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ECONOMIC UPDATE

In the eye of the economic storm

The scale of the initial economic shock caused by the COVID-19 crisis has become clear with the release of the June quarter GDP data across the globe. Many countries have suffered the steepest fall in output since official records began, almost all are in recession and the path to recovery is anything but certain. In particular, there has been a worrying resurgence in COVID-19 cases in several countries, following a tentative easing of restrictions, which poses significant downside risks to the outlook. Accordingly, fiscal and monetary stimulus will likely need to remain in place for much longer than initially expected. Despite the still sobering economic environment, equity markets have made a strong recovery buoyed by aggressive stimulus measures and in the US, equities have recorded the most rapid recovery from a bear market in living memory.

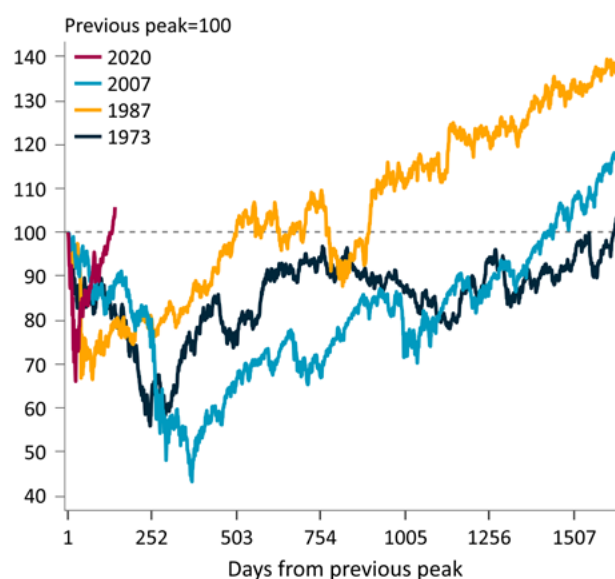
Global: Best and worst of times for markets

We wrote in these pages last quarter about the surprising strength of the recovery in global equities markets – coming despite economic uncertainty remaining extremely elevated. That narrative has not changed over the past quarter, indeed since our last missive the US S&P500 has risen another 17.6% (at the time of writing). This comes with the tailwind of extreme global monetary stimulus, unprecedented fiscal stimulus and speculation on vaccines for COVID-19. The market also largely ‘looked through’ weak economic data and a US company earnings season that was poor but not as bad as expected. Added to all this has been the relatively aggressive surge of retail investors using low cost trading platforms. These factors have driven the quickest recovery of US equity markets in modern history.

We show this in the context of the last four US bear markets in GRAPH 01. The S&P500 took a mere 17 days from its peak to reach bear market territory and it bottomed after 24 days. It then took just 106 days to recover its previous peak. The other bear markets associated with economic recessions in 1973 and 2007 took 244 and 370 days just to reach a bottom and another 1383 and 1071 days to recover previous peaks. The 1987 crash, with no recession, bottomed in 74 days and recovered 428 days later.

GRAPH 01 US S&P500 BEAR MARKET RECOVERIES

The 2020 bear market recovery is the quickest in modern history



Sources: IFM Investors, Bloomberg. Document finalized on September 3rd

» Global equities have had a similar shaped – but less spectacular – recovery, bouncing on March 23rd as the US Federal Reserve (Fed) took action. The MSCI World All Cap Index including the US market is up 45.5% from its bottom but only 30.5% up excluding the US – which itself has risen 58.1%. The US market has distinct winners and losers. The winners include consumer discretionary (containing Amazon and Tesla) and Information Technology (containing Apple and Microsoft) indices that have risen 94.1% and 80.3%, respectively, since March 23rd. Utilities, consumer staples, financials and real estate indices by contrast have languished, up just 25.1%, 34.2%, 35.5% and 38.1%, respectively. The varied performance within the S&P500 itself is stark, particularly between the market favourites in the IT space and the remainder of the index. Apple, Amazon, Alphabet/Google, Facebook and Microsoft have seen their market value rise 89.8% since March 23rd, leaving their market capitalisations 39.6% higher (just over US\$2 trillion) than their February peaks. The market value of the remaining 495 companies has, by contrast, risen 52.1% since March 23rd to be 1.9% from its February peak.

