EUR and Equity Flows: Bounce Around the Corner?

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FX FLOW PULSE December 3, 2019 by Jens Nordvig

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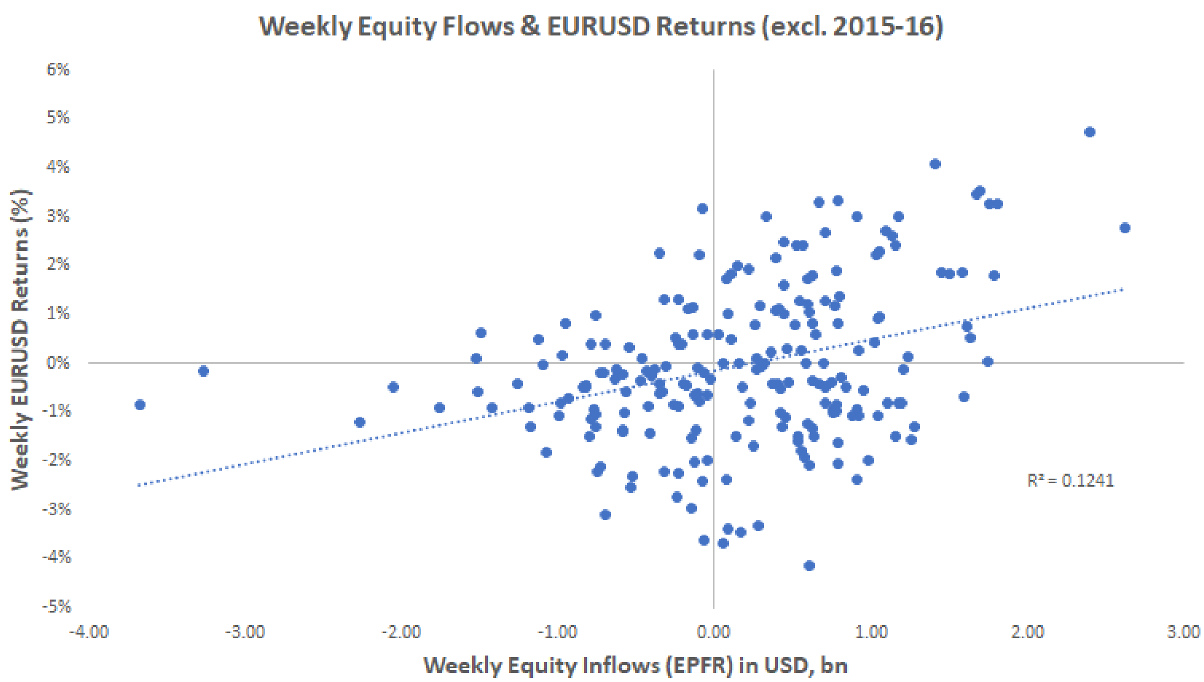
Eurozone equity flow indicators are showing consistent improvement over the past 1-2 months. In the past, medium-term turning points in equity flows have also marked turning points for EURUSD. Hence, it is logical to ask if a Euro bounce is around the corner; signs of bottoming global growth would certainly be an argument in favor of a EURUSD bottoming process. Additionally, hedging indicators are not looking extreme like in 2015, when large inflows to the Eurozone were mostly FX neutral. Hence, better equity flows should have some impact in this cycle. But the power of equity flows may be weaker than around key turning points such as 2011, 2013 and 2017. First, it seems that outflow are increasing meaningfully too and have greater potential to dominate the inflows. Second, the link between growth and rates is weakened, in a regime of more extreme ECB forward guidance. All told, we think improved equity inflows can support the Euro, although outflow momentum may matter more than in the past. Moreover, the 10-15 big figure EURUSD moves we observed around past turning point in equity flows may not be realistic on this occasion without rates support.

Eurozone equity flows and the EUR: The historical pattern

Over the past few months, we have been focused on the potential for an improving trend in US equity outflows (link) including signs of a pickup in Eurozone equity flows linked to better growth sentiment.

Those flows have attracted our attention because of their historical correlation with EURUSD, and because regime shifts in these flows have also coincided with turning points for the EUR in the past (see appendix).

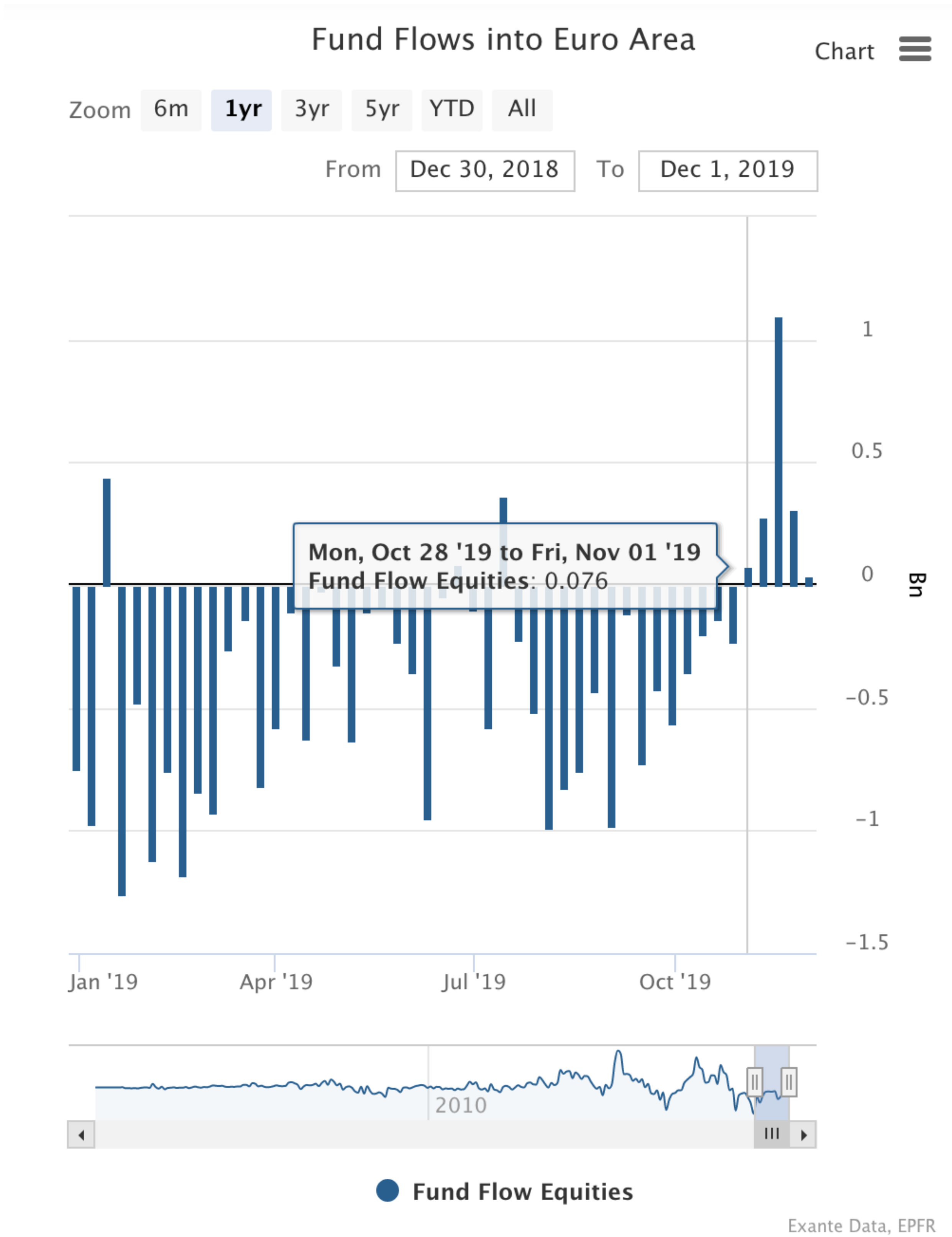
The scatter chart below shows that equity flows are correlated with EURUSD returns. Such return correlations are never super-high. But the link is clearly there in a coincident
fashion.



