US inflation running higher than EM inflation

By Gustavo Medeiros

Emerging Markets (EM) inflation is increasing at a lesser rate than feared, while United States (US) inflation is rising faster than expected. Chile adopted another lockdown in Santiago as still unvaccinated younger members of the population remain vulnerable to Coronavirus. In Peru, Pedro Castillo won the presidential election run-off by a razor-thin margin and his opponent, Keiko Fujimori, disputed the result. China's relationship with the US improved. Brazilian economic data surprised to the upside, leading to expectations of a lower debt to GDP ratio in 2021. Turkey's president will meet with his US counterparty today at a North Atlantic Treaty Organisation (NATO) meeting. Mexico's president moved his finance minister to Central Bank Governor and appointed an old ally as the country's new minister of finance.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	13.4	–	0.08%
MSCI EM Small Cap	12.3	–	1.19%
MSCI Frontier	11.6	–	0.45%
MSCI Asia	14.6	–	0.16%
Shanghai Composite	11.8	–	0.02%
Hong Kong Hang Seng	9.9	–	-0.33%
MSCI EMEA	10.3	–	-0.09%
MSCI Latam	10.9	–	-0.72%
GBI-EM-GD	4.92%	–	0.13%
China GBI-EM GD	3.20%	–	0.18%
ELMI+	2.26%	–	0.29%
EM FX spot	–	–	-0.03%
EMBI GD	4.82%	328 bps	0.96%
EMBI GD IG	3.18%	159 bps	0.97%
EMBI GD HY	6.90%	542 bps	0.96%
CEMBI BD	4.24%	298 bps	0.45%
CEMBI BD IG	3.03%	177 bps	0.44%
CEMBI BD HY	5.84%	458 bps	0.47%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	20.2	–	0.43%
1-3yr UST	0.15%	–	0.01%
3-5yr UST	0.75%	–	0.11%
7-10yr UST	1.46%	–	0.76%
10yr+ UST	2.15%	–	1.62%
10yr+ Germany	-0.27%	–	1.02%
10yr+ Japan	0.66%	–	0.78%
US HY	3.88%	290 bps	0.50%
European HY	2.91%	335 bps	0.35%
Bloomberg-Barclays	1.08%	-38 bps	0.29%
VIX Index*	15.65	–	-0.77%
DXY Index*	90.54	–	0.59%
EURUSD	1.210	–	-0.72%
USDJPY	109.75	–	0.46%
CRY Index*	212.2	–	1.95%
Brent	73.0	–	2.13%
Gold	1,864	–	-1.84%
Bitcoin	39,309	–	7.97%

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

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- EM inflation versus DM inflation

EM inflation rose by much less than feared in May. Consumer prices index (CPI) inflation as weighted by JP Morgan's GBI-EM GD, an index of local bonds markets, rose to 4.3% in May from 4.1% in April, which is only modestly above the declining trend line for EM inflation over the past 18 years as shown in Figure 1.[1]

Last week inflation surprised to the upside in Brazil and the Dominican Republic, but was relatively well-behaved across various other EMs, declining outright in the Czech Republic, Mexico, and the United Arab Emirates (UAE) as illustrated in Figure 2. US CPI inflation is now running higher than EM inflation, which is unprecedented.

[1] At the publication date, May CPI inflation was available in most countries including Brazil, Chile, Colombia, Dominican Republic, China, Czech Republic, Egypt, Hungary, Indonesia, Mexico, Peru, Philippines, Poland, Romania, Russia, Slovakia, Thailand, Turkey and Uruguay. Inflation was not published in Malaysia and South Africa where we assumed inflation would be stable and 30bps higher in May, respectively.

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Fig 1: **GBI EM GD weighted CPI inflation**

Source: JP Morgan, Bloomberg, Ashmore. Data as at May 2021.

