Market Perspectives

Viral uncertainties

March 2020

Content

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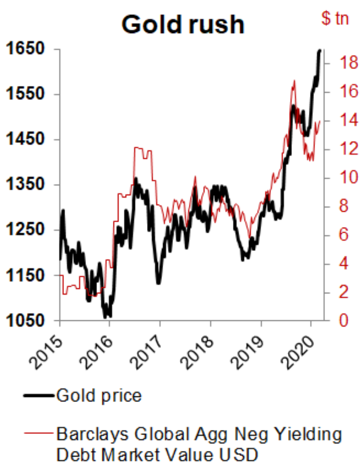
Global View – Viral uncertainties

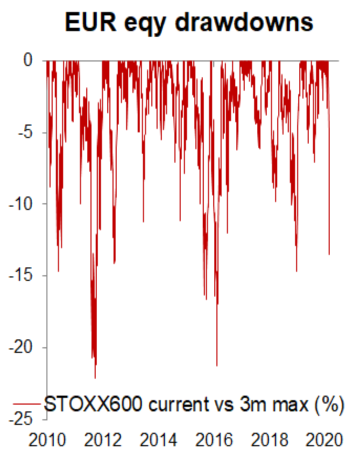
Vincent Chaigneau / Thomas Hempell

- **With Covid-19 going global, we scale back the previously cautious pro-risk bias in our portfolios.**
- **Markets are already discounting quite some bad news and may be prone for a rebound once global infections start to recede.**
- **That said, a global pandemics can no longer be ruled out. Amid very high uncertainties about further contagion and the economic fallout, we reduce our tactical equity exposure to neutral.**
- **As expected IG Credit has been resilient, with the fall in risk-free rates exceeding the widening in OAS spreads. We keep but reduce our overweight, with a preference for non-financials on continued support from the ECB's asset purchase program.**

The Covid-19 virus is turning from a regional health crisis to a global issue; uncertainties about the global economic impact have been rising sharply. After weeks of resilience, equity markets have sold off in late February, catching up with the safe-haven rally in core bonds seen earlier.

The peak in the number of new infections in mainland China already seems to be behind us. Yet business in China remains disrupted, as shown by stagnating daily indicators e.g. coal consumption and traffic congestion. We have cut our forecast for Chinese growth in 2020 to 5.4% from 5.9%, but the risks to this baseline remain tilted to the downside. In Europe, Northern Italy has been hit particularly hard. Lombardy and Veneto, the epicentre, account for about a third of Italian GDP and 40% of exports, hence the disruptions seem set to trigger a technical recession in the country.





Yet the true global impact is surrounded by very high uncertainties. Short-lived disruptions from epidemics tend to be recovered quickly over subsequent quarters - at least in manufacturing (less so in services). The more Covid-19 resembles a global pandemics, however, the higher the risk of a deeper and more protracted shock to consumer and business confidence.

As we have flagged at the early stage of the Covid-19 crisis, equity markets tend to recover around epidemics once the rate of new infections starts to recede. This pattern also roughly held this time, with equity markets stabilizing in early February (when dominant Chinese infections peaked). Yet hopes that the virus could be contained to China were clearly defied, with a new wave of contagion affecting South Korea, Japan, Iran, Italy and a large set of other countries. European infections may be lagging the Chinese epidemics by about a month (see special chapter overleaf) and the period of new infections may draw well into March.

Turning more prudent

Financial markets already discount a lot of bad news from the virus. With one of the worst weeks for equities since the GFC drawing to a close, global stocks are down by more than 10% and 10y UST yields have fallen by more than 50 bps since mid-January. This is substantial, yet safe haven demand may persist as long as the virus keeps spreading fast in Europe and potentially the US.

Bonds	26/02/20*	3M	6M	12M
10-Year Treasuries	1.34	1.20	1.40	1.70
10-Year Bunds	-0.50	-0.60	-0.40	-0.20
Corporate Bonds				
BofaML Non-Financial	95	95	90	85
BofaML Financial	96	100	95	90
Forex				
EUR/USD	1.09	1.09	1.11	1.15
USD/JPY	110	108	107	106
Equities				
S&P500	3157	3155	3170	3190
MSCI EMU	128.3	126.0	128.5	131.0

* avg. of last three trading days

For the coming weeks, we thus markedly cut back our thus far moderate pro-risk tilt in our portfolios. We completely unwind our overweight (OW) exposure in equities to neutral. We also reduce further our moderate OW in Credit and significant UW in core bonds. Should the Covid-19 situation escalate much further, these positions may suffer. Yet high-rated non-financial euro Credit continues to enjoy the substantial backing from the ECB's QE program. IG spreads have also proven robust over the past weeks, and we still see value in IG risk-adjusted carry in a bond universe dominated by negative yields. By contrast, we are cautious on HY near term as the cardiac arrest in some sectors of the economy will exert market pressure on highly leveraged companies. The USD may strengthen somewhat further near-term, but rising Fed cut expectations (75bp priced over 12 months) seem to have capped the dollar rally seen earlier this year.

Gauging Covid-19 contagion

Thorsten Runde

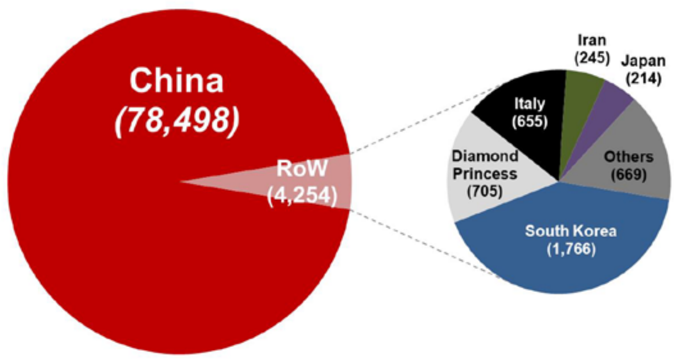
- **China still accounts for 95% of Covid-19 cases, but the virus has spread globally, with infections in South Korea, Italy, Iran and Japan rising sharply.**
- **Our contagion models suggest that cases in China may reach a peak in the first half of March at around 80k infections.**
- **For the rest of the world (RoW), the very dynamic evolution across different hotspots still provides very unstable aggregate projections. Baseline estimates suggest that overall cases are lagging China by two weeks and that infections may peak at around 60k. This gauge is surrounded by very high uncertainties, though, with revision risks on new data clearly tilted to the upside.**

The number of new infections in China has been declining since early February. Based on our contagion models, we anticipate the total number of Chinese infections to peak at around 80k in early/mid-March (see left chart below).

For RoW, estimates are much more dynamic and surrounded by significantly higher uncertainties. Our projections based on data with at least 1k (last 9 days) total cases suggest that RoW cases may peak at 32k in late March. We suspect, however, that risks are clearly tilted towards a much higher number. Applying the model only to the most recent 7 (5) days of observations, the RoW peak estimate jumps to 61k (112k). Furthermore, EM countries with poor health systems still look highly vulnerable. And sudden dynamics in new hot spots – like recently in Italy – cannot be ruled out. Low figures reported by countries close to China may also proof understated.

Such reporting issues should be less relevant in Europe, where the Italian dynamics are still dominant (with Italy accounting more than 80% of European cases). With estimation uncertainties even higher, our model points to an epidemic peak in Europe roughly one month after China. The model's current peak estimate of 5k infections looks particularly prone for significant upside revisions.

Confirmed COVID-19 Cases Worldwide



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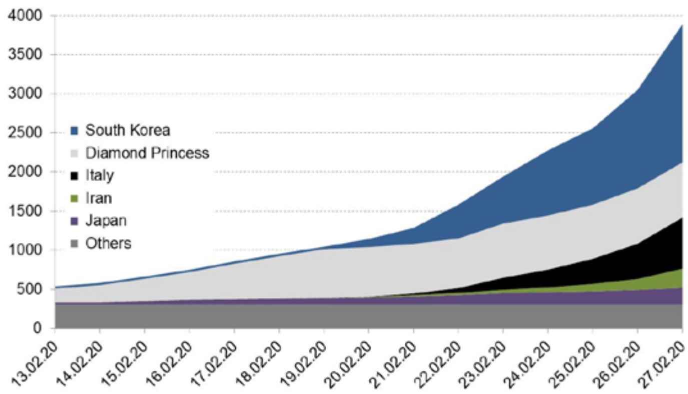
Confirmed COVID-19 Cases RoW



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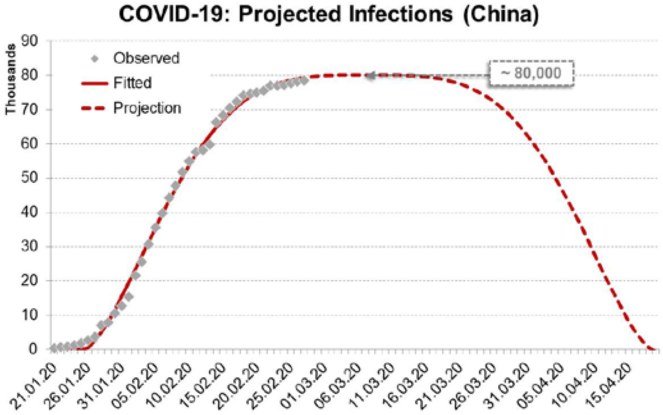
COVID-19: Projected Infections (China)



