

EM inflation after six months of FX weakness

By Jan Dehn

Despite the fall in EM currencies this year, there is no evidence of pass-through from currencies to inflation. Inflation remains low and falling in a number of countries, some of which have had major currency weakness. Higher inflation tends to be concentrated in late cycle economies and countries with bad macroeconomic management. The real yield is now high and attractive in EM, in our view. In Brazil, one of the leaders in the polls ahead of October's election is now in hospital. What does this mean? China is overhauling social security contributions, which may unleash significant investment in the corporate sector. The IMF discussions with Argentina continue, while South Africa sinks into a conventional recession. Protectionist threats continue to weigh on sentiment towards EM.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.7	—	-3.06%
MSCI EM Small Cap	10.5	—	-2.86%
MSCI Frontier	10.4	—	-0.51%
MSCI Asia	11.2	—	-3.26%
Shanghai Composite	9.4	—	-0.82%
Hong Kong Hang Seng	6.8	—	-2.62%
MSCI EMEA	9.0	—	-4.32%
MSCI Latam	11.3	—	-0.39%
GBI-EM-GD	6.72%	—	-1.04%
ELMI+	5.33%	—	-0.56%
EM FX spot	—	—	-0.65%
EMBI GD	6.63%	368 bps	-0.33%
EMBI GD IG	4.85%	189 bps	-0.55%
EMBI GD HY	8.71%	577 bps	-0.10%
CEMBI BD	6.22%	332 bps	-0.13%
CEMBI BD IG	4.89%	198 bps	-0.21%
CEMBI BD Non-IG	7.97%	506 bps	-0.04%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.1	—	-0.96%
1-3yr UST	2.71%	—	-0.05%
3-5yr UST	2.82%	—	-0.19%
7-10yr UST	2.94%	—	-0.51%
10yr+ UST	3.10%	—	-1.57%
10yr+ Germany	0.40%	—	-0.89%
10yr+ Japan	0.12%	—	0.09%
US HY	6.33%	336 bps	-0.15%
European HY	3.63%	418 bps	-0.27%
Barclays Ag	2.08%	-86 bps	-0.43%
VIX Index*	14.58	—	1.72%
DXI Index*	95.36	—	0.22%
EURUSD	1.1572	—	-0.40%
USDJPY	111.10	—	0.03%
CRY Index*	190.80	—	-2.15%
Brent	77.2	—	-1.18%
Gold spot	1192	—	-0.78%

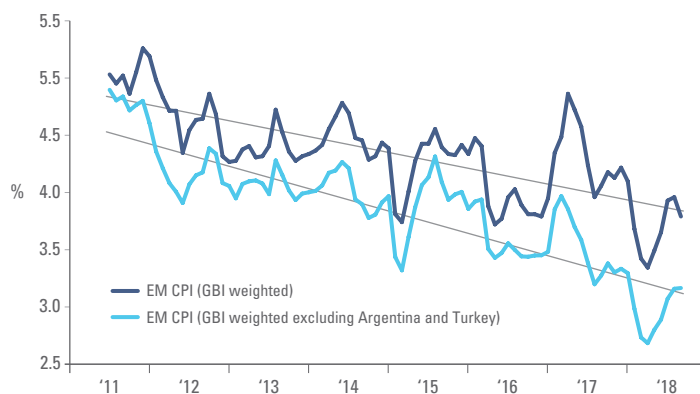
Note: Additional benchmark performance data is provided at the end of this document. *See last page for index definitions.

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- **Emerging Markets (EM) inflation:** EM inflation matters for three reasons. First, inflation is probably the best indicator of overall macroeconomic health and right now investors are a bit worried about contagion in EM. Second, in the context of EM local bond yields rising due to the pullback in EM this year the level of real yields depends crucially on inflation; generally, if inflation rises less than yields then bonds become more attractive. Third, many investors still fear strong pass-through from lower exchange rates to inflation, so, to the extent that weaker currencies have not been inflationary, the local bond market becomes all that much more interesting.¹

How then has six months of EM pullback, which has been concentrated heavily in the FX space, impacted EM inflation rates and real yields? Figure 1 shows EM inflation with and without Argentina and Turkey (whose inflation rates are more than two standard deviations wider than the rest). EM inflation has actually dipped a bit in the last few months and remains a full 20% lower than five years ago. If Argentina and Turkey are excluded EM inflation averages just 3% across EM (based on the countries in the GBI EM GD index of local currency bonds).

Fig 1: **EM inflation (up to and including 31 August 2018)**



Source: Ashmore, Bloomberg, JP Morgan.

