White Paper

“Uneasy lies the head that wears a crown”
Sovereign and Central Bank investment themes, 2019

September 2019
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In brief

◆ This paper draws on results from the Reserve Management Trends Survey, 2019 and survey data made available by the Sovereign Investor Institute (SII)
◆ Results have shown that geopolitics are having a major impact on reserve management, namely the US/China trade wars, Brexit and sanctions)
◆ The USD has remained the unchallenged safe haven currency but there is also a renewed interest in gold, as a result of global and geopolitical instability
◆ The integration of ESG into central bank portfolios has been gathering momentum over the past year
◆ There is increasing diversification into 'non-traditional' currencies and asset classes
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“Uneasy lies the head that wears a crown”¹

Who are these investors?

Central banks and sovereign funds have different roles in the management of the national balance sheet. Almost all countries have a central bank, but not all have, or need, a SWF. In some countries with no separately-established SWF, the central bank may perform both sets of functions.

Central banks hold foreign currency assets – “reserves” – as insurance against macroeconomic and financial tail-risks, or so-called “sudden stops”. These include exchange rate and balance of payments crises, runs on the domestic banking system, and so on. This means they hold large proportions of their portfolios in liquid, high-quality fixed income assets denominated in the major currencies – because those are assets whose value is most certain and readily-realizable when needed.

Many central banks hold more reserves than they are likely to need to liquidate quickly in a crisis. For them, their own need for income, or pressure to demonstrate competence in their management of public money, means they may tranche their portfolios. More than often, the portfolio is separated into liquidity and investment tranches. The investment tranche sacrifices liquidity, and to some extent security, to earn a higher return than the liquidity tranche. Even so, and with the exception of central banks that are also de facto SWFs, their portfolios tend to be relatively conservative with a low tolerance for realizing losses from default events in particular.

There is a vast range of literature on sovereign funds. Perhaps the best introduction remains the International Monetary Fund’s 2008 paper², which among other things introduced a taxonomy of funds which most of the subsequent work has followed. SWFs are a heterogenous group that may serve a variety of purposes, and the IMF distinguishes them according to their main objective:

i. stabilization funds, where the objective is to insulate the national budget and economy against swings in the price of commodity exports – e.g. Chile’s Fondo de Estabilizacion Economica y Social;

ii. savings funds for future generations, which aim to convert non-renewable physical assets (typically commodities) into a more diversified portfolio of financial and real assets, and so mitigate the risk of Dutch disease – e.g. Norges Bank Investment Management;

iii. reserve investment corporations, whose assets are often still counted as reserve assets, and are established to increase the return on excess reserves over and above those managed by the central bank – e.g. the Government Investment Corporation of Singapore;

iv. development funds, which typically help fund socio-economic projects or promote industrial policies that aim to raise a country’s potential output growth, or to diversify beyond the natural resource industries – e.g. Mubadala in the United Arab Emirates; and

v. contingent pension reserve funds, which provide (from sources other than individual pension contributions) for contingent pension liabilities on the government balance sheet – e.g. France’s Fonds de Reserve pour les Retraites.

A stabilization fund will typically invest in a less risky and more liquid portfolio than a savings fund or reserves investment corporation, but sovereign funds in general are set up to take a longer investment view than central banks, and to seek to earn risk premia on a broader range of asset classes. Central bank reserves have traditionally consisted of sovereign and agency bonds issued by the major developed economies, although as we shall see, for many of them this is now changing - at least at the margin. Sovereign funds are more invested in equity (publicly-listed, private equity and real estate) and tend rather to be ‘universal investors’ – i.e. they seek to invest in a cross-section of the economy.

² International Monetary Fund, Sovereign Wealth Funds – a work agenda, February 2008.

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Chart 1: Official Sector Institutions AUM Development

Central Banks’ Official Reserve Asset development since 2000 (USDtrn)

AUM (USDbn) development for the world’s largest SWFs since 2000

Chart 1 shows the development in total assets managed by central bank reserves managers and the largest sovereign funds over the past two decades. The profiles are similar: strong growth from the turn of the millennium followed by relative stability over the past five years.

The aggregate developments comprise a lot of different individual experiences in both the size and growth rate of assets under management. For example, of the $7.5 trillion managed by the largest sovereign funds, the Government Pension Investment Fund of Japan alone accounts for around $1.5 trillion. A small number of other large funds in Asia and the Middle East each manage many hundreds of billions of dollars. China and Japan are the largest reserves holders, with around $3.2 trillion and $1.2 trillion respectively, but many central banks hold less than $10 billion.

A number of overlapping broad themes underlie the recent history of aggregate asset growth. These include the accumulation of current account surpluses by many rapidly-growing EMEs that have integrated more fully into the global trading system over the past three decades. Also, strong global growth resulting in high oil and gas (and other industrial) commodity prices led to a growth in assets by commodity-exporting countries. In some cases, active management of the exchange rate resulted in reserves growing as domestic currency was sold for foreign currencies. In other cases, reserves increased as a result of policy choices to hold larger precautionary buffers against potential shocks. This was clearly the case for many Asian countries in the aftermath of the 1997-98 Crisis, and also for the United Kingdom after the Global Financial Crisis of 2008.


