Discovery Balanced, Moderate Balanced, Cautious Balanced Funds

Market background

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 Q3 2024. There are signs that consumer inflation is retreating in developed economies, but the surge in energy prices was concerning. An additional catalyst for difficult markets was the decision of Fitch Ratings to downgrade the US credit rating from AAA to AA+, increasing the focus on persistent budget deficits and the likely impact on rates.

Against this backdrop, US equities retreated amid interest rate worries and the underperformance of mega-cap stocks in September. Over the quarter, developed markets broadly matched emerging, with the MSCI World Index delivering -3.5% and the MSCI Emerging Markets Index returning -3.7% (both in USD).

Within high yield corporate debt, US high yield outperformed its European counterpart, despite the rising rate environment, and generated a small positive return. Within defensive assets, rate volatility remained a dominant theme: as 10-year bond yields in the US, Germany and Japan reached their highest levels since 2007, 2011 and 2013 respectively, bonds suffered further value destruction.

Gold fell by 4% during the quarter, reaching its lowest level since February.

The picture across the UK and Europe was gloomy. In the UK growth remains weak, inflation persistent and the labour market tight, compelling the Bank of England, which has raised interest rates 14 times since December 2021, to keep rates unchanged in September, at a 15-year high of 5.25%.

Economic activity in the EU was subdued in the year and is projected remain sluggish through the fourth quarter of 2023. The European Central Bank raised its key interest rate to a record high of 4% in September, but signalled that the hike, its 10th in a 14-month-long fight against inflation, was likely to be its last.

In China, data through the quarter suggested the economy is faltering, pushing the government to step in with measures to lift investor confidence and boost economic growth. The property slump also continued to bite. These headwinds fuelled a selloff in China's domestic stocks, continuing the trend from the second quarter. By the end of the quarter, the Shanghai Composite (-4.0%) and Hang Seng (-4.2%) were in the red, while the yield on China's 10-year government bond rose to around 2.7%.

South African equities continued the trend set in August and September, following international markets lower, with the All Share Index ending the quarter down 3.8%, but in positive territory for the year at 1.9%. 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. All eyes will be on the October mini-budget (Nov 1) for clues as to how this will be resolved – higher taxes or spending cuts.
Despite risk-off sentiment and US dollar demand, the rand ended the quarter just -1.2% lower than the USD. This meant fewer gains for investors in rand hedge shares like Richemont, BAT or Sasol and Anglo Platinum.

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Performance review

For the quarter, the portfolio delivered a negative absolute return as market sentiment reverted to risk-off after flirting with the risk-on sentiment seen towards the end of the second quarter and into July.

Sentiment soured after it became evident that global rates would remain higher for longer, causing bond yields to spike across developed and developing markets, and spilling into equity markets – leaving few places for investors to hide. Indeed, at an asset class level, the only place to hide was in cash.

Earlier in the quarter, we lightened some of the portfolio's exposure to global bonds and SA bonds and kept the proceeds in cash. Some of this cash was deployed later in the quarter, topping up existing holdings – for instance in diversified miners - on price weakness. We also added new positions, for instance in selected SA retail holdings, again on price weakness.

Key positive contributions:

- **Energy stocks**: ExxonMobil and BP on oil prices that surged higher following extended production cuts by Saudi Arabia and new cuts from Russia.
- **Google** added value from an absolute perspective.
- **SA Inc**: Stocks including ABSA, Shoprite, Sanlam, and Standard Bank Group had a strong run, providing relief in a sea of red.
- **SA bonds**: although negative on an absolute basis, they outperformed every other global asset class, largely due to the yield underpin.
- **Partners Group**: the private equity group has seen its stock rise by 28% since July on the back of results that exceeded expectations and demonstrated growth despite the low liquidity and high rate environment. We believe there is still runway ahead.
- **Property stocks** (Vonovia & Tritax): the European property group and UK-listed REIT have rallied by circa 25% since June, as investors diverted from cyclical to defensive assets in a risk-off European growth backdrop.

Key negative contributions:

- **Global equities**, across all sectors, including tech stocks and utilities.
- **Global bonds**, as yields rose on expectations that rates will remain higher for longer.
- **Stocks with exposure to China** – diversified miners such as BHP Group and South32, Richemont, Naspers and Prosus.

Outlook and strategy

The local market continues to be impacted by global market developments. Sentiment is now decidedly risk off as markets recognise that higher rates for longer will dampen global demand. We remain cautiously positioned and outline some of the factors that are potentially at play over the last quarter of the year that could test the asset class:

- Evidence is building, especially outside of the **US,** that growth is slowing. This is becoming increasingly apparent in the euro zone, where data points to a recession sooner rather than later.
- In the **US hopes are fading** that a recession will be confined to a soft landing. We will monitor economic data releases in the coming months to confirm our thesis of a recession in 2024. In addition, while inflation is coming down, the base effects in the coming months may create volatility in the data.
- The massive shakeout in **global bonds**, coupled with US dollar strength (which reduces global liquidity), tight policy and slowing global growth creates a potent risk-off cocktail. This means volatility and uncertainty will remain.
- We are monitoring **China** closely. After months of negative data releases there are some early signs that the bottom may have been reached. For instance, the Shanghai Stock Exchange Composite Index reached a bottom on August 25; exports contracted at a milder pace in August than the previous month, a key manufacturing gauge improved slightly, and deflation pressure eased. Also, local governments have ramped up borrowing to lift spending on infrastructure projects, selling the most amount of special bonds in more than a year in August, presenting an underpin to growth.
- **Liquidity** is tightening and will likely impact risk assets in the months ahead.

Given this backdrop, we remain cautious. Our **overall equity exposure has increased modestly**, but our equity mix is still tilted towards growth and defensives over cyclicals. We are paying close attention to this, as the market forecasts and the resultant share price reactions tend to overshoot to the downside, and this will create opportunities to buy these companies back in the months ahead. We believe this is starting to happen – hence we have opened positions on select SA retail stocks.

We have **increased** our exposure to **European bonds**, a holding we believe will add value in time. While we maintain a healthy **allocation to SA Bonds, which have an attractive yield underpin**, we took advantage of the mid-quarter rally and converted some of our holdings to cash, which is yielding an attractive risk-free return. Our concern about SA fiscal slippage is preventing us from adding to SA bonds for the time being. We will remain on the side-lines until ‘event-risk’ (the November budget) is behind us.

This dry powder in cash puts us in a better position to take advantage of future opportunities.

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