SPOTLIGHT | FEBRUARY 2020

THE VIRAL DEMAND SHOCK GOES GLOBAL

Key points

- With the failure of authorities to contain the coronavirus contagion to within China or even Asia, the prospect of a more sustained demand shock for global economies has emerged. This poses the potential for elevated risks for investors looking ahead.
- As a result, we expect we may have to lean heavily on the 'risk-off' and asymmetric exposure in the weeks ahead just as we did in the January market decline and when facing the periodic volatility seen since late-2018.
- In particular, US dollar duration should continue to prove valuable in this uncertain environment. Indeed, the yield declines seen in recent weeks only bring US risk-free yields to the mid-point of our estimated 0.8-1.8% fair value range.
- In FX, Swiss franc positions against the EUR and to a lesser extent against the USD should continue to be valuable within broader risk-off allocations.
- While we continue to believe that gold retains long-term value as risk-off protection, the one-sided positioning in particular combined with underlying, leverage suggest that at a minimum, near-term volatility may lie ahead before more significant asymmetry and potential upside can be realised.
- Risk oriented investors may find opportunities in the recent spike in volatility via asymmetric structured solutions to cushion downside risks while allowing for upside participation. Similarly, a further widening in US high yield spreads may once again trigger the implicit Federal Reserve 'backstop' in the asset class creating opportunities for investors ahead.

Global Investment Committee

UNION BANCAIRE PRIVÉE

The coronavirus demand shock may go global

Despite extreme containment measures in China since late-January, the meaningful clusters in Korea, Singapore, Iran, and Italy that have emerged in recent weeks suggest that China's efforts and the actions of global governments have not been enough to restrict the infection to Greater China.

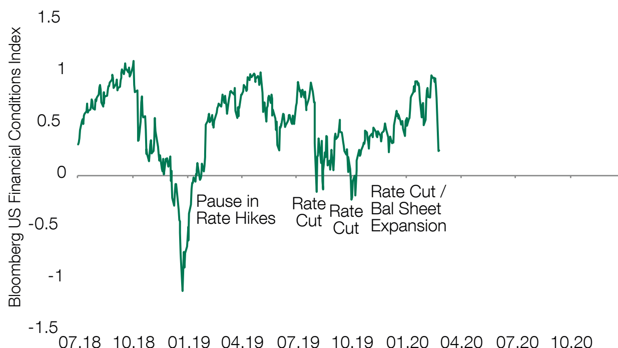
While the human tragedy of the viral outbreak is immeasurable, the widening number of geographic clusters as well as the prolonged disruption to air travel key pose a meaningful economic threat to global supply chains and activity that is as yet unpriced in global financial markets.

So, although we had anticipated that US and global policymakers had sufficient tools at their disposal to mitigate the impact of a temporary, localized outbreak in China, a more prolonged, global outbreak has the potential to test the policy toolkit and the political will of governments around the world.

Indeed, the US Federal Reserve while arguably retaining the most policy flexibility of Western central banks, may remain on the sidelines until the demand shock emanating from China finds its way on to American shores. This would echo the way the US central bank waited until 1998 for the 1997 Asian Financial Crisis to impact directly on US financial stability. Indeed, even though the Fed was more proactive in the face of the eurozone financial crisis, Fed action still came only once systemic threats emerged to the US economy.

Currently, despite market declines since mid-February, US and Euro area financial conditions still remain short of the tightening backdrop that spurred rate cuts and balance sheet expansion in late-2019 (chart). Similarly, while US credit spreads have widened following their late-2019 tightening, they sit short of the spreads that helped spur the July and October 2019 rate cuts.

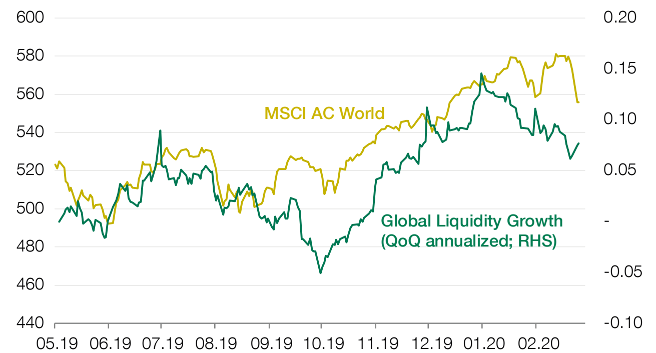
US Financial Conditions remain loose keeping the Fed on the sidelines for now



Sources: Bloomberg Finance L.P. and UBP

Some may indeed question whether Fed policy action will be effective, as the current bout of volatility has come against a backdrop of the Fed seeking to pause its balance sheet expansion. This approach followed on from the late-2019 surge and aims to ensure stability in American money markets as well as a broader deceleration in global liquidity growth (chart). We suspect, however, that renewed liquidity momentum would go a long way towards rekindling 'animal spirits' at least temporarily looking ahead.

