

Quarter 01 - 2021

ECONOMIC UPDATE



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Stimulus drives recovery

Global economies have come through what appears to be the worst of the crisis and continued policy support, combined with the roll out of vaccines, has given rise to an optimistic outlook. But concerns around inflation have recently emerged, driving uncertainty in equity and fixed income markets. Central banks remain dovish, however, and will likely keep easy policy in place for an extended period. While accommodative policy has prompted economic recovery, little has been done to address the underlying structural issues in advanced economies that have lowered potential growth rates. Reforms – not fiscal balances – need to become the focus.

Global: Markets contemplate what's next

Global equity markets finished 2020 strongly and looked forward to a year of economic recovery in 2021, largely shrugging off concerns around a resurgent COVID-19 as vaccination programs began. The buoyant mood has so far continued into the New Year, with an improving economic data flow underpinned by massive policy stimulus from central banks and governments. In the US, hopes of one of the largest fiscal stimulus programs in history has underwritten the markets' near term outlook. This stimulus has also supported one of the key near term themes in markets – the rise of the retail investor. Or perhaps more accurately – new investors, characterised by a high volume of small ticket trades, that take advantage of improved market accessibility and modern methods of communication and collectivisation to compete with larger incumbents. This impacted equity prices of specific companies but it also underpinned the almost euphoric rise of broader equity markets in the US. This rally has gripped most advanced economy markets, with Japan's meteoric rise clearly standing out with the Nikkei rising as much as 10% to its highest level since 1990, before retracing somewhat. But forward looking markets, having 'bought the rumour' on economic recovery, may at least begin consolidating on the fact.

GRAPH 01 GLOBAL EQUITY MARKETS

Markets enter 2021 with an optimistic tone

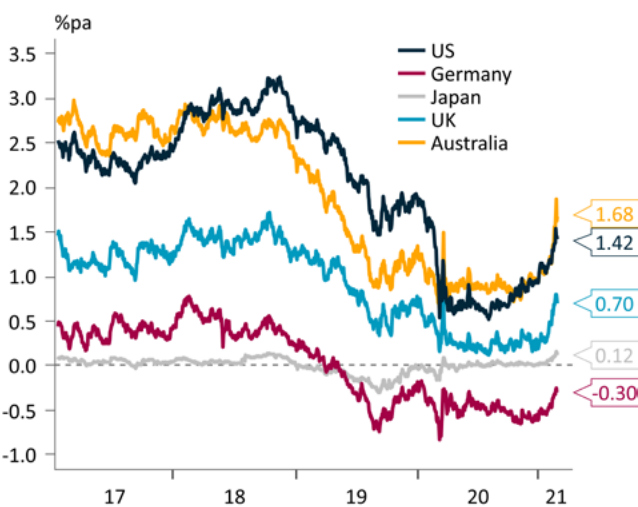


Source: IFM Investors, Macrobond

» We say this as the reflation trade regains prominence in global markets. It was always going to happen as massive stimulus was meant to bring about better economic outcomes and at least the prospect of inflation. Since we have moved through what is expected to be the worst of the public health crisis and the economy has started to recover, markets are looking forward to what ‘may be’ for the global economy. Nonetheless, the reaction in fixed income markets has been relatively sharp, reminiscent of the repricing before the previous global economic upswing in 2016 (and the election of the previous US President) and, before that, the ‘taper tantrum’ of 2013. The selloff in government bonds since the start of the year has been just under 3% (at the time of writing) and has so far reversed the gains made late last year. This may well be exacerbated for domestic investors who, if unhedged, would have had their losses compounded by a rising Australian dollar. The selloff in Australian fixed income has, so far, been in line with global markets, despite the prospect of a better than average economic recovery.

GRAPH 02 ADVANCED ECONOMY 10 YEAR BOND YIELDS

Bond yields are rising as economies recover



Source: IFM Investors, Bloomberg, Macrobond

The markets’ belief in economic recovery and the inflation that may result has not yet been shared by global central banks. Collectively, they remain cautious and dovish, asserting that they will be keeping aggressive policy accommodation in place. This is despite markets now beginning to challenge forward guidance that this will remain the case over coming years. This suggests markets are becoming more forward looking than central banks and seem to believe more strongly than the institutions themselves that central bank policy, combined with fiscal stimulus, will be successful. For their part, central banks who are perhaps shaken by the experience after the Global



It remains to be seen how high bond yields rise in this cycle, which will largely be determined by the strength of the economic cycle – on this, we are cautious over the coming years.