¹ Analysis shows that FX pass-through is largely a myth – see for example <https://www.ft.com/content/a52e621e-3407-11e7-99bd-13bebd0903fa3>

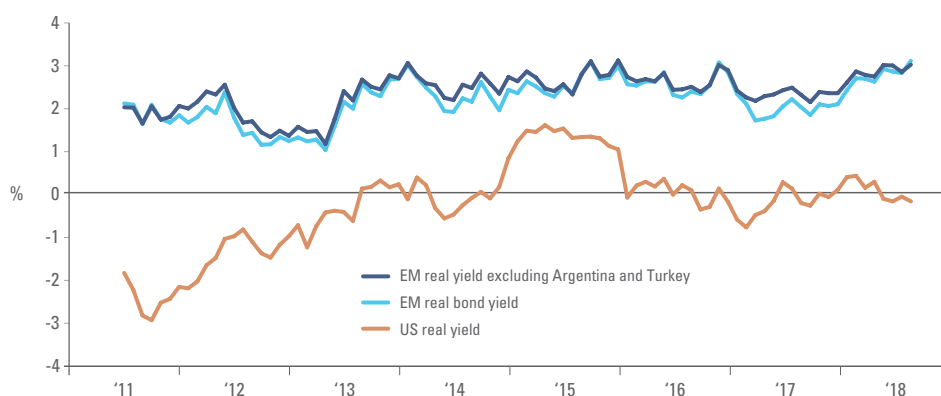
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To add a little bit more colour to the aggregate index numbers, consider the EM inflation prints released in the last week. Each tells a different story, underlining that by far the most important drivers of inflation is not FX, but rather domestic demand conditions and the credibility of central banks. Despite a 30% move in BRL this year alone, Brazilian inflation for August came in at -0.09% mom, which was below expectations of 0.00% mom inflation. On a yoy basis, Brazilian inflation declined to 4.19% in August from 4.48% in July. In Chile, inflation was 2.6% yoy in August, which was lower than in July (2.7% yoy). In Colombia, inflation was also very benign, just 0.12% mom in August in line with expectations, which took the yoy inflation rate to 3.10% from 3.12% in July. This is the lowest inflation rate since 2014. Mexican inflation was 0.25% mom, which was in line with expectations and lower than last month (0.29% mom). Inflation on a yoy basis was 4.90%, which was close to expectations (4.85%). In Russia, CPI inflation also remains low at 3.1% yoy. Granted, inflation picked up from 2.5% yoy in July, but it was mainly due to base effects from last year. In Taiwan, CPI inflation slowed to 1.5% yoy in August from 1.7% yoy in July. In Peru, the rate of inflation dropped very sharply to 1.07% yoy in August from 1.62% in July. In Egypt, the inflation rate dropped to 8.54% yoy from 10.9% yoy the previous month.

Two EM countries reported materially higher inflation this week. First, in Philippines, inflation increased to 6.4% yoy in August from 5.7% yoy in July, although the rate of core inflation increased more moderately at 4.8% yoy in August from 4.5% yoy in July. Philippines is late in the cycle and hiking rates to bring inflation down. In Turkey, the rate of inflation spiked to 17.9% yoy from 15.85% yoy for well-known reasons. In general, pass-through of broad-based EM currency weakness this year has simply not taken place except in the obvious places where one would expect it to happen, i.e. in countries where monetary policy is not credible to begin with.

Against this backdrop, the rise in bond yields this year is clearly interesting. In fact, EM nominal yield is about 6.80%, which is the same level as when the Fed last had the Fed funds rate at 5.25%, while real yields have pushed to the high end of the range over several years (Figure 2). Note that the real US 5yr Treasury yield (based on the 5yr nominal minus the last 12-month Headline CPI) is negative in real terms.

Fig 2: Real yields (EM vs US 5yr)



Source: Ashmore, Bloomberg, JP Morgan.

- Brazil:** After the courts ruled that former President Lula could not run for election, Brazilian politics took another turn when, on Thursday, a supporter of the PSOL party, a populist political movement at the far left of Brazilian politics, stabbed Jair Bolsonaro, the far right populist candidate. Jair was taken to hospital and had surgery, but will survive, although he may take weeks, perhaps even months, to fully recover. Bolsonaro's stabbing is a classic 'Nestor' event, that is, an event, which is a personal tragedy for the person involved, but a source of euphoria for the market.² USDBRL thus moved from 4.15 to 4.05 on news of the stabbing as traders perceived this event would strengthen Bolsonaro and weaken the Left. The knifing of Bolsonaro should induce some sympathy, which will help to improve Bolsonaro's high rejection rate, especially among women. The event should also, for a time, give Bolsonaro more mainstream TV time (which he sorely lacks though he is strong in social media). Bolsonaro can also say he has been proven right to make law and order the main theme of his campaign. The main potential negative, apart from the physical pain and possible psychological consequences of having a knife thrust into his flesh, is that Bolsonaro will be unable to campaign as long as he is recovering. The first round of the election is close – 6th October.

