ECONOMIC UPDATE

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Resilience or recession?

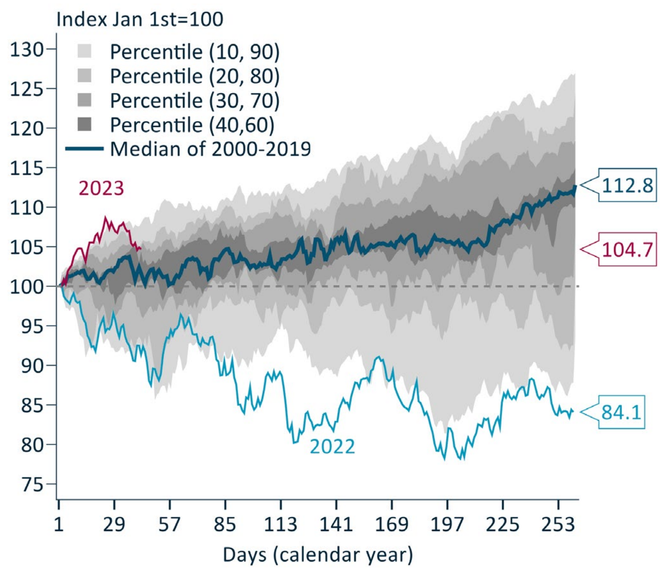
Recession fears have eased substantially in recent months in response to a raft of stronger-than-expected economic data. But this threatens to keep inflation higher for longer. Central banks are likely to lean hawkish and appear set to keep tightening policy until the data have turned, to remove any doubt that inflation will head back to target. This will likely require a painful downturn, the severity of which likely depends on how persistent inflationary pressures are. Markets have been volatile in response to these dynamics, with initial optimism around a better growth outlook quickly – and aggressively – giving way to concerns about higher policy rates and the associated negative growth implications later in the year.

Global: Resilience before recession?

Talk of global recession has been put on hold, at least temporarily, and replaced with a narrative of resilience. This comes despite aggressive and ongoing monetary policy tightening. Activity data has proven more robust than expected when forward looking sentiment surveys were suggesting it shouldn't be; meanwhile, inflation was coming off its peak. Added to this, a milder winter in Europe and news of Chinese re-opening buoyed investor sentiment. This has prompted an equity market rally as investor sentiment lifted from its late 2022 lows. This rally has so far weathered some challenging earnings news, and the reversal of an earlier rally in bond yields. At their peak, developed economy equity markets were up 7.0% year to date (selling off somewhat in recent weeks). European markets have been the standout, with double digit returns in Germany, France, Italy, and Spain. Key US markets lagged this performance, with the notable exception of IT and tech stocks that had been subject to a brutal sell off since peaking in 2021. Indeed, the drawdown in 2022 is likely also a key factor driving the 2023 rally to date as valuations became far less stretched and provided investors with a more acceptable balance of risks. The key question is can this last? We suspect not, with resilience still favoured to give way to recession, at least across many developed economics, at some point.

GRAPH 01 MSCI WORLD PERFORMANCE SINCE 2000

A solid start to 2023, but can it last?



Source: IFM Investors, Bloomberg, Macrobond

That said, there are several scenarios that remain possible and are worth considering:

1. A "benign disinflation" scenario, where inflation falls back to target in an orderly fashion through 2023 without an outright recession or a painful labour market adjustment, and without significant further central bank tightening.
2. A "delayed transition" where recent resilient activity is being driven by robust household balance sheets and consequently there is a slower-than-expected monetary policy transmission. Under this scenario, signs of a material slowdown would likely appear late in2023, with central banks potentially cutting rates to support activity later in the year, or in early 2024.
3. Continued "unexpected resilience" where the current level of interest rates is not sufficiently restrictive and requires further central bank tightening through 2023. In this scenario, rates are higher for longer, with recession risks being pushed back to around early-2024.

At this stage, we see some combination of the second and third scenarios as being most likely. Robust economic activity threatens to keep inflation higher for longer and policymakers are likely to err on the hawkish side given the intense pressure on central bank credibility that this inflationary episode has triggered.

The "benign disinflation" scenario seems unlikely in our view but arguably it is this outcome, and some measure of scenario two, that markets are currently pricing.

The rationale behind our thinking is that resilient economic activity threatens to keep inflation rates higher for longer. If this occurs, we believe central banks will be further emboldened to tighten monetary policy in an effort to remove any doubt that inflation will decelerate back to targets. While some inflation will ebb away given supply pressures easing, we do not believe there can be a benign disinflation that returns inflation to targets – it will take some effort. This is largely due to the breadth of inflation that now exists. In particular, core services inflation is a deep concern for central banks, as well as labour market conditions, as they seek to ward off any threat of wage-price spiral dynamics.

We expect central banks will tighten policy until something breaks and that something is likely economic activity, given inflation is a lagging indicator of that activity. And within these economies, it will be the household sector that falters as cost of living, higher rates and then job insecurity all conspire to cause a marked pull back in spending that will be enough to tip growth negative, given the sheer size of the household sector in advanced economies.. Inflicting damage on labour markets will be a key catalyst for this, and a necessary one, as introducing spare capacity will be a prerequisite to get core inflation back to target. But in doing so, central banks are undertaking substantial risks to activity, particularly because tight labour markets have been a key driver of resilient household consumption, despite record low consumer sentiment across advanced economies.

