Allianz Global Investors

Allianz Europe Equity Growth

Monthly commentary

Investment Objective

The Fund aims at long-term capital growth by investing in European equity markets with a focus on growth stocks in accordance with the Sustainability Key Performance Indicator Strategy (Relative). In this context, the aim is to outperform the Sub-Fund's Sustainability KPI compared to Sub-Fund's benchmark to achieve the investment objective.

What Happened in April

European equities retreated over April, as hopes of a series of rate cuts from the European Central Bank (ECB) were dashed by signs of improving economic activity. At a sector level, Energy companies rose the most, while Consumer Discretionary were among the weakest. Information Technology companies also slumped after disappointing results from semiconductor equipment maker ASML raised fears of an industry-wide slowdown.

The eurozone economy grew by a stronger-than-forecast 0.3% in Q1, marking the quickest pace of growth since Q3 2022. The HCOB eurozone composite purchasing managers' index (PMI) jumped to a 11-month high of 51.4 in April, with services activity rising to 52.9, the highest level since May 2023, although manufacturing activity contracted at the fastest pace in four months. Headline inflation held steady at 2.4% in April, but core inflation slowed to 2.7%. The ECB left rates on hold but said that the case for a rate cut in June was strengthening, although this would likely be followed by a pause.

German equities sold off. Germany's economy grew 0.2% in Q1, compared with a 0.5% contraction in the final quarter of 2023. The HCOB Germany composite PMI jumped to 50.5 in April, rising above the 50 level that separates expansion from contraction for the first time since June 2023. The Ifo Institute of German business confidence also improved, rising to its highest level in almost a year in April. However, inflation surprised on the upside, with the harmonised rate ticking up to 2.4% in April.

APRIL 2024

UK equities rallied, bucking the broader sell-off in global stocks, helped by the FTSE 100 Index's sizable exposure to Energy stocks, the strongest sector in April. The UK economy looks to have returned to growth in Q1. Additionally, the S&P Global UK composite PMI rallied to an 11-month high of 54.0 in April, driven by an acceleration in the UK's dominant services sector. While UK inflation slowed to 3.2% in March, it slightly topped forecasts. Markets are now pricing in the first rate cut from the Bank of England (BoE) in September or November of this year.

Performance Review

The Fund fell in a weaker month for European equities, underperforming its benchmark and the broader MSCI Europe. Sticky US inflation and geopolitical risk clouded the market backdrop for investors, wary also of higher valuations. Therefore, Value outperformed Growth for a second consecutive month, and cheaper UK was strong regionally. This explains some of the performance differentials more recently, with the Fund having a sharper growth orientation than both its benchmark and the MSCI Europe.

Among our most positive active contributors this month were several high quality Industrials such as Atlas Copco, after reporting strongly, as well as a mining and infrastructure equipment manufacturer and Trelleborg, holding steady in anticipation of potential upside ahead. Conversely, our MedTech names continue to show weakness, although the most prominent detractor was a payments company, after reporting revenue growth in line with guidance but a weaker take rate. The customer balance had tipped more in favour of large multinationals, and we view the selloff as overdone.

Catalysts for the Fund this year include a possible decline in interest rates, given euro area inflation has lowered to the 2.4% level (in March). Stronger earnings could similarly support growth valuations, and indeed many of our management teams have indicated H2 as a pivot point for growth. This is qualified by post-pandemic inventory normalising, order book visibility, an upswing in semiconductor capital expenditure (capex), and new innovations, investments and efficiency programmes ramping up.

Top contributors

Adidas added another circa 9% in April, taking year-to-date (YTD) returns over 22% as the stock continues its recovery alongside the business. Excellent Q1 results included topline growth of 5%, ahead of market expectations, and management suggesting double-digit order growth for Q2. The gross margin increase of +570 basis points (bps) year-on-year ex-Yeezy to 50.5% is also encouraging. The CEO visited our Frankfurt office in March. The turnaround strategy is focused on first building product momentum, then rightsizing the business, underlined by their product pipeline and order book returning to growth. Major summer sporting events (Olympics, European Cup, Copa America) are supportive, while inventories continue to alleviate, aligning with H2 optimism.

Atlas Copco's Q1 earnings results positively surprised, raising the stock over 7%. Better-than-feared industrial demand, a small pick-up in the semiconductor space, and continued strength in longer-cycle gas and process markets led to a strong order beat. Heavy impact from weak industrial markets seems to have been avoided, whilst the vacuum segment should see growth reaccelerate from rebounding semiconductor investments, as per the company's constructive commentary on market conditions. Capacity was being readied for this capex upswing. Coupled with continued robust operational execution, Atlas Copco appears well set up for the remainder of the year, and guides for similar customer activity levels next quarter.

