

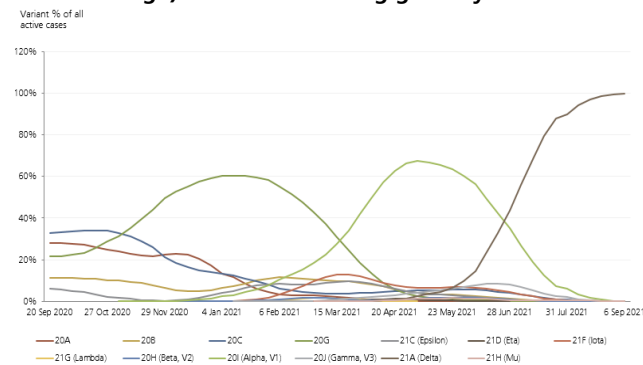
Sovereign Note: Positioning for a post-pandemic world

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

In our last note, we reviewed the current situation from a high-level perspective. We therefore think that currently, the spread and control of the virus as well as the policy response are marked by the following factors:

- In various Western economies, there has been a fundamental shift towards **herd-immunity** strategies based on the assumption that a high rate of vaccination across the entire population can be achieved. In Developed Market (DM) countries, we therefore consider **hospitalization rates**, as well as the **rate and severity of breakthrough infections** as the key metrics to monitor going forward.
- But the management of the transition from a **pandemic** to an **endemic** situation where ultimately everyone will be confronted at various times with the virus in their lifetime, raises several **challenges and risks**. For example, a herd immunity strategy might lead to significant additional waves and it is not yet clear what the effectiveness of vaccines is against new variants particularly among the elderly or immune-compromised patients.
- In contrast, countries that have been running **zero Covid-19 strategies** and were seen as the winners in the global fight against the pandemic, might have to review their re-opening strategies in the light of new highly-infectious variants.
- One key question will be how to deal with the 30%+ of people that have rejected **vaccinations** up to this point in some DM countries. The fact that Japan has now surpassed the US, and that many European countries have surpassed Germany in vaccination rates shows that there are major economies that are still at risk of significant additional waves among the unvaccinated. It is also unclear how far large DM countries want to go to further “discriminate” by offering more liberal social measures for those who are vaccinated, or if they might even be willing to impose outright vaccine mandates.
- While the vaccination campaign advances globally with EM now in the lead, the varying **effectiveness of different vaccines** will become more visible, in particular in the face of more aggressive and infectious variants like Delta, Lambda and Mu.
- We still consider the **UK** to be a **key signpost** to watch how the pandemic might continue (or end). This is not only because the UK reached **high vaccination rates** at an early stage but because it was the first DM nation that was significantly affected by the **Delta variant** and at the same time had already eased a lot of social restrictions. If developments had hinted at a miscalculation by the UK government, other DM nations might have quickly re-introduced new restrictive measures preemptively as soon as the Delta variant took over and cases had risen in their countries.
- However, until now, **hospitalizations rates in the UK have not risen significantly** and **breakthrough cases** among the vaccinated remain mostly mild. However, the UK is still running significantly higher case numbers than neighboring countries. According to FT data, the **7-day rolling average of infections** in the **EU** dropped to 9 per 100K residents with a steady fall since early September, while **UK** cases have stagnated and now stand at 50 per 100K people (**US**: 37).
- Ultimately, as is the case with the flu, it is now necessary to monitor the social consensus that will form around levels of casualties that are acceptable before new restrictions might be imposed.

Exhibit 1: US Covid-19 variants estimated frequency (4-week average): Delta dominating globally



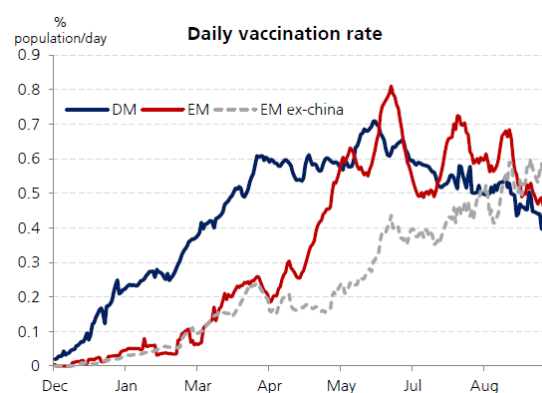
Source: UBS Evidence Lab, Nextstrain.org. Data as of September 2021.

