

Quarter 02 - 2021

ECONOMIC UPDATE

Inflation rears its head

The outlook across advanced economies as a whole is for stronger near-term growth as economies re-open and are fuelled by ongoing stimulus. Yet this outsized growth occurs while supply chains remain impeded by pandemic effects and consequently a disequilibrium has emerged in the global economy. This has sparked inflation concerns in some economies, notably in the US, that have reverberated through markets. Yet in our view – and that of most central banks – inflationary pressures will likely be transitory, with demand and supply normalising following the recovery phase. This view is reinforced by the fact that most pre-pandemic headwinds to inflation will persist over the medium-term.



Alex Joiner
Chief Economist



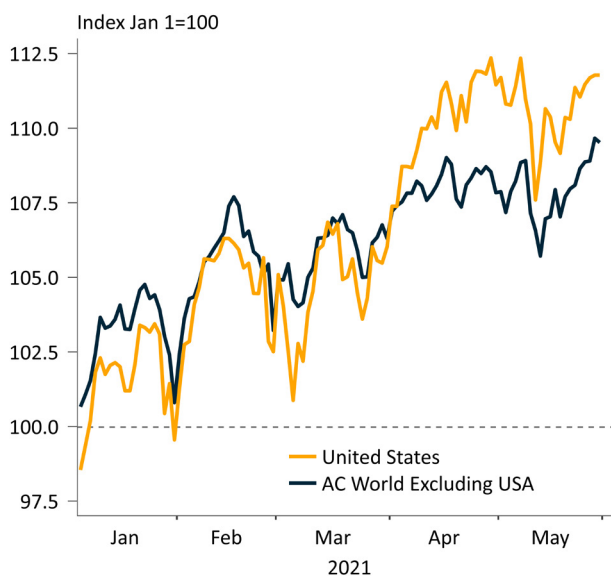
Frans van den Bogaerde
Economist

Global: Inflation is here, but for how long?

The momentum that characterised equity markets in late March has faded in recent months. The main factors driving markets were positive sentiment as restrictions were lifting, the improving data flow and the prospect of even more fiscal stimulus in the US. Yet the rally had been losing momentum through April and into May. At around the same time, the selloff in bonds also came to a halt ahead of two US data releases that were to confound markets - much weaker than expected US labour market data followed by much stronger US inflation. While there has been a tentative recovery in equity markets since this inflationary spike, inflation is the key tail risk for financial market investors at the moment. This has just as much to do with the impact inflation has on equities and other asset classes as it has to do with the fear that the US Federal Reserve (Fed), and potentially other central banks, will be forced to respond to it by removing some of the stimulus that has buoyed equity global markets for much of the COVID-recession. Reflation was always coming and has been evident in commodity markets, manufacturing surveys and semi-conductor and producer prices – but now it's arrived in consumer prices, markets seemingly face an inflection point.

GRAPH 01 GLOBAL EQUITY MARKETS

Markets lose momentum as inflation emerges



Source: IFM Investors, MSCI, Macrobond as at 2 June 2021

» The threat of inflation has come as the global economy finds itself in a state of disequilibrium. Global supply chains have struggled to recover fully and, in many instances, remain impeded due to the pandemic. Whereas the lifting of public health restrictions in economies that have received record levels of fiscal stimulus has caused demand to recover strongly. The US is where these pressures are most stark, particularly on fiscal stimulus. At the time of writing, US fiscal stimulus, including proposed spending not yet passed, is estimated to be around 36% of GDP according to US government sources. Around 16% of GDP is the average for Advanced Economies according to the IMF. Australian stimulus from the states and Federal government is around 17% of GDP according to government sources (but possibly slightly less, given revisions in the recent Federal Budget). For context, Australia's fiscal response to the Global Financial Crisis (GFC) was around 7% of GDP. Much of this fiscal effort has been targeted at households and businesses to support purchasing power and promote spending and/or investment in the economy – and it has clearly been successful.

But is the inflation stemming from this disequilibrium transitory or destined to be more persistent? Our view is likely the former. To some degree, we know the recent acceleration of inflation in a through the year sense is due to base effects. Prices that fell sharply through the depth of the recession (in some cases due to government policy intervention) are now normalising as restrictions are lifted. These factors should pass with time. Further, fiscal stimulus will fade and demand should normalise, and in some countries this will happen sooner than others. The supply-side should normalise too as the public health crisis recedes and in response to higher prices. This is because there appear to be more impediments to supply than outright shortages.

