

Navigating markets

Where to now?

The COVID-19 outbreak has created an 'overnight' global shutdown without precedent, and without much certainty as to its resolution. Central banks and fiscal authorities have responded with an impressive range of tools to support business and individuals, laying the groundwork for an eventual recovery.

Key Takeaways

- The COVID-19 pandemic has triggered the most abrupt global economic shutdown of modern times, and we believe the downturn will be deeper and more global in nature than the Global Financial Crisis of 2008/2009.
- We believe the economy is in a better position to recover quickly once the health crisis subsides due to fast and creative monetary and fiscal support around the world, which has already gone beyond what we saw in 2008/2009.
- From here, the key for markets is what happens with healthcare. That includes ensuring hospitals are not overwhelmed, widespread testing and tracking, and most crucially, developing effective antiviral therapies.
- Over time, aggressive monetary and fiscal policy has the potential to create inflation, which would significantly change the dynamics for asset allocation.
- Post-pandemic, deglobalization, greater use of digital options and a new appreciation of sustainability will create new investment risks but also create opportunities.

Evan Brown, Head of Multi-Asset Strategy

The COVID-19 pandemic continues with the US and Europe (ex-Italy) generally following Italy's trajectory of new cases, although at a somewhat faster pace. The economic shock also continues to grow, with new unemployment claims in the US shooting up to 6.6 million the week ending March 28, double the 3.3 million the week before.

Monetary and fiscal policy has played an enormous role in preventing this health and economic shock from turning into a financial crisis. The response has been faster, more creative and far more comprehensive than during the Global Financial Crisis of 2008/2009.

Stimulus will support an economic recovery once the pandemic is under control, but asset allocators are already assessing how it will change the investment landscape.

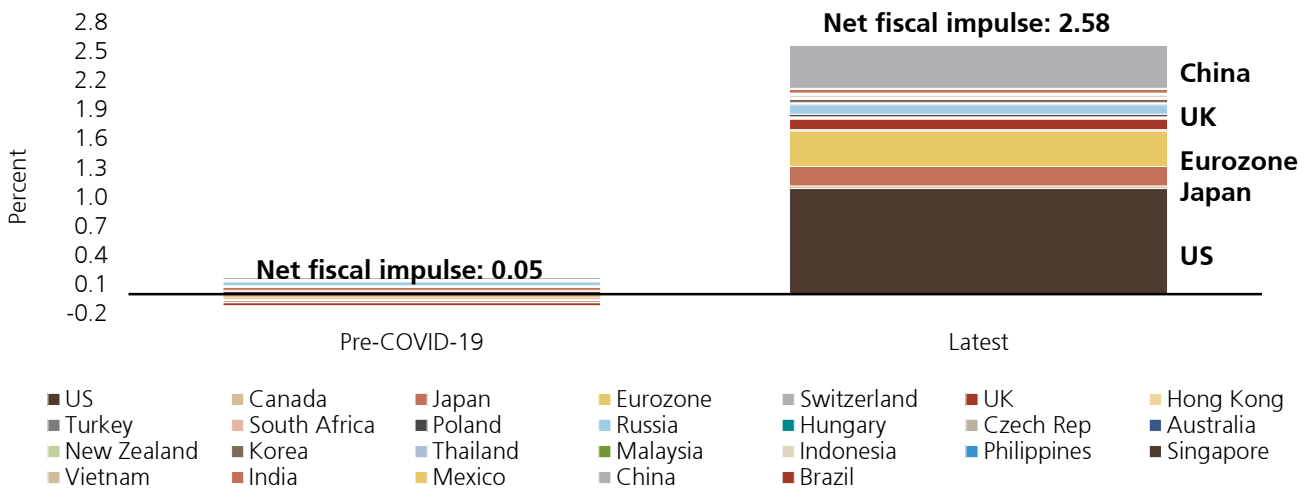
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Evan Brown

Our base case and negative scenario

Our base case - admittedly there's wide latitude around this - is a gradual re-opening, starting in mid- to late-May, with most mobility restrictions wrapping up by the end of June. The negative scenario has a longer shutdown or a second wave of infections later this year.