Vaccination trends around the world

UBS experts track global vaccination programs and produce detailed analysis where over **40 of the largest EM and DM economies** (two-thirds of the global population) currently stand with their programs.

- Vaccination rates in DM are now in the 60%-75% range with the exception of Australia and New Zealand which are expected to catch-up next month if they can maintain the current pace due to a **high 7-day run rate** of 18% of population per month in Australia and 16% in NZ, compared with 3.4% in the US and 2.4% in the EU27.
- When comparing countries from a “fully-vaccinated equivalents” basis the **US** currently sits at 59%, compared with 62% for the **EU27** (which however has a wider range when looking at member countries, with Spain having one of the highest at 74%) and 69% for the **UK**.
- The current **year-end projection** of our experts is that the EM vaccination share will be at 71%, DM at 80 % and the population-weighted global total at 72%.
- Opening up **to younger age brackets** is likely the only way to get population vaccination levels well above 80%. But when it comes to the vaccination of the younger population, large regional differences exist. For example, China approved Sinovac for children of 3+ years, while in the US, the FDA may be ready to approve Pfizer for 5-11 year old.

Exhibit 2: Vaccination rates in DM vs EM

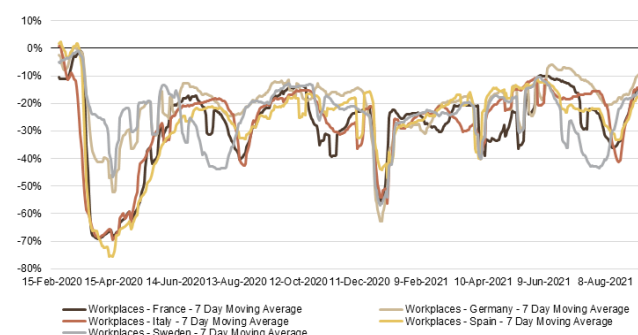


Source: UBS Evidence Lab, Our world in data, as of September 24.

Mobility and activity trends around the world

- **Traffic congestion** in the **US** has been rising and is now ~15% below pre-pandemic levels; in the **UK** it is over 20% above early 2020 levels.

Exhibit 3: Mobility trends by country



Source: UBS Evidence Lab, Google LLC as of September 22, 2021. The baseline is the median value for the corresponding day of the week during the 5-week period Jan 3 – Feb 6, 2020.

- **Foot traffic** to workplaces has been increasing in the UK and Germany but has been flattish in the US, Japan, and India.
- **Travel** out of Guangzhou and Shenzhen rose sharply ahead of the Mid-Autumn Festival, while Beijing ticked down after recovering for several weeks.
- In terms of **US reopening metrics**, concerns over being in public have increased, and expectations for social distancing continue to deteriorate, though concern over the spread of COVID-19 has declined, according to a survey of 5-10K consumers per week.

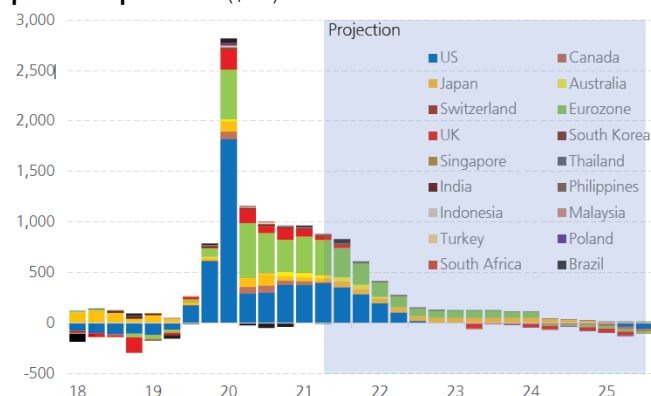
Policy response and execution: The unwinding of pandemic-related stimulus has started

Major DM central banks have started their **taper process**. However, UBS IB economists believe that **net injection of new liquidity** (purchases minus run-off once reinvestment programs stop) is expected to last until the third quarter of 2024.

- The **US Fed** is expected to cease purchases by the end of 2022 assuming it starts a 12-month taper process in December of this year.
- The **ECB** is assumed to run a stepped-up APP program until mid-2024, while the BoC and BoE are expected to already cease their purchases by the end of this year. The BoJ is expected to still run yield curve control for the foreseeable future.

