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Sovereign investors shift forex holdings amid political risks

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INCREASED political threats – not just limited to a potential full-blown trade war, but also including developments in Europe and the US – are changing the way central banks and sovereign wealth funds allocate their funds.

A survey by UBS Asset Management (UBS AM) of close to 30 central banks and sovereign wealth funds globally found that these investors are continuing to diversify their foreign exchange reserves, with most pursuing increased allocations to non-government-bond assets.

Central banks are classic fixed income investors, and government bonds usually make up 10-15 per cent of their portfolios. These sovereign investors first started diversifying to higher-risk fixed income assets and equities to beat the long-drawn low-yield environment.

The survey findings showed that central banks worldwide continue to increase their holdings of corporate debt and mortgage- and asset-backed securities, given the better quality of such instruments today compared to those that contributed to the global financial crash in 2008.

Some sovereign wealth funds, which have freer mandates to invest than central banks, are also increasing their holdings in illiquid asset classes like infrastructure investments to enhance returns.

The biggest gainers when it comes to currency allocations by central banks last year were the euro and the renminbi, with the RMB especially becoming the diversifier of choice. It is coming from a low base since not many countries held them as a reserve currency before.

According to the International Monetary Fund, the RMB currently represents 1.2 per cent of global reserves, less than the Canadian and Australian dollars and well below the share of leading reserve currencies such as the dollar and the euro, despite its inclusion as a reserve currency in the Special Drawing Rights (SDR) basket in 2016.

Survey respondents said their average long-term target allocation to the RMB is around 3.2 per cent, which means a doubling from current levels. With allocated reserves currently at US$145 billion in the first quarter of 2018, this would translate roughly into an additional US$200 billion flowing into RMB-dominated assets in subsequent years.

This is still small compared to about US$2 trillion and US$6.3 trillion invested in euro- and dollar-denominated assets, respectively.

But more participants said they are invested or considering to invest in the RMB, up 18 percentage points to 85 per cent of respondents, from 67 per cent in 2017.

This renewed interest in the RMB is significant, as interest in the Chinese currency had cooled and reserve allocations stagnated in the last few years, following the mini-devaluation of 2015.

This is likely because the 2015 devaluation and subsequent use of Chinese reserves to support the RMB as well as capital outflow restrictions on Chinese corporates dented the trust of international investors on China's commitment to RMB internationalisation.

However, UBS AM believes the RMB will gain ground as a reserve currency in due time, depending on China's economic growth and the speed at which it opens its domestic capital markets.

Meanwhile, the US dollar remains the default currency in which to invest new reserves. The average share of USD holdings among all the participants was about 71.5 per cent.

Data from the Society for Worldwide Interbank Financial Telecommunication (Swift) shows that the use of RMB in international transactions, after a rise in 2015 and 2016, slowed down in 2017 and in the early part of 2018.

RMB utilisation is now the sixth highest with a global share of 1.7 per cent, behind the Canadian dollar and the Japanese yen.

Offshore RMB deposits in Taiwan, Hong Kong, London and Singapore have also fallen in recent years, with the largest drop in Hong Kong and Macau.

Massimiliano Castelli, head of strategy at UBS AM, believes the use of RMB will likely rise towards a level of 10 per cent of global reserves in a decade's time.

The currency's slow progress since it was added to the SDR basket can be explained by operational challenges investors face when investing in RMB onshore through intermediaries other than the People's Bank of China.

These investors hope to see simpler mechanisms with which to enter and exit the RMB market; trading made available on Western time zones or a better process of leaving trading orders; better coordination with international bond custodians; as well as improved communication with investors, in particular on operational and regulatory topics.

Some central banks are also not able to access the market with their current custodians, yet they opt not to use a Chinese onshore custody as they consider the latter's trading procedures to be less standardised than in many other jurisdictions.

Dr Castelli says: "These issues are being addressed as we speak. We think that in the end, it's not a question of whether the RMB will become an important currency, but more a question of when."

Meanwhile, the selloff in the Chinese A-share market this year – rendering it one of the worst performers within the emerging markets – could provide an opportunity for investors to enter, says Benno Klingenberg, head of Asia-Pacific, global sovereign markets, UBS AM.

"What we are seeing right now is significant investor interest following a 20 per cent correction in the market. We are seeing a number of clients coming out to China to do their due diligence on Chinese investments. They are not just looking at onshore per se, but at the best opportunities there, whether in A shares or H shares...

"The demand for China is clearly picking up, and a lot of large Middle-Eastern sovereign investors are massively under-allocated to China across asset classes.

"Sovereign wealth funds have been investing in Asia and emerging markets (EM) since 10 to 15 years ago, and China was always a part of an EM investment, but today you probably should look at it as a standalone part of your asset allocation."