Financial Crisis where inflation targeting mandates were not sustainably met, want to observe success and not just forecast it. This is not only on inflation, but also full or maximum employment (extremely tight labour markets) – this need underpins their forward guidance. It remains to be seen how aggressively central banks will push back on this narrative.

As for economies such as Australia, these trends represent an unwelcome tightening of financial conditions, especially with the Australian dollar rising as a global growth proxy. Yet in the US, this tightening is even more problematic, with rising yields having greater potential to negatively impact real economic activity. For equity markets, subscribing to the reflation trade means that the period of pricing in more and more stimulus is coming to an end. With global growth now expected and inflation as well, the question becomes what next? And while this is the case, rising nominal bond yields potentially create a valuation headwind. We remain of the view that these risk free rates, while rising, will cycle around a structurally lower average.

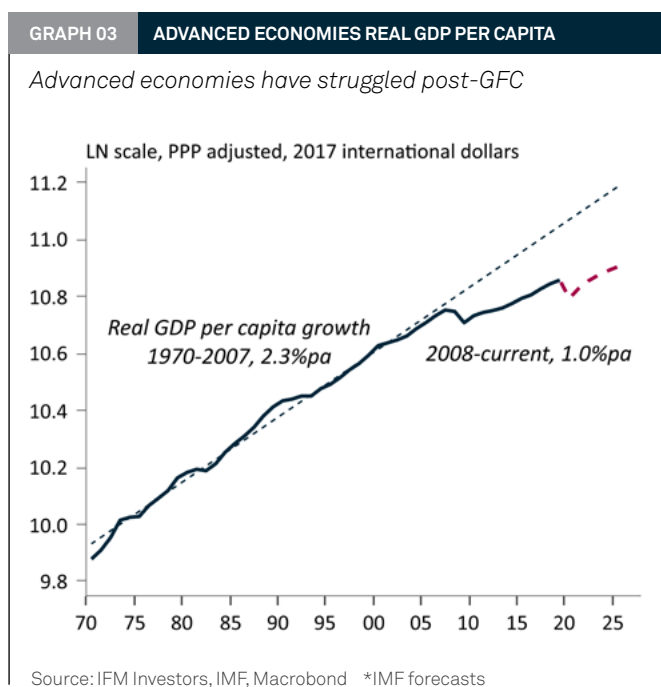
The onset of the 2020 COVID recession only underpins this thematic. During the synchronised strong upswing in global growth from 2017 to early 2019, US 10 year bond yields struggled to get above 3%. But even when this level occurred in 2018, it caused equity markets to take stock. We remain of the view that real rates, though rising modestly, will also remain structurally lower. If central banks, particularly the US Federal Reserve (Fed), are true to their word and tolerate an inflation overshoot of their targets while leaving accommodative policy in place, this would underscore our expectation. There also seems little doubt that neutral interest rates should remain low, and if anything, lower than before this COVID recession.

It remains to be seen how high bond yields rise in this cycle (yields backed off somewhat at the time of writing), which will largely be determined by the strength of the economic cycle – on this, we are cautious over the coming years. While 2021 will be characterised by a strong upswing in many economies, much of this is pent up demand from a combination of public health restrictions and government support of households. We question what comes after this? How does the economic recovery become self-sustaining



» after households have worked through their savings, or indeed chosen not to, and the impetus from lower interest rates in sectors like residential construction starts to fade? What's problematic is that while extreme monetary policy settings and massive direct fiscal stimulus have prompted economic recovery, they have done nothing to address the structural issues in advanced economies that have lowered potential growth – if anything, they have only exacerbated them. Here we highlight high private and public debt, lack of productivity growth, a dearth of private investment and ongoing demographic challenges. What's clear is that governments need to lead in the next phase of economic expansion with policies that seek to remediate these issues.