The other important piece of election-related news is that a poll issued late last week shows that the PT party's main candidate, Fernando Haddad, is failing to convince Lula supporters that he is the former president's alter ego. Haddad and Bolsonaro are currently the two leading candidates. The Ibope/Estado/TV Globo poll showed that 40% of Lula supporters would not vote for Haddad. The Left vote is split between Haddad,

² 'Nestors' were named after the former Argentina president, who, upon his death, triggered a 200bps spread compression in Argentine sovereign bonds.

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environmentalist Marina Silva and veteran left-winger Ciro Gomes. The sudden strengthening of Bolsonaro and weakening of Haddad suggests that Geraldo Alckmin, a centrist, who is the preferred candidate of investors, should shift the aim of his attacks towards the Left to get ahead of Haddad in the first round with a view to facing Bolsonaro in the second round. Finally, we note in passing that industrial production expanded at a rate of 4% yoy in July, which was well ahead of market expectations.

- **China:** The State Council is going to lower social security contributions for Chinese firms in a bid to stimulate investment and technological upgrades. The size of the cut has not yet been disclosed, but cuts are likely to be highly effective, because Social Security contributions in China are extremely high. They amount to 11% of corporate profits, which is the second highest rate in the world, according to the World Bank. The reduction in social security contributions is unlikely to result in a funding gap, because the government is also putting equity of state-owned enterprises into the social security fund. The equity of state-owned enterprises amounts to roughly RMB 140trn (roughly USD 20trn, i.e. more than US GDP). The transfer of equity to the social security fund should increase pressure on state-owned enterprises to operate more efficiently. In other news, Caixin services PMI moderated to 51.5 in August from 52.8 in July, but against a backdrop of rising orders and business expectations.
- **Argentina:** IMF and Argentina are making rapid progress towards revising the disbursement profile for IMF financing for Argentina. A revised stand-by agreement is set for approval by late September. On conservative assumptions for the rollover of domestic debt, frontloading of USD 10bn of IMF funding should fully fund Argentina. The main risk in Argentina is now political as the upcoming recession is likely to undermine support for the Macri Administration. Macri had hoped to get away with a gradualist but flawed approach to economic stabilisation after years of economic mismanagement under successive Kirchner Administrations, but things have turned out differently. Meanwhile, MSCI has announced that Argentina will be given a provisional weight of 0.3% in the EM MSCI stock market index next year, when it drops out of the Frontier Market index. The small weight suggests that there will not be great disruption arising from the change in benchmark index.
- **South Africa:** The economy has entered a recession after recording a second consecutive quarter of negative real GDP growth, leading to immediate comparisons with Argentina and Turkey. However, South Africa's situation is fundamentally different. The economic problems in Turkey and Argentina are due to sustained bad macroeconomic management, while South Africa's macroeconomic management is very sound. Instead, South Africa's economy need supply-side reforms. President Cyril Ramaphosa is aware of the need for reforms, but he hopes first to boost his mandate in the 2019 presidential election. He is therefore postponing reforms until after the election except for land reform, which should be popular with ANC supporters. Ramaphosa's version of land reform is likely to be benign, but it is nevertheless creating uncertainty, which has probably contributed to the weaker growth number. Adjustment is already happening, however. For example, the current account deficit narrowed materially to 3.3% of GDP in Q2 2018 from 4.6% of GDP in Q1 2018.

