

STATE STREET®

Post-Inflation Realities:
*Evidence from institutional investor
and sovereign wealth fund activity*



Introduction

Inflation was a dominant theme in 2022, resulting in a cost-of-living crisis and tightening financial conditions in many regions worldwide. Thankfully, global inflation may have peaked, and indeed some countries are seeing a stabilisation of inflation if not a gradual decline. As financial markets begin to assess that central banks may be nearer the end of their monetary tightening policy cycles, new narratives that have the potential to change financial markets are beginning to emerge. How have institutional investors and sovereign wealth funds positioned their portfolios for 2023? And what are the emerging themes that will likely drive portfolio positioning?

In this report, we uncover insights into how institutional investors and sovereign wealth funds implemented their capital flow and portfolio reallocation decisions over the past year as market conditions evolved. The research is powered by State Street's proprietary indicators of institutional investor flows and holdings derived from the anonymised and aggregated activity of institutional investors representing more than \$36.7 trillion in assets. This data is contextualised by input from members of the International Forum of Sovereign Wealth Funds (IFSWF).

Research methodology

State Street analysed its dataset of unique indicators that capture aggregated and anonymised capital flows, portfolio positions and the behaviour of long-term institutional investors across multiple asset classes, sectors and countries. The indicators provide a bird's-eye view into the activities of large and diverse global institutional investors such as sovereign wealth funds, collective funds, mutual funds, pension products, insurance products and others. These indicators are derived from security-level transactions, holdings, and borrowings and are aggregated and anonymised through a robust process to help preserve underlying client confidentiality. The indicators provide objective insights into demand and risk appetite derived from the aggregated activities of long-term institutional investors representing more than \$36.7 trillion in assets under custody and administration¹ at State Street.

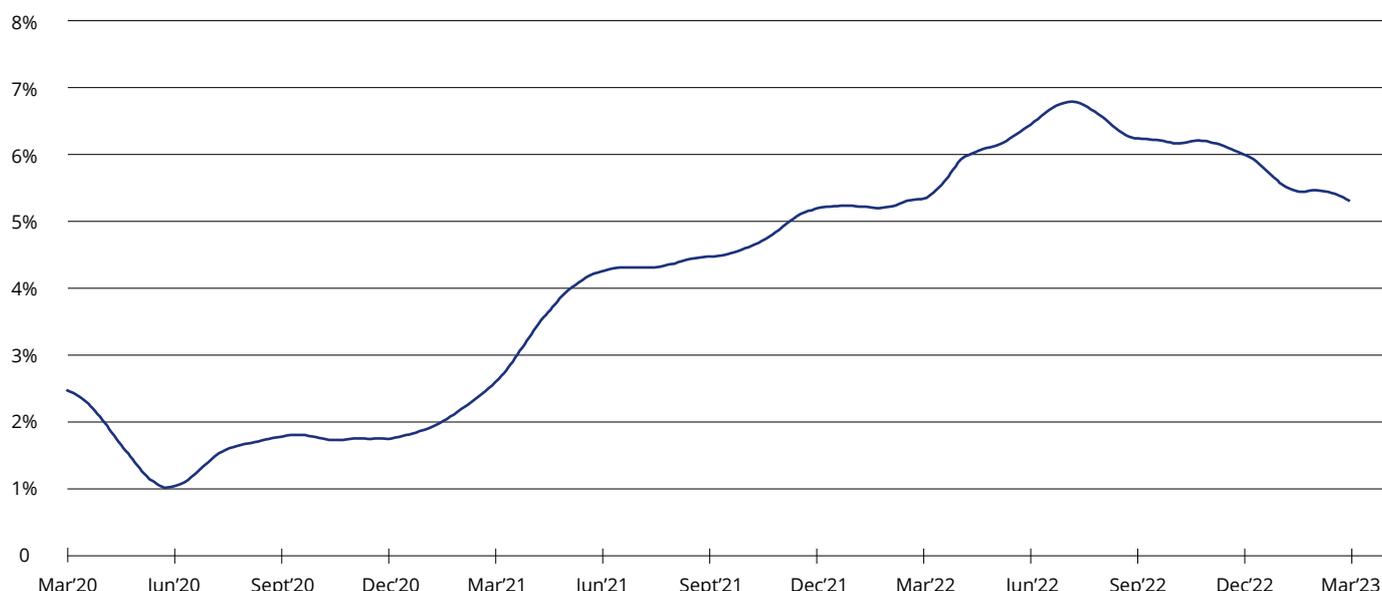
To complement this data and provide more colour and context for the quantitative analysis, the IFSWF asked nine members that deploy capital in global markets for insights into their asset allocation strategies over the last year. These responses were provided with the promise of anonymity. These institutions came from East Asia, West Asia, Australasia, and North America.

