IFM Investors

Economic Update
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Has the worst passed?

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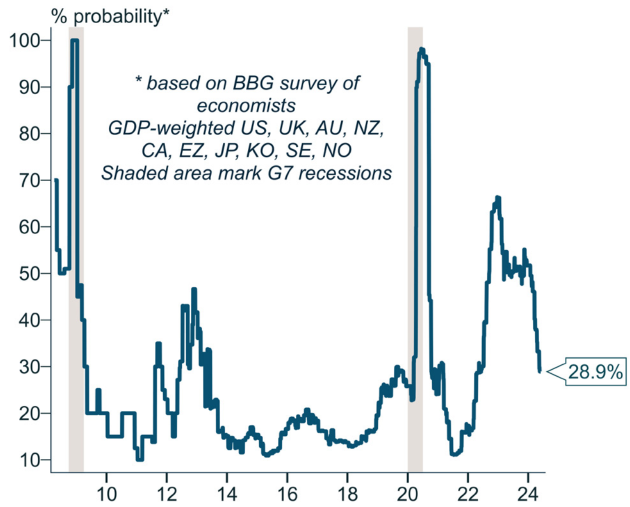
Resilient global growth and firmer-than-expected inflation prints in recent months have delayed rather than derailed expectations of an 'immaculate disinflation'. Expectations for deep cuts that drove equity market returns over the first quarter have been replaced by a more positive growth outlook, AI exuberance and robust corporate earnings. Nonetheless, the volatility that characterised markets in April highlights that receding expectations of monetary easing is key to underpinning investor sentiment. While focus remains on the US Federal Reserve, monetary policy is set to become increasingly asynchronous as other central banks seek to manage the idiosyncratic risks in their own economies.

GLOBAL: Softly does it

Since our last quarterly the global economic outlook has continued to evolve in a relatively positive manner with respect to economic activity. Collective advanced economy recession probabilities, as judged by market economists, have plummeted to around a one in three chance of a downturn in the next twelve months (after peaking at a two in three chance in late 2022 and a one in two chance for most of 2023). The consensus view that has formed is that the weakest point of this economic cycle is now behind us, and growth forecasts for year-end 2024 are being revised up. Better growth comes despite tight monetary policy as economic agents have been forced to adjust to these settings via improved productivity. And, of course, through ongoing household resilience that is underpinned by still tight labour markets and improving real incomes. As we have passed through the nadir in growth, progress on disinflation has been mixed but broadly continues towards central bank targets. 'Sticky' services inflation remains a key concern. And it is this risk that has seen expectations for deep rate cuts, that characterised the start of the year, all but evaporate. For equity markets, while facing some recent headwinds, this outlook has been broadly supportive of returns. The expectation of material rate cuts has been replaced by expectations for better growth. For fixed income, the environment remains challenging, with solid carry being eroded by higher yields since January's lows.

GRAPH 01 ADVANCED ECONOMY RECESSION RISKS

Risks receding…



Source: IFM Investors, IMF, Bloomberg, via Macrobond

It is a rare occurrence that monetary policy has been tightened at the rate and magnitude that it has without causing a material recession. Let alone when it is occurring in response to a supply-side inflationary shock. This is particularly true of the US economy which had its 'recession that wasn't' in H1 2022. That is, the US recorded two consecutive quarters of negative growth (a common definition of technical recession), but this was not classified by the National Bureau of Economic Research (NBER) as an 'official' recession, nor was it accompanied by any material labour market dislocation. The setback occurred more in anticipation of the rate increases that were to come than because of them. Since then, the US economy has surprised on the upside with a tailwind of fiscal policy and resilient household spending, despite consistent expectations for weaker growth. This expectation turned at the start of his year. At that time economist forecasts for year-end 2024 growth was a modest 0.7%yoy, even with rate cut expectations being supportive. But as we approach mid-year, rate cut expectations have been largely reversed and growth expectations have been strengthened to 1.7%yoy – around where the potential rate of growth was estimated to be before the pandemic.

The upshot of this is that investors holding a tilt to US risk/growth assets have been rewarded. And on the basis of economic activity accelerating they may continue to be. Arguably, however, this will likely be a more modest return given the outperformance of the US IT sector now moderating and a broadening-out of returns to less bullish old-economy thematics. This is despite relatively stretched valuations. We say this as economies are seemingly moving towards trend rates of growth that may persist for some time given the ample space for monetary policy support if needed. Indeed, in the absence of a shock, growth in this cycle could be prolonged by a drip-feed of easier policy over an extended period.

In the fixed income space, Treasury yields are attractive for those looking for some insurance. However, for long-term investors any aggressive tilt to defensive positioning that took place in late 2022 has meant medium term returns remain soft. The credit space has modestly outperformed, particularly over the past 12 months, given the more positive economic outlook. Again the risk/growth theme has paid dividends with US high yield credit materially outperforming, recovering all losses since the sell-off in late 2021 and into 2022 when rate hikes were being priced and recession expected. Other 'better' credit has not. Greater leverage into improved economic expectations, corporate earnings, and shorter duration has seen a stronger correlation with equity returns than lower-risk fixed income. Investor demand for higher yield has also been a factor but this may fade as it becomes more difficult to envisage any material further tightness in spreads.

Notably, mid-risk real assets, specifically infrastructure, are expected to perform relatively well, with valuation pressure from higher risk-free rates subsiding, less volatile inflation and a better economic outlook based on a resilient consumer. Commercial property more broadly remains more challenging, with valuations remaining under pressure. Industrial/logistics property is favoured over retail given the outlook. Office property is still undergoing a material adjustment, with the impact of working from home still playing out, relatively high risk-free rates, potential pockets of debt pressures and still poor investor sentiment.

