Global Macro Views – The EM Positioning Overhang

March 14, 2019

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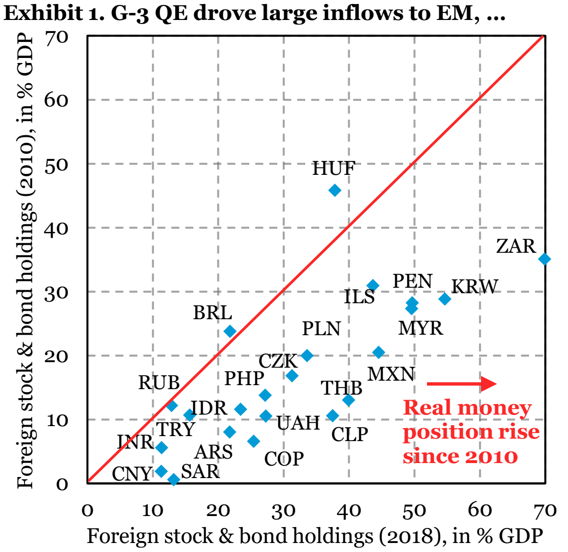
- The Fed has shifted dovish and China-US trade tensions have abated, …
- but EM currencies – after a brief rally in January – have been quite weak.
- We hear possible explanations ranging from remaining tail risk like Brexit, …
- to negative muscle memory among investors from the 2018 EM sell-off.
- We believe that emerging markets may be over-positioned in many cases, …
- after a decade of heavy real money inflows due to G-3 monetary easing.
- South Africa, Chile, Mexico and Indonesia look over-positioned to us, …
- while Brazil and Russia are the least positioned major EMs.

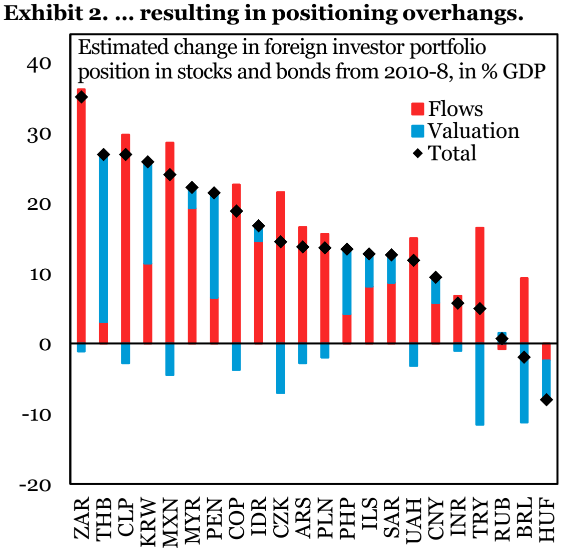
After a brief rally in January, emerging market currencies have been on the back-foot, a surprise given the dovish shift from the Fed and abating China-US trade tensions. We hear many explanations, ranging from tail risks like Brexit to investor caution after the EM sell-off in 2018. These things may play a role, but we see foreign investor positioning as the principal driver. After all, the backdrop to EM these days is a decade of ultra-easy G-3 monetary policy, which drove a wall of money to EM. Those flows have in some cases built up to large positioning overhangs, so that the same dovish shift from the Fed isn't the positive impulse it once was. Our new positioning measure, which we think is the most comprehensive metric for real money positions in EM, says South Africa, Chile, Mexico and Indonesia are the most over-positioned EMs, while Brazil and Russia are the least.

Exhibit 1. G-3 QE drove large inflows to EM, …



Source: Haver, IIF

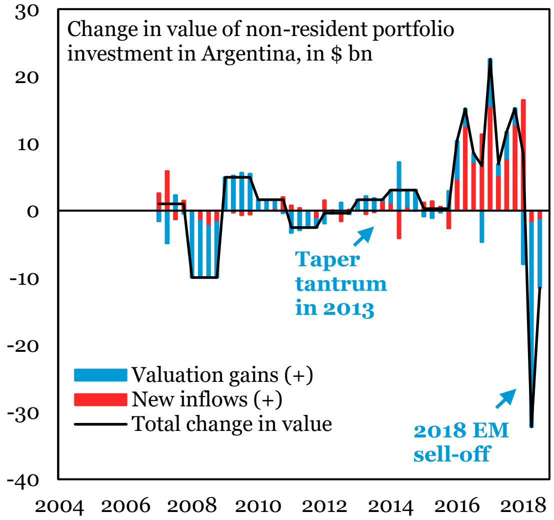
Exhibit 2. … resulting in positioning overhangs.



