No signs of rising inflation in EM so far

By Gustavo Medeiros

Inflation remains subdued in Emerging Markets (EM) despite rising inflation expectations in Developed Markets (DMs). In Ecuador the market-friendly presidential candidate from Guayaquil, Guillermo Lasso, will most likely face a run-off against Andrez Arauz on 7 April. The Brazilian congress approved the Central Bank Autonomy Law. Total social financing in China was stronger than expected. Goldilocks in India. The Colombian president unveiled a tax reform bill. Argentina's inflation rate rose on a sequential basis in January. Mexico's central bank cut the policy rate to 4.0%. Nigeria raised the debt ceiling and devalued the currency. Egypt issued USD 3.75bn in new bonds across three tranches, paying the lowest interest rates in five years. Uruguay kept the main policy rate unchanged at 4.5%.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	14.6	–	2.41%
MSCI EM Small Cap	11.7	–	2.42%
MSCI Frontier	10.5	–	-0.58%
MSCI Asia	15.9	–	2.54%
Shanghai Composite	12.6	–	3.92%
Hong Kong Hang Seng	9.5	–	2.74%
MSCI EMEA	10.1	–	2.70%
MSCI Latam	11.6	–	0.29%
GBI-EM-GD	4.32%	–	0.59%
ELMI+	1.98%	–	0.75%
EM FX spot	–	–	0.72%
EMBI GD	4.72%	343 bps	-0.32%
EMBI GD IG	2.94%	158 bps	-0.04%
EMBI GD HY	7.03%	580 bps	-0.64%
CEMBI BD	4.12%	313 bps	0.21%
CEMBI BD IG	2.87%	189 bps	0.04%
CEMBI BD Non-IG	5.80%	481 bps	0.43%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	20.0	–	1.28%
1-3yr UST	0.11%	–	-0.01%
3-5yr UST	0.49%	–	-0.04%
7-10yr UST	1.21%	–	-0.05%
10yr+ UST	2.01%	–	-0.58%
10yr+ Germany	-0.43%	–	-0.78%
10yr+ Japan	0.00%	–	-0.21%
US HY	3.96%	323 bps	0.30%
European HY	3.22%	378 bps	0.12%
Barclays Ag	0.93%	-28 bps	0.29%
VIX Index*	19.97	–	-0.90%
DXY Index*	90.30	–	-0.63%
EURUSD	1.2140	–	0.75%
USDJPY	105.10	–	-0.12%
CRY Index*	185.29	–	3.90%
Brent	63.6	–	5.05%
Gold spot	1823	–	-0.43%

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

Emerging Markets

- **Inflation:** The rapid fiscal and monetary expansions across the Developed Markets (DMs) in 2020 and so far in 2021 as well are leading to rising concerns about price stability with several indicators pointing to higher inflation over the next few quarters. The US monetary base as measured by M2 expanded at a yoy rate of 25.8% in January. Commodity prices measured by the Refinitiv Core Commodity Index are 6.5% higher than a year ago, but no less than 71% higher than at the lows on 28 April 2020, which implies potentially serious yoy inflationary pressures from base effects. The cost of shipping is also higher and there are signs of shortages building in the semiconductor industry as the US auto industry asks the US government to speak directly with the Taiwanese government to improve access to chips. The rate of consumer prices index (CPI) inflation in Europe has already risen significantly. Inflation in the US has yet to rise after CPI inflation surprised to the downside this month, but break-even inflation as priced by 2-year US inflation linked bonds increased to 2.62% last week, which is the highest rate of inflation since April 2011. Against this backdrop of rising inflation risks in DMs, how is Emerging Markets (EM) inflation faring?

  So far, there are no signs of widespread inflation across EM. The yoy rate of CPI inflation rate was stable at 2.3% in January 2021, which is broadly unchanged for the fourth consecutive month. In spite of stable inflation, the nominal yields on local currency bonds measured by the JP Morgan GBI-EM Global Diversified rose 5bps to 4.27%, thereby lifting the real index yield in EM to 1.95% in January 2021 from 1.91% in the previous month. In comparison, the real yield for 5-year US inflation linked bonds declined to -1.93% last week, which is the lowest level on record. As DM central banks vow to keep policy rates unchanged despite rising inflationary pressures, the weak Dollar trend is likely to continue, leading to stronger EM currencies, in our view.

