Discovery Target Retirement Date Funds

Market background

January saw volatility ratchet higher owing to a confluence of slowing earnings; rising inflation and hawkish pivots by major central banks to counter it; and intensifying geopolitical concerns as tensions between Russia and the West over Ukraine continued to escalate.

Global equities posted their weakest monthly performance since the March 2020 nadir, as investors grew wary of rising US interest rates and the sustainability of rich valuations in certain pockets of the market. There was sharp divergence over the month, with growth-oriented sectors coming under pressure from looming liquidity withdrawals and rising interest rates, while higher oil prices and rising government bond yields were a boon for the value segment, with the financials and energy sectors outperforming. Developed market (DM) stocks (MSCI World Index) closed the month down 5.3%, while emerging markets (MSCI Emerging Markets Index) did relatively better, limiting losses to -1.9%. Regionally, we saw US indices post heavy losses, with the S&P 500 down 5.2% for the month, while the tech-heavy NASDAQ suffered even bigger losses, with a -9% return. The Euro Stoxx 600 also lost considerable ground, down 5.2% for the month as investors reassessed their positions amid a higher interest rate outlook and heightened geopolitical tensions in the region. Elsewhere, Asian markets were not spared from the sell-off, with Japan's Topix losing 4.9%, as expectations of rising US interest rates and an Omicron-led spike in COVID infections soured risk sentiment. China's blue-chip CSI 300 Index also ended in the red as the US Federal Reserve's (Fed') hawkish policy tone prompted selling by foreign investors.

In fixed income markets, government bond yields climbed with investor attention zeroing in on inflation and quantitative tightening. The yield on US 10-year Treasuries rose to 1.78% at month end, while Europe's benchmark German 10-year bund yield moved into positive territory for the first time since May 2019, ending the month at 0.01%. The Bloomberg Barclays Global Aggregate Bond Index returned -1.8% for the month, outperforming equities, but proving less effective as a safeguard against inflationary risk, while corporate bonds also underperformed government bonds given a widening of spreads as investors' appetite for risk weakened.

The Bloomberg Commodities Index rose 8.8% over January. Oil had a very strong run (Brent Crude and West Texas Intermediate up 17.3% and 17.2% m-o-m, respectively), while returns were more mixed in industrial metals, with nickel and aluminium showing strength, while copper ended in negative territory.

All returns are quoted in US dollars.

South African equities bucked the trend in global markets, with the benchmark FTSE/JSE All Share Index (ALSI) gaining a modest 0.9% over the month, while the Capped SWIX delivered even stronger gains, up 2.4% over the same period. At a super-sector level, resources (+3.6%) and financials (+2.5%) helped prop up the bourse, while industrials snapped their winning streak, down 1.9% for the month. In yield-oriented assets, the JSE All Bond Index (+0.9%) ended the month higher, with the yield curve steepening over the month and non-residents becoming net buyers of local currency debt. The listed property sector (JSE All Property Index) slid back into negative terrain, losing 2.9% over the month. Cash, as measured by the STeFI Composite Index, returned 0.34%. In currencies, the rand was the best-performing emerging market currency in January, strengthening by around 4% against the US dollar.

Performance review

For the month, the portfolio delivered negative absolute returns.

Key positive contributions:

- On the local front, the allocation to MTN Group, Sasol and ABSA Group contributed strongly to performance over the month. Performance was further enhanced by our exposure to platinum-group metals (PGM) stocks (Impala Platinum and Anglo American Platinum) and diversified miners (Anglo American and BHP Group).
- The offshore equity component benefitted from exposure to financials, which along with energy, were the only sectors that had a positive month.
- The underweight allocation to offshore assets also added to returns during the month on the back of rand strength.
- The allocation to South African government bonds contributed positively over the month.

Key negative contributions:

- Richemont and Sappi came under pressure over the month. Positions in the Naspers-Prosus stable, Netcare and Life Healthcare also weighed on absolute returns.
- In addition to offshore equities having a weak month overall, the strong rand was an additional headwind for offshore earnings.

Portfolio activity

Over the month, within the local equity component, we used the market weakness to add to our overall SA equity exposure in the Fund. We also took profits by trimming our holdings in Richemont and Sasol after a strong run, as well as continuing to trim the exposure to Aspen Pharmacare. Some of the proceeds were used to initiate a position in British American Tobacco, where we feel the earnings revisions, cycle has the potential to inflect positively along with the potential announcement of share buybacks, and the valuation is attractive. We also allocated more capital to Nedbank Group and Investec, where the upside to market consensus forecasts remains positive and the valuations are very attractive. Moreover, we increased the existing position in Sibanye-Stillwater, as the semi-conductor supply chain impacts have started to ease and 2022 will see strong vehicle production given the low inventory levels and strong demand – which will be supportive of the PGM commodity basket.

