9 Flows by asset class: the two faces of 2016

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The **graph 1** summarises the **evolution of global portfolio flows** by fund category—equities, bonds, diversified, money market and alternative strategies—**since the beginning of the Great Financial Crisis** in 2007. This perspective allows us to see how, over the course of the economic cycle, the actions taken by public authorities and central banks progressively impacted the various asset types and flows as a whole.

As can be seen, at the peak of the sovereign debt crisis, **global inflows plummeted, dipping into negative territory over three consecutive years (2009-2011)**. Driven by very high risk aversion and falling interest rates, this period was characterised by a drying up of equity flows and massive outflows from money market instruments, with investments redirected almost exclusively into bonds and diversified funds.

With the exception of equities, which continued to lag due to a lack of visibility, **inflows returned to overall positive levels in 2012,** peaking at $450 billion, composed almost entirely of bonds.

This rebound continued from 2013 to 2015, with a major share of the inflows going to:

- **developed regions, to the detriment of the emerging economies** (+$789 billion overall for the developed regions vs. -$197 billion for the emerging economies). The emerging markets took a hit when the Fed began tightening its monetary policy[1] and suffered from slower growth in China (falling below 8% and then 7%) and the drop in oil prices beginning in mid-2014.
- **and equities, to the detriment of bonds** (+$578 billion overall for equities vs. +$14 billion for bonds). The improvement in growth and drop in unemployment in the United States (unemployment back at 5.0% in late 2015 compared to 8.0% at the beginning of the period) spurred investors to take on more risk.

Seen from this perspective, **2016 marks a shift on three fronts (see graph 2)**. First, global inflows became negative for the first time since 2011. Second, bonds overtook equities once again. Finally, flows into the emerging economies regained momentum on both bonds and equities—**at least until the election of Donald Trump.**

Since Trump's election marks a new turning point, we will examine the behaviour of portfolio flows in 2016 **(see graph 3)** by distinguishing two periods.

First, measured overall in the period ending in late October, outflows were essentially attributable to equities from the developed markets. This can be attributed to two factors in particular:

- First, investors began to believe that the **US equity market**—the leading market—**had become expensive** and was lacking genuine prospects for EPS growth.
- Second, the **near-uninterrupted momentum on European equities since late 2014**, fuelled by the ECB's QE programme (low interest rates and a weak euro) and cheap oil, **abruptly ended in January 2016**. Mounting doubts about global growth, the oil crash, banking system failures and leniency by the Fed[2] had convinced investors to return to less-risky investments. When the doubts surrounding China and the oil market

[1] *A process that proceeded in three stages: "pre-tapering" in May 2013, the end of tapering in October 2014 and the first rate hike in December 2015; each stage coincided with fund outflows from emerging assets.*

[2] *Early in 2016, Janet Yellen suggested that the Fed would withhold further tightening in view of the risk of contagion in the financial system.*

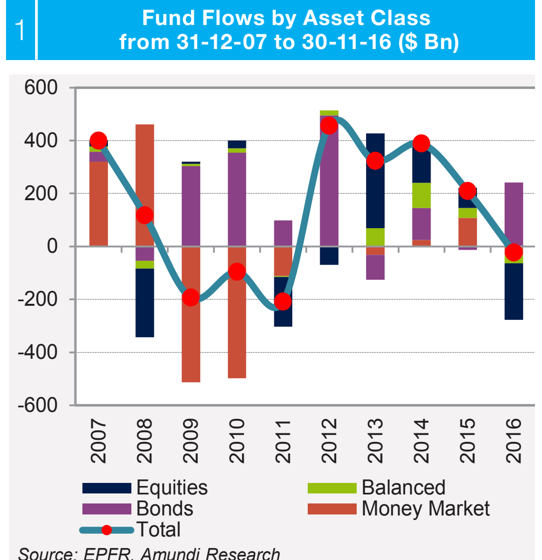
The essential

The year 2016 will go down as a period with two distinct phases. Until the election of Donald Trump, asset flows were characterised by a three-fold rupture from the trends seen from 2013 to 2015: global inflows became negative for the first time since 2011, bonds once again overtook equities, and flows into the emerging economies regained momentum. The surprise victory of Donald Trump reshuffled the cards, with US equities in particular making a strong comeback and emerging equities suddenly losing their appeal.

While the next few months may prove volatile in light of the recent market exuberance, in the longer term we should see a continuation of higher growth accompanied by stronger inflation. Asset allocation should be relatively aggressive, especially since, given a favourable tax situation, profit growth should lead to some positive surprises in 2017.

> "2016: a period with two distinct phases"

1 Fund Flows by Asset Class from 31-12-07 to 30-11-16 ($ Bn)



Source: EPFR, Amundi Research

began to dissipate, other risks, this time of a more political nature, began to accumulate. The erratic handling of the refugee crisis followed by the Brexit referendum finally convinced investors to stay away from European equities.

