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Investor Note

Global sovereign investor insights | UBS Asset Management
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UBS Asset Management has a rich history of providing institutional solutions and advisory services to some of the largest and most prestigious sovereigns globally. This note provides an update on what we currently hear from this investor group as part of our trusted advisory relationships when it comes to the most pressing challenges in the current environment.

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Trade war escalation, negative rates challenge investors

What are the challenges faced by sovereign investors in the current investment environment?
China/US Trade War: What started as a 2016 campaign promise by then-US presidential candidate Donald Trump to target 'unfair' trade practices from China has, two years into Trump's administration, evolved into a full-fledged trade war. The recent decision by the US to label China as a currency manipulator and the fall of the RMB below 7 raises the specter that the trade war might turn into a currency war.

We believe that future US administrations will eventually revert back to an international trade regime that is much less geared towards tariffs. On the other hand, economic and (geo)political hurdles to stop China from catching up as a high-tech superpower will become a more sticky feature in the confrontation between China and the US. The US-China confrontation will be a long-term game.

Increased trade tensions are having an impact not only on economic sentiments and markets but also on hard economic data. The recent drop in German and other countries' manufacturing sectors point to growing evidence of the cost of trade wars.

Central banks have already reacted to the worsening economic outlook with the US Fed cutting for the first time since 2008, the ECB expected to further loosen monetary policy and some Asia-Pacific region banks (India, Thailand and New Zealand) already cutting interest rates. We should not forget that there is more room for monetary policy easing via interest rates and eventually quantitative easing.

Lower for longer or lower forever?
The unfolding reversal in the US interest rate cycle has been pretty spectacular over the last few quarters. US 10-year yields fell from over 3% at the end of 2018 to below 1.60% as of 16 August 2019. The whole German government yield curve is now in negative territory.

The world's central banks have become not just the repairmen for the economy but in fact the fire brigade, due to their ability to be more nimble than political decision makers. Should more trade war-related pain materialize down the road, central banks could ease even more aggressively.

At the 2018 Reserve Management Seminar, UBS Chairman Axel Weber argued that the normalization in interest rates was unlikely to happen during this cycle and more

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cycles might be needed. It appears he was right and yields are likely to remain low over the medium-to-long term. A major reversal in trade negotiations and a fast recovery would be required to re-initiate the normalization trend interrupted in the last quarter of 2018. One year later, at the 2019 Reserve Management Seminar, two-thirds of the event participants, which consisted of over 60 central bankers from around the globe, revealed in an on-site vote that they expect the yield on the 10-year US Treasury note to be below 2% at the next RMS event in July 2020.

Which sovereign investors struggle the most in the current environment?
Central banks: The current investment environment is particularly challenging for fixed income investors who restrict themselves to conservative portfolio allocations. With a USD share of global FX reserves of above 60%, the fall in US interest rates is particularly painful for reserve managers.

US interest rate differentials provided central banks with good returns, particularly when compared to the Euro area, Japan and other advanced economies. Central banks have historically prioritized liquidity in their portfolios. This creates a preference for highly rated government bonds which can be liquidated at short notice and have tended to perform well in mark-to-market terms in risk-off environments. A short duration/cash portfolio USD hedged (see central bank sample portfolio 'CB1' in the table on the next page) generated a YTD return of about 1.8% as of 31 July 2019.

On the other hand, these portfolios–despite increasing diversification–have missed out on earning more carry on positions related to market and credit risk, particularly in an era of low realized volatility, quantitative easing and 'search for yield.' Those central banks that diversified into other fixed income products were able to generate a return of above 4% YTD. Those central banks which in addition allocated a part of their reserves (up to 20%) to equity were able to generate more than 6% YTD. For more information on the year-to-date performance of typical central bank portfolios, please refer to Exhibit 1 on the next page.

SWFs: Truly long-term investors like SWFs have the ability to stick to their long-term investment themes, using more illiquid investments that harvest the illiquidity premium over much longer time horizons. The current environment is challenging given the volatility in equities but also provides excellent investment opportunities as they rebalance according to their strategic asset allocations.

What should central banks and SWFs do in the current environment?
We think that the biggest risk in the current situation where single tweets can fundamentally alter the risk-on / risk-off situation for days or weeks is to become trapped in short-term thinking. Unfortunately, in particular more conservative investors, who have to stick to debt instruments, are forced into the ultimately impossible task of guessing the next moves by global central banks to manage their short-term fixed income portfolios.

