Diversification of Assets and Risks

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Disclaimer: The views expressed in this presentation are my own and not necessarily represent those of the Banco de Portugal or the Eurosystem.
1. The world has changed

2. Central banks are changing

3. Central bank reserve management is adapting to the new times
1. The world has changed
Market environment has changed

- Official interest rates
- Non standard monetary policy
- Yields and Spreads
- Stocks and Oil
- Growth and Inflation
- Geopolitical

Markets
New normal, post-crisis?

Average real GDP growth rates

Average inflation

Central banks’ actions: strong, innovative, unconventional

Official rates

Central banks assets (% of GDP)

Source: Bloomberg
Negative yields became a new (uncharted) reality

2-year Government bond yields

10-year Government bond yields

Source: Bloomberg
Global policy uncertainty index

Geopolitical issues and a sense of uncertainty

Note: Index reflects the number of instances words related to Economics, politics and uncertainty are mentioned in news. Last observation: April 2019
2. Central banks are changing
Change in size and composition of central banks balance sheet

2005

- Source: Banco de Portugal Annual Report

2018

- Assets
  - Gold
  - Reserves
  - Mon. Pol. Credit
  - Mon. Pol. Outright

- Liabilities + Equity
  - Banknotes
  - TARGET

€ 36 Bn

€ 154 Bn
Similar for all central banks?

Similar

- Rise in exposure to sovereign debt
- More attention to asset-liability
- Monetary policy assets overshadow role of investment portfolios
- Restrictions on some investments, for monetary policy reasons

Different

- Return / risk
- Distinct asset-liability concerns
- Euro area central banks, versus countries with autonomous monetary and FX policies
New trends in central bank governance

- More focus on central banks’ independence
- Reinforce accountability and transparency
- Separate and empower Risk Management function
- Risk Committee
- Investment Committee
- Strategic and tactical benchmarks
What distinguishes a central bank from other market participants?

- **Different priorities**
  
  Central banks’ objectives go beyond merely optimizing risk/return trade-off
  
  Monetary policy operations are not return-oriented

- **Risk transfer**

  Central banks must be ready to increase risks for themselves in adverse situations
  
  Acknowledge that some risks are unavoidable
  
  Measure, monitor and report
  
  Build sufficient financial buffers

- **Concerns with signaling effect and power to influence markets**
Attention to reputational risks – focus on communication

- Even small losses can have big reputational impact and affect credibility
- Central banks can no longer pass unnoticed – must lead by example
3. Central bank reserve management is adapting to the new times
“Traditional” assets in central bank foreign reserves

- Foreign Sovereign debt
- FX deposits in highly rated banks
- Gold

Reserve Management
Problems with this “traditional” investment strategy

- Sovereign debt not attractive at current low yields
- Low / negative yields also affect other items on some central banks’ balance sheet

Extreme example: Bunds

Breaking even is difficult in a low or negative yield environment
Possible diversification alternatives in a low yield environment

- ESG bonds
- ETFs
- Equities
- Floating rate notes
- Corporate bonds
- Currency diversification
- Return enhancement
Return enhancement

Synthetic short-term instruments can be created combining different tools and fully-hedged strategies.
Currency diversification

Exploring negative correlations between foreign currencies for a EUR based investor

Correlation between EUR/USD and EUR/JPY
Corporate bonds

...have consistently outperformed Treasury bonds

Source: Bloomberg and BdP calculations.
Floating rate notes

Outperform in rising yields environment

Source: Bloomberg and BdP calculations.
**Equities**

**Negative historical correlation with bonds**

Correlation between stock and bond indices

US-Treasuries and the S&P500

German government bonds and the DAX

Source: Bloomberg and BdP calculations.

Note: 260-working-day rolling correlations of daily index returns. Grey area is a two-sided 5% confidence interval.
Exchange Traded Funds (ETFs)

- Mitigate idiosyncratic risk
- Growing depth and liquidity
- Index replication
- Listed in exchanges

- Fees and transaction costs
- Basis risk

Global AUM historical trends by ETF type ($Bn)

ESG (Environmental, Social and Governance) Bonds

- Increasing issuance in the last years
- Growing interest by institutional investors
- Banco de Portugal became member of the NGFS (Network for Greening the Financial System)

Green bonds outstanding amounts by country
- China
- France
- Supranationals
- Germany
- USA
- Others

Green bonds outstanding amounts by sector
- Financial
- Governmental
- Energy
- Supranational
- Other
Wrap up

- **The world has changed**
  - Post-crisis world is converging to a new normal
  - History has cycles but does not repeat itself in exactly the same way
  - Sense of uncertainty

- **Central banks are changing**
  - Non-standard measures affect central banks’ governance and balance sheet

- **Central bank reserve management is adapting to the new times**
  - Search for sources of return, in a low/negative yield environment
  - Central banks role as agents of change