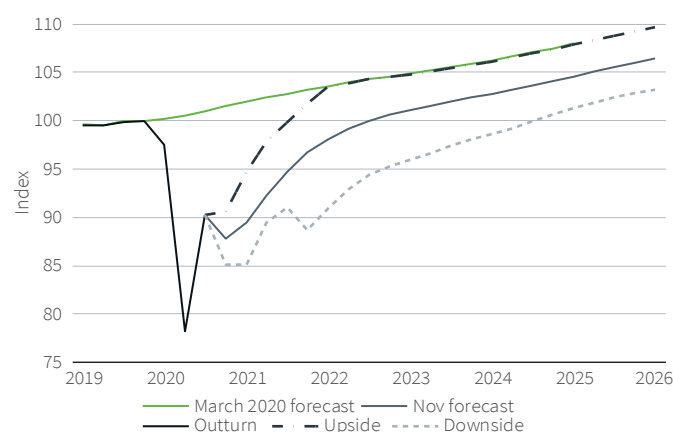
Policy support needed for a while yet

Figure 65. UK is the growth laggard
Revival in 2021, but underperforming peers
US, Eurozone and UK GDP outlook



Source: Aviva Investors, Macrobond as at 3 December 2020

Figure 66. OBR GDP scenarios
3% to 6% permanent losses to be expected



Source: Aviva Investors, Macrobond as at 3 December 2020

Japan: Suganomics takes over

- Japan's recession-within-a-recession is ending as virus recedes and the economy normalizes
- Underlying growth will remain weak, and conditions will be disinflationary, with a strong currency an additional challenge as exports benefit from a global recovery and tech demand
- The new Suga administration will look to complete Abenomics' third arrow of reform, stressing investment in ICT and structural reforms to banks and regulated sectors

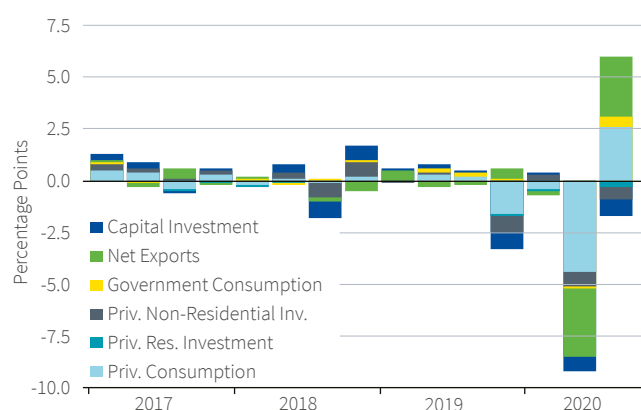
As in many other countries, Japan's 2020 output slumped not because of the coronavirus itself but mainly due to self-imposed or government-mandated suspension of normal activities. GDP contracted by 8.2 per cent in Q2, with household consumption down 8.5 per cent and exports slumping 17 per cent; the following quarter saw a 5.3 per cent rebound; the combined supply and demand shocks are progressively unwinding, but even with government support for industries and consumers, it will take several more quarters to get back to normal (Figure 67). The timing will be dependent on vaccines being rolled out successfully, but Japan has handled the pandemic relatively well and good news on the vaccine front means prospects are looking up, with leading indicators rising and coincident surveys following (Figure 68). True, Japan is, like many other countries, experiencing a third wave surge in coronavirus cases; a lockdown or emergency is unlikely but some slowdown around the turn of the year may be necessary, crimping growth temporarily once again; this will just be followed by a larger rebound subsequently.

Thus far, though, the recovery in Japan is slower than other rich economies and that should remain the case: PMIs remain below 50 for both goods and services, highlighting the long road ahead (Figure 69). Following the big bounce in Q3, quarterly growth should now be in a 2.5-3.5 per cent annualized range, with fluctuations caused by imposition and lifting of lockdowns, and the timing of vaccine distribution – as unknowable with any precision at present for Japan as elsewhere. Next summer, it is hoped that the Olympic Games will be held, a year late – with fan attendance boosting tourism and growth. Yet even though by the end of 2021 most of society should be back to normal functioning, the economic damage may take another year to heal, putting GDP back close to its potential only towards the end of 2022.

This year, the fiscal deficit is likely to come in at 12 per cent of GDP; next year this will probably be somewhere between 7 and 10 per cent, similar to 2010-13 levels – it depends on how

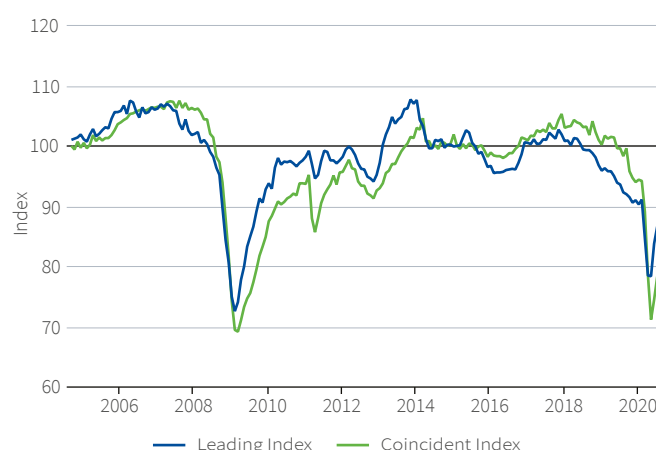
Japan's recovery is underway, but has lagged other economies

Figure 67. Rebound incomplete after double-dip
Contributions to GDP



Source: Japanese Cabinet Office, Aviva Investors, Macrobond as at 3 December 2020

Figure 68. Normalisation set to continue
Japan Cabinet Office ESRI surveys



Source: Aviva Investors, Macrobond as at 3 December 2020

generous the government is in expenditures and subsidies. This will become clearer in any supplementary spending and in next year's budget; on the revenue side, tax collections will be determined by the economy's capacity to continue its rebound, and with it tax revenues. Household incomes have been supported by government policies, though unemployment has risen from 2.2 per cent to 3.0 per cent in a labour market that is chronically short of workers. Similar to the US response, Japan's government made large cash payments directly to households, which were mostly saved, providing "dry powder" for spending going forward.

The Bank of Japan (BoJ), has of course made Bond Vigilantes extinct long ago; it will fully monetize the deficit and keep yields slightly below zero across most of the yield curve, with yield curve control (YCC) keeping 10-year Japanese government bond (JGB) yields around zero. Paradoxically, as long as the country can generate a modicum of positive growth and inflation, Japan's debt dynamics improve with each additional yen of debt, since $r < g$ (i.e. nominal interest rates are less than nominal growth). Low interest rates and large deficits, in this case, go hand in hand, and share a common cause: too much private savings. Indeed, Japan was already in a recession before COVID struck: private spending and investment have both slumped since late 2019, when a misguided consumption tax was erroneously seen as necessary to "make debt dynamics sustainable" (Figure 62). In fact, only growth and inflation will make government debt go down as a percentage of GDP, though debt reduction should not be an end in itself: a high structural savings rate, low investment by corporations, and a current account surplus of around 3 per cent of GDP necessitate government deficits.

That large difference of savings over investment, maintained for decades since the 1989 speculative bust, has resulted in a build-up of large foreign assets owned across government, corporations, and households. These days, the trade surplus is actually quite small, and fluctuates according to the price of oil and the global tech and industrial cycles; it has flipped from the pre-2015 deficits to a modest structural surplus. But the main factor behind the chronic current account surplus is the net income from all the foreign direct investment and financial assets (Figure 71).

For the past few years, the Abe administration had overtly encouraged un-hedged outflows, using the government pension investment fund to weaken the yen while doing an end-run around Trump's protectionism and the US Treasury's outdated criteria for currency manipulators, which instead flags countries such as Germany. Its benchmark adjustment is now done, though the state-run pension fund still has some leeway to increase exposures. A more important factor going forward is that the low rates in the US should induce hedging of existing exposures and cause a larger proportion of future outflows to be hedged. In short, many factors point to increased appreciation pressures on the yen, which on several metrics remains significantly undervalued. A break through the key ¥100 level for USDJPY is very likely, especially if our expected dollar depreciation against CNH and EUR is borne out.

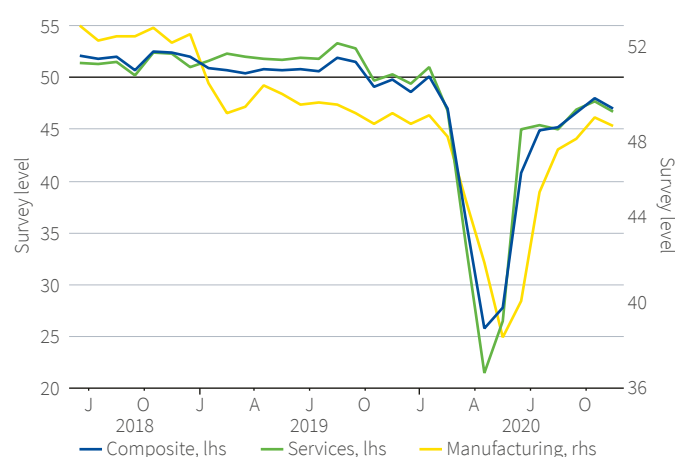
The central bank will monetize fiscal deficits, and yield curve control will keep a lid on interest rates

Too much savings requires deficits, and with too little investment causes current account surpluses

Currency appreciation exacerbates disinflation

Figure 69. PMI surveys are still oddly subdued

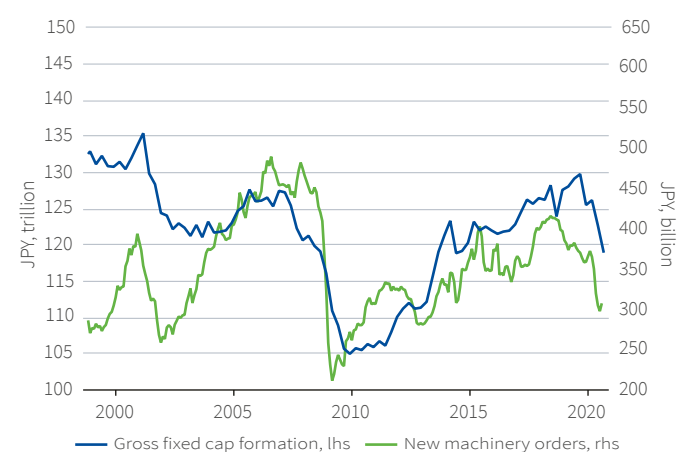
Japan PMI surveys



Source: Aviva Investors, Macrobond as at 3 December 2020

Figure 70. Investment has slumped

Machinery orders and investment



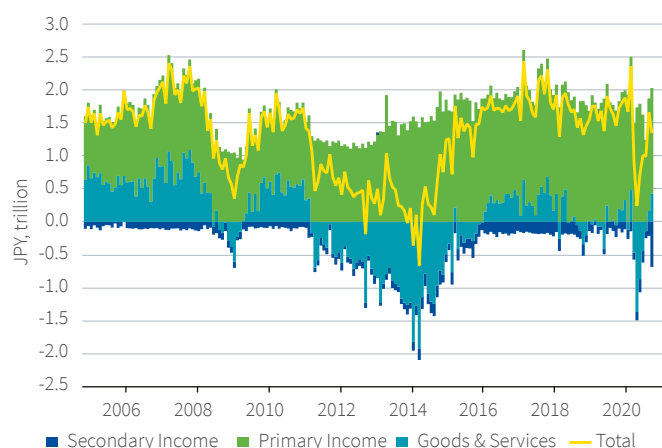
Source: Aviva Investors, Macrobond as at 3 December 2020

This will not come as welcome news for the BoJ, which is concerned more about preventing deflation than ever hitting its 2 per cent “inflation target”. We expect that CPI inflation will hover around zero in coming years (Figure 72), and markets have already priced that in. There might be some one-off rises, for example as subsidies for tourism wear off, and reductions in childcare and educational controlled prices come out of the base calculations. A downside risk is an attack on telecom pricing, which is seen as egregious and (erroneously) holding back spending in other areas. Though BoJ governor Kuroda will never admit it, there is no longer a functional inflation target: two percent is just a long-term aspiration, and is probably unachievable without aggressive fiscal cooperation, FX intervention, and helicopter money – none of which seem likely from the new(ish) Suga government whose team is largely the same as Abe’s. That does not mean the BoJ is unimportant: it is now dominated by the fiscus and must monetize debt issuance. While theoretically, the Ministry of Finance could just issue T-bills to the private sector, this would risk banks or other savers looking elsewhere for higher returns; instead QE creates excess reserves – assets in the banking system – which must stay on the central bank’s balance sheets as costless liabilities. Combined with a bit of financial repression this creates a stable, if boring equilibrium.

There is little push for more fiscal or monetary innovation, but on structural reform, a digitalization drive is potentially important: while it may not be the accelerated change some think COVID is ushering in, it should help to lift productivity and raise profits and investments, particularly at struggling SMEs. PM Suga seems to want modernization of these aspects of the economy as his legacy, and the establishment of a Ministry for Digitalization lets the government take the lead on replacing paper for transactions, forms, customer and business services, and promoting investment across the private sector as well. There is also a push for more efficiency as SMEs as well as consolidation of rural banks. Given the current crisis, investment in remote access and communications makes sense as well, even after COVID has come and gone. Assuming the government reforms are not too unpopular or painful, and especially if the Tokyo Olympics proceed, it seems highly likely that PM Suga will run, and win, another term – the only question is timing. A Q1 election cannot be excluded, but a “post-pandemic” success seems more natural, after the Paralympics wrap up; in any case the Diet’s lower house term ends on 22 October, 2021.

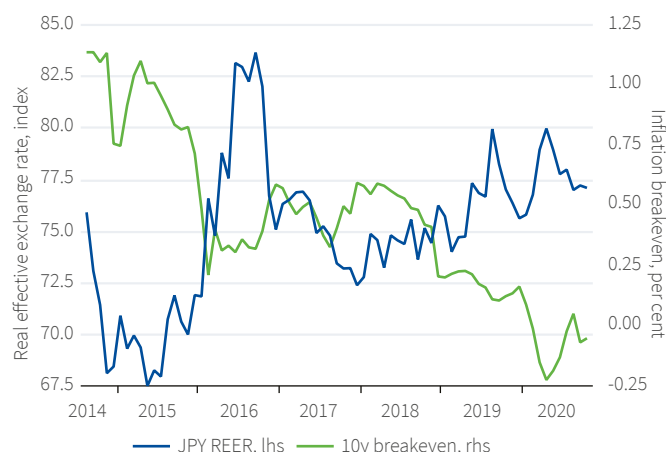
Reform is PM Yoshihide Suga’s focus, on which he will run a campaign sometime in 2021

Figure 71. Current account supports yen appreciation



Source: Aviva Investors, Macrobond as at 3 December 2020

Figure 72. A strong yen may be an inflation headwind



Source: JPMorgan, Bloomberg, Aviva Investors, Macrobond as at 3 December 2020

China: stronger and bolder

- The COVID-19 crisis is almost over from a domestic perspective, but Beijing's large fiscal and credit stimulus is ongoing. Through 2021 this will wane, and monetary policy may move from easy towards neutral
- Tariffs remain on exports to the US, and negotiations with the new US administration will take time; decreased confrontation and some cooperation should support confidence, even as tensions remain
- President Xi, and China's current system, have emerged from the crisis strengthened and emboldened; the new 5-year plan emphasizes peaceful development, domestic demand, technology, and openness
- Tech decoupling is unlikely but 5G, semiconductors are areas where strategic competition remains

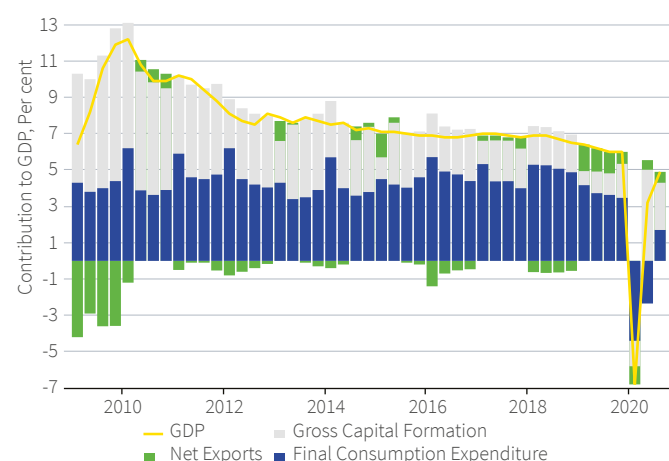
A year ago, it looked like China's economy could grow 6 per cent in 2020, with Trump's trade war finally on hold and the world economy picking up. And amazingly, Q4 output should be nearly 6 per cent above 2019's level, though obviously total annual output was disrupted and technically missed the official goal of doubling real GDP compared to a decade ago. Even China's able policymakers were proved not to be omnipotent in the face of a virus that required limiting activity – particularly face-to-face services, tourism, and entertainment. While China has rebalanced, investment is still a very large proportion of output, and state-directed spending could not fully cushion the economy (Figure 73). For the year, 2020 GDP will grow 1.8 per cent y/y, and because of base effects, we expect 2021 to grow a further 9 per cent, even though annualized sequential quarterly growth is expected to be “only” about 5.5 per cent. This is near its long-term trend, though there is still an internal rotation to manage: infrastructure and public investment will wane while household consumption of goods and services still has some way to go before fully normalizing (Figure 74), after which growth will decline to 5 per cent. In coming years it may slow further, but we expect Beijing to be less wedded to hitting a precise target, as other development goals become more important.

Of course, all of this depends on China's own vaccine creation programmes bearing fruit: manufacturing billions of doses both for domestic use and for export to other countries, including many poorer countries ignored by the rich world. China's joining the WHO's COVAX plan underscores its leadership and provides a contrast with the US's absence, though that shirking of global citizenship may be changed once the Trump presidency ends. Engagement with China is mandatory: the country records \$4.8 trillion in annual trade with the rest of the world, has invested over \$2 trillion in direct investment abroad, while \$3 trillion has

China is growing at a 5.5 per cent rate, which will take 2021 GDP to 9 per cent above 2020's depressed level

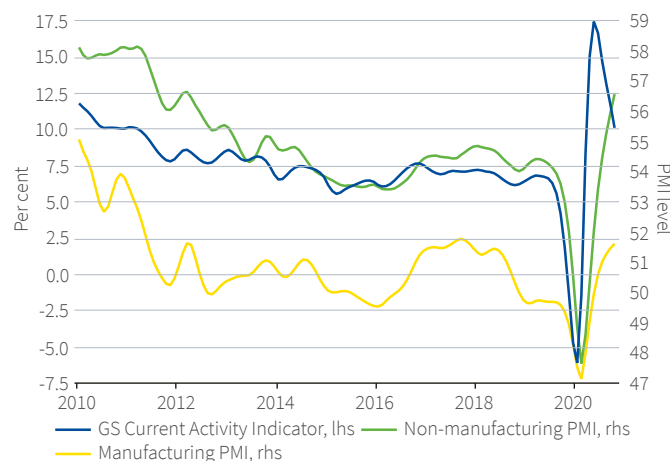
China is trying to step into the geopolitical vacuum opened by US unilateralism

Figure 73. Investment cushioned brief recession



Source: China NBS; Aviva Investors, Macrobond as at 3 December 2020

Figure 74. Growth momentum supported



Source: Bloomberg, Markit, Goldman Sachs, Macrobond as at 3 December 2020

been invested in China, which thus represents an important source of profits and jobs for multinational corporations. The unilateral confrontation of the past four years has not changed this trend, and China remains an autocracy that continues to invest heavily in improving its military, even as it has not been bellicose during its investment and development phase. Nor have China's human rights or foreign malfeasance materially shifted, though progress on corruption and market opening have improved, and pressure on intellectual property rights has yielded some improved protections, at least on paper. Although the trade and tariff wars may soon be over, the new US administration will still view China as a strategic competitor, and will arguably do a better job in corraling its allies into concerted action. Whether this takes the form of constructive negotiation and diplomacy, or continued sanctions and quarrels with negative repercussions, remains to be seen. The strains of this theme have not gone away, even as they have played second fiddle to the Coronavirus throughout 2020.

