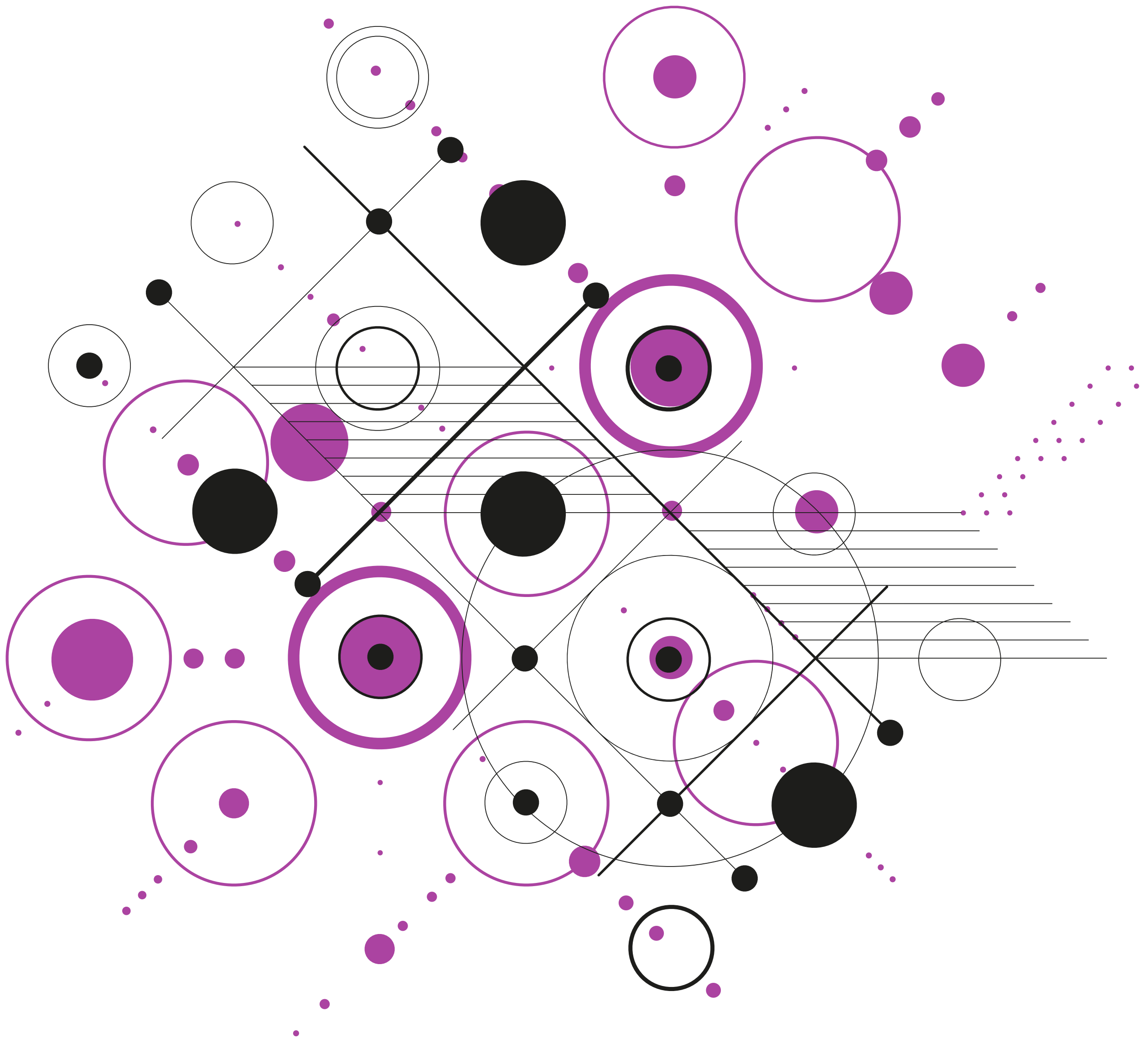
STATE STREET

Building Resilience:
Long-Term Investors Respond to Inflation Moderation

May 2024



IFSWF
International Forum of Sovereign Wealth Funds

Introduction

Most central banks worldwide have spent the last two years battling higher inflation with tighter monetary policy. Consequently, global inflation has shown signs of moderation, and policymakers, particularly in developed economies, are, to varying degrees, to consider revisiting their interest rate policies.

The prospect of looser monetary conditions has stirred financial markets and helped global equity markets set new highs. Given these changing market conditions, how have global institutional investors and sovereign wealth funds positioned their portfolios for 2024?

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 $40 trillion in assets[1]. This data is contextualised by input from members of the International Forum of Sovereign Wealth Funds (IFSWF).

1 as of 30 September, 2023

Research Methodology

State Street analysed its unique suite of proprietary macroeconomic indicators, including aggregate trends in capital flows and portfolio positions by 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 $40 trillion[2] in assets under custody and administration at State Street.

To complement this data and provide more colour and context for the quantitative analysis, the IFSWF asked ten members who deploy capital in global markets for insights into their asset allocation strategies over the last year. Sovereign wealth funds from the Middle East, Europe, East Asia, Australasia, and North America provided responses about their investment behaviours and allocations anonymously.

2 as of 30 September, 2023

Global Inflation: A Downward Trend with Signs of Divergence

Over the past two years, most central banks have made efforts to lower global inflation. The State Street PriceStats inflation measure derived from online prices shows that, after reaching a peak in the second half of 2022, aggregate annual global online inflation gradually declined (Figure 1A).

However, this aggregate measure masks differing inflation trends between developed and emerging markets and across sectors. While inflation in developed markets has remained somewhat stable, emerging market inflation rebounded and rose to its previous highs. Emerging markets were ahead of their developed counterparts in the fight against inflation, allowing many central banks to cut interest rates more quickly than their counterparts in developed markets. With inflation largely perceived to be under control in most G10 economies, central banks were beginning to contemplate interest rate cuts. Early expectations of looser monetary conditions in developed markets began giving investors the green light to start increasing their risk appetites. However, market expectations regarding the timing and strength of interest rate normalisation, thanks to stronger-than-expected employment and inflation data in the US (Figure 1B) and other major economies in Q1 2024. As a result, investors became more cautious in adding risk to their portfolios than they were towards the end of 2023.

