Discovery Strategic Bond

June 2024

Market background

The Fast View

- The US Fed left rates unchanged while signalling one rate cut expected late this year
- The Japanese yen slid to its lowest level since 1986 and household spending falls
- Another mixed quarter for EM fixed income, as politics and central banks take centre stage
- In SA, elections brough with them significant volatility, but in the end the formation of a government of national unity was seen as an investor friendly outcome

To read more, please click here.

Performance review

For the quarter, the portfolio outperformed the benchmark.

The US Federal Reserve (Fed) left rates unchanged at a range of 5.25%-5.50% for the seventh consecutive meeting in June, while signalling rates might be cut once this year.

It was a mixed quarter for EM sovereign debt markets. Starting on the local debt side, the JP Morgan GBI-EM fell 1.6% over the quarter. This was driven by EM FX (-2.2%), which weakened from the strength of the US dollar and an unwinding of carry trades in Latin America. Conversely, hedged EM local bonds returned a positive 0.5%, despite the rise in developed market bond yields. Locally, the JSE All Bond Index ended the quarter up 7.49% as the was a market-friendly outcome as the ANC entered into a Government of National Unity with the DA, IFP and other smaller parties. We were well positioned on the curve to benefit once the risk premium dissipated, which benefitted overall performance.

Inflation-linked bond (ILB) delivered a positive performance over the quarter. We have sold most of our ILB's as inflation continues to trend closer towards target.

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

Outlook and strategy

Current economic context: Amid the intricate tapestry of global economies, resilient growth continues to weave a diverse range of perspectives. Inflation expectations have moderated, with divergence in growth across individual economies, while the US and EMs look more resilient, the latter further boosted by an upside surprise in Q1 GDP growth in China.

South Africa: SA growth is showing signs of improvement, but challenges persist. Factory floor activity contracted for the second straight month although at a slower pace, with the manufacturing PMI coming in at 45.7 in June, from 43.8 the previous month amid weak demand conditions. Meanwhile, Eskom's Generation Operational Recovery Plan initiated in March 2023 has seen a marked improvement in reducing unplanned outages. The energy availability factor has trended consistently above 60%, reaching 65% by the end of June. The logistics crisis has similarly stabilised, with Transnet implementing several measures aimed at improving efficiency and reducing backlogs. The rand continues to find support in bullion prices and more recently found support following the formation of a coalition government which deemed more investor friendly. At its April Monetary Policy Review, the South African Reserve Bank (SARB) noted that expectations for easing sometime this year remain broadly intact.

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 remain overweight and have added duration in recent months, taking off some of the long positions and reallocating to the front end of the yield curve within the context of dovish comments from the South African Reserve Bank (SARB). We have maintained that performance will return as the benefit of income is realised and volatility subsides, and we have been steadfast in emphasising the importance of maximising yield and protecting capital.

We have sold most our exposure to ILBs as inflation remains inside the targeted band and continues to surprise to the downside. A lower inflation target looms on the horizon, which will lead to a repricing of the asset class in the not-so-distant future.

Investment-grade credit remains a neutral allocation in our portfolios, as we prefer sovereign debt instead. Spreads have tightened in recent years on the back of too much demand amid a slowdown in issuance. Our preferred sectors remain banks. Government-guaranteed SOEs (we are now more comfortable holding Transnet) and insurance, while looking for companies displaying strong asset quality, valuation, contractual cash flow, and conservative management.