Discovery Diversified Income Fund

Market background

The US economy grew at a slower pace than expected, with an annualised GDP print of +2% in Q3, below consensus expectations of +2.6%. The manufacturing purchasing managers' index (PMI) came in at 60.8 in October, from 61.1 the previous month as supply-side constraints and rising input costs continued to weigh down activity on factory floors. Headline inflation soared past economist expectations (5.3%) to a 13-year high of 5.4% in September, up from 5.3% in August. The Federal Open Market Committee (FOMC) maintained the Federal funds target range steady at 0.00-0.25% (markets are pricing in the first rate hike in Q3 2022, in line with recent 'dot plot' projections) when it met on 3 November. The FOMC also announced that tapering of its monthly bond purchases under the quantitative easing programme commence November/December.

The European economy delivered strong growth in Q3 2021, and while it outpaced the larger Chinese and US economies, the region is emerging from a much lower base and is yet to return to pre-pandemic levels, in contrast to the other two nations. Consumer prices spiked to an annual print of 4.1% on the back of soaring energy prices. European Central Bank (ECB) President Christine Lagarde stuck to the dovish script during a virtual press conference on 28 October, in which she reiterated that the bank expects inflation to moderate throughout 2022 and revert to below target over the medium term – pushing back against market expectations of looming rate hikes next year.

In emerging markets (EM), China's economy slowed in Q3 to 4.9% year on year (y/y), a sharp decline from the 7.9% growth recorded in the Q2 and below consensus expectations of 5.2%. This print was the slowest pace in growth since Q3 2021 and comes off the back of an economy that has had to battle a myriad of headwinds in recent months. That said, the annual growth target of 6% set by the Chinese government at the outset of 2021 remains within reach, on account of robust growth earlier in the year. The People's Bank of China has thus far kept policy rates unchanged since early last year, while delivering a surprise reduction in the reserve requirement ratio back in July. In September, the bank injected liquidity into the system as it tried to stem serious contagion to other markets from the Evergrande saga. This was followed up in October with c.CNY1 trillion of liquidity injected into the banking system through open market operations.

The manufacturing PMI weakened again in October (53.6) from a downwardly revised 54.7 in September. The 4-point retreat in the gauge could largely be attributed to the protest action in the steel and engineering industry, which lasted a good three weeks, and the ominous return of rolling blackouts by state utility Eskom. Price pressures continued to build as producer price inflation (PPI) quickened to 7.8% y/y in September, from 7.2% in August, higher than consensus expectations of 7.3%, with the higher oil price and double-digit increases in the cost of electricity weighing on producers. Likewise, consumer price pressures have also intensified, with headline inflation printing at 5.0% y/y in September, from 4.9% in August, driven largely by higher food and fuel prices, above consensus expectations of 4.8%. The petrol price is scheduled to rise on 3 November, which will only add to inflationary pressures. Recent warnings by the South African Reserve Bank (SARB) of potential upside risks to the inflation outlook has further prompted money markets to price in a 25 basis point hike in the main lending rate at the November MPC meeting – brought forward from Q1 2022.

Performance review

For the month, the portfolio performed broadly in line with the benchmark.

Global bond markets whipsawed throughout the month as persisting supply chain bottlenecks and increasingly stubborn inflation pushed markets to price in an earlier-than-expected normalisation of monetary policy. The yield on the US 10-year note rose to 1.56% at end of the month, while across the Atlantic, yields also climbed, with the German bund 10-year ending the month in less negative territory.

Locally, bond yields sold off during the month with the short end of the curve repricing the most over the period. The JSE All Bond Index (-0.5%) continued to be buffeted by the external headwinds from China, intensifying inflation fears and hawkish pivots by major central banks, while we also saw local risks such as elections and power outages begin to dampen investor sentiment toward local bonds and the rand. Our positioning weighed on performance over the period as the front and mid-dated areas of the curve sustained pressure. Our risk-mitigating bond put options helped cushion some of the pressure from the selloff. Our short US Treasury position protected the portfolios from some of the sell-off in yields.

The allocation to inflation-linked bonds (ILBs) continued to offer protection from rising inflation risks. The asset class is an important risk mitigator and diversifier for the portfolios.

Listed property recorded another weak month which weighed on performance. While we continue to tactically add to the asset class as and when opportunities present themselves, we maintain an underweight position given the volatility in the sector.

The yield-enhancing allocation to corporate paper continued to add value. We remain underweight investment grade credit amid a tight spread and tough economic climate.

We continued to increase our FX allocation over the month, which has helped counter some of the recent weakness. The US dollar slightly underperformed against a basket of its trade partners, thus dragging on the FX component of the portfolio.

Outlook and strategy

Global

While COVID has moved further down the list of worries for investors, the pandemic remains very much a present danger and inhibitor of growth as rising infections across regions delays the 'return to normalcy'. The pandemic continues to elongate and exacerbate supply chain constraints, which have become a driving force behind growing price pressures. We expect the global economic recovery to stay the course, however, likely to be more measured and desynchronised (given the great disparity in vaccinations between rich and poor nations), while we are also wary of the build-up of risks to the downside, overlayed with a policy arena which remains in a state of flux.

