Discovery

Discovery Money Market Fund

Market background

The optimistic sentiment that characterised the second quarter of 2023, leading to a favourable climate for riskier assets, dissipated over the following three months. Investors had hoped that the pace of rate hikes would gradually decrease and eventually cease by year-end. However, persistently high inflation rates, stable employment figures, and still 'above-trend' economic growth forced the market to accept that the Federal Reserve is likely to raise rates in November and will
maintain higher interest rates through 2024. This shift led to Treasury yields reaching their highest levels since 2007, making them harder to ignore for holders of stocks and other speculative assets. Yields on the benchmark 10-year Treasury rose by three-quarters of a percentage point, their largest quarterly rise in a year. In addition to hurting bond investors, the rise in yields hurt stocks, offering competition to equities while also raising the cost of borrowing for companies and households. The US is expected to continue to face challenges related to persistent inflationary pressures and a tightening monetary policy, resulting in a downward revision of market growth expectations. It's important to note that even a 'soft landing' implies a slowdown in economic activity.

In South Africa, investors remain concerned about holes in the nation’s budget, which the central bank said will force local rates to remain elevated for some time to come. Turgid economic growth, lower commodity prices, declining exports of coal and iron ore due to infrastructure deficits, and elevated expenditure have all contributed to the country’s looming fiscal crunch. All eyes will be on the Medium-term Budget (Nov 1) for clues as to how this will be resolved – higher taxes or spending cuts. The September quarterly bulletin released by the South African Reserve Bank provides few reasons for excitement, though there were snippets of good news. In particular, the bank noted that real gross fixed capital formation increased further and at a faster pace in the second quarter of 2023 as capital spending by the private sector increased significantly. This was offset slightly by a decline in capital investment by the public sector. Economic data over the period was mixed: retail sales fell below consensus forecasts, headline inflation eased within the South African Reserve Bank’s (SARB’s) 3-6% target range, while mining production rose well above market forecasts.

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However, household debt to disposable income edged higher to 62.5% in the second quarter of 2023 as household debt outpaced growth in nominal disposable income. This was exacerbated by higher debt servicing costs, given the cumulative 475 basis point increase in the prime lending rate since November 2021. Despite risk-off sentiment and US dollar demand, the rand ended the quarter just -1.2% lower than the USD.

Performance review

The third quarter saw weak performance for markets, with the latter half particularly challenging as central bank policy remained hawkish, forcing investors to push the likely timing of rate cuts to Q2 2024. While there are signs that consumer inflation is retreating, the surge in energy prices was a cause for concern. In developed sovereign bond markets, rate volatility remained a dominant theme as yields reached multi-year highs. Despite the yield on 10-year gilts at one point reaching a post-2008 high, yields later pared back some of these gains on a downside surprise in inflation data; as a result, UK gilts outperformed, enduring a slightly smaller loss. Investment grade corporate bonds also generated a small negative return, albeit with Europe outperforming the US. Elsewhere within defensive assets, the Japanese yen weakened relative to the US dollar, in part due to the Bank of Japan conducting an unscheduled buying operation of JGBs.

Domestically, the JSE All Bond decreased marginally by 0.33%, as local bond yields rose broadly in line with global bond markets. A further headwind to the domestic market was increasing concern over fiscal deterioration, with tax revenue undershooting expectations and already-elevated government spending rising. By the end of the quarter, the money market curve steepened as inflation edged up in August and the SARB maintained its hawkish tone while keeping rates unchanged at the September meeting. The one-year fixed rate negotiable deposit rallied 32bps over the quarter as the market priced in the end of the hiking cycle. After rallying aggressively to reach a low of 8.95% towards the end of August, some of the exuberance was priced out in September driven by higher oil prices, a hawkish SARB and higher global rates. Yields ended the quarter at 9.275%. Cash, as measured by the STeFI Composite Index, remained broadly stable, up 2.07% for the quarter.

For the quarter, the Fund outperformed the benchmark.

Key positive contributions:

- We selectively extended duration into weakness over the quarter, locking into higher yields
- The portfolio remains invested in floating-rate notes (FRNs) at attractive spreads, and the excess yield over benchmark rates continues to be a positive contributor to performance.

Key negative contributions:

- The market continues to remain excessively long in liquidity. Thus, although the repo rate has increased, cash and short-dated instruments continue to weigh on performance at current market levels.

Portfolio activity

We cautiously extended duration slightly over the quarter. We will look for further opportunities to increase duration into weakness going forward

Outlook and strategy

Global

Although some recent inflation prints have been higher than expected, with higher oil prices also posing a risk to inflation, the global inflation picture continues to be one of moderation overall. Furthermore, recent data releases have led markets to become more confident of a soft landing (rather than recession) for economies, especially in the US. While we believe that we are at the peak of the interest rate hiking cycle, resilient US economic data suggests some caution in expectations of extremely accommodative monetary policy from the Fed. In emerging markets, the China reopening story is faltering with renewed concerns about the property sector emerging. However, Beijing is expected to continue rolling out support measures and the People's Bank of China is expected to keep monetary policy supportive. While markets are likely to remain volatile, we continue to be constructive on the medium-term outlook.

Local

Headline consumer inflation (CPI) edged higher to 4.8% year-on-year (y/y) in August from 4.7% y/y in July. This marks the third time since April 2022 that inflation has fallen within the SARB's 3-6% target band. Earlier in the quarter, petrol deflation has provided particularly significant support to the inflation outlook – but this is now behind us. The risk of elevated oil prices has materialised, and we expect inflation to average 5.8% in 2023 and 5.1% in 2024.

The SARB was pre-emptive and started hiking interest rates earlier than developed market peers. The central bank was concerned about rising domestic inflation pressures when CPI was still below 5%. As at September 2023, the central bank opted to hold interest rates after raising interest rates by a cumulative 475bps, bringing the repo rate to 8.25%. The rand remains susceptible to exogenous shocks and domestic political volatility. With a slower pace of hikes by the Fed expected, we anticipate that the SARB MPC decisions will continue to be more data dependent. This is reassuring for bond investors as in the shorter term, there could be more volatility to come. With the global environment remaining uncertain and a focus on upside risks becoming apparent within the MPC, we believe a further hold is likely at the next MPC meeting.

Positioning

We remain cautious ahead of the next SARB MPC meeting but will look for opportunities to extend duration into weakness.

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