INSTITUTIONAL INVESTOR DIALOGUE

4 May 2022, 12:00 to 14:00 CET
(online event)

Participants

- Representatives of Aegon Asset Management, Allianz Global Investors, Amundi, Assicurazioni Generali, ATP, Aviva Investors, AXA, J.P. Morgan Asset and Wealth Management, Legal and General Investment Management, Nordea Asset Management, State Street Global Advisors and Zurich Insurance Group
- Members of the Governing Council of the ECB (or their alternates)
- ECB officials from the Directorates General Market Operations, Communications and Secretariat, as well as the ECB's Chief Compliance and Governance Officer

Summary

Outcome of the survey of participating investors

The meeting started with a presentation on the results of the recent survey of IID participants, which covered various aspects of recent as well as more structural developments in financial markets. The survey results indicated that most participating investors saw the ECB's policy rate path as the most critical element of the ECB's future monetary policy actions, followed by the timing and pace of the ECB's balance sheet reductions.

As regards perceived risks, political uncertainty and geopolitical risks were the key concerns, followed by uncertainty about the economic outlook and uncertainty about major central banks' decisions.

Meanwhile, the relevance of monetary policy expectations continued to rise as the key driver of the outlook for the EUR/USD exchange rate, followed by political uncertainty and geopolitical risks.

Nearly 60% of respondents did not envisage making any changes to their G3 currency allocations over the next 12 months. Around 20% of respondents planned to increase their Japanese yen or euro allocations, and views were divided regarding the US dollar.

Most participating investors did not anticipate making any changes to the allocation between equities and bonds. In developed markets (Europe, North America and Japan), investors were more likely to report plans to increase equity allocations rather than bond allocations (although the number of investors intending to increase their bond allocations had risen since the previous survey round).

As regards alternative investments, investors continued to regard private debt and infrastructure assets as the most attractive options, although their respective shares had declined somewhat since the previous survey round. Meanwhile, investment in real estate and private equity had become significantly less attractive to investors.

As regards investors' attitudes towards investments complying with ESG (environmental, social and governance-related) criteria, most survey participants expected investors to increase their exposures to this asset class, despite the recent underperformance.

Most investors indicated that they expected to reduce their risk exposure somewhat over a three to six-month horizon in response to the Russian invasion of Ukraine. As for the conflict's impact on the geographical distribution of investment, the most significant declines were expected to be seen in Europe, followed by China. The highest increases were expected to be seen in North America and emerging Asia.

The recent upside surprises in inflation had resulted in roughly equal increases in participating institutions' allocations of inflation-linked instruments, real estate, gold and equities. No investors reported having increased their allocation of crypto-assets in connection with inflation.

Most respondents indicated that the potential for a suboptimal response to inflation by central banks was the main risk to financial markets over a one-year horizon, whether as a result of an overreaction or a response that came too late. A prolongation or escalation of the conflict in Ukraine was also seen as a distinct risk by roughly one-third of participants.

The subsequent discussion focused on a few specific considerations highlighted by the survey results. Some participants expressed surprise that the investment community seemed to regard European investments as less attractive than those in other jurisdictions. Other members explained that this could stem from the fact that some investors' European allocations had been overweight before the war in Ukraine, with subsequent reductions in those allocations reflecting the fact that the proximity of the conflict and the overall uncertainty outweighed any perception that relative valuations were still more attractive in Europe. The importance of the euro area's monetary policy normalisation process for valuations was also highlighted, with markets in other relevant jurisdictions being seen as having already gone further in terms of pricing of a potential tightening cycle. It was also noted that US investors were preoccupied with the assessment of the US inflation and growth outlook and China-related risks, paying little attention to investment opportunities in Europe at the moment.

As regards purely geographical considerations, a few participants stressed that certain investment themes could be relevant when assessing future asset allocations. They emphasised that EU Member States' economic ties with and energy dependency on Russia were more important than pure physical proximity in their outlook assessments. It was also noted that most energy products were priced in US dollars and that a weaker euro would further increase European energy costs. Several participants highlighted opportunities to accelerate Europe's energy transition and the shift to a green economy. Although oil and gas assets had outperformed most other asset classes in the year to date, some participants hoped that this shock would contribute to a more holistic discussion on ESG concepts and expected the Russian invasion to strengthen investors' and policymakers' desire to move in the direction of energy autonomy, with an emphasis on renewable sources.

