Economic Update
Q3 2024

The turning tide

Alex Joiner
Chief Economist

Frans van den Bogaerde, CFA
Economist

Chris Skondreas
Economist

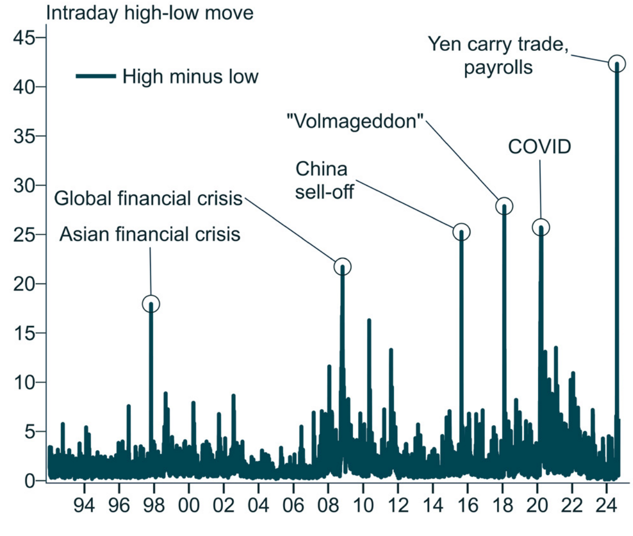
Global growth remains resilient, however, recent dataflow suggests slowing momentum. As disinflation progresses, labour markets and growth will guide monetary settings. However, the outlook remains asynchronous. Renewed recession concerns on soft US jobs and unexpectedly hawkish commentary by the Bank of Japan imparted historic volatility across global markets.

GLOBAL: Inflection point

Economic growth across the major developed economies continued to be robust in the face of still tight monetary policy in the second quarter. However, higher frequency data since have been mixed or softer depending on the country. Consequently, while inflation is not completely defeated, central banks have now either started to cut rates or are poised to do so. Market reactions have depended on jurisdiction where the growth narrative is weakest. Notably, in Europe, equity market performance in the last three months has underperformed. By contrast, in the US, equity markets have posted solid returns over the last few months underpinned by both economic performance and a solid earnings season (though high-profile tech companies underwhelmed). But it was of course not without incident with recession fears triggered by a soft US labour market print, combined with global growth concerns prompting a sharp sell-off and historic spike in volatility. Stretched valuations likely also played a role. The latter may have also played a role in the even more marked sell-off in Japan where a surprise move by the Bank of Japan caught investors off guard. While markets have, outside Japan, broadly recovered from this sell-off the impact on bond markets has been more permanent. The decline in bond yields since April accelerated amidst the equity market sell off as concerns of inflation gave way to those on growth. Fixed income investors welcomed major central banks moving collectively to provide support.

GRAPH 01 VIX INTRA-DAY PRICE CHANGE

Largest intra-day VIX move in history



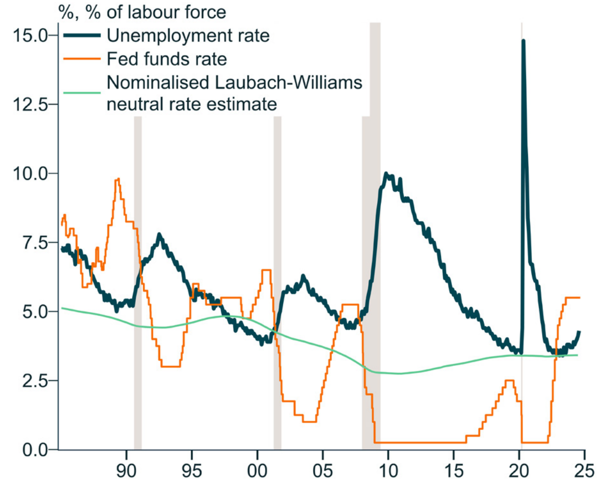
Source: IFM Investors, CBOE, Bloomberg, via Macrobond

Clearly the number of central banks easing policy will increase through the remainder of this year. Indeed, some may have cut rates multiple times by the end of this year, with the trickle of cuts early in the third quarter becoming a flood by year's end. These include majors like the Bank of England (BoE) and the European Central Bank (ECB), but also the Bank of Canada, Sweden's Riksbank, Denmark's Nationalbank and the Reserve Bank of New Zealand. Key for markets will be the easing phase for the US Federal Reserve. Chair Powell's Jackson Hole speech being a clear inflection point for its policy stance. The speech removed almost all doubt that the Fed will begin to ease policy at its September meeting and continue to do so through the rest of the year. Powell's speech noted: "The time has come for policy to adjust. The direction of travel is clear, and the timing and pace of rate cuts will depend on incoming data, the evolving outlook, and the balance of risks." How the Fed is thinking about the economy is similarly important, and it is evident that concern has shifted from inflation fighting to stemming weakness in the labour market.

Again, Powell's speech was instructive noting that the Fed does not "seek or welcome further cooling in labour market conditions". This pivot has been made possible by cooling inflation rather than having a pivot forced due to a soft labour market and/or weak growth as has been witnessed elsewhere. To stick the soft landing, our view is that unemployment may edge higher but will need to plateau and stabilise relatively quickly. The question is what policy response is required to achieve this?

GRAPH 02 **FED FUNDS RATE & UNEMPLOYMENT RATE**

Rates to move as unemployment rises



Source: IFM Investors, NBER, BLS, US Federal Reserve, FRBNY, via Macrobond

Nb: shaded areas are NBER recessions, LW estimate nominalised by historical headline inflation rate consistent with core PCE at 2%.

For what it's worth, financial markets are pricing in relatively aggressive moves with almost 100bp of cuts by the end of 2024 and 200bp over the next twelve months (see GRAPH 04). With three meetings to go this year that implies a 50bp easing at one of these meetings with September the short-priced favourite. The market focused on Powell's assertion that "We will do everything we can to support a strong labour market as we make further progress toward price stability". There is seemingly confidence that disinflation has some inertia which could allow for an aggressive start to any easing as it is well known it will take some time for the Fed Funds rate to be impactful on the economy.