Figure 1: Global inflation trend divergence

Figure 1A: Online price inflation

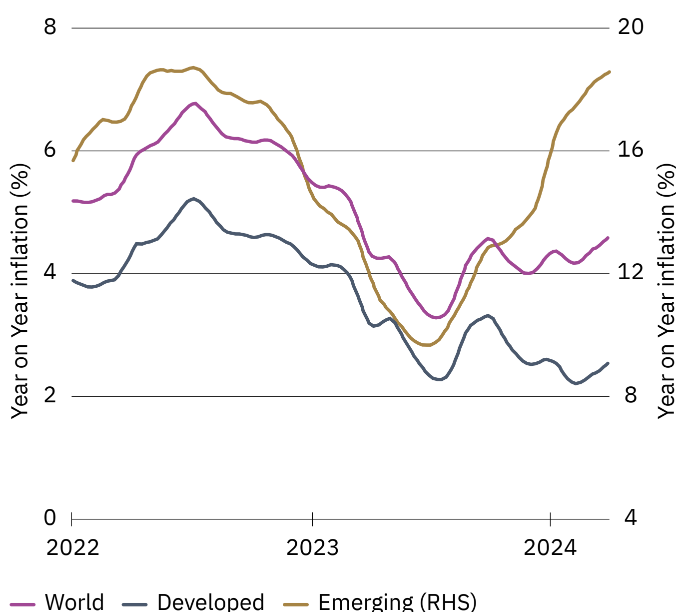
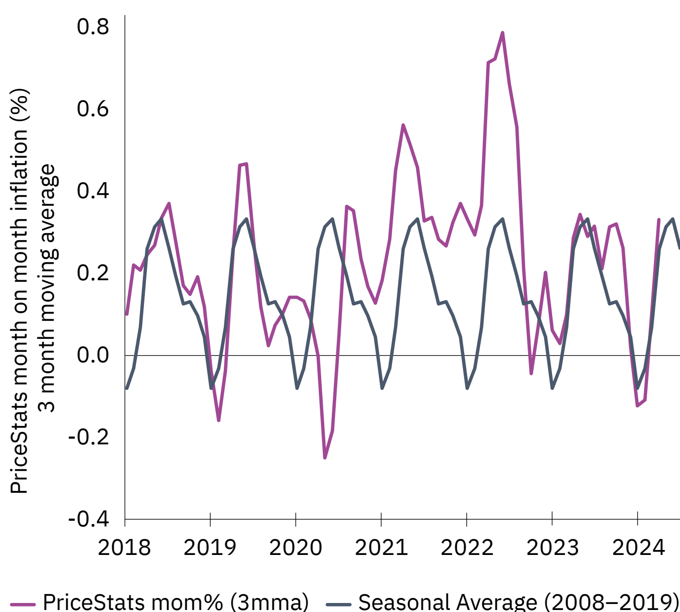


Figure 1B: US Online price inflation



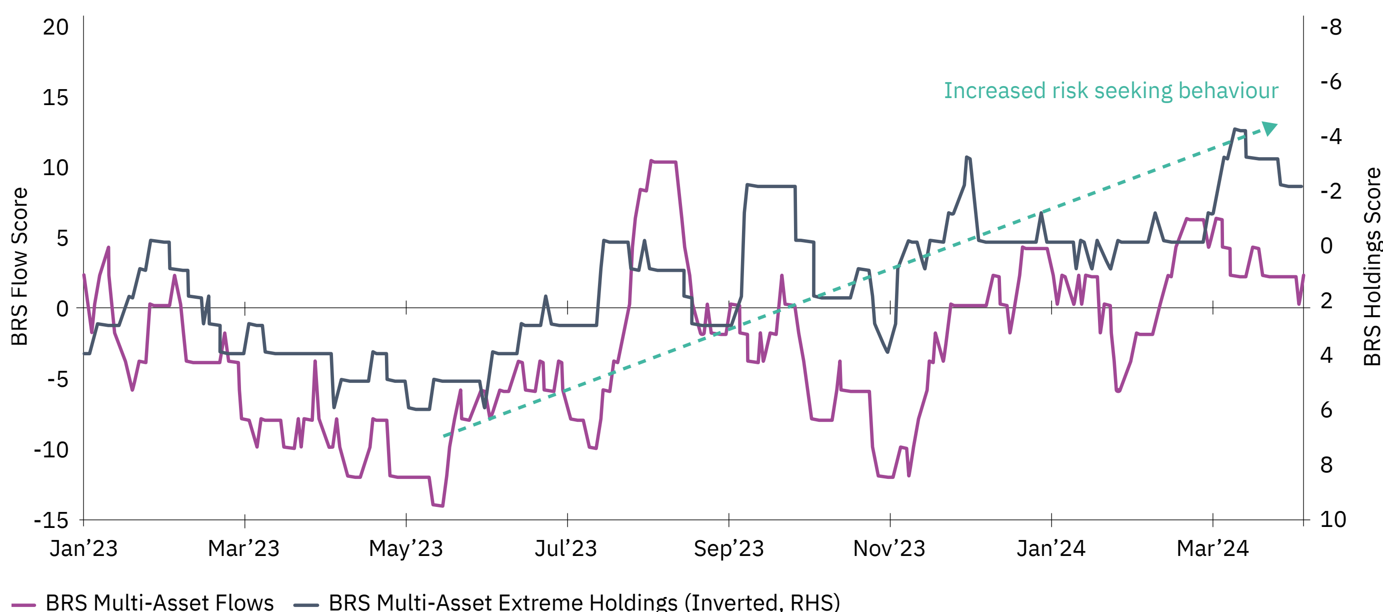
Source: State Street Global Markets, PriceStats. As of April 2024.

Rising Investor Optimism but Signs of Caution

Despite an uncertain economic and political backdrop, equity markets experienced a strong start to 2024 as investors appeared confident.

According to State Street's Behavioural Risk Scorecard (BRS) – an aggregate measure of risk appetite derived from the capital flows and portfolio holdings by global institutional investors across multiple asset classes and factors (Figure 2) – flows and holdings across risk assets have shown some evidence of a return to risk-seeking behaviour in 2024.

Figure 2: Investor flows and holdings across risk assets



Source: State Street Global Markets, PriceStats. As of April 2024.

