DIVAS EUROZONE VALUE

Monthly Report October 2021
Marketing material for professional clients

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Market environment

The first week of October displayed some softness in eurozone equities on daily headlines re supply chain bottlenecks which could potentially trigger stagflation and worries related to Evergrande that, to the markets surprise, eventually paid its coupon on time. During the ensuing three weeks, the market moved gradually higher driven by strong Q3 results.

According to new data released by the US Center for Disease Control and Prevention, Covid-19 vaccines remain extremely effective at preventing severe disease and death, confirming results seen in other countries. The data showed age-standardised deaths were far lower for the fully vaccinated population than the unvaccinated. The unvaccinated had an 11.3-times greater risk of dying from Covid-19. The Moderna inoculation saw the lowest rate of age-adjusted breakthrough cases and deaths.

In late October, Fed Chairman Powell indicated some concern about inflation risks, since shortages from the global supply bottlenecks were likely to last longer than previously expected. He thinks it is now time to taper.

Inflation in the eurozone accelerated more than expected in October to the highest level since 2008 (the 10-year bund yield was trading at +4% at the time), marking another surprise reading that will likely prompt investors to question whether the current price surge is really temporary. Consumer prices rose 4.1% versus market expectations of 3.7%. Core CPI, a measure stripping out volatile components such as food and energy climbed to 2.1%, a rate not seen in nearly two decades.

Starting from November 1, a new round of negotiations in Germany will show if the post-crisis landscape has bolstered bargaining power of unions at the heart of the eurozone.

Towards the end of the period under review, ECB President Christine Lagarde had to admit that the current phase of faster inflation “will last longer than originally expected”.

In October, 5-year forward inflation expectations jumped 10 basis points to 1.95%. Accordingly, the 10-year Bund yield rose 9 basis points to -11 basis points.

The Swiss Franc spiked 1.87% to 1.0584 on breaking a key technical support at 1.07. We are now close to the high of 1.05 seen at the peak of the Covid crisis. Not really a reflection of global economies running at full capacity and overheating, but a good indicator of the pronounced risk aversion currently prevailing in the market. Purely technically the Swiss Franc may continue to strengthen to 1.05, before reversing its course to return to a fundamentally more appropriate level of 1.20+.

Oil continued its winning streak after OPEC+ agreed in early October to maintain its schedule of gradual monthly oil-production increases, ratifying a 400,000 barrel-a-day supply hike scheduled for November, driving prices 8% higher. Nickel rose 8% on further inventory depletion while iron ore dropped 9% on China trying to engineer a steel output control.

In late October, copper tracked by London Metal Exchange warehouses that’s not already earmarked for withdrawal was near the lowest since the 1970s. The dramatic 88% drop in available stockpiles this month has been driven by a steady flow of orders to take metal out of European depots. While the record spot premiums should typically start attracting metal back into the warehouse network, there’s little sign of that happening so far.

The October Markit Eurozone Composite PMI depreciated to 54.3, as business activity in the euro area suffered from supply chain bottlenecks, hurting both services and manufacturers, as did the October US ISM Manufacturing PMI softening to 60.8 compared to market expectations of 60.5. Meanwhile, the October Caixin China Manufacturing PMI rose to 50.6 versus its preceding reading of 50.

Performance

In October, the MSCI EMU Index rose 4.1%. The fund’s euro I-shares appreciated by 2.93%, under-performing the MSCI EMU Index (net dividends reinvested) by 117 basis points.

Year-to-date the fund is up 34.54%, outperforming the benchmark by 1419 basis points. This despite the fact that this year the value factor has underperformed the blend benchmark by 151 basis points. Accordingly, we managed to generate an asymmetric Alpha of 1570 basis points.

Performance contributors

- ArcelorMittal outperformed the market by 6% on continued positive earnings and FCF (20% FCF yield) revisions from analysts.
- ABN AMRO Bank outperformed the market by 4% on positive earnings revisions from analysts.
- ENI outperformed the market by 3%, driven by blow-out Q3 results coming in 33% ahead of expectations, with exceptionally strong FCF of 2.1billion (14% FCF yield).

Performance detractors

- Telecom Italia, Telefonica and Orange underperformed the market by 13%, 11% and 3% respectively, driven by Q3 earnings shortfalls from Deutsche Telecom and Telecom Italia, which pulled the whole sector down.
- HeidelbergCement underperformed the market by 4%, as the sector continued to suffer from market perceptions that rising energy prices would squeeze their margins. The company had a 2020 energy bill of EUR1.5billion (50% electricity, 20% coal, 5% pellets, 5% natural gas and the rest biomass) or some 12% of COGS (production costs). Historically price increases occur annually in January. Since they are running at full capacity, they already had two smaller price hikes in 2021 and will do another larger one in January 2022. Because of the volatility in energy prices, they are likely going forward, to move to rolling pricing (spot) to be able to pass on energy price increases faster to their customers.

Positioning

In October, the fund reduced its position in ING, up 95% since purchase in December 2020 and having out-performed the market by 59%, to increase its holding in Orange.

Outlook

It is fascinating to observe, that not only rapidly rising inflation and inflation expectations are largely ignored by the bond market, but that equally sky-rocketing oil and industrial commodity prices are neither reflected in valuations of integrated oil companies (IOCs) nor mining companies. This clearly mirrors the utopian market perception, that record commodity prices and therefore inflation will rapidly reverse course to return to the deflationary pattern the market has become so used to over the course of the last 12 years.

This is as well the reason, why our portfolio currently is still trading at just 8.6x earnings and offers us a rich dividend yield of 3.7%, rather than trading on 16-17x earnings, as it historically did, when our companies enjoyed normalised margins, earnings and FCF as they currently do. This explains the circumstance as to why, in late September 2021, the value factor tumbled back to its all-time low seen on 16 October 2020 and still trades some 300 basis points cheaper than at the Covid crash low of March 2020! A period over which we managed to generate an asymmetric alpha of 56 percentage points.

To illustrate just how tight global commodity markets are a couple of numbers from the oil space to chew on: OPEC+ plans to add 400k boed each month through to August 2022, to fully return their 5.8 million boed back onto the market by early 2023. Oil demand is expected to grow some 3.3 million boed to 99.6 million in 2022. With spare capacity of OPEC+ at some 6-7 million boed and air travel gradually returning to normal (World jet kerosene demand at April 2020 through 2.6 million boed, currently 4.6 million boed and normalised 7.6 million boed), come end 2022 or early 2023 it is hard to see what will stop oil prices from running away. We therefore struggle to see how Biden's protest should change this dynamic. As indicated in previous reports, a USD100+ oil price looks rather likely. Since oil constitutes the vast majority of headline inflation, already running at a record +4.1%, there seems to be little let-up for inflation from rising further.

Late October, sentiment once again flipped back into negative territory. The market and investors are positioned for a sell-off. It's hard to get more of a sell off, when exposure is already so low and short on the margin and sentiment depressed.

November seasonally happens to be the strongest month for value stocks.

NAV: EUR 130.4
ISIN I shares: LU1975716835
Valor I shares: 47229643

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Currency Risk – Non-Base Currency Share Class: Non-based currency share classes may or may not be hedged to the base currency of the Fund. Changes in exchange rates will have an impact on the value of shares in the Fund which are not denominated in the base currency. Where hedging strategies are employed, they may not be fully effective.

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.