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
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Evan Brown
Head of Multi-Asset Strategy,
Investment Solutions

Max Luo
Director,
Investment Solutions

Stefan Sabo
Director,
Investment Solutions

Juha Seppala
Director,
Investment Solutions

Benjamin Suess
Director,
Investment Solutions

Joe McDonough
Investment Solutions

Reopen vs. reactivate: Lessons from China's experience

Highlights

– Investors must focus not just on when economies are set to reopen, but when and how consumers and businesses will feel safe resuming normal activities.
– We examine the experience in China, where discretionary consumption is recovering slowly as individuals change behaviors to reduce risk of infection.
– Developed economies are likely to face more difficulty normalizing than China or other North Asian countries, as there may be less individual acceptance of tracing and surveillance.
– We suspect the outlook for risk assets will become more challenging from here, as investors must price in greater uncertainty and solvency risks on the recovery path.
– Regionally, we prefer North Asian equities and credit given advantages in containing the virus.

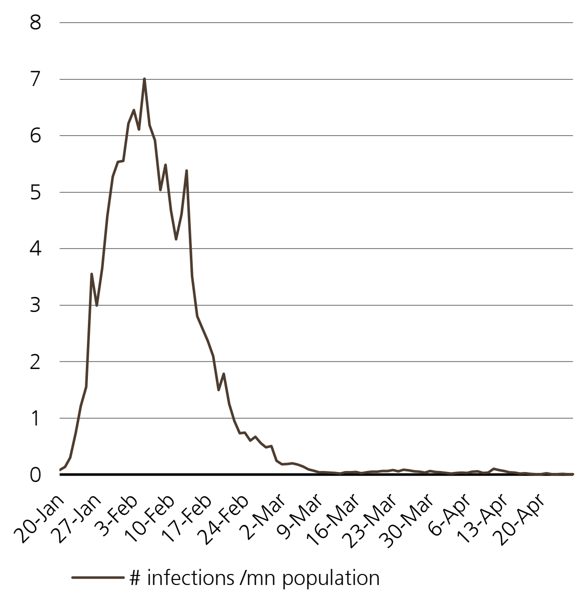
Across the world, investors and non-investors alike are focused on when and how economies will 'reopen,' after COVID-19 related shutdowns. But just as important, if not more so, is when will economies 'reactivate?' In other words, when and how do consumers feel safe enough to resume normal spending behaviors? When will businesses feel they have created a safe enough environment to bring back workers and resume pre-crisis levels of production? It is well understood that a widely available vaccine is still several quarters away. It is also broadly agreed that a reduction in social distancing policies risks second waves of infections and potentially renewed shutdowns. Therefore, in addition to the tendency for consumers and businesses to be cautious in the aftermath of a recession, we have to monitor behavioral changes based on lingering fears of further virus spread.

In attempting to examine potential post-virus behavioral changes, we think it most useful to look at China as a leading indicator for Europe and the US. China is a useful barometer given it is a country that experienced a severe bout of the virus but is now roughly two months into its 'reopening.' There are of course major differences across countries, given varying levels of severity of the virus, significant variation in public health infrastructure including testing and contact tracing, diverse macro policy responses, unique reopening strategies along with political and cultural differences. So we have to be cautious in drawing definitive conclusions from China's experience for western democracies. Still, we'd argue that the basic contours of human behavior are the same across regions, and that Chinese consumer and business behaviors post-reopening can provide important clues as to how things will look in the west.

China's reopening

China's strategy for containing the virus involved a nearly two-month-long lockdown of Hubei, the epicenter of the COVID-19 outbreak in China, which ended on March 25. Outside Hubei, Chinese local officials began opening up their economies two to three weeks after the extended Chinese New Year's holiday ended on February 3. The real catalyst came during the February 21 Politburo meeting, where the central government pushed hard for work resumption while remaining committed to containing any second waves. This required a strong contact tracing system, surveillance, temperature checking and some travel quarantining requirements. As an example, China mandates that individuals have barcodes on their phones signaling their relative health risk to others before accessing public transportation or entering buildings. Potentially contagious individuals face a mandated quarantine if they are deemed high risk to others. While there have been small outbreaks of the virus in particular localities, most seem to be imported from other countries. In response, China has sharply reduced international travel and mandated strict quarantine guidelines for incoming travelers.

