BBVA Research

Global Funds Outlook

EM bonds regain favor in a low-yield environment

July 2019

Creando Oportunidades

Key messages

‘Search for yield’ has emerged as the predominant driver of funds flows in the current low yield backdrop marked by slowing global growth, easing monetary policy, and stable commodity prices.

EM bond funds notched their 10th straight week of inflows by end July, mainly in hard currency, while EM equity outflows eased. Our bond equity preference indicator depicts a still heavy bias for bonds. European bond funds, including the peripheral ones, registered a bulk of inflows leading to historical low yields, while equity funds saw their longest stretch of outflows in 10 years.

Looking ahead, central banks’ dovish pivot, a soft landing in China and cautious optimism over US-China trade talks signal an extension in the search-for-yield cycle. That said, EM flows remain vulnerable to potential shocks, characterized by a deterioration in US-China trade talk progress, a no-deal Brexit and geopolitical tensions.

Idiosyncratic factors alongwith US dollar movement will also determine fund flow dynamics for EMs, while, in Europe, peripheral as well as corporate bonds will likely find further support from ECB’s ‘lower for even longer’ rate shift.

This notwithstanding, long-term core sovereign bonds will continue to play a vital role of key stabilizers in the context of lingering macro uncertainty.

Index

BBVA Research

01

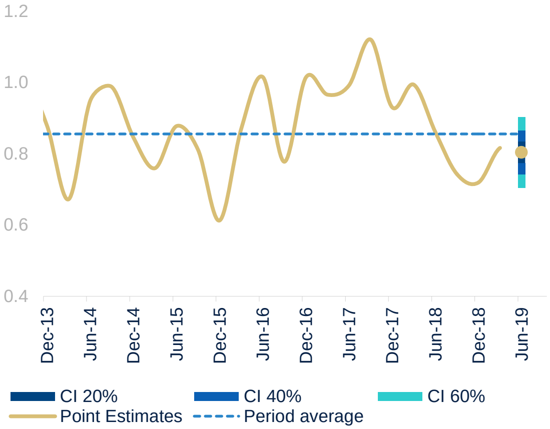
Core sovereign bond yields hit new lows, in turn raising the allure for higher yielding bonds

Investors intensify ‘search for yield’ in an environment marked by two key factors, complicated macro outlook and supportive central banks

01

Increasingly complicated macro outlook as trade frictions, Brexit, and geopolitical tensions weigh on global growth.

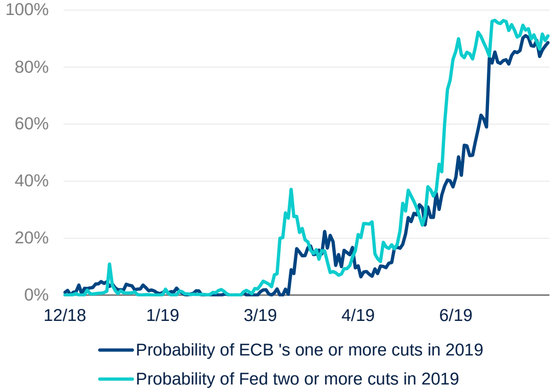
World GDP Growth
(Forecast based on BBVA-GAIN, % QoQ)



02

Dovish turn by major central banks, led by the Fed and the ECB.

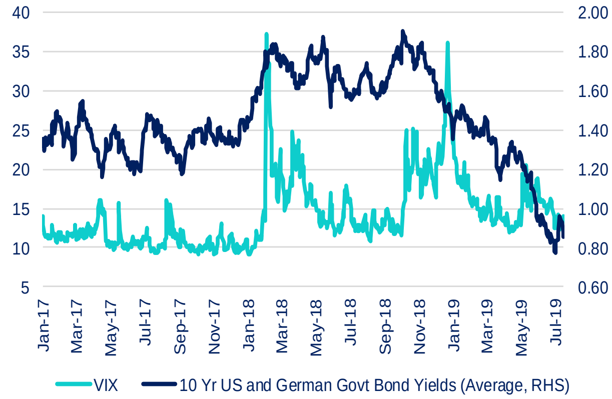
Market’s probabilities of Fed’s of ECB’s easing
(%)



03

Core sovereign bond yields hit new lows, while VIX stays at benign levels, in turn **raising the allure for higher yielding bonds.**

