Asia Strategy Weekly – A research report on Asian equities and fixed investments in a regional and global context

The theme for the week: Inflation in Asia and its impact on equities and interest rates

Inflation in Asia: For now not a serious concern for the markets

The story for investors

Inflation fears in the G20 dominate news on the expectations that the Fed and ECB will hike rates. As usual, these US-centric views obscure the fact that the current CPI inflation trends in the ten Asian economies we survey here, are different from each other and from those of the G20. Asian short-term rates are not linked to short-term USD rates because most Asian forex rates float, bar the HKD. So the different Asian inflation trends will have different impact on Asian short-term rates and, hence, on forex rates, yields and equities. The Fed hiking may not cause Asians to hike too, bar for HK. However G2 rate hikes will affect G2 equities and bonds and hence will, as always, have a ripple effect on Asian markets too. But, to repeat, inflation, for now, will be low in policy considerations for most Asian economies.

Investment conclusions

Only one Asian central bank has hiked rates- S.Korea, while Singapore tightened its forex rate. Six economies are registering accelerating CPI and four flat/ falling. Rising inflation trends reflect, among other, higher energy costs and food prices a key CPI component in Asia. Of the countries with accelerating inflation, negative low base effects distort underlying trends. China has domestic pressures, such as climate-related power shortages, but these are issues unrelated to expanding domestic liquidity. We highlight that, that in relative terms, in **China, Hong Kong, Indonesia and Taiwan** inflation concerns should rank low when it comes to equities and local bonds.

Inflation trends: The good, bad and indifferent

Fig.1 shows that Taiwan, S.Korea, Singapore, exhibit accelerating CPI, with some, having negative low base effects, while the trends in **Hong Kong**, **Thailand** and **Philippine**s are basically accelerating but with volatility. Fig. 2 shows that, with the possible exception of **Malaysia, China**, Indonesia and **India** have falling or flat inflation trends. Although this is not a strictly relevant comparison, the current CPI rates in Asia vary from a high 4.6% in the Philippines to a low of 0.70% in China. The current CPI rates in the US, EU and Japan are, by comparison, 5.4%, 4.1, 0.2% YoY, respectively. However what matters here is the <u>outlook of inflation</u> and not just current trends. The outlook will depend on a mixture of local and global trends for two basic reasons. **First,** unlike the G20 countries, Asian countries could not afford massive fiscal subsidies plus central banks' QEs and, hence, the domestic economies will not face the inflationary push feared now for the G20.For example, China's fiscal support during Covid 19 has been conservative (4.0% of GDP) as has the policy of the PBOC. **Second,** the local causes of inflation pressures are different in the ten economies surveyed here, with the industrialized Asians more susceptible to the supply chain cost push as opposed to the less industrialized. As the data in the Factbox point out, the Asian CPIs tend to have larger food component, characteristic of developing economies. Energy costs remain important though.

Differentiating

China's PBOC's conservative policy, possibly because of the property crisis, is combined with flat inflation. **Hong Kong** has the second lowest inflation rate in Asia and its interest rate will be determined by the Fed, and not by inflation. **Indonesia's** low/flat inflation supports its loose monetary policy. **Taiwan** is an ambivalent case with rising inflation but with one of the best equity performance market in Asia.

Fig 1 :Accelerating inflation 2017-2021

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Dr. Andrew Freris, Chief Strategist

UCAP ASSET MANAGEMENT

Ucap Hong Kong Asset Management Limited
3rd Floor, 33 Garden Road, St John's Building
Central, Hong Kong
Direct: +852 3465 7464 Mobile: +852 97380944
Email: andrew.freris@ucap-am.hk

