Fixed Income Group research

August 2022

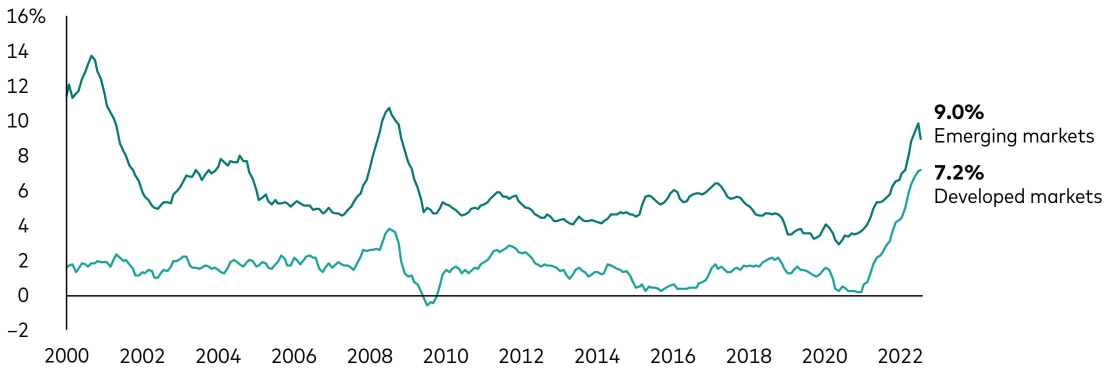
Higher inflation is creating an opportunity in emerging markets

Patient investors are likely to find a long runway for emerging market (EM) local-currency sovereign bonds to rally. Although it is difficult to predict exactly when EM inflation will peak, our analysis leaves us confident that we are close to this point and that disinflation will create a good buying opportunity for EM local-currency bonds.

Emerging versus developed market inflation

Developed market (DM) inflation has converged higher towards EM inflation since 2020. The latest readings for July 2022 put the annualised rates of inflation at a blistering pace of 7.2% for DM and 9.0% for EM – and the momentum remains strong.

Inflation has shot up to highs not seen in decades



Note: Annualised rates of inflation from 1 January 2000 to 1 July 2022. Please refer to the notes accompanying the "Real rates: Emerging markets versus developed markets" chart for a list of countries defined as EM and DM.

Sources: Vanguard and Macrobond, as at 29 July 2022.

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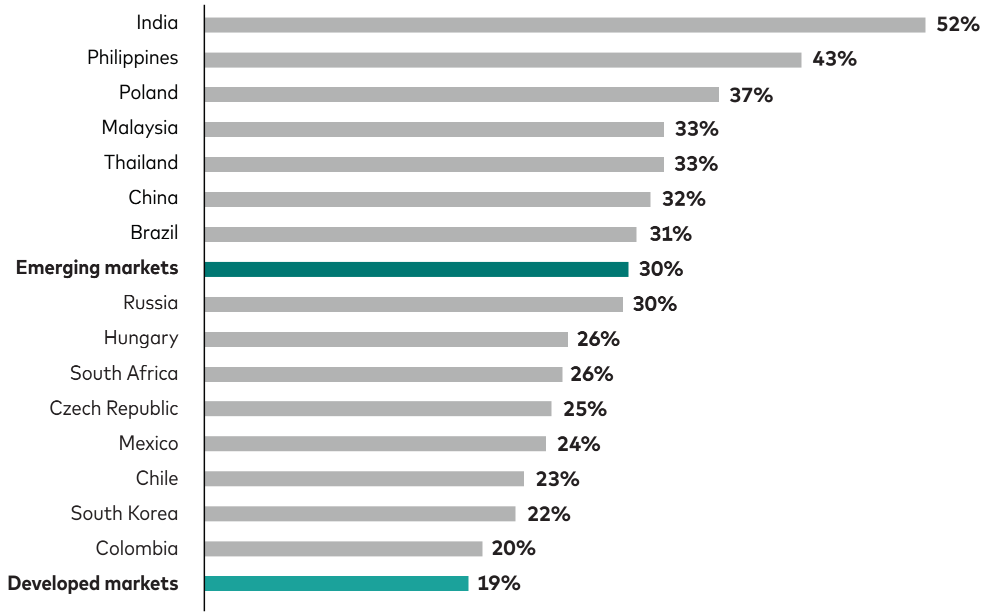
The composition of the baskets of goods and services used to measure inflation can vary between countries and contribute to differences in inflation rates. The conflict in Ukraine initially sparked a surge in energy prices and has more recently put additional upward pressure on food prices. Those two components tend to make up about 30% of the consumer price index (CPI) for EM, a much larger share than the 19% average for DM indices. Broadly, EM inflation has been more supply-driven than DM, as the latter received larger recovery stimulus to boost real growth above the pre-pandemic trend. This makes EM inflation more likely to fall when supply-side pressures abate.

