Discovery Money Market Fund

Market background

The quarter began on a positive note as risks facing the global banking sector began to dissipate. Subsequently, the political debate around raising the US debt ceiling (to prevent the US from defaulting on its debt) drove uncertainty, but the deal eventually passed to the relief of market participants. Investors' focus then shifted to global growth dynamics and signals of further rate hikes from key central banks.

The US Federal Reserve (Fed) hiked interest rates by 25 basis points (bps) in May, later signalling that two further hikes are likely to be needed this year. This, combined with data evidencing US economic resilience, caused yields to rise meaningfully across the US Treasury curve. The European Central Bank (ECB) raised its key interest rates by 25bps in May and again in June. President Christine Lagarde noted that the ECB still had more ground to cover and that the central bank would not be pausing its rate-hiking cycle anytime soon. Meanwhile, stubbornly high inflation in the UK prompted a bigger-than-expected hike (50bps) from the Bank of England (BoE) in June and increased the likelihood of rates needing to stay higher for longer. Elsewhere, economic data suggested a tailing off of China's recovery momentum from the first quarter (Q1), ultimately prompting the People's Bank of China (PBoC) to cut two key interest rates.

In South Africa, while load shedding weighed on the economic outlook and prompted warnings from the SARB around its negative impact on growth, the economy managed to grow 0.4% in Q1 2023. During the quarter, the rand reached a new record low against the US dollar on the back of the government's decision to grant diplomatic immunity to participants at the BRICS meeting later this year, which includes Russian President Vladimir Putin. Accusations by the US that the South African government had loaded weapons onto a US-sanctioned vessel while docked in local waters also weighed on local asset prices. Towards the end of the period, news reports suggested President Putin would no longer attend the BRICS summit, easing some of the geopolitical pressure facing the country.

After the SARB hiked rates by more than expected in March, the central bank governor was more hawkish than expected in his April speech. Earlier in the quarter, inflation proved stickier-than-expected, largely due to elevated food inflation, further fuelling the central bank's hawkish tone. Reflecting concerns over inflation and rand weakness, the SARB increased rates by an additional 50bps in May. Positively, also in May, annual inflation printed lower than expected at 6.3%.

Performance review

Developed market sovereign bonds struggled after inflation remained stubbornly above target and central banks continued to hike rates. UK gilts fared worse as the market anticipated more aggressive tightening in response to continued upside inflation surprises. Notably, the UK's Consumer Price Index (CPI) reached the highest level among G7 nations. In the US, the turmoil around the US debt ceiling in the first half of the quarter saw the yield of 1-month T-bills soar above 6% at one point. Elsewhere, US investment grade corporate bonds saw prices fall as rates rose. However, this was not the case for European investment grade corporate bonds which eked out a small positive return during the month. With no sign of the BoJ tightening policy yet, the Japanese yen depreciated over the quarter.

Locally, the JSE All Bond Index declined by 1.53%, reflecting a myriad of domestic idiosyncratic risks. Anaemic economic growth, ongoing loadshedding, and reports that South Africa may have supplied weapons to Russia for the war in Ukraine were all headwinds to the domestic market. Some of these losses were offset towards the end of the quarter as domestic assets rallied in response to the reversal in the currency, slight improvement in load shedding and the market's expectation that US inflation has finally peaked with the Fed pausing. In the money market, the one-year fixed-rate negotiable certificates of deposit (NCDs) continued to sell-off aggressively, with the SARB hiking the repo rate by another 50bps at the May MPC. This resulted in the 1-year NCDs reaching a peak of around 10% in May and ending the quarter yielding 9.60% - 60bps higher from the start of the quarter. Cash, as measured by the STeFI Composite Index, remained broadly stable, up 1.92% for the quarter.

For the quarter, the Fund outperformed the benchmark.

Portfolio activity

We extended duration over the quarter into weakness, locking into fixed rate NCDs at attractive yields and will look for further opportunities to increase duration going forward.

Outlook and strategy

Global

Thus far, the global economy has faced a number of challenges, including persistent geopolitical tension, elevated inflation and the resultant aggressive hiking cycles embarked on by key central banks. The collapse of SVB and Credit Suisse in the first quarter of the year revealed additional hidden banking stresses, and market sentiment remains cautious. While interest rates have risen sharply, we are not out of the woods yet. Although some inflation prints suggest that inflation may be peaking, we need to see a more sustained trend of deceleration before we can be confident. Resilient US economic data

further suggests caution in expectations of a pivot in the Fed's monetary policy. Across the Atlantic, European data is coming in weaker than anticipated but sticky core inflation will likely keep the European Central Bank hawkish. In emerging markets, the China reopening story is faltering, but Beijing is expected to continue rolling out support measures and the People's Bank of China is expected to keep monetary policy supportive.

Local

Headline consumer inflation (CPI) slowed to a 12-month low of 6.3% year-on-year (y/y) in May from 6.8% y/y in April. Food and transport remain the biggest contributors to inflation, accounting for 2.1 and 1 percentage points, respectively. While we expect food inflation to remain sticky in the near term, it will continue to decelerate to average c.11% this year. At the May meeting, the SARB Monetary Policy Committee (MPC) expressed serious concern about inflation, with electricity constraints and the significant depreciation in the currency exacerbating pressure on local prices. The SARB maintained their higher inflation forecasts at the May MPC meeting. However, with the loadshedding constraints showing some signs of reprieve this winter, and the rand on a significantly firmer footing, we believe inflation will continue to edge lower in the remainder of the year, thus allowing the MPC to be slightly less hawkish in its communication.

The SARB was pre-emptive and started hiking interest rates earlier than developed market peers. The central bank was concerned about rising domestic inflation pressures when CPI was still below 5%. As at May 2023, the central bank had raised interest rates by a cumulative 475bps, to bring the repo rate to 8.25%. The rand remains susceptible to exogenous shocks and domestic political volatility. With a slower pace of hikes by the Fed expected, we anticipate that the SARB MPC decisions will continue to be more data dependent. This is reassuring for bond investors as in the shorter term, there could be more volatility to come. With the global environment remaining uncertain and a focus on upside risks becoming apparent within the MPC, we believe a further hike of 25bps is likely at the next MPC meeting in July. We remain of the opinion, however, that we are close to the end of the rate hiking cycle and that inflation will continue to fall in the second half of the year.

Positioning

We remain cautious ahead of the next SARB MPC meeting and the Fund has moved from a more defensive positioning to neutral - slightly long positioning.

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