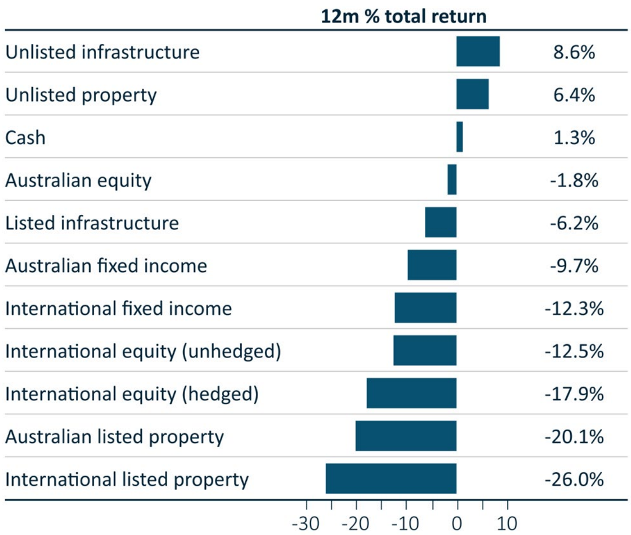
Central banks are still resting policy decisions on the data flow, with the labour market being key, and they will want to observe a turning point because they can't forecast it. By the time they see it, policy settings will likely have tightened further and the lags in the effectiveness of monetary policy will continue to impart a negative impulse on economies long after the tightening cycles have stopped.

How painful any downturn is will be largely determined by how persistent inflation is. Central banks will be much less likely to ease policy to support weaker economic activity if inflation remains uncomfortably high. It seems that markets do not see this as an impediment given expectations that central banks will loosen policy in a timely manner in response to weaker economic conditions. This has reduced recession fears from high levels, but to us, the risk is that easing does not occur until inflation clearly allows. We say this as we expect central banks to put some importance on returning inflation expectations to target – they would be in a difficult position if inflation reaccelerated aggressively as they eased too soon.

On balance, we view the market-moves this year as a touch too optimistic to be sustained through what we see as a period of elevated uncertainty and likely economic weakness. The current bear market rally seems hopeful of the 'benign disinflation' scenario playing out further, which to us seems unlikely. If the outlook evolves as we expect, this rally will fade and with it the narrowing of credit spreads that accompanied it. Those positioned defensively coming into 2023, at some relative cost in terms of returns to date, should find some value as the economic cycle weakened earning are put under pressure and a drawdown in equities occurs. We believe there is a more sustainable rally to come in growth assets as the cycle turns more positive, when central banks do eventually pivot and the risk of ongoing economic weakness has passed. We'd note in this scenario that allocations to mid-risk private market assets, such as unlisted infrastructure, should be maintained. The performance of this asset class was outstanding, on a relative basis, through 2022 when 60:40 funds were performing poorly. This demonstrated their resilient 'through-the-cycle' properties in a highly volatile and uncertain economic environment.

GRAPH 02 KEY ASSET CLASS 12-MONTH RETURNS

Mid-risk private market assets outperformed in 2022



Source: IFM Investors, Bloomberg, APRA, Data are to Q4 2022

Australia: Inflation surprise, hawkish RBA

The Reserve Bank of Australia (RBA) has taken a hawkish turn, and the 'narrow path' to a soft landing for the economy has become seemingly narrower, following an unexpectedly strong inflation print in the December quarter. The RBA increased the cash rate by 25 basis points in February, the first meeting of the year, and in its post-decision statement said that 'further increases in interest rates will be needed over the months ahead.' It continued to cite considerable uncertainties to the outlook for the Australian economy, namely the slowdown in household spending (discussed below), with the full effect of interest rate increases yet to be felt, and the response of the global economy to rising rates. Despite these uncertainties, the RBA remains 'resolute' in its determination to fight inflation, and minutes from the meeting show it considered a 50-basis point increase in the cash rate due to prices data exceeding expectations and concern that price and wage expectations would move higher, the more persistent inflation remained.

The RBA also published updated forecasts in its February Statement on Monetary Policy (SMP), which notably upgraded trimmed mean inflation in the near-term but continued to see it moving lower into next year. It also upgraded its wages forecast materially, likely due to information from its business liaison program given it also upgraded the profile for the unemployment rate. Its forecasts for real GDP growth and headline inflation were little changed.

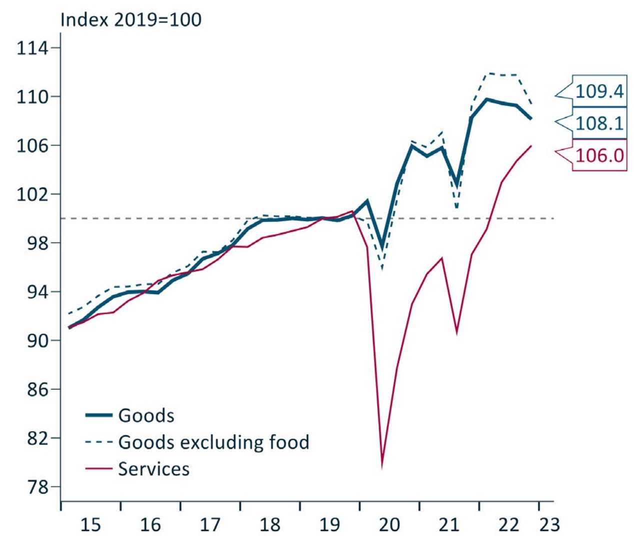
Inflation data surprised to the upside in the December quarter, with growth in both the headline consumer price index (CPI) and trimmed mean measures coming in above both market and RBA expectations. Headline inflation grew 7.8%yoy while trimmed mean inflation came in at 6.5%yoy. Inflation remained broad-based, with three-quarters of the basket experiencing price increases of more than 3%. While the print did not change our expectation that the December quarter saw the peak of (year-ended) inflation in Australia, the broad-based nature of inflation clearly gave the RBA cause for concern. Analysis from the RBA's SMP showed that the primary driver of inflation is still supply-side issue related to the pandemic, although domestic demand is playing a significant role.

High inflation has continued to erode real wage growth. Wages, unlike the inflation data, came in below expectations in the December quarter; this alleviated concerns of a wage-price spiral but suggested that household incomes are not keeping up with cost-of-living pressures. The Wage Price Index (WPI) grew at 3.3%yoy in nominal terms, but real wages growth continued to move further into negative territory at -4.18%yoy. Wages are expected to continue to increase, and the RBA is forecasting WPI growth to peak at 4.2%yoy at the end of 2023. While growth disappointed, the RBA noted in its SMP that firms in its liaison program have continued to use non-base wage incentives to attract and retain staff.

