IFM Investors

Economic Update
Q1 2024

Rate cuts: Not if, but when

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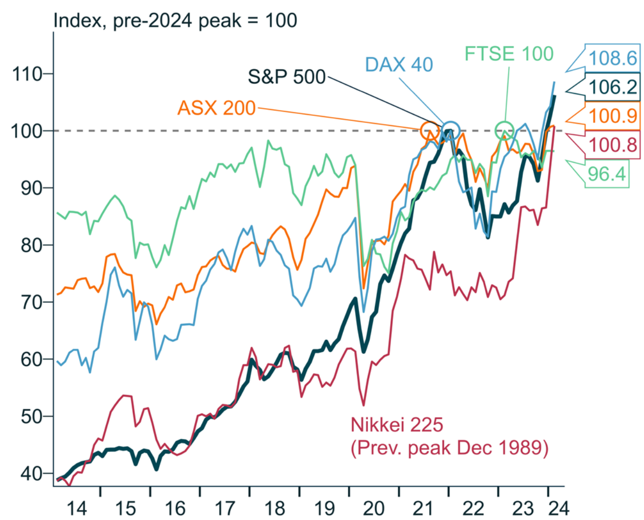
A combination of broadly favourable inflation and growth data has seen the 'immaculate disinflation' view become consensus in recent months. As inflation loosens its grip, market participants eagerly anticipate easier policy from central banks. This has driven strong risk asset performance, with equities and credit markets seemingly 'priced for perfection'. The concern is that conservative central banks are willing to risk some economic underperformance to avoid stoking inflation with overzealous easing. In this scenario, we expect the synchronised easing narrative to fragment as each central bank grapples with its own idiosyncratic set of risks. For markets, the risk of disappointment on the policy front is material.

GLOBAL: Priced for perfection

The dislocation between financial markets continued in the first quarter of 2024. It seems that because economies didn't fall into recession in 2023 when they were broadly expected to, then they never will. This emanates from the US, where economic performance has surprised to the upside (with the tailwind of fiscal policy) and inflation to the downside - hopes for a soft landing and immaculate disinflation are consensus. But are valuations in equity markets justified? Corporates are doing relatively well in a rapidly growing nominal environment that will inevitably fade as inflation, in our view, becomes re-anchored at targets over the next year or so. And why are we seeing the same thing in economies far more challenged than the US? In the Eurozone, growth is flat and recession risks are high; Germany is in recession but its equity market hit a record high in the quarter. Japan is in recession, but its equity market is also at record levels not seen since the late 1980s bubble. The UK is not too far from its record high of a year ago but is also in recession. Then there are smaller economies like Sweden, with record equity market highs and recessions. Australia fits into this narrative differently; but again, there was a record high reached in equity markets but an ongoing per capita GDP recession. What is going on?

GRAPH 01 KEY GLOBAL EQUITY INDICES

Several markets near/above all-time highs



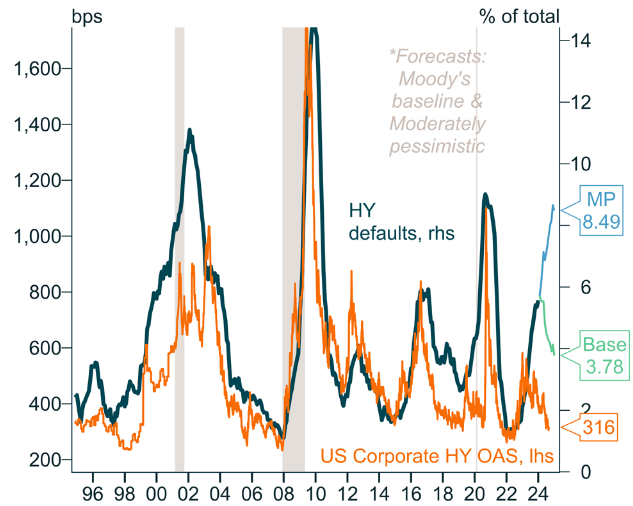
Source: IFM Investors, S&P, ASX, DAX, Nikkei, FTSE, Macrobond

The easy answer here is that the equity market is not the economy. However, the two tend to converge at points, and it will be a question as to which one gives first. Will economies perform better in 2024, justifying valuations? Or will equity market gains be tempered and economic reality eventually hit? The market seems to be betting on the first of these outcomes, that economies will gather momentum. This will be allowed by a disinflation trend that has been relatively low cost in terms of the negative impact on growth (so far, recessions have been very shallow) and unemployment that was expected to return inflation to targets. The kicker being that when this occurs or slightly before that central banks will cut rates and, in some cases, aggressively so. This quick policy turnaround is the market consensus across advanced economies (excluding Japan) and takes us back to the pre-pandemic notion that central banks will step in for markets and support valuations. And further make right the skew we see in markets like the US, where the earnings of a few darlings (the Magnificent 7, now 6) offset the weaker expectations of the many.

It is not only equity markets that have this expectation. Credit markets are also seemingly underpricing any material downside economic risks. This is most notable in US high yield markets where spreads are as narrow as they have been for much of the last decade, despite the clear uptrend in default rates and the risk that those default rates push further upwards even in a benign economic scenario, let alone a weaker-than-expected one. These markets are arguably focusing more on the solution to economic dislocation, that is, focusing on lower rates rather than the impact of the dislocation on valuations.

GRAPH 02 **US CORPORATE HIGH YIELD DEFAULTS* & CREDIT SPREADS**

Are investors under-pricing credit risk?



