

Discovery Global Equity Feeder Fund

Market background

It was the fifth consecutive quarter of gains for global markets, underpinned by strong economy data and corporate earnings, with pent-up demand and savings stimulating a consumer boom as vaccination programmes continue to be rolled out. Virus surges in India, parts of Latin America and recently Europe, however, were a reminder that the path to recovery may not necessarily be either uniform or smooth.

The period began with similar trends to the first quarter, as the on-going recovery and rising bond yields particularly benefited cyclical and value sectors such as materials and financials. However, Investors adopted a more risk-off tone in June, leading to a broad-based sell-off in global equities. The debate in the US regarding inflation and tightening of monetary policy was front of mind this quarter, but investors took comfort from US FOMC comments that inflation is temporary in nature and under control, which saw the US market reach an all-time high. As the US yield curve saw its biggest weekly decline in 9 years there was a sharp reversal in year-to-date sector trends, with 'growth' stocks once again leading the way and 'value' stocks seeing profit taking.

The energy, technology and health care sectors performed strongly over the period, while less cyclical sectors such as utilities and consumer staples lagged. The global semiconductor chip shortage weighed on chip manufacturers earlier in the period, while the Chinese government's moves on the technology sector and subsequently on commodity speculation also led to broader market volatility. Nonetheless, the technology sector was the best performer over the period. The oil price ended the quarter at its highest level since 2018, supporting the energy sector, but China's decision to start releasing industrial metals from its strategic stockpiles led the materials sector to underperform.

Performance review

For the quarter, the Fund underperformed the benchmark. driven by weak relative performance in the final month.

The technology sector performed well, but stock selection here proved challenging. Not owning the large cap semiconductor company NVIDIA impacted relative performance as the stock outperformed due to strong results helping justify its high valuation. Samsung Electronics underperformed despite strong results as news of significant capacity expansion plans by competitors raised fears of future overcapacity and pricing pressure.

German car producer Volkswagen continued to pull back from earlier strong performance as chip shortages create near-term industry volume disruption. However, we do not believe this detracts from our medium-term investment case. Chinese online music entertainment platform Tencent Music Entertainment continued to suffer from regulatory concerns regarding its break-up.

Offsetting some of these losses, US standby generator business Generac outperformed, as heatwaves in the US have led to power shutoffs by electricity suppliers, further increasing demand for the company's generators. Stock picking within industrials was positive. US companies Microsoft and Alphabet, the owner of Google, benefitted from increased investor attention as the quarter progressed as market focus shifted back to quality growth stocks. Microsoft's management has successfully repositioned the business towards higher growth areas, while Alphabet was helped by good results.

Although financial stocks generally lagged, US investment bank Goldman Sachs was among the top contributors to performance, helped by good results in its capital markets businesses.

Portfolio activity

Over the quarter, significant purchases included technology platform and digital payments company PayPal Holdings. The stock benefitted from the secular tailwinds of e-commerce and mobile and digital payment penetration, and this company is a high-growth compounder. Its new solutions for consumers and merchants will strengthen the company's competitive advantages, while the launch of a super App – encompassing payment, financial services and e-commerce – is set to lead to an improvement in engagement that could generate upgrades to current analyst forecasts.

Significant sales included British American Tobacco, who's stock remains cheap, but with the new regulatory overhang (the banning of menthol cigarettes in the US), we have little visibility that next generation product can become a sufficient growth driver and with earnings revisions being negative, we don't see the value materialising in performance in the near to medium term.

Outlook and strategy

With the broader markets obsessing over the timing and extent of a potential tightening from the US Federal Reserve, credit markets seem to have decided that any uptick in inflation will likely be transitory

in nature, pushing down the US 10-year Treasury yield. The future direction of inflation sentiment remains, to quote the late Donald Rumsfeld, a “known unknown”, but it does seem that the pace of recovery is being held back by supply disruptions in the manufacturing sector, despite strong order books. Shortages of key raw materials, higher freight costs and labour shortages have hindered growth in factory activity and raised manufacturing costs in recent months.

This will make the upcoming reporting season interesting, as we are likely to get some insight into the extent these pressures have had on corporate profitability and how managements perceive their persistence through reporting guidance numbers. After the broad-based Q1 earnings beats, we are likely to see more significant differentiation over the next few months as the corporate sector reports on Q2.

Nevertheless, we believe equity markets are likely to prove more forgiving on missed forecasts due to supply disruption, as these forces will be perceived as transitory, similar to what we have seen in bond market reaction. We will remain focused on those companies we believe to be demonstrating strong long-term operating performance.

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