STATE STREET GLOBAL ADVISORS

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Commentary

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Contents

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Global Macro Highlights

Steady Global Growth Masks Considerable Risks

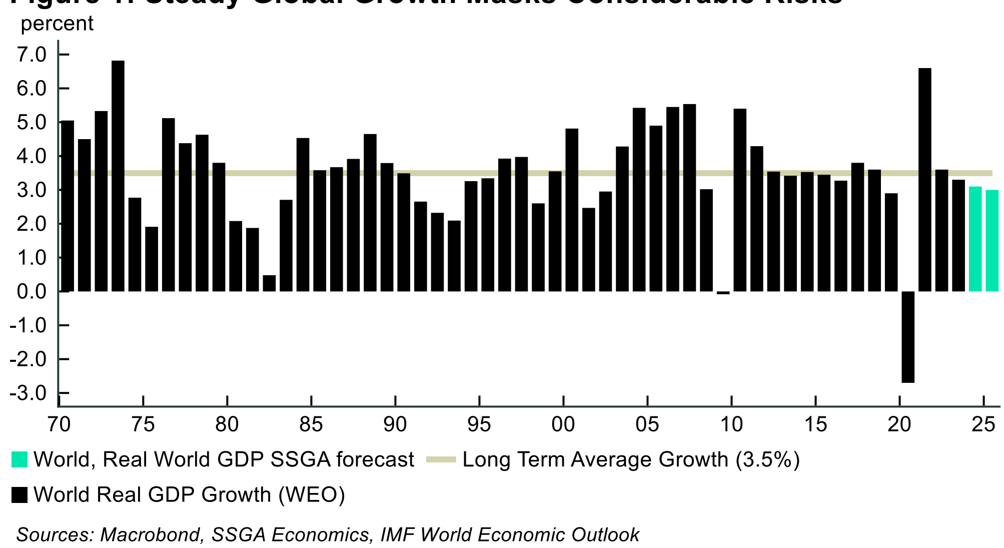
We close the books on 2024 with mixed feelings and some degree of trepidation about what the future holds. Judging purely by the numbers, the global economy outperformed expectations, with growth closer to trend than we thought it would be. And yet, that was very much a function of persistent US outperformance. Much of the rest of the world, including China and Europe, continued to struggle. Structural challenges in both regions require bold remedial policy actions but it is not clear that they are forthcoming.

2024 was a major election year globally; 2025 will be the year of adjusting to policy outcomes following those elections. For Europe, 2025 may matter even more. The need is clear: the region as a whole must do more to help itself. Will its political system rise to the occasion, or is economic pain still deemed not serious enough?

Policy uncertainty abounds. US trade and immigration policies could have deep global consequences, but we are yet to know the specifics of what is to come. And so, while global forecasts look better, we find only limited solace in that, knowing that there are considerable risks around these projections. Unlike this year, when risks were primarily about timing (when will inflation recede enough to facilitate rate cuts?), current risks are more substantive in nature (how will policies actually change?). For now, we simply await clarity. A year when “everything is possible” is a very hard year to forecast!

The best news of 2024 was the deepening disinflation and the broadening monetary easing cycle it facilitated. This was a core call for us, so it is nice to see it materialize. So, while the US didn’t get the full six cuts we predicted in December 2023, we did get four; the ECB delivered the four cuts we expected, and Bank of Canada did even more than we thought it would. The easing cycle continues in 2025: disinflation will be bumpier, but it is not yet dead. The BoJ remains the big exception to the easing trend.

Figure 1: Steady Global Growth Masks Considerable Risks



Sources: Macrobond, SSGA Economics, IMF World Economic Outlook
Updated as of 12/20/2024

Summary of World Output[1] and Inflation[2]

(Annual percent change)

	Weight	History					Forecast	
	(2022)	2019	2020	2021	2022	2023	2024	2025
World Growth	100.0	2.9	-2.7	6.6	3.6	3.3	3.1	3.0
Advanced Economies	40.7	1.9	-4.0	6.0	2.9	1.7	1.5	1.6
US	15.0	2.6	-2.2	6.1	2.5	2.9	2.7	2.2
Euro area	11.9	1.6	-6.1	6.3	3.6	1.0	0.7	1.1
Germany	3.2	1.0	-4.5	3.6	1.4	-0.1	-0.1	0.8
France	2.3	2.1	-7.6	6.8	2.6	1.1	1.1	1.1
Italy	1.9	0.4	-9.0	8.8	4.8	0.8	0.6	1.0
Japan	3.5	-0.4	-4.2	2.7	1.0	1.9	0.1	1.2
UK	2.2	1.6	-10.3	8.6	4.8	0.3	0.8	1.5
Canada	1.4	1.9	-5.0	6.0	4.2	1.5	1.1	1.3
Australia	1.0	1.8	-2.1	5.5	3.9	2.0	1.1	2.2
Developing Economies	59.3	3.7	-1.8	7.0	4.0	4.4	4.2	4.0
China	18.7	6.0	2.2	8.4	3.0	5.2	4.8	4.5
Advanced Economy Inflation	40.7	1.4	0.7	3.1	7.3	4.6	2.6	2.1
US	15.0	1.8	1.3	4.7	8.0	4.1	2.9	2.4
Euro area	11.9	1.2	0.3	2.6	8.4	5.5	2.4	2.0
Germany	3.2	1.4	0.5	3.1	6.9	6.0	2.2	2.0
France	2.3	1.1	0.5	1.7	5.2	4.9	2.1	1.9
Italy	1.9	0.6	-0.1	1.9	8.2	5.7	1.0	1.7
Japan	3.5	0.5	0.0	-0.3	2.5	3.3	2.5	2.6
UK	2.2	1.8	0.9	2.6	9.1	7.4	2.6	2.4
Canada	1.4	1.9	0.7	3.4	6.8	3.9	2.4	2.1
Australia	1.0	1.6	0.9	2.9	6.6	5.6	3.2	2.4
Developing Economies	59.3	5.1	5.1	5.9	9.6	8.1	7.0	5.0
China	18.7	2.9	2.4	0.9	2.0	0.2	0.4	0.9
Value of World Output ($ trl)								
At Market Exchange Rates		87.8	85.5	97.4	101.4	105.7	115.6	123.0
At Purchasing Power Parities		139.4	139.1	155.4	172.3	184.3	201.0	214.1

