Discovery Diversified Income Fund

Market background

The US economic expansion kicked on in February, while inflationary pressures persisted and COVID infections ebbed. Manufacturing activity remained robust, with the purchasing managers' index (PMI) rising to 57.5 in February, from 55.5 the previous month. The US labour-market recovery also continued in the face of surging infections in the winter months and the 4 March employment report is expected to show more jobs added in February on the back of slowing COVID infections and as restrictions are being gradually rolled back. The US Federal Reserve's (Fed's) preferred inflation measure (core personal consumption expenditures index) rose another 0.5% in January, which translates to an annual increase of 5.2%. The Federal Open Market Committee looks set to commence its interest-rate hiking cycle when officials gather for their scheduled 15-16 March.

Europe became the world's centre of attention in February as Russian President Vladimir Putin launched a so-called 'special military operation' in Ukraine, which has since escalated to a full invasion and triggered a raft of sanctions from the US and its allies aimed at isolating Russia's economy. Europe's economy had already lost momentum in Q4 2021. Policymakers now also have to contend with high inflation (which will be exacerbated by the conflict) alongside a tightening labour market, which together have fuelled the debate on potentially fast-tracking the normalisation of monetary policy. Consumer and business confidence indicators both fell in February. Consumer prices rose to a record high 5.1% y/y in January, from 5.0% year on year (y/y) in December, with energy prices the biggest contributor amid a power crisis in the area which has seen electricity, natural gas and coal prices shoot up, while the pandemic-induced supply-demand imbalance also puts pressure on prices. On 25 February, European Central Bank (ECB) President Christine Lagarde promised that the bank will "take whatever action necessary" to ensure price and financial stability in the region.

In emerging markets, China's economy recorded its slowest expansion in nearly two years over Q4 2021 amid a broad downturn in agriculture, industry and services sectors. Consumer spending has suffered from Beijing's persistence with its 'zero-COVID' policy. Incoming data points to a continuation in these conditions as the Omicron variant continues to spread and as weakness persists in the property market. Manufacturing activity held up in February, with the PMI unexpectedly rising to 50.4 from 49.1 in January (the 50 mark separates expansion from contraction). That said, steps to maintain growth are likely to be hindered by the rise in commodity prices following the Russian military operation in Ukraine. The People's Bank of China (PBoC) has vowed to keep its monetary policy flexible and responsive to changes in the economic situation, with the main goal of maintaining stability.

The mood on South African factory floors has remained upbeat so far this year, with the latest PMI readings improving analyst expectations for growth. The annual inflation rate fell to 5.7% in January 2022, from a near five-year high of 5.9% in December 2021, as predicted, but remained near the top of the South African Reserve Bank's (SARB's) target range of 3-6%. Core inflation (which excludes volatile items in the basket such as food, fuel and energy) rose for the fourth month in a row to 3.5% in January, from 3.4% in December. On the fiscal front, Finance Minister Enoch Godongwana delivered a market-friendly budget speech in which the corporate tax rate was lowered, while the windfall from the commodities rally boosted revenues and improved South Africa’s debt metrics.

Performance review

For the month, the portfolio outperformed the benchmark.

Globally, the prospect for higher inflation and more aggressive central-bank intervention harmed sovereign bonds, though there was some relief at the month's close. US Treasuries lost 0.7% for the month, while UK gilts, German bunds and Italian BTPs lost 1.5%, 1.6% and 2.4%, respectively. The Bloomberg Barclays Global Aggregate Bond Index closed 0.8% lower. At the time of writing, it remains unclear whether central banks will respond to higher oil prices by boosting the quantum or speed of interest-rate hikes to fight inflation, or by slowing the tightening cycle to prop up the economic recovery.

Locally, nominal bonds delivered flat performance over the period, with some yield-curve flattening as yields in the front end edged higher, while the long end remained largely steady. The JSE All Bond Index eked out +0.5% for the month, with foreigners net sellers of local bonds in February. Positive performance was recorded across most tenors of the curve and our positioning helped performance. Bonds remain an important source of income for the funds and continue to contribute positively to returns.

The allocation to inflation-linked bonds (ILBs), biased to the short end of the curve, helped performance, and continued to offer protection against rising inflation risks.

Listed property continued to endure weakness over the month, and this proved to be a drag on returns.