Given lagging wage growth and high inflation, labour market outcomes will remain particularly important for the evolution of domestic demand. The labour market remains tight, despite some softer data prints in January. Unemployment in January rose to 3.7%, despite a fall in the participation rate, already challenging the RBA's upwardly-revised forecast. January also saw the second consecutive monthly decline in employment. In an appearance before the senate standing committee on economics, Governor Lowe said that the RBA is expecting a stronger-than-usual outcome in February given there were roughly 100,000 people more than usual surveyed who were 'waiting to start work' in January. As such, the results of the next labour force survey will be crucial for policy settings. We hope that the RBA is correct, since further deteriorations in labour market outcomes could see the household sector become increasingly cautious, further narrowing the narrow path to a soft landing.

GRAPH 03 HOUSEHOLD SPENDING

Discretionary goods spending is under pressure



Source: IFM Investors, ABS, Macrobond

The early stages of this caution were evident in what were disappointing GDP data for the December quarter. The economy expanded 0.5%qoq and 2.7% through the year. However, the underlying tone was weak with the expansion in the economy able to be entirely explained by a commensurate expansion in population growth. Per capita GDP growth was flat in the quarter and productivity outcomes were poor. As we have written in these pages before the Australian economy is likely to return to some 2019 state in which the economy gets bigger but not better. Of the key drivers dwelling and business investment both went backwards in the quarter and inventories also subtracted.Net exports was by far the largest positive contributor to quarterly real GDP growth adding 1.1pp as exports volumes modestly expanded and imports fell sharply. The latter being of some concern should it prove a forerunner to weaker domestic demand which seems likely. Growth in real household spending decelerated sharply recorded only modest growth that was skewed to essential services and away from discretionary goods. Disposable household incomes went backwards in the quarter as mortgage payments rose and the rate at which people are saving declined again. Households are a key sector for the RBA to watch when deliberating on policy particularly with sentiment remaining so weak.

US: Too much of a good thing

The US economy is the clearest example of unexpected resilience in the face of tighter monetary policy. Labour markets remain tight, growth momentum seems to have picked up rather than faded, and inflationary pressures are persisting. Markets have been volatile in response to these dynamics with participants trying to grapple with the implications of these unexpectedly strong data.

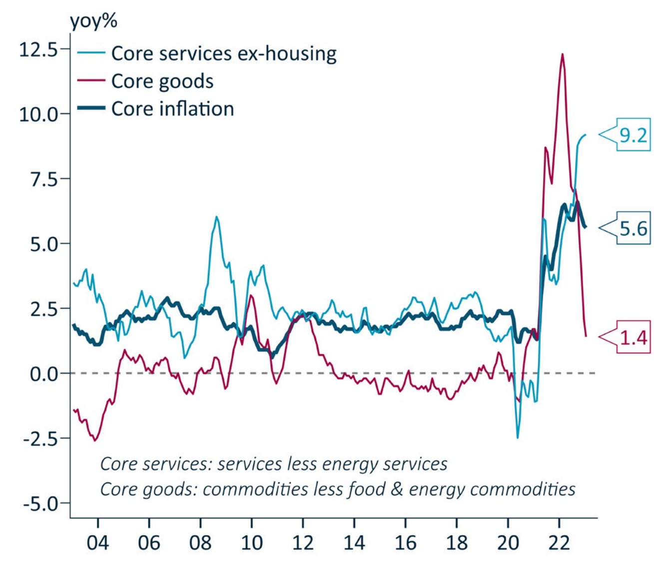
Headline GDP growth in the final quarter of 2022 was unexpectedly strong, with real output increasing at a 2.9% annualised rate (revised lower to 2.7% in the second print) compared to the prior quarter. But the headline figure is a touch misleading, and the details point to a weakening underlying growth momentum. Business investment was soft and inventory accumulation contributed an outsized 1.5 percentage points, which will likely reverse in the first quarter of 2023 and weigh on growth. More timely PMI data for January (ISM services PMI: 55.2) suggest that there is still decent growth momentum in the US services sector (though the manufacturing sector continues to contract). The details of the report were positive and suggest that the strong expansion in private sector services activity over the month was driven mainly by increasing business activity, new orders, and employment components. The fact that most strength is concentrated in services has implications for continued price pressures in the services space and that will be of particular interest to the Fed given that it is core services inflation it is most keenly focussing on.

The labour market has been the key standout in recent months. Unexpectedly strong employment growth saw the unemployment rate fall to 3.4% in January (last seen in 1969). Nonfarm payrolls figures for January showed a net increase of 517,000 jobs, nearly three times higher than expected and precipitated a sharp repricing in markets with US equities selling off and yields rising. Job vacancies data have been of particular focus in recent months given the series' importance as an indicator of excess labour demand and these data are also pointing to continued labour market strength. The downward trend in vacancies that was observed in March-August of 2022 has been arrested and vacancies shot up in December 2022 to just over 11 million. This brings a key measure of excess labour demand – job vacancies per unemployed person – to around 1.9 which is uncomfortably close to the historical peak in March 2022 of just under 2. Whether this trend of firming vacancies continues into 2023 remains to be seen. One of the key labour market prints that appears to be moving in the right direction are data on average hourly earnings. Here we see clearer signals of slowing, with the figure falling in 8 of the past 10 months to reach 4.4%yoy in January. But base effects are partly responsible for the year-on-year falls and earnings growth remains high in levels terms. And in terms of real earnings, falling inflation has actually contributed to an acceleration in real earnings growth in recent months. Finally, looking at labour market participation, there has been continued firming in the participation rate to 62.4% in January. But this remains around 1 percentage point below pre-pandemic levels and a further sustained increase in the participation rate would help ease labour pressures.