Snippets:

- **Argentina:** The real GDP growth rate was -4.2% yoy in Q2 2018 as the impact of the collapse of the government's policy framework began to extract its full economic cost. The rapid weakening of the currency should help to bring about the necessary adjustment.
- **Chile:** The central bank materially increased the growth forecast for 2018 to reflect the underlying cyclical recovery. The range for growth was raised to 4.00%-4.50% from 3.25%-4.00%. The growth range for 2019 was maintained at 3.25%-4.25%. The central bank left the policy rate unchanged at 2.5%.
- **Czech Republic:** Industrial production growth surged to 10.3% yoy in July from 3.4% yoy in June. This was partly due to working day adjustments, but even after adjustment the yoy growth was 6.7%.
- **India:** Services PMI moderated to 51.1 in August from 54.2 in July. The current account deficit was 2.4% of GDP in Q2 2018, which is only modestly wider than in Q1 2018. As per BAML, with capital flows at around 3-year low of USD 5.2bn (0.8% of GDP), India's balance of payments swung into deficit of USD 11.4bn in Q1FY19 from a surplus of USD 13.2bn last quarter. The sequential worsening of current account deficit in Q1 2018 by USD 2.8bn was less severe than the worsening in capital account by USD 20bn.
- **Hong Kong:** PMI picked up marginally to 48.5 in August from 48.2 in July.
- **Kazakhstan:** The National Bank of Kazakhstan left the policy rate unchanged at 9.00% in line with expectations.
- **Malaysia:** Exports expanded at a 16% yoy rate in July, up from 15.1% yoy in June. The rate of growth of imports slowed to a still strong 16.8% yoy from 22.9% yoy in June. The net effect was an increase in the trade surplus in July to USD 2.0bn from USD 1.5bn in June. The central bank left the policy rate unchanged at 3.25%.
- **Mexico:** Workers' remittances of earnings from overseas (mainly US) increased at a yoy rate of 10.3% in Dollar terms or 18.1% yoy in local currency terms.

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- **Peru:** The government is sending proposals to Congress for a 1% GDP increase in tax revenues via closure of tax loopholes and other efficiency improvements.
- **Poland:** The central bank left the policy rate unchanged at 1.5% in line with expectations.
- **Taiwan:** Exports expanded at a 1.9% yoy rate in August, lower than expected (5.1% yoy).
- **Turkey:** As part of its heterodox programme to stabilise the economy the government required Turkish exporters to repatriate all export earnings and convert 80% of them into Lira.
- **Ukraine:** The National Bank of Ukraine hiked the policy rate 50bps to 18%. Inflation was 8.9% yoy in July.

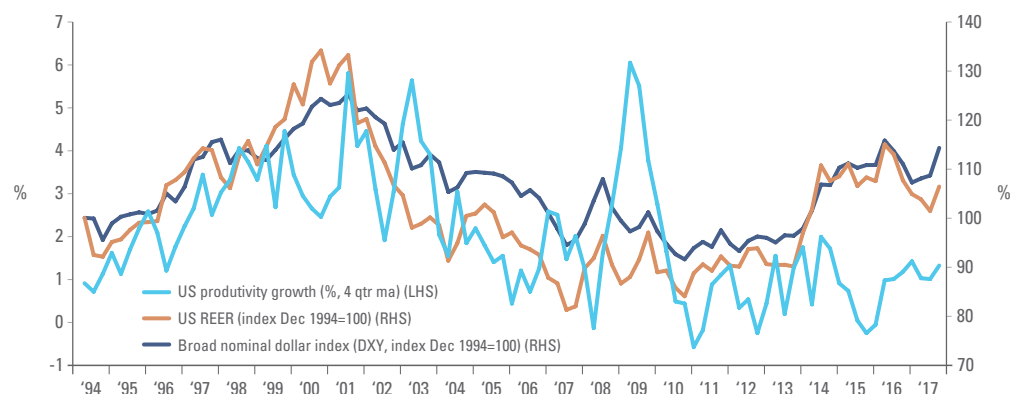
Global backdrop

The upcoming election in Brazil and the extent of protectionism in the US continue to weigh on global sentiment. Last week, markets were cautious fearing the imposition of tariffs on USD 200bn of Chinese imports to the US. President Donald Trump announced the tariffs could come at any time, but appears to have been pre-occupied with book launches and newspaper OpEds. However, we think the protectionist pressures will continue to rise ahead of the mid-term elections, which should sustain the negative sentiment towards EM for a little while longer, despite obvious value.

However, there is no doubt that protectionism will cost the American economy. Many of the goods affected by the next batch of tariffs will be intermediate goods, which means that costs to US business will be far greater than was the case for the first set of tariffs (on the first USD 50bn of Chinese imports). China will also retaliate, of course.

We think political support for tariffs will change after the mid-term elections. Members of Congress will begin to focus on the 2020 presidential election. Congress, which represents American companies, will increasingly be concerned that protectionism could push the US growth rate down, maybe even push the economy into recession within the next two years. This would hurt Republican election prospects. Trump may also come under pressure from Democrats if they take the House and the Mueller Inquiry will further increase pressure. All these factors should make it harder to push anti-growth policies, such as tariffs.

