ODDO BHF

MARKET *view*

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High bond yields become a risk factor for the equity markets

“We consider selective investments and diversification of investments to be the order of the day this year, 2025.”

Despite the cuts in key interest rates, the rapid rise in yields at the long end of the bond markets continued in 2024, as it had in 2022 and 2023. At the beginning of 2022, ten-year US government bonds were yielding around 1.7%. At the beginning of 2024, it had risen to just under 4 % and is entering 2025 at around 4.8%. This is the highest level since the end of October 2023. By mid-September 2024, the yield had fallen again to 3.6 % but has since risen by a good 1.2 %. This is a rapid increase on the bond markets. Coupled with the successful fight against inflation, real interest rates on government bonds in particular have risen sharply. In June 2022, the US inflation rate reached a high of 7.2 %, which meant that investors lost a considerable amount of wealth in real terms – after deducting inflation – on bond purchases. At the end of December 2024, the rate of price increases in the US was 2.9 %, meaning that investors in bonds are now also making a profit in real terms.

The rise in yields could become a risk factor for the US stock markets, which have been on a remarkably long upward trend for many years. High bond yields make debt securities attractive again, even in the low-risk investment-grade area, for investors who, in the face of low bond yields, had previously switched to equities but in reality value the reliable interest payments from bonds. In addition, higher interest rates in the bond markets are a burden for many companies seeking financing. Furthermore, higher interest rates result in lower future discounted valuations, since the discount rate used for future cash flow is higher. Thus, higher yields in the bond markets lead to lower company valuations.

For us, this does not mean that we would turn our backs on the stock market. However, we believe that investors need to be prepared for the fact that price gains will be less strong than in previous years and that the rise in interest rates will darken the earnings outlook for some companies. According to Factset, earnings of companies listed in the S&P 500 equity index are expected to grow by 14.6 per cent on average in 2025. Since this figure is an average, it means that some companies will report significantly higher earnings growth and others will presumably remain well below it.

In our view, this will be the big challenge in this investment year: identifying those companies that will suffer the least from the rise in interest rates at the long end of the bond market. In this market phase, the investment approach we are pursuing anyway could prove its worth.

In the equity markets, we are looking for companies that have a convincing business model, have built a strong market position, achieve a high return on equity, are appropriately valued and – last but not least – have low debt. These companies can be found in the US and European equity markets.

The US market also benefits from being supported by a robust economy. In its economic outlook published in December, the OECD estimated the growth rate of the US economy at 2.8% for 2024. For the current year, 2025, it expects a slowdown to 2.4%. This means that American growth will be significantly higher than in Europe – for the eurozone, the OECD expects economic output to rise by only 1.3 % in 2025. The economic policy announced by the new US President, Donald Trump, will have contradictory effects. On the one hand, the announced ban on immigration is likely to exacerbate the shortage of labour and the increase in import duties will make imports to the USA more expensive. This will weigh on American consumers and possibly slow the return of inflation. On the other hand, US companies could benefit if competitive pressure eases as a result of higher import prices.

For many years, the US stock market has been the big favourite among international financial centres. Successful technology companies have contributed significantly to this, companies such as Amazon, Meta, Apple, Google, Nvidia, Tesla or Microsoft, which have been grouped together under the term 'The Magnificent Seven', in reference to a Hollywood classic. But in addition to these seven high-flyers, many other stocks can be found on Wall Street that represent excellent investments.

For this reason, we have a high weighting for the US in our equity portfolios. In our model portfolio, they account for 52 %, although our internal benchmark is 35 %. We are comfortable with this overweighting in view of the extraordinary earnings power that some US stocks exhibit. However, we do not follow those investors who align their US allocation with the MSCI World equity index. In this index, US equities account for around 74 %. We consider this to be unreasonably high from a risk perspective. The possibility of a price collapse is not our top priority here – we cannot, of course, completely rule out this scenario, but we do not consider its probability to be alarmingly high. Rather, we are preparing for the fact that further interest rate hikes will put more companies under pressure than in the past and thus cloud the outlook for the market as a whole. Thus, we consider selective investments and diversification of investments to be the order of the day this year, 2025.

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