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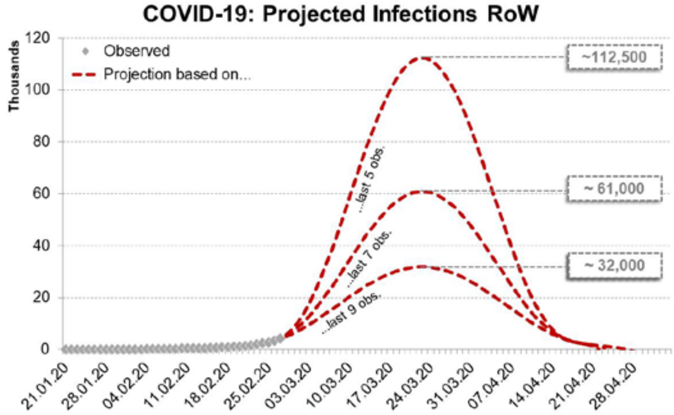
COVID-19: Projected Infections RoW



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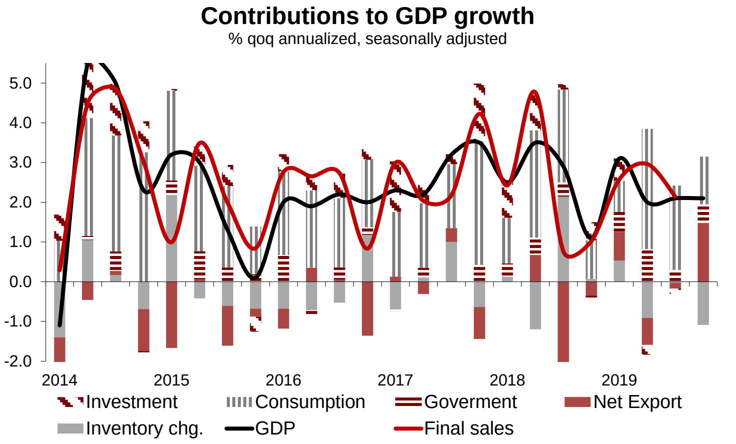
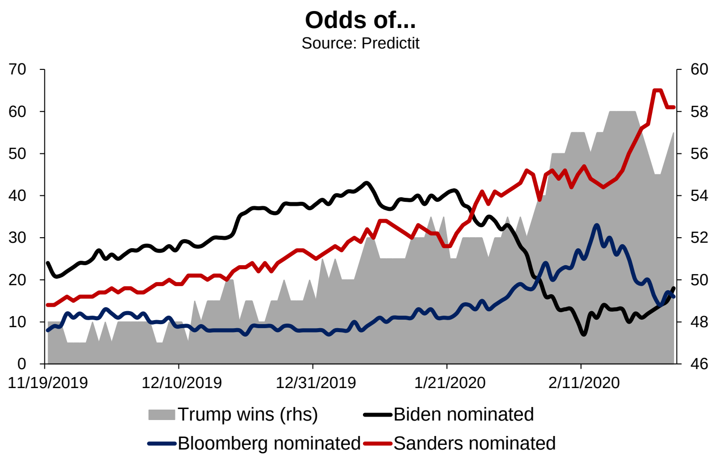
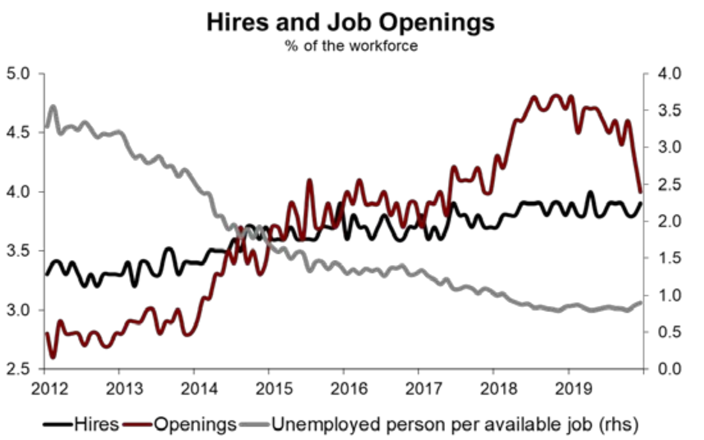
USA

Paolo Zanghieri







- **We expect annual growth to slide from 2.3% to 1.6% in 2020, with risk tilted to the downside.**
- **Covid-19 fears risk stopping the tentative manufacturing rebound. The lead taken by Sanders in the primaries will rise political uncertainty.**
- **The Fed plans to stay on hold in 2020 but virus related disruption adds to our case for a rate cut in Q2.**

After a decent 2.3% in 2019, we expect growth to average 1.6% this year, slightly below consensus (1.8%). The impact of Covid-19 will weigh on activity at least in the first part of the year, adding to the disruption caused by the halt to the production of the Boeing 737 MAX, likely to shave Q1 annualized growth by 0.5-0.8 pp (which should reverse when production resumes in H2, as announced). The pick up we expect for the second half of the year, is based on a relatively ordered resolution of the virus outbreak and no further trade tensions with China or the EU. Therefore there are still substantial downside risks to our forecast. As in 2019, consumption will make up most of growth as capex will remain hostage to uncertainty despite very favorable financial conditions. The evolution of the Democratic primaries is consistent with an increase in political uncertainty. Sen. Sanders, the candidate with the most leftist positions, has taken a clear lead. The outcome of Super Tuesday (March 3 when primaries are held in 13 states) may give more certainty on who will contend the presidency to Trump, who has a nearly 60% probability to win the November election, according to bets and polls.

Manufacturing rebound in doubt

The truce between China and the US boosted morale in the manufacturing sector, with the ISM and other indicators soaring in January. Yet, this still has to show up in hard data on manufacturing, while the negative impact of the Covid-19 on sentiment will manifest itself over the coming weeks. The labor market continues to power ahead with 225k new nonfarm jobs created in January. Data on job openings point to a slowdown in the coming months, but the pace of employment growth should remain strong enough to keep the unemployment rate at 3.6%.

Fed: a rate cut likely by June

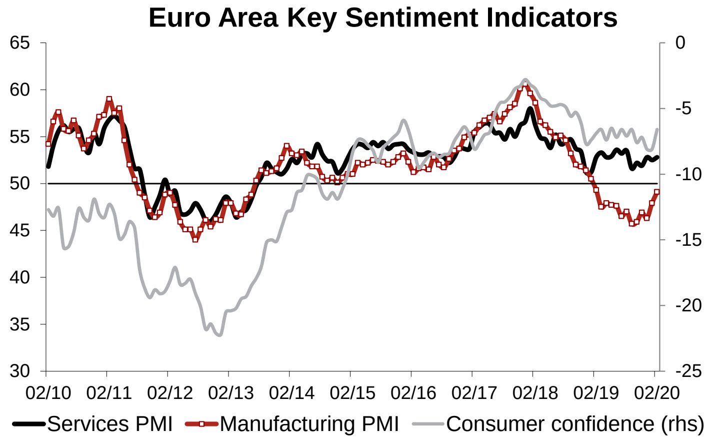
FOMC members continue to state that no change in the level of rates is foreseen. However, Covid-19 adds to the downside risks to the economy, given by the delayed effect of the tariffs imposed in the second half of the year. We confirm our view of one precautionary rate cut in H1, while the second one priced in by markets is not yet a done deal in our view. The March meeting will be probably too early for a cut, unless the situation deteriorates very quickly. The large scale purchases of short term bills managed to restore the functioning of the interbank market should stop in April.

Euro Area

Martin Wolburg

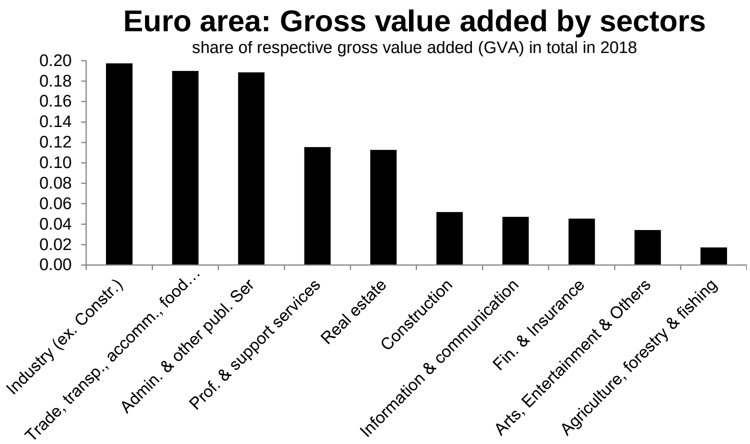
- **While sentiment indicators all in all advanced, the risk of a Covid-19 pandemic has increased and we expect more fallout than before.**
- **Therefore and because of weak hard data we revised our 2020 growth expectation down to 0.8%.**
- **We expect the ECB to stay on hold for now.**

Over the past month, euro area economic sentiment showed signs of improvement. The composite PMI advanced to 51.6, a six-month high, due to higher services (52.8, from 52.5) as well as manufacturing sector (49.1, from 47.9) sentiment. Also consumer confidence rose.



Covid-19 epidemic headwinds stronger than thought

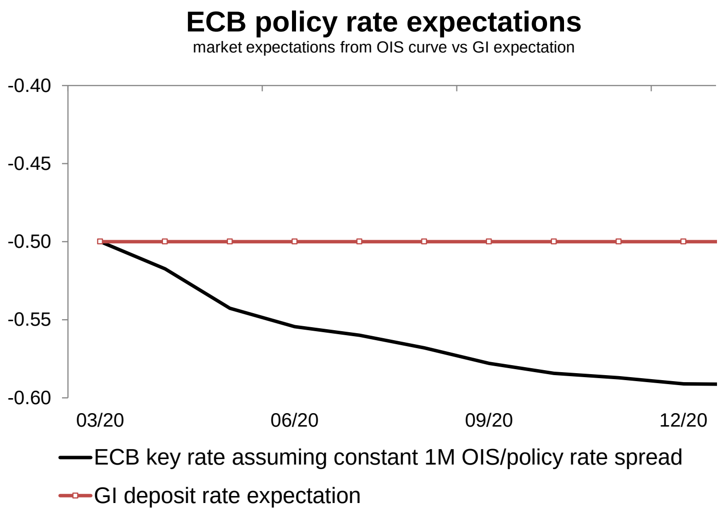
We nevertheless see the need to adjust our growth expectations to the downside. The elephant in the room is the Covid-19 epidemic. We see its dampening impact on Chinese activity stronger than foreseen with growth falling by more than 2 pp in Q1/2020, from 6.0% yoy before. In 2018, 5.6% of euro area goods exports went to China which is the fourth largest export market. Moreover, spillovers on other markets will also dampen export activity. According to the OECD 84% of value added in final demand is domestic while for the international part the US (2.5 pp) and China (1.9 pp) are most important. The February manufacturing PMI receded again which amid the increase of delivery times heralds already a weakening of the global manufacturing recovery.



