BARCLAYS

Equity Research

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Investor Intel

Who's buying equities?

Global equities have continued to rally despite $128bn of outflows from equity funds since mid-March. Futures buying and short-covering have more than offset the outflows. With that dramatic shift in positioning basically done, retail and foreign investors are the incremental buyers/sellers of equities; S&P 500 returns have been 49% correlated with shifts in their combined ownership over the last 20 years. Active equity MFs are selling amid large retail redemptions while foreign investors are also selling US equities.

A turn in retail/foreign sentiment and a resumption of equity inflows would get markets back to more of a grind since the positioning-driven bounce has played out, but still elevated active manager positioning leaves the market vulnerable to risks. To better assess the path for equities and identify potential opportunities, we seek to better understand the buying dynamics across the investor and corporate landscape:

- Since March, $60bn of net buying of US equity futures (notional) and $60bn of flow from short-covering in S&P 500 stocks more than offset the $50bn of outflows from US equity ETFs and MFs. Dynamics outside the US were likely similar. Short interest is back to 2015 lows and the equity HF beta is very high, leaving equities vulnerable.
- Equity MFs are net sellers given $164bn of redemptions since April, driven by retail. ETF inflows only offset some of the MF outflows. We are concerned that US equity funds are not prepared for a continuing redemption cycle with cash levels low.
- The rebalance into equities the end of June helped drive stocks higher, fuelled by the $2.5tr jump in the market value of bonds globally YTD ($1tr since May). The bond-equity correlation has risen over the last month, which is a risk to equity returns, and Fed comments at Jackson Hole (August 26) could be pivotal once again.
- Foreigners have been buying US bonds ($28bn per month) but selling US equities. Weekly data show that Japanese net buying picked up after May and spiked in mid-July, suggesting a return of the foreign buyer. Importantly, while net purchases of equities have fluctuated, gross purchases by Europe and Japan have surged, suggesting that QE may indeed be having a sizeable impact.
- With $1tr of annual dividends paid out globally and S&P 500 firms buying back over $500bn of stock on net, corporates remain the primary driver of equities. Strong Q1 buybacks likely primed the pump for the rally, but S&P 500 gross buybacks declined by $22bn in Q2 and 12m announcements are down $115bn YTD. Across sectors, actual net buybacks for healthcare and discretionary declined markedly from Q1 to Q2, while those for staples and financials rebounded sharply. Announcements for staples fell considerably, while those for technology rose and financials jumped.
- Across regions, Europe equity outflows YTD (-$85bn) reversed two-thirds of the post QE inflows and Europe MF positioning is underweight. EM equity MFs are also underweight as inflows have picked up. Across sectors, short-covering has been the primary driver of performance, but recent fund flows have gone to cyclical sector funds as defensives have had outflows. Across styles, small cap MF positioning is underweight as inflows picked up last week.

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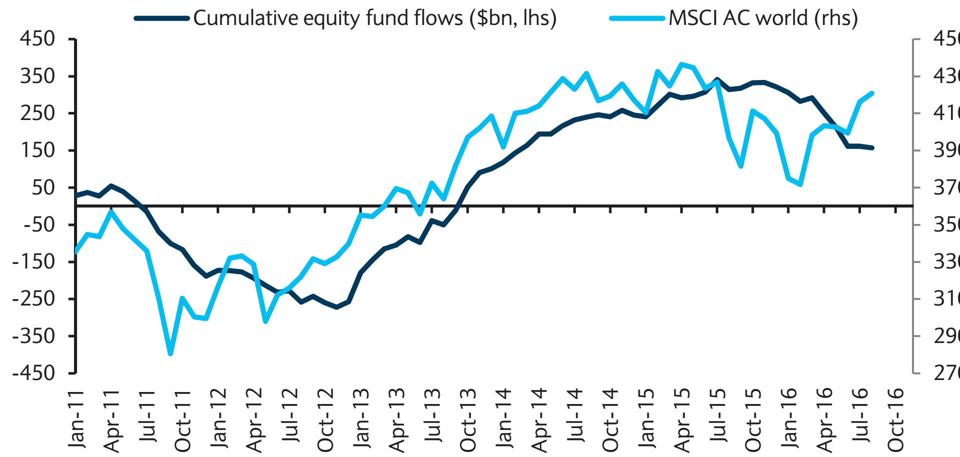
Disconnect: equity rally despite large equity fund outflows

To better assess the path for equities, we seek to better understand who has actually been buying through the equity rally. In particular, there is a clear disconnect between the magnitude of the equity rally (MSCI AC World +8% since mid-March) and the magnitude of the outflows from equity ETFs and MFs ($128bn since March). Thus, it raises the questions of who has been the incremental buyer and whether the dynamics are sustainable.

FIGURE 1

After a position covering bounce through mid-March, equities have rallied since then despite $128bn of outflows from equity MFs and ETFs



Source: EPFR, Haver Analytics, Barclays Research

Futures buying and short-covering has fueled the rally

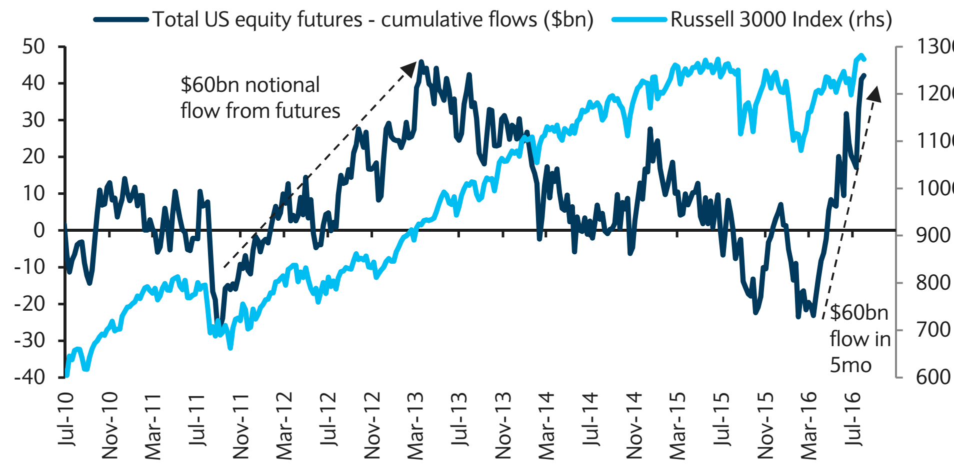
We estimate that buying of US equity futures and short-covering in single stocks have been a primary source of fuel for the equity rally (~$120bn since March), more than offsetting the $50bn of outflows from US equity ETFs and MFs. Although the analysis below is based on US futures and short interest because of data availability, we would suspect that the same dynamic has played out outside the US as well; that futures buying and short-covering have offset the outflows from equity funds.

