

Emerging Markets Rates and Inflation: EMTAC model and 2021 views

There is little debate as to the global growth dynamics of 2021 – both the US and China are expected to deliver sterling growth of 6%+ in a rebound year, with the US in particular being driven by stimulative monetary and fiscal policies. The Eurozone and Japan will likely lag behind, as usual, but the effect of growth volatility in the latter two countries has been a much less meaningful macro driver than that of the US and China. The powerful growth and stimulus in the US in particular has led to much talk of inflation. Our model of analysis is indeed showing major warning signals for EM inflation – driven by commodity (and food) inflation and the new phenomena of negative real rates in several EMs. This pressure will lead to either rate hikes in EM more than priced – or to outright inflation, or to both. Separately, we see US inflation as more of a chimera for the near term; but let's focus on our EM model first.

1. EM Inflation and our Local Markets Model

We look at EM inflation in a modified Taylor rule manner – we are concerned with the deviation of realized and projected inflation from each country's inflation target, and with the output gap that remains to be closed in each country. One way that we can show our process in a simple way is to calculate an estimated r-star (natural rate of interest) for each country taking into account the foreseen output gap and the distance between projected inflation and the central bank's inflation goal. We also incorporate an estimate of the country's inflation passthrough from FX moves.

From this we can simply note the difference between our r-star and the ex post real interest rate. We find that ex post real interest rates actually work better than ex ante real rates, as the latter are incorporating too much forecast and thus central banks and the markets don't really react to them – they react to the harder numbers. The table below shows the crucial part of the model results for major CEEMEA countries.

FIGURE1: EMTAC LOCAL RATES AND INFLATION MODEL

Position	Country	Inflation Target	Range	Current Headline CPI	Current Policy Rate	Real Policy Rate	R* Natural Rate	Difference
Pay	Russia	4%	'close'	5.7%	4.50%	-1.2%	2.0%	-3.2%
Pay	Poland	2.5%	+/-1%	2.7%	0.10%	-2.6%	1.0%	-3.6%
Pay	Czech	2%	+/-1%	2.2%	0.25%	-2.0%	1.0%	-3.0%
Pay	Hungary	3%	+/-1%	2.7%	0.60%	-2.1%	1.5%	-3.6%
	Turkey	5%	+/-2%	15.6%	17.0%	1.4%	3.0%	-1.6%
	South Africa	3%-6%	---	3.2%	3.5%	0.3%	1.5%	-1.2%
Receive	Egypt	7%	+/-2%	4.3%	8.25%	4.0%	3.0%	1.0%

The coloring of the table shows some simple stylized facts: under current CPI, inflation rates that are above the top of the central bank's band are in **RED**, those over the top of the midpoint are in **PURPLE**. In the Real Policy rate column, negative real policy rates are shown in **RED** – traditionally emerging market sovereigns did not enter this category – they are an epiphenomenon of the disinflationary global structure of the last few years, added on to by the epidemic. Finally, under Difference, we show in **RED** any negative deviation from the R^* real policy rate of more than -2%: these are countries that we perceive as having inflationary pressures that will bubble up soon, and thus are potential bearish rates trades (paid positions). Finally, countries that have positive real policy rates versus the natural rate are candidates for receiving positions or at least short-term rates exposure – in this case, Egypt stands out as a candidate.

We have translated these into market positions – we have paid (bearish) positions in Russia, Poland and Czech rates, and we are long short-end rates in Egypt. We note that we use the model as a guide, not a systematic driver – for instance we have so far not entered Hungary payers, due to some particular fundamental doubts with how quickly inflationary pressures will bubble up there. Note also that we are already taking some profits on our paid Russia positions, as inflation is already manifest and the central bank has moved to a hiking cycle as of 19 March.

2. EM Central Bank Reaction Functions and Inflation Surprise Phases by Country

Each EM central bank has its own reaction function – which drives curve shape and the ideal curve positioning. For instance, Russia and Brazil saw inflation pressures and have recently combated them by early or larger than expected rate hikes. The shorter end of the curve makes more sense to pay in these countries. Other countries such as Poland will lag in hiking rates – causing CPI to rise quickly in the next several months, which will be reflected in likely rapid increases in the belly or longer end of curves.

We reiterate that overall, global commodity and food inflation combined with negative real rates is a recipe for inflationary and/or rate hike pressures in selected EM with negative real interest rates; we believe countries such as Russia, Brazil, and Chile will clearly manifest the pressures before more EU-tied countries such as Poland and Czech – but that the latter countries will follow with large inflation pressures and/or interest rates pressured higher over the next 3-5 months. For instance, Polish rates are being kept artificially low – such that the 3 year swap is trading around 60bps – but the 3-year swap traded in the 2.0-2.3% range for some 5 years before the Covid crisis (and that was after the oil crash of 2014 – before that it traded in the 3%-6% range). If global liquidity and commodities just stay where they are, Polish rates will likely revert to the mean soon after EU vaccination levels pick up.

