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Global financial markets

Coronavirus scenarios: How should investors position?

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- Fears of a longer-lasting global fallout from COVID-19 weigh on investor sentiment.
- While we think recent market distortions create opportunities in selected markets, uncertainty about the further development of COVID-19 and the economic damage it creates remains high.
- In this report, we map two broadly defined scenarios and explain how investors can position in each of them.

In our last Global Risk Radar report, we highlighted that investors should not be complacent. Since then, the coronavirus has spread worldwide and global equities have experienced their largest weekly fall since 2008. We would characterize the market response since mid-January as typical "flight to quality" behavior. While cyclical asset classes such as Japanese and Eurozone equities as well as oil have suffered, the so-called safe-haven assets have benefited. For example, yields on 10-year US Treasuries fell below 1%, the lowest level on record.

While we believe the recent market distortion has created opportunities, it is far too early to declare an all-clear (see CIO alert from 2 March for more details).

A key part of our investment process is assessing the potential paths of current risks and the subsequent market reaction. Out of the range of possible outcomes, we have mapped two broadly defined scenarios for the next six to 12 months.

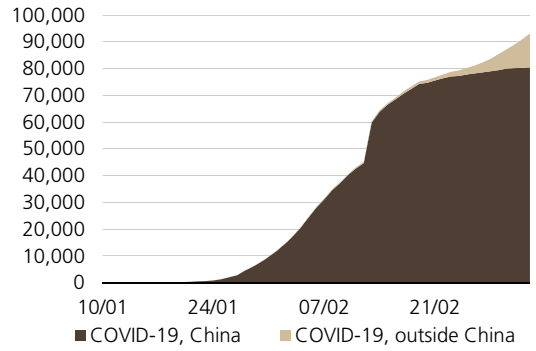
Base-case scenario. This scenario sees public fear of the virus fading over the next couple of months. The outbreaks in China, Japan, South Korea, Europe, and the US peak over the coming weeks and remain largely confined to regional epicenters like northern Italy. In addition to successful containment measures, the COVID-19 epidemic could also fade on its own, for example when temperatures rise during the spring season, similar to the seasonal flu. Under this scenario, global GDP growth slows in the second quarter. Some regional economies may see a contraction. But while there is a risk of a recession, policy action and people's ability to adapt should prevent it. A rebound in GDP growth should take place in the third quarter, as fear fades and demand recovers. The boost from easier central bank policy and fiscal stimulus would spur growth and help risky assets in Q2 2020.

Related reports

- Asia Pacific economy: Investment guidance amid virus fears III, 4 March 2020
- CIO Alert: Adding to risk after market sell-off, 2 March 2020
- CIO Alert: Markets brace for greater disruption from COVID-19, 29 February 2020
- Global Risk Radar: Coronavirus and other market risks for 2020, 6 February 2020

China seems to have peaked; global numbers continue to rise

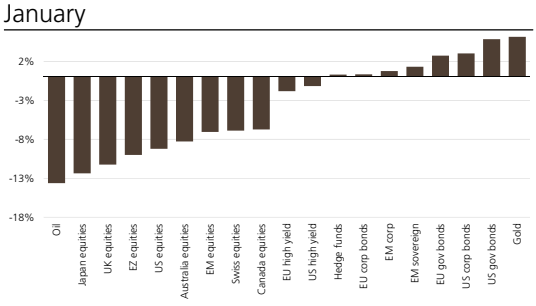
Total confirmed COVID-19 cases, China versus rest of world



Sources: Macrobond, WHO, UBS, as of 4 March 2020

Risky assets have underperformed since the January peak

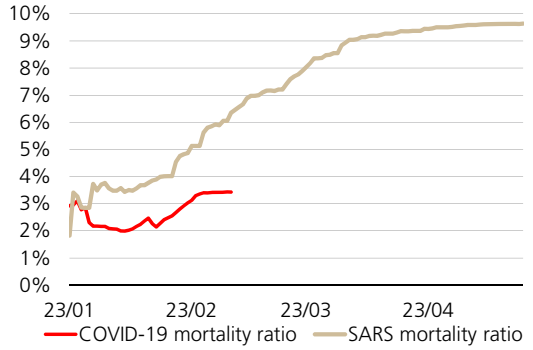
Total returns of select asset classes since 21 January



