SPOTLIGHT | MAY 2020

CLOUDS GATHERING ON THE HORIZON

Key points

- Global equities rallied 29% from their late-March lows to their April peaks as daily new cases of COVID-19 stabilised and global governments moved quickly to mitigate the economic fallout of the self-imposed shutdowns.
- Though the humanitarian costs of the pandemic will remain, secondary repercussions have begun to build warranting a cautious stance on the part of investors in light of the surge in risk-taking since late March.
- We see three key risks on the horizon: secondary outbreaks in the US, rising US-China geopolitical tension and political fragmentation in the Euro area.
- In particular, US-centric risks appear most troubling with the emergence of states from lockdown despite the daily infection rate in the United States not having begun to fall from its March-April peaks outside of New York and New Jersey, the original epicentre of the American outbreak.
- US tension with China appears to be accelerating again following the late-2019 truce in their trade war. Recent developments signal a shift in the battlefield for the broader Sino-American struggle from trade to capital and technology.
- Proactive monetary and fiscal policy have been instrumental in preventing the current recession from transforming into an outright depression. Investors should also use them as an opportunity to reinstate protection and asymmetry in portfolios. Just as in January-February, these moves should provide shelter should these second-round threats batter global markets once again.

Global Investment Committee

UBP
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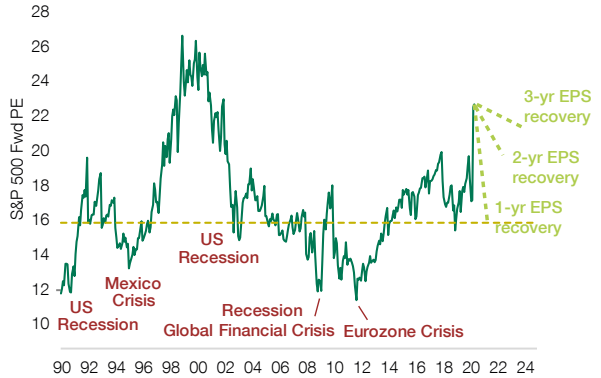
Recent rally leaves equities overextended

Though we had anticipated that a forceful policy response from the American central bank and fiscal authorities would be sufficient to stabilise and drive a rebound in markets, admittedly we were caught off guard by both the pace and magnitude of the rebound seen in recent weeks.

Indeed, the more than 30% rally from the March lows in US equities leaves them at their most expensive valuations since the technology bubble of 1999-2000. Compounding the challenge facing investors is the future earnings assumptions that must be made in order to justify current valuations.

Looking back, when the US economy has moved into recession at it appears to be in currently, earnings of the S&P 500 have taken between 3 and 3.5 years to return to the levels seen immediately before the onset of recession. At current levels, in the midst of a recession, the S&P 500 is in effect assuming that earnings of its constituent companies will rebound back to their 2019 peaks as early as 2021 (chart).

US equities optimistically imply a return to 2019 earnings as soon as 2021



Sources: Standard and Poor's, Bloomberg Finance L.P. and UBP

Though the size of the monetary and fiscal stimulus being provided by global governments is intended to shorten the length and reduce the depth of the ongoing economic slump, such a V-shaped rebound appears overly optimistic in our view.

Is the US emerging from lockdowns too soon?

It is clear that the recession has been significantly induced due to the lockdowns imposed on the American and global economy. As these begin to ease across several countries, there is reason to be concerned about renewed outbreaks especially in the world's largest economy.