Slowing liquidity momentum has been a headwind and a driver of volatility so far in 2020



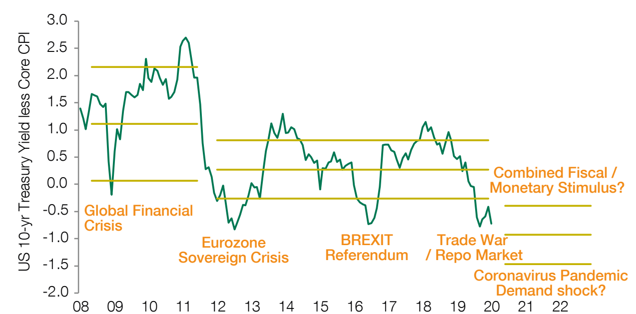
Sources: Bloomberg Finance L.P. and UBP

Lean on 'risk off' exposure in periods of uncertainty…

In light of the continuing period of global macro uncertainty, we have spent the better part of the past 18 months building a substantial, actively managed 'risk-off' portfolio to cushion returns during unnerving declines like we have now.

Across our risk-off allocation, we continue to see longer-dated US Treasury securities as valuable. With the prospect of a virus-driven demand shock and/or the potential for rising taxes under a Bernie Sanders administration following the 2020 US Presidential elections, we see the risk of a further decline to <1% on the 10-year US Treasury as a beneficiary in the face of such demand shocks (chart).

A sustained demand shock warrants <1% Treasury yields

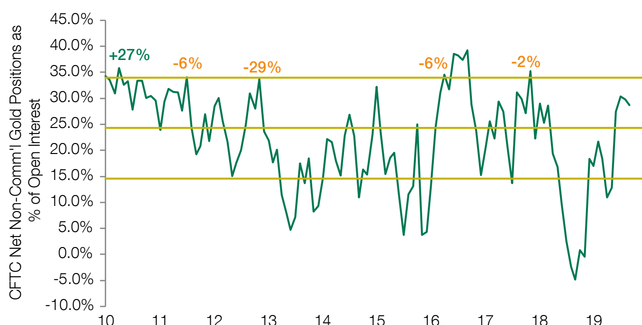


Sources: US Federal Reserve Bank of St. Louis and UBP

As highlighted in our 2020 Investment Outlook, safe haven currencies should also be a core part of risk-off allocations. In particular, we see positions in Swiss francs against the EUR and to a lesser extent against the USD continuing as being valuable within broader risk-off allocations.

Though we continue to believe that gold retains long-term value as a safe haven, the one-sided positioning in particular combined with underlying, leveraged positions suggest that at a minimum, near-term volatility may lie ahead before more significant upside can be realised. As a result, directional gold exposure may not provide the same risk-off cushion in the near term. Instead, exploring gold option strategies may offer more adequate asymmetric exposure in the weeks ahead.

Gold: Leveraged long positioning to bring volatility



Sources: CFTC; Bloomberg Finance L.P. and UBP

…paired with asymmetric, risky asset exposure

It is reasonable to have concerns about policy error on the part of either the US Federal Reserve or other central banks around the world. This is especially true given the risk of multiple demand shocks (including US money market instability and/or the prospect of the election of US Senator Bernie Sanders as the next US President). To counterbalance these issues, we aim to pair our 'risk-off' portfolio with our broader risky asset exposure. These potentially cushion returns during unnerving declines as seen recently. They also allow investors to maintain positions in risky assets such as equities that provide return drivers in more normal periods as seen since late-2018.

Indeed, the more than 5% decline in markets since the February peak is just below the average correction seen in 2019 where the Fed had proactively leaned against a tightening in financial conditions (which we expect them to continue to do in 2020). Making an even more cautious comparison of the current decline to that of 2018 when the Fed was raising rates and seemed more reactive to stress in the financial system, suggests we are approximately 50% of the way through a comparable decline.