In this environment, the Fed continued to tighten monetary policy and hiked rates 50 basis points in December before stepping down to a 25-basis point hike in February, taking the target range to 4.5-4.75%. Further tightening in policy is almost certain and was flagged in the statement accompanying the February decision, but the Fed has also signalled a shift to a more data-dependent approach. The statement also showed a dovish tilt in language, and it appears likely that policy changes over the next several months will likely be in 25 basis point increments, as opposed to the 50 or 75 basis point increments seen in 2022. There was also an explicit acknowledgement that inflation had eased but it was made clear that much more evidence of slowing core inflation will be needed to change the view of the Fed. This echoes the December minutes that emphasised the importance of further data to the outlook. Minutes from the February meeting expressed concern around easing financial conditions and that this may necessitate tighter policy. February minutes also pointed to less evidence of slowing core services ex-housing inflation and emphasised the importance of labour market softening to ease pressure on that component. The strength of the January labour market figures since the February meeting will form an important data point for the March meeting.

GRAPH 04 CORE INFLATION KEY COMPONENTS

Core services inflation has shown little evidence of slowing



Source: IFM Investors, BLS, Macrobond

Inflation has fallen significantly in recent months and looks to have peaked, though there remains considerable uncertainty around how quickly core inflation will return to target. The headline measure reached a peak of 8.9%yoy in June before falling sharply to 6.3% in January. The core measure reached its peak of 6.6%yoy later – in September – and fell to 5.5%yoy in January. However, the core services ex-housing component that the Fed referenced in the February minutes has continued to climb and firmed to 9.2%yoy in January. This has potentially concerning implications for inflationary persistence.

Taken together, the strong labour market and inflation figures released in February saw a material upward repricing of the federal funds rate by markets.

UK: It depends on the data

The UK economy managed to narrowly avoid a recession in the final quarter of 2022. Real GDP tracked sideways over the period following a 0.2%qoq contraction in Q3. Business investment was a standout and rebounded sharply (8.7%qoq), marking the series' first return to pre-pandemic levels in real terms. Household consumption also retraced some of the Q3 fall but these GDP figures are volatile, and the underlying picture remains relatively challenging.

A contraction in output in Q1 appears likely and recession risks remain material. But the expected severity of any coming recession has eased with a number of activity indicators holding up well. Preliminary PMI data for February suggest that private sector activity – particularly in the services sector – expanded over the month despite the headwinds of rising rates, labour shortages, and cost-of-living pressures. The details point to lower economic uncertainty, fewer supply issues, and rising customer demand as supportive but also continued to point to elevated price pressures, particularly in the services space where staff salaries were a key driver of these price pressures.

The Bank of England (BoE) will remain attentive to data on economic activity but will prioritise inflation and labour market releases over coming months. In terms of policy, the BoE continued to tighten and raised rates by 50bps in both December and February, taking the bank rate to 4.00%. A key factor behind the February move was a view among Monetary Policy Committee (MPC) members that inflation risks remained substantial and firmly skewed to the upside. There was a dovish shift in communication following the February meeting, however, with the MPC removing forward guidance that further hikes will be necessary and instead moved to an entirely data-dependent approach.

The minutes also flagged that a number of forward-looking indicators were pointing to slowing wages and inflation data, but the BoE will likely want to see evidence of this in the hard data before shifting stance again. Furthermore, there was disagreement among MPC members at February's meeting about the most appropriate course of action, with two dissenting votes opting for no more rate hikes on the back of concerns that policy was already restrictive enough and that the time lag between policy implementation and real economy impact means much of the previous tightening had yet to be felt. The BoE will be closely watching the data released between the publication of this piece and the March meeting. Of the data released over that period, it is the inflation and labour market data that will be of most interest.

In terms of its outlook, the BoE is more optimistic on both growth and inflation with lower energy prices a key driver of the improved outlook. Annual growth is, however, still expected to be negative in 2023 (-0.5% vs -1.5% previously) and 2024 (-0.25% vs -1% previously). On prices, headline inflation is still only expected to reach target in Q2 2024 but is now expected to average around 7.2% over 2023 compared to 8.3% previously.

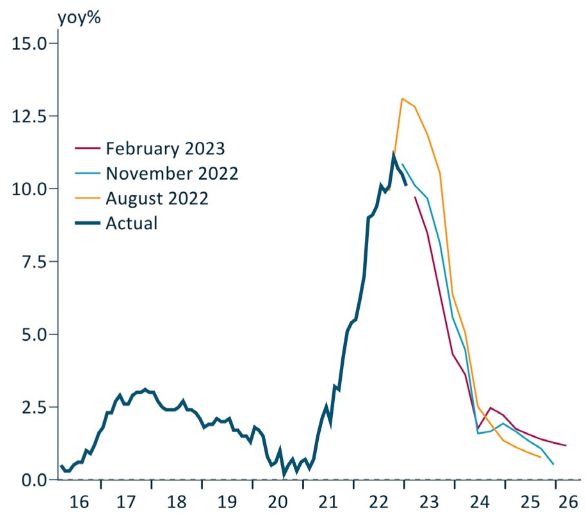
On inflation, it appears that a turning point has been reached. Headline price pressures have fallen in year-on-year terms for three consecutive months from a peak of 11.1% in October 2022 to 10.1% in January 2023. This is better than the BoE's own forecasts from the November Monetary Policy Report (MPR). Core inflation – which is of more interest to the BoE – has followed a similar trend and is down from 6.5% in October 2022 to 5.8% in January. The January release was responsible for the lion's share of the softening inflation story, but the details suggest caution around interpretation. Services inflation – a measure of underlying price pressures in the UK's services-based economy that is being focussed on by the BoE – has only fallen for one month after rising sharply to December. Additionally, seasonal impacts and rebalancing effects are weighing on the figure and not necessarily representative of fading price pressures.