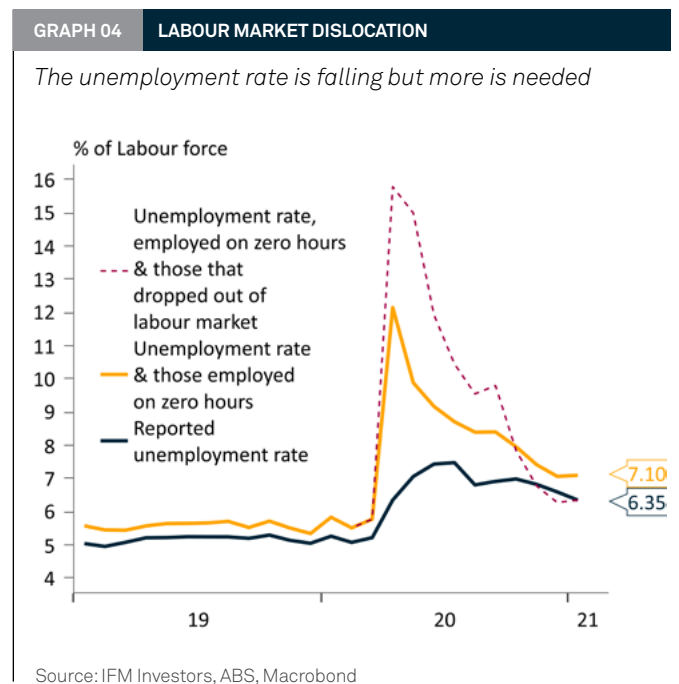
Reforms, not fiscal balances, must be the focus. Indeed any active withdrawal of fiscal stimulus via 'austerity' in coming years, as was the case in the post-GFC period, would be a clear policy error. With monetary policy in a parlous state, governments cannot, at least for the foreseeable future, rely on central banks to dial up growth. This paradigm is not without precedent as it has defined most advanced economies in the post-GFC period. Indeed, after real GDP per capita expanded at an average of 2.3%pa for the better part of 50 years leading up to that crisis, it has slowed to just 1.0%pa in the aftermath. This is because structural issues have weighed heavily on potential growth rates. In the wake of this recession, policymakers will need to do better or we will have to accept the consequence that the growth in living standards will remain much more modest than it has been historically. With economic recovery looking increasingly assured, we should now be asking 'what is it we are recovering to?' and what needs to be done to achieve sustainable growth that will reduce pressure on highly indebted governments and overstretched central banks.



Australia: Labour market repairing

The economic recovery in Australia continues to gather momentum. This comes despite sporadic, short snap lockdowns occurring in Brisbane, Perth and Melbourne/ Victoria in recent months. These occurred before the vaccination program began and remain a risk, albeit a reduced one, until more significant progress has been made. Nonetheless, the data flow remains relatively positive, particularly in the labour market where all the policy is appropriately focussed.

The labour market added 169,000 jobs in the three months to January. This represents the return to work for many but also additional employment. Indeed, employment levels as of January are higher than pre-crisis. The participation rate has also recovered sharply and is hovering around record highs. The unemployment rate has fallen to 6.4%, much better than most economists were forecasting mid-last year. There remains more progress to be made, as we know that there are still many employed by 'working' no hours in sectors that have not yet normalised activity, notably those reliant on inflows of international tourists and students. While the government's JobKeeper initiative has underpinned this labour market recovery, it will run off at the end of this month, and likely be replaced by more targeted support that is specific to still impacted sectors. With still some way to go until 'full' employment, wages growth remained subdued through the year, rising 1.4%yoy in Q4. The relatively strong 0.6%qoq rise in wages was a rebound from cuts that had occurred through the depths of the recession and is not yet – in our mind – indicative of a new trend in wages going forward.



» These labour market outcomes have supported elevated consumer sentiment, which combined with transfer payments, have supported overall retail sales despite some recent volatility in these data. Strong sentiment has also lit a fire under the property market, with prices rising 2.1% mom in February, the largest monthly gain in 17 years. There is promise of more to come, with January housing finance approvals hitting a record \$22.1 billion, 52% higher than a year ago. With credit growth to households, particularly owner occupiers, now accelerating, there seems little doubt that borrowing as a proportion of GDP will be higher as we exit the crisis than before.

Business confidence was also relatively high in January as the economy continues to recover and it appears that consumer spending will drive growth in the near term at least. High iron ore prices have also been supportive – particularly of the mining industry – and have resulted in ongoing trade surpluses and a rising terms of trade. These factors, along with improvement in the economy and labour markets, have enabled government finances to continue to come in better than expected.

