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UBAM - EUROPE EQUITY

Quarterly Comment | Q2 2019

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Market Comment

- The second quarter ended with positive performance across asset classes which marked the reversal of the weakness we observed during the month of May. Indeed, while economic data published in June was weak and the trade outlook remains uncertain, investor sentiment improved as both the Federal Reserve and the European Central Bank indicated that there would be further monetary stimulus to address the still low inflation.

- This lead to +4.9% expansion of the MSCI Europe ex-UK index which corresponds to a full recovery of what was lost in May, while the UK market was up a similar +4.0%. In other geographies, the American market performed strongly with the S&P500 up +7.1%, followed by the emerging markets index (MSCI EM) up +4.7%. Strong returns were achieved on the credit side too, +2.4% for the Euro Treasuries and +1.0% for the US Treasuries. While counterintuitive at first sight, the rally in both asset classes was made possible by the continued expectation of rate cuts which is now combined with anticipation of more quantitative easing.

- While we concluded the first quarter with hints of an economic slowdown, this was confirmed during the second quarter which was a period of greater volatility with a wider divergence between economic indicators and financial market performance. Indeed, trade uncertainty persisted, tariff implementation started, and political tensions did not reduce. Investors took this into account in May but found support for further bullishness in April and June.

- Overall, this made the quarter a strong one (equities up +4%) which allowed a strong first half. The US S&P year-to-date performance is +18.5%, followed by Europe (MSCI Europe ex-UK) at +18.1% and the UK FTSE100 up +13.1%. A slower performance was seen in emerging markets with the MSCI EM index up +10.2%.

- Politically, the US and China have pursued trade negotiations. Investors will probably find some relief in the fact that the worst case scenario has been avoided for now, but the continued uncertainty and potential degradation of the relationship is likely to weigh on the short-term sentiment. This is visible through Consumer Confidence and Manufacturing PMI levels which decreased throughout geographies when looking at 3-months aggregates.

- In the UK, the major event was Theresa May stepping down which was followed by a Conservative Party leadership race and renewed uncertainty around Brexit. It is still very likely that parliament will prevent a no-deal Brexit unless this is communicated by the population in either a referendum or a general election.

- Overall, the second quarter of this year has seen a reversal in economic indicators suggesting a widespread slowdown but this has not been visible in global markets as investors found conviction and support for their optimism in the supportive central bank messaging.

All performance figures are given net of fees unless stated otherwise. Past performance is not a guide to current or future returns.
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Performance Review

- The fund delivered a net return of +2.62% in Q2 2019 versus a return of +3.01% from the MSCI Europe benchmark, an underperformance of -0.39%.
- Geographically, the strongest performance came from the overweight positions in Ireland and Finland. This can be attributed to two individual stocks, Irish healthcare provider UDG PLC and Finnish mining equipment supplier Metso OYJ. Normally, we would expect macro factors to play a more prominent role in country performance attribution, but this was not the case in the second quarter.
- The largest negative contributors to the fund were our overweight position in Portugal and our small underweight in Spain. Once again both of these performances can be attributed to a single stock, oil producer GALP Energia SA in the case of Portugal and bank Bankinter SA in the case of Spain. In aggregate, Q2 was a low amplitude quarter for the dispersion of geographical attribution, with no single country adding or detracting more than 24bps. This was reflective of a general lack in direction of markets following a strong Q1.
- At a sector level, the overweight positions in contrasting sectors, Healthcare and Materials drove the strongest positive contribution in Q2. In Healthcare, overweights in Irish provider UDG and German biotech company Evotec SE were amongst the best performers in the portfolio. In the Materials space, Swiss chemicals company Sika AG was the second best contributing stock in the fund overall and the contribution was supplemented by an underweight in UK domiciled commodity company, Glencore PLC.
- In terms of detractors, the overweight in Consumer Discretionary and the underweight in Financials were the largest negatives. Amongst the Consumer Discretionary stocks it was UK travel retailer WH Smith PLC and Austrian motorbike manufacturer KTM which detracted the most from performance. Underweights in LVMH SE and Adidas AG were also significant negatives. Amongst financials, whilst we are underweight in the banks, the few stocks we did hold had a relatively large negative effect. UK motor insurance company Sabre was also a negative contributor.

Portfolio Activity

- Overall, our positioning during the second quarter has continued to be more defensive than in 2018. Q2 looks to have been a difficult trading period for many companies who have had to contend with adverse weather patterns, an escalating global trade war and a sharp cyclical slowdown in certain industries such as autos. We would anticipate a number of profit warnings and widespread downgrades to guidance as companies begin to report. We felt all along that companies had delivered an overly optimistic narrative in Q1 given the gathering economic and political clouds. Nothing that has subsequently happened has changed our view.

- Against this backdrop we have focused down the number of holdings within the portfolio towards 50 positions. We have concentrated on the names where we have highest conviction and sold exposure to stocks that may be at risk in a more difficult trading environment.

- This was an active quarter for us in terms of trading. In terms of purchases we primarily added to higher quality stocks, with strong dividend yields in sectors that most obviously offer value. Amongst non-life insurers we increased positions in Zurich Insurance and Swiss Re. In Healthcare we added to Glaxosmithkline PLC and in Telecoms we added To Deutsche Telekom and started a new position in KPN.

- Given our economic concerns, sales were focused on sectors where we perceive there to be the greatest cyclical risk. In IT we sold our position in IQE. In the Materials/Industrials sector we sold positions in Metso, Faurecia and Befesa SA. Amongst oil stocks we sold Cairn and GALP. Finally in the Consumer Discretionary space we sold positions in Next PLC, Dalata PLC and Burberry PLC.

Outlook

- European equity markets have recovered significant ground in the first half of 2019, against a backdrop of more challenging macroeconomic conditions and slowing earnings growth, boosted by a more accommodative stance from central banks and a recent softening of the tone of the US-China trade discussions.
- We believe that there is a likelihood of continued market volatility into the second half of the year as we see evidence of further deterioration in the outlook for corporate earnings coming into the second quarter earnings season.
- Nevertheless, any sign of stabilisation of economic indicators combined with a further improvement in international trade discussions could provide positive impetus for equities.

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