Rates, Inflation and Emerging Markets

Market Insight

July 14, 2022

INTRODUCTION

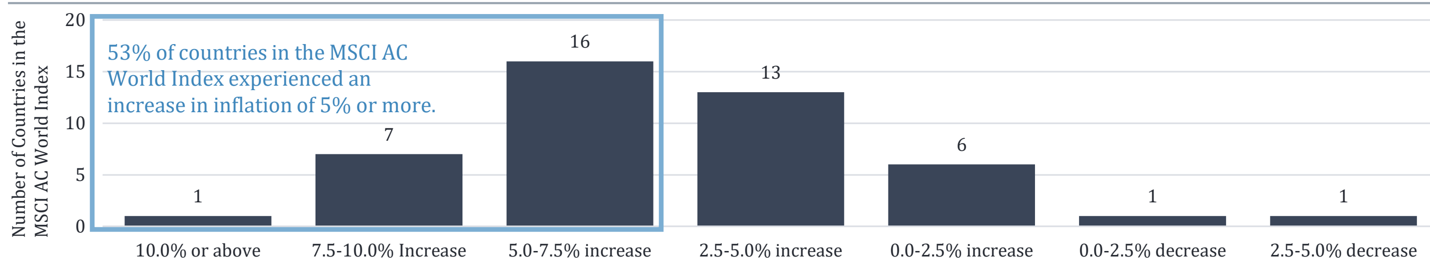
Gone are the days of low inflation and easy global financial conditions. Inflation in the US reached a 40-year high in May when the Consumer Price Index rose +8.6% for the prior 12 months. Concerned with price pressures, the US Federal Reserve (Fed) raised its key interest rates by 25 basis points in March 2022, by another 50 points in May and a further 75 points in June. After years of keeping interest rates near zero, it signaled plans to increase rates several more times in 2022 as it struggles to control inflation.

Following the Fed's rate hike decision, investors are closely tracking the impact that this policy path will have on emerging markets and their economies. The memory of past US monetary tightening cycles has not always been sweet for emerging economies. However, much has changed and there is evidence to suggest that many of these markets are better positioned to handle the current challenges than they have been in the past. The question is whether this improved positioning will be enough to meet the challenges created by the current combination of persistent global inflation and weaker growth.

INFLATION: GLOBAL & PERSISTENT

The US is not alone in its struggle with surging inflation. Soaring prices have become a global phenomenon as countries around the world have witnessed price spikes since the start of the pandemic. 39 out of the 45 nations in the MSCI All Country World Index have seen their annual inflation rate more than double from the first quarter of 2020 to the first quarter of 2022. Over 53% of the countries saw inflation increase by more than 5 percentage points during that same period.

A Global Surge in Inflation: Change in Year-Over-Year Inflation from March 2020 to March 2022



Source: Bloomberg as of March 31, 2022 and March 31, 2020. Graphs are presented for illustration purposes only and should not be relied on to make an investment decision.

While a post-Covid re-opening drove the initial spike in inflation, other factors have since contributed to its persistence into 2022. Russia's war with Ukraine and recent lockdowns in mainland China have further disrupted supply chains, adding to cost pressures. Food commodity prices are at a record high, while oil prices are up 41% over 2021.

AHEAD OF THE CURVE: EXPERIENCED AND CREDIBLE CENTRAL BANKS

While high inflation and interest rates may seem to be a relic of a distant past for generations of Americans, these memories are fresher for most emerging market economies. For better or for worse, central banks in these regions have built credibility fighting inflation over decades. They have remained vigilant amid high inflation reports, discipline has improved, and central bank independence has generally been safeguarded, with some exceptions (e.g., Turkey). Transparency and communication have been robust and policy makers have limited themselves to relying on conventional monetary policies to keep inflation expectations under control.

