Discovery Diversified Income Fund

Market background

Fast View:

- Sharp upward moves in US Treasury yields weighed on global fixed income markets
- The Bank of Japan made its first interest rate hike in 17 years, effectively ending its negative interest rate policy
- EM sovereign debt had a mixed quarter, while corporate debt had a strong start to 2024
- EM currencies came under pressure over the quarter from the strong US dollar given the rise in US Treasury yields
- Sticky inflation both locally and abroad contributed to reduced support for local fixed income markets, while election uncertainty further compounded the asset class

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Performance review

For the quarter, the portfolio underperformed the benchmark.

Minutes released in February from the US Federal Reserve's (Fed) January meeting showed that most of its members thought moving too quickly to cut rates carried a bigger risk than keeping policy tighter for longer. US Treasury yields rose and the US dollar strengthened, and by the end of February, only 85bps of cuts were priced in by the market. Overall, US Treasury yields rose across the curve, with the 10-year Treasury yield rising from 3.88% to end the quarter at 4.20%. In Europe, 10-year yields climbed across the continent over the quarter, notably in Germany and France, with yields in the UK also rising. This was largely due to the currently high correlation between US and other government bond markets. In Japan, the main developments over the quarter came in March, as the Bank of Japan (BoJ) made its first interest rate hike in 17 years, effectively ending its negative interest rate policy. The bank's yield curve controls were also scrapped. The Bloomberg Barclays Global Aggregate Bond Index ended the quarter down 2.1% in US dollar terms.

It was a mixed quarter for emerging market sovereign debt from a performance perspective. The local bond index (JP Morgan Government Bond Index-EM) fell by 2.1%, with this being driven entirely by EM FX, while local bond returns were a slight positive (+0.2%). EM currencies came under pressure over the quarter from the strong US dollar given the rise in US Treasury yields over the period. Locally, the JSE All Bond Index ended the quarter down 1.8% with waning support for local fixed income markets amid sticky inflation both locally and abroad which has pushed interest rate cuts further down the line. We have seen steady foreign outflows in recent months, while political uncertainty is now being priced into the local bond market. Yields rose across the maturity curve in March, with only the front end managing to eke out a positive return over the quarter. Our duration positioning was a drag on performance.

We saw some curve steepening in the inflation-linked bond (ILB) curve in the final month of the quarter. We have added marginally to our exposure to shorter-dated ILB's to protect against stickier prices.

SA listed property got off to a strong start in January but pared back some of the gains in the recent couple of months.

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

The FX component of the portfolio, the bulk of which is in the US dollar, was a tailwind to returns, with the dollar rallying against all G10 currencies as the market pushed out interest rate cuts.

Outlook and strategy

Global

Amid the intricate tapestry of global economies, resilient growth seems to be weaving a diverse range of perspectives. Inflation is trending lower, growth is proving to be resilient, and corporate profits are holding ground, especially amid the AI frenzy. The 'soft landing' story has grown more legs, but beneath the surface, some fissures are emerging, revealing a shifting landscape; The US labour market is now showing signs of cooling from fever pitch, with job openings coming down by c.25% from early 2022 peaks, auto and credit card default rates have risen to pre-pandemic levels, similarly, high yield default rates are picking up momentum in the corporate space, while commercial real estate delinquencies continue to make news headlines. For the Federal Open Market Committee (FOMC), delaying rate cuts on sticky inflation could see the soft-landing that is priced by markets morph into a mild recession, while premature delivery of rate cuts could trigger a rebound in inflation. We believe the Fed will continue to be data dependent, with the first cut only coming in the second half of the year. Across the Atlantic, the eurozone economy has surprised to the upside on the back of lower gas prices than initially feared pre-Russo-Ukrainian war, a recovery in bank lending, and the turning tide in global manufacturing output. We are likely to see the European Central Bank deliver rate cuts before the Fed. Elsewhere, Japanese economic activity has also exceeded expectations, while wage growth and inflation have moved toward the BOJ's targets. The BOJ took the first steps toward policy normalisation but still maintained a dovish posture while doing so, therefore, we do not expect more policy tightening any time soon.

In emerging markets (EMs), many central banks have already started to relax monetary policy (i.e., Mexico, Brazil, Hungary) as most EM central banks had already begun raising interest rates before their developed market counterparts. Indeed, disinflation has happened more quickly compared to developed markets. Some continue to raise interest rates due to FX shortages and runaway inflation, while others such as South Africa and India are standing pat as they wait for more evidence of a sustained deceleration in prices. Emerging market fundamentals have demonstrated resilience throughout the period of interest rate hikes, despite the challenges posed by US 'exceptionalism' and the slowdown in growth from China. We anticipate a positive shift in the narrative for EM in 2024. Expectations point to strong growth, although much of this relies on China's recovery. Newsflow from China remains a mixed bag given deflationary trends and property sector malaise. However, the 5% growth target set for 2024 seems to be a harbinger of more significant policy support to come, and this will provide the tailwind for emerging markets.

Local

SA narrowly avoided a technical recession in Q4 2023 but only just. Demand conditions remain challenging and business activity lukewarm, with factory activity slipping back below the 50-point mark in March, after a robust expansion just a month earlier. Ongoing power outages and logistical challenges at the ports have slightly improved in recent months which is encouraging. While US exceptionalism continues, the rand continues to find support in bullion prices amid geopolitical tensions and concerns on sticky inflation. Locally, higher fuel prices have brought pressure on prices in the first quarter. The SARB left interest rates unchanged at 8.25% at its March meeting, highlighting upside risks to food inflation from dry and hot weather conditions, while rand weakness presents further risks as rate cuts get pushed further back in major economies. Wage negotiations in the mining sector have come above inflation forecasts. We expect rates to remain higher for longer and cuts to only come in the second half of the year. We welcome the extension of tenures on the MPC and the addition Dr Mampho Modise as Deputy Governor as they signal institutional stability and policy certainty in a pivotal year for South Africa. Looking ahead, we expect growth to be a beneficiary of lower stages of loadshedding, some easing conditions at the ports, cooling inflation, and the subsequent relaxation of monetary policy. In politics, the noise continues to ratchet up as we approach the momentous National Elections in May. We are already seeing some of the uncertainty being priced into the local bond market.

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. That said, uncertainty in the global environment and some domestic idiosyncratic risks around the upcoming elections has seen an increase in volatility and yields climbing higher. We believe that performance will return as the benefit of income is realised and volatility subsides. In this uncertain environment, we remain cautious on positioning, and continue to emphasize the importance of maximising yield and protecting capital.

We have slightly increased our exposure to ILBs on the shorter-dated area of the curve, and maintain a cautious stance amid sticky inflation trends.

While we have increased our exposure to listed property, risks for the sector remain. We have switched out some of our local exposure offshore. We remain selective in our allocation and will continue to tactically seize opportunities where we see value.

Investment-grade credit remains a neutral allocation in our portfolios. 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.

In portfolios permitting FX exposure, we believe it is prudent to retain a small allocation to a basket of offshore currencies. We have become more neutral in our exposure. The FX component of the portfolio, the bulk of which is in the US dollar, continues to hedge the portfolio against local risks, as well as a fluid global environment.

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