Market Perspectives

Limping out of the lockdown

May 2020

Content

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Global View – Limping out of the lockdown

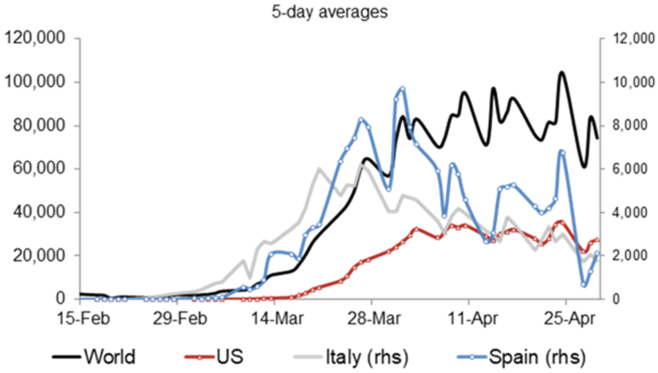
Thomas Hempell

- **As new Covid-19 cases flatten out, governments prepare for the exit from lockdowns. This will ease economic pain. But it is a fragile enterprise, given the risk of resurging infections.**
- **The global economy is headed for its worst slump since WWII, with the recovery set to be protracted and disinflationary pressures likely to grow.**
- **Bold and timely responses by fiscal and monetary policy help to cushion the fallout, supporting risk sentiment and Credit markets in particular.**
- **European leaders seem set to agree only on a soft form of intra-European burden sharing. EMU sovereign risk will remain largely in the hands of the ECB, which seems determined to deliver.**

As the Covid-19 pandemic has triggered shutdowns around the world, the global economy is headed for its worst slump in post-war history. With severe containment measures extending into May, we now pencil in a contraction of global GDP by 3.5% this year.

As a bright spot, containment is showing first effects. With global new Covid-19 cases plateauing, many governments are detailing exit plans from lockdowns. That said, all easing efforts will be very gradual, while consumer and business confidence is increasingly suffering. The risk of epidemic setbacks amid the opening of shops and firms remains very high. If the tentative return to normal triggers second waves of infections, the economic damage from renewed lockdowns may prove even more harmful. Risks are compounded by slumping (and temporarily negative) oil prices on demand and storage concerns, straining oil companies and weighing on (US) investment and EMs.

Confirmed new Covid cases
5-day averages



Fortunately, policy makers have been quick to act boldly. The Fed, ECB and BoJ have all lifted caps to asset purchases, flooded banks and markets with liquidity and supported non-financial corporates by outright Credit purchases and eased repo collateral rules. Globally, governments have rolled out fiscal stimulus worth roughly 4% of GDP while providing large-scale loans to companies hit by the crisis. However, policy support is much more limited by fiscal constraints among EMs.

Financial market have rebounded in April from the Feb/March, emboldened by the policy response, plateauing new infections and eased shutdowns. In the US, markets have recouped more than half of the Feb/March drawdown (Europe roughly a third). This has benefited our (albeit moderate) pro-risk stance assumed in April.

Navigate the tailwinds from central banks

Amid a looming sequence of bad economic data and earnings revisions, the risk of corrections is high, favouring an only small overweight in equities. We are more confident about high quality Credit, with spreads still elevated and policy makers determined to support firms' refinancing capabilities. We keep an underweight in cash and a long tilt in duration. The massive increase in supply on ballooning fiscal deficits would exert upside pressures on yields in 'normal' times. But disinflation pressures from a more sustained slump in demand and the unlimited commitment to QE by central banks will effectively keep a lid on core yields – and may drive them even lower.

Bonds	28/04/20*	3M	6M	12M
10-Year Treasuries	0.62	0.50	0.65	1.00
10-Year Bunds	-0.46	-0.55	-0.50	-0.30
Corporate Bonds				
BofaML Non-Financial	191	170	150	140
BofaML Financial	191	175	155	145
Forex				
EUR/USD	1.08	1.09	1.11	1.14
USD/JPY	107	106	106	105
Equities				
S&P500	2860	2875	2900	2950
MSCI EMU	102.5	101.5	103.0	104.5

* avg. of last three trading days

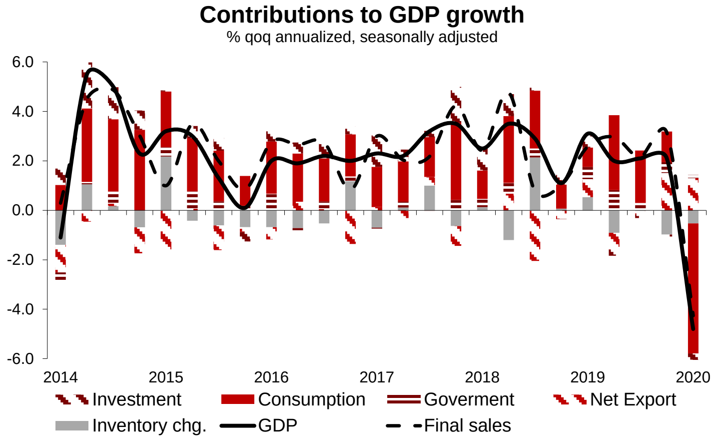
There is some value in longer-dated peripheral debt largely thanks to a more attractive carry. That said, this will require continued strong support by the ECB in the first place. European leaders keep struggling to agree on risk mutualisation and transfers. The measures agreed on so far offer cheap credit to governments and companies. But they will not prevent public debt levels from rising sharply in Southern Europe, an issue also reflected in Fitch's most recent ad hoc downgrade of Italy to BBB- (outloook stable). There may be some relief from the hotly debated Reconstruction Fund and the EU's new multiannual financial framework. But expect a big chunk of headline numbers to be devoted to cheap credit lines rather than grants, largely leaving the ECB as the key pillar of support for the foreseeable future.

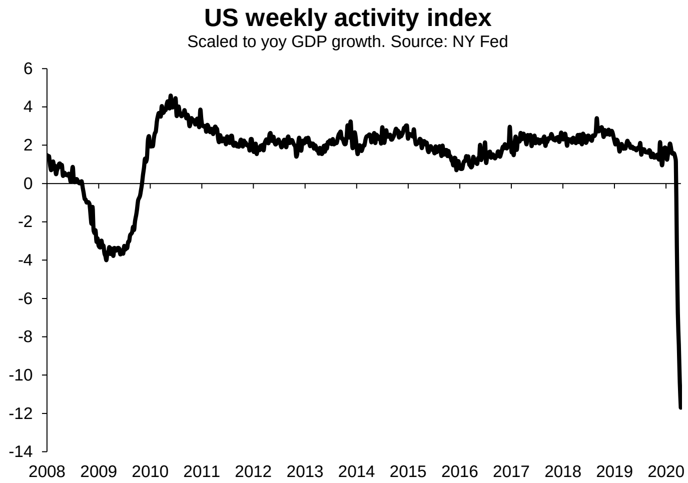
USA

Paolo Zanghieri

- **Q1 GDP dropped by 4.8% annualized. We expect growth to collapse by 7.5% in 2020 followed by a 4.5% rebound in 2021. Risks are heavily tilted to the downside.**
- **High frequency indicators point to an unprecedentedly large output plunge in Q2. The unemployment rate could exceed 15%**
- **In its April meeting the Fed warned about the medium term risks to the outlook and stood ready to step up the existing measures.**

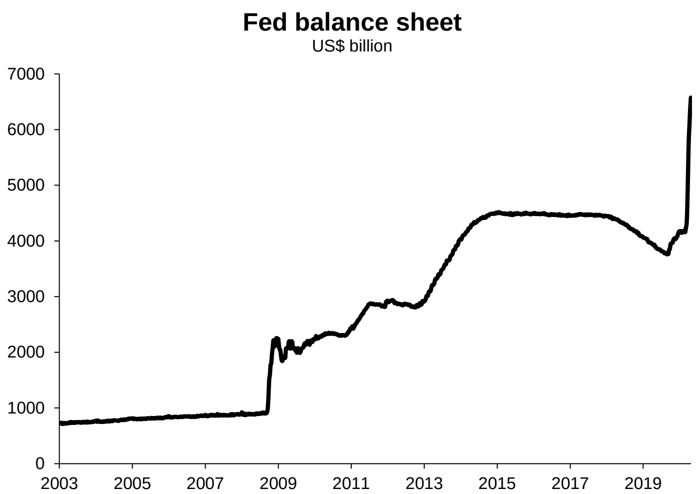
According to the first estimate, in Q1 GDP was down by 4.8% qoq annualized, with consumption falling by 7.6%. The tentative signs of strengthening shown at the beginning of the year were quickly overturned by the virus outbreak. A downward revision of the Q1 estimate is highly likely once more data on household spending and business activity are available. We see 2020 GDP down by a record 7.5%, with a 4.5% rebound expected in 2020. This is based on the assumption of lockdown measures bring lifted at the end of Q2 and recovery gathering speed from the summer onwards. The large uncertainty on the virus evolution and the effectiveness of the income support measures provides a negative tilt to the balance of risks to the forecast.





