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The Context

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Inside this week's edition…

Know The Flows – Emerging Markets Funds Forge Ahead in Mid-January

By Cameron Brandt, Director, EPFR Research

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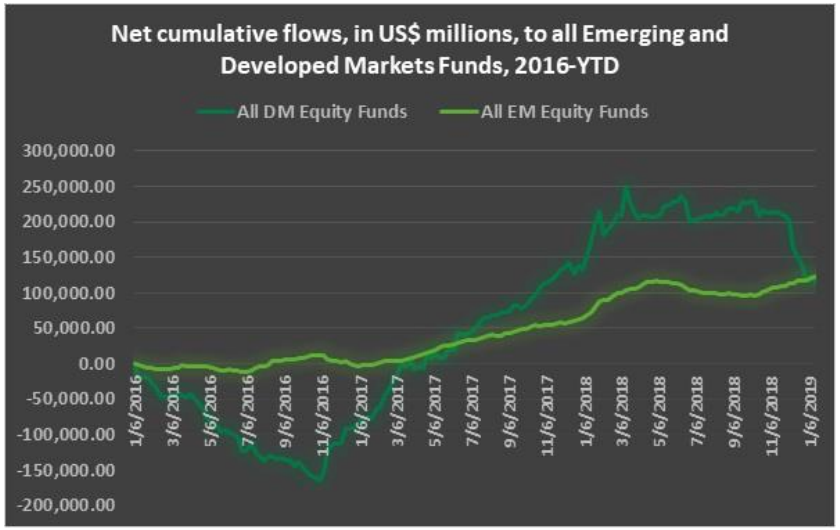
Going into the second half of January EPFR-tracked Emerging Markets Equity Funds posted their 14th consecutive inflow and commitments to Emerging Markets Bond Funds hit a 51-week high as investors reassessed these asset classes. With the US government shut down by partisan gridlock, the UK's exit deal with the European Union decisively rejected by British legislators and monetary policy still being tightened in the US and Eurozone, the faster growth and cheaper valuations offered by emerging markets are – in many cases – beginning to outweigh the risks associated with them.



The latest twists in the UK's 'Brexit' saga kept the pressure on Europe Equity and Bond Funds. The former recorded their 18th straight outflow, and 44th in the past 45 weeks, while Europe Bond Funds saw their three-week inflow streak come to an end. But High Yield Bond Funds benefited from the recent, modest increase in risk appetite, chalking up their biggest inflow since early 2Q17.

Overall, the week ending January 16 saw EPFR-tracked Bond Funds taking in a net $2.8 billion and Alternative Funds $586 million. Investors pulled $1.49 billion out of Balanced Funds, $4.8 billion from Equity Funds and $28.1 billion from Money Market Funds.

At the asset class and single country fund levels, flows into Norway Equity Funds and redemptions from Norway Bond Funds were the largest since 1Q17 and 4Q16 respectively. China Equity Funds posted consecutive weekly outflows for only the third time since the beginning of 2018 and redemptions from UK Equity Funds jumped to a 10-week high. Bank Loan Bond Funds extended their longest run of outflows since 1Q16, Inflation Protected Bond Funds posted an inflow for the first time in over four months and flows into Total Return Bond Funds hit a 37-week high.