Source: Bloomberg, UBS, as of 2 March 2020

Downside scenario: In this scenario, fear of the coronavirus intensifies, and attempts to slow its spread become more drastic and long-lasting. Even if fear peaks in the third quarter, demand would still take a blow and weaken further. A longer pandemic also means that the supply of goods will be disrupted as more workers fall ill. Fewer workers at their jobs would then mean less economic activity. The downturn will thus become more pronounced. This risk case increases the probability of a recession, but we still think policy stimulus will prevent that from happening. This scenario paints a more negative near-term economic outlook but sees the potential for a stronger bounce later in the year.

Mortality rate high enough to generate fear
COVID-19 versus SARS mortality (starting 18 March 2003)



Sources: Macrobond, WHO, UBS, as of 4 March 2020

Summary of our key findings across both scenarios

Selected Scenarios	Scenario Description	Expected market performance for select asset classes
Base case: Limited number of local epicenters	Outbreaks in China, Japan, South Korea, Europe and US should peak by end-March, and remain largely confined to regional epicenters.	**Global equities** +5% to +10% with single digit earnings growth expected this year. Valuations are more attractive now than at the beginning of the year **EM Equities** +10% to +15%profit from higher earnings growth and cheaper valuations vs Eurozone **US rates** subject to cuts and liquidity operations as a means of damage control **US HY** +3% to 5% as spreads tighten with investor demand resuming. Rising Treasury yields compensate part of the move **EURUSD** tests 1.10 in the short term, due to US yields bouncing back. EURUSD expected to reach 1.13 by end-June, due to improved global growth outlook **Diversified commodities** + 10% to perform positive amid pick up in global growth. Monetary policy remains accomodative **Derivatives**: to benefit from falling volatility, and participate in recovering risk assets, investors who can implement options should consider writing puts, buying call spreads, and implementing bull risk reversal strategies
Risk scenario: Global pandemic	A failure to contain the virus leads to a pandemic, and attempts to slow down the spread of the virus would be more drastic and longer-lasting. Economic activity would be seriously disrupted in the first half of 2020.	**Global equities** -10% due to weak consumer demand and supply chain disruptions continuing in the second quarter **EM equities** -10% to -15% as valuations are more appealing than in developed markets but earnings more cyclical **US rates** fall to new lows as the Federal Reserve is forced to take Fed Funds close to or below zero **US HY** -3 % as spreads price in a higher risk of recession and rising defaults but do not reach recessionary levels, as economic activity resumes in H2 **EURUSD** short term fall to 1.05; expected to remain in 1.05-1.10 range until global economy rebounds **USDJPY** towards 100, with limited monetary policy tools available to the BoJ **Cyclical commodities** expected to stay at depressed levels or weaken even further, with a delayed price recovery **Gold** to rise to USD 1,700–1,800/oz given greater monetary policy easing **Derivatives**: investors who can implement options, and are looking for protection, could consider put spreads to protect against equity losses at a lower cost than outright puts, but on the other hand do not provide unlimited downside protection

Expected total returns over a 6-month horizon. FX and spread levels as of end of Q2 2020.
Note: Upside and downside scenarios are possible events outside of CIO's base case expectations.
For further information please contact CIO strategist Dirk Effenberger, dirk.effenberger@ubs.com

Source: UBS, as of 5 March 2020

Fear—rather than the direct impact of the virus—is likely to be the main driver of both economic and market impacts. Fear changes

consumer, business, and policymaker behavior. It will cause consumers to spend less as they attempt to avoid the virus, although there will be some offsets from an increase in online spending. Fear could also cause companies to delay investment and hiring. Policymakers, in turn, will take measures to stimulate the economy. This support could come in the form of monetary or fiscal policy. Among the major central banks, the Federal Reserve has taken the lead in cutting interest rates.