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The Reserve Management Trends Survey, 2019

Each year, in association with Central Banking Publications, HSBC produces the Reserves Management Trends Survey (RMT). The RMT is acknowledged as the industry standard among practitioners and the stakeholder community. For the past few years, we have summarized its results for a wider audience and supplemented the data with comments based on conversations with monetary and financial policymakers, as well as reserves managers, from the central bank community. This year, we also discuss Sovereign Wealth Funds (SWFs) and Sovereign and state/province pension funds, based on conversations with them and survey data made available by the Sovereign Investor Institute (SII).

What is on the minds of sovereign and central bank investors?

Sovereign investors manage assets for public policy purposes, where the corresponding public liabilities may be known (e.g. the impact of population ageing) or more likely, contingent on some shock arising in the external sector (in trade or capital flows) which puts pressure on the national balance sheet. As they provide insurance against national calamities, it makes sense to hold assets whose returns are not dependent on the fate of the domestic economy. That explains why most, and in many cases all, of their assets are issued by non-domestic entities and denominated in foreign currencies. Given that, from the perspectives of both sides of the balance sheet, these investors have an international outlook on investment; and they need to navigate the major global macro themes in politics, economics and markets.

Chart 2 summarizes reserves managers’ responses to the question, ‘What is the most significant risk you face?’ over the past four years. Chart 2, courtesy of the SII’s polling of delegate at its two major conferences in London and in Singapore, shows responses from sovereign wealth and pension funds and central banks to the question, ‘What is your most urgent investment challenge?’ Taken together, they are an interesting diagnostic of the perception of risks from the macro environment and how they translate into investment challenges.

Source:
2. 70 respondents replied to this question.
Risks from the macro environment

The survey responses and almost all conversations with central banks and sovereign investors over the past few years have taken the form of an extended tour d’horizon of the closely-linked issues of:

- Extreme monetary policy - quantitative easing and very low central bank policy rates
- The role of extreme monetary policy in supporting high financial and real asset valuations across the board; and
- The risk that the exit from ultra-loose monetary policy, especially if not synchronized across the major economic areas, might result in: significant moves in exchange rates; disruption in capital flows (particularly in net flows to emerging market economies); and steep falls in asset prices.

In the event, of the major economic areas only the US has been able to make significant headway in the withdrawal from the effective lower bound to policy interest rates and in unwinding QE. There were episodes of volatility as the market sought to understand and price the Fed’s reaction function in the context of the fluctuating outlook for growth and inflation. But, on balance, I think it’s fair to say – even in the case of most emerging market countries – that things turned out about as well as expected, and certainly better than feared. Partly that’s because the Fed’s communication of its policy path, over a long period from mid-2013, helped prepare investors and global markets for the tightening cycle. And partly because the effects of monetary tightening on US demand were cushioned to a considerable extent by the Administration’s Tax Cuts and Jobs Act.

Subsequently, the US tightening cycle has clearly been attenuated, the FOMC has made a cut in rates and the market expects them to ease further. In other major economies tightening has been taken off the agenda for the foreseeable future before getting started.

The immediate reasons for the turnaround in the outlook for monetary policy are well-captured by this year’s RMT:

- Concerns about the continued strength of the US expansion and possible negative spill-overs to the rest of the world and to asset valuations, particularly as the impetus from fiscal stimulus wanes; and, relatedly,
- A portmanteau of geopolitical risks including the impact of trade disputes between the US and China, the unresolved issue of Brexit in Europe, and – a growing concern in the period since the RMT was compiled – uncertainty about the future of the Joint Comprehensive Plan of Action relating to Iran’s nuclear program.

Now, of course, there are always geopolitical risks. And often the response of sovereign investors with patient capital is to take a long-term view of short-term threats and disruptions: history shows that humanity is resilient and adaptable, and that (most of the time) the global system tends to survive individual episodes of economic and political breakdown. On that view, over-reactions by financial markets represent mis-pricing opportunities to be taken advantage of by those able to afford to take a sufficiently detached perspective on events.

That may well prove to be the correct attitude to this latest peak in geopolitical uncertainty. But many sovereign investors are uneasy about the nature of the current uncertainties, believing they may be particularly exposed this time. On that view, risks from trade disputes and rising nationalism are underpinned by ambivalence on the part of an apparently growing number of major economy governments about significant features of the international economic and financial architecture.

The history of the past three decades has been one of a near-continuous process of liberalization, widening and deepening in trade and capital flows as:

- The Uruguay Trade Round was completed
- The Soviet Union broke up
- China, India and other major EMEs integrated more fully in the global economy
- The European Single Market expanded and deepened

For sovereign investors, the risk now is that some or all of that process of liberalization stalls, or even goes into reverse.

They obviously have a keen interest in the continuation of trade and capital openness, underpinned by a shared global commitment to multilateral rules-based regimes. That’s because many sovereign investors derive their inflows from commodities and export-led growth, and almost all of them invest these surpluses in global capital markets. But now the underlying geopolitical risk sovereign investors face is that the global system they rely on is not guaranteed to survive in the form they have known it in living memory: therefore, uneasy lies the head that wears a crown.

