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INSIGHTS & PERSPECTIVES
Emerging Market Debt Team

AUGUST 2022

# Role Reversal: Why Some Emerging Market Central Banks Were Well-Prepared for the Global Inflation Shock, and What It Means for EM Debt

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Developed markets are currently experiencing price increases not seen in decades, leading central banks to begin a determined though still-sluggish effort to raise real policy rates above zero. In contrast, many emerging market central banks acted much more proactively, tightening monetary policy well in advance of their developed market counterparts. In this note we argue that more recent experience with unanchored inflation expectations, as well as the potential for exchange rate volatility and capital flight, led many emerging market central banks to stay “ahead of the curve”. In many cases, this inflation-fighting resolve has provided a tailwind to emerging market asset returns.

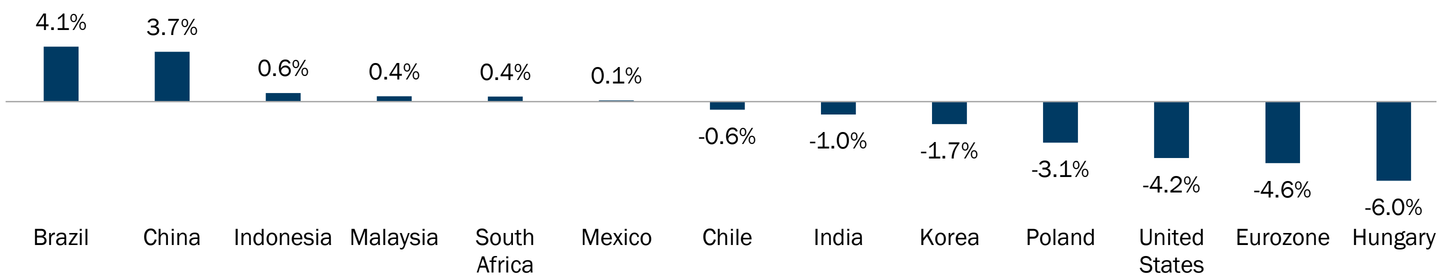
Developed markets are currently experiencing price increases not seen in decades. Central bankers’ previous focus on deflation risks and policy constraints in a low-rate environment has given way to a collective gasp at inflation prints that have an ‘off the charts’ feel to them. Many investors are now wondering if the Federal Reserve will demonstrate the same resolve to bring down inflation as Paul Volcker in the early 1980s, even if doing so risks a deep recession.

US monetary tightening, an even slower response from the European Central Bank and a plethora of different monetary policy decisions across emerging markets have left investors wondering which approach will most successfully navigate the challenging combination of high inflation but slowing growth. In this note, we explore why many emerging market central bankers have proven to be well-prepared to address rising inflation in a timely manner and what it means for investors. Using a series of comparable charts of the main policy rate and consumer price inflation, we discuss how select emerging economies have approached monetary policy and inflation risks over the past decade. We argue that prior experience with unanchored inflation expectations, capital flight and inflationary boom-bust cycles have led many emerging market central banks to be much more proactive in addressing inflation risks compared to their developed market colleagues.

## Real Interest Rates Diverge

Before we dive into the discussion about specific policy responses in emerging market economies, a cross-country

FIGURE 1: REAL POLICY RATES IN SELECT EMERGING MARKET ECONOMIES, THE UNITED STATES, AND THE EURO ZONE




Real policy rates calculated using latest core inflation data (June-July 2022)
Source: Haver Analytics, MacKay Shields.

comparison shows a stark contrast between countries where inflation is much higher than the main monetary policy rate and in turn real interest rates are deeply negative, and others where real interest rates are already positive. Looking at the chart on page 1, the US and Eurozone are towards the very negative end of the range; many emerging markets show negative but less pronounced real policy rates; and some, notably Brazil and China, already have positive real policy rates. In the decade before the COVID crisis, investors in European and US markets had been used to mildly negative real interest rates, with policy rates frequently at the effective lower bound and inflation at or below two percent. But now, developed market real interest rates have fallen to such low levels that investors are questioning whether the Federal Reserve and the ECB are simply too far behind the curve and ill-positioned to bring down inflation any time soon.

