

Opinion | 14 July 2021

INDONESIA MALAYSIA

Conditions for EM Asia getting less supportive

Higher for longer US inflation and a faster hiking Fed and strengthening USD look like exactly the wrong ingredients for a healthy emerging Asia



Shock inflation could spur more change from the Fed.

I've written in recent days about [the Cleveland Fed NowCast for inflation](#). Last night's US June inflation numbers show the limitations for such measures, though I struggle to understand why such measures can't include an accurate measure of used and rental car prices - both things you would imagine you could find out fairly easily if you were minded to look for them. So US June headline inflation not only managed to exceed last year's tough 0.5%MoM hurdle, it smashed it, rising 0.9%MoM taking the annual rate of inflation to 5.4%YoY and a similar monthly rise took core inflation to a whopping 4.5%YoY.

[James Knightley's piece here](#) covers the main details - note especially the pipeline pressures indicated by the NFIB survey, and also the likelihood of housing joining the inflation party over the coming 12 months as rentals catch up with house prices. As JK suggests, this is not consistent with the "transitory" story Jerome Powell has been feeding markets. And with him testifying in front of Congress tomorrow, JK thinks that we may get the first hint of an earlier taper a lot sooner than we had been expecting. Let's see how markets digest that (watch also for tonight's Beige book).

Markets are coming to terms with the higher inflation story, though their reaction is not totally conventional. Firstly, and as I mentioned too a few days ago, markets may also be anticipating an earlier taper, and an earlier first fed rate hike, just like we are. But they aren't necessarily pricing in more tightening in total. Earlier might mean less in total according to this market view, which seems to be the message you get when you look at today's USD OIS curve and compare it with the same curve a month ago. And not much is being priced in for the peak Fed funds in total. The long term peak in the OIS yield is about 1.2%, and that is years in the future, with medium-term yields 2-3 years ahead not much higher than 0.75%. Could this be one explanation for 10Y US Treasury yields in the 1.40 area? It seems reasonable until this view alters.

This backdrop of higher for longer US inflation and a faster hiking Fed and strengthening USD is not a good recipe for emerging Asia. Following the Fitch outlook revision of the Philippines long term foreign currency issuance to negative from stable (affirming the BBB rating), questions might well be drawn over nearby neighbours, Indonesia, but also Malaysia and Thailand, all of which are suffering from new waves of Covid which will weigh on activity, tax revenues and ability to repay foreign debt. We haven't seen too much spillover yet, but it is worth considering with the backdrop turning less supportive, we may have to deal with a broad-based EM souring in both bond and FX space (equities obviously too) as we head into the year-end.

Asia today

Korea has already released June unemployment data, which shows that before the latest Covid restrictions kicked in, Korea was making progress in the labour market. The unemployment rate for June edged down to 3.7% from 3.8%, with gains in most sectors except, interestingly, manufacturing. Total employment gained, and unemployment fell against a modestly increasing labour force, so the decline in the unemployment rate looks legitimate, though comes with caveats about what may happen if the Covid daily increase does not soon start to fall.

And in Singapore, 2Q GDP was just released, Prakash Sakpal writes "Singapore's advance GDP estimate for 2Q21 showed the economy growing by 14.3% from a year ago but contracting by -2.0% from the previous quarter. The outcome was in line with the consensus, so unlikely to have much market impact. Manufacturing remained in the driving seat for headline GDP growth with an 18.5% YoY surge. But the recovery of this sector was set back as we have also seen recently with exports data, and showed a 1.8% QoQ contraction in output. Likewise, construction and services sectors posted year-on-year rebounds but also contracted on a quarterly basis. The gradual reopening of the economy should instil some more life into the domestic economy, but this negative spell is likely to linger for some time to come. That means the recovery will be mainly dependent on exports regaining their recent strength. We see nothing in this data warranting any changes to the current fiscal or monetary policy settings just yet".

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