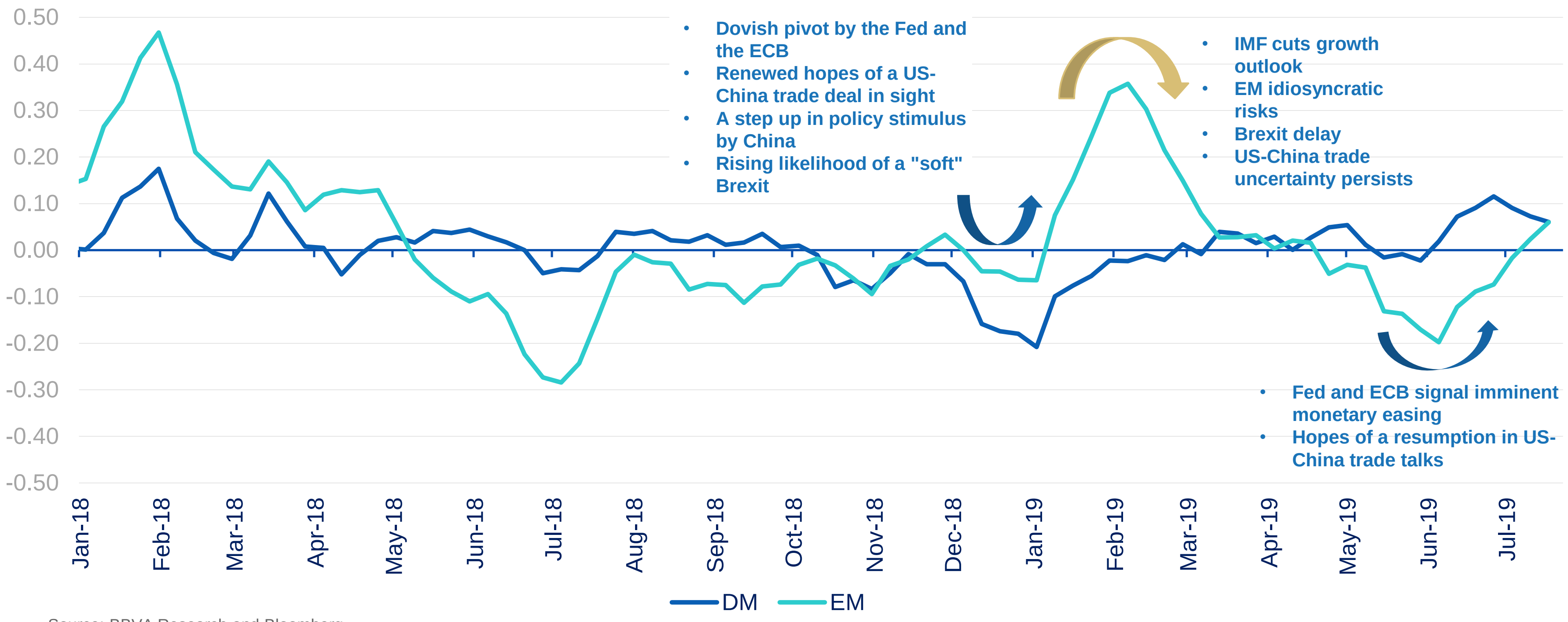
VIX vs. safe haven yields
(%)



Source: BBVA Research, Bloomberg

EM flows have revived remarkably, led by bonds, but remain vulnerable to potential shocks, including breakdown in US-China trade talks, as seen in May

GIF FLOWS TO EM AND DM
(WEEKLY FLOWS, 4W MOVING AVERAGE, % AUM)

