Alex Joiner
Chief Economist

Frans van den Bogaerde, CFA
Economist

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ECONOMIC UPDATE

Conflict threatens the recovery

Expectations of monetary policy tightening firmed significantly over the early part of the year, contributing to a sharp sell-off in equity markets and a material rise in government borrowing rates. The later Russian invasion of Ukraine precipitated sharp risk-off moves in markets and a partial retracing of hawkish monetary policy expectations. The outlook remains exceptionally uncertain, with inflation a key focus. This comes at a time when many economies remain vulnerable and has made the already challenging job of central bankers even harder.

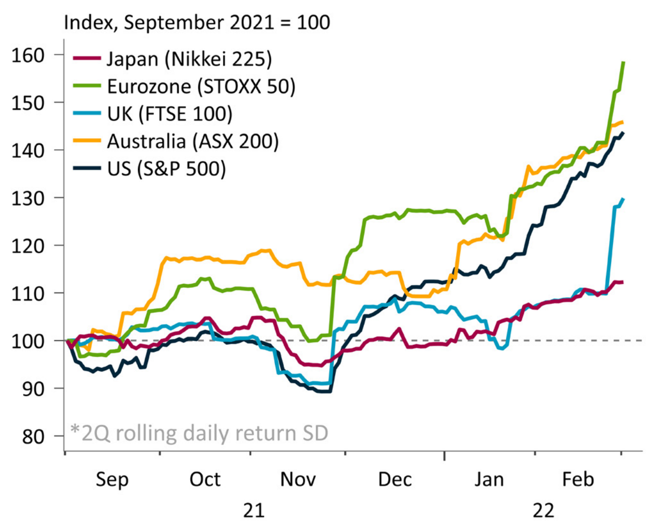
Global: Conflict and monetary policy in focus

It has been a challenging start to the year for markets with both economic and geopolitical concerns driving uncertainty. Most notably, inflationary pressures have intensified further and consequently there has been a sharp upward repricing of central bank policy rate expectations. This central bank 'pivot' has been most keenly felt in the US where as recently as November 2021, market pricing implied just two rate hikes through 2022. At the time of writing, markets expected the Federal Reserve (Fed) to hike around five times by year-end. Given the outsized importance of the Fed for the stance of global monetary policy, these rapidly changing expectations have rattled markets with equities falling sharply and yields firming materially. But the Fed is by no means alone with a re-pricing of policy expectations across many developed economies as inflation has proven stronger and more persistent than expected.

This path to higher rates will be a headwind to returns in both equity and fixed income markets. For equities, higher discount rates on future cash flows will weigh on valuations.

GRAPH 01 EQUITY MARKET VOLATILITY*

Tighter policy outlook and geopolitics have lifted volatility



Source: IFM Investors, ASX, S&P, STOXX, FTSE, Nikkei, Macrobond

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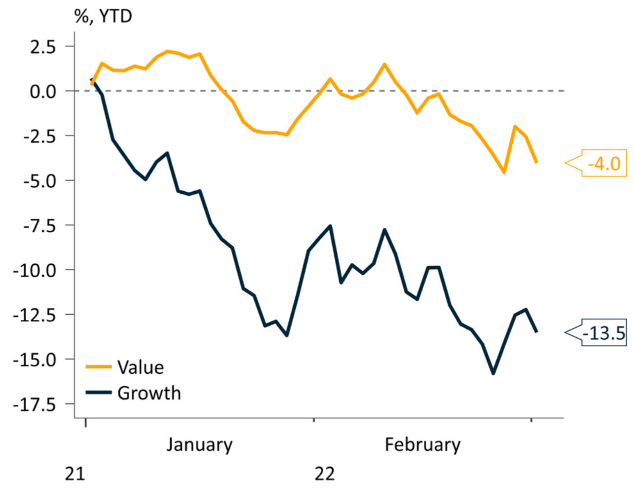
This has been particularly acute amongst growth stocks which are more sensitive to estimates of discount rates than value stocks. Indeed, since the start of the year growth stocks have fallen around 13.5%, with value stocks down around 4.0%. The dynamics of the macro-environment underpin this with tighter monetary policy acting to contain demand in response to supply-driven inflationary pressures. And although fiscal tailwinds are supporting a continued recovery from the pandemic, the strength and persistence of future growth is increasingly uncertain.