GRAPH 02 **US CORP HY & EQUITY MARKETS**

Credit favoured for more equity-like characteristics

Source: IFM Investors, Bloomberg, via Macrobond

The economic outlook for other major advanced economies is similar to that of the US. Although notably the Eurozone, UK and Japan have paid a higher economic price than the US did to get control of inflation, afflicted by both recession and malaise as monetary policy tightened. The Eurozone has expanded just 1.8% since the March quarter 2022 to the December quarter 2023, recording its recession (two consecutive quarters of negative economic growth) in H2 2023. Notably, Germany has been the laggard in the region. While not recording an official recession (that has held through data revisions) it has recorded four quarters of negative growth in the seven since Q1 2022 and was 0.1% smaller by the end of 2023 as a result (by comparison the Spanish economy expanded 5.7% over the same period). Similarly, the UK recorded three quarters of negative growth over this period, with a recession in late 2023, to be 0.3% smaller entering 2024. Japan followed a different path, swinging from solid growth to material declines and being revised out of recession in late 2023. It was also an outlier in Q1 2024, recording another reversal in growth, whereas the UK and Eurozone have recorded positive starts. The upside surprise in Q1 GDP for the UK has supported upward revisions to forecasts to 1.5%yoy by Q4 2024, compared with just 0.6% at the start of the year. Similarly, the Eurozone has firmed from 1%yoy to 1.2%yoy and Japan from 1.1%yoy to 1.4%yoy. Recession expectations are falling materially in all of these economies. This comes despite the prospect of deep rate cuts being all but priced out (at the time of writing there were 60bp and 34bp of cut priced for the European Central Bank (ECB) and Bank of England (BoE) respectively and 12bp of hikes for the Bank of Japan (BoJ). Of course, for Australian readers we remain an outlier with, as we have described before, the hardest of soft landings for the economy. Market economist forecasts have been unrevised so far this year, with expectations of 1.6%yoy growth for 2024 simply based on outsized contributions from the expansion of the population and despite ongoing per capita recession.

AUSTRALIA: Inflation bump won't phase RBA

The Australian economy continues to expand, underpinned by population growth, but is suffering an ongoing per capita recession and a material and ongoing reversal in the fortunes of the household sector. This is evident in retail sales, with a distinctly softer trend emerging in the monthly nominal data coming in at -0.4%mom and 0.1%mom for March and April respectively. An annual growth rate of just 1.3%yoy, despite higher prices and population growth being supportive, is a rate not seen even in recessions. There was a material reversal in volume terms in the March quarter with sales 0.4%qoq lower. In per capita terms sales were 1.2%qoq lower – the seventh consecutive decline in this measure, with the likelihood of more to come. Discretionary/durable retail sales volumes were particularly weak.

Cost-of-living pressures continue to undermine real spend and there was an unwelcome upside surprise to inflation in Q1. While through the year inflation continued to decelerate, the quarterly impulse was uncomfortably high with key measures – headline and trimmed mean – up 1.0%qoq. Importantly, non-tradable items in the CPI, reflecting domestic inflation pressures, rose 1.5%qoq. This is where the least disinflationary progress has happened, with an annual rate of 5.0%yoy. And where the Reserve Bank of Australia (RBA) remains concerned that wages growth in the absence of productivity growth will make it more difficult to get under control.

Wages growth itself seemingly peaked at 4.1%yoy in the March quarter, but much of this was due to the deceleration of public sector wages. Of more concern – and reflective of a still tight labour market – was the private sector wages measure (including bonuses) that has edged up to 4.4%yoy. In the absence of productivity growth this risks adding to inflationary pressure. Wages pressures are likely to gradually come off as the labour market continues to loosen and while employment growth is slowing in trend terms and running below labour supply. The result is the unemployment rate continuing to tick higher and at 4.1% is potentially moving towards the RBA's forecast from its May Statement of Monetary Policy (SMP) of 4.3% sooner than it expects.

It is the weakness of the household sector and loosening of the labour market that sees us downplay the potential of near-term rate hikes, which in our view were highlighted as a knee-jerk reaction to the upside surprise in the Q1 inflation data. While the RBA did suggest it weighed the option of raising rates, it also asserted in its minutes that it wanted to "avoid excessive fine-tuning" of policy in response to a "short-term variation" in inflation. This suggests the Bank will accept that the path of disinflation will not be smooth and equally will not react with policy to individual data points. For now, it is keeping a neutral footing with risks to the outlook "judged to be balanced". We suspect this will continue for some time before it looks to ease policy as the unemployment rate edges higher and inflation rate edges lower.

The Federal budget came and went with little fanfare, indeed the response in the consumer sentiment was negligible despite the cost-of-living measures it contained. It is our view that the budget was inflationary as it brings Stage Three tax cuts, frees up disposable income via rebates, and subsidies and imparts a positive fiscal impulse as it goes from surplus to deficit in coming years. This is even though it may mechanically serve to bring down the CPI calculation as subsidies tend to do. It compounds the cost-of-living measures coming from State governments, particularly Queensland, that at best will create volatility in coming inflation prints and at worst willfully go against the RBA's efforts for the sake of political expediency.

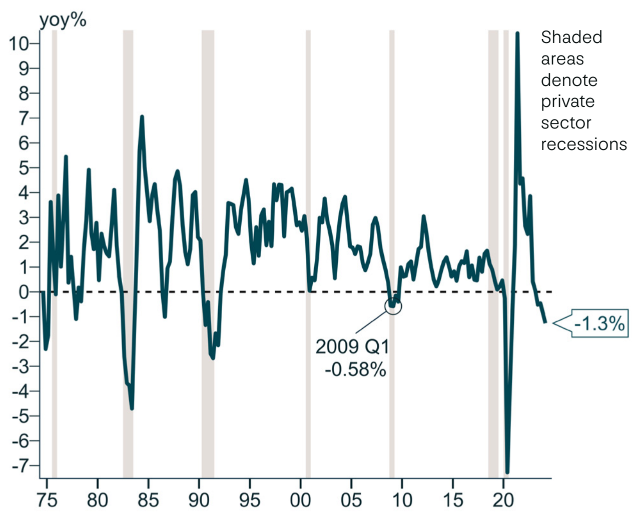
Real GDP in the March quarter expanded by 0.1%qoq and 1.1%yoy through the year, the weakest annual growth rate since the 1990s recession. The RBA's forecast to the June quarter this year is 1.2%yoy, implying 0.7% growth in H1 2024. The March quarter outcome leaves it running behind what is needed to achieve this and we will need to see a 0.5qoq% outcome in Q2 which has not occurred since March 2023. The RBA continues to have the challenge of managing weak economic outcomes and the risk that presents to a rising unemployment rate and still uncomfortably high inflation.