While the last two easing cycles highlight these lags in monetary policy, they are hardly indicative given the context - the COVID pandemic and the Global Financial Crisis. Both were characterised by unusually sharp reversals in economic activity and employment. But it is interesting to examine how two other easing phases – in 2001 and 1994 – evolved to support the US economy to gain some insight into what might happen in the current circumstance to pull off a soft landing. In 2001, the Fed (then facing a lower rate of headline and core PCE inflation than observed currently), cut rates 50bp as the unemployment rate started rising and it still went from 3.9% to 6.3%. However, based on a nominalised Laubach-Williams estimate of the neutral rate (or R*) it wasn't until June and 250bp of cuts before policy became accommodative and went another 225bp before the sharp rise in unemployment was slowed and subsequently halted. Notable then also was the pulse of US economic growth had stalled with two negative (but not consecutive) quarters of growth and that the through the year rate slowing to just 0.2%yoy. Arguably the Fed moved too late towards less contractionary settings despite aggressive policy easing.

> **The trickle of interest rate cuts from central banks beginning early in the third quarter risks becoming a flood by year's end.**

The soft landing of 1994 was different again. Core PCE was only a touch above 2%, brought lower by the Fed's rapid 300bp tightening which it quickly reversed by 75bp on concerns that it had overtightened and would impact growth. The unemployment rate at the time had stopped falling but was clearly not rising. It is notable that the soft landing was also assisted by strong rates of productivity growth that served to support growth and reduce inflationary pressure. Further, the North America Free Trade Agreement (NAFTA) was enacted earlier in the year delivering growth and the consumer benefits of globalisation which further supported the economy with little overall inflationary impact. These effects allowed monetary policy to remain in contractionary territory and a soft landing was achieved – but on this occasion the Fed had assistance.

For now, the Fed is confronted with a combination of these issues. Growth is solid but not spectacular and has for some time surprised to the upside. The housing sector in particular could use some support, as could the consumer. But it is the rise in the unemployment rate that is the clearest sign the Fed needs to get moving. While in our view the Sahm rule (when the unemployment rate is constructed from the underlying labour market data) has not been triggered, it may be in coming data. In any case the deterioration in the labour market is increasingly clear. This alone may warrant the Fed taking an aggressive first step. Powell's data dependency focus should note that these data are already somewhat lagging. That said, the market consensus sees the unemployment rate peaking at 4.4% in the December quarter and then remaining broadly stable thereafter. This forecast is predicated on a more gradual easing cycle than markets anticipate and importantly still solid economic activity, at least for now.

In our view a combined approach would likely be best – an aggressive start, followed by a slower pace to assess the impact not only on the labour market, but also inflation. Important in this assertion is that we suspect the neutral rate (R*) may be modestly higher than currently estimated given solid productivity growth, energy transition bolstered investment flows, the fiscal impulse and high levels of government debt – as such the Fed's easing may become more accommodative sooner. There is, at least currently, no emergency for the Fed to address that warrants taking policy to accommodative levels and we don't think there will be. This will be reflected in a relatively shallow decline of longer term US bond yields/risk free rates where markets have priced a move to near neutral settings in. To our mind this will benefit, in a relative sense, those investors tilted to growth rather than defensive asset classes from here. We note that circumstances may change rapidly, particularly with the US Presidential election only months away and the potential for growth momentum to be impacted by uncertainty.

AUSTRALIA: RBA the loan hawk

The Australian economy only grew modestly in the June quarter expanding by 0.2%qoq and 1.0%yoy through the year, the weakest annual growth rate since the 1990s recession (outside of the pandemic). The Reserve Bank of Australia's (RBA) forecast to the June quarter was 0.9%yoy. This weak growth is simply the cost of getting inflation under control with the RBA squarely focussed on inflation and the labour market to assess the appropriateness of its policy settings. The Bank has forecast this as the low point in economic growth but with its policy settings likely to remain unchanged for the remainder of the year the risk is H2 growth disappoints expectations of a modest recovery.

In the quarter the public sector is keeping growth positive as it is less susceptible to higher interest rates and growth. Whereas the private sector has stalled in aggregate. Household spending was negative, dragged lower by a slump in discretionary spending that was only partially offset by spending on essentials. Underlying business investment posted very modest growth despite a marked decline in machinery and equipment capex. The dwelling investment sector posted extremely modest growth, under pressure from high rates and costs. Indeed, the transaction of established housing added more to through-the-year growth than the building of new houses. The public sector has expanded strongly again in the quarter to a new record high as a proportion of the real economy – this is neither appropriate nor sustainable and it continues to be a sore point for the RBA.

GRAPH 03 UNDERLYING PUBLIC DEMAND*

Public demand is at record highs

Source: IFM Investors, ABS, via Macrobond

It is notable that the economy has now recorded its sixth consecutive quarterly reversal in per capita growth terms (making seven negative quarters out of the last eight). In level terms per capita real GDP is now 2.0% lower than it was in the June quarter of 2022. Productivity was very weak in the quarter after a recent bout of improvement and this put upward pressure on unit labour costs in the quarter which is not what the RBA wants to see. Living standards growth, as measured by real net national disposable income per capita, has slumped (falling in four out of the last five quarters) echoing the negative income shock experienced when the previous peak in the terms of trade retraced.

The weakness in household spending in particular is what is needed to get control of inflation but Australia remains behind other countries in the progress that has been made. The headline measure of inflation rose in line with expectations, 1.0%qoq and 3.8yoy%, while the policy-relevant trimmed mean measure surprised to the downside, 0.8%qoq and 3.9%yoy, scuttling calls for further rate hikes. Momentum continued in non-tradables sectors with prices rising 1.7%qoq and an uncomfortably high 5.0%yoy. And it is this domestically generated inflation that will require wages growth to slow and unit labour costs to improve.

For now, wages growth remains elevated at 4.1%yoy in June, edging slightly off the December 2023 peak, as sequential momentum has since moderated from 1.3%qoq to 0.8%qoq while a dramatic decline on a six-month annualised basis from 4.7%yoy to 3.4%yoy provides further confirmation. Private sector wages, those most exposed to the loosening labour market, expanded just 0.7%qoq, the slowest pace since December 2021. Pockets within the labour market where there are sustained wage pressures are where labour demand remains strongest within the non-market/government aligned sectors.

The labour market is gradually loosening, despite some mixed signals. Jobs growth in July grew by a solid clip, adding 58,200 against market expectations for 20,000, primarily on full-time workers. Yet strength in job creation was more than offset by a record participation rate which edged up to 67.1%, imparting an increase in the unemployment rate from 4.1% to 4.2%. The phenomenon likely reflects cost-of-living pressures pulling workers into the labour force. Employment growth has been underpinned by non-market sectors with private sector employment slowing materially in line with activity. There has also been an adjustment in hours worked, which allows for reduced labour demand without, as yet, the need for headcount reductions.