GRAPH 02 GROWTH VERSUS VALUE

Growth has been hit hard with expectations of rate rises



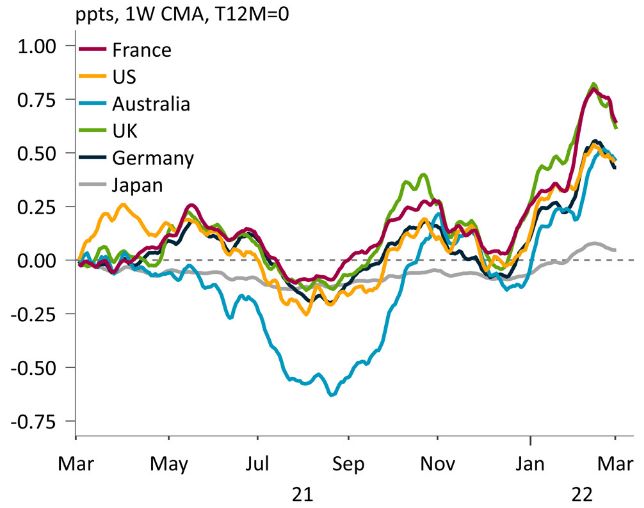
Source: IFM Investors, MSCI, Macrobond

In fixed income markets, investors maintaining longer duration exposures have been hit hard as expectations have been repriced, although further material bear steepening has also put shorter duration positions under pressure. Within fixed income, investment grade (IG) exposures will likely be more sensitive to rising risk-free rates than high yield (HY) exposures where credit spreads are the more significant return driver. Spreads have already widened and the withdrawal of monetary stimulus – and at least some creeping economic uncertainty – introduces a reasonable risk of further moves in this direction.

As we have noted previously, the current environment looks particularly favourable for alternative asset classes, namely real estate and infrastructure. This is because these asset classes tend to provide a more effective inflation hedge (often with explicit contractual links to inflation) and also benefit from stronger economic growth. Rising interest rates may act as a partial headwind, however in this cycle, rate rises have come well after, rather than pre-empting, higher inflation. We see this dynamic as supportive of overall returns and continue to believe that terminal interest rate levels (the rate at which central banks stop hiking) will remain low on a historical basis. We'd note that the unique disruption to office working arrangements borne out of the pandemic creates some ongoing uncertainty for commercial real estate that may offset this 'traditional' relationship.

GRAPH 03 GOVERNMENT 10-YEAR BOND YIELDS

Long end yields up on policy, down on geopolitics

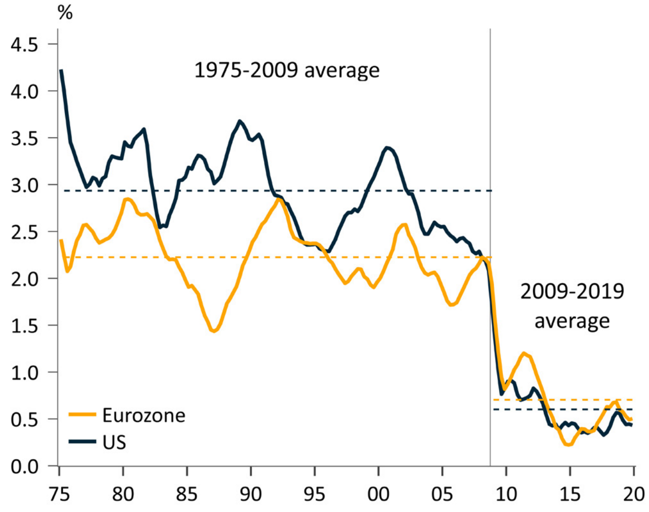


Source: IFM Investors, Macrobond

Taking a step back, there are some additional points about the current environment that are worth highlighting. Firstly, growth rates are expected to remain above trend over the next year or so as recovery and policy tailwinds remain. Secondly, although monetary policy will almost certainly become tighter over the next year or so, the overall policy stance is shifting from exceptionally expansionary to less expansionary, not from expansionary to contractionary. Markets are pricing relatively low terminal nominal rates (as noted above this is an assertion we agree with) and with long-term inflation expectations above pre-pandemic levels, real rates should remain low. This is on a historical basis, but also reflects how real rates compare to neutral rates. This should be a medium term fillip for real asset returns in particular.

GRAPH 04 NEUTRAL INTEREST RATE

Neutral rates collapsed in the post-GFC era



Source: IFM Investors, New York Fed, Macrobond

But should we challenge this thinking in a post-pandemic world? The structural downward shift in neutral rates emerged in the decade after the GFC (particularly in the US and Eurozone). But will the pandemic shift the economic zeitgeist from secular stagnation to something else? There are good reasons to believe that we are at an inflection point, not least because neutral rates are simply so low. It remains an open question whether the pandemic has precipitated (or indeed accelerated) structural changes in the global economy, for example:

- An increased acceptance among citizens for larger and more interventionist governments to employ economic/public health restrictions and to employ aggressive direct fiscal policy to bolster growth irrespective of public debt levels.
- An acknowledgment of the exhaustion of monetary policy and its reduced effectiveness to support economic cycles, bringing fiscal policy and reforms to the fore.
- The theme of 'slowbalisation' (slowing globalisation), the rebuilding of more 'resilient' domestic supply chains, and the potential for higher inflation (with the risk that technological change doesn't fully offset this).
- Demographic issues such as population ageing and retreat, labour potentially becoming less mobile, the stratification of society on the basis of public health criteria, and the wider acceptance of remote working.
- Entrenched inequality, that has been exacerbated through the pandemic, continuing to foster populist political outcomes and increased political polarisation.

Yet there's also an argument to be made that once the pandemic-induced disruptions work their way through the system we risk returning to a world of secular stagnation, with the economies of 2023-24 being characterised by many of the structural issues that hampered growth in the decade following the GFC. As we have suggested in previous missives, although fiscal policy dampened the pandemic shock, there has been little in the way of structural reform to foster productivity growth on a sustainable basis, a key factor required to boost potential growth rates and/or encourage a higher rate of business investment. Almost all economies show the 'cost' of fighting the pandemic through materially higher private and public debt levels that has left central banks with a hugely asymmetric set of policy tools.

