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# Inflation scourge

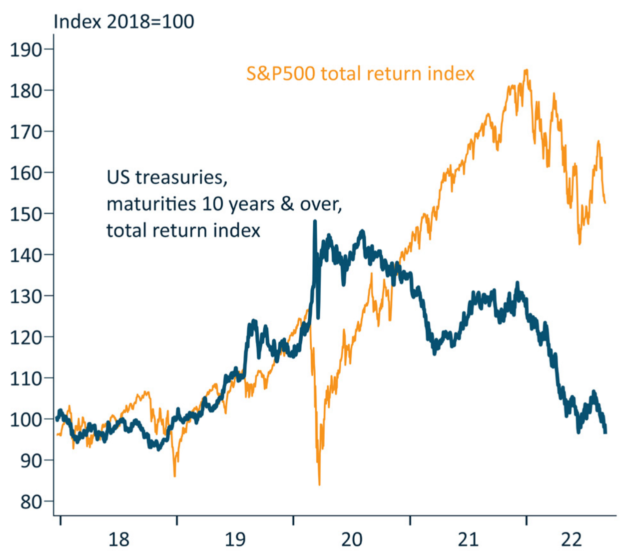
Advanced economies continue to navigate a challenging environment. Inflation remains elevated and central banks have signalled that a painful period of adjustment lies ahead. Households are set to bear the brunt of this and plunging consumer confidence points to increasing recession risks. Markets are still sensitive to inflation and monetary policy news and the trading environment continues to be challenging with high equity and bond correlations and volatility. The outlook for growth is clouded and a likely drift to below-trend rates is beset by downside risk. Much more uncertainty lies in the inflation outlook: has it peaked, will it come down and how much economic damage is done in the process?

## Global: Degrees of stagflation

Markets continue to find the 'stagflation-lite' economic environment difficult to price. We use this label as there's high and persistent inflation, slowing growth rates but not yet recession and importantly an absence of a rising unemployment rate. This falls short of the more painful textbook definition of outright stagflation, which is a key and ongoing risk. And it comes as the economic growth environment deteriorates due to inflation itself and central bank action that seeks to rein it in. Such uncertainty is evident in US equity markets, which are still posting a negative return year-to-date, despite rallying from lows seen in June. This rally, borne from the expectation that inflation momentum may have eased and central banks would not have to be as aggressive to slow economies, has been eroded by renewed central bank hawkishness. The correlation between growth and defensive assets has also continued in recent months, with fixed income experiencing gains in July, only to sell-off in late August. This lack of clear direction across markets seems set to continue as uncertainty becomes entrenched. What will end this malaise is either central banks breaking

**GRAPH 01** **US EQUITY AND BOND MARKETS**

*July rally short-lived and uncertainty persists*




Source: IFM Investors, MSCI, Bloomberg, Macrobond

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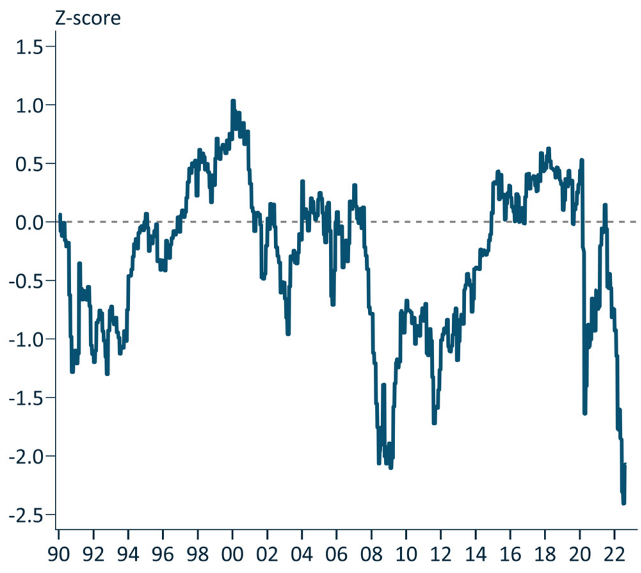
the back of inflation, breaking economies, or both. The relatively poor outlook for economies is already expected but the path of inflation remains unclear in terms of whether it has peaked and just how it may decline.