The epidemic is not confined to China but has reached Europe. Therefore we look for significant domestic headwinds as well. A scaling back of travelling, cancelling of holidays, reduced consumption due to fears of contagion and a general increase in uncertainty will be a blow to activity in the March/April period with branches like trade, transportation accommodation and food services (19% of GVA). Supply-chain disruptions will also take their toll.

Growth outlook adjusted to the downside

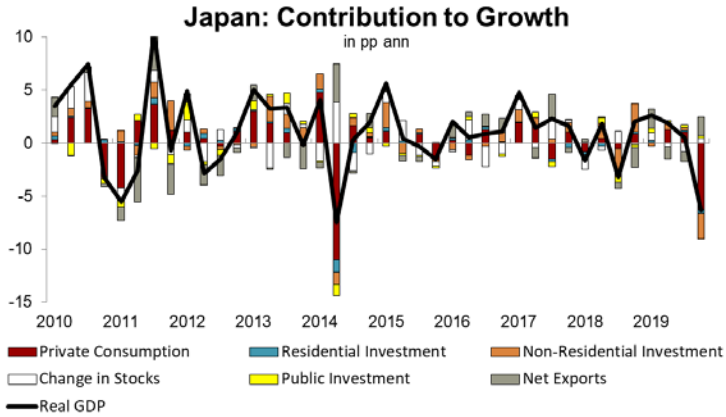
Over the coming months we look for a poor macro news flow. We expect Q1 GDP to stall and even do not rule out a recession in H1. That said, we look for a v-shaped improvement of activity in H2 when the Covid-19 epidemic will likely have ended. Therefore, we only reduced our 2020 growth outlook to 0.8% (from 1.0%) but still see the risks on the downside.



For the ECB the Covid-19 epidemic will become the top downside risk. But given its temporary nature there is not much monetary policy could do. Therefore, at the March 12 meeting we expect a downwards revision of the macro projections amid a dovish wording but do not see monetary policy action imminent. Only in case of a pandemic we could imagine another moderate depo rate cut to lift confidence.

Japan

Christoph Siepmann



- **Japan is likely to drop into a technical recession in Q4/2019 to Q1/2020.**
- **January data have been rather weak. Together with Covid-19, we see a recovery from the tax hike delayed by a least one quarter.**
- **Fiscal policy has already prepared a package which will be increasingly implemented in Q2. Monetary policy is likely to help bridge Covid-19 implied liquidity problems.**

Against the background of the Covid-19 outbreak and rather weak data, we revise our forecast for Japan's GDP growth in Q1 2020 down into slightly negative territory. Thus, we see Japan in a technical recession in Q4/2019-Q1/2020. Notwithstanding the uncertainties in the development of the epidemic, we expect growth to recover in Q2. The weak start into the year has a profound impact on 2020 growth, which we now see around -0.5%.

According to a first print, Japan's GDP growth fell 6.3% qoq annualized (ann) in Q4 2019 as a result of the sales tax hike. The main drivers were private consumption (-11% qoq ann) and investments (-9.9% qoq ann). Since Q4, data have come in on the weak side. The manufacturing PMI dropped to the lowest level since December 2012. Real exports receded by 4.6% mom in January whereas imports diminished by 2.9% mom. While the results are to a large extent caused by the Chinese New Year holidays, the Covid-19 outbreak in China also played a role. China's likely drop in growth let us expect no near-term relief. China accounts for 18.3% of Japan's exports, Asia for around 50%. Accordingly, we see exports to remain soft for the time being. The timing of Tokyo Olympic games is jeopardized.

Fiscal Policy measure to come into effect in Q2

Domestically, the number of infections in Japan has been also on the rise. Retail sales continued to recede in January on a yoy basis, extending the fall since Q4 2019. Covid-19 looks to deter already consumers from going out. Thus, we expect private consumption to broadly stagnate in Q1, but then to overcome the sales tax hike impact. Risks are on the downside. While the government measures were unsuccessful in stabilizing growth, they proved effective in largely neutralizing the tax hike impact (esp. the free education measure) on inflation. Headline inflation came in at 0.6% yoy, while core-core inflation remained at 0.8% yoy. Excluding the tax hike, core inflation is estimated at 0.4% yoy. Against this background and the softer yen, we expect the policy response to concentrate on the fiscal side. The supplementary budget passed the Diet and the FY2020 budget is under deliberations. Both are likely to help growth already in Q2. The BoJ is likely to help bridge possible enterprises' liquidity problems but not to change its interest rate targets.

China

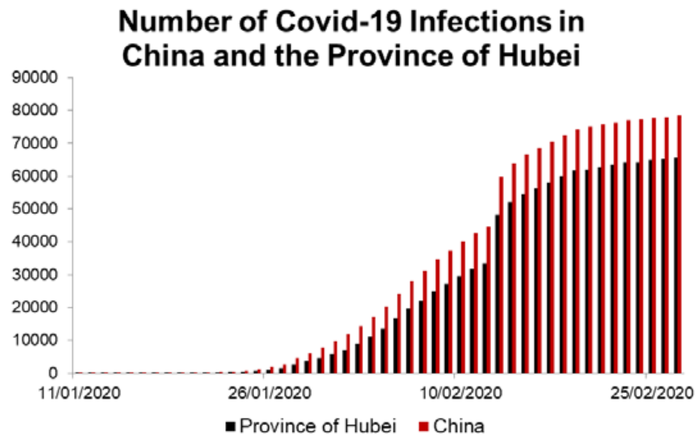
Christoph Siepmann

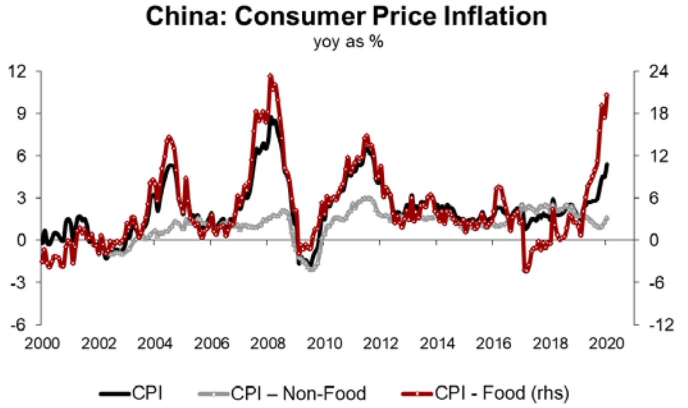
- **China looks to be successful in getting the Covid-19 outbreak under control. Accordingly, we cautiously expect GDP growth to trough in Q1. Nevertheless, it will take time until a full recovery.**
- **Monetary and fiscal policy will support the economy. There are also rumors of a large fiscal package, once the outbreak is under control.**
- **Overall, we expect growth at 5.4% in 2020.**

China's drastic quarantine measures to limit the spread of Covid-19 look to prove effective. The number of new infections has been slowing. Feb 26 marked the day when fresh cases outside China outnumbered those inside. However, close to 79,000 people have been infected with about 2800 dead. Accordingly, even outside the province of Hebei, economic activity remained suppressed. Daily indicators like property sales, traffic congestion, daily coal consumption and air quality stayed weak and have not recovered meaningfully since the end of the extended Chinese new year holiday. The central government has recently encouraged local governments, employers and workers to resume normal work. But the response was slow, given the need to prevent another outbreak. We see China's growth to be hit most strongly in the current quarter and expect official growth to drop below 4% yoy (from 6.0% in Q4 2019). Subsequently, we see activity to improve to around 5% yoy in Q2, before rebounding and even overshooting to some extent in H2. However, the timing is still very uncertain. Moreover, risk are not only limited to China anymore. International trade could still suffer due to outbreaks in other parts of the world. Overall, in our central scenario we revised the growth forecast for 2020 down to 5.4% (from 5.9% before the epidemic) and see 5.8% in 2021. Risks are still skewed to the downside.

Fiscal policy support package has become likely

Monetary policy (MP) and fiscal policy (FP) will continue to support the economy. The PBoC already cut interest rates and provided liquidity and other targeted measures. We expect the PBoC to cut the Loan Prime Rate by 40 bps in 2020, with the next two moves likely by the end of Q1/early Q2. We also expect the total reserve requirement rate (RRR) to be cut by an additional 50 bps, summing up to 125 bps in 2020. The central bank will also help bridging liquidity gaps in order to minimize the employment effect. SMEs, which provide 70% of China's jobs are considered increasingly jeopardized given the breakdown of their turnover and transport problems. Help will also come from targeted FP measures, like tax breaks, temporary tax exemptions or fees waivers. Of late, rumors have increased that the government is planning a sizable fiscal package (about 1.5% of GDP) once the outbreak is under control. This would likely include investment and private consumption support. The virus also added to already existing inflation pressures (swine flu). We revised our 2020 CPI inflation up to 3.5%, after 2.9% in 2019.