Base case: Containment calms markets in 2Q

China's drastic measures to fight the coronavirus bought Europe and the US time to prepare for its arrival. As a result, their initial response to local outbreaks have been relatively fast and targeted. So far, the number of confirmed cases remains manageable: around 4,000 in Europe and 200 in the US and Canada, as of 5 March. These comparatively low numbers allow the authorities to make intensive efforts to trace the sources of infection, which then improves the odds of containing, or at least slowing down, the outbreak. Warmer spring temperatures may also reduce the virus's ability to spread, if it behaves like the seasonal flu.

In this scenario, governments would only need to take local action and short-term measures to suppress regional outbreaks and limit the damage to economic activity. For our base case to hold, however, several conditions need to be in place. Larger outbreaks need to be contained regionally, and in other areas the number of daily new infections should be low enough to allow for tracing of points of contact. Ideally, China can also prevent a second wave of infections when workers return to factories. We would then expect market anxiety to peak by end-March, followed by a rebound in risk assets.

The following is what we see in store for major asset classes under our base case scenario:

Rates

- We like inflation breakevens.

CIO recently opened a US breakeven inflation trade, as we believe that market-implied inflation expectations in the US are likely to rise over our tactical investment horizon of six to 12 months.

Given the economic damage and fear created by the coronavirus so far, we think more central banks will step up and do what they can to ease financial conditions. This will most likely entail rate cuts and aggressive liquidity operations. That being said, at the time of writing, there are already significant central bank rate cuts priced in across all developed market rate complexes, and we believe that in our base case these expectations are overdone. The most aggressive is reflected in expectations on the US federal funds rate, where the Fed still has some policy space. Here we see 75 basis points (bps) of rate cuts priced over the next 12 months.

We believe the violent decline in interest rates over recent weeks presents a tactical opportunity to buy US inflation-linked bonds relative to US high grade bonds. Given that monetary policy alone can only largely stabilize financial conditions rather than stop the virus's spread or restore economic activity, we accept that growth for the first half of 2020 is likely to be well below potential globally. This is why we see inflation breakevens as the more efficient way to

Rate cuts and lower interest rates don't matter so much now but will once fears subside

10-year US Treasury yields

Source: Bloomberg, UBS, as of 4 March 2020

express our interest rate views, as opposed to tactically going short nominal US government bonds.

Credit

- We believe the market reaction to the coronavirus has made US high yield credit an attractive asset class to begin building a tactical long position.

In the US high yield segment, spreads widened above 500bps briefly, before tightening again in the last few days. Still, at current levels they are 140bps above January lows. This is a 150bps widening in less than two weeks. We see this as an opportunity as the current market pricing implies an expected annual default rate of 5–6%. In the base case scenario, we don't expect a significant spike in high yield defaults as we see the economic damage from the coronavirus as temporary and limited to 1H20. As such, we expect the default rate in US high yield to remain around 3.5% in 2020, implying a compression in the credit spread in the coming months. Furthermore, most companies in the US high yield universe are domestically focused, with 80% of revenues coming from within the US; therefore, international demand weakness and supply chain disruptions in China may have a more limited impact.

Equities

- We prefer emerging markets over Eurozone.
- We expect global equities to advance moderately and continue to perform better than high grade bonds.

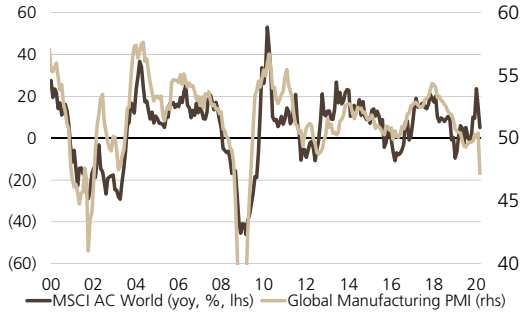
Central bank support and only moderate recession risks should allow for positive global equity returns over this period, while the impact of the coronavirus on economic growth and earnings should be limited to the first quarter in Asia, and very likely in the second quarter for other regions like the US and Europe. This can be seen in the context of outbreaks happening in waves, first hitting Asia, then Europe, then the US.

