JOHCM Continental European Fund

Q4 2023 MARKET REVIEW

Finish With a Flourish

Market Review

Shifting Views on Interest Rates Drove Markets Back and Forth

2023 saw strong equity returns but many twists and turns along the way, making it a challenging year to outperform. After a weak October, equities closed out the year in an exponential fashion, rallying by 11% in euro terms in the final two months on the back of the anticipation of interest rates falling faster than expected in 2024. Headline inflation fell in the euro area from 4.3% in September to 2.9% in December. Bond markets remained in full focus over the quarter; German 10-year yields fell by 82bps, closing the year at 2.02%. Indeed, November saw the best performance for Bloomberg's global bond aggregate since December 2008.

October saw a selloff in both bond and equity markets and significant geopolitical concerns in the Middle East. Mood music from the Federal Reserve encouraged investors to dial down rate cut expectations; the 10-year Treasury yield hit 5% for the first time since 2007. The European Central Bank (ECB) chose to leave interest rates unchanged and spoke of rates at current levels making a "substantial contribution" to returning inflation back to the 2% medium term target, which led many to believe that rates have peaked. The euro area PMI was weaker than expected at 46.5, falling 0.7 month-on-month, with manufacturing down to 43 and services at 47.8. The October flash headline inflation reading was at 2.9% year-on-year (YoY), the lowest since June 2021, some 20 basis points less than expected.

November was an incredibly strong month for European equities. Against a background of what increasingly looked like peak rates, driven by lower inflation, bond yields declined, with the German 10-year falling 36bps to 2.45%. Euro area inflation fell to a two-year low of 2.4% YoY, which led to downward adjustments to next year's forecasts. The PMI indices slightly surprised to the upside, with the composite at 47.1, with a slightly stronger new orders index up 1.3 to 45.1. Germany remained in focus on the fiscal front after the Constitutional Court ruling forcing the government to further reduce spending due to a strict interpretation of the debt brake. In response, the government has already announced a supplementary budget for 2023, implying the debt brake would be lifted by retrospectively declaring a climate emergency, whilst the debate on the 2024 budget continues, but some fiscal restraint is likely. As the month ended, seven OPEC+ countries announced voluntary production cuts for the next quarter, and Saudia Arabia extended its 1mbd cut. Still, oil prices softened against the background of recent higher-than-expected inventories.

The ECB similarly noted the decline in inflation

European markets finished 2023 with a flourish. By December, the market appreciated the growing dovishness of the Federal Reserve; Chairman Powell acknowledged the CPI improvement and confirmed the Fed had started debating rightsizing rates, which could happen before inflation reaches 2%. The ECB similarly noted the decline in inflation but did not go further in validating market

expectations, highlighting the continued data dependency. ECB staff projections lowered headline inflation expectations to 2.7% in 2024 and 2.1% in 2025, with core inflation being 2.3% in 2025, whilst they see real GDP at 0.8% and 1.5% in the coming two years. German ten-year yields fell by 42bps in December to close the year at 2.02%; those in the US fell by 44bps. Within the equity market, many of the more cyclical and bond-sensitive areas outperformed. Euro area GDP slowed to -0.1% quarter-on-quarter in Q3 and 0% growth YoY.

Rate-sensitive and technology sectors performed particularly well

Looking Down

German 10-Year Government Yield (%)

Source: Bloomberg.

The quarter again saw a huge polarisation in sector performance, against the index (non-12pm adjusted) up 7.5% in euro terms. Rate-sensitive and technology sectors performed particularly well with real estate up 22.7%, technology up 18.6%, industrials up 13.3% and materials up 11.8%. Energy was the largest underperformer by 10% versus the index, falling 2.6% in absolute terms. Other more defensive areas underperformed, led by healthcare, underperforming the index by 7%, consumer staples by 4.5%, and communications by 2.8%.

