Discovery Money Market Fund

Market background

US economic growth contracted 0.6% quarter on quarter (q/q) in Q2'22, lower than the initial estimate of 0.9% previously reported, as consumption and inventories were revised higher. The Fed's hiking cycle continued to weigh on business and consumer spending. The labour market remained robust, with non-farm payrolls coming in at 315,000 in August, above market forecasts of 300,000. Consumer prices (CPI) saw a second-consecutive month of easing, printing 8.3% y/y in August, the lowest reading in four months. Meanwhile, the core personal consumption expenditures price (PCE) index – the US Federal Reserve's (Fed) preferred measure of inflation – saw an unexpected rise to 4.9%, ahead of the expected 4.7%. The Federal Open Market Committee delivered a third straight 75 basis point (bps) hike at its September meeting, taking the Federal funds target range to 3.00-3.25%. More interesting, however, was the hawkish 'dot plot' (policy members' projections of interest rates), where the median view saw the Federal funds rate ending the year at 4.4%.

Growth in the euro area expanded at an annualised rate of 0.8% q/q in Q2 2022, revised higher from the second estimate of 0.6%. Growth in the region expanded at an annualised rate of 0.8% q/q in Q2 2022, revised higher from the second estimate of 0.6%. eurozone inflation also showed no sign of peaking, soaring to 10% y/y in September, from 9.1% in August. This was the first double-digit print on record. The European Central Bank (ECB) delivered an unprecedented 75bps hike in policy rates at the Governing Council's September meeting, which followed the 50bps hike in July. The central bank guided for more hikes in upcoming meetings, emphasising its commitment to staving off inflation.

In the United Kingdom, fiscal policy, became front page news towards the end of Q3, following the announcement of an unfunded and sizeable fiscal package that would significantly expand government debt. The measures reverberated across UK financial markets, sending the pound into free-fall, while gilt yields soared across the curve. Following a 50bps hike in the bank rate on 22 September, the Bank of England was forced to step in to stem the plunge in UK assets and restore financial stability – announcing a liquidity operation of new gilt purchases to run for a limited time frame.

China's economy continued to face headwinds over the quarter. Manufacturing activity deteriorated further in September, falling to 48.1 from 49.5, on the back of lockdown restrictions. A string of support measures introduced by the government began to take hold towards quarter-end, as industrial production and fixed investment improved. Retail sales, which are an important indicator in China, rose 5.4% in August, well ahead of consensus forecasts of 3.5%. While the rest of the world contends with inflation, China faces deflation as sporadic zero-COVID lockdowns put a lid on domestic demand. Both consumer (CPI) and producer (PPI) fell to below consensus forecasts in August, coming in at 2.5% and 2.3% respectively. The People's Bank of China (PBoC) provided monetary support as it lowered its policy rate marginally by 10bps to 2.75%, while further support measures were announced by China's State Council, totalling 1 trillion yuan.

Following an improvement in sentiment on factory floors in August, rolling power outages made an unwelcome return to everyday life in South Africa. The manufacturing PMI slid back into contraction in September, coming in at 48.2, a drop from 52.1 in August. Incoming data suggests the SA economy likely entered a recession in Q3, and the outlook for Q3 and the remainder of 2022 is not encouraging, as the country's longest-ever stint of power outages, and a lack of business confidence and policy reform continue to hinder growth. There was, however, a modicum of relief as consumer prices eased to 7.6% y/y in August, in line with consensus, as transport inflation moderated. The South African Reserve Bank (SARB) followed through with another 75bps hike in September, bringing the repo rate to 6.25% p.a., and guided for more tightening ahead as it aims to bring inflation back to target.

Performance review

Hawkish central bank rhetoric and sticky inflation saw bond markets routed in Q3. US Treasuries fell 4.4% over the quarter, with the yield on the US benchmark 10-year note ending September at 3.83%, from 3.01% at the beginning of July. European sovereigns also lost ground, down 5.1%, while a tumultuous week in the UK financial markets in September saw gilts book the worst performance in the quarter as they soared to 14-year highs before the Bank of England stepped in. The Bloomberg Barclays Global Aggregate Bond Index ended the month down 6.9%. All returns are quoted in US dollars.