Unprecedented GDP fall, but fiscal boost will increase

Business and consumer surveys have rapidly turned pessimistic and high frequency data like fuel and electricity consumption or retail sales point to a year on year GDP contraction higher than 10% in Q2, nearly three times worse than what happened in 2009. In the four weeks since March 28, 23 million workers were forced by the lockdown to claim unemployment benefits. As a consequence, April unemployment rate could soar to 15% or higher. The extraordinarily large (12% of GDP) fiscal package the Congress agreed on will be further increased in size the coming months, as the resources for income support for firms are already proving too small. Other measures, such as infrastructure spending may be added.



Fed will increase the size of the existing programs

In its April meeting the Fed highlighted that the recovery may be slower than anticipated, as uncertainty on the evolution of the pandemic may make consumers reluctant to spend for a while. He reminded that the Fed has just lending powers, it is up to the Congress to decide how much and where to spend resources. However a clear priority is to minimize the risk of hig long term unemployment and that of unnecessary household and corporate insolvencies that could permanently harm the economy. The Fed will keep the Fed funds Rate at 0%-0.25% until the economy is clearly recovering It will continue its asset purchases program, and if needed, will beef up credit and liquidity provision. Contrary to some expectations, no new measures (especially yield curve control) were announced.

Euro Area

Martin Wolburg

- **Key indicators plummeted into unchartered territory, confirming that the Covid-19 induced recession is unprecedentedly strong.**
- **Quantifying the output loss is still uncertain, depending not only on the length of the shutdown period.**
- **Despite bold fiscal and monetary policy action we expect GDP growth to drop by -8.0% in 2020.**

In March the Covid-19 pandemic has started to hit Europe severely. With the number of infections rising sharply all countries were forced into lockdowns of large parts of their economies. With the situation stabilizing, tentative steps towards normalization have been taken or at least announced. Still, the deepness of the recession is subject to significant uncertainties.

Deepness of recession subject to huge uncertainties

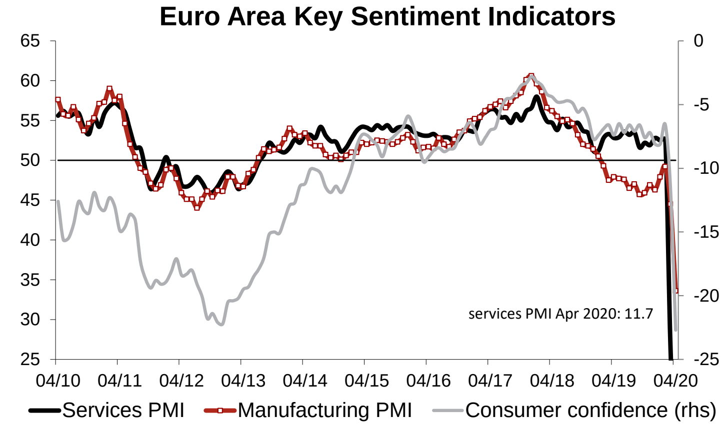
The largest economies will have spent about two months in lockdown before relaxing the measure with the degree varying with the severeness of the pandemic. International organizations like the IMF and the OECD find that one month of lockdown causes annual growth to decline by 2 pp to 3 pp, for Germany the Ifo institute even expect a wider range (2.4 pp to 6.8 pp).

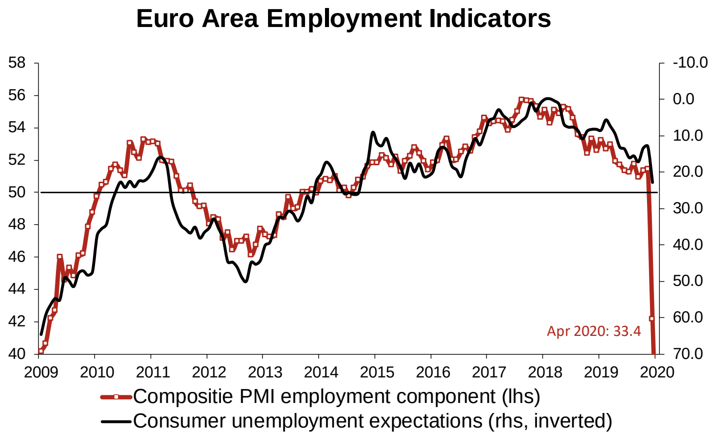
A key uncertainty arises from the speed of normalization and the risk that a renewed lockdown might become necessary. On the positive side, governments supported employment and firms by various measures, e.g. generous short time working allowances, credits and loans. Yet it is unknown whether it really helps to prevent dismissals and firms from going bankrupt. In April, the employment component of the composite PMI dropped to merely 33.4 indicating rising unemployment. Moreover, the pandemic has now also reached EMs and the US which bodes extremely ill for export prospects. The PMI export component dropped even well below the GFC low and there is a risk that insufficient Covid-19 response makes international environment an additional drag for longer. On top, it is hard to assess the lasting effect of the pandemic on consumer and firm confidence.

We see euro area GDP contracting by 8.0% in 2020 and look for a rebound to 4.5% in 2021. The risk is still on the downside, related to a second wave of the pandemic.

Even bold fiscal policy support needed

To whether the pandemic the ECB reacted in March with additional QE and credit support measures. Later it embarked on more QE (PEEP) and collateral easing. Direct fiscal policy support from countries as well as from the EU sums up to around € 450 bn according to our calculations. Looking ahead we share the overall agreement that much more policy support will be needed to overcome the fallout from the crisis.



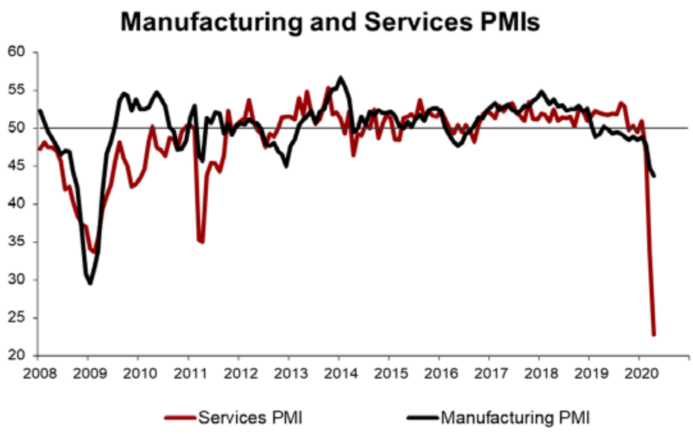


Latest ECB policy measures

Asset Purchases	Credit Support
• € 120 bn for the CSPP in 2020 • € 750 bn PEPP in 2020 (includes commercial papers, shorter maturities than in PSPP, relaxation of issuer limit more flexible capital key buying)	• LTRO until next round of TLTRO III in June (av. depo rate) • Improved TLTRO III terms for June-2020 to June 2021 period • Banks allowed to operate below required capital level • Collateral easing

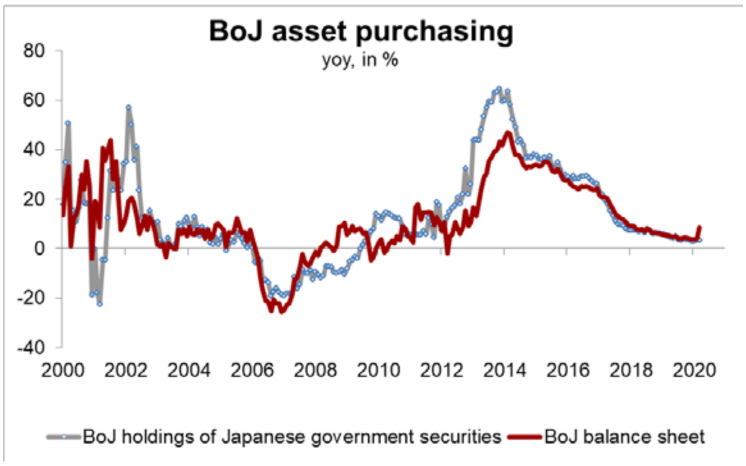
Japan

Christoph Siepmann



Japan's Emergency Fiscal Package (¥ tr)

	Total size	of which is fiscal spending
Total	117.1	48.4
1. Directly related to corona virus disease	2.5	2.5
2. Measures to support employment and businesses	88.9	30.8
Cash handouts to households		12.9
Direct Payments to small businesses		2.3
Funding measures for small/medium-sized firms		3.8
Measures to support funding through FILP		9.9
(FILP = Fiscal Investment and Loan Program)		
3. Measures to support recovery	8.5	3.3
4. Measures to construct more resilient economy	15.7	10.2
5. Contingency funds	1.5	1.5



- **Given the corona crisis, we expect Japan's GDP to drop by 5% in 2020, followed by an upturn to 3% in 2021.**
- **The government is fighting the crisis with a large fiscal package. Effective fiscal spending could be about 8% of GDP.**
- **Accordingly, the BoJ scrapped its JGB buying limits, moving further towards helicopter money. It also increased support for corporate finance.**

Amid the Covid-19 crisis, Japan's government declared the state of emergency for seven prefectures including the Tokyo region on April 7. It widened it later to the whole country. The shutdown will last at least until May 6. However, corona cases have not yet decelerated meaningfully. Consequently, we expect Q2 GDP growth to be hit substantially. April is not yet covered by hard data. PMI survey data showed a strong drop. The manufacturing PMI fell to 43.7 points while the services index dived even more strongly to 22.8. With the Q2 quarter on quarter growth rate most likely again negative, Japan has to digest lower activity for the third quarter in a row. The reason is that the country was still in the process of recovery from the sales tax hike on Oct. 1, 2019. Looking into the second half of the year, we expect Japan's economy to improve again under the assumption that the virus can be brought under control. Like elsewhere, the risk of a renewed corona outbreak will probably lead to a more stretched out recovery process instead of a v-shaped upturn. All in, we see Japan's GDP to drop this year by 5%, followed by a plus of 3% in 2021.