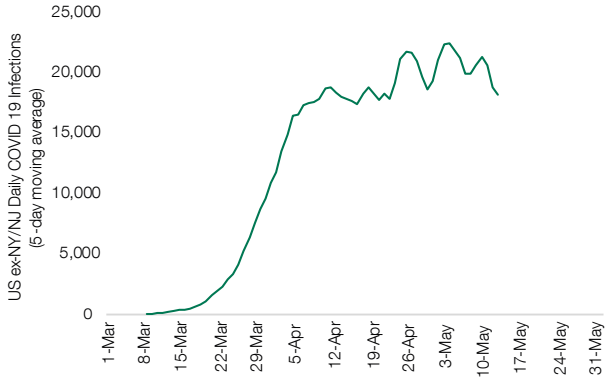
Fortunately, the American states of New York and New Jersey, the epicentre of the initial outbreak in the United States have seen a peak and steady decline in daily infections since early April. This mimics the pattern seen in countries in Europe and in Asia, according to data from Johns Hopkins University.

However, looking at the remainder of the country, excluding New York and New Jersey, the US has shown little progress in slowing the pace of daily infections across the rest of the economy as of yet.

It is worth noting the different approach in Europe where daily infections fell by 80-90% from their March peaks in Germany and Switzerland before they began slowly reopening their economies from lockdown. In contrast, in the US excluding NY and NJ the average number of daily infections as of mid-May is equal to the average seen through all of the month of April (chart).

Admittedly, though the sharp declines in New York and New Jersey are significant as these two states combined account for 9% of the American population and 10% of US GDP, the states of California (12% of the US population and 15% of GDP) and Texas (9% of population and GDP) are both seeing average daily infections in the month of May that are 20-25% above the averages seen in the month of April.

US daily infections outside of NY/NJ remain near their peak



Sources: Johns Hopkins University and UBP

This suggests that, at a minimum, the scope for a sustained consumption-led rebound as lockdowns ease should be somewhat limited. In the background lurks the risk of a secondary outbreak leading to a restoration of lockdown conditions as seen in Singapore recently. This remains a credible risk in the months ahead.

Sino-American tensions growing in the background…

The December, 2019 trade war truce between the US and China took pressure away from increasingly frayed Sino-US relations and long-term tensions took a back seat while efforts concentrated on combating COVID-19 in February and March.

However, in recent weeks, moves taken by both China and the United States suggest that the broader hegemonic struggle between the two largest economies in the world looks set to move to new battlefields as outlined in our August, 2019 Spotlight, *The End of the US-China Trade War…*

Many have focused on the headline grabbing suggestions by some in the United States (and other nations) that China should pay reparations for the spread of COVID-19 around the world. However, to the keen observer, looking beyond such political grandstanding, the US has been taking steps that, we believe, lay the groundwork for a potentially wider attack on the Chinese economy extending beyond just trade as seen in 2018-19.

In particular, the White House has recently instructed federal government pension plans to refrain from using benchmarks which include Chinese equities – effectively banning their purchase. Though small in size (appx US$50 billion), the move reflects a new way for the United States to attack China, via its reliance on access to US capital markets.

China has already recognised the threat of this line of attack and has further eased restrictions on foreign investment into onshore Chinese equity and bond markets in an effort to begin the long journey towards building a foreign investor base for mainland financial markets.

Should the US move more rapidly to cut off Chinese access to US dollar capital, this will likely prove destabilising for global capital markets as a whole as these rely on the free flow of dollars to facilitate global activity.

Beyond this, the United States has also been moving to continue to restrict China's access to key technologies that could solidify its dominance in 5G and reduce China's reliance on non-Chinese suppliers in the years ahead.

The US Commerce Department has announced, but not yet implemented, rules that would seek to curb exports of advanced technologies such as semiconductor production equipment – eliminating a provision that allowed for civilian but not military exports of such dual-use technologies.

Should the US proceed, that would leave China reliant on one of three suppliers – the United States, Korea, and Taiwan – for advanced chips to power its next generation technology ambitions. More broadly, as highlighted in *The End of the US-China Trade War*, China is particularly reliant on global technology component suppliers. This move could represent a broader attempt to constrain Chinese ambitions across the wider technology supply chain.

Though China has pivoted to increase agricultural imports to curry favour from farm states ahead of President Donald Trump's re-election campaign, it is not clear whether these efforts will be sufficient to divert US hawks from their new apparent path. The only question, in our view, is whether a confrontation on this axis occurs prior to the November, 2020 US Presidential elections or shortly thereafter. Recent moves increase the risk, that the former is increasingly in play.