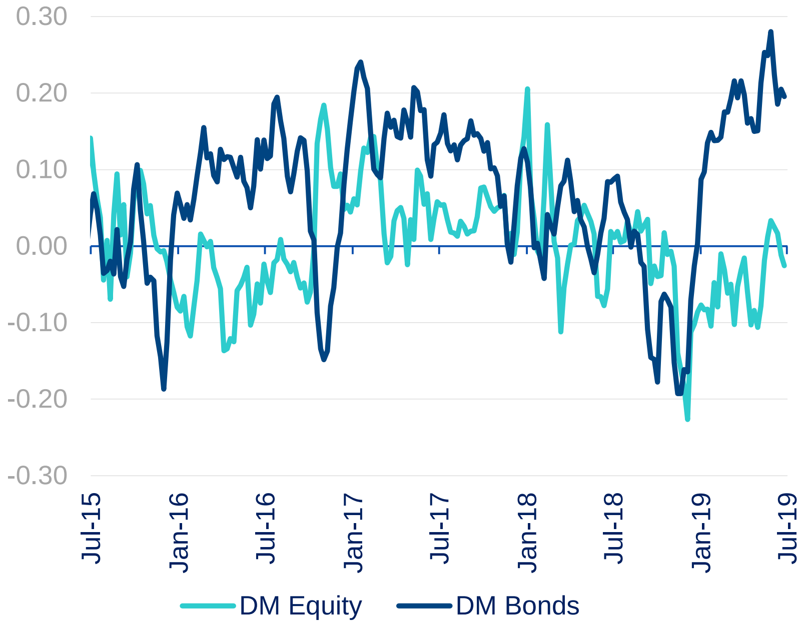


Source: BBVA Research and Bloomberg

Bond flows into DMs remain strong with a nascent revival in equity flows to the US; EMs bond inflows see visible pick up while equity outflows ease

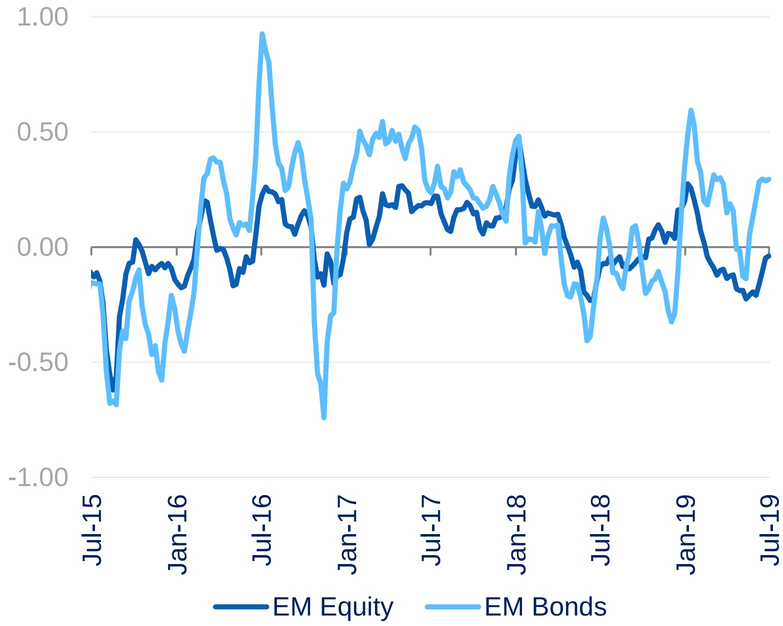
DM FUND FLOWS – EQUITY VS. BONDS

(% AUM)



EM FUND FLOWS – EQUITY VS. BONDS

(% AUM)

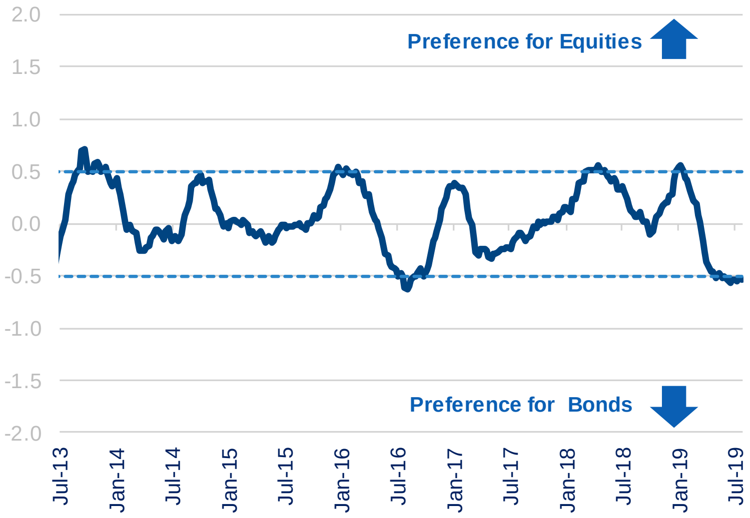


Source: BBVA Research, EPFR

Preference for bonds (vs. equities) has intensified while emerging markets and eurozone periphery bonds are regaining favor in the quest for yield

