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ECONOMIC UPDATE

Reality bites

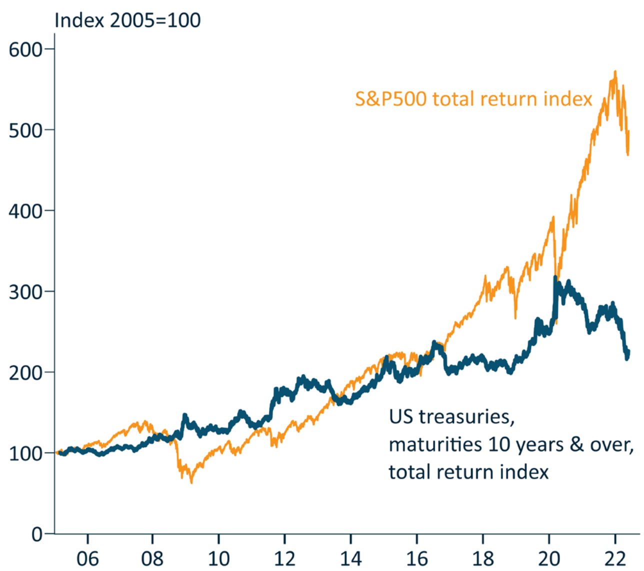
The global growth narrative continues to soften with rampant inflation and the withdrawal of extremely accommodative monetary settings. Policy tightening is the correct course, but it will be challenging to navigate the withdrawal of stimulus and there is a material risk of a policy overshoot. This environment has seen yields rise and equities fall, putting pressure on the returns of traditional equity/bond style portfolios. The question for markets now is whether we have reached peak inflation and monetary policy tightening expectations. Central banks will be hard pressed to shift to more dovish rhetoric against the current backdrop and there will need to be unambiguous price signals over the next few months to precipitate a central bank pivot.

Global: Markets struggle with stagflation

The recovery of the global economy from the pandemic-induced recession is being increasingly beset by downside risks. Meanwhile historically high rates of inflation plague most advanced economies. While policymakers had little trouble in stimulating demand, much of the challenge is now with supply side issues. Yet there is little experience in recent decades with having to deal with both exogenous and endogenous supply shocks. While fiscal policymakers bask in the success of minimising the severity of the pandemic recession, responsibility for managing the inflationary fallout from these shocks is largely falling to central banks - institutions that are ill-equipped for such a challenge. Nonetheless, this has not deterred monetary policymakers from signalling their collective intent to tackle inflation. Indeed, it seems apparent that central banks are rushing in to try to rectify their collective miscalculation around the persistence of inflationary pressures and discounting the impact it would have on economic growth. The dynamics of the post-pandemic global economic and geopolitical environment have been difficult enough for markets to digest and now central bank hawkishness has added to concerns around the pace and robustness of economic growth.

GRAPH 01 US EQUITY AND BOND MARKETS

Nowhere to hide as markets digest the economic outlook



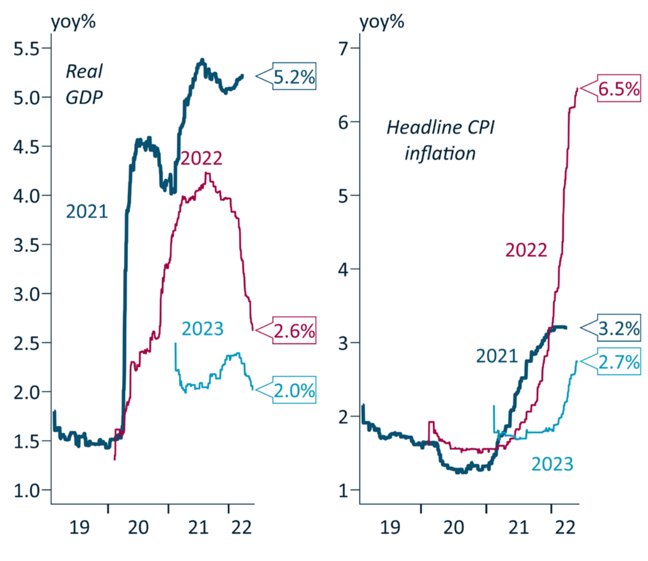
Source: IFM Investors, MSCI, Bloomberg, Macrobond

Bond markets have repriced largely due to what they expect central banks to do in response to inflation. This translates into a valuation impact on equity markets that adds to the weakness these markets have experienced because they believe policy tightening will slow the growth outlook. All the while high rates of inflation march on, eroding returns across both. While we are not yet at the point of textbook stagflation - low unemployment rates and still positive economic growth being the saving grace - markets are cognisant of the risks. Investors hope policymakers can pull off a 'soft landing' but are positioning themselves in case they don't. This appears increasingly prudent.

