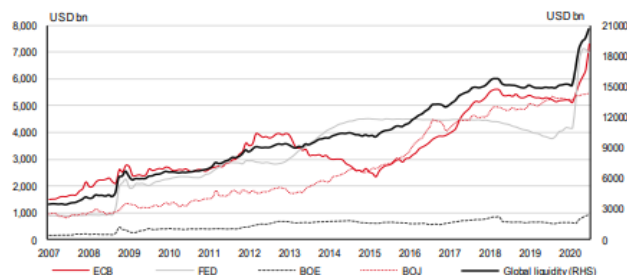


EM Flows: All about FX

Global investor enthusiasm for EM has never quite recovered from the giddy days of 2011/2012. While global liquidity has been steadily rising since the 2008 GFC from the expansion of G3 central bank balance sheets, EM has struggled to attract flows since the Taper Tantrum.

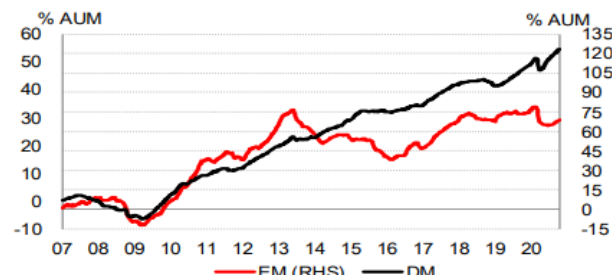
Comparison of flows to DM and EM, and global liquidity

Chart 5. Central bank balance sheets: total assets (USDbn)



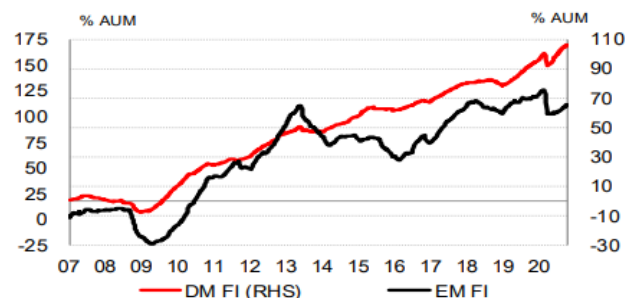
Source: Bloomberg, HSBC

Chart 6. Cumulative DM and EM fund flows since 2007



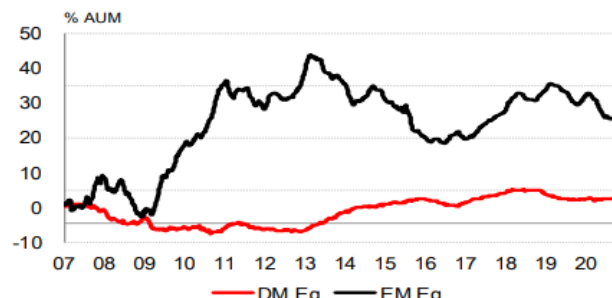
Source: Bloomberg, EPFR Global, HSBC

Chart 7. Cumulative DM and EM fixed income fund flows since 2007



Source: Bloomberg, EPFR Global, HSBC

Chart 8. Cumulative DM and EM equity fund flows since 2007

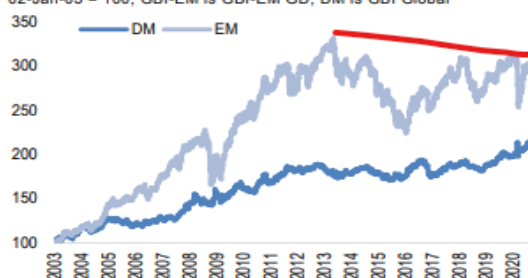


Source: Bloomberg, EPFR Global, HSBC

EM has underperformed DM as inflows have stalled and

Exhibit 79: EM local govt bonds have outperformed DM govt bonds since 2003 but not since 2011 given EM FX's drag...

