BNY MELLON

iFlow

MONTHLY

October 2023

October month-end flows only favoured USD due to the selloff in fixed income. CAD and MXN were the best-performing currencies on the month, but weakness in their equity and bond markets left total-return exposures largely unchanged, obviating the need for strong rebalancing. In equities, the downtrend in Cyclicals has continued. Inflation protection has picked up in the US, mirroring the move in bonds. APAC Cyclicals have turned sharply lower but Growth is finding some support, indicating a mixed reaction to China stimulus hopes. In iFlow Green, Developed EMEA equity markets continue to show the weakest alignment with ESG factors.

Our 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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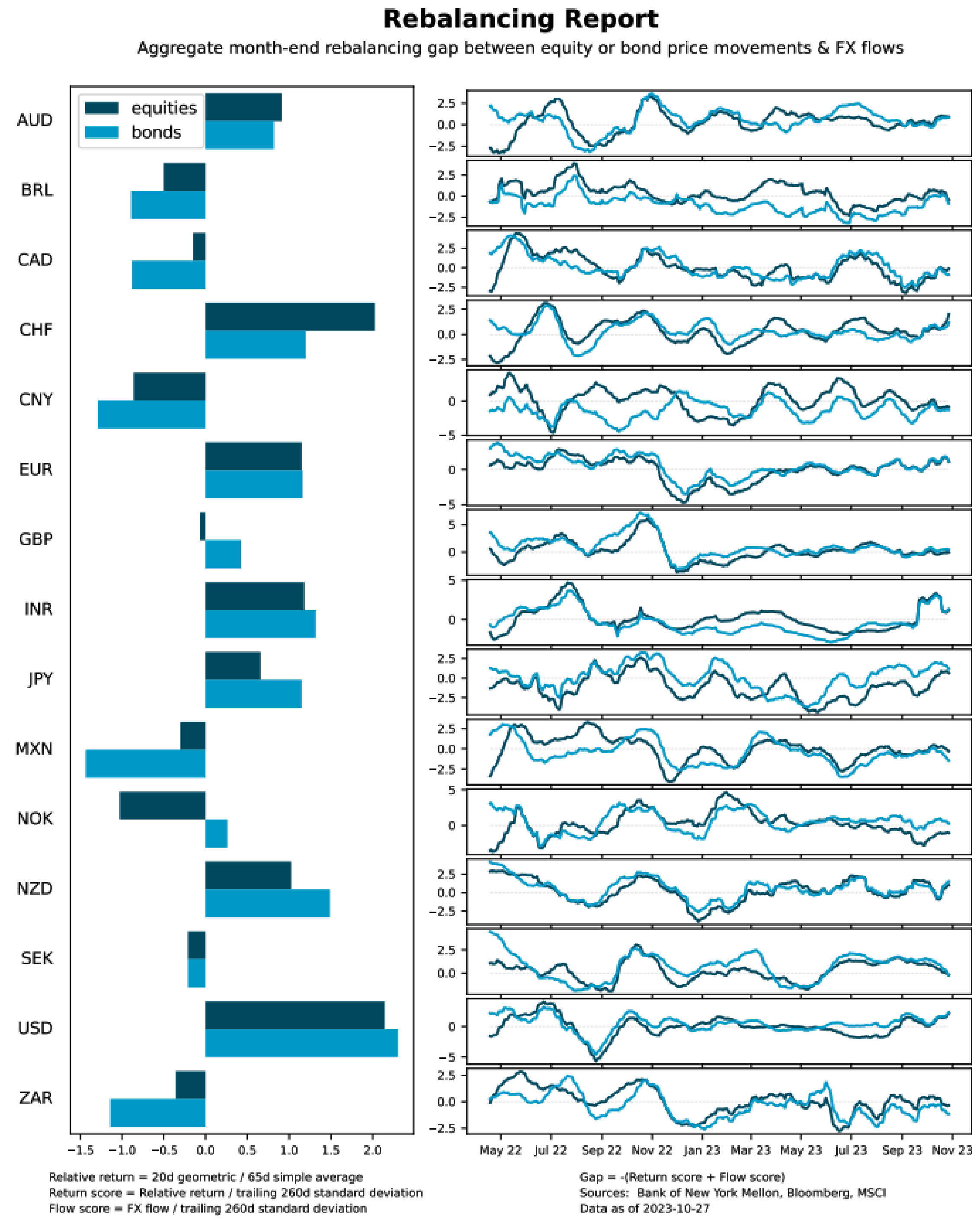
The chart below details rebalancing results into month-end, as well as the evolution in FX flows and returns which drove the imbalance. Click anywhere on it for the full report.



