Discovery Diversified Income Fund

Market background

The US Federal Reserve (Fed) closed off the calendar year by raising the Fed funds rate by 50bps to 4.25% – 4.5%, largely in line with market expectations and pushing interest rates to their highest levels since 2007. Monetary policymakers signalled that further interest rate hikes would be appropriate as the Fed continues its battle to bring inflation back to within its 2% target. The Fed revised its interest rate forecast higher at its December fixing, with borrowing costs now expected to increase to 5.1% in 2023 before falling to 4.1% in 2024 and 3.1% in 2025. Meanwhile, inflation continued to show signs of cooling despite remaining elevated, slowing to 7.7% in October and 7.1% in November. The Fed's preferred measure of inflation (core PCE Index) also eased to a four-month low of 4.7% in November from 5% in October.

Euro Area GDP growth for the third quarter (Q3) was confirmed at an annualised 0.3% q/q, marginally higher than preliminary estimates of a 0.2% expansion. The European Central Bank (ECB) raised interest rates by 75bps in October and 50bps in December, noting that it expects interest rates to rise further following an upward revision to its inflationary outlook. Inflation forecasts show consumer prices increasing by 8.4% in 2022, 6.3% in 2023 and 3.4% in 2024. October saw inflation in the region reaching its highest level, climbing to 10.6% before slowing to 10.1% in November.

In the United Kingdom, growth prospects in the UK remained muted on the back of a tighter labour market, soaring inflation and higher wage growth. Investor sentiment was further dented after final Q3 GDP growth numbers confirmed that the economy had contracted by an annualised 0.3% q/q, more than initial estimates of a 0.2% fall. However, there was some reprieve during the quarter following the appointment of Rishi Sunak as Prime Minister, which saw much of the turmoil caused by his predecessor's proposed economic policies being reversed. The Bank of England (BoE) raised its key interest rate by 50bps to 3.5% in December, just one month after making its single largest hike in 33 years (75bps).

In Asia, the Chinese economy expanded by an annualised 3.9% q/q in Q3, marginally above market forecasts of a 3.5% increase and significantly beating the 2.7% contraction recorded in the previous quarter. Economic activity over the period was buoyed by a series of pro-growth policies and stimulus measures put forward by the government to help revive economic activity, including the partial relaxation of its COVID policies and the further reopening of its economy. The People's Bank of China (PBoC) left its key lending rates unchanged for Q4 as widely expected. Meanwhile, in a move that surprised market participants, the Bank of Japan (BoJ) increased the upper limit of its tolerance band on 10-year government bonds from 0.25% to 0.5%, which saw a sharp rise in Japanese government bond yields. Investors saw the move as a potential precursor to a shift away from the BoJ's ultra-loose monetary policy in 2023.

South Africa's GDP grew by an annualised 1.6% q/q for the third quarter of 2022, well above market forecasts of a 0.6% increase. Eight out of ten economic activity areas expanded over the period, with the agricultural sector making the biggest contribution to growth (+19.2%). Rolling blackouts, however, continued to weigh on the country's economic growth prospects, after Eskom reintroduced Stage 6 load shedding after breakdowns at several of its power-generating units placed additional strain on its already-low diesel reserves. The South African Reserve Bank (SARB) raised its repo rate by 75bps to 7% in November, marking the seventh consecutive rate hike since November 2021. The SARB's decision was widely expected and broadly in line with international economies, as local policymakers continued the battle to bring inflation back to within the SARB's 3-6% target range. Data showed that inflation in South Africa unexpectedly rose to 7.6% in October (from 7.5% a month earlier), before easing to a five-month low of 7.4% in November.

Performance review

For the quarter, the portfolio outperformed the benchmark.

Government bond markets had some of their steepest falls in 2022 as central banks were caught off guard by soaring inflation, which necessitated aggressive interest rate hiking cycles as a result. US Treasuries posted their worst annual performance on record. For the fourth quarter, performance ended largely flat, after yields rose in December on the likelihood of further interest rate hikes and slower economic growth leading into 2023. The Fed now forecasts the terminal rate to be around 5.10% next year. The yield on the benchmark US 10-year Treasury note closed the quarter at around 3.87 (up from 3.68 in November and 3.83 at the end of Q3). European sovereigns also lost ground, with the 10-year bond yield (AAA- rated composite) climbing to 2.55% at the end of December, compounded by news that the European Central Bank would begin reducing its €5 trillion bond holdings as of March 2023. The Bloomberg Barclays Global Aggregate Bond Index ended the quarter up 4.5%. All returns are quoted in US dollars.