While many had expected the RBA's August meeting to be 'live' before the release of the June quarter inflation report, largely on what was a false signal from the monthly CPI indicator, the quarterly print dealt a blow to this narrative. However, the RBA also pushed back on the idea of rate cuts this year, the Governor noting that this was "not aligned" with the Board's current thinking. The assertion that 'policy will need to be sufficiently restrictive until the Board is confident inflation is moving sustainably towards the target range' will likely mean the RBA will see the year out with rates on hold. There is only one quarterly print forthcoming before the end of the year and we don't think this will be enough to give the RBA confidence that inflation headed sustainably towards the target band. Importantly, the bank reiterated that trimmed mean inflation would guide policy decisions, given the volatility imparted to the headline measure in the forecast period by government subsidies. As such the RBA seems destined to be among the last developed market central banks to ease policy.

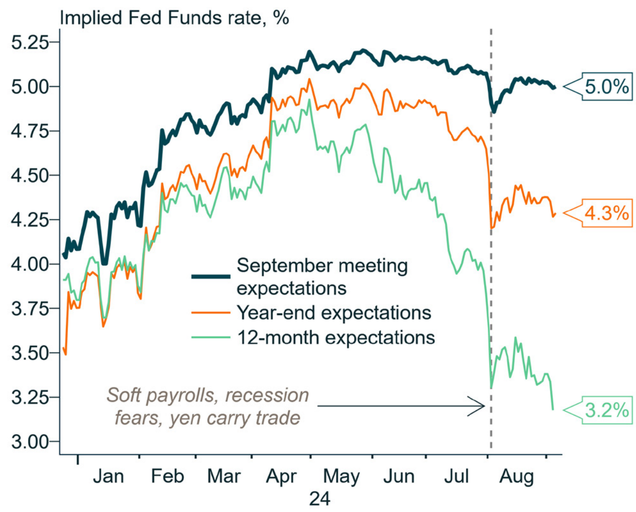
US: Release the doves

The Fed has been squarely in the spotlight over the last few months as market participants try to anticipate the timing and depth of the coming monetary easing cycle. Expectations have been volatile, with hopes for material cuts earlier in the year dashed by stronger than expected inflation in Q1, causing the Fed to send a somewhat hawkish signal at the June meeting. Market pricing reacted accordingly with, at one stage, not even a solitary 25bp rate cut expected in 2024. The outlook has changed substantially since then.

July's labour market data was the catalyst – released shortly after the Fed's meeting that month – coming in softer than expected. This precipitated a sharp market sell-off and increased rate cut expectations on renewed recession fears. The initial moves appear to have been overblown, but the incident does highlight how sensitive markets are to any signs of faltering US growth.

GRAPH 04 **US FED FUNDS RATE EXPECTATIONS**

Soft payrolls and Fed guidance see cuts more likely



Source: IFM Investors, Bloomberg, via Macrobond

Looking at the details, context, and other more timely labour/activity indicators released since, suggests that there is no imminent sign of a US recession. Though it does point to a potential overshoot in the labour market correction and argues strongly in favour of timely policy support. Nonfarm payrolls were the key focus with 114,000 net new jobs (and a material downward revision to previous figures) falling well short of market expectations. On a three-month smoothed basis, however, job growth looks much more respectable at just under 170,000 net new jobs per month. The soft payrolls print was exacerbated by an unexpected rise in the unemployment rate to 4.3%, just under 1ppt higher than the cycle-low seen around the start of 2023. It is worth highlighting that most of the rise in unemployment was due to temporary layoffs, which is a weaker signal of economic malaise than permanent layoffs. This rise in unemployment has seen the Sahm Rule recession indicator dangerously close to being triggered (the indicator was triggered when using unrounded unemployment rate figures).

There are differing opinions on whether late June and early July's Hurricane Beryl distorted the data. The Bureau of Labour Statistics (BLS) says that there was no discernable impact, but there was a sharp increase in the number of workers unable to work due to weather in Texas, where the hurricane first made landfall. There are also issues around the undercounting of immigration which may be further distorting the data. Either way, one soft labour market print does not define a new trend and further releases will be watched closely by the Fed which has little tolerance for any further deterioration.

The weekly initial and continuing jobless claims figures have remained largely stable in the prints since the troubling July labour data and have gone a long way to convince markets that the situation is not as dire as initially thought. Timely ISM indices have also provided relief with the ISM services index rebounding sharply in July back into expansionary territory (51.4). The ISM manufacturing index remains mired in contractionary territory but is less consequential for overall US growth. Furthermore, June retail sales were better than expected with the control group – which feeds into GDP – growing by 0.9%mom and assuaging fears of a faltering US consumer. On balance, indicators point to continued momentum with the Atlanta Fed's GDPNow – a daily tracker of US GDP growth – averaging at 2.5%qoq annualized through August.

Third quarter momentum follows on from a stronger than expected acceleration in real GDP growth in Q2. The initial print came in at 2.8%qoq saar beating expectations and was revised up to 3.0%qoq saar in the secondary print. The composition was robust with strong domestic demand being driven by both private investment (1.3ppts) and personal consumption (2.0ppts), the latter driven by the ongoing strength of services demand. Inventories were also a key growth driver (0.77ppts) following a reversal of the inventories drag in Q1. The external sector was a drag on growth subtracting 0.7ppts largely on strong imports of goods which are feeding the solid growth in domestic demand.

In spite of above-trend economic growth, headline (2.9%yoy) and core (3.2%yoy) inflation have slowed faster than expected and are both down materially relative to when our previous update was published. In three-month annualised terms, headline inflation has been below the Fed's 2% target for two consecutive months, with July seeing a rate of 0.4% (the slowest rate since June 2020). This progress is encouraging, but underlying inflation remains elevated as evidenced by the core services measure still tracking well above target at 4.9%yoy, though a softening trend is clearly continuing. This puts the Fed in a good position to ease policy, which it is now almost certainly expected to do at the September meeting (as discussed in the Global section above). Key will be the Fed's accompanying communication, economic forecasts and 'dot plot' to anchor expectations of just how aggressive its coming easing cycle may be – particularly in the near term.

