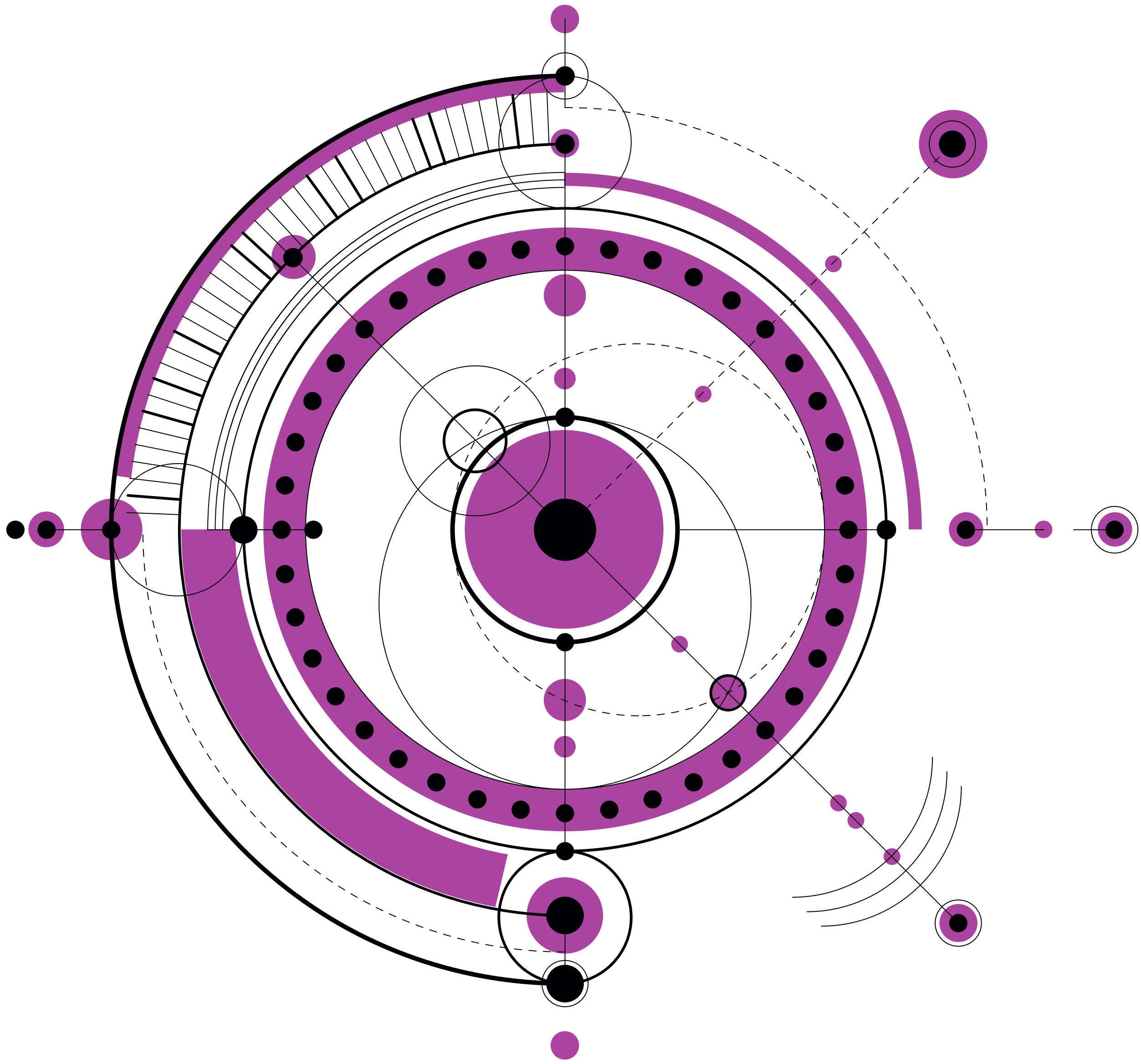
STATE STREET

Navigating market divergence and new narratives:

Evidence from long-term investors

April 2025



IFSWF
International Forum of Sovereign Wealth Funds

Introduction

If 2024 was the year of elections, with half of the global population participating in national polls, 2025 is likely to be the year in which the outcomes will be felt. In particular, the re-election of President Trump in the United States and the policies of the new US administration present an uncertain backdrop for markets with the potential to transform the global landscape for international trade and geopolitical risk.

This uncertainty is likely to significantly impact financial markets, with investors facing the prospect of heightened market volatility and potential for divergence in asset markets, severely testing the resilience of institutional portfolios. But how have global institutional investors and sovereign wealth funds positioned their portfolios for the disruptive outlook for 2025?

This report reveals 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 $46 trillion in assets[1]. This data is contextualised by input from members of the International Forum of Sovereign Wealth Funds (IFSWF).

1 As of 31 December 2024

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 $46 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 six member sovereign wealth funds that 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.

