

# 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;
2. Where we stand in terms of **vaccination rates and distribution**;
3. The **policy response** and execution to alleviate the impact on economies and markets;
4. 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: Managing the gradual re-opening process

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.

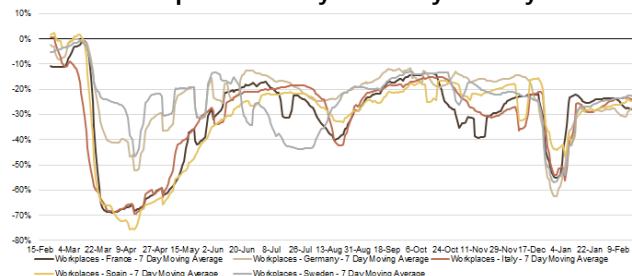
The spread of mutated strains has also led to additional travel restrictions and border shutdowns and various countries have still effectively shut down their borders to anyone who hasn't tested negative.

We continue to monitor existing and future mutations as a **signpost** for potential trouble ahead for the overall rather optimistic sentiment that has developed in global markets since the earlier-than-expected approval of effective vaccines.

On a positive note, the number of COVID-19 **hospitalizations** and deaths, which we consider one of the key signposts for the impact of the disease and the regulatory response, are dropping considerably around the world. In the **US**, hospitalizations continue to decline and are now 62% below the 6 January peak. Therefore, what we considered to be a key signpost for the severity of the disease (hospitalization rates) is improving significantly. As a consequence, several States are easing restrictions, with Texas taking the most aggressive steps by declaring basically all measures voluntary from early March onwards. The CDC is however warning against these steps and it is unclear yet if increasing vaccination rates and higher temperatures can offset the effects of more infectious strains over the next weeks.

In **Europe**, it also seems that countries have reached the peak in daily cases and deaths in January, when the vaccine rollout was still in its early stages. This however also means that the decline in the case count was largely driven by recent lockdown measures rather than vaccinations, and explains why governments are opting for a relatively gradual phasing out of the restrictions.

## Exhibit 1: European mobility trends by country



Source: UBS Evidence Lab, Google LLC as of end-February 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.

**European mobility rates** have therefore stagnated since January and are hovering relatively stable at -20% to -30% below the January 2020 baseline. However, with infection rates past their peak and the vaccine rollout under way, we expect mobility restrictions to be eased from mid-March onwards, and more meaningfully during Q2. Several countries have gradually eased certain restrictions already, and some have outlined paths to a gradual opening, with pre-determined openings steps kicking as long as case numbers are continuing on a downward path.

For example, in **Belgium, Austria** and **Italy**, non-essential shops are now open again, and restaurants in half of all regions of Italy are allowed to stay open until 6pm. **Germany** reopened schools for some classes in a number of states on 22 February, but non-essential shops will remain shut until 7 March, and also after that date, only a select number of more essential shops were allowed to open. The **UK** outlined a very gradual opening timeline, with non-essential retail reopening at the earliest on 12 April, followed by a broader reopening of the hospitality and entertainment sectors from 17 May.

### Vaccination rates and distribution

We see good progress on the **pace of vaccinations**, which we see as a key **signpost** through 2021; however, large differences between countries and regions still exist.

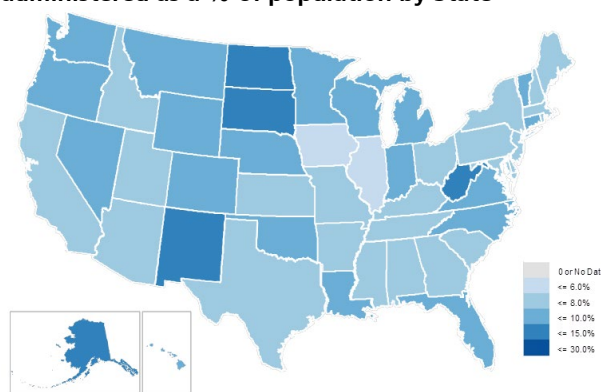
A total of over **230 million** vaccine doses have been given across over 100 countries so far. Globally, the UBS IB Global Vaccination Tracker shows a strong pick-up in **DM**, which is now vaccinating fast enough to reach 55% of the population this year (up from 42% last week). Overall, twenty out of the twenty-six largest economies saw an improvement, including every single developed economy that is tracked, but **EM's** pace slowed, mainly due to China and Turkey. Supply constraints are more binding given EM has purchased only one sixth of the vaccine that DM has and recent supplies have been in the 'few hundred thousand' range rather than the millions. The pace will continue to pick up in the next few weeks as Asia has just started vaccinating.