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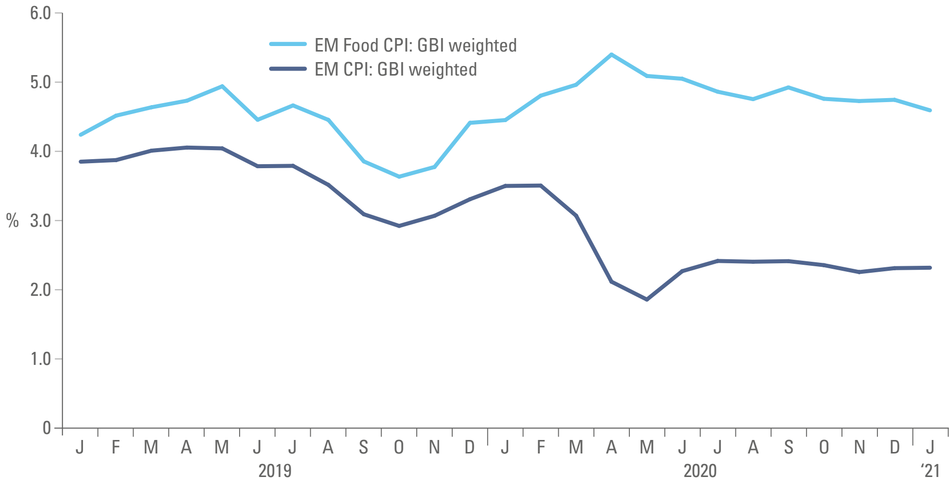
Emerging Markets

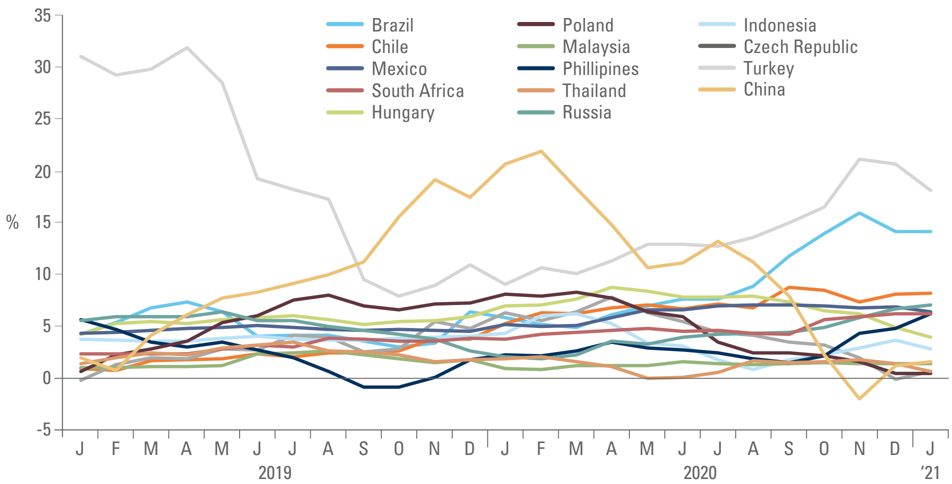
It is also noteworthy that there is no evidence of widespread inflationary pressure coming through in food prices in EM countries. Food inflation is always of particular concern as it threatens social stability by pushing up inequality and, depending on the macroeconomic environment, may also bring about pass-through inflation to the services sector, thus forcing central banks to react. The good news is that EM food price inflation actually declined to a yoy rate of 4.6% in January 2021 from 5.4% in March 2020, as per Figure 1. While food inflation is generally low in most countries, there are a few notable outliers. Figure 2 shows that food inflation is running at double-digit levels in Turkey and Brazil and has been increasing in Russia, Philippines as well as Peru. On the other hand, the one-off spike in inflation coming from pork prices in China as the swine flu outbreak is now over, lead to a collapse in food price inflation in China. There is also subdued inflation across Asia and Eastern Europe, helping to keep the overall EM food inflation index anchored. We believe the few instances of inflationary pressure across EM are temporary and that most central banks will look through them. Higher commodity prices should enable EM countries in Latin America to allow their currencies to strengthen against the Dollar, which should reduce the prices of commodities in local currency terms.