FIGURE 2: Poland 3-year INTEREST RATE SWAP



Inflation surprises typically are phased through EM markets – for instance they are first seen in countries with irresponsible central bank policies such as Turkey and Nigeria (already with double digit inflation); they then move to countries that are moderately developed and previously had fairly aggressive but not irresponsible easing policies – like Russia and Brazil. Finally they will hit countries which are more developed but have had long term easy policy – Poland, Chile, Czech, and Hungary are examples of this category. The timing of EM rates trades must take this under consideration.

3. Confusion Between Inflation Formation Process Between EM & DM As Driver

Recently we have seen an interesting dichotomy between EM and DM observers – both economists and traders. Some observers have seen commodity price dominant PPP gains in the US and decided- this is good evidence that core CPI inflation will soon jump a lot. In EM, the economists/investors we speak with see the same thing and decide it is ‘transitory’.

As an example, after Russia hiked rates on March 19 (to the surprise of most forecasters – only 3/41 predicted a hike at this meeting), a major sell-side bank changed its call for Russia from no hikes to 75bps of hikes in 2021. But they then said: ‘Nevertheless, our stance on underlying inflation has not fundamentally changed. We still expect disinflationary pressure to lower headline CPI at the end of this year, once the transitory factors recede,’

We believe the theme that will play itself out for 2021 is actually the opposite – EM inflation pressure, with DM inflation – importantly the US, but also in the EU and Japan - more benign. We make three observations:

- i. The US has a small percentage of energy in the consumption basket- EM countries usually have a large energy/food component in their CPI baskets.
- ii. The US Fed has massive credibility – over credibility in fact, as they haven’t been able to reach low inflation targets despite years of trying. Many/most EM countries had high inflation recently.
- iii. Actual inflation expectations in US are very hard to push up, despite some headline market moves. In EM, inflation expectations are basically contemporaneous in most countries.

We see a similar dichotomy when looking at the belly of interest rate curves. US observers seem to look at belly of US curve pricing in a great deal of rate hikes and say ‘well even if that many rate hikes are unlikely, we have to price in inflation risk premia/term premia - so they make sense’. In EM, investors seem to look at 2-5 year curves in terms of ‘how much is priced in’ only. We believe this thought process should be reversed – EMs should have more risk premia in the curve than DM. EMs have a lot more risks to be priced in than US - in addition to more questionable central bank response there is FX depreciation and volatility risk, credit risks, more political risk, and as above, more exposure to global energy and food volatility. In general, we see these confusions as downstream from different economic philosophies being applied by economists in different seats. This will be a driver of investment opportunities for the year.

4. Global Macro – The Federal Reserve Stance & US Inflation

EM inflation will manifest quickly – NOT US inflation.

The US bond market selloff of 2021 has been driven by an extraordinary degree of monetary easing and fiscal easing by the US authorities. This comes in the context of the Fed’s move to ‘FAIT’ – Flexible Average Inflation Targeting. It is indisputable that these policy stances, coupled with more economic opening as the vaccination process moves forward, will lead to strong US growth in 2021 – on the order of 6% or higher. We are already at the stage of the market cycle where agents are concerned that the Fed is somehow underestimating the degree of inflationary pressures that the easing will accomplish, as seen by rising breakevens and even a selloff in the belly of the US yield curve – implying at one point 75 bps or more of rate hikes in 2023, a much more aggressive schedule than the Fed itself is projecting.

As Emerging Markets sovereign specialists, we are used to thinking about the factors that lead to inflation in a myriad of environments. Our diagnosis is that the Fed's policy (backed up of course by a fiscal assist from Congress) will NOT lead to any quickly manifesting inflationary process in the US (base effects notwithstanding of course), but WILL lead to quick inflation pressure in many EM countries.

It has become increasingly clear that commodity and food price inflation is not enough to create any kind of replicable, self-sustaining inflationary process in the US – as US consumption has much less exposure to these factors than, for instance, EM inflation.

The holy grail for US has been a hope for demand-pull inflation – IE: employment gets tight in the US, the output gap is closed, and there is thus services inflation and upward pressure on wages. But that is far, far away, by our analysis. Despite excitement about the most recent non-farm payrolls number, at the recent pace of payrolls growth it will take until late 2024 to recover the 10 million lost jobs in the US. To add insult to injury, the Phillips curve wasn't working when the US had 3.5% unemployment in late 2019 in any case- and of course, this has led the Federal Reserve, in the new FAIT framework, to effectively scrap the idea that a low unemployment rate by itself can lead to tightening policy.

