Global Funds Outlook

Bond-equity divergence and waning EM appeal

May 2019

Creating Opportunities

Main Takeaways

- The dynamics of Global Investment Funds (GIFs) flows in Q1 2019 can be characterized in two ways – 1) a widening bond-equity divergence, particularly in developed markets (DMs), in favor of bonds, and 2) a visible moderation in inflows to emerging markets (EMs) after the buoyancy at the start of the year.
- A sharper than expected deterioration in global growth outlook, uncertainty surrounding trade protectionism and Brexit, and reinforced monetary policy accommodation by the Fed, the ECB as well as in China, has driven GIFs flows towards hard currency assets such as bonds rather than growth-sensitive ones such as FX and equities.
- Our investment mood index suggests market's risk-on mood has visibly tempered since the start of the year.
- The pullback in EM flows was in line with our model-predicted baseline scenario one quarter ago. EM-DM preference has turned in favor of DMs, as EMs continue to lose sheen.
- EM equity fund outflows have accelerated in recent weeks, particularly from China, in wake of escalation in US-China trade tensions. Idiosyncratic risks have also weighed on some vulnerable countries across EMs. DMs, meanwhile, have seen a pick up in bond fund inflows, although outflows from Eurozone equity funds continue.
- Policy interventions in wake of rising downside risks to global growth have helped alleviate financial stress. Thus, our financial tensions index improved in general during Q1 2019, across both DMs as well as EMs.
- Looking ahead, economic-policy reaction still favors a soft landing of the global economy, but a sharper slowdown in China, a new wave of protectionist measures and a disorderly Brexit, could trigger more negative scenarios. In this regard, the latest escalation in US-China trade tensions has exacerbated downside risks. We still expect the US and China to reach an agreement on trade, although risks of a full blown trade war have risen.
- Our baseline scenario for GIFs flows suggests that EM outflows will continue at a moderate pace until global volatility eases notably. In a risk scenario with higher volatility, EMs to face more intense and persistent outflows.

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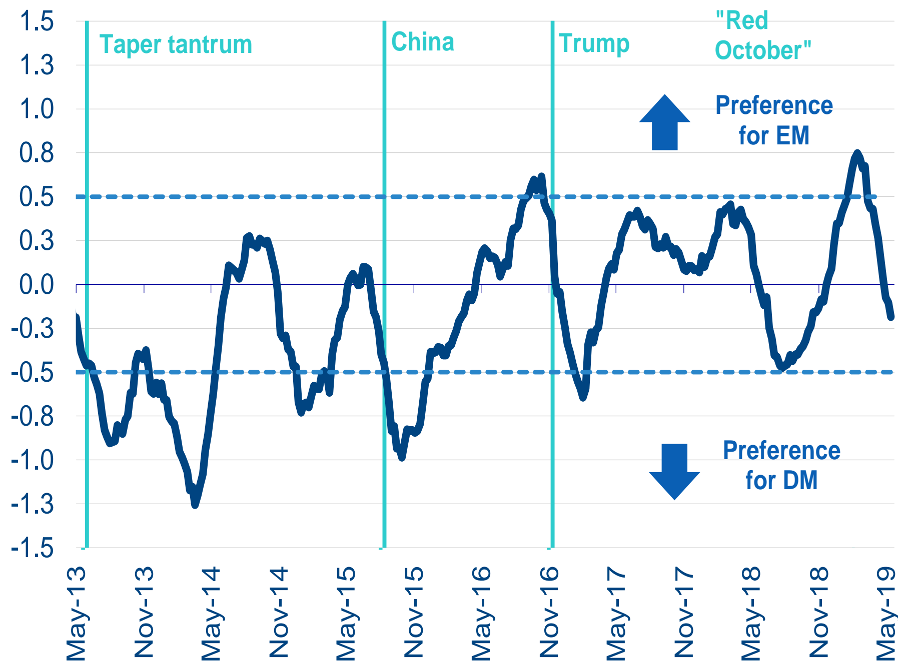
How have portfolio flows evolved over the past quarter and what is driving them?

GIFs flows since the start of 2019 have been marked by 1) EM-DM preference turning in favor of DMs and 2) global rotation out of equities and into bonds

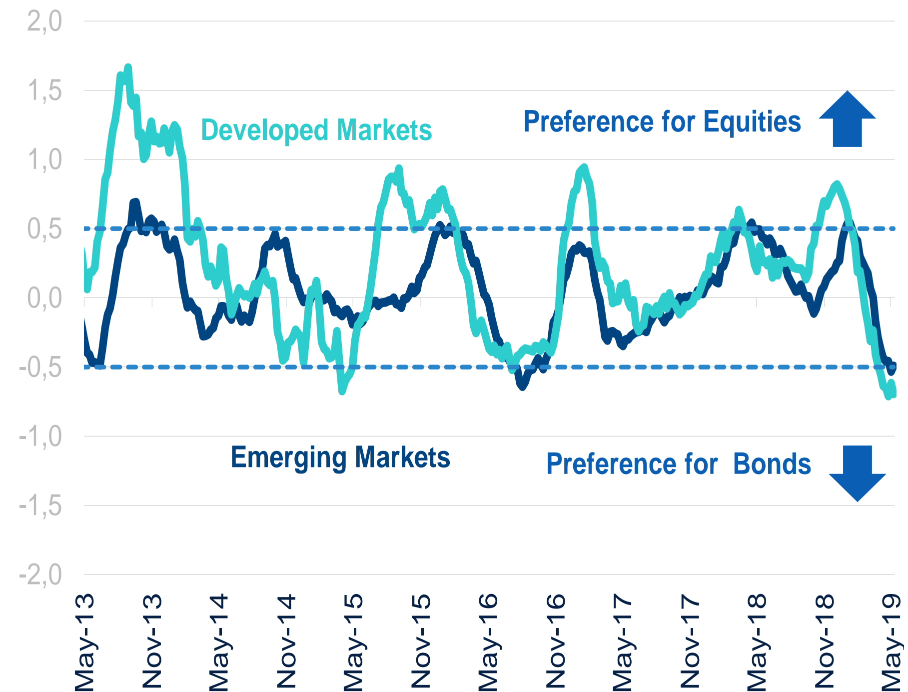
Investor appetite for DM vs EM

(Indicator expressed as standard deviation from historical mean)



