

The end of emerging market inflation risks?

August 2008 - Author: Daniel Wood, Fund Manager

American comedy writer Robert Orben once wrote that “inflation is bringing us true democracy. For the first time in history luxuries and necessities are selling at the same price.” This quote very accurately describes the feelings of rioters in over twenty countries worldwide this year. Food prices have increased so dramatically that millions are currently unable to feed their families with even the most basic of goods. However, the moving scenes of desperate Filipino’s raiding food warehouses in Manila and Egyptian textile workers fighting toe to toe with riot police in Cairo, contrast starkly with the dramatic fall in bond yields within emerging markets this month.

To glance at the figures you could easily be forgiven for thinking that the inflationary pressures, that have built steadily over the past year, have suddenly disappeared. Although central bankers have the ability to determine rates at the very front end of the yield curve, it is the market that largely sets longer dated bond yields, based primarily on expectations of future inflation levels. These rates now seem to imply that either the global inflationary phenomenon has passed, or that central bankers have done enough to convince investors they have the situation under control.

A quick look at the change in 10 year bond yields this month tells its own story. In Brazil and South Africa they have fallen approximately 1.5%, in Indonesia 1.8% and in Turkey, the longest dated bond yield has fallen an amazing 3%. These movements are just the tip of the iceberg. Dramatic falls in bond yields have been widespread across a diverse range of economies, with investors paying little attention to the country specific dynamics driving inflationary pressures upwards – these price moves mock the theorists claiming emerging markets are now fully efficient. But what is driving this over-riding optimism? Simple - the price of commodities has fallen. From metals and oil to wheat and gas, investors believe the supply side pressures that have been almost exclusively blamed for the sharp increase in global inflation, have now subsided.

Whether this is temporary or the beginning of a trend has historically proved difficult to establish and is beyond the scope of this article. However, the same investors who just one month ago admitted confusion as to the direction, let alone the scope of commodity price moves, are now suddenly convinced. Price movements not only suggest that investors believe commodity prices are declining but that this decline will bring an end to the inflationary demons that have plagued the market for months. If only it were that simple.

Food and energy prices are disproportionately large components of emerging market CPI baskets. Therefore, it follows that falls in the price of commodities will naturally create favourable base effects that will enable the levels of year on year inflation to subside. However, we may be too late. Emerging market economies are still growing apace and are becoming less reliant on exports to developed market as their primary source of growth. In many emerging markets, domestic consumption is rising as households take advantage of real interest rates that are actually lower than they were a year ago and which are in many cases, negative.

The International Monetary Fund (IMF) in their recent report on the state of the global economy, re-iterated their belief that the risks to inflation are still on the rise and they now believe that 2008 average inflation levels in emerging markets are 9.1%. In April, this figure was 1.7 percentage points lower. They warned that if emerging market central banks did not act promptly and appropriately, then the effects would be damaging and that they would have to hike even more aggressively later. They also believe that investors will discriminate among those countries that do not take the proper measures. In July, the herd mentality was prevalent as investors ignored these warnings, indiscriminately purchasing emerging market bonds in a vainglorious search for yield.

Nowhere is this more apparent than in South Africa, where Investec released a report this month that implied that monetary policy had been excessively tight in the country. The market's interpretation of this thesis was: if the new CPI basket to be introduced in January had been introduced a year earlier, reported inflation would now be 1.5 to 3% lower than the current level. This gave the market the excuse to move yields 100 to 150bp lower across the curve.

What buyers of South African bonds specifically, and emerging market bonds generally, have conveniently forgotten is that the second round effects of inflation are becoming embedded in the system. Inflationary expectations are on the rise and are finding their way into both private and public wage settlements. The threat of higher inflation has the effect of lowering savings and increasing spending rates, therefore extending the inflation cycle. With unemployment rates at historical lows, skill shortages in many key sectors prevalent and growth running above potential, it is difficult to believe that falling commodity prices will have such a swift and dramatic effect on the inflationary phenomenon. You cannot rid an economy of embedded inflation in one month as the market appears to be suggesting. In the United States in the 1980s, it took double-digit unemployment to reverse the effects of the embedded inflation from the 1970s.

Emerging markets in the past decade have benefited enormously from an increased number of independent, inflation targeting central banks and floating exchange rate regimes. In many instances, these economies have a history of wealth destroying hyper-inflation. The credibility that central banks have taken years to build is unlikely to be taken lightly. Whilst emerging economies have started to tighten more aggressively, there is still some ground to cover and rates are still too accommodative. Once full credibility is established and inflation expectations within emerging markets are contained over a prolonged period of time, market rates should normalise to developed market levels. However, for all the progress made in recent years, the market is too early and too suddenly pricing this in.

In the early 20th century, American entertainer Will Rogers advised the public to invest in inflation as it is the only thing that is going up. In these uncertain times, this advice may well prove to be just as prudent a century later.