INFLATION RHAPSODY

Views From Our Local Teams

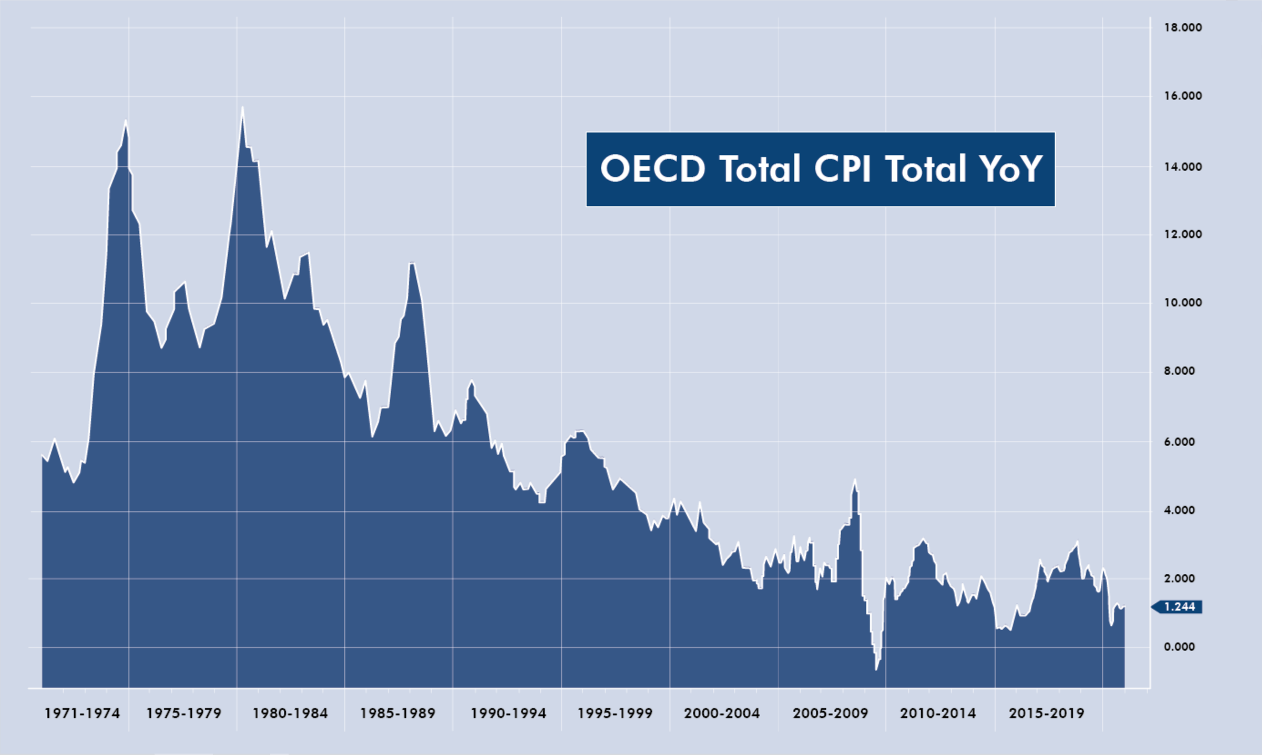
Fixed Income Committee, March 2021

We keep hearing about the inflation slowly becoming a mainstream theme. "Slowly" because, we, as the Fixed Income Committee produced our first piece in October '20, flagging the risk of rising inflation in 2021 driven by the exceptional measures introduced by banks and governments across the globe to fight the dire consequences of the Covid-19 crisis.

We recently asked some of our colleagues based in EM countries to elaborate on inflation dynamics locally, to get a better sense on the driving forces and how inflation might look like in those regions in the future.

The views on the inflation will be mixed given the different drivers of inflation among the countries. But having in mind the recent dynamics in developed markets and commodities, it is amply clear that the deflationary environment we have experienced in the last few quarters is over. The same is probably true for the ultra-low-inflation period which has been with us for the most part of the last decade.

Nicolò Bocchin
Senior Portfolio Manager and Head of Fixed Income
LUXEMBOURG



Source: Bloomberg

ASIA

A slightly higher oil price causes a slightly higher mid-21 inflation peak in Asia. However, in China low core inflation is a concern as it threatens to constrain pricing power internationally. In contrast, high inflation in India reflects local factors.