Australia's improving economic narrative was also highlighted in the national accounts for the December quarter. The economy expanded a better than expected 3.1%qoq and 1.1% through the year. This quarterly outcome was materially higher than the global median of 0.9%qoq and largely reflected the lifting of restrictions in Victoria whilst many other advanced economies were forced to impose restrictions to curb COVID outbreaks. Indeed, Victorian state final demand rebounded 6.8%qoq, reflecting the lifting of restrictions, and contributed 1.6pp to the overall 3.3%qoq expansion of domestic final demand. The farm sector also added materially, contributing 0.5pp to overall growth as export volumes surged 23.5%qoq. The detail of the national accounts showed that the key driver was household consumption, with a 4.3%qoq expansion, contributing 2.3pp to overall growth. This was because households saved at a slower rate (the household savings ratio fell to 12.0% from 18.7%) and restrictions were lifted – discretionary spending rose almost 10%qoq, underpinned by a marked rebound in the purchase of motor vehicles (31%). Also positive was the turnaround in the residential construction sector which



The Australian economy continues to recover relatively well, but to date this is largely a reflection of the lifting of restrictions on activity and huge fiscal stimulus.

added 0.2pp, and non-mining business investment that also added 0.2pp. Public demand also added a solid 0.3pp as spending to support the economy continued to rise and investment in infrastructure continues. Net exports and inventories both subtracted 0.1pp.

The economy continues to recover relatively well, but to date this is largely a reflection of the lifting of restrictions on activity and huge fiscal stimulus. The economy will need to adjust to a 'new normal' in the near term, primarily due to the winding down of fiscal largesse, many adopting a different style of work and spending, still closed international borders and record low population growth. These factors will weigh on growth in our view in the near term. And over the medium term, we suspect the economy will be hampered by the same pre-COVID structural issues – most notably a dearth of productivity growth and private investment. With the possibility of a Federal election later this year, we should be asking both sides what they will do to make the economy better and more resilient than it was entering the crisis.

For the Reserve Bank of Australia's (RBA) part, the rebound in growth exceeded its expectations. But its near term focus was on markets as it responded to rising bond yields by "buying more bonds than scheduled" and by flagging in its March meeting press release that it would continue to buy bonds "as necessary" and that it was "prepared to do more". This suggests it may increase its QE purchases should that be necessary (after lengthening and increasing the program by \$100bn at its February meeting). In this sense the RBA is responding to global factors as much as Australian ones, given the current correlation of bond yields to the US market, and will need the support of other larger central banks – which should be forthcoming – to limit the rise of term interest rates. The RBA's assessment of the economy was unchanged, noting there is still a long way to go before it reached its objectives. And while noting rising dwelling prices again, the RBA affirmed that it does not expect the cash rate to rise until these objectives are met. The RBA's current expectation is that this will be "until 2024 at the earliest". While markets are challenging this view, it seems still reasonable as the key objective for the Bank is an unemployment rate that is close to 4%. It is this measure of labour market tightness that will lift wages and spur inflation and it was a level that the RBA could not achieve prior to the crisis.

US: Stimulus wave to come

US lawmakers finally passed an additional COVID-19 emergency relief bill in December worth around \$900bn, with key support measures including further direct \$600 payments to households and extended unemployment benefits. At the time of writing, further fiscal support appeared likely with the House of Representatives passing a \$1.9tn (around 9% of GDP) coronavirus relief package late in February. The package includes direct \$1,400 payments to households and extended unemployment support. The package still needs to pass the Senate and this seems

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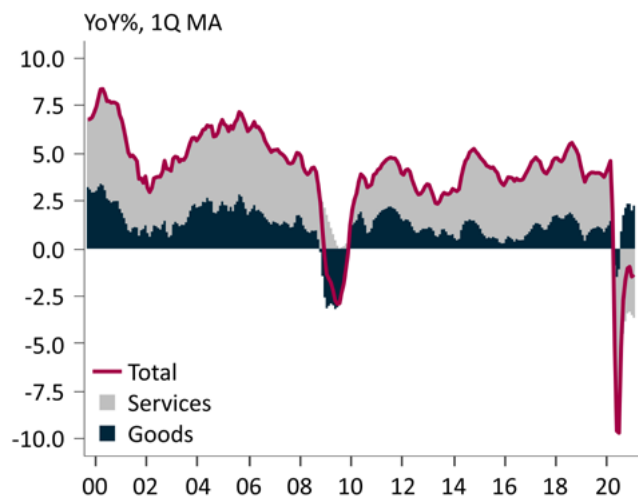


