Discovery Diversified Income Fund

Market background

2020 saw the US economy record its first contraction since the Global Financial Crisis (GFC). Year on year (YoY), GDP shrank 3.5%, capping the worst performance since the year following World War II. The economy slowed from the robust 33.5% seen in the third quarter (Q3), only mustering an annualised 4% growth rate in Q4 against the backdrop of an unrelenting COVID-19 virus which has left the American consumer low on confidence and the labour market in distress. The US Fed Federal Open Market Committee (FOMC) kept the federal funds target range at 0.00% - 0.25% at its January meeting with Chair Jerome Powell quelling fears of tapering and emphasising the need to keep policy supportive until the economy and the labour market recover from the pandemic. Newly minted US Treasury Secretary Janet Yellen struck a dovish tone following her confirmation, calling for the White House to "act big" now in order to avoid long-term "scarring" to the US economy.

The rampant surge in infections across the euro area saw countries such as Germany, France and the Netherlands implement stricter lockdown measures. Meanwhile, the rollout of vaccines has been slow, meaning herd immunity will take much longer, while new mutations have become more virulent, posing risks to the efficacy of current vaccines. The region was also destabilised by political upheaval in Italy and the Netherlands during the month. All the above paints a much weaker outlook for the bloc's economy this year, carrying over into 2022. On the monetary front, the European Central Bank (ECB) Governing Council (GC) kept its policies unchanged, as widely expected. There were no changes to key interest rates, nor the Pandemic Emergency Purchase Programme (PEPP) or the Asset Purchase Programme (APP). ECB President Christine Lagarde noted that while the rollout of vaccines was a positive, the resurgence in cases, new variants, and resulting lockdown measures, and low inflation remain a concern going forward, and the ECB remains committed to reinforce support if need be.

In emerging markets, China's economic recovery switched to a higher gear in January, according to an aggregate index tracked by Bloomberg. This, after registering 2.3% growth in 2020 (the only major country to have grown), driven largely by robust performance from industrial production, an export boom, property investments, a buoyant stock market and government spending, offset slightly by declining retail sales. 2020 saw the country make further inroads into its share of the world economy, with the year expected to see China's economy account for 16.8% of the global economy, up from pre-trade war levels and further growth is expected this year, with consensus in excess of 8%. Coming into the new year, the resurgence in COVID-19 cases and reintroduction of containment measures in January has dampened sentiment, as seen in softer readings of manufacturing and services PMIs, while demand took a harder knock as Beijing clamped down on travel ahead of the February Lunar New Year festival. With the recovery well on track, the People's Bank of China (PBoC) signalled in January that it is mulling rolling back some of the stimulus measures adopted to counter the effects of the pandemic.

Back in South Africa, despite an upward surprise in the manufacturing PMI in January (up to 50.9 from 50.3 in December), this reading still in came in lower than the average recorded over the final three months of 2020. The business activity index meanwhile declined for the fourth straight month as production activity suffered from extended lockdowns and interrupted energy supply from Eskom's load shedding. Headline inflation edged lower in December to 3.1% YoY from 3.2% in November. Core inflation remained steady at 3.3% YoY over the same period; the stronger rand in the second half of 2020 has helped keep inflation muted. The South African Reserve Bank (SARB) Monetary Policy Committee (MPC) opted to keep rates steady at 3.50% p.a. at its scheduled January meeting, with two members voting for a 25 basis-point cut and three members against. The MPC currently views risks to the local growth outlook to be balanced, but noted that constraints to energy supply, subdued investment and uncertainties surrounding the rollout of vaccines pose "serious downside risks to domestic growth". SARB Governor Lesetja Kganyago noted in a Bloomberg interview late in the month that the central bank does have room to provide more stimulus in the event the economy takes another hit from a third wave of coronavirus.

Performance review

For the month, the portfolio outperformed the benchmark.

January witnessed the continuation of positive momentum in financial markets, despite weak economic data and political and social upheaval in the US and Europe. The first half of the month saw a resurgence in infections across regions, reinforced lockdowns, vaccine angst and US treasury yields rising above 1% for the first time since the COVID-19 outbreak, thus fuelling a rally in the dollar - all of this bringing EM currencies under pressure. Risk-on sentiment did, however, receive a shot in the arm in the second half as Joe Biden moved into the White House, while a dovish US Treasury Secretary and US Federal Reserve (Fed) Chair signalled more fiscal and monetary easing on the cards. Against this backdrop, sovereign bonds ended weaker across developed markets, while locally, South Africa benefitted from yield-seeking capital as non-residents continued to be net-buyers of local bonds, albeit at a reduced pace. The bond yield curve saw some flattening over the month as yields on the front end edged higher. The JSE All Bond Index delivered a modest return of 0.71%. Overall, our duration positioning (largely biased to the front and mid-dated area of the curve) was a positive contributor to performance over the month.

Inflation-linked bonds (ILBs) continued their good run of form with a rally across the curve. Our allocation to the asset class (favouring the shorter-dated instruments), added positively to returns.

Listed property pared back gains from prior months, ending the month back in negative territory and our limited exposure here nonetheless weighed on returns over the period.
The yield-enhancing corporate bond allocation added to performance, as did the FX exposure in the portfolio, as the US dollar strengthened against most of its G10 peers.

