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GLOBAL RISK ALERT

By Konfidants
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COVID-19 to Shave Off at Least $2 Trillion in Sovereign Wealth Funds

The coronavirus tsunami has created an unprecedented level of stress and losses on the $8 trillion combined assets of Sovereign Wealth Funds (SWFs) globally. Analysts at Konfidants have just concluded a COVID-19 global assessment of SWF portfolios that projects that **collectively, SWFs could lose around $2 trillion in a best-case scenario, and a worst-case scenario shortfall of a minimum $3.6 trillion.** Over 80 Sovereign Wealth Funds around the world were included in the global assessment.

Sovereign Wealth Funds are suffering what Konfidants has termed "a triple-drain" on their assets: As SWFs are (a) liquidating assets to shore up government budgets to fight COVID-19, the funds are also simultaneously (b) losing money on investments (as corporate profits and stock markets tank) and (c) losing much of the annual funding allocations they receive in normal times (as a result of collapse in prices of the commodities that feed many SWFs, and the fiscal crunch starving non-commodity SWFs). We estimate that it will take SWFs a minimum of 4 years to recover their pre-crisis asset valuations.

Different kinds of SWFs will be impacted differently. **Stabilization Funds** will suffer the biggest impact in absolute terms – some risk being depleted to the last dollar if the crisis drags over the course of multiple budget cycles. Even though **Savings/Future Generation Funds** are not allowed to be as depleted as Stabilization Funds, they could still end up losing more money than Stabilization Funds in relative terms – because they have bigger exposures than Stabilization Funds to the significant wealth evaporation going on on the world's stock markets.

Strategic Investment Funds will suffer the least impact – although for a while many will struggle to perform their core task of crowding-in private capital. In some cases, government fiscal and monetary response measures are directed at salvaging the industries in which Strategic Investment Funds have invested, and hence may even enjoy some degree of impact mitigation. While oil and commodity funds will suffer the deepest impacts, non-commodity SWFs will not be spared either as government revenues or fiscal surpluses go negative.

While SWFs with lots of muscle have been on a shopping spree – as many Gulf funds have been doing – these do not necessarily reflect lack of impact from the crisis. In our view, much of the ongoing shopping spree rather reflects the impact of the crisis on wealthy funds, and their desire to re-allocate resources and re-balance portfolios from a loss-diversification and resilience building standpoint. They are shopping for distressed cheap assets to compensate their losses.

We predict that the devastating effects of COVID-19 may well lead countries to dream up new types of Sovereign Wealth Funds as well as substantial modifications to the mandates, business models and architecture of existing funds.

1. Snapshot of recent developments

As we write, the world's biggest Sovereign Wealth Fund – Norway's SWF – has lost $113 billion in stock market losses in Q1 2020. Some projections indicate that the government will require around $57 billion (6% of total asset under management) from the fund to support expenditure this year – which puts total estimated reduction in assets for Norway's fund at $170 billion. This amount is set to increase should the pandemic drag longer than expected.

The Gulf region is projected to experience a decline in SWF assets of more than $300 billion this year. Some analysts project that oil-rich wealth funds risk losing $225 billion in stocks whereas both oil and non-oil based Sovereign Wealth Funds have already sustained about $1 trillion in equity losses – 12% of total global assets under management. Iran's Supreme Leader Ayatollah Ali Khamenei approved the withdrawal of €1 billion from the country's Sovereign Wealth Fund to help fight the pandemic.

The total value of The Alaska Permanent Fund dropped from $64.9 billion as of February 29 to $58.7 billion by March 16, 2020. Quatar's Sovereign Wealth Fund is reported to be considering the use of some of its most high-profile European equity investments to raise $7.6 billion loan to bolster its cash reserves.