Source: IFM Investors, Bloomberg, Moody's, Macrobond

It is interesting to consider whether the best returns in equity and credit markets are behind us, at least for the near term, given this pricing for perfection. Where do valuations go – given what is already priced – in the event that we see a very soft or no landing, with inflation well-behaved and at targets and central banks cutting rates to reduce further downside economic risks? We would likely need to see central banks cut rates more than expected, taking policy back into accommodative territory to justify further valuation optimism. This is currently not expected. Instead, we expect that central banks might go the other way in terms of both the timing and magnitude. This is true in the US context, where there seems to be no emergency that the US Federal Reserve (Fed) needs to address. Economic growth has surprised to the upside, the unemployment rate is low and the equity market is flying. The Fed has the luxury of choosing when it eases rather than being forced to ease by a weaker economy or market. Why would the Fed risk the reputational hit of stoking inflation again by easing too early and too deeply? As we have experienced recently, even the slightest bump along the disinflation path has the potential to wind back pricing of rate cuts materially. And to us it would be unsurprising for central banks more broadly to keep a slightly hawkish and cautious tone on inflation risks until they are completely confident they have slayed the dragon.

This brings us to consider the second of these propositions - will markets be forced to recognise the economic reality? This to us, seems like a key risk to current pricing. Central banks still have to entertain inflation risks from 'stickier' elements of the basket, such as services, while the lags in their policy take a greater economic toll than is currently expected. This may reinforce a higher-for-longer narrative on policy rates that would take some of the exuberance out of markets. To us, this is still a risk. In addition, there is the chance that conservative central banks are content to take some risk to economic performance so as not to potentially stoke inflation with overzealous easing. In this scenario, we also expect the synchronised easing narrative to fragment as each central bank grapples with its own idiosyncratic set of risks. We continue to see that some central banks will get to choose when to ease policy, and some will be forced to. And it will not be a smooth path for all. This has the potential to impact valuations in financial markets and also reverberate through exchange rate markets in which volatility has been in steady decline since late 2022.

In both of these scenarios, the risk seems to be that coming reductions in rates disappoint expectations, particularly for investors that are heavily overweight fixed income. It seemed right to be defensive amidst the peak bearishness of late 2022 when global recession risks were at their peak. However, whether that positioning will pay off with outperformance in these asset classes going forward has come into question.

AUSTRALIA: Per capita malaise

The Australian economy continues to hold up despite households being under ongoing cost-of-living pressures and the impact of higher interest rates on mortgage holders.

For its part, the Reserve Bank of Australia (RBA) held rates at 4.35% at its February meeting. It is heartened by the progress on disinflation, with the quarterly figures showing a deceleration in headline terms to 4.1%yoy and 4.2%yoy on the trimmed mean measure. But the RBA noted that it "needs to be confident that inflation is moving sustainably towards the target range" and that it would be "some time yet" before inflation did so. While it went on to note that "a further increase in interest rates cannot be ruled out" this is more than likely a desire not to remove any tightening bias completely given the uncertain outlook and potential still for some volatility along the path to the mid-point of the target. The goods-heavy January print of the monthly CPI indicator showed that the disinflationary process continued early in 2024 with a negative outcome for the quarter, dragging the headline measure to 3.4%yoy. Nonetheless, the measure excluding volatile items and holiday travel remains at 4.1%yoy. The Statistician noted that energy rebates were holding electricity prices lower. However, we share the RBA's caution on the inflation outlook, which leads us to still expect that any rate cuts will not be delivered until the second half of the year.

Our call on rates is being underpinned by the labour market, still very low unemployment rate and high levels of participation and employment to population that have supported the household sector through cost-of-living and interest rate pressures. We remain watchful in this space as it is clear the labour market has loosened in the past six months, but it has not yet buckled. That said, the unemployment rate has ticked up to 4.1%, and hours worked have declined sharply, pushing the underutilisation rate higher to 6.6%. A more pronounced increase in unemployment in recent months has been avoided due to a simultaneous retracement of a recent spike in the participation rate. Of further concern is the slowdown in employment growth that sits at around 7,300 per month in trend terms while the labour force is expanding by 32,700 people (assuming constant participation). A continuation of this trend would see a strong labour supply overwhelming weakening labour demand – pushing unemployment materially higher. We do not have to necessarily see large outright job losses to have unemployment rise.

Further, the composition of this employment growth has also shifted, demonstrating business caution. Since June 2023, 58,000 full-time job losses and 214,000 jobs have been gained – the latter being more loosely attached to the workforce. The Statistician noted that the weakness in employment in January was due to seasonal factors delaying New Year job starts and that more people would be commencing work in February - meaning this upcoming print will be a big test. The unemployment rate rising beyond the RBA's expectations would be of concern, as this would likely prompt consumers to act on woeful levels of sentiment and a further pullback from retail spending. It would be desirable to keep the labour market tight to facilitate ongoing wages growth, that was 4.2%yoy in Q4 2023. There is clearly no threat of any wage-price spiral dynamics, and some sustained real wages growth will be needed to repair the purchasing power damaged by the inflation shock.

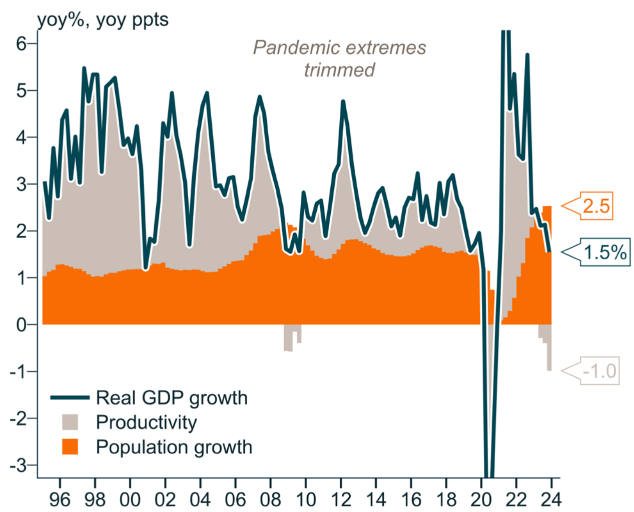
The national accounts for the December quarter showed that the economy edged out some modest growth in Q4, expanding 0.2%qoq and 1.5%yoy. Yet again, this was supported by population growth. Notable at the headline level was the economy recorded its fourth consecutive reversal in per capita growth GDP (1.0%yoy lower), an unusual occurrence outside a traditional headline technical recession. And even then, it has not happened since 1982-83. Underscoring again how population growth is the key driver of growth and without it the economy would be in recession.

