Macro Monthly

For global professional / qualified / institutional clients and investors and US retail clients and investors. For marketing purposes.

UBS Asset Management | Economic insights and asset class attractiveness
April 2020

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The policy response and its implications

Highlights

- The COVID-19 shock has catalyzed a historic policy response from monetary and fiscal authorities in the US and globally.
- Policymakers have significantly reduced the left tail risk, namely that this economic and health crisis would morph into a financial crisis.
- The Fed in particular has substantially expanded its mandate to support corporate credit markets more broadly, and even purchase equity securities linked to bonds.
- In the near term, investors will have to weigh the severe economic contraction against this policy response, alongside evolving news on the virus and mobility restrictions. This will keep markets volatile over coming weeks.
- Going forward, we believe that the expected returns on risk assets have improved while those on sovereign bonds have worsened.
- Investors must keep an open mind to upside inflation risks in the future, as aggressive stimulus meets supply side constraints.

Our Q1 2020 Macro Quarterly, *'The Next Decade in Asset Allocation,'* discussed how the policy response to the next recession would create a new era for markets. Writing it in December, we certainly did not think the timing of that recession would come so soon. But the policy reaction in a broad sense has come in line with our expectations. With rates near the effective lower bound across developed economies, the commonly used tools of monetary policy on their own would not be enough. We suggested elected officials would need to step up fiscal stimulus and that the lines would blur between where central bank policy ends and fiscal policy begins. In this *Macro Monthly* we discuss the features of the US and global policy response to the COVID-19 recession, near-term implications and some thoughts about how the economy, policy and markets may look when the virus has largely run its course.

COVID-19 and the associated steps to contain its spread have caused what is likely to be the sharpest contraction in economic growth in history. In addition to causing tragic human and direct economic costs, the speed of the shock exposed underlying fragilities in financial markets. These included a banking system, partly due to constraints of post-crisis regulation, reluctant to intermediate the US Treasury Curve, the world's liquid benchmark, discount rate and diversifier. The cost of dollar funding for both domestic and international users spiked, credit markets froze and volatility in major asset classes reached record highs.

The Fed swiftly cut rates to zero, expanded quantitative easing on an unlimited basis to re-liquefy the Treasury Curve and mortgage-backed securities, and opened foreign exchange swap lines to heal dollar funding. These were all vital steps, but it wasn't until partnerships with the fiscal agent, the US Treasury, to provide direct financing to

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Exhibit 1: The Fed's 'alphabet soup' of programs to support the economy and markets

Fed Action	Description	Used in '08
Commercial Paper Funding Facility (CPFF)	– Special purpose vehicle (SPV) will purchase A1/P1 commercial paper and short-term municipal bonds from US issuers through primary dealers – Encourages investors to engage in term lending for CP and supports the flow of credit to businesses and municipalities	X
Primary Dealer Credit Facility (PDCF)	– Provides 90-day loans to primary dealers against broad collateral including IG and CP – Unclogs dealer balance sheets, enhances market function, and facilitates the viability of credit to businesses	X
Money Market Mutual Fund Lending Facility (MMLF)	– Provides loans to banks/broker-dealers against eligible collateral purchased from MMFs, with no capital impact – Eligible collateral was expanded to short-term municipal bonds, municipal VRDNs, and CDs – Enhances liquidity for MMFs and unclogs dealer balance sheets	X
Term Asset-Backed Securities Loan Facility (TALF)	– Creates an SPV to lend against eligible ABS with underlying credit exposures incl. auto loans, student loans, credit card receivables, and certain small business loans – Helps to support the flow of credit to consumers and businesses by improving market conditions for ABS	X
Primary Market Corporate Credit Facility (PMCCF)	– Creates an SPV to purchase bonds, rated at least BBB1/Baa3 and under four years in duration, and provide loans to eligible issuers, US companies headquartered and with material operations in the US – Helps to provide liquidity for new bond and loan issuance	
Secondary Market Corporate Credit Facility (SMCCF)	– Creates an SPV to purchase eligible individual corporate bonds, rated at least BBB1/Baa3 and under five years in duration, as well as corporate bond portfolios in the form of US-listed ETFs, with Investment objective to provide broad exposure to US IG corporate bonds – Helps to provide liquidity for outstanding corporate bonds	
Main Street Business Lending Program	– Creates program to support lending to eligible small-and-medium sized businesses, complementing efforts by SBA. Details to be announced soon	

Source: Federal Reserve Bank of New York, Bank of America, UBS Asset Management as of 30 March 2020.

corporations, that risk assets began to stabilize. The Fed and Treasury brought back some of the 2008-2009 'alphabet soup' of programs, supporting commercial paper and consumer ABS markets. But they also introduced new facilities to purchase corporate bonds in primary and secondary markets, including notably the purchase of ETFs tied to corporate bonds, a direct intervention of US policymakers into the stock exchange. Last but certainly not least, the Fed and Treasury announced new programs to provide lending to small- and medium-sized businesses.

