Discovery Diversified Income Fund

Market background

The US economy grew at an annualized 6.5% quarter on quarter in Q2 2021, weaker than consensus expectations of 8.5%, but finally back to pre-pandemic levels. Behind the headline number, weakness was seen in residential investments and inventory drawdowns, which offset robust consumption as consumers emerged from lockdowns to resume travel and other previously restricted activities. Inflation data was another upside surprise in June, with the headline CPI print coming in at 5.4%, showing somewhat broad-based price pressures beginning to emerge. In the labour market, 850,000 jobs were added in June, above consensus forecasts of 700,000 and the strongest growth in employment in 10 months. At its two-day meeting on 28 July, the US Federal Reserve's (Fed) Federal Open Market Committee (FOMC) announced that it had made "progress" to achieving its mandate of full employment and 2% average inflation, but that this did not warrant an immediate change to its policy stance. The Federal funds target rate range was held steady at 0.00-0.25%, while the pace of its asset-buying programme was left at a minimum of US$120 billion per month

Preliminary data released on 30 July showed the bloc's economy advanced by 2% quarter on quarter in Q2, ahead of consensus expectations of 1.5% and signalling a rebound from the two preceding quarters of COVID-induced contraction. Business and consumer confidence bounced back strongly as lockdown restrictions were eased, alongside the acceleration in vaccinations and government support, and retails sales also returned to pre-pandemic levels. The manufacturing purchasing managers' index (PMI) came in at 62.8 in July, a marginal decline from 63.4 in June (readings above 50 indicate an expansion in output). In the labour market, the unemployment rate in June declined to 7.7% amid re-openings, marking the lowest rate since May 2020. The European Central Bank (ECB) held key interest rates steady at -0.50%, with no changes to the asset-purchasing programme and the higher pace of purchases under the pandemic emergency purchase programme (PEPP), while its revised forward guidance on rates reinforced the bank's dovish stance that it will maintain ultra-loose policy and record-low rates for as long as is necessary to achieve its price-stability mandate.

In emerging markets (EM), Incoming data continued to point to a more balanced and stable recovery of the Chinese economy amid escalating risks to the growth outlook. The official manufacturing PMI eased to 50.4 in July, from 50.9 in June, below consensus estimates of 51.0. Growth has slowed significantly since the record 18.3% year-on-year expansion in Q1 2021. The slowdown comes as COVID outbreaks in major economic hubs have added pressure on supply bottlenecks and the cost of raw materials. Retail sales and industrial output expanded at a slower pace in June, while the ever-important housing market also appeared to be showing signs of easing. The People's Bank of China (PBoC) MPC reiterated that the recent reduction in reserves banks must hold was not a change in its policy stance – which would remain broadly stable for the second half of the year to support "high-quality development".

Back home, civil unrest erupted in South Africa as supporters of former president Jacob Zuma ignited violent food riots which later evolved into arson of key infrastructure – what President Ramaphosa later called an "attempted insurrection". The ABSA PMI fell sharply from 54.7 in June to below the expansionary 50 level, coming in at 43.5 in July as the civil unrest in Kwa-Zulu Natal and Gauteng, as well as lockdown restrictions, weighed on business activity and sales orders. Headline inflation eased from 5.2% in May to 4.9% year on year in July, slightly above consensus expectations of 4.8%. The South African Reserve Bank (SARB) MPC projected a softer tone on borrowing costs as it unanimously held the main lending rate steady at 3.5% p.a. on the back of potentially peaked inflation in May, weak demand and the recent unrest.

Performance review

For the month, the portfolio outperformed the benchmark.

Volatility continued in bond markets during the month owing to the persisting inflation debate and a somewhat hawkish/dovish (depending on the reader) FOMC statement. US Treasury yields dominated the headlines as they continued their descent to below 1.2% for the benchmark 10-year note during the month, while their European peers continued to move deeper into negative territory. The Bloomberg Barclays Global Aggregate Bond Index closed 1.3% higher for the month with investors largely pushing out the expected start of the interest rate hiking cycle following somewhat dovish comments from the US Federal Reserve (Fed), notwithstanding higher prints in inflation.

Locally, nominal bonds tracked the rand lower during the month as non-residents continued to pare back positions in SA sovereigns amid social unrest and heightened fiscal concerns. We saw some yield curve steepening by month end, with short-dated yields moving lower, while rising on the longer end of the curve. Despite the turbulence during the month, the JSE All Bond Index managed to deliver a respectable return, with positive gains made across all tenors. Our positioning across the curve contributed positively to relative performance over the period.

The inflation-linked bonds (ILBs) exposure delivered muted performance over the period as the asset class weakened across the curve. We have trimmed back our exposure as we believe inflation has peaked.

Listed property weighed on performance as the sector retreated during the month with REITs coming under pressure amid the civil unrest. We continue to tactically add to the asset class but maintain an underweight position given the volatility in the sector.

The yield-enhancing corporate bond allocation continued to add value, but we remain roughly neutral the asset class.

The FX component of the portfolio delivered muted gains over the period with the dollar relatively flat against a basket of its G10 peers.

