Discovery Diversified Income

31 January 2025

Market background

The Fast View

- Fed keeps interest rates unchanged as it waits to see progress on the inflation outlook
- ECB cut rates to bolster the economy; UK 10-year Gilt yields reach 17-year high
- The SARB cuts interest rates amid softer inflation but cautions heighten global risks
- The BoJ raised rates as pressure on wage inflation increased

Performance review

For the month, the portfolio slightly underperformed the benchmark.

Fixed income markets began the year on a volatile note, reflecting oscillations in most bond markets. Cautious rhetoric from some members of the Federal Reserve's (Fed's) rate-setting committee, coupled with surprisingly strong economic and labour market data, prompted a sell-off in the 10-year US treasury market. Subsequently, however, signs of improving inflation dynamics, more dovish rhetoric from the Fed, and a temporary sense of relief (Trump did not immediately impose tariffs after taking office) helped restore market confidence. As a result, expectations for a further rate cut this year remained intact, and treasury yields ended the month broadly unchanged.

It was a better month for EM currencies after the sell-off seen at the end of 2024, with the US dollar weakening after Trump's initial hints at a softer stance on tariffs. Within emerging market economies, China reported stronger-than-expected growth thanks to ongoing strength in exports, but activity levels in both the manufacturing and services sectors were weaker. In Latin America, divergent trends in inflation saw rates cut in Peru and hiked in Brazil. Capping a strong year for the country's economy, Argentina reported a fiscal surplus for 2024. Elsewhere, Turkey's current account data was better than expected, and the central bank cut interest rates for the second time in this cycle, as expected. Against this backdrop, EM fixed income and currency markets posted gains.

Locally, inflation slightly increased to 3% year-on-year (y/y) in December from 2.9% y/y in November. The print was still well below the mid-point target of the South African Reserve Bank (SARB), which provided policymakers room to provide additional rate relief by cutting the Repo rate to 7.50%. Amid global volatility, the JSE All Bond Index only managed to deliver a modest gain of 0.44% – supported by the short end of the curve.

Due to the uncertainty in the global environment, we took a cautious approach in managing the portfolio during the month by reducing some risk. We sold some duration which helped limit losses.

We maintained our zero holdings in inflation-linked bonds (ILBs) as inflationary pressure remains benign.

Meanwhile, our holdings in listed property were a drag, with the sector pulling back during the month.

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

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To further protect the portfolio, we increased our FX exposure during the month as a hedge against volatility and prevailing risks¬—and we expect to hold on to the US dollar for slightly longer than usual.

Global

We expect market volatility amid uncertainty in the global environment fuelled by protectionist trade tactics. At the time of writing, US tariffs on China have proceeded as planned. The levies come after Beijing's economy grew by 5.4% y/y in Q4 of 2024, up from 4.3% in the previous quarter. This acceleration was attributed to a series of stimulus measures implemented by China since September to boost economic growth. The ECB cut interest rates for the fifth time since June to stimulate the eurozone economy. The central bank maintained that its monetary policy stance remains restrictive, indicating the possibility of further rate cuts in the future. Meanwhile, 10-year Gild yields reached 17-year highs in the United Kingdom due to a weakening pound amid broader concerns regarding the country's economic outlook.

South Africa

We anticipate a reasonable budget announcement by the National Treasury later in February. The 2024 Medium-Term Budget Policy Statement acknowledged the country's fiscal challenges, including a widening deficit amid rising debt levels, while also outlining plans to stimulate the economy. We believe the government has implemented appropriate structural reforms. The National Treasury continues to perform well, with revenue collections running slightly ahead of budget, partly due to increased tax revenue from the recent two-pot retirement system withdrawals. Following the recent rate cut, the market is now pricing in a 50% chance of further easing, which we consider reasonable. However, there is a possibility that no further cuts will materialise this year due to ongoing global uncertainty. Additionally, Stats SA reweighted the CPI basket, which led to a 10bps downside surprise in inflation.

Positioning

From a South African perspective, South African Government Bonds (SAGBs) are still attractive on a six to 12-month view, but there is still concern about short-term global risks. The political and economic outlook is improving, and yields remain attractive. Global headwinds continue to pose risks. The strategy is to stay cautious and manage risk in the portfolios in the short term and look to buy back some duration as yields rise.

We maintain a zero holding in Inflation-linked bonds (ILBs). We expect inflation to remain benign, with a slight increase in the second half of 2025, potentially reaching 4.4% by year-end.

Our exposure to listed property remains underweight, and we remain selective in our allocation.

In portfolios permitting FX exposure, we have slightly increased our allocation to a basket of offshore currencies to mitigate some of the global risks. We have increased the exposure to the US dollar amid a fluid global environment and rand volatility.

We continue to emphasise the importance of maximising yield and protecting capital, and we will continue to tactically seize opportunities to participate where we see value.