DIVAS EUROZONE VALUE

Monthly Report August 2020

Marketing material for professional investors

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Market environment

In August, Eurozone equity markets oscillated within a 5% band, driven higher on better-than-expected results before dropping back again on worries of a second wave.

Despite the holiday season induced rise in daily new coronavirus cases, other than in Spain and Greece, the major holiday destinations, the rest of the Eurozone was well contained. For Europe as a whole, new cases stayed well below the peak levels seen in March and April (In Germany some 1'500 versus some 7'000 in March/April on twice the number of tests). The fall in new cases to be expected from the holiday season in Europe having come to an end late August, should partially offset the expected rise in new cases from the back to school season.

With all our companies having reported their Q2 results, a record 88% have beaten market expectations. This compares to very good quarters in the past of 66% beats. Once again the banking sector reported the strongest beats, with 70% reporting results ahead of expectations, generating a very healthy 45 basis points of CET1 capital in what was probably the worst economically impacted quarter since the great depression. Not really what a structurally challenged sector would be expected to deliver.

In late August, Germany extended its furlough scheme to the end of 2021 at a cost of EUR10 billion and reduced the expected COVID impact on its 2020 GDP from -6.3% to -5.8%. This is very positive for both unemployment and projected corporate bankruptcies and will help keep non-performing loans at banks in check.

5-year forward inflation expectations rose 7 basis points to 1.24%. Finally, the 10-year Bund yield stopped moving opposite to rising expected forward inflation, by rising 13 basis points to minus 40 basis points. Eurozone money supply growth (M3) reached a new all-time-high of +10.2%. The Swiss Franc weakened 27 basis points to 1.079.

The ongoing V-shaped recovery visible in global manufacturing and construction continued to drive commodities higher. Brent crude oil rose 3%, nickel appreciated 11% and iron ore jumped 14%.

Having reached mid-cycle levels at 54.8 in July (back to the highs seen in March 2018), August Markit Eurozone Composite PMI fell to 51.6 driven by notable weakness in the Service component, as the rise in new coronavirus cases seen in July required more stringent measures for some parts of the service sector. In manufacturing, where distancing is not an issue the recovery sustained its pace. The German manufacturing index (most cyclical economy in the EMU) even jumped to 53 from 51 previously. The August US ISM Manufacturing PMI jumped to 56 versus 54.2 previously, comfortably ahead of expectations and with particular strength in the all-important New Orders and Prices Paid sub-indices. The August Caixin China Manufacturing PMI continued to rise to 53.1 versus 52.8 previously, rising more than expected, as output and new orders registered the fastest growth since January 2011.

Performance

In August, the MSCI EMU Index appreciated by 3.52%. The fund's euro I-shares rose 8.25%, outperforming the MSCI EMU Index (net dividends reinvested) by 473 basis points.

Performance contributors

- Covestro outperformed the market by 18%. In addition to previously pre-announcing positive Q2 results in July, the company delivered a positive Q3 preannouncement August, reflecting the visibility of their orders. They guided for an EBITDA of about EUR350 million, some 30% above market expectations of EUR268 million and Q1 of EUR125 million. One of many of our holdings in manufacturing which is seeing a V-shaped recovery.
- Telecom Italia outperformed the market by 13%, as the company managed to agree with KKR and Fastweb on a plan to set up a company, to be called FiberCop, to run Italy's secondary network. They acceped an offer of EUR1.8 billion from KKR for a 37.5% stake in its landline grid. This values Telecom Italia's stake at EUR4.8 billion, representing 56% of its market cap and allows the company to rapidly deleverage. Its letter of intent was approved by state lender CDP.

- **ING Group** outperformed the market by 12% on reporting a pre-provision profit strongly ahead of expectations with CET1 ratio spiking 100bps to 15% versus market expectations of 14%.
- **HeidelbergCement** outperformed the market by 9% as the global V-shaped construction market recovery continued.
- **ArcelorMittal** outperformed the market by 10% as the global V-shaped construction and manufacturing market recovery continued, while iron ore spiked another 14%, up 36% year-to-date (outpacing gold's 30% advance).
- **Banco BPM** outperformed the market by 8% on reporting a strong revenue and core pre-provision profit beat with a CET1 ratio of 13.3%, 40 basis points ahead of market expectations.

