Schroders

Falling EM inflation points to rate cuts

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A pivot in emerging market monetary policy does not appear to be fully priced into markets.

Emerging market (EM) inflation has surprised expectations to the downside in recent weeks as headline consumer price index (CPI) rates have begun to roll over from high levels. An equal-weighted average of headline inflation in 17 major EMs fell below 9% year-on-year in March from a near-14 year high of 10% in January. Inflation is still above target almost everywhere – China being the obvious exception where disinflation remains a concern despite the ongoing economic rebound – but inflation has fallen in recent months in the vast majority of large EMs.

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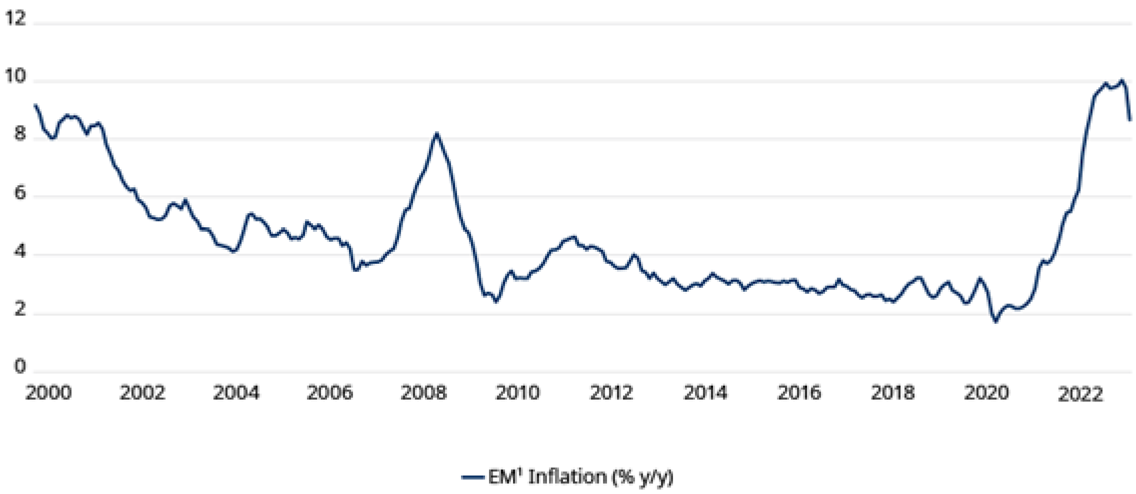
Inflation is rolling over at high levels



Source: Refinitiv, Schroders. [1]17 EMs equal-weighted. 608266

As in the case in most parts of the world, a decline in energy inflation has so far been doing the heavy lifting as the effects of the spike in oil prices following Russia's invasion of Ukraine wash out. Energy inflation should fall even further in the near term and, if oil remains around current levels, stay low for the foreseeable future. The obvious risk here is that rising demand from China as its economy reopens could cause oil prices to climb and energy inflation to pick up again as we head into 2024. This would be against a backdrop of OPEC+ production cuts and geo-political tensions. This is a risk we began tracking in our higher commodity prices scenario during the Q1 forecast round.

Energy inflation has started to fall sharply

Source: Refinitiv, Schroders. 608266

Food inflation should also start to fall sharply in the months ahead. The rate of price increases has overshot expectations and the longer lags in the pass-through from changes in commodity prices (typically around six months) means that EM food inflation is only just starting to roll over.