Fig 1: **EM CPI inflation weighted by the JP Morgan GBI EM GD Index (% change, yoy)**



Source: Ashmore, Bloomberg. Data as at 31 January 2021.

Fig 1: **EM food inflation – selected countries (% change, yoy)**



Source: Ashmore, Bloomberg. Data as at 31 January 2021.

- Ecuador: Andres Arauz, the candidate supported by former President Rafael Correa, will most likely face the market-friendly candidate Guillermo Lasso in the second round of the presidential election on 7 April. With 99.7% of the votes counted, Arauz has secured 32.7% of the votes followed by Lasso with 19.7%. Indigenous candidate Yaku Perez is in third with 19.4% of the votes cast, while Xavier Hervas is fourth with 15.7%. Hervas, a businessman from Guayaquil with no previous political experience, has called for an election alliance between Lasso, Perez and himself to defeat Arauz. Perez and Lasso both supported a broad recount of votes to eliminate any doubt about the result, thereby reducing the risk of disruption from indigenous communities. The legislative election outcome pointed to a fragmented parliament with a leftist bias as three coalitions to the left of the political spectrum, namely Union por la Esperanza (Arauz), Pachakutik (Perez) and Izquierda Democratica received 31.6%, 17.4% and 12.2% of the votes, respectively. This compares to just 9.7% for Lasso's Creando Oportunidades.

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- Brazil: Congress approved the Central Bank Autonomy Bill, which staggers the periods of the mandates of central bank directors with respect to parliamentary and presidential elections. The bill also mandates the monetary authority to focus its efforts primarily on achieving the inflation target. The bill gives more checks and balances against potential future political interference in monetary policy. In other political news, local newspaper O Estado de Sao Paulo reported that the Bolsonaro Administration and Congress are in advanced negotiations to extend emergency income transfers of BRL 250 per person by four months starting in March at a total cost of BRL 30bn. The economic team is working to fund the project by reducing expenditures in other line items in the budget, which requires a constitutional amendment. Cutting the size of mandatory expenditures in other areas of the budget will enable the government to comply with the expenditure ceiling until 2026. In economic news, the yoy rate of CPI inflation rose 4bps to 4.6%, which was in line with consensus expectations. Services output declined 0.2% in December, and is down 3.3% on a yoy basis. In corporate news, Petrobras, the state oil company, increased diesel and gasoline prices by 6% and 8%, respectively. The company also announced the sale of a refinery to Abu Dhabi's Mubadala for USD 1.65bn. Breaking up the company's monopoly over refining in turn reduces Petrobras' control over domestic fuel prices, which in turn means a lower risk of political interference in the company's operations.

- China: Total social financing (TSF) in China rose to RMB 5.2tn, which was higher than the consensus expectation of RMB 4.6tn. TSF is rising a yoy rate of 13%, while the yoy pace of growth of the broad monetary aggregate M2 slowed by 0.7% to 9.4%. TSF was buoyed by loans to households, which jumped to RMB 1.3tn in January from RMB 564bn in December and undiscounted bankers' acceptances, which went from RMB -222bn to RMB +490bn. The Bank of International Settlements said the Chinese household debt-to-GDP ratio hit 59.1% in June 2020, which is similar to levels in the Eurozone and Japan. However, in China about 20% of household debt is operational loans for small businesses, wherefore the true household leverage ratio is closer to 46% of GDP. In other news, the yoy rate of the producer price index (PPI) inflation rose to 0.3% in January from -0.4% yoy in December. This is the first return to positive readings in a year. However, CPI inflation declined to -0.3% yoy in January from +0.2% yoy in December.

- India: The yoy rate of CPI inflation declined to 4.1% in January from 4.6% yoy in December, coming 30bps lower than consensus expectations. Core CPI inflation was unchanged at 5.5% yoy in January, while the wholesale price index rose 0.5% to a yoy rate of 2.0% in January with manufacturing product price gains outpacing lower food prices. Industrial production (IP) rose 1.0% on a yoy basis in December from -2.1% in November, thereby surprising consensus expectations to the upside. The combination of improving economic activity and declining inflation is the sweet spot in macroeconomic terms often dubbed 'Goldilocks'.

