HEPTAGON Capital

European Focus Equity Fund

Market commentary and attribution analysis as of 30th June 2024

Portfolio Management

Christian Diebitsch

Investment Objective

The Fund aims to deliver long-term capital appreciation by investing in European equities. The Fund employs a high conviction, bottom-up, low turnover, research driven strategy with a focus on companies that exhibit sustainable long- term growth.

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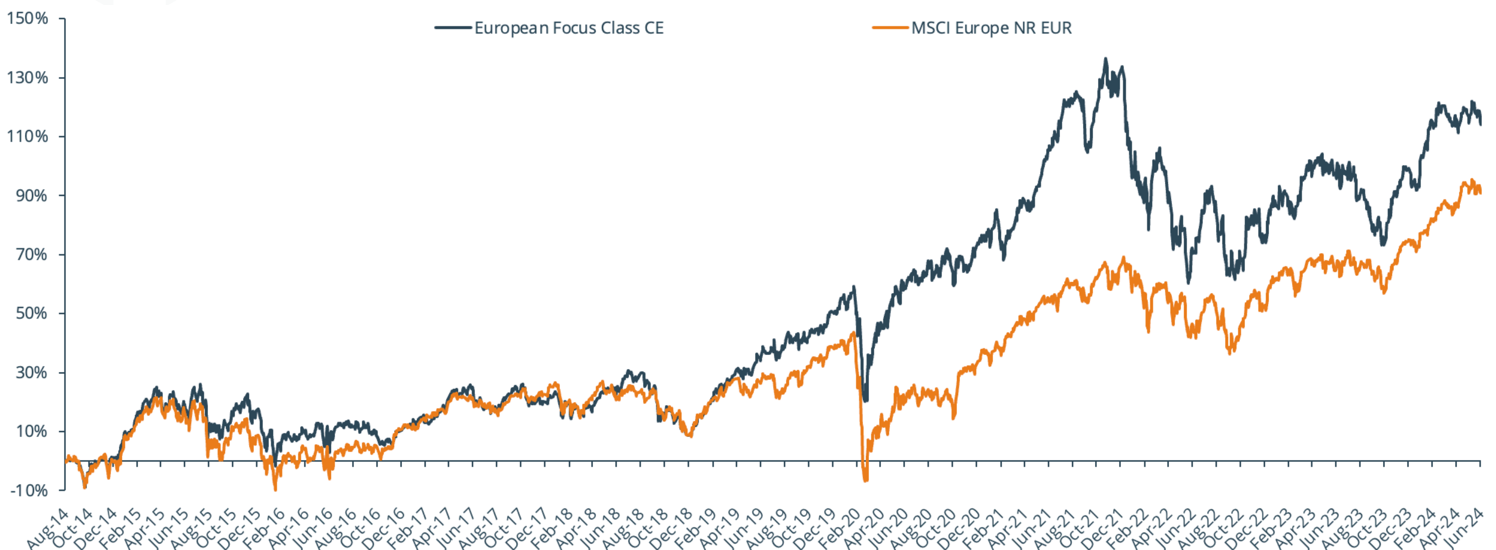
Opinions expressed whether in general or in both on the performance of individual investments and in a wider economic context represent the views of the contributor at the time of preparation.

Investors should note that, relative to the expectations of the Autorité des Marchés Financiers, this European Focus Equity Fund presents disproportionate communication on the consideration of non-financial criteria in its management.

Performance and executive summary

During 1H24, the Heptagon European Focus Equity Fund advanced by +7.51% in absolute terms to a NAV of €214.15, but the Fund underperformed the benchmark MSCI Europe Net (EUR) index which rose by +9.05% in comparison. The main reason for the reversal of the Portfolio's strong performance vs. the benchmark in 1Q24 (+10.7% vs. +7.6% respectively) vs. 2Q24 related to investor-concern that Central Banks would continue to hold interest rates higher-for-longer. While this paradigm was prevalent particularly in April and May, sentiment swung in the first half of June to a majority believing that Central Banks would commence near-term rates cuts and consequently, the performance of Fund again moved ahead of the benchmark in the YTD. Unfortunately, the decision by France's President, Emmauel Macron, to call for a snap general election on 30th June caused a sharp rise in European bond yield spreads in the second half of June and this had the same adverse impact on the Fund's performance as the higher-for-longer stance in April and May.

The European Focus CE share class performance since inception on 26 August 2014



**From Fund launch 26/08/2014*
Source: FactSet Research Systems

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Attribution analysis for 1H24

In the below attribution analysis for 1H24, the performance of each stock has been converted to EUR from its local currency. Each stock's EUR-denominated performance should be compared with the benchmark index, MSCI Europe NR (EUR), which advanced by advanced by +9.05% over the same period.

Contributors

Novo Nordisk (NOVOB DC)

NOVOB (Denmark: +44.0% and 9.9% exposure), the world's largest manufacturer of insulin and obesity drugs, was the best-performing stock in the Portfolio in 1H24 (and the fourth best-performing stock in 1Q24. The fundamentals of the company's top-selling obesity drug, *'Wegovy'*, still appear to be truly outstanding. The focal points for healthcare authorities and society to consider are: *(i)* obesity should be regarded as a chronic and relapsing disease; *(ii)* the market value of obesity drugs is expected to reach some $200bn within the next decade; *(iii)* according to the WHO more than 1bn people globally are currently suffering from obesity and this number is expected to double by 2035 due to sedentary lifestyles and rising availability of processed food; *(iv)* the World Obesity Federation expects the economic cost of obesity to reach around 3% of global GDP by 2035.

