Discovery Diversified Income Fund

Market background

The US headline Q1 GDP figure did little to assuage growth concerns. That said, core growth remains strong on the back of healthy fixed investment and a strong consumer. Consumer prices slowed to 8.3%% year on year (y/y) in April, easing from the 8.5% reading in March. The core personal consumption expenditures price (PCE) index, which is the US Federal Reserve's (Fed) preferred measure of inflation, rose by 4.9% in April from a year ago, down from 5.2% in the previous month. The Fed announced the largest hike in the Federal funds target range since the turn of the millennium (now 0.75%-1.00%), as it delivered a unanimous 75 basis points (bps) hike at its Federal Open Market Committee (FOMC) meeting early in the month. It also confirmed that it will begin the process of shrinking its US$9 trillion balance sheet (quantitative tightening) on 1 June by allowing these securities to mature without reinvesting their proceeds into new purchases.

Europe's economy grew by an annualised 0.3% q/q in Q1, upwardly revised from the 0.2% initial estimate. Nonetheless, the eurozone's economic outlook remains rather gloomy, as the protracted war in Ukraine continues to put upward pressure on commodity prices and already strained supply chains. Downside risks to growth continue to build, but inflation remains the primary concern for the European Central Bank (ECB) as soaring prices continue to strangle households. Inflation in the area continued its record-breaking run, soaring to 8.1% in May, from 7.5% in April, with energy prices accounting for the bulk of the move higher. Underlying measures of inflation have also continued to pick up steam, prompting a sense of urgency at the ECB to fast-track the tightening of monetary policy, with the Governing Council turning more hawkish as it prepares to 'front-load' its rate-hiking strategy.

In emerging markets, China's economy slowed for three consecutive months, according to numerous surveys of businesses and industries. The official manufacturing PMI rose to 49.6 in May from 47.4 in April – pointing to an improvement in factory activity but still below the expansionary 50 level. The slower pace in contraction hinted at the potential bottoming of the economic fallout as authorities begin to roll back lockdown restrictions, but the impact on activity and supply chains may still be felt for months to come. Economists have pencilled in sub-5% growth for the world's second largest economy, some way off the government's 5.5% target as a result of the growth-restricting 'zero-COVID' strategy.

The removal of all lockdown restrictions has helped growth return to pre-pandemic levels, as the economy expanded 1.9% q/q in the first quarter of 2022, compared to an upwardly revised 1.4% in the previous period, and well ahead of expectations of 1.2%. Headline inflation remained at 5.9% year on year (y/y) in April, unchanged from the March print and slightly below the consensus expectation of 6.0%. Core inflation (which excludes volatile items in the basket such as food, fuel and energy) rose to 3.9% in April, its highest reading since October 2019. The South African Reserve Bank (SARB) delivered a 50bps hike in the main lending rate at its May Monetary Policy Committee (MPC) gathering. The committee judged risks to growth to be balanced, while assessing risks to inflation to be on the upside. On 20 May, credit ratings agency S&P Global Ratings upgraded South Africa's rating outlook to positive, citing an improved short-term economic outlook and better fiscal metrics. The country's long-term foreign debt rating was affirmed at 'BB-', three levels below investment grade.

Performance review

For the month, the portfolio outperformed the benchmark.

Investors sought refuge in bonds as the focus shifted from (problematic) inflation to (weaker) growth. Government bond yields edged lower (yields fall as prices rise) amid growing concerns that aggressive quantitative tightening (QT) by central banks could tip economies into a recession. The bond market rally saw the global benchmark (US 10-year Treasury) yield settle back down from its three-year high of 3.20% earlier in the month to 2.84% at the time of writing. The Bloomberg Barclays Global Aggregate Bond Index ended the month up 0.3% in US dollars.