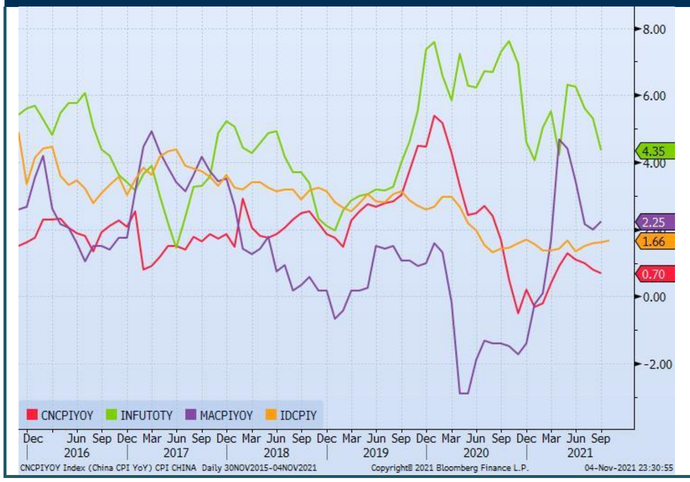
Asian fiscal and monetary policies

The inflation concerns in the G20 economies and in the US in particular, have been triggered by the massive fiscal and monetary injections to counter the CV19 damage to the economies. This ample funding and liquidity, combined with supply chain problems which pushed some commodity prices up, plus limited labor supply in some sectors have caused CPI to accelerate. These injections (definitions though vary) account for 17.0% of GDP in the US, 15.0% in Japan and 17.0% in Germany. The equivalent percentages for China are about 4.0%, India 9.0%, Thailand 12.0% and Indonesia 3.0% ,while for HK, for 2020-21, about 4.0%. While the monetary policies in G3 resulted in huge balance sheets for the G3 central banks, Asian central banks were far more restrained. Where part of the policy tools, key interest rates were cut after the onset of Covid 19 in the 1Q.2020.Asian central banks injected liquidity in their banking systems in various forms, including lending to banks for them to on-lend to corporate and private clients, reducing reserve requirements and, of course, cutting benchmark rates. The PBOC has no key rate but controls instead 1Y and 5Y bank lending rates, which were cut. In Hong Kong, the key rate was cut to near zero in line with the USD pegged forex rate. In Indonesia the central bank helped to finance the growing fiscal deficit by direct purchases of govies as did, but less directly, the central bank of the Philippines by purchases in the secondary market. Singapore guides its forex rate rather than setting interest rates. But nowhere in Asia there was the massive expansion of the monetary base as in the G3 economies and, not surprising, the asset inflation in Asia during 2021 was modest.

FactBox: CPIs in Asia; the case of food.

Developing countries tend to have comparatively larger food weights in their CPI thus making inflation quite susceptible to food price increases. In China, Food, Alcohol and Tobacco have a 30.2% weight compared to the 17.4% in the US CPI. Food alone in China has a 21.6% weight. In India Food and Beverages has a 45.8% weight, and in the far more developed Hong Kong a 27.4% weight, with the Restaurant and Takeaway component at 17.2% and Basic Food 10.3%. However on a global basis, some Asian-sensitive food prices have been falling. Soybean price, used in China for pork feed and for cooking oil has been falling in 2021, while the price of rice in the two globally major producers Thailand and Vietnam has been falling, the former through 2021, the latter till August 2021. Note, however, that food price hikes remain highly politically sensitive in China.

Fig 2: Decelerating and flat inflation 2016-2021



Summarizing

The argument developed here is that the inflation concerns guiding the monetary policies of the G20, are based on the putative inflationary impact of the loose monetary and fiscal policies since 1Q.2020 following the outbreak of Covid 19.As the G3 economies recovered in 2Q.2021, inflationary pressures arose because of the supply chain constraints, higher commodity and energy prices caused by the recovery, as well as labor shortages in the US economy. Capital markets became concerned over future rate hikes. Not all G3 central banks agree, with ECB hinting that rates will not rise next year, the BoE not hiking. Very few of all these developments were/are present and/or relevant in the Asian economies. **First,** the fiscal and monetary expansion to counter Covid19 has been modest compared to that of the G20, let alone G3. Purely monetary considerations are of minor importance in the Asian inflation context. **Second,** the current inflation trends in Asia are quite diverse with at least 4 economies not registering decelerating/flat inflation and with absolute numbers comparative low. **Third,** the impact of supply chain constraints is variable, with, for example, Taiwan and S.Korea possibly benefiting from the attendant shortage of chips. **Fourth,** some rises in food prices are of threat to Asian economies, but higher oil and gas prices for major oil importers such as China and India are. However, higher interest rates will not be an appropriate response in these cases. Hence our conclusion that inflation is, for now, not a threat to Asian interest rates and equities.

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