The Fed's key policy settings remained unchanged in recent months with an overall dovish tone still prevailing.

probable – with some adjustments perhaps (notably the proposed rise in the minimum wage) – given that the Democrats won two key Senate races in Georgia in early January. The Party now has control of the Senate by the narrowest of margins (with Vice President Kamala Harris a tie-breaking vote). The sheer quantum of this stimulus package has fuelled debate, most notably between the incumbent Treasury secretary Janet Yellen and former one Larry Summers, as to the macroeconomic outcomes of the package. Yellen asserts that it is a key policy to return the US economy to ‘full’ employment, whilst Summers is more concerned about the inflationary impact. Both reflect a US economy that would be recovering rapidly and markets have agreed – a contributing factor to the rising bond yields discussed earlier.

GRAPH 05 PERSONAL CONSUMPTION EXPENDITURES

Soft services consumption continues to weigh on growth



Source: IFM Investors, U.S. BEA, Macrobond

For the Fed's part, key policy settings remained unchanged in recent months with an overall dovish tone still prevailing. The Federal Open Market Committee (FOMC) did provide new guidance on its asset purchases, however, stating that purchases will continue until “substantial further progress has been made toward the Committee's maximum employment and price stability goals.” This comes as the Fed's near term economic projections were revised modestly higher but with core personal consumption expenditure (PCE) inflation not expected back at target until 2023. Officials also flagged in the January FOMC meeting that the medium-term economic outlook was “considerably stronger” than the prevailing outlook at the December meeting, largely due to the prospect of increased fiscal support. In late February, Federal Reserve Chairman Powell reiterated his dovish stance noting that “the economy is a long way from our

employment and inflation goals” and that it will likely “take some time for substantial further progress to be achieved”.

The overall progress of recovery underwhelmed modestly in Q4, with GDP expanding less than expected at a 4.1%qoq annualised rate. Personal consumption disappointed, growing 2.4%qoq annualised as the virus resurgence weighed particularly heavily on services consumption which was down 6.8% compared to the same quarter last year. Investment was the key outperformer, jumping 26.5%qoq annualised to be up 3.5% versus Q4 2019 and contributing 4.0ppts annualised to quarter-on-quarter growth. This solid growth should persist with key surveys such as the ISM manufacturing index printing strongly in terms of activity but also showing some evidence of price pressures.

The labour market continued to improve, on balance, in recent months. Employment growth moderated, with 86,000 net jobs added in the three months to January. But this softness was largely driven by particularly soft December data as the COVID-19 situation worsened in the US. There is upside risk to employment numbers going forward as the virus situation continues to improve. Indeed, initial jobless claims – a more timely release – were elevated in late-2020/early-2021 but slowed markedly towards the end of February. Despite soft employment growth, the unemployment rate continues to fall and in January reached 6.3%, a long way from the pandemic peak of 14.8%. The participation rate has moderated in recent months as well, however, and sat at 61.4% in January, still well below pre-pandemic levels. In line with the still elevated spare capacity in the labour market, inflationary pressures remain relatively subdued.

Headline CPI inflation has firmed in the past two months to be at 1.4%yoy in January, but core CPI inflation has fallen for two consecutive months to 1.4%yoy. PCE inflation – the Fed's preferred measure – accelerated in January (headline: 1.5%yoy, core: 1.5%yoy) but remains low relative to pre-pandemic prints. Personal incomes spiked 10.0%mom in January, supported by the \$600 stimulus checks and additional unemployment insurance from the \$900bn relief bill. This saw retail sales up significantly more than expected (5.3%mom) and personal spending up a robust 2.4%mom and a material increase in savings. There is upside risk to income and consumption in the near term given the considerable size of the stimulus package likely to be passed in March. The consumption outlook improved in January and February with consumer confidence up to 91.3, but confidence continues to track well below pre-pandemic levels.

