DIVAS EUROZONE VALUE

Monthly Report April 2021

Marketing material for professional clients

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Market environment

The USD 20 billion Archegos Capital Management hedge fund blow-up combined with disappointments on the vaccination front, with AstraZeneca basically out of the game and delays for the one-shot vaccine from Johnson & Johnson (J&J), triggered a temporary rotation back into secular growth stocks at the expense of financials and cyclicals.

During the first three weeks of April the value factor underperformed growth by some 550 basis points, correcting all overbought levels in the value space and creating a beautiful base for a recommencement of the rotation back into value. As one would expect, the US Dollar appreciated, yields declined and banks badly underperformed, only to forcefully rally in the last week of the month, as banks once again reported stunning beats, Eurozone growth continued to surprise on the upside and rising inflation gathered pace.

German factories, meanwhile, saw their order stock increase at the fastest pace in a decade. Shortages of raw materials and freight capacity pushed up input costs to the highest level since 2011 and output prices to their highest in more than two years. This is the sweet spot in the economic cycle for our cyclical companies, since this allows them to expand their margins by hiking their prices more than the incurred increase in input costs. This feeds through producer prices (PPI) straight into rising inflation. At the same time, US NFIB and ISM prices paid both imply significant increases in inflation as well. The European Central Bank can exit from its exceptional crisis measures while maintaining accommodative monetary policy, French Governor Francois Villeroy de Galhau made it clear in an interview that the institution will let inflation overshoot its 2% target.

The European Union is set to lay out its blueprint to raise nearly $1 trillion of debt over five years as it seeks to fund its recovery from the coronavirus pandemic. This huge injection of capital will further accelerate the normalisation of interest rates.

In April, eurozone services actually grew for the first time in eight months, a milestone for a sector that has been hamstrung by some of the worst restrictions since the outbreak. Household savings in Germany have spiked to EUR120bn from some EUR50bn pre-Covid, thus ensuring that the consumer will come roaring back as governments open up the service sector.

This exceptionally healthy environment is reflected in the earnings revision ratio for the eurozone, which showed profit upgrades outpacing downgrades by the most since 2010.

Headline emotions apart, Pfizer Inc. and BioNTech SE announced in mid-April that they will boost their vaccine deliveries to the European Union by 25% to 250 million by June 2021. With this the EU is now well on track to reach its target to vaccinate 70% of adults by September 2021.

Germany upped its **daily** vaccinations from 150'000 in mid-April to 1.1 million by the end of the month, actively using their network of 35'000 medical practices across Germany. At this pace, half of the 83 million German population will be vaccinated by the end of May 2021. As supplies increase, Germany may be in a position to lift vaccination prioritisation in the coming weeks, a step that would open access to all adults, according to internal discussions between the government and federal states.

In late April, the European Medicines Agency announced that the benefits of J&Js vaccine outweigh the risk of very rare occurrence of blood clots (17 out of 8 million vaccinations).

Having skyrocketed in March, 5-year forward inflation expectations traded flat at 1.54% in April.

The 10-year Bund yield rose 9 basis points to the all-important technical level of -20 basis points. The Swiss Franc appreciated 0.83% to 1.0978.

Following the short breather in March, the commodity complex continued to steam ahead, as global leading indicators continued to surprise on the upside. Brent crude oil rose 7% as crude oil inventories continued to fall. Nickel appreciated 10%, while iron ore jumped 18%.

The April Markit Eurozone Composite PMI continued to rise to 53.7 versus 52.5 previously. Despite incremental lock-down measures, the Eurozone Service PMI moved into expansionary territory, rising to 50.3 from 49.6 previously and Germany lifted its 2021 GDP growth forecast from 3% to 3.5%. The April US ISM Manufacturing PMI took a breather, slowing to 60.7 on supply chain bottlenecks, as global industries are running at full capacity. April Caixin China Manufacturing PMI rose to 51.9 versus its preceding reading of 50.6.

Performance

In April, the MSCI EMU Index rose 2.16%. The fund's euro I-shares depreciated 0.18%, underperforming the MSCI EMU Index (net dividends reinvested) by 234 basis points.

Performance contributors

- Banco Santander outperformed the market by 10% on reporting a 38% pre-tax profit beat.
- Société Générale outperformed the market by 4% as BNP Paribas reported a massive beat in its equity division, an area Société Générale is heavily exposed to.
- ABN AMRO Bank outperformed the market by 2% on analysts raising their expectations for capital return to shareholders through higher dividends and share buy-backs.
- Bayer outperformed the market by 2% as corn prices skyrocketed 23% in April. This will drive farmers profits and leads to higher crop and fertiliser demand as farmers expand acreage.

Performance detractors

- Despite an appreciation of 7% in Brent crude oil prices and the companies reporting results way ahead of expectations, the energy space underperformed across the board. Total, Repsol, Royal Dutch Shell and ENI underperformed the market by 9%, 8%, 7% and 7% respectively.
- Aegon underperformed the market by 6%, following the huge outperformance seen since last September.
- UniCredit underperformed the market by 5%, as some shareholders questioned the compensation of the incoming CEO.

Positioning

In April, the fund switched Volkswagen pref., up 70% since purchase in May 2019, and having outperformed the market by 46%, into Continental.

