ODDO BHF

MONTHLY INVESTMENT *Brief*

11 JUNE 2025

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When the "Big Beautiful Market" meets the "Big Beautiful Bill"

> *Financial markets have shown remarkable resilience post Liberation Day, but the current level of the "Big Beautiful Markets" increasingly reflects optimism rather than realism.*

Despite geopolitical risks, the last few weeks have felt like a welcome gentle breeze in markets, which have chosen resilience over retreat. Yes, there is a lot of noise, but positive micro and macro signals are louder and are shaping a "Big Beautiful Market". Ultimately, investors are no longer chasing calm but have learned to thrive in the noise. The recent rally reflects that the "Big Beautiful Market" is adapting faster than it is fracturing. Policy may twist and yields may rise, but the foundation is firming, at least for now. If we need to address the question of why financial markets are up, the central question is "how high is too high" and what could carry them further…Not sure the "Big Beautiful Bill" promised by Donald Trump will help.

Why are stock markets so high?

Market conditions have stabilized following the intense post-Liberation Day turmoil. Most tariff-sensitive assets are now above the levels registered prior to Trump's inauguration. Before assessing the likelihood for another leg higher for risky assets, let's have a look at the three main drivers behind the recent sharp rebound.

Soft data, strong momentum: Amidst all the noise surrounding trade and Trump's twists and turns, resilient activity data has helped equity markets to climb the wall of worry since Liberation Day. The May PMI figures confirm an improvement in confidence due to fewer concerns about US tariffs. The US composite index beat estimates, increasing to 52.1 from 50.6, driven by a jump in manufacturing and services, to 52.3 each. In Germany, business sentiment has also improved slightly corroborating the message from other soft-data indicators of Eurozone business activity. Overall, the probability of recession has sharply decreased in recent weeks and 2025 growth forecasts for the main regions have been revised upwards.

Diminishing tariffs effect: Of course, there is always a risk of unexpected storms, but markets have grown accustomed to it and react less drastically to tariffs threats, as these are now mostly considered non-credible. For example, the Stoxx Europe 600 was down less than 1% after the 50% tariff threat on Europe in May, compared to a 5 % fall seen after the 20% tariff announced on Liberation Day. We believe that, as a base case, company earnings expectations and GDP forecasts now factor in a 10% baseline tariff plus sector-specific tariffs (versus the current 15-17%, which is still the highest in decades), which explains much of the recent rebound.

Renewed optimism on earnings: Corporates not only delivered healthy Q1 earnings growth of +10% for the S&P 500 and +2% for the Stoxx Europe 600, but more importantly, their guidance and tone were better than expected at a time when the implied aggregate tariff rate was ~20%. As a consequence, the earnings sentiment reflected by the Earnings Revision Ratio has skyrocketed. This helped alleviate concerns about an abrupt end to the business cycle and earnings growth.

We believe that the recent market resilience can continue, particularly in Europe. Global policymakers want a successful outcome from the trade talks. Tariff uncertainty is being increasingly priced in as a fact of life rather than a surprise. Recent monetary easing (along with the expectation of further easing) is still filtering through to ease financial conditions. Furthermore, the market recovery itself means that markets are avoiding negative wealth effects and tighter financial conditions. Nevertheless, we have identified some areas that require attention.

After the "trade war", the "capital war" is the next narrative to pay attention to

The first point of interest lies in the "One Big Beautiful Bill Act", which would extend the 2017 tax cuts and introduce new tax and spending measures. If the "Big Beautiful Bill" is passed, it is possible that equities will benefit from continued support for growth which could outweigh the negative effects of higher rates. However, the devil is in the detail, which could change the overall picture. One worrying detail is section 899 of the tax bill currently in the Senate. This section introduces retaliatory tax measures against non-US individuals, corporations, and governments from countries that impose "unfair foreign taxes" on US persons (like the Digital Services Taxes, also known as the "GAFA tax" in Europe). The main taxation channel for listed companies will be an increase in withholding tax, starting at 5% and then increasing by 5 percentage points each year up to a maximum of 20% and applicable to both active business income (profits) and passive income (dividends, interest, capital gains). It will affect non-US individuals, foreign governments, sovereign wealth funds (which are explicitly included in the bill), foreign corporations (>50% owned by non-US entities), and foreign trusts. It is expected to raise USD 116bn in revenue over the next decade. Another section of the tax bill is the planned tax on overseas remittance transfers, which could generate USD 22bn over ten years. Beyond these figures, these two provisions cast doubt on the future of full capital mobility in the US economy. We do not have the answer, but it becomes (once again) obvious that the Trump administration has shifted the narrative. Reinvesting excess dollars in the US is no longer a slam dunk for foreigners. Firstly, due to the uncertainty surrounding policy. Secondly, because it is increasingly apparent that Trump's promises to rein in government spending are false. Thirdly, and perhaps most importantly, all of the various Trump measures are linked and driven by the idea that "foreigners will pay".

