Week Ahead

15th - 19th January 2024

More questions than answers

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INTRODUCTION

Aided by a quiet data calendar, the relatively benign start to the year continued this week, seeing markets continue to ease back into action following the holiday period. With the main event coming in the form of Thursday's US CPI release and little other entertainment available, most currency pairs were left drifting sideways at the start of the week, albeit with a few notable exceptions. Chief amongst these was the Japanese yen, which after rallying close to 1% against the dollar in the early part of the week, then fell by 2% before retracing to finish where it started. Underpinning this activity was speculation around BoJ policy normalisation, which having appeared to become more likely in recent weeks, took a step back on Tuesday following wage data that significantly undershot expectations. Elsewhere, surprises came in the form of currencies failing to move when they ordinarily would, in particular, the oil sensitive NOK and CAD, which remained relatively stable despite sharp gyrations in crude prices on the back of tensions in the Middle East. Indeed, even the well anticipated US CPI release failed to spark much of a reaction in the dollar. Despite signs of inflationary stickiness in the publication, market pricing for Fed easing remained largely unmoved. This saw the greenback struggle to make sustained gains and left many in markets with more questions than answers.

Starting this weekend things really should start to crank up, however, with voters in Taiwan set to head to the polls in a hotly contested presidential election on Saturday. Whilst the outcome remains too close to call, the pro-independence candidate Lai Ching-te held a narrow opinion poll lead heading into the vote. A victory for Lai would likely spark a new round of tensions with China, with this risk almost certain to weigh on TWD if realised. Whilst not our base case, a military response from China is not out of the question either, an outcome that could draw in US involvement with global consequences. Looking ahead, those lucky enough to get an invite are due to gather in Davos next week, where most notably for FX markets, the ECB's Christine Lagarde is due to speak twice. Outside of Davos, inflation is set to be in focus again for many countries, with prints due for Sweden, Canada and the UK, with the latter also seeing a labour market, and a retail sales release. Australia too is set to receive its latest jobs print and a retail sales report is due in the US. Perhaps most important though are China's Q4 GDP figures, which should show that authorities managed to achieve their 5% growth target, having looked at risk of missing it for much of last year. Given the somewhat perplexing price action so far this year has left us with more questions than answers, we have used this edition of the week ahead to gather questions from the floor, hopefully offering insight into some of the topics currently front of mind.

ECONOMIC CALENDAR

All times in GMT

Monday 15/01

Time	Country	Event	Period	Estimate	Prior
00:00	Australia	Melbourne Institute of Inflation MoM (YoY)	Dec		0.3% (4.4%)
00:01	UK	Rightmove house prices MoM (YoY)	Jan		-1.9% (-1.1%)
01:20	China	1-year medium term lending rate		2.4%	2.5%
07:00	Sweden	CPI MoM (YoY)	Dec	0.6% (4.2%)	0.3% (5.8%)
09:00	Switzerland	Domestic sight deposits	Jan 12		457.1b
	Poland	CPI MoM (YoY)	Dec F		0.1% (6.1%)
	Germany	GDP YoY	2023		1.8%
10:00	Eurozone	Trade balance SA	Nov		10.9b
15:30	Canada	Bank of Canada BoS and CSCE	Q4		
23:30	Australia	Westpac consumer confidence MoM	Jan		2.7%

Tuesday 16/01

Time	Country	Event	Period	Estimate	Prior
05:00	Sweden	PES unemployment rate	Dec		3.2%
07:00	UK	Payroll change MoM	Dec		-13k
		Average weekly earnings 3M/YoY	Nov	6.7%	7.2%
	Norway	GDP MoM	Nov		2.1%
	Germany	CPI MoM (YoY)	Dec	0.1% (3.7%)	0.1% (3.7%)
07:15	Eurozone	ECB's Villeroy and IMF's Gopinath speak on Davos panel			
09:00	Eurozone	ECB 1-year inflation expectations	Nov		4.0%
10:00	Germany	ZEW survey expectations	Jan	12.0	12.8
	Eurozone	ZEW survey expectations	Jan		23.0
12:00	Brazil	IBGE services volume MoM (YoY)	Nov		-0.6% (-0.4%)
13:00	Poland	CPI core MoM (YoY)	Dec	0.3% (6.9%)	0.0% (7.3%)
13:30	Canada	CPI MoM (YoY)	Dec	-0.3% (3.2%)	0.1% (3.1%)
	US	Empire manufacturing PMI	Jan	-2.9	-14.5
16:00	US	Fed's Waller speaks on economic outlook and monetary policy			
21:45	New Zealand	Card spending MoM	Dec		1.6%

