ECONOMIC RESEARCH

# Working Paper 202

September 15, 2016

} MACROECONOMICS } FINANCIAL MARKETS } ECONOMIC POLICY } SECTORS

Gregor Eder

## Emerging markets: Sustainable turnaround in capital inflows?

Allianz

AUTHOR:

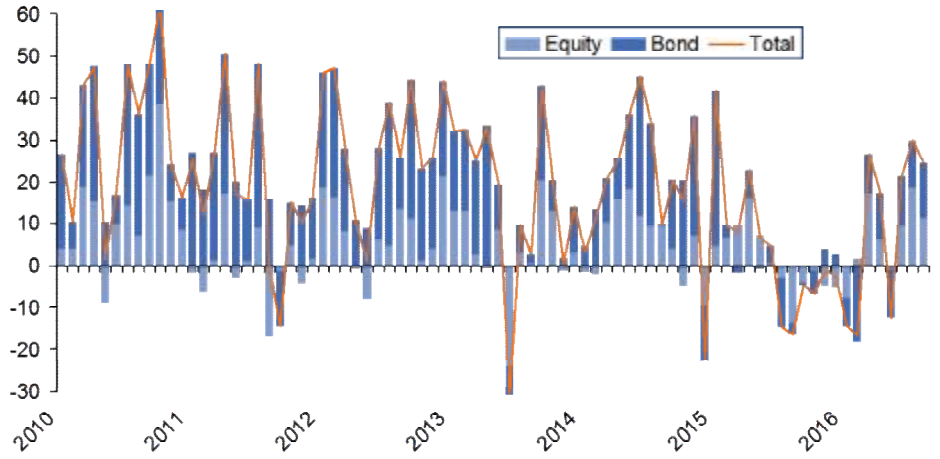
GREGOR EDER
Tel. +49.69.24431-3358
gregor.eder@allianz.com

# Emerging markets: Sustainable turnaround in capital inflows?

For several months now emerging markets have been enjoying increased popularity again among portfolio investors. Estimates released by the Institute of International Finance (IIF) suggest that, over the last three months, on balnce an average of more than USD 25bn has been plowed into emerging market stock and bond markets every month - compared with a long-term average of around USD 18bn. This comes after a period of what were, at times, hefty capital outflows starting in the middle of last year. In the period between July 2015 and February 2016, non-resident portfolio investors pulled a cumulative total of more than USD 76bn out of the emerging markets.

## Portfolio investors rediscover emerging markets

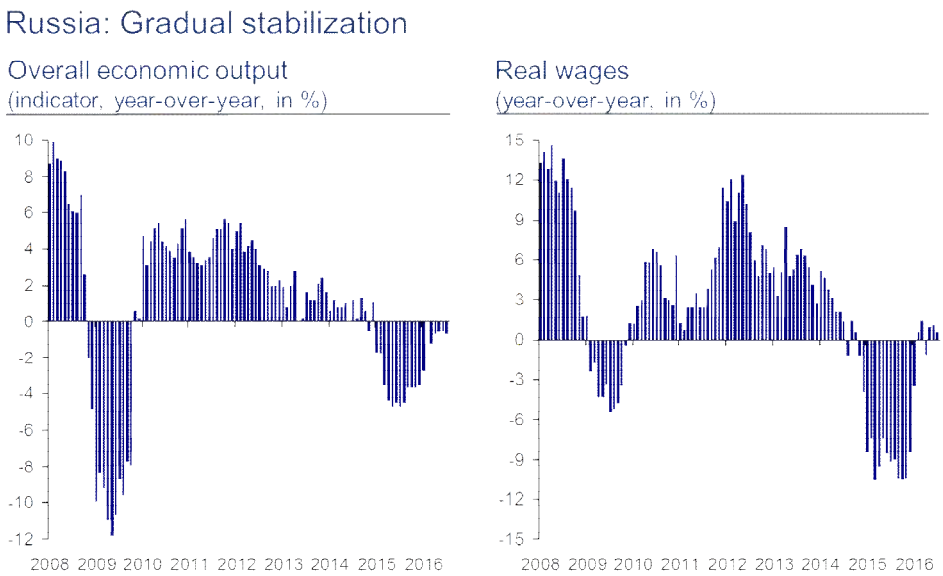
Emerging markets: Non-resident portfolio inflows, net, USD bn




Source: IIF.

