IFM Investors

Economic Update
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Rates high, growth low

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The global economy will continue to be under pressure in 2024. While some economies are more likely than others to pull off a soft economic landing, recession risks remain. Central banks will retain tight policy settings until inflation moves sustainably toward their targets before easing relatively cautiously. Investors will remain relatively defensive as they await a turn in the cycle.

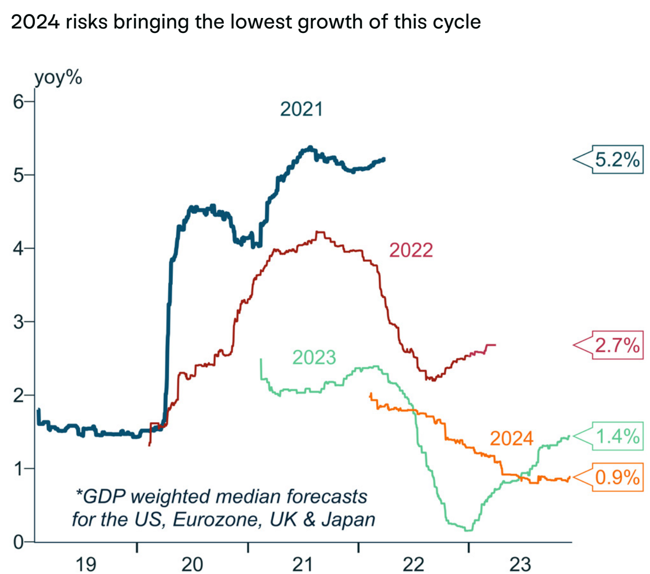
GLOBAL: Waiting on central banks

Around this time last year, there was a clear expectation that most of the world's advanced economies would enter some sort of recession in 2023, becoming casualties in the central bank war on inflation. What transpired was unexpected resilience. Whether this can continue is one of the key questions for 2024. The answer likely lies firstly in labour markets. Economic activity has been supported by the persistence of extremely low unemployment rates. This has served to underwrite households put under cost-of-living pressures that have not been seen in generations. These pressures have been compounded by the impact of interest rate increases hitherto not experienced by most borrowers. Secondly, the course of inflation will be crucial. Progress on disinflation continues, driven largely by decelerating goods inflation. The services side remains a key uncertainty. The outlook for both of these factors will define the timing and scope of the monetary policy easing that is to come.

Investors will be watching closely. While it is uncontroversial now to be overweight fixed income, awaiting lower rates has tested the patience of investors many of whom positioned defensively in late 2022. The overwhelming consensus is that rates will move lower in 2024. How this will pay off for long-duration investors is going to be defined by what sort of economic landing is in store. This seems like a reasonable set of expectations, but as we have seen in recent years, geopolitics is a wildcard that risks being disruptive again.

GRAPH 01 ADVANCED ECONOMY REAL GDP FORECASTS

2024 risks bringing the lowest growth of this cycle



Source: IFM Investors, Bloomberg, IMF, Macrobond

As 2023 comes to a close, our starting point is that advanced economy central banks are likely done with policy tightening (or extremely close to it). And while rates are near peak, investors seem content in building defensive positions - attractive yields mean that marginal additions to fixed income allocations at this point in the cycle offer solid returns outright before even considering the prospect of capital appreciation. This is a crowded trade with asset manager positioning (see GRAPH 02) reflecting this. Moving up the risk curve in fixed income also potentially locks in solid returns. This is particularly true should the consensus expectation of a soft landing occur. Equity risk premiums in advanced economies have narrowed markedly such that fund investor attention will remain on fixed income.

GRAPH 02 **NET POSITIONING OF ASSET MANAGERS**

Investors positioned for lower rates

Source: IFM Investors, Bloomberg, CFTC, Macrobond

How economies evolve over 2024 will define just how long this attention lasts. The outlook for economic growth looks far more asynchronous than the immediate post-pandemic period. Various degrees of interest rate pressure, growth sacrifices, and unemployment increases will be required across jurisdictions to bring inflation to heel. Broadly, we expect that central banks will be on hold well into 2024 to be sure inflation is sustainably anchored at respective targets before discussion shifts to rate cutting. The central case, therefore, is a policy plateau where rates stay elevated for some time into 2024 before a 'slow and steady' rate cutting cycle to minimise risks of a secondary inflation outbreak (that would be particularly humbling for policymakers).

Downside surprises on inflation and/or upside surprises on unemployment may alter this view. Isolated downside inflation surprises speak to the soft-landing narrative, similar to what has occurred in the US through 2023. Although, in this case, it is still likely central banks would still ease cautiously. Upside surprises on unemployment are likely far more economically destructive and risk a hard landing. In this case, central banks could be expected to ease policy more aggressively. These two scenarios are key as long-duration investors look to potentially rotate back to growth assets. A soft landing would facilitate this at the expense of returns in fixed income assets. Conversely, a hard landing would deter any rotation given the expectation of poor economic conditions and questions of how far rates might fall. Whatever the easing cycle, central banks will once again be looking to get a feel for what the neutral rate (r*) might be, particularly in a soft landing scenario. While labour supply, better productivity and fiscal largesse may all support the notion of a higher r*, we remain unconvinced that this could be sustained in a higher debt world.

