ODDO BHF

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Bull & Bear – It's not all about recession

> "After the decline at the beginning of the year, pockets of investment are reappearing"

After a nerve-racking four months for investors, the market has entered a phase of horizontal consolidation marked by continued high volatility. The European equity market is trading at 12.7x 12-month earnings, a 13% discount to its 10-year average (14.5x). The recent de-rating (lower P/E ratio) reflects investors' recognition of rising bond yields and the massive capital outflows triggered by the war in Ukraine. A bear market in equities even as we were witnessing a bull market in profits. But the market is nothing short of contradictory at the moment. We will come back to this.

What catalysts could restore investors' risk appetite?

Any de-escalation in the Russia-Ukraine war would support appetite for European equities. Rather than outlining more or less realistic scenarios on the evolution of the conflict, let's focus on the three main catalysts that could restore investors' risk appetite.

1. A marked decline in inflation leading to a less restrictive policy by central banks. This catalyst seems obvious given the extent to which the tightening of financial conditions has depressed operators.
2. A reacceleration of the Chinese economy brought about by a reopening and a pronounced fiscal stimulus. European earnings are indeed highly exposed to Chinese growth, both directly through revenues generated in China and indirectly through the supply chain. In this respect, the gradual reopening of Shanghai is good news and recent infrastructure spending should help support the Chinese economy and therefore, the consumption of European products.
3. Sustained corporate margins thwarting the gloomiest of forecasts. The consensus forecast is that earnings per share for European companies will rise by an average 13% this year, and by 7.6% if commodity-related sectors are excluded. This is significantly higher than at the beginning of the year when expectations were limited to a 7% increase. However, the recent trajectory of the economy and more specifically the implementation of a less accommodating monetary policy lead us to be more cautious than the consensus. Admittedly, if the European economy does not fall into a sharp recession, there is a chance that the expected wave of downgrades will not occur, as margin compression could be partially offset by higher revenues.

But let's be clear, while the fall in share prices through higher discount rates is probably behind us (we are close to the inflation peak), the danger that it will turn into a drop justified by sagging earnings is as real as ever. The faster inflation falls, the more valuations will improve as rates drop. But if falling inflation also means recession, then earnings will be hit hard, more than offsetting the positive effect of rates.

It's not all about the recession

For now, there is still no consensus on a global economic recession. Unfortunately, however, the economy doesn't have to be in recession to see a drop in profits.

Why? The answer lies in the concept of operating leverage. Sales may be volatile, but costs - which are dominated by wages - are fixed and much slower to adjust. If sales growth is higher than cost growth, then the leverage on profit growth is considerable. This is the magic of operating leverage. But if the opposite happens, the magic turns into a nightmare. Operating leverage reverses, and profits collapse. We therefore recommend limiting the weight of the most cyclical companies today, with the exception of service companies, which will benefit greatly from the reopening of the economy after the Omicron wave.

Too early to significantly reposition on European equities

Europe is already stagnant and on the verge of a recession in the coming quarters. Rising input costs and a likely increase in wages show that the squeeze on margins is already underway. For the time being, exporting companies, which are very present in the indices, have benefited from a favourable exchange rate effect which has limited the impact and caused few negative comments from business leaders. But this is the tree that hides the forest, and a reappreciation of the euro is possible if monetary rates return to positive territory. In this sense, the "valuation" signal alone does not authorise a significant repositioning on the European equity markets. If we go back to our trigger criteria, at least two of the three criteria are not met.

However, we had recommended repositioning on Chinese equities. A little early perhaps, but we are sticking with this choice. Over one month, the MSCI CHINA is up 6.85%. Here, positions should be further increased because at 10.4x earnings, the Chinese market has rarely offered such a discount compared to developed markets and should benefit from the reopening of the economy in the coming weeks. The three criteria are therefore met, as long as the Chinese central bank's policy supports companies and particularly the real estate segment, which has been faring badly over the past year.

In bonds, we are seeing a pause in the rise in interest rates, as expected, but this should be used to sell the least liquid assets. High yield does not yet offer an attractive risk/return ratio. It is only if the recession sets in that high yield becomes a buying opportunity, but we are not there yet.

What if there is no recession? What if central banks achieve a soft landing? Then yes, we will have a strong buy signal, especially on equities. **In the meantime, we remain slightly underweight, concerned about analysts' complacency about the impact of the slowing economy on profits and certain that central banks will not deviate in their desire to "break" inflation.** Unfortunately, the tightening of financial conditions and the sharp liquidity withdrawal in the market remain the key criteria dictating our allocation.

But after the decline at the beginning of the year, pockets of investment are reappearing. We mentioned some US technology stocks in our last editorial, and Chinese stocks are now adding to our pockets of diversification. The year is far from over...

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OUR CURRENT CONVICTIONS FOR EACH ASSET CLASS

Asset class		-2	-1	0	1	2
Equities	Large cap Eurozone		-1			
	Mid cap Eurozone		-1			
	Small cap Eurozone	-2				
	UK		-1			
	US		-1			
	Emerging Markets			0		
	Japan			0		
Convertible bonds	Europe			0		
	US			0		
Currencies	USD/€			0		
	YEN/€				1	
	GBP/€			0		
	CHF / €				1	
Commodities	Gold			0		
	Crude Oil			0		
Government bonds	Core Europe		-1			
	Peripheral Europe	-2				
	US		-1			
Corporate bonds	Investment grade Europe			0		
	Credit short duration			0		
	High yield Europe	-2				
	High Yield USA	-2				
	Emerging markets			0		
Money Market	Developed markets					2
Alternative assets	Private Equity			0		
	Private Debt				1	
	Real Estate		-1			
	Hedge fund				1	

Source: ODDO BHF AM, data as of 02/06/2022

Changes vs previous month

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