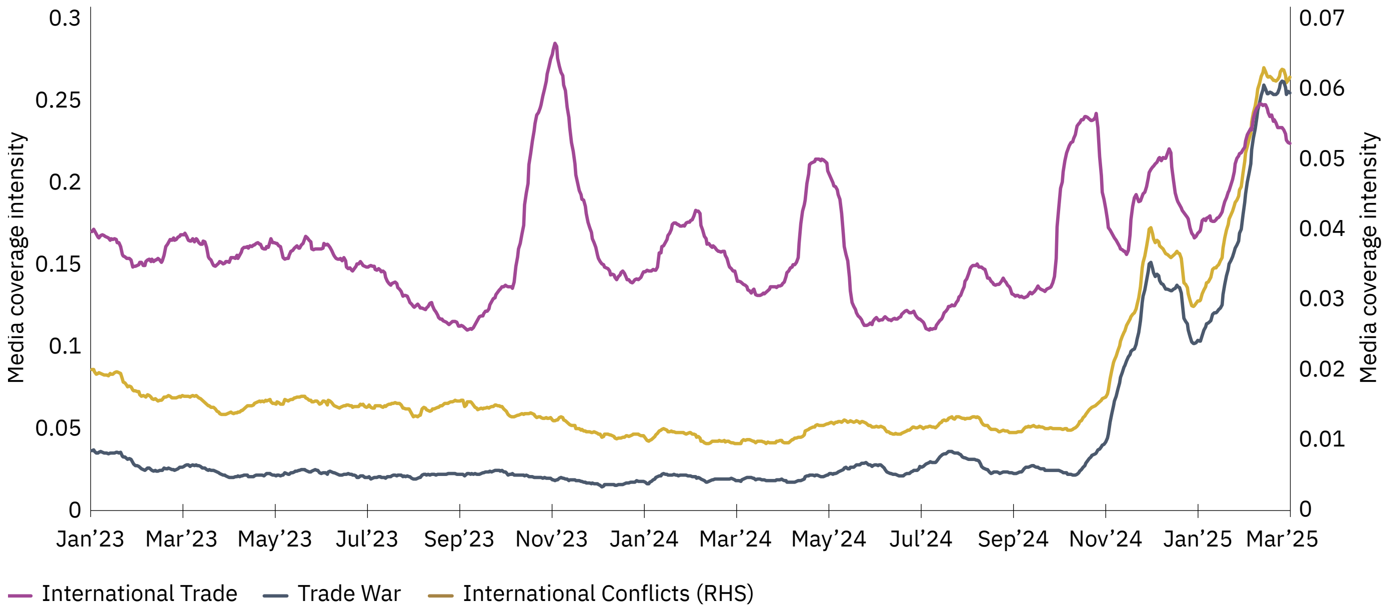
2 As of 31 December 2024

New governments, new policies

The year in which half the global population participated in national elections witnessed a swathe of new governments being elected.

Most notably, the re-election of President Trump to the White House brought new policy directions for international trade and geopolitics with potentially significant implications for financial markets. As can be seen in State Street's Thematic Indicator (Figure 1), which measures the intensity of media coverage on themes, international trade, trade wars, and international conflicts, are prominent narratives covered by the media that have risen in intensity over recent months.

Figure 1: Media coverage of themes



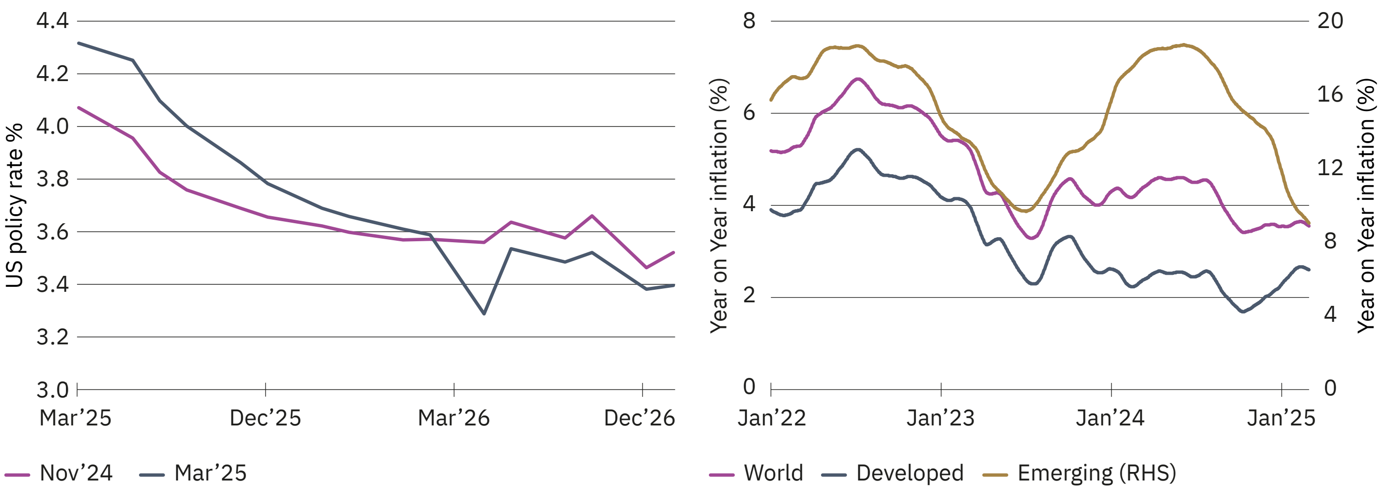
Source: State Street Global Markets, MKT MediaStats. As of March 2025.

Interest rate markets have reacted to the outcome of the US elections. Comparing the current US policy rate path implied by markets to those before the 2024 US election (Figure 2A), market expectations of interest rate cuts have reduced as investors adjust to the administration's trade tariffs, which could lead to price rises for consumers. While inflation in developed markets has been trending downwards over the past three years, it has recently started rising again. Meanwhile, emerging-market inflation continues to fall from its peak in mid-2024 (Figure 2B). The sovereign wealth funds surveyed for this report ranked changes to interest rates and inflation as the two most important factors in driving changes to their portfolios, just ahead of the risk of recession or a slowdown in economic growth and geopolitical risks (Figure 3).