Strong fiscal and monetary easing

The Abe administration announced a very strong fiscal response with a headline number of ¥117 tr (nearly 20% of GDP). About 8% of GDP are actual fiscal spending but include measures from previous announced packages. The largest part are measures to support employment and businesses. This includes ¥12.9 tr cash handouts to households (2.3% of GDP). Most of the other support measures are repayable. While the measures provide urgently needed funding support, the rise in repayable debt could prove difficult especially for small businesses. Depending on the Covid-19 development, there are already rumors that another fiscal package could follow. Regarding the BoJ, it kept its yield curve control policy unchanged but scrapped the JGB buying limits (de-facto buying did not reach ¥80 tr per year), thereby moving further in the direction of helicopter money. In addition, the BoJ focused on supporting corporate finances by raising holding limits for CPs and corporate bonds as well as extending the Special Funds-Supplying Operations. Regarding inflation, the BoJ gave up to reach its 2% target even by 2022, supporting the view that monetary policy has effectively reached its limits.

China

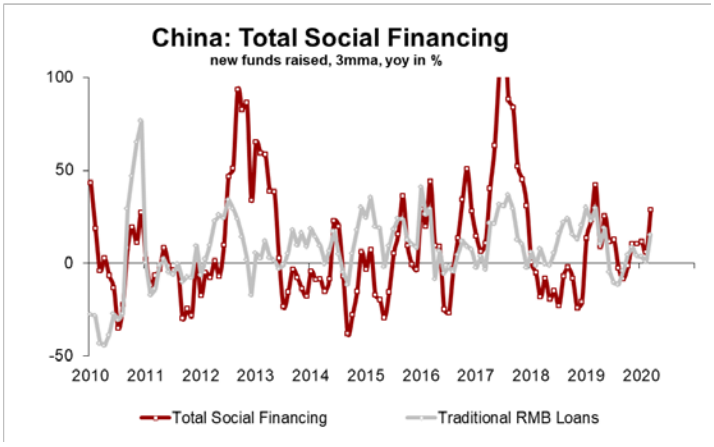
Christoph Siepmann

- **The pace of China's Q2 recovery will likely be restrained by a lack of domestic and international demand. This could also backfire on production.**
- **Against this background, we expect more support from fiscal and monetary policy to minimize the risks and to provide the basis for a sustained recovery in H2 2020. We expect GDP growth at 1.3% this year.**

China's real GDP growth dropped by 6.8% yoy in Q1 2020. However, March activity indicators bounced back, albeit to a different degree. While IP growth improved substantially (to -1.1% yoy from -13.5% yoy before), retail sales advanced much less. We expect these already visible uncertainties on the demand side to limit the upcoming pace of the recovery. China – like all countries – needs to prevent a renewed outbreak of the corona virus. Thus social distancing will continue to restrain the opening up of certain services sectors. Moreover, the past income and confidence loss will weigh negatively on domestic consumption. Daily indicators suggest that still less migrant workers returned to large cities than in 2019. Consequently, unemployment has probably risen. While good employment data do not exist, the latest Politburo meeting announced that stabilizing employment is the top policy priority. Thus indirectly, the statement hints at a substantial issue. The domestic demand problem will be exacerbated by international trade. Although, March exports shrank much less than forecast, the global shutdown will weigh on with a lag. Given the large drop in GDP e.g. in the US and Europe, it is unlikely that trade only faces a temporary shift but as well a lower level. Accordingly, inventories could rise and trigger another setback of production and employment, if domestic and foreign demand were to remain subdued.

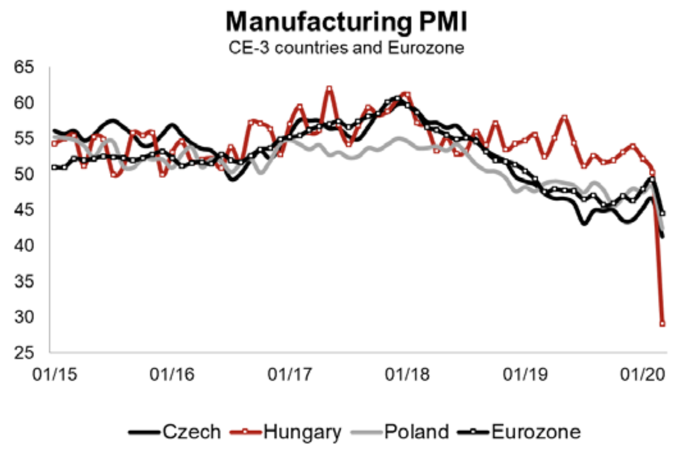
More monetary and fiscal support expected

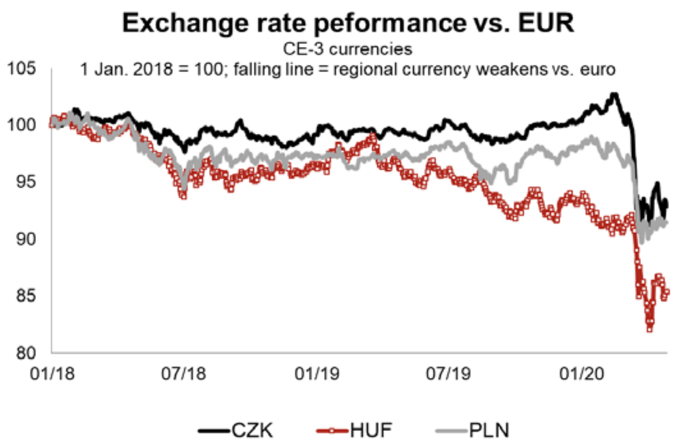
This speaks in favor of a larger fiscal package and suggests measures to prop up consumption resp. to improve employment. The unemployment benefit scheme is reportedly undersubscribed (esp. by migrant workers), so that a widening of the scheme or direct cash transfers could be appropriate. Support for SMEs would help employment as they provide the bulk of jobs. A rise in infrastructure projects could also elicit short-term results. Nevertheless, in comparison to other countries China has been rather reluctant with extra fiscal measures so far. Negative experiences with the very large GFC package 2008/09 as well as the high credit/GDP ratio may play a role. We expect announcements to be held back until the National People's Congress starting on May 22. We expect a fiscal impulse of overall 3.5% to 4% of GDP. In addition, we see the PBoC to additionally cut the Loan Prime Rate by 30 bps via MLF cuts and additionally cut RRR by 100 bps in 2020. All in, we forecast China's GDP to slow to about 1.3% in 2020, followed by a rise to 8% in 2021 (base effects).



Central and Eastern Europe

Radomír Jáč





Main Forecasts	2018	2019	2020f	2021f
Czech Republic				
GDP	2.8	2.4	-7.0	5.0
Consumer prices	2.1	2.8	2.8	1.9
Central bank's key rate	1.75	2.00	0.50	0.50
Hungary				
GDP	5.1	4.9	-6.0	4.2
Consumer prices	2.8	3.4	3.2	3.0
Central bank's key rate	0.90	0.90	0.90	0.90
Poland				
GDP	5.2	4.1	-3.0	3.9
Consumer prices	1.6	2.3	3.0	2.5
Central bank's key rate	1.50	1.50	0.25	0.25

GDP and consumer prices: annual % change; CB interest rate: in %, year-end

- **Economic activity in the region is hit negatively by coronavirus-restrictions. GDP will fall in 2020 with the sharpest rate of decline expected for Q2.**
- **Inflation remains above target in all CE-3 countries but price pressures are expected to moderate as weaker economic activity will lead to lower demand and capacity utilization.**
- **Monetary policies were eased significantly, incl. introduction of QE. Particularly Czech and Polish central banks may relax their stance further while Hungary takes into account a weaker forint.**

Economic activity in the CE-3 region is hit by restrictions introduced in fight against the coronavirus. These measures are likely to lead to GDP contraction in Q1 and Q2. Although we expect GDP to recover in quarter-to-quarter terms in H2, the full-year 2020 performance should be sharply negative with annual growth returning into positive territory only in 2021.

Inflation in the CE-3 region still remains above official targets despite moderation reported for March. Recession related to pandemic will drive CE-3 economies' output below their potential. This should lead to a decline of price pressures in the rest of 2020 and also in 2021.

The current level of inflation is thus irrelevant for monetary policy setting and central banks made bold steps towards easing of financial conditions. However, exchange rate volatility is having impact on form and calibration of such measures, as regional central banks want to avoid excessive weakening of their currencies.

