Discovery

Discovery Diversified Income Fund

Market background

Looking back at the first quarter of the year (Q1), January saw global equity and fixed income markets enjoy a firm start, as declining inflationary pressures across key economies fuelled optimism that central banks were approaching the end of their rate-hiking cycles. Sentiment reversed somewhat in February, with stickier inflation prints and a more resilient labour market in the US sparking concerns that rates would remain higher for longer. In March, after the initial wobble around financial sector concerns, growth stocks rallied on the back of falling bond yields, which helped global financial markets close Q1 firmer.

The US Federal Reserve (Fed) raised its key interest rate by 25 basis points (bps) in March, pushing borrowing costs to their highest levels since 2007. The decision came against the backdrop of the second-largest bank failure in the US, sparking liquidity concerns in the banking sector – more specifically, around the sector's ability to absorb further rate hikes. The Fed restored calm to the markets, reiterating the sector's resilience and justifying the need for further rate increases. Subsequently, however, signs of easing inflation raised hopes that the Fed may begin to slow the pace of its interest rate hikes sooner than expected. February's data showed annual inflation slowing to 6% year-on-year (y/y), while Core PCE (the Fed's preferred gauge to measure inflation) fell to 4.6% y/y. In the labour market, February's non-farm payrolls increased by a stronger-than-expected 311,000, while the average hourly earnings for non-farm payrolls rose only 0.2% month-on-month (m/m), indicating a deceleration in wage pressures.

In the UK, the Bank of England (BoE) raised its key bank rate by 25bps in March, in line with market expectations. Policymakers signalled that inflation was likely to fall during the year, but warned that further tightening would be required if pressures continued to persist. Turning to the Euro Area, the European Central Bank (ECB) raised its key interest rate by 50bps in March as expected. Consumer price inflation softened to 8.5% y/y in February, still well above the ECB's 2.0% target, while the core inflation rose to a fresh record high of 5.6%. Eurozone GDP growth stalled in Q4, weighed down by contractions in Germany and Italy.

The People's Bank of China (PBoC) kept its key lending rates steady in March and cut the reserve requirement ratio for financial institutions by 25bps. Following the relaxation of the country's COVID policy last year, the economy continued to show signs of recovery, while inflation has remained surprisingly low. China's annual inflation rate fell to 1.0% y/y in February from 2.1% in the prior month, marking the lowest reading in a year. Manufacturing activity expanded in February, while non-manufacturing PMI surged to its highest reading since 2011. General Services PMI also advanced, expanding for the fourth consecutive month, with new export growth hitting a three-year high.

The South African Reserve Bank (SARB) hiked its benchmark repo rate by 25bps in January and then by another 50bps in March, above market consensus. Annual inflation increased above market expectations to 7% in February, while GDP growth for Q4 2022 contracted by 1.3% q/q, below market forecasts of a 0.4% fall. South Africa's energy crisis continued to weigh on economic activity and growth forecasts, with Standard & Poor's downgrading the country's sovereign credit rating outlook from 'positive' to 'stable', and the IMF projecting a sharp deterioration in the country's near-term growth outlook. South Africa's manufacturing PMI contracted for the first time this year, with declines recorded across all sub-indexes (business activity, new sales orders, employment and inventories). Mining output also declined, pointing to the twelfth consecutive month of contraction.

Performance review

For the quarter, the portfolio outperformed the benchmark.

In a volatile start to the year, sovereign bonds saw a solid start to the year. US Treasuries experienced their best quarter since the start of the pandemic, closing the quarter at 3.47% (down from 3.92% in February and 3.87% at the end of Q4). Similarly, it was also the best quarter since Q3 2019 for European sovereign bonds, bringing an end to a run of five consecutive quarterly declines. The volatile period was driven by the ebb and flow of expectations for growth, inflation, and the US Federal Reserve's (Fed) policy stance. Initially, it was thought that inflation pressures would ease, helped by falling energy costs, and this would allow the Fed to end its tightening without serious damage to the economy. Data in February suggested otherwise and resulted in market weakness. However, more benign data and the swift response to the collapse of Silicon Valley Bank resulted in bond yields falling rapidly in March and ending the quarter on a positive note.

Locally, the JSE All Bond Index increased by 3.39% over the quarter. The yield curve bear steepened at the end of March — with front-end yields decreasing rallying while yields rose at the longer end of the curve as National Treasury introduced a new 2053 maturity bond. The domestic yield curve reflected the spate of bad news since the start of the year, including the greylisting decision by the Financial Action Task Force, a bigger-than-expected contraction in growth in Q4 2022, a higher frequency and intensity of loadshedding, the resignation of the head of energy utility Eskom and S&P lowering the outlook on SA's sovereign rating from positive to stable. Positive performance was noted across all tenors of the curve, and our positioning, which mostly favours the front-end and the belly of the curve proved beneficial to returns.