Wednesday 17/01

Time	Country	Event	Period	Estimate	Prior
02:00	China	GDP QoQ (YTD YoY)	Q4	1.0% (5.2%)	1.3% (5.2%)
		Industrial production YTD YoY	Dec	4.5%	4.3%
		Property investment YTD YoY	Dec	-9.5%	-9.4%
		Retail sales YTD YoY	Dec	7.3%	7.2%
07:00	UK	CPI MoM (YoY)	Dec	0.2% (3.8%)	-0.2% (3.9%)
		Core CPI YoY	Dec	4.9%	5.1%
08:10	Sweden	Riksbank's Bremen speak on monetary policy			
09:30	UK	House Price Index YoY	Nov		-1.2%
10:00	Eurozone	CPI MoM (YoY)	Dec F	0.2% (2.9%)	0.2% (2.9%)
		Core CPI YoY	Dec F	3.4%	3.4%
11:00	South Africa	Retail sales MoM	Nov	1.3%	-1.2%
12:00	Brazil	Retail sales MoM (YoY)	Nov		-0.3% (0.2%)
12:15	Eurozone	ECB's Knot speaks at Davos			
13:30	US	Retail sales MoM	Dec	0.4%	0.3%
		Retail sales control group	Dec	0.3%	0.4%
15:00	US	NAHB housing market index	Jan	38	37
15:15	Eurozone	ECB President Lagarde speaks at Davos			
18:30	Eurozone	ECB's Nagel speaks at Davos			
19:00	US	Fed beige book			
20:00	New Zealand	REINZ house sales YoY	Dec		12.2%
	US	Fed's Williams speaks at NY Fed event			

Thursday 18/01

Time	Country	Event	Period	Estimate	Prior
00:00	Australia	Consumer inflation expectation	Jan		4.5%
00:01	UK	RICS house price balance	Dec		-43%
00:30	Australia	Unemployment rate	Dec	3.9%	3.9%
		Employment change	Dec	15k	61.5k
09:00	Eurozone	ECB current account SA	Nov		33.8b
09:00	Poland	Consumer confidence	Jan	-15.2	-15.2
09:30	UK	Bank of England bank liabilities/ credit conditions survey			
10:30	Switzerland	SNB Governor Jordan speaks at Davos			
12:00	Brazil	Economic activity MoM (YoY)	Nov		-0.06% (1.54%)
12:30	Eurozone	ECB publish minutes of December meeting			
12:30	US	Fed's Bostic speaks on monetary policy			
13:30	US	Initial jobless claims	Jan		202k
15:30	Sweden	Riksbank's Thedeen speaks			
23:30	Japan	National CPPI YoY	Dec	2.6%	2.8%

Friday 19/01

Time	Country	Event	Period	Estimate	Prior
07:00	UK	Retail sales MoM (YoY)	Dec	-0.4% (0.9%)	1.3% (0.1%)
07:30	Switzerland	Producer and importer priced MoM (YoY)	Dec		-0.9% (-1.3%)
09:30	Sweden	Riksbank publishes FX sales data			
10:00	Eurozone	ECB President Lagarde and IMF's Georgieva speak at Davos			
12:00	Mexico	Retail sales MoM (YoY)	Nov		0.8% (3.4%)
13:30	Canada	Retail sales MoM	Nov	0.0%	0.7%
15:00	US	University of Michigan 5-10 year inflation expectations	Jan P		2.9%
21:15	US	Fed's Daly speaks in fireside chat			

QUESTIONS FROM THE FLOOR

What do the Taiwanese elections mean for FX markets?

