Discovery

Discovery Money Market Fund

Market background

Data on the US economy continued to impress throughout Q1, in spite of a COVID wave, supply-chain entanglements and associated inflationary pressures. GDP grew at an annualised 7% quarter on quarter (q/q) in Q4 2021, revised higher than the initial estimate of +6.9% and in line with consensus expectations. Year to date, manufacturing activity continued to find support in rising demand, and fewer supply-side COVID-related impediments to activity. The US labour-market participation rate has also started to improve, with the jobless rate (down to 3.8% in February) already back at "full-employment/maximum employment". Annual inflation soared to 7.9% in February, the highest print since January 1982 and line with market consensus. The Federal Open Market Committee meeting on 16 March took on a notably aggressive tone as members the delivered the first rate hike in four years, raising the Federal Funds target rate range by 0.25% to 0.50%, and revising sharply higher projections for rate increases this year.

Europe was the centre of attention over Q1 as Russia invaded Ukraine, triggering a raft of sanctions from the West, aimed at isolating Russia's economy from the rest of the world. Europe's economy had already slowed notably in Q4 2021 and is now poised to absorb most of the heavy blows from the ongoing conflict. Given the trade and energy ties to both Russia and Ukraine, the protracted conflict between the two nations has seen the costs of war mount for the region, with consumer prices soaring to a record-high print of 5.9% in February, driven largely by energy. At its 10 March meeting, the European Central Bank (ECB) stuck to its February guidance of 'maximum optionality in the face of maximum uncertainty', on the back of the ongoing crisis in Ukraine, while also announcing the end of the PEPP (Pandemic Emergency Purchase Programme) by the end of March and a faster winding down of quantitative easing under the APP (Asset Purchase Programme) before the year is out.

Following its slowest expansion in nearly two years over Q4 2021, key indicators for January and February showed investment, industrial production and retail sales trending above consensus expectations. This data, however, contrasts with the ongoing challenges in China's property market, the slowdown in credit growth, the disruption to supply chains and the services sector from China's pursuit

of a ‘zero COVID’ policy, and weaker manufacturing PMI data exacerbated by the lockdowns in Shenzhen (world’s fourth busiest container port), Shanghai (China’s biggest city and global financial hub) and Changchun (largest auto manufacturing, R&D hub in China). At its quarterly meeting, the People’s Bank of China (PBoC) reaffirmed that it will continue to ensure reasonably sufficient liquidity and stable credit growth, while the meeting minutes also highlighted a commitment to optimising the monetary policy transmission mechanism (the effectiveness of monetary policy decisions on economic conditions and asset prices).

The South African economy advanced 1.2% q/q in Q4 2021, bouncing back from an upwardly revised 1.7% decline in the preceding quarter, and below consensus forecasts of +1.3%. The Q4 reading translates into a 4.9% expansion for the full year but follows a 6.4% contraction in 2020 during the pandemic nadir. On a more sombre note, the unemployment rate deteriorated further in Q4 2021, climbing to 35.3%, up from 34.9% the preceding quarter. Headline consumer prices (CPI) remained steady at 5.7% y/y in February, unchanged from the month prior and slightly below consensus of 5.8% and did not account for the 7.2% m/m increase in the cost of fuel in March. The South African Reserve Bank (SARB) MPC proceeded with a cautious 25bps hike in the main lending rate at its scheduled 24 March meeting, in line with market expectations. The bank also revised its inflation forecasts higher in light of the recent broad-based build-up in prices, which has been intensified by the Ukraine conflict.

Performance review

Fixed Income markets wrestled with gale-force winds in Q1, which saw government bonds endure a brutal selloff year to date, amid higher inflation expectations and more hawkish central-bank rhetoric in response. The US Treasury yield curve inversion (bond market jargon for the rare occasion when short-term yields surpass long-term yields), occurred on 29 March for the first time since the Sino-American trade spat in 2019, fuelling speculation that the US Federal Reserve’s (Fed) hiking cycle may lead to recession (yield curve inversion is often seen as a harbinger for recession). The Bloomberg Barclays Global Aggregate Bond Index (which measures total returns of sovereign and corporate debt) has thus far capped the biggest drawdown since the Global Financial Crisis and was down 6.2% in US dollar terms over Q1.

