Discovery Money Market Fund

Market background

The US economy contracted by an annualised 1.6% quarter on quarter (q/q) in Q1. This was the first contraction recorded since the onset of COVID in 2020, coming off the back of record-high inflation, record-breaking trade deficits, protracted supply-chain woes and labour shortages. The manufacturing purchasing managers' index (PMI) slipped further in June to 52.4 (from 59.2 in April and 57 in May), marking the slowest expansion in factory activity in nearly two years. Consumer prices surprised to a four-decade high 8.6% (y/y) in May, breaching 10% for the first time in 40 years. The core personal consumption expenditures price (PCE) index (the US Federal Reserve's (Fed) preferred measure of inflation) rose by 4.9% in April from a year ago. Following the record-high inflation print in the preceding week, the Fed raised the Federal funds target range by 75 basis points (bps) – to 1.5%-1.75% – instead of the expected 50bps that was initially priced in markets. According to Fed Chair Jerome Powell, the US economy remains in "pretty strong shape" and well-positioned to withstand the Fed's hiking cycle.

The eurozone economy grew at an annualised rate 0.6% q/q in Q1, upwardly revised from the initial estimate of 0.3%. Momentum remained weaker over the reporting period, as elevated commodity prices and supply-chain constraints (exacerbated by the war) weighed on industrial production. Manufacturing activity gauges tracked lower over Q2, with the June PMI coming in at 52 points, a 22-month low. The services sector also showed slowing momentum as the cost of living ratcheted up and pent-up demand began to ease. inflation continues to shatter records, with the June inflation print in France the highest since the introduction of the euro. For the area as a whole, expectations are for 6.8% inflation for the year, well beyond the European Central Bank's (ECB's) 2% target, with energy prices accounting for the bulk of the upward pressure. In other developments, the ECB announced plans to create a new tool to support highly indebted member states, given the uneven transmission of monetary policy normalisation.

China's economy lost a lot of ground in the early part of the second quarter on the back of the economically restrictive lockdown measures employed to contain COVID-19 outbreaks. May saw a recovery in momentum, as retail sales, exports, industrial production and fixed investment performed ahead of expectations. The latest data points to a potential bottoming of the economic fallout as authorities begin to roll back lockdown restrictions, but caution is warranted as the impact on activity and supply chains may be felt for some time to come. At the same time, the 'zero-COVID' policy remains in place, thus, the risk of restrictions being reintroduced remains. In a speech in late May, the People's Bank of China (PBoC) Governor Yi Gang promised that policy will in aggregate terms remain "accommodative to support economic recovery." President Xi Jingping also reaffirmed commitments to meet the country's "social and economic development targets for 2022 and minimise the impact of COVID-19" in a keynote address at the virtual BRICS Business Forum on 23 June.

The removal of all lockdown restrictions helped South Africa's growth return to pre-pandemic levels, as the economy expanded 1.9% q/q in the first quarter of 2022. Recent data, however, shows production in mining and manufacturing trending weaker on the back of weather conditions, while the deteriorating supply of electricity is also compounding the weakness. May also saw a decline in trade, which served as additional proof of the consequences of exogenous shocks from around the world, while locally, Eskom's worst rolling power blackouts on record and logistical disruptions at ports only added to the headwinds. Headline inflation printed at 6.5% y/y in May (0.7% m/m), from 5.9% in March and April, breaking through the upper limit of the South African Reserve Bank's (SARB) 3%–6% target band. Core inflation (which excludes volatile items in the basket such as food, fuel and energy) quickened to 4.1% in May, its highest reading since August 2019. In a Bloomberg TV interview at the Sintra Forum, SARB Governor Lesetja Kganyago said a 50bps rate hike in July was "not off the table" despite the bank's baseline scenario of 0.25% hikes at each of the next three meetings.

Performance review

Rather than offer refuge amid equity market weakness, government bonds and credit suffered the same fate as their equity counterparts as investors moved to price in significantly tighter monetary policy on the back of persistently high inflation. US Treasuries lost 4.1% over the quarter, while European sovereign bonds posted their weakest quarter in decades. The Bloomberg Barclays Global Aggregate Bond Index ended the quarter down -8.9%.