The **US** has currently administered over 80 million vaccine doses, reaching over 15% of the population according to data collected by the CDC. About 52 million have received at least one dose, and over 26 million are considered to be fully vaccinated. The current vaccination rate is at close to 2 million shots a day. That equates to 30% of all the vaccinations globally (despite only having a 4% share of the global population) and puts it on track to hit the target of 100mn doses in 100 days outlined by Joe Biden in the next 2-3 weeks. The NYT estimates that at the current rate, about half of the US population would be at least partially vaccinated by late June, and nearly all by late October.

Last week, the US authorized Johnson & Johnson's COVID-19 vaccine as the third one to be made available in the country. Compared with the two-dose vaccines from Pfizer/BioNTech and Moderna, the J&J version is a single dose and requires only normal refrigeration.

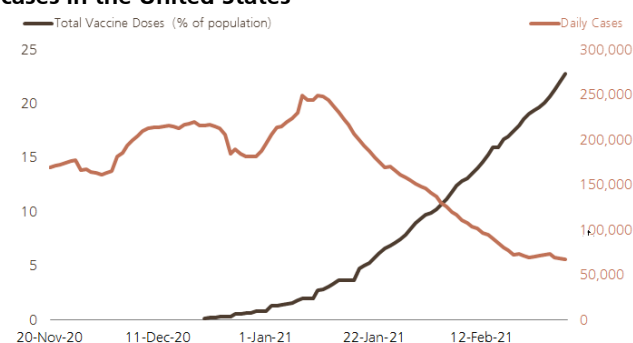
With Pfizer and Moderna having increased their supply targets and the rollout of the, Johnson & Johnson vaccine, we could see an additional boost to the pace of US vaccinations over the coming weeks.

**Exhibit 2: US Covid-19 vaccination second dose administered as a % of population by State**



Source: UBS, UBS Evidence Lab. Data as of Feb 27, 2021.

**Exhibit 3: Total vaccine doses (% of population) vs daily cases in the United States**



Source: UBS Evidence Lab, CDC, Ourworldindata.org, John Hopkins University. Data as of March 2020. Vaccine doses are the total administered and are presented as the latest data for a location. Daily cases are calculated as 7-day rolling average.

**Germany** and **France** are slowly but steadily increasing the pace of vaccinations; while they are on track to have key risk groups vaccinated by June, recent actions by regulators and related media articles have caused skepticism towards the AstraZeneca vaccine which led to an increase of no-shows among eligible groups in test centers that use this vaccine. Still, several European countries have recently dropped their resistance to use AstraZeneca for over 65-year olds (e.g. Germany, France, Belgium, and Sweden). In order to ease

shortages, Italy recently blocked vaccine exports to Australia, a move which has been endorsed by the European Commission. Germany is following the UK's example of stretching the interval between doses, and Poland has decided that those who have already had COVID and are assumed to have some immunity and therefore will receive only one dose of vaccine.

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

When it comes to the **fiscal** response to the crisis, in the **US**, the House of Representatives last week passed a USD 1.9tn fiscal package with votes that went along party lines. It later passed the Senate 50-49 on Saturday following a more than 25-hour marathon of amendment votes completed after Democrats settled an intra-party dispute over unemployment aid. The measure, the American Rescue Plan Act, now heads back to the House, and Democrats aim to have it signed into law next week. The bill could be followed later in the year by an additional USD 2tn infrastructure package (or even more). But the fiscal package alone would mean that the US is going from having one of the largest fiscal drags to being one of the most stimulative countries in the world. UBS Research assumes that a decent-sized US fiscal stimulus package could lift the UBS GDP forecast to about 8%, and in turn lifting global GDP to 6.5% or more in 2021. This is supported by strong recent data: The manufacturing ISM climbed to its highest level since early 2018, rising to 60.8 (consensus 58.5). New orders, production, and employment as well as export orders all showed a solid increase.

