Global risk radar

Coronavirus and other market risks for 2020
6 February 2020

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This publication series helps investors identify and assess global financial market risks and their investment implications.

At a glance

- The coronavirus has added uncertainty to an otherwise low-volatility market environment. Recent developments suggest that the spread of the virus can be contained.
- Overall economic momentum remains positive and monetary conditions are loose. However, monitoring key risks is warranted as markets tend to be more vulnerable to setbacks at an advanced stage of the cycle. Global trade talks, the US election, the global business cycle, and potential geopolitical flare-ups such as conflict in the Middle East will be important risks to watch in 2020.
- We are overweight equities with a preference for emerging markets, which look poised to outperform their developed market peers.

The coronavirus has introduced new uncertainty to a market that has been spoiled by positive economic momentum, accommodative central banks, and the forging of a trade truce between the US and China. Since concerns over the spread of the Novel Coronavirus (2019-nCov) emerged, equities in Asia have declined around 6% and oil prices 14%, while safe-haven assets such as gold and US Treasuries made gains.

The relatively strong market response to the virus illustrates how markets tend to react to negative news when valuations for most risky assets appear high and investor positioning in some areas looks stretched. As we have seen, any negative surprise can lead to larger drawdowns than during earlier stages of the cycle when valuations are usually lower.

On a more optimistic note, market participants now seem to have a better understanding of the key market risks that CIO is monitoring. Furthermore, our assessment is that these risks have a rather low probability of materializing over our tactical investment horizon of around six months. That being said, in light of the heightened market vulnerability, these risk topics deserve special attention. In this report, we cover scenarios around the global business cycle, the US elections, the global trade dispute, and the Middle East crisis.

Related reports:

- CIO Reaction, 30 January 2020
- Asia Pacific economy: Investment guidance amid virus fears, 30 January 2020
- UBS House View monthly letter, 23 January 2020
- Global risk radar: Global trade – Route to de-escalation, 14 November 2019
- Global Risk Radar: The return of political markets, 2 October 2019

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Why the coronavirus matters for markets

Global financial markets have reacted strongly to rising concerns over the spread of the Novel Coronavirus. As of this writing, the virus has killed 565 people and infected around 28,000, according to data from the World Health Organization. We are closely monitoring the situation and will continue to communicate our views via different channels.

One interesting question clients have asked is why the financial markets are paying much more attention to the coronavirus than they have to seasonal flu, which infects and kills far more people each year. We think this is because the unknown nature of the coronavirus primarily impacts markets as it creates the fear of an uncontrollable global pandemic. Fear itself can cause governments, businesses, and households to take severe preemptive measures, causing significant collateral damage to the economy. For example, the temporary closure of factories in China poses a risk to global supply chains, especially as this comes on the heels of a similar threat posed by the latest global trade conflict.

All told, the impact on economies and markets is hard to assess, and we can only go by the assumptions we can make by looking at similar events in the past. The SARS coronavirus outbreak of 2003 comes closest to the current situation. For China, we expect a deep hit to first-quarter economic growth, which made us revise down our full-year growth forecast from 6% to 5.4%. This reduces our global GDP growth forecast for 2020 from 3.1% to 2.9%, but it should rebound into 2021 to 3.7%.

Thankfully, so far the official numbers for infections and fatalities outside China don’t suggest an uncontrollable global pandemic scenario. The coming weeks could show that China’s containment measures are working, which would alleviate global fears, in our view. For investors, we recently recommended the following strategies (please see Asia Pacific economy, “Investment guidance amid virus fears” and CIO Reaction from 30 January):

**Short term:**
- Avoid vulnerable companies in Asia
- Invest in “stay at home” stocks
- Buy high dividends

**Long term:**
- Stay diversified in an asset allocation context
- Refer to Longer-Term Investments themes
In light of these risk factors, investors have plenty of opportunities to consider in the current environment.

