
# Discovery Diversified Income Fund

## Market background

Risk assets 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, underscoring the economy's ability to weather the barrage of tighter monetary policy measures by the Fed. July saw the Fed raise the target range for the federal funds rate by 25 basis points (bps), in line with consensus and bringing borrowing costs to their highest levels since 2001.

In South Africa, inflation continued to show signs of moderating in June, with CPI easing to 5.4% (vs 6.3% previously) 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% previously). 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%. The central bank however warned that the decision did not mark the end of the hiking cycle, stating that the committee would continue to monitor inflationary pressures. In other news, data released for May showed mining production falling 0.8%, reflecting the impact of lower commodity prices and increased loadshedding. While manufacturing PMI contracted for the fifth consecutive month, highlighting a deterioration in business conditions.

To read more, please click here.

## Performance review

For the month, the portfolio outperformed the benchmark.

In developed markets, sovereign bonds were little changed as central banks continued their hiking cycle and investors dialled back their bets of impending rate cuts given a resilient US economy. US treasuries fell, as did German bunds. In contrast, despite the yield on UK 10-year gilts at one point reaching a post-2008 high, yields later declined after the largest downside surprise in inflation data in two years; as a result, UK gilts outperformed and generated a small positive return. Investment grade corporate bonds also generated a small positive return, with Europe outperforming the US. Elsewhere, the monetary policy shift in Japan saw the Japanese yen appreciate versus the US dollar.

Locally, the JSE All Bond increased by 2.29%, reflecting the improved backdrop for emerging market bonds. After proving stubbornly sticky, inflation in SA seems to have finally peaked, allowing the SARB to pause its hiking cycle. We are also seeing encouraging signs of an improvement in performance from Eskom. Moreover, geopolitical risks have receded as SA has reiterated its neutral stance in the Russia/Ukraine war. Against this backdrop, positive performance was noted across all term buckets of the curve, contributing to performance.

Similarly, inflation-linked bonds (ILBs) delivered positive returns over the month, reflecting the more positive environment for local assets, despite inflation showing a decelerating trend.

Listed property also delivered a positive return over the month. Our select exposure to the asset class contributed to performance.

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

The foreign exchange (FX) component of the portfolio, the bulk of which is in the US dollar, weighed slightly on returns as the greenback weakened in response to expectations of a global ‘soft landing’

## Outlook and strategy

### Global

Global inflation pressures are continuing to moderate and recent events have led markets to price in a higher probability of a soft landing, especially for the US. While we believe we are at the peak of the interest rate hiking cycle, resilient US economic data suggests some caution in expectations of extremely accommodative monetary policy from the Fed. Across the Atlantic, European data is coming in weaker than anticipated but sticky core inflation will likely keep the European Central Bank hawkish. In emerging markets, the China reopening story is faltering, but Beijing is expected to continue rolling out support measures and the People's Bank of China is expected to keep monetary policy supportive. Markets are likely to remain volatile, but we continue to be constructive on the medium-term outlook for returns.

### Local

National Treasury's revenue expectations appear optimistic against the current backdrop. Coupled with expenditure pressures remaining on the upside, the fiscal picture warrants some concern. The June revenue figures demonstrated weak corporate tax receipts, predominately due to the weak commodity cycle. We are watching this figure closely as it will give us key insight on the resiliency of 'SA Inc.' (companies that derive most of their revenue domestically) considering the sustained headwinds. We expect a firm but volatile environment for local fixed income assets. SA growth is highly sensitive to loadshedding; therefore, any improvement should contribute to a better outlook in our GDP forecasts.

Turning to monetary policy, the SARB was pre-emptive and started hiking interest rates earlier than developed market peers. The central bank was concerned about rising domestic inflation pressures when CPI was still below 5%. As at July 2023, the central bank opted to pause interest rates after raising interest rates by a cumulative 475bps, bringing the repo rate to 8.25%. The rand remains susceptible to exogenous shocks and domestic political volatility. With a pause by the Fed expected soon, we anticipate that the SARB MPC decisions will continue to be more data dependent. This is reassuring for bond investors as in the shorter term, there could be more volatility to come. With the global environment still uncertain and upside risks being apparent within the MPC, we believe a further hold is likely at the next MPC meeting. We remain of the opinion that we are at the end of the rate hiking cycle and that inflation will continue to fall in the second half of the year.

### Positioning

From a positioning perspective, South African government bonds (SAGBs) remain attractive on valuation grounds, relative to other asset classes in the fixed income universe and relative to their historical record. That said we remain cautious in our positioning due to uncertainty in the global environment and some domestic idiosyncratic risks. Over the month, we reduced some of our short-dated bonds into market strength. We will continue to look for opportunities to add back duration in market selloffs. Furthermore, we have some hedges in place to reduce portfolio volatility. We continue to stress the importance of earning yield and protecting capital in this fluid environment.

Overall, our positioning in ILBs is slightly underweight, favouring short-dated linkers, but we will look to add some if yields retrace. The portfolio is underweight at the long end of the real yield curve, as we expect inflation to continue to fall in the second half of this year. As price momentum has topped, nominals are still well positioned to outperform ILBs.

As the fundamental picture for listed property has begun to clear, we have increased our allocation to the asset class. The sector remains highly volatile and vulnerable to global and local news flow, while rising short-term interest rates have also begun to weigh down on many property firms given the reliance on financing for expansions. The deteriorating local growth outlook is an additional headwind on fundamentals going forward. We maintain select exposure and will continue to tactically seize opportunities where we see value.

Investment-grade credit is a neutral allocation in our portfolios. We maintain a cautious approach to adding credit to the portfolio in a tight spread and tough economic environment. Our bottom-up views remain consistent, with a preference for assets with defensive credit qualities.

The foreign exchange (FX) component of the portfolio, the bulk of which is in the US dollar, continues to hedge the portfolio against local risks as well as any upward surprises in global inflation.

# DISCLAIMER: