ECONOMIC UPDATE

Taming inflation

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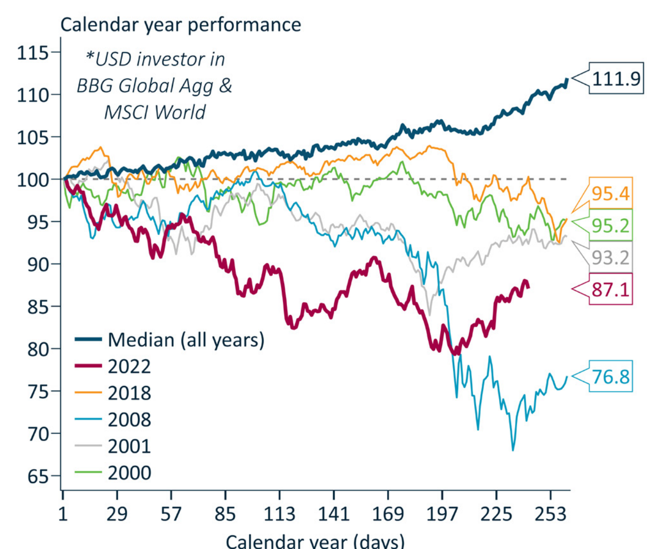
Advanced economies are navigating the dual challenge of high inflation and a weakening growth outlook. High rates of inflation have caused central banks to raise interest rates exceptionally quickly and, in most cases, tightening will likely continue based on near term data, suggesting downside risks to economic growth in 2023. This is the cost of central banks trying to drag inflation meaningfully lower. The inflation outlook is critical and will define just how much economic pain central banks will have to risk before they potentially pivot. While there is emerging evidence that the peak in inflation is behind us, the speed at which it decelerates will be a key signpost for investors.

Global: weaker growth, but lower inflation?

In our 2021 end-of-year missive we expressed the view that 2022 would be a challenging year as central banks pared back policy settings with the aim of remedying supply-demand imbalances and getting inflation back to target. Whilst the directionality of this call was broadly correct, 2022 was characterised by weakness across most asset classes that few – ourselves included – could have envisaged. It was one of the most challenging years for a long time for many investors, particularly in a year where there was no outright recession. Nonetheless the key driver was still economic in nature: the difficulty of pricing 'stagflation' and the consequent policy response into the economic outlook. The year was defined by this narrative from the outset with key advanced economy government bond yields rising rapidly and equity markets selling off as investors realised that central banks were intent on raising rates exceptionally quickly to get inflation back under control. Rising risk-free rates, coupled with rampant inflation and a weakening economic outlook, prompted increasing correlations across both growth and defensive asset classes, leaving investors with few places to hide. Indeed, 2022

GRAPH 01 GLOBAL 60:40 PORTFOLIO*

Lack of asset class diversification was costly in 2022



Source: IFM Investors, Bloomberg, Macrobond

was one of the worst years on record for the traditional '60/40' portfolio in terms of outright returns and economic risks are, to our mind, only building as we enter 2023.

Looking forward to the coming year, we expect markets to remain sensitive to these inflation and monetary policy considerations. However, in the near term we view further significant selloffs as unlikely and are looking for some modest upside as pressures recede in global markets, better-than-expected economic data and peaking inflation exerting less pressure on central banks. This represents a push back from the 'peak-pessimism' that emerged in global markets through much of late 2022. Most notably, the extreme weakness of consumer sentiment globally as interest rates and inflation (i.e. the cost of living) rose in tandem. This theme was evidenced in November when lower-than-expected US inflation data prompted a material risk-on move that pushed the S&P500 up over 5.5% and the US 10-year bond yield down 30bps in a day. This is the largest decline of the 10-year bond since early 2009. Excluding the pandemic-induced volatility of 2020, this is also the largest positive one day move in the S&P500 since early 2009. Interestingly, this rally was characterised by similar positive correlation between growth and defensive asset class returns.

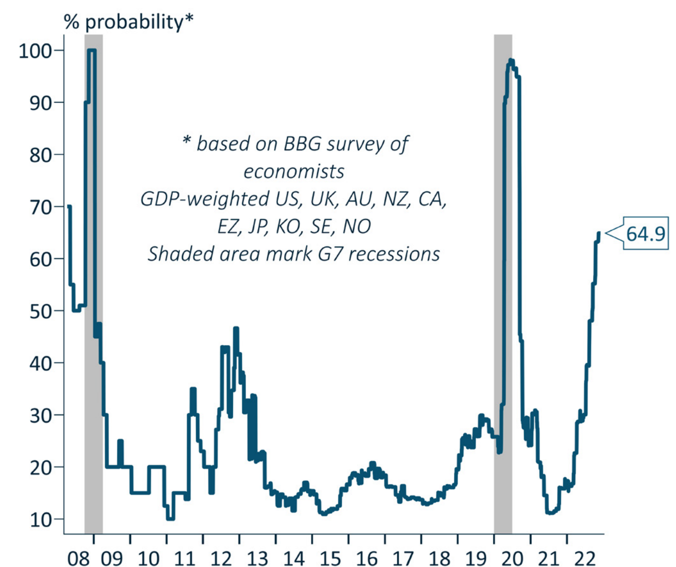
The temptation for these risk-on moves to occur is understandable. The equity market sell-off in 2022, particularly in the US and Eurozone, has reset valuations so they no longer appear as stretched as they were in the peak-pandemic stimulus period. Further, while equity markets may not yet have bottomed, investors seem to believe that further modest declines are manageable, particularly if they are based on the expectation of a softer landing than is currently being priced. Bond yields have similarly moved higher due to central banks tightening policy to neutral levels (or beyond) given elevated inflationary pressures. Again, in bond markets there is an expectation forming that yields have peaked and being wrong about this in the current environment is likely to be less costly than it was when rates were lower. This view appears more consensus for investors who are awaiting the economic downturn in 2023.

