Assessing the timeline for Emerging Market central bank rate cuts

In this paper our specialist Emerging Markets equities investment partner, Northcape Capital, seeks to answer the question about when central bank rate cuts are likely to intensify across the Emerging Markets. The team has noted an overall slowing in the pace of rate hikes in 2023, and in September there was a net zero outcome with eight countries raising rates and eight cutting. Here the team consider the drivers and outlook for further rate cuts across the universe.

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This information has been prepared by Northcape Capital, the underlying investment manager for the Warakirri Global Emerging Markets Fund.

Assessing the timeline for EM Policy Rate Cuts?

To answer this question about when rate cuts are coming, we first revisit the level of global policy rates activity through the "Hikes minus Cuts Index". We note the pace of rate hikes has continued to slow over the course of 2023 – see **Chart 1**. Indeed, over September for the first time since January 2021, there was a net zero outcome – that is, eight countries raised rates whilst eight cut rates.

Over the past two and half years it's been a case of significantly more policy rate hikes than cuts, as central banks have moved to quell inflationary pressures and prevent expectations becoming unanchored. Thereby trying to avert the deadly spiral of rising inflation and wages, as per the 1970s. **Most of the main central banks are in pause mode now, waiting to see the impact of their aggressive tightening over the past 18 months on overall economic activity and inflation**. However, at the margin, we are starting to see some policy rate cuts in EM, as this cohort was quicker to adjust to a tightening phase relative to DM.

Notable EM cuts over the September quarter were Chile -175bps to 9.5%; Brazil -100bps to 12.75%; Peru -25bps to 7.50%; and China -10bps to 3.45%.

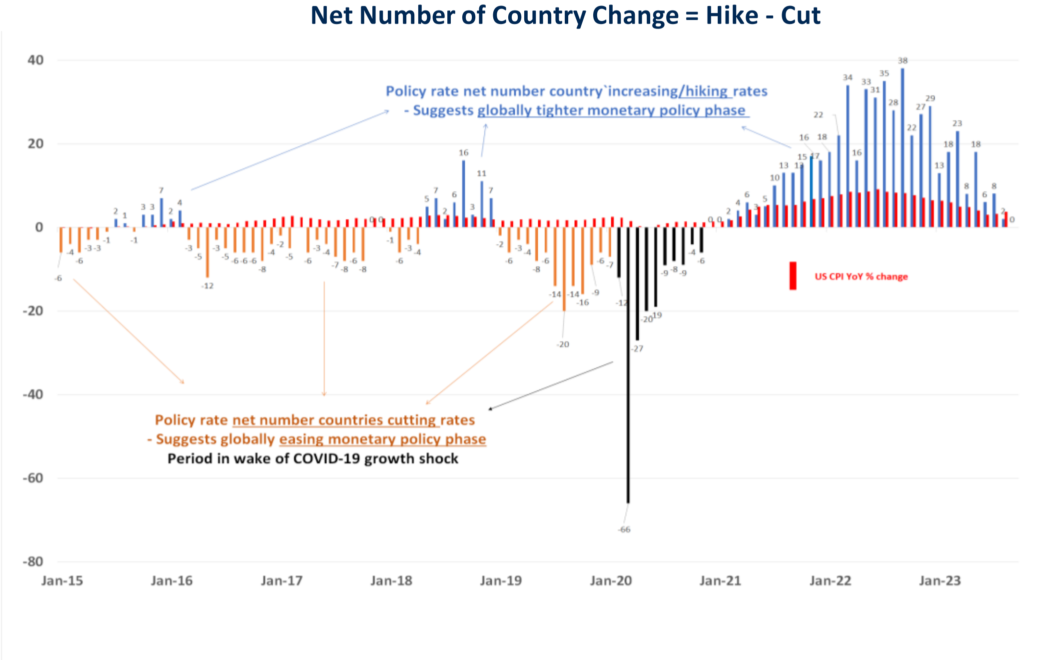
All these countries have hiked policy rates well above their respective CPIs.

Poland surprised with a -75bps rate cut to 6% in September, however its rate is still well below its CPI of 8.2%. It seems the easing was politically motivated with Poland's general election coming on 15 October 2023. The Polish Zloty slumped -6% over September – the worst performing EM currency over the past month.

A salutary reminder that if an EM central bank conducts unorthodox policy moves – their capital markets will be punished.

Our analysis shows that central bank policy rates for most EMs have increased to such an extent from the COVID emergency lows, that they are now well above their past 5-year average and in most cases, as mentioned, are now well above current underlying rates of inflation. This is not to say more needs to be done, but encouragingly suggests that **these countries are generally well placed to sit back and see the impact unfold of their monetary tightening and contemplate the timing of cutting.**

Chart 1: Policy Rate Changes Jan 2015 – September 2023
Net Number of Country Change = Hike - Cut



To that end, it is insightful to have a look at economic activity readings through monthly purchasing manager indices (PMI) for manufacturing (note: a PMI reading above 50 indicates activity is expanding month on month, whilst a data point below 50 indicates a contraction). This will help provide some insight into the timing of rate cuts.