Food and energy make up a larger portion of the CPI basket in many EMs



Note: Data are as of 1 July 2022. Please refer to the notes accompanying the "Real rates: Emerging markets versus developed markets" chart for a list of countries defined as EM and DM.
Sources: Vanguard and Macrobond, as at 29 July 2022.

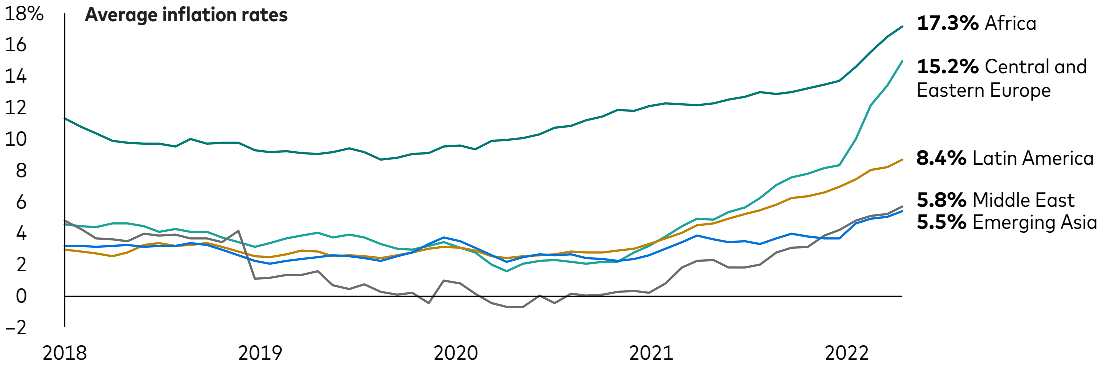
Subtle differences within regions

Although inflation is rising across EM, there are subtle differences. **Central and Eastern Europe (CEE)** has been hit the hardest by rises in energy and food prices. In our view, CEE policy rates may have to stay higher for longer, as this is a region in EM where policy rates are the most negative and labour markets are very tight. Rising inflation expectations here suggest that there is risk of CEE entering into a wage-price spiral.

In **Latin America (Latam)**, relatively aggressive fiscal and monetary easing in comparison to other EM countries in response to the economic shocks brought on by the Covid-19 pandemic is partly to blame for the elevated rate of inflation. The resulting depreciation in the currency exacerbated the price pressures mainly coming via food and wages. However, in our view, Mexico is different, and has been a relative outlier in the region. It provided very little fiscal support during the pandemic and the central bank maintained tighter policy. As a result, growth has been weaker, and while inflation has risen, the increase has been less dramatic than elsewhere.

Asia, in contrast to CEE and Latam, has suffered relatively tame increases in inflation. Asia has benefitted from having more anchored inflation expectations, lower supply-chain cost pass-through due to closer proximity to global manufacturing hubs like China and relatively more fiscal space to fund targeted subsidies. China, with its economic slowdown, remains an outlier, with no expectations for the central bank to raise rates, which is partially bolstered by benign core inflation prints.

