INVESTMENT *strategy*

September 13th, 2023

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Hovering flight or losing altitude?

> *Despite possible short-term setbacks, AI remains a core theme for the long term.*

While the holiday season in Europe was marked by extreme weather, capital markets managed to avoid major turbulence over the summer. In marked contrast to last year, when investors could do almost nothing right, profits were easier to come by this year. But there were big differences. Risk-free government bonds stagnated with yields below 1%. Corporate bonds, both investment grade and high yield, offered slightly better returns of between 2 and 6 per cent. These results were eclipsed by the soaring performance of US technology stocks, although the surge was driven by just a handful of stocks, the "Magnificent Seven", which accounted for much of the gains in the S&P 500. Most recently, Nvidia's quarterly results, which beat most analysts' expectations, prolonged the tech boom that was losing steam. For many investors in Europe, this sounds like news from another planet, as evidenced by the inflows into funds - with the economy growing only sluggishly, they have taken advantage of high interest rates to move money from overnight accounts into money market funds or short-term bonds. They now face the question of whether markets can maintain their level or are about to start a descent.

Unchanged agenda: interest rates, AI, economy

Back to work, investors were faced with much the same questions as at the beginning of the summer: the evolution of inflation and monetary policy, the impact of AI and the weakness of the economy, especially in Europe and China. So where do we go from here?

With long-term real rates at historically high levels and nominal growth slowing, the end of the hiking cycle is in sight. This should provide a tailwind for high-quality government bonds, which typically peak before the last rate hike in a cycle. So, there is potential for a price rally as yields start to fall. High-yield spreads have already tightened but are still far from the historic lows seen in 2007. With Moody's expected default rates of 4.3% over the next twelve months and higher average ratings in the high yield market, risk-adjusted returns remain attractive particularly on short-term issues. Equity valuations, on the other hand, offer little upside potential in the short to medium term. With corporate profit margins on the decline and economic downside risks rising in Europe and the US, equity investments should be made selectively. Despite possible short-term setbacks, AI remains a core theme for the long term, as the penetration of productivity-enhancing applications in the corporate world is still at a very early stage. The luxury sector also offers opportunities for quality investors, given the pricing power of big brands and high barriers to entry, making it more of a theme than a sector.

Private Assets: Opportunities in a challenging environment

A word on the market for private assets, where the rapid rise in interest rates is being felt with a time lag, with some valuations still having to catch up with reality. With transaction volumes declining for four quarters, funds are finding it harder to invest the capital they have raised. When transactions do take place, they often involve quality companies that can command higher prices in both good and bad times. It is worthwhile for investors to pay attention to the return differentials between individual managers, as it is precisely in times of recession that outperformance can be achieved. Yield differentials between strategies will narrow over the next few years and returns will be lower, except for private debt, which will benefit from higher interest rates. As many investors want to increase their liquidity, the secondary market currently offers interesting opportunities in addition to private debt. In general, investors should continue to invest in a broadly diversified manner across different managers and strategies.

Our recommendations

Looking ahead to the next few months, we generally favour fixed income over equities. We see opportunities in the following investment ideas:

- **Short-duration high-yield bonds** are our favourite – an attractive carry can compensate for the fact that spreads are unlikely to tighten further in the short-term.
- **Investment-grade bonds** – higher yields continue to offer an attractive risk-return profile with relatively low risk.
- **Defensive European equities** – given the ongoing economic weakness in Europe, we recommend rotating into defensive sectors such as healthcare and avoiding highly cyclical sectors.
- **Japanese companies** are benefiting from the weakness of the yen this year due to lower interest rates compared to other economies. This could trigger positive economic momentum and make the country attractive again to financial investors.
- While China will first have to overcome its economic weakness triggered in part by the real estate crisis, **other emerging market equities** are already trading at interesting discounts.

Before we would recommend taking on more risk, inflation would have to peak, and the end of monetary tightening would have to be in sight. On the positive side, there is little evidence so far that inflation is becoming entrenched through wage increases. Another catalyst will be the bottoming out of key economic indicators and earnings revisions. The US and emerging markets are ahead of Europe and China in this respect. Regardless of whether we see the desired soft landing or whether we must endure a harder bounce, those who invest in quality will be able to ride out the more turbulent phases.

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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Established in the form of a simplified joint-stock company with authorised capital of €21,500,000.
Entered into the Paris Register of Trade and Companies under number 340 902 857.
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