

## **INSTITUTIONAL INVESTOR DIALOGUE**

**15 November 2023, 13:30 to 15:30 CET  
(hybrid event)**

### **Participants**

- Representatives of Aegon Asset Management, Allianz Global Investors, APG Asset Management, Aviva Investors, Eurizon Capital, Generali, GIC, J.P. Morgan Asset and Wealth Management, Norges Bank Investment Management, Nissay Asset Management Corporation, Santander Asset Management, State Street Global Advisors, Swiss Re, 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, Economics, Communications, Secretariat, and the Compliance & Governance Division.

### **Summary**

#### **Outcome of the survey of participating investors**

The meeting started with a presentation of the results of a survey conducted among the participants in the Institutional Investor Dialogue (IID). The results showed that they continued to see the path of future interest rates as the most critical element of the ECB's future monetary policy, followed by the timing and pace of balance sheet normalisation related to the Asset Purchase Programme (APP) and Pandemic Emergency Purchase Programme (PEPP). Most respondents believed that the uncertainty about the economic outlook would be the main potential trigger of volatility in financial markets. The share of respondents that saw uncertainty about major central banks' monetary policy outlook as the main volatility trigger had declined notably from the IID survey conducted in March. Political uncertainty, geopolitical risks and financial stability risks in the bank and non-bank sectors had fewer mentions as key volatility triggers. The responses to questions on the asset allocation plans of the participating investors suggested an increased share for stable currency allocations and a clear majority planning to keep the share of assets geographically allocated to Europe unchanged.

In the subsequent discussion, several investors commented on the survey results noting that geopolitical risks were not among the key potential triggers of financial market volatility, despite the prominence of significant international tensions and crises in daily news. One explanation given was that, historically, geopolitical crises had typically a contained market impact, unless a severe disruption of global oil supply occurred. Other explanations referred to the binary nature of many geopolitical risks, which implied a low probability of a highly consequential impact, rendering such risks difficult to integrate in broad investment strategies. Nevertheless, several investors mentioned

that the protracted build-up of geopolitical tension between the United States and China had an impact on their investment behaviour, eliciting a cautious stance regarding asset allocations to China. However, others expressed the view that the case for investment in China remained compelling to them, based on China's high potential for innovation and currently cheap valuations.

Commenting on asset allocation developments in client portfolios at large, one participant argued that the increased attractiveness of cash rates and government bond yields posed competition to riskier asset classes. Still, investor risk appetite remained robust as material inflows continued to be observed into some market segments, such as private equity and private debt. Some investors observed client reluctance to increasing allocations to government bonds, driven by the fiscal outlook as well as the recent yield volatility. In terms of regional asset allocations, investors expressed mixed views on European equities: some saw the region's energy dependence and its needed catch-up in technology and artificial intelligence as weighing on its attractiveness, whereas others highlighted benefits of ongoing European integration, a solid banking sector, attractive equity valuations, and the EU's leading role in sustainable investments supporting Europe's investment appeal.

### **Global investment trends**

One investor provided an opening presentation, arguing that the investment regime had changed with the end of the low-interest rate environment. She expressed the view that bond yields in the largest developed markets would likely remain meaningfully higher than they had been for most of the past decade, marking a new interest rate regime. The impact could be protracted, as much of the existing stock of debt had been issued at long maturities and low yields in recent years and would only gradually require refinancing. For the time being, economic growth was resilient, given relatively strong household balance sheets and the continued impact of fiscal stimulus, particularly in the US. Nonetheless, going forward the new interest rate regime was expected to put strains on fiscal sustainability and on equity market valuations as well as on business models relying on significant debt levels, such as leveraged finance and real estate.

In the discussion that followed, several participants expressed nuanced views on recession risks. While balance sheets were strong in many sectors, a recession driven by weakening corporate earnings was mentioned by a few investors as a possible outcome, as companies faced rising labour and financing costs.

Several investors expressed agreement that the higher yield environment would put strains on certain private markets. As an example, one investor highlighted that private equity had sizable exposure to small and mid-sized companies, which typically relied relatively heavily on floating rate financing, making them vulnerable to higher interest rates.

The fiscal risks were echoed by several other investors, pointing not only at rising debt service burden but also at the lack of fiscal discipline of several governments around the world. In this context, it was argued that governments would likely also face large climate change-related costs. One investor felt that the risk of crowding out private sector borrowing was mitigated by the large amount of cash that

was still available to be invested. Another investor questioned the assumption that real interest rates would remain high. However, this investor also acknowledged that some factors, such as the increasing productive use of artificial intelligence, may lead to a rise in the neutral long-term rate.

### **Managing climate-related physical risks in institutional investors' portfolios**

One investor provided an overview of relevant issues for institutional investors' management of physical risks in their portfolios. He stressed that climate change was contributing to rising frequency and costs of weather-related catastrophes, with a 60% increase in such damages expected until 2040. While the increase in global temperatures was said to be broadly in line with modelled scenarios, the volatility of temperature and precipitation trends was materialising in ways that were difficult to predict and react to. This created a challenge for insurers and institutional investors, as calibrating climate-related premia was difficult when relevant data and methodologies were still lacking in quality and availability. Engagement with corporate issuers, regulators and data providers were seen as key actions that institutional investors could take to bridge the current gaps in each of these domains. Consistent with his remarks, the survey conducted among IID participants showed a wide majority of participants believing that physical risks are materialising more intensely than expected.

In the discussion that followed, investors agreed that the costs related to physical risks were high and rising. Some investors highlighted that the cost of upgrading the stock of real estate assets to currently required sustainability standards was prohibitively high, particularly in the commercial real estate segment. These investors raised concern about stranded assets, which at present could also be mostly held in more opaque, non-public parts of markets.

Other participants raised the issue of emerging insurance gaps. Connected with that issue, a participant mentioned that it was concerning that some assets recently destroyed or damaged by extreme-weather events were being reconstructed in the same vulnerable locations and funded by public investments. These trends, if left unabated, could affect financial stability, weaken the financial position of governments that cover losses and postpone the necessary and efficient adaptation to climate change. In response to these concerns, one participant stressed that private investors' financing of climate adaptation was of paramount importance.