Discovery Global Multi-Asset Fund

Market background

Risk assets ultimately succeeded in pushing higher in the final quarter of the year despite the number of market-moving events that took place. The emergence of the Omicron variant in November resulted in higher volatility and a mid-quarter market pullback as several governments responded to the development by increasing restrictions. However, by the end of the quarter, risk sentiment was helped by preliminary data that suggested the strain was less lethal. Elsewhere, the continued rise in commodity prices combined with broader supply chain shortages saw inflation concerns persist and prompted several central banks to dial back their monetary policy accommodation including the US Federal Reserve, the Bank of England and the European Central Bank. Whilst US President Biden's infrastructure bill was successfully signed into law, continued inflation momentum was in part responsible for the Build Back Better proposals being scuppered in their current form which marked a blow to the President's economic agenda.

Against this backdrop, most Growth assets generated a positive return. Global equities generated a solid positive return; however, this was led by developed markets and in particular the US which enjoyed a double-digit return and its strongest quarterly performance of 2021, extending its run of consecutive quarterly gains since the pandemic correction of Q1'2020. Japanese equities in contrast were challenged as the Japanese Prime Minister suggested an increased capital gains levy as well as guidelines on company share buybacks. In spite of the broader equity market rally in developed markets, most Covid-sensitive assets continued to struggle as a result of the spread of the new variant. Emerging market equities generated a negative return, largely attributed to China and the ongoing regulatory crackdown on tech firms. Elsewhere, credit underperformed equity; whilst US high yield corporate bonds managed to eke out a small gain, weakness in Europe was driven by supply. Emerging market debt – both hard and local currency – declined in value due to US dollar strength and hawkish action by central banks. Greater restrictions meant oil prices struggled, although these losses broadly recovered by the end of the quarter.

Within Defensive assets, persistent inflationary concerns put pressure on sovereign bonds, as did the subsequent hawkish action by central banks, leading to flat to slight negative returns. Gilts were the exception as in spite of the negative return posted in December as the Bank of England elected to raise rates, this was more than offset by the government's decision to cut Gilt issuance by more than expected earlier in the quarter. Strong inflation prints, healthy economic expansion, and confirmation that bond-buying will be cut by US$30bn a month starting January 2022 saw the US dollar appreciate against major currencies, with the exception of sterling. Most notably, the Japanese yen depreciated significantly over the quarter. Performance by investment grade corporate bonds was mixed with European bonds generating a small negative return, and US bonds a small positive.

Gold gained in value, ending the quarter at over US$1,800/oz. These gains occurred mostly in the final month as strong inflation data and a weak US dollar acted as tailwinds for the yellow metal.

Performance review

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

Equity markets generally rallied through Q4, despite challenges presented by the new Omicron variant and the prospect of major central banks removing policy accommodation. The US market was the strongest performer, cementing a strong year of returns, while Asia and emerging markets continued to struggle on both an absolute and relative basis – declining over the period. Economic weakness in China and a stronger US dollar remained headwinds for these regions.

The Fund's equity allocation contributed positively over the quarter. Holdings in Semiconductor equipment companies, US financials and a number of higher quality developed market holdings gained strongly, while positions in Asia generally detracted. An underweight to equities also detracted modestly.

In fixed income, government bond yields generally finished slightly higher. The Fund's fixed income allocation added to returns over the period due to being underweight the asset class and duration.

Portfolio activity

There were a number of changes to the portfolio over the quarter notably inequities, where we reduced exposure over the period through adding a hedge through European equity futures to move the portfolio further underweight as a result of our increasingly cautious outlook for equity markets heading into 2022. The reduction in equity was partially offset by additions to Asian equity towards in the end of the quarter, notably in China as we saw increasing evidence of a policy pivot from Chinese authorities towards easing.

In fixed income we sold our remaining holdings in US fixed income and went further underweight duration relative to the benchmark due to increased conviction for interest rate rises to take place in the coming months against the backdrop of expensive valuations.

Outlook and strategy

The Omicron variant has proved to be less dangerous than initially feared and the reintroduction of social distancing restrictions has been less harsh than in prior waves, while there is evidence that economies are generally coping better versus prior periods of restrictions as we learn to live with Covid. It is likely, however, that there will be some negative growth impulse in those nations where measures have been reintroduced. In general, the size of fiscal and monetary policy support remains significant as central banks and governments seek to support households and businesses. However, this is now in the process of being withdrawn. China has been notably ahead in withdrawing policy accommodation through 2021 and is now in the process of moving back towards easing policy with a clear pivot taking place through December. Although the lagged effects of prior policy tightening will continue to feed through, and growth will likely be weak in China in the first half of this year, we are more encouraged by the prospect of easing and the moving away from some of the policies that hampered Asian markets (regulation and deleveraging) over the past year. Chinese policy appears more market friendly heading into 2022 and should be more supportive of asset markets in the region. In developed markets the biggest risk appears to be that the Federal Reserve may have to withdraw policy support more quickly than is expected due to ongoing progress in the US economy and persistence in inflation. This is looking increasingly likely to be in the form of both rate hikes and quantitative tightening (a shrinking of the central bank's balance sheet).

Our central scenario for financial markets continues to be that volatility will likely remain elevated in the coming quarters. As we look six months out, into 2022, we believe investors should continue to focus on the prospect of slowing growth in China, which Asian markets may now be able to look through as a function of Chinese policy makers moving more decisively towards easing. While in the developed world, although we expect ongoing progress in the economic recovery, changing market liquidity dynamics – a function of Federal Reserve tightening – are likely to lead to increased volatility and risk placing downward pressure on both fixed income and equity prices for a period as we exit the extended period of ultra-loose monetary policy that has supported asset markets. We continue to watch the evolution of Chinese policy, the emergence of the Omicron variant and the direction of developed market central bank policy, believing that these are the primary forces driving financial markets from here. We will seek to take advantage of opportunities as they are presented.

Risk disclosure:
http://www.discovery.co.za/assets/discoverycoza/corporate/risk-disclosure.pdf