The Parliament of Ghana has amended the withdrawal limit to allow a $219 million (48% of funds) withdrawal from the Ghana Stabilization Fund to fight COVID-19, while a proposed further withdrawal from the Ghana Heritage Fund is currently being debated. Nigeria has approved an amount of $150 million from its Stabilization Fund, reducing the total value of funds under management to $201 million. And the government of Trinidad and Tabago is seeking to amend the SWF legislation for emergency drawdown to fight the Coronavirus. This trend is bound to continue as the pandemic deepens the three main shocks at play – investment profit and stock market shock, commodity price shock and government budget drawdown.

2. How Various Types of SWFs will be impacted

2.1. Stabilization Funds

Our analysis shows that, in absolute terms, Stabilization Funds will suffer the biggest impact as they would be depleted to serve the key purpose of insulating economies from macroeconomic shocks and smoothen government's expenditure. This depletion will happen even as they also suffer collapse in new cash inflows as a result of commodity price slumps and government fiscal crunch.

Unlike Savings/Future Generation Funds which have high stock market and equity exposures, the impact of ongoing stock market declines on Stabilization Funds will be very low because they usually have short investment horizons and tend to hold the most liquid and lowest risk assets, by traditionally allocating over 80% of their assets to fixed income securities, with about 70% of total assets in government securities .

However, their mandate of ensuring fiscal stabilization makes them the first port of call in terms of government drawdown for budget support. Consequently, the non-exposure Stabilization Funds are currently enjoying from stock market declines has a net-neutral effect. We expect that some Stabilization Funds will likely be liquidated to the last dollar if the pandemic and its economic fallout lingers. This also means that Stabilization Funds will sustain the biggest impact even though (unlike Savings/ Future Generation Funds), they will not suffer the full effects of the "triple-drain" shocks on their assets (they lose money from reduced or frozen replenishments plus sustained budget support liquidations but little exposure to stock and equity losses).

How quickly are Stabilization Funds likely to be replenished?

On careful analysis, we have taken a pessimistic view of the speed at which depleted Stabilization Funds will be replenished.

Much of that will depend on the rate of recovery in commodity prices to pre-crisis levels, speed of recovery from the recession and speed of recovery of government finances (both deficit and debts) – all of which depend on recovery from the pandemic. All these variables look bleak.

Governments are likely to freeze cash injections into Stabilization Funds until much later – delaying replenishment. At best, any early replenishments are likely to be drawn down again to support subsequent budget cycles if the economic pain lingers for long. In one sense this is what Stabilization Funds are designed to do – except that many have never in their history been faced with the unprecedented scenario in which they find themselves.

2.2. Savings/Future Generation SWFs

Savings /Future Generation Funds will suffer the second biggest impact from coronavirus in absolute terms – even though they may lose more money than Stabilization Funds in relative terms. This is because while they are not allowed to be substantially depleted for purely fiscal support (unlike Stabilization Funds), Savings/Future Generation Funds are the only kind of SWFs that will likely suffer the full effects of the “triple-drain” shock on their assets: they will lose money from plunging stocks and equity investments, they will lose new cash injections as government revenues plunge and many will suffer government drawdowns for budget support.

The only reason they are in the second-tier impact category (despite being the only funds to suffer the full “triple-drain”) is because Savings/Future Generation Funds are never allowed to be anywhere as depleted as Stabilization Funds – not even in the worst of crisis. They have serious restrictions and extremely high floor on liquidations while Stabilization Funds have ultra-low floor.

In principle, majority of Savings/Future Generation Funds are supposed to be strictly for wealth preservation for future generations and not permitted to be liquidated for budget support. In reality, though, many of these funds have a partial 'emergency mandate' to shore up government budget in crisis times. Governments with both Savings and Stabilization Funds may be tempted to share the fiscal burden by liquidating from both funds right from the outset, as has been proposed in the case of Ghana, or touch the Savings Funds much later when Stabilization Funds are depleted.

