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ECONOMIC UPDATE

Going for Goldilocks

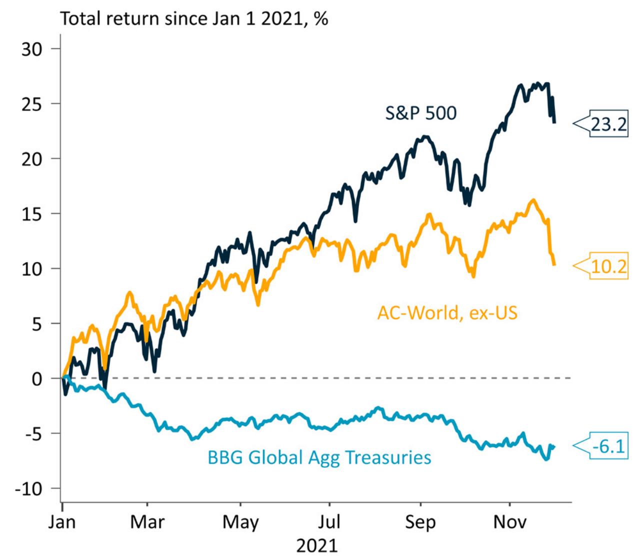
Most advanced economies have seen peak growth but there remains an expectation that above trend growth rates will continue in 2022. Policymakers have the unenviable task of now guiding the transition to a new normal with a focus on fixing supply-demand imbalances and working to see both inflation and unemployment fall. There is little room for error. Asset markets will need to cope with both the implications of policy normalisation and slowing growth rates that will weigh on returns. Uncertainty remains elevated, not least because of the appearance of the Omicron variant that presents considerable downside risks to the outlook.

Global: Growth beyond the recovery

While 2020 was a year of recovery in equity markets, 2021 has seen them post strong gains as economic activity improved, monetary accommodation remained unprecedented and entrenched, and fiscal policy remained supportive. The US S&P 500 has outperformed most other global markets and, at the time of writing, appears set to return in excess of 25% for the year to sit 43% above its pre-pandemic peak. Equity markets outside the US, that in many cases had a challenging start to the year, are likely to also post solid gains of around 14% (MSCI ACWI-ex US) to be just above 20% higher that the pre-pandemic peak. Equity markets have priced in much of the good news on economic recoveries so while they will remain favoured by investors, returns will be challenged in 2022 by the impact of slowing growth rates, already elevated inflation, and inevitable monetary policymaker action to gradually wind back pandemic-induced emergency settings. Fixed income returns, particularly for sovereign bonds, struggled in 2021 as economic recovery took hold and it became clear that inflation was more persistent than the word 'transitory' implies. It appears 2022 will be

GRAPH 01 **GLOBAL MARKETS**

Can equities keep delivering strong returns?



Source: IFM Investors, MSCI, Bloomberg, Macrobond another difficult year as central banks seek to pare back policy settings. As we write, the new Omicron variant of COVID-19 is reverberating through markets and the impact on markets and economies is highly uncertain. It is an open question as to whether this will be a less harmful variant that can be addressed within current parameters and vaccinations, or a more virulent strain that is a greater threat to public health. The latter would likely result in ongoing risk-off moves in markets as they anticipate renewed restrictions that would lower growth and foster even more inflation, and potentially more policymaker action.

In 2021, the global economy rebounded as expected from the pandemic-induced recession of 2020. However this strong global rebound masks considerable deviation in recovery strength between individual economies that has been highly dependent on vaccination rates and the lifting of restrictions that held back economic activity. This is illustrated by the fact that at the mid-point of 2021, 21 of the 37 largest economies globally had still not recovered to pre-pandemic levels of output. While most advanced economies are passed 'peak-rebound', there is an expectation that above trend rates of growth will continue in 2022. And in this environment policymakers are seeking to make the transition to a new normal for economies while fixing demand-supply imbalances to see inflation decelerate and unemployment rates fall too – a herculean task to get everything just right. And all this will only be possible based on the assumption that there is no material setback that stalls the winding back of public health restrictions. This is a highly uncertain point, with the Omicron variant now emerging, but as we write we are assuming that this variant can be better managed than previous ones, given relatively high vaccination rates and should this be the case growth will continue to be underpinned by the fiscal and monetary accommodation still in place. And thanks largely to the former combined with restricted ability to spend on services, the material build-up of cash on private sector, particularly household, balance sheets. This growth will likely be characterised by a swing back to spending on services rather than goods (particularly as global travel resumes), and facilitated by the dramatically reduced, but not resolved, friction in global supply chains. But we remain sceptical that economies will outperform pre-pandemic trends over coming years.

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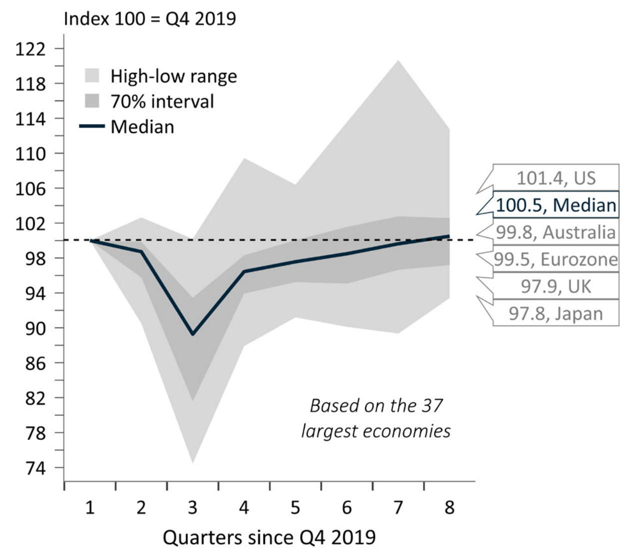
GRAPH 02 REAL GDP SINCE Q4 2019 GLOBAL

