



# DIVAS EUROZONE VALUE

Monthly Report June 2021

Marketing material for professional clients



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## Market environment

The month of June was all about the more contagious Delta strain from India, respective fears on delayed reopenings and its potential impact on economic growth and inflation.

Even though FED chairman Powell and various other governors vocally advocated the need for early tapering on higher than expected inflation, Delta variant worries dominated and triggered a yield curve flattening rather than the steepening the economic data would imply. This temporarily initiated a buy the dip rally in technology/secular growth stocks and had value underperform growth by some 350 basis points.

The Beige book out early June stated that evidence of shortages - whether of workers or goods - was widespread, and a main source of the rising prices that the FED and other officials were watching carefully. The Richmond FED reported that restaurants and hospitality services were unable to reopen fully, because they couldn't find workers. Retailers were limiting inventories because of shipping and production delays. With the Eurozone starting to reopen its service sector in July, similar bottlenecks are likely to become visible soon, thus driving inflation higher.

Mid-June, some European Central Bank officials issued warnings about higher rates of inflation, just a day after agreeing to keep monetary stimulus flowing at an accelerated pace through the summer.

The Bundesbank revised GDP growth expectations for 2021/2022 from 3% to 3.7% and from 4.5% to 5.2% respectively. Inflation expectations were upped accordingly, moving from 1.8% to 2.6%.

Late June case growth increased in the UK, remained at low levels in the US and Spain, and decreased in Canada, Germany, France, and Italy. Hospitalisations continued to fall across North America and Continental Europe and remained at low levels in the UK and Portugal despite the increase in cases.

In June 5-year forward inflation expectations declined by 1 basis point to 1.59%.

In June the 10-year Bund yield oscillated between -15 basis points and -22 basis points to close at -21 basis points. The Swiss Franc appreciated 0.2% to 1.0969.

Despite worries about the Delta variant, the commodity complex continued its ascent, with Brent crude oil jumping 8%, Nickel up 1% and iron ore up 4%.

The June Markit Eurozone Composite PMI spiked to a new all-time high of 59.2 versus 57.1 previously. June EC Economic Sentiment Indicator also jumped to a new all-time high of 117.9, comfortably exceeding the peak level seen in January 2018. The June US ISM Manufacturing PMI moderated to

60.6 from 61.2 previously. ISM Prices Paid, an indicator of future inflation, spiked to a new all-time-high of 92.1, comfortably ahead of the expected 87. The June Caixin China Manufacturing PMI softened to 51.3 versus its preceding reading of 52.

## Performance

In June, the MSCI EMU Index rose 1.05%. The fund's euro I-shares depreciated 2.79%, underperforming the MSCI EMU Index (net dividends reinvested) by 384 basis points.

## Performance contributors

- **Royal Dutch Shell** and **ENI** outperformed the market by 8%, and 1% respectively on the former announcing a major disposal and the general rise in the oil price.
- **Telefonica** outperformed the market by 2% supported by an analyst recommendation upgrade.

## Performance detractors

- Worries on the potential impact of the more aggressive Delta variant and the fact that eurozone retail banks had in May strongly outperformed, had financials underperform indiscriminately across the board. **Aegon**, **Banco BPM**, **ABN AMRO Bank**, **Banco Santander**, **AXA**, **UniCredit**, **BNP Paribas** and **Société Générale** underperformed the market by 9%, 8%, 7%, 7%, 6%, 6%, 6% and 6% respectively.
- Same thing with Cyclical. **Covestro**, **HeidelbergCement** and **ArcelorMittal** underperformed the market by 6%, 4% and 4% respectively.



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## Positioning

In June, the fund increased its holding in Aegon.

## Outlook

In the past we had repeatedly highlighted the immense cash return (dividends/share buy-backs) potential of the eurozone banking sector. Our extensive conversations in June with senior management comfortably exceeded our expectations. BNP Paribas, for example, is currently sitting on liquidity reserves of some EUR450 billion, deposited at the ECB and the FED for a cost of some 50 basis points. Not that they really needed anything close to that amount, but this is regulator imposed, expiring October 1, 2021. Purely operationally BNP prudently needed only some EUR200 billion to run their business, i.e., they have a mind-boggling liquidity surplus of EUR 250 billion, equivalent to 3 1/2 times their current market cap. In other words, the bank could in theory buy back three times the number of shares outstanding.