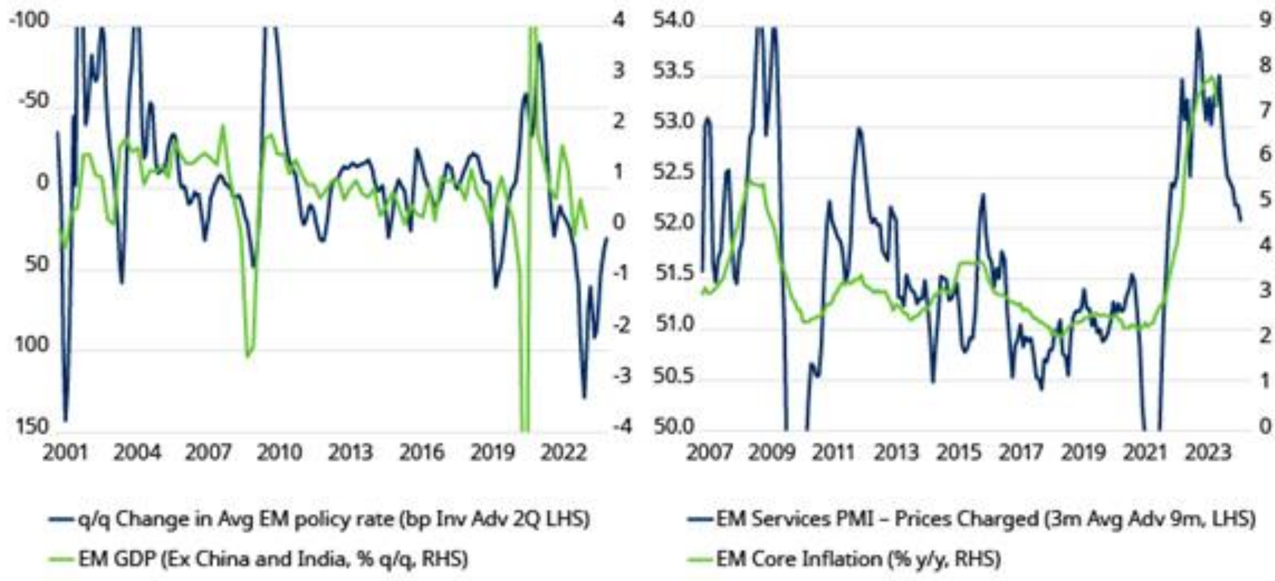
Food inflation is set to nose-dive into year-end

Source: Refinitiv, Schroders. 608266

However, leading indicators suggest that food inflation will nose-dive which, given its large weight in EM CPI baskets, could significantly lower headline rates of inflation. After all, food typically accounts for 20-30% of CPI baskets in most large EMs. As such, the roughly 12 percentage point (pp) decline implied by the lagged relationship with commodity prices could conceivably knock around 3pp off average EM headline inflation by year-end.

There are also signs that core inflation has peaked and will gradually decline in the months ahead. Core inflation is still well above target in most major EMs, particularly in Latin America and Central Eastern Europe. But it has at least stopped rising, and slower economic growth as higher interest rates bite ought to gradually bring down core inflation. Higher interest rates typically take six to nine months to feed through to activity and the lagged impact of aggressive rate hikes means that there is a good chance that growth in many EMs will fall short of expectations in the near term. Surveys such as the "prices charged" component of the EM services PMI suggest that core disinflation trend will soon gather pace against this backdrop.

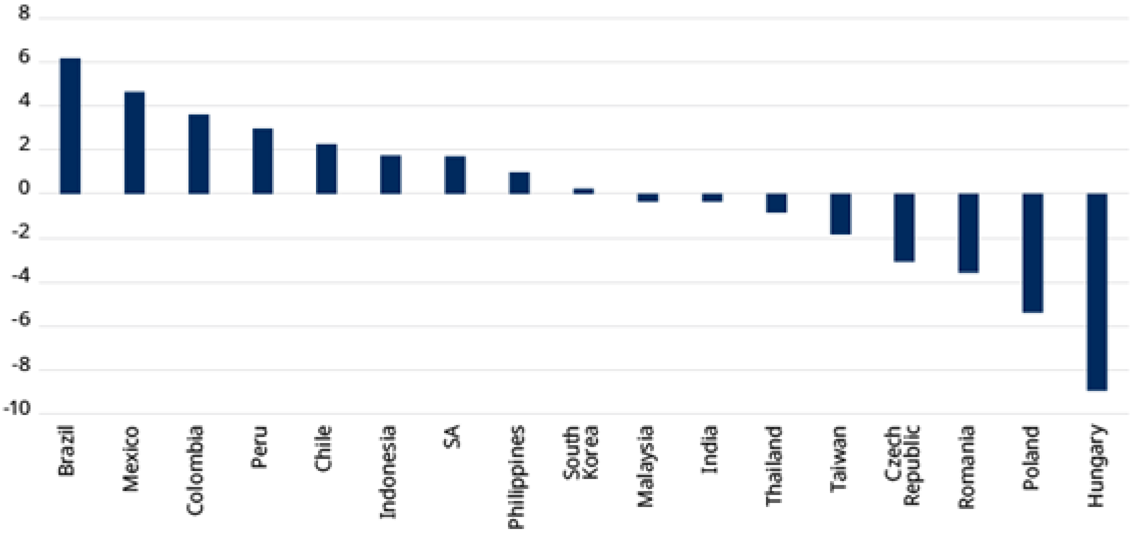
Higher interest rates should help to bring down core inflation