As inflation began to rise, central banks of many emerging economies were quick to begin raising rates. These fast responses were driven by the fact that most emerging markets do not have the ability to tolerate higher inflationary pressures in their own markets. First, for many of these countries, inflation tends to be stickier. This is particularly true of nations that utilize index mechanisms to link financial contracts and wages to inflation. Second, emerging markets tend to have a greater sensitivity to food and energy prices given their higher weighting in inflation index baskets. Finally, many emerging markets recall episodes

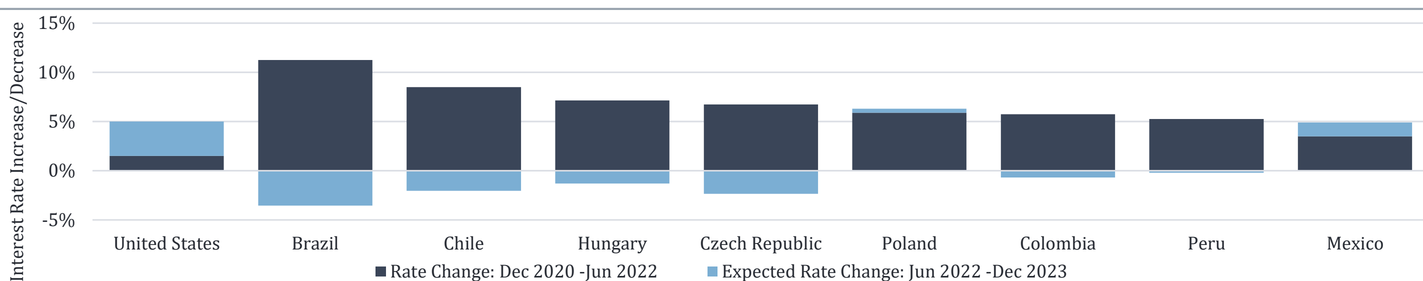
of double-digit inflation as a consequence of a slow reaction by central banks. With lessons learned the hard way, most economic teams have an increased propensity to adjust policy early to contain inflationary shocks.

This is perhaps why we find ourselves in an unusual situation at present. While many emerging market central banks responded almost immediately to inflation shocks, the US Fed did not at first view inflation as a real threat, instead classifying it as transitory for most of 2021. Indeed, several central banks anticipated the Fed's move, raising their own rates as early as March 2021. As of the end of March 2022, 16 out of the 24 countries classified as emerging markets had already started their rate hike cycle and some with meaningful magnitude. This contrasts with past experiences where emerging market central banks typically followed the Fed's lead with regards to monetary tightening.

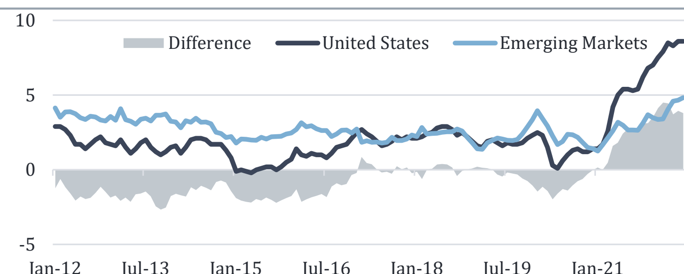
The most notable example is the Brazilian central bank which raised rates from 2% in March 2021 to 13% in June 2022. After this aggressive string of hikes, most economists estimate that inflation is at or near its peak. With the tightening cycle close to complete, forward-looking projections are focused around the size and timing of interest rate easing expected in 2023. Brazil is not unique in this regard. While forecasts point to tightening for developed markets, projections for several emerging markets see easing ahead.

There are, however, exceptions, the most notable of which is Turkey where inflation has accelerated to 78.6% in June 2022. The Turkish central bank started their easing cycle in September 2021, cutting rates from 19% to 14%. These decisions have been politically motivated and have resulted in uncertainty regarding the credibility and independence of the Turkish central bank.

