2. ASSET ALLOCATION

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TIME TO GET MORE ACTIVE?

In the face of short-term volatility, reserves managers are opting for longer-term strategies. By Neil Williams and Taylor Pearce.

HOW is the challenging macro environment impacting central bank reserves managers' investment objectives? And how might asset allocations shift as a result? This year's survey findings suggest that despite recognition of – and, to a large part, preparation for – a changing macro climate, the majority of reserves managers seem unfazed. Traditional approaches will generally be followed even if it means a lower return: the objective being to preserve capital, maintain liquidity and diversify.

When asked how the elevated rate of inflation across most major economies will affect their decision-making, 47% of this year's survey respondents answered that they plan to maintain their traditional risk approach and have accepted a lower real return. An additional 22% stated that their decision-making has not been affected at all.

Respondents were split on whether economic and market volatility will prompt them to adopt a more active approach to portfolio management, with 53% stating yes and 47% answering no. This division was also reflected in respondents' comments. One insisted that 'higher volatility in the financial markets requires a more active management approach.' Another commented, 'We will try to adopt a more defensive strategy in order to guarantee capital preservation and enhance returns in the current conditions.'

Nevertheless, a sizeable share of respondents reported already having sufficiently active portfolio management practices. 'We adopt an active approach to a very small portion of reserves and we are not planning to make changes on this front,' noted one, a sentiment which was echoed by many others. It appears that reserves managers are opting for longer-term strategies, refraining from drastically changing course as a result of increased short-term volatility and heightened uncertainty.

Across the board, capital preservation stands out as the primary asset allocation objective this year, with 97% of reserves managers listing it as a top-three investment objective, and 61% listing it as the number one consideration (Figure 1). Ensuring liquidity was also listed by 97% as one of the top-three asset allocation considerations, with 29% listing it as their top investment objective. This has remained relatively consistent with previous years' findings, with 75% listing capital preservation as the top objective in 2021.

Capital preservation has risen drastically in importance for reserves managers. It is now the top reason for diversification of assets among our polling group and has increased to 72% from 29% in 2020, the largest rise (by percentage points) across categories.

Increasing risk-adjusted returns remains the number one reported driver of diversification, with 75% reporting it among their top-three considerations. Risk/volatility reduction remains a key objective for 68% of respondents, although capital preservation ranked slightly higher this year, a reversal of the previous two years' findings. Each of these points should be considered in a growing inflation environment. But their ascent as drivers of diversification started early and do not appear to be symptomatic of a sudden pick-up in inflation fear this year.

The composition of assets is also revealing, with traditional risk-on assets still in vogue (such as equities and emerging markets), and yet seemingly no rush for the door from less inflation-protected assets such as fixed income. Bonds (government, quasi-government and corporate) still comprise on average 55% of portfolio composition, with equities (3%), cash (17%) and gold (9%) remaining a sizeable share, meeting an array of diversification needs (Figure 3).

Unsurprisingly, most of the respondents (71%) invest in physical gold, with a few others investing indirectly via futures markets (6%) and mining industries (3%). Although gold's strong presence might be associated with dysfunctional economies – inflation build-up and/or default risk – its importance to reserves management this year appears to be consistent with previous years. In 2020, 71% directly invested in gold and only slightly fewer (65%) in 2021 (see Chapter 5).

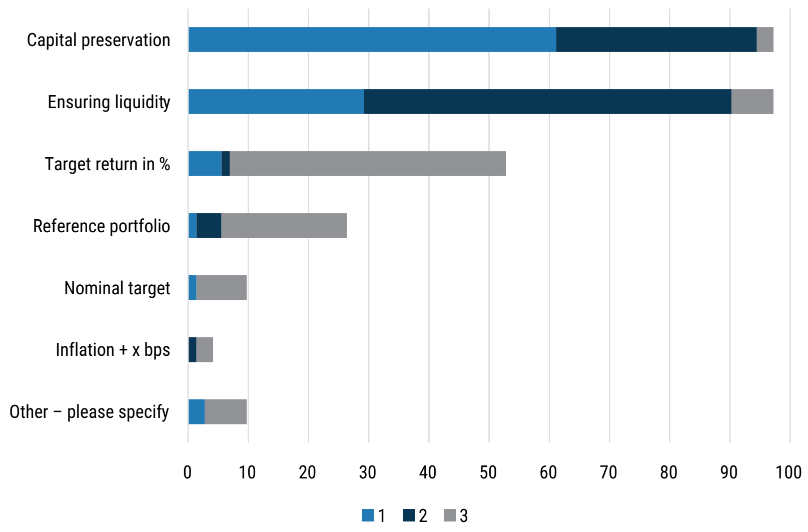
Notably, more traditional assets will be sought in the next one to two years, with an even greater allocation to bonds, equities and gold (Figure 4). A net increase of 22% is anticipated in government bonds, along with an 18% net increase in quasi-government bonds and a 20% net increase in corporate bonds. Net increases in gold and equities of around 18% and 14% respectively are also anticipated.