Earlier in the month, we trimmed the overall offshore equity exposure of the Fund following the strong run in December.

Outlook and strategy

Looking forward, we still expect a strong underlying economic environment in developed markets, and a stable environment in emerging markets. With inflationary pressures and COVID-related economic constraints likely to ease, the macroeconomic backdrop is favourable towards fundamentals. However, the big risk to markets for 2022 is around the persistence of inflation, and the quantum of central banks' policy actions as we start to see balance sheets peak in the second half of the year, and as they start to withdraw liquidity and raise interest rates. The other risk surrounds China, which continues to pursue a medium-term balanced growth policy. While we are seeing signs of policy easing and support, these have been moderate so far.

To navigate through this, we continue to have balanced and diversified exposure across asset classes, geographies, sectors and individual assets. In assessing the environment and making asset allocation decisions, we continue to tilt the portfolio to those asset classes (and underlying assets) that score well in terms of our compelling forces framework: fundamentals, valuations and market price behaviour.

South African equities bucked the trend in global markets, with the benchmark FTSE/JSE All Share Index (ALSI) gaining a modest 0.9% over the month, while the Capped SWIX delivered even stronger gains, up 2.4% over the same period. At a super-sector level, The offshore allocation remains favourably disposed to equities but has been slightly trimmed back earlier in January, with a tilt towards cyclical companies where earnings are recovering, and valuations are reasonable. Allocations to US and European financials, as well as semiconductor companies continue to see upgrades to forecasts as the economic recovery continues to play out. Our exposure to the autos sector will also benefit from easing supply chain constraints over the course of 2022, which will allow them to deliver into the strong demand environment. We also have exposure to high-quality, attractively valued companies with improving operating performance. This includes quality compounders with pricing power or structural winners in healthcare and tech-related sectors. We believe these companies exhibit a long runway for strong, sustainable earnings growth that the market appears to be underestimating.

Regionally, we continue to have a positive skew towards Asia, as Chinese markets continue to exhibit reasonable valuations after the high-risk premium embedded in the stocks post the regulatory crackdown in 2021. We believe earnings have substantial upside over the medium term, in our view. Policy is on an easing path in China versus the US and Europe, where policy is being tightened over the year.

The local equity composition is well diversified, and the portfolio remains tilted towards select cyclical exposures at the expense of more defensive holdings. Our defensive exposure is through the Naspers-Prosus stable, where earnings revisions appear to be troughing and sentiment is weak. We also initiated a position in British American Tobacco. We believe the earnings revisions profile is at an inflection point as the loss-making businesses start to improve, while the business is also in a position to signal potential share buybacks going forward. We continue to trim exposure in Aspen Pharmacare, where we believe the earnings revisions have played out. We boast an allocation to global cyclical stocks (diversified miners, Sappi, Mondi, Sasol and a reducing allocation to luxury goods maker, Richemont) geared to the global economic cycle and continuing to exhibit favourable earnings revisions profiles. Most of the exposures in this bucket are benefitting from tight commodity markets and low inventory levels, in our view. Our allocation to PGM miners (Impala Platinum, Anglo American Platinum and Sibanye-Stillwater) will benefit from the rising global auto production given low inventory levels and strong demand, and hence we believe that the earnings revisions have bottomed. We also continue to have a healthy allocation to SA banks where earnings revisions are strongly positive, and valuations are attractive. This sits alongside our slightly reduced exposure to select apparel retailers, which display good earnings revisions profiles, trading at reasonable valuations. The SA consumer has proven to be more resilient than the market initially feared, but caution is warranted as there is a lack of momentum in the jobs market. Our exposure to local defensive businesses is via MTN Group, Bidvest Group and Life Healthcare. The earnings revisions profile of Life Healthcare appears to have troughed, given an improving occupancy profile into 2022 that results in strong positive operating leverage that the market appears to be underestimating, in our view. However, we have trimmed our exposure to Netcare, as the business continues to battle cost inflation despite efficiency initiatives that have been undertaken and therefore is less likely to participate in the positive operating leverage as occupancies improve into 2022. We also continue to have a position in Shoprite holdings where they continue to take meaningful market share through their Checkers brand, as well as evidence of improved capital allocation by the management team that bodes well for future returns.

We continue to maintain the material allocation to local sovereign bonds, especially within the context of the global fixed income universe. Within fixed income, SA government bonds continue to perform very well, and we believe the high income will continue to buffer the asset class through volatility from global fixed income markets. The South African Reserve Bank will continue its hiking cycle into a normalised neutral rate for South Africa. Growth is likely revert to trend, and we continue to look for signs on investments in the power sector, and consumption supported by a normalisation in employment. While we expect inflation to peak this quarter, we do see some upside risks from second-order effects from oil and electricity prices to core inflation. Overall, we expect a supportive environment for domestic investments.