Discovery Diversified Income Fund

Market background

US GDP growth accelerated in the final three months of 2021, expanding at an annualised 6.9% quarter on quarter (q/q), far ahead of consensus forecasts of 5.5% and resulting in the best full-year growth figure since 1984. Manufacturing activity remained robust, despite reports of persistent shortages in inputs, with a downwardly revised purchasing managers' index (PMI) reading of 57.7 in December. The labour market continued its recovery, with the figure of 467,000 non-farm payrolls added in January far outpacing economist expectations of 150,000. There was no immediate change to monetary policy announced at the Fed's January meeting, but Chair Jerome Powell clearly guided for a tightening in policy in the coming meetings, with a March lift-off seemingly a 'done deal' at the time of writing.

Europe's economy lost steam in Q4 2021 (0.3% q/q annualised) – the slowest growth in three quarters. The Omicron variant continued to spread across the region and some countries reintroduced restrictions, which negatively impacted the services sector. Demand for labour remained healthy amid the ongoing recovery, as the unemployment rate fell further to 7.0% in December 2021, from a downwardly revised 7.1%. Meanwhile, consumer prices rose 5.0% y/y in December, from 4.9% y/y in November, driven largely by soaring food and energy prices. The European Central Bank (ECB) kept the interest rate policy steady at its December Governing Council (GC) meeting, signalling that rate hikes are unlikely in 2022. Eastern Europe was the centre of attention during the month, as geopolitical tensions intensified between Russia and the West over Ukraine.

In emerging markets, China's economy slowed down further in Q4 as the beleaguered housing sector continued to weigh on activity amid stricter government regulations and an unprecedented liquidity squeeze affecting some major property developers. Consumer-spending growth was also weighed down by Omicron's arrival in several provinces and major cities, compounded further by China's 'zero-COVID' policy, while household income growth has also been muted. China's broader macro policy has shifted over the last few months, with a focus on stabilising growth as headwinds mount; in contrast to much of the rest of the world, the People's Bank of China (PBoC) ramped up its monetary easing efforts in January as it announced a variety of policy rate cuts over the month.

Sentiment on South African factory floors got off to a cheerful start in January, with the monthly manufacturing PMI coming in at 57.1, following moderation at the onset of the Omicron-induced fourth wave of infections in recent months. Consumer prices (CPI) accelerated further to 5.9% y/y in December, from 5.5% in November and above economist expectations of 5.7%. The December print was the biggest rise in inflation since March 2017, stemming largely from food and non-alcoholic beverages and transport costs, amid record increases in the price of fuels. The core inflation rate (which excludes volatile items in the basket such as food, fuel and energy) also rose to its highest since October last year, coming in at 3.4% in December, from 3.3% the previous month. South African Reserve Bank's (SARB) MPC delivered a 25bps rate hike at its January meeting. The central bank also revised lower its growth forecasts for 2021 to 4.8%, down from 5.2% in November.

Performance review

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

Globally, government bond yields climbed with investor attention zeroing in on inflation and quantitative tightening. The yield on US 10-year Treasuries rose to 1.78% at month end, while Europe's benchmark German 10-year bund yield moved into positive territory for the first time since May 2019, ending the month at 0.01%. The Bloomberg Barclays Global Aggregate Bond Index returned -1.8% for the month, outperforming equities, but proving less effective as a safeguard against inflationary risk, while corporate bonds also underperformed government bonds given a widening of spreads as investors' appetite for risk weakened.

Locally, nominal bonds delivered positive performance in line with their equity counterparts. We witnessed the yield curve steepening over the month, and non-residents becoming net buyers of local currency debt. The JSE All Bond Index gained 0.9% for the month. Positive performance was recorded across most tenors of the curve and our positioning helped performance. Bonds remain an important source of income for the funds and continue to contribute positively to returns.

Our allocation to inflation-linked bonds (ILBs), which is biased to the short end of the curve, helped performance and continued to offer protection against rising inflation risks and the asset class remains a diversifier for the portfolios.

Listed property returned to weakness over the month and weighed on performance. Select exposure to high-quality counters did help offset some of the weakness as we continued to opportunistically seize on good opportunities over the period.

The yield-enhancing allocation to corporate paper added to returns.

The FX exposure in the portfolio has helped to cushion some of the impact from rising US yields. The US dollar was the strongest performer among its G10 peers, soaring to an 18-month high during the month. This aided the FX component of the portfolio.

