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Laurent Denize
Global Co-CIO ODDO BHF

Wind of Change

> *As unpredictability has become Donald Trump's defining characteristic, volatility will be a continuing feature of his presidency [...] The good news is that the wind can also change direction violently (but positively this time) for other geographies such as Europe and China.*

Sometimes the course of history changes in the blink of an eye. It is not easy for observers to keep up with such sudden changes. The same goes for investors in the capital markets. **Even a cursory glance at index levels at the end of February shows a 180-degree turn in market sentiment shortly after Donald Trump's inauguration.** While the predominance of the US in the capital markets was still unchallenged at the beginning of the year, the first decrees of the new administration changed the wind more sharply than expected. US equities, cryptocurrencies and the US dollar have sold off, while US treasuries have rallied, with yields falling steeply. This is a sharp about-turn from the initial market reaction following Trump's election victory, which was premised on the view that the new leadership would be positive for US growth, inflation, equity prices, bond yields, US dollar, and crypto. In contrast, European equities, which had previously been ignored, soared, as did Chinese equities following the success of DeepSeek, financials and gold. In Europe, investors initially focused on large caps. However, the sharp widening of multiples (12-month forward P/E ratio close to 15x), analysts' strong EPS revisions for both 2025e and 2026e, and a renewed interest among European investors in their own continent (+EUR 12bn net inflows into European ex-UK funds in February, the highest flows seen since January 2022) suggest that the positive momentum could spread to other capitalization sizes, especially mid-caps.

USA - Expelled from paradise

The market turnaround was driven by the fact that investors' assumptions inherited from Trump 1.0 were shattered in the first few weeks of the new administration. The deregulation and tax cuts (corporate taxes from 21% to 15%) that fueled the post-election Trump trade have ultimately proven far from the reality for the time being, while less market-friendly policies (tariffs, immigration and DOGE) have all shaken investor confidence. However, the indifference to the market's harsh reactions suggests that the new administration is determined to pursue a policy of conviction on both trade and geopolitics, and to push through its "America First" agenda in the face of opposition. The US president's tolerance for market instability is much greater than during his first term. So, if we still believe there is a "Trump put" to protect investors from stock market plunge, it is certainly much lower than the consensus expectation. It is possible that the protectionist overhaul of trade policy, which. in the long-term. is damaging to his own country, will be reversed if there is a negative impact on the real economy (as opposed to financial market turbulence). Initially, however, uncertainty will prevail among investors, consumers and businesses. This is especially true as recession fears are growing in the face of deteriorating leading indicators such as purchasing managers' indices. This makes the climate for investors more difficult.

Moreover, we highlighted in recent months that the sequencing and the details of US policies, together with the development of the AI complex, would be critical factors in sustaining US exceptionalism. The release of a new AI model called Manus, following shortly after the DeepSeek announcements in January, has raised further questions about the role of AI as a driver of US exceptionalism. The erosion of confidence in AI capex, monetization, and return on investment does not help to justify a “US moat”. Finally, with valuations at record highs, the so-called Magnificent 7 have lost some of their luster. Is this the time for the “lag-nificent 7” to rebound? Potentially for some of them as valuations have reached reasonable levels and as far as the EPS trend is still intact. Can small caps also catch up? Only if corporate taxes are cut as promised, credit is available at reasonable rates, growth and consumer sentiment remain positive and industrial policy favors domestic companies. Until then, investors have been kicked out of the US investment paradise.