We have continually asserted in these pages that we expected post-pandemic economic growth to return to a trend level, as it was in the years before. The same factors that beleaguered potential growth rates then (such as demographics, underwhelming private investment and lack of productivity growth) would reassert themselves after the impulse from pandemic-related fiscal and monetary accommodation had waned. What has been surprising is just how the stimulatory impacts have dissipated, along with expectations of materially above trend growth for 2022. This 'stagflation-lite' environment has rapidly become consensus among market economists, with a relentless downgrading of growth forecasts for 2022 and fading confidence into 2023 as well.

GRAPH 02 SUCCESSIVE MARKET G4* ECONOMIC FORECASTS

Weaker growth and stronger inflation are consensus



Source: IFM Investors, MSCI, Bloomberg, Macrobond *US, UK, Japan, Eurozone

What is concerning for markets is that there is uncertainty over the possible resolution of the two exogenous shocks to the global economy that are characterised by 'stagflationary' dynamics. The first is supply-side constraints in producer countries, most notably China, and subsequent supply chains underpinning inflation and holding back growth. The second is the Russia-Ukraine conflict. This conflict has contributed to a sizeable inflationary shock in energy and food, while also dampening economic activity (depending on a country's economic exposure to the belligerents). These exogenous shocks are exacerbating endogenous ones, namely a lack of labour supply and accelerating wages prevalent in many developed economies. Inflation is already a headwind to economic activity and central bank action seeking to remedy it will likely reinforce the slowing growth impulse. This policy tightening will drive demand destruction and possibly short circuit the endogenous inflationary forces, but it will do little to remedy the exogenous drivers.

It is the correct course for central banks to remove the extremely accommodative policy settings that were appropriate for the pandemic. There is a benefit to anchoring inflation expectations and to avert a wage-price spiral. However, the pace at which they seek to return to more neutral settings will be important for the growth outlook – primarily because it is only possible to observe the neutral rate once it has been reached.

The main risk is a policy overshoot as central banks seem to have a misplaced confidence that materially tighter policy settings near a pre-pandemic neutral rate are the best remedy for the current bout of inflation. This is their collective curse as with only blunt policy tools, central banks can only do what they can. And it may just be that while seeking to regain some lost credibility on inflation, central banks may lose some on the management of the economic cycle. The irony here being that the excess savings that built up in the household sector due to fiscal largesse through the pandemic is now being targeted by central banks seeking to reduce demand. Arguably the fiscal solution to the pandemic recession has been too successful in an environment in which supply remains constrained.

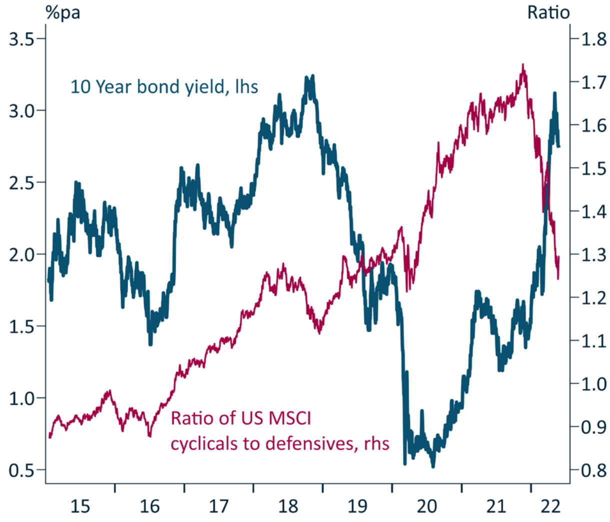
The question for markets is: have peak expectations for monetary policy tightening been priced in? Fixed income markets seem to have arrived at that conclusion, buoyed by expectations that inflation has also peaked and should start to decelerate in coming months. This is not to suggest that the factors driving inflation have materially improved; they have simply gotten no worse.

But even current expectations for policy tightening, coupled with already weakening growth dynamics, have equity markets nervous and stuck in a downward trend. Investors have turned more bearish and strategies that have delivered strong returns for years have sharply reversed. Cyclical and growth stocks have been sold off and defensive and value stocks favoured. The difficultly for investors is not only elevated equity market volatility, but also extremely high fixed income and exchange rate volatility. For some months now there have been only limited safe-haven options.

But is this all about to change? Many have speculated that should equity markets continue to haemorrhage, the US Federal Reserve's (Fed's) hawkish tone will fade. Indeed, many hope for the 'Fed put' to come in to play. But for that pivot to occur, inflation will need to have clearly turned and be on a trajectory back towards target. That seems some way off, with largely base effects being responsible for any near-term deceleration.

