EUROPEAN CENTRAL BANK
EUROSYSTEM

20 October 2021

INSTITUTIONAL INVESTOR DIALOGUE

6 October 2021, 12:00 to 14:00 CET,
online event

Participants

- Representatives of Aegon Asset Management, Allianz, Amundi, Assicurazioni Generali, ATP, Aviva Investors, AXA, BlackRock, DWS Group, GIC, J.P. Morgan Asset and Wealth Management, Nomura Asset Management, Nordea Asset Management, Norges Bank Investment Management, PGGM, 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 of the results of the Institutional Investor Dialogue survey, covering various aspects of recent financial market developments. The survey results indicated that most participating investors viewed the ECB's asset purchase programmes as the most critical element of the ECB's future monetary policy actions from the perspective of the investor community, followed by the ECB's forward guidance on policy rates.

In the previous survey, a large share of respondents had cited the ECB's strategy review as a crucial aspect of the ECB's monetary policy actions. The outcome of the strategy review was published in July 2021, and a large majority of respondents confirmed that it would have an impact on institutional investor behaviour.

From the perspective of the participating investors, key financial market risks included uncertainty about major central banks' monetary policy outlook and reaction functions, as well as uncertainty about the economic outlook, for example due to the impact of the COVID-19 pandemic. In addition, monetary policy decisions and expectations were identified as the main drivers of the EUR/USD

exchange rate, followed by political uncertainty and geopolitical risk, as well as macroeconomic fundamentals. Fiscal policy was no longer deemed a key factor influencing the exchange rate.

More than 60% of respondents did not envisage any changes to their G3 currency allocation over the next 12 months. Among the subset of investors planning some changes, quite a few respondents said they were intending to increase the portfolio share allocated to US dollar, while some others indicated that they were planning to reduce the overall portfolio share of G3 currencies.

Regarding their asset allocation between equities and bonds, most participating investors did not anticipate any changes. For developed markets (Europe, North America and Japan), more investors planned to increase the equity allocation rather than the bond allocation, even though bonds had become more attractive compared with the last survey round. For emerging markets, a number of survey respondents were considering increasing both the equity allocation and the bond allocation, although the majority of participating investors were not planning any changes to their asset allocation.

In terms of alternative investments, investors continued to view private debt and infrastructure assets as the most attractive options, while expressing a reduced appetite for real estate assets. As in the previous survey round, a large majority of respondents indicated that they had shifted their portfolio allocations into other asset classes over the past year owing to negative bond yields in several jurisdictions. Moreover, a much larger share of respondents no longer viewed the COVID-19 pandemic as having had a significant impact on investment activities in recent months.

All respondents were planning to further increase their allocation to investments complying with environmental, social and governance (ESG) criteria, but to varying degrees.

The survey also included a question on the likely impact of the latest report by the Intergovernmental Panel on Climate Change (IPCC), entitled “Climate Change 2021: The Physical Science Basis”, on institutional investor behaviour. All respondents believed that the report would encourage investors to step up their efforts to incorporate climate change criteria into their risk and asset management practices. A large majority also indicated that investors would try to limit their own impact on climate change (e.g. by reducing the carbon emissions of their activities) and prepare for a stronger than currently anticipated policy response to climate change by regulators and governments.

The subsequent discussion focused on a few specific considerations highlighted by the survey results. Some participants expressed surprise that central banks’ monetary policy outlook and reaction functions were listed as key investor concerns. It was suggested that this result might be a reflection of uncertainty regarding the inflation outlook more generally, rather than merely uncertainty about the reaction functions of central banks. Several participants viewed the inflation outlook as a source of concern and as a factor that could prompt heightened market volatility in the coming months. It was mentioned that markets were waiting to see how central bank monetary policy frameworks would be implemented if inflationary pressures were to prevail. The important role that monetary and fiscal policy had played during the pandemic period was also acknowledged.

In addition, several participants stressed the scarcity of attractive, ESG-compliant projects, noting that substantial demand for such investments outweighed supply, thus resulting in high valuations. Others

emphasised that carbon pricing and common standards, including a taxonomy, were necessary preconditions for this market segment to develop further in the future.

Global investment trends

One investor provided an overview of the major global investment trends.

According to the presentation, the main elements of the global investment environment were low bond yields, high levels of liquidity, positive growth trends as a result of the recovery and – consequently – high equity valuations. The global outlook was generally viewed as positive, in particular for Europe, where low interest rates were contributing to high asset valuations. Low yields had generally contributed to widespread search-for-yield behaviour, with substantial inflows into high-yield debt, equities and the alternative space. Given the material level of capital tied up in private equity and private debt, a rise in bankruptcies posed a potential future risk. Moreover, the investor underscored the importance of understanding the growing role of China in the global economy.

The ensuing discussion illustrated that the question of how to allocate assets to ESG-related investments remained a priority for investors. Several participants stressed the lack of investment opportunities in that space, with demand by far exceeding supply, resulting in elevated price levels. It was mentioned that both natural resources and available capital for the energy transition to renewable technologies were still insufficient, an important topic that would be discussed at the 26th UN Climate Change Conference of the Parties (COP26) in November 2021. The European Union’s Next Generation EU (NGEU) fund was mentioned by several participants as a game changer that would hopefully spur the development of more green projects in the ESG space. While more work was still required on defining a common language for ESG (i.e. establishing a taxonomy and improving the availability and transparency of data), it was noted that there had already been significant advances in that respect. Given the substantial effort needed to make progress in that area, one participant mentioned that several institutions in the industry were evaluating the scope for synergies by joining forces.

There was also a discussion on the higher correlation between equities and debt securities, which was making it more difficult for global asset managers to diversify their portfolios. In addition to the growing role of China, the increasing prominence of technology companies was highlighted as a global trend that raised pertinent questions about data ownership.

Transitioning out of the pandemic

One investor provided an overview of the topic. The investor put forward a view that lower net supply of government bonds in 2022 would likely be matched by lower central bank purchases. Moreover, there had been a gradual normalisation in labour markets, with furlough schemes ending and labour markets recovering. However, the economic rebound continued to face some headwinds. In manufacturing, these headwinds included not only shortages of materials, space or equipment, but

also a shortage of labour. Demand no longer seemed to be constraining the recovery. The most relevant source of uncertainty was the future evolution of inflation. Fiscal policy would likely remain accommodative. The NGEU, in particular, would play an important role in supporting the post-pandemic recovery.

The presenter also expressed some concern about the risk of bankruptcies. While the number of bankruptcies had declined considerably during the COVID-19 crisis owing to various support measures, it could potentially begin to converge again towards its long-term average. The investor also argued that rising house prices were fuelling inequality and could pose a risk for financial stability. As a result, economic growth could start to decelerate. This would contribute to keeping interest rates low, with technological advances also exerting a deflationary impact.

Finally, according to the investor’s analysis, fixed income valuations were elevated, in particular for spread products. Equities were comparatively more attractive. However, the investor argued that there was still a notable discrepancy between valuation levels in the technology sector and other industries.

Another investor pointed out that, when it came to sustainability, we were likely witnessing the most substantial reallocation of capital in our lifetimes, with a corresponding impact on the cost of capital. Many investors indicated that they were concerned about the potential risk of “greenwashing”.

Finally, the discussion also focused on China, including the apparent disconnect between the relative size of the country and the investor community’s current market portfolio allocations. Participating investors argued that this disconnect reflected both the potential and the need for China’s financial markets to continue to grow to be fully investable.