Discovery Diversified Income Fund

Market background

US economic data in the past month largely underwhelmed, showing an economy past peak growth with the rapid spread of the Delta variant slowing consumer spending and economic growth, while inflationary pressures remained at decade highs. The message was more dovish at the closely watched Jackson Hole Symposium at month end; US Federal Reserve Chair Jerome Powell signalled clearly that tapering could start towards the end of this year but said that acting too quickly would be harmful to the economy. Powell also clearly distinguished between the decision to start withdrawing support and the decision to start hiking rates, leading to market participants reducing their expectations regarding the latter.

The economic rebound in Europe continued to power on as Europe surpassed US vaccination rates during the month. The rapidly spreading Delta variant appeared to have little effect on the consumer-led recovery as travel and leisure indicators climbed to their highest levels during the summer holidays. The upcoming Governing Council (GC) meeting on 9 September is likely to be a challenging one for ECB President Christine Lagarde, with the bloc's growth rebound and the surge in inflation having reawakened the hawks within on the GC, who for the better part of the past year have been in hibernation. In the UK, the economy is likely past peak growth, but inflation jitters have prompted the Bank of England to communicate plans to pull back its pandemic stimulus measures to counter inflationary pressures.

In emerging markets (EM), The virulent Delta variant slammed the brakes on China's economic recovery in August, which already looked to be flat-lining. Authorities have responded swiftly to the spreading virus, reverting back to tried and tested methods of mass testing and tracking to contain the spread,

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while forgoing short-term economic activity. The People's Bank of China (PBoC) has since pledged to offer financial assistance to small businesses (SMEs) and better utilisation of local government bonds. The central bank has committed to US$46.4 billion in cheap funding to banks in order to help SMEs and economists widely expect more targeted measures to be introduced in the coming months as Beijing becomes increasingly worried on the China's growth outlook.

Back home, the mood on SA factory floors improved in August, with the manufacturing PMI soaring to a record high 57.9 in August (the quickest pace since record keeping began just over two decades ago) as the economic climate cleared up since the violent civil unrest which brought disruptions to supply chains and industrial activity. In the labour market, the official unemployment rate in SA rose from 32.6% in Q1 2021 to 34.4% in Q2 2021 – the highest jobless rate ever recorded since the introduction of the Quarterly Labour Force Survey (QLFS) in 2008. Headline inflation and core eased in line with market expectations. Headline increased by 4.6% y/y in July from 4.9% y/y in June. The moderation in the headline print was driven by core inflation, which decelerated from 3.2% y/y in June to 3.0% y/y in July. The South African Reserve Bank Monetary Policy Committee is scheduled to meet on 23 September where it is expected to keep policy accommodative for longer.

Performance review

For the month, the portfolio outperformed the benchmark.

There was very little movement in bond markets amid the August lull. The Bloomberg Barclays Global Aggregate Bond Index saw a modest decline of 0.4%. US Treasury yields barely moved in either direction, slightly down 0.2%, while European bonds retreated on hawkish comments from the ECB. EM sovereign bonds outperformed their DM peers with notably strong performance out of South Africa, Turkey, India and Indonesia as investors continued to search for yield in riskier markets.

Locally, nominal bonds tracked a firmer rand on the back of a dovish Fed and improved debt metrics following the GDP revisions. We saw some yield curve flattening by month end, with yields moving lower across the curve. Foreigners were small buyers of local bonds over the month, but the JSE All Bond Index managed to deliver a respectable return thanks to good local support. Our positioning across the curve buttressed relative performance.

The inflation-linked bonds (ILBs) exposure added to returns over the period as the asset class strengthened across the curve.

Listed property added to performance as the sector rebounded over the month. We continue to tactically add to the asset class but maintain an underweight position given the volatility in the sector.

The yield-enhancing corporate bond allocation continued to add value, but we remain roughly neutral the asset class.

The FX component of the portfolio delivered muted gains over the period with the dollar relatively flat against a basket of its G10 peers and a firmer local currency.

Outlook and strategy

Global

The world remains in a holding pattern for now, and myriad cross-currents (COVID variants, the pace of growth, monetary policy normalisation, inflation and the path of interest rates, and fiscal policy) remain sources of uncertainty and volatility.

EU mobility data continues to pick up, as are services purchasing managers' indices (PMIs), so we should see the wheels of recovery continue to turn in the second half of this year. In the US, the job market continues to recover, although demand has slowed since March with labour shortages, supply disruptions and the surge of COVID infections hampering a more robust expansion. We expect the US Federal Reserve (Fed) to maintain its wait-and-see approach to policy in the near term, especially in light of COVID developments; its cautious approach was reaffirmed at the Jackson Hole Economic Symposium on 26-28 August. In the EM space, the People's Bank of China (PBoC) has reiterated its intention to maintain policy, liquidity and the exchange rate at current levels – quelling fears of an impending tightening in policy – while the Communist Party recently pledged to remain supportive of the economy in light of the outbreak in COVID infections across key economic hubs.

Local

We expect the SA economy to continue its recovery from an extremely low base over the remainder of this year. We have pencilled in growth of 3.8% for 2021, but that means the level of economic output at the end of this year will still be below the pre-pandemic level. The economic recovery in the second half of this year will be bumpy, but we expect elevated commodity prices (especially for resources-rich countries like ours) and supportive global economic momentum to act as shock absorbers in the coming months. The announcement that private entities will be able to generate their own electricity (up to 100 megawatts) is growth additive, but we need to see traction on more reforms, as well as infrastructure spending.

Positioning

We believe South African Government Bonds (SAGBs) remain attractive, not only versus inflation and cash, but also relative to developed markets (DM) and their emerging market (EM) peers – underpinned by a supportive global backdrop and a compensating fiscal premium. We trimmed duration aggressively in late June but have slightly added back in recent weeks, reallocating the overweight in the long end of the yield curve to the belly. We continue to hold a balance of exposures, with an allocation to bond put-options, which offer protection for the portfolios.

We believe inflation peaked in May and have since have taken some profit in inflation-linked bonds (ILBs). A much slower pace in inflation will undermine the fundamental underpin to the asset class in the short term and we do not see break-even widening following the peak print.

We maintain an underweight position in listed property on account of an extremely cloudy outlook for the domestic economy and company distributions. Fundamentals remain weak in the sector, owing to prolonged and rising vacancies, negative rental revisions and rental holidays. Hence, we continue to proceed with caution, tactically seizing opportunities from time to time when we see value.

Investment-grade credit is a roughly neutral allocation on valuation grounds. Some paper has re-rated and supply-demand dynamics are supportive. We expect demand to remain strong for quality credit assets amid a slowdown in issuance. We have minimal exposure to the cyclical sectors of the economy, maintaining a preference for quality defensives; namely banks, insurers, real estate, telecomms and especially government-guaranteed debt, as well as large blue-chip corporates with strong balance sheets.

In portfolios permitting foreign-exchange (FX) exposure, we believe it is prudent to retain a reasonable allocation to a basket of offshore currencies. With positive terms of trade, strong current-account metrics and central-bank largesse globally, we remain underweight in the allocation to FX but have added slightly in recent weeks. We have a mix of US dollar, euro and EM currencies in order to diversify our FX exposure.

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