BBVA Research

Global Funds Outlook

on a roller coaster ride

February 2019

Creating Opportunities

Main Takeaways

- Global Investment Funds (GIFs) flows have been on a roller coaster ride since the start of Q4 2018.
- An intense bout of volatility and risk aversion towards the end of last year led to a sharp pullback in portfolio flows from developed markets (DMs). Capital outflows concentrated mainly in Europe, in equity funds and, particularly, in those funds investing in most risky assets (High Yield and Leveraged Loans); while preference for high quality liquid assets jumped.
- Capital flight, last December, was triggered by heightened uncertainty in wake of cooling global growth, mounting protectionist threat, political and sector specific issues in the Eurozone (EZ) and the Fed’s “auto-pilot” remark on quantitative tightening.
- In fact, our in-house risk-off indicator slipped into “risk redemption” territory twice in 4Q18, for the first time since 2015 (when concerns on China's hard landing escalated).
- This mood led the Fed to take a “U” turn in January, which, together with China`s stimulus and expectations of a truce on US-China trade negotiations, caused a positive twist in flows.
- Since the start of 2019, GIF flows to EMs have surged while DMs have seen a visible moderation in the pace of outflows. Furthermore, warning signals have since dissipated, as reflected in our Investment Mood Index.
- Assuming a soft landing in global growth and against the backdrop of a more dovish Fed, the outlook for EMs has recently improved. Looking ahead, our baseline scenario suggests EMs would continue to outperform DMs in attracting GIF flows over the short term (but at slower pace than in January), although hinged on Fed’s future rate actions and progress on US-China trade dispute. Given that risks surrounding the global outlook continue to be tilted to the downside, a repetition of risk-off episodes cannot be ruled out in the coming months-quarters.

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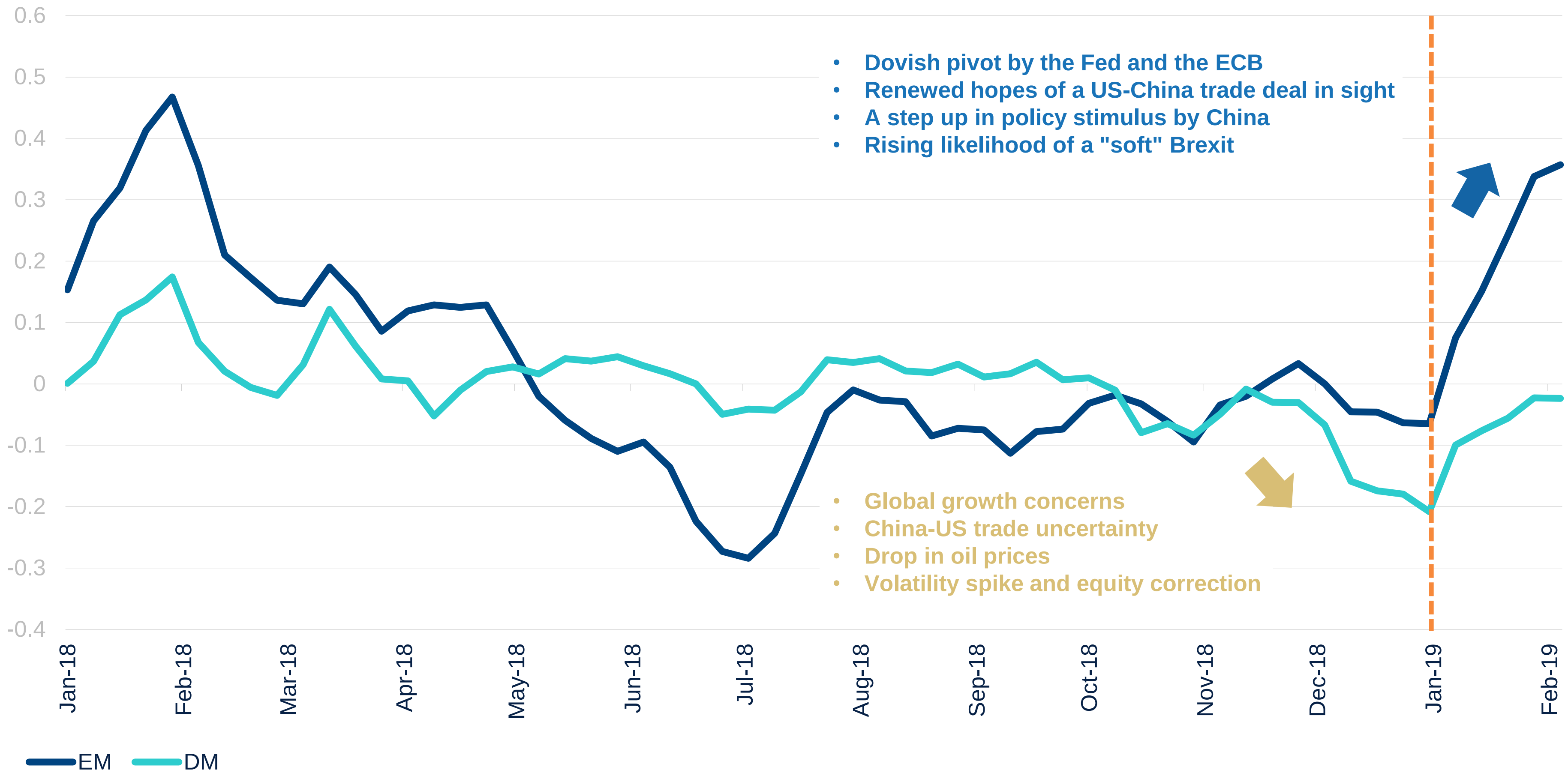
How have flows evolved over the past quarter and what is driving them?

Turning a corner in 2019 - Contrary to last year end, 2019 has, so far, seen a marked moderation in DM outflows and soaring inflows to EM

GIF flows to EM and DM

(Weekly flows, 4w moving average, % AUM)



Source: BBVA Research, EPFR

What led the flows to pivot back upwards at start of this year after a dismal end to 2018? The Good, the Bad and the Ugly

The Ugly

Global growth outlook dented. Global manufacturing cycle lost steam in 2H18 consistent with slowing world trade. Weak global demand weighed on oil prices. Increasing probability of **US recession** in the next 12 months.

