Discovery Money Market Fund

Market background

The US saw the Delta variant slow consumer spending and economic expansion over the summer months, while inflationary pressures remained at decade highs. Supply constraints have proved much worse than initially anticipated, which has resulted in inflation forecasts being revised higher and growth expectations being lowered. That said, many economists see risks to the economic outlook to be on the upside going forward, once the COVID strain on activity eases. In line with consensus, the Federal Open Market Committee (FOMC) made no changes to monetary policy at its 22 September meeting. US Federal Reserve (Fed) Chair Jerome Powell suggested that the "substantial further progress" test towards the Fed's inflation and employment goals was "all but met" and further progress could see the FOMC announce the start of tapering as soon as November. On the rates front, Powell reiterated the hiking cycle would proceed on a separate timeline, although, it appears that most FOMC participants (9 out of 18) now see rate hikes becoming necessary by next year.

As in the US, the eurozone's manufacturing and services purchasing managers' indicators (PMIs) declined further in September, although the contraction here was a lot sharper as slowing demand growth, supply chain disruptions and rising prices for raw materials continue to weigh on activity. Nonetheless, the bloc's economy looks set to deliver robust growth in Q3 on the back of higher vaccination rates through the summer. The European Central Bank (ECB) announced that favourable financing conditions could be maintained at a 'moderately lower' pace of purchases than the previous two quarters.

In emerging markets (EM), a deepening energy crisis has added further stress to already stretched global supply chains, while an endangered real estate sector on account of Evergrande's (one of China's most indebted property developers) inability to make debt payments has added financial stability angst

to an already fragile economic recovery in China. The People's Bank of China (PBoC) injected the biggest tranche of short-term liquidity in nearly eight months into the financial system in efforts to calm investor nerves over Evergrande and stem serious contagion to other markets. The confluence of these dynamics and a third straight month of weak data emanating from China has led to various financial entities subsequently lowering China's growth forecasts for 2021.

South Africa's GDP print of 1.2% quarter on quarter (q/q) over 2Q came in ahead of consensus expectations of 0.7%. Exports remained relatively robust, boosted by a reopening of trade markets and a strong commodity price boom which has been a boon for SA's mining sector and agricultural exports. Attention has now shifted to 3Q growth data, which is likely to come in weaker on the back of the July civil unrest and tougher lockdown restrictions amid the third wave of COVID infections. Inflation realized higher than we expected, in August. Headline inflation increased to 4.9% y/y versus 4.6% y/y in July. Transport inflation was the main driver of the increase driven by flight ticket prices. As widely expected, the South African Reserve Bank Monetary Policy Committee unanimously left the benchmark lending rate unchanged at its 23 September policy setting meeting but sounded a slightly more hawkish tone with members now pencilling rate hikes through 2022 and 2023.

Performance review

Inflation angst and the hawkish pivot by central bankers launched a plunge in prices reminiscent of Q1 2021 (yields rise as prices fall). US Treasuries, which serve as an important indicator for financial markets, saw yields on the 10-year note soar from 1.31% to 1.55% in a matter of days.

Local bonds were buffeted by intensifying inflation worries, negative developments in China, and hawkish guidance from major central banks – bad news for emerging market debt (EMD) and currencies. We witnessed steepening in the yield curve by the end of the quarter, with the yield on the 10-year note soaring to its highest level since March, while foreign investors offloaded just over R17 billion worth of bonds in September. One-year fixed-rate negotiable certificates of deposit (NCD's) drifted higher over the third quarter by 0.13% (from 4.79% to 4.92%) and weakened substantially into October as the market priced in aggressive rate hikes. Cash, as measured by the STeFI Composite Index, was broadly unchanged at 0.95% for the quarter. In currencies, the rand's vulnerability to external pressure was typified by its precipitous fall against the greenback, euro and pound sterling.

For the quarter, the Fund outperformed the benchmark.

Portfolio activity

Over the quarter, we continued to selectively add exposure to Government Treasury Bills which are currently showing value.

Outlook and strategy

Global

The past couple of months have seen the global economy expand at a dizzying pace as industrial activity resumed from COVID-induced re-openings. The recovery has in large part been sustained by the deluge of fiscal stimuli, ultra-loose monetary policy and pent-up consumer savings and demand. Many DM countries have recorded robust growth since the depths of the pandemic, but more recently, growth has moderated somewhat. Rehabilitation going forward is, however, likely to be more measured, desynchronised (given disparity in vaccinations between DM and EM) and restrained by a myriad of risks which have recently conspired to dampen growth forecasts; the outlook for COVID and mutations remains uncertain (Northern Hemisphere entering winter season), ongoing disruption and shortages in supply chains continue to put upward pressure on inflation (exacerbated by the gap in inoculations given the interconnected nature of global value chains, and an energy crisis), weak data and negative newsflow from China represents a real risk for the outlook in emerging markets, the political uncertainty in the US surrounding the debt ceiling pose serious risk of another recession and financial crisis in the world's largest economy.