Outlook and strategy

Global

For us, global risks remain a main concern. The deceleration of accommodative policy makes the macroeconomic outlook uncertain. The deluge of monetary and fiscal stimulus saw massive pent-up economic demand run into supply-side shortages, while recoveries in labour markets have put upward pressure on wages. The persistence in red-hot inflation prints have upended the 'transitory' narrative, prompting major central banks to pivot to more hawkish policy stances. The return to conventional monetary policy following more than a decade of quantitative easing in the aftermath of the global financial crisis – may potentially expose markets to significant stresses in the year ahead. For financial market participants, what transpired in January may serve as an opportunity to dig in on the dips, or a harbinger of more ominous risks on the road. The fine balancing act between growth and inflation has become more and more complex and nuanced, given the unique set of circumstances created by the COVID pandemic shock. Unlike the post-GFC era of low inflation and low demand, the question we are faced with as we emerge out of the depths of COVID is whether supply can keep up with demand.

We expect growth to moderate but remain above-trend in 2022 as both fiscal and monetary accommodation is gradually removed. Regionally, US growth will likely remain above-trend on the back of a strong consumer and a good dose of fixed investment spend. Elsewhere, China appears willing to tolerate weaker growth in the near term as it pursues more inclusive and sustainable growth. The 'Zero Covid' policy dampened economic activity more recently, but we expect fiscal and monetary policy to remain reasonably supportive going forward, which alongside pent-up demand, should hold up China's economy and support emerging markets more broadly. The inflation trajectory is likely to get worse before it gets better. Inflation was always going to run hot following the unwind of pent-up demand, desynchronised re-openings, and disrupted supply chains. There remains a divergence in the pace of monetary policy normalisation across major central banks, notably, the Fed (poised for March lift-off), the BoE (on a back-to-back hiking streak) and the ECB (which is likely to kick the can down the road).

Local

While the global story has deteriorated, the local story has improved somewhat and slightly offsets some of the global risks. South Africa's economy impressed with resiliency and a stronger-than-anticipated rebound in the first nine months of 2021, but this momentum was undermined by the Omicron-induced travel bans in the final three months of last year. Looking forward, we expect growth to return to pre-pandemic levels by year-end, notwithstanding a gradual SARB hiking cycle. We expect mining, financial services and agriculture to remain the driving force in the economy, but more worryingly, the labour absorptive sectors of manufacturing and construction sectors, are likely to be hamstrung by never-ending electricity supply issues and a lethargic policy arena. On the fiscal front, more growth would be a welcome reprieve for the public purse. While the October Medium-Term Budget Policy Statement (MTBPS) painted a better picture than was initially feared, we have witnessed some fiscal deterioration in the debt-to-GDP from pre-pandemic levels – South Africa's debt is currently forecast to reach 71% of GDP for the 2021/2022 fiscal year. On balance, the fiscus is better than feared, but we are still on a slippery slope. On the monetary front, the SARB has guided for a gradual normalisation of interest rates from their pandemic lows. We expect another. We expect four more 25bps hikes from the MPC in 2022.

Positioning

South African bonds remain an attractive market for South African investors. Our yields remain not only attractive versus cash and inflation, but relative to our developed markets (DM) and their emerging market (EM) peers – underpinned by a compensating fiscal premium. An investor in South African bonds can earn a yield of around 9.4% (at the time of writing) on a 10-year note – which is well above inflation. The market has run hard in recent weeks and we have slightly reduced duration to the shortest we have been for some time. The portfolios remain well-diversified, alongside an allocation to bond put-options, which offer protection for the portfolios in a hiking cycle and the multitudes of local and global risks.

We believe inflation has peaked. The Fund retains a reasonable allocation to inflation-linked bonds (ILB) as a purely defensive play. ILBs are a good hedge against potential rand depreciation and any inflation surprises. Our exposure maintains a bias to the short-dated instruments which serve as a risk mitigator and diversifier for the portfolios.

As the clouds surrounding fundamentals begin to clear, we have slightly increased the allocation to listed property, tactically seizing on opportunities following the recent sell-off. Notwithstanding, we maintain an exposure less than what would have been the case a few years ago, as the asset class remains highly volatile.

Investment-grade credit is marginally underweight allocation on valuation grounds. Some paper has re-rated and supply-demand dynamics are supportive. We expect demand to remain strong for quality credit assets amid a slowdown in issuance. We have minimal exposure to the cyclical sectors of the economy, maintaining a preference for quality defensives; namely banks, insurers, telecomms and especially government-guaranteed debt, as well as large blue-chip corporates with strong balance sheets.

In portfolios permitting foreign-exchange (FX) exposure, we believe it is prudent to retain a reasonable allocation to a basket of offshore currencies as a risk mitigator during times of rand weakness. We have a mix of US dollar, euro and EM in order to diversify our FX exposure.

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