The Bad

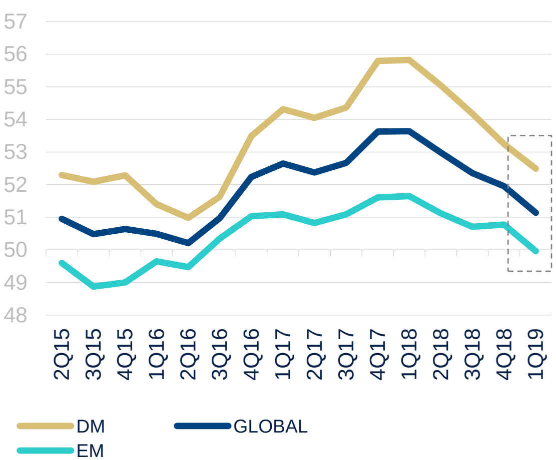
Rising protectionist threat, China slowdown concerns, rising political and sector specific uncertainty in the EZ and a Fed on "auto-pilot" unnerved financial markets, triggering intense volatility and equity sell-off in Dec 2018

The Good

Fed´s dovish shift, narrowing US-China trade differences and a step up in policy stimulus by China has, so far, underpinned the positive turn in GIF flows

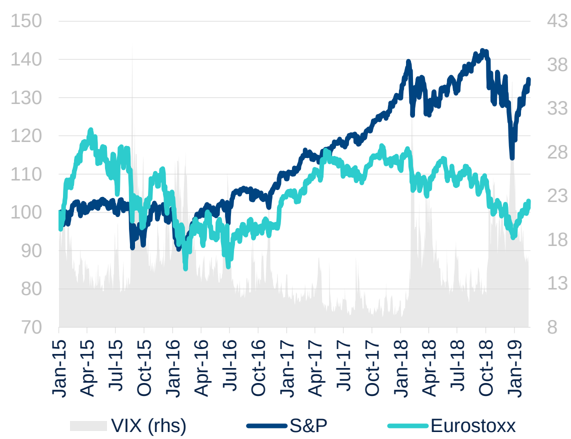
World manufacturing PMI

(Level ± 50)

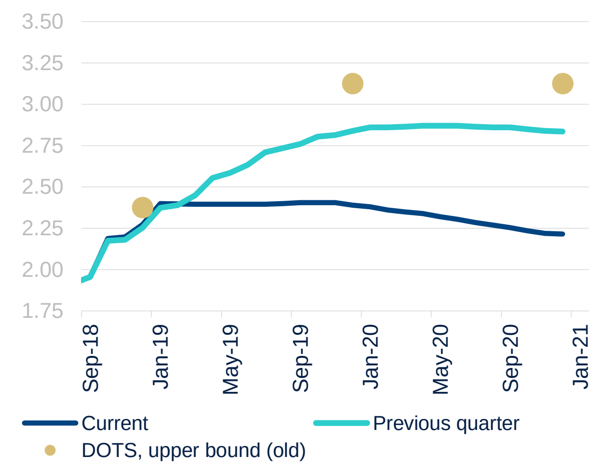


Developed market equity index and VIX

(indices, 100: January 2015 and Vix, %)



The Fed´s dovish shift altered market expectations of Fed´s rate hike trajectory

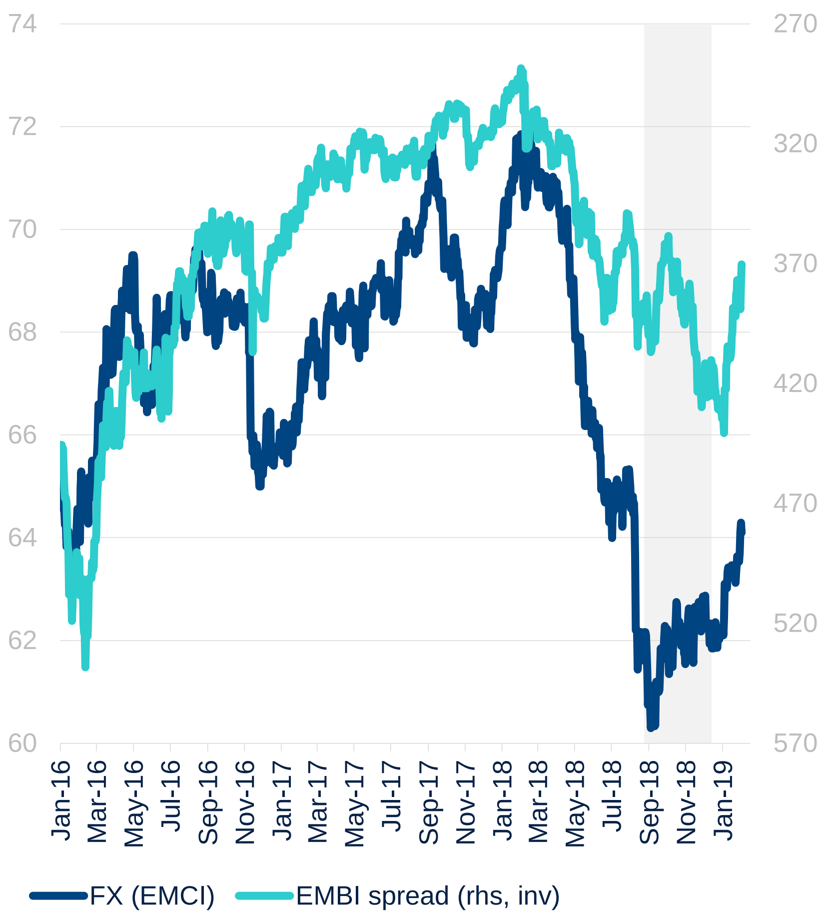


Source: BBVA Research

The recent change in Fed's stance supported EMs, which were struggling with rising global volatility

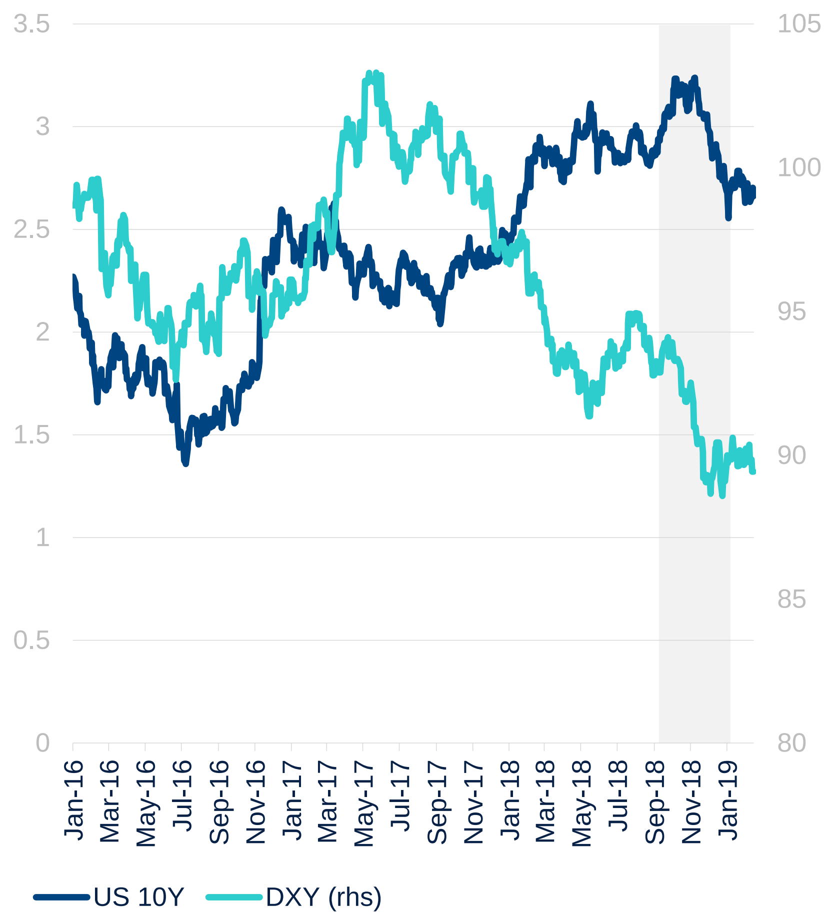
EM FX and EM bond spread

(indices)



