Discovery Global Equity Feeder Fund

Market background

The second quarter was a mixed one for financial markets. The second largest US bank failure in history did not lead to broader financial contagion, the US debt ceiling crisis was resolved, and volatility fell throughout the quarter. However, economic activity was subdued as inventories were run down, and at the same time inflation remained sticky. Hence, central banks continued to raise rates. This included the US's Federal Reserve (Fed), European Central Bank (ECB), and the Bank of England (BoE), with the latter raising interest rates to a 15-year high of 5%. In the final month of the quarter, the Fed paused its rate hiking cycle for the first time in over a year but signalled further rate hikes for the remainder of 2023. Conversely, the People's Bank of China (PBoC) elected to cut rates and add more liquidity to support China's recovery, continuing the policy divergence from its developed market counterparts. The Bank of Japan (BoJ) maintained its ultra-easy monetary policy despite stronger-than-expected inflation, resulting in a strong performance from the equity market but a weak yen.

Despite concerns about inflation, equities had another good quarter, helped by technology stocks that were caught up in the excitement surrounding artificial intelligence (AI). Developed markets outperformed emerging markets, with Chinese equities lagging but Japanese equities delivered their second-best quarterly performance in the last decade. US equities also fared well during the quarter, primarily driven by impressive gains in the technology sector. UK equities underperformed, not helped by the strength of sterling, which emerged as the strongest G10 currency in the period. Commodities struggled across the board, with oil prices down for a fourth consecutive quarter. Industrial metals such as copper also lost ground as a result of weak economic activity. Gold prices also fell. The technology sector drove much of the performance, but consumer discretionary stocks did well, and internet stocks lifted the communication services names. Against a background of weak commodity prices, energy and materials stocks underperformed, but traditionally defensive sectors such as healthcare, consumer staples and utilities also did poorly. The problems of the Chinese property sector were one reason behind the weakness of the real estate sector.

Performance review

For the quarter, the Fund delivered a strong absolute return but underperformed the benchmark.

Stock selection in the technology sector contributed the most to returns over the period. In particular, the rally in technology stocks lifted Nvidia, which was the largest stock contributor in the quarter. Nvidia's continued strong performance was mainly due to analysts raising their revenue and earnings forecasts for 2023 and 2024 after seeing record orders for AI (artificial intelligence) chips, particularly from large customers in China as they tried to get ahead of any future protectionist restrictions. The excitement around AI also lifted Broadcom.

Consumer credit checking business Transunion rallied after management suggested there were no signs of weakening consumer loan demand, implying possible upside to current profit forecasts. World Wrestling Entertainment outperformed on increasing expectation of a positive outcome for content rights negotiations and the value accretion associated with the merger with UFC (Ultimate Fight Club), the market leader in Mixed Marshal Arts content. Italian luxury car producer Ferrari re-rated over the period in anticipation of the successful release of its new Purosangue model. Banks recovered when it became clear that the problems of duration risk mismatching within SVB's bond portfolios did not necessarily apply to larger banks and the hedging of their MBS (Mortgage-Backed Security) exposures, and so did not represent a systemic risk. This lifted HSBC, which was also helped by management change and better interest margins.

Conversely, stock selection in the consumer discretionary sector proved more challenging. This was partly due to having an underweight position in Amazon, which recovered dramatically over the period. We have since moved overweight in Amazon. German online retailer Zalando, however, had disappointing results which led the market to question the near-term growth outlook. Being underweight Apple and not owning Meta Platforms, the owner of Facebook, also hindered relative performance as large cap technology stocks continued to lead the market higher over the quarter. Chinese spirits producer Kweichow Moutai was the largest detractor from performance over the period as both Chinese equities and consumer staples were out of favour. US test equipment business Thermo Fisher Scientific suffered from concerns that the market environment has weakened, and the stock lagged along with other healthcare-related stocks.

Outlook and strategy

As we move into the second half of 2023, investors and global equity markets are navigating a complex economic landscape. Consumer spending has remained robust, with higher saving ratios, stronger household balance sheets, longer term fixed rate mortgages, record low unemployment, reasonable wage inflation and still pent-up demand This uncertainty is compounded by the knowledge that supply shortages continue to amplify normal inventory cycles, making underlying demand even harder to judge and a bull-whip effect a further uncertainty.

The chief influence on markets in the coming months is likely to remain the shift in monetary policies around the world. As central banks in developed economies continue tightening monetary policy to curb inflationary pressures, rate rises - which have historically worked with a roughly 15-18 month lag - may eventually cause a pullback in equities and a rotation into more defensive companies if the market begins pricing in more recessionary conditions in Q423 or 2024. Consensus forecasts tend to incorporate expectation of a slowdown or mild recession later in the year, with many advocating a preference for staying exposed to Quality as a style. The danger here is that the Quality/Growth valuation spread versus more cyclical value stocks is back to the extremes last seen in 2000 at a time when discount rates are much more elevated. This is all against overall market valuations which have moved up since the start of the year and, for the first time since 2007, a US earnings yield/bond yield crossover has occurred, with higher bond yields again tempting investors.

As always, the market outlook is unclear. However, we continue to find individual stocks across a range of sectors that fulfil our investment philosophy, namely being of good quality with undervalued long-term prospects and for whom a positive inflection in sentiment could see a meaningful move to the upside.

In summary, then, even after the solid benchmark-relative performance of our value portfolios so far in 2023, we continue to see significant upside potential against the backdrop of a market that appears attractive for stock-pickers generally, and especially for value investors.

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