¹ Source: State Street. As of 31 December 2022.

New narratives impacting markets

2022 was a year dominated by high inflationary pressures that have spread across global markets, with many countries experiencing inflation levels not seen in decades. Indeed, the State Street PriceStats measure of online price inflation shows that the rise in inflation in 2022 had already taken root as early as the pandemic years of 2020-21. Thankfully, signs are emerging that global inflationary pressures may have peaked and beginning to decline (Figure 1).

Figure 1: Global online price inflation



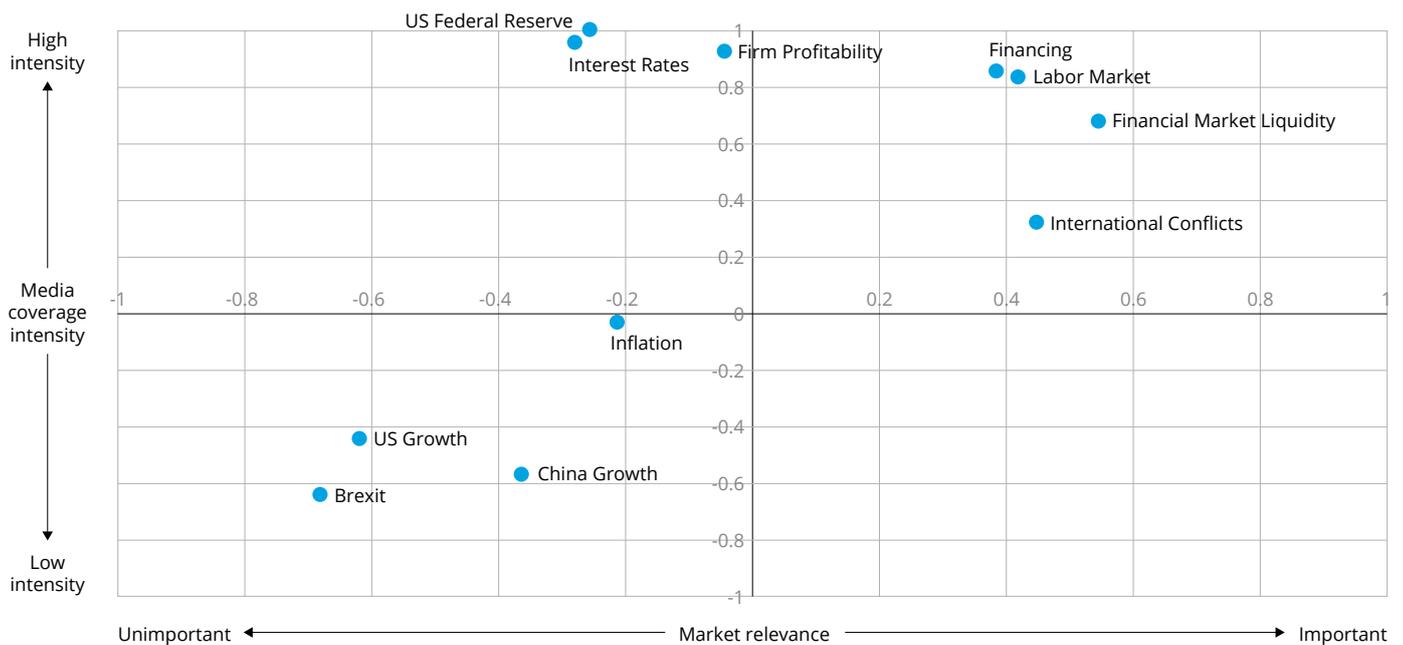
Source: State Street Global Markets, data as of 1 March 2023

All the IFSWF members contacted for this study told us they thought US inflation had peaked. However, there was also a consensus that it would remain stubbornly high (and some thought it potentially volatile). It was one of the most significant risks they saw facing their portfolios. They also noted the effect this might have on global economic growth, with recession or low growth being a related risk factor. They were also concerned about the impact of central banks' responses to a new era of higher inflation, noting that a new regime of tighter monetary policy, particularly in developed markets, was a significant risk to consider when evaluating their liquidity needs. However, several IFSWF members thought higher inflation would be less problematic for the US than for the European Union and the UK would fare "worst in the developed world". In emerging markets, according to one member, "Asia appears to be ahead in getting inflation to targets". Another told us that, "Asia will certainly continue to operate in a low-inflation environment". Their reasons for this outlook were that Europe would continue to be impacted by high energy prices and that the European Central Bank did not seem "prepared to go as far as the US in the tightening cycle". However, other members noted structural issues in Europe, "poorer demographics, the energy transition and the reweight of the income share from capital to labour may all contribute to higher structural inflation".

