JOHCM Continental European Strategy Q3 2023 Review

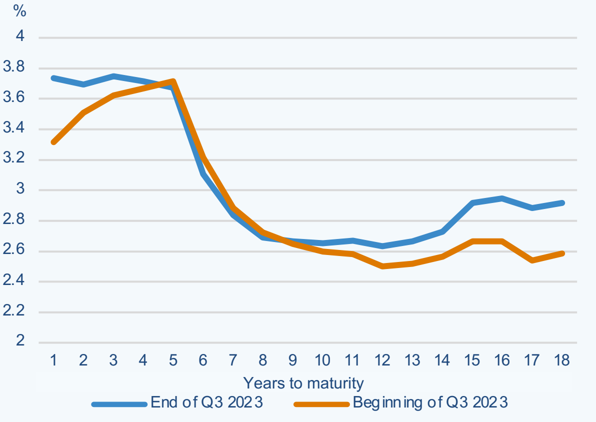
Continental Europe

Fund Literature	Fund Facts	Latest Fund Webinar

Scaling the Peak

Up Then Down

German Sovereign EUR Yield Curve



Source – Bloomberg

Market Review

Rates Continue to Rise Even as Inflation Continues to Ease

After positive returns in the two previous quarters, European equities fell by 3% in euro terms during the third quarter. July's strong returns were eroded in August and September. The overriding themes were largely unchanged, with the likelihood of a higher-for-longer interest rate outlook, driven by declining but above-target inflation. Bond markets, particularly in the US, but also in Europe, have seen a large upward shift in longer-term yields as the likelihood of recession has fallen, while higher issuance levels have also driven yields higher. In Europe, the German 10-year added 44bps to close at 2.84%, with a 65bps increase in 30-year yields over the quarter. Within the equity market, we have seen cyclicals underperform recently despite the rising yields, suggesting yields are moving up partly due to fears of a policy error.

Headline inflation fell from 5.3% to 4.3% within the quarter, closely mirrored by core inflation falling from 5.5% to 4.5%. The European Central Bank (ECB) raised rates in July, and for the tenth time in September to 4%. Chair Christine Lagarde's press conference comments focused on current rate levels which, if maintained, would make a 'substantial contribution' to revert inflation back to targeted levels. In effect, the market gained some comfort that interest rates may well have peaked. Despite this, staff inflation forecasts remain relatively high at 3.2% for next year and 2.1% in 2025 at the headline level. Wage inflation registered 5.5% in the second quarter and remains the key driver of core inflation. The ECB cut the interest rate paid on the minimum reserve requirement of the banking sector to zero in order to enhance the cost and efficiency of monetary policy.

The market received some soft-landing stimulus in July from the US inflation print, where the headline fell to 3% and core to 4.8%. US growth exceeded expectations in the second quarter at a 2.4% annualised level and Fed minutes confirmed that recession was no longer the base case scenario. The Fed increased rates in July before leaving them unchanged. Fitch Ratings downgraded the US AAA rating to AA+, given concerns over the growing government debt pile. The September median Federal Reserve dot plot reading caught the market's attention, now only expecting 50bps of rate cuts in 2024, having expected 100bps back in June. This was a key component of the bond market moves.

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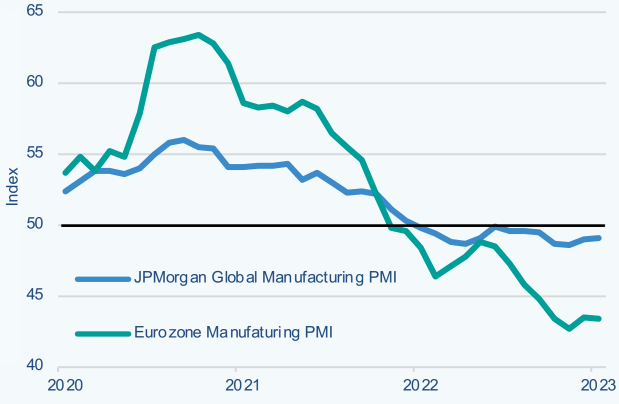
Holding the Line

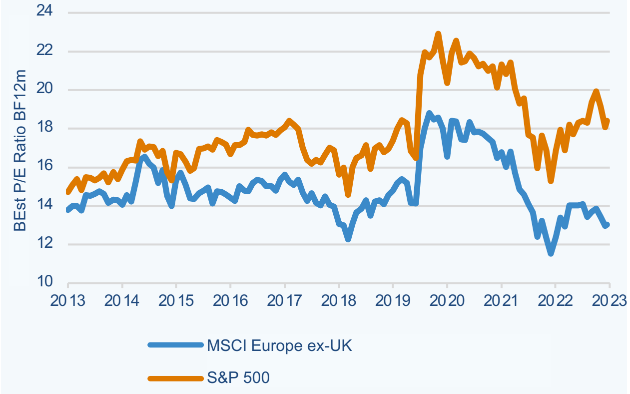
European Manufacturing Remains Resilient



Source – Bloomberg

Just Look at the Value

European valuations are lower than the US



Source – Bloomberg

The rise in real interest rates has been a particular focus of the market, not least as they have been driven by stronger growth expectations rather than higher inflation breakevens. We have seen the move in real rates put pressure on valuation multiples over the quarter. European earnings forecasts have so far been resilient, and year-to-date, earnings forecasts have, in aggregate, risen by a few percent.