Source: Refinitiv, Schroders Economics Group, 13 April 2023. 608266

Falling inflation and slowing economic growth ought to see EM central banks pivot towards interest rate cuts later this year. The messaging of EM central banks remains cautious as they await confirmation that inflation will decline in the months ahead, against a backdrop of still-rising rates in developed markets. However, most central banks have now paused aggressive hiking cycles. And if we are right in fearing near term downside risks to growth then it may not be long before attention turns to supporting ailing economic activity.

1 Year Ahead Market-Implied Policy Rate – 1 Year Ahead Rolling Consensus Inflation Forecast



Source: Refinitiv, Consensus Economics, Bloomberg, Schroders. 608266

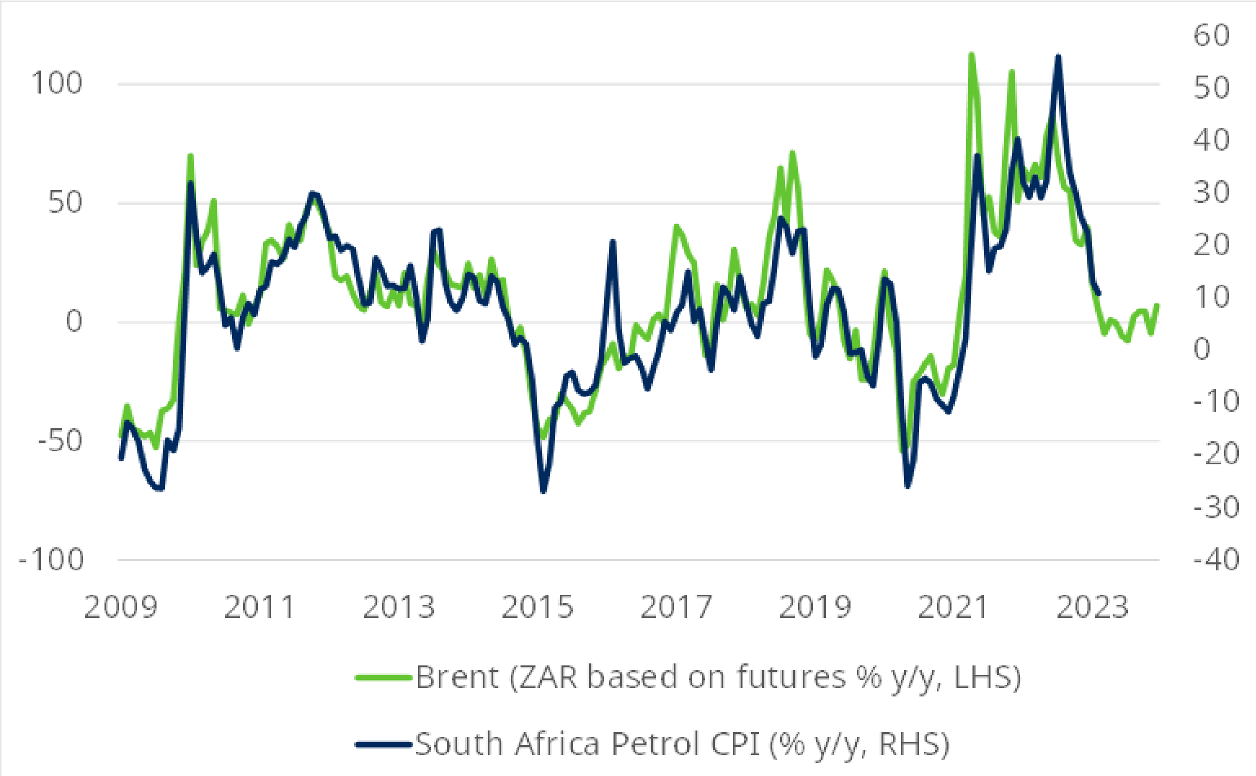
As we have previously argued, a pivot in EM monetary policy does not appear to be fully priced into markets. Based on consensus expectations for future inflation, which may be too high, market pricing implies that central banks in Latin America and parts of Asia would be running large, positive real interest rates at a time when economic growth is likely to be subdued. This feels intuitively wrong and suggests that the front end of curves in these parts of EM should ultimately fare well.