This increase in risk-taking is evidenced by global investors' asset allocation. We can observe rising allocations to equities funded by selling fixed-income assets and reducing cash reserves (Figure 3A). Investor equity allocations now stand above long-term average levels, within a percentage point of the highest allocation over the past decade. These allocation changes have coincided with low levels of market risk – State Street's Turbulence and Systemic Risk indicators that measure unusualness in asset returns and market fragility remained subdued throughout 2023 (Figure 3B).

Figure 3: Investor asset allocation trends and market risk

Figure 3A: Asset allocation of institutional investors

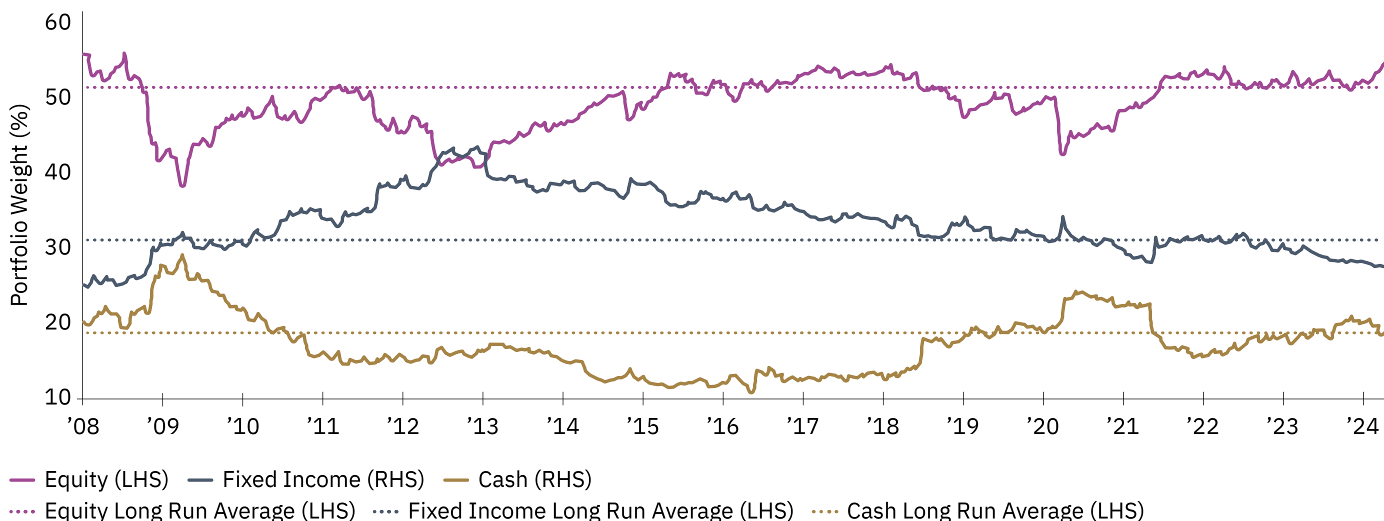
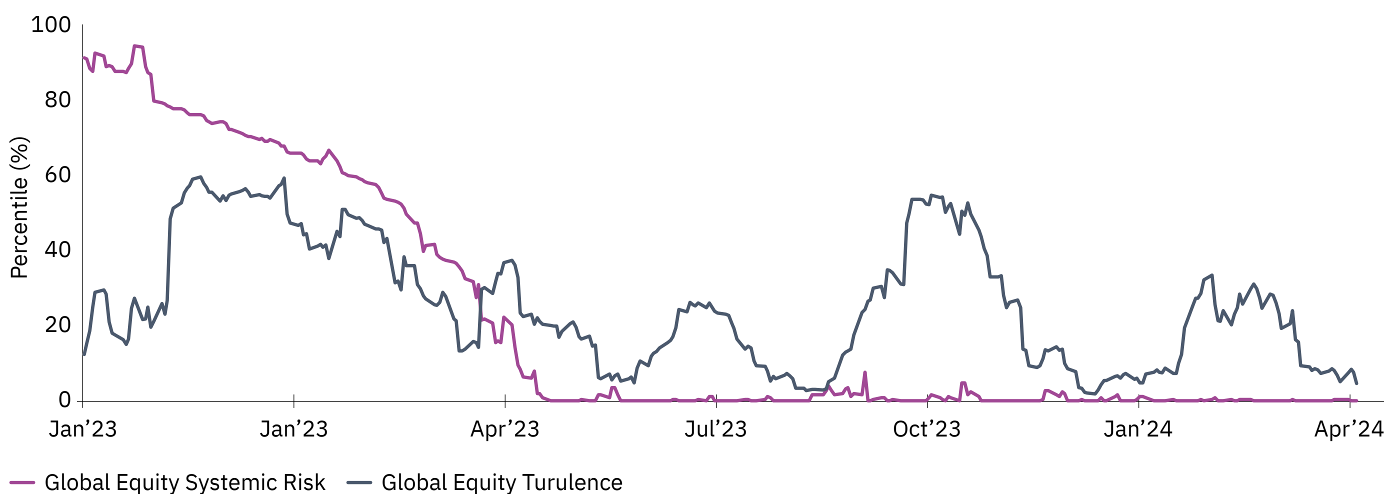


Figure 3B: Global Equity Systemic Risk and Turbulence



Source: State Street Global Markets. As of April 2024. 5-year percentile rank of 30-day average turbulence and 1-year percentile rank of systemic risk.

Within equities, State Street's data shows that investors express a preference for emerging markets over developed markets, with a steady net buying of stocks in the former throughout 2023 and net selling of the latter (Figure 4A). However, investors are not showing signs of complacency. Consensus global growth estimates are falling in most major economies outside of the US. Consequently, the interest rate easing cycle may get pushed further down the line, putting pressure on corporate earnings. Excluding the dominant US tech sector, global earnings and profits are contracting (Figure 4B). In line with this narrative, global investors have shown a defensive tilt in their equity investments, showing a preference towards quality (Figure 4C) and defensive sectors, such as Energy, Consumer Staples and Utilities (Figure 4D).

On the other hand, sovereign wealth funds surveyed by IFSWF revealed a more cautious approach to risk. Respondents anticipate that geopolitics, macroeconomic dynamics, policy changes, and market volatility will significantly influence asset markets in 2024. For this reason, they prefer listed equities to private equity and, in listed markets, domestic equities over overseas equities. Some sovereign wealth funds added exposure to Japanese equities. They have also increased their exposure to high-grade credit as direct lending markets boom on the back of banks' withdrawal from these markets.