Of the detail, the household sector was a surprisingly solid contributor given higher rates and cost of living issues continue to impact. Some of this surprise was due to a material revision of resident spending offshore. Business investment was weak outside of machinery and equipment and the sector loses confidence in the outlook. Government spending was solid but government investment fell, the former continuing to underpin economic activity. Inventories added to growth driven by solid imports that subtracted from growth and prompted a material subtraction by net exports.

Notable at the headline level was the economy recorded its fifth consecutive reversal in per capita growth terms (and sixth quarter out of the last seven), since Q2 2022 GDP per capita is 1.6% lower. The RBA remains concerned that aggregate demand has not slowed sufficiently to bring inflation sustainably back to target. But what is abundantly clear is that individual households, particularly those with a mortgage, are feeling the brunt of higher rates and cost of living pressures. Nonetheless, while inflation is uncomfortably high the RBA will judge it necessary to keep economic growth weak with rates remaining at current levels.

GRAPH 03 **REAL GDP PER CAPITA**

Worst per capita downturn since the 1990s



Source: IFM Investors, ABS, via Macrobond

US: Inflation – ups and downs

A sizeable inflationary spike in Q1 prompted a material re-pricing of prospective rate cuts from the Federal Reserve (Fed) and contributed to risk-off moves in markets. But recent activity data, including more modest US growth and some retracing of this inflation strength keep the Fed with an easing bias.

First quarter GDP disappointed expectations materially, with an increase of 1.3%qoq saar (consensus: 2.5%qoq saar) and cast some doubt on the Fed's forecast for 2024 of 2.1%. But the headline figure understated a more positive narrative of underlying growth momentum. Inventories (-0.45ppts) and net exports (-0.89ppts) were the main headwinds to overall growth. Excluding these volatile categories leaves growth up by a more robust 2.6%qoq saar with personal consumption (2.0%) continuing to grow and fixed business investment (6.0%) accelerating. This still represents a material slowdown in growth relative to Q4 (ex inventories and trade growth of 3.6%qoq saar). But with inflation not completely defeated, at-trend growth is not overly problematic. And this sentiment has been echoed by markets as it allows for monetary policy easing.

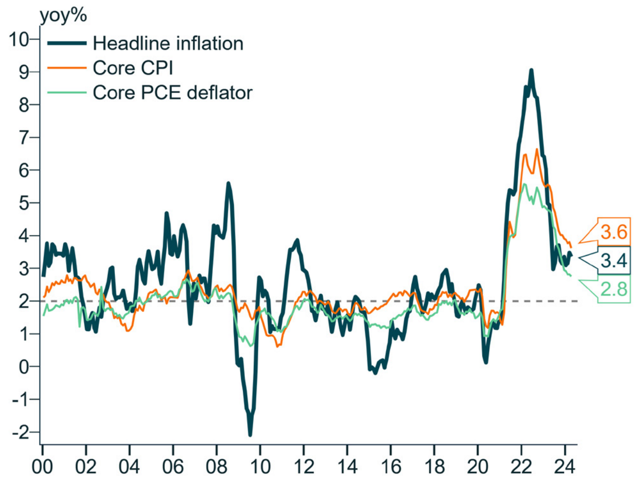
Higher frequency data continues to point a near-term moderation of activity. ISM indices in recent months are a key indicator of this, with both services and manufacturing falling into contractionary territory in April and the latter edging lower again in May. Services is the bigger story here, with three consecutive declines to 49.4 (the lowest reading since the pandemic, excluding a one-off slump in December 2022).

Growth may be slowing, but recession fears are still well-contained. The US consumer remains key here and some concerns have arisen. Retail sales disappointed in April (headline: 0.0%mom, control: -0.3%mom), and when combined with downward revisions to prior months, imply more moderate growth momentum heading in to Q2. This is corroborated by a sizeable decline in consumer confidence in May and softer-than-expected personal spending data. Again, this is not necessarily a bad development as slower consumption will help bring growth and inflation into better balance. And the evidence suggests a moderation rather than a material retracing in consumption.

How consumption evolves will continue to be dictated, in large part, by the labour market, which the data suggest is still performing well. The April labour market data were a 'goldilocks' print: non-farm payrolls were robust (at 175,000) but a step down from a strong trend. Employment growth remains more robust in 3-month moving average terms (242,000) so the April softness must be considered in context. The unemployment rate ticked up (3.9%), somewhat assuaging fears of strong wages growth feeding into inflation. Job vacancies per unemployed person is also signalling better balance in the labour market after hitting 1.3 in March (back at pre-pandemic levels). Average hourly earnings also continued to cool, with the headline measure down to 3.9%yoy and the private sector service-producing sub-index (a better measure of underlying market-based wage pressures) down to 3.7%yoy. Slowing earnings comes as a particular relief for monetary policymakers after a strong employment cost index print for Q1 (1.2%qoq), and further reinforces the view of ongoing orderly rebalancing.