Investor appetite for bonds vs equity

(Indicator expressed as standard deviation from historical mean)

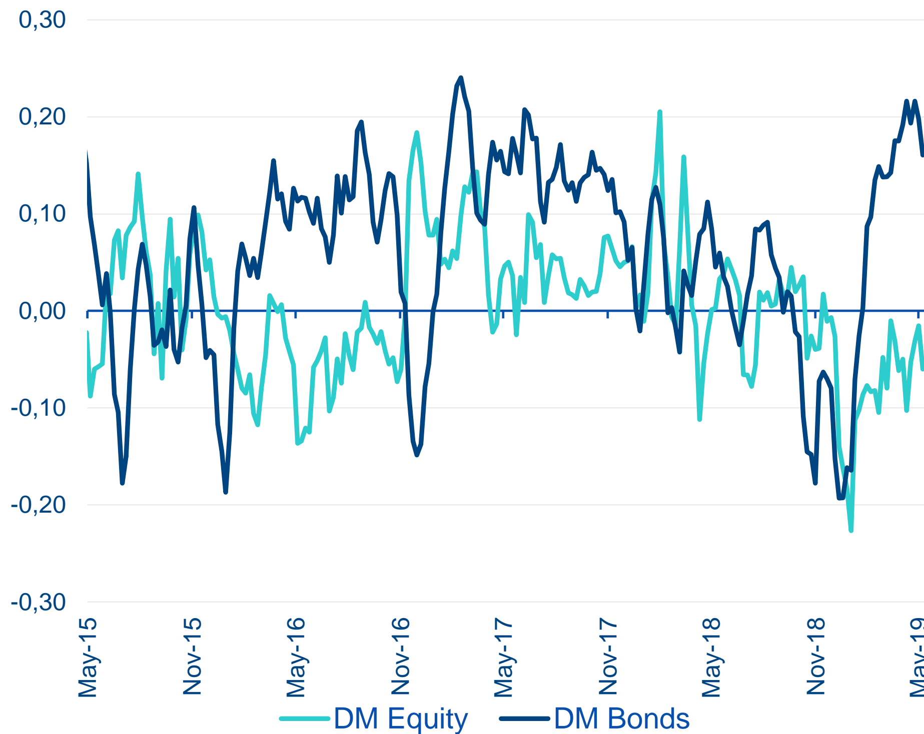


Source: BBVA Research, EPFR

Bond-equity divergence widened, more pronounced in DMs

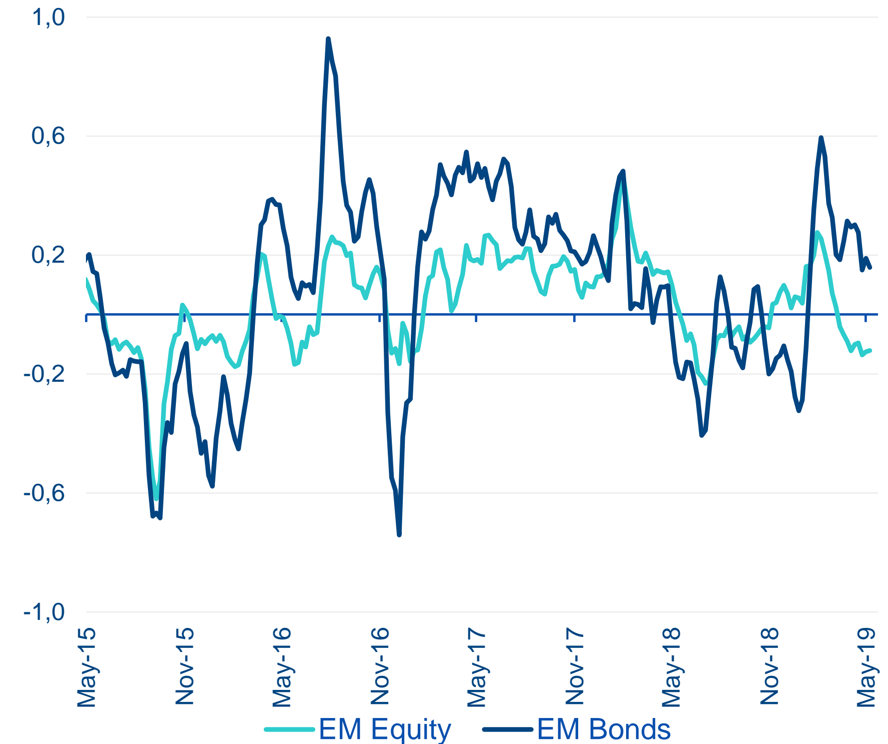
DM fund flows – Equity vs. Bonds

(% AUM)



EM fund flows – Equity vs. Bonds

(% AUM)



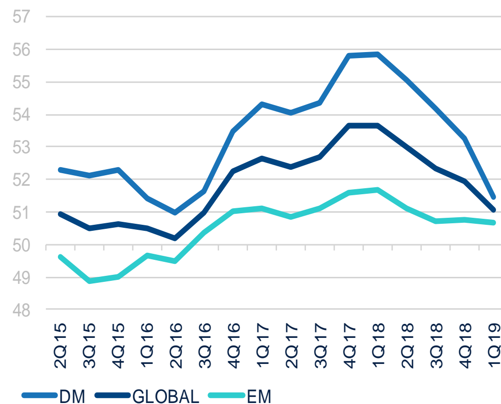
Source: BBVA Research, EPFR

Widening bond-equity divergence in favour of hard currency assets is driven by activity weakness, dovish central banks and uncertainty

01

PMIs across most developed economies, mainly Europe, trend lower. PMIs in EMs stabilize, led by China, although still at weak levels.

World manufacturing PMI
(Level ± 50)

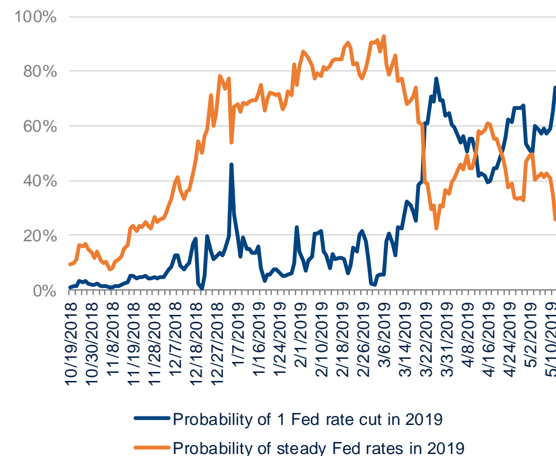


02

The Fed left rates unchanged and maintained policy patience, while strengthening its dovish signal with a downshift in path of Fed Funds rate.