[1] Real GDP; [2] Consumer Price Inflation

Weight is the share of world GDP on a purchasing power parity basis (IMF *World Economic Outlook)*

Historical data sources: Oxford Economics, IMF. Forecast: SSGA Global Macro and Policy Research

Politics and Geopolitics

What to Watch in 2025

1. US Policy Shifts under Trump 2.0
    - Scope, magnitude, and timing of increased US tariffs
    - Labor market impact from migration restrictions
    - De-regulation of select sectors as well as public sector reforms
    - Fiscal thrust and impact of 2025 budget

    ➔ *Assessment: pro-growth and anti-growth/inflation-boosting measures become misaligned so that negative impacts front-run stimulus. That said, the trade channel is not a major vector for overall US inflation.*

2. Chinese Policymakers’ Reform Appetite
    - Size, composition, and timing of fiscal and monetary stimulus
    - Asymmetric retaliation of US tariffs (e.g., export restrictions)
    - Pivot to structural reforms in favor of domestic demand
    - Spillover effects from stimulus and counter-tariff actions could look different from previous cycles

    ➔ *Assessment: Drip-drip in stimulus is priced in, but there has been a notable change in policy rhetoric highlighting need to lower national savings via reforms of pension, welfare, and healthcare system. Upside potential given declining bond yields and weaker RMB.*

3. European Policy Stagnation or Revival
    - Policy response to increased US tariffs, either retaliation or concessionary trade measures and mild FX depreciation
    - Pace of monetary easing
    - Size of fiscal impulse post-German election in February. Debt brake will be reformed but fiscal expansion unlikely to top 1% of GDP
    - French political impasse to be resolved with new election in H2

    ➔ *Assessment: poor European macro performance is priced into markets. Early resolution of US-EU trade tensions and larger Chinese stimulus offer potential upside given FX weakness.*

4. Geopolitics of De-Escalation
    - There are multiple drivers favoring a political resolution to the Ukraine war: US administration change; Ukrainian public opinion showing war fatigue; growing Russian economic damage. Cease-fire prospects realistic, but this does not necessarily mean durable peace settlement.
    - Middle East wars should also decline in intensity or return to cease-fire, with Iranian allies weakened and new US administration posing threat to Tehran. Like with Ukraine, a ‘pause’ in global proxy wars seems likely in 2025, with conflicts temporarily re-localizing.
    - Geopolitics not impactful for oil market as it remains amply supplied and demand driven, but natural gas and other energy forms to benefit from policy tailwinds (e.g. US-EU trade negotiations)

    ➔ *Assessment: modest upside for European sentiment as regional wars stabilize.*

Demographics

An Update on Ukrainian Refugees in the EU

Almost three years since the war in Ukraine began, the impact of refugees on the EU economy is increasingly visible. On one hand, high levels of non-EU immigration, led by Ukrainian refugees, have helped accommodate strong labor demand and increase GDP in the region as well as attenuate the effects of a challenging demographic outlook. On the other hand, strong population growth has added fiscal costs and has put pressure on infrastructure.

Roughly two-thirds of jobs created during the period 2019 - 2023 were filled by non-EU citizens. As shown in Figure 3, there is wide variation across countries in regard to both overall refugee employment rates and the sectors where refugees they worked. Poland, Sweden, and Czech Republic report high rates of refugee employment; Germany, Switzerland, and Italy report very low rates. Of note, most refugees are women, many of whom used to work in retail or education in Ukraine. That means it takes time for them to find jobs and they may work in sectors that do not necessarily match with their qualifications. Most of the refugees also have high level of educational attainment, with Belgium, Germany, and Ireland reporting that more than 60% have tertiary education.

Figure 2: Ukrainian Employment in EU

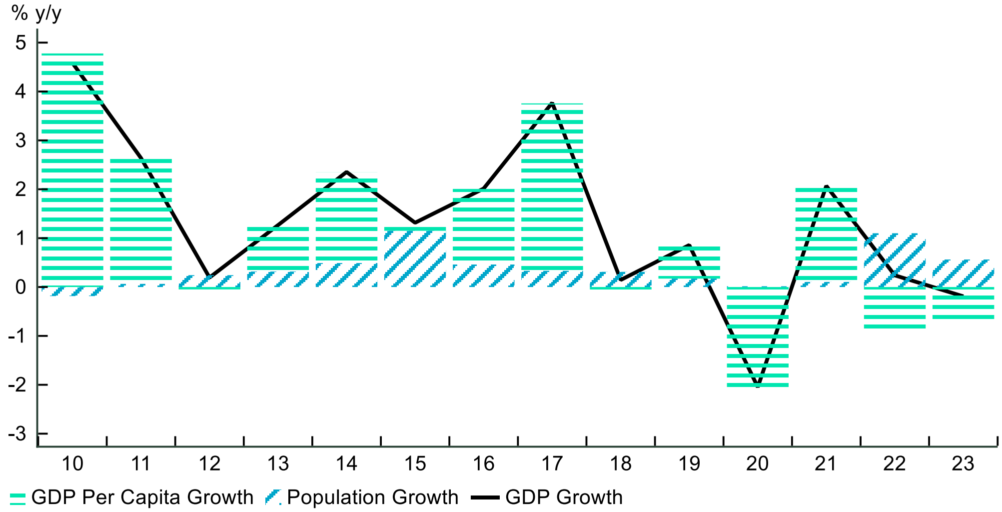
Country	Employment rate (%)	Main sectors of employment	Date
Poland	61	Manufacturing, accommodation and food service activities,	Aug-23
Sweden	56	Services; construction; ICT	May-23
Czech Republic	51	Unskilled/manual labour	Dec-22
Denmark	46	Cleaning; catering; warehousing	Apr-23
Netherlands	46	Business services sector, trade, transport & accommodation, food services	Nov-22
France	33	n/a	Apr-23
Ireland	28	Wholesale, transport and accommodation	Jun-23
Italy	19	Domestic services, construction, catering	Dec-22
Switzerland	19	Other sectors; hotel/catering; planning/consulting/IT	Jul-23
Germany	18	n/a	Jan-Mar 23

Source: UNHCR, Deloitte

Even so, Ukrainian refugees' quick integration into labor market has strengthened their positive impact on the regional economy. UNHCR (2024) estimated that

Ukrainian refugees who remained in Poland contributed to an increase of the GDP level by 0.7- 1.1% in 2023. Likewise, as shown in Figure 4, Germany population growth, driven by Ukrainian immigrants, was also the main contributor to GDP growth in 2022 and 2023. Germany population has increased considerably in these two years as strong net migration compensated for low birth rate and ageing population.

