EPFR

Informa Financial Intelligence

THOUGHT LEADERSHIP | REFLATION VS. INFLATION

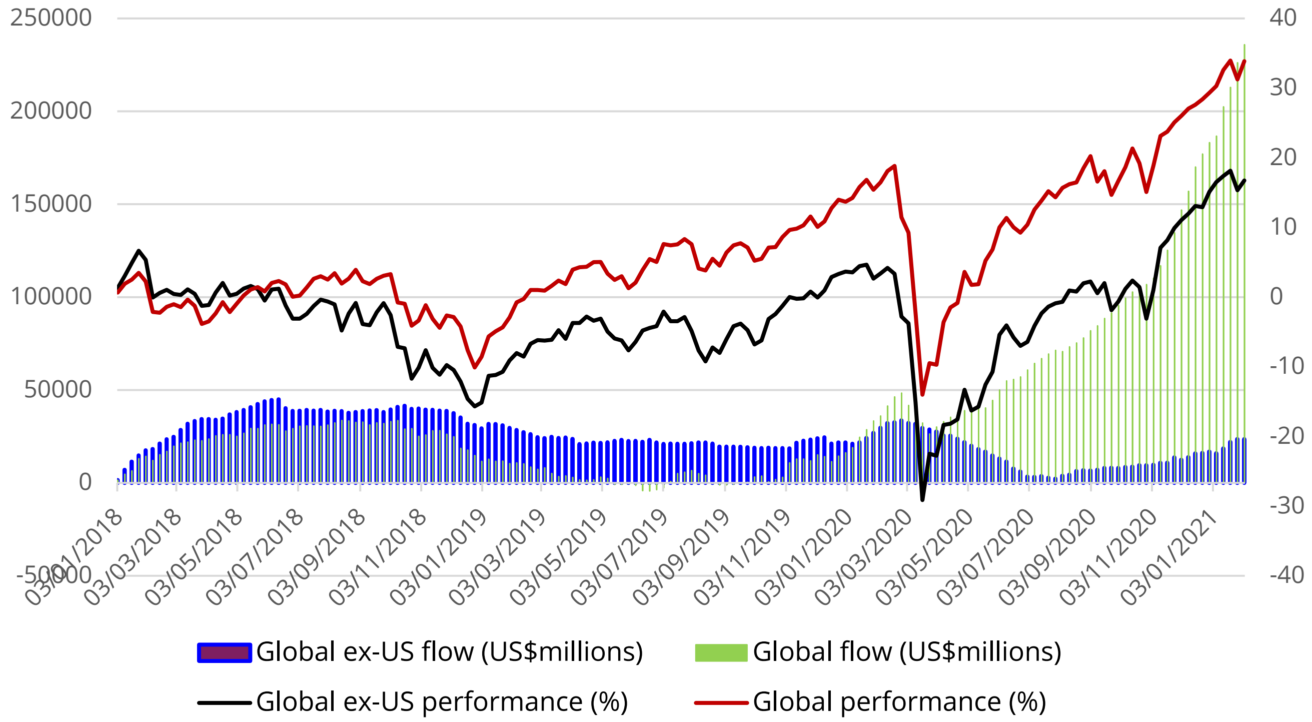
# Running hot...

What EPFR data and analysis tells us about global reflation and the chances a rising tide will also lift prices.

# Going for the global part of the reflation story (but staying close to the US)

Global Equity Funds have accounted for two thirds of headline inflows for all EPFR-tracked Equity Funds since the beginning of 2Q20. This has been driven by investors who sought exposure to the post-lockdown summer rebound and then positioned themselves for the vaccination-driven global reflation story.

**Cumulative weekly flows for Global and Global ex-US Equity Funds, 2018-YTD**



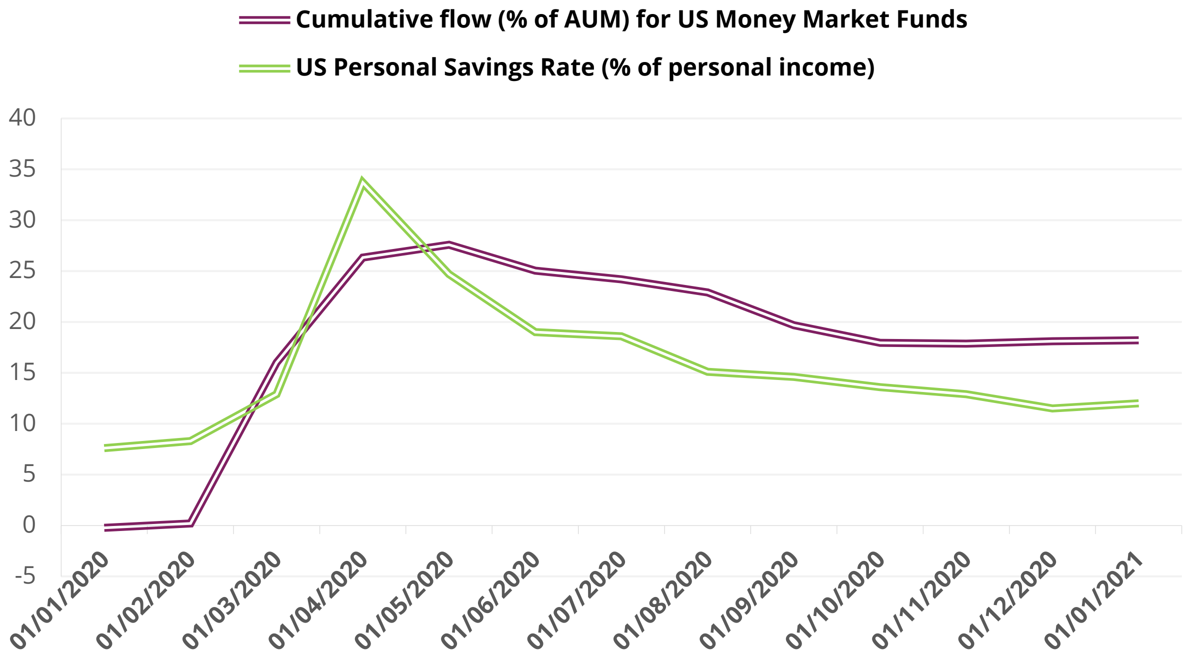

Over the past 10 months Global Equity Funds have broken their weekly inflow record three times - attracting fresh retail money for 41 out of 45 weeks. Funds with socially responsible (SRI) or environmental, social and governance (ESG) mandates have posted inflows 43 of the past 45 weeks.

In stark contrast to the period between 2013 and mid-2018, when Global Equity Funds with ex-US mandates attracted nearly three times the inflows recorded by their fully global counterparts, investors have turned away from Global ex-US Equity Funds for the past three years.

# No shortage of fuel for both reflation & inflation

The ‘excess’ cash in US Money Market Funds and retail savings products relative to pre-pandemic trends is estimated at around $3 trillion. The pre-pandemic US Federal Reserve’s balance sheet expanded by over $3 trillion and the European Central Bank’s by over $2 trillion.

**Cumulative flows to US money market funds and monthly US personal savings rate 2020-YTD**



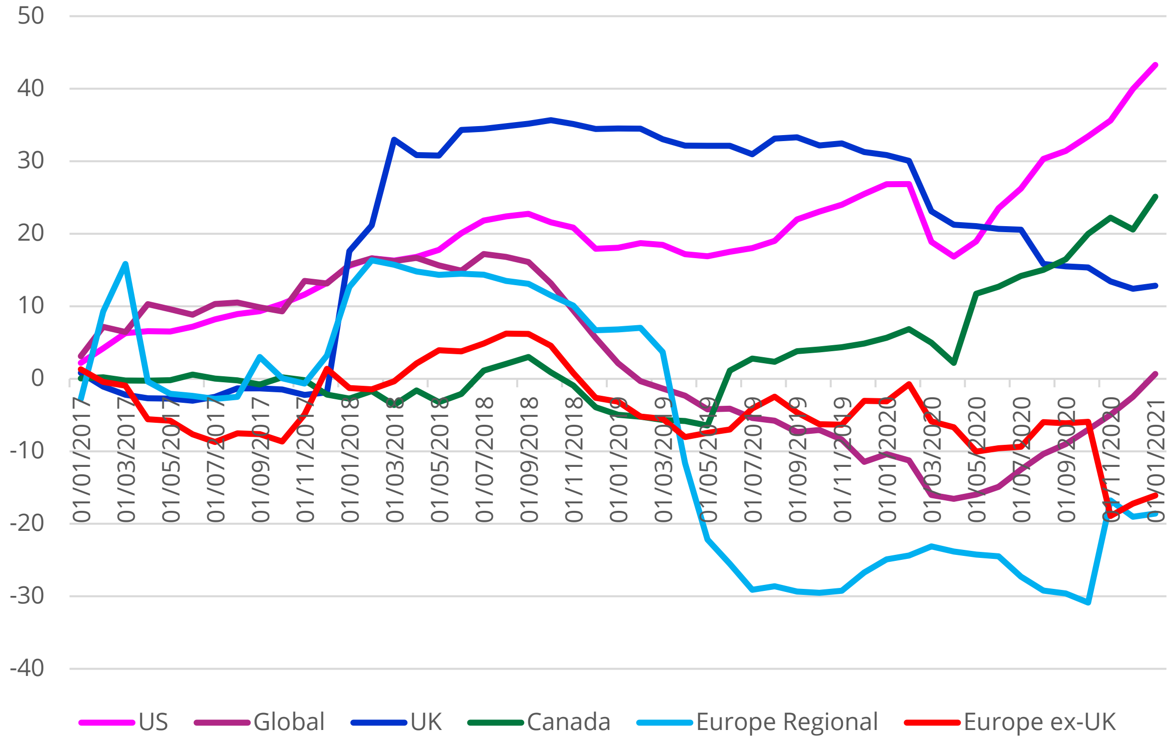

US President Joseph Biden’s administration is pushing for another fiscal stimulus package valued at US$1.9 trillion, which follows on the heels of the $2 trillion Cares Act in 1Q20 and the $900 billion pandemic relief package approved in late 4Q20.