So why have international investors been stepping up their investments in the emerging markets again of late? Is this development driven by fundamental improvements in the emerging markets themselves, or does it reflect an at least temporary rebound in risk appetite on the international financial markets? Looking at the latest economic indicators such as purchasing manager indices and “hard” data on foreign trade and industrial production in the three major emerging market regions Asia, Latin America and Eastern Europe, the broad picture is of a sideways movement – i.e. neither a significant acceleration nor a significant slowdown in growth.

Russia is one of the few exceptions. Eastern Europe's largest economy has been in the throes of recession since last year, with gross domestic product contracting by 3.7% in real terms in 2015. At the moment, the economy appears to be stabilizing at least, with GDP in the second quarter down by only around half a percentage point year-on-year. Industrial production would appear to have bottomed out and the past few months have brought a return to a moderate increase in real wages, which dipped by more than 9% last year. All in all, we expect growth to edge back into marginally positive territory by the end of the year. The average growth rate for 2016 is, nevertheless, expected to remain negative at around 0.6%.




Source: Thomson Reuters Datastream.

The sideways movement in the emerging markets also becomes evident if we take economic growth in the emerging markets as a whole as the benchmark. Although we expect to see growth of 3.7% this year following a disappointing figure of only 3.3% last year, these expectations of higher growth are due primarily to the economic stabilization in Russia mentioned above, as well as to a slight improvement in crisis-torn Brazil. Leaving Brazil and Russia out of the equation, aggregate growth would be unchanged on 2015.

So if the intensified capital flows to the emerging markets cannot be attributed to economic trends alone, as shown above, the main reasons must lie in the EM environment. In recent months two external parameters, in particular, have indeed favored investments in the emerging markets.

- Firstly, the protracted slide in prices of energy commodities, industrial metals and agricultural commodities has come to a halt. Although the picture is not uniform, prices of most commodities have at least firmed up in recent months. This reduces the pressure somewhat (not least on the currencies) of those emerging markets, particularly in Latin America, which are heavily reliant on commodity proceeds in terms of exports and tax revenues.

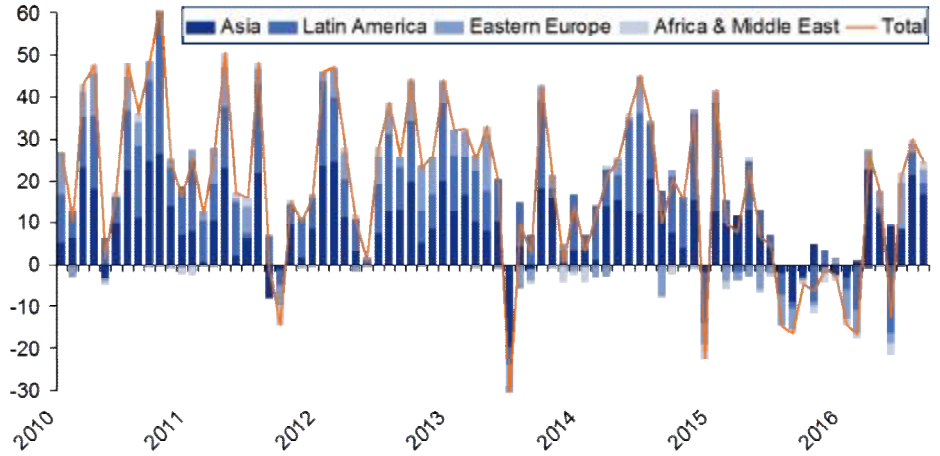
- Secondly, contrary to prevailing market expectations early in the year, the US Fed has not nudged interest rates up further so far this year. Even if the Fed does hike rates once this year, the correction in US monetary policy is taking longer than had been widely assumed. At the same time, other central banks such as the ECB and the Bank of Japan have remained on an expansionary course or have even stepped it up further. The Bank of England also expanded its accommodative stance recently. All told, this means that the low interest rate environment will probably remain with us for a long time, with the global hunt for returns thus set to continue for now.