Their outlook on inflation was shaped by another significant risk identified by our members: thorny geopolitics. While the conflict in Ukraine was obviously mentioned, the impact of the thawing or hardening of the broader relationship of the US and Europe with China and Russia was of more consequence as it would continue to impact energy markets and supply chains.

Against this backdrop, new narratives are emerging that have the potential to impact financial markets. Using the State Street MediaStats Narrative Map (Figure 2), designed to determine the themes relevant to financial markets, we see cyclically sensitive topics of labour markets, firm financing and profitability, and financial market liquidity as key themes that are influencing markets with high media coverage. On the opposite spectrum, the US' and China's economic growth and Brexit are narratives less covered by the media and have lower market importance. The topics of the US Federal Reserve and interest rates remain widely covered, but their ability to move markets is now relatively more neutral than in 2022. International conflicts as a narrative also remain on the markets' radar.

Figure 2: Media coverage of themes and their market importance



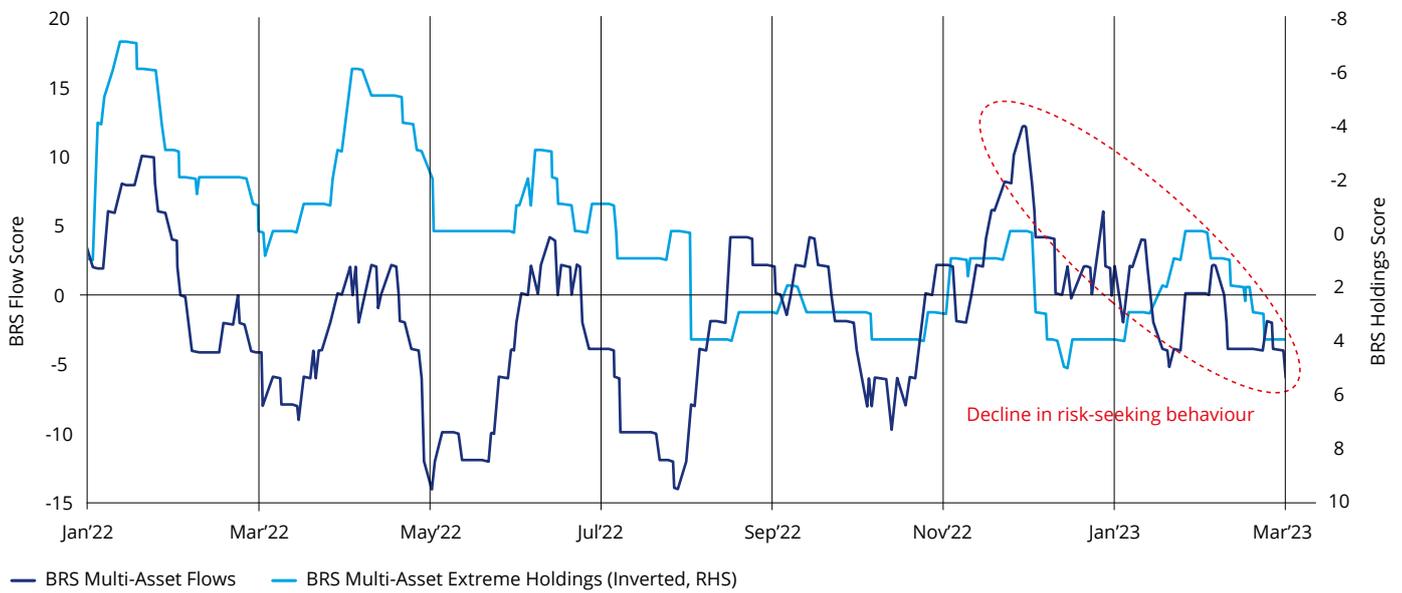
Source: State Street Global Markets, data as of 17 March 2023

What was striking in the responses we received from IFSWF members was their ability to see through the short-term topics covered by the media. None of them mentioned firm profitability or financing as risks, and only one mentioned the labour market, but in the context of rising inflation. In our first of these reports in 2020, we noted that despite the sudden convulsion of financial markets in March as governments imposed lockdowns across the globe, sovereign wealth funds had stuck firmly to their strategies. From the responses we received in 2022, we saw a similar reaction. None of the funds we asked had rebalanced their portfolios in response to 2022's turbulent market conditions. Instead, they had maintained their benchmarks and, in several cases, their years-long strategy to increase their alternatives (both private markets and liquid) allocation and their dynamic asset allocation strategies.

