IIF Capital Flows Tracker

December 2016

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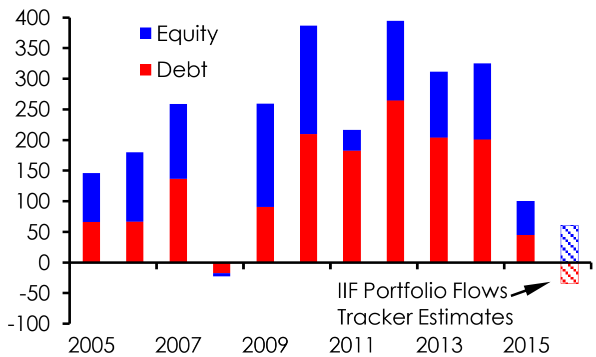
Worst Year for Portfolio Flows to Emerging Markets Since 2008

- **December portfolio outflows cap the weakest year since the crisis:** Non-resident portfolio outflows from emerging markets are estimated to have been $3.4 billion in December, mainly on the debt side.* December's dismal reading cuts total net non-resident EM portfolio inflows for 2016 to just $28 billion—the weakest year since 2008 and 90% below the 2010-14 average. Overall, EM equities did better in 2016, with $61.4 billion in net portfolio inflows; EM debt saw net portfolio outflows of $33.8 billion for the year.
- **A perfect storm**: No single factor stands out as the cause of the retrenchment in portfolio flows to emerging markets. Rising US yields—partly as a result of the reflationary "Trump trade" but also attributable to a more hawkish Fed—have been the main contributor to the weakness. However, idiosyncratic events in a number of EM countries, including Turkey and India, have weighed on domestic prospects, exacerbating portfolio outflows. Moreover, concerns about the path of the RMB and the potential impact of the incoming Trump administration's policy agenda have heightened concerns about the environment for global trade—a key consideration for many emerging markets.
- **China—outflows persist:** Net capital outflows from China intensified in November to an estimated $96 billion (vs. $70 billion in October). This brings net capital outflows from China (including errors and omissions) to some $635 billion through November—10% higher than the same period in 2015. Available data on onshore RMB trading volumes and on offshore CNYUSD forwards suggest that net capital outflows remained substantial in December.
- **Emerging markets (ex-China) continued to see net capital inflows in November:** Despite outflows from China, net capital inflows to other EMs were robust at $18 billion in November, only slightly below October's $21 billion. Net capital inflows to India rose to $8.7 billion, while Turkey, South Africa, Brazil, and Mexico saw lower inflows. Indonesia was the only country in our sample to see net capital outflows (around $0.8 bn) in November.
- **Net capital inflows to EM ex-China robust in 2016—with some exceptions:** At $185 billion, EM net capital inflows through November were 60% above the same period of 2015. Turkey ($37 bn) saw the biggest net capital inflows (though flows weakened significantly in H2 2016), followed by India ($33 bn) and Mexico ($30 bn). However, year-to-date net capital inflows to Brazil and India were almost less than half their 2015 levels.

**Non-resident portfolio flows are a subsection of overall net capital flows, which include all types of flows from both residents and non-residents covering portfolio flows, banking flows, direct investment and other components of the financial account.*

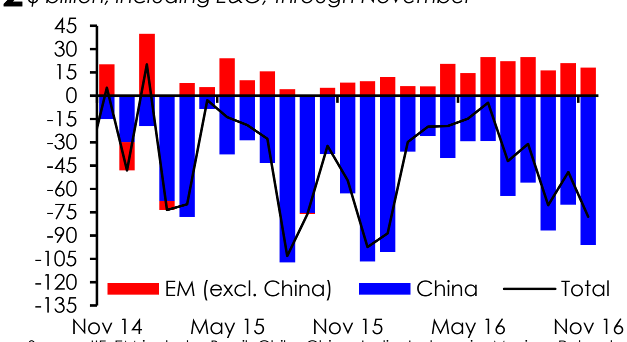
Data cutoff date: December 28, 2016

1 **Annual Non-Resident Portfolio Flows to Emerging Markets**
$ billion



Source: National Sources, IIF.