The ECB lowered their staff growth forecasts at the September meeting to 1% in 2024 and 1.5% in 2025, relatively similar to current consensus expectations. After the brief technical recession in the fourth and first quarters, growth moved positive in the second quarter, annualising 0.5% year-on-year. European PMI indexes remained pressured by the global growth slowdown, exacerbated by the incrementally weaker news flow coming out of China in regards to the state of the property sector. The composite PMI reading fell from 49.9 at the end of June to 47.2 in September, with Services falling 3.3 to 48.7 and manufacturing remaining close to the lows at 43.4. European labour markets remain very strong, with unemployment at the nadir of 6.5%.

Gas prices remained quite volatile in the period, between €25 and €45 per MWh; this was largely driven by concerns over labour strikes in Australian LNG export facilities, which were eventually called off. The EU reached its 90% gas storage target in the middle of August, some eleven weeks earlier than the mandated November 1st deadline. Energy prices were strong over the period, with Saudi Arabia and Russia extending their voluntary production cuts to the end of the year; Brent oil peaked in late September at $94 Brent.

The quarter saw a huge polarisation in sector performance, against the index down 3% in euro terms, the energy sector outperformed by 19%, real estate by 13% and financials by 6%. Naturally, both energy and real estate are relatively small sectors. Healthcare performed well, outperforming by nearly 5%. At the opposite end of the spectrum, consumer discretionary underperformed by 9%, technology by 7% and utilities by 6%.

Current Positioning

Cautious for Now

We have retained a cautious outlook regarding cyclicality, pretty much in line with our view at the end of the first half, leading to a portfolio that is generally defensive and low beta. The largest overweights are in the less cyclical sectors of utilities, communications, consumer staples and health care. We added (3.7%) exposure to the latter over the quarter, given the reasonably priced growth outlook that the sector is offering. Elsewhere, we added 2.5% to information technology.

The main underweights are in consumer discretionary, financials and energy. Within consumer discretionary we reduced the size of the luxury goods exposure.

Outlook

From Complexity to Clarity

We leave the third quarter with an unusually complex outlook for the nearer term, exacerbated by bond markets, whilst the medium term remains the slightly easier call. In Europe, earnings momentum has been positive year to date, better than in other developed regions, but we do expect some pressure moving into the forthcoming earnings season. Profit margins remain close to the post-Covid highs, but the operating backdrop is hardly crystal clear in regards to pricing power in the face of lower raw materials, demand dynamics, trade tensions and global manufacturing cycles.

The usual later cycle vulnerabilities are being amplified by current bond yield levels, the heavily inverted yield curve and particularly the upward shift in real yields. We must be aware of the potential for things to 'break' under such stress, as we saw back in March with the US regional banking collapse. The question is whether yields remain at such levels; we are tempted to think that outside of the issuance headwinds, yields will drift lower over the coming six months.

European bond markets will, of course, be very much led by the US, but ultimately, headline inflation should fall from current levels, with the caveat of what happens in oil markets. GDP growth in Europe is currently very weak, led by the manufacturing economies, likely to grow less than 0.5% in 2023. Economic and business uncertainty is high, not least as 2024 growth will remain subpar.

The labour market outlook remains a key positive, given the expectation of continued resilience. The scarcity of qualified labour will admittedly keep wage demands higher for longer. The likelihood of a backdrop of positive real wage growth for consumer spending will be mitigated by monetary policy lag effects, falling house prices (-1.7% Q2 in the Euro area) and recent increases in the savings rate (to 14.8%). The question is how this all nets out; we think big-ticket spending on the likes of autos and construction will stay under pressure, but an overall relative resilience will prevail.

The ECB has not categorically ruled out further hikes, but they appear less likely now, and it has become semantics in that we are already at near-peak levels. However, for now, we are happy to maintain a more defensive and lower beta stance, acknowledging the possibility that there is a risk that real rates could stay high as inflation falls.

The portfolio, whilst being heavier in more defensive sectors, is clearly more protected from weaker growth, but would also benefit from yields retracing their climb. The core thematics of the Green Deal, Health & Ageing and Digitalisation, provide the portfolio with resilience, whilst our noncyclical holdings outweigh our underweight of cyclicals.