Monetary policy stimulus can be extended further

The Czech central bank cut its key interest rate by 125 bps to 1% in two steps in March. We expect one more cut by 50 bps in early May. The majority of the CNB Board would also support interventions in FX markets in order to prevent the Czech crown from further depreciation. We think that the 28/EUR level could be important for such considerations: the CZK currently trades below 27.5/EUR. The CNB also received green light for QE but for now it does not want to launch purchases of government bonds.

The Hungarian central bank changed its policy framework in an attempt to support the economy and at the same time to prevent further weakening of forint, which was hit by global sentiment and loose domestic monetary stance. The MNB raised O/N and 1W collateralized lending rates by 95 bps to 1.85%, while the base rate was left at 0.90%. The MNB withdraws short-term liquidity via 1W deposit tenders and offers resources mainly via 5Y tenders. QE (government debt purchases) will be launched in May.

The Polish CB cut its key rate from 1.50% to 0.50% in two steps by 50 bps. While a further cut is likely, it seems that the MPC does not want to reduce rates towards zero. The central bank at the same time deployed QE, making significant purchases of government debt in early April.

Bonds/Fixed Income Strategy

Florian Späte

- **Driven by excessive numbers of heterogeneous news international government bond yields were on a roller coaster ride in April. Eventually, the downward trend prevailed and yields finished the month slightly below the March levels.**
- **Going forward, we see some further leeway for yields to drop. Not only the string of dismal economic news will continue, but also international central banks are expected to err on the side of caution and are likely to signal their readiness to do even more.**
- **Despite the strong intervention by the ECB, euro area non-core bond spreads widened. For the time being, we expect spreads to remain range-bound as non-core bonds continue to be trapped between an indecisive European fiscal response to the crisis and an proactive ECB.**

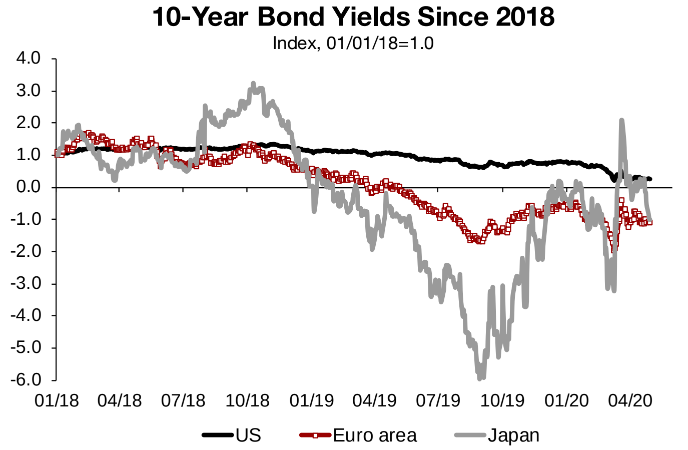
International bond markets remained caught in April by the news flow with respect to the spreading of Covid-19, the impending economic consequences and the monetary and fiscal efforts to soften the impact. Additionally, an unprecedented drop in oil prices kept financial markets on their toes and eventually contributed to a further decrease in yields during the month.

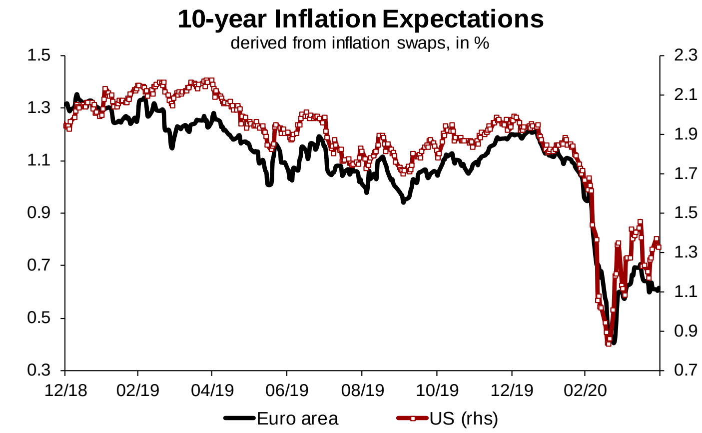
Overall, 10-year US and euro area yields fell by 7 bps and 2 bps, respectively. While inflation expectations fell strongly temporarily, they rebounded and even increased on balance (particularly in the US). Thereby, the unsustainable increase in real yields in March was partly corrected in April. As short-dated yields rose moderately as well, yield curves' steepness did not change substantially. They shifted downwards on balance in both regions.

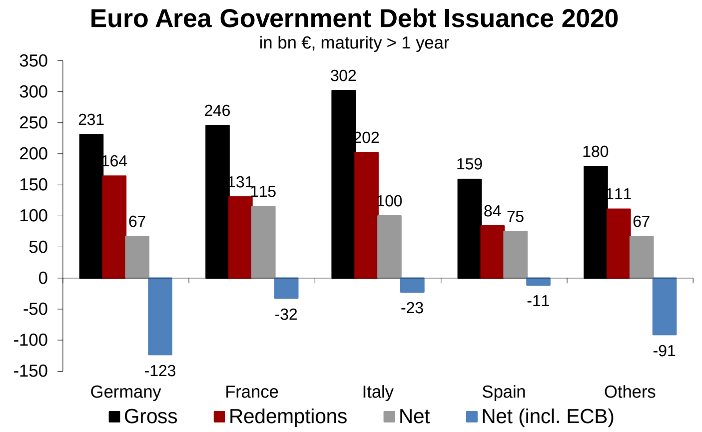
Central banks to lead the way

A forecast for international bond markets is currently particularly difficult. Not only the spreading of Covid-19 surely impacts international bond markets, but also economists still struggle to estimate the economic impact – which is of course strongly dependent on the containment of the virus and the timetable for opening up the economies. What is more, while governments around the world have reacted swiftly and set up huge fiscal programs, the fiscal response on a euro area level is still unfolding. While the EU Council agreed on a three-pillar package of policy measures worth €540 bn, many details are still unknown. Particularly, the establishment of a Recovery Fund (worth probably at least €1 tn) is still under discussion and further negotiations will be necessary. Hence, our forecasts are highly uncertain and vulnerable with respect to a changing environment. Therefore, they should be taken with a pinch of salt.

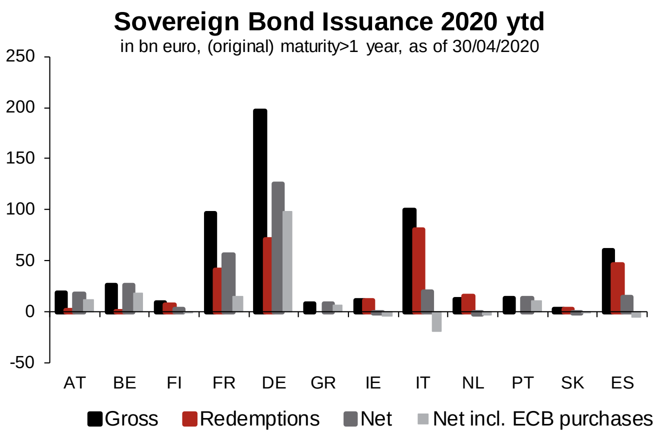
Notwithstanding, we expect central banks to lead the way in the weeks to come. Although they have taken steps to prevent a breakdown of financial market functioning, they

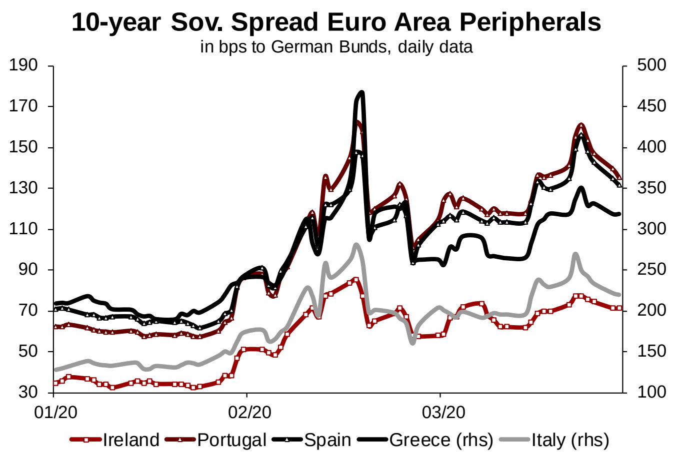


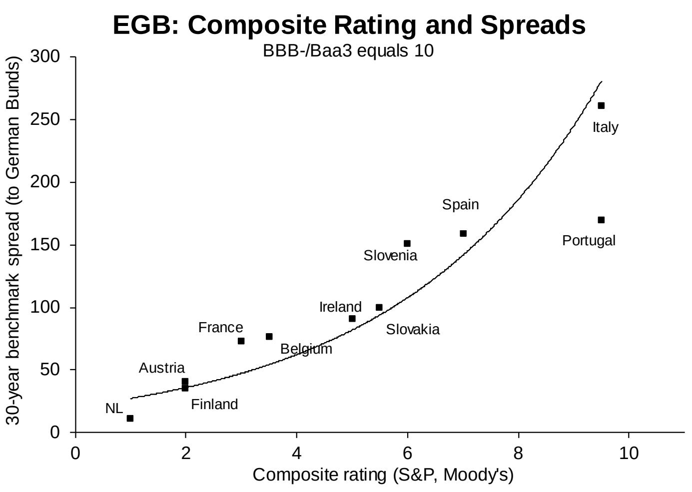




Bonds/Fixed Income Strategy







stand ready to do even more. Both, the Fed and the ECB, seem committed to deliver more in case it is needed. This applies in particular to the ECB as the lack of an uniform response on a euro area level leaves the ECB as the only European institution to brave market turmoil.