**Asset allocation:** Diversifying investment holdings across regions and asset classes remains the most efficient means of protecting portfolios against the downside during times of market stress. In our tactical asset allocation, we stay risk-on. We keep a preference for emerging market equities in spite of the recent virus-related sell-off. We expect the growth differential between emerging and developed economies to widen in emerging markets’ favor. Second, valuations are lower in emerging markets than in developed markets. Finally, many of the most promising secular trends in the coming decade of transformation are going to play out in emerging markets.

**Buy high dividend stocks:** We believe defensive stocks with strong cash flows and high dividend yields will provide diversification benefits for investors. The sharp decline in bond yields so far this year also increases the appeal of high dividend stocks.

**Gold:** Gold has proven its worth as a hedge against uncertainty this year. A long gold position can be considered as a potential hedge against many of the risk scenarios we mention.
As measured against their respective performance benchmarks

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* CIO investment themes should outperform their respective performance benchmarks in the mentioned CIO risk scenarios.

Source: UBS, as of February 2020

In Table 1 above, we summarize the likely market implications of our main upside and downside scenarios. Table 2 shows a selection of current CIO investment themes and tactical investment ideas that we expect to perform well relative to their benchmarks in our base case, as well as in some of our risk scenarios.

Expected total returns over a 6-month horizon. FX and spread levels as at end of Q2 2020. Note: Upside and downside scenarios are possible events outside of CIO’s base case expectations.

Source: UBS, as of February 2020
Key dates to watch

<table>
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<th>Feb</th>
<th>— 7 February, New Hampshire Primary</th>
<th>— 15 February, US-China Phase 1 deal comes into effect</th>
<th>— 22 February, Nevada Caucus</th>
<th>— 29 February, South Carolina Primary</th>
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<td>Mar</td>
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<td>— 5 March, China National People’s Congress</td>
<td>— 5 March OPEC meeting in Vienna</td>
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<td>Jun</td>
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<td>Nov</td>
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<td>— 21 November, G20 summit in Riyadh</td>
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<td>Dec</td>
<td>— 31 December, end of transition period for Brexit</td>
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Ongoing Monitoring

- **Central bank policy**
  - Board meetings / interest rate decisions
  - Statements by key officials

- **Politics**
  - Supranational organizations (e.g. G7, G20, IMF)
  - US-China relations (One China policy, South China Sea)
  - Middle East
  - Elections
  - Sanctions (e.g. Russia, Iran, North Korea)
  - Brexit negotiations

- **International trade**
  - Negotiation on new and existing free trade agreements (e.g. USMCA)
  - Discussion and action on tariffs (e.g. US tariffs on Chinese goods)
Will the global business cycle end in 2020?

Recent developments

Economic cycles ("business cycles") – from recovery, to expansion, to overheating, to recession – may be the single most important driver of financial market returns over a six- to 12-month investment horizon. Over the past few decades, the integration of supply chains and financial systems has made business cycles a largely global phenomenon. Global recessions are usually preceded by equity bear markets, with global stocks losing at least 20% of their market value over a period of six months or more. Today, the global business cycle is largely driven by two of the world’s largest economies: the US and China. Monitoring these economies for signs of a cyclical downturn is key in deciding the appropriate level of risk in an investor’s portfolio.

Current state of the business cycle

Forces that drive economic cycles in any given country include job creation, debt and inventory build-ups, monetary and fiscal policies, and the occasional exogenous shocks. The same applies to both the US and China, but the differences in the two countries’ economic models make their business cycle dynamics fundamentally different. Below is a brief overview of where we currently stand on each of these metrics.

- **Job creation:** *Currently in a late cycle ("overheating")*
  The US labor market has tightened significantly since the end of the last global recession in 2009. US unemployment is at a 70-year low, and scarcity of workers is starting to push up wages. A tight labor market is generally a sign of a late cycle, but it is not a concern until stronger wage growth puts upward pressure on inflation. That would indicate an economy running above its long-run potential growth rate.

