Wellington Strategic European Equity Fund

WELLINGTON MANAGEMENT®

MARKET REVIEW

European equities increased in August. Economic data was mixed amid progress toward lower inflation and concerns about lackluster growth in the eurozone economy, particularly in Germany. The region's business activity modestly strengthened in August; the HCOB Flash Eurozone Composite PMI rose to 51.2 in August, from 50.2 in July, driven by a solid and accelerating expansion in the services sector, which was aided by a temporary boost in French services activity due to the Paris Olympics. Eurozone employment was fractionally lower, ending a seven-month sequence of expansion. Against a mixed economic backdrop, eurozone headline inflation fell sharply to a three-year low of 2.2% in August, from 2.6% in July, while core inflation was stable at 2.8%. The Bank of England and Sweden's Riksbank lowered interest rates, Norway's Norges Bank left policy unchanged, and comments from European Central Bank officials suggested that policymakers are poised to continue easing rates in September. Second-quarter earnings for companies in the STOXX 600 Index are forecast to increase by 3.0% from a year earlier, according to LSEG. Geopolitical tensions remained heightened, with the Ukraine's surprising incursion into Russia marking a significant escalation in the war. Germany's manufacturing sector worsened in August, while the Global Flash UK PMI Composite Output Index showed that UK manufacturing production increased sharply, and services activity growth accelerated.

The MSCI Europe Index Net returned 1.6% for the month. Within the index, nine out of 11 sectors rose over the month. Real estate and health care were the top performing sectors, while energy and information technology were the bottom performing sectors for the period.

FUND PERFORMANCE AND ATTRIBUTION

- The fund modestly outperformed the index over the period.
- Security selection was the primary driver of relative outperformance. Strong selection in industrials and financials was partially offset by selection in communication services, energy and materials. Sector allocation, a result of our bottom-up stock selection process, modestly detracted from returns. Allocation effect was driven by our underweight to health care and overweight to industrials, but partially offset by our underweight to information technology and energy.
- At the issuer level, our top two relative contributors were overweights to Rheinmetall and Haleon, while our top two relative detractors were out of benchmark allocations to Technip Energies and United Internet.
- Shares of Rheinmetall rose over the period. The company reported strong 2024 first half results driven by demand for weapons in Europe remaining high due to the Russian invasion of Ukraine. Rheinmetall also announced it will acquire Loc Performance, a US-based vehicle specialist, for $950 million. Shares of Technip Energies fell as second-quarter net debt came in higher than expected, despite adjusted net income beating expectations. European stocks fell overall due to a weaker-than-expected jobs report in the US, raising concerns about the broader economy. Additionally, the unwinding of yen carry trades exacerbated the sell-off.

FUND POSITIONING AND OUTLOOK

European markets advanced strongly in August supported by a robust Eurozone second-quarter GDP print driven by higher real incomes and public spending. The broader economic sentiment also improved. The European Central Bank (ECB) left interest rates unchanged despite encouraging signs of headline inflation edging down to 2.2% in August. How central banks will balance inflation, growth and recession risk remains important going forward with the level of longer-term yields a key element to watch.

Against this backdrop, European real estate, healthcare and communication services were the best relative performers, while information technology and energy were the worst relative performers. We continued to see growth outperforming value as a factor by around 90 bps this month. We think that many stocks that drove growth equities to outperform in recent years continue to trade at unattractive valuation levels, particularly when looking at their weaker fundamentals.

We continue to monitor inflation and longer-term yield levels, recession risk, the situation in Ukraine and the Middle East and the evolving European regulatory framework. We assess companies for their long-term fundamental attractiveness based on our investment criteria and incorporating the implications a recession may have on this. Stocks must fulfil our criteria of a superior structural free-cash-flow and earnings growth outlook and a very strong competitive positioning combined with attractive valuation levels. We think that especially as it regards the competitive outlook many so-called growth stocks are currently wrongly priced.

Over the month, we added to existing positions in materials and consumer goods, while trimming some positions in healthcare and industrials. We will continue to use volatility to opportunistically adjust our positioning. We think the portfolio is well positioned, despite potential for near term volatility.

At the end of the period, our largest overweight was industrials and we were most underweight to health care and information technology. From a market perspective, our largest overweights were United Kingdom and Germany. We were most underweight to Switzerland and France.

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