INVESTMENT POLICY STATEMENT

A monthly review of the markets

Stone Harbor
INVESTMENT PARTNERS
A Virtus Investment Partner

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Emerging Markets Leads the Inflation Cycle This Time Around

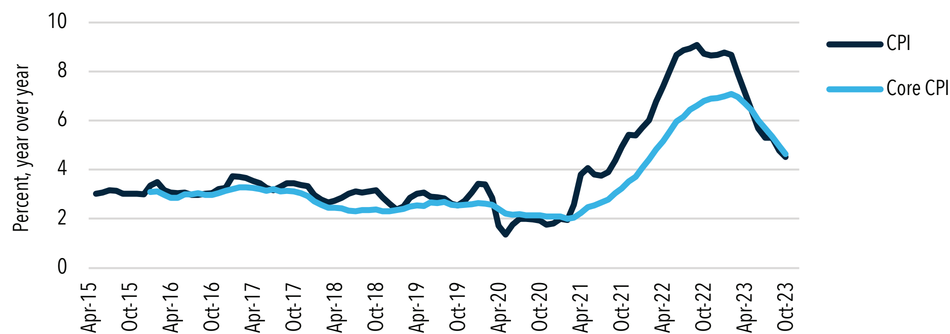
Inflation levels across Emerging Markets (EMs) and Developed Markets (DMs) have generally moved lower over 2023. In the process, particular attention has been focused on the path of U.S. inflation and the Federal Reserve's (Fed) response to economic data. As the narrative around easing U.S. inflation and the end to the Fed's hiking cycle now dominate market expectations, we highlight that EMs have actually led DMs in inflation moderation this cycle. In this update, we examine the key factors and developments that have contributed to the faster moves in EM's economic cycle, as well as what that timing and pace suggest for some of the largest DM economies in the coming months.

"It's not what you look at that matters, it's what you see."

– Henry David Thoreau, American Author

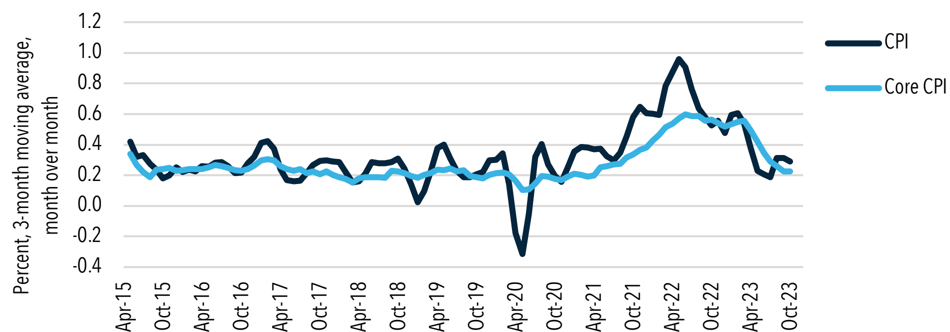
EMs have seen rapid disinflation through Q2 and Q3. And while headline and core year-over-year levels remain elevated, the 3-month moving average run-rate has already dipped down to pre-COVID levels (see figures 1 and 2). In developed markets, inflation has generally followed the same pattern as EM inflation, though with a lag and somewhat different characteristics, which we will discuss later in this report.

FIGURE 1: EMERGING MARKETS INFLATION, GBI EM GD WEIGHTED, YEAR OVER YEAR



Analysis as of December 6th, based on latest available data. Sources: Haver Analytics, JP Morgan, Stone Harbor Investment Partners.

FIGURE 2: EMERGING MARKETS INFLATION, GBI EM GD WEIGHTED, MONTH OVER MONTH



Analysis as of December 6th, based on latest available data. Sources: Haver Analytics, JP Morgan, Stone Harbor Investment Partners.

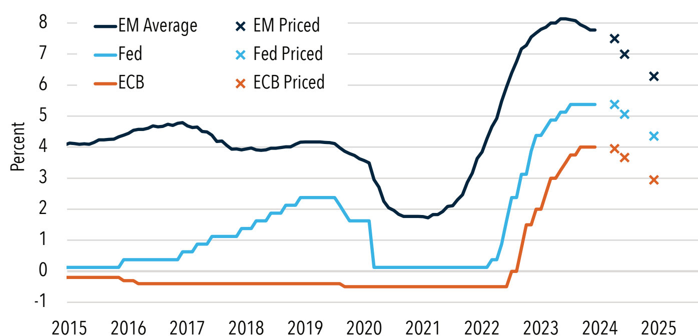
In our view, emerging markets have led the current economic cycle for several reasons. First, EMs embarked on rate hikes earlier than developed markets countries. Many EMs were more proactive in increasing policy rates when the inflation shocks became evident.