The ECB reaffirmed its dovish tone and readiness to act if needed.

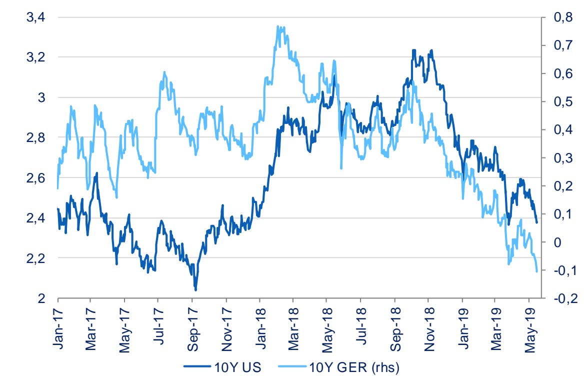
US: Changes in Fed funds probability
(%)



03

Global uncertainty persisted amid unresolved US-China trade issues and delayed Brexit. **Sovereign bond yields fell,** with German bund yields re-entering negative territory

US and Germany 10Y sovereign yields
(%)

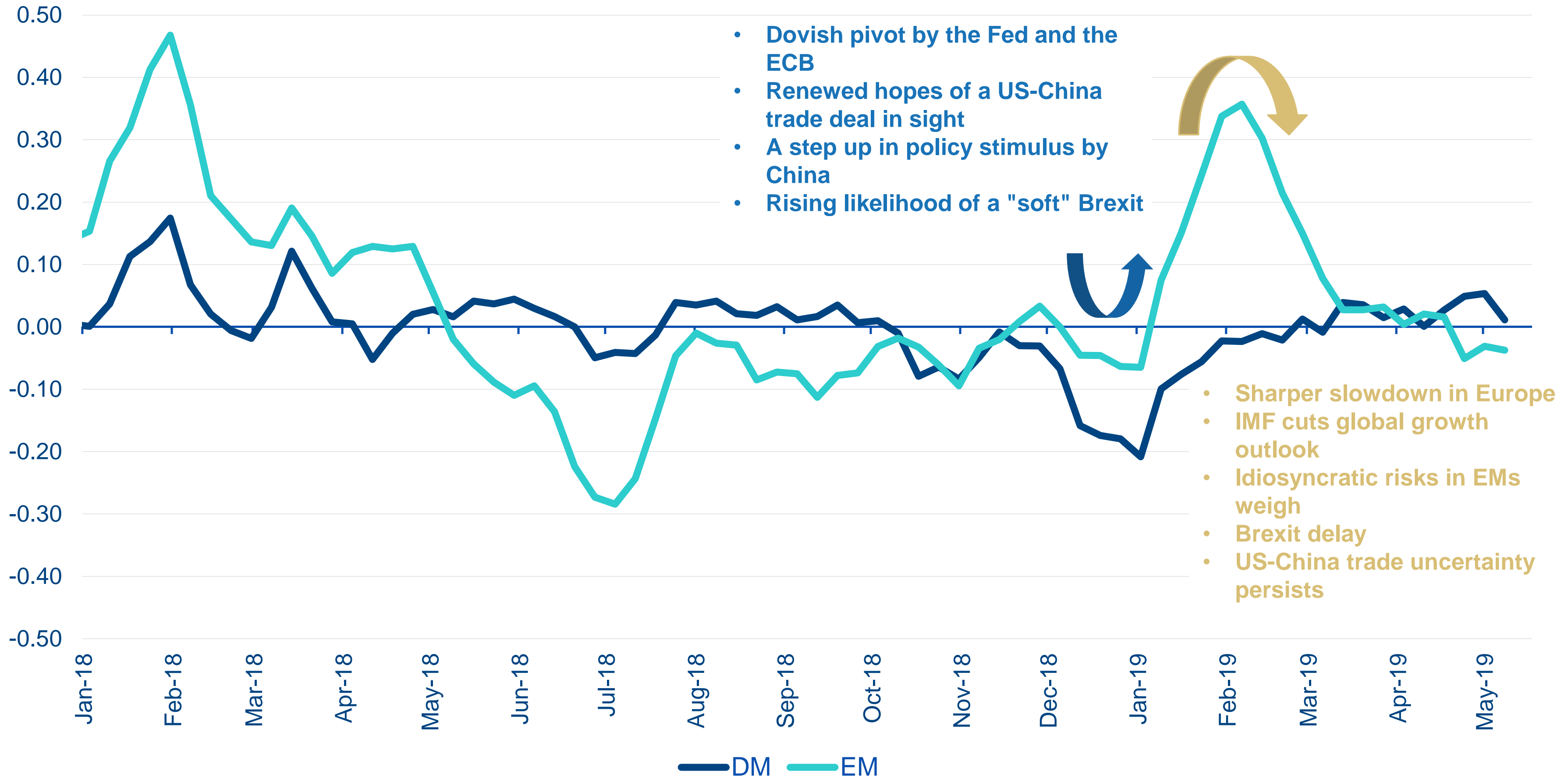


Source: BBVA Research

The pullback in EM flows was short lived, in line with our model-predicted baseline scenario from one quarter ago

