DIVAS EUROZONE VALUE

Monthly Report October 2020

Marketing material for professional investors

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Market environment

In the first 3 weeks of October, Eurozone equity markets behaved quite rationally and moved largely side-ways. However, they aggressively sold off in the last week of the month, as new selective coronavirus lockdown measures announced in Europe stoked demand concerns. The fact that negotiations re Brexit and the additional US stimulus package stalled, did not help.

Germany will spend another EUR10 billion for compensating restaurants, bars, clubs etc. with 70-75% of their respective revenues earned in November 2019 to fend off the potential negative impact on employment and bankruptcies.

Earnings estimates for the next 12 months for the tech-heavy Nasdaq 100 Index have lagged those of the S&P 500 Index since August. A potential peak in relative earnings from US technology stocks have historically been associated with investors rotating back to value.

As was the case in Q2 we have once again seen blow-out numbers from our companies, with all 11 out of our 25 holdings already having reported Q3 results way above expectations. Even though the value factor underperformed in October, we comfortably outperformed the benchmark, driven by positive earnings revisions from analysts on our companies. Strongest beats came once again from the banking sector, with all lenders downwardly revising their loan loss provisions for 2020, thus implying that the industry had already passed the peak in loan losses in Q220.

S&P kept the credit rating for Italy steady at BBB and revised the nation's outlook to stable from negative. Proof that debt mutualisation in the EU seems to be working was manifested by the EU bloc drawing an inconceivable EUR233 billion interest for its first Social Bond under the job-support plan. It had aimed to raise a mere EUR17 billion in 10- and 20-year AAA rated paper.

Second wave and no-deal Brexit worries drove forward inflation expectations down 2 basis points to 1.12% and saw the 10-year Bund yield decline 11 basis points to minus 63 basis points. The ultimate safe haven currency Swiss Franc accordingly strengthened 106 basis points to 1.068.

Libya's production recovery surprised the market to the upside with daily output end October reaching 800'000 barrels with the country aiming for 1.3 million barrels by the beginning of 2021. That compares to just 100'000 barrels a day in early September. Despite inventories coming down rapidly on continued strong global demand, this, combined with second wave worries pushed Brent crude oil prices down 11%. Since the peak of July 2020 OECD commercial inventories saw some 40MMbls draw to the end of September after the mammoth 232MMbls build in Q220. Weekly EIA inventory numbers from the US imply another heavy draw in October. Assuming a continued normalisation of global demand, we are likely to see inventories falling back to their 5-year trailing average of 2953MMbls by late 2021. This has historically coincided with the oil price gradually returning towards marginal cost of production, which for Brent currently sits at some USD61/boe. Nickel appreciated 4% and iron ore 1%, as strong demand in China continued to reduce inventories.

October Markit Eurozone Composite PMI softened to 49.4, ahead of expectations of 49.2. While we saw additional weakness in the Service component, Manufacturing continued its V-shaped recovery, with the Markit Germany Manufacturing PMI jumping to 58.2, way above expectations of 55 and its previous reading of 56.4. Only twice in the last ten years have we fleetingly seen a level slightly above 60. The October US ISM Manufacturing PMI spiked to 59.3 from 55.4 previously, with equal strength displayed across all three sub-indices New Orders, Prices Paid and Employment. The October Caixin China Manufacturing PMI rose to 53.6 versus 53 previously and ahead of market expectations of 52.8.

Performance

In October, the MSCI EMU Index dropped 5.59%. The fund's euro I-shares declined 2.54%, outperforming the MSCI EMU Index (net dividends reinvested) by 305 basis points.

Performance contributors

- Banco BPM outperformed the market by 14%, as short covering by speculators continued to drive the stock higher.