The correlation does not always work, however. In 2015, there was a major spike in equity inflows, linked to hope that ECB QE would revive Eurozone asset markets. Hence 2015-2016 is excluded. But the correlation seemed to kick in again strongly in 2017-2018, when the ups and downs in growth sentiment and equity flows moved very much in tandem with EURUSD returns.

Recent trends: A pickup in Eurozone equity inflows across indicators

Turning to the recent developments, the chart below illustrates that mutual fund flow relevant for Eurozone equities have looked more positive for about 5 weeks, based on EPFR data (with better flows starting around Oct 28, as highlighted). Compared to a very negative trend during all of 2019, and also the final three quarters of 2018. This is a potentially notable turning point.



Fund Flows into Euro Area
Chart
Zoom 6m 1yr 3yr 5yr YTD All
From Dec 30, 2018 To Dec 1, 2019
Mon, Oct 28 '19 to Fri, Nov 01 '19
Fund Flow Equities: 0.076
1
0.5
0
−0.5
−1
−1.5
Bn
Jan '19
Apr '19
Jul '19
Oct '19
2010
Fund Flow Equities
Exante Data, EPFR

Further, the improvement is also evident from a number of other equity indicators, although they are not equally up-to-date:

First, EFT flow, from the US to the Eurozone has looked more positive for 6 weeks, although the magnitude of positive flows is not huge (with better flows starting around Oct 21)

Second, our tracking of positioning within real money equity funds is showing a shift to overweight the EUR up to October (which is the last monthly data point available – link).

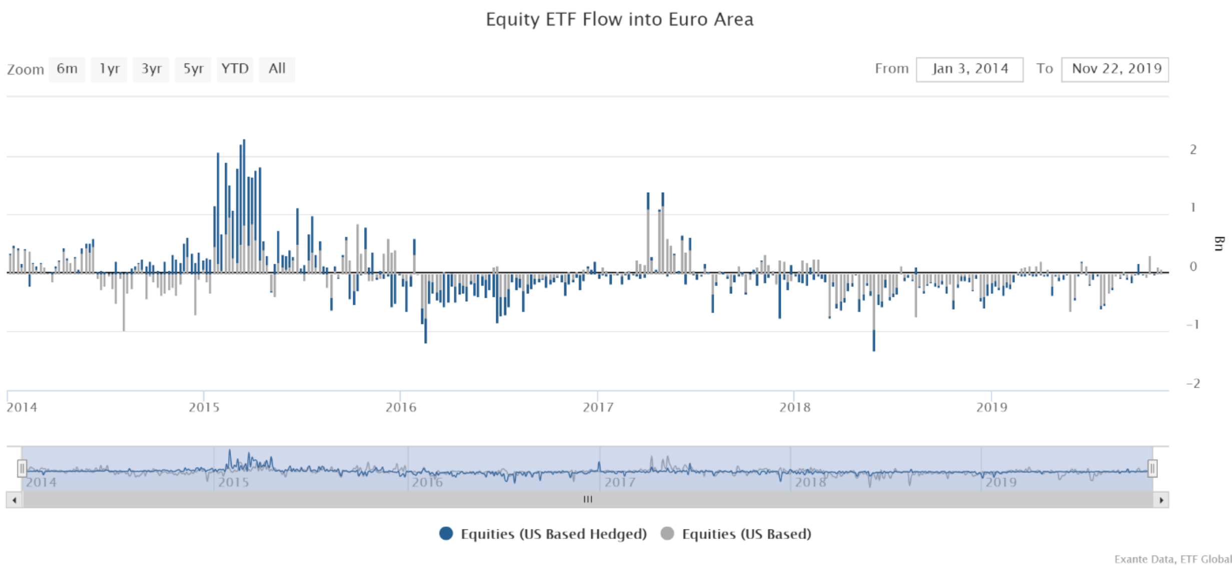
Third, official data, including balance of payments data, have shown better flows for some months, with ECB data pointing to better flows in June, July, August and September, and this is corroborated by US TIC flows available for June, July and August.