Net buying of US equity futures since March ($60bn notional) has surpassed the amount of buying between October 2011 and May 2013 (Figure 2). In less than five months, positioning in futures has seemingly swung as much as it did over the 20-plus month period following the 2011 lows. We would argue that the dramatic shift was more warranted after 2011 given the introduction of extraordinary Fed policy (calendar guidance, Twist, QE3), a pickup in growth after a mid-cycle slowdown and a reduction in risk from Europe. Central bank policy globally has remained extremely accommodative, but the economy is grappling with some later cycle dynamics as the Fed is still trying to hike a second time.

Separately, for S&P 500 stocks, the flow to US equities from short-covering since March has been $60bn, and $26bn since June (Figure 3). Indeed, short interest has fallen to the lows of last year as perceptions of risks have seemingly reset. Commensurately, our measures show equity HF net exposures are very high (Figure 4) amid the futures buying and short-covering. The wall of worry, as measured by short interest and HF net exposure, has come down.

FIGURE 2

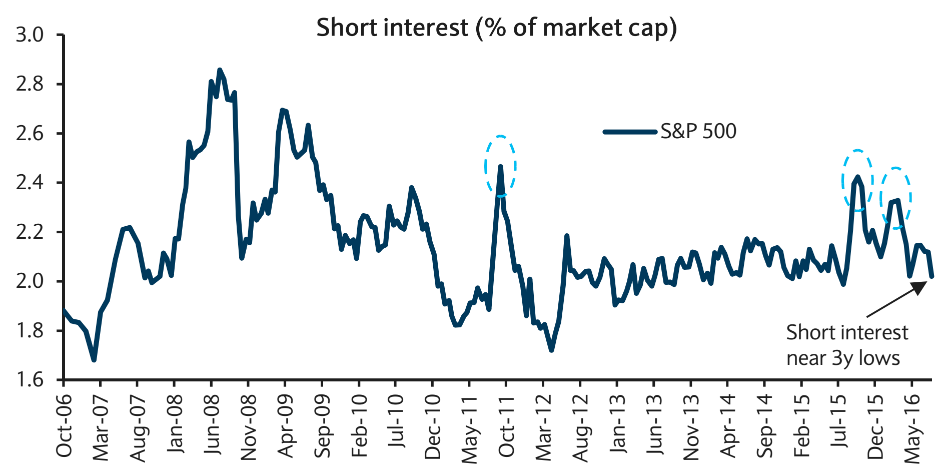
Futures buying since mid-March has provided a $60bn notional flow to US equities



Note: Total US equity futures includes net speculative futures and options for the S&P 500, Nasdaq, Russell 2000, Dow and S&P 400 indices. Source: CFTC, Haver Analytics, Barclays Research

FIGURE 3

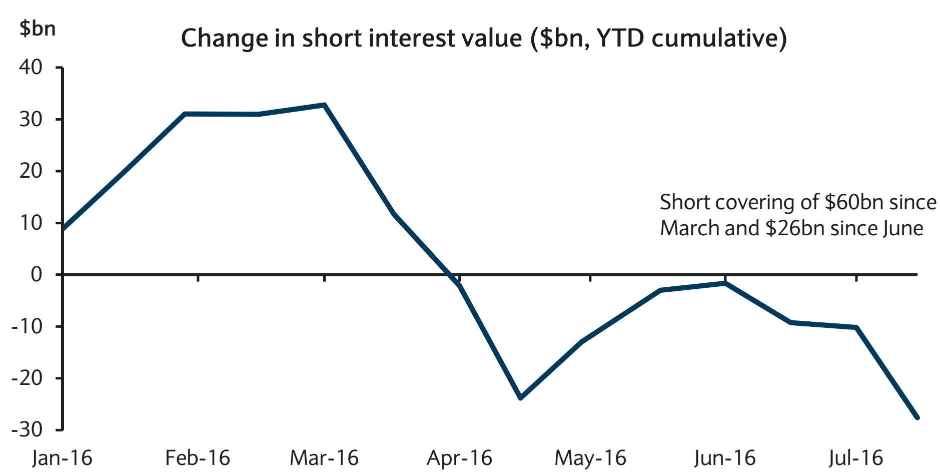
Short-covering has pushed short interest in S&P 500 stocks back to three-year lows …



Source: Factset, Barclays Research

FIGURE 4

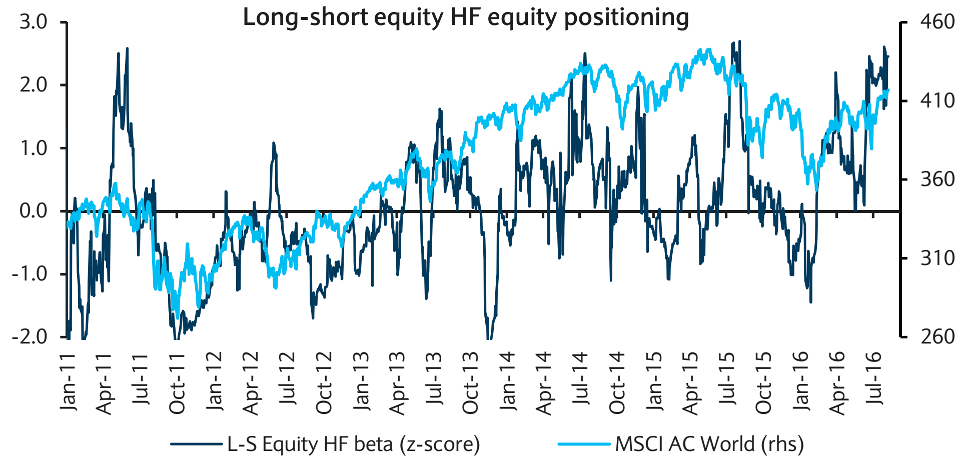
…and the associated flow to equities was $60bn since March and $26bn since mid-June



Source: Factset, Barclays Research

FIGURE 5

Long-short equity HF beta has risen toward post crisis highs



Source: Bloomberg, Barclays Research

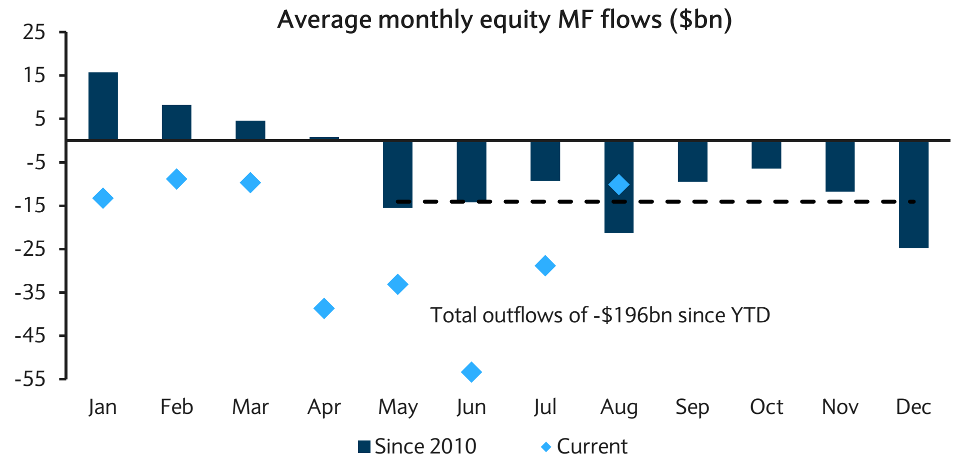
Active equity MFs continue to sell amid large redemptions