Europe - Back to work

While the US has been a negative surprise for investors, Europe is going from zero to hero. We have Donald Trump to thank for this shift. His break with the idea of transatlantic partnership, most clearly manifested in his new approach to Russia and Ukraine, is forcing European countries to organize their security more independently. **After years of inertia, the European states (including the United Kingdom, which is turning its attention back to Europe) have shown themselves to be equal to the new situation and have reacted quickly.** In Germany, even before the government was formed, the potential coalition partners presented massive spending programs for defense (debt brake exemption for defense spending above 1% of GDP), infrastructure and climate (EUR 500bn over 12 years i.e. 11-12% of German GDP plus more spending at the federal states level by raising their net borrowing cap from 0% to 0.35% of GDP). This has been rewarded with early praise in the form of strong gains in defense and construction stocks. Whether these are justified, however, will only become clear once the programs have been officially approved by both Bundestag and Bundesrat. But the EU is also opening the money floodgates, making it easier for its member states to borrow for defense spending (exemption clause for defense spending at EUR 650 bn over 4 years plus joint borrowing that could reach EUR 150bn). Several other factors suggest that Europe will make a comeback in portfolios beyond this short-term sentiment boost. While the US economy is faltering, Europe is showing signs of recovery despite the headwinds from the US. A possible ceasefire in Ukraine could also contribute to the economic recovery, given the need to rebuild destroyed cities (more than EUR 300bn in investments needed to rebuild) and the easing of energy prices (currently four times higher for German companies than for US ones). A key factor will be whether the EU manages to avoid a trade war with the US. In this respect, the purchase of liquefied natural gas from the US and the planned massive increase in defense spending could ease the negotiations. We confirm our positive view on European mid-caps and high-dividend companies. Germany is our top conviction. It offers the greatest potential to benefit from a European recovery. The focus should be on the MDAX. We also recommend a position in European value stocks, which are less dependent on exports and would benefit most from increased infrastructure spending. As regards sectors, given the volatility of the markets, it pays to be agile. The outlook is good for banks that can maintain their consistently high return on equity in a favorable interest rate environment. Defense and construction stocks should benefit from government spending programs. In the technology sector, software stocks stand to benefit the most from falling AI costs. In the chemicals sector, production volumes are expected to increase.

China - The new paradise?

China, a market that pessimists were too quick to write off as not investable, could once again one of the surprises of the new year. The reaffirmation of the ambitious 5% growth target by the National People's Congress is an important signal from policymakers that they are prepared to support economic growth and, in turn, confidence. To achieve the growth target, the government has adopted a much more expansionary fiscal stance than last year. The official budget deficit target rose to 4.0% of expected GDP, the highest ever. The quotas for local-government special-purpose bond and “ultra-long” special treasury bond issuance were increased from RMB3.9trn to RMB4.4trn and from RMB1.0trn to RMB1.3trn, respectively. Separately, RMB500bn of special treasury bonds will be issued to recapitalize large state-owned commercial banks. In addition, China has less to fear from a trade war than Europe, as it has invested more in developing its own technologies and expanding exports to the countries of the global south. After being held back by government regulation for so long, technology companies are now coming back into the limelight, as a meeting between Xi Jinping and five of them clearly signaled. **The new tech stars are Chinese and the fact that companies such as Alibaba, Tencent and BYD are still undervalued relative to their US peers, despite their year-to-date share price gains, offers opportunities for investors looking to return to China. It's only a short step from there to talking about the “Chinese Magnificent 7” (Terrific 7? 7 Titans? 7 Dragons?).**

Short duration is the key word for both rates and credit

With the risk of inflation expected to rise in the long term due to Trump's tariff policy, long duration positioning should be avoided in the US.

In Europe, the recent sharp rise in yields suggests that the bond market is now adequately pricing in the prospects of stronger growth in the eurozone, and increased bond issuance to fund higher defense and infrastructure spending. However, with Germany embracing large and continuous fiscal stimulus, there is a significant likelihood that the German economy will emerge from stagnation, contributing to a broader reflation in the eurozone. This scenario leaves considerable room for yields to adjust somewhat higher in the coming months. As regards credits, we recommend being underweight. Within the asset class, we remain constructive on investment grade credit risk. While spreads are tight, absolute yields levels are still attractive, also in light of decreasing money market returns. By contrast, high-yield spreads do not adequately compensate for the substantial increase in uncertainty, market volatility, trade war risks and, in particular, higher growth concerns in the US. However, short-duration high yield should continue to benefit from still attractive yields for a low level of risk.

Conclusion: Where is the “glory night”?

As unpredictability has become Donald Trump's defining characteristic, volatility will be a continuing feature of his presidency. The financial market regime in which we operated at the end of 2024 has been turned upside down in a very short space of time. The gentle, promising and sweet wind of change that we were expecting from the US turned out to be cold, violent and gusty. **The good news is that the wind can also change direction violently (but positively this time) for other geographies such as Europe and China**. That is where the “glory night” is right now.

READ THE PRESENTATION

ODDO BHF Asset Management SAS (France)
A portfolio management firm certified by the French Financial Markets Authority (AMF) under n° GP 99011.
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.
12. boulevard de la Madeleine - 75440 Paris Cedex 09, France - Tel. : 33 (0)1 44 51 85 00
am.oddo-bhf.com