2 **Net Capital Flows to Emerging Markets**
$ billion, including E&O, through November



Source: IIF. EM includes Brazil, Chile, China, India, Indonesia, Mexico, Poland, Russia, South Africa and Turkey.

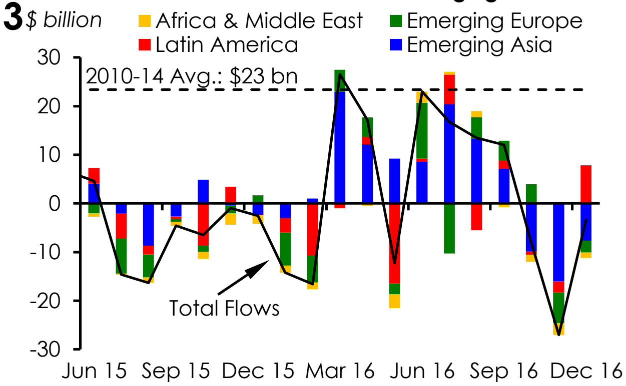
EM Portfolio Flows Tracker—December 2016

December Outflows Cap Worst Quarter Since Global Financial Crisis

- **Third straight month of outflows:** Non-resident portfolio outflows from EMs are estimated to have been $3.4 billion in December, with most outflows concentrated in debt markets (Table 1). LatAm (+$7.8 bn) was the only region to see inflows, primarily due to debt inflows to Mexico (with Banxico rate hikes and good liquidity offsetting the broader "Trump effect"; Chart 3). EM Europe (-$2.4 billion) and AFME (-$1.1 billion) saw modest outflows, while EM Asia (-$7.7 bn) was hit by large outflows from India in the wake of the demonetization initiative.
- **A dismal quarter:** Taking December outflows into account, we estimate that Q4 saw outflows of $38.4 billion—the worst quarter since 2008Q4 at the height of the Global Financial Crisis (Chart 4). This compares to our forecast of $54 billion of inflows made prior to the election in our *November Capital Flows Report*. Nearly all the outflows in Q4 were from debt markets, but equities also saw slight outflows, indicating that EMs are not benefitting from the rotation from bonds to stocks that has fueled all-time highs in the US stock market. In fact, it appears that there is a rotation from EMs to mature markets.
- **An enduring retrenchment:** One of the most striking features of the current downturn in flows has been its endurance. Our Flows Alert that began shortly after the US election in November finally ended at the end of December, making it the longest continuous "Reversal Alert" since our series began in 2005. What's more, since October 4, the countries in our sample that publish daily data have experienced $24.5 billion in outflows, which rivals only major previous retrenchments (Chart 5).
- **Fed risk beginning to show:** As we have often highlighted in recent years, a shift in market expectations towards a steeper path for Fed policy rates has a negative effect of EM flows—partly triggered by a more hawkish tilt at the December FOMC meeting on this occasion. Our behavioral model suggests that expectations of higher US rates were the main contributor to December's outflows, while stronger risk appetite was an offset (Chart 6).

Total Non-Resident Portfolio Flows to Emerging Markets

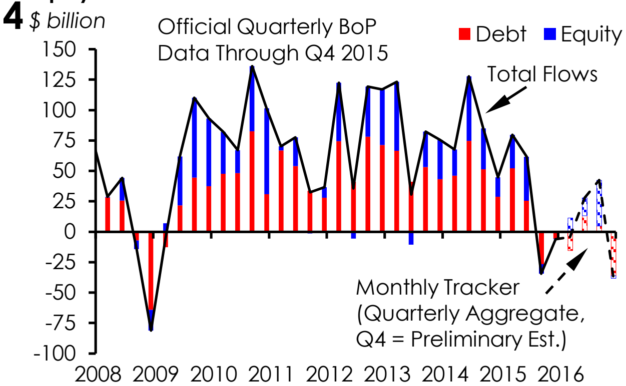
3 *$ billion*



Source: IIF.

Equity and Debt Non-Resident Portfolio Flows to EMs

4 *$ billion*



Source: IIF.