The GBI-EM GD weighted EM average policy rate had already increased by more than 250 bps by the time the U.S. Fed started to hike the fed funds rate. Second, while the debate around transitory vs persistent inflation that dominated DM economies was also relevant in EMs, many EM countries did not feel they had sufficient credibility to patiently wait for pressures to subside. Instead, they felt the urgency to signal their commitment by proactively hiking rates. Third, larger role of commodity prices in EM Consumer Price Index (CPI) has impacted EM economic cycle—hurting when the post-COVID recovery led to commodity price spikes, then helping when prices started declining persistently in late 2022. Finally, the EM response to COVID was fiscally more conservative, out of necessity, than developed economies. While DM households benefitted from extraordinary increases in transfers to cushion the COVID shock, EMs generally had much less fiscal space and COVID-era support programs were generally much smaller. The limited fiscal support drove households to cut back spending faster, which led to an earlier economic slowdown and more subdued demand pressures.

Collectively, these factors underscore the improved fundamentals of many EM countries and their ability to respond to external shocks. Solid fundamentals of many emerging economies have been supported by fiscal strength and prudent policymaking, which in turn have helped to produce healthy primary fiscal balances, as well as help stabilize debt-to-GDP levels. At the same time, the more fragile emerging nations have been supported by the International Monetary Fund (IMF) and other multilaterals.

As a result of faster declining inflation pressures and, in many countries, weaker economic momentum, EM countries have also been in a position to lead the rate cutting cycle. Across EMs policy rates have already turned down, and significantly more cuts are in the pipeline for the rest of 2023 and into 2024 (see figure 3).

FIGURE 3: GLOBAL POLICY RATES

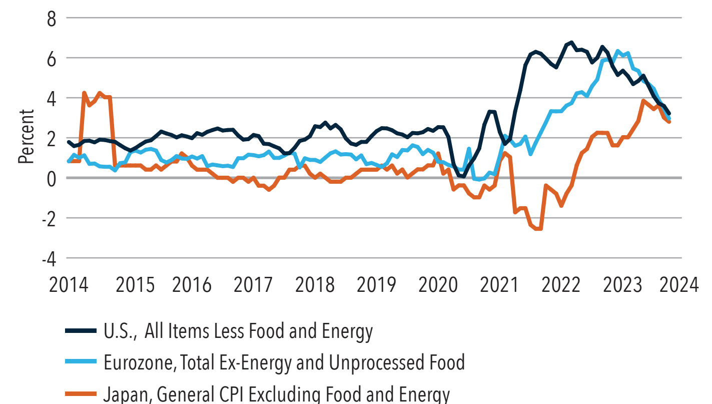


Analysis as of December 6th, based on latest available data. Sources: Haver Analytics, Bloomberg, Stone Harbor Investment Partners.

However, despite the recent inflation run-rate having normalized in most EMs and growth remaining subdued, markets are not pricing a full normalization of policy rates to pre-COVID levels. The key driver that is preventing a return to formerly "normal" levels for EMs is that markets currently price DM interest rates remaining elevated, driven by expectations of permanently higher core real rates. As a result, EMs are also pricing permanently higher real rates. Given these market expectations, one of the key macro developments in the period ahead, including for EM markets, will thus be the development of the U.S. economy and the Fed's policy rate outlook. Hence, we turn to the behavior of DM inflation rates, and the implications for policy.

So, how have the three largest DM economies—the U.S., Eurozone, and Japan—fared in terms of inflation? Currently, they are showing core inflation rates quite close to each other: a range from 2¾% to 3¼% on a 6-month annualized basis (see figure 4). For the U.S. and EZ, the current levels represent a substantial improvement from generationally high peaks as both saw core inflation rates that topped out around 5%, with even higher spikes in overall inflation rates. Japan currently sits around the same level, but for Japan this ~3% pace is still at the highest pace seen, not yet showing significant signs of moderation and certainly not yet the clear down trend seen in the U.S. and the EZ. Japan's peak, if it is peak, also appears a bit lower.