Despite this price action, we do not believe that one or two better-than-expected inflation prints mark the end of aggressive central bank action and therefore a potential soft economic landing. Whilst a 'pivot' from central banks, most notably the US Federal Reserve (Fed), is being watched for - and may indeed prompt a further rally (likely across both markets) - such a 'Goldilocks' outcome of a less aggressive tightening cycle based on well behaved economic data and inflation is not our base case.

We expect that the pivot will only come as the data flow deteriorates and the negative outlook painted by the soft data is realised in the hard data. And even then, central banks will want to be certain that the reduction in economic output and increases in unemployment rates are material enough to convincingly drag inflation lower. As we have noted before, the economic risks around this strategy from central banks are high. Implementing aggressive policy tightening and judging when to stop by observing the concurrent data flow is clearly inherently risky, particularly because policymakers are relying on weaker activity to push inflation lower. Inflation based on weaker demand is a very lagged indicator, so central banks that make assessments on inflation alone will likely be behind the curve, heightening the downside risks to economic growth.

GRAPH 02 ADVANCED ECONOMY RECESSION PROBABILITY

Recession expected, a matter of when and how deep



Source: IFM Investors, Bloomberg, IMF, Macrobond

This is particularly true as monetary policy makers are likely to err on the hawkish side in order to prevent any chance of a wage-price spiral and to keep inflation expectations anchored. Further, they are likely to keep rates elevated for an extended period to ensure their inflation objectives are met. The question is not whether inflation will abate in 2023, as it almost certainly will, but rather by how much we can expect it to abate and over what timeframe. This point is key for any central bank pivot and the potential reversal of policy tightening. And on this front, there is considerable disagreement.

So far, there hasn't been much evidence of outright wage-price spirals that would entrench inflation. But in jurisdictions where wages have accelerated materially, central banks must act at the margin given how prominent labour costs are for many businesses. The supply shocks from the pandemic and energy costs are also clearly having an indirect impact, pushing prices higher. And despite some of these costs retracing as demand falls, supply chains gradually improve (and potentially) evolve and energy and commodity prices ease, businesses will likely be slow to pass these lower costs on. These trends are already evident, with inflationary pressures becoming increasingly broad-based across goods and services categories in CPI measures globally. As such, there is a clear risk that inflation remains above target – though likely not egregiously above target – for several years.

As a brief aside, we do not believe that inflation will remain structurally higher in the post-pandemic world. A number of arguments ranging from demographic

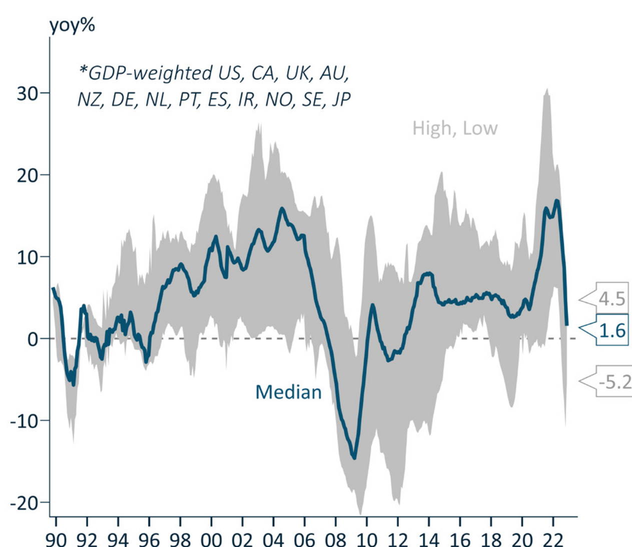
impacts to onshoring/friendshoring supply chains have been proposed as structural inflation drivers. And while these arguments do touch on important economic drivers, expecting inflation to be structurally above central bank targets is essentially taking a bet that central banks either can't, or aren't willing to, get inflation to target. We aren't prepared to take that bet.

On these points, Federal Reserve Chair Jerome Powell has been the most vocal of the major economy central bank heads and has signalled a commitment to keep policy tight until there is clear and unambiguous evidence of inflation moving in the right direction, even if that forces the US economy into a recession. A similar argument can be made for advanced economies as a whole, although in the UK and Eurozone it's more a case of how prolonged the recession will be given that those economies will very likely experience a recession in coming quarters.

