Discovery Diversified Income

31 December 2024

Market background

The Fast View

- The Fed cut rates by 25 basis points as expected
- Risk assets struggled as the Fed signalled fewer rate cuts in 2025
- Trump's inauguration and speech to indicate the direction of the markets in the new year
- Global headwinds continued to test the resilience of emerging market assets
- Inflation is under control in SA; further rate cuts are anticipated

Performance review

For the quarter, the portfolio performed broadly in line with the benchmark.

Yields in developed markets firmed as the US Federal Reserve (Fed) signalled a slower pace of rate cuts in 2025. The US 10-year Treasury yield fluctuated during the quarter but ultimately rose by 79 basis points (bps) to close at 4.57%. This comes after the initial reaction to Donald Trump's US election victory reflected concerns over elevated fiscal risks and higher inflation expectations.

As expected, the Fed lowered interest rates by 25 bps in December. Bond yields rose following a slight uptick in inflation, which rose to 2.7% year-on-year (y/y) in November, up from 2.6% in October. Fed Chair Jerome Powell indicated a more moderate pace for future rate cuts, resulting in a scaling back of market expectations around the speed of monetary policy easing in 2025. Treasury yields subsequently fell back following Trump's market-friendly Treasury Secretary nomination but soon resumed their rise on signs of sticky inflation and hawkish forecasts from the Fed – with the Fed's 'dot plots' pointing to just two rate cuts in 2025, down from four in its previous meeting.
The US dollar continued to appreciate against major currencies following Trump’s re-election, as reflecting market expectations that while inflationary policies might emerge during Trump's presidency, they are unlikely to significantly weaken the dollar.

South African Bonds (SAGBs) experienced fluctuations in the final months of the year, largely on the back of global headwinds. The JSE All Bond Index delivered a lackluster 0.43 % return over the final quarter. December was not a good month for risk assets, and the performance of most of the asset classes in the portfolio was muted. As such, we ended the quarter by protecting capital and earlier gains. We reduced some of our bond holdings into yearend, which helped mitigate losses, and exited our US Treasury positions before they retraced their outperformance.
Although inflation-linked bonds (ILB) ended the quarter positively, we remain underweight, as local inflation is anchored below the South African Reserve Bank's (SARB's) midpoint target.

Despite a strong year overall, SA-listed property ended the quarter slightly weaker as yield-oriented assets came under pressure. Our limited exposure to the asset class helped soften the losses.

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

The foreign exchange (FX) component of the portfolio added value as the US dollar firmed against a basket of its G10 peers.

Outlook and strategy

Global: Markets are expected to be nervous ahead of Donald Trump's inauguration as the 47th US president on 20 January. His first 100 days will clarify legislative priorities. Tariffs remain a key concern, potentially affecting growth and inflation, especially in Europe and China. However, global growth could improve if China implements fiscal stimulus or Germany adopts a relaxed fiscal policy post-election. China has introduced a stimulus plan to boost domestic consumption and stabilise growth. The Fed is likely to focus on inflation and continue normalising policy through 2025. Given the previous experience with tariffs back in 2019, we believe the Fed will focus on inflation and continue to normalise policy through 2025.

South Africa: Inflation rose slightly to 2.9% y/y in November, still below the SARB's 3-6% target range, suggesting a possible rate cut in January. Inflation is expected to stay in the low to mid 3% range, with a slight increase in the second half of 2025. The SARB is likely to cut rates cautiously. Q3 GDP contracted due to agricultural sector weakness, but business confidence and retail sales have improved. The Government of National Unity faces challenges in improving economic prospects, with political and economic stability crucial for recovery and growth.

Positioning

Global headwinds were among the main drivers behind fixed-income assets underperforming. However, we remain constructive on South African Government Bonds (SAGBs) in the medium term, which remain attractive on valuation grounds and relative to other asset classes in the fixed income universe. The Fund's strategy over the quarter was to protect capital during a volatile final few months. We have added back some duration into weakness and maintain our options strategy to protect capital in the portfolio.

We remain underweight Inflation-linked bonds (ILBs), as the asset class remains less favourable relative to other asset classes amid a low inflation profile. We expect inflation to continue to remain contained over the medium term.

We have reduced our exposure to local listed property. Over the medium term, we maintain a positive outlook on the sector but remain selective in our allocation and will continue to tactically seize opportunities in high-quality names where we see fair value.

Investment-grade credit remains a neutral allocation in our portfolios, as we prefer sovereign debt instead. Spreads have tightened in recent years due to increased demand and a slowdown in issuance. Our bottom-up views remain consistent, with a preference for assets with defensive credit qualities.

In portfolios permitting FX exposure, we believe it is prudent to retain a small allocation to a basket of offshore currencies. We have increased the exposure to the US dollar amid a fluid global environment and rand volatility.