Institutional investor risk sentiment: back to neutral

After expressing caution for the first three quarters of last year, the end of 2022 saw some optimism as investors exhibited risk-seeking behaviour towards the last quarter of 2022. Indeed, State Street’s Behavioural Risk Scorecard Multi-Asset Flow & Holdings scores (Figure 3) – an aggregate measure of risk appetite derived from the capital flows and holdings by institutional investors across multiple asset classes and factors – rose to its highest reading of 2022 in late November. However, risk appetite among institutional investors has faded since then to relatively more neutral, if not slightly risk-averse levels.

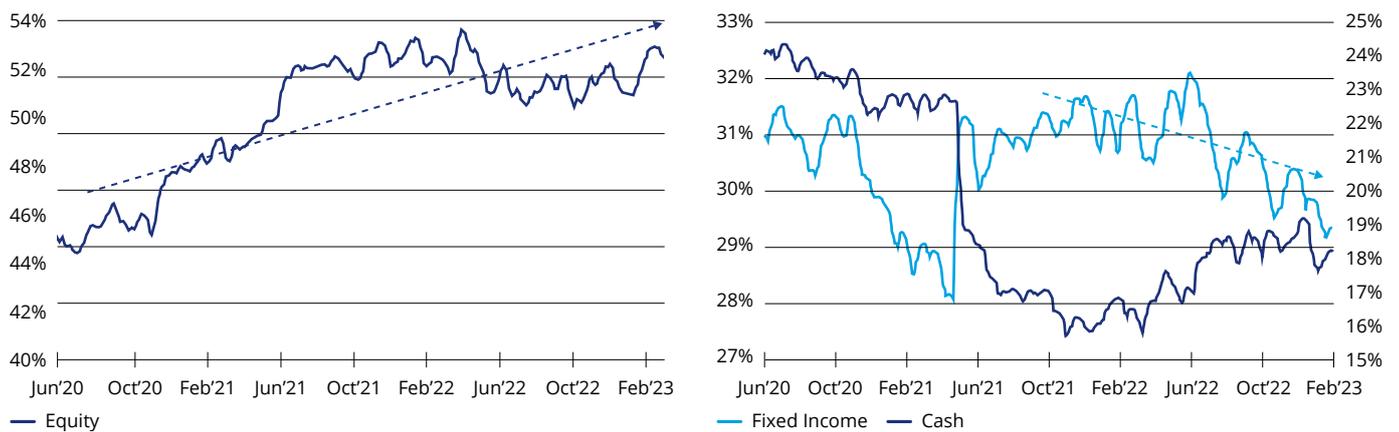
Figure 3: Institutional capital flows and holdings across risk assets



Source: State Street Global Markets, data as of 1 March 2023

However, the overall neutral reading for multi-asset investor risk appetite masks a divergence in sentiment across asset classes, which is evident from global investors' asset allocation decisions. We observe rising allocations to equities funded by decreased fixed-income assets while maintaining previously accumulated cash reserves as short-term interest rates rise with central bank policy rates (Figure 4).