The road ahead only becomes more challenging for the Federal Reserve and ECB. Currently, both central banks are emphasizing their commitment to lower inflation through monetary tightening. But in both economies, central bankers' expectations for real interest rates over the next few years remain quite low, judging by their official projections for policy and inflation. Thus it remains to be seen, despite their strong language, if policy makers will have the resolve to take forceful action even at the risk of recession. As importantly, both central banks may come under popular and political pressure to ease policy as unemployment rises, an issue emerging market colleagues have faced often in the past. In this event, Chairman Powell's and President Lagarde's current resolve to bring down inflation may weaken, which would open the door to the "stop-go" policies of the 1970s and a more prolonged stagflationary environment.

## Emerging Market Policy Is Influenced By More than Just Inflation

Historically, emerging market central bankers have had to take into account a range of factors that are not usually top-of-mind for their developed market counterparts. Aside from anchoring inflation expectations and by doing so cushioning the longer-term formation of pricing behavior, emerging market policy makers have also learned from past crises that positive real interest rates are crucial for avoiding a sudden outflow of capital. Historically, foreign investors will flee a market more quickly if nominal interest rates are far below inflation, but perhaps more importantly, preserving the purchasing power of the local currency for domestic investors can help stem a rapid deposit conversion into hard currencies by locals. After all, the pursuit of a positive real return elsewhere is not as pressing if the nominal return on domestic savings is higher than inflation. Political pressures can also have an outsized effect on how monetary policy is conducted, as the examples of Turkey and Argentina demonstrate below.

Inflationary boom-and-bust cycles are more common in developing markets and other factors, such as political pressures, exchange rate volatility or geopolitical crises can play a role in how monetary policy is conducted. Overall, we find countries that follow a rules-based framework have been rewarded during the extremely volatile first half of 2022, with early movers such as Brazil performing much better in sovereign debt markets than latecomers in Europe, which also had to grapple with the geopolitical fallout from the war in Ukraine. South Africa, on the other hand, benefitted from its relative openness, its diversified exposure to commodities and credible central banking. Using exchange rate performance as a proxy, the Brazilian real has outperformed the dollar materially this year as of the time of writing, despite the greenback rallying in trade-weighted terms. The South African rand has depreciated by a modest 3% against the US dollar over the same period, outperforming many developed market currencies, for example the euro, British pound, all Scandinavian currencies and by a marginal amount also the Swiss franc. The South African and Brazilian bond markets have also posted better returns than US Treasuries. In contrast, the Turkish lira and Argentine peso are already the worst performing currency pairs in emerging markets, and as inflation is still far outpacing this year's nominal depreciation of over 20% in both countries, investors will likely stay away.[1]

## Gained or Lost Confidence in Policy Making Often Determines Investment Outcomes

Monetary policy credibility where businesses, consumers and market participants trust that the interest rate environment will be adjusted adequately to allow for economies to prosper, is hard won, but easily lost. Emerging market economic history is richly endowed with episodes where policy makers set interest rates at inappropriately low levels, leading to high inflation and economic instability. For example, having successfully negotiated a much-lauded deal with holdout creditors in 2016,