GRAPH 04 US INFLATION

Sharp April inflation spike reignited monetary policy fears



Source: IFM Investors, BLS, BEA, via Macrobond

Inflation was also uncomfortably strong through Q1 with key measures accelerating. Key for the Fed, the headline personal consumption expenditure (PCE) price index jumped to 4.4% in three-month annualised terms in Q1. (A sobering 3.8ppts higher than that seen in the prior quarter.) This took headline PCE inflation to its highest since August 2022. CPI inflation saw a similar, though more muted, rise in Q1 and drove fears of a monetary policy shock that weighed heavily on risk assets. Softening inflation in April was therefore well received by market participants. Headline and core CPI ticked down to 3.4%yoy and 3.6%yoy, respectively. There was also a sharp retracing in three-month annualised core services inflation, a better proxy for underlying inflation than the usual core measure. PCE measures also softened in April. Whether this trend continues is an open question and is one of the key risks to the US outlook for the rest of the year.

The Federal Reserve left policy unchanged at its March and May meetings at 5.25-5.50%, as expected. Following the March meeting, the median FOMC participant (Fed dots) still had three 25bp cuts in 2024, with Chair Powell striking a dovish tone and downplaying the strong January/February inflation data. That has now changed. The next set of Fed dots will be released at the June meeting and will very likely see rate cut expectations walked back. At the May meeting, Powell indicated that inflation progress has been disappointing and that rates would likely need to stay higher for longer. Powell has provided clear reassurance to ameliorate growing concerns of a hawkish pivot and did not suggest that another hike is likely – the Fed has a high threshold for hiking and remains confident of gradual disinflation. Indeed, Powell highlighted that the Fed still feels it is in a position to cut rates should that be required to support the economy and labour market – a key factor underpinning valuations in growth asset classes. The Federal Open Market Committee (FOMC) also announced that it would start tapering the monthly cap on Treasury runoff from US$60bn to US$25bn (the MBS cap will remain unchanged at US$35bn) per month.

UK: Q1 bounce

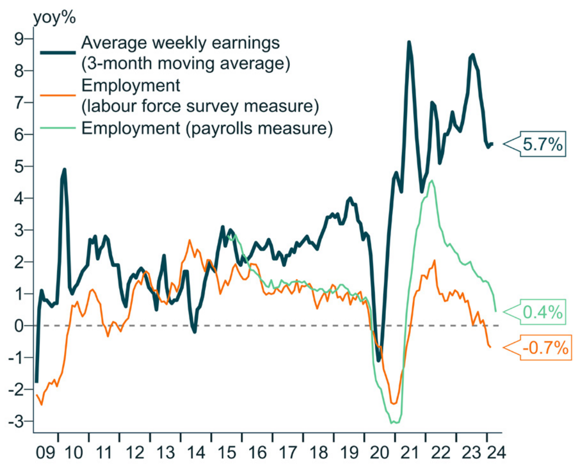
UK economic activity rebounded materially in the first quarter, suggesting that the most painful period of adjusting to tighter monetary policy and the soaring cost-of-living is now past. Real GDP growth was surprisingly strong in Q1 (0.6%qoq/0.2%yoy) to more than offset the contraction seen during the shallow recession at the end of 2023. Though this was the fastest quarterly growth rate since Q4 2021, there were some volatile drivers. Specifically, net exports was a key support (0.44ppts). This occurred despite a fall in exports, as it was overshadowed by an even larger fall in imports. The latter resulted in a run-down in inventories that also subtracted materially from quarterly growth. Overall, improving growth in household consumption (0.2%qoq) and fixed investment (1.4%qoq) points to respectable underlying domestic growth momentum.

While growth is expected to continue, the outright strength of the Q1 growth figure is unlikely to be repeated. Indeed, looking at PMI figures there is evidence of slowing growth in Q2 with the composite measure underperforming expectations and softening (52.8). Slowing in private sector services activity was the proximate cause, with survey details highlighting ongoing cost-of-living pressures and continued economic uncertainty as weighing on activity. Despite a softish PMI in the manufacturing sector actual activity was positive, expanding 2.3%yoy. Ongoing recovery in external demand should continue to support the manufacturing recovery in coming months and continue to narrow the wide gap between services and manufacturing performance seen for the last few years.

In aggregate, activity is expected to continue to recover through 2024, with further gains in real wages and fading drags from monetary policy underpinning household consumption. The extent of the support provided by real earnings gains depends on how labour markets and inflation track through the rest of the year. Labour market data suggest that the UK jobs market is cooling. Though this should be considered in context of the ongoing issues around survey response rates that is plaguing the ONS.

GRAPH 05 **EARNINGS AND EMPLOYMENT**

Strong wages diverging from softening employment



Source: IFM Investors, ONS, via Macrobond

The unemployment rate has continued to climb from 3.8% at the end of last year to 4.3% in March. This has been driven by a clear slowing of employment growth that has more than offset falling participation. Indeed, the UK economy lost 178,000 net jobs in the three months to March according to the official data, with an alternative payrolls measure of employment showing nearly 85,000 jobs were lost in April alone (the largest one-month loss since May 2020). Excess demand for labour also appears to have returned to pre-pandemic levels after a long adjustment period, as evidenced by job vacancies per unemployed person reaching 0.61 in March. Nonetheless, earnings growth has so far showed somewhat more limited evidence of slowing. Headline average weekly earnings (total economy total pay) growth was stronger than expected at 5.7%yoy in three-month moving average terms in March (compared to 5.8% in December). The message from the Bank of England's (BoE) preferred measure – private sector regular pay – is similar, despite it decelerating to 5.9% (vs 6.2% in December). While this is 0.1ppts softer than the BoE's projection in its May Monetary Policy Report it is still well above wage growth consistent with the BoE's inflation target.

Ongoing earnings pressures will have implications for the inflation outlook. This is particularly true for the stickier and more wages-exposed services inflation measure, which surprised materially to the upside in April (5.9%yoy). For reference, the BoE projected services inflation of 5.5%yoy. This unexpected strength in services inflation was broad-based across several services categories – suggesting that wage costs were a contributing cause – and saw both headline (2.3%yoy) and core (3.9%yoy) inflation beat expectations.

