Discovery Global Equity Feeder Fund

Market background

The problems that afflicted equity markets in the spring continued to take their toll during the third quarter. Although oil prices fell over the period, the lagged effect of higher fuel costs, labour market tightness and supply issues were now being seen in core inflation. The US Federal Reserve continues to tighten policy to bring inflation back to acceptable levels. This lifted the US dollar index to a twenty-year high. This effective tightening of US dollar liquidity is causing strains in other financial markets, most notably in the UK.

Global demand is weakening and even the US indicators suggest the possibility of recession there. Corporate profit forecasts are being reduced, especially in those sectors, such as technology, that are particularly sensitive to economic activity. Investor sentiment and business confidence inevitably deteriorated over the period. Although supply chains have recovered somewhat from the strains of the pandemic, periodic lockdowns in China remain an issue. The US market outperformed over the period, helped by the currency. Brazil achieved a positive return as investors anticipated a change in regime. A change of administration was not so helpful for the UK which suffered a double-digit decline over the quarter in dollar terms, requiring central bank intervention to reassure investors. Intermittent lockdowns and concerns about global demand took their toll on the Chinese market which was among the weakest performers over the period.

Although oil prices retreated, the ongoing uncertainty caused by the Russian invasion of Ukraine meant that energy stocks were the best performers over the third quarter. Other sectors saw more material declines, with those especially sensitive to rising bond yields faring the worst, especially real estate, communication services and utilities.

Performance review

In a difficult period for markets, the Fund underperformed the comparison index.

From a factor perspective, momentum and quality outperformed, while value underperformed. Stock selection in the communication services sector proved helpful. World Wrestling Entertainment outperformed after reporting strong Q1 2022 results, which evidenced strong engagement and increasing interest in sports rights by digital operators. Additionally, the company benefitted from improving ratings and new international commercial agreements.

Helped by electric vehicle battery demand, the strength in lithium prices continued to exceed expectations, supporting Igo Limited. The miner was further helped by the completion of the Western Areas acquisition, strong spodumene pricing and a weaker supply outlook as CATL withdrew from a joint venture to develop low grade lepidolite lithium ore in China. The shares were also supported by strong electric vehicle (EV) sales and the US Inflation Reduction Act promoting EVs. Keysight Technologies' Q3 earnings exceeded expectations, driven by strong orders and a record backlog. The US testing company also received increasing investor attention as it continues to deliver against a challenging macroeconomic environment with sustainable order growth.

Rate hikes by the US Federal Reserve refocused the market on DBS's interest rate sensitivity. The bank continues to be capital generative, which will underpin its solid capital position and support a mid-to-high single-digit dividend yield. Similarly, M&T Bank was a beneficiary as higher rates act as a tailwind for net interest income. Conversely, AIA, a Hong Kong multinational insurance company, had been recovering, but COVID lockdowns in China contributed to a weak sales outlook. The lack of visibility on the Hong Kong border reopening was a further headwind. A mixed reporting season for banks generally, especially around capital return communications, contributed to HSBC seeing some mean reversion following strong year-to-date performance.

Stock selection in the consumer staples sector weighed the most on performance. Industry data signalling downside earnings risk as volumes continued to trend negatively affected food company Nomad. Despite reporting good Q2 results earlier in the period, Sanofi derated on litigation fears related to Zantac, which can become carcinogenic if ingested in larger amounts after heat exposure.

Outlook and strategy

With markets increasingly nervous after the more hawkish tone set by the Federal Reserve chair at Jackson Hole, there is almost universal consensus that a global recession is on the way, despite the supporting evidence being somewhat ambiguous at this stage. The key question being asked at this point is how severe a recession is being priced into the market? From a bottom-up perspective, we remain sceptical about many sell-side analysts' earnings forecasts, which we see as vulnerable to downgrades. While the contraction in valuation multiples resulting from weaker share prices suggests that a market bottom could be close, recent corporate results demonstrate there has been significant selling pressure for those that have missed consensus earnings estimates.

As third quarter results season starts, we believe there will be a comparable scenario. Significant earnings misses will likely be punished, while those companies meeting, or exceeding estimates are likely to go unrewarded as nervous market participants believe that better-than-expected numbers are just postponing disappointment. In our view, the key signal for a market bottom will occur when negative earnings surprises are no longer leading to major price corrections. This will demonstrate that bad news has been sufficiently priced into valuations.

In navigating the market, it is important to avoid companies that are vulnerable to profit disappointments, while building Funds that will benefit from the recovery when it materialises. Our framework of focussing on high quality stocks incorporating a reasonable valuation, while enjoying relatively positive momentum for both earnings revisions and technical considerations, should stand us in good stead.