

EUROPE ONE YEAR ON



Paul Wild
Senior Fund Manager

- Looking at the portfolio's performance over the past turbulent 12 months, the early decision to look through the shocking headlines and the noise has paid off, particularly the avoidance of excessive balance sheet risk.
- While the pace of vaccinations across the Continent is obviously disappointing when compared to the UK or US, the theme of Europe emerging stronger from the pandemic is still intact.
- The backing of the Recovery Fund and the next European seven-year budget for the Green Deal has bolstered my enthusiasm for maintaining high exposure to green initiatives.
- The Fund has had a solid start to 2021 so far, mainly facilitated by the financials overweight and underweights in consumer staples and healthcare.

JOHCM Continental European Fund

Writing just over a year since global markets hit pandemic lows, the recovery in equity markets – the MSCI Europe ex UK (price) index has returned 48% in the 12 months to 19 March 2021 in euro terms – still seems remarkable given the economic deep freeze of the past year.

In Europe, the powerful recovery in stock markets has been spearheaded by certain sectors, namely consumer discretionary (up 90% over the 12-month period) and industrials (up 84%). Meanwhile the consumer staples and healthcare sectors have experienced still decent but more pedestrian returns of 11% and 13%, respectively, over the same period.

Looking at the portfolio's performance, whilst by no means has everything gone to plan, I am pleased that the early decision to look through the shocking headlines and the noise paid off, particularly the avoidance of excessive balance sheet risk. We have now gone through a period where cyclicals have seen strong performance versus defensives, albeit value has only more recently prevailed over growth on a one-year basis and still lags considerably over the last five years.

Europe emerging stronger

I believe the theme of Europe emerging stronger from this crisis is intact, albeit the pace of vaccinations across the Continent is obviously disappointing when compared to the UK or US. Encouragingly, there is scope for over-delivery on this front in Europe during the second quarter, not least if the AstraZeneca vaccine debate is quelled.

Efforts surrounding the Recovery Fund are now gathering pace, having overcome objections from Hungary and Poland last year. Each member country's 'Recovery and Resilience Plan' needs to be submitted by the end of April, with up to three months set aside for approval.

These plans are focused upon six main policy areas. At least 37% of the funds are set to go towards the green transition, at least 20% for digital transformation, with the other four key areas being sustainable and inclusive jobs and growth, social and territorial cohesion, health and resilience, and policies for the next generation.

Clearly the Recovery Fund is not just a short-term cyclical buffer but contains a large structural element, which has been noticeably missing from the European fabric up until now. The Fund employs strict conditionality based upon each country's explicit progress against pre-set project milestones in order for each funding tranche to be released. This is, of course, hugely important for Southern Europe, and the Recovery Fund could easily drive an incremental 1-2% per annum GDP boost in the coming years. This is why Mario Draghi's arrival at such a critical juncture is so important for Italy. A combination of well-targeted domestic reform

measures and the tailwind of the Recovery Fund could tangibly improve the outlook here. In the meantime, Draghi has unveiled a €32bn Social Decree to further target the worst affected companies and to bolster the healthcare system.

Going green

The backing of the Recovery Fund and the next European seven-year budget for the Green Deal has bolstered my enthusiasm for maintaining a high exposure (over 35% currently) to green initiatives.

It is becoming clear that vehicle electrification is set to far exceed initial expectations and the car companies themselves are on a roadmap to ESG transformation. Portfolio holding Volkswagen is now aiming for half of its sales to be battery electric by 2030, with the highest penetration (60% of sales) being in Europe and EV sales of 70% targeted for the Volkswagen (VW) brand itself. At its recent 'Power Day', VW set out a target for six new battery gigafactories, the first to be opened by 2023, with a combined 240GWh of battery capacity in Europe alone by 2030. This is key to its unified cell strategy to reduce battery costs by 30-50%. VW aims to add 18,000 fast charging points in Europe over the next four years, with the ultra-fast charging points reducing charging time by half, to just 12 minutes, by 2025. The fact that a company with such scale is committing to such massive infrastructure investments, some €35bn in electromobility and €27bn in digitalisation over the next five years, in addition to the continued rollout and development of its electric vehicle platform and model line-up, is a huge step forward. Meanwhile VW is trading on less than 8x 2022's consensus earnings and 0.45x EV/Sales, versus Tesla on nearly 10x EV/Sales next year, whilst VW's battery electric revenue will be similar to Tesla's next year, with the prospect of selling over one million battery-powered vehicles in 2022.

Reverse greenwashing?

Volkswagen currently has a poor ESG rating, but as Europe's largest car company by volume and as the Continent's largest investor in vehicle electrification, the company is core to CO2 emission reduction. It is hard to see how components of the rating will not see improvement in coming years. The company is well aware of its ESG standing and will hold dedicated ESG capital market days to highlight its transition.

Whilst not wanting to dismiss VW's 'dieseltgate' scandal, it does highlight that ESG ratings are essentially backward looking and companies in certain subsectors are guaranteed to have poor ratings, regardless of their potential path of improvement. Financial journalist Merryn Somerset Webb nicely framed the debate in a recent FT article about oil and mining stocks, citing the idea of "reverse greenwashing", or investors selling low ESG-scoring companies to flatter their own portfolio scores, despite the fact it is the transition of these lowly rated companies that is critical to sustainability and net zero carbon emissions. I think, over time, a pragmatic view here will pay off, as long as such companies make genuine progress.