All are recovering but some better than others



Source: IFM Investors, Various national statistical agencies, Macrobond

One of the reasons for this is that both monetary and fiscal stimulus are being reversed simultaneously. The key growth driver from fiscal stimulus - cash on household balance sheets - will wane relatively quickly in our view. The focus of fiscal stimulus was flows from governments to households whose spending then benefited corporates. But it remains to be seen if this will translate into a sustained uplift in investment (particularly outside of that imbedded by the structural demands of climate change). That leaves just public investment, but with debt burdens having become significantly larger, we suspect a material expansion in this space will not be forthcoming, with the notable exception of the relatively long-dated US infrastructure plan. Of course this then leaves productivity, and while improvements in this space may be prioritised in the wake of the pandemic, to our long-standing lament, governments are unlikely to push through any aggressive reformist agendas. Here we can quote our own words from last year's Q4 missive as the words still ring true: *"Economies will eventually recover from this crisis, but they clearly won't be 'better', nor ready to face future setbacks in the near term".*

While growth did not surprise in 2021, inflation certainly did. The degree to which it decelerates over the course of 2022 will be a key determinant of the stance of global monetary policy. What is clear is that the word 'transitory', a mainstay of the 2021 central bank lexicon, has itself proved transitory in terms of its usefulness to describe inflation. Price pressures have been far more persistent than expected as fiscally-fuelled demand combined with pandemic-induced supply constraints. Most believe the latter will clear as the health crisis abates, supply chains both in producer and consumer countries improve (in terms of production and logistics) and supply responds to price signals. But that will remain a matter of faith as policymakers' ability and proactivity to remedy these issues remains questionable. The

» risk is that the deceleration of inflation occurs at a measured pace. In those countries and sectors in which wage growth has not kept pace, this will act as a near term headwind to growth as consumers face permanently higher prices (no one is expecting the spike in inflation to unwind completely).

So far the major central banks have held their collective nerve and sought to 'look through' supply side inflation that they have little influence over. This has been the correct course to take as adjusting policy to meet it would clearly risk economic recoveries and the key objective of labour market repair. The word 'stagflation' has been re-popularised but in the stricter sense of the concept - high and rising inflation and unemployment and weak growth - it has been overplayed. The greater risk appears to be slower growth and less pronounced labour market repair, and central banks seeking to address current inflationary pressures would only exacerbate this risk.

Such an eventuality is counter to the objective of all central banks, which is to generate sustainable, near target, inflation spurred by the demand side and the Phillips curve. The challenge for central banks will be to calibrate policy as economies transition from the "inflation that must be tolerated" (and inflation expectations managed) to the "inflation that is desired". This is particularly true as it becomes even more difficult to differentiate between the two once indirect effects flow through. It is a new paradigm for them. After spending the years before the pandemic setting policy to get inflation to accelerate, they are now trying to get inflation to decelerate and have a soft landing as their targets.

On the basis of the current inflation outlook, our expectation is that in the first half of 2022 developed economy central banks will seek to draw to a close the emergency and largely quantitative policy settings employed to address the economic impact of the pandemic. Although we believe that current market pricing for rate hikes is overdone in terms of timing and magnitude, we do expect to see the early stages of what will be a cautious path of policy normalisation.[1] The Bank of New Zealand has already begun this process and the Bank of England (BoE) is widely tipped to lift its policy rate later this month. Of the majors, the US Federal Reserve (Fed) is likely to be the first to raise rates early in the second half of 2022, with the European Central Bank (ECB) and Bank of Japan (BoJ) content to let the Fed go it alone, adjusting only non-interest rate policy over the course of the year. We expect the Reserve Bank of Australia (RBA) to also fall into this category.

For asset markets, the challenge will be to cope with the passing of peak policy stimulus and the speed at which that stimulus is removed, particularly in the US. This will occur as economies move from the outright recovery phase of the economic cycle to a broadly expansionary one that's characterised by already elevated levels of inflation. In this environment, equities should continue to do relatively well in 2022, yet not as well as 2021 when headwinds were still limited. As this year comes to a close, equity market valuations appear stretched, particularly in the US. Fundamental drivers, such as company earnings, will

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need to keep on delivering in economies in which stimulus is fading, This may be possible in the nearer term, but it may be challenged if economic growth underperforms expectations. The removal of monetary stimulus, however gradual, will keep fixed income returns under pressure. It remains uncontroversial to be underweight government bonds from a strategic perspective. But investors will likely take tactical positioning around duration across jurisdictions as global central banks decouple their policy settings. In the credit space, the extreme compression of both investment grade and high yield spreads will likely continue to gradually unwind to levels that prevailed, on average, pre-pandemic. This should occur as central bank quantitative easing (QE) purchases are wound down and corporate issuance is expected to remain strong. This view assumes no material rise in corporate stress, with economic conditions supportive and balance sheets solid.

We expect to see some paring back of overweight positions in global equities and investors remaining underweight the bulk of the fixed income space. However, real assets continue to look attractive. This reflects investors looking for additional returns by edging up the risk curve and the supportive macroeconomic backdrop. Over the course of the coming year, infrastructure offers an attractive hedge against elevated rates of inflation. We observe this directly via our own global infrastructure portfolio which has a positive inflation 'beta'. Further, in previous cycles inflation would have been preceded or accompanied by central banks tightening monetary policy that would push up risk free rates. However, this is not the case in this cycle. Inflation has come first and central banks are seemingly content to remain cautious. While we do not expect real rates to stay at or near record lows, we believe they may stay low, and possibly negative for some time yet, serving as a tailwind to the infrastructure sector. We also believe the sector benefits from the dynamics of reopening economies, given strong GDP linkages. For example, strong demand for goods has lifted port volumes materially higher, particularly in jurisdictions that have been able to get goods supply. Another late cycle example is the rebound in airport traffic that should gather momentum through the course of 2022 as international border restrictions ease. »

[1] It is worth noting that the neutral level of rates is in the recovery phase of this cycle is unusually uncertain, though we expect that once economic activity normalises, neutral rates will be lower than before the pandemic.