Performance detractors

- **Aegon** underperformed the market by 8%, despite reporting a very strong Solvency II ratio of 195% versus market expectations 186% and 201% in H1/19, as the stock got punished on rebasing its interim dividend to 6c (EUR120 million) vs implied 15c in 2019, by skipping the final 15c dividend which saves the company EUR314 million. Strong normalised capital generation of >EUR600 million in 1H/20 and cash remittances to the HoldCo of >EUR700 million allows the new CEO Lard Friese, who in his previous capacity as CEO had very successfully restructured NN Group, to use this excess FCF to deleverage and strengthen the balance sheet. The HoldCo cash level of EUR1.7 billion is now above the company's EUR1-1.5 billion target range. Lard reduced long-term interest rate assumption by 150 basis points and took a reserving charge on the much-debated Long Term Care book. His new strategy targets will be communicated at Aegon's investor day on 10 December 2020.
- **LafargeHolcim** underperformed the market by 3%, on profit taking, following its strong run post reporting blow-out Q3 numbers end July.
- **AXA** underperformed the market by 2%, as Hurricane Laura hit the Gulf of Mexico.

Positioning

In August, the fund reduced its position in ING Group and ABN AMRO Bank, up 57% and 19% since purchase in March and May 2020, to increase its holdings in Société Générale and Aegon.

Outlook

The 10-year real yield gap in favour of the US Dollar versus the Euro, which peaked in October 2018 at 292 basis points, has now been completely erased. With this positive carry falling away, there is now less incentive to invest into US Dollar assets. This combined with the factual debt mutualisation achieved in the Eurozone, should see the Euro further appreciate versus the US Dollar. A strengthening Euro, combined with expanding PMIs, flat to rising bund yields and a rising oil price, has historically been a major driver for liquidity to flow back into European equities, thus accelerating the rotation back into value stocks.

Historically all major rotations in the Eurozone back into the value space were driven by meaningful flows from the United States returning to Europe. To US investors, Europe is a cyclical market (some 40% economic exposure to manufacturing versus only 15% in the US). Therefore, whenever they returned to Europe in the past, those flows always ended up in cyclicals and financials or value stocks in general, thus accelerating the rotation back into value. The fact that this historical correlation still holds was proven early June and early August, the first two weeks of inflow since 2017.

Following three years of relentless weekly outflows from Eurozone equities, we experienced the first weekly cumulative inflow in the first week of June. Within a matter of just 5 trading days the performance of our fund spiked 18.3%, outperforming its benchmark by 895 basis points and Nestle, the momentum/safe haven proxy by some 21%. There was no other fundamental news that could have explained this hefty move. The following week this inflow was not only reversed, but net net an extra billion on top again exited Eurozone equities as second wave worries resurfaced. In early August Eurozone equities experienced a smaller inflow, allowing us to generate an Alpha of some 600 basis points within a matter of days. So, we have the proof that these historical correlations still hold.

The Swiss Franc weakening beyond the technically important level of 1.0850 versus the Euro and the 10-year Bund yield breaking above minus 20 basis points would lend further support to that rotation.

From talking to clients, I recently noticed that barely anyone seems to remember the proper sequence of events of the last tech bubble bursting back in March 2000. Since it is already 20 years since, those having been around at the time only seem to remember the outsized losses they had suffered from their personal TMT (Technology/Media/Telco) investments and are convinced that this period coincided with a total market melt-down. Ironically their fear is therefore, that should technology finally crumble, that value stocks would be hit disproportionately. The opposite is actually the case. The collapse in technology shares back in 2000 triggered a major rotation back into value stocks. In the seven months following the bubble's burst, Eurozone value stocks had appreciated by 8.8%, outperforming the blend benchmark by 22%. Deutsche Telecom a benchmark heavyweight at the time tumbled 62% over that same period. To put this into context: from 3 March 2009 to the end of December 2009 an 11.5% value factor outperformance allowed us to generate Alpha of 115%.

NAV: EUR 78.69
ISIN I shares: LU1975716835
Valor I shares: 47229643

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