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ECONOMIC UPDATE

View from the peak

Continued monetary policy tightening in recent months sees rates at levels where risks to inflation and wider economic activity are finely balanced. There are sufficient disinflationary signals to justify a pause soon but what remains unclear is how long policy will need to stay elevated once peak rates are reached. If the prevailing view of below-trend growth and limited labour market softening proves correct, we will likely see an extended period of economic discomfort as rates remain restrictive for some time to get inflation back to target in an orderly fashion. Against this economic backdrop markets have struggled to find clear directions with defensive positioning still favored by investors.

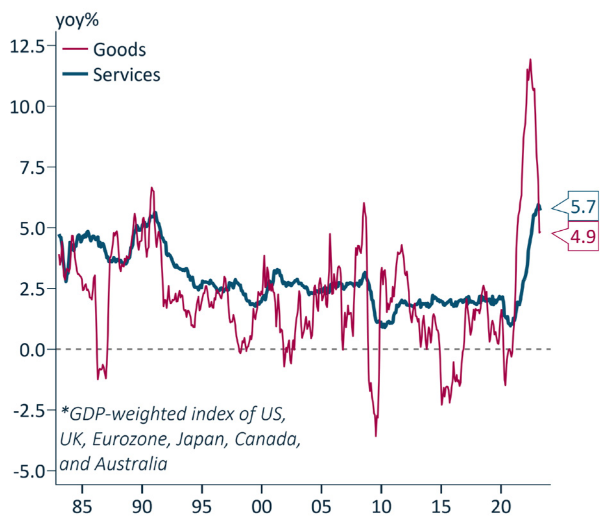
Global: Inflation - the tail wagging the dog

Many of the key thematics discussed in our previous economic update remain in play: inflationary pressures remain uncomfortably visible, central banks (though nearing peak policy) retain a hawkish bias, and activity and labour market indicators continue to hold up relatively well. The price to be paid for getting inflation under control is that expectations for further weakness in the advanced economies of the world persist. Recession is a risk, particularly in the US, but not a certainty. 'Soft landings', as hoped for by central banks, cannot be ruled out though they still seem unlikely. What has been heartening to date is that inflation is decelerating around most of the world in the absence of a sudden ascent in unemployment rates. This is because improvements in supply-side pressures have been responsible for much of the disinflation thus far, particularly for goods inflation. However, it is the abatement of demand-side pressures, particularly for services, that will be needed to get inflation back to targets. Achieving this will likely require central banks to put an end to stable unemployment rates that will get wages growth lower. The 'stickiness' of services inflation historically suggests that policy rates may need to be held higher for longer than markets expect. As a consequence, goods prices may indeed overshoot and flirt with deflation as demand factors weigh heavily, compounding the easing of supply pressures.

The expectation that the peak of policy rates may turn into a plateau is of key concern to markets, who continue to expect central bank easing as inflation gives way. This is because higher-for-longer

GRAPH 01 **ADVANCED ECONOMY INFLATION**

Services inflation remains more persistent



Source: IFM Investors, national statistical agencies, Macrobond

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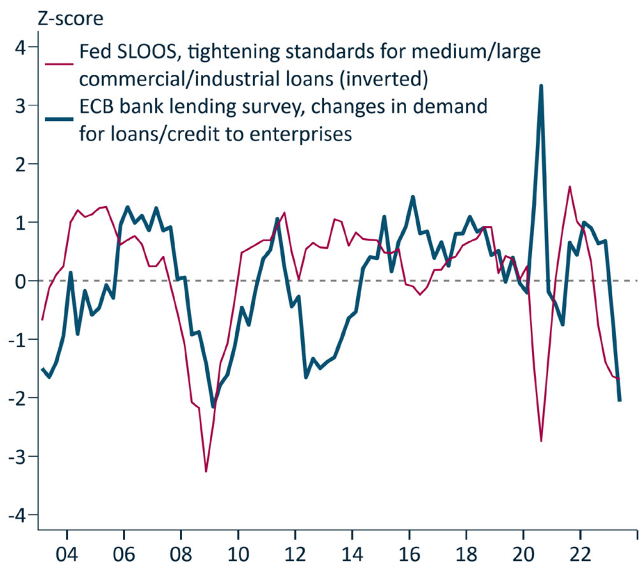
rates have the potential to unintentionally break other elements of economies and markets, not just to intentionally address inflation. The obvious example of this was the failure of a number of US banks in recent months. Our view at the outset was that failures were largely idiosyncratic, the financial system remained stable as a whole, and inflation remained the core concern of central banks. But that does not mean these events won't have a lingering effect on the economy. Banking sector stress, even if driven by factors like poor risk management at specific institutions, can impact the real economy through the credit provision channel. It remains unclear how much of a credit impact has been felt but the combined impact of banking stress and tighter policy has seen a marked decline in US and Eurozone lending indicators that will be a headwind to activity. It will likely add some complexity to monetary policy settings as the peak of tightening phases is reached. And so will any other sectors, particularly in the investment space, that buckle under the weight of higher rates; most give the example of commercial property coming under pressure as risk-free rates rise and sector yields adjust. However, it is not just higher rates that will weigh on returns. As the tide of liquidity (in the form of central bank bond purchases and inexpensive funding for the banking sectors) that was employed to fend off the effects of the pandemic recedes further, more asset classes may be put under pressure.

GRAPH 02 **US & EUROZONE LENDING INDICATORS**

Credit wind back could restrict economic activity



Source: IFM Investors, ECB, Fed, Macrobond

Indeed, central banks are at a point where these factors, combined with inflation dynamics, exacerbate the risks of overtightening on the economy, particularly as they have moved to largely data-dependent policymaking. It appears that peak rates are within sight, as there are sufficient disinflationary signals to justify a pause in the coming months. What remains unclear, however, is how long policy will need to stay elevated once peak policy is reached. We see the risks of the duration of tighter policy as skewed to the upside, with sticky underlying price pressures the primary limiting factor to any easing.