Taiwan goes to the polls on Saturday to select a successor to the outgoing Tsai Ing-wen, and with the outcome of the election still hanging in the balance. The most recent opinion polling data suggested that Tsai's successor as head of the ruling Democratic Progressive Party (DPP), Lai Ching-te, held a narrow lead over the opposition Kuomintang's (KMT) Hou Yu-ih, with the Taiwan People's Party (TPP) candidate in a distant third. However, with no polls published in the 10 days leading up to the election, and the polling difference well within the margin of error, the race looks far too close to call as yet. The election is important not just for Taiwan domestically but will also play a huge role in shaping cross-strait relations over the coming years, a factor that is likely to play a pivotal role within the US Presidential election too. Victory for the DPP would likely see further escalation in tensions across the Taiwan strait, whilst a KMT win could see a short-term respite. For FX markets, the impact of the election will likely be limited to just local assets. However, there is a risk that a more separatist outcome results in another round of military flexing from China off the coast of Taiwan, or worst case an outright invasion. This has broader reaching implications and will lead markets to pay close attention to the election outcome for some time after.

Importantly, whilst no major Taiwanese party is seriously advocating for reunification, they do differ markedly in their attitudes towards China. The DPP is the most pro-independence of the three parties, albeit this position has moderated during its current stint in power. That said, Lai has previously called himself as a "pragmatic worker for Taiwan's independence", and has been described by China as a "severe danger" that would threaten peace by following the "evil path" of independence. On the other end of the spectrum lies the KMT, which broadly recognises a one-China policy and has advocated a more conciliatory approach with the CCP. Indeed, the party has advocated not just resurrecting its trading relationship with China, but joining a number of other regional trade blocs as well. The TTP sits somewhere between the two other parties in its approach, though given it is unlikely to win power this time around, this has little bearing on cross-strait relations in the immediate future.

> "For markets, the reaction to Saturday's vote is likely to be asymmetric in the short-run, with larger upside in TWD in the less likely event of a KMT victory, though largely dependent on China's response."

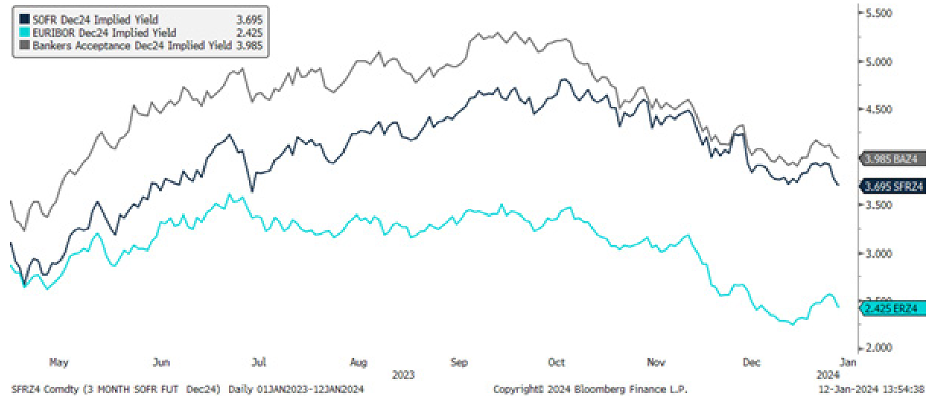
Notably, Chinese authorities have already reimposed some tariffs on Taiwanese goods in response to DPP's poll lead, and further economic retaliation appears likely if Lai were to claim victory. Such an outcome would likely weigh modestly on Taiwaneese assets given the potential downside to trade, though given that it largely maintains the status quo, we would not expect a sharp sell-off. Under this scenario, we think USDTWD could rally as much as a percent. A victory for the KMT's Hou by contrast would be welcomed in China. Under this scenario we would expect to see tariff barriers relaxed, with both a reduction in tension and a boost to trade supporting TWD appreciation. Whilst not our base case, there remains a small risk that the elections trigger a military response from China such as a blockade of the island. Not only would this weigh heavily on TWD, but it would also significantly disrupt the global supply of advanced semiconductors, of which Taiwan produces 90%. This could well see a repeat of the Covid fuelled disruption to global goods supply chains, reigniting inflation pressures across developed markets. Given this, a US response under such a scenario seems likely to us, raising the risks of a direct confrontation with China and triggering a dollar haven bid in the process.

