Economic Update
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Waiting for the turn


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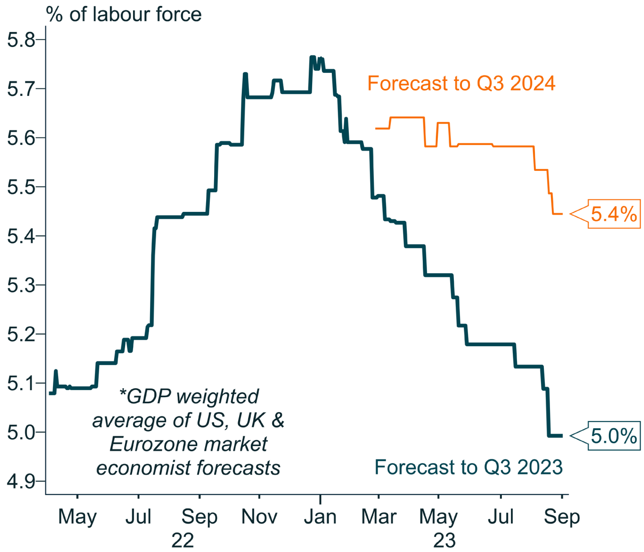
The global economy still proves resilient to cost of living pressures and higher interest rates as unexpectedly tight labour markets support activity. Central banks may need to hold rates higher for longer to bring inflation down, leaving investors overweight fixed income waiting for longer duration positions to prove their worth.

GLOBAL: Fragmented landing

As we move into the third quarter of 2023, it is clear that economies have proven far more resilient to cost of living pressures and the subsequent tightening of monetary policy than expected. The impulse and momentum imparted to advanced economies by fiscal policy has been a challenge for central banks to rein in with monetary policy. The household sector, in particular, has proved far more resistant to these shocks than initially thought. A key reason for this is that very tight labour markets have persisted for longer than either market economists or central banks expected. And this has challenged a principal tenet of monetary policy's transmission process – that reducing demand in the economy to tackle inflation will prompt a rise in the unemployment rate. In the same way as the Phillips curve confounded policymakers before the pandemic, Okun's law has so far not played out as expected after it. To date, firms have seemingly been reluctant to shed labour amidst persistent skills shortages. Any reduction in labour demand is more visible in reduced openings and vacancies rather than redundancies as economic growth has decelerated. But equally persistent low unemployment arguably has supported economic activity in turn. Consequently, economists and some central bankers have wound back recessionary expectations. But whether recession has been averted or is merely delayed remains an open question.

GRAPH 01 **UNEMPLOYMENT FORECASTS**

Unemployment rates have defied expectations



Source: IFM Investors, Bloomberg, IMF, Macrobond

IFM Investors

As this macroeconomic environment has evolved, debate rages around what type of landing central banks can achieve. While a hard landing or recession is certainly not out of the question, neither is a soft landing. Some have even put forward the notion of 'no landing' (noting here we define 'hard landing' as a recession caused by policymakers rather than one induced by a crisis). We discount the likelihood of the latter as central banks are of the mind that some sort of material shift in the course of economic growth is required to lower inflation. But what that will look like across advanced economies appears increasingly fragmented. This is observable in inflation and activity surprise indexes. Here, the US has had upside surprises on growth and downside ones on inflation – giving rise to soft landing expectations. The Eurozone has had downside surprises on growth and neutral on inflation. And the UK has had upside surprises on growth and inflation. These dynamics have informed expectations of future central bank action.

We anticipate this increased fragmentation of economic performance (and sectoral performance within them) will define the coming 12-18 months, with materially different paths of inflation back to target across advanced economies. The lags in monetary policy transmission mean the full impact of peak policy is only felt some time after peak rates are reached. The quantum of that impact remains a significant unknown that will likely precipitate a bifurcation across economies, broadly, into a hard-landing and a soft-landing camp. This will force a decoupling of central bank policies.

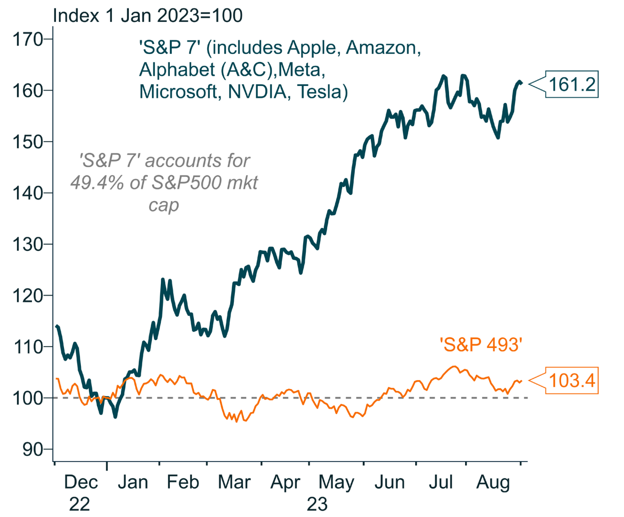
How much policy decouples may be defined, at least in part, by how resilient each country's labour market is. And from this, how much disinflation can be achieved without a rise in unemployment rates. This question arises in our mind because of the need for most central banks to get control of unit labour costs and the potentially stickier elements of services inflation underpinning those labour costs. In many advanced economies, nominal wages pressures remain elevated while productivity growth remains flat or negative. A rise in the unemployment rate may be necessary to remedy both parts of this equation, as is reducing nominal wages pressures and forcing businesses to improve productivity (where governments have done little to achieve this, and any material impact artificial intelligence may have is likely a more medium-term thematic). This may sound like a heartless proposition, but it is how monetary policy works – blunt but effective. Governments are better placed than central banks to address any distributional consequences that arise.