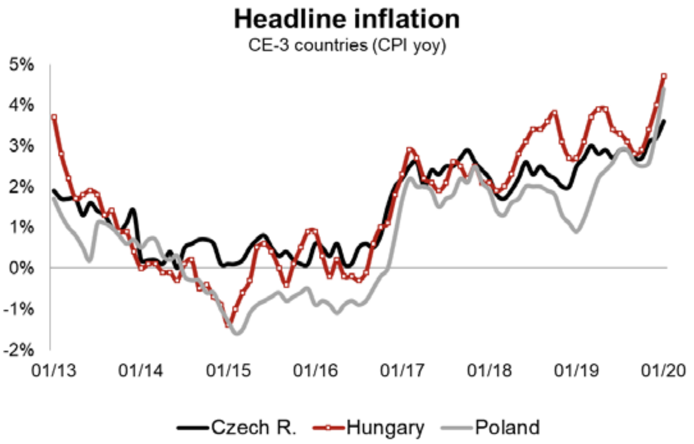




Central and Eastern Europe

Radomír Jáč

– **Headline inflation accelerated further in all three CE-3 countries at the start of 2020, well above targets of the CE-3 central banks. GDP growth at the same time remained robust in Hungary in Q4 but slowed in the Czech economy and Poland.**
– **The Czech CNB increased its key rate by 25 bps to 2.25% while the Hungarian MNB tightened monetary conditions via lower supply of liquidity. The MNB will debate tightening measures at its policy meeting in late March. The Polish NBP is likely to keep its policy stance on hold this year.**



Main Forecasts	2018	2019	2020f	2021f
Czech Republic				
GDP	2.8	2.4	1.9	2.4
Consumer prices	2.1	2.8	3.3	2.1
Central bank's key rate	1.75	2.00	2.00	2.00
Hungary				
GDP	5.1	4.9	3.5	2.9
Consumer prices	2.8	3.4	3.7	3.4
Central bank's key rate	0.90	0.90	1.00	1.25
Poland				
GDP	5.2	4.1	3.2	3.6
Consumer prices	1.6	2.3	3.4	3.0
Central bank's key rate	1.50	1.50	1.50	1.75

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

Inflation in the CE-3 region jumped above expectations in January. Headline CPI rose from 3.2% to 3.6% yoy in the Czech Republic (with the target set at 2%), from 4% to 4.7% yoy in Hungary (target: 3%) and from 3.4% to 4.4% yoy in Poland (target: 2.5%). The CPI increase was to a large extent driven by commodity prices but core inflation rose as well.

Preliminary data for GDP in Q4 reported stronger than expected growth in Hungary (1% qoq and 4.6% yoy) but a slowdown for Czech (0.2% qoq and 1.7% yoy) and Poland (0.2% qoq and 3.5% yoy) GDP growth. The region feels the impact of slower growth in the euro area: not only via exports but also via investment expenditure. Hungary was an exception with strong investment outlays, co-financed by the EU-funds. This factor will hardly repeat in 2020. This will lead to slower GDP growth in Hungary but the overall dynamics should remain solid. For Poland and the Czech Republic we also expect a deceleration in the pace of economic growth. This should impact monetary policy, as the regional central banks will not rush to tighten their policy stances despite high inflation.

Czech CNB raised rates but next move may be a cut

The Czech CNB increased its key interest rate to 2.25% in February. The CNB debated such a step already in autumn but the rate hike came as a surprise, as stable rates had clear majority support in past months. The CZK firmed below 25/EUR in response to higher interest rates. The CNB forecast says that monetary policy should stay on hold until mid-2020 when a 25 bps rate cut may follow.

Hungary faces a mix of higher CPI, weaker FX rate and excessive liquidity in the banking sector as a result of a relaxed monetary policy stance. The MNB responded via a sharp reduction in supply of new liquidity, which led to increase in market interest rates and helped the forint to recover from historical lows. The monetary policy stance will be reassessed in March: the MNB is likely to cut the target for liquidity supply for Q2 and may debate an increase in O/N deposit rate (currently at -0.05%).

The Polish MPC is expected to keep its policy stance steady with the key rate at 1.5%. The NBP will present new macro forecast in March where higher CPI for 2020 is likely to be accompanied by a weaker GDP growth outlook.

Bonds/Fixed Income Strategy

Florian Späte

- **As Covid-19 is spreading to the euro area, the downtrend of international government bond yields intensified. Global investors particularly demand US Treasuries.**
- **Given that a lasting containment of the virus in the developed world is likely still some way off, this downtrend can continue in the short term. Further out, the impact is seen to fade and government yields have scope to rise again.**
- **As Italy has become an epicenter of Covid-19, the already moderate economic outlook has become even worse. Despite a reasonably stable political situation, the BTP/Bund spread is forecast to widen more in the short run.**

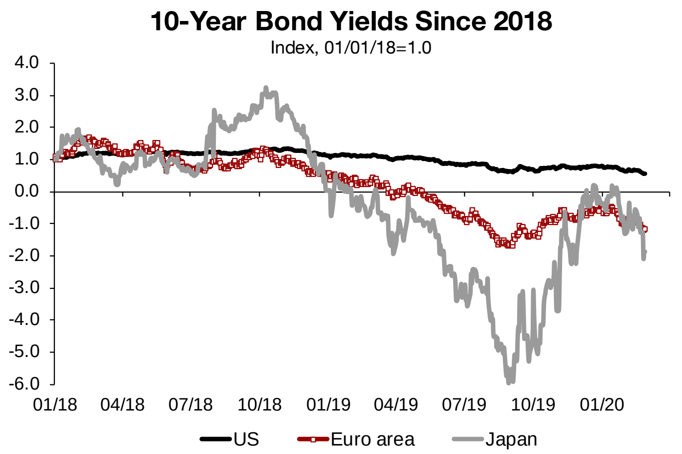
After trading sideways until the mid of February, international government bond yields decreased sharply towards the end of the month. The number of reported Covid-19 cases rose, signaling that the euro area is unlikely to avoid a more substantial outbreak of the virus. In this environment, macroeconomic data releases played a less important role. This applies even more as in most cases the spreading of the virus has not been reflected yet in the macroeconomic data.

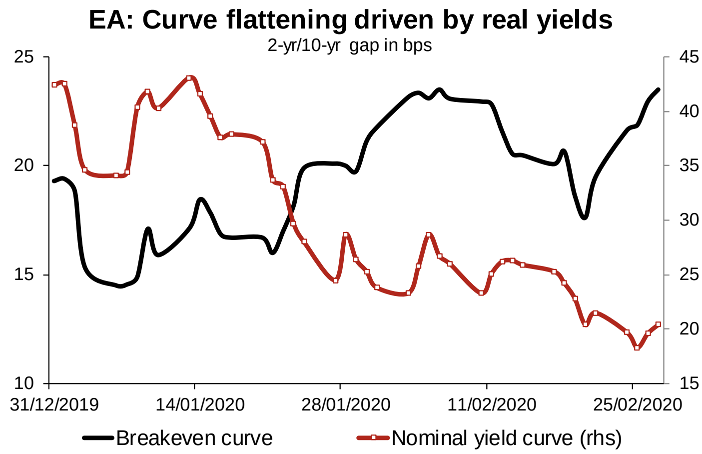
Overall, nominal yields fell globally. Particularly, US Treasuries remained well bid as a safe haven with medium- and long-dated US yields marking new historical troughs. Yield curves bull-flattened. Since the start of the year the euro area 2-year/10-year yield gap has decreased by more than 20 bps driven mainly by a flattening of the real yield curve. As short-dated US yields had more leeway to adjust downwards, the US yield curve flattening was less extreme.

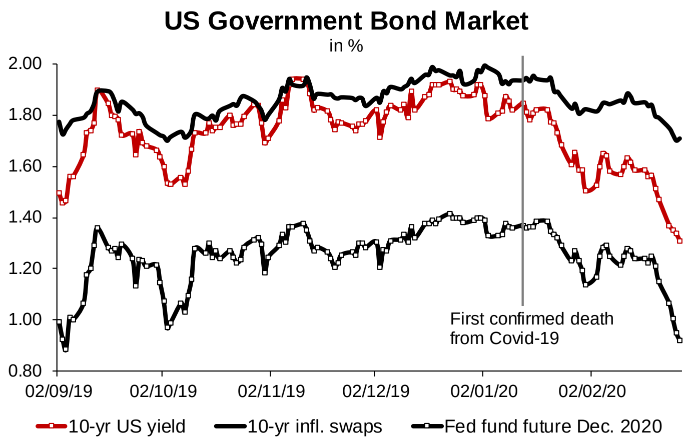
Bond markets positioned for a lasting impact

Looking further down the road, the outlook for international government bond markets depends strongly on the news flow with respect to Covid-19. After several cases were reported in Western countries recently, with all probability the virus will spread further in the weeks to come. Although the global economic impact can hardly be assessed at this time (and it hinges on the extent to which demand and supply chains will eventually be hit), a lasting rebound in government yields is unlikely in the short term.