The average aggregate inflation rate for EM belies stark differences by region

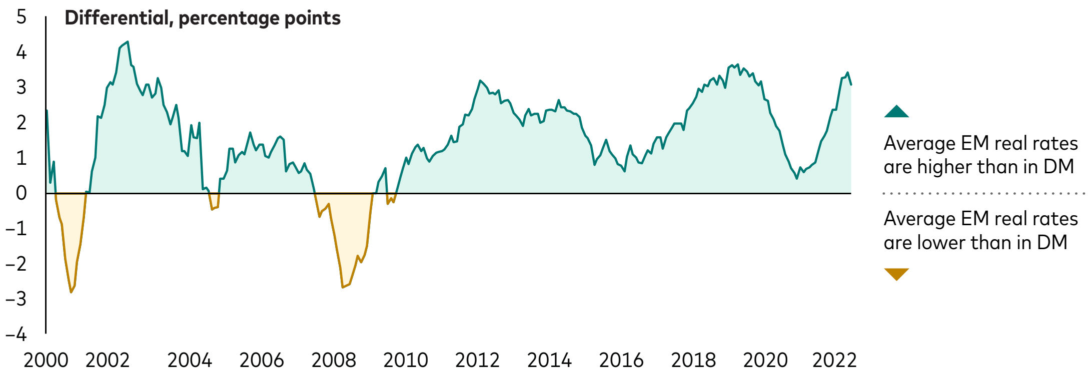


Note: Inflation from 1 January 2018 to 1 June 2022.
Sources: Vanguard and Macrobond, as at 29 July 2022.

EM central banks have been proactively hiking

Emerging markets have also broadly preserved higher real rates than developed markets through the recent inflation spike by proactively hiking policy rates. At some point, high baseline effects from commodity and food prices will dampen inflation readings. The higher weights of these cyclical components in EM consumption baskets portend a stronger disinflation story than for DM.

Real rates: Emerging markets versus developed markets

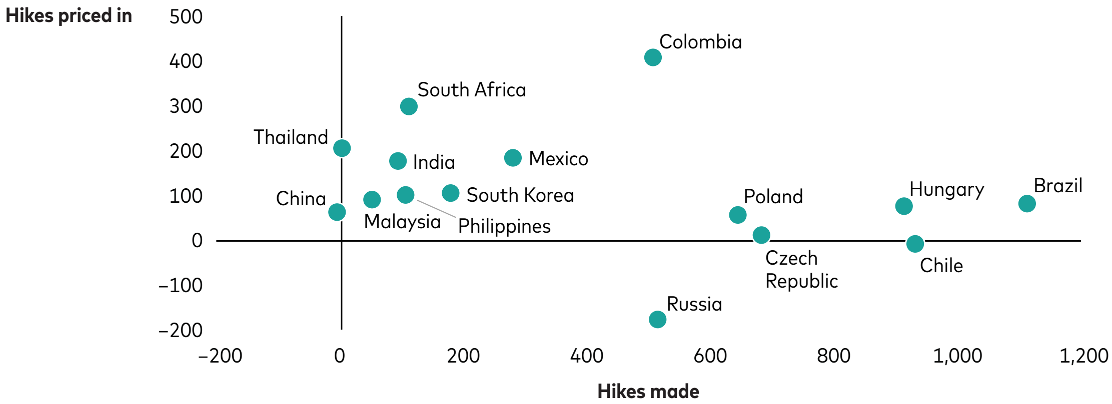


Notes: Data are monthly readings from 1 January 2000 to 1 June 2022. Real interest rates are measured as the central bank policy rate minus the annualised inflation rate. EM countries include those in Africa (Angola, Ghana, Kenya, Nigeria and South Africa), emerging Asia (China, India, Indonesia, Kazakhstan, Malaysia, the Philippines and South Korea), Central and Eastern Europe (Croatia, Hungary, Poland, Romania and Ukraine), Latin America (Colombia, Brazil, Chile, Dominican Republic, Ecuador, Mexico, Peru and Uruguay) and the Middle East (Bahrain, Egypt, Oman, Saudi Arabia and the United Arab Emirates). DM countries include Canada, France, Germany, Italy, Japan, the United Kingdom and the United States.
Sources: Vanguard, based on data from Macrobond, as at 29 July 2022.