Regionally, we are overweight emerging market (EM) versus Eurozone equities. While both regions are heavily exposed to the coronavirus, emerging markets have higher 2020 expected earnings growth and cheaper valuations. EM equities were first hit by the COVID-19 outbreak in January, with MSCI EM down more than 10% from its peak that month. However, the virus is now better contained in China. As such, the first-quarter earnings weakness should be followed by a recovery from the second quarter, driven by the release of pent-up demand and policy support with an emphasis on affected sectors. This should also clear a path to recovery in global supply chains and trade activity. Therefore, we only expect a moderate earnings impact on full-year emerging markets earnings.

Following the recent setback, Eurozone equity valuations appear fairer in absolute terms, but the pressure on earnings continues. We expect a 1% decline in Eurozone earnings per share (EPS) this year —well below consensus estimates of 11% growth—due to weak top-line growth and pressure on profit margins. In addition, based on 12-month-forward P/E, Eurozone stocks are trading at 12% premium versus EM equities.

Global equities hit by weakening macro data

Global PMIs and change in MSCI AC World



Source: Datastream, as of 5 March 2020

Equity sectors

- We maintain a non-cyclical bias and prefer quality stocks.
- We are overweight communication services and healthcare.
- We are underweight IT and materials.

The global earnings momentum remains negative on the whole. While we had started to see signs of stabilization in economic indicators, worries about growth due to the impact of the coronavirus—and valuations that are still above long-term historical averages—may be a drag. All in all, we maintain a non-cyclical bias in our global sector allocation.

We are overweight communication services because of the attractive mix of telecoms' non-cyclical qualities and the secular growth of US and Asian internet giants. We are also overweight healthcare, which benefits from above-average earnings momentum and reasonable valuations. This should more than offset the potential drag from political uncertainty ahead of the US presidential election in November.

We are underweight IT as the sector strongly outperformed the wider market last year, leading to stretched valuations by historical standards, which in turn leaves little room for negative earnings surprises. We are underweight materials, which suffers from weak earnings momentum amid a challenging commodity price environment. With significant uncertainty over demand in several key end-markets, and looming oversupply as China seeks self-sufficiency in a wider range of chemical products, the near-term outlook for the chemicals industry is muted.

The quality factor provides exposure to positive earnings growth fundamentals but also the ability to withstand volatility better than the overall market. High-quality stocks typically perform better than the market when the economy grows below trend, and when risk-aversion and volatility rise.

Currency markets

- EURUSD likely to rebound to 1.13 by June.

In our base case, we expect the US dollar to first recover against the safe-haven currencies (Swiss franc, Japanese yen, euro) as US yields climb back from currently depressed levels and investors reengage in long USD carry trades. As a result, we see a good chance for the EURUSD exchange rate to test 1.10, USDCHF to test parity, and USDJPY to test 110 in the short term. Going into summer, we expect an improved outlook on global growth—in particular a rebound in exports and the normalization of supply chains—propelling export-oriented and commodity currencies, mostly to the detriment of the greenback. We see EURUSD climbing back to 1.13 by end-June.

Commodities

- Sell downside risks in Brent crude oil and nickel with a six-month tenor.

Commodities have been most adversely affected by the coronavirus outbreak. As commodity demand is likely to remain weak and concerns should continue to linger in the very short term, the asset class should see a fair bit of volatility in the coming weeks, with repeated bouts of price weakness.

That said, in our base case, we expect a pickup in global economic activity from 2Q onwards. This should provide a supportive backdrop for broadly diversified commodity benchmarks like the Bloomberg Commodity Index or the UBS Bloomberg CMCI Composite Index. Industrial metals and energy hold the best return outlook, in our view, considering their sensitivity to global economic growth. We are modestly positive on precious metals as monetary and fiscal policies ease further. Agriculture and livestock should also get a lift, with livestock having the best prospects for recovery amid severe supply challenges.