This is the case because, as we have written in these pages recently, current inflation largely stems from an exogenous supply shock that policymakers have little or no control over. Supply chain recovery has only been gradual and remains uncertain, and there is no expedient solution. And while commodity prices in key sectors may have come off peaks, energy prices remain high and, in some cases, have moved materially higher. These energy price pressures, most notable in Europe and the UK, are being driven less by pandemic-related factors and more by the ongoing conflict in Ukraine – a conflict with no end in sight, which even in resolution could result in ongoing sanctions. How these pressures resolve on the supply side is unclear. How they resolve themselves on the demand side is via materially weaker growth; this is the path central banks are currently pursuing with undeterred vigour.

This policy course, in the words of US Fed Chair Powell, will bring "pain to households and businesses". But to our mind, it is clear that this pain will be centred on the household sector because they are weathering both inflation and higher interest rates. Although businesses are facing higher rates, they at least can pass on the cost pressures they face to households via price increases. Furthermore, despite the pick-up in wages in many economies, most households are experiencing a profound setback in real incomes that will likely take years to unwind. Consequently, consumer sentiment has collapsed in almost all developed economies to a level not observed in three decades, not even temporarily during the COVID-pandemic or the global financial crisis.

**GRAPH 02** **DEVELOPED ECONOMY CONSUMER SENTIMENT***

*Consumer sentiment has collapsed globally*




Source: IFM Investors, National providers, IMF, Macrobond *GDP weighted

> **For now, nominal spending is holding up and a tight labour market is a key factor offsetting weak sentiment.**

Households under such pressure brings the clear downside risk for growth in these economies. While it remains true that households in aggregate still have outsized savings on balance sheets, the outlook suggests savings may remain there rather than be spent, weighing on real growth. For now, nominal spending is holding up and a tight labour market is a key factor offsetting weak sentiment. Yet real spending growth is starting to rollover as inflation erodes purchasing power. Job security is also at risk as central banks seek to avoid wage-price spiral dynamics and are therefore either explicitly or implicitly seeking to push unemployment rates higher. We know that consumer spending is by far the largest component of GDP in most countries, so a weaker household sector and more uncertainty likely means weaker growth. This will almost inevitably feed into a softening of business sentiment and, likely, investment.

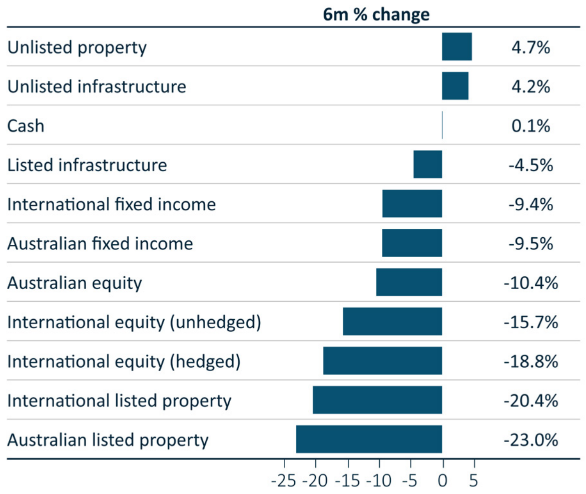
Hopefully a less painful moderation of demand will be enough to reduce inflationary pressures, but central banks are treading a fine line that they risk crossing. This is due to uncertainty around the level at which their policy settings will gain traction, combined with an urgency to act. Central banks are of the collective mind that "...a failure to restore price stability" would mean far greater pain than the increasing pressure of policy action on households. Although, one could argue that the only thing worse for households than paying materially higher prices is not being able to pay them due to job loss.

Nonetheless, expectations for policy action increasingly suggest that central banks will move to contractionary settings (though they will know that they are indeed contractionary only in hindsight) and then pause for a period to keep downward pressure on inflation. At the same time, central banks hope for a benign scenario in which economies can land softly as inflation moderates. If inflation does not moderate sufficiently, or in a timely manner, central banks may push policy settings further into contractionary territory and/or hold them there for an extended period. This is the "stagflation-outright" scenario which would bring further downside risk to economic activity. To this end, the sizeable risk-off moves post the hawkish messaging at Jackson Hole should be seen as a positive. Tightening financial conditions facilitate the transmission of contractionary monetary policy and will help central banks in their objective to slow activity.