The speed of the market recovery has got many wondering where to from here? Valuations are becoming stretched and investor uncertainty is high. This is particularly true as the global economic recovery also remains highly uncertain. The World Bank reports that, on a per capita GDP basis, 93% of the world's economies will be in recession in 2020 compared with 61% in the Global Financial Crisis (GFC) in 2009 and 84% in the Great Depression in the early 1930s. It forecasts a 5% reversal in global output this year compared with the 1.8% decline in the GFC. With this comparison in mind, the equity market responses (in GRAPH 01) to these episodes is somewhat confounding. We expect everything will need to go right in the health crisis and subsequent economic recovery for markets to maintain this level of exuberance. But this outcome is anything but certain.

We have now, for the most part, observed only the initial economic impact of the public health crisis on June quarter economic output. The median decline in GDP across reporting countries has been just under 10%qoq. While many countries will see a 'bounce' in growth rates in the September quarter, this seemingly risks being much more modest than previously forecast. We argue this as second waves of COVID-19 hit many countries. We observe this in GRAPH 02 where the second wave of the virus has been larger than the first in the US, Japan and Australia and is threatening a similar trend in Europe and the UK. This has occurred as restrictions were tentatively eased in many jurisdictions but is also, in part, likely due to larger testing numbers more clearly revealing case numbers. Nonetheless, the resurgence cannot be ignored and increases the risk that governments have to re-impose restrictions to 'flatten curves' again, potentially curtailing the economic recovery. Conversely, if government action

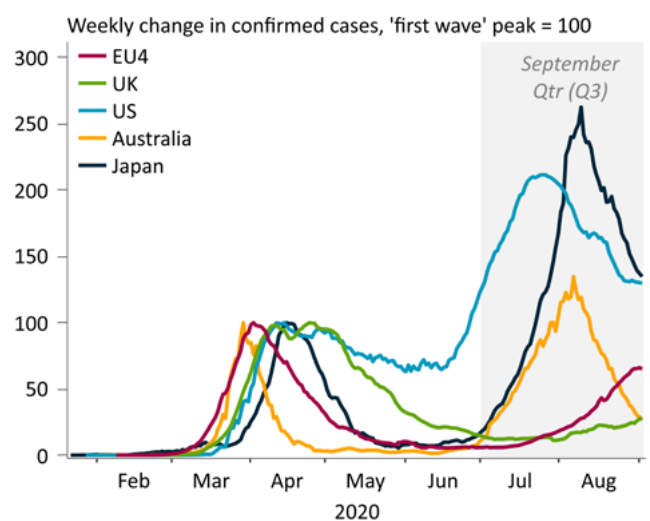


Equity market strength is occurring while 93% of the world's economies are in the deepest recession in modern history

is absent, people's own self-imposed restrictions – as they observe rising case numbers – may have the same effect. We expect increased case numbers will ensure that elevated levels of 'restrictiveness'¹ will likely remain in place in the major developed economies for an extended period. Whether state mandated or self-imposed, these factors are preventing populations from acting in a normal economic manner and this is clearly observable in the only partial recovery in daily mobility indicators (that are derived from mobile phone data). This is particularly true in the absence of a proven vaccine against COVID-19 which is the 'silver-bullet' required to restore public confidence. A vaccine still seems some way off and consequently the current public health dynamics suggest to us that the path of recovery in most developed economies in particular will be a long, drawn out U-shape as a best case scenario.

GRAPH 02 COVID-19 NEW CASES

Second waves of COVID-19 are exceeding the first



¹ as defined and measured by Oxford University that records government responses to the health crisis see <https://www.bsg.ox.ac.uk/research/research-projects/coronavirus-government-response-tracker>



...accommodative policy settings will be in place for an extended period.

What is clear from this assessment is that central banks will have to leave accommodative settings in place for an extended period. Indeed, there remains the risk the central bankers will do even more to support economies in the near term. Central banks continue to rapidly expand their balance sheets, with the combination of the US, Eurozone, Japan and UK now being 75pp larger than they were before the crisis hit. This comes despite concerns that policy efforts are doing more for markets than real economic activity, which risks exacerbating inequality even further.

Equally, fiscal policy in most cases will also need to remain in place for longer than governments had first expected, particularly when a V-shaped recovery remains a slim prospect. This will be to the detriment of fiscal balances and balance sheets, given the realisation that monetary policy is less effective and too blunt a tool to address the economic fallout from this crisis. Fiscal policy-makers will not only have to lend more support, but will likely add more direct stimulus in an attempt to get economies to recover, while facing the simultaneous challenge of making economies 'better' and more productive via reforms to drive growth. The COVID-19 economic crisis has hastened the transition from monetary to fiscal policymaking as the key driver of cyclical economic management.