Figure 4: Asset class weights of institutional investors

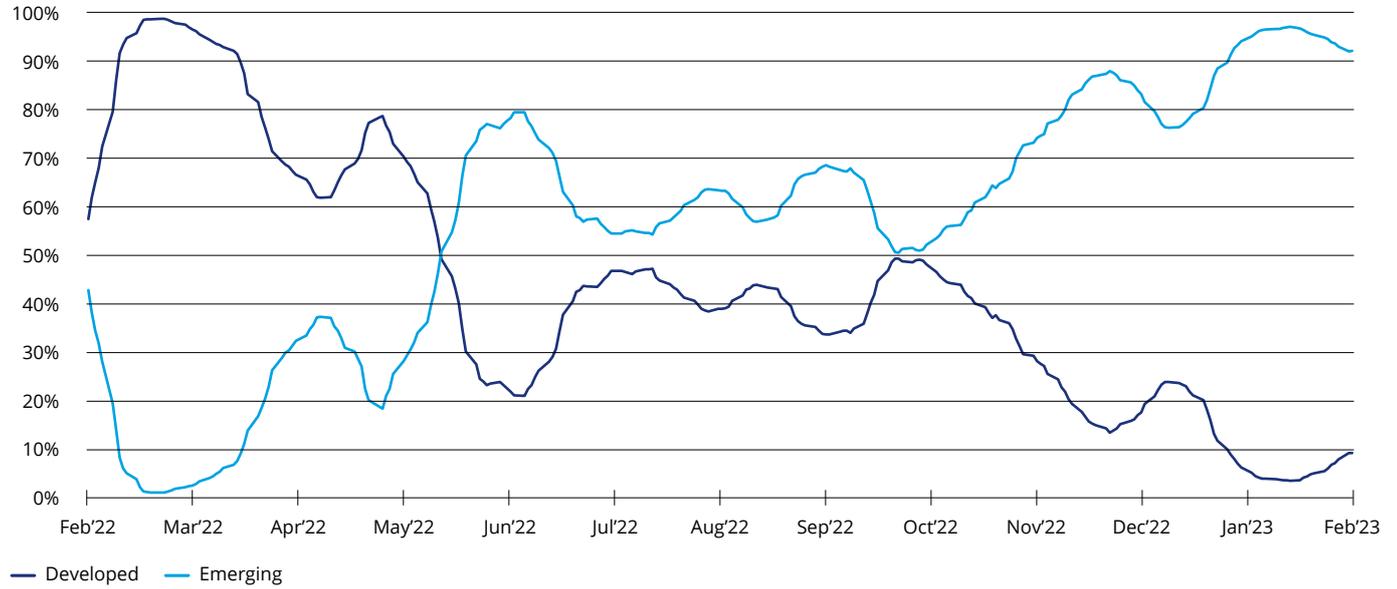


Source: State Street Global Markets, data as of 1 March 2023

Furthermore, investors have flipped their preferences within equities over the past year. We have seen net buying of emerging-market equities since June 2022 and net selling of developed-market stocks during the same period (Figure 5). Although most of the IFSWF members we asked were sticking to their equity benchmarks, the four that were more active were increasing their emerging market equity allocations.

Interestingly, the sovereign wealth funds that contributed to this study seemed more pessimistic than the market. More than half of the respondents said they were "increasing downside protection" or having "more active hedging programmes relative to prior years". Only two of the nine IFSWF members that contributed to this study said they had "no plans in this regard currently".

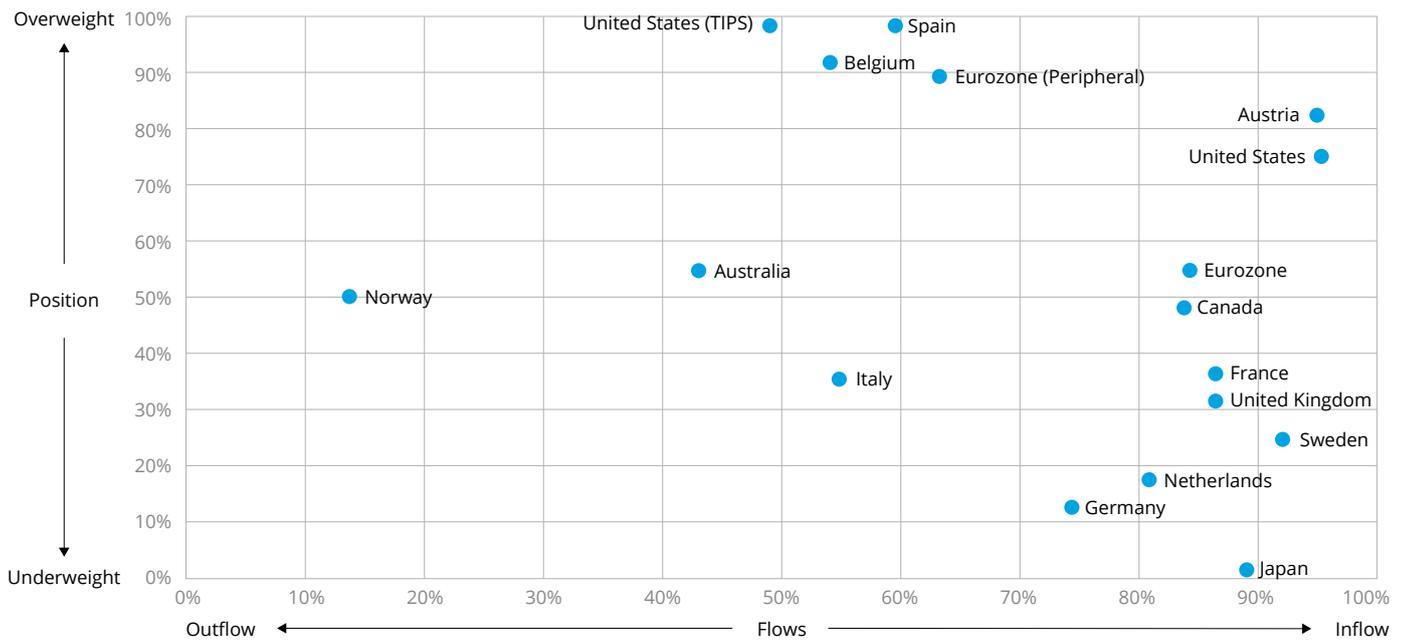
Figure 5: Equity market institutional capital flow