Central banks will need to make certain that the easy gains in the disinflationary process from supply chain repair continue if they are to remain confident of successfully returning inflation to target.

This process may take longer than expected as inflation begets inflation and relatively higher rates of contracted inflation wash through the system. To defeat inflation, central banks must also defeat inflation expectations, re-establishing their collective credibility to provide an anchor. Failing to do so will have negative implications for inflationary persistence.

Turning to the economic outlook, recent activity data have prompted a further moderation in recession risks among many advanced economies, although the US remains a special case. Notably, Germany was revised into recession in the March quarter. Nonetheless, the Bank of England (BoE) and the European Central Bank (ECB) upgraded growth expectations for 2023 in their most recent set of projections and expect only a moderate softening in the labour market over the coming years. Should this view of below-trend but non-recessionary growth, combined with limited increases in spare capacity, prove correct, we will likely see an extended period of economic discomfort as policy rates remain in restrictive territory for some time to return underlying inflation to target gradually and in an orderly fashion. Risks remain skewed to the downside, and there remains considerable uncertainty about the lagged impact of monetary policy. It is still possible that a sharper and more acutely painful adjustment comes to pass, but this is no longer the central expectation. The US, by contrast, looks set for a shallow recession around the end of the year. Labour market conditions are expected to remain favourable, however, with a subdued increase in unemployment a key factor that will support households. The periodic game of political chicken - the debt ceiling - increased volatility over the period, but an agreement was reached days before the Treasury was due to run out of funds, much to the relief of markets.

China's reopening impulse was a tailwind to global activity recently, but continued support through this channel is uncertain. Activity data in China through April disappointed significantly and suggested slowing growth momentum as the positive impacts of front-loaded policy support and the release of pent-up demand have likely peaked.

Against this economic backdrop, markets have struggled to find a clear direction. While US equities have made some gains, these have been confined to a narrow range of IT and consumer sectors and largely mark a recovery from last year's losses. Broadly, investors have continued to be positioned defensively, waiting for late-cycle dynamics to play out. Elevated allocations to high-quality fixed income have been held for some time: for the year of to March-April, this position had been rewarded, but returns have since been pared back (domestic investors with overweight Australian government allocations have outperformed US markets). The forward view remains clouded by considerable uncertainties and the absence of any clear signal from the global economy to rotate out of defensive allocations to growth. For investors, at least ongoing resilience, or the slim prospect of a soft economic landing, could make this a more nuanced decision than an outright and clear recession, particularly given the likely smaller pivot in monetary policy. Not our base case but not an immaterial risk either.

Australia: Inflation surprise, hawkish RBA

The Reserve Bank of Australia (RBA) has kept market participants somewhat on their toes with a series of line-ball decisions over the past few months. It chose to pause at its April meeting with the cash rate at 3.6% before hiking again in both May and June (by 25bps) to 4.1%. In its April decision to pause, the RBA voiced a desire for more time to assess the incoming economic data before future rate hikes, most notably the Q1 CPI print (discussed below), following the unprecedented quick tightening in monetary policy. In its May decision to hike, the RBA noted that the CPI data, which came in line with its expectations, showed a welcome decline in inflation but ultimately contributed to the narrative that inflation would remain above the top of the target range for too long. In June, the Bank became increasingly concerned about inflation and consequently hawkish noting "Recent data indicate that the upside risks to the inflation outlook". While activity may be slowing the partial inflation data, in the form of the unofficial and unofficial monthly prints, gave the RBA comfort that inflation is following suit.

The RBA also published updated forecasts in its May Statement on Monetary Policy (SMP), which saw it revise CPI growth lower over 2023 but unchanged in the outer forecast years, ultimately returning to the top of the target range by June 2025. Real GDP was revised lower on account of the ongoing softness in activity data and on the expectation that household consumption, which makes up over half of the Australian economy, remains subdued over 2023 as higher consumer prices and interest payments weigh down consumption supported by tight labour market outcomes.

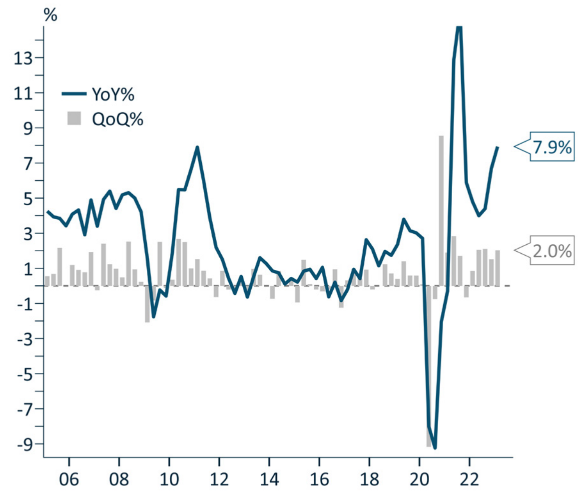
Nonetheless, the ABS quarterly data underscored that at least inflation has peaked in Australia, coming in roughly in line with expectations. Headline CPI grew 7.0%yoy, a touch below expectations, while trimmed mean grew 6.6%yoy, a touch above expectations. The most significant contributions to headline inflation were from housing, food & beverage, and cyclical goods prices. Market goods inflation (excluding volatiles) has peaked, but market services inflation (excluding volatiles) accelerated in the quarter; the RBA has voiced its concern over this trend, pointing to experiences overseas suggesting that this carries upside risk to inflation in the future.

In what has become an ongoing trend, slightly disappointing wages data showed that high inflation continues to erode real wages growth. While the wage price index (WPI), accelerated to 3.7%yoy, slightly below RBA and market expectations. Real wages growth, however, fell (albeit at a slightly lower rate than previously) 3.2%yoy. There was little in the wages data to suggest that the RBA has cause for concern about a wage-price spiral. But again, in the absence of productivity growth, this dynamic remains a risk. The labour market remains tight, and the unemployment rate is still near historic lows. However, the most recent data for April were slightly weaker-than-expected and saw the first fall in employment for the year and a slight uptick in the unemployment rate to 3.7% (from 3.5% in March). Labour supply continues to expand apace, and it will not take much in the form of reduced demand to send the unemployment rate higher.