Investors will clearly be hoping for the more benign outcome that would allow central banks to be contractionary for less time. There would likely be rallies in both equities and fixed income were this to be the case. A more stagflationary outcome would likely result in a further drawdown in equities markets and potentially a rally in government fixed income, particularly if recession is being viewed as necessary to bring inflation under control. But markets currently expect any recession to be relatively shallow so over time we expect investors to take on more risk as defensive assets start to underperform, with central banks not needing to be overly aggressive on policy easing to steady economies.

**GRAPH 03** **BENCHMARK ASSET CLASS PERFORMANCE**

*Inflation hedges outperform in H1 2022*




Source: IFM Investors, APRA, Bloomberg, MSCI

In the first half of 2022, these themes have been priced into markets and have contributed to a rise in the attractiveness of private markets and 'mid risk' assets. This is particularly true as public markets have become unusually corelated. These asset classes, most notably unlisted infrastructure, have been able to leverage their growth and defensive properties, as well as being effective inflation hedges.

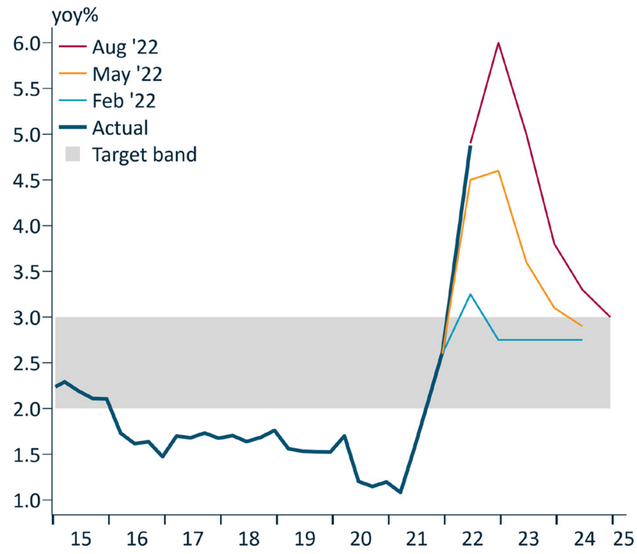
## Australia: Solid before the slowdown

The Reserve Bank of Australia (RBA) continued to tighten monetary policy in recent months to tame inflation and to remove the exceptionally stimulatory settings seen over the course of the pandemic, implementing a record four consecutive 50 basis-point increases from June to September that took the cash rate to 2.35%. In its communication, the RBA has stressed the need to return inflation to the target band while keeping the economy on an 'even keel'. This suggests to us that the RBA is not yet as hawkish as its counterparts in the UK and the US, which are resolved to act more aggressively to tame higher inflation. It notes that "price stability is a prerequisite for a strong economy" and how higher rates pose a downside risk to economic growth, rather than the more direct language of the Fed who admit that households are being caused "pain" by its policy action.

Nonetheless the RBA did not allude to any slowing of the current pace of rate hikes, stating it will be "guided by the incoming data" with regard to future moves. We'd assert that the Bank is moving at a pace that means it will only know it has moved policy into contractionary territory in hindsight, which poses a risk to the economy. At least in its rhetoric and actions it is seemingly discounting this future risk to address current inflationary conditions. With no signal in the data to date that suggests the RBA should stop raising rates, further tightening is expected over the coming months.

**GRAPH 04** **RBA SMP TRIMMED MEAN INFLATION FORECASTS**

*RBA continues to revise inflation expectations higher*




Source: IFM Investors, ABS, RBA, Macrobond

The urgency the RBA seemingly has to respond to inflation is observed in its forecasts. It expects inflation to remain outside its target range until end 2024 and in its August Statement on Monetary Policy (SMP) upgraded its inflation forecast for the Consumer Price Index (CPI) to around 7.75%yoy (previously 6%) by the end of this year. June quarter inflation rose at its fastest pace since the early 1990s: headline CPI increased by 6.1%yoy and trimmed mean inflation, a measure of underlying inflation, was 4.9%yoy. While long-term inflationary expectations remain anchored, measures of short-term inflation expectations increased in the June quarter, and the RBA noted that businesses in its liaison program have reported inflation as a factor in recent wage negotiations. The RBA forecast headline and underlying inflation to start to decline in early 2023 and return to the target band at the end of 2024. The primary driver of inflation outcomes is increases in labour costs in response to the tight labour market, although the risk of additional supply shocks remains.

