

Discovery Diversified Income

31 March 2026

Market background

The start of 2026 was marked by significant volatility across financial markets, with the US Treasury market posting a loss over the quarter. War in the Middle East resulted in a global risk-off move and drove a reversal of expectations around the path of interest rates. Prior to the conflict, stable inflation and an improving jobs market allowed the Federal Reserve (Fed) to keep rates on hold. Yields then declined as AI-disruption fears sparked volatility in equity markets in February and investors sought safety in bond markets. But the oil price shock seen since war broke out has caused an abrupt shift, prompting the Fed to adopt a more hawkish tone and revise up its inflation projections. US Treasury yields ended the quarter higher across the curve, with front-end yields rising more than in longer-dated bonds as markets priced out expectations of rate cuts for 2026.

South Africa entered 2026 on a genuinely positive footing. Local assets were performing well, supported by strong commodity prices, improving fiscal fundamentals, and expectations of further gradual monetary easing. Inflation reached the SARB's new 3% target in February and Finance Minister Godongwana delivered an encouraging budget, projecting narrowing deficits and stabilising debt.

The Iran conflict changed the picture materially. The outbreak of hostilities disrupted global energy markets, which sent oil prices surging. The 10-year government bond yield rose to 9.32% by quarter-end, and the rand closed at R16.94/USD having briefly touched R15.73 in January. The SARB held the repo rate at 6.75% at both its January and March meetings, with the market now pricing in rate hikes on the expectation that the conflict persists.

Performance review

The Fund underperformed the benchmark over the quarter.

Although performance was positive in January and February, supported by our positions in long-dated South African government bonds and listed property, this was more than offset by weaker performance in March. The outbreak of war negatively impacted market sentiment, leading to a rise in long-term bond yields and weighing on the portfolio's return. In response to the increased uncertainty, we introduced greater optionality within the Fund by increasing our foreign exchange exposure, as the need for hedging positions became more apparent. This helped to partially mitigate the risks faced during the period.



Outlook and strategy

The Iran conflict, now entering its second month, has shifted from an emerging risk to an active constraint on the inflation outlook. While a fragile ceasefire agreed in early April has offered some near-term relief, its durability remains uncertain, and oil prices are materially elevated relative to where they began the year. Should hostilities resume or the Strait of Hormuz face renewed disruption, a further energy shock would place significant upward pressure on fuel and food prices, complicating the SARB's path toward reaching its 3% inflation target. We continue to monitor developments closely, as the trajectory of the conflict remains the single most important variable shaping both the domestic inflation outlook and the extent to which the SARB is able to look through the effects of the shock.

Duration

We have a neutral outlook on government bonds and have slightly reduced our duration exposure.

Curve positioning

Having previously been positioned in the long end of the yield curve, we have moderately reduced this exposure as yields have experienced a notable rise in this part of the yield curve.

Currency

We have increased our foreign exchange exposure as the rand has suffered as a result of US dollar strengthening.

Property

The possibility of interest rate hikes is expected to dampen the growth and recovery exhibited in the sector, and we are therefore not adding to our exposure.

Linkers

The upside risk to inflation as a result of the oil price shock and weaker rand bodes well for inflation-linked bonds, and we view the asset class favourably.

Credit

As spreads have tightened, the availability of attractive investment-grade credit opportunities has diminished, and we are being more cautious in terms of where we may add to our exposure.