On fiscal policy, in May, the Federal government announced the 2023/24 Budget. This included an update to the Budget of 2022/23, which saw an improved estimate of a modest surplus of 0.2% of GDP (previously, a -1.5% of GDP deficit was estimated). The surplus was driven largely by parameter variations, namely the extremely conservative commodity price assumptions. For the coming year, the Budget will be in a modest deficit (-0.5% of GDP), with the bottom-line improved mostly due to parameter variations. Some main policies announced include assistance for 'cost of living' pressures, including assistance on energy bills, increased health funding, and increased defence funding.

GRAPH 03 **NON-FARM UNIT LABOUR COSTS**

Rising unit labour costs won't help get inflation back to target



Source: IFM Investors, ABS, Macrobond

National accounts data for the March quarter showed that real GDP expanded by 0.2%qoq and 2.3%yoy. This was slightly weaker than market expectations. For the RBA, this means June quarter growth needs to come in at 0.25%qoq to hit its 1.7%yoy forecast for June 2023. There seem to be real downside risks to this given the tightening of policy through the year to date. Also concerning was that unit labour costs accelerated again, as wages growth rose and productivity growth remained negative. This pushed against the disinflation the RBA is trying to achieve.

Households are bearing the brunt of the economic growth slowdown. Real spending decelerated markedly as household disposable incomes came under pressure from increased interest and income tax payments. The composition of spending in the quarter shifted from non-essential to essential items. The savings ratio declined to the lowest level since 2008; in real terms the drawdown in savings funded household spending with real disposable incomes negative. Per capita GDP growth was negative in the quarter at just 0.3%yoy. Productivity was weak, declining 0.2%qoq. This saw unit labour costs accelerate by 2.0%qoq to 7.9%yoy. The RBA assert that this is not consistent with sustainable disinflation that would support inflation returning to target in a reasonable time frame, and it therefore keeps upward pressure on policy settings. This in turn brings downside risks to economic growth in coming quarters and upside risks to unemployment.

US: Still flirting with recession

The US has undergone a challenging period in recent months. The failure of SVB (~US$209bn assets) and Signature Bank (~US$110bn assets) sent shockwaves through financial markets and caused panic among investors who feared a banking crisis might unfold. These concerns turned out to be largely unfounded, with issues being a combination of idiosyncratic factors rather than systemic issues. Policymakers quickly enacted substantial support measures that helped calm nerves. Going forward, there is risk of additional regulation on the banking sector being re-imposed to reinforce this (reversing a wind back of regulation by the previous Administration). For now, the banking system has been assessed as "sound and resilient" by the Federal Reserve (Fed), but there may still be an impact on real economic activity via a tightening of credit conditions.

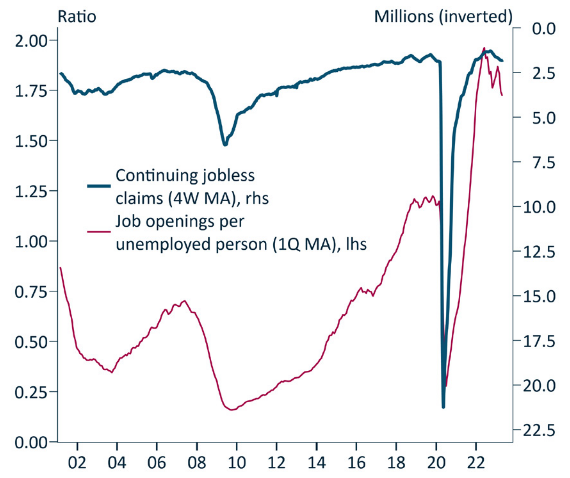
The potential credit channel impact has been a key focus for the Fed, with Powell flagging in March that tightening credit conditions could be akin to a hike or two. A number of commentators expected the Fed to pause its tightening cycle at the March meeting in the wake of the bank failures for fear of aggravating financial stability concerns, but the Fed persisted, raising rates 25bps, with inflation still a front-of-mind concern. Minutes from the March meeting showed that the banking stress did lower some members' view of terminal rates, but the overall tone suggested a continued tightening bias, with progress on "unacceptably high" inflation being "slower than expected". May saw another 25bp hike, taking the target range to 5.00-5.25%. This may be the peak in rates this cycle; the post-meeting statement suggests that the bar to further hikes has been raised. Indeed, Powell noted in a speech in May that the stance of policy was restrictive and that the lagged effects of policy tightening and potential credit tightening from banking stresses were an important consideration. Powell added that the Fed "can afford to look at the data and the evolving outlook to make careful assessments". Minutes from May echo this sentiment and suggest a June pause is a possibility. Several officials feel further hikes may not be necessary, while others who favour further tightening are open to a pause in June. Nonetheless, rate risks remain skewed to the upside, particularly in terms of duration, where the potential for continued persistence in underlying price pressures shouldn't be ignored. The Fed's Minutes highlighted that continued strength in nominal wages growth remains a concern that may facilitate this 'stickiness' of inflation.

For now, recent inflation data points to a continued moderation in the headline measure, with a sharp fall in March, bringing year-on-year headline inflation below core for the first time since January 2021. Yet disinflationary momentum in the core measure has stalled in recent months, largely unchanged over the last 4-months to reach 5.5%yoy in April (headline 4.9%). PCE inflation is also concerning after an unexpected acceleration in April. However, the composition of core inflation drivers has improved, with the less sticky core goods component re-accelerating in March/April, offsetting a fall in the stickier and core-services focussed component over those months. Slowing shelter inflation and weaker corporate pricing power look set to continue to pull core inflation down in the coming months.

