DIVAS EUROZONE VALUE FOCUS

Monthly Report June 2022

Marketing material for professional clients

This product is intended exclusively for qualified investors in Switzerland and professional investors in the UK

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Market environment

In June, eurozone equity markets tanked some 9%, while the stocks of companies with economically sensitive business models tumbled 15% to 30%, as cyclicals priced in recession (PMI of around 45) and banks adjusted in anticipation of the next non-performing loan cycle. A scenario hard to depict with record surplus savings/cash in the system (households, corporates and banks) and a red-hot job market.

Q1 year-on-year labour costs accelerated to +3.2% from +1.9% in the previous quarter, a strong confirmation that rising inflation is rapidly feeding into higher salaries.

Another testimony to this dynamic was the announcement, in late June, of IG Metall, Germany's biggest labour union, that they would seek a wage increase of 7% to 8% to help 3.8 million metals and electronics workers cope with rampant inflation. The negotiations, starting in September, will be Germany's biggest wage settlement, and its outcome may provide an indicator of how overall pay will develop across sectors.

June Eurozone inflation continued to accelerate to a new all-time high, rising to +8.6%, compared to +8.1% previously.

In early June, the Governing Council of the ECB decided to end net APP purchases on 1 July, announced that key policy rates will rise by 25 basis points in July and signalled that a 50 basis points increment is likely in September, unless the medium-term inflation outlook improves.

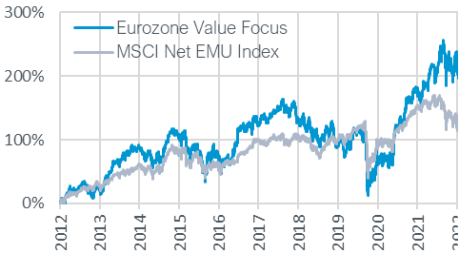
In mid-June, European Central Bank Vice President Luis de Guindos said in an interview that markets should have no doubt about how determined the ECB is to tackle fragmentation (spread widening between the bund yield and the periphery). "Inflation will be higher than we expected for a longer period of time. For September, we will look at the possibility of a bigger increase, if the outlook for inflation is maintained or if it worsens; future decisions will be based on data".

Federal Reserve Chair Jerome Powell called his commitment to curbing

Performance 30/06/2022

IX shares

NAV: **EUR 296.22**
ISIN IX shares: **LU0777828426**
Valor IX shares: **18472017**



in %	June 2022	YTD	1Y	3Y	5Y	since 15 June 2012
Fund	-11.63%	-7.52%	10.38%	48.73%	30.71%	196.22%
BM	-9.21%	-18.69%	-13.85%	5.95%	11.67%	115.61%
Value vs Growth	-3.47%	11.59%	9.55%	-4.66%	-22.70%	-51.28%

Source : Bloomberg

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inflation "unconditional" and another of his colleagues backed raising interest rates by 75 basis points again next month, even as Democrats warned him against triggering a recession.

In late June, the IMF downgraded US 2022 growth forecast from 3.7% to 2.9% and reduced its 2023 growth estimate from 2.3% to 1.7%. It noted "material risk" from current headwinds will prove more persistent than expected. However, the IMF sees the US narrowly avoiding recession, arguing front-loaded Fed tightening will help reduce inflation and protect real incomes, sustaining economic growth. With strategists already having dialled up recession probabilities, this offers room for positive surprises.

In June, 5-year forward inflation expectations declined 10 basis points to 2.06%, on the market anticipating a recession.

The 10-year Bund yield moved opposite to forward inflation expectations, rising 21 basis points to +1.33%, as rates continued their gradual path to normalisation.

The Swiss franc spiked 2.77% to 1, as the Swiss central bank hiked rates by 50 basis points to -0.25% and on recession worries.

In June, Brent crude oil declined 3%, while nickel tanked 20%, as prices returned to more sustainable levels, following the short squeeze of the century experienced in March. Iron ore dropped 11% as markets priced in recession.

The June, Eurozone Composite PMI softened to 51.9 compared to 54.8 previously. The June China Composite PMI spiked to 54.1 from 48.4 previously as some Covid restrictions were lifted. The non-manufacturing gauge, which measures activity in the construction and services sectors, climbed to 54.7, the highest in more than a year and well above the consensus forecast of 50.5. The June US ISM Manufacturing PMI slowed to 53 from 56.1 previously.

Performance

In June, the MSCI EMU Index tumbled 9.21%. The fund's euro IX-shares dropped 11.63%, underperforming the MSCI EMU Index (net dividends reinvested) by 241 basis points. Year-to-date the fund declined by 7.52%, while the market tanked 18.69%, thus outperforming the benchmark by 11.17%.

