Discovery Strategic Bond

31 May 2025

Market background

May was a pivotal month for the US Treasury market, with a credit-rating downgrade underscoring broader concerns around US public finances. While market participants welcomed signs of easing trade tensions with China, fiscal concerns were front of mind, given the prospect of continued tax cuts and rising debt levels. This, together with the mid-month downgrade from Moody's – moving the US's credit rating to Aa1 from Aaa – drove yields higher across the Treasury curve.

On the monetary policy front, the US Federal Reserve (Fed) kept rates on hold as expected, with commentary from Fed Chair Jerome Powell focusing on the uncertain growth and inflation outlook. Despite the CPI print for April coming in slightly lower than expected, inflation expectations for the rest of the year continued to rise. By the end of May, the market was pricing in fewer rate cuts for the rest of this year.

Despite a weak start to the month, South African capital markets ended May broadly firmer. Investor sentiment was buoyed by two key developments: a landmark diplomatic engagement with the US and a reduction in domestic political uncertainty following the successful passage of the national budget.

A benign inflation print prompted the South African Reserve Bank (SARB) to revise its 2025 inflation forecast downward to 3.2%, prompting policymakers to cut interest rates by 25 basis points (bps) as widely expected. The central bank, however, noted domestic growth remained a concern, lowering its 2025 GDP growth forecast to 1.2%. The bond market rebounded after a period of volatility, supported by easing inflationary pressures and a broad political consensus on the budget. By the end of May, 10-year bond yields had dropped to 10.14%.

Performance review

The portfolio outperformed the benchmark.

At the beginning of the month, we added duration via long-dated bonds to the portfolio; the portfolio benefited from a subsequent flattening of the yield curve.

We were underweight the US dollar as we expected the rand to appreciate as risks diminished.

Outlook and strategy

The domestic political backdrop has calmed and the budget has passed through Parliament smoothly. The outlook for monetary policy is also encouraging, with a further rate cut by SARB looking likely later this year.

With the tariffs imposed on 'Liberation Day' effectively being reversed or reduced, we will be watching cautiously to see when this pause comes to an end. President Donald Trump continues to be an unpredictable factor, and we will be cognisant of any erratic decisions potentially coming throughout the year.

We remain underweight foreign exchange exposure, with less than 1% of holdings allocated to dollars, and diversified into Euros. Although we have a positive view on the rand, given the unpredictability of the Trump administration, our allocation to foreign exchange exposure is there to dampen any possible volatility which may hurt the currency.

We have sold out of a significant portion of our inflation-linked bond (ILBs) holdings in light of the SARB setting a lower inflation target, which is typically negative for ILBs.

The next SARB Monetary Policy Committee meeting is two months away and with cooling inflation, lower oil prices and the rand stabilising, there is a possibility of another rate cut coming within this current cycle. We expect the yield curve to continue to flatten, and have therefore added duration via long-dated positions.

Due to limited attractive domestic credit market opportunities, we did not adjust our credit exposure, which maintains a bias toward good quality, investment-grade issuers.