Equity flows and the EUR: The relationship today

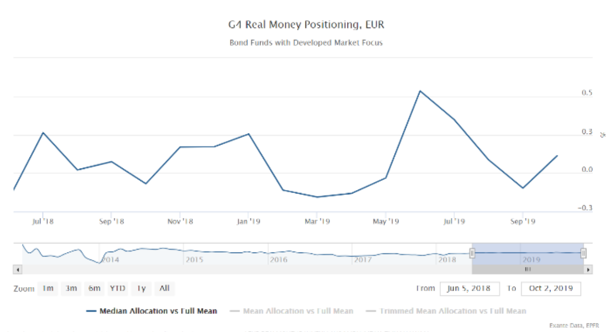
Hence, it is worth thinking hard about whether the improving equity flows to the Eurozone are flashing a turning point for the Euro too, as we have seen in the past. We think the following observations are relevant:

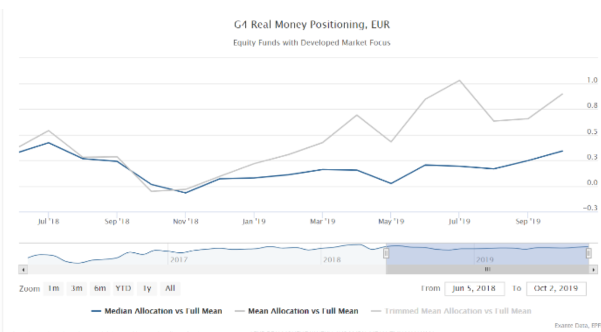
1) Recent fresh equity inflows do not appear to be FX hedged (as in 2015)

The latest ETF data does not show hedged flows as in in 2015 (inflows) and 2016 (outflows). In the 2015-2016 period FX hedging likely blunted the FX impact of the flow factor (along with QE driven fixed income portfolio rebalancing/outflows and forward guidance).



Furthermore, there is little sign of aggressive hedging from our real money positioning indicators ([link]()). In fact, if anything our real money indicators suggest that equity funds have been adding EUR exposure (some even fairly dramatically). Against this background, it is perhaps a bit puzzling that the Euro has derived little observable support from improved equity flows.

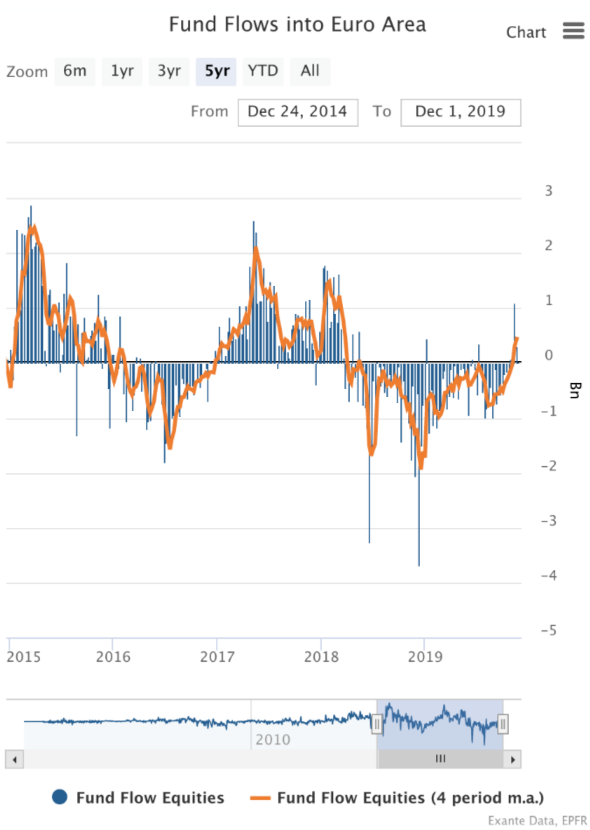


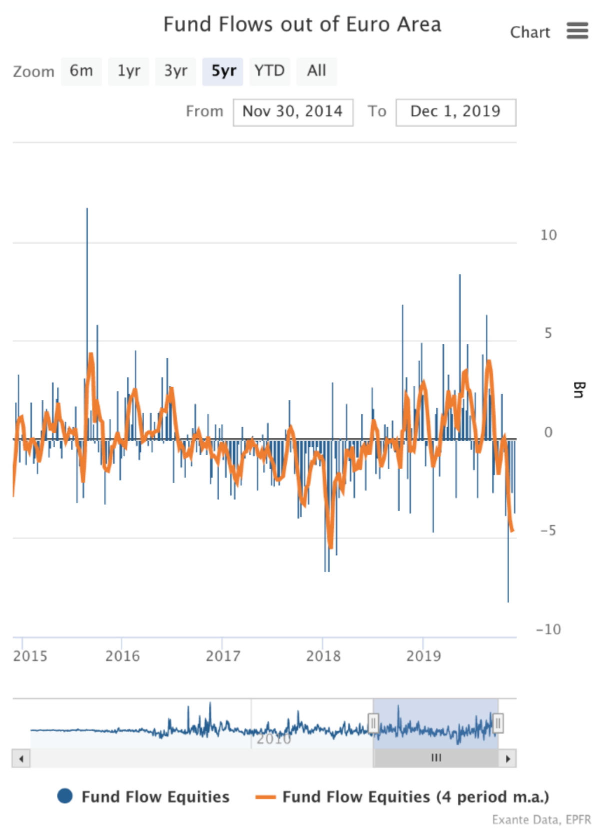


All told, we think the improved equity flows mapping into FX flows too, based on our hedging signals.

2) Inflows are correlated with outflows, and the outflows are seemingly increasingly volatile

The chart below puts the fluctuations in Eurozone equity inflows in the context of the variability of the outflows. The first observation here is that the average weekly flows are not huge. Hence, their relevance is more to do with signalling, than their nominal amounts.





The magnitude of the swing in equity flows is in line with the experience from previous turning points (or perhaps somewhat more moderate, based on the 4-week moving average in the chart to the left).

In contrast, the outflows, shown in the panel to the right, have arguably staged a more dramatic turn (a negative number in the chart signals outflows from the

