Allianz Global Water

Monthly commentary

Summary

- Global equities rallied over February, with China, Japan, and the US among the strongest markets, buoyed by hopes of further stimulus measures in China, ongoing resilience in the US economy and solid corporate earnings.
- Allianz Global Water returned 6.6% (in EUR, gross of fees) versus 4.7% for the MSCI AC World Index for the month of February.
- Robust US growth has been the main source of support for the equity markets so far.

Market environment

Global equities rallied over February, with China, Japan, and the US among the strongest markets, buoyed by hopes of further stimulus measures in China, ongoing resilience in the US economy and solid corporate earnings. At a sector level, growth stocks in the consumer discretionary, industrials and information technology sectors were the top performers in the MSCI All Countries World Index, while utilities, consumer staples, real estate and energy lagged.

Global central banks indicated they were in no rush to reduce borrowing costs but suggested that rate cuts would likely be possible later this year. Headline inflation rates slowed modestly but policymakers continue to be vigilant for signs that inflationary pressures, such as wage growth, may be accelerating again. While economic activity appeared to improve in Europe during February, it deteriorated slightly in the US and Japan.

The Japanese yen weakened against other major currencies as the Bank of Japan maintained its ultra-accommodative stance. Elsewhere, the US dollar and euro rose against the British pound. Central banks in both the US and the euro zone moved to dispel speculation that rates might be cut in March but suggested that rate cuts were still on the cards later in 2024.

Oil prices traded just above USD 80 a barrel for much of the month (Brent crude) as investors weighed hopes for a ceasefire in the Israel/Hamas conflict against the forthcoming OPEC+ decision as to whether to extend production cuts. European gas prices fell to the lowest level since May 2021 as a warm winter coincided with abundant inventories.

Water investments performed above global equity markets over the course of February. That said, there is no alternative to clean water creating a non-disrupt able investment topic and recent news-flow from European countries witnessing severe water stress underscores our long-term investment case. As the IRA plan of the US-authorities is focussing on water investments as well, this is creating further awareness to the overall topic. The long-term track record of the entire strategy ultimately provides an attractive, long-term resilient growth opportunity regardless short-term topics that rather focus on macro development. Given recent news flow combined by a solid backing from governments and institutions all over the world and the global farming business which currently shows decent investment activity the overall business fundamentals remain well supported. We continue to emphasize our long-term approach to investing in high quality water solutions providers which are well positioned to generate not just financial alpha, but also environmental and social alpha over the market cycle.

Performance overview

Allianz Global Water returned 6.6% (in EUR, gross of fees) versus 4.7% for the MSCI AC World Index for the month of February. Sector allocation as well as stock selection effects contributed positively to overall results. From a sector perspective the overweight to industrials benefited the portfolio just as the underweight to Consumer Staples and Healthcare did. The underweight to Consumer Discretionary and Information Technology created a minor burden just as the overweight to Utilities did. Industrial stocks benefited from the news flow regarding macroeconomic sentiment. Stok selection worked best in the Industrial sector. Positive contributors to overall performance have been Ebara (Water Supply) after surprising market participants with very good earnings numbers. Xylem (Water Equipment) and Trane Technologies (Sustainable Communities) both benefited from decent earnings releases as well. Besides the underweight to index heavyweights like Nvidia and Meta negative contribution has been witnessed from Veolia Environment (Water Supply) and American Water Works (Water Supply) as utility companies have not been able to catch up with rising markets. As the world grapples with water supply and quality issues, Allianz Global Water continues to invest in solution-oriented companies, such as those whose products and services enable us to do more with less water supply, companies that supply the parts and equipment required to upgrade and enhance our infrastructure, and companies that assist in identifying and addressing general quality concerns.

The recent summer and the latest news flow in 2023 has shown that water stress occurs in more and more regions in the world and drought and floods don't seem to be a one-time effect. This has led to the awareness that clean fresh drinking water is not a given and water stress could easily repeat and affects more and more people. Having said that the old infrastructure needs to be modernised to cope with the challenges to come. Nevertheless, the long-term water theme remains uninterrupted and should do relatively good in terms of rising inflationary concerns due to their pricing power and high market barriers to entry. As the world continues to grapple with water supply and quality issues, Allianz Global Water continues to invest in solutions-oriented companies, such as those whose products and services help us do more with less water supply, companies that provide the parts and equipment needed to upgrade and enhance our infrastructure and companies that help to identify and address general quality concerns.

Outlook

Robust US growth has been the main source of support for the equity markets so far. At the same time, there are more and more indications that sentiment in Europe is cautiously, but steadily improving. It seems that fears of a "hard landing" in the US can be put safely aside for the next few quarters. This view is supported by the trend in corporate earnings, which have been quite healthy overall in recent weeks and months. As the economy is humming along, the Federal Reserve needs to deal with the challenge of bringing inflation down towards the target without choking off growth. As long as earnings growth is stable, market participants should remain optimistic even in the face of new record highs. Nevertheless, equity valuations appear ambitious in many markets, which makes them vulnerable to a slowdown in earnings trends and/or a significant deterioration of the economic environment. In addition, the general uptrend is driven by the development of a comparatively small number of stocks. This is particularly true for the US. Many investors are obviously still focussed on future-oriented topics such as digitisation or artificial intelligence. Against the background of this market concentration, it probably makes sense to pursue a differentiated, active approach to stock and sector selection.

The leading international central banks have successfully dampened market participants' expectations about the timing and size of rate cuts. In response, the bond markets have recently struggled. Money market participants currently expect the Federal Reserve (Fed) and the European Central Bank (ECB) to take the first-rate steps towards mid-year. The ECB might even act earlier than the Fed. From our vantage point, the combination of moderate to low growth, slower inflation, and relatively high interest rates in the developed economies for some time to come should support the fixed income markets. High-quality bonds appear particularly attractive at the current rate level. Corporate bond risk premiums (spreads) have narrowed in sync with the uptrend in equity prices and have reached historically low levels by now. As a result, corporate bonds appear vulnerable to a potential downturn in economic activity. That is why we believe that active issuer and security selection based on individual fundamentals remains key for the success of bond portfolios, particularly when it comes to avoiding default and setback risks.

The companies we own in the fund continue to be well positioned for long term resilient growth and high market barriers to entry. Allianz Global Water keeps its long-term approach of investing in high quality, pure play companies delivering sustainable solutions to safeguard water infrastructure. As the structural support for the theme generally remains strong, the most recent events have shown us that sustainability focused solutions among the water value chain are an area where more capital expenditures should occur globally.

Opportunities

+ High return potential of stocks in the long run
+ Investments specifically in the water area
+ Broad diversification across numerous securities
+ Possible extra returns through single security analysis and active management
+ Potential currency gains with share classes not hedged against investor currency

Risks

– High volatility of stocks, losses possible. The volatility of fund unit prices may be strongly increased.
– Underperformance of the investment theme possible
– Limited participation in the yield potential of single securities
– Success of single security analysis and active management not guaranteed
– Potential currency losses with share classes not hedged against investor currency

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