Rising fears over the economic outlook, combined with higher US rates, weighed on emerging market debt. The yield on the South African 10-year note rose past 11% for the first time since April 2020 (yields rise as prices fall). In the money market, one-year fixed-rate negotiable certificates of deposit (NCDs) sold off sharply over the quarter by 1.04%% (from 6.4% to 7.44%%), with the SARB hiking rates by 0.50% in May, taking the repo to 4,75% after hiking rates by a cumulative 1.25% since November last year. The 3-month JIBAR kicked higher by 64bps over the quarter. Cash, as measured by the STeFI Composite Index, returned 1.2% over the same period. In currencies, the rand plunged to its weakest level since October 2020 against the greenback, and also lost ground against the euro and pound sterling.
For the quarter, the Fund outperformed the benchmark.

Portfolio activity

We continued to increase exposure to Prime-linked NCDs as a portfolio hedge. The Fund maintained its defensive positioning throughout the quarter.

Outlook and strategy

Global

The global outlook for investors remains incredibly foggy given the interplay of a myriad of factors: COVID-induced lockdowns in China, which have raised the specter of slowing economic growth; a protracted war in Ukraine; and building inflationary pressures. At the same time, monetary policymakers are attempting to engineer a 'soft-ish' economic landing as they withdraw liquidity from the financial system after many years of ultra-loose monetary policy. Inflation remains stubbornly elevated and could force the US Federal Reserve (Fed) to move quicker and more aggressively toward a contractionary policy stance, while attempting to reach a 'neutral' level (the rate of interest at which the economy is neither accelerating nor decelerating). Considering US economic conditions together with market-implied expectations of interest rates and inflation suggests that the Fed will need to tighten more than the market expects. This, however, poses downside risks to GDP later this year. Underlying measures of inflation have also continued to pick up steam, prompting a sense of urgency at the ECB to fast-track the tightening of monetary policy, with the Governing Council turning more hawkish as it prepares to 'front-load' its rate-hiking strategy. For emerging markets, surging inflation and slowing growth is turning the screws on debt-laden low-to-middle income countries, with bond yields shooting up and capital beginning to head for the exits as investors seek safer-havens.

Local

We remain cautiously optimistic on the local outlook. The devasting floods in parts of the KwaZulu-Natal (KZN) Province came at a time when the economy was still emerging from a the COVID pandemic and the violent civil unrest in July of last year. Tragically, the floods led to more than 400 deaths; significant relief efforts will be required to restore public services and business operations and help the thousands left homeless in the aftermath. The impact of the flooding reflected in April's data, which showed the first merchandise trade deficit since the onset of COVID in 2020. We remain equally concerned about a prolonged crisis in Ukraine and sanctions on Russia, the effect this continues to have on oil and food prices, and the associated lingering risks of socioeconomic unrest, which would further dent economic activity. The gradual tightening of monetary policy through higher interest rates adds further stress to the eroding purchasing power of households and workers, especially those on the lower end of the socioeconomic ladder. While the strong run-in commodity prices has kept the proverbial engine running, we cannot rely on this for much longer. Furthermore, the ongoing crisis in energy supply is a major concern for growth and sentiment, adding further stress to the rand. We continue to emphasize that South Africa needs to move the needle on much-needed structural reforms in order to get back on a sustainable growth path.

Positioning

Overall inflation momentum globally remains high. The ongoing conflict in Ukraine and the broadening of price pressures should keep inflation running higher for longer than we would have forecasted before the invasion. While inflation has spread rapidly across the globe, South Africa's inflation rate has been relatively contained. For the first time in nearly two decades, South Africa's inflation is tracking below the global average. However, higher oil prices and supply disruptions sparked by the tragic events in Ukraine have created upward inflationary pressures on the domestic front. Inflation risks are skewed to the upside and some of those risks are beginning to materialize. As such we have recalibrated our inflation forecasts. We have now revised our inflation expectation to a 6.8% y/y average for 2022 from 6.4% and 5.6% for 2023; our core inflation forecast is only 10bps higher at 4.0% y/y average from 3.9% for 2022 and 4.4% for 2023 from 4.3%. Our peak in inflation is now 7.8% y/y in October 2022 from 7.2%y/y previously.

Against a backdrop of higher global and local inflation, the SARB has embarked on a rate-hiking cycle, steadily adjusting monetary policy towards a more neutral setting. As it evaluates how to battle inflation without harming the economy, the SARB will keep a careful eye on inflation factors such as international oil prices, local food prices, and currency movements. We expect the Bank to continue to be data dependent, focusing on second-round effects rather than transient price shocks.

Although we think the short end of the curve remains vulnerable and positioning remains cautious overall, we will look for opportunities to add duration into weakness.