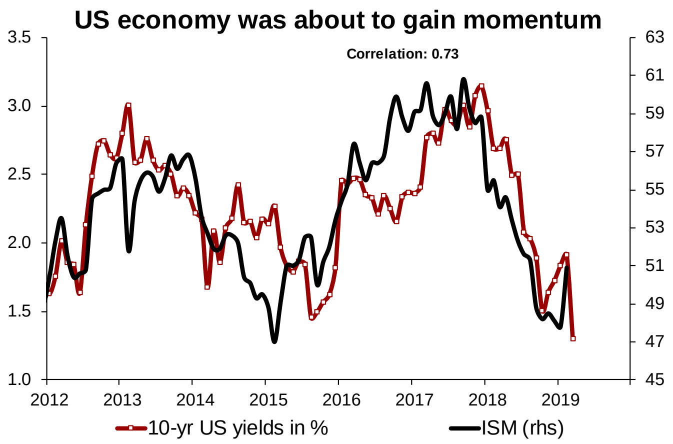
Accordingly, although international bond markets are already positioned for a strong economic impact and additional accommodative monetary policy measures (more than three further key rate cuts each 25 bps by the Fed are priced), we expect government yields to fall further. In case containment measures remain unsuccessful and a pandemic becomes the base scenario, US yields will decrease even more across the curve and long-dated euro area yields will follow to a limited extent. What is more, given the narrow scope for additional ECB

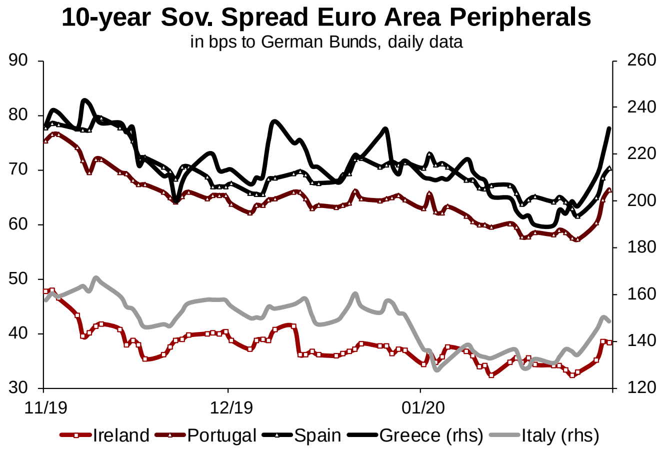


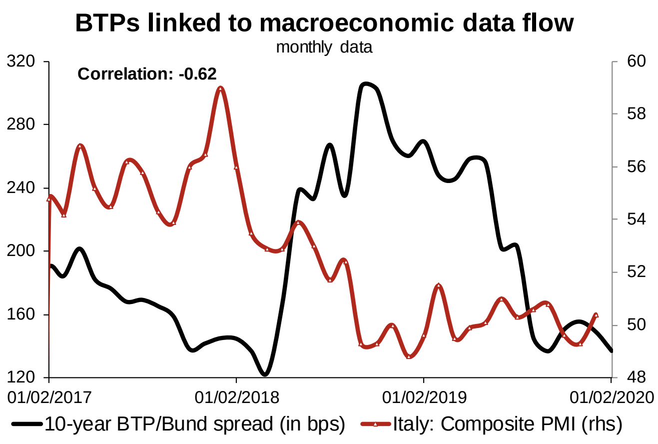




Bonds/Fixed Income Strategy







policy measures, the leeway for short-dated euro area yields to drop appears more restricted as well. Hence, we expect the outperformance of US Treasuries versus Bunds to continue for the time being.

Eventually, however, the impact of the virus will fade. Most of the economic damage will be temporary and a certain rebound is likely in H2. Moreover, the slight upward trend in inflation rates is expected to resume. After all, over the course of the year financial markets will likely scale back their key rate expectations.

Starting from very low yield levels, there is scope for a considerable upward trend once the news flow will turn more reassuring. However, it is unlikely that government yields will make up for the lost ground completely. Hence, the yield forecasts for year-end 2020 envisaged only two months ago are unlikely to be achieved. Overall, we forecast 10-year US yields to finish this year at around 1.60% and 10-year Bund yields at -0.30%.

Concerns about economic impact on Italy

Euro area non-core markets performed worse than core ones in February. This is exclusively the result of the news flow regarding the spreading of Covid-19 to Western countries – with Italy an epicenter. All non-core spreads widened, but particularly higher-yielding Greek and Italian bonds suffered. The performance of non-core bonds, however, is still decent as the decrease in underlying yields covers the sharp spread widening in the last week of February. Still, year-to-date the total return of non-core bonds is lower than the one of core bonds.

Particularly, the situation in Italy looks worrisome. Even assuming there will be no further spreading of the virus (which we doubt), the partial shutdown of important regions in Italy will be sufficient to trigger another negative quarterly growth rate. As the economic situation was already fragile before, a GDP contraction in Q1 of up to 1.0% qoq appears reasonable. Although part of it would be recovered over the course of the year, this aggravates the fiscal situation of Italy. Independently of this, the ability of fiscal policy to offset a supply-side shock is limited anyway.

Hence, we see scope for BTP risk premiums to rise more in the short term. Although the political situation has stabilized after the regional elections at the end of January this will not be sufficient to keep BTP spreads from widening in the short term. In the wake of a higher risk premium for Italian assets, other non-core bond spreads are expected to follow suit. Particularly, Greek bonds appear vulnerable to a higher risk aversion.

Further out, non-core spreads are forecast to recover part of the lost performance once risk sentiment improves and investors will again look for higher-yielding bonds.

Corporate Bonds

Elisa Belgacem

- **The recent Covid-19 related risk aversion phase has led to a significant repricing of credit markets**
- **The CSPP is currently running in a nearly EUR 5 bn per month in line with our expectations strongly supporting the eligible universe.**
- **Extending the trend started in December, Credit spreads started the year on tightening spreads, with the rally in HY being particularly pronounced.**
- **The recent coronavirus risk-off related mood has caused most of the tightening in HY to reverse while IG has been very resilient but started to widen as Covid-19 started to spread in Italy.**
- **Overall, beyond short-term volatility, we expect the technicals to be stronger until year-end resulting in tighter spreads in IG while HY should suffer more reflecting lower growth prospects.**

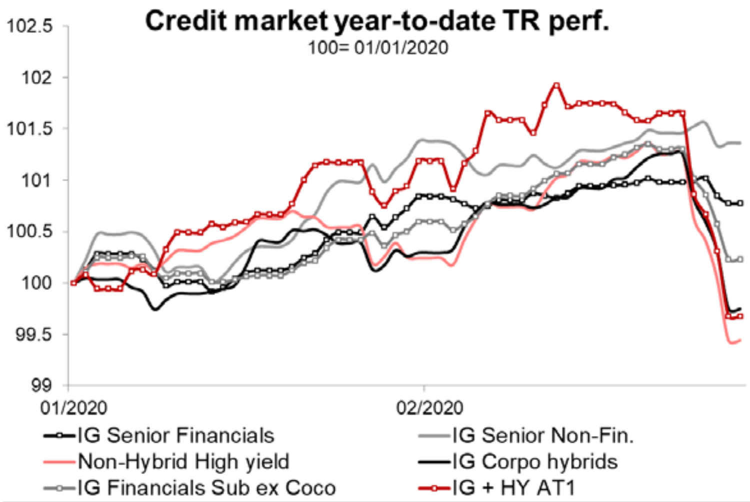
The rising number of Covid-19 outside of China has marked the beginning of a strong risk-aversion phase across risky assets. We have seen IG corporate bonds widening by 15 bps in OAS vs government terms while HY has been widening by more than 72 bps. Subordinated bonds have also massively repriced led by AT1, not to mention that Italian names across the board were the worst-performers. The most resilient segment has been unsurprisingly the senior non-financials as they represent the bulk of the ECB CSPP eligible universe. In terms of sectors performance in the sell-off, logically, we are seeing a better resilience of defensive sectors, like Utilities and Telecommunications, while Autos Basic resources and Banks are among the worst performers.

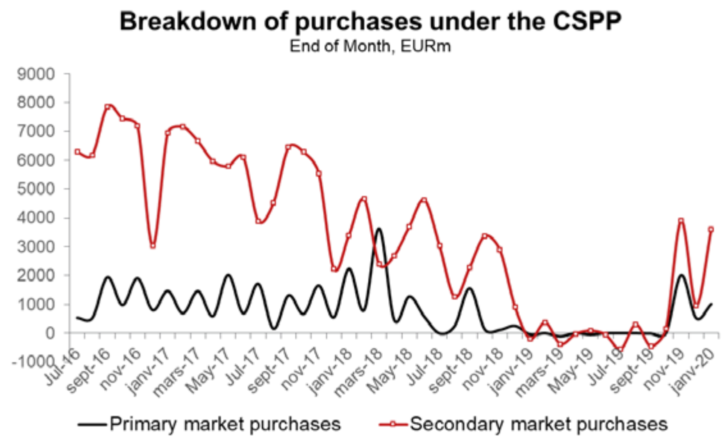
Indeed since November, last year the credit market has put great attention to first data releases of the new ECB QE CSPP 2. As anticipated we have seen in the first weeks of purchases the share of credit going significantly up compared to previous programs going from below 15% on average to currently slightly below 30% of the overall program size of EUR 20 bn. We are currently running near EUR 5 bn per month pace, in line with our expectations.

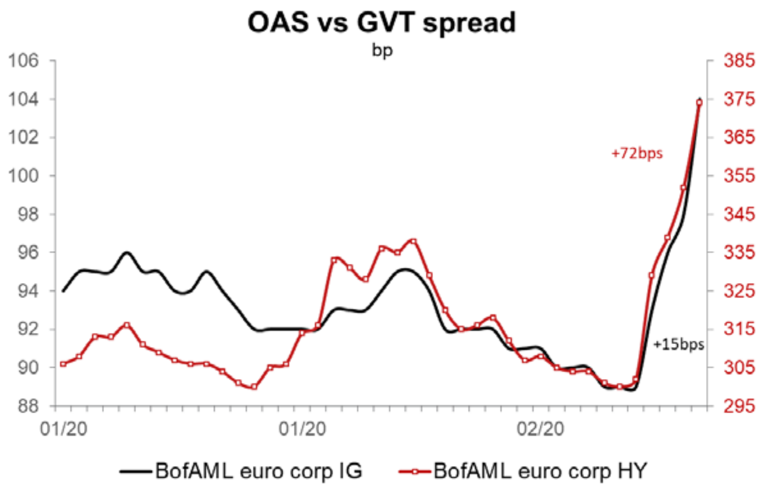
Resilience in IG non-financials thanks to ECB

We note that, despite the Covid-19 related sell-off, year-to-date total return performances of IG non-financials has been barely affected thanks to the ECB. We think that there is still room for further valuation divergence between eligible and non-eligible assets. We do expect IG and particularly non-financials to remain relatively resilient in this context as they are supported both by their carry and the ECB purchases.