Putting these market drivers into context; NOVOB's FY24 sales are expected to reach nearly $42bn, of which some $10bn relate to obesity drugs (circa 25%), which implies that there is a considerable upside potential for obesity drugs assuming that NOVOB will capture a significant part of this market, which has been the case of insulin. A few additional attributes also attract us in respect of NOVOB's FY24 outlook and beyond. *First*, the company will ramp-up production of Wegovy in 2024 to meet demand. *Secondly*, Wegovy will be rolled out in several European countries. *Thirdly*, NOVOB has also set its sight also on the *prevention of obesity* to better understand the underlying causes of weight gain. NOVOB's Investor Day (7th Mar) and the 1Q24 set of results on (2nd May) were both well-received. Against this backdrop, we have no reason to believe that the forthcoming 2Q24 report on 7th Aug will be anything but solid.

ASML (ASML NA)

ASML (the Netherlands: +41.4% and 7.2% exposure), the world's leading supplier of semi-conductor manufacturing equipment was the was the second best-performing stock in the Portfolio in 1H24 (and the third best-performing stock in 1Q24). Two drivers continue to underpin the company's strong fundamentals. *First*, ASML holds a de-facto monopoly in EUV (Extreme Ultra-Violet) technology, which is the most advanced method to manufacture semiconductors enabling chipsets size, speed and thus energy efficiency. *Secondly*, countries recognise that semi-conductors are a necessity and thus pursue *'tech-sovereignty'*. Over-and-above these strong fundamentals, the US bell-weather company, Nvidia, frequently remind investors that AI is here to stay – and to which ASML should supply semi-conductor manufacturing machinery for many years to come. ASML's 1Q24 results (17th Apr) were ahead of highly set market expectations, but the stock price reaction was negative as the order intake slowed down. However, management reiterated its view that business volumes are set to strengthen in 2H24 and into FY25. ASML's 2Q24 set of results is due on 17th Jul, we believe management will reiterate the same outlook.

Lonza (LONN SW)

LONN (Switzerland: +38.6% and 3.2% exposure), the world's largest CDMO (Contract Development Manufacturing Organization) was the third best-performing stock in the Portfolio in 1H24 (and the best-performing stock in 1Q24). The LONN share temporarily fell from grace about a year ago as not much went the company's way during 2H23. In fact, the problems commenced following the release of the 1H23 results (21st Jul-23). *First*, there was under-utilization in early-stage biotechnology services (due to higher funding costs). *Secondly*, there was lower demand for nutraceutical capsules (caused by weaker consumer-spending). Management duly cut the FY23 sales guidance (from *'high single-digit'* to *'mid-to-high single-digit'* LfL growth) as well as the EBITDA margin guidance (from *'30-31%'* to *'28-29%'*). To add insult to injury, LONN shortly thereafter released a communique (18th Sep-23) stating that Pierre-Alain Ruffieux

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(the CEO), would leave the company. Naturally, this raised concern about the company's medium-term outlook. Around the same time, there was another press release referring to the discontinuation of the JV between LONN and Moderna in respect of the manufacturing of Covid-19 vaccines. LONN swiftly organised an Investor Day (17th Oct-23) when the main takeaways were that the medium-term (2024-28) annual LfL sales growth rate should be in the 11-13% range (FY23: 10.9%) and core EBITDA margin in the 32-34% range (FY23: 29.8%). However, LONN's predicament for FY24 (at the time) was that profit growth would be subdued due to a termination-fee of the JV with Moderna in FY23, which would temporarily hamper the growth trajectory.

All things considered we consider LONN to have addressed the market-concerns quickly. Although the FY23 set of results (26th Jan), included several restatements and lacked transparency, investors took a liking to the report as the long-standing Chairman and acting CEO, Albert Baehny, announced his departure. The replacement of Chairman was Jean-Marc Huët (Unilever's former CFO and the current Chairman of Heineken), who took over at the AGM (8th May). Baehny stayed on as acting CEO until July when Wolfgang Wienand took over as CEO. In his previous role, Wienand was the CEO of Siegfried Holding AG (another Swiss CDMO). LONN will publish 1H24 results on 25th Jul. While we do not anticipate any meaningful improvement in LONN's profitability, we are hopeful that the new CEO and Chairman along with the rest of the management team will improve the company's transparency and disclosure.

Adidas (ADS GY)

ADS (Germany: +21.1% and 4.8% exposure), the world's #2 biggest manufacturer of sports-shoes after Nike, was the fourth best-performing stock in the Portfolio in 1H24 (and the second best-performer in 2023). We construe that since the arrival of Bjørn Gulden as CEO in 2023, sentiment to the ADS share has significantly improved as the company has gotten its 'house in order'. Not only has the ADS' communication with the investment community improved dramatically, but we sense that internally there is a much stronger sense of purpose amongst the staff and the different departments, which in turn has led to a much stronger product pipeline. There are some tangible indicators to support this. *First*, according to management the order intake of ADS' higher-end ranges has been stronger than the order intake of the lower-end ranges implying that more affluent consumers are still willing to spend. *Secondly*, due to a successful sell-out of ADS' inventory (22% of net sales at end 4Q23 and 20.5% of net sales in 1Q24), the order intake for 2H24 looks solid as the company should be able to supply retailers with new products rather than selling out legacy stock. At the last investor call in connection with the 1Q24 set of results (30th Apr), management commented that over-and-above the several new teams and athletes which have signed up for sponsorship agreements, ADS will supply sports shoes to 41 different sports activities at the Paris Olympics. The company will release its 2Q24 statement on 31st Jul. While we do not expect another pre-announcement or profit upgrade ahead of these numbers, we anticipate ADS to reiterate previous comments regarding an acceleration in business activity during 2H24.