China's management of the crisis has been impressive: the development model has weathered Trump's misbegotten trade war and the COVID-19 crisis, stepping into 2021 on the front foot. As with previous shocks, fiscal and monetary authorities working in tandem combined with state control over wide swathes of the economy allows for GDP being a policy target. However, targeting the quantity of one variable means loss of control over other dependent variables: credit must grow to whatever level is needed to achieve growth (Figure 75). The Chinese official government deficit is kept low – though it did increase to 3.6 per cent in 2020, and should decrease back to 3 per cent next year – so banks, state-owned corporations and local governments must borrow to fund projects that produce the desired level of activity. It is for this reason that, as with the last credit-fuelled infrastructure push, Beijing is keen to rein in stimulus before financial instability risks get too big. The sheer scale of the increased indebtedness shows why: Total Social Financing was already rising at a 14 per cent clip at the end of 2019, to offset the Trade War and a global slowdown, but the past 12 months have seen it increase at a staggering 40 per cent y/y from \$320bn to \$460bn per month! While as always, some of these funds refinance existing debt or have not been deployed, in the four months since June, Fixed Asset Investment is growing 14 per cent y/y, far in excess of nominal GDP. Similarly, after painful progress on private deleveraging from 2017-18, debt levels have risen sharply again this year. Fiscal and credit easing will have to be normalized, along with other measures, though this tightening should be seen as move from very loose to more neutral rather than trying to turn policy settings to a restrictive posture.

This also includes the monetary stance: money market rates have risen ~100bps from the April lows (Figure 76). Key policy rates (LPR, MLF) will be kept at low levels, if they are raised at all, but CGBs and corporate yields should rise slowly from here; rising defaults meant that as in 2019, loan rates fell much less than government bond yields (Figure 77). Inflation is quiescent, despite base effects that will depress CPI (to around 1-2 per cent) and lift PPI (to around 2-3 per cent assuming energy prices rise modestly); core CPI really is well below 1 per cent and a strengthening CNH is likely to contribute to less loose monetary conditions. We expect the Peoples Bank Of China (PBOC) to manage the renminbi to appreciate gradually on a trade

Credit growth accelerated in order to support growth

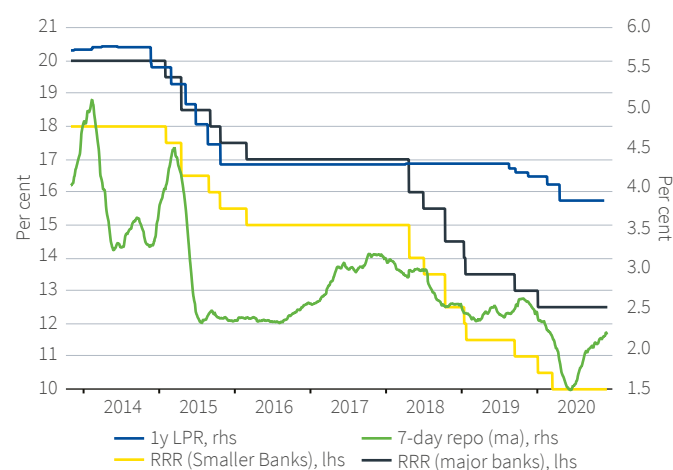
Fiscal and Monetary policies are normalising from ultra-loose levels

Figure 75. A fourth credit-fuelled infrastructure push



Sources: Bloomberg; Aviva Investors, Macrobond as at 3 December 2020

Figure 76. Very easy PBOC policy is reversing



Source: Aviva Investors, Macrobond as at 3 December 2020

weighted basis – justifiable given the burgeoning trade surplus (Figure 78). Against a basket of currencies, the exchange rate is still about 3 per cent below the late-2015 / early-2016 high. Resolution on tariff issues and trade with the new US administration could boost the currency, and the economy, even further.

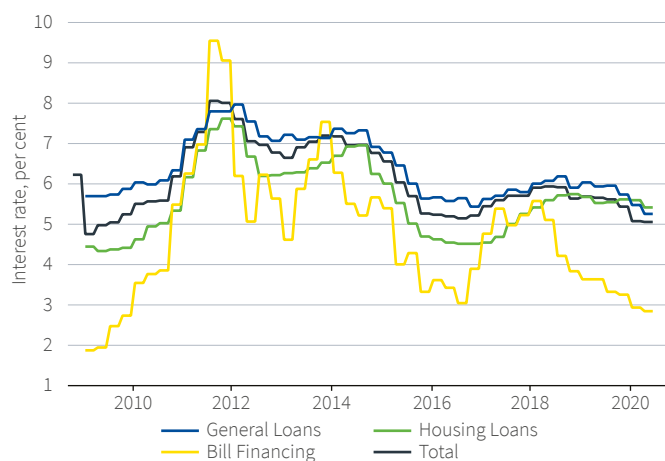
Looking out further, the 5th Plenum of the 19th Party Congress set out economic and social goals, though further details will be ironed out in the 14th NPC in March 2021. This will set goals for various ministries, the minutiae of which will be made more clear as they begin to be implemented Q2 onwards. Near-term growth targets have been abandoned, though doubling GDP is an aim for 2035 which implies a 4.7 per cent minimum annual growth rate in the medium term. The emphasis, though, is on “higher quality growth”: reforming the economy with the markets playing more of a role. Technological self-sufficiency and low-carbon power, industry and transport will be key areas pushed from the centre.

China will never score well on ESG metrics as long as it limits freedoms, lacks transparency, suffers from typical emerging market corruption, and is rife with government interference in business. Yet autocracy certainly has silver linings in achieving societal changes, as tackling COVID-19 has shown. China has previously focused on reversing the environmental damage caused by pollution from rapid industrialization and dependence on coal, but its rulers are now turning their attention to climate change. President Xi announced the ambition to get to peak carbon emissions before 2030, and in a potentially transformative announcement, pledged to get to net zero by 2060. As with other goals, the devil is in the details, but it surely foreshadows investment and promotion of electric vehicles, alternative energy, and carbon sequestration technologies, with benefits for both domestic and global companies that can contribute to this burgeoning value chain.

China’s relatively nascent “dual circulation” concept — using huge domestic demand to develop national champions and tech prowess while investing and competing abroad but avoiding “decoupling” — will be as much a challenge for China to achieve as it is for its trade partners, and may be seen as a threat by rivals. Moreover, President Xi is continuing to tighten his autocratic grip and allowing no dissent with Communist Party diktat as he builds a surveillance state and digests the early absorption of Hong Kong. These internal issues come alongside China’s projecting power and money through the Belt and Road Initiative, leading to concerns on human rights, corruption, and China’s growing geopolitical influence.

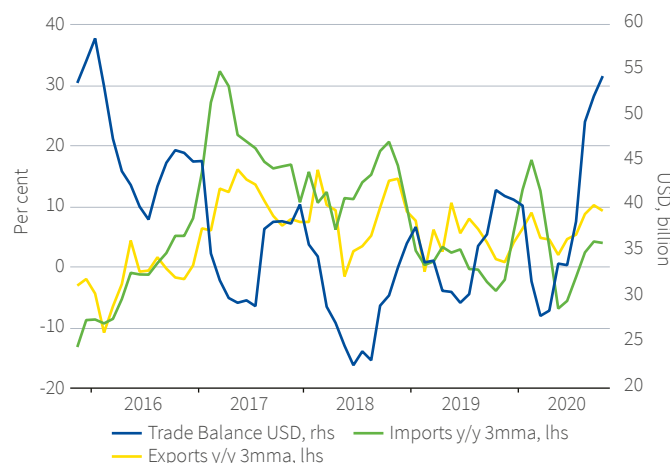
Tackling pollution and carbon emissions gets renewed emphasis in the 5th Plenum plans

Figure 77. Loan rates are down modestly



Source: Aviva Investors, Macrobond as at 3 December 2020

Figure 78. Exports did well during the COVID-19 crisis



Source: Aviva Investors, Macrobond as at 3 December 2020

Australia: more than just luck

- **Effective management of COVID pandemic puts Australia in strong position to rebound quickly**
- **Household have large savings buffer to draw on and easy fiscal policy is set to continue**
- **RBA could ease further, with little prospect of tighter policy for several years**

In 1964 a book by Donald Horne was published called “The Lucky Country”. It was a critique of Australia’s economic and political system, and the fact that despite its shortcomings, Australia rose to a high standard of living because of the democratic institutions it inherited from Britain and the endowments it had in the form of natural resources. Essentially, it got lucky. In the intervening years the phrase has morphed into a more favourable nickname for the country. But as we look towards 2021, perhaps there is reason to believe that rather than just relying on the luck of history and natural resources, that good policy-making will deliver superior economic outcomes for the country. Like the rest of the world, Australia has been greatly impacted by the COVID pandemic. However, a more rapid and forceful response from Federal and State governments saw Australia limit the spread of the virus (although only after a second, more severe, wave than the first) and reduced community transmission to almost nothing by November 2020 – one of only a handful of large countries to achieve such an outcome. While the restrictions required to achieve that outcome resulted in a significant national decline in activity in 2020 H1 (and in Victoria in Q3 as well), the monetary and fiscal support packages were amongst the largest in the world. As a result of the fiscal support for households, disposable income rose sharply in 2020 (Figure 79). With household spending on services constrained by restrictions, and the substitution into goods far from complete, households have built up a considerable buffer of savings. With the exception of the United States, no other country has supported household income to such an extent.

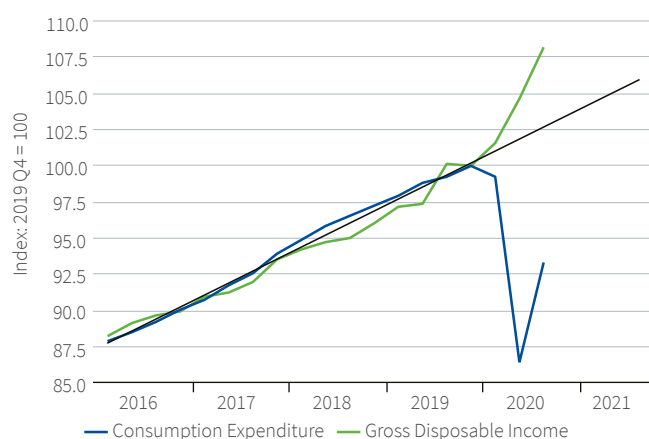
With COVID cases largely eliminated and the restrictions on activity eased, the pace at which the economy can continue its recovery through the end of 2020 and the start of 2021 should be better than elsewhere around the world. Indeed, outside of Victoria where restrictions were less harsh due to low case numbers, final demand was already back to only 2 per cent below pre-COVID level in 2020 Q3. Looking further into 2021, the roll-out of COVID vaccines should further reduce uncertainty and allow for a re-opening of the service sector, including tourism and foreign students. Indeed, business and consumer sentiment have already rebounded

Rapid and large-scale fiscal and monetary policy support, alongside effective restrictions to stop the spread of COVID, have put Australia in a strong position

We expect rapid growth in 2021, with pre-COVID level to be reached by Q2

Figure 79. Household income and spending

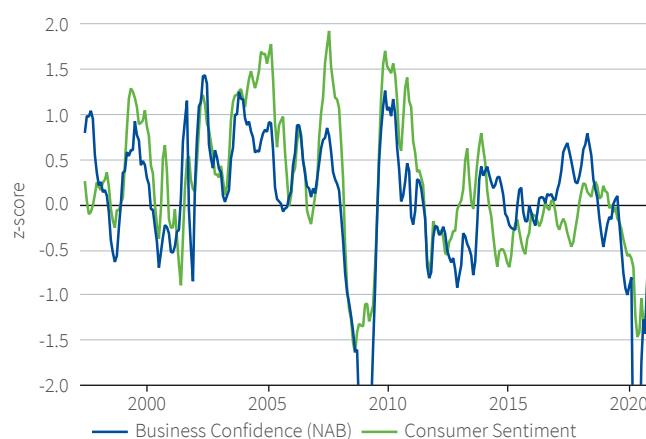
Fiscal support has boosted income and will support consumption



Source: Aviva Investors, Macrobond as at 3 December 2020

Figure 80. Business and consumer confidence

Re-opening and vaccine news have boosted sentiment



Source: Bloomberg, Aviva Investors as at 3 December 2020

sharply in recent months (Figure 80). Moreover, the global recovery should support demand for Australian commodities. As a result, we expect the economy to surpass its pre-COVID level of activity by 2021 Q2 and for growth over the year as a whole to be around 4 per cent. One area of risk to the growth outlook could come from a further escalation in tensions with China. As Australia's largest trading partner, China can have a meaningful macro impact should the spate of recent tariffs and quotas on certain goods such as wine and barley extend into more important commodities. Iron ore remains the most important, and throughout the recent diplomatic dispute it has not been impacted. We expect that to remain the case, as China would not be able to easily source iron ore elsewhere, but it is a risk.

The fiscal support for households and businesses to bridge through the COVID restrictions has been vital. But perhaps even more significantly, the recent Federal Budget brought forward planned income tax cuts and announced new spending measures that are expected to see the budget stay in deficit for the next decade, a stark change from the last Budget update in late 2019 (Figure 81). With deficits projected to last longer, the ratio of government debt to GDP is expected to rise sharply in 2020 and 2021 and largely lock those increases in over the medium term. This represents a significant departure from the more austere fiscal stance post-GFC and comes with something akin to fiscal forward guidance, whereby the government has committed to keeping fiscal policy as loose as necessary to bring unemployment back down below 6 per cent.

In addition to the new fiscal outlook, the Reserve Bank of Australia has also undergone somewhat of a reset in its policy outlook. Following the reduction in policy rates to zero, yield curve control and the introduction of large-scale Quantitative Easing they have indicated that they will be placing greater emphasis on actual, rather than forecast inflation in determining their policy stance. With inflation well below the RBA target range of 2-3 per cent (Figure 82), and expected to remain there for the foreseeable future, the potential remains for further easing, with any tightening in policy likely to be years away.

The policy mix is one that should benefit growth in both the short and medium term. Increased public investment should take up some of the slack in private investment, which is expected to pick up more materially in the second half of 2021. While the low interest rate environment, alongside strong income growth is expected to support a rapid recovery in the housing market, reversing the drag from construction in recent years. However, that does present a future risk, with Australian households already amongst the most heavily indebted in the world. That may ultimately require further policy intervention down the track to once again tighten borrowing standards.

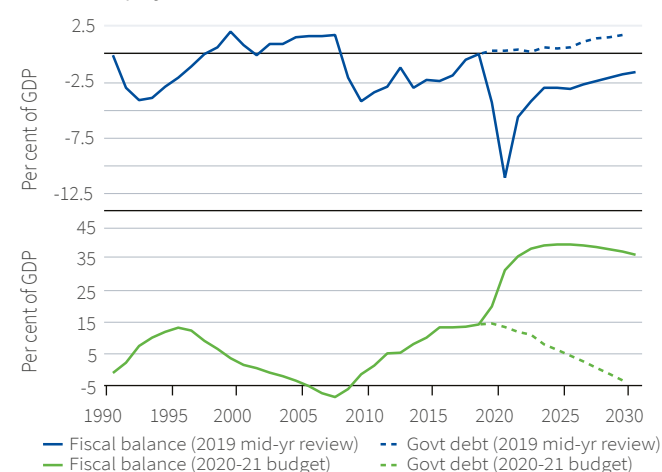
Fiscal to play a bigger role in boosting long-term growth prospects

RBA expected to keep monetary policy very easy for several years

Stretched household balance sheet remain a risk

Figure 81. Fiscal projections

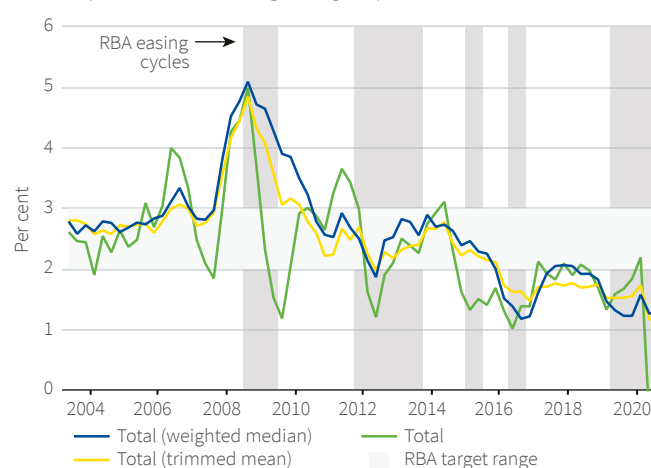
Deficits now projected over the next decade



Source: Aviva Investors, Macrobond as at 3 December 2020

Figure 82. CPI inflation

Extended period below the target range expected to continue



Source: Aviva Investors, Macrobond as at 3 December 2020

Canada: a difficult winter

- Canada is seeing resurgent infections in a worrying second wave
- Renewed restrictions will slow growth in Q4/Q1 but it should pick up sharply later in 2021
- Fiscal and monetary support will remain supportive for some time

Like many other nations, Canada is experiencing an alarming second wave of COVID-19 infections. Although the death rate is not as high as that reached during the first wave, it is still rising and pressure on hospital capacity is also increasing again. What is perhaps more worrying is that in Canada's case there is, as yet, no visible sign of trends changing despite new restrictions on activity having been in place now for some weeks (Figure 83). As elsewhere, vaccine deployment will eventually help to change both economic and medical outlooks fundamentally. Canada is well-placed here, having ordered more vaccine doses per capita than any other major developed nation. In the shorter term, prospects are less upbeat, with the possibility (likelihood really) of more selective containment measures being imposed, largely at a regional (province and city) level. These will obviously result in a renewed hit to growth in Q4 that could yet stretch into early 2021. Canadian GDP fell by more than 11 per cent in Q2 but rebounded strongly (+8.9 per cent) in Q3. Canada is one of the few countries which reports a monthly GDP series, and that further layer of granularity already reveals a clear loss of momentum that is set to worsen over the winter months (Figure 84). Overall activity is still some 5 per cent below the pre-COVID level and if growth now stalls again, that GDP high water mark is unlikely to be breached until early 2022.

