DIVAS EUROZONE VALUE

Monthly Report May 2020

Marketing material for professional investors

Hansueli Jost
Lead Manager
DIVAS Asset Management AG

Market environment

14 May 2020 seems to have been the watershed moment for any non-momentum asset. Following the initial sharp market sell-off in the first two weeks of May of some 7%, sensitivities on all asset categories experienced a major turning point. On 14 May 2020 we saw a substantial intraday reversal in factors, with value reversing its morning weakness and momentum rapidly selling off in the afternoon. Every day during the following two weeks we saw the same pattern, regardless of whether markets traded up, down or flat. In the morning the value factor underperformed or started with modest outperformance and then persistently recovered or expanded into considerable outperformance over the course of the day. The machine that has a vested interest to defend the positioning of its USD3 trillion momentum products kept riding multiple intra-day assaults on the value factor, but consistently failed. The only day the momentum factor prevailed was month-end, where the window dressing of the momentum factor typically dominates. This is a pattern I last experienced in March 2009, the low of the GFC, which marked the start of the last major rotation back into value. Mid-May also seems to have coincided with the peak of the weekly cumulative inflows into global tech equity and health care equity funds. This coincided with record cash positions, sentiment nearly as bearish as at the lows of the GFC, the European equity risk premium (ERP) reaching a new record high of some 10% (7% peak in March 2009) and the multi-year high of the Swiss franc.

Valuation distortions between the growth and the value factor mid-May had reached the most extreme levels ever, pricing in a Bund yield of minus 400 basis points versus effective -55 basis points. It is impossible to imagine, what economic scenario would ever justify this, but that's what's in the price.

In the ten years from 2008 to 2018, weekly cumulative inflows into global tech equity funds had averaged some USD5bn. Mid-May we witnessed a mind-boggling USD68bn of weekly cumulative inflows, or some 14x the preceding 10-year average. With 25c and 44c of every dollar flowing into the same six stocks (Facebook, Amazon, Netflix, Google, Apple and Microsoft) in the S&P and the Nasdaq, stocks every investor effectively has to own, this has become a self-fulfilling prophecy.

By late May cash levels (money market funds) had reached a new record of USD4.8 trillion, up USD1.1 trillion alone over the preceding 9 weeks. This compares to USD461bn raised in the GFC of 2008 taking the total to USD3.9 trillion at the end of January 2009. Plenty of money, therefore, to eventually return back into equities.

Economic data in China, which is some two months ahead of Europe on the road to recovery, displays a clear V-shaped recovery. In particular, manufacturing and construction and the energy consumption that goes along with it, have come a long way. Mid-May 2020 oil demand in China was already back to 13m boe (barrels of oil equivalent), just a notch below the end 2019 level of 13.7m boe. This V-shaped recovery pattern is as well visible in the car industry (Daimler and Volkswagen generate some 45-50% of their EBITDA from China). April China Industrial Production is even up 3.9% year-on-year.

By far the biggest positive earnings surprises in Q1 were once again reported by the banking sector.

5-year forward inflation expectations, rose 7 basis points to 0.98%. The 10-year Bund yield rose 14 basis points to minus 43 basis points. The Swiss Franc, which had peaked at 1.05 mid-May, weakened 92 basis points to 1.068.

Brent crude oil skyrocketed 34% to USD37.84, as it became apparent that oil demand in China was factually back to end 2019 levels and inventories had plateaued. Nickel appreciated by 1% and iron ore spiked 19%.

May Markit Eurozone Composite PMI spiked to 30.5 from the all-time low of 13.6 reported in April, coming in comfortably ahead of expectations. The May US ISM Manufacturing PMI jumped to 43.1 versus 41.5 previously, with strong new orders and prices paid sub-indices. The May Caixin China Manufacturing PMI continued to rise to 50.7 versus 49.4 previously.

Performance

In May, the MSCI EMU Index appreciated by 4.75%. The fund's euro

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I-shares rose 2.87%, underperforming the MSCI EMU Index (net dividends reinvested) by 188 basis points.

Performance contributors

- Saint-Gobain outperformed the market by 12%, having delivered a robust set of results, indicating that their China construction business had, by mid-April 2020, already recovered back to prior year levels.
- ING outperformed the market by 11% on reporting an excellent set of results, way ahead of expectations, with an attractive net interest margin of 151 basis points.
- Continental outperformed the market by 10%, having delivered diligently on working capital management and displaying a strong liquidity position of EUR2.5bn in cash and equivalents and EUR4.3bn in unused credit lines.
- UniCredit outperformed the market by 4%, having reported a very healthy CET1 ratio of 13.44% and an exceptionally high MDA buffer of 436 basis points.