Elsewhere, Japan has approved stimulus measures totalling some $3 trillion since the start of the COVID-19 pandemic, the European Union approved a $800 billion ‘rescue fund” that will be deployed over the next two years and China spent some $500 billion combating the economic effects of the pandemic.

# Fixed income investors taking out insurance

Flows into EPFR-tracked Inflation Protection Bond Funds surged even as the COVID-19 pandemic's first wave was cresting in early 2Q20, setting a new inflow record during the third quarter while US Treasury Inflation Protected (TIPs) Funds set new monthly inflow records in June and again in December.

**Cumulative monthly flows, in % of AUM terms, for major Inflation Protected Bond Fund groups, 2017-YTD**



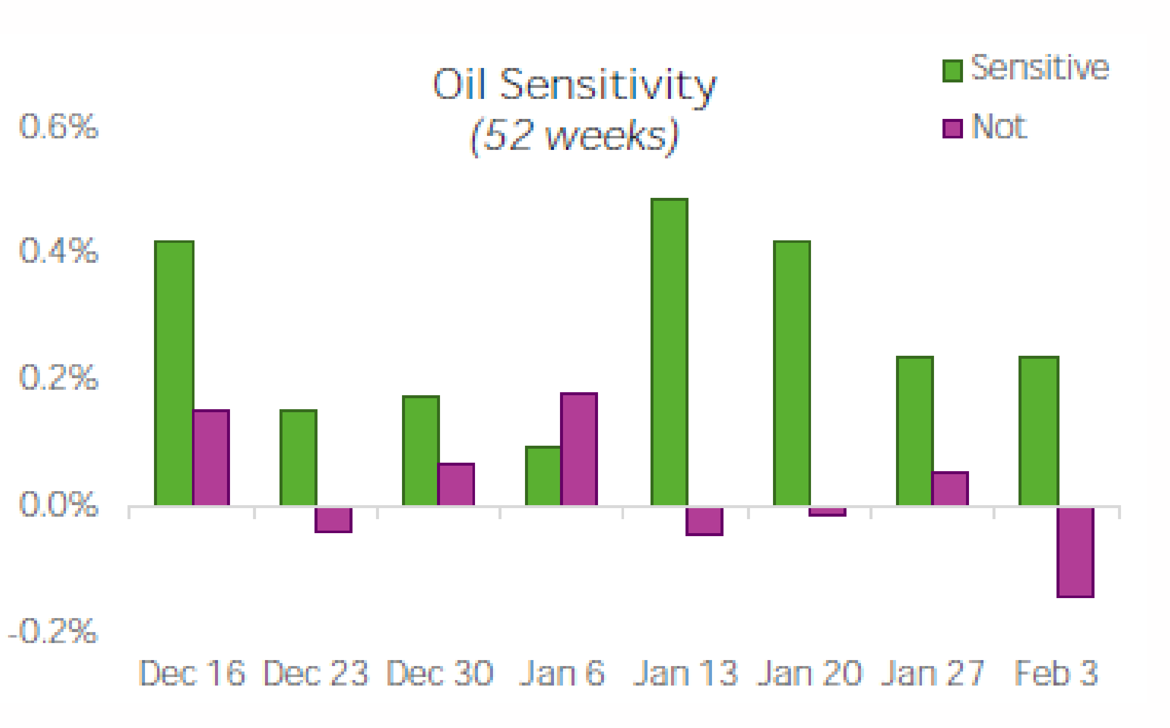

The current consensus for US inflation calls for headline inflation to move north of 2% in the spring - and stay there through the summer - before dropping back as consumers brace for possible spikes in the COVID-19 infection rate going into the winter.

Flows to UK Inflation Protected Funds took a hit when the country's government confirmed plans to align the current official measure of inflation with one that has historically delivered a lower reading.

# Oiling the wheels of a global recovery

Although the political and social tides are running strongly in favor of green energy, it will be some time before solar, wind and other sources have sufficient capacity to drive an economic expansion. Investors expect it will still be oil and natural gas that does the heavy lifting when the global economy stages a post-pandemic rebound.

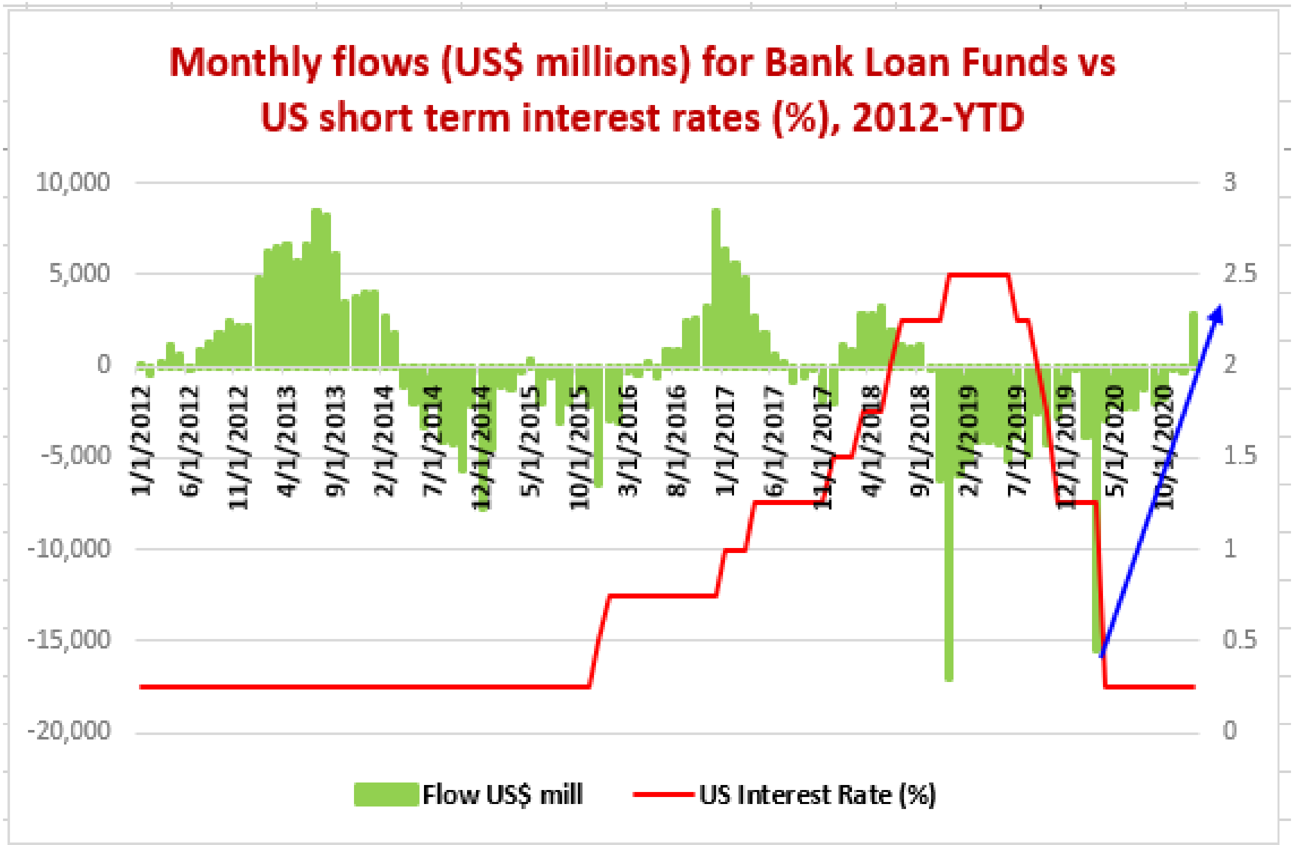
One of the factors EPFR uses to analyze its stock-level flow data is oil sensitivity, which divides stocks that have a positive correlation with rising oil prices (sensitive) and those that do not (insensitive) into separate baskets. Recent data shows oil sensitive stocks enjoying a substantial advantage over insensitive stocks as investors anticipate the increased demand that will come if the global reflation story materializes.




Expectations of increasing demand as warmer weather and vaccination programs rein in the COVID-19 pandemic are also reflected in broad flows to Energy Sector Funds. Year-to-date, net flows into this group are the largest among the 11 major Sector Fund groups tracked by EPFR.

# Banking on higher rates?

After two years on the back foot as US interest rates rolled over, Bank Loan Funds saw fresh money start to roll in coming into the New Year. Flows into these funds during January hit levels last seen in April 2018. That reflects a consensus among some investors that the global recovery will run hot, pushing inflation out of the US Federal Reserve's comfort zone and putting interest rate hikes back on the table as early as 1Q22.