Central banks almost unanimously share this assessment, believing that the current acceleration of inflation is transitory and the US Fed is among the most vocal. But with US core inflation having now accelerated, outcome-based guidance on policy could become problematic. The Fed now must explicitly believe inflation will decelerate to its target (rather than the reverse). But forecasting deceleration is just as difficult as forecasting acceleration, especially given evidence of inflation is quite widespread. The difficulty for markets - whether they believe the Fed or not - is the impact on valuations. Should the Fed begin to discuss winding back policy measures in response to inflation, valuations would no doubt need to adjust in the near term.

It seems for now at least, central banks, including the Fed will stare down inflation and markets are more or less willing to believe them (pending the data flow). While the Fed and other central banks believe inflation is transitory based on evidence and forecasts, to some degree they are forced down this path. This is because their objectives include economic recovery and maximum

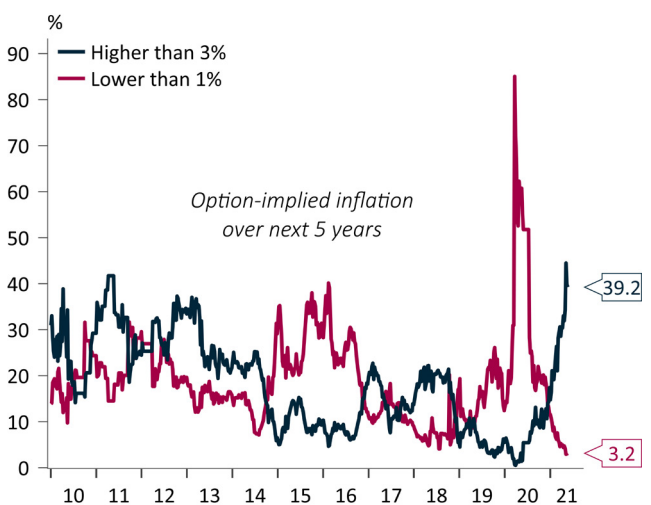
employment. It would be a policy mistake for central banks to address supply-side driven inflation, even if it proves stubborn in the near term, by tightening policy to lower demand. Central banks have been fixated for years on policy being driven by *their* type of inflation, that which stems from the Phillips Curve and tight labour markets. It is this type of inflation that central banks want to see and can react readily to. Other sources of inflation are more difficult to manage and they are unlikely to try now. Markets likely take comfort from such an assessment.

It should also be noted that this inflation scare is so far quite distinct to the US among the major advanced economies. And this begs the question as to whether US fiscal stimulus itself is too generous. Other countries have experienced some acceleration from low levels and will undoubtedly endure base effects. Indeed Australian headline inflation will more than likely accelerate from below the lower bound of the 2-3%yoy target band through the top of the target band in the June quarter data. Importantly, despite what is occurring in the US, Australia and elsewhere, inflation expectations remain well anchored over the medium term at or around central bank targets.

Nonetheless it is US inflation dynamics that are reverberating through markets. As the Minneapolis Federal Reserve market based probabilities of inflation analysis shows (GRAPH 02), expectations have shifted from a high probability of the US economy flirting with deflation to a reasonable chance of experiencing persistently high inflation. As yet the market is not expecting a materially different inflation regime over the medium term. That said, expectations have shifted materially so it is unsurprising we have seen a pickup in equity and bond market volatility.

GRAPH 02 MARKET-BASED PROBABILITIES OF US INFLATION

Markets are flirting with inflation persistence



Source: IFM Investors, Minneapolis Fed, Macrobond as at 2 June 2021



” **Australia’s recession has not been as deep as the global median experience and this has facilitated a more pronounced recovery.**

And indeed for financial market investors that often deploy capital over a shorter time horizon, inflation above 2%yoy for 12 months may seem more than transitory. For longer term investors, such as those in private infrastructure markets, this time frame is much less concerning. However, the COVID recession has made economists at least think twice about what medium/long run dynamics around inflation will prevail. It remains our view that neither monetary nor fiscal stimulus has made economies ‘better’. Despite fostering recovery, they haven’t to any great extent remedied impediments to growth present before the crisis, most notably lack of both productivity growth and private investment. While at the same time they have increased the public and private debt burden across the global economy. This should temper medium term growth expectations after the recovery phase spike in growth has passed. The case for inflation is similar. The headwinds to inflation from demographics, reduced employee wage bargaining power, the erosion of corporate pricing power, e-commerce and technology/automation have not gone away. Although one key factor in long term downward price pressures may change in the wake of the COVID recession - Globalisation.