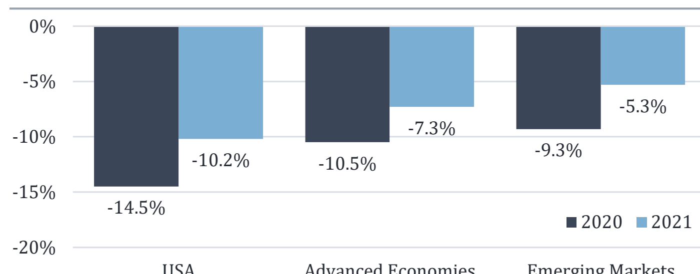
Interest Rates: Emerging Markets vs. Developed Markets



Inflation: Emerging Markets vs US*



General Government Overall Fiscal Balances, 2020-2021



Source for Inflation and Interest rates: Bloomberg as of June 30, 2022. Source for General Government Fiscal Balances: Bloomberg, International Monetary Fund – Fiscal Monitor, and Patria Research.Past returns are not a guarantee of future results. Graphs are presented for illustration purposes only and should not be relied on to make an investment decision
*Emerging Markets Inflation defined as the weighted average inflation utilizing country weights of the MSCI Emerging Markets Index as of June 30, 2022.

The result of the generally proactive rate tightening stance in most emerging markets, is that while inflation within these economies has continued to climb, the pace has slowed, particularly relative to the US. Indeed, for the first time in over a decade US inflation readings have outpaced that of emerging markets. While real rates in most developed markets are entrenched in negative territory, emerging market rates are closer to zero and in some cases even positive.

On the fiscal front, accounts in both developed and emerging nations deteriorated in 2020 as meaningful stimulus measures were implemented to counteract the disruption caused by the pandemic. While fiscal deficits have yet to be fully normalized, many emerging countries were swift to work towards this goal as early as 2021. Meanwhile, developed markets have lagged and have larger budget imbalances.

While the proactive and responsive attitude of emerging market economies has diminished the risks associated with local inflation, important concerns remain. With developed markets behind the curve, the greatest risk for many emerging economies is imported inflation and spillover effects from developed markets. Even so, the favorable monetary and fiscal policies should provide some tailwinds for emerging markets.

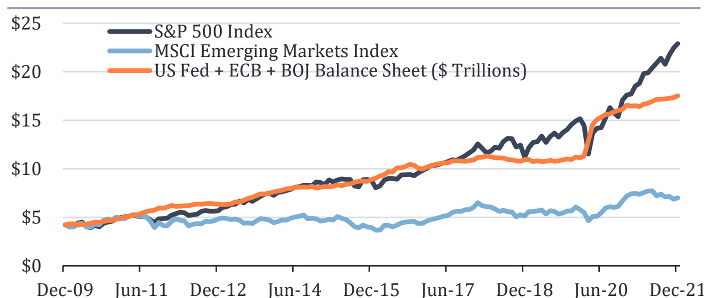
END OF THE ERA OF "FREE MONEY" AND EMERGING MARKETS VALUATION GAP?

Stretching back to 2010, the US, Europe, and Japan have instituted massive Quantitative Easing programs and kept the cost of borrowing at historical lows. In total, these central banks purchased over $13 trillion of assets from 2010-2021. In practice these stimulus measures acted as a put option, preventing disaster any time the markets experienced meaningful turbulence. With this safety net laid out for investors, the risk management function shifted from investors to central banks. Risk assets, particularly developed market stocks, thrived under these conditions and both performance and valuations surged.

