Discovery Balanced, Moderate Balanced, Cautious Balanced Funds

Market background

July was largely positive for financial assets across the board, despite developed market central banks continuing their hiking cycles. In the US, equity markets rallied after a string of encouraging data pointed to the increased likelihood that the US Federal Reserve (Fed) could navigate the US economy towards a soft landing. GDP growth for Q2 came in above market expectations (2.4% vs 1.8%), underscoring the economy's ability to weather the barrage of tighter monetary policy measures by the Fed to curb inflationary pressure. The tone from the central bank was less hawkish, causing investors to speculate that the end of the hiking cycle could be near.

In the Eurozone, inflation remained above target and the European Central Bank (ECB) tightened policy, although rhetoric became notably more dovish. While the Bank of England (BoE) has drawn criticism for not doing enough to curb inflation, year-on-year CPI saw a downside surprise for the first time since January. From a growth perspective, the British economy contracted 0.1% on a month-on-month basis in May, bringing the year-on-year number down into contraction territory (-0.4%).

In Japan, the Bank of Japan (BoJ) kept its policy rates unchanged but surprised markets after announcing that it would use the 0.5% upper limit on the 10-year yield as a reference and no longer a hard limit, effectively widening the band to 1.0%. This was the first major move by Governor Kazuo Ueda since taking office, and markets are betting on further policy normalisation and stimulus measures as his tenure continues. The move sparked a surge in bond yields, sending the benchmark 10-year to its highest level in 10 years.

In China, the Peoples Bank of China (PBoC) kept its policy rate unchanged despite signs of a stalling economic recovery. China's economy grew by just 0.8% in Q2, slowing sharply from the 2.2% recorded in the previous quarter. Support, however, came in the form of the Politburo meeting held towards the end of the month. The communist party's top authoritative arm signalled more stimulus for the country's embattled property sector in addition to reducing the government's debt burden. Markets responded positively, particularly commodity-linked counters.

In South Africa inflation continued to show signs of moderating in June, with CPI easing to 5.4% (vs 6.3%) back to within the South African Reserve Bank's (SARB's) 3-6% target range. Core inflation, which has historically been more 'sticky', also continued its downward momentum, easing marginally to 5.0% in June (vs 5.2%). Softer inflation prints supported the SARB's decision to pause its monetary policy tightening, leaving its key repo rate at a 14-year high of 8.25%

News flow out of China and Japan were among the main drivers of global market movements for the month.

Performance review

In July the portfolio delivered a positive absolute return. This was supported by a strong performance from South African equities and South African bonds. Offshore equities detracted, largely due to the strength of the rand. Global bonds detracted on an absolute level.

Market sentiment improved in July as loadshedding eased and SA Inc stocks experienced a positive run.

Key negative contributions:

- Rand strength over the period negatively impacted the offshore exposure of the fund.
- The largest detractor over the month was global bonds. Bond markets were initially jolted by the Bank of Japan, as its unexpected move alarmed markets – which pictured waves of cash invested in US and European debt making its way back to Tokyo. In addition, the US Fed increased bond sales for the first time in two and a half years to fund the US deficit. These factors sent 10-year yields to the highest levels since November 2022.
- Tech stocks such as Microsoft, ASML and TSMC, which have performed well year-to-date, cooled slightly in July.

Key positive contributions:

- Retailers like Woolworths and Shoprite advanced, as did SA banks, and among insurers Sanlam had a good month. Of the industrial stocks Bidvest Group also rallied strongly.
- Northam Platinum advanced by roughly 20%, following news that it had sold Royal Bafokeng Platinum to Impala Platinum, part of an ongoing effort to derisk its balance sheet.
- The offshore equity's allocation to China-listed shares added positively to absolute returns.
- Better performance came from stocks outside of the 'magnificent seven' (which have driven market performance this year). Healthcare stocks like Johnson &Johnson, Elevance Health, UnitedHealth Group, delivered positive performance, after dragging their heels for most of the year.
- Among technology stocks, Google advanced strongly after delivering better-than-expected results.
- In the local fixed income component, SA bonds were a positive contributor over the month.

Outlook and strategy

Equity markets have remained buoyant. However, these are some of the factors that are potentially at play over the course of the second half of the year that will test the asset class:

- There is a growing market consensus for a “softer or no landing scenario” to play out, underpinned by the tight labour market and stabilising housing market data. We are monitoring economic data releases in the coming months to confirm our thesis of a high probability of an acceleration in slowing growth in developed markets (due to many of our indicators pointing to this). In addition, while inflation is coming down, the base effects in the coming months may create volatility in the data.
- Liquidity has been a supportive driver over the first half of the year. Our view is that liquidity is becoming less supportive in the coming months and will likely impact risk assets.
- China’s reopening recovery remains slow and uneven, and stimulus measures have yet to play out. This contrasts the recoveries seen in other economies following the lift-off in COVID restrictions. As a result, sentiment towards China is now trending more negative. In the absence of a stronger stimulus drive, slower growth out of China will have a broader impact on global growth dynamics.
- While South Africa-focused risk assets have underperformed global markets due mainly to our own goals from electricity shortages. The key question of whether the worst is behind us will be answered after the winter – a period when maintenance and weather-related factors that are supportive in energy availability start to reverse.

Given this backdrop, we continue to have a lighter overall equity exposure. Within the local equity component, our company earnings analysis has steered us to increase positions in more defensive exposures, at the expense of SA cyclicals, since earlier in the year. We are paying close attention to this, as the market forecasts and the resultant share price reactions tends to overshoot to the downside, and this will create opportunities to buy these companies back in the months ahead. Developed market (DM) equities remain fully valued and do not yet reflect the high likelihood of earnings downside risk due to; record margins and sales levels in the goods side of the economy continuing to decline towards trend, and exacerbated by the slowing growth trajectory, as well as less supportive inflationary underpins to toplines in the months ahead. The offshore stock selection continues to favour a position in Asia ex-Japan equities to benefit from the expected consumption tailwinds from China, while DM exposures are tilted to areas of relative earnings resilience (e.g.: Iberdrola, Rentokil, PepsiCo, Intact Financial and select healthcare names) or companies with structural earnings tailwinds (e.g., Microsoft, Mastercard, Universal Music Group) given the heightened earnings risk from the slowing growth backdrop.

As we are nearing the end of the global hiking cycle, our position in defensive government bonds should enhance returns of the overall portfolio going forward. One notable shift within the portfolio has been our bond exposure; we shifted out of US bonds and into longer-duration EU bonds. Despite the EU starting its rate-hiking cycle six months later than the US, the US remains remarkably resilient, while data from the eurozone suggests that economic activity within the region is cooling fast. Money supply is slowing, while credit supply and credit growth data show that credit is slowing along with rapidly deteriorating ISM and PMI data.

The market has also downgraded growth expectations for the SA economy. While we maintain a healthy allocation to SA Bonds, we took advantage of the recent rally and converted some of our holdings to cash, which is yielding an 8.5% return. This dry powder puts us in a better position to take advantage of future opportunities. We continue to look for opportunities to rotate into shorter-duration SA bond assets in the months ahead.

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