IFM Investors

Economic Update
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Soft landing, tumultuous times


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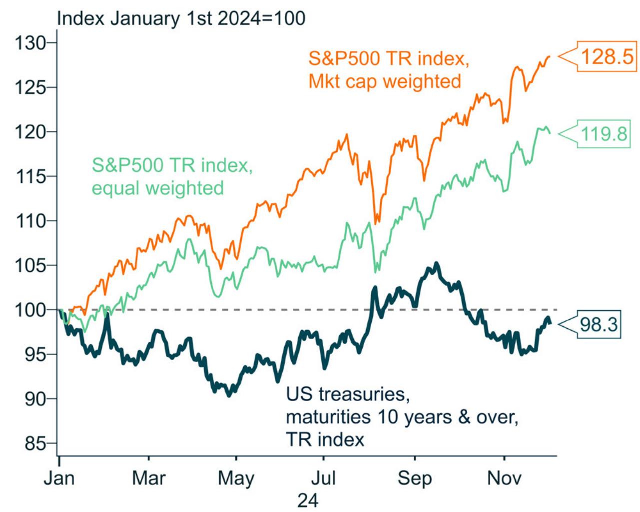
In 2024, inflation finally abated across most jurisdictions with a lower-than-expected cost in terms of growth and unemployment. Given this resilience at the start of the central bank easing phase, a key question for investors in 2025 will be how far will rates be cut to balance growth needs and inflation caution in a time of geopolitical uncertainty?

GLOBAL: Divergent jurisdictions

As 2024 draws to a close, macroeconomic conditions have finally allowed most major central banks to begin easing. The rapid and synchronous increase in interest rates, and their brief pause in contractionary territory, was largely effective in lowering inflation - an unsurprising result. What has been more surprising has been that this has not tipped the global economy into recession, with growth momentum impeded rather than stopped. Consequently, labour market gains have been, for the most part, preserved and this has been key in allowing the consumer to cope with a permanently higher cost of living. The US economy is the clearest example of this in terms of continued growth and labour tightness. Other major developed economies have been more mixed with a weak Japan and Germany, a soft Italy, a solid France and an above trend Spain. Population growth was a key support in other notable economies with Australia and Canada recording modest growth but long and deep per capita recessions. Of the larger emerging economies China is on track to see growth just under 5%, with policy support key, and India has recorded solid growth rates. The broad soft-landing narrative has satisfied equity markets, that have rallied across the globe, holding faith that rate cuts would arrive as disinflation continued to support late cycle growth. Equally, these outcomes have frustrated those investors positioned defensively in fixed income markets, expecting more difficult economic conditions that did not arrive.

GRAPH 01 US EQUITIES AND LONG DURATION TREASURIES



Source: IFM Investors, Bloomberg, via Macrobond

The key global public market asset class benchmarks have reflected this year-to-date. On equities, again it is US exceptionalism with the total return on the S&P 500 above 25% at the time of writing (20% in equal-weighted terms see GRAPH 01). Other jurisdictions with less than stellar economic growth have also performed well – Japan's Nikkei is up 17% (pulling back from a 25% gain earlier in the year), Germany's DAX is up 19% slightly outpacing the Euro STOXX 50 at 10% and the UK at 11%. Australia has not been left out with a 15% total return on the ASX200, led by the IT and financials sectors.

By contrast, fixed income returns have been mixed. It has become clear that deep rate cuts from central banks to accommodative settings are not, at the moment, required. Defensive sectors of the market in the global treasuries space are almost 1.5% lower year-to-date, global credit recorded a relatively modest 3.0%. Better carry up the risk curve has offset either negative or only modest moves in prices. Indeed, credit spreads have continued to edge narrower, again a more prominent occurrence up the credit curve, as any lingering concern around a deterioration in economies was ameliorated by central bank easing. In the US corporate high yield returns have been around 9% compared to just over 2% across US treasuries and a 1% drawdown in longer duration treasuries.

The economic outlook for 2025 is relatively modest, global growth is expected to decelerate and this is largely due to the developed economies and China. The US outlook is for growth slightly above trend, Japan, UK and the Eurozone are expected to be distinctly at trend, and China is expected to grow slightly below its current target. With inflation likely to be around target, central banks will have no cause to take policy to accommodative settings, despite a slightly negative fiscal impulse. But investors and policymakers will not only face economic risk but political and geopolitical risk. Much of this stems from the second coming of President-elect Trump.

We already know this brings a new global trade paradigm. Aggressive tariffs on Chinese imports and 10% across all others will likely be an opening gambit potentially softened by negotiation, but they will still be impactful. China's response is equally important as it grapples with deflationary dynamics, low levels of consumption and a capitulated property sector. A weaker external sector is not what it needs and if faced with barriers to the US market it may seek to accelerate trade with both other advanced economies and its loosely aligned BRICS-plus partners. How the US Administration deals with actual, as opposed to economic, conflicts – notably Russia-Ukraine and in the Middle East – will also inject uncertainty into the outlook.

More certain and domestic focussed are corporate tax cuts and the extension of household tax cuts, due to expire next year, that are expansionary and risk spurring inflation. Investors will need to consider the growth and inflationary implications of these (and other) policies collectively – an impossible task as it stands – and may simply be guided by what they know best - the new Trump administration is for growth, the 'deal' and for Americans to feel like they are becoming wealthier. These policies risk supporting rates at the long end of the curve and therefore valuations across asset classes.