Despite the clear risks of the lags of monetary policy fostering a hard landing scenario, we remain in the soft landing camp, but it is a broad church. This is predicated on our expectation that every step inflation takes towards central bank targets brings greater freedom to address growth concerns by easing policy, should they arise. Nonetheless, we expect growth to be somewhat weaker in 2024 than in 2023. This is particularly true in the US, which has experienced the most robust growth of major advanced economies and will likely slow coming from a relatively high base. The Eurozone and the UK are already stagnating. Growth through 2024 will very likely remain weak not too dissimilar to 2023 – recession risks in these economies remain the most acute. The UK will likely be a touch weaker than the Eurozone with potentially more persistent inflation. Japan's growth will likely moderate after a better-than-expected 2023, with that economy being an exception to the global increase in policy rates. And then there's China, risks abound, yet policy support will likely stabilise growth.

What may knock consensus is heightened geopolitical risks. Outright conflicts will continue with the Russia-Ukraine conflict and now the Israel-Hamas conflict, both potentially imparting further shocks to the global economy, particularly via the energy complex. Slow-moving but tectonic shifts in geopolitical and economic alignments will continue to shape trade and capital flows. US-China tensions are notable, but also the broader BRICs-plus bloc against advanced economies threatens to be destabilising. Political polarisation and populism also threaten to be disruptive. Clearly, the US Presidential election is at the forefront of these concerns with the contest, which may again be Biden versus Trump, having domestic and global implications. There are also elections in India, Mexico and Taiwan that will be closely watched.

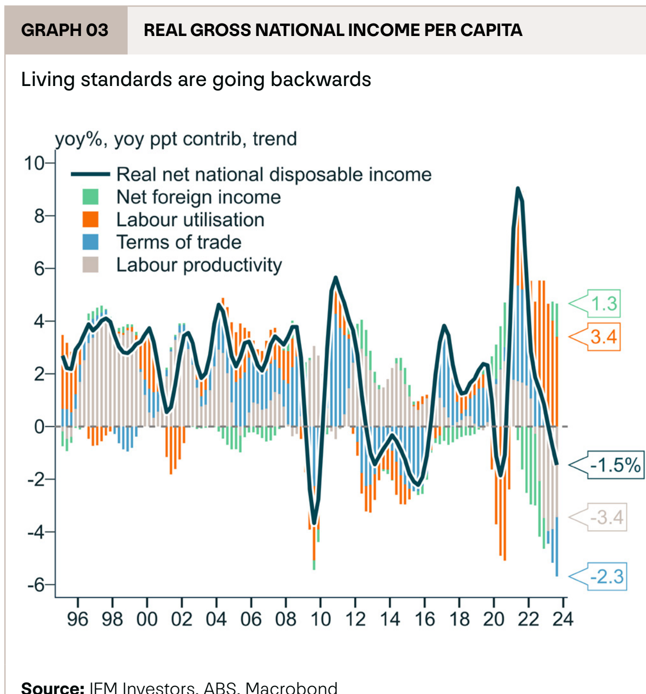
It seems that 2024 is a year to be cautious as an investor. There is a strong view of where we are in the rates cycle, and this lends itself to asset allocations that favour fixed income over equities despite some relatively surprising, though inconsistent, equity market performance in 2023. Nonetheless, the 60/40 fund model was again under pressure in 2023 as bonds had not yet delivered, and equity returns were highly dependent on jurisdiction and sector. It has been a mixed year for private markets, particularly unlisted infrastructure. Risk-averse investors and those experiencing a 'denominator effect' have shied away from the asset class. This is despite very solid returns through both 2022 and 2023 to date. The turbulent economic years exiting the pandemic may have made it difficult to allocate to private markets, but those already exposed have observed true 'mid-risk' performance through this unusual cycle and we believe the asset class is well positioned heading into 2024.

AUSTRALIA: Hardest of soft landings

The Australian economy of 2023 has continued to expand, and while the economy is bigger, it is not necessarily better. Population growth has been a key driver, with real GDP growth declining on a per capita basis. This will continue in 2024 with the risk that persistent inflation will keep the Reserve Bank of Australia (RBA) from turning to an easing bias until very late in the year.

Australia's economic resilience in 2023 is borne from a dramatic rebound in population growth. Concerns around the imbalances it is causing (housing and infrastructure are two notable sectors) were cast aside as the demand for labour to address skills shortages remained a priority. To date, the labour market has been able to absorb unprecedented increases in labour supply, with the unemployment rate remaining well below 4%. This underpinned strong wages growth in Q3 and saw negotiated wages accelerate sharply. Limited productivity growth (if any) has meant this has at the margin supported inflation, which in the September quarter surprised to the upside with the headline measure at 5.2%yoy and the trimmed mean measure decelerating to 5.2%yoy – this came despite government rebates and subsidies across childcare, rents and electricity.

It was clear to most in the immediate aftermath of the CPI print that the RBA would be forced to recommence its tightening cycle at its November meeting as the data implied a "material" miss against its August forecasts. It did so moving the cash rate up 25 basis points to 4.35%. At its December meeting, the RBA noted it had "limited information" since November to justify a follow up hike, highlighting that there are "encouraging signs" on goods inflation globally, that may foreshadow the same in Australia. Yet services inflation has so far "remained persistent". This is the key concern for Australia as services inflation is domestic in nature and idiosyncratic factors here define much of the upside risks contained in the outlook.



GRAPH 03 REAL GROSS NATIONAL INCOME PER CAPITA

Living standards are going backwards

Source: IFM Investors, ABS, Macrobond

The September quarter national accounts showed further modest growth of 0.2%qoq and 2.1%yoy through the year. Poor productivity and a declining terms of trade have prompted an outright fall in living standards growth as measured by gross national income, compounding already very weak per capita growth. Real household spending decelerated markedly as household disposable incomes come under pressure from increased interest and income tax payments. The savings ratio declined again to the lowest level since 2007. These are just some of the costs of the RBA's fight against inflation that will continue deep into next year.