Households will continue to bear the brunt of the economic adjustment in 2023. Real disposable incomes have been set back a decade in many countries as sharp cost-of-living increases and higher debt servicing costs bite. With the latter of particular concern for countries with high proportions of variable mortgages and high rates of household indebtedness or both (for example Australia). The wealth channel is also negative as the ratcheting up of interest rates is causing a synchronised global fall in dwelling prices from the peaks formed in the immediate aftermath of the pandemic as ultra-low interest rates were capitalised into prices. Wealth is also being hit by the fall in global markets that has negatively impacted direct investment portfolios and pensions alike. Falling house prices and rising rates will also have a sizeable negative impact on housing investment (that has already been under significant cost pressures) and given the large multiplier effects associated with this sector, this could be another key driver of the coming economic downturn.

GRAPH 03 ADVANCED ECONOMY DWELLING PRICE INDEX*

Dwelling price falls will continue for some time to come yet



Source: IFM Investors, various national statistical agencies, IMF, Macrobond

The two key positive factors supporting households are the continued labour market robustness and elevated savings. On the first, with consumer sentiment at record lows it is only extreme labour market tightness that has been holding household spending together. But the labour market will not be this tight forever and is set to weaken in 2023 as slower growth weighs. On the second, elevated savings aren't a panacea, particularly as a material amount of dissaving has already taken place and people will be less willing to spend out of savings if they are uncertain about the future. A reversal in household sector demand in economies will likely be a key driver of any recession.

Given this outlook, for investors, it seems prudent to remain overweight defensive asset classes, either cash or government bonds as we enter 2023[1]. To be overweight duration risk in fixed income, based on our outlook, is justifiable on the basis of limited further upside to yields and what is currently relatively attractive carry. More uncertainty lies in the outlook for equities, and arguably credit. As mentioned earlier, there may be a rally based on central banks winding back some hawkishness, but the question will be how this is going to be sustained and underpinned by earnings, once the economic downturn takes hold. There's a risk that further drawdowns in equities occur after the Fed pivots and, even more so, if the Fed is expected to ease given this implies a deeper downturn than is currently expected.

That said, we currently expect any recession, at least in the US, to be relatively shallow and short, so the temptation to tilt towards growth assets will build in anticipation of economic recovery. This trade will gather momentum as it becomes clear that returns in fixed income will likely be defined by the pricing of only a shallow easing phase from central banks, should inflation allow – it seems very unlikely yields will plumb the lows of the pandemic period. Similarly, at trend economic growth and the tide of global liquidity still receding and effectively weaning markets off monetary stimulus driven returns, will likely mean more moderate returns in growth markets in the post-downturn environment.

Risks to the outlook, outside of domestic economic uncertainly in advanced economies, abound as heightened geopolitical tensions remain. The evolution of the Russia-Ukraine conflict and China's COVID zero policies are key unknowns. We have asserted since the depth of the pandemic that economies will recover to some sort of post-global financial crisis malaise. While there has been much more volatility than we expected as this occurs, the coming year will be a step towards that environment. The global economy has experienced the upside in the immediate post-pandemic recovery and 2023 threatens to be the hangover that we had to have.

Australia: Finding the narrow path

The Reserve Bank of Australia (RBA) increased the cash rate for the eighth consecutive time at its December meeting, with another 25 basis point move. The cash rate target has now increased 300 basis points in the current hiking cycle to 3.1% - a rate not seen for a decade. The RBA stressed that it remains committed to fighting

[1] Forecasts are based on reasonable assumptions and are provided for informational purposes as of the date of this material. Such forecasts are not a reliable indicator of future performance and are not guaranteed to occur. Please see the "Important Disclosures" for more information.

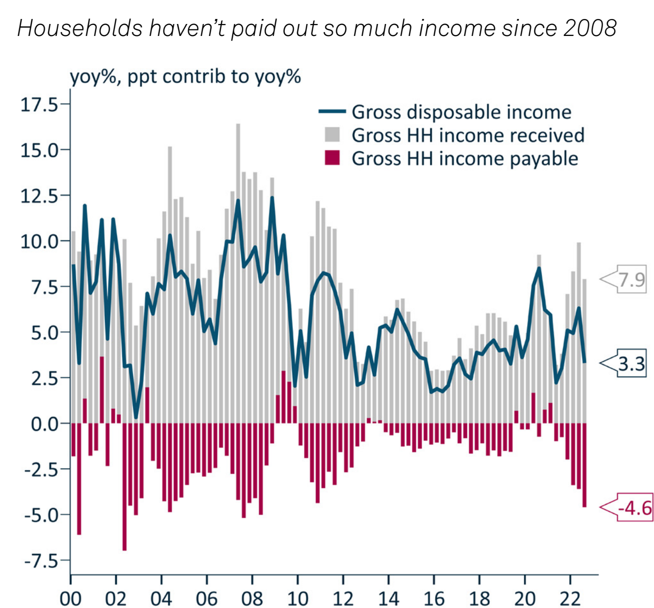
inflation, which remains well outside the target band. But equally it remains cautious, seemingly more so than its global peers, around overtightening policy and having an undue negative economic impact. In December, the RBA asserted that it seeks to tread a 'narrow path', attempting to keep the economy on an "even keel" to realise a "soft landing". While it is keeping an eye on a deteriorating economic environment, the key to achieving this lies with the uncertain, lagged, impact of "material" interest rate increases on households. Further, unlike other central Banks, it does not need to as aggressively introduce spare capacity into the labour market by reducing demand. The return of net migration proportionally well in excess of what is observed in other advanced economies and a high participation rate means the labour market will become less tight as a matter of course and consequently reduce any threat of a wage-price spiral dynamic emerging.