Wage growth was modest in the June quarter (0.72%qoq) and was just shy of the consensus expectation of 0.8%. This is in the context of the very tight labour market domestically and the wages growth observed in advanced economies that have similar labour scarcity. Forecasters continue to expect the WPI to accelerate in the second half of 2022, reflecting award wage increases and the fact that employers traditionally put through wage increases at the start of the September quarter. Most firms in the RBA's business liaison program expect to raise wages by more than 3% in the coming year, suggesting wages growth will be less than headline inflation. Wage pressure continues to come from a tight labour market, with unemployment edging lower to 3.4% in July.

Despite the tight labour market, the RBA downgraded its profile for economic growth, which it expects to remain strong over the rest of 2022 before slowing in 2023. The RBA sees household consumption as a key driver of growth over 2022 before it moderates next year, noting that the evolution of consumer spending in an environment of rising interest rates and slowing real income growth is a key uncertainty. Indeed, consumer sentiment continued to decline in Q3 but retail sales have held up so far. High terms of trade will provide a boost to national income, however.

Economic growth was 0.9%qoq in the June quarter and 3.6% through the year. This was in line with the RBA's expectation (of 1.0%qoq and 3.5%yoy) but this outcome is well and truly in the rear-view mirror, with monetary conditions having changed materially since Q2. The details of the release show an economy that is still benefiting from reopening, particularly for households, and difficulties with weather supply chains and the lingering impact of COVID on the workforce in the business and public sectors. Indeed households accounted for all of the growth in domestic demand contributing 1.1ppts. Dwelling investment was negative, business investment edged higher and public demand was flat, leaving domestic demand at 1.0%qoq. Inventories subtracted 1.2ppts and net exports added 1.0ppts, continuing a run of volatility in both these sectors.

This outcome shows the vulnerability of economic growth going forward as a slowdown in the household sector is to be expected as rapidly rising interest rates curtail spending. Indeed the RBA itself notes that whether household spending will continue to be robust is a key area of "uncertainty" in its forecasts. Other sectors of the economy will need to pick up in order to sustain an even "at trend" rate of activity. We don't think this will occur to a great enough degree to offset slowing consumer

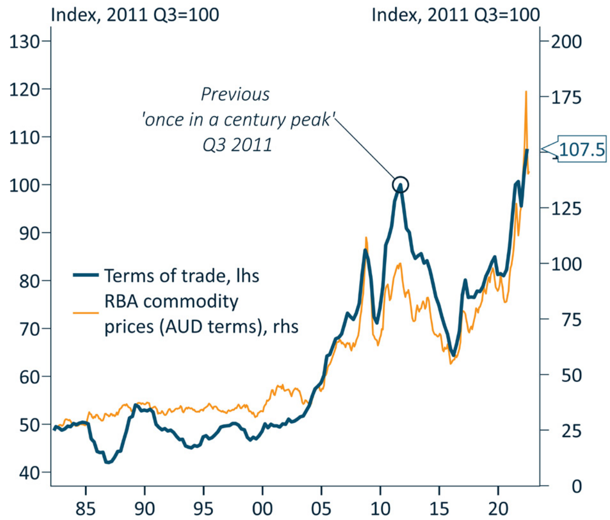
> **Most firms in the RBA's business liaison program expect to raise wages by more than 3% in the coming year, suggesting wages growth will be less than headline inflation.**

spending and GDP growth is likely to slow materially as we head into latter stages of this year and into 2023.

Australia's good luck, being a net exporter of energy, also shone through, with the terms of trade reaching a new record high eclipsing the previous peak in 2011 that at the time was thought of as a once in a century occurrence. This was evident in both nominal GDP expanding at 12.1%yoy and real gross domestic income at 5.6%. While this acts as a tailwind for the economy and government revenues currently, the inevitable decline in commodity prices will mean this becomes a headwind in the not too distant future that policymakers will need to be cognisant of.

**GRAPH 05 TERMS OF TRADE**

*High commodity prices are currently a tailwind*




Source: IFM Investors, ABS, Macrobond

We remain of the view that the pace of economic growth will decelerate markedly through the remainder of the year and into 2023. This will come as higher interest rates and elevated inflation weigh heavily on the household sector. And we have long been of the view that the economy will recover to a pre-pandemic state in which economic growth is over-reliant on the expansion of the population and lacks meaningful productivity improvements.