As we first highlighted in *Equity positioning at post-crisis highs* (April 5, 2016), one key risk to equities was the acceleration of redemptions from active equity MFs as positioning at funds was very elevated (i.e. low cash levels). Total outflows from equity MFs have been $196bn YTD with a monthly pace of about $40bn since April (Figure 5). Accordingly, mutual funds have been large net sellers of equities. On the other side, ETF inflows have not been enough to offset the MF outflows.

The DOL's new fiduciary regulation is likely to keep MF redemptions at an elevated pace, and we are concerned that higher risk exposures and lower cash levels at equity MFs make the market more vulnerable (Figure 6). US equity MF beta is 1.4 std above average, levels that have historically coincided with market pullbacks.

FIGURE 6

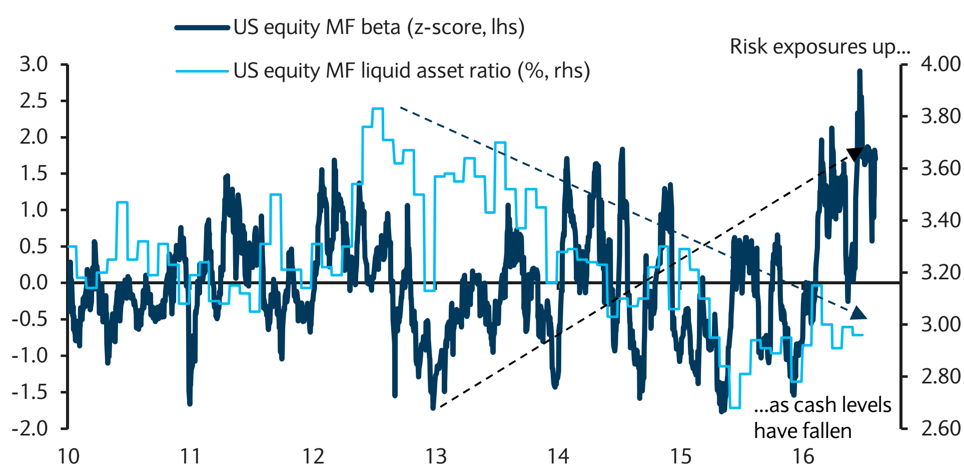
Equity MF redemptions have been $196bn YTD and the pace has accelerated since April



Source: EPFR, Haver Analytics, Barclays Research

FIGURE 7

US equity MF beta is still extremely high as cash ratios are near the lows



Source: ICI, Haver Analytics, Bloomberg, Barclays Research

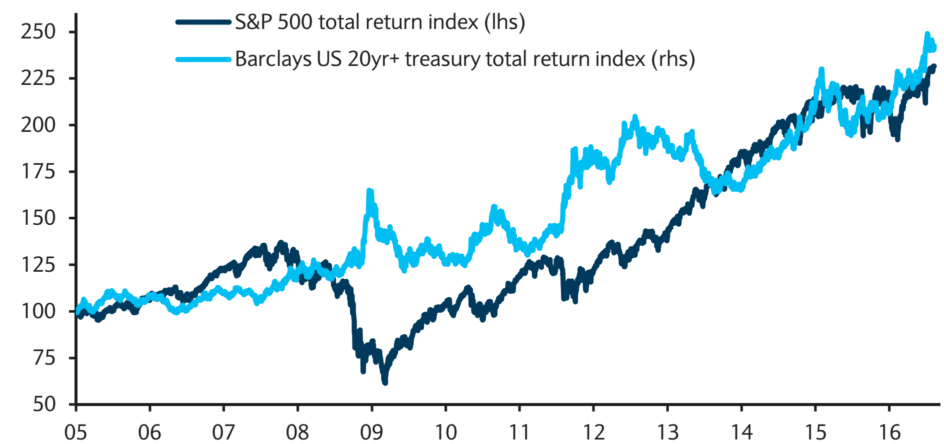
The rebalance into equities was significant, but the rise in the bond-equity correlation is a risk

The S&P 500 and the Barclays 20+yr US bond index have more than doubled since 2005 as yields have fallen with the long bond considerably outperforming since last year (Figure 7). As we discussed in *Data driving equities higher, for now* (July 14, 2016), the $2.5tr increase in the market value of bonds globally YTD ($1tr since May) dwarfed the excess cash on the sideline on our measures. The ensuing rebalance into equities around the end of June helped drive stocks higher as rates stayed relatively low. Equity-bond allocations are back to fall 2015 levels while cash ratios have fallen notably as both equities and bonds rallied.

However, as equities and bonds have both moved higher, the correlation between bonds and equities has risen considerably over the last month (Figure 8). The extreme negative correlation allows many multi-asset funds to have higher (and leveraged) exposures to both bonds and equities given the lower volatility of the diversified portfolio. A shift in that correlation could lead to weaker equity returns, as it did last spring and in 2013.

FIGURE 8

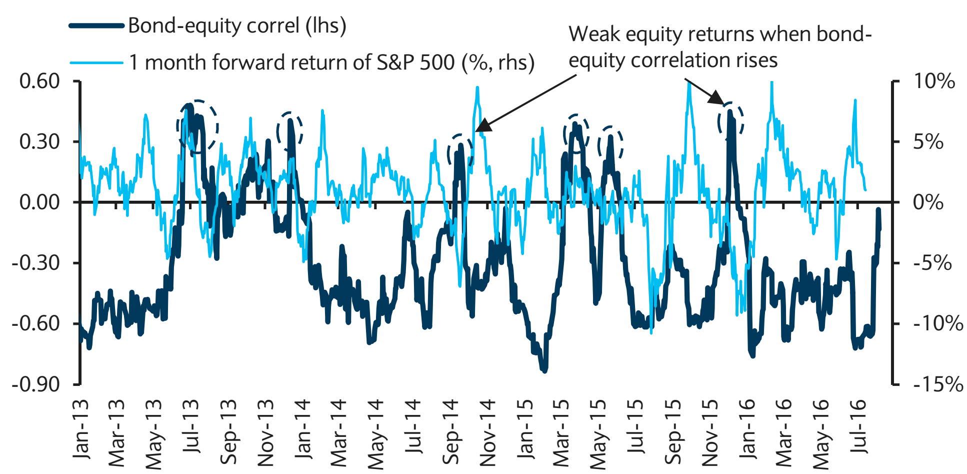
Long duration bonds and equities have both more than doubled since 2005



