Discovery Global Equity Feeder Fund

Market background

Many of the themes that have plagued markets this year continued to have an impact in the fourth quarter. Central banks continued to raise rates to combat inflation, although there was some hope that rates might be close to a peak as US inflation eased somewhat. However, service inflation continues to rise even as energy costs abate, labour markets remain tight and a more aggressive tone from central banks in December regarding future rate hikes sparked the resumption of the coordinated selloff of major equity indices and sovereign bonds. Elsewhere, China abandoned the zero-COVID policy that have plagued global supply chains. The re-opening of the Chinese economy helped commodities such as copper and iron ore to perform well. The war in Ukraine continues to raise concerns about energy supplies in 2023 but oil prices ended the quarter largely where they had begun, and US gas prices fell over the period.

Against this backdrop, global equities rose through October and November before giving up some of their gains in December, with technology stocks underperforming due to the hawkish rhetoric from central banks and the resulting move higher in discount rates. As a result, US equities fared poorly, but emerging markets were helped by a weaker dollar and a recovering Chinese market as the authorities pledged more support for the real estate industry as well as for the broader economy. Performance of commodities was positive over the period in anticipation of a Chinese re-opening. Japanese equities continued to struggle. Against a backdrop of a further weakening of the US dollar, gold returned nearly 10%.

Industrials and materials did well in anticipation of a recovery in 2023. The technology sector remained challenged though, and significantly lagged over the period.

Performance review

In a volatile period for markets, the Fund outperformed the index. Stock selection and underweight positioning in the consumer discretionary sector contributed the most to returns. Not holding mega cap Tesla contributed to relative performance as it declined on evidence of weakening demand and increasing price discounting. Concerns around the overhang effect of Elon Musk's entanglement with Twitter were a further headwind. Similarly, not holding Amazon contributed to relative returns as it underperformed due to slowing demand and profitability across its business.

Stock section in technology proved positive. Infineon Technologies preannounced better-than-expected Q4 results, and also upgraded its long-term guidance for growth and margins, to a level above consensus, driving earnings upgrades. In industrials, Siemens reported very strong Q4 results and initial guidance for 2023 earnings which were well above market expectations, driven by strong demand for the company's automation and energy management products. Conversely, a position in LG Energy Solution weighed on performance. The leading pure-play electric vehicle (EV) company outside China reported a good set of results but underperformed in line with its largest customer, Tesla. Exxon reported strong Q3 2022 results reflecting high refining margins. The company also benefitted from significant increases in natural gas prices. Within consumer staples, Coca-Cola EuroPacific performed well as it upgraded its medium-term guidance at its investor day as well as benefiting from a rotation into European-exposed stocks. In contrast, high-end baijiu distiller Kweichow Moutai suffered along with the Chinese market before rallying in December as COVID restrictions were relaxed.

Communication services weighed on returns, with Alphabet underperforming after reporting Q3 results that missed analyst expectations as the slowdown in advertising revenues was faster than anticipated. World Wrestling Entertainment underperformed after profit taking following a Wall Street Journal article citing the former CEO's desire to return to the company as well as ongoing personal litigation risk.

Two of our financial holdings underperformed as the benefits from rising interest rates did not come through as expected; SVB's net interest income sensitivity to rising rates appears lower than anticipated due to a shift in the balance between non-interest bearing and interest bearing deposits while at M&T Bank, investors debated whether net interest margins have peaked. Updated Q4 guidance pointed to rapidly accelerating deposit betas dampening net interest margin progression.

Outlook and strategy

The vast majority of market observers, including politicians and central bankers, are now convinced that the world is looking at a looming recession in 2023. The debate has now turned to how bad and how long a downturn has already been discounted by the market after its decline of 2022. Certainly, at the moment, there remains a tension between top-down economic forecasters and bottom-up stock analysts, with the latter much more optimistic about the magnitude of an earnings decline in 2023. History shows us that, when slowdowns occur, it usually transpires that the macro-economic forecasters are right about profit attrition but that they also tend to forecast recessions that do not materialise. This is also true of stock markets, which tend to respond to real or imagined recessionary fears ahead of their realisation or confounding.

Throughout last year's multiple contraction, it was noticeable that companies which failed to meet forecasts were punished by investors to a greater extent than those who met or exceeded earning predictions were rewarded. This asymmetrical response pattern is typical of markets subsequent to a period during which "risk on" investment strategies have been rewarded for a sustained market up cycle and investors are rebalancing towards a more defensive stance. This is a process that can take time but whose culmination ultimately results in a market price level that over-discounts the damage done to longer term growth trends for the global economy. Thereafter, share prices eventually move to a new upcycle.

The issue, of course, is to identify when this moment is reached. We suspect that this will prove to be at some point in 2023 and will be signalled by a more symmetrical share price response to earnings surprise. Obviously, there are many geopolitical events and other unknowns that can significantly alter the investment landscape but given the huge shift in investor preference towards cash, it appears to us that there are good quality companies out there whose longer term prospects seem undervalued at this point and for whom a positive inflection in sentiment could see a meaningful move to the upside.