In its November Statement on Monetary Policy (SMP) the RBA revised up its forecast for headline and trimmed mean inflation, largely on the back of expected energy price rises. It now forecasts a peak of 8%yoy and 7.25%yoy respectively in the December quarter before decelerating to be above the target band, at 3.2%yoy, at end 2024. The September quarter saw headline CPI inflation rise 7.27%yoy (1.3%qq) and trimmed mean inflation rise 6.1%yoy (1.8%qoq), and both measures are now growing at the fastest rate in around 30 years. The pass-through of non-labour cost pressures and supply issues contributed to goods inflation, while higher input costs and demand contributed to the pick-up in services inflation. Inflation is broad-based, with the majority of the CPI basket (83%) rising at a rate above 2.5%yoy. The prices of non-discretionary items and goods (excluding volatile items) are rising particularly quickly. Long-term measures of inflationary expectations remain well anchored, however, and there are no clear signs of a wage-price spiral.

Wages growth has picked up but has not kept pace with inflation. The Wage Price Index grew 3.13%yoy (1.0%qoq) in the September quarter, largely due to increases in private sector wages for jobs under individual agreements. The ABS noted that the Fair Work Commission's decision to increase award wages by between 4.6% and 5.2%, the largest award increase in more than a decade, and a tight labour market contributed to an increase in both the size of average wage changes and the proportion of jobs in the private sector recording a wage change. The increase in wages remains in line with the RBA's forecasts, that are expected to continue to increase through to end 2024. This seems likely while the unemployment rate remains at historical lows, although employment growth is showing tentative signs of slowing and labour supply is returning and this may reduce pressures on wages.

This is especially true as the RBA also downgraded its economic outlook expecting growth to slow to just 1.4%yoy by the end of 2023. When accounting for official forecasts of population growth, this leaves per capita GDP, and implied productivity growth, close to zero. While this is poor quality growth it likely means the threat of recession in the Australian context is relatively low. The Q3 national accounts have begun to foreshadow this slowdown in economic activity. GDP growth was 0.6%qoq in Q3 modestly weaker than expected with through the year growth coming in at 5.9%yoy. This was in the context of material downward revisions to previous quarters. Growth in Q3 was driven almost entirely by household spending, with the business sector adding only very marginally and the public sector not at all. Dwelling investment expanded in the quarter, but this merely represents a rebound from the previous quarter's decline and further weakness is expected. With this skewed mix of growth, the RBA is rightly concerned about its impact on the household sector heading in to 2023. Indeed, consumption was again supported by a run down in the rate at which households have saved with disposable income growth heavily curtailed as interest payments from households have risen and rates of tax payable remain above average. While gross income growth was relatively strong, the rate of income payable rose sharply, working in the other direction. This acceleration in income payable, largely on the back of rate rises, has not been experienced

GRAPH 04 GROSS DISPOSABLE INCOME



Source: IFM Investors, ABS, Macrobond

since Q2 2008 when the cash rate was over 400bp higher.

Looking ahead, the main uncertainty for Australian economic growth, outside domestic concerns, is the deterioration of the global economy. And this is the second key factor that underpins our expectation that much if not all the RBA's work on tightening policy has been done. We believe the economic data will either drift or deteriorate over the Summer and this will define what the Bank will need to do when it returns in February. Globally, developments in China will be important for Australian economic outcomes in 2023. Headwinds in the Chinese property market, which underperformed in 2022 relative to past years, could result in lower demand for Australian iron ore and lower national income. The future path of China's COVID policies could also flow through to domestic demand via the return (or lack thereof) of international students and inbound tourists.

US: Skirting recession

US growth has been volatile through 2022. High inflation, tight financial conditions, and volatile net exports and inventories pushed the US into a shallow technical recession – on a two consecutive negative quarters definition (though not declared an 'official' recession using the NBER definition) - in H1 2022 before a 2.9%qoq saar recovery in Q3 reversed those declines. Nonetheless the details of the Q3 GDP release suggest that underlying demand is softening and the the outlook for the US economy is relatively weak. Through 2023 growth is expected to slow to around 0.5% - the weakest rate of expansion, outside of the pandemic, since the global financial crisis. And while recession is not as assured as in some other advanced economies, risks to the forward view are substantial and a number of uncertainties remain around inflationary persistence and the resilience of the US economy to higher interest rates.