Source: Bloomberg, Barclays Research

FIGURE 9

A rise in the bond-equity correlation has coincided with weak forward equity returns



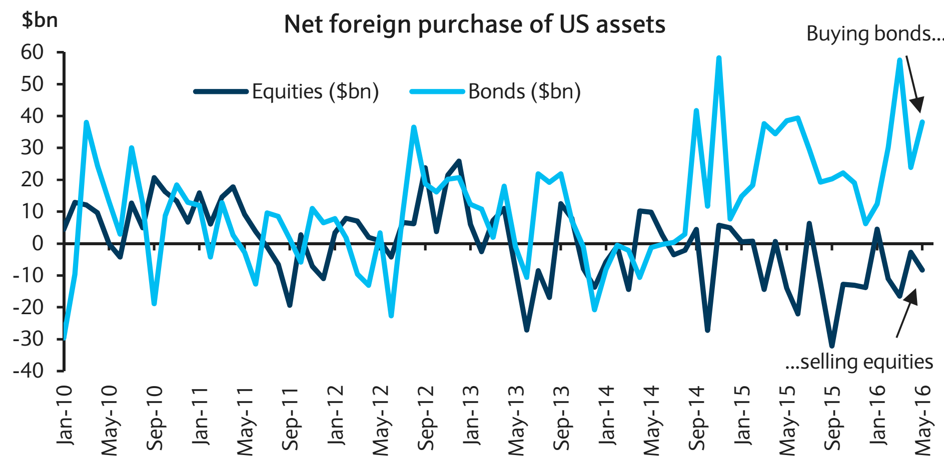
Source: Bloomberg, Barclays Research

Foreign selling of US equities and buying of US bonds ...

As the US dollar has strengthened since the middle of 2014 and rates have fallen, foreign buying of US bonds has been insatiable, averaging $28bn per month (Figure 10). On the flip side, foreigners have been selling US equities since early 2015; part of the selling is likely due to rebalancing out of US equities, which have outperformed, to other regions. The strengthening dollar did not seem to attract net foreign inflows to US equities like the 1990s. All key regions have been large net sellers of US equities YTD (data through May); Japan is the exception. Many investors point to the indirect support from extraordinary monetary policy and QE outside the US as providing a bid for equities, but that does not appear to be showing up in the data yet. Selling by the likes of Saudi Arabia and others has been larger than Japan's buying. Specifically, foreign official institutions (central banks, etc.) have been net sellers of US equities since mid-2013 with occasional small net buying.

FIGURE 10

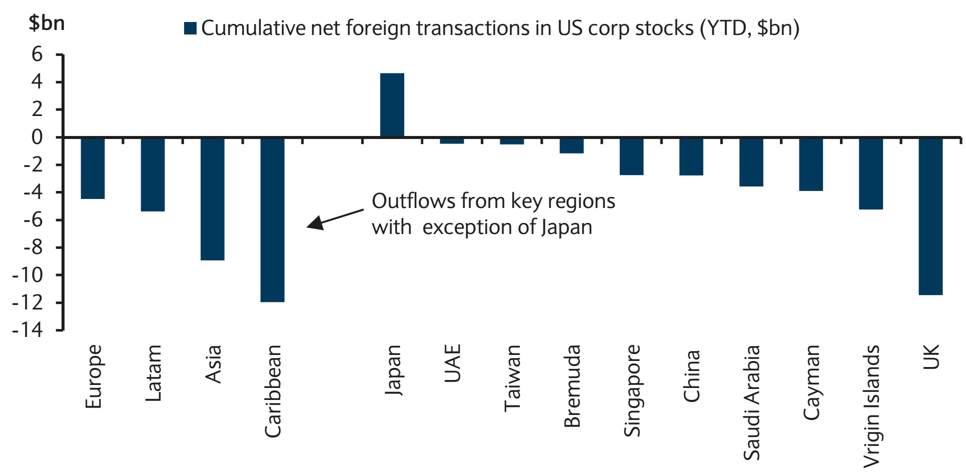
Foreign buying of US bonds and selling of US equities has been a clear trend since 2014



Source: US Treasury, Haver Analytics, Barclays Research

FIGURE 11

All key regions have been net sellers of US equities with the exception of Japan



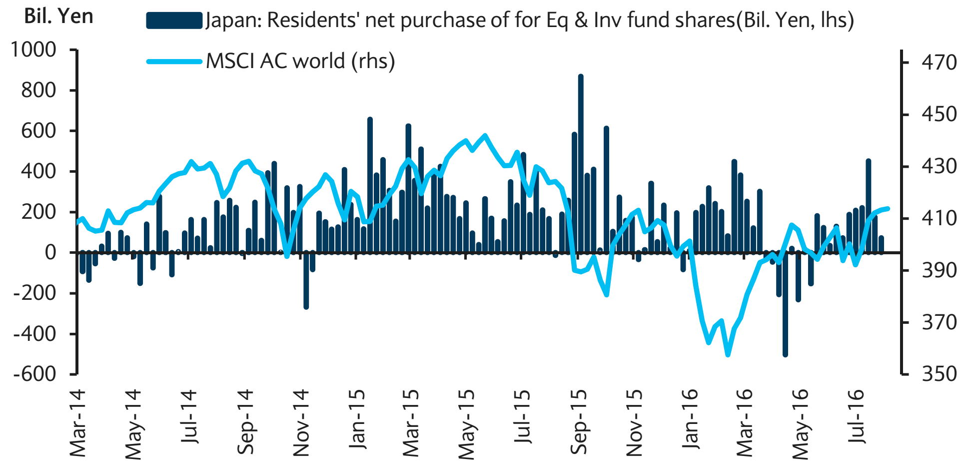
Source: US Treasury, Haver Analytics, Barclays Research

... but signs of a turn in foreign buying

The weekly data from Japan's MoF shows that net buying of foreign equities by Japanese investors picked up moderately since June with a large spike in mid-July when equities took the last leg higher. However, the pace of Japan's net buying of foreign equities is still slower than the pace prior to March 2016. However, as net purchases of equities have fluctuated, gross purchases have surged in Europe and Japan, suggesting that QE may indeed be having an impact. For Europe, gross purchases of US equities have risen by about 60% since the end of 2014. Japan's gross purchases of foreign equities have tripled since QE began.