Fig 2: **Last week's CPI inflation across EM (%)**

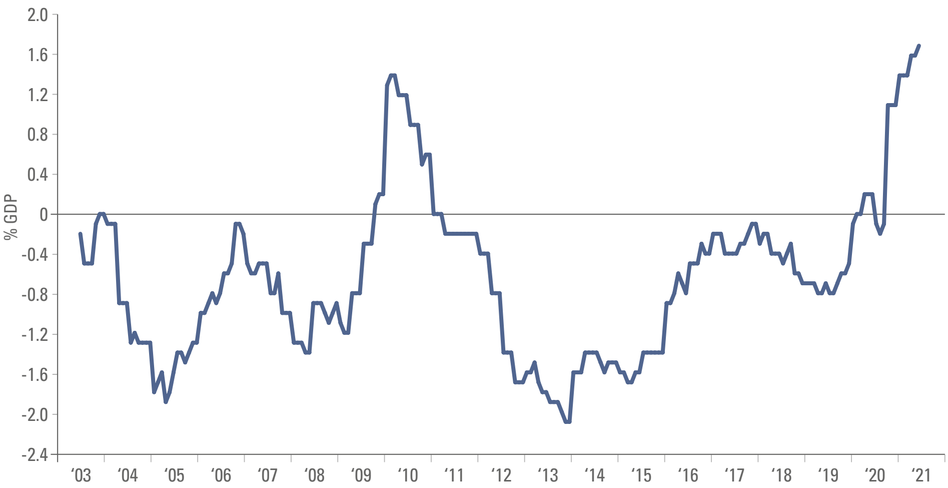
Country	May	April	Change
Brazil	8.1	6.8	1.3
Chile	3.6	3.3	0.3
China	1.3	0.9	0.4
Czech Republic	2.9	3.1	-0.2
Dominican Republic	9.7	8.3	1.4
Egypt	4.8	4.1	0.7
Greece	0.1	-0.3	0.4
Hungary	5.1	5.1	0.0
Mexico	5.9	6.1	-0.2
Romania	3.2	3.1	0.2
Russia	6	5.5	0.5
Taiwan	2.5	2.1	0.4
United Arab Emirates	-2.0	-1.9	-0.2

Source: Bloomberg, Ashmore. Data as at May 2021.

- **EM real yields versus DM real yields:** Given recent inflation prints, the ex-post real interest rate (measured as the yield to maturity minus inflation over the past twelve months) in EM local bond markets declined to 0.6% in May. This is the lowest real yield since the beginning of the series. Higher recent inflation prints have also pushed the median expectation for EM CPI inflation in 2021 marginally higher to 3.7% on a yoy basis, so the *ex-ante* real interest rate (measured as the yield to maturity minus 2021 expected inflation) dropped to 1.2%. Still, this renders EM local bonds highly attractive relative to US or German bonds. The real interest rates on US and German 5-year bonds measured as yields to maturity less inflation are currently -4.3% and -2.1%, respectively.

- **EM external accounts:** EM external accounts continued their improvement in Q1 2021. The GBI-EM GD weighted current account surplus in Q1 2021 reached the highest level on record at 1.7% of GDP in May, up from 1.6% in April. Figure 3 shows how the EM current account balance has swung from a deficit of close to 0.8% in the same period of 2019 to the record large surplus of today. The positive balance on the current account stands in contrast with low foreign participation in local markets, which is a positive technical backdrop ensuring the fallout from any global instability should prove relatively limited.

Fig 3: **GBI EM GD weighted EM Current Account**



Source: Bloomberg, Ashmore. Data as at May 2021.

- **Monetary policies in EM versus DMs: Hawks versus doves**

EM central banks remain committed to anchoring inflation expectations, which bodes well for price stability and the performance of EM currencies. Last week the Russian Central Bank hiked its policy rate by 50bps to 5.5% and signalled more hikes in the future. The Central Bank of Chile kept its policy rate unchanged at 0.5%, but signalled that rate hikes going forward are likely. This week the Brazilian Central Bank is likely to hike its policy rate by another 75bps to 4.25%, in our view. The Turkish Central Bank would do well to avoid reacting to political

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pressure and keep it policy rates unchanged at 19.0% as inflation appears to have peaked in April, but remains elevated. Indonesia and Taiwan are likely to keep their policy rate unchanged at 3.5% and 1.125%, respectively in the absence of serious inflationary pressures in either country. Finally, the People's Bank of China (PBoC) kept its policy rate high throughout the pandemic as the Chinese authorities placed greater emphasis on targeted fiscal and credit stimuli, leading to more stable macroeconomic dynamics, including a stronger Renminbi. The relatively hawkish stance adopted by EM central banks contrasts sharply with the very accommodative postures adopted by the Federal Reserve (Fed) and the European Central Bank (ECB). Last week the ECB kept its asset-purchasing programme unchanged as ECB President Christine Lagarde said any changes in the pandemic emergency purchase programme (PEPP) would be premature.