Canada has seen the same patterns as elsewhere in terms of components of demand. The retail goods element of consumer spending has revived quickly as households have swiftly adapted to new ways of shopping, while services expenditure has been more subdued, adversely impacted by the effects of social distancing, official containment measures and more cautious attitudes from firms and individuals. As is the case in its larger neighbour to the south, Canadian households have benefited greatly from an unprecedented level of fiscal support as the Government aims to ensure that incomes are maintained during these difficult times. The various support programmes to businesses and households combined are estimated to have distributed almost C\$200bn (11.5 per cent of GDP) by the end of Q3. (Fiscal support overall is expected to approach C\$500bn.) They include enhanced unemployment benefits and the Canada Emergency Response Benefit (CERB), whereby around one-third of Canadian adults unable to work received up to C\$500 a week for a four-week period. There are also wage and rent subsidy programmes for business owners as well as bespoke schemes

Growth has already slowed markedly before the impact of renewed restrictions has been fully felt

Households and businesses have been supported by generous fiscal assistance

Figure 83. Canadian virus cases are rising sharply

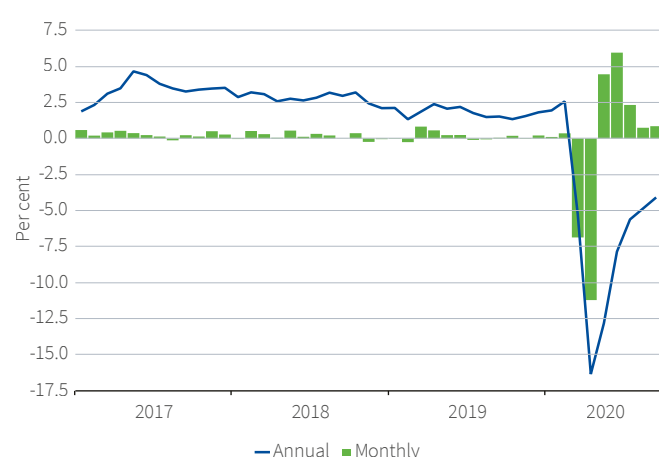
Canada: COVID-19 cases and deaths, daily change, 7-day mavg



Source: Aviva Investors, Macrobond as at 3 December 2020

Figure 84. Growth momentum has already slowed

GDP growth rates



Source: Aviva Investors, Macrobond as at 3 December 2020

to assist students, the disabled, farmers and fishermen. The Government has committed to retaining most of these schemes until the pandemic subsides, with the exception of the CERB which was always intended to be temporary. Overall, Statistics Canada reports that household incomes rose by more than 7 per cent in the last nine months, with much of that attributable to Government handouts in Q2 (Figure 85). The savings rate was still running at more than 15 per cent at the end of Q3, well above the average over the last two decades of a little under 4 per cent. The improvement in virus trends over the summer allowed many to return to work (and transfers to stop) which led to a retracement in overall incomes as Government payouts dropped or were withdrawn. It remains to be seen whether any such programmes will have to be reinstated over the winter because of new restrictions on economic activity.

Monetary and fiscal policy support is set to remain in place for many months. The Bank of Canada (BoC) recently reasserted that its QE purchases will continue until the recovery is “well underway” and indicated that policy rates are not expected to change until 2023 at the earliest. It is also widely believed that the BoC will next year follow the Fed’s lead and adopt a more flexible inflation-targeting regime. The federal government has signalled that they will continue to provide a high level of fiscal stimulus to support the economy through the crisis and, crucially, into the post-pandemic period of growth as well. The budget deficit is expected to reach a record 17.5 per cent of GDP this year and only to fall to about 8 per cent the following year. Wage subsidies, rental and credit support for business and loan guarantee programmes have all been extended well into 2021. The general principle being adopted is that if companies can operate and workers work, then they should do so. But if that is not possible because of COVID restrictions, then help is at hand and can be accessed.

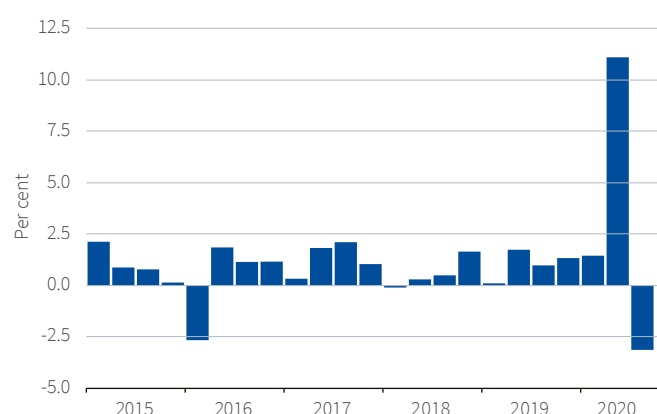
As elsewhere, although the overall picture is one of ongoing recovery in 2021, it may start slowly. Activity in the travel, leisure and hospitality sectors will remain well below pre-crisis levels and require ongoing support to prevent lasting damage. Until the COVID crisis is truly beaten, uncertainty will remain elevated and sentiment will be heavily impacted by local trends in case numbers and pandemic policy. As in the US, there is two-way risk for households: a greater belief in future recovery may bring forward spending financed by running down savings. But continued worries about the virus or future prospects may lead to a more precautionary approach. As always, the oil price is important for Canada. If that is boosted by a global recovery, that will be an important additional boost for the country. GDP growth should reach around 5 per cent next year (Figure 86).

Monetary and fiscal support is expected to remain in place until well into 2021

Recovery should pick up speed next year, helped by a return to growth in world trade and, perhaps, by a higher oil price

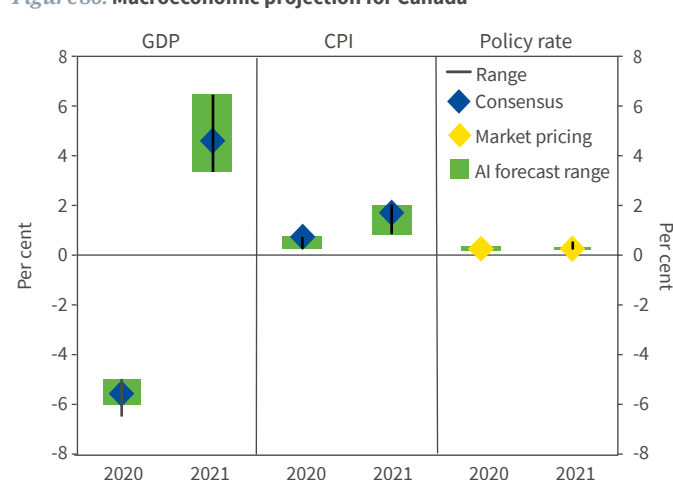
Figure 85. Household incomes boosted by handouts in Q2

Household disposable income, q/q percent



Source: Aviva Investors, Macrobond as at 3 December 2020

Figure 86. Macroeconomic projection for Canada



Source: Aviva Investors, Macrobond as at 3 December 2020

Asia ex-Japan: big Vs and little vs – varying recoveries across a diverse region

- North Asia fared far better during the COVID shock, suffering less and rebounding fast, buoyed by Tech exports and success containing the pandemic
- Central bank easing and fiscal loosening are important countercyclical measures, and have reached unprecedented levels; low inflation (apart from India) allows for some further easing
- Though Asia has prevented uncontrolled spreading of the virus, vaccine deployment will further the inequalities between and within countries; still, all will benefit from growth in China and restored global activity and tourism

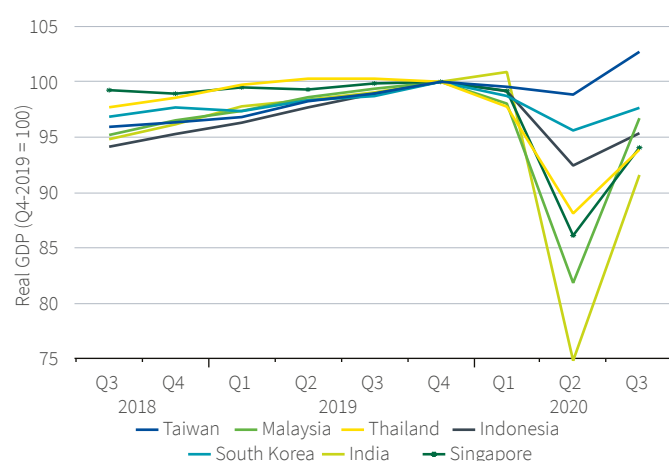
India: The Indian economy experienced some of the strictest lockdowns to contain the pandemic and is beginning to show signs of recovery, with a notable improvement in several higher frequency activity indicators. Manufacturing PMIs have rebounded strongly, industrial production is picking up, and tax receipts have also recovered. After an expected contraction of 9.4 per cent in FY 21 (Figure 87), the economy is anticipated to grow 10.2 per cent in FY 22 driven by a combination of low base, continued fiscal support and a rebound in consumption. Inflation has been uncomfortably high, coming in far above the RBI's target range; elevated vegetable prices are the primary cause, although core inflation has also risen above 5 per cent (Figure 88). Looking ahead to FY 22, inflation is expected to moderate to 4.4 per cent assuming normal monsoon conditions. A retracement in inflation and still nascent economic recovery point towards the RBI being on an extended pause, maintaining its accommodative stance. India's current account has adjusted to a surplus for the first time in more than 10 years, and in combination with strong capital flows led to a healthy basic balance surplus. While the current account will likely revert to a modest deficit in FY 22, ongoing capital flows will maintain strong external dynamics and demand for the Rupee; we expect further appreciation even as the RBI continues to slow appreciation pressures by building FX reserves.

Korea: Korea weathered the 2020 crisis well, after entering the year with 2019 growth slowed down by the global weakness. Thanks to the pandemic being well-contained, and powerful fiscal support/stimulus, domestic activity bounced back quickly and lockdowns never needed to be as long and severe as elsewhere; GDP growth should post only a small, 1 per cent drop this year while next year recovering to around 3 per cent y/y. That should still mean little inflation pressure, though rents are an upside risk. CPI is barely above zero now and will be near 1% at

India is recovering strongly, as the RBI looks through uncomfortably high inflation

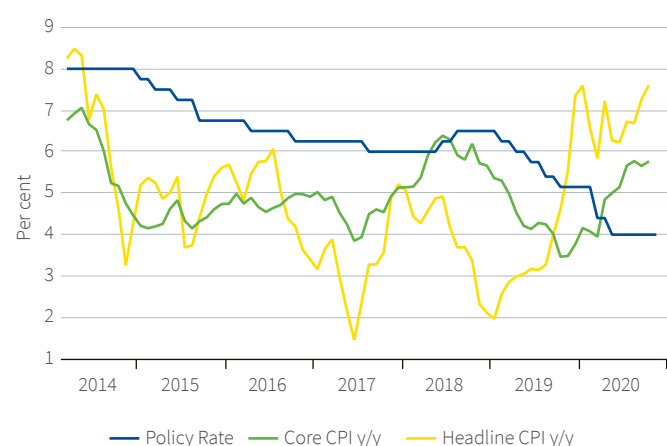
The Korean Won is under upward pressure, as exports support an economy that suffered relatively little

Figure 87. Recessions ranged from deep to mild



Source: Aviva Investors, Macrobond as at 3 December 2020

Figure 88. India cut rates, ignoring high inflation



Source: Macrobond, Indian Ministry of Statistics as at 3 December 2020

the end of 2021: no need for the BoK to change its accommodative stance. Meanwhile, exports are now up y/y, after their initial 25 per cent drop, while a low oil price has helped the current account surge; the KRW is under strong upward pressure as exports are recovering strongly (Figure 89). It is unclear how the central bank will respond if it views the exchange rate as disruptive to inflation or exporters; tech exports are a tailwind, while potential sanctions of exports to Chinese companies are a downside, at the margin.

Taiwan: One of the few geographical areas to avoid any y/y growth declines in 2020, Taiwan's GDP grew even in the horrible Q2-2020, eking out +0.4 per cent y/y gains thanks to strong growth in late-2019, even as the island's economy suffered a minor technical recession in H1-2020. Taiwan has had barely any COVID cases at all: just 700 in total for a population of 23 million (Figure 91). Sophisticated track-and-trace capabilities enabled authorities to limit damaging lockdowns, while demand for electronics around the world soared, lifting exports (Figure 89). Solid GDP growth of ~3.5 per cent should continue in 2021 and slow slightly the year after, but like Japan and Korea, an ageing population and high savings are disinflationary; CPI should rise slightly but will struggle to get much above 1 per cent on a sustained basis. Risks of deflation and mercantilist competitive instincts make the Bank of China wary of allowing the TWD to appreciate rapidly; stealth interventions and manipulated fixings have been par for the course, but if the USD is weak enough – especially against CNH, KRW, and JPY – the Taiwan Dollar will follow.

Malaysia: Malaysia, along with many of the economies in the ASEAN region, faces an uneven economic recovery given the flare up in COVID infections and limited resumption of tourism until vaccines are rolled out. The economy is expected to grow 6.5 per cent in 2021 driven by an increase in public investment and private consumption, reversing a 5.5 per cent GDP contraction in 2020. Headline inflation has been negative since March driven by oil and utility prices but is expected to recover to 2 per cent in 2021. After 125bps of cuts in the policy rate, we expect BNM to be on hold throughout 2021 as the economy rebounds and inflation picks up. After reaching the highest level in almost a decade despite the loss in tourism revenues, the current account surplus is likely to moderate in 2021 but should still provide support for the Ringgit alongside its relatively attractive valuation. The political outlook is a source of uncertainty, with potential for elections in early 2021 given the narrow government majority.

Indonesia: The Indonesian economy is expected to rebound with GDP up 4.7 per cent in 2021 after contracting 2 per cent in 2020. The authorities continue to struggle with high levels of COVID cases and this will weigh on recovery with household consumption anticipated to remain below trend in 2021. Meanwhile, inflation has fallen steadily since the pandemic outbreak and is expected to remain below the 3 per cent midpoint of the Central Bank's target through 2021. While most of the central banks within the ASEAN region are likely to be on hold, there is room for Bank Indonesia to extend the easing cycle given the shallow recovery, absence of inflationary pressures and a macro framework that points towards stability in the Rupiah. We expect a further 25bps cut to the policy rate to end the easing cycle which has seen rates

Taiwan suffered one of the shallowest recessions in the world, with barely any damage; demand for tech leads the rebound

Political uncertainty clouds the outlook in Malaysia, whose economy has fared poorly

In Indonesia, low inflation and a stable currency may allow further monetary easing

Figure 89. North Asian exports buoyed by tech



Figure 90. Thai Baht rebound will rely on tourism



Source: Aviva Investors, Macrobond as at 3 December 2020

Source: Macrobond, Indian Ministry of Statistics as at 3 December 2020

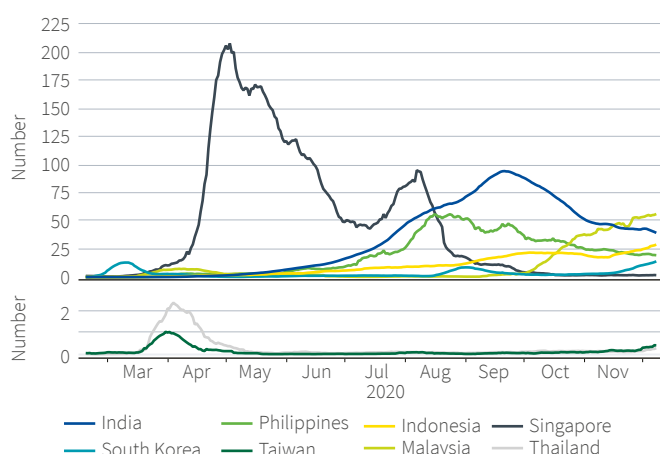
reduced by 125bps in 2020 and cumulative 225bps since the 6 per cent peak in 2019. The current account deficit is expected to widen modestly next year but will remain small as imports stay subdued. The recent passing of the Omnibus law aimed at improving Indonesia's business and investment climate should contribute to higher FDI over the medium term and reduce reliance on more volatile portfolio flows. A balance of payments surplus and potential for foreign investors to return to the Indonesian bond market after outflows in 2020 points to a favourable outlook for the Rupiah.

Singapore: The island-state's economy rebounded strongly following the easing of COVID-19 lockdown restrictions but will still contract by 6 per cent in 2020. A 5.5 per cent GDP rebound in 2021 should be driven by domestic demand and stronger exports. It is expected that Singapore's output will return to pre pre-COVID-19 levels in H2 2021. We expect a cautious stance from the MAS until it becomes more confident in the recovery and the roll-out of the vaccine. The Singapore Dollar nominal effective exchange rate (NEER) has been stable since the rapid decline in March which was aligned with a policy easing and a recentring of the band at a weaker level. The MAS has committed to an accommodative stance, but we don't anticipate further easing in 2021, keeping the trade-weighted SGD rangebound.

Thailand: The Thai economy has rebounded strongly led by external demand and private consumption and is expected to expand 4 per cent in 2021 after a near 8 per cent contraction in 2020. Although Thailand had relatively low numbers of COVID-19 cases and deaths (Figure 91), the economy is one of the worst affected in the region given its high dependence on tourism, which made up around 12 per cent GDP in 2019. While the vaccine news could provide an upside surprise, the tourism sector is likely to take a long time to recover. Alongside the economic recovery and higher oil prices, inflation will rise, but only to a still-subdued 1 per cent y/y in 2021, which is merely the lower end of the central bank's target range. We expect the Bank of Thailand will maintain rates at current levels while attempting to limit Baht appreciation (assuming a vaccine allows visitors to resume travel; Figure 90); the currency is supported by the current account surplus and limited capital outflows.

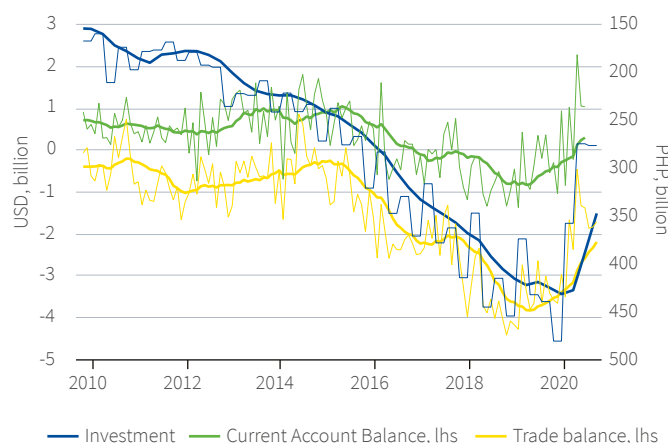
Philippines: The pandemic plunged the Philippine economy – recently among the fastest growing in Asia—into a deep recession in 2020 (Figure 89), with GDP not likely to return to its pre-COVID levels till mid-2022. The economy is expected to contract 8% in 2020 before recovering 7.5% in 2021. The resumption of major infrastructure projects, which have been a key contributor to growth, are only likely later in 2021 suggesting a tepid recovery till then. With those public investments on hold and domestic demand depressed, the trade balance has adjusted accordingly with the current account moving to surplus for the first time in three years (Figure 92). The current account dynamics provided support to the Peso and saw the BSP accumulate US\$10bn in FX reserves. Given current valuations – the real effective exchange rate is at elevated levels – it is likely the BSP will have less tolerance for further gains and will likely continue to intervene and build reserves. After cutting rates by 25bps to 2% in November, the need for continuing policy support, and with inflation likely to remain in the bottom half of the target band, suggests room for a more accommodative policy stance ahead.

Figure 91. Asia has fought off the pandemic
Coronavirus: 2 weeks' cases per 100k population



Source: ECDPC, Aviva Investors, Macrobond as at 3 December 2020

Figure 92. Investment abates, driving swing in Philippines' BoP
Philippines: fixed investment and trade data



Source: Philippine CB & stat agencies, Aviva Investors, Macrobond as at 3 December 2020

Singapore's central bank, the MAS, seems unlikely to further devalue the Singapore Dollar

An outsized exposure to tourism makes Thailand more dependent on vaccine success

The large investment spree has ended, reversing pressure that had previously widened the current account deficit and weakened PHP

Latin America: socially distanced

- Social impact of the health crisis is likely to be prolonged
- Prospects for growth recovery appear favourable given the rebound in China
- Political landscape will remain a source of uncertainty

The COVID-19 crisis has hit the region particularly hard across social, political and economic channels and with potentially long-lasting effects. With a weak economic backdrop as the starting point (Figure 93) the crisis has amplified existing political uncertainty in Brazil and Peru whilst exacerbating social unrest in previously stable countries such as Chile. Previously assumed limitations to policy support in the region have been discarded in favour of social and economic support implying that debt sustainability challenges (Figure 94) will remain a key consideration for investors going forward. In response to the pandemic, interest rates in the region have been taken back to recent lows (Figure 95). With inflation largely low and under control (Figure 96), that should prove no obstacle to ongoing policy support.

