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 January

Eurozone equities moved higher in January, hitting their highest levels since January 2022, amid growing confidence that the European Central Bank (ECB) would reduce rates in 2024. Dutch stocks were especially strong, boosted by robust gains from semiconductor equipment maker ASML. At a sector level, Information Technology companies posted double-digit rallies, while Energy, Materials and Utilities companies lost the most ground.

The eurozone economy flatlined in Q4 2023. While German gross domestic product (GDP) fell 0.3% and France showed no growth, output in Italy, Spain and Portugal was stronger than expected. The flash estimate of January's HCOB eurozone composite purchasing managers' index (PMI) rose to a 6-month high of 47.9, as an improvement in manufacturing activity offset a deeper decline in services. Headline eurozone inflation accelerated to 2.9% in December, from 2.4% the prior month, but early indications suggested that inflation rates may have eased again in January. The ECB kept rates on hold. ECB President Christine Lagarde acknowledged that the worst of the inflation fight was likely over and the "disinflation process was at work", but signalled that rate cuts were more probable in the summer than the spring.

A further modest increase in German equities meant the DAX Index touched another record high in the closing days of January. Germany's economy shrank 0.3% in the final quarter of 2023, weighed down by a weak manufacturing sector. The flash HCOB Germany composite PMI slid to 47.1 in January. While services activity fell at the fastest rate since August, manufacturing showed a notable improvement, albeit remaining in contraction territory. German inflation eased to 3.1% in January on a harmonised basis, after jumping to 3.8% in December.

UK equities fell modestly (in GBP terms). UK inflation accelerated to 4.0% in December, the first increase in 10 months, dashing hopes of an early cut in interest rates from the Bank of England (BoE). Retail sales slumped 3.2% over the month of December as consumers did their holiday shopping earlier than normal. Nevertheless, the flash S&P Global/CIPS UK composite PMI jumped to a 7-month high of 52.5 in January, as service sector activity rose at the fastest pace in eight months, although manufacturing output slid to a 3-month low.

Performance Review

The Fund made a small gain in January, following a strong run in the two preceding months. January's result led to an underperformance versus the benchmark, however a small gain compared to the broader MSCI Europe.

ECB President Christine Lagarde signalled that eurozone rates were more likely to be cut in the summer rather than the spring. Linked to this delay, many stocks thought to be under pressure by higher rates pared back recent gains. In particular, numerous Materials and Industrials names detracted from performance where we are overweight, helping explain our weaker relative return versus the style benchmark.

Heading into the Q4 earnings season was also influential. Top active contributors ASML Holding (semiconductor equipment), Novo Nordisk (pharma), and an information technology (IT) solutions and services provider (custom software) all delivered above market expectations. Conversely, Sika (construction chemicals) disappointed on sales growth, giving up its gains made late last year. Management highlighted how some construction projects are being delayed in expectation of lower interest rates ahead, with this thinking potentially echoed across numerous industries, which could even create a pent-up demand situation.

We continue to believe our Growth portfolio offers an interesting opportunity in 2024, as interest rate pressure eventually fades. Our companies are selected for their ability to grow even in weaker environments, and indeed double-digit earnings growth continues at portfolio level, while possible rate cuts could offer tailwinds.

Top contributors

ASML Holding stock was rather flat through much of 2023 as the semiconductor cycle troughed. Again, 2024 was labelled as a transition year, before expectations of "significant growth" in 2025. Management had raised 2025 guidance on new or increased structural drivers, despite the recent advanced deep ultraviolet (DUV) export controls to China (15% of all sales). Given the current conservatism, record bookings posted in their Q4 results this month surprised positively. Breaking the orders down, strong demand from China for DUV equipment added to orders from other regions for brand new high numerical aperture equipment. Management also noted higher servicing sales, set to rise further as their customers increase utilisation.

