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WHY A VERSATILE GERMAN EQUITY MARKET IS ABOUT MORE THAN AUTOS

IN THIS Q&A, ROB SMITH, MANAGER OF THE BARINGS GERMAN GROWTH TRUST, SHARES HIS THOUGHTS ON HOW GERMAN EQUITIES ARE PLACED AMID POTENTIAL HEADWINDS THAT INCLUDE TRADE DISPUTES WITH THE U.S., BREXIT, AND CONTINUED PRESSURE ON THE AUTOS SECTOR.

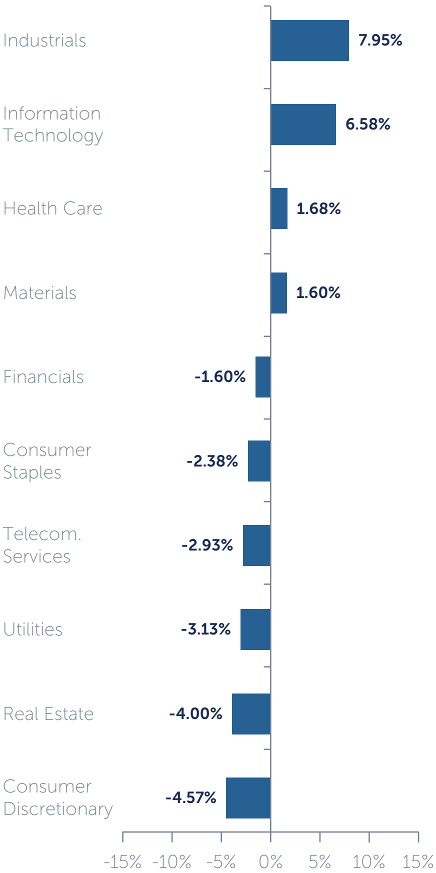
What could be the biggest potential long-term impacts of a more protectionist trade position by the U.S.? How is the strategy positioned to combat this?

The German autos sector is by far and away the biggest segment of the German economy. It's also the one that gets the headlines as some of the brands are known globally, and sell in the U.S. Before all of this trade war rhetoric, we had picked up that the new emissions testing procedures in Europe were causing a bottleneck in terms of testing all of the different model variants, simply because there are not enough testing facilities to deliver what is required after the emissions scandal began in 2015. We concluded that there would be some significant issues, especially in the third quarter of this year, so we dramatically scaled down our exposure to the autos sector. Going into 2018, we didn't hold any Volkswagen or BMW, and we sold our Daimler holding early in the year on ESG grounds. On the back of this new emissions testing issue, we cut back on the parts suppliers as well. So, when President Trump started threatening tariffs, we had minimal exposure to the sector.

German autos are not yet a buying opportunity, in our opinion, because there remain a number of unknowns. President Trump does have a valid argument in asking Germany to reduce the tariffs they impose, as a 10% tax is imposed on U.S. cars going into Europe, compared to 2.5% the other way, but he can't just make an agreement with Germany, as that would need the approval of all E.U. countries. Why would, for example, France agree, when they don't export any vehicles to the U.S.? There are a lot of structural issues in the German auto market at the moment that need more clarity before considering to buy, which is why we haven't held them in the strategy for the most part of this year.

If the trade war escalates, it will start impacting different consumer products, beyond autos, so it would then become less relevant for the German economy, where it's arguably already as bad as it can get. If large tariffs were to come on, Mercedes and BMW could always shift SUV production out of America and into Europe or China.

SECTOR BREAKDOWN



SOURCE: *BARINGS, JUNE 30, 2018. WEIGHTINGS ARE SUBJECT TO CHANGE. EXCLUDES CASH, FORWARDS AND FUNDS.*

On the back of this, how is the strategy positioned in other key sectors?

We're significantly overweight industrials and information technology, and underweight autos (which comes under consumer discretionary), real estate and utilities. While we're conscious of our sector exposures, it's important to point out that any sector overweight positions are driven by our fundamental bottom up research, not by a conscious decision to specifically overweight a sector. We look in particular for companies with credible management, healthy financials and strong earnings growth potential on a five-year horizon, which inevitably means sector weightings fluctuate, sometimes to the extent that sectors are totally avoided.

In recent years, the first half has been more difficult for some small/mid-cap holdings, but these have performed well in the second half. Should we expect the same this year?

Smaller companies in Germany are typically characterized by owner-managers, who have historically had a more cautious mentality. These companies are often keen to under-promise and over-deliver, which can lead to underperformance earlier in the year, followed by much stronger performance in the second half as companies exceed market expectations. There's certainly potential for this to happen again this year: economic growth continues to look robust, with the German ifo Business Climate Index having stabilized at an elevated level, and our on-the-ground company research continues to indicate that earnings growth will remain strong.