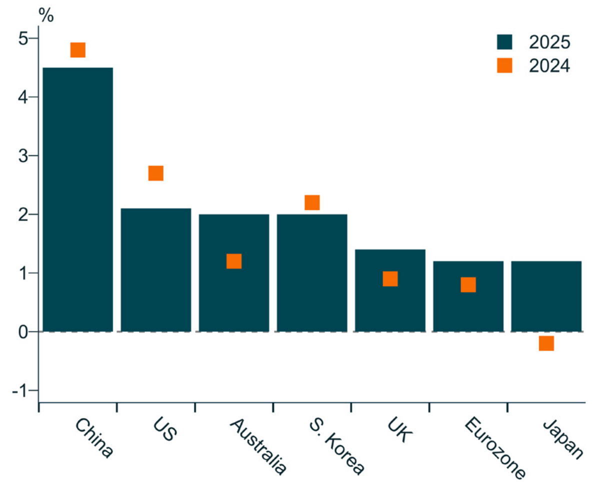
We suspect further gains in equity markets, that have run hard particularly in the US, will be far more measured in 2025. But in a relative sense being more exposed to equities remains preferable to bonds. We say this as equities have seemingly priced in a lot of the pro-growth economic initiatives from the incoming administration, largely tax cuts, and less of those impeding it. This has resulted in US markets in particular having stretched valuations against most metrics and against current economic performance. At least to some degree earnings and economic performance will need to come through in 2025 to justify markets moving higher again.

On fixed income we see another challenging year for treasuries. We see the US yield curve bull steeping being the key risk, with longer end rates edging lower rather than materially declining. This may come as economic and inflation risk remains, there's increasing issuance of treasuries (that is accelerating over the next few years) and an uncertain fiscal outlook justifies a more positive term premium than has been the case for some time at the longer end. Indeed, the US Federal Reserve (Fed) may look to ease the funds rate a little more than consensus currently expects to get the desired financial conditions. We discount, currently, any rhetoric from the Trump administration that it will intervene in the workings of the Fed – given the potential to undermine market confidence. Other developed nations will also continue to ease monetary policy, as will China, with Japan the outlier still looking to edge rates higher.

In mid-risk real assets, at trend economic performance and modestly lower long end rates should be supportive of infrastructure and property markets. The more defensive nature of the former, due to broader economic exposure, in a time of geopolitical risk and still upside concerns around inflation sees private infrastructure well-placed to anchor portfolio returns in 2025. Property is far more uncertain as the unlisted space still looks to find a bottom in valuations, particularly true in the office space, lower rates and tight labour markets will be important.

GRAPH 02 **MARKET ECONOMIST GDP GROWTH EXPECTATIONS**

2025 a better year for growth for some but not others



Source: IFM Investors, Bloomberg, via Macrobond

AUSTRALIA: Better late (2025) than never

The Australian economy was tested over 2024. Indeed, growth decelerated materially, reaching a nadir of 1.0%yoy by June, the worst yearly growth rate since the early 1990s recession (excluding the pandemic). Record population growth, buoyed by immigration, has meant that the economy has managed to eke out growth at the headline level but the elongated ‘per capita recession’ persists. Countercyclical government expenditure has also supported growth and employment but arguably has been a factor in the Reserve Bank of Australia (RBA) not being able to cut interest rates this year. By contrast household consumption has been particularly weak as cost-of-living pressures and the lag effects of tighter financial conditions pared back non-essential spending.

While the RBA has made good on its promise to preserve post-pandemic labour market gains (assisted greatly by non-market employment growth) with the unemployment rate at 4.1% as of October’s labour force print, inflation progress has been less forthcoming. As we entered the second half of the year, state and commonwealth government electricity rebates have knocked headline inflation into the RBA’s target band, however it has made clear its intention to focus squarely on trimmed mean inflation. After providing some false signals earlier in the year the trimmed mean measure has eventually decelerated to 3.5%yoy in Q3 but the RBA wants to see further progress on this measure before gaining comfort to consider policy easing.

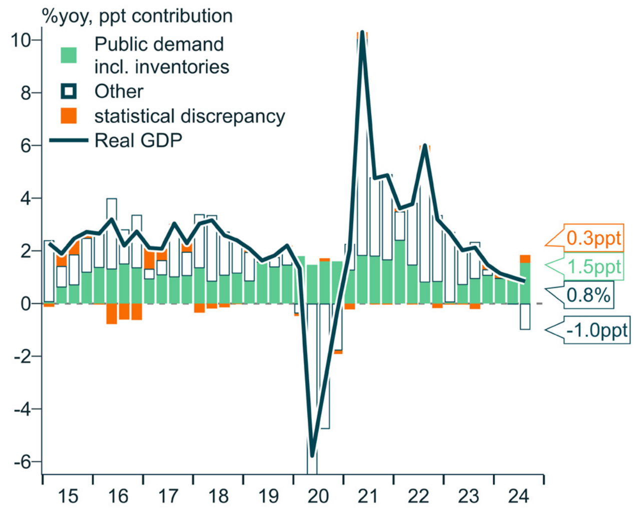
Consequently, the RBA left the cash rate unchanged at 4.35% at its November meeting. Indeed, the minutes from that meeting suggest that Board members would like to see more than one ‘good inflation outcome’ to be confident that it is moving ‘sustainably back to target’. Put simply, the Bank will likely not have the requisite dataflow to obtain this confidence until its May next year at the earliest. This leaves the Bank well behind its global peers and dashes government hopes of a rate cut before the Federal Election (that at the latest must occur by 17 May, with the RBA meeting on 19-20 May).

Real GDP in the September quarter expanded by 0.3%qoq and 0.8%yoy through the year – materially disappointing expectations. The through the year growth rate marks a new cyclical low that hasn’t been seen (outside the pandemic) since December 1991. Any recovery in coming quarters is likely to be modest as households and businesses become accustomed to a permanently higher cost base that will not be overcome by any modest future easing of monetary policy. The RBA’s forecast to the December quarter 2024 is 1.5%yoy. This implies that a 0.8%qoq outcome in Q4 is required to meet this target. It will need a material improvement in growth to hit this forecast and the risk is it may need to downgrade its near-term growth forecast.