The BoE left rates unchanged in March and May at 5.25%, as expected. Messaging at both meetings tilted dovish but the continued strength in earnings measures and the upside inflation surprise in April have pushed back against imminent rate cut expectations. Several policymakers have pointed to stickiness in services inflation and wages growth that requires a cautious approach to policy normalisation. Furthermore, the improved growth outlook for the UK removes some of the urgency around rate cuts as the BoE can afford to be more patient to wait for a clearer signal without causing undue harm to the economy.

In politics, Prime Minister Sunak has called a general election for 4 July - earlier than expected. Polls suggest that the Labour Party is the strong favourite, with a lead of around 20 points over the Conservative Party. Neither party has released election manifestos that discuss policy priorities, and it is therefore hard to comment on any potential fiscal implications at this stage. Nonetheless, there is very limited fiscal space available after the Spring Budget presented by Chancellor Hunt in early March. The budget is expected to provide some modest near-term growth support, with a 2% cut in personal taxes the flagship announcement. This is worth around ~£10bn and will be funded by a further reduction in the Office for Budget Responsibility (OBR)-estimated fiscal headroom, small revenue raising measures, and lower spending on public services. Given limited fiscal space, near-term stimulatory policies are unlikely and fiscal risks are more relevant for next year.

EUROZONE: First major to ease?

The Eurozone economy now seems to be through the worst of the growth headwinds from the dual inflation and rates shock. First quarter real GDP expanded by a surprisingly strong 0.3%qoq, to put an end to five consecutive quarters of stagnation and the (shallowest possible) downwardly revised recession in the second half of 2023. Of the large economies, Spain continues to outperform substantially (0.7%qoq), with Italy (0.3%qoq), France (0.2%qoq) and Germany (0.2%qoq) growing at a more muted pace.

Country-level details show that foreign demand was the primary driver of growth over the quarter, but also highlight respectable gains from fixed investment and household consumption. (Germany is the notable exception to the consumption story.) Some of the outperformance may be related to mild weather over the quarter, and despite the substantial growth contribution for external demand, national data suggest a broader improvement in underlying domestic demand.

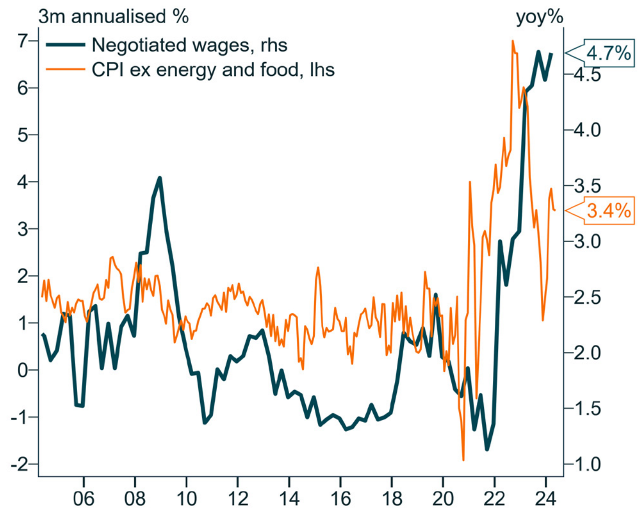
Survey-based indicators add support to this view, with the PMI figures for April/May pointing to an acceleration in private sector growth in the bloc. Services continues to be the main driver, but an unexpectedly strong manufacturing performance in May was also supportive.

Monetary policy remains a key focus with the impending ECB meeting on June 6th. This is expected to be the first properly 'live' meeting of any major central bank since the beginning of the post-COVID rate hiking cycle. Indeed, it is the overwhelming market consensus that that the ECB will start easing, with a 25bp cut. This was signalled at the ECB's April meeting, where it stated that it would be "appropriate to reduce the current level of monetary policy restriction" once there is confidence inflation is moving sustainably toward its target. The April policy statement went into some detail on how this confidence would be obtained, with progress needed on moderating wage growth, and firms absorbing part of the rise of labour costs to ensure disinflation continued. There was also a note of caution with price pressures recognised as remaining strong and services inflation remaining high. The account of the April meeting reinforced the expectation of a June cut. Communications stressed that the ECB remains data-dependent, but also suggest that the ECB is focusing on the broad trend in the data rather than on one particular data point.

The data released since the April meeting have broadly surprised to the upside. Inflation (particularly services inflation) and wages remain the key focus for the ECB, and the data suggest that there remains a troubling amount of persistence. On prices, both headline (2.6%yoy) and core (2.9%yoy) inflation were materially stronger than expected in May. This has seen the three-month annualised change CPI ex-energy and food spike recently to remain near its highest level since June 2023. Of particular concern was the jump in services inflation from 3.7%yoy to 4.1%yoy, which has seen services inflation essentially track sideways since November 2023.

GRAPH 06 INFLATION AND WAGES

Sticky wages and inflation a problem for the ECB



Source: IFM Investors, ECB, via Macrobond

In terms of wages – and the labour market more broadly – conditions remain tight. The most important development over the quarter was the unexpected reacceleration in negotiated wage growth in the bloc from 4.5%yoy in Q4 2023 to 4.7%yoy in Q1. Another measure, the hourly labour cost index, also accelerated in Q1 by a sizeable 0.6pp to 4.8%yoy. Employment growth was also strong in Q1 (0.3%qoq), with the unemployment rate ticking down to 6.4%. The downside of the robust Q1 employment growth is that it has seen output per worker stagnate over the quarter. This is problematic for the ECB, which expected a productivity pick-up to allow a softening in unit labour cost growth relative to wages.

Despite these upside surprises, communications from ECB officials since the April meeting continue to suggest that June will likely see rates eased. ECB Chief Economist Philip Lane, in particular, highlighted that "barring major surprises… there is enough [evidence] to remove the top level of restriction" in June. Lane emphasised that rates need to remain restrictive through the year, "but within the zone of restrictiveness we can move down somewhat". The outlook beyond the June decision remains uncertain and the ECB will remain firmly data-dependent regarding the pace of future rate cuts.

