Discovery Diversified Income Fund

Market background

Rising interest rates and record high inflation continue to weigh on business and consumer spending in the US. The labour market, however, remains red hot, with 525,000 jobs added in July, double consensus forecasts of 250,000, while the unemployment rate eased further to 3.5% in July, the lowest reading since February 2020. Labour demand (job openings) was also upwardly revised in July. Consumer prices (CPI) also eased in July to 8.5% y/y, from 9.1% in June, largely due to cooling energy prices from multi-decade highs. Similarly, the core personal consumption expenditures price (PCE) index – the US Federal Reserve's (Fed) preferred measure of inflation – slowed to 4.6% in July, from 4.8% in June. On 26 August, Fed Chair Jerome Powell delivered a highly anticipated speech at the Fed's Economic Symposium in Wyoming, reiterating that monetary policy would need to be tighter "for some time" to bring inflation under control, even if it comes at a cost of slower growth and a weaker labour market.

The eurozone economy expanded at an annualised rate of 0.8% q/q in Q2 2022, higher than the second estimate of 0.6%. This was the strongest expansion in three quarters, driven by the relaxation of COVID-induced restrictions and the summer season. The outlook, however, continued to deteriorate, with Germany (and the area as a whole) likely to slip into a recession given the protracted supply chain issues, slowing growth in China, an ageing workforce and the deepening energy crisis. Inflation in the area rose to a record-high 8.9% in July, up from 8.6% in June, giving further impetus to calls for a larger interest rate hike at the September European Central Bank (ECB) Governing Council (GC) meeting, following the 50 basis points (bps) hike in July. At the time of writing, money markets are pricing in a cumulative 100bps in hikes from the next two GC meetings.

In emerging markets, high-frequency data showed China's economy continued to face pressure on multiple fronts: a distressed property market, the 'zero-COVID' policy, ongoing supply chain challenges, and power outages as the worst drought in the south-western part of the country hampered hydroelectric power generation. Manufacturing activity in the world's second largest economy contracted in August, with the official manufacturing PMI registering 49.4 in August, above market expectations of 49.2 but falling short of the 50 level which separates contraction from expansion. Retail sales, industrial output and investment were weaker in July and below economist expectations. The

People's Bank of China (PBoC) delivered an unexpected 10bps cut in the key policy rate mid-August, and further reductions in bank reserve requirements (RRR) could be in the offing.

Respite from the worst spate of loadshedding earlier in Q3 improved sentiment on South African factory floors in August. The manufacturing PMI rose to 52.1 in August, from 47.6 in July, rising above the 50-point level for the first time since March. Headline inflation overshot market expectations of 7.7%, rising above the South African Reserve Bank's (SARB) 3%–6% target range to 7.8% y/y in July, from 7.4% y/y in June. During the month, SARB Deputy Governor Kuben Naidoo, warned that upward pressure on wages (above the 3%-6% target range) without productivity gains could lead to a wage-price spiral, necessitating calls for even tighter monetary policy. This comes amid trade union demands of a 6.5% increase in the wages of public servants. The SARB is expected to continue its hiking cycle into the next year, in tandem with other central banks across the world.

Performance review

For the month, the portfolio outperformed the benchmark.

Hawkish rhetoric from the Fed's Jackson Hole Symposium had the global bond market back-tracking into bear 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. Across the Atlantic, the European sovereign debt market suffered its worst month on record as investors mulled the possibility of more aggressive rate hikes at a time of stratospheric inflation. The Bloomberg Barclays Global Aggregate Bond Index ended the month down a weighty 3.9%.

Fears about the global growth outlook, combined with higher US rates, weighed on emerging market debt. The JSE All Bond Index weathered the storm somewhat, eking out a +0.3% return for the month. Foreigners remained net sellers of local bonds, albeit at a much slower pace than in July. The rand endured another month of volatility amid global risk-off sentiment, weakening against the US dollar, euro and renminbi, but stronger against sterling, which had a horrid month. The yield on the benchmark 10-year government note edged higher during the month, rising 12 basis points to end the month at 10.89%. We noted positive performance across most tenors of the curve. Our positioning was beneficial to performance, building on gains from the previous month.

The allocation to inflation-linked bonds (ILBs) continued to enhance gains, in particular, the short-dated maturities, offering protection for the portfolios against prevailing inflation risks.

Listed property weighed on performance as the sector pared back the previous month's gains amid continued volatility for the asset class.

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

We continued to add to the FX allocation during the month as a hedge, which countered some of the rand weakness. The US dollar outperformed against a basket of its major trade partners, which helped the FX component of the portfolio.

Outlook and strategy

Global

We anticipate the availability of energy to remain a major source of economic uncertainty in Europe, placing significant pressure on the region's growth and inflation dynamics, and ultimately leading to a recession in the area. The US will likely encounter spill-over effects from the pullback/destruction of demand in Europe. The Fed continues to tread a steep and slippery slope of taming inflation and tightening financial conditions, and as Chair Jerome Powell warned in his Jackson Hole Symposium speech, policymakers are willing to bring inflation under control even if it comes at the expense of slower growth and a softening labour market. We expect a downturn in US growth in the second and third quarter of this year. The EM growth outlook has similarly deteriorated. China continues to wrestle with a myriad of crosscurrents and a slowdown in growth, and given its share of global GDP, the weakness in China will remain a significant drag on global GDP.

Local

The local economic outlook is negatively affected by the external environment. South African business and consumer continue to track at all-time lows. Although back to pre-pandemic levels, a survey of economists by Bloomberg expects growth in the second quarter (Q2) to decrease by 0.9% quarter on quarter (q/q). Furthermore, the intensity and frequency of power blackouts and strike action in various industries are likely to have a perilous effect on Q2 growth and remainder of this year. Despite the move lower in fuel prices in August and September, prices remain elevated, and in combination with higher rising interest rates, will remain a stranglehold on business and households (especially the low-income cohort), and thus we expect these dynamics to drag on growth in the remainder of the year. On a more positive note, an easing in power outages in August has helped sentiment on SA factory floors to a broad-based recovery, following the marked deterioration in July. On the monetary front, the rand remains at the mercy of exogenous shocks. Given elevated inflation locally, the worsening in longer-dated inflation expectations and rising interest rates in the developed world, we expect the SARB, to maintain a firm handle on policy in the coming months to fight the erosive power of inflation on household incomes and savings. This is reassuring for bond investors.

Positioning

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. Our government bond yields remain attractive versus EM yields, cash rates and inflation. At the time of writing, SA bond investors can earn a yield of around 10.9% on 10-year government bonds, which is still comfortably above inflation – underpinned by a compensating fiscal premium. Even if there are upside surprises in terms of rate hikes, SA bond yields are unlikely to spike materially (when bond yields rise, bond prices fall). The portfolios remain well-diversified; this – in combination with active allocation –

aims to provide some protection against the multitude of the local and global risks we face, while also allowing us to participate in the upside potential of a bond market rally.

We remain positive on inflation-linked bonds (ILBs) but will look to reduce exposure in the coming months, reallocating to nominals instead, which tend to outperform when inflation approaches its zenith. ILBs continue to be a good hedge for the portfolios and we maintain a bias to for short-dated maturities.

As the fundamental picture for listed property has begun to clear, we have increased our allocation. Our exposure to the asset class remains limited, but as we did in the preceding quarter, we will continue to tactically seize on 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.