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MACRO MORNING BRIEFING

August 23, 2024

MSCI August Index Review, T+1 and iFlow

During the summer, investors traditionally reflect on the performance of their portfolios and debate whether this is a market of stocks or just a stock market. The battle between active or passive management extends into August, with rebalancing into the last month of the third quarter seasonally one filled with reversals and volatility. As usual, the last two weeks of August keep equity markets busy trading the new quarterly weightings from the MSCI. The benchmark for many managers – the All Country World Index (ACWI) will be reweighted. MSCI has $15.6trn of equity assets tracking their indices as well as over 1,370 ETFs tracking them. While the shifts in equity markets stand out in adding to August volatility, the rebalancing also has implications for bonds and FX markets as well.

The three largest additions to the MSCI World Index measured by full company market capitalization will be Galderma Group (Switzerland), Zealand Pharma (Denmark) and Addtech B (Sweden). The US sees nine companies deleted and one added, while Canada sees two deleted. The UK loses two, while France and Germany each lose one. Japan loses six and gains one.

The three largest additions to the MSCI Emerging Markets Index measured by full company market capitalization will be Nu Holdings A (Brazil), Huaneng Lancang River Hydropower A (HK-C) (China) and Adnoc Drilling Company (United Arab Emirates). Brazil gets six added and two deleted, while Mexico gets one added.

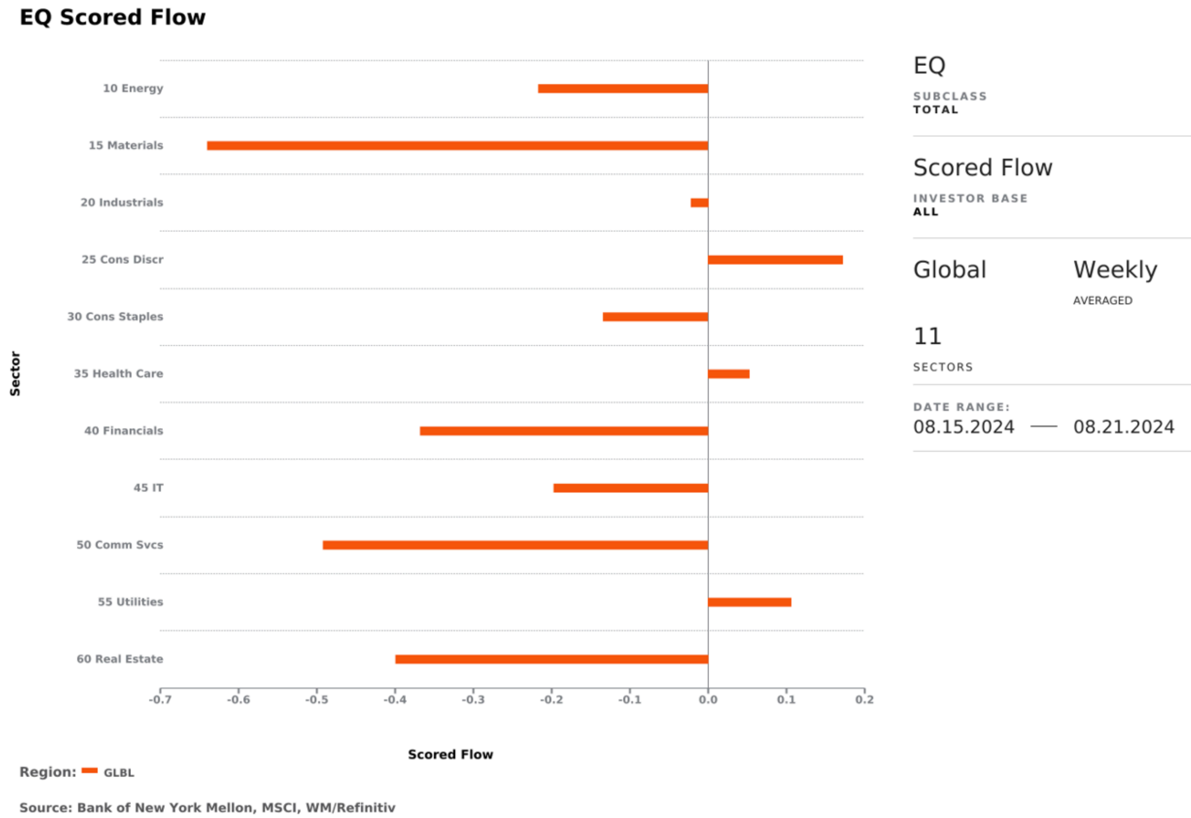
The India market remains the biggest winner over the last four years, moving from 8% to 20% by the end of the month for the MSCI EM index with up to $3bn of net passive inflow in the latest rejiggering. China, in contrast, sees its share drop to 22% of the EM index with 60 companies from China and Hong Kong removed at the end of August, following the 56 removed in May and 66 in February. MSCI China is up 1% year-to-date while the MSCI EM index is up 4.4% year-to-date and MSCI India is up 18% year-to-date.