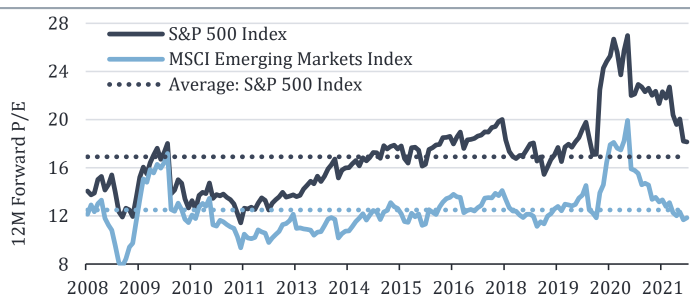
Meanwhile, emerging markets did not enjoy the same benefits. Without the ability to spend the same magnitude on stimulus measures, emerging market equity performance has lagged, giving rise to a growing valuation gap between developed and emerging assets.

Now, with the Fed raising rates and ending Quantitative Easing, investors find themselves in a new era. Whereas developed market valuations look stretched, emerging market equity fundamentals and valuations look attractive despite the economic hurdles of the current environment. Indeed, valuations for the MSCI Emerging Markets Index are inexpensive not only relative to developed markets but also relative to its own history. Further, 12 month forward looking earnings potential in emerging markets are twice as high as developed markets. Investors are naturally left questioning if there is a case for developed and emerging markets valuations to finally converge.

QE Purchases vs. S&P 500 vs MSCI EM Performance: 2010-2021



Attractive Valuations: Emerging Markets vs US Equity



Source: Bloomberg, Federal Reserve Bank of St. Louis, and ECB Eurosystem. QE refers to Quantitative Easing. Valuations data as of May 31, 2022. Graphs are presented for illustrative purposes only and should not be relied on to make an investment decision. Please see the end of this presentation for important disclosure information.

EXTERNAL ACCOUNTS, BALANCES & RESERVES

One of the main reasons rising US rates are often considered to be a hurdle for emerging economies is its impact on currency, external financing, and capital flows. As the US dollar strengthens and emerging market currencies depreciate, external debt burdens increase. Higher risk aversion triggers capital outflows from emerging market assets and central banks become inclined to tighten financial conditions to protect currencies and economies from imported inflation. In the past this has created financial and economic instability for these economies. Today, strengthened external positioning has meant that many emerging economies are equipped with greater external buffers to face the current uncertainty.

Over the past decades, several emerging economies have boosted reserves and strengthened current account positions. Indeed, over the last 25 years, total foreign reserves in emerging markets countries have increased by $6.5 trillion, over 12 times their value at the end of 1997[1]. At the end of last year, 14 out of the 19 emerging market countries tracked by the International Monetary Fund (IMF) were considered to have adequate international reserves in 2021, according to their reserve adequacy ratio[2]. In addition, several emerging markets are running current account surpluses, and those with deficits are small compared to historical levels. While these reserve buffers will help absorb the Fed policy tightening shock, the question remains of whether they will be enough to stem exchange rate pressures.

A CHANGE IN THE GROWTH NARRATIVE: STAGFLATION & RECESSION CONCERNS

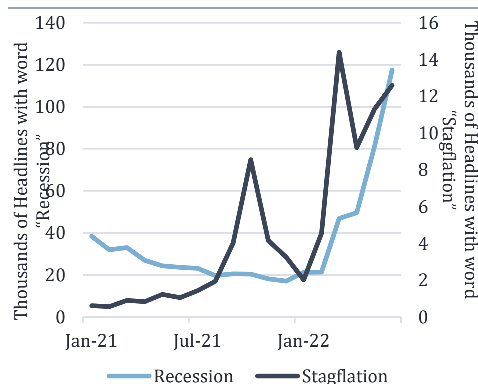
History suggests that a US tightening cycle alone does not necessarily imply an emerging market drawdown, but rather that the driver of the rate hikes is the more determining factor. When interest rates hikes are a response to excessive growth, improved trade channels are likely to compensate for the financial impact. In these situations, emerging market currencies will weaken making exports more attractive and consequentially stimulating growth in emerging countries. In contrast, rate hikes motivated by inflation or changes in risk sentiment tend to be more challenging for emerging market assets.

