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Will China Go with the Flow?

With under-utilized capital delivering minimal returns in a depressed financial market, emerging economies such as China could see an even greater inflow of funds, prompting demand for data and tools that track these capital flows. By Simon Ringrose and Cameron Brandt, managing director and senior global markets analyst, respectively, at fund flows data provider EPFR Global

In the current liquidity crisis, fund flows and fund allocations data are critical inputs for financial institutions that need to understand where and when liquidity is returning to global markets. Demand is growing for high-frequency, transparent data that shows where investor capital is moving—particularly in the Asia-Pacific region, where fund flows and fund positioning data is attracting the attention of traders, money managers, regulators, index providers, and market data managers.

For investment professionals, the story is ultimately about growth outperformance, and which regions or market sectors will outperform others after the global credit crisis subsides. As flows out of US equity funds reach record levels, market participants are increasingly looking at emerging market flows and high-growth economies such as China and Brazil.

For market data managers, access to reliable flow and positioning data is a high priority. Flows and positioning data describe a compelling shift in the market—a view that is not available in company-level data or other types of economic data. Investors globally are switching out of money market funds, which provided a safe haven at the height of the 2008 credit crisis, into higher-growth asset classes. Sectors such as commodities and energy are gaining new flows as investors foresee a declining US currency and increased demand for commodities—particularly from the growing Chinese economy. Knowing the flows has become essential.

Market data users rely on fund flows and positioning data to help understand the big picture and understand how returning liquidity acts as a leading indicator of prices across markets—and shifts in these flows will present huge opportunities for traders and investors as global liquidity returns. Thus, as investors and traders can demonstrate that this data contributes directly to profits, firms' appetite for this data—and their willingness to invest in services that provide it—is growing.

Hedge funds, traders, and governments in Asia carefully track changes in flows and positioning to identify potential changes in direction. For example, flows into so-called “fast money” such as exchange-traded funds with exposure to China A shares are particularly important signals, because the A shares market is primarily only accessible by domestic Chinese investors, and foreign investors have typically had limited access to this market. However, ETFs such as the iShares FTSE Xinhua index and certain country funds do offer A shares exposure. Foreign flows into relatively illiquid markets can be an important determinant of future market direction.

Used as a factor in momentum models, or trading rules, flows provide useful information about demand that can change quickly from week to week. Particularly in the Asia-Pacific region, technical signals are well understood as a complement to company-level data. Investors are also developing flow-based factors such as momentum strategies and market timing signals to take advantage of index rebalancing.

Kick-starting Flows

Investor interest in Asia has grown enormously this year and is likely to continue. Soon after China's National People's Congress met in March and signed off measures to sustain GDP growth at eight percent, a global equity rally took off. The Chinese government's action contributed to a flood of new money into emerging markets equity funds, with Asia (excluding Japan) accounting for \$16 billion of that and China equity funds accounting for \$4 billion. These flows include dedicated country funds, exchange-traded funds, and flows from global funds shifting their positions in search of higher-growth markets.

In 2009, fund managers are aggressively shifting their portfolio allocations to take advantage of these global market changes. For example, in March 2009, many global emerging market managers repositioned their equity portfolios, to give them higher allocations to China that are well above benchmark levels.

Long-only managers use flow and allocation data as a key input to the process of sector and country selection. Making the right country or sector calls can have a much larger impact on overall portfolio performance than individual stock selection. In both tactical and strategic asset allocation, the data is an increasingly important factor in the investment process.

In addition to equity and bond markets, new research shows that equity fund inflows are significantly correlated with current and future foreign exchange appreciation. Currency strategists and traders use flow data—particularly equity fund flows to emerging markets—as a determinant of short-run FX rate behavior.

Government regulators track cross-border fund flows to stay current on foreign investor interest in their market. Particularly in less liquid equity markets, foreign demand can have a major impact on market prices. And in the same way that equity demand leads to more demand for local currency, these fund flows will also impact demand for local currencies. Another ongoing factor is attention to US dollar weakness. While many Asia-Pacific markets rely on the US export market, regional governments also hold huge US dollar reserves.

Demand for high-frequency flows and positioning data will continue. Looking forward, money market funds are still sitting on assets of over \$3 trillion that yield minimal returns. This suggests there is still a huge amount of portfolio capital that could benefit from moving into favored equity markets, and surveys of global investment managers indicate that China and Asia-Pacific markets are high on the list of preferred markets for any inflow of funds.

For market data managers and investment professionals, fund flows and fund allocations are increasingly critical datasets for understanding market dynamics in this age of liquidity and massive global shifts of capital. EPFR Global and other data providers are continuing to invest in this area to meet growing market demand.