GRAPH 03 CYCLICAL-DEFENSIVE RATIO & BOND YIELDS

Investor uncertainty has prompted a defensive tilt



Source: IFM Investors, MSCI, Bloomberg, Macrobond

For now, it is a hard sell for any central bank to become more dovish while inflation exceeds target so egregiously, even if equity market drawdowns worsen. Should the Fed put come into play, it would likely be due to supply-side inflationary pressures being overcome by demand-side weakness, with accompanying upward pressure on the unemployment rate. While this should be supportive of fixed income markets, the weaker economic outlook may weigh on equity markets in an environment of moderate, but not extreme, policy accommodation.

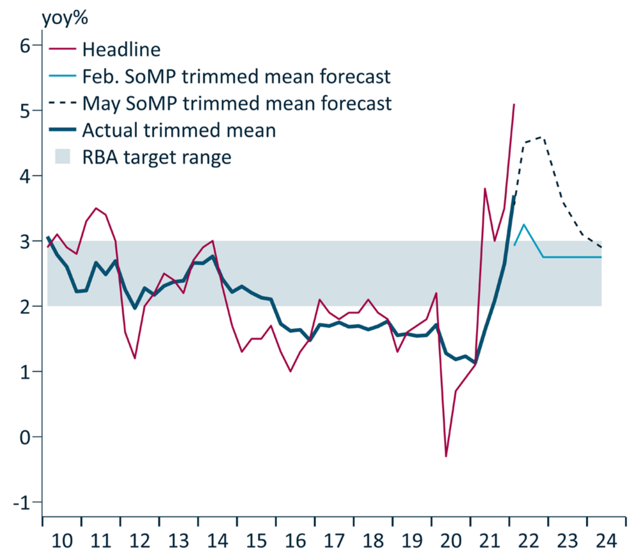
Australia: The winds of change

In Australia, the Reserve Bank of Australia (RBA) began the process of removing monetary policy accommodation after it raised rates in May by 25 basis points to 0.35%. This is the first episode of monetary tightening since November 2010 and comes after the period of exceptionally stimulatory settings that were appropriate for the pandemic. This tightening occurred in response to the underlying inflation rate accelerating above the 2-3% target band for the first time in over 10 years. A prudent course, even though this acceleration was driven by forces beyond the scope and influence of its own policy. The RBA has now moved away from what was relatively dovish rhetoric centred on 'patience', with its communications now setting the stage for further monetary tightening in coming months.

The RBA's May Statement on Monetary Policy (SoMP) provides an insight into how significantly the Bank's view has changed compared to the previous SoMP released in February. Inflation has been significantly upgraded, with the trimmed mean measure now expected to peak in the second half of this year at 4.6%yoy, compared to prior expectations of a 3.25%yoy peak in the first half of 2022. Furthermore, trimmed mean inflation is now only expected to return to the top end of the target band in mid-2024 (2.9%yoy) compared to a previously expected end-2022 return-to-target. Actual data for Q1 showed a sharp acceleration in price pressures, beating already strong expectations. The headline measure surged to 5.1%yoy (fastest since 2001) and the trimmed mean measure hit 3.7%yoy (highest since 2009) to be well above the top of the RBA's target band.

GRAPH 04 INFLATION AND RBA FORECASTS

RBA added to the list of central banks surprised by inflation



Source: IFM Investors, ABS, Macrobond

The outlook for wages growth has also strengthened materially, with wage price index (WPI) growth upgraded to such an extent that the much focussed on '3% plus' target is now set to be reached in mid-2023 (versus mid-2024 previously). Actual WPI growth in Q1 was broadly in line with RBA expectations (0.7%qoq, 2.4%yoy) and has limited implications for monetary policy as the minutes of the RBA's May meeting flagged that the RBA's liaison program and business surveys had already sent a clear signal on wages growth prior to the WPI data. This adds to the already signalled shift in focus to more broad-based earnings metrics, which tend to be more sensitive than the WPI to economic conditions, and adds to the hawkish narrative.