The RBA's forecast for the quarter growth was 0.3%qoq and 1.5%yoy so policy implications are few. The household sector was very weak as higher rates and cost-of-living issues continue to impact. Household spending in real term expanded 0.1%qoq with a focus on essential spending that rose 0.8%qoq and at the expense of non-essential items where spending fell 0.9%qoq. Dwelling investment went backwards sharply as the construction sector slump continues, but solid growth in business investment was a positive. Nonetheless private demand overall was flat in the quarter, the public sector added modestly yet after inventories subtracted materially, gross national expenditure contracted 0.2%qoq. Only a solid contribution from net exports kept headline GDP positive.

The adjustment in hours worked was again highlighted in the national accounts falling 0.3%qoq after a 0.7%qoq decline in Q3, with growth still modestly positive this resulted in an improvement in Australia's beleaguered productivity performance. This is predominantly 'forced' productivity stemming from the RBA's policy settings squeezing businesses rather than any proactive reform or importation of productivity enhancing technology or other improvements. The challenge ahead is to generate sustainable productivity growth to underpin real wages growth as this is what is required to remediate cost-of-living issues that will be ongoing long after inflation is back to the RBA's target.

GRAPH 03 **REAL GDP DECOMPOSED**

Population the key driver of growth



Source: IFM Investors, ABS, Macrobond

US: Still going strong

US growth continued to soundly beat expectations in the final quarter of 2023. Real GDP grew by 3.2%qoq annualised, substantially faster than the 2.0%qoq annualised rate initially expected by economists. Yet the growth composition suggests underlying momentum is a touch softer than the headline measure. Net exports (0.32ppts) were a material contributor, and inventory drawdown was less muted than expected in Q4 following a surge in Q3. Domestic demand still looks healthy with personal consumption (2.00ppts) and the unusual skew to government spending (0.73ppts) rather than private sector investment (0.17ppts), driven by expansionary budget settings, nonetheless all supported output.

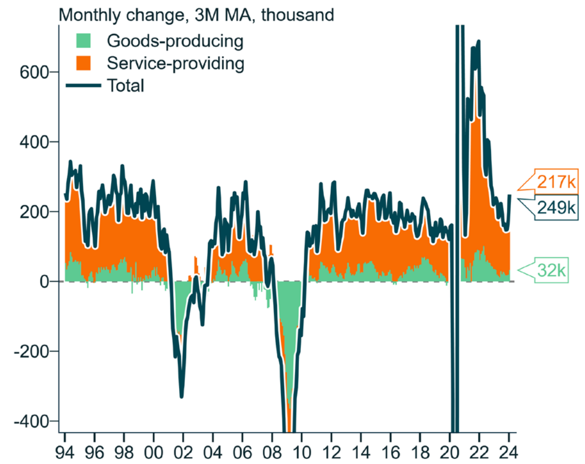
Higher-frequency data suggest that activity momentum has continued into Q1. The Atlanta Fed's high-frequency GDP tracker (GDP Now) has US real GDP expanding at an average of 2.7%qoq over the first quarter this year, and the New York Fed's weekly economic index has activity tracking at around the 15-year average. Disappointing retail sales data for January (headline: -1.1%mom, control: -0.4%mom) – coupled with negative revisions to previous figures – may suggest a moderation in consumer spending. However, this should be balanced against seasonality issues around December/January and the generally positive directionality of consumer sentiment in recent months.

Other soft data also support this broadly positive outlook. The ISM services PMI remained solid in February (52.6) with a strong composition (the employment, new orders, and business activity components all expanded). The manufacturing sector remains softer (in line with global manufacturing softness); the ISM manufacturing PMI had trended up in recent months but in February retracted some of that positive momentum to come back to 47.8, still in contractionary territory.

This growth momentum has been reflected in the continued robust performance of the US labour market. Nonfarm payrolls growth accelerated sharply in December and January to see an average of 343,000 new jobs added per month over those months (100,000 more than the median monthly growth for the last 10 years). This has seen labour conditions remain historically tight, with the unemployment rate at 3.7% in January. Excess demand for labour appears to still be in a moderating trend with vacancies per unemployed person reaching 1.4 in January (compared to around 1.2 pre-pandemic). The signal from earnings/wages data is also broadly consistent with a continued re-equilibration in the labour market. The employment cost index for Q4 (4.2%yoy) has continued a clear downward trend from Q2 2022 (5.1%yoy), the Atlanta Fed wage tracker in 3-month moving average terms has softened materially from 6.7%yoy in August 2022 to 5.0%yoy in January 2024, and private sector average weekly earnings softened sharply in January to 3.0%yoy to continue a (volatile) downward trend. Average hourly earnings is an outlier here and has surprised sharply to the upside (4.5%yoy). But this is linked to a sharp fall in hours worked (pushing earnings per hour up) and a few strong prints from a single indicator doesn't on its own offset the progress suggested by other earnings measures.