FIGURE 12

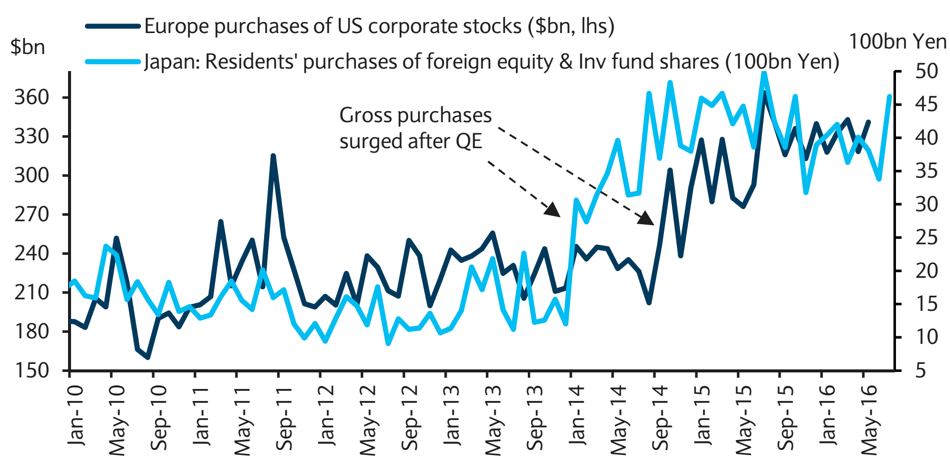
Japanese net buying of foreign equities picked up after May, particularly in mid July



Source: Ministry of Finance Japan, Haver Analytics, Barclays Research

FIGURE 13

Europe and Japan gross purchases of equities have increased significantly since QE



Source: Ministry of Finance Japan, US Treasury, Haver Analytics, Barclays Research

Foreign + retail is the key

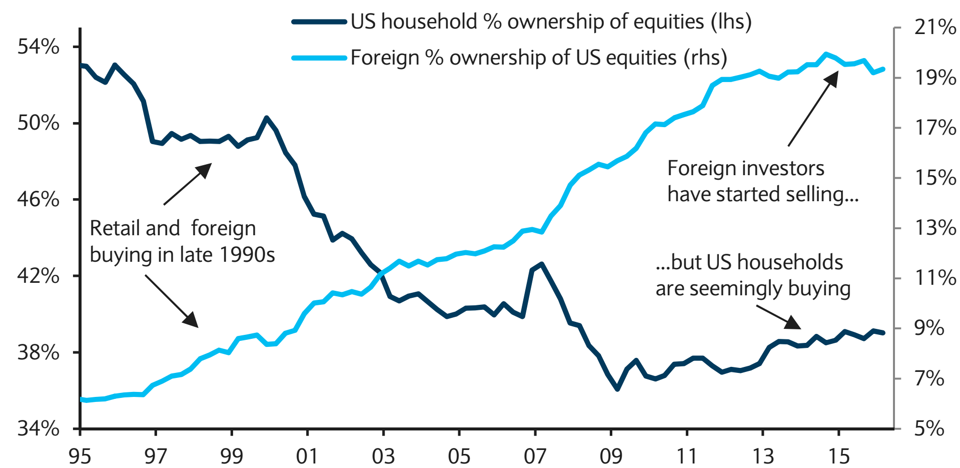
From a demand perspective, we believe that foreign and retail investors are the incremental buyers (or sellers) of equities with US institutional equity allocations already at or near the highs and their cash levels fairly low. Against a secular downtrend, household ownership of equities plummeted during market collapses of 2000-2003 and 2007-2009 (Figure 15). On the other hand, flat to higher household ownership through 1996-2000, 2004-07 and since 2009 (or 2012) coincided with market rallies. All the while, foreign investors have been increasing exposure to US equities, particularly the late 1990s and 2008-2014.

As discussed above, foreign investors have been selling US equities on net since 2014 and foreign ownership levels have edged lower. Household ownership has drifted higher, suggesting that retail investors in the US are buying equities. Figure 16 shows the change in the combined ownership of households plus foreign (x-axis) graphed against S&P 500 yoy returns; US equity returns have been 49% correlated to the combined shifts since 1996.

Foreign and retail investors are the key, in our view, given the uneasy tension between low rates globally, the cash piles in China/Asia and the still mediocre growth backdrop with later cycle risks.

FIGURE 14

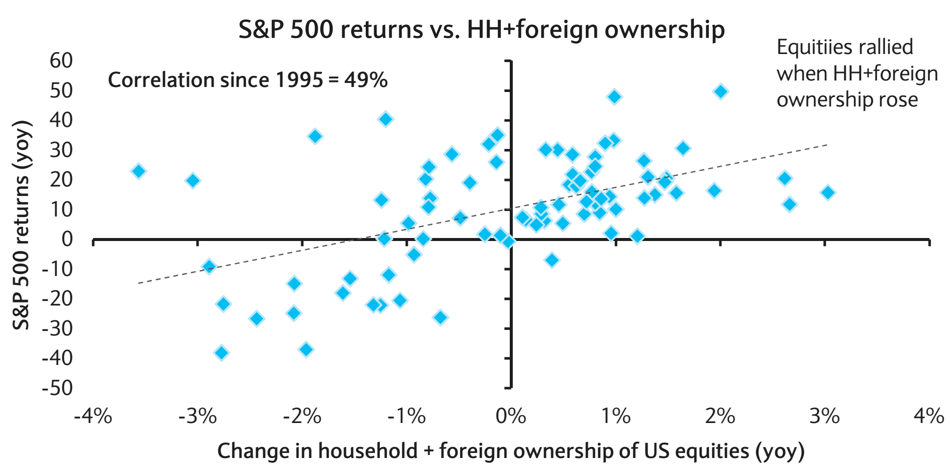
After rising since the 1990s, foreign ownership of US equities has fallen recently amid selling of US equities; on the other hand, household ownership has edged higher



Source: FRB, Haver Analytics, Barclays Research

FIGURE 15

S&P 500 returns have been very correlated with shifts in foreign + household ownership



Source: FRB, Haver Analytics, Barclays Research

Corporate bid is still solid, but it is slowing

The biggest buyers of equities are corporates themselves with S&P 500 net buybacks rising to $500bn over the last four quarters from $375bn in 2013. To put that into perspective, total inflows into equity MFs and ETFs were $159bn in 2013. With about $1tr of dividends being paid out globally, reinvested dividends are also a key source of flow, particularly outside the US where buybacks are less popular. Reinvested dividend payments rose in early August. The drop in IPOs YTD (~50%) and the continuation of M&A have also been supportive from a demand-supply perspective.

