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ECONOMIC UPDATE

It's not over just yet

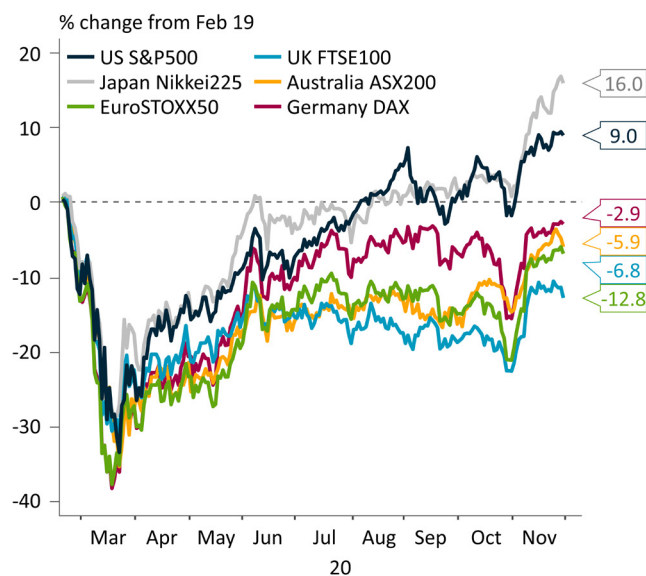
Globally, a surge in COVID-19 over the fourth quarter will weigh on growth in the near term and highlights economies' continued vulnerability to the virus. To this end, the announcement of several promising vaccines has at last provided some light at the end of the tunnel. Equity markets have continued to recover well over November in response to the news but the underlying economic picture remains mixed. We believe policy measures will need to remain extremely accommodative as economies adjust to a 'new normal', with fiscal policy needing to do most of the lifting as monetary policy has been stretched to its limits.

Global: The challenge ahead

As we move into the last month of a tumultuous 2020, equity markets have recovered strongly. Both the S&P500 and the Dow Jones index reached record-highs and appear to be closing the year full of optimism; buoyed by entrenched monetary stimulus, the promise of more fiscal stimulus in the New Year and positive news around vaccines. We've noted before that it's been a remarkable recovery for markets given the depth of the recession. But markets are again comfortable pricing in better economic times as long as it is supported by ongoing and seemingly limitless – for the time being – policy support. Also notable are the winners and losers emerging from the current public health and economic paradigm. Broadly, the winners are larger companies that could sustain or even increase trade as public restrictions hit. Companies that couldn't do this have struggled. Among advanced economy equity markets, Japan has also finished the year well, reaching a high not seen since 1991. This comes as investors look to an export led recovery as global growth returns. Other markets have not returned to pre-pandemic highs: the Eurozone is grappling with high COVID-19 cases; the UK has a high COVID-19 caseload and must also contend with Brexit; and Australia's relative economic success is not reflected in the level of its equity market.

GRAPH 01 GLOBAL EQUITY MARKETS IN 2020

Markets remain relatively optimistic on 2021 growth



Source: IFM Investors, Macrobond

» The question is whether the confidence that markets seemingly exude is warranted going into 2021? Only time will tell, but our economic outlook remains cautious, particularly in the near-term. While markets are riding high into the end of the year, the economic picture around the world is mixed. This is because of resurgent COVID-19 case numbers throughout the US, UK, and the Eurozone in particular, as we enter the Northern Hemisphere winter. Restrictions have been re-imposed in the UK and the Eurozone and these will take an economic toll. In the US, restrictions vary across states and a more uniform approach to tackling this may be forthcoming with the inauguration of President Elect Biden in January. So, it will likely be an uncertain start to the New Year in growth terms. And while global growth should be much improved in 2021, compared with 2020, this will mainly reflect a rebound once the most stringent restrictions are lifted. Other restrictions that take more time to be lifted, such as social distancing, forms of social and business gatherings and international travel, will remain a drag. Consequently we will not be back to a pre-pandemic level of output for some time to come.

A similar dynamic is likely to also take place in the labour market. Of the major economies, material improvements have so far happened only in the US. However, after the initial spike in employment that will come after restrictions are lifted, further progress in the labour market may become more difficult to achieve for the same reasons that economic activity will be impinged in the future. Further, we know from previous recessions that labour markets take longer to repair than economic output. Even with significant fiscal support in many economies, the labour market recovery will likely lag in this recession and will be disparate across countries. The relatively rapid fall in the US unemployment rate, and the expectation that unemployment in the US will have peaked around mid-2020, contrasts with the experience in many other developed economies where the unemployment rate is expected to peak in 2021 or at least late-2020, before slowly retracing. This is at least partly attributable to differing policy responses: the US prioritised protecting household incomes with expanded unemployment benefits so the many individuals who lost their jobs were supported, whereas other economies (e.g. Australia, the UK, and the Eurozone) prioritised preventing jobs being lost in the first place.