» UK: Vaccinations promise better times

Brexit uncertainty was – again – a key focus over recent months, with the UK and the EU struggling to come to an agreement on key issues including fisheries and a regulatory “level playing-field” for companies before the transition period deadline. Fortunately, a deal was struck at the last minute.

In economic data, the UK economy grew 1.0%qoq in Q4 against expectations of a more modest 0.5%qoq expansion. This growth was driven mainly by unexpectedly strong government spending (6.4%qoq) and an unexpected increase in investment (2.1%qoq). Household consumption contracted 0.2%qoq, as expected, with net exports also a drag on growth. There is considerable downside risk to Q1 2021 growth figures given that a third national lockdown was announced in early January in an attempt to get the worsening COVID-19 caseload under control. The sharp rise in case numbers has contributed to the aggressive rollout of the UK’s vaccination program, with around 30% of the population (the third largest proportion of population vaccinated after the UAE at 61% and Israel at 92%) having been given at least one dose of a vaccine at the time of writing. This has resulted in some measured optimism that a sustained recovery will be forthcoming once restrictions are lifted.

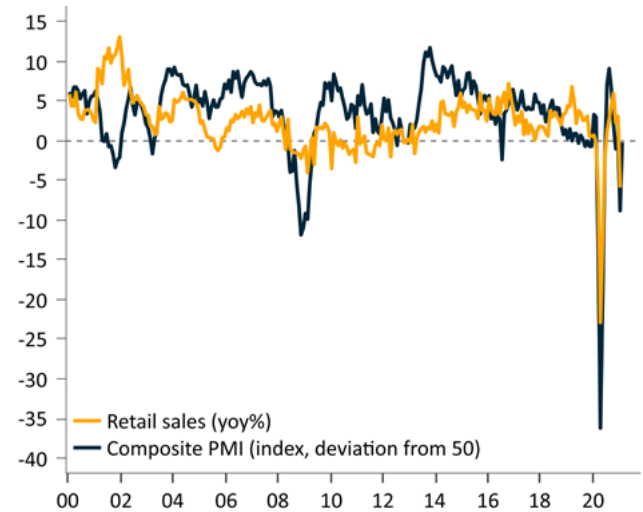
For now, pressures remain, particularly in the UK labour market. Traditional data continue to paint an incomplete picture of the underlying labour situation because of the potentially distortionary policies in play. With this in mind, the unemployment rate ticked up to 5.1% in the three months to December. This is the highest rate since March 2016 and there is a significant risk of further deterioration given the deteriorating COVID-19 situation in late-December/early-January and renewed lockdown measures. This contrasts starkly with experimental data from the Office of National Statistics that suggests the labour market remained soft in January with the claimant count unemployment rate at 7.2% - still near the pandemic peak of 7.5%.



The Bank of England left monetary policy settings unchanged in the three months to March but flagged downside risks to growth in the near term given the tightening COVID-19 restrictions.

GRAPH 06 UK COMPOSITE PMI AND RETAIL SALES

Lockdowns hit services and retail hard



Source: IFM Investors, ONS, IHS Markit, Macrobond

This continued labour market slack has contributed to ongoing soft inflationary pressures, despite an uptick in inflation in December and January. Headline inflation in particular remains well below pre-COVID levels at 0.7%yoy, with core inflation still well below target but at a more moderate 1.4%yoy. Retail sales took a significant hit over the period as lockdowns weighed, with a small rise in December followed by an 8.2%mom collapse in the headline figure and an 8.8%mom collapse in the core figure in January (the second largest fall on record). The consumption outlook improved somewhat in February with consumer confidence firming reasonably to 23 but the metric remains well below pre-pandemic levels.

The Bank of England (BoE) left monetary policy settings unchanged in the three months to March but flagged downside risks to growth in the near term given the tightening COVID-19 restrictions. Officials downgraded Q1 growth forecasts sharply but still expect a robust vaccine-driven rebound, with GDP likely recovering to pre-COVID levels in Q1 2022. Officials also agreed to prepare for the possible future use of negative rates but it is unlikely that negative rates will become a reality given the improved economic outlook and the limited enthusiasm for negative rates from several BoE officials. The relative dovishness of the BoE contrasts with the relatively hawkish comments from BoE Chief Economist Andy Haldane who – echoing the concerns of Larry Summers in the US – noted that he believes there is a “...tangible risk inflation proves more difficult to tame, requiring monetary policy makers to act more assertively than is currently priced into financial markets”.



