Discovery Money Market Fund

Market background

The US Federal Reserve (Fed) closed off the calendar year by raising the fed funds rate by 50 basis points (bps) to 4.25% – 4.5%, largely in line with market expectations and pushing interest rates to their highest levels since 2007. Monetary policymakers signalled that further interest rate hikes would be appropriate as the Fed continues its battle to bring inflation back to within its 2% target. The Fed revised its interest rate forecast higher at its December fixing, with borrowing costs now expected to increase to 5.1% in 2023 before falling to 4.1% in 2024 and 3.1% in 2025. Meanwhile, inflation continued to show signs of cooling despite remaining elevated, slowing to 7.7% year on year (y/y) in October and 7.1% in November. The Fed's preferred measure of inflation (core PCE Index) also eased to a four-month low of 4.7% in November from 5% in October.

Euro Area GDP growth for the third quarter (Q3) was confirmed at an annualised 0.3% q/q, marginally higher than preliminary estimates of a 0.2% expansion. The European Central Bank (ECB) raised interest rates by 75bps in October and 50bps in December, noting that it expects interest rates to rise further following an upward revision to its inflationary outlook. Inflation forecasts show consumer prices increasing by 8.4% in 2022, 6.3% in 2023 and 3.4% in 2024. October saw inflation in the region reaching its highest level, climbing to 10.6% before slowing to 10.1% in November.

In the United Kingdom, growth prospects in the UK remained muted on the back of a tighter labour market, soaring inflation and higher wage growth. Investor sentiment was further dented after final Q3 GDP growth numbers confirmed that the economy had contracted by an annualised 0.3% q/q, more than initial estimates of a 0.2% fall. However, there was some reprieve during the quarter following the appointment of Rishi Sunak as Prime Minister, which saw much of the turmoil caused by his predecessor's proposed economic policies being reversed. The Bank of England (BoE) raised its key interest rate by 50bps to 3.5% in December, just one month after making its single largest hike in 33 years (75bps).

In Asia, the Chinese economy expanded by an annualised 3.9% q/q in Q3, marginally above market forecasts of a 3.5% increase and significantly beating the 2.7% contraction recorded in the previous quarter. Economic activity over the period was buoyed by a series of pro-growth policies and stimulus measures put forward by the government to help revive economic activity, including the partial relaxation of its COVID policies and the further reopening of its economy. The People's Bank of China (PBoC) left its key lending rates unchanged for Q4 as widely expected. Meanwhile, in a move that surprised market participants, the Bank of Japan (BoJ) increased the upper limit of its tolerance band on 10-year government bonds from 0.25% to 0.5%, which saw a sharp rise in Japanese government bond yields. Investors saw the move as a potential precursor to a shift away from the BoJ's ultra-loose monetary policy in 2023.

South Africa's GDP grew by an annualised 1.6% q/q for the third quarter of 2022, well above market forecasts of a 0.6% increase. Eight out of ten economic activity areas expanded over the period, with the agricultural sector making the biggest contribution to growth (+19.2%). Rolling blackouts, however, continued to weigh on the country's economic growth prospects, after Eskom reintroduced Stage 6 load shedding after breakdowns at several of its power-generating units placed additional strain on its already-low diesel reserves. The South African Reserve Bank (SARB) raised its repo rate by 75bps to 7% in November, marking the seventh consecutive rate hike since November 2021. The SARB's decision was widely expected and broadly in line with international economies, as local policymakers continued the battle to bring inflation back to within the SARB's 3-6% target range. Data showed that inflation in South Africa unexpectedly rose to 7.6% in October (from 7.5% a month earlier), before easing to a five-month low of 7.4% in November.

Performance review

In fixed income markets, we saw government bond markets endure some of their steepest falls in 2022 as central banks were caught off guard by soaring inflation, which necessitated aggressive interest rate hiking cycles as a result. US Treasuries posted their worst annual performance on record. For the fourth quarter, performance ended largely flat, after yields rose in December on the likelihood of further interest rate hikes and slower economic growth leading into 2023. The Fed now forecasts the terminal rate to be around 5.10% next year. The yield on the benchmark US 10-year Treasury note closed the quarter at around 3.87 (up from 3.68 in November and 3.83 at the end of Q3). European sovereigns also lost ground, with the 10-year bond yield (AAA- rated composite) climbing to 2.55% at the end of December, compounded by news that the European Central Bank would begin reducing its €5 trillion bond holdings as of March 2023. The Bloomberg Barclays Global Aggregate Bond Index ended the quarter up 4.5%. All returns are quoted in US dollars.

