Discovery Diversified Income Fund

Market background

In the US, investor sentiment improved on the back of stronger-than-expected corporate earnings and the prospect that the Federal Reserve (Fed) could begin slowing the pace of interest rate hikes as early as February. Market consensus suggested that the Fed would increase rates by 25 basis points (bps) at its next policy meeting following a 50bp hike in December. Supporting this viewpoint was a steady decline in inflation data. Annual inflation slowed for a sixth consecutive month to 6.5% year on year (y/y) in December from 7.1% in November. Meanwhile, annual core PCE (the Fed's preferred measure for inflation) fell to 4.4% in December from 4.7% in the previous month, marking the smallest annual increase since October 2021. Detracting from the rate outlook somewhat were signals of a stronger economic recovery. The US economy expanded by an annualised 2.9% q/q in Q4 2022, beating market forecasts of 2.6%. The labour market also showed signs of tightening, with the unemployment rate dropping to 3.5% in December, below market expectations of 3.7%.

Euro Area GDP grew by an annualised 0.1% q/q for the final quarter of 2022, above market forecasts of a 0.1% contraction and below the 0.3% expansion posted in Q3. The muted growth came against the backdrop of easing demand and activity, higher inflation, rising interest rates and ongoing supply chain challenges. In other news, Euro Area inflation printed lower at 9.2% y/y in December, down from November's 10.1%. Inflation in the region remains well above the European Central Bank's 2.0% target, suggesting that the central bank may continue its policy-tightening campaign. Markets are currently pricing in two 50bp hikes over the next two policy meetings.

In the UK, Morningstar's credit arm DBRS downgraded the UK's long-term foreign and local currency from AA (high) to AA, citing divisive politics compounded by economic challenges within the region as the primary drivers. Annual inflation printed marginally lower in December at 10.5% (vs 10.7% in November), with consensus forecasts suggesting that the Bank of England would raise interest rates by 50bps to 4.0% at its February meeting.

Asian markets rallied on the back of China reopening its economy and relaxing its COVID policies. Sentiment improved further after Chinese authorities said that the government would take the necessary measures to help boost market confidence and increase support for manufacturers and small companies. In addition, policymakers indicated their intention to promote consumption and boost imports in a bid to spark a resurgence in Asia's largest economy. GDP data showed that China's

economy had stalled in Q4 2022, growing at a flat rate compared to the market consensus of a 0.8% contraction. In other news, the People's Bank of China (PBoC) left its key lending rates unchanged in January as widely expected. While annual inflation rose to 1.8% y/y in December from November's eight-month low of 1.6%.

In South Africa, sentiment was buoyed by the prospect of a less-hawkish Fed and renewed optimism over the reopening of China's borders. Other news lifting investor sentiment came in the form of a smaller-than-expected rate hike from the South African Reserve Bank (SARB). The central bank raised the benchmark repo rate by 25bps to 7.25%, below market forecasts of a 50bp increase. In its monetary policy statement, the SARB painted a sobering picture of the country's economy, highlighting rolling blackouts and other logistical constraints as key risks to economic growth. The SARB's latest GDP forecast now sees the economy expanding by just 0.3% (vs 1.1%) in 2023 and 0.7% (vs 1.4%) in 2024. Positively, the reserve bank expects headline inflation to continue its trajectory towards the midpoint of its 3-6% target band over the next two years. Meanwhile, annual inflation continued to show signs of slowing after easing to 7.2% y/y in December from 7.4% in November. South Africa's retail trade surprised on the upside, rising 0.4% y/y in November following two straight months of declines, beating market forecasts of a 0.2% fall. Manufacturing PMI came in at 53 in January, almost unchanged from the seven-month high posted in December and pointing to the third successive month of expansion in manufacturing activity.

Performance review

For the month, the portfolio outperformed the benchmark.

January was a very strong month for risk assets. Investor sentiment was boosted by the reopening momentum in China, a mild winter in Europe and signs of moderating inflation in the US. A further boost to financial markets came from the resultant drop in US Treasury yields, which fell by around 37 basis points over the month (10-year Treasuries).

Developed market sovereign bonds performed positively. The prospect of an evolution in the Fed's plans saw Treasuries deliver their second best performance since the start of the COVID pandemic in March 2020. Investment-grade credit also delivered a positive return, benefiting from the move in rates, with the US outperforming Europe in both sovereign and credit bonds. Elsewhere, following the initial excitement from the Bank of Japan's (BoJ) policy change to allow the yield on the 10-year government bond to move 50 basis points either side of its 0% target, it was clear that the BoJ intended to maintain its accommodative monetary policy. Nonetheless, Japanese government bonds rebounded on the announcement of the expanded lending programme The Bloomberg Barclays Global Aggregate Bond Index ended the month up 3.28% in US dollars.

Locally, the JSE All Bond Index delivered a 2.94% return for the month. We saw the yield curve bull-steepening at month-end, with front-end yields decreasing by a larger magnitude than the longer-end of the curve. In terms of performance, the month shaped up well as South Africa is particularly well positioned to benefit from China's reopening as a net exporter of commodities. Positive performance was noted across all tenors of the curve, and our positioning, which mostly favours the belly of the curve contributed positively to performance.

The reduction in inflation-linked bonds (ILBs) in recent months continues to prove beneficial as these bonds delivered negative returns over the period.

Listed property delivered a negative return in January, and our select exposure to the asset class offset some of our gains in the nominal bond space.

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 on returns as the greenback weakened considerably against a basket of its major trading partners over the period. We had reduced our exposure to FX 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, European data provided evidence that the economy has been faring better than initially expected, while in the US and the UK the reverse was true. The Standard and Poor's (S&P) Global/CIPS Flash United Kingdom (UK) purchasing managers' index sank to a two-year low of 47.8 points in January 2023. The survey results indicated that higher interest rates and low consumer confidence were the main drivers of the sustained downturn in UK business activity. In emerging markets, China abandoning the restrictive 'zero-COVID' policy continues to provide 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. February will be particularly important given elevated event risk in the form of the State of the Nation Address and the imminent cabinet reshuffle, the National Budget, and lastly the Financial Action Task Force will announce its decision on South Africa's greylisting. With more hikes expected from the Fed, albeit at a slower pace, 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.

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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, rising interest rates (both locally and globally) and domestic idiosyncratic risk, we remain cautious in our positioning. We started to add duration in January to reflect our positive view. 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, cash and listed property 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 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 on opportunities where we see value.

Investment-grade credit is a neutral 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.

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