iFlow MONTHLY

July 2023

July month-end rebalancing signals are more limited as carry has fallen back to neutral. Good equity returns have mostly been offset by FX sales. Strong bond returns in Brazil and China coupled with moderate FX inflows point to selling risk in BRL and CNY – perhaps not unwelcome to their central banks as sequential inflation is flat or negative in both countries. Moderate but clear outperformance of US Cyclicals vs. Defensives indicates confidence in sustained US growth. APAC Cyclicals have also started to outperform as China stimulus potential becomes difficult for markets to dismiss.

Our recently enhanced iFlow Monthly incorporates new datasets from equities and ESG to generate the following reports (links take to white papers detailing index methodology):

- Monthly Rebalancing index, based on marginal equity and fixed income returns, offset against marginal FX flow scores generated by iFlow.
- US Equity Styles, details US equity purchases across different style indices
- International Equity Flows, assesses asset allocation preferences across developed and developing markets on a regional basis
- iFlow Green, assesses alignment between ESG factor flows and general equity flows

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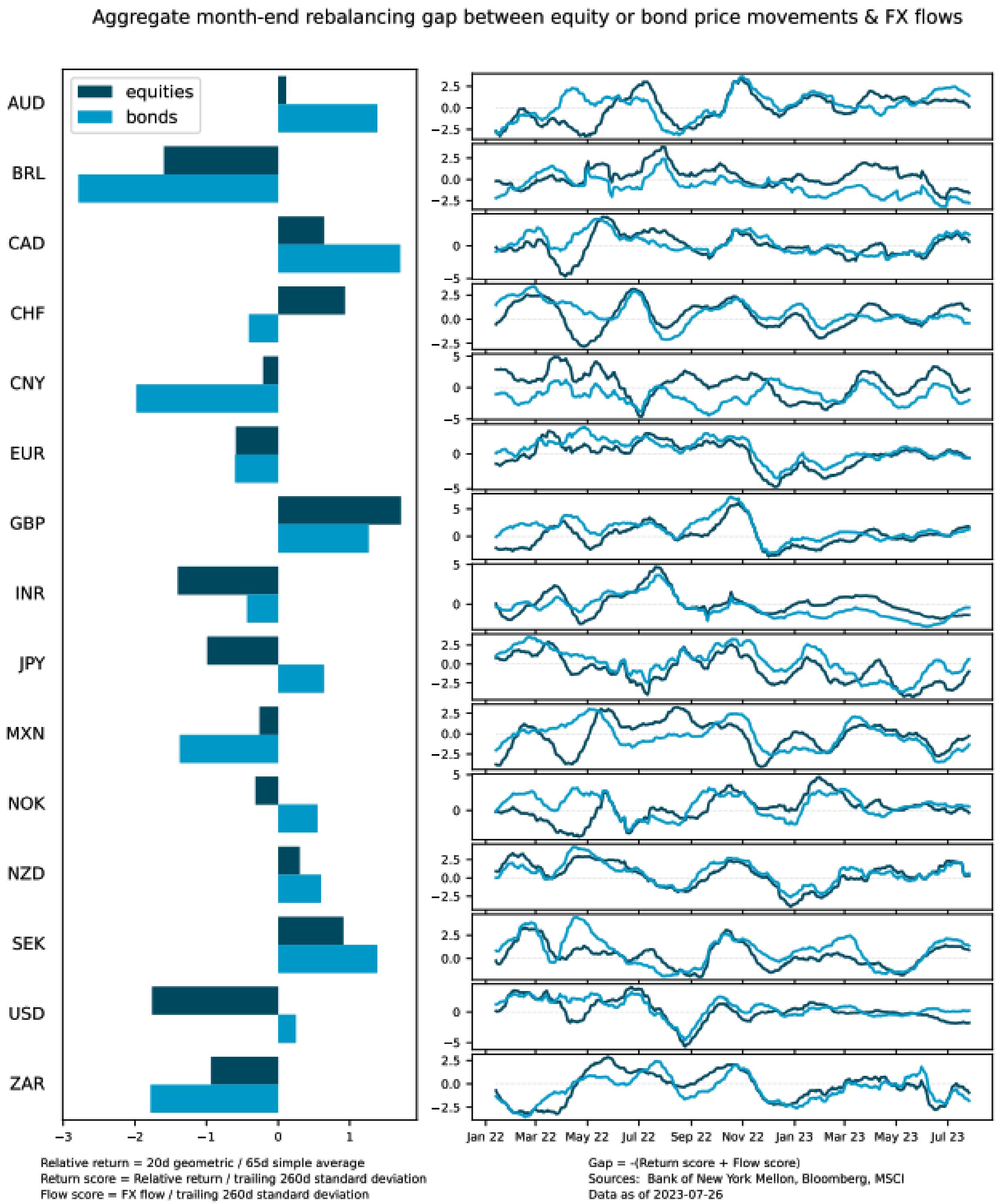
The chart below details rebalancing results heading into month-end, as well as the evolution in FX flows and returns which led to the imbalance. Click anywhere on it to view iFlow Monthly.