UK: A tentative first move

The BoE became the second major central bank to lower rates in the global easing cycle. The BoE cut rates by 25bp to 5.00% in August, as expected, but the decision was close and only just managed to pass with five votes in favour and four dissenting. Even within those voting in favour, it was noted that the decision was "finely balanced". Among the dissenters some members noted that inflationary pressures still looked too entrenched and that this potentially reflected changing structural factors like potential growth or the neutral rate of interest. In terms of the rates outlook, the BoE has a cautious easing bias but remains non-committal on the timing/pace of cuts. Governor Bailey signalled a gradual pace of rate cuts from here saying: "We need to be careful not to cut rates too much or too quickly." The BoE will keep watching the data closely as there remains substantial upside risk to underlying inflation in its view. Furthermore, the BoE has substantially upgraded growth expectations for H2 2024/ H1 2025. This gives the BoE more room to be patient as the 'cut rates to support growth' argument is less relevant.

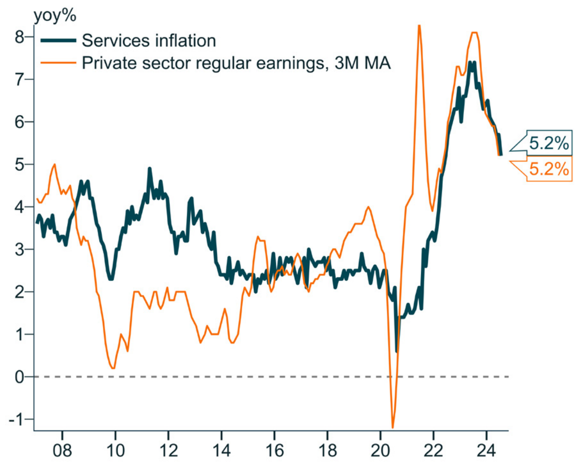
Indeed, UK growth was again robust in Q2 (0.6%qoq; 0.9%yoy) to continue the positive activity momentum seen in Q1 (upwardly revised to 0.7%qoq). The rebound comes after the recession of H2 2023 and lack of growth momentum that characterised the previous 18 months. However, growth needs to become more balanced and driven by the private sector to be sustainable. Household consumption (0.2%qoq) was again soft and business investment (-0.1%qoq) was also disappointing despite robust business confidence. It was strong government consumption and investment that was the primary growth driver. This release was noisy with a sharp drag from net trade (-2.2ppt) driven in large part by non-monetary gold imports which are GDP neutral and offset in gross capital formation (2.4ppt). On balance, the underlying growth pulse looks a touch softer than the headline figure but remains decent and should continue through Q3.

This view is supported by PMI figures, which have signalled better-than-expected private sector activity growth in the first two months of the third quarter. Both services and manufacturing output growth have pushed further into expansionary territory. Manufacturing performance in particular is in stark contrast to the experience in other advanced economies where the sector remains mired in contractionary territory. The details in the August report point to a solid uptick in employment growth with respondents also increasingly optimistic about the domestic economic outlook. Price pressures also continued to abate with softening in the stickier services sector prices the main driver.

This evidence of continued services disinflation will be well received by the BoE. Indeed, services inflation had been falling more slowly than expected for much of the year and this was a point of some concern for the BoE as it is for most central banks. So July's inflation data came as a relief, with services inflation falling a significant 0.5ppts to 5.2%yoy. This saw both headline and core inflation come in lower than expected at 2.2%yoy and 3.3%yoy, respectively.

GRAPH 05 **SERVICES INFLATION AND EARNINGS**

Good progress on inflation and wages



Source: IFM Investors, ONS, via Macrobond

The July labour market data were also cause for some optimism and should support the consumer sector, though data reliability remains an issue. The unemployment rate unexpectedly fell from 4.4% to 4.2% on strong employment growth and a marginal softening in participation. The BoE has downplayed the prior rise in unemployment given data issues, so this print provides some vindication of that view. There was a troubling spike in claims for unemployment – which saw a material increase in an alternative unemployment measure – but this can be largely discounted as being driven by recent rule changes regarding job search requirements and earnings thresholds that will push claimant rates up. Earnings measures also continue to ease, broadly in line with expectations. But national living wage changes are impacting the data. Headline average weekly earnings slowed sharply in July (4.6% 3m/yoy) but the less volatile regular pay measure has slowed more moderately (5.4% 3m/yoy). This is positive for the consumption and growth outlook as regular real weekly earnings growth remains elevated at 2.4% 3m/yoy.

In politics, the Labour party won a landslide victory with a total of 412 seats in parliament (comfortably above the 326 required for a majority). The Conservatives won just 121 seats. Labour's manifesto contains five key missions including 1) kick-starting economic growth, 2) boosting a clean home-grown energy sector, 3) tackling crime and security, 4) reforming childcare/education, and 5) modernising and improving the NHS. Near-term fiscal constraints are sizeable given the limited headroom after the previous government's Spring Budget. Fiscal matters have been made worse with the spending audit announced by the new Chancellor of the Exchequer on 8 July 2024 showing a larger-than-expected fiscal shortfall driven by undeclared overspending by the previous government. This has prompted the Labour government to gradually shift its stance on tax rises – it had initially indicated no intention to increase taxes but that is being walked back which may threaten the tentative household recovery.

EUROZONE: First mover

The ECB cut rates by 25bps on 6 June to become the first major central bank to begin an easing cycle. This move was widely expected given the unambiguous signalling at its previous meeting. Further easing is expected with President Lagarde signalling that there is a "strong likelihood" that the ECB has entered a "dialling back" phase. However, the timing and pace of future cuts is uncertain. The ECB left rates unchanged in August and is clearly in data dependent mode with no guidance being provided around whether September will see a cut. Minutes from the ECB's June meeting suggest that the decision to cut in face of upside data surprises was more balanced than suggested by the near unanimous vote. The data surprises were seen as increasing the uncertainty about the inflation outlook but not derailing the "bigger picture" outlined in the disinflation forecast – the ECB has indicated that it is prepared for bumps in the disinflation journey.

And there have indeed been some bumps. Two key earnings measures – the Eurozone labour cost index and Eurozone negotiated wages – both firmed in Q1. The signal from the labour cost index was particularly strong, jumping from 3.4%yoy in Q4 2023 to 5.1%yoy in Q1 2024. The series is volatile however, and negotiated wages were much softer in Q2, falling sharply to 3.6%yoy. This has been accompanied by a downward trend in employment growth that sits at just 0.8%yoy (well below pre-pandemic rates of growth), though the unemployment rate remains at historical lows at 6.4%. Slowing employment growth has seen productivity growth improve, but it remains soft in levels terms following six consecutive quarters of contraction. This is a positive from the ECB perspective as improving productivity should ease labor cost pressures and provide a disinflationary impulse. Taken as a whole, the data suggest that labour market cooling is continuing, despite the bumps, and has not derailed the disinflation path. Indeed, market expectations of another 25bp rate cut in September have increased from approximately 50% following the June meeting to fully priced at the time of writing.