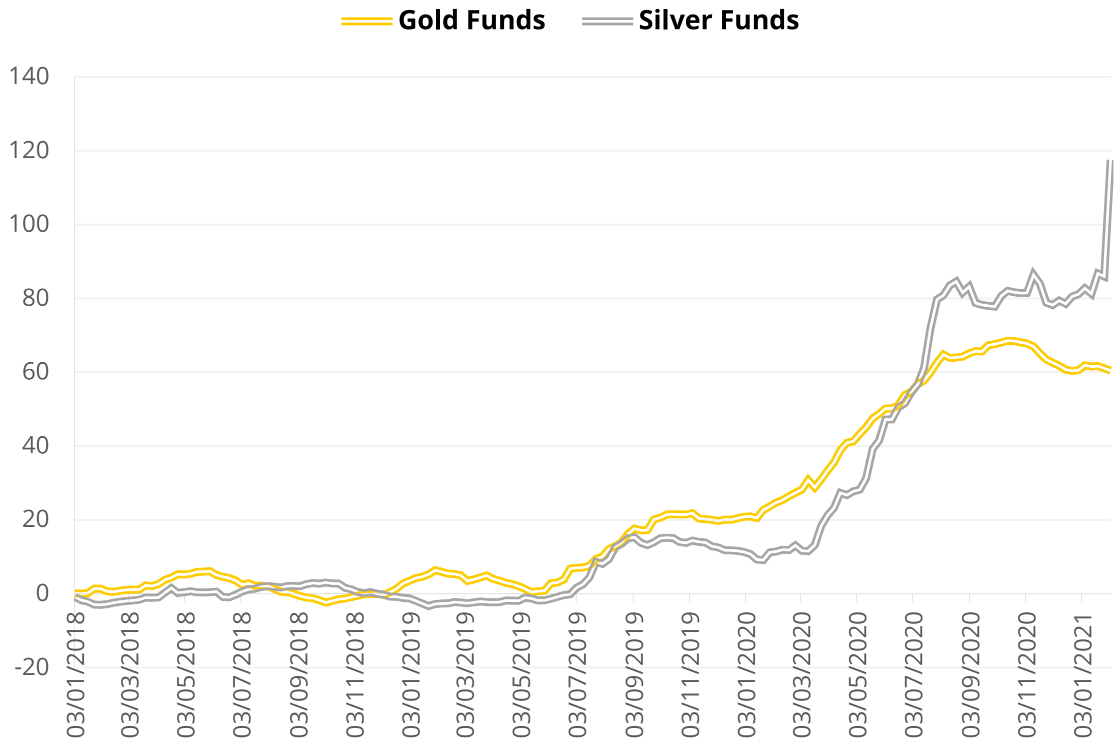

Bank, or floating rate, loans come with variable interest rates that reset in line with short term rates. Funds dedicated to this asset class have historically been viewed as a way to play rising interest rates, especially in the US. These loans are usually utilized by companies with sub-investment grade credit ratings.

With yield hunger even more acute in Europe, where interest rates on investment grade debt are negative far out along the yield curve, banks have expanded their lending in this area. As a result, the European Central Bank is tightening its oversight of commercial banks with significant exposure to these loans.

# And the silver medal goes to.....

Although flows into both Gold and Silver Funds accelerated during the second half of last year, Silver Funds recorded – in relative terms -- the bigger influx of fresh money and carried some momentum into 2021. A surge of retail money in early February steepened the flow curve.

**CUMULATIVE FLOWS, IN % OF AUM TERMS, TO GOLD AND SILVER FUNDS, 2018-YTD**



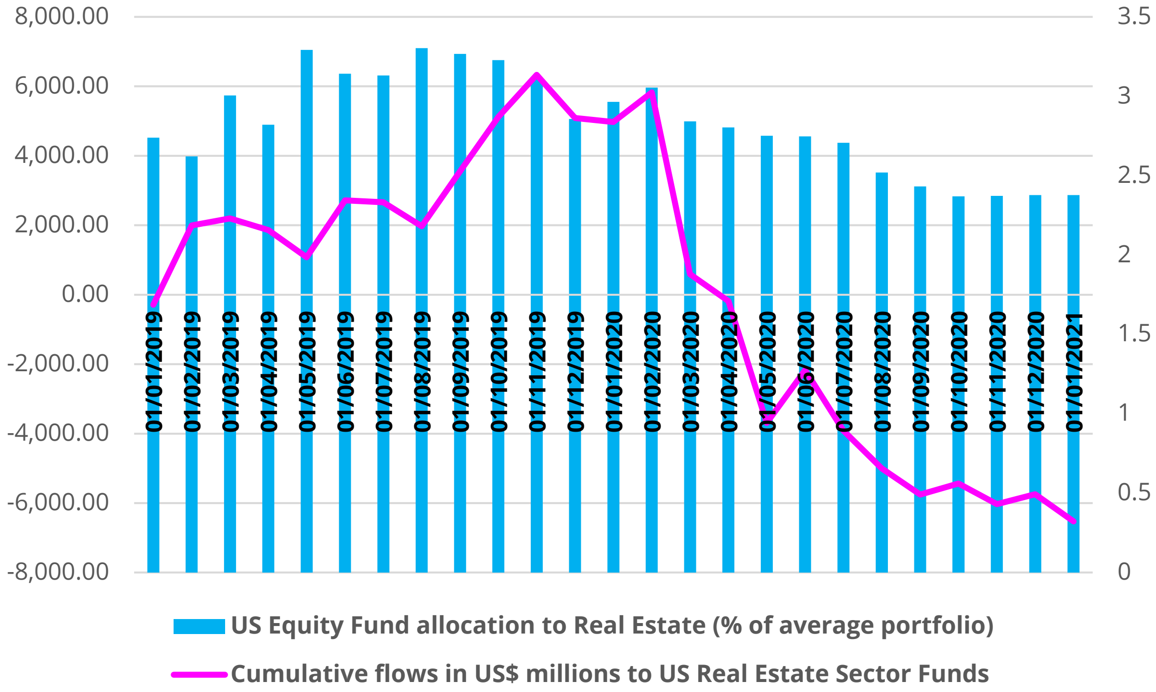

While gold has a long history as a hedge against inflation and the frailties of fiat currencies, demand for silver has a stronger correlation to industrial demand. Roughly 55% of the annual demand for silver comes from industrial users compared to some 15% for gold.

Among silver's industrial applications is the manufacture of solar panels, a product that is expected to see massive increases in demand as counties around the world shift to clean energy sources and invest in green infrastructure.

# In the US, not betting the house on inflation

At the sector level, real estate has historically been viewed as one of the better investments during inflationary periods. So far, however, neither investors or fund managers in the US are positioning themselves to take advantage. The US Real Estate Funds tracked by EPFR have seen over $10 billion redeemed since March of last year while the average US Equity Fund allocation has dropped by a fifth over the same period.

**Monthly flows to US Real Estate Sector Funds and average US Equity Fund allocation to real estate, 2019-YTD**

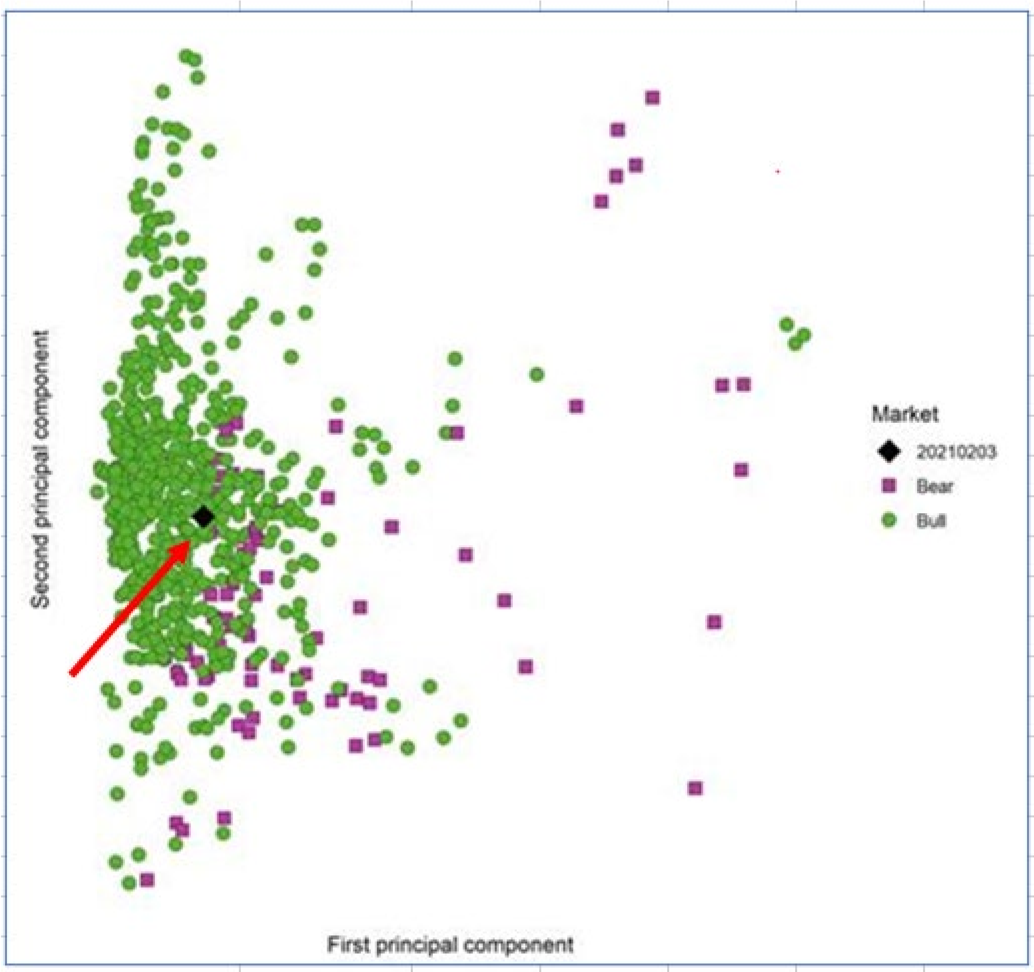



Fundamental issues tied to the pandemic are still influencing both managers and investors. Among these are the long-term implications for commercial real estate of the forced switch to remote working and the outlook for rental properties once state and federal support winds down.