The outlook for 2024 remains uncertain. Technical recession (two consecutive quarters of negative growth) in Australia is unlikely given population growth. But GDP per capita risks extending its run of negative growth and further weighing on living standards/national income already under pressure as the terms of trade likely also falls. We look for real GDP growth in the year at around 1½%. But this is lazy growth, with the more important question being whether poor productivity performance can improve, which will add to growth and take pressure off inflation. This will have to come from businesses under pressure from higher rates (headcount or hours reductions while producing the same output) or importing better productivity outcomes from other advanced economies. It seems unlikely that any government initiatives, should they come, or ill-defined references to technology and artificial intelligence will move the needle in the near term. Population growth is also a risk to the labour market because if labour demand falters, a strong labour supply risks increasing the unemployment rate. Only a fall in participation could prevent this. A rise in the unemployment rate risks unravelling consumer spending, which is a key downside to growth.

Disinflation in Australia is running behind other advanced economies. We may just be lagging, but we risk being different - likely a combination of both. Goods disinflation is in train but may be slower to come down than elsewhere as population growth will underpin demand so businesses don't need to lower prices as readily. We don't buy the assertion of the RBA, that population growth offsets this demand in the near term by adding to supply. This is not evident in the labour market nor wages growth as yet. Inflation will also be supported by fiscal policy with Stage Three tax cuts due mid-year that were promised at an election when the Federal budget was in vastly worse shape than it is now. Indeed, the risk also seems to be that May's budget (or perhaps before) seeks to address the perceived inequity of the tax cuts by distributing some of the expected budget surplus to lower income households via initiatives to alleviate the cost-of-living pressures. Services inflation may also prove more 'sticky' in Australia due energy prices, rents and other services where cost increases are being passed through. Inflation risks remaining above the RBA's upper bound of 3%, and its mid-point of 2.5%yoy is unlikely to be realised until 2025 at the earliest. Given this outlook we don't expect the RBA will be comfortable shifting to an outright easing bias until very late in the year unless there's a material downside surprise on inflation or an upside surprise to unemployment (or both). This will likely leave the RBA one of the last, if not the last, advanced economy central banks to ease policy.

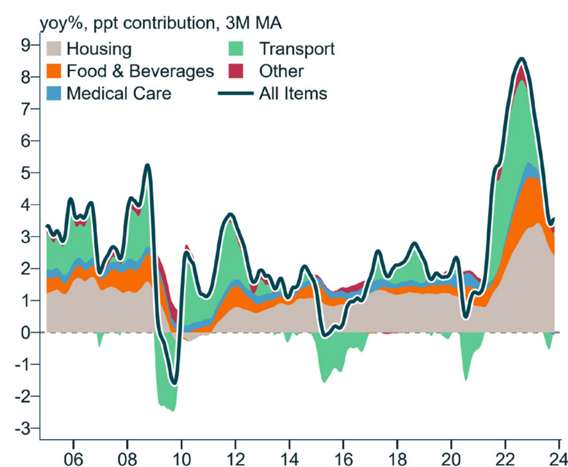
US: Slow down for landing

The US economy performed far better than expected through 2023. Strong household consumption underpinned continued robust growth momentum despite headwinds to activity and good progress on disinflation. Yet growth headwinds look set to persist in 2024. And while the chance of recession has reduced, output is expected to expand at a below-trend pace so it remains a risk. A soft landing remains our base case despite lack of historical precedent.

Inflationary pressures in the US are now well past peak, with October seeing headline CPI inflation falling to 3.2%yoy, and core CPI inflation down to 4.0%yoy. Core services inflation – a proxy for 'stickier' underlying inflation – has decelerated for eight consecutive months from a peak of 7.3%yoy in February 2023 to 5.5%yoy in October 2023. This 'immaculate disinflation' has been accompanied by surprisingly solid growth: Q3 real GDP (5.2%qoq annualised) accelerated markedly from the prior quarter leaving the economy 3.0% larger in year-on-year terms. Continued strong private consumption momentum was the key growth driver. Inventory accumulation also supported growth but will likely unwind in coming quarters, which will, along with other factors, likely weigh on Q4 growth. Indeed, leading indicators are already pointing to a material slowdown in Q4.

GRAPH 04 **US INFLATION DRIVERS**

Broad-based disinflation progress in 2023, so far



Source: IFM Investors, BLS, Macrobond

Labour market momentum has continued to decelerate in recent months, but conditions remain tight overall, supporting households. Nonfarm payrolls growth has clearly trended down but remained around 200,000 per month on average in August-October (very similar to the 10-year pre-pandemic median). The unemployment rate also appears to have bottomed after ticking up to 3.9% in October (cycle low of 3.4%). Job vacancies per unemployed person also continue to decline sharply but remain well above pre-pandemic levels. Earnings measures are also moving in the right direction, with average weekly earnings slowing to 3.2%yoy in October and nonfarm unit labour cost growth falling sharply in Q3 to just 1.9%yoy (only 30bps above the 10-year pre-pandemic median of 1.6%yoy).

The Fed left rates unchanged at its September meeting, marking the first pause since beginning the tightening cycle in March 2022. The Fed has raised rates a cumulative 525bps this cycle and looks to have reached peak policy after pausing again in October. Messaging from Fed communications has leaned hawkish and policymakers stand ready to tighten policy further should that be warranted. There remains a risk that stalling inflation progress forces further tightening or extending the duration for which the policy will need to remain tight, the latter seems more likely at this stage.

