

EM STRATEGIC FOCUS

EM INFLATION: MIND THE GAP

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EM INFLATION: MIND THE GAP

A regime shift is taking shape in the global inflation landscape. In Developed Markets (DM), geopolitical risks and the changing contours of globalization, newfound fiscal largesse as well as demographics point towards an exit from the post-GFC “lowflation” era. Within Emerging Markets (EM), however, a relatively disciplined policy stance and dis-inflationary forces from China has prevented trend inflation from rising. The net result is a structural narrowing gap between EM and DM inflation. We believe such a regime shift should improve the risk-reward in EM debt, particularly in the local currency debt space.

By Witold Bahrke, Senior Macro and Allocation Strategist

EM vs. DM inflation: Regime shift

In the aftermath of the pandemic, regime shifts are crystalizing in the global inflation landscape. While the dust from the pandemic has not completely settled, several global macro and policy factors supports our view that developed markets (DM) inflation will settle on a higher trend compared to pre-pandemic years. In addition, the gap between Emerging Markets (EM) and DM inflation is narrowing. In stark contrast to its DM counterpart, underlying EM inflation seems to settle close to its pre-pandemic trend. The reasons behind changing inflation patterns go beyond temporarily clogged supply chains in the aftermath of Covid. Historically, inflation has been a slow mover, exhibiting multi-year trends. This time is no different, in our view.

When dissecting the risk-reward of EM bond investing, inflation in both developed markets and emerging markets naturally has a key role to play. Consequently, a regime shift towards higher DM inflation and a narrower spread between EM and DM inflation would have wide-reaching implications for EM investors, particularly when it comes to local currency sovereign debt. So how has the global inflation landscape changed in the aftermath of the pandemic?

Topic du jour: DM inflation

As a starter, let’s take a closer look at developed countries. After declining rapidly in 2022-23 (see appendix figure 1) from multi-decade highs, DM inflation is showing signs of levelling off markedly above the “lowflation” trend witnessed after the Great Financial Crisis (GFC), see chart below. As things stand, inflation is still markedly above most DM central bank’s inflation targets of around 2% annual price changes¹. Several factors have contributed. While a deep-dive into the root cause of higher DM inflation is beyond the scope of this note, three of these factors are worth highlighting.

Firstly, structurally higher fiscal deficits with DM countries moving from fiscal conservatism to (in some cases pro-cyclical) fiscal largesse have a key role to play, in our view. Given a more direct impact on final demand, fiscal easing tends to be more inflationary than monetary easing.

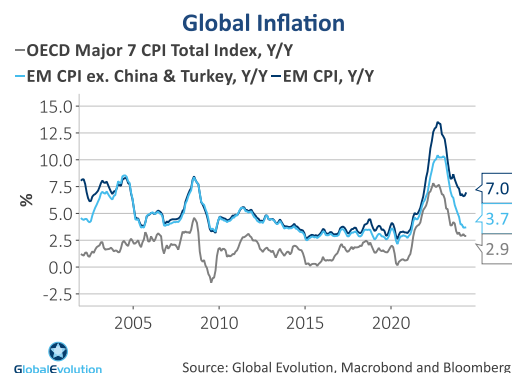
Secondly, the changing contours of globalization rank high on the list of inflationary game-changers, as well. Rising geopolitical tensions have triggered a near- and friend-shoring trend in manufacturing. Ultimately, this limits China’s ability to export its own deflation to developed markets countries.

¹ Quantifying the medium-term lift to US core inflation as an example, our medium-term inflation model suggests core inflation to be 1-1½%-pts. higher compared to the post-GFC period, see appendix

figure 4. naturally, these estimates have to be interpreted with caution during times of structural shifts and, hence, unstable model parameters.

Demographics is the third key factor. A huge amount of retiring baby boomers in the developed world is limiting labour supply, structurally lifting wage pressures. In the US, this has been mitigated by large immigration flows as of late. But large immigration flows are unlikely to last given political pressures to curb the inflow of foreign-born workers ahead of the US election in November.