The question of which approach is better is largely informed by the nature of the economic shock that the policies are aimed at addressing. Should the shock prove transitory, with little structural impact to an economy, the job protection approach is likely to be better as underemployed/furloughed individuals can rapidly and easily return to work with existing employers, facilitating a faster recovery. If the connection between employers and employees is severed in this scenario, the recovery will be hampered by the lags associated with previously employed individuals needing to search for appropriate roles. The income protection approach is likely better if the shock in question is more

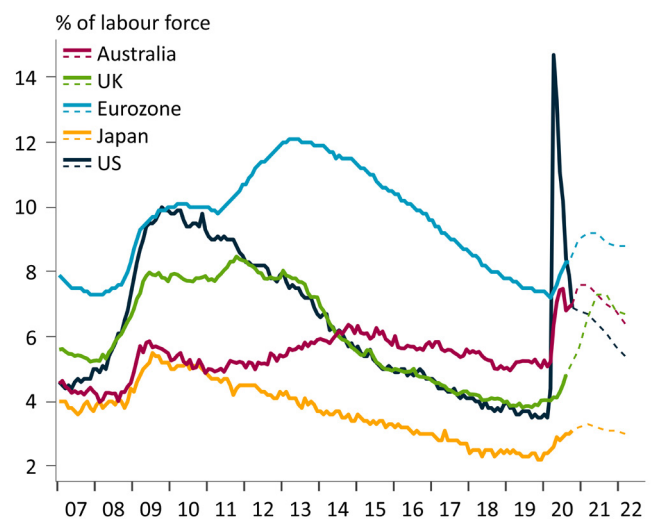


While markets are riding high into the end of the year, the economic picture around the world is mixed

persistent and leads to more structural shifts in the economy (as appears increasingly likely in the COVID-19 shock). In this scenario, labour resources can be more efficiently reallocated as unemployed persons move to areas of the economy where labour demand is highest. The job protection approach in this scenario may distort the allocation of labour resources by continuing to support individuals for whom there may no longer be demand for their original roles. This disincentivises them from seeking out employment in other industries and contributes to a more sclerotic labour market recovery.

GRAPH 02 GLOBAL UNEMPLOYMENT RATES

Market forecasts of unemployment rates



Source: IFM Investors, National statistical agencies, Bloomberg, Macrobond

This is an important point to address as we know that monetary support in developed economies in particular will be in place for as long as there is any spare capacity in labour markets. Indeed, the US Federal Reserve (Fed) has moved from the concept of 'full' employment to 'maximum' employment. To achieve this, inflation will be allowed to run above target for a period of time. Other central banks are coming to, or have arrived at, similar conclusions. The Phillips curve will have to be pushed even harder in the post-COVID period than it was before, as wages are considered a key



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The commitment to boost inflation and using entrenched ultra-accommodative policy settings to get there, suggests low real bond yields will persist and underpin the performance of growth assets in particular.



driver of sustainable inflation. That said, it seems uncontroversial to suggest that monetary policy alone will have just as difficult a time as it did before the crisis, if not more so, in achieving this objective. The commitment to boost inflation and using entrenched ultra-accommodative policy settings to get there, suggests low real bond yields will persist and underpin the performance of growth assets in particular.

We believe fiscal support will also need to be entrenched. Currently this seems less assured, with governments identifying dates at which schemes will end, and then extending them – creating unnecessary uncertainty for employers and employees alike. It is well acknowledged that fiscal policy needed to play a greater role in the management of this crisis than in previous crises. But we do not view this as a short term phenomenon. Indeed, the COVID-crisis has forced the hand of central banks and virtually exhausted the effectiveness of their policies to generate real economic growth. We believe that this will force fiscal-policymakers to the fore, whether they like it or not. This will require both the deft management of fiscal policy budgetary settings and a commitment to not remove these accommodative policy settings too quickly. Indeed, the success of fiscal policy in 2021 will be judged by how well labour markets recover and economies can be weaned off of fiscal support. A deployed vaccine will clearly be crucial to these efforts as economies can normalise more quickly. Consensus seems to be that a vaccine could start to get traction in the second half of 2021, but there remains uncertainty around its effectiveness. There is also uncertainty around how much confidence a vaccine will give to households to behave in the manner they once did and how the business sector will respond. The likelihood of significantly better investment seems remote as the pre-COVID challenges remain. It is also a vexed debate as to what a new 'COVID-normal' will look like, in terms of how we work, consume, travel and even interact. The likely changes that take place could both impede growth and

provide opportunities for it.

In 2021 and beyond, fiscal policymakers will need to more actively address the challenges that presented themselves in the wake of the Global Financial Crisis but were never solved. The global dearth of productivity growth is key among them. Success in this space is needed to drive living standard improvements and push back against declining potential growth rates. And in a highly indebted world, nominal growth from this and any other source, will be key as advanced economies in particular carry an even greater public debt load coming out of the crisis. Monetary policy is going to be side-lined for some time. Indeed, an exit plan from the current very accommodative policy settings is not even being actively contemplated. Economies will eventually recover from this crisis, but they clearly won't be 'better', nor ready to face future setbacks in the near term. And the course for policymakers to improve the economic outlook in coming years will likely be tougher than ever.