Derivatives

- We like put-writing on equities.
- Alternatively, consider call spreads and risk reversals to benefit from a market rebound.

The recent spike in market volatility has led to an increase in option prices across asset classes. We therefore like strategies that benefit from falling implied volatilities and provide exposure to a recovery in risk assets, should the negative impact of the coronavirus gradually fade. Currently, writing put options on equities is particularly appealing to us, as investors can take advantage of higher option prices while building a more defensive exposure to the underlying asset.

To position for a gradual recovery in risk assets and potential central bank support without overpaying the cost of options, investors can also look at call spread structures instead of buying outright calls. Call spreads consist of buying a call with a strike usually just above the price of the underlying asset, and selling another call at a higher strike. Although the short call position caps the maximum gain of the structure, it also significantly reduces the costs of establishing the bullish position when implied volatilities are elevated.

Replicating a long equity exposure through a so-called bull risk reversal also appeals to us. The strategy combines the potential benefits of writing puts with the upside participation of calls. Generally, a risk reversal is particularly attractive when the skew—the difference between the implied volatilities of out-of-the-money (OTM) puts and calls—is elevated. The premium of the put can be used to finance the purchase of a nearer-the-money call, hence generating an attractive asymmetric potential payoff.

Private markets

Private markets have not been immune to the impact of the coronavirus outbreak on financial markets. Equity market volatility has prompted some private equity groups to delay public exits. In addition, venture capital deal activity in China has fallen by 60% in the last six weeks compared with the same period last year. However, as we see limited risk of a material long-term negative impact on the global economy, we view the current situation as an attractive opportunity for investors.

- Historically, the best vintages for private equity firms have often coincided with dislocations in public equity markets, for example in years 2001 and 2008.
- The current disruption may present opportunities to get Asian exposure at more attractive valuation levels. Longer term, we are constructive on the region given powerful secular drivers.

- Opportunities for funds specializing in turnaround and distressed situations are likely to increase the longer the disruption continues.

Fund managers are well funded, with record levels of dry powder, so they have the necessary ammunition to snap up bargains when they arise. We think cycle-tested managers with a prudent approach to capital deployment are best equipped to navigate this environment.

Downside scenario: Pandemic creates longer-lasting economic damage

If governments fail to contain the coronavirus with moderate local measures, a larger and longer-lasting economic slowdown becomes likely, in our view. Containment measures would be stepped up in order to at least slow down the virus spread. It would remain paramount to reduce the strain on healthcare systems, which already grapple with the usual flu season. Instead of trying to trace back the chain of infections for every person, policy focus could shift to further cancellations of mass events, more quarantines, social distancing (work from home), and potentially travel restrictions.

Hence, a pandemic that infects more people in the second quarter could lead to drastic restrictions in business activity. Risk assets would likely stay under pressure for several months. We are therefore closely monitoring the patterns of outbreaks in Europe and the US in terms of their geographic reach and speed.

There is the view that warmer spring temperatures may slow the spread of the virus in the northern hemisphere, with daily new cases peaking in the second quarter. But that could also mean a second wave of infections could come to Europe and the US later in the year, when the weather cools again. So far, many experts remain skeptical on the chances of a successful treatment or a vaccine becoming available this year.

In such a scenario, we think central banks would have to cut rates aggressively and implement significant balance sheet expansion. Given that official policy rates are already historically low across most developed and emerging economies, the question then becomes how effective monetary policy can actually be in restoring economic equilibrium. This opens up space for fiscal policy to become active.