The stalling in the monetary tightening cycle and, to some extent at least, a root cause of many of the geopolitical risks, are aspects of the theme that has dominated discussions with sovereign investors for several years: relatively weak growth, low inflation, low interest rates and low expected investment returns.
For much of the last decade that was put down to a protracted, and not completely unexpected, sluggish recovery from the Global Financial Crisis (GFC). The mood improved during the apparently synchronized global cyclical upswing in 2017. But with the fading of that and, more recently, concerns about the health of the US recovery, the one remaining strong engine of growth, conversations with sovereign investors are turning once again to secular stagnation. By secular stagnation, they mean that much of the developed world is stuck in a state of chronic lack of demand; even economies that are experiencing at least some positive GDP growth and relatively strong increases in, and high levels of, employment. As one senior G7 central bank policymaker described it to me earlier this year: “in 2017 the glass looked half full, now it looks half-empty.”

There is a lively academic and policy debate about secular stagnation, and this isn’t the place to attempt even a summary. Conversations with investors focus on the role of deleveraging after the GFC, and of ageing populations in many large economies, as potential explanations of the excess of savings over business investment which is the distinguishing feature of secular stagnation. Others emphasise rising income inequality as a factor in weak aggregate demand (rich people have a lower marginal propensity to consume). Another factor often mentioned is the role of the widespread slowdown in productivity growth, which may result from ageing workforces – and may also be a cause of consequence of weak business investment. Secular stagnation is also characterized by a surplus of savings over investment opportunities. A consequence of that is frequently thought to be rising prices in financial assets and real estate. The potential over-inflation of asset prices is directly of interest to sovereign investors, as we shall see below.

It contributes to the sense of unease many of them feel, even as asset prices continue to rise in economies experiencing high levels of employment and reasonable GDP growth. Geopolitical risks, softening or flat-lining growth, and a persistent sense that all is not quite right with the global economy help to explain the widespread expectation that central banks will need to ease monetary policy further. But, among sovereign investors, and among many central bank policymakers, it’s fair to say that a consensus is developing that the limits of effectiveness of monetary policy are close to having been reached. That’s as true of conventional unconventional monetary policy (QE, negative policy rates, etc.) as it is of conventional policy.

On that view, there should be a lot more emphasis on fiscal policy to increase demand. Particularly as many developed economy governments can borrow at negative real interest rates, and there is widespread agreement that there is no shortage of projects with high social returns in which to invest - including the need to finance the transition to a lower carbon economy. Another major strand of this debate is the policy prescription of supply side reforms to address some of the root causes of secular stagnation: for example, Larry Summers suggests “fighting monopolies, promoting a more equal income distribution, and strengthening retirement security”.

Be that as it may, what many investors see on the global agenda currently is not sensible domestic and international economic and financial policy coordination. Rather, it is the prospect of continuing geopolitical risks to the international trading system, with too much of the onus for cushioning the impact again being placed on central banks via lower rates for even longer and a possible resumption of QE programs.

To the extent there is an alternative to this underwhelming prospect, they worry that it might be some variant of Modern Monetary Theory (MMT). MMT has been a feature of the very early stages of the US 2020 election campaign. This is not the time or the place for a summary of the debate on MMT. Suffice it to say that it involves a distinguished cast list of academics and policymakers, and that MMT’s potential policy effectiveness and risks in the current US context have been controversial. And that all sides of the argument would agree that MMT challenges conventional beliefs about the role of government in the economy, the nature of money, the use of taxes and the significance of fiscal deficits.

For sovereign investors in US assets, the focus of immediate concern is on that building block of MMT which states that the government of a country with its own currency should never face the need to default on sovereign debt denominated in its own currency, whatever the stock of outstanding debt or size of its budget deficit. That’s because the government can always instruct the central bank to create enough new money to service and repay the outstanding debt. As a general proposition, it’s hard to disagree with that. The concern investors have is what the effects of MMT might be on the value of money: relative to goods and services (via the risk of an increase in inflation), and relative to other countries’ money (via the risk of a depreciation of the exchange rate).

So, those sovereign investors who have thought about MMT are watching with a degree of unease the possibility, however small, of a major monetary experiment with the US dollar – which, as we shall see, remains pre-eminent as the global reserve currency and which is dominant in most of their portfolios.
Investment challenges

Chart 3 focuses these issues and themes through the lens of investment challenges facing sovereign investors. The responses here are from delegates at the SII’s Global West (London) and Global East (Singapore) conferences for the past few years. The delegates comprise for the most part senior investment staff from SWFs, sovereign and public pension funds and central banks from all parts of the world.

To start with straightforward macroeconomic concerns, the chart shows that worries about deflation have receded since 2015 and that there is, and has been, remarkably little concern about inflation despite the maturity of the current economic cycle. Currency risk has been a more constant theme, as noted above in the context of diverging monetary policy stances between major central banks.

However, the main investment challenges they identify are persistent and at least loosely-linked.