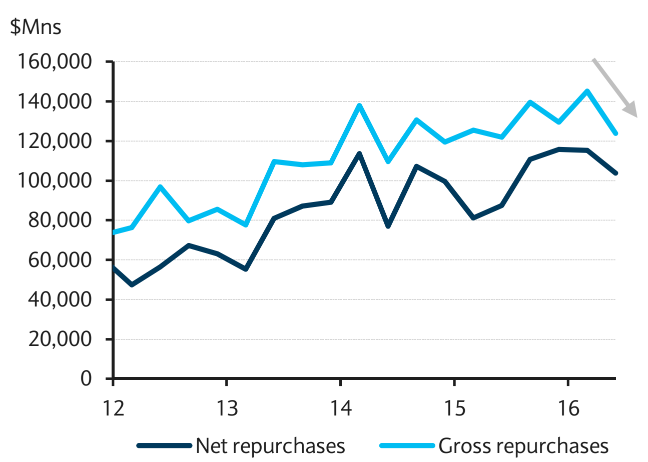
Based on those S&P 500 companies that have reported buyback data for Q2, gross buybacks fell by $22bn (-15%) from Q1 to Q2 and net repurchases declined by $11bn (-10%) (Figure 16). For the first time since 2012, more S&P 500 companies reduced the amount of buybacks in Q2 than increased the size (Figure 17). However, this followed a strong Q1 when companies seemingly upped repurchases during the selloff. Trailing four quarter buybacks remain stable. We would expect flat to mildly lower growth in Q3 as weak comps roll off. As a percentage of market cap, net buybacks in Q2 are 1.5% annualized, about the same level of 2012-2014 as buybacks have kept pace with market value.

The fall in buyback announcements earlier in 2016 foreshadows a continued softening in buybacks but not a complete falloff (Figure 18). Buyback announcements are down $115bn yoy, but GE's $50bn announcement in 2015 explains 45% of that difference. Announcements remain weak but have showed modest yoy growth in the last two months, driven by the financial sector following CCAR results and the technology sector. As discussed in *High payout ratios suggest low returns ahead* (June 30, 2016), the total payout ratio of buybacks plus dividends surged to 128% and extremely high payout ratios pointed to lower dividend growth and lower returns going forward.

Across sectors, from Q1 to Q2 net buybacks declined most in discretionary and healthcare, followed by industrials and technology. Financials were flat, and staples were up sizeably. Year-to-date, buybacks are up, driven by driven by financials, staples, healthcare and industrials (Figure 19). Announced buybacks show broad-based declines YTD. Financials are now in-line after CCAR as are industrials excluding GE (Figure 20).

FIGURE 16

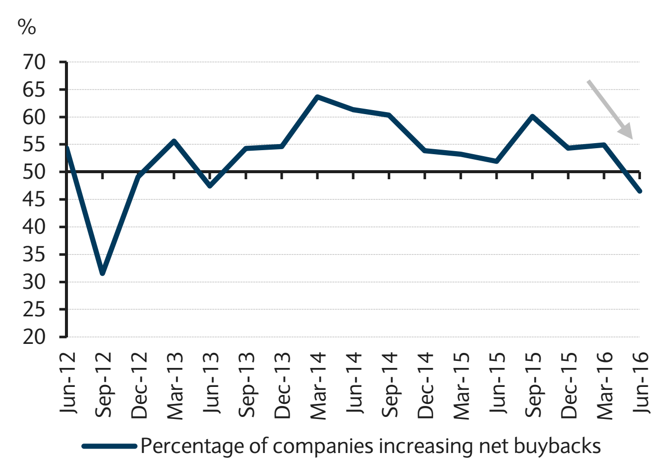
Buybacks declined from 1Q to 2Q …



Source: FactSet, Barclays Research
Note: Includes S&P 500 companies that have reported 2Q16 results.

FIGURE 17

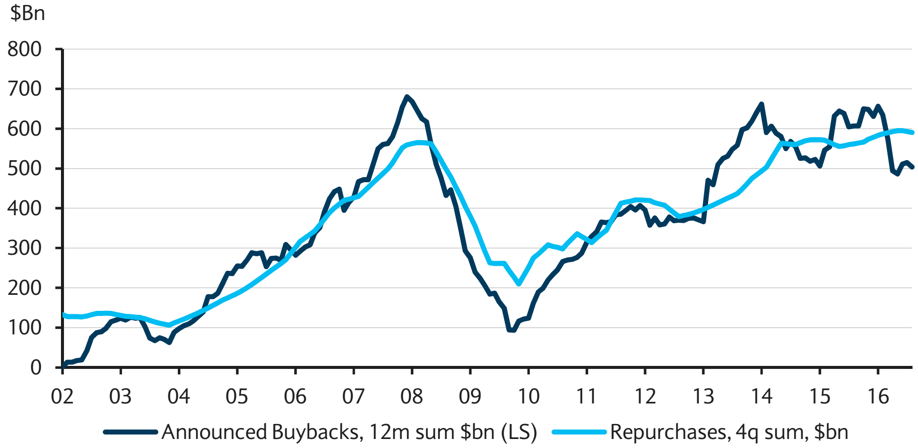
… and less than half of companies increased net buybacks



Source: FactSet, Barclays Research
Note: Includes S&P 500 companies that have reported 2Q16 results.

FIGURE 18

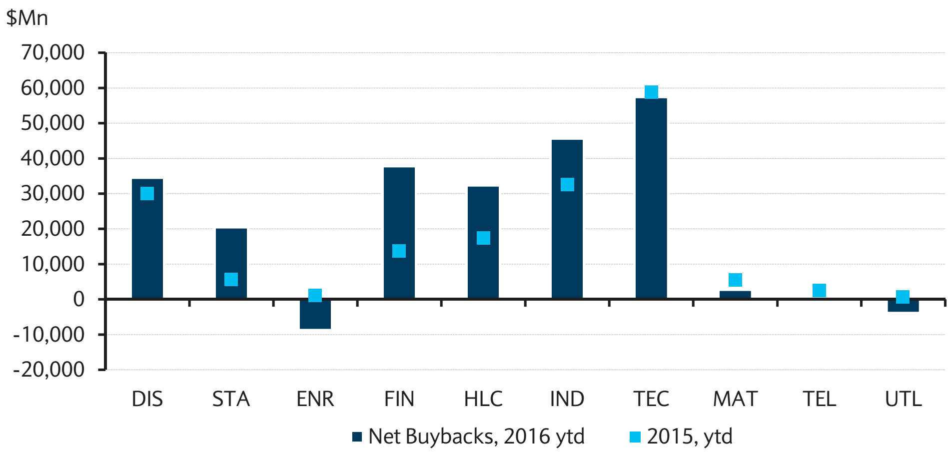
Buyback announcements fell earlier in 2016. GE's $50bn announcement in 2015 explains 45% of the yoy difference



Source: FactSet, Bloomberg, Barclays Research.