Adding to the uncertainty of the outlook are new tensions in the geopolitical space. Specifically, the Russian invasion of Ukraine. Developments are unfolding rapidly and it remains unclear how the situation will progress. What we do know is that the conflict is generating material financial market volatility, negatively impacting equity performance, and increasing the demand for safe havens in a broad risk-off move. This may be exacerbated by investor and bank exposures to Russia that will be impacted by Russia's restricted access to the global financial and payments system. Broader sanctions will have a peripheral impact on the global economy with Russia not being a major contributor to international trade flows outside of energy. It is in the energy and food markets (due to agricultural disruption in Russia and Ukraine itself) where the economic impact of the conflict could be most pronounced. This would be via supply disruption adding to inflation, with higher oil and gas costs in particular only adding upside risks to the inflation outlook. This is a particularly unwelcome development in advanced economies that are already beset with pandemic-induced inflation. Concerns around stagflation in advanced economies persist and the conundrum around what central banks can and will do in this environment intensifies – for what it's worth, markets are currently pricing less aggressive moves by central banks than before the conflict.

The year of economic recovery from the pandemic threatens to be derailed somewhat by the Russia-Ukraine conflict. It has heightened geopolitical tensions and has materially clouded the investment outlook over 2022. And this comes when expectations of returns were already notably more modest than in 2021. Assuming geopolitical tensions gradually resolve, we still expect that at this point in the cycle the relative returns of equities and alternatives continue to look attractive compared to much of the fixed income space. Consequently, in our view, investors should remain overweight equities and infrastructure. For this view to shift, bond markets would need to have a peak in rates firmly in view to provide confidence to investors that an attractive entry point is emerging as the cycle begins to wane. We don't expect this to occur in 2022.

Australia: RBA to remain patient

As in almost all advanced economies, monetary policy has been the key focus in Australia in recent months. A surfeit of communication from the Reserve Bank of Australia (RBA) has seen it pivot its stance in an environment of stronger than expected inflation. Key data releases have been eagerly analysed by markets to justify expectations of rate increases coming sooner and in greater number.

Most notable among these data were Q4 inflation that surged to beat already strong expectations. The headline measure firmed 3.5%yoy, with trimmed mean inflation (the measure preferred by the RBA) reaching 2.6%yoy. While this outcome confirmed inflation would be persistently at target for the RBA, it is clearly a much weaker inflationary pulse than observed elsewhere and this underpinned the Bank's measured response.

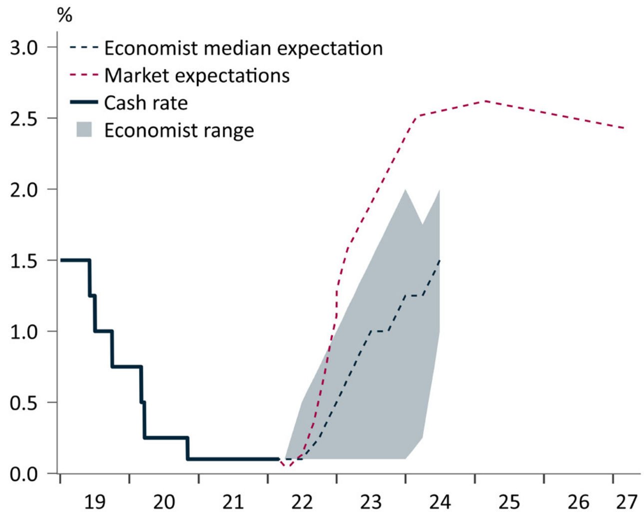
For the RBA, the labour market/wages nexus remains key. However, Q4 Wage Price Index (WPI) data (0.7%qoq, 2.3%yoy) failed to deliver an upside surprise, being broadly in line with economist and RBA expectations and therefore didn't move the needle much on the policy front either way. The details in the release are consistent with further ongoing and gradual firming in wages growth. It is worth highlighting that the WPI may take longer to respond to underlying economic changes than other earnings measures (as the WPI deliberately abstracts from changes to labour force composition, hours, and characteristics), and the RBA notes it will be assessing a broad range of income measures and how they may underpin inflation.

The labour market itself continued to recover in the three months through February with data beating expectations. A record 366,100 net new jobs were added to the economy in November, with further (but more moderate) gains in December and January, despite the Omicron 'shadow lockdown'. The Omicron impacts were most keenly felt in hours worked but this should rebound sharply in upcoming months. The unemployment rate wasn't materially impacted and managed to retrace the sharp Delta-lockdown-induced jump in October (5.2%) and remains near all-time lows at 4.2% in January. This was achieved despite a jump in the participation rate from October to be at 66.2% in January (near all-time highs). We'd note that the reopening of borders and the gradual increase in labour supply will be an interesting facet of the labour market to observe given the material impact it could have on spare capacity.