Weaker growth may also be a factor as first quarter GDP figures disappointed expectations, with real output increasing 1.3%qoq annualised. This is a substantial slowdown from the 2.6%qoq annualised in the previous quarter, but the headline figures mask a better underlying growth picture. Personal consumption (2.5ppts) was the key positive driver in Q1, with a sharp fall in private inventories following a build-up in Q4 subtracting 2.1ppts from growth. Excluding inventories, Q1 growth was 3.4%qoq annualised (compared to just 1.1%qoq annualised for Q4). Despite resilient underlying activity momentum, the Fed has downgraded its growth expectations and expects a mild recession later in 2023.

GRAPH 04 **VACANCIES AND JOBLESS CLAIMS**

Data suggest tentative softening, but demand remains high



Source: IFM Investors, BLS, DOL Macrobond

The severity of any coming recession will crucially depend on the labour market response. To date, the labour market has proved exceptionally resilient to the economic headwinds, and we still see respectable momentum. But there are tentative signals of a turnaround in conditions, and we look for further signals of slowing to emerge in the coming months. Nonfarm payrolls growth has trended down since around August 2021, where in 3-month average terms, over 700,000 net jobs were being added to the economy per month, compared to around 280,000 on the same basis in May this year. Although employment growth is slowing, momentum remains surprisingly strong, and this has been sufficient to keep a lid on unemployment rates (3.7%) despite an upward trend in participation rates (62.6%). Average hourly earnings have also trended down over the last year, growing 4.3%yoy in May, but more progress will need to be made here. The key leading indicators pointing to a potential softening of labour markets are job openings and initial jobless claims, which have for several months been trending in a direction consistent with falling (but still high) labour demand.

The possibility of a US default in early June rattled markets as political brinkmanship delayed an agreement on the US debt ceiling. A deal was agreed days before the Treasury was due to run out of funds. The agreement raises the US borrowing limit until 2025 and caps spending for the next two years but is expected to have only a modest impact on growth.

UK: Sticky inflation may force more hikes

The UK has one of the most difficult inflationary environments of the advanced economies. Not only is the level of inflation elevated relative to peer countries, but there has also been a continued acceleration in underlying price pressures where peer countries mostly seem to be near or past peaks. The latest figures have headline CPI falling substantially from 10.1%yoy in March to 8.7%yoy in April. But this was a much smaller fall than expected by economists and is largely due to the base effects of the electricity/gas price surge from last April dropping out of the calculation. Core inflation is even more concerning, with April seeing a surge from 6.2%yoy to 6.8%yoy (highest since March 1992). By component, goods are the primary disinflationary driver. The services component, which is a better proxy for domestically generated inflationary pressures and of much more concern to the Bank of England (BoE), continuing to accelerate to 6.9%yoy in April.

These inflation figures are problematic for the BoE and highlight that the UK still has strong underlying inflationary momentum. Headline inflation is set to continue to decelerate materially, but the path for core inflation returning to target is looking increasingly drawn out. The BoE, for its part, has continued to tighten monetary policy, raising rates by 25bps in both March and May, taking the bank rate to 4.5%. The 25bps moves mark a step down from the 50bps moves in prior months and reflect a more balanced risk outlook as policy makers try to navigate an end to the tightening cycle. Details from the March meeting suggest that the BoE was relatively sanguine about a spike in inflation in February, attributing the increase largely to volatile moves that were unlikely to persist. Later moves in core inflation made this interpretation seem generous and forced the BoE to raise rates again. Further tightening seems increasingly likely on the back of the April inflation figures, and if May inflation is similarly strong, the BoE will be hard pressed to keep rates on hold at its June meeting.

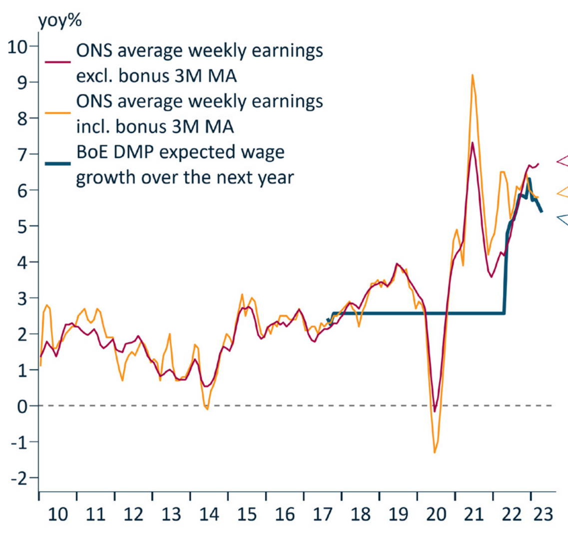
In terms of the wider economic outlook, the BoE substantially upgraded its growth forecasts in its May Monetary Policy Report. Indeed, forecasts have been improved such that it has reversed its previous recession expectations. In 2023 annual GDP growth is forecast at 0.25% (-0.5% previously), and in 2024 it is expected to be 0.75% (0.25% previously). As far as the March banking sector stress is concerned, the BoE showed limited concern and noted that the domestic banking sector was resilient, with robust capital and strong liquidity positions. Fiscal policy developments have also been a positive for the UK. The budget announced in mid-March represents substantial additional spending with an improved outlook for the UK economy from the Office for Budget Responsibility (OBR), providing the additional fiscal space to facilitate stimulatory measures. As with the BoE, the OBR improved its forecasts for the UK economy and no longer expects a technical recession in 2023. Whilst the BoE and OBR forecasts certainly can't be considered a strong rebound, the improved outlook is a positive.