Current S&P 500 decline looks similar to declines in 2019

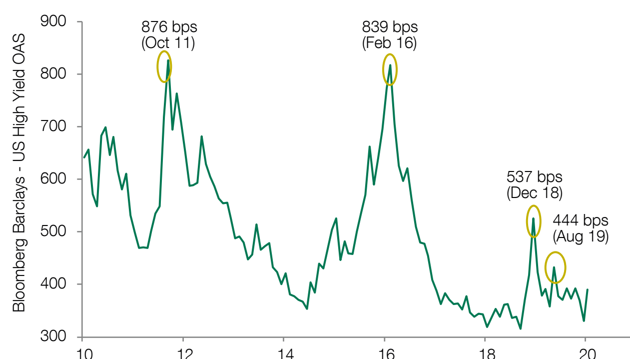
Year	Peak	Trough	Length (days)	Peak to Trough S&P 500 Decline
2018	Jan 26	Feb 09	14	(8.8%)
	Mar 09	Apr 02	24	(7.3%)
	Sep 20	Oct 29	39	(9.9%)
	Dec 03	Dec 24	21	(15.7%)
Average			25	(10.4%)
2019	Apr 29	Jun 03	34	(6.8%)
	Jul 26	Aug 05	10	(6.0%)
	Sep 12	Oct 03	20	(5.1%)
Average			23	(6.0%)
Current			7	(4.7%)

Sources: Standard & Poors; Bloomberg Finance L.P. and UBP

Indeed, with the spike in volatility in recent days, asymmetric structured equity solutions are once again presenting themselves and should continue to serve portfolios well in cushioning downside risks. They also allow for participation in even temporary recoveries as seen in early-February.

Moreover, with US high yield spreads remaining short of the levels seen when the Fed was cutting rates and restarting its balance sheet expansion in late-2019, a modest further widening in spreads may offer renewed opportunities in the asset class as seen in late-January in anticipation of the Fed restarting policy easing.

Look for a Fed 'backstop' to contain sustained spread widening in USD high yield



Sources: Standard & Poors; Bloomberg Finance L.P. and UBP

Authors

Michaël Lok
Group Chief Investment Officer (CIO)
and Co-CEO Asset Management

michael.lok@ubp.ch

Norman Villamin
Chief Investment Officer (CIO)
Wealth Management and
Head of Asset Allocation

norman.villamin@ubp.ch

Patrice Gautry
Chief Economist

patrice.gautry@ubp.ch

Yves Cortellini
Deputy Head of Asset Allocation

yves.cortellini@ubp.ch

Disclaimer

This document is a marketing communication containing GENERAL INFORMATION on financial services reflecting the sole opinion of Union Bancaire Privée, UBP SA and/or any entity of the UBP Group (hereinafter "UBP") as of the date of issue. It is not and does not purport to be considered an offer or a solicitation to enter into any transaction with UBP, buy, subscribe to, or sell any currency, product, or financial instrument, make any investment, or participate in any particular trading strategy in any jurisdiction where such an offer or solicitation would not be authorised, or to any person to whom it would be unlawful to make such an offer or solicitation. This document is meant only to provide a broad overview for discussion purposes, in order to determine clients' interest. It does not replace a prospectus, KID, KIID or any other legal document relating to any specific financial instrument, which may be obtained upon request free of charge from UBP or from the registered office of the issuer of the instrument concerned, where applicable. The opinions herein do not take into account individual clients' circumstances, objectives, or needs.

UBP performs analysis on the financial instruments on offer in the market and may maintain and/or seek to develop business affiliations with third parties for that purpose; furthermore, UBP may create its own financial instruments. This generic information is therefore not independent from the proprietary interests of UBP or connected parties, which may conflict with the client's interests. UBP has policies governing conflicts of interest and takes appropriate organisational measures to prevent such cases.

The information contained in this document is the result neither of financial analysis within the meaning of the Swiss Banking Association's "Directives on the Independence of Financial Research" nor of independent investment research as per the EU's regulation on MiFID provisions. EU regulation does not govern relationships entered into with UBP entities located outside the EU.

Reasonable efforts have been made to ensure that the content of this document is based on objective information and data obtained from reliable sources. However, UBP cannot guarantee that the information contained herein and gathered by the Bank in good faith is accurate and complete, nor does it accept any liability for any loss or damage resulting from its use. Circumstances may change and affect the data collected and the opinions expressed at the time of publication. Therefore, information contained herein is subject to change at any time without prior notice. UBP makes no representations, provides no warranty and gives no undertaking, express or implied, regarding any of the information, projections or opinions contained herein nor does it accept any liability whatsoever for any errors, omissions or misstatements in the document. UBP does not undertake to update this document or to correct any inaccuracies which may have become apparent after its publication.

This document may refer to past performance which is not a guide to current or future results. All statements in this document, other than statements of past performance and historical fact, are "forward-looking statements". Forward-looking statements do not guarantee future performances.