EM fixed income markets endured a tough quarter as growing recession fears, a rampant US dollar and rising DM sovereign yields took their toll. The yield curve shifted higher towards the end of the quarter. The JSE All Bond Index had a tough month but managed to end the quarter on positive footing, up 0.6%. In the money market, one-year fixed-rate negotiable certificates of deposit (NCDs) continued to sell off sharply over the quarter by 1.15% (from 7.44% to 8.59%), with the SARB hiking rates by more than the market had initially expected with 0.75% in July and 0.75% in September, taking the repo to 6.25%. Cumulatively, the SARB has hiked by 2.75% since November last year. The 3-month JIBAR kicked higher by 1.45% over the quarter. Cash, as measured by the STeFI Composite Index, delivered a 1.4% return over the same period. The rand spent the third quarter on the backfoot, as hawkish rhetoric across major central banks piled pressure on risk assets.

For the quarter, the Fund outperformed the benchmark.

Portfolio activity

The Fund maintained its defensive positioning, but we will look for opportunities to increase duration going forward.

Outlook and strategy

Global

We anticipate the availability of energy to remain a major source of economic uncertainty in Europe, placing significant pressure on the region's growth and inflation dynamics, and ultimately leading to a recession in the area. The European Central Bank (ECB) looks poised to ramp up its interest rate-hiking cycle on the back of the energy price shock in the area, although fragmentation risks remain elevated given the vulnerability of some member states. The US will likely also encounter spill-over effects from the pullback of demand in Europe. The Fed continues to tread a steep and slippery slope of taming inflation and tightening financial conditions, and as Chair Jerome Powell warned in his Jackson Hole Symposium speech, policymakers are willing to bring inflation under control even if it comes at the expense of slower growth and a softening labour market. We expect a downturn in US growth in the second and third quarters of this year. The UK, meanwhile, is trying to widen fiscal deficits while the Bank of England is trying to clamp down on inflation – creating financial instability in UK markets as seen in the pound's demise and the spike in gilt yields in recent weeks. In the EM world, the growth outlook has certainly deteriorated further since our last note. China continues to wrestle with a myriad of crosscurrents and a slowdown in growth, and given its share of global GDP, the weakness in China will remain a significant drag on global growth.

Local

The local economic outlook is negatively affected by the external environment. Most notably, the ongoing conflict in Ukraine and the stringent lockdowns in China continue to exacerbate supply-chain challenges and inflationary pressures. South African business and consumer confidence indices continue to track at all-time lows. Furthermore, the intensity and frequency of power blackouts and strike action in various industries are likely to have a perilous effect on growth for Q2 and the remainder of this year. Despite the move lower in fuel prices in August and September, prices remain elevated, and in combination with higher rising interest rates, will remain a stranglehold on businesses and households (especially the low-income cohort), and thus we expect these dynamics to be a further drag on growth. On the monetary front, the rand remains at the mercy of exogenous shocks. Given elevated inflation locally, the worsening in longer-term inflation expectations and rising interest rates in the developed world, we expect the SARB, to maintain a firm handle on monetary policy in the coming months to fight the erosive power of inflation on household incomes and savings. This is reassuring for bond investors.

Positioning

High inflation, rising interest rates and falling markets have battered investors this year. Aggressive rate hikes in the US to temper rampant inflation have not only driven equity markets sharply lower but have also pummeled bond markets. While inflation in South Africa has not reached the highs of US and European inflation, we still saw consumer price inflation (CPI) surge to 7.8% in July – a 13-year high, although decelerating in August (7.6% y/y) and July the likely peak in headline CPI. Headline inflation in the developed world seems poised to continue rising in the midst of the current sanctions on Russian oil, which results in more upward pressure on energy prices.

For some time, South Africa had muted inflation when the rest of the world was experiencing rampant inflation. We have not been able to escape it entirely, with rising food and fuel prices the main drivers of domestic inflation. Fortunately, the SARB has been pre-emptive in terms of policy action to contain inflation. It has been one of the leading central banks globally on this front.

The SARB revised their near-term quarterly inflation higher to 7.4% from 7.0% for 3Q'22. The rest of its inflation outlook has been revised lower by an average of 30bps each quarter until 2024. Their biggest revision was in 3Q'23 which was revised lower from 5.2% to 4.4%. There are near-term upside risks to the bank's inflation forecasts. Inflation remains outside of the target range and significantly above the mid-point. As such, we believe the SARB will carry on with rate hikes given their concern of high inflation getting entrenched in inflation expectations. More so, given the vulnerability of the rand. We currently expect another 75bps hike in the repo rate in November. The aim, in our view, is to get to the 'neutral' repo rate, which they believe to be 7.0%.

We continue to remain cautious, expecting some volatility in the months ahead.