QNB Economics
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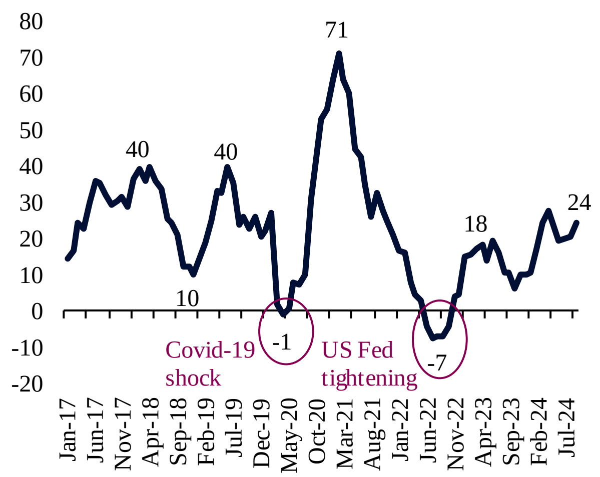
24 November 2024

Are capital inflows to EM set to accelerate?

Despite ongoing volatility, the year has been more constructive for capital flows to emerging markets (EM). This has been predicated by the global easing cycle led by the US Federal Reserve (Fed) and the European Central Bank (ECB) as well as the massive policy stimulus announced by Beijing in September. Importantly, these supportive conditions emerged after several quarters of a more difficult environment following the aggressive monetary tightening that took place in major advanced economies in 2022.

The more positive global macro backdrop is pushing capital towards EM. According to the Institute of International Finance (IIF), non-resident portfolio inflows to EM, which represent allocations from foreign investors into local public assets, experienced a significant shift from negative territory to positive in late 2023. Such inflows led to a rally that is reflected in robust returns across different EM asset classes since their bottom in October 2023, including gains of 20.2% for equities (MSCI EM) and 19.6% for bonds (J.P. Morgan EMBI Global).

Non-resident portfolio inflows to EM
(6-month average, USD Bn, 2017-2024)

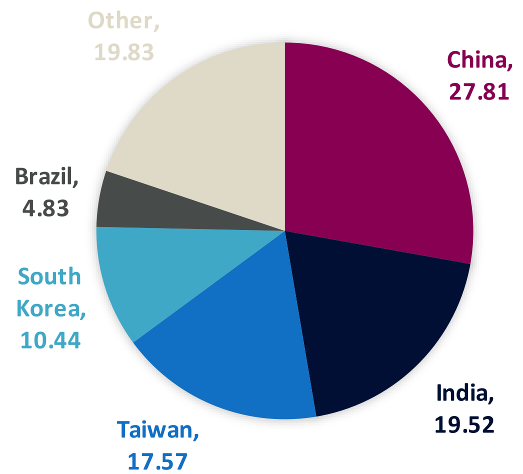


Sources: Haver, IIF, QNB analysis

In our view, there is scope for further acceleration of capital flows to EM, despite potential shocks coming from trade conflicts and economic policy weaponization. Three main factors sustain the outlook for higher capital inflows into EM: the ongoing policy easing by major central banks, the positive change in major drivers from China and the overall improvement of EM macroeconomic imbalances, as well as their policy credibility.

First, changes in interest rates across advanced economies are set to favour investments into EM, as the easing cycle from major central banks deepens over the next few quarters, despite concerns about fiscal populism. In fact, the US Fed is expected to cut policy rates by 75 basis points (bps) next year, whereas the ECB is likely to cut rates by 100 bps during the same period. Traditionally, interest rates are a major driver of capital flows, with investors seeking to allocate their resources to assets with high, risk-adjusted yields. Hence, a reduction of benchmark nominal yields in US and Europe drives investors to be more prone to allocating to riskier investments, such as EM-based assets.

Country weights of MSCI EM Index
(% of total, September 2024)



Sources: Bloomberg, MSCI, QNB analysis

Second, the decision from Chinese economic authorities to take more comprehensive action to support growth and local asset markets is expected to be a continued tailwind for capital flows into EM for the next several quarters. This is key to drive further capital inflows into EM as China is by far the largest country component of major EM indices, such as the MSCI EM. After a massive stimulus encompassing fiscal, monetary and regulatory measures, the Chinese government provided additional guidance that it is willing to further deploy more measures should it be needed for growth and financial stability. This is expected to revive the "animal spirits" of domestic Chinese investors and attract foreign investors that are underexposed to Chinese equity and fixed income markets.

Third, macroeconomic fundamentals are currently stronger in most EM. Several advanced economies have accumulated acute imbalances from excessive policy stimulus following the pandemic and the Russo-Ukrainian conflict, leading to issues such as high public debt and unstable inflation. In contrast, most EM countries have been conservative with their fiscal policy space, in order to prevent too much debt accumulation or increasing external vulnerability. As a result, several EM countries have gained policy credibility, which increases the attractiveness of their markets.

All in all, after a period of subdued capital inflows into EM, the more positive global macro outlook should provide some support for an acceleration of flows. This is expected to be driven by continuous policy easing by the Fed and the ECB, stronger growth in China and more robust domestic conditions in most major EM.

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