

Discovery Diversified Income Fund

Market background

The US economic revival is running full steam ahead on the back of a consumer turbocharged by the US government's fiscal largesse, re-openings and an impressive inoculation programme. The manufacturing and services purchasing managers' indices (PMIs) rose to their highest levels on record in May. However, while consumer demand has bounced back strongly, the speed of the rebound has not all been good news, with production constraints being further compounded by severe supply-chain disruptions and businesses facing rapidly rising input costs. CPI inflation printed 4.2% in April 2021, from 2.6% in March. The Fed's preferred inflation measure, the personal-consumption expenditures index (which strips out food and energy), rose to 3.1% in April, way above the Fed's 2% target, and the highest level since the 90s. The US Federal Reserve (Fed), however, continued to downplay these prints as due to "transitory factors" which are likely to dissipate later in the year. However, some murmurs from certain officials in recent weeks suggest the Federal Open Market Committee is inching ever closer to commencing discussions on when to begin tapering.

Across the Atlantic, the prospect for robust growth this year have improved, as several high-frequency data pointed to a strong rebound in Q2 from a double-dip recession, with consumer spending on travel, leisure and entertainment bouncing back as vaccinations rise and infections trend lower. The region's PMIs maintained their positive momentum from the previous month. The manufacturing PMI has been on an upward trajectory since last year, but the services PMI was largely held back during this period owing to persisting lockdown restrictions and a lethargic start to vaccinations. Improvements on these fronts has since lifted the services PMI to its strongest pace of expansion since June 2018, with a reading of 55.2 in May. The ECB remained upbeat in the economic outlook for the bloc, despite citing concerns of rising financial stability risks posed asset bubbles.

In emerging markets (EM), China's economy cooled down in April as retail sales missed consensus expectations. Incoming data revealed flat domestic consumer spending data, while fixed investment spending and industrial production were a beat on expectations. The latter rose at a slower pace in April at +9.8% on year from 14.1% in March. Fixed investment also moderated from the previous period, while retail sales, (a key measure of domestic consumption) also disappointed, up 17.7% y/y in April from a height of 34.2% in March, well short of consensus. Retail sales were of disappointment to policymakers, who continue to monitor the data as China pivot towards a consumption-driven economy and one less dependent on manufacturing and exports. The manufacturing PMI held steady in May as soaring input prices weighed on smaller businesses, while the commodity price boom has also dragged on the profitability of those firms reliant on raw materials.

Back in South Africa, incoming data points to a modest expansion of the SA economy over Q1 2021. South Africa recorded its twelfth consecutive trade surplus April, aided by robust prices in precious metals exports and also reflecting weakness in imports demand. Manufacturing and mining production (which make up circa a third of GDP) and retail sales rose in Q1 relative to 4Q 2020. The manufacturing PMI continued to track above the expansionary 50 mark, rising to 57.8 in May from 56.2 in April. In labour markets, the official unemployment rate rose 32.6% in the first three months ending March 2021 – the highest jobless rate since the introduction of the Quarterly Labour Force Survey back in 2008. Headline inflation (4.4% y/y, from 3.2% in March) rose to a 14-month high in April, fuelled largely by rising food inflation and transport prices. The acceleration in prices was very much expected given the rise in international oil prices in recent months and we expect this upward pressure to continue as oil prices average higher, while locally, electricity prices are due to get a jolt in July. The South African Reserve Bank's (SARB) policy committee unanimously left interest rates unchanged at its 21 May meeting.

Performance review

For the month, the portfolio outperformed the benchmark.

Globally, was another reasonable month in bond markets, despite inflation jitters that continued to fuel volatility over the period. The Bloomberg Barclays Global Aggregate Bond Index recorded its second straight month of positive gains, up 1.1% for the period, with UK and US bonds outperforming European sovereigns. Local bonds continued to find support from a supportive external backdrop and positive domestic dynamics, with yields edging lower (yields fall as prices rise) across most tenors in the wake of the reduction in issuance which was met with sufficient demand. The JSE All Bond Index (+3.7%) outperformed equities for the second consecutive month, as foreigners turned net buyers of local bonds over the period. Our positioning across the curve contributed positively to relative performance over the period.

Our allocation to inflation-linked bonds (ILBs), with a bias to shorter-dated instruments, added to performance on the back of strong performance across the curve.

Listed property weighed on performance as the sector came off the boil during the month, paring back stellar gains from the month prior. We continue to tactically add to the asset class but maintain an underweight position.

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 continues to benefit from a very positive terms of trade in South Africa. The US dollar weakened against a basket of its trade partners over the month, which saw the FX component slightly weigh on performance.

Outlook and strategy

Global

Investors continue to tread cautiously, and markets have become jumpy surrounding any news flow to do with inflation and the Fed. Bond markets are likely to remain in a state of uncertainty throughout this year. We expect volatility to persist in the medium term until this cloudy economic picture begins to clear up on more 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 mantra of 'lower for longer'. In the EM space, we expect China to be the twin engine (alongside the US) driving the global and emerging market recovery in 2021 as it emerges from the depths of COVID-induced lockdowns. The recent GDP print signals the country is well on track to meet its +6% growth target this year.

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 expect the economy to grow by 3.8% this year, but that still means that 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 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 reforms, as well as infrastructure spending to change the 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, renewed lockdowns, electricity shortages) but stronger commodity prices and supportive global economic momentum should act as shock absorbers in the coming months.

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, there are early signs that the SA economy has proven to be more resilient than anticipated at the depths of COVID-19. We now expect no further rate cuts from the South African Reserve Bank (SARB) and have thus started 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 inflation-linked bonds (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 will be looking to trim down on our exposure over 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 have increased our exposure after the sell-off in the asset class last month.

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 small 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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