GRAPH 04 **US PRIVATE NONFARM PAYROLLS**

US labour market momentum is strong



Source: IFM Investors, BLS, Macrobond

A 'Goldilocks' outcome continues to be realised with ongoing disinflation progress against the solid growth and tight labour market backdrop. However, some stronger-than-expected inflationary signals and a re-acceleration in key inflation metrics in recent months warrant caution. The downward trend in headline inflation has stalled, with the measure oscillating around an average of approximately 3.5%yoy for the last nine months to be at 3.1%yoy in January. Core inflation has continued to trend down but progress stalled in January with the measure tracking sideways at 3.9%yoy. Looking at figures in three-month annualised terms highlights the issue further. Core inflation has trended up to reach a 4.0% rate in January (up from 2.6% in October). Even more concerning, services have accelerated from 4.4% in July 2023 to 6.2% in January. This is not to say that inflation is on track to spike again, but rather to highlight that we shouldn't be complacent and declare inflation vanquished. There is still a risk of persistent price pressures in the system. Having said that, it is worth pointing out that the Fed's preferred measure of inflation (the core PCE price index), continued to slow and reached 2.9%yoy in December. Even more encouragingly, this measure fell below the Fed's target of 2% in 3-month annualised terms, reaching 1.5% on this basis in December.

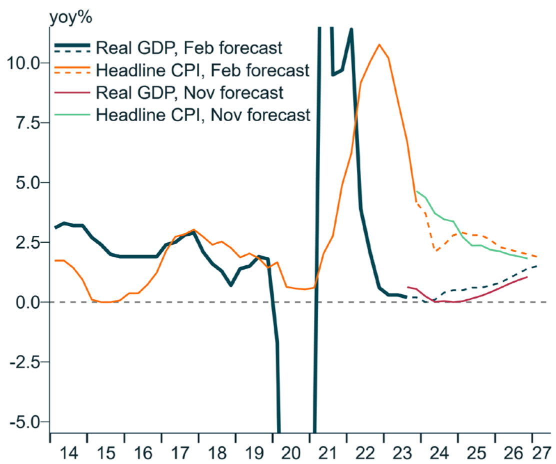
The Fed can afford to be patient and wait for further data to get a better sense of how the economy is evolving. There are no imminent signs of a growth slowdown, the labour market remains solid, and although inflation progress is slowing, there are no signs at this stage of a dangerous inflation resurgence that would require further tightening. Accordingly, the Fed continued to leave rates unchanged at 5.25%-5.50% at its December and January meetings. Communications from the January meeting also pushed back on market expectations of rate cuts, which had become quite aggressive given the positive dataflow at the time. The statement accompanying the January decision highlighted that the Fed needs to be more confident that inflation is sustainably back at target before it begins reducing rates. Powell said this condition was unlikely to be satisfied by the March meeting, but communications also highlighted that the Fed feels risks to its inflation/ employment goals have become more balanced.

UK: Recession likely over already

The UK slipped into a shallow technical recession in the final quarter of 2023. Third quarter GDP growth was revised down from 0.0%qoq to -0.1%qoq and was followed up by a larger-than-expected contraction of -0.3%qoq in Q4. This has seen real GDP nearly flatline in 2023, with the economy growing by just 0.2% compared to 2022. Looking at the context of these data – and the details of the GDP report – suggests that the UK has likely experienced a trough and is going through something more like a stagnation than a true recessionary environment. Indeed, a key drag on activity through Q4 was net exports (-0.6ppts), driven by a sharp 2.9%qoq contraction in exports. Looking through this external demand-induced softness, domestic demand grew by a healthier 0.3%qoq. This was largely driven by investment (0.44ppts), which more than offset soft consumption from both households (-0.08ppts) and government (-0.06ppts).

GRAPH 05 **BOE GDP AND CPI FORECASTS**

Faster disinflation, better medium-term growth



Source: IFM Investors, ONS, BoE, Macrobond

Higher-frequency activity indicators are already pointing to recovering growth in early 2024. PMI data show overall private sector activity increased in both January (52.9) and February (53.3) on the back of continued private services expansion (54.3). Manufacturing activity continues to disappoint but is significantly less important for overall activity for the heavily services-reliant UK. Details in the PMI release flagged a solid rise in customer demand in January and highlighted that optimism regarding the year-ahead outlook has reached its highest level since February 2022. There are encouraging developments for the household consumption outlook through 2024 as well. Real average weekly earnings grew by 1.9%yoy in December, as falling inflation is being outstripped by nominal earnings growth. Continued positive real earnings growth, combined with expectations of easier monetary policy later in the year, will likely support household consumption.

Inflation progress has stalled somewhat in the last three months, with the headline measure rising from 3.9%yoy in November to 4.0%yoy in December and January. Core inflation has performed similarly, tracking sideways at 5.1%yoy since November. Nonetheless, this was a softer outcome than expected by economists. Much of the softer-than-expected read was concentrated in transport services, including the volatile airfares component. To look through some inflation volatility, the Bank of England (BoE) in December flagged a measure of services inflation that excludes airfares, non-private rents and accommodation, which has recently accelerated to 6.8%yoy. On balance, however, price pressures seem to be ebbing and will likely continue to do so in the coming months.

This needs to be balanced against renewed strength in labour market data around the end of 2023. The unemployment rate has fallen to 3.8% (near the historic low of 3.4% in 1973) after five consecutive declines and challenges the view of a material loosening in the UK labour market over recent months. These developments have also seen an end to the downward trend in job vacancies per unemployed person (a measure of labour demand), which has risen for five consecutive months to 0.71 in November (materially above the roughly 0.6 in pre-covid times). Earnings data also showed signs of strength. Though the headline measure of average weekly earnings continued to soften in December, growing 5.8%yoy in three-month average terms, this was still above economist expectations. Furthermore, the private sector regular pay measure (a better indicator of underlying wage dynamics in the economy) remains elevated at 6.2%yoy in three-month average terms and has accelerated for two consecutive months in three-month change terms. There is also evidence of stickiness in wages in the BoE DMP forward-looking wages survey, where progress has stalled since around May 2023.