Australia: RBA goes all in

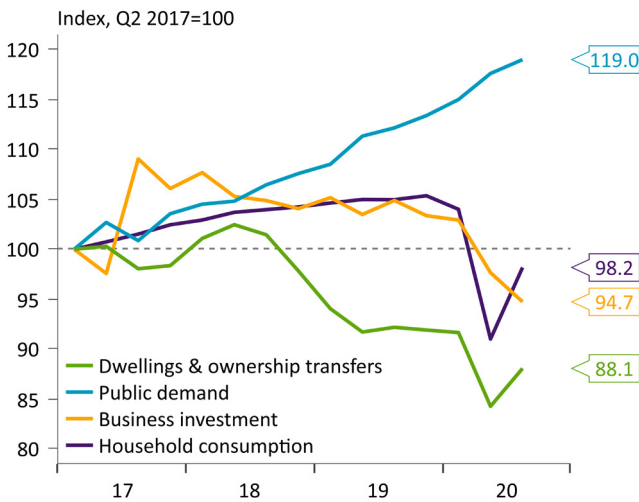
Australia is an outlier among the advanced economies. The material second wave of COVID-19 in Victoria has been effectively handled. The pain of the required restrictions hit the economy in Q3 and consequently it underperformed the rebound in GDP that occurred in other countries (particularly in the Northern Hemisphere), where the median increase so far is 7.8%qoq. Yet the Australian economy should outperform in Q4 as those countries are again impacted by the virus, while Australia continues to open up.

The economy rebounded 3.3% in the third quarter, ending the technical recession, but remains 3.8% weaker than this time last year. Household spending was a key driver of growth in the quarter, rebounding 7.9%qoq and accounting for 4.0pp of quarterly growth. However the rest of the private sector again went backwards, with business investment declining 4.1%qoq and demonstrating the current level of uncertainty in the outlook. Dwelling investment rose modestly due to alterations and additions rather than new home building. Public spending rose again and remains elevated at 22% of real GDP, a record amount this year and required, in part, to support ongoing recovery. Disappointingly, public investment (largely infrastructure), despite rising 3.3%qoq in the quarter, was flat through the year – this comes despite the large dollar amounts spoken about on infrastructure spending. Net exports subtracted a record 1.9pp from real GDP as imports rose, as domestic activity picked up, and export volumes slumped as resources and agricultural exports fell after recent growth.

By state, as expected we saw a smaller than expected contraction in Victorian state final demand which fell 1.0%qoq. By contrast, New South Wales and Queensland led growth, both recording a 6.8%qoq expansion. Victoria's impact is more obvious in through the year growth, as it accounted for -2.5pp of the 3.5%qoq decline in Australian domestic final demand.

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GRAPH 03 DOMESTIC DEMAND KEY DRIVERS

Further rebound to come but we need to do better

Source: IFM Investors, ABS, Macrobond

In the absence of a further outbreak, we should see some consistent growth heading into 2021. But this will need to be supported by ongoing and aggressive policy support. This was forthcoming on the fiscal side, with the Commonwealth Budget for 2020-21 released in October. Existing measures, such as the JobKeeper/JobSeeker programs, were extended (as flagged by policymakers in July) and additional support measures were announced including 1) the JobMaker hiring credit subsidising the hiring of eligible younger workers and worth A\$4 billion over four years, 2) an expanded infrastructure pipeline of circa A\$10 billion over four years, 3) an additional A\$17.8 billion in personal income tax relief of which A\$12.5 billion will come in the next 12-months, and 4) temporary tax incentives to encourage private investment.

Support was also forthcoming in monetary policy, with the Reserve Bank of Australia (RBA) easing policy settings in November, as had been widely expected. The cash rate target, 3-year yield target, and the lending rate on new drawings under the term funding facility (TFF) were cut 15bps to 0.1%. This marks another record-low cash rate. The RBA also announced it would undertake conventional quantitative easing (QE) for the first time. Purchases of 5- and 10-year bonds will be worth A\$100 billion over the next six months and the RBA encouraged markets to look at its balance sheet as a guide to how accommodative its policy is. At the time, the RBA's balance sheet was around 15% of GDP and it will now move towards 20%. This is large in a domestic context, but still well short of what major global central banks have undertaken. The curious accompaniment to this further easing was an improved assessment of the economy in November, but the RBA continues to emphasise the significant uncertainties around its assessment. The growth outlook was upgraded (6%yoy in June 2021 vs 4%yoy

previously), and the unemployment rate is expected to peak at 8% in December 2020 versus 10% previously. However, considerable labour slack is still expected by the end of 2022, with the unemployment rate at 6%. Considering what more can be done, the RBA pushed back against implementing negative interest rates, highlighting that "The Board is not contemplating a further reduction in interest rates" with additional QE being flagged as the focus should further easing be required. The RBA's December meeting came and went without incident, flirting with a glass half-full narrative as recent data have been "better than expected". That said, the RBA remains ready to add more stimulus if necessary.

In economic data, the labour market performed well in August-October, with weakness in Victoria more than offset by rebounds in the other states. Employment growth over this period was unexpectedly strong, with more than 300,000 new jobs added to the economy. Employment is now just 1.7% below pre-virus levels. The strong employment growth saw the unemployment rate fall to 7.0% in October from 7.5% in July. This is despite a significant firming in the participation rate to 65.8% in October to be back around pre-pandemic levels. But hours worked, which is likely a better measure of labour market slack given the potential distortions to the unemployment rate as a result of government policy, remains around 3.8% below pre-pandemic levels. Labour market repair remains the key focus of both monetary and fiscal policies. Only when the labour market resembles or betters pre-crisis levels of unemployment can we confidently assert the recession is over.