They are concerned about rising portfolio risk, particularly about the risk of a shock to equity valuations; they are looking for ways to diversify their portfolios and to minimize volatility; and they are concerned about their ability to meet their return targets on a forward-looking basis.

In conversation, they expand on these responses largely in terms of the characterization above of the macro outlook and risks. The concerns about portfolio risk and equity market shocks tend to be rooted in the view that high valuations are underpinned by very low discount rates, but that persistent very low interest rates may not be an equilibrium phenomenon.

The glass half full view of the risk is that, as the global economy improves, interest rates will rise beyond what is currently priced into the forward curve— and that rising discount rates will pose a threat to asset valuations.

The glass half empty view is that the cycle is at a very mature stage, that economies will slow, or even go into recession, and that interest rates will fall further— on that view slower growth will mean that the expected income streams will prove to be unattainable, and that will pull down asset prices.

Conversely, if very low rates do prove to be a persistent phenomenon, on some version of the secular stagnation view of the world, then meeting portfolio return targets is likely to prove challenging. Asset price inflation underpinned by falling discount rates means that many of them have been able to meet return targets over much of the past decade. On a forward-looking basis, with market valuations now very high, many feel that it will be difficult to meet largely-unchanged return targets without taking more, new, or different risks. Again, uneasy lies the head that wears a crown.

Chart 3: What is your most urgent investment challenge?

Source: Sovereign Investor Institute

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How their investment approach is evolving

That is the background to the emphasis given by sovereign investors in the survey responses to seeking ways to minimize portfolio volatility and to diversification by asset class. The section below on the evolution of their investment approach picks up these themes.

Chart 4 shows a very high-level overview of the strategic asset allocation of a selection of sovereign funds, covering SWFs, sovereign and sub-sovereign pension funds and central banks with significant investment tranches. Consistent with the points made above on the taxonomy of sovereign funds, there is clearly a high degree of differentiation in SAA weights between different funds. At least as interesting as the point in time snapshot provided in Chart 4 is the direction of travel these funds are taking in terms of changes to their SAA.

Chart 5 illustrates that by way of aggregating responses by sovereign funds to surveys of changing asset allocation conducted at SII conferences over the past few years. As is fairly well-known, the main theme for almost all types of sovereign investor in the past several years has been increasing allocations to Alternative assets. Alternatives is a broad category including “traditional” alternatives such as private equity and hedge fund investments and real estate, as well as rapidly-developing categories such as private debt and infrastructure assets. As Chart 5 shows, there is interest in allocating more across the board to Alternatives.

There are a number of, not mutually-exclusive, explanations for this. First, there is the desire to increase portfolio diversification via exposure to different asset class premia and investment styles. That is consistent with the ‘universal investor’ approach, and with anxiety about valuation levels and volatility in publicly-listed equity and fixed income markets. In that sense, the objective is to position the overall portfolio at a higher point on the efficient frontier. In conversation, many of these investors also remark on the distinction between daily mark-to-market requirements on listed securities and the generally much less frequent valuation reporting on most Alternatives as being an advantage in managing portfolio volatility. Not that the underlying economic volatility is much – if any – different, but that managing their stakeholders is less challenging if a significant part of the portfolio is not marked-to-market in real time.

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**Chart 4: Sovereign Wealth: Strategic Asset Allocation**

**Source:** Sovereign Wealth Research - Sovereign wealth fund 2018

**Chart 5: What are you adding over the next 12-24 months?**

**Source:** Sovereign Investor Institute

*Note: Sovereign and Government fund delegate count = 458, as at 2018*
A second set of reasons for the increase in allocations to Alternatives is that it is a universe that is expanding as different asset classes and opportunities evolve. Perhaps the best example is the increase in interest in, and allocations to, private debt. That has been supported in the post-GFC period by the strategy of many leading banks to deleverage their balance sheets partly as a result of the crisis and because of the, related, changes in capital adequacy regulation via the implementation of Basel III. Taken together, that has created opportunities to invest in assets that are released from bank balance sheets and also, to some extent, to disintermediate banks and to lend directly to borrowers.

Another example within the more traditional Alternatives set is in real estate. Sovereign investors have long been owners of, and investors in, commercial property. They have high-profile investments in cities in the major developed economies – shops and office buildings in Manhattan and Knightsbridge, hotels in Mayfair and so on. But with the structure of the retail industry, for example, changing substantially, sovereign investor real estate investments are increasingly taking the form of the warehouses and other logistical infrastructure that has grown up to support the growth in online shopping.

A third main reason for rising allocations to Alternatives is that many sovereign investors, particularly in Asia, have only fairly recently been given clearance by their stakeholders to invest outside of publicly-listed securities. Many of them are therefore still in the process of seeking to fulfil new or higher allocations to Alternatives in their SAA. So, while there have been some fairly public episodes of sovereign investors reducing or cutting out their allocations to some Alternatives (hedge funds, for example), many of the investors are still building up their presence.

