J O Hambro
Capital Management Group

News

Europe comes to the fore

Paul Wild, manager of the JOHCM Continental European Fund, on Europe's improving macro picture and how he is positioned to benefit.

Paul Wild

02 Feb 2022

Europe comes to the fore

It has been a fascinating few months for global markets and, as always at inflection points, things can change very quickly. What started as a transitory itch for central banks has morphed into a world of worry surrounding core inflation staying higher for longer. In parallel, almost all regions of the world are expected to experience monetary tightening at some point soon meaning the likely trajectory of yields is upward. German 10-year bund yields made a pandemic-driven low of -86 bps on the 9th March 2020 yet even now, they reside at just close to zero whilst staggeringly, the equivalent real rate closed the year at -3.85%, based on core CPI. With thankful signs that the health, economic and mobility effects of the pandemic are in decline, it has become clear that the wall of central bank stimuli has been excessive, not least with the doubling of the Fed’s balance sheet to $8.9 trillion over the last two years. This is difficult to criticise given the nature of events, but this is the pertinent issue looking ahead, no more so than in the US where verging full employment is driving significant wage pressures.

The last decade has cemented two perceived axioms. Firstly, that the US will almost always outperform Europe and secondly, that Growth type stocks are the only solution. For those of us without an intrinsic growth bias but with a definite valuation rigour, these have been trying times, particularly in recent years. But, encouragingly, what we definitely do know is that monetary policy inflections really mean one thing in particular for equity markets and that is simply that valuation becomes important again - and very quickly. For too long the margin of safety of a free cash flow yield of two or three percent has seemed attractive to many, but with rate futures now pricing in five hikes in the US this

year and further implicit tightening from quantitative tightening, the margin of safety has to inexorably rise. In this context, Europe stacks up admirably well with a current forward consensus P/E of 14.3x based upon an irrationally low earnings growth rate of 7%, whilst GDP growth is likely to exceed that of the US for the next few years with consensus forecasting 4% this year and 2.5% next. All of a sudden, 'slow growth Europe' is not growing so slowly. As ever, headline P/E ratios disguise a myriad of truths, since intra-sector valuation spreads have never been greater, so even in Europe investors need to be careful where forward looking bets are placed. The first few weeks in January have borne out this point clearly and we would expect this polarisation to continue as investors re-evaluate their valuation assumptions.

Interestingly Europe remains at a fortuitous juxtaposition, that of being highly rate or value sensitive (given its sector composition) whilst having a central bank which remains highly rate averse. The Pandemic Purchase Program is set to be terminated in March and the loss will be cushioned by a temporary rise in the Asset Purchase Program for the subsequent few quarters. Meanwhile, interest rates in Europe are unlikely to rise much until 2023 given the level of medium-term inflation expectations remains marginally below their targeted 2% level. Post the recent ECB meeting, futures predict around 108 basis points of rate rises over the next two years. This naturally does not mean that bond yields cannot rise, it actually becomes more likely that the yield curve steepens in Europe versus a flattening curve in the US, given short rates remain more anchored.

Fiscal expansion has clearly been a massive theme from very early in the pandemic and has continued to be so in various key geographies. In the US, the Infrastructure plan was passed in November, but the larger Build Back Better plan failed to get through earlier this year and thus the fiscal impulse in the US is set to fizzle out by the end of this year. Europe remains in a more pro-fiscal regime with around 75% of the €750bn Recovery fund (otherwise called Next Generation EU) to be distributed over the 2022-2024 period, at 5.5% of Eurozone GDP, this is significant. The European Commission has defined future proofing areas for spending: it is estimated 45% of funds will be spent on the green transition and 27% on digitalisation. As ever, its greatest impact will be in those countries most severely affected by the pandemic with the likes of Spain and Italy getting the highest absolute grant allocations. Meanwhile the funding of the Recovery Fund, having broken the taboo on joint issuance by the European Commission on behalf of the EU, further reduces the perceived political risk premium in the Eurozone. In Germany, the newly elected traffic light coalition is also additive to the fiscal outlook, particularly climate transition, challenging the stringent historic budget management. This means we have greater confidence and certainty that the European growth outlook will stay higher for longer, a greater resilience pervades the area with the overall debt to GDP ratios being lower than peers.

