Discovery Target Retirement Date Funds

Market background

Following a dreadful first half of the year for capital markets, July provided a welcome reprieve as investors priced in the likelihood of the US Federal Reserve pivoting away from its aggressive hiking cycle, given a deteriorating global growth outlook and some signs that inflation may be peaking.

While the jury is still out over the Fed's stance, risk assets latched onto this more dovish narrative, with developed market (DM) equities (MSCI World Index) rallying to post a 8.0% gain for the month, well ahead of their emerging market (EM) peers (MSCI Emerging Markets Index, -0.2%) which were hobbled by weak Chinese stocks that were dragged lower by the protracted real estate crisis and a resurgence of COVID cases. Growth stocks were back en vogue, paring back some of their year-to-date losses. A reasonable corporate earnings season propelled the US benchmark S&P 500 Index (+9.2%), while the tech-heavy Nasdaq Index did even better, posting gains of 12.4% over the same period. Across the Atlantic, European equities (Stoxx 600 Index, +5.7%) also rebounded with their biggest monthly gain since November 2020 as investors shook off gloomy inflation and growth concerns and took comfort in the potential Fed pivot.

In fixed Income, we saw developed market government bond yields track lower 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. US Treasuries gained 1.6% over the period, with the yield on the US benchmark 10-year Treasury falling 36 basis points (bps) to end the month at 2.65%. Following their weakest quarter in decades, European sovereign bonds emerged from the depths of despair to post their biggest monthly gain on record amid mounting growth concerns and a precarious energy outlook. The Bloomberg Barclays Global Aggregate Bond Index ended the month up 1.8%.

All returns are quoted in US dollars.

South African equities and bonds also enjoyed some reprieve along with their global peers. The FTSE/JSE All Share Index gained 4.2% over the month, with the Capped SWIX up 2.8%. At a super-sector level, industrials (+5.8%) led performance, followed by financials (+4.6%), while resources also ended on a modest +1.3% return. Select pockets of the EM fixed income universe caught a bid in July as yields in the developed world retreated on recession fears. The JSE All Bond Index recouped some of the heavy losses of the previous month, returning +2.4% in July. Cash, as measured by the STeFI Composite Index, returned 0.4% over the same period. It was another turbulent month for the local currency, but it did claw back some ground in the final week of the month on a perceived 'less hawkish' Fed, ending slightly firmer against the euro but weaker against the greenback and pound sterling.

Performance review

For the quarter, the portfolio delivered a negative absolute return.

Key positive contributions:

- Our exposure to the local listed property sector, and holdings in Shoprite, Richemont and Glencore contributed strongly to absolute returns over the month. Absolute returns were further enhanced by our holdings in South African banks (Absa Group, FirstRand, Nedbank, and Standard Bank) and mobile operator, MTN Group.
- Offshore equities had a broad-based strong month, especially in the technology sector (Microsoft, TE Connectivity & KLA), utilities sector (NextEra & Iberdrola), ExxonMobil and Thermo Fisher Scientific.
- Locally, in fixed income, our allocation to South African bonds added to returns, while our offshore allocation to Korea, New Zealand, Australia and Canadian government bonds also boosted returns.
- The offshore exposure of the Fund benefited from rand weakness over the month.

Key negative contributions:

- Within the local equity component, the allocation to British American Tobacco and Sasol detracted from returns.
- In the offshore leg of Fund, the equity allocation to China detracted from performance over the period.

Portfolio activity

Within the local equity component, we took some profits by trimming some of the exposure to Standard Bank, where our earnings forecasts are now slightly below consensus and the share has performed relatively well in the sector. This was trimmed in favour of FirstRand and Capitec Bank, where we expect further upgrades to consensus forecasts. Diversified miner, Anglo American, was trimmed and switched into luxury goods retailer, Richemont, where the relative earnings revisions profile is stronger. We also took profits and sold our holding in Truworths International, as the earnings revisions has largely played out and we are concerned around market forecasts into 2023. We used the proceeds to initiate a position in Rand Merchant Investment Holdings.

The offshore component continued to add exposure to global government bond duration exposure in the USD bloc economies (Australia, New Zealand and Canada). These economies all have household-leverage imbalances and thus have vulnerable housing markets. It is therefore unlikely that these economies can tolerate interest rates at an elevated level for a long period.

Within local fixed income, we continued to add to our inflation-linked bond position and funded half of our acquisitions with sales of nominal bonds across the short end and belly of the curve, as well as utilising the proceeds of large coupon payments made in July.

Outlook and strategy

Looking forward, we continue to monitor the data points feeding into inflation in the US, as this will have an impact on the extent of policy adjustment to be taken by the Federal Reserve. This will have a resultant impact of growth, which is already showing signs of slowing. The two resultant outcomes are that of stagflation or recession, depending on the extent of policy tightening, and creates a tough backdrop for risk assets in the short term.

To navigate through this, we have a neutral overall equity exposure whilst continuing to add to offshore government bonds, while the equity selection has a balance of defensive and select cyclical exposure. Our preference for SA Equity over offshore equity remains, as we believe the valuation support (South Africa did not enjoy the multiple expansion seen in developed markets), coupled with strong earnings revisions profiles across our holdings, has tilted the portfolio to the domestic market.

Regionally, in our offshore equity allocation, we continue to have a positive skew towards Asia as Chinese markets continue to exhibit reasonable valuations after a high risk premium was embedded in the stocks post the regulatory crackdowns in 2021. Furthermore, earnings have upside over the medium term, in our view, as the economy reopens after the latest lockdowns and Chinese government policy is on an easing path. From a sector perspective, the stock selection has favoured a larger position in more defensive sectors (healthcare, utilities and real estate) given the earnings risk in cyclical sectors such as consumer discretionary and industrials.

The local equity composition is well diversified, with defensive exposures in our existing holdings of Naspers and Prosus, British American Tobacco and Bid Corp, where we believe earnings revisions are likely to inflect positively in the second half of the year. This sits alongside a reduced, but still healthy allocation to global cyclical stocks (diversified miners, Sappi, Mondi, Sasol) continuing to exhibit favourable earnings revisions profiles. We continue to have a healthy allocation to South African banks, where earnings revisions remain positive, and valuations are attractive. This sits alongside exposure to select apparel retailers (The Foschini Group, Pepkor and Mr Price) which display good earnings revisions profiles. Our exposure to local defensive businesses is mainly via holdings in MTN, Life Healthcare and Shoprite.

We still hold a large allocation to local sovereign bonds, which continue to be attractive on a valuation basis within the broader global fixed income universe. The relative attractiveness of South African fixed income valuations is tempered by global central banks' determination to anchor inflation expectations, even at the expense of jobs and growth. However, the absolute yield available provides a large buffer from capital loss in the event of a further sell-off.