EU parliamentary elections will take place over 6-9 June, where citizens will elect 720 representatives for the next five years. Polling and recent electoral processes in Germany, the Netherlands, Spain, and Portugal suggests that a shift to the right is likely, and while the green transition remains a priority, the focus looks set to continue to shift towards competitiveness. There are limited implications in the near term from a macroeconomic perspective and, as is commonplace in the EU, major changes aren't expected absent a crisis. A key risk is around the US election, should former President Trump re-take office. This may create uncertainties around EU-US trade, security policy with the EU and a shift in policy on the Russia-Ukraine conflict.

CHINA: Unbalanced upside

China's economy continues to gradually recover but its economic revival has been uneven. Dataflow over the first half of 2024 reflects several headwinds: continued weakness in the property sector; further deterioration in household consumption and ongoing deflation. Export strength and investment in manufacturing and infrastructure remain the only bright spots, however questions are being raised regarding the sustainability of these growth drivers. Indeed, rising geopolitical tensions and protectionism may threaten China's export competitiveness while a repeat of premature fiscal consolidation and the fiscal cliff that hurt the economy in 2023 may jeopordise the recovery. On a positive note, policymakers have announced an ambitious list of measures to support China's property market and restore consumer confidence.

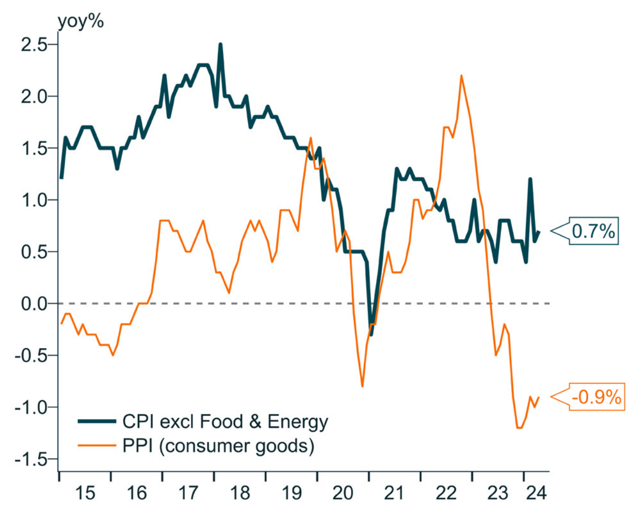
The economy opened the year on a positive, with real GDP expanding 5.3% over the year to March, comfortably beating expectations. Quarterly output expanded 1.6%, equating to annualised growth of 6.4%, considerably higher than the Politburo's reaffirmed 2024 target of 'around 5%'. But this is unlikely to be sustainable, given what was an over-reliance on the public sector in driving growth.

Notably, the GDP price deflator came in at -1.1% and is expected to edge higher over coming quarters. Deflationary risks have eased, accordingly, but have not been dispelled. Consumer prices increased marginally in April but remain subdued, edging up 0.3%yoy, after a soft print in March thanks to CNY base effects, while producer prices contracted 2.5%yoy. Weak price pressures are symptomatic of supply-demand imbalances in China's economy. Industrial production, a proxy for supply, expanded 6.7% over the year to April and 1% mom, the biggest move in 3 years. Meanwhile, weak household demand persists, as retail sales growth fell to 2.3%yoy in April from 3.1%yoy in March.

Forward-looking soft data reinforce this deceleration thematic. The April NBS Manufacturing PMI was slightly expansionary at 50.4, buoyed by momentum in construction and production but eased to 49.5 in May. Worryingly, the new orders subindex continues to edge lower, as around 60% of managers surveyed reported insufficient demand. Nonetheless, firmer exports are supportive of domestic activity and in the year to April, China's export value increased 4.9% in yuan terms, despite export prices contracting 8%. Policymakers from Western economies believe that this data corroborates claims that China is exporting deflation to oversupplied markets, which could raise the risk of additional tariffs in the medium term. Policymakers will look to limit the economy's long-term reliance on external demand as the blueprint of the current leadership is to use 'domestic circulation' to replace 'external circulation'.

GRAPH 07 **CHINA INFLATION**

Policymakers continue to deal with subdued prices



Source: IFM Investors, NBS, via Macrobond

In April, fixed asset investment (FAI) slowed to 4.2%yoy, dragged lower by a faster fall in property investment (10.5%yoy) while manufacturing (9.3%yoy) and infrastructure investment (8.2%yoy) remained buoyant. In May, authorities called for acceleration in the issuance of special government bonds to promote 'national strategic areas', while in April's Politburo meeting, a more dovish tone was adopted regarding fiscal policy as authorities stated a need to maintain 'fiscal intensity'. This may provide additional fiscal headspace to support infrastructure and manufacturing FAI and dispel fears of premature fiscal consolidation experienced in 2023. Of ongoing concern is that fiscal and monetary policy has been insufficient in turning around the property sector which may impact the outlook for Australian iron ore among other commodities. Through the year to April property sales declined 23%, new starts contracted another 14% and completions declined 19%. Further, developers' source of funds remained in deep contraction, falling 21%. Promisingly, in May, the State Council announced its most forceful attempt to resuscitate the nation's property market as policymakers have become increasingly concerned about the sector's drag on economic growth. The package involves the removal of mortgage rate floors, easier access to the government's provident home fund and lower mandatory downpayments on property to re-stimulate demand. Most significantly, to digest excess inventory, the People's Bank of China (PBoC) has earmarked CN¥300bn (US$41.5bn) in cheap funding to facilitate government purchases of land from developers and residential housing units for conversion into affordable housing.