Meanwhile eurozone tensions are in the open for all to see…

In contrast to the chess match between the US and China taking place in the background, the tension, ostensibly between North and South in the Euro area is happening very much in the open.

With Italy and other southern nations having been rebuffed in their efforts to create mutualised debt to fund both the battle against COVID-19 and the subsequent economic recovery effort, markets are increasingly concluding that the prospect of a fully fledged monetary and fiscal union is fading.

Though those risks have indeed increased, we believe that the European Union has once again 'kicked the can' albeit a much shorter distance down the proverbial road than in previous crises.

Italy and other Euro area nations have the capability to access a variety of facilities including the European Stability Mechanism to address the near-term burdens of combating COVID-19. As a result, the absence of 'corona bonds' need not prove fatal to the single currency area in the near term.

However, we expect this challenge will return once lockdowns are eased and Italy and other nations begin to realise that their economic recovery efforts will be hamstrung by fiscal constraints potentially limiting their economies to stagnation in the years ahead. In other words, in winning the battle with the coronavirus, the Euro area will be forced to confront the war that is the completion of the Euro project – and whether members are willing to take the next steps towards a monetary and fiscal union.

As a result, while widening Italian spreads are worrisome, we continue to expect the European Central Bank, even in light of the recent German court challenge, to have the capability to buy time for the continent in the midst of the corona crisis. However, should political pressures in Italy accelerate resulting in a sooner than expected confrontation then an additional shock to the global economy would begin to take shape.

Shifting from offence to defence – Restoring asymmetry to portfolios

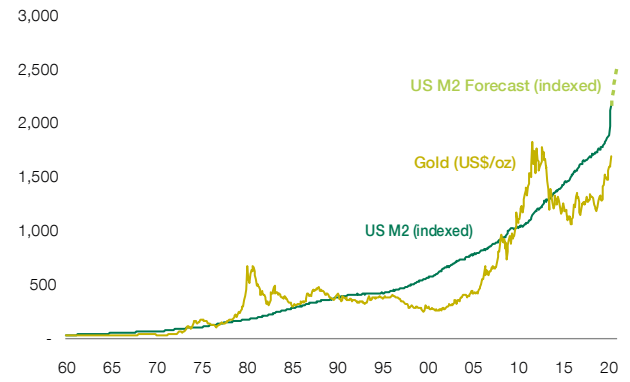
In January, 2020, facing a deteriorating economic backdrop, an accommodative Federal Reserve and historically expensive valuations, we counselled investors

to expand asymmetric, risk-off strategies within portfolios given the asymmetric – limited upside, meaningful downside – risk/reward offered by markets.

We believe such advice is once again relevant in spite of the efforts of the US central bank to offer an increasingly overt 'Fed put' for investors.

Like in early-2020, we believe that gold continues to serve as an attractive store of value for investors as central banks increasingly seek to monetise the challenges facing the global economy. Indeed, despite the 14% rise year-to-date, gold continues to underprice the 'whatever it takes' monetary policy of the US Federal Reserve (chart).

Gold continues to underprice the 'whatever it takes' policy of the US Federal Reserve



Sources: Federal Reserve Bank of St. Louis, Bloomberg Finance L.P. and UBP

However, in contrast to early 2020, with interest rates at the zero bound, long-dated US government bonds no longer provide the same safe haven they had previously offered investors. Instead, with limited upside potential and a meaningful downside, we believe such positions sit asymmetrically positioned against investors looking ahead.

Instead, we continue to look to safe-haven currencies – the Japanese yen and Swiss franc – as alternatives especially for USD-referenced investors.

For investors continuing to hold risky-asset positions in equities, we are leaning, just as we did in January, increasingly heavily on options strategies and our high-quality long/short hedge fund exposure to shield positions against potential drawdowns.

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