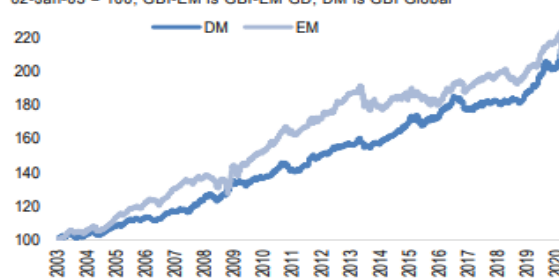
GBI EM and DM Cumulative Total Return Indices ratios, *unhedged* in USD
02-Jan-03 = 100, GBI-EM is GBI-EM GD; DM is GBI Global



Source: J.P. Morgan

Exhibit 80: EM rates have outperformed DM rates but returns are much more comparable, with EM volatility reduced

GBI EM and DM Cumulative Total Return Indices ratios, *hedged* into USD
02-Jan-03 = 100, GBI-EM is GBI-EM GD; DM is GBI Global



Source: J.P. Morgan

Exhibit 91: Assets benchmarked to EM Local Sovereign indices have stagnated since 2013

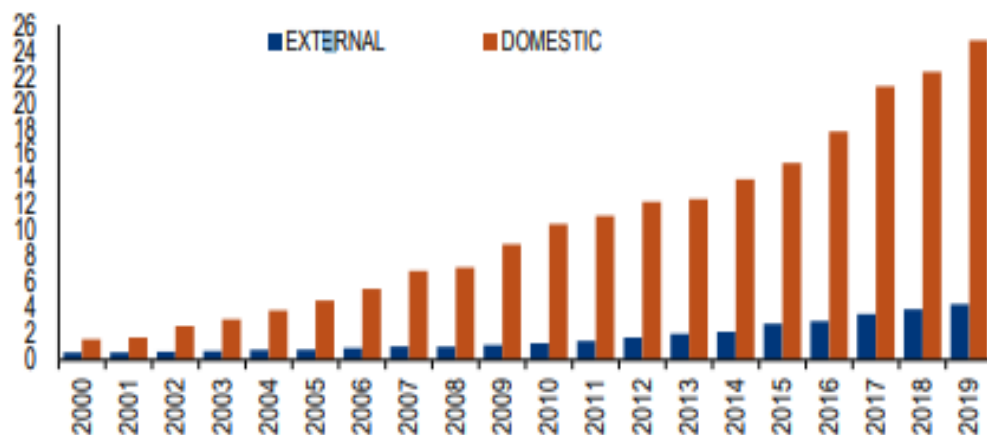
US\$ billions

(in US\$ billions)	11-Dec	12-Dec	13-Dec	14-Dec	15-Dec	16-Dec	17-Dec	18-Dec	19-Dec	20-May
Local Market (GBI-EM)	146	195	217	217	202	206	228	224	233	222
External Sovs USD (EMBI)	231	293	293	301	296	318	361	360	393	375
External Corp USD (CEMBI)	30	47	63	74	78	81	93	104	121	123
EM Money Markets (ELMI+)	26	25	25	22	19	20	26	26	26	22
Asia Credit (JACI)	44	55	58	61	61	64	74	75	80	75
EM ESG								3	12	15
Total AUM	478	615	655	676	659	692	786	795	869	836

Source: J.P. Morgan.

... Issuance has surged

Chart 6: Domestic tradable debt growth outpaces external debt (US\$ tn)

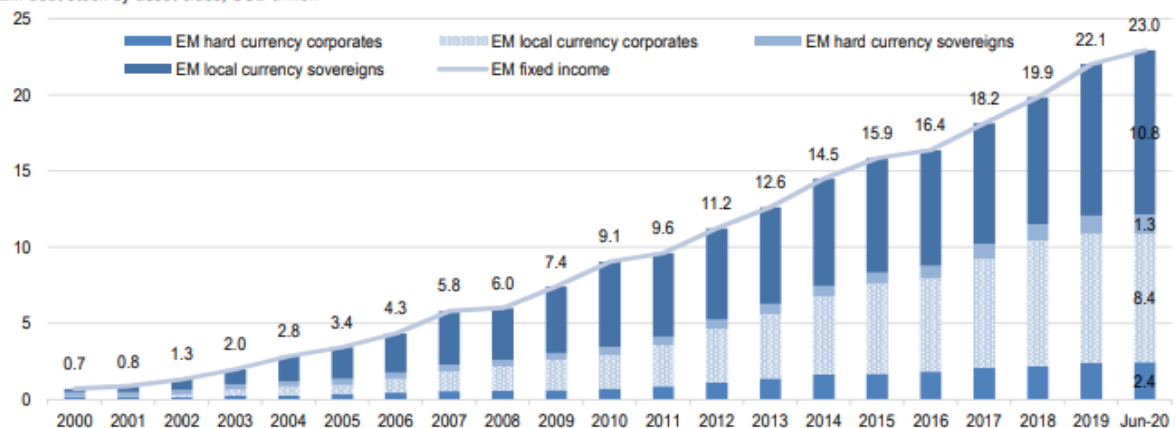


Source: BofA Global Research, BIS

Scarred by the debt defaults of the 80s &90s, EM countries deepened their local markets allowing governments and Corporates to issue in their local currency

Exhibit 72: The EM debt stock has increased to \$23 trillion, a nearly 400% increase since the GFC

EM debt stock by asset class, USD trillion



Source: J.P. Morgan

... but flows have favoured hard currency credit which has been the 'easier' allocation in EM

Cumulative EM Fund Flows vs. Performance and Global Flows

- The share of cumulative EM retail fund flows as a % of global fund flows is **17.3%**
- The share of cumulative EM retail bond fund flows as a % of global bond fund flows is **13.6%**
- The share of cumulative EM retail equity fund flows as a % of global equity fund flows is **33.4%**

Exhibit 57: EM retail hard currency bond fund flows vs. EM hard currency bond performance

Left axis: Cumulative EM retail hard currency bond fund flows since 2004, US \$bn; right axis: EMBIGD total return, 2004 = 100

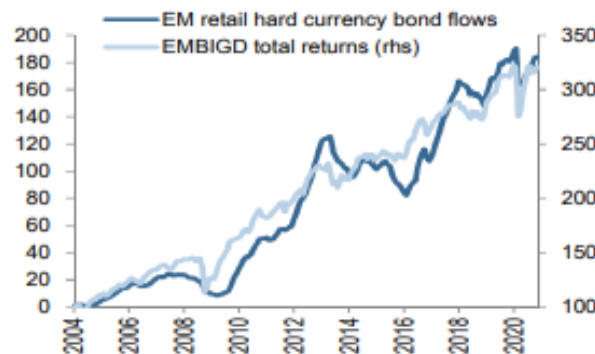


Exhibit 58: EM retail local currency bond fund flows vs. EM local currency bond performance

Left axis: Cumulative EM retail local currency bond fund flows since 2004, US \$bn; right axis: GBI-EM GD USD total return, 2004 = 100

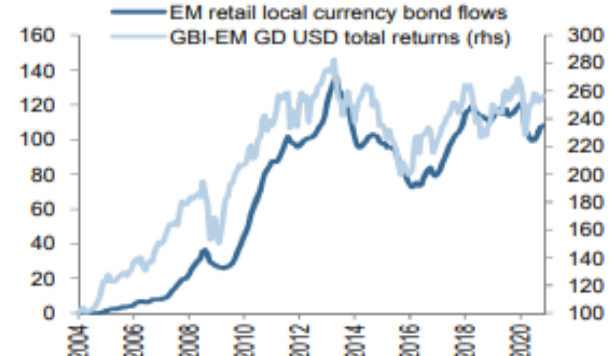


Exhibit 59: EM retail equity fund flows vs. EM equity performance

Left axis: Cumulative EM retail equity fund flows since 2004, US \$bn; right axis: MSCI EM total return, 2004 = 100

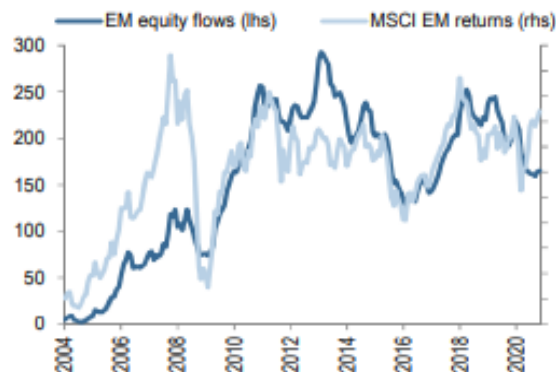


Exhibit 60: EM retail fund flows vs. global fund flows

Left axis: Cumulative retail fund flows since 2004, US \$tr; right axis: EM share of global fund flows (%)

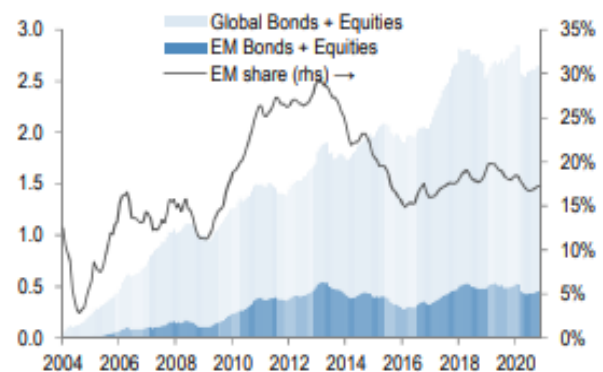


Exhibit 61: EM retail bond fund flows vs. global bond fund flows

Left axis: Cumulative retail fund flows since 2004, US \$tr; right axis: EM share of global fund flows (%)

