MARKET *view*

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TOMORROW THERE WILL STILL BE TIME

KEY HIGHLIGHTS

- We have entered a bullish cycle in commodities that will also generate more structural inflation.
- Inflation has become a proven macroeconomic risk and the correlation between stock and bond yields could become negative again.
- We maintain our cautious positioning but are looking at possible tactical buying opportunities, such as discounted stocks, Chinese stocks or investment grade bonds, to take advantage of some market dysfunction.

Let's be clear, the outlook for equity markets has significantly deteriorated since the start of the year. Beyond the global growth trajectory, higher-than-expected inflation is having negative consequences, not only on bonds but also potentially on equities.

What is the relationship between inflation, the neutral rate of central banks and the level of 10-year bonds?

Let's briefly go through the theory to define what the equilibrium point for US rates could be in the medium- term.

Conceptually, the yield on a 10-year government bond should be equal to the sum of potential growth and inflation. In the US, potential growth is around 2%. If long-term inflation is estimated to be around 2.5%, then the long-term value for the yield on the 10-year US Treasury bond should be more like 4% to 4.5%. The US 10-year bond is currently worth 2.75%. So we are far from the mark. Why such a discrepancy?

Central bank activism has played a large part in the financial repression we've been experiencing for the past 10 years, but that's not the only reason. These past years, investors were willing to pay a high price and sacrifice yield to own long-term bonds, resulting in negative term premiums. Indeed, owning bonds offered the prospect of capital gains to offset the loss on equities in the event of an adverse macroeconomic environment. In addition, falling bond yields (especially real ones) pushed equities to new highs in an eviction effect.

However, now that inflation has become a proven macroeconomic risk, the correlation between stock and bond yields could become negative again.

Rising inflation is likely to push up bond yields even as stocks go down. The incentive to hold long-term bonds will decrease as they will no longer play the same "shock-absorbing" role. This will lead to an increase in the term premium.

So the real question is: what can the inflation regime be in the coming years?

We have entered a bullish cycle in commodities. Indeed, commodities are actual resources (food, energy, metals), and insufficient access to resources cannot be solved with quantitative easing... You can print money but not crude or wheat.

While governments deploy more or less targeted measures to cushion the increases, at the cost of deteriorating fiscal balances, central banks face the dual objective of curbing inflation while preventing bond market dislocation. This heightened uncertainty about monetary policies,- which are increasingly asynchronous-, is generating additional volatility in exchange rates. The need to accelerate energy, health and food independence will push countries to accumulate reserves, no longer of foreign exchange but of basic products. Beyond sovereignty and the need to secure supplies, the just-in-time model is out of date. Inventories will have to be reconstituted, a phenomenon that will also generate inflation that is no longer cyclical but structural.

In the long-term, we hold on to our conviction: long-term rates are too low.

While the trend is clear in the medium-term, recent movements and growth concerns suggest taking partial profits in the short-term. The Fed is unlikely to raise rates as much as anticipated by the market and should remain flexible. So should we. Make no mistake: we remain sellers but in the short-term, we are reducing amounts at stake from a risk management perspective. Remember that the 10-year bond was worth 1.17% on August 31, 2021. It can take a break at 2.75%

What impact will a change in inflation regime have on equity markets?

Inflation in itself is not a bad thing for companies, as long as their productivity gains exceed the rise in unit labour and input costs. But too strong and too sudden an inflation most often comes with economic slowdown. Today, this is our main concern with, as a corollary, its impact on companies' results and therefore, market performance. Equities are a partial hedge against inflation, but do not offer complete protection. Yet, US and European indexes are currently trading at levels higher than those seen before the invasion of Ukraine. The war would therefore be, according to the markets, good news (sic)

We do not share this view.

We are maintaining our slightly bearish bias and are increasing our selling at these levels. We believe investors are too complacent, not about the Ukrainian risk but rather about the trajectory of the global economy and the extent of the consequences of the inflationary shock.

Which asset allocation in this context?

While we take a more cautious directional stance, we are also reshaping our portfolio. We remain buyers of the Swiss franc, the dollar and are also taking advantage of certain market dysfunctions.

1. Discounted companies have seen their beta (market sensitivity) fall significantly relative to the overall equity market. They offer a substantial valuation cushion over growth stocks. We are back to buying value companies.
2. At the other end of the spectrum, defensive stocks with strong balance sheets offer attractive risk/return combinations.
3. Geographically, Chinese stocks offer remarkable entry points for a long-term allocation at the cost of very high volatility. Domestic (A shares) and Hong Kong (H shares) stocks are making a comeback in our portfolios at the expense of some European stocks.
4. We are also returning to Investment Grade credit, considering that credit spreads are now more risk-rewarding than at the beginning of the year, while taking care to actively manage duration. High-yield spreads are still not providing enough protection against risk.

The upcoming earnings sequence and company guidance will certainly dictate our allocation in the coming months. In the meantime, we prefer a perhaps overly cautious positioning to the mantra "TINA (There Is No Alternative)". Circé has warned us to steer clear of the sirens' song.

OUR CURRENT CONVICTIONS FOR EACH ASSET CLASS

Asset class		-2	-1	0	1	2
Equities	Large cap Eurozone		-1			
	Mid cap Eurozone		-1 ←			
	Small cap Eurozone	-2 ←				
	UK			0		
	US		-1			
	Emerging Markets			0		
	Japan			0		
Convertible bonds	Europe			0		
	US			0		
Currencies	USD/€			0		
	YEN/€				1	
	GBP/€			0		
	CHF / €				1	
Commodities	Gold			0		
	Crude Oil			0		
Government bonds	Core Europe		→ -1			
	Peripheral Europe	-2 ←				
	US		→ -1			
Corporate bonds	Investment grade Europe			0		
	Credit short duration			0		
	High yield Europe	-2 ←				
	High Yield USA	-2 ←				
	Emerging markets			0		
Money Market	Developed markets					2
Alternative assets	Private equity				1	
	Private Debt				1	
	Real Estate		-1			
	Hedge fund				1	

Source: ODDO BHF AM, data as of 04/06/2022

Changes vs previous month

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