On this background, we keep our positive stance on credit toward the end of the year. On high yield, we had a widening on our screens only in H2 but lower growth prospects combined with very low oil price is leading us to our expectations for a widening.

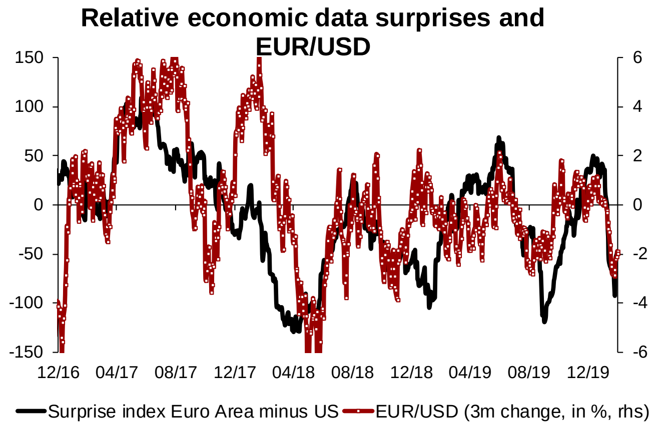


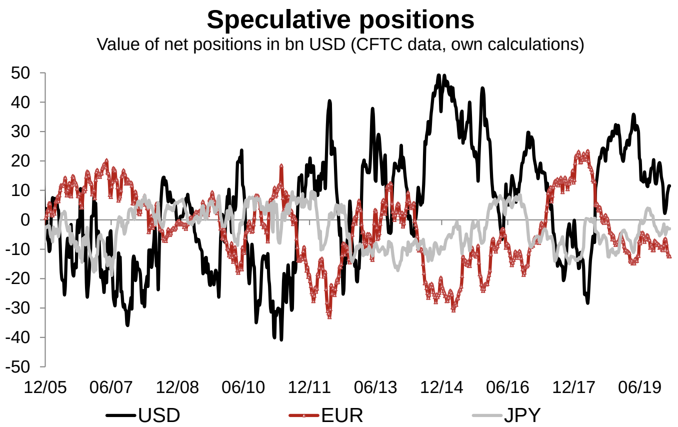


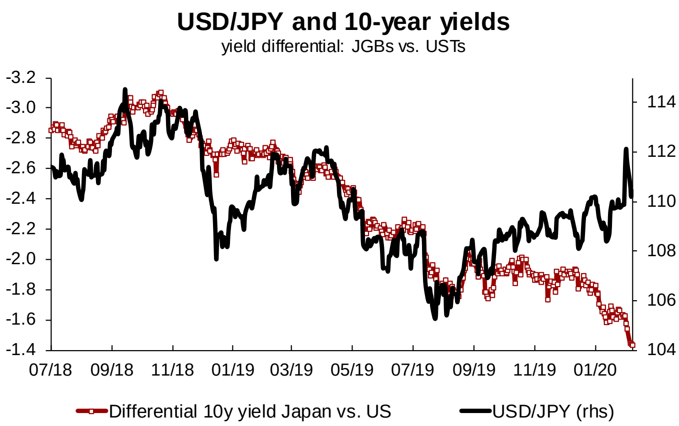


Currencies

Thomas Hempell







- **The global spreading of Covid-19 has sparked global recession fears, boosting the USD.**
- **With uncertainties high and the full economic impact yet to show up, the dollar peak may materialize only later in H1.**
- **Short-term risks to the EUR/USD are slightly tilted to the downside, but we still see a move higher to 1.15 once the Covid-19 drag fades.**
- **Amid growing domestic risks in Japan and signs of pension funds rebalancing, USD/JPY has decoupled from US yield. We still see a JPY recovery over the course of the year.**

The Covid-19 fears have propelled the USD to new strength. The USD DXY has gained more than 2% ytd. Rising bets on a Trump victory in the presidential elections – perceived as bullish for the US economy by investors – alongside support have lent further suppor, even though more recently speculations about Fed rate cuts have capped the rally.

Covid-19 to prolong US outperformance

Relative economic prospects between the US and euro area keep driving the EUR/USD (top chart). With the fallout from the Covid-19 likely to affect the European economy more severely over the coming weeks, we see the near-term risks to EUR/USD tilted slightly to the downside, with the potential of a bounce back to current levels on a 3-months view. Barring a Covid-19 pandemic – which would harm global growth on a more sustained basis – a fast recovery in global growth over subsequent quarters should ultimately trigger broader USD weakness, including a gradual recovery of the euro. We thus leave our 12-month target of 1.15 EUR/USD intact.

A EUR/USD rebound may be amplified if the Fed opts for deeper rate cuts in response to the global economic risks (even though markets are already discounting rate cuts by cumulated 75 bps in 2020). Further USD downside arises from a tighter race between a potential Democratic candidate Sanders and incumbent Trump in the US presidential election race.

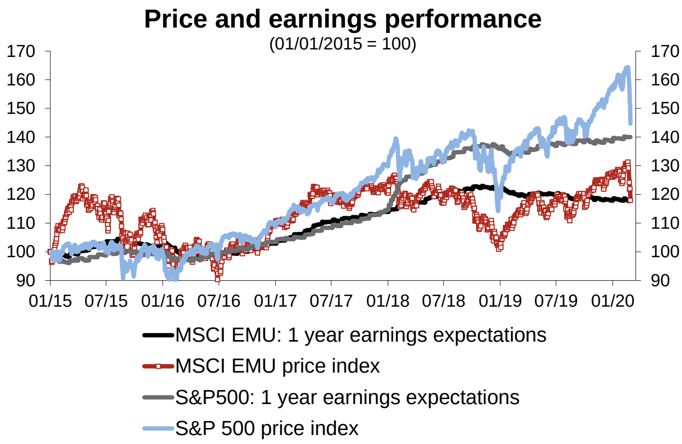
Striking decoupling of JPY from yields

In a striking move, the JPY weakened amid the recent bout of risk aversion, questioning its long standing safe haven properties. Uncertainties over the Japanese economy after its VAT hike and the fallout from Covid-19 have deepened the divergence between yield differentials and the USD/JPY, which was already visible in late 2019 (see chart). The divergence may have been amplified by temporal factors, too, such as signs of a rebalancing of Japanese pension funds assets into foreign bonds. With these factors fading and the imminent Covid-19 fears petering out, however, we still expect USD/JPY to trend lower over the course of the year.

Equities

Michele Morganti

- **Sentiment plunged as Coronavirus spreads outside China.**
- **Volatility will remain elevated in the short term till we can measure more precisely the negative effects on the economy along with the earnings growth and get a clue that contagion is peaking also in the west world.**
- **Current PEs are at a fair level (ex. US) but a further 5% discount can not be excluded. That said, lower yields and further interventions through both monetary and fiscal policies will help.**
- **We are cautious in the short term (neutral) but remain constructive in the medium term expecting positive mid-single digit total returns with flat or slightly negative earnings growth for this year.**



Sentiment plunged as virus spreads outside China

The stock markets up to a week ago benefitted from macro news indicating slight recovery, a good reporting season useful for the fourth quarter of 2019 and the renewed electoral consensus for Trump, perceived as a pro market and pro business candidate.

Before that, both the Brexit risk and that related to the US-China trade dispute had also decreased. Nonetheless, after the massive sell-off of the last few days (nearly -12% from February 20), the S&P 500 and the Stoxx 50 now show a negative year-to-date performance (by 6.5% and 8.5%, respectively).

Volatility will remain elevated in the short term (the VIX is at 35 as we write) till we know the speed of contagion outside China diminishes and investors get more clue of the negative economic and earnings growth impact.

Furthermore market multiples are not "cheap" in absolute terms: even in the euro area (EA) still lingering above the historical average by 4-7% (including Thursday's price action) especially due to the high P/cash flow while the PE looks aligned to history.

