DIVAS EUROZONE VALUE

Monthly Report September 2021

Marketing material for professional clients

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Market environment

In the first three weeks of September, Eurozone equities moved largely sideways, only to ultimately sell off some 5% on the back of worries that the Chinese company Evergrande could go bankrupt. This initial sell-off on Evergrande concerns and a spike in Treasury and Bund yields late September fuelled investor rotation out of expensive secular growth stocks into cheaper valued equities that can benefit from the economic reopening.

While banks rarely comment on single name exposures, the absence in the press of such mentions seems to be an indication of limited direct exposure of European banks to Evergrande. There were also comments, at different conferences, by several major European banks of no direct exposure at all.

According to the latest results of a trial, involving almost half a million health workers in South Africa, Johnson & Johnson's Covid-19 vaccine cuts the risk of getting infected with the disease by about half and the vast majority of the breakthrough infections were mild.

Meanwhile, the FOMC statement offered more explicit tapering hints. It noted that moderation in the pace of asset purchases may soon be warranted if progress continues as broadly as expected. Powell's press conference remarks are consistent with a formal tapering announcement in November. He said tapering will be gradual and likely done by mid-2022. The 'Dot plot' showed that the Committee was evenly split for a rate hike in 2022.

Meanwhile, the European Central Bank announced that it will slow down the pace of its pandemic bond-buying program in the final three months of 2021 and acknowledged that the euro area's recovery is strong enough to endure with less support.

According to U.S. Labor Department, Wall-Street style bonuses haven't been enough to fill the surging number of available jobs with U.S. state and local governments. Such openings jumped to 936'000, the highest number since 2000. The push speaks to the nationwide labor shortage, with governments struggling to find workers even as the economy broadly reopens from the pandemic and children return to school.

Data from the National Federation of Independent Business showed a record 50% of US small-business owners said they had vacant positions, while an unprecedented number boosted wages to lure workers. Some 41% of small firms indicated they raised compensation, the most in monthly data back to 1986.

This blatant labour shortage visible in the U.S. is likely to become evident in Europe as well soon. Thanks to Covid, Labour Union representatives in the eurozone have, despite record earnings from their companies, so far been overly politically correct, completely abstaining from announcing any claims publicly. This is likely to change drastically in early 2022, when they start pushing their agenda for hefty pay hikes.

In September, 5-year forward inflation expectations jumped 15 basis points to 1.84% on actual inflation sky-rocketing to a new high of 3.4%, exceeding the level seen at the very top of the 2011 growth cycle, when the 10-year Bund yield traded at +2%. Core inflation (ex. food & energy) jumped to 1.9%, a rate not seen since 2008, when global GDP growth peaked, just before the Lehman collapse wreaked havoc and the 10-year Bund yield traded at +4%.

Accordingly, the 10-year Bund yield spiked 18 basis points to -20 basis points, while the Swiss Franc appreciated 0.2% to 1.079.

Brent crude oil rose another 10% as it dawned on the market that, with crude inventories back at their 5-year average, risks of a speculative spike in oil prices to USD80-100+ was rising exponentially. Meanwhile nickel and iron ore dropped 8% and 12% respectively.

The September Markit Eurozone Composite PMI dropped to 56.1, as business activity in the euro area suffered from supply chain bottlenecks, hurting both services and manufacturers. Confidence in the euro-area economy unexpectedly rose in September as consumers turned more optimistic about the outlook and construction companies saw employment prospects improve.

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The September Caixin China Manufacturing PMI rose to 50 versus its preceding reading of 49.2, as did the September US ISM Manufacturing PMI rising to 61.1 from 59.9 previously.

Performance

In September, the MSCI EMU Index dropped 3.37%. The fund's euro I-shares rose 2.04%, outperforming the MSCI EMU Index (net dividends reinvested) by 541 basis points.

Year-to-date the fund is up 30.72%, outperforming the benchmark by 1510 basis points. This despite the fact that this year the value factor has underperformed the blend benchmark by 27 basis points. Accordingly, we managed to generate an asymmetric Alpha of 1537 basis points.

Performance contributors

- UniCredit, ING Group, BNP Paribas, Aegon and ABN AMRO Bank outperformed the market by 12%, 11%, 10%, 10% and 9% respectively, as they benefited from analyst's earnings upgrades following their stellar Q2 results and rising Bund yields.
- Repsol, Royal Dutch Shell, ENI and TotalEnergies outperformed the market by 20%, 19%, 19% and 16% respectively, driven by pronounced positive earnings revisions on the back of strong Q2 results and rising oil prices.

Performance detractors

- Holcim and HeidelbergCement underperformed the market by 11% and 9%, on fears that rapidly rising energy costs, which constitute a large part of their COGS (cost of goods sold), were to burden their margins. Since they are factually running at full capacity, they are in a position to more than pass on rising energy costs with the typical time lag of 3-6 months.
- ArcelorMittal underperformed the market by 4% on lower iron ore prices.

Positioning

In September, the fund reduced its position in ENI and UniCredit, up 94% and 49% respectively since purchase and having outperformed the market by 45% and 26%, to increase its holdings in HeidelbergCement, TotalEnergies and Banco BPM.

Outlook

Top European banks plan to reward shareholders with at least EUR23 billion of excess capital, built up after their regulator restricted dividends and share buybacks during the pandemic. The European Central Bank's controversial cap ended October 1, 2021 and Andrea Enria, who leads its oversight arm, stated that he will only intervene if payments are imprudent.

Market participants seem to want to move on from Evergrande, the trend of Delta is very encouraging and global economic activity is picking back up as lockdowns ebb. October to January are seasonally the strongest months for inflows into equity funds, October being the strongest. Sentiment is depressed and investors are either hedged or retain record cash positions.

The pronounced outflow from eurozone value equities since early March 2021 into secular growth stocks, basically more than reversed the inflow observed from mid-October 2020 to early March 2021, when markets timidly started to price in some reflation. This drove a relative performance strongly opposite to the strong fundamentals observed in in the value space. Despite the fact that our strategy has enjoyed some 80% positive earnings revisions since mid-October 2020, on September 23, 2021 the value factor retested the all-time low seen on October 16, 2020. In late September the 'growth machine' finally seems to have exhausted itself. This follows 6 months of a complete unwinding of the economically justified reflation trade, in which the value factor inconceivably underperformed by 1600 basis points relative to growth.

If you buy our strategy today, you acquire a portfolio growing its earnings in the low teens (5-6% organically + 5-8% from share buy-backs) for the next three years, trading on 8.5x earnings, 0.9x book and paying you a dividend yield of 3.8% (growing to some 4.5%, when banks, over the next couple of weeks, announce their final dividends).

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

NAV: EUR 126.69
ISIN I shares: LU1975716835
Valor I shares: 47229643

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Equity: Investments in equities may be subject to significant fluctuations in value.

Capital at risk: All financial investments involve an element of risk. Therefore, the value of the investment and the income thereof will vary and the initial investment amount cannot be guaranteed.

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