  In China, labor markets are less of a cyclical concern as state interventions ensure stable job growth as a key priority. But at the same time, China’s employment dynamics are an important gauge of political stability, as a broken promise to workers may cause social unrest, resulting in a shock to the economy. Currently, China’s labor markets do not seem to pose an immediate concern.

- **Debt build-up:** *Currently in a late cycle ("overheating")*
  Both the US and China have pockets of excessive debt - albeit in different sectors of the economy. In the US, leverage has built up in the non-financial corporate sector after a decade of aggressive monetary easing by the Federal Reserve. In China, the burden of over-indebtedness falls on local governments as the state uses debt-fueled public spending as a means to stabilize economic growth.

  Over-indebtedness is a strong sign of a late economic cycle, as it limits the scope for further consumption and investment. High leverage in an economy is not an imminent concern in and of itself, but it does become a systemic risk once the creditworthiness of debtors gets called into question. In the US, this may happen if rising inflation expectations put pressure on the Fed to resume raising interest rates; in China, this may happen if the aggregate debt-to-GDP ratio reaches an unsustainable level, or if the central government makes a policy mistake.
- Monetary policy: Currently in mid-cycle (“expansion”)
In 2019, the global economy experienced a “mini-cycle” that has thrown monetary conditions back into mid-cycle territory.aced with an economic drag from the US-China trade dispute, the Fed took a U-turn from its interest rate hiking cycle and cut rates three times. Meanwhile, the People’s Bank of China (PBoC) eased monetary policy and the Chinese government relaxed its previous restrictions on leverage growth.

As a side-effect of these measures, the trend of moderating economic growth and tightening financial conditions – an environment normally associated with a late economic cycle – was interrupted. Instead, 2019 was a year when an external growth shock led to easing financial conditions, causing a rally in financial markets and further buildup in Chinese debt. At the same time, the growth slowdown in China created new slack that can be filled as growth recovers.

Our view

Base case (50% probability): Protracted late cycle
The global manufacturing sector is slowly picking up now from the slump caused by US trade tariffs on China. Global economic growth is seen bottoming by end-1Q20 with China and Asia leading the way up, although the coronavirus outbreak may delay this recovery somewhat. A modest rebound in growth amid a looser monetary policy should create a market-friendly environment which CIO thinks can last throughout 2020 as long as the Fed is able to keep its monetary policy on hold, and the Chinese authorities do not lose their grip on financial stability.

Downside scenario (25% probability): Cyclical downturn in 2020
CIO does not believe that a downturn is imminent in 2020. If anything, major economic risks that we are following seem more contained today than they were a year ago. Still, loose financial conditions in a late cycle economy often bear unintended side-effects: Asset bubbles tend to form more easily, and aggregate debt levels keep rising to unsustainable levels. In the long run, this makes the economy more vulnerable to both internal and external shocks, which can range from rapid changes in interest rates, to market-unfriendly political outcomes, to any number of unknown unknowns.

As risks to the business cycle only tend to rise with time and market impact can be quite severe, economic growth in the US and China requires constant monitoring. If either the US or China were to enter a cyclical downturn, investors would be well-advised to reduce exposure to equities, credit and other risk asset classes in favor of safer investments such as high-quality bonds, safe-haven currencies, or gold.

Upside scenario (25% probability): Return to mid-cycle
As with the shocks that may end the cycle, economic conditions may conspire to prolong and accelerate this expansion. Technological advancements in the US may finally come through in productivity growth which has remained stagnant for much of the past decade. This may help the global economy to re-accelerate without the negative repercussions of late cycle overheating. Economic conditions could follow monetary policy in re-entering a mid-cycle environment, and markets could enjoy a few more years of uninterrupted capital gains.

Investment conclusions
In the base case, CIO believes that a combination of gradually re-accelerating growth and loose financial conditions should create a
positive environment for risk assets, especially emerging market (EM) equities and select EM currencies. We maintain a pro-cyclical bias in our global asset allocation for the time being as we see the main downside risks as largely contained. Our risk-on positioning would benefit even more strongly in the upside scenario of a cyclical upswing.