There are reasons for optimism based largely on expectations for ongoing global reflation and specifically the outlook for China and related commodities. Growth levels are expected to improve throughout 2021 supported by improving terms of trade and the increasing likelihood of vaccine support, however the crisis has uncovered a great deal of underlying angst amongst populations aimed at social and financial inequalities which will continue to inform an uncertain political backdrop in the region.

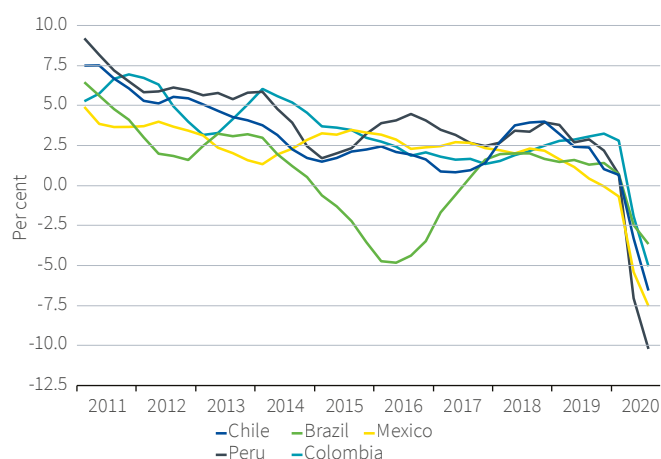
Brazil is set for a growth recovery in 2021. However, the lasting effects of one of the highest global COVID-19 death tolls and elevated levels of debt could cast a shadow over Bolsonaro's popularity whilst placing further doubt in investors' minds with respect to fiscal prudence. Those concerns need to be seen alongside sizeable FX reserves, low external debt and a central bank that will be willing to take a flexible approach to balance inflation, yet also embed a policy premium should policy makers not be willing to adopt a credible fiscal approach. The possible removal of stimulative policies in China will be key determinant of the external backdrop for Brazil next year, whilst social spending and tax reforms will inform expectations for fiscal consolidation.

By some social, political and fiscal metrics, Mexico has been a picture of relative stability within the region. However, the effects of fiscal prudence will become apparent next year and are likely to result in a shallower economic recovery than regional peers. Having started 2020 on a weak economic footing given ongoing geopolitical tensions, AMLO's surprisingly muted approach to economic stimulus throughout the COVID-19 crisis may result in a more

COVID-19 pandemic has hit the region hard

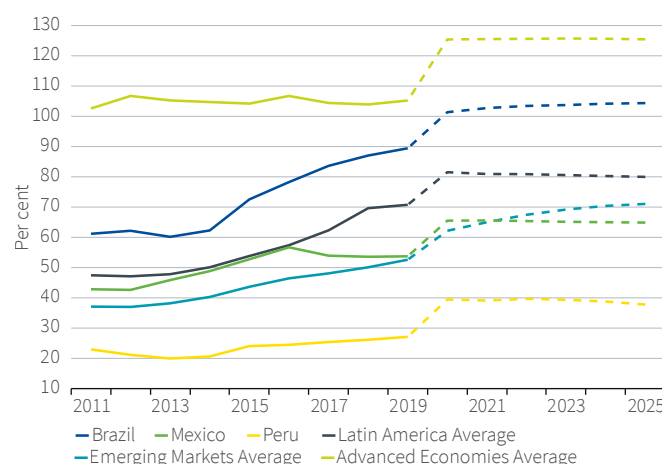
Brazil has been hit especially badly

Figure 93. Latin American annual GDP growth



Source: Aviva Investors, Macrobond as at 3 December 2020

Figure 94. Gross debt to GDP, per cent



Source: Aviva Investors, Macrobond as at 3 December 2020

favourable view from investors over the long term. However, the approach is likely to further exacerbate existing economic challenges in the short term. Private investment has been particularly weak in recent years which looks unlikely to improve next year, albeit Mexico should be a beneficiary of US fiscal stimulus in 2021 in the likely absence of its own major fiscal support. Inflation concerns are likely to validate the cautious monetary policy stance from Banxico into the new year, although investors should expect a moderation in inflation expectations and further policy easing as a result.

Political and social tensions in the Andean region have been a major cause for concern and look likely to remain so during 2021. In Chile, violent social unrest has ultimately led to both the formation of an entirely new constitution and challenges to the architecture of the domestic pension system, hitherto viewed as a bastion of Chilean institutional credibility. An overwhelming consensus voted for a new constitution in October and will return to the ballot boxes early in April 2021 to elect the new members, ultimately leading to a validation of that constitution in 2022 with general elections and a second round of Presidential elections likely in December. The starting point for the fundamental backdrop in Chile is one of strength and, despite a high degree of political and social uncertainty, the recent rebound in economic activity is likely to remain healthy due to the tailwinds from strong fiscal and monetary support together with domestic consumption from further pension withdrawals.

The political landscape in Peru has been particularly uncertain of late even by its own typically volatile standards. General elections are scheduled for April 2021 with an interim government in place until then following the appointment of three different presidents in seven days during November. An uneasy social backdrop and ongoing protests, amplified by the severe impact of COVID-19, as well as potential political reform will create more uncertainty for investors ahead of the general elections and likely inhibit the economic recovery during the early part of 2021. A populist fiscal approach should support the economy next year and, as in Chile, pension fund withdrawals will support domestic consumption. However, risks to the outlook will once again be framed by domestic politics and ongoing dollarization.

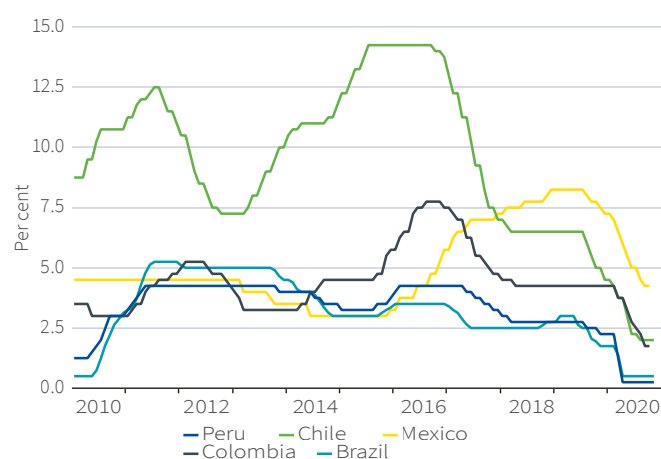
As a twin deficit country Colombia will continue to require a supportive external environment to enable the post COVID-19 recovery whilst avoiding the loss of its investment grade credit rating. Monetary policy is likely to remain supportive and could be complemented by moderate fiscal consolidation, albeit bringing questions on policy sustainability into view. Presidential elections in the first half of 2022 will also dictate plans for fiscal consolidation and reform, details for which should become available in the first quarter of next year.

Argentina is expected to agree a new IMF deal during the early part of 2021 as it seeks to resolve pre-COVID-19 concerns relating to debt restructuring and financial crisis measures. Policy levers were already limited, and Argentinian authorities will need to find the right balance to convince investors and the IMF that ongoing stabilisation is achievable.

Political and social tensions to continue into 2021

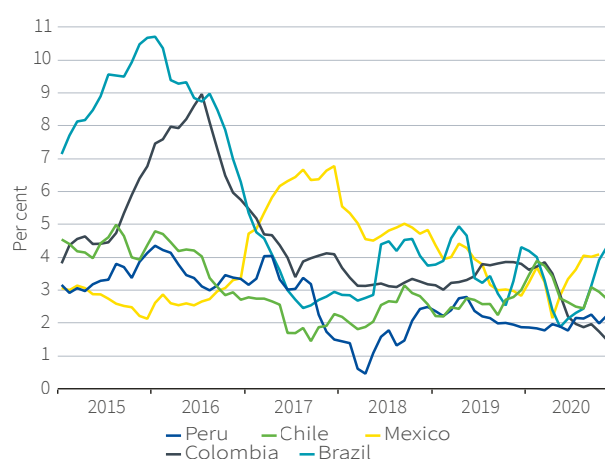
Policy to remain generally supportive in all countries

Figure 95. Policy rates in Latin America



Source: Aviva Investors, Macrobond as at 3 December 2020

Figure 96. CPI inflation across Latin America



Source: Aviva Investors, Macrobond as at 3 December 2020

Central Europe, Russia, Turkey and South Africa: a mixed bag

Central European countries have fared relatively better through the COVID-19 crisis than their western European counterparts. The benign course of the first wave of the Coronavirus pandemic, which resulted in early and short-lived lockdowns, were among the reasons. As a result, the damage to labour markets, business and household confidence was less than elsewhere in Europe. Prompt and significant, even by developed market standards, monetary and fiscal responses also helped. Poland, Hungary and the Czech Republic boosted public spending by more than 5 per cent of GDP. All central banks cut rates aggressively; in the case of Poland and the Czech Republic to near zero (Figure 97). In Poland and Hungary central banks rolled out sizeable bond purchasing programmes, worth in excess of 5 per cent of GDP and 3 per cent of GDP, respectively. Romania's response was more muted, having come into the crisis from a much weaker fiscal position. The new liberal government, which is expected to take office following parliamentary elections in early December 2020, is anticipated to put the economy on a more fiscally sustainable path. CEE-4 economies are expected to expand by 3 to 3.5 per cent in 2021-22, following an estimated contraction of 5 per cent in 2020. The European Recovery fund, if implemented as planned, should further support the central European economies and skews the risks to economic growth to the upside.

This fairly constructive economic outlook puts potential inflation pressures in central Europe in the spotlight. The recession in 2020 did not dampen inflation as much in CEE-4, as seen elsewhere in Europe (Figure 98). These economies were already running hot into the COVID crisis. Although prices in the region are expected to gradually converge to their inflation targets over the next two years, risks are skewed to the upside. Term premiums in the local bond markets, in Poland and Czech Republic in particular, don't seem to reflect that risk.

Russia's status as one of the most resilient countries in EM was re-affirmed in 2020. Government debt-to-GDP is low at 20 per cent, while the current account has remained in surplus. The economy contracted less than feared this year despite its oil dependence. An improved macro framework, healthier private sector balance sheets and a different policy response — counter-cyclical, rather than the previous pro-cyclical approach — all contributed. The government is expected to withdraw almost two thirds of its 3 per cent of GDP fiscal stimulus in 2021, likely containing the recovery to below 4 per cent next year (Figure 99). High real rates give the Russian central bank scope to cut rates early next year, particularly as the base effects from the currency as well as negative output gap curtail inflation. Recent upside inflation surprises may delay the decision to cut. Concern about geopolitical risks and sanctions keep risk premia

CEE-4 fare better than rest of Europe

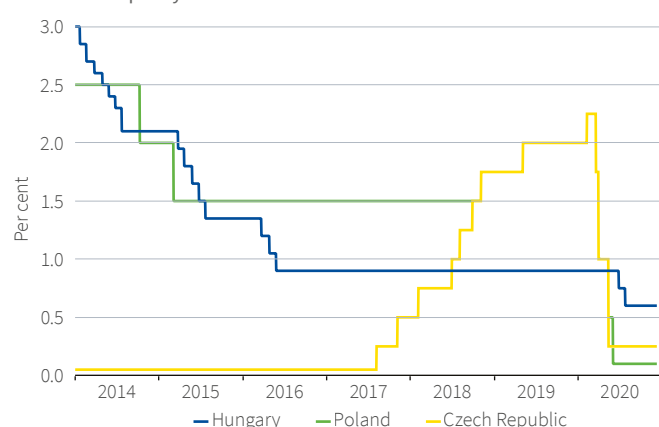
Inflation pressures may be underestimated

Prudent policies in the past paid off in the pandemic

Figure 97. Policy rates have been cut to lower bound

And central banks have increased QE too

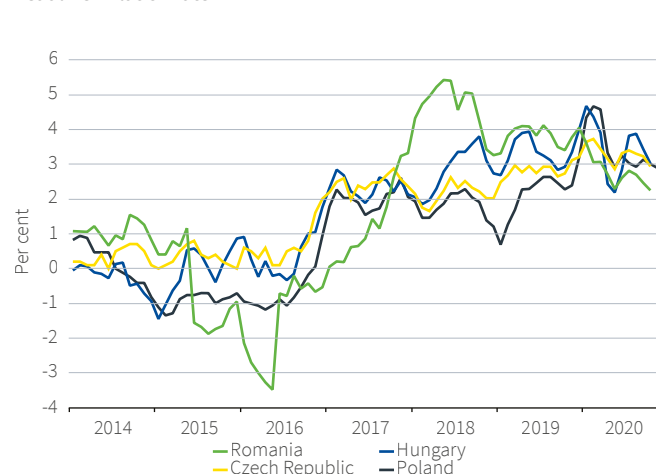
Central bank policy rate



Source: Aviva Investors, Macrobond as at 3 December 2020

Figure 98. Inflation rates have hardly fallen

Headline inflation rate



Source: Aviva Investors, Macrobond as at 3 December 2020

above the level implied by strong fundamentals.

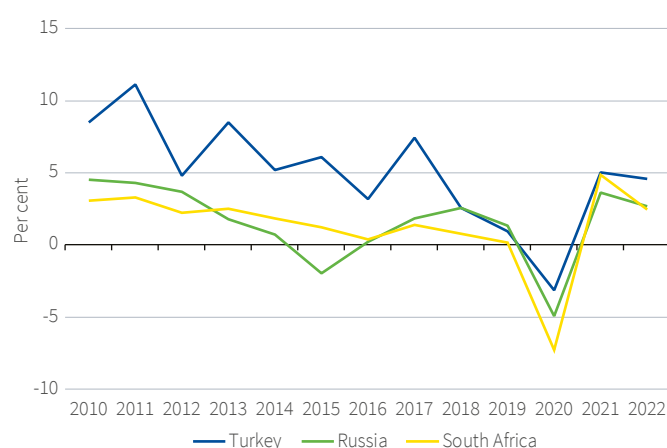
Excessively loose policy and limited foreign exchange reserves have left Turkey teetering on the brink of a balance of payments crisis. Recent policy actions by the central bank, as well as the departure of some key policy makers, suggest a potential return to more orthodox economic policy-making. Scepticism about their ability and willingness to engineer an economic rebalancing is high. The risk of a balance of payments crisis and the re-instatement of unorthodox policies remain. Next year will be crucial for the Turkish economy. Interest rates will need to be hiked again, perhaps as early as December 2020. The current account deficit should swing into a surplus and reserves will need to be rebuilt. The improved global backdrop, particularly liquidity, should aid their efforts. Geopolitics will remain front and centre in Turkey over the coming months, as the Biden administration takes office. A return to heightened risk aversion would leave Turkey among the most exposed larger emerging market countries.

South Africa came into the COVID crisis with stagnant growth, sharply rising government debt and limited appetite for reform (Figure 100). The pandemic has exacerbated these trends. While 2021 will see a cyclical recovery in growth, the extent of the upswing will likely be muted by still-ongoing challenges in the electricity sector, the need to consolidate public finances and limited reform momentum. In 2021, the budget deficit will likely remain in double digits as a per cent of GDP, among the highest in emerging markets and debt-to-GDP could touch 90 per cent. More meaningful fiscal consolidation rests on the government's ability to reach an agreement on containing wage growth with belligerent public sector unions. Wage negotiations have sparked violent protests in the past. Without a shift towards more meaningful reform and fiscal consolidation in the coming months, South Africa risks falling into the 'B' rating category. A short, sharp fall for a country rated investment grade less than four years ago.

Failure to reform will leave vulnerabilities further exposed

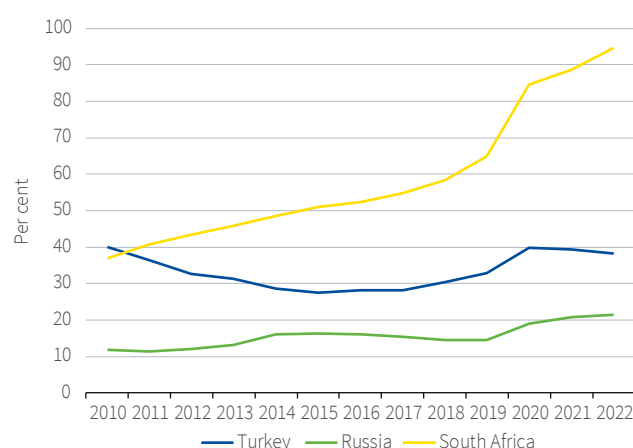
South Africa looks set to join 100 per cent debt to GDP club

Figure 99. GDP growth



Source: Aviva Investors, Macrobond as at 3 December 2020

Figure 100. General government debt (per cent of GDP)



Source: Aviva Investors, Macrobond as at 3 December 2020

Market Outlook



DM Equity: economic recovery to provide support

- Valuations are expensive, but earnings should support equity markets in 2021
- Rotation towards value, albeit bumpy, will continue into 2021
- Digitalisation of everything has taken a step forward during the pandemic

We believe that equities will build on their recent stronger performance and deliver positive returns in 2021. This is driven by an expectation of strong EPS delivery, and not much, if any, multiple compression. However, it is unlikely to be a straight line. In the near term, there will be weak economic data as COVID-19 restrictions in Europe remain in place, and there may yet be new restrictions in the United States. Moreover, while the progress on vaccines is undoubtedly good news, there are still questions that need to be answered regarding distribution, efficacy, safety and duration of immunity.

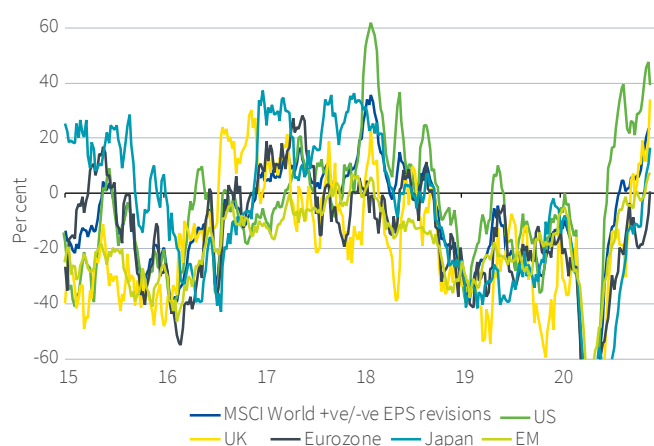
Across the headline equity indices, forward P/Es are uniformly expensive compared to history, as equities have strongly rebounded ahead of earnings already. Europe looks cheaper (relative to its own history) than most of the other regions including the US, Japan and EM. As at end-November, MSCI Europe's P/E at 15.8 is around 1 standard deviation above the long-run average.

The anatomy of stock market recovery after a recession is usually driven first by P/E expansion, as earnings continue to fall, then by an EPS rebound taking over the heavy lifting. We are already seeing this pattern emerging, with P/Es starting to fall year-on-year, and earnings starting to recover. Earnings growth is ultimately a function of economic growth. While 2020 has therefore been a very poor year for earnings, the low base effect of these levels sets us up nicely for a strong rebound in 2021. The second wave and winter soft patch are a worry, but the high efficacy of the vaccines provides reassurance on the medium-term view: that we return to a more normal economy by mid-to-late 2021, and that earnings are likely to continue to recover robustly. Higher commodity prices next year may also help earnings, as the two typically move closely together.

EPS revisions, a measure of sentiment towards earnings, have broadly picked up and are now back to flat/positive for all regions except Eurozone, which dipped lower again recently. We see a more uniformly positive picture when we look at the momentum of earnings, with strong upgrades being seen across all regions (Figure 101 and Figure 102).

