The Fed Interest Rate as the Dominant Factor of Portfolio Equity Flows

Wilman San Marino(✉), Nugraha, and Ikaputera Waspada

Universitas Pendidikan Indonesia, 40154 Bandung, Indonesia
wilmansanmarino@upi.edu

Abstract. The drivers of the equity portfolio flow to Emerging Market Countries (EMCs) are divided into factors, i.e., the global environment that supports EMCs investment and the attraction factors that are the domestic environment and EMCs attract those invest money. The main factor that has the greatest impact on the portfolio balance going to emerging countries is the Fed Funds rate, which is one of the most motivating factors. This research is based on descriptive analysis and literature review methods to explain why the Fed interest rate is so important. In conclusion, the Fed analyzes macroeconomic indicators to understand the current growth rate and potential in the future and adjust policies, one of which is interest rates. The Fed is an expert on economic information. Therefore the market will react to policy publications, and investors will make trading decisions based on those policies.

Keywords: Portfolio Equity Flows · Fed interest rates · Push Factors · Pull Factors

1 Introduction

Economic and structural reforms in emerging countries in various regions demonstrate the ability to attract foreign capital, especially portfolio equity funds. Emerging countries are making liberalization of the capital market, which allows foreign investors to invest in the capital market. At least four characteristics distinguish capital markets in emerging countries from developed countries: high returns, low correlation with returns in developed markets, observable returns, and volatility is high. Liquidity in emerging capital markets can predict future returns [1, 2].

Low international correlations indicate that investors can reduce portfolio risk if they diversify internationally rather than domestically. The structure of international relations is one of the influential factors in reducing risk as a relative benefit of investing in various countries [3–5]. The development of various foreign financial markets and the development of information technology have made financial markets around the world interconnected [6].

The difference in growth rates between developed and developing economies over the last few decades has motivated the growing literature on the relationship between economic growth and returns on capital. It is predicted that developing countries' economies

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will outpace developed countries using a growth approach derived from neoclassical growth models [7]. Capital should have higher returns in countries with low per capita capital markets, usually emerging countries.

Emerging countries benefit from cross-border portfolio investments as opportunities to grow their economies. Foreign investment in the domestic market and foreign financial institutions will offer new products that further stimulate competition in the domestic market. Increased investment flows, savings, and financial liquidity are factors that have a beneficial effect on economic growth. Liberalization of financial flows should result in increased financial discipline, increased transparency, and changes in market efficiency. It also contributes to lowering the cost of national borders and encourages the government to phase them out [8, 9].

Foreign investors have the goal of rebalancing their international portfolios by placing them in Emerging countries. Rebalancing is motivated by the following motives: (1) to reduce exposure to foreign exchange rates and (2) to pursue higher returns in emerging markets. The motive for reallocation is to increase returns rather than reduce the risk [10].

Portfolio equity flows to developing countries are increasing sharply with high volatility and concentration but changing significantly from time to time with all the risks [11]. An in-depth analysis is needed to explain this phenomenon, especially the main factor causing it.

2 Methods

THE RESEARCH METHOD USED IS THE EXPLORATION METHOD, WHICH AIMS TO DEEPEN KNOWLEDGE ABOUT CERTAIN SYMPTOMS. Data collection techniques are literature study.

3 Result and Discussion

Portfolio investment is defined as the investment of capital and foreign securities, mainly stocks and bonds and is a short-term investment. Some may be long-term investments, especially in multi-year bonds of the other countries provided by the government [9]. The difference between foreign investment and foreign investment is that the money is invested to achieve a higher rate of return on investment than that provided by the country and to diversify the portfolio in terms of risk reduction life, not to gain effective control over the business [12].

An increase in portfolio equity refers to portfolio investments beyond the limits that can be seen from a country's balance of payments, which is a standardized record of all economic transactions that occur in one period between domestic residents and residents of other countries. In terms of time, it can be a year, a quarter, or a month, although other times are possible; also, note that because the balance of payments refers to a specific period of time, it is, therefore, a flow concept [13].

Portfolio equity flow is influenced by many factors, divided into push factors and pull factors. There are three driving factors: First, the transmission of global risk that was common during the financial crisis. Various empirical studies have found a strong

relationship to the increase in global risk in the component of portfolio flows [14–21]. Second, external interest rates, which are represented by the Fed's interest rate, have a negative relationship with portfolio flows. When the Fed's interest rates rise, it will reduce portfolio flows to developing countries [14, 15, 19, 22–29]. Third, regarding GDP growth in developed economies, there is limited research on the assumption that GDP growth in developed countries that do not match expectations encourages portfolio flows to emerging countries [22, 30, 31].

Pull factors are internal factors in emerging countries that attract portfolio flows. First, the relatively high economic growth of developing countries compared to developed countries has become a special attraction related to portfolio flows [22, 32, 33]. Second, high market returns in emerging countries, with very different characteristics from the capital and financial markets in developed countries, are associated with increased portfolio flows [10, 15, 26, 34–39]. Third, in the Country Risk indicator for portfolio flows, we find that a higher debt-to-GDP ratio leads to lower portfolio flows [25, 40].

The portfolio equity flows are dominantly influenced by fed interest rates. The Fed is an expert on economic health information. Its policy signals will make the market react, making it one of the economic indicators and drivers in financial markets that have a significant impact on asset prices [41, 42]. The relationship between Fed policy and capital markets lies in the industry valuation methodology, The Fed Model is a common tool used by major financial institutions such as Prudential, ING, and J. P. Morgan. Influential market participants embrace and make the Fed model a leading investor valuation tool to check whether they should buy equity or bonds [43].

The Fed's contractionary monetary policy provides a signal that will have a significant impact on equity markets in the U.S., Europe, and even the world [41]. In recent times equity analysts have seen the consistent impact of Fed rates on equity markets, which shows that to understand portfolio flows, Fed rates have become important data [43].

4 Conclusions

The dominant factor of portfolio equity flows to EMCs is the Fed interest which is an economic indicator and driver in financial markets that have a significant impact on asset prices. In recent years, the consistent impact of Fed rates on equity markets shows that to understand portfolio flows, The Fed interest rates have become important data.

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