The US economy is expected to slow in 2024, with consensus looking for 1.0% growth over the year as a number of headwinds build and tailwinds abate. Recessionary risks continue to fade, and a "soft landing" looks increasingly likely, but we are not out of the woods yet. There remains considerable uncertainty around how long and variable the lags in monetary policy actually are, and how long it will take underlying inflation to get sustainably back to target. Inflation progress has been good, and expectations are for further progress next year (consensus headline inflation of 2.7% in 2024). This should facilitate the Fed easing cautiously late in the year to facilitate a soft landing rather than any more dramatic cuts that would be in response to a recession.

Fiscal policy will be a drag in 2024 compared to 2023, where the stimulatory impulse of the CHIPS and Inflation Reduction Act was sizeable. Though the 2024 deficit will still likely be large, the growth impulse is set to be negative as the deficit will likely be smaller than 2023. Continued tight bank lending standards will also hamper output.

Households – a key growth support through 2023 – will continue to be under pressure in 2024. The continued rundown of excess savings through 2023 was a tailwind, but most of the income distribution looks to have drawn down this buffer, so further growth support may be limited. There will also be a drag from the resumption of student loan payments and higher household interest payments. This will be somewhat offset by a continued improvement in real incomes as nominal earnings grow faster than inflation. But this must be considered against the impact of rising real rates as nominal rates remain elevated in a falling inflation environment.

The US political landscape remains a key uncertainty with the Presidential election in November 2024. Currently, expectations are for the contest to be between current President Biden and former President Trump. But neither is guaranteed to get to the starting line. The outcome could have sizeable geopolitical and economic implications. A Biden victory will see continued US global engagement and support of multilateral institutions, whereas a Trump victory will likely see an inward turn and more focus on narrow domestic concerns. Both will likely mean expansionary fiscal policy but with vastly different priorities. Domestic political focus risks the US-China relationship remaining on a downward structural trajectory, and either candidate will stick to the hawkish China stance given bipartisan positioning on the matter. These issues are more relevant for the medium-term outlook from 2025 onwards but are worth being mindful of throughout 2024.

UK: Stiff upper lip

The UK suffered a particularly unfavourable set of economic circumstances through 2023. Consumers were hit with an extreme cost-of-living shock. This was only exacerbated by monetary policymakers being forced to continue aggressively raising rates in an attempt to curb stubborn underlying inflation that threatened to be underwritten by wage-price spiral dynamics. The outlook for 2024 is for another year of uncomfortable adjustment with pain for households, sluggish growth, and recession risks that are materially higher than other advanced economies.

The latest growth figures for the third quarter show output flatlining in quarter-on-quarter terms to be up 0.6%yoy. The details show domestic demand looking soft, with both household consumption (-0.4%qoq) and business investment (-4.2%qoq) in decline. Nonetheless, the current growth picture appears consistent with stagnation than an outright recession. The upside of the soft growth environment is more material disinflationary progress being made, which looked far from certain in our last update.

As it stands, headline inflation has continued to slow sharply, reaching 4.6%yoy in October (the slowest rate in two years), reflecting lower energy prices and base effects. Though on a positive note, core inflation looks to have finally peaked as well, with the measure falling for five consecutive months to 5.7%yoy. The turnover of services inflation – a particularly important proxy for underlying domestically generated price pressures in the UK – is more tentative but should continue in the coming months. That said, services inflation is running at 6.6%, twice the average rate that prevailed in the two decades before the pandemic. A softer labour market and, in particular, what finally looks like a peak in earnings momentum should assist in getting 'stickier' inflation sectors under more control. But progress may be slow. September earnings measures continued to trend down (private sector regular pay: 7.8%yoy 3M MA). There remains a lot of progress to be made before earnings growth is again consistent with the inflation target.

It has been encouraging, then, in this context, that the ratio of job vacancies to unemployed persons has continued a strong downward trend and is now back around pre-pandemic levels. This has been associated with a notable upward trend in the unemployment rate from a low of 3.5% in August 2022 to somewhere around 4.2% currently. The Office for National Statistics has run into issues around response rates for the labour force survey and has had to publish alternative unemployment measures since the July survey based on experimental data. A number of indicators support this narrative around the labour market loosening gradually.

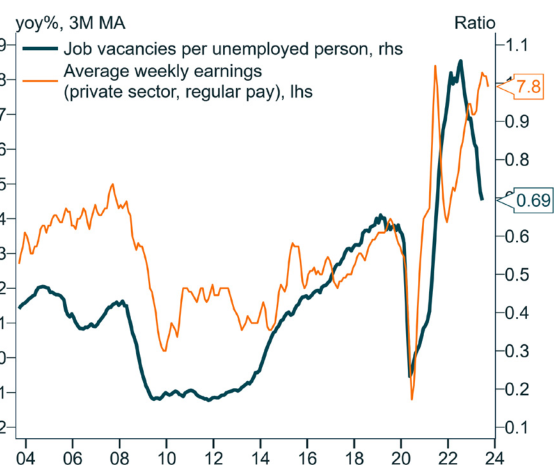
The Bank of England (BoE) will continue watching the data carefully but appears broadly comfortable with the policy stance, for now, after leaving rates unchanged at its September and November meetings. The signaling from the BoE remains hawkish, particularly around policy likely needing to stay higher for longer to get persistent inflation back under control, noting given the outlook, "monetary policy is likely to need to be restrictive for an extended period of time".

The outlook for the UK economy through 2024 is subdued, with both structural and cyclical factors weighing. Following flatlining output in the latest GDP figures, we will likely see only a modest recovery in 2024, with consensus expectations of growth of around 0.4% over the year, similar overall to 2023. Despite pressure on households, their spending will likely be the main growth support in H1 2024 – there will be further growth in real disposable incomes as nominal wage growth continues to comfortably outstrip inflation in coming months. But this effect looks set to fade through the second half of next year.