Figure 3: Immigration Has Lifted German Growth



Sources: Macrobond, SSGA Economics, USCB, BEA, StatCan, DESTATIS, ABS, INSEE, Istat, ONS, SBJ, CAO, NBS, Eurostat
Updated as of 12/20/2024

An influx of refugees also helps lessen the burden of an ageing population in the EU. Most of the refugees are between working-age population, allowing the pace of the increase in old age dependency ratios to slow down. Overall, despite the associated costs, Ukrainian refugees are likely to have notable impact on the EU's labor market and economic growth in long run, particularly if refugees integrate into their host countries.

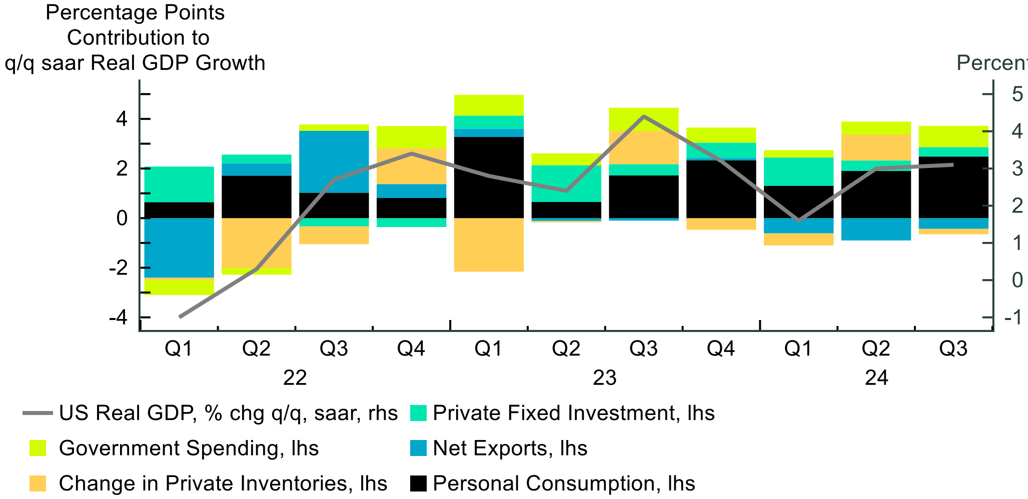
Country Macro Highlights

Please see individual country commentaries in respective sections below.

US: A Higher Baseline Still Awaits Policy Details

The US economy ends 2024 on solid footing, with full-year real growth estimates upgraded once again to now stand at 2.7%. Consumption has persistently surprised us to the upside this year, a mystery that became less of a mystery once data revisions in Q3 showed substantially higher income than previously reported. Turns out that the savings rate—which earlier data had shown to have fallen below 3.0%—had, in fact, never even reached 4.0%. This "little" detail extends the runaway for consumer spending in and of itself. There are forces pulling both ways on the consumption outlook for 2025. Tariffs and deportations are headwinds, but lower interest rates should spur both vehicle and housing-related demand. Indeed, not only is there considerable pent-up demand in both of these areas, but inventory levels are improving as well. Record household net worth and record housing equity ensure the financial wherewithal. Only a meaningful decline in employment could disrupt this dynamic; it seems quite unlikely absent unforeseen shocks.

Figure 4: Private Consumption Powers US GDP Growth



Sources: Macrobond, SSGA Economics, BEA
Updated as of 20/12/2024

Fixed investment has also done very well, with robust growth in both the private and government sectors. Government fixed investment continued to surge on the back of policy-driven initiatives; it rose 13.4% cumulatively since the start of 2023 through Q3 2024. We estimate it to have grown 6.6% in calendar year 2024, which would mark the second best performance since 2007 (the best was 2023 with 7.4%!). There is more where this came from as efforts to support reshoring activities and improve domestic infrastructure remain a national policy focus.

Private investment is estimated to have grown 4.3% in 2024, up sharply from 2.4% in 2023. The rebound was partly facilitated by a recovery in residential fixed investment. Rising interest rates had caused private residential fixed investment to shrink 8.6% in 2022 and a further 8.3% in 2023 but activity finally stabilized this year. For 2024 as a whole, private residential fixed investment likely grew 3.8%. The outlook for this segment is a little trickly and we only anticipate flattish performance in 2025. On one hand, slightly lower interest rates will support housing demand, but they will likely also drive an increase in supply in the existing home segment. With more competition from existing homes and the inventory of new completed homes for sale sitting at the highest level since 2009, homebuilders will likely manage inventory quite carefully, especially in the multi-family segment. The renovations market holds the key to how private residential investment will perform in 2025. Equipment investment has been and will likely remain robust, reflecting both reshoring efforts and recovery in aircraft orders. This is an upside risk to the forecast as the natural progression of reshoring efforts does imply a boost to equipment investment.

The real trade deficit (national accounts basis) is hovering near records as strong demand relative to the rest of the world and the strong US dollar have thwarted hopes of improving this metric. It remains to be seen if tariffs make a dent here because reshoring efforts themselves also imply a boost to import demand (even if temporary and satisfied from different sources).

All in all, the growth picture looks fairly robust for 2025. Our 2.2% real GDP growth forecast faces two-sided risks. On the downside, tariffs and deportations could be taken too far, undermining demand. On the upside, investment could fare even better; moreover, the risk of a big “fiscal cliff” at the start of 2026 has diminished. In other words, the baseline for growth has shifted a little higher.

