Discovery

Discovery Global Multi-Asset Fund

Market background

The second quarter of the year was strong for most markets overall, supported by continued progress on the global vaccination rollout and a reduction in new global COVID-19 cases, although the Delta variant started to be a cause for concern towards the end of the period. US inflation significantly beat market expectations for two consecutive months, rising by +4.2% and +5.0% respectively on a year-on-year basis. This fuelled concerns of the US overheating as a result of significant fiscal support, supply bottlenecks and increased consumer spending as economies continued to reopen. However, having reiterated their dovish stance for a number of months, the Fed made a perceived hawkish pivot in the final month of the quarter, bringing forward expectations of the first rate hike to 2023. This helped to ease investor concerns regarding the tail risks surrounding inflation.

Against this backdrop, global equities generated high-single digit positive returns, although this was predominantly driven by developed markets. Whilst China still generated a solid positive return during the quarter, growing concerns around the softness in growth and the tightening of policy caused the region to lag. Conversely, US and European equities both reached fresh all-time highs over the period. In the latter half of the quarter, following the Fed's meeting, the growth over cyclical trade reasserted itself and technology stocks rebounded. Elsewhere, emerging market debt generated a positive return in part helped by US dollar weakness, whilst spreads of high yield bonds compressed further which saw prices rise with the US outperforming Europe. Within commodities, oil performed strongly during the quarter thanks to further progress with vaccinations and economies reopening. Copper also moved up in value for the fifth consecutive quarter despite a sharp pullback in June.

Sovereign bonds saw some divergent performance; in spite of inflation data showing higher pricing pressures, US treasuries and UK Gilts recovered whilst their European counterparts lost ground.

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Investment grade corporate bonds generated a positive return; the US outperformed European with the spreads of US investment grade bonds having now reached the tights of the previous cycle. The US dollar lost ground against some major currencies over the course of the quarter although saw a bounce following the June Fed meeting. Conversely, emerging market currencies saw some sizeable moves and had a positive period overall. Bitcoin declined by -41% during the quarter as it was negatively impacted by scrutiny from authoritative bodies.

Gold recovered from its poor first quarter and returned 4%, to end the period on $1,770/oz, albeit falling sharply in June due to the Fed meeting narrative.

Performance review

For the quarter, the Fund delivered a positive absolute return but lagged the benchmark.

Equity markets struggled over the period and posted losses because of concerns surrounding the liquidity position of Chinese property developers, rising energy prices and the prospect of central bank liquidity withdrawal. Asia and emerging markets trailed other major regions in light of slowing growth in China, US dollar strength and an increasing number of Chinese property developers missing or seeking to defer interest or principle on debt repayments. The US market struggled towards the end of the quarter as the technology sector came under pressure due to the prospect of a rising discount rate. European markets fared slightly better, due to a higher concentration of 'value' stocks in the region, which outperformed "growth" toward quarter-end. The Fund's equity exposure detracted over the period as a number of Asian holdings were weak, as were more defensive names in the utilities and consumer staples sector. Exposure to US insurance companies, however, did help counter some of this weakness. In fixed income, government bond yield movements were mixed, but generally rallied before selling off towards the end of the period as central banks discussed the tapering of quantitative easing programmes and inflation releases remained stubbornly high. The Fund's fixed income allocation detracted from returns, with positions in New Zealand and US government bonds weakening.

Portfolio activity

There were a number of changes to the fund over the quarter. In equities, we reduced exposure over the period bringing the equity weight down from 66% at the end of June to 54% at the end of September, this was implemented on a broad basis although focussed largely in cyclicals as a result of our increasingly cautious outlook for equity markets heading into the next 6 months. In fixed income, we exited a position in Australian government bonds, which was added in April, post a strong rally resulting from the nation re-entering national lockdowns. We added some of the proceeds into New Zealand government bonds where valuations remain more attractive. We also added to the position in Russian government debt to reflect our increased conviction that the central bank is at the end of the hiking cycle, as well as the positive view on the currency given strong energy prices and high interest rates relative to the rest of the world.

Outlook and strategy

The successful rollout of vaccines has allowed social distancing restrictions to be eased and the recovery to continue for much of the world. At the same time, the size of fiscal and monetary policy support remains significant as central banks and governments seek to support households and businesses to foster a return toward full employment. However, this is beginning to turn, and we believe that we are passing the point of maximum liquidity as central banks begin to dial back policy support and taper quantitative easing programmes over the next 6 months. One area where policy withdrawal is more advanced is in China, where the credit cycle, a primary policy lever, has turned sharply lower through this year as authorities seek to address imbalances in local government debt and the housing market. As a result, we believe there is scope for the Chinese economy to disappoint versus investor expectations over the next 6-12 months, while there is an increasing likelihood that the Federal Reserve may have to withdraw policy support more quickly than they expect due to ongoing progress in the US economy.

Our central scenario for financial markets continues to be that volatility will likely remain elevated in the coming quarters, although the drivers of this volatility are likely to shift. As we look six months out, towards the beginning of 2022, we believe investors should focus on the prospect of slowing growth in China, as a function of the current down-cycle in Chinese credit creation, at a time when the Federal Reserve are also likely removing policy accommodation. This confluence of forces has scope to place upward pressure on the US dollar and add volatility across asset markets, given extended valuations. Although we continue to see opportunities for medium-term investors, we have moderated risk and raised cash in order to be in a position to take advantage of any bouts of volatility. We continue to watch China’s credit cycle, the ongoing economic recovery and the direction on central bank policy, believing that these are the primary forces driving financial markets from here. We will seek to take advantage of opportunities as they are presented by market volatility.

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