For investors who see a higher chance of a cyclical downturn in 2020, a more cautious stance may be appropriate. Investors looking to protect their portfolios from a possible bear market may consider allocating a higher proportion of their capital to safe-haven assets such as the Japanese yen, the Swiss franc, and US Treasuries. Given the current environment of near-zero safe bond yields outside the US, safe-haven opportunities in ex-US high-quality bonds and the US dollar appear limited; in this context, some allocation to gold may be a prudent alternative.

Surveys of manufacturing business activity (Manufacturing PMI) for the US, EMU, China, and globally, in levels.

Key dates to watch
- **29 Feb 2020**: China business activity surveys
- **6 Mar 2020**: US labor report
- **18 Mar 2020**: Fed meeting / policy rate decision
- **27 Mar 2020**: US April core PCE inflation
- **17 Apr 2020**: China GDP growth for 1Q 2020

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Global trade

Will import tariffs undermine global growth?

Recent developments

On 15 January, the US and China signed a Phase 1 trade deal after months of dispute. The US confirmed a partial removal of tariffs on Chinese imports, while China promised to ramp up purchases of US goods and services by an additional USD 200bn over the next two years—greater even than the USD 186bn value of goods and services China imported from the US in 2017. The deal also establishes a new enforcement mechanism with monitoring and dispute-resolution functions. It marks an important turn for financial markets, as it reduced the risk of tariff escalation between the world’s two largest economies.

By contrast, no progress has been made on US trade with the European Union, which could be the next target of President Donald Trump’s administration. The US and France recently agreed on a truce in their trade dispute, but France is joined by other European countries in planning to introduce a digital tax chiefly targeting revenues of US technology companies.

Our view

Base case (65% probability): A year of temporary relief, with occasional hiccups

The US presidential elections in November should provide some relief from trade tensions as political priorities shift away from escalating disputes. Hence, the US and France recently hold fire in its trade dealings with China and the EU in 2020. Global trade risks still need to be monitored, however, as many fundamental reasons for the conflicts remain in place.

With the Phase 1 deal signed, financial markets will likely turn their attention to the agreement’s implementation and to the future of US-EU trade relations. The chances for positive surprises are low, in our view. For one, the agreed targets on Chinese imports of US goods are too ambitious to begin with—and they won’t get easier if China’s economy gets disrupted in the first quarter by the outbreak of the Novel Coronavirus. On a positive note, China recently announced they will halve tariffs on USD 75bn of US imports.

Occasional flare-ups could still arise from the US blacklisting of Chinese technology companies, or from political developments in Hong Kong where legislative elections are scheduled for September. It’s important to keep in mind that not only President Trump but also the US Congress could become more vocal about these topics.

The range of sources for potential conflict between the US and the EU is large. It covers trade in aircraft, cars, and natural gas; technological standards; and digital taxes, among others. Complicating the situation is the paralysis in the appellate body of the World Trade Organization. We think, however, that an escalation to the same extent as the US-China conflict last year is unlikely in 2020. Taking a tough stance against the EU seems a less popular view in the US, and the risk of potentially large economic damage should also tamp down the appetite for escalation.
Renewed tensions between the US and Mexico also cannot be ruled out. The US-Mexico-Canada trade agreement (USMCA) has been signed by President Trump. That said, in April last year, he gave Mexico a one-year notice to stop the flow of illegal drugs and migrants from Mexico, or else face tariffs on autos. The US election campaign may increase political attention on these issues.

**Upside (15% probability): Further easing of tensions accelerating growth upswing**

President Trump could try to improve his reelection chances by further promoting his image as a dealmaker. A further de-escalation could see a relaxation of the US blacklist against Chinese tech companies, a Phase 1 trade deal with the EU, or even a Phase 2 deal or early tariff reductions with China. A preliminary deal with the EU could see increased purchases of US agricultural products and natural gas, while China and the US could roll back some tariffs in a Phase 2 deal. A further easing of tensions between the US, China, and the EU could support the recovery in business sentiment and lead to higher investments and stronger economic growth.