Givaudan (GIVN SW)

GIVN (Switzerland: +18.0% and 4.8% exposure), the world's leading supplier of flavours and fragrances, was the fifth best-performing stock in the Portfolio in 1H24. Having only managed to show limited positive impact on the profit margin after price increases during most of last year, GIVN's FY23 set of results (25th Jan) were ahead of market expectations implying that 4Q24 was the turnaround quarter. The Fragrance & Beauty division (48% of group sales) showed continued LfL sales growth acceleration and profit margin expansion while the Taste & Wellbeing division (52% of group sales) appeared to be lagging somewhat behind. Nonetheless, management commented that: *(i)* price increases were implemented across all product groups and *(ii)* the 'Fine Fragrances' sustained high levels of new business. These trends appear to have been reinforced in 1Q24 as the sales report (11th Apr) also was ahead of market expectations. The Fragrance & Beauty division showed its fourth consecutive acceleration in LfL sales growth to 16.3% in 1Q24 (4Q23: 11.1%; 3Q23: 6.5%; 2Q23: 6.0%; 1Q23: 6.8%) supported by all regions and customer groups. The Taste & Wellbeing division also recorded sequential acceleration in LfL sales growth to 9.3% in 1Q24 (4Q23: 4.5%; 3Q23: 1.7%; 2Q23: -2.8%; 1Q23: 1.0%). GIVN will release 1H24 results on 23rd Jul. At this stage, we anticipate another meaningful uplift to the company's profit margin and positive guidance by management for 2H24.

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Detractors

Straumann (STMN SW)

STMN (Switzerland: -20.8% and 4.2% exposure), the global leader in dental implants an ancillary orthodontal products and materials, was the worst performing stock in the Portfolio in 1H24. After a decent performance in until the end of March, the stock dropped sharply following the 1Q24 sales report (30th Apr). Although this statement exceeded market expectations reflecting a LfL growth rate of +15.1% (compared to consensus, which expected +13.3%), investors took a negative view to the report as the growth-profile was significantly tilted to the APAC region (circa 20% of group sales), which showed a very strong growth rate of +82.0% – and particularly in China due to VBP (Volume Based Procurement). The strong APAC performance contrasted with the much more muted growth rates in STMN's traditional European and North American markets (circa 40% and 30% of group sales respectively). From a business perspective, the shortcomings here related to 'clear aligners' which the company markets under the brand name *'Dr Smile'*. In a nutshell, clear aligners suffered from weakness in consumer-confidence in both regions. However, if clear aligners were excluded from sales in Europe and North America, LfL growth in these markets would have been in the *'high-single digit territory'*, according to management, compared with the reported growth rates of +5.2% and the +3.7% respectively. Due to the premium rating of the STMN business, the stock tends to be sensitive to movements in bond yields. Against this backdrop, we are hopeful that the share will regain its poise during 2H24, when the Fed and other Central Banks are likely to initiate interest rate cuts. STMN's 1H24 set of results is due on 14th Aug.

Dassault Systèmes (DSY FP)

DSY (France: -20.2% and 4.9% exposure), the world's leading provider of software for 3D-solutions was the second-weakest performer in the Portfolio in 1H24 (as well as in 1Q24). We continue to be confounded by the poor performance of this stock given the strong advance of the European Technology sector throughout 1H24 (+17.6% in 1Q24 and +5.2% in 2Q24, which compares with +7.6% and +1.3% respectively of the benchmark index). We believe a few shortcomings related to the poor performance. *First*, DSY's 4Q23 set of results (1st Feb) fell short of market expectations as sales and profit growth came in at the lower end of management's guidance. *Secondly*, given the formal appointment of Pascal Daloz – a 25-year veteran in DSY (with prior roles as COO and CFO) to CEO, as of 1st Jan and the long-standing CEO, Bernard Charlès, moving to an Executive Chairman position – the market considered the new CEO to have come across as too conservative as management guided for 8-10% LfL sales growth in FY24 (FY23: 9%) and an EBITA margin guidance in the range of 32.5-32.8% (FY23: 32.4%). DSY's 1Q24 report (24th Apr) also fell slightly short of market expectations. While management tried to put a positive spin to the report, they acknowledged that the reported numbers were at the *'lower end of their internal projections'*. During the 1Q24 webcast, however, the CEO estimated that order intake (not an official DSY metric) was running around 10% higher Y/Y, which implies that management is expecting an upturn in 2H24. There was also a slight increase in management's FY24 guidance in the 1Q24 report, but this is common with this management team which tends to raise the guidance quarter-by-quarter as the fiscal year progresses. DSY will publish its 2Q24 results statement on 25th Jul. While we do not expect these numbers to be exceptional, we anticipate the company to raise the FY24 guidance in a more meaningful manner.

Hays (HAS LN)

HAS (the UK: -11.5% and 2.7% exposure), Europe's largest specialist recruitment company was the third weakest performing stock in the Portfolio in 1H24. The HAS share is the most recent addition to in the Fund (we initiated a 2.5% position in HAS on 14th Dec-23), which we added to boost our second most recent position, Page Group (see below). As in the case of Page Group, the HAS share typically display excellent bounce back characteristics once underlying business conditions (i.e. LfL net fee growth) starts to improve. In our view, what makes HAS (and Page Group) interesting is the underlying *'talent shortage'* caused by the tight labour markets. HAS closes its accounts by the end of June; although the company's 1H23/24 results (22nd Feb) fell short of market expectations, the stock still responded positively by investors. Like its UK peer, Page Group, HAS' management commented that candidate confidence has fallen in line with lower wage growth (currently in the range of flat to +5%) along with longer lead-times for clients (i.e. companies) to reach hiring decisions. We construe this implies that

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recruitment volumes will remain suppressed in the short-term. However, as 2024 progresses HAS' net fee base numbers for comparison will become considerably easier which implies that business momentum is poised to accelerate. We do not expect this to become visible in the company's 4Q23/24 trading statement, which is due on 11th Jul, but there should be a sharp improvement in LfL net fee growth during the 1Q24/25 period, which is due in early October.

