ODDO BHF

INVESTMENT *strategy*

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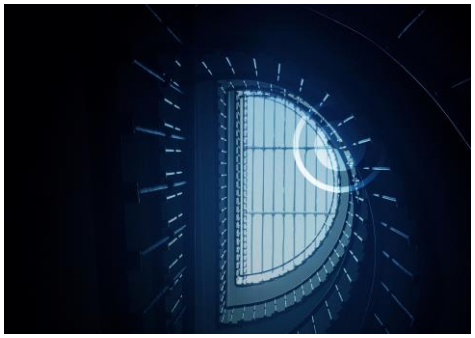
On your marks



> *Within our baseline scenario of a moderate recession in Europe and a global economic slowdown, European equities, especially the still extremely undervalued value stocks, offer upside potential.*

The past year was perceived by most observers as historic. With the war in Ukraine, the sharp rise in inflation, the quick departure from the era of cheap money and the energy shock, there was a cornucopia of burdening factors for investors. In the capital markets, equities fared poorly, losing an average of 15 per cent, but except for overvalued technology stocks, this was not a disaster if compared with other stock market crashes of the recent past. Bond investors, on the other hand, experienced a perfect storm with losses of more than 17 percent on European government bonds, for example, which hit many unexpectedly in their supposed safe haven. Is the worst now behind us?

First, the themes of 2022 will continue to dominate the new year, albeit with diminishing force. Inflation will come down faster in the US than in Europe. Core inflation (excluding energy and food prices) will be decisive for the further course of events. Only when this also falls will the central banks be able to end their restrictive monetary policy. The sensitivity of the markets to monetary policy was evident in December in the reaction to what was perceived as overly harsh communication in connection with the otherwise expected interest rate hikes. China's sudden departure from the zero-covid policy poses risks to supply chains in view of high infection figures but could also trigger a surge in growth and unfortunately also costs in a low-growth environment during the year. These uncertainties will be with us for a while, which is why many investors remain on a wait-and-see basis.

First bonds, then equities

In terms of valuations, bonds are ahead. For several months now, short-term interest rates have been above long-term rates, usually read as a signal of an impending recession. The extent of this inversion has recently corrected somewhat, but investors still expect that a difficult economic environment could force the Fed to make its first rate cuts later this year. We do not expect this bet to work out. While caution is therefore still advisable with government bonds, **corporate bonds again offer good yield opportunities**. Despite the recent narrowing of spreads, yields are at historic highs and thus offer a buffer in case of further, even unexpected, interest rate hikes. Issuers in the **investment grade segment** have sufficient liquidity to weather more difficult phases. Equities are now also more attractively valued, but the correction has not been severe enough to remove all overvaluations.

Especially in the US, risk premiums are not too abundant, **while Europe seems better equipped for a phase of further rising interest rates.** In currencies, diverging monetary policies on both sides of the Atlantic could put an end to the dollar's surge.

In our view, the focus should be on bonds first, with a view to increasing equity ratios later in the year. In doing so, we would set the following priorities:

Bonds: Both investment-grade and high-yield bonds offer interesting entry prospects in our view. With a view to an attractive risk-return profile, we favor the **Euro high-yield** segment, where positive returns are still feasible even in extreme negative scenarios.

Equities: Within our baseline scenario of a moderate recession in Europe and a global economic slowdown, **European equities**, especially the still extremely undervalued value stocks, offer upside potential. **European banks** which are benefiting from rising interest, rates, are also trading at a discount that cannot be justified solely by their lower profitability compared to US institutions. **US technology stocks** have meanwhile depreciated significantly. Those who believe in the future of digitalization (and who doesn't) can now find market-leading companies in areas such as payment and financial services, e-commerce or AI / cloud computing at prices not seen for a long time. For the **small caps** that have recently been left behind, it is important to wait for the moment when interest rates peak. Finally, valuations and macro data for emerging markets have rarely been so favorable.

Outlook: The shock of 2022 is still reverberating in the new year. The new era ahead is slow in coming and requires patience. For a significant repositioning, inflation would have to reach its peak, an end to the rate hike cycle would have to be in sight, the yield curve would have to stabilize and key market indicators would have to reach lows. Negative surprises in inflation and monetary policy cannot be ruled out, but likely, we will be allowed to focus more on the opportunities than the risks of investing in the course of the new year.

READ THE PRESENTATION

Past performance is not a reliable indication of future return and is not constant over time. These examples are not investment recommendations

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