Our analysis shows that Savings/Future Generation Funds will suffer their biggest blow from the stock market plunges and declines in corporate profits. This is because they traditionally have substantial stock market and equity exposure per their long-term investment strategies. As already stated above, Q1 2020 equity losses alone suffered by the world's SWFs are thus far around $1 trillion dollars; losses that are not expected to be fully recovered for several years.

2.3. Strategic Investment Funds (SIFs)

SIFs are the least to be affected by the three risk variables – given that their investment direction is towards priority socio-economic projects such as infrastructure, industrial transformation projects, or support for SME's. The level of impact to such investment vehicles depends on the extent to which the priority sectors invested in have been greatly affected by the pandemic. Example, investments in the Airline, Hospitality and Tourism industries would greatly impact SIFs.

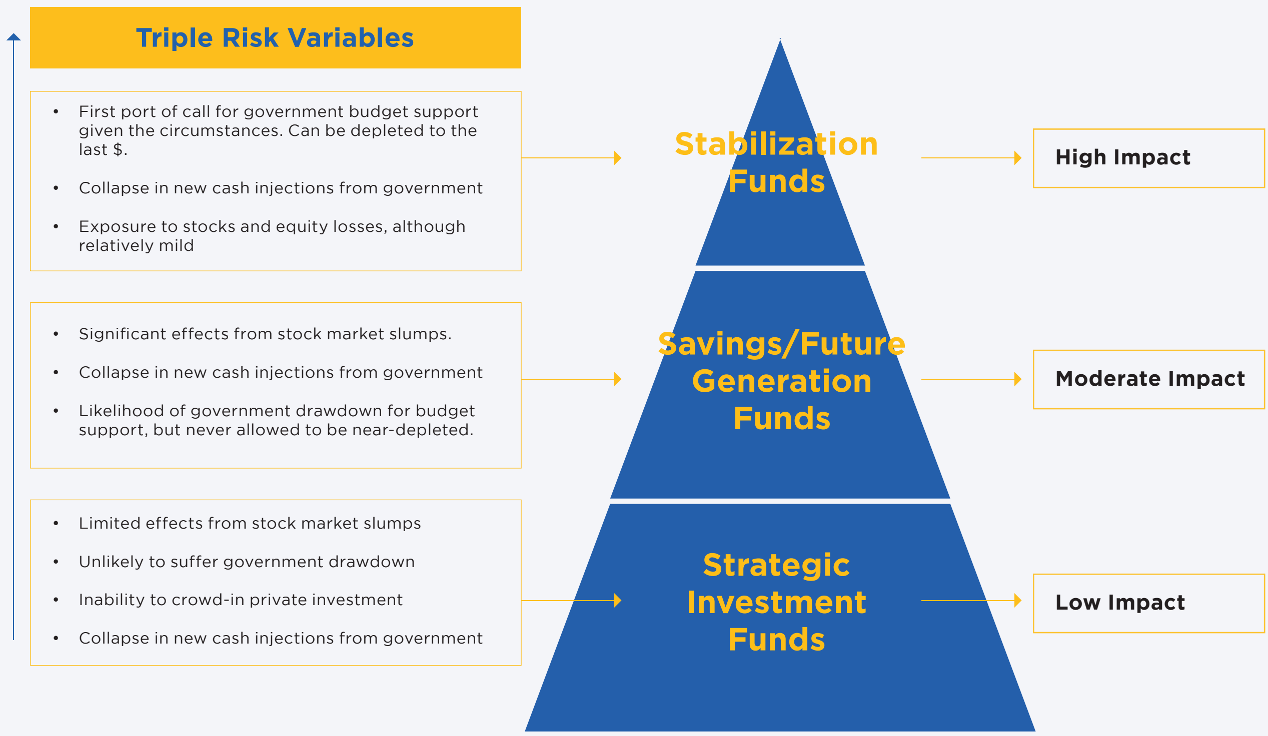
In some cases, government fiscal and monetary response measures are directed at salvaging the industries in which SIFs have invested, and hence they may even enjoy some degree of impact mitigation. Nevertheless, the worldwide economic turbulence would undermine the ability of these funds to crowd-in private capital – which is core to their mandate. Although unlikely, it will not be surprising, given the severity of the pandemic, to see governments channel existing resources from SIFs to support government expenditure in the form of COVID-19 impact mitigation investments – such as health infrastructure expansion that may not necessarily be based on SIFs 'strategic investment' viability considerations.