Demand for residential real estate remains strong. Since 2012 the widely tracked Case-Shiller Composite House Price Index has climbed over 78% versus 13% for the Consumer Price Index (CPI).

# Is there a bear in the woods?

The broad market narrative and recent stock market performance suggest better days ahead, with a reflation of the global economy putting even more wind in the sails of major asset classes. EPFR's 'Bear Detector' model, which utilizes four data streams and eigenvectors to create, organize and map data points for every week since early 2Q07.



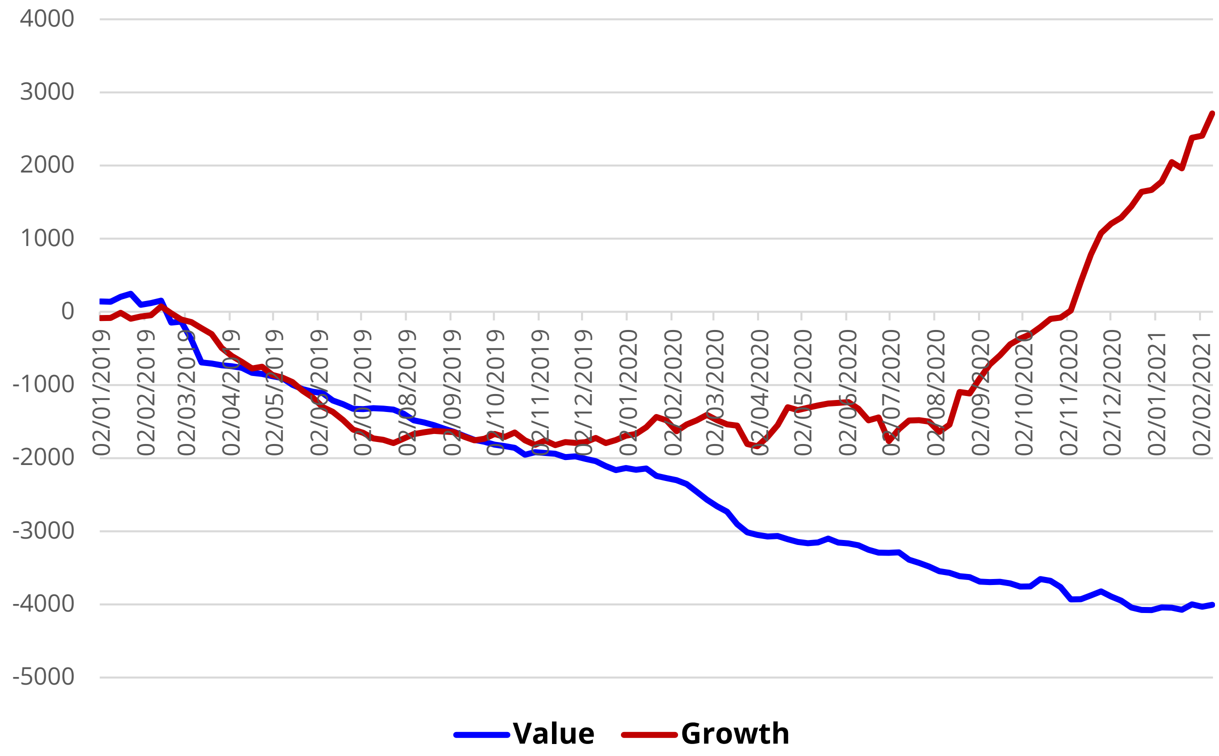

Those points that correspond to known bear markets are colored purple and those that correspond to bull markets are colored green, with the most recent point represented by a black triangle.  The result is a visual representation showing the "center of gravity" for bull markets and a dynamic illustration of where recent data points are in relation to that center.

The latest point is well within the body of 'bullish' points. But it is close enough to the frontier between the sea of green and the area inhabited by the 'bear' points to warrant treating the current consensus with a degree of caution.

# When it comes to emerging markets, investors betting on growth

Faced with a choice between growth and value, investors with an emerging markets focus are putting their chips on the former. EPFR-tracked Emerging Markets Equity Funds managed for growth have recorded inflows 25 of the 27 weeks since mid-August. During the same period, EM Value Funds have recorded just nine weekly inflows.

**Cumulative weekly flows (US$ millions) to Emerging Markets Growth and Value Funds, 2019-YTD**




The latest International Monetary Fund (IMF) full year forecasts estimate collective GDP growth for emerging markets will average 6.3% versus 4.3% for developed markets. Emerging Asia is projected to expand at a more than 8% clip.

Some level of inflation is a given for emerging markets investors. In 2019, over 90 emerging markets had inflation rates above the US Federal Reserve's target rate of 2%.

# When it comes to the sinews of economic growth, fund managers are diverging

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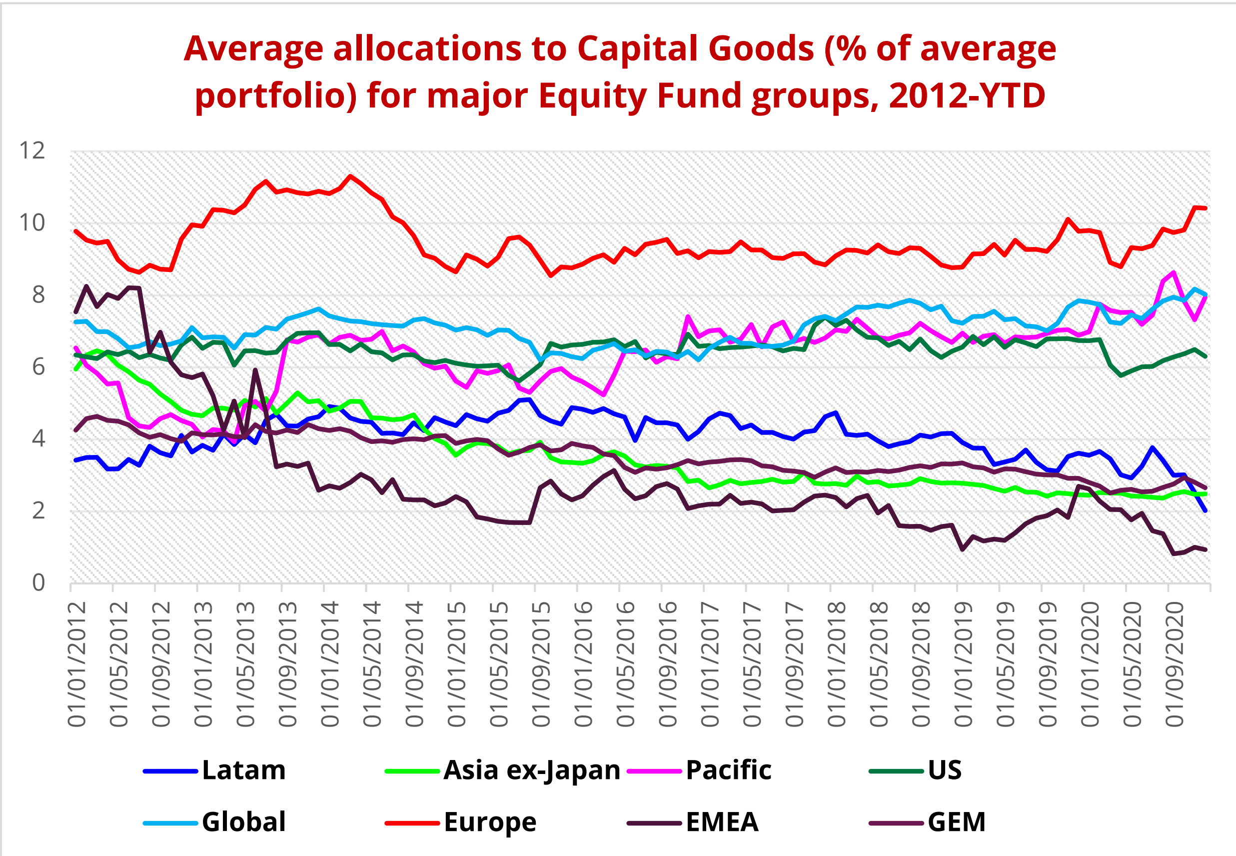


