

Discovery Diversified Income

30 September 2024

Market background

The Fast View

- Cooling US inflation and expectations of further rate cuts led to a sharp fall in US Treasury yields
- US Fed cut interest rates by 50 basis points (bps) for the first time in four years
- Beijing announced a co-ordinated stimulus plan to revive its economy
- The rand found support in a weaker US dollar and a positive shift in sentiment towards the South African economy

Performance review

For the quarter, the portfolio outperformed the benchmark.

Falling inflation and interest rate cuts provided a boost to many fixed income markets. Interest rate cuts in the US led to a sharp fall in Treasury yields. As was expected by some, the US Federal Reserve (Fed) reduced interest rates for the first time in four years in its September meeting. After much debate across markets, a larger 50bps cut reflected a slowing labour market and increased confidence around inflation dynamics.

Given the backdrop of falling developed market bond yields, a weaker US dollar and an increased appetite for risk, emerging market (EM) fixed income and currencies delivered a strong performance. Locally, the JSE All Bond Index (ALBI) delivered a robust 10.5% return for the quarter as bonds outperformed their equity peers. South Africa's benchmark bond yield fell below 10% for the first time in more than two years as supportive tailwinds from abroad and an improving outlook for growth and stability following the formation of the Government of National Unity (GNU) continued to fuel investor sentiment over the period. The rand continued its momentum over the quarter, supported by a combination of a weaker US dollar and a positive shift in sentiment towards the South African economy.

All tenors across the yield curve outperformed, and our overweight duration positioning benefitted performance. We tactically added duration on US Treasuries, which also added value.

We remain very underweight ILBs amid a slowdown in inflation expectations.

SA-listed property delivered a stellar quarter on the back of an improving interest rate environment and positive investor sentiment towards SA assets and prospects for local growth. Our increased exposure over the period benefitted performance, and we have thus reduced our overall exposure towards the end of the quarter.

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



The FX component of the portfolio, where we remain underweight, proved to be a drag on returns as the US dollar weakened against a basket of its major trading partners.

Outlook and strategy

Global: The US economy remains resilient based on available data, while Europe has lagged. We do expect the US economy to be weaker this year coming off the strong performance from 2023. The US labour market has cooled, but we continue to see robust job creation. With the inflation leg of the Fed's mandate now grinding to a halt, we believe that going forward, labour data will be the main determinant of the timing and quantum of further policy normalisation. Elsewhere, Europe and China continue to grapple with lukewarm cyclical data and structural issues. Although inflation is contained in China, a miss in Q2 GDP print and an uneven recovery so far dims the outlook for commodity exporting countries and EMs more broadly. The end of the quarter witnessed a revival when Beijing announced a coordinated stimulus plan. While capital market sentiment has risen strongly, concerns over the trajectory of the economy remain. The call for increased fiscal spending and the implementation of rate cuts raised market expectations for additional stimulus, particularly on the fiscal front. The focus on stimulating domestic consumption renewed optimism for long-awaited measures aimed at stimulating demand. We continue to monitor escalating geopolitical tensions, especially in the Middle East, as any escalation here is likely to have an inflationary impulse through higher oil prices, while attention also shifts to the tail risks of the upcoming US election and its implications for capital markets.

South Africa: SA growth is showing signs of improvement due to some positive developments, including increased electricity supply, easing of the logistics crisis at the ports, which should improve productive capacity and exports, moderating inflation and lower interest rates, which should alleviate some of the pressure on the consumer, while the two-pot system withdrawals are also expected to have a short-term boost to households. We have already seen GDP (+0.4% in Q2 2024 from a revised flat print in Q1 2024) improve on the back of no loadshedding for a full quarter. Manufacturing was a notable rebound in Q2, as was construction, while agriculture pulled back. Eskom's Generation Operational Recovery Plan has seen a marked improvement in reducing unplanned outages, while carrying out more planned maintenance. The energy availability factor has trended consistently above 60%, and at the time of writing, the country has enjoyed six months without any loadshedding. With this trend expected to continue, we are more optimistic on the growth prospects for 2H2024. The South African Reserve Bank (SARB) assesses the risk to inflation to be balanced, whereas previously, they were on the upside. The rand continues to benefit from disinflationary trends abroad and locally, supported by strong gold prices, also finding support from the formation of the Government of National Unity (GNU), which has seen a more optimistic outlook begin to take shape on South African assets. Our terms of trade have thus improved, as have interest rate differentials following the Fed and SARB cuts. While we see further policy normalisation to come from the SARB, we expect a shallow cutting cycle going forward.

Positioning

From a positioning perspective, we believe South African government bonds (SAGBs) are fairly priced at current levels and remain attractive relative to other asset classes in the fixed income universe. We have taken profits on strong performance but maintain an overweight duration position, while continuing to reduce our underweight in the ultra-long area of the curve, where valuations have improved. We have also added positions to the front end of the curve, which should benefit from an easing bias from the SARB. We have maintained that performance will return as the benefit of income is realised and volatility subsides, and we have been steadfast in emphasising the importance of maximising yield and protecting capital. We have protective strategies in the portfolios, such as FX options, to mitigate potential risks associated with market fluctuations and political events.

We remain underweight ILBs, preferring nominals instead, as the disinflationary trend continues.



Our increased exposure to listed property in recent months has done well for the portfolios as the risk premium came off following the elections alongside an improving interest rate environment. We have cut back on some of the exposure to the sector and taken some profits on strong performance. We remain cautiously optimistic in our outlook for the sector.

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 FX, we remain underweight as we expect the US dollar to weaken as the Fed embarks on its cutting cycle. We also expect a more stable rand in the foreseeable future as the lower oil price helps our terms of trade.