The MSCI ACWI country weights are important to FX markets and hedging – with the US accounting for 64.5%, Japan 5.3%, the UK 3.4%, Canada 2.7% and France 2.5%, while the rest of the world makes up 21.5%. For the ETF markets and the current rotation trades, the MSCI rebalancing also matters. By sector, the MSCI is 24.9% IT, 16.1% financials, 11.1% health care, 10.6% industrials, 10.3% consumer discretionary, 7.6% communication services, 6.3% consumer staples, while energy is 4.4%, materials 4.0%, utilities 2.6% and real estate 2.1%.

- The Global Index ACWI will add 27 securities and cut 96 at the end of August.
- The Small Cap ACWI will add 181 names and remove 114 companies.
- The Global Investable market index (IMI) sees 172 additions and 174 deletions.
- The All-Cap index will get 109 additions and 63 deletions.
- The Frontier Market index sees seven additions and four deletions.

The Global Equity Sector flows we have seen in the last week suggest that relative value trading has dominated August and that selling in materials, financials, communication and real estate reflect more overweight position adjustments and, similarly, buying of consumer discretionary, health care and utilities reflect less-held sector rebalancing. Managers appear prepared for the month-end effects of the MSCI rebalancing, so this event may be less important as a driver even as it spikes volumes back in passive flows.

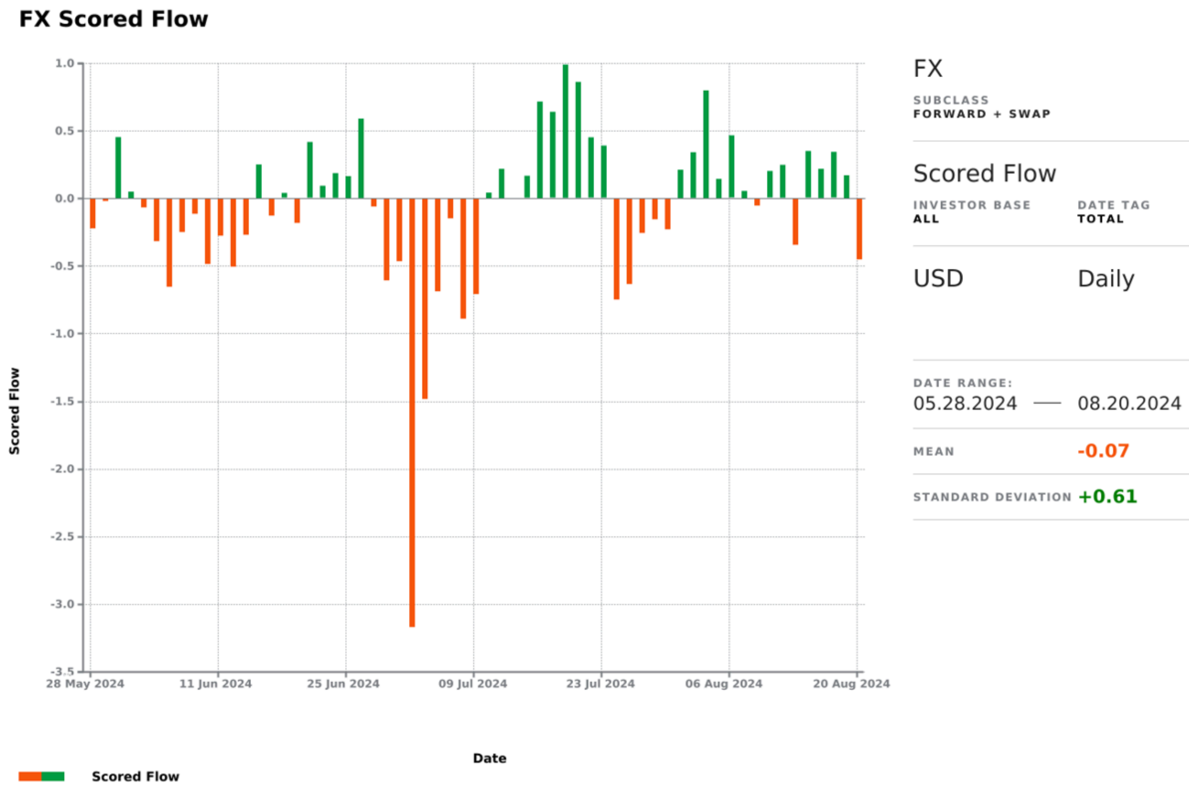
Exhibit #1: Global Equity Sector Flows Show RV Bias

