

INSTITUTIONAL INVESTOR DIALOGUE

29 March 2023, 14:00 to 16:00 CET
(online event)

Participants

- Representatives of Aegon Asset Management, Alecta, Allianz Global Investors, Amundi, Aviva Investors, AXA Global Investors, BlackRock, Eurizon Capital, Legal and General Investment Management, Nissay Asset Management Corporation, Nordea Asset Management, Norges Bank Investment Management, State Street Global Advisors, 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. Most investor replies were received in early March, i.e., before the episode of high market volatility related to certain banks. 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. Among respondents who planned currency allocation changes, reducing US dollar and increasing Japanese yen and euro allocations were the most common answers. When asked which investor types are most likely to make up for central banks' shrinking demand for government bonds, all the respondents said that insurers and pension funds would step in, and most also mentioned other private institutional investors. Banks and retail investors were seen as less likely to step in. As regards the impact of the recent inflation developments, more than half of investors do not see any impact on their asset allocations. Among those that reported changes, the most frequent responses referred to reducing the share of equity holdings.

The subsequent discussion focused investors' views on the most recent market developments. Participants perceived European banks as being generally resilient and benefiting from a strict and comprehensive implementation of international regulatory standards. One participant was of the view that recent events could indicate that the current set of bank regulatory ratios could still lead to blind spots, despite the enhancements after the Global Financial Crisis. Another participant responded that those indicators remain relevant but need to be implemented in an even more comprehensive and consistent manner, and also needed to be complemented by qualitative indicators, such as the quality

of bank management and governance. Policymakers nevertheless received praise from participants for moving fast, flexibly and taking decisions quickly, even if some were seen as controversial. The public statements by euro area and UK authorities clarifying the treatment of Additional Tier 1 (AT1) bonds in absorbing losses were perceived as positive and calming to markets. Some investors expressed unease with the sharp moves in the Credit Default Swap market over the preceding month, which were perceived as unrelated to fundamentals and partly reflecting the reduced liquidity of those instruments. They urged for regulatory scrutiny of this market during times of heightened volatility.

Several participants expressed disagreement with the market pricing of the Fed rate cuts in 2023. However, the fast rate hiking cycle, combined with the consequences on lending conditions of recent banking stress, was seen as very likely to lead to a recession at some point, albeit not a severe one. Equity market pricing was seen by several participants as too optimistic and not yet reflecting this narrative, while bond pricing seemed more in line with risks to the macroeconomic outlook.

On Japanese investors, most of those who spoke were of the view that they had already reduced their holdings of European government bonds and that they would not decrease their exposures further. One participant mentioned that Japanese investors have no interest to invest in inverted yield curves because of the negative carry when hedged for currency risks. As regards the Japanese yen, some noted that it acted as a safe haven currency for the first time in a long time and that this could renew interest of foreign flows into Japan.

Global investment trends

One investor provided an overview of major global investment trends. He expressed the view that markets are now in a new regime, in which central banks face a trade-off between crushing economic activity or living with high inflation for longer, and markets are still underestimating the implications of this new environment. Economic damage would eventually emerge due to the aggressive hiking cycle, resulting in a recession, but this should not stop central banks from continuing to fight inflation, especially as inflation may turn out to be more stubborn than in past cycles. In particular, this investor was of the view that central banks will not start cutting interest rates unless there is the imminent threat of a strong recession or depression.

The recent banking crisis and the outflow of deposits from US regional banks into large banks and money market funds were also mentioned by the presenter. US regional banks were seen as important lenders in the commercial real estate market, and recent tensions raise the risk of a credit contraction for this market segment.

He also touched upon the People's bank of China, which provided support by cutting the reserve requirement ratio earlier than expected by the markets. In the presenter's view such support was not problematic given how low China's inflation is. He added that China is one of the most challenging topics for American investors as any thorough analysis is followed by a political discussion, resulting in under-allocation to this country.

In the discussion that followed, it was stressed that there is no trade-off between price stability and financial stability and that the ECB has different tools in place to tackle each of them. On the treatment of Credit Suisse AT1 bondholders, it was mentioned that the prospectuses' terms were clear, and decisions were in line with the Swiss legal framework, but that the treatment of equity holders relative to AT1 bond investors remains difficult to understand. Such precedent could have further implications for the future of the AT1 market, and the ability of banks to rely on this form of hybrid capital. A participant expressed concern about the US saving rates falling rapidly. Labour markets were generally seen as strong, but with wide intersectoral divergences.

Targeting net zero carbon portfolios amidst a challenging energy landscape

One investor provided a presentation on this topic. She stressed that ambitious climate targets are still feasible, but time is running out. Delayed action would be very costly and emerging markets are likely to be most exposed to both physical and transition risks. It was stressed that the battle on climate change will be won or lost in emerging markets as they have high growth and high emissions. The need for further convergence among various data and methodological initiatives was emphasised as critical to reduce uncertainty as regards portfolio alignment with long-term targets.

The presenter then mentioned various approaches by which investors can take climate action. Several, for example, apply investment exclusions as it is the most straightforward approach to implement, but with the downside of not addressing the need for an economy-wide transition to net zero emissions. Another promising and sophisticated approach was for investors to capitalise on sustainability opportunities via "transition" funds focused on active management of investments in companies that are climate leaders in their respective operational domains.

In the discussion that ensued, a participant stressed that regulators are focusing particularly on green assets, labelled instruments and exclusions so as to avoid accusations of greenwashing, even though these might not have the strongest impact (relative to, for instance, engaging with 'climate laggards'). Investors involved in the environmental, social and governance-related (ESG) space were said to often face backlash, on the one side from NGOs seeking further stringent actions against laggards, and on the other from a growing anti-ESG movement, particularly in the US. Another investor stressed that, to address ESG concerns considering the whole value chain, institutional investors needed to engage directly with banks financing polluting activities. The topic of biodiversity risks was also mentioned as growing in relevance, with the need for regulators to clearly separate these risks from climate change themes.

As regards investors' interest in 'green' investments, one participant mentioned that in Asia the appetite for ESG investments has been low given last year's underperformance, leading to strong outflows. Finally, a participant mentioned that to keep sustainable investments attractiveness and effectiveness, European regulators could give a significant contribution by establishing a taxonomy for transition activities, which would be instrumental in providing rigorous definitions that current market standards are lacking.