This has come despite only modest progress on disinflation in recent months. Headline inflation in July was 2.2%yoy (just 0.2ppts below November 2023), with the majority of the disinflation from July coming through the energy sector. Consequently, core inflation (2.8%yoy) has broadly tracked sideways since March. Services inflation – which is particularly important to the ECB as an indicator of wage-driven and underlying price pressures – is sending a more concerning signal. Since reaching a cycle low in April of 3.7%yoy, services inflation has accelerated to 4.2%yoy. Some of the recent strength can be attributed to the Olympic effect and seasonal German holiday prices, but the trend remains problematic particularly if it does not reverse these temporary factors in coming data. Even so continued easing in Eurozone labour market conditions and lower wages growth will likely be necessary for services inflation to decelerate more materially.

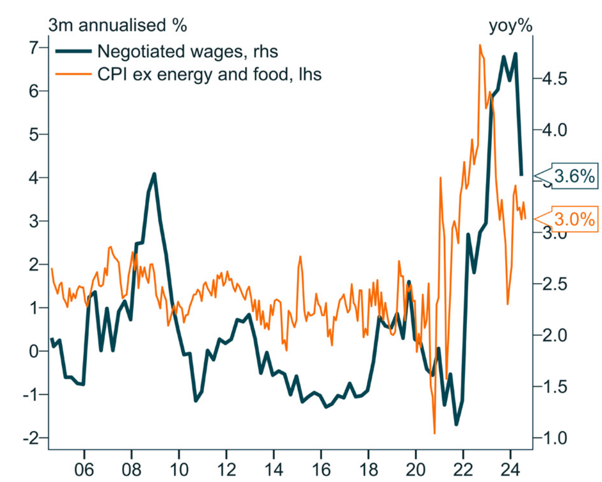
One factor in favour of further rate cuts sooner rather than later is the soft growth outlook for the Eurozone. This contrasts the US/UK where continued growth momentum has allowed policymakers to focus more squarely on what needs to be done to handle inflation, rather than a more careful balancing of inflation and growth concerns. Euro area real GDP expanded 0.3%qoq (consensus: 0.2%qoq) underpinned by broad based improvement in activity across countries and expenditure categories. Germany was a notable drag, contracting 0.1% on the back of weak construction and equipment investment while France and Spain surprised positively, supported primarily by exports.

Timely PMI data paint a picture of soft underlying growth momentum into Q3. The June/July figures were soft with weakness in both services and manufacturing broadly disappointing expectations. August data appear more encouraging on the surface following a strong services outperformance that lifted the composite measure more comfortably into expansionary territory. But services growth was concentrated in France and reflects the Olympics rather than underlying growth improvement. Details in the reports point to stagnating employment growth and falling business sentiment. It's not all bad though, the ECB's latest bank lending survey showed the first increase in loan demand in two years and points to a stabilisation in lending standards which should be supportive to growth.

It has been a momentous few months politically for the Eurozone. European Union (EU) citizens took part in elections to choose members of the European Parliament (one of the two legislative bodies of the EU, the other being the Council). As anticipated right-wing parties made gains at the expense of centrists, though the right-wing shift was less than anticipated. No single bloc managed to secure an overall majority. The party of France's President, Emmanual Macron, was beat soundly in EP elections by Marine Le Pen's right-wing party, which prompted Macron to call snap elections in France's lower house. The elections were held in two rounds on 30 June and 7 July and saw a last-minute left-wing coalition formed to prevent Le Pen from gaining too much ground. No party was able to secure a majority and political uncertainty is elevated as the hung parliament has no precedent in the current institutional regime.

GRAPH 06 **EMPLOYMENT AND WAGES**

Softening labour market makes earlier ECB cuts more likely



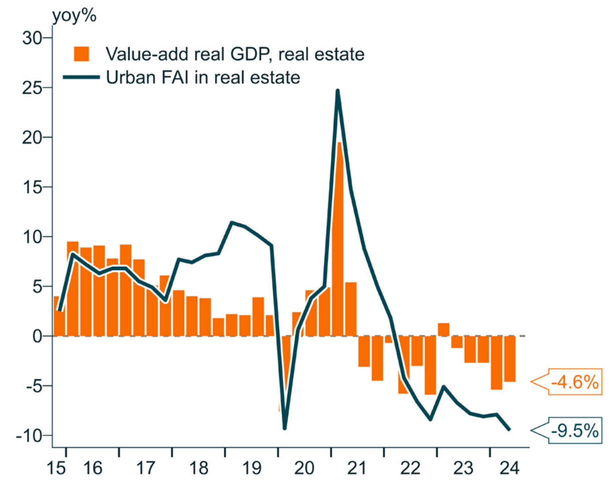
Source: IFM Investors, ECB, via Macrobond

CHINA: Dragon's deflation dilemma

China's economy decelerated materially over the June quarter. Sequential growth momentum stalled as real GDP expanded 0.7%qoq (4.7%yoy) compared to 1.5%qoq (5.3%yoy) the prior quarter, undershooting market expectations for 0.9%qoq (5.1%yoy). Consequently, payback over coming quarters is required if Beijing is to achieve its real growth target of 'around 5%'. However, several headwinds look increasingly likely to jeopardise this objective and some further stimulus may be required. A particular issue remains the real estate sector (-4.6%yoy) that is yet to find a bottom and continues to be a drag on real growth – as it has been for 11 of the past 12 quarters. The downturn continues to spillover to household consumption, imparting deflationary pressures across the broader economy. Meanwhile, still elevated secondary industry growth (5.6%yoy) suggests that manufacturing activity remains relatively resilient, boosted by firm exports and continued fiscal support.

GRAPH 07 **REAL ESTATE INVESTMENT & ACTIVITY**

Real estate remains a drag on real GDP



Source: IFM Investors, NBS, via Macrobond

Industrial production (IP) is reflecting this trend, expanding 5.3%yoy in June on resilient external demand (which counteracted the impact of fewer working days over the month). The slight deceleration in IP from 5.6%yoy in May reflects slower growth in computer and chemical manufacturing industries as well as continued weakness in steel output. Export volumes rose 12.6%yoy in the June quarter on improving global demand and a pull-forward of shipments ahead of potential tariff increases from the US that may materialise with the re-election of former President Trump. Fixed asset investment (FAI) remained firm despite decelerating to 3.9%ytd in June from 4.0%ytd in May. On a positive infrastructure investment expanded 9.4%yoy up from 7.7%yoy and manufacturing investment remained elevated at 9.3%yoy. The latter, being a beneficiary of Beijing's equipment upgrade program (designed to assist in energy conservation and transition), while property investment contracted further, slumping 10.1%yoy.

