

# CHAPTER 02 MACROECONOMIC CONTEXT AND EVOLUTION OF THE SWF INDUSTRY

By Max Watson, series adviser

The global outlook for growth and capital flows has been transformed since most SWFs were set up. In the past two years, the issues confronting these funds have been turned upside down. Just as some were shifting towards longer-term assets, liquidity conditions in world markets imploded. For those wedded to diversification, risk correlations in many asset classes shifted alarmingly towards unity. Safe bets on the financial sector's globalised future became the problem assets of several SWF portfolios. And at the macroeconomic level, concerns to insulate the local economy from overheating, or to save for the future, were displaced suddenly (from Kazakhstan to Singapore) by a mandate of emergency fiscal support, leading to tensions between the external focus on most SWFs and a new internal focus, what we term National Wealth Funds.

After this turmoil, what lies ahead? Understanding the global macro outlook and its risks is clearly key to evaluating how SWF asset managers can navigate a successful investment path.

## The global setting

The outlook for the world economy today is dominated by the 'exit strategy' – a way out of the fiscal and monetary stimulus – of the G20, and more specifically the US, the euro area and China. Policy-makers, after a stellar feat in stabilising markets and output, are now trying to steer the world economy along a path that (i) does not shock the private sector into excessively rapid and volatile restructuring, but (ii) does not just revive the unbalanced growth model of the past decade – along the lines that might be termed Greenspan II or Bretton Woods III. A revival of unbalanced growth – referred to in Chapter 4 as the 'status quo ante' scenario – could be driven either by the historical imbalance between monetary expansion and low savings in the US and low domestic consumption in the emerging Asia or by new, yet to emerge, threats – perhaps informally co-ordinated devaluation by the US and China leading to the a structural medium-term loss of euro-area and non-China East Asian competitiveness.

The main contours of this exit strategy – and its risks – are now clear. It is based centrally on:

- ▶ Interest rates that not only are low but are promised to remain low. This provides policy-makers with reassurance that fiscal policy can safely become less expansionary, that monetary conditions for the private sector will remain easy, and that an upward-sloping yield curve will help strengthen bank capital (by enhancing the returns on maturity transformation);
- ▶ Policies in the US and China that remain centrally focused on reflation – based on fiscal expansion and, in practice perhaps, an acceptance of parallel depreciation (the only exchange rate constellation that is tacitly acceptable to both these global powers); and
- ▶ Liquidity support with low conditionality by an expanded IMF, except within the euro area (where mutual support arrangements are slowly being put in place).

This is in many ways the natural extension of a trenchant approach to crisis management that quite literally saved the system.

It is the best exit strategy we have. But it is certainly not without policy risks:

- ▶ Central banks are assuming that the only speed limits their monetary policies can hit lie in the labour market (i.e. if monetary expansion were absorbed by rising wages), and they assume that wages are due to stay quiescent for some time. In reality, a policy of rapid monetary expansion could hit problems in the foreign exchange or bond markets in countries where international confidence in the government's fiscal policy is weak, thereby limiting access to international financing or confidence in the currency;