FIGURE 4: INFLATION HAS MODERATED SUBSTANTIALLY IN THE U.S. AND EUROZONE, BUT STILL HIGH IN JAPAN



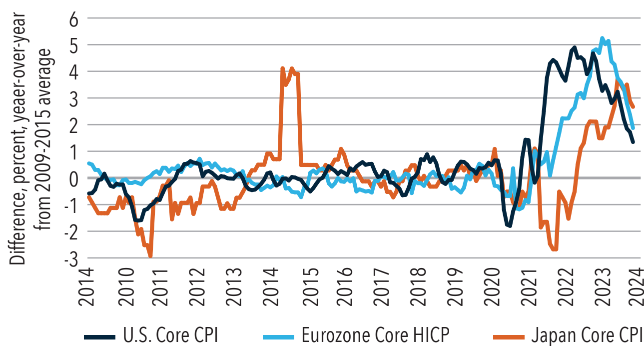
Analysis as of December 6th, based on latest available data. Sources: Bureau of Labor Statistics, Eurostat, Ministry of Internal Affairs and Communications, and Haver Analytics.

That highlights another important observation about the post-COVID DM inflation spike: the timing has differed across countries. Inflation in the U.S. moved first both on the way up and on the way down. The Eurozone followed the same pattern, with a lag of several months both on the way up and on the way down. Japan was the last of the large DMs to see the move up in inflation and, as noted, has yet to see substantial moderation. However, inflation has stopped increasing in Japan and the 6-month measure has shown some very slight moderation, which hints that a similar move down in inflation is worth watching for in Japan.

While this broad-stroke comparison is helpful in identifying the general trends, that similar current inflation rate of 2¾-3¼% obscures nuances between the three economies. It's also useful

to look at the deviation of inflation rates from their pre-COVID 10-year average since the U.S. had average inflation above the Eurozone, which likewise had more rapid inflation than Japan. In doing so, it becomes clearer that the U.S. is farthest along the path back toward pre-COVID normal. U.S. inflation is about 1¼ percentage point (pp) higher than before the pandemic. Europe is still about 2pp above and Japan nearly 3pp. This exercise also shows that size of the inflation shock now looks more similar across economies. All three saw inflation move up by 4-5pp from the pre-COVID average (see figure 5).

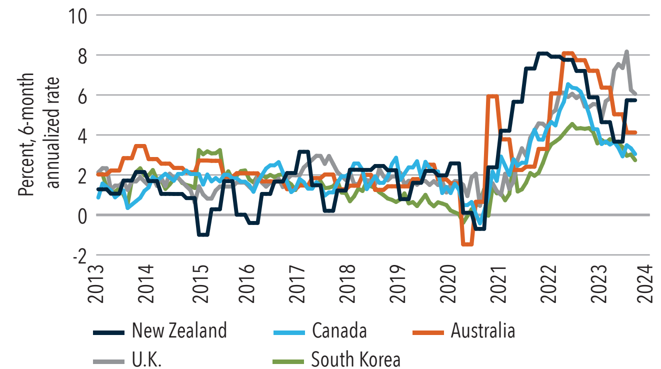
FIGURE 5: WHEN COMPARED TO PRE-COVID PEAKS, INFLATION INCREASED ROUGHLY THE SAME AMOUNT ACROSS DEVELOPED MARKETS



Analysis as of December 6th, based on latest available data. Sources: Bureau of Labor Statistics, Eurostat, Ministry of Internal Affairs and Communications, Haver Analytics, and Author's Calculations.

We see the same pattern in smaller DMs. The smaller Anglosphere countries—the U.K., New Zealand, Australia, and Canada—all also saw substantial runups in the aftermath of COVID, with the precise timing differing across countries (see figure 6). But, just like the three bigger DMs, these countries have since mostly seen meaningful moderation. That's not uniform though, with the U.K. looking somewhat different. There was a 2023 spike, though there was the unique post-Brexit dynamics potentially at play. Away from the Anglosphere, we also see the same pattern in other DMs. Here we include three—South Korea, Norway, and Switzerland. The pattern is the same, the substantial runup over the course of the post-COVID recovery, but substantial moderation since then.

FIGURE 6: INFLATION IN SMALLER DEVELOPED MARKETS HAS FOLLOWED SIMILAR PATTERN



Analysis as of December 6th, based on latest available data.Sources: Statistics New Zealand, Statistics Canada, Australian Bureau of Statistics, Office for National Statistics, Statistics Korea, and Haver Analytics.

Our base case continues to be anchored around a soft-landing scenario, where higher rate environment keeps U.S. growth somewhat below potential, particularly for the most interest rate-sensitive sectors, such as housing. In China, the housing crisis and a slowdown in global economic activity constrains growth. In our view, China will likely refrain from large-scale bailouts and debt restructuring. Importantly, U.S. inflation continues to moderate through the first half of 2024, increasing the possibility of the Fed initiating a rate-cutting cycle and by extension we see more rate cuts across many EMs.

