Europe at a crossroads

INVESTMENT STRATEGY

JULY 2020

In recent weeks, Europe has awoken from a Covid 19-induced coma after three months of stagnation. The street cafés and offices of the metropolises are slowly filling up again, the beach promenades are awaiting summer vacationers. The stock markets have also recovered after the shock losses of the spring. Almost all risky assets have recovered at least 50% of their crisis losses. While the crisis winners from the technology and health care sectors were in demand during the lockdown, from mid-May investors' risk appetite turned to cyclical industrial stocks. Long-term, structural investment trends such as digitization, AI and sustainability were even strengthened by the corona crisis. Thanks to support from central banks in Europe and the USA, high-yield bonds gathered large inflows worldwide. So, everything back to normal? Or have the capital markets once again decoupled themselves from macroeconomic reality?

Whether the rally after one of the shortest bear markets to date is sustainable will ultimately depend on whether we succeed in slowing down the further spread of Covid-19. In most developed countries, the number of new infections is declining. However, there are still regions with outbreaks of new cases and the risk of a second wave will certainly accompany us for quite some time.

Emerging stronger from the crisis?

As severe as the shock caused by the global containment measures was - 147 countries worldwide are in recession (compared to 88 during the Great Financial Crisis of 2009) – growth could now go up just as fast. This is indicated by the sharply rising figures from China for infrastructure investments and retail consumption. The decisive factor for the development in Europe was the reaction of governments and central banks, which acted quickly and massively. With the European Recovery Fund proposed by the European Commission with a volume of 750 billion euros, for the first time there is a chance of a solidarity-based balance between countries with fiscal leeway such as Germany and France and those without such leeway such as Spain and Italy. Europe is at a crossroads here - if it succeeds in reconciling solidarity with value creating investments, it could emerge stronger from the crisis.

Apart from the dreaded second Covid-19 wave - which we are carefully monitoring looking at high frequency data- there are, however, other risks that threaten to slow down the upswing. Apart from the US where fast job reallocation plans are made possible by the market structure, unemployment could prove more persistent than expected due to the structural changes triggered by the pandemic. If the recession turns out to be more severe than expected, more company bankruptcies will become inevitable. The US presidential elections in the autumn and the Brexit negotiations increase political uncertainty. Especially in the US, a victory of the Democrats will be accompanied by an increase in corporate taxes with direct impact on EPS. It remains to be seen whether current valuations adequately reflect these risks. How should investors position themselves in this environment?

Has the big rotation really begun?

Equities: Looking at the equity market performance and the P/E ratios, it seems to be as if 2020 were not part of the equation anymore. Interestingly, Value stocks have clearly outperformed Growth and Quality stocks since mid-May. Has the big rotation that many investors have long been waiting for finally begun? The large valuation difference between growth and value stocks in terms of price-to-book ratio could be an argument for this. Especially, IT stocks which were in demand during the Corona crisis, have achieved historically high valuations. However, with only modest signs of rising inflation and interest rates, support for a sustained value renaissance is limited. Typical value sectors such as automobiles or telecommunications also face burdensome challenges with necessary investments in e-mobility and the build-up of the 5G network. In this context, we continue to favor IT and healthcare stocks that are benefiting from long-term trends, industrial stocks that are supported by the economic recovery and banks that have already largely adapted to the tightened regulatory environment.

Fixed income: The rally in the high-yield segment has been fast, largely pushed by central bank support and tight supply (only partially offset by former investment grade bonds, so-called Fallen Angels). If we stay constructive in the medium/long-term, we consider there is maybe less potential in this segment in the short-term. By contrast, peripheral government bonds and investment-grade credit continue to offer at least some yield potential.

Currencies: Our conviction is that Euro may finally appreciate vs. Dollar. We think this upward movement is going to be driven by a limited interest rate differential, deepening twin American deficits, and an unprecedented European solidarity oriented towards growth and investment. Last, it is worth mentioning the pandemic, which is currently more problematic in the US than in Europe.

There is thus much to suggest that risky assets will continue to recover: falling infection figures, maximum support from governments and central banks, less volatility, businesses returning to normal at the end of the lockdown phase, first signs for an economic recovery. As soon as earnings expectations of corporates begin to brighten again, we can indeed return to normality. But until then, caution is still necessary.

Laurent Denize

Global Co-CIO
ODDO BHF Asset Management

LEARN MORE

Disclaimer

ODDO BHF Asset Management (ODDO BHF AM) is the asset management unit of the ODDO BHF group. ODDO BHF AM is the joint brand of four legally independent entities: ODDO BHF Asset Management SAS (France), ODDO BHF Asset Management GmbH (Germany), ODDO BHF AM Luxembourg and ODDO BHF Private Equity (France).

The following document was produced by ODDO BHF ASSET MANAGEMENT SAS for promotional purposes. Dissemination of this document is under the responsibility of any distributor, broker or advisor. Potential investors are invited to consult an investment advisor before subscribing to the fund regulated by the Autorité des Marchés Financiers (AMF), the Commission de Surveillance du Secteur Financier (CSSF) or the Federal Financial Supervisory Authority (BaFin). Investors are hereby informed that the funds incur a risk of loss of invested principle, as well as a number of risks incurred from investing in portfolio instruments and strategies. When investing in the fund, investors are required to read the Key Investor Information Document (KIID) or the fund prospectus, in order to obtain full information on the risks incurred. The value of financial investments is subject to both upward and downward fluctuations, and it is possible that invested sums will not be returned in full. The investment must be in accordance with the investor's investment goals, investment horizon, and ability to cope with the risks incurred by the transaction. ODDO BHF AM assumes no liability for any direct or indirect damages of any sort resulting from the use of this document, or any portion thereof. Information is provided solely as an illustration and is subject to change at any time without prior notice.

Past performances are not a reliable indication or guarantee of future performances, which are subject to fluctuations over time. Performances are expressed on an after-fee basis, with the exception of any subscription fees that may be charged by the distributor, and of local taxes. The opinions expressed in this document reflect our market expectations at the time of publication. They are subject to change with market conditions and may under no circumstances incur the contractual liability of ODDO BHF ASSET MANAGEMENT SAS. The net asset values provided in this document are meant only as illustrations. Only the net asset value given on the transaction statement and account statement is binding. Fund subscriptions and redemption requests are made on the basis of a then-unknown net asset value.

The KIID and prospectus are available free of charge from ODDO BHF ASSET MANAGEMENT SAS or at am.oddo-bhf.com as well as from authorised distributors. The annual and interim reports are available free of charge from ODDO BHF ASSET MANAGEMENT SAS or on request from ODDO BHF Asset Management GmbH.

Please note that, effective from January 3, 2018, when OBAM provides investment advisory services, it always does so on a non-independent basis pursuant to the European Directive 2014/65/EU (so-called "MIFID II Directive"). Please also note that all recommendations made by OBAM are always provided for diversification purposes.