The state of play in South Africa

Inflation in South Africa has continued to surprise to the upside in the past couple of months. The South African Reserve Bank (SARB) unexpectedly hiked rates by 50bp to 7.75% at their last meeting in late-March, and the further increase in headline inflation is likely to concern policymakers.

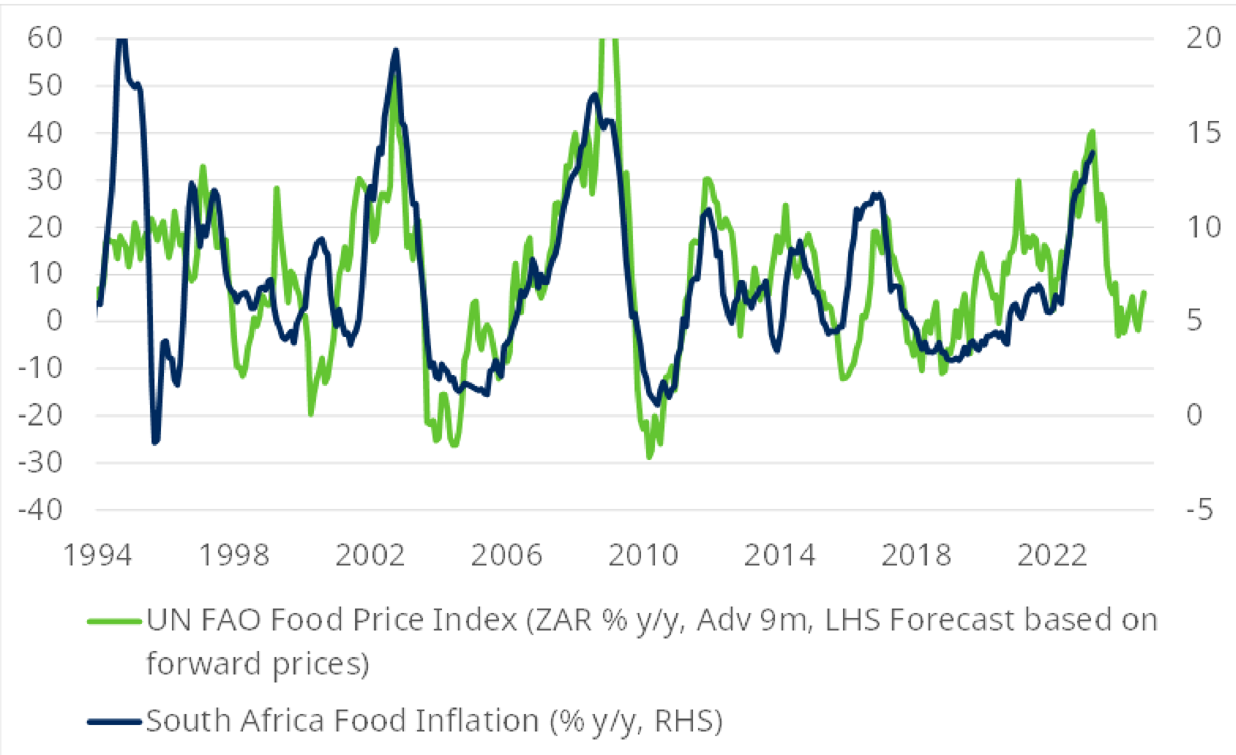
However, there are several reasons to think that inflation should come down in the months ahead, and that SARB will eventually start to consider easing policy again.

