# CARMIGNAC ABSOLUTE RETURN EUROPE: LETTER FROM THE FUND MANAGERS

**15/10/2024** | DEAN SMITH, JOHAN FREDRIKSSON

*Over the thirds quarter of 2024, **Carmignac Absolute Return Europe** (A EUR Acc share class) realized a negative performance of -2.19%.*

## MARKET ENVIRONMENT

Global equity markets produced a positive return in Q3 but the headline numbers mask a very tumultuous period of volatility during the quarter driven by a series of conflicting macro forces.

**After a positive start to the early part of July, a toxic combination of weaker US data and a spike in the Japanese Yen following an interest rate rise in Japan set off a spectacular chain of events in the first few days of August which forced systematic funds to unwind their highly leveraged Yen carry trade, creating a significant global equity degrossing with long positions forcibly liquidated and covering of short positions.**

Japanese equities had their worst one day sell since 1987 which was followed by the biggest upside move since 2008 and this had a knock-on effect across the globe. The VIX volatility risk indicator was propelled to a level above 60, a level only seen 3 times in the last 35 years (2008 GFC & Covid sell off in March 2020).

After an aggressive sell off, markets steadily recovered as central banks pivoted in a more dovish direction with the Fed, the ECB and the Bank of England embarking on rate cuts. In addition, US economic data which had been a cause for concern showed signs of improvement which allayed fears of a US recession. This was followed in September by another material macro event in the form of an announcement of significant economic stimulus measures from the Chinese government, which catalysed a surge in Chinese equities and China exposed stocks in European markets. On the last day of the quarter alone, Chinese equities rallied 8.3% taking the main Chinese index from a 5 year low to a 1 year high. **The knock-on effect in Europe was heavy selling of year-to-date winners and defensive stocks, as investors sought to reduce multiyear underweights/shorts in China exposed names.**These macro forces unleashed a series of sectoral rotations with winners one month becoming the losers next month and vice versa which acted as a short circuit to fundamental stock picking. Few, if any investors around the globe, including us were positioned for this.

Over the quarter the best performing sectors in Europe were Communications, Real Estate, Industrials and Utilities while the main detractors were Technology, Consumer Staples, Energy and Healthcare.

# PERFORMANCE REVIEW

**These macro driven rotational forces acted as a short circuit to our fundamental stock picking and in this difficult environment the fund lost around 2%, with August seeing the worst impact.** Any positive returns from our defensively positioned long book were more than offset by the losses in our single stock shorts and portfolio hedges which were squeezed higher by aggressive rotational short covering.

**Within the portfolio, the most positive sector returns came from Communications, Real Estate, Industrials , Financials and Utilities while the main detractors were Technology, Consumer Staples, Energy, and Healthcare.**

On a stock level, the main contributors were:

| Q3 Stock contributors: | Catalyst of the positive returns: |
|---|---|
| Long position in Fresenius | Positive numbers drives rerating |
| Long position in Deutsche Telekom | Earnings beat and improving cash returns |
| Long position in National Grid | Recovery from sell off ahead of capital increase |
| Long position in Nexans | Significant contract signed for underwater power cable |
| Long position in Vonovia | Asset disposals refinance balance sheet, German real estate market bottoming |

On a stock level, the main detractors were:

| Q3 Stock detractors: | Catalyst of the negative returns: |
|---|---|
| Long position in ASML | Disappointing order numbers and concerns over US restrictions on sales to China |
| Long position in Novo Nordisk | Long-market worried about risk of new entrants in the GLP-1 market |
| Long position in National SK Hynix | Profit taking in AI and weak macro impacting legacy business |
| Long position in Alphabet | Disappointing numbers |
| Long position in STMicroelectronics | Q2 earnings below expectations |

Much of the portfolio activity for Q3 was driven by risk management in what were incredibly challenging conditions for long /short investors. **Whenever the portfolio is not working, we always act to reduce risk by managing down gross exposure and in this case we took our gross exposure down from 150% at the end of June to 120% at the end of July and then down to 100% in August in order to preserve capital**, until such time as the macro volatility calms down and that stocks can return to a more normal behaviour and where again we feel the risk reward is compelling enough to can take advantage of opportunities created by the moves.

