Discovery Diversified Income Fund

Market background

In November, cooler-than-expected US inflation data hinted that the Federal Reserve might soften its stance on interest rates, spurring equity market growth. Black Friday's record online sales in the US boosted consumer sentiment and marked a strong start to the holiday season for retailers. In the manufacturing sector, the PMI showed slight improvement, signalling stabilization. However, the services sector experienced slower growth, with declines in various areas. The labour market also slowed, adding only 150,000 jobs, below expectations. Both equity and bond markets rallied strongly, with November being the best-performing month of the year. The lower inflation also spurred demand for long-dated US Treasury bills. The UK saw a drop in inflation to 4.6%, aided by reduced energy prices. The manufacturing sector showed recovery signs, but the economy did stagnate in Q3. The government introduced tax cuts and investment incentives, forecasting a 0.6% economic expansion. In the Euro Area, inflation hit a two-year low, but the European Central Bank (ECB) hinted at ongoing struggles with inflation and possible rate hikes.

In emerging markets, China formulated plans to support property developers amidst the woes in this sector. The People's Bank of China (PBoC) maintained its lending rate, and the new finance minister announced increased government spending, though concerns about the nation's debt and economic recovery capacity lingered.

Back home, headline inflation rose at a faster pace to 5.9% in October compared to a year ago, up from 5.4% in September. Notwithstanding, the South African Reserve Bank (SARB) noted a slight improvement in its inflation projections at its November MPC meeting, and voted unanimously to leave the key rate unchanged at 8.25% p.a.

Performance review

For the month, the portfolio outperformed the benchmark.

Financial markets saw off November on a positive note, buoyed by emerging signals of economic moderation in the US and a retreat in inflation across developed economies. Economic data broadly reinforced the notion that we have seen the last of central bank rate hikes in this cycle, which provided

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a tailwind for both equity and fixed income asset classes. Government bond yields declined over the period, with the benchmark US 10-year Treasury yield moving below 4.4% at month end, from a peak around 5% back in mid-October. Across the Atlantic, German bunds and UK gilts also saw notable declines in their yields, while the spread between bunds and Italian BTPs narrowed on the back of a favourable credit rating update for Italy's sovereign debt. Investment grade credit also benefitted from lower yields and expectations of rate cuts in 2024, as did emerging market debt where more accommodative central bank policies and a weaker greenback were particularly supportive.

Locally, softer US inflation led to strong rally in South African government bonds, luring foreign investors back into the nation's debt instruments. This contributed to extended gains for the rand, which gained the most against the US dollar since July. Further tailwinds which contributed to the rand's recovery included risk reversals, the higher carry trade and lower implied volatility levels. The JSE All Bond Index delivered a 4.7% return for the month. Yields declined by an average of 66 basis points across the maturity curve, with positive performance booked across all term buckets, which aided the Fund's performance.

Inflation-linked bonds (ILBs) rallied over the month, generating positive returns for the portfolio, as the curve bull steepened. The asset class found support in favourable budget announcement, the rally in global bonds and the reconstitution of the iGOV Index.

Listed property delivered robust returns over the month, adding to performance.

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

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

Outlook and strategy

Global

Economic momentum across the developed world remains subdued and sentiment remains cautious as we enter the final weeks of 2023. Inflation has made considerable ground downwards without any calamity in the job market, largely driven by energy prices. Although, core inflation now seems to be acquiescing, central bankers across the Fed, ECB and Bank of England warn that core could be tougher to budge in this final leg of the journey, making it difficult for headline inflation to stay down consistently once energy price effects dissipate. Barring an event, the Fed is likely to keep official rates on hold until inflation has been genuinely tamed. Policymakers has now shifted the focus from data dependency to 'higher for longer'. We believe a Fed cut in the second quarter of 2024 is a reasonable expectation, barring significant deterioration in the data, which could see that timeline brought forward. Across the Atlantic, sharply falling inflation in Europe suggests more emphatically a peak in rates. Economic weakness is palpable in Europe. Eurozone GDP contracted in Q3 2023, with growth of just 0.1% year on year (y/y). The ECB has aggressively raised interest rates and run down its balance sheet by 19% of GDP, compared to the US Federal Reserve's 8%. It is no surprise that we are seeing a strong transmission of monetary policy into European GDP trends. ECB policy will keep the pressure on the EU consumer; thus, we do not see any pickup in growth in this region anytime soon.

In emerging markets, a handful of central banks have already begun to ease monetary policy, given that most EM central banks had already started their hiking cycles ahead of their developed market

peers. Disinflation has occurred faster relative to DMs. EM fundamentals have shown resilience despite headwinds from exceptional US growth, higher US Treasury yields, stronger dollar, and weaker growth headwinds from China. We expect the narrative in EMs to improve in 2024, largely driven by fading US “exceptionalism” and the expected move lower in US Treasury yields which should help the carry trade. Growth looks set to be healthy, with China likely to be a drag. However, we believe growth supportive policy moves by Beijing and the PBoC will be a tailwind for emerging markets in the coming year. Any pick-up in growth in China will be supportive on two fronts for EMs.

Local

Following a surprisingly robust expansion in Q2, growth disappointed in Q3, contracting 0.2% q/q. Agriculture, industry and lower investment were the main drags on growth over the period. Taxi strikes in the Western Province and the flooding alongside power outages were a drag on Q3 activity. We saw an improvement in PMI data in November, but demand conditions remain challenging and business activity lukewarm following the ramp-up in power outages in November and a worsening situation at the ports. Looking forward, we expect these structural constraints to continue to be a drag on growth in the second half of 2023. For 2024 we believe growth prospects will improve as inflation and interest rates ease. While loadshedding has eased, it still remains a thorn on the growth side. The pickup in renewable energy capacity next year will no doubt be growth additive. The SARB is likely to remain hawkish on the back of the upside surprise to inflation in October but is expected to start cutting rates in the second half of 2024. While the Bank was ahead of the Fed et al on the way up, we do not expect the MPC to be pre-emptive on the way down, especially in an election year. Our outlook into year end and early next year is brighter, but we maintain some risk-mitigating strategies in case of showers.

Positioning

From a positioning perspective, South African government bonds (SAGBs) remain very attractive on valuation grounds, relative to other asset classes in the fixed income universe and relative to their historical record. We were long going into November, then cut back following the rally, and added back after the retracement. We remain vigilant in our positioning due to uncertainty in the global environment and some domestic idiosyncratic risks. In this uncertain environment, we continue to emphasize the importance of maximising yield and protecting capital.

Overall, our positioning in ILBs remains neutral to shorter-dated linkers. The asset class served us well as a hedge against this and any rand weakness for the portfolios. Real yields appear attractive relative to history and have rallied.

The fundamental picture for listed property continues to clear. We have increased exposure to the asset class, but risks for the sector remain. The asset class remains highly volatile and vulnerable to weak growth prospects, high nominal bond yields, while elevated short-term interest rates have also begun to weigh down on many property firms given the reliance on financing for expanding their portfolios. We maintain select exposure and will continue to tactically seize opportunities where we see value.

Investment-grade credit remains a neutral allocation in our portfolios. We maintain a cautious approach to adding corporate bonds 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. Our preferred sectors remain banks, government guaranteed SOE’s (we are now more

comfortable holding Transnet) and insurance, while looking for companies displaying strong asset quality, valuation, contractual cash flow and conservative management.

In portfolios permitting FX exposure, we believe it is prudent to retain a small allocation to a basket of offshore currencies. 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 uncertainty in the global environment.

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