There is a concern that the massive increase in government bond issuance will trigger higher yields going forward. While it appears largely unquestionable that this year's issuance volume will reach a new historical peak, we doubt that this will lead to higher yields. Although the gross issuance is expected to reach more than €1120 bn, the ECB stands ready to absorb the bulk of it. We estimate that the central bank will purchase more than €720 bn of euro area sovereign bonds in 2020. This will be the highest annual amount ever and will contribute to a negative net issuance, thereby alleviating the issuance burden. What is more, despite the market turmoil euro area treasuries have already pressed ahead with issuance activity. Particularly smaller countries are well advanced in terms of funding progress and some have issued more than 50% of the (increased) annual target (e.g. Belgium more than 60%).

Overall, we think there is some leeway for lower yields further down the road. The forthcoming dismal economic releases in combination with the very accommodative stance of international central banks are likely to contribute to lower nominal yields in the months to come. However, we do not expect this to happen via lower inflation expectations. Although the near-term outlook to inflation is forecast to remain depressed, the recent stabilization of oil prices are expected to drive inflation expectations moderately up again.

Once the spreading of the virus is contained for good, we think there is scope for a modest increase in yields. However, even on a 1-year horizon US and euro area yields will remain on depressed levels in historical comparison.

Non-core spreads trapped in a trading range

Our cautious stance with respect to euro area non-core bonds we expressed at the end of February proved to be correct. Both, semi-core and non-core bond spreads widened in April. Temporarily even the spread levels ahead of the announcement of the Pandemic Emergency Purchase Program were reached again.

Assuming no breakthrough towards debt mutualization, we expect non-core spreads to remain range-bound. While the ECB's interventions will prevent any disorderly widening a lasting tightening trend is not on the cards either. The weakened fiscal situation will bring debt sustainability concerns to the fore and the uncertainty about rating agencies (S&P kept rating unchanged in April, while Fitch downgraded Italy to BBB- outside of the scheduled dates) will stand in the way of a lasting tightening trend – at least for the time being.

Corporate Bonds

Elisa Belgacem

- **Credit spreads have continued their recovery in April, with a significant spread tightening.**
- **Both IG and HY have benefitted from an unprecedented central bank buying, combined with direct government support.**
- **The Fed is now buying HY, while the ECB has made fallen angles eligible as collateral.**
- **The pause in issuances, as the reporting season has started, will also continue to help.**
- **Overall, we continue to recommend an OW in IG as we expect near zero defaults and positive total returns. We are neutral on HY defaults which will continue to rise, counterbalanced by strong public support.**

The public support to the economic world has reached unprecedented levels, and the political will to preserve economic activity has so far led authorities to support bond holders. Indeed to prevent liquidity risks to rise, the access to credit market is fundamental to keep companies afloat. For instance the temporary framework issued by the European commission is currently allowing states to support banks without asking contribution of subordinated instruments., while we expect in the coming days a similar step to be taken on the non-financial side.

Moreover, central banks are lowering the quality of assets on their balance sheet like never before, buying HY in case of the FED, while the ECB has temporarily allowed fallen angels as collateral. An expansion of the PEPP program by the ECB would most likely also include those fallen angels further supporting the Xover space.

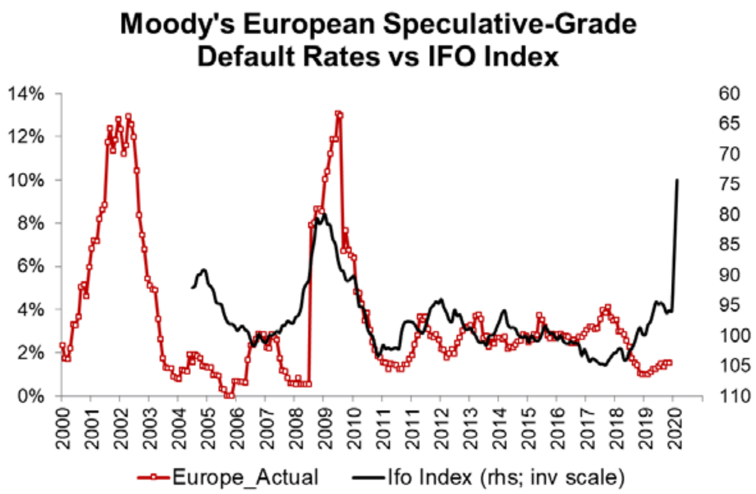
As a consequence we have seen IG corporate bonds tightening by 50 bps in OAS vs government terms while HY has been tightening by more than 125 bps. Within the senior space, Financials have been by far the best performers. Subordinated bonds have also massively performed led by AT1, which are benefitting from the temporary suspension of BRRD.

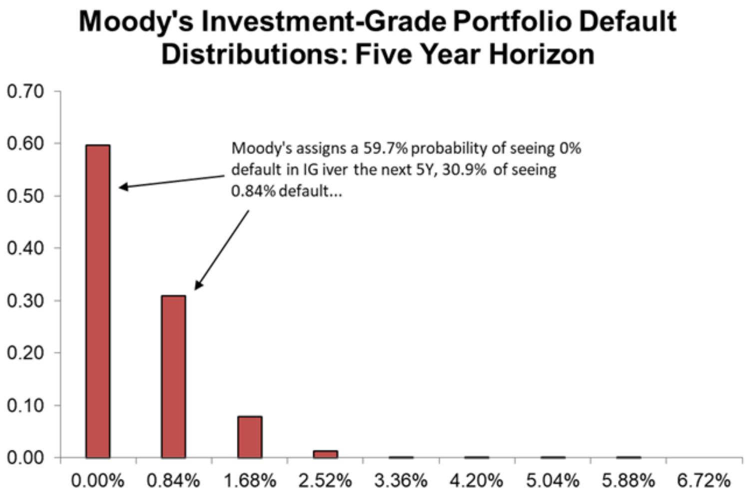
Non-financial IG spreads have been lagging

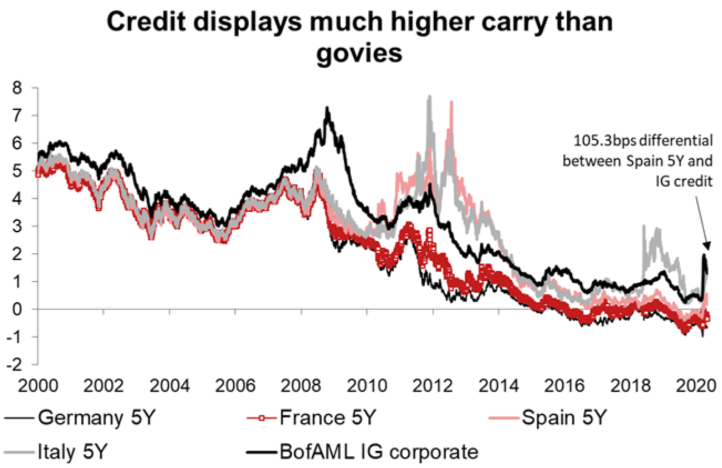
Indeed because of the intense issuance activity before the reporting season as corporates were craving for liquidity.

Going forward, we think that there is still room for further valuation divergence between IG and HY. Indeed rising default rates will continue to weigh on HY into 2021 despite record public support.

On IG on the opposite we expect near zero default rates, while the pick-up versus govies is high. Yes there will be migration risks, but we think it is well reflected in the price. Hence we recommend an OW on IG skewed toward non-financials.