The labour market has not yet sent any convincing signals that sizeable softening is underway. True, there has been a sharp and continued fall in unfilled vacancies but in level terms, excess demand is still elevated and it remains unclear how much falling vacancies will act to ease labour market pressures. The traditional data remain strong, with the unemployment rate for the 3-months through December tracking sideways at 3.7% (near the lowest level since 1970s) and regular earnings over this period accelerating for the 8th consecutive month to an exceptionally high 6.7% compared to the same period the year prior. There are some potential signals of labour slowing when looking at the data in unsmoothed terms – earnings fell for the first time in 7-months. Furthermore, data from the BoE's monthly Decision Maker Panel (a survey of UK CFOs) for January points to both realised wage growth and, more importantly, expected year-ahead wage growth, falling over the month. But more reads like this will be needed before any robust conclusions can be made.

As it currently stands, the risks are finely balanced between a 25bp hike or a hold in March. If inflation falls materially again in February, or if there are convincingly soft data in the labour market figures, then that would tilt risks towards a hold as the BoE will feel more comfortable to 'wait and see' how things develop.

GRAPH 05 **BOE HEADLINE CPI FORECASTS**

Inflation down faster than expected, but will it last?



Source: IFM Investors, ONS, BoE, Macrobond

Eurozone: Back to growth?

In our previous quarterly economic update, we expressed a sense of cautious optimism with regards to the Eurozone economy on the back of a number of encouraging fundamentals. The data since then have pointed to activity being more resilient than we initially expected. This is a positive development, but not an unalloyed one as it presents a problem for the European Central Bank (ECB) insofar as resilient activity will act to keep inflationary pressures high.

The Eurozone economy narrowly and unexpectedly avoided a contraction in the fourth quarter of 2022 with real GDP increasing 0.1%qoq. This lowers the chances of a bloc-wide technical recession and, at the very least, suggests the severity of any forthcoming recession will be milder than initially feared. Output in Germany (-0.2%qoq) and Italy (-0.1%qoq) fell but it expanded in Spain (0.2%qoq) and France (0.1%qoq). Beyond this fourth quarter strength, a range of more timely survey-based indicators suggest cautious optimism for the first quarter of this year is warranted as well. February PMI data (composite: 52.3, services: 53.0, manufacturing, 45.8) were the most surprising data in this category, with private sector activity expanding at the fastest rate in nine months and pointing to surprising momentum in Eurozone output. The details of the release point to fading supply problems and receding energy price pressures as key drivers of activity. It's not just a supply-side story, however, and there was evidence of improving demand as well. Details also showed continued elevated price pressures in the services sector with higher wages a key driver. This will be of particular note to the ECB as it is looking closely at the wages/inflation nexus. In addition to the PMI data, various sentiment indicators have firmed materially in recent months as well, though they broadly remain below pre-pandemic levels.

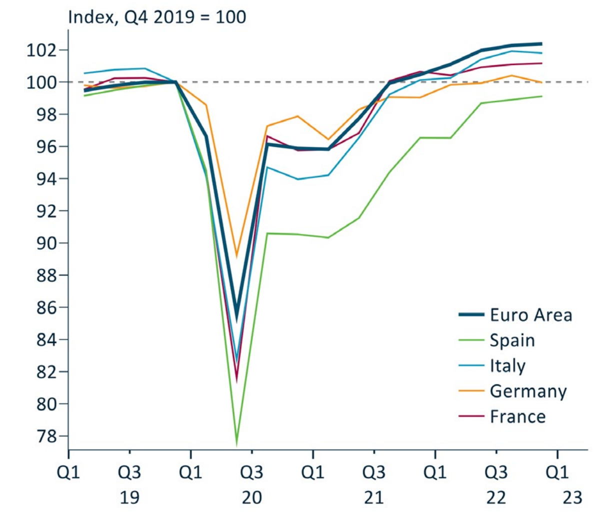
On inflation, it seems like the headline figure has peaked following three consecutive falls from the October high of 10.6%yoy to 8.6%yoy in January. Core inflation is a different story, however. While there is evidence that core inflationary momentum has abated in recent months, there is as yet nothing to point to a clear peak. Indeed, core CPI continued to accelerate in January to a new all-time high of 5.3%yoy following a 5.2%yoy increase in December.

In the labour market, there has so far been little evidence to suggest increasing spare capacity. The unemployment rate tracked sideways at 6.6% in December and job finding and vacancy rates both remain above pre-pandemic levels, suggesting tighter labour market conditions than looking at the unemployment rate alone. Data for fourth quarter employment also continue to point to further job gains in the bloc (0.4%qoq increase). Shifting the focus to earnings, the key measures of eurozone-wide wages are lagged quarterly metrics and provide limited insight into current labour market conditions. But despite this, there has been evidence of strengthening wages pressures on the back of continued labour market robustness and inflation catch-up themes during wage negotiations. Real wages growth has been negative for some time but as headline inflation continues to rollover, and as nominal wages continue to grow, real wages growth is set to pick up. The ECB has signalled that it is closely watching how wages growth develops, given the implications for inflation, but at this stage the view on wages growth expressed by ECB president Lagarde has been rather sanguine – wage growth is seen as being part of 'catching up' rather than a wage-price spiral.

In terms of actual monetary policy decisions, the ECB continued to tighten, as expected, and raised rates by 50 basis points in both December and February to take the marginal lending facility rate to 3.25%, the main refinancing operations rate to 3.00%, and the deposit facility rate to 2.50%. Further tightening is all but certain as the Governing Council (GC) made an unconditional commitment to another 50-basis point hike in March before signalling a shift to more data-dependent policymaking. Risks to policy beyond March appear skewed to the upside on the back of strong activity data and continued inflationary pressures.

