

Editorial

Rebound in portfolio investments: a not so passive management

After tightening in Q4-2018, external financing conditions in the emerging countries have eased since the beginning of the year. At the same time, there was a net upturn in non-resident portfolio investments, which shows that investors have a greater appetite for risk after the US Fed announced that it would pursue a cautious and flexible monetary tightening policy, and would pause the reduction of the Fed's balance sheet. The Institute of International Finance (IIF) even concluded that investors were overexposed to the emerging markets. According to the IMF, so-called passive fund management (ETF and other indexed funds) has either reached critical mass or at least has sufficient leverage to trigger financial market instability.

After tightening in fourth-quarter 2018, external financing conditions in the emerging countries have eased since the beginning of the year. Risk premiums on sovereign and corporate debt in foreign currencies, as calculated according to the JP Morgan and Crédit Suisse indexes, have fallen by 70 and 60 basis points (bp), respectively, from their peak in late 2018 and early 2019. B-graded counterparties (the most risky components) reported the biggest declines of 110bp and 140bp, respectively. At the same time, all of the emerging currencies appreciated against the dollar, with the exception of the Argentine peso and Turkish lira. Moreover, the market's main sovereign borrowers, such as the Gulf countries, easily placed their international bond issues.

In general, non-resident portfolio investments have picked up robustly since the beginning of the year. According to preliminary IIF estimates, they amounted to USD 109 bn in Q1 2019 (USD 87 bn excluding investments in the Chinese equity markets), which is twice the amount for the period May-December 2018. Excluding China, it is nearly seven times higher. As the IIF points out, the rebound was concentrated in a few major emerging markets (South Korea, India, Indonesia and Mexico). This shows that investors have a greater appetite for risk after the US Fed announced that it would adopt a cautious and flexible monetary tightening policy in the United States, and would pause the reduction of the Fed's balance sheet. It also corresponds to an improvement in the returns on carry trade operations (see chart). After correcting for valuation effects, the IIF even concludes that investors are overexposed to the emerging markets (EM positioning overhang).

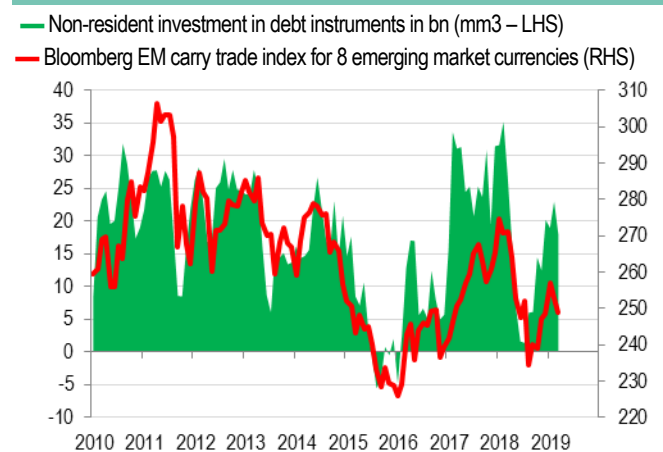
■ Passive management: an underlying current

Portfolio investment inflows naturally raise questions about the risks they pose in cases of stress on financial market stability in the receiving country. In the IMF's latest Global Financial Stability Report, the fund's economists present a detailed study of the potential risks associated with the development of Exchange-Traded Funds (ETF) and indexed funds, and so-called passive portfolio management in general¹.

According to the IMF, emerging market bond funds using passive management strategies (indexed to JP Morgan-Chase indexes) amounted to USD 800 bn in 2018. At first sight, this only represents a very small share of the total amount of the underlying debt (2% of

the foreign currency debt compartment and 1% of the local currency sovereign debt compartment). In practice, however, passive management is also applied outside of the domain of ETF and indexed funds. According to the IMF, 70% of funds are influenced by benchmark indexes. Moreover, the USD 800 bn figure represents 40% of the cumulative flows of non-resident bond investments over the past decade. Passively managed equity funds account for a more consequential share of total capitalisation (10%), and probably most of non-resident equity investments.

The return of the carry trade



Source: Bloomberg – IIF

ETFs and indexed funds have either reached critical mass or at least have sufficient leverage to trigger instability in the bond or equity markets, and indirectly in the forex market through their change in market positioning².

First, indexed funds are very sensitive to the asset price factors common to all of the emerging markets (global factors), such as the direction of US monetary policy, the strength of the dollar, the level of volatility in the developed markets, and the ups and downs of Chinese growth³. Indeed, indexed funds consider the emerging

² Other investor categories can introduce inertia (institutional investors) or to stand against the market consensus (notably hedge funds).

³ The aggregate pair-wise correlation between benchmark-driven flows to individual emerging markets was about 80% compared with about 30% for overall portfolio based on BoP data.



markets as an asset category as a whole, and make little or no distinction between countries. As a result, the most fragile countries benefit from the same capital inflows as the more robust countries during risk-taking phases and from similar outflows during risk reduction phases.

Second, the revision methods used for the composition of country baskets that comprise the main benchmark indexes tend to cap the weighting of big issuers and swell the weighting of small issuers. As a result, the share of non-resident investment in local currency sovereign debt can be very high for small sovereign issuers.

François Faure

francois.faure@bnpparibas.com

