Discovery

Discovery Diversified Income 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

For the quarter, the portfolio outperformed the benchmark.

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%. Notwithstanding some weakness in the final month of the quarter, positive performance was recorded across all tenors over the period, and our positioning, which is mostly biased to the belly of the curve, held us in good stead to consolidate gains built earlier in the quarter.

The allocation to inflation-linked bonds (ILBs), which has mostly focused on the shorter-dated maturities, continued to add value over the quarter, but we have since sold down this exposure and switched into nominal bonds to enhance the yield of the Fund.

Listed property weighed on returns as the sector extended losses over the quarter amid continued volatility.

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The yield-enhancing allocation to investment-grade credit was a positive contributor to performance over the period.

We continued to add to the FX allocation over the quarter as a hedge, which helped counter some of the rand weakness witnessed. The US dollar grew in strength over the period, which helped the FX component of the portfolio.

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

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From a positioning perspective, the valuation argument for SAGBs remains intact. That said, against the backdrop of higher inflation and rising interest rates – both locally and globally – we remain cautious in our positioning. Poor global investor sentiment, fuelled by inflation concerns and aggressive rate hiking by the US Federal Reserve (Fed), has resulted in emerging market (EM) bond yields moving much higher this year. The valuation buffer that the market weakness has created provides some comfort that we should not see significant capital outflows out of EMs, including South Africa (SA). Notwithstanding, we have some hedges in place to seek to reduce portfolio volatility. We continue to stress the importance of earning yield and protecting capital in the current environment.

We have sold inflation-linked bonds (ILBs) as we believe inflation has likely peaked in SA and, reallocating to nominals and cash instead. The asset class has served us well as a hedge for the portfolios. As price momentum approaches the zenith, nominals tend to outperform ILBs, hence we have switched some of this exposure into nominals.

As the fundamental picture for listed property has begun to clear, we have increased our allocation but still remain underweight the asset class. The asset class remains highly volatile and vulnerable to global and local newsflow, as evidenced over the quarter. Our exposure here remains limited, but we will continue to tactically seize opportunities where we see value.

Investment-grade credit has moved from marginally underweight to a marginally overweight allocation in our portfolios. We maintain a cautious approach to adding risk to the portfolio in a tight spread and tough economic environment.

In portfolios permitting foreign-exchange (FX) exposure, we believe it is prudent to retain a reasonable allocation to a basket of offshore currencies. We maintain the bulk of the allocation to the US dollar. From a portfolio-construction perspective, our foreign currency exposure acts as a risk mitigator during times of rand weakness. We have also used US Treasuries as a hedge in the portfolio to cushion the impact of rising US yields.