

Quarter 03 - 2021

ECONOMIC UPDATE



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COVID caution

It's around a year-and-a-half since the pandemic began and many economies seem to be at or near 'peak rebound', with the tailwinds of expansionary fiscal and monetary policy set to fade and continued supply constraints a headwind to growth. Equity markets remain cautiously optimistic despite a resurgence in COVID. Bond markets are more circumspect. The rapid spread of the Delta variant poses downside risks to the outlook, with even highly-vaccinated countries being severely impacted. Inflation fears have subsided somewhat, but markets are now faced with the uncertainty of how and when policy support will be unwound and how economies will respond.

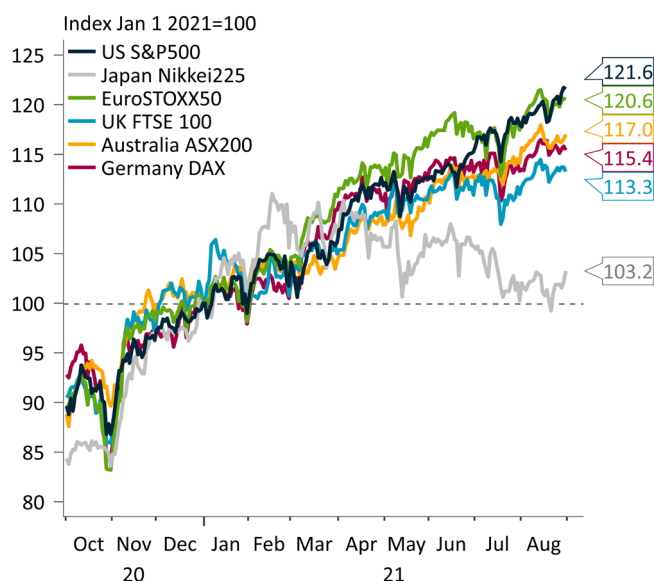
Global: Markets push on, economies peak

There is a cautious sense of optimism in markets as shown by the mixed, but positive, performance of most major equity indices in late July and into August. That said, the Delta variant of COVID-19 does present downside risks. This has been observed in the Japanese equity market that has weakened over recent months as case numbers have risen above previous waves, putting Japan's economic recovery at risk. This contrasts sharply with the performance of the US S&P500 Index, which recorded solid gains, despite rising COVID cases and mixed data recently, largely in response to future earnings expectations. The other relative outperformer was Australia's S&P/ASX200 as stimulus fueled earnings, high commodity prices and low interest rates underpinned performance – despite COVID lockdowns across two-thirds of the economy.

Bond markets were more circumspect, with US 10-year yields broadly range bound after the April-July rally. Reflationary sentiment has been tempered by the US Federal Reserve's (Fed) insistence that inflation is transitory. Fed speakers have been relatively dovish and the data flow was mixed. Institutional investors and pension funds are also seeking to rebalance portfolios after recent equity market strength, with the latter remaining relatively overweight equities.

GRAPH 01 GLOBAL EQUITY MARKETS

Markets diverge as delta casts country specific doubt



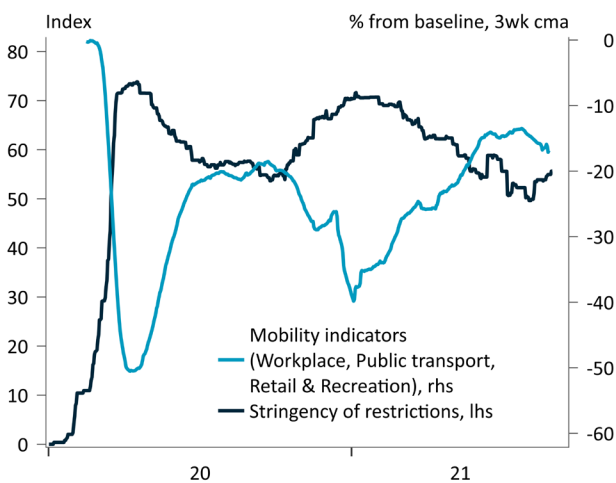
Source: IFM Investors, Macrobond. As at 1/9/2021

The pulse of global growth has improved over the course of the year as major economies have partially reopened and recovered. Around 40% of the 35 largest economies in the world experienced a negative quarter of growth in Q1. To date in Q2, only 10% of these economies have recorded (or are expected to record) negative growth and this improving trend should continue. Based on current projections, advanced economies will likely recapture levels of real GDP growth that prevailed before the pandemic in Q3. Importantly however, unemployment rates remain relatively elevated, with progress being slower and somewhat inconsistent. This will likely keep policy accommodation in place for an extended period, even though the more aggressive aspects of fiscal and monetary support may be wound back.