Fig 3: The real and nominal Dollar and US productivity growth



Source: Ashmore, Bloomberg, BIS.

Of course, it is absurd to try to close trade deficits using country-specific tariffs in the first place. In July, the US trade deficit thus widened to USD 50.1bn from USD 45.7bn in June despite tariffs, or, more accurately, because of tariffs. When a country imposes a tariff on imports from another country the currency appreciates, which tends to lead to weaker exports. Meanwhile, the inability to buy the cheapest goods from abroad forces importers to buy more expensive goods, which in turn raises the costs in the economy. The combination of a stronger Dollar and rising costs amounts to real exchange rate appreciation, but given that the US real exchange rate is already overvalued, it follows that tariffs actually widen trade deficits over time. In addition, dangerously, the combination of tighter monetary policy and loose fiscal policy can induce hot money inflows. Today, as Figure 3 shows, the link between US productivity and the value of the Dollar has completely decoupled; it is increasingly hot air, which supports the Dollar – plus fears of protectionism.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-3.06%	-9.84%	-3.65%	12.56%	4.17%
MSCI EM Small Cap	-2.86%	-11.74%	-4.77%	9.11%	3.85%
MSCI Frontier	-0.51%	-13.05%	-7.34%	4.40%	3.80%
MSCI Asia	-3.26%	-7.91%	-0.17%	13.88%	7.13%
Shanghai Composite	-0.82%	-16.41%	-17.79%	-2.18%	7.20%
Hong Kong Hang Seng	-2.62%	-6.24%	-0.94%	9.43%	4.38%
MSCI EMEA	-4.32%	-17.36%	-11.13%	5.10%	-1.94%
MSCI Latam	-0.39%	-11.24%	-14.26%	10.83%	-2.25%
GBI EM GD	-1.04%	-11.40%	-12.37%	3.95%	-1.55%
ELMI+	-0.56%	-6.03%	-5.65%	2.76%	-1.05%
EM FX Spot	-0.65%	-10.42%	-12.31%	-2.20%	-7.29%
EMBI GD	-0.33%	-4.80%	-4.26%	4.94%	5.58%
EMBI GD IG	-0.55%	-2.57%	-2.41%	4.25%	5.09%
EMBI GD HY	-0.10%	-7.15%	-6.26%	5.72%	6.03%
CEMBI BD	-0.13%	-2.66%	-2.02%	4.58%	4.98%
CEMBI BD IG	-0.21%	-1.11%	-1.05%	3.48%	4.62%
CEMBI BD Non-IG	-0.04%	-4.52%	-3.09%	6.48%	5.46%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	-0.98%	8.86%	18.76%	16.66%	13.95%
1-3yr UST	-0.10%	0.27%	-0.29%	0.45%	0.64%
3-5yr UST	-0.28%	-0.66%	-2.07%	0.40%	1.30%
7-10yr UST	-0.60%	-2.04%	-4.11%	0.28%	2.47%
10yr+ UST	-1.54%	-4.41%	-5.15%	1.40%	5.33%
10yr+ Germany	-0.89%	3.42%	1.70%	3.25%	6.99%
10yr+ Japan	0.09%	-0.04%	0.02%	3.68%	4.58%
US HY	-0.13%	1.86%	3.02%	6.87%	5.60%
European HY	-0.27%	-0.09%	0.97%	4.78%	5.76%
Barclays Ag	-0.43%	-1.94%	-2.74%	2.17%	1.38%
VIX Index*	13.37%	32.07%	20.30%	-40.17%	0.34%
DXY Index*	0.23%	3.51%	4.38%	-0.10%	16.54%
CRY Index*	-1.11%	-1.58%	5.32%	-3.64%	-34.22%
EURUSD	-0.26%	-3.61%	-3.19%	2.59%	-12.78%
USDJPY	0.06%	-1.41%	1.56%	-7.89%	10.67%
Brent	-0.25%	15.49%	43.60%	57.97%	-30.58%
Gold spot	-0.77%	-8.51%	-10.21%	7.31%	-12.61%

*VIX Index = Chicago Board Options Exchange SPX Volatility Index. *DXY Index = The Dollar Index. *CRY Index = Thomson Reuters / CoreCommodity CRM Commodity Index.

Source: Bloomberg, JP Morgan, Barclays, Merrill Lynch, Chicago Board Options Exchange, Thomson Reuters, MSCI, total returns.

Figures for more than one year are annualised other than in the case of currencies, commodities and the VIX, DXY and CRY which are shown as percentage change.

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