

## *Discovery Money Market Fund*

### Market background

The US economy continued to march forth over the first quarter (Q1); supported by rapid vaccinations, the rollback of restrictions on businesses, pent-up savings by American households, and massive injections of fiscal stimulus by the Biden administration. The U.S Labour Department delivered a blockbuster jobs report showing robust hiring in the final month of Q1, with businesses adding 916,000 jobs (the most in seven months) and smashing consensus expectations of 647,000. U.S Federal Chair Jerome Powell noted that hiring is likely to pick up in the coming months, although the economy remains a long way from reaching full employment. The Fed's policy committee kept short-term interest rates and the pace of its asset purchases unchanged, while upwardly revising its growth forecasts for 2021 to 6.5% from 4.2% in December – reflecting the better-than-anticipated pace of vaccinations and impact of the incoming US\$1.9 trillion American Rescue Plan.

The euro area's dominant services sector continued to struggle under lockdown conditions, held back by the continued spread of the virus across the region. On a more positive note, the manufacturing PMI rose to its highest level since record keeping began in 1997, with the March reading coming in at 62.5 in March 2021, well ahead of February's 57.9 reading. Incoming data suggests the euro economy is, however, tracking ahead of economist expectations in March, owing to the solid surprise in manufacturing output. That said, economists do not expect this robust PMI data to prevent the eurozone economy from posting its second consecutive contraction in Q1 (given the impact of tighter and extended social restrictions), which will see it slip into a technical recession. In light of this background, the European Central Bank (ECB) maintained its stance on combatting any tightening in financial conditions as it front-loaded its bond-buying programme to stave off the contagion of the debt selloff from across the Atlantic. In a divergence from the UK and US, the ECB is the only major central bank that committed to pushing back against rising bond yields.

In emerging markets (EM), China's economy gathered pace in March as the industrial, construction and services sectors improved following the Lunar New Year holidays on account of strong domestic and external demand. The country's industrial production is 35.1% higher from the previous year, reflecting robust expansion in China's industrial economy. This strong showing is predicated on solid export activity, fiscal aid and China's excellent record in keeping the coronavirus at bay. The official manufacturing PMI rose to 51.9 in March after edging lower to 50.6 in February. The non-manufacturing PMI (which comprises services and construction) also ticked higher to 56.3, marking the highest reading since November 2020. Overall, the upbeat economic trajectory has given Beijing and the People's Bank of China (PBoC) more room to pull back the massive injection of stimulus since the advent of COVID, as it pursues its agenda of to rein in debt and the risk of asset bubbles. The PBoC reiterated at its scheduled quarterly meeting in March that it intends to maintain monetary policy flexible and respond appropriately to changing dynamics.

Back home, the South African Reserve Bank (SARB) policy committee unanimously voted to keep the repo rate unchanged at 3.5% p.a. at its scheduled March meeting. This was a change in the voting pattern from the previous four meetings where two members out of the five had been voting for a 25bps cut. The Monetary Policy Committee (MPC) assesses risks to growth and inflation to be balanced, which allows it further room for rates to remain lower for longer and to adopt a gradual normalisation process. On the fiscal front, the February budget balance was a positive surprise both from a spending and revenue perspective, which should also provide temporary relief on the ratings front, pending the implementation of growth-additive reforms. Tax collections continue to surprise on the upside as the SA economy shows it is slightly more robust than feared. This will result in an improvement in our fiscal metrics.

## Performance review

Q1 was largely a continuation of risk-on sentiment in financial markets. For risk assets in particular, equities continued to benefit from the large-scale and rapid rollout of vaccines across regions and positive economic data coming out of China and the US, which reinforced the theme that the global economic recovery (albeit desynchronised due to vaccination disparity) is gathering pace. On the other hand, Q1 did government bonds no favours, with the US 10-year Treasury yield shooting up 0.836% over the quarter (yields rise as prices fall), the largest such rise since late 2016, as investors continued to offload bonds in anticipation of a robust global economic recovery and associated pickup in inflation. The sell-off contagion spread to other markets and brought considerable pressure to bear on emerging market debt (EMD) and currencies. The JSE All Bond Index (-1.7%) enjoyed a good start to the year but came under immense pressure as rising US Treasury yields saw some profit-taking in the domestic bond market, triggering large outflows by non-residents. One-year fixed-rate negotiable certificates of deposit (NCD's) sold off 58 basis points (from 4.04% to 4.62%) as the market started to price in rate hikes on the back of global reflation concerns. We allowed duration to roll-in over the quarter and were thus reasonably well positioned for the move, only selectively adding duration in Government Treasury Bills where there was value. Cash, as measured by the STeFI Composite Index, remained broadly stable, returning 0.9% for the quarter. In currencies, the rand traded weaker against the greenback and British pound but firmed against the euro.