Global investment trends

One investor provided an overview of major global investment trends. According to that presentation, the prevailing global investment environment was characterised by elevated inflation pressures and a softening of growth and earnings expectations. Investors' preference for commodities increased amid a broad-based de-risking, which was seen as favouring developed markets' equities and sovereign bonds over emerging markets and corporate bonds. The most significant recent shift in terms of trends had been the reversal of policy stimulus globally. While credit spreads were expected to widen further in this environment of rising sovereign yields, it was noted that this would, ultimately, also increase the potential attractiveness of fixed income from a diversification and returns perspective. The significant increase in ESG assets under management was expected to continue, with the issuance of instruments such as green bonds expected to be key for this asset class.

The ensuing discussion focused on the ways in which headline inflation was being impacted by various underlying components. One participant noted that earlier headline inflation figures had led many to think that the inflation would be transient, but recent rises in food prices may imply inflationary factors would persist for longer. Other participants noted that while there were marked differences between the forces driving inflation in the various jurisdictions, the widely held view last year that price pressures stemming from energy and supply chain issues would be transitory had not proved to be correct. Strong consumer demand (in specific sectors) and labour price pressures were seen as key drivers in economies such as the United States, but other regions could also be affected, with some differences in terms of timing and intensity.

As regards inflation pressures stemming from the conflict in Ukraine, a few participants expected the intensity and persistence of these pressures to be more pronounced in European jurisdictions, where supply chain disruptions and increases in energy and insurance costs were expected to have a stronger impact on markets. A number of participants noted that the potential de-globalisation of supply chains was one of the most significant upside risks to inflation over a longer horizon. While several participants recognised that the inflation and growth outlook meant that central banks faced a difficult balancing act at the current juncture, a number of speakers emphasised that monetary policy was in a good position to influence inflation expectations – even if it was only over the medium term.

Investment in times of geopolitical uncertainty

One investor provided an overview of this topic. It was noted that the financial market impact of geopolitical shocks was typically limited and short-lived, but that the impact of Russia's invasion of Ukraine had been more severe, coming at a time when the economy was still relatively weak. So far, risk premia had increased only moderately, and portfolio allocations had not been changing as fast as economic sentiment. The investor mentioned that real assets offered better protection against rising inflation. The growing redemption risk had increased the preference for liquidity, and it could also be beneficial to reduce the cyclicality of portfolios, being tactically cautious on equities while moving towards defensive sectors such as consumer staples or healthcare. Wider yield spreads were starting to make low-risk instruments with a low capital intensity spread (such as covered bonds) look more attractive.

The subsequent discussion centred around three trends that would require careful monitoring in the months ahead. The first part of that discussion looked at “friend-shoring”, which involves a sovereign country committing itself to working with other nations that share its norms and values. This would have the potential to impact investment flows, reduce diversification opportunities and increase home bias in investment. Against this background, investors stressed that EU integration needed to be accelerated, also with the support of the ECB. It was felt that the war in Ukraine would strengthen European unity. One participant noted that some companies were engaging in “near-shoring”; they were not taking any risks and were bringing their supply chains as close as they possibly could. The inflationary impact of this type of behaviour was likely to be even stronger than that of “friend-shoring”.

The second part looked at the mitigation of financial risk resulting from geopolitical shocks. It was emphasised that investors needed to be prepared for hostile cyber activity, which could potentially lead to severe economic losses. Cybersecurity had become a major issue, as well as an investment trend. Consequently, public-private partnerships were being explored throughout the industry.

The third part looked at investment in ESG. Recent underperformance had raised concerns about these assets’ resilience to shocks. Nonetheless, all of the members who spoke expected investors to remain focused on ESG, with the war in Ukraine accelerating the transition to a green economy. Some members warned that rising inflation was leading to increased concerns about inequality, so the “social” part of ESG was becoming more important. There was also greater emphasis on sovereigns’ governance in this new world order. From a climate perspective, one concern was that the recent negative returns would affect the attitude towards ESG and slow down investment, particularly in parts of the United States and Asia, which had already been lagging behind Europe before the war. One participant expressed concerns that there were only two providers of ESG ratings, and both were North American, so there was an urgent need for a European approach involving a European agency. It was also emphasised that institutions should be cautious about promising that ESG assets would produce superior performance in terms of returns and risk, as at some point there would be a trade-off between ESG characteristics and risk-adjusted returns, and that would be a difficult balancing act for asset owners and managers.

Finally, one participant noted that there had previously been a strong shift into alternative types of investment, particularly fixed income private debt. With rates rising, there were already signs of changes in this regard. Another participant felt that infrastructure projects in Europe were not sufficient to meet demand and stressed that it was important to encourage more public-private partnerships in order to accelerate investment (especially investment of an ESG nature). One other participant stressed the need to harmonise the regulatory playing field for insurers in the EU so as to promote the capital markets union, given that the industry was reportedly suffering from a lack of coherence between the various local regulators.