**Downside (20% probability): Renewed escalation leading to a US recession**

In our risk case, we see the chances of a US recession and a material global economic downturn rising dramatically. A key difference to 2019 is that it would probably take longer to escalate trade tensions now due to certain procedural requirements that have been put in place. This makes such an outcome less likely for the first half of this year. Actions that could trigger our risk case include:

- **Tariff escalation between US and EU:** President Trump has repeatedly threatened to impose a 25% tariff on European cars. This would harm major auto exporters such as Germany while also hurting the US auto industry. Last November’s deadline for the US to impose such tariffs passed without a decision. This could complicate and lengthen the process of introducing them now. The US administration could also use tariffs to retaliate against the introduction of digital taxes in some European countries.

- **Renewed tariff escalation between US and China:** If China fails to meet the Phase 1 import targets, tensions could rise again. The Phase 1 deal includes a bilateral evaluation and dispute-resolution mechanism. The maximum of 75 days to resolve a dispute indicates that an escalation could take several months to unfold. If the implementation of the Phase 1 deal fails, both administrations could resort to reintroducing tariffs. Negotiations on a Phase 2 deal, including contentious issues like intellectual property protection, will likely be drawn out into 2021. A premature escalation could also lead to rising tariffs this year.

- **Escalation on technology issues:** The Trump administration could decide to restrict US companies from trading with Huawei and other Chinese companies on a so-called "entity list." China could respond with its own list of "unreliable" companies. An economic recession in the US would only seem likely, however, if this leads to another ramp up in tariffs.

**Investment conclusions**

In our view, the transition to a protectionist environment will generally favor companies that depend more on consumer than
business spending. Emerging market infrastructure could also offer opportunities as supply chains adjust.

In our upside scenario, risk assets would appreciate and yields on safe bonds rise. For global equities, we would expect returns of 0–10% while the USDCNY exchange rate could drop to 6.50.

Our downside scenario would significantly increase the risk of a US recession in 2H20 or 2021. Ultimately, this would shift markets from a late-cycle stage to end-of-cycle territory, with more severe consequences for risk assets. We would expect global equities to experience a drawdown of 10–15%, with sectors exposed to the trade conflict (e.g., industrials and materials) suffering more than defensive sectors such as consumer staples and healthcare (two global sectors we also like in our base case scenario). Safe-haven currencies such as the Swiss franc and the Japanese yen would likely appreciate alongside gold and high-quality bonds.

### Key dates to watch

- **15 Feb 2020**: US-China Phase 1 deal comes into effect
- **17 Feb 2020**: Huawei Temporary General License extension ends
- **1 Apr 2020**: Earliest likely date for next release of the US Treasury’s semiannual FX report
- **4 Apr 2020**: Potential tariffs on imports of Mexican cars

**Expected market impact**

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<td>EM FX</td>
<td>USD</td>
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<td></td>
<td>CNY vs. USD</td>
<td>USD</td>
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</table>

Note: UBS expert assessment of expected asset class performance on a 1- to 12-month view. In absolute terms, upside and downside scenarios are outside of UBS’s base case expectations.

Source: UBS, as of February 2020
Global risk radar

Oil supply

Will tensions in the middle East disrupt oil supply and what does it mean for markets?

Recent developments

On 3 January, Iranian top general Qasem Soleimani was killed in Iraq in a US military drone strike ordered by President Donald Trump. US officials declared the strike came in response to the killing of an American contractor and recent Iranian-backed attacks on the American Embassy in Baghdad. The killing of Soleimani risked dragging the Persian Gulf to the brink of war but Iran’s retaliation of firing missiles on a jointly run US-Iraq base in Iraq carefully avoided causing any US casualties.