Sovereign wealth funds have also increased their nominal interest rate exposure slightly, as well as their allocations to short-duration fixed income to increase liquidity given capital requirements and possible market dislocations.

Figure 4: Equity allocations reveal signs of caution

Figure 4A: Equity flows by region

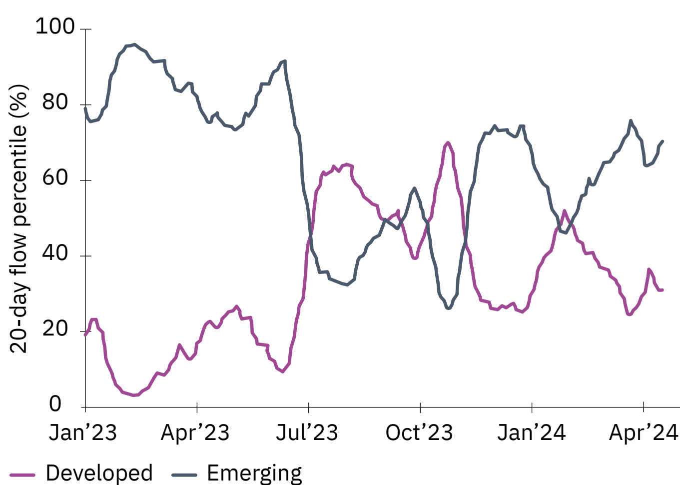


Figure 4B: Earnings & profit margin

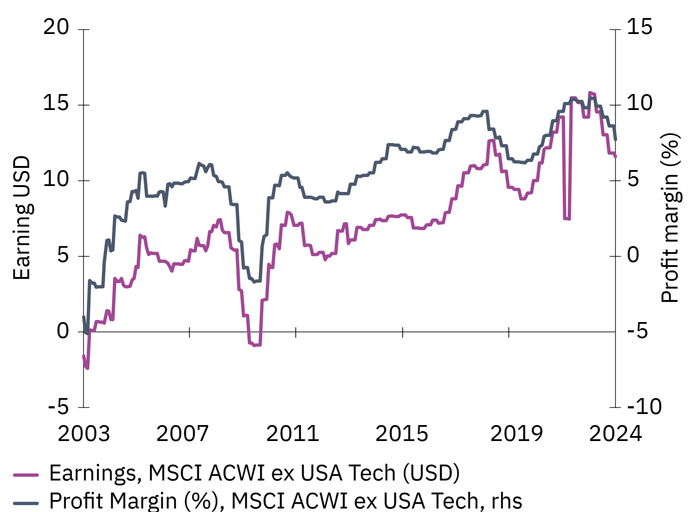


Figure 4C: Equity flows by style

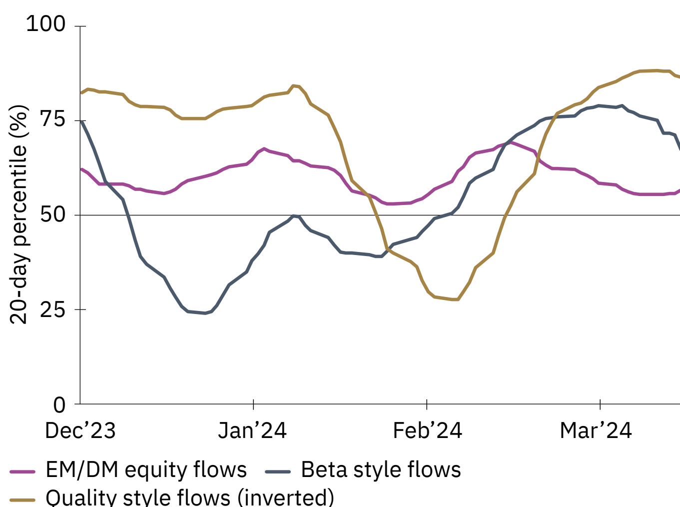
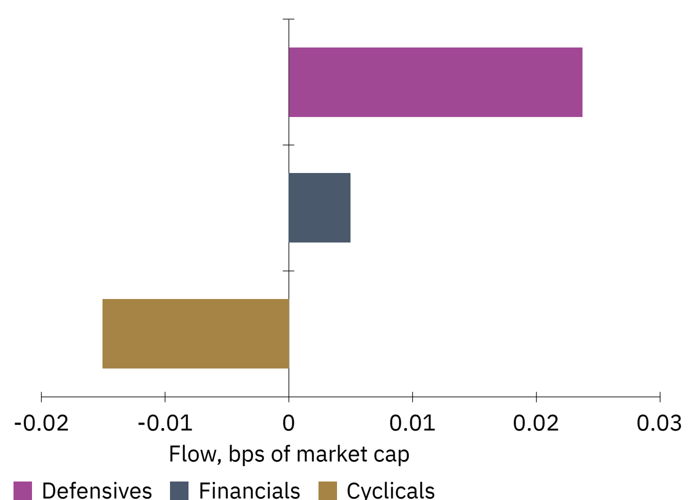