With Brent crude oil up 75% year-on-year, the European oil sector is entering its most cash generative phase in the cycle, as higher commodity prices, better margins and volumes across all businesses are coupled with ongoing capital and cost discipline. On current oil prices the group generates some USD75 billion in FCF for 2021 and 2022 or 4 times the 10-year annual average. As balance sheet repair is largely complete, the sector can now shift its focus to returning cash to shareholders. Since they already pay very generous dividends, they are very likely, come 2022, to embark on aggressive share buy-backs.

In recent months, US and Asian investors, including domestic investors (who have been sellers in recent years), have been piling into European equities as they are cheaper than the US and offer exposure to cyclical sectors that benefit from economic reopenings. There has been a move into Value and Cyclical, following consistent outflows from these styles in previous years. However, recent flows have retraced only a small amount of the net outflows in recent years, and the inflows have lagged the improvement in the PMIs considerably. European equities have been a long-term underperformer and hence most investors have much lower weightings in the region than historically. The ability of European equities to continue to attract capital will largely be driven by its superior GDP and earnings growth.

There is a major debate ongoing among central bankers and investors as to whether the current spike in inflation is only temporary or will stay with us for an extended period of time. It is not uncommon for shifts in inflation at turning points to be seen as transitory. In general, higher inflation is matched by higher bond yields. But different periods have shown that this trade-off is priced differently according to the perceived risks. The slope was high in the 1970s but low in the 1980s. Investors didn't really expect the high levels of inflation in the early 1970s to persist, at least to begin with. They were willing to accept a relatively low yield compared with reported inflation as it began to spike. It took some time for expectations to adjust to the reality that a high inflation regime was likely to last. Similarly, once high inflation had become established, by the time inflation started to come down

in the early 1980s investors were doubtful that this was the start of a new trend. Bond yields remained much higher than reported inflation for a long time.

For the last 6 years QE of European and US central banks saw to it, that a major gap between expected 5-year forward inflation and nominal interest rates opened up, i.e., rates trade way below expected inflation. The FED mid-June clearly and unequivocally signalled it will take away the punching ball for bond markets by starting tapering rather sooner than later. The pronounced short-term appreciation of the US Dollar this statement triggered, will allow the ECB to soon follow suit with the same narrative, without risking a major sell-off in the US Dollar. Removing this artificial support for bond markets will ensure that yield curves will normalise and the gap to expected forward inflation will eventually be closed.

The market across all asset categories was totally unprepared for this sudden tapering talk, creating the wildest gyrations in various asset categories. Hedge funds, heavily positioned in the 5s30s yield curve steepeners were forced to aggressively unwind their positions, thus temporarily driving the entire yield curve lower. A move in extent and intensity very comparable to the one experienced at the crash low of March 2020. Simultaneously copper long positions were unwound with net long positions now at its lowest level in 12 months.

This brutal short-term reversal on rates and commodities beautifully laid the ground for the reflation trade to continue. Once authorities start



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tapering, yield curve normalisation/steepening will materialise rapidly. Should history be any guide, once the artificial intervention (QE) of the last 6 years is removed, the current exceptionally healthy global economic environment and respective 5-year forward inflation expectations would imply a normalised 10-year Bund yield of +1.25%, rather than current -0.21% and a 10-year Treasury yield of 2.25%, rather than the prevailing 1.47%. Needless to say that eurozone financials will be the major beneficiaries and momentum/secular growth/long duration assets will get crushed.

A fast vaccination rate, falling infections and easing restrictions will see euro area economic activity to surge in the

next few months. Strong balance sheets mean forward-looking indicators of consumer and corporate spending are buoyant. Consequently, a eurozone GDP growth of some 4.5-5% in 2021 and 2022 seems quite realistic. The fact that inventories globally are close to historic lows, will sooner or later trigger an inventory cycle, thus further fuelling an already overheated global economy.

Property markets globally are running hot. From the US to the UK and even in Japan, home prices are surging as a result of loose monetary policy. Another reason for the central banks to tighten monetary policy in the second half.

This Delta variant will neither seriously delay the opening of the global service

sector nor slow global GDP growth or hold back inflation and the normalisation of yield curves, but has created a very attractive entry point into the value space. Go for it! This window of opportunity will not be available for long.

**NAV: EUR 119.89**

**ISIN I shares: LU1975716835**

**Valor I shares: 47229643**



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