Discovery

Discovery Global Multi-Asset Fund

Market background

The third quarter saw weak performance for markets, with the latter half particularly challenging as central bank policy remained hawkish, forcing investors to push the likely timing of rate cuts to Q3 2024. While there are signs that consumer inflation is retreating, the surge in energy prices was a cause for concern.

Data was mixed but the economic picture was more downbeat in Europe and China relative to the US. Monetary policy continued to diverge in China, with the People's Bank of China (PBoC) announcing its intentions to step up policy adjustments to support China's economic recovery.

Against this backdrop, global equities were weak in the quarter, falling by low-single digits, although there was some regional divergence. US equities retreated amid interest rate worries and the underperformance of mega-cap stocks in September. Despite supportive monetary and fiscal policy, Chinese equities declined as data releases underperformed expectations and concerns over the property market persisted. Elsewhere, within high yield corporate debt, US high yield outperformed its European counterpart, despite the rising rate environment, and generated a small positive return.

Rising rates as well as the strengthening US dollar, were headwinds for emerging market debt which declined in value.

Within defensive assets, rate volatility remained a dominant theme as yields reached multi-year highs: Bonds suffered further value destruction as 10-year yields in the US, Germany and Japan reached their highest levels since 2007, 2011 and 2013 respectively. The 30-year treasury yield saw its biggest quarterly increase since Q1 2009, resulting in a fall in prices. Investment grade corporate bonds also generated a small negative return, albeit with Europe outperforming the US.

Elsewhere within defensive assets, the Japanese yen weakened versus the US dollar, in part due to the Bank of Japan (BoJ) conducting an unscheduled buying operation of JGBs.

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Performance review

For the quarter, the Fund delivered a negative absolute return, underperforming the benchmark.

We maintained defensive positioning across the overall portfolio as a function of our cautious outlook. From an asset allocation perspective, being underweight equities contributed positively to returns. However, being overweight to defensive fixed income in a quarter that saw a large rise in bond yields was a significant detractor relative to the benchmark and drove underperformance.

We continue to hold a more cautious view on the market environment over the coming 6-12 months and have maintained defensive positioning within the portfolio as a result. This is summarised in the outlook section.

Within fixed income, long duration positioning in developed markets was the largest detractor on an absolute and relative basis, following the more hawkish narrative from central banks which caused extreme moves in yields.

Within equity, China and Hong Kong listed equities were the key detractors on an absolute and relative basis. Economic data releases in China were weak during the quarter, which caused increased investor pessimism about the prospect for a sustained recovery. We continue to see a lot of value in businesses with solid growth prospects in these markets and continue to expect a bumpy but sustained recovery, driven by targeted stimulus measures. Being underweight US equities was beneficial for relative returns, though stock selection within the US detracted. Derivative positions performed well, partially offsetting some equity losses.

The contribution from active currency positions was negative driven by the long Japanese yen exposure which detracted as the yen depreciated over the quarter.

Portfolio activity

The allocation to equities (excluding listed property) remains underweight versus the benchmark, albeit the underweight reduced over the quarter. The increase in equities over the quarter was principally driven by reducing the material underweight to US equities, as well as changes to the underlying equity holdings earlier in the quarter which included adding exposure to the Italian utility ENEL and London Stock Exchange Group.

As at end of September, the portfolio was underweight equities (excluding listed property) in aggregate by c.2%, with the most significant position being underweight European equities. The ongoing slowdown in Europe, cyclical sensitivity, and continuing push to maintain restrictive policy from the ECB are the primary drivers behind this view.

The strategy remains overweight Asian equity, principally in China where the combination of attractive valuations, ongoing policy support and bottoming macro data give us confidence of relative outperformance on a forward-looking basis.

The duration of the portfolio was c. 1 year overweight at the end of September. The underlying fixed income portfolio changed in composition over the period as we rotated much of the US treasuries exposure into 30 year German bunds, which represented c. 2.7 years of absolute duration at the end of September. We also removed our small emerging market debt position.

Outlook and strategy

Our market outlook remains cautious with defensive positioning across multi-asset portfolios driven by an expectation that the significant policy tightening which has taken place globally over the past 18 months is likely to act as a material headwind to growth in the coming quarters. This is based on our tested belief that policy settings today define the outlook for growth and inflation in the future. When policy is ‘tight’, future growth and inflation will slow. When policy is ‘loose’, future growth and inflation will accelerate.

In developed markets, we assess policy as notably tight with interest rates having been moved to a restrictive setting by the Federal Reserve and ECB coming into 2023. Given the evident time lags, tight policy usually feeds into an economy 6-18 months later. Thus, we do not expect to see the full impact of this hiking cycle for another 12-18 months given that monetary policy tightening has likely only recently just peaked.

The lags in the US have been longer than in Europe due to higher levels of pandemic excess savings, a positive fiscal impulse and lower levels of variable debt. We would highlight however, that excess savings are likely now run down – according to the Federal Reserve measures – and the fiscal impulse is set to fade. A key component of assessing whether policy is tight is the flow through to money supply and then into the supply of and demand for credit. Both US & eurozone lending standards have tightened considerably and credit growth has slowed sharply in recent months – as evidenced by material declines in credit impulses. These usually impact higher frequency economic data in 6-9 months. Note that China's credit impulse did this in Q2 2021. We expect further progression into negative territory for these measures while policy is this tight, which will be a significant constraint on developed market growth.

In Europe we are seeing a faster feedthrough into higher frequency economic data releases due to there being less supportive factors vs. the US, as noted above. Data releases have been weakening across the board which has added conviction to our central scenario that Europe is entering a downturn with policy now at a notably tight setting. Ongoing declines in the Eurozone's credit impulse should add further headwinds to growth and inflation in the coming quarters. We do not believe these dynamics are currently being reflected in the pricing of European assets with expectations still relatively sanguine about the outlook. As a result, we believe that the degree of dislocation between current market pricing and prevailing fundamentals leads to significant asymmetry and provides an opportunity when taking positions to the contrary.

Our central case is to remain more constructive than the consensus on the outlook for the Chinese economy over the medium-term, one-to-two year, view. Our expectation continues to be for a bumpy but sustained recovery, driven by a reopening from COVID lockdowns and targeted stimulus measures against the well-known backdrop of an indebted property sector. The communications since July's Politburo meeting had some notable highlights. These include dropping the phrase that houses are for living, not for speculation' and calling for 'implementing a comprehensive debt solution' for local government financing. We note the calls from the PBoC Governor for the credit impulse to remain positive.
Multiple measures have subsequently been announced, the most important factors to highlight are the cumulative stimulus, implemented with increasing momentum with measures primarily targeting the housing market. We expect the relaxation of the first time buyer definition across the large cities, the reduced down-payment rules, and the lower borrowing costs to be particularly effective. Fiscal measures include an increased pace of local government bond issuance and measures to deal with stretched local government balance sheets; property measures have included the loosening of several lending restrictions.

As discussed in prior months, our multi-asset strategies have been positioned for the evolution of two major macro forces that we believe are underappreciated by financial markets: the first is the extent of the coming slowdown in the US and Europe as these economies look set to suffer the consequences of one of the largest and most rapid hiking cycles in many decades. The second is the prospect for recovery in China after the country experienced recessionary conditions last year. As a result of these dynamics our strategies remain underweight equities, with a bias towards the Hong Kong and Chinese markets where valuations are attractive, and policy appears to be 'loose'. In fixed income, we remain overweight defensive duration given our outlook for a weaker growth profile. Within currencies we maintain a defensive stance with long positions in reserve currencies (US dollar and Japanese yen).

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