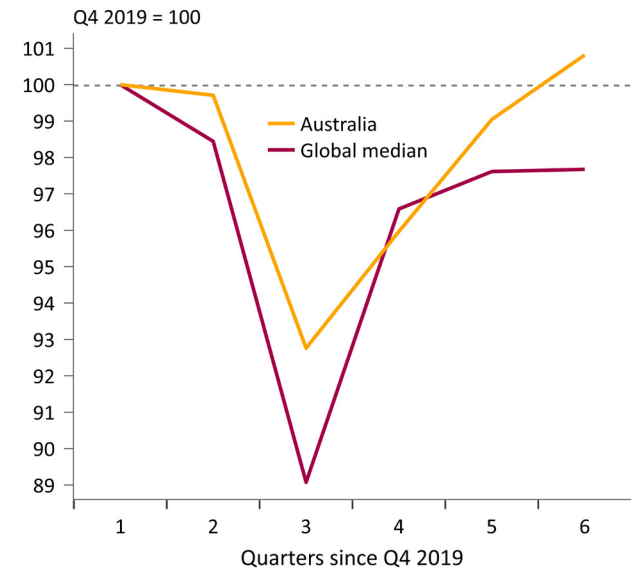
To what extent pre-existing global trade tensions will potentially be exacerbated by the nature of the COVID recession is uncertain. The desire for governments to onshore key supply chains will have to be balanced with the ability to produce key goods and services domestically in a cost effective manner – a difficult task. Yet if this cannot be achieved, or if punitive trade measures escalate, supply-side pressures on inflation may persist. Making the task of cyclical management for demand-focussed central banks all the more difficult.

Australia: Progress continues

The economic recovery in Australia is continuing strongly according to data released in recent months. Notably, real GDP growth came in at 1.8%qoq in Q1, beating expectations and recording 1.1%yoy growth through the year. Importantly, the economy is 0.8% larger than it was in Q4 2019, recovering beyond this pre-pandemic level of output. It is notable that Australia’s recession has not been as deep as the global median experience and this has facilitated a more pronounced recovery.

GRAPH 03 DOMESTIC AND GLOBAL REAL GDP

The Australia economic recovery continues



Source: IFM Investors, ABS as at 2 June 2021

Key drivers of growth were household consumption, dwelling investment and business investment (adding 0.7pp, 0.3pp and 0.4pp respectively) – all sectors that have and continue to benefit from fiscal stimulus. Inventories being rebuilt also contributed strongly to quarterly growth, adding 0.7pp, while net exports subtracted 0.6pp. The latter was largely prompted by stronger import volumes due to improving domestic demand. The larger states of New South Wales and Victoria added 0.5pp and 0.6pp of the 1.6%qoq rise in overall domestic demand. At the time of writing, Victoria has entered an at least two week period of lockdown restrictions due to a small COVID-19 outbreak. This will impact the monthly data flow to some extent and will weigh on overall growth in the June quarter.

The labour market recovery continued in the three months to April with an average of 44,000 net new jobs each month. It is worth highlighting that this includes an unexpected fall in employment of 30,600 in April – the first month after the end of the government’s JobKeeper support. There were fears that the withdrawal of government support could contribute to a significant rise in unemployment in the months following policy expiration but that appears not to have been the case with the ABS noting that “*the end of the JobKeeper wage subsidy did not have a discernible impact on employment.*” It seems that residual seasonality associated with an early Easter likely contributed to the soft print. Overall, employment levels as of April were 0.35% above pre-pandemic levels. The unemployment rate over this period fell from 6.4% in January to 5.5% in April, marking six consecutive falls. The participation rate firmed sharply in March to a new high of 66.3% but softened materially to 66.0% in April, driving a fall in the unemployment rate in April despite net job losses.



We expect the RBA to remain cautious as it does not want to unduly tighten policy relative to other central banks and underpin a marked appreciation of the AUD.

» Working age population growth continues to be historically weak with borders closed and this, combined with high levels of vacancies, suggests spare labour market capacity should continue to be eroded in coming months.

