ODDO BHF

MARKET *view*

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Recession looms - and what do we do now?

> *According to a popular bon mot: "Prediction is very difficult, especially if it's about the future". Economists analyse cause-and-effect relationships when they forecast the future.*

1. The invasion of Ukraine has led to a supply shock and high inflation. Central banks will continue to raise interest rates significantly. The US is already in a "technical recession". The probability of a recession as defined by the National Bureau of Economic Research (NBER) has risen to over 50% in the US. In Europe, the probability of a recession is even higher due to the energy crisis.

2. Equities typically correct markedly during a recession. We have been slightly underweight on equities since February 14, 2022. After the correction in recent months, equities in Europe and the emerging markets are no longer expensive according to common valuation ratios. In the US on the other hand, equities are still relatively highly valued, based on historical average.

3. We have resumed a neutral equity positioning on July 25, 2022. Our cautious positioning is currently carried out through a more defensive orientation in the selection of individual stocks and greater diversification, and no longer through an underweight in equities. Experience shows that only at the end of a recession or shortly thereafter, should the equity quota be significantly increased again.

In the eurozone, inflation recently rose to 9.1%. Higher inflation, in turn, leads to lower purchasing power and a slump in consumer sentiment. For instance, the "consumer sentiment index" as calculated by the University of Michigan is currently lower than during the Covid crisis. High inflation is forcing central banks to raise key interest rates significantly. The Federal Reserve raised the federal funds target rate several times since March 2022, to 2.25-2.50% today. After a longer period of hesitation, the ECB finally raised its key rates by 50-basis points on 21 July, and again by 75-basis points on 8 September. **Further increases will follow. Higher policy rates lead to lower investment and a slowdown in growth.**

Following this line of thought, one can assert that a recession looms, as consumers spend less and investment falls. Economists use different definitions when they speak of a "recession". A "technical recession" is when the gross domestic product (GDP) falls for two quarters in a row. In the US, the economy fell -1.6% and -0.6% (both figures annualised) in the first and second quarters of 2022. The US is thus in a technical recession. So far, the eurozone has been able to avoid a technical recession: growth in the eurozone was surprisingly positive at +0.8% (3.2% annualised) in the second quarter of 2022.

In the US, the National Bureau of Economic Research (NBER) defines a recession as "a significant decline in economic activity that spreads to the entire economy and lasts for several months." According to the NBER, typical characteristics of a recession include a slump in production, income and demand, along with high unemployment rates. That is not yet the case. The unemployment rate in the US, for example, remains unusually low, at 3.7%. The key question for capital markets is: how likely is it that the US will slip into a recession as defined by the NBER in the future? Such probabilities can be estimated using different models.

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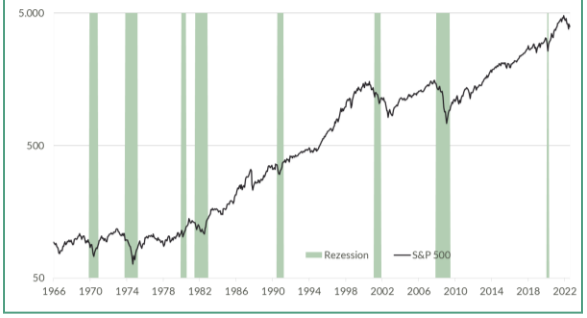
On 14 February, 2022, shortly before Russia's invasion of Ukraine, the Global Investment Committee of Oddo BHF Group decided to go "slightly underweight" on equities. On 25 July, 2022, following the sharp correction on the stock markets, we decided to return to a "neutral" stance relative to the strategic guidelines of our clients. The decisive argument in favour of that move, is that share valuations have become much more attractive as a result of this correction. Using price/book ratios, we see that equities in Europe and the emerging markets are now trading below their long-term average levels. Looking at price/earnings ratios, free cash flow yields and other valuation metrics also show that at least a mild recession is already factored into prices. In the US, equities are still trading above their long-term average levels. However, there are good reasons for this. First, Europe is closer to the war. A recession in Europe is more likely than in the US because of the energy crisis. But above all, companies' average return on capital is substantially higher on the other side of the Atlantic - not least because of the greater weight of technology stocks.

A second reason to become a little more optimistic, despite all the caution, is the extremely negative mood among investors and consumers. We are trying to act anti-cyclically. In the past, it has proven successful to gradually and slowly build up risk positions when investor fears are particularly high. Of course, the risks that corporate profits will drop sharply as a result of the recession remain high. In the first phase of the crisis, from 14 February, 2022, we slightly underweighted equities relative to our clients' specifications. Since 25 July, 2022, our cautious positioning has been achieved through a more defensive orientation in individual stock selection and higher diversification, but no longer primarily through an underweighting of equities. As quality investors, we invest over the long term in companies that have high returns on capital and clear competitive advantages, as well as structural growth - i.e., as independently as possible from general economic fluctuations. **We buy company shares when they are trading at a reasonable price and then hold them for the long term**

The graph below shows that share prices fall sharply during recessions. They usually bottom out during, rather than after, a recession. The S&P 500 bottomed during periods of recession in 1970, 1974, 1982, 1991, 2009 and 2020, and then rose again. During the post-Internet bubble recession in 2000, the S&P 500 fell until September 2002, and then rebounded sharply until September 2007. **Experience shows that those bold enough to invest in equities at the end of a recession or immediately afterwards usually achieve attractive returns over the long term** - as the graph below illustrates.

RECESSION AND THE S&P500



Source: National Bureau of Economic Researchs

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