**Our net exposure fluctuated between 10% and mid-20%s.** The principal adjustments to the portfolio were tactical reductions in longs in Technology and Healthcare and profit taking in Utilities which had performed very strongly on the back of falling bond yields. Elsewhere we reduced short positions in Consumer discretionary, Industrials and Materials and added to Financials, mainly Banks and to Real Estate names which are significant beneficiaries of falling interest rates.

# WHAT IS OUR OUTLOOK FOR THE COMING MONTHS?

As we now embrace the challenges and opportunities of the last quarter of the year, whether the FED cuts a further 50 or 75bps before the end of the year, or indeed the ECB accelerates their pace or not, it really shouldn't matter too much as the rate cycle has inflected. However, unlike these recent weeks when markets have quickly shifted from one narrative to another, for example from 'the Fed being behind the curve' to ' a goldilocks' scenario and back again, we should hopefully begin to see a more stable macro trend emerging. Instead, **the bigger challenge for equity investors in the coming weeks will be, how to best navigate the most important quarterly reporting season of the year.**Usually, at the 9-month stage is when we tend to see a much higher frequency of corporate profit warnings (or upgrades), vs any point earlier in the year. Some refer to it as ' the confession season'.

This is simply due to the timing of the year, by which time management teams come to realize that time is running for them to either meet or beat their full year guidance & fiscal outlook expectations. In addition, it is also the time when most sell side analysts really begin to properly adjust their growth forecasts for the coming year ahead, so lots of earnings expectation risk which should be a fertile period for long/short investing.

Even though, uncharacteristically, and unexpectedly September was a relatively strong month for equities, given the current 'setup', post all these rotational forces, **we believe the upcoming Q3 season will be very 'rich' of opportunities.** We can think of several sectors, whereby the top-down narrative might be in direct conflict with the short-term bottom up. For example, **some Luxury stocks have seen big rallies of their lows on the back of China stimulus, but can they sustain those gains against weak Q3's with possibly further downgrades to 25' estimates?**

Similarly, with some of the Consumer discretionary or Industrials stocks, we face the same question and challenge. Many of these names too have rebounded, particularly Miners & Industrials in Europe that are indirectly or directly linked to China. And the main question we must ask, is how much of this rebound is due to China stimulus vs expectations of lower rates and a turn of the cycle in 2025? Meanwhile, what we do know, meeting with the management teams of several of these companies during the many conferences in September, is that their messaging is at best cautious, and with very limited visibility. In some cases, the lack of visibility is also likely to be linked to the upcoming US election, where seemingly decisions on spending, capex plans etc. are put on hold until we know the outcome of who will take the White House in November. Could that result in a rush of spending, new investment plans and announcement post the election? It is possible.

**Therefore, this reporting season is likely to be particularly challenging, but equally, will offer significant opportunities both for our short and long book. This is why we are deliberately running a relatively low gross exposure at around 100% currently, keeping lot of 'dry powder' ready to deploy once we see the initial signs to how this reporting season will emerge, sector by sector, stock by stock.**We are confident that this level of flexibility will give us the best chance to really capture as much as possible in what tends to be the best period of the whole year for alpha.

On a sector level, we stick with most of our defensive, structural Technology and Communication names, such as Meta, Amazon, Google, Microsoft & SAP. However, **our weightings in more cyclical Technology names (semis) have been reduced overall and is currently mainly focused in semi equipment names, such as ASML and ASM International.**Further, we've just recently sold our long in Nvidia post the rally in the shares but retain upside in the name through call options.

**In Healthcare, a sector which has been a drag on our returns during Q2, we've reduced our exposures in the GLP1 names, both Novo Nordisk and Zealand.**These stocks have clearly been used to fund sector rotation, and whilst we still believe in the long-term narrative for these names, it has become abundantly clear, that they now need new positive catalysts to again begin to perform. Thus, we believe Q3's will be a big test for them, alongside new drug read outs. But with Novo having sold off by some -25% from its peaks, we do believe expectations are now possibly too low and that the stock should soon inflect. **Our largest healthcare stock is today Fresenius SE which we believe is defensive and still much too cheap (11x PE).**

Meanwhile, for many of the more cyclical sectors, Consumer discretionary, Industrials, Miners & Chemicals, we are today more balanced than at any time earlier in the year. This is mainly because several of our short positions in these sectors have now played out, and we subsequently taken profits. Or in some cases, it is because we simply don't yet know what level of patience the market will 'display' between wanting to buy these names into a recovery next year vs likely poor Q3's, with further FY24 downgrades?