Arguably the first test of what the electorate will want to see from governments will come on a grand stage on November 3rd with the US presidential election. It has already been a polarising early lead up, with both parties diametrically opposed on many issues and lacking any form of previous orderly co-operation on significant initiatives to support the ailing US economy.

There is an unprecedentedly strong anti-incumbent sentiment going into the election before we even get to the policy platforms of each party. And both sides are also making a strong push for people to get out and vote (2016 voter turnout was reportedly 55.7%).

The Democrats, led by former Vice-President Joe Biden, have an economic policy platform centered on his "Build Back Better" plan which focusses on four "great national challenges": 1) promoting manufacturing and technology, 2) building modern infrastructure and supporting clean energy, 3) supporting caregiving and education, and 4) seeking to priorities issues around social justice, inequality and race. The Republicans, led by President Donald Trump, are running on his record of doing what he promised with regard to tax cuts and border control in particular. His platform, currently less detailed, has an emphasis on: 1) extending tax reforms implemented in 2017, 2) pushing a "Made in America" industry policy with tax incentives, 3) a

less ambitious climate policy focusing on environmental deregulation, 4) controlling borders and immigration and 5) social issues such as gun rights and restrictions on abortion.

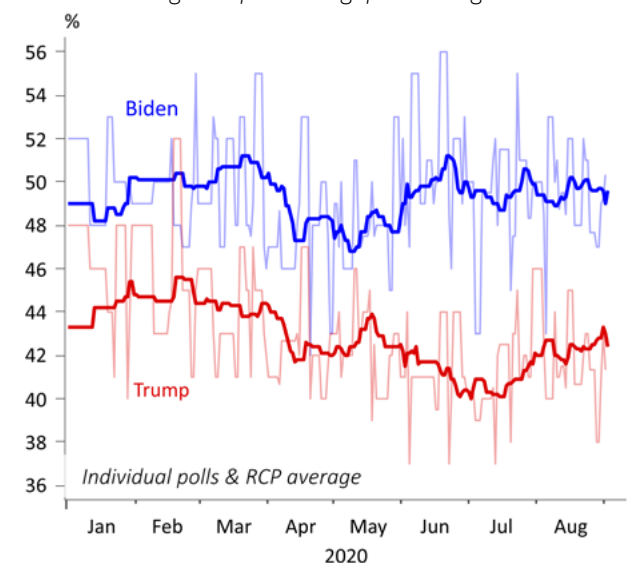
Both sides are pushing trillion dollar infrastructure agendas, but recent history has demonstrated how difficult it is to get enough political support for this despite both sides agreeing that there is a clear need. Another issue with bipartisan support is the relationship between the US and China. Both sides carry equal skepticism of the latter's geopolitical and economic practices (but will have vastly different approaches to dealing with them).

As the polls currently stand, see GRAPH 03, the Democrats are favoured to win the election, with Joe Biden becoming President. However, the gap is narrowing after the two parties held their national conventions and against a backdrop of increasing civil unrest. The strong likelihood of a Democrat clean sweep of the House and Senate has also faded, with a Democrat House and Republican Senate an increasing possibility.

At least at this stage, there remains a healthy skepticism around concluding too much from polling too early, especially given the experience of 2016. Consequently, it is difficult to know how markets might choose to position themselves in coming months going into the election. And even more difficult to deduce is how markets will react to a seemingly dramatic change in political course and style that a change in President may bring. In 2016, the prospect of such change saw equities track sideways in the months leading up to the election, dipping 3% in the final weeks before rallying into 2017 as the new President's pro-business/tax cutting agenda was embraced. It is an open question as to whether this time will be different, and the backdrop of economic recovery from the deepest recession in modern history only complicates the outlook.

GRAPH 03 US PRESIDENTIAL ELECTION POLLING

Biden is leading Trump but the gap is closing



Source: IFM Investors, RealClear Politics

» Australia: Uncertain near term recovery

Second quarter real GDP fell 7.0%qoq, more than expected, and the worst result in the history of the modern national accounts since 1959. But it was still better than most advanced economies at this stage of the pandemic, where the median decline was 9.7%qoq. Household consumption was particularly hard-hit (-12.1%qoq) as restrictions to contain the public health crisis impacted. Exacerbating this was the household savings ratio that spiked to 19.8%, the highest since June 1974 when the economy was also in recession. This boost was driven by large 'social assistance' payments from the government and is indicative of a household sector that was extremely and understandably cautious. It is also notable that savings were boosted by \$18.1bn due to the early release of superannuation balances – a cash flow not usually recorded in the national accounts and it will also be reflected in coming data as a marked deterioration of the household sectors' asset position.