Figure 2: Post-US election policy rate adjustment and online price inflation

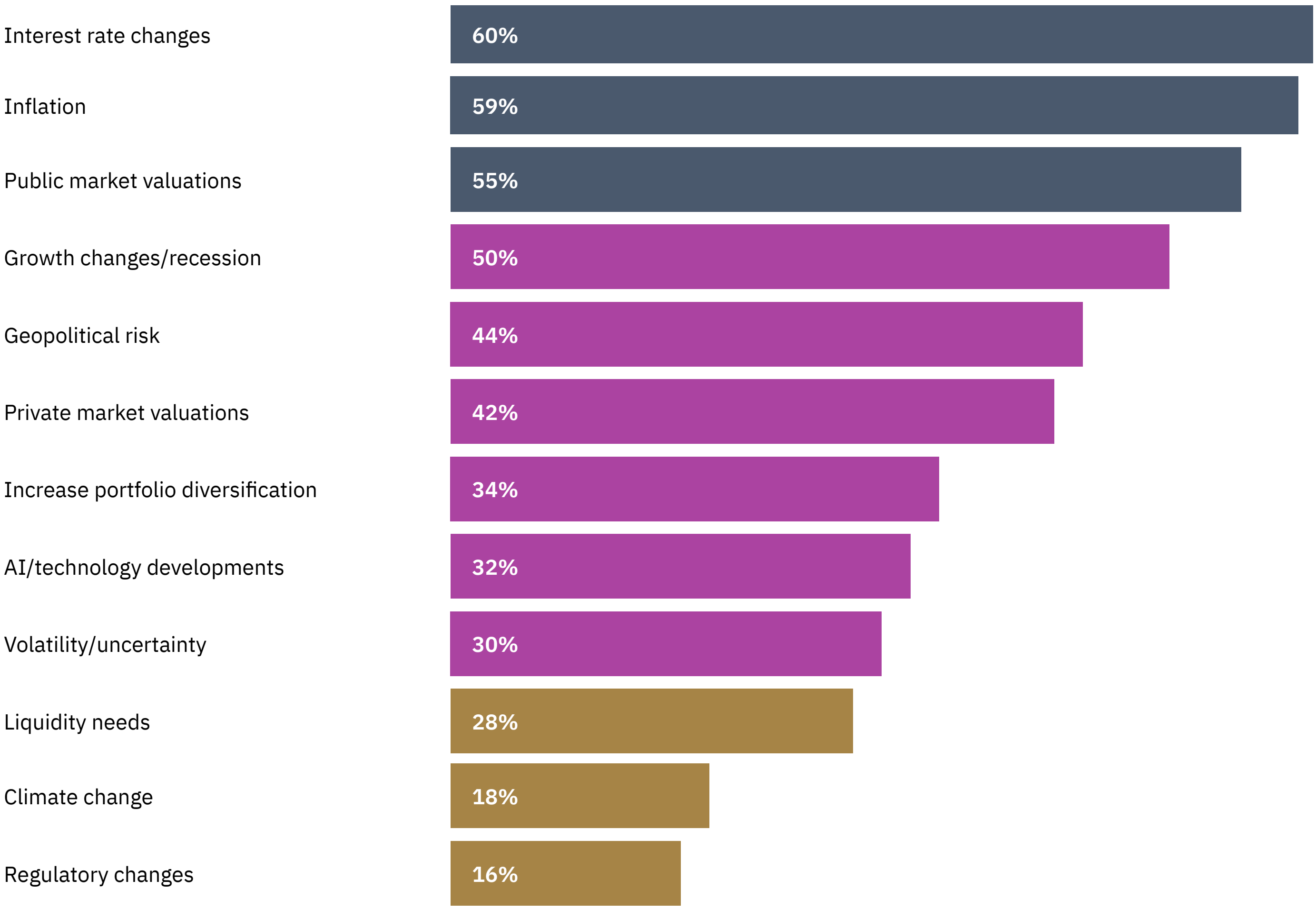
Figure 2A: Market implied US policy rate path

Figure 2B: Online price inflation



Source: State Street Global Markets, Bloomberg, PriceStats. As of March 2025.

Figure 3: Which of the following were key factors in driving portfolio adjustments over the past year? From most likely to least likely.



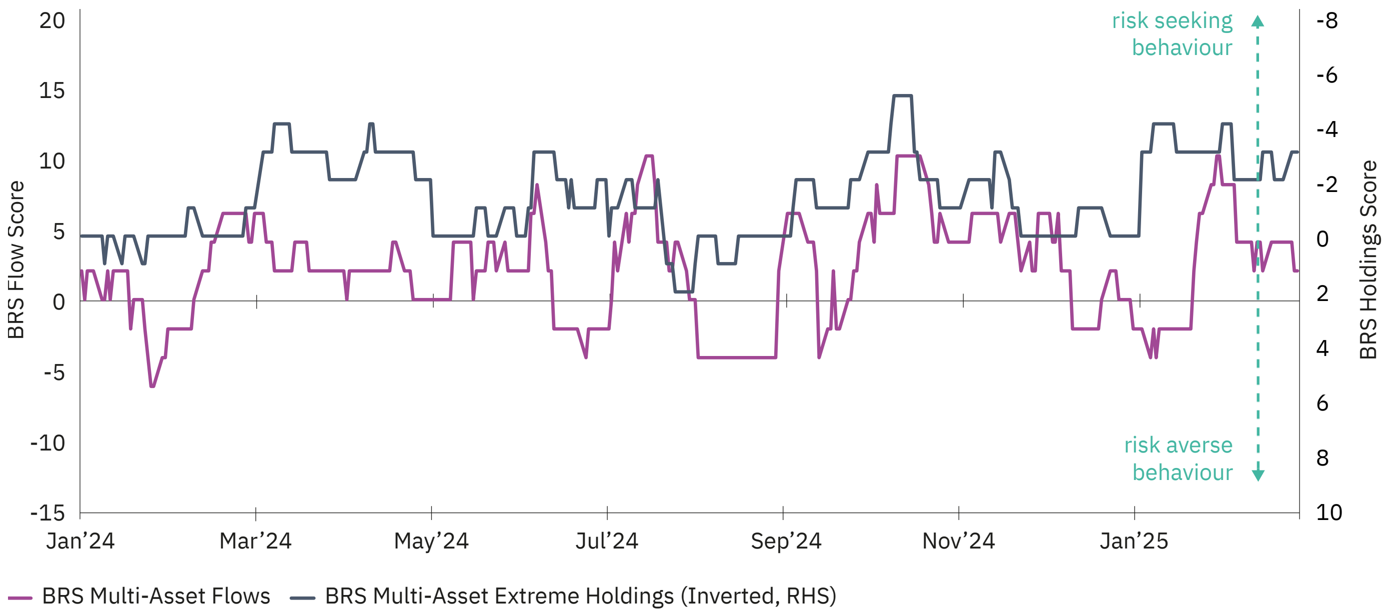
Source: IFSWF Survey March 2025.

Signs of caution

In line with a rapidly changing geopolitical backdrop, investors are showing signs of caution in their portfolios. Global protectionism, the impact of evolving trade tariffs, and ongoing developments with respect to Russia's invasion of Ukraine and conflict in the Middle East continue to create uncertainty for investors, and the implications of these risks carry significant potential ramifications for the macro outlook, global infrastructure disruption, volatility and decoupling of asset markets.

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 4) – flows across risk assets evidenced risk-seeking behaviour throughout 2024, but this has been pared back since the start of 2025. Investor holdings across risk assets continue to show capacity to increase their allocations to risk.

Figure 4: Investor flows and holdings across risk assets



Source: State Street Global Markets as of March 2025.

This stance may also reflect global institutional investors' asset allocation preferences. Allocations to equities rose significantly during 2024 at the expense of fixed-income assets (Figure 5A), with cash reserves in line with long-term average levels. Their equity allocations are now near their highest level for the past decade. These changes have coincided with moderate episodes of financial turbulence – reflecting the unusualness of market volatility and asset correlations – and low levels of market fragility as measured by State Street's Turbulence and Systemic Risk indicators (Figure 5B). 2025 will likely provide a test of portfolio resilience should policy and macroeconomic uncertainty continue to manifest. Equity-market volatility will likely continue to be elevated. However, the potential divergence in capital flows, performance and risk across asset markets and geographies may provide opportunities to identify tactical adjustments to investors' asset allocation decisions.

