Discovery Diversified Income Fund

Market background

August got off to a rocky start after the US Treasury announced that it would increase the size of its quarterly bond sales to help finance its growing budget deficit. Shortly thereafter, Fitch Ratings downgraded the US government's credit rating from AAA to AA+, sparking concerns over a broader deterioration in the global economy and triggering a global sell-off across bond and equity markets. Further weighing on market sentiment was the prospect of more interest-rate hikes, after minutes from the US Federal Reserve's (Fed's) July meeting highlighted the potential need for further policy tightening to curb inflationary pressure. A raft of stronger economic data followed, increasing speculation that the Fed would continue its policy-tightening campaign.

Domestically, South Africa hosted the BRICS Summit in Johannesburg during the month. Key discussion points included positioning the bloc as an economic alternative to the West. The group announced that Saudi Arabia, Iran, Ethiopia, Egypt, Argentina and the United Arab Emirates would be incorporated as members from the start of the new year. South Africa also used the summit to broker a deal with the Chinese government to assist the country with its power crisis, mainly through infrastructure sponsorship and additional funding. Economic data over the period was mixed: retail sales fell below consensus forecasts, headline inflation eased further within the South African Reserve Bank's (SARB's) 3-6% target range, while mining production rose well above market forecasts. However, it was a tough month for miners as lower commodity prices and concerns over slower growth in China weighed on the sector.

Performance review

For the month, the portfolio outperformed the benchmark.

Volatility was a dominant theme and in aggregate, global bonds lost ground in August. US treasuries fell given the market's reassessment of the rate outlook, and the 10-year US Treasury yield reached its highest level of this cycle so far, driven by a move higher in real yields. In the UK, gilt performance was also negative as yields rose, at one point reaching their highest level since August 2008, thanks to strong GDP and wage data. Despite the move higher in rates, European investment grade corporate bonds generated a small positive return, whilst their US counterparts fell. Elsewhere within defensive assets, the Japanese yen weakened relative to the US dollar, in part due to the Bank of Japan (BoJ) conducting an unscheduled buying operation of Japanese government bonds.

Locally, the JSE All Bond Index decreased by 0.23%, as local bond yields rose broadly in line with global bond markets. The yield curve steepened at the end of the month with increasing concerns over fiscal deterioration acting as a further headwind to the domestic market. Elsewhere, the rand continues to track the level of loadshedding and depreciated in tandem with Stage 6 rearing its head once again. On a more positive note, headline inflation came in better than expected, declining further within the SARB's 3-6% target band. Against this backdrop, positive performance was noted across the belly of the curve and our positioning, which mostly favours that area of the curve contributed positively to performance.

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

Listed property also delivered a positive return over the month. Our select exposure to the asset class contributed to performance.

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

The foreign exchange (FX) component of the portfolio, the bulk of which is in the US dollar, added slightly to returns as the greenback strengthened, supported by higher rates.

Outlook and strategy

Global

Global inflation pressures are continuing to moderate and recent events have led markets to price in a higher probability of a soft landing, especially for 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 any accommodative monetary policy from the Fed. Across the Atlantic, European data is coming in weaker than anticipated but sticky core inflation will likely keep the European Central Bank hawkish. In emerging markets, the China reopening story is faltering, but Beijing is expected to continue rolling out support measures and the People's Bank of China is expected to keep monetary policy supportive. Markets will continue to remain volatile, however we continue to be constructive on the medium-term outlook for returns.

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. The June revenue figures demonstrated weak corporate tax receipts, predominately due to the weak commodity cycle. We are watching this figure closely as it will give us key insight into the resiliency of 'SA Inc.' (companies that derive most of their revenue domestically) considering the sustained headwinds. We expect a constructive but volatile environment for local fixed income assets. 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.

Turning to monetary policy, 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 of July 2023, the central bank opted to pause 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 pause by the Fed expected soon, 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. With the global environment remaining uncertain and upside risks being apparent within the MPC, we believe a further hold is likely at the next MPC meeting. We remain of the opinion that we are at the end of the rate-hiking cycle and that inflation will remain inside the target band for the second half of the year.

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 month, we reduced some duration into market strength. We will continue to look for opportunities to add back this duration in market selloffs. Furthermore, we have some hedges in place to reduce portfolio volatility. We continue to stress the importance of earning yield and protecting capital in this fluid environment.

Overall, our positioning in ILBs is neutral after increasing our exposure as a hedge against the rising oil price. We favour short-dated linkers while being underweight at the long end of the real yield curve.

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 credit to the portfolio in a tight spread and tough economic environment. Our bottom-up views remain consistent, with a preference for 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 any upward surprises in global inflation.

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