Private sector business investment was also weak and the sector mirrored household caution. This was particularly true in non-mining sectors, where investment fell 6.9%qoq. By contrast, the mining sector increased investment by 1.3%qoq, buoyed by ongoing robust commodity prices. The public sector was one of the few that added to growth in the quarter, but even this was all on the spending side with consumption up 2.9%qoq to reach a record high of 22.2% of GDP. Public investment subtracted from GDP, declining 1.6%qoq despite the much talked about infrastructure pipeline in place. However, this is likely due to restrictions on work being done, rather than an absence of work, and is therefore a temporary setback.



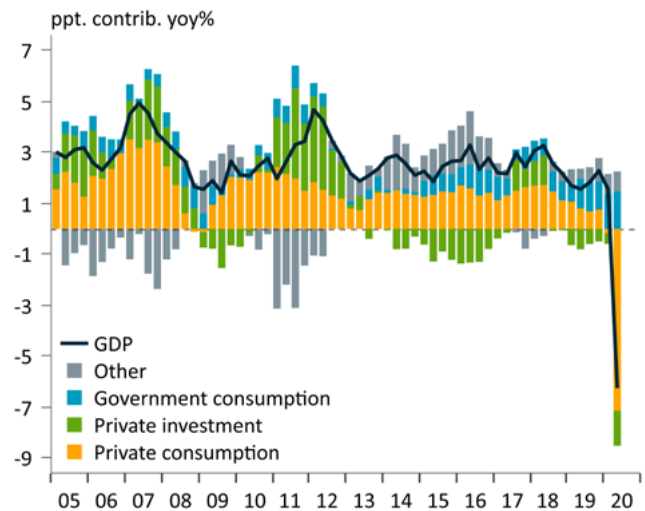
The Q3 lock-down in Victoria will weigh on the national recovery...

Of the states, New South Wales and Victoria were hit hardest, with 8.6%qoq and 8.5% declines in state final demand and the average decline in the other states was 6.3%.

Yet it is abundantly clear there will be a divergence in state performance in the September quarter, with Victoria going into its strictest lockdown since the pandemic began after the state suffered a surge in COVID-19 cases in July and August. This poses a downside risk to the recovery as Victoria accounts for roughly a quarter of Australian economic output and a third of the labour force.

GRAPH 04 AUSTRALIAN GDP CONTRIBUTIONS

A collapse in household spending leads GDP decline



Source: IFM Investors, ABS

The factor that continues to be key as we recover from this recession is how policy-makers support the economy on its path to recovery. To this end, the Federal government announced an extension to the JobKeeper payment to 28 March 2021 at an expected cost of A\$16.6bn, with a phased tapering and tiering of payments and rolling eligibility requirements for firms. The JobSeeker supplement was also extended at an expected cost of A\$3.8bn to the December quarter at a reduced rate of A\$250 per fortnight compared to \$550 per fortnight previously. The government also announced the 'HomeBuilder' scheme, which (under certain circumstances) provides \$25,000 grants for the building/renovation of a home. The package is estimated to be worth \$688mn. Further stimulus is likely heading into October's Federal Budget, with support measures likely to stay in place and household tax cuts potentially being brought forward.

On monetary policy, the Reserve Bank of Australia (RBA) left the cash rate unchanged at 0.25% through the quarter, but in September it extended the size and access window of the Term Funding Facility by approximately \$60bn to \$200bn. The RBA has highlighted a willingness to do more to support the economy if needed, despite continually ruling out negative interest rates. The RBA has also flagged that the recovery will likely be slower than previously anticipated (partly due to Victoria's second wave but also due to extreme uncertainty weighing on the spending plans of households and businesses). The RBA's 'wait and see' approach, combined with a weaker US dollar, contributed to a solid appreciation of the AUD which traded above US\$0.7400 briefly late in August. This appreciation, if maintained, removes any tailwind from this source as the global recovery broadens and international borders reopen.

» In other data flow, the labour market continued to recover, adding a net 61,400 jobs in the three-months to July but, following April's record fall, it is still down 546,000 jobs compared to March. This has contributed to the rise in the unemployment rate over this period to 7.5% in July (the highest since November 1998). Including those stood down or working zero hours, this rate was 8.3%, with levels of underemployment and labour market dislocation (dropping out of the market all together) making even this figure a significant underestimate of what is occurring. Further, these figures will likely soften in next month's data as the impacts of the Victoria lockdown feed in. Indeed, timelier weekly payrolls data have pointed to a deterioration in recent weeks following a tentative recovery as activity levels improved. In line with the soft Q2 labour market outcomes, wages growth slowed more than expected in the second quarter to 0.2%qoq, bringing the year-on-year rate down to just 1.8% (a record low). This was but one factor that is keeping inflationary pressures muted. Headline inflation data for the June quarter weakened significantly, falling a record 1.9%qoq and the trimmed mean measure declined for the first time (-0.1%qoq) in the series history. The former was due largely to the impact of free child care, that has now been reversed, and significantly lower petrol prices.

