R&S European Equity Fund

Q2 2023 Commentary

Performance with principles®

PERFORMANCE

	3 Months	6 Months	1 Year	3 Years	5 Years	10 Years
Fund Performance (B Class)	-0.6%	6.3%	19.0%	40.4%	39.1%	136.1%
FTSE World Europe ex UK TR GBP	0.6%	9.3%	19.6%	32.1%	43.4%	136.8%
IA Europe Excluding UK	-0.1%	8.0%	18.6%	28.4%	34.0%	122.1%
Sector Quartile	3	4	3	1	2	2

Source: Morningstar. Figures compared on a Bid to Bid basis with Net Income Reinvested.

MARKET REVIEW

European equities enjoyed a second straight quarter of positive performance, although gains were far more modest in Q2 2023. Once again, macro concerns dominated the headlines, with inflation remaining persistently strong despite signs of weakness in food and energy prices. This prompted central banks to double down on their hawkish stance, with the European Central Bank (ECB) raising rates by 25bps twice during the period to take the key deposit rate to a 22-year high of 3.5%. ECB President Lagarde cautioned that there was still 'ground to cover' in tackling inflation, suggesting the tightening cycle is not over yet. While Europe's economic growth has been lacklustre, the employment market continues to hold up and the consumer remains resilient. From a sector perspective, banks enjoyed a slight recovery from the credit crisis in March amid few signs of further contagion. Technology stocks also benefited from strong sales projections among semiconductors, as well as excitement about the potential for artificial intelligence to underpin a technology revolution.

PERFORMANCE & ACTIVITY

The Fund underperformed during the quarter. At a sector level, the Fund's sizable underweight to consumer staples was the biggest contributor to performance, while financials also added to performance. Having cut back the Fund's exposure to banks at the start of the year, ahead of the banking crisis, we took advantage of lower valuations to increase the Fund's weighting and benefited from the post-crisis recovery. In general, we favour retail banks in Europe due to the improved operating environment amid higher interest rates. Insurers also performed well during the quarter. However, we pared back our overweight position by selling Munich Re. An overweight in telecoms was the biggest detractor during the period despite there being little negative newsflow, and an underweight in technology also proved costly as the sector rallied strongly.

At the stock level, Talanx led this quarter's winners. The German multinational financial services company is best known for owning Hannover Re; in our view, it also owns several other attractive businesses which are not necessarily yet reflected in its valuation. Dutch conglomerate Philips also performed well as litigation concerns surrounding its sleep apnoea machine were soothed when the first case was settled. Philips is also benefiting from the post-pandemic resumption of elective surgeries. French property group Covivio was our worst performer, reflecting wider concerns about the real estate sector in an environment of higher borrowing costs. However, we feel these fears are arguably overdone and that there are some attractively valued companies in the sector, especially those – such as Covivio – which are exposed to the recovery in tourism. Swedish pulp and paper manufacturer Billerud on weaker-than-expected results and Finnish telco Nokia was hurt by fears the capex cycle for 5G is waning.

OUTLOOK

Although Europe is continuing to suffer from the impact of the Ukraine war and its damaging effect on inflation, the relative economic outlook for Europe versus the US and the UK is more positive than it has been since the credit crunch in 2008. The shadow of recession is looming over the US, where its banking system appears to be in poor shape following the collapse of several regional banks and domestic consumers appear to be over-extended, having used up all of their excess pandemic funds. In contrast, Europe is further behind the US in the economic cycle, its banks are in a stronger position this time around and its consumers are holding up well.

That said, we are now back in the territory of more conventional business and investment cycles following an extended period of low growth and inflation. In this new environment, equity investors will need to be more aware of the threats to companies from higher financing costs and dampening demand. Any poor newsflow is likely to prompt markets to propel entire sectors lower, even though the investment drivers for individual companies may be very different. This herd mentality instinct tends to create interesting stock opportunities, so picking well-run, quality companies, with strong balance sheets, will become even more essential. While our long-term investment approach is value-orientated, we remain flexible and our portfolio positioning is relatively neutral, balancing both defensives and cyclicals with a focus on good-quality companies with attractive valuations.