To be fair, poor demographics is not solely a DM phenomenon. On the EM side, China also struggles with a shrinking labour force. But as opposed to e.g. the demand-focused policy tilt in the US, China's policy focus is firmly on stimulating the supply side. This has contributed to vast overcapacities in China's manufacturing-driven economy. As a result, the inflationary impact of an ageing population in China has so far been much more limited as compared to the impact from demographics in service- and demand-driven DM economies like the US. Finally, the energy transition away from fossil fuels could also be listed as an important long-term driver behind higher DM inflation. However, it is less clear to which degree this factor mostly impacted DM or EM inflation.



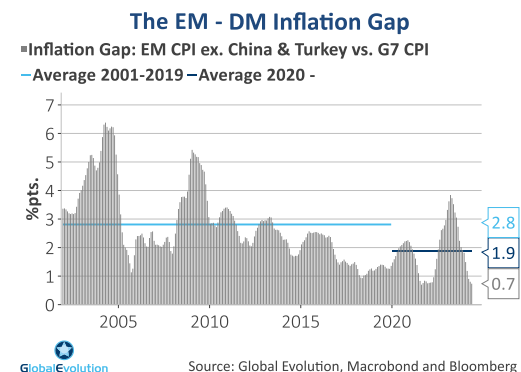
The main focus of this report is the difference between EM and DM inflation trajectories and what it means for EM fixed income. Clearly, with one part of the equation being DM inflation, the factors driving DM inflation higher should also be consequential for EM inflation. While there are no signs of hyperinflation unfolding or a 70's redux, none of the drivers behind higher DM inflation are short-lived in nature.

Under the radar: The EM-DM inflation gap

On top of higher DM inflation, the gap between EM and DM inflation has tightened. This becomes clear when looking at the different trajectories of EM and DM inflation in the post-pandemic years. The difference between average inflation in EM versus G7 inflation currently stands at a historical low of 0.7 %-

Pt. as per chart below. In order to gauge the underlying trend in EM inflation, we have removed the extremes at both ends of the inflation distribution: China at the deflationary tail and Turkey on the inflationary end. On the one hand, a narrowing EM – DM inflation gap is driven by DM inflation shifting into higher gears after the pandemic. Lately, sticky US and Euro Area inflation have been poster children for this development, taking both central banks and large parts of the investor community by surprise. On the other hand, underlying EM inflation in and of itself has contributed to the tightening gap, as well. It came off the boil at a much faster clip than its DM counterpart and has largely managed to return to its pre-pandemic trend.

Although central banks and investors still struggle to adapt, persistently high DM inflation has kept investors awake at night for some time. In stark contrast, the gap between EM and DM inflation as such has caught far less attention among the investor community, although it might be equally as important for EM investors.



Cyclical or Structural narrowing? Policy is key

Why should investors pay attention? In short, because higher trend inflation in DM and a declining gap between EM and DM inflation most likely represents a structural shift rather than cyclical blip, with profound implications for strategic asset allocation. It seems unlikely to us that DM returns to the post-GFC lowinflation era and the EM – DM inflation gap to its pre-pandemic levels anytime soon. The reasons behind are three-fold.

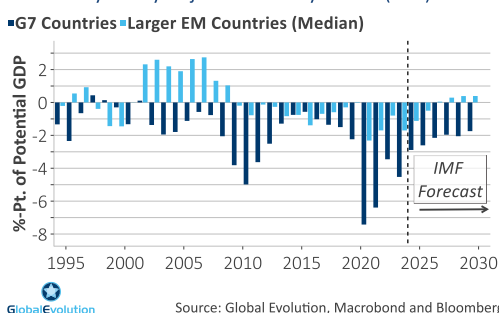
Firstly, on the DM side of the equation, we believe none of the drivers behind higher inflation are likely to fade anytime soon. When it comes to demographics, current retirement trends were determined decades ago. Geopolitical risks are still on the rise amid lingering conflicts and diverging interests between the

two superpowers US and China. At the same time, the benefits from globalization as we know it are increasingly being questioned in a political context of rising populism, further fueling protectionism. Last, but not least, after years of fiscal prudence starting with the great moderation took hold in the 90's, DM countries newfound fiscal largesse might still be in the early innings. Case in point, irrespective of who wins the US election, primary deficits are unlikely to be reduced much. Instead, the main question is what will keep them wide – fiscal spending or tax cuts. In DM, the fiscal genie is out of the bottle. It will be challenging to put it back. Altogether, a deteriorating policy backdrop makes for a moderately *deteriorating* growth-inflation trade-off in developed countries.

