Discovery Diversified Income Fund

Market background

US economic growth was noticeably weaker in Q3 amid lower household spending and surging COVID infections. Fixed investment spending and export activity also contracted over the period, but incoming indicators point to a quicker pace in expansion over Q4. Rising demand for labour, record-high job vacancies and the expiration of unemployment benefits saw unemployment moderate back to pre-pandemic levels over the quarter. The personal consumption expenditures index (the US Federal Reserve's preferred measure of inflation) soared to 5.7% in November from one year ago, marking the quickest rise in prices in nearly four decades. The minutes from the Fed's December meeting saw inflation forecasts being revised higher, while officials also confirmed the widely held view that interest rate hikes may come "sooner or at a faster pace", with a March 2022 lift-off and three hikes in 2022 now pencilled in.

In Europe, supply chain shortages induced a sharp drop off in activity in Q4. Inflation in the region also soared (up 4.9%) year on year (y/y) in November, while core inflation reached multi-decade highs. While the European Central Bank (ECB) remained more dovish than their Fed counterparts by keeping interest rates steady, they also indicated that asset purchases would continue to slow as they entered 2022. Unlike the ECB, the Bank of England (BoE) surprised markets and raised interest rates by 15 basis points (bps) as higher inflation persisted, coupled with tighter labour markets.

In recognition of the headwinds to China's economic growth from the coronavirus and the ongoing slowdown in the property market, the People's Bank of China (PBoC) revealed a more dovish stance at the start of December. The PBoC cut the Reserve Requirement Ratio (RRR) and reduced slightly the loan prime rate – the rate at which companies and households can borrow. Further signs of a shift towards

a more supportive policy stance came mid-month at the conclusion of China's Central Economic Work Conference. This saw the country's leadership recognising the increased pressure on the domestic economy and stating that stabilisation will be a key priority in 2022.

Elsewhere in emerging markets, Turkey's strong growth data was scuppered by high and rising inflation and a sell-off in the lira (following interest rate cuts, which President Recep Tayyip Erdogan encouraged) – eroding the purchasing power of household incomes and dampening both confidence in the economy and credibility in the central bank.

Back home, South Africa's GDP contracted over Q3 as output fell more than expected amid the social unrest and violent protests in July. The contraction followed four consecutive quarters of expansion. The onset of the fourth wave of Omicron-led infections poses further downside risks to the pace of the economic recovery. Price pressures at the factory gate continued to intensify as producer price inflation (PPI) quickened to 9.6% y/y in November, from 7.8% in the previous month, while consumer prices (CPI) accelerated to 5.5% in November from 5.0% y/y the previous month, above consensus expectations of 5.4%, driven by transport and fuel price hikes.

Performance review

For the quarter, the portfolio outperformed the benchmark.

Fixed income markets endured a downbeat year, with persistent global inflation and either the prospect of monetary policymakers paring back support or (in much of EM) proactive rate hiking to tackle inflation weighing on bond prices. The fourth quarter closed flat as bond investors continued to digest the evolving global monetary policy outlook, including a notably hawkish pivot by the US Federal Reserve (Fed). The Bloomberg Barclays Global Aggregate Bond Index ended the quarter down 0.7%.

Locally, Q4 got off to a rocky start as yields sold off and the JSE All Bond Index came endured external headwinds from China, intensifying inflation fears and hawkish pivots by major central banks, while local risks such as elections and power outages dampened investor sentiment toward local bonds and the currency. Non-residents were net sellers of South African Government Bonds over the quarter amid selling pressure in emerging market debt (EMD) markets. Selling pressure continued into December, although at a slower pace than the penultimate month's outflow. We saw the yield curve bull-steepen in December, with short-dated bonds moving lower, dragging longer-dated yields along (yields fall as prices rise). Over the quarter, positive returns were noted across all tenors and our positioning across the curve contributed positively to relative performance over the period. Our risk-mitigating bond put options also helped cushion some of the downward pressure during the quarter.