In this context, US bonds—which offered higher returns than eurozone bonds in view of the ECB's QE programme—**and emerging market bonds**—which had become inexpensive after being trounced in the second half of 2015 due to the Chinese crisis and concerns about the Fed—**came into favour.** Thus, in late October 2016, US bonds ($225 billion and 6.3% of assets under consideration) and emerging bonds ($51 billion, 12.7%) together drew in **inflows of over $275 billion**. At the same time, US equities (-$137 billion, -1.9%) and European equities (-$110 billion, -9.0%) saw **outflows of nearly $250 billion**. Between these two extremes, emerging market equities ($16 billion, 1.4%) and European bonds ($11 billion, 1.5%) achieved **moderate success**, together drawing in just over $25 billion in inflows.

Toward the year's end, the surprise election of Donald Trump marked a new turning point. As the impacts of unconventional monetary policy were beginning to wane, the prospect of a more aggressive policy mix (increased public investment and a proliferation of public-private partnerships) led to an upward revision to growth and inflation outlooks. This, in turn, pushed up interest rates and the US dollar. Thus, from November 7, eve of D. Trump election, to December 23 2016, the US 10-year bond yield—at its highest since September 2014—has risen from 1.8% to 2.5%, and the US dollar has risen by 5% against the euro and 12% against the yen.

As bond prices are inversely correlated with interest rates, the pressure on interest rates resulted in **divestment from bonds** (-$37 billion from 9 November to 14 December according to EPFR sample data) **and renewed investment in equities** (+$36 billion)—almost exclusively US equities, which drew in $31 billion from 9 to 16 November, the highest amount of inflows they had ever received in a weekly period. This trend reversal occurred suddenly, catching the majority of "active" investors by surprise. This explains why nearly all equity flows over the period were attributable to passive investing and ETFs.

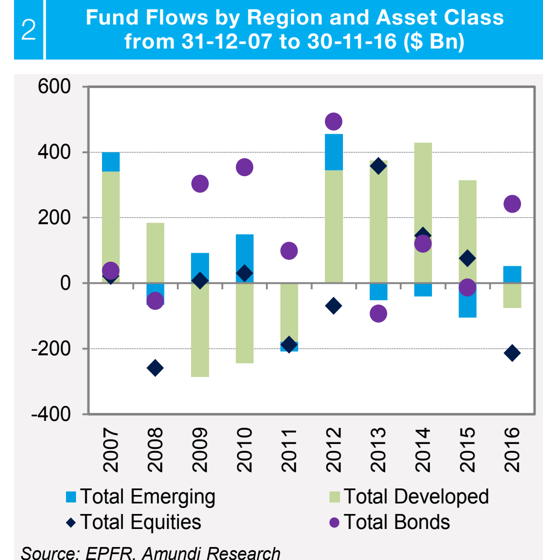
In contrast to US equities, emerging market assets, which had enjoyed broad momentum prior to the election, have since seen major outflows, albeit with significant differences among individual countries. Echoing the themes of the US electoral campaign, Mexico found itself weakened by threats to its exports and remittances by its expatriates and saw the sharpest investment declines. On the opposite end, Russia, boosted by hopes of the lifting of Western sanctions and the recovery of oil prices, saw significant inflows.

While 2016 can be categorised by two very distinct trends with regard to portfolio flows, one prevailing prior to the election and the other subsequent to it, **what can be said of 2017?** Will the "Trump effect" continue to boost equities (especially US equities), or will we see a return of the previous trend, when US bonds and emerging market assets dominated?

Despite the nearly unbroken market growth since his election, **the "Trump effect" risks losing steam in the short term,** especially as we approach symbolic thresholds on 10-year bond yields (3%) and the US dollar (1:1 with the euro). **There will be two key things to watch** for once the new President is sworn in on 20 January:

- **First, his decisions on foreign policy** (trade and tariffs)—an area where he'll have significant leeway—will need to be carefully scrutinised in order to discern the real changes behind the headlines, particularly with regard to China, Mexico and Russia.
- **The other decisive moment will occur (presumably) in late March, when the federal budget will be submitted to the scrutiny of Congress**. After months of wild speculation, we will find out if the compromises reached live up to expectations.