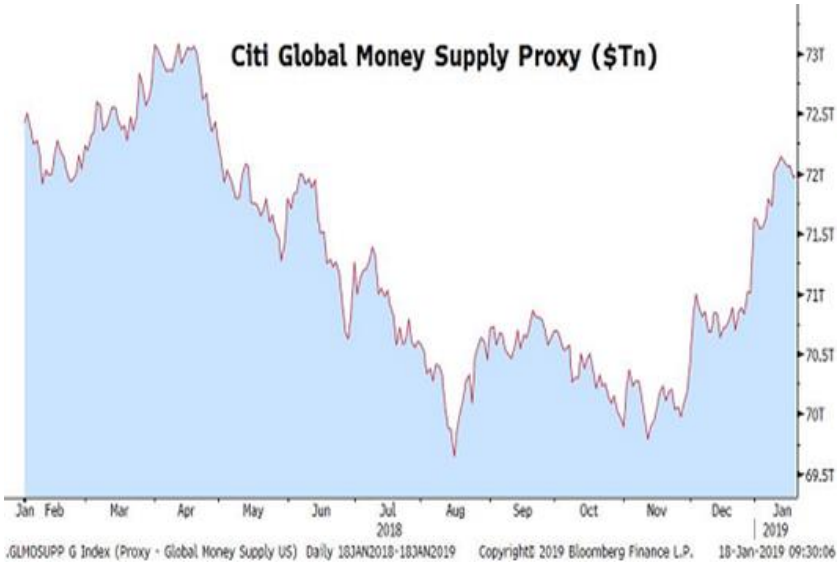
EPFR-tracked Real Estate Sector Funds continued to benefit during the second week of January from the market's perception that the US Federal Reserve's rate hiking cycle is on hold – and may even have peaked – after December's 0.25% increase. But the global headwinds that underpin this optimistic view of the Fed's intentions sapped investor appetite for other Sector Fund groups. While Real Estate Sector Funds recorded their biggest inflow since early 1Q17, Technology and Financial Sector Funds extended their longest redemption streaks since 2Q16 and 2Q04 respectively and Energy Sector Funds posted their biggest outflow since late 3Q14.

With the technology and telecoms sectors still digesting Apple's profit warning, which it tied to a sharp drop in Chinese demand, Technology Sector Funds posted their sixth straight weekly outflow. Flows from all EPFR-tracked Equity Funds to these sectors slumped in December when the exodus from dedicated funds was compounded by outflows from big, diversified Global and US Equity Funds.

Liquidity is Back … Volatility Recedes … Go Figure?

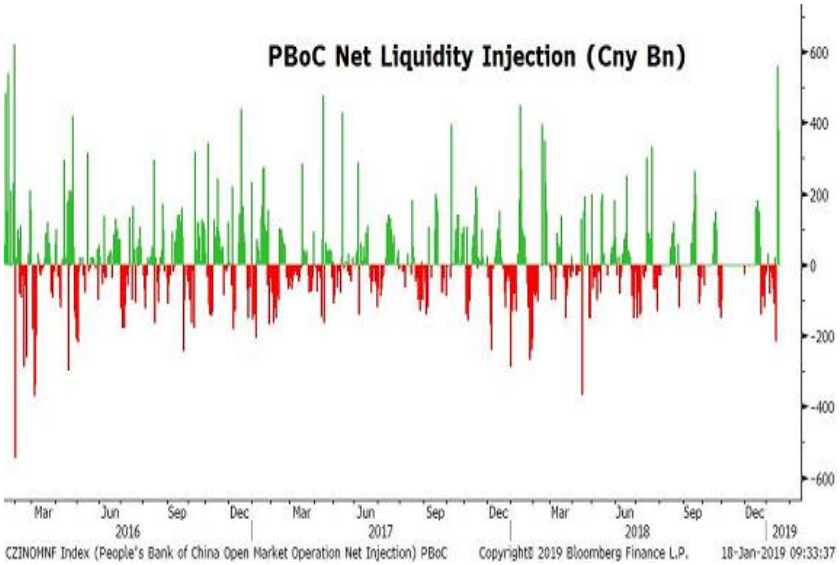
By Marcus Dewsnap, IGM Head of Fixed Income Strategy

VOLATILITY has calmed somewhat across all asset classes. In some respects, this shouldn't be surprising given the amount of liquidity that has returned. A glance at the Citi Global Money Supply proxy confirms this.



There is also the huge injection by the ***PBoC***, not all of which can be attributed to Chinese New Year preparations.

This is not to mask over the underlying concerns regarding economic growth, geopolitics and earnings season (which really gets going up this week).