Emerging market debt (EMD) delivered high single-digit returns, helped by a weak US dollar. Whilst the greenback posted its biggest yearly advance since 2015 and was one of the few dependable 'safe havens' for investors during the market mayhem of 2022, the application of a more aggressive monetary policy by central banks in Europe and – more recently – Japan signalled the intention to close the gap with higher US yields, which helped to drive their currencies higher and the US dollar lower. The JSE All Bond Index was among the standout performers across EMD, ending the quarter on a positive footing, up 5.7%. Positive performance was recorded across all tenors over the period, where our allocation bias in the mid-dated area of the yield curve proved beneficial to returns.

The continued reduction in the allocation to inflation-linked bonds (ILBs) over the quarter proved beneficial to returns as these bonds came under pressure with price momentum approaching its zenith.

Listed property closed the quarter and year out in robust fashion, building on gains during the quarter and our select exposure to the asset class supported gains over the period.

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

The FX component of the portfolio, the bulk of which is in the US dollar, weighed on returns as the greenback weakened considerably against a basket of its major trading partners over the period.

Outlook and strategy

Global

2022 was a volatile and challenging year for investors. Geopolitical tensions escalated rapidly with Russia's invasion of Ukraine, which sparked a surge in energy prices, record levels of inflation which saw central banks move aggressively to get the inflation genie back in the bottle through rate hikes and quantitative tightening. Despite interest rates rising sharply in 2022, we are not out of the woods yet. Although some inflation prints in certain regions appear to support the 'peak inflation' narrative, we would like to see a more sustained trend of deceleration. Across the Atlantic, the headwinds have mounted in the euro area (i.e., cost-of-living crisis, soaring energy prices, fragmentation risks) but we still expect the ECB to stay the course on tightening monetary policy. The UK seems to have returned to some semblance of calm following the change in leadership and the adoption of more prudent fiscal policies. The reversal of Kwasi Kwarteng's expansionary budget should see a lower peak in the Bank rate. In emerging markets, China effectively moved away from the restrictive 'zero-COVID' policy (amid growing discontent, which spilled over into unrest), while further support measures for the domestic property sector have provided a modicum of relief for the global growth outlook. We expect Beijing to continue rolling out support measures for the economy and the PBoC to keep monetary conditions supportive.

Local

South African business sentiment fell for a third consecutive quarter in Q4, while consumer confidence remains severely depressed amid rising borrowing costs and elevated inflation. Furthermore, the intensity and frequency of power blackouts and labour strikes are keeping the SA economy from building any sustained forward momentum. While the National Treasury is banking on better revenues, spending pressures remain upside risks given low growth and higher public sector wages. On the monetary front, the rand remains susceptible to exogenous shocks and domestic political volatility. With more hikes expected from the Fed, we expect the SARB to keep fighting the erosive power of inflation on household incomes and savings. This is reassuring for bond investors. We do, however, believe we are approaching the end of the hiking cycle and the pace of hikes should moderate given the deteriorating growth outlook. The growth outlook for the year ahead will continue to be shaped by developments in the global sphere of influence, Eskom and progress on the implementation of structural reforms.

Positioning

From a positioning perspective, SAGBs remain attractive on valuation grounds, relative to other asset classes in the fixed income universe and relative their historical record. That said, against the backdrop of higher inflation and rising interest rates – both locally and globally – we remain cautious in our positioning. We started to add duration in the final quarter of the year to reflect our positive view, but the ramp up in political uncertainty locally towards the latter stages prompted us to reverse course and take some risk off the table. Furthermore, we have some hedges in place to seek to reduce portfolio volatility. We continue to stress the importance of earning yield and protecting capital in this fluid environment.

We sold down ILBs in recent months on the belief that inflation has peaked in SA, reallocating the proceeds to nominals and cash instead. The asset class has served us well as a hedge for the portfolios. As price momentum has topped, nominals are poised to outperform ILBs, hence we have switched some of this exposure into former. ILBs have become less attractive from a valuation standpoint relative to nominal bonds and lower potential return prospects.

As the fundamental picture for listed property has begun to clear, we have increased our allocation and moved to a more neutral allocation to the asset class. The sector remains highly volatile and vulnerable to global and local newsflow, while rising short-term interest rates have also begin 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 on opportunities where we see value.

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

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.