This comes despite the continuing per capita malaise in the economy that households, in particular, find themselves in. Indeed, the household sector was again weak in aggregate terms falling slightly in the quarter, business investment was also weaker. Dwelling investment recorded a surprise increase from a weak base. Countercyclical public demand continues to drive economic growth, accounting for all the growth in the economy in the quarter and the year. This is serving to also keep the labour market tight and therefore at the margin underpins inflation – keeping the RBA cautious.

GRAPH 03 **PUBLIC DEMAND & PUBLIC INVENTORIES**

Public sector continues to contribute the most to growth



Source: IFM Investors, ABS, via Macrobond

Notable at the headline level was the economy recorded its seventh consecutive reversal in per capita growth terms (and eighth quarter out of the last nine), since Q2 2022 GDP per capita is 2.2% lower. Productivity was again very weak in the quarter and this along with a falling terms of trade has undermined living standards growth, as measured by real net national disposable income per capita have slumped (falling in five out of the last six quarters) echoing the negative income shock experienced when the previous peak in the terms of trade retraced.

The outlook for Australia is expected to improve according to consensus with growth of 2.0% in 2025. We think there’s some downside risk to this as population growth decelerates, productivity remains stalled and higher costs for consumers and businesses alike hold back the expected recovery. The Federal election may also have some bearing on this with the incumbent government likely to continue to be fiscally supportive (including the extension of household energy rebates) while the Coalition promise more fiscal restraint. Of course there is also some risk from the incoming US administration’s trade policies but we suspect any direct impact will be limited. Firstly, the US does not have a trade deficit with Australia so it is unlikely feel the full brunt of aggressively targeted tariffs. Secondly, Australia’s manufacturing export sector is very small and exemptions may be negotiated (as with steel and aluminium in 2018). Where Australia could be in a precarious position is if there is a tariff exposed growth slowdown in China and an associated decrease in external demand from our largest trading partner. That said, this could provide impetus for China to provide further and more material rounds of monetary and fiscal stimulus to support their domestic economy which could be a positive for Australia.

US: Exceptional, again

The US economy continued its better-than-expected performance in 2024. Resilient activity and an ongoing softening in inflation pressures have essentially seen a full realisation of the 'immaculate disinflation' scenario. However, just as uncertainty surrounding the post-pandemic inflation and rates shock seemed to get under control, geopolitics has reasserted itself as a primary risk driver. The outlook for the upcoming year is – yet again – riven with uncertainty.

Last year's consensus growth expectations for 2024 have been widely beaten, with expectations now at 2.4% - following Q3 growth figures which came in relatively solidly at 2.8%qoq saar. Compositionally, the result is further indication that the US consumer is a strong engine of growth. Indeed, personal consumption expenditures contributed a robust 2.37ppts. This is underpinned by a labour market that has normalised with a still low unemployment rate (4.1%) and decent jobs growth (clouded in October by hurricane/strike impacts). Indicators of excess labour demand have also normalised, with job openings now broadly back to pre-pandemic levels. Inflationary pressures through 2024 were a touch higher than what was expected this time last year. But this is understandable given the much stronger growth outcomes. Inflation looks set to continue to trend towards target, though underlying measures highlight that some ground must still be covered. This combination of labour market normalisation and an ongoing disinflationary impulse has been positive for real wage growth, which edged up 4.0%yoy in September.

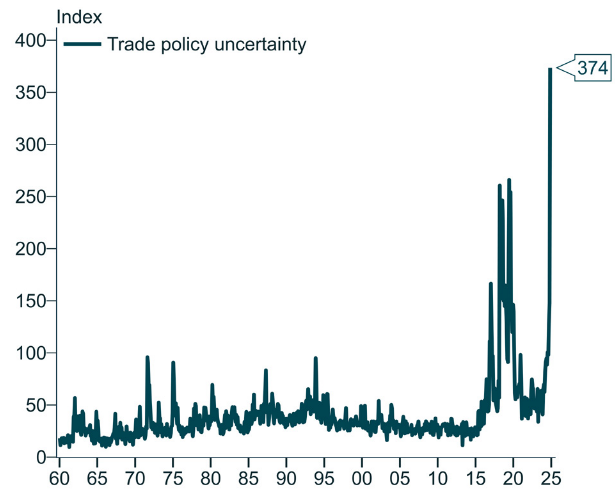
Nonetheless, concerns flared on both sides of the Fed's dual mandate in 2024. On inflation, a string of hotter than anticipated inflation prints were ultimately false signals, while a rise in the unemployment rate, from its cyclical low, triggered the so-called 'Sahm rule' also raising concern. The Fed held its nerve through this and finally commenced its easing cycle in September with a sizeable 50bp cut, framed as a recalibration to protect the labour market from downside risks. The Fed eased a further 25bp in November and signalling around the decision was dovish with Fed chair Jerome Powell indicating that further labour market cooling is unwelcome. Powell also expressed confidence that inflation/inflationary drivers were behaving well.

The Fed will almost certainly continue cutting rates through 2025, but the timing and size will depend on how the business cycle evolves. A key risk to the outlook will be how policy changes implemented by the new government impact the economy. President-elect Trump won a convincing victory with the Republicans flipping the Senate and retaining control of the House. A united Republican government will have few constraints on implementing its agenda, which will be broadly focussed on 1) trade (increased tariffs); 2) immigration (reduced migrant inflow and potential deportations), 3) deregulation; and 4) fiscal expansion primarily via tax cuts. This policy platform combined with already solid late-cycle growth suggests that the Fed will move modestly going forward leaving policy settings relatively tight and above R* for most if not all of the year.

