Insights
Multi-Asset Solutions

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Recovering Emerging Market Flows

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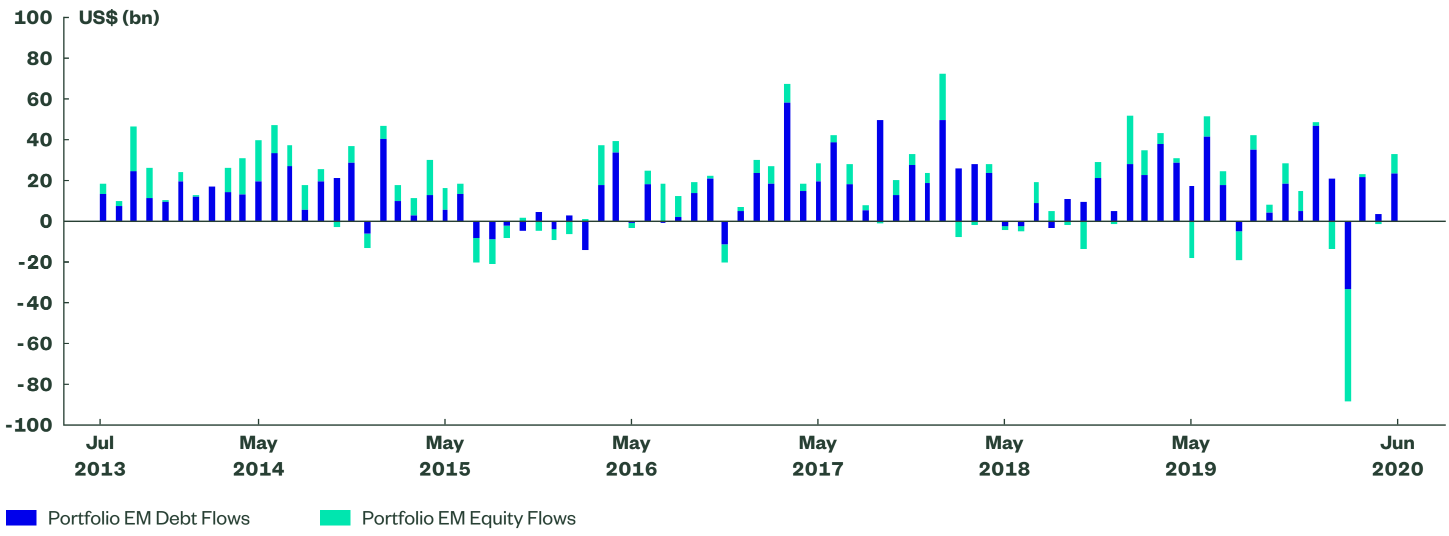
Investment flows in emerging markets (EM) assets were hugely impacted by COVID-19. But the massive exodus has been followed by renewed inflows, attracted by the fundamentals underpinning EM growth prospects and potential return opportunities.

COVID-19 Impact on EM Flows

The long upward trend of investment flows into EM assets came to an abrupt halt with the onset of the coronavirus outbreak in early 2020. The broad flight from riskier assets during this period resulted in steep falls for EM asset values. In the subsequent risk rally that began in late March, emerging markets were initially a bit slower to regather earlier momentum, but there was a notable pick-up late in Q2 as investors reversed some of the earlier outflows.

As the virus spread and the crisis unfolded in the first quarter, it is estimated that there were outflows of more than $80 billion from EM assets in the month of March alone (Figure 1). COVID-19 wasn't the only factor at play as the crashing oil price was a key aspect in the accelerating sell-off during March. According to the Institute of International Finance, there were EM equity outflows amounting to $72 billion in the first quarter, while portfolio EM debt outflows totaled about $25 billion.

Figure 1
After Record Outflows in March, Flows Return in Q2



Source: National Sources, Bloomberg Finance L.P., IIF.