DIAGEO

Diageo (DGE LN)

DGE (UK: -10.8% and 3.6% exposure), the world's largest distiller manufacturer was the fourth weakest performer in the Portfolio in 1H24. Sadly, not much has gone this company's way over the past few months. DGE's problems started in 2H23, when the recently appointed CEO, Debra Ann Crew's (DGE's ex-Head of North America), was forced to issue an ill-fated profit-warning (10th Nov-23). Management referred to weakness in the LATAM and Caribbean business (11% of group sales) and highlighted three specific issues: *(i)* higher-than-expected inventory; *(ii)* higher interest rates in the US had substantially affected consumer-spending in Brazil and *(iii)* the tequila segment in Mexico was performing poorly.

Unfortunately, the profit-warning was announced just a few days before the company's planned New York Investor Day (15th Nov-23) and against this backdrop the investment community (naturally) honed-in on the recent shortcomings rather than give management an opportunity to showcase DGE's excellent standing in its industry. With hindsight, we consider the CEO to have made a significant tactical rookie-error. Rather than wait a few more months to get accustomed to her new role, she rushed without having a sufficiently strong pipeline of good news. To add insult to injury, the CFO at the time, Lavanyan Chandrasheker, who has since departed and been replaced by Nik Jhangiani (3rd May-24), orchestrated a conversion of DGE's reporting currency from GBP to USD, based on the fact that the USD will become an increasing important currency for the company. Although that may well be the case, we are yet to find any European company where its stock market valuation has been enhanced when the reporting currency and the stock-quote have different denominations. DGE will release FY23/24 results on 30th Jul. While we do not believe these results will show any meaningful improvement, we believe management will guide for brighter trading conditions in 1H24/25 and beyond (partly because of easier base-numbers for comparison).

PageGroup

Page Group (PAGE LN)

PAGE (the UK: -10.6% and 4.6% exposure), Europe's second largest specialist recruitment company was the fifth weakest performing stock in the Portfolio in 1H24. Like its British peer, Hays (see above), the PAGE share is the second most recent position in the Fund (we initiated a 1.5% position in HAS on 31st Aug-23). Due to the aforementioned *'talent shortage'* as in the case of Hays, PAGE's net fees have held up well as the company is more reliant on permanent placement than its other British peer. However, PAGE Group's LfL net fee growth rate has now fallen sequentially for six consecutive quarters. While we anticipate that it may be (perhaps) one more trading statement showing a downward trajectory, LfL net fee growth should start to recover in 3Q24 due to easier base numbers for comparison. Once such a reversal kicks in – this stock (along with Hays) – tends to bounce back in the range of 80-120% over the next 12-18 months. It is our aim to continue to further add to this position in 2H24. PAGE's 1Q24 trading statement (15th Apr) was at the lower end of market expectations reflecting LfL net fee growth of -12.7% (4Q23: -8.9%; 3Q23: --7.99%; 2Q23: -6.5%; 1Q23: -2.4%). The company's 2Q24 trading statement is due on due on 10th Jul, and the 1H24 report is due on 8th Aug.

European Focus Portfolio changes

The '5/10/40' UCITS rule states that: *(i)* positions over 5% cannot have an aggregate weighting which exceeds 40% and *(ii)* an individual position cannot have a weighting which exceeds 10%. As trades of less than 1% are too small to have any meaningful impact on the Fund's performance, we generally only comment on trades exceeding this level.

We did not make any individual trades exceeding +1% of the AUM during 1H24 (1H23: 4 trades).

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Sector performance in 2Q24 1H24

Analysing different clusters of sectors, stocks and their price action vs. the broader equity market often gives meaningful insight to investors' appetite and aversion to risk. The table below sets out the performance of European sectors in 1H24. We have included 1Q24 as a reference point to illustrate the change in attitude investors adopted in respect of the higher-for-longer doctrine in April and May. Having comfortably outperformed most sectors in 1Q24, European Focus clearly took a backseat in early 2Q24. As discussed initially, investors' perception of when a first interest rate cut could happen again changed in June, but France's snap election announcement unfortunately reversed this view during the last two weeks in June. This meant that 2Q24 was a poor quarter for the Portfolio (only the Consumer Discretionary sector performed worse than the Fund during this period).

Sector performance of the MSCI Europe NR (EUR) index and European Focus in 2Q24 and 1H24