As well as the increase in Alternatives, another significant development summarized in Chart 5 is the interest in EME equity and debt. Here some of the reasons underpinning the support for Alternatives also apply, particularly the scope for exposure to EMEs to better position the overall portfolio on the efficient frontier. To some extent, that has always been the case. In terms of timing – i.e. why now? – a variety of push and pull factors have been making a more compelling case for EMEs for a wider range of sovereign investors in recent years.

On the push side, these include persistent slow growth, low rates and a subdued outlook in much of the developed world. On the pull side, in many major EMEs governments have been implementing liberalization and reform policies; and these reforms are supporting a better outlook for growth and returns on capital than in much of the developed world. Over-simplifying a bit, in terms of the factors of production the challenge facing many of the advanced economies is ageing populations, shrinking workforces, and weak productivity growth as a cause or consequence of disappointing business investment growth. The case for EMEs is based on younger populations, growing and increasingly skilled workforces, and scope for productivity convergence underpinning the case for business investment.

Chart 6: Reserve managers are exploring new asset classes
84% have adjusted asset classes in the past 12-18 months

Have you added/removed any asset class to/ from your CB’s reserve portfolio in the past 12-18 months?1,3

![Chart showing the percentage of respondents who added or removed asset classes](image)

Source:
2. The total number of respondent varied for each asset class
3. 32 respondents replied to this question

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Chart 7: Number investing in equities is rising
Reserve managers use a variety of ways to access equity markets

Which view best describes your attitude to the following asset classes?¹,²

If your central bank is investing in equities, please say how you access this asset class?¹,³

Sources:
2. The total number of respondent varied each year
3. 20 respondents replied to this question. 5 selected 2 options

Chart 6 and 7 is taken from this year’s RMT and narrow the focus on SAA changes to central banks. More than 80% of respondents had added and/or removed an asset class from the reserves portfolio in the past 12 to 18 months. The top panel in Chart 6 summarizes reserves managers’ attitudes to different asset classes from the core reserve assets – high-quality government bonds – on the left hand side to fixed income categories less commonly-held in reserves portfolios on the right hand side. One interesting feature, and a diagnostic on the search for yield, is the apparent interest in ABS, MBS, covered bonds and EM bonds as well as lower-rated investment grade government bonds. The bottom panel of Chart 6 focuses these issues and themes through the lens of investment challenges facing sovereign investors.

Probably the most marked development in reserves portfolios in the past decade has been the increase in investment in corporate bonds and in equities. More than 40% of respondents to the survey currently invest in corporate bonds, almost all of that in the investment grade category, and another 20% say that they are either currently considering or would consider investing. There has been quite a large increase in the proportion of reserves managers investing in equities over the past year, with more than 25% now doing so and another 20% either actively considering or being prepared to consider equities. Equities are a long way from being a traditional reserve asset, but investment by central banks has stepped up since the GFC. Partly that reflects the presumed low correlation of equities with government bonds which form the bulk of most reserves portfolios, given the belief in the potential for ultra-low yields to correct upwards (and therefore government bond prices to fall) as economic recovery became established after the crisis. Initially, investment in equities was mainly by a relatively limited number of relatively large reserves managers, but more recently equities have found favor with some central banks with smaller reserves portfolios too. A sign of that can be seen in the panel of Chart 7 showing how central banks access equities as an asset class. Larger reserves holders tend to do so either via a mandate with an external manager or via their own direct purchases in the market. But the more than one third accessing via ETFs is likely to be a testament to smaller-scale.
Environmental, Social and Governance (ESG) principles in investment

At the same time as navigating their portfolios through an investment environment made tricky by unusual macroeconomic and acutely uncertain geopolitical circumstances, sovereign investors also have to consider and calibrate their responses to the rise of ESG principles; and in particular to the challenge of climate change. I think it’s fair to say that, as investors in the public eye, they understand that the need to be seen to do something to show leadership (or to avoid criticism) is as important as making fundamental changes to their investment approaches. Hence the formation of the One Planet Sovereign Wealth Fund Group, which has drawn up a set of voluntary investment principles to promote the integration of climate change analysis in the management of large, long-term and diversified asset pools. And of the central bank Network for Greening the Financial System, following which a growing number of reserves managers now say they are implementing ESG principles in their investment decisions.

Chart 8 is taken from the SII’s conference survey of sovereign and central bank investors, and testifies to the importance now of responsible investing in the internal culture of these funds: more than 70% say it is very or increasingly important.

Chart 9 is taken from this year’s RMT and is a more granular breakdown of reserves managers’ motivations in this area. Ten central banks, 13% of respondents, said they were implementing ESG principles in investment decisions; a further 24, 32%, said they were actively considering it. In terms of motivation, moving in line with the market, ethical considerations and an improved public standing were the three main reasons given by these reserves managers. This comment from an EME central bank encapsulated the survey responses and summarizes conversations with many central banks on this set of issues: “Our institution is committed to ESG principles, and wants to lead by example in the domestic financial system. The diversification advantages of ESG investments are under investigation.”