Chart 2 shows PMI data over the past ten years (see the teal bars on the chart). One can see the collapse in the EM composite PMI in March 2020 to 35.1 when COVID struck – a massive exogenous shock to economic activity. The black line (RHS axis) is the net number of countries globally where their central banks are either raising or cutting policy rates (we have overlaid the data series from Chart 1). There is a relationship that is evident here between the two data series. For example, EM PMIs were rising over 2016 and 2017, and over that same time policy rates were being cut on a net basis (the black line is below the blue dotted line of zero).

By late 2017 there were concerns about inflation risks brewing, and as such global monetary policy went into a tightening cycle – which saw the black line rise above zero over 2018 – i.e., more countries on a net basis were hiking policy rates. However, by 2019 it was obvious that economic momentum was slowing, evidenced by falling PMIs and weaker inflation, so policy rate hiking gave way to cuts again.

Over 2020 we obviously saw unprecedented policy rate cuts post COVID, and then tremendous policy rate increases with the index rising to a peak in July 2022 with inflation ramping up.

If we fast forward to 2023, Chart 2 shows the EM composite manufacturing PMI for August slipping below 50 for the first time this year and dropping further in the most recent reading for September to 49.7.

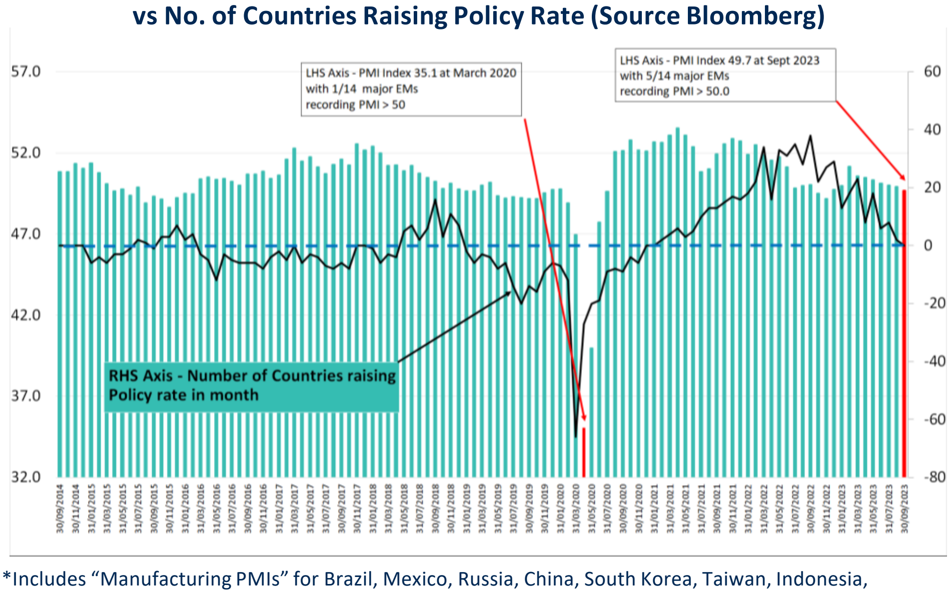
Importantly out of the 14 EMs we track, 5 countries of the group had a reading above 50 for September 2023, led by India with the highest reading of 57.5, followed by Indonesia at 52.3. This compares with 12 countries out of 14 in June 2022 with observations above 50, highlighting growth was more ubiquitous in EM back then. Therefore, **it does seem that activity levels across EM have lost momentum in the wake of much higher policy rates over the past 18 months**. Not dissimilar to 2018-2019.

So, to answer the question of rate cut timing?

It seems the PMIs in the months ahead are on track to fall further, as we believe central banks will keep monetary policy rates high until there is clear and overwhelming evidence of much weaker growth and lower inflation. Indeed, there are growing risks that central banks “overdo” the tightening, which brings on a recession.

This potentially much weaker activity will in turn reduce inflationary pressures in EM, **opening the opportunity for policy rate cuts to become more widespread**. All things equal this should become apparent in 2024, thus providing a potential fillip for activity to reaccelerate, **benefitting EM which is a leveraged play on global growth.**

Chart 2: PMI Composite Index* - Sep 2014 to 2023
vs No. of Countries Raising Policy Rate (Source Bloomberg)



*Includes “Manufacturing PMIs” for Brazil, Mexico, Russia, China, South Korea, Taiwan, Indonesia, Malaysia, South Africa, Turkey and Philippines.