Meanwhile, household consumption growth slowed sharply in the June quarter expanding 5.0%yoy following a prior gain of 8.3%yoy. The slowdown was broad based, notably involving a fall in residence and entertainment related expenditure. Consumption remained sluggish despite Beijing's allocation of RMB300bn in special treasury bonds for household trade-in of consumer goods for which uptake has been slow. Further, retail sales growth declined to 2.0%yoy after expanding 3.7%yoy in May, reflecting a pull-forward of consumption because of an earlier '618 Online Shopping Festival'.

On balance, July activity data are suggestive of further weakness as we head into Q3. IP decelerated slightly to 5.1%yoy with high tech-sectors, specifically electric vehicles (up 27.8%yoy) and microchips (up 26.9%yoy) outperforming on Beijing's push to promote 'new growth drivers', whereas steel and non-metallic minerals were the largest drags. Retail sales picked up to 2.7%yoy as the impact of distortive sales events subsided and following an uptick in recreation spend imparted by one-off global sporting events. FAI decelerated to 3.6%ytd on weather-related slowdowns in infrastructure decelerating to 5.6%yoy and further contraction in real estate, slumping 10.8%yoy. China's official manufacturing PMI edged down in July on weakening domestic demand and extreme weather. According to the survey, new orders dropped materially while new export orders edged up. Further, the sub-indices for input and output prices retreated, indicating ongoing weakness in the domestic economy and lingering deflationary pressures. Indeed, inflation remains in positive territory albeit at low levels. Headline CPI rose 0.5%yoy in July from 0.2%yoy in June. A weather-related halt in food price declines was the main contributor to the uptick, while services prices added its smallest contribution since January. Underlying inflation measured by core CPI (excluding food and energy) increased 0.4%yoy, the weakest result this year. Meanwhile producer prices registered a 0.8%yoy fall in July and a second consecutive monthly decrease. All signs point to a continued divergence between the domestic and external sector.

On monetary policy, the People's Bank of China (PBoC) lowered the 7-day OMO reverse repo rate and both the 1-year and 5-year loan prime rates by 10 basis points in July. The cuts were followed by a 20bp reduction in the medium-term lending facility to 'intensify countercyclical adjustment and support for the real economy'. Despite a macro environment that appears conducive to further rounds of monetary easing a roadblock for the PBoC has been its reluctance to add depreciation pressure to the yuan. A slide in the US dollar over the quarter amid expectations for steeper cuts by the Fed has provided the yuan with a breather, opening an ideal window for the PBoC to become incrementally dovish.

Property sector activity remains weak in high frequency data to July suggesting supportive policy measures introduced in May have been insufficient. The PBoC had previously earmarked Rmb300bn in cheap financing for governments to convert excess housing inventory into social housing, however only 4.0% of this allocation had been utilised by June amid concerns projects are not economically viable for government borrowers. As such, the average inventory absorption rate for unsold homes or those under construction actually increased from 5.5 to 5.6 years since the package was announced. Property sector woes have weighed on the domestic steel sector and this is driving iron ore prices lower – a key driver in the reversal of Australia's terms of trade in recent quarters. Moreover, the slump in the volume of sales widened to -18.3%yoy from -14.1%yoy. On a positive note, growth in property demand-to-supply in July remained in positive territory despite decelerating to 9.8%yoy from 16.3%yoy. Historically positive growth in this indicator bodes well for Australian iron ore exports and price.

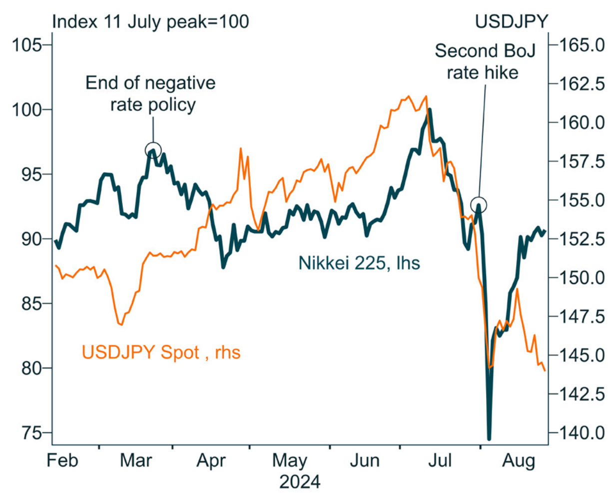
JAPAN: Land of the rising yen?

It has been a tumultuous few weeks for Japanese financial markets that saw the worst sell-off in Japanese equities since the Black Monday crash of 1987. The rout was triggered by a steep appreciation in the yen after the Bank of Japan (BoJ) tightened monetary policy, lifting the uncollateralized call rate to 0.25% from 0.10%. Indeed, hawkish commentary made by Governor Ueda seemed to aggravate markets more so than the decision itself, which was anticipated on the day. The BoJ Outlook Report fuelled speculation over the timing of future hikes, as the Bank argued gradual adjustments to the policy rate sooner would mitigate the risk of being cornered into making 'rapid adjustments later'. Further came suggestions that current monetary settings were significantly below neutral and a warning that '0.5% was not a ceiling for rate hikes'. The upshot was a steep appreciation in the yen and an unwinding of carry trades whereby investors had capitalized on cheap borrowing costs in Japan to invest in higher yielding foreign assets. It also served to add momentum to what was a global equity sell off as discussed earlier in the Global section of this issue. The narrowing of the US-Japan policy rate differential and unwind of the carry trade saw a material appreciation of the yen which served to underpin the sell-off of Japan's exporter-heavy equity market.

Domestic and global market volatility caught the BoJ offguard and it immediately pivoted to 'damage control mode'. In a government address, Deputy Governor Uchida clarified the Bank will leave rates on hold in the face of 'unstable' financial markets and monitor market developments with 'utmost vigilance', winding back some of the perceived hawkishness contained in the BoJ's Outlook Report. These comparably dovish remarks were well received by markets as the USDJPY fell and Japanese equities subsequently retraced much of the ground lost. The yen has also been supported by dovish comments from Fed Chair Powell at Jackson Hole but nonetheless the Nikkei has failed, unlike other markets, to recover levels preceding the flash crash which for Japan was a record high.