Current Positioning

A Little More Beta, a Little Less Defensive

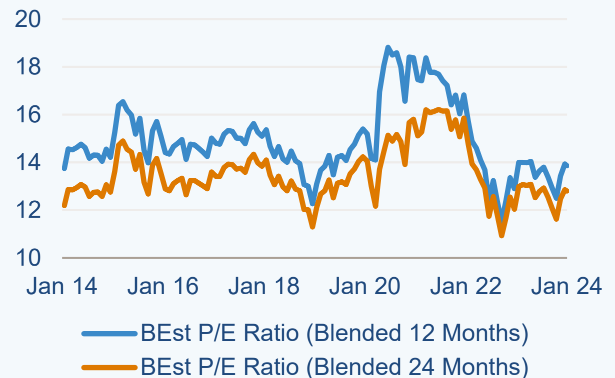
We slightly increased the beta of the portfolio during the quarter, and whilst embracing the likelihood that rates will fall in 2024, we chose not to add excessively to early cyclical-type companies.

The main position changes at the sector level included additions to technology and industrials whilst increasing consumer discretionary.

We reduced financials, believing that the sector, having outperformed for the previous few years, is now at a turning point given headwinds from interest rates and provisioning ahead. This sector is heavily dependent on earnings momentum, more so than valuation, given the volatility in earnings over the cycle. Elsewhere, we reduced consumer staples and healthcare, slightly mitigating our defensiveness and communications.

Looking Over

MSCI Europe ex UK Forward Valuations



Source: Bloomberg.

Outlook

Improved Opportunity in Make Up of the Index

After a particularly strong finish to 2023, it is possible in the short term that investors have borrowed against returns in 2024. The key market driver has been the elevation in expectations for the amount of

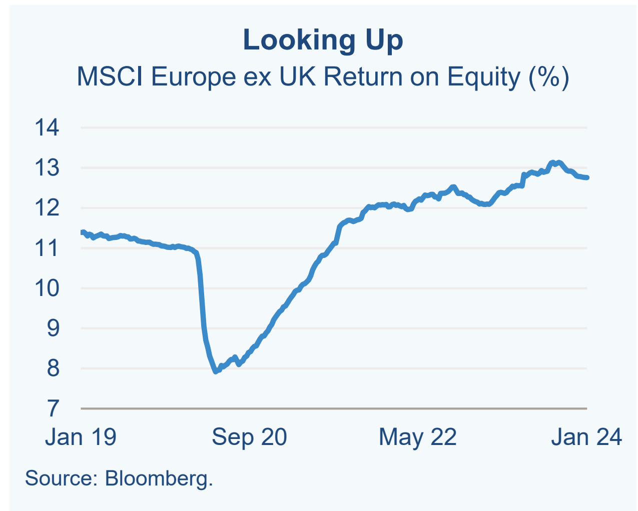
interest rate cuts, which have already started to recede in the first week of 2024, but currently still expect rate cuts of 145bps by the ECB and 134bps by the Fed over the next twelve months (as at the 9th of January). Given the significant downward shift in inflation, we believe rates will fall but would not count ourselves as being more dovish than where the market stands.

European valuations remain appealing, trading below the ten-year average

The GDP backdrop looks to be a little better than 2023, another sub-1% year of growth, but we would expect the direction of incremental change to be more positive. Consumer confidence is showing signs of improvement with the return of real wage growth, and we expect the labour market overall to remain resilient. The manufacturing outlook has been under pressure, but it increasingly looks like the PMIs have troughed and will be geared on the upside to change in China and the US. However, economic momentum looks like it will be gradual, and thus, there is no need here and now to be buying low quality early cycle type companies. Instead, we find far greater attraction in some of the structurally underpinned Industrial stocks such as Siemens and Airbus. Similarly, when playing cycles, we prefer to be very specific and find attraction in the semiconductor names where there are clear signs of the market having troughed.

