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MARKET *view*

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It's all about timing

KEY HIGHLIGHTS

- In the event of a scenario that avoids recession, we think the market has a strong rebound capacity
- While it is still too early to reposition significantly on equity and high yield markets, entry points are close

After a cataclysmic first half of the year, and with the economic outlook in developed countries deteriorating, prudence would prompt a withdrawal from risky assets in anticipation of a lull. But is caution always a good advice?

Timing is key in equity markets

Fears that developed economies are heading into recession have recently been exacerbated with the US ISM manufacturing index at 53 (56.1 in May), hit by the contraction in new orders and employment. As for the stock markets, the S&P and European indices are down around 20% since the beginning of the year. After this significant decline, the question is whether the market is rewarding risk enough today.

In the US, we put the probability of a recession at 40% (30% mild recession, 10% severe recession) and the probability of an economic slowdown over the next 12 months at 60%. In the event of a scenario that avoids recession, we consider that the market has a strong rebound capacity. Let's look at the earnings trend over the next 12 months.

We have already pointed out that US profit margins are extraordinarily high and will eventually narrow. However, we believe that these adjustments will be slower than investors currently anticipate. Indeed, over the long term, the earnings performance of S&P500 companies has been driven primarily by the information technology sector. The technology sector is now dominated by natural monopolies - companies that benefit from network effects and strong economies of scale. Increased regulation will erode their positioning over time, but this is likely to be a slow process.

Over the long term, the upward trend in profit margins outside the technology sector is less impressive. As the economy slows, industrial and agricultural commodity prices fall, allowing companies in defensive sectors with strong gross margins, such as food and beverages, to maintain reasonable margin levels. On the other hand, it is true that companies in sectors with low gross margins, such as Retail or Building Materials, face the dual challenge of managing constrained pricing power and a likely decline in volumes.

On balance, US S&P500 company margins are expected to decline but remain at reasonable levels over the next 12 months.

In Europe, the fall in the euro is clearly supporting exports and will limit the decline in profit sequences in the second quarter. The decline is more likely to be felt in the third quarter. But here too, the worst is not certain, as companies are confirming that their order books are full and that they are able to adjust their prices to compensate for most of the inflation in inputs. Possible social movements with rising wages are to be expected, but the effects will not be felt until later in the year or even in 2023. The situation in Ukraine remains the main risk for Europe. The cessation or further reduction of gas supplies may call into question the evolution of companies' EPS growth for the coming months.

In conclusion, on the equity markets, we note that valuations are starting to incorporate major stress scenarios. While it is still too early to reposition significantly, entry points are close.

Still a bit early on credit

High yield spreads imply that the market is considering a default rate of 7-8% over the next 12 months. In its worst-case scenario, Moody's estimates it at 6%. In March 2020, the market estimated it at 12%. Part of the risk is therefore clearly in the prices.

It should be noted that the absolute yield is currently above 7.50%. Historically, at this level, the probability of generating a positive return over the next 12 months is beyond 80%. Furthermore, a yield of 7.5% allows for sufficient carry to support an additional spread widening of around 250 basis points... the highest levels reached two years ago.

In conclusion, we believe that the High Yield market needs a final capitulation so that the last weak hands (opportunistic buyers) are replaced by investors with a more strategic view. It will then have achieved sufficient risk premiums to stabilise and return to sound fundamentals.

Close to entry points

As the month of July kicks in, we are a little more constructive. The macroeconomic figures do not bring good news, but the divergence in monetary and fiscal policy in China and Japan should limit the deceleration in global growth. The resilience of companies is impressive. But it is the resilience of consumers that will be tested. Even if savings are plentiful, the least privileged categories, and the broadest base of the population, are suffering from a sharp erosion of their purchasing power. Gale or storm on consumption? It is difficult to say.

In any case, we are approaching entry points in both the equity and high yield markets. The risks remain, of course, but the return already partly reflects the many uncertainties. The low liquidity of the summer months may cause mini market shocks, which would be used for a more significant repositioning.

In the meantime, we wish you a great summer.

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