Consequently, further progress in the labour market will have to be driven by a slowing growth pulse; many of the world's major economies have either passed their strongest growth rates or are rapidly approaching them. The current outlook is for the recovery to continue but rates of growth will gradually decelerate. This reflects an easing of fiscal and monetary tailwinds, the passing of sharp growth rebounds following the lifting of restrictions, supply constraints in producer countries holding back growth and the testing of vaccination faith with Delta-variant case numbers rising in many countries (leaving some lighter restrictions in place). This trend is supported by higher frequency data on the public health crisis and in more timely soft data releases. The pace at which public health restrictions are easing across advanced economies has begun to slow at a level only modestly beyond that which occurred in 2020, after the first global wave of COVID had passed. It also remains well above the pre-pandemic baseline. As expected, this trend has coincided with a plateau in economic 'mobility' which implies the same for activity. Overall mobility has declined modestly in recent months reflecting a small decline in a large country, notably Japan, and large declines in small countries, notably Australia and New Zealand. These have offset the overall trend of lifting restrictions that have underpinned activity.

GRAPH 02 ADVANCED ECONOMY RESTRICTIONS & MOBILITY*

Re-opening loses momentum

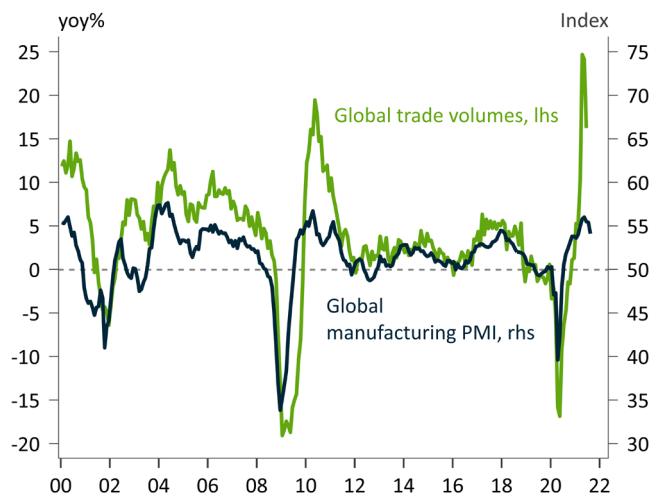


Source: IFM Investors, Oxford University, Google, IMF, Macrobond. As at 1/9/2021

China has also experienced a rise in COVID case numbers recently, which has compounded growth concerns and strengthened the case for further policy support in the second half of the year. Indeed the Chinese manufacturing and service PMIs peaked in late 2020 and have been broadly lower, and volatile, ever since. Weakness across South East Asia is also notable, with the ASEAN manufacturing PMI dropping sharply into contractionary territory in recent months. By contrast PMI performance in developed economies are just off recent highs but remain historically elevated in expansionary territory. According to IHS Markit data, the developed economy manufacturing PMI sits at 59.8 in July whilst the emerging economy measure is at a more modest 50.7. This divergence began in November 2020 (as the developed economy measure recovered rapidly after falling more than the emerging market measure at the height of the pandemic) and, at 9.1pts has rarely been wider on a historical basis. The overall global PMI level is being flattered by the relative strength of developed economy PMIs but the expectation is that these will likely continue to fade. The "Goldilocks" outcome for the global economy would be for emerging market activity to improve (as public health outcomes improve) and narrow this divergence, fostering not only economic growth for supply-starved developed economy companies but also alleviating the consequent inflationary pressures that have emerged.

GRAPH 03 GLOBAL MANUFACTURING SURVEYS AND TRADE VOLUMES

Growth will go on but the best may be behind us

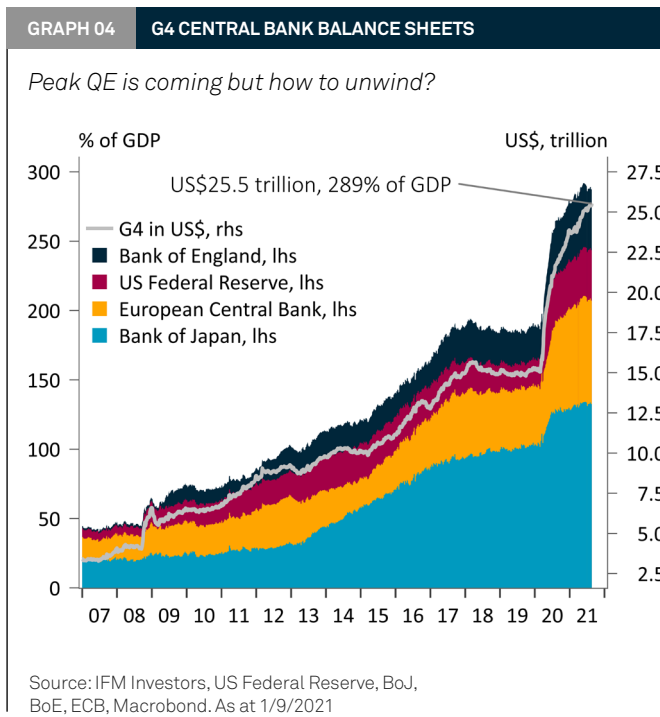


Source: IFM Investors, IHS Markit, CPB, Macrobond. As at 1/9/2021

Aside from near term growth and pandemic dynamics, investors are also eyeing developments in monetary policy. Of course the US Fed's deliberations on the time of tapering of its quantitative easing (QE) program are key. The recent Fed minutes note that while progress has been made towards its price stability mandate, there is still some way to go on labour market progress. Yet the Federal Open Markets Committee (FOMC) highlighted that "looking ahead, most participants noted that, provided that the economy were to