Performance detractors

- Despite iron ore prices rising 19% and the company reporting results ahead of expectations, ArcelorMittal underperformed the market by 18% on announcing a USD2bn rights issue. Not that they would have needed that capital, with available liquidity of USD10bn, but they wanted to avoid S&P, the ratings agency, following Moody's in downgrading their debt to junk. This move served its purpose with S&P the following day reiterating its BBB- rating. With the stock up 80% from its mid-March lows, this news triggered some profit taking.
- Telecom Italia reported net debt in line with expectations on strong working capital efficiencies and lower taxes, maintained its FCF guidance for 2021/22 and announced exclusive negotiations with Ardian Consortium for the sale of a significant minority stake in TIM TowerHoldCo (remaining 33.2% Inwit stake) for some EUR1.5bn, However, the stock underperformed the market by 12%, as it reported domestic mobile service revenues of -2.3%, which was somewhat below market expectations.
- Even though Royal Dutch Shell reported results in line with expectations and the oil price spiked 34%, the stock underperformed the market by 11% on profit taking, following the 80% appreciation from its March lows.

Positioning

In May, the fund switched Deutsche Bank, having outperformed BNP Paribas over the last 6 months by 85%, into BNP Paribas and Saint-Gobain into AB InBev. Furthermore, it reduced its position in AXA and Covestro in order to increase its holdings in ABN AMRO Bank, Société Générale, and Banco BPM.

Outlook

In late May, the European Commission proposed a Recovery Plan of EUR750bn, including EUR500bn of grants and EUR250bn of loans, to be disbursed over 2021-24, as part of the 2021-2027 EU budget. With regards to the loan-based mechanisms for investment, this is even somewhat more generous than the Franco-German proposal. Regarding the country allocation, it looks to be skewed towards Southern and Eastern Europe. This proposal is likely to have its first formal discussion in the Eurogroup on 11 June 2020, possibly followed by further discussions at the EU summit 18-19 June. However, to get the program approved, it needs to be ratified by the 27 national parliaments.

In mid-May, most Eurozone banks made new all-time lows or retested their 16 March 2020 lows, trading 25%-65% below the trough of the GFC. To put this into context, Eurozone banks guided for an average cost of risk (CoR or loan loss provisions) for 2020 of 90 basis points in their Q1 results. This compares to peak 2009 credit losses of 140 basis points of loans. Excess capital over MDA (amount banks can return to shareholders in form of dividends or share buy-backs), plus 2020 pre-provision profits, average some 500 basis points of loans. This would allow the banks to cover 3-4 times the level of CoR experienced back in 2009. Put another way, even if you assumed double the guided credit losses were to occur, banks would still enjoy 320 basis points of MDA buffer, which they could use to return to shareholders. In view of the government-initiated back-up loan guarantee schemes, to the tune of EUR520bn for Germany, EUR400bn for Italy, EUR300bn for France and EUR120bn for Spain, such a scenario is anyway highly unlikely.

In May 2020, Research Affiliates published a very timely and highly up-to-date (to March 2020) empirical analysis as to whether value was dead. Even though the study was conducted on US equities, the conclusions are likely to be even more salient to Eurozone stocks, since Europe has

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nothing comparable to the six key performance drivers of growth seen in the US. The analysis basically splits the July 1963 to March 2020 period into two episodes. One from 1963 to 2007, a period the value factor delivered an average annual outperformance over growth of 6.1% and the last 13 years from 2007 to 2020 over which the value factor suffered an average annual underperformance, over growth, of 5.4%. The narrative that growth stocks post-2007 were both more profitable and had faster sales growth than pre-2007 were both disproved. ROE declined from 17% pre-2007 to 16% post-2007, while sales growth actually tumbled from 14% pre-2007 to 8% post-2007. However, what is even more remarkable is that the net delta of the change in ROE and sales growth of growth versus value (post-2007 versus pre-2007) yielded an annual net 1% benefit in favor of value, i.e. had valuations had any relevance over the last 13 years, value should have outperformed growth. The reason value has suffered a 50% drawdown over the last 13 years is fully explained by the collapse of relative valuations, i.e. value moved from the 23rd percentile (expensive) versus growth to the 100th percentile (cheapest-ever). A modest move to the historical 75th percentile, halfway between the cheapest-ever and the median valuation for value relative to growth, would imply a 53% relative performance for value over growth.

With the pattern change seen prevailing since 14 May 2020, value should soon start to display momentum characteristics and the machine will as unemotionally and frantically start buying value as it had sold value over the course of the preceding 14 years. Food for thought!

NAV: EUR 72.39
ISIN I shares: LU1975716835
Valor I shares: 47229643

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