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Analysis

Emerging Markets Update - Inflation

February 2022

Will developed market central banks follow their emerging market counterparts in combatting inflationary pressures?

Central banks continued to dominate capital markets and last week it was the turn of the European Central Bank (ECB) to communicate its hawkish stance, where there was "unanimous concern" from the governing council over inflation.[1]

ECB watchers brought forward the ending of the asset purchase programme to June and the rate lift-off to the fourth quarter of the year. [2] Not to be outdone, the Bank of England (BOE) raised rates 25bps with 4 out of the 9-member committee wanting to hike 50bps. [3]

Understandability, European assets underperformed their US counterparts,[4] with the exception being the Euro currency which appreciated 2.8% vs. the US dollar and pushed emerging market (EM) assets to become the best performers year to date.[5]

In EM, the Brazilian central bank monetary policy committee (Copom) hiked interest rates 150bps to 10% and communicated a reduced pace of hikes going forward, with consensus forecasters setting the terminal rate at 12% to be reached by the end of June 2022. [6] Meanwhile Vladimir Putin attempted to dial down political tensions before jetting off to the Winter Olympics, and Russia CDS closed 30bps tighter on the week. [7]

This week we dusted off our favourite EM inflation models (see chart). I confess that I never envisaged using it for G10 central banks but found the model very effective in predicting the direction and speed of EM central bank monetary policy cycles.

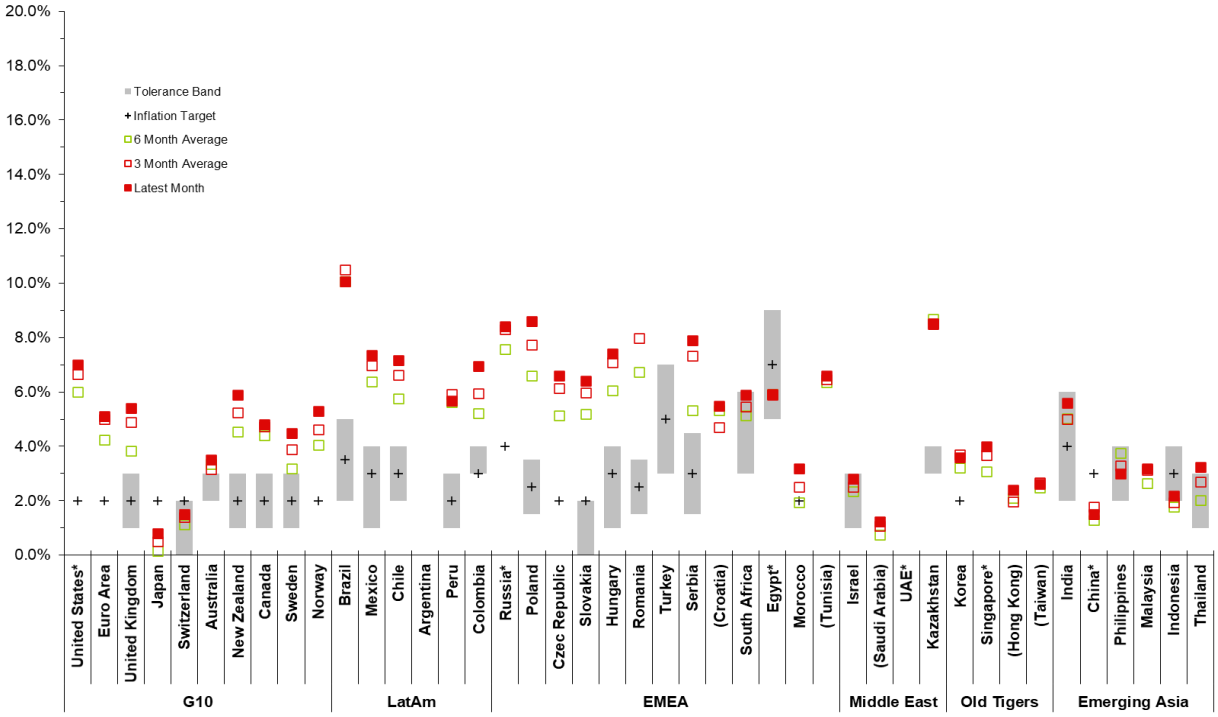
Warren Hyland

Portfolio Manager

Prior to joining Muzinich, Warren worked for Schroders, where he was a Global Portfolio Manager, and later the Senior Portfolio Manager for Global Emerging Markets. In the latter role, he managed about $2 billion and helped to develop the firm's emerging markets corporate capabilities. Previously, Warren was the Head of European Money Markets at UniCredito Italiano. Warren has a BSc in Mathematics for Business from the Middlesex University London, and later received his MSc in Shipping Trade and Finance from the CASS Business School. He holds the Chartered Financial Analyst designation.