We'd also note there's considerable uncertainty around how real incomes play out given the wide range of expectations around where nominal earnings growth will settle. Similarly, just how fast underlying inflation will dissipate and how wage-price dynamics evolve. On balance, inflation will likely prove relatively sticky in the heavily services-exposed UK economy, given that pricing momentum in services is persistent and more heavily determined by wages growth. Expectations are that UK inflation will prove relatively persistent (consensus of 3.1% in 2024), and this will likely force the BoE to maintain tighter policy through to late 2024. Mortgage channel impacts will also be a drag as the effective mortgage rate increases via the rolling-over of fixed rate mortgages. Fiscal policy will likely be a drag overall, with the Chancellor's stimulatory Autumn Statement insufficient to offset unwinding energy and COVID support measures.

GRAPH 05 **UK VACANCIES AND EARNINGS**

Rebalancing labour market, earnings turning



Source: IFM Investors, ONS, Macrobond

Risks to the outlook remain elevated and depend crucially on the labour market response. There has already been a sizeable labour adjustment to slowing growth, most clearly visible in the falling vacancies-unemployment ratio and rising unemployment. But if further adjustment takes place through an even more material rise in the unemployment rate, that could be sufficient to tip the economy into a recession via contracting household consumption. In politics, the UK will hold a general election some time in 2024 (January 2025 at the latest). The outcome of the election is more important for the 2025 outlook, though the policy ambitions of the victor will likely be constrained by structural headwinds and limited fiscal headroom. Unlike the US, the UK election is predominantly an issue of domestic concern and has negligible implications for the global economic landscape.

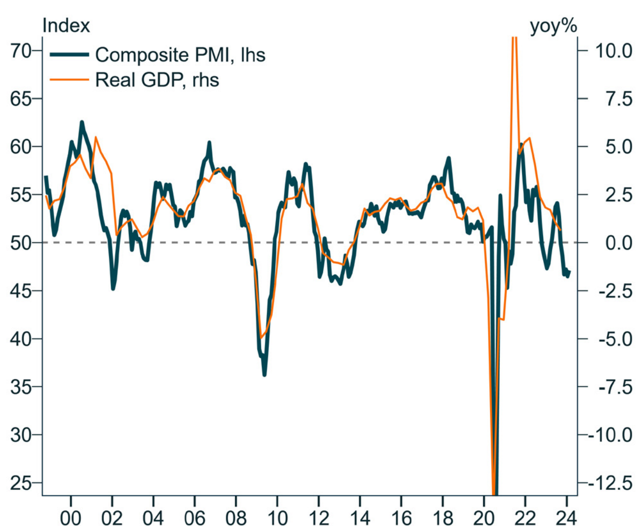
EUROZONE: Recession risk

Surprising economic resilience in the first half of 2023 quickly gave way to disappointing activity momentum in the second in the Eurozone. There were headwinds from continued policy tightening, ongoing cost-of-living pressures, and a sharp (largely external demand driven) softening in industrial activity. The outlook for next year remains gloomy. Key economies of Germany and Italy are beset by elevated recession risks (75% and 60% according to market economists) that may tip the entire region into a downturn. Continued progress on inflation and potential monetary easing may see overall conditions improve at the margin, late in 2024.

Third quarter real GDP contracted 0.1%qoq to have expanded just 0.1% in year-on-year terms for the bloc as a whole. On a country level, continued weakness in the industrial sector has again seen more sector-reliant countries like Germany (-0.1%qoq) and Italy (0.0%qoq) fare worse than less exposed countries like France (0.1%qoq) and Spain (0.3%qoq). The ongoing headwinds facing this sector are key to the recession risk facing the region. Leading growth indicators highlight the risk of a Q4 contraction with very soft PMI data in October/November in both private sector manufacturing and private sector services. Additionally, the European Central Bank (ECB) bank lending survey points to continued tightening in lending standards and a fall in loan demand that will likely weigh on activity.

GRAPH 06 **REAL GDP GROWTH & PMI**

Fading growth momentum across the bloc



Source: IFM Investors, Eurostat, S&P Global, Macrobond

Any near-term recession that does materialise may be tempered given the continued strength of the Eurozone labour market. The unemployment rate (6.5% in October) remains near all-time lows of 6.4% and is set to increase only modestly in the coming months. The silver lining to the continued soft growth backdrop is ongoing progress on inflation. Headline CPI inflation hit 2.4%yoy in October (seven consecutive falls, 8.2ppts below cycle peak), with the core measure down to 3.6%yoy (2.1ppts below cycle peak). Progress on services inflation – a useful proxy for underlying inflation – has been slower. This is to be expected given the slow-moving nature of services inflation, but most importantly, it looks like there will be further progress through 2024.

The ECB raised rates in September by 25bps but left policy unchanged at its October meeting. The ECB has signalled that it is likely finished with its tightening cycle, with the Governing Council of the view that rates, if held at current levels for a "sufficiently long duration", will "make a substantial contribution to the timely return of inflation to the target". How long "sufficiently long" proves to be remains a contentious point. However, given good progress on inflation and elevated downside growth risks, it looks like we are at peak policy. The door to further hikes remains open, but the hurdle for restarting rate hikes looks high. Similarly, the hurdle for cuts looks high as well, with the ECB (along with every other major central bank bar Japan) wanting to be confident that inflation is well on track back to target before beginning to cut.