This presents EM local bonds (or "rates") as an attractive asset class since the market is now pricing in a good deal of rate hikes over and above what has already been delivered by central banks, as the figure below illustrates.

Some EMs have done more of the heavy lifting on interest rates than others

Hikes made in the last two years, and hikes priced in by the market for the next 12 months, both in basis points



Notes: Data are as of 1 August 2022. Priced-in hikes reflect the difference between current policy rate and 1-year forward implied policy rate. A basis points equals 1/100 of a percentage point.
Sources: Vanguard and Bloomberg, as at 29 July 2022.

Where we see potential for alpha generation in local rates

Forward curves in domestic rates have built in expectations of further tightening in most of EM. Our active fixed income teams are prepared to seek opportunities in long-duration EM local rates when we gain confidence that the current trend has decisively turned, or when we believe that a certain curve is pricing in too much tightening.

For example, in **CEE**, despite expectations of persistent core inflation, we are analysing Polish government bonds as we find them attractive on the scale of repricing and fundamentals. In **Latam**, Brazil's central bank is likely to signal a pause in rate hikes soon after raising rates from 2% to 13.25%, and we feel steepeners (investment strategies that profit from higher longer-term rates versus shorter-term rates) are likely to become attractive. In Chile, with growth and inflation still accelerating, we do not think the central bank will be able to cut rates this year and prefer to be short duration in the front end of the yield curve to take advantage of the cuts being priced out.

In **Asia**, China suffers from fears of a resurgence of Covid-related lockdowns in the face of a slowing housing market, and we are evaluating the attractiveness of re-engaging in long rates positions. We are more confident in more credible central bank regimes in Asia, such as Thailand, Malaysia and South Korea, to play the first innings of the topping out of Asia's inflation momentum. In Indonesia, improving credit activity and the central bank's heavy involvement in supporting local rates make us wary of entering long-duration positions just yet.

In **Africa**, South Africa's central bank is showing proactiveness to prevent double-digit inflation by raising rates and setting a hawkish tone, and we are carefully monitoring the political situation and yields, with a bias towards long-rates positions.

Important part of the process

Rising global inflation and a pro-cyclical US Federal Reserve have raised funding costs in EM in both US dollar and local market terms. We are not confident in calling the peak in EM inflation yet but recognise that local EM rates are starting to look attractive. We believe that our active fixed income teams have a strong process in place to seek opportunities in long-duration EM local rates when the trend decisively turns, and we think that we are close to this point. Our active fixed income teams continue to tease out the best risk/return opportunities within EM local and external debt for our clients and constantly weigh one against the other. With high inflation a reality today across the globe, having a good read of it and how it presents opportunities in EM is an important part of our active process.

Written in collaboration with Zoe Odenwalder, Latin America credit analyst, Nishan Pradhan, senior emerging markets credit analyst, and Daniel Shaykevich, senior emerging markets portfolio manager.

Who we are

FIXED INCOME GROUP

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Vanguard Fixed Income Group manages $2.2 trillion globally in active and passive funds with a global team of more than 180 investment professionals.

YEARS IN FIXED INCOME

35+ years

Vanguard's active fixed income team manages over $607 billion across various actively managed fixed income strategies. For more than 35 years, Vanguard has managed active fixed income funds with an experienced team of credit research analysts, traders and portfolio managers.

WE MANAGE RISK

90+

Our investment teams are supported by our 50-plus member economic research team that informs our economic outlook and our 80-plus member risk management team that is integrated into our investment process.

Data as at 31 December 2021.

Investment risk information

The value of investments, and the income from them, may fall or rise and investors may get back less than they invested.

Some funds invest in emerging markets which can be more volatile than more established markets. As a result the value of your investment may rise or fall.

Funds investing in fixed interest securities carry the risk of default on repayment and erosion of the capital value of your investment and the level of income may fluctuate. Movements in interest rates are likely to affect the capital value of fixed interest securities. Corporate bonds may provide higher yields but as such may carry greater credit risk increasing the risk of default on repayment and erosion of the capital value of your investment. The level of income may fluctuate and movements in interest rates are likely to affect the capital value of bonds.

Important information

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