US 10Y bond and the USD

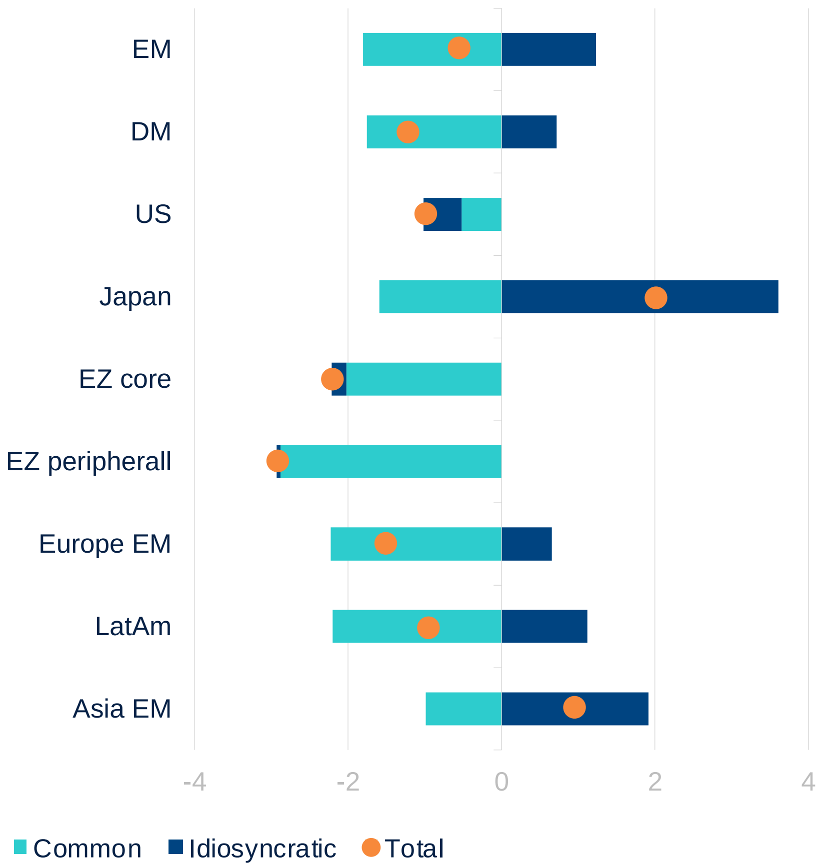
(% and DXY index)



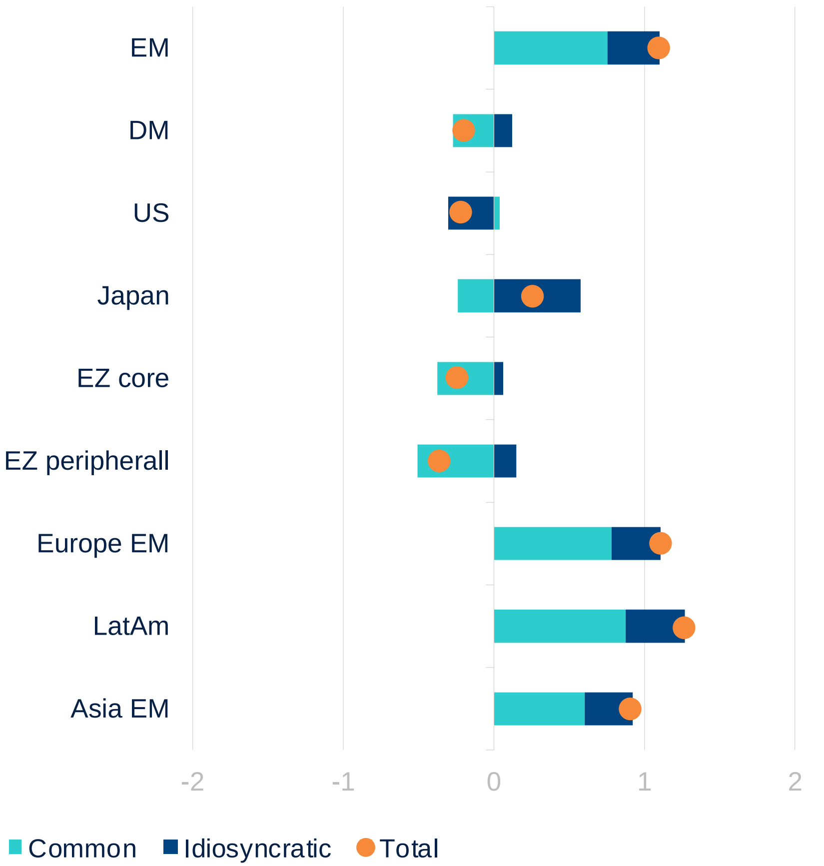
Source: BBVA Research

Inflows to EMs this year have been driven mainly by a positive turn in common factors, while idiosyncratic factors remained supportive

GIF flows across regions in 4Q18: common vs idiosyncratic factors
(Monthly average,%, AUM)



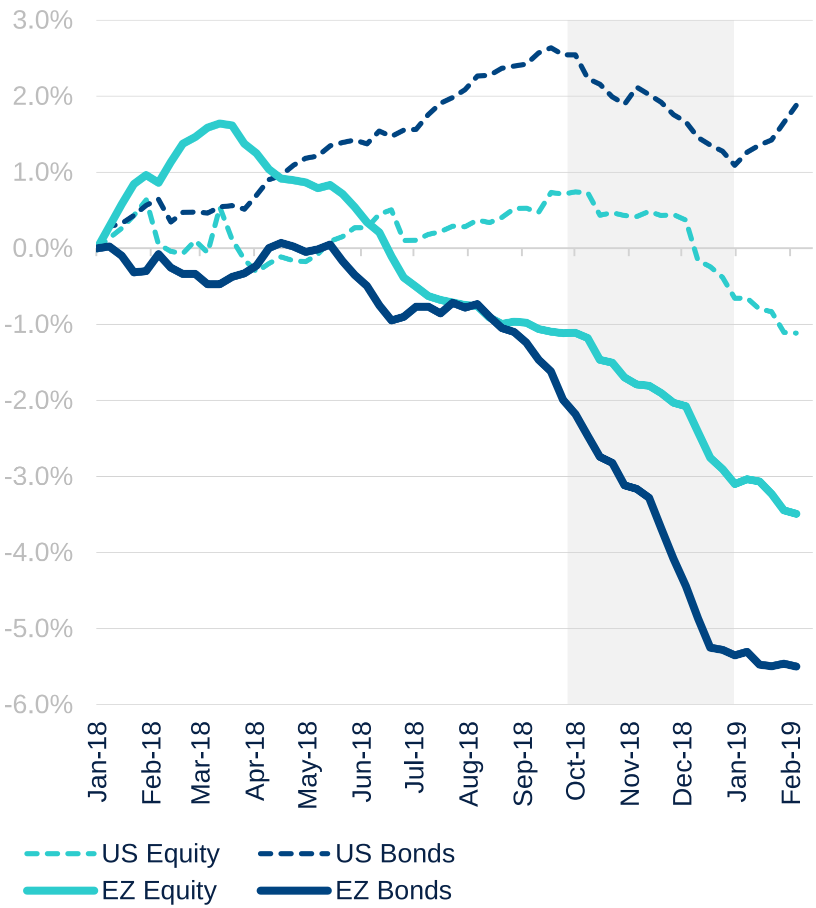
GIF flows across regions in January 2019: common vs idiosyncratic factors
(Monthly average,%, AUM)



