Discovery Global Multi-Asset Fund

Market background

Financial assets generally performed well over the quarter as the Chinese economy continued to reopen, energy prices fell, and consumer confidence improved. This was despite the collapse of three regional US banks, including Silicon Valley Bank (SVB). One of the consequences was the hasty acquisition of Credit Suisse by UBS in an emergency rescue deal aimed at securing financial stability. Although authorities fought to avoid market contagion and the immediate volatility subsided, these events resulted in a growing concern about the increasing likelihood of a recession. Labour market data and PMIs continued to be better than expected. Initially, this resulted in markets pricing in further central bank hikes, especially as inflation in both the US and the Euro Area reached record highs. However, towards the end of the quarter markets were more focused on the strains from the banking sector and what that might imply for overall economic health.

Global equities delivered high mid-single digit returns during the first quarter of the year with developed market equities outperforming emerging market equities. There was meaningful sector dispersion; within the US, tech stocks benefitted from the decline in yields while bank stocks were negatively impacted by the financial turmoil. Although emerging market equities lagged their developed market counterparts, overall emerging market assets had a good start to the year with equities, bonds and FX all in positive territory benefitting from the depreciation of the US dollar. The rally in risk assets carried over to credit with European and US high yield both delivering positive returns.

After a difficult 2022, developed market sovereign bonds also enjoyed a strong albeit volatile start to the year and experienced their best quarter since the pandemic turmoil of Q1 2020. However, the US Treasury yield curve remains inverted, which is viewed by some investors as an indicator of a pending economic recession. Investment grade corporate bonds also benefited from the move lower in yields and prices moved higher during the quarter, with the US outperforming Europe. Within FX, overall, the US dollar was marginally weaker against a broad currency basket.

Performance review

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

The largest detractor from relative returns was security selection, notably an overweight to Asia equity and underweight in developed markets. Asset allocation was also a detractor due to an overweight in cash as equity and fixed income markets rose over the quarter.

Portfolio activity

Over the period, cash equity exposure increased by 2%, through physical equity as we reduced our allocation to US equities and added Asian equities where we see better valuations. Within China we added to consumer discretionary and financials. We continue to hedge a portion of the portfolios cash equity through short positions in US and European index futures.

We have added to real estate exposure and the portfolio is now overweight the sector, focused on logistics and data tower infrastructure which we view as better insulated from the typical property cycle. We also added to materials where we see a structural tailwind driven by a rapid increase in climate investment and fossil fuel demand moderation accelerated by the Russia-Ukraine war and signature policy initiatives globally.

In fixed income, we continued to build duration exposure to government bonds, notably through longer dated US treasuries given weakening growth and peaking inflation, against a backdrop of attractive valuations given the repricing in yields that has taken place as a result of central bank tightening over the past 12 months.

Outlook and strategy

We continue to believe that two primary forces remain 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.

On the former, financial markets appear to be discounting a high probability of a soft landing in developed economies, supported by expectations that the Federal Reserve will pivot and ease policy later this year to support softer growth. Our outlook remains more cautious for two reasons: First, inflation is likely to remain stickier than expected due to ongoing tightness in the labour market, while the level of wage growth remains inconsistent with inflation returning to target. Second, soft landings have historically been associated with long and shallow hiking cycles, whereas the speed of hiking cycle experienced in the US over the past year has historically been associated with deeper recessions. We expect the full effects of this hiking cycle to be felt in the second half of this year.

On China, financial markets have moved to discount a reopening of the economy over the past six months, but investors remain sceptical about the prospect for a sustained recovery in growth and corporate earnings. We would highlight that China's credit cycle troughed over a year ago and appears to be entering a new up-cycle, while the regulatory cycle peaked a year ago and new initiatives on this front will likely remain quiet until the economy has shown notable improvement. At the same time, there appears to be material pent-up demand and close to 10% of GDP in excess savings, while policy makers continue to add stimulus.

We remain cautiously positioned, with an elevated exposure to Asian risk assets, as a function of these dynamics. We continue to watch the evolution of Chinese policy, the direction of developed market liquidity, growth and corporate earnings, believing that these are the primary forces driving financial markets from here.