Speedy and Extended Selloff

What was particularly remarkable was that both the speed of the decline and the scale of outflows were more extreme than other periods since (and including) the global financial crisis. By about six weeks into the GFC, the outflows had largely stabilised; similarly, during the "Taper Tantrum" of 2013 and "China Scare" of 2015, the selloffs quickly bottomed. In the latest instance though, the move out of EM assets continued to accelerate, as illustrated in Figure 2.

Figure 2
Speed and Scale of COVID-19 Flows Dwarf Past Crises

Source: Institute of International Finance as of July 2020.

Flows Recover

EM equities were among the hardest hit in the COVID selloff, and they accounted for about $50 billion of the March outflows. As portfolio flows have turned positive once more, the reversal in equity movements have lagged portfolio EM Debt flows. Positive net equity flows have been estimated at approximately $9.2 billion in the second quarter compared to about $46.5 billion for EM debt.

	March 2020	April 2020	May 2020	June 2020
EM debt (bn)	-33.5	+21.5	+3.5	+23.5
EM equities (bn)	-55.2	+1.4	-1.7	+9.5

Source: Institute of International Finance as of July 2020.

Fundamentals Underpin Flows to Emerging Markets

While emerging market portfolio flows inevitably fluctuate during bouts of short-term volatility, there are a myriad of fundamental factors underpinning the long-standing trend for investing in EM assets.

Higher Growth, Lower Debt	Long-standing economic outperformance set to continue. Generally lower debt-to-GDP levels provide scope for more central bank action
Demographic Change	Younger populations and growing middle class underpin changing domestic economic landscape
Domestic Consumption	Increased urbanisation, rising affluence driving a consumer boom
Valuations	EM bonds trade at attractive valuations relative to DM peers

Higher Growth, Lower Debt EM growth has topped that of advanced economies for more than two decades. Even against the COVID-19 backdrop, the SSGA Global Macro and Policy Research Team forecast that EM economies, as a whole, will outperform in the downturn in 2020 and the rebound in 2021 (Figure 3). The nature of EM growth is evolving as improved infrastructure, employment, economic conditions and rising affluence is helping create stronger domestic consumption and diversify reliance on exports.

Figure 3
Emerging Market GDP Growth Maintains Lead

Real GDP Growth	2019 (%)	2020 (%) Forecast	2021 (%) Forecast
World	3.0	-2.8	4.7
Advanced Economies	1.7	-4.3	3.9
United States	2.3	-3.4	3.9
Eurozone	1.2	-6.6	5.0
Japan	0.7	-4.2	2.5
United Kingdom	1.4	-6.7	4.4
Developing Economies	3.9	-1.8	5.3

Source: State Street Global Advisors Global Macro and Policy Research Team, June 2020.

Demographic Change Many emerging markets have younger populations, which ensures a deeper pool of labour, lower healthcare costs compared to developed peers and a trend towards urbanisation that has transformed the economic landscape.

Domestic Consumption Strengthening economies and rising employment have driven improvements in the standard of living as competition for labour has boosted wages, which in turn is driving demand for better housing, restaurants, cars, holidays etc.

Valuations Emerging markets are still maturing and are prone to greater volatility and external shocks. As such, EM assets typically attract a higher risk premium. Compared to DM counterparts, EM equities trade on lower price-to-earnings multiples (albeit at high levels relative to history), while emerging market governments and companies pay a higher interest rate to borrow funds. While the gap with developed peers remains, the higher potential return is a key driver of investor demand.

Driving Investor Interest

Local currency EM bonds have rebounded strongly from the sell-off and yields have declined to new lows. Investor flows into EM debt often trail the change in the real yield differential between emerging and developed markets. US Federal Reserve interest rate cuts in 2019 had helped spur EMD gains and the Fed response to COVID-19 by further cutting rates to near-zero has highlighted the yield pick-up available on EM bonds at a time when developed market yields are anchored by widespread ultra-low policy rates.