Source: State Street Global Markets, data as of 1 March 2023

In fixed-income markets, investors have continued to show a preference for developed-market sovereign debt, holding overweight positions in the US and Eurozone while continuing to buy, and underweight positions in UK gilts, Japanese government bonds and German bunds (Figure 6).

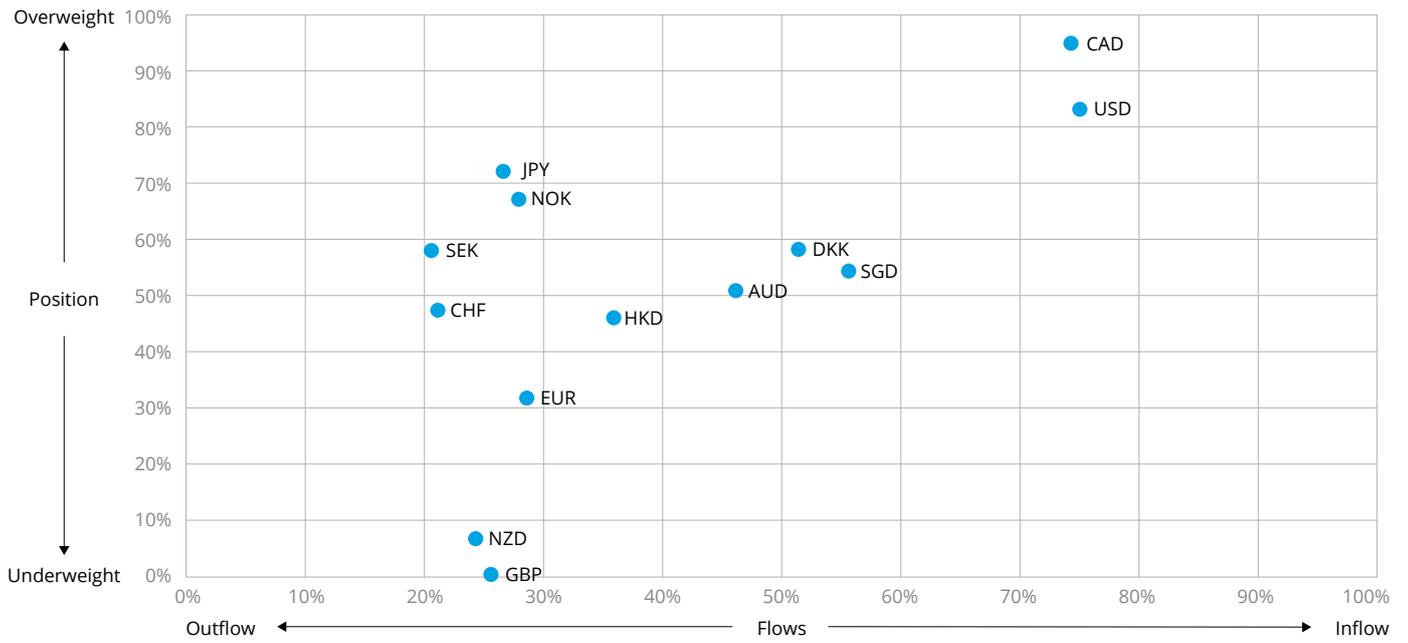
Figure 6: Fixed-income market institutional capital flow and positioning



Source: State Street Global Markets, data as of 1 March 2023

In foreign exchange markets, investors have shown a preference for the US and Canadian dollars, while being underweight and selling of Sterling, the New Zealand dollar and the Euro (Figure 7).

