BNY MELLON

iFlow

MONTHLY

September 2023

September month-end flows point to strong INR purchases due to an extreme round of sales around the IMM dates. CAD and NOK, by contrast, face sales as an offset to the good performance in both currency flow and their respective equity markets, most likely associated with higher energy prices. In equities, Cyclicals continue to outperform Defensives in the US and leverage flows have neutralised. Globally, Cyclicals continue to outperform in APAC but EMEA flows are now neutral as growing stagflation risk points to a problematic asset allocation outlook. iFlow Green EMEA as a whole is starting to show weaker 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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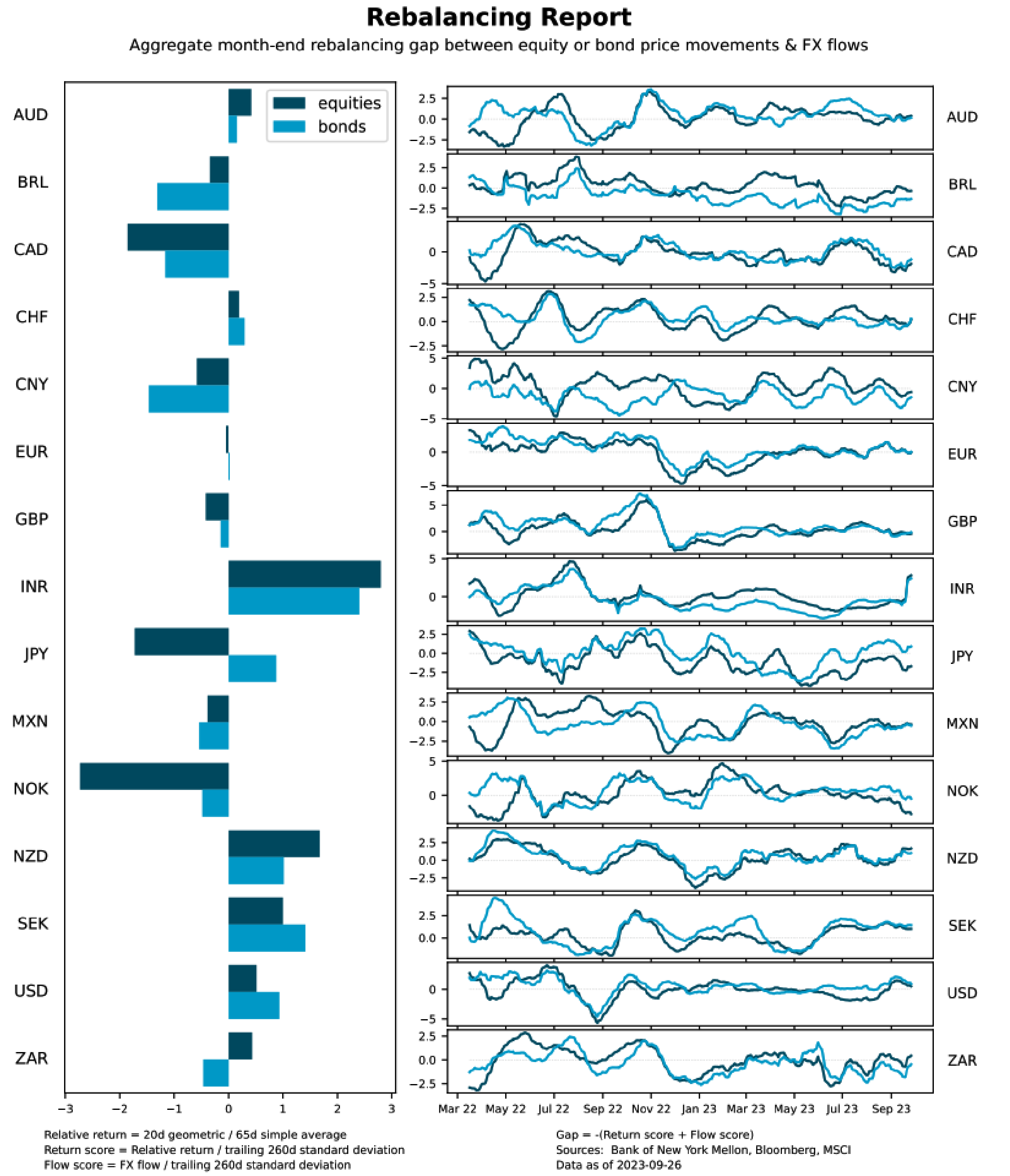
The chart below details rebalancing results into month-end, as well as the evolution in FX flows and returns which drove the imbalance. Click anywhere on it for the full report.



