

IMF-WB Annual Meetings

Emerging Markets: Reflation, inflation, or stagflation?

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Markets

- ◆ As the world is reeling from the pandemic and rising energy prices take cost-push inflation to multi-decade highs ...
- ◆ ... many EM central banks are trying to get ahead of the curve with rapid monetary tightening
- ◆ An uncertain outlook keeps investors rather cautious at the 'virtual' IMF-WB annual meetings; we provide a summary

Uncertainty reigns

The International Monetary Fund (IMF) – World Bank (WB) annual meetings were held in a virtual format again this year and coincided with the final week of HSBC's flagship Global Emerging Markets Forum. We had numerous online policymaker meetings with the opportunity to take the pulse of investors based on the questions and discussions during our conference. We infer that sentiment is rather cautious in general as uncertainty reigns over the outlook for the global economy and emerging markets. The conversation has morphed rapidly from reflation earlier in the year, to inflation in the summer, and more recently, galvanised by the ongoing mini-energy crisis, to stagflation.

Emerging markets (EM) is indeed facing multiple, negative supply-side shocks. The pressure continues to build against a backdrop of global trade tensions and pandemic-related disruptions in supply chains, but also the recent spike in energy costs – which are especially inflationary in EM – and the impending tightening in global liquidity as major central banks edge towards normalisation of ultra-loose monetary policy. Our global views and forecasts suggest that stagflation could still be avoided but at a minimum, EM's growth-inflation mix is deteriorating fast.

On the other hand, the technical picture is favourable. EM asset classes, particularly equities and some currencies, are cheap by historical standards, positioning is light despite record inflows in 2021, and cash levels of the institutional investors are high. The adverse backdrop is, to a large extent, already priced in.

So it remains unclear which path the world economy and emerging markets will follow: **reflation, inflation, or stagflation**. These and other subjects dominate the IMF-WB meetings as we head into 2022.

This is an abridged version of a report by the same title published on 18-Oct-21. Please contact your HSBC representative or email AskResearch@hsbc.com for more information.

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Summary of investor takeaways on key EM from HSBC-hosted meetings

China

- ◆ Significant headwinds are emerging from a tightening of regulations, real estate concerns, and power cuts, and are likely to put downward pressure on growth. There were discussions on whether there will be a sustained rebalancing of growth including a shift to a greener economy. China's inclusion in the FTSE Russell World Government Bond Index was also a topic.

India

- ◆ Investors agree that the Reserve Bank of India's stealth policy tightening needs to gain traction. For prospective key bond index inclusion for India government bonds, there are still some hurdles that need to be cleared.

ASEAN: Indonesia, Malaysia, Thailand, Philippines

- ◆ There has been little indication from central bank officials across ASEAN of a rush to normalise policy, in contrast to other EM regions. Policy is set to remain supportive, to ensure that the economic recovery has traction. Inflation pressures are more contained in the region.

CEE: Romania, Hungary, Czech Republic

- ◆ Romania's strong growth recovery masks underlying challenges, with high inflation eroding household purchasing power and a lower COVID-19 vaccination rate than its EU and CEE peers
- ◆ Hungary's economy recovered to its pre-pandemic Q4 2019 level but the focus has now shifted to the outlook for fiscal policy and debt.
- ◆ The Czech economy has been slower bounce back as low unemployment and supply-side disruptions generate uncomfortably high inflation and a strong labour market and wage growth remain as upside risks.

Russia

- ◆ The economy reached pre-pandemic levels in Q2 but inflation has continued rising. This combination prompted Russia to be among the first EM countries to begin policy normalisation.

Egypt

- ◆ There appears to be an agreement among investors that Egypt has recovered well from the COVID-19 downturn, yet concerns remain, centred on Egypt's external account position.

South Africa

- ◆ Investors discussed risks around the inflation outlook, which are likely to keep Central Bank policy in focus, and an agreement that South Africa's current account puts the country in a better position than during the 2013 taper tantrum.

Argentina

- ◆ Investors are focused on debt dynamics as we approach the government's March 2022 deadline to come to an agreement with the IMF to potentially reschedule payments. The fiscal outlook also came up as results could deteriorate sharply in the latter part of this year. The reopening of outward tourism may carry the risk of further erosion of the current account.

Brazil

- ◆ Higher inflation and rates outlook could come at the expense of lower growth, due to downward pressure on disposable income and economic activity in general. Investors are also becoming increasingly focused on the upcoming elections, especially the October 2022 presidential election.

Mexico

- ◆ Investors have been discussing inflation and the possibility of stagflation in Mexico though, on balance, most investors agreed that stagflation would be avoided.

