Discovery

Discovery Diversified Income 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 US Federal Reserve (Fed) may have to raise rates in November and is likely to maintain higher interest rates through 2024. This shift led to Treasury yields reaching their highest levels since 2007, negatively impacting stocks and other emerging market yields. 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 weaker revenue growth which will see the budget having to be revised in November, 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 challenge. All eyes will be on the Medium-Term Budget (1 November) for clues as to how this will be resolved – higher taxes, spending cuts or a combination of both. The September quarterly bulletin released by the South African Reserve Bank (SARB) 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 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 (bps) 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 US dollar.

Performance review

For the quarter, the portfolio marginally underperformed the benchmark.
The third quarter saw weak performance for markets, with the latter half particularly challenging as central bank policy remained hawkish, forcing investors to push out the likely timing of rate cuts. 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 Japanese government bonds.

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 nominal curve bear flattened as inflation edged up in August and the SARB maintained its hawkish tone while keeping rates unchanged at the September meeting. Against this backdrop, negative performance was noted in the longer end of the yield curve. Our underweight positioning in this area of the curve managed to minimise the drawdown.

Inflation-linked bonds (ILBs) delivered positive returns over the quarter, reflecting short-term inflation concerns related to an increasing oil price and depreciating currency.

In a volatile period, listed property delivered a negative return over the quarter.

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

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 quarter, supported by the sharp rise in US treasury yields.

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

National Treasury's revenue expectations appear optimistic against the current backdrop. Coupled with expenditure pressures remaining on the upside, the fiscal picture warrants some concern. Revenue figures released thus far have demonstrated weak corporate tax receipts, predominately due to the weak commodity cycle. We will be watching the upcoming Medium-term Budget Speech closely to assess whether the Minister has enough political will and backing to stabilise the budget. In another area of importance, SA growth is highly sensitive to loadshedding; therefore, any improvement should contribute to a better outlook in our GDP forecasts. On a more positive note, domestic geopolitical risks appear to have receded with the BRICS Summit presenting a positive shift in the country's standing. We expect a firm but volatile environment for local fixed income assets.

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

From a positioning perspective, South African government bonds (SAGBs) remain attractive on valuation grounds, relative to other asset classes in the fixed income universe and relative to their historical record. That said, we remain cautious in our positioning due to uncertainty in the global environment and some domestic idiosyncratic risks. Over the quarter, we switched out of ultra-long bonds and into the belly of the curve – given increasing fiscal concerns. We will continue to look for opportunities to add back duration in market selloffs. We have added some hedges in shorter-dated interest rate swaps to reduce portfolio volatility. We continue to stress the importance of earning yield and protecting capital in this fluid environment.

Our positioning in ILBs is slightly overweight the asset class, after increasing our exposure as a hedge against a stubborn oil price. We favour short-dated linkers while being underweight at the long end of the real yield curve. As price momentum has topped, nominals are still well positioned to outperform ILBs.

As the fundamental picture for listed property has begun to clear, we have maintained our allocation to the asset class. The sector remains highly volatile and vulnerable to global and local news flow, while elevated short-term interest rates have also begun to weigh down on many property firms given the reliance on financing for expansions. We maintain select exposure and will continue to tactically seize opportunities where we see value.

Investment-grade credit is a neutral allocation in our portfolios. We maintain a cautious approach to adding yield to the portfolio in a tight spread and tough economic environment. Our bottom-up views remain consistent, with a preference over assets with defensive credit qualities.

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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