The 41 respondents, 54%, either not considering or, in one case, having rejected incorporating ESG principles, were split into those who saw it as a possibility in time and those who were more skeptical. This extended comment from one of them is fairly representative of this side of the debate:

“At the moment (meaning it can change in the future), we think that ESG is: (i) a marketing sticker and not an investment strategy; (ii) rather a policy (like economic, health, education, etc.) that is primarily performed by governments; (iii) the role of FX reserves is to back monetary policy and therefore ESG can be outside a central bank’s mandate; and (iv) in many cases ESG is behind the line between developed and emerging markets, and without being allowed to invest in emerging markets, ESG is not eligible.”

Problems with defining ESG was the most common objection given by reserves managers, and their comments reflect a certain amount of frustration. A central bank from the Americas noted, “It is hard to establish specific ESG guidelines to determine asset eligibility since there isn’t a common and homogenous rating system for all assets.” A European reserves manager said, “Definitions and benefits are not yet clear. The market is not deep enough, the market data are confusing, and the effects of ESG, other than financial, are difficult to measure.”

Chart 8: Are responsible investing practices important in your organization?

Source: Sovereign Investor Institute Note: SWF and GPF delegate count = 203, as at 2018

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Chart 9: ESG – gathering significant momentum
10 are implementing, a further 24 are considering

If you answered implementing or considering investing in ESG, what were your reasons?¹,²

<table>
<thead>
<tr>
<th>Reason</th>
<th>Respondent #</th>
</tr>
</thead>
<tbody>
<tr>
<td>Good market practices</td>
<td>24 (69%)</td>
</tr>
<tr>
<td>Implementing ethical view in investment decision process</td>
<td>23 (66%)</td>
</tr>
<tr>
<td>Improved public perception</td>
<td>18 (51%)</td>
</tr>
<tr>
<td>Protection of portfolio against potential downside risks</td>
<td>10 (29%)</td>
</tr>
<tr>
<td>Lower volatility of ESG investments</td>
<td>5 (14%)</td>
</tr>
<tr>
<td>Creation of alpha in portfolio</td>
<td>3 (9%)</td>
</tr>
</tbody>
</table>

If you answered not considering or rejected investing in ESG, what were your reasons?¹,³

<table>
<thead>
<tr>
<th>Reason</th>
<th>Respondent #</th>
</tr>
</thead>
<tbody>
<tr>
<td>Problems with the definition of ESG principles</td>
<td>16 (55%)</td>
</tr>
<tr>
<td>Lower returns</td>
<td>9 (31%)</td>
</tr>
<tr>
<td>Lower liquidity</td>
<td>8 (28%)</td>
</tr>
<tr>
<td>Costs of obtaining ESG data</td>
<td>7 (24%)</td>
</tr>
<tr>
<td>Lower portfolio diversification</td>
<td>6 (21%)</td>
</tr>
</tbody>
</table>

Source:
2. 33 respondents replied to this question.
3. 29 respondents replied to this question.

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Currency views

Geopolitical risk is one of the classical motivations for countries to hold foreign exchange reserves. Its re-emergence has added interest to the debate about reserve currencies that has been dominated in recent years by ultra-low yields and by the steps taken by China to internationalize the RMB.

Chart 10 shows IMF data for allocated global reserves over the past two decades. There has been a shallow decline in dollar holdings, although it remains the dominant reserve currency both in terms of its more than 60% weight in allocated reserves and of its role in the international payments system. The euro remains in second place with a weight of around 20%. That represents a pull-back from its pre-GFC peak, reflecting the euro area sovereign crisis and the subsequent period of negative policy rates and negative yields on German bunds in particular. The RMB is growing steadily from a low base; the shares of the yen and sterling are similar and broadly unchanged; and the post-GFC period has seen a rise of “other” currencies – mainly relatively higher-yielding developed economy currencies including the Canadian and Australian dollars and Scandinavian currencies.

Chart 11 summarizes survey responses on the impact of geopolitical risk on reserves currency allocation. Two points stand out. First, the near-unanimity of central banks that the US dollar is still the safe haven currency. Secondly, while four fifths of respondents see geopolitical factors as impacting global reserves currency allocation, only one third expect it to affect their own central bank’s allocation.

The responses on the dollar’s current status are not particularly surprising. Of more interest is the distinction that comes out in discussion with central banks between its pre-eminence in the short term, and the medium-term potential for geopolitical and political choices to undermine its status. As one Asian reserves manager said: “The strength of the US in global financial markets, higher proportion of worldwide reserves being in US dollars, and more faith in the US economy compared to the rest of the world prove that the dollar is still the safe haven currency.” The more nuanced medium-term view is summarized by a central bank from an emerging market country: “There are no other safe alternatives you can consider investing in a short time period. However, geopolitical challenges and US political developments may potentially harm the dollar’s safe haven status. That is why, in our view, we experience the recent rise in the importance of gold.”

The minority of central banks who reported that geopolitical risks were impacting their own currency allocations reported a variety of direct and indirect channels. A respondent from Latin America said that they “decided not to increase our RMB allocation because of trade tensions between the US and China, despite its diversification benefits;” they had also limited their exposure to the won, partly reflecting (diminishing) geopolitical risks on the Korean peninsula and the potential for negative spill-overs to the Korean economy from US/China trade tensions. For good measure, they had also “decided to eliminate our British pound allocation given uncertainty around Brexit.” Another respondent was concerned about broader contagion: “A worsening of the US/China trade relationship could fuel a sell-off in emerging market currencies.”