This assertion on unit labour costs suggests that it may be the labour market that is increasingly holding the key to sustained deflation back to central bank targets. While the decline in goods prices is the 'easy' leg of the deflation phase that sees the fall from peak inflation, more effort will be required to complete the task with services. This, for us, means it is too much to hope for a benign disinflation all the way back to central bank targets. If the labour market remains as resilient as it has been to date, then we expect the risk will become inflation hovering above central bank targets for an extended period. This frustration for central banks would be met by more tightening or higher rates for longer until a labour market adjustment is made that sees unemployment rates move to or above NAIRU (non-accelerating inflation rate of unemployment). Such an eventuality was alluded to by US Fed Chair Powell recently at the Jackson Hole summit, where his comments seemed 'duration hawkish' rather than 'level hawkish' in terms of the outlook for the Fed Funds rate. Supporting our view that risks to the length of time that policy rates will need to remain elevated are skewed to being longer, even if we are at/near peak rates.

For investors, the outlook is challenging. Those who tilted defensive in late 2022 and early 2023, when economic pessimism was at its peak, have had to deal with a 'pain trade' – since then, equities performed well on fading recession fears, and yields kept rising on central bank hawkishness. Equities look stretched and have priced in a lot of good news, particularly in the US. Much of the equity rally is down to AI mania and the performance of the 'Magnificent 7' (See Graph 02). Though, it is little comfort to defensively positioned investors that they were more or less right on the other 493 companies in the S&P500, where returns have been modest.

GRAPH 02 **S&P 500 PERFORMANCE**

The 'Magnificent 7' drives US equities higher



Source: IFM Investors, Bloomberg, IMF, Macrobond

If the soft-landing narrative continues, equities likely have some more room to run, bolstered by a broader rally across sectors. Though if our duration hawkish view – which does not necessarily preclude a soft landing – proves correct, the extended policy plateau implied by that view risks seeing equities selloff in line with the drawn-out growth headwinds from higher rates. This would also mean returns from longer duration fixed income remain modest. Nonetheless, it is in fixed income where investors are seemingly still holding the most conviction, with global fund manager surveys, net positioning data in Treasuries and allocations observed in Australian superannuation funds all indicating materially overweight positions. Economic resilience suggests they may have to wait some time yet for yields to fall and may be underwhelmed when they eventually do.

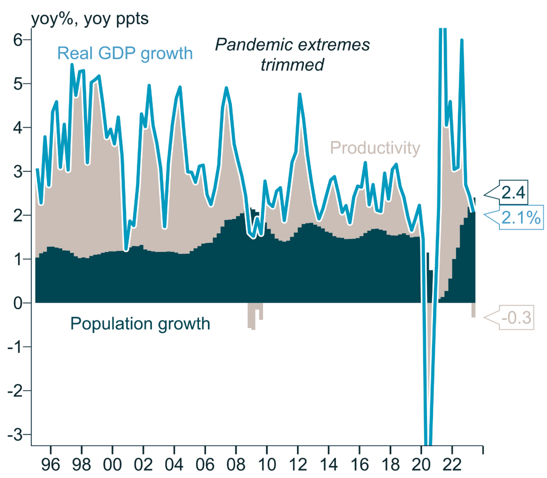
AUSTRALIA: Per capita reversal

The Reserve Bank of Australia (RBA) continues to search for the 'narrow path' to a soft landing, pausing its hiking cycle in recent months to preserve gains in the labour market as inflation starts to retreat and Australian economic activity, on the whole, has started to slow.

The RBA left the cash rate target unchanged at 4.1% in September, August and July after its last hike in June; since the beginning of the hiking cycle in May 2022, the cash rate target has risen by 400 basis points. In its decision statement, the RBA noted that 'some further tightening of monetary policy may be required'; most economists see either an extended pause on the horizon or one more rate rise (likely in November, following the next CPI print in October). Outgoing Governor Phil Lowe has characterised the RBA as being in a "calibration phase", while incoming Governor Michelle Bullock noted it is "watching the data" and that policy decisions will be made on a "month by month" basis until next year.

GRAPH 03 **REAL GDP GROWTH**

Strong population growth not productivity driving growth



Source: IFM Investors, ABS, Macrobond

The RBA also published updated forecasts in its August Statement on Monetary Policy (SMP), which overall were little changed. Headline CPI is expected to decline to the top of the target band by mid-2025 and to drop below 3% by the end of 2025. Real GDP growth was revised modestly lower over the near term as cost-of-living pressures and rate rises weighed on domestic demand.

Inflation in Australia continues to retreat but remains well above the RBA's target band of 2-3% and could see a slower return to target than in other parts of the world. In the June quarter, headline CPI rose 6.0%yoy (0.8%qoq) while underlying (trimmed mean) inflation rose 5.9%yoy (0.9%qoq), both slightly below expectations. Inflation continues to be broad-based, with around 75% of categories recorded in the CPI rising above 2.5%yoy. While goods price inflation has peaked as global supply chains have improved and domestic demand has slowed, services inflation remained strong, and market services inflation is yet to peak. Rent inflation has been particularly high due to tight conditions in the rental market and rose at the fastest pace in 14 years.

Perhaps even more so than in other parts of the world, the labour market in Australia has been resilient to the slowdown in global growth and rising interest rates. Unemployment in Australia has hovered around a historic low of 3.5% for several months, which is below the RBA's and others' estimates of full employment. At the same time, the participation rate has remained near historic highs. The proportion of people losing their jobs is also historically low, suggesting that at least some of the strength in the labour market, particularly as activity weakens, could be due to labour hoarding. Recently, there are some emerging signs that the labour market is loosening: the unemployment rate ticked up to 3.7% in July despite a slight fall in the participation rate, and total employment fell. Given the strength of labour supply, any softer employment growth near term will have an outsized impact on the unemployment rate.

