

COVID-19 update: Impact on Sovereign Investors

UBS Asset Management | **Global Sovereign Markets—views from our team**

Since the start of the COVID-19 pandemic, the Global Sovereign Markets - Strategy & Advice team has published frequent notes for Sovereign Investors to guide them through these times of uncertainty. In that process, we have used a number of signposts we believe investors should look for to trigger portfolio actions, primarily:

1. The **spread** and control **of the virus** across regions and countries and where we stand in terms of **vaccination rates and distribution**;
2. The **policy response** and execution to alleviate the impact on economies and markets;
3. The **market response** and the implications for **sovereign investors**.

We will continue with this approach by analyzing how far we have come with the different measures and what we have learned. We will also analyze what other signposts might be relevant going forward.

Spread of the virus and current status of global vaccination efforts

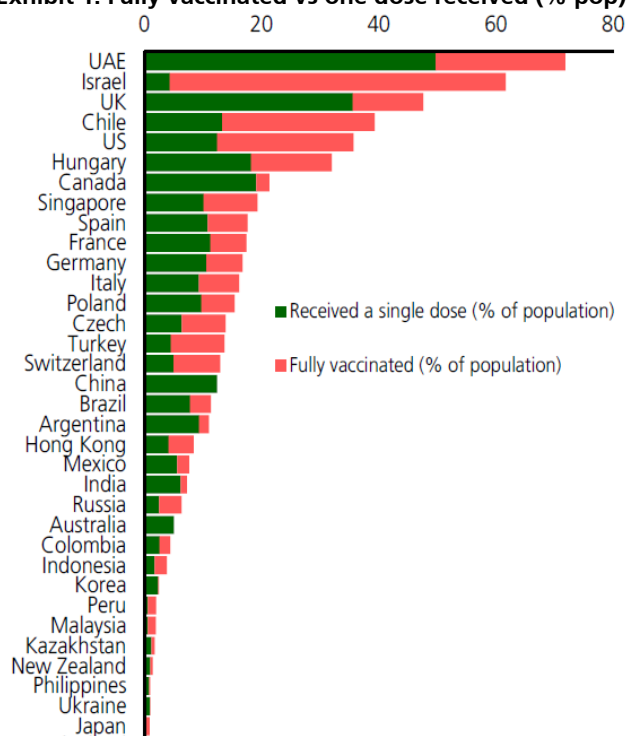
The Coronavirus spread has proven to be more unpredictable and less linear than one would have hoped at the onset of the pandemic. In addition, the ongoing spread of **new, highly transmissible** COVID-19 variants which may have the ability to partially defeat the immune response in people that already have antibodies or are vaccinated has triggered **widespread lockdowns** across Europe which are still ongoing. The spread of mutated strains has also led to additional travel restrictions and border shutdowns and various countries have still effectively shut down their borders to anyone who hasn't tested negative.

While the availability of rapid tests and more testing capacity globally might play a role in the increase in reported case numbers, last week saw the **highest number of reported cases** (5.2mn) than at any time during the pandemic. In Japan, the press reports that Osaka is set to seek a state of emergency. In Canada, the province of Ontario has expanded stay-at-home orders. India is in the middle of a deadly second wave and New Delhi imposed a week-long lockdown on

Monday as cases soared again. The country is seeing a record number of cases (about 250,000 per day) and has been put on the "red list" for travel by the UK.

Currently, the most relevant signpost is the **pace of vaccinations**; while large differences between countries and regions still exist, Europe was able to catch up significantly over the past weeks.

Exhibit 1: Fully vaccinated vs one dose received (% pop)



Source: Our World in Data, UBS, as of April 16th, 2021.

The **US** is still accelerating its vaccine rollout with almost 40% of the population having received at least one dose. More than 3.3 million vaccine doses are administered on average per day. While the country currently reports only about 700 deaths per day on average, the lowest number since last October, case numbers and hospitalizations have shown an upward trend. In total, the US is now averaging slightly over 70 000

cases per day, up 16 000 per day compared with a month ago. Pockets of rising infections exist for example in Ohio and Wisconsin, where cases have climbed by the most in nearly a month and two months, respectively. Michigan seems to be the most affected state overall as it accounts for more than 10% of the country's daily cases.