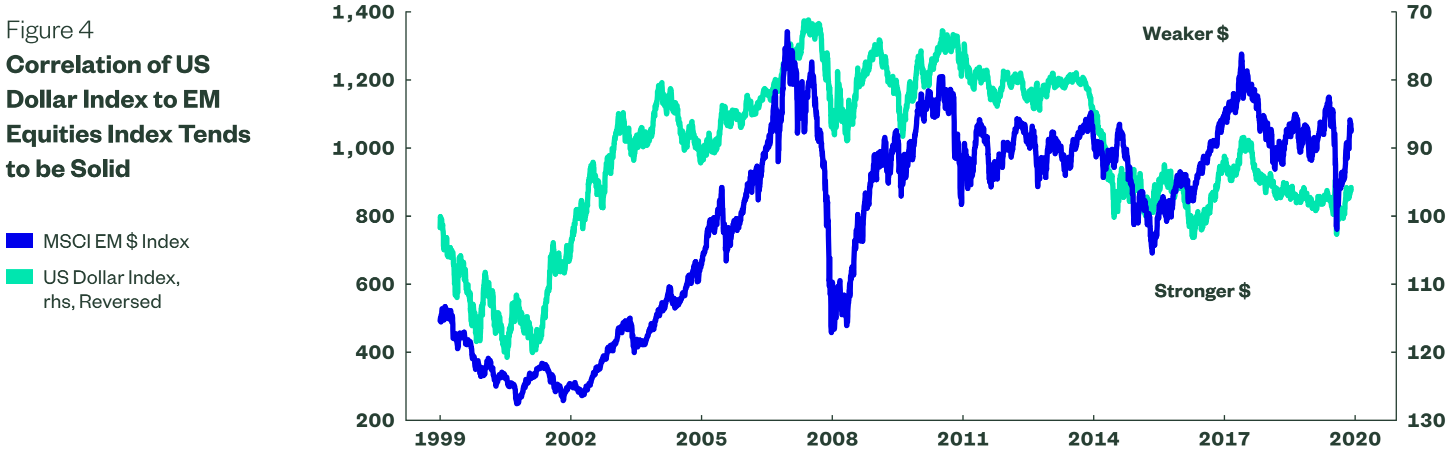
The near-term case for hard currency debt is less convincing, notwithstanding some improvement. Hard currency issuers are generally poorer and more exposed to this crisis from a health, humanitarian and economic perspective. And with borrowings in US dollars, these countries' bonds have continued to trade at relatively stressed levels.

The Currency Driver

Emerging market currencies entered this crisis undervalued against the US dollar and subsequently weakened even more. Historically, periods of undervaluation have been followed by strengthening of local currencies and that seems likely to play out again. That is an attraction for investors considering investment in local currency emerging market debt or in EM equities.

The correlation of the US dollar index to the EM equities index tends to be quite solid (see Figure 4). Some retracing of US dollar strength is likely as the crisis atmosphere normalises. This, together with the backdrop of low yields, quantitative easing, and the US Federal Reserve providing dollar liquidity, creates a favourable backdrop for EM equities.

Figure 4
Correlation of US Dollar Index to EM Equities Index Tends to be Solid



Source: Bloomberg Finance L.P., MSCI as of 17 July 2020. Past performance is not a guarantee of future results.

EM For the Long Haul

The long-term drivers of EM portfolio flows and the EM investment story remain largely intact, while the issues that hit hard during the COVID crisis have lessened in intensity. The flows out of EM assets have reversed amid investors' pursuit of returns. EM governments have been taking advantage of this interest and the low yield environment to issue debt. Meanwhile, EM currencies have steadied, and crude oil prices have rebounded from the steep declines that weighed heavily on sentiment during March. Furthermore, the International Monetary Fund has been quick to provide support to governments experiencing funding difficulties.

There is still a long way for the global economy to travel to recover and additional hurdles around trade-related issues and the substantial decline in tourism income are worries for many emerging markets. And for some countries, particularly in Latin America, the inability to control the coronavirus outbreak provides reason for caution. But while emerging markets remain vulnerable to risk sentiment, it should also be noted that many of them typically have more scope to implement fiscal and monetary measures to support growth.

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