- US inflation and US Treasury bonds

US CPI inflation surprised to the upside at a yoy rate of 5.0% in May from 4.2% yoy in April, while core CPI inflation rose to 3.8% yoy from 3.0% yoy over the same period. Both rates were 0.3% higher than median consensus expectations. Higher than expected US inflation was a distinct possibility given recent hefty increases in commodity prices and disruptions in supply chains. In spite of the higher than expected US inflation print, the yield on the 10-year US Treasury bond (UST) dropped by 10bps to 1.45%. The main reasons behind the strong performance of US bonds in the face of higher inflation are:

- Recent US labour market data has been weaker than expected.
- Some investors unwound 'short' (i.e. paying rates) positions in US rates.
- The US Treasury issued less debt than in the previous quarters as the US government is spending close to USD 1trn of cash accumulated in 2020, while the Fed continued to buy bonds and mortgage-backed securities to the tune of USD 80bn and USD 40bn per month, respectively.
- Foreign investors continue to receive fixed rates due to the higher relative carry relative to other DM bonds on a currency-hedged basis.
- Talks over the Biden Administration's infrastructure plans were frustrated.
- Investors rightly or wrongly continue to have faith in the Fed's argument that inflation is temporary.

It remains to seen whether the recent spike inflation is temporary. Price increases in some areas such as used cars and some specific services may prove temporary, but price increases in the majority of goods and services may not reverse without a strong slowdown in economic activity. The key prices to watch are wages. The US government has encouraged higher wages via direct income transfers, higher minimum wages, and explicit calls for companies to pay their staff higher salaries. The labour market remains imbalanced. Last week the job openings and labour turnover survey (JOLTS) registered 9.3m job openings in April compared to 8.3m in March. This is the highest level of job openings since the beginning of the series. The JOLTS data contrasts sharply with the non-farm payroll data, which showed lower hiring in the past two months. The distortions in the labour market are likely to persist until the end of September, when the current programme of monthly US government income checks expires. Other than labour markets, price impulses are coming from commodity prices, which are up 3.2% month-to-date. Supply chain disruptions in a number of sectors are now deemed to be such a big problem that the Biden Administration last week launched a plan to deal with shortages (see section on United States below). Elevated inflation is currently keeping real interest rates at extremely low levels, which should keep the Dollar under pressure too, a positive background for EM currencies, in our view.

- Chile: The government placed central Santiago and surrounding municipalities into full lockdown after occupation of intensive care unit (ICU) hospital beds rose to fresh highs. The lockdown in Santiago has led to questions about the effectiveness of the Chinese-made Coronavac vaccine. After all, Chile has vaccinated a larger proportion of its population than the US and United Kingdom (UK). However, a closer look at the data reveals that most of the serious cases and fatalities are happening among the younger segments of the population, which are yet to receive the vaccine. The data also shows that the Chinese vaccines appears to offer excellent protection for fully vaccinated individuals. In other Chilean policy news, a new bill proposed by opposition parliamentarians to increase royalties for mining companies would reduce the internal rate of return on existing mining assets to below the cost of capital, even with copper prices 10% higher than at current levels. The government is trying to have the bill amended, since it would be very damaging for the very important mining industry. In economic news, the yoy rate of core CPI inflation rose to 3.1% yoy in May from 2.8% yoy in April, slightly below consensus expectations. Wage inflation is picking up with the yoy rate of nominal wage growth rising to 5.8% in May from 4.3% in April. The trade surplus was better than expected at USD 1.3bn in May after USD 2.0bn in April. Over the last month, exports declined marginally and imports rose.