GIF flows to EM and DM

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

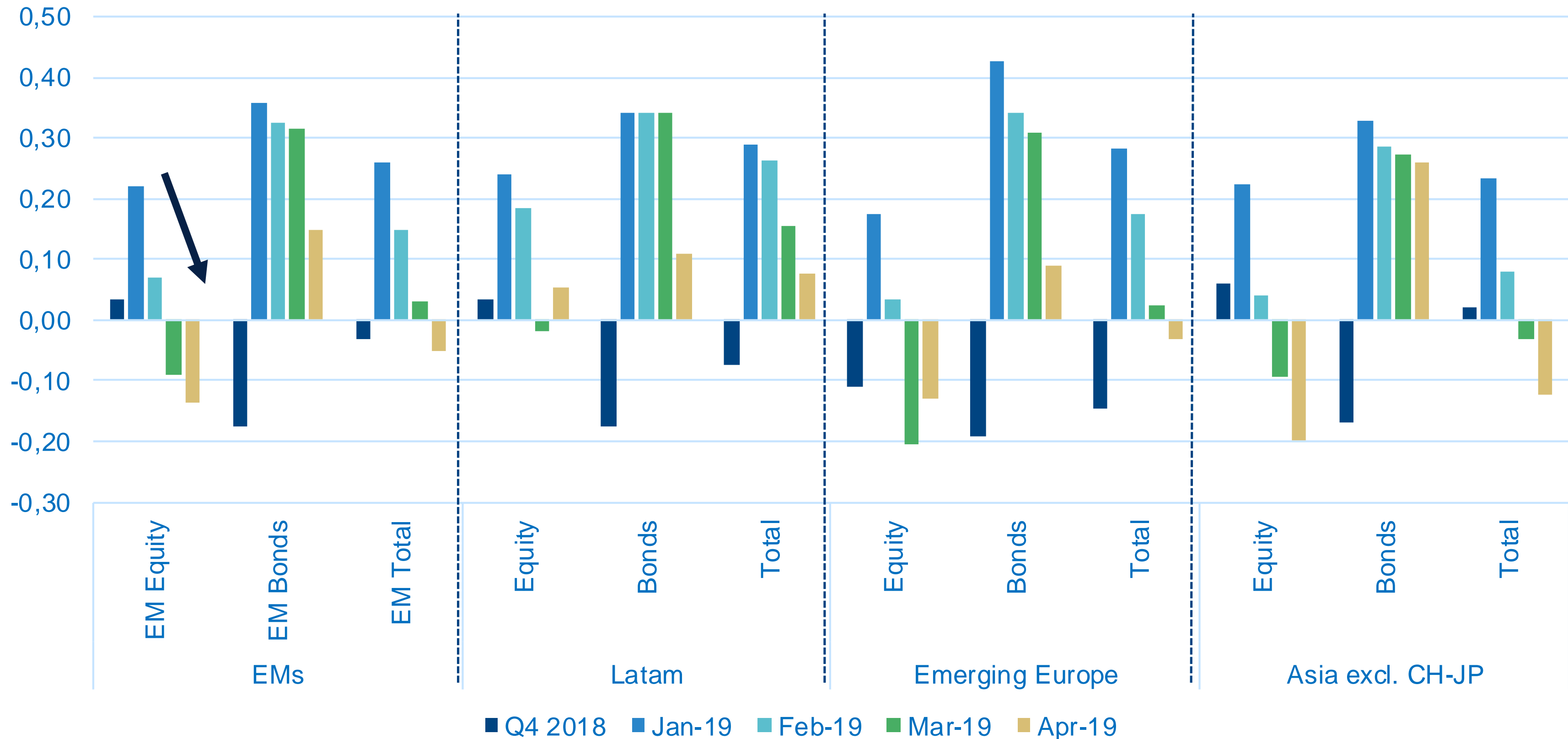


Source: BBVA Research, EPFR

Across EMs, idiosyncratic factors have weighed on some vulnerable countries; total flows into Latam still hold up relatively well

GIF flows across EMs by region and asset class

(Quarterly flows, % AUM)

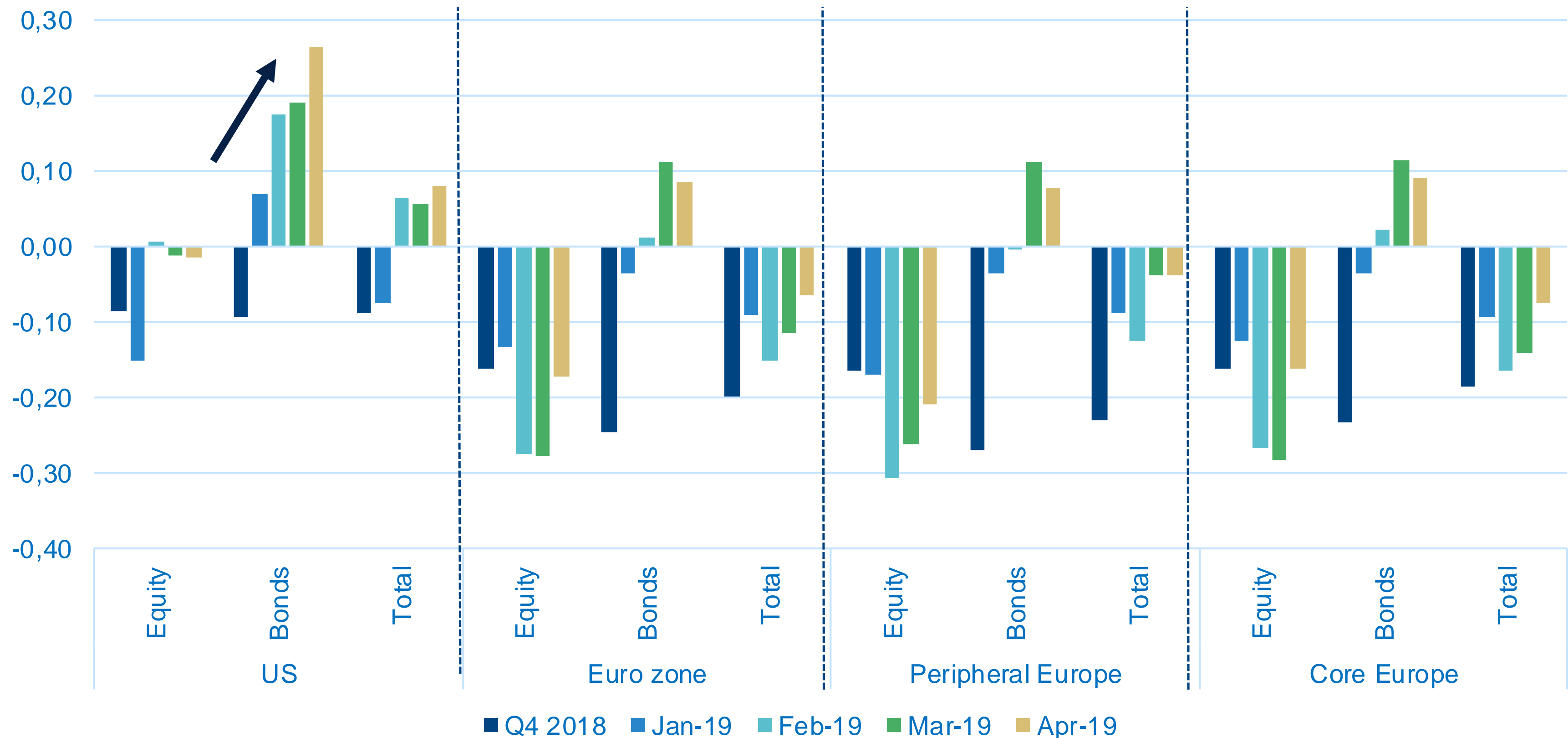


Source: BBVA Research, EPFR

DMs have seen a pick up in bond fund inflows, both in US as well as Core and Periphery Europe, while EZ equities see significant outflows