In the **UK**, the opening of pubs was a milestone, but only affected the outside area of restaurants. The country is benefitting from severe restrictions that lasted for months while at the same time a successful vaccination campaign that focused on everyone receiving at least one shot was executed. Almost 50% of people have received at least a first dose, while this number for the EU currently stands at about 15%.

In **Europe** ex-UK, vaccination rates have improved significantly over the past weeks. UBS estimates that while the EU27 a month ago was on track to vaccinate only 40% of its population with a full dose by year-end, the vaccination pace had increased to 51% by last week and this week it has jumped to 75%. This means that the EU27 is now vaccinating at about the same pace of the US in mid-February and on track to hit its September target to inoculate 70% of the adult population or 57% of its total population by year-end.

UBS estimates that the largest improvement in vaccination rates globally last week was in **Germany** which started to allow GPs to vaccinate people. Another reason for the increase in European vaccination rates was that several European countries are becoming less strict with the prioritization by groups. **France**, for instance, has opened up for everyone aged 55+ and widened the gap between the 1st and 2nd dose for Pfizer/Moderna. In **Spain** the ratio of administered vs delivered vaccines rose from 78.6% to 84.1% over the last week.

Short-term, there were however **setbacks** coming from AstraZeneca with cases of blood clotting emerging in some countries. Some European states have suspended the use of this vaccine and Denmark has been the first country to ban it entirely. In addition, Johnson & Johnson suspended shipments of its vaccine after similar concerns were raised in the US.

However, these setbacks are unlikely to dent the rapid rate of inoculation in Europe thanks to additional shipments of 100mn Pfizer doses in Q2 almost fully offsetting the delay in the J&J vaccine rollout. Also, once the pace of US vaccinations slows down, which should be the case in June, de-facto export bans will be lifted and the significant US production capacity will find its way first to Europe and then the rest of the world. Therefore, the key goal for Europe has to be to mitigate a third wave with the so-called British variant which now makes up the majority of cases on the Continent until vaccinations can be ramped up significantly.

European mobility rates have therefore declined again and are now at -30% to -40% below the January 2020 baseline as a consequence of significant restrictions that remain all over Europe.

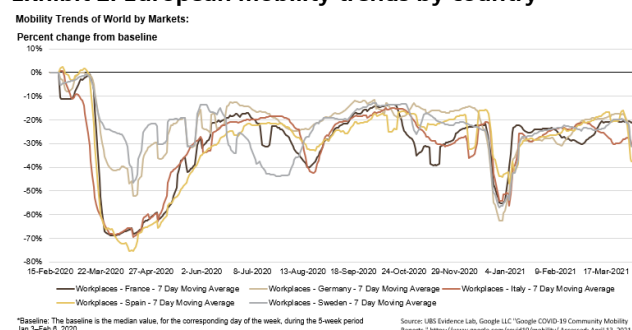
In **Germany**, private meetings remain restricted to max 5 persons from only one other household and the country is still considering a curfew from 9pm as soon as weekly case numbers rise over 100 per 100k, which currently is the case.

In **France**, a hard lockdown is in place since 3 April which is supposed to last for 4 weeks and includes the closure not only of shops and restaurants, but also schools. A curfew is in place from 7pm onwards. The situation in hospitals is severe in several regions.

In **Italy**, a hard lockdown is in place until 30 April. A traffic light system separates the country in green, orange and red zones, with currently no green regions. In red zones, visits of relatives are forbidden.

In **Austria**, a hard lockdown is in place in several regions, but not country-wide. Vienna restaurants and schools are closed.