*Indexes are population-weighted

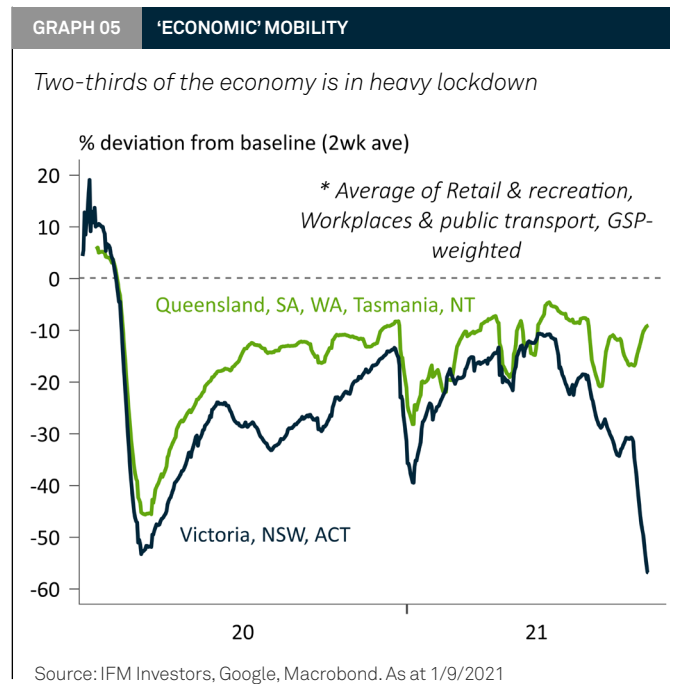
» evolve broadly as they anticipated, they judged that it could be appropriate to start reducing the pace of asset purchases this year.” This decision likely hinges on upcoming payrolls data being strong, but is a clear signal that the Fed is ready to gradually wind back some of the unprecedented policy easing that was unleashed to support the US economy through the pandemic. And at the same time, fostered the spectacular recovery and rise in US equity markets over the past year. While other smaller central banks, such as the Bank of Canada, have reduced their asset purchasing, or in the case of New Zealand stopped outright, the Fed’s move will no doubt reverberate through markets to a greater extent given its sheer quantum. The G4 economies (US, UK, Japan, Eurozone) alone have added US\$9 trillion to their balance sheets over the course of the pandemic, equivalent to 130% of their combined GDP. How this is unwound and the impact it will have on economies and markets is likely to shape prospects in the coming year. And this is before we consider the timing of any increase in policy rates which, in the case of the US, is still a long way off – likely in late 2022 or into 2023.



Australia: COVID to set economy back

Australia has again been hit by significant restrictions on activity in an attempt to address the spread of the highly transmissible Delta variant. The survey data flow have softened markedly in response with Victoria and NSW the states most significantly impacted to date. And there’s little doubt the unexpectedly strong economic recovery that has been observed in the hard data to date will unwind due to the renewed restrictions that are ongoing and will potentially impact into the fourth quarter. A key uncertainty is the degree to which policymakers are comfortable with significantly higher COVID caseloads, an outcome that seems almost certain given the more limited

effectiveness of vaccines at preventing the spread of the Delta variant as evidenced in highly-vaccinated jurisdictions around the world. Vaccines remain effective at limiting hospitalisations and deaths and it seems prudent to shift the focus from raw case numbers to hospitalisations/deaths as a more appropriate metric for policymakers. There has already been signaling that some states may favour a COVID-zero approach or at least aspire to it, even after vaccination targets have been reached. For the economy, this is a misstep in our view. Another key issue is that the uncertainty around the outlook will likely cloud economic decisions and should we find ourselves in an environment with significantly higher cases, then individuals may choose to self-moderate their activity.



The June quarter GDP release came in better than expected and demonstrated the momentum the economy had leading in to the current lockdowns. The economy expanded 0.7%qoq to be up 9.6%yoy through the year of recovery. The sheer size of the fiscal and commodities tailwinds the economy had is evident in the 16.4%yoy expansion of nominal GDP – the strongest rate of annual growth since Q3 1981.