- Peru: Presidential candidate Keiko Fujimori claimed the presidential run-off was fraudulent after she lost the election by only 50k votes (0.14% of the total votes). The Organisation of American States (OAS) said it found no evidence of serious irregularities. President-elect Pedro Castillo appointed Pedro Francke, a respected economist

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as his Finance Minister. The economic team issued a statement saying that the "economic plan has not considered nationalization, expropriation, confiscation of savings, price controls or import controls". This allowed Peruvian assets to stage a relief-rally towards the end of the week. In other news, the central bank kept its policy rate unchanged at 0.25% but dropped the commitment to keeping rates close to the 0% lower bound for a prolonged period.

- China: Commerce ministers from US and China "agreed to promote the healthy development of pragmatic cooperation in trade and investment" between the two countries. The bilateral relationship appears to be improving since the return of more pragmatic foreign policies under the Biden administration. In another display of pragmatism, US President Joe Biden revoked a ban on TikTok and WeChat last week. The tentative normalisation of bilateral relations is welcome news for the global economy, in our view, as key production chains are likely to remain centred in Asia for a long time.[2] In economic news, producer prices index (PPI) inflation in China rose to a yoy rate of 9.0% in May from 6.8% yoy in April, surprising to the upside in spite of a recent benign CPI inflation print (Figure 2). New Loans rose marginally to CNY 1.50trn in May from CNY 1.47trn in April, while aggregate financing improved to CNY 1.92trn from CNY 1.85trn over the same period. In pandemic-related news, the governments of Guangzhou and Shenzhen tightened controls after modest increases in Covid-19 cases.

- Brazil: Retail sales rose by 1.8% in April from -1.1% in March, above consensus expectations of -0.3%. Vehicle sales rose to 189k in May from 175k in April, slightly above average monthly sales over the same period in the previous five years. Higher than expected nominal economic growth and better than expected tax revenues last week prompted most economists to revise Brazil's ratio of net debt to GDP for the end of 2021 to 62.5% from 65.0% one month ago and 70.0% six months ago. The forecasts for net debt to GDP for the end of 2021 is now only 3.5% higher than the median forecast as of December 2019, indicating that the fiscal fallout from the pandemic has been relatively small after taking the business cycle into account. In other news, the governor of Sao Paulo state anticipated the vaccination calendar by 1 month and is targeting to have the adult population fully vaccinated by the end of September.

- Turkey: President Recep Tayyip Erdogan will meet US President Joe Biden at the NATO summit in Brussels today. TRY strengthened 4.0% last week on the back of an expected deal to end the dispute with the US sparked by Turkey's decision to purchase the Russian anti-missile S-400 defence system, which saw Turkey removed from the US-led F-35 fighter jet programme.

- Mexico: President Andres Manuel Lopez Obrador (AMLO) pledged to propose further constitutional changes despite his coalition's failure to obtain a two-thirds majority in the recently concluded mid-term parliamentary election. AMLO also said he is looking to maintain fiscal discipline. In other news, AMLO appointed an old ally, Ramirez de la O as Minister of Finance (MoF) as he moved former MoF Arturo Herrera to the post as governor at the Central Bank of Mexico (Banxico). The change in the Banxico may signal a more lenient stance on inflation, in our view. In economic news, industrial production (IP) rose at a yoy rate of 36.6% in April from 1.7% yoy in March, but remains 2.5% below pre-pandemic levels.

Snippets:

- Argentina: The yoy rate of IP rose 55.9% in April from 32.8% yoy in March, taking it to 12.5% above the level of December 2019. The yoy rate of construction activity surged at a yoy rate of 321.3% in April from 97.6% yoy in March, taking the construction index 25.6% higher than December 2019.
- Czech Republic: The yoy rate of retail sales rose 21.0% in April from 15.6% yoy in March, which was slightly lower than consensus expectations. Retail sales ex-autos slowed to a yoy rate of 7.5% from 9.2% yoy over the same period.
- Egypt: The yoy rate of core CPI inflation rose to 3.4% in May from 3.3% in April, still much lower than the central bank inflation target of 7% (+/- 2%).
- Hungary: IP dropped 3.2% in April from +0.1% in March, but still printed 59.2% growth in yoy terms from 16.2% yoy for the previous month. The fiscal deficit in the first 5 months of the year widened to HUF 1.3bn, which is nearly twice the average size of the fiscal deficit of HUF 528bn in the previous five years.
- India: The yoy rate of IP surged 134.4% in April from 24.1% in March, buoyed by base effects. In sequential terms, IP declined 13% mom in April due to the impact of the recent lockdown, bringing the index back to below pre-pandemic levels.
- Israel: Naftali Bennett is Israeli's Prime Minister in a coalition government involving parties across the political spectrum. Naftali worked as Chief of Staff to outgoing Benjamin Netanyahu, who leaves the top position in Israel after 12 years in power.