Exhibit 2: European mobility trends by country



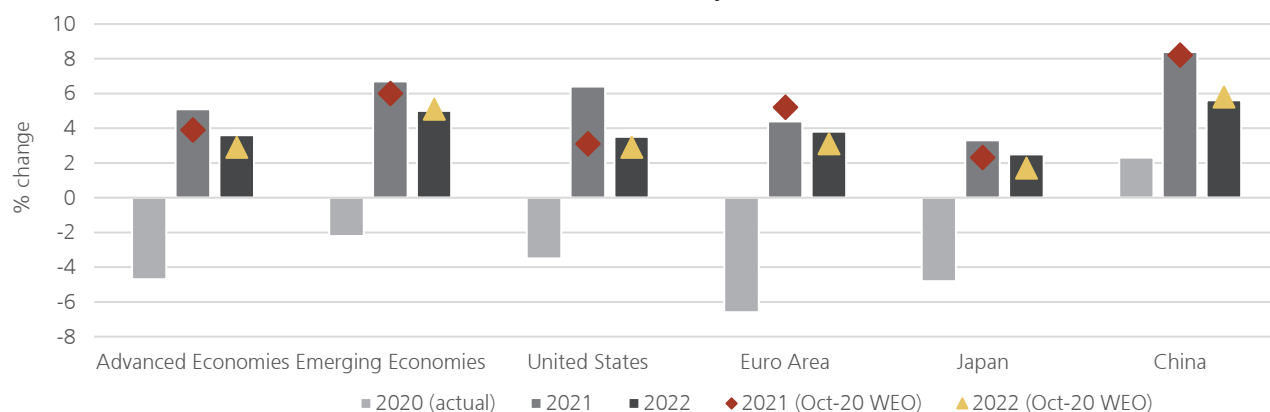
Source: UBS Evidence Lab, Google LLC as of end-March 2021. The baseline is the median value for the corresponding day of the week during the 5-week period of Jan 3-Feb 6, 2020.

Policy response and execution: How will interest rates affect monetary and fiscal stimulus?

Still-stringent mobility restrictions across Europe and other parts of the world do not appear to have substantially reduced the prospects of the ongoing economic recovery. Growing evidence from the UK and the US that mass distribution of vaccines can reduce contagion and hospitalization rates have prompted the IMF to increase the growth forecast for this year to 6% in 2021 and to 4.4% in 2022.

When it comes to the **fiscal** response to the crisis, given that the pandemic is not under control yet, the expected reversal of the stimulus has diminished somewhat in the first months of 2021. UBS estimates the global fiscal impulse at -1.1% of GDP in 2021, less than half of their forecast 6 months ago, and

Exhibit 3: Overview of 1Q 2021 IMF World Economic Outlook Projections



Source: IMF as of April 2021. <https://www.imf.org/en/Publications/WEO/Issues/2021/03/23/world-economic-outlook-april-2021>

about 70bp below the estimate from January. This includes the recently passed \$1.9trn US stimulus package. Still, the amount of global fiscal drag is still historically large (2x what we had post GFC) but since this is not a normal recession and the recovery should be quicker, this could be offset by a boost to private sector demand that will come from the lifting of mobility restrictions and normalization in the service sector.

When it comes to the question if the change in stimulus this year will be larger in the **US** or the **Eurozone**, the very sizeable stimulus in the US might merely replace last year's stimulus. Also, our experts estimate that only \$1.3trn out of the \$1.9trn will fall in 2021. Next, some of the stimulus approved in the Eurozone in 2020 will fall only into this year, while the multi-year US fiscal package likely to be approved later this year has only a very small impact on 2021 numbers. Therefore, all in all, the US is expected to have a positive fiscal impulse of 0.5% of GDP this year and the Eurozone of 1% of GDP.

When it comes to the **monetary** policy response, with long-term interest rates stabilizing after the increase in volatility in March, the policy focus has shifted back to the management of the tapering process. **US Fed** Chair Powell reiterated that the Fed will scale back its bond purchases before considering raising interest rates. "We will reach the time at which we will taper asset purchases when we've made substantial further progress toward our goals". When it comes to timing, he stressed that "most members of the committee did not see raising interest rates until 2024". Atlanta Fed President **Bostic** said that over the past decade, data has shown the US economy can run hotter without causing inflation. Cleveland Fed President **Mester** said markets may now be more optimistic about recovery than the Fed.

Consensus is that the Fed will not react to strong data over the next few months. However, some market participants believe that the eruption of post-pandemic economic activity will be

so strong that the Fed will be forced to tighten in early H2, ultimately hurting global equity and other risk markets. UBS expects an upgrade in the Fed's language at the 27-28 April FOMC meeting that implicitly refers to a taper. They see the phrase "some time" being removed from prepared remarks that "it is likely to take some time for substantial further progress to be achieved." This should put the Fed on track to achieve further progress at the June meeting before formally announcing a taper in September.