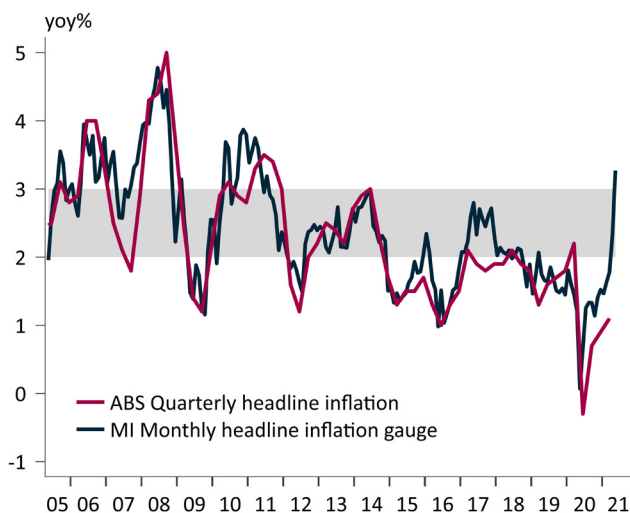
Yet for now wages growth is modest, with the wage price index rising 0.6%qoq (slightly higher than expected) in the first quarter taking the year-on-year change to 1.5%. The better-than-expected print was driven partly by earlier-than-expected revisiting of wage reviews that were postponed during the pandemic. In year-on-year terms, wages growth remains well below where it needs to be to place upward pressures on prices. Indeed, inflation remained surprisingly soft in Q1, with the headline measure rising 0.6%qoq to be up 1.1% through the year. Underlying inflation also disappointed, with the trimmed mean measure at 0.3%qoq and the weighted median measure up 0.4%qoq. Several temporary factors contributed to this soft print including HomeBuilder grants weighing on construction costs and an unseasonably soft rise in vegetable prices. Looking forward, there should be a sharp – but temporary – rise in Q2 driven by base effects, with the longer-term outlook for inflation still facing ongoing headwinds as long as wages growth remains modest. This has been demonstrated already in the unofficial monthly headline inflation gauge which hit 3.3%yoy as of May. This base effect was not enough to see the monthly trimmed mean measure – up 1.8%yoy – break the bottom of the Reserve Bank of Australia's (RBA) target band. Interestingly, May saw a monthly decline in both headline (0.2%mom) and trimmed mean prices (-0.1%mom). While it's too early to suggest that this is a trend, it certainly shows inflation is not all one way. We'd note consumer import prices in the March quarter fell 1.9%qoq to be down 4.4%yoy – suggesting the Australian dollar has been a factor, to some extent, keeping global inflationary forces at bay.

House price inflation, by contrast, has been anything but subdued against the backdrop of continued economic recovery and accommodative monetary policy. Prices were up a very strong 7.1% in May in the capital cities compared to February this year. The rapid appreciation in dwelling prices has fuelled concerns of an overheating housing market but the RBA, for its part, flagged that there are tools other than interest rates (such as macroprudential regulation) that can be used to address concerns around an overheating housing market. Furthermore, Australian Prudential Regulation Authority (APRA) Chair Byers highlighted that it is not the regulator's mandate to address house price affordability and that it is instead focussed on lending standards which – in its view – have not yet deteriorated.

In monetary policy, the RBA left key settings unchanged in recent months. The Board did highlight, however, that it would consider adjustments to the quantitative easing (QE) and yield curve control (YCC) programs in July. On the economic outlook, the Bank flagged several forecast upgrades ahead of the Statement on Monetary Policy (SoMP) and highlighted that the *“recovery in Australia has been stronger than expected and is forecast to continue”*. This was highlighted in May's SoMP that contained substantial upgrades to forecasts of growth and unemployment. GDP for 2021 is now expected to grow by 5.25% compared to 4.0% previously and GDP for 2022 is expected to rise by 4.0% compared to 3.25% previously. The unemployment rate is expected to fall to 5.0% by end-2021 (compared to 6.0% previously) and is expected to be at 4.5% by end-2022 (compared to 5.5% previously). Nonetheless the RBA's forward guidance has, as of its June meeting, remained unchanged, that its objectives are unlikely to be met *“...until 2024 at the earliest.”* Therefore it does not expect to raise policy rates before then. This underscores the RBA's commitment to achieving its inflation target given policy will remain so accommodative for so long despite much better than expected economic conditions. It also highlights just how much stimulus it thinks is required to return inflation to its target on a sustainable basis. We may get some guidance at the July meeting on the RBA's unconventional policy and in what way it will continue or taper its bond purchases. But we expect the RBA to remain cautious as it does not want to unduly tighten policy relative to other central banks and underpin a marked appreciation of the AUD.