Spare capacity in the labour market and pressure on business saw wages growth for Q3 slow to just 0.1%qoq to be 1.4% up versus a year ago. This is the slowest annual rate of growth since index inception in 1997. The outlook for household income remains soft given that upward pressures to wages are contingent on reducing slack in the labour market which is unlikely over the near- to medium-term. Income support measures from the government will need to remain in place for some time and forthcoming income tax cuts will also be important to prevent a decline in household spending. Preliminary retail trade data firmed in October (1.6%mom) and are now well above pre-pandemic levels,

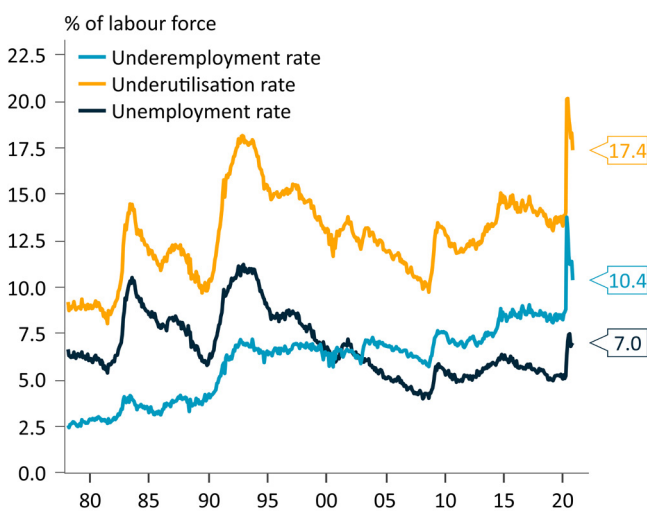


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with the consumption outlook also improving after consumer confidence firmed for the third consecutive month in November to 107.7, the highest in seven years. This increased confidence is also prompting a recovery in property markets, which will likely continue into 2021 and indeed could gather so much momentum that it becomes concerning for the RBA as it keeps its policy rates low for such an extended period.

GRAPH 04 LABOUR MARKET DISLOCATION

Still much to do to repair the labour market



Source: IFM Investors, ABS, Macrobond

Inflation pressures were also very modest in Q3 data. The trimmed mean measure firmed but remains near all-time lows in year-on-year terms at 1.2%. The headline measure rebounded following a very weak Q2 but this was largely driven by a rebound in childcare and petrol prices and the measure remains well below target (0.7%yoy). We'd note that the RBA has allowed its favoured trimmed mean measure of inflation to wallow below the bottom of the target range for an extended period. To get inflation back to where it is mandated will require a much tighter labour market than before this crisis and that's going to be some time off to say the least.

Australia appears poised for a reasonable recovery in the near-term given the expected ongoing management of the public health crisis and a vaccine to be deployed likely in H1 2020. But some growth will likely be held back until late in the year at the earliest, particularly that generated by the inflows of tourists, students and broader migration that supported the pre-COVID economy. There is also increasing concern around the deteriorating relationship with China and the economic impact it may have. In the medium term, the outlook remains modest in our view, losing momentum in the wake of the recovery. Private sector activity was weak

pre-virus and was unresponsive to then record levels of monetary accommodation. There seems little reason to believe that will change. And the issues of weak productivity growth and high household debt that characterised the economy leading into this crisis remain going forward.

US: Charting a new course?

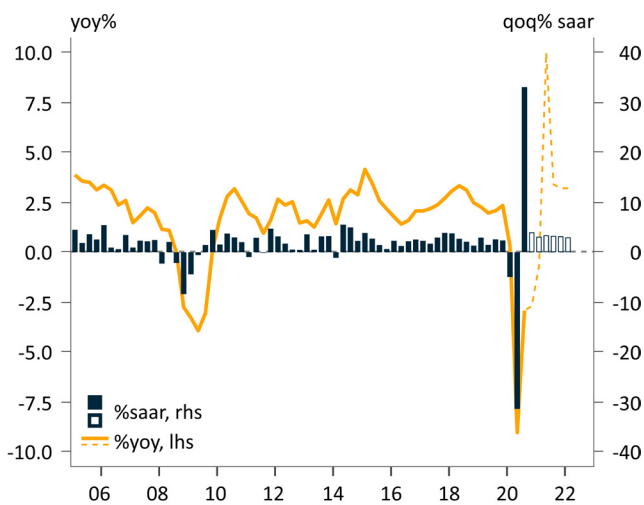
There's no mistaking that the key event on the US calendar this year was the presidential election. Joe Biden has become President-elect appearing, at this stage, to have bested President Trump by a projected 306 electoral votes to 232, in a race that was closer than anticipated. Whilst the incumbent President has so far refused to officially concede, raising concerns of voting irregularities in some States, we expect a concession will come in due course. But as President Trump exits the political scene, the longer-term thematic of populism he represented remains. Voter turnout in the 2020 election easily eclipsed that of 2016, Biden received a record number of votes, around 80 million. However, Trump got around 74 million, more than 10 million more than he received in 2016 and also a record for a Republican candidate (and more than either Hillary Clinton received in a losing campaign or Barack Obama received in his two winning ones). Accordingly, the Republican Party has a strong mandate to frustrate policymaking. To this end, the two Senate runoff elections in Georgia on 5 January are a focal point as the Democrats need to win both seats to gain control of the Senate and, by extension, control of Congress (the Democrats retained control of the House). This appears an unlikely outcome, however, and if the Republicans do retain control of the Senate, Biden's policymaking will likely be severely constrained by an intransigent Republican Senate for at least two years. This will be most keenly felt in domestic policy where some of the more ambitious plans on Biden's agenda – including tax hikes, a significant climate package, and a US\$15 federal minimum wage – will likely fall prey to Republican fiscal hawkishness.