As expected, in May the PBoC left its one-year medium-term lending facility (MLF) rate unchanged at 2.50%. The PBoC faces significant trade-offs regarding further monetary policy easing. Anemic consumption continues to drag on a production-led recovery, CPI inflation remains close to zero, private investment remains weak and a surprise contraction in credit has cast doubt over the growth outlook. However, a reduction in the MLF before other major central banks opt to cut policy rates will further widen interest rate differentials and exert unwanted downward pressure on the yuan. The fact that the PBoC has held in spite of these economic challenges suggests that it is placing increased emphasis on currency stability in its reaction function and thus as expected, has intervened to ensure that the yuan trades within a tight range over the first half of 2024. Should other major central banks ease later in the year, the PBoC may get some additional comfort to strike a balance between supporting the economy and the yuan. In the meantime, fiscal policy is expected to do most of the heavy lifting.

JAPAN: A new normal

Japan looks to usher in a new era of nominal growth after decades of stagnation. Secular labour shortages, COVID reopening effects, including inbound tourism, firm corporate profits, and a surge in import prices in recent years may have shifted wage and price dynamics. As such, the BoJ smoothly ended its experimental easing measures in March, asserting that a ‘virtuous wage-price cycle’ was now a realistic prospect.

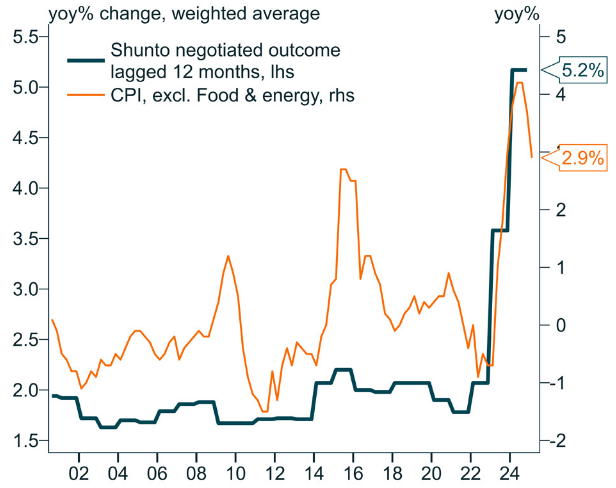
But the news over the quarter was not all positive. Real GDP contracted 0.5%qoq (-2.0%qoq saar) over the March quarter, surprising to the downside as expectations centred on a 0.3% decline. Notably, Japan skirted a technical recession after growth in the December 2023 quarter was revised up to zero and thus the soft result over March (although preliminary) represents a sharp decline into negative territory. Private demand was especially weak (-0.4ppt) of which private consumption (contracting for the fourth consecutive quarter) was the largest drag (-0.4ppt), followed by residential and business investment (-0.2ppt), offset by a positive contribution from private inventories (0.2ppt). Net exports were also a significant drag (-0.3ppt) while public demand (0.2ppt) buoyed by government consumption was a bright spot. Special one-off factors emanating from a suspension of shipments/production at a major automaker due to safety issues saw a sharp contraction in consumer spending, notably a 40.5% decline in durable goods consumption. The same issues were a source of drag on Japanese exports and are likely to reverse over the next quarter. In fact, stripping out this factor is estimated to result in marginally positive real growth. The BoJ will hope that cycling this issue, one-off tax cuts in June and strong wage momentum will provide necessary impetus for private consumption to improve going forward.

In April inflation decelerated with the headline rate down to 2.5%yoy from 2.7%yoy in March. Similarly, core inflation (ex-fresh food) and core-core inflation (ex-fresh foods and energy) also decelerated to 2.4%yoy and 2.0%yoy respectively. Notably, the decline in the core measure represents a fading impact of the sharp rise in food prices over the period. Meanwhile, energy prices grew modestly on the back of an increase in fuel import prices and further volatility is likely in coming months as the government aims to terminate caps on electricity and gas prices by June.

In March the Japanese Trade Union Confederation (JTUC or Rengo) released its FY2024 shunto initial wage negotiation data for agreements between companies and labour unions. The results indicate a base pay rise of 3.7% and a headline wage increase including scheduled wage increases of 5.3%. Although these figures are considerably lower than the respective increases of 4.3% and 5.9% demanded by unions, they come in significantly higher than last year’s figures. The result marks the first time in over 30 years since a base pay rise of more than 3% was negotiated, a reflection of high corporate profits, entrenched inflation expectations and severe labour shortages. Indeed, unemployment remains very low and stable at 2.6% in April, buoyed by a high jobs-to-applicant ratio and absorbing trend shifts in the participation of women and older age groups in the labour force.

GRAPH 08 **‘SHUNTO’ WAGE NEGOTIATIONS & CPI**

Can the ‘virtuous cycle’ continue?



Source: IFM Investors, Japanese Trade Union Confederation (Rengo), JSB, via Macrobond

The BoJ determined that a ‘virtuous cycle between wages and prices’ has taken shape, as unions react to inflationary pressures by demanding higher wages, to which employers respond by incrementing sales prices. Historically, there is a high correlation between periods of high inflation (above 2%) and strong shunto base pay rises and BoJ forecasts of 2.4% headline CPI over FY2024 should support another strong shunto base rise in FY2025. In March, basic wages increased by 2.2%yoy compared to 2.1%yoy in February on a same-sample basis, while the decline in real wages slowed from -1.4%yoy to -0.9%yoy. Stronger results are likely in coming months as negotiated wage increases take effect at the beginning of the fiscal year in April.

After a 25-year period of unconventional monetary policy, the BoJ concluded its March meeting with an overhaul of negative interest rate policy and yield curve control. That said, it maintained discretion over Japanese Government Bond (JGB) purchases. The BoJ raised its uncollateralised overnight call rate to a range of 0 to 0.1% on the back of improving wage-price dynamics and stated the price stability target of 2% would be achieved by the end of the projection period. As noted above, the main catalyst for the decision was strong negotiated wage outcomes consistent with sustainable growth in prices. In April the bank held the policy rate. To support the path to monetary policy normalisation, the bank shifted messaging in its outlook report, underscoring inflation coming in as expected, rather than overshooting forecasts, would be enough to warrant additional hikes. Further, potential rate increases were categorised as an ‘adjustment to easiness’ rather than outright tightening. Indeed, BoJ estimates place the natural rate at around 1%, whereas current real rates remain in negative territory, suggesting that the policy rate will remain accommodative for some time yet. Compared to March, Board members were incrementally hawkish. The bank deliberated on recent weakness in the yen (the worst performing Asian currency against the US$ in April ytd) which challenges the bank’s view that cost-push pressures are waning. Despite having no target to defend, the BoJ curtailed bond purchases in the 5-10-year sector in May, signaling it is actively monitoring movements in the yen.