The outlook for 2024 growth remains subdued, but conditions look set to improve over the year relative to end-2023 on improving real incomes and a turnaround in manufacturing activity. Expectations put 2024 growth somewhere between the US and the UK, with the consensus forecast at 0.7% for the year. The manufacturing slowdown seems to have tentatively bottomed, and output should recover through 2024, helped by higher demand and as inventory levels normalise. Structurally higher energy prices and a more modest growth outlook for China will remain a headwind and industrial activity is unlikely to return to a pre-COVID trend.

Real incomes are set to grow on continued robust nominal wages growth and ongoing disinflation. The importance of union-negotiated wages is relatively more important in the Eurozone than in the UK/US and contributes to earnings growth that is relatively less responsive to labour market conditions. Inflation is also a key determinant of negotiated wages, such that the recent exceptional inflation environment leaves additional room for a continued upward adjustment in negotiated wages growth. On balance, this should see wages growth peak over 2024 but remain above rates consistent with the inflation target. The ECB will want to see clear evidence of a moderation in wages growth for it to be comfortable with easing policy.

In the fiscal space, policy will be a drag, in line with continued normalisation of post-pandemic fiscal support and the ending of energy subsidies. Risks to the outlook are skewed to the downside. Similar to last year, energy prices are the main risk to the H1 2024 outlook. Escalating geopolitical tensions or a cold winter could see energy prices rise substantially, which would weigh on real household incomes and growth. This risk is less acute than last year given high gas storage levels, higher LNG imports, and substitution away from gas over the last year or so. Another risk to look out for in the Eurozone is related to how long policy has to stay tight: if yields have to stay higher for longer, Italian sovereign spreads may widen materially, and the question of Italian debt sustainability might become more urgent.

CHINA: Policy easing needed

Economic activity in China has picked up after its recovery stalled a few months ago, but the anticipated strong recovery did not materialise. A destabilised property sector has compounded weakness in household consumption, and policy will likely need to do much of the heavy lifting to ensure growth outcomes meet targets in 2024. While China is unlikely to recover to its pre-pandemic growth trend, the recent stabilisation in economic activity means that China is set to meet its 5% growth target for 2023.

GRAPH 07 **CHINA FIXED ASSET INVESTMENT**

Where to provide stimulus?

Source: IFM Investors, National Bureau of Statistics, Macrobond

Industrial activity has shown tentative signs of stabilising recently, though a more consistent improvement in economic activity has yet to materialise. Industrial production expanded 4.6%yoy in October, slightly above expectations, and improved sequentially in September. The manufacturing PMI slipped back into contractionary territory in October, after briefly breaking into expansionary territory in September (the first expansion since March this year). New export orders were particularly low, alongside the weakness in global demand. Fixed asset investment in manufacturing has driven an overall improvement in private sector investment, despite the decline in residential investment.

China's economy grew faster than expected in Q3, with real GDP expanding 1.3%qoq to be up 4.9% in year-on-year terms. Despite the positive result, China's National Bureau of Statistics talked down the success, noting that domestic demand "remains insufficient" and that "the foundation for economic recovery and growth needs to be further consolidated" with manufacturers facing low market demand. China is, however, on track to meet the growth target of 5% for 2023. Indeed, the IMF upgraded its annual growth forecast for China in 2023 to 5.4% from 5% on the back of the stronger-than-expected Q3 result and announcements of policy support for the property market. The IMF also raised its forecast for 2024 growth to 4.6% from 4.2% but noted that key risks to the outlook are ongoing weakness in the property market and restrained global demand. Looking forward, China will likely maintain its 5% growth target for 2024 with some risk of a change to a target of 4.5% annual growth. Over the past ten years, the GDP growth target has not changed by more than 50bps. If the growth target is maintained at 5%, we expect that this will require fiscal stimulus aimed at local government, additional infrastructure spending, monetary easing, and property market support.

The property sector continues to weigh on economic growth as developers are facing difficult financing conditions. Developers are struggling to tap capital markets, and defaults have meant that banks are less forthcoming with loans. Over half of China's top 50 private developers have defaulted, and further defaults are likely in coming months. A recent notable example was Country Garden, which defaulted in October. Projects have stalled as a result: residential starts in October were 75% of their 2022 level and around 40% of their pre-pandemic 2019 level. Authorities have announced a number of stimulatory measures for the property sector, including lowering mortgage rates and the homebuyer downpayment ratios (in some cities), reducing the amount of cash that banks must hold as reserves, and lifting restrictions on home purchasing in tier-one cities. While the measures have lowered buying and debt servicing costs for purchasers, this has done little to prop up demand. Floor space sold in the first ten months of 2023 was roughly two-thirds of floor space sold over the same period in 2019.

Weakness in the property sector has particularly affected household consumption, and it remains unclear to what extent consumption will improve over the near term. Much of the economic recovery to date has been supported by household consumption, particularly in services. China recently exited a deflationary period, with recent inflation largely driven by services. Goods inflation remains weak. While spending on services has continued to improve, the savings rate is now at pre-pandemic levels, making it difficult for household consumption growth to continue to outstrip wage growth. The official unemployment rate has declined over recent months to 5% in October and while high employment should support consumption, other labour market data have been mixed.

External conditions have been challenging for China's exporting sector, a traditional growth driver, with exports down 6.4%yoy in nominal terms in September. While the improvement in the global chip cycle will support exports in Q4, external demand will likely not drive growth over the near term.

While external conditions for China remain challenging overall, trade conditions with Australia have continued to improve. Australia and China have suspended their dispute, lodged at the World Trade Organisation, over China's tariffs on imports of Australian wine, which China has agreed to review. In 2020, China imposed tariffs of between 107% and 212% on imports of Australian wine, amid rising diplomatic tensions. The review of the tariffs follows China's lifting of tariffs on Australian barley in August. The return of Chinese students and tourists to Australia in 2023 has gained momentum and there's further upside in 2024 should pre-pandemic levels be recaptured.