First, fuel inflation has already begun to drop sharply and should fall a bit further before stabilising.



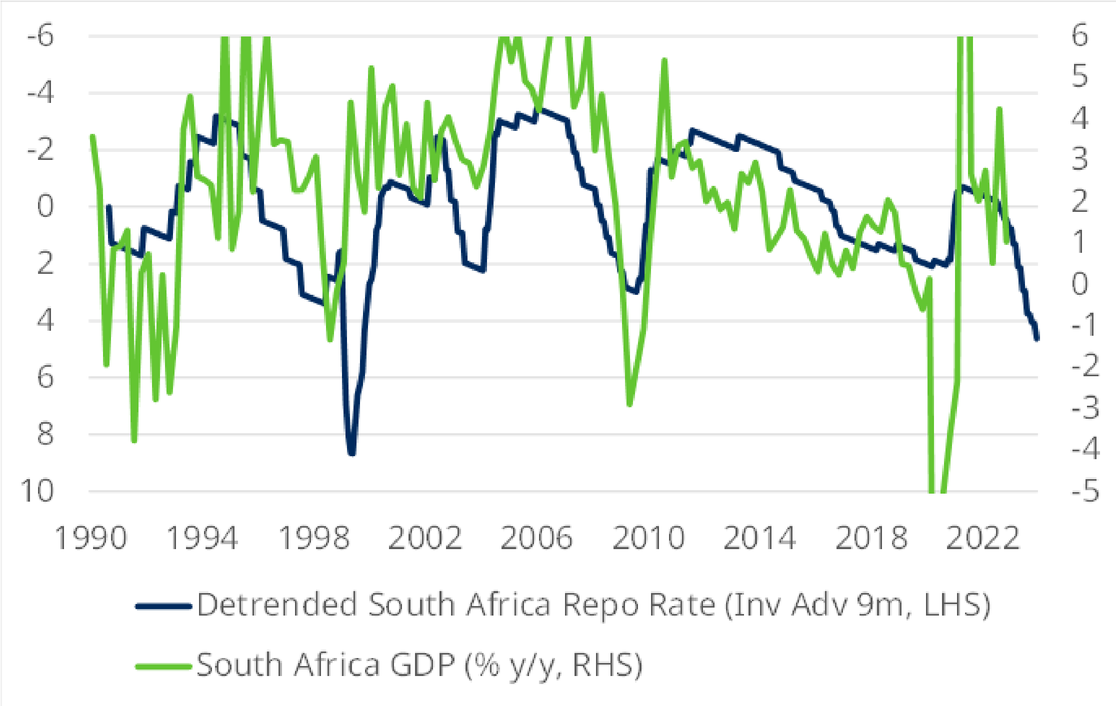
Source: Refintiv, May 4th 2023

Second, while the upside surprise to March inflation was due in large part to the food component, our leading indicator suggests that it should now be around its peak. Crucially, our lead implies that food inflation will fall by about 10%-pts into year-end. Food is around a fifth of the CPI basket, meaning this could knock about 2%-pts off headline inflation in the second half of this year.



Source: Refintiv, May 4th 2023

Third, tighter monetary policy is a clear downside risk to economic activity and a slowdown/recessionary environment would usually cool core inflation. If that happens, then the focus of markets and policy makers would eventually start to shift back from fighting inflation to supporting the economy.



Source: Refintiv, May 4th 2023

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