GIF flows across DMs by region and asset class

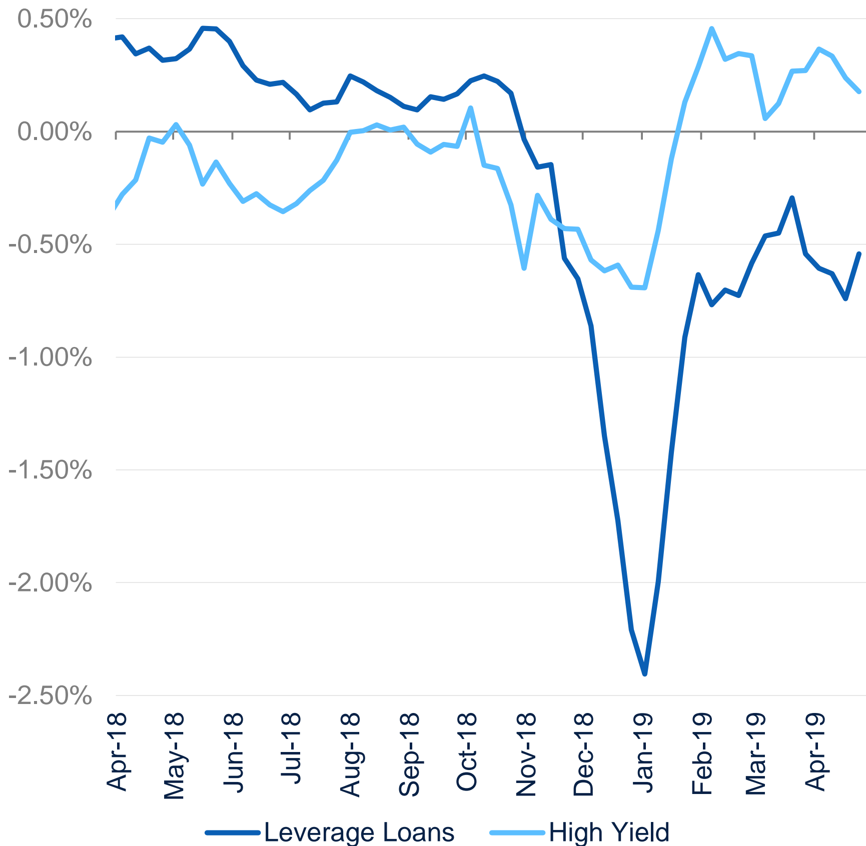
(Quarterly flows, % AUM)



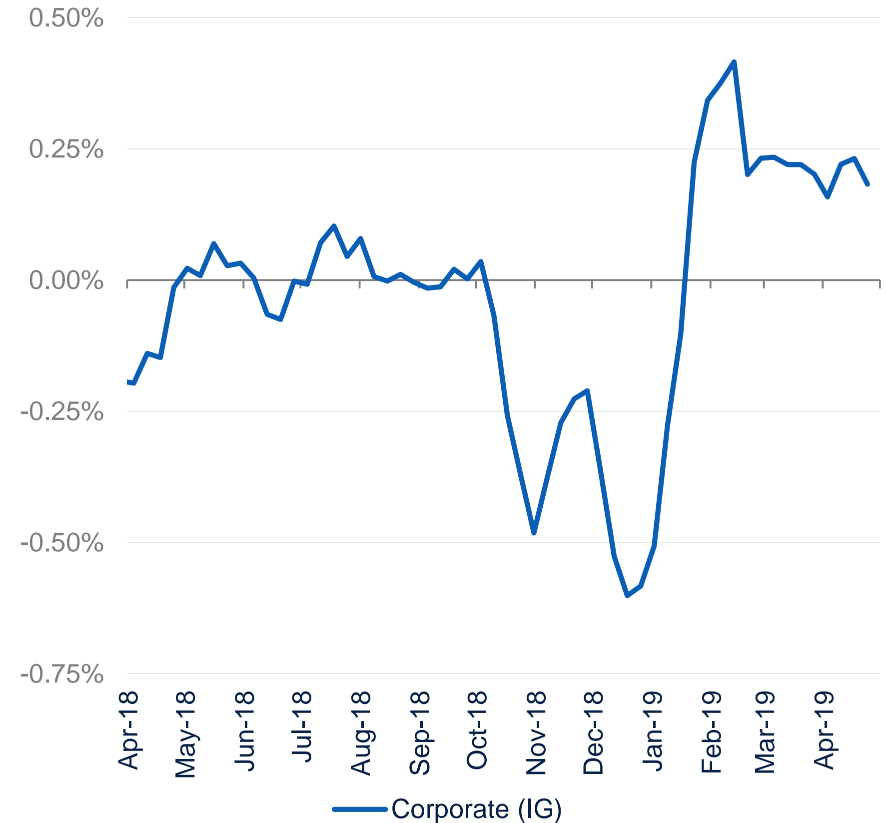
Source: BBVA Research, EPFR

Alternative assets : Fed's dovish shift has helped boost inflows to corporate bond funds, while financial stability risks related to leveraged loans persists

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



Flows to Investment Grade Corporate Bonds
(4w m.a. % of AUM)