Chile

- ◆ Investors noted that the COVID-19 situation in Chile had improved. This has come alongside a swift recovery in economic activity but with inflation continuing to rise.

Colombia

- ◆ Economic activity is improving, driven by the reopening of several sectors yet the inflation outlook remains a focus for discussions alongside deficits, and current account deterioration.

Disclosure appendix

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Buy: refers to buying the first currency in the named pair in exchange for the second currency in the named pair.

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The tenor of the instrument will be denoted and will refer to a settlement date relative to the opening date of the trade idea e.g. 1m refers to a settlement date 1 month forward from the open date of the trade idea. NDF trades normally fix two working days prior to the settlement date.

Distribution of currency trades

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Our ratings are re-calibrated against these bands at the time of any 'material change' (initiation or resumption of coverage, change in target price or estimates).

Upside/Downside is the percentage difference between the target price and the share price.

Prior to this date, HSBC's rating structure was applied on the following basis:

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*A stock was classified as volatile if its historical volatility had exceeded 40%, if the stock had been listed for less than 12 months (unless it was in an industry or sector where volatility is low) or if the analyst expected significant volatility. However, stocks which we did not consider volatile may in fact also have behaved in such a way. Historical volatility was defined as the past month's average of the daily 365-day moving average volatilities. In order to avoid misleadingly frequent changes in rating, however, volatility had to move 2.5 percentage points past the 40% benchmark in either direction for a stock's status to change.

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As of 17 October 2021, the distribution of all independent ratings published by HSBC is as follows:

Buy	60%	(31% of these provided with Investment Banking Services in the past 12 months)
Hold	34%	(30% of these provided with Investment Banking Services in the past 12 months)
Sell	6%	(28% of these provided with Investment Banking Services in the past 12 months)

For the purposes of the distribution above the following mapping structure is used during the transition from the previous to current rating models: under our previous model, Overweight = Buy, Neutral = Hold and Underweight = Sell; under our current model Buy = Buy, Hold = Hold and Reduce = Sell. For rating definitions under both models, please see "Stock ratings and basis for financial analysis" above.

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Overweight: For corporate credit, the issuer's fundamental credit profile is expected to improve within the next six months. For covered bonds, the bonds issued in this country are expected to outperform those of the other countries in our coverage over the next six months.

Neutral: For corporate credit, the issuer's fundamental credit profile is expected to remain stable for up to six months. For covered bonds, the bonds issued in this country are expected to perform in line with those of the other countries in our coverage over the next six months.

Underweight: For corporate credit, the issuer's fundamental credit profile is expected to deteriorate within the next six months. For covered bonds, the bonds issued in this country are expected to underperform those of other countries in our coverage over the next six months.

Definitions for trades (Rates & Credit)

Buy and **Sell** refer to a trade call to buy or sell a bond, option on an interest rate swap ("**swaption**"), interest rate cap or floor, inflation cap or floor, or Total Return Swap ("**TRS**"). The buyer/seller of a TRS receives/pays the total return of the underlying instrument or index at the end of the period and pays/receives the funding leg.

Buy protection and **Sell protection** refer to a credit default swap (CDS): the protection buyer/seller is effectively selling/buying the reference entity's credit risk.

Pay and **receive** refer to a trade call to pay or receive the fixed leg of an interest rate swap (IRS), a non-deliverable IRS, the first-named leg of a basis swap, the realised inflation leg of an inflation swap, or a forward rate agreement (FRA). An investor that executes a pay or receive trade is said to be "**paid**" or "**received**."

Payer and **receiver** refer to inflation caps or floors and to swaptions: a payer is an option giving the right but not the obligation to enter a paid position in an interest rate or inflation swap, and a receiver is an option giving the right but not the obligation to enter a received position in an interest rate or inflation swap.

ASW (also asset-swap, Buy on asset swap, Buy on an asset-swapped basis): Buy a bond packaged with a swap that is tailored to eliminate the bond's interest rate risk, effectively transforming the bond to a floating rate instrument whilst preserving the credit exposure to the bond issuer.

RASW (also reverse asset-swap, Sell on asset swap, Sell on an asset swapped basis): Sell a bond packaged with a swap that is tailored to eliminate the bond's interest rate risk, effectively transforming the bond to a floating rate instrument whilst preserving the credit exposure to the bond issuer.

Distribution of fundamental credit and covered bond recommendations

As of 30-Sep-21, the distribution of all independent fundamental credit recommendations published by HSBC is as follows:

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Underweight	25%	(35% of these provided with Investment Banking Services in the past 12 months)

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Distribution of trades

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Sell	21%	(50% of these provided with Investment Banking Services in the past 12 months)

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