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

The FX exposure in the portfolio has helped to cushion some of the impact from rising US yields. The US dollar built on its strong performance strongest performance against a basket of its trade partners in February, thus advancing the FX component of the portfolio.

Outlook and strategy

Global

The Russo-Ukrainian crisis is a curve ball which has made an uncertain transition to normalised monetary policy even more murky. The outlook for monetary policy and the ongoing geopolitical turmoil remain key drivers of capital markets at the moment. Yield curves have risen sharply this year on the back of record-high inflation prints. The deluge of monetary and fiscal stimulus saw massive pent-up economic demand run into once-in-a-lifetime supply-side shocks, while recoveries in labour markets have put upward pressure on wages.

We expect growth to moderate but remain above-trend in 2022, as fiscal and monetary stimuli is gradually phased out. Regionally, US growth will most likely remain above-trend, owing to a strong consumer and a healthy dose of fixed investment spending. Elsewhere, as it pursues more inclusive and sustainable growth, China appears willing to tolerate slower growth in the short term. The 'zero Covid' policy has recently dampened economic activity, but we expect fiscal and monetary policy to remain reasonably supportive in the future and the People’s Bank of China (PBoC) has pledged to keep monetary policy flexible and responsive to changes in the economic situation, with the main goal of maintaining stability. This along with pent-up demand, should support China's economy and emerging markets more broadly.

Local

While the global story has deteriorated, the local story has improved somewhat and slightly offsets some of the global risks. South Africa's economy impressed with resiliency and a stronger-than-anticipated rebound in the first nine months of 2021, but this momentum was undermined by the Omicron-induced travel bans in the final three months of last year. Looking forward, we expect growth to return to pre-pandemic levels by year-end, notwithstanding a gradual SARB hiking cycle. We expect mining, financial services and agriculture to remain the driving force in the economy, but more worryingly, the labour absorptive sectors of manufacturing and construction sectors, are likely to be hamstrung by never-ending electricity supply issues and a lethargic policy arena. On the fiscal front, more growth would be a welcome reprieve for the public purse. The February budget announcement was supportive of the economy and painted a better picture than was initially feared. Notwithstanding, flagging state-owned enterprises, rising borrowing costs, a bloated public sector wage bill and lukewarm growth pose downside risks to the fiscal outlook. The global picture has deteriorated significantly coming into 2022, while the local outlook is not entirely bleak. Nonetheless, South Africa is not impervious to exogenous shocks. And so, the outlook for the year ahead comes with a health warning: the longer the conflict between Russia and Ukraine takes to resolve, the more the corollary will begin to morph into the dreaded double whammy of higher inflation and slower economic growth.

Positioning

We remain cautiously optimistic on EM debt and are comfortable to hold South African Government Bonds (SAGBs). Our yields remain not only attractive versus cash and inflation, but relative to our developed markets (DM) and their emerging market (EM) peers – underpinned by a compensating fiscal premium. An investor in South African bonds can earn a yield of around 10.15% (at the time of writing) on a 10-year note – which is well above inflation. In contrast, US Treasury investors have to contend with deeply negative real yields. We have shaved off a bit of duration in recent weeks to the shortest we have been for some time in light of growing geopolitics. The portfolios remain well-diversified, alongside an allocation to bond put-options, which offer protection for the portfolios in a hiking cycle and the multitudes of local and global risks.

We expect four more 25bps hikes from the MPC in 2022. We are however concerned about a prolonged crisis in Ukraine and the affect it will have on oil and food prices. We will maintain a defensive positioning until we see some positive steps to resolve the conflict.

We have increased the allocation to inflation-linked bonds (ILBs). The inflation outlook has deteriorated, largely on the back of recent geopolitical developments. We have increased the allocation to the asset class, which are a 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.

As the fundamental picture for listed property has begun to clear, we have slightly increased the allocation to listed property, tactically seizing on opportunities following the recent sell-off. Notwithstanding, we maintain an exposure less than what would have been the case a few years ago, as the asset class remains highly volatile.

The portfolio is marginally underweight credit, with minimal exposure to the cyclical sectors of the economy. We maintain a preference for quality defensives, namely banks, insurers, telecommunications and 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 as a risk mitigator during times of rand weakness. We have a mix of US dollar, euro and EM in order to diversify our FX exposure.