» While the expansionary phase of the cycle should continue in 2022, geopolitical and domestic policy risks will likely bubble away through next year with potentially material impacts on markets and economies. Key among those that are known are:

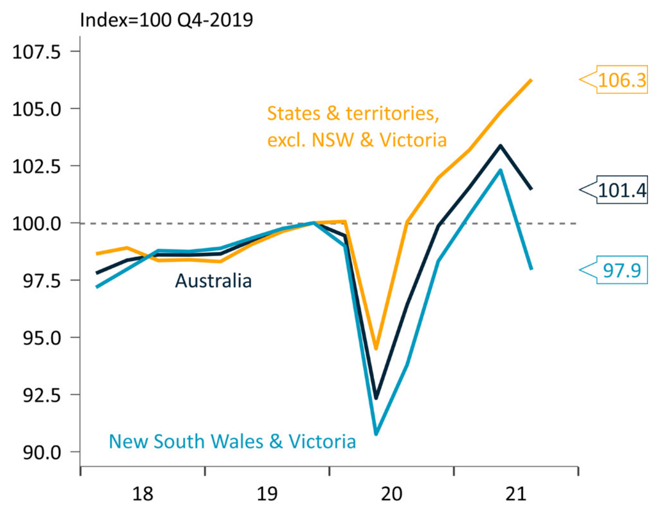
- **A reversal of improving pandemic conditions.** This is not to be underestimated given several European countries are currently facing at least some reintroduction of restrictions due to case numbers rising despite relatively high vaccination rates. As we noted earlier the emergence of the Omicron variant of COVID is a developing story currently around which there is little certainty, the outlooks canvassed in this piece are all highly dependent on this being resolved with aggressive prolonged restrictive public health measures being unnecessary.
- **US-China trade tensions remain**, despite a lull in antagonistic rhetoric on both sides through the pandemic and with the change in the US administration. By contrast, China's deteriorating relationships with middle-powers will continue to drift, with particular risks for Australia. US-Iran discussions about nuclear capability has scope to reignite regional tensions, with likely consequences for oil prices.
- **US mid-term elections**. History has shown that incumbent Presidents lose support at the mid-terms and as it stands the poor approval ratings of the Biden Administration means the 2022 mid-terms will likely be no different. This may create uncertainty with regard to the passage of fiscal stimulus and the debt ceiling.
- **In Europe there are several elections**, with Presidential races in France and Italy being key given the potential for them to set the post-Merkel tone in the region (along with the fledgling German coalition government elected in 2021).
- **Brexit-related risks continue in the UK**, with a non-trivial risk that Article 16 of the Northern Ireland protocol is triggered, a signal that trade tensions between the UK and Europe will continue for some time to come.

Australia: Recovery from lockdown

Australia's relatively aggressive public health approach to the public health crisis through the second half of 2021 saw it fall behind many advanced economies, in terms of recovery in Q3. This was evident in the national accounts that showed a 1.9% reversal of fortune due to prolonged lockdowns in the two largest states (in terms of economic output and population). In annual terms, the economy has now expanded at a 3.9yoy rate but despite this, output remains 0.2% below the level that had prevailed before the pandemic. Encouragingly, this is largely confined to a single quarter impact. Growth was most heavily negative in household consumption which was 4.8% lower in the quarter due to restrictions that partly impacted retail trade and heavily impacted services spending. Households had little to do during the quarter as evidenced by the household savings ratio jumping to 19.8%. This sets households up for a strong spending rebound in Q4 and likely 2022. Business investment and dwelling construction activity both weighed on quarterly growth, and inventories also subtracted as stocks were run lower due to supply shortages. On the positive side, public spending added to quarterly growth, as did net exports, with the latter adding 1.0pp in the quarter. While adding to growth, net exports more accurately reflect an economy that was restricted in terms of both demand and supply. The 4.0%qoq fall in imports, dragged lower by a slump in consumer goods, was the key driver of the net exports outcome. The lockdown effect was most pronounced on a state-by-state basis, with state final demand contracting sharply in New South Wales and Victoria (by 6.5%qoq and -1.4%qoq respectively), while other states expanded a collective 1.4%qoq. Price pressures across the economy have so far been moderate, with the domestic demand deflator and household consumption deflator up 2.3%yoy and 1.8%yoy respectively.

GRAPH 03 DOMESTIC & STATE FINAL DEMAND

Lockdowns hold back expansion in largest states



Source: IFM Investors, ABS, Macrobond

On CPI inflation, Australia has faced some upward price pressures but these have been more moderate than other advanced economies. Indeed headline inflation decelerated to 3.0%yoy in the Q3 release, with much of that attributable to inflated petrol prices and home-building costs (as government subsides rolled off). Underlying inflation surprised market expectations by accelerating materially (trimmed mean: 2.1%yoy, weighted median: 2.1%yoy) yet this appears largely driven by pandemic-induced factors. And while this does represent a return to the RBA's target band it has not been generated by the sustained uplift in wages the Bank wants to observe before concluding it can be sustained.

Wages growth has been modest, as expected, in Q3 at 0.6%qoq bringing the year-on-year change to 2.2% reflecting labour market conditions, skills shortages in some sectors, and wage bargaining agreements. The labour market was recovering well before the H2 lockdowns and this will likely have resumed, and be observed in coming data, as the lockdowns were lifted. That said October's data, » which reflected a sooner than usual survey period, did not reflect the lifting of restrictions in NSW and Victoria that occurred later in the month. Indeed the survey caught the ongoing lockdown impact with a net 46,300 jobs lost. The expectation is for a rapid recovery in coming months as lockdowns have been lifted and the number of people who remain "attached" to a job has remained largely unchanged through the most recent lockdowns. These soft employment figures saw the unemployment rate spike significantly more than expected from 4.6% to 5.2% in October, but this rise is set to be largely retraced in coming months.