## US: Inflation fight continues

Inflation and monetary policy continue to be the key focus in the US, and although there have been developments in the fiscal space, these will likely have negligible economic impacts over the shorter term and are mostly relevant for political considerations. Tighter financial conditions and high rates of inflation have caused the pulse of economic activity to weaken materially, with real output contracting (-0.6%qoq saar) in Q2 following a contraction in Q1 (-1.6%qoq saar). This satisfies one technical definition of a recession (two consecutive quarters of negative growth), but the official arbiter of what constitutes a recession in the US (the NBER) has yet to make a judgement. It is unlikely H1 2022 will constitute an official recession given the shallow nature of the contraction and the strength in other aspects of the economy – particularly the labour market. Nonfarm payrolls continue to be strong, with around 1.1m net new jobs added in June through August. The unemployment rate continued to trend lower in June and July, reaching 3.5% in July (equal to February 2020 and the lowest rate since 1969), before a strong rise in participation in August saw the unemployment rate tick up to 3.7%.

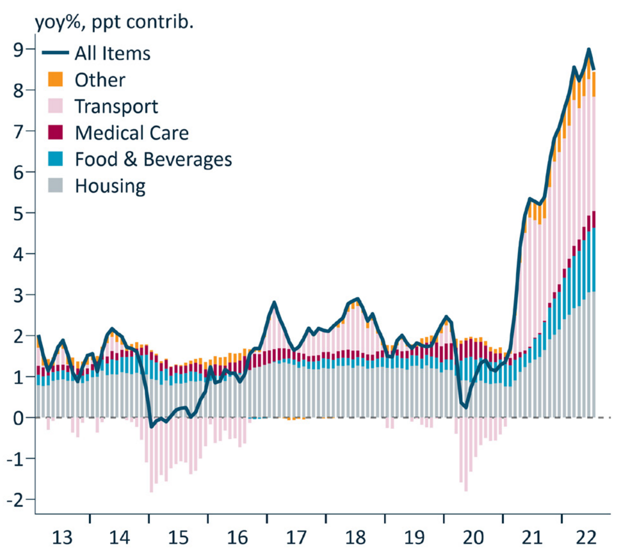
There are some tentative signals that labour momentum may be slowing, however. Participation and jobless claims have weakened and there has been some softening in vacancies at the margin (but levels remain exceptionally elevated). Wages growth – in nominal terms at least – has been robust and will likely continue to be until some of the heat is taken out of the labour market.

Continued strong inflation means that earnings and disposable incomes have been softening in real terms. This suggests that a pullback in consumption is possible, but for the time being the data show that consumers are still spending, despite elevated cost-of-living pressures. Indeed, inflation reached 8.5%yoy in July, still very high despite being down from 9.1%yoy the month prior. Core inflation has not accelerated for four months (5.9%yoy in July) and whilst these are welcome prints, it is too early to say with any confidence that inflation has peaked. And evidence of increasingly broad-based price pressures casts doubt on how long inflation will take to get back to target.

The Fed has signalled that it wants to see clear and unambiguous progress on price stability before it will feel comfortable pausing/reversing monetary policy tightening, even at the cost of softer growth and higher unemployment. This comes after rates were raised by 75bps in June and July, taking the policy rate target range from 0.75-1.00% to 2.25-2.50%. Further tightening essentially remains a foregone conclusion, but communications show that the Fed is cognisant of indicators pointing to cooling activity and will take a more data-dependent approach to policymaking. Having said that, inflation is the key data that decisions are dependent on, and the Fed seems willing to force a recession if need be.

**GRAPH 06** **US INFLATION CONTRIBUTIONS**

*Inflationary pressures are becoming more broad-based*




Source: IFM Investors, US BLS, Macrobond

**“The step to partially forgive student debt is also noteworthy but neither of these policy changes look set to have a meaningful, nor sustainable, fiscal impulse.**

In fiscal policy, the passage of the “Inflation Reduction Act” was a significant achievement for the Democrats and is touted as having material implications for health/climate related matters. The step to partially forgive student debt is also noteworthy but neither of these policy changes look set to have a meaningful, nor sustainable, fiscal impulse. Politically they are important, however, and when combined with prominent and polarising social issues, are aimed at the Democrats having a platform with which to campaign ahead of November’s midterm elections. Yet on balance, the chances of a Republican majority in the Senate and/or the House (leading to a divided government) remain high based on the swing against incumbents that has been observed through recent history.