For most of 2021 and throughout early 2022, most economists expected global growth to rebound as the world emerged from the Covid pandemic. This benign global growth outlook combined with the tailwind of sharp commodity rally, reserve buffers and higher rates in emerging markets helped limit the initial effects of the impending policy tightening on these economies and markets.

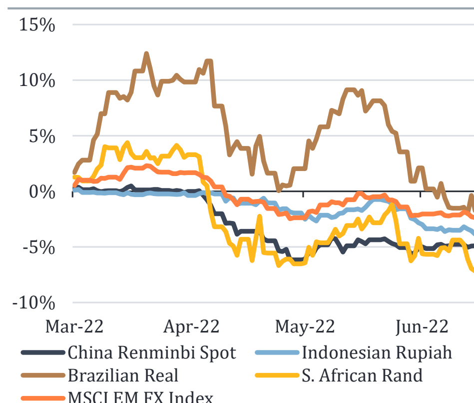
By May 2022, the narrative seemed to have shifted towards a more negative tone. Supply chain disruptions and commodities shortages aggravated by China's Covid Zero Strategy and Russia's war in Ukraine compounded the damage from the pandemic, elevating inflation to levels not witnessed in decades. Meanwhile, economic growth expectations rapidly deteriorated. The IMF's 2022 GDP growth forecasts for emerging markets were revised down from 5.1% in October 2021 to 3.8% in April 2022, citing inflation and rising rates as a key headwind. Developed market growth forecasts have followed a similar path[3]. In the US, the main focus became whether the Fed could raise rates enough to slow down inflation, without pushing the economy into recession.

Against this backdrop, investors have shifted their focus to the risk of global stagflation, the painful coexistence of high inflation and low growth. The result has been meaningful volatility in financial markets throughout the past months. While emerging markets have been caught in these crosscurrents of declining investor sentiment, losses have thus far been in line with developed market equities. As risk assets sold off, the MSCI Emerging Markets Index and S&P 500 Index respectively plunged -17.6% and -20.0% for the year through June 30, 2022. Emerging market currencies fell only -3.9% for the year.

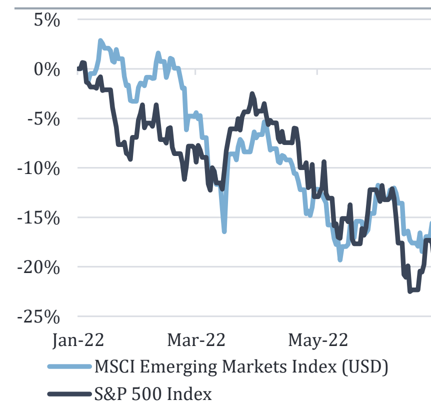
Change in Narrative: Headlines Which Make Recession Risks Hard to Ignore**



Performance of Select Emerging Market Currencies: March 16 – June 30 2022



Emerging Market and US Equity Performance: January 1 – June 30 2022



Source: Bloomberg as of June 30, 2022. ** Daily headline count in thousands. Data based on the Bloomberg terminal, which aggregates 150,000 news sources with every bulletin categorized and counted. Past returns are not a guarantee of future results. Graphs are presented for illustration purposes only and should not be relied on to make an investment decision

EXCESS PESSISM OR REASON FOR GREATER CONCERN?

History has showed us that investor sentiment can at times get ahead of itself. In the past, the mere expectation of US economic trouble has triggered an early selloff across emerging market equities and currencies. As we enter the third quarter of 2022 with double digit equity losses, investors are left considering how much pessimism and recessionary views have already been priced into these markets.