This improved growth outlook may allow the BoE additional freedom to tighten rates without forcing an outright recession. But equally, continued resilient activity increases the chances of only gradual underlying disinflation and suggests policy rates will be higher for an extended period. The hard data show the UK continued to eke out another quarter of positive growth in Q1 2023, with real output up by a modest 0.1%qoq. Business investment remained surprisingly strong considering its sensitivity to rates and the uncertainty around the outlook and was a key and unexpected driver of growth over the quarter. Household consumption was unchanged from the prior quarter and continued to hold up, considering negative wage growth and weak consumer confidence. However, the metric remains 2.3% below pre-pandemic (Q4 2019) levels. The headline GDP figure was also somewhat surprising because the upside risk suggested by the decent monthly GDP print for January/February was wiped out by an unexpectedly soft March in the services sector. This contrasts the signal sent by PMI data that suggest private sector activity in the UK has grown reasonably well over February-May. Details in the report point to services providers being under continued cost pressures, with strong wages pressures as the key factor.

The labour market remains a key support as while households facing cost-of-living pressures remain employed, they can still fund their expenditures (albeit with non-discretionary spend accounting for a larger proportion of total consumption). That said, we are seeing some tentative signs of a loosening in labour markets. While the unemployment rate remains exceptionally low at 3.9% in the 3-months through March, other indicators have softened. Notably, April jobless claims increased (46,000), and payrolled employment decreased (136,000), the largest moves in these metrics since February 2021. Job vacancies also continue to trend down strongly. Perhaps most important for the BoE and the inflation outlook is that there are signs of slowing earnings growth. Headline average weekly earnings have slowed in March to 5.8%yoy from the November 2022 peak of 6.5%yoy and a BoE survey of expected wage growth over the next year has slowed similarly. Core earnings signals are less clear in year-on-year terms, but in 3-month change terms, there is a stronger sign of softening.

GRAPH 05 **EARNINGS GROWTH AND EXPECTATIONS**

Earnings growth looks to be losing momentum



Source: IFM Investors, ONS, BoE, Macrobond

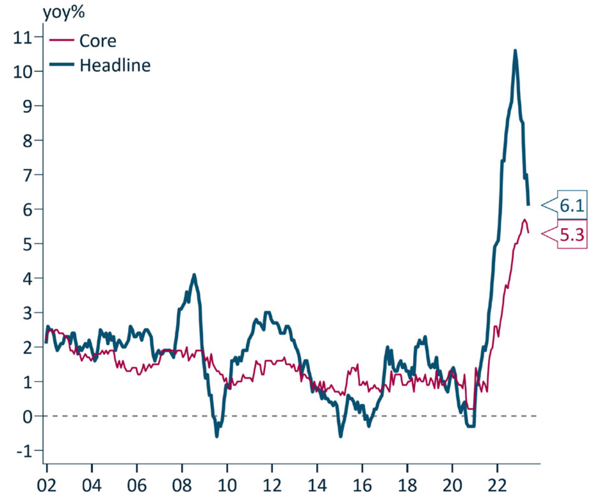
Eurozone: Outlook better, but still soft

The Eurozone economy continues to limp along, with the region managing to skirt a technical recession with real GDP increasing 0.1%qoq in Q1 following a 0.1%qoq contraction in Q4 (downwardly revised from a 0.1%qoq increase in an earlier release). A mild winter, a sharp fall in gas/energy prices, and support from a tight labour market were all behind the Eurozone managing to avoid what was – as of last year – a widely expected recession. Forecasts from the European Commission suggest that the outlook has also improved, with EU growth for 2023 expected at 1.0% compared to 0.8% previously. However, risks remain skewed to the downside and growth is expected to remain on the soft side for some time.

Of the major economies, Italy (0.5%qoq), Spain (0.5%qoq), and France (0.2%qoq) all showed accelerating growth from the prior quarter. However, concerning for the entire region was that Germany has experienced a recession, with output falling 0.3%qoq in Q1 2023 following a 0.5%qoq contraction in the previous quarter. This isn't entirely surprising as Germany's economy is particularly exposed to energy-intensive manufacturing. This sector has faced substantial headwinds and has proved much less resilient than services in recent months.

GRAPH 06 EUROZONE INFLATION

Headline inflation falling sharply, core softening more slowly



Source: IFM Investors, Eurostat, Macrobond

The yawning gap between services and manufacturing is best highlighted in PMI data. While the composite measure continues a five-month run of signalling a moderate expansion (53.3 in May), this has been entirely driven by services (55.9), with manufacturing (44.6) having contracted for 11 straight months. The difference between services and manufacturing has grown rapidly from 2 points at the start of the year to 11.3 points in May. Details in the PMI releases highlight that weak demand, lower raw materials prices, and surplus supply have all contributed to deflation in the goods producing sector. Against this, employment growth in the services sector has been around the highest level over the last year. This is associated with continued wages pressures and strong price pressures in services. Other survey indicators suggest that the continued challenging conditions are weighing on sentiment across a number of aspects of the economy.

Official data support this. Wages growth in the bloc remains robust, and there has been no sign of increasing spare capacity in the labour market, with the unemployment rate falling to 6.5% in April, another record low. Inflation data have broadly been moving in the right direction, but a lot of progress remains, and there are some concerning dynamics at play. Headline inflation continues to come down from October 2022's 10.6%yoy peak to reach 6.1%yoy in May, and further disinflation is expected on energy and food price base effects and falling price expectations in the industry. However, core inflation is a different matter; it appears to have only tentatively peaked after falling to 5.3%yoy in May from the 5.7%yoy high in March 2023, and there are few reasons to expect sharp falls in the future. We see a similar pattern when breaking inflation into goods and services – goods inflation has clearly peaked, but the much more focussed on services component is sending far more muted disinflationary signals. Strong wages add to the expected services inflationary persistence through wage-price dynamics. Adding to this, the ECB's March consumer expectations survey showed a worrying increase in 12-month inflation expectations from 4.6% in February to 5.0% in March. For reference, 5.4% was the previous peak for this inflationary cycle and was reached in October 2022. This suggests that second-round effects are becoming more prominent and gives some credence to concerns around de-anchoring inflation expectations.