Source: BBVA Research, EPFR

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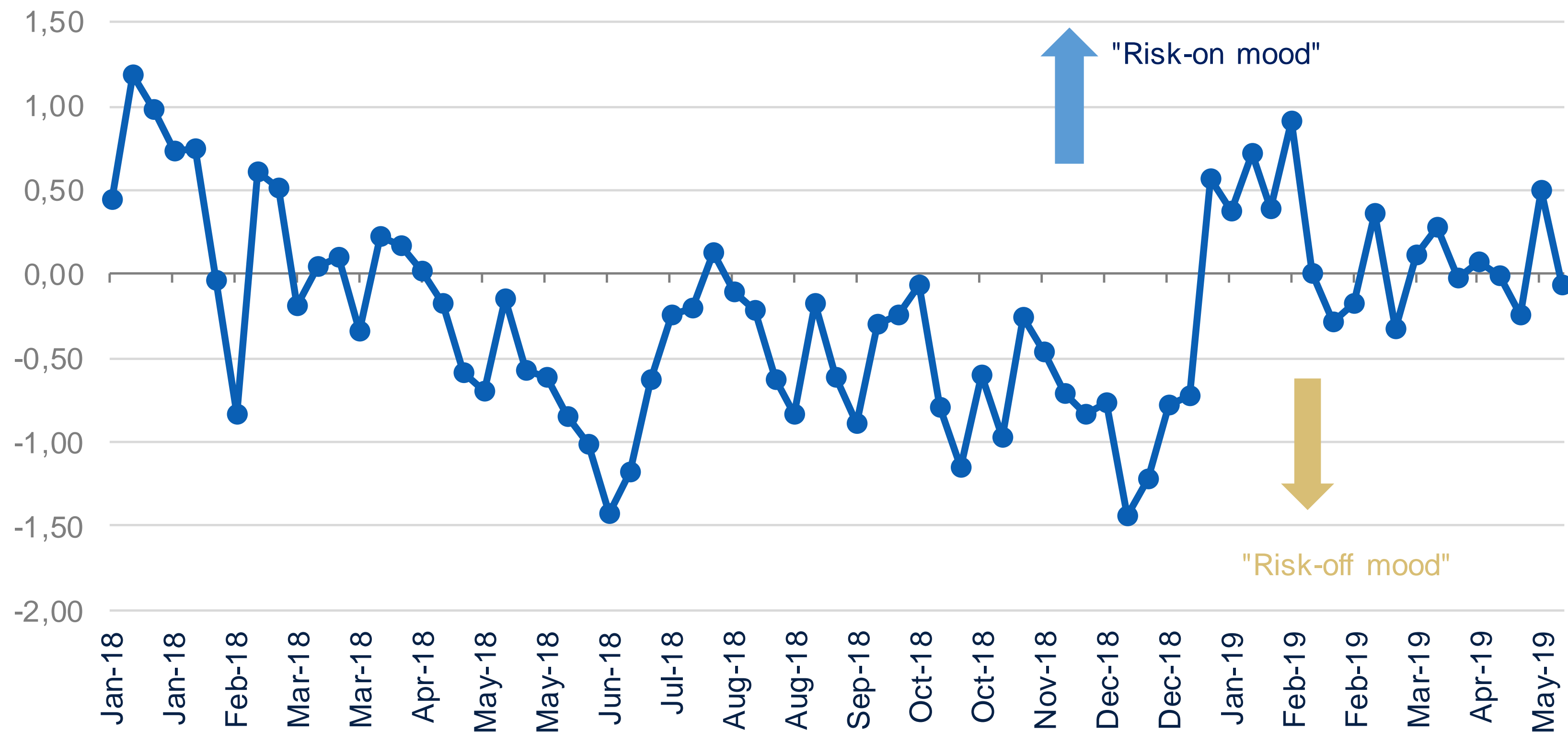
Warnings from our risk-off indicator

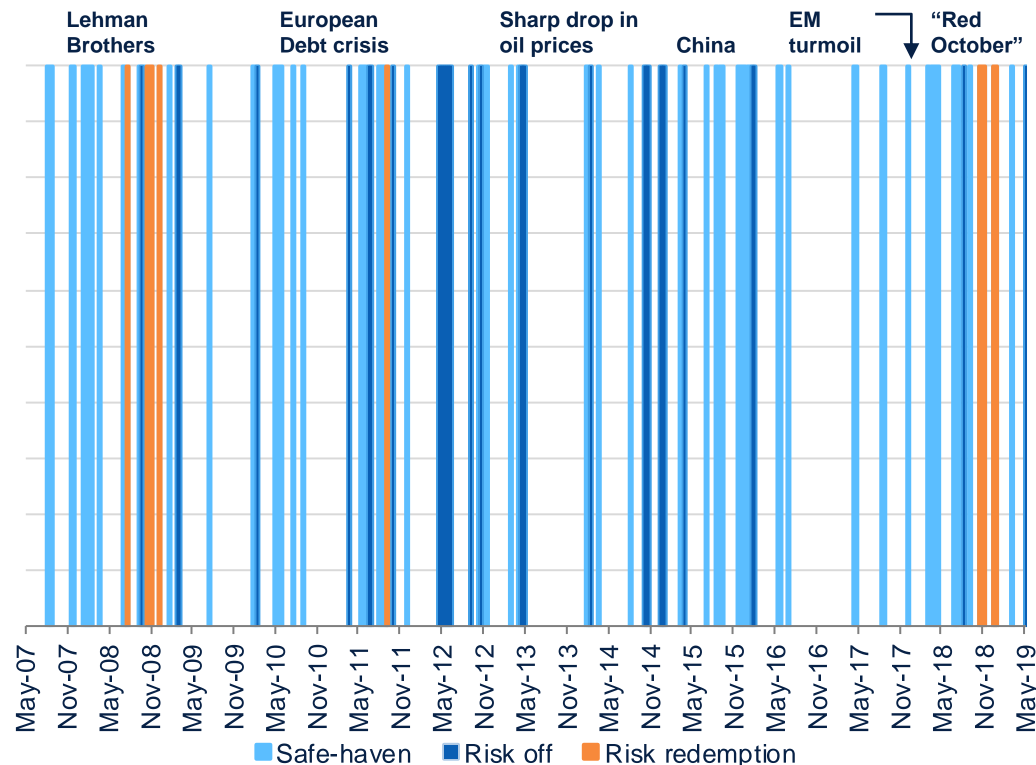
Our investment mood index suggests markets risk-on sentiment has visibly tempered since the start of the year



Source: BBVA Research, EPFR

Our risk-off indicator has remained is “safe haven” territory, reflecting movement in GIFs flows from EM to DM assets

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



(*) 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

What's next?