Blanket tariffs are a key risk to inflation but we suspect are a low probability outcome for both legislative and geostrategic reasons. First, although the President holds executive authority, an unprecedented avenue for blanket tariffs, the congressional route would make the most sense. The reason is twofold; under budget reconciliation rules the Republicans only need a simple as opposed to two-thirds majority to obtain legislative approval on trade policy; the revenue received from tariffs could then be used as an offset against the $4-5 trillion in lost federal revenue required for the administration to make good on their promise to extend the 2017 Tax Cuts and Jobs Act. However, any dissenting voices from within the party could make obtaining even a simple majority challenging. Indeed, the Senate Majority leader has cautioned against the inflationary impacts of blanket tariffs. Alternatively, and most likely, tariffs will be applied selectively on a range of goods or sectors from specific countries where US substitute goods are readily available (eg autos), through the President's executive authority. The contours of this approach involve a ratcheting up of tariffs against mainly Chinese and European imports. Sanctions would also be levied on those countries facilitating the transshipment of blacklisted imports with Mexico a clear target. The broader impact of tariffs also rests on the potential for trade partner retaliatory actions. It will be a matter of degree how the evolving situation puts upward pressure on inflation and downward pressure on growth.

GRAPH 04 **US TRADE POLICY UNCERTAINTY**

Trade policy uncertainty spiked post Trump election



Source: IFM Investors, EPU Indices, via Macrobond

The labour market remains a point of focus, with two countervailing drivers. While labour demand has softened into the end of 2024 in line with economic activity, expectations of lower immigration will curtail labour supply growth. In fact, labour supply growth will remain an open question due to lack of clarity around the incoming administration's immigration policies.

Overall, the US outlook is for continued outperformance with consensus growth expectations of 2.1% in 2025 (roughly the average annual growth rate over the last 20 years). Uncertainty is yet again elevated, however, with two-sided growth risks that depend crucially on the policies implemented by the Trump administration.

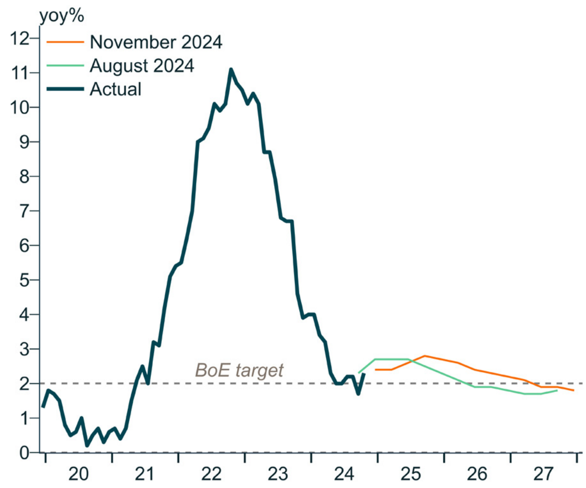
UK: Better than expected

Economic activity in the UK has also proven surprisingly resilient to higher interest rates through 2024. Headline inflationary progress has outstripped expectations, but underlying inflation has been stickier and may keep the Bank of England (BoE) on a hawkish footing. This is exacerbated by considerable uncertainties for the 2025 outlook stemming from material budgetary changes by the new government, a lack of confidence in labour market statistics, and risks around US trade policy.

Third quarter GDP grew 0.1%qoq, representing a marked slowdown from the robust 0.5%qoq Q2 growth and disappointed consensus expectations. Underlying growth is likely better than the headline figure suggests, however, with the details pointing to robust domestic demand offset by net trade impacts. Indeed, household consumption was the main growth driver (0.5%qoq) with healthy investment (1.1%qoq) and government consumption (0.6%qoq) also supportive. Consensus expectations for 2024 annual growth now stand at 0.9%. This marks a substantial outperformance relative to the 0.4% growth expected this time last year.

GRAPH 05 **BOE INFLATION PROJECTIONS**

Inflation to remain above target until 2027



Source: IFM Investors, ONS, BOE, via Macrobond

The Autumn Budget should be stimulatory with tax increases of around £30-40bn starting in 2025 being more than offset by a £60-70bn rise in public spending. The bulk of the tax increases come from an increase to employer national insurance contributions (NIC) with spending mostly focused on day-to-day public services rather than investment. Public spending tends to have high growth multiples compared to tax changes and, accordingly, the budget will likely be supportive of 2025 growth and could place upward pressure on inflation.

Better growth has underpinned inflationary pressures with the headline measure beating expectations in October (headline: 2.3%yoy, core: 3.3%yoy). The acceleration in the headline measure was expected due to a strong rise in domestic energy bills but the upside surprise was largely due to goods price impacts on core inflation. There is evidence of sticky services inflation – a key focus for the BoE – but looking through some volatile components within services, underlying inflationary pressures do appear to be softening.

Labour market data remain problematic due to reliability issues and limit the usefulness of the traditional indicators. Indeed, recent estimates from the Resolution Foundation – a UK-based think tank – based on alternative labour force data suggest that the current labour force survey is overestimating the unemployment rate and/or the rate of economic inactivity. With this in mind, the latest official data have been mixed. The unemployment rate rose sharply in September from 4.0% to 4.3%, though other job indicators were generally stable/soft with jobless claims rising again, another fall in payrolled employees, and continued falls in vacancies. Vacancies per unemployed person – a useful measure of labour demand – is now slightly below pre-pandemic levels at 0.57.

The BoE cut rates by 25bps at its November meeting after leaving rates unchanged in September. The November Monetary Policy Report highlights that the BoE views the budget as inflationary with updated projections seeing inflation remaining above target until 2027 (a year later than the previous projection). The implication that rates will need to remain elevated for a longer period than was the case pre-budget.