## UK: Winter of discontent

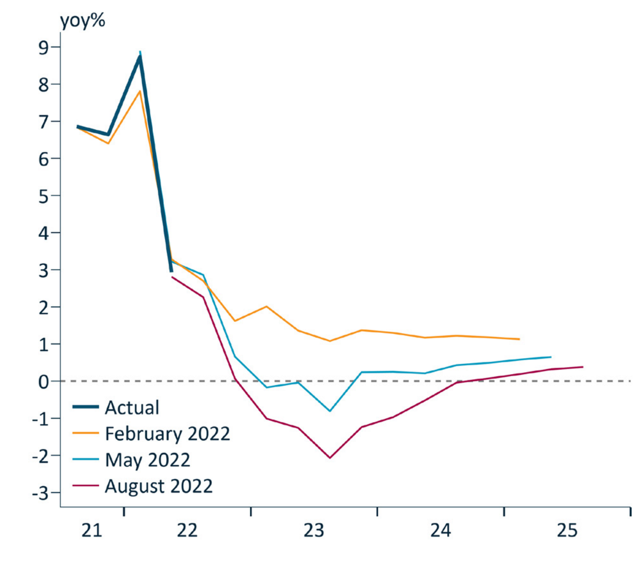
A continued deterioration in the economic fundamentals has been a headwind to activity and the outlook continues to soften, with increasing risks of a sizeable recession over the coming quarters.

The Bank of England (BoE) has the unenviable task of navigating one of the most acutely challenging macroeconomic environments of any advanced economy central bank (the European Central Bank is in a similarly uncomfortable position). Since June, the BoE has raised rates twice (25bp in June and 50bp in August) taking the bank rate to 1.75%. Further tightening is anticipated, despite the BoE downgrading its forecasts and now forecasting a recession from Q4 2022 as its base case in its August Monetary Policy Report. The BoE notes that there are considerable uncertainties around these forecasts. Overall, the BoE remains particularly focused on signs of inflationary persistence and the rate rhetoric remains hawkish. Committee members remain committed to “act forcefully” if necessary, but elevated uncertainties require a more data-dependent approach.

Inflation continues to surprise to the upside (July headline: 10.1%yoy) and the BoE now expects headline CPI to peak in the fourth quarter of this year at a touch over 13%yoy. These strong figures largely reflect energy price impacts driven by Russian gas supply disruptions and sharp increases in the household energy price cap announced by Ofgem (UK energy regulator). But there is the potential that inflation of this magnitude leads to second-round inflationary effects, prolonging elevated price pressures.

GRAPH 07 **BANK OF ENGLAND MPR GDP FORECASTS**

*Growth outlook continues to soften and a recession is expected*




Source: IFM Investors, BoE, ONS, Macrobond

Soft August data suggest that these dynamics are a headwind to activity. Briefly, second quarter real GDP contracted 0.1%qoq, in line with expectations. This is not a strong print, but there are a number of idiosyncratic factors that make it hard to draw more insightful conclusions (the Office for National Statistics explicitly noted caution when interpreting these data). Preliminary PMI data for August show that manufacturing activity was particularly hard-hit, falling well into contractionary territory. One positive to note from the details was a considerable easing of cost pressures to a 10-month low. Services activity held up better, but it is hard to envision how the sector will continue to expand in the coming environment. Indeed, consumer confidence fell to a new all-time low in August, suggesting consumers are even more pessimistic than during the depths of the pandemic. This has been matched by a clear downward trend in retail sales since around May 2021.

The standout, again, are the labour market data. Figures for the three-months through June continue to point to decent employment growth and low levels of spare capacity (160,000 new jobs, 3.8% unemployment rate). But some key leading indicators are looking concerning. Labour demand continued to soften, with job vacancies trending lower and the number of inactive persons in the labour market increased sharply over the reference period. This labour tightness has seen continued strong nominal wages growth but inflation continues to put a squeeze on real incomes.

