February 2024

Key Themes

Rebalancing: Capitulation in China equities and renminbi requires strong recovery flow

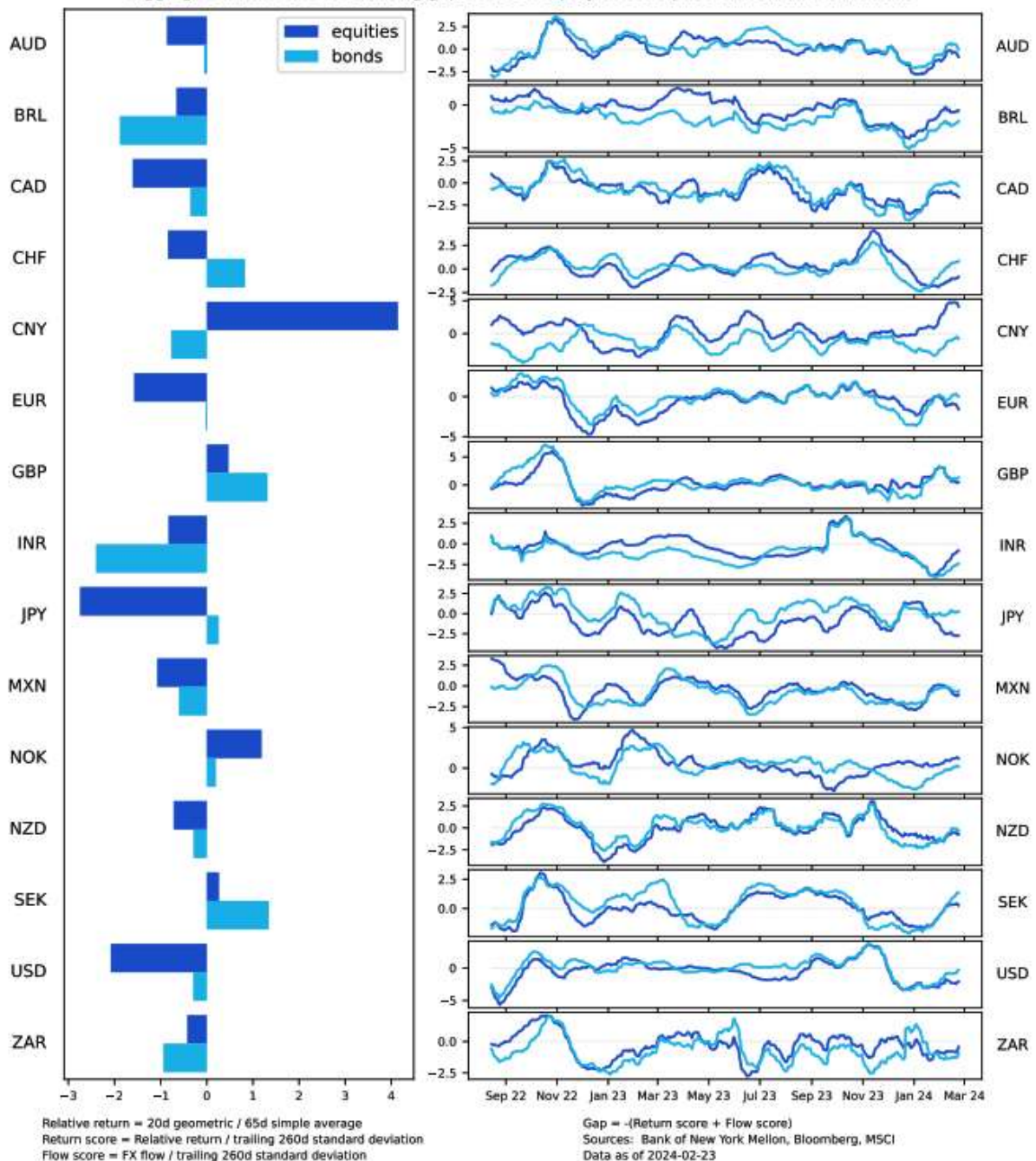**US Equity Styles**: Cyclical and Leverage interest decline

International Equity Styles: Strong recovery in Cyclical flows in DM APAC

iFlow Green: EM ESG alignment deteriorates sharply

Click on the image below to launch a PDF with all graphics.*

Rebalancing Report

Aggregate month-end rebalancing gap between equity or bond price movements & FX flows