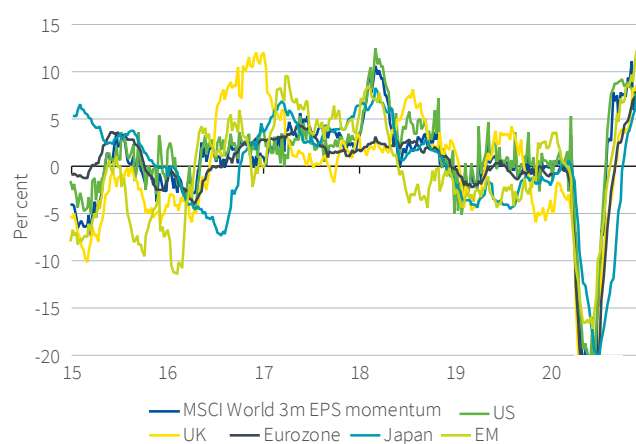
Vaccines and the economic rebound will power earnings

Figure 101. Earnings revisions (upgrades to downgrades) are back to flat/slightly positive for all regions except Eurozone



Source: Refinitiv as at 3 December 2020

Figure 102. ...and the earning momentum picture is showing upgrades across the board



Source: Bloomberg, Aviva Investors as at 3 December 2020

Beneath the surface, valuation dispersion at the European sector level is extreme, with some cyclicals like Discretionary, Industrials, and Tech trading well above historical averages. Some other sectors, like Energy and Financials, which are both “value” in style, are actually relatively cheap vs. their own history, despite earnings falling dramatically this year.

Nonetheless, the dramatic move lower in rates favoured defensive or secular growers. This has led the dispersion between value and growth valuations to near all-time highs (Figure 103), causing the defensive/quality/growth parts of the market to become exceedingly expensive relative to some of the cheaper and more cyclical value parts of the market.

The pattern of outperformance and underperformance of different market sectors and factors through the phases of the business cycle is termed “rotation”; these patterns might not repeat word for word, but they tend to rhyme. On analysing significant value rotations seen in the past, there are three key points to note: First, today’s starting point is lower than 2009, 2012 and 2016; second, EPS upgrades in these episodes have not been a key factor – in fact value saw EPS downgrades as they outperformed, driven by a re-rating of relative PE multiples. Third, waiting for the upgrades means missing significant gains, even though the re-rating does not stop at long-term averages but usually sees value stocks going from cheap to expensive.

Figure 104 shows a simple calculation for the relative price move required to get the relative valuations back to historic average (top vs bottom quartiles in each cases so the ~50% would be return of cheap stocks relative to expensive stocks on an equal weight basis). The blended value factor we use combines forward PE with trailing price-to-book (PB) and dividend yield.

As the roadmap to exit from the pandemic becomes clearer, with vaccines, testing and likely increasing population immunity, we have seen a degree of recovery in travel and leisure stocks. A lot of that rebound is already priced; the challenge for investors is to identify companies that strengthened their competitive and cost position in the downturn, and will see market share gains and stronger operating leverage into recovery.

We are less positive on business travel and office space which we see to be structurally impaired, as businesses will continue using remote working models post pandemic. Conversely, some companies, especially people businesses with premium real estate costs and significant business travel requirements will see material and lasting benefits via cost savings on travel and office space.

Financials were one of the casualties of the pandemic, due to the triple impact of the drop in interest rates, anticipation of credit losses and – in some markets – curtailment or outright ban of dividend payout.

For banks, low interest rates remain a headwind, although some banks are able to offset that through fee-based business and re-pricing of liabilities.

Growth and Quality have massively outperformed... Value and other laggards have begun a catch-up phase

There is good reason to believe this has further to run

Top Down and Bottom up converging towards value, albeit remaining selective

Figure 103. Extreme P/E dispersion between growth and value



Source: Refinitiv as at 3 December 2020

Figure 104. In Europe, Value has lagged significantly



Source: Refinitiv as at 3 December 2020

More visibility of the end of the pandemic, combined with government support measures in the downturn, means credit losses will be more contained than some feared. Finally, regulators' willingness to allow resumption of dividend payments will also help sentiment.

Where we see more opportunity is in property and casualty insurance. Insurance rates were already on the rise, but at this point we're seeing the best insurance pricing environment in two decades. Insurance companies that have the capital to write new business in this market will benefit from this change and do well over the next year and onwards.

In the telecoms space, we have seen ongoing roll-out of high-speed broadband by operators, and take-up of higher speeds by consumers, driven in part by the needs to support working from home and more streaming video and gaming entertainment. 5G network roll-outs across the world have started in earnest. Still, as yet the long-term promise of 5G connectivity remains theoretical, with no clear business models or roadmaps in place. Immediate opportunity from this change accrues to the suppliers of components that are enabling these network upgrades and roll-outs. These companies — predominantly in technology hardware and semiconductor sectors — are already seeing these benefits, and gains are likely to continue into the next year.

Where the change related to digitalisation is less well understood and is in earlier innings is in industrial sectors. Modern factories will increasingly resemble computer networks, and so will the products they turn out. Once an item is manufactured, sold and installed in the field it increasingly becomes a connected platform, with a layer of digital services offered by the manufacturer alongside it. This calls for technology upgrades along the whole industrial manufacturing value chain and will present opportunities to well-positioned companies (Figure 105 and Figure 106).

The key driver of this is the maturity of the underlying technologies — EVs had become competitive, desirable cars, with comparable ownership costs to internal combustion vehicles. Wind and solar energy are reaching grid parity on cost in more and more regions globally.

In addition to that the “build back better” approach in fiscal stimulus measures will likely continue to support this trend across the “carbon transition value chain” through both direct financial incentives (such as EV subsidies) and regulatory and policy pressure.

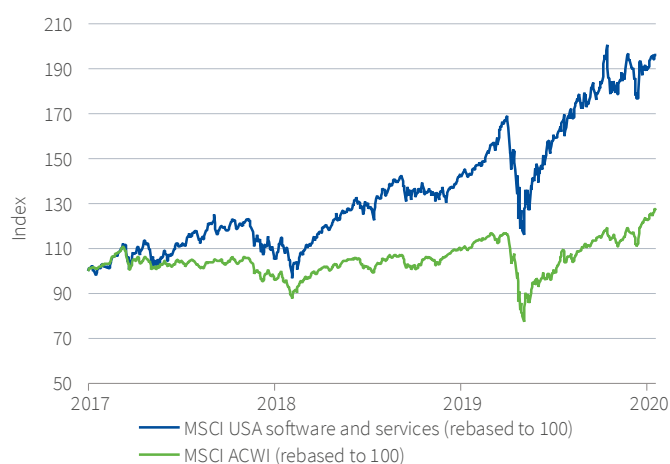
In areas of healthcare closely associated with COVID testing and vaccine development and deployment, we will see some pullback. However, the pandemic has also highlighted broader underlying change in the industry — companies' ability to develop multiple innovative vaccines quickly and gear up for their production for large global populations stems from innovations in analytical technologies and biomanufacturing, that will be longer-term positive changes far beyond the COVID pandemic.

Connectivity has become essential, for both consumers and enterprises

Car electrification and renewable energy remain compelling secular trends

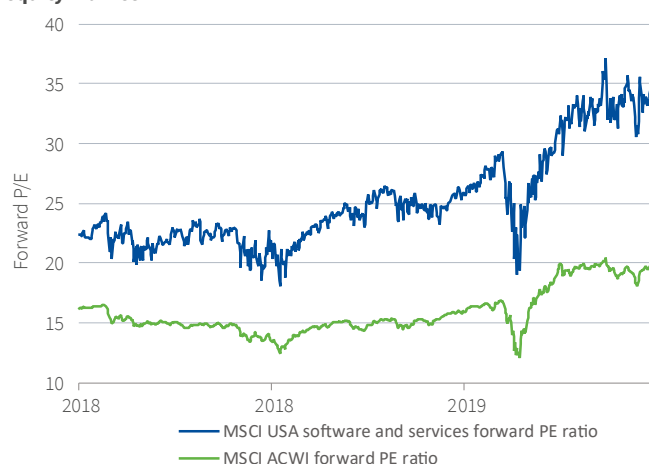
Some healthcare companies had been beneficiaries of the pandemic, but others were adversely impacted and present potential opportunities

Figure 105. US software & services vs MSCI ACWI relative performance



Source: Bloomberg, Aviva Investors at 3 December 2020

Figure 106. MSCI USA software & services valuation vs global equity market



Source: Bloomberg, Aviva Investors at 3 December 2020

EM Equity: a dividend market

Global emerging market equities have in aggregate proven surprisingly resilient through the turmoil of 2020, both in absolute dollar terms and relative to developed market equities. As Figure 107 shows, despite the collapse in March as the impact of COVID-19 on the global population and economy became apparent, the asset class subsequently managed to claw back a little of 2019's under-performance against its developed counterparts, helped by surplus liquidity and a quick rebound in China's economy. These headline figures conceal dramatic volatility and divergence, and this divergence has been notable both at the regional level and at the sector level.

As economic activity decelerated sharply across all emerging market economies amid local lockdowns the damage to aggregate GEM equity earnings expectations was considerable. Figure 108 shows consensus expectations which at the start of the year were for low-teens earnings growth but then slumped to -20 per cent in short order. They have rallied a little since then, helped by the earnings performance of mega-cap technology stocks that have grown in proportion within the index. Analyst consensus for 2021 currently implies full recovery as vaccines are rolled out and economic activity normalises. This seems reasonable to us, albeit with risks attached.

At a country level the COVID-19 pandemic has highlighted significant differences in macro resilience and political preparedness, within emerging as well as within developed markets. Countries such as Taiwan, with well-funded healthcare and social security systems combined with good political organisation and foresight, did a better job of protecting their populations and enabling a quicker return to normal life than the laggards. In contrast many parts of Emerging Europe and Latin America have struggled. Figure 109 shows the extent of the divergence in regional performance which is unprecedented in recent emerging market history. As the subsequent figure demonstrates (Figure 110), this divergence has been fundamental and corporate earnings driven. Most Asian economies are net importers of oil and other commodities and have a high weighting of information technology and healthcare in their benchmark indices; the opposite is true for many EMEA and Latam countries, which have also suffered more domestic economic damage.

Turning to the divergence in sector performance, equity investors sought refuge from market chaos by focusing on a relatively small selection of companies where business conditions remained strong during COVID-19 and whose long-term growth prospects seemed to be enhanced by structural changes accelerated by the pandemic. At the epicentre of the pandemic in February and March 2020 the North Asian markets provided an early template of how living and working conditions would change going forward for the world. There was a dramatic acceleration in growth in e-commerce, social networks, gaming and other home entertainment, contactless payments (for example the Korean 'untact' plan for its post-

A volatile year for
EM Equities

Substantial contraction in
corporate earnings

Massive divergence in
regional performance

Equally big divergence in
sectoral performance

Figure 107. EM vs DM performance



Source: Bloomberg, MSCI, Aviva Investors at 3 December 2020

Figure 108. EM earnings expectations



Source: Bloomberg, MSCI, Aviva Investors at 3 December 2020

pandemic economy), connectivity and distributed computing. Companies in these sectors enjoyed substantial re-rating alongside their relatively solid earnings. In contrast, companies in cyclical and/or structurally troubled segments of the market such as travel, financials and energy were dumped. These trends were amplified in an environment of surplus liquidity and the desire for investors to buy thematic winners and national champions, particularly in China. Stock selection based on traditional valuation metrics has worked poorly for active investors this year. As a result, there has been spectacular performance from the fastest growing companies in the GEM universe including e-commerce operators, vehicle manufacturers and food delivery specialists.

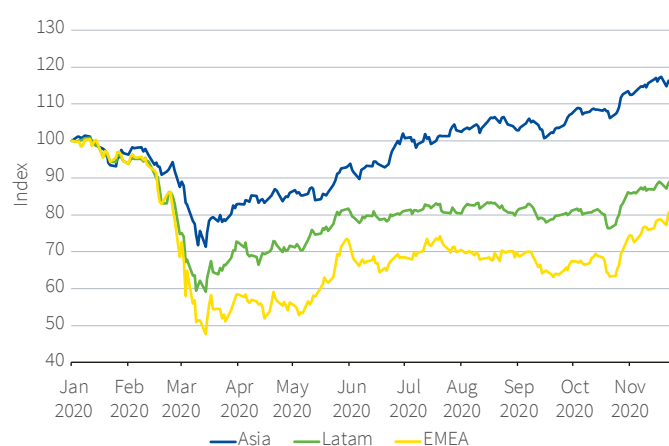
One consequence of this has been the growing concentration of the benchmark MSCI EM equities index. Far from the diverse exposure across the emerging market opportunity set that the index used to represent, it is now increasingly geared to technology and North Asia. Some of the larger companies now have a bigger weight in the index than the entire representation of Malaysia and Indonesia for example. The contrast between the underlying exposure to the emerging markets offered to investors from EM Equity and the more diversified Emerging Market Debt continues to widen. Looking forward, however, a reversal of trend is likely. As vaccines are rolled out and economies recover, we expect to see less emphasis on thematic trends and more emphasis on the performance of individual companies. Not every country, sector or company will recover at the same rate and there should be great opportunities for bottom up investors to analyse these changing trends. This environment should favour investors willing to go off the beaten track and examine previously overlooked companies and markets. For example, frontier markets, including those of sub-Saharan Africa which have coped with the pandemic relatively well, may regain investor interest.

Trade and political tensions between US and China deteriorated once more in the run-up to, and indeed aftermath of, the US presidential elections. In contrast to the general tariff measures of 2018 this time the legislation was directed at individual technology companies, notably Chinese national champions Huawei, its chip design subsidiary HiSilicon and foundry Semiconductor Manufacturing International Corp. At the same time the startling global success of Chinese-owned mobile app TikTok, which is taking significant global market share from rival social networks, met with a sharp and somewhat protectionist response. We would expect the trend of de-globalisation to continue in sectors such as technology and energy, with countries focusing on national interest rather than on comparative advantage when setting industrial policy and allocating capital. More broadly these issues partly reflect the continuing steady transfer of technology leadership from West to East. Intel's continuing struggles with node transition in logic semiconductor manufacturing leave Taiwan Semiconductor and Samsung Electronics as the only global companies with the ability to

EM Equity Indices unsustainably concentrated

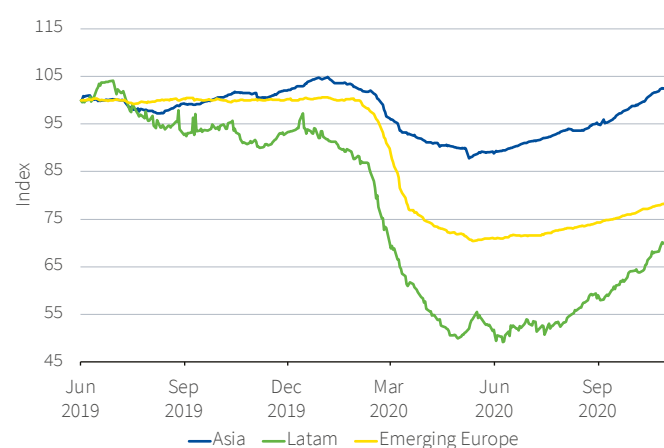
Trade tensions, de- globalisation continuing

Figure 109. Regional performance



Source: MSCI, Aviva Investors, Bloomberg at 3 December 2020

Figure 110. EM regional earnings revisions



Source: MSCI, Aviva Investors, Bloomberg at 3 December 2020

manufacture at the 7 nanometre and 5 nanometre line widths critical for high performance computing. The battle for technological dominance will continue to be a driving force in geopolitics.

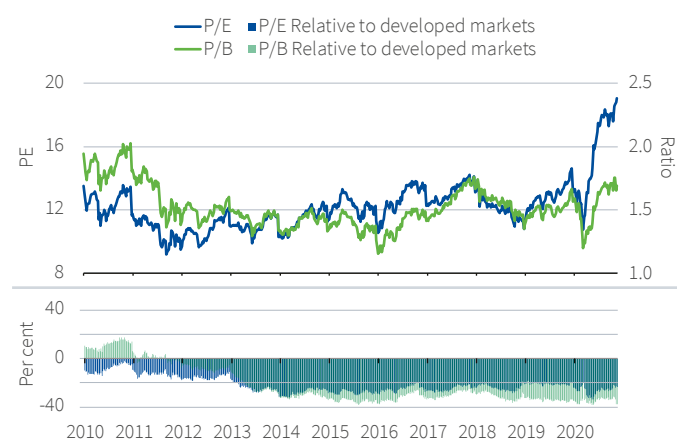
Despite the economic disruption this year, efforts to combat climate change remain on the agenda within emerging markets. In September 2020, Chinese President Xi Jinping announced a set of ambitious climate targets, pledging that China would hit 'peak carbon' in 2030 and cut emissions to near-zero by 2060, setting a role model for other emerging countries. This implies a rapid phase out of coal-generating power plants and big investment in renewable energy infrastructure. This policy programme should benefit a wide range of companies including solar glass manufacturers, onshore and offshore wind farm specialists and gas distribution players. The decarbonisation effort is also likely to accelerate demand for electric vehicles. Some of the electric vehicle manufacturers in EM look to have stretched valuations, but others could prove more attractive to investors.

What are the investment prospects from here? As Figure 111 shows, prospective price/earnings has jumped to all time highs for emerging market equities. However, their discount to developed markets on both earnings and book value has widened further. It is also the case that the valuation expansion has been concentrated in the internet and biotech sectors with most other sectors still on reasonable valuations. The final figure (Figure 112) shows the extent to which internet-dominated GEM sectors such as consumer discretionary and telecommunications are priced well above their ten-year averages on prospective earnings while others are not stretched. Swathes of the market, notably emerging market income stocks and small caps, remain demonstrably cheap against their long-term levels and global peers. In an environment of economic recovery in 2021 it seems likely that these areas will catch up.

De-carbonisation an important emerging market trend

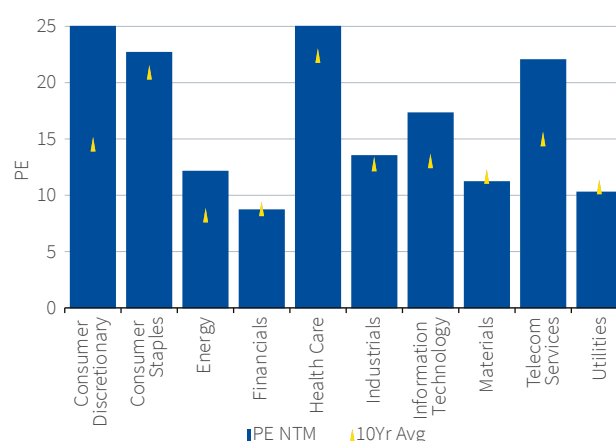
A positive outlook

Figure 111. EM valuation, historic and vs DM



Source: Bloomberg, MSCI, Aviva Investors at 3 December 2020

Figure 112. Sector valuations



Source: Bloomberg, MSCI, Aviva Investors at 3 December 2020

Rates: back to life, back to reality

- From recession to recovery will see a move higher in bond yields
- Monetary policy to remain accommodative whilst inflation slowly recovers
- Cyclical bounce rather than a structural break of the low-yield environment

Overview

When we compiled our rates outlook for 2020, we projected an uneven and modest growth recovery supported by an extended period of accommodative monetary policy together with muted inflationary pressures. Of course, the reality was an unprecedented shock to the global economy that aggressively impacted financial markets. However, the rapid response from both governments and central banks to the pandemic, plus the swift development of a number of vaccines has seen the global economy steadily recover. With this framework our starting point has many similarities to that of our 2020 outlook, with growth expected to recover, albeit at a much faster rate, and monetary policy to remain firmly accommodative as global policymakers focus on ensuring a smooth economic and labour market recovery. The unprecedented nature of this recession means that uncertainty will persist, and the recovery may well be quicker and more aggressive than prior recoveries. We still do not foresee an end to the multi-decade bond market rally and so while we see upside risks to bond yields in 2021 our medium-term forecasts point to an eventual return to reality.

