Discovery

Discovery Strategic Bond Fund

Market background

Concerns that the US Federal Reserve (Fed) would continue hiking interest rates for longer weighed on investor sentiment. Minutes from February's Federal Open Market Committee policy meeting indicated the central bank would continue its monetary policy tightening until there was sufficient evidence that inflation was on track towards its 2% target This followed the Fed's decision to increase interest rates by 25 basis points (bps) at the beginning of February, pushing borrowing costs to a range of 4.5% - 4.75%, the highest level since 2007. The likelihood of further rate hikes increased after the core personal consumption price index (PCE), the Fed's preferred measure of inflation, rose by an annualised 4.7% in January, above market expectations of 4.3%. The labour market also showed signs of tightening, with January's unemployment rate falling to an over-five-decade low of 3.4%.

The European Central Bank raised its key interest rate by 50bps to 3.0%. Annual inflation printed marginally higher than initial estimates, increasing to 8.6% y/y. While annual core inflation painted a slightly worse picture, accelerating to a new record high of 5.3% in January. Meanwhile, services PMI in the Euro Area showed signs of improving, advancing to 53.0 in February, buoyed by a resurgence in tourism and media activity. In the UK, sentiment improved on the back of stronger-than-expected economic data. Annual inflation dropped to 10.1% in January, signalling the largest monthly decline since January 2019. The Bank of England raised its key interest rate by 50bps to 4.0%.

In China, a strong run of economic data towards the end of the month helped support financial markets. The People's Bank of China (PBoC) kept its key lending rates steady as widely expected, while annual inflation ticked up marginally to 2.1% y/y, although still below market expectations. On the geopolitical side, tensions between the US and China escalated after the US shot down a suspected Chinese surveillance balloon in US air space. Concerns that China's reopening was faltering were a further drag on the market.

In South Africa, Finance Minister Enoch Godongwana delivered his 2023 Budget Speech where he announced the government's plan to take on R254 billion of Eskom's R423 billion debt over the next three years, and encourage investment in renewable energy projects. The message was well received by investors, given the impact of the energy crisis on the country's growth outlook (estimated to cost South

Africa around R899 million per day). Another positive development was the announcement that bond issuance would not be increased in the coming fiscal year Meanwhile, the Financial Action Task Force (FATF) added South Africa to its greylist over concerns that the country had insufficient controls to adequately deter money laundering and terrorist financing activities. In other news, manufacturing activity contracted in February (PMI fell to 48.8 from a seven-month high of 53 in the previous month). Retail sales fell by an annualised 0.6% y/y in December, below market forecasts of a 0.1% fall, and annual inflation eased for the third straight month to 6.9% y/y in January, largely in line with market expectations.

Performance review

For the month, the portfolio performed in line with the benchmark

After a strong start to the year, February proved to be a mixed month for global financial market returns. The prospect of rising US interest rates and higher inflation weighed on global debt markets, with the yield on the benchmark US 10-year Treasury yield rising 41 bps to close the month at around 3.9%. Similarly, European long-term yields moved higher. The German 10-year bund yield was up by 37 bps to end the month at 2.65%. As with sovereign bonds, it was a rough month for credit bonds in both the US and Europe. Elsewhere, Incoming Bank of Japan (BoJ) Governor Kazuo Ueda stated that the country's trend inflation must heighten significantly for the central bank to consider tightening monetary policy. The governor reiterated that the recent rise in Japan's consumer inflation is driven by cost-push factors rather than strong demand, warranting the BOJ to maintain its ultra-loose policy.
Locally, the JSE All Bond Index declined by 0.87% over the month. The yield curve bear-flattened at the end of February — with front-end yields increasing by a larger magnitude than the longer-end of the curve. The repricing of key central bank hike expectations filtered through to our domestic market. Negative performance was noted across all tenors of the curve, and our positioning, which mostly favours the front-end and the belly of the curve weighed on performance.

Inflation-linked bonds (ILBs) have sold off aggressively in recent months. February was no different, with the asset class delivering a negative return.

The yield-enhancing allocation to investment-grade credit continued to add value.

Outlook and strategy

Global

2022 was a volatile and challenging year for investors. Geopolitical tensions escalated rapidly with Russia's invasion of Ukraine, which sparked a surge in energy prices, record levels of inflation which saw central banks move aggressively to get the inflation genie back in the bottle through rate hikes and quantitative tightening. 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. Across the Atlantic, European data provided evidence that the economy has been faring better than initially expected, while in the US and the UK the reverse was true. The Standard and Poor's (S&P) Global/CIPS Flash United Kingdom (UK) purchasing managers' index sank to a two-year low of 47.8 points in January 2023. The survey results indicated that higher interest rates and low consumer confidence were the main drivers of the sustained downturn in

UK business activity. In emerging markets, China abandoning the restrictive 'zero-COVID' policy continues to provide a modicum of relief for the global growth outlook. We expect Beijing to continue rolling out support measures for the economy and the PBoC to keep monetary conditions supportive.

Local

The intensity and frequency of power blackouts and labour strikes are keeping the SA economy from building any sustained forward momentum. While the National Treasury is banking on better revenues, 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 view the National Budget as relatively positive with National Treasury delivering a formidable balancing act. We welcome the decision on Eskom and the fact that there was no new issuance announced is positive for the bond market. 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 the South African Reserve Bank to keep fighting the erosive power of inflation on household incomes and savings. This is reassuring for bond investors. We do, however, believe the market is overly bearish and thus we expect fewer hikes than what is priced given the downward trend in inflation and the deteriorating growth outlook. The growth outlook for the year ahead will continue to be shaped by developments in the global sphere of influence, Eskom and progress on the implementation of structural reforms.

Positioning

From a positioning perspective, SAGBs remain attractive on valuation grounds, relative to other asset classes in the fixed income universe and relative to their historical record. That said, against the backdrop of higher global inflation, rising interest rates (both locally and globally) and domestic idiosyncratic risk, we remain cautious in our positioning. We reduced duration at the beginning of the month and will look for opportunities to add back duration in market sell-offs. Furthermore, we have some hedges in place to seek to reduce portfolio volatility. We continue to stress the importance of earning yield and protecting capital in this fluid environment.

We sold down ILBs in recent months on the belief that inflation has peaked in SA. ILBs have sold off aggressively in recent months, in February we took advantage of this improvement in valuation to increase our allocation to short-dated ILBs marginally. The asset class has served us well as a hedge for the portfolios. As price momentum has topped, nominals are still poised to outperform ILBs.

Investment-grade credit is a neutral allocation in our portfolios. We maintain a cautious approach to adding yield to the portfolio in a tight spread and tough economic environment. Our bottom-up views remain consistent, with a preference over assets with defensive credit qualities.