The baseline for inflation has done the same, and we no longer anticipate core PCE inflation to hit 2.0% by mid-2025 as we did previously. Nevertheless, we still see further progress with disinflation over the course of next year. But with core PCE inflation now only seen reaching 2.3% y/y in Q4 2025, we’ve trimmed expectations for Fed easing in 2025 to a total of 75 basis points, bringing the upper Fed Funds rate to 3.75%. This is one less cut than we expected in September and one more than what the FOMC signaled in the December summary of economic projections. There are two-sided risks to both the inflation and the Fed call. Tariffs are clearly inflationary, but the impact of immigration policy is not quite as clear cut; a decline in immigration could help along the shelter disinflation process; given the large share in the inflation basket, this can offset tariff effects. And with the unemployment rate currently at the Fed’s estimation of NAIRU (non-accelerating inflation rate of unemployment), some reduction in labor supply in the context of lower labor demand may not drive much wage inflation. 2025 will be a true “dual mandate” year for the Fed.

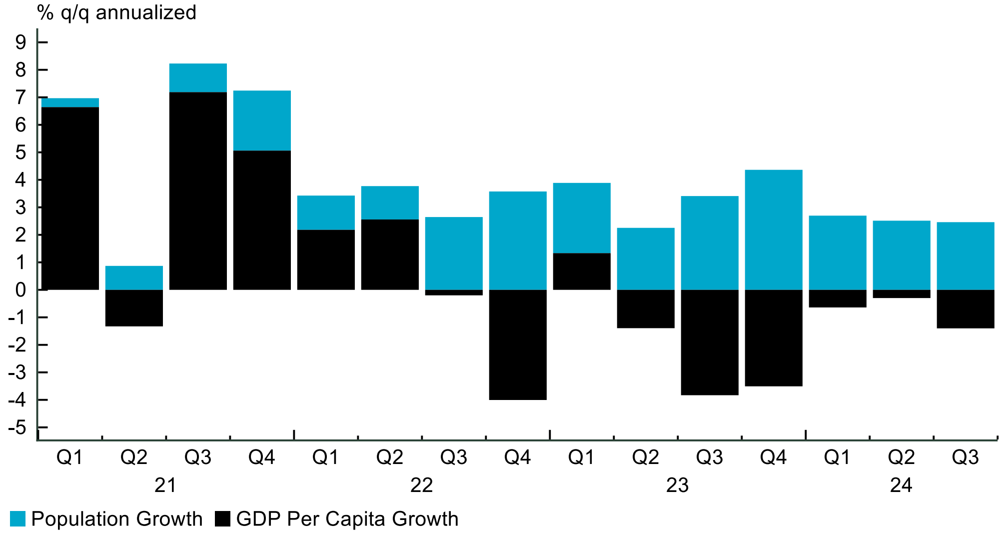
Canada: Several Headwinds To Come!

Since our last quarterly update in September, the economy has evolved largely in line with our expectations. GDP growth slowed down sharply in Q3, and weak underlying momentum is likely to continue in the near term. Our growth forecast for 2024 remains unchanged at 1.1%. We downgraded 2025 growth by four tenths to 1.3%, given increasing downside risks to trade and immigration curbs. However, we expect GDP per capita, which contracted in Q3 for the sixth consecutive quarter, will likely bounce back next year given supportive fiscal policy, monetary easing, and at-target inflation.

Q3 GDP growth underwhelmed at 1.0% (seasonally adjusted annualized), with soft business investment, lower net exports, and slower inventory accumulation that partly offset strength in consumption, government spending, and housing. However, the underlying trend in retail spending seems to get better, albeit modestly, suggesting a rebound in consumption. Meanwhile, the labor market continues to loosen. The unemployment rate jumped 0.3ppts to record high of 6.8% in November, driven by a higher participation rate. Heading into 2025, the economic growth will likely pick up slightly in Q1, supported by increased consumer spending on the back of policy changes such as GST holidays. Still, some of positive impact from GST holidays will reflect consumers pulling forward purchases, implying softer spending in Q2. Meanwhile, mortgage rule changes will support the housing market which has already gained some traction due to lower borrowing costs. Longer 30-year amortization periods for first-time home buyers purchasing new builds as well as an increase in the cap for insured mortgages should contribute to a moderate increase in home sales and prices next year.

Population growth has been strong in recent years, mainly driven by a surge in immigration. However, the recent immigrants are largely categorized as temporary residents including low-skilled workers and students. These newcomers are likely unemployed or in low-earning jobs, dampening growth in income per capita while adding upward pressure on infrastructure such as housing and healthcare.

Figure 5: Canadian Per Capita GDP Keeps Shrinking



Sources: Macrobond, SSGA Economics, StatCan
Updated as of 12/20/2024

In that sense, the government's unprecedented immigration curbs seem meaningful. The **new immigration plan** suggests lowering permanent resident admissions by more than 20% to less than 400k annually over 2025-2027. Moreover, the government is planning to bring the population share of temporary residents down to 5% by the end of 2026, from 7.3% in Q3 this year. The federal government projected marginal contraction in population at 0.2% in both 2025 and 2026 before returning to positive growth rate of 0.8% in 2027. Given policy lags, we expect population growth will not completely decline but moderate sharply, still suggesting a drag on aggregate demand and labor supply. On one hand, we expect the negative impact on growth to be countered by several factors including falling interest rates and rising real income per capita. For now, we do not expect material impact on housing demand, but it is likely that the new immigration plan will curb future home price gains and rent growth. On the other hand, we anticipate that a drag on labor force growth will be mitigated by a recovery in participation rate in due course as the economy gets better.

The proposed 25% **tariffs** by president-elect Trump are clearly a bargaining tool but they imply higher possibility of a disruptive USCAM. Our baseline forecast is that Trump will impose targeted tariffs on specific areas including steel and some agricultural products rather than a universal tariff. Canada has a large goods trade surplus with the US, of which energy accounted for more than 25% of total exports. The US heavy reliance on Canada's energy suggest that these sectors are likely to avoid tariffs imposed by Trump administration. Likewise, the high interdependence between US and Canada's auto sectors suggests that motor vehicles and parts, Canada's second largest export to the US, would not be subject to tariffs or at least just suffer a modest decline in export volumes. Having said that, there is a lot of uncertainty around this. The worst-case scenario would be when Canada faces a universal tariff, and the US withdrew from USMCA. In that case, we expect faster rate cuts from the BoC to support demand, while the central bank will likely look through high import inflation.

Political uncertainty and little fiscal space left indicate a shallow path for **fiscal policy** in 2025. Disagreements within the incumbent government on fiscal policy, which contributed to Finance Minister Chrystia Freeland's resignation, lowered the chance of many of the measures announced in the 2024 Fall Economic Statement being implemented. In addition, the 2024 Fall Economic Statement (FES) highlighted little fiscal space within the government's self-imposed fiscal framework and that has not yet considered potential risks from US trade policy under Trump administration. Overall, we expect fiscal policy to offer a limited boost to the economic growth.

