Emerging markets regain their appeal

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Investors, who have been fleeing from emerging markets for quite some time, are starting to look at these economies again, which has been reflected in the recent portfolio flows. The most frequent data clearly shows the change in investor sentiment with regard to allocating capital: there is greater appetite for emerging assets, especially in fixed income, and less interest in “safe haven” assets.

This is a new development taking into consideration that capital allocation in the last two years has shown a clearly negative trend in emerging markets. Since the Federal Reserve starting sending the first signals that QE is drawing to a close, which was one of the primary factors driving the massive flows into emerging markets between 2008 and 2013, capital outflows has been the dominate trend- albeit with lots of volatility.

There are two noteworthy aspects to this nascent reversal of capital flows. First, the improvement is across the board in the main countries, although we can see that the Latin American countries appear to be benefitting somewhat more than, for example, Asian markets, partly because they were also the hardest hit by the period of outflows (2014 and 2015). Second, investors are discriminating by asset type; while fixed income assets are seeing significant inflows, the equity space-more tied to the economic cycle outlook-hasn’t managed to take off. This data should make investors take a cautious approach.

The million dollar question is if this sudden surge in investor appetite for emerging markets will continue or lose steam sooner than later. Our analysis of the factors that underpin the recent turnaround indicate that the latter is probably more likely. According to our estimates, capital flows into emerging markets are mainly due to a common denominator of a global nature: less aversion to risk. Within the erratic movements we are seeing in the markets, two factors have recently combined to increase risk appetite and, therefore, interest in emerging economies: China has not given us any negative surprises, the price of oil has recovered on expectations that a production cap agreement will be reached and last, but not least, the market expects the Fed to take an ultraconservative approach to rate hikes, which weighs on dollar weakness. Of course this is all good news, but the positive tone may be fleeting due to its very nature. In other words, if after the recent capital flows we were to witness a more “fundamental” factor come into play, we could see a more lasting turnaround take hold: especially considering that emerging assets have proven to be highly sensitive to changes in market sentiment.

In any case, regardless of these reasonable doubts, we can say the outlook is slightly more positive than a few months ago. Barring any major distress, particularly from China, the expectations of a moderate recovery in global growth and confidence that the Fed will be able to successfully manage the rate-hike cycle, should support capital inflows into emerging markets, although at a slower pace than we have seen up to now. The first test will come in the next few days when China releases its growth data and the meeting of oil-producing countries is held this weekend. Looking farther out, the risk events hovering over the global growth scenario include the Brexit referendum or a possible Fed rate hike in June, to name two of the most important ones.

In short, it’s time to remain vigilant not only as far as emerging markets are concerned, but with regard to so-called risk assets in general.

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