Discovery Diversified Income

31 October 2024

Market background

The Fast View

- Government bond yields rose across developed markets, especially in the US and UK
- In EM fixed income market yields rose, showing a bear steepening trend
- In Japan, the leading coalition party lost its majority in elections; while the Bank of Japan kept rates on hold as expected
- SA Finance Minister Enoch Godongwana delivered a pragmatic midterm budget

Performance review

For the month, the portfolio underperformed the benchmark.

Yields across government bond markets rose in October, resulting in negative total returns in fixed-income markets. This was mostly pronounced in the US and UK. The Bloomberg Barclays Global Aggregate Bond Index fell 3.4% for the month.

In the US, yields rose across the entire US Treasury yield curve. The dial-down in interest rate expectations and election uncertainty drove two and 10-year Treasury yields past the 4.0% level.
For emerging markets, a repricing of the pace of rate cuts, a stronger US economy and a firmer dollar weighed on fixed income assets in emerging markets. Locally, the JSE All Bond Index declined by 2.20%, with the long end of the curve being the biggest contributor to the decrease. Our duration position came under pressure during the month, and against this backdrop, we took some risk off the table by mainly selling government bonds and buying some optionality.

We remain underweight on inflation-linked bonds (ILB) amid a slowdown in inflation.

SA-listed property pared back gains during the month as yield-oriented assets came under pressure. However, due to the uncertainty around US elections, we sold property at the beginning of the month to protect capital.

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

We increased our dollar exposure as a hedge against the rand. The foreign exchange (FX) component of the portfolio added to performance as the US dollar strengthened over the period.

Outlook and strategy

Global

Globally, inflation continues to cool down, and economic data appears to support the US' trajectory towards a soft lending. We initially expected the Fed to cut rates by 100bps this year; however, it looks like the central bank is no longer behind the curve, and may now pause at the December meeting. In China, after the government announced a comprehensive economic stimulus package to energise its economy – GDP data for Q3 2024 recorded growth of 4.6% year-on-year. This was slightly above expectations, but it was the slowest expansion since early 2023. We continue to monitor the fallout from the US elections and its implications for policy and capital markets, as well as developments in geopolitics, especially the Middle East, as instability could cause oil prices to edge higher, undoing the disinflationary story.

South Africa

The medium-term budget by the National Treasury was the focal point for the month. Although there was an unexpected revenue shortfall for the fiscal year, and debt services costs slightly increased, we believe finance minister Enoch Godongwana provided a pragmatic budget. The National Treasury also revised economic growth to 1.1% for 2024, down from 1.3% estimated in the February budget. Although the formation of the 'Government of National Unity' has continued to improve sentiment toward South Africa, economic growth remains a concern. On a positive note, the National Treasury emphasised the government would focus on maintaining macroeconomic stability, implementing structural reforms, building state capacity, and supporting growth-enhancing public infrastructure investment over the medium term. Meanwhile, inflation continues to behave. In September, it printed 3.8% year on year (y/y), down from 4.4% y/y in August, aided by a decline in fuel prices. We expect the South African Reserve Bank to lower rates further by 25 bps at the November policy setting meeting as inflation continues to remain within the central bank's midpoint target.

Positioning

Due to the US elections, we have increased optionality in the portfolio, as we expect volatility for the next couple of weeks.

From a positioning perspective, we remain positive on South African government bonds (SAGBs) and are underweight ILBs against a weaker inflation profile. We gradually reduced duration during the month, but will look for opportunities to add some back once US election uncertainty has been removed from the table.

After reducing the property holdings coming out of Q3, we started to add some exposure back during the month. In the medium term, we maintain a positive outlook to listed property.

Investment-grade credit remains a neutral allocation in our portfolios, as we prefer sovereign debt instead. Spreads have tightened in recent years due to too much demand amid a slowdown in issuance.

In the FX component of the portfolio, we have increased exposure to the US dollar, as we expect a firmer dollar on the back of a resilient US economy and repricing of Fed cuts. We also maintain exposure to FX as a hedge against rand volatility.