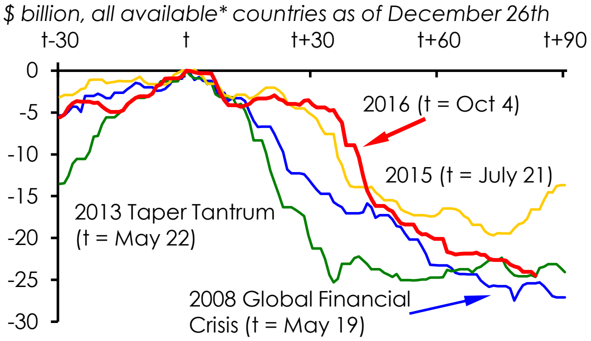
Table 1
Non-Resident Portfolio Flows to Emerging Markets
$ billion

	Total	Equity	Debt
Oct.	-8.0	6.4	-14.4
Nov.	-27.0	-7.9	-19.1
Dec.	-3.4	-0.7	-2.7
YTD	**27.6**	**61.4**	**-33.8**

Source: IIF.

Cumul. Daily Portfolio Flows to EMs During Major Reversals

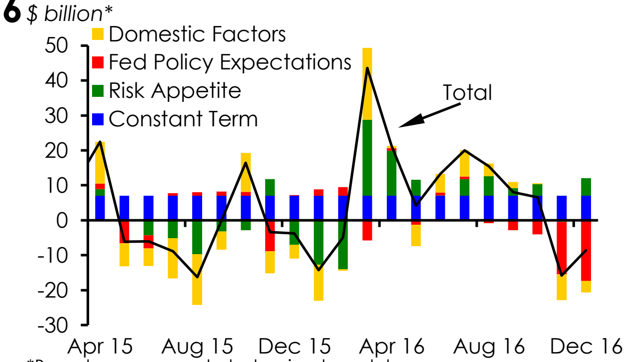
5 *$ billion, all available* countries as of December 26th*



t = day before retrenchment began
*IN, ID, KO, TH, PH, ZA, BR, HU.
Source: National Sources, Bloomberg, IIF.

Contributions from Drivers of Portfolio Flows

6 *$ billion**



*Based on a separate behavioral model.
Source: IIF.

China Net Capital Flows—November 2016

Outflows on the rise again

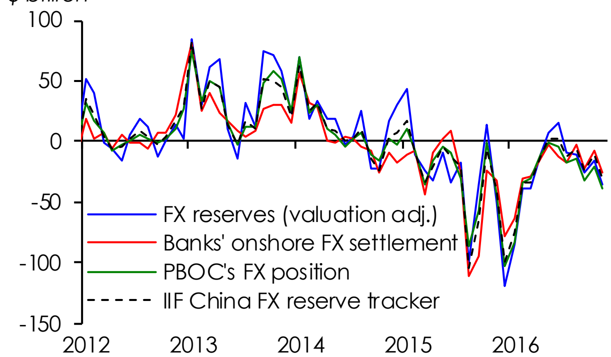
- **FX intervention accelerated:** Domestic demand for hard currency picked up in November, with Chinese banks selling a net $26 billion of foreign exchange on behalf of their clients compared to $7.5 billion in November. This increase was in line with earlier-released data on headline FX reserves, implying a rise in PBoC FX sales ($35 bn in November vs $15 bn in October) in valuation adjusted terms. Separately, data on the PBOC's net FX position suggest that the central bank's FX sales amounted to some $56 billion in November, marking an increase of around 40% compared to October. On this basis, our preferred measure of reserve operations—an average of valuation-adjusted reserve changes, commercial banks' net onshore FX settlement and change in the PBOC's net FX position—suggests that the PBoC significantly stepped up its intervention in FX markets, from $21 billion in October to $39 billion in November in an attempt to curb the strong downward pressure on the RMB after the US presidential election (Chart 7).