The sectors investors are focusing on in the equity space include technology, healthcare and consumer.

Investors are also drawn to RMB-denominated debt because it allows them a more diversified currency composition.

While the difference in yield between USD and RMB government bonds has come down dramatically from over 100 basis points (bps) to less than 50bps, investors can still achieve better yields in quasi-sovereign RMB bonds such as those issued by the China Development Bank, compared to similarly-rated bonds denominated in euro or yen, he says.

Asked if the ongoing Sino-US trade war could dampen the projected rise of the RMB's share in global reserves, Dr Castelli says the trade war is not likely to translate into a currency war.

"This is more of a journalistic speculation – that China might retaliate by halting its purchase of US Treasuries, but I don't think we are there yet...

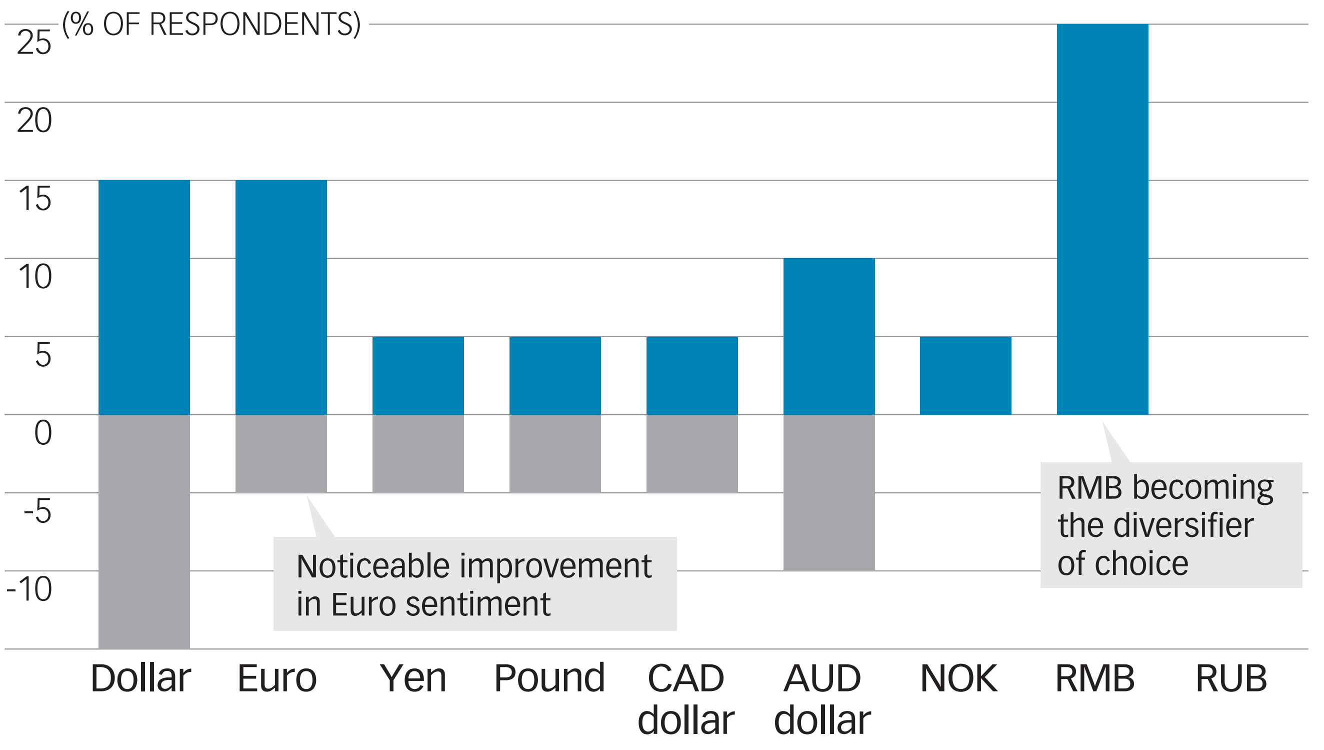
"China has a lot of interest to keep the RMB stable, as they transit from higher growth to lower growth. They do it not to please the US, but more for domestic reasons, because the RMB is an important anchor for the Chinese economy."

Besides, unlike the dollar, the RMB is not used as an international transaction currency much, so the link between RMB strength and the trade war is tenuous at best.

But he adds that this is unless the trade war becomes a factor of weakness for the domestic Chinese economy, which may then lead its central bank to support the currency by providing stimulus to keep capital from flowing out of its economy.

Currency allocations

Changes among sovereign investors in the last 12 months



Note: The average share of USD holdings among all participants was about 71.5%

Source: UBS Annual Reserve Manager Survey, results as at June 2018