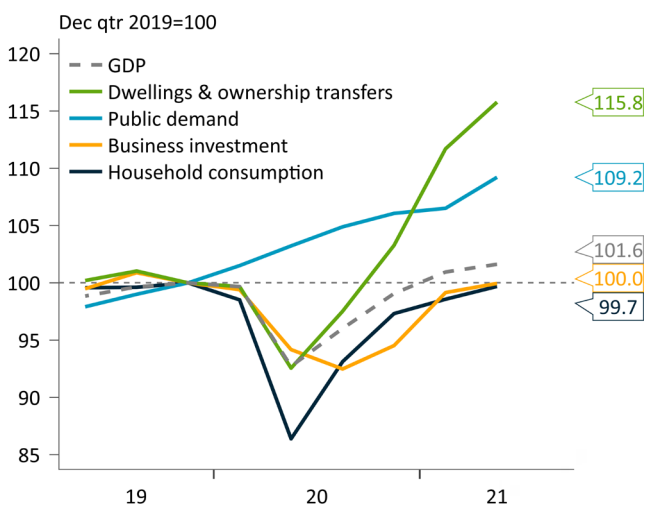
Growth was relatively broad-based in the economy, again underscoring how solid the recovery phase has been. Household consumption added 0.6ppt to the quarterly outcome, with services being the key driver, adding 0.54ppt, and retail categories a more modest 0.09ppts. Business investment was solid as was dwelling investment. These sectors combined added 0.4ppts to quarterly growth, roughly matched by the contribution of the public sector that added 0.5ppt. Weighing on growth was a 1.0ppt subtraction from net exports and 0.2ppts from inventories. The latter was much better than expected due to the 0.7ppts subtraction from growth from private inventories being

largely offset by those in the farming and public sectors. As at the June quarter it is clear the public and housing sectors have sustained growth while the household and business sectors have recovered. Unfortunately this trend will need to continue for the remainder of this year at least.

Should economic restrictions be lifted in the fourth quarter, it appears a technical recession (using the narrow definition of two consecutive quarters of negative growth) will be avoided. This is relevant given we expected the Reserve Bank of Australia (RBA) could have been pressured to act on policy given the optics around not acting in response to a recession that it did not forecast. It remains to be seen if the extended lockdowns and economic dislocation that have characterised Q3 prompt any shift in thinking at its next meeting. This may come even though we have asserted, and the Bank has acknowledged, its policy tools are not the most appropriate to address the current bout of pandemic-related economic weakness.

GRAPH 06 REAL GDP COMPONENTS

Public sector has underpinned a private sector rebound



Source: IFM Investors, ABS, Macrobond. As at 1/9/2021

The Q2 economic expansion underpinned a labour market that has performed well in recent months; around 147,000 net new jobs were added in the three-months through July that saw the unemployment rate fall to 4.6%, the lowest since November 2008. The unemployment rate is below pre-pandemic levels but still has a way to go to reduce spare capacity in the labour market. The outlook is soft, however, with the details of July's data showing that some of the fall in unemployment was driven by a drop in participation and there were also a significant number of workers who were recorded as employed despite working zero hours (contributing to a fall in total hours worked over the month). As lockdowns drag on, the unemployment rate will likely start to rise again. This doesn't bode well for wages growth which was disappointing in the second quarter. The wage price index (ex. bonus) for Q2 2021 was up just 0.4%qoq to record 1.7% growth through the year. This remains well

below the approximately 3.0%yoy rate flagged by the RBA as a necessary condition for sustainable 2-3%yoy inflation. And although inflationary pressures did accelerate sharply in the second quarter in line with expectations, this strength will almost certainly be transitory. Indeed, the headline measure firmed 0.8%qoq to be 3.8% higher in year-on-year terms. Looking through the volatility, the trimmed mean and weighted median measures also accelerated to 1.6%yoy and 1.7%yoy, respectively, still well below the RBA's 2-3% target.

In monetary policy, the RBA left the cash rate unchanged in the three-months through August. There were some key announcements in the July meeting, however, including a tapering of the QE program from \$5bn to \$4bn per week, no extension to the 3-year yield curve control target, and a shift to outcomes based forward guidance, with a stronger-than-expected recovery prompting the move. The minutes from the August meeting suggest the Bank was optimistic on the economy, expecting a rebound after restrictions are eased. The forecasts from the August SoMP also paint an optimistic picture of the economy but as the lockdown continues to weigh, the forecasts therein now seem unlikely to be realised. The minutes from the August meeting also note that the board did discuss reversing its QE tapering decision but that ultimately tapering was appropriate given the expectation of robust growth in 2022 (with any additional QE also not having its full effect until 2022) and their view that fiscal policy – which has been ramped up to support incomes again – was a more appropriate response to temporary and localised reductions in income. Nonetheless, there is a strong market expectation, again, that the RBA will need to delay its tapering timetable given events. This may occur as soon as the September meeting and, if so, our view is that it is more for optics rather than providing any near term support for the economy. It would be more concerning if this occurred and the Bank cited weaker growth late in the year and into 2022 as the driver.