Longer term, a Chinese invasion of the island and forcible reunification remains a risk, whoever wins at the weekend. That said, we think a KMT victory makes this relatively more likely given the parties commitment to cut defence spending and a vow to shorten conscription terms. This would leave Taiwan less prepared and therefore less ready to resist an invasion, which despite Hou being likely to foster better relations with China, would make invasion relatively more likely. It is also worth noting that parliamentary elections are also due to take place on Saturday, where the TPP's involvement means that no party is likely to secure a majority. A gridlocked legislature therefore appears a probable outcome, and is likely to stymy any President's efforts to either repair relations with China, or to shore up the islands defences. Finally, the US election later in the year is also key to Taiwan's future prospects. Whilst Biden has repeatedly signalled a willingness to defend the island, Trump has not. As such a victory for the latter could well see further downside risk priced in for TWD come November.

CAD and EUR haven't extensively sold off against the dollar as per your forecasts, why is that?

This is a good question. As noted, one of our main conviction calls for Q1 is that both CADUSD and EURUSD are trading too rich relative to the underlying performance of their economies. While we expected data out of Canada and the eurozone to highlight this as soon as January, we noted that pricing of both respective central banks was fairly well aligned with our base case. Thus, the bulk of the repricing was set to be driven by US rates aligning with our more conservative path for Fed easing. However, even though data out of the US over the past fortnight has struck a hotter tone than markets were positioned for, this just hasn't occurred, with markets still pricing a high probability that the Fed cuts in March and embedding one more rate cut for 2024 relative to our baseline. As such, concerns over weak growth in both Canada and the eurozone thus far have only marginally weighed on both CAD (-0.9%) and EUR (-0.6%) since the turn of the year.

Having previously pared Fed easing bets this year, markets returned to pricing a more dovish outlook. This capped the dollar's performance against both EUR and CAD



While on the US side, the data calendar thins out ahead of the next round of jobs and inflation data early next month, there are still a few releases that could turn the tide in markets. Firstly, key growth indicators are set to be released on the 24th in the form of flash January PMIs, and on the 26th in the form of real personal spending.

> "Should both indicators paint a picture of more resilient growth in the US as we forecast, it will likely add to the recent NFP report and CPI print in raising questions over the level of inflation persistence."

Second, before the turn of the month, the Federal Reserve is set to announce its latest policy decision. Here, the tone of Chair Powell's press conference is going to be pivotal, especially as commentary from FOMC members in the intermeeting period hasn't uniformly pushed back on market pricing.

Outside of the US events, we still think we can get some moderate CAD and EUR weakness on domestic developments, especially seeing as rate differentials have been narrowing on these pairs as of late. In Canada, although recent economic data has printed weak, there have still been some concerning data points. In December's payrolls, while the details of the report were soft, the uptick in wage growth from 5% to 5.7% was striking. While we de-emphasised the data at the time, it nonetheless provides grounds for the BoC to remain ambiguous with its forward guidance. Additionally, while November's inflation data showed the 3-month annualised core rate falling to 2.4%, the 0.3% MoM figure was also surprising given our view on weak underlying growth. Whether or not these data points were anomalous or not will be determined by next week's data.

