

Discovery Diversified Income Fund

Market background

The US economy continued to roar ahead in the second quarter (Q2) on the back of fiscal largesse, re-openings and an impressive inoculation programme. The manufacturing and services purchasing managers' indices (PMIs) rose to record levels during the quarter, reflecting record factory activity amid reopening. CPI inflation soared to a 13-year high 5% in May from 4.2% in April and above consensus of 4.7%. The US Federal Reserve's (Fed) preferred inflation measure, the personal-consumption expenditures index (which strips out food and energy), rose to 3.4% in May (3.1% in April) taking it way above the Fed's 2% target, and the highest level since 1992. The Fed view, however, remains one of a temporary push in inflation in 2021 amid the 'restart' but which should fade overtime and settle back to the Fed's 2% target. In line with consensus expectations, the Federal Open Market Committee made no changes to policy at the end of its two-day policy meeting on 16 June.

Europe's impressive turnaround in inoculations is turning up in the economic data as retailers, restaurants, and bars reopen and summer travel resumes. Economist expectations for robust growth this year have improved, with several high-frequency data pointing to a strong rebound in Q2 from a double-dip recession. Earlier in June, the European Central Bank (ECB) raised its growth forecast for the currency area to 4.6% this year, although citing concerns of rising financial stability risks. The ECB's Governing Council meeting on 10 June 2021 was relatively dovish as the pace of quantitative easing was stepped up despite the pickup in activity. The dominant view on the council is that the uptick in inflation will be transitory, while elevated unemployment and a weaker medium-term outlook calls for a continuation in current policy, supported by fiscal support from member states.

In emerging markets (EM), Recent indicators pointed to a more balanced and stabilising Chinese economy, following record growth in the first quarter of this year. The official manufacturing PMI was broadly stable at 50.9 in June from 51.0 in May, but this was the lowest reading since March. The non-manufacturing gauge on the other hand, came weaker than anticipated at 53.5 in June from 55.2 the previous month as the recent spike in COVID cases in some regions and notably, the major economic province of Guangdong, added further pressure on supply bottlenecks. The latest PMI readings have reinforced economist expectations that growth will continue at a healthy clip throughout the year, but at will gradually ease, and thus provide the People's Bank of China (PBoC) enough room to maintain its policy stance.

Back home, The South African economy grew by an annualized 4.6% quarter on quarter in Q1 2021, following a downwardly revised 5.8% in the preceding fourth quarter 2021, and comfortably clearing expectations of 2.5% growth. As per StatsSA, eight of the 10 industries recorded positive growth, with finance, mining and trade industries in particular, doing most of the heavy lifting. Electricity shortages and disruptions to water supplies on the other hand, saw those sectors weigh on growth. Headline inflation soared to a 30-month high in May (largely due to base effects), printing 5.2% from a year earlier, relative to 4.4% in the previous month, taking it well above the midpoint of the South African Reserve Bank's (SARB) 3 – 6% target range. This is, however, expected to be the peak and inflation is likely to moderate going forward. The SARB policy committee unanimously left interest rates unchanged at its 21 May meeting.

Performance review

For the quarter, the portfolio outperformed the benchmark.

Inflation jitters were a source of volatility in bond markets. The Bloomberg Barclays Global Aggregate Bond Index closed the quarter up 1.3%, although with divergence in returns across regions, with UK and US bonds outperforming European sovereigns. The backdrop of low global sovereign yields and rising inflation meant the search for higher yielding assets benefitted emerging market debt over the quarter.

Local bonds soundly outperformed their equity counterparts as the bond market continued to benefit from a supportive mix of external and domestic dynamics, with the downward trend in yields (yields fall as prices rise) sustained across most tenors over the period. Our positioning across the curve contributed positively to relative performance over the period.

The allocation to inflation-linked bonds (ILBs), with a bias to shorter-dated instruments, continued to add to performance, with strong performance seen across the curve.

Listed property posted a strong quarter amid the reopening trade, despite a wobble in May. We continue to tactically add to the asset class but maintain an underweight position given the volatility in the sector.

The yield-enhancing corporate bond allocation added to returns, but we remain roughly neutral the asset class.

We maintained a low allocation to FX as the rand continued to benefit from a very positive terms of trade in South Africa. While the US dollar enjoyed a Fed-inspired rally in June, this was not enough to advance the FX component of the portfolio over the quarter as a whole. We started increasing our FX exposure as SA has outperformed over the quarter and we wanted to protect the portfolio against any risk events.