In the meantime, the US Congress also acted quite swiftly relative to its history to pass the CARES Act, a USD 2.2 trillion (~10% of GDP) headline stimulus bill. A large share was allocated to industry relief, including USD 450 bn in capital for the Treasury to back the programs listed above, which can be levered 10 to 1 by the Fed. More broadly, the bill's purpose is to at least partially restore lost incomes for individuals, keep workers tied to employers, and prevent larger numbers of bankruptcies. Reports suggest congressional leaders see this as just one of several large stimulus packages to come.

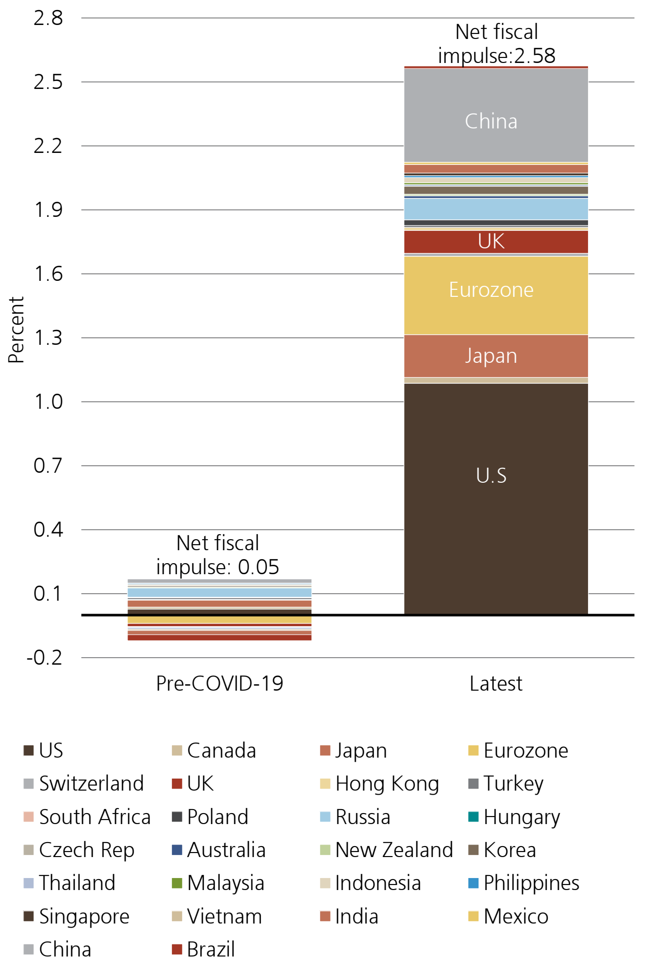
Exhibit 2: The CARES Act in brief

Relief target	Size (Billions USD)	Purpose and breakdown
Industry relief	529	– USD 454Bn for Fed facility risk capital. Can be levered USD 4.5Trn – USD 50Bn in loans and grants for airlines, USD 8Bn airline cargo, USD 17Bn for national security industries
Small business assistance	377	Loans that become grants if employers pay workers, utilities, rent
Payroll relief	300	Employers can defer 2020 payroll taxes for up to 2 years
Individual checks	300	USD 1,200 per individual, USD 2,400 per couple and USD 500 per child for individual incomes under 75k. Phases out after that
Unemployment insurance benefit	250+	Increase of USD 600 per week benefit, expanded availability
Additional funding for state and local governments and hospitals	~250	Includes USD 150Bn for state/local. USD 100Bn for hospitals

Source: US Congress, UBS Asset Management as of 30 March 2020.