2.4. Short-Term versus Long Term Impacts

Our analysis also brought up some short-term versus long term impact variations. In the short term – as the pandemic took off – we've already noticed that Savings/Future Generation Funds suffered a greater impact than Stabilization Funds due to immediate effect of stock market declines – immediate impacts that Stabilization Funds have little exposure to. The reported $1 trillion Q1 equity losses are thus predominantly losses of Savings/ Future Generations Funds.

In the long term however, Stabilization Funds would suffer the biggest impact as they would be depleted to shore up multiple budget cycles even as Savings/Future Generation Funds slowly regain some of their earlier losses – thanks to stock market recoveries.

Three levels of COVID-19 impact: A triple drain on SWFs Assets



Source: Konfidants 2020, SWFs Global Risk Alert

3. How Much Money Are SWFs Likely Lose?

These are early days as most countries are still battling the pandemic, but several Sovereign Wealth Funds are already making huge losses. Below we shed some light on our best case and worse case scenarios.

Best case scenario

Based on current optimistic projections of the pandemic, we expect majority of countries to flatten their curves by end of year, helping to ease the pressure on Sovereign Wealth Funds as stock and commodity markets will begin to recover steadily, and government drawdowns will reduce as economies rebound from lockdowns. Although governments would require some funds to rehabilitate their economies from aftershocks, the depth of damage would not have been as grave, given the projected duration of the pandemic. Our best-case scenario expects an end to the pandemic by end of 2020 and a rapid V-shaped economic recovery by end of 2021.

Our analysis projects that aside the $1 trillion in stock losses already suffered by SWFs, global assets under management are set to dwindle by at least another $1 trillion dollars (combining estimates of potential budget liquidations with estimates of diminished or frozen replenishments). We estimate that stock market recovery may take up to about four years to reach their pre-crisis levels– even if a V-shaped rebound from the recession happens by 2021. This is guided by historical evidence that it takes an average of 3.1 years for the U.S. broad market to regain its pre-bear market level on a dividend and inflation adjusted basis. Additionally, the ‘Great Recession’, even though less severe than the ‘Great Lockdown’ plunged the S&P 500 to levels that took 4 years to recover to its pre-crisis mark . Factoring in all the above, our overall best-case projection is that COVID-19 and its economic impact could shave off approximately $2.1 trillion in global SWFs assets by the end of 2021.

Worst case scenario

Going by expert projections of up to a 2 year timeline for a vaccine discovery, this pandemic – and its likely new infection waves – is expected to wreak sustained havoc on economies such that a complete economic rebound would take nothing less than 4 years to achieve. Economies will only begin to recover completely when a vaccine is discovered and made widely available across the globe. We estimate the total global SWF asset under management to decline by a minimum $3.6 trillion in a worst-case scenario.

We find our worst-case analysis restrained by what we call 'intrinsic-limits' to how much liquidations SWFs can suffer. At some point, we predict – as well as advise – that governments will stop depleting SWFs and start pursuing other sources of unorthodox and creative financing. Our advice is that governments that run out of options and cannot obtain help from international concessional sources should rather use Sovereign Wealth Fund assets to collateralise and guarantee highly selective financing and refinancing deals to raise money. Legislative amendments would be required for such manoeuvres.

About Konfidants

Konfidants is an international advisory firm of consultants, scholars, and advisors that specializes in supporting companies, governments, and international organisations to achieve impact. Konfidants publishes the African Sovereign Wealth Funds Index.

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