GAM Star Fund Plc - GAM Star Continental European Equity

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Performance

The GAM Star Continental European Equity fund (EUR, institutional share class) rose in value by +1.20% versus a rise in value of +1.79% for the MSCI Europe ex-UK Net Index, representing an underperformance of -59 basis points (bps) in August. Year-to-date the fund is up by 13.46% versus an increase of 11.31% for the index, representing an outperformance of +215 bps.

Positive attribution (greater than +20 bps) for August included Inditex and Haleon while negative attributors (less than -20 bps) included Kingspan and Shell.

Market conditions

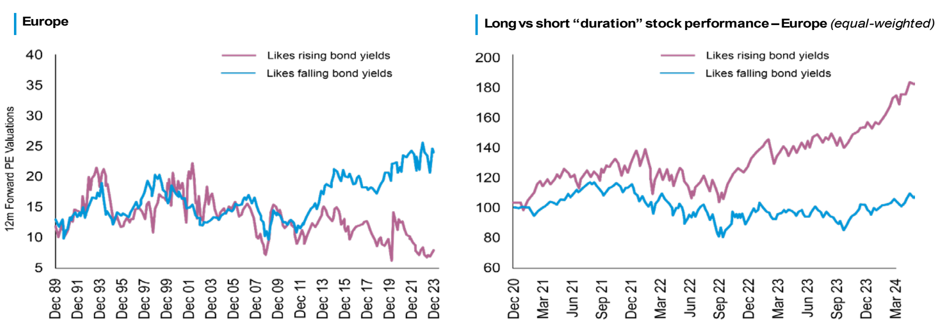
August turned out to be a much quieter month than was promised earlier in the month, with markets settling down after a volatility 'explosion' in the first few days; indeed, for anyone who went away in July and turned their screens off it would have appeared as if nothing much happened when they re-engaged in September. However, writing this note in early September it does not feel as if this calm is going to hold given the large changes in US interest rate expectations over the last few weeks and perceptions that the US economy is cooling, set against a 'bottom-up' picture that remains far more robust; this suggests a likely tug-of-war and much factor churning. Expecting a less calm market has not motivated us to change anything but might provide us with opportunities to increase/buy positions in areas of the market that we like from a fundamental perspective but have struggled with from a valuation perspective (in recent months), such as semiconductor capex equipment and electrification stocks.

What is particularly striking in recent days/weeks is that many 'growth' stocks have not performed well despite falling bond yields, perhaps suggesting that a broader rotation away from 'quality growth' is under way. We have written repeatedly about the continued high valuation of "quality growth" stocks in recent years and the very cheap valuation of banks and energy, and we remain of the view that valuation compression is likely. The charts below – courtesy of the Société Générale Quant Team - show the Price-to-Earnings (PE) valuations of quality growth stocks ("likes falling bond yields") and value ("likes rising bond yields", mainly banks and energy) indicating that no closing of the historically wide valuation gap has occurred over the last three years, despite the outperformance of 'value stocks', indicating that the outperformance has been earnings-driven. There is nothing unusual about this – regime changes as we move from one 'investment era' to another often take several years to embed themselves into equity valuations; those holding onto their "quality growth" European funds are likely to have several years of disappointment (and losses) yet to come as equity markets adjust to the new reality.

Niall Gallagher
Investment Director of GAM Star Continental European Equity

Quality growth still trades at a significant premium

Outperformance of value driven by earnings, not re-rating



Past performance is not an indicator of future performance and current or future trends.

Source: Société Générale Cross Asset Research/Equity Quant
The views are those of the manager and are subject to change.

GAM Investments

This is not to suggest that there is no fundamental reason to own any growth stocks – indeed there are areas of 'growth' we like, such as semiconductor capex and select industrials – but it is a reminder that high multiples must be justified by high growth and high Return on Capital Employed, and that the bond yield-induced quality growth bubble of 2018-2021 will surely continue to deflate as it becomes evident that the world of zero rates and perpetual quantitative easing is not coming back.

The picture in European economics is encouraging, although some of this is obscured by a very weak Germany influencing the broader eurozone 'numbers', but not other European economies. Peripheral (and not so peripheral) European economies, what we used to call the 'PIIGS' (Portugal, Italy, Ireland, Greece and Spain), are performing well (especially Spain and Ireland), the Nordics are picking up and France is about 'in-line', highlighting that it is really Germany that is the economic problem child. Even the UK – long considered the sick economy of Europe – seems to have found a higher gear. Lending growth seems to be picking up in some markets such as Spain, Ireland, Netherlands and to a more nascent extent in the Nordics, with this being driven by a mixture of corporate lending and mortgages, suggesting a firmer economic rebound is taking shape in numerous economies. On the negative front, high energy costs – the result of very poor energy policies, which we have written about extensively – are causing serious damage to the German industrial economy, and to a lesser extent Italy. It is simply not tenable for energy-intensive German industrial concerns to face energy costs 2-3x (electricity) or 5x natural gas those of competitors elsewhere in the world, and there is little reason to be positive on such companies (chemicals, autos, materials).

The latter part of European Q2 earnings results was very much a continuation of July with banks the 'star' of the season (again) and luxury particularly/incrementally weak. This has been reflected in subsequent earnings revision trends, with banks seeing upgrades and luxury stocks downgrades, and we have reduced our luxury holdings further.

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