Another sign of some tightness coming out of the labour market is the underwhelming performance of wages growth. The Wage Price Index (WPI) grew 3.6%yoy (0.8%qoq) in the June quarter, slightly below RBA and market expectations. Fewer jobs received wage increases in the June quarter this year compared to last year (12% vs 14%), as employers felt less need to put through 'ad hoc' wage increases to attract or keep staff. While wages growth was not broad-based, jobs that did receive a wage increase saw larger increases, with the share of jobs receiving wage rises of over 4% at its highest level in over 10 years. WPI growth is expected to peak in the September quarter when increases to award wages and wages for aged care workers take place.

Headline economic growth in Q2 was again underpinned by population. Real GDP growth expanded by 0.4%qoq and 2.1%yoy through the year. The RBA's forecast was 0.2%qoq and 1.6%yoy, so this is running ahead of its expectations. More concerning for it was that unit labour costs growth is elevated, pushing against the disinflation the RBA is trying to achieve.

Households are bearing the brunt of the economic growth slowdown. Real spending decelerated markedly as household disposable incomes came under pressure from increased interest and income tax payments. The savings ratio declined again to the lowest level since 2008. Business investment was solid in the quarter as expiring tax incentives brought forward capex spend. Public demand also added materially with a welcome rotation from spending to fixed capital formation.

Per capita GDP growth was negative for the second consecutive quarter and just 0.1%yoy. Population growth in the quarter was 0.7%qoq, the strongest rate in this current series (to 1974). Productivity was weak, declining 2.0%qoq. This saw unit labour costs accelerate by 1.6%qoq to 7.3%yoy. The RBA assert that this is not consistent with sustainable disinflation that would support inflation returning to target in a reasonable time frame and will mean it retains a tightening bias for some time to come. We expect economic growth to slow further still in coming quarters as inflation is brought under control.

US: From recession to soft landing?

Data out of the US have been remarkably positive and talk of recession has largely given way to resurgent optimism that the Federal Reserve (Fed) will be able to navigate a 'soft landing' for the economy. We remain cautiously optimistic but note that monetary policy will continue to weigh with a lag. But the data don't lie.

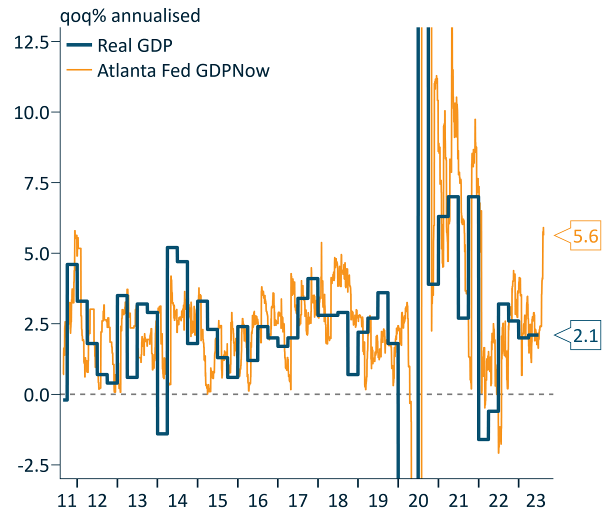
Second quarter real GDP figures showed the US economy expanding at a respectable 2.1%qoq annualised (compared to around 2.5%qoq annualised average growth rate over the last 10 years). Details in the GDP report were solid and suggest robust underlying growth, with investment (3.3%qoq annualised) and personal consumption (1.7%qoq annualised) as the key drivers. Higher frequency data point to solid Q3 activity as well. The Atlanta Fed GDPNow indicator accelerated sharply in July/August and suggested growth of around 6%qoq annualised at the time of writing. But the US is not immune to the headwinds facing the global economy and although private non-manufacturing activity continues to expand, according to ISM PMIs, manufacturing activity has contracted for ten consecutive months. This highlights the fragmentation of growth within economies and not just between them.

Nonetheless, the surprising resilience in activity overall has driven a reassessment of recession probabilities, with many forecasters now saying a recession is a risk rather than their base case. Another reason for the more sanguine outlook is the continued strength in the US labour market. The unemployment rate (3.8%) remains near pre-pandemic lows and job creation remains robust. Though the pace at which jobs are added to the economy has been trending down, there are tentative signs of a rising spare capacity. Furthermore, excess labour demand does seem to be cooling. The number of jobs per unemployed person has come down from around 1.9 at the start of the year to below 1.6 in July. This is still well above pre-pandemic levels and is one factor contributing to continued strength in labour income. Average hourly earnings (AHE) growth in year-on-year terms has slowed somewhat since the start of 2023 to reach 4.3% in August. This level of earnings growth is inconsistent with the Fed's 2% inflation target, and until we see a much more material slowdown, underlying inflation will very likely remain stubbornly above target.

It is important to keep the above considerations in mind when looking at the recent US inflation progress. Headline inflation has continued to trend lower and stood at 3.2%yoy in July. But as with most other advanced economies, the headline measure isn't grabbing policymaker attention. It is largely driven by the mostly exogenous factors of supply chain normalisation and deflating energy prices. Focus remains squarely on stickier measures of underlying inflation, such as core and core services inflation, which are now well above headline. Progress is being made on overall core inflation, which is down to 4.7%yoy, yet the more persistent core services inflation subcomponent slowed to a still high 6.1%yoy in July. This disinflation is certainly worth something but is a long way to 2%, and the strong activity and tight labour markets argue for caution around declaring victory too soon – underlying inflation may still take some time to glide back to target. Markets and consumers seem optimistic on this front, with inflation expectations softening markedly through 2023. This is positive insofar as expectations can impact actual price pressures, but if inflation progress stalls, there may be an episode of volatile market repricing as participants digest the implications of an extended policy plateau.