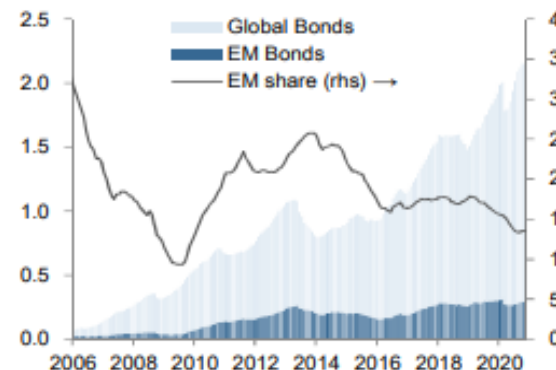
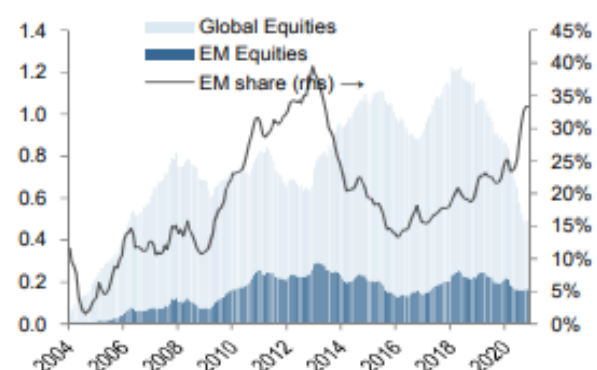
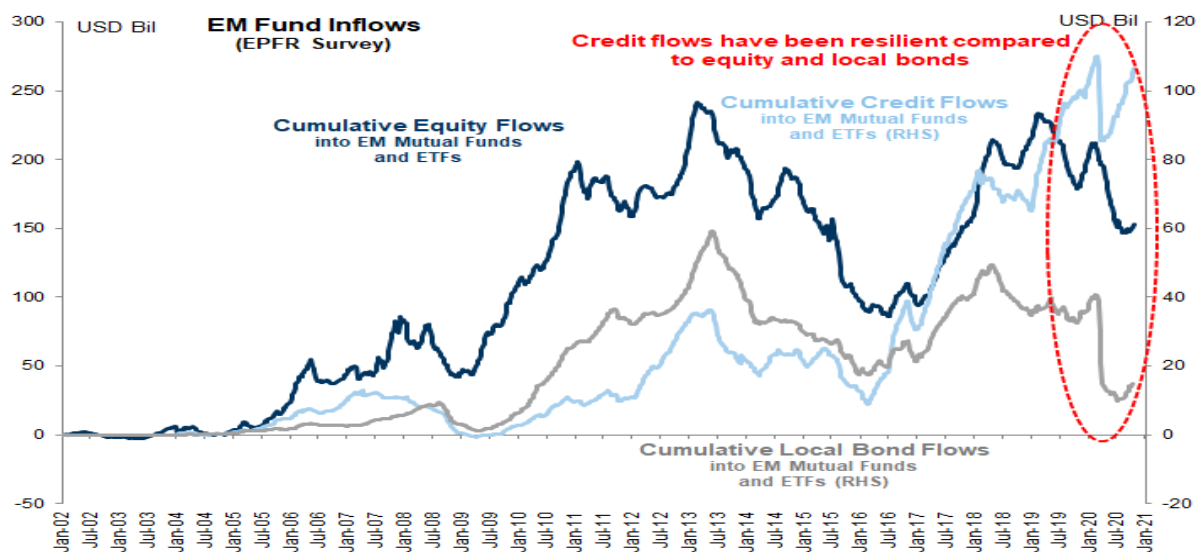


Exhibit 62: EM retail equity fund flows vs. global equity fund flows

Left axis: Cumulative retail fund flows since 2004, US \$tr; right axis: EM share of global fund flows (%)



Similar picture from GS using EPFR fund flows



Local currency index has only outperformed hard currency once in the 7yrs (2017) and is considerably more volatile due to FX