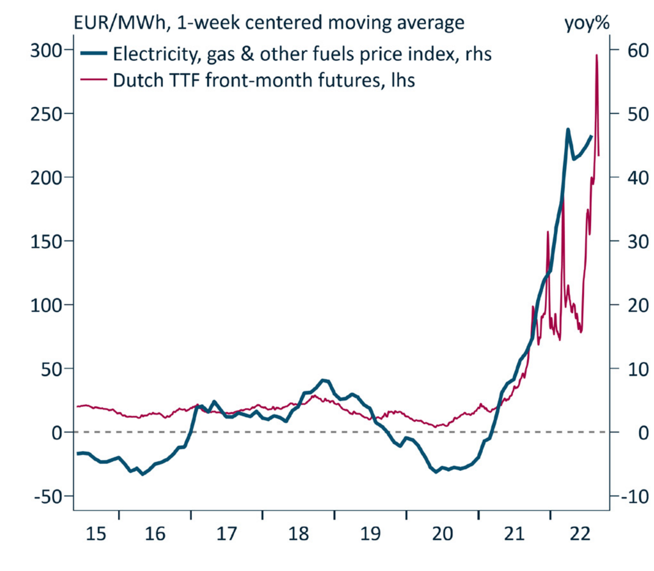
Briefly in politics, UK PM Boris Johnson resigned during the quarter amid a mass walk-out of Tory MPs who were fed up with his conduct. Party members decided in early September that the next PM will be Liz Truss, who ran on a right-leaning policy platform focussed on tax cuts and reduced regulation. In the nearer term, however, the energy crisis takes precedence and Truss is working on an energy relief package of up to £100bn.

## Eurozone: Bearing the cost of conflict

The already bleak outlook for the Eurozone continues to darken with deepening concerns around inflation persistence, negative growth impacts from tighter monetary policy, and the looming threat of uncertain winter energy supplies.

GRAPH 08 **EUROPEAN GAS PRICES AND ENERGY INFLATION**

*Sky-high gas/energy prices are disrupting growth*




Source: IFM Investors, Eurostat, ICE, Macrobond

Real GDP data for Q2 show that the Eurozone economy expanded at a decent 0.6%qoq, comfortably above expectations. But developments since then mean these figures are of limited usefulness and Q3 figures will almost certainly be softer. Growth risks are skewed to the downside, with the looming risk of a significant/total cessation of gas flows from Russia as part of the Russia/Ukraine conflict. Gas prices have been exceptionally disruptive to Eurozone activity and the EU is set to announce measures aimed at managing any further disruptions from gas prices. A recession isn't a foregone conclusion at this stage but the risks of a recession in end-2022 through H1 2023 are sizeable.

Indeed, timely PMI data suggest that aggregate private sector activity slowed in July and contracted at a faster pace in August. Services activity growth has slowed sharply, and manufacturing activity has moved into contractionary territory. The one positive in these soft activity indicators is the inflation implications: slowing growth will contribute to more moderate price pressures through easing demand. Indeed, the details of the report flag that inflationary pressures faced by businesses continue to ease. But despite the improving directionality, price pressures remain exceptionally elevated in levels terms. The CPI data released over the last few months highlight that consumers continue to be squeezed, as four consecutive inflation accelerations saw August headline inflation hit 9.1%yoy, with core inflation at 4.3%yoy. And any improvement in inflation sentiment has been replaced by softening growth sentiment.

Consumption indicators are also sending concerning signals. Retail sales slumped in June (-1.2%mom) as reopening effects faded and continued cost-of-living pressures eroded disposable incomes. The outlook for consumption remains soft, with consumer confidence – and a range of other confidence indicators – either already at very low levels or continuing clear downward trends. Contrasting this, the labour market remains a standout, with employment growing again in Q2 and the unemployment rate tracking sideways at 6.6% in June. This, along with elevated savings, are both positives for the consumption outlook and will act to balance some of the negative signals by improving households' ability to bear continued cost pressures. But on balance, the aforementioned factors will likely be dominated by the headwinds.