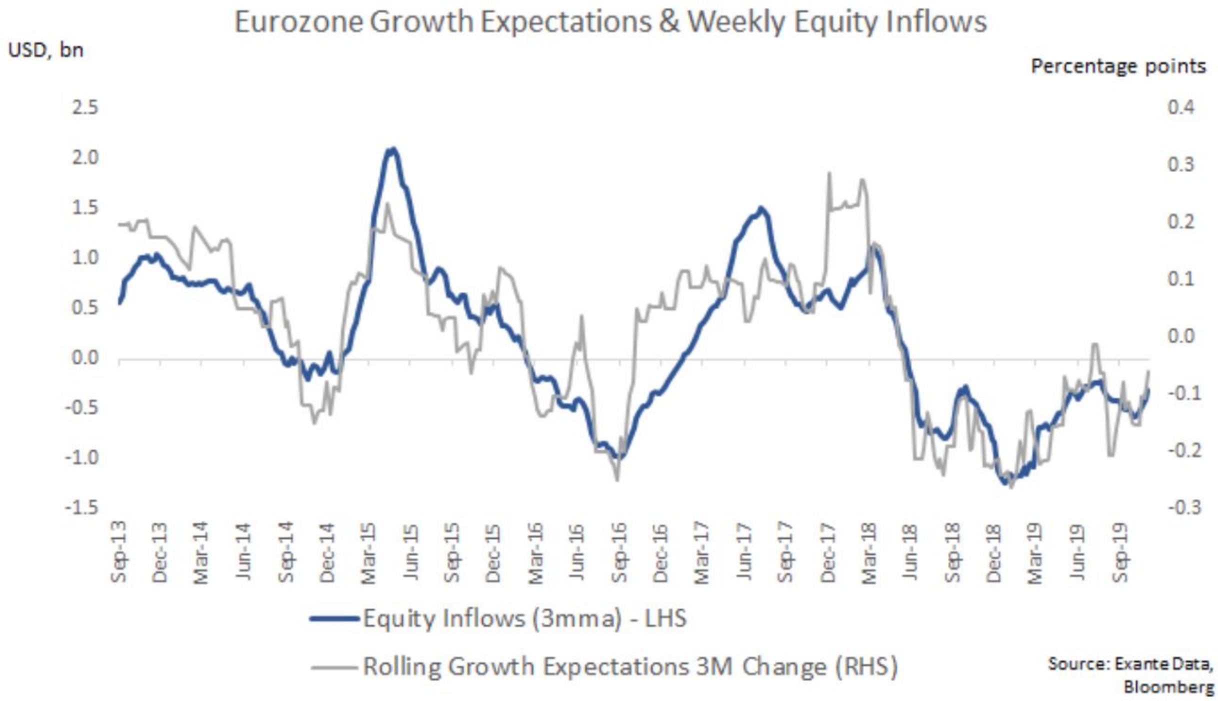
Eurozone and into foreign equity). This is the case in nominal terms, from nearly $5bn of weekly repatriation during the summer to nearly $5bn of weekly outflow over the past four weeks. But it is also the case relative to the series own history. A swing approaching $10bn in the weekly flow trend has not occurred in the past.

As such, it is possible that the greater variation in the outflows will have more importance today than in the past.

3) The link between growth (equity flows) and rates is weakening

One important consideration is whether the correlation between growth sentiment (and equity flows) on the one hand and Eurozone rates on the other has changed.

As the chart below illustrates, it it is very clear that equity inflows are highly correlated with growth expectations.



However, the forward guidance in place since September certainly suggests that the bar for pricing ECB hikes is quite high.

Relatedly, Eurozone rates have been trading in a very narrow range over the last 4-5 weeks (after the disappointment with ECB's rate move in September had been digested). For example, ERZ0 has traded within a few bp range since end-October.

We think this reduces the potential for significant EUR appreciation, even if growth sentiment improves. For example, the spike in EURUSD towards 1.25 in early 2018 was clearly linked to the market starting to price ECB tightening (ERZ0 moved 35bp within a few months). AT this time, we can perhaps price out around 5bp of rate cuts currently priced for 2020. But pricing actual hikes would seem a tall order.

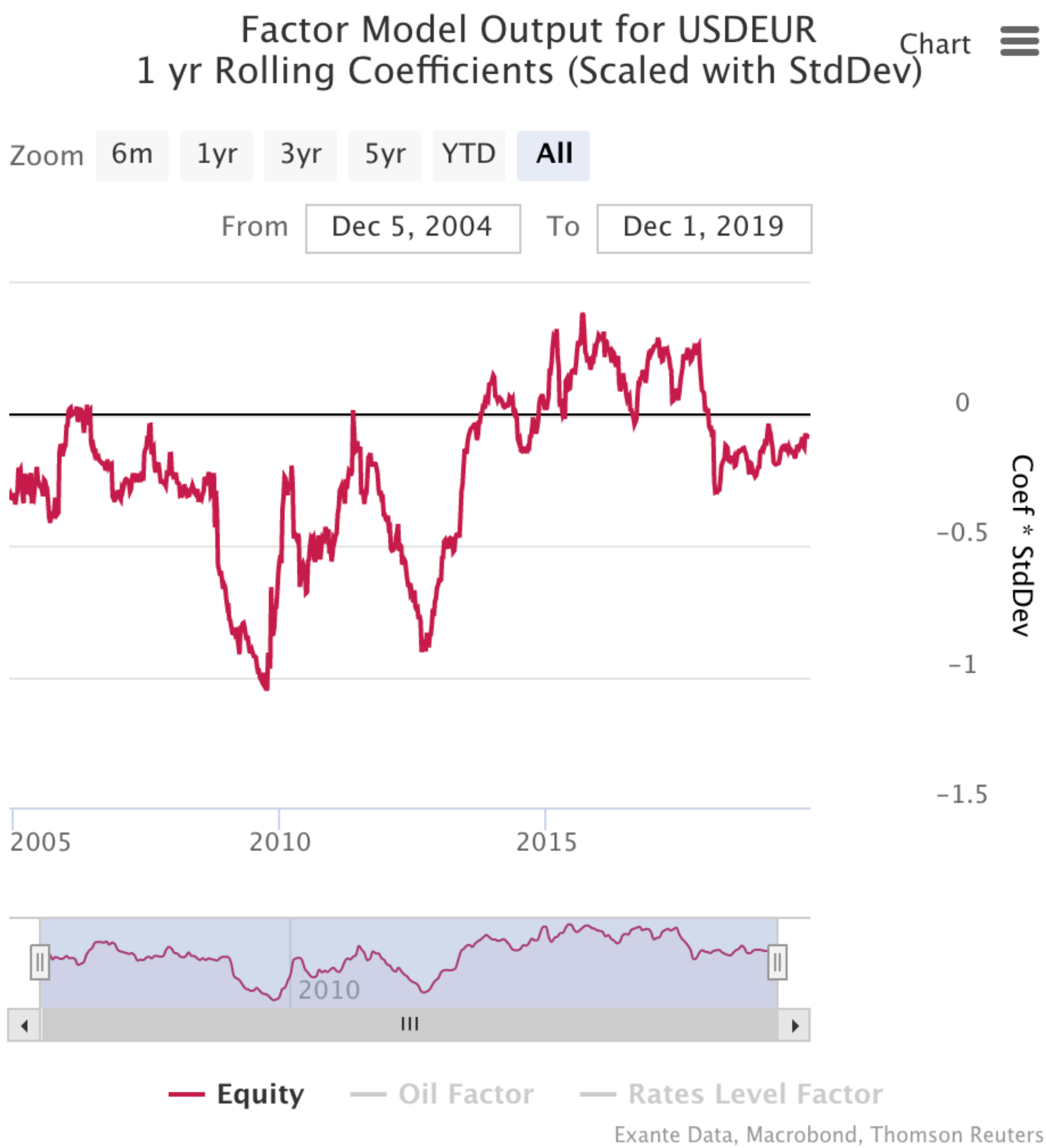
This is not to say that a EUR recovery is 100% reliant on a move in EUR rates. For example, the EUR recovery in H1 2017 was not closely linked to EUR rates moving. But it is likely to play into the size of any move (lower the beta, so to say).

