Discovery Diversified Income Fund

Market background

The US saw the Delta variant slow consumer spending and economic expansion over the summer months, while inflationary pressures remained at decade highs. Supply constraints have proved much worse than initially anticipated, which has resulted in inflation forecasts being revised higher and growth expectations being lowered. That said, many economists see risks to the economic outlook to be on the upside going forward, once the COVID strain on activity eases. In line with consensus, the Federal Open Market Committee (FOMC) made no changes to monetary policy at its 22 September meeting. US Federal Reserve (Fed) Chair Jerome Powell suggested that the "substantial further progress" test towards the Fed's inflation and employment goals was "all but met" and further progress could see the FOMC announce the start of tapering as soon as November. On the rates front, Powell reiterated the hiking cycle would proceed on a separate timeline, although, it appears that most FOMC participants (9 out of 18) now see rate hikes becoming necessary by next year.

As in the US, the eurozone's manufacturing and services purchasing managers' indicators (PMIs) declined further in September, although the contraction here was a lot sharper as slowing demand growth, supply chain disruptions and rising prices for raw materials continue to weigh on activity. Nonetheless, the bloc's economy looks set to deliver robust growth in Q3 on the back of higher vaccination rates through the summer. The European Central Bank (ECB) announced that favourable financing conditions could be maintained at a 'moderately lower' pace of purchases than the previous two quarters.

In emerging markets (EM), a deepening energy crisis has added further stress to already stretched global supply chains, while an endangered real estate sector on account of Evergrande's (one of China's

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most indebted property developers) inability to make debt payments has added financial stability angst to an already fragile economic recovery in China. The People's Bank of China (PBoC) injected the biggest tranche of short-term liquidity in nearly eight months into the financial system in efforts to calm investor nerves over Evergrande and stem serious contagion to other markets. The confluence of these dynamics and a third straight month of weak data emanating from China has led to various financial entities subsequently lowering China's growth forecasts for 2021.

South Africa's GDP print of 1.2% q/q over 2Q came in ahead of consensus expectations of 0.7%. Exports remained relatively robust, boosted by a reopening of trade markets and a strong commodity price boom which has been a boon for SA's mining sector and agricultural exports. Attention has now shifted to 3Q growth data, which is likely to come in weaker on the back of the July civil unrest and tougher lockdown restrictions amid the third wave of COVID infections. Inflation realized higher than we expected, in August. Headline inflation increased to 4.9% y/y versus 4.6% y/y in July. Transport inflation was the main driver of the increase driven by flight ticket prices. As widely expected, the South African Reserve Bank Monetary Policy Committee unanimously left the benchmark lending rate unchanged at its 23 September policy setting meeting but sounded a slightly more hawkish tone with members now pencilling rate hikes through 2022 and 2023.

Performance review

For the quarter, the portfolio outperformed the benchmark.

Inflation angst and the hawkish pivot by central bankers launched a plunge in prices reminiscent of Q1 2021 (yields rise as prices fall). US Treasuries, which serve as an important indicator for financial markets, saw yields on the 10-year note soar from 1.31% to 1.55% in a matter of days.

Local bonds were buffeted by intensifying inflation worries, negative developments in China, and hawkish guidance from major central banks – bad news for emerging market debt (EMD) and currencies. Foreign investors offloaded even more local debt in September, selling just over R17 billion worth of bonds in the month. We witnessed steepening in the yield curve by the end of the quarter, with the yield on the 10-year note soaring to its highest level since March (yields rise as prices fall). Over the quarter, returns were mostly positive across all tenors. Our positioning across the curve contributed positively to relative performance over the period. Our risk-mitigating bond put options also helped cushion some of the pressure from the selloff.

The allocation to inflation-linked bonds (ILBs), with a bias to shorter-dated instruments, continued to protect the fund from rising inflation risks, with healthy performance seen across the curve. The asset class is an important risk mitigator and diversifier for the portfolios.

Listed property posted a strong quarter amid the reopening trade, despite the REITs coming under pressure during the civil unrest. We continued to tactically add to the asset class and taking profits following good performance, but maintain an underweight position given the volatility in the sector.

The yield-enhancing allocation to corporate paper continued to add value. That said, we maintain an underweight allocation to the asset class amid a tight spread and tough economic climate.

We increased our FX allocation during the quarter, which helped soften the blow from the risk-off trade in September. Inflation concerns and a hawkish Fed provided a fillip to the US dollar as it outperformed its G10 peers, thus advancing the FX component of the portfolio.

Outlook and strategy

Global

The past couple of months have seen the global economy expand at a dizzying pace as industrial activity resumed from COVID-induced re-openings. The recovery has in large part been sustained by the deluge of fiscal stimuli, ultra-loose monetary policy and pent-up consumer savings and demand. Many DM countries have recorded robust growth since the depths of the pandemic, but more recently, growth has moderated somewhat. Rehabilitation going forward is, however, likely to be more measured, desynchronised (given disparity in vaccinations between DM and EM) and restrained by a myriad of risks which have recently conspired to dampen growth forecasts; the outlook for COVID and mutations remains uncertain (Northern Hemisphere entering winter season), ongoing disruption and shortages in supply chains continue to put upward pressure on inflation (exacerbated by the gap in inoculations given the interconnected nature of global value chains, and an energy crisis), weak data and negative newsflow from China represents a real risk for the outlook in emerging markets, the political uncertainty in the US surrounding the debt ceiling pose serious risk of another recession and financial crisis in the world's largest economy.

