ODDO BHF

INVESTMENT *Strategy*

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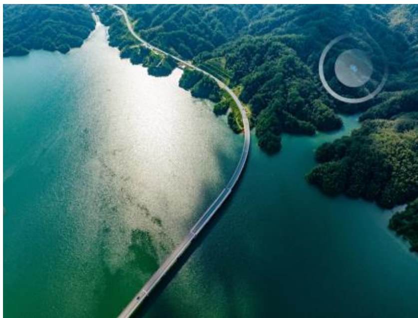
The US: An Artificial Paradise?



> *For the time-being, US stays a non-artificial paradise. It remains our favorite choice on Equities for putting money back to work and offset (at least partially) the yield erosion*

Broad diversification is rightly regarded as the recipe for long-term success in asset management. Last year, however, the most successful investors were those who threw this advice to the wind. Those who stuck to seven mega tech companies, the so-called Magnificent Seven, more than doubled the return of a Nasdaq ETF. Thanks in part to technology companies, US equities are now significantly more expensive than those in the eurozone, which is characterized by political instability and weak growth. Donald Trump's election victory has added to the tilt towards the US in portfolios. And given the alternatives, most investors seem reluctant to leave the artificial paradise of the US equity market in the short term. In the longer term, however, regional and sector diversification will become more important again, given the geopolitical risks and the high concentration in the equity market.

Macro paradise, USA!

There are good reasons for the US's stock market dominance. Tax cuts and deregulation promised during the election campaign are additional stimulus, but the US is already leading in terms of growth momentum and productivity gains. Analysts' forecasts and sentiment indicators also point to continued growth in the US, while China is stagnating due to weakness in the property market and domestic consumption, and the largest EU economies are facing declining growth figures. Given the high level of political uncertainty in France and Germany, the expected further interest rate cuts by the ECB are unlikely to trigger an economic miracle. For export-dependent German manufacturers, this would require a sustained recovery in China, which is not expected before the end of the year.

The disinflationary trend should continue to support risky assets worldwide. It has recently stalled in the US, where core inflation is well above the 2% target, but is still intact in Europe. With the ECB having more room for manoeuvre to cut rates in the face of a sluggish economy, monetary policy on both sides of the Atlantic will continue to diverge. It remains to be seen whether the Trump administration will trigger a surge in inflation. According to calculations by Oxford Economics, higher import tariffs, especially against China, would add a full percentage point to the general price level in the US. The recent sharp rise in long-term US government bond yields could also derail the US blue sky scenario, but we're not there yet if the 30-y mortgage rate does not skyrocket.

According to our analysis, the picture for investors remains mixed: growth is slowing in different regions of the world, but there is no recession;

the disinflationary trend continues; loose monetary policy and a possible stimulus program in China should provide stimulus; Donald Trump's erratic governing style, political uncertainty in Germany and France and geopolitical crises remain negative factors.

In US we trust

For investors, this means that the US continues to offer more opportunities than other regions. Valuations are very high, but they are still supported by high profit margins and high Return on Equity, unlike in other regions of the world, although these margins have come under more pressure recently. According to FactSet, market participants expect average earnings growth of 14.6% for the S&P 500, but only 8.2% for stocks in the Stoxx Europe 600 in 2025e. There are signs that the extreme polarization in the US equity market is at least beginning to abate. With stocks in the S&P 500 moving less uniformly than in the past, there are attractive opportunities for active investors who focus on specific themes and individual stocks. What could spoil the good mood for US equities? Most likely the amount of spending by large data center operators on AI-capable semiconductor chips, which are responsible for much of the additional investment in this area. If the adoption of AI stalls, the decline in investment would put a damper on the stock market. But this is not our central scenario.

Some reasons that could bring Europe back in the game

European equities are massively undervalued (and oversold) relative to their US counterparts. Even ex Magnificent-7, the discount of Europe vs US remains at its highest at 30%. Additionally, ECB rate cut expectations are still too cautious and should surprise positively. However, **this is not yet enough to reverse investors' negative sentiment towards the Old Continent. Although we believe an underweight position would be overdone, investors should wait for signals to increase their exposure. The focus is not only on the important export market of China, but also on Germany, where elections will be held at the end of February**. In the third year of recession, the new government is expected to take concrete measures to support the sluggish economy. Steps to reduce corporate taxes, which are high by international standards, and to ease the burden of energy prices could encourage German companies to invest, which would benefit Europe as a whole. Until then, stock-picking must favor European stocks with a strong US exposure - either through local production or through services - not impacted by tariffs.

Where are the other paradises?

Since the introduction of Chat GPT, **there have been many predictions of a premature end to the AI boom. We believe that generative AI is just the tip of the iceberg.** All the major internet companies, from Open AI to Google and Apple, are currently working on AI agents that will autonomously search the web for us. This would have serious implications for the way we use the internet and how that use can be monetised. The first agents have already been integrated into software solutions from Salesforce and Service Now. AI agents are also needed to develop AI solutions for robotics or autonomous driving. The rapid pace of development in this area argues for active and anticipatory management, as not all of today's high-flyers will survive the competition unscathed.

As the share of electricity in energy consumption is set to increase massively in the coming years (partly due to datacenters), the investments needed for electrification will open up long-term earnings opportunities. The same applies to investments in sustainable energy. Most of the necessary CO_2 savings will be achieved through technology rather than behaviour change. As the costs of these technologies fall as they become more widespread, we believe that ecological transformation will remain a growth theme, despite headwinds from the US. The same is true for the European Defence sector. With the new US administration widely expected to call on Europe to cover more of its security needs, we see the potential for upside pressure to defence budget plans in Europe. This supports our thesis of a multi-year upcycle in European defence spending and multiple expansion at the stock level.

Significantly undervalued US Small Caps and European Mid Caps also offer interesting diversification opportunities in the equity world. Cyclical stocks have performed well recently on the back of overly optimistic economic expectations, so we would favour defensive growth stocks in the near term. Emerging markets have disappointed recently, but now offer a lot of catch-up potential. We expect the Chinese government to take decisive action to stabilise the economy, particularly in response to the tariff hikes, which will have a knock-on effect on other Asian markets.

As regards Rates, we maintain our conviction that duration should be increased for Europe, but not too much for the US with the term premium resuming an upward trend, leading to higher yields.

As regards Credit, we reiterate our call that carry justifies an exposure to Corporate Bonds, although short maturities are more attractive.

As regards Diversification, we believe it is too early to be long Euro. We also maintain a fundamentally low exposure to oil, suffering from an imbalance between supply and demand.

Conclusion

For the time-being, US stays a non-artificial paradise. It remains our favorite choice on Equities for putting money back to work and offset (at least partially) the yield erosion linked to recent interest rate cuts from Central Banks. However, it doesn't come cheap, and extreme dispersion between perceived winners and losers since the Trump election means that selectivity and cautiousness in stock-picking are key. Some alternatives outside US are also part of our playbook. Is Europe (as a whole) part of it on Equities? Despite cheap valuations, lower positioning, a weaker euro, and potential for reforms in Germany and peace in Ukraine may improve the asymmetry for Europe, we consider it is too early to reposition massively on the old paradise.

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Past performance is not a reliable indicator of future returns and is subject to fluctuation over time. Performance may rise or fall for investments with foreign currency exposure due to exchange rate fluctuations. Emerging markets may be subject to more political, economic or structural challenges than developed markets, which may result in a higher risk

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