MARKET *view*

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A COMPLEX EQUATION

KEY HIGHLIGHTS

- The global economy is plagued by a number of ailments, the combination of which makes it difficult to steer investors' portfolios.
- Weakened by recession worries and Chinese economic fluctuations, European corporate earnings are also not immune to the second-round effects of inflation.
- Against this backdrop, we favour US equities in two disruptive tech sectors with attractive valuations.

Investors are faced with a dilemma: lower the level of risk again in line with the deterioration of the global economy in a market that has already corrected by nearly 15% or rebalance equities by favouring the results of companies that are currently solid but potentially at risk.

Let's cut to the chase: current earnings estimates in Europe for 2022 are overly optimistic considering China's economic slowdown, the deteriorating global economy and the energy supply shock.

First, corporate profits in Europe are as sensitive to Chinese economic fluctuations as they are to European economic activity, which is suffering from the strong German slowdown. Even if Chinese credit supply is set to rebound, the lagged effect of the previous slowdown in credit flows will continue to hurt European growth in the short-term. Beijing's political response to the latest COVID outbreak only adds to this headwind.

Second, the slowdown in global growth outside China is also threatening European earnings. The decline in the ratio of new orders to inventories in the US ISM index is a leading indicator of slowing earnings growth in the eurozone. Global export growth has collapsed to 5.5% from over 20% a year earlier and is expected to deteriorate further.

Third, the pass-through of higher energy prices is not strong enough to protect corporate profit margins. The second-round effects (price/wage spiral) already present in the US could take hold in Germany. Historically, this has resulted in a contraction of operating profit margins.

We therefore need to focus our investments on companies whose earnings are growing faster than long- term inflation, which we simplistically estimate at 3%. For example, 10% earnings growth allows a company to pay out 16x its earnings so that it can offset inflation over 10 years, but only 12x if inflation is at 5%. The S&P is now trading at 19x earnings, the STOXX600 at 13x but with historically lower earnings expectations.

The equation to solve is a complex one. Building a robust portfolio will require combining discounted companies and profitable growth stocks. Indeed, a recession would indicate a further underperformance of cyclical sectors, even though they are low valued. Conversely, an even more pronounced rise in inflation would significantly hurt growth stocks.

In this context, let's try to find investment opportunities.

First idea: the US software industry

Since the start of 2022, the software industry in the US has entered a phase of successive buyouts from private equity funds. Private equity funds have historically focused a large part of their investments on the software industry, given its unique characteristics: 1) addressable markets with strong growth and high visibility (the waves of investment linked to digitalisation, public cloud or cyber security are only in their infancy); 2) business models increasingly based on recurring sales (given the sector's migration from a licence/maintenance model to a subscription model also known as Software as a Service); 3) free cash flow generation much higher than that of the market as a result of high operating margins and relatively low investments.

Furthermore, it should be noted that valuations are currently more attractive. The US software sector is worth around 9.6x sales (compared to a 9.5x sales average over the past 5 years and 17.2x sales at the sector peak in 2021, according to Morgan Stanley).

Finally, with the expected slowdown in growth, the largest software companies will boost their future growth by buying other companies that will provide them with entry points to one or more high-growth markets, or even access to certain technologies. The most attractive segments are expected to remain Cyber Security, Devops, Analytics, Observability, ITSM (IT Service Management), ITOM (IT Operations Management), and Collaboration Software.

Second idea: US biotech companies, especially those equipped with innovative, digital development platforms

The average development time of a drug over all its cycles is 8 years. The pharmaceutical industry has therefore always been structured around long cycles and returns on capital employed limited by low success rates in the development phases. As we have seen during the Covid crisis and the extremely rapid developments in mRNA vaccines, recent advances in Artificial Intelligence (AI) and Machine Learning (ML) will take this industry to the next level.

Three types of benefits of AI/ML can already be identified:

1. identification of innovative therapies;
2. reduction in drug development time;
3. higher probability of success for molecules in clinical trials.

For example, Machine Learning algorithms will bring major benefits in defining the right dosage of a tested molecule to reach the optimum "efficacy vs. toxicity" ratio and in the constitution of patient cohorts that meet the desired characteristics (phenotypes and genotypes) for clinical trials. These innovative therapeutic approaches open up prospects for a cure that were unthinkable a few years ago. At current prices, some valuations have been divided by 3 or more and offer attractive entry points.

To wrap things up, we are maintaining a cautious equity allocation, remaining short duration and further reducing our active weight against the benchmark. As you can see, the next earnings cycle is likely to be less favourable... for some sectors or themes, but not for all.

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OUR CURRENT CONVICTIONS FOR EACH ASSET CLASS

Equities	Large cap Eurozone		-1			
	Mid cap Eurozone		-1			
	Small cap Eurozone	-2				
	UK			0		
	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				1	
	Private Debt				1	
	Real Estate		-1			
	Hedge fund				1	

Source: ODDO BHF AM, data as of 05/04/2022

Changes vs previous month

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