For the quarter, the portfolio outperformed the benchmark.

## Portfolio activity

Over the quarter, we continued to add exposure to Government Treasury Bills and debentures (which are attractive relative to bank NCDs).

## Outlook and strategy

### Global

As we embark on post-recession recoveries, we believe this period of below-target inflation and low interest rates still has some legs to go before policymakers begin to 'normalize' policy. Similarly, we do not believe that governments are about to start lowering spending or raising taxes any time in the near- to -immediate term. In the EM space, we expect to see strong growth in China in 2021 as the global economy emerges from the depths of COVID-induced lockdowns. The rise in bond yields poses risks for EMs which have large foreign financing needs (e.g. Turkey) and adds pressure on these countries to tighten rates. Any sustained rise in local currency debt yields would certainly make life uncomfortable for central bankers in EMs such as Brazil and South Africa. Brazil and South Africa are examples of two EMs where given their high levels of debt, have already had to resort to austerity measures in order to stabilise their debt profiles (read our latest insights on SA's debt sustainability [here](#)).

Looking ahead, we expect a robust recovery-led inflation push in certain pockets of the economy (e.g. manufacturing and commodities). Inflationary pressure will be more intense in the US (which is already at an advanced stage of its recovery and about to receive another shot of stimulus) but more fleeting in the euro area. Furthermore, the Fed's average inflation targeting will allow it room to let CPI run hot for a sustained period before beginning to message any tightening to markets. We believe consolidation of Treasury yields at current levels and accommodative monetary policy alongside moderation in dollar strength should provide decent support for EMD and offer enough shade for EM central bankers to keep rates elevated due to price stability and foreign capital needs.

### Local

This positive global backdrop remains supportive for South Africa's economic recovery. Recent announcements by the government of new acquisitions of vaccines in the pipeline (albeit not at the pace in the global north) alongside a positive surprise in the national budget announcement back in February, have improved the rather gloomy picture we had coming into 2021. Macroeconomic news flow has undoubtedly been incrementally positive. Tax collection exceeded National Treasury's forecasts for the first time in five years, while we also recorded the largest trade surplus on record for 2020, benefitting from favourable terms of trade (the relative price of exports to imports) on account of robust export minerals and metals prices and the weakness in international oil prices. Incoming data further suggests GDP is likely to continue to recover from here and the continued rollout of vaccines and policy support should provide the tailwinds for economic activity going forward. The IMF has upgraded South Africa's growth to realise 3.1% in 2021, up from 2.8% in January.

On the fiscal front, the key now is whether the rest of Cabinet will adhere to the positive budget tabled by National Treasury in February. Even with the wage restraint, the budget is a necessary though insufficient solution to South Africa's debt problem. The public sector wage bill remains a risk to the fiscus and we will be watching developments around the negotiations later in the year.

That said, stimulating growth remains the most important factor to get the country back on track. Weak growth is the root of SA's problems. Since 2009, South Africa has experienced slower growth than all major emerging market countries that form part of key indices such as the JP Morgan GBI-EM and Citibank WGBI indices. The solution is to dramatically boost investor expectations of future growth while at the same time curtailing government spending. The SARB has aggressively cut interest rates to help stimulate the economy and we now need meaningful structural reforms around electricity production and spectrum availability to ensure growth can become sustainable.

#### Positioning

South Africa's manufacturing PMI readings have edged higher in the past three months with the March reading of 57.4, the fastest pace of expansion on the factory floor since October 2020. Headline inflation slowed to 2.9% in February of 2021 from 3.2% in January, below market expectations of 3.1% and below the South African Reserve Bank's (SARB) target range of 3-6%. The reading was the lowest since June 2020 as food & non-alcoholic beverage inflation moderated. Core CPI slowed to 2.6% from 3.3 the prior month.

While the fiscal risks remain elevated, the SA economy has proven to be more resilient than we anticipated at the heights of COVID, government revenues have surprised positively, as discussed above, the currency remains supported by our terms of trade and has shown a surprising resilience we have not seen in recent memory. The SARB is now on pause and we expect them to keep rates lower for longer with a slow normalisation.

The SARB upwardly revised their 2021 inflation forecasts to 4.3% (from 4.0%), 2022 has come down from the previous forecast of 4.5% to 4.4% and 2023 is 4.5%. We believe inflation remains under control and our revised 2021 forecast sees prices averaging lower than the SARB's at 4.1%, while 2022 and 2023 are in line with the SARB at 4.4% and 4.5%, respectively.

We remain cautious, given the volatility we have seen in the short end of the market, both globally and domestically. A lot of the froth has now been priced out of short ends and valuations are more reasonable. We will continue to look for opportunities.

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