US: Growth & Fed policy to peak

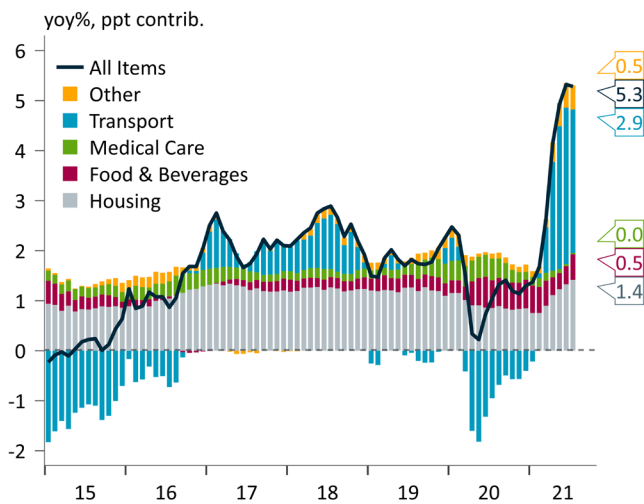
The US economy's expansion in the second quarter disappointed expectations, but real GDP still rebounded at a 6.6%qoq annualised pace. Within this result, household consumption (11.9%qoq annualised) outperformed as the economy continued to reopen and consumers spent fiscal transfers. However, private investment (-4.0%qoq annualised) was soft with inventories (-1.3ppts) in particular a drag. Government consumption and investment also detracted. Despite an alarming increase in COVID cases in the third quarter, expectations are for a similar sized rebound in activity in Q3 before some moderation late in the year and into 2022. The ongoing economic recovery has underpinned a solid labour market performance in the three months through July with an average of around 832,000 net new nonfarm jobs added to the economy each month. This saw the unemployment rate continue to track down from 6.1% in April to 5.4% in July. There is evidence that supply constraints were weighing on jobs growth around April and June, with record levels of labour demand (as measured by job openings) not seeing a commensurate rise

» in employment. That no longer appears to be the case but August figures will be watched carefully to get a sense of what impact the Delta wave has had on labour markets.

Inflationary pressures accelerated sharply in recent months. In June the headline measure reached 5.4%yoy (highest since July 2008) and the core measure reached 4.5%yoy (highest since August 1991). Some of this strength is due to base effects but inflation in month-on-month terms has also been startlingly strong. July figures remained strong, largely in line with expectations (headline: 5.4%yoy, core: 4.3%yoy). Hotel and airfare price levels are roughly around pre-pandemic trends and used car price inflation (a key positive contributor in prior months) has slowed sharply, suggesting that inflationary pressures from these sources will be less significant going forward. PCE inflation was also largely in line with expectations in July with the headline measure (4.2%yoy) accelerating and the core measure (3.6%yoy) tracking sideways.

GRAPH 07 EUROZONE SENTIMENT SURVEYS

Inflation to decelerate modestly but remain elevated



Source: IFM Investors, BLS, Macrobond. As at 1/9/2021

Despite these strong inflation figures, policy makers have stressed that they likely remain transitory and, consequently, will not illicit a policy response. Nonetheless, the key focus for markets is the eventual timing of asset purchase tapering. Minutes from the Fed's June meeting showed that some members of the FOMC believe conditions for tapering could be met earlier than expected and that some members had pulled forward expectations. Minutes from the July meeting echoed that sentiment, with most participants suggesting it may be appropriate to begin the tapering of asset purchases this year if their expectations are realised.

Dallas Fed President Kaplan – a tapering hawk – made comments that suggested the timing of tapering could be pushed back but these comments were walked back after Kaplan highlighted that the Delta wave appears to have a more muted economic impact than previous waves. He has renewed his call for a September tapering announcement.



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Most importantly Fed Chair Powell signaled that the Fed could begin tapering asset purchases in coming months at his speech at Jackson Hole. Powell acknowledged the strong July employment report but noted that the Delta variant posed risks to the outlook. August payrolls will be a key data point in informing tapering expectations. Powell also highlighted that the inflation surge is expected to be temporary and he stressed that the tapering decision was not intended to give a “direct signal regarding the timing of interest rate liftoff.” The decision on future rate hikes depends on a “substantially more stringent test”.

While monetary accommodation is wound back, more is being done on fiscal policy with two sizeable infrastructure packages working their way through Congress. The first package is smaller (US\$1tn) but critically has bipartisan support. The second infrastructure package is a much larger (US\$3.5tn) and much more ambitious package (that includes many aspects outside traditional infrastructure) being championed by progressive Democrats but political obstacles remain. Both of these packages would be supportive of economic growth over the medium term and add materially to the US government's debt burden.

