



INVESTMENT *strategy*

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Carry on



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For investors at least, the summer this year ended in Jackson Hole, Wyoming, at the annual conference of central bankers and academics. The message from the speeches of Fed chief Jerome Powell and ECB representative Isabel Schnabel was unmistakable: both central banks are sticking to the restrictive monetary policy necessary to fight inflation and are accepting significant losses in the rate of growth to do so.

At the same time, corporate profits, especially in Europe, are coming under pressure from rising energy prices and a probable gas embargo. **Here, a recession is our base scenario, even if the length and depth of the downturn are still open.** The recovery rally that began in June consequently ended abruptly in late August. **Cautiousness is the key word on the European equities for the time being, but it does not mean that other regions or asset classes do not provide some opportunities.** The title of this article is indeed a spoiler!

2022 - Resilience needed

For the capital markets, 2022 has turned out to be the worst year so far since the 2008 financial crisis- only the US dollar and oil were able to generate significant returns. Not only equities recorded double-digit losses since the beginning of the year, but even investments that were intended to stabilize, such as government bonds, no longer

offered any refuge. The summer equity rebound was driven not only by hopes of a less restrictive monetary policy but also by better-than-expected corporate earnings. A closer look shows that these came largely from commodity and energy companies. In addition, there were market movements due to stock purchases by investors who had to unwind their short positions. In view of the ongoing uncertainties, institutional investors intend to further reduce the risks in their portfolios, i.e., lower equity ratios and keep duration short. Valuations also no longer offer a safety buffer in view of rising interest rates and the recessionary trend. **The focus should therefore be on companies that have enough resilience for a market environment characterized by rising inflation and declining growth figures.**

The government bond market will remain characterized by a further rise in interest rates and a flattening of the yield curve. Volatility should not decline either. In addition, there is the danger of fragmentation, i.e., the spreads of individual states widening, especially in the euro area. While government bonds offer little perspective, at least in Europe, the situation looks better for corporate bonds. **Especially in the high-yield segment, the opportunity to capture high spreads is opening up right now,** but only under the condition of a careful credit analysis of the respective issuers.



Moderate recession as a base scenario

In our central scenario, to which we assign a probability of 60%, we assume a moderate recession in Europe accompanied by a global slowdown in growth. This could also lead to a decline in inflation next year, although not yet to the ECB's target level of 2%. **What should investors focus on in such a market environment?**

Equities: In the current circumstances, a clear focus on quality stocks is recommended. This means companies with high returns on capital, clearly defined competitive advantages, low debt, and a reasonable valuation. In contrast, one should avoid highly indebted and energy-dependent companies, e.g., chemical, or industrial stocks. Among the regions, Japan and the Emerging Markets have more value potential than still ambitiously rated US equities. Some investment themes offer earnings and diversification potential, especially in a time marked by upheaval. These include the ecological transformation, which is gaining additional momentum due to the need for energy independency in Europe. The overvaluations in these companies have also been reduced in the meantime. Food security has also come into focus because of the war. To feed the world's growing population, food production must be increased by 60% by 2050 without harming the environment. The necessary food revolution opens investment opportunities in a rather defensive sector. Finally, firms providing security for IT infrastructure or online payment systems show great growth potential. And last but not least, these themes have proven to be more resilient as they have lost half of the indexes on a YTD basis.

Fixed Income: With the rise in interest rates, the valuation of Investment-Grade (IG) and High-Yield (HY) bonds has become attractive again. It cannot

be ruled out that spreads will widen even further, which would entail losses. But historically, the beginning of a recession has always been the best moment to start gradually entering the high-yield market. The spreads today account for a probability of 85% of a positive return close to 8%, calculated on historical computed data. At least HY bonds provide a way to limit the capital erosion according to our analysis. **Carry is the name of the game:** if spreads are widening by 2%, which is significant, the carry will fully compensate the loss on capital (*Ceteris Paribus*).

Diversification: Against the backdrop of the recession, most commodities should continue to lose value. Besides gold or currencies (CHF, USD), the portfolio can also be diversified by investing in private assets, especially Private Equity. The capital is tied up for a longer period and impairments are possible in the meantime, but once the crisis is over, there are attractive return opportunities.

Outlook: We do not yet see the moment to take substantial risk. For this to happen, inflation would have to peak, central banks would have to approach the end of the cycle of interest rate hikes, the yield curve would have to stabilize, and important market indicators would have to reach troughs. Depending on the extent of the market corrections, we will start to gradually build up positions in risk assets such as equities and high-yield bonds. In this context we do recommend carrying on, and for sure not losing faith. 2023 might look like 2009, finally...

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