Sovereign wealth funds, however, have been less keen on public equities than their peers. Half of the sovereign wealth funds surveyed by IFSWF said they had left their allocation unchanged, and a third said they had decreased their allocation to public stock markets in 2024. Instead, they preferred to leverage their long-term investment horizons and lack of liabilities to take on risk in private markets and other alternatives, which are more illiquid and have less volatile valuations. Two-thirds reported that they had increased their allocation to private equity in 2024 and half an increase to other alternatives, such as real estate, infrastructure, hedge funds and commodities.

Figure 5: Investor asset allocation trends and market risk

Figure 5A: Asset allocation of institutional investors

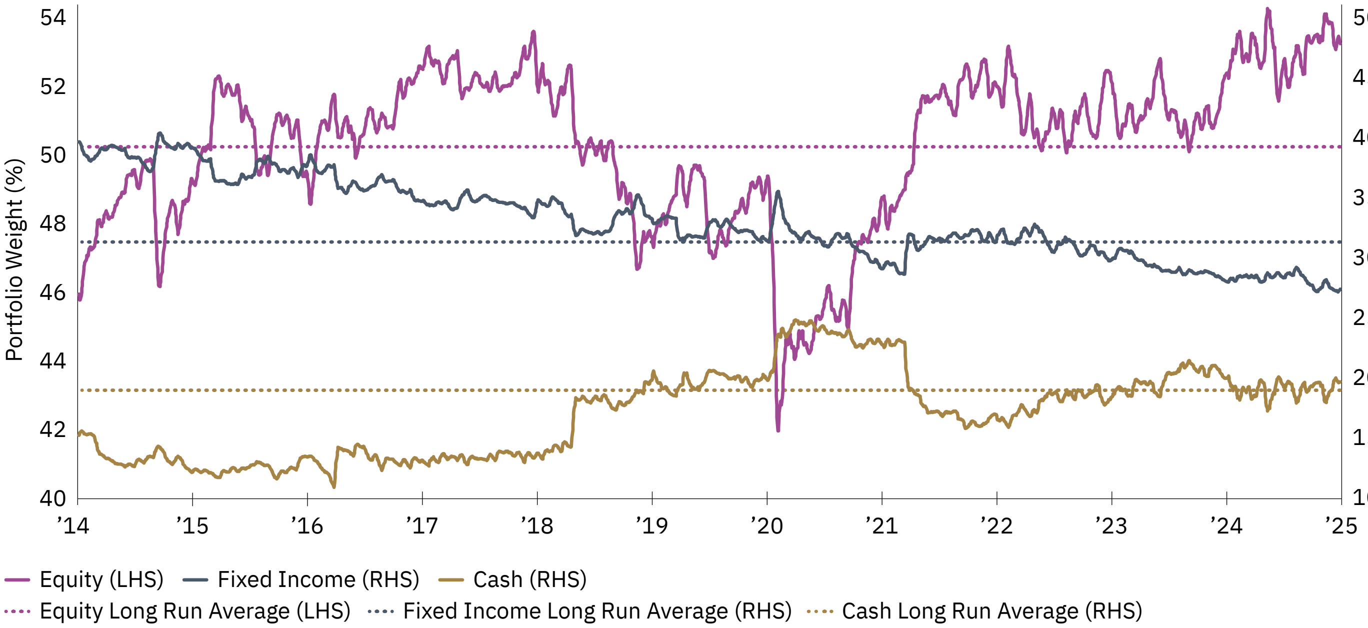
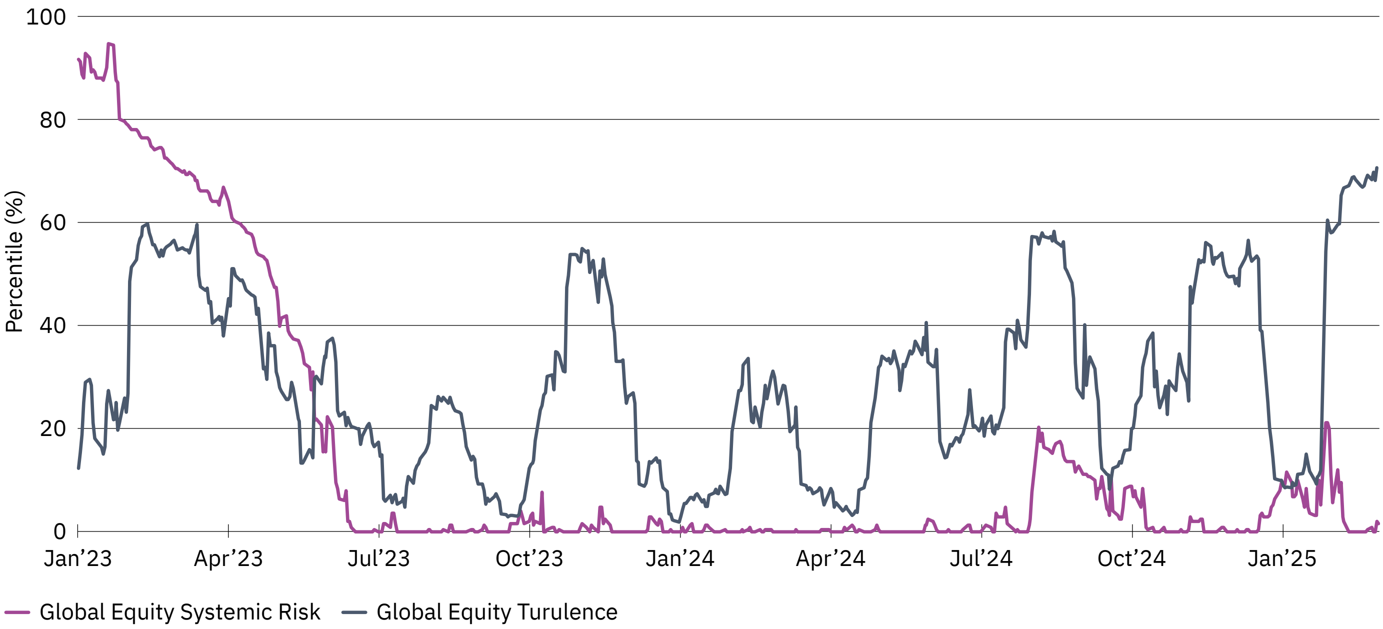


Figure 5B: Global Equity Systemic Risk and Turbulence



Source: State Street Global Markets. As of March 2025.
Five-year percentile rank of 30-day average turbulence and one-year percentile rank of systemic risk.