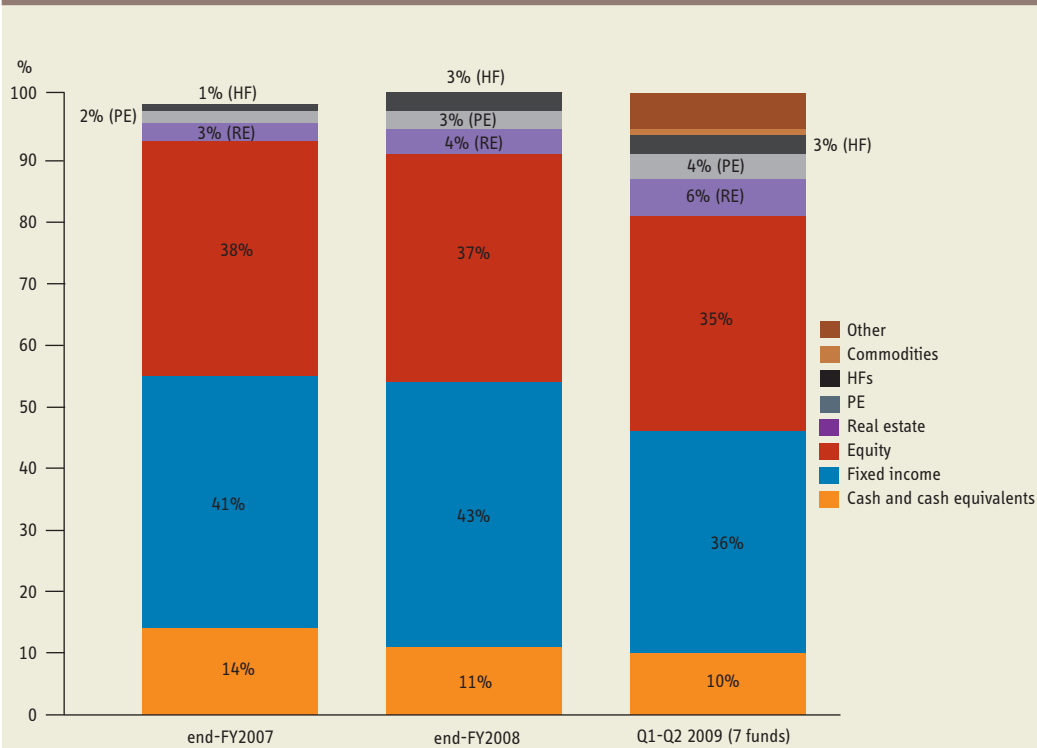
Clearly, the composition is as of end 2008 while the performance, to the degree that it was dependent on asset-type mix rather than geography and ‘alpha’ would have been dependent on the average composition for the year. Ignoring proactive portfolio adjustments (discussed below), the ‘Equity’ percentages will have fallen during the year but, all other things being equal (and ignoring geography and alpha), they would have fallen proportionately.

As we can see, funds located towards the top of the graph, with higher equity exposure, have on average experienced higher losses than those in the lower half – with more conservative portfolios. US Texas and Alaska funds look like exceptions to the rule, recording 6% and 4% losses respectively, while all the other heavily equity-invested funds lost from 30% to 40%, which is in line with the losses on equity markets during 2008.

Indeed, largely due to losses becoming increasingly apparent, this distribution of portfolios did not remain constant during the dramatic months of the financial crisis, as discussed above. Although official investment strategy review is still ongoing for some funds, and others never launched an overall strategy review, most funds seemed to have been relatively flexible in their short-term investment decisions, as seen in the changing portfolio composition of selected funds (for which official data was available), in Figure 7.5 below. Nonetheless, it is important to note that whenever we or other analysts speak about major shifts in investment strategies of SWFs – they still represent marginal shifts in the range of 1–5 percentage points. Although marginal, the changes are demonstrating clearly the trends in the SWF market:

- ▶ **Cash and money market instruments** holdings amounted to 14% at the end of FY2007, and were reduced to 11% in favour of fixed income instruments in 2008. In 2009, however, the return on both cash and fixed income holdings plunged, and SWFs cut the former further to 10%;
- ▶ **Fixed income investments** grew only by 2p.p. between 2007 and 2008, from 41% to 43%, despite falling equity markets. Combined with the fall in the share of cash and money market instruments it is intriguing that the overall switch during 2008 was out of conservative assets into higher risk assets (cf changes in equities and alternatives below). To be precise, there was a sharp increase in risk appetite in H1 2008, with a pullback in H2 2008 which only partially reversed the changes in H1. As recovery started to gain momentum in the second quarter of 2009, the fixed income share fell to 36% due largely to market effects;

Figure 7.5: Aggregate portfolio composition of selected SWFs, FY2007, FY2008 and Q1 or Q2 2009 (%)<sup>31</sup>