EM funds: Bond funds related benchmark performance

Chart 13. EM hard currency debt funds (y-t-d performance of related benchmark, %)

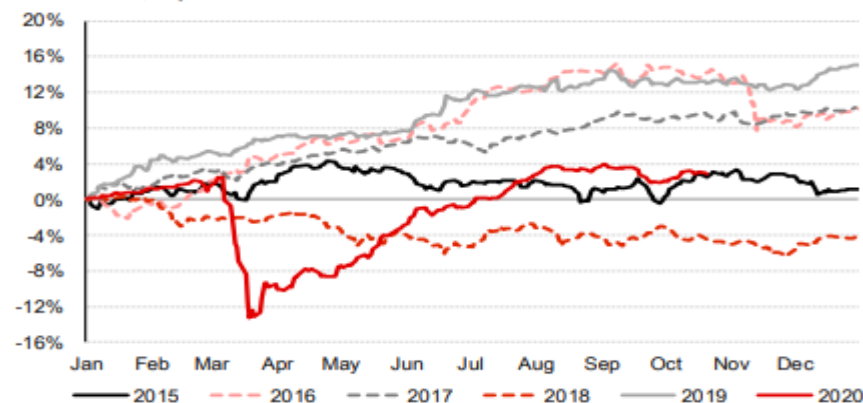
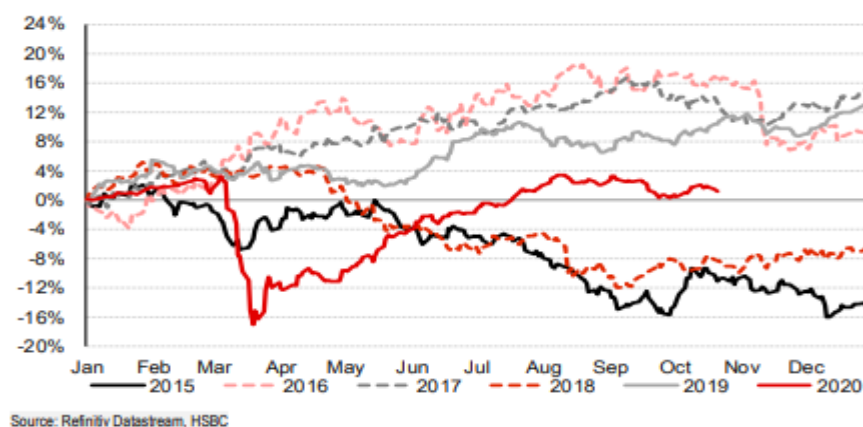


Chart 15. EM local currency debt funds (y-t-d performance of related benchmark, %)



EMFX is the culprit, as local currency flows track FX spot (Chart 37) rather than yields or spreads

Chart 35. EXD bond flows and spread (% of AuM)

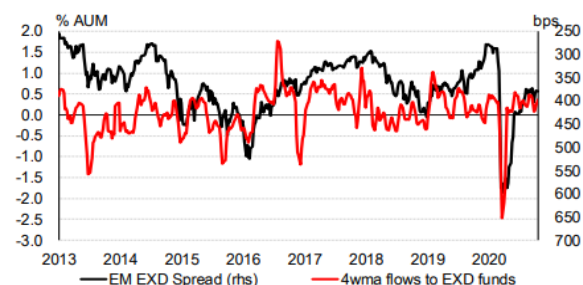


Chart 36. LCD bond flows and spread (GBI-EM Yield vs UST 10yr yield)

