Discovery Diversified Income Fund

Market background

In Q3 2023, the US economy's annualized growth rate was adjusted to 4.9%, down from the initial 5.2% estimate. Consumer spending, a key driver of the economy, increased by 3.1%, less than the 3.6% previously estimated, but it was still the highest since Q4 2021. The year ended with signs of a slowdown due to tighter credit, slower job growth, the resumption of student loan repayments, and an automotive sector strike, while the manufacturing PMI dropping below 50 in October, ending the year at a downwardly revised 47.9 in December, was an indication of a bigger deterioration in manufacturing conditions. Growing concerns about sustained high-interest rates led to significant bond market sell-offs, further impacted by persistent inflation and rising oil prices. By late October though, markets responded positively to downside surprises in inflation, and an increasingly dovish sounding (Federal Open Market Committee). The potential for Fed rate cuts in 2024 sparked a major rally across most asset classes in Q4, with November booking the best month on record for the Bloomberg Global Aggregate Bond Index (+5.0%) since the 2008/09 Global Financial Crisis (GFC).

Locally, South Africa's economy shrank by 0.2% in Q3 2023, slightly more than the expected 0.1% contraction. This was mainly due to power outages, port logistics issues, and external factors. Manufacturing PMI remained in contraction for 11 straight months. Some positive data emerged in December with better-than-expected industrial, mining, and manufacturing figures, potentially averting a technical recession in the second half of 2023. However, October's retail sales were weaker than anticipated. Inflation eased in November, with the headline rate slowing to 5.5%, driven by reduced transport inflation. Core inflation remained high at 4.5%. The South African Reserve Bank sees inflation risks but considers its current monetary policy restrictive enough. It is expected to start easing from mid-2024, likely following the US Federal Reserve's lead.

To read more, please click here.

Performance review

For the quarter, the portfolio outperformed the benchmark.

2023 was punctuated by significant market events, including the Silicon Valley Bank collapse in March, an AI driven tech boom, and higher interest rates causing a major bond sell-off. Though by late October, many asset classes began to rally as declining inflation and anticipated rate cuts buoyed confidence. Fixed income markets participated in the rally, capping their best quarterly performance in nearly two decades, inspired by anticipation of rate cuts in 2024, narrowing spreads, and weakening US dollar. A more sanguine outlook for interest rates was a boon for sovereign bond returns over the quarter. Government bond yields fell sharply across the board, with the US benchmark 10-year Treasury falling from 4.57% at the start of the quarter to end Q4 at 3.87%. Across the Atlantic was where performance ran the hottest, with UK Gilts up 8.7% gain over Q4, while tightening spreads between the Euro's benchmark German Bunds pushed the Italian BTP to a 7.5% gain. The Bloomberg Barclays Global Aggregate Index returned +4.2% for the quarter. Corporate bonds also enjoyed strong returns on growing hopes of a 'soft landing' and easing financial conditions.

Emerging market debt was the best performing sector over the quarter as funding risk from higher for longer interest rates dissipated. Locally, South African government bonds benefitted from the exogenous tailwind effects of continued disinflation and the positive outlook for US interest rates, luring foreign investors back into the nation's debt instruments. This alongside risk reversals, the higher carry trade and lower implied volatility levels supported the rand over the quarter but was not enough to erase year-to-date losses. The JSE All Bond Index carried momentum from November to finish a strong +8.1% for the quarter. Yields declined across the maturity curve, with positive performance booked across all term buckets, which aided the Fund's performance.

Inflation-linked bonds (ILBs) rallied 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.

SA listed property was surprisingly the best performing asset class in 2023 after going on a tear in the final two months of the year. We had been adding selective exposure here and were well positioned to benefit from the rally.

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 on growing hopes of a Fed pivot.

Outlook and strategy

Global

Undoubtedly, signs of a broad slowdown in both economic expansion and price increases had been apparent well ahead of the FOMC meeting in December. There were strong indicators of the US labour market slowing down, while importantly, there was evidence of prices cooling to levels very close to the Fed's target of 2%. The possibility of recession looked less and less likely, with the unemployment rate consistently trending below 4% for two years running. Across the Atlantic, however, the situation was more worrisome in Europe, where the region's economy tethered on recession, while the UK wrestled with stubbornly high inflation. Meanwhile in Japan, central bankers were finally considering moving away from their yield-curve control measures and considering raising interest rates for the first time in a generation. On account of developments in the US, it is reasonable to assume that the Fed is primed to cut rates in the second quarter of 2024, barring significant deterioration in the data, which could potentially see that timeline brought forward. Across the Atlantic, sharply falling inflation in Europe suggests more emphatically a peak in rates and economic weakness is palpable. The ECB has aggressively raised interest rates and run down its balance sheet by c.20% of GDP, almost twice as much as the Fed. It is no surprise 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 during the hiking cycle, notwithstanding the headwinds US "exceptionalism" and weaker growth headwinds from China. We expect the narrative in EMs to improve in 2024, largely driven by fading US exceptionalism and the continuing trend 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.

Local

Following the disappointing contraction in growth over Q3, the cumulative effect of the litany of challenges that have plagued SA's economy (notably Eskom and Transnet) and weaker incoming data may push SA into a technical recession in the fourth quarter of 2023. We've seen an improvement in PMI data in recent months, but demand conditions remain challenging and business activity lukewarm following the ramp-up in power outages in November and the intensification of port crisis in Durban. 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 price pressures ease and financial conditions become less restrictive. While loadshedding has eased, it remains a thorn on the growth side. The pickup in renewable energy capacity in 2024 will however counter some of the downward pressure on the national grid and be growth additive. A weaker dollar and Fed cutting cycle usually winds up investor appetite for EM portfolios and currencies, but idiosyncratic issues have for a long time been a put-off for investor sentiment towards SA. The rand should benefit from exogenous factors, but volatility is guaranteed. We expect the SARB to hold rates steady when the Monetary Policy Committee convenes on 25 January 2024, just days before the FOMC. We are pencilling in the first cut for around mid-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. History teaches us that the

SARB's default setting is hawkish. Although upside risks to inflation remain in the near term, remain due to exogenous factors, we believe the pass-through from currency weakness, demand-pull inflation, wage pressures, and administered prices, should remain subdued, thus dulling the second-round effects to prices. Overall, our outlook for the first few laps of 2024 is for a smoother ride, 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 added duration over the quarter and switched some of the ILB exposure into nominals. 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 underweight. The asset class served us well as a hedge in 2023 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 increased our exposure to the asset class, but risks for the sector remain. We have added to our property position in recent months and are now the most exposed to the sector since pre-COVID. We remain selective in our allocation 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. We have become more neutral in our exposure. 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 a fluid global environment.

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