Figure 7: Foreign currency exposure



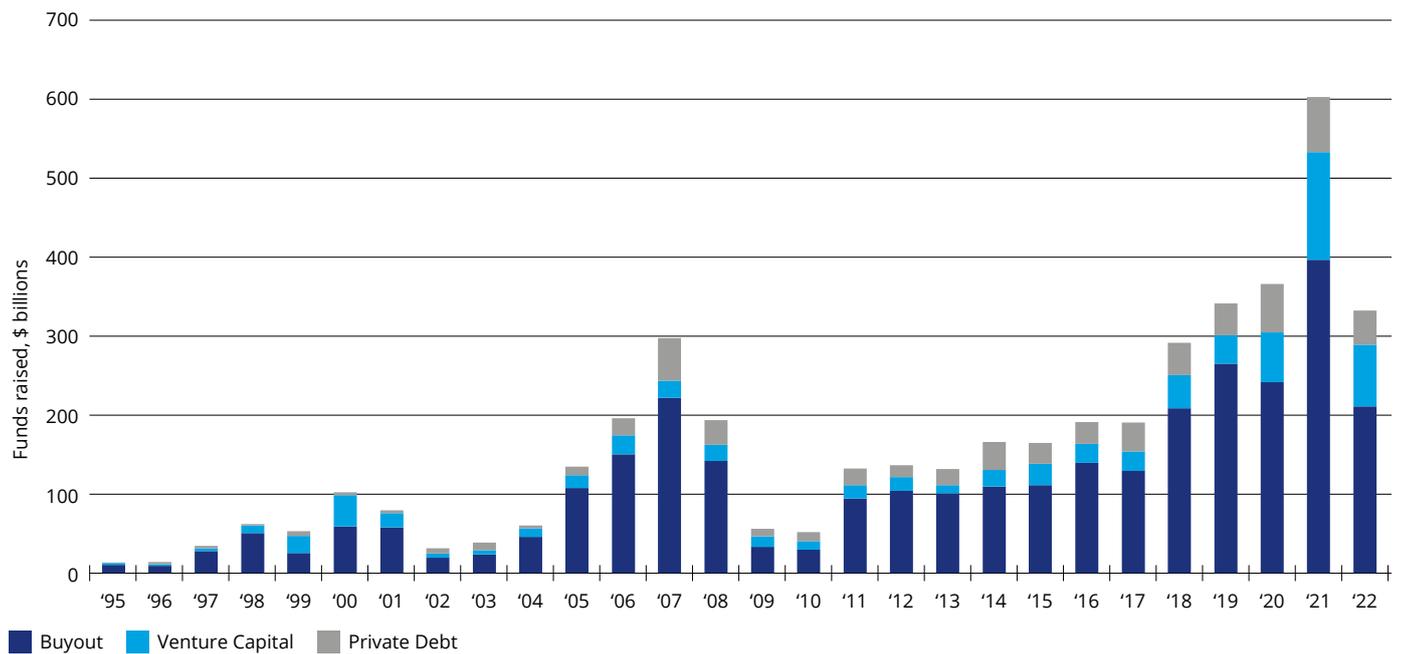
Source: State Street Global Markets, data as of 1 March 2023

Trends in private markets

After strong fundraising activity by private market general partners (GPs) in 2021, there has been a notable slowdown across the board in private market fundraising in 2022. Using State Street’s Private Equity Index data, in the first three quarters of 2022, Buyout and Venture Capital funds raised \$211 billion and \$78 billion, respectively, while Private Debt funds raised \$43 billion, indicating sharp slowdowns across all strategies (Figure 8). Across regions, in the first three quarters of 2022, the US and Rest-of-World funds raised \$229 billion and \$93 billion, respectively, while Europe funds experienced a significant slowdown with a total fund size of \$11 billion.

Several IFSWF members had noticed a slowdown in fundraising, while others said they thought it had remained steady. One sovereign wealth fund told us that higher interest rates had resulted in “the use of leverage becoming more expensive, which substantially slowed down the overall growth. Under the circumstances of expected recession and declined economic momentum, institutional investors turned cautious and more conservative on making new commitments, especially when evaluating new names of GP or PE [private equity] funds.” The same fund also told us that after years of increased allocations, investors had begun “to expect more realisation activities and receive capital distributions from old vintage funds”.