This is consistent with diversification, but it may surprise inflation seekers that bonds are higher and may surprise growth optimists that there will be only a moderate uplift in equities and gold. The only real downscaling is expected in cash, suggesting reserves mangers have thus far little trepidation of aggressively rising rates. This may also displease deflationists.

Compared with previous years, reserves managers' appetites for bonds over the next two years have increased across the board, as has

1. CAPITAL PRESERVATION AND LIQUIDITY STAND OUT AS PRIMARY ASSET ALLOCATION OBJECTIVES

What is your investment objective? Please rank top three in order of importance. Share of respondents, %

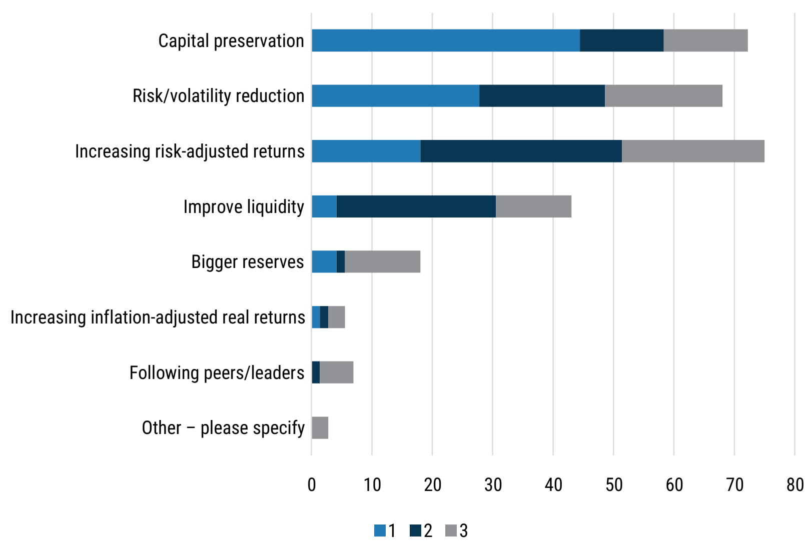


Source: OMFIF GPI survey 2022

2. CAPITAL PRESERVATION, VOLATILITY REDUCTION AND INCREASING RISK-ADJUSTED RETURNS KEY DRIVERS OF DIVERSIFICATION

What are/have been the main reasons for the diversification of reserves? Please rank the top three in order of importance. Share of respondents, %.

Note: 'Ensuring liquidity' was not listed as an option in previous surveys. It was included this year due to feedback from respondents, many of whom (>25%) listed it as a primary objective under 'Other' in previous years.

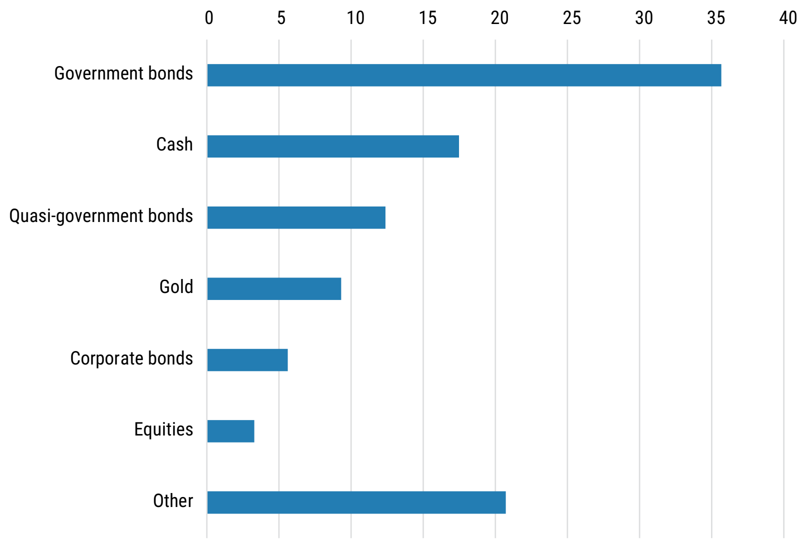


Source: OMFIF GPI survey 2022

3. PORTFOLIO COMPOSITION STILL FAVOURS TRADITIONAL ASSETS

Share of total portfolio invested in following asset classes. Average response, %

Note: 'Other' includes supranationals, special drawing rights, collateralised securities and fixed deposits.



