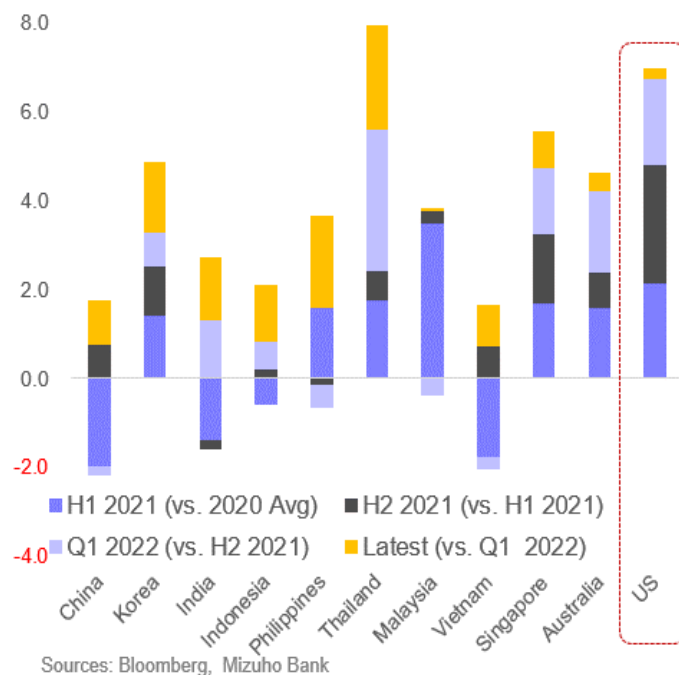
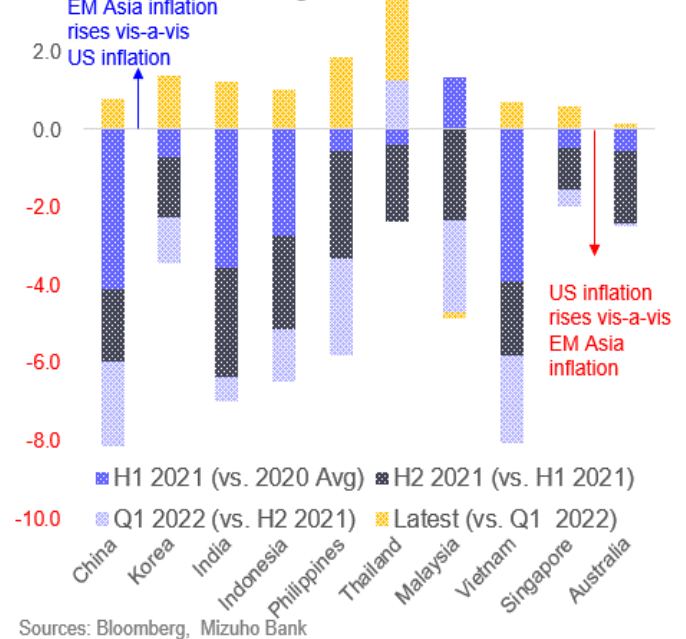


EM Asia Risks: Inflation Shocks to Overtake?

Inflation Shifts/Shocks (%-pts, YoY): At the Margin Upward Inflationary Pressures in EM Asia Are Set to Overtake US.



Inflation Shock Spread vs US (%-pts, YoY): While US inflation Remains Higher than in EM Asia, the Incremental Inflationary Pressures Are Larger for EM Asia.



"I presume nothing" – Sherlock Holmes

In a Nutshell: Relief from peaking US inflation may be compromised by accelerating inflation in EM Asia. Point being, even as (US) inflation is undeniably the dominant driver for markets and policy, it is not a one-dimensional risk. In fact, ironically, peaking US inflation accentuates, rather than assuages, associated macro-stability risks in EM Asia in the context of EM Asia's inflation out-run. As Sherlock Holmes said, "presume nothing".

Admittedly, peaking US inflation imaginably provides some relief from fears of an inadvertent policy-induced hard-landing from Fed oversteer. But this may be insufficient to override capital outflow risks associated with coincident out-run in EM Asia's inflation (vis-à-vis the US) eroding EM Asia's real (excess) returns in EM Asia.

Especially as uncomfortably elevated, despite peaking, US inflation constraints the Fed's ability to dial back hawkish instinct. And consequent pressures on EM Asia central banks to tighten as macro-stability vulnerabilities mount may compound economic woes while fiscal space for cushion is compromised. In all these inflation shocks narrow the path to averting worse-case outcomes.

EM Asia's Inflation Outrun: In-coming inflation shocks reveal EM Asia's price pressures accelerating to catch-up with US inflation. More pronounced vulnerabilities to food and energy price shocks, as a consequence of considerably higher weights for food and energy in the consumption basket, means that the out-run in EM Asia's inflation looks set to extend and entrench. Especially as lags in EM Asia's re-

opening underpin the *contrast between peaking US inflation and rising EM Asia cost shocks* – which turns up stagflation-type[^] pressures in EM Asia.

Resultant Inflation “Inversion Reversion”: The resultant **inflection in EM Asia-US inflation spread**, as EM Asia’s inflation pick-up overtakes that of the US (as it has almost ubiquitously since Q2, and since Q1 for Thailand; see Charts), is **consistent with our earlier warning*** of inflation “inversion reversion”. Specifically, in reference to *inflation dynamics beginning to reverse out uncharacteristically “inverted”, state of higher US inflation vis-à-vis EM Asia*.

Accentuating Hawkish Fed Risks: And **insofar that US inflation**, despite peaking, is **not set to recede convincingly enough for the Fed to renege on its aggressively hawkish stance**, EM Asia’s **inflation “inversion reversion” will accentuate capital outflow risks from an aggressively hawkish Fed**. Especially considering that in the context of stagflation-type pressures, real returns in EM Asia are undermined by a double-whammy of compromised growth and exacerbated cost-shocks.

Necessary, But Insufficient Policy Response: Admittedly, EM Asia central banks have stepped up to the plate in front-loading the removal of accommodation. But the risk is that **sharp policy trade-offs** (between growth and tackling inflation) will **limit options and cushion**. Upshot being, **EM Asia’s policy tightening is necessary to insure against worst-case macro-stability threats, but insufficient to render the Fed’s far more aggressive tightening a glancing blow to financial stability**.

Narrow Path to Avert Worse-Case: What’s more, monetary **tightening comes at the expense of growth**, which in turn also compromises growth/returns/stability. Invariably, it is a **narrow path to avert worse case outcomes**; especially **as fiscal space to compensate for monetary policy dilemma is compromised by pre-existing COVID strains** now vulnerable to the *risks of negative ratings cycle that tend to accompany rising global/US rates*. With Fed’s rate hike strewn with risks from war, China, lingering COVID and a myriad other moving parts, we can benefit from Sherlock Holme’s wisdom to “*presume nothing*”.

[^] Please see Mizuho Chart Speak - EM Asia: Stagflation-Type Risks Mount, 1 Jun 2022.

*Please see Mizuho Chart Speak - EM Asia FX: The Inflation ‘Inversion Reversion’ Risks, 21 Feb 2022.

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