Both the US and Iran thereafter sought to play down the attacks to de-escalate the situation and Trump announced he would respond by imposing further sanctions instead of another military strike. Brent crude prices soared up to USD 70/bbl right after the US strike on Soleimani as investors applied geopolitical risk premiums, but subsequently dropped again below USD 60/bbl as tensions abated.

Following the killing of Soleimani, the Iraqi parliament called for foreign troops to be expelled from the country, a pledge renewed by the newly appointed Iraqi Prime Minister Tawfiq Allawi. Prior to the attacks, Iraq had also been the siege of three months of relentless anti-government protests, with demonstrators pressing for an overhaul of the country’s political system. Violent clashes have burst between police and demonstrators, with 500 people killed in the unrest so far.

Our view

Base case (90% probability): Limited upside to oil prices

We think tensions in the region will continue to experience ebbs and flows, but a full-blown military conflict between the US and Iran is unlikely. We suspect that both sides will continue to come into conflict occasionally and keep up the heated rhetoric. Further Iran-led attacks on regional energy facilities over the coming months are also possible.

As the January events have demonstrated, both sides seem willing to avoid an all-out war. Iran knows they could hardly win a shooting war with the US and would wreak enormous economic damage on the Islamic Republic. For the US, a large scale military involvement would be very costly and drawn out given Iran’s wide-ranging military capabilities, something that Trump likely would want to avoid going into the US presidential election.

Recent comments suggest that Iran may conduct further retaliatory actions, after the country’s supreme leader Khamenei admitted the US base strike in Iraq was a limited response. The Islamic Republic has a long record of using terrorism and attacking its enemies via regional proxies such as the Houthis in Yemen or Hezbollah in Lebanon. It is likely to see an increase in militia activities aimed at disrupting US interests in Iraq as well. We expect such attacks to have only a short-term impact on oil prices, but prices could bounce considerably as markets temporarily incorporate risk premiums. We believe any overshoot above USD 70/bbl is unlikely to be sustained.

On balance, we retain our positive outlook for oil prices in 2H20, with Brent recovering to USD 64/bbl in 3Q20. We expect ample supply growth and sufficient spare capacity of OPEC+ producers to keep

Risk dimensions

CIO expert assessment (downside scenario)

Note: Distance from center (1-4) represents the dimension score. The CIO risk score is an average of the four risk dimensions.

Source: UBS, as of February 2020
the market well supplied in 1H20. Worries that the spread of the coronavirus will impact economic growth could lead to a temporary downward pressure on oil prices, in our view.

**Downside scenario (<10% probability): Military escalation leading to a sustained oil supply disruption**

The likelihood of a military escalation leading to a full-scale crisis is contained for now, in our view, but the fundamental reasons for conflict are unresolved and Iran has various tools to disrupt oil supply from the region. We see a blockage of shipping in the Strait of Hormuz as very unlikely but more attacks on targeted tankers could be conducted. In addition, Iran is able to mobilize its proxies in the Middle East, to target oil facilities.

In Iraq, which is actually a larger oil producer than Iran now, both domestic unrest and the surrounding geopolitical tensions are feeding worries concerning oil output in the country, according to the International Energy Agency (IEA). The nature of US-Iran hostilities has changed the domestic political landscape in Iraq and there is a real risk that Iran-backed militias are now driving Iraq back towards conflict. In late 2019, some oilfields were temporarily shut down as the widespread unrest had escalated.

The impact on the oil price would depend on how much oil volume is disrupted and for how long. In the worst-case scenario, prices could spike above USD 90/bbl for months. A meaningful and sustained spike in oil prices could weigh on global capex and the consumer, increasing the likelihood of pushing the global economy into a recession. However, in such a scenario, the IEA could potentially request its members to deploy their strategic oil reserves to counter the price spike. We assign a very low (less than 10%) probability to that scenario.