1 Muzinich & Co. views and opinions as of February 2022, and subject to change without notice.

Inflation



Source: Bloomberg, Muzinich & Co. (aggregated monetary policy data from global central banks), as of 4th February 2022. *Indicates target from secondary source (i.e. not central bank data).

The preferred scenario for central banks is for inflation to be within its target range; in this regime they can do nothing, where "confidence" in controlling the economy is clear to be seen. Take Israel as an example. This may also explain why the South African tightening cycle has been so shallow.

Historically, a bad scenario for EM central banks is when inflation is above its target band, combined with the latest consumer price index (CPI) print (red box) being greater than the 3-month average (red outline box), which is greater than the 6-month moving average (green outline box).

This pattern can clearly be seen for the eurozone and UK. This pattern also questions the credibility of central banks to control inflation and kick start a hiking cycle. If we review the Brazilian CPI box plot, the latest reading is lower than the 3- and 6-month averages which are basically the same.

This is a good sign that the monetary tightening has effectively brought inflation into check and helps explain why the Copom has now signaled a slowing of its tightening cycle.[8] The Copom is skilled at fighting inflation, something it has had to deal with for decades.

The question is, are developed market central bankers going to follow the short very aggressive approach of Brazil? In March 2021, the Selic rate was 2%, consensus for the Selic rate is now to peak 15-months later 10% higher. [9] Yet the cost is considerable. Economic growth is forecast to slow down with the consensus Bloomberg growth forecast for Brazil at 0.7% for 2022, well below economic potential of 3%. [10] Only time will tell.

1. European Central Bank, as of 3rd February 2022
2. Financial Times, as of 1st February 2022
3. Bank of England, as of 3rd February 2022
4. ICE BofA ML Euro High Yield Index (HE00), ICE BofA ML US Cash Pay High Yield (J0A0), ICE BofA ML Euro Corporate Index (ER00), ICE BofA ML US Corporate Index (C0A0), as of 4th February 2022
5. ICE BofA ML High Grade Emerging Markets Corporate Plus (EMIB), ICE BofA High Yield US Emerging Markets Liquid Corporate Plus Index (EMHY) as of 3rd February 2022
6. Trading Economics, as of 2nd February 2022
7. RUSSIA CDS USD SR 5Y Cbil Currency, as of 3rd February
8. Central Bank News, as of 2nd February 2022
9. Trading Economics, as of 2nd February 2022
10. Bloomberg Survey, as of 31st January 2022

Index Descriptions

C0A0 - The ICE BofA ML US Corporate Index tracks the performance of US dollar denominated investment grade corporate debt publicly issued in the US domestic market. Qualifying securities must have an investment grade rating (based on an average of Moody's, S&P and Fitch), at least 18 months to final maturity at the time of issuance, at least one year remaining term to final maturity as of the rebalancing date, a fixed coupon schedule and a minimum amount outstanding of $250 million.

HE00 - The ICE BofA ML Euro High Yield Index tracks the performance of EUR dominated below investment grade corporate debt publicly issued in the euro domestic or eurobond markets. Qualifying securities must have a below investment grade rating (based on an average of Moody's, S&P and Fitch), at least 18 months to final maturity at the time of issuance, at least one year remaining term to final maturity, a fixed coupon schedule and a minimum amount outstanding of EUR 250 million.

J0A0 - The ICE BofA ML US Cash Pay High Yield Index tracks the performance of US dollar denominated below investment grade corporate debt, currently in a coupon paying period that is publicly issued in the US domestic market. Qualifying securities must have a below investment grade rating (based on an average of Moody's, S&P and Fitch), at least 18 months to final maturity at the time of issuance, at least one year remaining term to final maturity as of the rebalancing date, a fixed coupon schedule and a minimum amount outstanding of $250 million.

ER00 – The ICE BofA ML Euro Corporate Index tracks the performance of EUR denominated investment grade corporate debt publicly issued in the eurobond or Euro member domestic markets. Qualifying securities must have an investment grade rating (based on an average of Moody's, S&P and Fitch), at least 18 months to final maturity at the time of issuance, at least one year remaining term to final maturity, a fixed coupon schedule and a minimum amount outstanding of EUR 250 million.

EMIB – The ICE BofA ML High Grade Emerging Markets Corporate Plus index is a subset of the ICE BofA ML Emerging Markets Corporate Plus Index (EMCB) including all securities rated AAA through BBB3, inclusive.

EMHY - The ICE BofA High Yield US Emerging Markets Liquid Corporate Plus Index is a subset of The ICE BofA US Emerging Markets Liquid Corporate Plus Index including all securities rated BB1 or lower. The ICE BofA US Emerging Markets Liquid Corporate Plus Index tracks the performance of U.S. dollar denominated emerging markets non-sovereign debt publicly issued in the major domestic and eurobond markets.

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