Within the equity market, State Street's indicators reveal that investors have expressed a preference for emerging markets and Europe over the US more recently, having reduced their US equity holdings (Figure 6A), a trend also reflected by the sovereign wealth funds surveyed by IFSWF. Although their geographical allocations were largely unchanged, there was a slight tendency to increase allocations to global emerging markets and to China (although not to Asia-Pacific ex-China). Institutional investors have also shown evidence of rotating out of their active positions in Information Technology to Consumer Discretionary, as seen recently (Figure 6B). The sovereign wealth funds surveyed by IFSWF confirmed this stance for 2025, seeing the best opportunities in non-US markets and their domestic markets.

Figure 6: Equity Allocations

Figure 6A: Out of US into the EU and Emerging Markets

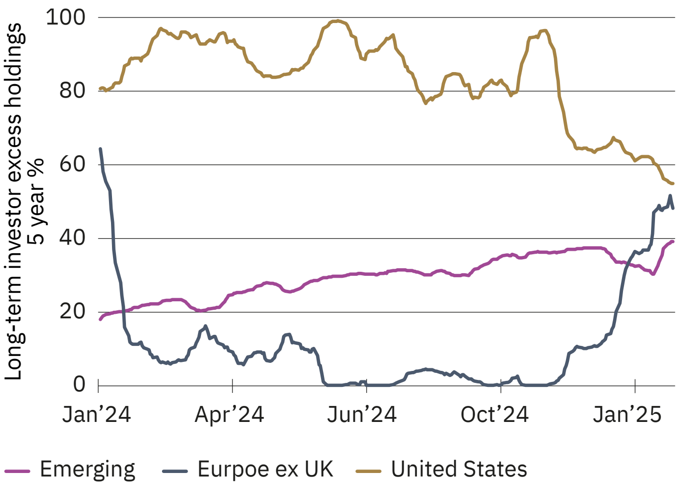
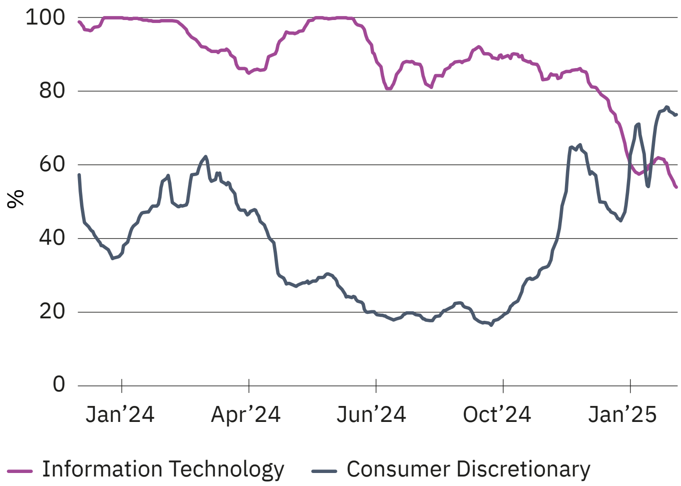


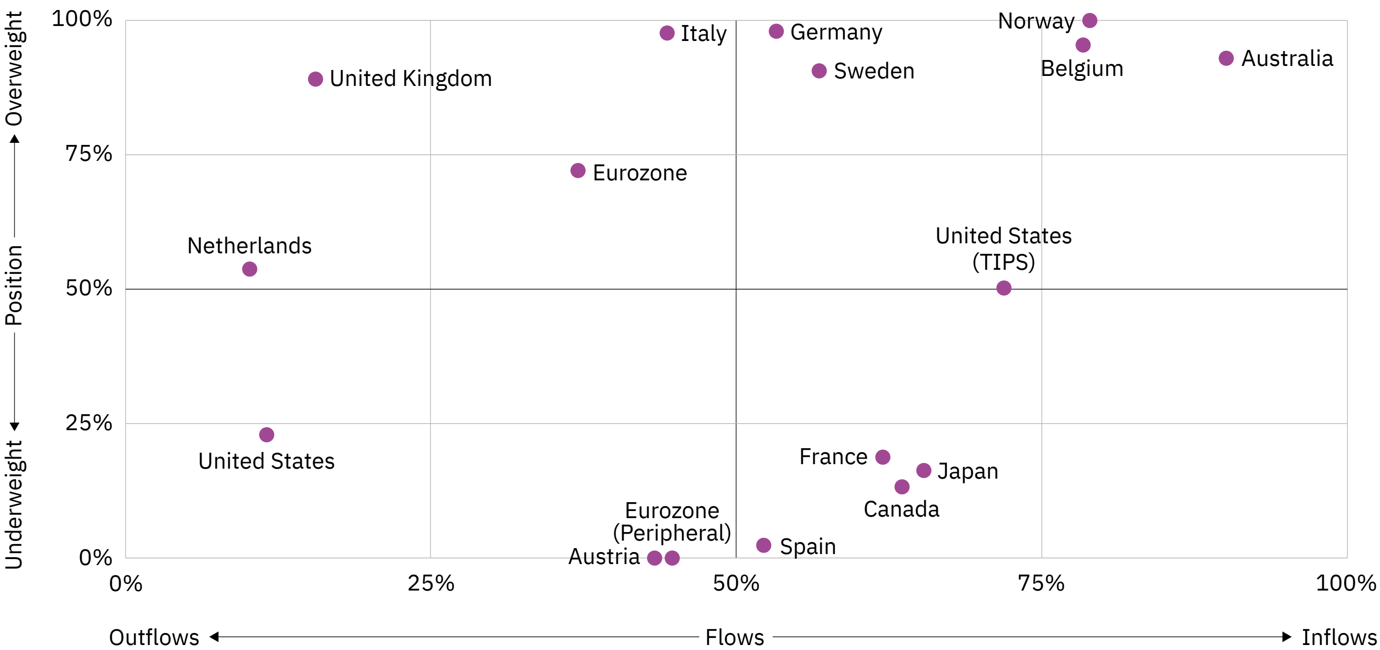
Figure 6B: Out of IT into Consumer Discretionary



Source: State Street Global Markets. As of March 2025.