Emerging market debt (EMD) delivered high single-digit returns, helped by a weak US dollar. Whilst the greenback posted its biggest yearly advance since 2015 and was one of the few dependable 'safe havens' for investors during the market mayhem of 2022, the application of a more aggressive monetary policy by central banks in Europe and – more recently – Japan signalled the intention to close the gap with higher US yields, which helped to drive their currencies higher and the US dollar lower. The JSE All Bond Index was among the standout performers across EMD, ending the quarter on a positive footing, up 5.7%. In the money market, one-year fixed-rate negotiable certificates of deposit (NCDs) initially rallied during the quarter before reversing the rally (as the SARB hiked the repo rate by 75bps, with a somewhat more hawkish tone following the MPC meeting and negative political developments earlier in December which unsettled markets) to end the quarter broadly unchanged. Cash, as measured by the STeFI Composite Index, delivered +1.6% over the same period. It was a mixed quarter for the rand, after gaining ground against the US dollar, the local currency was flat against the pound sterling and tracked lower relative to the euro.

For the quarter, the Fund outperformed the benchmark.

Portfolio activity

We added a small amount of duration into weakness during the quarter, but the Fund remains defensively positioned overall. We continued to purchase prime-linked and short-dated instruments to maintain our defensive positioning ahead of the MPC meeting.

Outlook and strategy

Global

2022 was a volatile and challenging year for investors. Geopolitical tensions escalated rapidly with Russia's invasion of Ukraine, which sparked a surge in energy prices, record levels of inflation which saw central banks move aggressively to get the inflation genie back in the bottle through rate hikes and quantitative tightening. Despite interest rates rising sharply in 2022, we are not out of the woods yet. Although some inflation prints in certain regions appear to support the 'peak inflation' narrative, we would like to see a more sustained trend of deceleration. Across the Atlantic, the headwinds have mounted in the euro area (i.e., cost-of-living crisis, soaring energy prices, fragmentation risks) but we still expect the ECB to stay the course on tightening monetary policy. The UK seems to have returned to some semblance of calm following the change in leadership and the adoption of more prudent fiscal policies. The reversal of Kwasi Kwarteng's expansionary budget should see a lower peak in the Bank rate. In emerging markets, China effectively moved away from the restrictive 'zero-COVID' policy (amid growing discontent, which spilled over into unrest), while further support measures for the domestic property sector have provided a modicum of relief for the global growth outlook. We expect Beijing to continue rolling out support measures for the economy and the PBoC to keep monetary conditions supportive.

Local

South African business sentiment fell for a third consecutive quarter in Q4, while consumer confidence remains severely depressed amid rising borrowing costs and elevated inflation. Furthermore, the intensity and frequency of power blackouts and labour strikes are keeping the SA economy from building any sustained forward momentum. While the National Treasury is banking on better revenues, spending pressures remain upside risks given low growth and higher public sector wages. On the monetary front, the rand remains susceptible to exogenous shocks and domestic political volatility. With more hikes expected from the Fed, we expect the SARB to keep fighting the erosive power of inflation on household incomes and savings. We do, however, believe we are approaching the end of the tunnel and the pace of hikes should moderate given the deteriorating growth outlook. The growth outlook for the year ahead will continue to be shaped by developments in the global sphere of influence, Eskom and progress on the implementation of structural reforms.

Positioning

Despite the lower headline inflation print in November, core inflation remained sticky at 5% y/y, marking a 0.1% rise m/m in November (lower than the 0.5% m/m rise in the previous month), and showing an increase in a long list of categories in the consumer basket. The 5% y/y core print remains above the SARB's mid-point range and reflects much stickier underlying prices. Notwithstanding the deceleration in global food prices in November as production levels ramp up and the easing in global supply chains as China reopens, locally, food prices continue to face upward pressures from currency weakness. The weaker exchange rate has also not seen local fuel prices reap the benefit of softening Brent crude oil prices.

Inflation remains elevated, although we expect it to moderate in the coming months. However, the SARB has reiterated its commitment to anchoring inflation expectations around the mid-point of its 3%–6% target range, and as such, we expect the Bank to deliver another hike in the repo rate in Q1'2023. The Bank expects headline inflation to be slightly higher this year and next, at 6.7% and 5.4%, respectively. For 2024 and 2025, the Bank forecasts inflation of 4.5%, respectively. Core inflation remains at 4.3% for 2022 and is higher than anticipated at 5.5% (up from 5.4%) for 2023. 4.8% remains the forecasted value for 2024, while 4.5% is predicted for 2025. Inflation in the services sector is mostly unchanged and is still being driven by growing unit labour costs and anticipated spill-over effects.

We remain cautious ahead of the upcoming SARB MPC meeting, but will look for opportunities to extend duration into weakness.