Discovery Diversified Income Fund

Market background

In the US, the release of stronger-than-expected economic data raised concerns that the US Federal Reserve (Fed) would keep interest rates higher for longer, weighing on equity and bond markets. Preliminary estimates showed that the US economy expanded above market expectations for the third quarter (Q3) of 2023, while a sharp uptick in nonfarm payrolls pointed to a tighter labour market. Both manufacturing and services PMI data came in stronger-than-expected for September. Retail sales continued to advance, underscoring the resilience of the US consumer despite higher prices and rising borrowing costs. In other news, annual inflation printed marginally above consensus, while annual core CPI continued to show signs of easing.

Domestically, concerns over the country's fiscal outlook continued to weigh on investors, as did comments from the South African Reserve Bank Governor Lesetja Kganyago, who noted that local interest rates were likely to remain higher for longer to help curb inflationary pressure. Underscoring this sentiment was the release of September's inflation print, which showed annual inflation accelerating above forecasts, while core inflation trended lower. Other economic indicators were broadly mixed for the month. PMI data showed factory activity slowing further into contraction territory while manufacturing output missed consensus growth forecasts. Meanwhile, annual mining production contracted more than expected, while retail sales recorded its eighth consecutive monthly decline, highlighting the pressure on consumers.

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Performance review

For the month, the portfolio marginally underperformed the benchmark.

October was a weak month globally as investors fretted about the conflict in the Middle East adding to geopolitical risks and long-dated bond yields continuing their recent rise. Within defensive assets, investors were reluctant to buy duration as a safe haven. US treasury bonds sold off, losing ground for the sixth month running. In the US curves steepened with yields broadly flat at the short end and rising sharply at the long end of the curve with continued strong growth and only slowly declining inflation data. European government bonds outperformed as the flash CPI release for the eurozone in October fell to a 2-year low and data weakened. The prices of global investment grade corporate bonds also fell as yields rose, led by the US as their European counterparts generated a small positive return in local terms. Finally, despite the risk-off environment, the Japanese yen fell vs the US dollar.

Locally, the JSE All Bond returned 1.71%, as the longer end of the yield curve rebounded from oversold levels in the previous month. This was despite lingering concerns related to the deteriorating fiscal outlook. Against this backdrop, positive performance was noted across all term buckets, contributing to performance.

Inflation-linked bonds (ILBs) delivered negative returns over the month, reflecting diminishing long-term inflation concerns domestically.

In a volatile period, listed property delivered a negative return over the month, detracting from performance.

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

The foreign exchange (FX) component of the portfolio, the bulk of which is in the US dollar, contributed to returns as the greenback strengthened over the month, supported by its safe haven status.

Outlook and strategy

Global

The global investment landscape is currently facing a number of challenges, including stubbornly tight monetary policy, higher energy prices, and slightly weakening consumer trends. Sentiment remains cautious and hawkish holds by central bankers are now in fashion. Central banks around the world have been raising interest rates in an effort to combat inflation. This has also made it more expensive for businesses and consumers to borrow money, which has slowed economic growth. Resilient US economic data further suggests caution in expectations of a pivot in the US Federal Reserve's (Fed's) monetary policy, however, a healthy rebalancing of the labour market from the supply side evident in recent payroll data increases the likelihood that the Fed has reached the peak of its rate hiking cycle. The US yield curve, a leading recession indicator, alongside weakening consumer sentiment, and a cooling jobs market (see October non-farm payrolls) are all indicating a gradual slow down ahead combined with some progress in moderating inflation although some upside risks still persist. Across the Atlantic, the UK's economic malaise continues, while the parts of Europe are sliding into recession, and the European Central Bank's (ECB) policy will keep the pressure on the EU consumer, thus, we do not see any pickup in growth in this region anytime soon.

In emerging markets, higher US Treasury yields (which weakens the carry trade for EM local debt) and a stuttering Chinese economy have dampened investor sentiment towards emerging market debt. However, the Chinese government's efforts to boost the economy (increased spending on infrastructure, interest rate cuts, and relaxing curbs on home purchases) seem to be finally showing some results. Recent data showing expected retail sales, industrial production, and total social finance (a broad measure of credit and liquidity in the economy) all have been better than expected, which has brought some stabilisation to the world's second largest economy. A key risk worth noting, however, is the property sector, which continues to labour under significant stress. China's inflation also remains low relative to the rest of the world, while prices for goods sold at factories (PPI) are also falling – which does allow more room for authorities to inject further stimulus. We expect the People's Bank of China and fiscal policy (where the deficit has recently been lifted) to remain accommodative in the immediate term.

Local

High-frequency data indicates a moderation in SA economic growth in the third quarter, following a surprisingly robust expansion in Q2, which shows the resilience of our economy despite all the domestic headwinds. Base effects aside, the slowdown would have been driven by a number of factors that hamstrung growth in Q2, including ongoing crises related to energy availability, rail transportation, and logistical challenges at the ports, which adversely impacted exports, employment, and also revenues. Looking forward, we expect these structural constraints to continue to be a drag on growth for the rest of 2023. Additionally, the flooding in September caused some damage to wheat crops and infrastructure and will no doubt have a negative impact on economic activity. Meanwhile the 'higher for longer' interest narrative is taking hold across regions, and South Africa will be no exception. Risks to inflation are more balanced, with core inflation well behaved. We expect the South African Reserve Bank (SARB) to maintain a cautionary stance and keep interest rates at current levels when the Monetary Policy Committee convenes on 23 November. We can leave any talk of rate cuts to the second half of next year. On the fiscal side, it has been clear to us since the July 2023 company income tax receipts that National Treasury's budget projections were too optimistic. The commodity windfalls

of recent years have all but disappeared. Pressure is coming from both revenue and spending, and the outlook is challenging, but we were encouraged by the pragmatic approach of the finance minister at the MTBPS.

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, we remain slightly cautious in our positioning due to uncertainty in the global environment and some domestic idiosyncratic risks. We added back some duration when markets sold off. We will continue to buy back longer-dated tenors into any market weakness. We have maintained some hedges in place to reduce the volatility of the portfolio. In this uncertain environment, we continue to emphasize the importance of maximising yield and protecting capital.

Overall, our positioning in ILBs is neutral, favouring short-dated linkers. Inflation had proved stickier than expected and the asset class has served us well as a hedge against this and any rand weakness for the portfolios. Real yields appear attractive relative to history.

The fundamental picture for listed property continues to clear. We maintain an allocation to the asset class, but risks for the sector remain. The asset class remains highly volatile and vulnerable to weak growth prospects, high nominal bond yields, while elevated short-term interest rates have also begun to weigh down on many property firms given the reliance on financing for expanding their portfolios. We maintain select exposure and will continue to tactically seize opportunities where we see value. We have slightly increased exposure but maintain an underweight position.

Investment-grade credit remains a neutral allocation in our portfolios. We maintain a cautious approach to adding corporate bonds to the portfolio in a tight spread and tough economic environment. Our bottom-up views remain consistent, with a preference for assets with defensive credit qualities. Our preferred sectors remain banks, government guaranteed SOE’s 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. The foreign exchange (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 uncertainty in the global environment.

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