What is our macroeconomic outlook? Global growth is moving towards a soft-landing of global growth, amid high uncertainty

Notable slowdown in global growth, but no hard-landing

Lower inflation after the fall in oil prices

Increased financial tensions in developed countries

More cautious and patient central banks

Global risks intensify

Specific issues worrying in many countries and areas

Monetary policy is going to be looser than previously expected, as growth moderation has caused a shift in monetary policy in the US and the Eurozone, and new stimuli in China

Fed

- **Long pause in the pace of rate increases**, but there could be a hike by the end of the year
- **The normalization (reduction) of the balance sheet will end earlier than expected** (Sep-19)

ECB

- **Postponement of monetary normalization**
- **Lower interest rates** for longer and additional liquidity (TLTRO-III)
- No refi **rate hikes** expected until Dec-20

China

- **Additional monetary stimulus:** reserve requirement and lending rate reductions in 2019
- **Increase in public deficit,** to 2.8% of GDP in 2019
- **Tax cuts** (2% of GDP)

Latam and other emerging countries

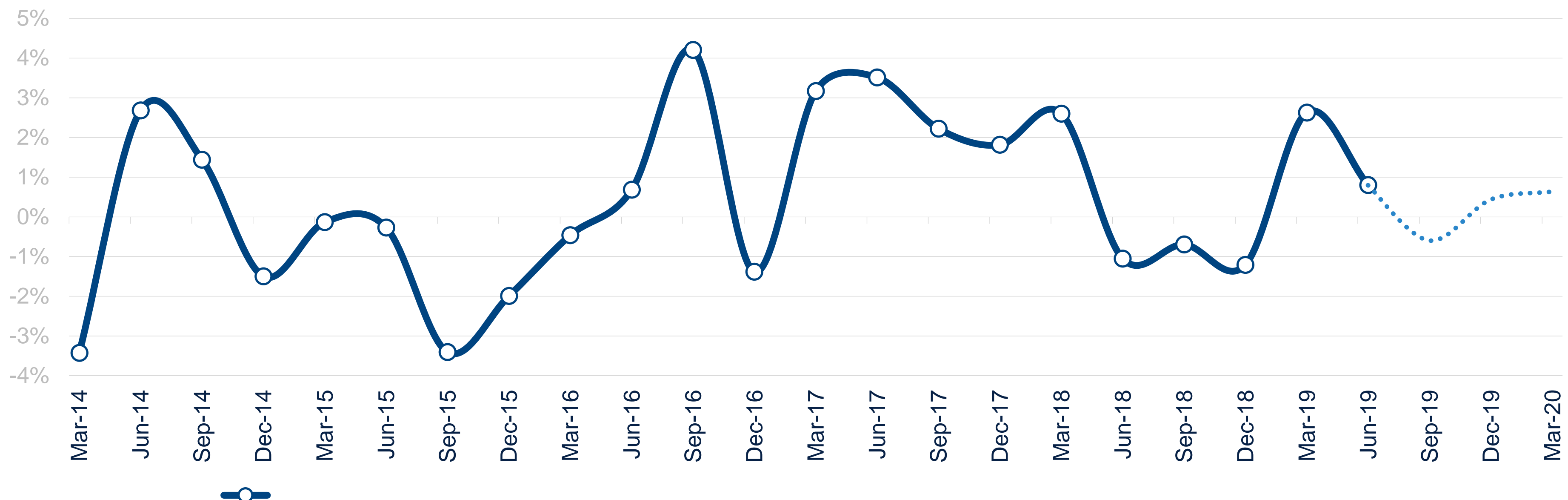
- There is room for a **more dovish monetary policy**

Outlook for portfolio flows – Expect outflows from EMs to continue at a moderate pace, but outflows could intensify if downside risks materialize

- Reinforced monetary policy accomodation by the Fed, as well as a step up in stimulus by China has proved supportive of financial conditions in 2019, in turn underpining flows to Emerging Markets.
- However, with global growth increasingly vulnerable, in wake of lingering uncertainties, particularly rising protectionist threat and idiosyncratic risks in some EMs, we expect volatility to stay elevated.
- Against this backdrop, and under the assumption of higher Fed balance sheet alongside looser monetary policy, we expect moderate outflows from EMs to continue going forward, although such outflows could intensify if downside risks materialize.

Portfolio flows to EM (Actual and forecast as under our baseline scenario)

(% of AUM)



Source: EPFR, BBVA Research

Under a high risk scenario with higher volatility, EMs would face more intense and persistent portfolio outflows

Alternative Scenario - 1: A scenario closer to broader market expectations and slightly positive for EM flows compared to our baseline.

1 **Fed** maintains rates in 2019

2 **Volatility** moves in line with our baseline scenario, moderating from current levels in 2H19

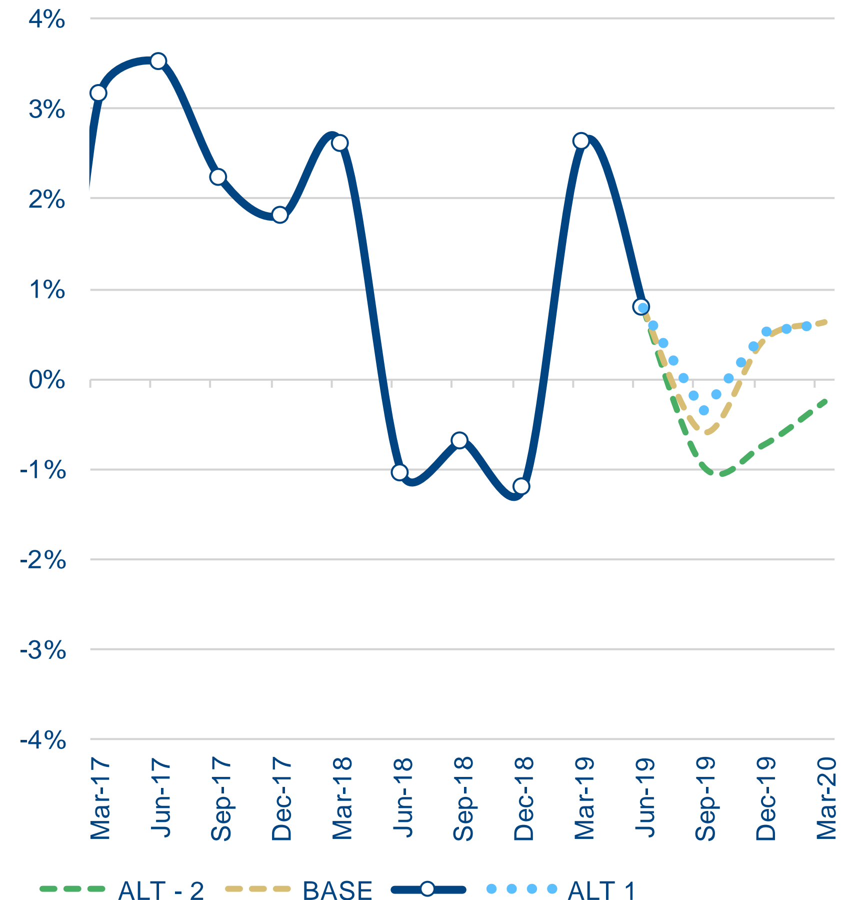
3 **Long-term US rates** ease in line with forwards market rates (slope tighter), pick up starting 1Q20

