

iFlow

MACRO REVIEW

May 2024

Key Themes

Rebalancing: JPY buying and ZAR sales feature, and align with fundamentals

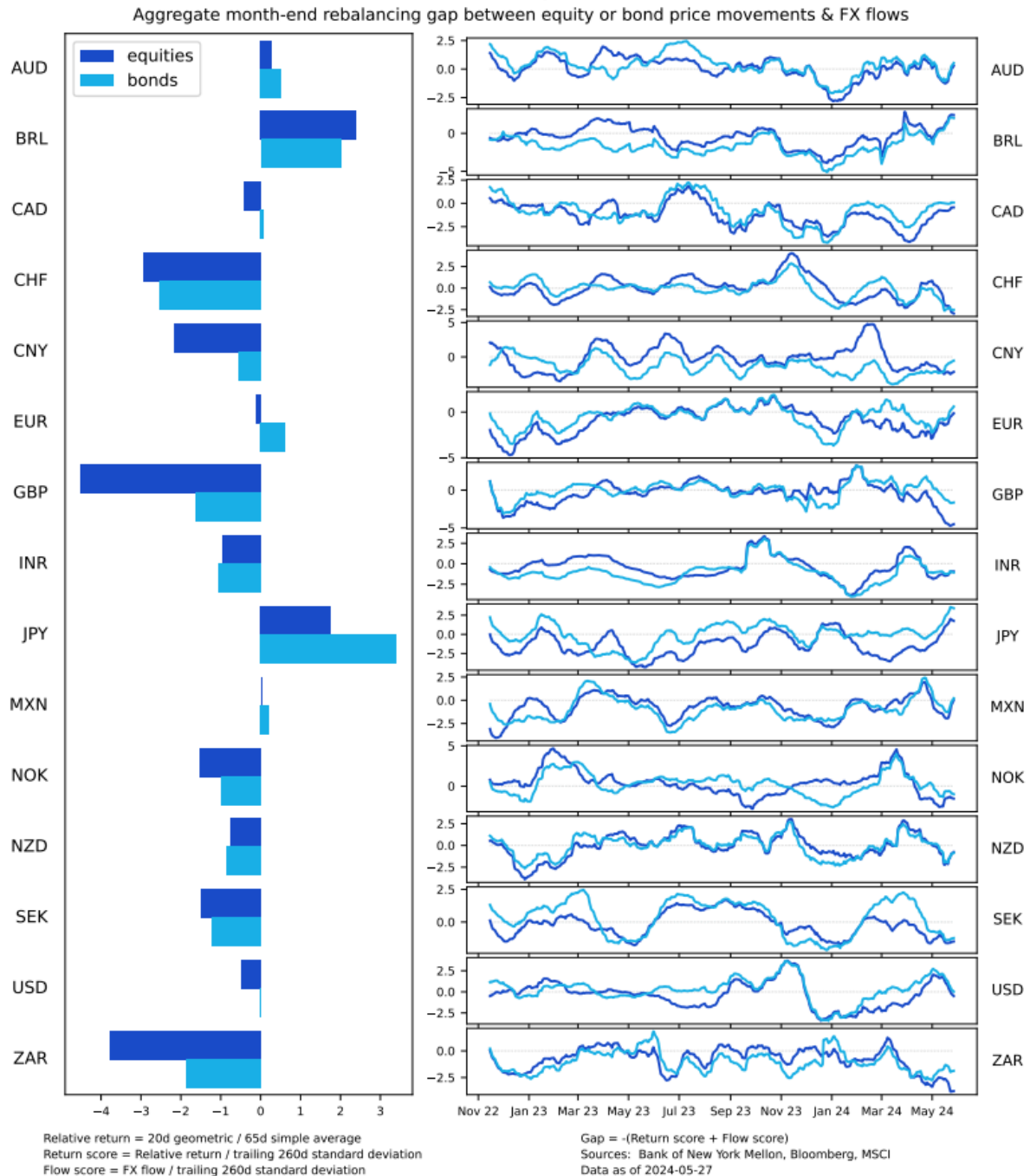
US Equity Styles: Growth recovers well, reflecting improvement in risk sentiment

International Equity Styles: Cyclical interest notable in EM

iFlow Green: EM ESG alignment staying negative, APAC continues to deteriorate

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Rebalancing Report



Rebalancing Update

Risk appetite has recovered in May as both policy guidance and data have supported renewed easing in financial conditions. The Federal Reserve appears on course to ease this year, even though at a very measured pace. Crucially, data continues to support this view. We have observed throughout the month that iFlow is in a carry-favourable mode across several asset classes – though perhaps not in FX yet, as both carry and funding currencies struggle to reach any kind of buying or selling consistency, respectively. This was evident in flow ranks throughout the month. For example, CHF was the best-bought currency but closely followed by ZAR. In contrast, JPY was strongly sold but BRL was second from bottom. These offsetting flows point to the FX equivalent of a ‘stock-picking’ environment, where there is greater focus on idiosyncratic aspects. The bottom line is that the carry trade

is in play but both legs are being chosen carefully. These flows were relatively strong in May and will likely generate material month-end rebalancing flows as a result.