Fiscal stimulus will easily exceed the 2008-2009 response



Source: US Congress, UBS Asset Management . Data as of March 30, 2020

While a vaccine is 12 to 18 months away, successful trials and ultimately widely available therapeutics would go a long way in restoring consumer and business confidence. We expect to have more information about such medications by the end of this month, which could prove an important market catalyst.

In the meantime, global stimulus programs are providing necessary economic relief now, and 'laying foam on the runway' for an eventual rebound.

The investment landscape will change as growth returns

At the moment, the global economy is experiencing a disinflationary shock. But when the economy recovers and considering new supply constraints and the degree of monetary and fiscal stimulus, investors should not rule out the return of inflation.

Historically, inflation above 2.5% was enough to shift the negative stock/bond correlation we've experienced over the last 20 years back to the historical norm of a positive stock/bond correlation. If central banks continue to keep rates low, we at the very least will move from a negative to flat stock/bond correlation over the medium term.

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This presents a challenge to asset allocators looking to diversify equity exposure. This is a good time to consider alternatives for hedging different macroeconomic outcomes. Investors may consider liquid real assets, absolute return or risk control strategies.

Massimiliano Castelli, Head of Strategy, Global Sovereign Markets

One way to understand the investment implications of the crisis is to look at sovereign institutions -- central banks and sovereign wealth funds around the world -- which are among the largest institutional investors. These funds have different investment profiles, some require more liquidity while others are broadly invested in long-term alternative assets. Equity allocations have generally risen over the years for most of them because of equities' better expected long-term return given the low interest rate environment.

Sovereign funds' surprising reaction to the crisis

So far in 2020, losses for sovereigns have been around 12% to 15%. Equity markets are down around 25%, cash rates are around 0%, while long-term debt yield is an ongoing problem.

What are these funds doing?

Based on anecdotal evidence, we can say this:

- we haven't seen panic selling
- central banks' stimulus programs have improved the liquidity situation
- these funds traditionally are big on rebalancing, but...
- they are not rebalancing yet

The market sell off has significantly improved the five-year outlook for some key risk assets, while fixed income investing will remain a challenge.

Massimiliano Castelli

We believe this is due to uncertainty about the markets and we believe many will wait until the environment is less uncertain. The market sell off has significantly improved the five-year outlook for some key risk assets, while fixed income investing will remain a challenge.

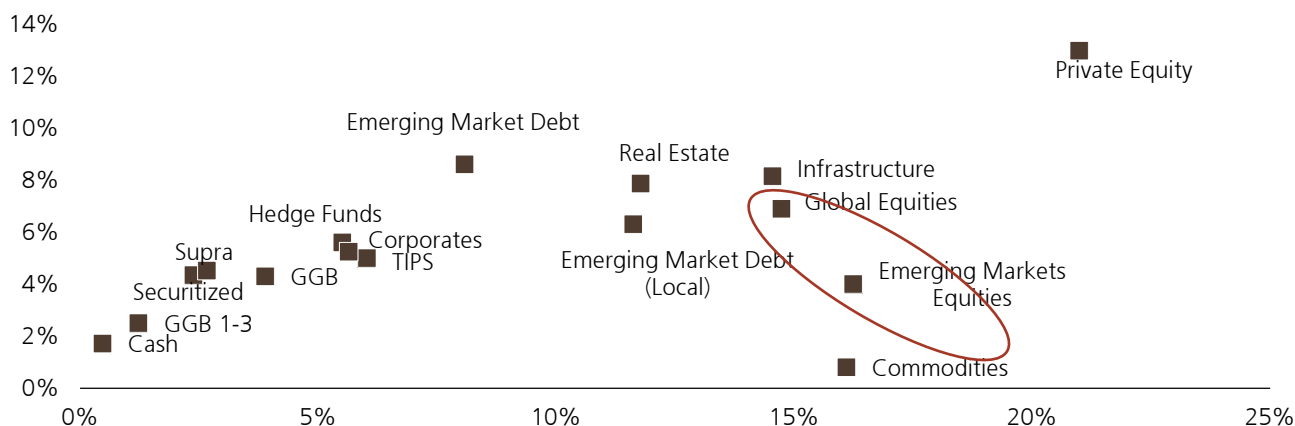
I believe some are increasing exposure to the US and Chinese equity markets, which continues a pre-pandemic trend.

