COMMENTARY

June 10, 2016

Dear clients and colleagues,

Global financial markets have been on a roller coaster in 2016. In mid-February, international equities were down about ten per cent year-to-date and "recession" headlined practically every piece of financial news in circulation. The public sentiment was that of concern, due to volatility in oil prices, Brexit, China, interest rates and more. But then came a sudden rebound, which wiped out all losses in the US equity market, but not in European markets.

The lack of a recovery was justified as disappointing Q1 sales figures were reported by European companies included in the STOXX 600. According to Societe Generale, these are the worst sales results reported since they started their analysis back in 2005, with a mere 11% of companies reporting sales that beat consensus. Worst of all, almost every sector was affected. The bright side to the disappointing results is that while negative surprises have increased for the fourth quarter in a row, they are not at all-time highs.

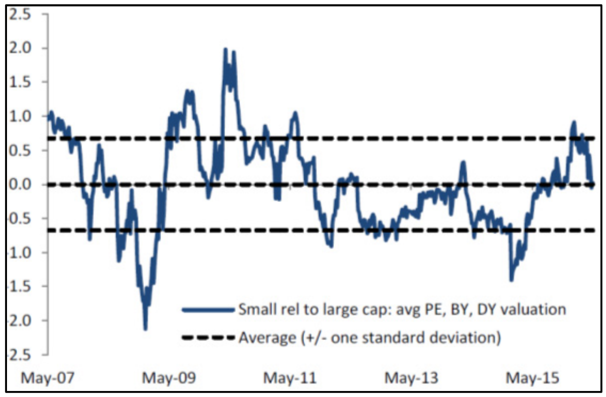
The other positive note is how well the names in our portfolios performed in comparison. Out of the European companies in our portfolios that reported sales figures in Q1 2016, a remarkable 24% reported above consensus. What might be even more impressive is their year-over-year revenue growth amid these turbulent times. Portfolio names averaged 14.9% sales growth compared to Q1 of 2015, with 65% of the companies showing positive growth. This significantly outpaced Eurozone companies as a whole, with only 10% reporting positive sales surprises and a year-over-year growth of 0.2%.

Despite the weak start to the year, we believe that small cap equities could benefit from a capital increase post the UK EU referendum. The most recent Peel Hunt UK small cap investor survey revealed significant optimism in the small cap space for the upcoming year. These results were based on investors' assumptions of the most likely outcome of the UK's EU referendum, with the vast majority expecting the UK to remain in the Eurozone. The survey showed that the respondents are bullish about the FTSE Small Cap Index. On average, 55% of respondents expect the Small Cap index to outperform for the remainder of 2016. Their opinions can be supported by cheaper valuations which show Small Cap entities trading at around 12x forward earnings while FTSE 100 trade at 16x.

A similar conclusion can be observed in the Eurozone where small cap companies look cheap on a relative basis. We believe that valuation gaps that persist between Eurozone equities and the US equities could tighten in the coming quarters. German equities have never been so cheap, and French equities are trading at a historical discount.

The fact that European small cap valuations have recently moved back to their long-term averages represents an interesting investment case in favour of small cap.

European small cap versus large cap



Source: DB

Have a good weekend.

The Global Alpha Team