On monetary policy, the ECB met in March and May and raised rates by 50bps and 25bps, respectively. The evolving banking stresses at the time stoked uncertainty around the policy decision. The ECB opted for the larger 50bp hike that it effectively pre-committed to in the February meeting in spite of financial stability concerns. The ECB did acknowledge the potentially destabilising effects of banking stress and that the events posed risks to the economic outlook. However, the ECB remains confident that the banking sector is resilient (strong capital ratios, ample liquidity buffers, more limited impact than in the US) and signalled that it stands ready to step in to ensure financial stability and the smooth transition of monetary policy. President Lagarde also noted that there would be "more ground to cover" if inflation rates evolve in line with projections (which were finalised prior to financial stress) released at the March meeting. Specifically, core inflation is still expected to be well above target through 2023 and 2024. Minutes from the March meeting read hawkish, with most members supporting the 50bp move. Growth risks were viewed as skewed to the downside, but the focus remains squarely on inflation, with a number of members seeing inflation risks skewed to the upside across the entire forecast horizon. The slowdown in policy tightening in May suggests that the ECB has entered the final stages of fine-tuning monetary policy as risks to economic activity and inflation become more finely balanced. The outlook for inflation at the ECB is that it is still set to be "too high for too long", and a peak has likely not been reached just yet. But the ECB has pivoted more strongly to a data-dependent policymaking approach and accordingly, there is less of a clear line-of-sight on future policy decisions than a few months ago.

China: An uneven recovery

China's economy rebounded well in the March quarter following its reopening in December last year, though the pace of recovery may have slowed somewhat into the second quarter of the year on the back of sluggish activity in the industrial sector. Furthermore, renewed growth has so far been relatively uneven and within the key drivers of the Chinese economy, with domestic services consumption outperforming factory activity and exports.

The Chinese economy grew 4.5%yoy (2.2%qoq) in the March quarter, exceeding expectations and well on track to meet the authorities' stated growth target of 5% for 2023. Growth was driven by household consumption, particularly on services and fixed asset investment. Exports also rebounded, though net exports were a slight drag on the economy. Despite the relatively strong result, the National Bureau of Statistics (NBS) cautioned that 'the foundation for economic recovery is not solid yet' and that domestic demand remains 'inadequate'.

Household consumption grew by around 5%qoq in Q1, accounting for over half of GDP growth. Goods consumption has been relatively subdued: real retail sales grew substantially in March (10.6%yoy) and April (18.4%yoy) but were largely bolstered by base effects and came in well below market expectations. Most growth has come through services as the relaxation of all COVID-19 requirements resulted in the realisation of household's pent-up demand; indeed, services consumption accounted for almost the entire increase in household consumption in Q1. The services sector has shown signs of ongoing strength in Q2, with the official NBS non-manufacturing PMI showing that services activity continued to expand in April and May, albeit at a slightly slower-than-expected pace.

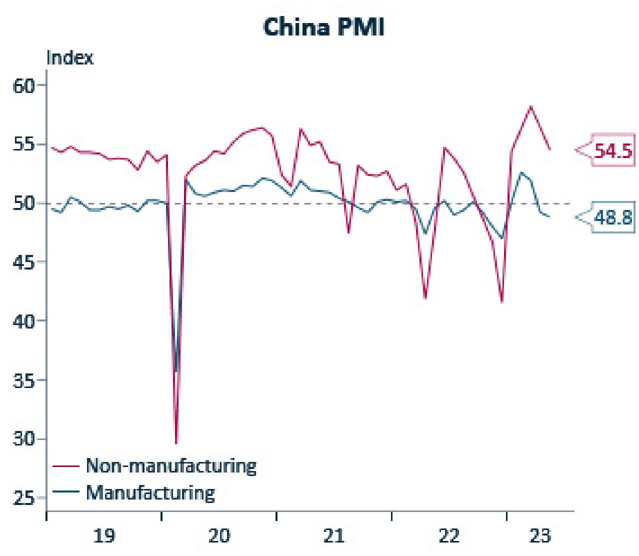
Services consumption has been helped by the rebound in tourism. Domestic tourism has rebounded to above pre-pandemic levels in May, with domestic travel over the May Day holiday (1 May) nearly 20% above the 2019 level. Overall, domestic flights and hotel occupancy ratios have picked up strongly and are comparable with pre-pandemic. The number of international flights, while significantly lagging domestic activity, has also picked up strongly since the beginning of the year to be up 36% since the end of Q1. Nonetheless, international passenger numbers are still around 75% lower than 2019 levels. Chinese airlines being granted permission by the US Department of Transportation to increase weekly round-trip flights to and from the US from eight flights to twelve (matching the round trips to China by US airlines) should facilitate ongoing recovery in these numbers. While outbound international tourism has been increasing, Chinese short-term visitor arrivals to Australia remain at around a fifth of pre-pandemic levels. Arrivals slipped slightly in March after increasing over the first two months of 2023, as high travel costs and geopolitical concerns weighed on travel prospects. The Approved Destination Status (ADS) scheme, an arrangement between China and other foreign governments that allows Chinese tourists to travel in guided groups, remains "paused" in Australia. This could be impeding the recovery of Chinese tourist numbers coming to Australia. By contrast, last month, China's Ministry of Culture and Tourism added New Zealand to the list again; China was New Zealand's second-largest source of tourism in 2019.

Domestically, the outlook for consumption continues to depend on the recovery in the labour market. While the urban unemployment rate has dropped back 5.2%, around pre-pandemic levels, youth unemployment reached a new high of 20.4% in April. While a continued improvement in the services sector, which hires younger workers, should help bring down youth unemployment, a skills mismatch remains a structural concern. In contrast to consumption, industrial activity has disappointed in the second quarter so far. The NBS manufacturing PMI moved into contractionary territory for the first time in 2023 in April and fell further into contractionary territory in May (from 49.2 to 48.8); notably, the sub-index for production also recorded a reading below 50 for the first time since January this year, when factory production was still very much impacted by the relaxation of pandemic restrictions. Industrial production recorded its fastest growth rate since September 2022 (before the rapid growth in COVID-19 cases last year) but still came in well below market expectations despite growing 5.6%yoy in April, lifting from 3.9%yoy in March. Industrial profits were also down on the year over the first four months of 2023, as producers are affected by weaker-than-expected domestic demand and soft exports.