FOMCers, who enter purdah ahead of the January meeting, are trying to do their bit by indicating a pause is very much on the table, but without committing to it. Even notorious hawk Esther George has turned, an important signal as she is a voter this year. Still, with liquidity on the mind, it is worth noting that on the one hand Kaplan indicated a concern over the balance sheet drawdown, referencing credit spreads, but Bostic suggested the jury was still out on the impact (see HERE in a blog titled 'Quantitative Frightening?);

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Liquidity is Back … Equities Rebound … Go Figure? … cont'd

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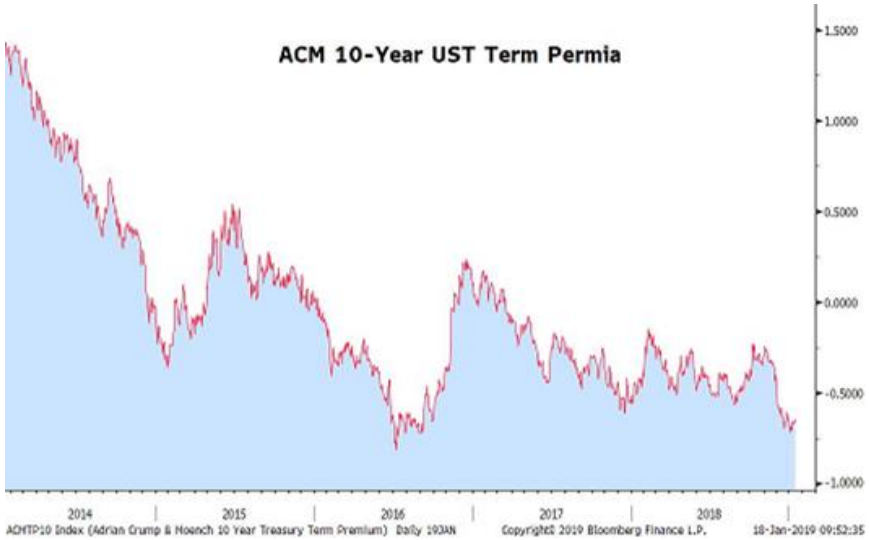
'In my own judgment, it is far from clear that the ongoing reduction in the balance sheet is having an outsized impact on the stance of monetary policy.'

And,

' … if the term premia channel is a critical piece of what makes balance-sheet policy work, I'm hard pressed to see much evidence of financial tightening via rising term premia in the data so far.'



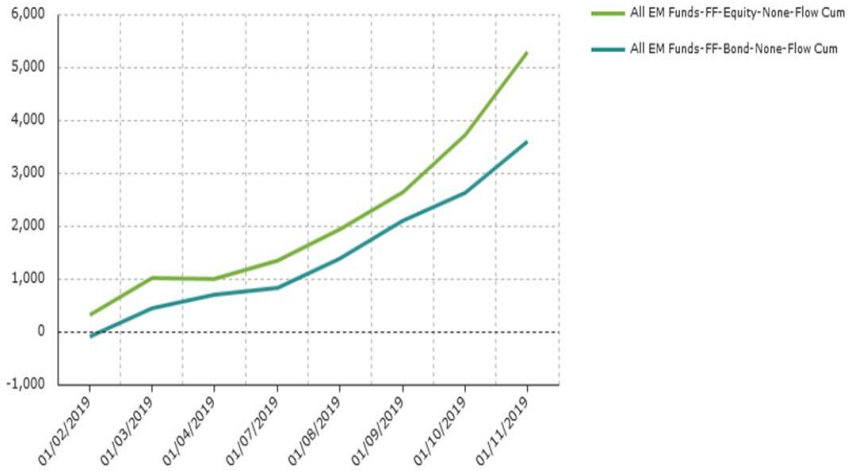
Term Premia, he notes is only one 'theory' though. Bostic did however think 'patience' should be applied to all aspects of monetary policy. FOMCers seem to be unanimous in pushing flexibility credentials above all else. And here there is a risk that if equity markets rally enough, treasury yields will also rise as the market starts to price hikes back-in (the Jan19-Jan20 Fed Funds spread is at a ytd high of … +3bp).

The ***ECB*** (Thursday) may well need to engage in some interesting linguistics to avoid what most think should be an unequivocal shift in the balance of risks to the *downside*. Three major economies are struggling (Spain currently viewed as the outlier) although Germany did (on preliminary data) avoid a technical recession in Q4. Although here, domestic demand held up well, and this is something which Mario Draghi has highlighted as a significant positive. Some also point towards improving inflation dynamics at the 'super-core' level and the last lot of wages data as evidence to avoid the unequivocal downside tag. Although the market is much less confident on the inflation outlook.

Are CEEMEA FX And Bonds Offering Good Value in Early 2019?