Sector	1Q24	Sector	Apr-24	Sector	May-24	Sector	Jun-24	Sector	2Q24	Sector	1H24
Technology	17.6%	Energy	6.4%	Finance	4.6%	Technology	8.4%	Healthcare	6.5%	Technology	23.8%
Cons disc	11.6%	Healthcare	1.1%	Industrials	4.5%	Healthcare	3.0%	Technology	5.2%	Healthcare	14.0%
Euro Focus	**10.7%**	Utilities	0.1%	Comm serv	4.4%	**MSCI Europe**	**-1.0%**	Energy	1.6%	Finance	9.3%
Finance	10.1%	Materials	0.1%	Real estate	3.6%	**Euro Focus**	**-1.4%**	**MSCI Europe**	**1.3%**	**MSCI Europe**	**9.1%**
Industrials	9.2%	**MSCI Europe**	**-0.9%**	**MSCI Europe**	**3.3%**	Comm serv	-1.4%	Comm serv	0.7%	Industrials	8.0%
MSCI Europe	**7.6%**	Cons stapl	-0.9%	Technology	3.0%	Energy	-2.1%	Finance	-0.7%	**Euro Focus**	**7.5%**
Healthcare	7.0%	Real estate	-1.2%	Utilities	2.6%	Cons disc	-2.8%	Utilities	-0.8%	Comm serv	5.0%
Comm serv	4.3%	Industrials	-2.0%	Healthcare	2.4%	Cons stapl	-2.8%	Industrials	-1.1%	Energy	4.2%
Materials	3.2%	Comm serv	-2.2%	Cons stapl	1.8%	Finance	-2.9%	Materials	-1.6%	Cons disc	2.6%
Energy	2.5%	Finance	-2.2%	**Euro Focus**	**1.8%**	Materials	-2.9%	Cons stapl	-2.0%	Materials	1.6%
Real estate	-1.4%	**Euro Focus**	**-3.2%**	Materials	1.4%	Utilities	-3.3%	Real estate	-2.8%	Cons stapl	-3.4%
Cons stapl	-1.5%	Cons disc	-5.3%	Cons disc	-0.5%	Industrials	-3.4%	**Euro Focus**	**-2.9%**	Real estate	-4.2%
Utilities	-5.4%	Technology	-5.7%	Energy	-2.5%	Real estate	-5.1%	Cons disc	-8.4%	Utilities	-6.1%

Source: Bloomberg

In several previous of our Quarterly reports, we have argued that the US economy sets the investment climate for most of the world's regions and asset classes. We have also highlighted that a typical US rate hike cycle lasts for some 10 quarters on average (i.e. 2.5 years) and over that period, the Federal Reserve normally eradicates circa 80% of headline CPI. Since the Fed's first interest rate hike in the current cycle was made in Mar-22 – assuming that history is a guide – this implies that the first US interest rate cut should happen sometime from Sep-24.

Since economic data never moves up or down in a straight line, we believe the aforementioned rationale for the timing of a first US rate cut still holds true. The Fed started to make *'hawkish pauses'* to interest rate increases already in 2H23, implying that the Bank already at this stage believed that it had reached a restrictive level of interest rates. Our observation is that investors' inflation and inflation expectations have since moderated and presently, there appears to be less differentiation in market views regarding meaningful catalysts for equities. In many ways, investors are thus forced to *'do time'* by sitting tight and observe implying that the equity market climate has turned into a *'wait-and-see'* game. At the time of writing, we believe this has had the following implications to equity markets:

- Investors have had to become more (macroeconomic) data-driven in their analysis, which is similar how Central Banks operate (but these Banks call it 'data-dependent').
- Companies' quarterly reports represent the main differentiating factor to how businesses in various sectors are faring.

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Wage growth remains the key stumbling block to lower inflation

It is a common view amongst investors and Central Banks that *'scarcity for talent'* has been a key stumbling block to bring inflation lower. However, as inflation and inflation expectations have moderated, we believe smart consensus primarily focuses on 'core inflation', which strips out food and energy prices. As 1H24 has progressed most inflation data in the leading economies has continued to decline. Moreover, while each geography has its peculiarities for the prevailing tightness in labour market conditions, it now appears that job markets are softening.

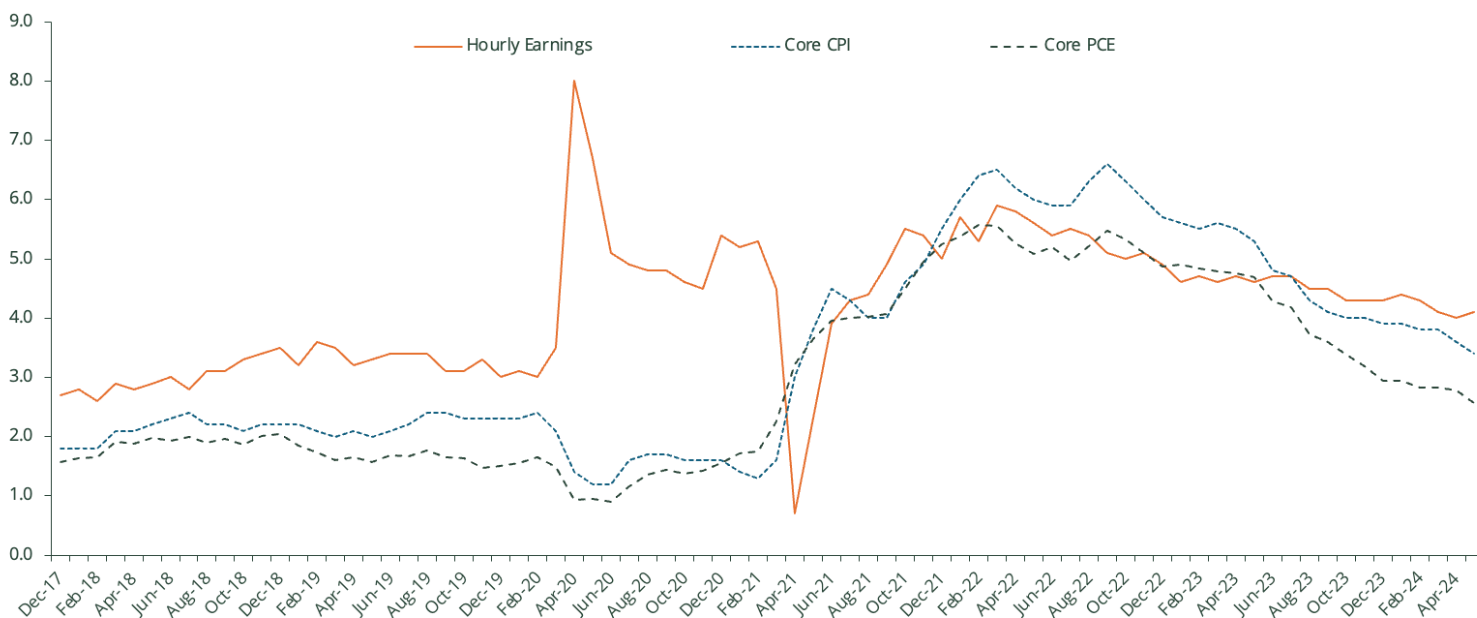
From our inhouse analysis and by continuously listening and speaking to our Portfolio/Universe companies which are involved with recruitment, we construe that:

- Demand for 'talent' continues to be as high as ever (albeit we would take this with a *'pinch of salt'* as it is in their interest to emphasize business strength).
- Candidate confidence has weakened as wage pressures have softened in 2024 to a range of +1-5% (from +5-8% in 2023). Our latest understanding confidence has deteriorated further so that candidates 'job-hops' primarily happen if new positions are materially better (or financially more lucrative) in comparison to current positions.
- Clients (i.e. companies) take longer to make up their minds regarding hiring decisions and they tend to opt for temporary recruitment as opposed to permanent employment.

While it looks as if the employment environment is weakening, wage growth arguably still needs to soften for core inflation to find a new equilibrium. Nonetheless, as we go through 2024, we anticipate slightly higher unemployment rates while wage pressure for 'talent' to continue to be sticky.

Time and time again, the Federal Reserve has reiterated its commitment to bring inflation and inflation expectations down to the self-imposed target of around 2%. The chart below illustrates the relationship between annual Hourly Earnings (i.e. wage growth) vs. core CPI and the Fed's preferred inflation measure 'the PCE' (Personal Consumption Expenditures) index. While Hourly Earnings are trending lower, we believe this set of data points will have to decline slightly further for the Fed to make its first interest rate cut.

Hourly earnings vs. core inflation (core CPI and core PCE)



Note: data as of 5th Jul-24
Source: Bloomberg

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Possible drivers for equities in 2H24 and onwards

Inflation vs. accelerating economic activity

While we believe inflation and inflation-expectations will continue to be one of the key factors in terms of how investors construct their Portfolios in 2H24, we also believe market participants need to consider gradual economic recovery.

At the time of writing, US core CPI was running at 3.4% Y/Y in May-24 (down from 3.9% in Dec-23), but this remains notably higher than the Fed's objectives of: *(i)* lower inflation to the self-imposed target of 2%; *(ii)* to restore price stability while at the same time *(iii)* achieve maximum employment.

FOMO as economic activity could gain strength

Equities as an asset class tends to perform best when economic growth is accelerating. Based on consensus data – both from top-down and bottom-up perspectives – US economic activity should have bottomed out in 2023 and now pick up. Our analysis, which will be discussed below shows that consensus GDP forecasts (according to Bloomberg data) were gradually raised for 2023 throughout last year while growth forecasts 2024 have been raised – particularly in more recent months.

Top-down

The first table below sets out annual top-down GDP growth expectations for 2024-25 for some of the world's largest economic areas. The table shows that economic momentum slowed down in 2022 as countries felt the adverse impact of Central Banks' interest rate hikes. We believe economic activity regained strength in 2023 (except in the Eurozone) for two main reasons: *(i)* there was a lag between the effect of higher interest rates and buoyant employment markets due to *'talent shortage'*, which meant that wages continued to rise and *(ii)* supply-chain constraints eased while consumption recovered and spending was temporarily bolstered by excessive household savings from the pandemic period.

% change	2021	2022	2023	2024e	2025e	2026e
USA	5.8%	1.9%	2.5%	2.3%	1.8%	2.0%
Eurozone	5.9%	3.4%	0.5%	0.7%	1.4%	1.3%
China	8.4%	3.0%	5.2%	5.0%	4.5%	4.2%
Japan	2.7%	1.2%	1.8%	0.3%	1.1%	0.9%
Average	**5.7%**	**2.4%**	**2.5%**	**2.1%**	**2.2%**	**2.1%**

Source: Bloomberg 1st Jul-24

The above table also shows that all leading economic areas (except the Eurozone) are expected to generate lower economic activity in 2024 compared to 2023 – possibly because: *(i)* inflation has remained higher-for-longer thereby forcing households to reign in their spending and *(ii)* pandemic-related household savings have been depleted. However, as the global economy is likely to advance going into 2025, we expect economic activity to gradually regain momentum – starting in 2H24.

The table below, which covers 2023 and 2024, is decomposed so that GDP growth forecasts reflect the average of the four quarters at each period when the data was recorded (starting from Jan-23). In other words, as the table illustrates GDP growth expectations for each forward-looking year on a continuous basis, i.e. it illustrates how economists' consensus view changed quarter-by-quarter.

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Evolution of consensus rolling four-quarter GDP forecasts for leading economic regions

% change	23e (Jan-23)	23e (Apr-23)	23e (Jul-23)	23e (Oct-23)	23e (Dec-23)	24e (Apr-23)	24e (Jul-23)	24e (Oct-23)	24e (Dec-23)	24e (Apr-24)	24e (Jul-24)
USA	0.3%	1.1%	1.3%	2.1%	2.4%	0.7%	0.6%	0.9%	1.4%	2.3%	2.5%
Eurozone	-0.1%	0.6%	0.7%	0.6%	0.5%	1.1%	1.2%	0.8%	0.5%	0.6%	0.7%
China	4.8%	5.4%	5.6%	5.0%	5.2%	5.1%	4.7%	4.5%	4.5%	4.7%	5.0%
Japan	1.3%	1.0%	1.3%	1.9%	2.0%	1.2%	1.1%	1.0%	0.7%	0.6%	0.3%
Average	**1.6%**	**2.0%**	**2.2%**	**2.4%**	**2.5%**	**2.0%**	**1.9%**	**1.8%**	**1.8%**	**2.0%**	**2.1%**

Source: Bloomberg 1st Jul-24

The above table shows that consensus average GDP growth expectations for 2023 were at their lowest level in Apr-23 (second left-hand column average 2.0%), but as 2023 progressed, expectations improved to finish at an average of 2.5%. In other words, reality turned out better compared with economists' initial expectations.

