ODDO BHF

INVESTMENT *Strategy*

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In the triangle of uncertainties - AI, FED and Elections

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If European investors took a break from the news cycle in their summer vacations, they may be surprised on their return by how little appears to have changed in the capital markets at first glance. Artificial intelligence continues to drive stock markets, geopolitical tensions persist, and companies are nevertheless increasing their profits. However, several developments are undermining the foundations of the bull market: the ongoing risks in the Strait of Hormuz, accompanied by rising energy and transport costs; the US Federal Reserve's increasingly unpredictable monetary policy; and growing doubts about the credibility of efforts to combat inflation amid government intervention in bond markets and rising debt levels. Against this backdrop, the sharp increase in long-term bond yields signals mounting investor skepticism. At the same time, the higher interest-rate environment is making it more difficult for US growth companies to secure financing.

Investors are therefore confronted with the question of whether the recent increase in equity market volatility signals the beginning of a necessary correction in an overheated market environment or merely a temporary interruption in the AI-driven bull market. Several warning signs support the correction scenario: a hedge fund focused on AI investments was forced into emergency asset sales; the South Korean stock market, heavily weighted towards semiconductor stocks, experienced significant turbulence; and substantial investment in AI infrastructure led Alphabet to report its first negative free cash flow since its IPO. At the same time, the optimistic scenario is underpinned by continued growth in demand for computing capacity to support AI applications. So far, there are no indications of an oversupply of data centers. Nvidia expects its revenues to increase by 70 per cent by 2028.

Greater caution in an uncertain market environment

We recommend adopting a more cautious stance in the months ahead rather than positioning for further market gains. Following a first half of the year marked by strong risk appetite, we believe markets are now entering a phase of increased caution and more selective investment. Rising energy prices driven by the conflict in Iran, growing uncertainty over the eventual winners and losers in the AI race, and higher long-term interest rates are likely to weigh on investor sentiment. Moreover, cash flow generation matters more to equity investors than future earnings expectations, and warning signs are beginning to accumulate. Although quarterly results were strong, they were distorted by one-off effects, such as investments in private companies accounted for on a mark-to-market basis (where successive funding rounds at higher valuations are reflected in the quarterly results of hyperscalers).

Given investors' elevated expectations and the low cash allocations of many equity funds, the risk of disappointment and profit-taking is increasing.

Equities – there's more to it than just AI hardware

How should investors position themselves in such an environment? Much will depend on whether the massive investments in artificial intelligence generate sustainable long-term returns. This spending is driven in no small part by the geopolitical competition between the US and China. While the US focuses on high-performance AI models, China is concentrating on the broad application of AI and open-source solutions. In this race, steady profit growth is no longer the only decisive benchmark. Rising depreciation and higher debt levels could weigh on profitability. The key factor remains that return on invested capital (ROIC) must consistently exceed the weighted average cost of capital (WACC). The so-called hyperscalers, such as Amazon, Meta and Google, still have sufficient room for maneuver in this regard. The situation differs for the 'neoclouds', which provide AI computing capacity to other companies and are currently destroying capital.

For investors seeking to avoid the risks associated with the semiconductor and data center sectors, the AI trend also offers alternative investment opportunities. Numerous industries with significant AI application potential are still at an early stage of development. These include legal services, film and television production, and biotechnology. For example, pharmaceutical company Moderna is using AI to develop a personalised cancer vaccine that has produced positive results in a pivotal trial. Analysts describe this as a scientific breakthrough.

Software companies, which were hastily declared obsolete at the start of the year, are also proving resilient in the face of potential disruption from AI. Salesforce, a specialist in CRM solutions, has demonstrated how its software can be enhanced using AI tools. Particularly in the case of AI-related stocks, careful analysis of individual companies is crucial at this stage. This creates opportunities for active investors. It is not only the construction of data centers that is driving demand for electricity and grid infrastructure. The opportunity set now extends far beyond power generation and includes the infrastructure that enables electrification in the first place. Alongside energy producers, providers of grid technology, storage systems and energy management solutions are expected to benefit most.

In Europe, the economic recovery is supporting banks, industrial and defense stocks, as well as German mid-caps. In Asia, Chinese and South Korean equities are once again offering potential following recent price declines, while higher bond yields could weigh on Japanese stock.

Bonds – limited return potential

In the bond markets, return potential is limited in the short term. The sharp rise in long-term yields is a structural phenomenon, as markets are demanding higher risk premiums for inflation, government debt and political uncertainty. In the US, the combination of a high fiscal deficit, rising debt levels and weakening demand from foreign investors could push yields even higher over the long term. In the eurozone, risks are particularly pronounced in France, where there is little prospect of debt reduction ahead of next year's presidential elections. Given the elevated uncertainty and an unfavourable macroeconomic environment, a neutral to slightly underweight duration stance is recommended. Return prospects in credit markets are also constrained by very tight spreads. In this environment, credit selection is essential, while short maturities continue to offer an adequate risk-return profile.

Having emerged from its recent period of weakness, gold remains an indispensable portfolio diversifier. In recent years, demand for commodities has increasingly shifted from purely consumption-driven use towards investment. As a result, prices are more heavily influenced by investment flows, which may tend to lead to persistently higher commodity prices and structurally increased inflationary pressure. In the long term, however, this effect could be partially offset by productivity gains resulting from the use of artificial intelligence.

Short-term caution, long-term confidence

Markets have largely priced in expectations of sustained growth, easing inflation and accommodative monetary policy. At the same time, structural risks are increasing. Elevated valuations and the substantial capital needs of ongoing investment programs are raising the risk of a market correction, without undermining the long-term growth trend. Against this backdrop, Europe, and Germany in particular, currently offers more attractive opportunities than the US. A higher cash allocation also gives investors greater scope to take advantage of potential market setbacks. This is a time for consolidation rather than a major correction. Let the market catch its breath.

READ THE PRESENTATION

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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