Asian core inflation is expected to remain static, with the increase in commodities driving the headline inflation above the core. The peak disinflationary effect from the oil was seen in May 20. Then headline inflation rates averaged 0.6% below core; the peak of the commodity price boost to headline CPIs will occur in mid-2021 when headline inflation rates, on average, will be around 1ppt above core inflation. The oil and commodity prices are forecasted to accelerate slightly. On average, our inflation forecasts for Asia-ex-Japan in 2021 are 0.1% higher than they were three months ago.

As the inflationary acceleration is coming only from the commodity prices, and we anticipate little pass through into downstream manufactured goods prices or service prices, and when commodity prices peak the acceleration will go into reverse. Inflation will therefore be falling again in 2H21 and into 2022. On a calendar year average basis, inflation in Asia-ex-Japan in 2022 will be below that of 2021, except for China (due to the pork price effect) and Korea and Malaysia.

Kuan Weng Pang
Senior Portfolio Manager
SINGAPORE

Inflation expectation 2021

	China	Hong Kong	India	Indonesia	Korea	Malaysia	Philippines	Singapore	Taiwan	Thailand
Government	n.a.	n.a.	Below 5 %	2-4 %	1.0 %	2.5 %	2.7 %	-0.5 % -0.5%	1.2 %	1.0 %
Consensus	1.8 %	1.5 %	4.0 %	2.7 %	1.1 %	1.8 %	3.0 %	0.9 %	1.0 %	1.0 %

Source: Bloomberg, CLSA

China
Food prices will make an increasingly negative contribution to headline inflation in early 2021 as pork prices were high in early 2020. High pork prices were a squeeze on real income and may have contributed to the economic weakness (through hidden by the much greater COVID noise). However, the persistent softness of the non-food and core inflation is worthy of comment. Core inflation is running more than 1% below pre-COVID levels. We expect that this will edge up but, thus far the increase has been slower than we expected. The consensus inflation is expected to be 1.8% in 2021.

Hong Kong
Inflation headlines are distorted by the government rebates introduced in response to COVID-19; these have been depressing inflation over the summer of 2020 and 2021 will see a corresponding base effect boosting the YoY headline. Aside from this, the inflation pressure has been very weak; about 1ppt of the 1.5% inflation we forecast for 2021 comes from this base effect.

India
Obscured by the high inflation prints (7.6% headline, 5.8% core in October), there is little price pressure from domestic demand. This was evident from the 3.8% GDP deflator, much lower than the 6.9% average CPI inflation, in 3Q20. The central bank (RBI) expects the average inflation to fall from 6.8% in 4Q20 to 5.8% in 1Q21 with a continued fall below 5% in the first half of FY22. The demand side price pressure is expected to remain subdued, which would imply downside risk to the RBI's inflation projection. The market consensus for the inflation will be at 4% in 2021.

Indonesia
Inflation fell from 3% YoY at the outset of COVID-19 to 1.3% in August and then edged up to 1.6% in November. The core inflation has fallen consistently from 2.9% to 1.7% over this period. Price pressures have been absent since the epidemic disrupted the domestic demand. The recent government policy for 0% LTV loan on mortgage and auto loan is likely to cause asset inflation. Inflation will gradually rise until mid-2021. The average inflation is expected to rise to 2.7% in 2021 and subsequently easing to 2.2% in 2022.

Korea
Inflation is low, on average it has been below the central bank's target for 7 years. However, Korea's inflation rate is sensitive to the terms of trade. Higher commodity prices and the slowdown in the rate of Korean Won appreciation will raise inflation in 1H21. But CPI inflation remains tame at present (0.6% in Jan), thanks to the negative output gap and slack in the labor market. As such, we still see no urgency for the BOK to move to raise the rates in the near term. The market consensus for 2021 inflation is 1.1%.

Malaysia
Weak domestic demand has kept the headline inflation negative and core inflation close to 1%. We expect average inflation to rise as consumer demand rebounds, but the commodity price trend will turn down in 2H21 keeping the average inflation subdued at 1.9% in 2021 and 2% in 2022.

Philippines
Prices have been stable during COVID-19 pandemic containing average inflation at 2.6% YoY in 2020. Inflation will fall after the November spike, but then edge up with rising oil prices in 1H21. Thereafter, markets expect the prices to stabilize for 3% average inflation in 2021.