The re-opening of borders in 2022 (pandemic-permitting) and the sooner than expected resumption of skilled and perhaps unskilled migration in coming months may slow this progress somewhat (noting that the current Omicron variant may halt this progress). This is despite the expectation of economic growth remaining well above trend for the entire year, buoyed by strong household balance sheets. The net inflow of temporary and long-term migrants will be an economic positive but insofar as the labour market is concerned the additional supply of workers may again risk frustrating the RBA's attempts to generate robust wages growth and by extension inflation sustainably in the target zone. It is also worth remembering that pre-pandemic wages growth and inflation were lower in Australia compared to other advanced economies and when pandemic-induced disruptions to supply and consumption activities fade there is reason to believe that the structural forces in play before the pandemic will reassert themselves.

Whatever the eventual outcome markets are of the view that rates could begin rising as soon as mid to late 2022, significantly earlier than the Bank's initial forward guidance of 2024 at the earliest. The RBA pushed back in November on the market view by characterising a 2022 hike as "extremely unlikely". The base case remains for a 2024 hike as the RBA wants to be sure inflation is sustainably higher but the possibility of a 2023 hike was formally acknowledged. For what it's worth we look for a 2023 move but are cognisant that the regime shift of the border re-opening, or not, has the potential to impact this expectation. What seems more certain is that the Bank will wind back the last of its major emergency settings – its QE program– early in the year.

> **The US economy has shown its "exceptionalism" among advanced economies once again through the 2021 pandemic year for several reasons.**

This comes after the Bank pushed back on market calls in September to abandon its plan to taper asset purchases given the worsening COVID situation. Its desire to reassess the programs in February 2022 provides strong guidance that with an absence of any economic setback over summer QE will no longer be needed to underpin economic expansion.

A Federal election will also occur next year, the specific timing is uncertain but it must be before May. While too early to tell which side is favoured the promise of fiscal largess is likely and this should underpin the recovery in the economy. Indeed economic management, climate change and the handling of the pandemic will be key subjects for debate. We do not hold out much hope of the economic debate evolving beyond arguments on "debt and deficit" and the curious debate around who has kept interest rates lower and can continue to do so in the future. Despite the desperate need to make the economy more productive, any reforms that would plot a path to such an outcome are unlikely to surface in this election. On geopolitics Australia's fractious relationship with China will continue. While Australia may hold the ethical and moral high-ground it also faces the greater economic risk. While China still, for the most part, needs Australia's high quality iron ore it does not need too much else. Further, the reopening of international borders will be a key test and Chinese tourists and students outnumbered all others leading into the pandemic, whether these numbers return remains questionable should the relationship not improve.

US: Again exceptional

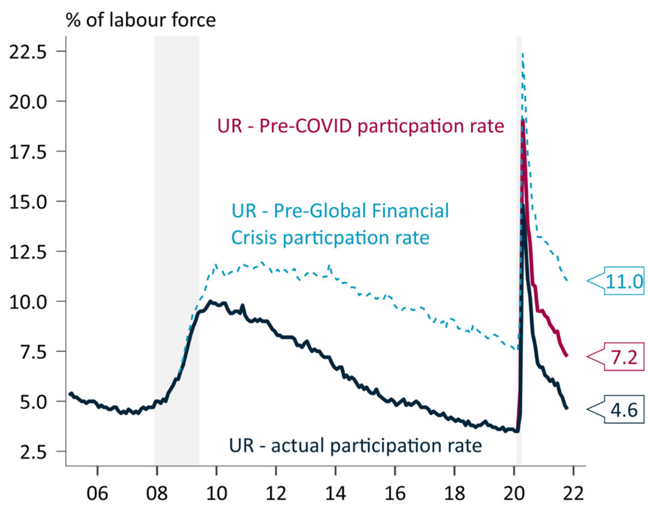
The US economy has shown its exceptionalism among advanced economies once again through the 2021 pandemic year: no central bank has expanded its balance sheet, in dollar terms, as much as the Fed; no government has added more fiscal stimulus; and nowhere have the imbalances between supply and demand been so acute and generated so much inflation. And interestingly nowhere have equity markets rallied so strongly over the course of the year.

Third quarter GDP was a slight and likely temporary hiccup in the growth narrative, however, as the US economy expanded at a slower-than-expected 2.1%qoq annualised pace. Consumption contributed positively with evidence of a rotation away from goods consumption (-2.11ppt qoq saar contribution) and into services consumption (3.29ppt contribution) which was the key growth driver. Private investment was also supportive (1.93ppt contribution) but this was largely driven by a change in inventories (2.13ppt contribution). Looking forward, growth in the US is expected to have continued apace in Q4 and likely into 2022 but thereafter growth is expected to decelerate. Indeed, consensus expectations for 2021 are for 5.0%yoy growth with 3.5% growth expected through 2022. It is worth highlighting that this expected deceleration still represents growth that is well above trend which will be necessary to make consistent improvement in the labour market.

The growth slowdown looks set to be driven more by supply side constraints than weak demand. Households have around $2.3tn dollars in excess savings due to a combination of incomes being bolstered by fiscal support and lower consumption from a combination of a number of factors including fewer spending opportunities and precautionary savings motives. Corporate balance sheets are also flush with cash. These factors should support consumption and investment and bolster domestic demand but global supply chain issues look to be a binding constraint here. Labour markets appear to be faced with a similar dilemma: data suggest that demand is high with job openings reaching all-time highs in July before softening at the margins through August and September to average around 10.7mn over those three months. But labour supply hasn't kept pace with this, contributing to stubbornly high job openings. Indeed, nonfarm payroll growth has been disappointing on balance in recent months (average of 443,000 per month in August through October) arguably held back, in part, by insufficient labour supply. The participation rate so far remains mired well below pre-pandemic levels (around 63.3%) at 61.6% in October. While this has facilitated the unemployment rate falling to 4.6% in October, it also represents a loss of productive capacity that serves to lower the economy's potential growth rate. While a gradual reversal of this decline in the participation rates is expected as pandemic-induced effects wane there is a risk that this does not happen (with the post-Global Financial Crisis period a prominent example of this).