Keep a close eye on US bond yields

As highlighted in the past two editions of our Monthly Investment Brief (*My name is Bond, Donald Bond* published in April 2025 and *Habemus Donald Trump for another 1,300 days* published in May 2025), the second point of concern lies in the fact that the equity rally faces a looming threat: a potential resurgence in rates volatility. With the nominal 10-year US Treasury yield now back at 4.5%, it is important to note that the term premium is at its highest level since 2014. Additionally, the "Big Beautiful Bill" has shifted market focus to the US fiscal sustainability concerns. Let's keep in mind that the US runs twin deficits of 10-11% of GDP, with roughly 6.5% of GDP on the budget, and almost 4% on the current account. Any renewed spike in rates volatility, potentially triggered by further term premium repricing linked to fiscal headlines, would destabilize lofty equity valuations. The Trump administration's public rift with its former budget hawk only heightens this risk. Looking back at the past 20 past years, US equities tend to appreciate alongside rising bond yields when the market expects economic growth to increase. However, they struggle when yields rise due to other factors, like fiscal concerns. Regardless of the macro drivers, equities have historically struggled when bond yields have risen by more than two standard deviations in a month. Recent weeks have shown that we are in such a pattern. Another concern related to US bond yields is the elevated level of real rates, which raise the cost of capital. Considering equities make up 30% of the total assets of US households, the impact of high real rates is detrimental to the US credit cycle, US consumption, and US growth.

How to position?

- **Equities**: We maintain a slight overweight position on equities but recommend reducing the tracking error and moving closer to neutral. Following the recent bounce, we believe that a softer leg is in store next for US equities for six reasons. Firstly, although soft data is recovering, the gap with hard data remains significant, and weaker activity ahead could coincide with an increase in US inflation prints from July. Secondly, bond yields could rise due to a pickup in inflation, as well as worsening fiscal concerns (Section 899 could penalize investment in the US), which could also lead to further USD weakness. Thirdly, consensus earnings growth projections of 10% for 2025 and 14% for 2026 appear elevated. Fourthly, at 22x, the US forward P/E ratio remains stretched. Fifthly, on the back of the equity rebound, positioning and sentiment are far from cautious anymore, US households' equity weight as a percentage of total assets is at a record high. Sixthly, the "safe haven" status of US assets is being questioned and the great rotation away from US towards Europe and emerging markets could gather pace. We maintain a slightly overweight position on European equities. Fiscal expansion by Germany through both infrastructure & defense plans (expected to impact German GDP growth by 1.3-1.6% in 2026) and expected tax cuts for businesses estimated at EUR 50bn are clear sources of support. We are quite confident of a positive outcome to the trade negotiations (with Europe buying more energy and more defense equipment and easing the Digital Services Tax) and the Russia-Ukraine ceasefire is a wildcard. Within Europe, we prefer large and mid caps with a clear tilt towards Germany. As regards sectors, defense could see some bouts of profit taking, but we recommend maintaining a structural long position in the sector. Financials, construction materials, chemicals and utilities are also among our convictions. Tactically, we prefer emerging markets due to the potential peak in trade headwinds versus China, a potentially weaker USD and increased stimulus in China. The region is cheap and under-owned. Within Emerging Markets, we continue to be bullish on Chinese tech companies.

- **Rates**: We have neutralized our short duration call at the beginning of the month through buying longer maturities on both the US and Europe due to the ongoing disinflation process, recently confirmed by the soft CPI print in the US, which fuels rate cut talks.

- **Credit**: We become slightly more constructive on credit risk as the risk of a global recession has faded somewhat. However, spread levels remain low and only partly compensate for a potential slowdown in growth, especially in the case of long duration high yield. In contrast, short-duration investment grade and high yield should continue to benefit from still attractive yields and their relatively low drawdown potential. We maintain a preference for European credit over US credit.

- **Currencies**: We maintain our slightly short position on the USD as long-term indicators such as PPP and current account balances point to an appreciation of the euro. In addition, a slowdown in US growth could weaken the USD.

Conclusion: The "wall of worry" has not disappeared, but investors have learned to climb it

Financial markets have shown remarkable resilience post Liberation Day, but the current level of the "Big Beautiful Markets" increasingly reflects optimism rather than realism. Meanwhile, market positioning is no longer cautious, with investor sentiment turning increasingly bullish despite some unresolved downside risks. While there are still some selective opportunities, especially in Europe and emerging markets, the overall conditions argue for a more cautious and balanced approach. Yes, the sky is the limit but don't forget that "pigs (markets) don' t fly".

Stay tuned.

READ THE PRESENTATION

ODDO BHF Asset Management SAS (France)
A portfolio management firm certified by the French Financial Markets Authority (AMF) under n° GP 99011.
Established in the form of a simplified joint-stock company with authorised capital of €21,500,000.
Entered into the Paris Register of Trade and Companies under number 340 902 857.
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