Discovery

Discovery Money Market Fund

Market background

Looking back at the first quarter of the year (Q1), January saw global equity and fixed income markets enjoy a firm start, as declining inflationary pressures across key economies fuelled optimism that central banks were approaching the end of their rate-hiking cycles. Sentiment reversed somewhat in February, with stickier inflation prints and a more resilient labour market in the US sparking concerns that rates would remain higher for longer. In March, after the initial wobble around financial sector concerns, growth stocks rallied on the back of falling bond yields, which helped global financial markets close Q1 firmer.

The US Federal Reserve (Fed) raised its key interest rate by 25 basis points (bps) in March, pushing borrowing costs to their highest levels since 2007. The decision came against the backdrop of the second-largest bank failure in the US, sparking liquidity concerns in the banking sector – more specifically, around the sector's ability to absorb further rate hikes. The Fed restored calm to the markets, reiterating the sector's resilience and justifying the need for further rate increases. Subsequently, however, signs of easing inflation raised hopes that the Fed may begin to slow the pace of its interest rate hikes sooner than expected. February's data showed annual inflation slowing to 6% year-on-year (y/y), while Core PCE (the Fed's preferred gauge to measure inflation) fell to 4.6% y/y. In the labour market, February's non-farm payrolls increased by a stronger-than-expected 311,000, while the average hourly earnings for non-farm payrolls rose only 0.2% month-on-month (m/m), indicating a deceleration in wage pressures.

In the UK, the Bank of England (BoE) raised its key bank rate by 25bps in March, in line with market expectations. Policymakers signalled that inflation was likely to fall during the year, but warned that further tightening would be required if pressures continued to persist. Turning to the Euro Area, the European Central Bank (ECB) raised its key interest rate by 50bps in March as expected. Consumer price inflation softened to 8.5% y/y in February, still well above the ECB's 2.0% target, while the core inflation rose to a fresh record high of 5.6%. Eurozone GDP growth stalled in Q4, weighed down by contractions in Germany and Italy.

Discovery Life Investment Services Pty (Ltd): Registration number 2007/005969/07, branded as Discovery Invest, is an authorised financial services provider.

The People's Bank of China (PBoC) kept its key lending rates steady in March and cut the reserve requirement ratio for financial institutions by 25bps. Following the relaxation of the country's COVID policy last year, the economy continued to show signs of recovery, while inflation has remained surprisingly low. China's annual inflation rate fell to 1.0% y/y in February from 2.1% in the prior month, marking the lowest reading in a year. Manufacturing activity expanded in February, while non-manufacturing PMI surged to its highest reading since 2011. General Services PMI also advanced, expanding for the fourth consecutive month, with new export growth hitting a three-year high.

The South African Reserve Bank (SARB) hiked its benchmark repo rate by 25bps in January and then by another 50bps in March, above market consensus. Annual inflation increased above market expectations to 7% in February, while GDP growth for Q4 2022 contracted by 1.3% q/q, below market forecasts of a 0.4% fall. South Africa's energy crisis continued to weigh on economic activity and growth forecasts, with Standard & Poor's downgrading the country's sovereign credit rating outlook from 'positive' to 'stable', and the IMF projecting a sharp deterioration in the country's near-term growth outlook. South Africa's manufacturing PMI contracted for the first time this year, with declines recorded across all sub-indexes (business activity, new sales orders, employment and inventories). Mining output also declined, pointing to the twelfth consecutive month of contraction.

Performance review

In a volatile start to the year, sovereign bonds delivered robust performance. US Treasuries experienced their best quarter since the start of the pandemic, closing the quarter at 3.47% (down from 3.92% in February and 3.87% at the end of Q4). Similarly, it was also the best quarter since Q3 2019 for European sovereign bonds, bringing an end to a run of five consecutive quarterly declines. The volatile period was driven by the ebb and flow of expectations for growth, inflation, and the US Federal Reserve's (Fed) policy stance. Initially, it was thought that inflation pressures would ease, helped by falling energy costs, and this would allow the Fed to end its tightening without serious damage to the economy. Data in February suggested otherwise and resulted in market weakness. However, more benign data and the swift response to the collapse of Silicon Valley Bank resulted in bond yields falling rapidly in March and ending the quarter on a positive note.

Locally, the JSE All Bond Index increased by 3.39% over the quarter. The yield curve steepened at the end of March — with front-end yields rallying while yields rose at the longer end of the curve as National Treasury introduced a new 2053 maturity bond. In the money market, one-year fixed-rate negotiable certificates of deposit (NCDs) sold off during the quarter as inflation proved to be sticker than previously anticipated and the SARB hiked by a larger-than-expected 50bps. Cash, as measured by the STeFI Composite Index, delivered +1.75% over the same period. The rand was the second worst performing currency against the US dollar over the quarter. The country was impacted by a spate of bad news since the start of the year, including the greylisting decision by the Financial Action Task Force, a bigger-than-expected contraction in growth in Q4 2022, a higher frequency and intensity of loadshedding, the resignation of the head of energy utility Eskom and S&P lowering the outlook on SA's sovereign rating from positive to stable.