It must be flagged, however, that there have been issues around the reliability of some of the labour force statistics. The Office for National Statistics (ONS) suspended its labour force data release last year given low survey response rates and resumed publication in mid-February this year, after addressing some of the issues. However, the ONS continues to warn that figures are not fully reliable. This has complicated the job of policymakers. Indeed, although the unemployment rate was 'officially' 3.8% in December, BoE Governor Bailey has flagged that BoE staff have advised that whether the unemployment rate is really 3.8% or 4.2% (as suggested by experimental data) is hard to judge.

The BoE has felt comfortable leaving policy as is, with rates remaining unchanged at both its December and February meetings. Governor Bailey flagged that things are moving in the right direction but it is still too soon to cut. The minutes noted easing (but still elevated) wages growth and a faster-than-expected/broad-based decline in inflation. However, against this backdrop, Bailey flagged that the BoE needs to be more confident of a sustainable return to target before easing could be considered. The BoE also released a new set of macroeconomic projections with downward revisions to inflation and an improvement to the medium-term growth outlook. The Monetary Policy Committee (MPC) also acknowledged at its December meeting that fiscal easing should add 0.2-0.3% over the forecast horizon but should only have a limited inflationary impact due to the supply-side focus of measures. Several senior BoE representatives have made speeches (and testimony) late in February to the effect that market expectations of policy easing are "not unreasonable", but "more evidence" that inflation does not persist at elevated levels is required before that takes place.

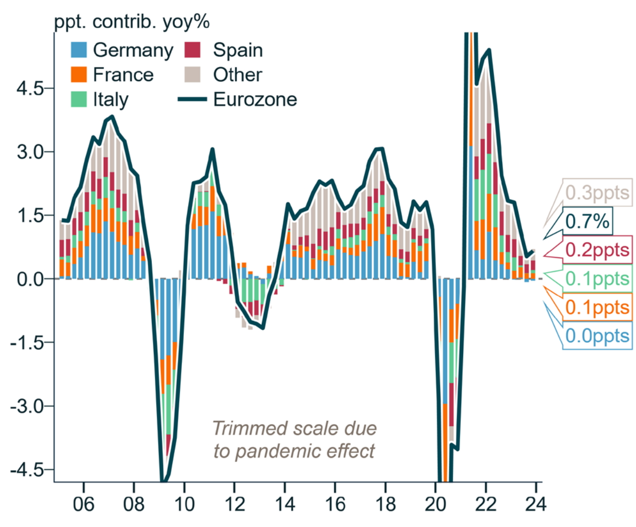
EUROZONE: Not out of the woods yet

The Eurozone skirted a technical recession (subject to revisions) in Q4. Real GDP tracked sideways over the quarter after a 0.1%qoq contraction in Q3. This leaves the output in the bloc up by a trifling 0.5% in 2023 compared to 2022 – well below the 25-year average of 1.4%. Germany was the clear underperformer of the big four economies in Q4, with real GDP contracting 0.3% over the quarter. And although Germany has managed to avoid a technical recession by the slimmest of margins, two consecutive zero-growth quarters over the year have seen output contract by 0.1% over 2023. On the other end of the spectrum sits Spain, which has been more insulated from the global manufacturing downturn and saw modest growth in Q4 of 0.6%qoq to see annual growth of a respectable 2.5%yoy. Italy (0.2%qoq, 0.7% annual) and France (0.0%qoq, 0.9% annual) posted overall growth between that of Germany and Spain.

In what has become a familiar refrain in past quarters, the outlook for the bloc remains challenging. The survey-based composite PMI suggests that Eurozone private sector output continued to contract in February (48.8), marking nine consecutive months of contraction. However, the pace of contraction has slowed since around October 2023. The data also highlight continued fragmentation across sectors and key geographies, with a sharp slowing in Germany's manufacturing sector activity dragging the bloc-wide manufacturing measure (46.1) further into contractionary territory. It must be noted, however, that exogenous impacts from Red Sea disruptions may have added volatility to the manufacturing numbers. Services activity continues to recover, with the Eurozone measure (50.0) exiting contractionary territory for the first time since July 2023. Other survey indicators that focus on sentiment have broadly been soft and disappointing. In February, consumer confidence (-15.5) remained well below long-term average levels. Services and industrial confidence and economic sentiment across the bloc have also broadly softened in the last few months.

GRAPH 06 **EUROZONE REAL GDP**

No recession but output growth still soft



Source: IFM Investors, Eurostat, Macrobond

Labour market spare capacity remains at all-time lows, with the unemployment rate in the Eurozone at 6.4% to start the year. Trends are diverging among the big four economies, with France (7.3%) and Germany (5.8%) seeing unemployment slowly rising, while Italy (7.2%) and Spain (11.8%) appear to be trending down/flat. The main implications of these tight labour markets are robust wages growth and a support to household consumption. The wages story is particularly important right now given that wages are, arguably, the primary concern for the European Central Bank (ECB) in how it sees monetary policy evolving (discussed further below). The ECB's corporate telephone survey shows that firms in the Eurozone still view wages catching up to the inflation-induced fall in real terms but that easing inflation and subdued demand will contribute to a normalisation in wages growth over time. It also comes as a relief that negotiated wages growth in Q4 slowed down to 4.5% from 4.7% in Q3.