GRAPH 06 EUROZONE GDP LEVELS

A deep recession seems less likely given resilient output in Q4



Source: IFM Investors, Eurostat, Macrobond

Following the March hike, the ECB may be comfortable enough with the general level of rates to downshift to 25 basis point moves in future meetings to "fine tune" policy. But there is a risk of another 50 basis point move at the May meeting, should labour market and inflation data remain uncomfortably robust. Communications from the ECB show that officials are cognisant of increasingly balanced risks to the inflation outlook but inflation risks, in their view, remain skewed to the upside. Consequently, the bias in the February meeting was generally hawkish, with governing council member Schnabel in particular receiving traction in an interview arguing for tighter policy based on a view that monetary policy transmission may be weaker than prior cycles and that market pricing (at the time) of a 3.5% terminal rate was conditioned on an overly optimistic view of inflation. She asserted that the ECB is still some distance from "claiming victory on inflation" and that underlying measures, in particular, had proven more persistent. ECB Chief Economist Lane didn't push back on these points but did emphasise caution given that much of the impact of tighter policy implemented to date was still in the pipeline. Market moves since the February decision have priced higher rates (closer to a 3.75% peak than 3.5%) that are more consistent with the broadly hawkish views expressed by ECB members over the month.

Japan: New faces and new wages

Despite a Q4 GDP print that surprised slightly to the downside, and inflation risks tilted to the upside, we expect Japan's growth to slow but for domestic demand to remain somewhat resilient with rising wages and the return of tourism. Much will also depend on the external environment that Japan exports into, with an expected deceleration of growth potentially a headwind.

The Japanese economy expanded 0.2%qoq (0.6% annualised) in Q4 2022, continuing a relatively inconsistent run of growth that has characterised economic performance for the duration and in the aftermath of the pandemic. Growth was primarily driven by net exports and private consumption. The downside surprise was largely due to a surprisingly large inventory change.

Private consumption continues its modest recovery from the pandemic, with durable goods consumption rising 2.7%qoq, on the back of improved supply chains, and services consumption increasing 1.4%qoq, as the relaxation of pandemic-related restrictions continues to see services consumption pick up. While total household spending has very nearly returned to pre-pandemic levels, services consumption remains clearly below its end-2019 level, potentially providing some upside to growth in coming quarters.

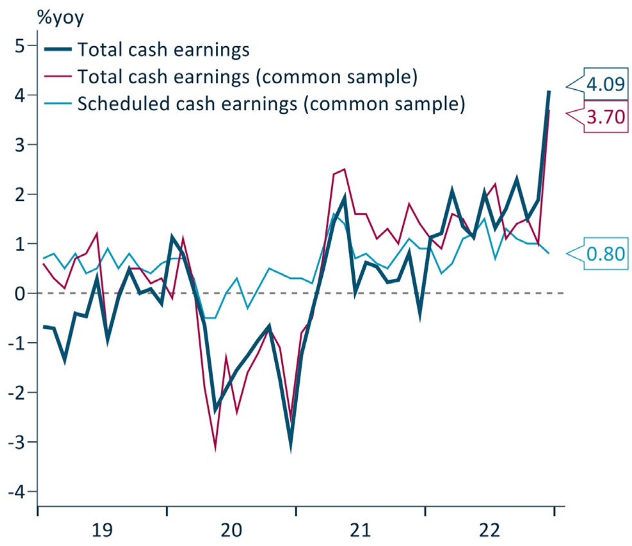
Private consumption should also continue to be supported into the year by recent improvements in wages outcomes. Nominal wages growth was the fastest it has been in 26 years in December. While this excited headlines, the fast pace of wage growth, at 4.8%yoy, was largely thanks to growth in 'special pay', such as bonuses, which Japanese firms typically pay in December. The growth in scheduled cash earnings (base salary excluding overtime pay and bonuses) was a more modest 1.8%yoy. The growth was slightly lower, at 1.0%yoy, looking at scheduled wage growth for the common sample (the Monthly Labour Survey replaces a portion of its sample every year, and bonuses in Japan are typically paid from December-February). However, wages growth for full-time earners was higher in both samples, suggesting a positive momentum.

Looking forward, wages are expected to continue to increase in 2023. Not yet borne out in the data, there have been prominent headlines about businesses raising wages in the upcoming Spring wage negotiation (Shunto): Fast Retailing, which owns Uniqlo, reportedly will increase employee wages by up to 40 per cent in March. The Japanese Trade Union Confederation is looking for a 5%yoy result, or 3%yoy for base pay. Economists widely expect a slightly weaker, but still historically strong, headline Shunto result of around 2.8%; this lines up with the survey by the Institute of Labour Administration, which tracks the Shunto headline outcome relatively well. This would still fall below the 3% level that the Bank of Japan has deemed to be a 'sustainable rate of nominal wage growth consistent with productivity and inflation of 2%.

Pressure on businesses to increase wages stems from ongoing inflation, which is the highest in around 30 years. Unlike in other advanced economies, inflation in Japan is yet to peak. Headline inflation increased to 4.3%yoy in January; core inflation (excluding fresh food) increased to 4.2%yoy and core-core (excluding fresh food and energy) increased 1.9%yoy in January. Price growth in durable goods slowed a little for the first time since February as supply chains recover, but remains elevated (6.8%yoy), while services inflation accelerated to 1.2%yoy. By category, prices in recreation and culture also accelerated as international inbound tourism continues to increase demand. While inbound tourism continued to pick up in the new year, it remains just above half of inbound tourist volumes in 2019.

GRAPH 07 **JAPANESE WAGES**

Headline wages are growing at the fastest pace in 26 years



Source: IFM Investors; Japanese MHLW, Macrobond

In monetary policy, unlike in other advanced economies, the focus has been less on interest rate moves and more on the Bank of Japan's change in governorship. In a move that was not anticipated in the market, the National Diet named Kazuo Ueda as the next Governor of the BoJ, replacing Governor Kuroda in April. The appointment of Ueda, an academic who served on the BOJ board between 1998-2005, when he helped introduce forward guidance, was a surprise to a market which largely expected Deputy Governor Amamiya to be named as Governor Kuroda's replacement.