Chart 10: Allocated Global Foreign Exchange Reserves by Currency Over Time (%)

Source: IMF COFER Statistics 31 March 2019
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Chart 11: Geopolitics is center stage for reserve managers
USD is still seen as the safe haven currency

Do you see geopolitical factors impacting currency allocation in the following?1,2

- Yes, 80%
- No, 20%

Global central bank reserves

To what extent do you agree that the US dollar is still the safe haven currency?1,3

- Agree, 51%
- Strongly agree, 47%
- Disagree, 3%
- Strongly disagree, 0%

Source:
2. 76 respondents replied to this question
3. 77 respondents replied to this question

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Chart 12 shows that the shift in language from the US Federal Reserve at the beginning of 2019, which was widely interpreted at the time as a signal that monetary policy normalization would be more gradual than had been expected, had not led reserves managers to change their exposure to the dollar. Almost 90% of respondents were of that view. The survey also asked whether the ECB halting its asset purchase program and signaling the possibility of a policy rate rise in 2019 had resulted in changes in exposure to the euro. The overwhelming response, over 80%, was no (although this is now largely a historical curiosity, given the subsequent shift in ECB language on monetary policy as its growth and inflation outlook deteriorated).

Chart 13 summarizes this year’s responses to the annual questions about the role of RMB in reserves portfolios. The responses conform to the established pattern: an expectation of a steady growth over the next decade, and that the share of the RMB in aggregate global reserves will be roughly double the average of its share in the individual portfolios of respondent central banks. Compared to its weight of just under 11% in the SDR basket, respondents expect the RMB to account for almost 14% in global reserves by end-2030 while on average they see it at 7.3% in their own reserves.

---

**Chart 12: Lower rates for longer USD and EUR still account for over 80% FX reserves**

**Any changes to your dollar exposure?**

<table>
<thead>
<tr>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>13%</td>
<td>87%</td>
</tr>
</tbody>
</table>

**Any changes to your dollar exposure?**

<table>
<thead>
<tr>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>17%</td>
<td>83%</td>
</tr>
</tbody>
</table>

Source:
2. 78 respondents replied to this question
3. 75 respondents replied to this question

**Chart 13: 68 official institutions investing as of Sept 2018 USD and EUR still account for over 80% FX reserves**

**What proportion of global reserves do you think will be invested in the renminbi by...?**

<table>
<thead>
<tr>
<th>2016 Survey Results</th>
<th>2017 Survey Results</th>
<th>2018 Survey results</th>
<th>2019 Survey results</th>
</tr>
</thead>
<tbody>
<tr>
<td>End of this year</td>
<td>3%</td>
<td>4%</td>
<td>6%</td>
</tr>
<tr>
<td>2020</td>
<td>7%</td>
<td>9%</td>
<td>7%</td>
</tr>
<tr>
<td>2025</td>
<td>10%</td>
<td>9%</td>
<td>10%</td>
</tr>
<tr>
<td>2030</td>
<td>14%</td>
<td>13%</td>
<td>15%</td>
</tr>
</tbody>
</table>

**What proportion of your reserves do you think will be invested in this currency by...?**

<table>
<thead>
<tr>
<th>2016 Survey Results</th>
<th>2017 Survey Results</th>
<th>2018 Survey results</th>
<th>2019 Survey results</th>
</tr>
</thead>
<tbody>
<tr>
<td>End of this year</td>
<td>2%</td>
<td>3%</td>
<td>3%</td>
</tr>
<tr>
<td>2020</td>
<td>4%</td>
<td>4%</td>
<td>4%</td>
</tr>
<tr>
<td>2025</td>
<td>7%</td>
<td>6%</td>
<td>5%</td>
</tr>
<tr>
<td>2030</td>
<td>9%</td>
<td>7%</td>
<td>7%</td>
</tr>
</tbody>
</table>

Source:
2. The total number of respondent varied each year

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As in previous years, the contrasting results on the RMB reflect the tension between the size and growth rate of China’s economy on the one hand; and, on the other, concerns about market risk in the currency and the pace of Chinese financial liberalization. For example, a European reserves manager thought that “RMB holdings in global reserves will in the long run reflect the economic strength of China.” A Middle East respondent made the point that “There is significant currency risk in the RMB and the market needs to develop further to compete for allocation from US dollar, euro and sterling.” And a Latin American central banker said “Our exposure to RMB will be a function of the level of liberalization that the Chinese markets display.”

Gold was the original, and for most of the past 5,000 years the only, reserve asset. It isn’t altogether surprising therefore that, at a time when geopolitical risks and political policy uncertainty are relatively elevated, there is renewed interest in gold’s role in reserves portfolios. Chart 14 shows that an overwhelming majority of survey respondents – almost 90% - expected that central banks would increase their exposure to gold over the next two to three years. As one of them put it, “Global instability and geopolitical instability are driving central banks, especially from emerging markets, to increase their gold holdings.” Another explained that “Trade barriers, economic and political crises, which significantly affects the stability and predictability of global financial markets, at the same time encourages central banks to invest more in safe assets in their reserves.”