We would expect the following reactions from major asset classes ahead of a global downturn:

Rates

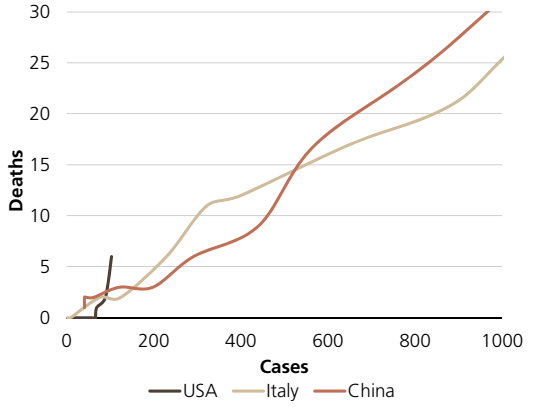
- US rates would approach zero.

In our downside scenario, we believe that fiscal policy would be the only effective tool. It would then become a question of details and the nature of the fiscal policy. We have already seen some countries announce fiscal policy as a result of the economic disruption (e.g., Hong Kong, Italy). Interestingly, in Italy's case, the European Commission has shown some flexibility around deficit rules in order to allow Italy to provide support for its economy.

Ultimately fiscal expansion raises the question of debt sustainability, particularly if the impact on growth is minimal and a country is already in a weak fiscal position. If done in conjunction with aggressive central bank balance sheet expansion, sovereign credit

US cases to follow Italian and Chinese pattern?

COVID-19 confirmed cases against confirmed deaths in USA, Italy, and China



Sources: Macrobond, WHO, UBS, as of 4 March 2020

risk only becomes an issue if there is a loss of credibility in the currency.

If the coronavirus proves to be a more severe and long-lasting drag on the global economy, interest rates would be poised to drop even further from today's historically low levels. There is a possibility that US interest rates may break the zero bound, although, similar to what we have seen in Europe, the public and political backlash would be significant. We would generally expect yield curves to steepen once fiscal and monetary policy has been activated, but this view may be challenged if central banks decide to utilize yield curve control similar to what the Bank of Japan is doing today.

Credit

- We would prefer adding duration and diversifying credit exposure.
- Derivatives may offer temporary protection against credit risk.

Investors should avoid holding too much credit and liquidity risk, and should make sure they are comfortable holding such positions through a potential market correction. Adding duration and diversifying credit exposure as broadly as possible should help to mitigate any sell-off. Derivatives (e.g., credit default swaps) may be considered to temporarily protect against credit risk without selling positions outright. But it should be noted that the basis between cash bonds and credit default swaps spreads often widens in stressed situations as liquidity starts trading at a premium.

Our downside scenario would likely see a sharp widening in credit spreads from current levels as rising downgrade risks, defaults and illiquidity get priced in. Bonds with lower credit ratings would suffer disproportionately. We could envisage USD HY bond spreads widening to around 650bps, while USD IG could reach around 200bps on average – pricing in a higher likelihood of recession. But as in this scenario economic growth would still rebound in H2 and a recession would be avoided, we are not seeing spreads reaching previous cycle highs, as defaults will likely be limited to already challenged sectors. US senior loans would likely fare worse than they have historically, given the structural deterioration of credit quality, loan-only structures and covenant protection. Recovery rates in credit would be far lower.

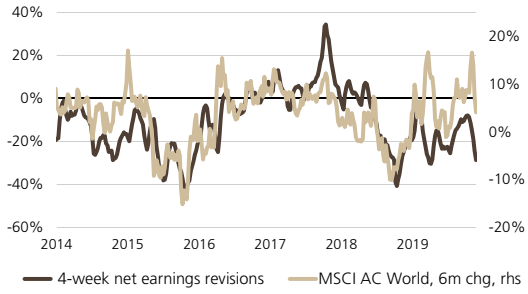
Equities

- Global earnings growth would fall to zero.
- US and Switzerland would outperform the Eurozone, Japan and UK.

