MONTANARO

ASSET MANAGEMENT

Montanaro European Companies Trust

Quarterly Commentary – Q3 2023

Market review

The optimism of the summer months was dashed towards the end of the quarter. Rising bond yields were accompanied by similar style headwinds to those of 2022: Europe ex-UK Growth underperformed Value by 6%, while SmallCap has now underperformed LargeCap by 8% so far this year.

There was a marked difference to 2022, however. Then, equity markets sold-off because interest rates were moving rapidly higher. The decline in markets during the third quarter of 2023 was because investors now expect interest rates to remain *"higher for longer"*.

This was partly explained by surprising economic strength in the US, where the labour market remained extremely resilient. With Halloween fast approaching, the spectre of another interest rate rise spooked both equity and bond markets. The yield on certain benchmark bond indices hit levels last seen during the Global Financial Crisis. It was a painful time all-round for risk assets.

Portfolio

During the quarter, the NAV of the Trust declined by 12%, an underperformance of 8.8% relative to the MSCI Europe SmallCap (ex UK) Index as share prices were hit by the effects of rising bond yields.

The strongest contribution during the quarter came from **VZ Holding**, the Swiss wealth manager, which reported good interim results as interest income was higher than expected. **Technoprobe**, the Italian probe card manufacturer for semiconductors, rose on optimism that the semiconductor cycle may be boosted by AI applications. **Delta Plus**, the global leader in the production of Safety equipment and clothing, remained relatively unaffected by stock market weakness.

The weakest contribution came from **NCAB**, the leading PCB supplier, which reported continued pressure in orders, yet expanding margins. **MTU**, the aircraft engine manufacturer, declined on the news that Pratt & Whitney must inspect thousands of engines due to powder metal contamination. **Kitron**, a leading Scandinavian electronics manufacturing services company, saw profit taking after a very strong share price performance in the first quarter.

Outlook
It is challenging for investors to know where to turn. Cash isn't quite king (that crown is currently shared by the "Magnificent Seven" technology stocks, which have returned 92% on average so far this year), but short term savings offer attractive nominal yields without the risk of market volatility.

Where does this leave our asset class? SmallCap is on track for a third straight year of underperformance, for the first time since our records began in 1999. The last quarter was also the second worst for SmallCap Growth versus Value in over 13 years.

At some point, this underperformance is likely to reverse. The question is "when?" While market timing is a fool's game, the reasons for owning SmallCap are becoming more compelling. European SmallCap is trading well below its long-term P/E average, at just 11x (versus an average of over 14x). It is also close to its largest ever discount relative to LargeCap, at -19%. This is wider than the discount reached during the Global Financial Crisis. Historically, the greater the discount, the stronger the SmallCap rebound. With a Portfolio of quality businesses with strong balance sheets, the Trust is well placed to benefit from any change in market sentiment.