The size of any further COVID-19 support will also depend on who controls the Senate: a Republican Senate is unlikely to pass another multi-trillion dollar package. At the time of writing, a US\$908 billion bill with bipartisan support was announced that would provide further support for small businesses, the unemployed and airlines. The bill still needs approval from the Trump administration, Biden and House and Senate leaders to become law. Should this fail, the chance of another major fiscal support package before year-end seems unlikely, despite the recent expiration of key fiscal support measures. We'd hope a package would then be forthcoming in the New Year, after the inauguration, and amount to between US\$500 billion and US\$1 trillion. Biden will be less constrained in foreign policy and he will likely pursue a more conciliatory approach with US allies than his predecessor. But he will remain tough on China, although likely taking a more conventional multilateral approach in doing so.

In economic data, US real GDP rebounded strongly in the third quarter (33.1%qoq annualised) with a strong rebound in personal consumption (particularly in services) accounting for the bulk of the improvement (25.2ppts). Despite this record-breaking expansion, output remains down 2.9% year-on-year.

GRAPH 05 US REAL GDP GROWTH

Market economist forecasts look for post-COVID growth



Source: IFM Investors, BEA, Bloomberg, Macrobond

The US labour market has, on balance, performed better than expected in recent months. In the three-months to October, 2.8 million net jobs were added. This strong jobs growth has seen the unemployment rate fall exceptionally quickly from the 14.7% peak seen in April to 6.9% in October. This is in stark contrast to the painfully slow fall in unemployment seen after the GFC. Labour force participation has also improved (61.7 in October) but remains well below the 63.4% in February. Underemployment has also fallen to 12.1% in October - still elevated by historical standards but a significant improvement from the 22.8% seen in April. Initial jobless claims for November were concerning, however, after rising for two consecutive months. This suggests that the strong labour market recovery may stall in the near term. In line with the elevated spare capacity in the labour market, inflationary pressures remain subdued and softened in October, with headline CPI inflation slowing more than expected to 1.2%yoy and the core measure unexpectedly ticking down to 1.6%yoy. PCE inflation also softened over the month (headline: 1.2%yoy, core: 1.4%yoy). Similarly, personal incomes over this period fell (-0.7%mom), largely reflecting the expiration of fiscal support measures. Although personal spending increased slightly more than expected (0.5%mom), funded partly by a fall in the savings rate. The consumption outlook has deteriorated in recent months with the recovery

in consumer confidence stalling following a larger-than-expected fall in November (96.1).

In monetary policy, settings remained unchanged but Fed officials did note that the economy has recovered significantly faster than anticipated. Officials also highlighted that the recovery has a long way to go, with an emphasis on downside risks (particularly a deterioration in the COVID-19 situation and a lack of further fiscal aid). Minutes from the November meeting show that FOMC participants see the current stance as appropriate and essential to support the recovery. And given the desire to allow inflation to run over 2%yoy we expect these settings to be entrenched for some time with the main risk being for more stimulus not less.

Looking forward, more stimulus may be needed should the worsening COVID-19 caseload have to be aggressively managed, with restrictions, in the near term. There is a risk that the situation will deteriorate further over the holiday season as Americans travel and gather with family and that more stringent social distancing restrictions may be implemented, weighing on activity. We expect Q4 2020 and Q1 2021 to be soft but in the medium-term, the positive news around vaccines poses an upside risk to 2021 growth. The US is well placed to vaccinate a significant proportion of its population in a relatively short timeframe. This would support a more rapid normalisation of activity than could have been hoped for earlier.

UK: Brexit (still) awaits

The UK economy recovered sharply in Q3 2020, with real GDP jumping 15.5%qoq, largely in line with expectations. Yet this came after the economy suffered the largest quarter-on-quarter GDP fall in modern history. All told, the UK economy remains 9.6% smaller than this time last year following the eye-watering 19.8%qoq collapse in activity in Q2. Private consumption fared especially well, beating expectations to be up 18.3%qoq, as restrictions were lifted and Britons were encouraged to go out and spend. Gross fixed capital formation also surprised to the upside (15.1%qoq), although business investment disappointed, rising just 8.8%qoq following a 26.5%qoq collapse in Q2, with the sector remaining cautious as to the outlook. The measure remains 20.7% down in year-on-year terms. Government spending missed expectations as well (7.8%qoq).

