

INSTITUTIONAL INVESTOR DIALOGUE

8 May 2024, 13:00 to 15:00 CET
(hybrid event)

Participants

- Representatives of Aegon Asset Management, Allianz Global Investors, Amundi, APG Asset Management, Generali, GIC, J.P. Morgan Asset and Wealth Management, Legal & General Investment Management, Nissay Asset Management Corporation, Norges Bank Investment Management, Santander Asset Management, State Street Global Advisors, UBS Asset Management, Union Investment and Zurich Insurance Group
- Members of the Governing Council of the ECB (or their alternates)
- ECB officials from the Directorates General Market Operations, Macroeconomic Policy and Financial Stability, Communications, Secretariat, and the Compliance & Governance Division

Summary

Outcome of the survey of participating members

The meeting started with a presentation of the results of a survey conducted among the investors that participated in the IID. The results showed that the investors continued to see the path of future interest rates as the most critical element of the ECB's future monetary policy, followed by forward guidance on policy rates. The pace of balance sheet normalisation related to the Asset Purchase Programme (APP) and the Pandemic Emergency Purchase Programme (PEPP) had declined markedly in perceived importance compared to the previous edition of the survey conducted in the fall of 2023. Most respondents continued to believe that a shift in the economic outlook would be the main trigger of volatility in financial markets. In terms of risks to financial markets in the next 12 months, political uncertainty and geopolitical risks jumped higher since the previous survey and became the main risk according to respondents. Moreover, participants considered the risk of premature easing by central banks as larger than the risk of keeping monetary policy restrictive for too long, a result echoing the message of caution that central banks have expressed regarding the potential persistence of inflation. Only a small share of respondents considered complacency in markets for risky assets among the main risks. The responses to questions on the geographical asset allocation overall suggested stable allocations to most regions. Europe and to a lesser extent emerging Asia were the only regions for which a meaningful share of investors expected to increase their allocations.

In the subsequent discussion, several investors commented on the survey finding that complacency in risk asset markets was not among the main risks to financial markets. A number of speakers were of the view that the risk of a significant asset price correction was material in equity and corporate bond markets in certain developed markets, in which the valuation was stretched relative to historical norms. In this context, a few members reported a reduction in their exposures to risk assets since the last IID meeting. In contrast, others noted that valuations had historically been a poor predictor for short-term market developments and several speakers mentioned factors that could help to explain the observed strength in risk asset markets, including that corporate earnings had so far kept up well with expectations, that the probability distribution for the economic outlook in the US had shifted towards more positive scenarios, that artificial intelligence had a large productivity-enhancing potential and that corporations had been effective in locking in low funding costs when interest rates were low. Confirming the survey outcomes, several investors spoke about increased (geo)political tail risks and emphasised the difficulty in hedging against the related tail scenarios. Diversified asset allocations were mentioned as the most effective strategy to somewhat protect investors from these risks. Overall, a limited immediate impact on asset allocations was reported and expected.

Global investor trends and sovereign bond market deep dive

The participant introducing the global investor trends presented a view on the global economic outlook in which some degree of monetary policy divergence was considered likely, given that the ECB would probably ease monetary policy ahead of the Fed. However, the speaker expected this to be temporary, as the cooling of inflation was expected to take place across jurisdictions, giving rise to an overall rather synchronised easing of monetary policy. Based on client behaviour, the presenter showed that institutional investors maintained relatively high allocations to cash, mainly at the cost of longer-term bond investments. This reflected high money market rates but might also be a sign that investors anticipated a gradual easing cycle with limited prospects for a sharp bond rally. In the context of US exceptionalism, it was noted that equity Exchange-Traded Funds (ETFs) investment flows had predominantly been directed into US-focused funds of late. This suggested that retail investors anticipated a continuation of US outperformance, in which the flexibility and technological lead of the US economy attracted investments despite fiscal and political risks. This exceptionalism and the global geopolitical backdrop were seen to provide support to the US dollar versus other major currencies. Nonetheless, the worsening US fiscal situation was expected to remain a market focus and might lead to a risk premium on US assets at some point.

The participant introducing the sovereign bond market deep dive argued that sovereign bond yield spreads within the euro area had declined based on improving fundamentals and attractive outright yield levels. This had brought new or previously sidelined investors including retail and foreign investors back into euro area government bonds. This dynamic had mitigated the impact of central bank balance sheet normalisation and had also allowed banks to reduce their euro area sovereign bond holdings with little market impact. In anticipation of monetary policy easing, the presenter expected investors to

increasingly move from cash and short-dated instruments to longer-term bonds. The functioning of the euro area bond market was overall seen as good in recent years, but debt levels remain high and bid-ask spreads had proven variable at times. The drivers of sudden increases in bid-ask spreads had not always been clear. Average transaction sizes in the euro area government bond (EGB) had been declining over time, potentially reflecting a growing adoption by the buy-side of electronic and algorithmic trading, even though block trades continued to be executed with dealers.

In the discussion, the scenario of a stronger than expected US economy was discussed, as the strong US labour market and historically elevated consumer checking account balances suggested ongoing momentum. The size and structure of US fiscal packages were also echoed as a key factor for US outperformance against other developed nations. In such a scenario, disinflation in the US may progress slower than elsewhere, leading to more meaningful monetary policy divergence and possibly a stronger US dollar as a result. However, some participants noted that the deteriorating long-term fiscal outlook for the US in combination with higher-than-expected inflation could trigger a change in sentiment towards the US dollar and a crowding out of private borrowing. The importance of identifying and understanding potential concentrations in the investor base of government bonds was highlighted, and reference was made to the Liability-Driven Investment (LDI) episode in the UK.

Participants reported a further increase in investor interest in private credit markets. The asset class had been developing into a standard component in institutional investors' asset allocations. However, due to infrequent transactions and limited public data, monitoring this class was said to be more difficult than the public credit market, posing particular challenges for marking-to-market investments. In commercial real estate, an improvement in the liquidity for smaller projects was reported. Improvements for larger projects could follow suit but were not noticeable yet because of financing constraints. Elsewhere, participants had observed an increasing interest in active ETFs, particularly in the US and Asia, but most likely also soon in Europe. These ETFs with an active investment strategy were predominantly popular for environmental, social and governance (ESG) focused investments. One fund manager reported that investment flows in ESG funds had lately been more resilient than non-ESG investments. In addition, collective engagement with issuing firms on topics related to ESG was reported to remain strong and growing, particularly in Europe, while there were signs of pushback in the US.