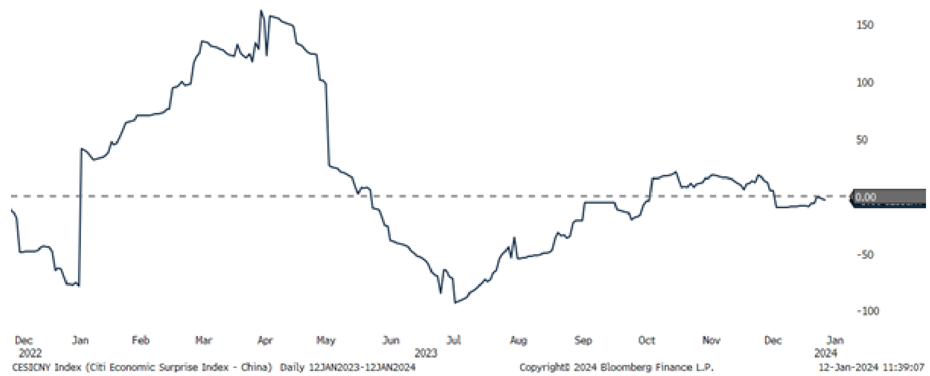
"The BoC's Q4 Business Outlook Survey and Canadian Survey of Consumer Expectations will be key in determining businesses' wage growth expectations and the consumers plans for consumption this year, while the extent to which core inflation is persistent should be determined by December's inflation report."

Under our base case, the BoC surveys continue to reflect a weak growth outlook and more slack emerging in the labour market, while core CPI returns to disinflationary territory as monthly price growth in travel tour and clothing prices mean revert. If realised, there is scope for markets to bet on more BoC easing in 24H2, which should reopen US-Canadian rate differentials and unlock further upside in USDCAD. In the eurozone, however, the focus is instead on central bank policymakers, namely President Lagarde who speaks twice at the World Economic Forum in Davos. Signs that the ECB's core message is continuing to shift in a dovish direction should weigh on EURUSD at the margin, although the bulk of the readjustment on the EUR side of the equation is likely to be contained until January 24th when January's flash set of PMIs are released.

It seems that with Fed easing sitting front and centre for markets that China's growth outlook is no longer a primary consideration for risk assets?

This is true, to a large extent, but the lack of focus on China's growth data all of a sudden is also a result of other factors. Not only has China's economic data begun to stabilise after a particularly turbulent start to the year during the reopening phase (see chart), but policymakers have also continued to step up their efforts to support the economy throughout the fourth quarter, with CNY 1tn of additional fiscal stimulus approved in October, CNY350bn of liquidity added through the pledged supplementary lending programme in December, and CNY 100bn re-lending support for rental housing announced. This has combined to stabilise expectations for China's growth rate, which looks set to achieve the official 5% target for 2023. This should be confirmed on Wednesday with the release of Q4's GDP data, which is expected to print at 5.2% YTD YoY. Furthermore, with expectations of Fed easing providing a more accommodative backdrop for fiscal issuance, and the corresponding monetary easing in China, expectations are that policymakers will maintain an active role in supporting growth through the economic transition.

China's economic data stabilised in Q4 after proving to be particularly turbulent in 23H1



Nevertheless, while the implications from China's rate of economic growth for risk assets have waned in recent months, we don't expect it to be a durable theme. Under our base case, market pricing of the Fed's easing cycle is likely to become more conservative in the first quarter due to more persistent inflation and above-consensus growth. This should lift yields across the Treasury curve, re-exerting pressure on risk assets and thus moving the focus back onto China's growth rate and the level of support it provides. Furthermore, it should place the PBoC under renewed pressure, both in terms of its tolerance to offset market forces and synthetically keep the yuan strong, as well as its overall economic management with most analysts looking for the PBoC to cut the 1-year MLF rate in Q1 by 10-15bps. However, against a backdrop of higher US yields, such actions will only increase pressure on the yuan and capital outflows, meaning a rate cut isn't necessarily a done deal.