Retail trade has performed relatively well, with preliminary data suggesting that sales rose for the third consecutive month in July (3.3%mom) to bring the measure 12.2% higher compared to July 2019. There is downside risk going forward, however, given that government income support begins to taper off in September and consumer confidence has softened again in August to 79.5 to be back near the April-low of 75.6. Business confidence for July also softened sharply (-14), and although business conditions continued to firm to 0 (around average levels over the past 10-years), these metrics predate Victoria's second lockdown and risk deteriorating further in August.

US: Fed to keep support

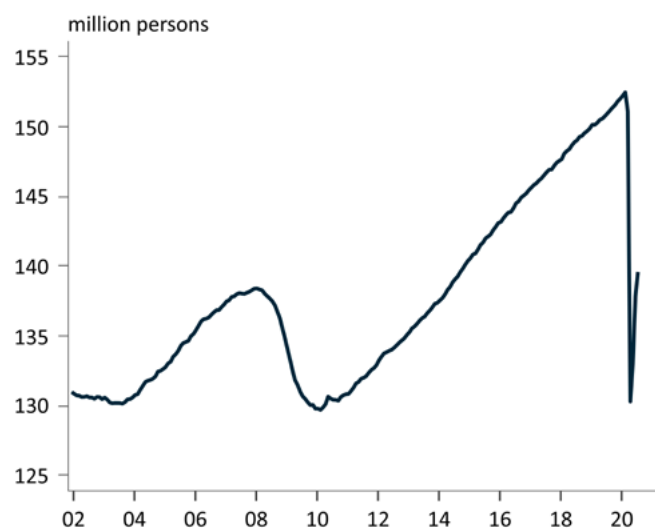
US GDP in the second quarter slumped 31.7%qoq annualised (9.1%qoq), the largest fall in post-war history. The contraction was driven primarily by a collapse in services consumption – heavily impacted by containment measures – subtracting 24.8ppts annualised from GDP. Private investment also weighed heavily in the quarter, slumping 46.2%qoq annualised. Despite this unprecedented economic reversal, fiscal policymakers were unable to reach an agreement on further stimulus even with the expiration, at the start of August, of crucial support measures for households – most notably the US\$600 weekly unemployment supplement. An agreement seems unlikely in the near-term: House Speaker Pelosi is pushing for at least a \$2tn package but Republicans are considering a significantly smaller package. As a short-term fix, President Trump signed an executive order providing – among other things – a \$400/week benefit to most unemployment claimants.

In monetary policy, the Fed left conventional policy settings unchanged over the period but announced an extension to 31 December 2020 of its lending facilities. Fed Chair Powell also announced the outcomes of the Federal Open Markets Committee (FOMC) policy framework review which was initiated in early 2019. The first key change is that the FOMC is shifting to a “flexible form of average inflation targeting”. Accordingly, following periods of below 2% inflation, monetary policy will “likely aim to achieve inflation moderately above 2% for some time”. The second key change is that policy will be based on “shortfalls of employment” rather than “deviations”. This means that the Fed will allow the labour market to tighten beyond its maximum level provided there are no signs of unwanted inflationary pressures or other risks. This implies that the Fed's accommodative policy settings will remain entrenched as the post-financial crisis period demonstrated, it is one thing to say inflation will go above 2% and another thing achieving it on a sustainable basis. Inflationary pressures firmed somewhat in recent months as activity levels recovered, but still remain subdued relative to the past few years: core CPI and core PCE inflation lifted to 1.6%yoy and 1.3%yoy, respectively.

In relatively good news, the labour market recovery has beaten market expectations in May and June's data. In the three months to July, the economy added a record 9.3 million jobs. However, this is less than half of the 20.8 million jobs lost in April and the pace of job growth has slowed since the June peak. This saw the unemployment rate fall from April's peak of 14.7% to 10.2% in July (still above the GFC peak of 10%). Ongoing tentative re-opening of the economy will likely slow the pace of labour market recovery and this assertion is supported by initial and continuing jobless claims data where the momentum of improvement has faded somewhat.