Performance contributors

- Prosus outperformed the market by 43% on announcing an open-ended share repurchase programme to be funded by the sell-down of its Tencent stake (75% of NAV). This triggered a tightening of its Tencent stake discount from 52% to 43%. A very long way to go to reach a feasible discount.
- AXA outperformed the market by 2%, benefitting from rising interest rates.

Performance detractors

- ArcelorMittal underperformed the market by 21%, as the stock priced in recession.
- Lanxess underperformed the market by 13% on rising gas prices and the stock pricing in the next economic downturn.
- Société Générale and UniCredit moved opposite to rising interest rates (a 100 basis points increase in the yield curve adds some 20% to their earnings on a recurring basis) underperforming the market by 8% respectively, as the banks priced in the next non-performing loan cycle.

Positioning

In June the fund reduced its positions in Lanxess and Prosus, having outperformed the market by 18% and 32% respectively, thus contributing 21 and 115 basis points to the fund's excess return to increase its holdings in AXA, Randstad, ArcelorMittal and Volkswagen pref.

Outlook

For the first time since July 2016, net investment in environmental, social and governance (ESG) focused exchange-traded funds (ETFs) was in the red. Investors withdrew a net USD300 million from such ETFs. Through May, net investment into ESG ETFs totalled USD22.3 billion, down from USD60 billion at the same point in 2021. On May 25, the US Securities and Exchange Commission proposed an amendment to the Investment Company Act which could disqualify many ETFs from being classified as ESG-focused, though the definition of what constitutes ESG remains so nebulous that it still may leave room for mislabelling.

The low inflation we have witnessed since the 1990s was not so much the result of astute central-bank policies, but rather the addition of hundreds of millions of inexpensive Chinese and Eastern European workers to the globalised economy, a demographic dividend that pushed down wages and the prices of products they exported to rich countries. Together with new female workers and the large baby-boomer generation, the labour force supplying advanced economies more than doubled between 1991 and 2018. This deflationary trend is likely to go into reverse over the next decade.

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For a true recession, with all its negative implications (mass unemployment, a collapse of consumer spending, a property collapse, a credit default to trigger a massive non-performing loan cycle, etc.), to happen, a strongly leveraged system needs to be in place. However, with governments being the only sector currently leveraged, in contrast to the abundant excess savings available for corporates (5% of GDP) and the household sector (11% of US GDP and 7.5% of eurozone GDP), a banking sector awash with surplus core tier 1 capital, and fiscal stimulus to the tune of 1.5% of eurozone GDP in place, none of these conditions are in place.

The above combined with the fact that the current gap between unfilled jobs (11.4 million) and unemployed Americans (6 million) is still near the widest in the past 75 years and the unemployment rate in the eurozone at 6.8%, its lowest level since the inception of the eurozone, and likely to continue its downwards path towards some 6% by end 2023 (this compares to >10% post Lehman collapse and >12% at the height of the Eurozone crisis), poses the following question: Can we really fall into a serious recession when jobs are abundantly available and savings or excess cash/equity on all levels (households, corporates and banks) so plentiful? Even though history does repeat itself, the making of this cycle is so different from any other we have seen over the last 100 years, that the outcome may strongly differ from what we have experienced over the past couple of decades. Since cyclicals are already pricing in a recession (implied PMI of 45) and eurozone banks priced in anticipation of the next non-performing loan cycle (which may come some 6-7 years down the road but definitely not within the next 18 months), the current striking mispricing of eurozone financials and cyclicals very much looks like a multi-decade buying opportunity.

Portfolio

Fund positions as of 30/06/2022

	P/E	P/B	Dividend yield	Weight
SOCIÉTÉ GÉNÉRALE	4.7	0.26	7.9%	9.4%
BANCO SANTANDER	5.1	0.51	3.7%	9.8%
UNICREDIT	4.9	0.37	5.9%	9.4%
AXA	6.8	0.81	7.1%	10.5%
AEGON	5.4	0.41	4.1%	9.1%
VOLKSWAGEN PREF.	3.6	0.45	5.9%	10.0%
PROSUS	16.4	2.6	0.2%	11.4%
RANDSTAD	9.4	2.03	4.8%	10.2%
LANXESS	6.1	0.72	3.1%	10.4%
ARCELORMITTAL	3.4	0.37	1.7%	9.7%
Cash				0.2%
Fund	6.6	0.85	4.4%	100.0%

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