Secondly, in the aftermath of the pandemic, emerging markets have gained substantial policy credibility relative to DM. While some Fed watchers have speculated, that the US central bank might – either implicitly or explicitly – lift its inflation target, countries like Brazil or Indonesia have actually lowered their inflation targets over recent years. On the EM side of the equation, we therefore see an *improving* trade-off between growth and inflation. An important part of the story is a more tempered fiscal expansion during the recent years. As opposed to developed markets, there was no break-out of primary deficits, see chart below. A sounder fiscal policy foundation should reduce inflation risk and therefore contribute to a permanently tighter inflation gap between EM and DM.

Primary Budget Balance: EM vs. DM

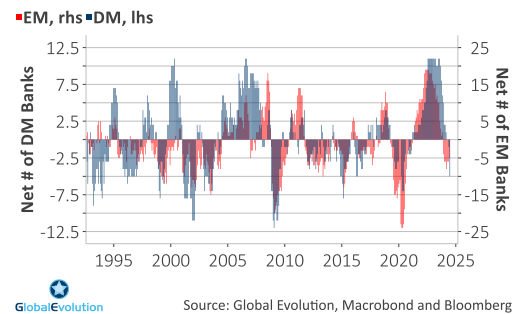
Cyclically Adjusted Primary Deficit (IMF)



Turning to monetary policy, the chart below highlights that EM central banks reacted more proactively to the most recent inflation shock, starting their hiking cycle earlier and more forcefully than their DM peers. This also enabled them to start cutting at an earlier stage.

Global: Policy Rates

of Central Banks Raising vs. Lowering Rates (3M Window)



The disciplined fiscal and monetary stance over recent years could be a one-off. And it almost goes without saying that there are and always will be worrying policy outliers among the EM crowd. The current political pressure on the independence of Brazil's central bank is a brilliant example hereof. In the grand scheme of things, however, it seems that emerging market central banks by-and-large have learned their lessons from previous crisis episodes. As EM countries have suffered from the negative impact on their currencies in the past, a return to broad-based *laissez-faire* fiscal and monetary policy seems unlikely.

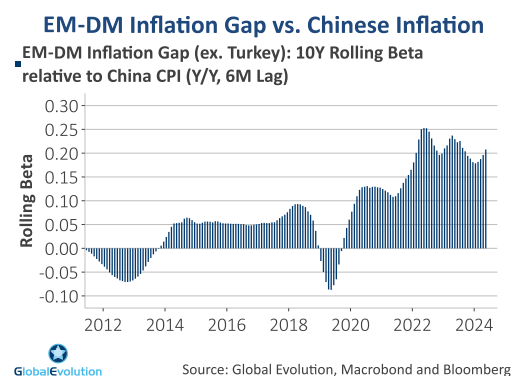
If we are right in extrapolating the fiscal and monetary policy reaction function over the recent years, it would mark a decisive improvement in the EM policy backdrop, as policy – both monetary and fiscal – historically has been one of the weaker spots of the EM universe relative to DM. As a result, inflation risks are set to decline structurally in EM.

Third, falling Chinese inflation contributes to a narrowing EM – DM inflation gap, failing to curb DM inflation. While the US currently is the reflationary epicenter in the global economy, China has arguably been the primary disinflationary pole among the major economies over the recent years. The root causes behind China's disinflation are structural. The country has been stuck in a property crisis after years of overinvestment and overleveraging in real estate. Given high amounts of private savings tied to housing, the property slump is a major drag on household confidence. These headwinds prevent private consumption from boosting overall demand, keeping saving rates elevated and demand-driven inflation lower for longer.

Lately, policy makers have shown some signs of willingness to address the root causes of the property malaise. But despite anemic growth, policy-driven reflation is not in the pipeline. Stimulus efforts have

been modest, at best. A possible explanation might be Beijing's fear of spiraling Renminbi depreciation. A consumption revival would drive the current account into negative territory. Capital outflows and financial instability could be the consequence, putting pressure on FX – at least that seems to be the line of thinking in Beijing. The limited amount of stimulus announced so far has been guided in a decisively dis-inflationary direction. Instead of the property sector and household demand, policy makers have prioritized supporting the manufacturing sector, expanding existing overcapacities.