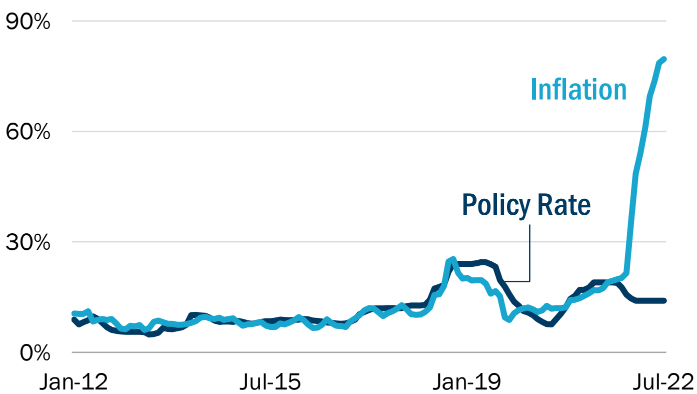
1. Source: Bloomberg

the Argentine central bank eased credit conditions to engineer a boost to growth and even relaxed the inflation target, despite core inflation still running at 20%. The higher inflation target and two successive interest rate cuts in January 2018 delivered a 'permanent shock' to the central bank's credibility, in the words of the then-governor Federico Sturzenegger. The political demise of the Macri administration, a currency crisis and Argentina's 9th sovereign default soon followed. Argentina reminds us of what can happen when policy makers opt for growth before inflation expectations are well anchored.

More recently, an exchange rate crisis is also impacting Turkey, where the Turkish lira has moved from trading at 8 liras per US dollar in the summer of 2021 to 18 liras per dollar now, a halving of purchasing power for each lira in dollar terms. As a result, the Turkish central bank has further damaged its reputation as a credible, independent institution, a reputation that it had acquired painstakingly since the early 2000s. The ousting of several well-respected economists and a rotational replacement of political appointees that have responded to pressure from the president have left the central bank among the least trusted globally. After all, convincing investors to invest in a market where the main policy rate is set at 14%, while the latest inflation print showed 79% is impossible. (See Figure 2 below)

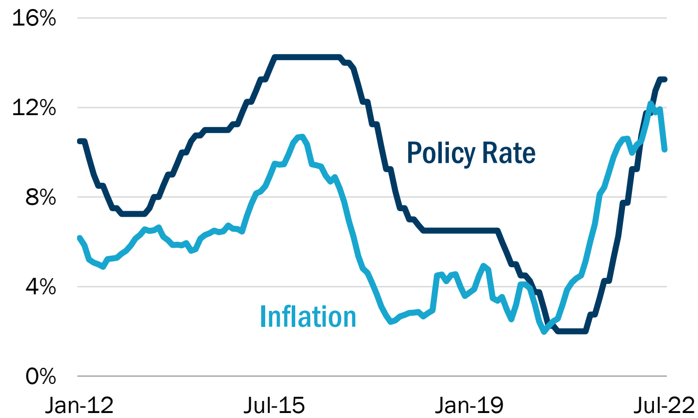
We take comfort from the fact that Turkey and Argentina are isolated cases, where ultimately political decisions determined a crisis-prone economic policy response. In contrast, many other emerging markets have behaved very prudently and even led the global monetary response to accelerating price

FIGURE 2: TURKEY: RUNNAWAY INFLATION, NO CHANGE IN POLICY RATE




Source: Haver Analytics.

FIGURE 3: BRAZIL: REAL INTEREST RATES ARE ALREADY POSITIVE

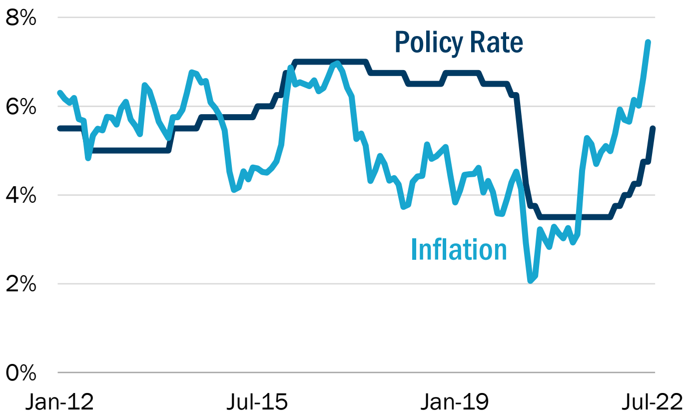



Source: Haver Analytics.

pressures. For example, the Copom, the rate-setting committee of the Brazilian central bank, delivered its first interest rate hike a full 15 months before the US Federal Reserve in March 2021 with 12 successive hikes following the initial 0.25% move. As Figure 3 strongly indicates, the Brazilian central bank has been very keen to re-establish a situation where policy rates, now at 13.75%, are in fact higher than headline inflation, which has fallen from 12.1% in April to 10% in July, showing early signs of policy success. Needless to say, this is in stark contrast to the Federal Reserve and European Central Bank, where policy rates remain deeply negative. Brazilian policy makers' proactive stance and clear communications have contributed to a stable macroeconomic setting, along with a supportive commodity price environment. At the time of this writing, the Brazilian real has appreciated by over 8% against the US dollar this year, a clear indication that markets embrace the actions of governor Neto and his colleagues on the Copom.