By Christopher Shiells, Managing Analyst EM

After the sell off in 2018 for Emerging Markets, investors are now using this early 2019 window of opportunity to put money to work – especially in undervalued EM FX and bonds. This can be seen in the latest EPFR Fund Flows data, which shows EM bond and equity funds experiencing healthy net inflows every day this year (up to Friday 11th).



Are Emerging Market Currencies and Bonds offering good value?

EM assets remain very cheap in both absolute terms and relative terms after going through a significant period of negative flow and valuation adjustment in 2018, due to factors that were largely temporary. The pullback was due to a USD rally in response to stronger US growth after a peak cycle tax cut, Fed hawkishness from April, and President Trump's instigation of the China trade war in May.

The risks of these episodes have now reduced and in some cases are reversing, with the head winds of a stronger USD and US yields unlikely to persist this year.

For example, EM Hard Currency Bond spreads are now ca +300bp over USTs, (according to Bloomberg Barclays EM Hard Currency OAS), the widest levels since 2016, with most EM bonds currently pricing in some 200bps more hikes than the Fed is likely to deliver. At the same time, most EM currencies were at 1.5yr lows on REER basis heading into 2019 and have about 20% upside potential versus the USD to get to fair value on this basis, (please see dashboard on next page).

Thus, the famous EM Carry Trade is back on and it is looking attractive thanks to the spike in yields in H2 2018 and the relatively benign inflation backdrop, especially in the CEE region. This has ensured real yields remain attractive in most major CEEMEA and LatAm markets (see chart on next page). The CEEMEA and LatAm regions remain a source of yield that exceeds inflation, and we have previously noted that this hunt for yield (real or otherwise) has been a major driver of flows into EM assets.

However, the real yields data suggests that compared to before the big sell-off last year a number of CEEMEA and LatAm countries have softer real yields, although back then currencies were not so undervalued. This is because inflation has surged for most of these countries in 2018, and only began to moderate again from Nov. The Turkish real yield is now sharply negative as yields slumped.

The data suggests that the Mxn, Zar and Pln offer the best real yield pick-up, vs. in Mar 2018, and also offer the potential for local-currency gains.

Investors should of course proceed with caution as many tail risks remain. Not least we believe that the market has got ahead of itself with regard the repricing of US rate hike risk, and there could still be two hikes this year

However, it would seem the conditions have fallen into place for a more sustainable recovery in markets in the next few weeks. As long as this dynamic is not overpowered by fundamental/political impulses, relative real yields are set to remain an important consideration for EM investors and resulting flows for funds.

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Are CEEMEA FX And Bonds Offering Good Value in Early 2019?