Despite our view that China's data is likely to become more influential for markets, the reluctance by traders to price out a March rate cut from the Fed even after firmer jobs and inflation data, suggests next week's data is unlikely to cause too many waves. Growth is expected to finish the year comfortably above the official 5% target, but the underlying performance of the economy is set to remain mixed. Industrial production activity is set to remain moderate, while retail sales growth is likely to rebound from November's slump but remain underwhelming on the whole. Conversely, investment growth is likely to improve, reflecting recent policy support. The steady levels of economic performance, risks that markets turn more hawkish on the Fed, and the collapse in Chinese Banks' net interest margins in Q3 leads us to believe that the PBoC won't preempt the data dump with a 10bps cut in the 1Y MLF rate, as suggested by the economist consensus. Nevertheless, in this environment, a cut in the policy rate will likely only have positive effects for risk assets in the short-term, although markets will likely await confirmation that the rate cut wasn't motivated by weak economic data just a day later before reacting in such a way.

Does next week's data make a difference for the BoE?

Next week brings with it another round of UK data releases, the final set before a rate decision and MPR are due to be released by the Bank of England on February 1st. Despite this, we think the immediate impact of next week's data for the MPC will be limited, with the Bank set to stay on hold for at least the next few meetings. Granted, it should also confirm the need for revisions to Bank staff forecasts, reflecting the better-than-expected evolution of data since the November MPR. In particular, this will almost certainly see a lower path for inflation given the faster than anticipated cooling in price growth, and likely an upgrade to this year's GDP path too, especially given the improvement in leading indicators and a prior forecast that saw activity flatlining in 2024.

"Nonetheless, we still think the MPC will sit on their hands when it comes to rate cuts until the impact of April's rise in the National Living Wage can be seen in the data, especially given prior warnings by policymakers on the passthrough of wage rises to inflation pressures."

Whilst the immediate impact should show up in prints released just prior to the June meeting, the proportion of workers that directly benefit is narrow. Instead, concerns that this increase would push up wages higher in the distribution, an effect that may take longer to play out, should see the Bank of England stay on hold until Q3, absent projections for very rapid disinflation. More likely is that next week's publications set the scene for a modest downgrade to the Bank's inflation forecasts, opening the door for policymakers to remove their tightening bias from communications, but insufficient to accelerate the likely timetable for policy easing. That said, whilst the opportunity is likely to be there, we are a little sceptical that this linguistic pivot will be delivered in February. Given the risk that markets misinterpret it as signalling imminent rate cuts, we think the MPC would prefer to wait until later in the year to deliver this shift in tone.

Data should continue to cool, but not enough to see rate cuts in Q2

Turning to next week's releases in more detail, first up is November's labour market report, released on Tuesday. Given the suspension of large parts of the normal publication over reliability concerns, the upcoming release will once again be truncated. In terms of the data still due to be published, further signs of cooling wages are expected, pointing to softening domestic inflation pressures. Average weekly earnings are expected to ease once again, with consensus projecting a fall from 7.3% to 6.7% 3m/YoY. Moreover, the private sector regular pay measure closely watched by the BoE also looks set for a further decline. Having printed at 7.3% 3m/YoY in October, this now looks set to undershoot the BoE's 7.2% year-end of forecast by some margin. Even so, with both measures remaining well above levels consistent with 2% inflation, and one year ahead pay expectations reported in the Bank's Decision Maker Panel rising marginally to 5.2% in the December release, these prints are unlikely to see the MPC declaring victory over domestic inflation pressures any time soon, despite signs of progress.

Inflation data on Wednesday is set to be the week's big event. Consensus expectations project modest easing for the headline figure, looking for price growth to fall from November's 3.9% YoY, to 3.8% in December. Similar modest cooling is anticipated across core measures of price growth too, with 0.2pp declines expected for both the core and services CPI prints, leaving them at 4.9% and 6.1% respectively. Given that Bank staff projections had pegged headline inflation at 4.6% and services inflation at 6.9% at the end of 2023, this round of data will again confirm that inflation is cooling much faster than the MPC had foreseen. All told, we think this warrants a reasonable downgrade to the Bank's inflation forecasts for the near term. Nonetheless, given signs of inflation persistence in both the PMI reports and wage data, the February MPR is unlikely to predict inflation returning to target significantly earlier than prior forecasts.