In **Europe**, the European Commission laid out guidelines for further suspension of fiscal rules. Our experts at IB Research expect the Stability and Growth Pact fiscal rule framework to be reinstated only in 2023, with flexibility on a country-by-country basis even afterwards. Payouts from the EU recovery fund (which comes on top of measures from national budgets) are projected to be at 0.3% of GDP in 2021 and 0.6% of GDP in 2022.

When it comes to the **monetary** response, the focus over the past weeks shifted towards the impact of rising rates on the reaction function of central banks. Here, a number of speakers including Fed Chair **Powell** in his semi-annual Monetary Policy Testimony tried to make very clear that they are not worried yet about an increase in yields. With real, not nominal, yields at the core of central bank modeling of the economy, the Fed seems to interpret a rise in real yields as a positive sign for now. **Richard Clarida**, Vice Chair of the Fed Board stressed that if rates rise because the market sees a better economic outlook, he does not consider it a problem. Fed's **Barkin** said rising bond yields on improved economic expectations are a "natural reaction". With regard to the move in rates, he stated that "We obviously have control of the yield curve at the short

end. And at the longer end when it moves it depends a lot on the driver."

However, a **continued, sustained selloff in rates** would ultimately tighten **financial conditions** which could hurt the recovery and cause a fall in risk assets, and Fed communication has therefore already gradually shifted to reflect this aspect. Still, our experts at IB Research expect the Fed to announce a **taper** of its asset purchases at the September FOMC.

In the **EU**, ECB President Christine **Lagarde** said that the ECB would continue to "play its part, as we have done since the first days of the crisis" by providing access to financing. **Isabel Schnabel** and **Philip Lane** stressed in a coordinated fashion that the ECB is closely monitoring the rise in long-term bond yields. Mr Lane said: "We will purchase flexibly according to market conditions and with a view to preventing a tightening of financing conditions that is inconsistent with countering the downward impact of the pandemic on the projected path of inflation." Ms Schnabel said that policy will have to step up its level of support in the event of rising real long-term rates during the early stages of the recovery. Of its PEPP envelope of €1.85 trillion, the ECB has so far spent about €854bn, implying it still has plenty of firepower to increase its purchases above the recent weekly purchases of about €17bn without raising the envelope at this stage.

### **Market response and implications for Sovereign Investors**

Global and US equities rallied to all-time highs in the middle of February as falling hospitalization rates and the rollout of COVID-19 vaccination programs increased optimism about economic normalization and the recovery. Optimism over a global economic recovery also drove up **commodity** prices, with the Bloomberg Commodity Spot Index hitting an eight-year high in the last week of February.

Then, however, a combination of looming fiscal stimulus and progress towards economic normalization contributed to rising 10-year yields, arresting the global equity rally and prompting further rotation out of growth stocks into value and cyclicals. However, **equities** stabilized in the first week of March which supports our view that February's setback for stocks was a volatility spike, rather than a fundamental shift in the market outlook. US real yields have been rising because of a stronger growth outlook, rather than a monetary policy tightening scenario (such as the 2013 taper tantrum). The Federal Reserve has made it clear that it won't be tightening policy anytime soon, a position firmly reiterated last week by Chair Jerome Powell. As a consequence, we believe that equities remain attractive relative to bonds, with the **current equity risk premium** of 315bps within the 285–470bps range that has prevailed since 2015.

UBS Research also assumes that the recent sell-off is not a fully-fledged tantrum and sees 1.8% in the **US 10-year yield** as a reasonable level where a further sell-off would stop. In addition, one could argue that current yield levels are on the higher end of expectations as the yield curve has already priced in significant Fed rate hikes in late 2022 and 2023 despite the Fed continuing to stress that it needs at least 3 years to achieve its average 2% inflation target.

**In Credit** markets, performance was mixed in February as the higher-rated credit segments suffered on the back of the rise in government bond yields. Returns on USD IG bonds and EUR IG bonds fell 1.7% and 0.9% respectively over the month. Spread compression in the higher-beta-lower-rated segments offset the negative impact of rising rates with USD HY and EUR HY both delivering positive total returns in February. USD-denominated EM bonds also suffered from the impact of rising yields given their sensitivity to rates changes.