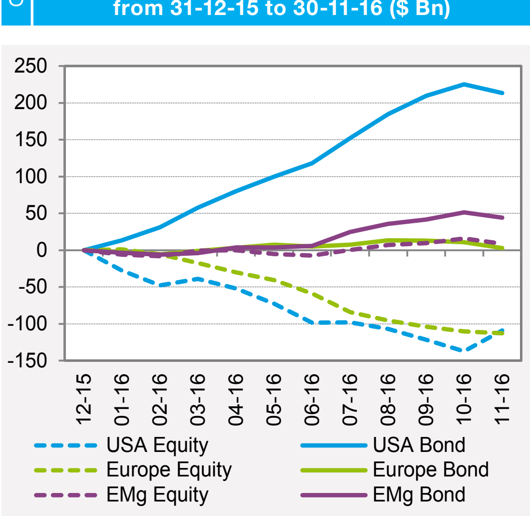
2 Fund Flows by Region and Asset Class from 31-12-07 to 30-11-16 ($ Bn)



Source: EPFR, Amundi Research

"In the short term, the 'Trump effect' should lose steam"

3 Fund Flows by Region and Asset Class from 31-12-15 to 30-11-16 ($ Bn)



Source: EPFR, Amundi Research

"We should see a continuation of higher growth accompanied by stronger inflation, with relatively aggressive asset allocation"

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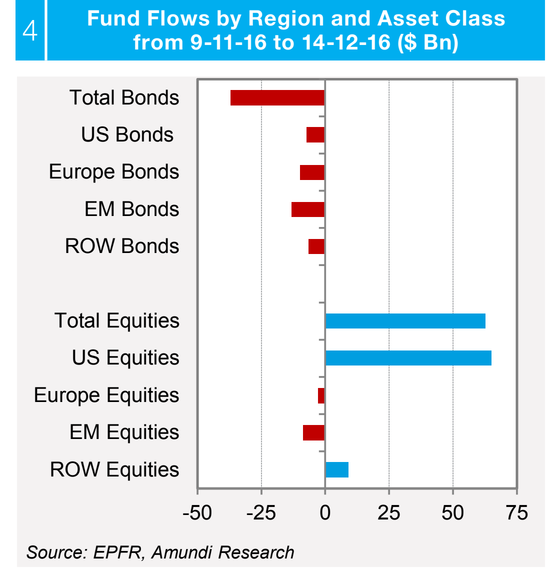
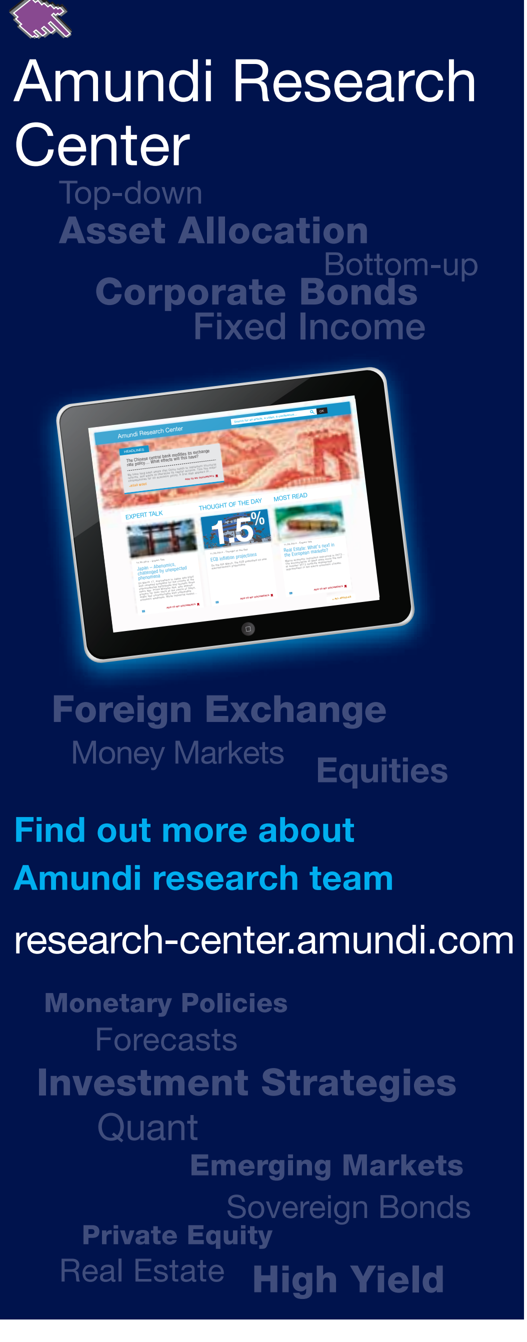
While the next few months may prove volatile in light of the recent market exuberance and the nearing of symbolic thresholds, in the longer term fundamentals should take precedence. Thus, unless there is a radical change in the policy mix—which seems an unrealistic and untenable proposition—there should be a continuation of higher growth accompanied by stronger inflation. Asset allocation should be relatively aggressive, especially since, given a favourable tax situation, profit growth should lead to some positive surprises in 2017.

4 **Fund Flows by Region and Asset Class from 9-11-16 to 14-12-16 ($ Bn)**



Source: EPFR, Amundi Research

January 2017



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