Others emphasized gold’s role as a diversifier in the reserves, and made the point that as currency reserves grew so more gold was acquired to maintain its weight in the portfolio. The safe haven and diversifying properties of gold were both emphasized in this extended comment from a European central banker: “Despite a decreasing role of gold in the global financial system, most central banks treat it as the strategic asset taking into account the physical properties of gold, its scarcity and lack of credit risk or lack of connections with the economic policy of any country. Several, especially developing economies’ central banks, increase gold holdings in order to assure adequate share in the growing reserves.”

Chart 14: 88% see higher gold allocations in the next 2-3 years
Increased interest driven by diversification and geopolitics

Do you see central banks globally increasing their exposure to gold over the next 2-3 years?1,2

<table>
<thead>
<tr>
<th>Yes</th>
<th>88%</th>
</tr>
</thead>
<tbody>
<tr>
<td>No</td>
<td>12%</td>
</tr>
</tbody>
</table>

Which of the following best represents your view of the value gold brings to reserve portfolios today?1,3

<table>
<thead>
<tr>
<th>Safe haven</th>
<th>Portfolio diversifier</th>
<th>Symbolic</th>
<th>Inflation hedge</th>
<th>Liquid asset (for use as last resort)</th>
<th>Liquid asset (to trade and lend)</th>
</tr>
</thead>
<tbody>
<tr>
<td>17</td>
<td>20</td>
<td>5</td>
<td>11</td>
<td>7</td>
<td>1</td>
</tr>
<tr>
<td>Most significant</td>
<td>2nd most significant</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source:
2. 65 respondents replied to this question
3. 62 respondents replied to this question

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Concluding comments

"Uneasy lies the head that wears a crown" is taken from King Henry IV’s speech in Shakespeare’s eponymous play, in which he contrasts the exceptional weight of the king’s responsibilities with those of his subjects. Using it in the title of a paper on sovereign investment trends is, of course, over-elaboration to the point of being a conceit. In partial mitigation I plead that, in a crowded market place, one needs to attract attention. However, while most features of the current investment outlook are common to institutional investors in general, I do think some aspects are especially relevant to sovereign investors.

In particular, resentments and disputes over the pattern of global trade and the rise of nationalism in many advanced economies. As we have seen, sovereign portfolios have substantially increased in size in the past two decades; and what underlay that was typically persistent current account surpluses, often going hand in hand with fixed or managed exchange rates.

In my time as an IMF official and central banker, in international meetings at the Fund and at Basel we used to talk politely about the financial market consequences of global imbalances in capital flows. For example, in the context of the ‘Greenspan Conundrum’ (in which intermediate and long-term US Treasury yields fell, even as the FOMC was steadily raising short-term policy rates in 25 basis point increments by a total of 400 basis points) one hypothesis was that large-scale purchases by foreign central banks and sovereign funds were suppressing term premia.

Another strand of that debate was the role that global imbalances suppressing yields might have played in preparing the ground for the GFC. On that view, low risk-free rates and investors’ search for yield stimulated the development of and boom in securitised and structured credit, as the financial system evolved to generate higher-yielding AAA-rated securities.

The politics of all of this has now shifted decisively from the realm of technocrats discussing capital flows in ivory towers to that of populist politicians loudly denouncing trade imbalances to disgruntled electorates in the heartlands of major advanced economies. It remains to be seen how all of that will play out, but it has the potential to contribute to a hostile environment for sovereign investors. They know that, of course. Just as the Santiago Principles on SWF transparency were a response to the need to provide reassurance about their presence as significant investors and owners in advanced economies a decade ago, so their new initiatives on ESG and climate change will help to position them on the right side of public opinion now.

In many other respects, the investment challenges they face are versions of those facing all institutional investors: the difficulty of meeting little-changed return expectations given the low growth, low return outlook in much of the world; and of selecting new asset classes and calibrating their risk appetite as they migrate beyond their traditional habitats in the quest for higher returns.
Before joining HSBC Global Asset Management in 2015, Michael had a twenty-five-years career in the official sector, for the most part at the Bank of England, but also at the International Monetary Fund where he was Private Secretary to the Managing Director, Michel Camdessus, between 1997 and 2000. At the Bank of England, he was Head of Sterling Markets Division, responsible for the implementation of monetary policy and liquidity-supplying operations to the banking system in the Global Financial Crisis, between 2007 and 2009. From 2009 to 2015 he was Head of Foreign Exchange Division and Reserves Management, during which time the UK’s foreign exchange reserves were doubled as part of the policy response to the challenges of the post-crisis period. At the same time, he was a member of the Secretariat of the Monetary Policy Committee, Chairman of the London Foreign Exchange Joint Standing Committee, and a member of the Markets Committee of central banks at the BIS. Michael holds MA, MPhil and PhD degrees from the University of Cambridge.
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