Source: BNY Mellon

July Rebalancing Summary: BRL, CNY face sales after strong FI returns and FX inflows

The unwind of the FX carry trade we flagged towards end-June remains a pertinent flow theme, but not to the extent that high-yielding currencies faced serious selling. iFlow Carry is currently neutral, which suggests no clear theme through the month and rebalancing needs ultimately highly contingent on underlying asset performance. Equities lacked clear signals, too. Equity returns through the month were generally positively skewed, but most markets which performed well also faced some offsetting sales. The only outlier was in the UK – sterling selling and weak performance of local markets suggest GBP purchases need to improve, though not excessively so by iFlow standards. Considering current FTSE 100 valuations, further damage from FX translation is not desirable, so perhaps it's just as well that any residual GBP purchases will be light. The US, by contrast, has performed well. Light USD purchases in July indicate a market that needs to downwardly adjust US exposure.

In fixed income, the most notable rebalancing signals would require CNY and BRL sales. China and Brazil have benefitted strongly from fixed income performance as inflation headwinds accumulate. That BRL sustained inflows based on carry and CNY was net bought as carry unwound speaks to 'carry neutrality', i.e., high-yielders and funders can be bought in equal measure while iFlow Carry is neutral. FX rebalancing is also in line with macro conditions. China needs inflation and lower real rates, for which CNY strength is not conducive. BRL will likely be a strong candidate for increased hedging if funds start pouring back into EM fixed income, especially in LatAm where real rates are high. The Brazil rating upgrade this week also suggests its fixed income could continue to outperform.

Methodology: Using the 'markets are made at the margin' principle, rather than take outright asset returns against marginal FX flow we look at the marginal return against the marginal FX flow to determine the incremental hedging needs generated by larger-than-expected moves. Using the same methodology as iFlow Hedge, we construct a set of marginal monthly returns using the 20-day exponential moving average against the 65-day simple moving average. Subsequently, we calculate scores for these marginal returns and flows by dividing the return and flow sets by their rolling 1-year standard deviations – the same methodology we use in iFlow. To proxy for hedging needs, we simply take the difference between the flow scores and chart the 'distance' that the FX flows are needed to make up for hedging the return profiles.

iFlow Equities 2.0 Style Indices - flows of significance:

1. US Equity Styles

- Cyclicals continue to outperform Defensives in the US but there has been no marginal improvement over the past month. The soft-landing narrative is very much in place but markets appear unwilling to push for excessive outperformance, as leading data such as ISMs do not point to any re-acceleration in economic activity.

- Leverage flows have continued their improvement through July and look set to challenge the highs of earlier this year. There has been no incremental deterioration in credit performance, and the strong showing of banks through the earnings season suggests that there are enough buffers in place for mitigation purposes.
- Unsurprisingly, inflation-related flows fell through the second half of the month, edging into negative territory. This is fully in line with ongoing declines in inflation expectations and suggests the market is comfortable with the view that a Fed rate peak is approaching.

2. International Equity Styles

- Considering the extremely poor performance of German survey data at present, it is striking that within DM EMEA, Industrials is the only strongly bought sector. As a result, Cyclicals are strongly outperforming Defensives in Developed EMEA, whereas within EM EMEA the neutral performance of Cyclicals relative to Defensives is much more in line with data trends. The divergence underscores differences in supply-chain positions, with input/intermediate goods producers clearly under-performing finished goods economies.
- APAC style flows indicate that Cyclicals have moved back into positive over the past month as the potential for China stimulus proves too difficult to ignore, even if the flows are going to be tactical in nature. The current performance is only seen in DM in the region, as opposed to EM, pointing to stimulus benefitting higher value-added economies, possibly Australia also if real estate recovers. EM APAC is also recovering but at a more subdued pace.

3. iFlow Green

- On a regional level, the biggest deterioration seen in iFlow Green is within EM Americas. Every single ESG factor is now showing a light negative correlation with underlying flows, suggesting that exposures to stocks with poor ESG scores have been increasing.
- DM EMEA and DM APAC are showing mixed factor flow significance at present, but there are some strong negative relationships in place. For example the UNGC – Anti-Corruption component is performing extremely poorly within DM APAC. UNGC – Labour Rights also has a high negative relationship with general flows in the region.
- On a factor level, ESG-Governance continues to show the poorest alignment with flows. Only DM EMEA flows are still showing a weak positive relationship with this factor. ESG-Environment’s alignment with equity flows has also begun to decline, with adverse flow patterns in both EM and DM EMEA.