This is also the first quarter since the inflation spike where wages grew in real terms (i.e. wages growth less headline inflation). While this should support households somewhat, real wage growth is expected to be more muted than the UK/US and will likely have a more limited impact than in those economies. On balance, the data are consistent with wages growth continuing to slow from high levels which will likely keep upward pressure on underlying inflation over the transition period. Inflation progress appears to have slowed somewhat in recent months. Inflation surprised to the upside in February and has seen an end to the downward trend in the headline measure (2.6%yoy, 0.3ppts higher than the November 2023 post-surge low). Core inflation continues to fade (3.1%yoy), but the important services sub-component (3.9%yoy) has broadly tracked sideways since November.

As expected, the ECB left policy unchanged at its December and January meetings. Market participants have been especially sensitive to commentary from the ECB in recent months as they try to anticipate when monetary easing will begin. President Lagarde's comments at Davos – and ECB communications around the December meeting – broadly read as hawkish and pushed back on market pricing of early and rapid cuts. A key message was that the premature easing of financial conditions associated with market pricing would make it harder for the ECB to achieve its inflation target. The ECB's stance has continued to evolve since then. Minutes from the January meeting had a cautious tone, highlighting concerns about the near-term activity outlook with officials widely acknowledging that activity would disappoint previous expectations in the near term, and that staff projections would likely push the recovery back by one or two quarters. The consensus among officials was that it was too early to discuss rate cuts – patience was still needed, and easing policy too soon could damage inflation progress. The ECB also noted that continued disinflationary progress was good news, but wages growth was far above the 2.5%-3.0% growth rate, which is compatible with the 2% inflation target. Wage dynamics over the medium term remain crucial and further data will be needed for the ECB to have more confidence around how wages are evolving.

CHINA: Deflation a problem

China's economy continues to face a number of headwinds as we move further into 2024. Ongoing weakness in the property sector, weak household consumption, soft consumer/business confidence, worsening deflation, and labour market stresses will all weigh on output. Policymakers have emphasised the importance of stability in light of these challenges and have indicated that macro policy will remain accommodative throughout the year. Indeed, policies to stimulate domestic demand have already been stepped up – which will be a much-needed tailwind to activity – but measures taken to date appear insufficient to fully offset the numerous growth drags.

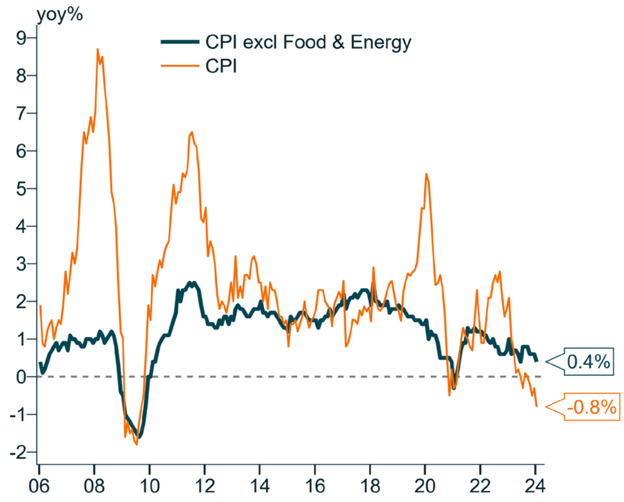
Overall output slowed at the end of the year to see real GDP up by 1.0% compared to the prior quarter. This was broadly in line with expectations and sees growth in annual terms accelerate to 5.2% in 2023 compared to 3.0% in 2022. The improvement in annual growth has seen China meet its growth target of 5% and was largely driven by a normalisation in economic activity through the year following the highly economically disruptive COVID-related policy measures in place through much of 2022. Underlying activity momentum looks to have remained broadly stable in Q4 compared to Q3 and output composition also appears to have remained similar across consumption (0.83ppts), gross investment (0.29ppts), and net exports (-0.11ppts). Higher frequency PMI data has been mixed to start the year. NBS PMIs saw the manufacturing index tick lower to 49.1 in February. The non-manufacturing index moved higher to 51.4, but this was due to spending around the Lunar New Year holiday and therefore risks retracing. The composite measure was flat in the month.

Despite a continued contraction in property investment, fixed asset investment looks to have accelerated on strong infrastructure and manufacturing investment. This is to be expected given that stimulatory measures to date have exhibited somewhat of a bias towards production and investment. Further policy easing has been announced since the previous update and is discussed in more detail below. Given muted income growth and soft household consumption, the outlook for domestic demand remains subdued. This means that the supply/demand disequilibrium in China is set to persist in the near term, at least with continued weak inflation pressures likely.

The lack of price pressures has become a more acute concern in recent months with the headline CPI measure hitting -0.8%yoy in January to see four consecutive deflationary prints. Some of this softness can be attributed to seasonal effects (Lunar New Year celebrations took place in February this year compared to January last year) and volatile food prices, but the underlying trend remains weak. Core inflation is trending down (0.4%yoy in January). Though outright deflation is likely only temporary, inflation is expected to remain subdued through 2024. It may prove a headwind to activity via higher real rates (lower inflation expectations as low inflation appears to become more entrenched) and negative impacts on nominal growth (potentially through lower corporate profits and by making local government financing vehicle and property deleveraging efforts more difficult).

GRAPH 07 **CHINA INFLATION**

Policymakers now dealing with deflation



Source: IFM Investors, NBS, Macrobond

The People's Bank of China (PBoC) unexpectedly left the one-year medium-term lending facility unchanged at 2.5% at its Q4 meeting in December. The PBoC is facing a number of trade-offs regarding monetary policy easing. Deflation, foreign exchange and capital outflow considerations, and a structural decline in natural rates all argue in favour of cutting. Arguing against cutting are constraints in the banking sector via NIM and capital adequacy pressure, uncertainty about how effective policy will actually be, and more limited room for monetary easing than in the past. The PBoC has been clear that monetary policy will remain "precise and effective". And despite no easing at the Q4 meeting, the PBoC did announce some targeted stimulatory measures in January/February. Specifically, it has lowered the reserve requirement ratio (RRR) by 50bp for large and medium financial institutions to 10.0% and 6.5%, respectively, cut the relending and rediscount rates to rural/SME sectors by 25bp to 1.75%, and reduced the five-year loan prime rate (LPR) by 25bps to 3.95%. The RRR cuts should unlock approximately ¥1trn in long-term liquidity. The PBoC explicitly highlighted improved liquidity as necessary to facilitate government bond issuance. On balance, the PBoC remains dovish and will likely ease policy further throughout 2024 to support activity.

