MARKET *view*

July 8th, 2022

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Five lessons from the first half of 2022 for global financial markets

> *Equities remain one of the most attractive asset classes over the long term and equity markets have already fallen sharply. Yet, as supply shocks typically last longer than demand shocks, we are still waiting to buy.*

Investors' nerves are strained. Equity and bond markets have suffered one of the worst half-years in decades. The S&P500 plunged 19.97% in USD terms in the first half of the year, while the Euro Stoxx 50 lost 17.39% in EUR terms. Down 29.22% at the end of the half-year, the Nasdaq Composite Index suffered even bigger losses. As for 10-year government bonds, investors in the USA, Germany and France each lost over 10% during that period. There was little opportunity to escape the price plunge: Bitcoin, which was trading above $60,000 in November 2021, fell to $18,731 at the end of the first half of 2022. More than two-thirds of the cryptocurrency's value vanished into thin air in just a few months. Energy prices for oil and gas alone, as well as currencies considered safe havens such as the USD and CHF, have risen in value as a result of the war in Ukraine.

The first lesson from the first half of the year is that we are dealing with a supply shock. As with a demand shock, GDP falls in a supply shock but the crucial difference is that prices rise. They don't fall as in a demand shock. Consumers will have less money available for additional spending because of increased prices. In addition to consumer spending, investment will also fall or stagnate because interest rates will rise. Gross domestic product will grow much more slowly and could even fall temporarily. The risk of a recession in the USA, for example, is around 50%.

The second lesson for the second half of the year is that the era of cheap money is over. Until December 2021, the ECB assumed that inflation would settle at 1.7% in 2022 in the 19 economies of the eurozone. Now, in its June 2022 Staff Projections, the ECB expects inflation to average 6.8% in 2022 and 3.5% in 2023. With inflation well above 8% in both the eurozone and the US, well beyond the ECB and the Fed's target inflation of 2%, both central banks will be forced to raise interest rates significantly. We expect the effective federal funds rate to rise to 3.4% in June 2023. In Europe, the ECB deposit rate will most likely rise to above 1.4% in June 2023.

The third lesson is that the funding risk of highly indebted sovereigns is rising, forcing central banks to intervene. Those with high debts will suffer when they have to refinance at rising interest rates. This applies to companies as well as entire states. Greece's 10-year yields (debt-to-GDP ratio: 193%) rose to 4.7% in the short-term last month, Italy's (debt-to-GDP ratio: 151%) to over 4.1%. In Europe, the ECB convened an emergency meeting in mid-June, as it looks to counteract a "fragmentation" of the eurozone, i.e., to avoid a significant rise in yields in the southern peripheral states. The ECB has announced that it will use the returns from the PEPP (pandemic emergency purchase programme) measure to avoid a sudden rise in yields in the highly indebted member states. Moreover, in its statement following the emergency meeting on 15.6.2022, the ECB indicated that it is working on an "anti-fragmentation instrument", which presumably means further purchases of government bonds from the highly indebted peripheral states. In Japan, too, the central bank is being forced to buy more government bonds. Hedge funds are increasingly betting that the Japanese central bank will have to abandon or modify its yield curve control. Last month alone, the Japanese central bank bought USD 119 billion of bonds. It now holds over 50% of Japan's government bonds.

The fourth consequence is that exogenous shocks due to the Ukraine conflict are becoming more likely. In Europe, the threat of an energy embargo looms. In the event of a complete gas ban, the Bundesbank considers a slump in gross domestic product of up to 5% a possibility in Germany, with the joint diagnosis of the economic research institutes forecasting a slump of up to 8.9%. This means that one of the most severe recessions in post-war Germany and Europe is conceivable. Whether this will actually happen remains uncertain.

The fifth lesson is that, with all the risks described above, long-term investors should ask themselves when to increase the risk in their portfolios again. Equities remain one of the most attractive asset classes over the long term and equity markets have already fallen sharply. Valuations in Europe and emerging markets are no longer expensive by standard valuation criteria. In the US, however, equities are still trading well above average valuation levels of the past. The Shiller price/earnings ratio, the price/book value ratio and the "Buffet indicator" (US market capitalisation/US GDP), to name the most common valuation measures that have proved reliable in the past during periods of stress in the financial markets, are still above their long-term averages in the US.

As supply shocks typically last longer than demand shocks, we are still waiting to buy.

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