Discovery

Discovery Global Equity Feeder Fund

Market background

A volatile quarter was driven by the ebb and flow of expectations for growth, inflation and the US Federal Reserve's (Fed) policy stance. Initially, it was thought that inflation pressures would ease, helped by falling energy costs, and this would allow the Fed to end its tightening without serious damage to the economy. Data in February suggested otherwise and resulted in market weakness. More benign data and the swift response to the collapse of Silicon Valley Bank resulted in bond yields falling rapidly in March, lifting equities and ending the quarter on a positive note.

Despite the emergency rescue of Credit Suisse, Europe was the best performing region over the quarter. Asian and emerging markets lagged, the main exception being the technology-heavy indices of South Korea and Taiwan. Technology stocks in the US also lifted that market, despite the flurry of nervousness over the health of US banks. China's somewhat tepid recovery from lockdown was given a boost by evidence of a more relaxed regulatory attitude to its leading technology stocks, helping the market recover some of its previous underperformance in March. Energy prices fell throughout the quarter, which helped inflation forecasts. However, the UK market's exposure to energy and banking acted as a drag on the benchmark there.

Large technology stocks, especially in the US, proved to be something of a safe haven, with the result that the technology sector was the best performing sector. Media stocks in the US and China also did well, contributing to a strong performance from the communication services sector. Against a difficult background for oil prices and for the banking sector it is no surprise to find that financial and energy sectors were the worst performers over the quarter.

Performance review

In a volatile period for markets, the Fund delivered a positive absolute return for the quarter but underperformed the index. Stock selection in the technology sector contributed the most to returns. In particular, the rally in technology stocks lifted NVDIA, which was the largest stock contributor in the quarter. NVDIA's strong performance had three drivers: an improved near-term earnings outlook, greater appreciation of the company's positioning in the crucial developing area of generative artificial intelligence and lower discount rates. A positive pre-announcement of results helped German semiconductor company Infineon. The company cited resilient business dynamics in its core automotive and industrial segments, benefitting from price, mix and lower energy costs, and resulting in increased profit forecasts for the full year. Improving sentiment towards Korean battery producer LG Energy Solutions lifted the stock as it became clearer that it was likely to benefit from US EV (electric vehicle) growth and the US Inflation Reduction Act. World Wrestling Entertainment outperformed on increasing expectation of a positive outcome for content rights negotiations and M&A. Italian luxury car producer Ferrari re-rated over the period in anticipation of the successful release of its new Purosangue model. In industrials, German conglomerate Siemens continued to benefit from strong demand for the company's automation and energy management products, amid evidence that Germany had avoided a manufacturing recession as the energy crisis abated.

Conversely, stock selection in the consumer discretionary sector proved more challenging. This was partly due to not owning EV giant Tesla, which recovered dramatically over the period. Being underweight Apple and not owning Meta Platforms, the owner of Facebook, also hindered relative performance as large cap technology stocks led the market higher over the quarter. Despite reporting a good set of results, UnitedHealth underperformed due to a market rotation out of healthcare. The other detractors from performance were in the financial sector where there was no hiding from the repercussions caused by the demise of Silicon Valley Bank. US regional bank Huntington Bancshares was one of the most directly negatively impacted and the position has been sold, and even Dutch insurer ASR Nederland suffered in the aftermath.

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Outlook and strategy

Equity markets remained relatively robust through the first quarter of 2023 as a number of issues proved less worrisome than expected. Falling inflation, helped by natural gas prices down c80% from June peaks in Europe and globally freight rates also similarly down c80% from peak, have contributed to falling bond yields (UST10Y down to 3.3% from a 4.2% peak in Oct 22). The high savings ratios built up through the pandemic have also served to cushion consumers temporarily from rapidly rising interest rates. This has delayed the typical early cycle economic slowdown which follows aggressive monetary tightening, with growth expectations actually improving through Q1.

Markets may ultimately react negatively to more restrictive monetary policy but can make significant gains in the meantime — as we have seen with both Europe and Nasdaq up over 20% since the Oct 22 lows. The latest banking crisis, with the high profile insolvency of Silicon Valley Bank in the US and the demise of Credit Suisse in Europe, serves as a warning of the damage a liquidity crisis can cause. Ongoing deposit outflows and banks reining in lending are classic signs that a broader credit crunch has also been unfolding. Private Equity and Venture Capital funding for small loss-making businesses recently all but dried up, and markets are also concerned about the overexposure of small banks to the leveraged commercial real estate sector. This uncertainty was reflected in market leadership of the technology sector, reflecting a return to mega-cap firms generating positive cashflows.

As we enter Q2, it is clear that the market outlook remains uncertain. The main debate remains whether monetary tightening will destabilise the global economy and in turn hurt corporate earnings to a greater degree than the prevailing consensus. Our base case remains that corporate earnings growth will, on average, remain subdued over the coming quarters and we would not be surprised to see growth expectations falling further in the near term. On the other hand, the market will also look further ahead as the pace of the global rate tightening cycle is set to slow from here. There are always opportunities for bottom-up investors such as ourselves as the regions and sectors that make up the global equity market are not homogenous. We therefore remain focussed on company specific fundamentals and continue to look for good quality business that are trading at attractive valuations and exhibiting positive operating momentum.

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