Fiscal policy will also need to continue supporting activity, and we will get a better idea of what might be done with the National People's Congress being held early March. Importantly, Premier Li Qiang will announce the real economic growth target for the year at this Congress. The expectation is that the target will be again "around 5%" with a requirement for "proactive fiscal policy". This is especially true given the economy faces challenging global conditions and will lack the tailwind from the pandemic re-opening. Any less than this may undermine confidence that the government can reinvigorate activity with policy measures as it has previously, denting broader levels of confidence.

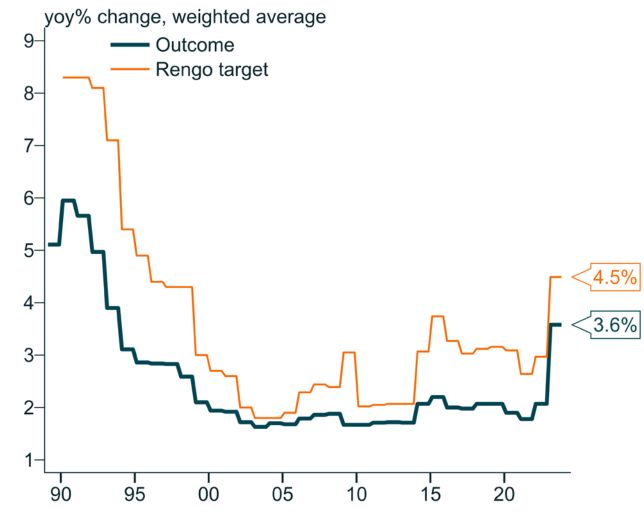
JAPAN: Unexpected slip

Japan's economy took an unexpected backward step in Q4. Preliminary figures showed that the economy contracted 0.4%qoq saar, pushing the economy into technical recession. This was made worse by a material downward revision of an already negative print in Q3 from -2.9%qoq saar to -3.3%qoq saar. The post-pandemic economic environment continues to be changeable, with five out of the last 12 quarters to Q4 2023 recording negative outcomes. The disappointment in economic performance was homegrown with domestic demand contracting for the third consecutive quarter. Private consumption led the decline in Q4, under pressure from negative real wages growth. Performance was mixed across spending categories: durable goods consumption was up sharply (6.4%) but semi-durable and non-durable goods spending both fell (-1.7% and -0.3% respectively). There was also a fall in services consumption, down 0.6%, after recent strength. There was also modestly softer activity recorded for both business, residential and non-residential investment. Public demand was also weaker, and both spending and investment went backwards. Net exports was the only key expenditure sector to contribute to growth, with a modest increase in exports and softening imports, the latter reflecting weaker domestic conditions.

As mentioned earlier, the performance of the Japanese economy and the equity market highs don't sit well together. Nonetheless, rejuvenated interest from foreign investors (after years of underperformance) has stemmed from strong earnings buoyed by the nominal economy, improved corporate governance and a weak yen benefitting exporters. There is also a belief that despite demographic challenges there is renewed dynamism in the Japanese economy that could see it outperform modest expectations for growth in the coming years.

GRAPH 08 **'SHUNTO' WAGE NEGOTIATIONS**

Further wages growth should be forthcoming



Source: IFM Investors, Japanese Trade Union Confederation (Rengo), Macrobond

A stabilisation in growth is expected in the coming quarters, emanating largely from the household sector (any negative impact from January's earthquake being more limited than feared). This begins with the Shunto wage negotiations (between unions and employers) with some announcements from larger corporates suggesting wages growth could be on par with last year's strong outcomes or perhaps modestly higher (results coming through mid-March). Indeed, the 'Rengo' (Japanese Trade Union Confederation) is reportedly looking for a 5% wage rise, the highest target in more than 25 years. Wages increases are expected to broaden across a relatively tight labour market with non-regular workers in particular benefitting from government efforts to equalise pay.

At the same time, the unemployment rate has edged lower to 2.4% in December, supported by what is a still high job-to-applicant ratio. Other labour market dynamics are important for broader household incomes, most notably a turnaround in labour force growth underpinned by dramatic trend shifts in participation rates. Japan's overall participation rate has moved up to 63.1% after reaching a nadir in December 2012 of 58.8%. Since then, female participation has moved materially higher (from around 48% to 55.3%) after stagnating for much of the previous decade. There's been an even more dramatic increase in older workers (aged 55-64), with the participation rate rising from 67.9% to 81.2%. For now, this increase in participation has offset the effects of very modest population growth. While nominal wages are set to keep rising at a healthy pace it is not enough to overcome inflation, and real wages growth remains negative. This will need to change to support real consumption.

Inflation continues to decelerate with the headline rate down to 2.2%yoy from 2.6%yoy in January. Similarly core inflation (ex-fresh food) and core-core inflation (ex-fresh food & energy) also decelerated to 2.0%yoy and 3.5%yoy respectively. Energy price inflation remains negative for now. While this is good progress, in the near term, we may see some inflation volatility as discounts and energy rebates from the government work through the data.