UK: Reopen recovery

The UK removed most COVID-related restrictions on 19 July despite an alarming acceleration in cases in the lead up. The strong vaccine rollout is a positive here and has facilitated a divergence between case numbers and deaths. This is a useful case study for other countries who have or are approaching significant vaccination rates and are considering various reopening strategies with the Delta variant still running rampant. Although vaccines have only limited effectiveness in preventing illness altogether, they are still very effective at preventing serious cases and deaths. This means that fully vaccinated economies can reopen with a much lower risk of healthcare systems becoming overwhelmed. This ‘living with the virus’ will be the next phase in the recovery. More than a year on and there are still uncertainties around

» how quickly different economies will move to this ‘new normal’ and what the new normal will even look like.

The economic data were improving in the lead up to restrictions being lifted with real economic activity bouncing back sharply in Q2 (4.8%qoq) as the strong vaccination rollout supported the second-fastest quarter-on-quarter growth rate since Q1 1973. Private consumption (7.3%qoq) and government spending (6.1%qoq) both comfortably beat expectations, but looking forward the Delta wave will act as a headwind to Q3 growth – even with almost all COVID restrictions lifted in mid-July. The response of individuals is important with some people choosing to moderate their activity out of concern, as suggested by plateauing mobility indicators in early Q3. Growth in the second half is expected to slow materially from the June quarter’s strong pace.

The inconsistent path of economic recovery was reflected in retail sales data that unexpectedly declined 2.5%mom in July. This may be due in part to the impact of the Delta wave, but it may also represent a correction following a sharp rise in retail spending on reopening (retail spending remains around 6% higher than pre-virus levels) and a shift to higher consumption of services.

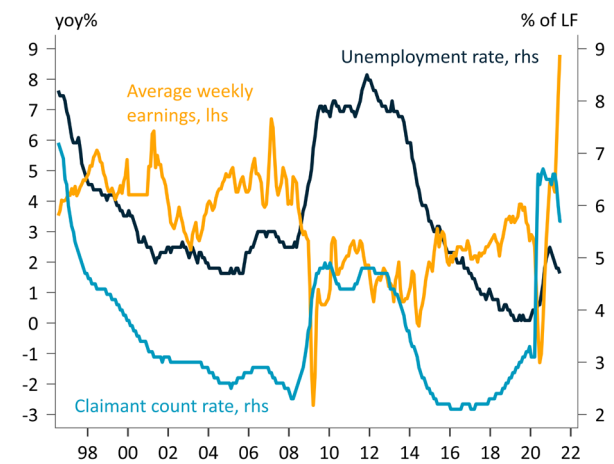
The labour market, which is heavily lagged, has performed reasonably well over the three-months through June with a net 95,000 new jobs added and the unemployment rate unexpectedly falling from 4.8% to 4.7%. Average weekly earnings over the period were 8.8% higher than the equivalent period in 2020. But this measure was impacted by the furlough scheme and some compositional and base effects. More timely experimental ONS data were positive on balance – the claimant count unemployment rate tracked sideways at 5.7% in July following a downward revision to June’s print, and the jobless claims change fell again over the month. Looking forward there is downside risk as government policy remains supportive and will roll off in coming months.



As with other central banks, the Bank of England’s (BoE) focus remains on labour market repair and thus far it asserts inflationary pressures are transient.

GRAPH 08 UK UNEMPLOYMENT AND WAGES

More progress is needed in the labour market for the BoE



Source: IFM Investors, ONS, Macrobond. As at 1/9/2021

Inflationary pressures have accelerated markedly in recent months. June inflation reached its fastest growth in year-on-year terms since around mid-2018 (headline: 2.5%yoy, core: 2.3%yoy), before decelerating by more than expected in July (headline: 2.0%yoy, core: 1.8%yoy). This slowing is likely only temporary, with expectations of higher inflation over coming months as economic activity continues to pick up. Nonetheless, expectations remain for a material slowdown in inflation in 2022.

As with other central banks, the Bank of England’s (BoE) focus remains on labour market repair and thus far it asserts inflationary pressures are transient. The Bank seems relatively optimistic around the medium-term outlook despite noting both upside and downside risks to activity from the spread of the Delta variant in the near term. Yet it remains concerned about the impact on the economy and labour market once the labour market furlough scheme ends in September. For now, policy settings remain on hold but the BoE notes that “...some modest tightening of monetary policy over the forecast period is likely to be necessary” should the economic recovery continue.