In the risk scenario, we would expect global equities to drop by an additional 10%, taking the MSCI AC World down to 550 versus 612 as of writing. Weak consumer demand in the first and second quarters and supply chain disruption continuing in the second quarter would put business investments and thus global earnings growth under pressure. Earnings growth would very likely contract in the first half and recover in the second half. Overall, we would expect global earnings growth to move from the currently expected +4.4% to 0% for the year. Eurozone, Japan and the UK would face the highest risk of contraction, while emerging markets, the US and Switzerland would likely show lower-than-expected but still positive growth.

Negative earnings revisions resume after coronavirus spreads

Earnings revisions and change in MSCI AC World



Source: Datastream, as of 5 March 2020

Equity sectors

- We would prefer minimum volatility strategies and quality stocks.
- Cyclicals and energy would underperform.

In our risk scenario, we would expect cyclicals to be under further pressure despite valuations becoming more attractive. Consumer discretionary, banks, industrials, information technology, and materials would likely experience strong earnings downgrades. In particular, further negative news around the scale of coronavirus would pose a tactical downside risk for the US technology sector, which generates 15% of its sales from China (vs. 2% for S&P 500). Banks would suffer from the low levels of bond yields and increasing non-performing loans. Sectors that are less sensitive to economic activity would likely outperform, including consumer staples, healthcare, utilities, and real estate. If the risk scenario were to result in a lower oil price, energy stocks would likely underperform.

Minimum volatility strategies and quality stocks would be the best positioned in such environment, in our view, sustained by lower bond yields and higher earnings resilience versus the overall global market.

Currency markets

- CHF would strengthen, EURUSD would fall to 1.05.

In our downside scenario, while the dollar may at first be challenged by the Fed's greater space to cut rates, we believe it would eventually regain its role as a global safe haven. In this situation, we also believe that EURUSD would fall toward 1.05 in the short term and EURUSD would remain in a 1.05–1.10 range as long as the global economy does not rebound. We'd expect USDJPY to trend toward 100 and USDCHF to 0.90 in 2Q20, as the Swiss National Bank and the Bank of Japan have more limited tools to ease policy than the Fed and would have to tolerate some appreciation of their own safe-haven currencies

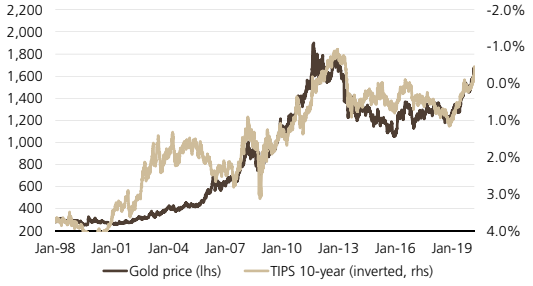
Commodities

- Stay long gold.

In the risk case, we would expect cyclical commodities like crude oil and industrial metals to stay at depressed levels or to weaken even further in the short term. A price recovery would likely come later than in our base case, as it would take longer for economic activity to recover. Gold, in our view, would outperform. Greater monetary policy easing by key central banks would see (US real) interest rates trending lower, allowing the yellow metal to rise to USD 1,700–1,800/oz or above over the coming months.

In our risk case we could see gold moving higher

Falling (US) real interest rates have supported gold



Source: Bloomberg, UBS

Derivatives

- Protective puts and put spreads could offer some protection against downside risks.
- Collar strategies are an alternative that reduce the cost to implement a hedge, but do give up some downside protection.

A worsening of the outbreak would clearly weigh on risk assets. In such a scenario, investors should look for positions that would benefit from a further rise in implied volatility and, at the same time, would offer portfolio protection. To reduce risk, the most basic

defensive strategy in the option space is buying a protective put with a strike slightly below the price of the underlying asset. Losses below the strike level would therefore be offset by the long put position. To reduce the protection costs, investors could consider adding a short put position with a strike close to the expected drawdown of the underlying asset, ultimately building a put spread. Put spreads are suitable for investors that seek protection against a moderate correction in the underlying asset without incurring the full costs of outright puts. Collar strategies—i.e., the combination of protective puts and covered calls—are another solution to limit losses in the underlying asset while keeping hedging costs under control.

Appendix

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