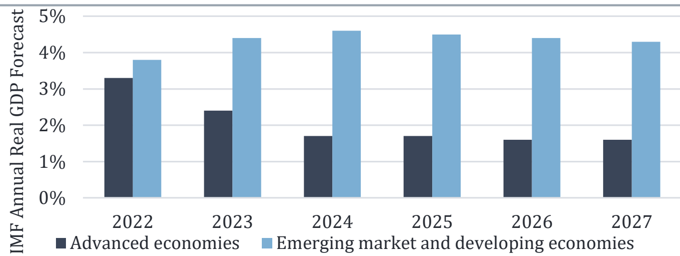
On one hand, a prolonged global stagflation environment undoubtedly presents challenge. This is especially true if we see continued unexpected shocks to supply chains and global trade as was the case with the War in Ukraine and Covid lockdowns in China.

On the other hand, there is an argument to be made that beyond the short-term turbulence, emerging markets will be cushioned by a favorable economic and valuation dynamics. Reasons to believe "this time could be different" are abound, led by improved monetary, fiscal, and external policies. Further, according to IMF GDP growth forecasts for the next 5 years, emerging economies are expected to resume their elevated growth trajectory while developed markets growth will dip as these markets struggle with recessionary pressures[4].

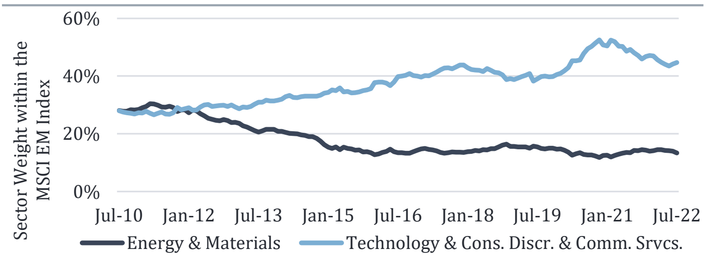
In addition, the transformation within emerging markets economies should further insulate these countries from developed market spill over risks. Over the last decades, emerging markets have evolved away from an export-driven economic model and increasingly into diversified economies boosted by domestic consumption, transformative structural trends, and leapfrogging technologies. As the drivers of growth have shifted, these countries have become less sensitive to the broader global macro cycle

which have historically driven volatility in the asset class. Within the MSCI Emerging Markets Index, exposure to sectors typically associated with exports such as energy and materials has fallen to less than 50% of its size in 2010. Meanwhile domestic oriented sectors such as technology, consumer discretionary and communication services grew to represent 45% of the index as of June 2022. Even in areas of the market tied to exports, global trade partners have become more diversified. The result is a growth of deep and broad domestic-oriented investment themes which have the potential to perform regardless of the broader global backdrop.

GDP Growth Divergence: Emerging vs Developed Markets



Evolution Away From Exports Towards Domestic Themes



Source for GDP data: IMF as of June 2022. Source for Sector Exposures: Bloomberg. as of July 1, 2022. Graphs are presented for illustration purposes only and should not be relied on to make an investment decision

CONCLUSION

For now, there are only two certainties for investors. First, pressure and volatility on exchange rates and risk assets are likely to persist over the coming 12 to 18 months. Second, there will be opportunities ahead for experienced investors with deep local knowledge of how the global conditions uniquely affect their economies and markets of specialty. Indeed, environments of heightened economic pressure often serve to remind investors that emerging markets are not a homogeneous universe. Idiosyncratic factors will result in some countries and areas of the market within these countries suffering more or less than others. Debt burdens, fiscal budgets, the inflation cycle, interest rate policy and whether the country is an importer of food and energy are just some of the factors that will cause differentiation. We believe a local lens will be more important than ever for investors to understand the impact each factor will have on investments, risks and opportunities.

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[1] Source: World Bank as of 2021.
[2] Source: IMF as of 2021. https://www.imf.org/external/datamapper/NGDP_RPCH@WEO/OEMDC/ADVEC/WEOWORLD
[3] Source: IMF as of April 2022. https://www.imf.org/en/Publications/WEO/Issues/2022/04/19/world-economic-outlook-april-2022
[4] Source: IMF as of April 2022. https://www.imf.org/external/datamapper/NGDP_RPCH@WEO/OEMDC/ADVEC/WEOWORLD