Discovery Balanced, Moderate Balanced, Cautious Balanced Funds

Market background

Summer came to a brutal end for both stock and bond investors, as monetary policymakers doubled down on their commitment to fighting inflation through higher interest rates and quantitative tightening – warning households and businesses to brace for challenging times ahead.

Equities booked heavy losses in August as market hopes of a dovish pivot were eviscerated in an 8-minute speech delivered by US Federal Reserve (Fed) Chair Jerome Powell. Developed market (DM) stocks (MSCI World Index) fell 4.1%, while emerging markets (MSCI Emerging Markets Index) managed to eke out a +0.5% return helped by some positive data points in certain regions. Regionally, the US benchmark S&P 500 Index fell 4.2%, while the pan-European Stoxx 600 Index closed 2.9% lower amid looming rate hikes and recession in the currency bloc. In Asia, Japanese stocks (Topix, +1.2%) remained in favour amid sustained yen weakness, while Chinese equities (CSI 300 Index, -2.2%) extended losses, as weak data points and the imposition of fresh COVID-related lockdowns stoked fears of a more challenging economic recovery ahead.

In fixed Income, the global bond market back-tracked into bear-market terrain (falling c.20% from its peak). US Treasuries were down 2.5% for the month, with the yield on the US benchmark 10-year note ending the month at 3.20%, while the yield on the 2-year Treasury touched 3.50% for the first time since 2007. The Bloomberg Barclays Global Aggregate Bond Index ended the month down a weighty 3.9%.

All returns are quoted in US dollars.

South African equities held their ground for most of the month but succumbed to the rout in global markets with the Capped SWIX losing 1.3%. At a super-sector level, resources (-3.8%) were the main source of weakness on weaker precious metals prices, followed by financials (-2.5%) and industrials, which were only down 0.4%. The JSE All Bond Index managed to weather the storm somewhat, eking out a +0.3% return form the month. Following a strong rebound in July, listed property (JSE ALPI) sold off again in August, down 6.0%. Cash, as measured by the STeFI Composite Index, returned 0.5% over the same period. The rand endured another month of volatility amid global risk-off sentiment, weakening against the greenback, euro and renminbi, but stronger against pound sterling, which had a horrid month.

Performance review

For the month, the portfolio delivered negative absolute returns.

Key positive contributions:

- Our exposure to South32, Bid Corp and British American Tobacco contributed strongly to returns over the month. Returns were further enhanced by our holdings in South African Retailers (Shoprite, Mr Price Group and The Foschini Group).
- Locally, in fixed income, our allocation to SA bonds added to returns.
- The offshore exposure of the portfolio benefited from the rand weakness over the month.

Key negative contributions:

- Within a sea of red in the local market, the allocation to Anglo American, MTN Group and Sappi, in particular, detracted from returns over the month.
- There was broad-based weakness across equity and global bond holdings that detracted from overall returns for the month.

Portfolio activity

Following the strong recovery rally in global and local risk assets over July/early August, we took the opportunity to reduce exposure to local equities, global equities and SA bonds during the first two weeks of August. All the proceeds were deployed into cash, with half of the local sales being taken to offshore cash.

Within the local equity component, we took some profits by selling our holding in Mondi and Anheuser-Busch InBev, while also trimming our holdings in Sappi and MTN, as the earnings revisions profile is no longer supportive of these positions. We also topped up our holding in British American Tobacco, Glencore and FirstRand. In the offshore equity component, we added a new position in Universal Music Group, while taking profits on Procter & Gamble and KLAC, post recent outperformance.

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The offshore component also added a currency position of long USD/short USD block economies (Australia, New Zealand and Canada). In our view, dollar bloc economies face material structural headwinds to growth and inflation, given large imbalances within their household sectors and housing markets. It is therefore unlikely that these economies can tolerate interest rates at an elevated level for a long period. At present, there is increasing evidence that housing markets in dollar bloc economies are either softening quickly or seeing outright prices decline. With structural imbalances beginning to show signs of weakness, we believe now is an appropriate time to implement these positions on a 6 to 12-month investment horizon, as the risk of policy divergence is increasing and slowing global growth has the potential to put downward pressure on commodity prices and terms of trade for these commodity exposed nations.

We took the opportunity to lighten our position in SA bonds by selling across the curve soon after the market peak in mid-August. We also lightened our duration position by not reinvesting coupons.

Outlook and strategy

Looking forward, we continue to monitor the data points feeding into inflation in the US as this will have an impact on the extent of policy adjustment to be taken by the Fed. This will have a resultant impact on growth, which is showing signs of slowing. The two resultant outcomes are that of stagflation or recession, depending on the extent of policy tightening, and creates a tough backdrop for risk assets in the short term.

To navigate through this, we now have an underweight in our overall equity exposure, while the equity selection has a balance of more defensive and select cyclical exposure. Our preference for SA equity over offshore equity remains, as we believe the valuation support (SA did not enjoy the multiple expansion seen in developed markets), coupled with strong earnings revisions profiles across our holdings, has tilted the portfolio to the domestic market.

The offshore stock selection has favoured a larger position in more defensive sectors (healthcare, utilities and real estate) given the earnings risk in cyclical sectors such as consumer discretionary and industrials.

The local equity composition is well diversified, with our increased defensive exposures in our holdings of Naspers and Prosus, British American Tobacco and Bid Corp, where we believe earnings revisions are likely to inflect positively in the second half of the year. This sits alongside a reduced, but still healthy allocation to global cyclical stocks (diversified miners and Sasol) continuing to exhibit favourable earnings revisions profiles. We continue to have a healthy allocation to South African banks, where earnings revisions remain positive and valuations are attractive. This sits alongside our exposure to select apparel retailers (The Foschini Group, Pepkor and Mr Price) that display good earnings revisions profiles. Our exposure to local defensive businesses is mainly via our holdings in Life Healthcare and Shoprite and a reduced exposure to MTN.

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The valuation argument for local sovereign bonds still holds and we maintain a large allocation overall. With headline inflation rates peaking, the next few months are critical for global rates.

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