Inflation returned to 2% much faster than the BoC and market expected, partly driven by lower energy prices. Upside risks to inflation have also lessened while soft demand suggests that **headline CPI** will oscillate around 2% through most of 2025. We have lowered our inflation forecast for 2025 by one tenth to 2.1%.

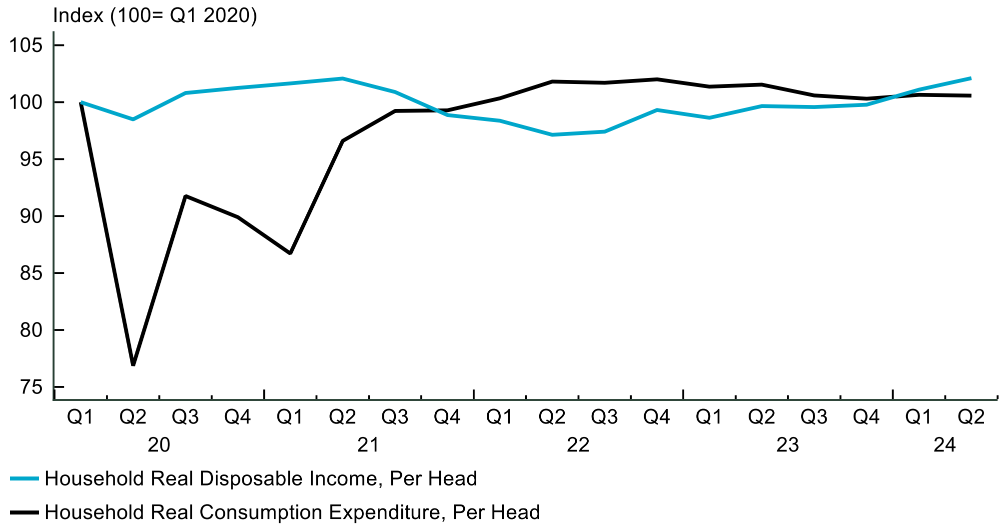
Since the BoC kicked off its easing cycle in June, the **policy rate** has already been lowered by 175 bps. Going forward, softer growth outlook and at-target inflation justify further rate cuts, albeit at a slower pace. At this stage, we expect that the bank will steadily lower rates until it reaches 2.25% by June 2025.

UK: Growth Momentum Comes To An End in Q4

We end 2024 precisely where we said we would at the start of the year. Weak underlying growth in the second half means that the economy will likely grow modestly by 0.8% this year. We also maintained 1.5% growth forecast for 2025 given a number of tailwinds to activity next year. Lower inflation, monetary easing, and fiscal stimulus should continue to support the economy. We note that with an economy running close to full capacity, the boost to growth from fiscal policy will likely to be narrower than would have been otherwise. Higher taxes and restrictive monetary policy as a response to front-loaded stimulus will likely offset some of the positive impact of the new budget. Meanwhile, potential trade frictions following the US elections are clouding the UK economic outlook.

As expected, the economy lost momentum in the second half of the year, with a modest Q3 GDP growth of just 0.1% q/q. Consumer spending and investment gained some traction, but the underlying momentum in the economy was weaker than we previously thought. **Households** remain cautious. The households savings rate remained elevated at 9.8% in Q2 2024, despite a strong recovery of real disposable income. Uncertainty on the economic outlook and high incentives to save from higher interest rates are likely to continue slowing down the recovery in household consumption next year. At the same time, the uncertainty around the budget and expectations of higher input costs have delayed some investment plans for businesses and households in Q4.

Figure 6: UK Household Consumption Persistently Weak



Sources: Macrobond, SSGA Economics, ONS
Updated as of 12/20/2024

The labor market is undoubtedly loosening. Payrolled data shows that private employment declined 0.9% since the beginning of the year, having fallen further in November. Vacancy rates across sectors continued trending downward and have broadly fallen below the pre-covid levels. Private wage growth has surged in recent months, reaching 5.4% y/y in October, but the data tend to be volatile. Meanwhile, the new budget and expectations of higher input costs may be starting to impact the jobs market, with Dec PMIs showing a material drop in services employment. The BoE's latest Decision Maker Panel (DMP) survey also showed that more than 54% of companies expect lower employment and 38% expect to pay lower wages as a response to higher employer NICs.

Inflation is expected to pick up in the new few months before resuming a move lower throughout 2025. Higher government spending and public sector wage growth will support demand, but soft labor market will drive down inflationary pressures next year. We expect average headline inflation to reach 2.4% in 2025, three-tenths higher than our September's forecast (2.1%).

Budget Outlook

The larger-than-expected fiscal stimulus has heightened the expectations of stronger demand in the near-term. Still, the total budget suggests some tightening over the course of the parliament including next year, indicating that growth will likely ease in the second half of the year.

The new budget aimed at increasing productivity growth through higher investment. Higher spending in health, education and infrastructure will help the

UK labor force become more competitive as well as increase potential output. This will be important for the economy's long-term prospects, especially after two decades of subdued productivity growth due to low level of investments. However, any boost to productivity will happen gradually, and the impact can vary depending on how the total budget and related reforms can unleash efficiency gains and incentivize business investment.

As highlighted in our report "UK Autumn Budget Signals Fiscal Expansion", there is a fiscal slippage risk in the budget. As the current fiscal headroom is very limited, the government may be forced to raise taxes again in coming years.

Uncertainty Around US Election

On the trade front, the impact of US tariffs on the UK seems modest at this stage. The US is UK's largest trading partner but nearly 70% of exports to US are services, which are less subject to tariffs, compared to goods. Still, uncertainty around potential tariffs from the US is expected to be hit the EU, which could also spill over into the UK, albeit to a lesser extent. On monetary policy, the US expansionary fiscal policy could slow the pace of rate cuts in both US and UK, which could further delay consumption and investment recovery in the latter.

Bank of England left interest rates at 4.75% in their December meeting and struck a slightly more dovish tone. We continue to expect that the next 25 bps rate cut will come in February. We believe that Bank will cut rates further and faster than market expects, until rates reach 3.50% at next year end.