FX abnormal flow scores did not differ in ranking from the outright flows, but for JPY and BRL the abnormal scores have been amplified by a sharp change in direction in overall flows. JPY was one of the strongest-performing currencies throughout April as markets built up a hedge against Bank of Japan normalisation, but with no need for additional 'protection' in the near term, these positions have unwound sharply, shifting JPY back to strongly underheld. BRL also moved from a significant carry driver towards facing outflows. CHF, ZAR and GBP were prior underperformers but the past month brought a material reversal of fortunes, which in turn amplified their abnormal flow scores. These five currencies will be the ones most likely to see rebalancing flows as a result of high abnormal flow scores.

Equity markets continued to perform well on a marginal basis, helped by the general direction of policy guidance. Only Australia, New Zealand and Japan generated negative abnormal return scores, but they were all quite light and probably not enough alone to cause any material rebalancing flows due to significant under-allocations. The UK and South Africa were the strongest performers on the month. Although a distant third, Norway was also well-bought. Considering the mix of those three, there is clearly some degree of commodity demand in play globally, which would be consistent with the market seeking 'protection in real terms' in a backdrop of policy easing, even though the Bank of England, South African Reserve Bank and Norges Bank are hardly at the forefront of that. South Africa may have also received a fillip from more favourable expectations for the upcoming election.

Of the five currencies with large rebalancing gaps generated from equities, GBP and ZAR selling are by far the most relevant. Both their equity markets were best performers but also generated strong FX performance, so rebalancing in favour of sales should not surprise. The selling in these currencies should also mark the need for a small adjustment in the reflation trade led by commodity prices, to which both countries' exchanges have strong exposures, thus affecting the currencies. Despite some sign of recovery in growth and China's support for the stock market, we think the fundamental case for commodity-based reflation is weak. JPY and BRL purchases also seem required due to strong sales on the month. JPY should benefit from the additional underperformance in Japan's equity market.

Fixed income was mixed and most G10 markets relatively subdued. Overall, the only market which faced any significant adjustment was Japan's, where the prospect of policy normalisation, no matter how slow, continues to impact price action as the broader concern over a BoJ exit from the JGB market will likely continue to exert an impact on bond market returns. There is also a case to be made in the front end, whereby BoJ rate hikes may need to be more aggressive amid currency weakness. With this in mind, buying back JPY should already be a natural reaction to both the behaviour in the curve – which should generate

rebalancing – and additional purchasing pressure from potential intervention by the BoJ.

Total returns have been the strongest in emerging markets: India and South Africa would be a real yield story, whereas China's bond performance will have a policy aspect to it; markets will need to be cognisant of greater PBoC participation in the bond market, especially for the longest maturities. As a result, it comes as no surprise that the strongest signal from fixed income markets is JPY purchases: it was net sold in May and fixed income markets also heavily underperformed, resulting in heavy under-exposures on a total return basis. As highlighted above, cross-border investors will probably be wary of exposures to JGBs due to the prospect of the BoJ further exiting from that market. But extreme JPY valuations have amplified the under-exposures, which means rebalancing pressure is strong. Fundamentals appear supportive of further JPY strengthening, as well. At the other end, CHF and ZAR likely require sales to rebalance – mostly due to currency performance, but we note that some defensive positions in South African fixed income are also probably necessary ahead of the election. This seems best achieved by increasing ZAR hedges.

iFlow Equities 2.0 Style Indices - Flows Of Significance

1. US Equity Styles

- After a poor April for cyclical themes, the lack of a hawkish push by the Fed has allowed Cyclicals to start performing against Defensive flows again in May. Although markets are tentative, relative performance may start shifting in a positive direction.
- The improvement in risk sentiment has also helped Growth outperform Value. Leverage flows have also moved back into positive, albeit not very strongly.
- Inflation flows are currently neutral as some attempts to push into positive in recent weeks have largely faltered amid data not strong enough for another push into hedging against price risks.

2. International Equity Styles

- Within international equity flows, the only notable move of significance is Cyclicals outperforming Defensives in EM EMEA – this surged in May to the highest levels since end-2020. It follows a similar move in DM EMEA, indicating some cyclical alignment in the region, matching the improvement in PMI numbers, even though the indicator remains at depressed levels.
- Flows in APAC have returned to convergence, though from opposite directions for emerging and developed markets, respectively. Cyclicals are no longer strongly outperforming Defensive flows in EM APAC, and Growth vs. Value has moved fully towards neutral in the region.

3. iFlow Green

- There is very little change in ESG alignments compared to April. All ESG factors remain deeply negative across EM, led by APAC, indicating that exposures to highly rated companies continue to decline. UN Global Compact Human Rights and Labour Rights flows, and to a lesser extent ESG - Social in Latin America, are the only bright spots in emerging markets.
- Developed markets are lightly negative, with only mildly positive correlations in the Americas helping sustain alignment. Developed APAC is also deteriorating, led by sharp drops in environmental factors across both factor frameworks.

***iFlow Macro Review PDF contains the following:**

- Monthly Rebalancing index, based on marginal equity and fixed income returns, offset against marginal FX flow scores generated by iFlow.
- US Equity Styles, detailing US equity purchases across different style indices.
- International Equity Flows, assessing 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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Please direct questions or comments to:

iFlow@BNYMellon.com



Geoff Yu

EMEA MACRO STRATEGIST

CONTACT GEOFF



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