Discovery Target Retirement Date Funds

Market background

The third quarter (Q3) was a tale of two halves. The first half, up to mid-August, saw most asset classes rebound from Q2 lows, as investors priced in less aggressive interest rate hikes by the US Federal Reserve (Fed) due to softening economic conditions and a ‘peak inflation’ narrative. However, it was downhill from there. In the end, Q3 was marked by extreme volatility across asset classes and regions, rocked by growing fears of recession, hawkish central bankers, controversial fiscal announcements in the United Kingdom, and a deteriorating energy and geopolitical environment in the greater euro area.

Developed market (DM) stocks (MSCI World Index) fell 6% over the quarter, while emerging markets (MSCI Emerging Markets Index) reflected heavier losses, down 11.4%.

In fixed income, hawkish central bank rhetoric and sticky inflation saw bond markets routed in Q3. US Treasuries fell 4.4% over the quarter, with the yield on the US benchmark 10-year note ending September at 3.83, from 3.01 at the beginning of July. European sovereigns also lost ground, down 5.1%, while a tumultuous week in the UK financial markets in September saw gilts book the worst performance in the quarter as they soared to 14-year highs before the Bank of England stepped in. The Bloomberg Barclays Global Aggregate Bond Index ended the month down 6.9%.
All returns are quoted in US dollars.

South African equities fell in lockstep with their global peers over the quarter. The Capped SWIX 3.8% for the month and 2.4% for Q3 as a whole. At a super-sector level, financials (-4.2%) were the main source of weakness, followed by industrials (-1.3%) and resources (-0.9%). The JSE All Bond Index had a tough month but managed to end the quarter on positive footing, up 0.6%. Listed property (JSE ALPI) extended losses, down 4.1% in Q3. Cash, as measured by the STeFI Composite Index, delivered a 1.4% return over the same period. The rand spent the third quarter on the backfoot, as hawkish rhetoric across major central banks piled pressure on risk assets. The local unit breached R18/US$ for the first time since May 2020.

Performance review

For the quarter, the portfolio delivered a negative absolute return.

Key positive contributions:

- Our local equity exposure to ABSA Group, BHP Group, Glencore and Pepkor contributed to positive returns over the quarter.
- The offshore equity component benefitted from our exposure to Bank Rakyat, HDFC Bank and NextEra Energy.
- Locally, in fixed income, our allocation to SA bonds added to absolute returns.
- The offshore exposure of the Fund benefited from rand weakness over the quarter, while the currency position of short USD bloc economies versus USD also added strongly to absolute returns.

Key negative contributions:

- Within a sea of red in the local market, the allocation to Sasol, MTN Group, Capitec Bank, Kumba Iron Ore and Sappi, in particular, detracted from returns over the quarter.
- There was broad-based weakness across global equity and bond holdings that detracted from overall returns.

Portfolio activity

Following the strong recovery rally in global and local risk assets over July/early August, we took the opportunity to reduce exposure to local equities, global equities and SA bonds during first two weeks of August. All the proceeds were deployed into cash, with half of the local sales being taken to offshore cash.

Within the local equity component, we sold our holding in Mondi, Anheuser-Busch InBev, AngloGold Ashanti and Investec, while also trimming our holdings in Sappi and MTN, as the earnings revisions profile is no longer supportive of these positions. We used the proceeds to top up our holdings in British American Tobacco, Richemont and Bid Corp on share price weakness, where the earnings revisions profiles are stronger. We also trimmed our position in Standard Bank due to the potential earnings revisions risk of their Africa exposure in future and topped up our position in FirstRand with the proceeds. We also initiated a position in Woolworths, where the turnaround in struggling units (SA clothing, Country Road and David Jones) appears to be turning and supporting earnings revisions. In the offshore equity component, we added a new position in Universal Music Group, while taking profits on Procter & Gamble and KLAC on strength during the quarter.

A currency position of long USD/short USD bloc economies (Australia, New Zealand and Canada) was initiated during the quarter. In our view, USD bloc economies face material structural headwinds to growth and inflation given large imbalances within their household sectors and housing markets. It is therefore unlikely that these economies can tolerate interest rates at an elevated level for a long period. At present, there is increasing evidence that housing markets in USD bloc economies are either softening quickly or seeing outright price decline. With structural imbalances beginning to show signs of weakness, we believe now is an appropriate time to implement these positions on a 6 to 12-month investment horizon, as the risk of policy divergence is increasing and slowing global growth has the potential to put downward pressure on commodity prices and terms of trade for these commodity exposed nations.

We took the opportunity to lighten our position in SA bonds by selling across the curve soon after the market peak in mid-August. We also lightened our duration position by not reinvesting coupons.

Outlook and strategy

The ongoing liquidity withdrawal and higher interest rates are likely to impact growth in the coming months and continue to drive volatility in risk assets. To navigate through this, we have an underweight in our overall equity exposure, while the equity selection has a balance of more defensive and select cyclical exposure. Our preference for SA Equity over offshore equity remains, as we believe the valuation support (SA did not enjoy the multiple expansion seen in developed markets), coupled with strong earnings revisions profiles across our holdings, has tilted the portfolio to the domestic market. The offshore stock selection has favoured a larger position in more defensive sectors (healthcare, utilities and real estate) given the earnings risk in cyclical sectors, such as consumer discretionary and industrials.

The local equity composition is well diversified, with increased defensive exposures in our holdings of Naspers and Prosus, British American Tobacco and Bid Corp, where we believe earnings revisions are likely to inflect positively in the second half of the year. This sits alongside a reduced, but still healthy allocation to global cyclical stocks (diversified miners and Richemont) continuing to exhibit favourable earnings revisions profiles. We continue to have a healthy allocation to South African banks (with a preference for ABSA, Nedbank and FirstRand) where earnings revisions remain positive, and valuations are attractive. This sits alongside our exposure to select apparel retailers (The Foschini Group, Pepkor and Mr Price) that display good earnings revisions profiles. Our exposure to local defensive businesses is mainly via Life Healthcare and Shoprite and a reduced exposure to MTN.

The valuation argument for local sovereign bonds still holds and we maintain a large allocation overall. With headline inflation rates peaking, the next few months are critical for global rates.

