Strategy Insights | Fixed Income

Inflation expectations create pressure points for global rates markets

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Overview

- Inflation and inflation expectations have become pressure points for rates markets globally.
- September was an active - and hawkish - month for EM central banks. However, we believe we are close to, or potentially past, the peak in the acceleration of emerging market (EM) rate hikes.
- **Country spotlight:** the Czech National Bank surprised markets with a larger than expected rate hike in September. The move may have knock-on effects in the region.

With COVID-19 slowly fading and economic activity robust, price pressures and, perhaps more importantly, inflation expectations, have become pressure points for rates markets globally. The US Federal Reserve (Fed) has cleared a path for tapering and we are starting to see other developed market (DM) central banks indicate a gradual unwinding of their extraordinary monetary stimulus implemented over the last 18 months.

While the Fed's communication on tapering was positive for the US dollar in the short term, we believe the impact on equity valuations may halt, or even reverse, the strong flows into equities (primarily US and Chinese) that have benefited the US currency. To see US dollar weakness in the medium term, however, we believe we would need to see continued improvement in non-US growth combined with US growth in line with market expectations. Over the next few months, monetary and fiscal developments in the US will likely have an outsized impact on global markets, as excess savings will potentially be attracted to perceived "safer" risk assets.

In addition to inflation concerns, market participants turned their focus to China in September. The fallout from China's crackdown on its over-levered real estate sector and power shortages (though partially government-enforced for environmental reasons) may lead to slower growth and could have broader implications for other EMs in the region. However, it remains to be seen if either factor will impact supply chains or add to global inflation pressures.

Market pulse

Our regional preferences have evolved over the past month, including greater caution on Latin American interest rates. Inflation was higher than expected in Colombia, for example, prompting its central bank to start hiking and possibly frontload its tightening cycle. Similarly, in Mexico, bi-weekly inflation reports continue to put pressure on the Bank of Mexico. We remain cautious on the central and eastern European (CEE) countries while remaining constructive on South African long-term and Russian and Mexican medium-term interest rates. We are generally constructive on EM currencies and favor CEE over Latin America and Asia.

In terms of policy, September was another active - and hawkish - month for EM central banks. There was a large rate hike in Brazil (+1% to 6.25%), accelerating rate hikes in the Czech Republic (+0.75% to 1.5%) and Peru (+0.50% to 1%), gradual hikes in Mexico, Russia and Hungary and an initial hike in Colombia (+0.25% to 2%).[1] In Turkey, where a long-anticipated policy error was realized, the central bank cut rates by 1% to 18%.[2]

The policy rate gap between EMs and DMs continues to grow in nominal terms, and we expect this to translate into a significant differential in relative real interest rates in 2022, as inflation ebbs in various EMs. We, therefore, believe we are close to, or potentially past, the peak in the acceleration of EM rate hikes. While pressures to tighten policy will likely persist over the next few quarters, we believe they will be limited as the early hikers are near the end of their current cycles, the new hikers will likely be gradual in their approaches to tightening and only a small subset of the very low yielders with high negative real rates might accelerate policy rate moves in the coming months.

1. Source: Bloomberg L.P. Brazil September 22, 2021. Czech Republic September 30, 2021. Peru September 9, 2021. Colombia September 30, 2021.
2. Source: Bloomberg L.P. September 23, 2021.

Country spotlight: Czech hikes

Last month we highlighted the accelerating pace of rate hikes by the Central Bank of Chile. This month, the Czech National Bank (CNB) followed suit and surprised markets by raising its policy rate by 75 basis points.[3] As with Chile, financial markets appeared to be pricing in a smaller hike – in the range of 25 to 50 basis points.[4] The CNB has always been an orthodox central bank and the larger than expected hike was a signal that inflation is likely to be more persistent than originally forecasted. Our team believes current oil and natural gas shortages ahead of the winter season could put upward pressure on inflation, leading the CNB to frontload its rate hiking cycle. With this in mind, we believe the five-year part of the rate curve is interesting. We expect the curve to invert but are cautious on duration overall, as questions remain over where the terminal rate will ultimately end up. Additionally, the CNB's decision will likely have knock-on effects in the region, and other central banks (National Bank of Hungary, National Bank of Poland, National Bank of Romania) may be compelled to be more aggressive in their policy normalization going forward.

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3. Source: CNB, September 30, 2021.
4. Source: Reuters, September 30, 2021.

All data as of October 15, 2021, unless otherwise stated. All data is USD, unless otherwise stated.

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