Soft-Enough Landing (55%)

- Higher rate environment keeps U.S. growth somewhat below potential. Growth slowdown rotates from the most interest rate sensitive sectors—e.g., housing—to consumer and business investment. Eurozone growth somewhat slower.
- Weakness in global economic activity and a continuing housing slump constrain China's growth.
- Growth in other emerging markets (EMs) is supported by rate cuts in the second half of 2023 and solid domestic demand in some EMs, offsetting the drag from low DM growth. Commodity exporters still benefit from supportive terms of trade.
- U.S. core PCE remains somewhat firmer through the fall, and then dips slightly lower into the new year.
- Fed keeps rates flat into 2024 and balance sheet runoff continues at sustained US$95 billion/month pace. With inflation continuing to moderate through the first half of 24, Fed cuts are on the horizon, but Fed is relatively slow to implement. European Central Bank (ECB) dynamics similar.
- Rate cuts across many EMs following lower inflation pressures.
- China continues gradual monetary easing. Some incremental stimulus measures slowly roll out, but high debt levels restrain the aggressive use of credit policies. Large-scale bailouts or debt restructurings are avoided due to moral hazard concerns.

Global Recession (25%)

- Fed resumes rate hikes in the winter and fed funds tops out ~6%. Lagged effects of tighter fiscal and monetary policies combine with renewed banking issues, commerical real estate issues, and associated credit contraction to tip global economies into recession.
- U.S. growth fades into the winter. Interest rate sensitive sectors—housing, business investment, and durables—sink. Recessionary dynamics take hold in the labor market and weakness spreads.
- Inflation moderates rapidly with slow consumer and demand contracting activity.
- Already sluggish European growth follows U.S. growth down. The recession spills over into other DM and EM economies, though they perform relatively better than the U.S./EZ.
- China also stalls amid global growth headwind and initially tighter financial conditions. Policy stimulus limits downside.
- As recession dynamics take hold, the FOMC reverses course and starts to cut the funds rate. By Q3 2024 rates are back to around 2½% with potential for further cuts. Balance sheet shrinkage stops, but purchases do not restart. ECB likewise begins reversing hikes.
- EM economies policy stance also shifts, with more decisive cuts than in base case scenario.

High Growth, High Rates, and Inflation Still Too High (10%)

- U.S. growth remains solid, notably over current estimates of the potential growth rate (~1¾%).
- The ongoing firm growth outlook, despite substantial rate increases, does two things. First, it keeps upward pressure on inflation rates, which remain substantially above the FOMC's target into 2023 and do not appear to be declining. Second, it supports upward reassessments in markets of where neutral interest rates are.
- In response, the Fed pushes up policy rates further—to over 6%—so as to put downward pressure on growth and inflation. Longer-term rates also move higher with the higher expected future neutral rates.
- Eurozone growth firms from the current dip, but as in the U.S., inflation remains stubbornly high. Solid U.S. growth provides some support to other DMs.
- EM effect varies. Positive impact from solid U.S. and better EZ growth dominates, but some countries feel the effects of the higher rate environment.
- Oil broadly supported by the robust growth.

Housing Slowdown Pulls Down Chinese Economy (10%)

- Measures to promote Chinese housing demand fail to gain traction. Real estate sales volumes drop further, triggering more outright price declines.
- Defaults spread among real estate, local government financing vehicles, wealth management products. Policy makers incrementally add more stimulus measures. However, cautious on adding more leverage and concerned about exacerbating moral hazard, they shy away from large-scale bailouts and debt swaps.
- China GDP growth declines ~2pp vs. base case
- Non-China EM GDP growth declines around 1pp; more for commodity exporters, less for manufacturing exporters.
- More limited effects on DM economies. Drag on U.S. economy attenuated by ongoing decoupling. Eurozone sees somewhat larger effects.
- Commodity prices decline and risk premia rise.

	Soft-Enough Landing (55%)	Global Recession (25%)	High Growth, High Rates, and Inflation Still-Too-High (10%)	Housing Slowdown Pulls Down Chinese Economy (10%)
U.S. Real 4Q GDP (%)	1.25	-1.50	2.50	1.00
Fed Funds (%)	5.38	2.88	6.38	5.13
U.S. Core PCE (%)	2.75	2.00	3.50	2.60
2yr Treasury (%)	4.65	2.00	6.00	4.50
10yr Treasury (%)	3.75	1.75	5.50	2.75
10yr Bund (%)	2.75	1.00	3.50	2.25
China 4Q GDP (%)	4.00	3.00	5.25	2.00
EM 4Q GDP (%)	3.50	1.75	4.25	2.00
Oil (WTI/Brent)	$80/85	$55/60	$90/95	$65/70

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