In the **EU**, ECB president **Lagarde** said the euro zone economy is still standing on the "two crutches" of monetary and fiscal stimulus and these cannot be taken away until the patient makes a full recovery. Overall, despite some fiscal tightening at global level, the global policy stance will remain supportive.

Market impact and investment positioning

Markets have been looking through mixed news on COVID-19, including the imposition of stricter restrictions in parts of Europe and the acceleration in vaccination. On balance, in the **short term** investors remain relatively optimistic: the S&P 500 has reached new record highs and is now up around 11% since the start of the year. This positive view on US equity reflects expected record quarterly earnings in Q1, a manageable rise in inflation that shouldn't threaten margins, and a lower-than-proposed rise in corporate taxes as a split Congress constrains the White House

In the **medium-term**, investors are likely to be torn between optimism over accelerating growth and worries over higher inflation. Recent economic data from the US has reinforced the reflation narrative, with the strongest ISM Services survey since 1997 and positive signals from the labor market. Our experts think that a pickup in global growth as vaccination programs ramp up is likely, but as soon as pent-up demand meets supply constraints, a (manageable) pickup in inflation could actually materialize.

Exhibit 4: 5-year capital market expectations

	Typical central bank portfolios				Typical SWF portfolios		
	CB1	CB2	CB3	CB4	Sav1	Sav2	Sav3
Cash	50%	10%	10%	10%			
GGB 1-3	50%	50%	30%	30%			
GGB			10%	10%	23%	23%	15%
Corporate Bond		10%	10%	8%	10%	10%	
TIPS		10%	10%	8%			
Securitisied		10%	10%	8%			
Supranationals		10%	10%	8%			
EMD Hard Currency			10%	3%			
EMD Local Currency					3%	3%	
Global Equity				15%	60%	40%	35%
Real Estate					5%	12%	10%
Private Equity						13%	20%
Hedge Funds							10%
Infrastructure							5%
Commodities							5%
Performance							
2021 January	0.01%	-0.13%	-0.33%	-0.38%	-0.99%	-0.50%	0.12%
2021 February	-0.05%	-0.62%	-1.09%	-0.41%	0.97%	1.32%	2.56%
2021 March	0.02%	-0.25%	-0.42%	0.20%	1.73%	2.50%	3.35%
Performance 2021 YTD	-0.02%	-1.00%	-1.83%	-0.59%	1.71%	3.33%	6.12%
Performance 2020	1.52%	4.28%	5.14%	6.81%	12.36%	9.41%	8.14%
Performance 2019	2.76%	5.56%	7.10%	9.33%	20.97%	22.76%	24.40%
Performance 2018	2.00%	1.04%	0.46%	-0.47%	-5.30%	-5.12%	-6.58%
Performance 2017	0.90%	2.00%	3.07%	5.22%	15.17%	12.88%	13.02%
Performance 2016	0.91%	2.29%	3.34%	3.50%	6.40%	6.87%	7.88%
Performance 2015	0.51%	0.31%	0.39%	0.29%	-0.53%	1.16%	0.21%
5y outlook							
Base case	0.46%	0.78%	1.18%	1.68%	3.79%	4.03%	4.71%
Recession/Stagnation	0.09%	0.62%	1.25%	1.21%	1.85%	1.96%	1.79%
Stagflation	0.27%	0.08%	0.37%	0.57%	1.39%	1.63%	2.74%
Upside	-0.91%	-0.59%	0.33%	1.45%	6.91%	6.62%	7.17%
Standard Dev	1.20%	3.04%	3.04%	4.01%	10.69%	10.82%	11.76%

Source: UBS Asset Management. As of 31 March 2021.

As US **equity** markets touch new highs, our experts advise investing in regions where it's still early cycle, like Europe and emerging markets as goods activity is strong globally and poised to stay so, with uneven vaccine access producing dispersion in service sector recoveries.

With US stimulus support peaking, and future policy actions likely to include both higher spending and higher taxes, there should be a preference for procyclical, value, and international equities relative to broad equity beta.