In fixed-income markets, we observe recent evidence of the uncertain investment environment, with global investors demonstrating greater differentiation in their preferences across sovereign markets. For example, investors hold larger allocations to sovereign bonds in Italy, Germany and the UK, in addition to commodity-exposed economies such as Norway and Australia. In contrast, they hold much lower allocations than usual to sovereign bonds in Peripheral Europe, the US, and Canada. However, recent capital flow trends reveal that global institutional investors continue to prefer sovereign debt in the case of Australia and Norway. There is also evidence of selling their significant exposure to UK government debt (Figure 7).

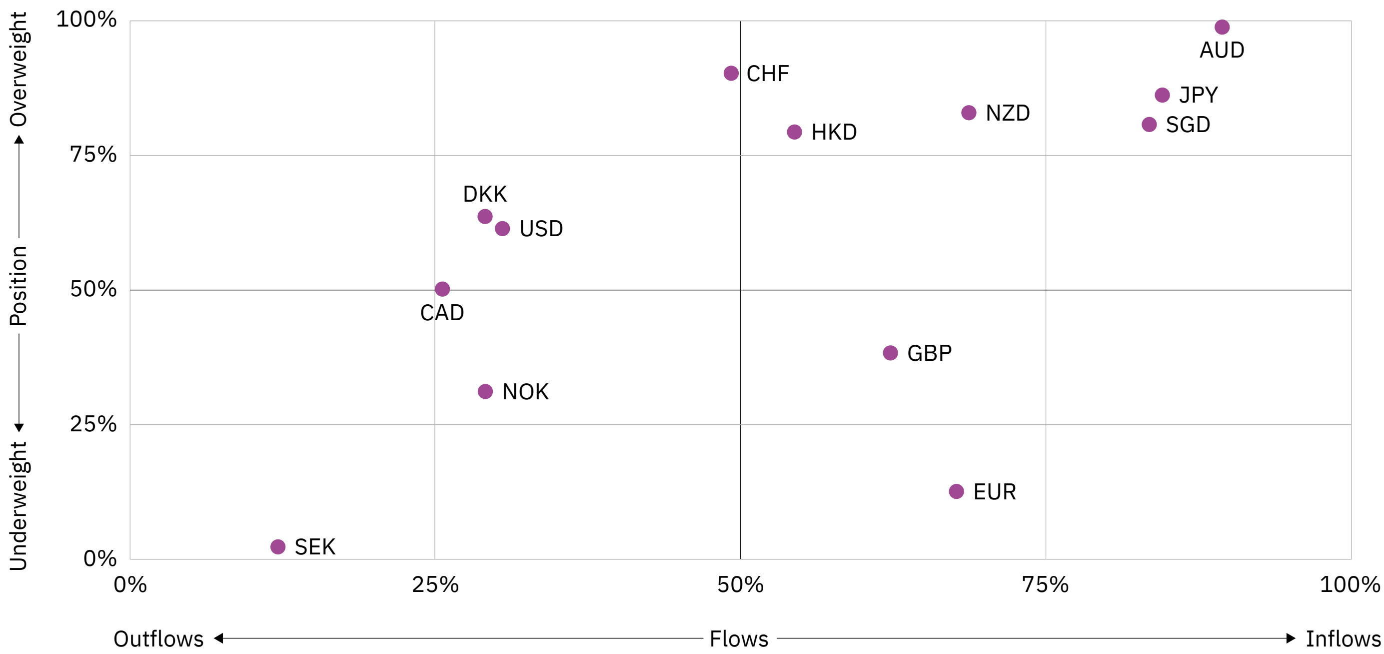
Figure 7: Fixed income allocations



Source: State Street Global Markets. As of March 2025. Five-year percentile rank of 20-day flows and excess holdings.

From a foreign exchange perspective, institutional investors have begun to unwind their overweight positions in USD and CHF while they continue to prefer commodity-exposed currencies AUD and NZD. Both currencies continue to experience inflows from already overweight positions. However, this preference is not evident in CAD, where ongoing trade tariffs are being imposed by the US. Global institutional investors have also recently shunned the EUR and SEK (Figure 8).

Figure 8: Foreign exchange positions and flows have become polarised



Source: State Street Global Markets. As of March 2025. Five-year percentile rank of 20-day flows and excess holdings.

Private market trends

Private markets performance has continued to improve in recent quarters. According to the State Street Private Equity Index, derived from underlying investor cash flows representing $5.4 trillion in committed capital to private markets,[3] the global private equity market recorded a robust 2.92% return in the latest available quarterly data of Q3 2024, marking its highest quarterly return since the Federal Reserve's interest rate hikes in Q1 2022 (Figure 9A).

Recent performance has also become more broad-based, with positive returns observed across all strategies and sectors, representing a significant improvement in venture capital performance, in particular, over recent years. Despite these improvements, private equity continues to underperform the public equity market, lagging large-cap stocks across multiple investment horizons (Figure 9B). While the recent performance in private equity and private debt appears more encouraging, we are yet to see a return to the performance observed before 2022.

Fundraising activity in private equity and private debt looks healthy, with total capital raised in the first three quarters of 2024 reaching $280 billion, with venture capital funds already exceeding 2023's fundraising levels and private debt funds already raising 95% of the funding raised in the previous year (Figure 9C). This trend aligns with the sovereign wealth funds surveyed by IFSWF, the majority of which revealed that they had increased their allocations to private equity in 2024. Cash flow trends derived from State Street's Private Equity Index also reveal that net cash flows turned positive at the highest level since 2018, with distributions exceeding contributions – particularly for private debt and, to a weaker degree, buyout funds. Venture capital funds continued to report negative net cash flows (Exhibit 9D).

Global dry powder increased over the recent quarter to a total of $971 billion, reflecting an all-time high across private equity in aggregate and for private debt.