Against this backdrop, the Bank of England (BOE) left the policy rate unchanged at 0.1% but announced a larger-than-expected increase (£150 billion) to its QE program in November to provide further monetary accommodation. Monetary policymakers also noted that risks appear tilted to the downside - in particular given renewed lockdowns and Brexit uncertainty - such that strong early action was warranted. The BOE did not, however, provide any further indication around the likelihood of negative rates. In fiscal policy, Chancellor Sunak announced additional fiscal support measures in September, including a scheme to support the

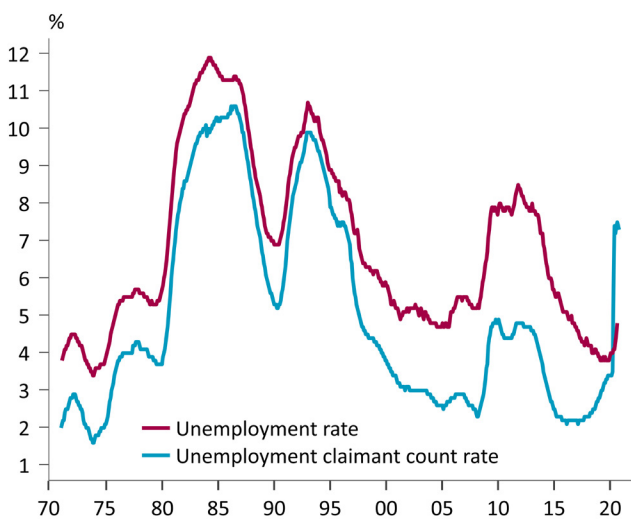
wages of employees, an extension to the VAT cut for certain industries, and more spending on public services. Further fiscal easing will likely be forthcoming in the near term.

This additional fiscal support will be needed given that another nationwide lockdown began in November as COVID-19 cases surged across the country. Impacts are already being seen in more timely data. The composite PMI plunged back into contractionary territory (47.4) in November as activity in the services sector slowed materially, despite the manufacturing sector still expanding.

Consumer and business confidence both fell in October and November to -33 and -21, respectively, following four consecutive months without a fall. Both confidence measures remain well below pre-pandemic levels and consumer confidence is just 1 point above the pandemic low score of -34. Somewhat surprisingly, retail sales continued to be an outperformer and unexpectedly firmed in October (headline: 1.2%mom, core: 1.3%mom) such that the core measure is now up 7.8%yoy. This strength will likely fade in the near term given the circumstances.

GRAPH 06 UK UNEMPLOYMENT AND CLAIMANT COUNT

The unemployment rate remains low, but looks set to rise



Source: IFM Investors, ONS, Macrobond

The labour market in the UK continues to deteriorate. In the three months to September 164,000 net jobs were lost, which saw the unemployment rate lift to 4.8% as expected. As highlighted in previous commentary, these data are lagged and continue to be distorted by government policy. More timely experimental data for October are encouraging, with the claimant count rate falling to 7.3% and the number of jobless claims falling by 29,800, following a downward revision to September's print from a 28,100 rise to a 40,200 fall. But given the sharp deterioration in the outlook since then, further weakness is likely.

Inflation firmed more than expected in October but, in line

with the soft economic picture, remains below target with the headline measure up 0.7%yoy and the core measure up 1.5%yoy. Retail sales continue to be an outperformer and unexpectedly firmed in October (headline: 1.2%mom, core: 1.3%mom) such that the core measure is now up 7.8%yoy.

Brexit, an issue that was not discussed much this year because of more pressing concerns, has once again come to the fore. The transition period following the UK leaving (on 31 January 2020) that allows lawmakers to work out a trade deal ends on 31 December 2020, but no deal has yet been agreed. If no deal is agreed to by the deadline, then trade defaults to WTO rules (a disorderly Brexit). This would be a shock to both the UK and Eurozone economies, although the UK is expected to be impacted more materially. The risks of a disorderly Brexit appeared to increase in September with the UK government introducing the "Internal Markets Bill" that contained clauses that would violate aspects of the withdrawal agreement. Should the bill be passed with these clauses included, it is unlikely that the EU will agree to a trade deal. At this stage, it is unclear whether, or in what form, the bill will be passed. Whatever the case, a deal appeared increasingly likely through November but at the time of writing there was still an appreciable risk of a disorderly Brexit.

Looking forward, the UK recovery is expected to stall in Q4 given the deteriorating COVID-19 situation and renewed lockdown measures. Activity is expected to pick-up in Q1 2021, but even in the best-case scenario of an orderly Brexit with a comprehensive trade deal, non-tariff barriers and more limited services trade will weigh on activity. Over the medium term, the positive news around a vaccine is encouraging, with the UK relatively well placed to quickly vaccinate a significant number of its residents. Fiscal and monetary policy will remain accommodative for some time and will support the recovery.

