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CONTINENTAL EUROPE

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The world has changed

Continental European equity markets have suffered their sharpest ever sell-off, plunging some 35% in euro terms over a four-week period (as measured by the Fund's benchmark, the MSCI Europe ex UK index – 12pm adjusted). The beginning of the year's gentle optimism, which was driven by the tailwinds of the trade resolution and slowly improving leading indicators, seems like a lifetime ago. The West is quickly having to embrace China's toolkit to limit the spread of Coronavirus, and, in doing so, deal with the imposition of unprecedented societal limitations. The shutting of schools and factories, remote working, prevention of large social gatherings and limitations on crossing regional and international borders have become the blockbuster medicine needed to halt the deadly contagion.

The good news amid the gloom would seem to be that the faster the lockdown measures are enacted, the faster we are likely to see a semblance of social normality and eventual market recovery. Indeed, Wuhan has not reported a new virus case for four days (at the time of writing on Monday 23 March) after an almost a two-month lockdown, so there is hope out there. But we should all prepare ourselves and our portfolios for the possibility that freedom of movement restrictions may last for rather longer than is widely expected.

It's all about the balance sheet

From an investment standpoint, this really focuses upon having the balance sheet capacity to withstand this period, as there are barely any sectors which won't be affected. Whilst most companies can survive low revenues for a month or two, there are fewer which have the capacity to absorb longer periods, as we are seeing in the most extreme case of the government-led bailout of the airline sector.

The macro guessing game has commenced in earnest as to where GDP figures will go. With some certainty we know that the H1 2020 figure for Europe will be very significantly negative. Whilst we hope a combination of pent up demand and policy stimulus will lead to a much better second half, the full-year number seems inevitably to be a negative one by a number of per cent. This is against a background of expectations at the start of the year for global growth of around 3%, which now rapidly looks to be heading to sub-1%. Again, the good news is that given the extent of market declines, it is less likely we will have to wait for the bottoming of the macro data to see recovery. Instead, the incremental change in virus numbers is likely to act as the guide to returning normality.

Meanwhile earnings expectations are a similar imponderable. Current forecasts of single-digit earnings growth are heinously out of touch with reality, albeit the buy-side has evidently already adjusted, with a more likely outcome being a decline well in excess of 20%. As regards valuation, the market's headline P/E ratio of circa 11.5x equates to an underlying number of closer to 14x, based on a notional 20% aggregate earnings decline, which is close to the long-term average. In this context, we are cognisant that there could be further downside ahead, but there is potentially significant upside from an expectation that 2021 could see very strong growth given the ease of comparison numbers, thus allowing a rapid decline in the earnings multiple next year. Naturally, conditions are far from normal and the lockdown longevity is the key determinant, for which only time will tell. For this very fact, we favour maintaining a defensive position for the time being; our largest overweights are currently +10% in healthcare and +5% in utilities. We added aggressively to healthcare in late February, after the sector surprisingly showed a lack of defensiveness in the early stages of the sell-off.

The policy-makers' response

The ECB was widely regarded as having underdelivered at its first meeting, but it has followed up with a €750bn Pandemic Emergency Purchase Programme extending to the end of 2020. The aim of this action is to aid the monetary transmission mechanism across the Eurozone. And in doing so this may help to allay the move in Southern European sovereign bond yields we have seen over recent weeks. Additionally, in a quasi "whatever it takes "repeat, Madame Lagarde is "fully prepared" to increase the programmes if necessary. This aside, the Eurogroup disappointed against high hopes and have effectively left it up to member governments to provide key fiscal support, which in itself is likely to necessitate a temporary relaxation of the Maastricht criteria. Italy has launched a €25bn package, including support for the health sector, loan and mortgage suspensions, tax credits and loan guarantees. Elsewhere, Spain has confirmed €18bn of fiscal support measures, and the French government unveiled a package including the deferment of social charges and a job preservation scheme costing tens of billions of euros.

Credit spreads blow out

Credit markets have seen a rapid widening in spreads. The initial focus was in reaction to the plunge in the oil price after Saudi Arabia's pledge to massively boost production to regain market share, to the detriment of US shale and oil-associated corporate bond issuers. This has escalated into a wider credit concern as regards relatively high corporate debt levels in the US in the face of a hopefully short-lived recession. European leverage is at lower levels, but we have seen a near 500bp move in the European high yield ITRXX.