The path of inflation and monetary policy will be a major focus point for investors in the coming months. While inflation has run hotter for longer than expected, the Fed remains steadfast in its view that these price pressures are transitory. The Fed has also clearly distinguished that 'tapering' of asset purchases is different to 'tightening', the latter only likely to commence in 2023.

In Europe, the ECB maintains that a slower pace of asset purchases does not equate to 'tapering' but rather a 'recalibration' – with a broader recalibration likely to be announced at the December meeting as the ECB seeks to embark on a gradual normalisation process. Elsewhere, the UK is poised to lag other advanced economies such as the US and the euro zone, while a tight labour market and a spike in gas prices are fuelling inflation alongside supply chain disruptions. Pandemic relief measures such as the furlough scheme also expired on 30 September, which are likely to weigh on household finances, leading to weaker consumer confidence and household spending. While the Bank of England (BoE) intimated for the first time that it could raise rates this year still, policymakers face a tough and tricky test of keeping inflation in check without further supressing growth conditions.

In EM, the world's second-largest economy is contending with headwinds from all directions, including Delta-induced restrictions, supply-chain bottlenecks, a global chip shortage, shutdowns at regional ports, skyrocketing commodity prices and an unprecedented regulatory crackdown across various sectors. China serves as a proxy for risk and for EM countries like ours, and as one of the biggest consumers of our commodity basket, we have a general and specific correlation to China. That said, we expect authorities to continue to provide both fiscal and monetary support as evidenced by the PBoC's injection of stimulus amid the Evergrande saga. Other emerging economies unfortunately do not have the luxury of ultra-accommodative monetary policy for much longer, given weaker fiscal metrics and

the need to keep interest rates elevated to compensate investors for the risk taken on. Brazil, Russia, Mexico, Pakistan and Paraguay have begun raising interest rates, while Turkey reversed course recently by slashing rates, although on the back of government pressure.

Local

South Africa's economy has proven more resilient than was initially anticipated at the depths of the pandemic. The second-quarter numbers came in better than expected and recent revisions in South Africa's GDP statistics by StatsSA also indicated that the economy registered 11% more growth in 2020 than previously estimated – which has also improved the debt-to-GDP ratio. The civil unrest back in July threw off momentum in the recovery, and we expect growth to remain lacklustre for the remainder of the year, which means our level of economic output at the end of 2021 will still be below the pre-pandemic level. Local dynamics remain much better than initially feared, but we remain fragile to exogenous risks such as China. Furthermore, the softening in our terms of trade (the relative price of exports to imports) is a concern, although commodity prices are still at higher levels relative to 2019. Notwithstanding, South Africa needs to act more decisively on self-help measures, in particular, we still need to see further traction on structural reforms, as well as infrastructure spending to put us on a more sustainable growth trajectory.

On the monetary front; the SARB was not as trigger-happy on rate cuts in the past 18 months relative to our EM peers and took a more conservative and pragmatic approach. This has allowed them to keep interest rates on hold for longer to support the recovery, while the commodity price boom also helped our terms of trade and local currency amid a contained inflation environment.

Positioning

From a positioning standpoint, we remain cautiously optimistic on EMD and are comfortable to hold South African Government Bonds (SAGBs). South Africa's real interest rates (the interest rates after subtracting inflation) remain not only attractive versus history but relative to the rest of the world, thus making local bond yields attractive to investors. This is underpinned by a supportive global backdrop and a compensating fiscal premium, with fiscal risks still on the radar and major central banks sounding more and more hawkish. With 10-year yields at c.9.5%, the carry trade remains very appealing for domestic sovereigns, although we are mindful that rising yields in the US may start eating away at this in the near term. All that said, we remain cautiously optimistic and overall, we have dialled down our risk appetite. We continue to hold a balance of exposures, with an allocation to bond put-options, which offer protection for the portfolios. Our focus as always, is on more than just returns, but also carefully evaluating the risks and preserving capital.

We believe inflation peaked in May and have since taken some profit in inflation-linked bonds (ILBs). A much slower pace in inflation will undermine the fundamental underpin to the asset class in the short term and we do not see break-even widening following the peak print. ILBs are still a good hedge against potential rand depreciation, especially amid intensifying inflation fears. Our exposure maintains a bias to the short-dated instruments which serve as a risk mitigator.

We maintain an underweight position in listed property, owing to a still uncertain outlook for the domestic economy and company distributions. While we have seen a re-rating in the sector in recent

months, we continue to proceed with caution, tactically seizing opportunities from time to time when we see value.

Investment-grade credit is a neutral 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, real estate, 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. From a portfolio construction perspective, we have accelerated our FX exposure on the back of global developments and market volatility and more specifically, to offset a vulnerable rand. We have a mix of US dollar, euro and EM in order to diversify our FX exposure.

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