4) Is the Euro's beta to risk changing?.

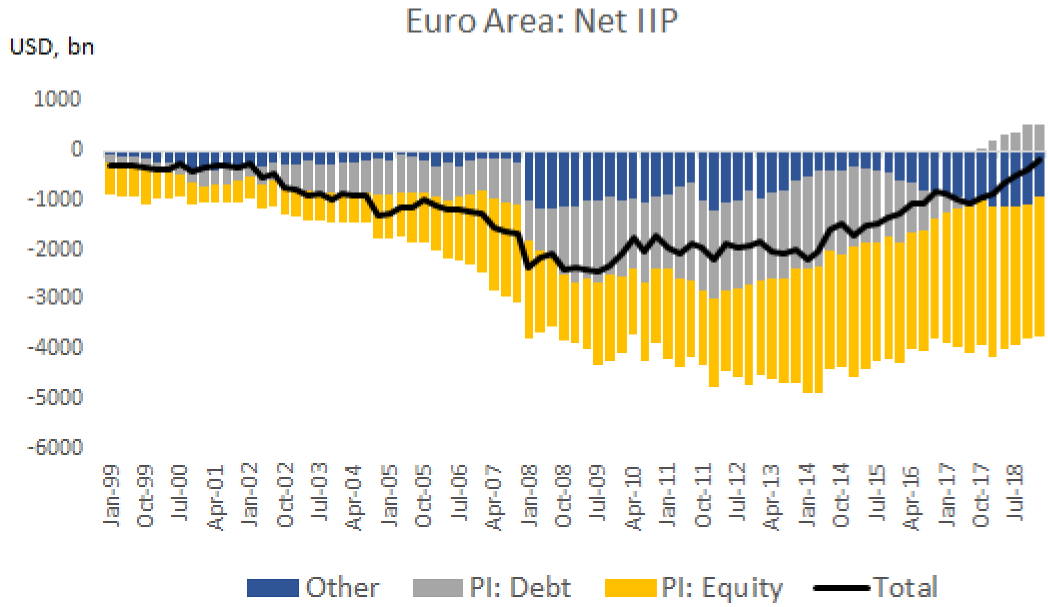
A fourth reason why the EUR is not responding to better equity inflow may be that its beta to risk sentiment is in flux.

The chart below shows the coefficient on the equity factor in our USDEUR factor model, using a 1-year rolling regression window.

Historically, the coefficient for USDEUR vs global equity moves has been negative, meaning that EURUSD benefits from higher equity prices. But the relationship has been weak over the last 4-5 years, with a coefficient fluctuating around zero.



It is worth contemplating if EURUSD is turning more 'yen-like' such that equity gains are a net negative. One possible explanation for the shift in the EUR beta to risk could be changes in the hedging behavior, particularly of Eurozone fixed income investors, as the bloc has shifted from a net debtor to a net creditor in the fixed income space and appears to be on track to shift from a negative to a positive overall net international investment position.



Source: Exante Data, IMF

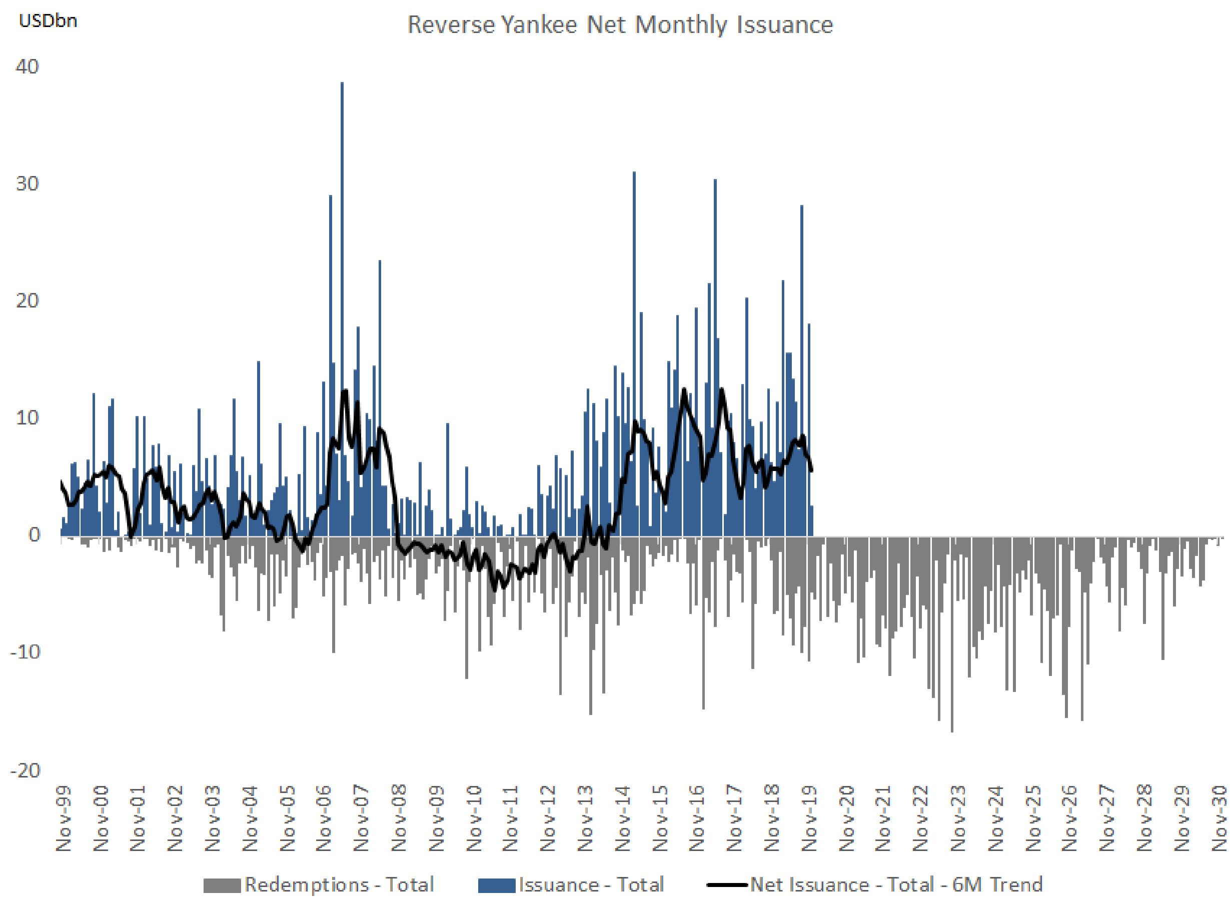
As is the case in Japan (which is among the largest net creditors in the world based on NIIP) the emergence of the Eurozone as a net creditor could over time lead to a permanent shift in the EURUSD beta to risk and even potentially to a reversal of the sign on the risk coefficient. In such a scenario, EURUSD, like USDJPY, could become more susceptible to "safe haven" repatriation flows during periods of risk off and more aggressive outflows during periods of improving risk sentiment would serve to limit the Euro's appreciation potential.