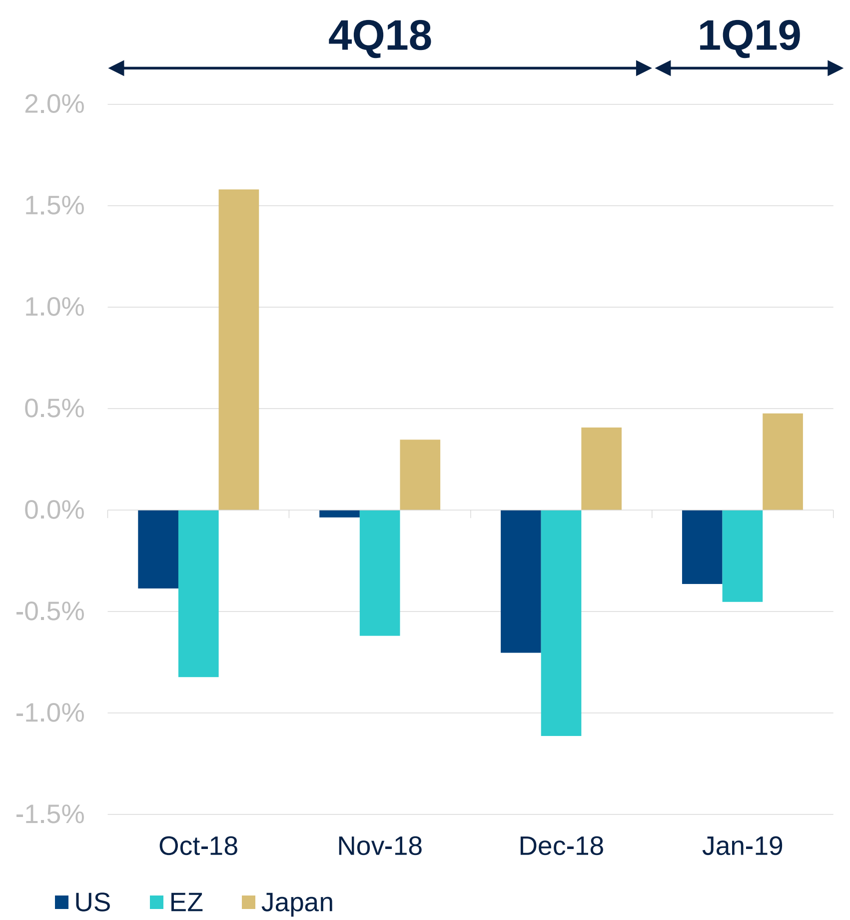
*All comparative inferences across countries are based on inflows relative to each country's total assets under management (AUM). They are NOT based on actual USD flows, which tend to be significantly larger for the US than for any other economy
Source: BBVA Research, EPFR

DM flow dynamics remain weak even in early 2019 despite moderating pace of outflows – EZ leading the weakness

Accumulated flows to DM
(% of AUM from January 2018)



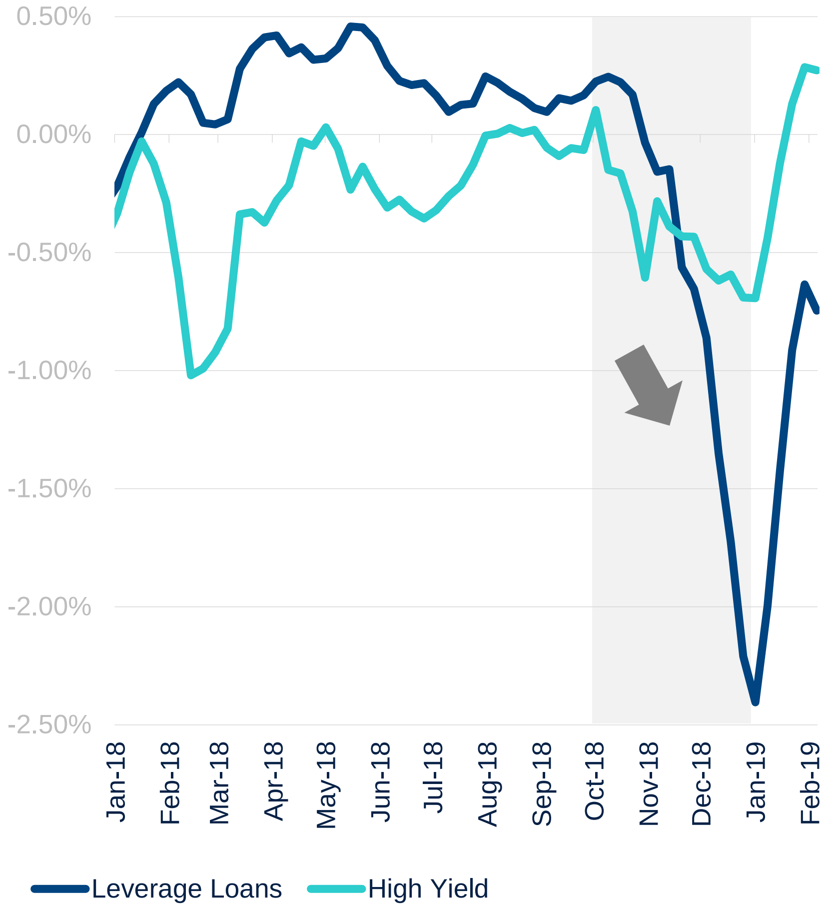
Breakdown of monthly portfolio flows by DM region (% of AUM)