Markets	Price / Earnings *		Price / Book *		Price/ Cash Flow *		Dividend Yield *		Avg.	Avg.
	current	hist. avg.	current	hist. avg.	current	hist. avg.	current	hist. avg.	Discount, %	Disc. (-1M), %
WORLD	15.8	16.0	2.2	2.0	10.4	8.9	2.6	2.7	8.1	16.7
USA	16.8	15.4	3.0	2.4	12.0	10.0	2.1	2.2	14.1	25.1
JAPAN	12.9	15.3	1.1	1.2	7.2	7.1	2.7	2.0	-16.4	-8.5
UK	12.0	13.8	1.5	1.8	7.4	7.9	5.0	4.1	-14.5	-5.1
SWITZERLAND	16.2	15.4	2.6	2.3	11.4	11.2	3.4	3.3	5.0	11.3
EMU	13.7	14.1	1.5	1.5	7.7	6.6	3.6	3.8	4.9	9.7
FRANCE	13.8	14.3	1.5	1.5	8.0	7.0	3.6	3.7	3.8	11.2
GERMANY	13.1	15.0	1.4	1.5	7.8	6.8	3.4	3.4	-1.3	6.8
GREECE	11.0	12.8	2.2	1.6	6.1	6.1	6.5	4.1	-10.3	9.4
ITALY	11.2	15.0	1.2	1.2	5.2	4.7	4.9	4.7	-4.5	1.6
PORTUGAL	17.2	12.8	2.1	1.7	6.3	5.9	4.4	4.5	16.1	16.3
SPAIN	11.3	12.9	1.1	1.6	4.8	5.1	5.1	5.0	-11.9	-7.5
EURO STOXX 50	13.1	13.2	1.5	1.5	7.5	6.3	3.9	4.2	7.0	15.6
STOXX SMALL	15.8	14.6	1.7	1.7	9.0	8.4	3.1	3.2	5.0	13.1
EM, $	11.9	14.4	1.4	1.6	7.4	7.5	3.2	3.1	-7.8	-2.8
BRAZIL	12.4	9.2	1.7	1.7	7.1	13.3	3.8	4.3	-0.9	14.8
RUSSIA	5.9	6.9	0.8	0.9	4.6	4.4	9.5	4.1	-39.6	-27.5
INDIA	17.9	14.7	2.6	2.7	11.3	11.5	1.7	1.6	2.8	7.9
CHINA	11.9	12.9	1.5	1.7	8.1	7.5	2.3	3.0	2.6	2.7

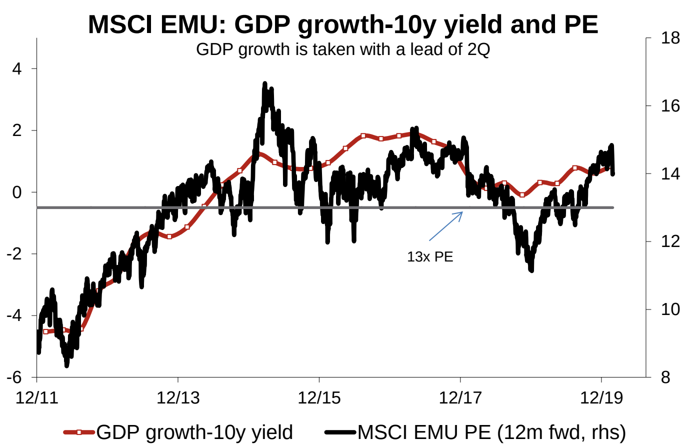
Note: The first four markets (ex. World) are based on the main local indices, the rest on the corresponding MSCI indices.
Multiples are based on 12m forward estimates; PEs are since 1987, the rest is since 2003.
Discount in % to historical average: blue and negative numbers = undervaluation. Red and positive numbers = overvaluation.
Source: Thomson Reuters Datastream, IBES estimates.

Equity to bond valuation suggests limited downside

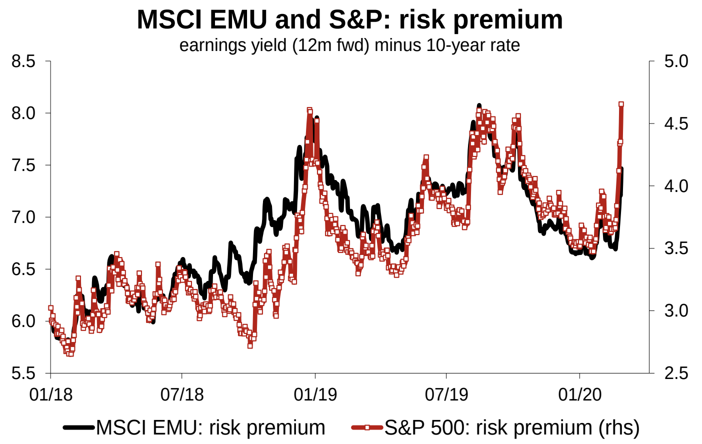
Some market data suggest that the panic level is already quite extreme. In particular, the 10-year US rates returned to the lows (135 bps) recorded in mid 2012 and 2016, also moments of high uncertainty.

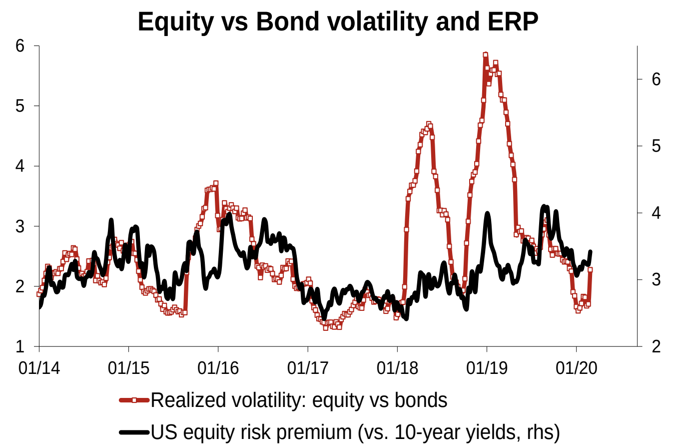
Such low rates will be a support for the real economy and potentially for risky assets' performance vs bonds, even adjusted for the respective volatility.

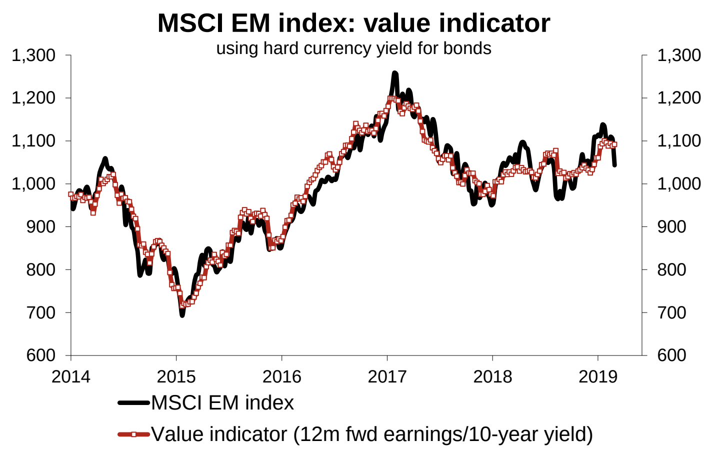
Central banks, both in the developed and emerging world, will remain even more accommodating than expected a few weeks ago. Finally, we see how equity valuations remain very attractive compared to bond valuations - clearly assuming that we will not see a collapse in corporate profits.



Equities







To get a clue of a theoretical downside potential we firstly look to the spread of GDP growth vs the 10-year rate. It shows that current PE in the EA is fair (at 14X). At 13X (-7% from here or -5% adjusted for Thursday's price action) we would have an "average" discount to the fair value (14X) under current risky circumstances. The same conclusion applies when looking to the current equity implied risk premium where with another surge of 50 bps for the MSCI EMU's risk premium we would reach previous recent market peaks. Usually 50 bps of higher risk premium corresponds to 5-7% of negative price action. Current equity volatility vs bonds' one (chart in the middle) would have to surge appreciably from here to induce such equity risk premium movement.

Under the hypothesis that the containment measures decided by the authorities manage to restrain a further, prolonged propagation of the virus out of China and that the global economy does not fall into recession (our base scenario), we are cautious in the short term but remain constructive in the medium term expecting positive mid-single digit total returns even with flat or slightly negative earnings growth for this year.

OW EU, Value vs Growth, N Cyclicals vs Defensives

Inside equities, we have a slight preference of EU (including periphery) and US vs EMs and Japan. We are also neutral on cyclicals vs. defensives. OW: Utilities, software, discretionary and energy (3 SD undervalued vs the MSCI Europe). UW: Real Estate, Materials and IT hardware. Limited OW on Momentum, Low Leverage. Neutral on Quality. Banks (OW): a more helpful regulation news flow comes on top of the recent stabilization in the economic momentum. The greater clarity in regulation could also support a higher M&A activity (which the ECB encourages).

EM: to benefit from a V-shaped recovery

In February, EM equities continued suffering from Corona virus related news and fallen overall by 0.8% (LC), -6.5 year-to-date and -10% since February peak.

When looking at their multiples vs history, they are now trading at a discount of 8% vs norm. Earnings estimates for 2019 and 2020 have largely been lowered over the last month: except for South Africa (+0.3% and 2.3% for 2020 and 2021, respectively). EM prices have essentially moved in line with their earnings trend (in terms of 3-month changes) but our value indicator is pointing out that EM stocks are getting cheap. Likewise, the EM PEs are showing a positive gap to the US-denominated yields taken for the EM universe (both in yoy changes).

That said, in the short term we are cautious as we expect the earnings revisions to remain relatively weaker vs developed markets and the stronger US dollar to hurt sentiment.