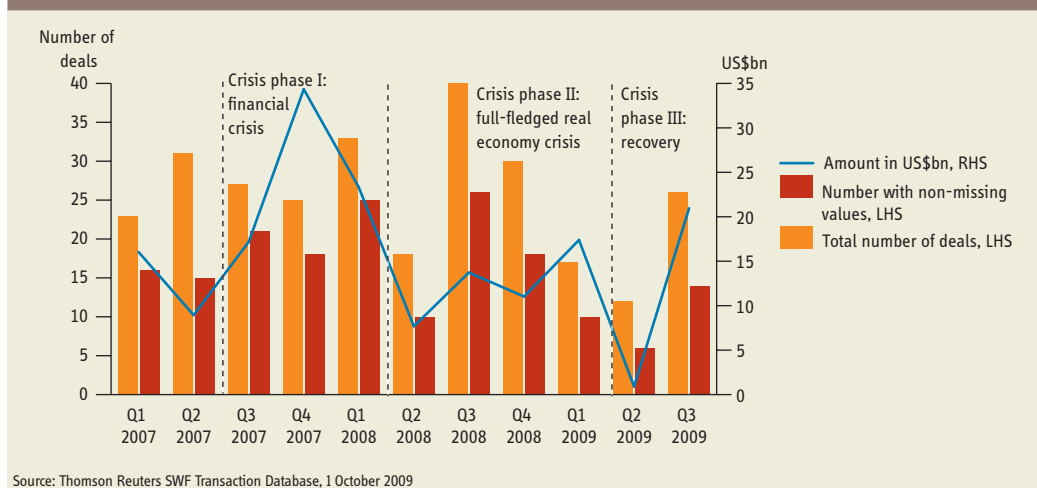


Note: a sharp increase in ‘Other’ in 2009 reflects the Irish NPRF’s bailout of two local banks, which we excluded from equity investments not to distort the average.  
Source: Funds’ annual reports and CEOs’ statements in the media

As capital markets plummeted in Q3 2008 in response to the Lehman Brothers bankruptcy, a full-fledged real economy crisis rolled out, and SWFs, 'once-bitten twice shy', moderated their investments to US\$14bn. Investments in financials also slowed, but did not stop entirely, as Figure 8.6 shows.

Most importantly, however, Q4 2008 and Q1 2009 were in fact the very bottom of the market, as can be seen from Figure 8.4, and the recovery, however questionable its pace and sustainability might prove to be, resumed in Q2 2009. At the same time, SWFs' investments were rather sluggish in Q4 2008–Q1 2009<sup>5</sup>, almost came to a halt in Q2 2009, and picked up considerably only in Q3 2009, effectively missing the bottom of the markets by half a year.

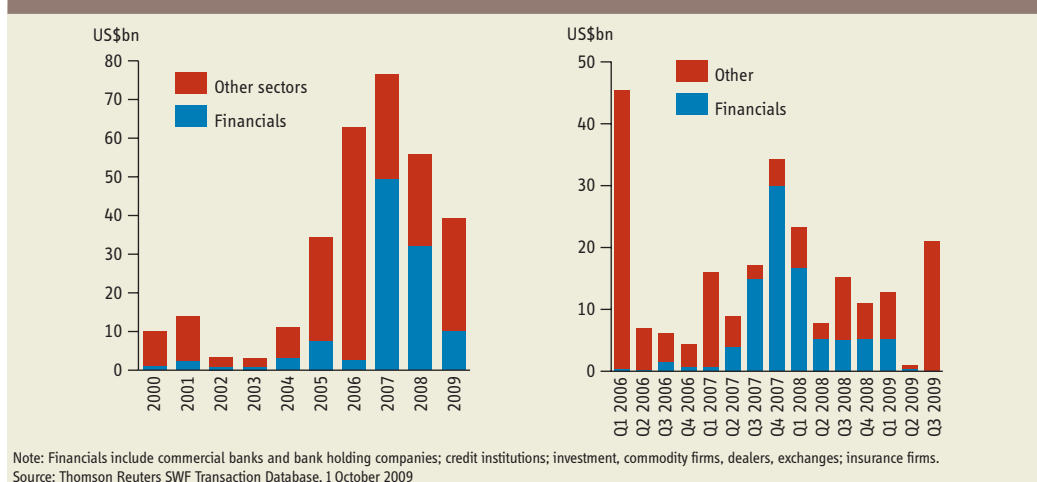
Figure 8.5: Quarterly SWF equity investments, Q1 2007–Q3 2009 (US\$bn)