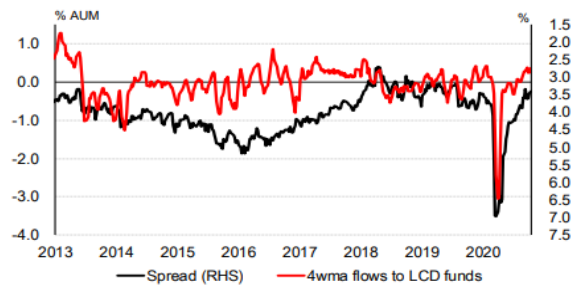


Chart 37. LCD bond flows and EMFX spot

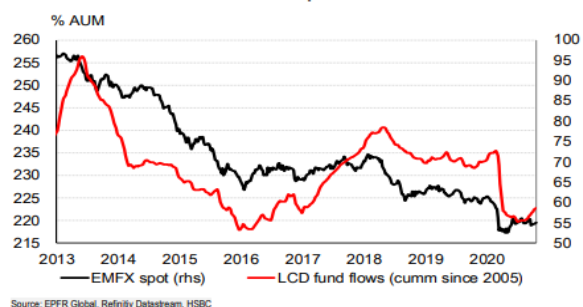
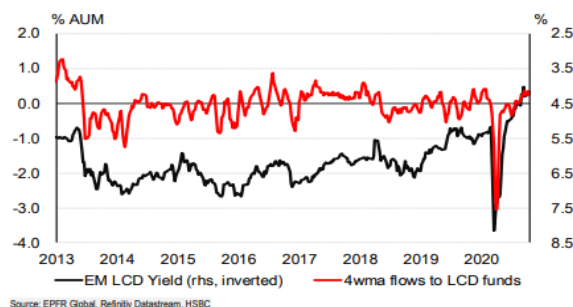


Chart 38. LCD bond flows and GBI-EM Yield



..and, as MS shows, the divergence between hard & local flows also track EMFX vs USD

Exhibit 8: Investor demand for EM has favoured USD denominated assets

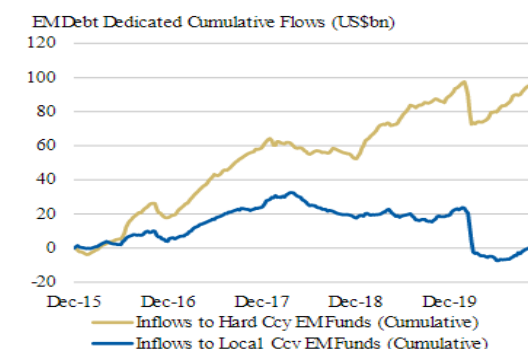
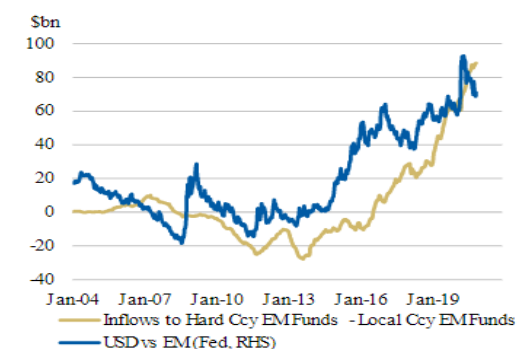


Exhibit 9: A weaker USD should lead to a flows favouring local currency assets



EMFX spot appreciation drove returns between 2001-08 on China, commodity prices & growth

Exhibit 76: EM FX has experienced 3 regimes, with spot appreciation only seen in the 2003-8 period...
EM FX return indices for spot, carry and total return (TR)

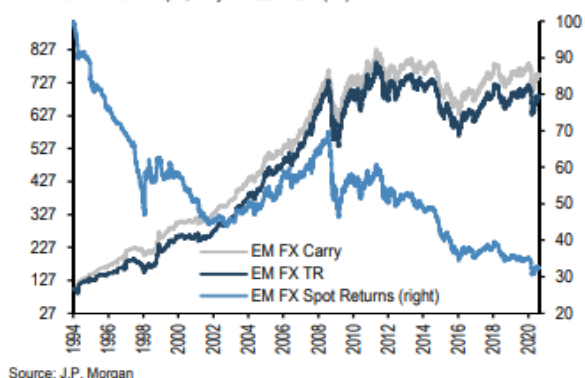
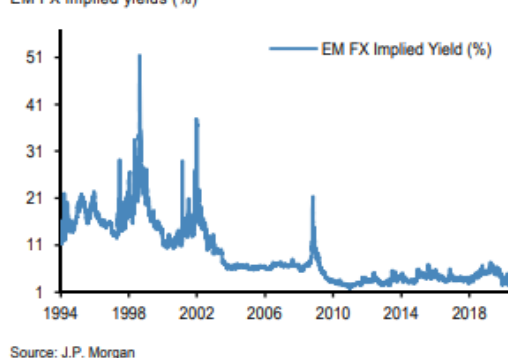


Exhibit 77: ... EM FX carry over-compensated for spot losses in the 1990s but has fallen to current historical lows.
EM FX implied yields (%)



EMFX has had a much worse time of it recently... with 2017 the exception

Exhibit 3: RSM shift to the 'neutral' regime suggests a better backdrop for risk assets in the weeks to come