Eurozone: A bump along the way

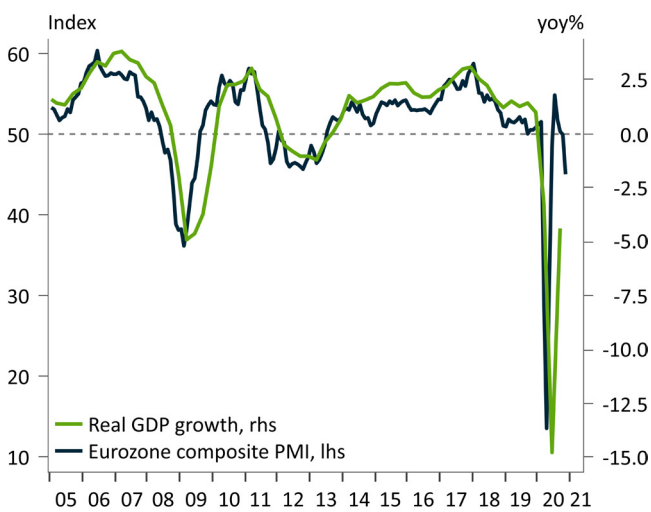
The Eurozone economy looked distinctly fragile going into 2020, with domestic uncertainties and a manufacturing slowdown on the back of global trade uncertainty weighing on growth. Then came COVID-19, and growth in the first half of 2020 crashed. Growth then rebounded strongly in the third quarter (12.7%qoq) but economic output across the Eurozone was 4.4% smaller in year-on-year terms following the H1 collapse and challenges with managing the public health crisis remain.

Individual country GDP prints show that France experienced the most significant quarter-on-quarter GDP rebound of the large Eurozone economies in Q3, with output rising a phenomenal 18.2%qoq (not annualised). Spain and Italy were close behind, with 16.7%qoq and 16.1%qoq recoveries, respectively. Germany recovered a more modest – but still record breaking – 8.2%qoq which is largely due to a less-severe Q2 contraction than the other three economies. Despite these unprecedented Q3 growth figures,

» these economies are still worse off in year-on-year terms. Germany (-4.2%yoy), France (-4.3%yoy) and Italy (4.8%yoy) have been hit similarly hard, but Spain (8.7%yoy) was a clear underperformer. What has become clear is that this recovery is set to stall in the near-term as the continuing rise in COVID-19 caseloads and renewed lockdowns make a contraction in Q4 increasingly likely. Indeed, many indicators are sending concerning signals. The Eurozone composite PMI plunged deep into contractionary territory again in November (45.1), driven by a sharp fall in the services index deeper into contractionary territory over the past 3-months (41.3). The manufacturing sector has held up fairly well – in November the PMI was at 53.6 – as it is more insulated from domestic lockdown measures. There is still a risk that prolonged services sector weakness may weigh on manufacturing. Growth expectations also fell sharply in the two months to November (32.8).

GRAPH 07 EUROZONE REAL GDP & PMI

PMIs point to Q4 contraction in growth



Source: IFM Investors, Eurostat, IHS Markit, Macrobond

In the household sector, confidence indicators have taken a sharp turn recently, with consumer confidence falling in both October and November to -17.6, the lowest level since May. Retail sales are already softer, falling more than expected in September (-2.0%mom) but have performed well in year-on-year terms (2.2%). August numbers were likely inflated by a postponed sales period in several countries contributing to the unexpectedly soft month-on-month print, but further weakness over Q4 is likely given new COVID-19 restrictions across the bloc and softening consumer confidence flagged earlier. This softness continues to come through in the labour market data with the unemployment rate rising to 8.3% in September. Other labour data show that employment in the third quarter rose 0.9%qoq, but the

measure remains 2.0% below Q3 2019 levels. Inflation remained subdued in November with price declines in the month keeping headline inflation in negative territory at -0.3%yoy and the core measure a modest 0.2%yoy

The European Central Bank (ECB) has left policy settings unchanged since June but, at its October meeting, it effectively pre committed to easing policy in December, noting that it will “recalibrate its instruments, as appropriate, to respond to the unfolding situation”. The ECB also flagged that the economy was “losing momentum more rapidly than expected”. In fiscal policy, French Prime Minister Jean Castex gave details on a €100 billion fiscal package that includes measures to strengthen the competitiveness of firms, to support employment and investment, and to speed up the transition to a greener, more digital economy.

In terms of the outlook, the near-term picture is bleak with another contraction in Q4 expected. There is also a risk that lockdown measures will need to stretch well into Q1 2021 which would weigh on growth in that quarter. Over the medium-term, however, the positive news around a vaccine has improved the outlook. The Eurozone is well placed to vaccinate a significant proportion of its population relatively quickly which will facilitate a more rapid normalisation of activity than we could have hoped for earlier. Over the longer term, it is also worth highlighting the importance of the establishment of a federal deficit for the EU for the first time to fund the €750 billion recovery package agreed to in July. Even the most optimistic observer would have found this sort of fiscal integration hard to believe just a year ago given the differing views between EU members. But, as said by a founding father of the EU Jean Monnet: “Europe will be forged in crises”. Indeed, this deeper fiscal integration was both a significant and necessary achievement given the scale of this crisis, an ailing growth outlook pre-crisis, a trend towards increasing Euroscepticism, and the challenges of trying to manage several economies with a unified monetary policy but no unified fiscal policy. And although this recovery package is a one-off, there are potentially significant implications for how the EU manages economic cycles in the future. This may be particularly important in an environment where monetary policy is increasingly ineffective.