Singapore
We see Singapore inflation edging higher than the consensus because of the effects of loose liquidity. The headline inflation figure is expected to register 0.4% YoY, the first positive reading since the COVID-19 crisis. While the low base last year is one factor, the ongoing recovery is another key driver. Growth trajectory is heading up and the labor market has bottomed. Inflation should continue to inch higher in the coming months with market expecting it to be 0.9% in 2021.

Taiwan
After dropping during COVID-19 outbreak, the core inflation has risen to around 0.5% YoY. We expect a little further gain meaning that, though commodity price effects will raise headline inflation to a mid-year peak of 2%, it will not stay at this level for long. Market expects the inflation to be at 1% in 2021.

Thailand
Persistent negative inflation during the COVID-19outbreak has highlighted the absence of demand driven price pressure. Weak domestic demand preceded COVID-19 with core inflation contained at or below 1% since April 2015. The market consensus expects average inflation to turn positive, but remain subdued at 1% in 2021.

BRAZIL

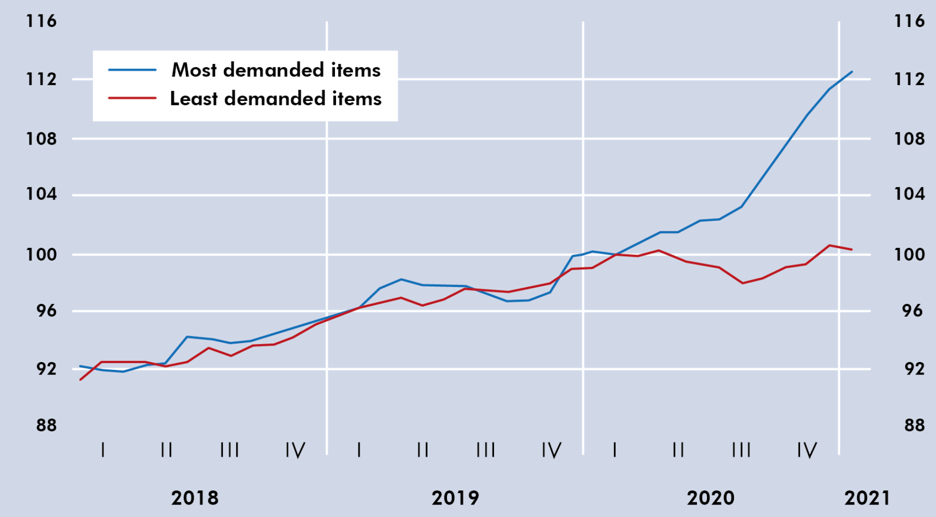
Understanding inflation dynamics during Covid-19 Pandemic was not an easy task in Brazil due to the myriad of moving pieces that affected supply and demand of several items in different ways. At first, the shortfall in demand for most services resulted in sharp CPI decrease towards 2%. But since 3Q20, we saw three different drivers for higher inflation arising: (i) very strong demand for goods; (ii) building cost pressures from a 30% depreciation of BRL and (iii) recovery of services prices to pre-Covid levels.

Covid-19 crisis resulted in more time spent indoors and money previously spent in services got redirected towards goods consumption (both industrial and food items). Another strong boost came from the government transfers to households that more than offset the income shortfall (almost 5% of GDP). Since demand remained strong, companies were able to pass cost increases to consumer prices (manufacturing sector capacity utilization is much higher than before crisis), resulting in 18% inflation for food items and 12% inflation for the "most demanded items".

The "least demanded items" (mainly services sector that require social interaction) show almost no YoY inflation. This results from deflation over 1H20 due to demand shortfall given health risks involved in these activities. In 2H20, companies managed to recover back to pre-Covid price levels, but inflation reacceleration should only resume when we have safer conditions, which we think will occur from 2Q21 on.