[2] See https://www.scmp.com/comment/opinion/article/3135941/production-shifts-china-asean-asias-supply-chains-remain-stronger

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- **Malaysia:** The yoy rate of IP rose 50.1% in April from 9.3% yoy in March due to base effects. In sequential terms, IP rose only 0.1% in April after a 2.2% drop in March, keeping IP marginally below the December 2019 levels.
- **Philippines:** The unemployment rate rose to 8.7% in April from 7.1% in March due to the second lockdown imposed by the country.
- **Romania:** The yoy rate of real GDP growth was unchanged at -0.2% in Q1 2021, in line with consensus expectations.
- **South Africa:** The current account surplus rose to 5.0% in Q1 2021 from 3.7% in Q4 2020, backed by a strong trade surplus equivalent to 8.0% of GDP.
- **South Korea:** The unemployment rate rose 10bps to 3.8% in May, slightly above consensus expectations.
- **Taiwan:** Exports rose 38.6% on a yoy basis in May, virtually unchanged from April, but higher than consensus expectations. The Wholesale Price Index (WPI) rose at a yoy rate of 11.3% in May from 10.3% yoy in April, but core CPI rose by only 1.6% yoy from 1.4% yoy over the same period.

Global backdrop

- **Coronavirus:** US President Joe Biden announced the US would distribute 500m vaccine doses to the World Health Organisation's Covid-19 Vaccines Global Access programme known as COVAX. The vaccines will go to low-income countries. This is welcome news, even if the measure comes very late. The US has hoarded 850m more vaccines than needed to inoculate its own adult population. Europe should follow suit as it has purchased 1bn vaccines in excess of needed. By contrast, China understood early that the world will not be safe until the majority of the global adult population has been inoculated. In this spirit, China has been distributing large quantities of vaccines to other developing countries at the same time that China has vaccinated its own population. Large DMs and EMs remain on track to vaccinate 78% of their populations by year-end, but the risk of mutations originating from low-income countries is likely to remain present throughout 2022 due to the West's short-sighted approach to vaccinations.

- **United States:** The average US pension plan was 98.3% funded in April, according to the Milliman 100 PFT funded ratio. The funded status has oscillated between 77.5% and 92.5% between 2016 and 2020.[3] Pension funds that achieve fully funded status are likely to come under pressure to sell equities and buy long dated fixed income in order to match their assets with existing liabilities. This could trigger important flows in US capital markets as US pension plans holds about USD 3.5tn of assets, around half of which is invested in (mostly US) equities. In other US news, the Biden Administration announced a task force to address supply chain disruptions in the semiconductor and advanced packaging markets plus pharmaceuticals and markets for critical minerals required in the production of advanced batteries.[4] The task force includes a working group that includes the Department of Agriculture and the Environmental Protection Agency to ensure that sites to produce and process critical minerals adhere to environmental, labour and sustainability standards. This policy implies a significantly expanded role for the government compared to previous administrations.

In other economic news, the University of Michigan sentiment survey rose to 86.4 in June from 82.9 in May, while the median 1-year ahead inflation expectation moderated to a yoy rate of 4.0% from 4.6% yoy over the same period. The 5-10 year inflation expectation also moderated. Mortgage applications declined another 3.1% in the week ending 4 June after a 4.0% decline in the previous week. Mortgage applications are now 34.2% below their peak on 29 January. Lower mortgage applications seem to be driven by higher house prices that may be undermining affordability. The 30-year mortgage rate is certainly no obstacle, given that it is sitting at 3.1%, which is close to the lowest historical level of 2.9% from late-January of this year. The decline in demand for mortgages illustrates how a period of high inflation can lead to declines in future aggregate demand unless wages do not adjust higher in line with the rises in other prices. The US trade deficit moderated to USD 68.9bn in April from 75.0bn in March, but remains elevated compared to the average deficit of USD 46.1bn in the month of April over the last 5 years. The budget deficit moderated to USD 132bn in May from USD 399bn in April.