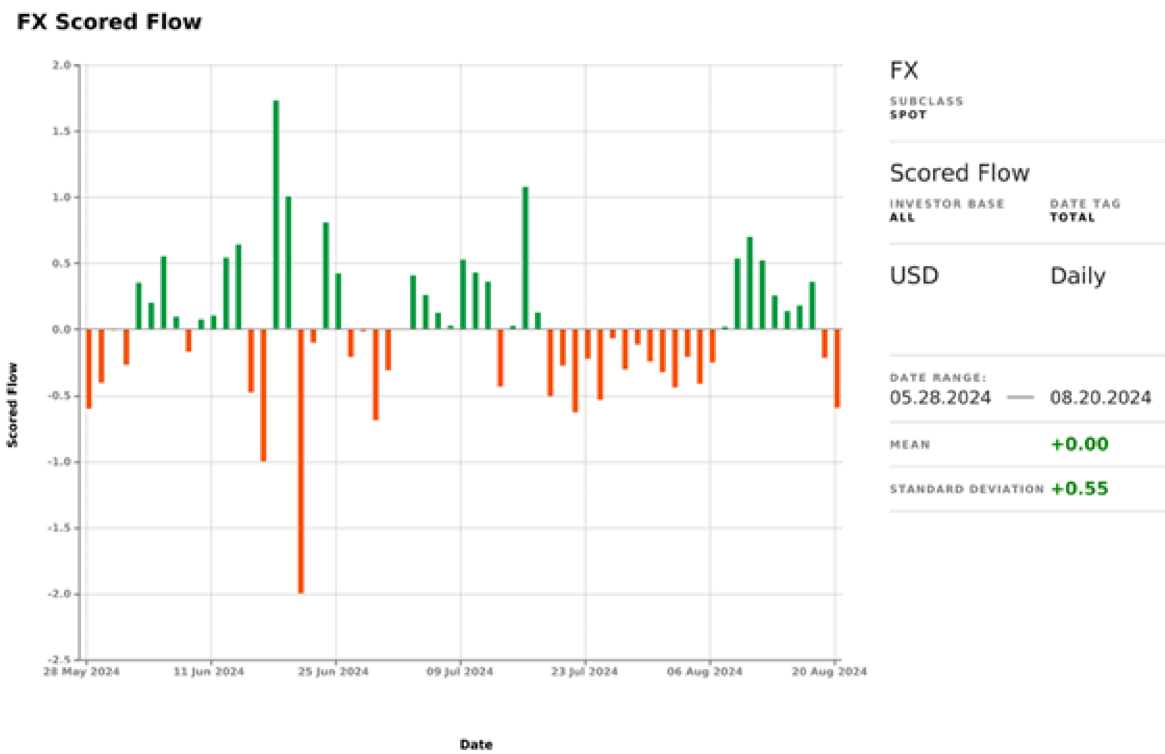


Source: iFlow, BNY

Apart from shifting the hedge ratios of FX to the MSCI portfolios, the shift also has implications for liquidity into month-end and the long weekend given that September 2 is the Labor Day holiday in the US. The surge in volume for closing trades has been notable in past rebalancing – NASDAQ research notes in the past five years volumes rose over 10% more at the close on such days. There is a test for T+1 on such days as well. The first test came May 28 and looking at that period through to the present following the new settlement regime through our iFlow lens is interesting.