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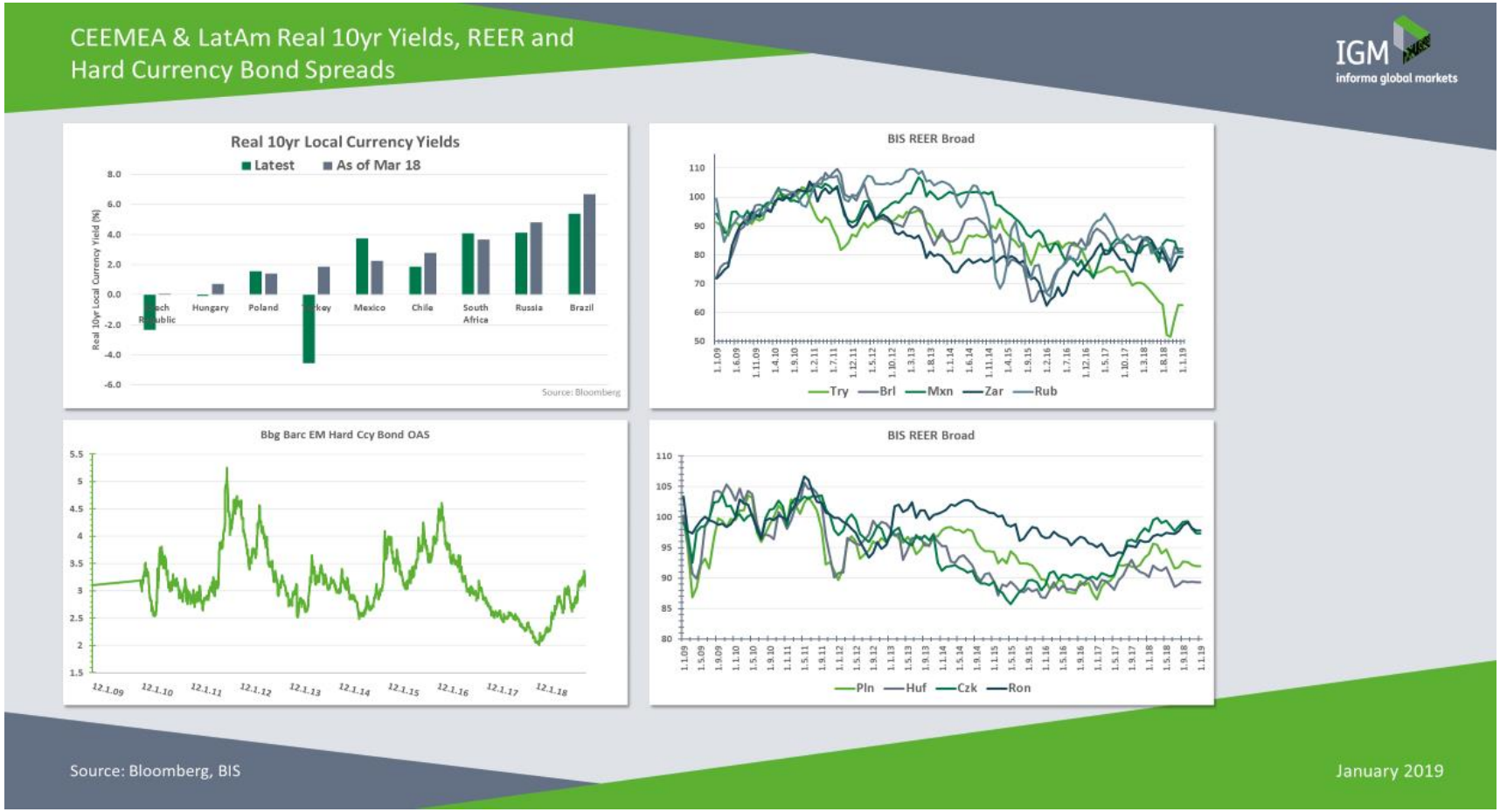

China Insight: Yield Curve Starts to Flatten in the New Year

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By Tim Cheung Head of China, Riki Zhang EM Analyst

It is argued that a key hurdle for aggressive easing in the money market (e.g. reverse repo rate cut) has been the desire to prevent the CNY from depreciating past the critical level of 7 vs USD. With the recent rally of the CNY riding on the prospect of a trade deal, and the market pricing out Fed hikes in 2019, we believe this hurdle has sufficiently reduced. Now the door is open for a reverse repo cut, but the action may not be immediate. PBOC may prefer to wait for more assurance that Fed would not hike in March before the move. In addition, it may choose to lower the TMLF rate first (3.15% currently), as the new longer-tenor liquidity provision facility may help lower bank funding costs and encourage lending to targeted sectors in a more effective fashion.

In our view, policymakers have a much stronger preference for a RRR reduction (chart 1) than a benchmark interest rates cut as the latter could spark capital outflows, putting pressure on FX reserves. And as a matter of fact, overall funding costs should be able to go much lower if policymakers can improve the effectiveness of monetary policy transmission without lowering the benchmark interest rates, given that the prevailing banking system liquidity is already very ample.

Chart 1

China onshore liquidity net injection (CNY bn)

Date	Reverse repo	MLF	SLF	Treasury cash deposit	PSL	RRR cut	Net injection
2017Q1	-1025	607	-59.011	-20	163.2	0	-333.811
2017Q2	270	160.2	-25.363	20	195.3	0	620.137
2017Q3	-80	129.5	19.05	80	125.4	0	273.95
2017Q4	770	167.5	66.737	40	151.1	0	1195.337
2018Q1	-960	395.5	-82.21	50	303.8	450	157.09
2018Q2	340	-71.5	8.82	50	193.8	1300	1821.12
2018Q3	-470	606.5	-9.58	190	51.9	700	1068.82
2018Q4	680	-501	45.33	-390	142.5	1201.5	1178.33
2019 (up to 16 Jan)	110	-398	NA	-100	NA	750	362