The new Governor of the BoJ will likely act in a similar manner to his predecessor and maintain a cautious bias towards the Japanese economic performance and management of inflation through this current episode and into the medium term. We expect the Governor of the BoJ to potentially begin normalising policy gradually in the first half of this year by changing the parameters of its yield curve control (YCC), with the foundation of this incremental shift being laid late in 2022. This will be quite an achievement in itself, with Australia's own Reserve Bank having some difficulty managing market expectations around the end of its own relatively modest YCC policy. We do not think that it is likely, however, that negative interest rate policy (NIRP) will be reversed this year, particularly if economic challenges mount in the domestic and global economies. While inflation risks in Japan are tilted to the upside, the BoJ under its new governor will likely still want to see meaningful wage growth to tighten policy. So the spring wage negotiations will be key.

China: Re-prioritising growth

China's re-opening, which began in early December, has resulted in a relatively strong although bumpy recovery. The removal of zero-COVID policies and the announcement by authorities of a slew of growth-focused initiatives targeted for the year ahead should see the recovery continue; indeed, the IMF revised up China's growth outlook for 2023 to 5.2% from its forecast of 4.4% in October, and authorities are expected to formally announce a growth target of no less than 5% in March. The ways in which this spills over to the Australian economy is somewhat mixed: education exports are expected to pick up, resources demand should remain well supported, and the outlook for tourism remains uncertain.

Authorities in China continued to impose strict lockdown and testing measures in November of last year to manage COVID-19 infections, which began increasing in late October, in order to maintain their zero-COVID stance. The restrictions proved unsustainable, however, and the Chinese government began easing restrictions; this included reducing lockdowns and allowing people who tested positive to quarantine at home.

As a result of restrictions – which at one point affected a quarter of China's GDP by area – and widespread infection, economic activity was relatively weak in the fourth quarter of 2022 (0%qoq, 2.9% annualised). There was a negative contribution from net exports on account of supply chain issues and weak external demand, and a significant weakening in consumption growth (0.6%yoy; 4.1%yoy in 3Q), particularly in services. Growth was mostly supported by investment: infrastructure FAI was strong throughout the last three months of 2022, on account of government policy, while real-estate activity remained relatively weak.

In the new year, both the demand side and supply side of the economy continued to recover well. The Spring Festival (Lunar New Year) celebrations saw an increase in mobility, but not quite to pre-pandemic levels. Mobility and economic activity picked back up quickly in January, as people were able to travel again: domestic operated flights increased by nearly 80% from December to January, and high-frequency mobility indicators suggest that passenger traffic around the lunar new year was 50% greater than in 2022 (when zero-covid measures were in place) but still around half of their 2019 level.

Consumption has been particularly weak and the relatively sudden relaxation in restrictions has weighed on sentiment. Authorities have stressed the need for private consumption to recover, and indeed consumption has often followed a V-shaped recovery in economies following the relaxation of restrictions. This should be aided by both the substantial household savings that Chinese households have built up and improvements in the labour market.

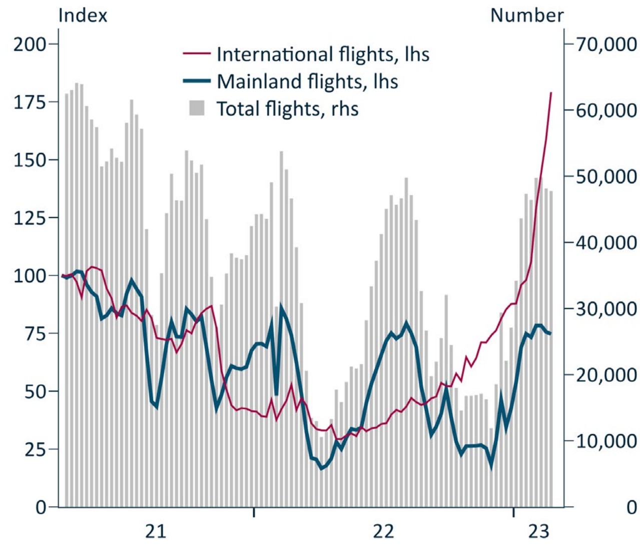
The authorities' priorities for the year ahead are focused on growth to prevent any long-term scarring from the pandemic. This is a shift away from the policy agenda of the past few years which focused on containing the virus and reducing risks in the real estate market and financial system. December's Central Economic Work Conference (CEWC), the annual meeting where authorities set economic policy priorities and goals for the coming year, saw authorities emphasise the need for monetary policy to be 'targeted and 'effective', rather than the previous year's guidance of 'flexible and moderate'.

The pro-growth agenda is also expected to come through a more supportive regulatory policy stance for China's property sector, which saw restrained investment in 2022. While the authorities reiterated their stance that real estate is for 'living, not for speculation', the authorities will expand access to credit and financing for more successful developers and improve access to pre-sales funds for developers.

China's re-opening should be a tailwind for Australia's economic performance in 2023, though will likely benefit services exports more than goods exports. Services exports are expected to increase but to perform unevenly between education and tourism. Education exports are set to recover well, with at least 50,000 students expected to arrive in Australia in 2023. The outlook for tourism, however, remains clouded, as slow restarts to domestic travel and consumption, high costs of travelling and visa delays weigh on demand. Overall, flight seat capacity from China to Australia is at about 44% relative to 2019 levels.

GRAPH 08 WEEKLY OPERATED FLIGHTS IN CHINA

Mobility improves, but the outlook for tourism is unclear



Source: IFM Investors, VariFlight, Macrobond

On the goods side, weakness in the property cycle, with any policy effects yet to be felt, will likely result in only a partial recovery for Australian goods exports. While iron ore prices have rallied since the re-opening, given the anticipation of government stimulus, particularly in infrastructure projects, falling house prices and weak new starts in the property sector are likely to limit the upside to China's iron ore demand. Improving relations between the Chinese and Australian governments (that have been a priority for the Albanese government since its election) will also, in time, be supportive of sectors of the Australian economy that where subject to punitive trade measures through the pandemic. Notably among these, seafood, some agriculture and wine exporters, could be in line to benefit after trade was effectively halted.