Source: BNY Mellon

September Rebalancing Summary: INR purchases expected after sharp sales post-IMM; CAD and NOK may correct after recent oil surge

FX flows were quite eclectic through September and there was no clear overriding theme. CAD and MXN led the way, which suggests the market is in search of proxies that could reflect US and dollar strength. However, USD was one of the underperformers due to unattractive valuations. CNY had a very good month as asset allocators facing ever-stronger language from the PBoC started to exit positions expressing a negative view on the yuan.

JPY also did well due to expectations for BoJ tightening, but last Friday's decision will likely have an impact on month-end flows. European currencies were mixed. SEK heads into month-end on a weak note – its post-Riksbank rally may have reflected some prior rebalancing need. INR was by far the worst performer despite the index inclusion news for local fixed income, which suggests very strong medium-term capital inflows.

For rebalancing, we find the most significant signals will likely materialise in equities. Large INR outflows will likely generate some purchases, and INR is the only currency with a gap score in equities above +2. New Zealand equities strongly underperformed and there was further FX selling, but not to the extent that portfolios turned heavily underweight NZD. On the purchase side, CAD and NOK face sales – both equity markets had positive absolute and surge returns. Coupled with good performance, especially in CAD, FX sales appear needed. This is also consistent with our view that the energy FX trade may not prove sustainable due to weak global demand.

The strongest signal in the fixed income space is also in INR. Even though it was the best-performing bond market in our set, the FX outflows were too strong to serve as an offset. This means that markets are likely over-hedged in INR relative to the capital inflows. Either duration will need to outperform more strongly or some FX hedges need to be lifted. Although the FX signal is strong, the unique circumstances of India's fixed income market and the incoming passive flow suggests that underlying asset interest may dominate as much as FX, especially in a strong dollar environment. BRL and CNY have had a good month in FX and bonds. Some offsets appear needed but the rebalancing scores are just shy of 2.0, which is our threshold for a strong signal.

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 has been mixed this month, though generally the outperformance has ended. Relative flows continue to favour Cyclicals into month-end,

but it is hard to justify adding so late in the cycle, especially after the Fed’s decision to shift higher its rate expectations through the forecast horizon.
- Leverage flows have finally declined sharply and now look set to underperform as the effect of additional tightening comes into play. Whether this foreshadows a material slowdown in the US economy remains to be seen. A similar round of weak flows around the March US bank events didn't derail the overall strong growth narrative.
- Inflation flows remain negative but show signs of a light recovery approaching month-end. We doubt there will strong appetite to go outright positive on associated exposures. Considering current risks, though, a tactical recovery is understandable.

2. International Equity Styles

- In EMEA, Cyclical vs. Defensive flows are flat in both developed and emerging markets. The region as a whole faces strong stagflation risk so asset allocation will prove difficult; it is hard to make a strong case in favour of either strategy. There's not been much divergence between Growth and Value for the same reasons.
- In APAC, Cyclicals continue to generally outperform Defensives, extending the summer recovery, but the level of outperformance has topped. This is further sign that positions expressing a view on China weakness continue to pull back. However, with China clearly seeking to stabilise its economy, we doubt Defensives can outperform strongly soon. Growth and Value flows across the region are well-aligned.

3. iFlow Green

- The majority of regions remain positively aligned with ESG factors. However, there is clear deterioration in developed EMEA’s ESG alignments – especially across the United Nations Global Compact (UNGC) factors. We fear this may be an early indication of markets responding to a pullback in the continent’s commitment to associated policies, especially on the environment. However, it is UNGC-Human Rights and UNGC-Labour Rights which are showing the weakest flow interest.
- EM APAC remains negatively aligned across all factors, but compared to the previous month the region is relatively neutral. There are some signs of deterioration as well in EM Americas as several UNGC factors have moved towards neutral alignment, while ESG-Governance is performing poorly.
- Globally, ESG-Governance still has the poorest alignment with equity flows, but continues to approach neutral. UNGC-Anti-corruption is also moving into neutral. ESG-Environment and UNGC-Environment remain very strong, suggesting that moves in European policy to the contrary are not yet affecting global flow alignment.