From a global perspective, near-shoring production in order to safe-guard supply chains against geopolitical risks and increasing trade barriers are not only fueling structural inflation in DM, limiting China's disinflationary spill-overs to DM [see also [here](#)]. It is also amplifying existing overcapacities in China. In the current geopolitical context, China therefore can be counted as an additional driver behind both structurally higher DM inflation and a narrower EM-DM inflation gap – despite several years of disinflation and in stark contrast to the pre-pandemic era. The below chart shows, the inflation gap has had a positive and increasing beta to lagged Chinese inflation. In an era of deflation in the world's second biggest economy, this simple analysis implies China added to the narrowing spread between EM and DM inflation.



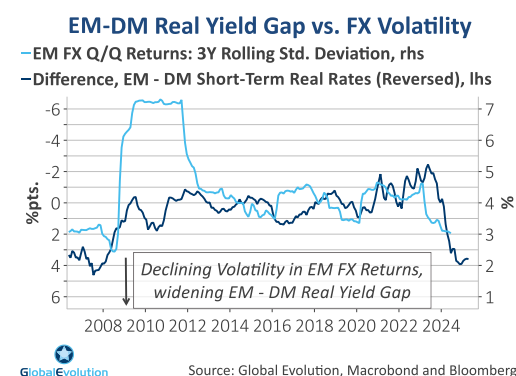
Mind the gap: 3 take-aways for investors

How does a structurally tighter gap between EM and DM inflation impact the EM fixed income investment landscape? We see three main takeaways.

Firstly, a narrower inflation gap should mitigate the depreciation trend of EM currencies over recent years. The narrowing inflation gap will increase EM real yields relative to DM real yields, all else being equal. Higher real yields lend support to EM currencies, which have been on a downtrend since 2012. The real interest differential model² helps to explain the relationship between currencies and real yields. According to the model, a tighter long-run expected inflation differential result in an appreciating exchange rate. Clearly, exchange rates are impacted by a plethora of other factors, not covered by such a model. A more supportive EM-DM real yield in and of itself might not be enough to turn a multi-year downtrend in EM FX around. However, a more favorable EM-DM real interest rate differential should e.g. help to counterbalance the negative impact on EM currencies from other factors such as the peak in China's downward sloping growth path, reducing the overall headwinds on that front.

Over the past 10 years, returns in EM local currency sovereign bonds have trailed those from EM hard currency sovereign bonds. Going forward, FX should be less of a drag. From a strategic investment perspective, the upshot for EM investors are higher expected returns in local currency EM debt over the coming 1-3 years as compared to the previous decade.

Secondly, risk-reward is set to improve. A more credible policy foundation in the shape of proactive monetary policy as well as relatively disciplined fiscal policy (see previous section) should lower both interest rate volatility via the term premium and EM FX volatility - in an absolute sense and relative to developed markets. The bulk of this improved risk profile stems from the FX channel, see chart below.

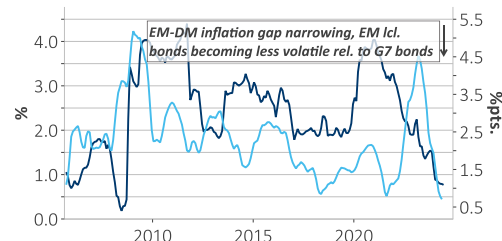


² Frenkel, J. (1976). 'A Monetary Approach to the Exchange Rate: Doctrinal Aspects and Empirical Evidence'. Scandinavian Journal of Economics, Vol.76, pp. 200-224

The difference between the realized volatility of EM local currency bonds and G7 government bonds has declined as the gap between EM and DM inflation has narrowed over the last few years as below chart highlights. Less volatility in and of itself improves the Sharpe ratio of EM local currency bonds. To the degree that the overall volatility in EM bonds declines, it should also result in more attractive diversification when adding EM bonds to global bond portfolios.