INVESTOR APPETITE FOR EQUITIES VS. BONDS

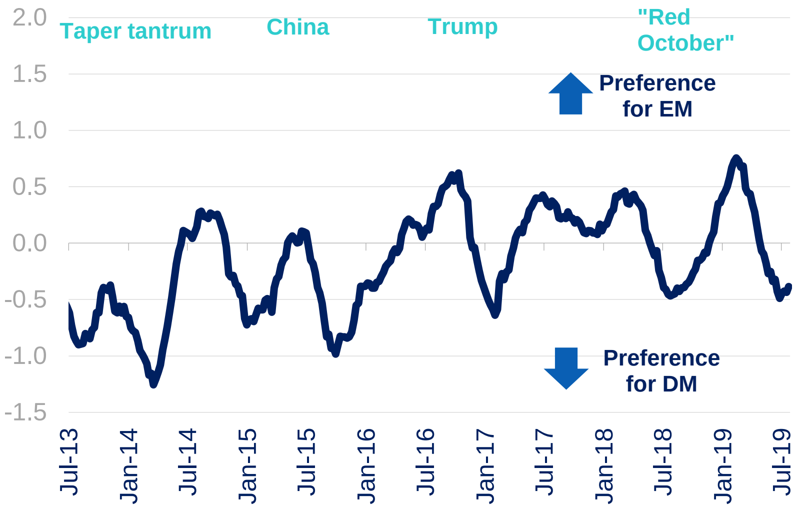
(STANDARD DEVIATION FROM HISTORICAL MEAN)



Source: BBVA Research, EPFR

INVESTOR APPETITE FOR EM VS. DM

(STANDARD DEVIATION FROM HISTORICAL MEAN)

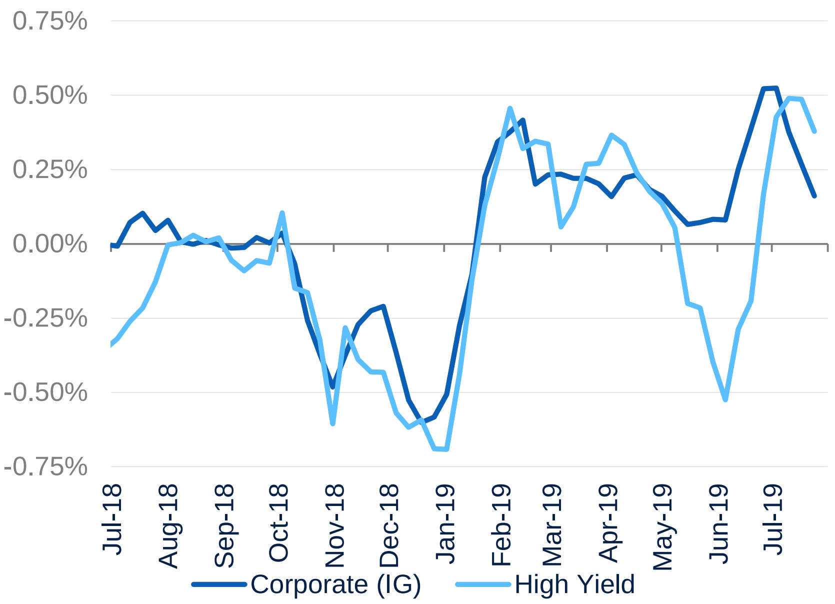


Source: BBVA Research EPFR

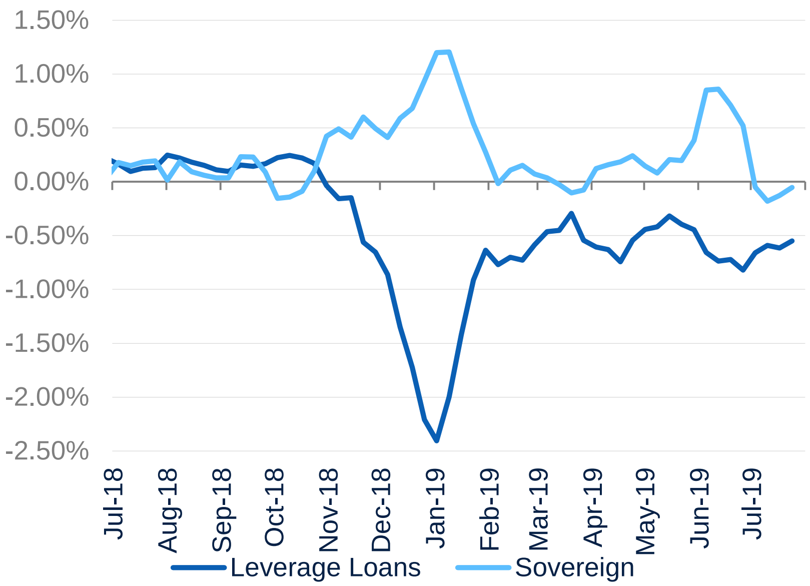
Nearly $12 trillion in global bonds currently trade at negative rates, the highest since its peak in June 2016. Almost half of all European government bonds have a negative yield, while at the end of May, 20% of European investment grade corporate debt had a negative yield. Equities, meanwhile, have failed to attract significant fund flows.