Our experts assume that such a taper schedule would take **combined central bank purchases** (excluding large loan programs in the Eurozone and Japan) from an average of \$925bn/quarter (Q4-20 to Q3-21) to \$146bn by fourth quarter of **2022** and then averaging a bit over \$100bn in **2023**. The full-year drop-off would mean that we move from \$3.5tn in net purchases this year to \$1.5tn in 2022 and \$421bn in 2023.

Exhibit 4: Quarterly change in central banks' asset purchase portfolio (\$bn)



Source: UBS, Haver. Data as of September 2021.

When it comes to **policy rate normalization**, UBS predicts that therefore for **DM**, only 6 out of the 80bp in (GDP weighted) pandemic-related cuts to have been reversed by the end of 2022, with normalizations not yet happening in the largest economies (but in the UK, Canada and New Zealand).

EM, by contrast, is projected to already be back at pre-pandemic policy rate levels by end '22 due to early hiking cycles in Brazil, Russia, Mexico and others.

When combined, these policy changes will take the **weighted average policy rate** up to levels of about 1.34% by end-2022, compared with a pre-pandemic level of 1.9% and a trough in August of 2020 of 1%. This is still extremely accommodative when seen in the medium-to-long term. Together with continued asset purchases, our economists expect tightening next year to mostly come from market rates pricing in tightening further down the road.

This is also reflected in recent statements by central bank officials regarding **monetary** policy response. In the **US**, with long-term interest rates rising once again, the policy focus was on the management of the tapering process. **Chicago Fed President Evans** indicated that he is ready to taper the Fed's bond purchases but not yet ready to contemplate raising interest rates. In his view, the US is close to meeting the "substantial further progress" target to start bond tapering, but that inflation does not yet meet the target of a sufficient overshoot that would be required for rate hikes.

In **Europe**, **ECB President Christine Lagarde** said it is evident that the economic recovery in the European Union is increasingly advanced but that the outlook is still uncertain. Speaking before the European Parliament's economic and monetary affairs committee, Lagarde said the Governing Council continues to view the inflation upswing as temporary and it is entirely committed to preserving favorable financing conditions. She added that there are some factors that could lead to stronger price pressures than currently expected but that the ECB is seeing limited warning signs so far.

New Economic scenario and sample portfolios

In the light of recent developments in the global economy, UBS Asset Management has once again updated its **5-year Capital Market Assumptions framework** that covers 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 (45% probability) 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 **Stagnation** scenario (15% probability) could materialize if there are setbacks in the fight against the virus from new variants, amplified by geopolitical 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 (15% probability) would also foresee a difficult recovery from the Coronavirus crisis leading to a world marked by trillions in additional debt and substantial government stimulus, coupled with ongoing supply chain disruptions and shortages of commodities and food which would ultimately boost inflation. In such a scenario, the stock-bond correlation would turn positive.

Finally, we changed the upside scenario a **High Growth & Inflation** (25% probability). In this scenario, we would see a quick end to the global pandemic and no new waves. In addition, the massive shift toward a digital economy occurred during the pandemic would lead to a period of sustained growth with growth rates similar to those experienced in 1996-2004 period. With still ample stimulus in the system, inflation would rise faster than expected amplified by labor shortages, forcing central banks to hike rates more aggressively.

In the baseline scenario, 5y expected returns **are generally lower** than those experienced by central banks and SWFs over

the last few years. This is clearly a reflection of the **low expected return on fixed income** assets coupled with **rich valuations** in the equity markets.

Central banks, with a heavy allocation to government bonds, will struggle to protect the capital in real terms in the post-pandemic world. 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 will 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.