Although dated by rapidly moving events (most notably the Omicron outbreak in Australia), Q4 GDP growth posted a strong rebound from the pandemic-induced contraction in Q3. While the 3.4%qoq rebound was in line with market expectations, the through-the-year pace of 4.2%yoy implies a material disappointment relative to RBA's more bullish forecast (5.0%yoy). The result showed all the hallmarks of an economy recovering from lockdowns with the rebound in consumer spending very strong and growth in the larger restricted states of New South Wales and Victoria being most pronounced. Of some concern was the contraction of dwelling investment and business investment. This is because the latter in particular is anticipated to be (by the RBA and others) a key driver of the economic recovery going forward.

GRAPH 05 **RBA CASH RATE EXPECTATIONS**

Markets beating even the most hawkish economist



Source: IFM Investors, RBA, Bloomberg, Macrobond

To date, these data remain sufficient for markets to justify their sharp hawkish adjustments in expectations for the future path of the cash rate. Indeed, markets are looking for rates to climb faster than even the most hawkish of economists (refer to Graph 05). For this outcome to be realised, we would need to see ongoing upside surprises to the data flow. A highly uncertain prospect. In terms of actual policy, the RBA announced the end of its QE program at its February meeting, as expected. The Bank also reiterated that the cash rate will not be increased until inflation is "sustainably" at target (with little clarification on what constitutes "sustainably") and that it was too early to conclude whether this was the case. The RBA signalled that it is prepared to wait for more data points (CPI, WPI, labour market) before it will be confident that the underlying economic picture justifies tighter policy. The importance of wages growth was repeatedly emphasised, as the RBA expects it will be some time before wages growth is in the range (somewhere above 3.0%yoy) consistent with the Bank's inflation goals. Though there remains uncertainty about how wages growth will respond to record low levels of unemployment. In terms of forward guidance, RBA Governor Phil Lowe signalled that a 2022 hike was now "plausible" in the RBA's central scenario. In our view, liftoff before August is unlikely as the RBA is expected to remain patient. The Russia-Ukraine conflict will be disruptive and the potential impacts to energy and inflation add uncertainty to the outlook. Additionally, the RBA wants to see a "couple" more inflation/wages prints and then a very gradual removal of record stimulus is warranted. This accords with the RBA's February Statement on Monetary Policy that provided material upgrades to unemployment and inflation forecasts. The wages outlook, however, remains tepid.

On fiscal policy, the Mid-Year Economic and Fiscal Outlook (MYFEO) showed little change in the deficit over the next few years as the boost to fiscal revenue from a stronger-than-expected economy was largely offset by increased spending. It is more than likely the government will seek to implement some targeted fiscal stimulus ahead of the Federal election in May (and clearly balancing both economic and political imperatives). These may offset the tightening of monetary policy later in the year. But we do not expect significant fiscal policy shifts due to the election, and we continue to lament the focus on interest rate levels, debt, and the deficit rather than any – even measured – reforms to bolster productivity.

US: Inflation increasingly problematic

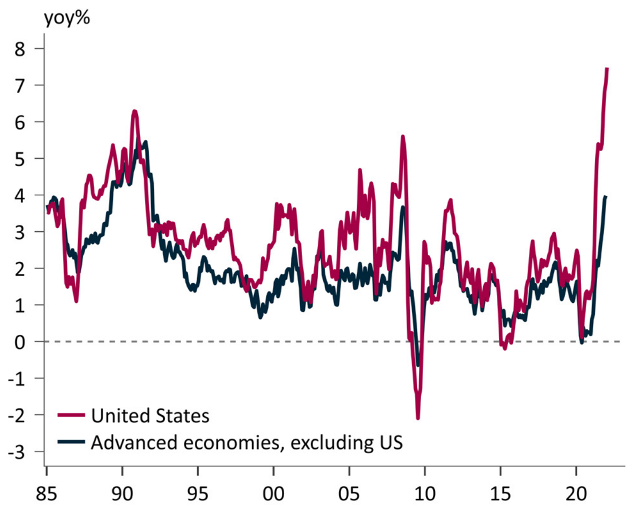
Advanced Economies – with the notable exception of Japan – have been experiencing intense upward price pressures in recent months (refer to Graph 06). The Advanced Economy group, excluding the US, recorded the highest rate of inflation since December 1991, with headline CPI hitting 4.0%yoy. Not to be outdone, the US economy – where the tension between supply constraints and accommodative policy is arguably most acute – has seen headline CPI inflation hit an eye-watering 7.5%yoy. This is the strongest inflation in around 40 years. Worse still, the Federal Reserve's (Fed) preferred measure of inflation, the personal consumption expenditure (PCE) core price index, has not fallen in 15 consecutive months and also hit a nearly 40-year high in January (5.2%yoy).

The unexpected strength and persistence of inflation precipitated a dramatic shift in expectations of central

» bank policy actions, with a 25bp rate hike in March now fully priced in. As of mid-February, a 50bp hike was briefly the baseline expectation for the March meeting but pushback from Fed officials and impacts from the Russia-Ukraine situation unwound this pricing towards the end of the month (refer Graph 07).