‘Search for Yield’ has led investment grade corporate bonds to notch 27 straight weeks of inflows, while high yield bond inflows hit 7 straight weeks.

FLOWS TO HY & INVESTMENT GRADE CORPORATE BONDS
(4W M.A. % OF AUM)



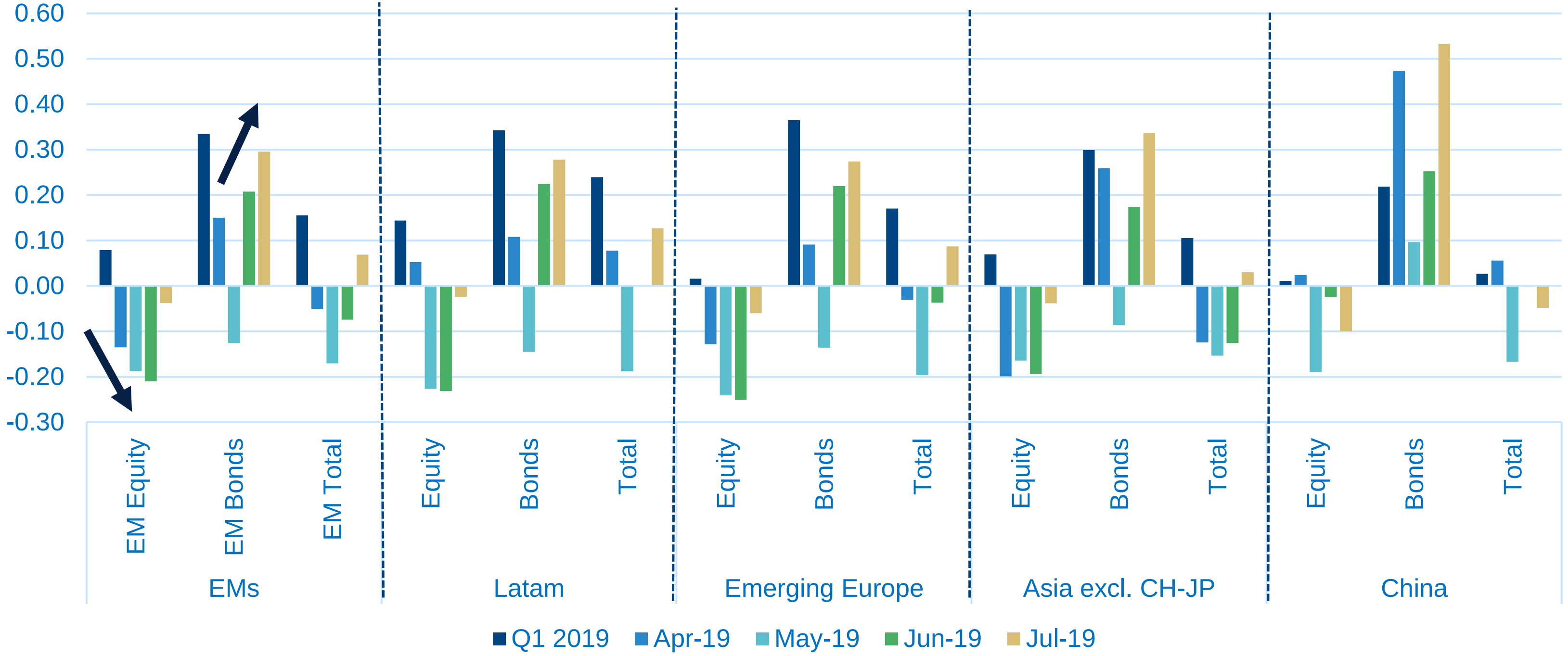
FLOWS TO LEVERAGED LOANS AND SOVEREIGN BONDS
(4W M.A. % OF AUM)