GRAPH 08 **JAPANESE YEN & EQUITY MARKET**

BoJ policy moves impart volatility



Source: IFM Investors, Bloomberg, via Macrobond

The Japanese economy has also had its fair share of turbulence swinging from contraction to expansion twice in the last four quarters. For the June quarter, preliminary estimates show a solid 3.1%saar rebound after the -2.3% contraction in the March quarter. A broad-based recovery in domestic demand (up 3.4%saar) was underpinned by strong growth in household consumption (2.1ppts) rebounded after four consecutive quarters of contraction. This was driven by a surge in durables spend, as several automakers resumed production after an ongoing safety scandal. Positive real wage growth and income tax cuts were also supportive. A much-needed rebound in residential investment has occurred after a material decline over the previous three quarters. Meanwhile, there was positive news out of the private sector as capex rose 0.9%qoq after a 0.4%qoq fall over the prior quarter. The external sector, where import growth outstripped exports and private inventories, were notable drags on quarterly growth. Growth in imports, despite a historically weak yen through the quarter, may reflect an improvement in domestic demand.

In June, Japan's wage growth accelerated more than markets had anticipated as raises agreed at shunto (spring wages negotiations) began to be reflected in pay checks. Special cash earnings which usually refer to bonuses drove the gains, reflecting a back pay of negotiated base salary increases. Labour cash earnings increased 4.5%yoy up from 2.0%yoy the prior month while for the first time in 27 months real wages turned positive rising 1.1%yoy following a 1.3%yoy fall in May. Growth in wages on a same sample basis, the all-important measure for the BoJ, accelerated significantly to 5.4%yoy from 2.6%yoy. These results reinforce the notion that a virtuous cycle between wages and prices is beginning to materialise, a prerequisite to policy normalisation for the BoJ.

In July, the national headline inflation measure was unchanged at 2.8%yoy. Core inflation, which excludes fresh food, accelerated slightly to 2.7%yoy from 2.6%yoy in June following an expiry of government utilities price controls. The government is set to temporarily reintroduce these measures from September to November which will place downward pressure on both the headline and core measures. In comparison the 'core-core' measure which strips out fresh food and energy decelerated to 1.9%yoy from 2.2%yoy in June. The slowdown was mainly due to base effects of food prices (excl. fresh food), mobile phone charges and lodging charges which rose sharply over the same month last year.

In politics, Prime Minister Kishida, plagued by his party's internal corruption issues, announced that he will not run for the leadership of the Liberal Democratic Party (LDP) thus ending his premiership in September. With a general election slated for October 2025, the resignation should give Kishida's successor time to regain public confidence before then. Part of this will likely include a supplementary budget which may see further extension of energy and gas subsidies that work to mechanically lower headline inflation, a measure that may be supportive of household spending but looked through by the BoJ when assessing the inflation environment.

KOREA: Cross currents

Korea's economy appears to be running at two speeds, characterised by an anaemic domestic sector partially offset by a firmer external sector. In the March quarter, an unexpected upswing in domestic demand emanating from one-off factors, including favourable weather conditions, the release of a new smartphone, a backlog of construction starts, and base effects saw real growth expand by an impressive 1.3%qoq. A cycling of these factors saw real growth contract -0.2%qoq in the June quarter driven by a slowdown in domestic demand (-0.1ppts). Final consumption made no contribution to economic growth as a fall in private consumption (-0.1ppts) was offset by a rise in government spending (0.1ppts) as elevated debt servicing costs continue to weigh on households. The weakness of the household sector is of concern to the government who are looking to provide fiscal support to encourage spending directed at small business. Gross fixed capex (-0.1ppts) was driven lower by a fall in construction (-0.2ppts) and facilities capex (-0.2ppts) partially mitigated by a rise in inventories (0.3ppts). The outlook for facilities capex remains weak as business surveys continue to point to manufacturers' investment intentions remaining below long run forecasts.

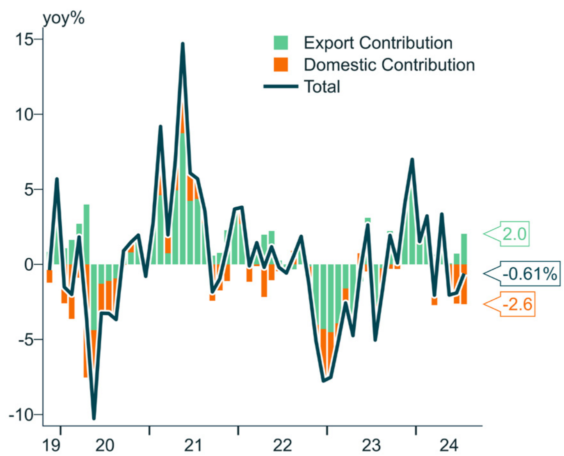
Meanwhile, in the all-important external sector exports softened expanding a relatively modest 0.9%qoq compared to a 1.8%qoq uptick in the previous quarter. Whereas a rebound in imports of 1.2%qoq more than offset this seeing net exports remove 0.1ppt from quarterly growth. Nonetheless, the outlook for exports remains comparably bright with semiconductors expected to do much of the heavy lifting on AI related tailwinds despite breaking a 6-month streak of gains over the first 20 days of trade in August. More broadly, on a workday adjusted basis, August exports accelerated 18.4%yoy from 13.7%yoy the previous month with gains led by ships, autos, and petroleum products. That said, historically Korean exports remain sensitive to slowdowns in the global economy, particularly the US, which accounts for 20% of its exports, therefore the exports outlook rests heavily on whether the US can engineer a soft landing. To some extent, structural changes to Korea's export mix in recent years has seen an increase in the export of investment-linked capital goods which should provide a buffer against any retail driven slowdown in auto shipments. Going forward the strength of the external sector remains key with the entire expansion in industrial production over the year to June driven by export demand as the domestic economy remains weak.

The upshot is that the economy expanded at an annualised pace of 2.8% over the first half, slightly missing the Bank of Korea's (BoK) May forecast for 2.9%. Indeed, there are growing signs that the Bank is moving closer towards an easing pivot, with four out of seven board members now open to a cut in the next three months, despite August's unanimous decision to keep the policy rate unchanged at 3.5%. It is clear that the macro environment is becoming supportive of a cut as growth divergence between the domestic economy and external sector widens, while the bank has reiterated its confidence that inflation will converge towards target. The BoK is hoping that strength in the external sector will lead a consumption recovery as export sector strength broadens out from the tech sector while bonus payments, following robust corporate earnings, (particularly in the tech sector) should work to prop up spending. However, ongoing financial stability issues seem to be a constraining factor for the BoK, especially the question around whether a recent spike in Seoul house prices will broaden out to other regions. In essence, the BoK sees the current economic environment as conducive to easier monetary policy but remains cautious around the property market. The government is looking to address this concern by looking to act to boost housing supply. Further, the recent surge in house prices may be the result of pulled-forward borrowing (and perhaps lending) as households look to lever up ahead of new government macro-prudential measures that aim to address high levels of household debt from the beginning of September. Consequently, we expect the BoK will remain in data dependent mode to ascertain the impact of these policies before determining whether it can pivot in October or November.