GRAPH 06 **HEADLINE CPI INFLATION**

US inflation far higher than Advanced Economy average



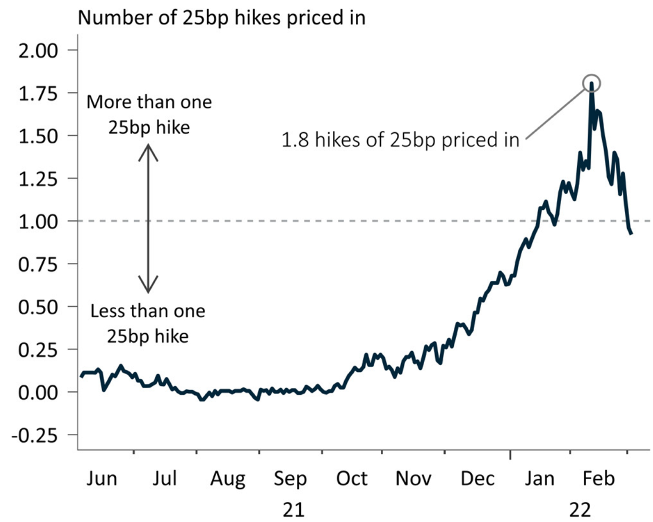
Source: IFM Investors, U.S. BLS, Dallas Fed, Macrobond

Labour market data sent mixed signals in recent months, most notably in payrolls. November and December figures came in much softer but upward revisions were robust and January saw a net 467,000 jobs added (far above expectations). The unemployment rate continues to fall, but ticked up to 4.0% in January, despite solid job gains, in part because of a notable firming in the participation rate to 62.2%. This is still well below pre-pandemic levels of 63.4%, however. On balance, the data were broadly consistent with labour supply constraints and upward wage pressures. If participation remain below pre-pandemic levels, spare capacity in the labour market should remain low.

> **“The most likely date for US monetary tightening is at the 16 March meeting and, as mentioned earlier, a 25bp hike rather than a 50bp hike is expected.**

GRAPH 07 **FED FUTURES IMPLIED NUMBER OF HIKES FOR MARCH MEETING**

A 25bp hike in March is priced in



Source: IFM Investors, Bloomberg, Macrobond

Retail sales comfortably beat expectations in January (headline: 3.8%mom, core: 4.8%mom), rebounding from a sharp contraction in December. Seasonal adjustment factors are at play here, but even controlling for those this is a strong read. The consumption outlook was largely unchanged according to consumer confidence data (the Conference Board measure) that ticked down in February to 110.5, a smaller than expected fall and importantly not replicating the sharp fall in the University of Michigan measure that called into question the durability of the consumption recovery. Incomes are problematic to the consumption outlook because although nominal average hourly earnings growth in January was strong (5.7%yoy), inflation has eroded the purchasing power of those earnings with real average weekly earnings down by 3.1%yoy. For the time being, US consumers have relatively healthy balance sheets but should this trend continue, consumption will likely suffer. Indeed, inflation and its regressive effects have become a significant political issue for the US Administration.

Real GDP growth remains solid, for the time being at least, with Q4 surprising to the upside (7.0%qoq annualised). But the composition was less convincing with inventories contributing a hefty 4.9 percentage points to growth, taking a lot of the shine off the solid investment figures. In monetary policy, the Federal Open Market Committee (FOMC) is seeking to address near-term inflation that is no longer described as 'transitory'. The December meeting included a decision to double the pace of QE tapering to $30bn/month from January, and the January FOMC meeting signalled that rate hikes are around the corner (it will "soon be appropriate" to raise rates). The most likely date for monetary tightening is at the 16 March meeting and, as mentioned earlier, a 25bp hike rather than a 50bp hike is expected. Global developments in the Russia-Ukraine conflict may cause the Fed to show some » caution. But can it wait? Given the escalation to conflict in Europe is most disruptive to energy and food markets, there seems little doubt that any delay risks adding to US inflationary pressures which are already acute.