South African government bonds held the upper hand on their equity peers, with the JSE All Bond Index registering a 1.0% gain over the month. Despite foreigners being net sellers over the period and auction activity reflecting weaker demand from local investors over the period, rand-denominated government bonds were the best-performing local debt on the continent in May. The strength in performance during the month was largely on the back of local investors. We witnessed some steepening in the yield curve over the month with moves lower on the shorter-dated end of the curve and increases in the long end. Positive performance was recorded across most tenors of the curve and our positioning helped performance. Bonds remain an important source of income for the funds and continue to contribute positively to returns.

The allocation to inflation-linked bonds (ILBs), which is mostly focused on the short-dated instruments, added to performance, building on April's gains.

Listed property extended losses, which weighed on our select exposure to the asset class.

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

We maintained our FX allocation during the month, which has helped counter some of the recent weakness. The US dollar's stellar run in recent months came to a halt in May, ending the month down against a its major trade partner currencies, which weighed on the FX component of the portfolio.

Outlook and strategy

Global

The global outlook for investors remains incredibly foggy given the interplay of a myriad of factors: COVID-induced lockdowns in China, which have raised the spectre of slowing economic growth; a protracted war in Ukraine; and building inflationary pressures. At the same time, monetary policymakers are attempting to engineer a 'soft-ish' economic landing as they withdraw liquidity from the financial system after many years of ultra-loose monetary policy. Inflation remains stubbornly elevated and could force the Fed to move quicker and more aggressively toward a contractionary policy stance, while attempting to reach a 'neutral' level (the rate of interest at which the economy is neither accelerating nor decelerating). This, however, poses downside risks to GDP later this year.

Local

We remain cautiously optimistic on the local outlook. The impact of the flooding reflected in April's data, which showed the first merchandise trade deficit since the onset of COVID in 2020. We remain equally concerned about a prolonged crisis in Ukraine and sanctions on Russia, the effect this continues to have on oil and food prices, and the associated lingering risks of socioeconomic unrest, which would further dent economic activity. The gradual tightening of monetary policy through higher interest rates adds further stress to the eroding purchasing power of households and workers, especially those on the lower end of the socioeconomic ladder. While the strong run in commodity prices has been the engine keeping the proverbial engine running, we cannot rely on this for much longer. We continue to emphasise that South Africa needs to move the needle on much-needed structural reforms in order to get back on a sustainable growth path.

Positioning

Against this backdrop of higher inflation and rising interest rates – both locally and globally – we remain cautious in our positioning. We have reduced our allocation to South African assets, lowering exposure to South African Government Bonds (SAGBs). Furthermore, we have some hedges in place to seek to reduce portfolio volatility. That said, local yields remain attractive, not only versus cash and inflation, but relative to developed markets (DM) and emerging market (EM) peers – underpinned by a compensating fiscal premium. Even as inflation approaches the top end of the SARB's target range, an investor in South African bonds is still earning a healthy real yield on SAGBs. Given this, we believe that local bonds continue to offer an appealing long-term income opportunity for investors, and we will look to add exposure back to the portfolio when inflation risks dissipate.

We have been increasing the allocation to ILBs. The inflation outlook has deteriorated, and we have since had to re-calibrate our inflation forecasts higher. ILBs have served as a fantastic hedge for the portfolios. We are, however, looking to shift some of this exposure into strength – toward nominal bonds in the coming months.

We have reduced exposure to listed property but will continue to tactically seize on opportunities where we see value. Our exposure is less than it would have been the case a few years ago, as the asset class remains highly volatile.

Investment-grade credit is a marginally underweight allocation in our portfolios on valuation grounds. We have minimal exposure to the cyclical sectors of the economy, maintaining a preference for quality defensives; namely banks, insurers, real estate, telecomms and especially government-guaranteed debt, as well as large blue-chip corporates with strong balance sheets.

In portfolios permitting foreign-exchange (FX) exposure, we believe it is prudent to retain a reasonable allocation to a basket of offshore currencies. From a portfolio-construction perspective, our foreign currency exposure acts as a risk mitigator during times of rand weakness. We have also used US Treasuries as a hedge in the portfolio to cushion the impact of rising US yields.