5) The carry factor…

Another aspect of the structure of rates is that the low level of rates is impacting funding dynamics, keeping the EUR depressed even if equity inflows are improving.

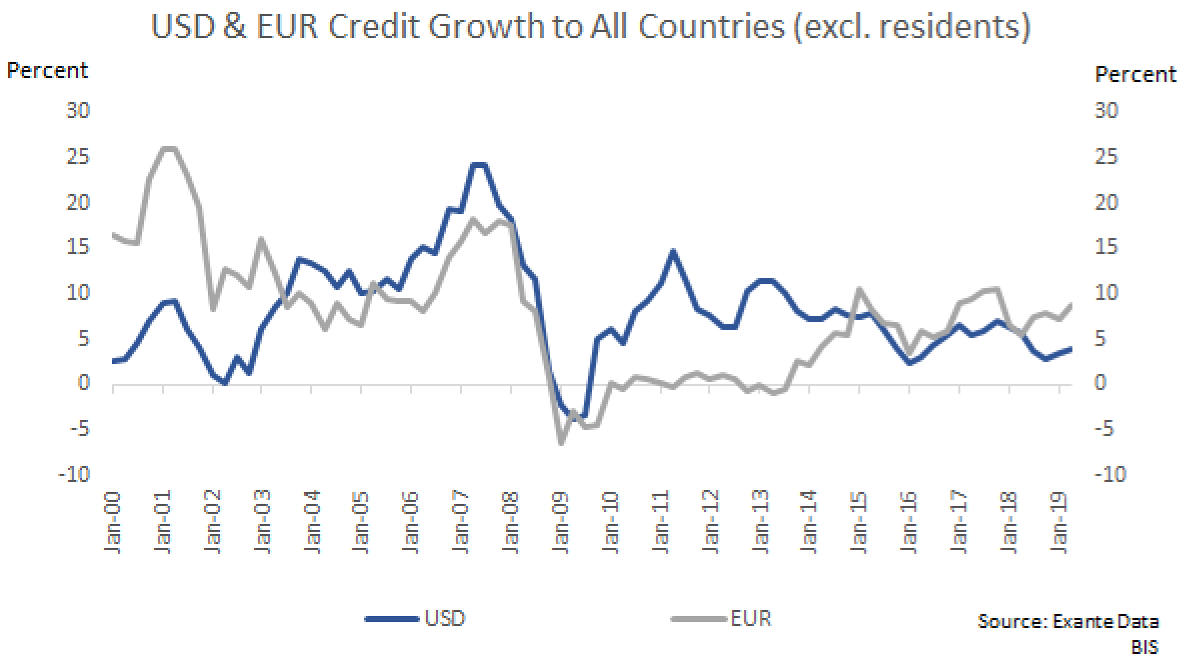
There is some evidence that the persistent low interest rate environment has led to the EUR becoming a funding currency. This is reflected in the data in several ways:

A) US corporates are increasingly funding in EUR, via so-called reverse yankee issuances. While it is unclear how much of this issuance is hedged (by selling USD/buying EUR forward), we think there is likely to be a residual amount generating EUR selling/USD buying. The chart below shows that net issuance of reverse yankee bonds has picked up over the last 12 months.

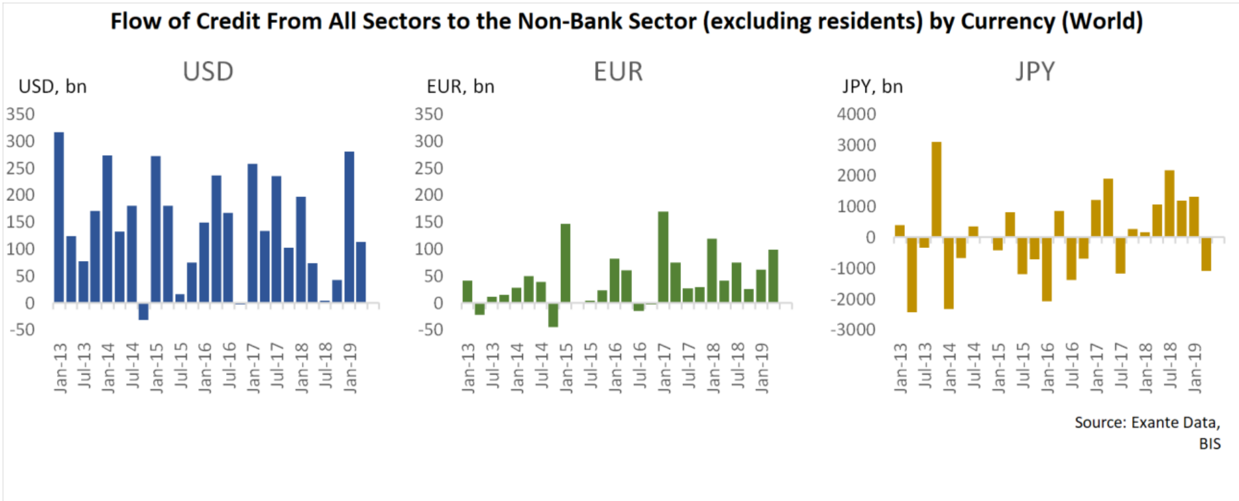


B) The role of EUR as a “funding” currency is also visible in the rapid growth in total (global) EUR-denominated credit (admittedly off a much lower base than global USD-denominated credit).

The first chart below shows how EUR cross-border credit is growing much faster than USD cross border credit for the past 3-4 years.