Ultimately, investing over the next year remains very much a call on when interest rates start to fall; here a consensus is growing around late summer to autumn 2024. We believe this will correspond with the likely start of a new cycle and will inevitably require some changes in portfolio positioning, yet the near term needs to be navigated with some care. As ever, we must remember that the market always looks ahead and with Europe trading on just 12.5x forward earnings, some of the weaker earnings news flow is already priced in, so we must remain alert for opportunities.

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Paul Wild
Senior Fund Manager

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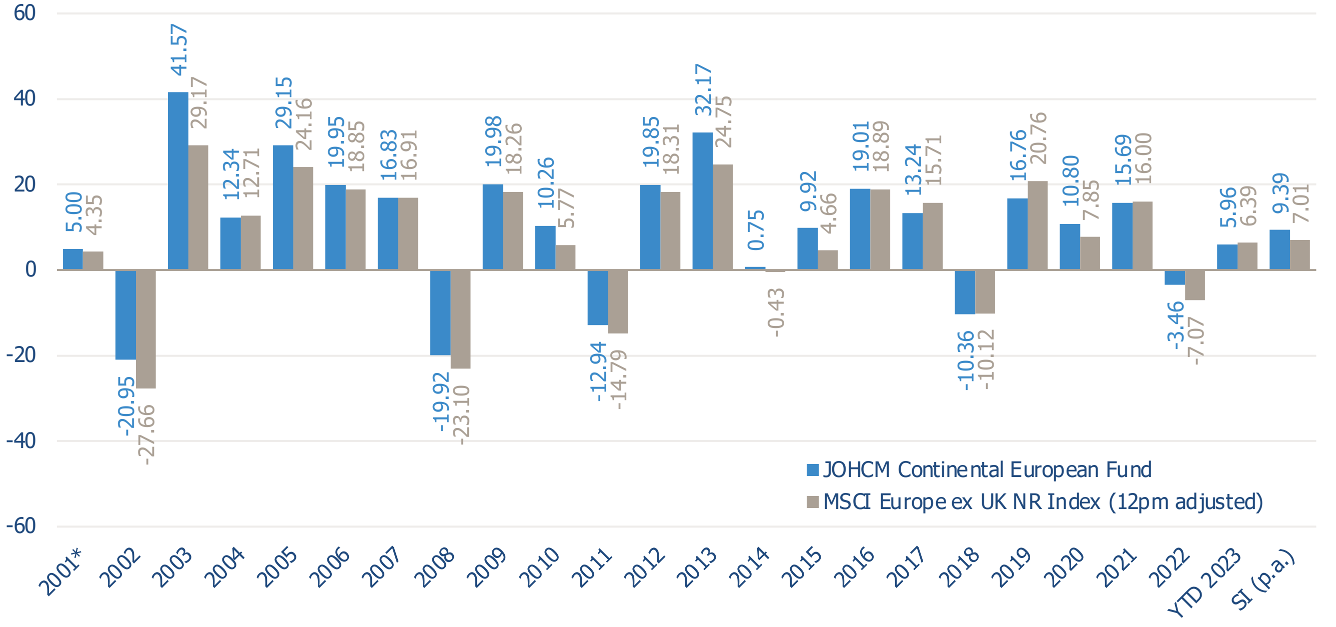
FUND PERFORMANCE

JOHCM Continental European Fund (GBP) (%): 4 November 2001 – 30 September 2023



Periodic performance (%)	1 month	3 month	1 year	3 years	5 years	SI	SI annualised
Fund	**-1.15**	**-1.82**	**20.79**	**31.34**	**34.47**	**614.85**	**9.39**
Benchmark	-1.40	-1.53	19.50	25.29	32.87	341.39	7.01
Relative return[1]	0.25	-0.29	1.08	4.83	1.21	61.95	2.22

Discrete performance (%)	30 Sep 23	30 Sep 22	30 Sep 21	30 Sep 20	30 Sep 19
Fund	**20.79**	**-11.74**	**23.20**	**1.59**	**0.78**
Benchmark	19.50	-13.32	20.96	0.10	5.94
Relative return[1]	1.08	1.82	1.86	1.49	-4.87

Past performance is not necessarily a guide to future performance. The value of an investment can go down as well as up and investors may not get back the amount invested. For further information on risks please refer to the Fund's KIID and/or the Prospectus. Source: JOHCM/MSCI Barra. NAV of share class A in GBP, net income reinvested, net of fees, as at 30 September 2023. Benchmark: During the period 4 November 2001 to 31 December 2012 the Fund was benchmarked against the FTSE Eurofirst 300 TR Index. For the period 1 January 2013 to present the Fund is benchmarked against the MSCI Europe ex UK NR Index (12pm adjusted). Performance of other share classes may vary and is available upon request. *Part period return since inception 7 May 2003 to 31 December 2003.

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Sources: JOHCM/Bloomberg/Lipper/MSCI Group (unless otherwise stated).