Discovery Diversified Income Fund

Market background

The US economy expanded at an annualised 2.6% quarter on quarter (q/q) in Q3 2022, ahead of consensus forecasts of 2.4%. On closer inspection, the narrowing of the trade gap was the main driver of growth. Data showed consumer demand continuing to weaken amid policy tightening and slowing growth. Consumer price rises (CPI) continued to ease, printing 8.2% y/y in September, above market forecasts of 8.1% but the lowest reading in seven months. Meanwhile, the core measure of inflation – which strips out volatile items such as food and energy – increased slightly to 6.6% in September, from 6.3% the previous month. The labour market remained tight within the narrow 3.5%– 3.7% range, sustaining upward pressure on inflation. All of this gave further impetus to monetary policy tightening, with the US Federal Reserve (Fed) serving a fourth straight 75 basis point (bps) hike on 2 November, taking the Federal funds target range to 3.75-4.0%, the highest range since 2007.

Europe continues to grapple with a myriad of headwinds; sky-rocketing energy prices, rising interest rates and a cost of living crisis. Growth in the region expanded at an annualised rate of 0.2% q/q in Q3 2022, following a 0.7% expansion in Q2 and in line with consensus expectations. This was the slowest growth in the area since the Q2 2021 when the economy bounced back from COVID-19 lockdown restrictions. Key indicators point toward a contraction in Q4. Strained supply chains and elevated energy prices pushed inflation to 10.7% y/y in October, higher than the 9.9% recorded in September and above market forecasts of 10.2%. As largely expected, the European Central Bank (ECB) delivered another 75bps rate hike at the Governing Council's October meeting, bringing the cumulative rate-hiking total to 200bps since the cycle began in July.

In the United Kingdom, The British economy contracted 0.3% in August 2022. Data released in October also showed continued weakness in consumer confidence, a contraction in retail sales and a larger-than-anticipated widening of the fiscal deficit. Consumer price inflation rose to a 40-year high of 10.1% y/y in September, after easing back down to 9.9% in August. The Bank of England's (BoE) Monetary Policy Committee (MPC) delivered a record 75bps point hike in the Bank rate on 3 November. According to the meeting minutes, most MPC members believed that further rate increases were needed to bring inflation back to the 2% target level on a sustainable basis. Markets are now pricing in a peak in UK rates of circa 4.75%. Politics continued to dominate the headlines, with former finance minister Rishi Sunak installed as the new Prime Minister. Meanwhile, the new Chancellor of the Exchequer Jeremy Hunt reversed the bulk of the Liz Truss-era tax cuts, while pledging to table further fiscal policy tightening measures in November.

The world's second-largest economy expanded at a rate of 3.9% q/q in Q3, ahead of market forecasts of 3.5% and a rebound from the 2.7% contraction in the preceding quarter. Marking the strongest pace of growth recorded since the Q2 2020, the latest reading was supported by the rollout of various stimulus measures and policies by the government in recent months. That said, a whole host of headwinds continue to weigh on China's economy. Politics were the main digest in October, as President Xi Jinping strengthened his grip on the levers of power at the Communist Party's 20th National Congress and is now poised to remain at the helm beyond the end of the current five-year term in 2027. Separately, the People's Bank of China (PBoC) Governor Yi Gang pledged more support for the economy, a ramp-up in bank lending to certain sectors and a faster pace in rolling out existing economic policies.

The manufacturing PMI rose to the expansionary 50-point level following the contraction in September to 48.2. While positive, the reading indicates subdued sentiment on South African factory floors, especially against a backdrop of weakening global demand. The recovery in activity and demand has been stifled further by ongoing power outages, which have also had perilous effects for key services such as healthcare and water and sanitation. Consumer price inflation eased for a second straight month to 7.5% y/y in September, from 7.6% the previous month, in line with consensus. Meanwhile, core inflation continued to trend higher, printing at a five-year high of 4.7% in September, with a m/m increase of 0.5% driven largely by exchange-rate sensitive components of the core basket. Inflation remains above the upper limit of the South African Reserve Bank's (SARB) 3%–6% target range, and the SARB is largely expected to remain in lockstep with the major central banks by delivering another rate hike at its scheduled November MPC meeting. On the fiscal front, the National Treasury delivered a medium-term budget that was broadly welcomed by the market as the government looked to maintain fiscal discipline.

Performance review

For the quarter, the portfolio outperformed the benchmark.