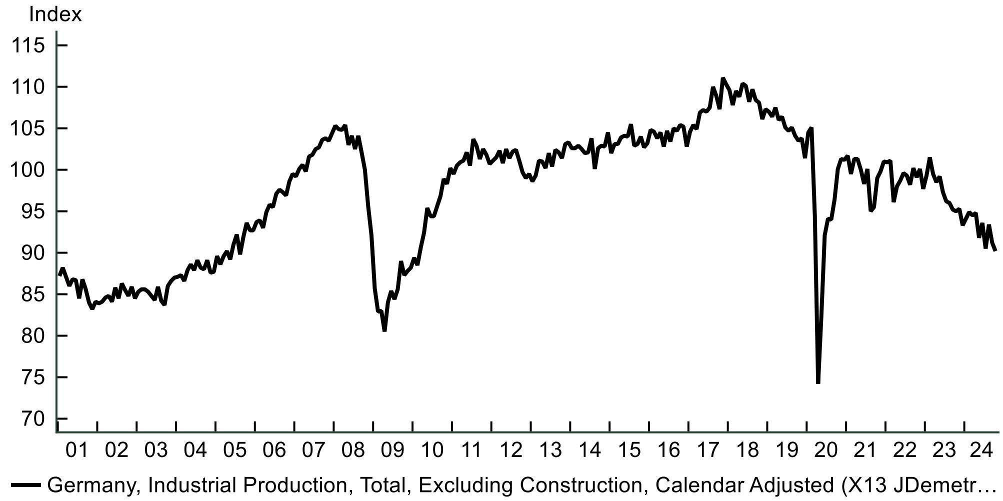
Eurozone: The Time Is Now!

Three months ago, we wrote here that "It is hard for the team to do well when the star player is injured… And injured it is." That is as true today as it was then. Following a 0.3% q/q contraction in Q2, the German economy barely grew in the third, leaving real GDP down 0.3% y/y. The details remain dismal. Real household consumption was down 0.1% y/y in Q3 while fixed investment plunged 3.4% y/y. The earlier conclusions stand: "domestic demand dynamics are weak—consumers are reluctant to spend despite considerable savings cushion—and export performance is curtailed by Germany's energy cost-induced competitiveness loss. There is little in the way of near-term demand catalysts, so it is at least good that sharply lower inflation has opened the door for more ECB rate cuts."

We can now say that the **ECB** has delivered the two cuts we had expected in October and December. This helps. More will come, though elevated wage growth may limit the ECB to just 100 basis points worth of cuts in 2025. While the ECB is both willing and able to help, it cannot provide the true solution to eurozone's economic malaise. That is a matter for national governments and for Brussels. This is why President Lagarde seems to avail every opportunity (including at the December meeting) to remind the continents' political leaders that "It is crucial to swiftly follow up, with concrete and ambitious structural policies, on Mario Draghi's proposals for enhancing European competitiveness and Enrico Letta's proposals for empowering the Single Market. We welcome the European Commission's assessment of governments' medium-term plans for fiscal and structural policies, as part of the EU's revised economic governance framework. Governments should now focus on implementing their commitments under this framework fully and without delay.”

German elections are scheduled for late February. After two years of incremental declines, a pro-growth agenda is badly needed; we hope it will prevail, but fear that our 0.8% 2025 growth projection may be too optimistic. To us, the picture is grim enough to argue for a decisive departure from the overly constricting policy limitations of the past. Germany and the whole of Europe must do more to help itself, especially given an incoming US administration that will not be inclined towards a gentle approach. The time to act is now.

Figure 7: The Bleak Reality Of Germany's Industrial Decline



Sources: Macrobond, SSGA Economics, DESTATIS
Updated as of 20/12/2024

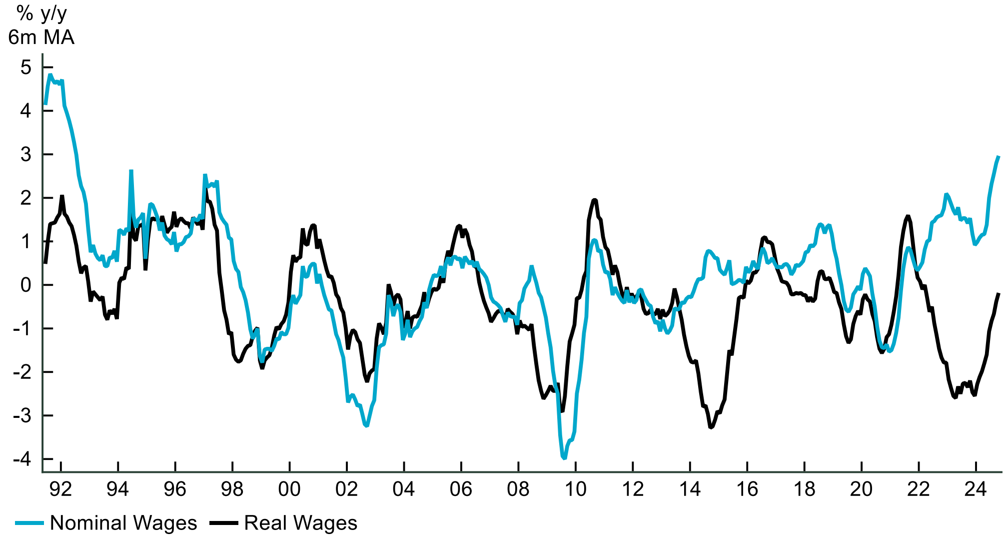
Conditions are only slightly better in either Italy or France. In Italy, the post-Covid rebound, partly fueled by foreign travel demand and construction incentives, has lost momentum. Investment and exports have both turned negative y/y. The relative resilience in French GDP growth is primarily a reflection of increased government spending as fixed investment was down 2.3% y/y in Q3. Absent any clear catalyst for growth, there is only modest improvement in regional growth performance next year (from 0.7% to 1.1%).