- Colombia: The government announced a tax reform to raise around 1.5% of GDP in revenues. President Iván Duque Marquez said higher taxes would be coupled with direct assistance to poor households in order to sweeten the bill. The reform seems to incorporate a broadening of the VAT base and a lower income tax threshold both of which will be challenging politically. The yoy rate of CPI inflation was unchanged at 1.6% in January. Some increase in food prices was compensated by significantly lower core CPI inflation which declined 0.1% to 0.9% yoy in January.

- Argentina: CPI inflation was 4.0% in the month of January, or 38.5% on a yoy basis, which is unchanged from the previous month. After raising the tax rate on exporters and the wealthiest part of the population, the government said it would cut income taxes for 1.2m workers in the formal sector. The government also met with businesses and unions to agree on a cap on prices and wages in an attempt to control inflation. The measures are likely to increase economic distortions and will likely not have a permanent effect on inflation rates.

- Mexico: The yoy rate of CPI inflation rose 9bps in January to 3.54%. However, but the rate of inflation in the last 15 days of January was 19bps above consensus expectations at 3.74%, so this points to the emergence of a pattern of sequential increase in prices. The Central Bank of Mexico said that the higher inflation rate was consistent with its own forecast and cut the benchmark policy rate by 25bps to 4.0%, which was in line with consensus expectations.

- Nigeria: The government raised the borrowing limit for the 2020-2023 period to 40% of GDP from 25% previously. The domestic/external debt ratio was also increased to 70%/30% from 60%/40% previously. The debt level may appear modest at first sight, but Nigeria only raises about 10% of GDP in taxes, so Nigeria's ability to service debt will be lower at the new higher levels of debt. In other news, the central bank weakened the exchange rate to NGN 401 per Dollar from NGN 393 per Dollar.

- Egypt: The government issued USD 3.75bn in new Eurobonds across three benchmarks with 5, 10 and 40 years maturity at 3.875%, 5.875% and 7.50%, respectively. These are the lowest yields for new issuance in Egypt since 2015. In positive fiscal news, Finance Minister Mohamed Maait said Egypt's primary surplus rose to EGP 18.1bn in the seven first months of the 2020-21 budget year, which took the overall fiscal deficit to 4.4% of GDP. In other news, the yoy rate of CPI inflation declined to 4.3% in January from 5.4% yoy in December, thus bringing inflation below the lower limit of the central bank's inflation target range of 5.0% to 9.0%.

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Emerging Markets

- **Uruguay:** The Central Bank of Uruguay (CBU) left the policy rate unchanged at 4.5% following lower than expected inflation in January. In comments following the rate decision, the board mentioned inflation expectations for companies for the first time. Corporates in Uruguay expect 9.0% inflation over the next 12 months, which is higher than CBU's own survey finding of 7.4% as well as the ceiling of the central bank's inflation target of 7.0%.

Snippets:

- **Benin:** The rating agency Fitch kept Benin's sovereign credit rating at 'B', but improved the outlook to positive from stable after the re-opening of the country's border with Nigeria.
- **Chile:** The yoy rate of CPI inflation rose to 3.1% in January from 3.0% in December, surprising consensus expectations to the upside for the second consecutive month.
- **Czech Republic:** The yoy rate of CPI inflation rose to 1.3% in January from -0.2% in December, thereby surprising to the upside relative to consensus expectations. In yoy terms, the inflation rate declined to 2.2% from 2.3% over the same period.
- **Ethiopia:** Fitch downgraded Ethiopia's sovereign credit rating to 'CCC' after the country said it would consider joining the G-20 debt initiative. For a discussion of the G-20 debt framework see: *'The well-meaning misguided G20 proposal'* Market Commentary, 7 May 2020.
- **Ghana:** The yoy rate of CPI inflation dropped to 9.9% in January from 10.4% yoy in December, mainly driven by lower food prices inflation.
- **Malaysia:** IP rose 1.7% in December, surprising expectations to the upside. However, Q4 2020 GDP contracted 3.4% on a yoy basis, down from 2.6% yoy in Q3 2020. The balance of payment moved to an overall deficit of USD 0.7bn in Q4 2020 as the USD 4.6bn current account surplus was offset by a large USD 2.6bn deficit in errors & omissions and a USD 2.6bn outflow in the financial account.
- **Peru:** The Central Bank of Peru kept its policy rate unchanged at 0.25% in line with consensus expectations.
- **Philippines:** The Central Bank of the Philippines (CBP) kept its policy rate unchanged at 2.0%, in spite of a higher 2021 inflation forecast of 4.0%, which matches the ceiling of the CBP's 2.0% to 4.0% inflation target band.
- **Poland:** Real GDP growth contracted by 0.7% in Q4 2020 bringing the yoy rate to -2.8% from -1.5% in Q3 2020.
- **Russia:** Rating agency Fitch affirmed Russia's sovereign credit rating at 'BBB' with a stable outlook. The Central Bank of Russia kept the policy rate unchanged at 4.25% in line with consensus expectations.
- **Rwanda:** The government increased its 2021-22 spending target by 6.3% to USD 3.4bn (c. 30% of GDP). The World Bank committed USD 500m to support the country's covid-19 recovery plan.
- **Sri Lanka:** Sri Lanka repaid a USD 400m swap line with the Reserve Bank of India, because the swap line was conditional upon an agreement with the International Monetary Fund (IMF), which does not appear to be forthcoming. Foreign exchange reserves declined to USD 4.8bn in January from 5.7bn in December 2020 and USD 8.9bn in June 2019.
- **Zambia:** The IMF started virtual talks with Zambia. Talks are expected to last until 3 March.

