Mizuho Chart Speak

Economics & Strategy | Asia ex-Japan

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Inflation Spread Advantage for AXJ Liable to be Overwhelmed

In a Nutshell:

- A notable development is the **re-emergence of Asia-US inflation spreads to the advantage of AXJ** (by boosting real returns in Asia).
- Cyclically, this trend may be overstated **given subsidies** and **temporary factors that flatter Asia's dis-inflation** vis-à-vis the US.
- *Nonetheless,* this trend is worth monitoring given that **US-China geo-economic forces could divert China's spare capacity to Asia**, therefore structurally pressuring Asia-US inflations spreads.
- Regardless, for now, **AXJ could benefit from modest and marginal support** from the advantageous Asia-US inflation dynamics.
- **But** this is **not to be mistaken for sharp and sustained AXJ boost** given a conspiracy of overriding policy and geo-political risks.
- Specifically, pressures from *relatively more dovish central banks in Asia* as well as *Trump 2.0 tariff threats* confronting Asia are likely to *overwhelm AXJ dynamics*.
- *The upshot being* ***incremental (and cyclically overstated)inflation spread advantage for AXJ*** *is* ***likely to be overwhelmed by policy tensions and trade uncertainties***.

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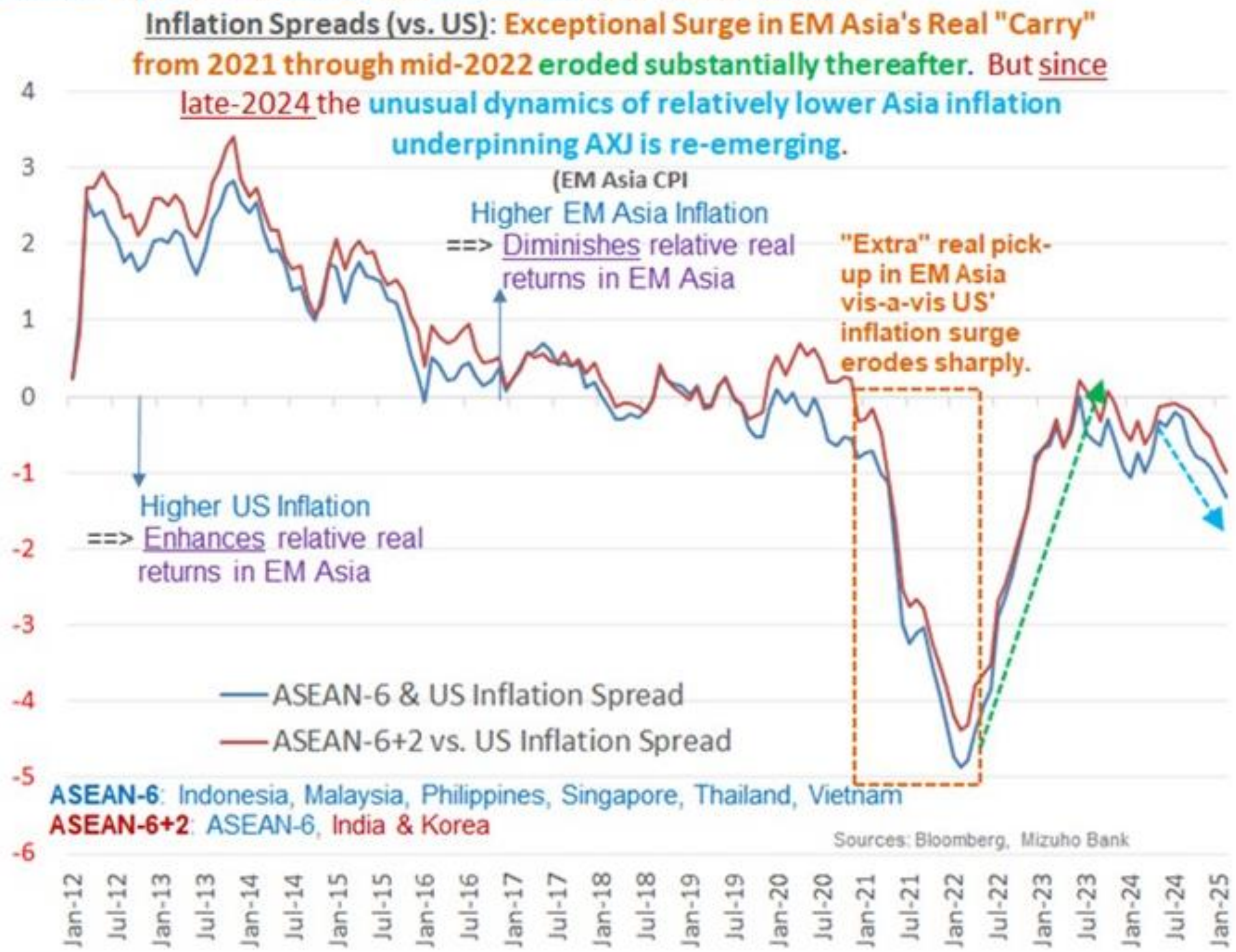