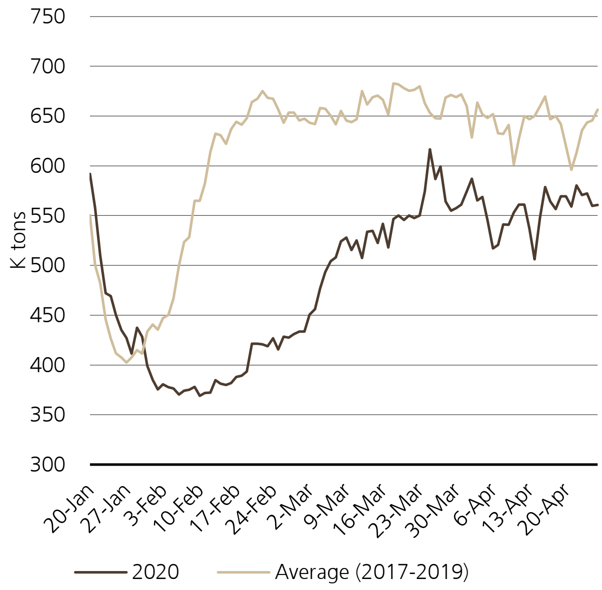
Exhibit 1: Daily new infections/million pop. in China



Source: Wind, UBS Asset Management, data as of 20 April 2020. Note: The spike on Feb 12 was a result of changing guidelines for identifying infections. The number was a one-off adjustment with cumulative cases as of Feb. 12. In order to smooth the curve, we made an assumption that the actual number of infections on Feb. 12 was the average of those for Feb. 11 and Feb. 13. We then distributed the additional throughout the earlier days between Jan. 20 and Feb. 11 in proportion to the numbers reported each day.

Given the challenge of reopening the economy while making sure the virus is contained, the slope of economic activity was inevitably flat at the very beginning and gradually moved higher as the government and the public gained more confidence in health conditions. The signs of an acceleration of daily activities as measured in coal consumption, property sales and city traffic congestion levels are visible around late February and early March, following the aforementioned Politburo meeting on February 21. But two months in, current levels of activity are still somewhat subdued from previous years.

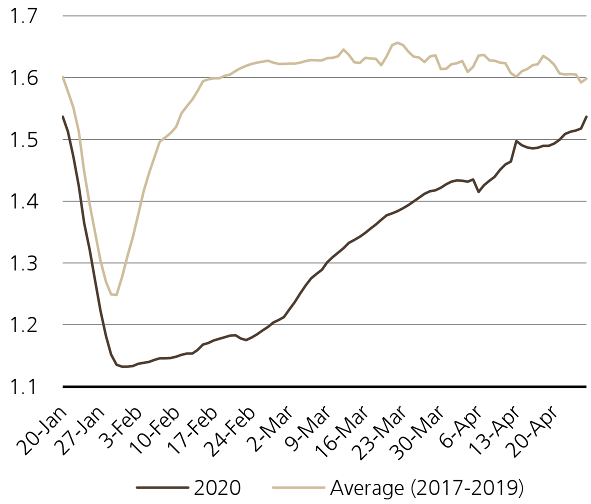
Exhibit 2: Coal consumption of 6 largest power groups



Source: Wind, UBS Asset Management, data as of 20 April 2020.

Our colleagues in China do note a change in much of the public's daily routines. Ridership of city public transport has remained far below pre-outbreak levels, with many preferring to drive to work. Indeed, city traffic congestion has almost returned to pre-outbreak levels, and during peak hours is particularly congested. But the length of such peak hours has shrunk, as individuals choose to return home from city centers as opposed to staying out for leisure purposes.

Exhibit 3: 100-city traffic congestion index (7-day ma)



Source: Gaode Traffic Congestion Index, UBS Investment Bank, data as of 20 April 2020.