The path of inflation and monetary policy remains a major focus point as we close out the year, especially in the context of inflation realising 'higher for longer'. That said, the prevailing view at the Fed is that these price pressures will moderate in due course. While the Fed finally announced it will begin tapering its US$120 billion per month in November/December this year, attention now shifts towards the outlook for the interest rate hiking cycle, which Powell emphasised will run on a separate runway to the QE taper. Overall, we believe the Fed will maintain their accommodative stance until its labour market objectives have been satisfied and the committee is confident the economy can withstand the normalisation of policy with limited undesired effects. Likewise, we expect monetary policy in the euro area to remain supportive. The ECB shares the same belief as the Fed in that the blowout in prices is largely the result of supply chain bottlenecks and soaring energy prices and believes the outlook for inflation does not support the commencement of a hiking cycle in the next year. Elsewhere, the BoE took a surprising dovish U-turn after billing up a rate hike for weeks leading up to the November MPC meeting. The bank faces a tough and tricky test of keeping inflation in check without further supressing growth conditions but has reiterated rate hikes remain very much on the horizon.

In EM, we expect economic recovery to proceed at a more measured pace; the reopening jolt will wear off, the resurgence of COVID cases in certain regions and lack of vaccinations risks more severe strains emerging, supply shortages will continue to weigh on economic activity, while less room for prolonged monetary and fiscal stimulation will keep the recovery in low gear. China continues to wrestle with a myriad of headwinds, which is not good for the EM complex. China serves not only as a proxy for risk and for EM countries like ours, but as one of the biggest consumers of our commodity basket, we also have a general and specific correlation to China. The prospect of a slower Chinese economy next year does not bode well for industrial metals mining countries such as South Africa, Brazil, Peru and Chile. Nonetheless, we expect authorities to continue to provide both fiscal and monetary support as evidenced by the PBoC's continued injection of stimulus in recent weeks, as it aims to stem malaise in the property sector from spreading to other markets. Other emerging economies unfortunately find themselves in a spot of bother, with money markets wagering a faster hiking cycle by EM central banks than what will unfold in the developed world.

Local

While the South Africa economy has displayed an impressive resiliency and a stronger-than-anticipated rebound in the first half of 2021 from the pandemic nadir, the outlook has somewhat dimmed on the back of both external and domestic risks to the downside. The persisting global supply chain disruptions, a weaker Chinese economy, a flagging inoculation programme, the negative effects of the recent civil unrest on business sentiment, sky-high unemployment, protest action in the steel and engineering industry, and the seemingly never-ending saga of Eskom blackouts, all make for an arduous road to recovery. Calls for the fast-tracking of fiscal reforms are growing louder both domestically and from abroad, evidenced by the recently held JSE virtual conference in which US-based investors urged the SA government to speed up the spectrum rollout, energy security and green transitions. On the fiscal front, we expect a decent budget announcement by the Ministry of Finance in the coming days, with better-than expected revenues from the commodity price windfalls, while the rebasing of the GDP data would have also improved debt metrics. That said, this is overshadowed by external headwinds, while locally, risks remain elevated over the short-to-medium term, given public sector wage settlements and the growing propensity to spend more on social programmes.

On the monetary front; the SARB's more conservative approach to the cutting cycle during the pandemic has bought the bank more time to keep policy accommodative for longer, while the commodity price boom has also helped our terms of trade and local currency amid a contained inflation environment. Notwithstanding, the September SARB meeting had a hawkish tone to it, but more recent statements have cooled down somewhat. We expect the SARB to embark on a gradual normalisation process.

Positioning

From a positioning standpoint, we remain cautiously optimistic on EMD and are comfortable to hold South African Government Bonds (SAGBs). While we while we maintain the view that SAGBs continue to offer good value, value never stops a sell-off. Further down the line, we stand to benefit from these attractive yields, but at the moment we are caught in a web of global uncertainty and need markets to begin pricing in a calm taper by the Fed and a market reaction that will not result in a tantrum. We thus remain cautiously optimistic overall and have dialled down on duration. We have shifted some of our short-dated exposure to the long end of the curve, as we believe it is more insulated because of the anticipated hiking cycle and better fiscus, while the short end is more vulnerable to short-term inflation fears. We continue to hold a balance of exposures, with an allocation to bond put-options, which offer protection for the portfolios. Our focus as always, is on more than just returns, but also carefully evaluating the risks and preserving capital.

We expect inflation to peak in the next couple of months and then begin to simmer down through 2022. Our inflation-linked bond (ILBs) exposure remains a purely defensive play. ILBs are a good hedge against potential rand depreciation, especially amid intensifying inflation fears. Our exposure maintains a bias to the short-dated instruments which serve as a risk mitigator.

We maintain an underweight position in listed property, owing to a still uncertain outlook for the domestic economy and company distributions. While we have seen a re-rating in the sector in recent months, we continue to proceed with caution, tactically seizing opportunities from time to time when we see value.

Investment-grade credit is a neutral allocation on valuation grounds. Some paper has re-rated and supply-demand dynamics are supportive. We expect demand to remain strong for quality credit assets amid a slowdown in issuance. 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, we have accelerated our FX exposure on the back of global developments and market volatility and more specifically, to offset a vulnerable rand. We have a mix of US dollar, euro and EM in order to diversify our FX exposure.

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