GRAPH 05 US NON-FARM PAYROLLS

A significant bounce in jobs but some way to go yet



Source: IFM Investors, BLS

» The July activity data continue to point to a (tentative) recovery as activity normalises. Durable goods orders unexpectedly firmed 11.2%mom, although this was largely due to transportation, with core orders up a more moderate 2.4%mom. Both measures remain below pre-pandemic levels, however, given the scale of the collapses in March and April. Industrial production also firmed in recent months (up 9.82% in July compared to three months ago), but remains at levels last seen in September 2012, following the sharp contractions in March and April. PMI data for August were particularly positive, with the services PMI unexpectedly ticking up to 58.1 and the manufacturing PMI firming again in August to 56.0 (the highest readings since late-2018/early-2019. For households, personal income and consumption have been volatile in recent months, driven by a number of factors but most notably generous government stimulus payments, massive job losses, and changes in consumer behaviour (whether state mandated or a matter of personal choice). Personal income has moderated since April's spike to be 8.2%yoy higher in July, with personal consumption showing the reverse and recovering somewhat since April's collapse to be 2.8%yoy lower in July. While these dynamics have been supportive of the recovery in retail sales, there is downside risk in the household sector going forward, with uncertainty around government unemployment support a key factor. This, combined with a COVID-19 resurgence in recent months, weighed on consumer confidence which softened in July and August to 84.8, below the April trough of 85.7, to be the lowest level since April 2014.

UK: Among the hardest hit

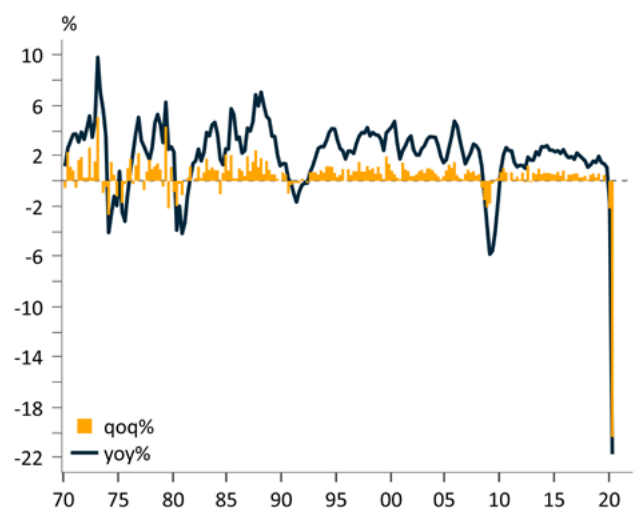
The services-intensive UK economy has been among the hardest hit of the larger global economies, with GDP collapsing 20.4%qoq in the second quarter (not annualised). There were particularly large falls in private consumption (23.1%qoq) and business investment (-31.4%qoq). Net exports were the key quarterly positive contributor (adding 3.5 percentage points), with imports falling more than twice as much as exports. The Bank of England (BoE), in a bid to further support the ailing economy, decided to increase its quantitative easing program (QE) by £100bn to £745bn in June. BoE Governor Andrew Bailey in August flagged that the Bank is "not out of firepower by any means" and has considerable room to loosen policy further, including by cutting rates into negative territory and expanding the range of assets it buys.

On the fiscal front, additional support was announced by the government in July – paying firms a £1000 bonus to retain employees after the Job Retention Scheme expires in October. This will provide a useful support to the labour market, which will be important considering the outlook. The UK economy lost 220,000 jobs (consensus: -330,000) in the 3-months to June, yet the unemployment rate unexpectedly tracked sideways at 3.9% (consensus: 4.2%). However, the

unemployment rate is a relatively uninformative indicator of the current state of the labour market given the prevalence of the government's furlough scheme (which is due to end in October) and the lagged nature of the data. More timely data for July are more gloomy, with the unemployment claimant count rate ticking up to 7.5% (the highest since March 1996) and with a net jobless claims increase of 590,500 in the three months to July (still far above pre-pandemic peaks). There have also been reports of significant redundancies in August (the first month where employers have been expected to contribute a portion of the cost of their furloughed employees). Consequently, wages data over this period were softer, in line with this apparent labour market slack, with headline average weekly earnings falling 1.2% and the ex-bonus measure down 0.2% (the slowest growth since the series began in 2001) compared to the same period last year. Inflation data somewhat contrast this weakness after firming since May with the headline (1.0%yoy) and core (1.8%yoy) measures both up in June and rising more than expected in July. This strength is likely transitory, however, with forthcoming policy changes (VAT cut, restaurant subsidies) weighing on prices.