How does Germany compare against other European markets?

We remain optimistic on the outlook for German equities in the medium to long-term. Recent months have seen heightened volatility and profit taking as geopolitical and trade tensions have caused uncertainty in the markets across Europe, and this may continue to have a dampening effect on returns. Nonetheless, this is not reflective of the underlying business fundamentals enjoyed by German companies, which continue to look strong, in our view. Overall, we expect earnings growth to remain a key driver of the equity market performance and believe earnings upgrades by sell-side analysts will eventually exceed downgrades.

Barings' German Growth strategy has the flexibility to invest in companies across all market capitalizations, but we are generally biased towards small and mid-cap companies as we believe they offer higher growth potential. The German equity market offers a rich source of companies operating in sectors that stand to benefit from cyclical as well as structural growth over both the short and longer-term. No other country has as many "hidden champions" as Germany, especially in the fields of electrical engineering and industrial products. These are often global industry leaders in their specific niche sectors, which tend to be overlooked by analysts. These medium-sized, or Mittelstand, companies are often at the forefront of innovation: they find and define a niche, and then sell on an international level. With about 1,500 such companies operating in Germany, these hidden champions are one of the key pillars of the German economy and we believe they will continue to drive growth in the long run.

Furthermore, economic growth in the U.S., emerging markets and especially the recovery in Brazil and Russia, combined with a still growing Europe, point to continued synchronized global growth at a time when we are starting to see capacity constraints in many industries. This means that corporates will need to invest, and when this occurs the German machinery makers, which are arguably the best in the world, tend to benefit disproportionately.

The recent bridge collapse in Italy also highlights a distinct lack of infrastructure spending, not only in Italy but also across Europe and the U.S. following the credit crunch, while government finances have remained under pressure. We believe safety concerns and the need for ongoing maintenance, as well as new infrastructure projects to support growing economies, will compel governments to increase infrastructure spending, to the benefit of Germany's excellent construction companies. Large absolute positions in the strategy that we believe will benefit from these trends include industrial technology groups Siemens and S&T, and Heidelberg Cement on the construction side.

Outside of industrials there are a wealth of growth opportunities, in our view. For example, Cyan, which offers digital security for mobile service providers; M1 Kliniken, which is the first company to tap the botox market on the German high street; and battery maker Akasol. The latter has a suite of long-term contracts that gave it the confidence to IPO earlier this year in order to build facilities to fulfil the contracts, which should facilitate tremendous growth.

> *"The country has a swathe of strong, innovative companies that might not generate headlines, but they do generate growth."*

What are the main impacts that Brexit could have on the German economy?

If an agreement is made that allows the exchange of goods with no hard border with Europe, there will be no change at all, in theory, so soft Brexit would mean a limited impact. With a hard Brexit, it all depends on whether the U.K. would start imposing tariffs to protect its own companies from competition. The current rhetoric seems to endorse free trade, in which case the country should remain fairly tariff free. Delays at the borders may necessitate an increase in working capital for companies on both sides, meaning increasing costs, however the impact should be contained if tariffs are not applied. The crucial thing to look for in commentary is the terms of future trade agreements.

How do you view the short-term outlook for the European stock market and the Euro currency?

We continue to take a positive view on the outlook for the European stock market. Our conviction in this outlook has strengthened following the recent agreement between the U.S. and E.U. to negotiate on trade, with the aim of reaching zero tariffs, barriers and subsidies. We continue to be mindful of developments in this area, however this apparent climb-down in trade war rhetoric could mean a significant calming of trade uncertainties over the next few months. This may lead to an acceleration in many European economies that had previously been held in stasis by trade uncertainties, which our portfolio is positioned to capture.

Aside from this, the German equity market continues to be priced at a lower valuation to the wider Pan European market, and has historically generated superior earnings growth. In this context, we are continuing to identify investment opportunities in German companies with the potential to deliver strong earnings growth, and at a reasonable price. As bottom-up experts, we will continue to seek and invest in such attractive opportunities.

It's important to mention that, if we were to see a renewal in trade war rhetoric, the euro currency is a natural shock absorber. If punitive tariffs were to be implemented, the euro will likely sink against the dollar, which would boost the earnings of German exporters. If tariffs are removed, the euro would likely appreciate, granting an immediate boost to the top line; over time, however, the strong currency would deter buyers, leading to earnings downgrades. This creates a natural hedge.

Any trade war between the U.S. and China should have limited impact on German equities as there is little overlap between the wider German market and these countries. Once any impact of a trade dispute is baked in to German autos, which it arguably has been, then any escalating rhetoric shouldn't affect Germany. The country has a swathe of strong, innovative companies that might not generate headlines, but they do generate growth.

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