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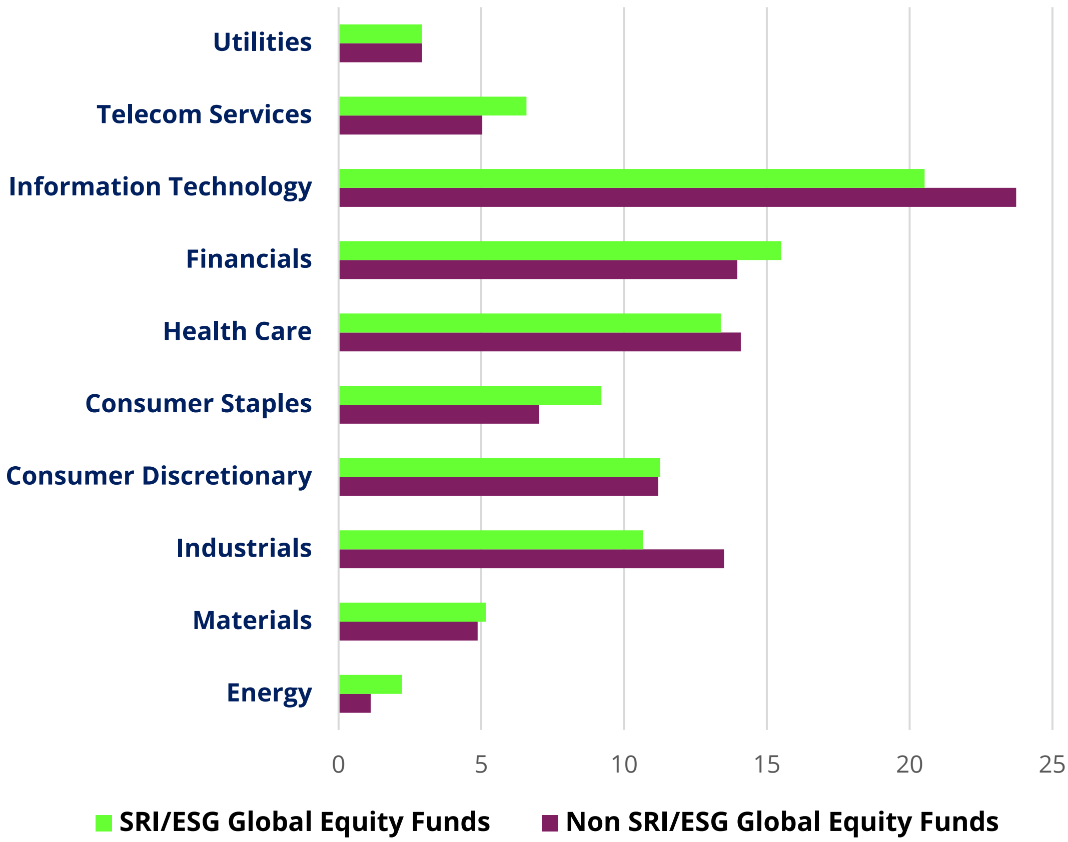
# A green vision of the immediate future

Based on flows over the past 26 months, funds with environmental, social and governance (ESG) or socially responsible (SRI) mandates will be the most reliable allocators of fresh money as the global reflation story plays out. A basic comparison of the current sector allocations for SRI/ESG and non-SRI/ESG Global Equity Funds suggests that the former still viewing the current year with caution.

**Sector allocations (% of average portfolio) for SRI/ESG and non-SRI/ESG Global Equity Funds**

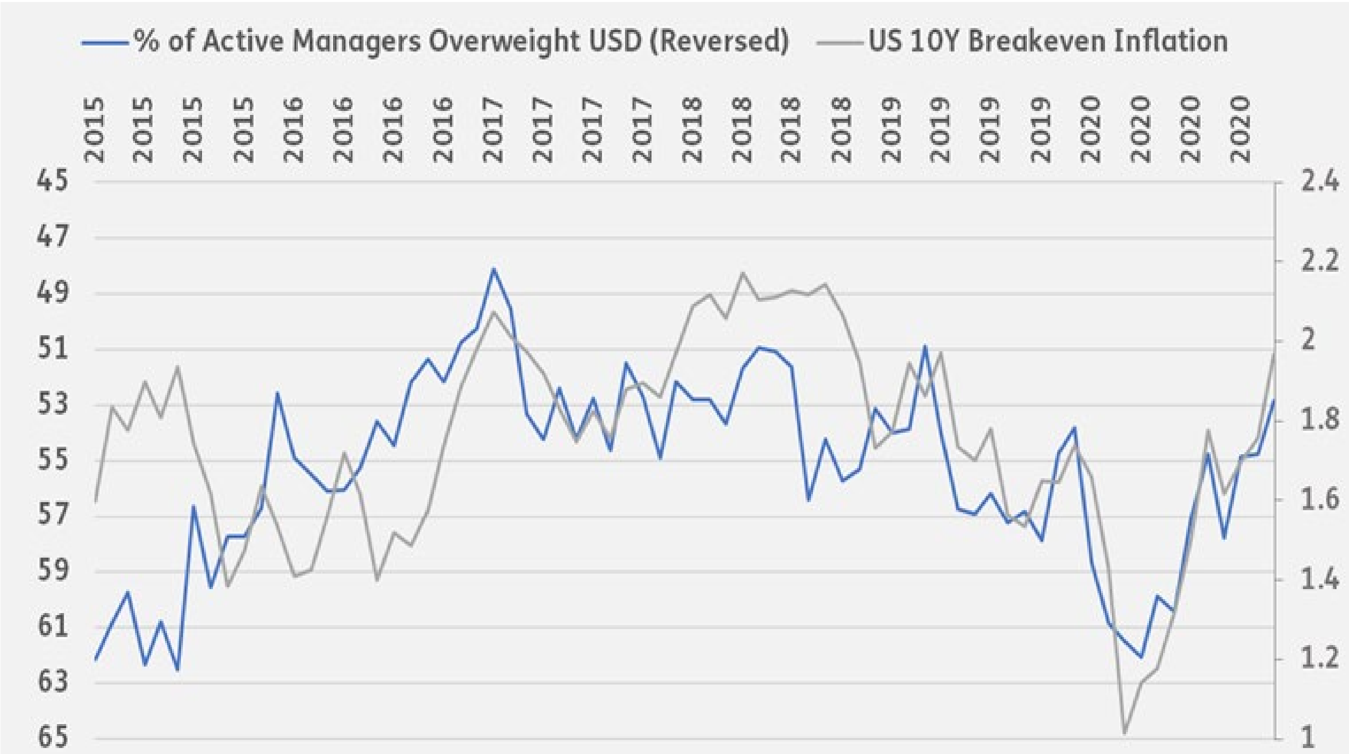



Compared to their non-SRI/ESG counterparts, managers of SRI/ESG Global Equity Funds are gravitating to defensive sectors such as telecoms and consumer staples while remaining relatively underweight technology and industrial stocks.

SRI/ESG Global Equity Funds do have greater exposure to energy plays than non-SRI/ESG funds. But those allocations may be influenced by expectations of greatly increased public spending on green energy and climate change initiatives rather than expectations for stronger demand in 2H21.

# Inflationary expectations nipping at dollar's heels

The share of actively managed funds tracked by EPFR who are overweight in their exposure to the US dollar is approaching a five-year low, another indication that financial professionals are taking the threat of higher than anticipated inflation in the world's largest economy seriously. As the chart below illustrates, there is a strong correlation between inflationary expectations and the unwillingness of fund managers to load up on dollar-denominated assets.

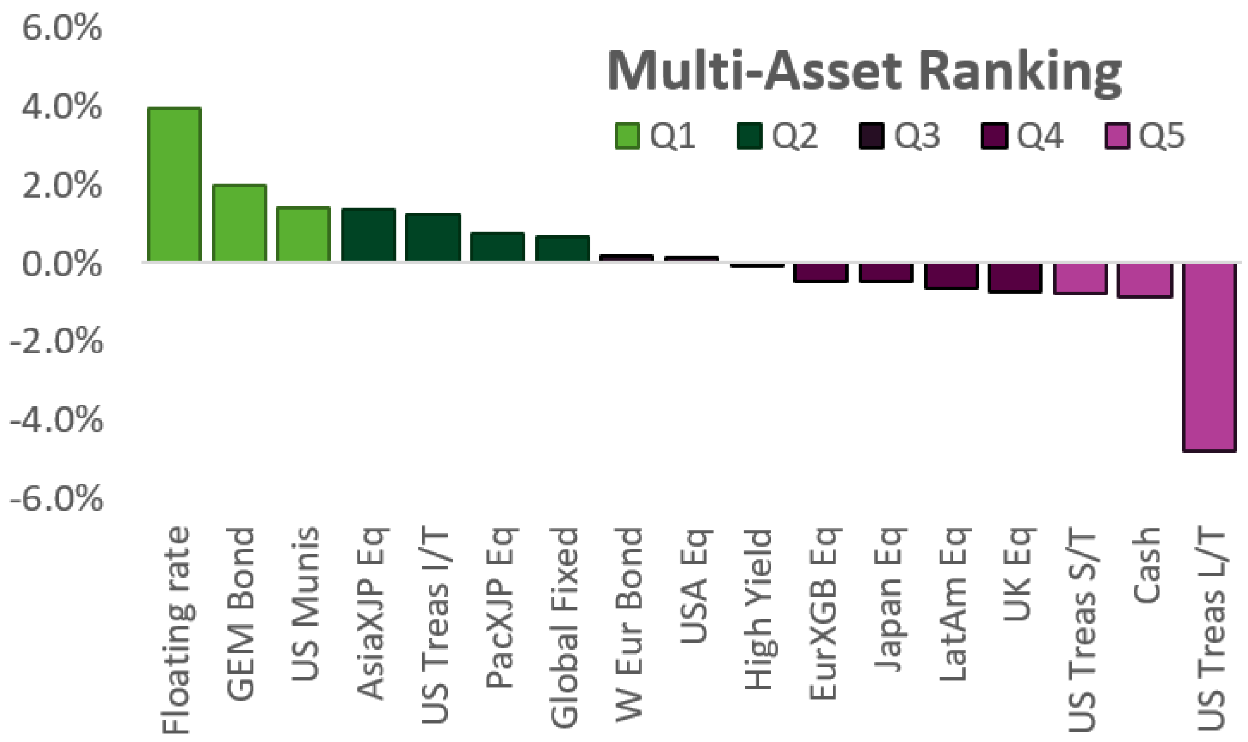



EPFR's FX Allocations data set is based on the FX positioning of over 600 mutual funds and ETFs. Each asset held by these funds is denominated in a specific currency. These weights are then aggregated to the currency level to arrive at the FX allocations.