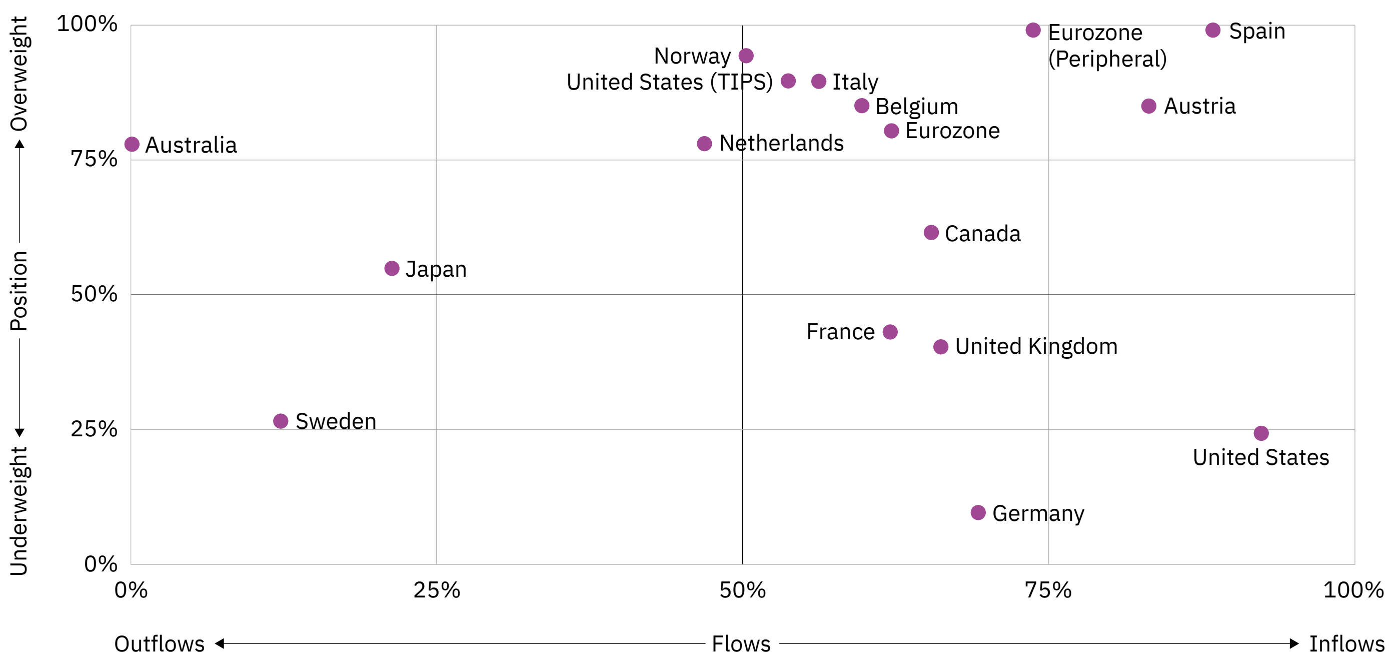
Figure 4D: Equity flows by sector profit margin



Source: State Street Global Markets. As of April 2024. 5-year conditional percentile rank of trailing 20-day flows.

2024 has been a challenging year for fixed-income markets as interest rates have not come down as quickly as expected, and the markets have also been less volatile. Consequently, returns were lower than market participants were banking on, particularly in safer sovereign and investment-grade corporate markets. That said, a more stable market equilibrium may yet align with the expected loosening in global financial conditions and synchronised future rate-cutting cycle. We see recent evidence of differentiation in global investor preference across sovereign markets, with persistent inflows in US Treasuries and appetite for Eurozone and UK government debt, but notable outflows from Australia since the start of 2024, and Japan and Sweden more recently (Figure 5).

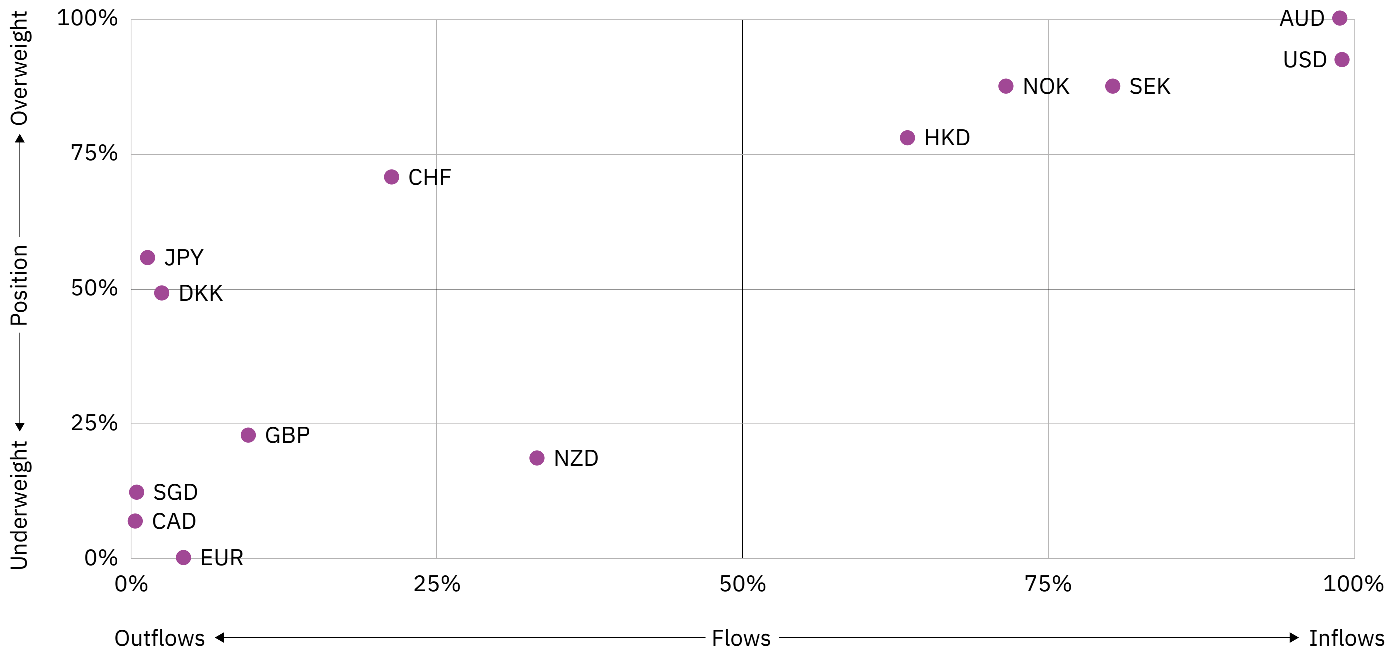
Figure 5: Fixed income allocations have become more segregated



Source: State Street Global Markets. As of April 2024.

From a foreign exchange perspective, institutional investors have added to their USD, AUD and NOK exposures where they hold extended overweight positions. The USD offers yield, stable and relatively strong growth appeal and safe haven characteristics as geopolitical risks continue to unfold. The commodity exposure associated with AUD and NOK also seems to appeal, a factor that should also support USD, given its status as the world's largest oil producer. On the other end of the spectrum, investors have shunned the EUR and CAD, in particular, to the lowest portfolio holdings since 2021 and 2020, respectively (Figure 6).

