DIVAS EUROZONE VALUE

Monthly Report July 2020

Marketing material for professional investors

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Market environment

In the first 2 1/2 weeks of July Eurozone equities gradually appreciated some 7%, only to give away some 8% in the final 1 ½ weeks of the month. Markets peaked on 21 July 2020 as EU leaders finally agreed on a landmark stimulus package which will see the bloc issue EUR750 billion of joint debt to help member states mitigate the economic downturn. The emergency fund will distribute EUR390 billion of grants and EUR360 billion of low-interest loans. Italy will likely be the biggest recipient with about EUR82 billion in grants and approximately EUR127 billion in loans. Some 70% of the grants to Italy and Spain will be spent in 2021 and 2022. Loans provided by the Recovery Fund do not have to be repaid until 2058 and are on the same terms the EU borrows, i.e. close to 0%.

This is the decicive move towards European debt mutualisation, we have been awaiting for a very long time. This will not only make speculators think twice before betting against the Euro and Eurozone assets, but, for the first time since the Eurozone crisis of 2011, renders Eurozone equities investable again. Needless to say, Eurozone banks are the major beneficiaries of this agreement.

On the day this deal was announced, worries about the delay in approval for the next US stimulus bill resurfaced and the market was spooked by the uncertainty over the US coronavirus evolution (some 75% of the US population is currently experiencing some sort of restrictions), returning to focus on growth stocks while ignoring valuations.

Prospects for Britain leaving the EU without a trade agreement at the end of 2020 and the European Central Bank's request to extend a moratorium on bank dividend payments and share buybacks until 1 January 2021 obviously did not help. The latter will be reviewed in Q4 2020 and would help to keep some EUR30bn of capital in the banking system.

Despite the broad unlocking in the Eurozone in June and July, daily new coronavirus cases were surprisingly well contained, an indication of the effectiveness of contamination control measures in Europe.

As was the case in Q1, the overwhelming majority of our companies reported Q2 results comfortably ahead of expectations, with strong working capital and cost management, thus either limiting the cash burn or generating FCF. In fact, the ratio of 89% beats is the highest I have ever experienced.

5-year forward inflation expectations, rose 5 basis points to 1.17%, with EU July core CPI spiking to 1.2% from 0.8% previously and market expectations of 0.8%. This move was flatly ignored by investors (as reflected by the 10-year Bund yield moving in opposite direction by declining 7 basis points to minus 53 basis points), busy worrying about the rebound in US COVID cases. The Swiss Franc weakened 109 basis points to 1.076, on pronounced EUR strength versus all other currencies (The USD weakened 4.8% versus the EUR).

Global leading indicators continued to rally, coming in way ahead of expectations, thus driving global commodity prices higher. Brent crude oil rose 5%, nickel appreciated 8% and iron ore jumped 14%.

July Markit Eurozone Composite PMI spiked to 54.8 (back to the highs seen in March 2018) from 48.5 reported in June, coming in way ahead of expectations of 51.1, with particular strength in the New Orders component. The July US ISM Manufacturing PMI jumped to 54.2 versus 52.6 previously, way ahead of expectations and with notable strength in the all-important New Orders sub-index. The July Caixin China Manufacturing PMI continued to rise to 52.8 versus 51.2 previously, comfortably above expectations.

Performance

In July, the MSCI EMU Index depreciated by 1.4%. The fund's euro I-shares declined 5.13%, under-performing the MSCI EMU Index (net dividends reinvested) by 373 basis points.

Performance contributors

- LafargeHolcim outperformed the market by 10% on reporting blow-out numbers, with recurring EBIT of CHF932 million versus market expectations of CHF744 million and an exceptionally strong FCF of CHF749 million. Management expects fast demand recovery for

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the second-half of 2020, with FY20 FCF of over CHF2 billion and debt leverage below 2x. The CEO stated: "The peak of the crisis is behind us. We expect a solid second-half of the year based on June's full recovery, the trend of our order book and upcoming government stimulus packages."

- Daimler outperformed the market by 8% on reporting strong preliminary numbers, with a positive Industrial FCF of EUR685 million versus market expectations of negative 1.3bn, on strong working capital and cost management. June global car sales were already slightly above 2019 levels.
- Anheuser-Busch outperformed the market by 7% on reporting Q2 results comfortably ahead of expectations with very strong volume recovery seen over the course of the quarter (April -32.4%, May -21.4% and June a positive +0.7%).
- HeidelbergCement outperformed the market by 2% on reporting solid preliminary numbers with Q2 operating EBITDA year-on-year down 4.5% to EUR 999 million on better than expected revenues and a break-even in operational cash flow.
- ArcelorMittal outperformed the market by 1% on reporting a Q2 adjusted EBITDA of $707 million versus market expectations of $562 million on strong cost savings in Brazil and Mining.

Performance detractors

- Despite reporting ahead of expectations our holdings in financials and energy under-performed across the board, ranging from 2% to 15%, dragged down by worries of a second COVID wave and its potential repercussions on growth.

Positioning

There were no transactions in July.

Outlook

Over the course of the past 12 months, there have been various major changes within the Eurozone framework, the major beneficiaries of which are Eurozone banks, ironically the worst performing sector by a wide margin:

Last November Germany dropped its opposition to a common deposit insurance scheme thus opening the door for banking reform. By appointing Olaf Scholz as finance minister, Germany has moved from having the most restrictive fiscal stance to the loosest in the EU, easing fiscal policy to the tune of 8% of GDP. The ECB is currently expanding its balance sheet as a percentage of GDP to the same extent as the Fed does and has temporarily dropped the capital key, which allows it to disproportionately buy southern European debt papers. And finally, as of 21 July 2020 the EU managed to agree on the terms for the EU Recovery Fund, thus taking the last step towards European debt mutualisation.

The furlough scheme and loan guarantee schemes have meant that both unemployment and projected corporate bankruptcies have risen far less in the EU than in the US. The EU's recovery is therefore likely to be quicker than that of the US. According to the IMF the euro area should exit this crisis with government debt to GDP at a level of 43 percentage points below that of the US and a budget deficit of 7 percentage points below. This evidently brings less corporate tax risks.

Contrary to the GFC of 2008/09, when wholesale lending constituted a very large part of any bank's balance sheet (the unwind of which at the end of October 2008 triggered a factual shut-down of credit availability), corporate lending conditions today function quite normally. TLTRO3, the vast loan guarantee schemes put in place by the major Eurozone countries, together with the Recovery Fund should ensure that the availability of credit will be abundant. Corporate loan growth in the Eurozone is currently running at some 7%, the highest in ten years. Eurozone banks can access TLTRO funds at -1% and can, as long as their loan growth does not decline, reinvest those funds in government bonds, thus reaping a lucrative profit.

The market is currently implying an inconceivable cost of equity for Eurozone banks of 13%. The last time (2012) the P/B ratio of Eurozone banks relative to US banks was this cheap (some 60% discount), European banks outperformed US banks by 50% over the following six months, which highlights the potential extent of the current opportunity.

NAV: EUR 72.69
ISIN I shares: LU1975716835
Valor I shares: 47229643

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DIVAS Asset Management AG, 2020

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