The pandemic is accelerating long-term trends

We see several ongoing global trends that we believe are being accelerated by reaction to the COVID-19 pandemic. Three in particular have significant implications for investors

The past two decades of asset returns, 2002-2019

Historical returns and standard deviation, 2002–2019



Source: UBS-AM. Please note that past performance is not a guide to the future. Data as of end of December 2019.

Note: Data for Private Equity and Real Estate for 2003 – 3Q 2019.

The most obvious is de-globalization. Value chains are shortening as the pandemic underscores the ongoing trend of bringing production within borders. One example: The ongoing US-China decoupling.

The pandemic will drive increasing use of technology and the digitization of many businesses, particularly in countries that lagged behind the leaders.

Sustainability has been a concern for investors for some time. We believe concern about sustainable economies will broaden generally once a rebound gets underway.

Q&A:

1 What major moves, changes or revisions have you made on the asset allocation side in the past month, and how does that related to some of your sovereign wealth fund clients?

Evan Brown (EB): We are starting to see the increase in risk premia, so we find equities attractive.

Within equities markets we are overweight Japan and China equity. This is largely a reflection of the fact that Asia is a little bit more ahead of other countries, in particular Europe and the US, in terms of the spread of COVID-19.

On the fixed income side we are overweight particularly Chinese fixed income. This is a result of the fact that the interest rate differential between RMB-denominated bonds and the USD increased because they only had to buy US bonds.

We find the short end of the US curve attractive. We also like US investment grade. These are our most practical views.

2 What questions are you hearing from clients?

EB: Clients have been asking about the timing of an eventual re-entry on risk assets. And this is very much linked to the fact that we are in a sort of uncharted territory here.

I do not think there is an answer yet about the timing of the control of the coronavirus, or even about the magnitude of the damage in economic terms, because we don't know yet how far and how deep these policies that are being implemented around the world will eventually provide support.

3 What else should we expect from governments in the US, EU and China in the coming weeks? Do you think the current pace of the policy response is sustainable from a financial stability basis, from a legal basis and from a social basis?

EB: The US is not done. You already are seeing President Trump and Nancy Pelosi, the House majority leader, talking about large infrastructure plans and the need for more stimulus. As to infrastructure, it may be hard for Democrats and Republicans to get on the same page, as they have very different views on how to deliver those sorts of plans. But we do think we'll get something more: probably a payroll tax cut to give more support for families affected by the by the virus, and more support for state and local governments in dealing with the shutdowns and the aftereffects.

We just had a USD 2.2 trillion plan and I would not be surprised to see another USD 1 to 2 trillion plan being in motion by the end of April. Europe is trickier to gauge.

We're absolutely seeing fiscal responses by individual countries right now, and now European leaders are debating the exact way to create a more coordinated policy response. Italy, Spain and France are looking at so-called Coronavirus bonds or joint bond issuance, where there's a low cost and shared liability.

Meanwhile, Germany and Netherlands have been more hesitant on that. We'll get more news on that over the next week or so. And then in China, we've seen about 1.2% of GDP stimulus. We expect to see another 1.2% GDP stimulus, as they try to get their economy going.

Is this sustainable? Yes, as long as interest rates remain low and countries are able to maintain low interest rates, which they should be able to do. So, I think it is sustainable in the near term given the deflationary shock. We're not likely to see any kind of surge in inflation at the moment. I believe we're going to see continued monetary fiscal stimulus and coordinated stimulus and this is what the new normal will look like for counter cyclical monetary policy. We expect to see more monetary and fiscal coordination and less independent central bank. How sustainable it is over the long term will depend on society's tolerance for inflation.

Register for the next in our series on **Wednesday April 8 (GMT: 1430)** with a panel of our most experienced equity portfolio managers on what opportunities they see in the coming months. Use this [link](#)

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