Discovery Diversified Income

July 2024

Market background

The Fast View

- Most bond markets posted gains in July, thanks to the rising prospect of interest-rate cuts in the US and Europe
- In contrast, the Bank of Japan (BoJ) hiked its policy rate by 15bps to 25bps at the end of the month
- It was another positive month for EM Fixed Income markets
- SA yield-oriented assets generated strong returns over the period

To read more, please click here.

Performance review

For the month, the portfolio outperformed the benchmark.

Developed market sovereign bonds performed strongly as speculation grew that the US Federal Reserve (Fed) would cut rates before September.

Against the backdrop of the global bond rally, particularly in the US, EM fixed income had a strong month in July. In the SA Bond market, the JSE All Bond Index delivered another solid month of gains, up 4.0%. We were well positioned on the curve as all tenors rallied over the period.

Inflation-linked bond (ILB) continued to underperform nominal bonds. We have sold most of our ILBs as inflation continues to trend down, closer towards the SARB's mid-point of the target.

SA listed property continued its recovery with another strong month of performance, and our selective exposure here benefitted performance.

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

The FX component of the portfolio remains under-weight, but was a drag on performance, as the greenback weakened against a basket of its G10 peers.

Outlook and strategy

Global: The global environment appears more supportive for interest rates. The US economy remains resilient based on recent GDP data, although we are beginning to see signs of weakness emerging. Likewise, we are beginning to see some softening in the labour market, with unemployment ticking higher, while consumers are beginning to feel the pain of higher borrowing costs. Elsewhere, emerging economies have thus far shown resilience. However, a surprise miss in China's Q2 GDP print dims the outlook for commodity exporting countries and EMs more broadly.

South Africa: Economic indicators are showing signs of improvement in the country's economic conditions with manufacturing activity climbing back strongly into expansionary territory with a PMI reading of 52 in July, following two consecutive months of contraction. Business confidence also rose in Q2 2024, to the highest it has been in over a year, mainly attributed to the absence of loadshedding for nearly four months. Eskom has made notable strides in improving its energy availability factor (EAF), breaching the psychological 70% mark, which is a significant improvement, and levels last seen nearly three years ago. The utility is currently generating more capacity than required, which has allayed some of the initial fears that supply would not meet the demands of an improving economy. On the logistics side, Transnet also continues to show a small improvement in operations at the ports. Exports in the citrus industry have surprised to the upside yet again in terms of tonnage, despite some challenges during the export season. Overall, we think risks to growth are currently skewed to the upside. The rand appears to have stabilised, and continues to find support in gold, while inflation has moderated and continues to trend towards the mid-point of the South African Reserve Bank's (SARB) target range and expect the MPC to follow through with a 25bps cut in key rates at the September meeting.

Positioning

From a positioning perspective, we remain overweight South African government bonds (SAGBs), which remain very attractive on valuation grounds and relative to other asset classes in the fixed income universe.

We remain underweight ILBs, having sold down most of our exposure, preferring nominals instead, as inflation remains inside the targeted band and continues to surprise to the downside. A lower inflation target potentially looms on the horizon, which will lead to a repricing of the asset class in the not-so-distant future.

While we have slightly reduced exposure listed property, and banked gains following strong performance, we remain cautiously optimistic on the outlook for the asset class, while mindful that risks for the sector remain.

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

In portfolios permitting FX exposure, we believe it is prudent to retain a small allocation to a basket of offshore currencies. We have moved underweight in our exposure, although slightly increasing our USD exposure as a hedge against a risk-off trade.