GRAPH 04 **US 'EFFECTIVE' UNEMPLOYMENT RATE**

US participation rate risks failing to recover fully



Source: IFM Investors, NBER, Macrobond
*Shaded areas denote NBER-defined recessions

This labour force supply/demand mismatch has already contributed to strong wages growth (though base effects probably play some part as well) with the employment cost index up 3.7%yoy in Q3 – the fastest rate since the end of 2004 – and average hourly earnings up 4.6%yoy in October. This trend can be expected to continue with potentially significant implications for US inflation. Of key concern is to what degree inflationary pressures prove 'persistent'. Indeed, US inflation was always expected to firm substantially on a combination of base effects and the recovery, but the price rises that have been seen to date have been significantly larger than expected (headline: 6.2%yoy, core: 4.6%yoy) to record the strongest inflation figures in over 30 years. This is being driven largely by excess demand for durable goods – where a strong recovery in demand has not been met by a commensurate increase in supply. The normalisation of global supply chains and at least some resolution of idiosyncratic domestic logistic/supply issues combined with improving domestic labour supply are key factors in how inflationary pressures will evolve. The longer they persist the more significant are the risks of inflation expectations becoming unanchored and harder to tame. This unexpectedly persistent inflation has forced market participants to re-evaluate the Fed's tightening timeline, with lift-off now expected in the second half of 2022. Consensus expectations are for inflation to remain elevated through 2022 with headline CPI at 3.7%yoy and core PCE at 3.0%yoy before both measures soften to 2.3%yoy in 2023. The Federal Open Market Committee (FOMC) for its part has and continues to signal that price pressures are likely to be transitory and expects that rates will be raised more slowly than market pricing suggests. Although the federal funds rate remains unchanged the FOMC at its November meeting flagged that the "substantial further progress" test for tapering had been met. Accordingly, the Fed started paring back purchases of Treasuries by $10bn and agency MBS by $5bn per month starting in mid-November. At the current pace tapering will conclude by mid-2022 but there is a risk of accelerated tapering should the recovery continue on the same trajectory. Fed Chair Powell himself has alluded to this possibility, noting that there is a risk that inflation is not so 'transitory' and flagging that at its December meeting, the FOMC will discuss potentially accelerating the taper and ending QE early. In fiscal policy the $1.2tn bipartisan infrastructure bill was signed into law over the month. Joe Biden's $1.7tn Build Back Better bill that focusses on climate and welfare spending was passed in the House but currently lacks the votes for Senate approval as horse-trading continues in an attempt to get a few key moderate Democrats on-side. Further in politics, US midterm elections are in November next year and with well below 50% of Americans approving of the current administration (according to *RealClearPolitics* polling averages) the risks of a divided government where the Democrats lose either the Senate and/or the House is significant. Indeed, the fact that a republican candidate was elected governor in the Virginia gubernatorial elections in early November this year portends poorly for the Democrats: Virginia was won by Biden comfortably in the 2020 elections. The razor thin margins in the Senate – just one senator – make a loss there particularly likely. A divided government would frustrate policymaking for the remainder of Biden's term and has the potential to make it even more difficult to pass meaningful legislation than it has already been.

UK: Inflationary pressuring

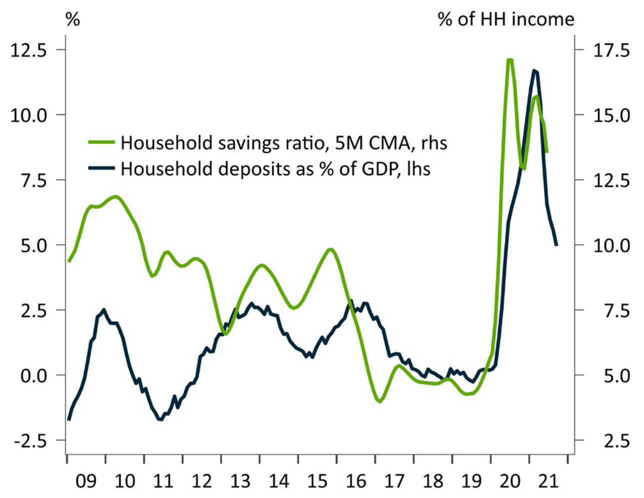
The UK economy enjoyed a period of relative normalcy through the middle of the year thanks to a rapid roll-out of vaccines. Despite a subsequent rise in case numbers in Q3 the economy continue to recover with GDP increasing 1.3%qoq. As to be expected this was a material slowdown from the 5.5%qoq growth recorded in Q2 as the economy reopened but still marked a disappointment relative to both BoE and market expectations. In terms of contributions household consumption was supportive (1.2ppts) with services consumption particularly strong (2.5ppts) as spending activity continues to tilt back towards services on reopening. Investment was softer than expected with business investment particularly disappointing after growing just 0.4%qoq.Underscoring the uncertainty of the outlook as well as supply constraints, business investment has lagged behind consumption in the recovery and remains around 12.5% below its pre-pandemic level in Q3 (compared to around 4.5% below for household consumption). This leaves the UK economy 2.1% smaller than pre-pandemic levels; a laggard compared to other major economies. Supply constraints have weighed on activity on a combination of pandemic- and Brexit-induced disruptions. Fourth quarter output is also being held back by these constraints with the BoE now expecting slower growth of 1.0%qoq, a full percentage point lower than what it expected for Q4 back in August. Looking forward, growth is expected to continue at a decent clip; consensus expectations are for 5.0% growth in 2022 with a sharply decelerating year-on-year growth trend, down from 7.0% growth expected for this year as a whole. An erosion of consumer confidence and information from card spending data has been flagged by the BoE as a signal for weaker consumer demand in Q4, a further headwind.

