ODDO BHF

INVESTMENT *strategy*

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2024: Tempering expectations

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The turn of the year is a popular, if arbitrary, time for reviews and predictions. Equity investors also seem to have had a change of heart this New Year after an impressive year-end rally. As a result, the first few days of trading have been dominated by profit-taking and losses on last year's winners. But even this "diet", like so many others, is unlikely to last the whole year. Nevertheless, it has been a sobering start for the capital markets. The expectations of interest rate cuts that underpinned the rally need to materialize before the party can really continue. The question is not so much whether rates will be cut, but when and by how much. With strong growth and improved financing conditions, the Fed can wait for a sustained decline in inflation and act cautiously. The situation is more difficult for the ECB. Recession is looming in Europe; bank lending has stalled, and the Governing Council is far from unanimous on the next steps. Investors are therefore advised to temper their expectations of rapid clarity and an uninterrupted continuation of the equity rally.

Satisfactory end to a volatile year

The strong annual performance of capital markets outside China masks the fact that 2023 was largely characterized by volatility and uncertainty. This is reflected in the strong inflows into low-risk assets (particularly on Money Market) that have become profitable thanks to the turnaround in interest rates. Whether this war chest built up for uncertain times will find its way back into other asset classes will determine the outcome in 2024.

The case for Fixed Income

For Fixed Income investors, the question is whether the trend of falling yields that began at the end of last year will continue or come to a halt. Interest rates are still so high by historical standards that government debt is unsustainable. One argument in favor of investing in long-dated government bonds is that they are now one of the few investments with convexity, i.e., the value of the bond rises faster when interest rates fall than when they rise. This provides some risk buffer. In our view, corporate bonds also continue to offer a good risk/return profile for both Investment Grade and High Yield.

Where there is still growth

While the opportunities outweigh the risks for Fixed Income, the opposite appears to be true for equities, given the slowdown in growth and challenging valuations. Ultimately, however, it comes down to company growth trends, which vary from sector to sector. Even the high valuations of AI stocks, which were already booming last year, can be justified by historical comparison. When PCs, mobile phones and cloud technology were introduced, the number of users and therefore the earnings potential were significantly underestimated. This could happen again. After AI infrastructure was the main driver of growth last year, app-based applications could provide further momentum in the coming years. The opening of the GPT store by Open AI at the beginning of the year would then be the starting signal for the use of AI beyond the technology sector. This could make a difference: 2 billion iPhones were sold after the launch of Apple's first App Store, compared to 2 million before. In the luxury sector, valuations have not yet got out of hand, except for high-end ultra-luxury players. Green investments have been less favorable recently due to tighter financing conditions and supply chain issues. However, we still see a lot of potential here, given the need to expand renewable energy and government support for the sector. Finally, the more defensive healthcare sector offers not only stable earnings but also growth from pharmaceutical companies benefiting from their diet blockbusters. We would be more cautious on Chinese equities - valuations are promising, but it is still uncertain whether international investors will regain confidence.

Our convictions for the coming months

Looking ahead to the next few months, we generally favor bonds over more volatile equities because of their higher real yields. For a scenario in which a recession is avoided despite a slowdown in growth, the disinflationary trend continues, and the first interest rate cuts take place later in the year, our positioning is as follows:

- Be slightly cautious on equities, given the soft-landing scenario already priced in.
- Focus on long-term growth trends in some selected sectors such as AI, environmental transition, luxury, and healthcare
- Neutral positioning in fixed income as long as yields remain high at the short end
- Overweight short-duration high-yield bonds, which offer attractive carry and are unlikely to experience high default rates even in a mild recession.
- Initial investments in sectors of strategic importance to the Chinese government

In the event of economic stagnation, defensive equities and yen would be our investments of choice. Commodities would be the best way to prepare for a return of inflation. Not all New Year's predictions will come true this year. Those who moderate their expectations and do not commit themselves too early will be able to take advantage of the opportunities offered by unforeseen, surprising developments.

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