JAPAN: Progress towards a new normal?

Japan sought to stabilise its economy through much of 2023, but that plan hit a speed bump in Q3 with a worse-than-expected decline in output of 2.1%qoq saar (-0.5%qoq), slowing through the year growth to 1.2%yoy. Weakness was seen throughout the private sector, with household spending and investment in housing moving lower. Importantly, consumption has now contracted on a through the year basis. Households were likely responding in part to cost-of-living pressures as highlighted by the consumption deflator edging up to 3.1%yoy. This was a key driver of the GDP deflator accelerating to 5.1%yoy – the strongest rate since at least 1995. Weak growth and broad price increases across the economy have put policymakers under some pressure. Business investment was 0.6% lower in the quarter after a 1.0%qoq decline the previous quarter as both non-residential investment and broader gross fixed capital investment retreated. The sector also chose to deplete inventories due to increasing domestic and global uncertainty, a material drag on growth in the quarter. Net exports also subtracted slightly in the quarter, with imports rebounding solidly after a run of weakness despite a solid export performance.

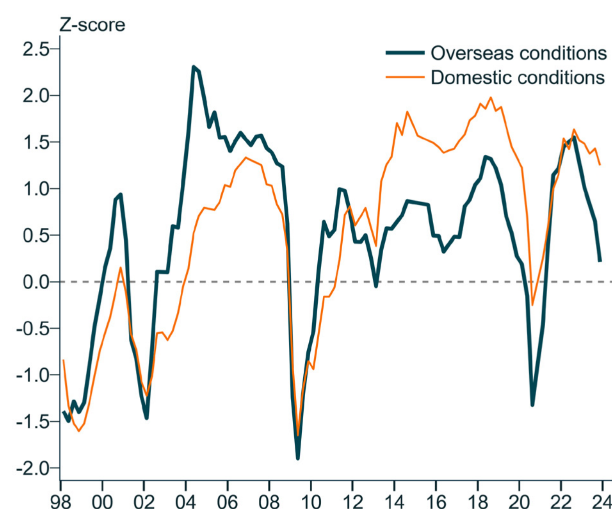
A rebound in growth is expected in Q4 to see out the year, but a pickup in the soft data is needed to have any confidence in this. November's PMI data has not been overly promising, with the manufacturing sector recording its sixth straight decline with both output and new orders lower. The news on services is somewhat better, with the PMI ticking higher in November and remaining in expansionary territory. Activity data for October have been mixed with industrial production up 1.0%mom but retail sales fell unexpectedly sharply in the month.

Weaker economic activity is bringing inflation lower and pleasingly for the Bank of Japan (BoJ) this is best evidenced in the both the ex-fresh food (2.9%yoy), and ex-fresh food and energy measures (4.0%yoy). But progress towards disinflation back to target is far slower than other advanced economies as there has been no tightening of monetary policy to drive it lower. The BoJ will be reliant on falling import inflation which may be facilitated by a stronger Japanese yen that peaked above USDJPY150 in recent weeks – a level not seen since 1990 after depreciating around 19% year to date at the time of writing and an "intensified virtuous cycle between wages and prices". This is expected to "gradually" bring CPI inflation back to target. The BoJ has consistently demonstrated that it is prepared to be patient.

Growth in 2024 is likely to move back to a trend rate of around 1.0% after recording what we expect will be a 1.7% expansion in 2023. This is a relatively modest achievement in the context of Q3 real GDP falling below Q3 2019 levels. Output has exceeded this mark only once since and that was in Q2 2023. Despite a material budget deficit and mammoth public debt burden, Prime Minister Fumio Kishida announced a fiscal package worth ¥17 trillion or 2.8% of GDP in early November. The package includes tax cuts, cash handouts, energy subsidies for households to ease costs of living and subsidies for businesses that increase wages. In doing this he hopes that the "increase in the income of the people will be higher than the rise in prices in the summer of next year". It is expected that the FY24 Shunto wage negotiations should support this effort keeping the momentum from last year with some large employers (flush with solid profitability and competing in relatively tight labour markets) already touting material increases. This growth in incomes is hoped to overcome inflation and support consumer spending (around 54% of the economy).

GRAPH 08 **TANKAN SURVEY EXPECTATIONS**

Concerns about global growth



Source: IFM Investors, Bank of Japan, Macrobond

The absence of further external shocks to energy prices and a global soft landing will be needed for a more sustained recovery in industrial sectors. The Tankan survey for Q3 highlighted this with expectations that domestic conditions will remain solid. But overseas conditions risk deteriorating. This dynamic is also reflected in manufacturing, where the external facing sector is experiencing weaker activity, a contrast to the strength of domestic facing non-manufacturing services sectors. Indeed, for large enterprises, the non-manufacturing index has been at the highest level since Q4 1991.

The modest economic outlook should be matched by measured disinflation towards the BoJ's target. This should occur over 2024, noting that the BoJ does not want to impart too much disinflationary momentum. Modest adjustments to the BoJ's yield curve control through 2023 were noted as more aimed at "improving its resilience" and "reducing the chance of speculative moves". This is rather than a shift in policy footing with the effects of monetary easing assessed as "sufficiently maintained". The BoJ will want to observe inflation, driven primarily by domestic sources, anchored at its target before considering formal policy normalisation. We expect the outlook for inflation and the domestic and global economies may make this an unlikely prospect in 2024.