More important looking ahead are GDP growth expectations for 2024 which also appear to have turned out better than expected for most regions (except the Eurozone) When looking at the US economy in isolation, consensus GDP growth forecasts for 2024 showed a different profile as growth projections markedly accelerated in 2H23 (while those for the Eurozone moved in the opposite direction). By the end of 2023 – and particularly in 2024 – GDP forecasts for the US have been raised significantly (from only 1.4% in Dec-23 to 2.3% in Apr-24 and further to 2.5% in Jul-24). In other words, as inflation and inflation expectations have been coming down, optimism of an economic recovery has strengthened.

We also note that the profile of GDP growth expectations in 2H23 converged into a more conventional global *'recovery pattern'* which is typically underpinned by the US economy, which leads overall economic activity back to recovery. This ties in with our view that the US is a consumer-driven economy (circa 68%), while Europe (52%) and Asia (N/A) are export-dependent. In other words, once the Americans start to consume, Europe and Asia will export their way back to prosperity. This contrasts with what we considered to be a highly unusual recovery pattern until Jul-23 when economists expected Eurozone GDP growth for 2024 to be higher than that of the US.

Bottom-up

At the same time as we collect consensus GDP growth data on monthly/quarterly basis, we also analyse how the EPS growth of the S&P500 index is evolving. According to Bloomberg's consensus estimates from 1st Jul-24, EPS growth is expected to rise to +9.8% in 2024 (up from +7.7% in 2023) and further to +12.5% in 2025. When looking at the growth rates for the same years but with estimates taken from 1st Jan-24, EPS growth was expected to be +11.7% in 2024 (up from +5.0% in 2023) but only +8.9% for 2025. In other words, expectations for a stronger economic recovery have been building as we have moved forward in time also from a bottom-up point of view.

The power of compounding

We first introduced the below table in 2021 to depict the astounding benefits of compounding (according to Albert Einstein *'the eighth wonder of the world'*). The top-part of the table shows how sales, EBITDA and EBIT growth have developed and are expected to progress for the European Focus Fund and for Europe (the MSCI index) during 2020-26e, according to Bloomberg's consensus estimates.

The lower part of the table illustrates how these growth rates impact the overall sales and profits bases on current prospects. We have anchored the numbers to 2019, i.e. one year before the pandemic. The table shows the benefit of not *'foregoing'* sales and profit growth over periods of economic weakness as an increasingly higher base from where to grow business can continue from.

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Projection of sales and profit growth of European Focus and MSCI Europe index)

HEFEF	FY19	FY20	FY21	FY22	FY23	FY24e	FY25e	FY26e	MSCI	FY19	FY20	FY21	FY22	FY23	FY24e	FY25e	FY26e
Sales		2.2%	20.9%	13.2%	10.6%	6.1%	10.9%	8.8%	Sales		-14.1%	4.1%	24.4%	1.9%	-1.2%	3.1%	3.6%
EBITDA		5.0%	31.3%	16.9%	10.7%	14.5%	17.5%	12.3%	EBITDA		-23.9%	32.6%	23.4%	-0.4%	6.2%	8.0%	5.2%
EBIT		4.8%	61.6%	22.1%	21.1%	20.8%	21.5%	9.3%	EBIT		-39.8%	82.9%	26.2%	6.3%	14.7%	7.1%	5.8%

HEFEF	FY19	FY20	FY21	FY22	FY23	FY24e	FY25e	FY26e	MSCI	FY19	FY20	FY21	FY22	FY23	FY24e	FY25e	FY26e
Sales	100	102.2	123.6	139.9	154.7	164.1	181.9	197.9	Sales	100	85.9	89.4	111.2	113.3	111.9	115.4	119.5
EBITDA	100	105.0	137.8	161.1	178.3	204.1	239.8	269.2	EBITDA	100	76.1	100.9	124.5	124.0	131.7	142.3	149.7
EBIT	100	104.8	169.4	206.8	250.4	302.6	367.7	401.8	EBIT	100	60.2	110.1	138.9	147.6	169.3	181.3	191.9

Source: Bloomberg dated 28th Jun-24

The above tables are based on the Portfolio weightings of European Focus at the end of 1H24 for the purpose of forecasting. For the prior years (2019-2023), the year-end weightings of the Portfolio have been used. Based on Bloomberg's consensus forecasts, European Focus and the MSCI Europe index are expected to show the following:

- **Sales:** European Focus is expected to grow its sales by +6.1% in FY24 compared with a -1.2% sales decline of the MSCI Europe index. For FY25, European Focus is expected to grow its sales by +10.9% compared with only +3.1% of the MSCI Europe index. We recently introduced the FY26 expected growth rates, which for European Focus show sales to growth at a rate of +8.8% vs. only +3.6% of the MSCI Europe index.
- **EBITDA:** European Focus is expected to grow its EBITDA by +14.5% in FY24 compared with only +6.2% of the MSCI Europe index. For FY25, European Focus is expected to show EBITDA growth at +17.5% compared to only +8.0% of the MSCI Europe index and further by +12.3% in FY26 compared to only +5.2% of the MSCI Europe index.
- **EBIT:** European Focus is expected to grow its EBIT by +20.8% in FY24 compared with +14.7% of the MSCI Europe index. For FY25, European Focus is expected to grow its EBIT by +21.5% compared to only +7.1% of the MSCI Europe index and further by +9.3% in FY26 compared to +5.8% of the MSCI Europe index.