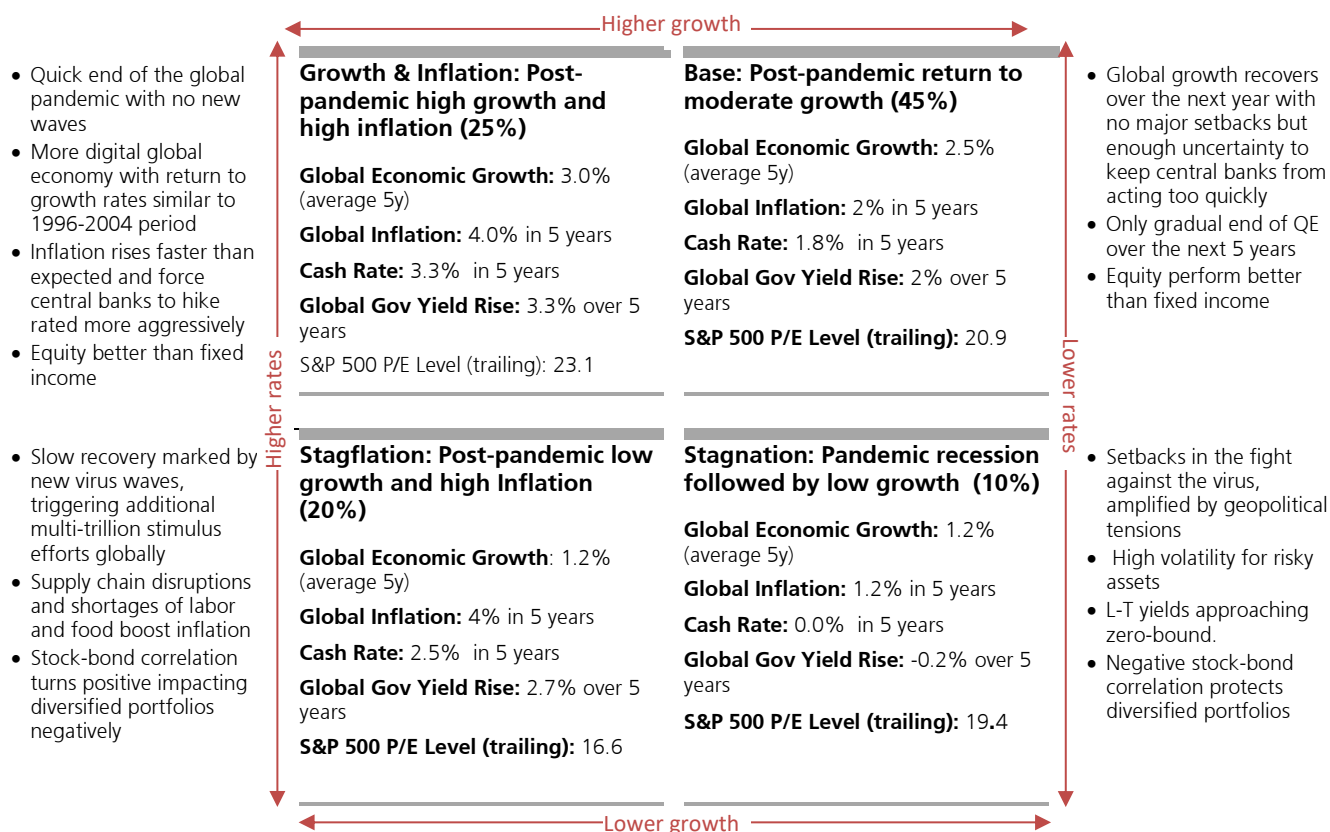
SWF returns will be more than 3% lower than the historic averages over the past 20 years. These institutions have a **higher risk tolerance** than central banks and thanks to a much more diversified portfolio, they will take advantage of additional upside in equity prices. However, many SWFs – particularly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

Exhibit 5: Expected returns and 5-year capital market expectations for central bank and SWF sample portfolios

	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%
2021 April	0.02%	0.34%	0.59%	1.07%	3.37%	3.96%	4.78%
2021 May	0.03%	0.25%	0.37%	0.46%	1.16%	1.21%	1.35%
2021 June	-0.05%	0.22%	0.38%	0.50%	1.22%	1.65%	1.79%
2021 July	0.08%	0.68%	0.84%	0.96%	1.74%	2.63%	2.80%
2021 August	-0.01%	-0.08%	-0.01%	0.31%	1.47%	1.41%	1.56%
Performance 2021 YTD	0.05%	0.40%	0.32%	2.74%	11.13%	15.04%	19.86%
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	0.70%	0.71%	0.96%	1.56%	3.61%	3.86%	4.55%
Recession/Stagnation	0.09%	0.56%	1.10%	0.65%	-0.12%	0.64%	0.65%
Stagflation	0.27%	-0.07%	-0.04%	-0.38%	-1.68%	-0.42%	0.97%
Inflationary Growth	0.37%	-0.43%	-0.62%	0.63%	4.50%	5.08%	7.25%

Source: UBS Asset Management as of September 2021.

Exhibit 6: Economic scenarios - Uncertainty with regards to the end of the pandemic and the inflation outlook remains high but the probability of a prolonged recession has fallen



Source: UBS AM as of 3Q 2021. This does not constitute a guarantee by UBS AG, Asset Management.

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