While headline CPI came in a little hotter than expected in July, expanding 2.6%yoy from 2.4%yoy in June (beating market expectations) the result was largely driven by a pickup in non-core components. In particular fresh food prices were impacted by an abnormally wet July leading to a surge in prices of popular summer fruits and vegetables. Further, fuel inflation rebounded 8.9%yoy, up from 4.6%yoy in June on the back of base effects, a rise in oil prices and a reduction in fuel tax cuts. Services inflation picked up, rebounding 2.3%yoy from 2.2%yoy in June driven by both eating out and non-eating out categories. On the other hand, core inflation remained at 2.2% for the third consecutive month only 20 basis points higher than the BoK's target. Cognisant of one of impacts on inflation the Bank still asserts that "the conditions in terms of inflation and economic developments are favorable for us to consider a rate cut at an appropriate time in the future". As such, we expect a gradual easing cycle to begin in the further quarter.

GRAPH 09 **SHIPMENTS BY SECTOR**

Industrial shipments to the domestic sector remain weak



Source: IFM Investors, BoK, via Macrobond

Important Disclosures

The following disclosure applies to this material and any information provided regarding the information contained in this material. By accepting this material, you agree to be bound by the following terms and conditions. The material does not constitute an offer, invitation, solicitation, or recommendation in relation to the subscription, purchase, or sale of securities in any jurisdiction and neither this material nor anything in it will form the basis of any contract or commitment. IFM Investors (defined as IFM Investors Pty Ltd and its affiliates) will have no liability, contingent or otherwise, to any user of this material or to third-parties, or any responsibility whatsoever, for the correctness, quality, accuracy, timeliness, pricing, reliability, performance, or completeness of the information in this material. In no event will IFM Investors be liable for any special, indirect, incidental, or consequential damages which may be incurred or experienced on account of a reader using or relying on the information in this material even if it has been advised of the possibility of such damages. Certain statements in this material may constitute “forward looking statements” or “forecasts”. Words such as “expects,” “anticipates,” “plans,” “believes,” “scheduled,” “estimates” and variations of these words and similar expressions are intended to identify forward-looking statements, which include but are not limited to projections of earnings, performance, and cash flows. These statements involve subjective judgement and analysis and reflect IFM Investors’ expectations and are subject to significant uncertainties, risks, and contingencies outside the control of IFM Investors which may cause actual results to vary materially from those expressed or implied by these forward-looking statements. All forward-looking statements speak only as of the date of this material or, in the case of any document incorporated by reference, the date of that document. All subsequent written and oral forward-looking statements attributable to IFM Investors or any person acting on its behalf are qualified by the cautionary statements in this section. Readers are cautioned not to rely on such forward-looking statements. The achievement of any or all goals of any investment that may be described in this material is not guaranteed. Forecasts are based on reasonable assumptions and are provided for informational purposes as of the date of this material. Such forecasts are not a reliable indicator of future performance and are not guaranteed to occur.

Past performance does not guarantee future results. The value of investments and the income derived from investments will fluctuate and can go down as well as up. A loss of principal may occur.

This material does not constitute investment, legal, accounting, regulatory, taxation or other advice and it does not consider your investment objectives or legal, accounting, regulatory, taxation or financial situation or particular needs. You are solely responsible for forming your own opinions and conclusions on such matters and for making your own independent assessment of the information in this material. Tax treatment depends on your individual circumstances and may be subject to change in the future. This material is confidential and should not be distributed or provided to any other person without the written consent of IFM Investors.

United States Disclosure

This material is for use with institutions only and not for use with retail investors. The material, if presented in the US, is offered by IFM (US) Securities, LLC, a member of FINRA and SIPC.

Australia Disclosure

This material is provided to you on the basis that you warrant that you are a “wholesale client” or a “sophisticated investor” or a “professional investor” (each as defined in the Corporations Act 2001 (Cth)) to whom a product disclosure statement is not required to be given under Chapter 6D or Part 7.9 of the Corporations Act 2001 (Cth). IFM Investors Pty Ltd, ABN 67 107 247 727, AFS Licence No. 284404, CRD No. 162754, SEC File No. 801-78649.

Netherlands Disclosure

This material is provided to you on the basis that you warrant that you are a Professional Investor (professionele belegger) within the meaning of Section 1:1 of the Dutch Financial Supervision Act (Wet op het financieel toezicht). This material is not intended for and should not be relied on by any other person. IFM Investors (Netherlands) B.V. shall have no liability, contingent or otherwise, to any user of this material or to third parties, or any responsibility whatsoever, for the correctness, quality, accuracy, timeliness, pricing, reliability, performance, or completeness of this material.

United Kingdom Disclosure

This material is provided to you on the basis that you warrant that you fall within one or more of the exemptions in the Financial Services and Markets Act 2000 (“FSMA”) [(Financial Promotion) Order 2005] [(Promotion of Collective Investment Schemes)(Exemptions) Order 2001, or are a Professional Client for the purposes of FCA rules] and as a consequence the restrictions on communication of “financial promotions” under FSMA and FCA rules do not apply to a communication made to you. IFM Investors (UK) Ltd shall have no liability, contingent or otherwise, to any user of this material or to third parties, or any responsibility whatsoever, for the correctness, quality, accuracy, timeliness, pricing, reliability, performance, or completeness of the information in this material.

Switzerland Disclosure

This Information is provided to you on the basis that you warrant you are (i) a professional client or an institutional client pursuant to the Swiss Federal Financial Services Act of 15 June 2018 (“FinSA”) and (ii) a qualified investor pursuant the Swiss Federal Act on Collective Investment Schemes of 23 June 2006 (“CISA”), for each of (i) and (ii) excluding high-net-worth individuals or private investment structures established for such high-net worth individuals (without professional treasury operations) that have opted out of customer protection under the FinSA and that have elected to be treated as professional clients and qualified investors under the FinSA and the CISA, respectively.

IFM-06 SEPTEMBER 2024-3829127