The allocation to inflation-linked bonds (ILBs), with a bias to shorter-dated instruments, continued to protect the portfolio from rising inflation risks, with healthy performance seen across the curve. The asset class is an important risk mitigator and diversifier for the portfolios.

Listed property started the quarter on the backfoot, but pared back losses in November and December to cap off a stellar recovery year of positive performance. Our select exposure to high-quality counters

added to returns. We also continued to tactically add to the asset class as and when opportunities presented themselves, but maintain an underweight position overall, given the volatility in the sector.

The yield-enhancing allocation to corporate paper continued to add value. That said, the asset class remains a neutral allocation on valuation grounds.

We continued to increase the FX allocation over the quarter, which helped counter some of the recent weakness. The US dollar outperformed against a basket of its trade partners, thus aiding the FX component of the portfolio.

Outlook and strategy

Global

The transition to normalised monetary policy makes the macroeconomic outlook uncertain. Financial 'normalisation' – central banks' return to conventional monetary policy after years of abnormally accommodative stances – may be a similarly difficult transition, potentially exposing markets to significant stresses in the year ahead. However, vaccine roll-outs should help underpin growth in 2022. China's new willingness to tolerate weaker growth in the near term will weigh on regions that rely heavily on Chinese demand, like Europe. In contrast, the US is well positioned to sustain above-trend growth in 2022. In much of the emerging world, short-term interest rates have already begun to rise. We expect economic recovery to proceed at a more modest pace; the emergence of Omicron and lack of vaccinations means supply shortages will continue to weigh on economic activity, while less room for prolonged monetary and fiscal stimulation will keep the recovery in a low gear.

Local

South Africa's economy impressed with resiliency and a stronger-than-anticipated rebound in the first half of 2021 from the pandemic nadir, however, the outlook in recent months has somewhat dimmed on the back of both external and domestic risks to the downside. Recent Q3 growth data came in weaker than forecasted, and we expect softer growth over Q4 and into this year on the back of the fourth wave of COVID infections. On the fiscal front, the Medium-Term Budget Policy Statement (MTBPS) showed South Africa to be in a relatively better position in the medium term than a year ago. That said, the jury is still out on whether the National Treasury can achieve fiscal sustainability in the face of government inertia in implementing reforms and plugging the fiscal slippage from the public sector wage bill and struggling state-owned enterprises. On the monetary front, the SARB pre-emptively hiked interest rates to ensure we stay ahead of any inflation surprises. We do not foresee an accelerated hiking cycle going forward, but a more gradual and data-dependent approach to normalisation over the next 18–24 months.

Positioning

South African bond yields remain attractive versus developed markets (DM) and their emerging market (EM) peers – underpinned by a compensating fiscal premium. That said, while real yields and spreads look attractive versus history, we are also mindful that value never stops a sell-off. Further down the road, we expect to benefit from these attractive yields, but for now we are still navigating a web of global volatility and uncertainty. We remain moderately constructive in the medium term and are

cautiously positioned on duration. We have shifted duration more neutrally across the curve with a normalisation cycle well priced into front-end rates. We continue to hold a balance of exposures, with an allocation to bond put-options, which offer protection for the portfolios in a hiking cycle. Our focus as always, is on more than just returns, but also on carefully evaluating risk and seeking to preserve your capital.

We expect inflation to peak in the next couple of months and then begin to simmer down through 2022. Our inflation-linked bond (ILB) exposure remains a purely defensive play. ILBs are a good hedge against potential rand depreciation, especially amid intensifying inflation fears. Our exposure maintains a bias to the short-dated instruments which serve as a risk mitigator and diversifier for the portfolios.

Alongside the volatility exhibited by property, we believe our material underweight position here is justified and supported by our capital-preservation bias. Relative to bonds, property companies trade at lofty valuations. We proceed with caution, maintaining exposure to select high-quality counters and tactically seizing opportunities from time to time when we see value.

Investment-grade credit is a 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. From a portfolio- construction perspective, we have upped our FX exposure on the back of global developments and market volatility and more specifically, to offset a vulnerable rand. We have a mix of US dollar, euro and EM in order to diversify our FX exposure.

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