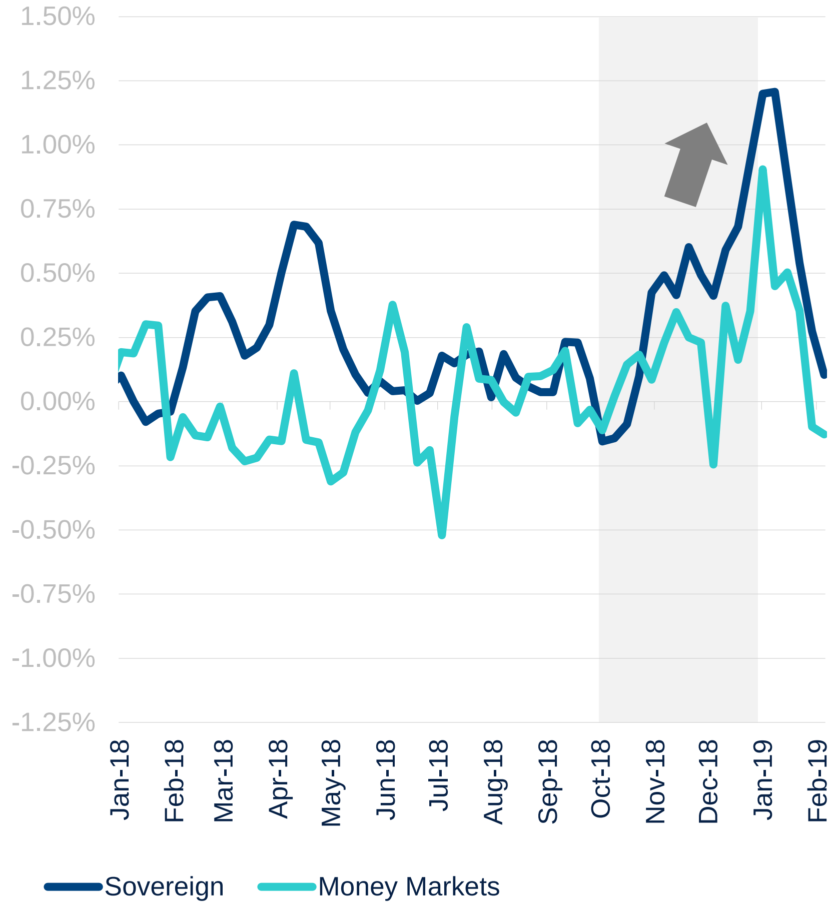
Source: BBVA Research, EPFR

The tale of two halves for flows is evident in the recent rebound in high yielding assets at the expense of sovereign bonds and MMFs

Flows to HY & Leverage loans
(4w m.a. % of AUM)



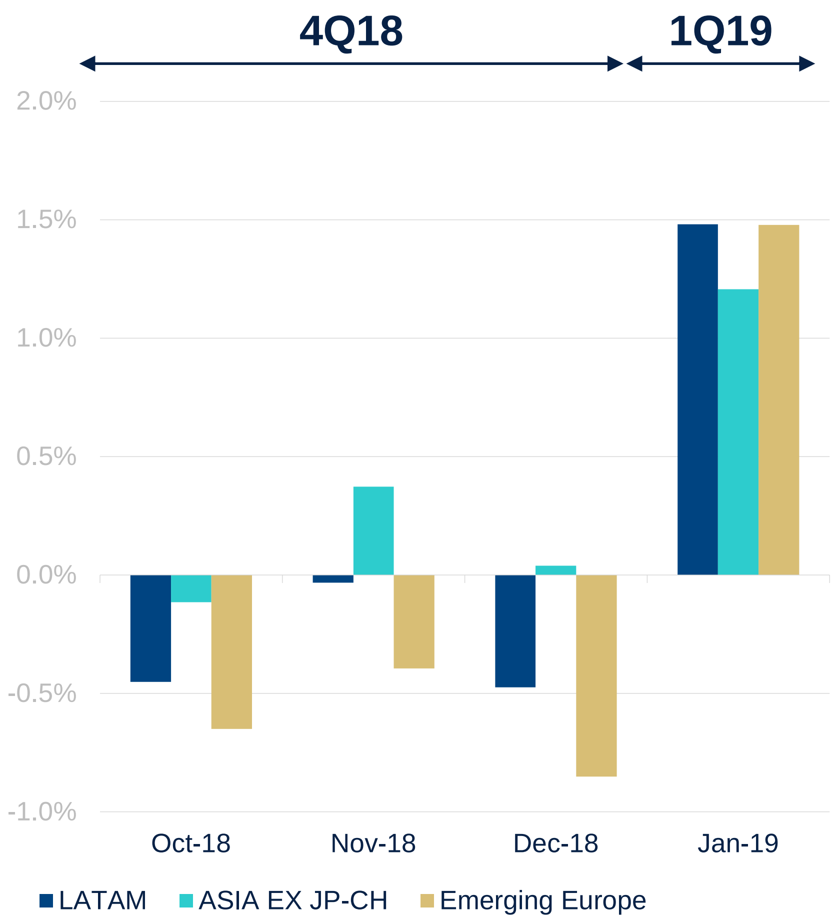
Flows to Sovereign bonds & Money markets funds
(4w m.a. % of AUM)



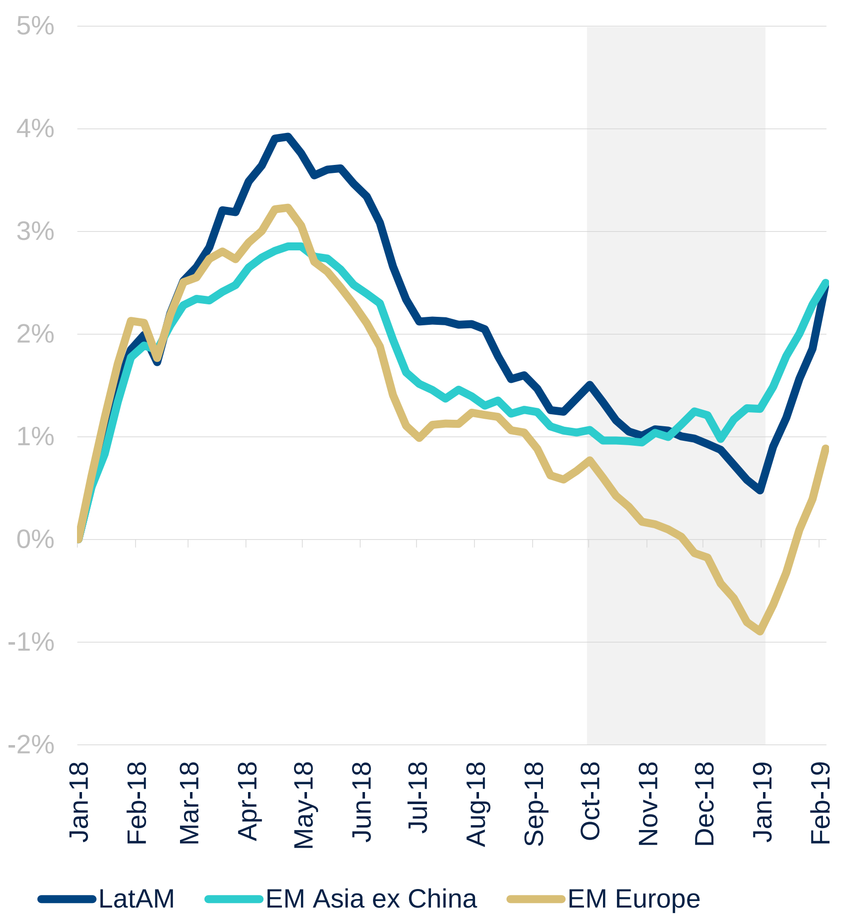
Source: BBVA Research, EPFR

During 4Q18, Asian funds led EMs in outperforming developed funds. However, the recovery in the 1Q19 seems to be broad-based

