MONTANARO

ASSET MANAGEMENT

Montanaro European Income Fund

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: Growth underperformed Value by 5%, while SmallCap underperformed LargeCap, the eighth time it has done so in the past ten quarters.

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 Sterling Share class declined by 4.5%, an underperformance of 2.4% versus the composite benchmark.

The strongest contribution during the quarter came from **Partners Group**, the Swiss private markets asset manager, which reported strong numbers as their performance fee income remained strong. **GTT**, the engineering expert in containment systems, performed well after the company reported strong H1 numbers that beat consensus expectations. **Elmera**, the Norwegian electricity retailer, benefited from stable numbers in its consumer division.

The weakest contribution came from **MTU**, the aircraft engine manufacturer, which declined on the news that Pratt & Whitney must inspect thousands of engines due to powder metal contamination. **NCAB**, the leading PCB supplier, reported continued pressure in orders, yet expanding margins. **Kitron**, the 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 it offers attractive yields without the risk of market volatility.

Where does this leave our asset class? European 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 more 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 and strong balance sheets, the Fund is well placed to benefit from any change in market sentiment.