Japan: Surely, But Slowly

The Bank of Japan (BoJ) skipped the December hike and left the policy rate at 0.25%, despite a spree of positive economic data over the last month. Governor Ueda said the lack of sufficient clarity on next year’s wage growth and the uncertainty on the incoming Trump administration’s trade policies were the primary reasons. He also mentioned that the Bank may need *‘considerable time’* to see the full picture, and that the prospect of a trade war will have *‘large effect’* on Japan’s economy. The stance contradicts the confident undertones in the Statement such as – *“Japan’s economy is likely to keep growing at a pace above its potential growth rate”.* This unexpected dovish turn forced us to reevaluate our BoJ call.

<u>We still foresee two hikes next year, but to 0.75%.</u> However, our view has downside risks and is plausible only if the next year's *shunto* remains around 3.5% and if the potentially higher tariffs do not adversely impact the economy. We know that the Confederation of Japan Automobile Workers' Union is looking for at least 12,000 yen ($ 80) per month of a raise next year, their first such target in seven years. As such, both nominal and real wage growth improved in 2024 (Figure 5).

Figure 8: Wage Dynamics Have Improved In Japan



Sources: Macrobond, SSGA Economics, MHLW
Updated as of 20/12/2024

While we are unsure why the BoJ was deliberately indecisive despite sound economic setting, the sudden dovishness means that the consequences through the yen may be at large. The yen weakened past 157 against the USD after the meeting and we see it testing new lows. If the BoJ maintains their dovishness notwithstanding these developments, inflation is highly likely to be revived through higher import prices, keeping our two hikes forecast next year closer to reality.

As such, the Bank estimated the neutral rate between -1.0% to +0.5% in its broad-perspective review of monetary policy. It noted that the extraordinary monetary policies since 2013 had negative effects on the bond market functioning and financial intermediation, but downplayed them as the assessment needed to be taken in considerable latitude. However, the policies were 'effective' in pushing up economic activity and prices, somewhat defending them for potential use in future.

Otherwise, we expect inflation to strengthen and prove persistent next year. Services prices will continue improving, while goods inflation will mean-revert higher, driven by food. CPI in November rose 2.9% y/y, and the BoJ core (excluding fresh food) rose 2.7% y/y. Of note was the 4.9% rise in food prices and a staggering 63.6% jump in rice prices. Energy prices rose sharply as well following the removal of subsidies. All in all, price pressures remain firm and intense, and we expect inflation to average 2.6% y/y next year.

The silver lining is an optimistic growth picture, driven by domestic and well as external demand. We see GDP growth average 1.2% y/y in 2025. More importantly, we expect household consumption to trend near the long-run average growth of 1.5% in H2 2025.

The key question will be whether the BoJ regains confidence and hikes again or not?

Australia: Not Until The Cows Come Home

The combination of weak economic growth and inflation within the target may bring rate cuts from February next year. However, we believe the strong labor market, and the higher 'level' of prices may keep the Reserve Bank of Australia (RBA) uncomfortable enough to prevent any aggressive easing. Hence, we see only three rate cuts next year from the Bank, with the cash rate coming down to 3.6%, still at a restrictive level.

The unfortunate consequence will be continued sub-par economic growth, something that we have written about repeatedly this year. Furthermore, we do not see the limited rate cuts spurring higher growth as well. Since 2010, Australia's GDP growth averaged 2.5% y/y each quarter, but has eased to 1.5% since 2023 and just 1.0% this year. Of note is the weakness in consumption, which grew two-full points below its 2.4% y/y average since 2010 in Q3 2024. The recovery in consumer sentiment proved to be limited in the last few months, with weaknesses on the economic outlook and indexes measuring willingness to buy dwellings or a major household items. This gives the impression that household spending may remain constrained by high cost of living and benign wage growth.

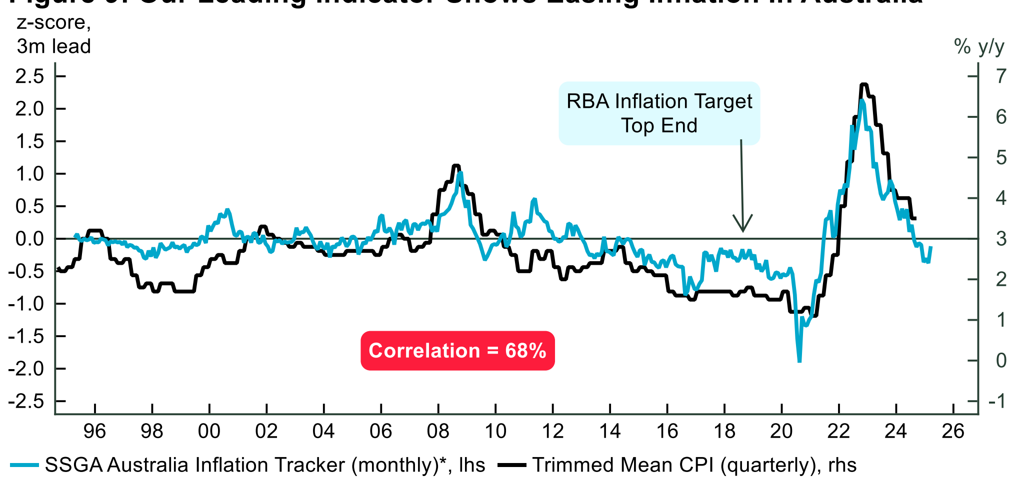
While these issues seem to get little recognition, markets remain fixated on the strength in the labor market as an inhibiting factor for any rate cuts, even after the the dovish pivot by the RBA. To be fair our assessments on the labor market have been humbled by data releases in 2024. Yet, we feel the numbers are not providing a true assessment. Nearly 77% of the employment created since 2023 were in just four industries: health & social care, education, public administration and electricity, gas, water & waste services. And then there is the seasonality issues in the data, which may have palyed a role in lowering the unemployment rate to 3.9% in November, missing the consensus by a massive three tenths. However, we believe this could reverse in the coming months.

As private demand eased, employment creation was led by the public sectors and hence, it appears that the strong labor market is a blessing in disguise to the economy. However, we do not expect that these new jobs to lift inflation. Furthermore, as the huge lift in Q3 last year drops out, the overall Wage Price Index growth could normalize into the 3% handle, which means inflaiton could come in more consistent with the RBA's 2-3% target range.