3 Source: State Street Global Markets. As at Q3 2024.

Figure 9: Trends in Private Equity and Debt

Figure 9A: Historical Quarterly Returns (%)

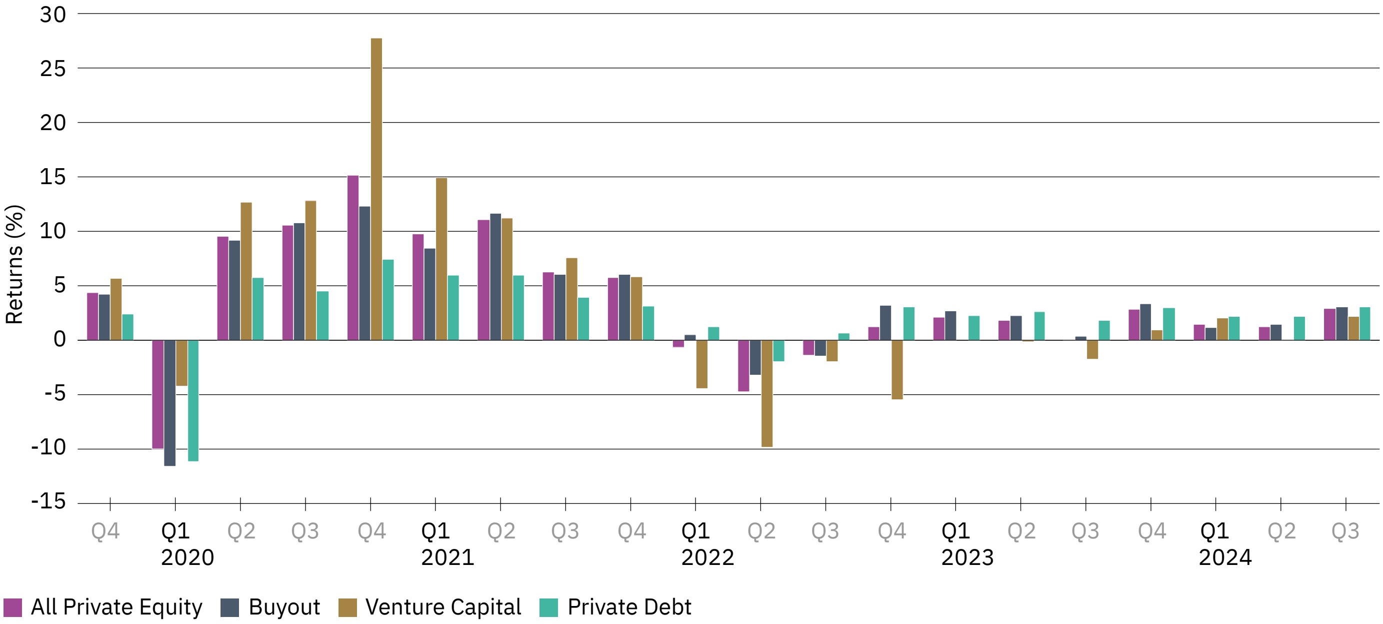
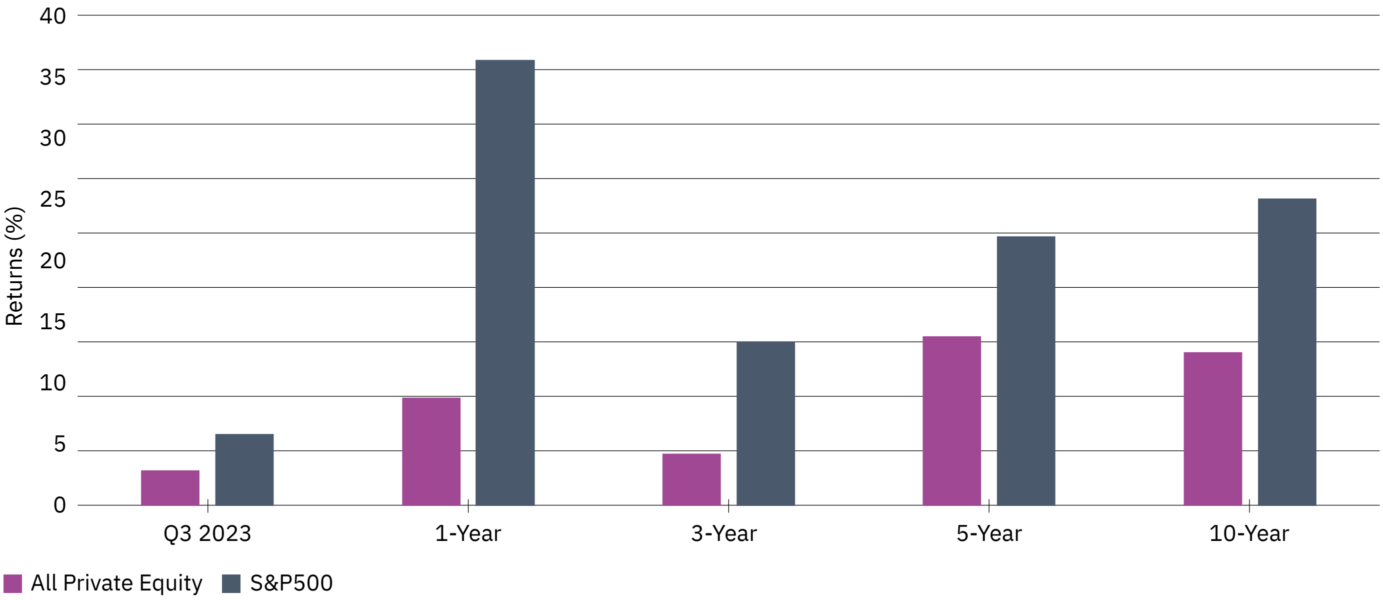


Figure 9B: Private Equity Performance vs S&P500



Source: State Street Global Markets. As at Q3 2024.