Also is worth noting that our overall non-EU exposure is limited to ca 15% of our total gross exposure.

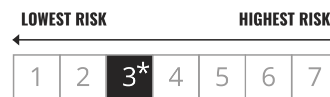
Finally, **we continue to be net long of financials, mainly European Banks. Recent meetings with management teams of these Banks and speaking to analysts, have increased our conviction in them**, despite in some cases already strong year-to-date performances. In addition, we believe that for European banks, Q3 earnings risk is relatively low vs most other European sectors. We continue to argue that due to their strong capital bases, hedged net interest incomes exposures, rich cash distribution, low valuations and more recently the emergence of European banks M&A, selective banks stocks still offer good upside from here.

# CARMIGNAC ABSOLUTE RETURN EUROPE A EUR ACC

(ISIN: FR0010149179)

SFDR - Fund Classification** :

**Article 8**




Recommended minimum investment horizon **3 YEARS**

## MAIN RISKS OF THE FUND

**RISK ASSOCIATED WITH THE LONG/SHORT STRATEGY**: This risk is linked to long and/or short positions designed to adjust net market exposure. The Fund may suffer high losses if its long and short positions undergo simultaneous unfavourable development in opposite directions. **EQUITY**: The Fund may be affected by stock price variations, the scale of which is dependent on external factors, stock trading volumes or market capitalization. **INTEREST RATE**: Interest rate risk results in a decline in the net asset value in the event of changes in interest rates. **CURRENCY**: Currency risk is linked to exposure to a currency other than the Fund's valuation currency, either through direct investment or the use of forward financial instruments.

**The Fund presents a risk of loss of capital.**

*Risk Scale from the KID (Key Information Document). Risk 1 does not mean a risk-free investment. This indicator may change over time. **The Sustainable Finance Disclosure Regulation (SFDR) 2019/2088 is a European regulation that requires asset managers to classify their funds as either 'Article 8' funds, which promote environmental and social characteristics, 'Article 9' funds, which make sustainable investments with measurable objectives, or 'Article 6' funds, which do not necessarily have a sustainability objective. For more information please refer to https://eur-lex.europa.eu/eli/reg/2019/2088/oj.

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**Entry costs :** 4,00% of the amount you pay in when entering this investment. This is the most you will be charged. Carmignac Gestion doesn't charge any entry fee. The person selling you the product will inform you of the actual charge.

**Exit costs :** We do not charge an exit fee for this product.

**Management fees and other administrative or operating costs :** 2,30% of the value of your investment per year. This estimate is based on actual costs over the past year.

**Performance fees :** 20,00% max. of the outperformance if the performance is positive and the net asset value exceeds the high-water mark. The actual amount will vary depending on how well your investment performs. The aggregated cost estimation above includes the average over the last 5 years, or since the product creation if it is less than 5 years.

**Transaction Cost :** 0,98% of the value of your investment per year. This is an estimate of the costs incurred when we buy and sell the investments underlying the product. The actual amount varies depending on the quantity we buy and sell.

## PERFORMANCE (ISIN: FR0010149179)

| Calendar Year Performance (as %) | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|
| Carmignac Absolute Return Europe | +2.5 % | -8.0 % | +8.9 % | +14.6 % | +4.4 % |

| Calendar Year Performance (as %) | 2019 | 2020 | 2021 | 2022 | 2023 |
|---|---|---|---|---|---|
| Carmignac Absolute Return Europe | -1.3 % | +5.2 % | +12.6 % | -6.4 % | +0.0 % |

| Annualised Performance | 3 Years | 5 Years | 10 Years |
|---|---|---|---|
| Carmignac Absolute Return Europe | +1.5 % | +2.9 % | +3.3 % |

Source: Carmignac at 29 Nov 2024.
Past performance is not necessarily indicative of future performance. Performances are net of fees (excluding possible entrance fees charged by the distributor).

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