GRAPH 04 US GDP & REAL-TIME ESTIMATE

Growth still robust, could it be accelerating too?



Source: IFM Investors, Atlanta Fed, BEA, Macrobond

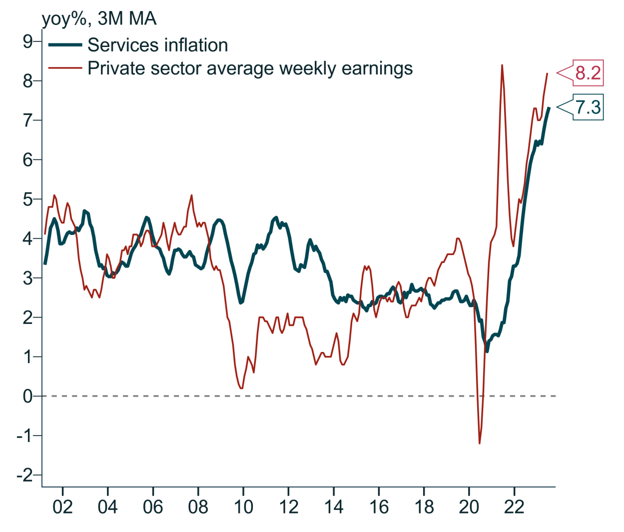
The Fed has signalled that it remains attentive to these risks. One complicating factor for advanced economy central banks in general is the elevated uncertainty associated with this tightening cycle – policymaking needs to lean more heavily on actual inflation data. Given that inflation is a lagging economic indicator, this leads to higher risks of overtightening and pushing the economy into a recession as policy measures fully transmit. The Fed has explicitly highlighted that data in the coming months will be important in determining whether further tightening is needed. As it stands, the Fed has slowed its pace of hiking in recent months after holding rates steady in June and hiking in July by 25bps. In terms of the forward view, the recent slowing in the pace of hiking and the increasingly data-dependent approach of the Fed suggests that September will likely be a pause. This will give the Fed two additional labour market and CPI releases to analyse. If progress continues, the July hike might turn out to be the final of the cycle. Communications from the Fed and Fed officials through August suggest a slight hawkish bias but we would characterise this as more 'duration hawkish' rather than 'level hawkish', where the main risks are around policy staying elevated for longer as opposed to rising materially from current levels. The stronger-than-expected growth momentum and continued labour market robustness were flagged as key risks driving the 'higher for longer' narrative, but policymakers have also highlighted an increasing focus on over-tightening risks as they approach the end of the tightening cycle.

UK: Wage price spiral risks

Inflation remains problematic in the UK, particularly compared to other advanced economies. This is not to say that no progress towards disinflation has been made in recent months: headline inflation has fallen sharply from a peak of 11.1%yoy in October 2021 to 6.8%yoy in July 2023. But the disinflationary gains seen in the last year or so will likely prove to be some of the easiest in hindsight. This has largely been driven by a combination of collapsing energy inflation (59.0%yoy in October 2022 to -7.8%yoy in July 2023) and sharp goods disinflation on the back of supply chain and energy issue resolution. These drivers should continue to place downward pressure on headline inflation in the coming months but focus is squarely on the lack of progress made on underlying inflation measures. Underlying inflationary pressures remain near historical highs, with core and services inflation at 6.8%yoy and 7.4%yoy, respectively. Furthermore, there is no clear evidence that underlying inflation has peaked yet. Services inflation is particularly important in the UK, given that services account for over 45% of the CPI basket. As long as services inflation remains elevated, it will be hard to get overall inflation sustainably back to target. UK services also have a relatively small import component making the domestic wage/price nexus more important than in other advanced economies.

GRAPH 05 **WAGES AND INFLATION**

Earnings accelerated, underlying inflation strong



Source: IFM Investors, ONS, Macrobond

The recent acceleration in earnings is, therefore, particularly problematic. The ex-bonus earnings measure for the overall economy surged in recent months to 7.8%yoy in three-month average terms in June (this is even higher than during the exceptionally distorted pandemic period when the measure peaked at 7.3%). The private sector analogue – which tends to be more responsive to economic conditions – has risen even faster, sitting at 8.2%yoy. Wages growth will need to slow substantially to around the pre-pandemic average of 3% to be consistent with getting inflation back to target. And for that to happen, we will likely need to see a nontrivial increase in spare capacity in the UK labour market. There have been tentative signals of softening in certain labour market indicators, including the unemployment rate, which has risen 0.4ppts since April to 4.2% in June. The job vacancies per unemployed person statistic also points to softening labour conditions and has softened sharply over the last year from a peak of over one job per unemployed person to approximately 0.7 as of May. There remains considerable uncertainty surrounding just how high unemployment will need to go to exert sufficient downward pressure on labour costs, but conditions will likely continue to soften in the coming quarters in line with the generally softening growth expectations over that timeframe.

The outlook for UK GDP is subdued and the rest of 2023 through to 2024 will likely see anaemic growth similar to that seen through the first half of the year. Specifically, the second quarter GDP expanded just 0.2%qoq following a near stagnation (0.1%qoq) in Q1 to see GDP up just 0.4% in year-on-year terms. Details in the report were more encouraging; business investment (3.4%qoq) recorded another exceptionally strong quarter of growth, and household consumption (0.7%qoq) remained robust. The forward view is more muted, with prominent survey indicators suggesting the past three months have seen a material slowdown in private sector activity. The latest PMI figures show overall business activity contracting for the first time in six months and at the fastest rate since January 2021. This contraction is broad-based and is impacting both manufacturing and services (which has proven remarkably resilient in recent months). Details in the report were soft as well but did show moderating inflation and employment growth, which will at least come as some relief to policymakers. Rising interest rates will continue to feed into debt servicing costs and consumption will likely remain under pressure as more mortgage refinancings feed through.