Policymakers around the world are delivering robust policies to defend against the COVID-19 shock. China has stepped up infrastructure investment and introduced tax cuts. In Europe, the European Central Bank (ECB) has significantly expanded quantitative easing to stem the widening of Italian debt spreads to bunds. While joint bond issuance has not yet gone ahead, budget rules have been relaxed on a national level and Germany, long reluctant to engage in fiscal stimulus, has broken from constitutional rules that prevented deficit spending. Countries like Germany, France and the UK have stepped in to guarantee business survival and employee wages. Overall, the net global fiscal stimulus as a percent of GDP already surpasses that of 2008-2009.

Exhibit 3: Contributions to change in global fiscal impulse



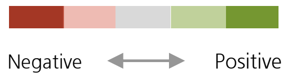
Source: UBS Investment Bank, data as of 30 March 2020.

In our view the global monetary and fiscal response will be enough to prevent a health and economic crisis from turning into a financial one. Indeed, while we are enduring an unprecedentedly sharp contraction, this may end up being the shortest recession in history assuming economies can come back online over the coming months. Still, as impressive as the monetary and fiscal response to this crisis has been, the only true 'bazooka' is a healthcare breakthrough. Progress towards widely available therapeutics and eventually a vaccine seem the most dependable 'solutions' to normalize consumer and business behavior and establish a more solid foundation for risk assets. We expect to hear progress on potential anti-viral medications by late April while a broadly available vaccine still appears over a year away.

As such we continue to expect volatile markets as investors grapple with the virus's evolution, the duration of social distancing policies and the speed at which macro policies announced gain traction. How these factors evolve will help determine whether the ultimate recovery in the economy and markets is V, U, or L shaped. At this point, given the sharp increase in unemployment expected in the US, a true V-shape looks unlikely and we expect finding a durable bottom in risk assets will be a process rather than a distinct event.

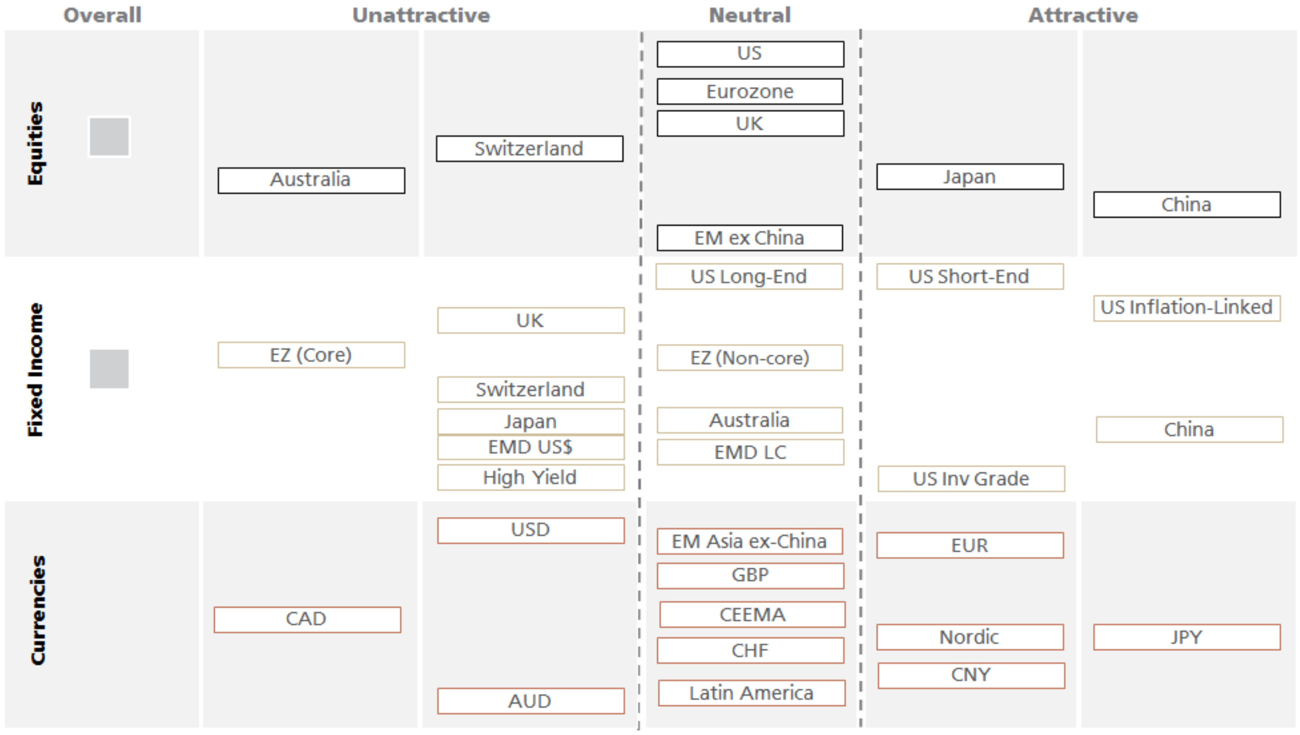
Given the wide range of possibilities in this environment, we are keeping overall risk asset exposure near benchmark. Our focus continues to be on relative value, overweighting equity markets in Asia, which appear to have seen the worst of the virus as compared to developed markets including the US, where the battle is still in early stages. In fixed income, we are long real yields as protection against further deterioration in risk appetite and as central banks do whatever is needed to ease financial conditions. In foreign exchange we are underweight the USD against reserve currencies EUR and JPY as dollar funding stresses ease and underlying vulnerabilities in the US economy become apparent. Indeed, relatively less flexible labor markets in Europe and other regions can be a blessing in disguise during a crisis, ensuring workers and businesses remain tied together and geared for the rebound once the virus is contained.