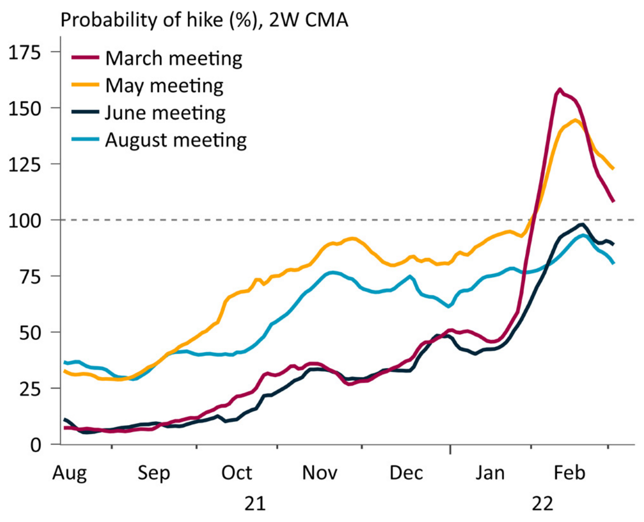
UK: Rates to continue to rise

Monetary policy remains a key focus in the UK, with the Bank of England (BoE) having already increased rates twice. Lift-off was in December, where the Bank surprised markets by hiking rates from 0.1% to 0.25%, despite the threat posed by the Omicron outbreak at the time. A robust labour market and signs of persisting price pressures were cited as key justifications for the hike. This was followed by an expected hike of 25bp to 0.5% at its meeting in early February. But there was a hawkish surprise in the details of the meeting, with a minority of the MPC members (four out of the nine) preferring to raise rates by 50bps. Looking forward, markets have now more than fully priced 25bp hikes in March and May (though pricing has come off sharply in line with elevated geopolitical risks). Once rates hit 1%, the outlook is a little less certain (refer to Graph 08). The BoE may pause, given policymakers have flagged that they will consider actively selling bond holdings to reduce the size of the Bank's balance sheet once rates reach the 1% threshold.

The primary driver behind this intense focus on monetary policy is, unsurprisingly, inflation. Price pressures accelerated again in January to be a touch higher than expected (headline: 5.5%yoy, core: 4.4%yoy). This is another multi-decade high, with figures this strong not seen since the early 1990's. Strong wages growth, continued supply chain disruptions, and elevated energy prices (that may be further exacerbated by the Ukraine-Russia conflict) are expected to keep inflation strong throughout 2022.

GRAPH 08 **MARKET EXPECTATION OF 25BP RATE HIKE AT BOE MEETINGS**

Market looking for tightening, less sure once rates reach 1.0%



Source: IFM Investors, Bloomberg, Macrobond

The labour market remained in good health according to recent data. Despite the UK economy losing a net 38,000 jobs in the three months through December, this was not sufficient to see the unemployment rate rise (4.1%). Furthermore, labour demand remains robust, with vacancies reaching a new all-time high (~1.3 million). The entire reference period was after the expiry of the Job Retention Scheme, suggesting that the UK labour market is being minimally disrupted by the withdrawal of stimulus. More timely, experimental indicators also sent positive signals with the claimant count unemployment rate for January tracking sideways at 4.6%, accompanied by another fall in jobless claims over the month (31,900). A tightening labour market is fostering strong increases in headline average weekly earnings that were up a more-than-expected 4.3%yoy, whilst the core measure was up 3.7%yoy. The Office for National Statistics (ONS) notes that the temporary distortions to wages growth have largely worked through the data and the most recent data suggest strong underlying earnings growth. As in other advanced economies, high inflation is weighing on real income growth. Indeed, the ex-bonus measure was down 1.2%yoy as of December. In spite of this, retail sales rebounded in January (headline: 1.9%mom, core: 1.7%mom) following a sharp fall in December that was driven by Omicron impacts and the pull-forward of Christmas consumption into November.

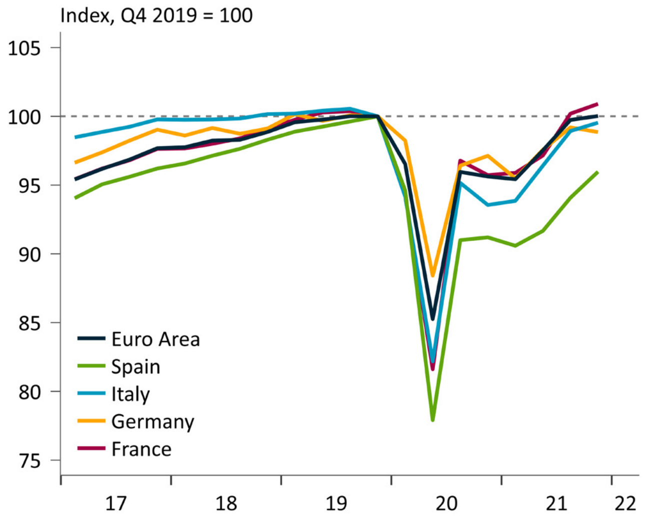
Looking at the overall picture, fourth quarter GDP came in a touch lower than expected with real output increasing 1.0%qoq to be up 6.5% through the year. There is an expectation that real GDP growth rates will decelerate as base effects flow through but remain robust enough to support the labour market, enabling the BOE to continue raising rates gradually over the course of the year.

Eurozone: War on the doorstep

Conflict between Russia and Ukraine erupted in late February following an invasion by Russia. Russia has since been placed under severe sanctions, with restricted access to global payments systems the most significant measure to date. The conflict precipitated some particularly notable action from Germany. The final approval of the €10bn Nord Stream 2 pipeline was suspended, and although the immediate implications of such a decision are limited, given that the pipeline has yet to begin transporting gas from Russia to Germany, there are longer term implications for Germany's energy policy and its relationship with Russia. Indeed, Chancellor Scholz highlighted that the invasion had security implications for Germany's energy policy and that Germany "must change course to overcome our dependence on imports from individual energy suppliers" (almost certainly referring to Russia). This coincided with a sharp about-face in defence policy as well – Scholz announced the immediate setting up of a €100bn fund for the armed forces, with a commitment to increase defence spending to at least 2% of nominal GDP (a NATO target that Germany has long fallen short of).