Outlook and strategy

Global
2020 was a traumatic year and one we would like to forget and put behind us. However, as we enter this new year, investors still face a number of challenges brought about by COVID-19. Although economic forecasts are pointing towards a recovery (the IMF currently projects global growth of 5.5%, 30bps above their previous forecast on the back of vaccinations and additional fiscal support in certain regions), a harsh resurgence of second and third waves of the virus and new more virulent and potentially deadlier mutations – particularly in the northern hemisphere – has led to expanded government support schemes and a reintroduction of lockdowns and social distancing measures. It remains to be seen how long these restrictions will last, and the extent to which economies remain depressed. Turning to markets, risk-on sentiment appears intact. As we embark on post-recession recoveries, we see this period of low-inflation and low rate regime going the distance. We do not believe that governments are about to start lowering spending or raising taxes any time in the near- to -immediate term. In our view, fiscal austerity will only come into play once bond yields begin to shoot up (as vaccines jumpstart the recovery but muted inflation should keep a lid on this) and investors begin to question the sustainability of government debt levels.

Looking ahead, we expect loose monetary policy and a weaker US dollar will remain supportive for emerging market debt (EMD) and should provide cover for EM central bankers to keep rates elevated due to price stability and foreign capital needs. While the greenback has found support from softer equity markets and slow vaccine rollouts, we do not believe US dollar strength will persist and this bodes well for EMD.

Local
South Africa entered the new year on a negative note as second waves of infections forced government to reintroduce an "adjusted Level 3 Lockdown". Compounding an already weak economic environment, power utility Eskom reinstated national rolling power outages during January. President Ramaphosa's linchpin R200 billion loan programme to shore up the economy is on track to only reach 10% of its intended target. The banking association of participating banks cited policy uncertainty and structural inefficiencies as deterrents to business confidence and the primary reasons for the weak demand for credit.

In hindsight, however, it turns out our economy was a lot more resilient that many had expected. While not underplaying the humanitarian and financial turmoil suffered by households and businesses in 2020, overall, from a growth, business, and government revenue perspective, it was not all doom and gloom. We did leave 2020 with some notable positives in our back pocket. We have seen an improvement in mining and manufacturing production data, while PMI data trended in expansionary territory for most of the second half of 2020 and has picked up where it left off in January. We also recorded the largest trade surplus on record for 2020, benefitting from favourable terms of trade as prices of export minerals and metals soared. We witnessed significant progress in certain areas, especially on the corruption front and more traction on 5G spectrum auctions. The Ramaphosa administration has also made strides in restoring capacity and quality of various state institutions. 2020 was also a great year for agriculture, with bumper crops (citrus, maize and wheat) and above-average rainfall. All these proved a powerful mix for the local currency. In the immediate term, the key focus area will be the rollout of the vaccines, while attention will also be focused on the upcoming February Budget announcement (where execution risk still looms large) and some tangible progress on structural reforms.

Positioning

South African Government Bonds remain attractive, not only versus inflation and cash, but also relative to their emerging market (EM) peers – underpinned by a supportive global backdrop and positive local inflation dynamics. Despite the sell-off in in the first week of 2021, yields have nonetheless held firm, and with cash rates so low, SA investors requiring a decent income from their investments are finding attractive real yields in our domestic bond market. We rolled back duration and de-risked the portfolios in the lead up to extended lockdowns and fiscal risks, and thus, we were able to lock in gains following the significant move lower in yields. Our positioning is biased to the front end of the yield curve, which offers attractive returns and is tethered to SARB action relative to long-end tenors, which are more vulnerable to deteriorating fiscal metrics.

We enter this year more constructive inflation-linked bonds (ILBs). We believe the lower trend in inflation has bottomed out and the investment case for the asset class has improved. We are poised to see some carry going forward as inflation ticks higher and real yields across the curve stand to be more attractive relative to 2020. ILBs are still a good hedge against potential rand depreciation and we maintain our short-dated exposure as a risk mitigator.

From a portfolio-construction perspective, we believe our material underweight position in listed property is justified, owing to an extremely cloudy outlook for the domestic economy and company distributions. We maintained low exposure to the sector in the past year, only increasing the allocation to select high-quality names on valuation grounds in the fourth quarter, but have since taken some profits here. Although we are seeing attractive valuations, we believe there are no obvious catalysts in our view that will precipitate a sector re-rating in the near term.

Investment-grade credit is a neutral-to-underweight allocation on valuation grounds. The asset class remains susceptible, in our view, to a sell-off should the pace of economic activity fail to reflate sufficiently, and sovereign credit quality continue to deteriorate. Security selection remains paramount and we continue to look for yield-enhancing opportunities that meet our investment criteria. We have minimal exposure to the cyclical sectors of the economy, maintaining a preference for quality defensives; namely banks, insurers 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 small allocation to a basket of offshore currencies as we believe the US dollar is likely to remain under pressure in 2021 due to negative real rates in the US. With the improvement in our terms of trade, a likely current account surplus for 2020 and central bank largesse globally, we remain underweight in the allocation to FX.

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