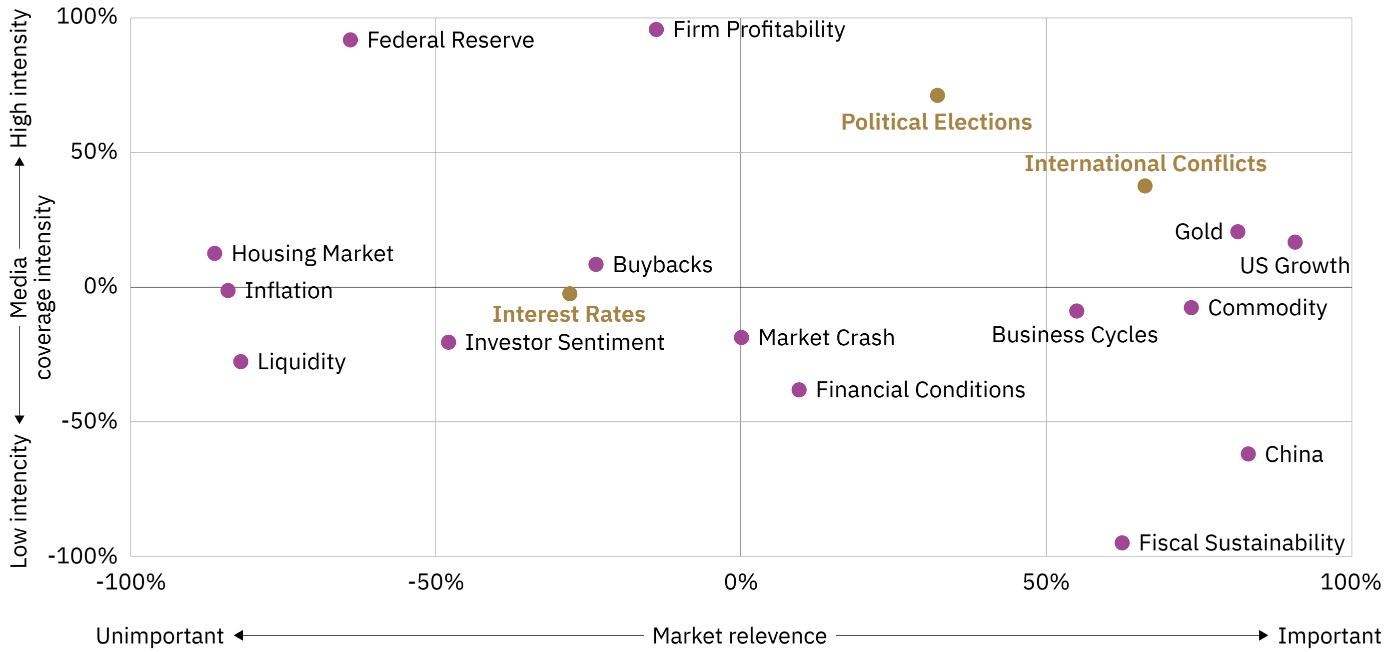
Figure 6: Foreign exchange positions and flows have become polarised



Source: State Street Global Markets. As of April 2024.

Politics will undoubtedly remain a major theme for markets in the foreseeable future, not only because of ongoing tensions between the US and China and conflicts in Ukraine and Gaza but also because half the global population will participate in national elections in 2024. As such, the theme of elections is widely discussed in global media and is impacting asset returns. State Street's Narrative Map (Figure 7) identifies the themes most relevant to financial markets. International Conflicts and Interest Rates are also prominent narratives in global media, with an uptick in recent market impact. IFSWF members surveyed for this report also reflected these themes, as do the topics of interest in IFSWF's ongoing member knowledge-sharing programme, which have included the impact of deglobalisation and the performance of the Chinese economy. For some IFSWF members, geopolitical events have a limited immediate impact on commodity markets, with their repercussions felt more profoundly over extended periods. Short-term disruptions may be mitigated by market mechanisms swiftly adjusting to accommodate fluctuations in supply and demand. However, prolonged geopolitical tensions tend to exert a more significant influence, disrupting supply chains, altering investment patterns, and prompting shifts in governmental policies. Such protracted uncertainties can lead to sustained disruptions in commodity markets, elevating prices and affecting global trade dynamics.

Figure 7: Media coverage of themes and their market importance



Source: State Street Global Markets, MKT MediaStats. As of April 2024.

Private market trends

2023 proved to be a challenging year for private market managers, particularly those seeking to exit their investments.

Due to rising interest rates and deflated valuations, among other factors, exit activity failed to rebound in 2023, leading some observers to conclude the year represented the worst or second-worst year for private equity distributions in 25 years[3]. The State Street Private Equity Index – derived from underlying investor cash flows representing $4.9 trillion in committed capital to private markets[4] – confirms this sentiment, with distribution levels historically low throughout 2023 (Figure 8A). Private markets have underperformed public markets over the last year up to Q3 2023 (Figure 8B), with the S&P500 returning approximately 20% in the recent year while private equity across all strategies returned close to 5%. Among strategies, private debt performed more strongly than buyout and venture capital (Figure 8C). Across sectors, energy-focused funds benefitted from surging oil prices and the impact of geopolitics on supply chains, followed by comparably strong performance in industrials and financial sector-focused funds.

Similarly, some IFSWF members were exposed to the denominator effect, which meant they had to reduce their exposure to private equity by 1-3%. The denominator effect occurs when the value of an investor's total portfolio decreases due to market downturns or underperformance of other asset classes. The decrease in portfolio value can cause the proportion allocated to illiquid investments, like private equity, to increase relative to the total despite no change in the actual investment value.