Another positive for households is that the labour market recovery to date has been better than expected.

In addition to this the overall fiscal impulse is negative and will weigh on disposable income growth. Firstly, the government's Job Retention Scheme (JRS) expired in September. The JRS supported workers who had to be temporarily furloughed and its withdrawal introduces downside risk to the labour market (although the data to date suggest that the labour market impact has been limited so far). Secondly, a temporary increase to Universal Credit expired in early October but will be offset by permanent adjustments to work allowances such that the net effect is to leave households at the bottom end of the income distribution around £1.5bn worse-off per year. Thirdly, there is a 1.25pp increase to National Insurance Contributions that will cost households and businesses a significant amount. Somewhat offsetting this will be higher government consumption over the next few years which will continue to provide support to the economy. Despite these fiscal headwinds to households their balance sheets remain solid with an additional £300bn added to deposits (around 13% of GDP) since the crisis began.

GRAPH 05 UK HOUSEHOLD SAVINGS AND DEPOSITS

Household balance sheets remain solid



Source: IFM Investors, ONS, BoE, Macrobond

Another positive for households is that the labour market recovery to date has been better than expected. In the most recent print – for the three months through September – a more-than-expected 247,000 new jobs were added to the economy. Despite this there are still around half-a-million fewer employed persons compared to pre-pandemic levels. This employment growth has seen the unemployment rate fall to 4.3% but the consensus outlook is for the unemployment rate to rise in Q4 2021 – ostensibly due to the JRS expiry – before retracing some of the loss through 2022 to reach 4.5% by Q4 2022. Headline average weekly earnings were up 5.8% compared to the same period last year but the Office for National Statistics (ONS) continues to note that data should be interpreted with caution given the significant distortionary effects of the pandemic. BoE staff estimates place underlying pay growth at still robust rate of a touch over 4%yoy. Experimental labour market statistics from the ONS for October point in the same direction as the traditional data with the claimant count rate (5.1%) and the jobless claims change both falling. These data are particularly important given that this represents the first month following the expiration of the JRS and suggests that the economic impacts have so far been limited. Vacancies data also lend weight to this view with the three-month average figure growing by around 64,000 to reach a record of nearly 1.2mn in October. This is approximately 390,000 higher than pre-pandemic levels and points to robust labour demand. This should dull the impact of the JRS

» expiry but one factor that will have important implications for wages and employment growth is whether there is a mismatch between the skills required to fill vacancies and the available skill set of the labour pool. To this point the BoE has noted that skill shortages and other labour market frictions are contributing to pay pressures. Price pressures continued to accelerate sharply in recent months beating already strong expectations. In October, headline inflation firmed 4.2%yoy and the core measure was up 3.4%yoy, the strongest figures in around 10 years. The BoE projects that CPI inflation will peak around 5% in April next year, mainly reflecting strong rises in energy, goods, and food prices as input costs and supply disruptions impact. Over the medium-term inflationary pressures are expected to abate as supply bottlenecks ease on the back of spending rotating away from goods towards services and as supply chains normalise with the BoE expecting a rate of 3.5% for 2022 and 2.25% for 2023. Consensus expectations for inflation are a little softer on balance with inflation expected to peak in Q2 2022 at 4.3% before slowing to 3.6%yoy at end-2022 and 2.1%yoy at end 2023. Markets had also priced in a rate hike at the November BoE meeting on the back of the strong inflationary prints but the BoE surprised by holding steady at 0.1% by 7 votes to 2. Several key Monetary Policy Committee (MPC) members had stressed a desire for tighter policy driven by rising inflation expectations prior to the meeting but a 'wait-and-see' approach was favoured. In particular the impact of the JRS expiry and slowing growth momentum were focal points. Looking forward consensus expectations are for the Bank to raise rates at its December meeting with policy very gradually tightened over 2022 and into 2023.

Eurozone: supply constrained

The second half-2021 narrative for the Eurozone economy is one of caution around rising virus case numbers and a recovery that is being hampered by lack of supply, not only to consumers but to producers, and this along with energy prices is fuelling an acceleration of inflation. This dynamic was evident in Q3 GDP data in which the Eurozone economy grew 2.2%qoq. Among the large economies Spain (2.0%qoq) and Germany (1.7%qoq) disappointed with France (3.0%qoq) and Italy (2.6%) outperforming expectations. Output for the bloc is now 0.5ppts below pre-crisis levels but the overall picture masks considerable variation across countries. In particular, Spain is a key laggard with output in Q3 still 6.6ppts below Q4 2019 levels. Real GDP in Italy is 1.35ppts off pre-COVID levels with activity in Germany down by 1.1ppts and France real GDP down just 0.1ppt. Unfortunately the prospect of material further recovery in the final quarter of 2021 is unlikely. The near-term outlook for the Eurozone is darkened by a rapid deterioration in the COVID situation in recent months with restrictions being implemented to slow the spread. Again. This will weigh on activity, particularly in the services sector. A combination of the highly infections Delta variant and the colder weather is likely to blame but a silver lining is that the high vaccination rates across the bloc and the appearance of effective antiviral drugs will hopefully keep hospitalisations and deaths down compared

