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 July

Eurozone equities closed July flat. At a sector level, Information Technology stocks fell sharply, with ASML hurt by reports that the US may consider tougher restrictions on what semiconductor equipment can be sold to China. Luxury goods companies were also hit after LVMH reported slower-than-expected sales in Q2. At the other end of the scale, Utilities companies were the strongest performers. In political news, the second round of France's parliamentary elections resulted in no outright majority for any party, although the far-right National Rally slumped to third place. France now needs to form a coalition government although the process will not commence until after the Paris Olympic Games.

The eurozone economy grew 0.3% in Q2, slightly above forecasts and the same growth rate as in Q1. Growth appears to be stagnating in Q2. The HCOB eurozone composite purchasing managers' index (PMI) fell to a 5-month low of 50.1 in July. Services activity fell from 52.8 to 51.9, while the manufacturing index dropped from 45.8 to 45.6.

Headline eurozone inflation quickened to 2.6% in July, up from 2.5% in June. As widely expected, the European Central Bank (ECB) kept rates on hold as minutes of its rate-setting meeting in June showed that policymakers had been divided over whether to cut rates by 25 basis points (bps) given higher-than-expected wage growth. ECB President Christine Lagarde said another cut in September was "wide open" as she noted that "the risks to economic growth are tilted to the downside".

German equities rose slightly, outperforming the broader euro zone. Germany's economy unexpectedly contracted 0.1% in Q2, after growing by 0.2% in Q1. The HCOB Germany composite PMI slumped to a weaker-than-expected 48.7 in July, suggesting the private sector was declining for the first time in four months, while inflation ticked up to 2.6% on a harmonised basis in the same month.

UK equities advanced, helped by the FTSE 100 Index's value tilt and its lack of exposure to technology companies. The FTSE 250 Index of domestically focused companies performed even better after the Labour Party won a landslide victory in the UK general election, boosting hopes of political stability, improved relations with the European Union (EU) and a period of fiscal prudence. The S&P Global UK composite PMI accelerated to 52.7 in July, mainly driven by stronger manufacturing activity. UK inflation held steady at 2% in June.

Performance Review

The Fund slipped in July, underperforming the benchmark and the broader MSCI Europe.

We were fortunate to have a rebound across several construction and MedTech holdings on rate cut hopes, and positive surprises in Q2 earnings results boosting a handful of stocks, given the very difficult market conditions this month for the Fund. The backdrop included elections in the UK and France again, plus geopolitical rhetoric from the US and rising scepticism around artificial intelligence (AI), that developed into a global tech selloff alongside a sharp Value rotation. Weak economic data from China prompted a series of rate cuts, but critically the US and Europe kept rates steady, offering little respite to a market with high hopes of reductions.

The top active contributor was DSV (logistics), now one of two bidders left for the coveted acquisition of a logistics company, and after they narrowed their guidance in the upper range of the previous guidance. The main active detractor was top position ASML Holding (semiconductor equipment), retracing some of its 42% year-to-date run prior. We spoke with management about recent geopolitical threats and agree that China has already very limiting chip equipment restrictions, while the US is not yet self-sufficient enough to afford retaliation on semiconductor processes that are globally linked.

Markets are very volatile at the time of writing, given high rotational activity on low liquidity. Fundamentally, we are optimistic given the positive H2 outlooks from our holdings, where better growth is broadly expected, and greater capacity is being readied in some spaces. Rate cuts are key.

Top contributors

DSV rallied over 19% in July, after delivering a 2.3% earnings before interest and taxes (EBIT) beat on accelerating air volume growth and better yields at sea. An improved H2 outlook raised guidance to the upper end of financial year (FY) 2024 targets. We met with the CFO late in April. DSV is switching focus from mergers and acquisitions (M&A) (a key growth driver historically) to organic growth and market share gains. Team and operational changes seek to raise collaboration, and better support key customers with value added services, another route to structural growth. A new cost savings initiative aims to add DKK 750 million in run rate savings through digital and automation initiatives. DSV is a clear contender for the major acquisition of a logistics company, one of two bidders remaining (alongside a consortium led by a private equity company).

A manufacturer of high-performance insulation and building envelope technologies is yet to report their Q2 results, with the stock gaining circa 8% this month on improving sentiment that has surrounded numerous stocks in the home improvement and construction spaces. It was also a bounce from the dip last month again despite limited news flow. The company's Q1 results showed lower raw materials prices being passed through to customers, resulting in a sales growth contraction. Management expects this negative effect to annualise by mid-year. A bright spot was data and flooring sales, growing at circa 14%. Here, the company recently added capacity to manufacture specialised products and systems such as raised access flooring.

Assa Abloy's Q2 results were roughly in line, with their organic revenue decline of -1% only a slight miss to consensus at 0%. The Asia Pacific region was a weak spot in line with what many of our companies tell us, while US non-residential demand proved resilient. While management has not officially guided, the stock gained almost 6% on increasing confidence compared to a year ago. Also very relevant is ongoing, bolt-on acquisitions and divestments, a structural aspect of their growth expected to bump Q3 sales in a margin accretive way. Rising electromechanical adoption continues. Assa Abloy also likely appreciated alongside its home and construction peers, rising on expectations of lower interest rates ahead.