GRAPH 04 QUARTERLY AND MONTHLY INFLATION MEASURES

Base effects will see inflation above target next quarter



Source: IFM Investors, ABS, Melbourne Institute as at 2 June 2021

In fiscal policy, the 2021-22 Federal Budget was released in May and surprised with a significantly higher than expected forecast deficit of A\$106.6bn in 2021-22. The government is set to spend most of the windfall from the 2020-21 deficit that was significantly lower than expected in the December Mid-year Economic and Fiscal Outlook (MYEFO). Indeed, the 2020-21 deficit was revised down to A\$161.0bn compared to December's MYEFO expectation of A\$197.7bn, supported by a faster than expected labour market recovery and elevated iron ore prices. This was a surprisingly progressive budget for a traditionally conservative government, with focus in the medium term on supporting the economy – particularly with respect to reaching full employment (unemployment below 5%) – rather than fiscal consolidation. This is a welcome change of tone and represents a further alignment of monetary and fiscal policy over the near- to medium-term. New spending is targeted towards households and social services but regrettably there is little in the way of meaningful structural reform, something that we see as being key to addressing weaknesses in the Australian economy and supporting growth over the longer term.

US: Fiscal fuel on the fire

The US economic recovery continues, with real GDP up by 6.4%qoq annualised – a touch lower than expected – in the first quarter of 2021. The key growth drivers were personal consumption which contributed 7.4pp annualised (durable goods consumption recovered particularly well from Q4 2020 up 48.6%qoq annualised) and fixed private investment which contributed 1.96pp annualised. The key drags on growth were a rundown of private inventories, subtracting 2.78pp annualised, and net exports (-1.2pp annualised). The lifting of public health restrictions, a strong vaccination rollout and fiscal transfers to households were all important factors in the recovery.

However, despite this growth, key labour market data in recent months have sent mixed signals. Employment growth was strong in February and March, with the unemployment rate falling to 6.0% in March. Yet data for April disappointed, with a huge miss relative to expectations: nonfarm payrolls recorded a net 266,000 new jobs added in April against expectations of an increase of 1 million. This contrasts with other solid labour market data over the month – particularly record-high job openings – and is at odds with the continued reopening of the economy. The household survey for April was also surprisingly soft, with the unemployment rate unexpectedly ticking up from 6.0% to 6.1% (still below the 6.3% in January). However the details here are more encouraging, with rising unemployment not driven by a net loss of jobs but by the firming of the participation rate to 61.7% that more than offset a net increase of 328,000 jobs. The current expectation is that payrolls will rebound as the recovery continues. The number of job openings supports this contention, despite the suggestion that higher rates of unemployment benefits are incentivising some lower paid works not to seek employment.

In contrast to the disappointing labour market data, inflation has sharply accelerated in recent months. Personal consumption expenditure (PCE) measures were strong, with the headline measure up 3.6%yoy in April (highest since September 2008) and the core measure up by a more-than-expected 3.1%yoy (highest since July 1992). CPI inflation for April was similarly strong and surprised materially to the upside, with the headline measure accelerating to 4.2%yoy (fastest since 2008) and the core measure up 3.0%yoy (fastest since 1995). In both instances, this is partly driven by base effects. Month-on-month figures were also strong. Take core CPI inflation for example which rose 0.9%mom (strongest since 1981).

Personal income and spending have both been volatile in recent months given the disbursement of various support payments made to households as part of further expansionary fiscal policies. Personal income has been well above pre-pandemic levels in recent months – up around 11% from February 2020 levels even after a 13.1% fall in April. Personal spending is up around 4.6% on February 2020 levels. The consumption outlook strengthened in recent months, with consumer confidence up sharply from February but still well below pre-pandemic levels.

Fiscal policy continues to be important, with the Administration's relief bill worth approximately US\$1.9tn being signed in to law in early March. The package included US\$1,400 direct payments to eligible individuals and an extension to the enhanced unemployment insurance benefits of US\$300 per week. However, the increase in the minimum wage to US\$15/hour that was in the original bill was scrapped.