Data source: WIND

With reference to the MOF yield curve, we have noted some sort of curve flattening in recent months (chart 2) to reflect a spillover of liquidity easing into the long-end of the curve:

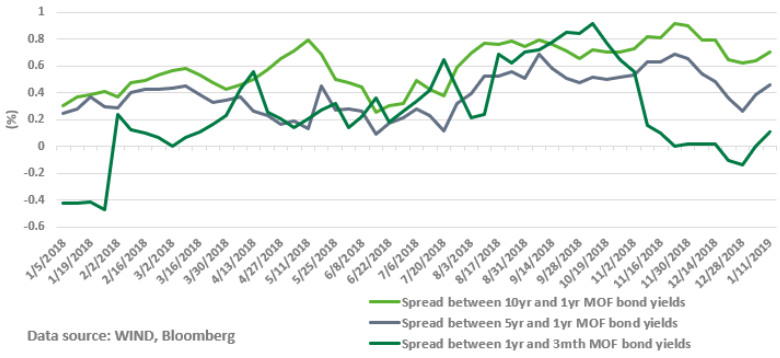
- 1-year vs 3-month, which had widened to multi-year wide 95bp in Oct last year, corrected sharply to par level during Dec.
- 5-year vs 1-year, which had widened to 3-year wide 70bp in Nov last year, corrected sharply to 20bp before returning to current level 40bp.
- 10-year vs 1-year, which had widened to 3-year wide 90bp in Nov last year, is still at as wide as 70bp.

Obviously, the long-end of the curve is still reluctant to shift downward due mainly to the persistently huge risk premium demanded by long-term loan providers given their concerns over default outlook and the balance sheet constraints arising from macro prudent assessment (MPA).

However, with the central government starting to reduce its efforts to deleverage, we think fewer corporate credit default cases will happen this year. That in combination with the balance sheet contraction over the past 18 months should give FIs more room to invest in long-term bonds and/or lend out long-term funds, as a result bringing the risk premium in the long-end of the curve lower this year. To capitalize on this, we should enter a curve flattening trade involving long-term bonds, such as the 10-year.

Chart 2

MOF bond yield spreads



Data source: WIND, Bloomberg

Viewpoint: Short PLN/HUF Revisited as NBH Creeps Nearer to Policy Normalisation

By Christopher Shiells, Managing Analyst EM & Andrew Dowdell, FX Technical Analyst

Our contrarian trade of the year for 2018 was a SHORT PLN/HUF position (targeting 72.19) that never really panned out, but as 2019 gets underway we believe that the trade is still worth looking at and many of the arguments remain the same. Back then we said the Pln may struggle due to a dovish NBP faction that remains in majority and deteriorating relationships with the EU/political risk, whilst the Huf may gain due to the NBH being on the verge of starting policy normalisation.

For 2019:

- The PLN remains in that narrow range around the 4.3000/Eur handle, which has been the case since Jul last year.
- This is due to the passive NBP policy outlook, which after the January meeting shows no signs of changing. The NBP expects inflation to remain around the 2.5% target in the coming quarters and now expects the pace of its acceleration in the near term to be slower than previously expected.
- The CB also said the pace of economic growth will gradually slow in the coming quarters and highlighted this slower GDP growth, oil and the power price freeze as factors keeping inflation tame.
- Gov Glapinksi now believes that rate stability could last beyond 2019 and 2020 and said that a discussion could be expected on implementing unconventional measures, though these would be up to the next council.
- Throw into the mix the uncertainty around Brexit, still deteriorating relationship with the EU (both put Poland at risk of negative outcome in EU budget negotiations), and the Q4 general election, and we see little reason for Eur/Pln to break below 4.25, and expect the pair to target 4.350-4.400.

The HUF had been underperforming on poor liquidity this year, but this has now changed.