Top detractors

ASML Holding has not escaped tech stock volatility, rising 10% in June only to drop 11% in July. Q2 revenues fell 10% year-on-year but exceeded market expectations. Orders also beat consensus, with the backlog worth 18 months of revenue. Guidance was maintained. Overshadowing these results was geopolitical risk, but China's access to equipment is unlikely to reduce further with extensive bans already in place. ASML's latest high numerical aperture (NA) equipment is a bigger mid-term story, with its far higher price, margin, and servicing fees. Management always described 2024 as a "transition year" with H2 set to outpace H1. Capacity has been expanded for 2025, where greater volumes should achieve higher operating leverage and margins.

Novo Nordisk was one of our best absolute performers this year to June, returning 45%. Optimism surrounds their new generation oral weight loss drug Amycretin, which boasts early Phase 1 results that are far superior to injectable Wegovy. The competitive space is ramping up however, with a competitor also showing Phase 1 results for a handful of patients on a small molecule peer, encouraging the stock's retraction this month. Meanwhile, the US Centers for Medicare and Medicaid Services (CMS) indicated Medicare coverage for Wegovy in patients with cardiovascular disease and obesity, and last month China approved the drug for sale. Novo Nordisk's purchase of a contract manufacturing organisation helps secure supply. We continue to review the investment case.

Atlas Copco's Q2 numbers delivered a slight miss of 1-2% versus consensus across the top- and bottom-line. Especially sharp was the -13% drop in Industrial Technique orders, highlighting again a slower-than-expected take up of electric vehicles (EVs) in Europe that postponed projects, as well as short-term overcapacity in China. The Power segment was also soft, while Compressor was stronger, and in Vacuum capacity was being readied for the coming capital expenditure (capex) upswing. Management guides for similar customer activity levels next quarter. Also relevant was the stock's allegiance with big tech themes, given its vacuum exposure. The 6% share price drop left this diversified, high quality industrial trading at a 5% discount to its 5-year average.

Sales

We sold a large manufacturer of pharmaceutical and biotech solutions. It is an asset heavy company with a low return on invested capital (ROIC) and a high valuation. Not the kind of profile we usually like to see. The growth expectations are high. If the company indeed grows so well, maybe other companies like a pharmaceutical and lab equipment supplier would be a better way to invest into that growth path.

Market Outlook

With markets being very noisy currently, we rather defer to fundamentals and our management teams, who are looking ahead to a brighter couple of quarters.

Our Q2 earnings results were generally robust, although with low reward at this time. Key headwinds represented the consumer space (rather than B2B which we tend to favour), selected cyclical end markets like construction and automotive, and especially China, being a major market for our global leaders. Investors seem to view Q2 as the trough however, with stocks in more cyclical sectors rebounding to enjoy some of the best performance in July. Smaller cap companies, and value names, were also beneficiaries of this rotation that pre-empted the first interest rate cuts in the US, highly anticipated now in the weeks ahead.

Funding this was profits taken from crowded large tech and semiconductor-linked names, following the incredible run of some AI leaders, particularly a graphics processing units manufacturer (not owned) which momentarily became the world's most valuable company. Most recently, investors broadly have been querying how long it will take for the major AI infrastructure investments to pay off. This change in optimism affected semiconductor-linked companies also in Europe. Increasingly, investors like us want to see companies really monetising on AI technology, given the extreme costs involved in the infrastructure build-out. This would provide more confidence when presented with extreme back of the envelope estimates of market opportunities worth "hundreds of billions of dollars" over the next few years.

At the time of writing in early August, this rotational activity has met with recession fears, a surprise interest rate increase from Japan that upended the yen carry trade, and low market liquidity, creating a stunning surge in volatility that even rivalled the 2020 pandemic and 2008 global financial crisis. As always, such volatility brings opportunities, and we made several smaller repositioning trades across our portfolios over the past few weeks.

As we look ahead to the remainder of 2024, we are optimistic on the sentiment effects of rate cuts, as well as their technical effect on valuations. They are also valuable to unlock capex, with our companies across various industries relaying that customers are waiting for lower rates seemingly just around the corner. This could support our numerous Industrial names, while our semiconductor leaders are projecting an excellent 2025 set to neutralise the current selloff, and our fallen MedTech stars appear to have troughed with upside from here. Meanwhile, M&A seems to be increasing with our cashed-up firms not beholden to interest rates, noting there are great opportunities at the current time.

Volatility could well continue, on monetary policy changes, and the sectoral factors above, plus the US elections, the wild card of China given recent stimulus, and even the quite crucial results of the aforementioned graphics processing units manufacturer, and outlook in late August as a test for the traction and sustainability of AI. On solid fundamental grounds and owning high quality market leaders that are active currently to maintain high structural growth, we believe we are well positioned for a more optimistic environment ahead.

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