Export demand remains weak as global demand softens amidst rate rises and consumption activity skews towards services. Weak export activity may contribute to a continuation of uneven growth in Q2, as the new export orders subindex of the NBS manufacturing PMI fell further into contractionary territory in May for the second month in a row. Encouragingly, Australia's trade relationship with China has continued to normalise in Q2. In April, Australia and China suspended the WTO proceedings over China's barley tariffs as China initiated a review, which could see a trade resolution reached in the next few months, while in May, China lifted import bans on Australian timber.

GRAPH 07 | CHINA PURCHASING MANUFACTURERS' INDEX

Domestic services outperforming globally exposed manufacturing



Source: IFM Investors, National Bureau of Statistics, Macrobond

Japan: Something different

Japan's economic recovery from the pandemic has continued well into 2023, bolstered by domestic demand and steadfastly accommodative monetary policy. While headline inflation has come off its peak, 'core-core' inflation continues to accelerate, so questions remain over the future path of inflation and the Bank of Japan's (BoJ) ability to achieve its goal of 2% price growth over the longer term.

The Japanese economy emerged from a technical recession in the first quarter of 2023, surpassing consensus expectations by recording real growth of 1.3%yoy (0.4%qoq, 1.6% annualised). Household consumption, notably the pick-up in demand for services, and business fixed investment drove growth.

Household spending, which accounts for over half of Japanese GDP, picked up in the first quarter of 2023 and rose 0.6% over the quarter. Household consumption is likely still supported by excess savings from the pandemic since real wages have been eroded by inflation. Services spending increased for the second quarter in a row but remained below pre-pandemic levels. Consumption of durable goods continued its growth streak from the past several quarters amidst strong demand for automobiles, though consumption of semi-durable goods declined. Consumer confidence also hit an eleven-month high in April due to improved wage growth, decelerating headline inflation, and the continuing return of tourism. Looking forward, an improvement in wages will continue to support household incomes: encouragingly, the outcomes of the Shunto wage negotiations in March were strong (discussed further below).

Not to be outshone by household consumption for once, private sector capex experienced positive growth for the first time in three quarters, rising 0.9%qoq. Factors contributing to the increase include the postponement of capex during the pandemic and seeking to improve capacity to address pent-up demand. Overall, business sentiment is improving, and the composite PMI remained in expansionary territory in April. Business sentiment in non-manufacturing sectors continued to improve over the first four months of this year, reflecting the recovery in tourism and services. Sentiment has improved in April in the manufacturing sector recently after declining in Q1 to its worst level in more than two years amidst the slowdown in the global economy. The manufacturing PMI returned to expansionary territory at the start of Q2; in contrast, the global manufacturing PMI was contractionary. The BoJ anticipates that as commodity prices continue to decline and global economic growth picks up, businesses' profits will improve, leading to an increase in business fixed investment.

While domestic demand was strong in the first quarter of the year, net exports proved to be a drag on the Japanese economy. Export growth declined by 4.2%qoq, largely due to sluggish global economic growth. Despite this, real exports have been gradually improving since February – particularly passenger car exports to the US and the EU – while exports to the rest of Asia remain sluggish. Imports also fell in the quarter by 2.3%. While much inflation in recent quarters has been imported, it seems this has given way to domestic inflationary pressure: the GDP deflator rose to 2.0%yoy, while the domestic demand deflator remained elevated at 2.9%yoy.

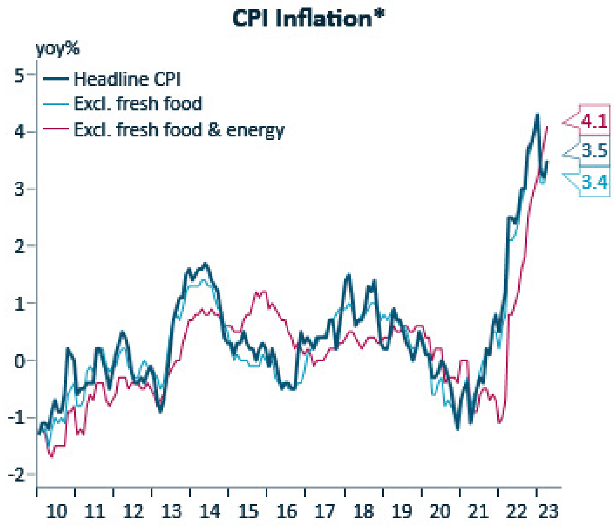
Inflation remains historically high in Japan. Headline CPI and core CPI (excluding fresh food) peaked at the end of 2022 but ticked up in April, growing at 3.5%yoy and 3.4%yoy respectively. Meanwhile, core-core inflation (excluding fresh food and energy) continued to accelerate, reaching 4.1% in April. The primary contributors to inflation have been food prices and hotel charges amidst the influx of overseas tourists. Hotel charges, in particular, contributed to the increase in services inflation, which though modest, could pick up in the future as the labour market tightens and services demand picks up.

The BoJ believes that the current elevated rate of inflation growth, surpassing 3%, primarily stems from cost-push factors originated from overseas rather than (primarily domestic) demand-pull factors. Therefore, it views the heightened inflation as temporary, acknowledging that substantial progress towards the 'virtuous cycle' in which higher wages drives demand for goods and increase prices is necessary to achieve its price stability target of 2%. Therefore, the BoJ is projecting that CPI growth will likely be above 2% for some time as the impacts of inflationary pressures abroad on import prices continue to be passed through; however, it is projecting this to fall to below 2% towards the middle of FY23/24 (October this year).

The BoJ has stressed that maintaining a rate of inflation above 2% would require further wage increases. Nevertheless, they deemed the outcome from the wage negotiations earlier this year as 'favourable': wages, on average, should increase by 3.8% over FY23/24. While this is an early sign that the virtuous cycle is beginning, the BoJ will want to see widespread adoption of wage increases, particularly among small- and medium-sized firms, and further increases in the years ahead. As a result, and due to downside risks in the global economy, the BoJ has indicated that it will continue with the current monetary policy settings.