On the upside, savings remain elevated, labour markets relatively tight, and a reduction in July of the government's Energy Price Guarantee by around 20% should all provide some support to consumers. Additionally, the erosion of the purchasing power of wages should abate and may even reverse at some point in line with falling inflation and continued elevated earnings growth. The Bank of England (BoE) finds itself in a position where the risks to inflation and growth are finely balanced. This is complicated by the fact that BoE inflation models have not performed well in the post-pandemic environment, such that BoE policymakers have had to rely more heavily on the lagged signals provided by actual data. The strong data prior to the June meeting saw the BoE step up to a 50bps hike, followed by a 25bps hike at the August meeting. Communications also indicate that the BoE now views policy as 'restrictive' and lowered its GDP growth expectations through 2024 and 2025. Furthermore, the Bank flagged that some risks associated with persistent inflationary pressures may have begun to crystallise – policy will accordingly likely remain elevated for longer as a result.

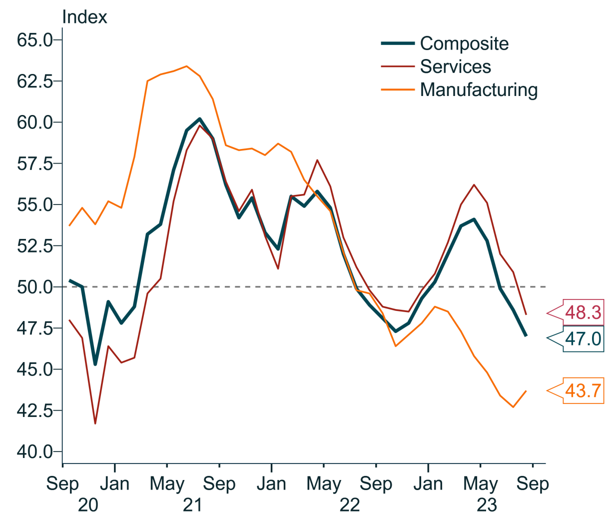
EUROZONE: Dark clouds gathering

The outlook for the Eurozone economy has darkened in recent months and the European Central Bank (ECB) is in a position where the risks to inflation and activity are much more finely balanced. Second quarter growth data show a tepid improvement over Q1, with real output expanding 0.3%qoq for the bloc as a whole. These figures are somewhat misleading, however. Growth in Ireland has been volatile (due largely to many large US technology and pharmaceutical companies being headquartered there) and the 3.3%qoq surge in Ireland's output in Q2 masks a weaker underlying growth picture for the Eurozone. In the larger economies, Germany (0.0%qoq) and Italy (-0.3%qoq) suffered from the global manufacturing slowdown – given the relative importance of manufacturing in those jurisdictions – whereas the more services-oriented France (0.5%qoq) and Spain (0.4%qoq) were more insulated.

More timely PMI data highlight just how dire the situation has become for industrial sectors throughout the regional economies. Private sector manufacturing activity has been contracting for over a year and Germany has seen manufacturing output contracting around its fastest rate since 2009 (excluding pandemic volatility). A relatively new development is the weakness in the services sector first seen in August. Services had, until August, been a key growth support counterbalancing the contraction in manufacturing. That now looks to have changed. Additionally, details in the PMI reports flag a near flatlining of employment growth and some concerning strength in inflationary pressures (though the overall trend in price pressures remains down). Other prominent survey measures, including consumer/industrial confidence and services/economic sentiment, are sending concerning signals as well after softening in August. Another factor expected to weigh is the ending of the summer tourist season, which has supported growth in Q3.

GRAPH 06 **EUROZONE PMIS**

Services have entered contractionary territory



Source: IFM Investors, S&P Global, Macrobond

Despite the uninspiring growth situation, the labour market remains exceptionally tight. The unemployment rate (6.4% in July) remains at record lows, and wages growth for the bloc continues to grow at an elevated pace (4.6%yoy in Q1). The lagged nature of the wages data limits its usefulness for policymaking but looking forward, there are strong wage agreements in the pipeline which suggests further upward pressure on wages in the coming months. There are some tentative signals of easing labour market tightness, with vacancy statistics in Germany and France looking like they have peaked. Furthermore, the unemployment rate in Germany has been slowly trending up but this impact has been drowned out by continued downtrends in the rest of the bloc. Looking forward, we expect to see clearer signs of increasing spare capacity through the remainder of the year as the lagged impacts of the softening growth impulse feed into the labour market.

The generally bleak outlook does have a silver lining in terms of the implications for inflation. Slower growth and rising unemployment will help the ECB get inflation back towards target. There has been some progress to date and price pressures have broadly been moving in the right direction. The headline measure (5.3%yoy in August) has come off sharply on deflation in energy prices and strong goods disinflation. Core inflation (5.3%yoy in August) looks to have tentatively peaked, but there is not yet clear and unambiguous evidence of an underlying disinflationary process. Services inflation in August, another useful proxy for 'stickier' inflation, was just 0.1ppt below the inflation cycle peak of 5.6%yoy in July. Continued pressure from wages growth is a particular concern given that labour compensation forms the most significant cost component of services. When underlying inflation begins to soften, it is also unlikely to be anywhere near as rapid as headline disinflation. There is more good news in terms of consumer inflation expectations for the next year. This metric has fallen significantly in recent months to just 3.4% in June, such that the risks of a destabilising unanchoring of inflation expectations appear remote.