GRAPH 06 UK YEAR-ON-YEAR AND QUARTER-ON-QUARTER GDP

The UK economy was hit exceptionally hard in Q2



Source: IFM Investors, ONS

The road back for the economy is a long one, but there are tentative signs of a rebound in activity according to PMI data, with the preliminary composite PMI for August coming in better than expected at 60.3 (the highest since October 2013), driven primarily by a recovery in the services sector. The manufacturing PMI also firmed over the month to 55.2. Retail sales have also firmed strongly in the three months to July, following a collapse in April, with headline and core retail sales now 1.4% and 3.1% higher than levels in July 2019. Faltering consumer confidence, however, poses a downside risk going forward. The measure tracked sideways at -27 in August against expectations of a rise.

» Eurozone: ECB goes all in

The Eurozone economy was one that took a material hit in the March quarter, due to early action against the pandemic in many countries, and this has been followed up by a record 12.1%qoq decline in output in Q2. Consequently the bloc's economy has lost 15.2% of GDP in six months. This is better than the UK losing 22.1%, but much worse than the other big two global economies – the US and Japan – which lost 'only' 9.1% and 7.8% respectively. Spain was particularly hard hit in Q2, contracting 18.5%qoq with France, Italy, and Germany suffering falls of 13.8%, 12.8% and 9.7% over the quarter, respectively. All record falls. In light of these material disruptions, EU leaders agreed on a significant €750bn Recovery Plan that was presented in May and will establish a federal deficit for the EU for the first time. The plan will disburse €360bn as loans and €390bn as grants to the hardest hit EU states focusing on three key pillars: helping businesses recover from the pandemic, investing to protect against future crises, and rolling out measures to reform economies for the long term. The German government also announced additional stimulatory measures worth €130bn (including a temporary three percentage point VAT cut and increased welfare payments) with France announcing around €100bn in additional spending. In addition, the French and German governments both announced an extension to their short-time work

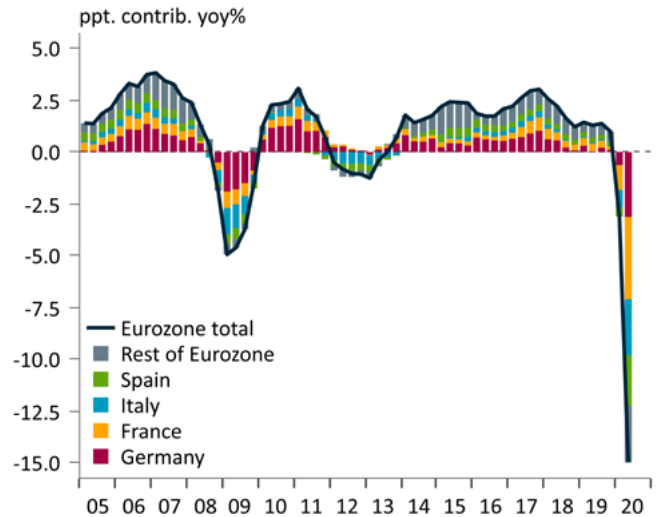


...the ECB is ready to adjust all instruments as needed...

schemes. The European Central Bank (ECB) also eased policy in June, expanding its Pandemic Emergency Purchase Programme (PEPP) by €600bn to €1.35tn and announcing that the program will be extended through at least June 2021. Minutes of the July ECB meeting emphasise that uncertainties remain elevated and that "although economic activity was gaining momentum, there was no room for complacency". ECB Chief Economist Philip Lane expressed that the ECB expects a very gradual recovery following the initial rebound and flagged the importance of a coordinated and high-quality fiscal response as key to the recovery.

GRAPH 07 EUROZONE GDP

All Eurozone countries were hit hard by COVID-19



Source: IFM Investors, Eurostat

Lane also highlighted that the ECB is ready to adjust all instruments as needed and that lessons from the pandemic response will feed into its ongoing policy framework review.