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Korea: A pause OK for the BOK

Economic growth in Korea has slowed over the past few months on the back of a significant fall in exports due to weak external demand and softening in private consumption as interest rates rose. The latter was driven by a relatively aggressive tightening phase from the Bank of Korea (BOK) in its efforts to rein in inflation that has likely peaked but remains high, and is expected to remain above target for some time. While it is too early to judge the outcome of growth in Q1 2023, it is worth noting that the South Korean economy has only experienced a technical recession (two consecutive quarters of negative growth) twice since 2000, with the external environment playing a prominent role – and therein lies the risk in 2023. It is notable that both times the economy recovered on the back of strong results in net exports.

Softening activity has not gone unnoticed by the BoK, which paused its rate hiking cycle in February citing weak domestic demand, particularly a 'deepened sluggishness' in the IT sector, led by the semi-conductor industry, and a relatively uncertain outlook for exports. The base rate is now 300 basis points higher than in August 2021, the beginning of the tightening cycle, and the BoK has said it will maintain a restrictive policy stance 'for a considerable time' while it assesses the evolution of inflation in the economy. The BoK expects headline inflation to recede from March, and inflation over the year to be around 3.5%, noting that the pace of the slowdown will be slightly slower than in other major economies due to the increase in public utility fees. Core inflation has been softening since November and increased at 4.1%yoy in January. Unlike in other economies, services inflation has been slowing since October. Headline inflation is also down from its July 2022 peak (but ticked up to 5.2%yoy in January off the back of increased electricity tariffs).

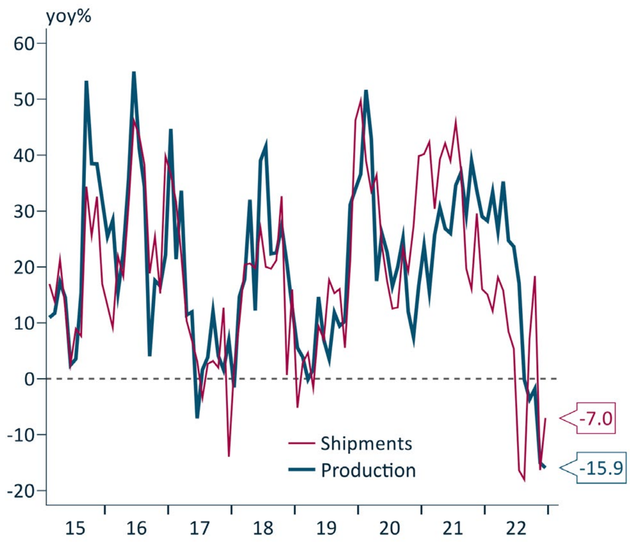
Weakness in Korean economic activity saw GDP contract 0.4%qoq in the December quarter of 2022 (with through the year growth decelerating to 1.3%yoy). This was the first quarter of negative growth since the pandemic hit in March 2020. The slowdown was broad based, with all components except government spending recording negative growth in quarterly terms. While household consumption has played an important role in the economic recovery from the pandemic, rising interest rates, domestically and abroad, are weighing on growth by dampening investments and exports. The Bank of Korea's (BoK) composite leading indicator has been on a downward trend, suggesting the risks to growth are skewed to the downside.

Net exports weighed particularly on growth, as slowdowns in major trading partners' economies and demand for computer goods hit exporters. Exports (as reported in monthly data) have been falling in year-on-year terms since November 2022 and continued to fall in January (-4.4%yoy and -5.8%qoq); partial trade data suggests that exports remained weak into February. Business sentiment amongst export-oriented manufacturing firms fell in February, as did sentiment for the outlook. A cooling in the chip cycle, alongside weak external demand, saw IT sector exports weakened in particular: shipments of semiconductors fell -7.4%yoy in December, while chip inventories continued to increase.

Looking forward, however, China's accelerated re-opening might confer positive benefit for Korean exporters. China is Korea's largest export market, capturing around 25% of trade in 2021. Around 80% of Korea's exports to China are intermediary goods, so an improved outlook in Chinese manufacturing should feed through, though weak global demand, as the effect of higher interest rates bite, may limit the upside that this provides. Services exports, though a much smaller part of the trading relationship, should also begin to recover as Korea lifts restrictions on travellers from China due to concerns around the spread of COVID-19 infections. Chinese citizens make up the bulk of tourists in South Korea, accounting for over a third of arrivals in 2019.

GRAPH 09 **SEMICONDUCTOR SECTOR**

The chip cycle is at a low, can it recover?



Source: IFM Investors, Statistics Korea, Macrobond

Private consumption growth slowed 3.2%yoy, but fell -0.4% in the quarter. Consumer sentiment remains at very low levels and ticked down in February, and survey results suggest households are pessimistic about domestic economic conditions and future living standards. Real retail sales lifted 1.6%mom in December (-2.5%yoy), as sales of durable goods, particularly IT goods, fell. In levels terms, retail volumes are just a touch above December 2019 levels for both durable and non-durable goods.

The outlook for consumption remains relatively weak, with most growth expected to come from government spending rather than private household consumption. The majority of mortgages in South Korea (around 80 per cent) are variable rate and rising interest rates, coupled with falling property prices, have hit consumers hard. Given the weakness in private consumption, which has led the recovery thus far, and in response to the economic slowdown, the government announced in January that it will implement nearly two-thirds of its budget over the first half of 2023 to support growth.

Another risk to the consumption outlook is further softening in the labour market. Employment growth has been slightly negative for the past three months, and the participation rate has been falling since July in 3mma terms. The unemployment rate picked up slightly from 2022 lows to 2.9% in January to remain near historical lows.

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