Discovery Global Multi-Asset Fund

Market background

The second quarter was mixed for financial markets. It started with the second largest US bank failure in history; however, fears that this would lead to broader financial contagion were misplaced and volatility fell throughout the quarter. With turmoil contained and signs that markets had stabilised, central banks maintained their focus on measures to tackle persistent levels of inflation, as well as resilient economic data, by hiking rates.

Despite concerns about inflation, global equities advanced for a third consecutive quarter, although there was some regional divergence, and developed markets outperformed emerging markets. Japanese equities had their second-best quarterly performance of the last decade, while US equities also fared well. This was mostly a result of strong performance by tech stocks thanks to optimism about the potential of AI to improve productivity and boost economic growth. Chinese equities fared the worst, weighed down by disappointing economic data. Elsewhere, global high yield corporate bonds also delivered a positive return, with European bonds marginally outperforming their US counterparts. Emerging market debt also made gains, benefiting from the eventual pause in rate hikes by the Fed, and the depreciation of the US dollar. Commodities struggled across the board, with oil prices down for a fourth consecutive quarter.

Within defensive assets, sovereign bonds struggled after inflation remained stubbornly above target and central banks continued to hike rates. UK gilts fared worse as the market anticipated more aggressive tightening in response to continued upside inflation surprises, with UK CPI now having reached the highest level in G7 countries. In the US, the turmoil over the US debt ceiling in the first half of the quarter saw the yield of 1-month T-bills soar above 6% at one point.

Performance review

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

From an asset allocation perspective, being underweight equities and overweight defensive fixed income duration over a period where equity markets generated positive returns and fixed income in aggregate generated negative returns was the main driver of underperformance over the period. We continue to hold a more cautious view on the market environment over the coming 6-12 months and defensive portfolio positioning as a result. This is summarised within the outlook section.

In absolute terms, equities, and fixed income positions both detracted from returns over the quarter. Within equity, US equities contributed positively while negative returns from China and Hong Kong listed equities were a key detractor. Economic data releases in China were volatile and weakened during the quarter, which prompted the People’s Bank of China (PBoC) to cut rates in June and add more liquidity to support China’s recovery. We continue to see a lot of value in businesses with solid growth prospects in these markets and expect a recovery in the region over the coming months.

Fixed income positions also detracted, impacted by the continued hawkish message from developed market central banks which has pushed yields higher over the quarter. The contribution from active currency positions was mixed but detracted in aggregate, driven by the long Japanese yen versus short Taiwanese dollar position which detracted as the yen depreciated over the quarter with no sign of the Bank of Japan (BoJ) tightening policy yet.

Portfolio activity

The overall equity allocation was broadly unchanged but there were some changes to the underlying composition of the portfolio. We initiated a position in German reinsurance company, Hannover Re and in utility company Orsted which specialises in offshore wind energy production, a sector with a long structural growth runway for the most experienced operator of these assets. We sold a number of individual holdings on valuation grounds including Novo Nordisk.

Within fixed income, the portfolio duration was broadly unchanged and our preference for defensive sovereign duration was maintained over the period through our exposure to US treasuries. In currency we maintain a long position in the Japanese yen as we continue to expect a more supportive rate environment as well slowing developed market growth to be a support for the currency, which remains cheap.

Our overall positioning remains defensive and underweight risk assets in line with our current cautious outlook, but we will continue to monitor the global macro environment and will look to reintroduce growth asset exposure should the outlook become more supportive and valuations more attractive, in line with our countercyclical approach to investing.

Outlook and strategy

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

In the developed world we have witnessed a material increase in interest rates, and bond yields, to the point where we would describe policy as being notably 'tight'. Policy action typically has a lead on the economic data of around 12-18 months, and therefore we are yet to see the full impact of the rapid tightening that has taken place since early 2022. In terms of the evidence that policy is tight, money supply aggregates in both the US and Europe have been contracting. Rapid money supply during the pandemic caused a nominal boom in the economy, while notable money supply contraction is likely to have the opposite impact. In the case of the US this is the first occurrence since the 1930s and is one of the contributors to the stress in US regional banks. One cause of money supply contraction has been central banks running down their balance sheets through quantitative tightening with about a US$2 trillion decrease in the last 12 months. A further US$2 trillion of quantitative tightening is likely over the next 12 months and will remain a headwind to monetary aggregates.

The evident lags of monetary policy tightening could potentially be more extended versus history due to the exceptionally low level of real rates at the start of the tightening cycle and the extent of the COVID related policy stimulus which has provided a spending buffer for households. The credit channel is something we monitor closely as a key component in the expected stalling of growth in the months ahead. Year to date in the US, bankruptcy filings are at the highest level since 2010 and we expect default rates to accelerate from here, particularly for highly geared borrowers with floating rate exposure and near term funding risk. Fifteen months since the first rate rise, the US credit impulse has rolled over sharply; a process which we expect to continue with lending standards having tightened and the demand for borrowing having moved to levels consistent with prior recessions.

While growth data has held up so far, the major macroeconomic forces described above typically lead and we expect a broader slowdown to emerge in the coming 6-12 months, notably in areas of the economy that have to date held up, such as the labour market and the services sector. So far labour markets have remained extremely resilient, given significant excess demand for labour. However, there are tentative signs that weakness is occurring, notably in some of the more leading elements of the labour market data such as initial claims.

Typically, central banks have responded to weaker economic data releases through policy easing, but still elevated inflation means they have less flexibility, and they are likely to be materially restricted in their ability to support growth and increase liquidity at a time when the market expects action as it has become accustomed to in the post-GFC era.

While our outlook is more cautious, investors more broadly appear relatively optimistic with a pause in the negative earnings revisions that has been evident over the past 12 months. At present, there is only a marginal year on year percentage decline in global earnings expected, while earnings decline during historical periods of slowdown, consistent with the forces described above have been notably deeper. We therefore expect investors to be disappointed with earnings over the coming 6-12 months.

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 however we are focused specifically on high grade markets such as in Australia, Canada, New Zealand, South Korea, and Sweden. Household balance sheets in these countries have dramatically increased leverage over the years and typically financed themselves at variable rates which is a source of imbalance, and we expect their economies to be impacted sooner and harder than the US economy. We express a similar theme in currencies and maintain a defensive stance with long positions in reserve currencies (US dollar, Japanese yen, and Swiss franc) vs. the currencies of more economically vulnerable countries (Australian dollar, Canadian dollar, New Zealand dollar and Swedish krona).

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