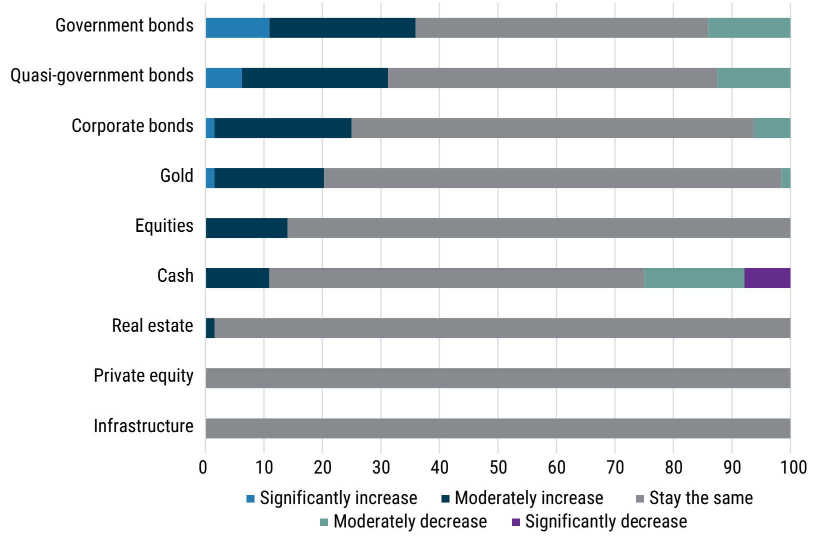
Source: OMFIF GPI survey 2022

PERCENTAGE OF RESERVE MANAGERS WHO INVEST DIRECTLY IN PHYSICAL GOLD:

2020:	2021:	2022:
71%	65%	71%

4. NO SIGNIFICANT FLIGHT FROM ASSET CLASSES LESS PROTECTED FROM INFLATION

Reserves managers' expectations to increase, reduce or maintain allocation to the following asset classes over the next 12-24 months. Share of respondents, %



Source: OMFIF GPI survey 2022

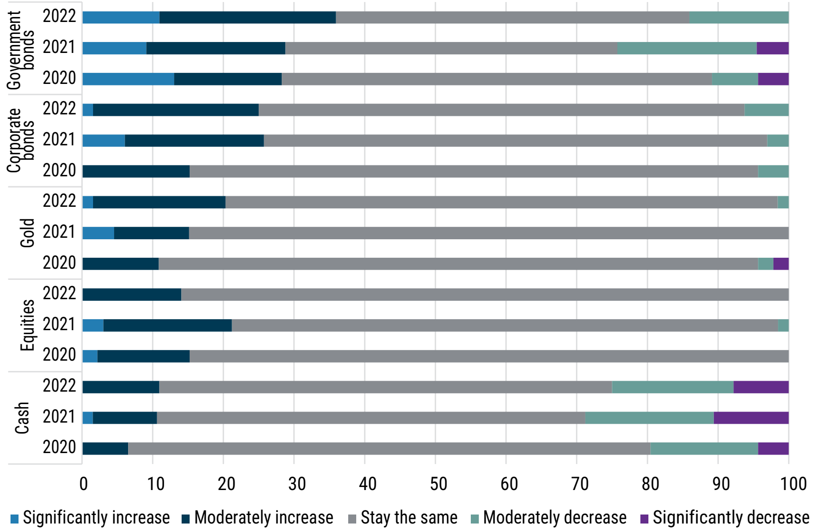
anticipated demand for gold (Figure 5). Equities and cash both saw a marginal net decrease, but neither looks substantially different to last year. As allocation intentions over the short term seem to be a continuation of previous trends, this suggests little obvious fear that monetary tightening will be aggressive.

Consistent with that is an intention to move down the spectrum in the next two years to shorter-maturity bonds (Figure 6). The anticipated move is true for all maturity categories under 10 years, while a net reduction of 9% is anticipated for more than 10-year maturity bonds. This looks in line with expectations of higher inflation, which would disproportionally impede longer maturities, and possibly of quantitative tightening. Respondents' comments echo this, with one expressing an intention to 'reduce the impact of the rising rates environment by shortening our portfolio's duration,' while others added that they plan to 'decrease duration exposure' and to shift towards 'shorter duration.'

There is a higher allocation expected for both triple-A (15% net increase) and non-triple-A (22% net increase) investment-grade sovereign debt (Figure 6). The only category where net reductions are expected is for sub-investment grade debt (around 9% net decrease). However, neither the small net reduction planned nor the more negative stance compared with 2021 appears to be a sign of sudden risk aversion.

5. EVEN GREATER ALLOCATION TO BONDS, EQUITIES AND GOLD EXPECTED OVER SHORT TERM

Reserves managers' year-on-year expectations to increase, reduce or maintain allocation to the following asset classes over the next 12-24 months. Share of respondents, %