The tax treatment of any investment depends on the client's individual circumstances and may be subject to change in the future. This document does not contain any tax advice issued by UBP and does not reflect the client's individual circumstances.

This document is confidential and is intended to be used only by the person to whom it was delivered. This document may not be reproduced, either in whole or in part. UBP specifically prohibits the redistribution of this document, in whole or in part, without its written permission and accepts no liability whatsoever for the actions of third parties in this respect. This document is not intended for distribution in the US and/or to US Persons or in jurisdictions where its distribution by UBP would be restricted.

Switzerland: UBP is authorised and regulated in Switzerland by the Swiss Financial Market Supervisory Authority (FINMA).

UK: UBP is authorised in the United Kingdom by the Prudential Regulation Authority (PRA) and is subject to regulation by the Financial Conduct Authority (FCA) and limited regulation by the PRA.

Dubai: This marketing material has been communicated by Union Bancaire Privée (Middle East) Limited, a company regulated by the Dubai Financial Services Authority ("DFSA"). It is intended for professional clients and/or market counterparties only and no other person should act upon it. The financial products or services to which this material relates will only be made available to a client who meets the professional client and/or market counterparty requirements. This information is provided for information purposes only. It is not to be construed as an offer to buy or sell, or a solicitation for an offer to buy or sell any financial instruments, or to participate in any particular trading strategy in any jurisdiction.

Hong Kong: UBP is a licensed bank regulated by the Hong Kong Monetary Authority (HKMA) and a registered institution regulated by the Securities and Futures Commission (SFC) for Type 1, 4 & 9 activities only in Hong Kong. The securities may only be offered or sold in Hong Kong by means of documents that (i) are addressed to "professional investors" within the meaning of the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong) and any rules made thereunder (the "SFO"); or (ii) are defined as "prospectuses" within the meaning of the Companies Ordinance (Chapter 32 of the Laws of Hong Kong) (the "CO") or constitute offers to the public within the meaning of the CO. Unless permitted to do so under the laws of Hong Kong, no person may issue or have in his/her possession for the purpose of issuing, whether in Hong Kong or elsewhere, any advertisement, invitation or document relating to the securities, directed at, or likely to be accessed or read by, the public in Hong Kong, except where the securities are intended to be disposed of only to persons outside Hong Kong, or only to "professional investors" within the meaning of the SFO.

Singapore: UBP is a bank regulated by the Monetary Authority of Singapore (MAS), is an exempt financial adviser under the Financial Advisers Act (Cap. 110 of Singapore) to provide certain financial advisory services and is exempt under section 99(1) of the Securities and Futures Act (Cap. 289 of Singapore) to conduct certain regulated activities. This document has not been registered as a prospectus with the MAS. Accordingly, this document and any other document or material in connection with generic recommendations may not be circulated or distributed, whether directly or indirectly, to persons in Singapore other than (i) to institutional investors under Section 274 of the Securities and Futures Act (Cap. 289) of Singapore ("SFA"), (ii) to relevant persons pursuant to Section 275(1), or any person pursuant to Section 275(1A) of the SFA, and in accordance with the conditions specified in Section 275 of the SFA, or (iii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA. This advertisement has not been reviewed by the Monetary Authority of Singapore.

Luxembourg: UBP is registered by the Luxembourg supervisory authority the Commission de Surveillance du Secteur Financier (CSSF).

Italy: Union Bancaire Privée (Europe) S.A., Succursale di Milano, operates in Italy in accordance with the European passport – held by its parent company, Union Bancaire Privée (Europe) S.A. – which is valid across the entire European Union. The branch is therefore authorised to provide services and conduct business for which its parent company, Union Bancaire Privée (Europe) S.A., has been authorised in Luxembourg, where it is regulated by the Luxembourg financial supervisory authority, the Commission de Surveillance du Secteur Financier (CSSF).

Monaco: This document is not intended to constitute a public offering or a comparable solicitation under the Principality of Monaco's laws, but might be made available for information purposes to clients of Union Bancaire Privée, UBP SA, Monaco Branch, a regulated bank under the supervision of the Autorité de Contrôle Prudentiel et de Résolution (ACPR) for banking activities and under the supervision of the Commission de Contrôle des Activités Financières for financial activities.

© UBP SA 2020. All rights reserved.

26 February 2020

Union Bancaire Privée, UBP SA | Head Office
Rue du Rhône 96-98 | P.O. Box 1320 | 1211 Geneva 1 | Switzerland
ubp@ubp.com | www.ubp.com

Signatory of: PRI Principles for Responsible Investment
Subscribe to our newsletter on ubp.com