GRAPH 05 US PAYROLLS AND JOB OPENINGS

The jobs are there to support employment growth



Source: IFM Investors, U.S. BLS, Macrobond as at 2 June 2021

» In monetary policy, the Fed has left key policy settings unchanged since its January meeting. The Fed did appear more optimistic on the economic outlook at its March meeting, however, upgrading projections of real GDP growth in Q4 2021 from 4.2%yoy to 6.5%yoy and lowering its unemployment forecast for Q4 2021 from 5.0% to 4.5%. In terms of inflation (core PCE), the Fed now expects 2.2% in 2021, 2.0% in 2022, and 2.1% in 2023. But despite the improved inflation outlook, the Fed signalled that rate rises won't happen until 2024. Minutes from the March meeting show that Fed staff expect GDP growth to step down but still outpace potential growth through 2022 and 2023, with the unemployment rate expected to fall to historically low levels. The key takeaway from the April meeting was an update to the post-meeting statement acknowledging that economic activity had strengthened and that inflation had risen primarily due to transitory factors. Despite the characterisation of inflation as transitory in the post meeting statement, minutes from the April meeting suggest that the Fed is thinking about normalising policy sooner than initially anticipated with a number of participants suggesting it may be time to start discussing tapering asset purchases. The recent strong CPI prints and the material firming of inflation expectations in recent months may lend further weight to these more hawkish comments but should be viewed against the weak payroll numbers.

UK: Vaccination optimism

A national lockdown was in effect over much of the first quarter and this weighed heavily on UK growth, with the economy shrinking 1.5%qoq (from an already low base). This outcome was marginally better than expected and brings year-on-year growth to -6.1%. In terms of the components of GDP, private consumption was particularly disappointing (-3.9%qoq) as restrictions hampered spending and investment was soft (-2.3%qoq), with business investment particularly hard-hit (-11.9%qoq). Government investment was a key outperformer (19.7%qoq), with government consumption also positive (2.6%qoq).

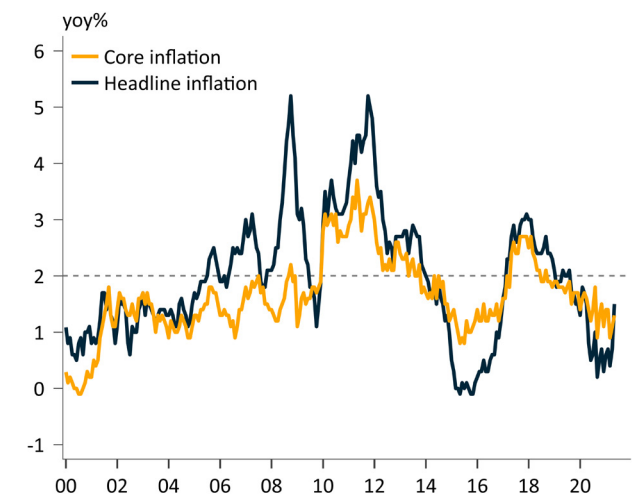


High rates of vaccinations, lifting restrictions and additional economic stimulus suggest a consistent path for UK economic recovery over remainder of the year.

Against this soft economic backdrop, further fiscal stimulus was announced in the UK in March with the unveiling of the 2021 budget. Support measures are worth around £65bn (2% of GDP), including an extension to the furlough scheme that provides employees 80% of their usual wages. As a result of this additional easing, the 2021/22 deficit is projected to stay above 10% of GDP. Tax increases were also announced, including a freezing of personal tax thresholds from next year and an increase in the corporate tax rate from 19% to 25% in 2023. High rates of vaccinations, lifting restrictions and additional economic stimulus suggest a reasonably consistent path of economic recovery is probable for the remainder of the year.

GRAPH 06 UK INFLATION

Inflation is set to rise further but not materially above target



Source: IFM Investors, ONS, Macrobond as at 2 June 2021

The extension of labour market support appears to have been effective, with employment growth in the three months to March coming in better than expected at 84,000. The unemployment rate also beat expectations, falling for a third consecutive month to 4.8%. Experimental indicators from the Office for National Statistics (ONS) were not as positive, however in the three months to April. The claimant count rate has remained largely unchanged since May 2020, oscillating between 7.0% and 7.3% (a near 25-year high) to be at 7.2% in April. Jobless claims change figures have been volatile, with a sharp rise in February before falls in March and April. Government policy remains supportive, but these data suggest that unemployment won't rise too far when support eventually does end. A key uncertainty is the extent to which the pandemic has precipitated structural changes in labour demand that enable the economy to effectively absorb workers when policy support expires.