The path of inflation and monetary policy will be a major focus point for investors in the coming months. While inflation has run hotter for longer than expected, the Fed remains steadfast in its view that these price pressures are transitory. The Fed has also clearly distinguished that 'tapering' of asset purchases is different to 'tightening', the latter only likely to commence in 2023.

In Europe, the ECB maintains that a slower pace of asset purchases does not equate to 'tapering' but rather a 'recalibration' – with a broader recalibration likely to be announced at the December meeting as the ECB seeks to embark on a gradual normalisation process. Elsewhere, the UK is poised to lag other advanced economies such as the US and the euro zone, while a tight labour market and a spike in gas prices are fuelling inflation alongside supply chain disruptions. Pandemic relief measures such as the furlough scheme also expired on 30 September, which are likely to weigh on household finances, leading to weaker consumer confidence and household spending. While the Bank of England (BoE) intimated for the first time that it could raise rates this year still, policymakers face a tough and tricky test of keeping inflation in check without further supressing growth conditions.

In EM, the world's second-largest economy is contending with headwinds from all directions, including Delta-induced restrictions, supply-chain bottlenecks, a global chip shortage, shutdowns at regional ports, skyrocketing commodity prices and an unprecedented regulatory crackdown across various sectors. China serves as a proxy for risk and for EM countries like ours, and as one of the biggest consumers of our commodity basket, we have a general and specific correlation to China. That said, we expect authorities to continue to provide both fiscal and monetary support as evidenced by the PBoC's injection of stimulus amid the Evergrande saga. Other emerging economies unfortunately do not have the luxury of ultra-accommodative monetary policy for much longer, given weaker fiscal metrics and the need to keep interest rates elevated to compensate investors for the risk taken on. Brazil, Russia, Mexico, Pakistan and Paraguay have begun raising interest rates, while Turkey reversed course recently by slashing rates, although on the back of government pressure.

Local

South Africa's economy has proven more resilient than was initially anticipated at the depths of the pandemic. The second-quarter numbers came in better than expected and recent revisions in GDP

statistics by StatsSA also indicated that the economy registered 11% more growth in 2020 than previously estimated – which has also improved the debt-to-GDP ratio. The civil unrest back in July threw off momentum in the recovery, and we expect growth to remain lacklustre for the remainder of the year, which means our level of economic output at the end of 2021 will still be below the pre-pandemic level. Local dynamics remain much better than initially feared, but we remain fragile to exogenous risks such as China. Furthermore, the softening in our terms of trade (the relative price of exports to imports) is a concern, although commodity prices are still at higher levels relative to 2019. Notwithstanding, South Africa needs to act more decisively on self-help measures, in particular, we still need to see further traction on structural reforms, as well as infrastructure spending to put us on a more sustainable growth trajectory.

On the monetary front; the SARB was not as trigger-happy on rate cuts in the past 18 months relative to our EM peers and took a more conservative and pragmatic approach. This has allowed them to keep interest rates on hold for longer to support the recovery, while the commodity price boom also helped our terms of trade and local currency amid a contained inflation environment.

Positioning

The SARB's GDP growth outlook has been revised up quite significantly. The GDP growth expectation was revised higher from 4.2% to 5.3% for 2021 but revised lower for 2022 and 2023 from 2.3% to 1.7% and 2.4% to 1.8%, respectively. The interest rate path determined by the SARB's Quarterly Projection Model (QPM) increased from 3.79% to 3.82% by the end of 2021, 5.17% by the end of 2022 and 6.36% by the end of 2023. One of the biggest uncertainties going into this meeting was how the recent GDP revision would affect the output gap and therefore the QPM's interest rate path. The GDP revision has thus resulted in a narrower output gap for each of the forecasted three years. This has been the main driver of the increase in the QPM's interest rate path.

The inflation outlook didn't change significantly versus the SARB's forecast in July. The SARB's inflation forecasts are 4.4% in 2021 (Ninety One at 4.5%), and unchanged at 4.2% (Ninety One at 4.4%) and 4.5% (same as Ninety One at) in 2022 and 2023, respectively.

We continued to allow duration to roll-in over the quarter and remain cautious given the significant repricing to global short-end yield curves, the trajectory of interest rates and what is currently priced into our market.

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