Global backdrop

- **Coronavirus:** The number of new global coronavirus cases and new deaths worldwide continue to decline. A global vaccine tracker published by UBS monitors the percentage of the population that is likely to be inoculated by the end of 2021 based on the current pace of vaccinations. DM economies are on track to vaccinate 41.8% of its population by the end of 2021, up from 37.5% last week while EM moved to 9.9% from 4.5% last week. EM has the potential to catch up much faster once supply bottlenecks are resolved. In Chile, the vaccination pace in the first week of February suggested that Chile would only have inoculated 9% of its population by the end of 2021, but after receiving an additional 4m doses of the Sinovac vaccine, the pace of vaccination rose to about 10% of its population per month. The World Health Organisation (WHO) said in a briefing that the covid-19 coronavirus was most likely transmitted through an animal intermediary or via cold-chain food products, dismissing speculation that the pandemic was due to a virus 'made' by China.

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Global backdrop

- **United States (US):** The Congressional Budget Office (CBO) issued a report, which puts the US ratio of debt/GDP at 102.3% at the end of 2021 compared to 100.1% at the end of 2020.[1] CBO's estimate does not include US President Joe Biden's additional fiscal package of USD 1.9tn (c. 8.8% of GDP). This additional fiscal stimulus could take the debt/GDP ratio to 106.4%, based on a 0.5x multiplier or 111% of GDP with a zero multiplier. CBO also released estimates for the output gap in the US economy of USD 380bn in 2021 and USD 760bn in the period from 2021 to 2023.[2] Former Treasury Secretary Larry Summers argues that the proposed stimulus of USD 1.9tn is too large, given the expected output gap and could therefore increase the risk of both inflation and bubbles. Summers' arguments are legitimate, in our view. An overheating economy would likely be accompanied by loose monetary policy due to the very large debt burden. This combination would de-anchor inflation expectations and lead to a weaker USD, in our view. On the other hand, if the Fed decided to react to rising inflation by hiking rates aggressively the recovery could easily be derailed.

In economic news, US activity data mostly surprised to the downside taking the Citibank surprise index down to 53.5 from 71.2 in the previous week. The yoy rate of CPI inflation was unchanged at 1.4% in January while Core CPI declined to 1.4% from 1.6% in December, both slightly below consensus expectations. Initial jobless claims declined to 793k in the week ending in 6 February from 812k in the previous week and continuing claims declined to 4.5m in the week ending in 30 January from 4.7m in the previous week. The University of Michigan consumer confidence index declined to 76.2 in the first preview of February, from 79.0 in January and mortgage applications declined 4.1% in the week ending in 5 February from +8.1% in the previous week. In external accounts, the December trade deficit narrowed to USD 66.6bn from USD 69bn in November on weaker domestic demand. One of the few positive data points was Bank of America credit card spending, which rose 9.7% on a yoy basis in the week ending in 6 February.