3 "Percentage of GP-Leds in PE Distributions Nearly Doubled in 2023," Private Funds CFO (blog), January 3, 2024

4 Source: State Street Global Markets. As at Q3 2023.

Figure 8: Trends in private equity and debt

Figure 8A: Monthly distributions to commitment (DCC, rolling 3m average)

Figure 8B: Private Equity performance vs S&P500

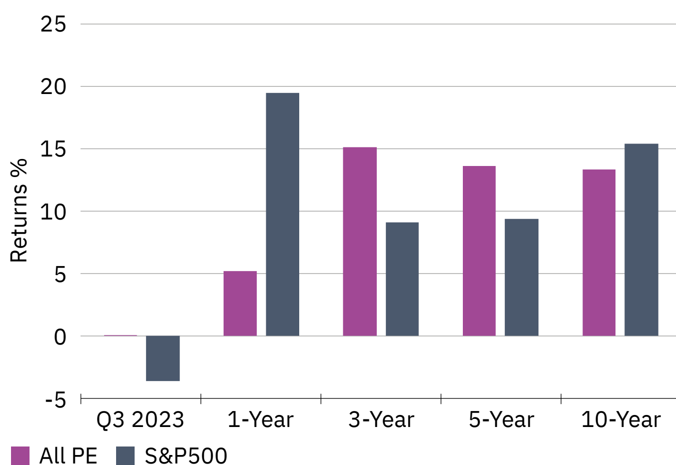


Figure 8C: Rolling annual return by strategy

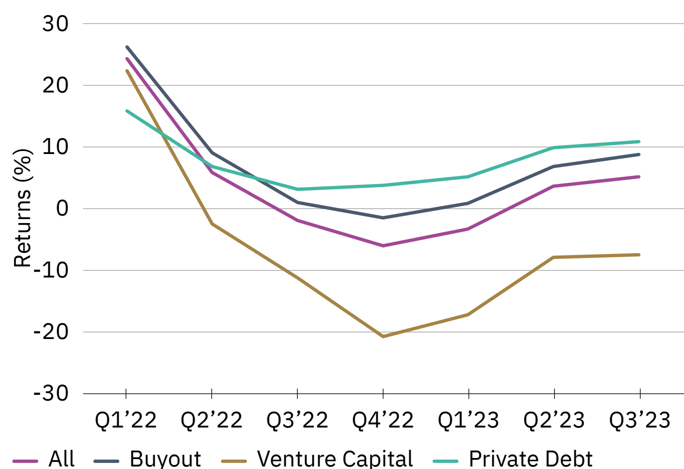
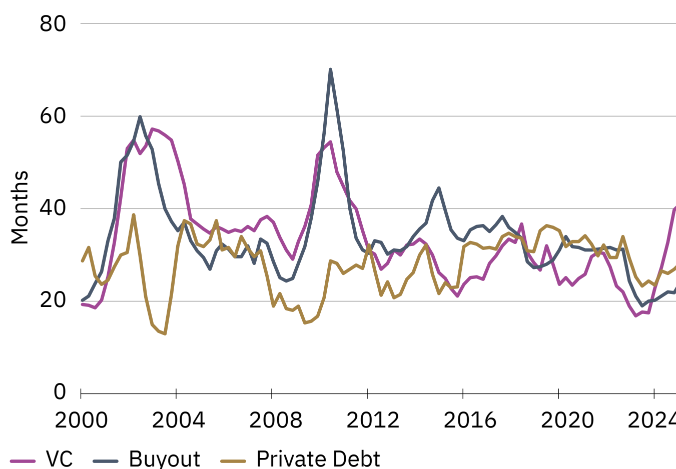


Figure 8D: Quarterly dry powder normalised by average contribution over prior year



Source: State Street Global Markets. As of April 2024. 5-year conditional percentile rank of trailing 20-day flows.

Private equity fundraising activity, however, shows signs of picking up and looks on track to recover to pre-Covid levels. However, it is projected to remain well below 2021 and 2022 levels, with particular weakness in activity outside of the US and Europe. In terms of unfunded commitments, dry powder amounted to $853 billion as of Q3 2023, indicating a slight deceleration in capital deployment compared to the previous quarter, consistent with levels seen over the past two years amid tighter financing conditions. The subdued deal activity in Q1 2024 led to an increase in the amount of capital available to private equity firms across all strategies, notably reaching elevated levels in venture capital. Specifically dry powder inventory, representing the duration until new fundraising activities are initiated, reached its peak since the Global Financial Crisis (Figure 8D).

Summary

With most investors considering that inflation is largely under control and on a downward trend, developed market central banks have begun to contemplate looser monetary conditions.

This expectation has ignited a return of risk appetite amongst investors, with increasing allocations to equities, albeit with a degree of caution. Although sovereign wealth funds appeared to be more selective than other long-term investors, they have not taken any more risk. Global GDP is expected to slow along with consensus growth estimates in most major economies outside of the US. As a result, the easing cycle may get pushed further down the line thanks to higher US inflation, putting pressure on earnings. In line with this, global investors have shown a defensive tilt in their equity investments, preferring quality and defensive sectors, while their fixed income and foreign exchange allocation decisions similarly reflect preferences for the US market, given its economic strength and safe haven credentials. In private markets, subdued exit activity and smaller and slower distributions remain an issue of concern for limited partners (LPs), along with more recent underperformance relative to public markets against a backdrop of higher interest rates and deflated valuations. Venture capital has lagged the most, with many funds underperforming and increased amount of uninvested capital, whereas private debt strategies have outperformed.

Looking ahead, elections will likely be a key theme for the remainder of 2024. The increased intensity of global media coverage has shown signs of the narrative beginning to impact financial markets more heavily recently. Interest rates, politics, and international conflict remain narratives that are likely to prove influential for global investors in the year ahead.

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.

About State Street Associates®

State Street's academic affiliate, State Street Associates® (SSA), is a unique partnership that bridges the worlds of financial theory and practice. Part of State Street's Global Markets® division, SSA conducts portfolio construction, risk management and investment strategy research for institutional investors, leveraging proprietary information assets as well as partnerships with renowned academics from the Harvard Business School, MIT's Sloan School of Management, Boston College and EDHEC. State Street Associates was appointed by the IFSWF in 2016 as one of its two official research partners.

Disclaimers

Disclaimers and Important Risk Information [2024.01]

This communication is provided only to professional clients or eligible counterparties or their equivalent by State Street Bank and Trust Company or, where applicable and permissible, its bank and non-bank affiliates (“State Street”). State This communication is provided only to professional clients or eligible counterparties or their equivalent by State Street Bank and Trust Company or, where applicable and permissible, its bank and non-bank affiliates (“State Street”). State Street Bank and Trust Company is authorized and regulated by the Federal Reserve Board, registered with the Commodity Futures Trading Commission as a Swap Dealer, and is a member of the National Futures Association. State Street Bank International GmbH (“SSBI”) is regulated by the European Central Bank (“ECB”), the German Federal Financial Supervisory Authority (“BaFin”) and the Deutsche Bundesbank. Details about the extent of SSBI’s regulation by the ECB, the BaFin and Deutsche Bundesbank are available from us on request. Products and services described herein may not be available in all jurisdictions or through all State Street entities. Activities described herein may be conducted from offshore. Information provided is of a general nature only and has not been reviewed by any regulatory authority.