Breakdown of monthly portfolio flows by EM region (% of AUM)



GIF flows to EM
(Cumulated flows since 2018 % AUM)



Source: BBVA Research, EPFR

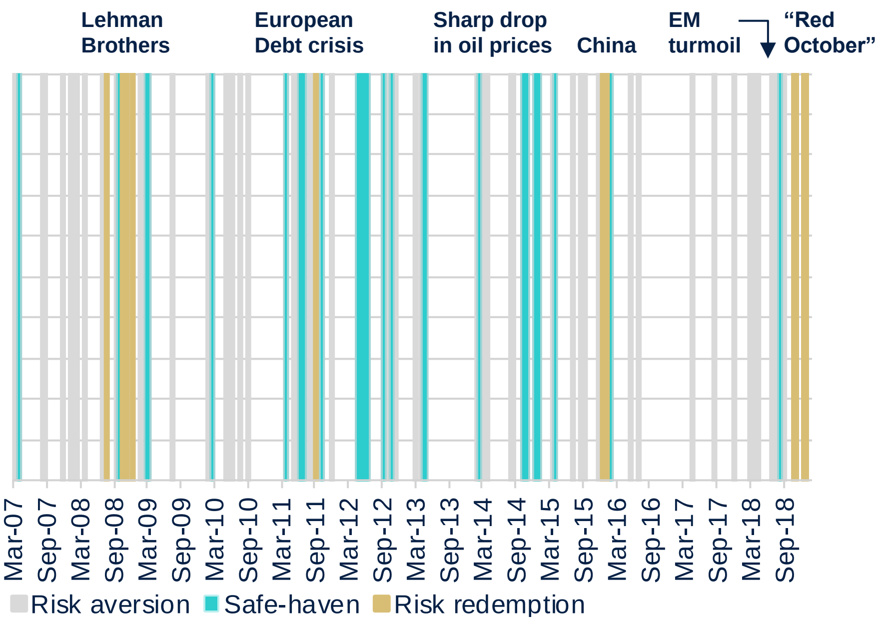
Warnings from our risk-off indicator and its implications

Our risk-off indicator slipped into "risk redemption" territory twice in 4Q18, a strong signal ahead of Fed's U-turn in January

Past episodes of financial market turmoil coincide well with our Risk Redemption alert

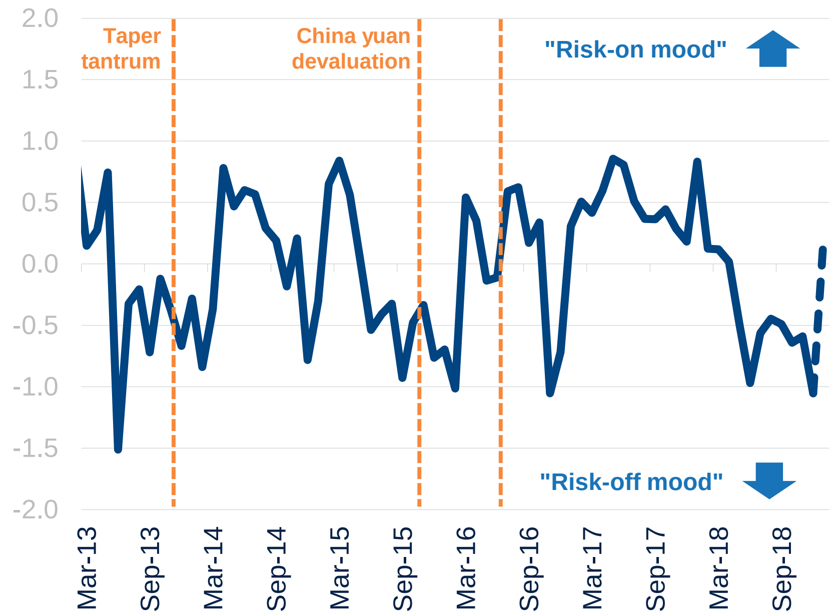
"Risk-off" alerts

(Colored areas indicate outbreaks)



Investment mood index*

(Above (below) zero = risk-on (risk-off) mood



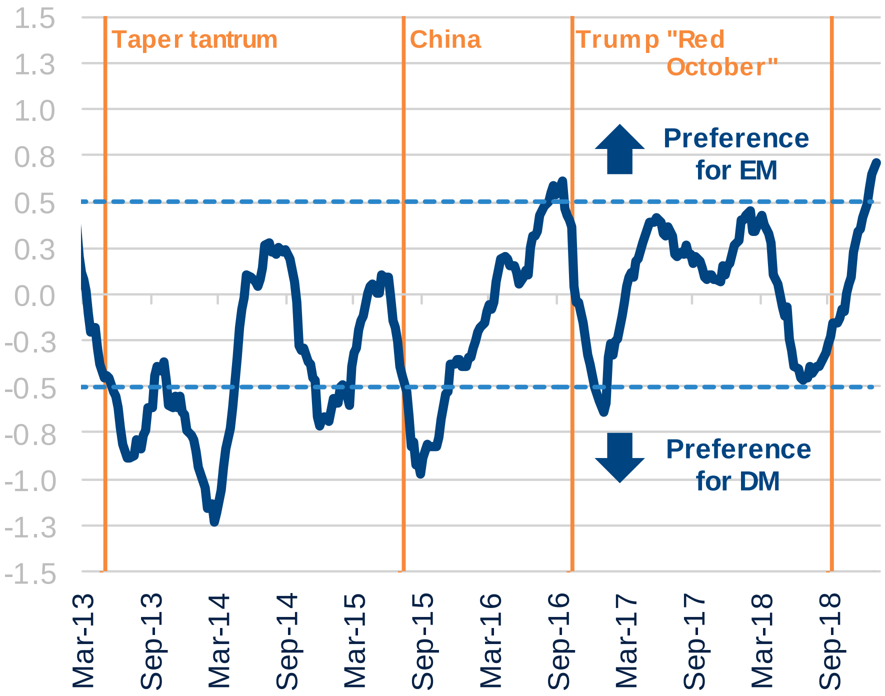
(*) see annex for more details.
Source: BBVA Research, EPFR

The "Risk aversion" alert is based on asset price movements (rates and VIX); while the "Safe-haven" and "Redemption" alerts are contained within the "Risk off" alert but focus on abrupt movement in GIF flows: "Safe haven" is linked to abrupt movements from EM to DM assets, while "Redemption" is linked to overall reductions in GIF assets towards other (probably more liquid) assets

Investors preference has increasingly switched towards taking positions in EMs after the Fed's pause