Exhibit #2: FX Flows at Month-End and Futures Expiry Spike



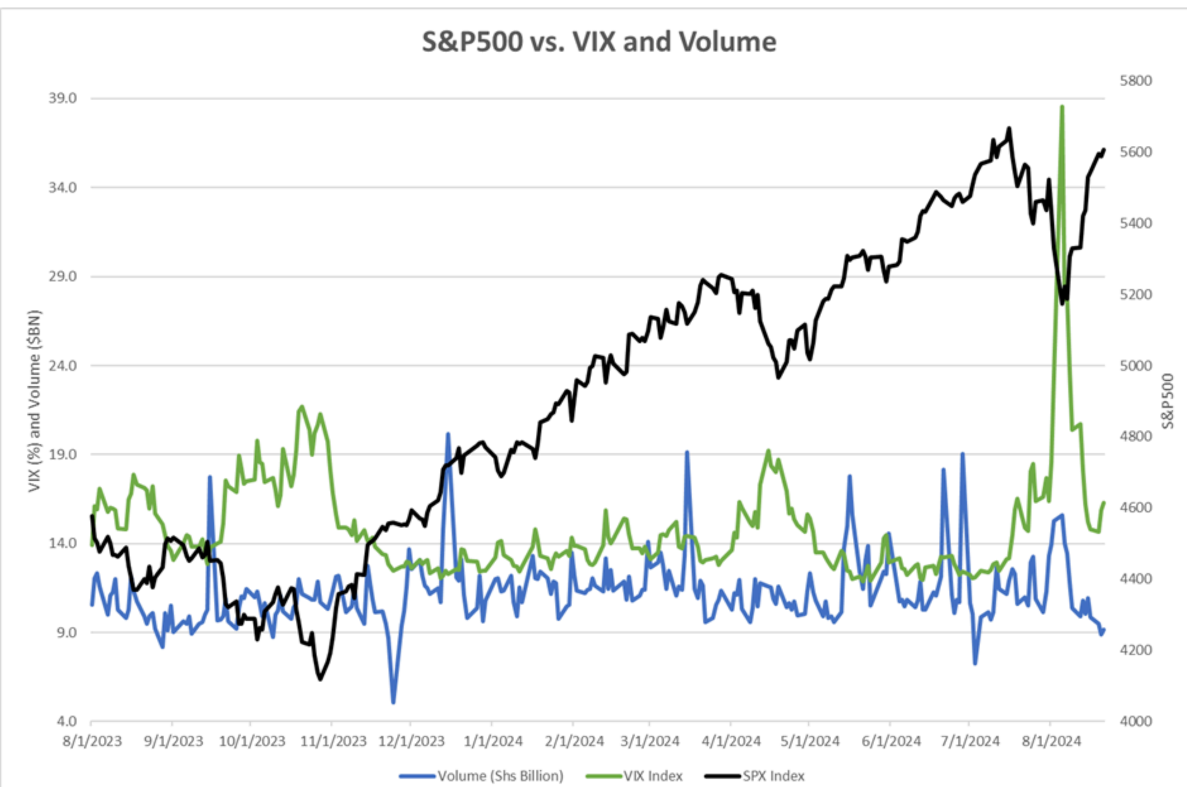


Source: iFlow FX flows spot and forward, BNY

The notable flows for spot FX since May show that volumes around the IMM futures rollover for contracts are significant, whereas the end of May and June flows were significant at 1+ standard deviation but not July. Further, no one flow was as important to the T+1 regime as the spike in the four standard deviation flows around the future contract expiry. When you look at the forward and swap volumes you get quite a different story. There is a clear spike in volumes at the end of June and statistically interesting increases in the last week of July. The question is whether this behavior will persist into the end of August. The T+1 effect on the USD markets has been observable but not abnormal and so not an issue to the liquidity function for the foreign exchange market.

The relationship of volume to volatility to price is another study to consider with the month-end risk ahead. Markets have seen a notable divergence between prices in August – with the US S&P 500 index rising modestly while volume collapsed. This is the lowest monthly volume in US equities since November 2023 – the Friday after Thanksgiving that year and the Thursday, July 3 pre-holiday this year stand out as the lowest volume days. The relationship of volume to volatility was positively correlated until this week. The price rally in August is clearly at odds with the drop in volume and contrasts with the spike in volume on the selling through August 5. The relationship of volume to volatility also breaks down on rebalancing, which, as described, spikes volumes on the close usually at the end of the month.