Andre Muller
Economist
BRAZIL

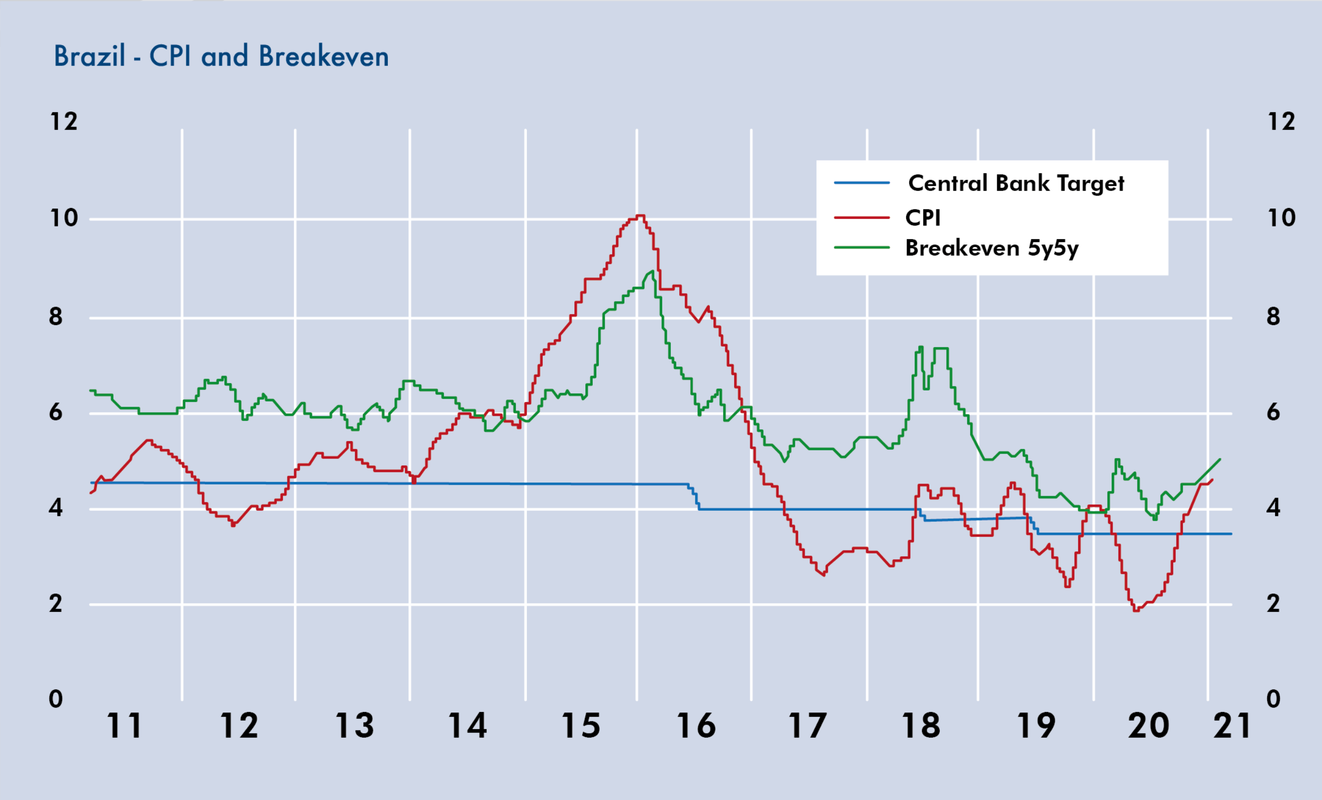
Brazil - Consumer price index (100=feb/21)



Source: Bloomberg, elaborated by AZ Quest

We expect Brazilian CPI to increase by 3.7% in 2021 (from 4.5% in 2020) with upside risks coming mainly from more persistent pass-through from PPI (which could add 1% to CPI in the worst-case scenario). **Markets are now pricing 4.2% CPI in 2021** (above the target), **and 5y5y inflation rates are trading 150 bps above the long-run Central Bank target,** after touching its lowest level last June (just 20 bps).

Current spread is at the usual 100-200 bps range that characterizes "normal times" in Brazil. By normal we mean periods when fiscal sustainability is not under threat, which is a condition for our base case scenario to hold. It is important to highlight that if political decisions turn out to hurt this scenario, another round of currency devaluation and increased uncertainty will result in much higher inflation.



