ODDO BHF

MARKET *view*

June 7th, 2023

Prof. Dr. Jan Viebig
Global Co-CIO ODDO BHF

Five topics that move the markets

> *We appreciate the rise of AI and digitalization as a mega trend in financial markets. AI is changing business models, the way we work and how we use human creativity.*

The financial markets have had to deal with a close succession of extraordinary events in recent years. We want to give our view on central questions investors are asking us frequently.

1. How will interest rates develop?

Inflation is more persistent than economists expected a couple of months ago. It is true that, after a peak of 10.6% in October 2022, the consumer price inflation in the eurozone came down to 6.1% in May 2023 (preliminary data). Despite this decline, inflation is still well above the 2% target set by the ECB. The indications from financial markets based on inflation swaps suggest that market participants expect the inflation rate in the eurozone to not drop below 3% before Spring 2024.
However, falling energy and food prices eased overall inflation even when the core inflation rate – which excludes the volatile prices for energy, food, tobacco, and alcohol - remains uncomfortably high at 5.3% in May 2023 (preliminary data) in the eurozone. We currently see second-round effects: Wage demands go up, and high energy prices from the past are pushing up prices for some non-energy products.

For all these reasons, the ECB in Europe and the Fed in the US did have not yet finished raising interest rates. The Fed recently announced, however, to consider a pause in rate hikes at their June meeting and to increase interest rates again at their July meeting. Will it be the last hike in this cycle? Well, there is some evidence for this assumption. In Europe however, the ECB is further behind the Fed. It had started later to react to the rising inflation than the Fed. Therefore, the ECB will probably stop raising rates later than the Fed. Nevertheless, we expect – based on the indications the central bankers gave to the markets – that most of the way is behind us and that we are approaching the interest rate peak.

2. Have interest rates reached a level that makes bonds attractive again?

For more than ten years, bonds have been a challenging asset class, creating return mostly by ever falling yields. Only 15 months ago, the current yield on German 10-year government bonds was negative. Coupon payments seemed like a phenomenon of the distant past. Now, German Bunds are yielding 2.3%, and Italian 10-year government bonds (BTPs) more than 4.0%. This is good news for bond investors. Although in real terms – if you account for inflation – governments bonds still have negative returns. Due to the steep rise in interest rates, the year 2022 was one of the worst years for bond investors. Now, as yields are positive and as policy rates seem to come to reach their peak in the foreseeable future, bonds have once again become an investment to consider.

Due to their yield advantage over sovereigns, we prefer corporate bonds. Especially with regard to Euro corporates, the risk premium offered is attractive as compared to long term averages. At the same time, credit risks seem manageable. Default rates may be rising in some sectors (e.g., real estate). Despite higher interest rates, slowing growth and more elevated input costs, the rating agency S&P for example expects the default rate of European high-yield bonds to rise rather moderately from 2.8% (March 2023) to 3.6% in March 2024. But the general outlook remains rather solid.

3. Will high public debt in developed countries be a drag on the markets?

Governments in developed countries all suffer from high debt. Policymakers launched generous assistance programs after the world has been hit by extraordinary events, such as the COVID-19 pandemic or the Russian war against Ukraine. Without these programs, private households, craftsmen, the self-employed and companies would have been hit hard by the economic consequences of the lockdown.
In the USA, national debt stood at 25.1 trillion dollars at the end of 2022, the debt-to-GDP ratio reached 121.2%. In the euro zone, public debt amounted at 12.2 trillion euros at the end of 2022 and the debt-to-GDP ratio stood at 91.6%, according to Eurostat.

It is true, this is far above the debt limit of 60% of GDP, that European governments once set as a threshold for their public debt in the eurozone. But the height itself does not worry us unduly, as this debt was justified by an extraordinary series of exceptional events. The increased borrowings probably helped to avoid a severe recession in developed countries. Now, however, it is becoming more and more important to reduce this debt through a disciplined budgetary policy and to control government spending in such a way that it strengthens the economy in their countries.

4. Are the equity markets overvalued?

Equities, especially in the US, are no longer cheap in our view following the recent market rally. In addition, the earnings trend is weakening somewhat in view of high inflation and a possible recession. Inflation appears to have peaked. Nevertheless, core inflation remains stubbornly high, which could require longer-term tightening of monetary policy and thus also poses a risk to earnings.

The stability of the banks also remains a risk. In this mixed situation, we continue to slightly underweight equities in our asset allocation. The markets remain vulnerable, especially as valuations have become more demanding again. Hereby, we see attractive yields in bond markets that are of great help in executing our current strategy.

5. Should investors have AI stocks in their portfolio?

Artificial intelligence (AI) has entered the public consciousness more than ever before. The presentation of ChatGPT in November 2022 showed how computers can use AI to write texts autonomously in the future. In the last year, stock market investors avoided tech stocks, which were seen as highly sensitive to rising rates. This year, much of the rise in the S&P 500 stock index can be attributed to tech companies, benefitting from the expected end of the rate hikes as well as from the excitement about AI innovations.

We appreciate the rise of AI and digitalization as a mega trend in financial markets. AI is changing business models, the way we work and how we use human creativity. From the perspective of financial markets, it is important to maintain a sense of proportion. AI and digitalization will produce winners as well as losers on the stock market.

Big tech companies like Microsoft (invested in OpenAI) or Amazon (optimal AI environment: data, cloud, user base) as well as the world's largest chip manufacturers (e.g., TSMC) are likely to capitalize on AI. Each business model has to be appreciated individually. Careful stock selection and a disciplined investment approach are key when investing in AI.

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