GRAPH 09 EUROZONE REAL GDP

Eurozone output back to Q4 2019, but Spain lagging



Source: IFM Investors, Eurostat, Macrobond

The conflict is set to be disruptive to growth in the bloc, more so than many other advanced economies. The main impact channel will likely be energy, given that Russia accounts for a significant proportion of Eurozone energy imports. The Eurozone also has some export exposure to Russia that will be negatively impacted, most notably in eastern Europe. Further financial market volatility will likely continue due to some European banks being exposed to the Russian economy and with Russian entities, including its central bank, being heavily restricted in their use of international payments systems. Furthermore, millions of refugees fleeing the conflict are likely to appear on the EU periphery, and supporting the refugees will require significant government spending that will further weigh on budget deficits.

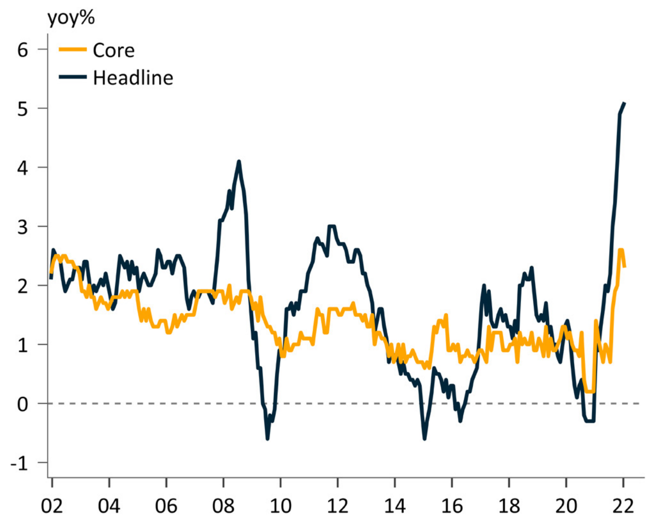
Moving to Eurozone economic data, real GDP growth slowed broadly in line with expectations in Q4 (0.3%qoq), with rebound effects moderating and growth held back by continued supply issues and COVID restrictions. Notably, output in Germany contracted 0.3%qoq, with that economy particularly exposed to global supply shortages. Output growth slowed but was still higher in France (0.7%qoq), Italy (0.6%qoq) and Spain (2.0%qoq). Output in the Eurozone is now back at pre-pandemic (Q4 2019) levels but Spain remains a notable laggard (refer to Graph 09).

Retail sales missed big in December (-3.0%mom), with the fall likely driven by another coronavirus outbreak and associated restrictions on activity over the month. The outlook remains clouded, with soft real wages growth (high inflation and weak nominal wages growth) and high energy prices weighing on future expected consumption. Despite only modest growth, the Eurozone labour market has performed better than expected and continues to recover, with employment growth of 0.5%qoq in Q4 and the unemployment rate down from 7.1% in November to 7.0% in December. Furlough schemes helped insulate workers during the worst times and the rolling off of those support measures does not appear to have led to a deterioration in labour market conditions. Demand for labour remains strong, with vacancy rates above pre-pandemic levels.

Inflation was again strong, with price pressures continuing to climb in January (headline: 5.1%yoy, core: 2.3%yoy). Energy remains the key driver of these strong inflation outcomes – and is set to remain with the Russia/Ukraine conflict – but generally more persistent services inflation was also robust, contributing nearly 1 percentage point.

GRAPH 10 EUROZONE CPI INFLATION

Inflation continues to firm, concerning the ECB



Source: IFM Investors, Eurostat, Macrobond

These inflation figures have taken the ECB by surprise and forced Bank officials to move away from the narrative that inflation is transitory. Levels of uncertainty around the inflation outlook were "exceptionally high" even before the Russia-Ukraine conflict and this will only further cloud the outlook such that a data-dependent policy path is most likely. Policy rates were left unchanged at the December meeting but the ECB did make some adjustments to its asset purchases. Specifically, the Pandemic Emergency Purchase Program (PEPP) was to be reduced in Q1 and set to end by March 2022, the Asset Purchase Program (APP) will be increased from €20bn to €40bn per month in Q2 2022 before being tapered to €30bn and then €20bn per month in Q3 and Q4 2022, respectively. Policy settings were left unchanged at the ECB February meeting, as expected, but the post-meeting press conference was instructive with the ECB flagging (for the first time in years) that inflation risks are tilted to the upside. Additionally, President Lagarde's refusal to commit to previous statements that a 2022 hike was highly unlikely suggests that lift-off has become possible later in the year. Sequencing (i.e. ending asset purchases prior to rate hikes) is still in place, so this development increases the likelihood of faster net asset purchase reduction. Overall the ECB appeared optimistic with respect to the economic outlook and adjusted its forecasts and

» policy stance accordingly but recent developments vis-à-vis Russia-Ukraine mean that those forecasts are now out of date and this puts the ECB in an even more difficult position.