There are substantial risks to the UK outlook through 2025, the most immediate of which is the impact of the Budget. The increase in employer NIC may very well have a negative impact on labour demand, and business sentiment/investment. Though there is also the potential for businesses to pass on higher costs to consumers which would add upward pressure to inflation. Externally, the threat of US tariffs is a major uncertainty. And while the UK is relatively less exposed than the Eurozone to US trade policy, the impacts may still be substantial. Direct exposure to the US through trade is limited, given that the majority of UK exports to the US are services, however the indirect impacts through policy uncertainty and softer global growth can still be material.

Consensus expectations are for 2025 growth to pick up to 1.4%, and the UK consumer is central to this. Continued support from household consumption will likely require a fall in the currently elevated household savings rate, as support from real income growth is set to fade. Indeed, real income growth has increased substantially over the last year, but the associated growth impact from this has been partially offset by household saving rates climbing around 10% in Q2 2024 (well above the 5-6% rate seen pre-pandemic).

Inflation remains a key focus and is expected to slow only marginally in 2025 and to remain above target at 2.4%yoy. The likely inflationary impacts of the budget are one of the main drivers behind expectations for increased inflation persistence. Further interest rate cuts are highly likely, but expectations for somewhat higher inflation combined with elevated uncertainty around the exact impact of the budget and external policy uncertainty will keep the BoE on its toes with a hawkish lean.

EUROZONE: A mixed decline

The Eurozone is facing a number of headwinds, but 2024 annual growth is likely to be a touch stronger than what was expected this time last year. This aggregate growth measure, however, masks significant regional divergence with the South proving more resilient than the North. Inflationary progress has been encouraging but has occasionally suffered from inconsistency. The 2025 outlook is bleak for many of the region's larger economies with structural headwinds and risks tilted to the downside on substantial domestic and international policy uncertainties and a challenging fiscal backdrop.

Tight labour markets and strong income growth have insulated the Eurozone against growth shocks to some degree. Indeed, following a surprisingly strong third quarter GDP print of 0.4%qoq, through-the-year growth is set to come in at around 0.8%qoq – 0.2ppts higher than expected this time last year. Gains in the most recent quarter were driven by growth in both private and government consumption on the expenditure side, and by modest improvements in services on the production side.

The underlying pace of growth is likely more moderate than the headline figure suggests, however, with large gains in Ireland's volatile growth and a strong contribution from the Paris Olympics. Looking through the noise, underlying growth was likely closer to 0.25%qoq. Spain continues to be the outperformer (0.8%qoq) of the big four with France expanding a more moderate 0.4%qoq (helped by the Paris Olympics). Germany (0.2%qoq) unexpectedly avoided a narrow contraction but this follows a 0.2ppt downward revision to Q2 GDP figures and as such remains a key Eurozone growth drag. Italy stagnated over the quarter.

The bloc is likely to finish the year on a somewhat more sombre note, however. The closely watched PMI figures – which are a leading indicator of economic activity – have softened sharply into the end of the year and point to a slowdown in activity. Private sector activity as a whole in the Eurozone appears to have contracted in November, with political instability weighing on France services in particular. Details in the report highlight falling business confidence and slowing employment growth.

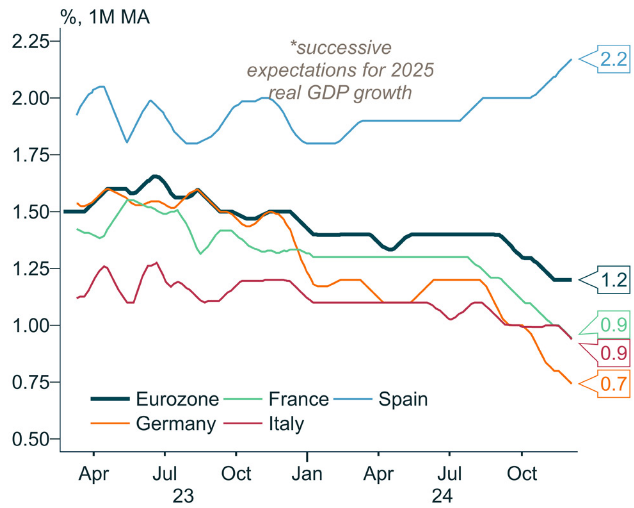
This is consistent with employment growth figures for Q3 (0.2%qoq), which broadly continue to show downward trend in employment growth despite unemployment moving to new all-time lows of 6.3% in September. These data do, however, imply stronger productivity growth in the Eurozone (but this is likely somewhat biased by the Paris Olympics and volatile Ireland figures). Looking through the noise, productivity growth does appear to have turned somewhat positive which will help offset some inflationary pressures from continued wage cost growth.

Much of this strength is being 'looked through' by the European Central Bank (ECB) as a largely one-off catch-up effect and it forecasts a sharp slowdown in earnings in H2 2025. Despite these strong wages figures, inflationary progress continues to be solid as of October (headline: 2.0%yoy, core: 2.7%yoy) particularly in 3-month annualised terms where core inflation is down to 2.16% and broadly paints a picture of underlying inflationary pressures that look less sticky than they have been in recent quarters.

This, combined with a soft growth outlook, has seen the ECB become the most dovish of the major advanced economy central banks. There are even indications that some members are beginning to consider the risks of an inflation undershoot through 2025. The ECB has, accordingly, continued to ease policy with a 25bp cut in both September and October.