The ECB continued to tighten policy, raising rates by 50bps since our last update (25bps at the June meeting, 25bps at the July meeting). The tone from the ECB shifted materially between the June and July meetings, however, as it became increasingly clear that the growth outlook for the Eurozone had deteriorated. June saw communications lean hawkish, with the ECB effectively pre-committing to a July move after saying more ground needed to be covered on rates and that a move was "very likely". July communications were much more balanced, and the ECB shifted even further to data-dependent policymaking. Indeed, Christine Lagarde, the president of the ECB, said that policymakers would need to keep an "open mind" at future meetings. There is less clarity on what the ECB will do at its next meeting in September. The softening economic backdrop is expected to take some steam out of inflation, but whether this will be sufficient to justify a pause remains to be seen. Whatever the case, the ECB looks unlikely to raise rates much further. And we may even find that the July hike was the last one of the cycle.

CHINA: Structural issues stalling the recovery

China's economic recovery following its reopening in December last year has stalled. Weaker household spending has resulted in difficulties rebalancing towards consumption-driven growth, while exports slump on the back of weak global demand, and the indebted property sector weighs on investment. Notably, China has flirted with deflation on the back of weak domestic demand: headline CPI fell to -0.3%yoy in July, while core (excluding food and energy) has been rising below 1%yoy each month since January. Overall, the outlook for economic growth is much weaker than before, and the Chinese authorities' GDP growth target for 2023 of "around 5%" is looking more and more difficult to achieve. A key question for the economic outlook will be how effective policy easing measures implemented to date will be, and how much more support, particularly to the property sector and households, will be provided.

The Chinese economy grew 6.3%yoy (0.8%qoq) in the June quarter, below expectations and slowing significantly from its Q1 post-reopening rebound. Household consumption drove growth; the contribution of investments was relatively modest (slowed by the property sector) and net exports weighed on growth.

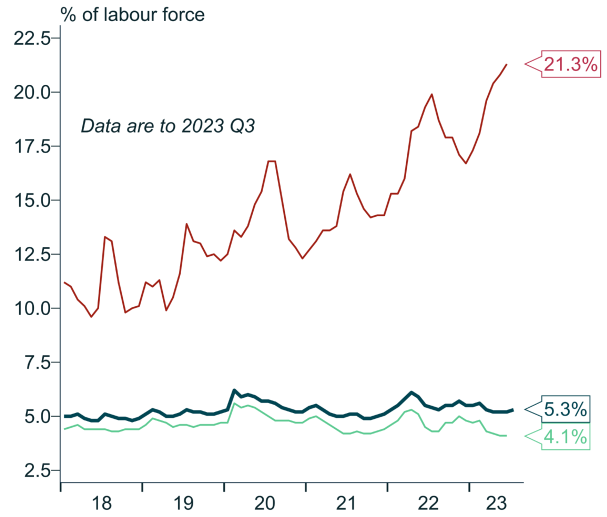
While household consumption drove growth in Q2, it remains below its pre-pandemic trajectory, which will make rebalancing towards consumption-driven growth while reaching the 5% GDP growth target difficult. The decline in the housing sector has weighed heavily on related consumer demand. Services spending has been more positive, and this is reflected in the non-manufacturing (services) PMI remaining in expansionary territory since the reopening but easing for the fifth month straight to August. But retail sales have slowed on the back of slowing goods consumption, and in July, recorded their slowest rate of increase since the reopening in December last year. The outlook is relatively weak, with consumer confidence falling significantly recently due to a loosening labour market and weakness in the property sector.

Some loosening in labour market conditions has precipitated the fall in consumer confidence, and in particular, consumer surveys have recorded an increase in stress around job security. While the unemployment rate has remained around 5% (its 2019 average), it has ticked up recently, to 5.3% in July. Some of this increase has been driven by the increase in youth unemployment, which in June reached a historic high of 21.3%. In August, the National Bureau of Statistics announced that it would temporarily stop publishing youth unemployment data, which many have interpreted as a sign the authorities are concerned about the growth outlook. Notably, when the authorities set the 2023 growth target of 5.0%, they also set a target for creating 12 million new urban jobs, or around enough jobs to absorb the 11.58 million college graduates in 2023.

The slowdown in China's property sector has also weighed on economic growth. Debt concerns of property developers have led to uncertainty around the completion of homes, which has led to a decline in housing sales. This, in turn, has further stressed developers' finances, making it even more difficult for them to complete existing projects. Floor space sold in 2023 is tracking well below its levels in the previous five years, and falling house prices are also weighing on consumers.

GRAPH 07 **UNEMPLOYMENT IN CHINA**

Unemployment rate low but youth unemployment a concern



Source: IFM Investors, National Bureau of Statistics, Macrobond

On trade, China's net exports subtracted 0.6 percentage points from economic growth in the June quarter after making only a slightly negative contribution in the March quarter. While import growth (in year-on-year terms) has been negative in the three months to August, amidst the relative slowing in household consumption, export year-on-year growth has also declined for five months straight to July, as the global slowdown continues to put pressure on external demand. The outlook is less optimistic, too: the new export orders subindex of the NBS manufacturing PMI has been in contractionary territory since April.

Consequently, the Chinese authorities have provided some fiscal and monetary support to the economy, although it is likely that more will be needed to achieve the 5% growth target. To support property demand, required LVRs for down payments and mortgage rates were lowered in Tier-1 and -2 cities, and the People's Bank of China (PBoC) cut a number of key lending rates. To support consumption, the authorities have introduced measures to promote spending on big-ticket items like cars and home renovations.