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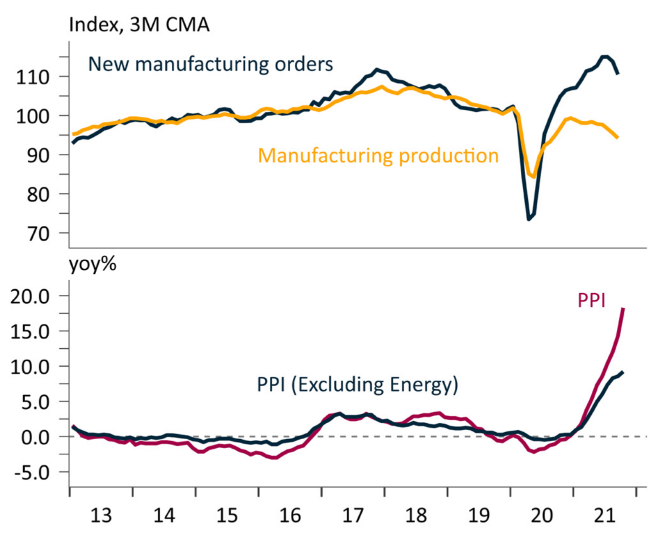
to previous waves so restrictions will unlikely be as harsh as they have been in the past. Additionally, economic activity appears to be less sensitive to restrictions, perhaps driven by economies adapting to function more efficiently in those environments. Of course, the appearance of the Omicron variant poses significant downside risks here.

The global supply chain woes besetting other economies have also weighed on activity in the Eurozone and will likely continue to be a key limiting factor for several months. The impact has been acute in Germany where manufacturing – which is particularly reliant on global supply chains – accounts for such a significant share of output. As it stands energy prices and the fact that production cannot keep pace with demand are both adding to producer prices. We expect that the spike in energy prices in the latter half of the year will be a drag through impacts to industrial activity and through impinging on the more discretionary use of household disposable income across the bloc.

GRAPH 06 GERMAN MANUFACTURING AND PPI

Supply - demand imbalances pushing up producer prices



Source: IFM Investors, German Federal Statistics Office, Macrobond »

» It is not immediately obvious that fiscal policy will be a further tailwind to growth. There will certainly by cyclical drags as pandemic emergency measures expire but this should be taken against additional structural support in 2022 from the disbursement of a portion of the Next Generation EU's €750bn in funds. And even if the fiscal impulse is negative, the stance is still set to be stimulatory. Ideally the private savings that were accumulated over the course of the pandemic will also be drawn down to counteract any fiscal drag such that demand will remain largely unaffected. Furthermore, the labour market performance in recent months has been good with unemployment falling from a pandemic peak of 8.6% to 7.4% in September, back to pre-COVID levels. It is clear that there are some headwinds, with peak growth likely in the rear-view. But the data suggests that the Eurozone entered the current problematic period with decent momentum. Past experience also suggests that activity picks up quickly after restrictions are eased such that medium term impacts are not expected to be too severe: a delay rather than a derail. Indeed, consensus expectations are for a 0.8%qoq expansion in the final quarter of 2021 with growth for 2022 expected at 4.2%; well above recent history. Inflation has accelerated sharply in recent months. In November the headline measure jumped to 4.9%yoy and the core measure reached 2.6%yoy. This marks the strongest inflation since the single currency was introduced in 1999. ECB communications in recent months highlight that the Governing Council are still firmly of the view that inflation is transitory, driven by a confluence of factors including reopening effects, supply chain disruption, energy prices and various country-specific factors like the VAT reversal in Germany. Price pressures are expected to drop below target next year (1.7%) before softening at the margins in 2023 (1.5%). Consensus expectations are for headline inflation to peak at 4.2%yoy in Q4 2021 before softening materially to 2.3%yoy at the end of 2022 and again to 1.5%yoy by the end of 2023. In light of these unexpectedly strong inflation figures the Bank did acknowledge that headline and core inflation had surprised to the upside, raising doubts "about how well the models relied on in the projections were able to capture what was currently happening in the economy, the structural changes implied by the pandemic and the impact of the ECB's new monetary policy strategy". On balance the ECB sees a hike in 2022 as a highly unlikely event. Indeed, consensus expectations are for Eurozone lift-off to happen in late-2023/early-2024, lagging rate rise expectations for the BoE, the Fed, and even the RBA. Any eventual increase in rates is predicated on a set of 'triple lock' conditions to avoid the premature tightening of 2011 and the associated negative economic fallout. These conditions include: 1) HICP inflation forecasts need to hit 2% "well ahead" of ECB's forecasting horizon, 2) HICP inflation must be expected to durably remain at 2% for the remainder of the forecast, and 3) realised underlying inflation must be "sufficiently advanced" to the goal of HICP inflation stabilising at 2% over the medium term. In politics Germany has a new government based on a coalition between the SPD, The Greens and the FDP. The SPD will take the chancellery with Olaf Scholz set to be the next Chancellor, replacing Angela Merkel after her many years at the helm. The Greens will get control of a newly created ministry of the economy and climate protection. The coalition aims to make Germany a "socio-ecological" economy and there is a potential for a significant growth impulse over the medium term on the back of material state and private investments. Near term changes will likely be insignificant given policy implementation lag. The new German government will need to focus on the regional political environment as well if momentum towards further integration is to be maintained. This is particularly true as the two other major regional economies France and Italy having Presidential elections in 2022.