- The NBH's Deputy Gov Nagy sent the clearest indication yet that the unwinding of monetary policy stimulus is imminent, stating it could begin if core inflation excluding the impact from indirect taxes reaches 3%.
- The first steps will include the adjustment of o/n interest rates and tweaks to the FX swap program, aimed at pushing up Bubor toward the benchmark rate of 0.9%.
- This combined with the country's C/A surplus and political stability (despite recent protests) should push Eur/Huf down initially below 320 and then down to 310-315.

Because of this we see potential for PLN/HUF to once again head lower and test 73.30. This is supported by the technical view (see chart on next page):

- Broader bullish momentum is waning, as the market probes increasingly shallow trendline supports.
- Recent sharp rejection from 75.56 (near a falling trendline drawn off the 4 Sep/3 Jan 2018 highs) highlights a broad rounding top pattern unfolding off the 76.26 peak (4 Sep 2018).
- Congestion may persist in the near-term as bears gain traction, but an eventual break lower is favoured.
- Initial targets are seen at 74.11/73.93 (19 Nov/5 Jul 2018 lows), near 38.2% of the entire Aug 2017 – Sep 2018 advance (70.39-76.26) at 74.02.
- Below there will expose 73.32/31 next (50% retrace/1 May 2018 low).
- Above 75.56 followed by 75.85 (3 Dec 2018 high) required to strengthen.

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Viewpoint: Short PLN/HUF Revisited as NBH Creeps Nearer to Policy Normalisation

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The following pages are dedicated to Technical Analysis.

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We will highlight the most compelling on these pages.

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German/US 10Y Spread – Look For a Lower Peak Then More Narrowing

Technical Analysis by Marnie Owen

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- Narrowed from a multi-decade peak at 2.794 to 2.400, near 32.8% of the move from 1.705 (7 July 2017 trough)

- Daily RSI and MACD studies suggest current widening from that area may breach a 2-month falling trendline, but several obstacles near 2.558/97 and 2.647 weigh, and the move should ultimately reverse

- Once narrowing resumes from a lower peak, look for a test of 2.249/29, possibly 2.054 if momentum is strong

STRATEGY SUMMARY

Position for narrowing from the 2.558/2.647 area with scope to test 2.229, possibly 2.054. Stop on widening through 2.710

Resistance Levels		
R5	2.794	6 November 2018 multi-decade peak
R4	2.710	28 November 2018 lower top near 2.701 (76.4% 2.794/2.400)
R3	2.647	11 December 2018 range top near 2.644 (61.8% 2.794/2.400)
R2	2.597	50.0% 2.794/2.400 near 2.596 (7 December 2018 trough) and the 50 DMA (2.599)
R1	2.558	26 December 2018 peak near 2.551 (38.2% 2.794/2.400) and the 200 DMA (2.554)
Support Levels		
S1	2.378	38.2% 1.705/2.794 near 2.386 (2 May 2018 trough) and 2.400 (3 January 2019 narrow)
S2	2.229	21 February 2018 wide near 2.233 (2 April 2018 narrow) and 2.249, 50.0% 1.705/2.794
S3	2.121	61.8% 1.705 (7 July 2017 trough)/2.794
S4	2.054	23.6% -0.340 (24 November 2011 low)/2.794 near 2.062, 8 February 2018 trough
S5	1.955	2018 trough – 11 January, near 1.962, 76.4% 1.705/2.794

EUR/CHF – Firms Over Multi-Week Double Bottom

Technical Analysis by Andrew Dowdell

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- Decline off 1.1501 lacked momentum & a multi-month double bottom is now forming over Sep/Jan's 1.1184 lows

- MACD is heading back into positive territory having crossed above its signal line earlier in the month

STRATEGY SUMMARY

Look to buy for a target of 1.1501. Below 1.1247 delays the advance, risking back to 1.1210 initially.

Resistance Levels		
R5	1.1558	8 August 20185 high
R4	1.1501	22 October 2018 high
R3	1.1470	6-8 November highs
R2	1.1436	19 November 2018 high
R1	1.1350	20 December 2018 high, near the 11 Jan 2009 high at 1.1341
Support Levels		
S1	1.1247	14/15 January 2019 lows
S2	1.1210	9 January 2019 low
S3	1.1184	7 September 2018/3 January 2019 lows
S4	1.1156	61.8% of the 21 February - 20 April 2018 advance (1.0632-1.2005)
S5	1.1129	20 May 2016 high

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