

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**.

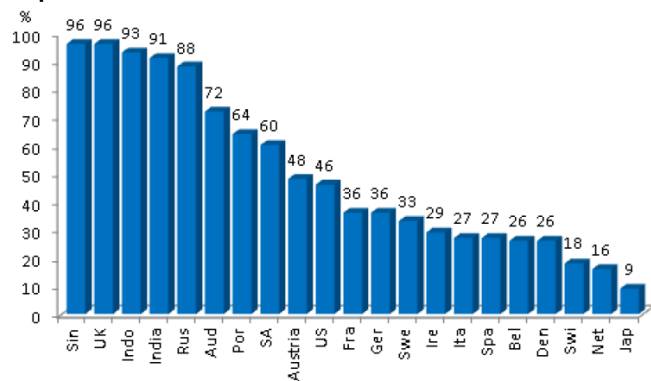
This approach was helpful in analyzing how far we have come with the different measures, and to check for signposts which might be relevant for investors.

Over the past months, however, certain things have changed rather fundamentally, which makes it necessary to review the current situation from a high-level perspective. We would like to highlight in particular the following issues:

From lockdowns to herd-immunity strategies

- Thanks to the high rate of vaccination, over the last few weeks in countries like the UK and the US there has been a fundamental shift towards **herd-immunity** strategies. In the UK, a broad reopening remains scheduled for 19 July despite the recent sharp rise in case numbers as Prime Minister Boris Johnson declares 'we begin to learn to live with this virus.' In Singapore, restrictions are expected to be eased further around the end of July when at least half of the population are expected to be fully vaccinated. Across Europe, the rapid spread of the Delta variant has not yet led to the reintroduction of more restrictive measures and the holiday season appears to be in full swing. This strategy is based on the assumption that a high rate of vaccination across the entire population can be achieved.
- With a herd-immunity strategy, measures are no longer linked to case numbers but to **hospitalization** and **death rates**. 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**.
- A herd immunity strategy might lead to significant 3rd or 4th waves and it is not yet clear what the effectiveness of vaccines is against new variants, particularly among the elderly or immune-compromised patients that were not able to mount a sufficient immune response with the help of the vaccine in the first place. With experts like Neil Ferguson expecting a 4th wave in the UK to reach a peak of 150-200K new infections per day, it is yet unclear what this would mean in terms of hospitalizations and deaths, the key metrics in a world where Sars-CoV-2 becomes endemic. What would the new threshold levels be before measures would have to be re-implemented? Is there a risk that governments might only do so when the strain on the healthcare system is already too high and unable to manage the weeks until new measures show their effect? While a larger percentage of the elderly might have died in a care setting during the first waves, never affecting hospitalization numbers, this is very different for younger age groups. Therefore, we consider **hospitalization rates among younger cases**, as well as the **severity of breakthrough infections** as the key metrics to monitor going forward.
- Another question is, what will happen with the 30%+ of people that have rejected **vaccinations**? A new upturn in vaccination rates is not expected over the summer holiday season, and in countries like Germany where 40% of the population has been fully vaccinated, the trend appears to have started to flatten, following US developments over recent weeks. In order to motivate people to get the vaccine, we expect more and more countries, in particular in emerging markets (EM), to "discriminate" by offering more liberal social measures for those who are vaccinated.

Exhibit 1: Delta variant's share of total analyzed sequences in the last 2 weeks



Source: UBS Evidence Lab, Our World in Data, covariants.org. Data as of July 9, 2021.