Eurozone: Rebound as restrictions lift

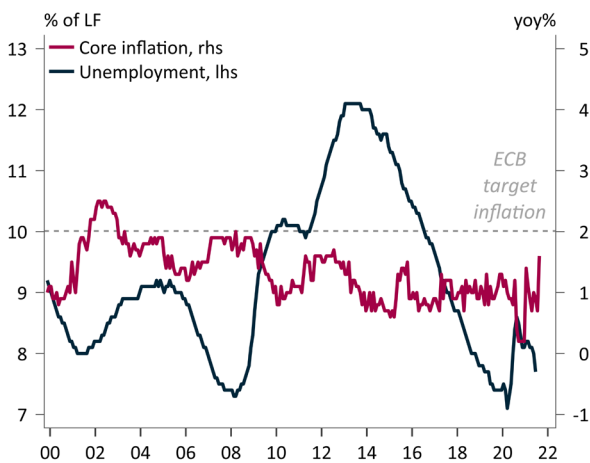
The Eurozone economy performed well in the second quarter with real GDP up 2.0%qoq, materially more than expected. But a key focus here is that although demand is robust, supply constraints are a limiting factor and are acting as a headwind to growth. Of the larger economies, Spain recovered most strongly (2.8%qoq) followed closely by Italy (2.7%qoq), with a more subdued recovery in Germany (1.6%qoq) and France (1.1%qoq).

The near-term outlook remains strong but there is evidence that growth is slowing. Indeed, a suite of prominent survey measures in the Eurozone have turned over in recent months, reaching a local peak around June/July before softening into August and disappointing expectations almost across the board. Although the indicators have softened in

» recent months, they remain at high levels, suggesting the growth impulse remains strong but that peak growth has likely passed. Details highlight the acute impact that supply shortages are having on manufacturing production, with a sharp decline in observed production despite new orders still coming in strongly. This impact is also visible in less timely industrial production data, which have been soft in recent months. Industrial production fell more than expected in May (-1.1mom) and June (-0.3%mom). Disruption to supply chains have been a key factor, driving supply constraints that are a headwind to growth. Semiconductor shortages are another focus, hitting the car sector particularly hard. Robust demand means that these supply issues are unlikely to derail the recovery, but they will still weigh on growth.

GRAPH 09 EUROZONE UNEMPLOYMENT AND INFLATION

Underlying inflation subdued, unemployment falling



Source: IFM Investors, Eurostat, Macrobond. As at 1/9/2021

Underscoring this theme, preliminary August PMI data from the Eurozone were marginally weaker than expected, on balance. The composite PMI (59.5) was down a bit more than expected with services (59.7) beating slightly and manufacturing (61.5) disappointing. The indices are still well into expansionary territory and also suggest continued elevated growth in Q3. The details of the PMI releases in recent months have been positive; firms took on extra workers at the fastest rate in several years, but rapidly recovering demand continues to outstrip supply, resulting in more acute price pressures. Indeed, average input prices rose at their second highest rate on record and average prices charged for goods and services rose at by far the fastest rate on record.

The lifting of restrictions is apparent in the retail space with June sales up a solid 1.5%mom, and despite a downward revision to April's figures, retail consumption has been robust in the past two months. Risks to the outlook remain, including to what extent pent-up demand has been relieved, whether consumption will be focused on services in the coming months as economies continue to normalise, and to what extent the Delta variant will impact behaviour.



Disruption to supply chains have been a key factor, driving supply constraints that are a headwind to Euro zone growth.

Consumer confidence for August provides some insight into what to expect for retail sales and although the impulse has been soft, with two consecutive falls in the measure, confidence levels remain above pre-pandemic levels.

The labour market continues to recover in the Eurozone. Employment for the second quarter increased 0.5%qoq which saw the unemployment rate fall in both May and June to reach 7.7%, beating expectations. This is a positive signal but with furlough schemes supporting the labour market there may be more slack than suggested by these numbers.

Inflation has been stronger than expected in recent months, with the headline measure jumping to 3.0%yoy – the fastest rate since November 2011. Much of this strength was driven by energy prices and will likely prove transitory, such that the European Central Bank (ECB) should look through it. The core measure firmed to a more modest 1.6%yoy. The ECB left key monetary policy settings unchanged in the three-months through August. The Bank did, however, announce that it would continue to front load asset purchases, suggesting that the pandemic emergency purchase program (PEPP) envelope (the total amount of assets the ECB can purchase as part of the PEPP) could be increased and extended beyond March 2022, or that there will be significant tapering in the fourth quarter. Forward guidance was also more dovish with the ECB saying rates would remain at current or lower levels until the ECB views inflation “*stabilising at two per cent over the medium term*” which may “*imply a transitory period in which inflation is moderately above target*”. The ECB also announced the results of its strategy review. The key takeaways from the review are that the inflation target was changed from “*below, but close to 2%*” to a symmetric target of 2% (with inflation allowed to overshoot in certain circumstances); the ECB will now also look at inflation measures that “*include initial estimates of the cost of owner-occupied housing*”; and the ECB has formally incorporated climate change into policy.