Source: OMFIF GPI survey 2020-22

DEVELOPED MARKET CURRENCIES AND ASSETS STILL FAVOURED FOR NOW

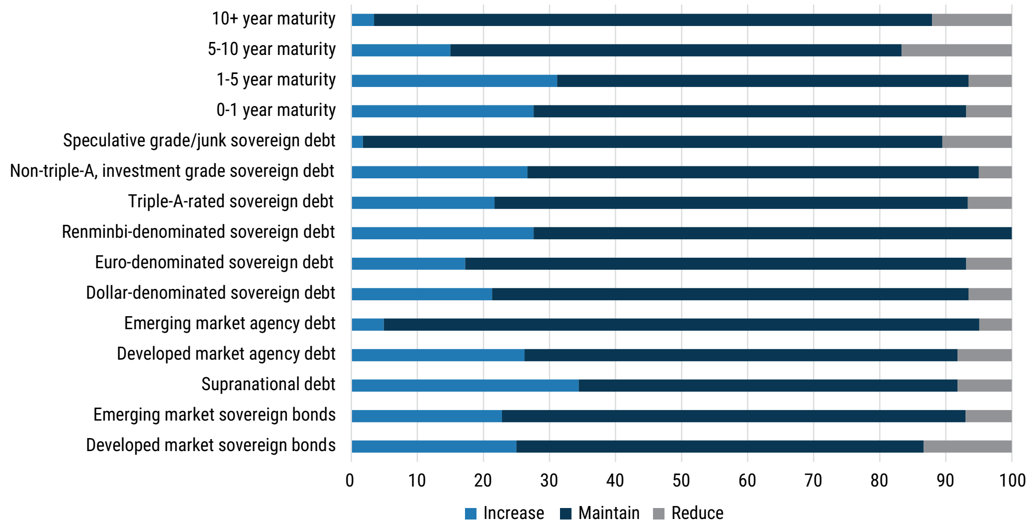
At least three other aspects seem to rule out increasing risk aversion in response to changing events. These also seem consistent with a continuation of longer-term strategies, rather than any short-term panic.

First, while exposure to developed markets outweighs that to traditionally higher-risk emerging markets by a factor of 10, this is relatively unchanged from last year. This year's reported portfolio allocation among survey respondents averaged 9% investment in emerging markets versus 90% in developing markets, compared with 10% and 87% respectively in 2021.

In 2023-24, North American assets are expected to lose some ground to the Asia Pacific region, which stands out as the main gainer (Figure 8). But for now, the US is still highly favoured even within developed market allocations, with exposure to the North America region increasing to average 45% of regional portfolio composition, slightly higher than last year's figure (43%).

6. MOVE TOWARDS SHORTER-MATURITY BONDS EXPECTED OVER SHORT TERM

Reserves managers' expectations to increase, reduce or maintain allocation to following categories of government bonds over the next 12-24 months. Share of respondents, %

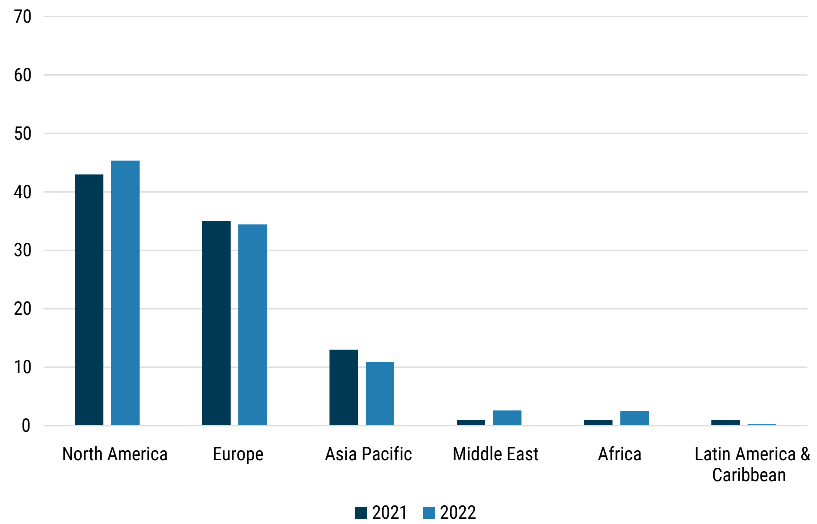


Source: OMFIF GPI survey 2022

7. NORTH AMERICA STILL MOST FAVOURED REGION FOR PORTFOLIO INVESTMENT

What percentage of your total portfolio is invested in the following regions? Average response, %

Note: Remainder (>5%) invested in supranationals, special drawing rights and gold

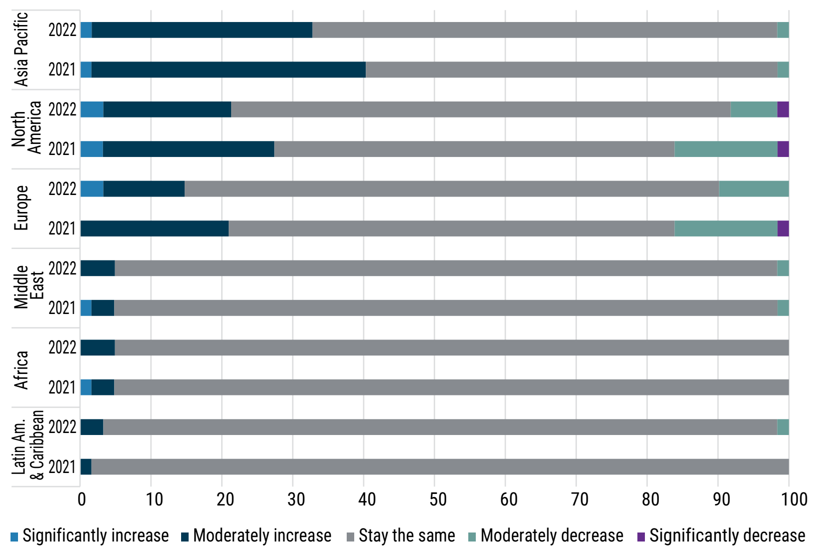


Source: OMFIF GPI survey 2021-22

8. ASIA PACIFIC REGION STANDS TO GAIN MOST OVER SHORT TERM

Reserves managers' expectations to increase, reduce or maintain exposure to following regions over the next 12-24 months. Share of respondents, %