Japan: Continuing to struggle along

Japan continues to distinguish itself among advanced economies. Whereas most central banks are being intently watched by market participants for an idea of what path monetary tightening will take, the Bank of Japan (BoJ) isn't expected to raise rates for at least the next two years given a distinct lack of material inflationary pressures and a sluggish economy. This comes despite Japan reacting to the pandemic in much the same way as other economies, in terms of stimulus and restrictions. While inflation has accelerated, it remains well below that observed elsewhere. Japan has recently experienced a sizeable outbreak of the Omicron strain and restrictions on activity were implemented to slow the spread of the virus. To date, these measures have been less severe than during previous outbreaks, and the impact of any restrictions should be more limited given the tendency for economies to be less sensitive to any given level of restrictions as behaviours adapt. Nonetheless, this presents downside risk to Q1 growth, after a solid Q4 2021 rebound, and casts some doubt on whether Japan can gain economic momentum over the course of the year.

Data released in recent months were disappointing almost across the board. GDP figures in the final quarter of 2021 showed output grew by 5.4%qoq annualised against expectations of 6.0%qoq annualised growth. There was, however, a significant upward revision to Q3's figure which was positive. Consumer spending recovered sharply, supported by the lifting of various states of emergency and a commensurate improvement in mobility, but inventories and public demand were a headwind. The economy remains smaller than it was before the pandemic.

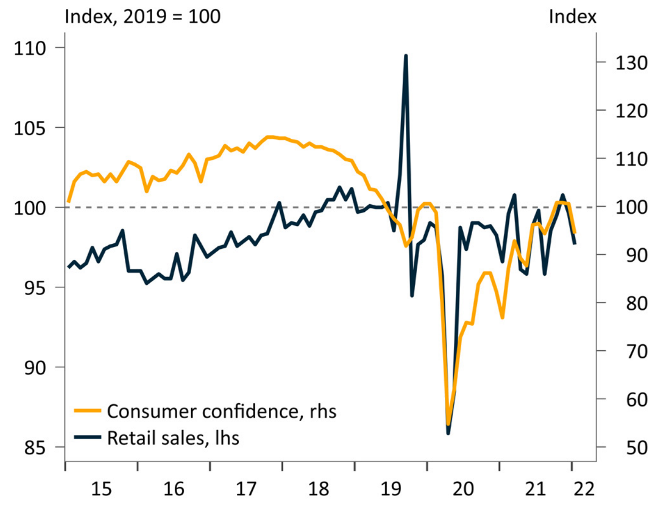
Key survey data (PMIs) that present a more timely picture of the situation reinforced the negative tone. The composite measure has fallen sharply in recent months to reach 44.6 in February. The main driver of this fall (in a now familiar pattern) was softening services, with private sector services activity suffering the sharpest fall in 20 months. Private sector manufacturing activity remains more robust but has not escaped the slowdown completely. Details of the PMI release show that cost-push inflation pressures are emerging with average cost burdens rising by the most since August 2008.

Japan's labour market has performed relatively well compared to the rest of the economy. The jobless rate has oscillated between 2.8% and 2.7% for the past six months (2.7% in December), though this is still above pre-pandemic levels of 2.2-2.5%. The job-to-applicant ratio (another key labour market indicator) has continued its upward trend since late in 2020 to be at 1.16 in December. This suggests a modest and gradual tightening in the labour market.

Income growth, by contrast, has been disappointing. Nominal labour cash earnings were down 0.2% in year-on-year terms in December with the real measure

GRAPH 11 RETAIL SALES AND CONSUMER CONFIDENCE

Key economic indicators remain below pre-pandemic levels



Source: IFM Investors, CaO, METI, Macrobond

down a much larger-than-expected 2.2%yoy, despite the deflation to date. In line with soft income growth, household spending also disappointed in December (-0.2%yoy). This does, however, represent an improvement from November's sharp unexpected fall but was insufficient for a full recovery. More recent consumption data for January were also soft, with retail sales falling 1.9%mom and consumer confidence falling to 36.7. Neither measure is above pre-pandemic levels.

On the inflationary front, price pressures remain few and far between. The most recent data – as of January – show a notable softening in national CPI inflation (headline: 0.5%yoy, core: -1.1%yoy) as special factors, including subsidised travel and lower mobile phone charges, dropped out. Energy prices continue to place upward pressure on inflation. These data suggest that Japan's household sector remains cautious, given retail sales in other advanced economies point to demand that is well above pre-pandemic levels. This is not the case in Japan and is likely a key driver of the lack of inflationary pressures besetting other economies.

This leaves the BoJ with far fewer reasons to be hawkish than other central banks. The BoJ left key policy rates unchanged at its December meeting and announced a change to its special pandemic corporate financing support program. Specifically, provisions for non-government-supported loans will be extended by six months and the BoJ will taper its purchases of corporate debt back to pre-pandemic levels. In terms of the economic assessment, the BoJ upgraded its view on private consumption, however, the spate of weak consumption data since then may prompt some revision. Indeed, the BoJ's assessment of overall GDP growth in 2022 already looks optimistic and it will be an ongoing challenge for the relatively new Prime Minister, Fumio Kishida, to bolster confidence and spur investment to drive recovery and improve Japan's medium term economic prospects. »

HEAD OFFICE

Level 29 | Casselden | 2 Lonsdale Street | Melbourne | VIC 3000
+61 3 8672 5300 | www.ifminvestors.com

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