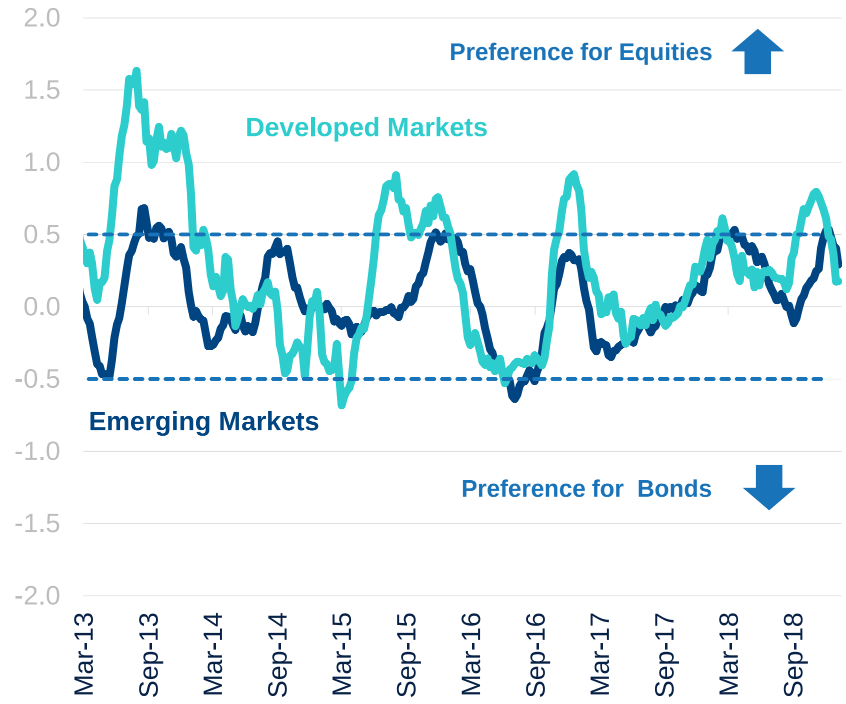
Investor appetite for DM vs EM

(Indicator expressed as standard deviation from historical mean)



Investor appetite for bonds vs equity

(Indicator expressed as standard deviation from historical mean)



Source: BBVA Research, EPFR

The relative preference for EMs increased since October. However, EM funds continued to register outflows during 4Q, but to a lesser extent

Fed's pause seems to have increased the appetite for EMs and especially for bonds, the assets that suffered the most during 4Q18

What's next?

Main trends surrounding our economic and financial outlook

Economic outlook

- Soft landing in global growth
- Downward revision of growth affecting mostly developed markets, more sizable in the EU
- Downward revision in oil prices based on mix of demand and supply factors

Financial markets

- Financial volatility to stay for a while (until 2Q19 while fears on key risks moderate).
- Low long-term rates on safe-haven flows.
- USD unlikely to appreciate sharply
- EM on the sidelines due to high volatility
- Central banks (including Fed) to stay dovish
- A step up in policy support by China

Central banks

- More aware of the downside risks (sensitive to market turmoil) and more prudent on policy normalization:
  - Altering the path of interest rates (Fed to pause earlier, ECB to delay the hiking cycle)
  - But, no changes in the non-standard measures (balance sheet), for now

Assumptions on key risks

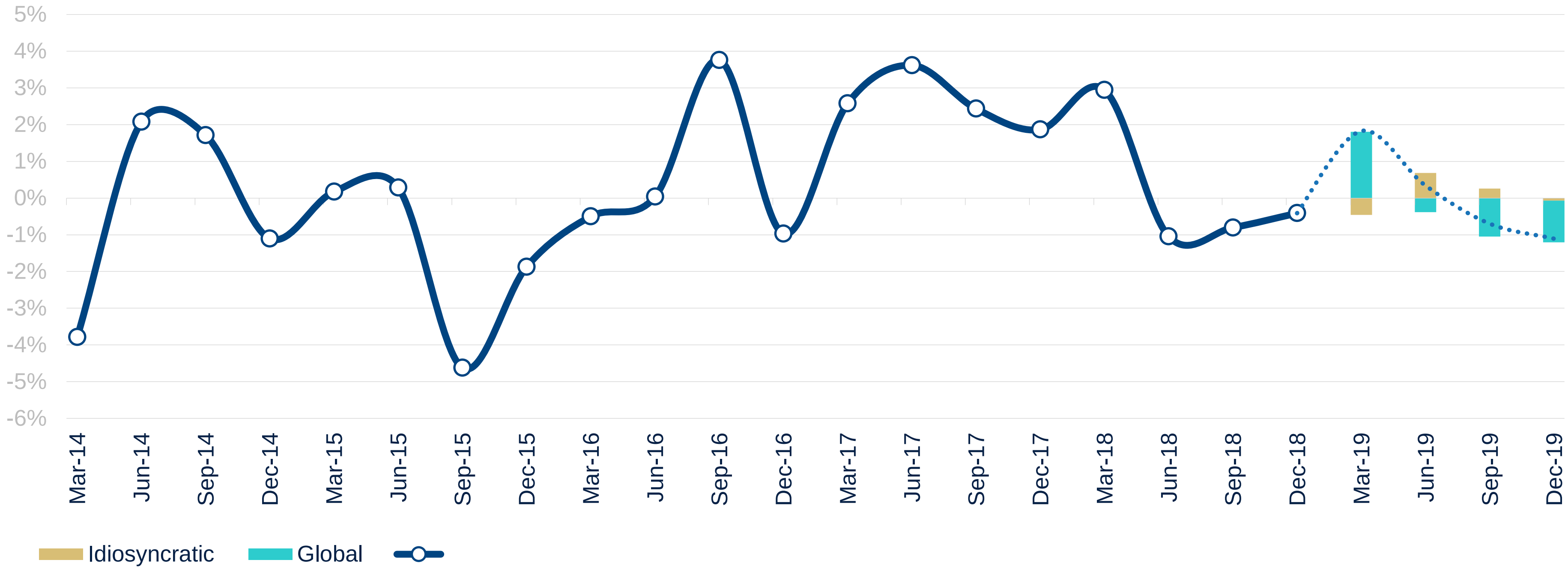
- Three key assumptions in our projections:
  - Easing US-China trade tensions: Tariffs left unchanged, but structural issues remain
  - Tail risks in Europe are eventually resolved (orderly Brexit; Italy)
  - More dovish Fed (2 vs 3 hikes in 2019; "data dependent")
  - ECB (refi-rate hike postponed to 2020), further room for EM central banks
- All in all, risks remain tilted to the downside

Source: BBVA Research

Portfolio flows outlook: With the most favorable environment already priced in, GIF inflows to EMs are unlikely to sustain for a long period

- Our baseline scenario suggests EMs would continue to outperform DMs in attracting GIF flows over the short term, although hinged on Fed's future rate actions and progress on US-China trade dispute
- That said, we think recent strong EMs attractiveness does not seem sustainable given that the most favorable environment is already priced in

Portfolio flows to EM
(% of AUM)



Source: EPFR, BBVA Research

Under a more favourable scenario with the Fed on a prolonged pause and lower volatility, the positive mood in EM could last till year end