South African policy makers also enjoy a stellar reputation among emerging market rate setters, gained through consistent adherence to a rules-based framework. The South African Reserve Bank (SARB) seeks to keep the consumer price index within a 3-6% band and has committed to adjusting interest rates accordingly. Last month, policy makers increased the pace of tightening to address the fact that inflation is above the upper end of the target. The SARB hiked the policy rate by 75 basis points to 5.5%, more than economists had forecasted. As seen in Figure 4, the consumer price index has been within or near the target band for most

FIGURE 4: SOUTH AFRICA: POLICY RATE ADJUSTMENT UNDERWAY




Source: Haver Analytics.

inflation prints over the past decade. Similar to Brazil, strong tailwinds from higher commodity prices have mitigated price pressures that might have otherwise transmitted into the country through a weakening exchange rate. The South African rand has depreciated by a modest 3% against the US dollar so far this year. Capital flows into South African debt and equity markets have held up well as a result. An improvement in the terms of trade for South Africa over the last few years is a further boon for the country.[2] Terms of trade improve when export prices rise faster than import prices, which in South Africa's case has led to a sharp turnaround from a trade deficit to a surplus.

## Diverging Paths Can Lead to Interesting Investment Opportunities

Looking to emerging markets to learn from their monetary policy conduct is interesting as additional dimensions that are not usually a consideration in developed markets come into play. Volatile politics, rapidly moving exchange rates and less credible institutions all play a role in interpreting if the economic cycle can be managed successfully and in turn where capital is best deployed. As we have discussed in this piece, political interference can swiftly dispose of a hard-earned reputation, while following a rules-based framework and some good fortune can lead to a fertile environment for capital inflows that fund development. Investing in countries where central banks are committed to get ahead of the curve quickly in order to anchor inflation expectations, but also in order to shore up capital flows and prevent outflows, can be very rewarding for investors. As investors we find that anticipating some of these dynamics can reward the patient investor and offer good return capture in the long term. In our recently published EMD outlook for the second half of 2022, we maintain that underlying fundamentals for many emerging markets are stronger than is often perceived. It is our view that pro-active monetary policy, decision makers that have learned lessons during crises past, as well as a supportive commodity price environment, have all created a fertile environment for harvesting attractive risk premiums in emerging markets.

2. Source: Bloomberg

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10 unique languages spoken among the team members

**Prior to joining MacKay,** the team led management of approximately **$4 billion** across EMD sovereigns and corporates.

**Valentina Chen**
CO-HEAD & PORTFOLIO MANAGER

**Philip Fielding**
CO-HEAD & PORTFOLIO MANAGER

**Henry Stipp**
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## BLOOMBERG COMMODITY INDEX

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## BLOOMBERG US TREASURY 10 YEAR TERM INDEX TOTAL RETURN

The Bloomberg US Treasury 10 Year Index measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury with 10 years to maturity. Treasury bills are excluded by the maturity constraint, but are part of a separate Short Treasury Index.

## ICE BOFA US CORPORATE IG INDEX

The ICE BofA US Corporate IG Index tracks the performance of U.S. dollar-denominated investment-grade corporate debt publicly issued in the U.S. domestic market. Qualifying securities must have an investment-grade rating (based on an average of Moody's, S&P and Fitch) and an investment-grade rated country of risk (based on an average of Moody's, S&P and Fitch foreign currency long term sovereign debt ratings). In addition, qualifying securities must have at least one year remaining term to final maturity, a fixed coupon schedule and a minimum amount outstanding of $250 million.