Source: BBVA Research, EPFR

EMs, across the board, have seen a rebound in bond inflows over the past two months while equity outflows have receded in July

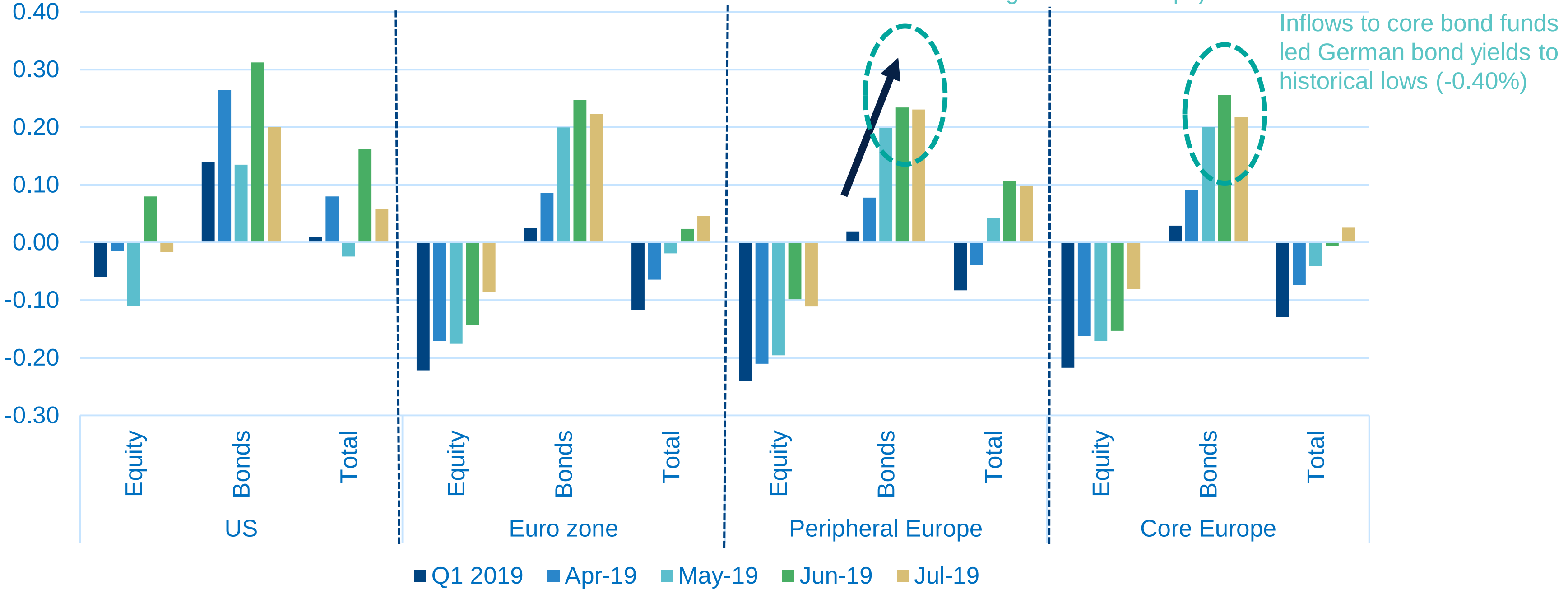
GIF FLOWS ACROSS EM BY REGION AND ASSET CLASS
(QUARTERLY FLOWS, % AUM)



Source: BBVA Research and Bloomberg

Q2 saw modest inflows to DMs post outflows in Q1 as robust bond inflows to US as well as Europe, particularly in the periphery, offset equity outflows

GIF FLOWS ACROSS DM BY REGION AND ASSET CLASS
(QUARTERLY FLOWS, % AUM)