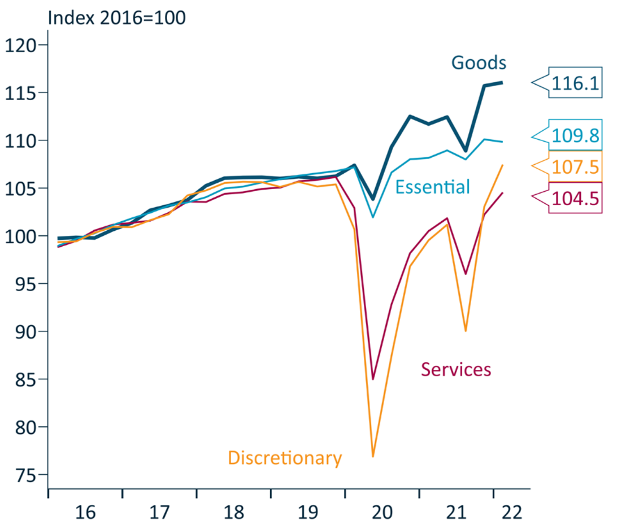
The upgraded wages outlook is partly due to a continued improvement in labour market conditions. The unemployment rate has continued to fall, reaching 3.9% in April (lowest since 1974) and forward indicators point to strong demand for labour. However, there has been a slowing in employment growth in recent months, especially considering job vacancy levels, and falling participation is partly to thank for the continued improvement in the unemployment rate. This deceleration could be indicative of slowing labour market momentum, increasing frictions around skills mismatches, wage expectations or sectoral labour shortages (it could also be a temporary quirk of the survey). Another key factor relevant for the outlook is the extent to which net overseas migration recovers and provides a robust supply of prime-age workers to fill skills gaps. Data as of April suggest a recovery in migration, and consequently labour supply, continues and while there is a long way to go before reaching pre-pandemic levels, the 'easy' progress on reducing the unemployment rate has been made.

Whilst further tightening is effectively a foregone conclusion, there remains uncertainty as to how much tightening the economy can withstand. Domestic factors leave the Australian economy particularly sensitive to short-end rates. Furthermore, with low rates having been entrenched for such an extended period, the response to interest rate hikes will likely be asymmetrical, with a one percentage point rise in rates having a significantly more material (contractionary) impact than the (stimulatory) impact of a one percentage point cut in rates, ceteris paribus. While we are not concerned about the stability of the system to withstand rates, it is how they impact those at the margin that will determine the future course of economic growth. Adding to this is the growing concern about the durability of the global growth backdrop.

Australia's GDP growth came in at 0.8qoq and 3.3% yoy, in line with expectations. That said, it implies that the RBA's forecast of 3.6%yoy in the June quarter will require a 1.1%qoq outcome, so further momentum will be needed. It should be noted that weather events did impact negatively on quarterly growth and should rebound in the June quarter. The key driver of growth in the March quarter was the consumer, with spending up 1.5%qoq adding 0.8ppts to quarterly growth. The ongoing rebound in services and discretionary items spending was notable. The public sector and inventories were also significant contributors. More modest was the contribution from private business investment that added 0.2ppts, and outright disappointing was the decline in dwelling investment, noting weather impacts but also the large pipeline of work across the country. Net exports were the key subtraction, removing 1.7ppts, with the positive being a large uplift in imports potentially reflecting stronger domestic demand going forward.

GRAPH 05 REAL HOUSEHOLD SPENDING

Rebound in services and discretionary items continued in Q1



Source: IFM Investors, ABS, Macrobond

It is noticeable that so far Australia is one of the only developed economies where economists have not consistently downgraded growth expectations, buoyed by the continued expectation that households will spend their excess savings. We expect there is only downside risk in this space, and a lot will depend on how households react to higher interest rates and declining wealth. Even if this does not occur, the RBA's own SoMP had Australian economic growth decelerating to 2.0%yoy by mid-2024. This is concerning as it is underpinned by expected population growth of around 1.3%yoy. This leaves per capita GDP growth at just 0.7%yoy – a rate weaker than the years leading up to the pandemic in which policy rates were 1.5% and falling.

This will be but one of the challenges for the incoming Labor government that won the Federal election. Anthony Albanese was sworn in as the new PM and leads a government with a very narrow majority. Neither the outgoing, nor the incoming government ran on particularly ambitious policy agendas, so there are limited near-term economic implications from the result. It would be our hope that more prominence is given to addressing the structural issues facing the Australian economy and its transition to reflect the electorate's clear expectations for energy and climate policy.

US: Release the hawks

The Federal Open Market Committee (FOMC) decided in March and May that it was time to move from extreme policy accommodation to a tightening stance to tackle surprisingly strong inflationary pressures. The federal funds target rate range was raised by 25bps in March and 50bps in May to bring the range to 0.75-1.00%. The last time the Fed raised rates this fast was in May 2000, at the height of the dot-com bubble. Further tightening is almost certain with minutes from the May meeting setting the scene for additional 50bp hikes at the June and July meetings. Fed Chair Powell's hawkish stance was underscored by his willingness to move policy to a contractionary setting, noting "*If that involves moving past broadly understood levels of neutral we won't hesitate to do that*".