GRAPH 06 **MARKET ECONOMIST GDP GROWTH EXPECTATIONS**

Growth to slow, divergence across regions



Source: IFM Investors, Bloomberg, via Macrobond

Next year is expected to be challenging for the Eurozone. Heightened political instability and trade uncertainty relative to this time last year are key new risks and will combine with ongoing structural headwinds from high energy prices, a lack of competitiveness, and fiscal pressures. Despite the challenging backdrop, consensus growth expectations look for continued annual growth of around 1.2%. Risks are sizeable, however, with a skew to the downside. The one bright spot is that the ECB looks on track to get inflation back to target by the end of 2025 with consensus expectations of 2.0% by year-end.

The most material driver of uncertainty is external and is related to President-elect Trump's plan to impose tariffs. Whilst the size and scope of any eventual tariffs is as of yet unclear, the higher trade policy uncertainty for next year is likely to weigh significantly – and has likely already begun to have an impact. The Eurozone is much more exposed to US trade than the UK, and countries like Germany which have a significant manufacturing base and open trade will be the hardest hit, the already soft motor vehicle sector a key risk.

Domestic political uncertainty is another key development. The French government is fractured and weak and the collapse of the delicate German government in November will see snap elections early in 2025. Fiscal constraints and structural headwinds will continue to limit government effectiveness and weigh on public perceptions of the government and will likely keep political instability in the bloc elevated through the year.

CHINA: Great wall of tariffs

China's economy has faced myriad challenges over 2024. The property downturn entered its third year and continues to impart a negative impulse to growth via real estate investment and a wealth-effect related consumption slump. Consumers currently have a low propensity to spend, and policymakers are dealing with a protracted deflationary cycle. Despite their efforts so far, policymakers have been unable to materially stimulate consumption or achieve a stabilisation in the real estate sector (in part due to liquidity issues of local governments). And consequently, because private consumption has been muted, the domestic economy has struggled to absorb strong levels of industrial output leading to downward pressure on prices. Indeed, external demand has been the main growth driver as this excess capacity continues to be pushed offshore. As we look ahead, a new US administration has China in the crosshairs as the key target of punitive trade policies.

In the September quarter GDP growth surprised to the upside as real GDP rose 4.6%yoy against market expectations for 4.5%yoy driven primarily by a pickup in domestic activity. Since August, expanded consumer trade-ins and equipment upgrade programs from policymakers have nudged the domestic economy in the right direction as retail sales and industrial production growth edged up to 3.7%yoy (prior 2.1%yoy) and 5.4%yoy (prior 4.5%yoy) respectively for September. Meanwhile, property continued to weigh on investment, although the pace of the decline moderated slightly over the month. The external sector has remained solid as exports outperformed, expanding 7.2%yoy in Q3 largely on autos. Core CPI accelerated to just 0.2%yoy in October – just a tenth higher from September's 0.1%yoy (the lowest since the global financial crisis excluding the pandemic). This inability to lift inflation reflects the difficulty policymakers are having in stimulating consumption and supporting an ailing property market.

In September, the People's Bank of China (PBoC) surprised markets with the extent of its easing measures. The reserve requirement ratio was reduced by 50 bp with additional cuts signalled. Further, the 7-day reverse repo rate was cut by 20 bp and the downpayment requirement for those wanting to buy a second home was lowered. The PBoC also gave guidance that there would be further cuts to the medium-term lending facility (MLF) and loan prime rates (LPR). Principal amounts extended to state owned enterprises to absorb housing inventory were also increased from 60% to 100%. Efforts were also ramped up to provide cheap re-lending to corporates wanting to undertake stock buybacks to support equity markets and promote a positive wealth effect. While the market welcomed these measures, they are cyclical in nature with some calling for a longer-term comprehensive housing stabilisation program (akin to Spain's long-term pledge to absorb housing inventory after the global financial crisis). Going forward, given the recent success of consumer trade-in and equipment upgrade subsidies, policymakers may use remaining bond quotas to scale up these policies to stimulate services consumption in key areas highlighted by the State Council earlier this year.

Efforts to stimulate the broader economy will be hampered should the property crisis not start to improve. To date, efforts have centred around providing developers with the requisite liquidity to complete unfinished projects. Without this a large backlog of partially completed homes has emerged, negatively influencing supply-demand dynamics. Earlier this year, policymakers identified a 'whitelist' of these troubled developers and directed local governments and state-owned enterprises to provide liquidity. In October, this list was expanded, and it was announced that loan approvals to these entities would grow from RMB2.3trn to RMB4trn by the end of 2024. However, housing inventory levels edged higher over Q3 indicating that these measures have been insufficient. Local governments clearly don't view these projects as economically viable which makes property destocking more difficult. The recent announcement of a RMB10trn debt swap facility may be a step in the right direction as it lowers debt servicing costs for local governments, potentially increasing spending and support for the developers (without pressure on salaries).

The pace of economic growth may again be challenged in 2025 with 4.3%yoy the current consensus expectation. While we see possible extensions in government trade-in programs boosting consumption as well as inflation, and debt resolution efforts allowing local governments to effectively destock property, there are clear reasons to be cautious on the outlook for the export sector and its impact on domestic activity. Indeed, consensus expectations are for export growth to slow from 7.2%yoy in Q3 2024 to just 1.0%yoy by Q1 2026. With 60% tariffs currently slated for certain Chinese exports and the tech up-cycle losing steam, the risk is that the external sector does little to assist China in achieving its ~5% growth target. This may provide the necessary impetus for policymakers to be more forthcoming with domestic stimulus in 2025. Risks to this scenario include tariffs being applied to all products or a crackdown on the so-called 'China plus one' transhipment of goods to third party countries. We consider that intra-regional trade has deepened alongside China-led trade agreements, and we expect this to continue with a controlled depreciation in the RMB a likely tailwind. The latter could also help to preserve profit margins for Chinese firms that continue to export to the US and offset any negative volume effect.

