J O Hambro
Capital Management Group

News

Emerging Markets Spotlight

We have seen continued high inflation prints across the world, with volatility in interest rate expectations testing the resolve of central banks...

James Syme

17 Nov 2021

October saw a continuation of high inflation prints across the world, with volatility in interest rate expectations and sell-offs in government bond markets testing the resolve of central banks who have mostly been sticking to the view that the current inflation spike will prove to be transitory.

In developed markets there has been significant pressure on some central banks, including those of the UK, Australia and Canada. The governor of the Bank of England said that the monetary policy committee 'will have to act' if inflation in the prices of consumer goods and energy feed through to inflation expectations.

Meanwhile, the Reserve Bank of Australia had to abandon its yield curve control policy (which had pegged 2024 government bond yields at 0.1%). The bank had stopped supporting the policy as fears about inflation were priced into bond markets through October, with yields on the April 2024 government bond rising from 0.05% at the start of October to 0.78% at the end of the month.

Similarly, October saw the Bank of Canada catch rates and bond markets by surprise by ending its government-bond purchase program and accelerating expectations for when it might start hiking policy interest rates.

Emerging market central banks have not been immune from this shift

Many emerging markets have variously seen inflation data that is high and/or above expectation, and sharp shifts in central bank policy.

Brazil has seen an aggressive sell-off of government bonds in recent months, that intensified in October. Inflation data has been difficult, with both September and October CPI printing above 10% YoY. Inflation expectations continue to increase, with the five-year breakeven inflation rate now over 6%, despite the central bank (the BCB) sticking to its 2024 CPI target of 3%. More fundamentally, fears of a water crisis (that would have inflationary implications for power pricing) and/or a relaxation of fiscal discipline ahead of the October 2022 presidential election have undermined market participants' confidence in BCB's inflation-fighting credibility.

This has happened despite BCB hiking rates and the bond market pricing in continued aggressive policy rate increases. Year-to-date, BCB has hiked the policy interest rate from 2.0% to 7.75%, but the shorter end of the yield curve has also moved higher by 3% or more, leaving the BCB much to do.

As we have discussed in previous commentary, this is very much driven by the inflationary outlook, as the Brazilian real looks, to our analysis, fundamentally cheap, and the external financial position of Brazil remains very strong. That does not, however, prevent the drag on economic activity and corporate earnings from a one-year real interest rate (adjusted for inflation expectations) of over 6%.

Another region where, for differing reasons, there has been a sharp shift in inflationary and interest rate expectations is Central and Eastern Europe. The greatest shift has been in Poland, where an Australia-style move in the front-end of the yield curve forced the central bank to hike rates from 0.1% to 0.5% in the October meeting (when a hold had been expected) and then to hike again from 0.5% to 1.25% in the November meeting (when a much smaller hike had been expected).

The Czech central bank has also shocked markets with the speed and scale of rate hikes, with a tightening phase that began with a move from 0.25% to 0.5% in June 2021 accelerating to leave policy interest rates at 2.75% at the time of writing.

It is not clear that Russia has serious inflationary problems, but the central bank, the CBR, has a reputation as one of the most orthodox and hawkish central banks in EM and has steadily hiked ahead of expectations through the year.

But there are bright spots...

Amidst this pattern of central banks potentially getting behind the inflationary expectations curve and having to then hike rates aggressively to catch up, there are bright spots. Some emerging markets, despite seeing higher fuel prices and economic recoveries, have seen moderate increases in inflation and have even been able to leave policy interest rates on hold at levels that are overall stimulative. This group absolutely includes India, which has seen inflation tick lower in recent months (to 4.35% in the year to September), allowing the Indian central bank to remain on hold, with policy rates at 4.0%. Other markets have also been able to remain on hold, including Indonesia (on hold at 3.5% with inflation to October of just 1.7%), and South Africa (on hold at 3.5% with inflation to September of 5.0%).

Clearly, the overall direction of financial conditions in emerging markets will also be driven by the direction of US monetary policy. The US Federal Reserve has kept short-term interest rates near zero, but bond markets are steadily pricing in interest-rate increases in 2022, with futures suggesting the most likely increase is two 0.25% increases next year. As those have been priced in, though, with shorter-dated bond yields rising, the longer-dated part of the yield curve has been falling. Interestingly, this is the opposite of what occurred during the taper tantrum in 2013, when the long end sold off in response to reduced asset purchases by the Fed.

Emerging markets respond well to higher growth and higher commodity prices, and poorly to higher US interest rates and increased volatility. With global growth strong and the Fed still committed to easy monetary policies, emerging economies and emerging markets are well placed,

but will need to see the current volatility in rates and yields calm down before investors can be more confident about the asset class.

Disclaimer

For professional investors only. This is a marketing communication. Past performance is no guarantee of future performance. The value of an investment and the income from it can fall as well as rise as a result of market and currency fluctuations and you may not get back the amount originally invested. Investing in companies in emerging markets involves higher risk than investing in established economies or securities markets. Emerging Markets may have less stable legal and political systems, which could affect the safe-keeping or value of assets. The Fund's investments may include shares in small-cap companies and these tend to be traded less frequently and in lower volumes than larger companies making them potentially less liquid and more volatile. The information contained herein including any expression of opinion is for information purposes only and is given on the understanding that it is not a recommendation. Information on the rights of investors can be found here.

Related Articles

Emerging Markets Spotlight

There has been substantial commentary around the changing regulatory environment in China, but is this overshadowing the economic data?

Read More

13 September 2021

Emerging Markets Spotlight

Pandemic policies and the implications for emerging market investors.

Read More

10 August 2021

Emerging Markets Spotlight

Five indicators to monitor risk and opportunity from the JOHCM Global Emerging Markets Opportunities team.

Read More

26 July 2021

Legal

This website is issued and approved in the UK by J O Hambro Capital Management Limited, which is authorised and regulated by the Financial Conduct Authority. Registered office: Level 3, 1 St James's Market, London SW1Y 4AH. Registered in England and Wales under No: 2176004. Issued in the European Union by JOHCM Funds (Ireland) Limited which is authorised by the Central Bank of Ireland. Registered office: Riverside One, Sir John Rogerson's Quay, Dublin 2, Ireland. J O Hambro is a registered trademark owned by and used under licence from Barnham

Broom Holdings Limited. JOHCM® is owned by J O Hambro Capital Management Limited. Telephone calls may be recorded.

© 2021 J O Hambro Capital Management Limited.All rights reserved.