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THREE REASONS TO LOOK AGAIN AT EUROPE

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Autumn update

- A policy paradigm shift
- A big (green) deal
- European stock markets have changed
- A rebound in our performance
- Opportunities after market weakness in recent weeks

JOHCM Continental European Fund

Reason 1: A policy paradigm shift

History may regard the summer of 2020 as a pivotal moment in the European project. The confirmation of the EU Recovery fund by European political leaders in July could prove, in time, to have been a game-changer for the Continent's economic destiny.

The €750bn fund (the Next Generation EU Fund), which is to be split between €360bn of loans and €390bn of grants, directly targets the "regions and sectors most hit by the (Coronavirus) crisis". 70% of the grants provided by the so-called Recovery and Resilience Facility will be made in 2021 and 2022, the rest by 2023 at the latest, with the individual country allocation based on the loss in percentage real GDP suffered by the member state as well as its respective size.

It is estimated that the package will boost Eurozone GDP by 0.6% per annum over a five-year period. Crucially, the taboo of joint debt issuance is to be broken, with the European Commission (EC) authorised to borrow on behalf of the EU in debt markets. Whether this is a one-off or not, this definitely enhances the argument that Europe is morphing into a much more politically cohesive state, a welcome position and one probably helped by member states' dim view of the UK's Brexit fumblings. The Recovery Fund now has to be passed by each of the EU27 member states before hopefully going live in January 2021.

Reason 2: A big (green) deal

In a further major development on the policy front, the European Green Deal has been bolstered by the EC President's recent pledge to increase the EU's 2030 greenhouse gas emission reduction target from 40% to 55%, with all the proposals set to be enshrined in the European Climate Law. Both 30% of the Recovery fund and 30% of the next 2021-27 EU budget will be devoted to fighting climate change, which equates to a collective €540bn. In effect, Europe has doubled down on decarbonisation during the Covid-19 crisis.

Having listened to many presentations over the last week by European utilities companies, it is difficult to overstate the revolution which is underway in energy production across Europe. Many of the Continent's largest utilities firms are signalling that their renewable targets are likely to rise significantly. Renewables' share of the power mix is likely to double from the current 35% by 2030.

Interestingly, even with the tremendous momentum in green technology,

UBS estimates that the goal of net zero carbon emissions by 2050 looks quite improbable; indeed, on its estimates, it would take a Covid-19-sized carbon reduction every year for the next 30 years for this target to be reached. This only means one thing: the demand for renewables will continue on its path, and this needs to be complemented by hydrogen development, better storage and huge capex in network grid infrastructure. Ultimately, without sufficient green electricity – not least to support green hydrogen development, which looks well placed to decarbonise industrial and heavy transport sectors – we cannot effectively combat climate change. To bolster the European effort to halt climate change, it is likely the Emissions Trading System (ETS) will be made more onerous, while a border carbon tax looks likely. EU Taxonomy legislation will also help to ensure private capital flows towards sustainable initiatives. We are excited by the decarbonisation trend and are looking to capitalise on it within the portfolio.

Reason 3: European stock markets have changed

There has been an increasing focus on the sector changes in the European stock market over the last decade, and how the region should now be perceived by investors. After sustained underperformance, banks and energy, at just 8.7% and 2.7% of the MSCI Europe ex-UK index, respectively, are no longer the big slices of the market they once were. The financials sector weighting has fallen 9.6% over the last 10 years, while both banks and energy have considerable headwinds that may be difficult to overcome in the near term. Healthcare is now the largest sector in the index at some 16.7%, a 5.7% increase over the last decade, whilst the technology weighting has more than doubled in recent years to 9.3%.

All in all, these changes have significantly reduced the embedded cyclicality or value skew of European stock markets and intrinsically enhanced the through-the-cycle revenue growth potential, which clearly explains some of the market's re-rating that we have seen over recent years. Increasingly strategists are coming back to the equity risk premium as the new bedrock to support a positive view on equities. And with bond yield spreads versus nominal dividend yields still elevated, we see relative attractions in European equities at a time when real interest rates are likely to stay negative for some time.

A rebound in our performance

Turning to recent fund performance, pleasingly we can report a strong rebound since the end of March. This has been driven in part by our largest positions in **Cap Gemini**, **Deutsche Post** and **RWE**, which have made the greatest relative contributions. There have naturally been instances where we have taken some profits and reduced position sizes given the nature of the V-shaped recovery, such as with **Deutsche Post**, **Arkema** and **SAP**.

Portfolio turnover over the period has been low. We have not established many new positions, but we have been excited by the opportunity in **Metso Outotec**, the recently combined Finnish mining equipment group. The mining industry's focus on debt reduction via lower capex over the past six years means the sector is now in a strong position. Meanwhile, a by-product of this reduced capex is an ageing mining equipment fleet, yet the pressure on mining companies to decarbonise through new equipment has never been greater. When combined with a weaker US dollar, which boosts commodity prices, the probability of increased mining equipment-related capex is high. Metso Outotec therefore is ideally placed to benefit, while the merger should drive significant improvement in margins from a series of self-help initiatives. This should lead to earnings upgrades and offers valuation upside over time. The stock fits with our focus on identifying companies that benefit from the importance of sustainability and that drive positive environmental change.

Elsewhere, within the utilities sector we have added further exposure through the purchase of **Engie**. Chairman Jean-Pierre Clamadieu is spearheading a fundamental restructuring of this business. This entails disposal of €8bn of assets, including part of the Customer Solutions business and its listed equity stakes, whilst targeting an increase in its renewable energy growth, from 3GW to 4GW per year, and further investment in networks outside of France.

Our largest sector overweight positions remain utilities, insurance, technology and industrials. We remain underweight in consumer staples, banks, consumer discretionary and energy.

Opportunities after market weakness in recent weeks

Looking ahead, there are reasons for both optimism and concern. For the latter, European markets and the European economy have seen a relatively V-shaped recovery, and there are signs that the incremental macro data is understandably now experiencing a modest retracement. Furthermore, Covid-19 numbers are surging across the region, in part because more people are being tested, and we face the possibility of regional lockdowns into the autumn. Adding to the reasons to worry, we have the US elections in November, where rhetoric around China in particular has become more antagonistic.

The greatest hope, of course, remains a Covid-19 vaccine. Here the World Health Organization has stated that 9 of some 300 vaccine candidates are close to reaching crucial Phase 3 trials. Meanwhile, the earnings and valuation outlook for our holdings remains robust.

As to what all this means, we have seen European stock markets suffer a small setback over recent weeks, but we are by no means bearish. Instead, we relish the potential, and possibly short-lived, opportunity to buy into our favoured names at cheaper levels. Regardless, we will remain vigilant and are very happy with the current shape of the portfolio.

JOHCM Continental European Fund

5 year discrete performance (%)

Discrete 12 month performance (%):

	30.09.20	30.09.19	30.09.18	30.09.17	30.09.16
A GBP Class	1.59	0.78	1.65	21.14	17.94
Benchmark	0.10	5.94	1.41	23.29	17.65
Relative return	1.49	-4.87	0.23	-1.75	0.25

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 30 September 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.

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