Australia's trade relationship with China has continued to achieve incremental improvements over recent months after the setbacks that characterised the pandemic period. While short-term arrivals to Australia from China are still only at a third of pre-pandemic levels, demand for travel to Australia will now likely increase as Australia's place in China's Approved Destination Status scheme, an arrangement between China and other foreign governments that allows Chinese tourists to travel in guided groups, was reinstated in August. Working in the other direction, weakening household consumption, reports that consumers are substituting more expensive international destinations for cheaper ones, and a substitution of international travel for domestic travel are weighing. On the goods side, China has also dropped its tariffs on imports of Australian barley; trade sanctions now only cover $2b of Australia's trade with China.

JAPAN: Progress towards a new normal?

Japan's economy has continued to outperform other advanced economies despite some emerging weaknesses in domestic demand. Encouragingly, there are signs that higher wages growth could support domestic consumption moving forward. The Bank of Japan (BoJ) still views the price stability target of 2%, on a sustainable basis, as out of reach for now, and so has maintained loose monetary policy. While it made some changes to its yield curve control policy in July, it had no meaningful economic implications and was largely to ensure the healthy functioning of the bond market.

Japan's economy grew 2.1%yoy (6.0%qoq annualised) in Q2, well above market expectations. However, there are signs that economic performance is uneven, with growth largely driven by the external sector as domestic demand weakens. The BoJ expects an economic growth rate of 1.5% for FY2023 and 2024, moderating to 1.0% for FY2025.

Growth comes on the back of a strong positive contribution from net exports, though this was assisted by a fall in imports. Exports grew in the quarter, supported largely by the ongoing resolution of supply chain issues and the improved availability of semiconductors for the auto industry. Services exports recorded strong growth again as tourism continues to support economic activity. This trend should continue for the rest of the year, as China reinstated Japan on its list of approved destinations for group travel. Meanwhile, the fall in imports was driven by a fall in goods demand, as households restrained spending and the trend away from goods consumption towards services consumption continued. Imports also fell on lower imports of energy commodities (notably LNG and oil).

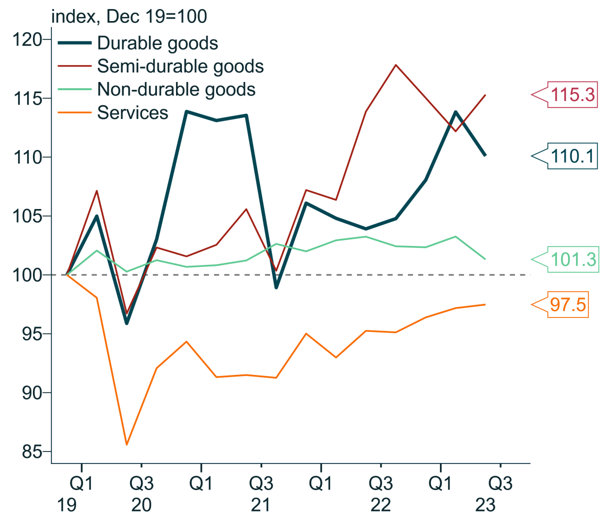
Domestic demand only contributed modestly to economic growth, however, and growth slowed in the quarter. Investment made a relatively small contribution to growth in Q2, but risks are skewed to the downside for future outcomes. The BoJ has noted that the largest risk to the outlook for investment is the performance of overseas economies, as global central banks try to navigate the path to soft landings, risks to financial stability remain (e.g. in the US banking system), and China's economy continues to slow.

Private consumption, which accounts for over half of Japanese GDP, fell in the quarter, and the outlook moving forward is mixed. Private consumption fell in Q2. And while services consumption has improved over the past few quarters, it remains below 2019 levels. In the quarter, this was offset by goods consumption, notably durables and semi-durables, that dipped below 2019 levels in Q2. Despite weakening private consumption, largely in the face of higher prices, consumer confidence had improved over the past few months (before dipping slightly in August), as labour market conditions and wages improved.

A key factor for the consumption outlook is the evolution of wages – that is, the extent to which progress towards a 'virtuous cycle' has been made, in which wages keep pace with price increases and support consumption, which continues to sustain higher wages and drive demand for goods in the future. Positively on this front, the rate of wages growth rate agreed to in the Spring wage negotiations (shunto) this year was the highest in three decades. Importantly, wage increases were also seen across small, medium and large firms to attract and retain staff as the labour market faces relatively severe labour shortages. Gains in employment since the pandemic have largely been preserved, and the unemployment rate in July remained low at 2.6%.

GRAPH 08 **PRIVATE CONSUMPTION IN JAPAN**

Services spending rebounding, while goods soften



Source: IFM Investors, Japanese Cabinet Office, Macrobond

Headline and core (ex-fresh food) CPI both rose 3.3%yoy in July while core-core (ex-fresh food and energy) CPI rose 4.3%yoy. The BoJ expects inflation to decelerate over the coming months, as base effects from the peak in import prices in mid-2022 work their way through. Afterwards, however, it expects inflation to 'accelerate moderately' as firms' wage- and price-setting behaviour changes, and people's expectations of wages growth and inflation rise. In its outlook report, the BoJ projected CPI to be 2.5% for FY2023, 1.9% for FY2024, and 1.6% for FY2025 – i.e., below the 2% price stability target. While the BoJ is optimistic that firms have begun to change their price-setting behaviours to anticipate further increases in wages, its assessment remains that achieving price stability of 2% has not yet come into sight.

The BoJ has maintained its loose monetary policy stance and is unlikely to change it until it views the 2% price stability target as achievable. The BoJ believes that the downside risks to missing the target, whether due to a too-hasty revision of monetary easing or a slowdown in global growth (particularly in China), are greater than the upside risks to overshooting the target and having a period of inflation above 2%.