Source: Haver, IIF

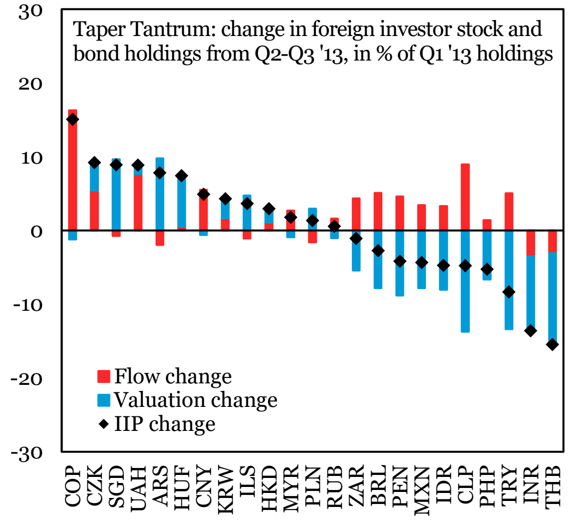
We unveiled new EM positioning data in a series of ***Global Macro Views*** late last year. Our data differ from other positioning metrics in two important respects. First, while most other measures track flows, i.e. measure short-term investor sentiment, we use countries' international investment positions to uncover the stock of non-resident portfolio investment in EM equities and bonds. Second, our positioning metric is fully representative of the market, because it relies on official balance of payments statistics, so there can be no doubt as to its representativeness. Exhibit 1 shows non-resident portfolio holdings in EM stocks and bonds in 2010 (vertical) and 2018 (horizontal), with countries furthest to the right from the red diagonal having the biggest rise in foreign investor positioning. Exhibit 2 breaks down that rise into flows (red), i.e. new purchases, and valuation gains (blue), reflecting currency appreciation mostly. South Africa, Chile, Mexico and Indonesia are among the countries that saw heavy inflows over the past decade, i.e. look over-positioned to us. Brazil and Russia look under-positioned.

Exhibit 3. Argentina saw little outflows in 2018.



Source: Haver, IIF

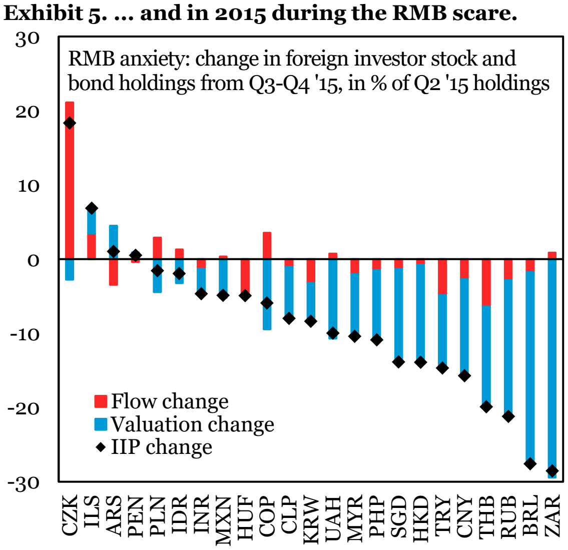
Exhibit 4. The same is true for EM in 2013, ...



Source: Haver, IIF

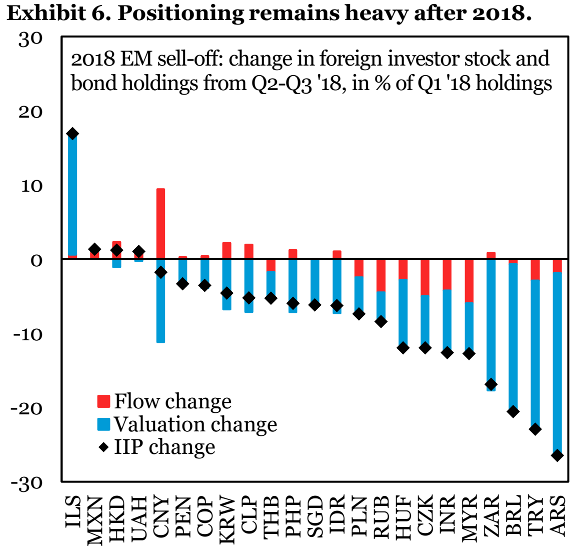
The EM sell-off last year raises the possibility that positioning has lightened, if foreign investors sold some of their underlying holdings. Exhibit 3 shows the example of Argentina, where the run-up to the sell-off saw large inflows (red), while 2018 saw little in the way of actual outflows. Foreign investors absorbed the bulk of the sell-off in valuation changes. We examine if this holds systematically for the 2013 taper tantrum (Exhibit 4), for the 2015 sell-off sparked by anxiety over possible RMB devaluation (Exhibit 5), and last year's EM sell-off (Exhibit 6). In each case, we look at flows (red) and valuation changes (blue) for two quarters, scaled by the foreign investor position in the quarter before. The reported numbers are thus the percentage outflow and percentage loss on the underlying position. In all cases, true positioning changes very little, with outflows modest in relation to the stock of foreign investor holdings. This means that – after 10 years of easy G-3 monetary policy – the positioning overhang in EM is likely still severe, even after last year's EM sell-off.

Exhibit 5. ... and in 2015 during the RMB scare.



Source: Haver, IIF

Exhibit 6. Positioning remains heavy after 2018.



Source: Haver, IIF