Exhibit 4: Chinese consumption demand recovery lags supply

Sector	Operating capacity vs. normal levels End-March (%)	End-April (%)	Estimated date of normalization	Demand vs. normal levels End-March (%)	End-April (Est.) (%)	Estimated date of normalization
Infrastructure construction	90	100	Mid to late April	95	100	Apr
Property construction	85	100	Mid to late April	70	80	Mid-May
Property sales	90	100	Mid-Apr	70	90	Mid-May
Auto sales at dealers	90	100	Mid-Apr	60	80	Beyond 2020
Airlines	70-75	90	June-Aug.	28	35-40	June-Aug
Rail	95	100	Early April	32	50	June
Shopping malls	100	100	End-Mar	60	70	Oct.
In-store services (such as beauty salons, massage services, etc.)	60-70	70-75	2nd half	~30	40-50	2nd half
Restaurants	80-90	90-95	End-June	30-50	50-80	End-June
Food delivery	100	100	End-March	75	90	May
Hotels	90	100	End-Apr./early May	40	70	End-June/Early Jul
Tourism	25	60	Jul	25	40	Oct
Cinema	0	5	Jul	0	1	Oct
Medical services	~80	90	Late-May	70	80	Late-May
Offline education*	0	10	Late-May/June	90-100	90-100	Mar
Total	**75-85**	**85-95**	**Late-May/June**	**50-55**	**60-65**	**3rd Q 2020**

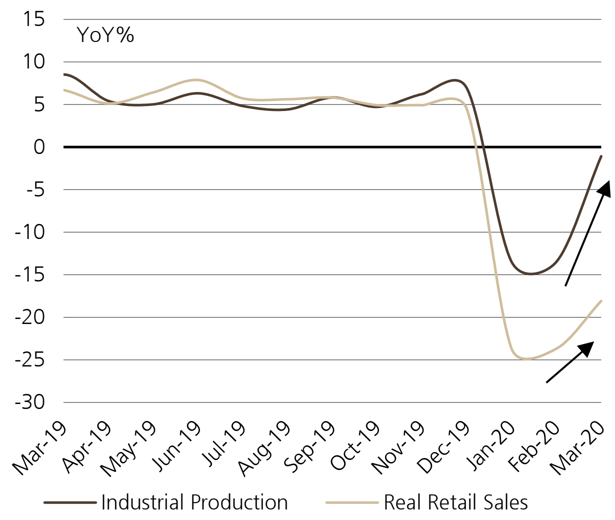
Color key: 0-19% in **red**, 20-39% in pink, 40-59% in orange 60-79% in yellow, 90-94% in light green, 95-100 in **dark green**.

Source: Morgan Stanley Research, 27 April 2020.
*The education demand has reached 90%-100% as most schools have shifted to provide online courses.

Indeed, while China has largely returned to work, the country has yet to return to spending in earnest. Overall discretionary consumption was down 20% from last year.[1] To be sure, much of this is due to the decline in real disposable income by 3.9% YoY in 1Q, the sharpest fall since data became available in 2002, as well as uncertainty about the future. But there is also a general desire to avoid crowds which has led to a slow recovery in discretionary spending. Shopping malls are open but are much less populated as people have chosen to avoid gathering. Dining out at restaurants is still a fraction of what it was pre-pandemic as is spending on in-store services like beauty salons. There has been a move away from offline towards online spending, with the former down 13%YoY and the latter up 11%YoY in March, according to official data. These fail to offset though because offline consumption is still roughly three-fourths of consumer spending. Exhibit 4 displays current and predicted activity levels across various areas of the economy, showing that while the supply side is mostly up and running, various areas of demand will take longer to normalize.

A recent paper from the National University of Singapore[2] has used high frequency data to track offline spending in China. The authors find that consumption patterns show a strong negative relationship to the severity of the health crisis, even accounting for distancing and mobility restrictions. Specifically, when the one-day lagged number of new cases rises, day-to-day consumption declines, and vice versa. This includes data in the first half of April, when most mobility restrictions had been relaxed and concerns grew over potential second waves of infections (either from imported or asymptomatic cases, which the government started to report at the beginning of April). The authors attribute much of the decline in consumption to uncertainty around the disease itself, suggesting that the more that can be done to manage the public health crisis and make people feel safe, the more genuine a recovery in normal consumption behavior will occur.

Exhibit 5: Supply outpacing domestic demand in China



Source: NBS, UBS Asset Management, data as of 31 March 2020.

[1] National Bureau of Statistics, Wind. As of 31 March 2020.
[2] The Impact of the COVID-19 Pandemic on Consumption: Learning from High Frequency Transaction Data. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3568574&download=yes

Early lessons from China's experience

China's approximately two-month re-opening process offers some guidance on what developed economies should expect. One takeaway is that there will likely be a very hesitant and gradual recovery in developed economies. Just because a business has reopened, it does not mean consumers will flock to it if they generally want to stay out of crowded places. A related and logical conclusion is that the safer people feel, whether that is due to low case growth nearby or trust in the public health infrastructure, the more likely they are to resume semi-normal activities.

