DIVAS EUROZONE VALUE

Monthly Report September 2020

Marketing material for professional investors

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Market environment

In the first 2 ½ weeks of September, Eurozone equity markets behaved quite rationally and moved largely side-ways only to sell off in the second-half of the month, on the back of a journalist article on stale and well-known information dating back to 1999 relating to money laundring and amid worries of a second coronavirus wave and a no-deal Brexit.

This article had basically aggregated and recycled known information that had supposedly happened between 1999 to 2017. Nevertheless the fat headline "The documents identified more than USD2 trillion in transactions that were flagged as possible money laundering or other criminal activity" implied that this affair was a regulatory investigation, which was going to lead to major penalties for banks. However, this was just a journalist article without any connection to neither US authorities nor European financial crime prosecutors. Between 2012 and 2018 this issue had basically been addressed by financial authorities both in the US and in Europe and had resulted in major penalties for various US and European banks.

September euro-area inflation rate came in at -0.3%. Recent ultra-low readings can largely be explained by a temporary cut in Germany's value-added tax rate as well as depressed prices for travel-related services over the summer.

Second wave and no-deal Brexit worries drove forward inflation expectations down 10 basis points to 1.14% and saw the 10-year Bund yield decline 13 basis points to minus 52 basis points. The Swiss Franc traded flat at 1.079.

The abovementioned worries catalysed a softening of the commodity complex across the board. Despite inventories coming down rapidly on continued strong global demand, Brent crude oil declined 7%, despite Inventories falling back to the levels of April. Nickel depreciated 6% and iron ore 5%.

September Markit Eurozone Composite PMI softened to 50.1. While we saw some additional weakness in the Service component, Manufacturing continued its V-shaped recovery, with the Markit Germany Manufacturing PMI jumping to 56.6, way above expectations of 52.5 and its previous reading of 52.2. The German September ZEW expectations of economic growth index spiked to 77.4 versus expectations of 69.5 and 71.5 previously. This is the highest level seen in 20 years. The September US ISM Manufacturing PMI softened somewhat to 55.4 from 56 previously, displaying softer New Orders but stronger Prices Paid and Employment sub-indices. The September Caixin China Manufacturing PMI moved sideways, coming in at 53.

Performance

In September, the MSCI EMU Index depreciated by 1.83%. The fund's euro I-shares declined 6.28%, under-performing the MSCI EMU Index (net dividends reinvested) by 445 basis points.

Performance contributors

- ArcelorMittal outperformed the market by 10% on announcing the sale of its US business to Cleveland-Cliffs for USD1.4 billion. ArcelorMittal USA has USD500 million net debt and USD 1.5 billion in Pensions and other Post-Employment Benefit liabilities. The company will use USD500 million for share buy-backs.
- Daimler outperformed the market by 10%, driven by several analyst upgrades and on expectations it may cut 1'000 employees at its Berlin site.
- Covestro outperformed the market by 8% on rumours, Apollo may acquire the company.
- Banco BPM managed to escape the aggressive sell-off seen in European banks, even outperforming the market by 4%, on the back of rumours that Crédit Agricole may be interested in acquiring the bank.
- Continental outperformed the market by 3% on announcing a major restructuring programme affecting 30'000 jobs globally (13'000 in Germany), to generate gross annual savings of over EUR1 billion from 2023 onwards.

Performance detractors

- Even though none of our retail banks was mentioned in this journalist article on money laundering, they indiscriminately underperformed the market between 9% and 15%.
- With global commodities softening on second wave worries, our

integrated oil companies indiscriminately underperformed the market to the tune of 8-12%, despite a lack of any company-specific news whatsoever.

Positioning

In September, the fund reduced its position in ArcelorMittal, up 48% since purchase in May 2020, to increase its position in Banco Santander.

Outlook

Even though all of the factors that have historically seen US flows returning to Eurozone equities, thus triggering pronounced rotations back into Value, are in place, the flows are being temporarily held back by second-wave worries and fears of a no-deal Brexit. For the market to start ignoring a potential negative impact from COVID, the second derivative of new cases has to start turning down. Looking at valuations of Eurozone equities with U.K. exposure, a no-deal Brexit seems to be priced in already. Should a deal still happen before year end, however diluted and irrelevant it may be, the perception of a binary risk that still prevails with US investors, will evaporate and should see US investors return in droves.

Other than US flows returning, there are many domino chips that may start to topple thus triggering the rotation. Potential toppling chips include the 10-year bund yield breaking the major resistance at -20 basis points, the Euro/Swiss breaking 1.0850, tech going into a serious correction, gold retracing to 1700 or one or multiple vaccines approved before year-end.

We don't know, which chips will be the first to wobble, ultimately knocking down the others, but we do know what will happen once the chips begin to tumble. We saw a similar scenario play out in first week of June 2020, when we had the first cumulative weekly inflow in three years, and in 2009, when the last major rotation took place.

With USD3 trillion worth of new products launched over the course of the last 11 years, all encapsulating the exact same sensitivity called momentum (proxy for growth, yield and low vol sensitivity) the onset of such a rotation will rapidly escalate into a panic.

In the same way that we saw absolute return, pair trading equity products evaporating from September 2015 onwards, we will experience a sense of déjà-vu, when the momentum factor starts to crumble. Any losses experienced in strategies that are supposed to protect investors from those very losses will trigger major redemptions, forcing managers across the planet to sell their momentum/growth stocks and cover their value shorts. I doubt the value space lends itself to even covering a fraction of that amount, without triggering an all-out panic.

October and November seasonally tend to be the strongest months for value.

NAV: EUR 73.75
ISIN I shares: LU1975716835
Valor I shares: 47229643

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