The European Central Bank (ECB) – hands tied by unacceptably high inflation – had no option but to tighten monetary policy despite the deteriorating fundamentals. The ECB increased the rate on its key policy instruments by 50bps in July. This marks the first episode of tightening by the ECB since 2011 and the size of the hike surprised markets (a 25bp hike was expected). The ECB signalled that further interest rate normalisation (i.e. increases) should be expected but a more data-dependent approach is in play, affording the ECB more flexibility in policy making. The ECB was set to meet shortly after the publication of this document and a rate hike is essentially guaranteed, with 50bps and 75bps seeming like the most likely moves. Finally, net asset purchases ended on 1 July and the reinvestments of the Pandemic Emergency Purchase Program will continue at least through end-2024 and will remain the main instrument against sovereign spread widening. The Transmission Protection Instrument was also added to the ECB's toolkit and is intended to facilitate the smooth transmission of monetary policy across Eurozone countries.

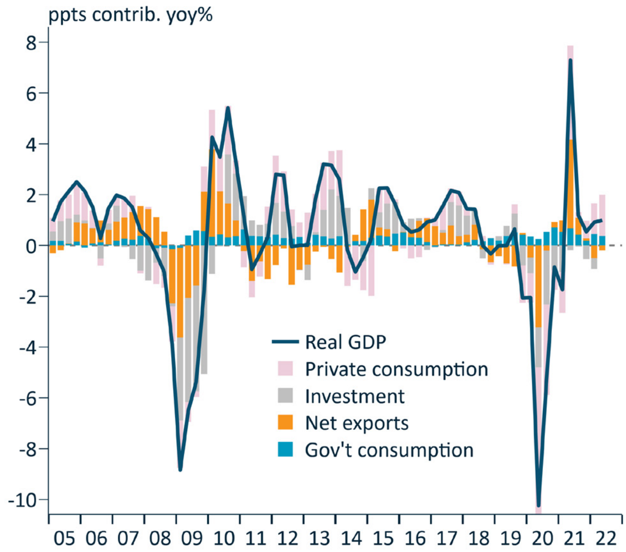
## Japan: Stability before slowdown

Japan's economy recovered to end-2019 levels in Q2 but the outlook for growth, which was consumption driven, remains uncertain given lingering impacts from the pandemic and weak real wage growth. While growth will likely continue at a slower rate in the near-term, any risk of recession is probably tied to slowdowns in global growth over the more medium term. Economic growth was positive but weaker-than-expected in Q2, with the preliminary real GDP annualised growth estimate of 2.2%qoq coming in below the consensus expectation of 2.6%qoq.

Growth was primarily driven by household consumption, particularly services consumption, which picked up with the removal of COVID-19 containment measures. Spending on durable and non-durable goods was more modest, likely due to inflationary pressures. The outlook for short-term growth is positive given the recovery in spending, although risks are tilted to the downside. High-frequency indicators show that in August mobility in workplaces, retail and recreation spaces, and transit stations was down by 10-20% relative to pre-pandemic levels as the population limited its movements in response to rising case numbers despite the government not reinstating any virus containment measures. Supporting consumption has been a solid labour market

GRAPH 09 JAPAN GDP CONTRIBUTIONS

*Consumption has been the main growth driver in Japan*




Source: IFM Investors, CaO Macrobond

in which the unemployment rate was flat at 2.6% for the second month in the row despite the jobs-to-vacancy ratio ticking up in the month. Wage growth is expected to remain weak, with earnings likely to slip below the 2.2%yoy rate recorded in June, taking real earnings deeply negative.

Rising case numbers will also likely weigh on private sector activity, which shows limited improvements in momentum following the easing of COVID-19 restrictions in the second quarter. The Tankan surveys for Q2 show that non-manufacturing firms benefited from the easing of domestic restrictions and recorded improvement in outlook (though less than expected). In contrast, international developments in supply chain issues (which worsened due to China's COVID restrictions) and increasing energy prices saw the outlook for manufacturing firms fall by the more than expected. Forward-looking indicators suggest that private sector activity has deteriorated a little over the quarter, with PMI data recording slowing growth rates for manufacturing services in July and a contraction in services and manufacturing output in August.

The positive but weak outlook for growth suggests that inflationary persistence will not be as strong in Japan as it is in other advanced economies. In saying that, both headline and core inflation are rising at their fastest pace since around 2015. Prices increased across the board in the quarter, particularly for durable goods. The Bank of Japan (BoJ) maintains that the present upswing is transitory and says that wage growth is insufficient (and will likely remain so) to see a more permanent inflationary mindset introduced. Accordingly, it is unlikely the BoJ will attempt to normalise policy soon.

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