Banking on trouble for banks; insurers preferred

The banks had been starting to regain credibility after better recent capital generation. This had allowed the hitting of capital targets by even the laggards, initiations of share buybacks, some regulatory softening and M&A in Italy.

However, in the face of the oncoming storm, it becomes very relevant that provisioning levels are at cycle lows. And despite various government guarantee schemes, it would seem naïve not to expect a large increase in the cost of risk. The initial ECB aid programme directly softened the Pillar 2 capital requirements for the banks. Since then countercyclical buffers have been relinquished almost everywhere.

The issue from an investment standpoint is that the increased credit risks will last much longer beyond the peak in Coronavirus patients. Therefore the investment appeal of banks has become imperilled despite share prices which have in many cases halved. For this reason, we have reduced our financials weighting by a considerable 9% over the last few weeks to a heavily underweight position. We think there is likely more appeal within the insurance names given the high solvency levels even after recent market moves and because in non-life there is unlikely to be a significant pickup in claims, albeit the investment income outlook is clearly lower and there will be exposure to credit losses.

A powerful earnings rebound in 2021

We remain cautiously optimistic that 2021 may be an explosive year from an earnings standpoint. And it is not altogether clear to us that next year's forecasts need to fall significantly, after allowing for base effects. This leaves the conundrum as to what areas of the market and names investors will look to buy into to benefit from an eventual recovery. Our roadmap currently focuses upon:

- Certain verticals where demand will return the soonest post-crisis and where the hangover effects are the least profound. The likes of the strong balance sheet technology names and certain industrials will likely feature large here.
- Discretionary consumption patterns will gradually normalise, which may benefit the likes of hotels, spirits and luxury goods. We remain wary of autos given the likely drop in sales and working capital requirements, but there will be survivors.
- The fiscal picture is evolving, which will most directly benefit the likes of building materials and certain healthcare stocks. Infrastructure generally has been a hot area in the low interest rate era. Inevitably, as transportation patterns normalise, the likes of Vinci will benefit over time.
- The themes of emissions reductions and energy efficiency are not going away, even if there happens to be shorter-term deferment of certain targets. This leaves the renewable utilities and likes of Neste, Alstom and Schneider looking increasingly attractive.
- Stock anomalies where the proverbial baby has been thrown out with the bath water, such as instances where defence stocks have fallen as much as civil aerospace or where media content stocks are trading well below franchise valuations.

Inevitably, as time progresses, the buying into of certain of the above areas will require reducing exposure to a number of areas that have held up relatively better during the sell-off. Ultimately it comes down to relative risk-adjusted upside potential.

Punch drunk and disorderly markets

The market has become increasingly disorderly over recent days, with the likelihood that forced deleveraging from certain parties is overwhelming fundamental decision-making, whilst short sale bans are being imposed across most markets. The disorderliness in itself provides medium-term opportunities to buy great companies at discount prices, examples being the declines in recent days in the likes of CRH, Philips and SAP. We should expect such price action to continue for some time, but the importance is to be able to try, without taking excessive risk, and look through near-term volatility for medium-term gain.

Final thoughts: a deep short-term recession, not enduring depression

In conclusion, we are currently treating the outlook as one of short-term recession, not unending depression. We expect an expedient market recovery once the signs are there that the pandemic is under control, but we will remain vigilant in the coming month or two where we sadly expect headlines concerning corporate gridlock to dominate.

Thank you for your continued support of the Fund. Nico and I wish you and your families the best of health at this worrying time.

JOHCM Continental European Fund

5 year discrete performance (%)

Discrete 12 month performance (%):

	29.02.20	28.02.19	28.02.18	28.02.17	29.02.16
A GBP Class	0.62	-5.83	12.46	23.58	-1.62
Benchmark	5.57	-3.40	11.37	25.93	-5.92
Relative return	-4.68	-2.51	0.98	-1.87	4.57

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 29 February 2020. 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.

Past performance is no guarantee of future performance. 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. 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.