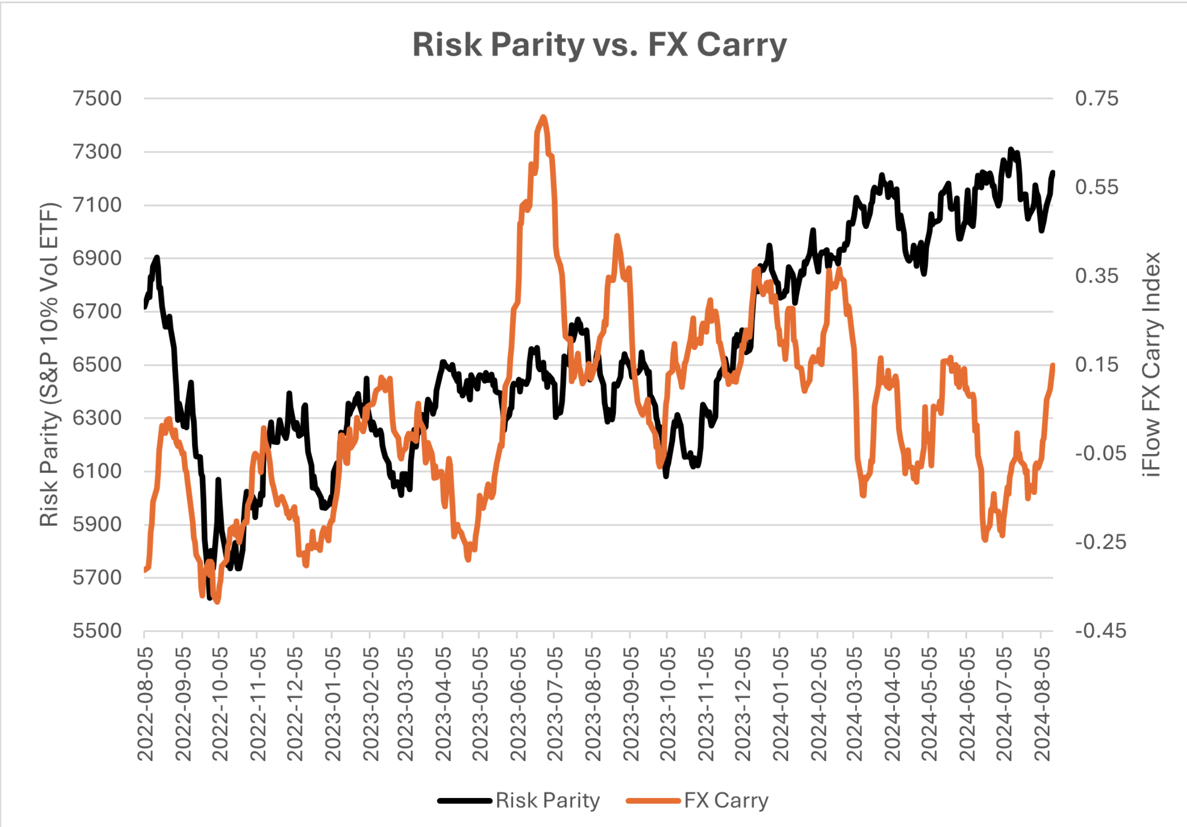
Exhibit #3: S&P 500 Price vs. VIX vs. Volume



Source Bloomberg, BNY

The risk for a larger USD move and a further break in the dollar to equity correlations lies less with equity market moves and more with the US bond market rally. In fact, the MOVE volatility index in bonds has remained significantly higher from the events of August 2-5and volumes have remained significantly higher in August than in July. The drop in US yields opens the door for further USD selling at month-end as foreign owners of US bonds will need to buy their home currency even as the USD has weakened. The dollar selling in FX markets has not been as fast as the decline in rates. Importantly, the only places where FX looks likely to be bought at month-end are Japan, China, Sweden and Switzerland. This reflects the carry trade funding problem for markets and the risk of a reversal there.

Exhibit #4: Risk Parity vs. iFlow Carry Index



Source: iFlow, Bloomberg, BNY Mellon

Bottom Line : The relationship of the JPY carry trade to global markets was the surprise in August, and the rebound in carry since the August 5 bottom in USD/JPY near 142 stands out. Markets face significant ongoing reversal risks as this link of carry to stocks continues into next week with the FOMC and BOJ Friday focus important to setting the tone for the month-end trading.

Disclaimer & Disclosures

Please direct questions or comments to: iFlow@BNY.com

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