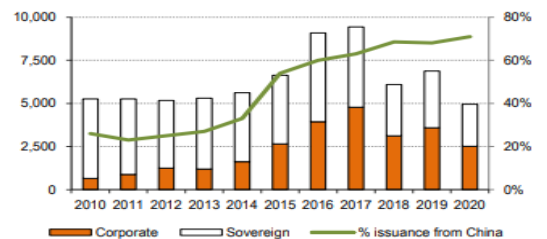
MS EMRegime Switching indicator



Source: Morgan Stanley Research

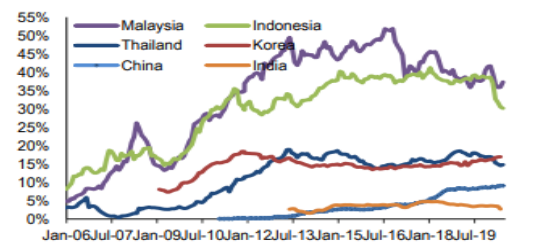
China is the exception now as it attracts inflows into its local bonds on index inclusion...

Chart 2: LDM issuance - 2010-20 YTD : China is over 70%



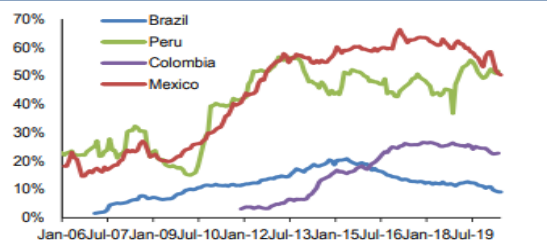
Source: BofA Global Research, SRCH on Bloomberg

Chart 3: Asia foreign bond holdings share



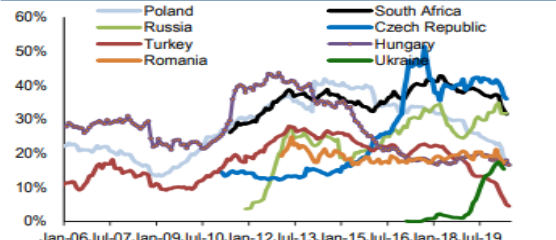
Source: BofA Global Research, Bloomberg, central government websites.

Chart 4: Asia foreign bond holdings share



Source: BofA Global Research, Bloomberg, central government websites

Chart 5: EEMEA foreign bond holdings share

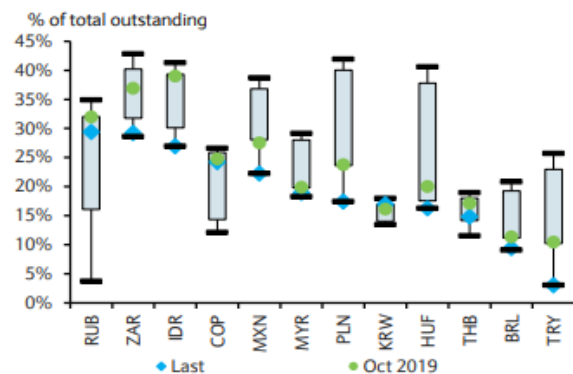


Source: BofA Global Research, Bloomberg, central government websites

... while foreign holdings of local bonds are decade lows for most large EM countries

FIGURE 2

Foreign ownership of EM local bonds remains close to multi-year lows in most countries



Note: Dashes show maximum and minimum; boxes cover 10th to 90th percentiles. Sample period is Dec-2011 to last available. Source: Haver Analytics, Barclays Research

Sustained inflows need growth outperformance, positive real yields and a secular USD decline

... finally, given the potential for higher & steeper UST, a timely analysis from MS

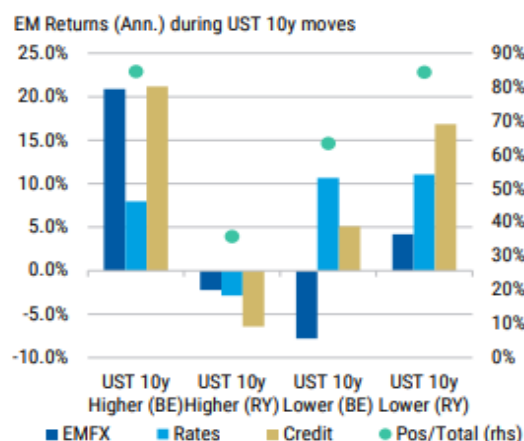
Exhibit 1: EMs clearly perform better when rising UST yields are driven by breakevens