- **European Union (EU):** Former President of the European Central Bank and newly appointed Prime Minister Mario Draghi won the support of a broad coalition in Italy's parliament. Germany decided to extend its lockdown by four weeks to 7 March in spite of big declines in the incidence of coronavirus cases. Cases per million have dropped from a peak of 307 cases on 23 December to 100 as of 10 February.

- **United Kingdom:** The real rate of GDP growth was by 1% in Q4 2020. This took growth rate for 2020 to -9.9%, which is the biggest collapse in economic growth since the Great Frost of 1709.

Benchmark performance

Emerging Markets	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
MSCI EM	7.49%	10.70%	10.70%	31.98%	10.35%	18.11%
MSCI EM Small Cap	7.21%	7.30%	7.30%	30.34%	5.86%	12.74%
MSCI Frontier	1.57%	1.96%	1.96%	5.54%	0.36%	7.91%
MSCI Asia	7.66%	11.95%	11.95%	39.74%	13.21%	19.45%
Shanghai Composite	4.94%	5.24%	5.24%	29.43%	7.83%	8.12%
Hong Kong Hang Seng	5.99%	10.64%	10.64%	14.28%	3.88%	13.57%
MSCI EMEA	5.25%	6.43%	6.43%	3.33%	-0.80%	9.75%
MSCI Latam	5.84%	-1.27%	-1.27%	-11.55%	-3.46%	10.72%
GBI EM GD	0.91%	-0.17%	-0.17%	3.41%	2.11%	6.46%
ELMI+	0.89%	0.31%	0.31%	3.24%	0.74%	3.92%
EM FX Spot	0.93%	-0.05%	-0.05%	-2.68%	-5.07%	-1.35%
EMBI GD	0.23%	-0.86%	-0.86%	2.48%	5.61%	7.06%
EMBI GD IG	-0.33%	-1.56%	-1.56%	4.63%	7.91%	7.18%
EMBI GD HY	0.88%	-0.04%	-0.04%	-0.33%	3.05%	6.88%
CEMBI BD	0.55%	0.49%	0.49%	5.55%	6.56%	7.30%
CEMBI BD IG	0.12%	-0.02%	-0.02%	5.48%	6.81%	6.16%
CEMBI BD Non-IG	1.14%	1.17%	1.17%	5.55%	6.22%	9.15%

[1] See https://www.cbo.gov/publication/56991
[2] See http://www.crfb.org/blogs/america-faces-380-billion-output-gap#:~:text=In%20the%20interim%2C%20CBO%20estimates,potential%20through%202023%2C%20on%20net.

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Benchmark performance

Global Backdrop	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
S&P 500	6.01%	4.93%	4.93%	18.55%	16.18%	18.39%
1-3yr UST	-0.01%	0.02%	0.02%	2.77%	2.85%	1.76%
3-5yr UST	-0.13%	-0.25%	-0.25%	4.84%	4.55%	2.53%
7-10yr UST	-0.68%	-1.76%	-1.76%	5.50%	6.85%	3.20%
10yr+ UST	-3.02%	-6.52%	-6.52%	4.32%	9.79%	4.68%
10yr+ Germany	-2.27%	-3.54%	-3.54%	1.32%	7.65%	3.66%
10yr+ Japan	-0.18%	-0.74%	-0.74%	-3.08%	1.36%	1.93%
US HY	1.01%	1.34%	1.34%	7.42%	7.04%	9.90%
European HY	0.89%	1.43%	1.43%	2.64%	3.50%	5.81%
Barclays Ag	-0.45%	-1.32%	-1.32%	7.35%	4.36%	3.81%
VIX Index*	-39.65%	-12.22%	-12.22%	45.98%	4.39%	-21.38%
DXY Index*	-0.31%	0.41%	0.41%	-8.90%	1.93%	-5.87%
CRY Index*	6.36%	10.42%	10.42%	7.13%	-4.22%	15.54%
EURUSD	0.03%	-0.63%	-0.63%	12.03%	-2.93%	8.82%
USDJPY	0.40%	1.79%	1.79%	-4.35%	-0.97%	-8.29%
Brent	13.85%	22.82%	22.82%	10.99%	-1.10%	90.54%
Gold spot	-1.34%	-3.97%	-3.97%	15.29%	34.66%	50.74%

*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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