DIVAS EUROZONE VALUE

Monthly Report July 2021

Marketing material for professional clients

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Market environment

In July Eurozone equities experienced two sell-offs triggered by worries related to the fast-spreading Delta virus, oscillating within a 5% band to eventually close flat on the month.

Prices paid by US consumers surged in June by the most since 2008, topping all forecasts, as higher costs associated with the economy's reopening continue to fuel inflationary pressures. The consumer price index jumped 0.9% in June and 5.4% from the same month last year, according to Labour Department data released early July. Excluding the volatile food and energy components, the so-called core CPI also rose 0.9%. Year-on-year core inflation increased 4.5%, the largest advance since November 1991.

In early July, European Union officials markedly raised their outlook for the euro-area economy for the second time (GDP +4.8% versus +4.3% previously) and said there's a higher risk of inflation taking hold as loosening virus restrictions allow demand to snap back.

In July, 5-year forward inflation expectations spiked 9 basis points to 1.67%, the highest level since 2008, when the 10-year Bund yield traded at +60 basis points.

The 10-year Bund yield tumbled 25 basis points to -46, in direct contrast to rapidly rising inflation expectations. Meanwhile, the Swiss Franc jumped 2% to 1.075, both a knee-jerk reaction on Delta virous worries.

Brent crude oil initially slumped 8% to close up 2% on the month. Nickel rose 7% while iron ore depreciated by 8%.

The July Markit Eurozone Composite PMI rose to a new all-time high of 60 versus 59.5 previously. The July Caixin China Composite PMI rose to 53.1 versus its preceding reading of 50.6. Conversely, the July US ISM Manufacturing PMI moderated to 59.5 from 60.6 previously.

Performance

In July, the MSCI EMU Index rose 1.31%. The fund's euro I-shares depreciated 0.98%, underperforming the MSCI EMU Index (net dividends reinvested) by 229 basis points.

Performance contributors

- ArcelorMittal outperformed the market by 12% after reporting an exceptionally strong set of results, increasing guidance for apparent steel demand for 2021 from 4.5-5.5% to 7.5-8.5%, and announcing a USD2.2 billion share buyback program (6% of shares outstanding).
- HeidelbergCement outperformed the market by 2% on raising FY21 guidance from a slight to a strong increase in LFL EBITDA. The firm also announced a EUR1 billion share buyback equivalent to 7% of shares outstanding.
- AXA and Aegon outperformed the market by 1% and 2% respectively, supported by analyst earnings upgrades.

Performance detractors

- Despite reporting Q2 results in line with expectations and reiterating its cumulative FCF guidance for FY21-23 of EUR4 billion, Telecom Italia underperformed the market by 12%.
- Despite reporting Q2 results ahead of expectations with exceptionally strong FCF of EUR921 million, Repsol underperformed the market by 11%.
- The sharp decline in Bund yields saw banks underperform indiscriminately across the board. Banco BPM, Banco Santander, ABN AMRO Bank, BNP Paribas and ING underperformed the market by 8%, 5%, 5%, 4%, 4% respectively.

Positioning

There were no transactions in July.

Outlook

In, early July Johnson & Johnson said that its single-shot coronavirus vaccine neutralises the fast-spreading Delta variant and provides durable protection against infection more broadly. The shot neutralised the Delta variant within 29 days of a first dose, and protection matured and improved over time. This is great news for Emerging Markets, where the roll-out of a single-shot vaccine that can be kept at refrigerator temperatures will logistically be much easier and should help those countries to eventually close the vaccination gap relative to Developed Markets.

There is much ado about the Delta variant: for the fully vaccinated, the mortality rate is similar to a severe flu season. Therefore, we don't believe it is socially or politically acceptable to have widespread lockdowns to protect those who voluntarily refuse the vaccine. By year-end, there is enough capacity to vaccinate 6.8 billion people out of a global population of 7.9 billion.

The sharp fall in European bond yields since early July has occurred despite an ECB-inspired rise in Eurozone five-year inflation breakevens, which recently hit their highest level since late 2018 (i.e., Bund yields have temporarily moved strongly opposite to rising inflation expectations). Clearly, this is a deviation that is not sustainable and likely to be reversed strongly.

The gap between bond yields and nominal GDP or global PMIs is now unprecedentedly large (i.e., the Bund yield should be in positive territory not negative). Thus, as in 2018, Bund yields have the potential to rise, even if PMIs eventually fall!

A net 48% of European Value stocks beat earnings expectations this quarter versus a net 18% for Growth stocks. This positive skew in favour of Value is the strongest since 2007. Ironically, 2007 was the last time we experienced a value bubble and is an indication of how badly undervalued these stocks are currently.

Let me provide an historical anecdote: At the height of the Tech Bubble in March 2000, Information Technology represented 33% of S&P 500 equity capitalisation. By 2002, it had fallen to 13% (absolutely unimaginable these days). One year ago, for the first time since the Tech Bubble, Information Technology represented more than a quarter of S&P 500 equity capitalisation at 27%.

In July, global inventory levels moved to a new multi-year low, laying the ground for an additional boost to GDP growth going forward, as depleted inventories are rebuilt (inventory cycle).

Following the hefty underperformance of the value factor over the last two months, the little reflation trade that started to be priced in early March 2021, was completely reversed over the course of the last 5 months, compounding to an inconceivable 14 percentage points of under-performance of the eurozone value factor versus growth. This brings the value factor early August factually back to its all-time-low seen on 16 October 2020. Even though GDP and earnings growth have massively improved since mid-October 2020 and expected forward inflation has sky-rocketed to 1.67% from 1.08%, the value factor versus growth is basically back to square one. Totally absurd in view of fundamentals, but at the same time a great opportunity.

Since the crash low of 16 March 2020, the value factor has underperformed the blend benchmark by 319 basis points. Despite that style headwind, we have outperformed the benchmark by 37.83%, thus managing to generate an asymmetric Alpha of 41 percentage points.

NAV: EUR 118.72
ISIN I shares: LU1975716835
Valor I shares: 47229643

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