» Eurozone: Inconsistent growth

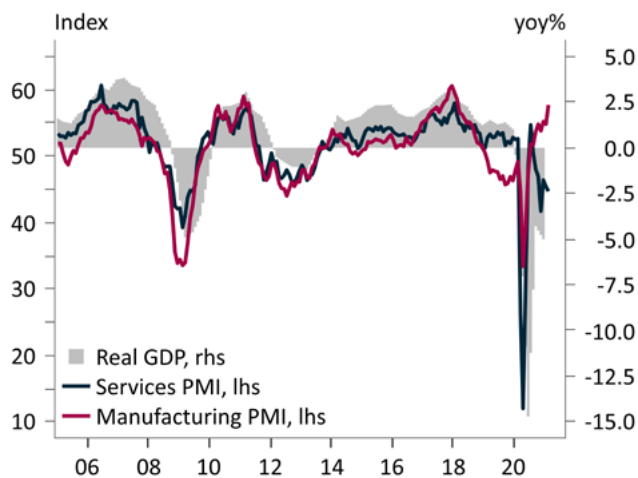
Ongoing lockdowns to manage the public health crisis have prompted an inconsistent recovery between countries across the Eurozone. The European Central Bank (ECB) met in December and announced a “recalibration” of its policy measures, stressing that this did not amount to “additional easing”. The key changes include an increase to the Pandemic Emergency Purchase Programme (PEPP) of €500bn to a total of €1.85tn, with purchases lasting until at least March 2022, an extension to TLTROs by 12 months (until June 2022), and an extension of Pandemic emergency longer-term refinancing operations (PELTROs) into 2021. These measures are clearly supportive, if not outright easing. The message that perhaps received more attention than any over recent months was the ECB’s Valentine’s Day social media post, “Roses are red, Violets are blue, We’ll keep financing conditions favourable, ‘til the crisis is through”. While a touch awkward as a communication, it underscores ECB Chief Economist Lane’s view that the ECB could “without a doubt” do more in the event of another economic shock.



Fourth quarter Eurozone GDP was better than expected but still posted negative growth. This was arguably a good outcome given the widespread public health restrictions that had been imposed across most economies.

GRAPH 07 EUROZONE PMIS AND RETAIL SALES

Services continue to struggle, manufacturing is picking up



Source: IFM Investors, Eurostat, IHS Markit, Macrobond

On the fiscal front, the European Council approved (at the last minute) the seven-year €1.8tn budget agreed to earlier in the year. Poland and Hungary had threatened to veto the budget over a rule of law mechanism but a compromise was reached in time. In politics the Italian Prime Minister Giuseppe Conte resigned after a key member of his governing coalition pulled the support of their party. Mario Draghi, the previous head of the ECB, was selected as the successor to Conte.

In economic data, fourth quarter GDP was better than expected but still posted negative growth. Real GDP contracted 0.6%qoq and the regional economy is still 5.0%

down from a year ago. This was arguably a good outcome given the widespread public health restrictions that had been imposed across most economies. Of the larger Eurozone economies, Italy (-2.0%qoq) and France (-1.4%qoq) suffered the largest falls in GDP, with Germany (0.3%qoq) and Spain (0.4%qoq), perhaps surprisingly, recording small increases over the quarter.

Employment improved over Q4 (0.3%qoq) but remains 2.0% down in year-on-year terms. This saw the unemployment rate for December track sideways at 8.3%, as expected, down from the pandemic peak of 8.6%. Despite the elevated spare capacity in the labour market, inflationary pressures firmed markedly in January, beating already strong expectations. The headline measure left deflationary territory to be up 0.9%yoy and the core measure accelerated to 1.4%yoy. This strength was largely due to temporary factors however (German VAT increase, delayed winter sales that usually take place in January). Indeed, core inflation softened markedly in February (1.1%yoy) with the headline figure tracking sideways. Prominent survey data for the bloc continue to paint a familiar picture: a services industry struggling amid the various restrictions intended to combat the spread of COVID-19 and a manufacturing industry that continues to recover. Indeed, the services PMI returned to contractionary territory in September 2020 and has stayed there, falling to 44.7 in February. Manufacturing activity, however, has expanded for eight consecutive months, with the PMI climbing to 57.7 in February (the highest in 3 years). Other key survey data (in the form of a range of confidence indicators) firmed in February but remain – for the most part – at low levels relative to the past.