**Investment conclusions**

Supply-driven oil price shocks have historically played an important role in the global economic cycle, especially in the 1970s and the 1980s. Higher oil prices feed through the entire economic value chain and can drive up prices for many products and services. Sustained spikes in crude oil due to geopolitical tensions have historically represented severe exogenous shocks for markets due to their stagflationary impact.

During previous significant oil supply shocks, global equities fell about 15% on average, but recovered within six months. In credit, high yield and emerging market bonds suffered the most, but recovered within three months. The worst hit-markets would likely be high-yielding crude importers (such as Egypt, Turkey, South Africa, Lebanon, and Tunisia). Investment grade-rated energy exporters with limited or no exposure to tensions in the Middle East may benefit (for example, Russia and Kazakhstan). High yield energy exporters could also benefit, but only if the impact of the oil spike on the global economy and investor risk appetite remains limited. High quality bonds have offered some protection in the past, but they may be a less effective hedge today as most interest rates are close to all-time lows. In the past, the US dollar initially appreciated as investors sought a safe haven, but then weakened on high oil prices. Due to its safe-haven status, we would expect gold to also show gains on renewed Middle-East tensions.

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### OPEC spare capacity is ample

<table>
<thead>
<tr>
<th>Country</th>
<th>Spare Capacity (mbpd)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Saudi Arabia</td>
<td>2.5</td>
</tr>
<tr>
<td>UAE</td>
<td>2.0</td>
</tr>
<tr>
<td>Iraq</td>
<td>1.5</td>
</tr>
<tr>
<td>Russia</td>
<td>1.0</td>
</tr>
<tr>
<td>Kuwait</td>
<td>0.5</td>
</tr>
<tr>
<td>Nigeria</td>
<td>0.0</td>
</tr>
<tr>
<td>Other OPEC countries</td>
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</tr>
</tbody>
</table>

**Values are in millions of barrels per day (mbpd)**

Source: IEA, UBS, as of January 2020

### Expected market impact

<table>
<thead>
<tr>
<th>Scenario</th>
<th>Positive for...</th>
<th>Negative for...</th>
</tr>
</thead>
<tbody>
<tr>
<td>Base case</td>
<td>EM Equities</td>
<td>US dollar</td>
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<tr>
<td></td>
<td>EM FX</td>
<td></td>
</tr>
<tr>
<td>Downside</td>
<td>High quality bonds</td>
<td>EMU equities</td>
</tr>
<tr>
<td></td>
<td>Crude oil</td>
<td>Japanese equities</td>
</tr>
<tr>
<td></td>
<td>Gold</td>
<td>Bonds of oil importing countries (EUR H1, Turkey, etc.</td>
</tr>
<tr>
<td></td>
<td>Swiss Franc</td>
<td></td>
</tr>
</tbody>
</table>

Source: UBS as of February 2020

### Key dates to watch

- **5 Mar 2020**: OPEC meeting in Vienna
- **6 Mar 2020**: OPEC+ meeting in Vienna

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US elections

Will the US presidential campaign lead to higher market volatility?

Recent developments

The first major test of the candidates’ popularity occurred on 3 February in Iowa. The state has a mediocre record of choosing national party nominees, but its position as the first official contest prompts extraordinary media coverage. Candidates that exceed expectations in Iowa often gain some momentum in subsequent contests, while those that fail to do so can encounter subsequent fund-raising challenges.

This week’s results are a case in point. With 71% of the voting precincts reporting, Pete Buttigieg and Bernie Sanders appear to have captured the lion’s share of the state’s delegates. Elizabeth Warren and Joe Biden trailed the leaders. Biden’s failure to meet expectations, despite a plea that he is better positioned to beat President Trump in November, levels the playing field and increases the probability of a lengthy nomination fight.

Senator Sanders cemented his position as the leading contender, which may result in the progressive wing of the Democratic Party coalescing around him as their standard bearer. He is well positioned to win in New Hampshire next week, where he holds a lead over Biden in recent polls, but will likely face obstacles in South Carolina later this month.