[3] See https://www.milliman.com/en/insight/pension-funding-index-may-2021

[4] See https://www.whitehouse.gov/briefing-room/statements-releases/2021/06/08/fact-sheet-biden-harris-administration-announces-supply-chain-disruptions-task-force-to-address-short-term-supply-chain-discontinuities/

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Benchmark performance

Emerging Markets	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
MSCI EM	0.52%	5.44%	7.80%	42.38%	9.56%	13.92%
MSCI EM Small Cap	2.48%	11.44%	20.01%	64.69%	10.00%	12.18%
MSCI Frontier	1.60%	12.88%	13.79%	37.06%	5.92%	8.19%
MSCI Asia	-0.05%	3.70%	6.43%	41.87%	9.89%	15.05%
Shanghai Composite	-0.49%	4.71%	3.78%	25.72%	8.00%	6.54%
Hong Kong Hang Seng	-0.91%	-1.05%	1.11%	12.08%	-0.30%	8.29%
MSCI EMEA	1.65%	10.11%	19.06%	38.76%	6.06%	8.20%
MSCI Latam	3.38%	15.86%	9.75%	36.89%	5.22%	7.93%
GBI-EM-GD	0.79%	5.64%	-1.42%	6.80%	4.02%	4.17%
China GBI-EM GD	-0.71%	3.58%	3.89%	11.88%	–	–
ELMI+	0.23%	3.51%	0.85%	7.01%	1.98%	2.78%
EM FX spot	0.39%	3.86%	0.12%	4.02%	-3.03%	-2.30%
EMBI GD	1.27%	4.61%	-0.14%	9.11%	6.72%	5.32%
EMBI GD IG	1.11%	2.70%	-2.74%	3.79%	8.03%	5.39%
EMBI GD HY	1.44%	6.80%	2.89%	15.65%	5.21%	5.17%
CEMBI BD	0.64%	1.89%	1.08%	9.00%	7.37%	5.92%
CEMBI BD IG	0.61%	1.40%	-0.32%	5.63%	7.13%	5.05%
CEMBI BD HY	0.67%	2.55%	2.97%	13.77%	7.68%	7.23%

Global Backdrop	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
S&P 500	1.08%	7.21%	13.83%	43.71%	17.28%	17.38%
1-3yr UST	-0.02%	0.12%	0.07%	0.27%	2.83%	1.70%
3-5yr UST	0.11%	0.81%	-0.54%	-0.28%	4.50%	2.30%
7-10yr UST	0.96%	2.60%	-3.29%	-4.22%	6.23%	2.58%
10yr+ UST	2.18%	5.03%	-9.16%	-11.84%	8.23%	3.41%
10yr+ Germany	1.42%	-0.50%	-6.73%	-3.29%	5.16%	1.87%
10yr+ Japan	0.58%	0.96%	0.19%	-0.34%	1.18%	-0.08%
US HY	0.78%	2.17%	3.04%	14.17%	7.15%	7.34%
European HY	0.70%	1.72%	3.59%	12.67%	4.30%	4.54%
Bloomberg-Barclays Agg	0.16%	2.38%	-2.19%	3.30%	4.58%	2.73%
VIX Index*	-6.62%	-19.33%	-31.21%	-56.64%	29.13%	-23.66%
DXY Index*	0.57%	-2.88%	0.67%	-6.96%	-4.57%	-4.62%
CRY Index*	3.18%	14.75%	26.49%	58.01%	6.65%	10.43%
EURUSD	-1.02%	3.17%	-0.94%	6.88%	4.62%	7.99%
USDJPY	0.16%	-0.88%	6.30%	2.25%	-0.80%	3.44%
Brent	5.32%	14.90%	40.95%	88.51%	-3.86%	46.52%
Gold	-2.23%	9.17%	-1.79%	8.06%	43.15%	45.00%
Bitcoin	7.13%	-33.33%	35.56%	318.98%	490.33%	5,600.53%

*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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