While managers are cutting their exposure to US dollar-denominated assets, the number of active managers who are overweight the Canadian dollar is close to a record high. The "loonie" is viewed as a commodities-driven currency that will benefit from the global reflation story.

# Floating to the top of the rankings

Floating rate debt, an asset class that usually gains in popularity when interest rates are rising, remains at the top of EPFR's weekly Multi Asset rankings. But the remainder of the asset classes in the ranking's top two quintiles are ambiguous when it comes to the driver – reflation or the threat of inflation – that is influencing allocations decisions.

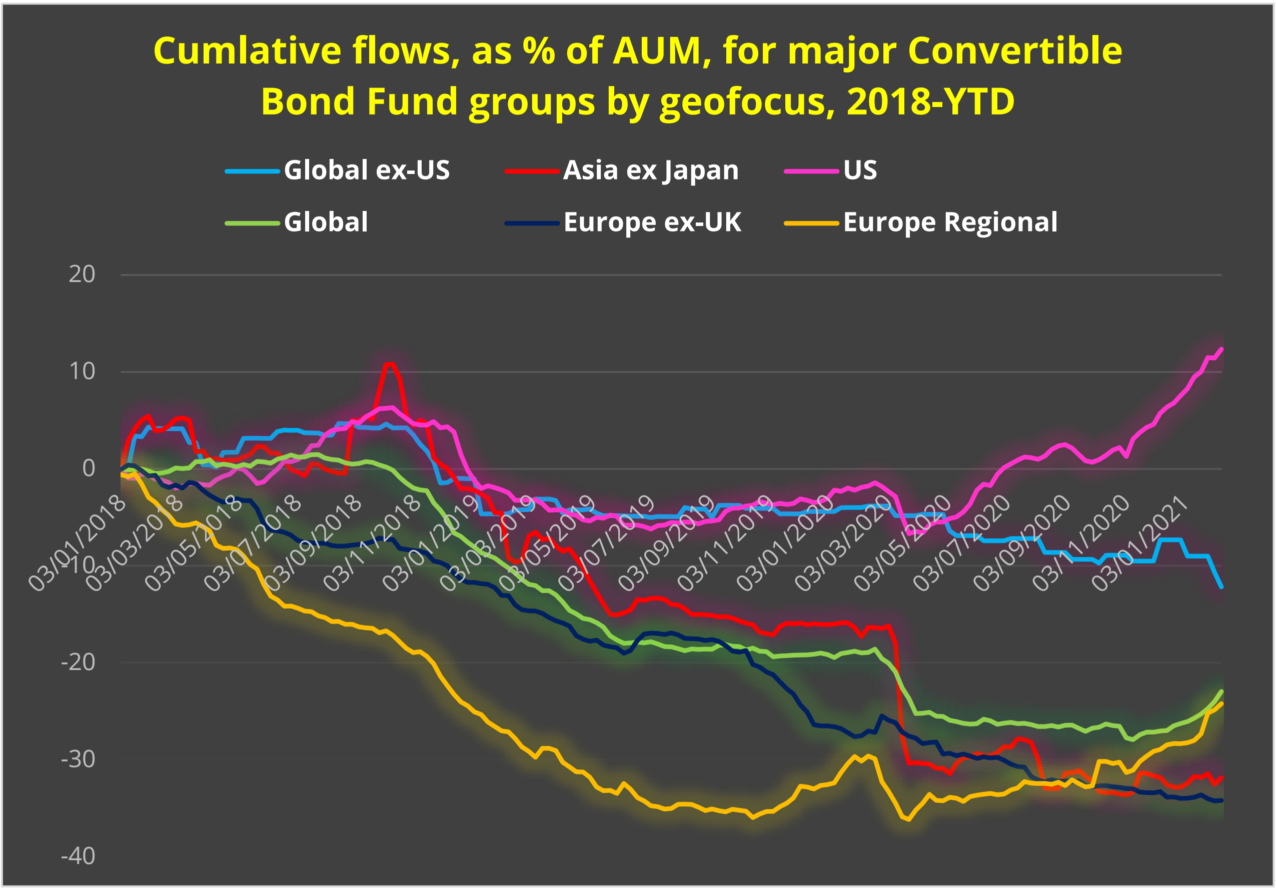



In several cases, current or anticipated government policies appear to be the main driver. Municipal debt has picked up tailwinds from expectations of greater federal support and higher taxes on the well off to pay for that support, while European Central Bank QE program and the EU's so-called Rescue Fund are underpinning demand for European debt.

EPFR uses flows into or out of a country or asset class as a percentage of assets held in that country or asset class, summed over the trailing four weeks, to predict future performance of -- and drive cross-sectional models for – equity and fixed income asset classes. The weekly Multi Asset rankings are based on this methodology.

# Keeping the door open with Convertible Bonds

EPFR-tracked Convertible Bond Funds recently posted a new weekly inflow record as they extended their longest run of inflows since a 25-week run ended in 3Q09. Convertible bonds give holders the right to convert it to stock in the issuing company, thereby providing some protection from duration risk if inflationary pressures force central banks to start raising rates.

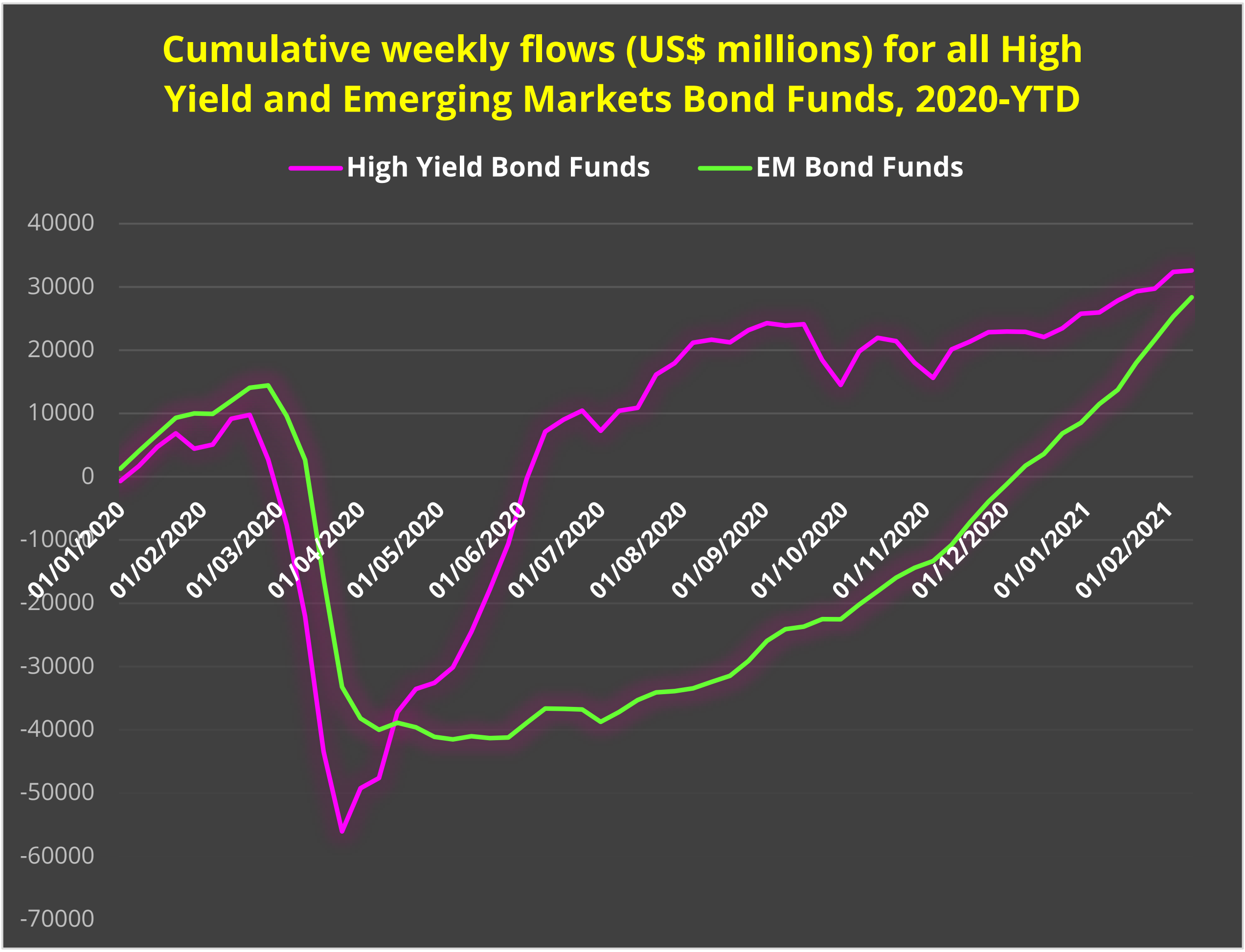



In terms of collective performance since the beginning of 2020, the Convertible Bond Funds tracked by EPFR are well ahead of High Yield Bond Funds, up 27% versus 3.7% for the latter.