Outlook and strategy

Global

The global economic recovery (or rather 'restart') from COVID continues apace at least in the global north where countries have managed to vaccinate their populations. Global COVID cases have been on a downward trajectory, notwithstanding some regions such as Latin America, India and recently South Africa, continuing to grapple with a surge in cases and slow vaccinations. A strong global growth outlook (though desynchronized due to COVID and vaccines) is underpinned by the deluge of fiscal stimuli, ultra-loose monetary policy and pent-up consumer savings and demand.

In financial markets, investors continue to tread cautiously, and have become jumpy around any news flow to do with inflation and the Fed, so much that forecasts of rate hikes two years from now is considered 'hawkish'. Bond markets are likely to remain in a state of fluidity throughout this year. We expect volatility to persist in the medium term until this cloudy economic picture begins to clear up on more reliable data. EU Mobility data continues to pick up, as are services PMIs, the Biden administration plans to inject more stimulus in the US economy and the major central banks have stuck to their 'lower for longer' interest rate regime. We believe it will take a lot more to convince central banks to fast-track the normalisation of monetary policy. In the EM space, we expect China to be the twin engine (alongside the US) driving the global and emerging market recovery in 2021 and economic data signals the country is well on track to meet its +6% growth target this year. The PBoC struck an upbeat tone at its quarterly meeting late June, reiterating its stance to maintain policy, liquidity and the exchange rate at current levels – quelling fears of an impending tightening in policy, while also indicating a shift in focus more toward the global policy environment so as to counter exogenous shocks.

Local

We expect the SA economy to bounce back from an extremely low base over the course of this year, with National Treasury pencilling in growth of 3.9%. The SA economy limped along in 2019, and subsequently shrank 7% in 2020 due to the pandemic crisis. We have pencilled in growth of 3.8% this year, but that means our level of economic output at the end of 2021 will still be below the pre-pandemic level. So even though the current growth picture is better than initially feared, the few green shoots are not enough on their own to pull the country out of the economic doldrums. We need to see further traction on reforms, as well as infrastructure spending to put us on a more sustainable growth trajectory. Furthermore, there are prevailing risks which could make our road to recovery a rather bumpy one (including but not limited to; slow vaccine rollout, extended lockdowns, and electricity shortages) but stronger commodity prices and supportive global economic momentum should act as shock absorbers in the coming months. On the monetary front, the SARB MPC assesses risks to growth

and inflation to be balanced, and we believe this allows it further room for rates to remain lower for longer and to adopt a gradual normalisation process.

Positioning

From a positioning standpoint, we remain cautiously optimistic on EMD and are comfortable to hold SAGBs given their attractive yields and the positive momentum from the fiscus. SAGBs remain attractive, not only versus inflation and cash, but also relative to US Treasuries and their EM peers – underpinned by a supportive global backdrop and improving local dynamics. While the fiscal risks persist, the SA economy has proved to be more resilient than initially anticipated at the depths of COVID-19. We expect no further rate cuts from the SARB and began shifting our bond exposure to the longer end of the curve. Inflation remains muted and thus higher-yielding government bonds are attractively valued. Our focus as always, is on more than just returns, but also carefully evaluating the risks and preserving capital.

We started this year more constructive on ILBs. We believe the lower trend for inflation has bottomed out and the investment case for this asset class has improved. ILBs are still a good hedge against potential rand depreciation and we maintain our short-dated exposure as a risk mitigator. We started to trim our exposure in the second quarter with inflation likely to peak in June.

We maintain an underweight position in listed property, owing to an extremely cloudy outlook for the domestic economy and company distributions. We remain cautious in this sector based on fundamentals, but we continue to tactically seize on opportunities from time to time when we see value. We increased exposure after the sell-off in May.

Investment-grade credit is a roughly neutral allocation on valuation grounds. Some paper has re-rated and supply-demand dynamics are supportive. We expect demand to remain strong for quality credit assets amid a slowdown in issuance. We have minimal exposure to the cyclical sectors of the economy, maintaining a preference for quality defensives; namely banks, insurers, real estate, telecomms 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 reasonable allocation to a basket of offshore currencies. With the improvement in our terms of trade, strong current account metrics and central bank largesse globally, we remain underweight in the allocation to FX. We have a mix of US dollar, euro and EM in order to diversify our FX exposure.

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