## ICE BOFA US HIGH YIELD INDEX

ICE BofA U.S. High Yield Index tracks the performance of U.S. dollar denominated below investment grade corporate debt publicly issued in the U.S. 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. In addition, qualifying securities must have risk exposure to countries that are members of the FX-G10, Western Europe or territories of the U.S. and Western Europe. The FX-G10 includes all Euro members, the U.S., Japan, the U.K., Canada, Australia, New Zealand, Switzerland, Norway and Sweden. Original issue zero coupon bonds, 144a securities (both with and without registration rights), and pay-in-kind securities (including toggle notes) are included in the index. Callable perpetual securities are included provided they are at least one year from the first call date. Fixed-to floating rate securities are included provided they are callable within the fixed rate period and are at least one year from the last call prior to the date the bond transitions from a fixed to a floating rate security. Contingent capital securities ("Cocos") are excluded, but capital securities where conversion can be mandated by a regulatory authority, but which have no specified trigger, are included. Other hybrid capital securities, such as those issues that potentially convert into preference shares, those with both cumulative and non-cumulative coupon deferral provisions, and those with alternative coupon satisfaction mechanisms, are also included in the index. Securities issued or marketed primarily to retail investors, equity-linked securities, securities in legal default, hybrid securitized corporates, Eurodollar bonds (USD securities not issued in the U.S. domestic market), taxable and tax-exempt U.S. municipal securities and DRD-eligible securities are excluded from the index. Index constituents are market capitalization weighted. Accrued interest is calculated assuming next-day settlement. Cash flows from bond payments that are received during the month are retained in the index until the end of the month and then are removed as part of the rebalancing. Cash does not earn any reinvestment income while it is held in the index.

### J.P. MORGAN CEMBI BROAD DIVERSIFIED COMPOSITE BLENDED YIELD

The CEMBI Broad Diversified is a uniquely weighted USD-denominated emerging markets corporate credit index. It employs a unique approach which uses only a certain portion of the current face amount outstanding for instruments from countries with larger debt stocks. This helps to limit country weights, while reducing index turnover. The blended yield of this index is the market value weighted average yield of its constituents.

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The J.P. Morgan CEMBI Broad Diversified Core Index (CEMBI CORE) tracks the performance of US dollar-denominated bonds issued by emerging market corporate entities. The CEMBI CORE follows the methodology of the flagship J.P. Morgan CEMBI Broad Diversified (CEMBIB Div) closely, while offering a more liquid and higher credit quality subset. The CEMBI CORE is based on the composition of the CEMBIB Div but removes the instruments with face amounts outstanding less than US$500 million and the instruments that are closer to maturity. The diversification methodology limits the weights of the larger index countries by only including a specified portion of those countries' eligible face amount outstanding, thus reducing single issuer concentration and providing a more even distribution of weights.

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The Emerging Market Bond Index Global Diversified (EMBIGD) is a uniquely weighted USD-denominated emerging markets sovereign index. It has a distinct diversification scheme which allows a more even weight distribution among the countries in the index.

### J.P. MORGAN EMBI GLOBAL DIVERSIFIED BLENDED YIELD INDEX

The Emerging Market Bond Index Global Diversified (EMBIGD) is a uniquely weighted USD-denominated emerging markets sovereign index. It has a distinct diversification scheme which allows a more even weight distribution among the countries in the index. The Diversification methodology constrains a country's weight by first adjusting the face amount outstanding and then applying an additional layer of maximum weight cap of 10%. The blended yield of this index is the market value weighted average yield of its constituents.

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### MSCI WORLD 100% HEDGED TOTAL RETURN USD INDEX

The MSCI World 100% Hedged to USD Index represents a close estimation of the performance that can be achieved by hedging the currency exposures of its parent index, the MSCI World Index, to the USD, the "home" currency for the hedged index. The index is 100% hedged to the USD by selling each foreign currency forward at the one-month Forward weight. The parent index is composed of large and mid-cap stocks across 23 Developed Markets (DM) countries* and its local performance is calculated in 13 different currencies, including the Euro.

### S&P 500 INDEX

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