Novo Nordisk posted Q4 group sales 4% above company consensus, and operating profit 5% ahead, with Ozempic being a key driver. For 2024, management expects sales growth of 18-26% and operating profit growth of 21-29% (at constant exchange rates). Wegovy is now available in nine countries and recently showed a 20% reduction in cardiovascular events (such as strokes and heart attacks). This could lead to more insurers and public health systems providing the medication. Development of Amycretin, an oral semaglutide drug, is progressing. The company is investing 4-fold their usual capital expenditure (capex) to raise production capacity, which could strain resources in the short term, but will support long-term growth and leadership.

The aforementioned IT solutions and services provider reported mixed Q4 results, with organic revenue growth of 4.9% beating the consensus view around 2.0%, however the adjusted earnings before interest, taxes, depreciation and amortisation (EBITDA) margin of 15.4% missed the bar set at 17.3%. Nonetheless, the market considers the result as a turning point given the sales improvement was broad-based ex the UK, and the lower utilisation affecting margins seems a temporary issue. We visited the company at their headquarters in November to revisit our investment case. Following their major acquisition of a Greek peer for EUR 235 million in October 2021, the management team have been investing into a new go-to market strategy. Meanwhile, valuation looks low in a historical context, and relative to digital transformation peers.

Top detractors

Sika stock has been under pressure given slowing global growth, however it has around 45% exposure to the more resilient refurbishment market, including infrastructure. Rising market share is another structural growth driver, including the integration of EUR 5.3 billion acquisition of a company specialised in construction chemicals products . In Q3, this led financial year (FY) 2023 sales guidance to rather lift from 6-8% to 15%. Some macro impact was apparent in their Q4 results however, so the stock gave up its strong gains made late last year. Organic sales declined -5.9%, missing market expectations by 2%. The North American market has weakened. Commercial projects are being postponed in the hope of better financing conditions shortly, and specialised labour is scarcer.

Infineon posted some of the strongest earnings upgrades in the portfolio last year, but the stock has corrected with the market still anticipating lower growth ahead. Infineon's FY 2024 guidance had pointed to further inventory correction and the trough nearing, raising the stock over 37% in the final two months of last year. Infineon's peers are now expecting a more challenging year ahead, so investors have prepared for a similar guidance cut in early February. In the longer term and more structurally, Infineon plans to expand its silicon carbide (SiC) fab in Malaysia, set to become the largest in the world. Infineon's SiC revenues are projected to reach over EUR 1 billion by FY 2025, with a plan for 30% market share by the end of the decade.

Stock of an engineered polymer solutions company remained resilient through 2023, gaining over 43% and becoming a top active contributor. This was mostly in appreciation of its higher quality business moving forward, having divested its wheel systems division. This month, the weakening industrial backdrop and expectation of a more contractionary economic environment led the stock down around 7% as sentiment shifted. We visited the company's headquarters and CEO in November. Management's target of over 8% total growth (4% organic plus 4%+ mergers and acquisitions (M&A)) seems reasonable. Recent disposals have led to a stronger business that is less cyclical. Pricing power, dominant market shares in small market niches, and share buybacks are all supportive.

Purchases

We purchased a leading hotel company, with over 6,000 open hotels and 1,800 in the pipeline. Despite a current market share of 4%, the potential for growth in this business appears very promising. As the market share of branded hotels increased from 20% in 2015 to 24% in 2020, it is reasonable to assume that this market will decrease its segmentation in the upcoming years, providing branded hotels with further potential growth. Moreover, the company's business model is also extremely profitable, as the capital for expansion is provided by the hotel owner, a 100% free cash flow (FCF) conversion is always to be expected. The main contributors to expansion in this sector are the number of rooms and the growth in revenue per available room (REVPAR), making it a solid choice for investment. The hotel chain opened 269 new hotels in 2022 and expects to grow its room count by over 30% from today's numbers in the upcoming years. Additionally, its REVPAR has shown consistent growth over the years, with an overall 10% increase in 2023 and an extraordinary 43% growth in Greater China.

Sales

We decided to sell a wealth management and financial planning advice company despite its recent weak performance and low valuation, as we do not anticipate any significant profit growth in the coming years. There is a high risk of increased involvement by the UK regulator, particularly regarding fee structures, but potentially affecting other aspects of the business as well. Our concern is primarily raised by the company's reliance on regulatory decisions that prioritise customers' interests, which could further impact its profitability.