And while the USD credit is coming from a much higher base, we have now reached a point where cross-border EUR credit is matching the USD counterpart, although the BIS data on this is lagged.



These forces are not new. But they could help explain the weakening of the EUR beta to risk and equity inflows.

The ‘carry flows’ do not make the equity flows irrelevant. But they could mean that there are periods in which the funding flows can moderate or even fully negate the signals from the equity flow dynamics. That said, if US rates continue to decline, funding patterns could also change more structurally.

Conclusion

After an 18-month period of very bearish cross-border equity flow dynamics in the Eurozone, the last several weeks have seen better signals. Importantly, in the past, we have observed a positive correlation between equity inflows and the Euro, and important regimes shifts on the flow front have coincided with notable trend changes for EURUSD.

It is too early to draw a final conclusion, as the equity inflow has only been in motion 1-4 months, based on which indicator you look at. But we think the following factors are worth keeping in mind when judging the importance of equity flow improvement for the Euro and EURUSD in particular:

First, as opposed to 2015, we are not observing any extreme hedging trends of equity flows currently. As such, strong inflows into the Eurozone do have potential to move the currency.

Second, it is relevant, however, that the improvement in inflows into the Eurozone have happened in conjunction with improved outflows (although the position of the net flow varies across indicators). Since the volatility of the outflows seems to be ascending, this could reduce the power of the signal from the inflows, if viewed in isolation.

Third, the ECB's strong forward guidance means that it is hard for Eurozone rates to move higher (especially in the short end), meaning that equity flows will support the EUR more as an isolated factor, as opposed to in conjunction with support from local rates.

Fourth, a structural shift in the Eurozone IIP over the last decade suggest that the EUR should increasingly behave more 'yen-like'. In particular, the increasing cross-border asset position of domestic investors may mean that the EUR's risk correlation may become more counter-cyclical. As such, it is an open question whether better risk sentiment will support the EUR as it has in the past.

Fifth, various indicators of carry/funding flow points to increasingly steady EUR selling via funding markets. This may limit the potential for a EUR bounce in the short-term, unless the shock is so big as to alter these funding behaviors. This may be relevant in EUR crosses as well as EURUSD. in a way, the carry dynamics is one force that could set in motion bigger swings in the future, even if it has reduced volatility in the past.

We are watching equity flows to the Eurozone carefully, including their relative strength vs outflow dynamics. In the past, improving inflows have been important signals for EUR gains. While the relationship appears to be getting more complex, in part due to decoupling of rates from growth sentiment, we think it is still a bullish force to reckon with.

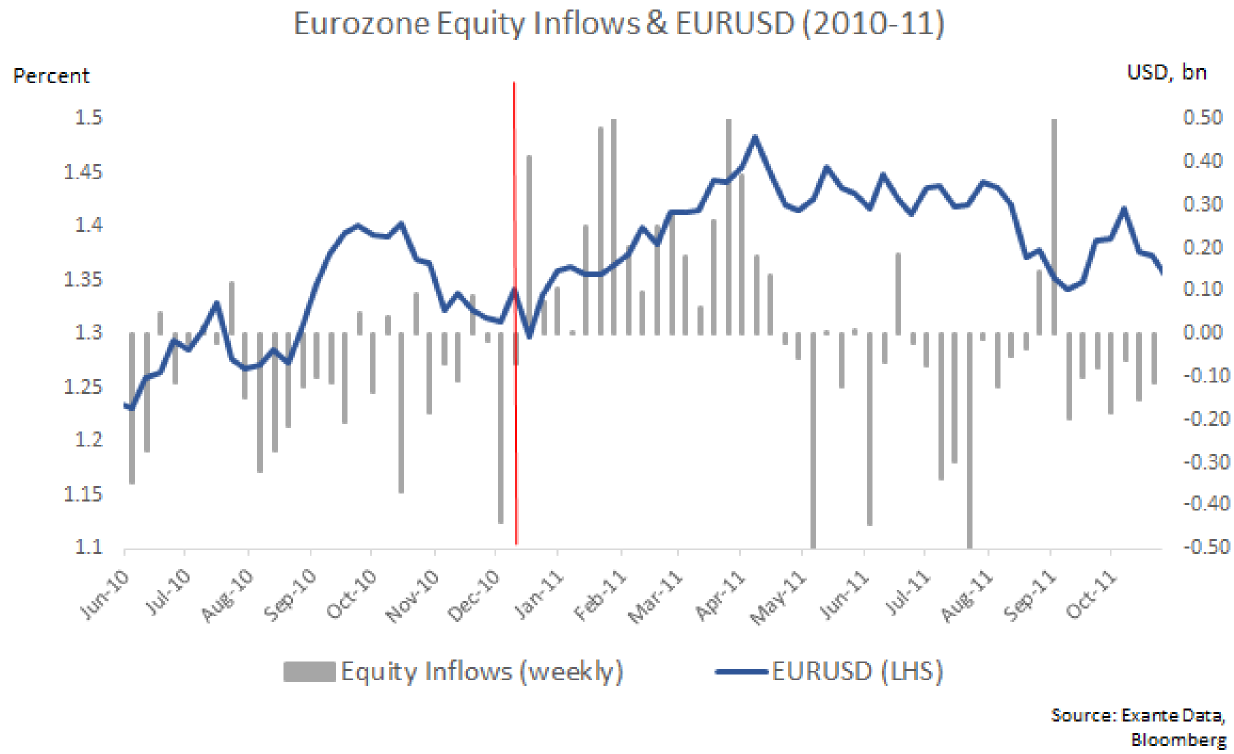
Appendix: A Closer Look at the Equity Flow vs EURUSD Link

Below we examine the link between EURUSD and equity inflows in three separate period that we think illustrate the historical relationship around turning points:

In early 2011: a turn in equity flows coincided with recovery in EURUSD from 1.30 to above 1.45