Asset Allocation

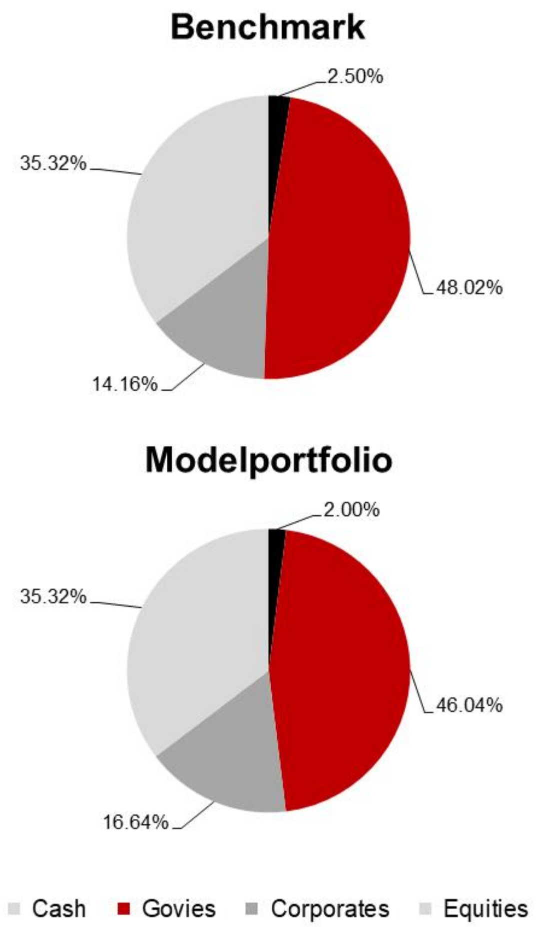
Thorsten Runde

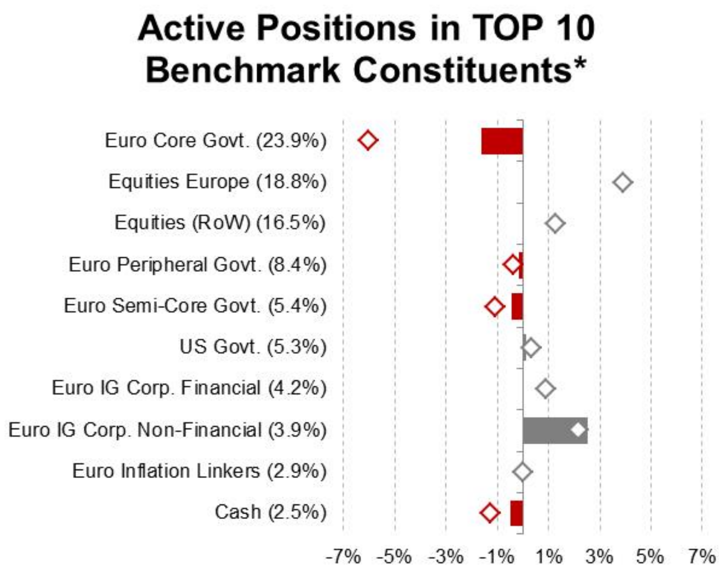
- **In February 2020 the development on financial markets was in the opposite direction, comparing the first and the second half of the month.**
- **Equities lost a good 2% on average in the complete month and even slightly less than 6% in the second half.**
- **Apart from Italy, the 10Y+ government bond segment accounts again for the largest gains across all regions. With +4% US Treasuries did particularly well.**
- **Corporates managed to stay in positive territory on average with investment grade credit clearly outperforming high yield.**
- **Looking ahead, we recommend to unwind the shift from core govies into euro area IG credit and to then reduce all active positions significantly. Additionally equities should be set to neutral reallocating the released exposure to euro area non-financial corporates. FX exposure should be completely neutralized.**

In February we were again able to observe a two-fold development on financial markets. Until Mid-February our pro-risk tactical allocation stance paid off quite well. In particular equities contributed roughly 15 bps to the overall outperformance of 25 bps until February 14. The distinct underweight in in core government bonds accounted for another 10 bps. Thus, the most important investment priorities were set correctly. Unfortunately things turned to the opposite in the second half of the month. Triggered by negative news about Covid-19 in general and the number of confirmed cases in Italy which unexpectedly and massively gathered pace after February 20. Thus, in the second half of the month the performance contribution of equities (-19.6 bps) and core govies (-14.2 bps) was clearly negative. All in the TAA model portfolio underperformed its benchmark by roughly -9 bps in February.

Pro-risk tilt to be scaled back significantly

With Covid-19 turning from a regionally limited disease into a worldwide issue, now also keeping a grip on Europe, worries about the global economic implications clearly dominate market behavior. Thus, the overall level of uncertainty has risen quite substantially. Consequently we recommend scaling back the pro-risk tilt in our model portfolio significantly. I.e., all positions are reduced close to benchmark weights. As we deem equities particularly vulnerable to potentially bad news about Covid-19 we even set them to neutral. The released exposure should be reallocated to euro area non-financial corporates, leaving this position nearly unchanged compared to last month. FX exposure should be completely neutralized.





*Benchmark weights in parentheses, diamonds indicating previous recommendations

Forecast Tables

Growth

	2018	2019f	2020f	2021f
US	2.9	2.3	1.6	1.8
Euro area	1.9	1.2	0.8	1.2
Germany	1.5	0.6	0.7	1.3
France	1.7	1.3	0.8	1.2
Italy	0.7	0.2	- 0.4	0.7
Non-EMU	1.6	1.4	1.0	1.3
UK	1.4	1.4	1.0	1.3
Switzerland	2.8	0.8	1.3	1.3
Japan	0.8	0.8	- 0.5	1.1
Asia ex Japan	6.2	5.2	5.1	5.4
China	6.6	6.1	5.4	5.8
Central/Eastern Europe	3.0	1.8	2.7	2.9
Latin America	0.1	- 0.1	1.6	2.3
World	**3.6**	**2.8**	**2.7**	**3.1**

Inflation

	2018	2019f	2020f	2021f
US	2.4	1.8	2.1	2.2
Euro area	1.8	1.2	1.3	1.4
Germany	1.8	1.4	1.5	1.5
France	1.9	1.2	1.2	1.3
Italy	1.1	0.8	1.1	1.1
Non-EMU	2.3	1.7	1.6	1.7
UK	2.5	1.8	1.6	1.8
Switzerland	0.9	0.4	0.3	0.7
Japan	1.0	0.5	0.6	0.6
Asia ex Japan	2.6	2.8	3.6	2.8
China	2.1	2.9	3.5	2.5
Central/Eastern Europe	6.0	6.7	5.0	5.0
Latin America	4.0	4.0	3.7	3.6
World	**2.8**	**2.6**	**2.8**	**2.6**

Regional and w orld aggregates revised to 2015 IMF PPP w eights; Latin America Inflation excluding Argentina and Venezuela

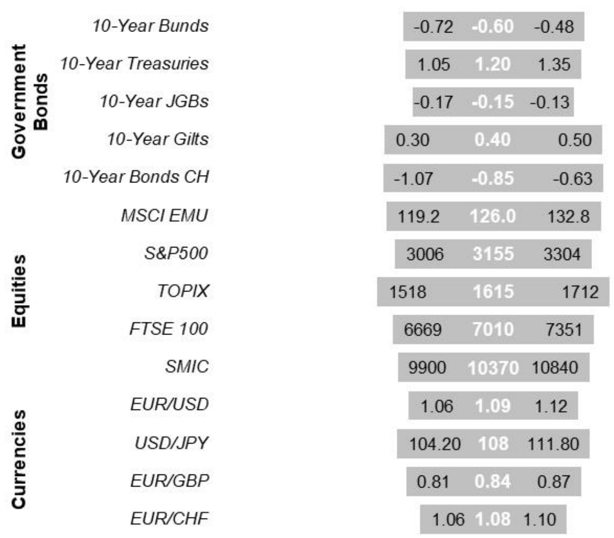
Financial Markets

3-month LIBOR	**26/02/20***	**3M**	**6M**	**12M**
USD	1.63	1.55	1.45	1.45
EUR	-0.45	-0.45	-0.45	-0.45
JPY	-0.06	-0.10	-0.10	-0.10
GBP	0.73	0.55	0.55	0.55
CHF	-0.72	-0.75	-0.75	-0.75
10-Year Bonds	**26/02/20***	**3M**	**6M**	**12M**
Treasuries	1.34	1.20	1.40	1.70
Bunds	-0.50	-0.60	-0.40	-0.20
BTPs	0.98	1.15	1.15	1.20
OATs	-0.23	-0.25	-0.10	0.10
JGBs	-0.09	-0.15	-0.10	-0.05
Gilts	0.52	0.40	0.55	0.70
SWI	-0.84	-0.85	-0.75	-0.60
Spreads	**26/02/20***	**3M**	**6M**	**12M**
GIIPS	110	120	110	105
BofAML Covered Bonds	39	40	40	38

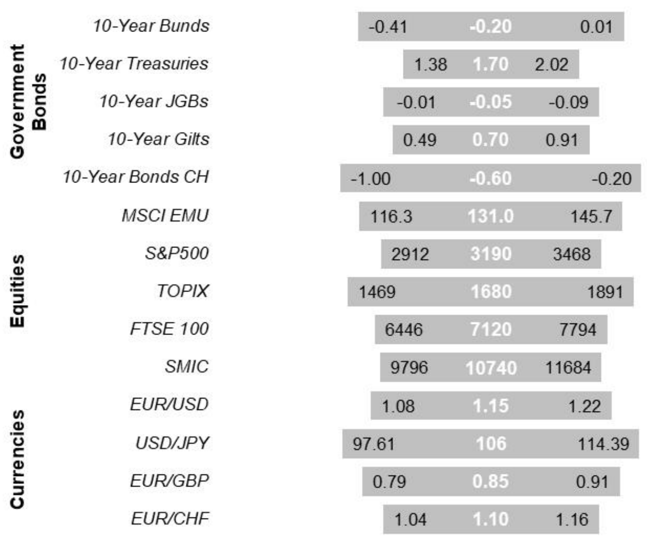
Corporate Bond Spreads	**26/02/20***	**3M**	**6M**	**12M**
BofAML Non-Financial	95	95	90	85
BofAML Financial	96	100	95	90
Forex	**26/02/20***	**3M**	**6M**	**12M**
EUR/USD	1.09	1.09	1.11	1.15
USD/JPY	110	108	107	106
EUR/JPY	120	118	119	122
GBP/USD	1.30	1.30	1.32	1.35
EUR/GBP	0.84	0.84	0.84	0.85
EUR/CHF	1.06	1.08	1.09	1.10
Equities	**26/02/20***	**3M**	**6M**	**12M**
S&P500	3157	3155	3170	3190
MSCI EMU	128.3	126.0	128.5	131.0
TOPIX	1633	1615	1640	1680
FTSE	7072	7010	7100	7120
SMI	10568	10370	10600	10740

*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.

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