Locally, emerging market differentiation from the geopolitical turmoil saw South African bonds and the local currency provide refuge for investors in choppy overseas markets. The local bond market (JSE All Bond Index) capped consecutive months of gains and in dollar terms was the second best-performing among emerging market peers as yields remained attractive to foreign investors. One-year fixed-rate negotiable certificates of deposit (NCD’s) kicked higher over the quarter by 0.97% (from 5.433% to 6.4%), as the market became increasingly concerned about global risks, while domestically moving to price in a higher probability of SARB rate hikes. Cash, as measured by the STeFI Composite Index, returned 1.03% for the quarter. In currencies, the rand was one of the best-performing EM currencies behind the Brazilian real over the quarter, up 9.2% against the US dollar.

For the quarter, the Fund outperformed the benchmark.

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Portfolio activity

We continued to increase exposure to Prime-linked NCDs over the quarter as a portfolio hedge and cautiously added a few selective fixed-rate investments into weakness.

Outlook and strategy

Global

The Russo-Ukrainian crisis is a curve ball which has made an uncertain transition to normalised monetary policy even more murky. The outlook for monetary policy and the ongoing geopolitical turmoil are the key drivers of capital markets at the moment. Yield curves have risen sharply this year on the back of record-high inflation prints. We expect growth to moderate but remain above-trend in 2022, as fiscal and monetary stimuli are gradually phased out. Regionally, US growth will most likely remain above-trend, owing to a strong consumer and a healthy dose of fixed investment spending. Elsewhere, as it pursues more inclusive and sustainable growth, China appears willing to tolerate slower growth in the short term. The 'zero COVID' policy has recently dampened economic activity, but we expect fiscal and monetary policy to remain reasonably supportive in the future and the PBoC has pledged to keep monetary policy flexible and responsive to changes in the economic situation, with the main goal of maintaining stability. This along with pent-up demand, should support China's economy and emerging markets more broadly.

Local

While the global picture 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 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 South African Reserve Bank (SARB) hiking cycle. We expect mining, financial services and agriculture to remain the driving force in the economy. However, the labour absorptive sectors of manufacturing and construction sectors, are likely to be hamstrung by never-ending electricity supply issues and limited progress in policy reforms. On the fiscal front, higher growth would be a welcome reprieve for the public purse. The February budget announcement was supportive of the economy and painted a better picture than was initially feared. That said, flagging state-owned enterprises, rising borrowing costs, a bloated public sector wage bill and lukewarm growth pose downside risks to the fiscal outlook. The debt-to-GDP ratio is expected to stabilise at 75.1% in 2024/25, lower and earlier than the 80.5% projection in the 2021 budget. On the monetary front, the SARB has guided for a gradual normalisation of interest rates from their pandemic lows. We are, however, concerned about a prolonged crisis in Ukraine and the effect it will have on oil and food prices. We will maintain a defensive positioning until we see some positive steps to resolve the conflict.

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Positioning

While inflation spread rapidly across the globe in 2021, South Africa's inflation rate was relatively contained. Besides the resilient rand, the SARB's measured approach to stimulus helped to keep a lid on prices. Nonetheless, South Africa will not be spared from the inflationary pressures stemming from recent geopolitical developments. Despite a pause in the fuel levy announced during the February budget speech, the surge in international oil prices will no doubt be felt in the upcoming fuel price hike in April, and indirectly in food prices. We expect the SARB will likely assess the potential second-round effects and impact on inflation expectations in its policy considerations when looking at the current moves in oil prices stemming from the Russo-Ukraine crisis.

The SARB has indicated that it will gradually normalise interest rates from their low levels. The MPC believes a gradual rise in the repo rate will be enough to anchor inflation expectations and ease the future path of interest rates. We expect three more hikes of 25bps through 2022.

We maintain our cautious approach as the long end of the money market curve remains vulnerable, in our view.

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