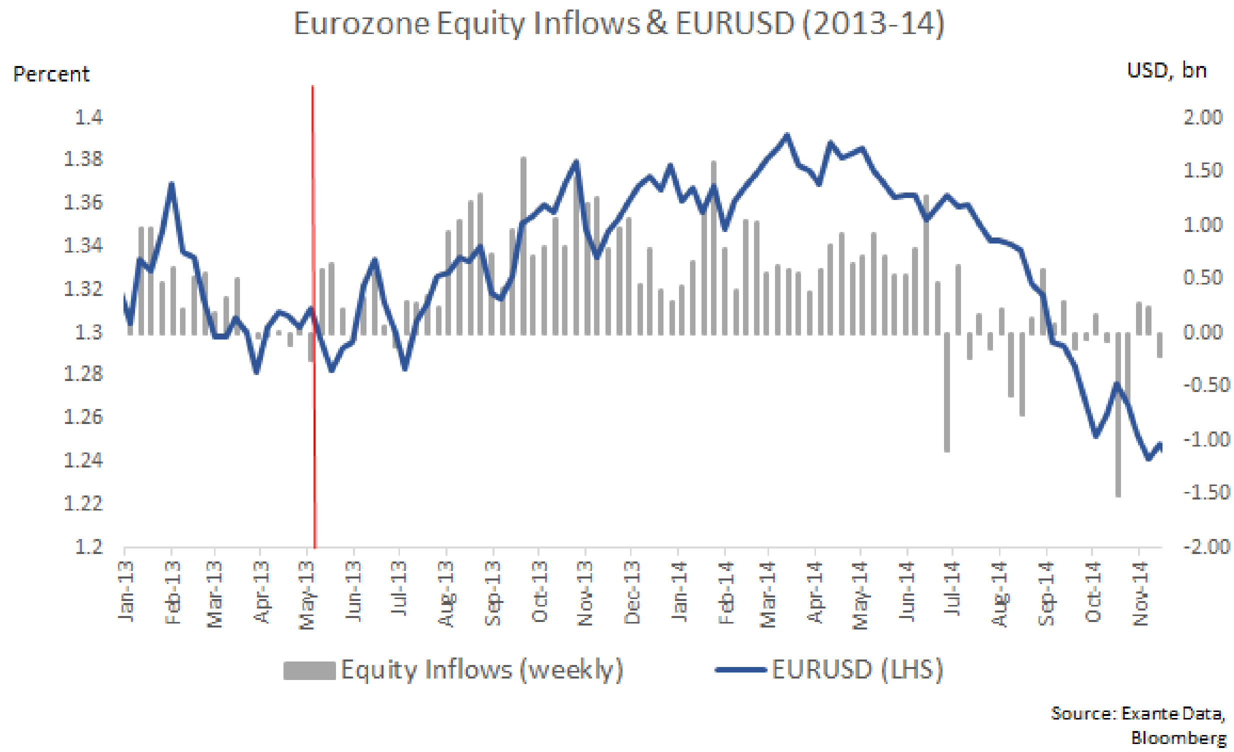
The red line marks when equity inflows turned positive, and EURUSD found a bottom immediately thereafter.

This equity flow recovery, however, also coincided with a notably repricing of ECB expectations as the market anticipated the hikes the ECB would deliver in April and July during the early months of the year.



In mid-2013: There was another turning point for Eurozone equity flows, which accelerated especially from June, this coincided with EURUSD rallying from below 1.30 to a peak near 1.40 in Q2 2014, while equity inflows remained consistently strong.

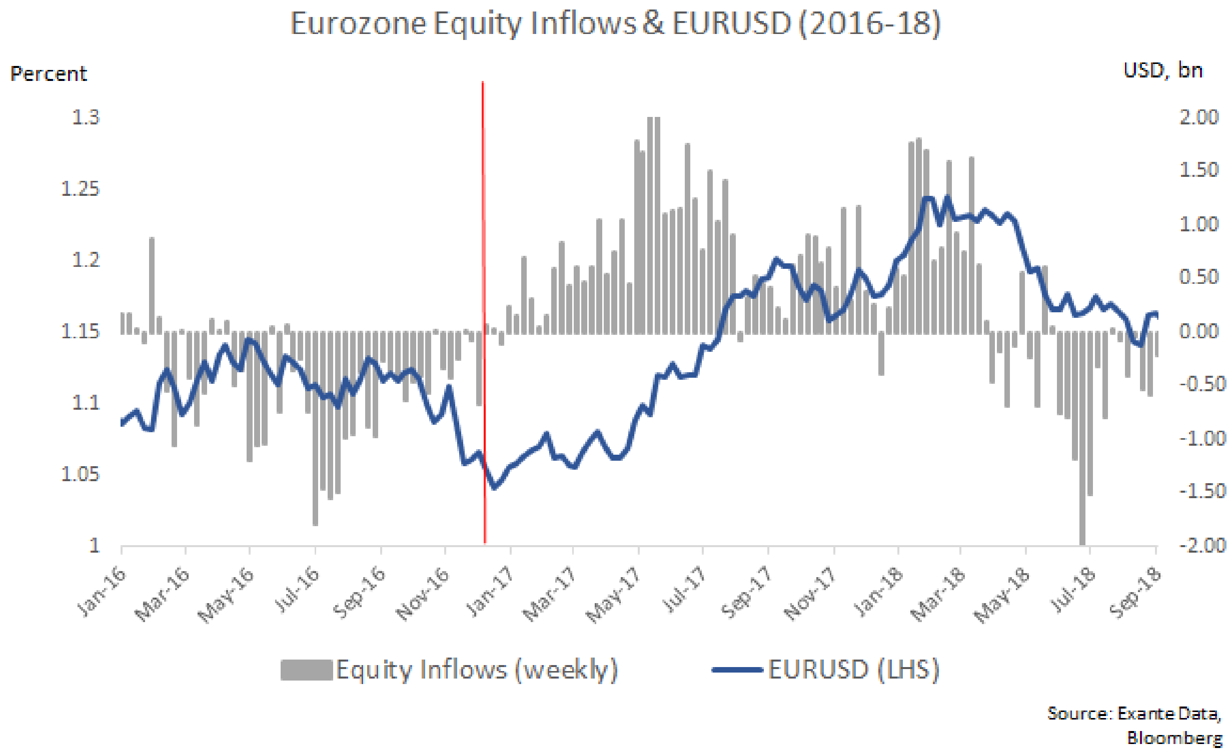
The red line again marks when equity inflows turned positive, and EURUSD found a bottom within a few weeks thereafter.



In early 2017, during the synchronized global expansion, the EUR moved from 1.05 to above 1.15

The red line shows the tuning point for equity flows, and the turn from negative to positive equity flows coincides almost exactly with the bottom in the EURUSD rate a touch below 1.05 in December 2016.

We have argued that global reserve accumulation trends also played a role in this period. Hence, we would not argue that this is only about equity flows. But the timing of the signal is very accurate nevertheless.



Real Money FX Positioning data included comes from direct partnership between Exante Data and EPFR.

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