Discovery Life Investment Services (Pty) Ltd, branded as Discovery Invest, is an authorised financial services provider. Company registration number 2007/005969/07.

For the quarter, the Fund outperformed the benchmark.

Key positive contributions:

- Prime-linkers continued to be an effective portfolio hedge during the quarter, with the SARB hiking by a surprising 0.50% at the March MPC meeting
- We selectively extended duration into weakness over the quarter, locking into higher yields
- The portfolio remains invested in floating-rate notes (FRNs) and government asset swaps (ASW) at attractive spreads, and the excess yield over benchmark rates was a positive contributor to performance.

Key negative contributions:

- The market continues to remain long liquidity post the change in the SARB's Monetary Policy implementation policy. Thus, although the repo rate has increased, cash and short-dated instruments continue to weigh on performance at current market levels.

Portfolio activity

We cautiously extended duration slightly over the quarter, but the fund maintained its defensive positioning overall. We will look for further opportunities to increase duration into weakness going forward.

Outlook and strategy

Global

Amid long-standing challenges in the form of persistent geopolitical tension, elevated levels of inflation which saw central banks entering aggressive hiking cycles, the start of 2023 presented another challenge. Financial turmoil erupted late in the first quarter of the year when the collapse of SVB reverberated through markets and revealed additional hidden banking stresses. While the response to SVB was swift, market sentiment remains relatively cautious. Despite interest rates rising sharply in 2022, we are not out of the woods yet. Although some inflation prints in certain regions appear to support the 'peak inflation' narrative, we would like to see a more sustained trend of deceleration. Resilient US economic data further suggests caution in expectations of a pivot in global monetary policy. Across the Atlantic, European data also provided evidence that the economy has been faring better than initially expected. In emerging markets, China continues to be in the early stages of reopening. We expect Beijing to continue rolling out support measures for the economy and the People's Bank of China to keep monetary conditions supportive.

Discovery Life Investment Services (Pty) Ltd, branded as Discovery Invest, is an authorised financial services provider. Company registration number 2007/005969/07.

Local

The intensity and frequency of power blackouts are keeping the SA economy from building any sustained forward momentum. While the National Treasury upwardly revised revenue expectations, spending pressures remain upside risks given low growth and higher public sector wages. On the monetary front, the rand remains susceptible to exogenous shocks and domestic political volatility. We viewed the National Budget as relatively positive with Treasury delivering a formidable balancing act. However, we are cautious given that implementation risk remains. More negatively, the FATF decision to greylist South Africa will be an overhang over the country for the next year or two. With more hikes expected from the Fed, albeit at a slower pace, we expect that the South African Reserve Bank's MPC decisions will continue to be more data dependent. This is reassuring for bond investors as in the shorter term, there could be more volatility to come. The February MPC statement focused on upside inflation risks, higher inflation expectations and currency pressures. Despite these risks, we forecast inflation to return sharply towards 5% in the first quarter of 2024. This forecast takes into account elevated, sticky food and fuel prices, which we are currently experiencing domestically. With the global environment remaining uncertain and a focus on upside risks becoming apparent within the MPC, we believe a further hike in May of 25bps is likely. We remain of the opinion, however, that we are close to the end of the rate hiking cycle and that inflation will begin to fall in the second half of the year. This will be a strong environment for local fixed income assets. The growth outlook for the year ahead will continue to be shaped by developments in the global sphere of influence, developments at Eskom and (more recently) Transnet, and progress on the implementation of structural reforms.

Positioning

Following three months of consecutive declines, headline consumer inflation (CPI) crept above market expectations to 7.0% y/y in February, from 6.9% in January. The main contributor to the annual inflation rate was food and non-alcoholic beverages inflation which reached 13.6% - the highest level since April 2009. The food component remains stubbornly high, our previous analysis suggested a peak in November, however we now expect food inflation to remain elevated in the short-term. While inflation remains above the midpoint of the SARB's 3%–6% target range, core inflation came in at 5.2% y/y in February. The US dollar was stronger over the volatile period, proving negative for the rand.
Inflation remains elevated, although we expect it to moderate over the year. However, the SARB has reiterated its commitment to anchoring inflation expectations around the mid-point of its 3%–6% target range, and as such, we expect that the SARB's decisions will continue to be more data dependent. The SARB expects headline inflation to ease to 6.0% and 4.9% this year and next, respectively. In a similar vein, we expect headline inflation to average 5.83% this year, before easing to 5.0% in 2024. Services inflation in the services sector is mostly unchanged and is still being driven by growing unit labour costs and anticipated spill-over effects.

We remain cautious ahead of the next SARB MPC meeting but will look for opportunities to extend duration into weakness.

Discovery Life Investment Services (Pty) Ltd, branded as Discovery Invest, is an authorised financial services provider. Company registration number 2007/005969/07.