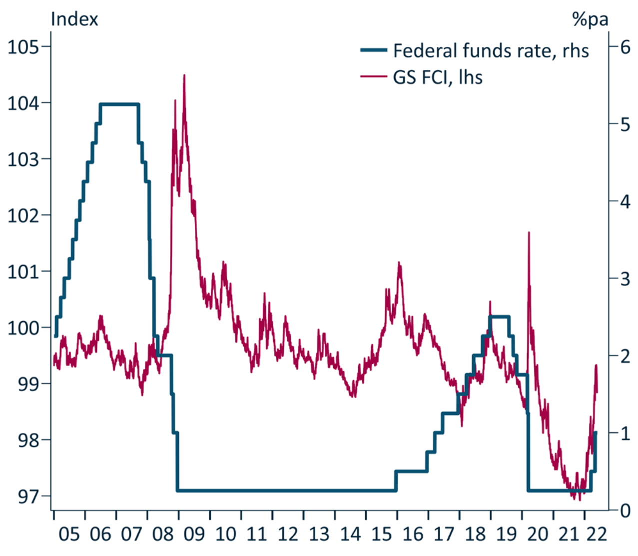
Policy tightening will also involve quantitative tightening, with the announcement that balance sheet reduction will begin in June with an eventual monthly cap of US$95bn (US$60bn in Treasuries and US$35bn mortgage-backed securities). This is just under twice the US$50bn per month rate that the Fed reduced its balance sheet in 2017-19.

Interestingly, this hawkishness was tempered somewhat very recently by signalling from key bank officials and discussion from commentators about 'pausing' after the forthcoming prodigious tightening to take stock and assess the impacts on the economy. This has seemingly been driven by increasing concerns about the difficulty of navigating a soft landing as the monetary taps are tightened and the sell-off in asset and credit markets.

There is good reason to be cautious as there are appreciable risks of a painful correction. The 'goldilocks' outcome is that Fed rate hikes are just right to dampen inflation without reducing growth unnecessarily. But that is easier said than done and the Fed doesn't have a good track record of managing soft landings. If the Fed tightens too much, the economy will be forced into a recession and if the Fed doesn't tighten enough, inflation could worsen and require even stronger action down the track. Fed actions to date – including signalling about future actions – have been sufficient to precipitate a sharp tightening in financial conditions. This may (perhaps counterintuitively) be good for the outlook because to the extent that financial markets adjust and price in current and future Fed actions, less actual policy tightening may be necessary to achieve a similar outcome. Whatever the case, leading indicators of activity have softened but are broadly pointing to enough momentum in the economy that a recession isn't imminent. But looking through to next year and the year after, there is a nontrivial risk of a contraction.

GRAPH 06 **FED FUNDS RATE & FINANCIAL CONDITIONS**

Financial conditions tightened appreciably ahead of Fed action



Source: IFM Investors, US Federal Reserve, Goldman Sachs, Bloomberg, Macrobond

On the data front, the seven consecutive months of accelerating inflation ended in April, with both headline (8.3%yoy) and core (6.2%yoy) inflation rising at a slower rate than in March. The Fed's preferred inflation measure (core PCE deflator) sent a similar signal after slowing in both March (5.2%yoy) and April (4.9%yoy). It's worth noting that some of the slowdown was driven by 2021's surge in used car prices falling out of the calculation and that price pressures remain exceptionally high. Inflation has likely peaked (or will do so soon) but this is largely due to base effects. We expect that the Fed will need to observe a materially lower annualised pace for some time before concluding inflation is coming under control. The ongoing rotation away from goods and into services should help take some of the pressure off stretched supply chains and soften inflationary contributions from the goods side. But there are elevated price pressures in services, with core services inflation continuing to accelerate in April (4.9%yoy). Adding to this issue is the limited spare capacity in the labour market such that a continued rebalancing towards services consumption – where a significant proportion of the costs are attributable to labour – could exacerbate wages acceleration and contribute to further inflationary pressures that prove more entrenched.

The labour market, to date, has not been a cause for concern, however, some unexpected weakness in the April numbers suggest that figures in coming months will be worth watching. Most notably, there was an unexpected fall in employment according to the household survey – despite continued nonfarm payrolls growth – that saw the unemployment rate track sideways (3.6%) on the back of an unexpected retracing in participation. On the income side, average hourly earnings growth has been exceptionally high in recent months but despite this, rampant inflation continues to erode the purchasing power of incomes with real earnings growth in negative territory. Consumption doesn't appear to be faltering just yet but there are some concerning signals – consumer confidence has been trending down for months and remains well below pre-pandemic levels. On the plus side, a drawdown of high household savings could support consumption. In terms of overall performance in Q1, GDP unexpectedly contracted 1.5%qoq annualised, but the composition was strong with decent domestic demand but an outsized negative from surging imports.