FIGURE 19

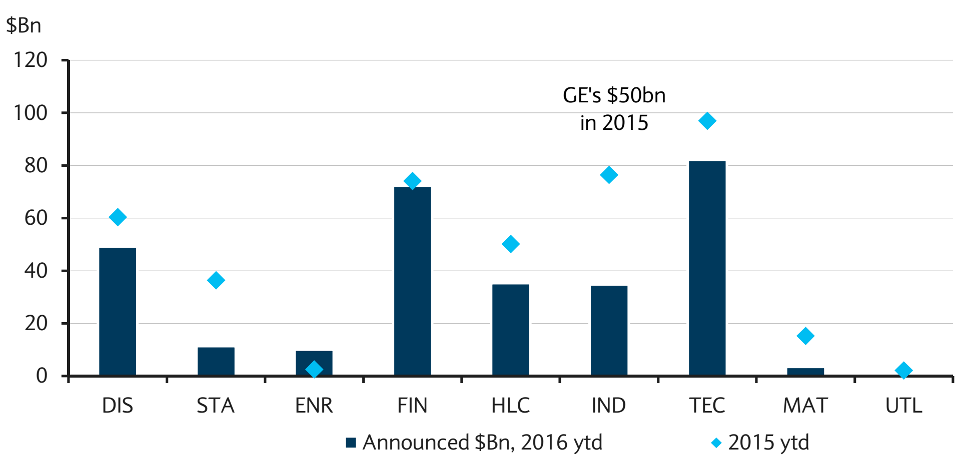
Actual net buybacks are up YTD, driven by financials, staples, healthcare and industrials



Source: FactSet, Barclays Research. Note: Includes S&P 500 companies that have reported 2Q16 results.

FIGURE 20

Buyback announcements are down YTD in all sectors except Financials and Energy. Excluding GE's 2015 announcement, the industrials sector is up yoy



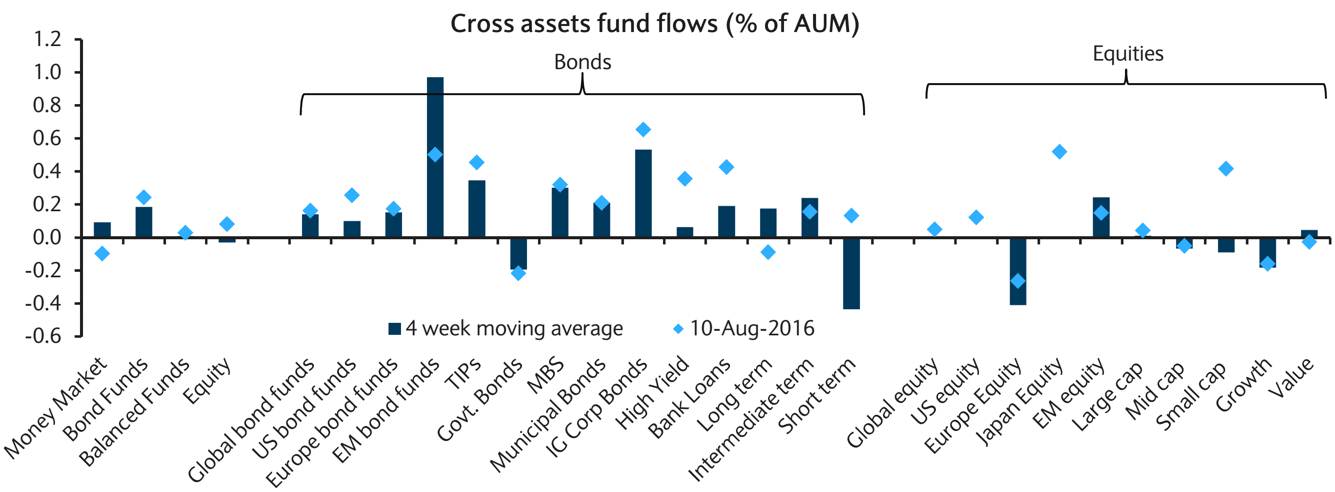
Source: Bloomberg, Barclays Research

Flows and positioning across countries, sectors, styles

From a fund flow perspective, bond funds have had inflows of about $164bn YTD with the weekly average running at a $9bn pace since Brexit. Credit and EM have been the primary beneficiaries and recent flows have continued that trend (Figure 20). On the other hand, equity MFs and ETFs have had very modest inflows of $1.7bn the last six weeks with the $6.4bn inflow last week the first sizeable inflow since mid-July. From a flows and positioning perspective, a few things jump out across regions, sectors and styles:

- Europe equity outflows YTD (-$85bn) have basically erased two-thirds of the post QE inflows of 2015.
- UK equity outflows have been less than Europe outflows as a % of AUM since Brexit (-1.5% vs. -3.2%).
- Europe, EM and global equity funds are underweight, US funds are overweight.
- Across futures, Dow and Nasdaq positioning is extremely high, VIX extremely short.
- Across styles, US small cap MFs are underweight and small cap inflows picked up last week. The combination of would be supportive on a relative basis for US small caps. Growth MFs have turned overweight.
- Across sectors, cyclical sectors have been getting sizeable inflows led by commodities and industrial while bond proxy sectors consumer and utilities have had recent outflows.