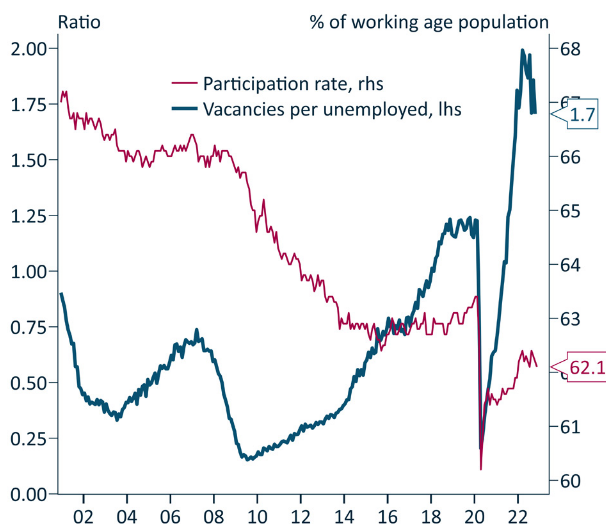
Recent data suggest US inflation has peaked. Headline CPI has fallen from 9.0%yoy in June to 7.8%yoy in October. This is welcome news, but it would be premature to declare inflation vanquished. Core measures of inflation haven't turned around as sharply as headline measures and price pressures have become more broad-based with 'sticky' categories like core services responsible for a larger share of inflationary pressures as other factors abate. Inflation is likely to move consistently, and in the first instance perhaps rapidly, towards the Fed's target. But progress will be more difficult to achieve as it does so and we'd expect inflation to remain well above target for much if not all of the year.

Cognisant of this, the Fed has signalled that it will keep rates restrictive until there is clear and unambiguous evidence of inflation heading back to target, even if that inflicts pain on the labour market and broader economy. To this end, it raised rates by 75bps in September and November taking the federal funds target rate to 3.75-4.00%. While remaining relatively hawkish the Fed is increasing noting the lagged nature of monetary policy and that its actions to date represent a substantial tightening in policy. Nonetheless, on balance, the Fed will very likely continue raising rates into 2023 with an expected peak of around 5.0% reached relatively early in the year. How long the Fed may pause at this elevated level will depend on the downward momentum of inflation. Consensus suggests that rates may be lowered modestly towards the end of the year should inflation be forecast to be moving to target in H1 2024.

The labour market response to tighter monetary policy is important to the inflation outlook from an outright demand and wages perspective. The US economy continues to see reasonable jobs growth (~277,000/month on average through August-November) and the unemployment rate, at 3.7% in November, remains around multi-decade lows. But there are tentative signals of a slowdown and as current conditions continue to weigh, further slowing seems inevitable. Several FOMC members have noted that much of the labour market adjustment to tighter policy could take place through softening vacancies and reduced demand for additional labour. Indeed, the number of job vacancies per unemployed person in the US spiked through 2021 and peaked at just under two in March 2022. Vacancies have trended lower since pushing the ratio to 1.7 in October of this year, but this is still well above the approximately 1.2 job openings per unemployed person seen pre-pandemic. Clearly there remains considerable excess demand for labour in the US and a further decline of this ratio will be a key gauge of how quickly it is being reduced.

GRAPH 05 VACANCIES AND PARTICIPATION

Vacancies softening, participation has ample room to rise



Source: IFM Investors, BLS, Macrobond

Another factor worth considering is a potential rise in the participation rate that remains at 62.1% in November, still well below pre-pandemic levels (63.4% in January/February 2020). There remains debate around why exactly this drop in participation has been so persistent, but it is possible that cost-of-living pressures, falling asset prices, and uncertainty about the outlook have motivated more people to start searching for a job. A full recovery in participation to pre-pandemic levels would represent around three million additional workers and would see the vacancies-per-unemployed ratio fall to around pre-pandemic levels (roughly 1.2-1.3) assuming no change in job vacancy numbers. Should this occur, it would put upward pressure on the unemployment rate and reduce wage pressures which is a preferable option compared to outright job losses. That being said, there remains considerable uncertainty around the elasticity of the unemployment rate to the Fed's policy rate in the current environment. The amount of labour market dislocation will be defined by just how much demand destruction is required to reduce inflation and whether the Fed can finesse policy to bring about a softer landing.

Labour market prospects will be key to the all important consumer outlook. To date, US consumption has remained relatively solid, despite very weak sentiment, as the labour market has been so tight. This is evidenced by personal consumption expenditures expanding at a 3-month average annualised monthly rate of 2% in real terms in September. But consumer confidence remains historically weak and most indicators imply a softening in spending going forward.

Importantly, while nominal earnings growth remains well above pre-pandemic levels, real income growth has been negative throughout 2022 and likely will be in 2023 as well. Further erosion of disposable incomes through higher debt servicing costs also weigh at the margin. Existing mortgage holders in the US are more insulated from rate rises, given the high proportion of long-term fixed-rate mortgages, but new housing construction will be negatively impacted by higher mortgage rates and this will also weigh on activity. While many US households will continue to be supported by elevated household savings to augment consumption, job insecurity may limit this. And there is evidence of stress in lower income households where savings have been run down already with an increasing reliance on credit to support elevated nominal spending. A weaker consumer outlook may make businesses more cautious, with downside risks to private investment likely.

We expect 2023 will be less politically divisive in the US. In November's midterm elections, the Democrats performed better than expected, retaining control of the Senate and the Republicans only narrowly took control of the House. This divided government means more constrained policymaking with cost of living, relations with China and Russia and domestic social division remaining key. The Administration will clearly have to rely on executive orders where possible, to pursue its agenda.