Source: BBVA Research and Bloomberg

BBVA Research

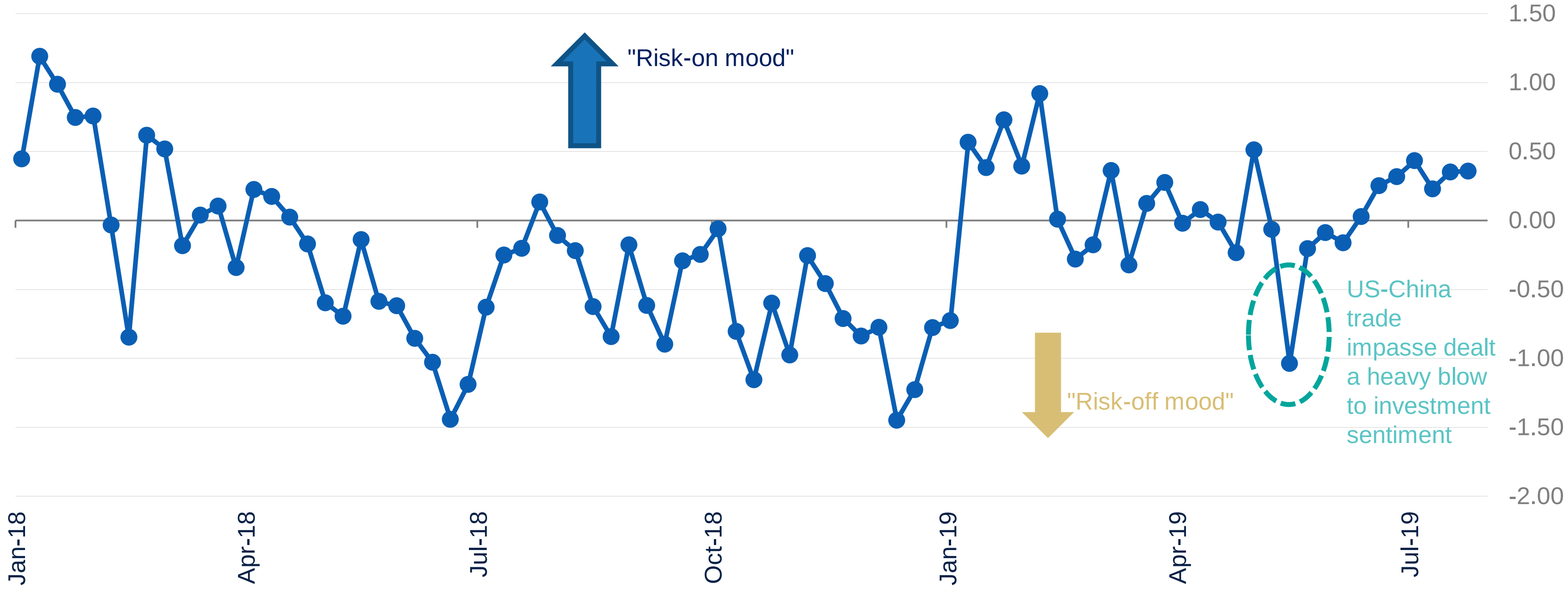
02

Warnings from our risk-off indicator

Our investment mood index indicates gradually improving market sentiment underpinned by policy support in wake of still significant global headwinds

INVESTMENT MOOD INDEX*

(ABOVE (BELOW) ZERO = RISK-ON (RISK-OFF) MOOD



Source: BBVA Research and Bloomberg

BBVA Research

03

What next?

The policy stimulus (demand channel) is expected to offset the effect of continued trade tensions (supply shock)

High trade tensions

- Irreversible damage has already been done
- The strategic rivalry between US and China is here to stay
- Lingering uncertainty to weigh on business decisions
- EMs more negatively affected by trade uncertainty than DMs

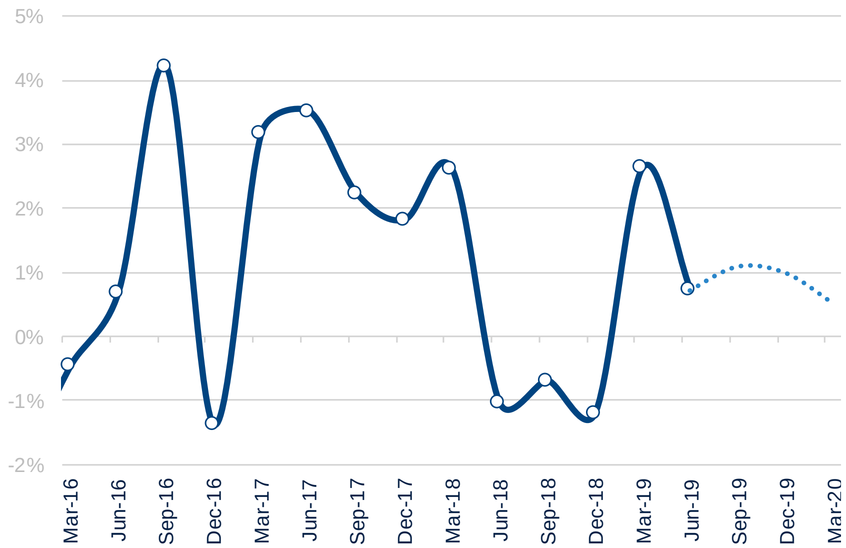
Further policy stimulus and support factors