For **fixed income**, our IB Research experts think that USD IG and HY corporate yields at 2.6% (vs. 2.2%) and 4.9% (vs. 4.0%) would provide an attractive entry point for investors to rotate back into more rate sensitive USD credit assets and capitalize on attractive carry plus modest capital gains into year-end. In **Europe**, our experts see the biggest risk over the next 3-6m for fixed income-centric investors if IG/HY spreads

were to start pricing out ECB liquidity prematurely as vaccination rates improve, while the expiry of 937bn in bank loan payments holidays could also start to weigh in on weaker banking regions should NPLs migrate higher. In **EM**, they expect high carry assets such as Asia USD HY to perform best over the next three months.

Updated capital market expectations

UBS Asset Management has recently updated its 5-year Capital Market Assumptions framework incorporating the impact of COVID-19 on expected returns in a wide range of asset classes. Global Sovereign Markets - Strategy & Advice calculated the 5-year expected returns for a number of sovereign sample portfolios which we think are representative of the investment behavior of central banks (portfolios CB1-CB4) and long-term sovereign saving funds (portfolios Sav1-Sav4).

The **baseline** scenario assumes a return to modest growth next year with no major setbacks but enough uncertainty to keep rates at ultra-low levels with only a gradual end of QE over the next 5 years.

The **recession** scenario could imply setbacks in the fight against the virus and depressed consumer sentiment as well as severe solvency issues for corporations, amplified by global tensions, leading to high volatility for risky assets. While global L-T yields would approach zero in such a scenario, a persistent negative stock-bond correlation would protect diversified portfolios to some extent. The **stagflation** scenario would also foresee a difficult recovery from the Coronavirus crisis leading to a world marked by trillions in additional debt and substantial additional government stimulus, which would ultimately boost inflation. In such a scenario, the stock-bond correlation would turn positive.

The results show that even in the baseline scenario, 5y returns are lower than those experienced by central banks and SWFs over the last few years.

Central banks, with a heavy allocation to government bonds, will struggle to protect the capital in real terms. These institutions have been on a diversification trend for many years now. Today, many central banks invest in listed equities and a few in alternative asset classes. The diversification trend is likely to continue and should eventually accelerate in the future as central banks struggle with a low yield environment. Alternatives might continue partially taking over the role that fixed income played in the past.

SWF returns will be about 2-3% lower than the historic averages over the past 20 years. These institutions have a higher risk tolerance than central banks and thanks to a much more diversified portfolio, they will take advantage of additional upside in equity prices. However, many SWFs – particularly commodity-based ones – still face the probability of withdrawals as their sponsoring governments deal with the ongoing fiscal fallout of the crisis.

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Exhibit 5: Equity indices at year-end 2020 and current, credit spreads by asset class, current and previous year

Index/Sector	Current	YTD	2020 performance
S&P 500	4173	11.1%	16.2%
NASDAQ	13950	8.2%	43.6%
EURO STOXX	4001	12.6%	-5.1%
NIKKEI 225	29188	6.4%	16.0%
China CSI 300	5089	-2.3%	27.2%
Korea KOSPI	3177	10.6%	30.7%
Technology		9.4%	43.6%
Health Care		8.8%	13.3%
Financials		19.1%	-1.7%
Energy		25.8%	-36.9%

Spreads by asset class	Current 04/21/2021	12/31/2020	12/31/2019	2021 Change
US IG	91	96	93	-5
US HY	298	358	336	-61
EU IG	85	91	93	-6
EU HY	298	346	292	-48
GBP IG	110	113	127	-3
GBP HY	365	467	397	-102
EU AT1	315	378	314	-63
CDX IG	52	51	45	0
CDX HY	295	296	280	-1
iTraxx Main	51	48	44	3
iTraxx Crossover	252	238	207	14
iTraxx Senior Fin	59	59	52	0
iTraxx Sub Fin	107	113	114	-5
Asia IG Cash	149	154	123	-5
Asia HY Cash	650	657	553	-7
EM USD Agg	277	281	301	-4
EM USD Sov	301	298	381	3
EM USD Corp	303	317	292	-14
EM USD Govt- Owned	217	225	203	-7
EMBI OAS	326	337	285	-11
IEMB	343	356	309	-13
CDX EM	164	152	174	13

Source: Bloomberg LLC. Data as of April 21, 2021.

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