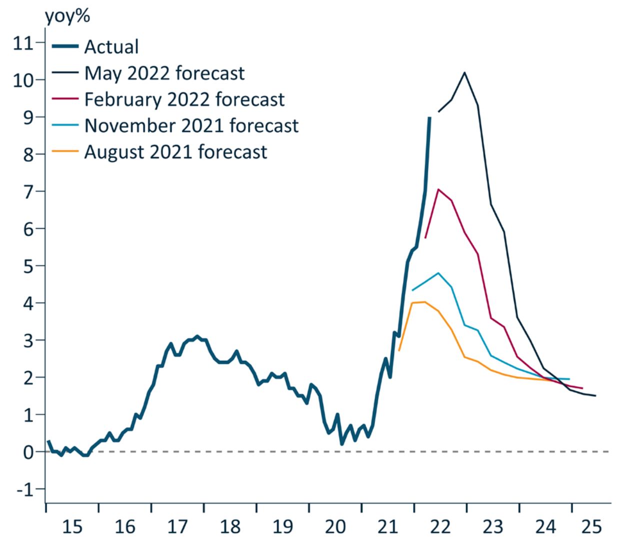
UK: Energy shocked

The UK finds itself in an unenviable position with the economy facing an acute set of potentially stagflationary fundamentals. The Bank of England (BoE) is tasked with navigating this environment, and in trying to get the least bad outcome has opted to continue the process of monetary tightening. The BoE raised the bank rate for the fourth consecutive month in May by 25bp to 1.00%. The minutes from the May meeting highlight how challenging the situation is with disagreements among members about the best course of action: the hawkish side were more concerned about capacity pressures and opted for a 50bp hike, whereas the dovish side see risks to activity and inflation as more evenly balanced and wanted to take a softer approach.

Regardless of who is right, the outlook for the economy is relatively bleak. The BoE significantly downgraded its expectations for growth and increased its inflation forecasts. The economy is now expected to contract in 2023 in annual terms, with only a very modest increase in output in 2024. Inflation, meanwhile, is now expected to peak at around 10%yoy in the last quarter of 2022 versus around 7%yoy in mid-2022 previously. For reference, the most recent April print had headline inflation spiking to 9.0%yoy, with the core measure also accelerating to a well above target 6.2%yoy. This was driven largely by a sharp increase in regulated energy price caps and food inflation – categories that tend to be volatile – the impacts of which are expected, but not guaranteed, to abate.

GRAPH 07 BOE INFLATION FORECASTS

BoE unexpectedly facing inflation levels not seen since 1982



Source: IFM Investors, ONS, BoE, Macrobond

Taking a broader view of the state-of-play highlights how delicate the position of the UK economy is. While inflation has significantly reduced the real purchasing power of incomes, nominal earnings growth (when including bonuses) has reached all-time highs (around 10%) and has been sufficient to outstrip inflation. This is ostensibly being driven by tight labour market conditions. Indeed, the three-month average unemployment rate hit an all-time low in March (3.7%) and there are now more vacancies than jobs in the UK economy for the first time since records began. More timely data for April send a similarly positive signal. This labour market strength suggests that further earnings growth should continue, and introduces upside risk to inflation with the possibility that 'second-round' impacts from the recent exogenous price shocks develop further and become increasingly entrenched and much harder to tame. Accordingly, the UK is facing a potential stagflation-type situation where further rate hikes will be needed to tame intransigent inflation at the cost of pushing the economy into a recession – or at least a period of markedly slower growth – with a softening labour market also eventuating.

Against this, it is worth highlighting that there is still room for labour force participation to improve. Overseas labour supply has been held back and will likely normalise as pandemic disruptions ebb, and skills mismatches between vacancies and available skills may misrepresent the state of affairs. While the labour market is tight, activity is slowing with preliminary estimates of Q1 GDP disappointing expectations with the economy expanding only 0.8% but was still up 8.7% year-on-year. Private consumption underperformed (0.6%qoq), unsurprisingly, given inflationary pressures with government spending (-1.7%qoq) recording a sizeable and unexpected contraction. Gross fixed capital formation was a standout (5.4%qoq), growing far more than expected, though within this business investment was relatively soft (0.5%qoq). As highlighted previously, the outlook is not good. Leading indicators suggest this narrative may become entrenched, with consumer confidence continuing to fall in May (-40) to an all-time low. Though businesses appear more comfortable with business sentiment remaining well above pre-pandemic levels in May (38). Continued cost of living pressures are contributing to what is expected to be one of the sharpest contractions in household disposable incomes on record. Finally, private sector activity expanded at a much slower rate (51.8) than expected in May according to preliminary PMI data. Geopolitical uncertainty and escalating cost pressures weighed on demand, particularly in the services sector.