The Bank of Japan (BoJ)continues to strive for the "virtuous cycle" of wages growth and prices that will land inflation back at its target. Buoyed by prospective negotiated wage increases in the Spring, it believes that the achievement of price stability has indeed "started to come in[to] sight". With this in mind, the BoJ notes the timing of this achievement "will likely determine whether to continue with its large-scale monetary easing measures, including the negative interest rate policy". At its January meeting, the BoJ noted the current time represents a "Golden opportunity" to end extremely accommodative policy settings, stressing the need to communicate its intent clearly to the market to avoid any market dislocation. Expectations are for yield curve control policies to be exited first, and then the exiting of zero interest rate policy, with speculation this process may begin in the first half of 2024. While this is a big first step, the following steps are likely to be very modest, with Governor Ueda noting that whatever the timing financial conditions will remain "extremely" accommodative.

KOREA: Steady growth and policy

Korea's economic performance to close out 2023 could be described as steady and more of the same. Real GDP growth in the advanced print came in at 0.6%qoq, the same rate as the preceding two quarters – this prompted a re-acceleration of economic growth through the year to 2.2%yoy. Net exports featured prominently in the quarterly outcome, as in Q3, with another solid expansion of exports and slightly softer imports. Domestic demand was far more mixed. Private consumption growth was relatively soft - up just 0.2%qoq - as households remain under pressure from higher interest rates and cost-of-living pressures. Public consumption was marginally stronger in the quarter but is still 1.0%yoy lower as the government retains a tightening fiscal stance. After a period of solid expansion through most of 2023, gross fixed capital formation contracted 1.6% in Q4 as firms remain relatively wary of the domestic and global outlooks.

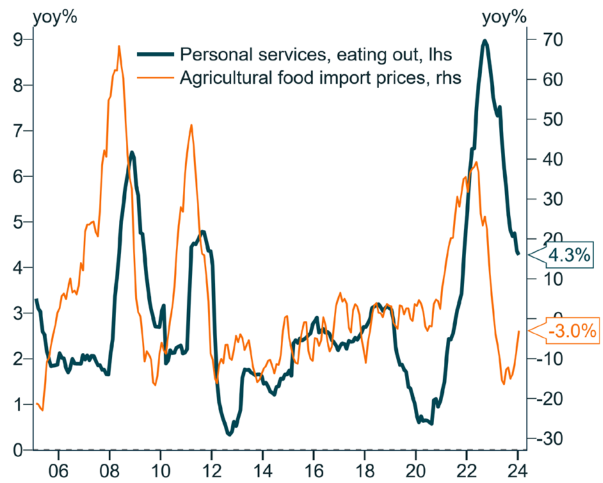
The outlook for the Korean economy rests on export performance, particularly an ongoing recovery in the semiconductor and IT product space. This has already been flagged in higher frequency data with material increases in both production and shipments. Shipments were up particularly sharply, the most since 1997, in an effort to clear backlogs in the sector. More broadly, industrial production growth accelerated to 6.2% in December after slumping through 2023. And this should also be reflected in improved private investment, though manufacturers are still wary of the boom-bust chip cycle that characterised the pandemic period. Here there are tailwinds from the AI thematic (with links between Korean chip makers as prominent AI players in the US) and a solid economic performance in the US. A headwind is the risk of underperformance in the Chinese economy.

There is an expectation that the consumer should also add to growth as we move further into 2024. Early signs have been positive with February retail sales accelerating to 8.2%yoy largely due to online spending activity. Further consumer confidence is relatively positive and unlike most advanced western economies has fully claimed back the sharp falls associated with the pandemic. These trends are underpinned by the labour market that remains relatively tight. That said, the unemployment rate has ticked up to 3.0%, but this is largely due to a sharply rising participation rate. Employment growth remains solid and the employment-to-population rate is also pushing to record highs (in the modern data series, for more than two decades). Robust labour market conditions are keeping nominal wages growth relatively strong and real wages growth will likely turn positive in the coming months as inflation decelerates back to the Bank of Korea's (BoK) 2% target. Should this be the case, some easing of monetary policy from the BoK should also assist the consumer. Policy easing may also support the property market and broader construction sectors where orders remained depressed through much of 2023, particularly in residential housing.

Progress on disinflation is key to the consumer narrative. The headline measure has continued to soften after a reacceleration in mid-2023 and is now back to 2.8%yoy as of January's print. The core measure (which excludes food and energy) hit 2.5%yoy. This disinflation progress is also dragging inflation expectations lower. While the inflation outlook remains uncertain, there are encouraging signs. This is particularly true of the relatively large 'eating out' sector, where inflation should be dragged lower by falling agricultural food import prices. Nonetheless, the BoK still has lingering concerns around labour and energy costs underpinned by persistent price pressures.

GRAPH 09 **'EATING OUT' INFLATION**

Imported food products should underpin disinflation



Source: IFM Investors, Statistics Korea, BoK, Macrobond

The uncertainty surrounding the inflation outlook was a key focus at the BoK's late-February meeting where it noted "high uncertainties" and that it would be impacted by "…geopolitical risks, by movements of global oil prices and domestic agricultural product prices, and by economic growth at home and abroad". Uncertainty also clouded the economic outlook with a booming AI & IT cycle noted as an upside risk and rising geopolitical risks and supply chain disruptions a downside. As such, the BoK left its GDP growth forecast unchanged at 2.1% and 2.3% for 2024 and 2025, respectively. The headline inflation outlook was also unchanged at 2.6% and 2.1% for 2024 and 2025, respectively. On core measures, there was a tenth revision lower to 2.2% and 2.0% in 2025. The broad conclusion from this analysis was that it was "premature to be confident that inflation will converge on the target level" and that the course for policy would be to hold rates in restrictive territory for a "sufficiently long period of time" to ensure its objectives were met. This assertion may need to be softened at coming meetings if consensus expectations of the BoK cutting by the third quarter are to pass.

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IFM-3431300-7March2024