Japan: Post-Olympic challenges

The outlook for the Japanese economy remains clouded in uncertainty with risks appearing tilted to the downside in response to the Delta-driven COVID surge in recent weeks. The continued vaccination rollout is a positive, and there appears to be a divergence between cases and deaths despite an upturn in both. To put this in context, the weekly number of new infections was around 3.3 times higher

» than the previous peak (at the time of writing), but deaths remained around 40% of the level of the previous peak (deaths are a lagging indicator and will likely continue to rise in coming weeks). In response to worsening caseloads, a fourth state of emergency was declared for select prefectures in early July. The state of emergency was extended and widened in August and now includes about 80% of the economy. A key difference between restrictions in Japan and other countries is that in Japan restrictions have few legal teeth and rely largely on voluntary adherence.

Leading into this renewed public health challenge, the economy had expanded more than expected in the second quarter with real output growing by 1.3%qoq annualised and a small upward revision to Q1 growth. Both private consumption (0.8%qoq) and business spending (1.7%qoq) beat expectations, with inventories (-0.2ppt) and net exports (-0.3ppt) disappointing and weighing on growth. Further details in the GDP report were also positive, including residential investment, much needed for an economy that has struggled to find its footing in recent quarters.

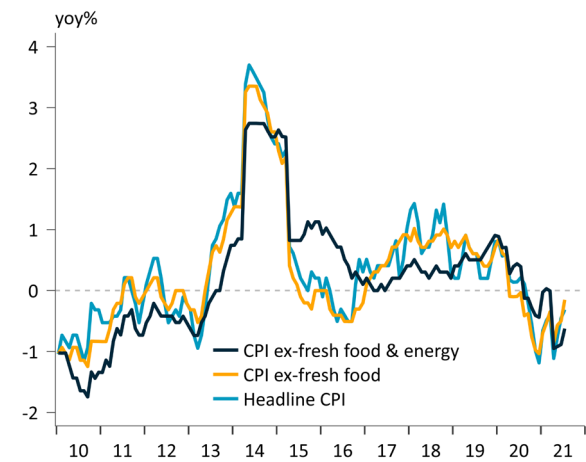
Despite the stronger than expected GDP figures, more timely indicators, such as PMI data, suggest that private sector activity as a whole contracted in the three-months through August, posing a downside risk to Q3 growth figures. COVID restrictions disrupted operations and acute supply chain pressures (particularly for manufacturers) were a headwind. Manufacturing activity continues to expand (52.4), although at a slower pace than July. Strong exports – spurred on by robust US and China recoveries – have been supportive, despite domestic weakness due to COVID restrictions. Services activity by contrast was in contractionary territory for a 19th consecutive month in August, with the preliminary services PMI falling to 43.5, the lowest reading since May 2020. Other key data also highlight the continued divergence between the services and manufacturing recovery. This was also observed in the Bank of Japan's (BoJ) Tankan survey. While the large manufacturing index firmed less than expected in Q2 it remains elevated for large firms (14pt), particularly compared to the non-manufacturing index (1pt). Also notable was that the current conditions and outlook remains solid overall for large firms but small firms remained mired in negative territory, underscoring a theme in many COVID-impacted countries that the recovery is not symmetrical across business size.



The inflation spike gripping many advanced economies has not yet emerged in Japan.

GRAPH 10 JAPAN KEY CPI MEASURES

Japan is an outlier to the global inflation theme



Source: IFM Investors, Ministry of Internal Affairs & Communications, Macrobond. As at 1/9/2021

Despite softening conditions, the labour market performed relatively well in recent months. The unemployment rate unexpectedly ticked down to 2.8% in July and the job-to-applicant ratio unexpectedly firmed to 1.15. Strong pent-up demand for labour following an easing of a state of emergency for several major city areas over the month likely contributed, but renewed restrictions are a downside risk to future labour market data. Labour cash earnings disappointed in May, growing 1.9%yoy. This was largely driven by a recovery in overtime wages, following a sharp fall in May 2020 due to the nationwide state of emergency in effect at the time.

The inflation spike gripping many advanced economies has not yet emerged in Japan. Indeed, after a faster than expected acceleration in inflationary pressures over July, prices are still deflating (headline: -0.3%yoy, new core: -0.6%yoy). This follows a significant downward revision to June's figures – the headline and new core measures were both revised down by 0.7 percentage points – which was driven by the five-yearly CPI rebasing that includes the updating of price index estimation methods. Mobile phone charges were the key driver of the downward revision. August Tokyo CPI data – a useful lead on national measures – also remains soft after decelerating from the prior month (headline: -0.4%yoy, new core: -0.1%yoy). The BoJ left policy rates unchanged over the three-months through August but flagged that it will be extending its special pandemic corporate financing support program to end-March 2022 (a six month extension). In terms of key risks to the outlook, the BoJ highlighted pent-up demand as a key upside risk to growth with COVID variants a notable downside risk. The BoJ also announced that it will provide interest-free loans to banks who lend to environmentally friendly projects and that more of their reserves would be exempt from negative rates. The BoJ will also support green bonds and has encouraged banks to disclose climate risks.



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