Fixed Income Group research

Higher inflation is creating an opportunity in emerging markets

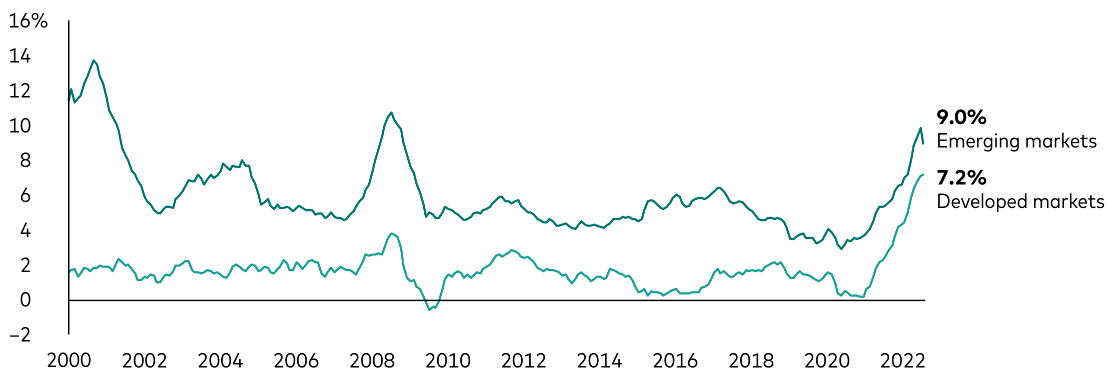
August 2022

Patient investors are likely to find a long runway for rates to rally in emerging markets (EM). Although we cannot call the top in EM inflation here, our analysis leaves us confident that we are close to it and that disinflation will create a good buying opportunity for EM rates.

EM inflation versus developed market (DM) inflation

DM inflation has converged toward EM inflation post 2020. The latest readings for July 2022 put the annualized rates of inflation at a blistering pace of 7.2% for DM and 9.0% for EM and the momentum remains strong.

Inflation has shot up to highs not seen in decades

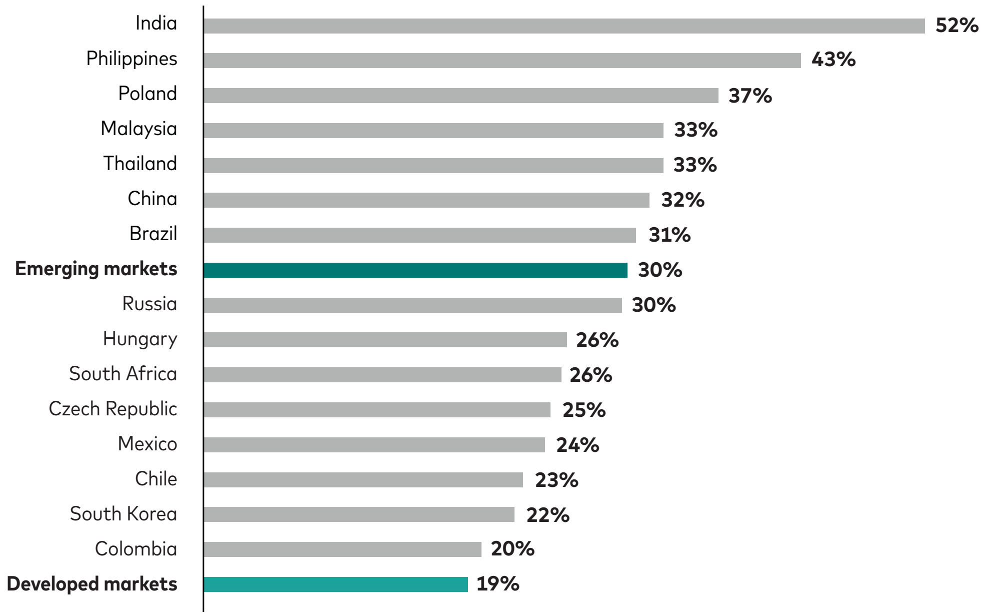


Note: Annualized rates of inflation from January 2000 through July 2022.
Sources: Vanguard and Macrobond.

Authors: Nishan Pradhan, senior emerging markets credit analyst | Liza Ermolenko, emerging markets credit analyst | Zoe Odenwalder, Latin America credit analyst | Nick Eisinger, senior credit analyst | Daniel Shaykevich, senior emerging markets portfolio manager

Differences in the baskets of goods and services used to measure inflation have contributed to higher EM inflation. The conflict in Ukraine initially sparked a surge in energy prices and has more recently put additional upward pressure on food prices. Those two components tend to make up about 30% of the consumer price index (CPI) for EM, a much larger share than the 19% average for DM indexes. Broadly, EM inflation has been more supply driven than DM, as the latter received larger recovery stimulus to boost real growth above the pre-pandemic trend. This makes EM inflation more likely to fall when supply side pressures abate.

Food and energy make up a larger portion of the CPI basket in many EMs



Note: Data are as of July 2022.
Sources: Vanguard and Macrobond.