- Besides those who reject vaccinations, infection rates can be influenced by children and people who are not able to produce antibodies based on vaccines. When it comes to children, with current infection numbers likely suppressed by the ongoing holiday season, the reopening of schools after the summer break could lead to significant rounds of new infections in this age group.
- As the vaccination campaign advances globally with EM now also accelerating, the varying **effectiveness of different vaccines** will become more visible, in particular in the face of more aggressive and infectious variants like Delta and Lambda, as well as future variants that still have to be discovered. Singapore has announced that people who are vaccinated with certain vaccines are getting excluded from its official count of vaccinations due to a lack of efficacy. With emerging markets like Thailand and Indonesia considering **booster shots** for medical workers that have received certain vaccines, this might further delay vaccination efforts and raise doubts in the general population, reducing mobility and activity rates. But even with high-quality vaccines, it now has to be seen how effective these are in a fully eased setting without masks, that might lead to infections that are seeded with much higher initial viral loads.
- 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 variants, in particular if their low COVID-19 infection levels create less pressure to vaccinate. With almost 90% of the UK population estimated to have SARS-CoV-2 antibodies, countries that have had severe infection waves coupled with a vaccination push could see significant different developments in their freedom to do business and to travel, depending on the outcome of above-mentioned

factors surrounding the severity of second or breakthrough infections from new variants.

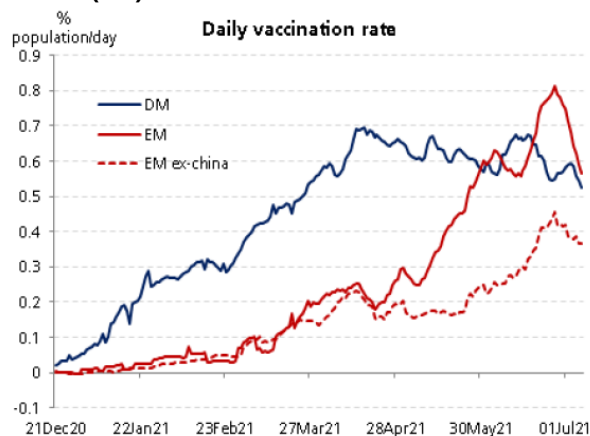
The UK is a key signpost to watch

- The developments in the UK over the coming weeks may be a key signpost to watch how the pandemic might continue (or end) globally in developed markets.
- This is not only because UK vaccination rates have even surpassed those of vaccination champions like Israel (68% vaccinated with one dose and 50% with both doses in the UK) but because it is the first developed market (DM) nation that is significantly affected by the Delta variant and at the same time has already eased a lot of social restrictions.
- If developments hint at a miscalculation by the UK government, other DM nations might quickly re-introduce new restrictive measures preemptively as soon as the Delta variant takes over and cases rise in their countries.
- However, should hospitalizations not rise significantly and breakthrough cases among the vaccinated remain mild, it could instead reinforce efforts by governments globally to achieve vaccination rates comparable to those of the UK.
- Ultimately, as is the case with the flu, it is also necessary to monitor the social consensus that will form around levels of casualties that are acceptable before new restrictions might be imposed, to estimate when countries can return back to normality.

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.
- All in all, the **global vaccination pace** has been increasing by 50%+ for three consecutive months, aided by improved vaccine supply. Dividing the total administered doses in these countries by 2 would result in 27% of the population already being vaccinated. If this rate is extrapolated to yearend, this number would reach 95%. However, if projected vaccination rates are calculated subject to a 100% cap for each economy, numbers come down a bit and also show a **slight decline** in the pace of vaccination over the past week: DM declines from 85% to 81% of their population by yearend (current vaccination share 42%), and EM from 67% to 65% (current vaccination share about 26%). The vaccine laggards have more momentum right now than the early leaders.

Exhibit 2: Daily vaccination rates across DM (blue) and EM (red)



Source: UBS Evidence Lab, Our world in data. Data as of July 1, 2021.

- On a positive note, supply constraints should be progressively less severe in H2 as the countries in scope of the analysis have only used 23% of their purchased vaccines for this year. It is however unclear when EM countries will reach their 'saturation points,' with the median DM economy currently standing at a 42% vaccination rate, while there is lots of ground to still make up in Asia and other EM economies, a slowdown could be expected around these levels as well.