	UST Move Driver	UST 10y Higher		UST 10y Lower	
		Breakevens	Real Yield	Breakevens	Real Yield
Mean	EMFX	20.9%	-2.2%	-7.8%	4.2%
	Rates	8.0%	-2.9%	10.7%	11.1%
	Credit	21.2%	-6.4%	5.1%	16.8%
Count	EMFX	13	27	10	30
	Rates	13	27	10	30
	Credit	13	27	10	29
Pos/Total	EMFX	85%	30%	20%	60%
	Rates	85%	44%	100%	97%
	Credit	85%	33%	70%	97%
	Months	2.4	3.3	3.3	3.8

Source: Morgan Stanley Research; Note: Returns are annualised.

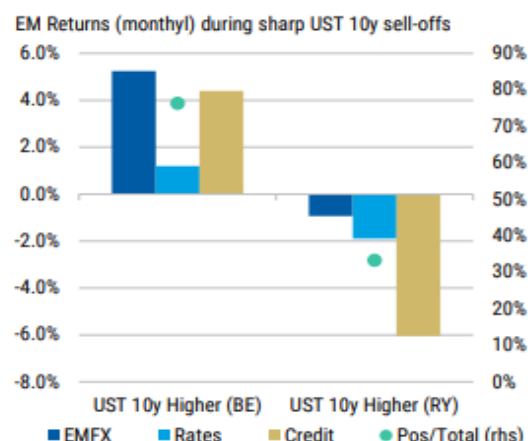
More than breaking even: As show in [Exhibit 2](#) and [Exhibit 3](#), the periods where 10y UST yields moved higher but driven by rising breakevens have historically been the most favourable for emerging markets. Currencies, rates and EM credit all perform very well when rising UST yields are driven by breakevens. In stark contrast, periods of rising 10y UST yields that are driven by real yields are not great for EM fixed income assets or currencies.

Exhibit 2: On average, EMFX performs best under higher US rates driven by breakevens



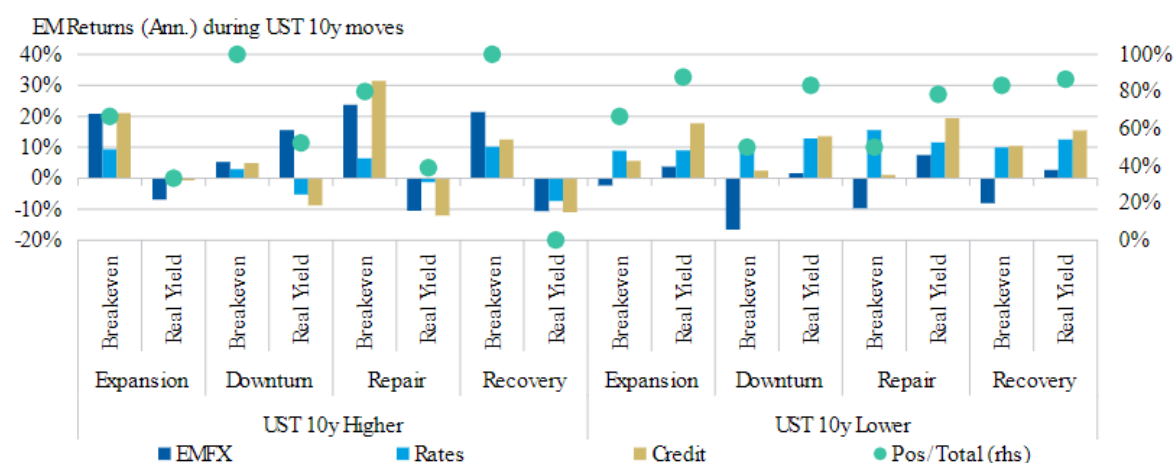
Source: Bloomberg, Morgan Stanley Research; Note: Pos/Total = positive return scenarios as a percentage of the total scenarios corresponding to that filter definition.

Exhibit 3: On average, EM assets perform well under higher US rates only if the move is led by breakevens



Source: Bloomberg, Morgan Stanley Research; Note: Pos/Total = positive return scenarios as a percentage of the total scenarios corresponding to that filter definition.

Exhibit 4: Average EM returns based on the US economic cycle and if the move was breakeven- or real yield-led



Source: Bloomberg, Morgan Stanley Research; Note: Pos/Total = positive return scenarios as a percentage of the total scenarios corresponding to that filter definition (cross-asset average).