Flows to Convertible Bond Funds with Asia ex-Japan mandates have been crimped by concerns that China's market for these bonds may be heading for a painful reset as regulators pay more attention.

# Mixed signals on the yield front

In the aftermath of the pandemic-driven sell-off in late 1Q20, the US Federal Reserve's decision to add some high yield debt to the asset classes it is willing to purchase lit a fire under flows to High Yield Bond Fund. But recently investors willing to stretch for yield have switched their focus to emerging markets debt




The Fed's explicit support, and its impact on junk bond yields which have fallen to record lows, has resulted in mutual fund investors treating high yield debt less like risk assets and more like low-risk government bonds. Global reflation is being interpreted as limiting default risks without appreciably adding to inflation risks.

Much of the recent influx of money into Emerging Markets Bond Funds has gone to China Bond Funds, which offer exposure to an asset class linked to a growing economy and denominated in a managed currency backed by the world's largest FX reserves.

# Retail flows rotating from equity to green and fixed income fund groups

While retail efforts to squeeze short sellers have dominated recent headlines, their engagement with mutual funds and ETFs has increased significantly since 2Q20 compared to the previous five years. They were early backers of the global reflation story, committing fresh money to both China and Global Equity Funds 41 of the 45 weeks since the beginning of 2Q20.

## Top 15 and bottom 15 fund groups, ranked by net retail flows since 4Q20

| Fund group | Net Flow in US$ millions |
|---|---|
| US Bond | 61,392 |
| SRI/ESG Equity | 38,651 |
| Global Equity | 35,977 |
| India Bond | 20,331 |
| Japan Money Market Funds | 16,697 |
| Technology Sector | 12,322 |
| China Equity | 11,285 |
| Inflation Protected Bond | 6,848 |
| SRI/ESG Bond | 5,407 |
| Municipal Bond | 5,031 |
| Asia ex-Japan Money Market | 4,899 |
| China Bond | 4,727 |
| Consumer Goods Sector | 4,481 |
| Energy Sector | 4,012 |
| Health Care/Biotech Sector | 3,934 |

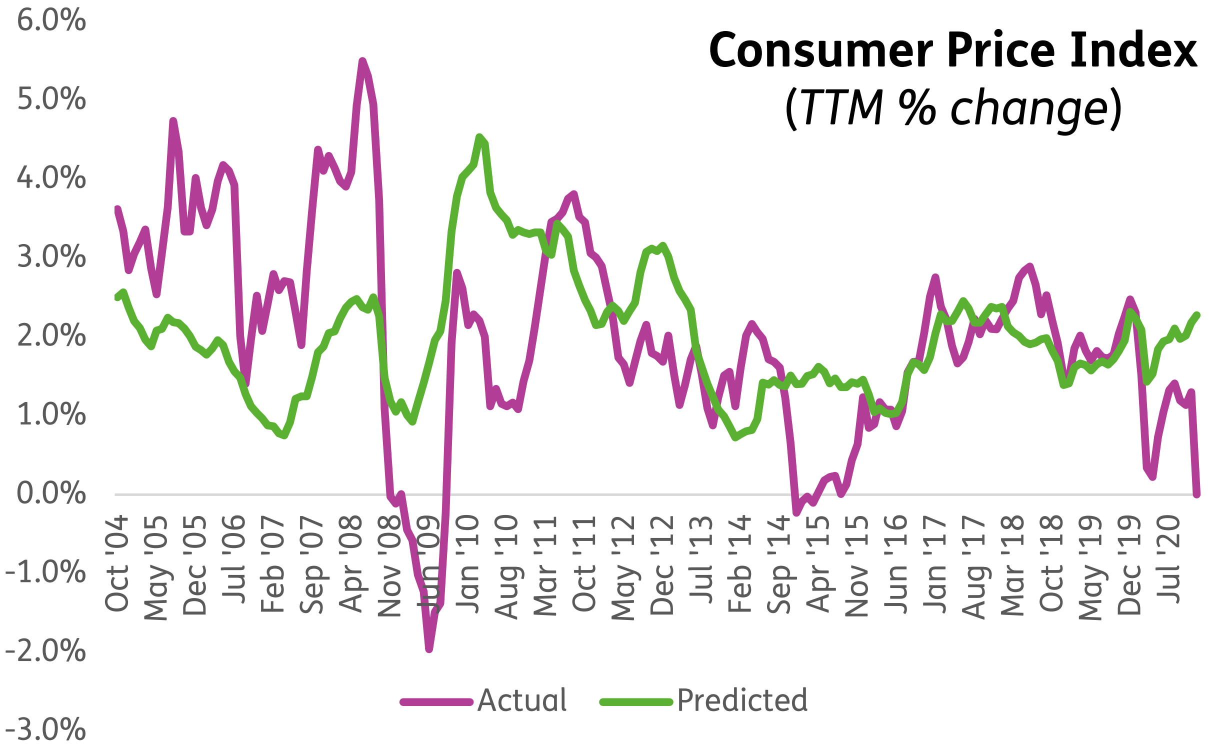
| Fund group | Net Flow in US$ millions |
|---|---|
| US Equity | -77,555 |
| Balanced | -28,027 |
| Dividend Equity | -20,901 |
| US Money Market | -11,886 |
| India Equity | -9,337 |
| Japan Equity | -7,555 |
| Western Europe Bond | -5,354 |
| Total Return Bond | -5,019 |
| High Yield Bond | -4,698 |
| Global Bond | -4,363 |
| Europe Money Market | -3,056 |
| United Kingdom Equity | -2,717 |
| Utilities Sector | -2,696 |
| Global Money Market | -2,455 |
| Bank Loan Bond | -2,053 |

Over the past five months, retail investors have rotated out of fund groups dedicated to US, Japanese and Indian equity, junk and European bonds, bank loans and multi asset strategies into US, India and China Bond Funds, China and Global Equity Funds, Inflation Protected Bond Funds, several major sector fund groups and funds with environmental, social and governance (ESG) or socially responsible (SRI) mandates.

Retail flows to China Equity Funds are now substantially greater than they were in the run-up to the Chinese market correction during mid-2015.

# For now, predictions for inflation and the official numbers keep diverging

What is quantitative analysis of EPFR's data saying about the likelihood of a spike in prices as the US economy heats up? A predictive model built by EPFR's quant team to gauge future inflation trends suggests prices growth will pick up. But official data, for the moment, continues to diverge.

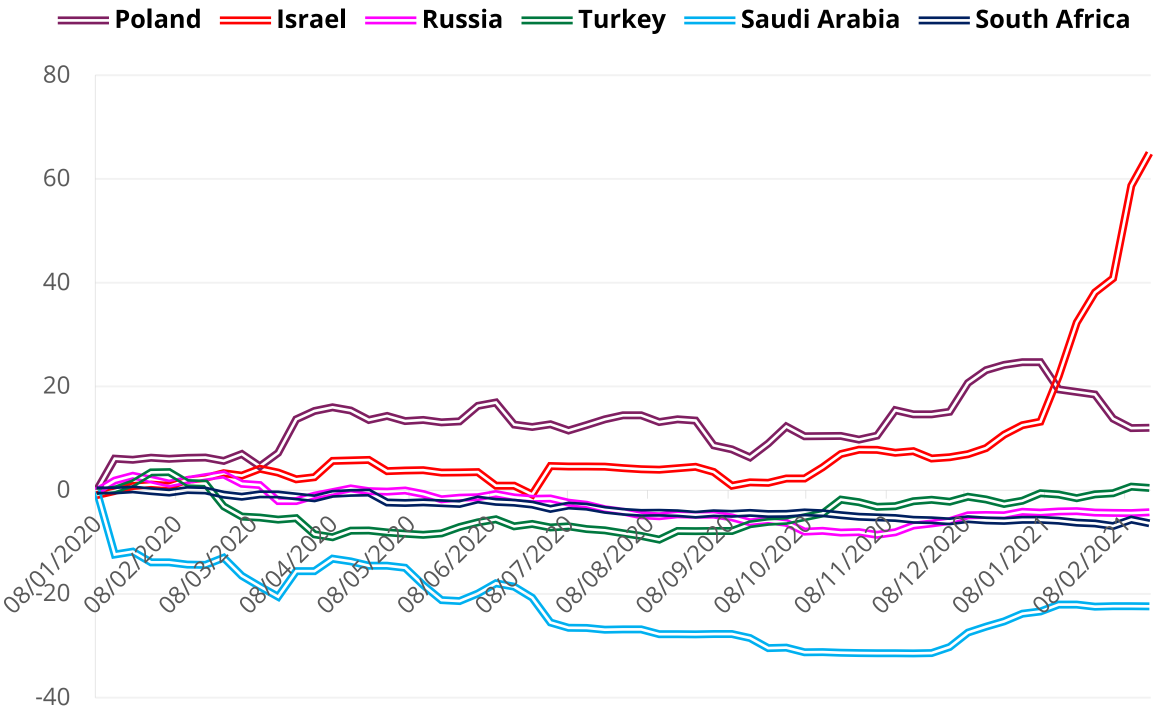



The model calculates monthly flows for a range of fund groups as a percentage of total assets, then whittles the pool down so that only the groups with significant t-statistics, a measure of predictive power, are retained. The groups that make the cut based on their t-statistic are then combined into a single multi-variate model that predicts the US CPI rate for the month ahead. Over the past 15 years the model has a solid record of anticipating monthly US inflation trends.

