MARKET *view*

December 9th, 2022

Laurent Denize
Global Co-CIO ODDO BHF

"And yet..." (a tribute to Charles Aznavour)

> *This economic outlook does not really encourage a greater reallocation into risky assets. And yet, we approach 2023 with a constructive view.*

And yet... 2022 was shaping up to be a great year. The year of monetary policy normalisation, a gentle, gradual and calm normalisation. The beginning of the year had been marked by a dazzling sector rotation towards value companies with an outperformance of nearly 10% in one month. Europe was recovering. But that was before M. Putin's decision to invade Ukraine. We know what happened next, resulting in a negative performance for almost all asset classes in 2022.

Growth deceleration and high inflation for 2023

As the year draws to a close, the global macroeconomic outlook looks bleak, especially for Europe. The prevailing scenario for us appears to be that of a slight contraction in Eurozone GDP for 2023, while in the US this could narrowly be avoided in the first half of the year. Despite a slight rebound in Chinese growth, global growth will continue to slow to around 2%.

But the main uncertainty for the coming year is the speed of the decline in inflation. Investors have recently revised down slightly the ECB (~3%) and FED's (~5%) terminal rates, and even expect the latter to ease monetary policy before the autumn. In that sense, investors are far too optimistic and likely to be disappointed. While inflation peaks now seem to be a thing of the past in the US and are on the verge of being reached in most other economies, core inflation (excluding volatile factors such as food and energy prices) shows little signs of weakness. Despite a marked slowdown in the real estate market, inflation is likely to be higher than the consensus forecasts. The labour market remains buoyant, wage inflation is becoming structurally anchored at high levels. The current decline in inflation is therefore likely to be only temporary and could take off again at the end of 2023, as the Chinese economy recovers and the need for investments to support the energy transition and relocation becomes more evident.

Both in the US and Europe, current long term interest rate levels appear to be too low or even complacent in view of the new structural inflation regime.

And yet, we remain constructive on risky assets

This economic outlook does not really encourage a greater reallocation into risky assets. And yet, we approach 2023 with a constructive view. The main reason for this cautious optimism is the valuation levels for equities and bonds, which are currently offering returns not seen since 2009.

Bonds are the asset class to favour in 2023

Without question, the credit market remains the preferred asset class. Depending on your level of risk aversion, you could favour quality bonds offering a 3.5% yield, or slightly riskier bonds with a 6.5% yield on 5-year maturities. It might also be worth positioning on subordinated bonds of quality issuers, from both the banking and the corporate sector. Yields are then close to 6% with very solid issuers.

Why position on credit when recession is near? For a somewhat more philosophical or sociological reason. During Covid, governments implemented fiscal policies aimed at protecting human and productive capital from the consequences of the combined supply and demand shock "at **all** costs". Such a commitment will take time to be reversed or even curbed, limiting the defaults that should have occurred with a contraction in the economy. It is therefore necessary to arbitrate between the risk premium offered today, i.e., the implicit probability of default included in the price of bonds (40% in cumulative terms over 5 years), and the probability of default that will be observed (much lower).

Equities: valuation levels are reasonable enough to absorb possible disappointments in earnings sequences

Given the extent of the recent rally, equity markets present a greater risk than in the past few weeks in the event of a major recession. However, they could get away with a decent performance in the base case scenario of a moderate recession. While the eurozone suffered 6 consecutive quarters of contraction between the end of 2011 and the beginning of 2013, the Eurostoxx index rebounded by almost 40% between 2012-2013... This index is currently valued at 12x estimated earnings (9x at the end of 2011, and 15x at the end of 2013), which is still modest in historical terms, and these estimates already factor in almost zero earnings growth in 2023.

This is where we need to change our perspective. In an inflationary context, we should no longer think in nominal terms but in real terms. From that angle, the contraction in real terms currently reflected in stock prices is significant (-7%). That being said, we expect to see few surprises in terms of sequential earnings growth. The rise in input costs has been amply reflected by companies in their selling prices, but it is now coming up against an overall decline in savings rates and disposable income. On the other hand, the compression of valuation multiples linked to rising interest rates is coming to an end. A return to historical averages (12-month forward P/E ratios of 14x) may thus drive European equity indices to higher levels. In which case, indices could grow by 5%, even with a further 10% fall in earnings.

Beware, however, of the aggressive sectoral shifts that are likely to persist. Faced with high inflation driven by energy costs, energy producers in Europe enjoyed spectacular margin growth in 2022 while property companies did not absorb the rate hikes well, with the implications on stock markets that we have witnessed. **What should you do in 2023?** Exogenous inflation is being absorbed. We must therefore focus on endogenous inflation caused by a possible acceleration in wages.

In an inflationary environment driven by second-round effects, one should favour companies with low human capital (such as the technology sector) and avoid labour-intensive sectors! Also, beware of overly concentrated exposure to the major beneficiaries of the fall of the Euro. With the recent rise of the single currency and an inflation situation that could lead the ECB to continue tightening after the FED has put an end to it, the currency exposure of portfolios could henceforth adversely affect the performance of unhedged ones.

At a regional level, we favour Europe, the UK and emerging markets (including China). The reversal of "carry trades" (borrowing in weak currencies and lending in strong currencies) should allow for a relative revaluation of these regions compared to the dollar area. This phenomenon has already begun and should accelerate in 2023.

Conclusion

Rising spreads and interest rates are breathing new life into bond investing. On the other hand, geopolitical uncertainty and the slowdown in the global economy make investing in equities more complex, but no less exciting. We therefore prefer growth stocks and geographical areas whose currencies seem undervalued to kickstart 2023. We will tell you more about this in our January investment strategy.

I wish all a very happy holiday season, with the hope that the 2023 "vintage" will be better than 2022, which was very "corked".

READ THE PRESENTATION

ODDO BHF
12, boulevard de la Madeleine - 75440 Paris Cedex 09 France - Phone: 33(0)1 44 51 85 00 - Fax: 33(0)1 44 51 85 10 –
www.oddo-bhf.com ODDO BHF SCA, a limited partnership limited by shares with a capital of €70,000,000 - RCS 652 027 384 Paris – approved as a credit institution by the Autorité de Contrôle Prudentiel et de Résolution (ACPR) and registered with ORIAS as an insurance broker under number 08046444. - www.oddo-bhf.com