Portfolio positioning

Within the fund, we have been heavily overweight financials since the end of the first quarter last year and these holdings have evidently started to deliver. The sector is like a coiled spring, the sensitivity to rising Euribor and medium-term yields is incredibly high. As an example, Caixabank recently estimated they would be earning 20-25% higher net interest income with a one percent increase in rates. The ECB's removal of its dividend ban at the end of September has unleashed a torrent of capital return, with a good number of names having total shareholder returns close to ten percent a year. Our holding in Unicredit is looking to distribute over 50% of market cap to the end of 2024. So whilst the sector has performed well, the size of the earnings upgrades have outpaced the valuation accretion, so valuations remain compelling and earnings forecasts will keep being revised higher. Elsewhere, autos are another area that we have added to over recent months. The valuation discrepancy between the European and US auto stocks is unsustainable, not least when the Europeans are using their huge free cash flow to pivot into leaders of vehicle electrification. The strong new car pricing power, which has been aided by semi-driven supply shortages last year, is set to continue as the enormous backlogs are worked through over the next eighteen months. We hold three of the big auto OEMS in the fund.

The fund's significant overweight in utilities admittedly performed poorly last year, this is now a little lower at a seven percent sector overweight. Over the previous months we have slightly changed the composition of the exposure by reducing some generation holdings, whilst maintaining a large position in Veolia, which was actually the largest single stock contributor to performance last year. The issue for the generators has been the huge increase in gas prices and political attempts in a small number of countries to force the utilities to dilute their own profitability to safeguard consumers, attempts which have subsequently largely failed. Our generation exposure is heavily weighted to the renewables-driven environmental transition, to which we are firmly committed. We maintain exposure via the likes of RWE and EDP but with smaller positions than previously. However, the overall fund exposure to Green Deal type areas remains over 30% of the total fund. As we have said before, given themes in nearly all cases are multi-sector in their composition, we focus on having strong thematic underpinnings in the core of the fund.

We have benefitted from reducing exposure to a number of stocks and areas which have been hit in the recent market tumult. These have been certain semiconductor names, Novo Nordisk and Schneider Electric. Whilst we do absolutely believe that many overvalued growth names will remain under a cloud for quite some time, we are not allergic to the idea that the sell-off will present opportunities in existing and new names which are more emblematic of growth at a reasonable price. The focus here being on one's understanding of what is "reasonable" in the new world. In all likelihood, opportunities here will be in areas where growth is structurally underpinned and that is partly why we have not reduced our technology weighting significantly. Our overweight exposures tend to be at the lower end of the relative valuation spectrum such as in the digitalisation leader of Cap Gemini or Ericsson within telco-infrastructure.

At a macro level we have to stay aware that significant monetary tightening in the US, and the expectation of it, may lead to a diminution in forward-looking growth prospects. We need to stay alert to signs of this as the year progresses, but for now we are not unduly worried. Elsewhere the Russian-Ukraine situation remains foremost in our minds, whilst we were pleased to see an orderly solution to the Italian Presidential succession. On the electoral front the French national elections take place in April, with polls currently favouring Macron by some margin.

Despite the inevitable risks our feeling is that we are returning to markets of old, where cherished valuation and earnings discipline will lead to stronger relative fund returns. We have made a good start to the year and looking ahead, have rarely been more optimistic on the outperformance potential of the fund. High conviction is also being demonstrated via a smaller number of holdings than in years gone by. As for markets, for what feels like too long, excessively low interest rates have fed the bubble of ever-increasing risk in long duration beneficiaries, yet, as always, there is an eventual period of reckoning. As we look out over 2022, we believe now, more than ever, there are compelling reasons to build belief in Europe and to believe in this fund. A overview of the fund can be found here.

Disclaimer

For professional investors only. This is a marketing communication. Information on the rights of investors can be found here. The investment promoted concerns the acquisition of shares in a fund and not the underlying assets. Past performance is no guarantee of future performance. The value of investments and the income from them may go down as well as up and you may not get back your original investment. 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. Investments 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 registrations of the funds described in this communication may be terminated by JOHCM at its

discretion from time to time.

Related Articles

Europe one year on...

A look at the investment landscape in Europe and the key areas where we are finding opportunities.

Read More

30 March 2021

Three reasons to look again at Europe

Is it time for investors to look again at European equities?

Read More

30 September 2020

Europe three months on – a steadier ship

The JOHCM Continental European Fund team point to signs of encouragement in European markets and economies.

Read More

19 June 2020

Legal

This website is issued and approved in the UK by J O Hambro Capital Management Limited, which is authorised and regulated by the Financial Conduct Authority. Registered office: Level 3, 1 St James's Market, London SW1Y 4AH. Registered in England and Wales under No: 2176004. Issued in the European Union by JOHCM Funds (Ireland) Limited which is authorised by the Central Bank of Ireland. Registered office: Riverside One, Sir John Rogerson's Quay, Dublin 2, Ireland. J O Hambro is a registered trademark owned by and used under licence from Barnham Broom Holdings Limited. JOHCM® is owned by J O Hambro Capital Management Limited. Telephone calls may be recorded.

© 2021 J O Hambro Capital Management Limited.All rights reserved.