- Banco Santander outperformed the market by 14%, on reporting blow-out Q3 numbers with attributable net income of EUR1.75 billion, basically double of what the market was anticipating, on much lower loan loss provisions and excellent cost management. The bank delivered 40 basis points of CET1 growth in the quarter and upped its FY20 underlying profit guidance to ~EUR5 billion compared to market expectations of EUR3.4 billion.
- Aegon outperformed the market by 11% on an upgraded recommendation from a major US broker.
- ArcelorMittal outperformed the market by 9%, on announcing an aggressive R&D project in hydrogen, with the aim to gradually reduce its carbon footprint to zero by 2050.
- Société Générale outperformed the market by 9%, driven by upgrades in analyst recommendations.
- Royal Dutch Shell outperformed the market by 7%, on reporting an exceptionally strong set of Q3 numbers, with a post-tax operating profit of USD1.79 billion, some 80% ahead of analyst expectations and a FCF (pre operating working capital and pre financing charges) of USD4.6 billion on strong operational cashflow of USD8.24 billion, USD1.46 billion ahead of market expectations. This allowed the company to further deleverage its balance sheet and increase its quarterly dividend by 4% to USD0.1665 or 6.5% annualised.
- Airbus outperformed the market by 7%, on reporting an adjusted EBIT of EUR820 million and an exceptionally strong FCF of EUR642 million, compared to market expectations of a negative EUR65 million, with Q3 aircraft deliveries rising to 145 planes compared to 182 in Q319. Current deliveries running ahead of output is giving confidence for Q4.

Performance detractors

- Telecom Italia underperformed the market by 9%. There was no company specific news flow, other than technical selling on the company hitting a new all-time low, which potentially explains such underperformance.
- AXA underperformed the market by 7%, as partial lock-down measures announced by European governments triggered fears of incremental insurance claims.
- UniCredit underperformed the market by 3% as the Italian government heaped pressure on the bank by offering a series of new incentives to buy the beleaguered Banca Monte dei Paschi di Siena from the state, including risk coverage guarantees and job cuts.

Positioning

In October, the fund switched its position in Daimler into TechnipFMC and reduced its positions in LafargeHolcim, HeidelbergCement, Continental, Banco BPM and Aegon to increase its positions in Royal Dutch Shell, ENI, AXA, ABN AMRO Bank and ING.

Outlook

Both Pfizer and Moderna have indicated that the initial interim data analyses from both trials should occur over the next 4-5 weeks. Vaccine efficacy (VE) above the low-end of 60-65% is likely to be viewed positively by the market. VE rates above 75% would be particularly good news, because that would imply a high likelihood of European Drug Authority approval by year-end and bode well for virus control in the Eurozone. VE rates between 50-60% would probably disappoint, but could still support FDA approval (minimum 50% per FDA guidance).

We are not speculating about the outcome of US elections. However, latest surveys would suggest a victory for Joe Biden. The hope is obviously that, should Biden take the presidency, he can win a narrow majority in the Senate. This would allow for a fast launch of the USD2 trillion fiscal stimulus package Biden intends to initiate. Hiking income taxes as announced, would cut some 9% off S&P500 earnings. This would shift the superior earnings growth balance even more in favour of the Eurozone. Global health care, having attracted massive inflows over the last couple of years - only bested by the inflow into global tech equities and trading close to their all-time-highs - is particularly vulnerable to a victory of the Democrats. Biden (being the constructive and consensual character he is) is likely to take up negotiations with the Chinese, to at least reverse part of the global growth damage created by the trade war initiated by Donald Trump January 25, 2018. All of the above-mentioned potential changes will bode well for assets returning into the value space. As would a likely shift in economic policy towards fiscal, rather than monetary, stimulus.

Most industrial commodities, other than iron ore, are likely to go into a deficit in

2021, thus pushing the commodity complex higher. Last time we had global commodities go into deficit was back in 2006/07. This coincided with the last major value bubble peaking in 2007.

In the next couple of weeks, the perceived tail risks still prevailing, such as an uncontrollable second wave in Europe, a no-deal Brexit and US election controversy are likely to shift out of the limelight, thus paving the way for American investors to finally return to Europe, and catalysing a major rotation back into value We could well be standing on the precipice of a monumental shift in the established status quo with a potentially lucrative risk-adjusted premium just waiting to be garnered by those with the courage in their contrarian convictions.

NAV: EUR 71.88
ISIN I shares: LU1975716835
Valor I shares: 47229643

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Currency Risk – Non-Base Currency Share Class: Non-based currency share classes may or may not be hedged to the base currency of the Fund. Changes in exchange rates will have an impact on the value of shares in the Fund which are not denominated in the base currency. Where hedging strategies are employed, they may not be fully effective.

Equity: Investments in equities may be subject to significant fluctuations in value.

Capital at risk: All financial investments involve an element of risk. Therefore, the value of the investment and the income thereof will vary and the initial investment amount cannot be guaranteed.