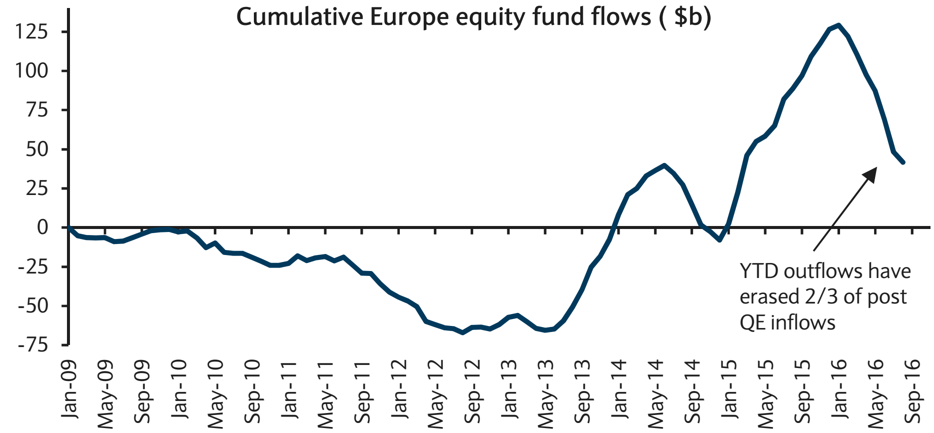
FIGURE 21
Fund flows across assets



Source: EPFR, Haver Analytics, Barclays Research

FIGURE 22

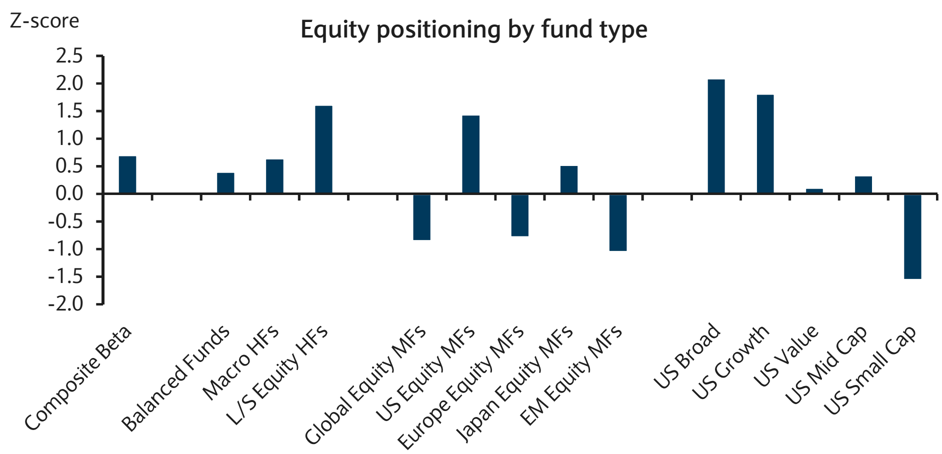
European equity funds have lost about 8% of AUM to outflows YTD, erasing about two-thirds of the inflows since the ECB announced QE



Source: EPFR, Haver Analytics, Barclays Research

FIGURE 23

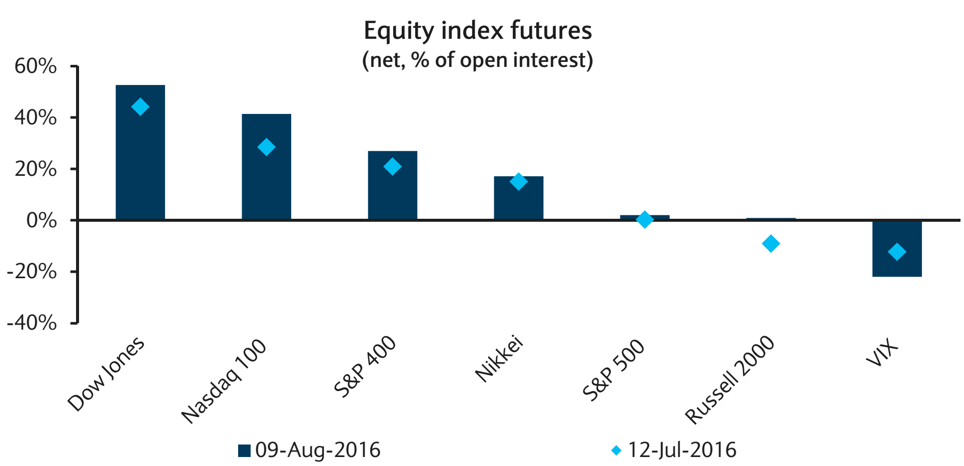
Europe, EM, global and small cap MFs are underweight while long-short equity HFs and US MFs are underweight



Source: Bloomberg, Barclays Research

FIGURE 24

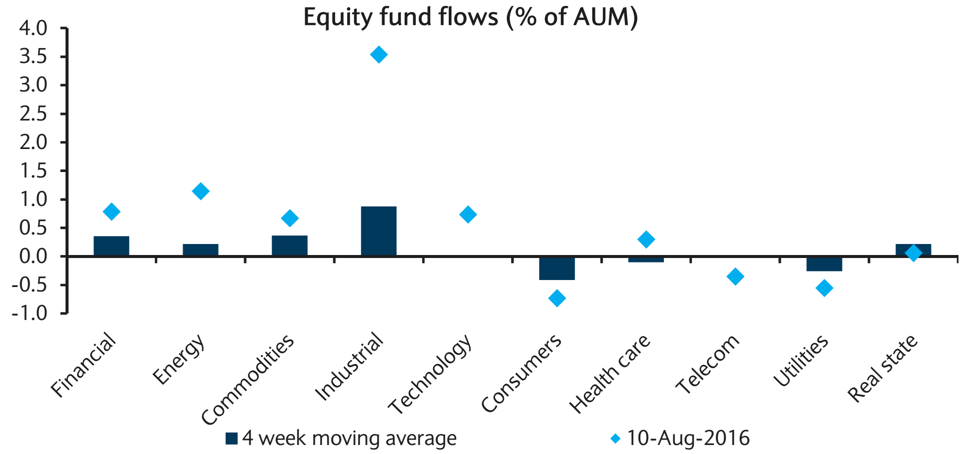
Dow Industrials and Nasdaq net speculative positioning has risen dramatically and is very high while positioning in VIX futures is extremely short



Source: CFTC, Haver Analytics, Barclays Research

FIGURE 25

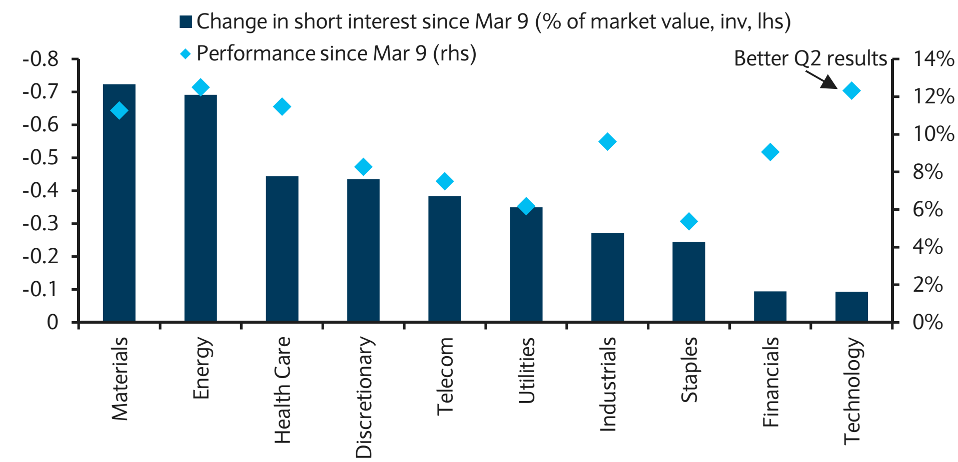
Cyclical sectors have been getting inflows while bond proxy sectors have had outflows recently



Source: EPFR, Haver Analytics, Barclays Research

FIGURE 26

Short interest covering since mid-March has been a big driver of performance



Source: Factset, Barclays Research

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In addition to the stock rating, we provide industry views which rate the outlook for the industry coverage universe as Positive, Neutral or Negative (see definitions below). A rating system using terms such as buy, hold and sell is not the equivalent of our rating system. Investors should carefully read the entire research report including the definitions of all ratings and not infer its contents from ratings alone.

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