GRAPH 08 JAPAN INFLATION

Core-core inflation continues to accelerate



*Excluding tax effects

Source: IFM Investors, Japanese Ministry of Internal Affairs & Communication, Macrobond

Korea: Weak external demand weighing

The Korean economy continues to face challenges as weak economic growth persists. In the first quarter of 2023, the Korean economy grew by a modest 0.3%qoq. The growth was primarily driven by household consumption, which showed signs of a modest services-driven recovery. However, net exports and private business investment, typically significant drivers of the Korean economy, weighed heavily on growth. Weaker demand from China and sluggish global demand for IT industry outputs amidst the global growth slowdown contributed to these drags. Government consumption remained flat during this period.

Looking ahead, growth is expected to remain below trend in the second quarter as the recovery in China's growth and the IT industry slump take time to pick up, likely in the second half of 2023. Consequently, the Bank of Korea (BoK) downgraded their growth projection for the full year from 1.6% to 1.4% based on the expectation of this delayed recovery. While the overall outlook remains subdued, South Korea avoided a technical recession in Q1, so growth has likely seen its trough.

Exports, which likely reached a low point in the first quarter of 2023, continue to be anaemic. South Korea recorded a trade deficit for the fifteenth month in a row as exports fell -15.2%yoy in May, marking the eighth consecutive month of declines in export values. Despite falling, export values still came in stronger than expected; in particular, car shipments increased significantly in the month as previously hampered supply chains continued to improve. Much of the slowdown in exports is due to sluggish global demand, particularly in line with China's stalling consumption and imports. Arguably, Korea's semiconductor sector is overly reliant on the Chinese and US markets, where demand has softened. Tensions between these two large markets have also buffeted demand. Consequently, shipments fell through the first quarter and continued to fall in April, as did semiconductor production. Chip inventories rose significantly at the start of the second quarter to be around 65% higher than in December 2022 and are at historical highs following a slight drop in March.

While exports have weighed on growth so far this year, private consumption made the most significant contribution to GDP growth in Q1, after detracting from quarterly growth in Q4 2022. Consumption was supported by increased services demand, but goods demand remained weak, and retail sales recorded slightly negative growth in the three-month moving average up to March. A modest recovery in consumption is anticipated in the second half of the year as services demand picks up. Encouragingly to this effect, the BoK's consumer sentiment index increased in April and May across all categories.

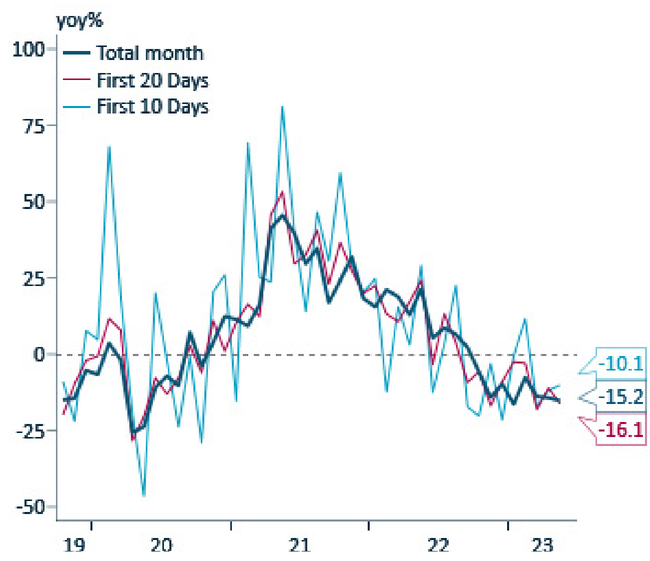
A relatively tight labour market is expected to further support the recovery in private consumption throughout the year. Employment grew over the first quarter of 2023, and the unemployment rate declined as the services industry saw an increase in demand for labour. This comes alongside an increase in the labour force participation rate since the end of last year, particularly among older age cohorts and women. The BoK expects the total number of employed individuals to increase by nearly double the previous projections by the end of 2023.

In terms of inflation, the headline measure continues to decline due to falling oil prices and a moderation in processed food inflation. However, core CPI (excluding food and energy) remains relatively high at 4.0%yoy. Headline CPI growth will continue to decelerate over the year due to base effects from elevated commodity prices in 2022. The BoK revised its forecast for core CPI in 2023 upward from 3.0% to 3.3%, anticipating higher import prices being passed onto consumers, increased demand for services, and wage pressures arising from the tight labour market.

Accounting for the relatively stunted growth in Q1 and the moderation in CPI, the BoK decided to keep the policy rate unchanged at 3.5% for the third consecutive meeting in May. Despite its decision to continue to pause any policy action and its release of downgraded GDP forecasts, the BoK was relatively hawkish in its post-decision statement and press conference. The decision statement noted that while domestic demand is expected to remain soft, inflation is projected to stay above target for an extended period. This would require the BoK to "maintain a restrictive policy stance for a considerable time". In a press conference following the decision, Governor Rhee Chang-yong stressed this point and cautioned against expectations of a rate cut any time soon, highlighting the need for the inflation rate to approach the 2% target before considering any rate reduction. The Governor also referenced the RBA's actions of raising rates again after a brief pause to discourage rate cut expectations. He emphasised that a downward revision of GDP growth alone would not justify a cut and argued that an annual growth rate of 1.4% is not a cause for concern in Korea since the average growth in developed economies is around 1.3%. Regardless, the market largely expects the next policy move from the BoK will be a cut against a backdrop of weak domestic demand and little encouraging spill-over from China's uneven economic recovery.

GRAPH 09 **SOUTH KOREAN EXPORTS**

Exports continue to lag as global demand weakens



Source: IFM Investors, Statistics Korea, Macrobond

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