After the COVID shock, 2021 should see a robust economic recovery...

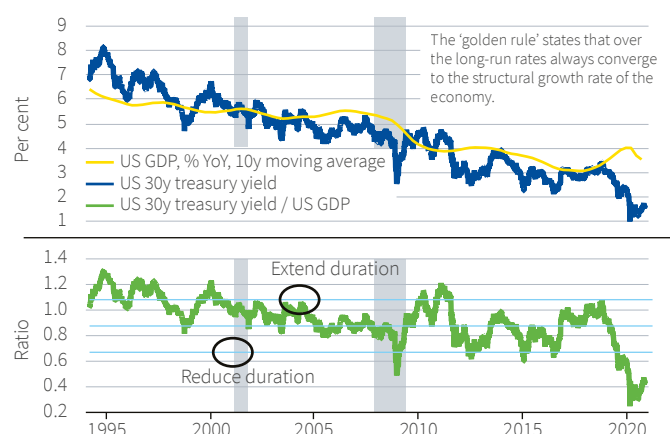
Regional breakdown

The expected cyclical recovery should see some upward pressure on bond yields, steeper yield curves, wider breakevens while real yields stay relatively low as growth continues to rebound to pre-coronavirus levels (Figure 113).

One of the key structural shifts that has occurred during 2020 has been the shift in the US Federal Reserve's (Fed) monetary policy framework to an average inflation targeting approach. We see the ongoing cyclical recovery in 2021 as a chance for them to demonstrate the credibility of their new framework and as such foresee a low probability that the Fed make any substantive change to policy even as inflation expectations begin to rise. Whilst we expect inflation to rise over time, it is still significantly below target and so there is plenty of room for spot inflation to recover before the Fed must respond (Figure 114).

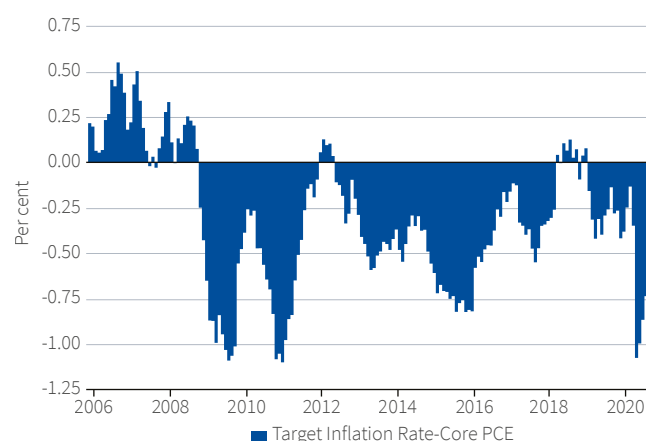
...but inflation should remain largely contained

Figure 113. United States, the “golden rule” and long term-yields



Source: Aviva Investors, Macrobond as at 3 December 2020

Figure 114. United States, target inflation rate and core PCE



Source: Aviva Investors, Macrobond as at 3 December 2020

We expect the Fed to continue to expand its balance sheet at its current pace through 2021 although they may look to shift the maturity of their purchases to support any unwarranted tightening in financial conditions that could impact the recovery. Whilst QE will continue to exert downward pressure on yields, we expect the cyclical recovery to dominate much like in prior recovery periods (Figure 115 & Figure 116).

While this policy outlook over the next few years will help to reduce uncertainty, it will also help to limit the range within which longer-dated yields will be able to fluctuate. This leaves us biased to see the effective range in longer-dated yields tilted narrower than prior recoveries. We target levels above current forward pricing and believe there is a reasonable probability that these levels are achieved sooner as the global economy recovers from the coronavirus recession. Importantly, we see yields moving higher for the “right reasons” and so this should limit the impact onto other asset classes. The risk case is that the recovery gathers pace far quicker than we expect, which could see inflation moving higher sooner. In this environment the market may challenge the probability of rate hikes in the next year which would see higher front-end yields, flatter curves and higher real yields.

With the European Central Bank (ECB) intensifying its accommodative policy measures in 2020 and European-related risk premia having declined following the European Council’s agreement on the Recovery Fund (RF) we have seen a strong performance of southern European peripheral spread markets. (Figure 117). While we expect some volatility and negative noise around the RF in H1 2021 we expect the combination of the lower-for-longer yield environment, no national elections on the horizon and the fact that redenomination risk now is much lower, to see Italian Government Bond spreads finally able to compress through 100bp relative to German Bunds. Elsewhere in Europe, inflation will be slow to recover and so this will limit the move higher in yields but with so little priced in for a recovery the EU area does have the potential to surprise to the upside relative to expectations as the global recovery picks up.

We continue to favour strategic long positions in Australian Government bonds which has been a key overweight across portfolios for several years now. We see the developments in 2020 as only strengthening the view with the Reserve Bank of Australia (RBA) conducting yield curve control by targeting 0.10 per cent on the 3-year government bond and for the first time moved to a “conventional” Quantitative Easing framework alongside most other developed market central banks. With the RBA remaining on hold for an extended period, high relative yield and steep yield curve, we continue to favour allocations to Australia (Figure 118).

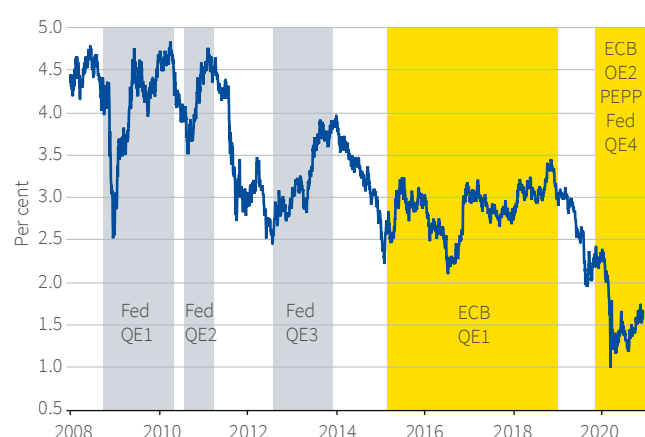
In the United Kingdom, the outlook for the gilt market is likely to remain highly uncertain, the subject of Brexit is still to fade, and the outcome of the UK/EU trade deal negotiations is likely to significantly impact the level of UK growth over the medium term. 2021 is also a year which

The Fed is expected to maintain policy stimulus

Inflation pressures are even more muted across Europe

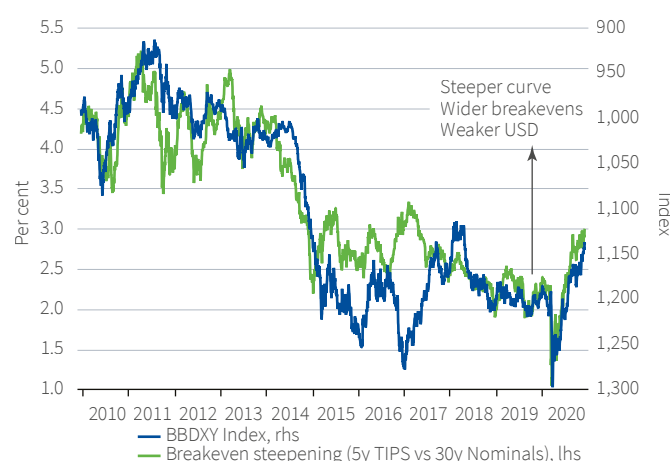
RBA also in comprehensive stimulus mode

Figure 115. United States, quantitative easing and long-term bond yields



Source: Aviva Investors, Macrobond as at 3 December 2020

Figure 116. United States, US dollar and yield curve



Source: Aviva Investors, Macrobond as at 3 December 2020

will see the UK gilt market navigate through both Scottish Parliament elections in May and the very likely introduction of “Green Gilt”, all of which could certainly bring some challenging issues influencing gilt yields. Nonetheless, it is evident that like many central banks, the Bank of England (BoE) will be in no hurry to signal any tightening and any such move would not be likely (if at all) until 2022/2023 or even later. Given the size of QE in play as well as the potential fiscal tailwinds from 2020, there is the potential for gilt yields to move higher and for some curve steepening to be seen over the course of at least the first half of 2021. Within UK inflation markets, with the RPI reform announcement as having now passed, we see UK breakevens as being a little expensive at their current levels and with the increased issuance likely in 2021, there is room for inflation breakevens to fall away to some degree.

UK has its own headwinds as well as the same global trend

Summary

We expect the cyclical recovery to continue through 2021 providing a positive backdrop for pro-cyclical assets. We expect bond yields to move higher to reflect this improved growth outlook with accommodative monetary policy providing an anchor to the speed and magnitude of any move. The result will be core sovereign bond markets delivering total returns slightly negative although if any downside risks materialise an allocation to government bonds will still provide protection and a positive return. The key unknown for next year will be the rebound in inflation as economies reopen given the unprecedented monetary and fiscal stimulus we have seen in 2020. While many structural headwinds to inflation persist, the market and central banks reaction to any inflation surprises will be a key factor to monitor going forward.

Figure 117. Europe, sovereign spreads to Bunds year



Source: Aviva Investors, Macrobond as at 3 December 2020

Figure 118. Global yield curves, 10s30s spreads



Source: Aviva Investors, Macrobond as at 3 December 2020

Credit: Compression obsession

Global investment grade

We are constructive on global investment grade (IG) credit in 2021 as the backdrop of continued central bank support, positive supply-demand technicals, and the relative safety of the asset class amid subdued growth are supportive. However, valuations are pricing in many of these and returns from credit spreads may be more carry-like.

Central bankers have insisted support will remain in place well into 2021 despite the latest vaccine developments to avoid a premature tightening of monetary conditions. Mass distribution of vaccines may not materialise until 2H 2021, meaning economic growth may remain subdued until then. This reduces the risk of an inflation burst and monetary tightening. Such a backdrop may be goldilocks for IG credit. The new US government may also look to defuse geopolitical tensions and trade wars. At the least, there will likely be a more measured approach to trade disputes and multilateral solutions, giving corporates a smoother ride and more visibility. This also reduces key tail risks for select sectors, including energy, healthcare and banks.

Unprecedented corporate debt issuance in 2020 was met with strong demand by investors in the search for yield. In 2021, new issuance will likely be materially lower, though closer to pre-pandemic averages as companies revert to their usual levels of new borrowing and refinancing activity. The strong level of demand seen in 2020 is expected to remain largely intact, bolstered by investors' search for yield. The amount of negative yielding debt is back to near records globally, bolstering technicals for spreads. However, optimism from vaccines and policy certainty could result in increased debt-funded equity payouts or M&A activity. This is a wildcard for credit, though the liquidity crunch experience at the peak of the COVID-19 crisis suggests companies may be more disciplined in their balance sheet management.

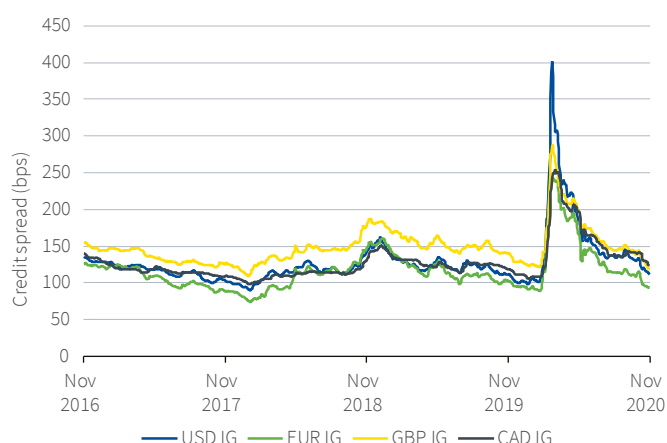
However, credit spread valuations are pricing much of the supportive backdrop, which suggests returns from credit spreads may be more carry-like. As the global search for yield continues, higher-yielding areas look more attractive. In terms of sectors, we are positive on banks globally but particularly in Europe. Balance sheets continue to see improvement and Europe is seeing consolidation, which is positive. US energy has lagged the recovery and could be a pocket of upside should the global recovery materialise, though security selection will be key. Aerospace and consumer cyclicals also have scope, though vaccine deployment may determine the velocity. Otherwise, we see value in select non-cyclical sectors such as healthcare and TMT, particularly BBB credits that are still deleveraging after previous M&A and have attractive carry.

Continued central bank and government support amid vaccine distribution is supportive

Supply-demand technicals are positive as record supply declines, while demand likely remains firm

While conditions are positive, valuations are pricing this in and credit selection will be important as ever

Figure 119. Credit spreads appear to be pricing in much of the positive backdrop...



Source: ICE Data Indices as at 3 December 2020

Figure 120. ...but technicals suggest modest spread tightening amid the search for yield



Source: ICE Data Indices as at 3 December 2020

Global high yield

We expect the global high yield market to have a good recovery in 2021. The passing of the global COVID crisis combined with continued support from central banks and capital markets will ease the stress we have seen in leveraged finance markets.

The biggest driver of the high-yield market in 2021 will be declining coronavirus cases versus vaccine roll-outs. Although the next few months will be hard, when a mass roll-out of one or more COVID-19 vaccines finally begins, it will bring some of the much talked about “zombie” companies back to life.

Travel and leisure firms that have been hit hardest by the coronavirus will be able to resume operations once a big enough proportion of the population is vaccinated. In 2020, many became “zombie” companies as they issued massive amounts of debt to stay afloat until they could restart business activity. After possibly an entire year with little to no revenues, they will gradually be able to begin going back to normal.

The turnaround in company fundamentals will also shape the high-yield market. At some point in 2021, the market will see a peak in default rates and leverage as a direct by-product of the pickup in earnings growth. Survivors will thrive as economic recovery continues, and we may see even tighter spreads as buyers hunt for yield. Figure 121 shows how the market and quality categories have rallied to tighter spreads but we are still wide of historic lows.

The Federal Reserve changed its inflation target in its 2020 framework review and will allow inflation to overshoot the two per cent target temporarily. The European Central Bank is widely expected to adopt a similar viewpoint when it publishes its own review in 2021. In addition, these central banks have acknowledged the dangers of tightening policy too early, as demonstrated in the wake of the global financial crisis. This change in attitude by major central banks should conspire to keep monetary policy loose even if the employment situation improves and we see signs of inflation picking up.

With rates remaining low, the high-yield market will likely see another year of massive supply. Current conditions are very favourable for companies to come to market for refinancings. Historical US and Global HY volumes are shown in Figure 122.

Yields on the asset class are at recent lows but credit spreads are not, and spreads have room to compress. With one or more vaccines and ongoing easy monetary policy widely expected in 2021, the high-yield market should also continue to see a broad turnaround in company fundamentals, all of which would be supportive for the asset class.

Development and roll-out of vaccines ends the crisis

Earnings growth resumes and survivors thrive

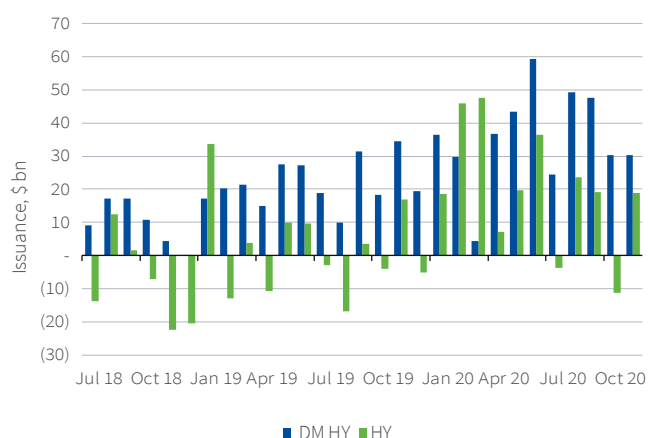
Central banks will continue support and the refinancing trend continues

Figure 121. Growth in the market value of US IG has risen to \$8.5 trillion, while yields have fallen to all-time lows at 1.85%



Source: BAML Indices as at 3 December 2020

Figure 122. New issuance volumes in global high yield



Source: Deutsche Bank as at 3 December 2020

Asset-backed and covered bonds

We are supportive of asset backed securities (ABS) for 2021. Central bank action has diminished yields in this sector, however the high risk-adjusted returns in this asset class continue to provide a welcome diversified allocation in portfolios. European ABS supply was down 30% in 2020. Central bank stimulus will continue to reduce the supply of publicly placed notes in favour of retained notes which will weigh down on any volatility. The carry from non-bank issuers versus bank issuers is significant so we continue to exploit this carry with ABS markets driven by strong technicals over fundamentals. With the favourable political and regulatory treatment for mortgage covered bonds over simple, transparent and standardised (STS) residential mortgage-backed securities (RMBS), we prefer STS RMBS over covered bonds (same pick of collateral assets) where there is more yield for portfolios that aren't subject to the higher capital charges.

Prefer non-bank vs bank issuers in European ABS

Auto loans

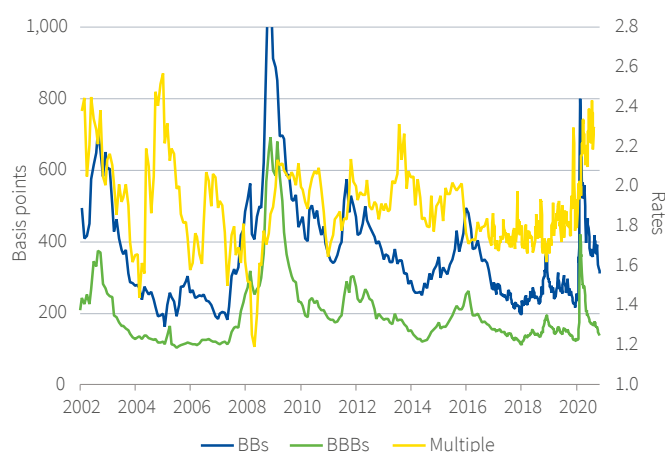
When assessing the future performance of auto loan collateral it is important to assess your prediction for second hand used car prices (or residual value risk). COVID-19 has driven new car sales to record lows following months of lockdowns globally. This will reduce the future supply of second hand cars increasing residual values which is very supportive for auto loan ABS. Residual values increased significantly in 2020 (an average 9% YTD ending October 2020 according to second hand cars CPI inflation data from the ONS) and we expect that trend to continue.

We favour auto loans over UK prime RMBS on a relative value basis as expect this premium to contract during the course of 2021

Residential mortgage-backed securities/covered bonds

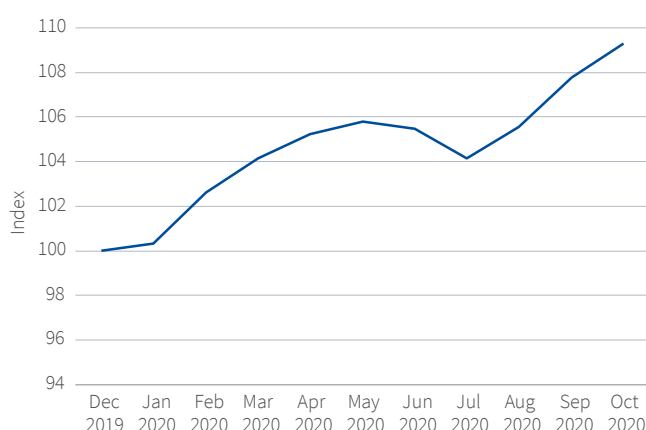
Defaults will likely be at or near to zero for prime and near-prime collateral in the UK and we are very supportive of this sector. Central bank schemes have taken away banks' requirement to access funding via the securitisation markets and supply from banks has been close to zero. We favour prime RMBS over covered bonds where a spread differential is driven by the favourable capital treatment of covered bonds.