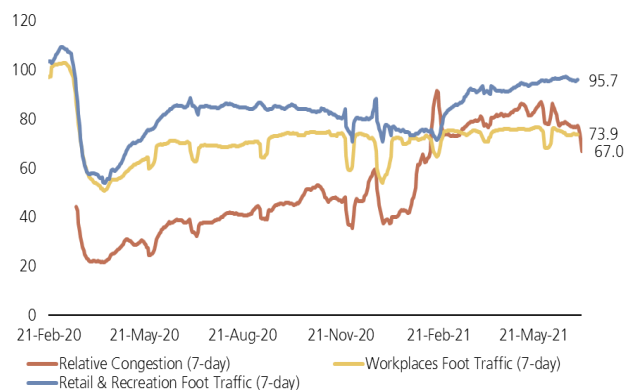
Mobility and activity trends around the world

- The primary driver of the shift from lockdowns to herd-immunity strategies is that the level of mobility can be maintained at higher levels. Retail and recreational traffic has reached almost 96% of the values seen before the implementation of large-scale social distancing measures in the US. While recent declines in workplace traffic and total relative congestion might be due to the start of the holiday season, the question is if average long-term values will reach starting levels again in the near future or if we will see a permanent drop in mobility and activity.
- Interestingly, in Australia, which was never subject to significant uncontrolled infection waves like the US, retail and recreational activity broke above the 100% line in November 2020, but has retreated shortly afterwards and has since then stagnated around the 90% line and currently stands at 87%.

Policy response and execution: What will central banks do?

- While worries about possible new waves following the spread of the Delta variant in countries like the UK has spooked market observers over the past days, recent

Exhibit 3: US mobility and activity trends



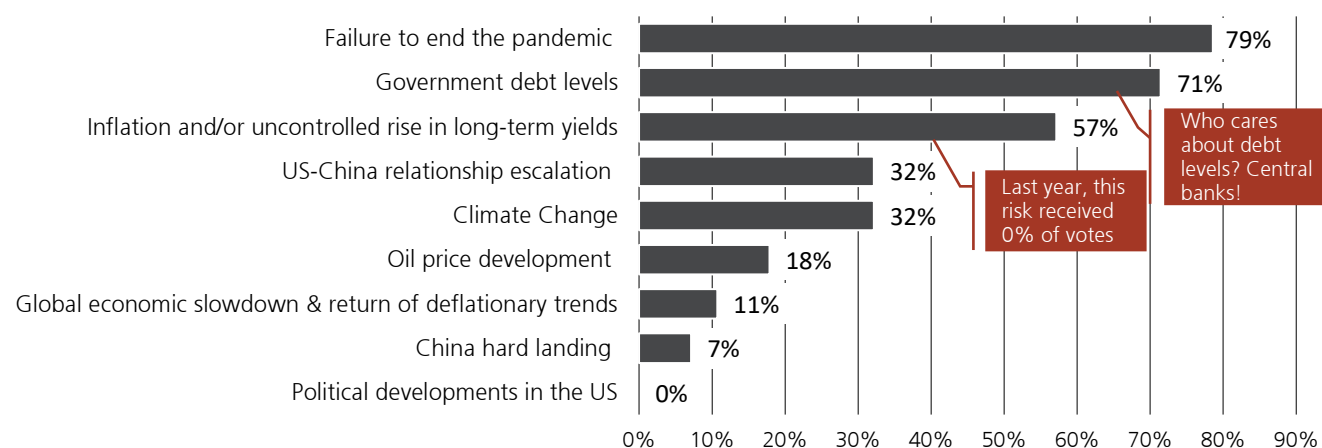
Source: UBS Evidence Lab, Google LLC as of July 4, 2021.

communication from central bank officials was done largely under the assumption that the pandemic could be brought under control over the summer months.