EM - DM: Volatility of Bond Returns

— Inflation Gap: EM CPI ex. China & Turkey - G7 CPI, rhs
— 3Y Rolling Std. Deviation: EM Local Currency - G7 Bonds, lhs



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Source: Global Evolution, Macrobond and Bloomberg

Lastly, transitioning into a macro environment with a lower inflation gap between Emerging Market countries and Developed Markets implies that capital gains should play a more prominent role in the total return composition of local currency EM sovereign debt. Historically, return contributions from high carry have been the primary driver behind investor's interest for the asset class. This will continue to be the case, especially in frontier countries. But on top of the carry allure in EM debt, relatively lower inflation risks backed by a more credible policy foundation and structural disinflationary waves in China should support local currency EM debt's duration risk premiums relative to DM peers.

To be clear, we do not expect a seismic shift lower in EM yields. Still, the different return drivers should behave in a more balanced way in the transitioning period towards higher DM inflation and a tightening EM-DM inflation gap. Some pundits have called the end of total return strategies in bonds as DM yields have hit a structural low point, implying that the prospect of price appreciation is more tactical rather than structural. In Emerging Markets, however, investors might increasingly add a capital gain aspect to their assessment of the asset class rather than viewing EM bonds solely through the carry lens.

EM local debt: Moving out of the doghouse

The bottom line, in our view, is that local currency EM sovereign debt stands to benefit in absolute and relative terms from the regime shift taking place in the inflation landscape.

We believe the gap between EM and DM has narrowed not only cyclically, but structurally with profound long-term consequences for EM bond investors. Looking ahead, structural depreciation pressure on EM FX should abate and the volatility gap between local currency EM debt and DM bonds tighten relative to the pre-pandemic era. As a result, we believe risk-reward and diversification merits of local currency bonds are set to improve. Mapped into a variance-return framework (appendix figure 6), the asset class should improve relative to other bond segments. EM local government bonds have lagged their hard currency peers for years. From a strategic return perspective, the worst should be behind. Going forward, we believe it's time to rethink their role relative to other EM debt segments, but also in a broader asset allocation context.