Offsetting, at least in part, the impact of tighter monetary policy is looser fiscal policy, with Chancellor Sunak unveiling a range of tax-cutting measures in March totalling around £46bn to support households and businesses amid a surge in the cost of living. Sunak also announced a package of measures in late May worth £15bn to support households that have been put under pressure by skyrocketing energy prices and broader cost of living squeezes in general. The package will be partly financed by additional borrowing and partly financed by a one-off windfall tax on the profits of oil and gas companies (approximately £5bn in additional tax revenue) who have benefited from more expensive energy.

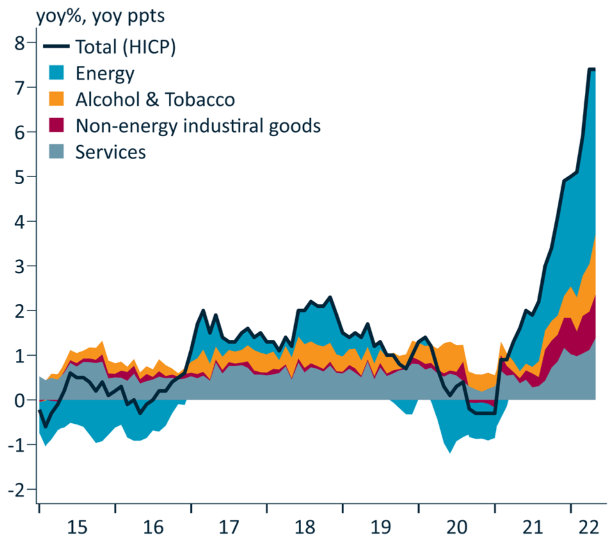
Eurozone: More stagflation risk

Eurozone first quarter GDP performed a touch better than expected according to preliminary estimates. Real output in the bloc grew 0.3%qoq to be up 5.1% compared to the same quarter last year. Performance was mixed across countries as the synchronous recovery narrative fades: Spain and Germany grew modestly; France stagnated; and Italy contracted. The outlook is equally mixed with rising cost of living pressures continuing to bite and elevated uncertainty stemming from the Russia-Ukraine conflict. Indeed, Russia cut off gas supplies to Bulgaria and Poland in April, and if similar action were taken against large Eurozone countries that would prove incredibly disruptive. For now, distinctly more moderate growth is expected in the second half of this year at around 1-1½%yoy. This assertion is supported by recent data, with preliminary PMIs suggesting the expansion continued in May (54.9), driven mainly by robust services expansion. The labour market data also remain solid. The unemployment rate ticked down in March to 6.8% and employment for Q1 grew 0.5%qoq, continuing to move beyond pre-pandemic employment levels. However, there are some concerning signals, with material contractions in industrial production in March and sentiment in this sector is edging materially lower, compounding the collapse in consumer sentiment. This is as high rates of both producer and consumer inflation take a toll.

As with the US and the UK, Eurozone inflation remains exceptionally high, accelerating to 8.1% in May. This is largely attributable to energy/commodities, yet core inflation is also well above target, at 3.8%yoy,

GRAPH 08 EUROZONE INFLATION

It's not only energy driving exceptionally strong inflation



Source: IFM Investors, ECB, Macrobond

and will likely remain elevated in the near term.

This puts the European Central Bank (ECB) in an uncomfortable position. Although it left policy settings unchanged at its April meeting, it is widely expected to raise policy rates over the next few months. After being a dovish holdout among global central banks, the ECB is increasingly of the view that exceptionally strong inflation (particularly the stronger-than-expected core inflation) needs to be addressed. But like in other advanced economies, any monetary tightening will primarily act through crimping demand in an environment where the economy is already looking unsteady, and uncertainty remains exceptionally high. Minutes from the ECB's April meeting underscored these concerns. On inflation, discussion centred around the impact of the Ukraine conflict and China pandemic measures on the supply side, structural upward pressure to inflation from decarbonisation efforts, and the possibility for stronger wages growth if cost of living pressures persist. Several members view current policy settings as inconsistent with the inflation outlook. On the economic growth outlook, risks had "*increased substantially*" due to the Russia-Ukraine conflict and remain "*clearly skewed to the downside*".

It is likely that the ECB will tighten policy at the July meeting, but the quantum of tightening is unclear with disagreement among Governing Council members. Markets are pricing 25bp at the July meeting, with some commentators suggesting that a 50bp hike is not off the table. All up, rates were expected to rise almost a full percentage point by year-end at the time of writing (rates haven't been that high since late 2011).