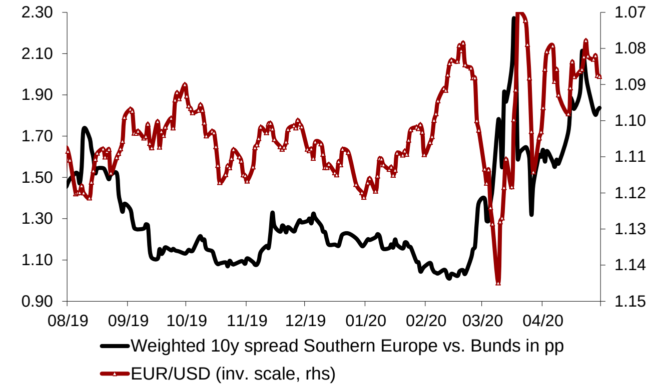


Currencies

Thomas Hempell

- **The eroded carry after the Fed rate cuts will burden the USD as Covid-19 strains ease.**
- **Yet public debt concerns will prevent the EUR from benefitting near term. With EMU leaders reluctant to subscribe to a large risk sharing on debt or providing grants, investors will remain reluctant to engage in the single currency.**
- **The boost to the Swiss franc may require even stronger FX intervention by the SNB to prevent the EUR/CHF from breaking below 1.05. A gradual recovery is a theme only for H2.**

EUR/USD more vigilant on debt risks

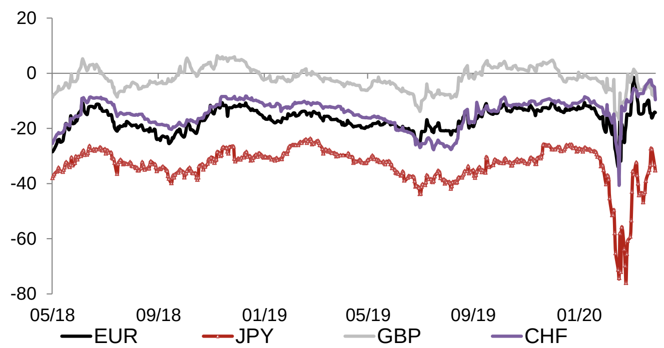


With several European countries detailing plans out of Covid-19 shutdown amid receding infections, reduced uncertainties may lend the single currency some support over the next weeks. While also some US states are lifting containment measures, the continued strong rise in US infections leaves the risk of re-tightened lockdown measures higher.

Yet the economic fallout in Europe is compounded by the hugely unequal fiscal capabilities of EMU members. Italy will see its public debt-to-GDP rise by about 20 pp to 155% this year. EU leaders agreed on €540 bn facilities of cheap loans and on a planned Recovery Fund. Yet, this fund may (again) be centred more on loans than outright grants, providing no game-changer to sustainability .

Basis swaps vs. USD

1Y, in bps



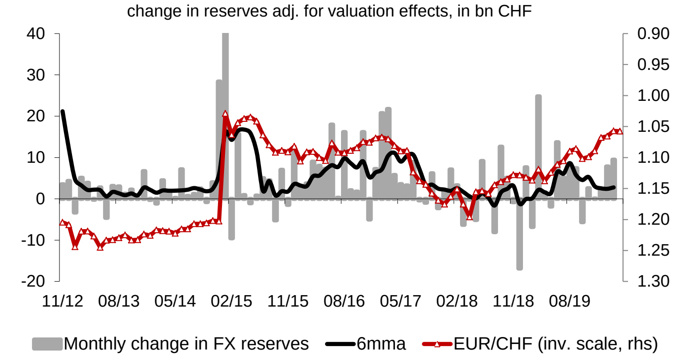
This leaves the burden on the ECB's shoulder with its €750 bn PEPP. The pending QE ruling by the German Constitutional Court (May 5) poses the tail risk of questioning this support. EUR/USD has turned more vigilant to Southern European bond spreads again (top chart), keeping a lid on the EUR/USD.

Fed has addressed USD squeeze successfully

A gradual exit from the lockdown will also reverse this year's USD strength vs G-10 FX (less so vs. EMs). The Fed has successfully addressed a global USD squeeze by quick and bold liquidity provision and inter-national swap lines, helping basis swaps to normalize (mid chart). Also, the Fed will stick to sharply cut rates for longer, leaving the USD's long-standing carry appeal vs. other major FX eroded. We see the EUR/USD near-term outlook balanced, but with upside over H2.

Swiss FX intervention and EUR/CHF

change in reserves adj. for valuation effects, in bn CHF



Covid-19 strains and rising spreads on Southern European debt have boosted the CHF as a safe haven. The Swiss National Bank (SNB) has stepped up FX intervention (bottom chart), even though at a relatively moderate pace. The SNB will be pushed to do more, as deflation risks loom and EMU debt uncertainties push the EUR/CHF closer to 1.05 over the coming weeks. Further out, though, we expect the lifting of the lockdown and economic recovery to be associated with easing safe haven flows and a moderate recovery in EUR/CHF.

Equities

Michele Morganti / Vladimir Oleinikov

- **Sentiment improved as huge policy action cut credit tail risks and new Covid contagions peaked.**
- **Since March 23, spreads and volatility decreased substantially, stabilizing the cost of equity and inducing a sharp decline in risk premium.**
- **While the effects of policy measures will be long-lasting, market multiples have reached stretched levels for the short term, so that we decreased substantially our OW position on equity.**
- **Longer term we remain constructive as, even cutting substantially earnings and dividends for 2020, a partial recovery in 2021 and lingering low yields will provide scope for positive total returns.**
- **Positioning is also far from being bullish. Inside equities we maintain a balanced portfolio still tilted to the defensive side.**

Better sentiment as policy intervention cuts tail risks

Since March 23rd equities rallied visibly: the MSCI world is up 27%, the S&P 500 28%, both outperforming the MSCI EMU (19%). Firstly, central banks interventions reached an unprecedented level (huge and flexible QE, guarantees, use of leverage etc.), cutting structurally tail risks in credit markets. The action was also extended to the riskier credit (high yield) which is the most correlated to equities. Moreover, fiscal policies are getting expansionary up to a level which has few examples in modern history. Initially, the agreed oil production cuts have also reassured investors albeit the demand-supply imbalances are going to stay with us at least for the next quarters. Furthermore, and most importantly, the new contagions peaked in the developed world reassuring investors in particular against an imminent collapse of health infrastructures. Lastly, China, the first country to experience a contagion peak, was able to exhibit a macro surprise index recovery from unprecedented cyclical lows.

Lower cost of capital and lower volatility

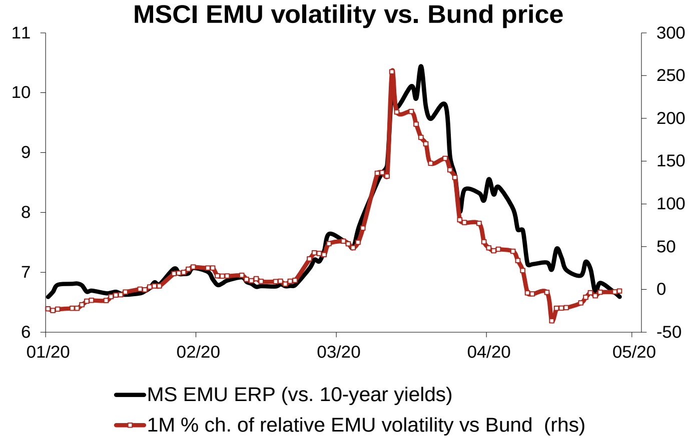
The policy action has induced a possibly enduring decline in government bond yields and corporate spreads from the levels seen at the end of March, with the implied cost of equity to decline from recent peaks.

The VIX (index for US equity volatility) halved from 62 to 33 thanks to the improved monetary conditions. This induced a drop also in the relative equity volatility vs bonds, thus supporting a steep decline in the implied equity risk premium (see charts) and consequently a positive price performance.

Market leadership and positioning remain defensive

During the rally, investors' preference went to Defensives, Growth and Quality styles (US, Nasdaq, EU ex-EMU, Switzerland), avoiding Value. Positioning still looks cautious, with mutual funds' cash holdings at record highs.

MSCI EMU volatility vs. Bund price

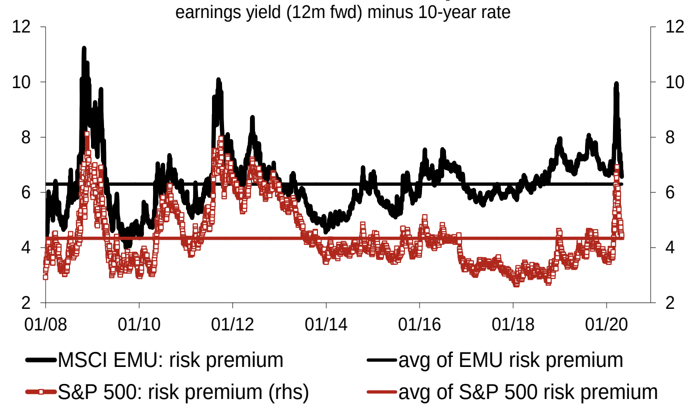


Markets	Price / Earnings *		Price / Book *		Price/ Cash Flow *		Dividend Yield *		Avg.	PEG adj.*
	current	hist. avg.	current	hist. avg.	current	hist. avg.	current	hist. avg.	Discount, %	
WORLD	18.2	16.0	2.1	2.0	11.3	8.9	2.6	2.7	13.1	
USA	19.8	15.4	3.0	2.4	13.2	10.0	2.1	2.2	21.2	1.9
JAPAN	13.4	15.3	1.0	1.2	7.3	7.1	2.8	2.0	-18.3	4.0
UK	13.9	13.8	1.4	1.8	7.8	7.9	5.3	4.1	-13.2	3.1
SWITZERLAND	17.6	15.4	2.6	2.3	12.0	11.2	3.3	3.3	9.2	2.4
EMU	14.6	14.1	1.3	1.5	7.4	6.6	3.8	3.8	0.7	2.5
FRANCE	15.2	14.3	1.3	1.5	8.2	7.0	3.7	3.7	2.6	3.0
GERMANY	14.1	14.9	1.2	1.5	7.4	6.8	3.5	3.4	-4.3	2.3
GREECE	11.8	12.8	2.2	1.6	6.1	6.1	6.1	4.1	-5.9	1.0
ITALY	11.7	15.0	1.0	1.2	4.7	4.7	5.6	4.7	-15.5	2.4
PORTUGAL	17.8	12.8	1.9	1.7	5.5	5.9	5.2	4.5	6.2	4.3
SPAIN	11.6	12.8	0.9	1.6	4.0	5.1	5.4	5.1	-20.5	2.1
EURO STOXX 50	14.1	13.2	1.3	1.5	7.4	6.3	4.0	4.2	4.2	2.4
STOXX SMALL	17.4	14.6	1.5	1.7	9.3	8.4	3.2	3.2	5.1	2.6
EM, $	12.2	14.4	1.3	1.6	7.3	7.5	3.2	3.1	-8.9	2.0
BRAZIL	11.5	9.2	1.4	1.7	6.2	13.2	4.6	4.3	-13.5	2.4
RUSSIA	6.4	6.9	0.8	0.9	5.6	4.4	9.0	4.2	-27.3	2.9
INDIA	16.7	14.7	2.2	2.6	10.6	11.5	2.0	1.6	-9.0	1.7
CHINA	12.4	12.9	1.5	1.7	8.4	7.5	2.2	3.0	5.0	1.3