These stimulatory measures have supported the region's labour market, with the unemployment rate ticking up less than expected to 7.9% in July – around 0.6 percentage points above pre-pandemic levels. But this metric is distorted by the effectiveness of short-time work schemes which place downward pressure on the unemployment rate. Indeed, inflationary pressures softened sharply in August – unlikely to be associated with such a marginal increase in unemployment. The headline measure fell into deflationary territory (-0.2%yoy) for the first time since May 2016 and the core measure slowed to 0.4%yoy (the slowest rate since the inception of the series in 2001). Other data are sending concerning signals as well: the Eurozone composite PMI unexpectedly softened to 51.6 in August, driven almost entirely by a moderation in the pace of expansion in the services sector, with the PMI falling significantly more than expected to 50.1 (just into expansionary territory). This suggests that the positive impulse to growth from relaxing lockdown measures is abating. This may also impact future retail sales that firmed again in June (5.7%mom), with an upward revision to 20.3%mom to May's print. This measure is back to pre-pandemic levels (1.5% above June 2019 levels). There is a risk that this strong rebound represents pent-up demand and will soften going forward. Indeed, the consumer confidence recovery appears to have stalled, with the figure in August back to June's level (-14.7) following a fall in July. Other confidence indicators continued to firm in recent months but remain below pre-pandemic levels in August (economic confidence: 87.7, industrial confidence: -12.7, services confidence: -17.2).

» Japan: BoJ pushes on as Abe steps down

The Japanese economy was already struggling in late 2019, digesting the impact of a value-added tax increase late in the year and recording negative fourth quarter growth. The reversal in the economy in March was relatively modest but the June quarter has delivered a 7.8% contraction (-27.8%qoq annualised). The fall was concentrated in consumer spending (down 28.9%qoq annualised) and net exports, which subtracted 10.8 percentage points. Capital expenditure fell by 5.8%qoq annualised, a result that surprised expectations. No significant new fiscal measures have been announced in recent months but the Bank of Japan (BoJ), for its part, expanded its support for hard-hit businesses by ¥75tn to ¥110tn in June. Governor Kuroda also reiterated that the Bank was prepared to take further action if required.

GRAPH 08 JAPAN UNEMPLOYMENT RATE AND JOB-TO-APPLICANT RATIO

Unemployment relatively low but other indicators are soft



Source: IFM Investors, MHLW, SBJ

The unemployment rate has remained surprisingly low in recent months (partly due to lower labour market participation), rising around 0.5 percentage points above pre-pandemic levels to 2.9% in July. Another important labour market indicator – the job-to-applicant ratio – has continued to soften, however, falling to 1.08 in July (the 7th consecutive fall in the measure to its lowest level since March 2014). In terms of employment changes, the economy added a solid 230,000 jobs in the three months to July, but is still down a net 840,000 following April's figures. Labour cash earnings have slowed sharply in the last few months to June (down 1.7%yoy) which has contributed to soft retail sales data with July's figure – already expected to be soft – disappointing (-2.8%yoy). The consumption outlook is also bleak, with August consumer confidence remaining low



The Japanese economy was already struggling in late 2019 going into the COVID crisis...

after ticking down to 29.3. Inflationary pressures remain elusive in accordance with these soft data. Nationwide inflation has firmed in recent months but disappointed at the margin in July (headline: 0.3%yoy and the core-core: 0.4%yoy). There is downside risk to nationwide CPI looking forward, however. Tokyo CPI data, which provides a useful lead on the nationwide data, improved in the months to July but softened sharply in August with the core (-0.3%yoy) and core-core (-0.1%yoy) measures falling into deflationary territory. The headline print was slightly better (0.3%yoy). Other data paint a similarly uninspiring picture.

The Tankan survey data for Q2 were the softest since the GFC: the large manufacturing and non-manufacturing indices plunged to -34 and -17, respectively, with the outlook also falling to -27 and -14, respectively. And although industrial production firmed sharply again in July, it remains 16.1% below the same month last year. A number of important activity indices also continued to firm in June but remain well below pre-pandemic levels: the all industry activity index firmed by 6.1%mom; the tertiary industry activity index jumped in June by a record 7.9%mom; the leading index for June firmed to 85.0; and the coincident index firmed to 76.4. The PMI data for August tell a similar story, with the manufacturing PMI (46.6) suggesting 16 consecutive months of contraction in the manufacturing sector and the services PMI (45.0) suggesting seven consecutive contractions in the services sector.

Shinzō Abe, Japan's longest serving Prime Minister, announced his resignation in late August but will continue to serve until a replacement is elected around mid-September. This is unlikely to impact policy in the short-term given the COVID-19 situation, but longer term this poses a risk to 'Abenomics' – ultra-easy monetary policy, expansionary fiscal policy, and structural reforms – raising speculation that his successor might push the Japanese economy in a different direction. The Bank of Japan has already signalled its ultra-easy policy settings will remain in place irrespective of who replaces Abe.

There is some irony in the fact that as the man himself steps down, the post-COVID economic environment suggests most of the world's advanced economies will need to be pursuing their own forms of Abenomics for the foreseeable future.



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