In politics, incumbent French president Emmanuel Macron defeated Marine Le Pen to secure a second term as France's president. This marks a victory for a more moderate, centrist leader against the populist and Eurosceptic Le Pen. The feasibility of Macron's political agenda depends on legislative elections in mid-June. In fiscal policy, the European Commission announced measures to mitigate the short-term impact of higher energy prices and also presented a longer-term strategy to remove energy dependence on Russia, including an accelerated green transition.

Japan: Growth volatility should have passed

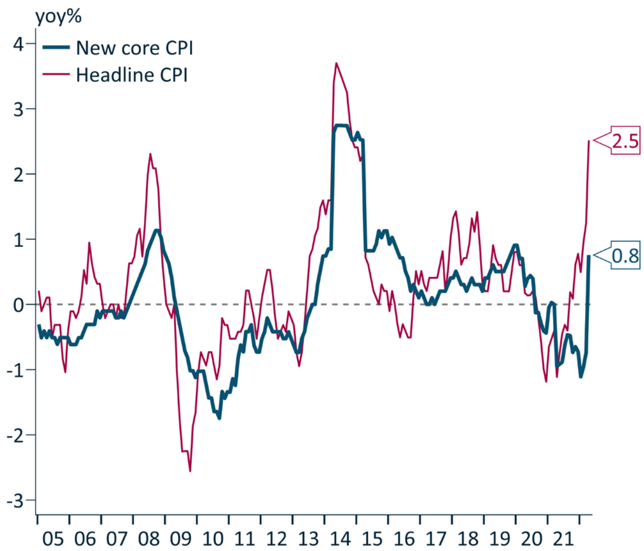
Japan recorded another fall in GDP in Q1 2022 as the economy continues to oscillate between expansion and contraction. The 0.2%qoq fall was not as bad as economists had expected, with the COVID restrictions in place over the quarter not denting private consumption as much as initially anticipated. Business spending was a touch softer than expected and net exports dragged on the back of surging imports. Looking forward, the second quarter should see a recovery, with the lifting of COVID restrictions in particular supporting the economy.

Easing COVID restrictions will certainly be welcome but the data suggest that the economy remains in a delicate position. The Bank of Japan's (BoJ's) Tankan surveys for Q1 show that the overall situation for large manufacturers and large non-manufacturers alike did not improve over the quarter, with the outlook for these corporations deteriorating faster than expected. Private sector activity as a whole has expanded in each of March, April, and May, according to preliminary PMI data. But the rate of expansion remains relatively modest and the impact of lockdowns in China and the Russia-Ukraine conflict continue to weigh on supply chains and are contributing to further intensification of price pressures. That said, there should be consistent expansion over the remainder of 2022, after posting three quarterly contractions out of the last five quarters since the start of 2021.

In the household sector, consumers have returned, with retail sales recovering in March following easing lockdown measures. These gains extended into April, but accelerating inflation takes some of the shine off of the nominal figures. This comes despite pressure on real household incomes, with real labour cash earnings down 0.2%yoy in March. The consumption outlook remains soft with consumer confidence still low after firming at the margin in April (33.0). As with many other advanced economies, the labour market continues to firm up with an unexpected fall in the unemployment rate to 2.5% in April, the lowest since March 2020. Accelerating price pressures are a headwind to the growth outlook. Inflation jumped in April in line with expectations (headline: 2.5%yoy, new core: 0.8%yoy). Tokyo CPI – a useful lead on national figures – continued this strength in May (headline: 2.4%yoy, new core: 0.9%yoy). This marks a sharp about-face in price dynamics - inflation has been mired well below the BoJ's 2% target for many months, with the new core inflation measure exiting deflationary territory for the first time since July 2020. These elevated price pressures are largely being driven by temporary factors, including mobile phone fee pricing changes (contributing a full 1.2ppts to the new core measure) and energy/commodity price shocks that are unlikely to persist.

GRAPH 09 **JAPAN INFLATION**

Japan getting its inflationary spike



Source: IFM Investors, MIC, Macrobond

However, 'temporary' inflation can prove unexpectedly persistent and may force the BoJ to do something.

On balance, the BoJ is unlikely to change its monetary policy stance and BoJ Governor Kuroda signalled that the prevailing view of price pressures is indeed that current inflation is largely cost-push and, accordingly, won't get inflation sustainably at target. Monetary support should, therefore, continue to remain accommodative to assist the economy towards the goal of "*stable, sustainable inflation*". While policy settings were left unchanged over the period, the BoJ did have to step in to purchase 10-year government bonds to defend the 0.25% yield target. And although inflation expectations one year ahead hit record highs in March with respondents expecting price rises of 3.8%yoy, Japan's experience with inflation – even after supply-side shocks and policy – suggests the BoJ will continue to tread carefully.

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