HEPTAGON Capital

European Focus Fund: Monthly Commentary

January 2021

Too much cash is a curse

We characterise January 2021 as comparable to November 2020, which in our opinion showed spectacularly unorthodox stock price action. While November reached the milestone of registering the best-ever month for European equities (+14%), we construe that the strong recovery that month was driven by mean-reversion after pan-European indices had more-or-less flat-lined since May and been subject to profit-taking in October. The bounce-back in November was therefore underpinned by unloved sectors, like energy and banking, which had lost more than -50% and -30% respectively during the first ten months of 2020.

In light of the above, we regard January 2021 as the first month of the current bull-market (since March 2009) that saw sanity go out the window. Although both European and US shares saw minor profit-taking last month, as evidenced by the slight decline of the regions' leading indices, volatility moved sharply higher on both sides of the Atlantic, as some stocks responded to exceptional short-squeezes. What drove these share price spikes was exuberant retail trading. Wild swings in North American stocks such as Gamestop (GME US: up 17 times in January!) and Blackberry (BB US: +113%), spilt over to some ADRs of established European businesses like Pearson (PSO US: +20%) and Nokia (NOK US: +17%). What prompted this type of behaviour was an onslaught of amateur investors who mobilised themselves by using social media platforms, like 'Reddit' and 'WallStreetBets', to spread information and move stock prices higher in issues where there was considerable short interest.

The question is whether this type of extreme trading and unusual stock price action will become a new normal and we construe that it is not unlikely. *First*, after several years of quantitative easing – and more recently COVID-19-related stimuli by central banks and governments – there is arguably too much cash in the global financial system. *Secondly*, it looks as if the world is becoming increasingly dichotomised. For people who have lost their jobs and/or are receiving compensation through furlough schemes and similar, times are arguably tough. However, for the fortunate people who have jobs, can work from home and are allowed to day-trade, many are likely to have accumulated savings since lockdown restrictions have prevented them from general hospitality consumption. Against this backdrop, they are likely to have more time on their hands and this is clearly reflected in the surge in retail trading volumes of stocks and options. Consequently, it can be argued that the madness witnessed in the equity markets in January was at least partly derived from excess liquidity in the financial system, which is not only pertaining to institutional money, but now also to non-professional market participants as well.

We would argue that the market-madness witnessed last month was not curtailed only to the investment community. January also saw the collapse of the 66th Italian government since the end of World War Two due to a disagreement amongst the leading parties on how to best invest €200bn from the EU's €750bn coronavirus recovery fund. Hence, it

seems there is too much liquidity across society – and we simply construe that too much is a curse. Consequently, we believe it makes sense to take a step back and take stock of what is actually happening.

January was a decent relative month for European Focus. After a strong absolute finish in 2020, the Fund fell by -0.52% in January compared with -0.75% of the benchmark MSCI Europe NR (EUR) index, which prompted a +23bps outperformance of the Portfolio. Although the index showed overall profit-taking during the month, there was a positive bias towards cyclical sectors, which attained the top-spots in terms of performance. Hence, the European tech-sector advanced by 2.3% in January, while the energy and the materials sectors rose by 2.0% and 1.0% respectively. For some time, however, we have noticed that the market is reflecting an almost seasonal pattern in January, i.e. cyclical industries tend to perform well in the early part of the month as market participants return from the Festive Season and tend to buy stocks with recovery potential. When the year-end results season gets underway during the second-half of January however, these cyclical sectors tend to lag the market and this was also the case last month. While the European tech-sector performed the strongest during the last two weeks of January (+0.5%), energy and the materials were very poor performing sectors, falling by -7.6% and -3.4% respectively.

What tends to bring sanity to equity markets are company results. During January, seven Portfolio holdings in European Focus, with a combined weighting of 34%, released figures (Lindt & Sprüngli, ASML Lonza, SGS, Diageo, Atlas Copco and Givaudan). With hindsight, some of the numbers were better than others. The strongest reports in our view were: ASML, Atlas Copco and Diageo. **ASML** (semi-conductor manufacturing equipment/Netherlands) guided for double-digit like-for-like sales growth in FY21 given a strong order intake for EUV-lithography equipment, where the company holds a world-leading position. **Atlas Copco** (capital goods/Sweden) guided for broadly unchanged business volumes compared with 2H20. However, management commented that demand for its vacuum pumps, which are used for semi-conductor equipment, are in high demand (we are positive that ASML is a large customer in this space), while general machinery/engineering is sluggish, with the exception of compressors and other equipment for electric vehicle production. **Diageo** (distilling/UK) delivered a strong set of 1H20/21 results. Management came across as optimistic for the second-half of the fiscal year (i.e. January-June 2021) on the back of a good performance in North America, where the premium brands performed well in particular. The Diageo share stands to substantially benefit as-and-when lockdown restrictions are ultimately scaled back (as already witnessed in November 2020 – when it was one of the best-performing stocks in the Fund).

The other aforementioned companies that released figures in January were on the whole ok, but our key takeaway from the varying webcasts is that most management teams came across as more guarded regarding the outlook for FY21. The caveat here was **Lindt & Sprüngli (L&S)**, which only announced FY20 revenues in January and did not host a webcast. Although L&S' 2H20 period showed sequential sales recovery vs. 1H20, it was regarded as insufficient due to poor travel retail selling and slightly disappointing sales volumes over festive periods like Thanksgiving and Christmas. Nonetheless, this fine company will publish its full FY20 set of results on the 2nd March. L&S has already confirmed that the previous profit-guidance for FY20 will be met (management is normally too conservative) and the company also flagged a return to the normal 5-7% life-for-like run rate in FY21. In March, L&S' management will also host a webcast and go on (virtual) roadshows with investors, which should improve sentiment to the stock.

Christian Diebitsch, Fund Manager

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