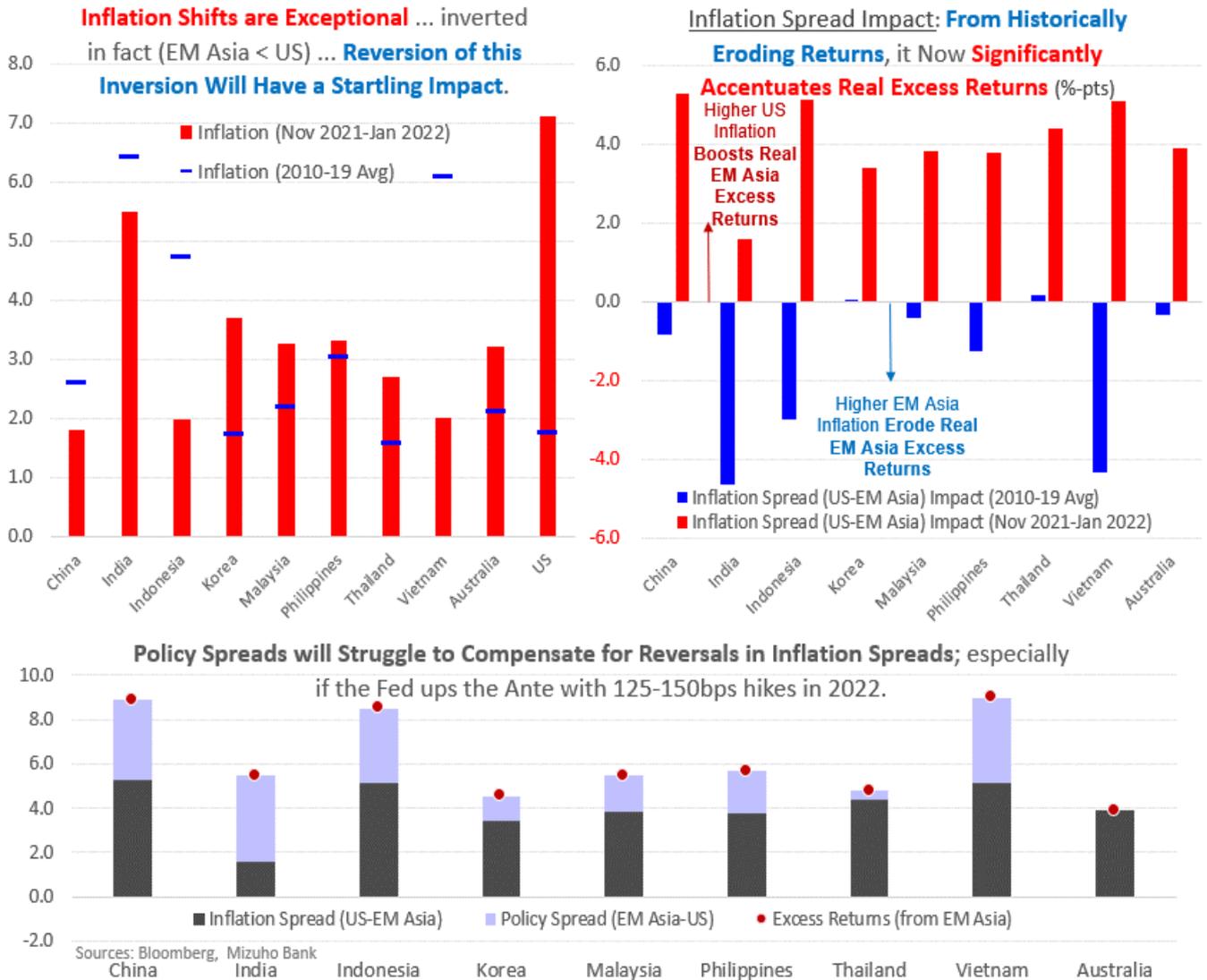


## EM Asia FX: The Inflation 'Inversion Reversion' Risk



- With US CPI at a 40-year high 7.5%, the **deafening narrative of soaring global cost pressures** distracts from, if not **drowns out**, an equally important and **unprecedented shift in US-EM Asia inflation spreads** that is **distorting risk pricing and overstating EM Asia’s asset/FX resilience**.
- That is, an exceptional **inversion of US-EM Asia inflation spreads** of an unprecedented scale and amplitude is likely to be **flattering the allure of real EM Asia returns**. The elephant in the room is **the risks and payback that come with a reversion** to US-EM Asia inflation spread “norms”.
- To be sure, relative inflation swings are profound even in the headlines as **US inflation has, uncharacteristically and unambiguously, surged past inflation anywhere else in EM Asia**
- Specifically, the **degree of US inflation upswing** (of 5.5-6.0%-pts) past its pre-pandemic 10-year (2010-19) average is **far more pronounced than the corresponding inflation surge in EM Asia**;

that is no more than ~2%-pts above its 10Y (2010-2019) average (See Top Left Chart).

- In fact, in some cases, such as **China, India, Indonesia and Vietnam, inflation is in fact lower than it was over the longer-term (2010-19) average.** This underscores the **wider point of far more subdued EM Asia inflation deviation from trend.**
- **As a consequence of which, the inflation spread between US and EM Asia inflation has flipped from higher inflation in EM Asia (vs. US) to higher inflation in the US relative to EM Asia.** In other words, there has been an **inversion in US-Asia inflation spreads.**
- And this **“inversion”** is **significantly beneficial to real excess returns in EM Asia (vis-à-vis US; Top Right Chart) insofar that returns in EM Asia are not eroded (by inflation) as much as in the US.**
- This is in sharp contrast to any sustained experience in past decades, when higher inflation in EM Asia (vs. US) in fact diminishes real excess returns.
- So, what’s **unprecedented** is that **even as the Fed prepares to embark on a hawkish path, the allure of real excess returns from EM Asia, flattered by the inflation inversion, may be acting as an exceptional backstop;** conferring more stability to EM Asia assets/FX than otherwise the case.
- In fact, at a very simplistic level, **EM Asia-US inflation spreads appear to be a far greater boost to EM Asia excess returns than policy spreads** (Bottom Chart).
- As a corollary, **“inflation inversion” set for reversion down the road,** as US inflation peaks and EM Asia inflation either catches up or remains sticky, then the **erosion in real excess returns in EM Asia may be profound.**
- Especially as already slim **policy spread advantages for most of EM Asia is likely to be eroded further, as most EM Asia central banks are likely to lag** (if not fall further behind) **an aggressively hawkish Fed; which has 150bps of hikes priced in for 2022.**
- And so, the clear and present danger heading into H2 2022 is that **inflation “inversion reversion” risk, resulting in a sharp erosion in real excess returns in EM Asia, may inadvertently destabilize of EM Asia assets/FX.** *Especially if a particularly aggressive hawkish iteration of Fed tightening and complacent EM Asia policy inertia conspire against a wider backdrop of “risk off”.*

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