Rounding out the week, retail sales on Friday are unlikely to repeat November's 1.3% growth figure. The key question will be whether they can continue to show growth at all given soft leading indicators. In particular, BRC shop price data undershot expectations for the month, suggesting the official December sales figures should soften. If realised, this would make the prospect of 2023 recession a coin toss, albeit any contraction would be by just the slightest of margins. Admittedly, GDP growth looks set to underperform BoE forecasts for both Q3 and Q4 in any case, but this would also imply a lower base for the

2024 projections. Combined with rising real wages that should support consumer spending and growth into the new year, this suggests to us that the Bank will need to upgrade its forecasts for GDP in 2024. Taken together, we don't think that this mix of data is likely to see a radical change in the MPCs outlook for the UK economy. However, a better growth outlook combined with our view that the BoE remains more hawkish than markets expect is a positive one for the pound. As such, we continue to expect sterling upside through the coming months, particularly on crosses, as this dynamic plays out for markets.

Is food inflation starting to become a theme again in EM economies?

Throughout 2023, most emerging market economies experienced pronounced rates of disinflation, leading most central banks to halt their tightening cycles and some to begin easing. With most of the disinflation progress now in the rearview mirror, however, central bank actions across EM economies are starting to diverge, with domestically produced inflation and food inflation being the key differentiators. The latter point may come as a surprise, given that food inflation has generally disappeared across DM economies following pronounced price rises over the pandemic years. However, for most EM economies, food inflation is now becoming a concern again. This has kept some central banks, specifically in Latin America and South East Asia, on a more hawkish footing than other peers. Specifically, Banxico, the Reserve Bank of India, and the Bank of Indonesia have recently pointed to rising food costs as a reason to keep policy on hold. The RBI has been the most direct on this point, owing to the large share of food in the CPI basket and the impact food inflation has on the overall economy.

So what has caused food inflation to return?

El Niño, a natural phenomenon that originates in the Pacific Ocean and creates unpredictable weather in the central and eastern tropical Pacific Ocean, is arguably the main driver of geographical food price inflation. Typical it brings poor maize yields in southern Africa and Central America, low wheat yields in Australia, and poor rice harvests in Southeast Asia. El Niño doesn't just impact crop harvests, however. Heavy rainfalls also drive energy commodity inflation, while goods inflation can also arise by seasonally low water levels in the Panama canal for example. This has already started to play out, and the effects are merely being amplified by export bans by key commodity producers and heightened geopolitical risks.

Where is it becoming visible?

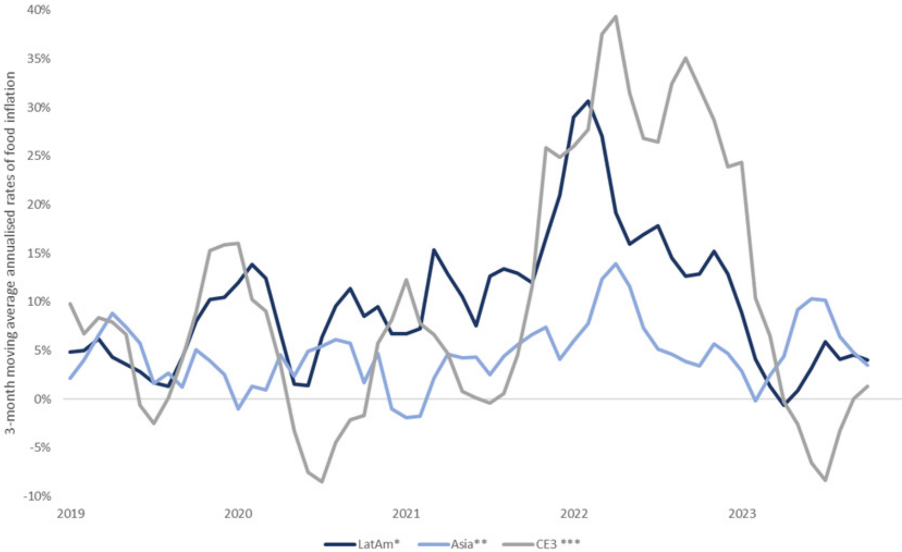
Initially, the return of food inflation became particularly visible in emerging markets in Asia, where a 32% increase in rice prices due to adverse weather shocks and export restrictions in India, the main regional rice exporter, started to slow the pace of disinflation across most EM economies. While the actions of some countries in Asia specifically have sheltered their economies from these effects, we note that there are continuing challenges in key economies like India and Indonesia when it comes to buffering the impacts of El Niño.