Source: Bloomberg, elaborated by AZ Quest

EGYPT

Egypt inflation rate has seen an inverted U-shape after peaking to the 30s levels with the devaluation of the Egyptian Pound in 2016. CPI growth has declined gradually since then to reach a single-digit in mid-2019 supported by the Central Bank of Egypt (CBE) tightening measures including raising interest rates by 7%. Inflation normalization encouraged the CBE to adopt a growth-oriented approach, gradually cutting rates by a cumulative 10.5% since early 2018, which was also a very crucial move in fighting back the Covid-19 repercussions. Accordingly, the Monetary Policy Committee has changed the target inflation rate down during its last meeting in 2020, to be 7% (±2%) on average by the fourth quarter (Q4) of 2022 compared to 9% (±3%) on average previously.

Inflation started the year with a positive surprise, where the headline inflation slowed down to 4.3% in January from 5.4% in December, which was below the lower end of the CBE's new targeted rate. The drop of the inflation rate was mainly driven by a sharp decline in fruits and vegetables prices by 15% MoM - attributed to seasonality. The decline in fruits and vegetables prices muted the effect of an increase in poultry, fish, seafood, and other core food items, including eggs, pasta, oil and fats, in addition to the increase in prices of services.

Hussein El Sawalhy
Strategist
EGYPT

Ahmed Hisham
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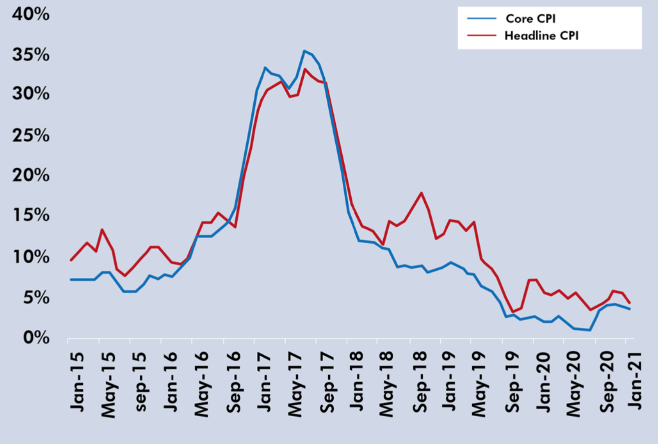
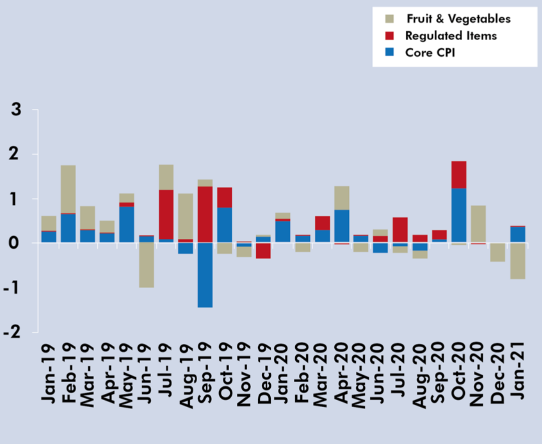
EGYPT

Headline CPI vs Core CPI (Jan 15 - Jan 21)



Contribution to Monthly Headline CPI Inflation (in percentage points)



Source: Central Bank of Egypt

However, inflationary pressures are expected to occur over the short and medium term essentially fueled by higher global commodity prices and the foreseen reflation environment as the vaccination process is taking place across the globe and economies are coming back to normality.

The inflationary pressure already started to show up in some local products, where **steel** rebars' prices increased by 35% from November 20 to date for example. Additionally, local **Food & Beverage** companies started pointing out their plans to gradually pass the increase in production cost driven by higher global prices of palm oil, skimmed milk powder, and sugar to the end consumers.

The latest inflation rate translates into **Egyptian Pound having the highest real rates globally of around 4%** (on policy rates), which still provides a good room for the CBE to further support the rebound in the economic activity. As the recovery of tourism activity is likely to take some time, portfolio investments in Egyptian treasuries will remain important to plug the current account deficit. So, it is not highly likely that the CBE will undertake any interest rate cuts during the 1H21. A 100 bps cut is anticipated to occur during the 2H21.

COUNTRIES OF THE GULF COOPERATION COUNCIL

As things stand currently, a rise in global inflation should have a positive impact on GCC economies if oil prices rise in tandem with global inflation pickup.