KOREA: An unexpected upswing

In Korea real GDP accelerated 1.3% over the March quarter, beating market expectations for 0.6% by a considerable margin. This acceleration translated to 3.4%yoy compared to 2.2%yoy in the previous quarter. Details show that strong domestic demand was a major contributor (0.7ppt vs -0.4ppt in Q4 2023). Main drivers of the upside surprise were strong rebounds in private consumption (0.4ppt) and gross fixed capex (0.2ppt). The latter was supported by a significant increase in construction, partially offset by weaker stock and facilities capex. Externally, net exports (0.6ppt) were still a solid source of growth but to a lesser extent than many would have anticipated, nonetheless exports continue to expand on robust global demand for semi-conductors.

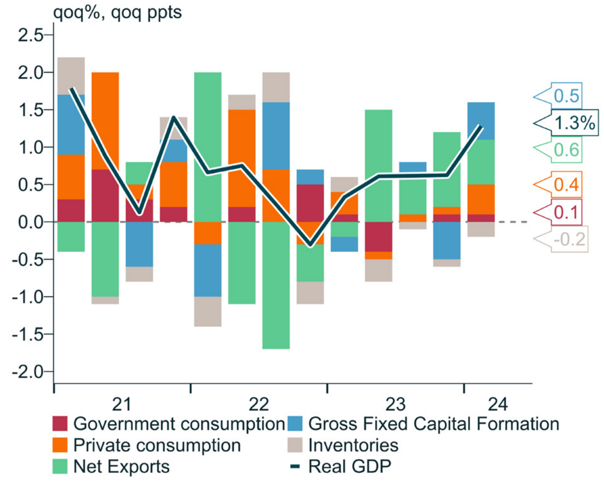
Strength exhibited in private demand is likely attributable to low base effects given weak levels of private consumption observed over prior quarters and a few one-offs. Soft data support this notion. Consumer sentiment improved around the end of 2023, potentially flowing through the consumption data with a lag effect. Indeed, momentum in consumer sentiment has stalled over the quarter against a backdrop of slower disinflation and monetary policy lags emanating from the Bank of Korea's (BoK) cumulative 300bp rate hiking cycle from August 2021 to January 2023. It is likely that this will cap the future recovery in private consumption going forward. Further, the BoK argued that better weather conditions over the quarter supported a huge upswing in construction capex as a contributor to growth over the quarter (0.4ppt vs -0.7ppt in Q4 2023) likely on a backlog of delayed project works since the pandemic. Various leading indicator data including lower levels of authorised starts, weaker transaction volume and subdued property market sentiment suggest that construction capex is likely to face weakness and a high base effect over the June quarter.

Exports are expected to be a prominent growth driver going forward. This notion is supported by another month of double-digit expansion in export growth in April (13.8%mom), on the back of strong demand for semis (56.1%yoy), which continues to be driven by a global tech upcycle, strong US demand and Chinese activity coming back online. Although healthy demand for AI-related tech remains a strong tailwind, promisingly Korea's export strength continues to broaden out across non-tech sectors – namely autos, ships and machinery. Partials data also confirm that momentum has continued over the first 20 days of May with Korean daily exports improving 17.7%yoy.

In April, headline CPI eased from 3.1%yoy to 2.9%yoy, slightly lower than market expectations for 3%yoy. The softening in the headline figure came from both core and non-core components. Notably, an easing of price rises for marine and agricultural products was enough to offset an increase in the price of oil products. On the former, this represents a break in a sustained upward trend since May 2023 and is likely a signal that government efforts to curb prices including supply adjustments, customs tax cuts and price subsidies are taking effect. Meanwhile core inflation eased to 2.3%yoy, in line with consensus on the back of lower inflation for eating out and other private services. The outlook for inflation remains that it should be near the BoK's target by year's end.

GRAPH 09 QUARTERLY REAL GDP GROWTH

Strong March quarter on domestic rebound



Source: IFM Investors, BoK, via Macrobond

Despite progress on disinflation, the BoK kept its base rate unchanged at 3.50% in May, a decision that was unanimous and in line with market expectations. The outcome suggests that the BoK isn't quite ready to shift away from its restrictive stance as inflation remains well above its 2% target, noting "if the policy stance is shifted too early, there are risks that the pace of inflation moderation could be slower". However, it still remains open to a rate cut in the second half. Reflecting on stronger than expected growth over the March quarter, the BoK revised up its 2024 growth target from 2.1% to 2.5%, resulting in a small downgrade to its 2025 target as it sees only a modest recovery in private demand going forward, with restrictive policy expected to weigh on households and the construction sector. The upgrade is attributable to strength in net exports rather than a material recovery of domestic demand, enabling the bank to leave its inflation forecasts unchanged. However, the BoK pointed out that risks to its inflation outlook remain tilted to the upside, highlighting supply side factors impacting the price of fresh food and oil amidst rising geopolitical issues. Like many economies, a high interest rate differential between Korea and the US is a source of currency depreciation that hinders the central bank's fight against inflation, driving up the price of oil and other key imports. In April, the BoK's Governor suggested Fed cuts would see more monetary policy divergence and give the BoK leeway in setting monetary policy based on the domestic economy. As a result, the won slid and the market interpreted these comments as an indication that the currency would be allowed to fall. Indeed, this makes the prospect of cutting the base rate before the Fed more difficult.

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