This communication is intended for general marketing purposes, and the information contained herein has not been prepared in accordance with legal requirements designed to promote the independence of investment research. It is for clients to determine whether they are permitted to receive research of any nature. Market commentary provided by trading desks is not investment research. This communication is not intended to suggest or recommend any transaction, investment, or investment strategy, does not constitute investment research, nor does it purport to be comprehensive or intended to replace the exercise of an investor’s own careful independent review and judgment regarding any investment decision.

This communication is not intended for retail clients, nor for distribution to, and may not be relied upon by, any person or entity in any jurisdiction or country where such distribution or use would be contrary to applicable law or regulation. This communication or any portion hereof may not be reprinted, sold or redistributed without the prior written consent of State Street. This communication and the information herein does not constitute investment, legal, or tax advice and is not a solicitation to buy or sell securities or any financial instrument nor is it intended to constitute a binding contractual arrangement or commitment by State Street of any kind. The information provided does not take into account any particular investment objectives, strategies, investment horizon or tax status.

The views expressed herein are the views of State Street as of the date specified and are subject to change, without notice, based on market and other conditions. The information provided herein has been obtained from sources believed to be reliable at the time of publication, nonetheless, we make no representations or assurances that the information is complete or accurate, and you should not place any reliance on said information. State Street hereby disclaims any warranty and all liability, whether arising in contract, tort or otherwise, for any losses, liabilities, damages, expenses or costs, either direct, indirect, consequential, special, or punitive, arising from or in connection with any use of this document and/or the information herein.

State Street may from time to time, as principal or agent, for its own account or for those of its clients, have positions in and/or actively trade in financial instruments or other products identical to or economically related to those discussed in this communication. State Street may have a commercial relationship with issuers of financial instruments or other products discussed in this communication.

This communication may contain information deemed to be forward-looking statements. These statements are based on assumptions, analyses and expectations of State Street in light of its experience and perception of historical trends, current conditions, expected future developments and other factors it believes appropriate under the circumstances. All information is subject to change without notice.

Participating in trading any financial instrument, including but not limited to foreign exchange, equities, futures, fixed income or derivative instruments, or investments in non-liquid or emerging markets, or digital assets, or participating in securities lending, repurchase transactions or other collateral services present risks, which may include but are not limited to counterparty, collateral, investment loss, tax, and accounting risks. Where applicable, returns may increase or decrease as a result of currency fluctuations. Derivatives may be more volatile than the underlying instruments. Certain foreign exchange business, including spot and certain forward transactions, may not be regulated in all jurisdictions. Past performance is no guarantee of future results.

Please contact your State Street representative for further information.

To learn how State Street looks after your personal data, visit: https://www.statestreet.com/utility/privacy-notice.html

© 2024 State Street Corporation – All Rights Reserved.

Global Markets Research Disclaimer Supplement [2024.01]

Australia: This communication is provided to wholesale clients by State Street Bank and Trust Company (Australian Business Number 70 062 819 630, Australian Financial Services License 239679).

Brazil: The products in this marketing material have not been and will not be registered with the Comissão de Valores Mobiliários – the Brazilian Securities and Exchange Commission ("CVM"), and any offer of such products is not directed to the general public within the Federative Republic of Brazil ("Brazil"). The information contained in this marketing material is not provided for the purpose of publicly soliciting investments from investors residing in Brazil and no information in this marketing material should be construed as a public offering or unauthorized distribution of the products within Brazil, pursuant to applicable Brazilian law and regulations.

Israel: State Street Bank and Trust Company is not licensed under Israel's Regulation of Investment Advice, Investment Marketing and Portfolio Management Law, 1995. This communication may only be distributed to or used by investors in Israel which are "eligible clients" as listed in the First Schedule to Israel's Regulation of Investment Advice, Investment Marketing and Portfolio Management Law 1995.

Japan: This communication is made available in Japan by State Street Bank and Trust Company, Tokyo Branch, which is regulated by the Financial Services Agency of Japan and is licensed under Article 47 of the Banking Act.

Oman: State Street Bank and Trust Company is not a bank or financial services provider registered to undertake business in Oman and is not regulated by the Central Bank of Oman or the Capital Market Authority.

Qatar: The information in this communication has not been reviewed or approved by the Qatar Central Bank, the Qatar Financial Markets Authority or the Qatar Financial Centre Regulatory Authority, or any other relevant Qatari regulatory body.

Singapore: This communication is made available in Singapore by State Street Bank and Trust Company, Singapore Branch ("SSBTS"), which holds a wholesale bank license by the Monetary Authority of Singapore. In Singapore, this communication is only distributed to accredited, institutional investors as defined in the Singapore Financial Advisers Act 2001 ("FAA") and its regulations. Note that SSBTS is exempt from Sections 27 and 36 of the FAA. When this communication is distributed to overseas investors as defined in the FAA, note that SSBTS is exempt from Sections 26, 27, 29 and 36 of the FAA. This advertisement has not been reviewed by the Monetary Authority of Singapore.

South Africa: State Street Bank and Trust Company is authorized in South Africa under the Financial Advisory and Intermediary Services Act, 2002 as a Category I Financial Services Provider; FSP No. 42671.

United Arab Emirates: The information contained within this communication is not intended to lead to the conclusion of any contract of whatsoever nature within the territory of the United Arab Emirates.

United Kingdom: State Street Bank and Trust Company is authorised and regulated by the Federal Reserve Board of the United States, authorised by the Prudential Regulation Authority ("PRA") and subject to regulation by the Financial Conduct Authority and limited regulation by the PRA. Details about the extent of our regulation by the PRA are available from us on request.

State Street Bank International GmbH is authorised and regulated by the European Central Bank and the BaFin, deemed authorised by the Prudential Regulation Authority, and subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details of the Temporary Permissions Regime, which allows EEA-based firms to operate in the UK for a limited period while seeking full authorisation, are available on the Financial Conduct Authority's website.

STATE
STREET

IFSWF
International Forum of Sovereign Wealth Funds