Figure 9: Trends in Private Equity and Debt

Figure. 9C: Total Fund Size by Strategy

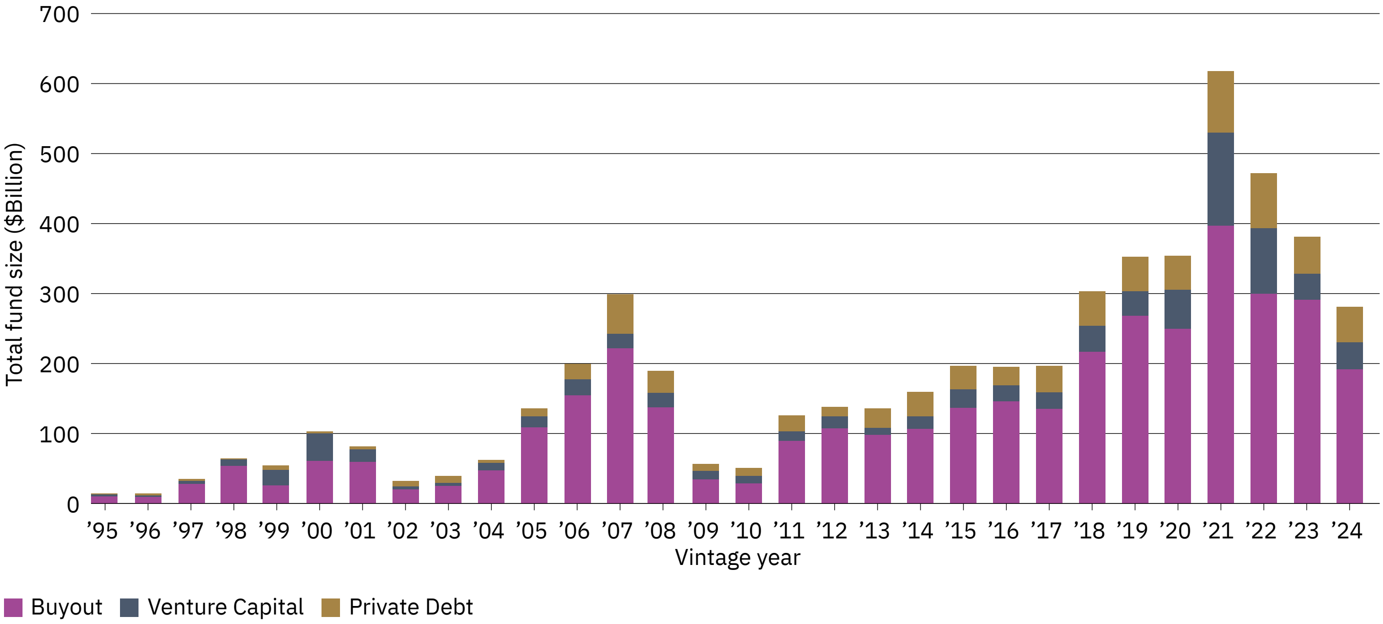
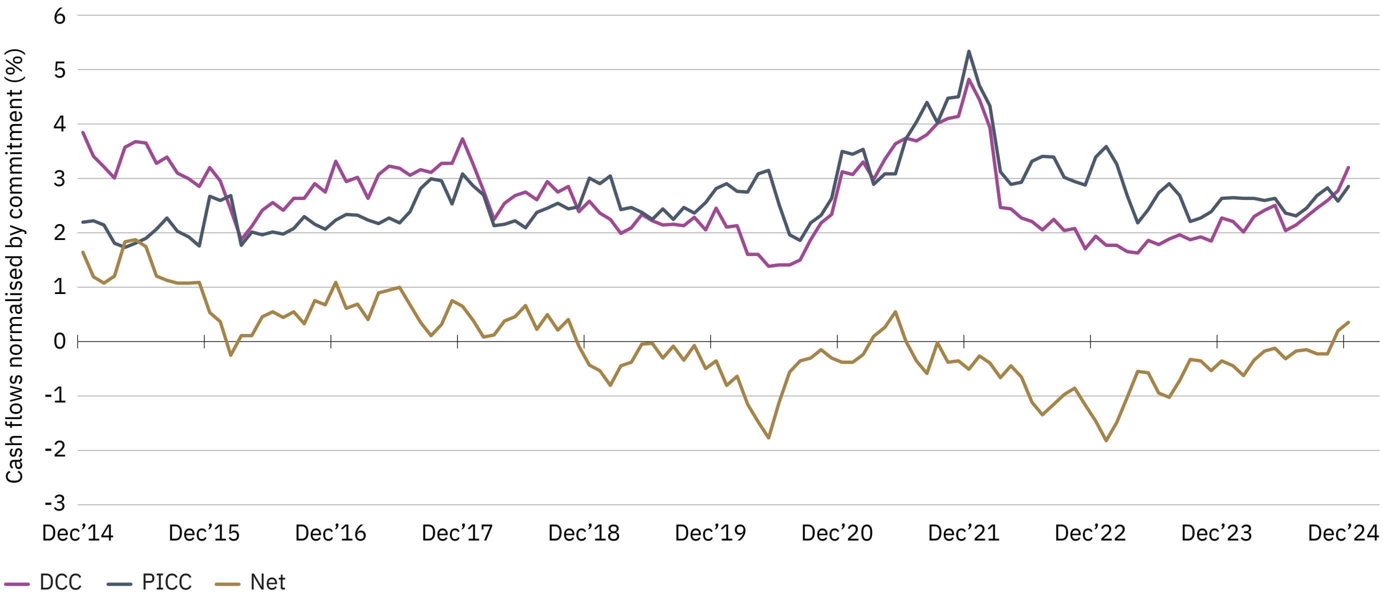


Figure 9D: Quarterly Cash Flows



Source: State Street Global Markets. As at Q3 2024.

Conclusion

Given the dynamic market backdrop of economic, international trade and geopolitical uncertainty, global institutional investors are showing some signs of caution. Capital flows across risk assets have shown evidence of risk-seeking behaviour throughout 2024, but this has been pared back since the start of 2025.

However, institutional investor holdings continue to show capacity to increase their allocations to risk, and, as such, equity allocations by institutional investors have remained near their decade-long peak. That said, we observe evidence that long-term investors are expressing some rotation in their portfolios within asset classes, including a preference for European and emerging markets equities over the US more recently, and closing some of the considerable positions in information technology into other sectors, such as consumer discretionary.

Institutional investors have also expressed selectivity in their fixed income allocation decisions, reflecting preferences for sovereign bonds in Italy, Germany and the UK, in addition to commodity-exposed economies such as Norway and Australia, with a weaker appetite to hold sovereign debt from the US, Canada and Peripheral Europe. In currency markets, we uncover evidence of global institutional investors unwinding overweight USD and CHF positions, with robust demand for AUD and NZD despite already holding large positions in these currencies.

In private markets, we have observed a continuation in the strong performance of private debt and improvements in private equity returns, which has also become much more broad-based by strategy and sector. Fundraising activity appears strong in aggregate, and cash flow trends convey a healthy pickup in both contributions and distribution activity, with more recent evidence of positive net cash flows at levels not observed since 2018.

Global trade protectionism, the impact of evolving trade tariffs, and ongoing developments of Russia’s invasion of Ukraine and the conflict in the Middle East continue to provide uncertainty to investors, and the implications of these risks carry significant potential ramifications for the macro outlook, global infrastructure disruption, volatility and decoupling of asset markets. Should policy and macroeconomic uncertainty, such as evolving trade tariffs, the erection of new trade barriers, and potential restrictions on capital inflows, continue to manifest, institutional investors should expect heightened volatility and potential divergence across asset markets ahead. This will provide a test of portfolio resilience and opportunities to identify tactical adjustments to their allocation decisions.

Contributors

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With thanks to Keng Goh, CFA and Neill Clark, CFA, MBA of State Street Associates for preparing the text and the charts and to Dr Victoria Barbary and Enrico Soddu from IFSWF for additional content and preparation.

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