ODDO BHF

MARKET *view*

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Waiting for a clear signal

> *Patience is a virtue. The good news is that the current context allows you to increase your capital by capturing carry in "short-dated" products.*

The 2022/2023 period was marked by a meteoric rise in money-market rates, from 0% to 5% in just a few months in the United States. However, the bond market has not kept up, with US 10-year yields now around 3.5%. Investors are thus sending a signal that a recession is near. **But are they really doing that?**

Before answering this question, it is essential to look at the quality of the historical signals sent by the interest-rate markets.

Are inflation and the yield curve still good signals of trends in long-term rates?

The inflation signal

The latest surge in oil prices, following OPEC+'s announcement of production cuts, shows the extent to which bond markets are struggling to assess supply shocks, reinforcing recent warnings from central banks that inflation is far from being contained. Break-even inflation expectations for the U.S. average less than 3% per year over the next year, even though it has remained at the very high level of 7.8% over the past 12 months. Given that central bank rate hikes have little effect on the exogenous drivers of inflation, the current paradox between fiscal stimulus and monetary tightening further complicates the task of economists and investors in modelling the path of inflation, both in its so-called transitory nature and in how much it is decelerating. Clearly, inflation remains, along with growth, one of the key parameters for estimating the level of long-term rates.

The yield curve signal

Other, formerly reliable bond signals also seem to have been altered. Inverted yield curves and swap contracts, which at the end of February priced in two key rate hikes in the United States for 2023, are now projecting three cuts.

Central banks artificially raised the price of government bonds during the years of quantitative easing. This was supported by regulations designed to prevent a repeat of the 2008 crisis by forcing banks to hold large amounts of those bonds. These amounts have disproportionately inflated captive demand from pension funds, insurers, index funds and even central banks' foreign-exchange reserves.

For more than a year, central bank holdings have been reversing course at a rate not seen since the 1980s. Yet even after the recent rise in yields, bond prices are still being driven by this inelastic demand. At the time, investor leverage was very low. Since then, regulation, or lack of it, has allowed unreasonable multiples for the same amount of committed capital.

The risk is therefore a deflation of this bubble. Although the probability of a soft landing has decreased significantly, the global economy should avoid a sharp recession. If so, it is unlikely that 10-year rates will remain at their current levels, unless underlying inflation collapses, which is not in our central scenario. In essence, U.S. long rates are too low. The equilibrium level is closer to 4% than to 3%.

What is the best positioning?

Rates

With the recent rise in short-term rates, positioning on 1 or 2-year rates on both sides of the Atlantic appears to us to be an excellent investment, as long as it is risk-adjusted. If a strong recession materialises, central banks will have no choice but to capitulate and lower key rates. The short end of the curve would be the main beneficiary. Only a deflation scenario would push long rates much lower. We are not there yet. **We therefore recommend that you limit your bond duration on the long end of the curve and reposition your investments on the short end.**

Credit

In the credit sphere, the situation is complex. The duration parameter is very important for investment-grade bonds, but much less so for high-yield bonds. Does this mean that we should overweight high yield in this configuration? No, but for other reasons. The recent financial instability will limit the supply of bank credit and push up default rates. "Zombie" companies will be squeezed between pressure on margins and an increase in financing costs, which for some of them will be fatal. **We therefore prefer the Investment Grade segment.**

Equities

All else being equal, if long-term interest rates rise, the present value of discounted cash flows will fall. This does not bode well for equities, unless we see a rise in earnings. However, this is not the current trend. A squeeze on margins will set in across all sectors with the ongoing slowdown in consumption. Less excess savings, lower purchasing power with resilient core inflation, and a labour market that should slowly normalise are the main elements of a more challenging scenario ahead for companies. **The focus should be on stocks of companies that generate enough growth to limit the impact of rates. In this sense, the technology sector has some real appeal.**

Conclusion

Patience is a virtue. The good news is that the current context allows you to increase your capital by capturing carry in "short-dated" products. At 3% or 5%, depending on the geographical area, the current yield does not yet cover inflation but it does more than limit the damage. And without risk. Not such a bad prospect for a few weeks, until we finally see a real signal.

Past performance is not a reliable indication of future return and is not constant over time. These examples are not investment recommendations

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