Central banks: We generally advise that central banks should look to maximize returns subject to meeting their own minimum liquidity requirements. Therefore, if liquidity requirements increase/decrease, risk appetite to earn return from other sources by taking credit or market risk should change accordingly.

Investment guidelines and **benchmarks** could be reconsidered: We recommend clients to slightly expand the eligible universe beyond standard benchmarks to give managers a bit more freedom in generating alpha. Also for conservative portfolios we would recommend increasing the list of off-benchmark countries rated BBB- or higher to allow small allocations for example to solid developed economies like New Zealand, and selected EM exposure to China or Mexico.

Allow **greater flexibility** in the use of derivatives: We would recommend allowing your managers to use bond futures and swaps not only for hedging but also for cross-market positions (e.g. long Treasuries/short Bunds) which have the potential to generate alpha. Allow more flexibility in styles for the manager to take on more credit risk vs market risk depending on the point in the cycle.

Central banks that are considering whether to diversify into equities as part of a long-term diversification of their allocation should stick to their plans. Current market conditions offer opportunities; a flexible phasing of the build-up in equity exposure (with possibility of halting or accelerating the equity build up depending on market trends) may be an effective and a less risky way for a first move into this asset class.

With recent trade wars, retaliation threats and spillover effects to the rest of Asia, is Asia, and EM in general, still the place to be when it comes to geographical diversification?
In the long run, we think that **emerging markets** (in particular APAC) will offer more growth and the potential for higher yields (both real and nominal) and scope for currency appreciation. In the shorter term, investors may face higher volatility and less liquidity in EM than in 'developed' markets.

For fixed income portfolios, we generally recommend increasing the list of off-benchmark countries rated BBB- or higher to include small allocations to selected EM countries like China and Mexico also in conservative portfolios.
With regards to Chinese assets, the latest trade escalation and the recent US labelling of China as a currency manipulator raised the specter of even more economic damage to the Chinese economy. Still, Chinese RMB fixed income provides yield enhancement and portfolio diversification, and Chinese equities (CSI 300) are up by 23% as of 14 August 2019.

Amid the noise, it is even more important to focus on material factors, including: a) the long-term commitment by the government to develop the Chinese consumer economy; domestic retail sales are holding up quite well; b) other secular trends including urbanization, innovation, automation and aging remain intact; and c) in our view, the People's Bank of China is unlikely to devalue the RMB aggressively.

Exhibit 1: Sample central bank and sovereign wealth fund asset allocations and performance

	Typical central bank holdings (% of portfolio)				Typical SWF portfolios		
	CB1	**CB2**	**CB3**	**CB4**	**Sav1**	**Sav2**	**Sav3**
Cash	50	10	10	10			
GGB 1-3[1]	50	50	30	30			
GGB[1]			10	10	23	23	15
Corporate Bond		10	10	8	10	10	
TIPS		10	10	8			
Securitisied		10	10	8			
Supranationals		10	10	8			
EMD Hard Currency			10	3			
EMD Local Currency					3	3	
Global Equity				15	60	40	35
Real Estate					5	12	10
Private Equity						13	20
Hedge Funds							10
Infrastructure							5
Commodities							5
Performance							
2019 January	0.23	0.70	1.17	1.91	5.74	6.33	7.11
2019 February	0.16	0.13	0.18	0.55	1.74	1.58	2.00
2019 March	0.38	1.05	1.29	1.23	1.62	1.85	1.65
2019 April	0.20	0.22	0.18	0.67	2.03	2.11	2.58
2019 May	0.40	0.90	1.04	0.03	-2.83	-2.19	-2.92
2019 June	0.32	0.78	1.14	1.78	4.66	4.26	4.50
2019 July	0.12	0.26	0.42	0.36	0.49	0.84	0.79
Performance 2019 YTD	**1.83**	**4.11**	**5.53**	**6.71**	**13.99**	**15.51**	**16.49**
Performance 2018	2.00	1.04	0.46	-0.47	-5.30	-5.12	-6.58
Performance 2017	0.90	2.00	3.07	5.22	15.17	12.88	13.02
Performance 2016	0.91	2.29	3.34	3.50	6.40	6.87	7.88
Performance 2015	0.51	0.31	0.39	0.29	-0.53	1.16	0.21

Source: UBS Asset Management
[1]Fixed income portfolios based on short-term (GGB 1-3) and long-term (GGB) government bond indices of the respective country. Country weights: US 65%, Germany 15%, UK 5%, Japan 5%, France 5%, Netherlands 5%.

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