European valuations remain appealing, trading below the ten-year average on a blended forward one-year and two-year basis. We continue to think that investors should pay more attention to the degree of change within the European index, which has an increasing weighting of less cyclical, higher return and stronger growth sectors and companies. The upshot of these changes is a more internationally exposed index and, most importantly, an outlook for a rising ROE on a multiyear basis, which we expect to be rewarded with re-valuation at the index level.

In short, we are excited that these changes will become increasingly visible to investors.



Source: Bloomberg.

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Fund Literature	Fund Facts	Views & News

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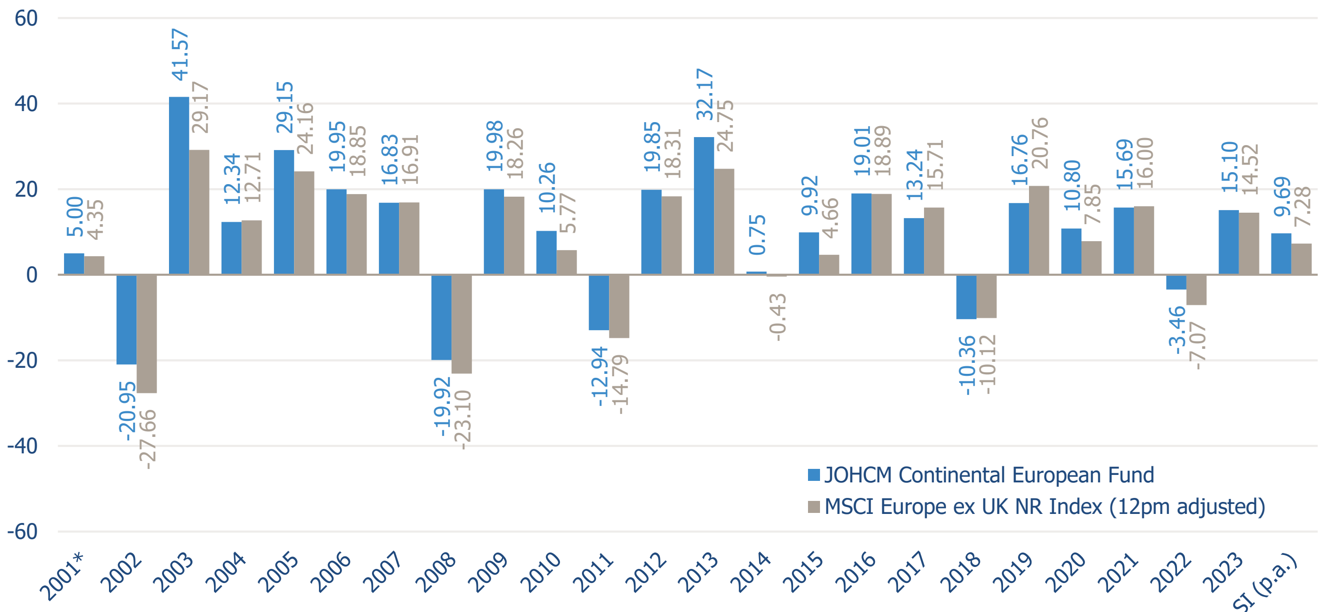
FUND PERFORMANCE

JOHCM Continental European Fund (GBP) (%): 4 November 2001 – 31 December 2023



Periodic performance (%)	1 month	3 month	1 year	3 years	5 years	SI	SI annualised
Fund	**5.18**	**8.63**	**15.10**	**28.55**	**66.30**	**676.52**	**9.69**
Benchmark	4.83	7.64	14.52	23.45	60.78	375.12	7.28
Relative return[1]	0.33	0.91	0.50	4.13	3.44	63.44	2.24

Discrete performance (%)	31 Dec 23	31 Dec 22	31 Dec 21	31 Dec 20	31 Dec 19
Fund	**15.10**	**-3.46**	**15.69**	**10.80**	**16.76**
Benchmark	14.52	-7.07	16.00	7.85	20.76
Relative return[1]	0.50	3.89	-0.26	2.74	-3.31

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J O Hambro
Capital Management Group

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