

Discovery Diversified Income Fund

Market background

The quarter began on a positive note as risks facing the global banking sector began to dissipate. Subsequently, the political debate around raising the US debt ceiling (to prevent the US from defaulting on its debt) drove uncertainty, but the deal eventually passed to the relief of market participants. Investors' focus then shifted to global growth dynamics and signals of further rate hikes from key central banks.

The US Federal Reserve (Fed) hiked interest rates by 25 basis points (bps) in May, later signalling that two further hikes are likely to be needed this year. This, combined with data evidencing US economic resilience, caused yields to rise meaningfully across the US Treasury curve. The European Central Bank (ECB) raised its key interest rates by 25bps in May and again in June. President Christine Lagarde noted that the ECB still had more ground to cover and that the central bank would not be pausing its rate-hiking cycle anytime soon. Meanwhile, stubbornly high inflation in the UK prompted a bigger-than-expected hike (50bps) from the Bank of England (BoE) in June and increased the likelihood of rates needing to stay higher for longer. Elsewhere, economic data suggested a tailing off of China's recovery momentum from the first quarter (Q1), ultimately prompting the People's Bank of China (PBoC) to cut two key interest rates.

In South Africa, while load shedding weighed on the economic outlook and prompted warnings from the SARB around its negative impact on growth, the economy managed to grow 0.4% in Q1 2023. During the quarter, the rand reached a new record low against the US dollar on the back of the government's decision to grant diplomatic immunity to participants at the BRICS meeting later this year, which includes Russian President Vladimir Putin. Accusations by the US that the South African government had loaded weapons onto a US-sanctioned vessel while docked in local waters also

weighed on local asset prices. Towards the end of the period, news reports suggested President Putin would no longer attend the BRICS summit, easing some of the geopolitical pressure facing the country.

After the SARB hiked rates by more than expected in March, the central bank governor was more hawkish than expected in his April speech. Earlier in the quarter, inflation proved stickier-than-expected, largely due to elevated food inflation, further fuelling the central bank's hawkish tone. Reflecting concerns over inflation and rand weakness, the SARB increased rates by an additional 50bps in May. Positively, also in May, annual inflation printed lower than expected at 6.3%.

Performance review

For the quarter, the portfolio underperformed the benchmark.

Developed market sovereign bonds struggled after inflation remained stubbornly above target and central banks continued to hike rates. UK gilts fared worse as the market anticipated more aggressive tightening in response to continued upside inflation surprises. Notably, the UK's Consumer Price Index (CPI) reached the highest level among G7 nations. In the US, the turmoil around the US debt ceiling in the first half of the quarter saw the yield of 1-month T-bills soar above 6% at one point. Elsewhere, US investment grade corporate bonds saw prices fall as rates rose. However, this was not the case for European investment grade corporate bonds which eked out a small positive return during the month. With no sign of the BoJ tightening policy yet, the Japanese yen depreciated over the quarter.

Locally, the JSE All Bond Index declined by 1.53%, reflecting a myriad of domestic idiosyncratic risks. Anaemic economic growth, ongoing loadshedding, and reports that South Africa may have supplied weapons to Russia for the war in Ukraine were all headwinds to the domestic market. Some of these losses were offset towards the end of the quarter as domestic assets rallied in response to the reversal in the currency, slight improvement in load shedding and the market's expectation that US inflation has finally peaked and the Fed will pause its hiking cycle. Against this backdrop, negative performance was noted across all term buckets of the curve, weighing on performance. Our positioning in the longer dated bonds managed to minimise the drawdown.

Similarly, inflation-linked bonds (ILBs) delivered negative returns over the quarter, reflecting the slowing inflation rate domestically and some of the idiosyncratic risk.

In a volatile period, listed property managed to deliver a positive return over the quarter. Our select exposure to the asset class contributed to performance.

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

The foreign exchange (FX) component of the portfolio, the bulk of which is in the US dollar, contributed to returns as the greenback strengthened marginally over the quarter. A range of worries - about the US debt ceiling negotiations, the health of banks, and the global economic outlook - contributed to overall dollar strength.

Outlook and strategy

Global

Thus far, the global economy has faced a number of challenges, including persistent geopolitical tension, elevated inflation and the resultant aggressive hiking cycles embarked on by key central banks. The collapse of SVB and Credit Suisse in the first quarter of the year revealed additional hidden banking stresses, and market sentiment remains cautious. While interest rates have risen sharply, we are not out of the woods yet. Although some inflation prints suggest that inflation may be peaking, we need to see a more sustained trend of deceleration before we can be confident. Resilient US economic data further suggests caution in expectations of a pivot in the Fed's monetary policy. Across the Atlantic, European data is coming in weaker than anticipated but sticky core inflation will likely keep the European Central Bank hawkish. In emerging markets, the China reopening story is faltering, but Beijing is expected to continue rolling out support measures and the People's Bank of China is expected to keep monetary policy supportive.

Local

The intensity and frequency of power blackouts are keeping the SA economy from building any sustained forward momentum. Against the current backdrop, National Treasury's revenue expectations appear optimistic. Coupled with expenditure pressures remaining on the upside, the fiscal picture warrants some concern. We will be watching June 2023 corporate tax receipts closely as the figures will give us the first indication of the resiliency of "SA Inc" in light of the sustained headwinds. In terms of issuance, the first South African 7-year floating-rate auction was very well subscribed. In the long term, this suggests that reduced fiscal risk will be priced into the bond market as fewer ultra-long-dated bonds will need to be issued. We expect a strong but volatile environment for local fixed income assets. SA growth is very sensitive to loadshedding; therefore, any improvement should contribute to a better outlook in our GDP numbers.

Turning to monetary policy, the SARB was pre-emptive and started hiking interest rates earlier than developed market peers. The central bank was concerned about rising domestic inflation pressures when CPI was still below 5%. As at May 2023, the central bank had raised interest rates by a cumulative 475bps, to bring the repo rate to 8.25%. The rand remains susceptible to exogenous shocks and domestic political volatility. With a slower pace of hikes by the Fed expected, we anticipate 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. In the short term, the SARB is concerned about inflation, and maintained their substantially higher inflation forecasts at the latest MPC. With the global environment remaining uncertain and a focus on upside risks becoming apparent within the MPC, we believe a further hike of 25bps is likely at the next MPC meeting in July. We remain of the opinion, however, that we are close to the end of the rate hiking cycle and that inflation will continue to fall in the second half of the year.

Positioning

From a positioning perspective, South African government bonds (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 stubborn inflation, rising interest rates (both locally and globally) and domestic idiosyncratic risk, we remain cautious in our positioning. Over the past three months, we reduced duration in periods of extreme volatility on the back of a myriad of domestic risks.

However, we added back some duration into market weakness. We will continue to look for opportunities to add back duration in market selloffs. 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.

Overall, our positioning in ILBs is neutral, favouring short-dated linkers. Inflation had proved stickier than expected and the asset class has served us well as a hedge against this and any rand weakness for the portfolios. However, the portfolio is underweight at the long end of the real yield curve, as we expect inflation to continue to fall in the second half of this year. As price momentum has topped, nominals are still well positioned to outperform ILBs.

As the fundamental picture for listed property has begun to clear, we have increased our allocation to the asset class. The sector remains highly volatile and vulnerable to global and local newsflow, while rising short-term interest rates have also begun to weigh down on many property firms given the reliance on financing for expansions. The deteriorating local growth outlook is an additional headwind on fundamentals going forward. We maintain select exposure and will continue to tactically seize opportunities where we see value.

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.

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