Outlook

Looking at current equity investments/positioning of market participants, ranging from small independent asset managers to large global financial institutions, there is a striking similarity; they are all positioned alike. Those trying to partially move away from the sprawling secular growth trade, but did not dare yet to venture into the exceptionally attractively valued large caps cyclicals, instead started last year to aggressively move into the mid-small cap space. Now a very crowded and overvalued segment that had started to underperform the value factor many months ago. With momentum gradually shifting away from secular growth to large cap cyclicals, this became the flavour of the day. A move that in view of skyrocketing leading indicators, could easily be explained to clients and, for independent asset managers, straightforward to implement with individual positions in large cap cyclicals, which is now a partially crowded space. For example, prominent representatives like ArcelorMittal and Volkswagen pref. are up four- and threefold over the last 13 months.

The last truly undervalued space globally in equities is eurozone retail banks. Having suffered 14 years of inconceivable underperformance, outright excluded as an investment category at many investment managers, never in history have they been as attractively valued, as healthy and as overcapitalised as they are today. The beauty is, that no-one has any meaningful exposure to this treasure.

The problem is that client psychology does not allow investment managers to gain outright exposure to banks - neither through segregated stocks (as independent asset managers tend to do) nor through passive banking ETFs as the rest of the industry would do. Above all because they have incessantly told their clients throughout the last decade, how structurally challenged and therefore uninvestable eurozone banks have become. Even the most courageous have given up long time ago, since the need for explanation towards clients for holding a bank is just unbearable.

Once this last truly undervalued asset category starts to seriously outperform, investors will get into a prisoner's dilemma. Either continue to preach the gospel the way they have done for the last 12 years and go down under for underperforming so royally (eurozone banks are still the single largest weighted sector) and losing clients in droves or give in to the pain trade to survive this earthquake and move part of their money into banks. The pain will eventually force everyone to transition.

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The earlier they move the lesser the pain. Since client psychology forbids them to gain outright exposure to the space, the only avenue to do so is to engage into an actively managed, bottom-up, valuation-based value fund.

Some 50-75% of eurozone retail bank's revenues are derived from net interest income, i.e., pooling client's savings and lending these savings at attractive net interest margins onto borrowers of all denomination. Historically, with steep yield curves, a hugely profitable trade. Over the last couple of years, factually flat yield curves have proved a major challenge. Put another way, core revenues of our bank's business model have been in recession for the last couple of years. The ironic thing is, that retail banks, currently suffering from depressed revenues (50-75% of revenue base on recessionary levels) are trading at depressed earnings multiples of some 7x. Banks, having cyclical business models, historically traded at some 16-18x trough earnings and some 10x peak earnings, i.e., current valuations are completely off the mark. Eurozone retail banks' loan books have an average maturity of some 6 years. A steepening yield curve implies that every low margin or loss-making loan on the back book is expiring and being refinanced into a higher margin loan on the front book, which will gradually drive net interest margins higher. This is not a 6-9 months occurrence, but a multi-year process.

Just to clarify, when we are talking about banks, we are not referring to the UBS and Credit-Suisse of this world, hybrid business models of investment banking and Wealth Management, both businesses in structural decline. We are talking about classical retail banks that keep accumulating surplus core tier 1 equity capital (CET1) they don't need, and will, come October 1, 2021, start returning these excess funds to shareholder in form of royal dividends (some 6.5%) and aggressive share buy-backs, to finally get rid of their enormous CET1 capital surplus, they were forced to accumulate by the regulator ever since 2009 and artificially massively depresses their reported ROEs.

With global economies in the process of overheating, before the first investments from the unprecedented global stimulus programs has even reached the real economy (the European Union is now in the process of readying the financing of the first EUR150 billion tranche of its EUR750 billion stimulus program that will flow into the economy in form of infrastructure investments starting June 2021), skyrocketing commodities (up 45%-175% over the last 12 months) will ensure that rising input costs in global economies will feed through PPIs into inflation (typically with a lag of 3 months). With most of our cyclical companies already reporting earnings exceeding pre-Covid levels and enjoying sprawling free cash flow (FCF), barbarians (union representatives) are gathering at the gates. They will definitely be asking for very generous pay hikes. Salaries constitute some 80% of core inflation.

This, combined with QE being partially disbanded with effect from July, will drive normalisation of yield curves. 5-year forward inflation expectations currently stand at some 1.6%. Even though we are highly likely to comfortably overshoot the 2% mark over the next 18 months, that number is at least in line with current inflation running at 1.6%. However, what is completely off, is the 10-year bund yield still trading at -20 basis points. Last time we had forward inflation expectations at 1.6% back in 2015, the 10-year bund yield traded at +75 basis points – mind the gap! The 10-year bund yield is at this very moment in the process of breaking the all-important technical level of -20 basis points. Should that level break, it is highly likely to unleash a buying panic in eurozone retail banks. It's the buy signal for the USD3 billion momentum machine.

The only asset that protects you from rising inflation, spiking (normalising) interest rates and momentum assets is eurozone retail banks. We currently have some 45% exposure to financials.

Since the COVID-induced trough of 16 March 2020, we have outperformed the benchmark by some 44 percentage points. The value factor has over that period outperformed the blend benchmark by just 1.5%, i.e., you have not yet missed anything and the full upside from this rotation back into value is still up for grabs.

NAV: EUR 117.27
ISIN I shares: LU1975716835
Valor I shares: 47229643

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