Why is the Fed's aim to create inflation (specifically, to have core PCE run 'moderately above 2% for some time) such a challenging one? It's not that the Fed can't create inflation at all. The problem is that the Fed's toolkit is only good at generating what one might call the 'wrong kind of inflation' – that is, commodities inflation, not services inflation. Running zero interest rate policy for an extended period and creating large reserve balances is very effective in creating commodities inflation. Effectively the Fed's strategy is to hope that this commodities inflation is transmitted into services inflation. Once upon a time (before the turn of the century) this would have been a productive approach. However, compositional changes in the services index have left services inflation almost insensitive to commodity inflation – the transition mechanism has collapsed.

Until about the year 2000, commodities inflation could be shown to be a significant driver of core services inflation (with an appropriate lag). However, since the 1990's the US economy has been swerving away from manufacturing and more towards services, and the consumption basket of the American consumer has moved away from commodities (e.g. 'prices at the pump') and towards services (especially healthcare and education) that have little correlation with commodities. A look at the composition of the core PCE index itself (which moves as the consumption basket of the consumer moves) shows a fading relative exposure to commodities. The bottom line is that for the last 20 years, commodities inflation has no longer been a noticeable driver of core services inflation in the US.

Can the 'fiscal' drive the inflation that the Fed seeks? There has been a lot of focus on the latest fiscal package – the third of a series that adds up to an impressive \$5 trillion (around 23% of one year of US nominal GDP). The fiscal packages have been quite useful in essentially taking the 'first loss' during the pandemic period, and in providing a safety net to those most negatively affected by the pandemic disruptions. But unless they are

replicated forever (another one each quarter?) they are not really able to change permanent behavior. It's even harder to make a case that the latest fiscal package will create a sustainable inflationary process.

The bottom line is that the only way for the Fed to get to the more sustained inflation environment it seeks will be to run policy hot for some 2-4 years until the output gap is clearly filled. The market will be disappointed several times in waiting for commodities inflation to translate to services.

Thus, we believe that there is a limit to how high nominal interest rates in US can go over the next year. Also there is clearly effectively a limit on 2s10s steepness – so the US 10 year can go up to 1.75% or maybe 1.90% in this scenario, but then will stop. There is also a clear speed limit on the 10 year coming from the low and/or negative yield levels in the Eurozone and Japan – at yields above 1.50%, US Treasuries hedged back into Euro or Yen become very attractive to pension funds and asset managers in those markets. This could more clearly manifest itself after the end of the Japanese fiscal year on 31 March.

5. Spillover of Fed Stance into Commodity & Food Inflation

Wait a moment – did you say 'commodities inflation'? There are countries that will show the effects of that, quickly. That is, countries in emerging markets.

EM inflation is very often cost-push – rather than demand-pull. Oil and food can be up to 50% of the consumption basket of EM countries. These countries are in a very different situation from the US. There is no easy way to keep 50% of the consumption basket from bleeding into core inflation. In particular, keep in mind that in many Emerging Markets countries, inflation expectations are not particularly well anchored.

6. EM Inflation Expectations as Contemporaneous

In fact, in the majority of the countries we cover, inflation expectations are effectively contemporaneous. That is, if inflation starts running at 6% YoY, inflation expectations will immediately go to that level.

7. Real Rates in EM are Historically Low and Largely Negative

In fact, EM countries are probably set up for a quicker inflation boost than in the past. In the last commodity price boom (the QE period of 2009-2014), most EMs were running positive real policy rates. This is no longer true, as seen in Table 1. The pandemic caused many countries to cut rates rapidly. As commodity prices enter higher ranges, negative real rates are no longer sustainable. EM Central Banks will either have to hike rates quickly or accept quick acceleration in inflation – many will have a bit of both.

Effectively, the Fed is blowing a commodity price boom – this is very good for commodity oriented EM credit. But, it will lead to upwards rates pressure on EM local rates.

8. The EMTAC Portfolio Construct

The EMTAC portfolio, is, as always based on our assessment of the individual outstanding risk/reward opportunities in the Emerging Markets space. The overall construct of the portfolio reflects our views of the macro themes of the next year. The driving force behind macro thematic for 2021 is the emerging ‘pandemic denouement’ period. This involves the continued US monetary policy and fiscal response – coupled with slow but steady progress on vaccinations which should allow more normalcy to return to economic activity. As we will have detailed herein, our specific assessment of the important macro themes for emerging markets have led us to a portfolio with two clear asset class views –in aggregate, we hold long positions in select HY EM sovereign credit, and net short exposure to EM local rates markets (rates payers).

EM Rates should start working, especially in the March to July period by which we mean not just following core rates, but autochthonous inflation pressure will become clear – leading to rate hikes or egregious avoidance of rate hikes, as is each particular central bank’s wont.

For countries with central banks that we expect will hike rates fairly soon, such as Chile, Czech Republic, and Russia, we believing paying in the shorter end of the curves is the best position. Russia has in fact proved this by surprising markets by a rate hike on 19 March. We like going further out on the curve for countries such as Poland which look to drag their feet on hiking – creating an inflationary process more quickly.

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