Discovery Diversified Income

30 June 2026

Market background

South African markets navigated a volatile second quarter, with the Middle East conflict the dominant driver across asset classes. The shock was transmitted primarily through commodity prices, particularly oil and gas, and bond yields, with the quarter's final moves reversing materially from those at its peak.

Turning to monetary policy, the SARB raised the repo rate by 25 basis points to 7% at its May meeting. The decision was driven primarily by headline CPI moving toward the upper end of the target band and concerns over potential second-round inflation effects stemming from the energy shock.

Domestic bonds sold off sharply mid-quarter in response to rising inflation expectations and geopolitical uncertainty, before recovering strongly as ceasefire negotiations progressed, leaving the ALBI in positive territory for the full period. The macro backdrop provided further support: GDP growth in the first quarter came in ahead of expectations, and South Africa received sovereign credit rating upgrades from both Moody's and Fitch during the quarter.

The rand initially depreciated in response to the terms-of-trade shock, but recovered as conditions stabilised. The fall was relatively well contained, with the local currency managing to retrace much of the sell-off by quarter-end as the country's terms-of-trade position improved.

Looking ahead, the key variable is the inflation trajectory. Having demonstrated a willingness to hike pre-emptively, the SARB's next move will be sensitive to incoming inflation data, with the balance of risks dependent on whether the energy price shock proves transitory or embeds more broadly into domestic prices.

Performance review

The portfolio outperformed its benchmark over the quarter.

After a very negative end to the first quarter, performance was supported by a recovery in global risk assets. The portfolio's bond position, property allocation, and positioning at the longer end of the curve were all additive to performance.

Towards the end of the quarter, we added to government bond duration in response to declining uncertainty around global energy supply chains and the positive supply outlook for the bond market over the next quarter.

We maintain our allocation to inflation-linked bonds, given the additional risks to inflation beyond energy. We also continue to hold below neutral dollar exposure in the portfolio, with terms of trade expected to continue to recover on the back of lower oil prices.

Outlook and strategy

As transport through the Strait of Hormuz normalises, we no longer view elevated oil prices as a significant risk to the inflation outlook. Nevertheless, inflation risks remain: core services are experiencing upside pressure, and on a forward-looking basis, food inflation presents some upside risk to our inflation outlook. With the second-quarter inflation expectations survey moving meaningfully higher, we expect the SARB to remain on the hawkish side and focus on bringing those expectations lower.

Stripping out the fuel levy relief provided by National Treasury to offset the significant increases in petrol prices over the second quarter, revenues are performing extremely well and are ahead of expectations, with both VAT and personal income tax contributing to the overrun. The June data, when available, will provide a clearer picture of whether corporate tax revenues are beginning to reflect the precious metals windfall from the second half of last year. This could be an important driver of fiscal outperformance over the course of the fiscal year.

In addition, the next two to three months will be supportive from a coupon-flow perspective, which should provide some support to the South African government bond market.

Duration
We added back duration towards the end of the quarter, bringing our position to marginally above neutral.

Curve positioning
We prefer the ten-year area of the yield curve. In our view, there is no significant premium to justify moving materially longer. We remain neutral in the 20- to 30-year area, and continue to avoid the front end given the inflation risks on the horizon.

Currency
We reduced US dollar exposure and are now sitting below neutral. Declining oil prices and improving global risk sentiment have been more supportive for the rand.

Property
There have been no changes to our property exposure.

Linkers
We maintained our exposure to short-dated linkers as a hedge against upside inflation risk.

Credit
We have switched a portion of local South African credit into short-dated developed-market investment-grade corporate bonds, which offer a significant yield enhancement relative to lower-rated credit in the South African market.