The change made by the BoJ to its yield curve control (YCC) policy in July caught the attention of market participants but had no real meaningful implications for policy. The BoJ now allows the yield of the 10-year Japanese Government Bond to fluctuate by 50 basis points around the target of 'around 0%', rather than by 25 basis points.

KOREA: The global slowdown hits

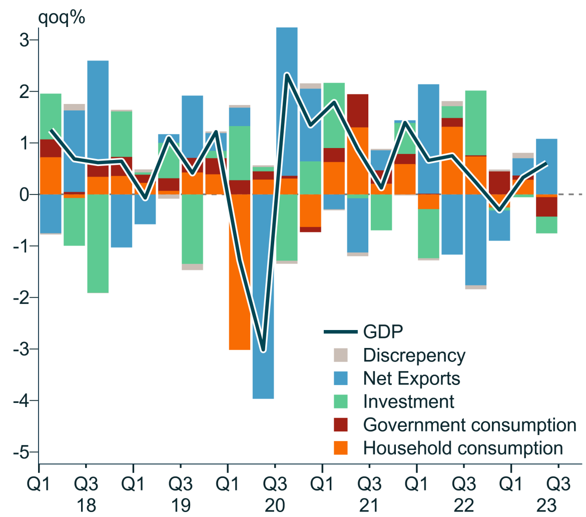
The Korean economy continued to slow as trade and the IT industry struggle to make up for weak domestic demand. The Bank of Korea (BoK) has adopted a more hawkish stance than previously, as demand for services spending keeps core CPI elevated and high levels of household debt create concerns over financial stability. The outlook for economic growth has softened, as the resilience in the labour market shows signs of fading and export growth remains soft, despite likely having bottomed out.

The BoK has left the Base Rate unchanged at 3.5% since February this year but adopted a more hawkish attitude in August than in previous months. Following its latest decision, Governor Rhee stressed that the focus for monetary policy is on whether or not 3.5% is a high enough terminal rate, rather than when policy rates will be cut – a topic that has dominated discussion among market participants. The BoK Board noted that given the outlook, it was "…warranted to maintain the restrictive policy stance for a considerable time and judge whether the Base Rate needs to be raised further". In August, all six monetary policy committee members were open to considering a terminal rate of 3.75%, while in July, only three members were open to this.

Like most central banks, the BoK must balance competing concerns in the economy. Weakness in domestic demand and China's lacklustre economic performance could slow growth further, adding strength to arguments to keep the terminal rate at 3.5%. Whereas stickiness in some components of core inflation and concerns over financial stability could push the terminal rate further up. Indeed, the BoK upgraded its forecast for core CPI in 2023, which it revised up 10 basis points to 3.4%. It made no changes to its forecasts for headline inflation (3.5% in 2023 and 2.4% in 2024), yet it expects inflation to remain above the target level for a 'considerable time.' The BoK also placed considerable emphasis on financial stability, calling out the upward trend in household debt as a downside risk to longer-term growth. According to the Bank for International Settlements, Korea's household debt service ratio at the end of 2022 as a share of income was 14.3%, second only to Australia's 16.3%.

GRAPH 09 ECONOMIC GROWTH IN SOUTH KOREA

Only net exports contributed positively in the quarter



Source: IFM Investors, Bank of Korea, Macrobond

On the data flow, inflation has continued to moderate but like in most economies core CPI is coming down more slowly than the BoK would like it to on account of robust demand for services. The headline inflation rate fell to 2.3%yoy in July, although this was largely due to base effects from global oil prices. The BoK expects that headline inflation will pick up slightly again and remain around 3% for the rest of the year. In contrast, core CPI is falling at a much slower pace, and rose 3.35%yoy in July. Demand pressures are keeping core CPI elevated, with services inflation, particularly personal services (including eating out), remaining stubborn. Some loosening in the labour market, as well as the household debt servicing burden, could lead these pressures to moderate in the near term.

Demand for services is supported by relatively robust labour market outcomes, though recently, some signs of loosening have emerged. Unemployment ticked up slightly to 2.8% in July, despite a slight fall in the participation rate. Employment growth has slowed and turned negative in June.

The BoK's hawkishness is not due to strength in economic activity, which in particular has been weighed down by weakening domestic demand. Headline activity appeared relatively robust given an environment of restrictive rates and global economic uncertainty in Q2, as growth picked up to 0.6%qoq (0.9%yoy), in line with expectations. Looking forward, the BoK kept its 2023 growth estimate at 1.4% in its updated forecasts but lowered its 2024 forecast by 10 basis points to 2.2%. This reflects weakness in China's economy and the slump in the IT sector, which will weigh on facilities and construction investments.

Net exports drove all of the quarterly economic growth in Q2 and contributed 0.9ppts to growth. Higher net exports, however, were mostly due to the fall in imports (mainly energy commodities) being larger than in exports. Exports in July fell 16.4%yoy, the weakest result since the start of this year. Exports in the first 20 days of August continued to fall in a year-ended sense. The slowdown in China's economic recovery is a headwind to a recovery in Korea's exports, with China still Korea's top export destination (despite some rebalancing over the past few years towards other markets).

Domestic demand weakened in the quarter and provided a drag on economic growth. Private consumption detracted 0.6ppts from quarterly growth and saw its slowest year-ended growth rate in just over two years. Higher interest rates and increased household debt weighed on private consumption; while consumer confidence has picked up recently, high interest rates, household debt and early signs of loosening in the labour market will likely weigh on consumption in the near term. Investment also weighed on growth in the quarter, with facilities investment particularly weak due to the global IT slowdown. Despite these challenges, the likelihood of outright recession remains low. However, the market expectation of growth accelerating to nearly 2.5%yoy may need to be tempered in our view.

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