Discovery

Discovery Diversified Income Fund

Market background

The US economy entered a 'technical recession' following a second consecutive quarter of negative growth. Growth contracted by an annualised 0.9% quarter on quarter (q/q) in Q2 2022 (following a 1.6% contraction in Q1), as rising interest rates and record high inflation weighed on business and consumer spending. Notwithstanding a slowing pace of growth and four-decade high inflation (9.1% year on year in June), the labour market remained robust, marked by another strong month of US jobs gains. At its 27 July meeting, the Federal Open Market Committee voted unanimously to raise the Federal funds target range by 75 basis points (bps) to 2.25%-2.50% but provided no guidance on the minutiae of upcoming rate rises.

The eurozone economy expanded at an annualised rate of 0.7% q/q in Q2 2022, following a downwardly revised 0.5% in Q1, and above consensus expectations of 0.2% growth. The easing of COVID-induced restrictions and the summer season in the area largely underpinned growth over the quarter. The unemployment rate was unchanged for the second straight month, at a record-low 6.6% in June and in line with consensus expectations. Meanwhile, inflation soared to a new record-high 8.9% y/y in July, forcing the European Central Bank (ECB) to deliver its first interest rate hike since 2011, as it announced a 50bps hike in all key rates. Given the myriad of crosscurrents at the fore, the ECB (like the US Federal Reserve), offered little guidance regarding future hikes.

In emerging markets, China's economy shrank 2.6% q/q in Q2 2022, the first quarterly contraction since Q1 2020. Economic activity suffered earlier in the quarter on the back of the COVID-induced lockdowns, which led to sharp pullbacks in retail sales and industrial production. The economy weakened further in July, with factory output and new orders slowing to levels last seen in 2020. The People's Bank of China (PBoC) promised support for the economic recovery by facilitating financing for the embattled property sector, while also announcing it will maintain stable overall loan growth and ensure sufficient liquidity through multiple monetary tools.

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Sentiment on South African factory floors, measured by the ABSA PMI, plunged in July (the first below-50 reading since the July unrest last year), as the worst spate of power blackouts on record curtailed production, alongside a deteriorating global economic backdrop, which is affecting major trade partners. Business confidence has fallen to the lowest level since Q1 2020, pre-COVID, while consumer sentiment is at levels last seen in 1986. At the same time, headline inflation soared further above the South African Reserve Bank's (SARB) 3%–6% target range, printing at 7.4% y/y in June (the highest reading since May 2009). The SARB surprised the market with a larger-than-expected 75bps rate hike at its 21 July Monetary Policy Committee (MPC) meeting and guided for more stern monetary policy for the remainder of the year.

Performance review

For the month, the portfolio outperformed the benchmark.

We saw developed market government bond yields track lower (yields fall as prices rise) on the back of a potential slowdown in the Fed's rate-hiking cycle, while much-improved risk sentiment saw US high-yield credit return 6.0% in July. The Bloomberg Barclays Global Aggregate Bond Index ended the quarter down -8.3%.

Select pockets of the EM fixed income universe caught a bid in July as yields in the developed world retreated on recession fears. We witnessed a shift lower in the yield curve by month end. The yield on the benchmark 10-year government retreated 21 basis points to end the month at 10.78%. Positive performance was recorded across most tenors of the curve, with the local bond market recouping some of the recent losses. Our positioning was beneficial to performance, and we were happy to participate in the July rebound given that this year has mostly been about protection.

The allocation to inflation-linked bonds (ILBs), in particular, short-dated maturities, continued to provide protection for the portfolios against prevailing inflation risks.

Listed property had a strong recovery month, and our select exposure to the asset class added to performance.

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

We upped the allocation to FX during the month as a hedge against which helped counter some of the weakness. The US dollar outperformed against a basket of its major trade partners, which helped the FX component of the portfolio.

Outlook and strategy

Global

Predictions of recessions in the world's largest economies continue to ratchet higher against a backdrop of unrelenting inflation, the ongoing conflict in Ukraine, brewing Sino-American tensions

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more recently over Taiwan, COVID flare-ups in China and a 'zero-COVID' policy which continues to disrupt supply chains and stifle economic activity. At the same time, monetary policymakers continue their fight against inflation as they press on with interest rate hikes and the withdrawal of liquidity from the financial system following the post-GFC deluge of cheap money. The markets appeared to read the tea leaves of the Fed's recent policy announcement as a potential pivot from an aggressive hiking cycle in the not-so-distant future. However, we believe, it was a reasonably neutral statement, and a 'data-dependent' approach could also mean that the Fed could tighten the policy screws even tighter should the data continue to deteriorate.

Local

The local economic outlook is negatively affected by the ongoing conflict in Ukraine and the stringent lockdowns in China, which together exacerbate supply-chain challenges and inflationary pressures. South African business and consumer sentiment is at all-time lows. Q2 2022 GDP growth is forecast to decrease by 0.9% q/q. The SARB's leading indicator of future economic activity six months ahead, fell by 8.5% y/y in May following downward revisions on the back of the tragic KZN floods. Furthermore, the intensity and frequency of power blackouts and strike action in various industries are likely to have a perilous effect on growth in the second quarter and remainder of this year. The recent announcement of energy reforms by the Presidency were broadly well-received, but optimism aside, we need to see a more detailed implementation plan with hard deadlines, KPIs, and accountability mechanisms built into the action plan. The reforms announced are growth positive and as bond investors, we are further encouraged by the Presidency and National Treasury working toward a sustainable solution to Eskom's debt problem. On the monetary front, the SARB views risks to inflation to be on the upside and have thus upwardly revised their projections for both headline and core inflation as price pressures become more broad-based. The rand remains at the mercy of exogenous shocks whenever risk sentiment deteriorates and investors flock to so-called 'safe-haven' currencies. Given elevated inflation locally, the worsening in longer-dated inflation expectations and rising interest rates in the developed world, we expect the SARB to maintain a firm handle on policy in the coming months to fight the erosive power of inflation on household incomes and savings. This is reassuring for bond investors.

Positioning

We have added some duration and have some hedges in place as we seek to reduce portfolio volatility. Local yields remain attractive, not only versus cash and inflation, but relative to developed markets (DM) and emerging market (EM) peers – underpinned by a compensating fiscal premium. Even accounting for inflation tracking above the SARB's target range, an investor in South African bonds continues to earn a healthy real yield on SAGBs. We recognise that local bonds continue to offer an appealing long-term income opportunity for investors. The portfolios remain well-diversified; this – in combination with active allocation – aims to provide some protection against the multitude of local and global risks, while also allowing the portfolio to participate in the upside potential of a bond market rally. This investment strategy has helped us to deliver attractive real returns to investors.

We maintain the allocation to ILBs. Inflation has printed higher, and we have accordingly revised our forecasts. ILBs to do their job as a hedge for the portfolios and we maintain a bias to for short-dated maturities.

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Following prolonged weakness in recent months, we added a bit of exposure to the listed property sector, tactically seizing on select opportunities on valuation grounds.

Investment-grade credit is a marginally underweight allocation in our portfolios on valuation grounds. We maintain a cautious approach to adding risk to the portfolio in a tight spread and tough economic environment.

In portfolios permitting foreign-exchange (FX) exposure, we believe it is prudent to retain a reasonable allocation to a basket of offshore currencies. We have added a bit to the FX component. The lion's share of the exposure resides in 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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