Our view

No clear primary winner yet

Aside from the prolonged delay in the release of results from the Iowa caucuses, this year’s primary season is unusual in three respects. First, the sheer number of candidates still vying for the Democratic nomination has resulted in a fragmentation of support among numerous candidates. Biden’s unexpectedly poor showing in Iowa has altered the dynamics of the race and opened the door for others to challenge Sanders for the nomination. Buttigieg’s prospects certainly have improved, but his campaign strategy of interacting personally with voters will be impossible to replicate as the campaign season accelerates. Warren’s campaign organization appears to be well organized, so she should be able to compete in multiple states for the foreseeable future.

Second, the rupture between the moderate and progressive wings of the Democratic Party appears to have widened. Rival proposals for federal involvement in the provision of healthcare are the most prominent examples of the competing policy platforms. The opposing perspectives raise the possibility of a hotly contested primary season and a divisive convention this summer. Democratic Party primary voters, or convention delegates, will have to decide whether to nominate a centrist capable of appealing to disaffected Republicans and independents or a progressive candidate who can energize an activist base enough to increase voter turnout substantially.

Third, the decision by former New York City Mayor Michael Bloomberg to enter the race changed the calculus in the important primaries scheduled for next month. Bloomberg did not campaign in Iowa. Nor is he expected to do so in New Hampshire or South Carolina. Instead, having already spent a fortune on mass media advertisements in states that hold primaries in March, he has increased staffing and doubled ad spending in the wake of the Iowa results. While his nomination remains
improbable, his presence in the race may be enough to prevent any one candidate from garnering enough delegates to lock up the nomination before the convention.

**Policy issues**

The contenders have promulgated a wide array of policy proposals but they do share some common characteristics. The details vary, but each one supports higher tax rates, more stringent regulatory requirements, and greater involvement by the federal government in the provision of healthcare. We believe the policy choices most likely to affect market behavior fall into four very broad categories: monetary, fiscal, trade, and regulatory policy.

The first of these, monetary policy, is the province of the Federal Reserve. The Fed has charted an independent course for more than a century and is expected to continue to do so regardless of the political pressure exerted by the US president.

The second, fiscal policy, will be actively debated and scrutinized by voters but requires Congressional legislation. There are numerous practical impediments to the enactment of higher taxes. Financial markets are likely to acknowledge those obstacles and discount the risk to some degree. The same can be said for greater federal involvement in the provision of healthcare, where a single payer system remains an unlikely outcome. However, the nomination of either Sanders or Warren poses the bigger risk to market valuations because a victory by either one in November would likely signal a simultaneous shift in the composition of Congress.

The third policy area is international trade. As we discussed in prior reports, the near absence of any overt criticism of tariffs within the Democratic Party is revealing. The candidates are more or less aligned with the general thrust of the Trump administration’s trade policies, particularly as it relates to China. To the extent they have registered any disagreements, the president’s tactics are criticized rather than the overall strategy.

The final policy area is one where a new administration has expansive authority to make substantive changes and therefore entails significant market risk. US presidents retain broad authority over the promulgation of new federal regulations. Each of the Democratic contenders is likely to use his or her regulatory authority, if elected, to impose more stringent regulations in the area of energy, heath care, technology, and financial services. If either Senator Sanders or Senator Warren capture the nomination, the market risks and resulting price volatility in these four broad equity sectors are likely to rise. Conversely, we believe a Biden or Bloomberg nomination would ease market anxiety and result in less market disruption. We expect greater clarity regarding the likely Democratic nominee after 10 March, by which time the state parties in 25 separate US jurisdictions will have awarded delegates to the national convention.

**Investment conclusions**

So we believe investors should consider strategies to increase the resilience and upside of their portfolios regardless of the electoral outcome. This can be achieved through diversification, strategies to protect against the downside, along with a focus on higher growth businesses.