Discovery Strategic Bond Fund

Market background

Financial market returns were broadly negative in May, as investors kept a close eye on the debt ceiling negotiations in the US, while weighing up the likelihood of the world's largest economy defaulting on its debt obligations. Against this backdrop, central banks continued to raise interest rates, including the US Federal Reserve (Fed) and the European Central Bank (ECB) whose 25 basis points (bps) hike left interest rates at levels last seen during the Global Financial Crisis. Meanwhile, the People's Bank of China (PBoC) elected to keep rates on hold and add more liquidity to support China's economic recovery, continuing its policy divergence from developed markets. Turning to South Africa, a string of negative data and newsflow, predicated by fears of an electricity grid collapse, followed by accusations that the government had supplied weapons to Russia, saw local assets close deep in negative territory.

Performance review

For the month, the portfolio underperformed the benchmark.

Within sovereign bonds, UK gilts were the underperformer as yields surged following the significant upside in the UK's April CPI report, leading investors to dial up the number of rate hikes expected from the Bank of England in the near term. In the US, the lack of a resolution on the debt ceiling saw the yield of 1-month T-bills soar above 6% at one point and close at a post-2001 high, indicating that investors were demanding extra compensation to hold those bills deemed to be at risk of default. 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.

Locally, the JSE All Bond Index declined by 4.79%, 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. The yield curve bear-flattened at the end of May — with front-end yields increasing by a larger magnitude than the longer end of the curve. This largely reflected expectations that the SARB would need to hike rates significantly in response to the rand depreciating to record low levels. Against this backdrop, negative performance was noted across all tenors of the curve, but our positioning in longer dated bonds managed to minimise the drawdown.

Inflation-linked bonds (ILBs) delivered a negative return in May, reflecting the lower inflation print for April. ILBs detracted marginally from returns.

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

Outlook and strategy

Global

Amid long-standing challenges in the form of persistent geopolitical tension and elevated levels of inflation which saw central banks entering aggressive hiking cycles, 2023 presented another challenge. Financial turmoil erupted late in the first quarter of the year, with the collapse of SVB and the demise of Credit Suisse reverberating through markets and revealing additional hidden banking stresses. While the response to SVB and other subsequent regional bank failures was swift, the market sentiment remains relatively cautious. Despite interest rates rising sharply thus far, we are not out of the woods yet. Although some inflation prints in certain regions appear to support the 'peak inflation' narrative, we would like to see a more sustained trend of deceleration. Resilient US economic data further suggests caution in expectations of a pivot in global monetary policy. Across the Atlantic, European data also provided evidence that the economy has been faring better than initially expected. In emerging markets, the China reopening story appears to be faltering. A raft of economic data pointed to weaker-than-expected industrial production, retail sales, and fixed asset investment, which all soured investor confidence towards the region. Positively, we expect Beijing to continue rolling out support measures for the economy and the People's Bank of China to keep monetary policy supportive.

Local

The intensity and frequency of power blackouts are keeping the SA economy from building any sustained forward momentum. Against the current backdrop, National Treasury's revenue expectations appear optimistic. Coupled with expenditure pressures remaining on the upside, the fiscal picture warrants some concern. In terms of issuance, the new South African 7-year floating-rate auction was very well subscribed. In the long term, this suggests that reduced fiscal risk will be priced into the bond market as fewer ultra-long-dated bonds will need to be issued. On the monetary front, 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 South African Reserve Bank's 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. In the short-term, the SARB is concerned about inflation, with electricity constraints and significant depreciation in the currency exacerbating pressure on local prices. The SARB has maintained their substantially higher inflation forecasts at the May MPC. With the global environment remaining uncertain and a focus on upside risks becoming apparent within the MPC, we believe a further hike of 25bps to 50bps is likely. 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. This will be a strong but volatile environment for local fixed income assets. The growth outlook for the year ahead will continue to be shaped by developments in the global sphere of influence, developments at Eskom and (more recently) Transnet, and progress on the implementation of structural reforms.

Positioning

From a positioning perspective, SAGBs remain attractive on valuation grounds, relative to other asset classes in the fixed income universe and relative to their historical record. That said, against the backdrop of stubborn inflation, rising interest rates (both locally and globally) and domestic idiosyncratic risk, we remain cautious in our positioning. We reduced duration at the beginning of the month but added back some duration into market weakness. We will continue to look for opportunities to add back duration in market sell-offs. Furthermore, we have some hedges in place to seek to reduce portfolio volatility. We continue to stress the importance of earning yield and protecting capital in this fluid environment.

Our positioning in ILBs remains underweight, favouring short-dated linkers. Inflation has proved stickier-than-expected and the asset class has served us well as a hedge for the portfolios. As price momentum has topped, nominals are still poised to outperform ILBs.

Investment-grade credit is a neutral allocation in our portfolios. We maintain a cautious approach to adding yield to the portfolio in a tight spread and tough economic environment. Our bottom-up views remain consistent, with a preference over assets with defensive credit qualities.