Europe Small Cap Strategy

Central Banks at the heart of market performance

• European small caps performed in line with their large cap counterparts in June
• Over the month, our flagship Fund, AXA WF Framlington Europe Small Cap, posted a return of +3.91% (net of fees, I EUR share class), underperforming the Stoxx Small 200
• This was mainly driven by stock selection, as sector allocation was marginally positive

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What's happening?

Central banks, and particularly the Fed, were quite vocal in June, implying that they would intervene in support of growth should it slow down materially. These reassuring remarks, as well as the postponed tariffs on Chinese goods caused a large collapse of yield curves and a material stock markets rebound. Thus, while the US 10-year rate was above 3.2% in October 2018, it fell and went below the 2% threshold at the end of the month. Similarly, in Europe, while the German 10-year rate was around 0.5% in October 2018, it continued its decline and is now in deep negative territory, stabilizing around -0.3%, pushing down September 2016's lows. These yield curve movements have inflated the valuation of risky assets, including equities, allowing the S&P 500 to once again hit new highs. Over the month, the dollar tended to weaken against other currencies, including the euro and the yen. The likelihood of failed negotiations between Europe and the UK, increasing the risk of a "no deal Brexit", penalised the Pound. Volatility indices collapsed, validating the assumption of central banks acting as a last resort. Finally, oil prices went up on the back of increased tensions between the US and Iran.

European small caps performed in line with their large cap counterparts in June. As for sector performance, cyclical sectors (and notably value stocks) outperformed defensive ones. As such, materials and industrials outperformed telecoms, utilities and consumer staples while the banking sector suffered from the yield curve movements.

Portfolio positioning and performance

Over the month, our flagship Fund, AXA WF Framlington Europe Small Cap, posted a return of +3.91% (net of fees, I EUR share class), underperforming the Stoxx Small 200. This was mainly driven by stock selection, as sector allocation was marginally positive. Our lack of exposure to utilities and our overweight exposure to materials and industrials helped us, but this tended to be offset by our over exposure to telecoms. As for stock selection, while it was positive within financials and telecoms, it detracted from returns within industrials, technology, materials and consumer goods.

Within healthcare, Evotec performed well. This drug discovery services provider announced the strengthening of its partnership with Celgene in the field of neurodegenerative diseases. UDG also progressed well. After a difficult year in 2018, the services provider to the pharmaceutical industry seems to be recovering and recently announced an acquisition to reinforce its communication and consulting division. Less positively, Siegfried cost us, as the Swiss group suffered from its defensive status.

Within financials, Ashmore and Fineco were sought after. Investors praised Ashmore's exposure to emerging markets, while Fineco, which was under pressure in May following a placement by its majority shareholder UniCredit, rallied in June. However, Italian bank Credito Emiliano was penalised by the adverse yield curve movements.

In consumer goods, Cairn Homes underperformed, as the Irish homebuilder suffered from the lack of visibility on the Brexit resolution. Emmi, a swiss dairy producer, was a drag in line with its defensive status. Conversely, Hugo Boss and Ferragamo, undergoing internal reorganisation and brand repositioning have sparked renewed interest after being away from the supportive environment in the luxury sector.

Within industrials, Comet cost us following the announcement of the departure of its CEO. Elsewhere, ID Logistics underperformed the rest of the sector. Kingspan and Travis Perkins were avoided for their exposure to the UK market, while Edenred held well.

In materials, our exposure to Croda weighed on performance, as the specialty chemicals player (whose end markets include defensive industries such as healthcare and food), did not benefit from the generalised enthusiasm for cyclical stocks.

In the energy sector, Hunting suffered from the lack of dynamism of unconventional oil and gas activities. On the other hand, TGS, which supplies and operates geophysical data, benefited from indicators pointing to a business recovery for its second quarter.

In technology, Aixtron was dragged down by the rest of the semiconductor sector, for which industry experts no longer foresee a recovery before the beginning of next year.

Finally, within consumer services, while Elior performed well, Rightmove was dragged down by the adverse sentiment around Brexit.

In terms of portfolio activity, we added to Alstria and Travis Perkins and took profits on Panalpina and Edenred.

Outlook

Considering the shift in tone of major central banks regarding the future path of monetary policy, the downward pressure on equity multiples has eased. As such, liquidity risk has moderated allowing small caps to resume their outperformance. Any improvement in global growth and the settlement in the Sino-US trade war could lead to more volatility in financial markets.