KOREA: Banking on external growth

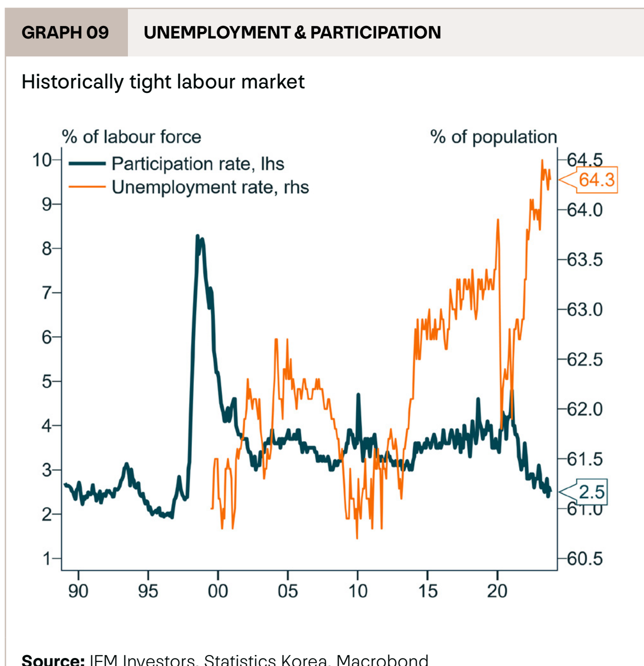
The Korean economy appears to be stabilising as 2023 comes to a close. But with this comes a reacceleration of inflation. The Bank of Korea (BoK) may be able to 'look through' some of these price pressures. For now, core inflation remains relatively well behaved, and a resumption of disinflation should open the door to a 2024 easing of policy.

Current data are showing improvements in economic activity. The September quarter advanced print for GDP came in better than expected at 0.6%qoq, with growth reaccelerating to 1.4%yoy. However, quarterly growth was largely driven by the external sector, which has continued to rebound after a very challenging 2022. Indeed, net exports added 0.6ppts in the quarter and 1.4ppts on a through the year basis. This has been driven by exports surprising on the upside, whereas imports have decelerated amidst weaker domestic demand. Partial indicators exposed to the external sector continue to be positive to close out the quarter, with industrial production unexpectedly strong in September, holding momentum from the previous month. A sharp rise in semi-conductor production again supported output and subsequently exports. Supporting this assessment is the BoK's business sentiment survey, where future expectations have been held back overall by manufacturing sectors exposed to the domestic economy. Whereas exporting enterprises recorded a bounce in sentiment in November to a level (69pts) not seen since late 2022.

However, growth in other sectors of the economy has slowed dramatically. This is most notable in household spending and private investment, both under pressure from rising interest rates. Despite the slowdown in growth, household spending has avoided an outright decline via the unemployment rate remaining around lows not observed since the Asian crisis of the late 1990s. Importantly this has been accompanied by record highs in participation.

GRAPH 09 **UNEMPLOYMENT & PARTICIPATION**

Historically tight labour market



Source: IFM Investors, Statistics Korea, Macrobond

The slowdown in the private sector has been by design. The BoK has remained relatively hawkish through 2023 despite being one of the first major central banks to pause on rates back in January. Solid economic growth has supported this stance late in the year as stubborn inflation and financial stability concerns around household debt remain key factors in the BoK's reaction function. At its November meeting, it delivered another relatively hawkish pause, keeping the base rate at 3.5%. It reiterated these themes noting it "will maintain a restrictive policy stance for a sufficiently long period of time until the Board is confident that inflation will converge on the target level". Concerns around inflation were key in the BoK's communication as the headline rate ticked higher to 3.8%yoy in October and the core measure, ex-food and energy, ticked 0.1ppt lower to 3.2%yoy. While these rates seem in line with other developed economies, inflation has exceeded the BoK's August forecast, and this was revised upwards in its November economic outlook.

It is expected that 2023 will be the low point in real GDP growth for the economy and that growth slightly above 2% should prevail in 2024. Retaining current momentum will be an export-led recovery, with the highly indebted household sector remaining under pressure from higher interest rates in terms of real spending. Key to this expectation will be that external headwinds from 2023, notably a weaker-than-expected Chinese economy and downturn in the tech cycle, reverse. Further, we assume that no material deterioration in geopolitics impacts either global growth or the energy space. Ongoing resilience in the US capex cycle will also be important.

The inflation outlook will be key to domestic growth in 2024, as in most other developed economies. If inflation moves back towards target with sufficient momentum, then that should give the BoK sufficient space to begin easing late in the year. That's our expectation, with headline inflation coming back to target by Q4. For now, a squeeze on fresh food supply and a brief rise in oil prices need to be worked through as this has led to a reacceleration of inflation across exposed sectors. Indeed, the broader measure of commodities inflation had decelerated to zero in July 2023 before this episode. The path of private services inflation, which has been decelerating in recent months, will also be key. The measure excluding eating out has ticked higher in recent data, with some potential stickiness in prices expected through 2024, particularly in utilities. More broadly, wage pressures continue to ease, despite the tight labour market. Should this outlook for inflation pan out as expected, then the BoK should be able to move to an easing bias in the second half and likely deliver cuts by year's end. One important caveat is the threat of household debt, which has risen appreciably over recent decades to a peak of 105% in 2021 (according to the BIS and notably still well short of Australia's peak at the same time of 122%). It has edged lower more recently as rates have increased and tighter credit conditions prevailed, but the BoK will need to see this ratio remain at least stable to give it comfort to ease policy. And even then, its moves are likely to be cautious, and this will likely result in some modest appreciation of the Korean won but nothing to derail the export-led recovery.

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