In Latin America, however, the sequence has been slightly different. While we did see headline inflation decelerate throughout the year and the focus of central banks in the region turn to core readings, fourth quarter data in some economies in the region seemed to set the stage for additional potential concern for policymakers. While fourth-quarter inflation reports from Chile and Colombia show no signs of a possible revival in food inflation, data from Mexico and Brazil seem to suggest that this trend could establish itself as a risk factor for disinflationary progress in the coming months. In Mexico, the latest inflation report released last week for the month of December showed a larger than expected increase in the headline inflation rate mainly due to an acceleration in the non-core component, which rose in December to 1.81% month-on-month, a significant increase compared to the 0.34% recorded in November. This rise was largely driven by agricultural commodity inflation, which recorded an increase of 3.25%, its highest value since November 2021. Behind this rise was fruit and vegetable inflation, which, with a 7.05% growth in December, reached its highest level in two years.

> "Meanwhile, in Brazil, the December data confirm that headline inflation is picking up during the last two quarters of the year, with food inflation being the category that is contributing most to the overall reading as a consequence of the rise in the price of some basic raw materials, particularly cucumbers, potatoes and carioca beans."

Finally, in the CE3 economies, it seems that this upturn has not been as evident as in the other EMs mentioned. The December inflation report for the Czech Republic shows a deceleration of headline inflation in December, from 0.1% to -0.4% month-on-month, where the biggest surprise came from the 1.4% drop in food. Meanwhile, in Poland, preliminary inflation readings for December showed that prices rose by 0.1% month-on-month and 6.1% year-on-year. This not only failed to meet consensus expectations, but the details of the report showed signs that headline inflation should continue to fall rapidly in the coming months, something that would also be a consequence of the government's recent decision to keep gas and electricity prices frozen also for the first half of this year. Finally, in Hungary, too, there have been no clear signs of a possible pick-up in headline inflation due to rising food prices. In fact, this category has shown a slight decline during the month of December. We believe that Ukraine's inability to export across the Black Sea might be benefiting Eastern European markets, as this is where all its food exports end up, which may ultimately be putting some downward pressure on food prices in the region, even as they rise elsewhere.

While we're not back at early 2022 levels, food inflation is starting to become a theme again in EM economies



* Mexico, Brazil, Colombia, Chile
** India, Indonesia, Taiwan, Philippines, Thailand
*** Hungary, Czech Republic, Poland

What are the effects of food inflation?

Outside of the obvious humanitarian impacts, the main result of higher food inflation is larger fiscal deficit, lower growth, and tighter monetary policy. For economies where the effects are acutely felt, this is specifically punitive given significant debt burgens, large twin deficits, and agricultures large share of GDP. In terms of some of the major economies, higher food inflation is already starting to appear in central bank communications, with Banxico, the Reserve Bank of India, and Bank Indonesia already noting that monetary policy needs to remain restrictive as a result. For the latter two, this is of specific note, not only because tighter monetary policy is currently supporting their respective currencies and could continue to as US rates fall conditional the same dynamic doesn't increase recession and debt concerns, but also because of elections this year. While it is unlikely to cause a regime change in India, high levels of food inflation in Indonesia poses a risk of political instability as it could hamper the prospects of two presidential candidates associated with the incumbent President Joko Widodo. All told, while food inflation has only just started to rear its head, it is definitely a theme that needs to be monitored closely across major EM economies, and some southern hemisphere DM economies.

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