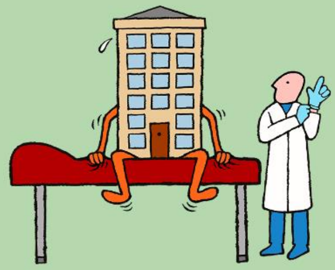
MONTANARO

ASSET MANAGEMENT

MESCT

Investment Commentary

Q2 2024



Market review

The strongest equity returns were to be found in LargeCap during the opening half of 2024. SmallCap underperformed its larger peer by a 4% over the 6 months to 30 June, while MidCap did not fare much better. Prior to the current period, Europe ex-UK SmallCap had not underperformed LargeCap for more than 2 consecutive years in the last 25. The asset class is now on track for its 4th year of underperformance.

Conditions in the equity markets continued to be dominated by two main themes: stickier-than-expected inflation and the ongoing domination of the large technology stocks in the US. In both the US and parts of Europe, inflation continued to be a source of concern for policymakers. This had a negative impact on smaller companies which are more interest rate sensitive compared to their larger peers.

LargeCap technology stocks – and in particular anything "A.I" related – performed strongly. Nvidia continued its heady triple-digit ascent (although the Magnificent Seven did begin to show some signs of bifurcation) while Europe's "GRANOLAS" also continued to perform strongly.

Towards the end of the second quarter, political upheaval weighed on most parts of the equity markets. The UK faced an election and a change of government, while in France a snap election was called by Emmanuel Macron, which raised market volatility. In the US, the election bandwagons began to roll.

Portfolio

During the quarter, the NAV of the Montanaro European Smaller Companies Trust ("MESCT") declined by 3.2%, an underperformance of 1.8% relative to the MSCI Europe SmallCap (ex UK) Index. Since the beginning of the calendar year, the NAV has outperformed by 1%.

The strongest contribution during the quarter came from **NCAB**, the full-service supplier of printed circuit boards, which outperformed after demand stabilised, and management indicated a gradual improvement over the coming quarters. **Plejd**, the Nordic provider of smart lighting control products, benefited from a very strong first quarter with organic growth accelerating to over 30% and an exciting new product pipeline. **AAK**, the producer of high-value added vegetable oils and fats, rose as analysts lifted their estimates after a strong Q1 report.

The weakest contribution came from **Sartorius Stedim Biotech**, the provider of equipment used in the production of biologic drugs, which continued to underperform following management caution around order intake. **ATOSS Software**, the provider of workforce management solutions in the DACH region, drifted after a good run despite posting strong Q1 results. **IMCD**, the global distributor of speciality chemicals, reported lacklustre Q1 results and also faced pressure in response to French election uncertainty.

Outlook

At the end of 2023 we suggested that the conditions might be ripening for the "SmallCap Effect" to emerge from its multi-year hibernation. This is yet to happen. How does this set us up for the next six months?

Despite inflation remaining "higher for longer", there were clear signs of cooling towards the end of June. Eurozone inflation slowed to 2.5% in June, allowing the European Central Bank to begin its rate cutting programme. Data in the US has also become more supportive. On a June annualised basis core CPI in the US was below 1%, while the three-month average was only a whisker above 2%. Most reassuringly for Growth investors, such as ourselves, CPI shelter inflation (the average cost of housing in the US) plummeted to 2%. Not so long ago it was above 8%. The market reaction to this data? Futures priced in a 91% probability of a rate cut in September (up from 55%); Treasuries rallied and the yield curve steepened; and the technology behemoths fell (Nvidia by almost 6%), while SmallCap gained.

With macro data becoming more supportive of smaller company investing, it is worth ending with a point on valuation. European ex-UK SmallCap looks increasingly compelling from this perspective, trading on a 4% P/E discount to LargeCap. This is higher than during the GFC of 2008! The last time SmallCap was yielding as much as LargeCap was more than 20 years ago. MESCT's share price is on a 13% discount to NAV versus a premium 3 years ago. This could indicate an attractive entry point to the shares.

Latest reports

- Deep Dive #11: Project Net Zero Carbon 2023
- Deep Dive #10: The Built Environment
- PRI 2023 – Assessment Report
- Proxy Voting Summary 2023

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