Note: Russia and Turkey both classified as Europe

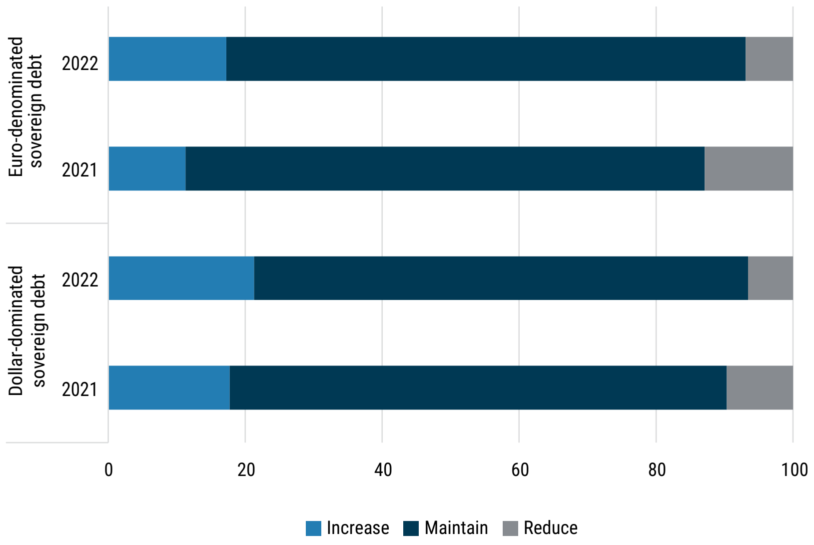


Source: OMFIF GPI survey 2022

> **THE US IS STILL HIGHLY FAVOURED EVEN WITHIN DEVELOPED MARKET ALLOCATIONS, WITH EXPOSURE TO NORTH AMERICA INCREASING TO AVERAGE 45% OF REGIONAL PORTFOLIO COMPOSITION.**

9. DOLLAR-DENOMINATED SOVEREIGN DEBT FAVOURED OVER EURO IN THE SHORT TERM

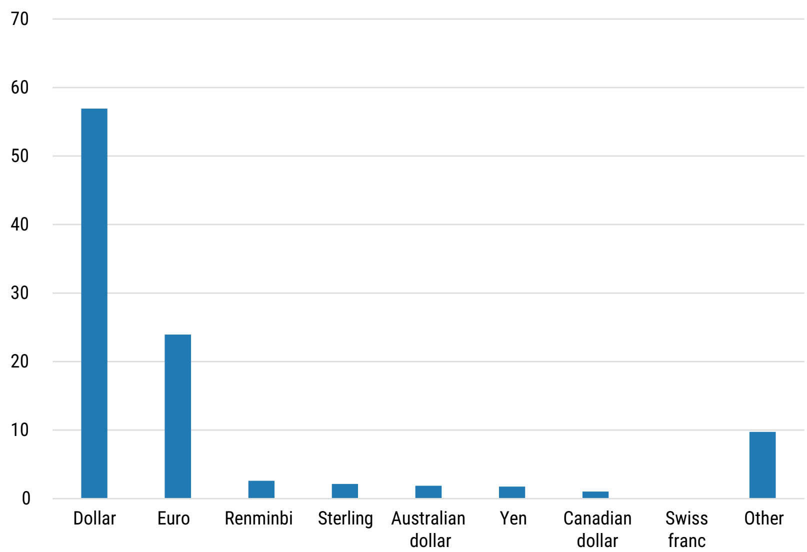
Expected portfolio allocation to government bonds over next 12-24 months. Share of respondents, %