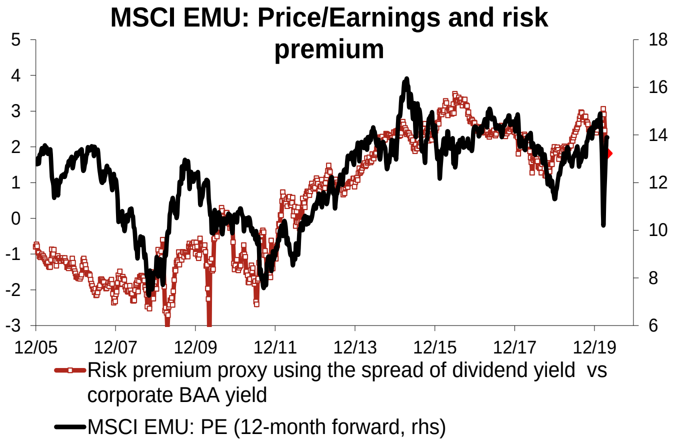
Note: The first four markets are based on the main local indices, the rest on the corresponding MSCI indices.
Multiples are based on 12m forward estimates; PEs are since 1987, the rest is since 2003. PEG is PE divided by expected EPS long-term growth.
PEG adj. (higher = expensve): PEG is modified by the ratio COE/ROE, which signals the ability to produce a return on capital higher than the cost of it.
COE = cost of equity = 10yr gov't bond rate + 6% mkt risk premium x country Beta versus MSCI WORLD (monthly returns over the last 10 yrs).
Discount in % to historical average: blue and negative numbers = undervaluation. Red and positive numbers = overvaluation.
Source: Thomson Reuters Datastream, IBES estimates.

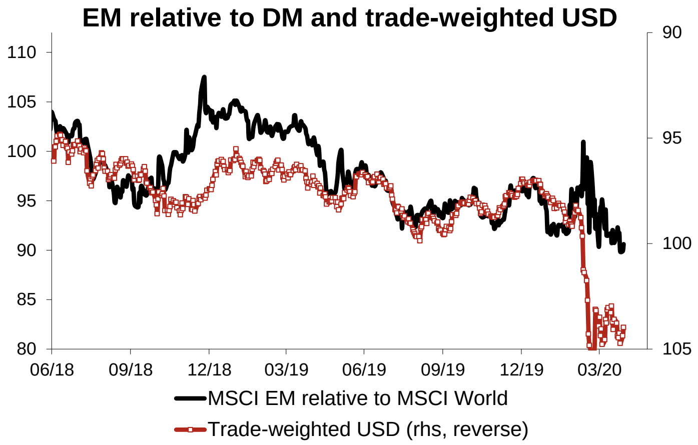
MSCI EMU and S&P: risk premium

earnings yield (12m fwd) minus 10-year rate



Equities





Short term we are more cautious: lower OW position

The policy-induced mitigating factors are going to stay, producing positive effects and maintaining volatility and risk premia at bay. This translates into an S&P 500 valuation range of 2,450-3,000 versus our former 2,150-2,750. So at current levels valuations look stretched. The 12-month forward PE is above 19X, higher than previous peak. The equity risk premium (a proxy of risk version, see previous page) went back to historical average, declining by more than 300 bps, showing no sign of stress anymore. The earnings reporting season looks bleak (-25% and -21% yoy, respectively the growth in EU and US) but Q2 will be even worse. Furthermore, there is uncertainty on recovery plans and a second wave of contagion which could induce additional credit accidents.

Longer term we continue to be positive

Equity risk premium versus government bonds or credit is back to average since 2008 but remains well above average if a longer history is taken into account (especially versus credit yields, s. chart). Yields will stay low for longer, volatility calmer, and even assuming 30% or 40% decline in earnings and dividends in 2020 and a milder recovery in 2021 vs past recession experiences, we see mid-single digit positive total returns in the next 12 months. As said, cash is still high, positioning not aggressive and investors did not played Value or Cyclical names yet, so there is space to rotate inside equities.

OW EU ex-EMU, US and N Value vs Growth

Inside equities, we have a slight preference for EU ex-EMU and the US vs EMs, Japan and EMU. We are also neutral on cyclicals vs. defensives. OW: utilities, software, IT, pharma, staples, telecoms. UW: real estate, discretionary, auto. Limited OW on Momentum, Low Leverage. Neutral on Quality, financials and oils.

EM: capped by resilient USD short term

In April, EM equities recovered part of previous losses, increasing by 7%. Falling global exports resulting from COVID fallout will cause earnings growth to suffer further. Judging by our value indicator (12-month forward earnings divided by 10-year yields), the market is slightly overvalued. Besides, the EM equities are for the time being still pressured by weak macro surprises. Spreads and trade-weighted dollar represent a further burden for EM firms (YTD +315 bps and 7.3% for spreads and TW USD, respectively). These factors along with global GDP and export slowdown would cap EM performance short term. In the longer term, EM stocks are to benefit from lower valuations (Shiller PE being 1.3 st. deviations below historical average) and higher economic growth, together with a weakening dollar. Within EMs, we favor Korea and Taiwan, having better Covid trends, M1 trends and valuations.