GRAPH 07 **CHINA IMPLICIT PRICE DEFLATOR**

The most protracted deflationary episode in recent history

Source: IFM Investors, China NBS, via Macrobond

JAPAN: Nominal renaissance

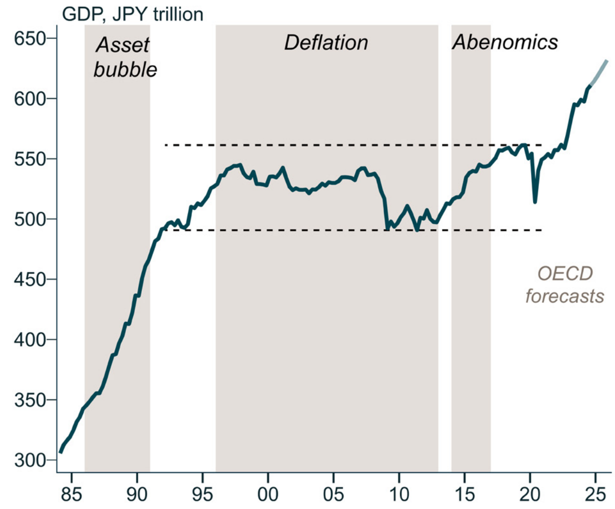
After several decades of stagnating nominal GDP growth, 2024 was further confirmation of Japan's 'nominal renaissance' spurred by what policy makers have declared to be a 'virtuous wage price cycle'. It was clear that 2024 would be a year where Japan's wage and price growth sustainability would be tested. The dataflow over the year suggests that it has some momentum, indeed enough to prompt an overhaul of negative interest rate policy (NIRP) in March this year. Record shunto wage negotiation outcomes have seen base wages increase 3%yoy, a level the Bank of Japan (BoJ) considers consistent with sustainable inflation and rising services prices. While the BoJ can be somewhat satisfied with these outcomes, less can be said for the historic volatility it helped impart across global financial markets following hawkish commentary made by Governor Ueda in August. The Governor's suggestion that current policy settings were 'significantly' below neutral and called for 'more rapid tightening', clearly caught markets off guard. What transpired was a steep appreciation in the yen and an unwind of carry trades whereby investors had been capitalizing on cheap borrowing costs in Japan to invest in higher yielding foreign assets. This added momentum to a global equity sell-off spurred by renewed US recession concerns and the exporter-heavy Japanese equity market experienced the worst sell-off since the Black Monday crash of 1987. We then saw the Bank pivot to 'damage control mode', walking back some of these comments in the days that followed.

More recently, the BoJ decided to hold its policy rate at 0.25% in October (as broadly expected). Governor Ueda stated that the 'clouds are clearing' on downside risks to the US economy following a strong August US employment report and subsiding financial market instability. Put simply, the message from the BoJ is that it remains in data dependent mode, highlighting it will keenly monitor the extent to which wage increases flow through to services prices. It is seeking an adequate degree of confidence that wages can sustainably grow beyond the 3%yoy threshold – a pre-requisite to sustain inflation near the target – before potentially shifting policy again. Unlike other central banks the BoJ will welcome robust inflation data that arrived in October with new core CPI accelerating from 2.1% to 2.3%yoy on strong contributions from services inflation signaling that companies are adjusting prices based on wage increases. Furthermore, recent weakness in the yen and continued post US-election dollar strength may provide the impetus for earlier hikes to mitigate import inflation, especially if the USD/JPY tests JPY160/USD (the level at the previous hike). We see the BoJ continuing to normalize policy as we head into 2025.

As an export-oriented economy, Japan's outlook will likely be directly or indirectly impacted by escalating trade tensions. As discussed previously, we see universal US tariffs as less probable than sector specific tariffs. Entertaining the universal tariff scenario, the relative competitiveness of Japan's exports does not diminish compared to trade restrictions that target specific countries and Japan will be impacted to the extent that US external demand decreases. Alternatively, Japan would be more acutely exposed to sector specific tariffs (potentially more likely). Indeed, Trump entertained the idea of levying a 25% tariff on Japanese autos in 2018 and if this materialises production cuts and decreased capex plans would be a significant drag on Japan's growth. Apart from policy impacts, we see currency volatility risking an acceleration in inflation as the greenback appreciates against the yen. Moreover, the Trump administration could pressure Japan to increase defence spending and while this would be a fiscal tailwind it comes at the cost of greater US arms imports. We remain watchful of these risks as we head into 2025 with growth expected to be more consistent at 1.2% after a forgettable year in 2024 with current expectations of a full year outcome showing a 0.2% reversal.

GRAPH 08 JAPAN NOMINAL GDP

Japan's nominal renaissance continued over 2024



Source: IFM Investors. Japanese Cabinet Office (CAO), OECD, via Macrobond

This 2024 outcome comes as preliminary estimates suggest that the economy grew a modest 0.9%qoq saar in the September quarter (2.2%qoq saar previously), on par with market forecasts for a more modest outturn after the Q2 rebound from a Q1 contraction. The deceleration is also attributable to special factors including weather conditions and stalled production at automakers following a safety scandal. Stripping these out we observe that domestic private demand is on solid footing, while external demand slumped as visitor spend declined and imports increased. The bright spot was the consumer, with household consumption growing 3.6%qoq saar due in part to wage related purchasing power but also emergency stockpiling. From here we see firm domestic demand supported by positive real wage growth and tax cuts and firm external demand on moderate global growth and a weaker yen. However, as mentioned, the outlook for global trade is highly uncertain.

After losing their lower house majority in October the Liberal Democratic Party (LDP) led coalition passed an economic package in November, designed to support growth, address inflation and support disaster recovery. As their power in the lower house has been diluted the LDP and their leader Prime Minister Ishiba (known as a fiscal hawk) have been forced to make concessions that make the bill more expansionary including a planned increase in the taxable income threshold in 2025. As such, fiscal policy should also be supportive into next year.

