Axel Botte "We recommend a modest tilt towards small stocks".

The upward revision of earnings and the poor performance of 2023 should support the recovery of small-cap firms. Axel Botte expects the Fed to raise rates one more time before pausing and does not foresee rate cuts until 2024.

The financial earthquake generated by the US regional banks stopped the rally in which markets were immersed. Although investors were nervous at the end of March, Axel Botte believes that the current situation is a far cry from that of 2008. The Ostrum AM strategist believes that institutions have acted quickly and that there are still attractive options in both bonds and equities.

The problems of regional banks in the US and the bailout of Credit Suisse revived the spectre of a financial crisis. Has the scare passed?

Systemic crises are difficult to predict, but what we have seen in mid-March with the collapse of Silicon Valley Bank or the bailout of Credit Suisse is more related to institution-specific issues than to an eventual systemic crisis like what happened in 2008 with Lehman Brothers. We do not believe that the institutions involved in the turmoil of the last few weeks, especially those in the US, fit the script of a systemic crisis, but rather that they are in many cases traditional banks under stress from deposit flight. In my view, the authorities have acted swiftly to ease the tensions. Yellen noted that regulators were prepared to guarantee deposits in the event of failure. The US is also going to strengthen its regulation and some of the measures, such as the Fed being able to lend money to banks if Treasury bonds are offered as collateral, will be permanent. This was one of the missing pieces that have accentuated the shock.

What happened with the banks and recession fears have dampened expectations of rate hikes. Do you expect rate cuts by the end of the year?

The market came to discount a final rate of 5.5% in the US before the shock, but the baseline scenario we are working with is that the Fed will raise rates by another 25 basis points. The ECB will stay the course and continue to raise rates. However, it will try to make a distinction between the objective of taming inflation and at the same time ensuring financial stability. If moments of tension arise, the ECB has instruments at its disposal to calm the market. Any rate cuts in both the US and Europe are postponed to 2024.

Until the banking earthquake, stock markets had made a good start to the year. Do European equities still have a chance?

In the first quarter we have seen many investors transfer flows from US to European equities and despite the scare generated by the banks we have had a very decent first quarter. After the falls in mid-March, valuations have adjusted. The current price at which the European stock market is trading is not an obstacle. The problem is that with high inflation the ability to maintain margins is reduced. However, we believe that there will be better buying opportunities further down the road. The latest advance data, such as the German PMI, should help support stock market performance.

What are the criteria that guide your investment in the stock market?

The cyclical outlook for the economy is very important as it determines the earnings potential of companies. Besides the macroeconomic backdrop and earnings, another criterion we follow closely is dividend payments.

Which is more attractive, small companies or large caps?

Small caps have performed worse than large caps in Europe so far this year, especially in March, when they fell by around 4% compared to large caps, which were flat. Despite this poor performance, upward revisions in small companies' earnings are becoming more pronounced, with 12-month growth of 8%. Signs of an incipient recovery in the euro area economy should be more beneficial to small companies, which have a higher proportion of domestic revenues. Although their valuations are tighter, we would recommend a modest positive tilt towards small caps, as the underperformance in 2023 should disappear.

What lessons can be drawn from the treatment of contingent convertible bonds in the UBS takeover of Credit Suisse?

The Credit Suisse bailout creates a dangerous incident that is difficult to assimilate. The conclusion is that when the government intervenes in financial institutions, the rules change and the pecking order is overturned, leaving what was previously expected up in the air. In the face of the uproar, the European Banking Authority (EBA) has tried to get out of the situation by saying that what happened with the Swiss institution is a particular case.

Do you see value in debt and what are your main fixed-income positions?

In a scenario like the current one, where debt curves are inverted, we focus on short maturities. We also see value in high yield debt because they offer attractive yields and we believe that the default rate remains low. In a context where we expect prices to remain high, we also see value in inflation-linked debt. While the yields they offer are low, coupons are updated in line with prices and this can bring extra yield to investment portfolios.

What are the main risks to the markets, and do they expect a recession?

The main risk for the market is that persistent inflation will force central banks to tighten monetary policy beyond current expectations. The markets expect cuts in the US and only two, or at most three, 25 basis point hikes by the ECB. Core inflation is unlikely to slow substantially this year and energy prices could be affected by OPEC cuts and stronger demand from China. However, we are not expecting a recession.