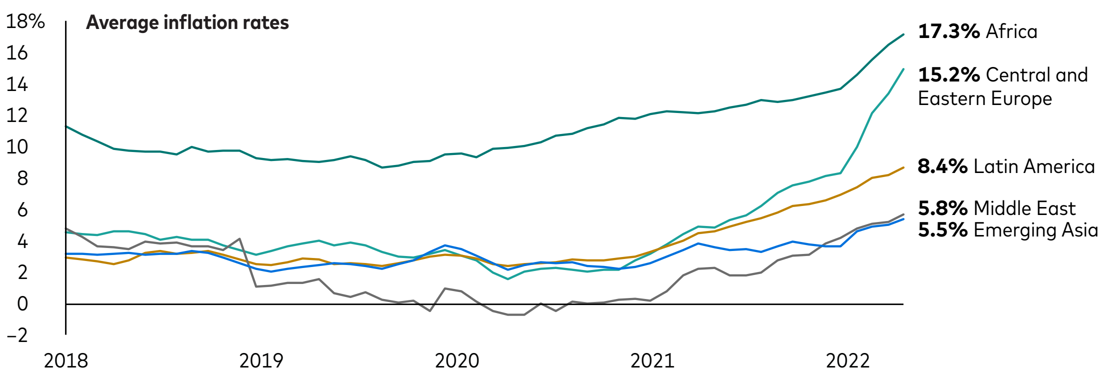
Subtle differences within regions

Although inflation is rising across EM, there are subtle differences. **Central and Eastern Europe (CEE)** has been hit the hardest by energy and food prices. Explaining how the regions' policy rates may have to stay higher for longer, Liza Ermolenko, EM analyst based in London, says, "CEE is a region in EM where policy rates are the most negative and labor markets are very tight. Rising inflation expectations here suggest that there is risk of CEE entering into a wage-price spiral."

In **Latin America (LATAM)**, relatively aggressive fiscal and monetary easing in comparison to other EM countries in response to the economic shocks brought on by the COVID-19 pandemic is partly to blame for the elevated rate of inflation. The resulting depreciation in the currency exacerbated the price pressures mainly coming via food and wages. However, Zoe Odenwalder, a credit analyst covering LATAM, says Mexico is different. "Mexico has been a relative outlier in the region. It provided very little fiscal support during the pandemic and the central bank maintained tighter policy. As a result, growth has been weaker, and while inflation has risen, the increase has been less dramatic than elsewhere."

Asia, in contrast to CEE and LATAM, has suffered relatively tame increases in inflation. Nishan Pradhan, a senior credit analyst covering Asia, explains, "Asia has benefited from having more anchored inflation expectations, lower supply chain cost pass-through due to closer proximity to global manufacturing hubs like China, and relatively more fiscal space to fund targeted subsidies." China, with its economic slowdown, remains an outlier, with no expectations for the central bank to raise rates, which is partially bolstered by benign core inflation prints.

The average aggregate inflation rate for EM belies stark differences by region

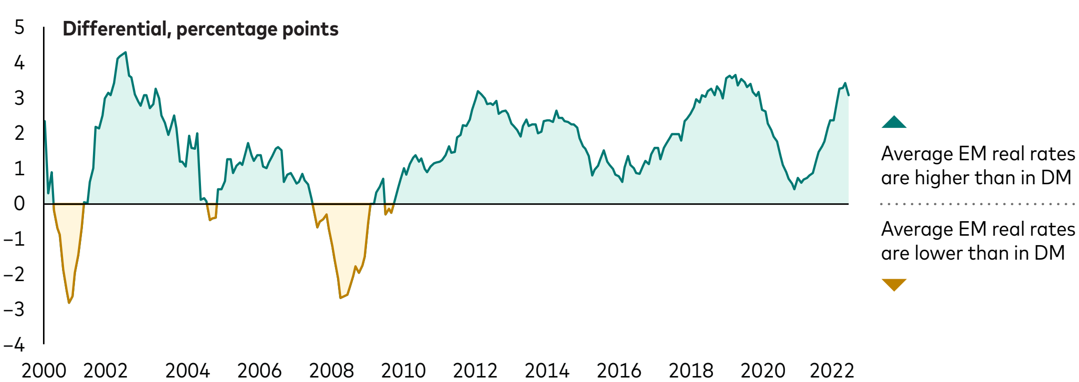


Note: Inflation from January 2018 through June 2022.
Sources: Vanguard and Macrobond.

EM central banks have been proactively hiking

Emerging markets have also broadly preserved higher real rates than developed markets through the recent inflation spike by proactively hiking policy rates. At some point, high baseline effects from commodity and food prices will dampen inflation readings. The higher weights of these cyclical components in EM consumption baskets portend a stronger disinflation story than for DM.