- **Capital outflows on the rise:** Combined with our estimate for November's current account surplus ($22 bn), the marked increase in PBOC's reserve operations implies a rise in net capital outflows to $61 billion in November compared to $51 billion in October. However, the actual size of the outflows could be much higher than this given the sizeable discrepancy between the official BoP reserve movements and our estimates over the past few quarters. As noted in our November Capital Flows Tracker, this difference mainly stems from uncertain valuation effects as the lack of available data on the composition of China's official reserves makes it difficult to make appropriate adjustments. Against this backdrop, a simple modification to our tracker based on the average difference between the BoP capital flow figures and our flow estimates in the last two quarters for which BOP statistics are available suggests that net capital outflows in November could be as large as $96 billion (Chart 8).

- **A first look at December 2016:** Although the RMB appreciated slightly against the new CFETS basket in December, it continued to weaken against the USD. While some market indicators such as the CNY/CNH spread showed no sign of stress, the 3-month implied volatility of CNHUSD reached levels last seen during December 2015 and January 2016 when net capital outflows were in excess of $100 billion per month. Also, expectations for further RMB weakness against the USD have prompted a sharp surge in CNH/USD forward points in recent weeks, with high trading volume in the onshore RMB signaling that the capital outflows remained large in December (Chart 9).

China: Change in Foreign Exchange Reserves

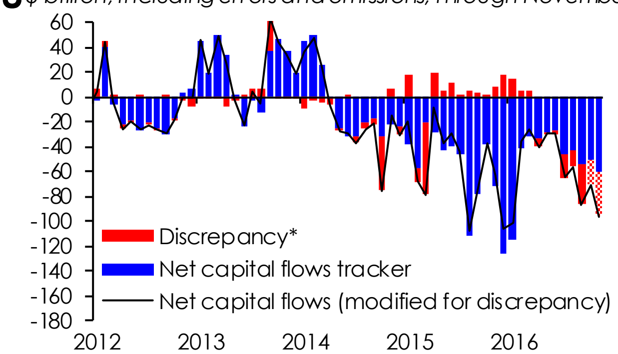
7 *$ billion*



Source: IIF.

China: Net Capital Flows

8 *$ billion, including errors and omissions, through November*

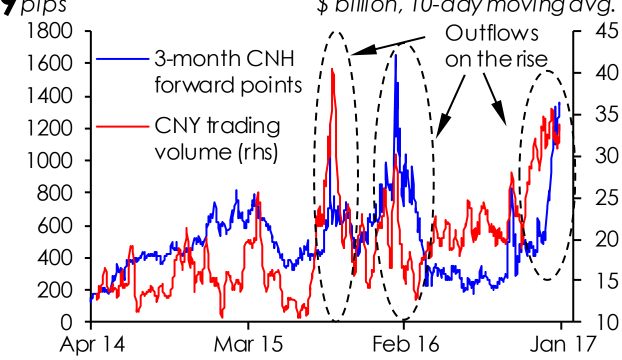


Source: IIF.

* A simple ex-post adjustment factor accounting for the difference between official BoP capital flow figures and our estimates. For the months of a quarter where there is no realized capital flow figures yet, the discrepancy is estimated based on the statistical correlation over the prior two quarters between ex-post discrepancy adjustment factors and the estimated monthly reserve figures.

Onshore CNY Trading Volume and Capital Outflows

9 *pips* *$ billion, 10-day moving avg.*



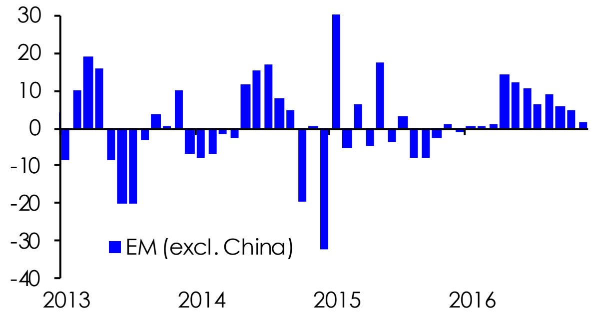
Source: Bloomberg, IIF.