KOREA: A trilemma for the BoK

Korea has had a two-speed economy for much of 2024. Year to date, export growth has outperformed on a global tech up-cycle and AI tailwinds primarily through strong global demand for semiconductors. In contrast, private demand has been anaemic with muted investment and a household sector under pressure from tight financial conditions and high debt servicing costs. At some point the pendulum will shift with early signs of a slowdown in external demand already surfacing and trade uncertainty on the horizon with the incoming Trump administration. The Bank of Korea (BoK) now faces the difficult challenge of reviving private demand, ensuring the currency remains competitive and stemming the rapid growth in household debt.

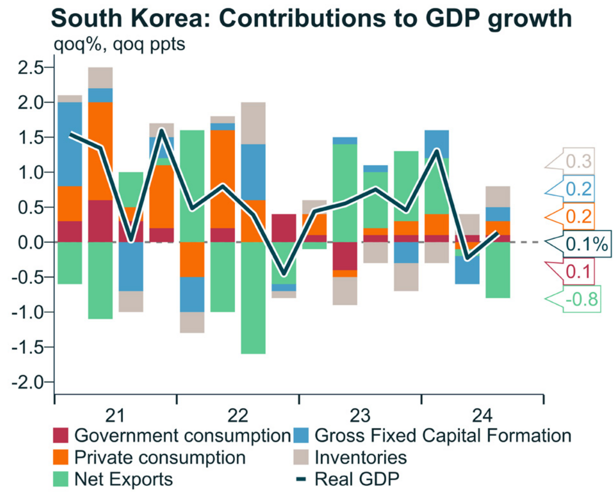
The September quarter growth outturn disappointed. Preliminary real GDP estimates had growth at 0.1%qoq (1.5%yoy) while the market centred on 0.4%qoq (2.0%yoy), a significant surprise to the downside. As mentioned, the external sector held up well for the first half of the year but was the single greatest drag in the quarter decreasing 0.4%qoq and deducting 0.8pts from growth. Goods exports contracted -0.6%qoq marking the first decline in almost two years. Weakness was most acute in autos on tepid demand for EVs while growth in tech-related sectors, including semiconductors, also slowed. Meanwhile private demand improved, as consumption bounced after a weak June quarter and investment picked up amid an increase in facilities investment.

From here we see continued improvement in domestic demand and a more limited contribution from export growth as we look to 2025. Indeed, leading indicator data suggest that exports have already slowed materially in October even with the extra business day captured in the data. Average daily shipments declined from a year earlier for the first time since September 2023 and headline export growth lost considerable steam growing 4.6%yoy compared to 7.5%yoy in September 2024. In nominal terms, semiconductor exports drove growth over October however in real terms only eked out 1.4%yoy growth. Export outperformance from here looks unlikely. By contrast, private demand, led by consumption should continue to improve as inflation stabilises and financial conditions ease gradually in 2025, especially considering large household and corporate exposure to floating rate debt. That said this will represent a rotation of growth rather than an improvement. Consensus expectations for real GDP growth in 2024 are currently 2.2% and are expected to slow modestly in 2025 to 2.0%.

The BoK is now seeking to ensure this outcome. It unexpectedly lowered its base rate by 25bp to 3.0% in November marking the first back-to-back rate cuts since 2009. With respect to pace of future cuts, the word 'carefully' was removed in the BoK's statement while half of its Board members indicated that they would be open to further cuts over the coming three months. This easing comes as the BoK notes that "downward pressure on economic growth has intensified". And it now faces the challenge of supporting an ailing economy and stabilising inflation (including through monitoring FX developments) while not stoking financial instability in Seoul's property market. Indeed, the move reflects a prioritisation of growth above all else with the BoK revealing that it had become incrementally bearish on the economy, lowering its 2025 growth target from 2.1% to 1.9%. It cited the incoming US administration's protectionist trade policies and external sector weakness as key concerns. On inflation, November saw the headline measure tick up from 1.3%yoy to 1.5%yoy, weaker than markets expected and still lower than the Bank's 2%yoy target, amid soft demand. The BoK will likely see this disinflationary pulse as transitory as electricity rate hikes and fuel tax cuts will be reflected in coming months. Further, currency developments pose an upside risk to inflation amid a widening US-Korea rate differential and a post-election rally in the greenback.

GRAPH 09 **KOREA GDP GROWTH CONTRIBUTIONS**

Export contribution to growth has started to reverse



Source: IFM Investors, Bank of Korea, via Macrobond

We see Korea's trade-based economy as being vulnerable to a ratchetting up of global trade tensions, the BoK noting itself that the global economy faces "...heightened uncertainties... ...driven by the new U.S. administration's policies". Negative spillovers from a tariff-imposed slowdown in China's economy would be a significant drag on external demand for Korean intermediate components. However, this impact will be at least partially offset by efforts to diversify supply chains away from China and a trend of Chinese localisation of high-end goods production (eg EVs and smartphones) since the 2018-19 trade war. A more acute concern for policymakers is that the incoming administration will likely voice strong complaints about the growing trade deficit it runs with Korea. A trend of US-onshoring (accelerated by the CHIPs Act) has seen South Korean production facilities move to the US. These firms are large importers of intermediate Korean goods. The incoming administration may overlook the utility that reshoring efforts have provided the American economy. With universal tariffs less likely, it is possible that the large deficit is used as a bargaining chip to gain concessions for the US. This could include coercing Korea into accepting energy imports, increased defence-cost sharing as tensions with Pyongyang continue to escalate and a reworked Korea-US free trade agreement (KORUS) which was attempted under Trump's first term.

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