- Favourable (for AXJ) Asia-US Inflation Spread Dynamics Re-Emerge: The **re-emergence** of **more emphatically negative Asia-US inflation spread**, an exceptional post-pandemic phenomenon, is notable for its ability to *enhance real returns in Asia*, *all else equal*.
- Temporary Quirk or Enduring Feature: The **real question** though is **whether this highly unusual state of falling inflation in Asia vis-a-via the US** is **merely a temporary quirk or a feature that endures**.
- Cyclical Distortion & Structural Shifts: It might be **a bit of both**. Near-term, and *cyclically Asia's inflation undershoot could fade* (with greater convergence to US inflation). Although, *structurally Asia-US inflation gap may be pressured more durably* (to the benefit of AXJ returns).
- Cyclically Flattered Asia Dis-inflation: To be sure, **relatively more pronounced dis-inflation in Asia** that has emerged in recent months is likely **exaggerated**, **if not outright distorted**, by *subsidies* and *weather/harvest -related factors*, which **will inevitably fade**. In this regard, *IDR and INR may have limited lift*.
- Structural Transmission of China-Driven Dis-inflation: Nonetheless, there is a case to be made that **China's overwhelming overcapacity, diverted away from the US** by the trade war, could **end up in Asia**, **resulting in a wider dis-inflationary spill-over**. Especially *relative to the US*.
- Energy the Exception: The notable **exception** may be with regards to **energy** in which the **US** appears set to establish dominance, thereby being **less vulnerable to energy price shocks vis-à-vis Asia**.
- US Real Return Advantage on Energy Shocks: Consequently, **energy-driven inflation shocks** will probably **revert inflation spreads in favour of real returns in the US**.
- Modest, Marginal AXJ Boost: Barring which, the **current inflation dynamics may set AXJ up to derive the benefit of modest**, **marginal support from advantageous inflation dynamics** (that boost real returns in Asia). More so **in the context of subdued energy inflation risks**.
- But No Reason to be Carried Away: But **conflating** more **advantageous inflation spreads with sharp and sustained AXJ outperformance** is **misguided**. Especially **given overriding policy shifts** and **global trade risks**.
- Devil in the Details of Asia Policy Doves: For one, the **dovish inclination of Asia central banks**, in contrast to a somewhat restrained Fed, could mean that *nominal rate expectations stacked against AXJ may still overwhelm the inflation spread advantage*.
- Trump Tariff Threats: Crucially, **highly unpredictable Trump 2.0 tariffs threats hanging over Asia's exporters** could also **hobble any attempt to substantially exploit the relative inflation advantage in AXJ**.
- Tentative & Opportunistic: The upshot is that the **shifts in inflation spread dynamics to unusually advantage AXJ**, **likely to be cyclically exaggerated**, are **at best tentative**. In fact, *any AXJ gains will remain **opportunistic** as trade uncertainties and policy tensions overwhelm*.