In terms of the outlook, the UK is very likely already in a recession and, if not, will almost certainly enter a recession over coming quarters.

UK: Exceptionally challenging outlook

The UK was a standout in 2022 for all the wrong reasons. Not only did the country experience some of the most acute inflation, monetary tightening, and growth concerns among advanced economies but it was also beset by an unfavourable fiscal position and unusual political instability. After Boris Johnson's ignominious exit, Liz Truss was elected prime minister, though her tenure was as brief as it was tumultuous. The Truss government in September introduced sizeable tax cuts and spending increases to be funded by additional government borrowing. This was greeted unfavourably by highly sceptical financial markets. The pound fell sharply, gilt yields jumped, and many UK defined benefit pension funds faced a liquidity crisis.

The Bank of England (BoE) eventually stepped-in to calm markets and pledged to purchase long-dated gilts, putting on hold its quantitative tightening timeline. Sterling and bond yields have since retraced those moves but this ill-advised policymaking forced Truss's resignation. Rishi Sunak was via internal vote elected to be the UK PM. In the wake of this turmoil, Jeremy Hunt – the Chancellor of the Exchequer – announced a path toward fiscal consolidation in his Autumn Statement. Measures will be evenly split between tax rises and spending cuts and will amount to almost £60bn of fiscal tightening over the next five years according to the Office for Budget Responsibility (OBR). To ease the cost-of-living crisis, Hunt also announced a substantial increase to the national living wage and an increase and extension in household energy support. It is clear that the UK will have economic challenges in 2023, and any further political instability will only provide further downside risks.

In terms of the outlook, the UK is very likely already in a recession and, if not, will almost certainly enter a recession over coming quarters. Real GDP contracted by 0.2%qoq in Q3, though the Office of National Statistics (ONS) has estimated that the additional bank holiday (for Queen Elizabeth's funeral) over the quarter is responsible for a sizeable amount of this contraction. More timely Purchasing Managers Index (PMI) data for October and November suggest that the contraction in private sector activity over the month accelerated. This sets the UK economy up to contract throughout all of 2023, likely recording contractions in most, if not all quarters, taking the economy backwards by around 1% over the year. This will come with the combination of high inflation, high debt servicing costs (UK mortgage repayments are more sensitive to short end rates than the US), and a softening labour market. Like most other advanced economies, much of the downturn is being driven by the adjustment forced on households, with soft consumption the key growth headwind.

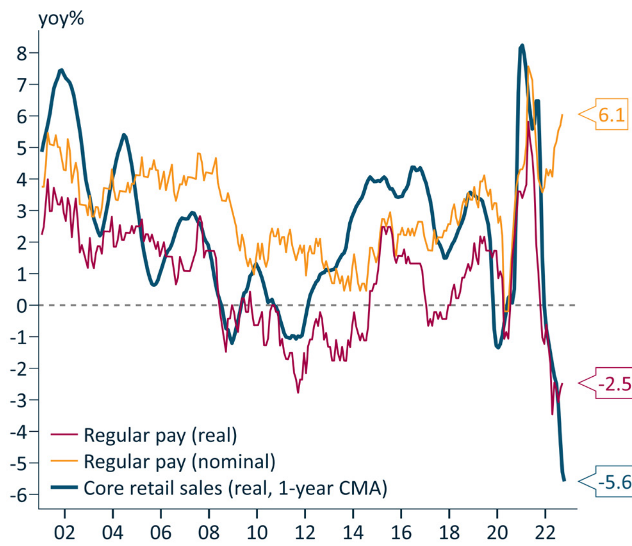
This bleak growth outlook is likely a necessary evil to the extent that the recession will help bring aggressively high inflation lower. This is sorely needed in the UK case, with October headline inflation up a more-than-expected 11.1%yoy. Core inflation also remains exceptionally elevated at 6.5%yoy. This has prompted a profound reversal in real incomes that has led to a collapse in real retails sales. Indeed the current episode is expected to be the most significant contraction in real disposable income in over half a century, according to OBR projections. A glimmer of hope comes from more timely survey measures that are pointing to some easing of inflationary pressures, so the current exceptionally high rate may represent peak or near-peak inflation. As with the US, UK inflation is expected to come down materially through 2023. But there remains uncertainty around how fast progress back to target will be made once the 'easy' disinflation gains have been made from fading energy/commodity prices and supply chain normalisation. Unlike the US, the UK is at the forefront of the energy price shock that has characterised 2022 and it is uncertain just how these pressures, that stem in part from the Russia-Ukraine conflict, will be ameliorated.

The labour market is key here. The unemployment rate remains very low (3.6% average in July-September) but

there are signals that labour market cooling has begun and will likely continue from here. One development worth noting is the five consecutive accelerations in regular nominal earnings between April (4%yoy) and September (6%yoy). This acceleration in nominal earnings increases the risks of inflation persistence should a wage-price feedback loop emerge.