Source: BNY Mellon

October Rebalancing Summary: Both equities and fixed income sold off but the worst-performing asset markets mostly had FX inflows through the month. The US dollar was the main beneficiary of steepening in fixed income curves.

October was characterised by severe volatility in fixed income markets. Geopolitics led to expectations of safe-haven flow, but the dominant theme was still bear steepening. Global bond markets struggled to sustain demand. However, the key anchoring currencies against the dollar – MXN, CAD, EUR, CNY – did not fall by the wayside due to sustained moves in

USD yields. Currencies of the US's trading partners north and south of the border were the strongest performers in October on an outright basis; CNY was also in the top five. We have highlighted how USD on a trade-weighted basis remained strongly underheld and net sold, but this also meant that rebalancing for purchases was needed for the greenback, irrespective of how underlying asset markets behaved.

For rebalancing, the difference from September is that both fixed income and equities had significant-enough performance on a directional basis (mostly selling) to generate rebalancing flow. However, some of the most-sold markets already had FX inflows throughout the month. Canada and Mexico in particular have some of the lowest rebalancing scores as FX purchase and equity liquidation almost fully offset each other. No currency managed to register an FX flow score above 2.0, though USD is the most significant, scoring above 1.5. The weak performance in European equities and the EUR may attract some rebalancing interest, too, though fundamentals may yet stand in the way.

USD managed to generate a strong rebalancing signal in fixed income. This matters globally as well: bond markets continue to face selling pressure heading into month-end, and if global total-return portfolios are heavily underweight the dollar, then a new surge of strength once again risks renewed inflation from exchange rate pass-through. This would be accentuated by any rise in energy and commodity prices. The recent surprise tightening by some Asian central banks already point to such risks surfacing. The EUR could also see some additional purchases, especially coupled with the equity gap. JPY also managed to touch 1.5 in rebalancing score, but sustained pressure on local bonds is already priced. For currencies at risk of sales, none managed to hit a return score with a magnitude above 1.5 in sales.

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 vs. Defensives performance remains volatile around a flat level but the general trend remains negative amid worries about the US and global economies. Macro data has started to come off the lows but there is very little sign of expansion.
- Leverage flows have continued their decline and have moved back into negative territory for the first time since H1. Growth vs. Value flows attempted a comeback but looks set to end the month on a negative note as there is simply not enough fundamental support – the recent adjustment in Tech has clearly had an impact.
- Inflation flows have rebounded strongly as the US economy continues to defy expectations with robust demand in place. Breakevens remain stable but the steepening in bond markets and likely Fed response continues to send strong signals about inflation expectations, and equity markets have adjusted accordingly.

2. International Equity Styles

- In EMEA, Cyclical vs. Defensive flows are generally close to neutral but EM EMEA has generated a light pick-up, even though the region continues to be dominated by geopolitical risk. Poland's election may have generated some changes in expectations for CEE flows. Growth vs. Value flows are relatively unchanged.
- In APAC, developed market cyclicals continue to heavily underperform – no sign of responding positively to the stimulus news out of China. On the other hand, growth in DM APAC has seen a good rebound. In EM APAC, the trend is also not favourable to Cyclicals but current performance relative to Defensives is relatively neutral.

3. iFlow Green

- There is notable improvement in iFlow Green. The only factor facing some stress is United Nations Global Compact – Anti-Corruption, which has several regions showing negative flow alignment. Developed APAC and EMEA are particularly exposed in this respect.
- EM APAC has managed to improve its ESG factor flow alignment strongly – the region is now neutral for all factors. The worst-performing region is Developed EMEA. It is now showing negative flow alignment with every single UNGC category. Considering the political pressure governments in the region now face with respect to the carbon agenda, we doubt improvement will happen soon.
- Globally, ESG-Governance is still the only factor with negate flow alignment, mostly driven by weakness in the Americas. Overall, despite the challenging environment it appears asset allocators are not aggressively reducing exposure to ESG factors. We expect greater challenges up ahead, however.

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