Following months of negative returns, the inflation-linked bond curve flattened during March, benefitting the asset class over the quarter. This positive return reflected the higher-than-expected inflation print we saw in February.

In an unpredictable period, listed property delivered a negative return over the quarter. We used this as an opportunity to cautiously increase our select exposure to the asset class.

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The yield-enhancing allocation to investment-grade credit continued to add value over the quarter.

The foreign exchange (FX) component of the portfolio, the bulk of which is in the US dollar, contributed to returns as the greenback strengthened. We took some profits and reduced our exposure to FX over the period.

Outlook and strategy

Global

Amid long-standing challenges in the form of persistent geopolitical tension, elevated levels of inflation which saw central banks entering aggressive hiking cycles, the start of 2023 presented another challenge. Financial turmoil erupted late in the first quarter of the year when the collapse of SVB reverberated through markets and revealed additional hidden banking stresses. While the response to SVB was swift, market sentiment remains relatively cautious. Despite interest rates rising sharply in 2022, we are not out of the woods yet. Although some inflation prints in certain regions appear to support the 'peak inflation' narrative, we would like to see a more sustained trend of deceleration. Resilient US economic data further suggests caution in expectations of a pivot in global monetary policy. Across the Atlantic, European data also provided evidence that the economy has been faring better than initially expected. In emerging markets, China continues to be in the early stages of reopening. We expect Beijing to continue rolling out support measures for the economy and the People's Bank of China to keep monetary conditions supportive.

Local

The intensity and frequency of power blackouts are keeping the SA economy from building any sustained forward momentum. While the National Treasury upwardly revised revenue expectations, spending pressures remain upside risks given low growth and higher public sector wages. On the monetary front, the rand remains susceptible to exogenous shocks and domestic political volatility. We viewed the National Budget as relatively positive with Treasury delivering a formidable balancing act. However, we are cautious given that implementation risk remains. More negatively, the FATF decision to greylist South Africa will be an overhang over the country for the next year or two. With more hikes expected from the Fed, albeit at a slower pace, we expect that the South African Reserve Bank's MPC decisions will continue to be more data dependent. This is reassuring for bond investors as in the shorter term, there could be more volatility to come. The February MPC statement focused on upside inflation risks, higher inflation expectations and currency pressures. Despite these risks, we forecast inflation to return sharply towards 5% in the first quarter of 2024. This forecast takes into account elevated, sticky food and fuel prices, which we are currently experiencing domestically. With the global environment remaining uncertain and a focus on upside risks becoming apparent within the MPC, we believe a further hike in May of 25bps is likely. We remain of the opinion, however, that we are close to the end of the rate hiking cycle and that inflation will begin to fall in the second half of the year. This will be a strong environment for local fixed income assets. The growth outlook for the year ahead will continue to be shaped by developments in the global sphere of influence, developments at Eskom and (more recently) Transnet, and progress on the implementation of structural reforms.

Positioning

From a positioning perspective, SAGBs remain attractive on valuation grounds, relative to other asset classes in the fixed income universe and relative to their historical record. That said, against the backdrop of higher global inflation, rising interest rates (both locally and globally) and domestic idiosyncratic risk, we remain cautious in our positioning. We reduced duration at the beginning of the quarter and looked for opportunities to add back duration in market sell-offs. Furthermore, we have some hedges in place

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to seek to reduce portfolio volatility. We continue to stress the importance of earning yield and protecting capital in this fluid environment.

We previously sold down ILBs on the belief that inflation has peaked in SA. In recent months, ILBs have sold off aggressively, in February we took advantage of this improvement in valuation to increase our allocation to short-dated ILBs marginally. The asset class has served us well as a hedge for the portfolios. As price momentum has topped, nominals are still poised to outperform ILBs.

As the fundamental picture for listed property has begun to clear, we have increased our allocation to the asset class. The sector remains highly volatile and vulnerable to global and local newsflow, while rising short-term interest rates have also begun to weigh down on many property firms given the reliance on financing for expansions. The deteriorating local growth outlook is an additional headwind on fundamentals going forward. We maintain select exposure and will continue to tactically seize opportunities where we see value.

Investment-grade credit is a neutral allocation in our portfolios. We maintain a cautious approach to adding yield to the portfolio in a tight spread and tough economic environment. Our bottom-up views remain consistent, with a preference over assets with defensive credit qualities.

In portfolios permitting FX exposure, we believe it is prudent to retain a reasonable allocation to a basket of offshore currencies. We maintain the bulk of the allocation to the US dollar. From a portfolio-construction perspective, our foreign currency exposure acts as a risk mitigator during times of rand weakness.

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