Figure 123. DM USD All Sectors – BBs vs BBBs



Source: Deutsche Bank, Dealogic, S&P/LCD as at 3 December 2020

Figure 124. ONS UK second hand car prices in 2020



Source: ONS

Note: Rebased to 100 from 31/12/19. ONS Second Hand Cars CPI Index is broadly representative of UK second hand car prices.

Emerging Market Debt: a shot in the arm for asset class returns?

Introduction

Whilst COVID-19 has significantly impacted emerging market economies and asset prices throughout 2020, the consequences of the health crisis and the resulting effects on the inhabitants and governments of developing countries are likely to be far reaching and potentially long lasting. At this juncture global macro conditions support a cautiously optimistic outlook across emerging market debt (EMD) asset classes, particularly if vaccine developments provide further support to the environment of low funding rates, a weaker USD and improving economic activity. However, the translation of those favourable global conditions into improvements in domestic fundamentals for emerging market (EM) economies remains a key consideration for 2021, especially against a backdrop of higher levels of debt, unconventional policy measures and the potential for the withdrawal of extraordinary stimulus in key countries such as China.

The intersection of global themes alongside economic, social and political factors within EM are likely to be key determinants of asset prices across EMD as we look forward into the new year. This investment landscape will require a robust and focused understanding of domestic fundamentals as they evolve and is likely to lead to ongoing divergence in returns and a differentiated approach for investors. EM policy and decision makers at both corporate and sovereign level will need to balance their awareness of global factors alongside domestic objectives in a way that does not expose fundamental vulnerabilities and demonstrates a credible approach to investors, which will undoubtedly create more challenges for some countries and sectors than others.

Whilst investors including ourselves continued to express a preference for hard currency (HC) asset classes throughout 2020, an environment where economic activity shows ongoing improvement in 2021 could see local currency (LC) given more consideration and deliver more attractive returns particularly if recent USD weakness extends.

Local currency

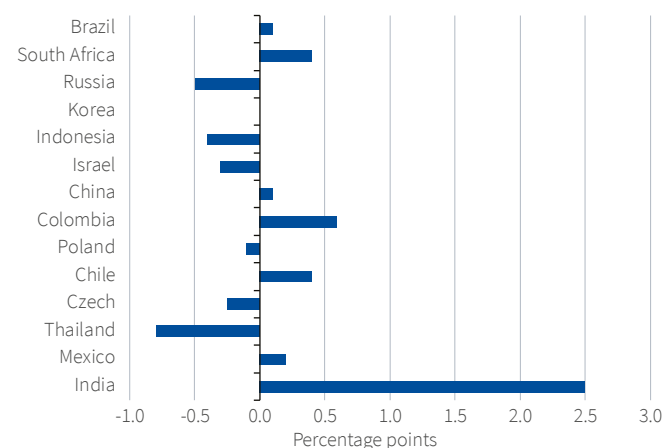
Local currency investors will be looking to determine whether market conditions in 2021 can facilitate a break out of multi-year ranges for the asset class and enable the delivery of more sustained investment returns. Much of that will depend on the outlook for global growth (Figure 125), the path of the USD and ultimately whether compelling EM foreign exchange (FX) valuations can be unlocked as a result. Recently, developments are encouraging in that regard and investor demand is showing modest signs of improvement.

For EM the translation of global tailwinds into an improvement in domestic fundamentals will be a key consideration

A balance of social, political and economic factors will drive divergence of returns and present both risks and opportunities

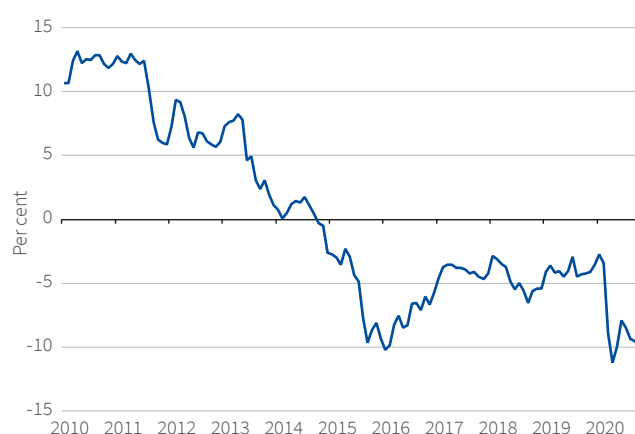
A weakening USD should unlock attractive EM currency valuations and lead to increased investor demand for the asset class

Figure 125. 3m change in 2021 growth forecast



Source: Bloomberg, Aviva Investors as at 3 December 2020

Figure 126. GBI-EM deviation from FX 'fair value



Source: Bloomberg, BIS, Aviva Investors as at 3 December 2020

The recent USD downtrend will continue to play a key role in asset class preferences and return expectations such that, if the weakening USD trend continues against a favourable global macro environment as we have observed more recently, we expect to see emerging market currencies outperform other EMD asset classes and form the key driver of returns for the LC asset class as a whole. At an asset class level EM currencies continue to offer more attractiveness than yields on valuation metrics (Figure 126 and Figure 127), however it will be underlying rates and duration that should provide the best idiosyncratic opportunities. This is particularly true in markets where the outright level of real/nominal yields or indeed curve steepness provide adequate compensation for risk, especially given inflation trends across EM pose little threat (Figure 128).

From a fundamental standpoint we envisage ongoing questions with respect to debt sustainability in countries such as Brazil and South Africa, policy credibility in Turkey and geopolitical concerns in Russia. However, in many cases valuations have sufficiently adjusted to reflect those concerns and, taken together with the continued strength of economic data in China and Asia as a whole, we expect conditions to remain supportive of a selective approach to LC. Within that framework Asian currencies are expected to perform well together with RUB and MXN, alongside preferred high yielding bond markets such as India, Russia and Mexico and lower yielding yet higher quality opportunities such as Chinese Government Bonds.

Hard Currency

In an asset class never short of drama, 2020 has been a year that will be very difficult to forget. The pace of the decline and subsequent recovery in asset prices is unparalleled. Macroeconomic and fundamental shifts that would normally play out over years, played out over a matter of months.

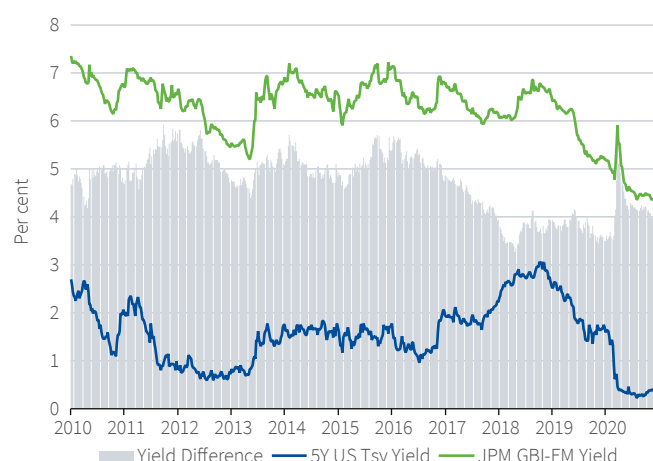
Lower US Treasury yields have been a support for returns and with spreads continuing to recover we are now at record low yields in both the hard currency sovereign and corporate asset classes (Figure 129). The question, therefore, is where can we go from here? As previously stated, the global macro conditions support a cautiously optimistic outlook. Monetary policy is likely to remain accommodative for an extended period of time. Whilst this will not necessarily push asset prices higher, a global growth recovery is something that can allow spreads to continue to compress. In this scenario high yield should outperform investment grade given still wide differentials.

However, the impact of COVID-19 is something that will have a lasting impact on fundamental factors. Investment grade countries and companies were generally coming from a position of

EM currencies are likely to be the main source of returns alongside selected high yield (HY) duration markets

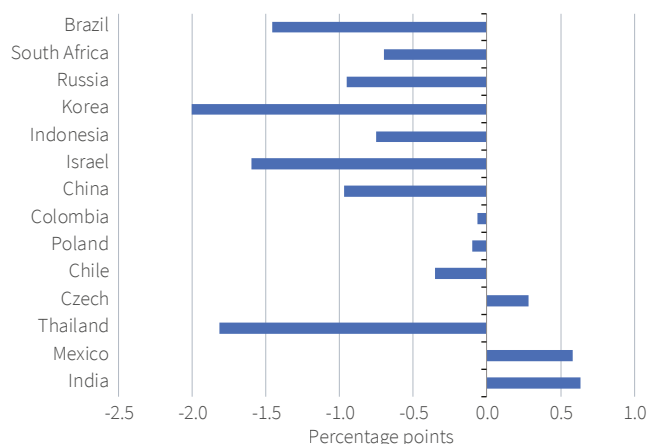
Both the hard currency sovereign and corporate asset classes are at record low yields

Figure 127. EM local yield v 5y US treasuries



Source: Bloomberg, JPM, Aviva Investors as at 3 December 2020

Figure 128. 2021 Inflation forecast relative to central bank target



Source: Bloomberg, Aviva Investors as at 3 December 2020

strong credit metrics. The situation, although challenging, is broadly manageable with ample global liquidity providing breathing room. The outlook for high yield is different (Figure 130). Solvency risks remain high, and we expect dispersion to remain elevated as well.

The more supportive the backdrop, the greater the scope for reduced idiosyncratic risks and stronger returns from the high yield components of the universe. Within the sovereign universe our preference for high yield assets is reflected in a search for:

- **Countries that will come out of the crisis with good growth momentum:** countries that grow faster should be able to consolidate budgets more easily and will face better debt dynamics. As one example, Kenya will likely face an easier fiscal consolidation path, compared to Oman, Pakistan and South Africa.
- **Countries that are pro-active about laying out a credible fiscal consolidation path,** and where needed engaging with the IMF sooner rather than later. The reformers of the past are no longer the reformers of the future. The new government of the Dominican Republic has put forward ambitious consolidation plans, and after the elections in December, Ghana is a country that could follow.
- **Countries with smaller twin-deficits and manageable external financing requirements,** and those that benefit more from inflows into the asset class are preferred. Egypt and Ukraine stand to benefit from inflows into local markets.

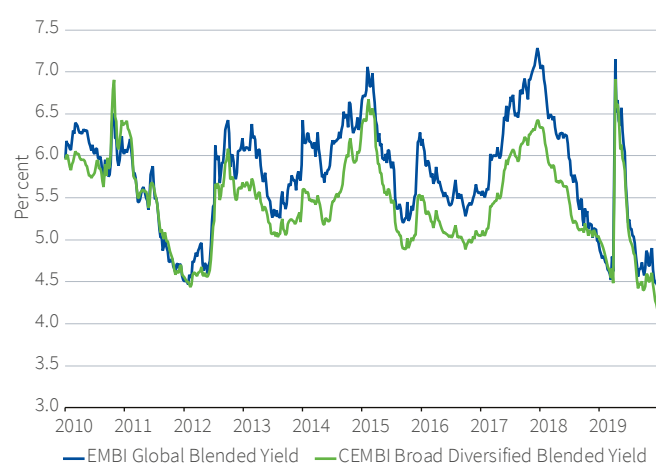
EM corporate debt is likely to gain further from a stronger fundamental backdrop and improved credit metrics. This should enable the universe to tighten but maintain the lower volatility relative to the sovereign benchmark that has been present over the past several years. With an expected HY default rate of 2.8 per cent in 2021, below the long-term average of 3.5 per cent, solvency risks are less pronounced than for sovereign issuers. Nonetheless returns are strongly enhanced by a focus on the most attractive opportunities in an asset class that continues to grow.

The more supportive the backdrop, the greater the scope for reduced idiosyncratic risks and stronger returns from the high yield components of the universe

EM corporate debt stands to benefit from a stronger fundamental backdrop and improved credit metrics

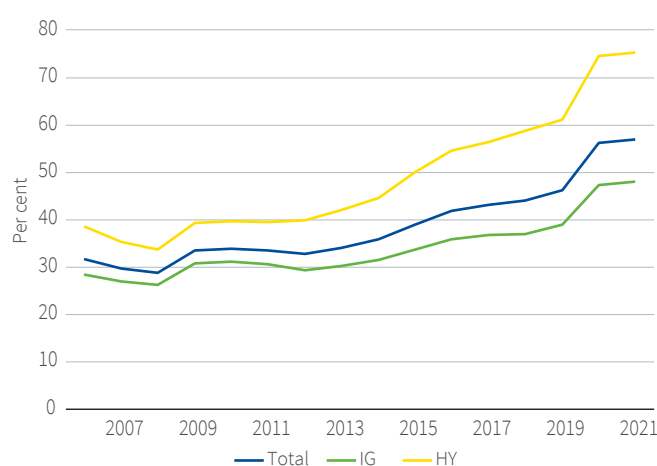
Figure 129. Hard currency yield history

Weekly history over 10yrs



Source: JPM, Bloomberg as at 3 December 2020

Figure 130. EMBIG weighted: debt to GDP



Source: Fitch Rating as at 3 December 2020

Currencies: dollar weakness here to stay

In 2020 the COVID-19 pandemic has also affected the FX market and brightened the safe-haven status of some currencies. From January to the peak of risk aversion recorded in March, the USD appreciated against all main currencies but JPY and CHF. Since April, the USD has significantly depreciated against all currencies (Figure 131), vis-à-vis commodities currencies like the Australian and the New Zealand dollar. Looking into the new year, with the perspective of vaccines and the return to normality, the dollar should be more fundamentally driven and less impacted by the risk-off/ risk-on rationale (Figure 132). This should also be supported by what is expected to be a more conventional and moderate Biden administration, therefore implying less political risk premium. But does this mean a stronger USD? We do not believe so, we rather believe that several cyclical factors are in place for a downward trend to continue.

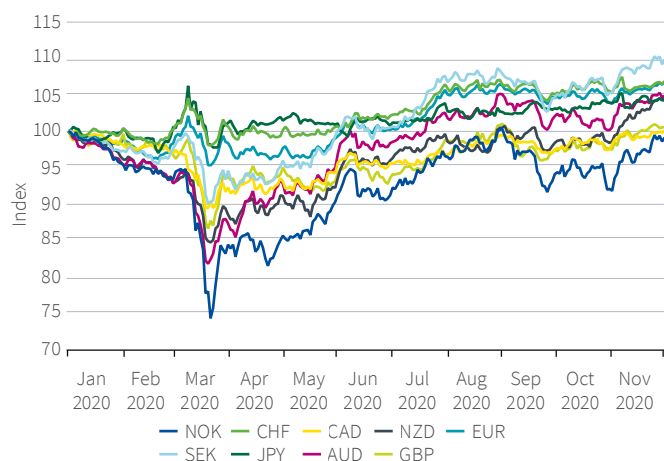
As we explained in the economic outlook section, we still have some difficult months ahead of us before the wide deployment of COVID-19 vaccines. Having said that, our central economic scenario points to a progressive global economic improvement in coming years, with a strong global growth in 2021. This was not a recession caused by economic or financial imbalances and the special nature of this crisis allowed an unprecedented global policy response. The fiscal and monetary impulse should continue also in 2021 and pave the way for a more substantial and rapid recovery than after previous recessions. Global growth might well go above 6 per cent (not seen for decades), after having fallen into negative territory for the first time since the Great Financial Crisis. In this environment, Figure 133 shows that USD should weaken further, because it exhibits a more negative relationship precisely during periods of steady upward path of global growth.

Figure 134 shows the last three main periods of trend appreciation of the greenback in real terms. The last started in 2011 and might have peaked last April. In real terms the dollar has appreciated by 32 per cent, broadly like the previous cycle of 1995-2002 (+34 per cent), although less than the 49 per cent of early-80s. During the last cycle the dollar has been accompanied by an environment of US outperformance versus the rest of developed markets and the euro zone in particular. The latter was dragged down by the economic and political consequences of the sovereign debt crisis. On more than one occasion ECB members have highlighted that ECB QE has accentuated the capital inflows into US debt. The sharp divergence of monetary policy cycles, with the Fed starting to hike rates in late 2015, has further increased the appeal of USD-denominated assets.

In 2020, the FX market has been driven by COVID and risk sentiment

The counter-cyclical properties of the greenback and a solid 2021 growth set the stage for a weaker dollar

Figure 131. G10 currencies vs USD, (rebase 01/2020=100)



Source: Aviva Investors, Macrobond as at 3 December 2020

Figure 132. The US dollar has fallen as equities have risen



Source: Aviva Investors, Macrobond as at 3 December 2020

Fed aggressive tightening (easing) cycles have always been key drivers of dollar appreciation (depreciation) cycles. As a legacy of the COVID pandemic, the pro-dollar environment has started to fade. With the compression of US yields and the Fed shifting to an Average Inflation Targeting (AIT) monetary policy framework, the ultra-accommodative stance is here to stay for some years, and it implies protracted negative (or more negative) real yields. All this does not bode well for the relative attractiveness of USD assets, and thus of the USD.

In addition to Fed policy, even in the absence of a “Blue Wave” from the US election, fiscal stimulus will be high relative to normal times (2.5 per cent of GDP at least). The current account has started to deteriorate fast in Q2, and the twin deficit is sinking towards -18 per cent. In the past this has always pushed the currency lower and may continue to weigh on the greenback (Figure 135).

Even considering the correction of the last 7 months, the dollar remains overvalued against the major currencies according to different types of metrics, be it in Purchasing Power Parity (PPP) terms (Figure 136) or be it in dynamic Equilibrium Exchange Rate model. We should expect the natural valuation pull from these levels would be biased towards a weaker USD. Carry strategies continue to post weak performances since March due to a global zero interest rate policy that eliminated interest rate differentials, while value strategies continue to perform strongly, especially in the G10 world.

The main short-term risk may be that of a resurgence of COVID-19 cases in the aftermath of Christmas seasons, thus “temporarily” deteriorating investors’ sentiment.

Of the above main arguments, two are mainly US domestic and one is global. What about the other side of the coin? There have also been material shifts for two important currencies; the EUR in the G10 world and the Renminbi in the emerging world. The COVID-19 pandemic has pushed the European Union towards closer integration. The Recovery Fund has been described by some as a Hamiltonian moment, but this is not universally accepted. True or false, it is undeniable that it has reduced the fear of one of the major nightmares for markets, i.e. the EU fragmentation. Quoting former ECB president Draghi, from a recent speech “...the Next Generation EU enriches the instruments of European policy. The recognition of the role of the European budget can play in stabilizing our economies, the start of common debt issues, are important and can be the principle of a design that will lead to an EU Treasury whose role in giving stability to the euro area has been affirmed over time”. In the short term EURUSD will probably tend to be driven by relative COVID-19 pandemic dynamics between the US and EU, the dose of further easing delivered by the two CBs and already long positioning in EUR. Having said that, the Recovery Fund is a potential game changer and structural positive factor for European countries and the EUR currency.

Fed Average Inflation Targeting is a key argument for a weaker dollar

A ballooning twin deficit and expensive valuations complement the case...

...together with a more constructive view on two important currencies, EUR and CNH

Figure 133. USD v G10 YoY (PC1) vs global growth



Source: Aviva Investors, Macrobond as at 3 December 2020

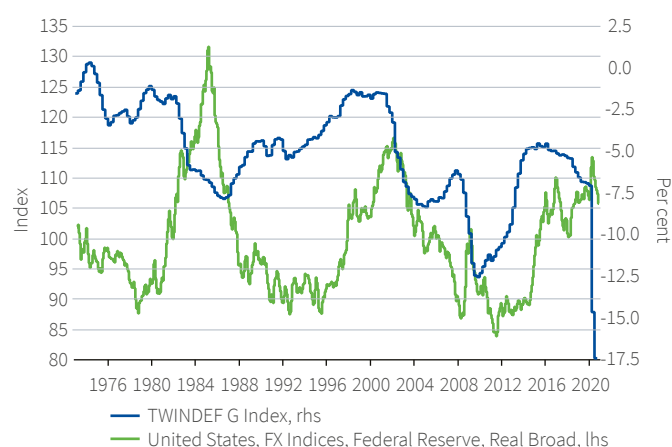
Figure 134. USD dollar appreciation trend bottoming out?