Alternative Scenario – 2: A high risk scenario, where EMs attractiveness wanes more rapidly and for longer compared to our baseline:

1 **Fed** cuts rates once in 2019

2 **Volatility** moves to higher levels than baseline, moderates with a longer delay

3 **Long-term US rates** ease and remain subdued for longer (slope tighter)



* See Annex for assumption details.

Source: EPFR, 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

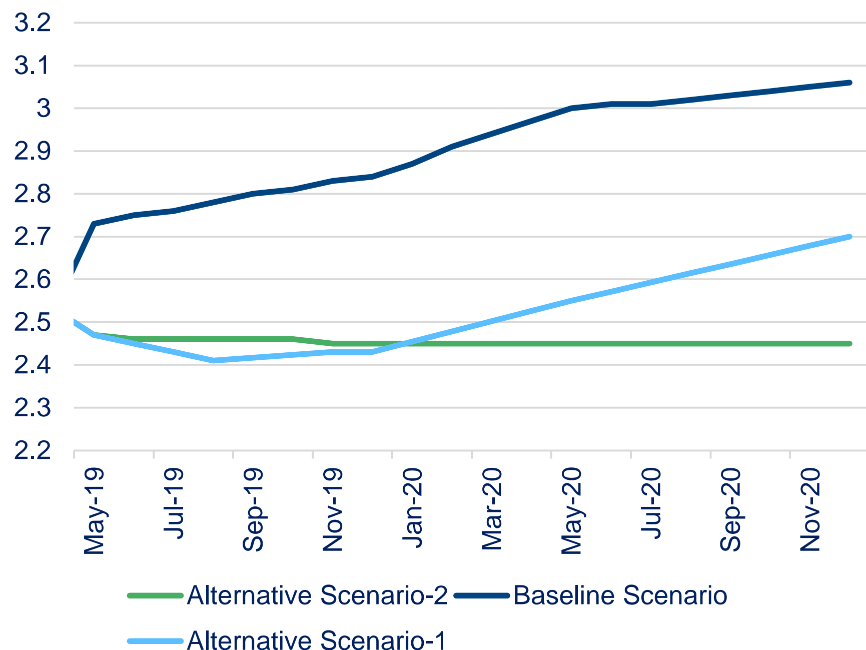
› DM ‹

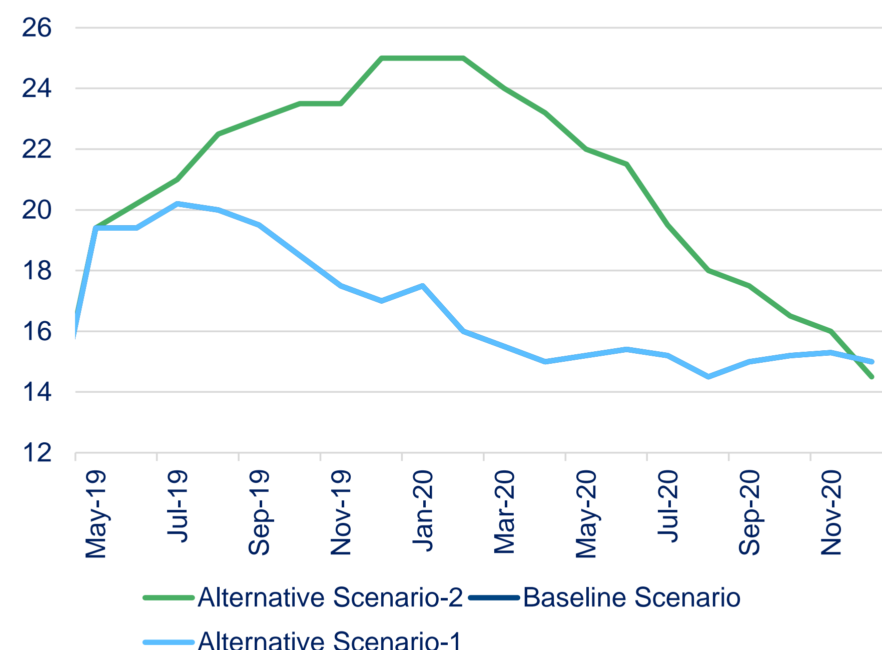
Developed markets included in our sample are Austria, Australia, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, the Netherlands, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom and the US

› 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

Key changes in our baseline vs. alternative scenario assumptions





Assumptions in baseline: VIX will hover around 20 before moderating in 4Q19. Fed will increase fed funds rate one time in 2019 by 25 bps and will halt Balance sheet normalization in Sept 2019. The 10Y UST yield will end 2019 at 2.8%.

Assumptions in alternative scenario - 1 (market scenario): VIX moves in line with our baseline scenario. Fed will hold interest rates unchanged at current levels. The 10Y UST yield will end 2019 around 2.4% but move higher thereon.

Assumptions in alternative scenario - 2 (risk scenario): VIX will increase to levels around 25% progressively until end Q1 2020 before moderating gradually. One interest rate cut by the Fed in 2019. The 10Y UST yield will end 2019 around 2.4% and stay at lower levels for longer.

Source: BBVA Research, EPFR