There are of course reasons to expect a less successful return to normal in developed economies than China's experience. The US and Europe have undergone much more severe outbreaks and longer plateaus of new case growth before declining. While contact tracing and surveillance tools are in development, participation is likely to be voluntary as opposed to mandatory in most situations. And unemployment rates, in the US in particular, are skyrocketing relative to China's. This means a slower reunion of workers and employers as well as a more cautious consumer.

Market implications

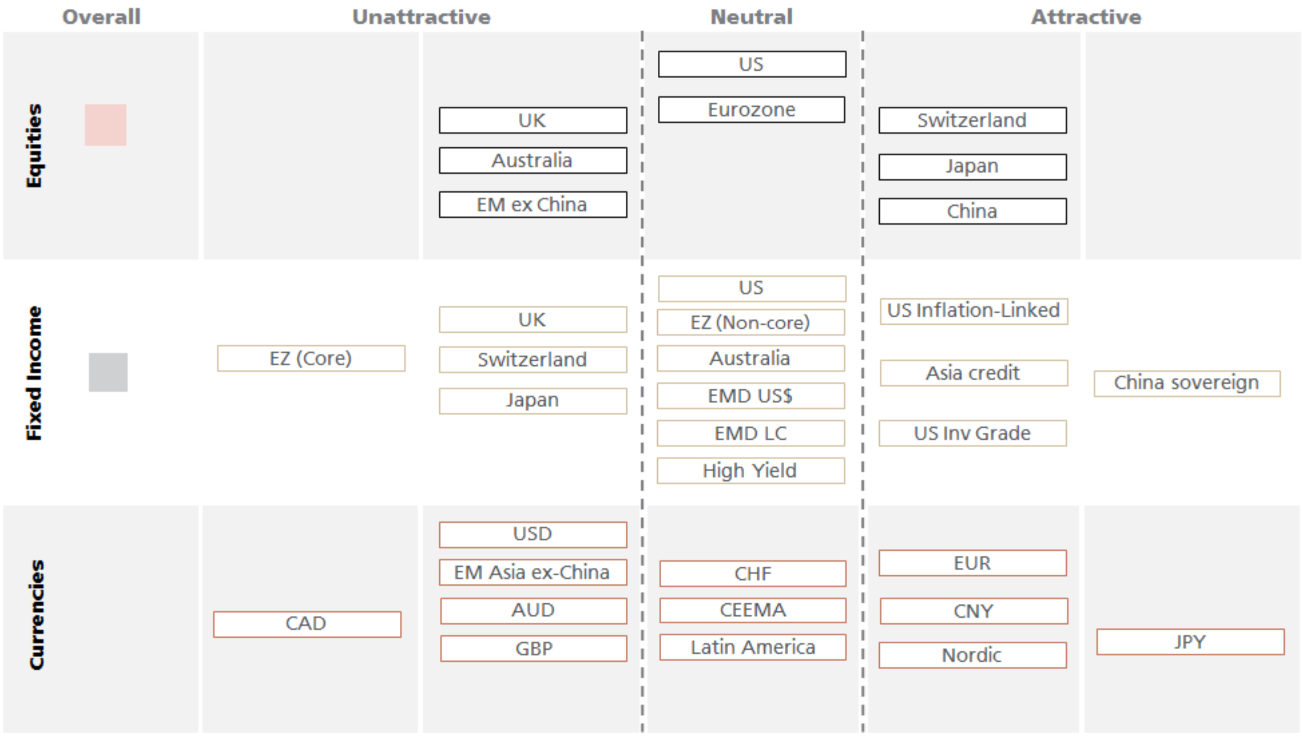
The above suggests caution is warranted on risk assets as global equity markets appear to be pricing in a swifter recovery with more certainty than is likely, given China's experience and differences from western economies. The S&P 500 is only down about 10% for 2020 which is quite remarkable given the sharp decline in the growth outlook and lofty valuations entering the year. As discussed in the April *Macro Monthly*, we have tremendous respect for the power of coordinated monetary and fiscal policy in providing a bridge through what will be a bumpy road for developed economies. But we would argue that policy support is largely priced in, and that current valuations do not adequately embed the meaningful uncertainty around growth and earnings over coming quarters and years. Indeed, while policymakers have helped provide liquidity where needed, they have not erased solvency risk. Credit and equity performance is likely to be more sideways as markets grapple with the risks of a much more difficult road to recovery, including potential for second waves of COVID-19. We have moved tactically underweight global equities after the recent rally.