Source: Aviva Investors, Macrobond as at 3 December 2020

Turning to the Renminbi, China has surprised many in its capacity to control the COVID-19 pandemic better than the rest of world, leading to the country recovering more quickly and outpacing the pre-COVID level of GDP already in the third quarter. For 2021, in all our three economic scenarios, we foresee a China outperformance with respect to the G7 countries. This growth momentum has come alongside a substantial improvement in China's external balance and the current account surplus is in good shape. The more solid fundamentals are allowing the PBOC to reverse the very easy monetary policy back towards a more neutral stance, mainly to avoid unmanageable financial instability risks. Besides, the increase in short- and long-term rates, almost unique among major economies, may attract further portfolio inflows into Chinese government bonds. To sum up, the macro picture and flow dynamics would justify further strength of the Renminbi and have materially decreased the risk of a CNH devaluation.

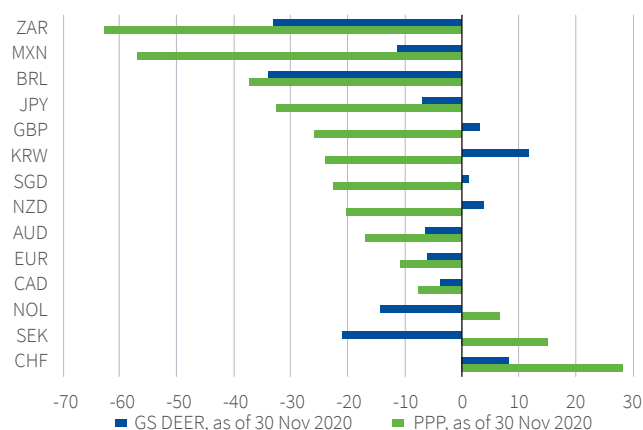
Figure 135. Twin deficits and dollar



Source: Aviva Investors, Macrobond as at 3 December 2020

Figure 136. FX major currency valuation

Per cent under/overvaluation



Source: Bloomberg, Macrobond as at 3 December 2020

Real estate: the future is coming fast

2020 was a year of diverging fortunes across real assets. In infrastructure, COVID-19 hit the demand for transport, but boosted the demand for data infrastructure. In real estate, retail and hospitality were hit very hard, but the crisis provided a tailwind for logistics.

As we move into 2021, it seems likely that changes in how we live post-COVID will continue to change the real asset investment landscape. From home working to online shopping, it seems likely that the pandemic will serve to accelerate some significant societal shifts. We expect to see greater differentiation of performance in each asset class, driven by their alignment to these changes.

For example, the crisis will hasten the move towards e-commerce. Where they can, people have shifted their spending online to avoid social contact and retailers are having to increase their e-commerce capacity to meet this higher demand. In the grocery sector, for example, many consumers may not return to physical stores. Investors in long-lease supermarkets must consider this when underwriting deals.

More broadly, European retail will need fewer and smaller stores. For low-engagement retailing – the type that competes directly with online shopping – retail sales in physical stores are likely to decline much faster than previously anticipated. Discretionary retailing will transition to platforms for discovery, engagement and interaction. Certain stores will remain part of a multi-channel strategy as online and offline retailing blurs. The most resilient high streets will tend to be those that combine shopping and leisure; in other words, places where people choose to spend their time.

Longer term, the high street's central role as a location for socialising will not be diminished, whether that be for leisure-based retailing or eating out. Demand for such space will rebound as the crisis eases and spending power improves. Increasingly though, real estate investors will seek to gain exposure to consumption through the logistics sector. A focus on supply chain resilience combined with a major boost from ecommerce has seen rental growth sustained in many markets.

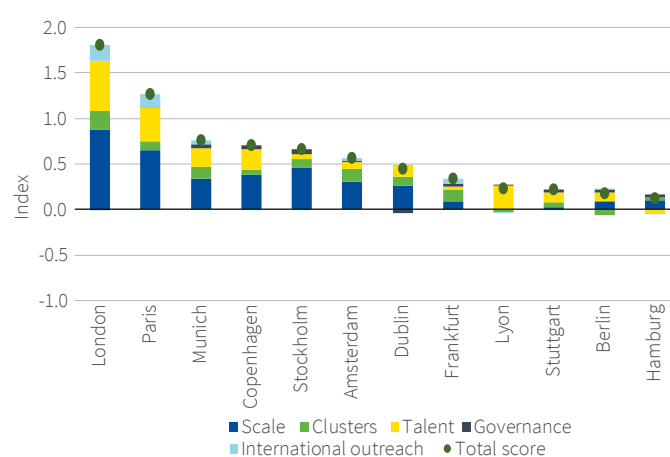
For office workers, the pandemic has created a significant working-from-home experiment. For many, this seems to be going better than expected, aided by new technology. For real estate investors, this has raised questions about the future of the office, even as the need for social distancing is set to diminish.

In our view, the importance of city offices for idea sharing and innovation is well-established, but not all offices are created equal (Figure 137). Irrespective of social distancing, the days of battery-hen style cellular offices desks are over. Agility is key. Just like in our homes, we need

Real estate investors to seek exposure to consumption through logistics

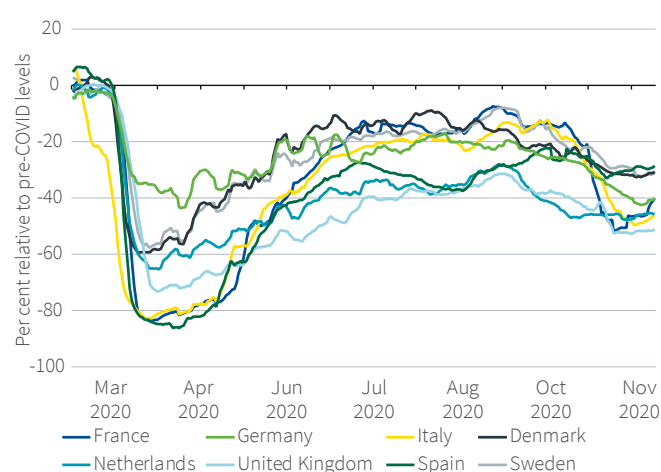
Offices to remain key to collaboration and building professional relationships

Figure 137. European offices: strategic markets



Source: Aviva Investors as at 3 December 2020

Figure 138. Public transport mobility



Source: Aviva Investors, Google as at 3 December 2020

different environments for different activities. Teams need spaces where they can form organic, temporary hubs for projects and space to co-work and collaborate, as well as places for individual tasks. We believe office space that facilitates collaboration will continue to be sought after, with locations that offer easy accessibility and attractive amenities likely to perform best. Office design will continue to evolve to ensure they remain places where people want to be and work with others.

The transport sector has been at the heart of the crisis. However, understanding the true supply and demand dynamics, particularly which are temporary versus structural, will be key. Once a vaccine is available, transport restrictions are expected to be removed, but consumer preferences may have changed.

In the near term, with goods transport more resilient than passenger traffic (Figure 138), ports and motorways with a high proportion of heavy goods vehicles should perform better. Airports look the most vulnerable but continued strong government support is expected for key assets (Figure 139). In the medium term, tourism will rebound. However, demand for some air travel is likely to be subdued. Video conferencing may be deemed a substitute for some business travel.

This crisis has supported the case for investment in data centres and fibre networks as our lives have become more data dependent than ever. Infrastructure providers are not directly exposed to data volume so revenues for the sector are likely to increase at a slower rate than the underlying demand. Yet, amid growing demand, investors should remain focused on the long-term business case for their investment. In the short term, where such infrastructure is rented to companies, the quality of tenant will drive asset performance. In the long term, the current crisis could well accelerate the displacement of older technologies by faster networks. Our analysis of relative value across real assets points to greenfield fibre offering particularly attractive opportunities for investors seeking growth.

From a relative value perspective, we also see opportunities in UK and European long lease real estate. There is often a perception that the lower initial yields of long lease mean lower expected returns. However, our analysis suggests expected returns in traditional sectors as well as student accommodation, supermarkets and hotels are similar to industrials on a 5-year horizon, and higher than from the office market, but crucially offer much lower volatility.

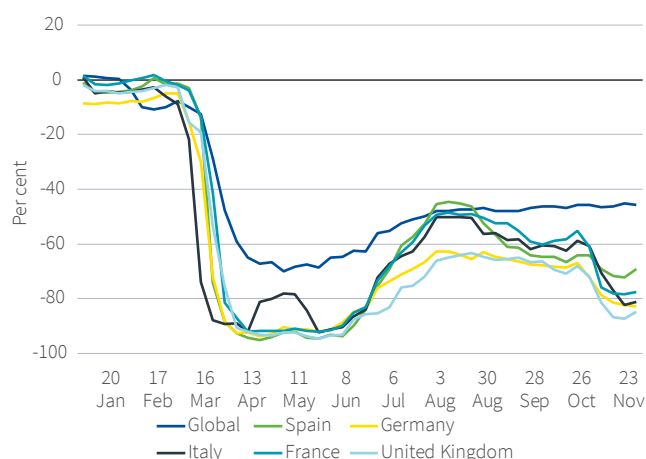
For UK logistics assets on long leases to tenants with strong covenants, the investment market is moving quickly with yields compressing (Figure 140). This is a reflection of the favourable relative pricing of real assets created by the change in the UK in monetary policy regime. Where investors have confidence in the resilience of the underlying income streams, income-hungry investors are attracted by current yield levels (Figure 141). As economic activity and real estate usage normalises over the course of next year, confidence in the strength income

Transport infrastructure: little distance travelled

More data dependent than ever

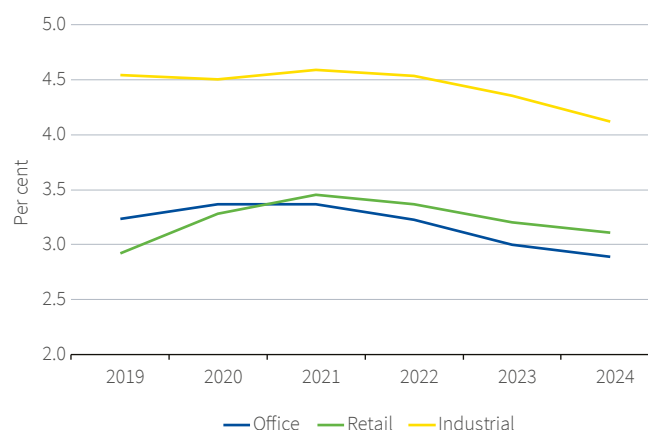
Long income real estate looking particularly attractive

Figure 139. YoY change in weekly flight frequency of global airlines



Source: OAG Schedules Analyser as at 3 December 2020

Figure 140. Europe (ex UK) property yields



Source: Property Market Analysis, Aviva Investors as at 3 December 2020

streams is likely to grow and investors are likely to be attracted to the excess return offered by real assets (Figure 142).

Looking ahead, we expect the carbon transition to increasingly determine investment opportunities and shape investment outcomes. The objective of net zero carbon is being enshrined in law across Europe. This will generate a large pipeline of opportunities to invest in low carbon infrastructure and cleaner buildings.

Following the Task Force on Climate-related Financial Disclosure recommendations, a growing number of investors are disclosing their portfolio's alignment with the net-zero objective, and the UK has recently made such disclosure mandatory. EU is also requiring some financial products to disclose their climate impact from next year using the taxonomy. As a result, alignment to the net-zero agenda will increasingly drive asset values. This will particularly impact new real estate and infrastructure developments, which have a higher embedded footprint.

Carbon transition to shape investment pipeline and outcomes

Figure 141. Europe (ex UK) All Property vs 10y German Bond

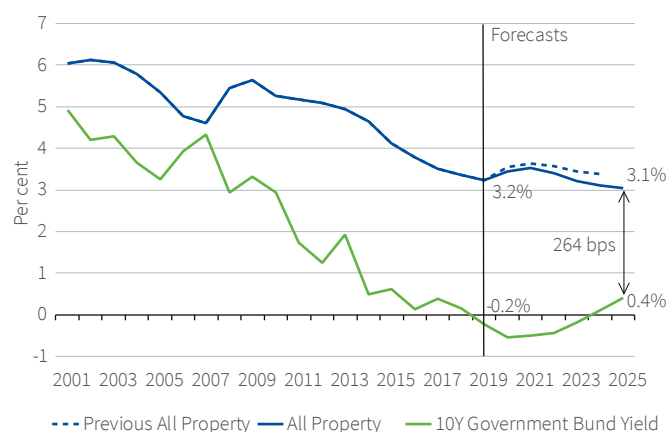
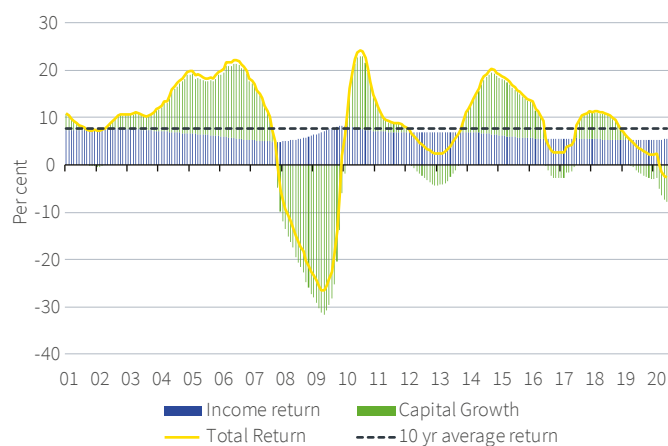


Figure 142. UK Real Estate MSCI Monthly Index (annual % change)



Cross asset volatility: lower for longer

With the US election out of the way, confirmation that we will be in a very loose monetary environment for a long time to come and with COVID-19 vaccines available soon, we are seeing volatilities starting to normalise (Figure 43 & Figure 44). This normalisation comes after the massive shock inflicted on markets in March 2020 and the soothing impact of the aforementioned events and policies working their way through the system. We expect this trend to continue, not only driven by the absence of further known events, but mainly driven by the implicit mandate of central banks to achieve price and financial stability. Combined with the ultra-low interest rate regime and very dovish settings for US monetary and fiscal policies, the selection of Janet Yellen as Treasury Secretary promises an era of extremely close co-operation between the Fed and Treasury. The continuation of the regime of near zero real rates will motivate market participants to use strategies by which they can harness the positive difference between the volatility implied in option prices and the realised volatility observed over time, in order to achieve yield.

These strategies had been extremely popular prior to the COVID-19 crash but, due to heavy losses in March/April 2020, many participants paused or stopped using them. We feel that these strategies will gain popularity again, as the risk premium is now a lot bigger than it was pre-crisis and that this will continue to help push implied and realised volatilities lower. A lot of this normalisation has already happened, but the trend continues to be lower. Central banks have given strong, long-term forward guidance with the mantra of “lower for longer”, reducing the surprise function, something that has historically led to swings in asset prices when the central banks catch the market off-guard, and the implicit volatility that comes with surprises. They have also engaged in asset purchase programmes, not only to support prices, but to guarantee price stability and market functionality. In effect they have removed or reduced a part of the distribution, again an impact that will reduce the overall volatility.

While it can be argued that the events of this year have triggered a renewed demand for hedging and long volatility structures, the extreme levels of experienced volatility have a strong effect on risk simulation, on risk appetite and will impact risk taking for some time. Similarities with the GFC can be drawn. Then the impact of the GFC shock became less relevant in risk simulations as time passed and global asset markets entered a phase of extremely low volatility that lasted for years, briefly interrupted by events such as the taper tantrum, the European sovereign debt crisis, the XIV event, the Trump trade war and others, without really significantly changing the downward trajectory of volatility.

It needed an event such as the COVID-19 crisis to change the overall volatility regime. The violent nature and duration of this shock allowed volatilities to reset higher, but the underlying drivers that led to the steady reduction of volatility have not changed. If anything, they have been increased and have solidified. On the other hand, we expect put convexity, the parameter

Volatility has begun to normalise as risk events fade and policy remains easy

We expect strategies that take advantage of implied vs realised volatility to once again come into favour

A downward trajectory of volatility is expected...

...but dealer balance sheets will likely see the cost of tail risk hedging remain more elevated

Figure 143. Volatility of the 1Y options on 10y & 30y US Treasury Swaps



Source: Aviva Investors, Bloomberg, Macrobond as at 3 December 2020

Figure 144. Volatility of the 6m ATM vol on the SPX



Source: Aviva Investors, Bloomberg, Macrobond as at 3 December 2020

that measures the price of the downside tail risk, to remain elevated for longer (Figure 145). This is due to the nature of the March 2020 shock, that was strong, deep and prolonged, with solid, outsized down moves and the regulatory framework that banks must adhere to. The regulators have, in the wake of the GFC, imposed risk limits on banks, limiting their losses in extreme market shocks and this has a strong impact into the pricing of those far-out-of-the-money puts, that have very low premium, but could potentially have a big value if the markets were to fall a lot. This means that the price of those options will fall more slowly than that of others and this in turn means that the implied volatility of those options remains elevated for longer.

It has become clear that central banks will not abandon financial markets and that they are heavily invested in the smooth working of those established markets. This implies their predominant wish is for lower volatility. The problem is that this has led, and will likely lead again, to complacency and risk premia that are too small. In our view we will likely see prolonged periods of very low volatility, followed by short periods of significant repricing, interrupting the overall trend to lower volatility. The frequency of those shocks will be hard to judge, but we feel that the magnitude of those shocks could likely be bigger than history would indicate.

An aggravating factor for those volatility spikes could be the reduced population of “natural” market-makers, such as banks and asset managers, who have been squeezed out by the high-frequency and ultra-high-frequency players. Those lightly capitalised and highly computerised hedge funds create a lot of volume and liquidity in normal times, but in times of stress they will quickly stop quoting or turn in the same direction, as they just do not have enough capital to take the other side of the market.

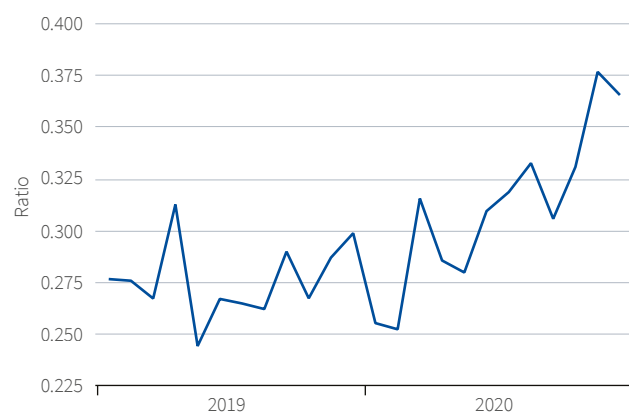
This will mean that the volatility risk premia will continue to be exploited, but that the risks associated with it will be bigger than anticipated and strong risk management and an adaptive and effective implementation will be even more important than it has been in recent history.

Expect periods of brief, but significant, increases in volatility

Reduced market liquidity, particularly in stress conditions likely to exacerbate vol spikes

Short volatility strategies will require careful risk management

Figure 145. Normalised volatility spread of the 6m Convexity of the SPX measured as $\{(10 \text{ delta put vol} - 25 \text{ Delta put vol})/50 \text{ Delta put vol}\}$



Source: Aviva Investors, Bloomberg, Macrobond as at 3 December 2020

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