Relative return = 20d geometric / 65d simple average
Return score = Relative return / trailing 260d standard deviation
Flow score = FX flow / trailing 260d standard deviation

Gap = -(Return score + Flow score)
Sources: Bank of New York Mellon, Bloomberg, MSCI
Data as of 2024-02-23

Source: BNY Mellon

Rebalancing Update

Risk sentiment has been generally ascendant in February, and the US dollar at the fore of renewed fears of elevated rate expectations. With USD decently bought on the month, this would usually limit the ability of other currencies to do well. As such, we can see that for the most part, flow ranges over the past four weeks have been generally light. ZAR and CAD are notable outperformers, but the monthly average flow magnitude is relatively light. CNY has been one of the biggest outliers amongst the majors: average outflow magnitude close to 1.0. Flows in this magnitude are quite rare and will likely have an impact on a marginal basis. For example, the strongest outflow in January (MXN) barely hit 0.5 in magnitude. This likely means a need for CNY to recover strongly on FX-based rebalancing alone.

Due to the strong performance in equities and the lack of movement in FX flows, it should come as no surprise that rebalancing needs could potentially be strong, barring any major adjustments over the coming days. Due to the Nikkei's strong performance, portfolios are now likely overweight JPY exposures so selling would be needed. However, any such sales, if having sufficient spot impact, may encourage further gains in Japan equities. In some respects, this is the kind of dynamic that should prompt the Bank of Japan to consider normalising policy – our core view – as excessive JPY weakness will start to impact profitability through the input cost channel and likely cause inflation expectations to rise again. The USD also faces sales given equity outperformance and the currency generally well-bought. The only meaningful buy signal, unsurprisingly, is CNY. While various measures from China's government limited equity losses on the month, it is still one of the biggest underperformers among key markets. On top of the very strong sales of CNY, the rebalancing need is extremely strong, resulting in a gap score of +4.0.

After two months of strong fixed income-generated rebalancing (mostly through FX sales as duration performed strongly), there are no discernible signals in that space. As noted above, only China, along with India, outperformed; other markets were generally flat. However, as the CNY was already strongly sold, the overall equity gap is flat for CNY. INR, by contrast, likely requires additional sales as it was not strongly sold to offset good performance of fixed income. BRL's score is just about large enough in magnitude to warrant a strong signal, due to good FX purchases and reasonable fixed income performance contributing to over-positioning at month-end. Overall, based on the fixed-income rebalancing requirements, it appears that carry trades will come under pressure for rebalancing.

iFlow Equities 2.0 Style Indices - Flows Of Significance

1. US Equity Styles

- The concentrated manner of US equities' performance at present means that broader flow styles may not align with current price action. This is apparent across key US styles such as Cyclicals versus Defensives, where the outperformance since the beginning of the year has faded. Pushing back of Fed easing expectations may continue to pressure this style; it is hard to see Tech capable of leading a reversal.
- Growth stocks continue to underperform Value. Leveraged flows have also turned negative. This could be a more consistent reflection of developments in financial conditions. Expectations of credit deterioration is a key barometer to follow as the Federal Reserve calibrates its next move.
- Inflation-related flows have recovered back to near the end-2023 highs. The shift indicates a response to a change in overall growth expectations, which could translate into stickier inflation, though we doubt this reflects an outright shift in market positioning for the US's price cycle.

2. International Equity Styles

- Divergence between Developed and Emerging EMEA is becoming clear. The latter is showing expectations of severe deceleration – Cyclical underperformance has reached the most extreme levels in over four years. In contrast, Developed EMEA Cyclical equities are performing strongly. Considering the supply chain linkages between the two regions, we do not see such divergence as sustainable.
- Developed APAC markets also generated strong interest in Cyclical stocks relative to Defensives, where relative performance is close to flat. There may be a reaction to additional easing by China, including more direct intervention in equity markets, but this also may not be sustainable unless Beijing delivers on fiscal stimulus.

3. iFlow Green

- Divergence between Developed and Emerging Markets Cyclical flows remains strong when measuring Cyclical performance relative to Defensives. This points to improved sentiment and data stabilisation in DM, though we doubt a cycle change is imminent.
- Surprisingly, Growth is strongly outperforming Value in EM APAC – this is the best period of relative gains since late 2022. However, we would be very cautious in interpreting such flows given the capitulation in China markets, as it could be an indication of heavier existing positioning in Value stocks available for liquidation.

*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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