> **Japan's economy has been beset by negative shocks to activity over the past two years or so and has struggled to find its footing in 2021**

Japan: A forgettable 2021

Japan's economy has been beset by negative shocks to activity over the past two years or so and has struggled to find its footing in 2021. Indeed, two of three quarters of GDP have recorded negative outcomes and one was only a modest positive. Similar to Germany for those economies that run current account surpluses (largely because they make things) supply chain disruptions have heavily impacted that business model. In Japan's case this was most notable in the autos sector hitting production, exports and capex. A resurgence in Delta-variant case numbers also put a dampener on the economic recovery. Japan has lagged many of its peer economies thus far and this was again the case in Q3. Activity in Japan contracted in the third quarter with real output down 3.0%qoq annualised. As a result the economy remains 2.2% smaller compared to pre-pandemic levels. And while a contraction was expected by market participants given the state of emergency and infection control measures in place over much of the quarter this contraction was significantly larger than expected. Private consumption suffered a sizeable contraction (4.5%qoq annualised) with durable goods consumption particularly soft (-42.9%qoq annualised). Gross fixed capital formation was down by an even larger amount (-11.9%qoq annualised) with private non-residential capital expenditures falling by 14.4%qoq annualised. Exports also softened materially »

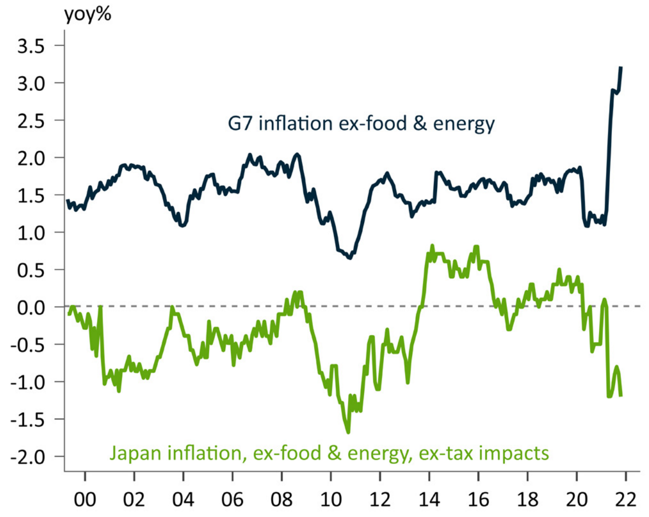
(-8.3%qoq annualised) on the back of supply constraints but a larger fall in imports (-10.5%qoq annualised) left net exports positive at the margins. Fortunately the outlook is now more optimistic than it was last year this time. After a slow start to vaccinations Japan has now overtaken many advanced economies (including US/UK/Germany/France). This, combined with new and effective non-vaccine therapies should put an end to the cycle of tightening and easing of restrictions that has frustrated the recovery. Indeed, the market supports this assessment with consensus expectations for growth of 2.0%yoy in 2021 before picking up substantially to 2.6%yoy in 2022. Consumption is expected to be a key driver of the recovery looking forward (consensus 3.5%yoy in 2022) for a number of reasons. Household savings are high on the back of limited consumption opportunities in recent times and government support throughout the pandemic.

Furthermore, the labour market has remained resilient over the course of the pandemic with the unemployment rate at 2.7% in October, following some volatility in prior months in line with the various states of emergency. Finally, household incomes haven't been persistently negatively impacted after rebounding sharply following a collapse in Q2 2020 to hit pre-pandemic levels in early-2021. Consumers in Japan therefore appear well placed to take advantage of pent up demand as restrictions are eased. A key factor working in the opposite direction, however, is the oft mentioned supply chain issue that may hold back goods consumption. But to this point it is worth noting that goods consumption has already recovered well but services consumption remains well below pre-pandemic levels and there is accordingly likely to be a pivot away from goods consumption towards services as has been seen in other economies in the recovery phase. Capital expenditures are also expected to be a notable driver of the recovery (consensus 3.6%yoy in 2022).

The pandemic laid bare the shortcomings presented by the limited digitalisation of some aspects of Japan's economy. To this end the government has signalled that modernisation is a key focus and launched an agency in September with a mandate to promote digitalisation in the public-sector. This private and public digitalisation push is expected to support capital expenditures going forward. Another distinctly positive development for the outlook was the announcement of a sizeable stimulus package in November amounting to ¥55.7tn. This far exceeded expectations and marks the largest fiscal package in Japan's history. Details around the package are limited at this stage and it is therefore difficult to make an assessment of the impacts on GDP but in terms of key measures announced these include subsidies for SMEs, cash payments to individuals, and further spending on COVID prevention and vaccine development. The headline figure may overstate the substantive impact of the package, however. To date approximately 30% of previously announced COVID-related emergency funds have not been used such that there is an expectation that some of these funds will also go unspent and also because of an elevated marginal propensity to save among individuals that would limit the multiplier effect of cash handouts. A key downside risk to the outlook, apart from the supply issue flagged earlier, is the risk of a China slowdown in 2022 which would have a significant negative impact on production and exports.

GRAPH 07 | JAPAN AND G7 'CORE' INFLATION

Consumers in Japan less impacted by supply chains



Source: IFM Investors, Japan Statistics Bureau MIAC, Macrobond

In stark contrast to the experience of other advanced economies Japan has not experienced surging inflation in recent months. Indeed, until September this year headline CPI was in deflationary territory for 11 consecutive months with new core inflation (excluding fresh food and energy) in deflationary territory for the past 7 months. As of October headline and new core were at 0.1%yoy and -0.7%yoy, respectively. Inflation figures are somewhat distorted by one-off factors including a shift in the base year and a collapse in mobile phone service charges but underlying inflationary pressures are certainly nowhere near the BoJ's target. And they aren't expected to be for some time yet with the market expecting core inflation to firm to 0.6%yoy in 2022 and 0.7%yoy in 2023. The BoJ is a bit more optimistic on core inflation but still expects it to be far off target through 2022 and 2023. In terms of monetary policy the BoJ hasn't made any significant changes in recent months and there is no expectation of policy rates changing through to 2023, in line with soft inflationary pressures.

In politics Yoshihide Suga unexpectedly resigned as Prime Minister early in September after a brief stint at the helm following the resignation of long-standing leader Shinzo Abe in mid-2020. Fumio Kishida was elected the leader of the ruling Liberal Democratic Party (LDP) later in September and by extension became the new Prime Minister of Japan. Shortly after the election of the new PM, Japan held a Lower House general election that saw the LDP retain its majority, although by a narrower margin than previously.

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