Over the last few years, large sections of GCC economies have been impacted by deflationary forces due to a steep decline in oil prices from mid-2018. Government expenditures, which were based on oil price assumptions of around USD80-90/ bbl, had to be cut back drastically due to the sharp and sudden reduction in the oil revenues. This in turn had an impact on sectors of the economy such as real estate and retail. Pandemic has exacerbated the situation by increasing unemployment which resulted in expats leaving GCC countries in large numbers. Headline inflation numbers, however, do not reflect the extent of deflation as governments have introduced VAT for the first time to cover the revenues shortfall. The impact of VAT is currently being reflected in inflation numbers.

GCC countries will be the beneficiaries if oil prices continue to rise which should enable governments to increase their expenditures. However, given the extent of overcapacity in large sections of the economy, there is a minor threat of inflation pickup in the near term from increased government expenditures. Note also that governments will continue to run significant deficits, even if oil prices rise by another 10 to 15 % from the current levels. I would estimate a paradigm shift for GCC economies if oil were to rise to around USD100/bbl but that's not a realistic scenario in the near term in my view, one reason being the ramp-up of US shale production.

Negating the benefit of rising oil prices would be a rise in USD bond yields. GCC countries have pegged their currencies to USD and as a result, will have to raise interest rates to maintain interest rate parity with USD. Given the overcapacity in domestic economies, rise in interest rates would be detrimental for GCC economies. Having said that, absolute level of yields is very low in historic terms and yields will have to rise materially before any impact is felt. Obviously, the worst case scenario would be the steep rise in yields with declining oil prices.

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MEXICO

Geronimo Noriega
Senior Portfolio Manager
MEXICO

2020

Inflation in Mexico increased until October 2020 to 4.09% outside of BANXICO's target range, after having been placed at a particularly low level of 2.15% in April. The rise in the headline inflation in the third quarter was due both to the evolution of the underlying components, as well as the significant increase in the core. For the core components the upward pressures were registered in the prices of goods, which overcame the pressures to low prices for services.

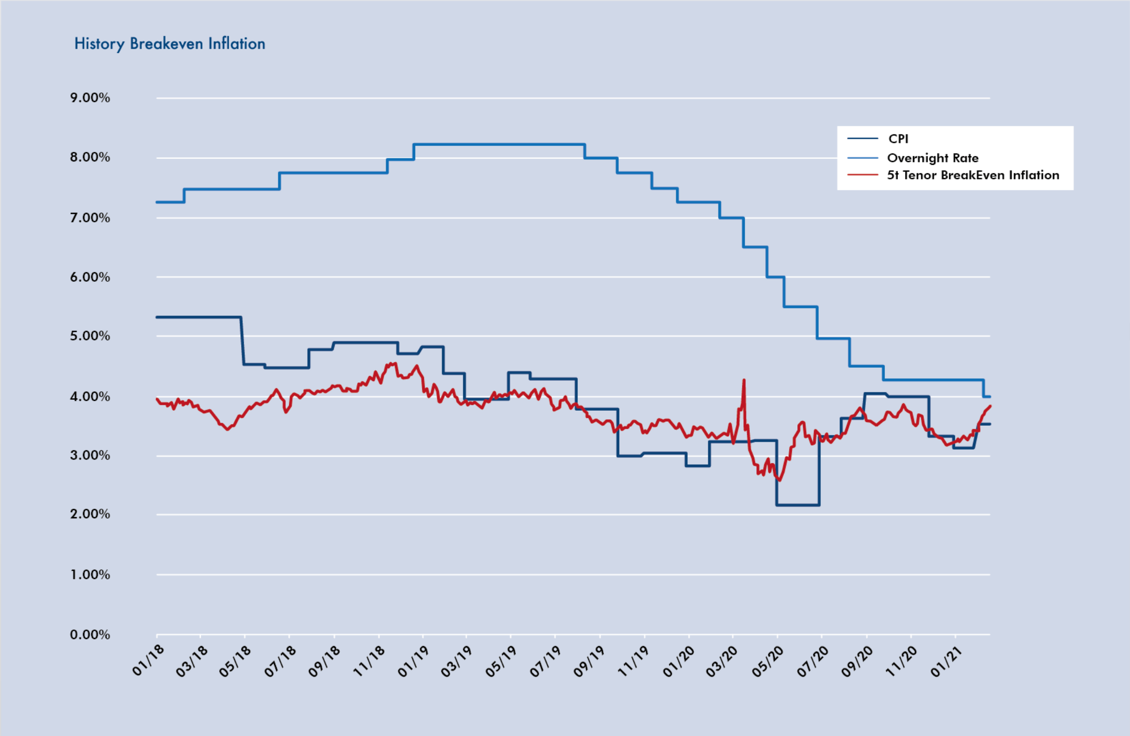
This mix within the core inflation reflected the effects of the pandemic on patterns of household consumption, coupled with the effects of supply shocks and the depreciation of the MXN peso.
Regarding non-core inflation, its behavior was determined mainly by the evolution of the prices of energy within an international context. In this regard, after historically low energy prices contributed to the fact that non-core inflation registered a negative level, the recovery of these prices put renewed pressures until October.
However, during November and December we saw a significant drop in annual inflation from 4.09% to 3.15%, due to the "Buen Fin" offers (the Mexican Black Friday) that were extended for 4 weeks. We considered this drop in inflation as a short-term temporary one.