Headline inflation firmed sharply in April, as expected, rising to 1.5%yoy. As with most other economies, this is largely due to pandemic base effects (combined with a sharp hike in household energy prices over the month).

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» Core CPI also beat expectations but firmed to a more moderate 1.3%yoy. Bank of England (BoE) Governor Andrew Bailey appears dovish about any potential inflation and flagged in a report to parliament's Treasury Committee that *"transitory developments should have few direct implications for inflation over the medium term"*. BoE Chief Economist Andy Haldane was more hawkish and noted that if the momentum of the economic recovery is sustained, there will be *"persistent upward pressure on prices, risking a more protracted – and damaging – period of above-target inflation."*

In terms of monetary policy, the BoE left the bank rate unchanged in recent months but did announce in May that it will taper the pace of its government bond purchases from £4.4bn to £3.4bn per week. The Bank also acknowledged the strength of the recent economic data and offered no pushback against the rise in yields that has taken place in recent months (contrasting the stance of the European Central Bank (ECB)) as, in the BoE's view, this is being driven by a stronger growth outlook.

Eurozone: Double-dip recession

The Eurozone economy has struggled in recent months. After a negative Q4, the Eurozone suffered another quarter of negative GDP in Q1 to record a double-dip recession. Lockdown measures to address upswings in COVID-19 case numbers weighed heavily on activity over the quarter. Real GDP contracted 0.6%qoq to see the year-on-year rate 'improve' to -1.8%. The year-on-year rate is flattered by base effects given the significant fall in Q1 GDP in 2020. Compared to pre-pandemic (Q4 2019) levels, output was 5.5% lower in Q1 2021. By country Germany was the hardest-hit of the big four (-1.8%qoq), though this is partly a reflection of the outperformance of the German economy in previous quarters relative to the other large Eurozone economies. Real GDP contracted by 0.1% in France, 0.5%qoq in Spain and 0.4%qoq in Italy.

However, more timely data from the region suggests that, following this period of protracted weakness, a robust rebound in activity is likely. In consumption data, March retail sales surprised to the upside (2.7%mom), with a significant upward revision to February's data and are now up 12.0% in



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year-on-year terms. This strong retail performance was likely supported by easing restrictions across the bloc over the month and suggests that further strength is on the cards as restrictions continue to be rolled back. Consumer confidence for May is another positive for the consumption outlook, firming more than expected to -5.1 to be above pre-pandemic levels for the first time since the pandemic began. Other confidence indicators performed equally well, with key measures for the bloc at or above pre-pandemic levels: Services confidence – long weighed down by restrictions on service-based activities – firmed sharply over the month to 11.3 and is back around pre-pandemic levels; economic confidence continues to improve and climbed further above pre-pandemic levels to 114.5 over the month; and industrial confidence (already at an all-time high in April) firmed to 11.5 in May. Details of the surveys highlight rising price pressures as firms plan to raise prices in coming months. Despite some price pressures emerging for producers, consumer price inflation remains relatively muted, with a 0.3%mom increase in prices in May to be 2.0% higher through the year. A rise in energy prices has been a key driver in the acceleration of inflation and should fade. Core price inflation, while picking up modestly, remains subdued at just 0.9%yoy and there seems little reason to expect a material outbreak in inflationary pressures across the region.

Key survey data – preliminary Purchasing Managers Index (PMI) data adds to the narrative that the Eurozone is improving steadily. The services PMI firmed more than expected to 55.1 and the manufacturing PMI ticked down to 62.8 but remains well into expansionary territory. This leaves the composite read at 56.9 in May, the highest level since early 2018 as regional economies slowed at the tail-end of the synchronised upswing in global growth.