The persistence of high inflation and tight labour markets kept central bankers in hawkish mode during the month. Bond yields in the US and Europe tracked slightly higher over the month. US Treasuries lost 1.7% over the month, with the yield on 10-year sovereign bonds in the US rising over the month to 4.05%, while 10-year yields across several European countries and the UK fell after the September spikes. The UK Gilt market enjoyed some reprieve in October on following yet another change of Prime Minister, along with a reversal of policy on the fiscal front and the BoE terminating its bond-buying programme. The Bloomberg Barclays Global Aggregate Bond Index ended the month of October down 0.7%.

The JSE All Bond Index delivered a modest 1.1% return for the month. The yield curve steepened by month-end, with yields in the front end edging lower, while the back end remained steady over the period. Notwithstanding the trend higher in global bond yields, the benchmark 10-year SA yield ended the month unchanged at a high 11.34%. We noted positive performance across all tenors during the month, and our positioning, which mostly favours the belly of the curve contributed positively to performance.

The reduction in inflation-linked bonds (ILBs) prevented a loss for the Fund as we switched to nominal bonds to enhance the yield of the Fund now that the peak in inflation is passed.

Listed property enjoyed a strong rebound over the month, and our select exposure to the asset class added to returns.

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

The FX component of the portfolio, of which the lion's share is in the US dollar, aided performance over the month, serving as an important hedge against protracted weakness in the local unit.

Outlook and strategy

Global

Uncertainty and volatility remain at large. The growth outlook continues to deteriorate, inflation remains elevated, central banks remain steadfast in tightening monetary policy as a result, and the war in Ukraine is escalating instead of de-escalating. While the jury is still out on the US recession, across the Atlantic, the eurozone and the UK recessions are fait accompli. The headwinds are mounting for the euro area i.e., cost living crisis, soaring energy prices, but we still expect the ECB to stay the course on tightening monetary policy. The UK seems to have returned to some semblance of calm following the change in leadership and the adoption of more prudent fiscal policies. The reversal of Kwasi Kwarteng's expansionary budget should see a lower peak in the Bank rate. In emerging markets, China (the second largest economy in the world) continues to wrestle with a multitude of headwinds which are a hindrance to growth. The weakness in China will remain a significant drag on global growth.

Local

The local economic outlook is not impervious to the external environment. Most notably, the ongoing conflict in Ukraine and the stringent lockdowns in China continue to exacerbate supply-chain challenges and inflationary pressures. South African business and consumer confidence remain severely depressed. Furthermore, the intensity and frequency of power blackouts and strike action in various industries stand to supress growth for the remainder of this year. The budget delivered by the finance minister in October was broadly well-received by fixed income markets. It was an aspirational budget versus the conservative approach taken over the past few years. The National Treasury is banking on better revenues, while spending pressures remain upside risks. The main budget deficit improved substantially both in the current fiscal year and over the medium-term expenditure framework, while gross debt-to-GDP has improved due to improving budgeted deficits and some revisions to nominal GDP. On the monetary front, the rand remains at the mercy of exogenous shocks. Given elevated inflation locally, little improvement in longer-term inflation expectations and more hikes in store by the Fed, we expect the

SARB to maintain a firm handle on monetary policy in the coming months to fight the erosive power of inflation on household incomes and savings. This is reassuring for bond investors.

Positioning

From a positioning perspective, the valuation argument for SAGBs remains intact. That said, against the backdrop of higher inflation and rising interest rates – both locally and globally – we remain cautious in our positioning, although we have started to increase duration across the board. Poor global investor sentiment, fuelled by inflation concerns and aggressive rate hiking by the US Federal Reserve (Fed), has resulted in emerging market (EM) bond yields moving much higher this year. The valuation buffer that the market weakness has created provides some comfort that we should not see significant capital outflows out of EMs, including South Africa. Notwithstanding, we have some hedges in place to seek to reduce portfolio volatility. We continue to stress the importance of earning yield and protecting capital in the current environment.

We have sold inflation-linked bonds (ILBs) as we believe inflation has likely peaked in SA and, reallocating to nominals and cash instead. The asset class has served us well as a hedge for the portfolios. As price momentum has likely peaked, nominals are poised to outperform ILBs, hence we have switched some of this exposure into nominals.

As the fundamental picture for listed property has begun to clear, we have increased our allocation but remain underweight the asset class. The asset class remains highly volatile and vulnerable to global and local newsflow. Our exposure here remains limited, but we continue to tactically seize opportunities where we see value.

Investment-grade credit has moved from marginally underweight to a marginally overweight allocation in our portfolios. We maintain a cautious approach to adding risk to the portfolio in a tight spread and tough economic environment.

In portfolios permitting foreign-exchange (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. We have also used US Treasuries as a hedge in the portfolio to cushion the impact of rising US yields.