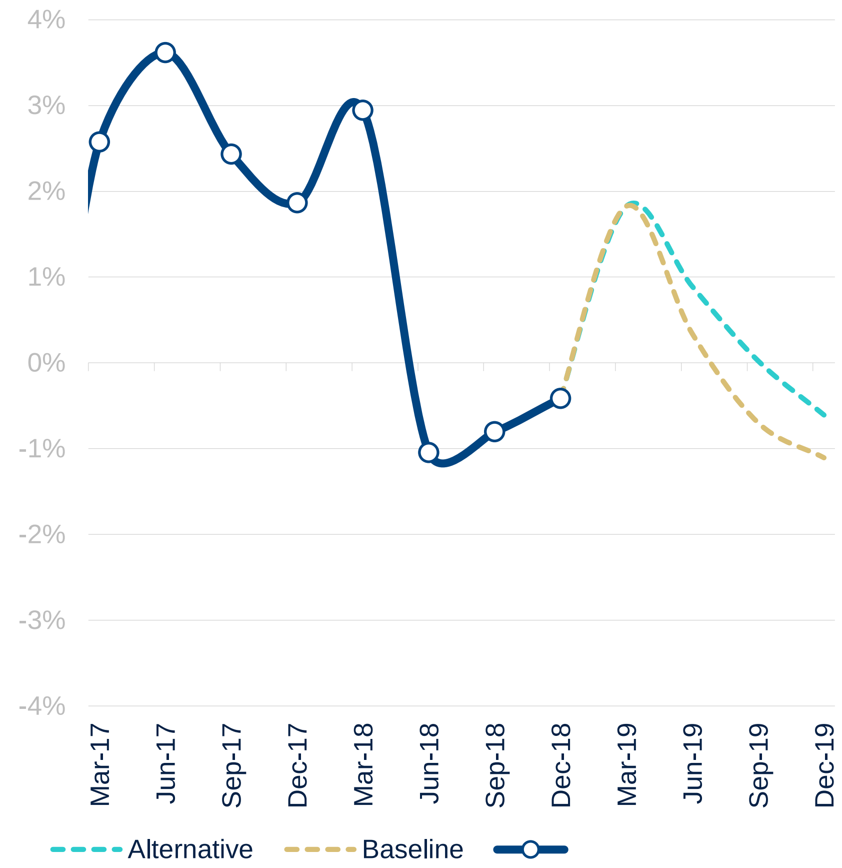
According to our sensitivity analysis, EMs could **maintain the positive mood during almost the whole 2019 if:**

1 **Fed halts the tightening**: no more rate hikes, and reduces the path of reduction of its balance sheet

2 **Volatility** moves to lower levels than baseline

3 **Long-term US rates** remain very subdued (slope very tight)

Portfolio flows to EM: baseline vs positive* scenario
(% of AUM)



Assumptions in baseline: VIX will remain hovering around 18%, Fed will increase fed funds rate two times by 25 bps each and will continue with BS normalization. The 10Y UST will end 2019 at around 3.3%. **Assumptions in alternative**: VIX will decrease to levels around 15% progressively, Fed will increase fed funds rate maximum once by 25 bps and the BS normalization will be slower. The 10Y UST will end 2019 around 2.90%.

Source: EPFR, BBVA Research

What to watch this year: Trade issues and China slowdown as main global threats while leveraged loans as a potential source of concern

01

Could Trade tensions derail global economy?
The approved tariff increase has already weighed on growth and the new round could hit harder

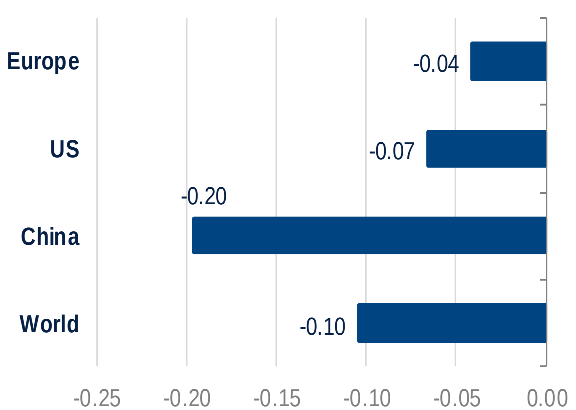
02

Are leveraged loans the new elephant in the room? The recent market mood curbed new issuances However, the maturities should not represent a short-term threat as they are concentrated between 2024-2025

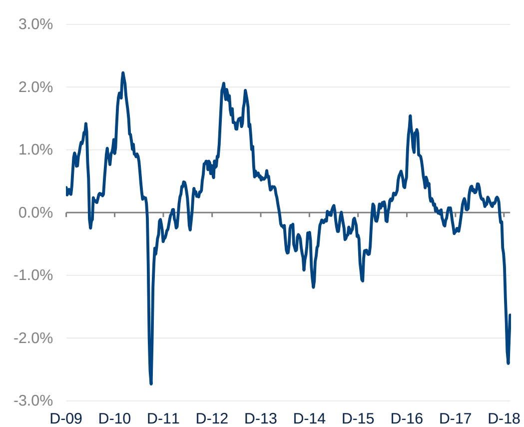
03

Is China's credit outlook a hot potato? Non-financial debt continued to increase supported by "targeted" monetary easing. Market caution reflected in downward pressures on the stock market and currency

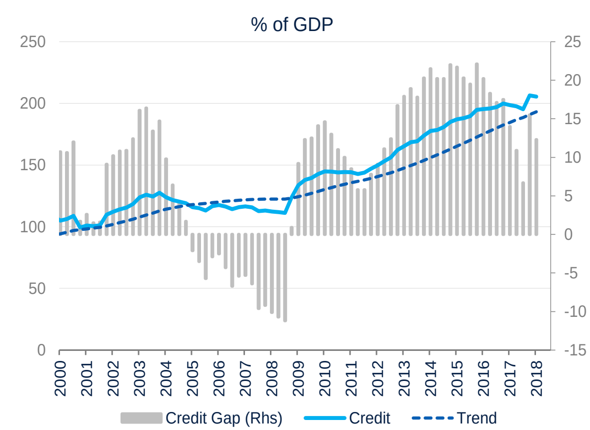
Effect on GDP growth of approved US tariffs and retaliation
(pp over two years, trade and financial/confidence channel)



Portfolio flows to Leveraged Loans funds*
(4w moving average, % of AUM)



Non-Financial Debt
(% of GDP)



Source: BBVA Research

Annex

Glossary

› GIF ‹

Global Investors Funds: these are the funds covered by the EPFR database in the “Country flows” allocation, with amounts shown in millions of US Dollars. This database includes the flows in country-denominated funds and the proportional amounts in global or supranational labelled funds

› AUM ‹

Assets under management in the EPFR database

› DM ‹

Developed markets included in our sample are Austria, Australia, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, the Netherlands, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom and the US

› EM ‹

Emerging markets included in our sample are Argentina, Brazil, Chile, China, Colombia, Czech Republic, Hungary, India, Indonesia, Korea, Mexico, Peru, Philippines, Poland, Russia, Slovenia, South Africa, Thailand, Turkey and Venezuela