We foresee the unemployment rate to rise to a peak of 4.4% next year, as we count on the proactiveness of the RBA in supporting the economy by easing rates. This may revive labor demand in sectors like construction, creating a headstart to work on housing shortages. Also, any reasonable stimulus from China may lift demand for Australia's resource exports, an upside risk to employment and growth. However, if rates remain higher for longer, the support from public demand may run out, posing downside risks. Hence, it seems upto the RBA whether to keep the blessing or run out of it in Australia.

We see inflation easing into the target range next year (2.4%), even if the labor market strength persists. This is due to base-effects and improving supply situation amid markedly eased demand. **This is the most crucial reason for reducing rates.** An upside risk emerged recently – household inflation expectations ticked back up after trending lower for a while; the 2-year ahead expectations in the ANZ/Roy Morgan Survey rose to 5.0% in November, after easing to 4.6% during the past two months. However, the CBA Household Spending Insights Index pared back to 2.7% y/y in November, after rising to 4.9% in October. We aggregate eight such leading indicators into our SSGA Australia Inflation Tracker, which leads the quarterly trimmed mean CPI with 68% correlation (figure 5), and clearly shows that inflation could come into the target next year.

Figure 9: Our Leading Indicator Shows Easing Inflation In Australia



Sources: Macrobond, SSGA Economics, NAB, Melbourne Institute of Applied Economic & Social Research, ABS, Ai Group, ANZ-Roy Morgan, CBA, S&P Global
Updated as of 20/12/2024

**avg. of z-scores of eight high-frequency price metrics in Australia. Average of available historical data.*

In summary, we expect inflation to ease into the target amid persistent labor market strength, meaning the RBA could begin easing next year, perhaps in February. But absent any material shocks, the easing cycle could be shallow with just three rate cuts next year. However, in such a setting growth is unlikely to rise back towards its long-run average, not until the cows come home.

Data Calendar

Week in Review (Dec 16 – Dec 20)

Country	Release (Date, format)	Consensus	Actual	Last	Comments
Monday, Dec 16					
US	Empire Manufacturing (Dec)	10	0.2	31.2	Too volatile for true signal.
CA	Housing Starts (Nov, thous)	245.1	262.4	242.2 (↑)	Strong.
CA	Existing Home Sales (Nov, m/m)	--	2.8%	7.7%	OK.
UK	Manufacturing PMI (Dec, prelim)	48.5	47.3	48	Weakening.
UK	Services PMI (Sec, prelim)	51	51.4	50.8	OK.
EC	Manufacturing PMI (Dec, prelim)	45.3	45.2	45.2	Weak.
EC	Services PMI (Sec, prelim)	49.5	51.4	49.5	Good to see the improvement.
GE	Manufacturing PMI (Dec, prelim)	43.1	42.5	43	Dismal.
GE	Services PMI (Sec, prelim)	49.3	51.0	49.3	Good to see the improvement.
FR	Manufacturing PMI (Dec, prelim)	43	41.9	43.1	Dismal.
JN	Core Machine Orders (Oct, m/m)	1.1%	2.1%	-0.7%	Mean reverting, positive for Q4 growth.
JN	Manufacturing PMI (Dec, prelim)	--	49.5	49.0	Still not expansionary.
JN	Tertiary Industry Index (Oct, m/m)	-0.1%	0.3%	-0.1% (↑)	Good data.
AU	Westpac Consumer Conf Index (Dec)	--	92.8	94.6	Poor confidence, again.
Tuesday, Dec 17					
US	Retail Sales Advance (Nov, m/m)	0.6%	0.7%	0.5% (↑)	Good.
US	Industrial Production (Nov, m/m)	0.3%	-0.1%	-0.4% (↓)	Soft.
US	NAHB Housing Market Index (Dec)	47	46	46	Modest.
CA	CPI (Nov, y/y)	2.0%	1.9%	2.0%	Good.
UK	Average Weekly Earnings (Oct, 3m y/y)	4.6%	5.2%	4.4% (↑)	Upside surprise.
UK	ILO Unemployment Rate (Oct, 3m)	4.3%	4.3%	4.3%	Unreliable due to data issues.
GE	IFO Business Climate (Dec)	85.5	84.7	85.6 (↓)	Steady.
GE	ZEW Survey Expectations (Dec_	6.9	15.7	7.4	Follows a string of declines.
Wednesday, Dec 18					
US	Housing Starts (Nov, thous)	1,345	1,289	1,312 (↑)	Permits fared better but high rates a problem.
US	FOMC Rate Decision (Upper Bound)	4.50%	4.50%	4.75%	FOMC projects just two cuts ibn 2025.
UK	CPI (Nov, y/y)	2.6%	2.6%	2.3%	In line with our expectations.
EC	CPI (Nov, y/y, final)	2.3%	2.2%	2.0%	Room for more ECB cuts.
Thursday, Dec 19					
US	GDP (Q3, annualized q/q)	2.8%	3.1%	3.0%	Stronger services consumption.
US	Philadelphia Fed Business Outlook (Dec)	2.8	-16.4	-5.5	Surprising step down.
US	Initial Jobless Claims (14 Dec, thous)	230	220	242	Low.
US	Leading Index (Nov)	-0.1%	0.3%	-0.4%	First big increase in a while.
US	Existing Home Sales (Nov, m/m)	3.2%	4.8%	3.4%	Will likely relapse amid higher mortage rates.
UK	Bank of England Bank Rate	4.75%	4.75%	4.75%	As widely expected.
GE	GfK Consumer Confidence (Jan)	-22.5	-21.3	-23.1 (↑)	Soft.
Friday, Dec 20					
US	Personal Income (Nov)	0.4%	0.3%	0.7% (↑)	Solid wage income.
US	Personal Spending (Nov)	0.5%	0.4%	0.3% (↓)	Savings rate at 4.4%.
US	U. of Mich. Sentiment (Dec, final)	74.2	74.0	71.8	Highest since April.
CA	Retail Sales (Oct, m/m)	0.7%	0.6%	0.6% (↑)	Recovery continuing.
UK	Retail Sales Inc Auto Fuel (Nov, m/m)	0.5%	0.2%	-0.7%	Worrying.

Source: for data, Bloomberg®; for commentary, State Street Global Advisors Economics.

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* Pensions & Investments Research Center, as of December 31, 2023.

† This figure is presented as of June 30, 2024 and includes ETF AUM of $1,393.92 billion USD of which approximately $69.35 billion USD is in gold assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated. Please note all AUM is unaudited.

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