Figure 8: Fundraising in private equity

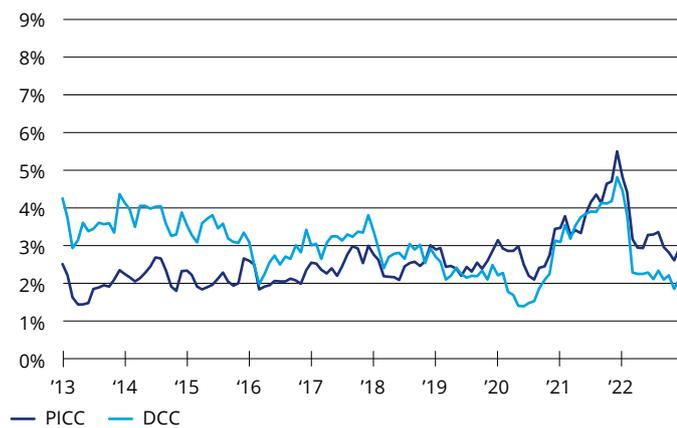


Source: State Street Price Equity Index, data as of Q3 2022

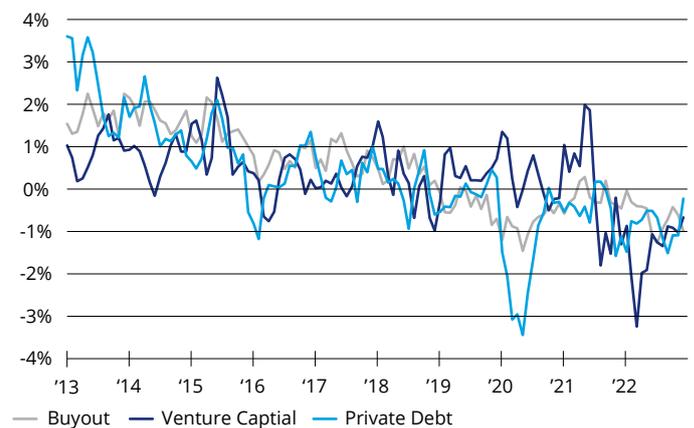
In terms of cash flow activity, after a sharp decline in Q1 2022 and a marginal drop in Q3 2022, the quarterly Paid-in Capital over Committed Capital (PICC) remained constant in Q4 2022. Likewise, following a similar pattern in the first three quarters of 2022, the quarterly Distribution over Committed Capital (DCC) also remained stable in Q4 2022. Throughout the year, PICC stayed much higher than DCC, resulting in significant negative net cash flows for all three main PE strategies. Figure 9b shows two quarters with sharply negative net cash flows recently: one for Venture Capital in Q1 2022 and the other for Private Debt in Q1 2020. Although they look similar on the chart, they were driven by very different factors. The negative cash flow of Private Debt in Q1 2020 was driven by increases in contributions in response to the outsized demand of private debt in the pandemic crisis, while the negative cash flow of Venture Capital in 2022 overall was driven by the sharp decreases of distributions, as a result of diminishing valuations and exit activities.

Figure 9: Global private equity cash flows

A) Paid in capital vs Distributions



B) Net cash flow (distribution – paid in) by strategy



Source: State Street Private Equity Index, data as of Q3 2022, rolling three month aggregate, the cashflows displayed are relative to committed capital.

Conclusion

After a year of record inflationary levels seen across many regions, solid signs are emerging in 2023 that global inflation may have peaked and is beginning to decline. However, concerns about prolonged high inflation, its effects on economic growth, and the potential for monetary policy missteps from central banks – particularly in developed economies – continue to weigh on the minds of financial market participants. To alleviate these concerns, sovereign wealth funds have signalled their intent to increase downside protection and active hedging programmes while sticking firmly to their strategies by maintaining their benchmarks. Meanwhile, institutional investors have shown evidence of rotating out of interest rate sensitive fixed income markets to emerging market equities, increasing their cash reserves, and raising their foreign exchange exposure to higher-yielding North American currencies of the US and Canadian dollars. In private markets, fundraising has slowed – a trend seen in custodial data and observed by the sovereign wealth fund community.

Taken together, signs of caution are evident, but if there is one lesson learnt from the pandemic years is that both institutional investors and sovereign wealth funds have the resilience and expertise to weather these new challenges on the horizon.

Contributors

About the International Forum of Sovereign Wealth Funds (IFSWF)

The International Forum of Sovereign Wealth Funds (IFSWF) is a global network of sovereign wealth funds established in 2009 to enhance collaboration, promote a deeper understanding of sovereign wealth fund activity, and raise the industry standard for best practice and governance.

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