INSTITUTIONAL INVESTOR DIALOGUE

5 October 2022, 11:00 to 13:00 CET
(online event)

Participants

- Representatives of Aegon Asset Management, Alecta, Allianz Global Investors, Amundi, Aviva Investors, AXA, Eurizon Capital, J.P. Morgan Asset and Wealth Management, Nomura Asset Management, Nordea Asset Management, Santander Asset Management, State Street Global Advisors, Swiss Re, 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, 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 a survey conducted among the IID participants. The 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 reduction. As regards potential triggers for higher volatility in financial markets, the uncertainty about the economic outlook and central banks' monetary policy decisions and their reaction function were respondents' main concerns.

The subsequent discussion focused on a few specific considerations highlighted by the survey results. Some participants mentioned that the answers reflected the high level of uncertainty surrounding the European and global economic outlook. The need for clear communication by central banks and for consistency with fiscal policies were mentioned as particularly relevant in times of policy normalisation, in order to mitigate the risk of extreme financial market volatility as seen in some jurisdictions recently.

As regards market functioning, some participants first recalled that the levels of volatility in a number of asset classes had reached multi-year highs. However, after many years of subdued volatility in an environment of accommodative monetary policy, current levels of volatility were to be expected and could be regarded as healthy. In this context, it was noted that low market liquidity could become a significant risk going forward, as valuation and liquidity models had to be updated to account for a period of high inflation and policy normalisation. Policymakers were asked to closely monitor developments in various corners of the market that could have broader implications, with collateral scarcity in some repo markets being mentioned as an example. Finally, some participants felt that the return of market volatility was welcome after the very low levels experienced in the last decade and did not see any need for central banks to intervene at an early stage but just to maintain the important role as lenders of last resort while letting markets to autonomously reach a new equilibrium.

Global investment trends in times of central banks' policy normalisation

One investor provided an overview of major global investment trends. According to the presentation, there were three main debates going on in the investment community. First, whether inflation, which is undoubtedly a big concern, had by now peaked. In his view the euro area headline inflation had peaked, but core inflation would continue increasing for a few more months. Some anchors for inflation were mentioned, such as government initiatives to temper energy prices, less pronounced supply disruptions, monetary policy tightening and the fact that wage increases are more linked to the inflation targets rather than actual inflation. Second, the role of monetary policy and the concern that central banks may tighten too much, potentially resulting in a pronounced downturn of growth. Third, the issue of fiscal sustainability was mentioned as fiscal prudence was perceived to have declined compared to a few years ago. However, as was illustrated by recent UK developments, expansive fiscal policy had its limits and markets would be expected to punish any misguided policy.

During the discussion several members explained that the objective of capital preservation had been one of the main themes in 2022 as both fixed income and equity indices declined in value and the historically negative correlation broke down. Nevertheless, some participants expressed their expectation that the traditional 60/40 strategy should not be dismissed (despite challenging absolute returns recently) as it would be expected to perform well again in the future. A question was raised on whether investors would move from less liquid private asset classes back to investment grade corporate or sovereign bonds as yields had increased. While views were mixed, it was mentioned that these less liquid instruments were still appealing to some investors.

One investor stressed that the market structure was very different than during the last hiking cycle, and that market liquidity is generally poorer and more asymmetric. Investors' trading styles have adapted to smaller transaction sizes and allowing for a longer time to trade a position, which in his view was an aspect that central banks might want to keep in mind when normalising their monetary policy.

As regards ESG (environmental, social and governance-related aspects), one investor noted that the funds had been under considerable pressure in 2022. He was of the view that this observed setback was only temporary as client interest and commitments remained strong, and their investment flows would also return. Some other participants confirmed that in general several investors were on the side-lines and would become more active only once the volatility declines.

Investment trends in times of high and volatile energy prices

One investor provided a presentation on this topic. She felt that global competition for energy would intensify in the coming years, with geopolitical events and the expected transition of the global energy matrix towards renewable energy sources driving price developments and volatility. The transition to a low carbon economy would change the world energy mix and redesign geopolitics in the future. Some regions that are now net importers of energy could benefit in the future from cheap green energy production costs, notably for photovoltaic systems and even green hydrogen. Europe, which is now seen as heavily dependent on external energy sources, could be one of the regions benefiting from this shift to renewables. Short-term tactical strategies employed by institutional investors in this regard were mentioned to include active sectoral, geographical and style tilting, return protection with inflation-linked bonds and duration hedges, as well as exposure to commodities needed for the energy transition. To address the issue on a long-term strategic horizon, investors were said to be looking to increase portfolio diversification and to adopt an ESG best-in-class and sector-neutral approach. The presentation concluded with the remark that total divestment from carbon-intensive sectors would not effectively contribute to the decarbonization of the economy, but only delay it.

The subsequent discussion centred around two main areas. The first part of the discussion focused on key takeaways by institutional investors as regards recent ESG developments and investment performance. One participant noted while the ESG approach was shown to have a strong bias towards growth and performance, being sector-neutral was of paramount importance to avoid underperformance in an environment of rising energy prices and interest rates. The inclusion of carbon-intensive sectors in ESG strategies, however, was said to present significant challenges in terms of assessing companies' decarbonisation commitments and financial disclosures.

The second topic discussed focused on the question of whether high and volatile energy prices would accelerate the green transition. Participants indicated that recent energy market developments were expected to further sharpen investors' attention towards the transition to renewable energy sources and energy autonomy. One participant highlighted that one channel for institutional investors' participation in that realm is to increase investments into real assets linked to the energy sector. Finally, another participant highlighted that European markets and investors had a lot of influence in the global discussions around sustainability and the financial instruments necessary to finance the green transition. As such, Europe stands at a good position to play a leading catalyst role for the accelerating decarbonization, whereas in some other developed economies, policy makers and elected officials face more opposing views as regards ESG measures.