

European Focus Fund: Monthly Commentary

April 2018

The price dynamics of equity markets changed in April

The price dynamics of equities reflected a sea-change in April compared with the previous months in this stock market cycle. *First*, US companies posted a record-beating earnings season in 1Q18 on the back of strong domestic fundamentals which were further boosted by the weakness of the USD. This contrasts with considerably more export-dependent European companies whose trading statements were more modest. However, while many companies in Europe showed either sequentially stable or accelerating underlying revenue growth on the back of improving macro-economic momentum, their absolute sales and profits were generally lower due to the strength of the EUR. Against this backdrop, the S&P500 total return index appreciated by a meagre 0.4% in April while the equivalent MSCI Europe total return index rose by 4.6%. In short, it appears as if the strong US earnings season was to a large extent already discounted as investors appear to have underestimated other economic factors which may have been at a disadvantage to US equities (such as the threat of Trump-infused trade-wars and/or import tariffs, rising inflationary pressures and the risk of Federal Reserve triggered interest rate hikes) and indirectly supported Europe.

Secondly, in terms of volatility our analysis shows that the market has entered its longest-ever period during which the S&P500's VIX has traded on consistently higher levels compared to the Eurostoxx 50 index's similar V2X. The VIX exceeded the V2X on 16 February and at the time of writing, it posted 50 consecutive trading sessions at a higher level than the V2X (the previous record was 35 sessions and set in February-March 2001). We believe this implies that volatility-related concerns are increasingly originating from the US as opposed to Europe. Since the US macro-economic environment appears to be in an overall good shape, we construe that current uncertainty is deriving from the US political environment (and possibly the White House).

Analysis of the sector-performance in the US and European equity markets in April shows consistently that energy stocks were by far the best performers posting close to 16% and 13% returns respectively. It therefore appears that investors are fearing a shortage of oil supply given trade-war related risks, the threat of a collapse of the Iranian nuclear deal and diminishing oil-exports from Venezuela. Over-and-above the energy stocks' solid performance in April, the sector performances in the US and Europe differed as European equities showed a stronger bias towards higher dividend-yielding stocks (such as telecom services, utilities and real-estate) compared with their US peers.

Turning to the 1Q18 reporting season in Europe and more specifically to our investment universe and the Heptagon European Focus Equity Fund, approximately half of the universe released trading statements in April. We note that *half of the half* of the companies which published sales and results releases showed accelerating like-for-like revenue growth. Companies which could combine an outlook of accelerating sales growth and at least confirm or raise their FY18 guidance generally had positive reactions to their stocks (Assa Abloy, Danone, Ericsson, LVMH, L'Oréal, Nestlé). One company showed unchanged sequential underlying sales growth and confirmed its FY18 guidance (Reckitt Benckiser), but still saw its share price drop, since what was supposed to be the fastest and most profitable division only generated anemic growth. Companies which showed a slowdown in sequential organic sales growth (Atlas Copco, Essilor, Eurofins Scientific, Givaudan, Hays, Novozymes, Page Group, Randstad) fell irrespectively of whether they confirmed their FY18 guidance or not. Two companies reported a slowdown in sequential growth but had a positive reaction to their stocks (Assa Abloy, Chr Hansen); Assa Abloy recovered on the back of management's comment that the company's revenues in the emerging markets had started to stabilize while Chr Hansen's 1Q18 statement was accompanied by an ensuing investor day in



London. Another company (Dassault Systèmes) reported acceleration in underlying sales growth while at the same time reconfirming its FY18 but still saw its stock price fall – possibly on the back of its full valuation.

The nascent recovery of the USD is undoubtedly good news for the sales and profit outlook of European companies. However, this should be contrasted with: (i) the flattening US yield-curve; (ii) slightly lower PMI data on both sides of the Atlantic and; (iii) 10-20bps reduction in consensus quarterly GDP forecasts for 2018 over the past month. In short, we believe the aggregate of data indicates that while macro-economic momentum is continuing to run at high levels in the leading economies, we struggle to see where renewed upgrades in a broader sense will come from. Against this backdrop, we continue to hold a Europe-centric profile to the bulk of our holdings as macro-economic momentum in Continental Europe is still showing the most rapid rate of change. However, we are likely to slightly raise our exposure to more USD-sensitive stocks should the currency continue to gain strength against the EUR. In addition, given the prospect of higher borrowing costs, we continue to hold stocks of companies that have robust balance sheets. In this respect, our analysis shows that the Portfolio was slightly net cash positive by the end of FY17. Given the positive cash flow projections of the Fund's constituents for FY18 and beyond, the Portfolio's weighted balance sheet strength should be further boosted.

Christian Diebitsch, Fund Manager



Glossary

Balance sheet	A document that provides information on the financial position of a company at a particular point in time. It includes what it owns (assets), what it owes (liabilities) and the value of business to equity holders (shareholders' equity).
Basis Point (bps)	A common unit of measure in finance. One basis point is equal to one hundredth of 1%, e.g. 0.01%
Cash Flow	The money generated by a business before it needs to repay debt and/or other obligations.
Dividend Yield	A percentage that shows how much dividends are paid out by a company in any given year relative to the company's share price.
Equity Security	A security that represents ownership in an entity and that may pay income as dividends.
Euro Stoxx 50 Index	An index that captures Europe's leading blue-chip companies. It covers 50 stocks from 11 Eurozone countries.
Federal Reserve	The Central Bank of the United States of America.
Fundamental Analysis	The evaluation of a company by investigating its intrinsic value, where intrinsic value is measured without reference to the security's market value.
Gross Domestic Product (GDP)	The value of all goods and services produced in a given country during a specific time period.
Macro Analysis	The analysis of economy wide factors, such as employment, inflation or monetary and fiscal policies.
MSCI Europe Index	A market cap weighted benchmark index that represents the performance of large and mid-cap equities across 15 developed countries (Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland and the UK).
Purchasing Managers Index (PMI)	An indicator of economic health in the manufacturing sector.
S&P500 Index	Standard & Poor's 500. An American stock market index that includes the 500 largest companies by market capitalization.
V2X	An index used to measure volatility in the Eurozone.
VIX	Volatility Index. A ticker symbol for the Chicago Board Options Exchange. It is a measure of volatility that calculates expected price fluctuations in the S&P 500 Index options.
Volatility	A statistical measure to show the degree of movement of asset prices over a set period of time.
Yield Curve	A line plotting fixed income securities with different maturity dates and their respective interest rates. Flattening of the yield curve means that long-term interest rates are decreasing more than short-term interest rates, or short term interest rates are increasing more than long term interest rates. A steepening of the yield curve means that long-term bond prices are falling relative to short-term bond prices.



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The Fund is subject to special risk considerations including geographic concentration risk, portfolio concentration risk and operational risk. The investment return and principal value of an investment will fluctuate so that the investor's shares, when redeemed, may be worth more or less than their original cost. Any investor should consider the investment objectives, risks and charges and expenses of the fund carefully before investing. Where an investment is denominated in a currency other than the investor's currency, changes in rates of exchange may have an adverse effect on the value, price of, or income derived from the investment.

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