Green forms of fuel are, of course, key to the decarbonisation path in Europe. In this context Siemens Energy has just held its "Hydrogen Day", which emphasised its strength in PEM (proton exchange membrane) electrolyser technology and the depth of its own roadmap, complemented with key industry partnerships. Siemens Energy's historic backbone is its gas-fired power station offering, so its ability to retrofit existing turbines, as well as innovating new solutions for hydrogen, will be very interesting, whilst also providing opportunities for its Transmission business. Through its 67% stake in Siemens Gamesa, the two companies are working on how green hydrogen production can be combined with both onshore and offshore wind turbines. This reminds us how the extent and speed of renewables deployment is likely massively underestimated.

Without green energy there is no green hydrogen, thus explaining our attraction to the big renewable utilities in Europe. McKinsey estimates that €300bn will be invested in hydrogen development by 2030, partly driven by government programmes such as the European Clean Hydrogen Alliance. Large scale usage is not realistic until towards the end of the timeline, not least to produce green hydrogen at such scale that the cost needs to become competitive. However, there are real examples here and now as to how it can be done. Alstom, for example, has had hydrogen fuel cell-powered passenger trains running in Germany since 2018. Rail is set to be central to the decarbonisation path of mobility, and I remain committed to the holding in Alstom.

Hitting reset on the economic cycle

The move in sectors, styles and factors year to date has been very much driven by the increases seen in bond yields, with the financials and energy sectors leading the way. As both the ECB and the Fed have stated, key short-term interest rates are unlikely to be moving for some time, but the anticipation of stronger-than-expected growth is driving real yields and near-term inflation indicators have been picking up. We shall see in time whether inflation picks up significantly or not, but the pandemic has reset the economic cycle and the speed of cyclical rebound is clearly conducive for sectors such as financials.

Having listened to nearly twenty presentations from banks and insurance companies at a recent conference, it is clear that optimism

within this area is rising. Banks have had a robust earnings season and the better economic conditions should keep provisions low. The investment banking cycle is also strong and the banks are well geared to a shift higher in consumer spending as things normalise. From the end of September, European banks, as permitted by the ECB as the single supervisor, will be able to pay non-restricted dividends again. When combined with catch-up dividends for those not paid last year, this will lead to the likes of ING, Nordea and Intesa paying very high single-digit yields. At the same time, it feels as though the pandemic-enforced mobile-centric way of banking is an unstoppable digitalisation force, which has significant repercussions for costs for the sector.

Recent portfolio performance – a solid start to 2021

The Fund has had a solid start to the year so far, mainly facilitated by the strong stock picking, the financials overweight and underweights in consumer staples and healthcare. The attractive mix of having sufficient exposure to ‘playing the cycle’ trends, as well as a large exposure to key thematic trends, I believe will leave the portfolio well-placed to continue its progress. I have affirmed the Fund’s ESG journey through categorising the Fund as an Article 8 Fund under the EU Sustainable Finance Disclosure Regulation (SFDR), thus promoting favourable environmental characteristics, which is a milestone coming at such an exciting time in Europe’s green revolution.



JOHCM Continental European Fund

5 year discrete performance (%)

Discrete 12-month performance (%):

	28.02.21	29.02.20	28.02.19	28.02.18	28.02.17
A GBP Class	22.86	0.62	-5.83	12.46	23.58
Benchmark	14.55	5.57	-3.40	11.37	25.93
Relative return	7.25	-4.68	-2.51	0.98	-1.87

Past performance is no guarantee of future performance

Source: JOHCM/MSCI Barra/FTSE International/Bloomberg, NAV of Share Class A in GBP, net income reinvested, net of fees as at 28 February 2021. The A GBP Class was launched on 7 May 2003. During the period 5 November 2001 to 7 May 2003 the performance record is based on the pre-existing share class that had a higher management fee. Benchmark: MSCI Europe ex UK NR Index (12pm adjusted). During the period 7 May 2003 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 on request.

The value of an investment and the income from it can fall as well as rise as a result of market and currency fluctuations and you may not get back the amount originally invested. The Fund’s investment include shares in small-cap companies and these tend to be traded less frequently and in lower volumes than larger companies making them potentially less liquid and more volatile. The information contained herein including any expression of opinion is for information purposes only and is given on the understanding that it is not a recommendation. Issued and approved in the UK by J O Hambro Capital Management Limited, which is authorised and regulated by the Financial Conduct Authority. Issued in the European Union by JOHCM Funds (Ireland) Limited (“JOHCM”) which is authorised by the Central Bank of Ireland. Registered office: Riverside One, Sir John Rogerson’s Quay, Dublin 2, Ireland. JOHCM® is a registered trademark of J O Hambro Capital Management Ltd. J O Hambro® is a registered trademark of Barnham Broom Ltd. Registered in England and Wales under No: 2176004. Registered address: Level 3, 1 St James’s Market, London SW1Y 4AH, United Kingdom.