The fact that commodity prices have started to firm up, and most importantly the low interest rate environment across the globe have given international investors more of a risk appetite in recent months, thus also contributing to the significant increase in the inflow of capital into the emerging markets. The breakdown of these fund inflows by region serves as further evidence that current economic developments in the emerging

markets themselves have played less of a role in this development: in the months June to August 2016, the emerging markets saw net portfolio inflows to the tune of USD 76bn. The most pronounced increase was seen in Asia, where inflows were up by USD 47bn. USD 7.5bn were plowed into Latin America, with almost USD 17bn destined for eastern Europe. Africa and the Middle East accounted for a far from insignificant USD 4.5bn or so. One could argue that portfolio investors are currently focusing disproportionately on Asia because the concerns that had reared their heads regarding the Chinese economy have failed to materialize as yet. The counterargument is that, in the first two months of this year, i.e. at the time of the "China panic", less than USD 2bn were pulled out of the Asian bond and stock markets, whereas outflows out of the other emerging market regions came to a total of just under USD 29bn.

## Portfolio investors prefer Asia at present

Non-resident portfolio inflows, by region, net, USD bn




Source: IIF.

The emerging markets are currently benefiting increasingly from this hunt for returns without seeing a substantial improvement in their own economic situation. As a result, we can expect volatility in the capital flows between industrial countries and emerging markets to remain elevated in the months ahead. Should, for instance, the US Fed jack up rates more sharply and/or swiftly than the markets are currently expecting, investors could rapidly switch from risk-on to risk-off mode and withdraw capital from the emerging markets. The same might well occur given negative growth surprises in China or a renewed slide in commodity prices. Thus, current capital flows to the emerging markets can hardly be described as sustainable.

These assessments are, as always, subject to the disclaimer provided below.

## ABOUT ALLIANZ

Together with its customers and sales partners, Allianz is one of the strongest financial communities. About 85 million private and corporate customers insured by Allianz rely on its knowledge, global reach, capital strength and solidity to help them make the most of financial opportunities and to avoid and safeguard themselves against risks. In 2015, around 142,000 employees in over 70 countries achieved total revenues of 125.2 billion euros and an operating profit of 10.7 billion euros. Benefits for our customers reached 107.4 billion euros.
This business success with insurance, asset management and assistance services is based increasingly on customer demand for crisis-proof financial solutions for an aging society and the challenges of climate change. Transparency and integrity are key components of sustainable corporate governance at Allianz SE.

## CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

The statements contained herein may include prospects, statements of future expectations and other forward-looking statements that are based on management's current views and assumptions and involve known and unknown risks and uncertainties. Actual results, performance or events may differ materially from those expressed or implied in such forward-looking statements.
Such deviations may arise due to, without limitation, (i) changes of the general economic conditions and competitive situation, particularly in the Allianz Group's core business and core markets, (ii) performance of financial markets (particularly market volatility, liquidity and credit events), (iii) frequency and severity of insured loss events, including from natural catastrophes, and the development of loss expenses, (iv) mortality and morbidity levels and trends, (v) persistency levels, (vi) particularly in the banking business, the extent of credit defaults, (vii) interest rate levels, (viii) currency exchange rates including the euro/US-dollar exchange rate, (ix) changes in laws and regulations, including tax regulations, (x) the impact of acquisitions, including related integration issues, and reorganization measures, and (xi) general competitive factors, in each case on a local, regional, national and/or global basis. Many of these factors may be more likely to occur, or more pronounced, as a result of terrorist activities and their consequences.

## NO DUTY TO UPDATE

The company assumes no obligation to update any information or forward-looking statement contained herein, save for any information required to be disclosed by law.