GRAPH 07 EUROZONE SENTIMENT SURVEYS

Sentiment has recovered across the economy



Source: IFM Investors, European Commission, Macrobond as at 2 June 2021

» The European Commission (EC) also forecast an improved economic outlook in its recently updated assessment of Eurozone growth. The EC now expects annual GDP growth of 4.3% in 2021 and 4.4% in 2022 (up from February forecasts of 3.8% in 2021 and 3.8% in 2022). Inflation is also forecast to be stronger in 2021 at 1.7% (compared to 1.3% expected in the February forecasts) but is forecast to slow back to 1.3% in 2022 as previously expected.

The ECB left settings unchanged at its meeting in March. But it recommitted its intention to keep policy accommodative, despite global forces, by announcing that it will front-load its asset purchases in the coming quarter following a rise in bond yields in response to inflation fears. This comes as the ECB left its growth expectations largely unchanged from December (4.0% in 2021, 4.1% in 2022). The ECB is also projecting stronger – but still far below target – inflation, reaching just 1.4% in 2023. ECB President Lagarde also stressed that the Bank will look through any temporary inflation acceleration and that the elevated spare capacity in the economy would hold wage pressures down. Minutes from the March meeting also flagged that the Bank views risks to the growth outlook as being more balanced than at the previous meeting.

Japan: Growth reverses in Q1

The Japanese economy contracted more than expected in the first quarter of 2021, according to preliminary figures. Real GDP contracted 5.1%qoq annualised, with very weak (but better-than-expected) private consumption that was down 5.4%qoq annualized and a significant disappointment on business spending that was down 5.5%qoq annualised. On the public side, government consumption (-6.9%qoq annualised) and government investment (-4.2%qoq annualised) both fell materially as well. This GDP outcome represents a sharp slowdown from the previous quarter, owing to a second state of emergency and renewed restrictions implemented in Q1 in response to a worsening COVID-19 situation. To make matters worse, a state of emergency for Tokyo and three other prefectures was declared in April in response to an alarming upswing in COVID-19 cases. Bars, department stores and theatres across Japan are closed for a period in an attempt to control the spread. The state of emergency was later extended. This will weigh on the nascent economic recovery in Japan and presents downside risks to Q2 growth.

In other economic data, the labour market appears to have softened in April, with the jobless rate rising more than expected from 2.6% to 2.8%. The job-to-applicant ratio ticked down to 1.09 (but has been oscillating between 1.1 and 1.09 for four months). Labour cash earnings unexpectedly firmed (0.2%yoy) in March but this follows a 0.2 percentage point downward revision to February's figure.

GRAPH 08 JAPAN GDP GROWTH

GDP growth slowed in Q1 and the outlook is subdued



Source: IFM Investors, SBJ, Macrobond as at 2 June 2021

In consumption data, household spending firmed significantly more than expected in March (6.2%yoy). This is in contrast to April retail sales figures which fell more than expected (-4.5%mom). In year-on-year terms, retail sales are up 12.0% but this reflects the exceptional fall in retail sales in the beginning of the pandemic. Compared to pre-pandemic levels (February 2020), retail sales are down 2.5%. The soft April figures are driven largely by a combination of the aforementioned emergency COVID control measures and various states of emergency in effect over the month. The quarterly tankan indices for large enterprises beat expectations in Q1, particularly in manufacturing, where conditions were up 15 points to 5, and the outlook firmed to 4 (both the highest readings since Q2 2019). Non-manufacturing conditions (-1) and outlook (-1) also improved but the measures both remain well below pre-pandemic levels as the services industry continues to struggle.

The spectre of high inflation continues to be notably absent in Japan. April inflation was broadly in-line with expectations after slowing significantly. Headline prices deflated at a faster rate (-0.4%yoy) than the prior month, marking the seventh consecutive deflationary print and the core measure fell again into deflationary territory (-0.2%yoy). Tokyo inflation was also broadly in line with expectations in May, with the headline measure firming to -0.4%yoy and the core measure softening to -0.1%yoy.

In monetary policy, the Bank of Japan (BoJ) left its policy rate and 10-year yield target unchanged in March but the Bank did widen the band around the yield target that it will allow rates to fluctuate within. The BoJ also established an interest scheme to promote lending and gave itself greater flexibility in its Exchange Traded Fund (ETF) and J-REIT purchasing operations. At its April meeting, the BoJ made some positive adjustments to the language in its Outlook Report around the economic situation, with an upgrade to FY2021 and FY2022 growth to 4.0% and 2.4%, respectively.



HEAD OFFICE

Level 29 | Casselden | 2 Lonsdale Street | Melbourne | VIC 3000
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