Within equity markets, the rebound has been driven by defensives and growth stocks – which is not part of the typical recovery playbook but understandable given the prolonged uncertainties we face. Valuation spreads between cyclicals and defensives are at extremes and will eventually snap back. We would expect this to occur in anticipation of a normalization in global spending patterns – which may require greater visibility on a vaccine. For now we favor a moderately defensive equity allocation which should include sectors that are less impacted from lockdowns such as communication services or health care in the current environment. As the road to recovery becomes clearer, we would expect the most sold-off sectors (e.g., automobiles, banks, energy) to bottom from an absolute point of view given they trade at deep recession prices and should eventually recover. Therefore, for investors with a longer time horizon and ample risk tolerance we believe that buying into those sectors on dips is likely to pay off.

We prefer China and other North Asia economies over their EM counterparts as the former have shown greater ability to manage the health crisis and control the outbreak. At the same time, countries like Korea, Taiwan and China are less vulnerable from an external financing point of view and have more room for policy action. We are expressing this view across equities and fixed income, the latter reflected in a preference for Asian high yield relative to broader emerging market debt. Over time, we expect the overvalued USD to weaken and gold to rally given extraordinary monetary and fiscal stimulus in the US.

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 April 2020.



Source: UBS Asset Management Investment Solutions Macro Asset Allocation Strategy team as at 30 April 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		– Global equities appear to be pricing in a quicker normalization of economic activity than we expect. The COVID-19 pandemic, associated steps to contain it and likely consumer and behavioral changes should make the recovery slow and bumpy. While these developments are being met with a historically powerful monetary and fiscal policy response, earnings, solvency and broader economic risks have not disappeared. We are modestly underweight global equities and remain focused on relative value opportunities amid the market dislocation.
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. The US equity market's 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 significant changes in US economic policy will likely still prompt bouts of volatility starting this summer. With COVID-19 still lingering across the US and labor markets experiencing an unprecedented shock, there are meaningful threats to growth in the medium term. Nevertheless, the quick action, potential for additional stimulus once the situation has improved and recent Fed actions have reduced left-tail risk.
Ex-US Developed market Equities		– A delayed and bumpy recovery from the COVID-19 shock means that more cyclical and trade-sensitive equity markets will likely fail to outperform at least in the near term, despite more attractive long-term valuations. Individual countries have responded with significant fiscal stimulus relative to history, but the European-wide fiscal response is weak relative to other regions. – To date, Japan has been able to contain the spread of the virus more effectively than Europe. Moreover, a more forceful and coordinated 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 North Asia (ex Japan), where COVID-19 has been largely contained, than in Latin America for example. Korea, Hong Kong and China are markets that have less external vulnerability and more fiscal headroom to deliver an effective response to the growth shock. Moreover, these economies were the first to experience the COVID-19 shock while other emerging markets around the world are only now grappling with the virus, in some cases with much worse public health infrastructure.
China Equities		– Perhaps ironically, China stands as somewhat of a regional equity safe haven from broader global COVID-19 concerns even having been the original country to face the virus. 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		– While yields are much lower than historically, global duration continues to play a role in hedging downside risks to equities and corporate bonds. The economic outlook has an unusually high degree of uncertainty, and investors will need to continue to hold safe sovereign debt to protect against further deterioration. In our base case, continued loose monetary and fiscal policy even in the face of improving data will 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		– US Treasuries will remain the world's primary safe haven amid downside risks to growth. The Fed's dramatic increase in quantitative easing will keep yields low even amidst higher government bond issuance, but we do not expect a significant rally anymore. 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 BoJ 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. Moreover, the decision to continue purchasing bonds that are downgraded below IG, so called fallen angels, should limit spread widening in IG. 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. However, credit is much closer now to pricing in a full default cycle which is likely amidst the current recession. Implicit support by the Fed in terms of HY ETF purchases, even if limited, warrants moving HY to neutral from underweight.
Emerging Markets Debt US dollar Local currency		– Given the COVID-19 induced global recession, the oil collapse, and still elevated dollar there clearly are risks to EM debt. However, investors are now much more if not fully compensated for these risks. Given the amount of global uncertainty about the economic performance and virus development, we recommend a neutral stance at this point. – We particularly favor Asian credit relative to rest of emerging markets given better infrastructure in controlling the COVID-19 shock and greater policy freedom to support their economies.
Chinese Bonds		– Chinese government 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.

Source: UBS Asset Management. As of 30 April 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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