We of course also remain focused on the longer-term risk-return profile for asset classes beyond the current period of elevated volatility. With the recent selloff, valuations for risk assets have broadly improved and may provide opportunities for long-term investors. At the same time, the prospective returns for sovereign bonds have worsened. As discussed in 'The Next Decade in Asset Allocation,' investors must recognize that with policy rates near their effective lower bound and fiscal policy becoming a more important driver, that the equity-bond correlation can become less negative. While the first-order effects of the COVID-19 shock as well as the sharp oil price decline are disinflationary, investors should be prepared for a surprise in inflation down the road, as aggressive monetary-fiscal policy meets potential supply side constraints. We reiterate the importance of diversifying portfolios broadly against a variety of macroeconomic outcomes, including exposure to real assets and absolute return.



Asset class attractiveness

The chart below shows the views of our Macro Asset Allocation Strategy team on overall asset class attractiveness, as well as the relative attractiveness within equities, fixed income and currencies, as of 30 March 2020.



Source: UBS Asset Management Investment Solutions Macro Asset Allocation Strategy team as at 30 March 2020. Views, provided on the basis of a 3-12 month investment horizon, are not necessarily reflective of actual portfolio positioning and are subject to change.

Negative ⟷ Positive

Asset Class	Overall signal	UBS Asset Management's viewpoint
Global Equities		– COVID-19's morphing into a global pandemic and the associated steps to contain it will continue to make equities volatile in the near term. These developments are being met with a historically powerful monetary and fiscal policy response, but uncertainties on the duration of social distancing policies leaves an open question of how much is enough to cushion the economy. We therefore remain focused on relative value opportunities within equities amid the market dislocation, rather than directional risk. Further out, improvements in valuations should make equities more attractive for longer-term investors.
US Equities		– US equities trade at a premium relative to other markets due in part to an economy with still solid foundations and a lower exposure to global growth factors. Their more defensive sector decomposition should be a positive attribute during uncertain times but domestic political uncertainty is set to grow. While fears about Bernie Sanders progressive agenda have dissipated, headlines around the 2020 US presidential election and potentially major changes in US economic policy will likely still prompt bouts of volatility. With COVID-19 spreading across the US, there are meaningful threats to growth in the short term. The USD 2.2tn bill passed should provide some near term economic support but more is likely to be necessary to offset the hit to activity. Nevertheless, the quick action, potential for additional stimulus once the situation has improved and recent Fed actions has reduced left-tail risk.
Ex-US Developed market Equities		– With COVID-19 spreading globally our conviction in the potential outperformance of ex-US stocks has diminished. Valuations may be attractive in a long-term context, but Europe and Japan are both more trade dependent and cyclical. Like the US, we expect monetary policy support in both regions but the short-term effectiveness of such stimulus in the face of COVID-19 is still uncertain. Major fiscal stimulus would be a more significant catalyst to a growth rebound and there are steps in the right direction, but the process may be slower than in other regions. – To date, Japan has been able to manage the spread of the virus more effectively than Europe. Moreover, a much more effectively monetary, fiscal and regulatory response, combined with more attractive valuations, suggest a preference for Japanese vs. European equities.
Emerging Markets (EM) Equities		– The stabilization of growth in China that we expect is likely to be positive for wider emerging markets. But we believe it is clearly more positive for emerging Asia (ex-Japan), where COVID-19 is closer to its peak, than Latin America. We believe that Korea, Hong Kong and China (see below) are the markets that have the most fiscal headroom and they have already announced using fiscal stimulus to mitigate against the risks to growth. These markets were also among the first to selloff due to COVID-19 and first to experience risk asset deterioration.
China Equities		– Ironically, China stands as somewhat of a regional equity safe haven from broader global COVID-19 concerns. Notwithstanding short-term risks to reported earnings from reduced intra-Asia tourism and consumption, we remain positive on China as policy measures continue to cushion the economy. The Chinese authorities have shown themselves willing and able to provide additional monetary, fiscal and regulatory support to help smooth the rebalancing of the Chinese economy amid ongoing developments. International capital should increasingly flow into Chinese assets following the inclusion of onshore Chinese equities in MSCI's widely followed EM equity indices.
Global Duration		– Given the COVID-19-induced slowdown global duration continues to play an important role in hedging downside risks. With the breakdown of OPEC+ talks and concerns about US corporate debt the slowdown is likely to be more severe than we originally thought. With monetary policy likely to remain loose even in the face of improving data, we see developed world nominal yield curves steepening. The combination of downside protection and aggressive monetary and fiscal stimulus makes inflation-linked bonds particularly attractive.