### Sectoral distribution of equity investments

Financial institutions – commercial banks, credit institutions, insurance companies, investment and commodity firms, dealers and exchanges – amounted to 4% of total investments in 2006, attracting only US\$2.6bn of SWFs' funds. In 2007, on the wave of the financial crisis, this number skyrocketed to US\$49.2bn, accounting for 56% of total investments. Fourth quarter of 2007 was by far the most prolific in this respect, with just under US\$30bn being spent on financials in this quarter alone. Q1 2008 was still rich in financial deals, with US\$18bn spent, and the remaining quarters of 2008 saw a slow-down in both total investments and financial deals in particular. In all, US\$33.5bn were spent on financials in 2008, or 41% of the total. In the first three quarters of 2009 financial acquisitions dropped significantly – at just over US\$5.5bn, or 14% of total investments.

Figure 8.6: Financial versus non-financial deals (US\$bn)



There are three possible ways that an SWF or an NWF can support the domestic economy:

- ▶ Providing direct budget support to the national treasury or funds to the central bank, whether through direct transfers or purchases of government debt;
- ▶ Providing loans and guarantees to domestic companies and banks;
- ▶ Taking direct stakes in domestic companies.

As previously discussed, direct budget support – in the form of either budget deficit financing or of fiscal stimulus spending – is the simplest mechanism of supporting the domestic economy in the short run, and it can be consistent with the goal of intergenerational savings if the budget support either is crucial to avoid a damaging, sharp economic contraction or is used to replace lost natural resources revenue to smooth overall government revenue.

## Budget support

Russia, which is running a budget deficit for the first time in years due to falling oil and gas revenues and the necessary increase in budget spending (budget deficit expected to reach 13.5% of GDP in 2009)<sup>4</sup>, offers an example of a potentially depleting budget support initiative. Thus far budget shortfall has been funded from the Reserve Fund (RF), which is essentially a macroeconomic stabilisation fund, while the National Wealth Fund (NWF), a higher-risk profile fund, has not been significantly utilised. As of 1 November 2009 the RF had already shrunk by US\$65bn from its peak of US\$142bn in September 2008, down to US\$77bn, and is expected to be further depleted in 2010, while the NWF will come into use as of 2010 and will fall from Rbs2.7trn (US\$93bn) to just over Rbs1trn (US\$34bn, assuming the same exchange rate) in 2012.<sup>5,6</sup> The government is trying to limit external borrowing as much as possible, and public spending in the coming years is expected to be maintained at the level of 2009–10 mainly due to the transfers from the RF and NWF.

In Norway the debate over the use of the oil fund (GPF-Global) to support the domestic economy dominated the recent elections, and is still a key topic on the public agenda. According to the current rules of using the GPF, the fund can be drawn upon to boost government spending at the level not exceeding its average annualised return, which is 4% at present. In 2009 the government spent over 5% of the fund, and the new governing coalition has revealed plans to spend 6.2% (Nkr148.5bn or US\$27bn) in 2010, or 2.2 p.p. higher than the permitted limit, which supposedly should boost 2010 GDP by 0.5%.<sup>7</sup> The coalition of the Labour, socialist left and centre parties is using this as a precedent to show that the government is willing to preserve the Norwegian welfare state even in times of hardship.

In terms of its impact on intergenerational savings, loans and guarantees have some similarity to direct budget support. Like direct budget support, they are mostly short-term in nature. Moreover, the case for loans and guarantees being supportive of the basic goal of national economic development and intergenerational savings hinges on the same case as with budget transfers: that guarantees and loans will support firms that would otherwise have collapsed due to short-term problems, but will be able to grow strongly in the long term without continued government support. However, like direct budget support, loans and guarantees risk substantial damage both to the finances of the fund, especially if loans and guarantees perform worse than expected, and to the competitiveness of the domestic economy. In the latter case, loans and guarantees can create, or even create the impression of, soft budget constraints for domestic firms, thereby removing the pressure of competing with international leaders and creating preconditions for costs to rise and quality to decline. There is a significant risk of this sort of outcome in, for example, financial services firms that are now operating under sovereign guarantee, as politicians may be tempted to soften budget constraints for these firms in return for them accelerating expansion of their lending to the domestic economy.