Discovery Diversified Income Fund

Market background

Fast View:

- The US Federal Reserve and European Central Bank held rates steady in January, indicating there will be cuts later in 2024
- Despite the rate-cutting narrative, fixed-income assets, particularly in developed markets, struggled to make gains in the month
- The South African Reserve Bank held rates at 8.25%, while the IMF downgraded SA's growth forecast
- The Bank of Japan provided stronger signals that it is getting ready to raise rates

To read more, please click here.

Performance review

For the month, the portfolio outperformed the benchmark.

The first few weeks of January, saw the yield on the global benchmark US 10-year Treasury note hover around 4.05%, further supported by positive bond supply dynamics, following news that the US Treasury would need to borrow less than initially projected. Across the pond, the German 10-year bund yield descended toward the 2.23% level, as money markets priced in a 25-bp cut by the European Central Bank (ECB) as early as April. However, the pushback by central bankers – notably US Federal Reserve (Fed) Chair Jerome Powell on Q1 rate cuts, saw global bonds struggle to generate a positive return for the month. US Treasuries ended the month down 0.2%, while their European counterparts were 0.6% in the red. Overall, the Bloomberg Barclays Global Aggregate Bond Index was down 1.4% for the month. In the investment-grade realm, spreads continued to narrow over the month, with blue-chip corporate bond spreads reaching their lowest levels since 2022. All returns are quoted in US dollars.

While emerging market (EM) debt came into the new year basking in the afterglow of a thawing global bond market, the asset class similarly found the going tough in the end, down 1.2% over the month (in US dollars). Locally, the JSE All Bond Index managed to eke out a modest 0.7% return for the month. Positive performance was noted across all term buckets, although the major drivers of performance came from the front and belly parts of the yield curve. Our duration positioning was a positive contributor to performance.

Our selective exposure to inflation-linked bonds (ILBs) added to returns and we continue to reduce our holdings here.

SA listed property carried its positive momentum into the new year and our allocation to the asset class was once again a positive contributor 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 US dollars, enhanced gains as the greenback strengthened against its G10 peers, as investors dialled back expectations on Fed cuts.

Outlook and strategy

Global and local

The Fed has indicated its plan to lower interest rates this year following a period of significant rate increases. The ECB is taking its time, but rate cuts are anticipated to occur in the first half of the year. This shift is expected to decrease the influence of monetary policy in bond markets, as inflation becomes more manageable. 2024 is expected to see more emphasis on growth. We expect the narrative in EMs to improve, as the influence of the US diminishes, and US Treasury yields decline.

Locally, we are more optimistic on the rand, although there may be bouts of noise and turbulence from time to time. The outlook for 2024 is expected to strengthen as inflationary pressures subside and financial conditions become more accommodating. As investors, the main event in February is the budget speech, as recent data from the National Treasury has brought to light worrisome news on both the revenue and expenditure fronts. The South African Reserve Bank's hawkish tone at its recent meeting suggests they are in no rush to cut interest rates, as they still expect inflation to be stubborn in the near term, alongside concerns surrounding fiscal prudence. We are pencilling in the first rate cut in the second half of 2024.

Positioning

South African government bonds remain very attractive on valuation grounds, relative to other asset classes in the fixed income universe and relative to their historical record. We trimmed duration into strength during the month and continued to switch some of our ILB exposure into nominals due to the improving inflation outlook. We maintain our property exposure and are neutral corporate bonds and FX, where we are underweight the euro relative to the greenback.

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