Japan: Challenges for the new PM

The Japanese economy finished 2019 in an unenviable position. The trade spat between the US and China weighed on the export-exposed economy throughout 2019 and the implementation of a long-delayed value-added tax hike in October hit consumption harder than expected and led to a sharp contraction in Q4 2019. The COVID-19 crisis then nudged Japan into a recession in Q1 2020, followed by a collapse in Q2. Activity recovered reasonably well in Q3; real GDP surprised to the upside after firming 21.4%qoq annualised. The economy remains 5.9% smaller in year on year terms following the contractions in the previous three

» quarters, however. Private consumption and net exports were the key growth drivers, providing 10.8 percentage points and 12.2 percentage points to quarterly annualised growth, respectively. Capital expenditures and housing investment were key drags, subtracting 2.1 percentage points and 1.0 percentage point from quarterly annualised growth.

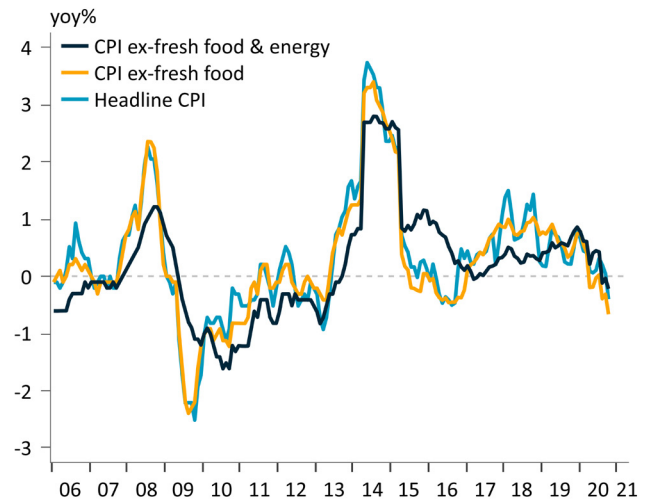
The labour market continued to soften in recent months, with the unemployment rate rising to 3.1% in October from a pre-pandemic rate of 2.4% in February. The job-to-applicant ratio – another key labour market indicator in Japan – has also softened over recent months to 1.04% in October. This is a relatively subdued rise in unemployment compared to other developed economies and, whilst it is misleading to do a direct comparison of Japan's labour market with other developed economies because of differences in unemployment definitions, it is clear that Japan's labour market has held up fairly well. Although here, as with a number of other economies, government policy may be distorting the true level of slack in the labour market by supporting workers that would otherwise have been classified as unemployed.

Inflationary pressures – which Japan has struggled to revive in the post-GFC period – have continued to soften in recent months. October's headline national CPI entered deflation for the first time since September 2016 (-0.4%yoy) and the core measure fell further into deflationary territory (0.7%yoy), the most material deflation since March 2011. Inflationary pressures are likely to remain subdued in the near term given weak growth, policy impacts and an uncertain outlook and are not expected to return to positive territory on an annual basis until the second half of 2021. Bank of Japan (BoJ) Governor Kuroda expressed the view that Japan isn't headed for entrenched deflation. But equally he noted that the BoJ were watching developments "carefully".

Weak inflation and spare capacity in the labour market have had a material impact on incomes, with September labour cash earnings down 0.9%yoy. This has likely contributed to the soft consumption outcomes seen recently. Household spending for September was down 10.2%yoy. At least part of this weakness, however, is from the base effects of an unusually strong September 2019 consumption figure as a result of frontloaded consumption prior to the October 2019 VAT hike. Consumer confidence firmed in September and October to 33.6, which is a positive for the consumption outlook but the metric is still materially below pre-pandemic levels. Prominent business survey data are less encouraging: both the services (46.7) and manufacturing (48.3) PMIs fell further into contractionary territory in November in preliminary reads. We await the much focussed on Tankan survey for Q4 (released mid-December) to gauge how the sector looks going into 2021, given the disappointingly modest rebound in the index in Q3 after the Q2 collapse.

GRAPH 08 JAPAN INFLATION

Inflationary pressures subside and Japan sees deflation



Source: IFM Investors, SBJ, Macrobond

In politics, Yoshihide Suga replaced Shinzo Abe as Japan's new Prime Minister in September following Abe's resignation announcement in the prior month. There were concerns that this would impact economic policy but, shortly after entering office, Suga signalled that he intends to continue with Abenomics, albeit with a heightened emphasis on structural reforms. In monetary policy, the BoJ left key policy settings unchanged from September, but in October the BoJ lowered real GDP forecasts for 2020 from -4.7% to -5.5%. A slow recovery in services demand was cited as the main driver of this downgrade. The BoJ acknowledged that there appears to be a tentative uptick in activity by marginally upgrading its assessment of economic conditions to "has picked up" from "has started to pick up". The BoJ also outlined its "Special Deposit Facility to Enhance the Resilience of the Regional Financial System" that will compensate qualifying financial institutions for their excess reserve balances.

Japan is also experiencing an increase in COVID-19 caseloads which weighs on the outlook. Fortunately, the situation is not as dire as in Europe or the US and the government should be able to balance pandemic suppression measures with further steps to normalise activity such that another contraction is not expected in Q4. Fiscal policy will likely be eased further in Q1 2021 as the government was, at the time of writing, drafting its third supplementary budget for 2020-2021. This, combined with enough vaccinations for around half of the population by early Q3 2021, should underpin activity and support a recovery. The COVID-19 situation presents a key downside risk and if the government needs to implement more restrictive measures, growth will take a hit.



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