Real rates: Emerging markets versus developed markets

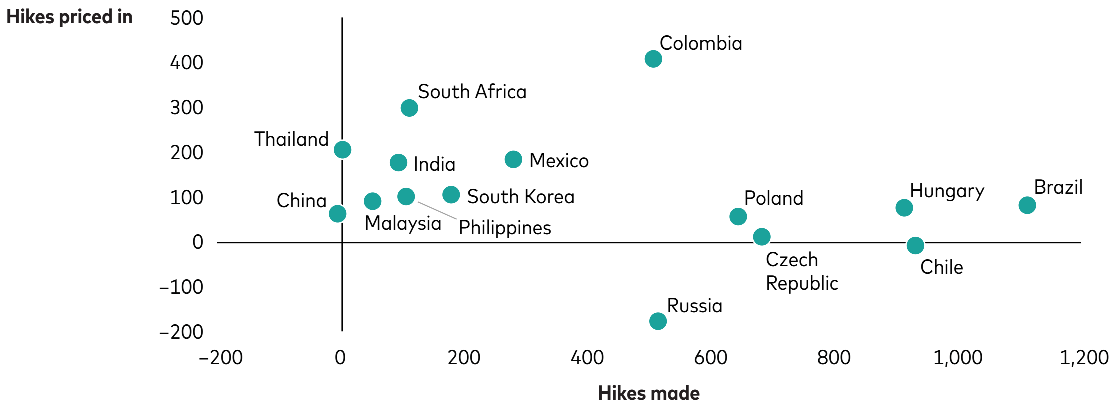


Notes: Data are monthly readings from January 2000 through June 2022. Real interest rates are measured as the central bank policy rate minus the annualized inflation rate. EM countries include those in Africa (Angola, Ghana, Kenya, Nigeria, and South Africa), emerging Asia (China, India, Indonesia, Kazakhstan, Malaysia, the Philippines, and South Korea), Central and Eastern Europe (Croatia, Hungary, Poland, Romania, and Ukraine), Latin America (Colombia, Brazil, Chile, Dominican Republic, Ecuador, Mexico, Peru, and Uruguay), and the Middle East (Bahrain, Egypt, Oman, Saudi Arabia, and the United Arab Emirates). DM countries include Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.
Sources: Vanguard, based on data from Macrobond.

This presents EM local bonds (or rates) as an attractive asset class since the market is now pricing in a good deal of rates hikes over and above what has already been delivered by central banks, as the figure below illustrates.

Some EMs have done more of the heavy lifting on interest rates than others

Hikes made in the last two years, and hikes priced in by the market for the next 12 months, both in basis points



Notes: Data are as of August, 2022. Priced-in hikes reflect the difference between current policy rate and 1-year forward implied policy rate. A basis points equals 1/100 of a percentage point.
Sources: Vanguard and Bloomberg.

Where we see potential for alpha generation in local rates

"Given that forward curves in domestic rates have built in expectations of further tightening in most of EM, we are prepared to play long duration EM local rates when we gain confidence that the current trend has decisively turned, or when a certain curve is pricing in too much tightening," says Nick Eisinger, a senior credit analyst based in the United Kingdom.

For example, in **CEE**, despite expectations of sticky core inflation, we are analyzing Polish government bonds as we find them attractive on the scale of repricing and fundamentals. In **LATAM**, Brazil's central bank is likely to signal a pause soon after raising rates from 2% to 13.25%, and we feel steepeners (trading strategies that profit from higher longer-term rates versus shorter-term rates) are likely to become attractive. In Chile, with growth and inflation still accelerating, we do not think the central bank will be able to cut rates this year and prefer to be short duration in the front end to take advantage of the cuts being priced out.

In **Asia**, China suffers from fears of a resurgence of COVID-related lockdowns in the face of a slowing housing market, and we are evaluating re-engaging in long rates trades. We are more likely to be confident in more credible central bank regimes in Asia, such as Thailand, Malaysia, and South Korea, to play the first innings of the topping out of Asia's inflation momentum. In Indonesia, where improving credit activity and the central bank's heavy involvement in supporting local rates makes us wary of going long duration just yet.

In **Africa**, South Africa's central bank is showing proactiveness to prevent double-digit inflation by raising rates and setting a hawkish tone, and we are carefully monitoring the political situation and yields with a bias to be long rates.

Important part of the process

Rising global inflation and a pro-cyclical Federal Reserve has raised funding costs in EM in both dollar and local market terms. We are not confident in calling the peak in EM inflation yet but recognize that local EM rates are starting to look attractive. "We are excited to have a strong process in place to play long duration EM local rates when the trend decisively turns. We believe we are close to this point," says Daniel Shaykevich, senior EM portfolio manager. We continue to tease out the best risk/return trades within EM local and external debt for our clients and constantly weigh one against the other. With high inflation being a reality today across the globe, having a good read of it and how it presents opportunities in EM is an important part of our active process.

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Taxable bond	Municipal bond	25+	35+	60+	130+
$333B in AUM *14 funds*/1 ETF*	**$193B** in AUM *5 national funds/7 state-specific funds*	Portfolio managers	Traders	Research analysts	Dedicated team members

***** Includes funds advised by Wellington Management Company LLP.
Note: Data are as of June 30, 2022.

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