EM Net Capital Flows (excluding China)—November 2016

Overall net capital inflows broadly stable despite net portfolio outflows

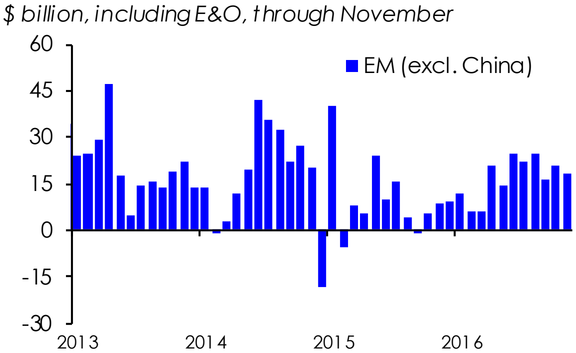
- **Reserve accumulation slowed:** In our sample of nine emerging market economies (ex-China), foreign exchange reserves fell by $15 billion to $1.57 trillion in November compared to a $10 billion decline in October. However, this decline was entirely driven by exchange rate fluctuations as the USD appreciated against almost all other reserve currencies, implying a valuation loss of some $17 billion in the value of the stock of FX reserves. This suggests that the EM central banks purchased FX reserves of around $2 billion in November, the slowest pace of FX accumulation since March 2016 (Chart 10). Central bank FX purchases were largest in India at around $2.8 billion, followed by Russia ($0.9 bn), Mexico ($0.8 bn) and Brazil ($0.8 bn). In contrast, our estimates suggest that the Indonesian (-$2.2 bn), Turkish (-$0.9 bn) and Polish (-$2.7 bn) central banks intervened to support their currencies in November.
- **A modest decline in net capital inflows:** Despite the large non-resident portfolio outflows in November, net capital inflows to emerging markets (ex-China) slowed only slightly from $21 billion in October to $18 billion in November, suggesting that other types of investment flows such as banking flows and FDI remained robust (Chart 11). Through November, 2016 net capital inflows were estimated to be around $186 billion—60% above those in the same period of 2015.
- **Winners and losers:** Indonesia was the only country in our sample recording net capital outflows in November at around $0.8 billion (Table 2). After a sharp reversal in October, flows to Russia recovered strongly to around $1.9 billion in November. While flows to India accelerated to $8.7 billion, flows to Poland were flat in November. The decline in monthly net capital inflows was more pronounced in Turkey, South Africa, Brazil, and Mexico.

10 **Emerging Markets: Reserve Operations (excl. China)**
$ billion, through November



Source: IIF. EMs include Brazil, Chile, India, Indonesia, Mexico, Poland, Russia, South Africa and Turkey.

11 **Net Capital Flows to Emerging Markets (excl. China)**
$ billion, including E&O, through November



Source: IIF. EM includes Brazil, Chile, India, Indonesia, Mexico, Poland, Russia, South Africa and Turkey.

Table 2
Net Capital Flows
$ billion

	Brazil	Chile	China	India	Indonesia	Mexico	Poland	Russia	S. Africa	Turkey
Q1	3.5	-0.5	-162.5	3.6	4.5	7.9	1.2	-9.6	3.7	10.0
Q2	6.9	0.9	-98.6	7.1	7.2	6.7	9.5	2.8	1.2	17.6
Q3	11.3	2.5	-207.3	12.0	10.2	9.2	4.7	7.4	3.3	2.9
Sept.	0.7	1.0	-86.8	5.9	2.8	2.8	2.8	1.6	1.7	-3.1
Oct.	2.8	1.5	-70.1	1.6	1.5	3.8	3.6	-1.1	2.6	4.6
Nov.	1.6	1.1	-96.1	8.7	-0.8	2.5	0.0	1.9	1.2	1.8
Ytd (2016)	26.2	5.4	-634.7	32.9	22.6	30.0	19.1	1.5	12.0	36.9
Memo:										
Ytd (2015)	57.8	3.7	-567.1	63.7	9.2	11.8	-5.0	-61.2	12.1	22.0
2015	60.0	4.4	-673.9	67.1	16.5	17.5	-8.2	-67.3	12.8	20.5

Source: IIF.