Chart Appendix

Figure 1: Recent Inflation trends on country-level

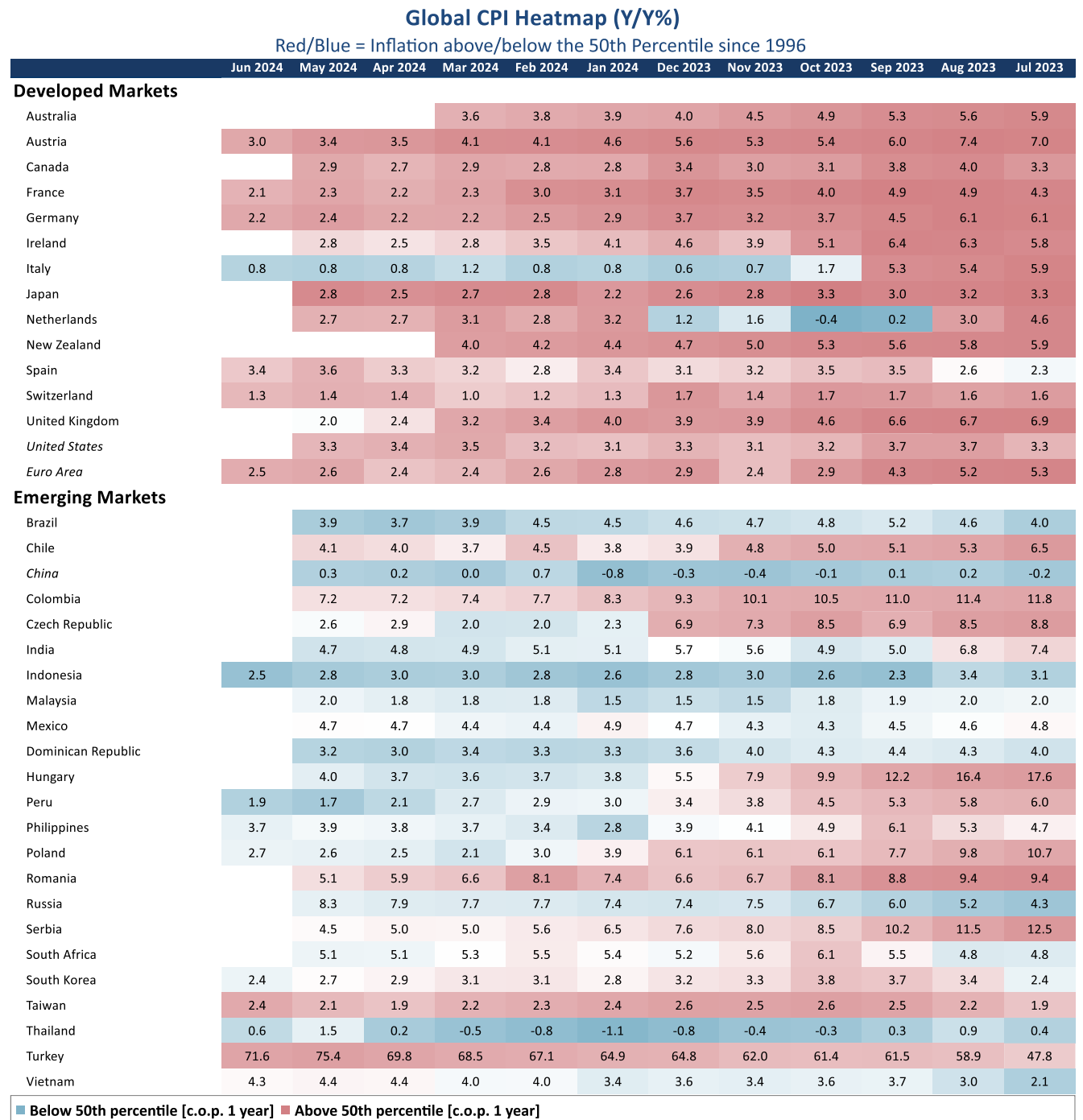


Figure 2: EM versus DM core inflation

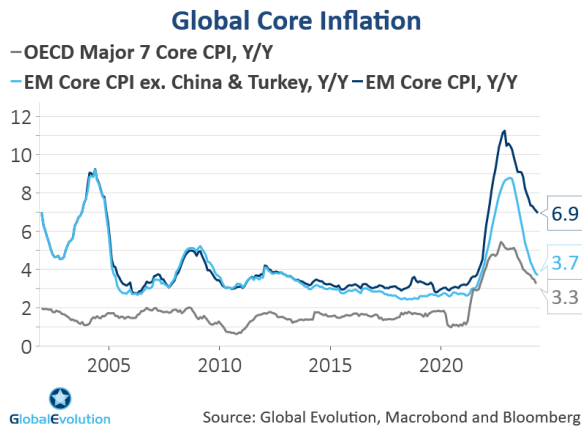


Figure 3: Gap between EM and DM core inflation

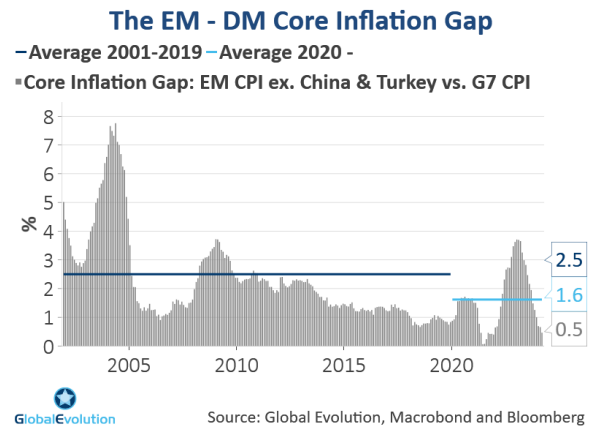


Figure 4: Medium-term US inflation model