GRAPH 06 EARNINGS AND RETAIL SPENDING

Real and nominal earnings diverging, retail sales falling



Source: IFM Investors, ONS, Macrobond

The BoE is paying close attention to the emergence of this potentially destabilising feedback loop and has signalled its readiness to "respond forcefully, as necessary". The BoE has indeed been forceful in recent months, opting to continue to raise rates by 50bp in September and 75bp (the largest single rate hike since the late 1980's) in November to take the Bank Rate to 3.00%. Expectations are for further tightening in coming months, but BoE head Andrew Bailey pushed back on market expectations of a roughly 5% terminal rate as of the November monetary policy meeting saying that rates were unlikely to rise that high. The BoE views inflation risks as skewed to the upside, but the pace of future hikes will likely slow given the already substantial tightening in monetary policy and the bleak economic outlook.

> **Whatever happens in the Russia-Ukraine conflict, it is clear that the Eurozone's existing energy framework has been shaken to the core.**

Eurozone: Recession energy

The Eurozone, like other advanced economies, has been beset by slowing growth and accelerating inflation. While navigating pressures in the post-pandemic recovery, the region has been directly impacted in terms of growth and inflation by the Russia-Ukraine conflict. The energy crisis precipitated by this conflict has been one of the defining features of the Eurozone's challenging year. And it is clear that action to remediate issues in the energy space will define prospects in the years to come.

As the conflict in the east worsened through 2022, a number of forecasters substantially downgraded their expectations for the Eurozone economy. But developments in October and November suggest both the immediate pulse of growth and the 2023 outlook may not be as bad as expected, at least compared to earlier in the year. Real output in Q3 eked out a small increase of 0.2%qoq to bring through the year growth to 2.1%yoy. More timely PMI data suggest that although private sector activity contracted in October and November, the rate of contraction was not as poor as expected. These indicators, along with a broad suite of confidence measures, suggest coming quarters will record negative growth, but these should be limited to Q4 and the first half of 2023.

Some relief has arrived in the form of gas prices collapsing from the August high of around €300/MWh to around €134/MWh (at the time of writing). This remains significantly above the €10/MWh-€30/MWh seen pre-pandemic, but is relative positive nonetheless. The Eurozone has also significantly reduced Russian gas imports and total gas usage overall and this, combined with lower energy usage given the mild weather to date, has allowed gas storage facilities to reach around 95% of capacity. This has lowered the risk of severe energy rationing that would be a sizeable headwind to activity. Winter weather remains a risk to this expectation and some rationing will be likely. In light of these challenges Eurozone governments sought to provide some limited fiscal support and have announced a number of measures aimed at limiting the passthrough of high energy prices to consumers. These measures will take some of the sting out of cost-of-living pressures but there will still be some material erosion of real disposable incomes and that will weigh on consumption going forward. On balance, the Eurozone will almost certainly enter a recession in early 2023, but it is unlikely to be as deep as had been expected a few months ago. Nonetheless growth over the course of the year will likely be slightly negative.

Whatever happens in the Russia-Ukraine conflict, it is clear that the Eurozone's existing energy framework has been shaken to the core. In coming years, the region will need to undergo a massive structural change to its energy supplies as it shifts permanently away from Russian gas. This is unlikely to be completed by next winter nor the winter after that. The inexpensive energy that has facilitated energy-intensive production is a thing of the

past, with energy prices expected to be structurally higher for a number of years. Producer prices have reflected this already with massive increases. This will put pressure on the region's export-led growth model, impacting the major economies differently. Germany is the most exposed to these shifts, with heavy reliance on gas (and an aversion to nuclear power) to power its significant manufacturing sector, whereas France is the most insulated with more nuclear power and manufacturing accounting for a much smaller share of GDP. Aside from the impacts on industry, consumers are set to face higher energy bills which will weigh on disposable incomes for a number of years.

GRAPH 07 **EUROZONE CPI & PPI**

Inflation may have peaked but that peak is extreme

Source: IFM Investors, Eurostat, Macrobond

While supply-side and energy impacts were responsible for the initial acceleration in inflation, there has been increasing concern around the emergence of 'second-round' effects. The October inflation data highlight how dire the situation is with headline CPI accelerating sharply to 10.6%yoy. While the November read, that edged lower to 10.0%yoy, may mean the peak may have been reached, the impact of these exceptionally high inflation figures on wages is particularly important and monetary policy officials have been attentive to the possibility of spiralling wages. Evidence for this has so far remained limited. This comes despite a very tight labour market (by European standards), with the unemployment rate ticking down to 6.5% in October. Despite this, hours worked remains around 2% lower than they were before the crisis which may indicate there is a little more slack in the labour market than the headline unemployment rate suggests. In terms of the forward view, a trade deal agreed to by one of the largest and most prominent unions in Europe is a step in the right direction as it strikes a balance between supporting individual living standards and preserving the real income fall necessary to moderate domestic demand and bring price pressures back under control. This will hopefully serve as a reference point for other wage negotiations and reduce the chances of a wage-price spiral emerging. The ECB will remain observant to this and to date has considerably tightened monetary policy with 75bp hikes in both September and October. Members signalled that rates should be expected to rise further but, going forward, the European Central Bank (ECB) is set to take a more data-dependent approach to policymaking, taking into consideration inflation and activity. Consensus is for the ECB's policy rate to rise just above 3%, but a weak pulse of growth and high uncertainty suggests the risk of over-tightening is high.