Infineon made a small gain, likely supported by investors hunting for value, given the semiconductor champion has a current price-to-earnings (P/E) of under 14x. Headwinds from the automotive end-market continue. After posting some of the strongest earnings upgrades in the portfolio last year, financial year (FY) Q1 2024 adjusted earnings before interest and taxes (EBIT) missed expectations by -1%. The company's FY 2024 guidance points to further inventory correction and the trough nearing, plus a consumer recovery in H2 based on current order trends. Competition is rising, and China is encouraging their electric vehicle (EV) makers to buy local chips. This could take years to materialise. Meanwhile, Infineon is expanding the world's largest 200mm silicon carbide fab, a potential EUR 7 billion revenue windfall by the end of the decade.

Top detractors

The aforementioned payments company delivered 21% revenue growth in their Q1 results, in line with management's guidance of "low 20's" growth. However, market expectations were too high at circa 24% and the stock plummeted 28% to resume January stock price levels. The lower take rate of -7% quarter-on-quarter also disappointed by 5%, although due to mix effects as larger enterprises outgrew smaller merchants. With volumes up an impressive 46%, and after speaking to the CFO post results, we view the sell-off as overdone. The runway for growth remains, with less than a third wallet share on the digital side and below 40% in unified commerce. The company recently hired over 500 sales and tech recruits to fuel the next stage of growth.

DSV stock fell around 11% in April, under pressure given concerns about logistics volumes and yields in the weaker macro environment, and uncertainty around future growth drivers. We met with the CFO late in April. DSV is switching focus to organic growth and market share gains, rather than mergers and acquisitions (M&A), which had been a key growth driver historically. Management and operational changes are therefore in play to raise collaboration, and better support key customers with value-added services, another way to promote structural growth. Regarding the partnership with Saudi Arabia's Neom city development, apparently the smaller project scope was anticipated by DSV in the business case already. The project is ready to go live in Q2.

A pharmaceutical and lab equipment supplier reported another set of weak numbers, with Q1 revenues and adjusted earnings before interest, taxes, depreciation and amortisation (EBITDA) missing consensus hopes by around 5% and 2% respectively. Soft demand for instruments and weakness in China specifically were key drivers, along with subdued investment activity. The continued sales recovery in consumables is evident, but a meaningful decline in equipment orders of -25% spooked the market. Management reiterated their FY 2024 guidance for mid to high single-digit revenue growth, implying a strong ramp up through the rest of the year. We feel management protected profitability well this quarter, and their outlook is reassuring, but will look to engage external industry experts for more insight.

Purchases

An operator of digital marketplaces for real estate has a dominant position in German real estate classifieds. It runs an asset-light business model that is highly cash generative and boasts a cash flow return on investment (CFROI) of over 50%. Material operating leverage is generated from their stable marketing intensity and well-established technology base. Value is added through innovative new products and price increases. The platform is also transitioning to a marketplace, with new products and services raising revenue, such as expansion into complementary services like financing and servicing. Synergies and network effects are highly supportive.

Sales

Following a thorough review of the performance of a producer of precision radiation therapy, we observed that its growth had been limited and its performance below expectations in recent years. Given that our stake in the company was already relatively small, we made the strategic decision to divest from it. This allows us to reallocate resources and focus on investments that align more closely with our conviction and where we see greater potential for growth and returns.

Market Outlook

The ongoing emphasis on inflation and interest rates seems to be more reflective of a market unsure how to position than any real risk mitigation, because the mathematics of a 25 or 50 bps rate reduction later this year is fairly insignificant after a 550 bps rise. The Q1 earnings season should therefore be valuable to provide more direction. So far, we have indeed seen some strong stock price reactions to the results and expect this to continue.

Pricing power is the first line of earnings defence for a lot of our companies, but further rises have become more difficult to push through given fatigue and the softer macro environment. The current creativity contest to drive growth is seeing many of our management teams react to market pressures with innovation, efficiency programmes, and vertical integration to stay ahead of the pack. We feel our companies are in a relatively stronger position here.

Our portfolio has indirect exposure to artificial intelligence (AI) (often the “enablers” like ASML Holding, or companies taking advantage of this new capability like an enterprise software leader), data centres (a building materials company and a manufacturer of electrical devices such as switches, sockets and cable management), sustainability themes (Infineon, Sika, and the aforementioned building materials company), luxury (LVMH and another luxury name), and generally more resilient companies in a slowdown (those with pricing power, sticky revenues, contracts, and providers of essential products and services as examples). Our companies’ underlying profit growth looks steady.

Given strong performance of late, we are monitoring what is priced in. While overall valuations have risen, we believe generally they are reasonable, assuming H2 is as strong as indicated. This has been a clear theme from our companies as they report: emphasis on H2 as a pivot point for growth. Geopolitical risks of course remain on the table. Aside from this, we share the optimism of many of our management teams for the year ahead.

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ADM-W3591652