**What are some of the opportunities we see in global bond markets?** Based on our current views and outlook, here are some of the opportunities that we are currently evaluating. These could evolve as market conditions change:

- We are looking to gradually add to US 10-year yields around these levels as we believe they represent a very attractive carry relative to unchanged zero Fed fund rate expectations over the next 2-3 years.
- We favor exposure to nominal US Treasuries over US TIPS. We believe nominals are more attractive now that long-run breakeven inflation pricing is at close to the Federal Reserve's target.
- We like long duration in those EM countries with subdued inflation such as China, Mexico and South Africa.
- UBS WM CIO currently still likes Asia high yield bonds because of the attractive yields and their potential to benefit from the continuation of the economic recovery as well as European crossover bonds and green bonds.

The rise in yields across markets have led to losses in the fixed income portfolios of central banks. According to our estimates, YTD central banks have suffered losses of between 1 to 2%. Sovereign Wealth funds with a lower allocation to fixed income assets have experienced positive returns YTD. The YTD performance of sovereign institutions' portfolios is a prelude of what is likely to be the investment environment post-Covid: low/negative return on fixed income and selected opportunities in the equity and alternative asset classes.

**Strategies to diversify your investment portfolio** are therefore of paramount importance to navigate post-Covid markets.

The time is now for investors to adapt to lower expected returns across asset classes and the growing importance of sustainable investing, both of which are altering the investment landscape. To address these issues, UBS Asset Management has launched a **series of whitepapers** that outline approaches you can take to upgrade your asset allocation and address these urgent challenges:

- Our updated [Five-year capital market assumptions](#) capture the difficult environment that investors are currently facing in a quantitative way.
- [Enhancing diversification in a low-yield world](#), outlines a set of solutions given the likelihood that developed market debt will fail to provide the same degree of ballast to portfolios during equity market drawdowns.
- [Alternative investments: Improving portfolio performance](#) provides a comprehensive overview of the different asset classes investors can integrate into their portfolios more broadly – private equity, hedge funds, real estate, infrastructure, and commodities – and how to do so.

Finally, for an overview of our key themes that we see as relevant for 2021, please refer to our presentation [Sovereign Investment Outlook 2021 – The Year of Choices](#) on our public website [www.ubs.com/am-gs](http://www.ubs.com/am-gs)

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**Exhibit 4: 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	<b>3892</b>	<b>3.6%</b>	16.2%
NASDAQ	<b>13021</b>	<b>1.0%</b>	43.6%
EURO STOXX	<b>3789</b>	<b>6.6%</b>	-5.1%
NIKKEI 225	<b>29030</b>	<b>5.8%</b>	16.0%
China CSI 300	<b>4971</b>	<b>-4.6%</b>	27.2%
Korea KOSPI	<b>2976</b>	<b>3.6%</b>	30.7%
Technology		<b>0.0%</b>	43.6%
Health Care		<b>1.2%</b>	13.3%
Financials		<b>15.8%</b>	-1.7%
Energy		<b>39.8%</b>	-36.9%

Spreads by asset class	Current 9 Mar 2021	12/31/2020	12/31/2019	2021 Change
US IG	<b>98</b>	96	93	<b>3</b>
US HY	<b>330</b>	358	336	<b>-29</b>
EU IG	89	91	93	-2
EU HY	<b>315</b>	346	292	<b>-31</b>
GBP IG	110	113	127	-3
GBP HY	<b>384</b>	467	397	<b>-82</b>
EU AT1	384	378	314	6
CDX IG	<b>56</b>	51	45	<b>5</b>
CDX HY	<b>313</b>	296	280	<b>16</b>
iTraxx Main	<b>50</b>	48	44	<b>2</b>
iTraxx Crossover	<b>257</b>	238	207	<b>19</b>
iTraxx Senior Fin	<b>59</b>	59	52	<b>0</b>
iTraxx Sub Fin	<b>107</b>	113	114	<b>-6</b>
Asia IG Cash	<b>137</b>	154	123	<b>-17</b>
Asia HY Cash	<b>673</b>	657	553	<b>16</b>
EM USD Agg	<b>282</b>	281	301	<b>1</b>
EM USD Sov	<b>316</b>	298	381	<b>18</b>
EM USD Corp	<b>304</b>	317	292	<b>-12</b>
EM USD Govt- Owned	<b>214</b>	225	203	<b>-11</b>
EMBI OAS	<b>356</b>	337	285	<b>19</b>
IEMB	<b>380</b>	356	309	<b>24</b>
CDX EM	<b>208</b>	152	174	<b>56</b>

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Source: Bloomberg LLC. Data as of March 9, 2021.

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