- As a consequence, the June Fed Minutes revealed a consensus within the FOMC that the Fed needs to be well positioned to reduce the pace of asset purchases in response to unexpected economic developments, including faster-than-anticipated progress. This was largely interpreted as a signal that a taper could be brought forward even to September.
- Since July, however, central bank communication has somewhat shifted. San Francisco Fed President Mary Daly warned about the surge in the Delta variant, saying it was "premature" to declare victory against COVID-19. ECB President Lagarde said in a hearing before the European Parliament in early July that 'the nascent recovery continues to face uncertainty due to the spread of viral mutations' and Austria National Bank Governor Holzmann warned at an UBS event in early July about the possibility of a '4th or 5th lockdown.'
- UBS Investment Bank economists believe that policy reactions to the spread of the delta variant will vary considerably across the different regions of the world. While in the US new material restrictions are unlikely unless new variants lead to a complete failure of current vaccines, in the Euro area the possibility of new lockdowns exists. Across Asian countries that are lagging behind Europe and the US in the vaccination campaigns, lockdown measures have already been introduced to fight the Delta variant.
- And even if these new restrictions might not be big enough to make a macroeconomic impact, they could easily lead to a dovish ECB outcome in September of this year and potentially leading to an extension of PEPP beyond March 2022.

Exhibit 4: UBS Reserve Management Seminar Survey - Main concerns impacting the global economy

What are the main risks that the global economy is currently facing?



Source: UBS Annual Reserve Manager Survey, results as of June 2021. Note: Multiple answers are possible.

27th annual UBS Reserve Management Seminar Survey shows pandemic as the top concern among central banks

- From April to June 2021, UBS conducted its annual Reserve Manager survey. With 23 years of comprehensive data, we believe the survey is among the most authoritative depictions of official reserve management activities available and it is frequently quoted by public institutions as well as in media articles and research papers. Like every year, we asked central banks about the key risks that the global economy is currently facing.
- A **failure to end the pandemic** remained the top concern in 2021 with 79% of all respondents mentioning it as a top concern (multiple answers were possible). We next specifically asked by when participants thought the pandemic would be over, and slightly more than half of respondents believed that the pandemic will only be over **after 2022**. With replies from central banks all around the world, we also noted a distinct separation between EM and DM locations, with DM being more optimistic and EMs likely influenced in some cases by severe domestic situations when it comes to the virus.
- Despite the concerns about a failure to end the pandemic, in 2021 reserve managers continued to **diversify** across asset classes and regions. Exposure to **equity, emerging market debt** including RMB fixed income and other spread products is rising as reserve managers search for diversification away from low-yield advanced economies' government bonds.
- Continuing reserve diversification into equities have been fueled by stock prices rising in 2021 after very good returns in 2020. The continuation of the stock market boom remains dependent on the success of the herd-immunity strategies that would allow the global economy to remain on the current recovery path.
- The recent drop in **UST yields**, despite rising inflation concerns, also support the diversification trend as the low-yield environment is expected to continue for a prolonged period of time.
- Please have a look at the full results of the 27th UBS RMS Survey on our [Reserve Management Seminar website](#).

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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	4369	16.3%	16.2%
NASDAQ	14678	13.9%	43.6%
EURO STOXX 50	4095	15.3%	-5.1%
NIKKEI 225	28608	4.2%	16.0%
China CSI 300	5089	-2.5%	27.2%
Korea KOSPI	3261	13.5%	30.7%
Technology		17.9%	43.6%
Health Care		14.4%	13.3%
Financials		25.4%	-1.7%
Energy		41.6%	-36.9%

Spreads by asset class	Current 07/13/2021	12/31/2020	12/31/2019	2021 Change
US IG	84	96	93	-12
US HY	267	358	336	-92
EU IG	83	91	93	-9
EU HY	288	346	292	-58
GBP IG	106	113	127	-7
GBP HY	365	467	397	-101
EU AT1	313	378	314	-65
CDX IG	49	51	45	-3
CDX HY	280	296	280	-16
iTraxx Main	47	48	44	-1
iTraxx Crossover	232	238	207	-6
iTraxx Senior Fin	54	59	52	-5
iTraxx Sub Fin	103	113	114	-9
Asia IG Cash	137	154	123	-17
Asia HY Cash	701	657	553	45
EM USD Agg	276	281	301	-4
EM USD Sov	304	298	381	6
EM USD Corp	307	317	292	-10
EM USD Govt- Owned	209	225	203	-15
EMBI OAS	327	337	285	-10
IEMB	344	356	309	-12
CDX EM	163	152	174	12

Source: Bloomberg LLC. Data as of July 13, 2021.

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