We exited the holding in a natural ingredients manufacturer which recently merged with a biotechnology company, altering our investment case.

Market Outlook

With inflation continually reducing and the bulk of rate hikes behind us, the technical pressure on our valuations lifts, putting fundamentals back in the spotlight. Elevated cyclical risk and slowing global growth should see our structurally growing companies shine, also due to their quality features like pricing power, product and service criticality, and low debt.

Inventories have lowered and post-pandemic normalisation is looking near complete, so that some of our formerly affected pockets like medtech are now set up for a better year. Industrials, where we remain overweight, could be boosted in any anticipation of a cyclical recovery. Currently, we see some opportunities in the Travel space. Small caps and semiconductor names might not be subdued for long, as always, the market is not the economy and typically moves faster.

A return of President Trump could raise uncertainty, but also fuel markets globally, given his typically expansionary policies. Effective stimulus in China seems more of a wild card, but would be strongly supportive for our global exporters.

Historically, our portfolio enjoyed competitive returns in fundamentally-led environments, and our team is working to fine tune performance further. We have implemented more structure in how we work together and look forward to adding a new team member in the coming months. We are also continuing our corporate headquarter onsite visits in Q1, having a semiconductor-related trip planned.

While confident, we do not anticipate all smooth sailing. Geopolitical risks appear to be increasing, which warns of risk-off market behaviour that may not always suit our long-term positioning. More focus on fundamentals at slightly higher valuations means our companies need to continue proving they can outperform. Our conviction is simply built on the visibility we feel we have on our companies delivering above average performance in a range of environments, where again in 2024, they appear well positioned to do exactly that.

Connect with Us | sg.allianzgi.com | +65 6438 0828 | Search more Allianz Global Investors

Like us on Facebook **Allianz Global Investors Singapore**

Connect on LinkedIn **Allianz Global Investors**

Subscribe to YouTube channel **Allianz Global Investors**

All data are sourced from Allianz Global Investors, Eurostat, IHS Markit and Office for National Statistics, as at 31 January 2024 unless otherwise stated.

The information presented here is intended for general circulation and does not constitute a recommendation to anyone; it also has not taken into account the specific investment objectives, financial situation or particular needs of any particular person. Information herein is based on sources we believe to be accurate and reliable as at the date it was made. We reserve the right to revise any information herein at any time without notice. No offer or solicitation to buy or sell securities and no investment advice or recommendation is made herein. In making investment decisions, investors should not rely solely on this publication but should seek independent professional advice. However, if you choose not to seek professional advice, you should consider the suitability of the product for yourself. Past performance of the fund manager(s) and the fund is not indicative of future performance. Prices of units in the Fund and the income from them, if any, may fall as well as rise and cannot be guaranteed. Distribution payments of the Fund, where applicable, may at the sole discretion of the Manager, be made out of either income and/or net capital gains or capital of the Fund. As a result of the payment, the Fund's net asset value is expected to be immediately reduced. The dividend yields and payouts are not guaranteed and might change depending on the market conditions or at the Manager's discretion; past payout yields and payments do not represent future payout yields and payments. Investment involves risks including the possible loss of principal amount invested and risks associated with investment in emerging and less developed markets. The Fund may invest in financial derivative instruments and/or structured products and be subject to various risks (including counterparty, liquidity, credit and market risks etc.). Past performance, or any prediction, projection or forecast, is not indicative of future performance. Investors should read the Prospectus obtainable from Allianz Global Investors Singapore Limited or any of its appointed distributors for further details including the risk factors, before investing. The duplication, publication, extraction, or transmission of the contents, irrespective of the form is not permitted, except for the case of explicit permission by Allianz Global Investors. This publication has not been reviewed by the Monetary Authority of Singapore (MAS). MAS authorization/recognition is not a recommendation or endorsement. The issuer of this publication is Allianz Global Investors Singapore Limited (79 Robinson Road, #09-03, Singapore 068897, Company Registration No. 199907169Z). AdMaster 3390709.