Asset Allocation

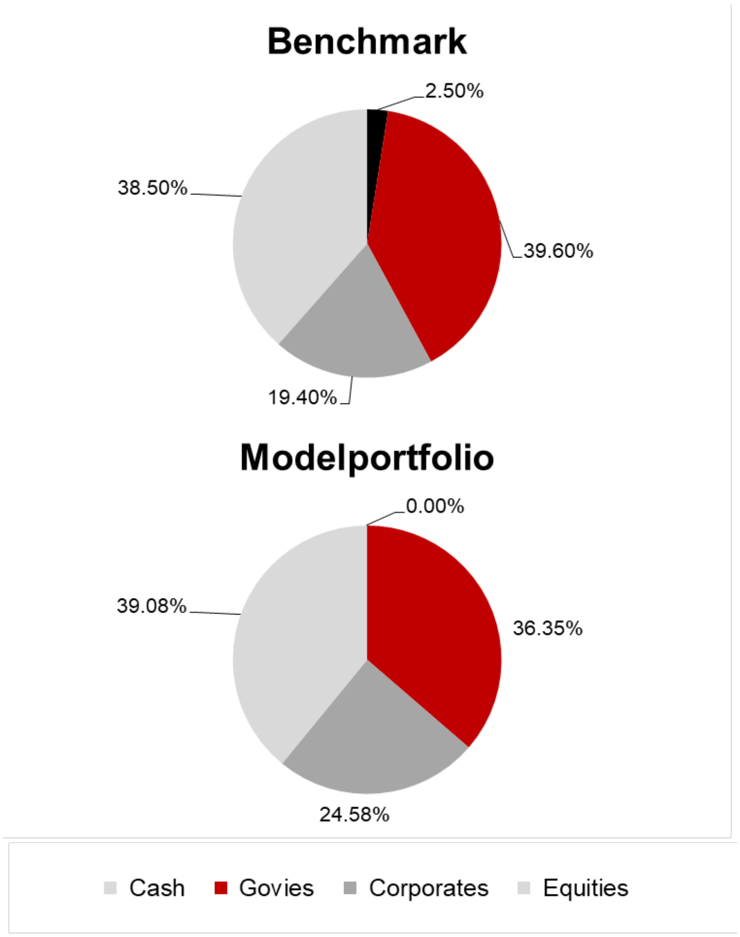
Thorsten Runde

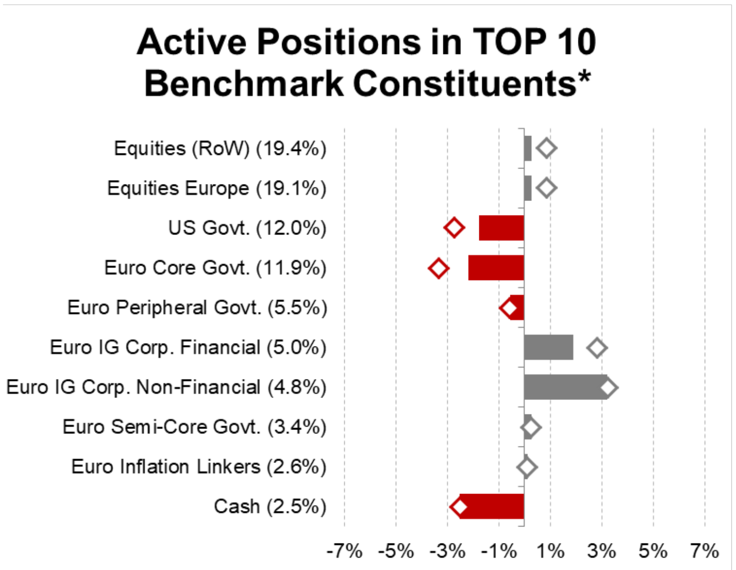
- **Developments on financial markets in the last two months were entirely in the wake of the COVID-19 pandemic. The initial sell-off in risk assets was followed by a significant rebound starting in the last week of March.**
- **Nevertheless, apart from US Treasuries which yielded a good 3.5% on a EUR-hedged basis, all other asset classes lost value over the past two months.**
- **Equity markets in particular suffered as a result of the COVID-19 crisis. They lost round about -13% since the end of February.**
- **On the fixed income side long-dated Spanish and Italian government bonds as well as EA HY credit suffered the most with losses ranging from -8.5% to roughly -10%.**
- **With new COVID-19 cases apparently peaking we recommend a very mild overweight in equities and HY credit after the recent rebound. We are constructive for EA IG credit, particularly non-fin, at the expense of core govies and cash. We recommend to lengthen duration after the rebound in rates.**

After the COVID-induced sell off in risk assets starting around the 20th of February, markets significantly rebounded since the last week of March. Being neutrally aligned in equities throughout March insured us against a large part of these losses. All in, the model portfolio underperformed its benchmark by just -15 bps compared to -133 bps if having maintained the tactical positioning of February. Against the backdrop of the grave equity market corrections and first signs of a moderate recovery as well as the massive central bank support for credit, we have cautiously rebuilt some risk positions in equities and EA IG credit at the beginning of April at the expense of core government bonds and cash. In April the TAA contribution was +39 bps, by contrast an unchanged tactical stance would have made a contribution of -1 bp. In that sense, the active tactical positioning during the two crisis months March and April can be considered as quite successful.

Prudent pro-risk stance favouring quality credit

As the number of new COVID-19 cases appears to peak we recommend a very mild overweight in equities and HY credit after the recent rebound. In this context, we deem focusing on defensive sectors and markets advisable. We confirm our constructive view on EA IG credit, particularly on non-financials. The corresponding overweight should be implemented primarily at the expense of core govies and cash. Within govies we have a clear preference for the longer maturity buckets after the rebound in rates which results in the recommendation to lengthen duration.





**Benchmark weights in parentheses, diamonds indicating previous recommendations*

Forecast Tables

	2018	2019f	2020f	2021f
US	2.9	2.3	- 7.5	5.0
Euro area	1.9	1.2	- 8.0	4.5
Germany	1.5	0.6	- 7.5	5.0
France	1.7	1.3	- 8.0	4.5
Italy	0.7	0.2	- 9.5	4.0
Non-EMU	1.6	1.4	- 6.7	4.9
UK	1.4	1.4	- 6.8	5.0
Switzerland	2.8	0.8	- 6.5	4.0
Japan	0.8	0.8	- 5.0	3.0
Asia ex Japan	6.2	5.2	0.8	7.2
China	6.6	6.1	1.3	8.0
CEE	3.1	1.9	- 4.4	3.8
Latin America	0.1	- 0.6	- 6.0	3.0
World	**3.6**	**2.8**	**- 3.5**	**5.3**

	2018	2019f	2020f	2021f
US	2.4	1.8	0.9	1.8
Euro area	1.8	1.2	0.3	1.0
Germany	1.8	1.4	0.3	1.5
France	1.9	1.2	0.3	1.3
Italy	1.1	0.8	0.4	1.2
Non-EMU	2.3	1.7	1.2	1.4
UK	2.5	1.8	1.2	1.4
Switzerland	0.9	0.4	- 0.5	0.7
Japan	1.0	0.5	0.1	0.2
Asia ex Japan	2.6	2.8	2.7	2.6
China	2.1	2.9	2.9	2.2
CEE	6.0	6.7	4.7	4.7
Latin America	4.0	4.0	3.5	3.3
World	**2.8**	**2.6**	**2.1**	**2.3**

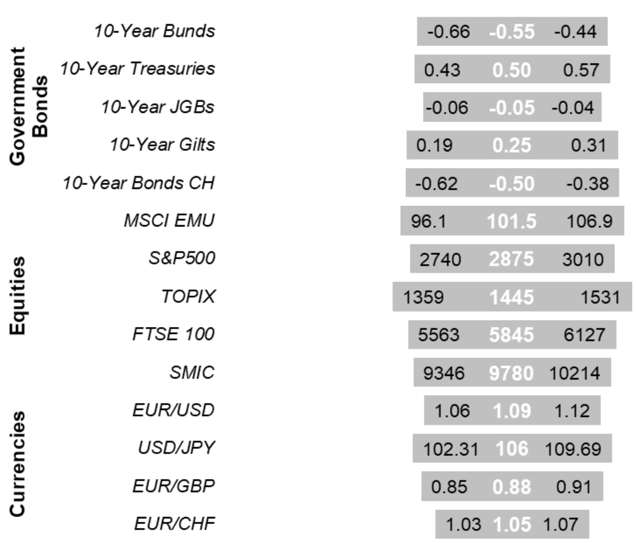
Financial Markets

3-month LIBOR	**28/04/20***	**3M**	**6M**	**12M**
USD	0.86	0.80	0.90	1.10
EUR	-0.17	-0.20	-0.45	-0.45
JPY	0.00	-0.10	-0.10	-0.10
GBP	0.64	0.55	0.55	0.55
CHF	-0.58	-0.60	-0.75	-0.75
10-Year Bonds	**28/04/20***	**3M**	**6M**	**12M**
Treasuries	0.62	0.50	0.65	1.00
Bunds	-0.46	-0.55	-0.50	-0.30
BTPs	1.79	1.65	1.60	1.50
OATs	0.02	-0.05	-0.05	0.10
JGBs	-0.03	-0.05	-0.05	0.00
Gilts	0.29	0.25	0.35	0.60
SWI	-0.45	-0.50	-0.45	-0.30
Spreads	**28/04/20***	**3M**	**6M**	**12M**
GIIPS	181	175	170	150
BofAML Covered Bonds	67	65	60	55

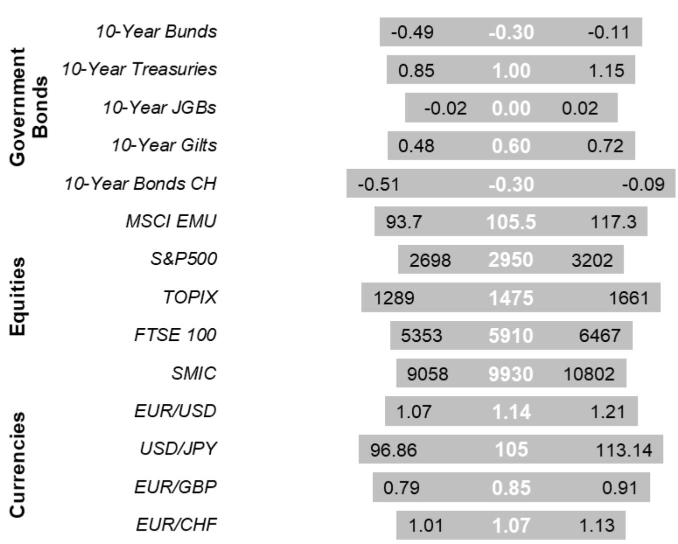
Corporate Bond Spreads	**28/04/20***	**3M**	**6M**	**12M**
BofAML Non-Financial	191	170	150	140
BofAML Financial	191	175	155	145
Forex	**28/04/20***	**3M**	**6M**	**12M**
EUR/USD	1.08	1.09	1.11	1.14
USD/JPY	107	106	106	105
EUR/JPY	116	116	118	120
GBP/USD	1.24	1.24	1.28	1.34
EUR/GBP	0.87	0.88	0.87	0.85
EUR/CHF	1.06	1.05	1.06	1.07
Equities	**28/04/20***	**3M**	**6M**	**12M**
S&P500	2860	2875	2900	2950
MSCI EMU	102.5	101.5	103.0	105.5
TOPIX	1439	1445	1455	1475
FTSE	5853	5845	5865	5910
SMI	9758	9780	9900	9930

*average of last three trading days

3-Months Horizon



12-Months Horizon



*The forecast range for the assets is predetermined by their historical volatility. The volatility calculation is based on a 5 year history of percentage changes, exponentially weighted. The length of the bars within each asset group is proportional to the relative deviations from their mean forecasts.

Imprint

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