» Japan: More fiscal to support the rebound

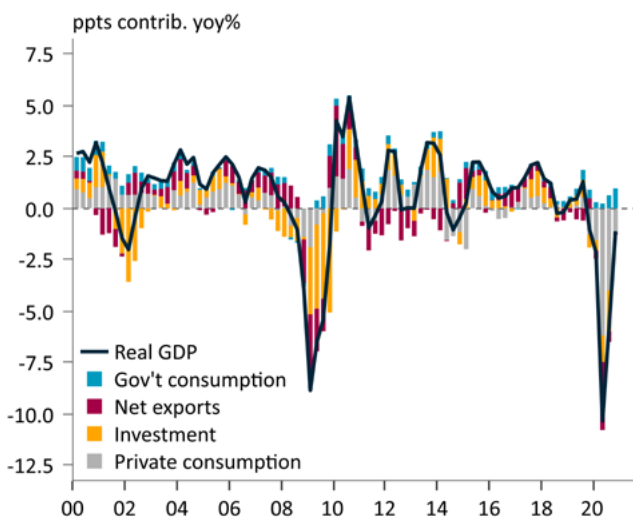
In order to support ongoing recovery, the Japanese government's additional fiscal stimulus package was approved on 8 December with a headline figure of ¥73.6tn. The headline figure includes projects already under way, however. The package has three main pillars: 1) measures to prevent the spread of COVID-19, 2) measures to facilitate structural change post-COVID, and 3) enhanced infrastructure to increase resilience to natural disasters.

This should underpin the recovery already underway, with fourth quarter GDP rebounding a better than expected 12.7%qoq annualised. The key drivers of this growth outcome were private consumption (4.8ppts annualised), business spending (2.9ppts annualised) and net exports (4.3ppts annualised). This follows an upward revision to Q3 GDP to 22.7%qoq annualised from 21.4%qoq annualised that saw the economy 1.1% smaller compared to Q4 2019. There is downside risk to Q1 growth figures, however: a state of emergency was declared in January encompassing several metropolitan area as COVID-19 infection numbers grew. Restrictions are less stringent than those enacted last year but will weigh on the recovery nonetheless. The state of emergency was extended in early February by approximately a month, introducing a further headwind to growth.

compared to a services industry where activity is disproportionately negatively impacted by social distancing and other restrictions. Labour market data were unexpectedly strong over recent months – the unemployment rate unexpectedly fell to 2.9% and the job-to-applicant ratio (a key labour market indicator in Japan) firmed sharply and unexpectedly to 1.1. Inflation firmed in January – largely on special factors – but remains subdued, with headline national and core CPI inflation both still in negative territory at -0.6%yoy. The main factor driving the firming inflationary pressures was the suspension of the government's travel campaign amid a worsening COVID-19 situation. Tokyo headline and core CPI both also firmed to 0.3%yoy but remain in deflationary territory. Key survey data continue to be subdued on balance: the preliminary composite PMI for February ticked up to 47.6 with services activity slowing to 45.8, marking 13 consecutive months in contractionary territory. On a positive note, manufacturing activity firmed (50.6), entering expansionary territory for the first time since April 2019. In monetary policy, settings remained unchanged over the period but the Bank of Japan (BoJ) did highlight at its December meeting that, in light of "downward pressure" in the economy, it would "conduct an assessment" to pursue further monetary easing to protect the economy from deflation.

GRAPH 08 JAPAN REAL GDP CONTRIBUTIONS

Gov't supporting growth while the private sector recovers



Source: IFM Investors, CaO, Macrobond

Other key fourth quarter data – the Tankan indices – were better than expected. The large manufacturing index (-10) and manufacturing outlook (-8) both returned to near pre-pandemic levels but the large non-manufacturing index (-5) and non-manufacturing outlook (-6) remain well below pre-virus levels. This is a pattern also seen in Europe and the UK where manufacturing is performing relatively well

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