Analysing how the revenue profiles of European Focus and the MSCI Europe index have progressed since pre-pandemic levels by using 2019 as the base year clearly illustrates the importance of not *'foregoing'* sales and profits, and thus benefit from compounding.

- **Sales:** European Focus' 'revenue base' is expected to stand at 164.1 at the end of FY24, i.e. some +64% ahead of its pre-pandemic level in 2019, while the MSCI Europe index is only expected to be 110.9, i.e. less than 11% higher than its pre-pandemic level. This is further amplified in FY25 when European Focus is expected to have a revenue base that is nearly 82% higher than its pre-pandemic level, which compares with only +15% of the MSCI Europe index. Further in FY26, European Focus' revenue base is expected to be nearly 2x higher than its pre-pandemic level, which compares with less than +20% of the MSCI Europe index.
- **EBITDA:** European Focus' EBITDA base is expected to stand at 204.1 at the end of FY24, i.e. more than twice of its pre-pandemic level in 2019 while the MSCI Europe index is only expected to be less than +32% higher than its pre-pandemic level. This is further amplified in FY25 when European Focus is expected to have an EBITDA base nearly 140% higher than its pre-pandemic level, which compares some +42% of the MSCI Europe index. Further in FY26, European Focus' EBITDA base is expected to be around +169% higher than its pre-pandemic level, which compares with less than +50% of the MSCI Europe index.
- **EBIT:** European Focus' EBIT base is expected to stand at 302.6 at the end of FY24, i.e. more than 3x ahead of its pre-pandemic level in 2019, while the MSCI Europe index is only expected to be some +69% higher than its pre-pandemic level. This is further amplified in FY25 when European Focus is expected to have an EBIT base that is some 169% higher than its pre-pandemic level, which compares with some +42% of the MSCI Europe index. Further in FY26, European Focus' EBIT base is expected to be substantially more than 4x higher than its pre-pandemic level, which compares with less than 100% of the MSCI Europe index.

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If these growth trajectories were to continue (which we believe is a fair assumption given that the average year of foundation of a Portfolio company dates back to 1932) the compounding effect should be further amplified. Over time, this should support the strong underpinnings for a premium valuation of European Focus against the MSCI Europe index.

Risks and uncertainties

- **Indebtedness:** most countries running deficits increasingly feel the pain from higher borrowing costs as the price of debt-servicing is becoming dearer. According to the S&P and the IIF (Institute of International Finance), global indebtedness stands at around $300tn, equivalent to around 350% of global GDP. Traditionally, economists consider a country's debt-to-GDP ratio in the 70-80% range as manageable, but once it exceeds 100%, the debt-servicing starts to compromise the country's ability to invest. As global interest rates are likely to stay higher than during Central Banks' QE-era, existing debt levels could pose an increasing problem for many large economies (and companies).

- **Inflation and bond yields:** inflation has fallen in most of the leading economies and at the time of writing, also core inflation is substantially lower from previous peaks. However, if wage growth remains elevated – say because of *'scarcity-for-talent'* – Central Banks are unlikely to start cutting interest rates.
- **Putin's war with Ukraine and the Israeli/Gaza conflict:** we still see a risk that Putin ramps up his war-efforts by deploying nuclear tactical weapons – perhaps as an act of desperation given the status quo after 2.5 years of fighting on what seems to be a *'road to nowhere'*. As discussed in earlier Quarterlies, we note similarities between the current Russian/Ukraine War and the Soviet/Afghan War in 1979-89. Once the US stepped up its efforts to supply equipment (in that case 'Stinger' missiles which were used against Soviet attack-helicopters), the Soviet Union's war effort faded which led to an eventual withdrawal of troops. In addition, the conflict between Israel and Palestine on the Gaza Bank could (and probably will) become longer than expected and it could also spread across other parts of the Middle Eastern.
- **Geopolitical issues:** China's property-infused credit crisis continues to simmer following the defaults of several real-estate giants (such as Evergrande, Country Garden and Shimao) and this is having an adverse impact on domestic Chinese consumption. Moreover, although China's seemingly close relationship with Russia is worrying from a geopolitical angle, we believe that China's ultimate aspirations are more closely aligned with its economic interests, and this should make the US and the EU Beijing's preferred trading partners. However, China has officially not yet condemned Putin for invading Ukraine; given the strong worldwide opinion against Russia – and the severe sanctions against this country – it is likely that China is running an even higher reputational risk by not taking a clearer stance against Putin's war efforts.
- **European right-wing movement:** after the poor outcome of Frances legacy parties in the European Parliamentary election in early June and decision of President to call for a snap general election (on 30th Jun and 7th Jul), we see a new political risk with the rise of Europe's left-wing/right-wing and populist parties. This could have a long-lasting impact on European interest rates, which in turn would affect the valuation of the region's equity markets.
- **US Presidential Election:** we recently added a *'Donald Trump risk'* should the ex-President get re-elected on 5th Nov-24. Should *'the then 78-year-old'* be sworn in again, we anticipate considerable populistic ideas to be brought to light – many which are unlikely to be well-regarded by the investment community. However, we also note that during Trump's previous term in Office (Jan-17 to Jan-21), the S&P500 index advanced by +78%, which is higher compared to +35% for the average President-term in office since 1929.

Christian Diebitsch, Fund Manager, Heptagon Capital

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