Source: OMFIF GPI survey 2021-22

10. DOLLAR REMAINS CURRENCY KING

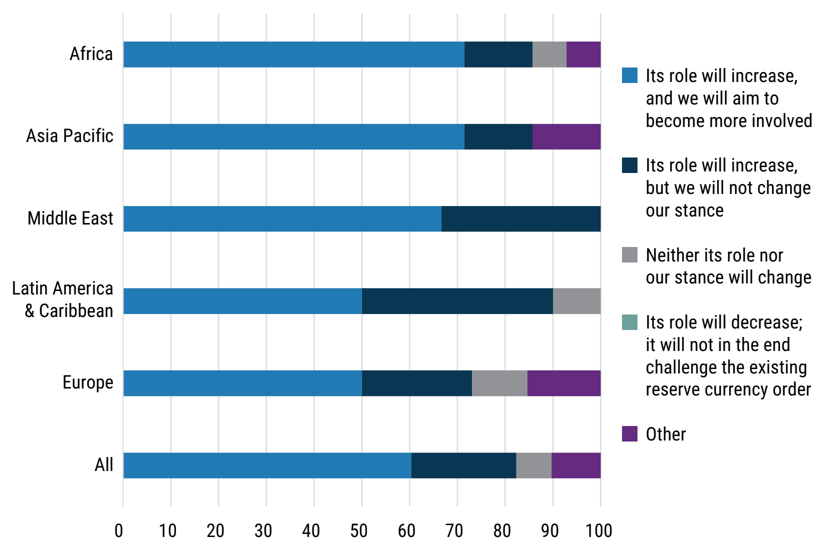
Portfolio allocation to following currencies. Average response, %



Source: OMFIF GPI survey 2022

11. RENMINBI ROLE ANTICIPATED TO INCREASE ACROSS ALL REGIONS

How do you see the role of the renminbi as a reserve currency developing over the next 10 years? How will you respond? Share of respondents, %

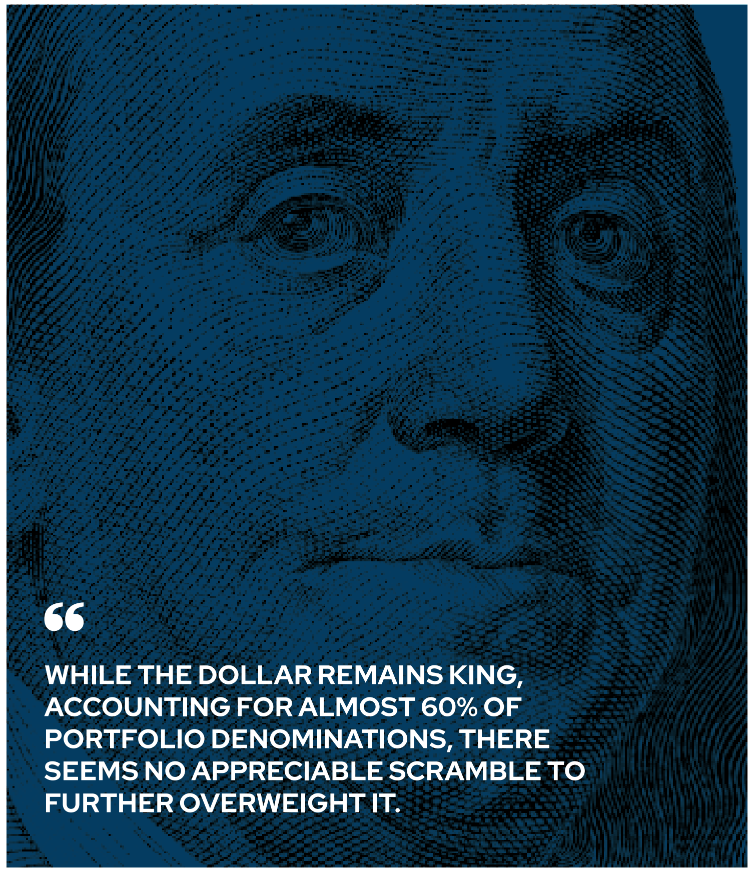


Source: OMFIF GPI survey 2022

Within sovereign debt, those hoping for a strong shift from US to euro area bonds might be disappointed: the survey revealed an anticipated 10% net increase in euro-denominated sovereign debt this year compared with a 15% net increase in dollar-denominated sovereign debt. This is a slight increase in anticipated investment in euro-denominated debt, but interest in dollar debt is still greater than that in euro debt, which was also the case in 2021 (Figure 9).

Second, while the dollar remains king, accounting for almost 60% of portfolio denominations, there seems no appreciable scramble to further overweight it (13% net increase anticipated). This looks true of other traditional 'safe-haven' currencies, such as the Japanese yen (>2% net decrease) and Swiss franc (>2% net increase). Sterling's status is expected to change little (>4% net increase), again accounting for only 2% of respondents' global portfolios (see Chapter 5).

Perhaps more telling is the approximately 30% intended net increase in renminbi exposure from 2021's 2.5% levels. The main driver is belief that the renminbi will assume a greater role as a reserve currency (87%), which looks circular, and thus potentially self-fulfilling. This view extends across regions (Figure 11). For all jurisdictions, the renminbi's attractions are its expected role in world trade (73%) and diversification potential (81%). Offsetting only some of that, geopolitics (71%) and poor market infrastructure (63%) look to be the main impediments to its wider use (see Chapter 5).