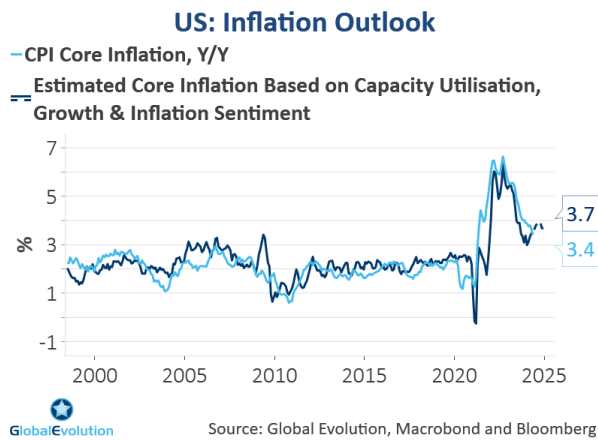


Figure 5: EM policy restrictiveness: Real policy rates

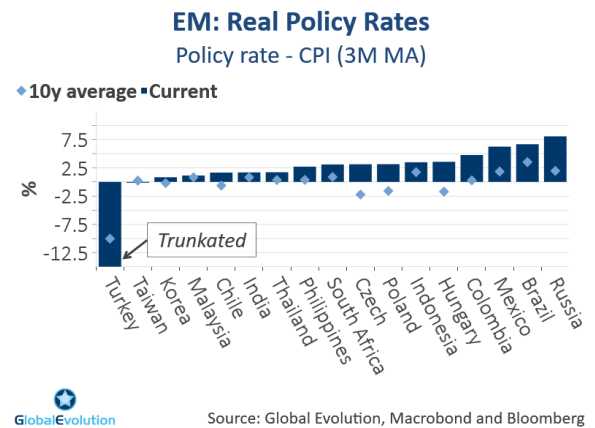
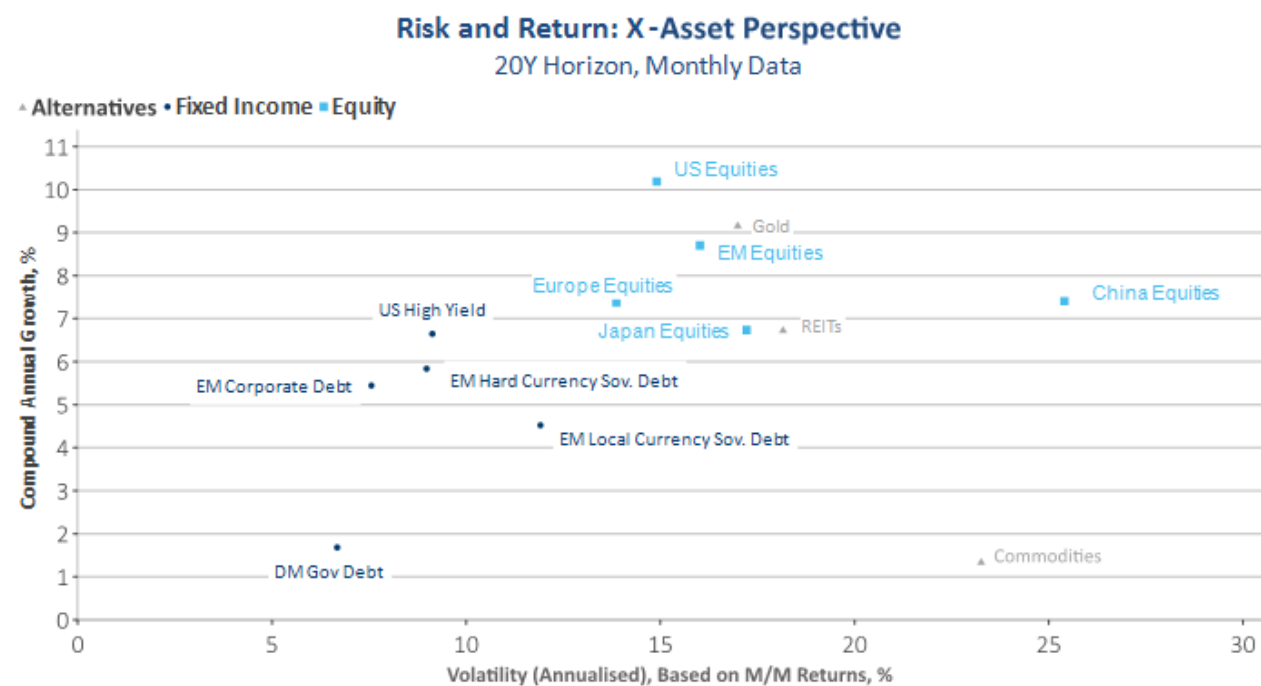


Figure 6: Returns and volatilities: Cross-asset perspective



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