Japan: Muddling through

The Japanese economy grew less than expected over the first three quarters of 2022, although the relaxation of all COVID containment measures, the re-opening of the international border and some improvement in supply chains (particularly those in the automotive industry and other export sectors) suggest growth will improve going into the end of the year and into 2023. This comes after Japan's economy unexpectedly contracted by 1.2%qoq annualised in Q3, disappointing the consensus forecast for an expansion of 1.2%. Net exports weighed significantly on growth, with exports falling due to weak global demand and imports rising on the back of elevated energy commodity prices (Japan imports more than 90% of its fuel). Household consumption, which grew at 0.3%qoq annualised, contributed modestly to growth. Household consumption has lagged the rest of the world, and consumer confidence remains weak; however, spending more broadly has picked up recently as the number of inbound foreign visitors increases.

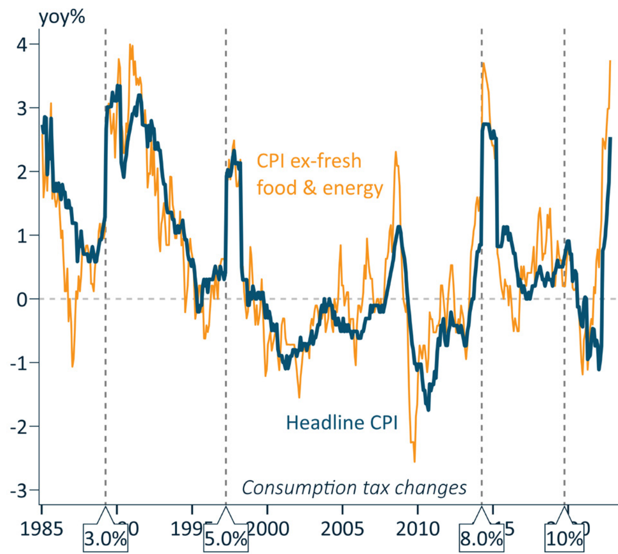
A headwind to consumption-driven growth is inflation, which continues to outpace wage growth and accelerate due to high energy and food prices. Headline CPI grew 3.75%yoy in October, its fastest pace in around three decades (particularly when considering periods of elevated inflation caused by consumption tax increases); core (excluding fresh food) reached 3.6%yoy, while core-core (excluding fresh food and energy) reached 2.5%yoy. Inflation is relatively broad-based and is increasing, particularly in durable goods. This is particularly true for those that are imported

> **Net exports weighed significantly on growth, with exports falling due to weak global demand and imports rising on the back of elevated energy commodity prices**

and the sharply weaker JPY over the course of the year has exacerbated this. Higher prices are a key factor that will constrain consumer spending over the course of 2023.

GRAPH 08 **JAPANESE INFLATION**

Inflation running as hot as ever outside VAT changes



Source: IFM Investors, Japanese Statistics Bureau, Macrobond

Working as an offset is some fiscal support to address cost of living issues. In October the Kishida government approved a stimulus package equivalent to nearly 15% of GDP which includes energy subsidies for households. Further support is evident in nominal wage growth that has been picking up moderately (3%yoy in September), reflecting strong demand for labour, although real wage growth is negative. The Bank of Japan (BoJ) expects wages to continue increasing moderately in the near-term, alongside an increase in the minimum wage and an improvement in labour market conditions. Japan's labour market is relatively tight and Japan is facing labour shortages, particularly in industries with exposure to tourism such as hospitality and transport services. The unemployment rate has been somewhat volatile but on a downwards trend (September: 2.6%), and the job openings-to-applicants ratio has climbed moderately. Employment has recovered to pre-pandemic levels. The BoJ expects that employment growth will slow over the coming two years, largely due to the structural change in Japan's demographics. Forward indicators of production have remained relatively robust. PMIs for manufacturing and services remain more expansionary than their global counterparts, and business sentiment mostly improved in the quarter (although mostly for non-manufacturing firms). This should underpin private business investment where there has been delayed flows to address de-carbonisation and improve supply chain resilience.

Recession risk is relatively low in Japan compared to other large advanced economies. A key reason for this is that the BoJ has indicated that it will maintain its current policy stance given what it sees as considerable uncertainty over the outlook. The Japanese economy is expected to grow modestly in 2023 by around 1¼% - this would continue a path back to a pre-pandemic level of output that has not as yet been recaptured.

Growth risks are skewed to the downside and include a deterioration in global economic conditions, the ongoing impacts of the war in Ukraine on commodity prices, and the effects of COVID-19 on domestic household consumption. Similarly, there is considerably uncertainty over the future path of prices, and whether the current inflationary episode is a one-off event. While some forecasters expect the BoJ to pivot in their policy stance, the BoJ wants to see more wage growth accompanying inflation to try and produce a shift in inflation dynamics. We do not expect any shift in the BoJ's policy stance to include an increase of the actual policy rate nor change in yield curve control (YCC) policy. Japan remains more scarred that most by an extended period of below target inflation and will want to be convinced that expectations have been re-anchored at a higher rate before moving. This will be left to Governor Kuroda's successor after the incumbent's term expires in April next year.

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