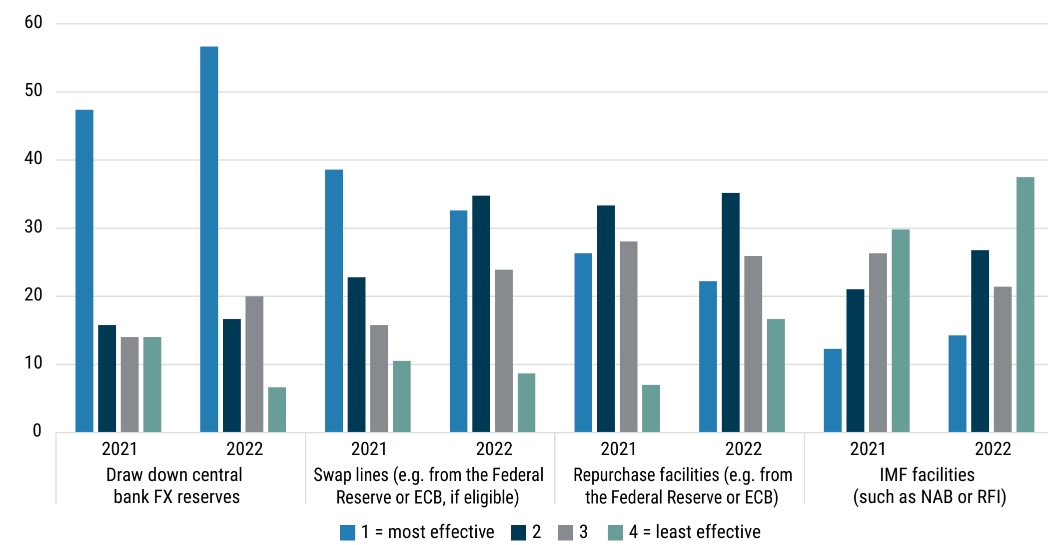
EQUIPPING CENTRAL BANKS FOR FUTURE CRISES

The third and final clue that suggests reserves managers are taking a longer-term approach pertains to the use of – and willingness to deploy – accumulated reserves. Doubtless reflecting previous planning, reserves appear more than sufficient and diversified to address any future currency-led crises.

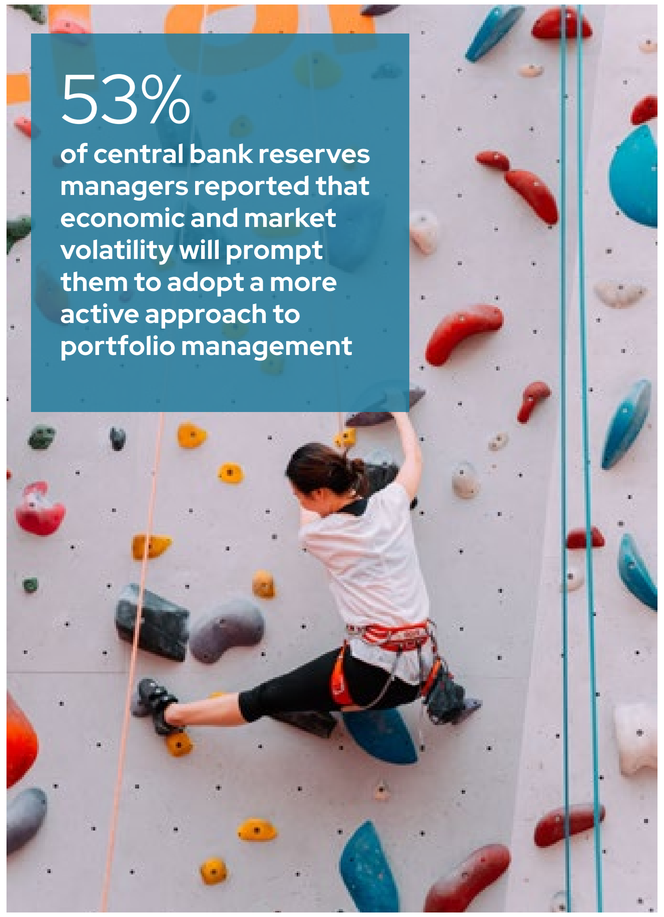
The sufficient accumulation and diversification of reserves is reflected in survey respondents' perception of drawing down reserves as the most effective element of the global financial safety net in a crisis. In contrast, swap lines and repurchase facilities from the Federal Reserve and/or European Central Bank, as well International Monetary Fund facilities, decreased in importance (Figure 12). Perhaps suggesting a reluctance to rely on

12. DRAWING DOWN FOREIGN EXCHANGE RESERVES BECOMING MORE IMPORTANT

Please rank the following elements of the global financial safety net in order of potential effectiveness during a period of stress. Share of respondents, %



Source: OMFIF GPI survey 2021-22



outside assistance or fearing negative signalling effects, 49% of reserves managers reported seeing a case for continued foreign exchange reserves accumulation, even as reserves reached their highest (nominal) levels this year, increasing by 5% from 2021 to total $16.17tn. Only 16% did not see a case for continued accumulation, and 35% remained uncertain.