# Israel taking the road most vaccinated

With freedom from the measures needed to contain the COVID-19 factor a key element in the global reflation narrative, Israel's position as the runaway world leader when it comes to vaccinating its population has played well with investors. Assets managed by the dedicated Israel Equity Funds tracked by EPFR have nearly doubled since the beginning of 4Q20.

**NET WEEKLY FLOWS, IN % OF AUM TERMS, FOR MAJOR EMEA COUNTRY FUND GROUPS, 2020-YTD**



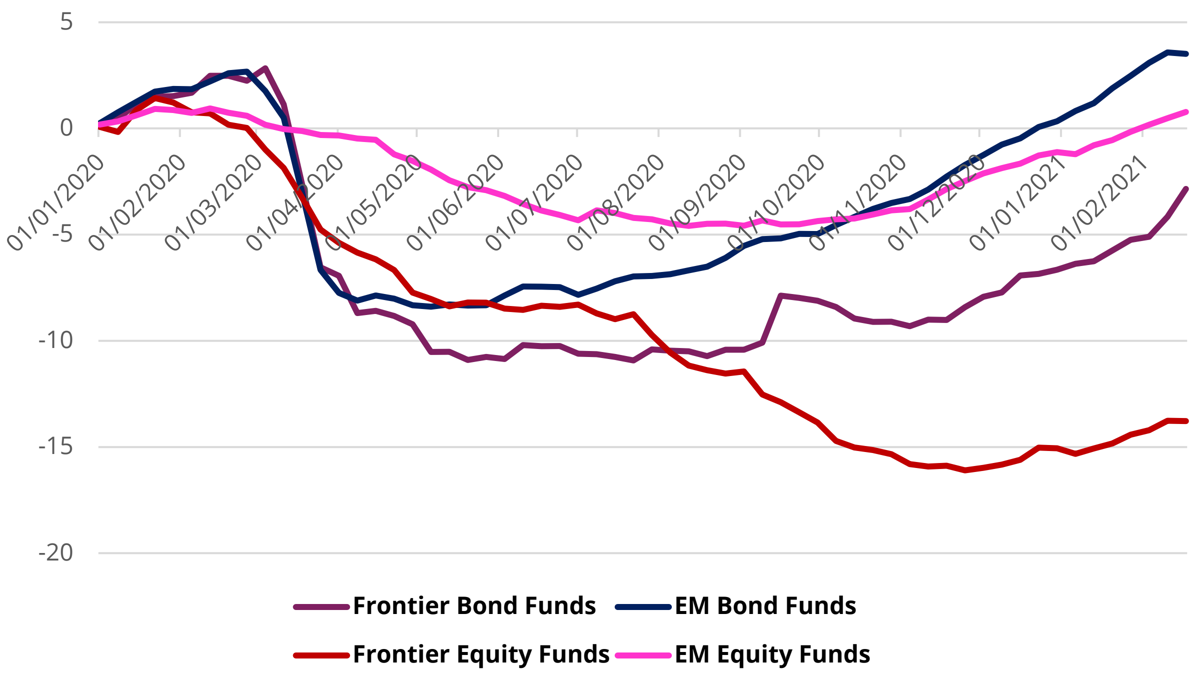

While its progress towards a fully vaccinated population has been the key driver of fresh money into Israel Equity Funds, that fund group is also benefiting from two additional tailwinds. The first is the country's reputation for cybersecurity expertise. Demand for this service has increased sharply since the news broke of the SolarWinds data breach in the US.

Improved relations with several Gulf States, codified in last year's Abraham Accords, have also prompted investors to revisit Israel's investment case.

# Getting to the frontiers of emerging markets exposure?

Funds dedicated to frontier markets, the riskiest and least developed cohort of the emerging markets, saw flows pick up several months after the upswing started for Emerging Markets Bond and Equity Funds in mid-2Q20 and late 3Q20 respectively. Some investors view rising flows to frontier funds as a signal of peak interest in emerging markets, other as vote of confidence that the tide of global reflation will lift all boats.

**Cumulative weekly flows (% of AUM) for Emerging and Frontier Markets Equity and Bond Funds, 2020-YTD**



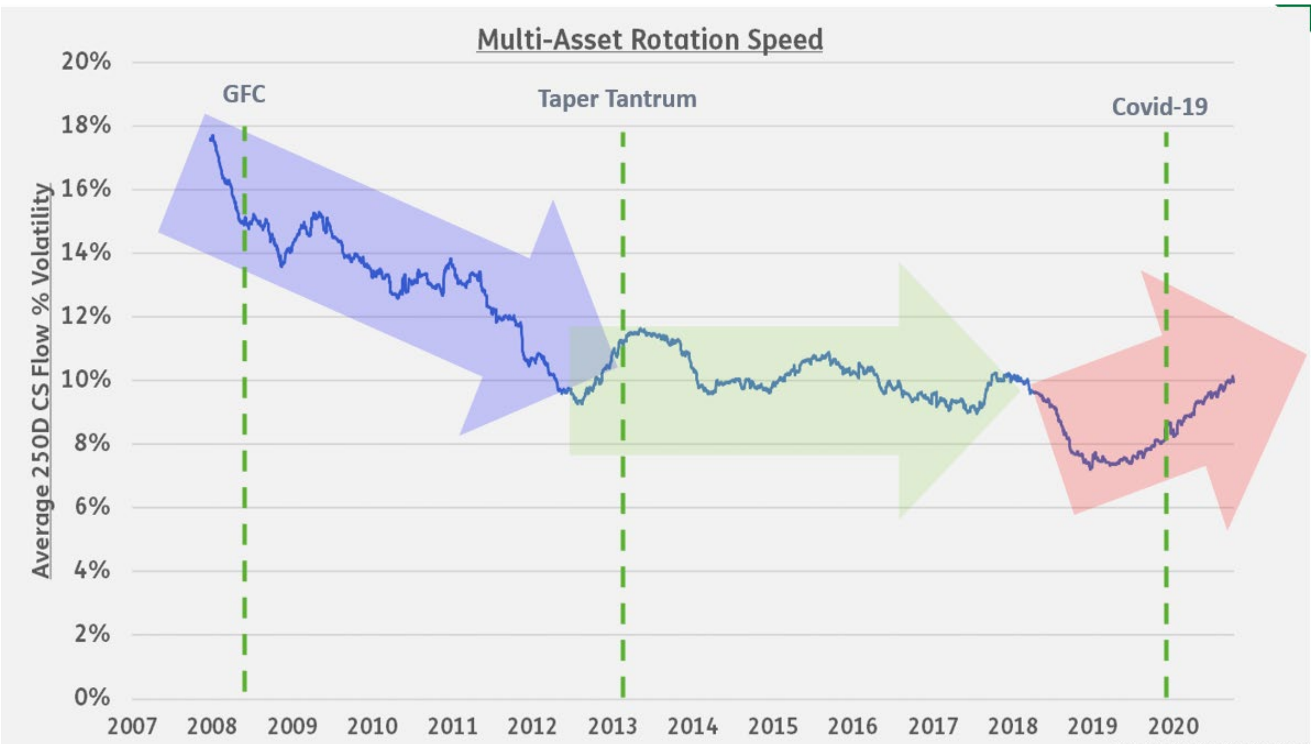

During the week ending Feb. 17, Frontier Markets Equity Funds saw their longest run of inflows since early 2018 come to an end while Emerging Markets Equity Funds posted their 20th inflow in the past 21 weeks. Frontier Markets Bond Funds, meanwhile, recorded their biggest inflow since mid-September during a week when Emerging Markets Bond Funds posted their first outflow since late September, snapping a 19-week inflow streak.

Vietnam is currently the biggest single country allocation among EPFR-tracked Frontier Markets Equity Funds. Egypt is the EMEA market with the biggest average weighting and Argentina among the Latin American markets.

# Reflation vs inflation as a catalyst for volatility

The possibility that the global reflation story will be accompanied by significantly higher inflation is an unsettling one for investors and fund managers. Will the tension between the two visions of how 2021 will play out inject higher volatility into financial markets? Analysis of EPFR data suggests this may already be happening.

Building on the observation that, as price volatility declined between 2012 and 2018 so did the dispersion of flow among different asset classes, EPFR's quant team set out to create a measure of implied volatility.  To do so they plotted the cross-sectional standard deviation of flows, averaged over a rolling year period, to create a measurement of the rotation speed between asset classes.




Since 2019 this rotation speed has increased steadily, with the pandemic that started in 1Q20 providing another tailwind for this shift. One key difference this time around is that, although the central banks are again throwing nearly everything in their toolbox at the pandemic-induced recessions, the rotation speed has continued to accelerate.

A more detailed discussion of this measure and the signals it is sending can be found by following the link below: [https://financialintelligence.informa.com/resources/product-content/quants-corner-is-volatility-coming-out-of-the-doldrums](https://financialintelligence.informa.com/resources/product-content/quants-corner-is-volatility-coming-out-of-the-doldrums)

## ABOUT EPFR

Informa Financial Intelligence's EPFR, a subsidiary of Informa plc (LSE: INF), provides fund flows and asset allocation data to global financial institutions gleaned from a universe of over 133,000 share classes domiciled globally encompassing over $45 trillion in assets. Our data helps portfolio managers, asset allocators, strategists and research teams generate alpha by giving them a clear picture of where money is moving, how fund managers are investing that money, and what impact those shifts are having on geographies, sectors, industries and securities.

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