DEAL OR NO DEAL?

AVIVA INVESTORS
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Key points

- Rebounding US output underpins favorable outlook for global growth
- It is unclear how much events in Greece will affect the world economy
- A US rate rise is justified, though unexpectedly fierce hikes could affect confidence and markets
- Prospects for risk assets look encouraging, though government bond yields remain unattractive

Ian Pizer[1]

Ian heads our investment strategy and is responsible for formulating our 'House View' and the risks to that view. He joined in 2014 as a senior fund manager in the multi-asset team, focusing on our multi-strategy range known as AIMS. Previously he spent over 10 years at Standard Life Investments.

Ian Pizer says the prospects for the global economy and risk assets are encouraging.

We believe the world economic outlook remains broadly favorable with global output set to expand at close to its trend pace this year and next. The US economy has rebounded reasonably well following an unexpectedly sharp slowdown in the first quarter, while there are also signs of improvement in Europe and Japan.

However, it is unclear how events in Greece will affect the global economy. Our central case is that aggressive action by European authorities will minimize the impact. Having said that, there are material downside risks in the event this is not the case.

Developed economies lead the way

The US central bank looks poised to raise rates for the first time in more than nine years in response to the recent pick-up in domestic economic data. There have been plenty of signals that suggest the US economy is in better shape. In particular, two areas that the Federal Reserve (Fed) deems especially important – the jobs market and monetary trends – have painted an upbeat picture.

European economic data has also strengthened steadily in recent months, after the European Central Bank (ECB)'s introduction of 'quantitative easing' helped underpin confidence. The ECB's action, by weakening the euro, has provided a boost to the region's exporters.

The world is adjusting to a new norm: a slowing Chinese economy. While output this year is likely to increase by around seven per cent, this would be the slowest rate of growth seen since 1990. But this deceleration is not a cause for concern.

US rate risks

We believe the Fed is right to consider raising interest rates. It may well be that not much tightening of policy is required. But not moving forward would, in our view, be a mistake. While there is a risk that longer term market interest rates in the US could rise significantly, both the domestic economy and riskier asset classes should be resilient. After all, the rise in rates is being driven by firmer economic data.

That said, we cannot rule out the possibility that a sudden surge in rates, augmented by reduced liquidity in US fixed income markets, could hit investor confidence to negatively affect risk assets. That could potentially have detrimental effects on global activity. We view such an event as unlikely unless the Fed is pressed into tightening policy more aggressively by a sharper rise in US inflation than is currently anticipated.

Such an event would have a negative impact on emerging nations as capital outflows could drive asset prices lower and currencies weaker against the dollar. Few emerging economies would be immune, although China, India and Russia have historically shown markedly less sensitivity to developments in US financial markets than other emerging economies.

[1] Investment professionals listed are members of AIA participating affiliate, Aviva Investors Global Services ("AIGSL")

Past performance is no guarantee of future results.

Cautious optimism

The outlook for riskier assets remains moderately favourable. However, given that many equity markets are still close to record highs, shares are no longer cheap, particularly because it appears they may have to contend with higher US interest rates soon.

We favor Japanese and European shares. Both will continue to be supported by the actions of the Bank of Japan and ECB. US stocks look relatively more expensive given the outlook for US interest rates and the strength of the dollar. Emerging market equities continue to look vulnerable given the likelihood the dollar will continue to appreciate.

We believe prospects for corporate bonds are mildly positive. Although the ongoing hunt for additional returns has pushed yields, relative to those available from government bonds, to their lowest level for some time, companies' balance sheets are generally in healthy shape.

As for government bonds, yields remain unattractive despite the recent sell-off.

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