The share of respondents reporting the possibility of devoting 30% or more of reserves to stave off future crises (35%) is admittedly down on 2021 (59%). Nevertheless, it remains at a high level with fewer fixed currency pegs to have to defend, offering some reassurance about facing economic challenges.

Finally, further evidence of the sufficient diversification and accumulation of reserves is apparent in their other reported uses, such as managing currency ranges and addressing trade imbalances. The majority of central banks' reserves seem sufficient to also be used when required to move into riskier assets, with 71% reporting they deploy their excess reserves to do so (Figure 14). For many, this still leaves open the possibility of devoting 30% or more of reserves to stave off future crises (Figure 13).

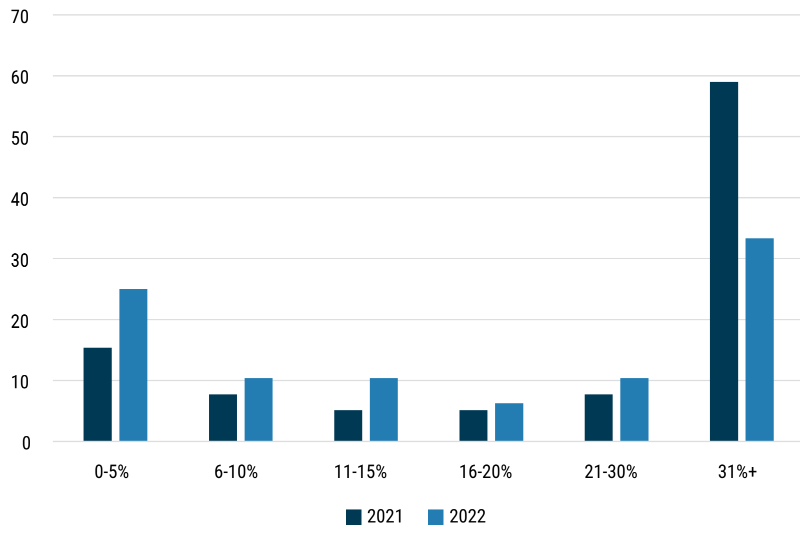
MINOR MOVES AMID MAJOR CHANGES

Overall, reserves appear more than sufficient and diversified to address any future currency-led crises. Gold and equities are still sought, presumably for inflation-cover. Yet, there seems little discernible flight from fixed income (government, quasi government, corporate bonds), nor from traditional risk-on assets (such as sub-investment grade and emerging markets). While many central banks expressed intentions to diversify in the future, developed-market currencies and assets, and particularly the US and dollar, remain most highly favoured.

All this suggests scepticism about underlying economic growth prospects, an easing in yield concerns after global bonds have 'cheapened' and, by moving towards shorter bond maturities, that money markets' rate-tightening expectations may be overdone. •

13. FEWER RESERVES MANAGERS WILLING TO USE GREATER THAN 30% OF RESERVES IN A SHOCK

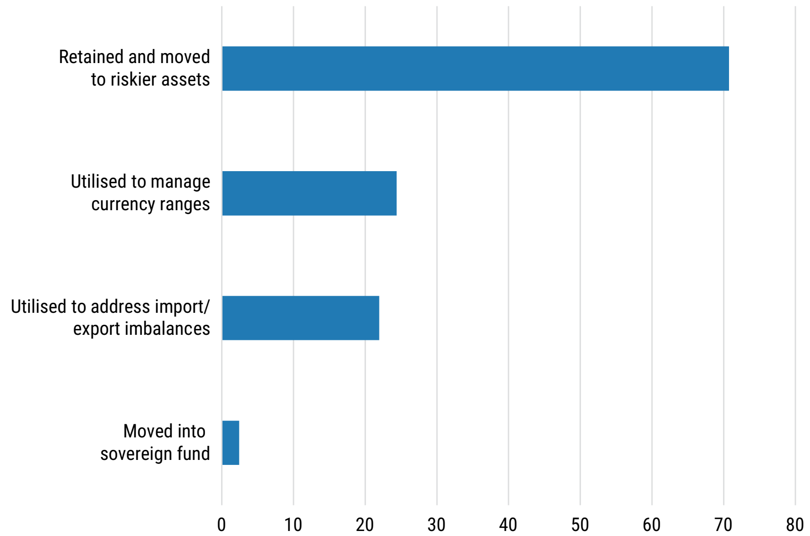
Maximum share reserves managers willing to use in the event of currency crisis. Share of respondents, %



Source: OMFIF GPI survey 2021-22

14. RESERVES ARE BEING DEPLOYED TO MEET OTHER OBJECTIVES

How are excess reserves currently deployed? Please select all that apply. Share of respondents, %



Source: OMFIF GPI survey 2022

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THIS YEAR'S REPORTED PORTFOLIO ALLOCATION AMONG SURVEY RESPONDENTS AVERAGED 9% INVESTMENT IN EMERGING MARKETS VERSUS 90% IN DEVELOPING MARKETS, COMPARED WITH 10% AND 87% RESPECTIVELY IN 2021.