ODDO BHF

INVESTMENT STRATEGY

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Time to put your money back to work

"We remain constructive on equities, with a particular focus on secular growth themes such as AI and the ecological transition. At the same time, we are adapting our portfolios to account for the new interest rate cycle"

As with a sweltering summer afternoon when thunderstorms occasionally break out without altering the long-term weather pattern, this summer has been similarly turbulent for the capital markets. Risky assets have experienced broad gains since the beginning of the year, but tensions mounted, culminating in a sharp market decline in early August. This turbulence was sparked by a combination of increasing recession fears in the US and a surprise interest rate hike in Japan, which rattled carry trade operators. Equity volatility surged, with the VIX spiking above 65. However, central banks in both the US and Japan acted swiftly to contain the sell-off through effective communication, and major market indices quickly bounced back to record highs on the prospect of rate cuts.

Despite this recovery, the underlying imbalances contributing to market fragility remain unresolved. Beyond technology stocks, valuations seem reasonable—though this holds true only if lofty earnings expectations can be met. Should economic slowdown signals intensify, volatility could resurface quickly, as seen in early September. Jittery market sentiment is likely to persist into the fall.

Our Take for the Next Four Months: Soft Landing, Disinflation, Rate Cuts, and Politics

1. Soft Landing: Slower Growth, No Recession

The global economy is showing signs of deceleration, but a full-scale recession seems to be off the table. Major economies are recalibrating after aggressive tightening policies, and while consumer demand has weakened slightly, there remains enough momentum to avoid a contraction. That is why we are the "soft-landing" camp, despite this not being the most common case after a period of rate hikes. It is also worth mentioning that the balance of risks has recently shifted for the Eurozone with strong 2025e GDP revisions (+1.3%).

2. Disinflation: Prices Easing Gradually

Inflation, once the central concern of global markets, appears to be easing (less than 2% expected for both US and Eurozone in 2025). This gradual reduction in inflationary pressures reflects a cooling of post-pandemic demand, improved supply chains, and central banks' efforts to rein in prices through higher interest rates. For consumers and businesses alike, this easing pressure offers a respite from soaring costs.

3. Rate Cuts: A Dovish Turn for Central Banks

With inflation seemingly under control, many central banks are shifting to a more dovish stance helped by an adequate cooling of the labor market.

Investors should prepare for this change in policy, as it could significantly affect bond markets, borrowing costs, and capital allocation strategies. Lower rates are historically favorable for equity markets, as they encourage borrowing and investment.

4. Politics: Risks on the Rise

The political environment is increasingly volatile, adding another layer of complexity to market dynamics. In the US, an election year looms, which could lead to increased market uncertainty. If both candidates' fiscal measures would deepen the federal budget deficit, the US election risk is more on Trump (trade tensions, inflationary measures, independency of the FED…). In Europe, political fragmentation within the Eurozone poses challenges, while geopolitical tensions in the Middle East remain a perennial risk. Investors must keep a close eye on these developments, as geopolitical shocks can quickly disrupt economic stability and lead to sharp market corrections. The interplay between these political risks and economic fundamentals will be crucial in determining future market trends.

3 Sources of Added Value to capitalize on the current market environment: Rotation, Duration, Carry

With the prospect of rate cuts on the horizon, money market investments are becoming less attractive. Investors must now consider how to put their money back to work in a volatile market. Three tactical strategies can unlock added value.

1. Rotation: Reallocating across Sectors and Assets

Sectoral polarization has been extreme. Just 7 to 10 stocks have accounted for half of the performance of key indexes like the S&P 500 and Eurostoxx—not only this year but over the last three to five years. A new cycle is emerging with the onset of rate cuts, providing opportunities for a shift into more defensive sectors that stand to benefit from easing rates and upward earnings revisions. Real estate, construction, consumer staples, and utilities are sectors with historically strong performance due to their sensitivity to interest rate movements. For those seeking duration exposure, these sectors are worth considering. We also detect strong opportunities in UK, particularly on Small & Mid Caps. Emerging countries shall be considered as the inflection point is now not far away.

2. Duration: Managing Interest Rate Sensitivity

Duration measures a bond's sensitivity to interest rate changes. As central banks prepare for rate cuts, managing duration becomes critical. But which duration should investors focus on? Most of the rate cuts are already priced into sovereign bonds, such as the German 10-year offering a return of 2%. Investors should instead focus on credit, which still provides a reasonable premium.

3. Carry: Enhancing Yield in a Lower-Rate World

In the current environment, where inflation is slowing but still present, carry strategies can provide steady income while also mitigating some downside risks. By investing in assets that offer higher yields, such as corporate bonds, investors can lock in returns that compensate for potential volatility elsewhere in the portfolio. In our view, investment-grade bonds now offer better prospects for returns than government bonds and would continue to perform well even in a negative economic environment. High-yield bonds continue to benefit from a historically low default rate and have sufficient buffers to withstand a sharp rise in risk premiums. Here, short maturities offer the greatest potential.

What if there are turbulences?

Several risk factors could disrupt the expected soft landing. A potential return of Donald Trump to the White House would bring trade policy back into the spotlight. As in 2018, uncertainty surrounding punitive tariffs could especially hurt export-dependent industries like automotive manufacturing, particularly in Europe. Additionally, a delayed rate cut is no guarantee against recession. While we believe this risk remains low, many investors are uneasy, remembering the economic downturns of the past. Moreover, inflationary surprises cannot be entirely ruled out. Whether driven by rising wages or falling prices due to cheap Chinese exports, inflationary or deflationary shocks remain possible. The market collapse in August should serve as a reminder of how quickly conditions can change. We are closely monitoring currency developments, as further unwinding of carry trades could trigger renewed volatility and push exchange rates higher.

Volatility as an opportunity

Periods of heightened volatility are inevitable in the coming months, but they also present opportunities to gain exposure to secular growth themes at more attractive valuations. Our focus remains unchanged: Artificial Intelligence (AI) and the green transition continue to offer long-term potential for exponential growth. The productivity benefits of AI will not happen overnight, and success will depend on proactive stock selection. Robotics, where Elon Musk envisions a future with one billion humanoid robots by 2040, and AI-driven pharmaceutical research remain underexplored by most investors, presenting significant opportunities.

Similarly, we believe the green revolution is far from over. Clean energy's expansion is not only socially desirable but also offers long-term potential for outperformance. Global investment in sustainable energy has surged more than eightfold over the past decade, driving down costs and making clean energy viable across various sectors. This momentum will unlock a broad range of investment opportunities in the years to come.

To sum up, we remain constructive about equities, with a particular focus on secular growth themes such as AI and the environmental transition. At the same time, we are adapting our portfolios to account for the new interest rate cycle through a tactical approach that balances Rotation, Duration, and Carry strategies.

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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