- FED and ECB: rate cuts in the short term
- China: further stimulus
- Financial tensions likely to remain under control
- Declining oil prices

Ongoing monetary policy easing in EMs could risk tempering inflows to EM bond fund

We expect portfolio inflows into EM to continue at current modest pace as Fed begins its rate cut cycle while idiosyncratic factors weigh negatively

PORTFOLIO FLOWS TO EM (ACTUAL AND FORECAST AS UNDER OUR BASELINE SCENARIO)
(% OF AUM)

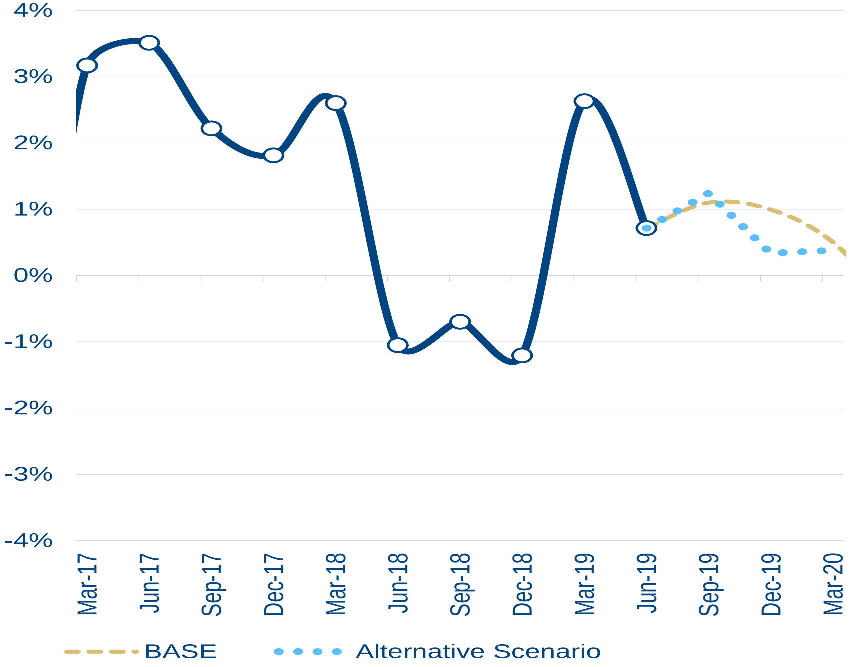


- The short-term outlook for EMs has improved (vs our previous quarter projections).
- Central banks' dovish pivot, China soft landing and cautious optimism over US-China trade talks suggest extension in search-for-yield cycle. Long term core sovereign bonds will continue to play an vital role of key stabilizers in the context of lingering macro uncertainty.
- Idiosyncratic factors alongwith US dollar movement to determine fund flow dynamics for EMs, while EZ peripheral as well as corporate bonds to find further support from ECB's 'lower for even longer' rate shift.
- EMs continue to remain vulnerable to sudden risk-asset selloffs (if trade tensions escalated again as in May), volatility spikes (if the Fed dissapoints) and/or stronger US dollar (that could trigger fears of currency wars).

Key Assumptions: 50 bps in aggregate Fed rate cuts in 2019, 25 bps additional cut in 2020; End 2019 estimate for US 10 year treasury yield at 1.7%; VIX eases modestly and holds steady around 12 until end Q1 2020 before rising gradually thereafter; EURUSD at 1.16 (end 2019). Source: EPFR, BBVA Research

A less favorable scenario, marked by just one rate cut by the Fed in 2019, would weigh on EM inflows towards the end of 2019

PORTFOLIO FLOWS TO EM: BASELINE VS. ALTERNATE SCENARIO (% OF AUM)



Source: BBVA Research, EPFR

Assumptions under a less favorable scenario, where EMs attractiveness wanes towards to end of 2019**:**

1 **Fed** cuts rates by an aggregate 25 bps in 2019.

2 **Volatility** VIX rises gradually over 2H19 and beyond.

3 **End 2019 estimate for US 10 year treasury yield** at 2.0%

Research

04

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