2021

At the beginning of 2021, we have seen a strong upward pressure on inflation, registering an increase in January to 3.84% and expectations for 4.10% by April, mainly due to the increase in the prices of agricultural products due to the weather conditions in the southern states of USA, energy, mainly gasoline and gas, and pressures on the MXN/USD. However, during the second half of 2021, we expect moderation, with the yearly rate averaging between 3.60% and 3.80%. Interesting to observe the alignment of breakeven inflations priced within the sovereign curve with our inflation expectations. However, some part of the curve seems to offer little upside compared to a few weeks ago.

Linked-Inflation Bond	Market Real Return	Breakeven Inflation	Expected Inflation for 2021	Expected Bond Nominal Carry	Duration	Maturity
S_UDIBONO_220609	0.76%	3.21%	3.70%	4.46%	1.30	09/jun/2022
S_UDIBONO_231116	0.64%	3.58%	3.70%	4.34%	2.65	16/nov/2023
S_UDIBONO_251204	0.99%	3.81%	3.70%	4.69%	4.40	04/dic/2025
S_UDIBONO_281130	1.47%	3.96%	3.70%	5.17%	6.84	30/nov/2028
S_UDIBONO_311127	1.94%	3.95%	3.70%	5.64%	9.40	27/nov/2031
S_UDIBONO_351122	2.44%	3.79%	3.70%	6.14%	11.15	22/nov/2035
S_UDIBONO_401115	2.85%	3.82%	3.70%	6.55%	13.82	15/nov/2040
S_UDIBONO_461108	2.91%	3.92%	3.70%	6.61%	16.43	08/nov/2046
S_UDIBONO_501103	2.92%	3.93%	3.70%	6.62%	17.95	03/nov/2050

Source: Bloomberg, elaborated by MasFondos



Source: Bloomberg, elaborated by MasFondos

TURKEY

Despite CBRT's efforts to tame it, Turkish CPI continues to behave stubbornly. In January, exceeding the expectations, the annual reading rose to 14.97% which was driven mainly by price adjustments observed in non-food groups (housing, household goods and transportation), significant price hikes persisted in groups sensitive to exchange rates and domestic demand. On a global scale, elevated food prices hand in hand with commodities could be more evident on inflation expectations in the coming months. However adjustments to administered prices, which take inflation targets into consideration, may dispel some of the upward pressure from the tube.

The appreciation of the Turkish Lira against a basket of currencies, with the annual change having thus receded to about 20%, suggests that the upward effect of this factor could eventually diminish. On the other hand, economic activity and domestic demand have remained immune to monetary tightening in the first month of 2021. **Minimum wage hike has been set substantially above the inflation target and thus has a potential to fuel the risks for inflation**. Currently more than 40% of the workers in Turkey earn minimum wage.

Consequently, barring a further major depreciation of the Lira, it seems conceivable for inflation to move within the 14-16% range in the first four months of 2021 and gradually ease thereafter to close the year within the 10-12% range. Also note that CBRT's Inflation Report points to the expectation of a gradual increase in inflation until April, to peak at a mid-point of 15.5-16.0% (upper limit 17.5-18.0%). In the event of a deviation from the estimated range in this period, additional tightening by the CBRT would not be a surprise for anyone as the Governor stressed repeatedly that they would not hesitate to **hike** in such a case.

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