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 May

European equities rallied over May, buoyed by growing hopes that the European Central Bank (ECB) would cut rates in June, although some late-month weakness capped the monthly gains. At a sector level, Financials and Real Estate stocks were the strongest in the MSCI Europe Index, while Energy was the only sector to end the month in negative territory.

Economic data continued to show signs of improvement, although inflation accelerated. The flash estimate of the HCOB eurozone composite purchasing managers' index (PMI) jumped to 52.3 in May, the highest level in a year. Services activity held steady at 53.3, while manufacturing activity contracted by the least in 15 months. Headline inflation quickened to 2.6% in May, up from 2.4% in the previous two months, while core inflation accelerated to a stronger-than-expected 2.9%, marking the first increase in nine months. ECB President Christine Lagarde indicated that it was highly likely that the central bank would cut rates in June but refused to comment on the subsequent path of interest rates.

German equities rose. The HCOB Germany composite PMI increased to a 1-year high of 52.2 in May, with services activity the strongest in 11 months, while manufacturing activity improved from 42.5 in April to 45.4 in May. The harmonised rate of annual German inflation picked up to a 4-month high of 2.8% in May, exceeding forecasts. German wages increased by 6.4% in nominal terms in Q1, marking the highest rate since records began in 2008.

UK equities moved higher but lagged other European markets. The UK economy exited recession in Q1, however hopes that the Bank of England (BoE) would cut rates as soon as June were dampened when inflation slowed less than

expected in April and the UK government called a surprise general election, to be held on 4 July. The ruling Conservative Party is currently trailing the Labour Party by a considerable margin in opinion polls.

Performance Review

The Fund gained in May, representing an outperformance versus the benchmark, and maintaining pace with the broader MSCI Europe. Indeed, value as an investment style slightly outperformed growth. Many of our high-quality Industrials enjoyed another strong month of gains.

The highest relative contribution was made by Infineon however, with the order backlog finally flatlining after five sequential quarters of declines. Conversely, a group of our medtech names have disappointed, being all somewhat linked in terms of weak customer demand, especially from China, and high inventories, where management teams appear quite optimistic on a recovery in H2. We view the situation as simply requiring more time.

Meanwhile, the portfolio has quite high exposure to numerous global leaders from Europe that are helping to build the infrastructure supporting cutting edge computing capabilities, including several semiconductor and data centre construction and equipment suppliers. We also have numerous firms whose products aim to reduce power consumption, another important factor for successful digital upgrades.

With the ECB lowering interest rates at the time of writing, the backdrop is more positive for European growth, and we may welcome increased flows back to our region that is so far differentiating here. We also look forward to potentially stronger fundamentals in H2, as suggested by a wide range of our companies.

Top contributors

Infineon returned over 12%, with investors finding value in the semiconductor champion with a price-to-earnings (P/E) that was under 14x. While their latest fiscal year (FY) 2024 guidance was downgraded again (revenues of EUR 15.1 billion from 16 billion), this was largely anticipated, and finally the order backlog flatlined after five sequential quarters of declines. The trough seems apparent now, with the stock further de-risked. We spoke to an industry expert in March. Competition has risen, and China is encouraging their electric vehicle (EV) makers to buy local chips. Infineon remains years ahead on sophisticated technology however, especially silicon carbide (SiC). This includes their expansion of the world's largest 200mm SiC fab, a potential EUR 7 billion revenue windfall by the end of the decade.

A life-saving medical equipment producer has delivered close to 100% return since the trough late in October last year. Organic revenue growth figures of 14% in FY Q1 and later 15.5% in FY Q2 suggest the business is strengthening, being well ahead of the original guidance range of 7-10% and triggering an upgrade to 10-12% last month. After reviewing the investment case in early February, we took an active decision to hold, concluding that the company is much more conservatively managed now and enjoying good momentum. In another good sign, recent contract renegotiations have been supportive, although we are conscious of rising competition. The runway is long, with 3% of the market converted to single-use, and an implied 5-year sales compound annual growth rate (CAGR) of 25-32%.

A construction and mining machinery company is a name we added to on weakness throughout Q1, so it was pleasing to see the stock's gain of almost 10% this month. Mining has been holding up quite well in this environment, while construction is a far smaller but weaker segment currently. Exploration continues among larger miners, but more junior players are hesitant given higher interest rates. Ageing equipment, and the need to electrify and automate, especially to reduce emissions and meet climate targets, add structural weight to the longer-term growth case. The company plans to

offer its underground mining equipment as battery-electric versions by 2025, and surface equipment by 2030. Electric equipment offers higher margins, as well as servicing.

Top detractors

A pharma 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 were key drivers, along with subdued investment activity. The continued sales recovery in consumables is evident, but a -25% decline in equipment orders spooked the market. Management reiterated their FY 2024 guidance for mid to high single-digit revenue growth, implying a ramp-up in H2. We attended their capital markets day in May. Biologic drugs have risen from 21% of total pharma market revenue in 2013, to 39% in 2023, and an expected 44% in 2028. Management's lack of visibility currently is concerning.

An integrated ophthalmology equipment producer lost further ground on weak Q2 results, where revenue disappointed by -7% and earnings before interest and taxes (EBIT) by -14%, placing full-year targets in question. China (25% of sales) remains a headwind, with the US also unsupportive currently. Post-pandemic inventory build-up has lowered demand for equipment and especially consumables, with a recovery expected in H2 only. Meanwhile, order growth was negative for several quarters, which we believe will correct in due course. Interestingly, the company is working on digitalising workflows: in a cataract workflow, surgeons save 30% of their operating time, there is 50% less data entry, 30% lower staff utilisation and 30% reduction in process time per step, raising value and network effects.

An intimate health care company slipped around 2% in May, having been another medtech holding under pressure. Their typically reliable 8% organic revenue growth had been held back also by pandemic-related inventory stocking and destocking effects, exceptionally high energy prices, and a couple of strategic acquisitions. FY Q1 results showed sales in high-margin ostomy and continence improving, plus a ramp-up at acquisition of a manufacturer of fish skin-based therapeutic products, propelling EBIT to beat expectations by 2.5%. In FY Q2, standard 8% revenue growth came with EBIT miss due only to currency headwinds. We appreciate the significant acquisition opportunity (wound care developed from cod fish skin), although it requires a lot of work (clinical studies, sales support) to reach potential.

Sales

An international food corporation is stable, however its growth has consistently fallen below our expectations and shows no signs of improvement. We previously reduced our position in this stock and have decided to exit the remaining position to reallocate funds towards higher-growth, higher-conviction investments.

Market Outlook

As we approach mid-2024, the global economic outlook shows signs of improvement. In the US, a soft landing is widely expected, and Europe is seeing growth, thanks to increased external demand. With the ECB taking the first step in lowering interest rates last week, the outlook for European growth is looking more positive and could encourage flows back to our region, which is differentiating here. However, uncertainties remain due to lingering effects of tight monetary policies, persistent inflationary pressures, and upcoming elections amidst geopolitical hotspots.

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 still challenging 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 (an insulation and building envelope solutions provider; and a manufacturer of electrical devices such as switches, sockets and cable management), sustainability themes (the afore-mentioned insulation and building envelope solutions provider, Infineon and Sika), luxury (a luxury goods company and LVMH), 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.

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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