Outlook and strategy

Global

The global economic restart remains supported by the increased pace in inoculations, especially in the developed world, while the glacial pace of vaccinations in emerging economies appears to be responsible for the rapidly spreading delta variant across regions, notably in the southern parts of Asia, as well as in the euro area and the US. The million dollar question for economists is how this will affect the global economic recovery. We believe not a whole lot, although we will not see a synchronised global recovery given the disparities in vaccinations between developed and emerging economies. The world is sort of in a holding pattern for now, while a myriad of crosscurrents (COVID variants, pace of growth, monetary policy normalisation, rise in inflation and rates and fiscal policy) remain a source of uncertainty and volatility.

As such, investors continue to proceed with caution and markets remain ultra-sensitive to any newsflow surrounding the above-mentioned crosscurrents, so we expect markets to trend sideways during this holding pattern. Bond markets are likely to remain in a state of flux for the remainder of this year. We expect volatility to persist in the medium term until this cloudy economic picture begins to clear up on more reliable data. Regionally, EU mobility data continues to pick up, as are services PMIs, so we should see the wheels of recovery continue to turn in the second half of this year. In the US, negotiations are still ongoing regarding the injection of more stimulus in the US economy. Vaccinations and re-openings continue to fuel growth, although supply-side bottlenecks are hampering a much more robust expansion and also adding upward pressure on inflation in the short term. We expect the Fed to maintain an ex-post approach to policy in the near term and do not foresee any fireworks at the upcoming Jackson Hole Symposium on 26-28 August. This is in line with major central banks and we believe it will take a large dose of bad news for monetary policymakers to begin turning off the QE taps. In the EM space, we expect China to be the twin engine (alongside the US) driving the global and emerging market recovery in 2021 and economic data signals the country is well on track to meet its +6% growth target this year. The PBoC at its recent meeting in July, reiterated its stance to maintain policy, liquidity and the exchange rate at current levels – quelling fears of an impending tightening in policy, while the Communist Party Politburo also vowed to remain supportive of the economy in light of the outbreak in COVID infections across key economic hubs.

Local

We expect the SA economy to bounce back from an extremely low base over the course of this year. We have pencilled in growth of 3.8% this year, but that means our level of economic output at the end of 2021 will still be below the pre-pandemic level. The recent eruption of civil unrest will no doubt be a dampener on Q3 growth, as will the stricter lockdown measures that were imposed at the height of the third wave of COVID infections. The full impact of the civil unrest is still largely unknown, but our calculations suggest an impact of 0.3% of GDP. The government has reinstated the US$24 (R350) relief social grants alongside the Temporary Employer-Employee Relief Scheme (TERS) payments to support workers. Together, these measures will cost the public purse c.R40 billion. The government also reached an agreement with unions on a wage bill that deteriorated by about R18 billion from what was budgeted. This is an increase of 4.9% to the compensation numbers versus the budgeted 2.1%. The National Treasury insists these will be funded from the "revenue overrun" from tax collections but we foresee fiscal slippage down the line.

The economic recovery in the second half of this year will be a bumpy one but we expect stronger commodity prices and supportive global economic momentum to act as shock absorbers in the coming months. The announcement that private entities will be able to generate their own electricity (up to 100 megawatts) is growth additive, but we need to see more traction on reforms, as well as infrastructure spending. On the monetary front, the SARB MPC assesses risks to the inflation outlook to be on the upside, with administered prices posing the biggest upside risk relative to demand pressure. The committee left growth forecasts unchanged (+4.2% in 2021) despite the recent riots. We expect the SARB to embark on a data-dependent approach and a gradual normalisation process. The market has priced out excessive rate hikes, and the first hike priced for early 2022.

Positioning

From a positioning standpoint, SAGBs remain attractive, not only versus inflation and cash, but also relative to DM and their EM peers – underpinned by a supportive global backdrop and a compensating fiscal premium, with fiscal risks now back on the radar following the recent unrest. Real yields and spreads are still attractive versus history. We trimmed back duration aggressively early July but have slightly nibbled back in recent weeks, reallocating the overweight in the long end to the belly part of the curve. Given heightened fiscal risks, we believed too much was priced into the short end in terms of rate hikes.

We believe inflation peaked in May and have since trimmed back our exposure to inflation-linked bonds. A much slower pace in inflation will be less supportive to the asset class in the short term. Nonetheless, ILBs are still a good hedge against potential rand depreciation, and we maintain our short-dated exposure as a risk mitigator and diversifier for the portfolios.

We maintain an underweight position in listed property, owing to an extremely cloudy outlook for the domestic economy and company distributions. The sector remains highly volatile, and fundamentals leave a lot to be desired. We remain cautious in this sector based on fundamentals, but will continue to tactically seize on opportunities from time to time when we see value amid the rebound.

Investment-grade credit is a roughly neutral allocation on valuation grounds. Some paper has re-rated and supply-demand dynamics are supportive. We expect demand to remain strong for quality credit assets amid a slowdown in issuance. We have minimal exposure to the cyclical sectors of the economy, maintaining a preference for quality defensives; namely banks, insurers, real estate, telecomms and especially government-guaranteed debt, as well as large blue-chip corporates with strong balance sheets.

In portfolios permitting foreign-exchange (FX) exposure, we believe it is prudent to retain a reasonable allocation to a basket of offshore currencies. With the improvement in our terms of trade, strong current account metrics and central bank largesse globally, we remain underweight in the allocation to FX. We have a mix of US dollar, euro and EM in order to diversify our FX exposure.

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