Negative ⟷ Positive

Asset Class	Overall signal	UBS Asset Management's viewpoint
US Bonds		– U.S. Treasuries will remain the world's primary safe haven amid downside risks to growth. The Fed's dramatic increase in quantitative easing will likely keep yields low even amidst higher government bond issuance. Over time we do expect the yield curve to steepen further as future growth and inflation prospects improve.
Ex-US Developed-market Bonds		– In aggregate, we see ex-US developed market sovereign bonds as unattractive. The ECB and Bank of Japan have committed to low rates for some time, limiting attractiveness of these markets. The ECB's expansion of QE should keep yields low, but we are watching BTP-bund spreads closely given a not fully coordinated fiscal backstop.
US Investment Grade (IG) Corporate Debt		– The Fed's decision to support IG credit markets provides an important backstop for the asset class. It will nevertheless take time to set up such a facility while fallen angel and default risks remain. Still, in an environment of low sovereign yields we find corporate bonds attractive.
US High Yield Bonds		– The oil price collapse and damage to travel and leisure sectors from COVID-19 risks further deterioration to the broader HY complex. Despite sharp widening of credit spreads, we do not see credit as yet pricing in a full default cycle which is more than possible given heightened recession risks. We are cautious on credit as well due to underlying liquidity concerns in the market, fallen angel risk and the lack of a Fed backstop for this market as of writing.
Emerging Markets Debt US dollar Local currency		– Given the COVID-19-induced slowdown, the breakdown of OPEC+ talks, and concerns about US corporate debt the slowdown is likely to be more severe than we originally thought. Elevated risk aversion tends to spread to EM assets as well and EM local and hard currency debt are no exception. For now we are cautious on emerging markets though valuations are approaching attractive levels once the global economy stabilizes.
Chinese Bonds		– Chinese bonds have the highest nominal yields among the 10 largest fixed income markets globally and have delivered the highest risk-adjusted returns of this group over the last 5 and 10 years. We believe that slowing economic growth, and inclusions to global bond market indices should continue to push yields down during the next 3-12 months.
Currency		– The COVID-19 pandemic has introduced meaningful downside risks to global growth. The negative commodity demand shock which this injected has been exacerbated by a crude oil supply shock from Saudi Arabia. Thus, cyclical and commodity-sensitive currencies face significant headwinds in this environment, with external financing demands driving idiosyncratic performance. The aggressive fiscal and monetary policy response in the US should cause the USD to weaken from its overvalued perch, but in the near term, financial stress may keep reserve and safe haven currencies bid. Elsewhere, China's strict quarantine measures and demand stimulus should serve as tailwinds for the CNY as well as regional economies supplying Chinese domestic demand.

Source: UBS Asset Management. As of 30 March 2020. Views, provided on the basis of a 3-12 month investment horizon, are not necessarily reflective of actual portfolio positioning and are subject to change.

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