Discovery Flexible Property

Market background

August was dominated by raging battle between global central banks and exorbitant inflation with markets caught in the crossfire. While central banks appear to be doubling down on their aggressive monetary policy, inflation continues to reach new highs.

Global markets took a pummelling in August (post a strong rally in July) as the US Federal Reserve (Fed) Chair was unequivocal in his hawkish tone towards fighting inflation with aggressive monetary policy. Developed markets (MSCI World Index) fell -4.1%, while emerging markets (MSCI Emerging Markets Index) were surprisingly resilient closing 0.5% higher. The S&P in the US fell -4.2%, followed closely by the European Stoxx 600 Index, closing -2.9% on back of impending interest rate hikes. In fixed income, post the Fed's speech at the Jackson Hole Symposium, the global bond market fell back into bear market territory, now c.20% off its peak. US treasuries fell -2.5% with the US benchmark 10-year yield closing the month at 3.2%. The Bloomberg Barclays Global Aggregate Bond Index ended the month down by a staggering -3.9%.

The US first quarter GDP numbers showed the economy contracting 0.6% quarter on quarter (q/q), putting the world's largest economy into technical recession. While rising interest rates and record high inflation continue to weigh on spending, the labour market strength continues unabated, adding 525,000 jobs in July far ahead of the consensus forecast of 250,000. Consumer prices (CPI) finally appeared to ease in July and while still high at 8.5% y/y, it was lower than the 9.1% reported a month earlier. With inflation remaining high and labour markets tight, Jerome Powell reiterated the Fed' stance on keeping monetary policy tighter "for some time" in order to bring inflation back under control. Challenged facing the Europeans Central Bank's (ECB) fight against inflation continue to mount with risk of fragmentation is the region continuing to grow.

In China, the world's second largest economy saw manufacturing activity contract in August, with the official manufacturing PMI registering 49.2 in August, above expectations but remaining in contractionary territory. Retail sales, industrial output and investment were all weaker in July and below economist expectations. The government has offered support through numerous channels in the past few months, including a 1 trillion yuan stimulus package aimed largely at infrastructure spending, adding liquidity to the troubled property market, and lowering costs for firms and house purchases.

After one of the worst spates of loadshedding earlier in Q3, there has been improved sentiment on South African factory floors in August. The manufacturing PMI rose to 52.1 in August, from 47.6 in July, rising into expansionary territory for the first time since March. Headline inflation overshot market expectations of 7.7%, rising to 7.8% y/y in July, from 7.4% y/y in June. StatsSA confirmed that price increases for food, fuel, and electricity, continued to be the main source of the upward pressure in the July print. In a briefing to parliament's finance committee, Governor Lesetja Kganyago warned that upward pressure on wages (above the 3-6% target range) without productivity gains could lead to a wage-price spiral, necessitating calls for even tighter monetary policy. The SARB is expected to continue its hiking cycle into the next year, in tandem with other central banks across the world.

Global equites sell-off impacted the local market with South African equites as measured by FTSE/JSE All Share index down -1.8% over the month. Resources lead the decline (-3.8%) followed by financials (-2.5%). In yield-oriented assets, a risk off environment lead to emerging market debt weakness, however the JSE All Bond Index managed to eke out a positive return for the month closing 0.3% higher. Listed property gave back some of the strong rebound seen only a month earlier and closed down -6% over the month. Cash, as measured by the STeFI Composite Index, returned a respectable 0.5% over the period. In currencies, the rand weathered a month of substantial volatility giving up ground to most major currencies excluding the pound sterling which was particularly soft over the period.

Performance review

For the month, the portfolio outperformed the benchmark.

Underweight positions held in both Fortress REIT A-share and Sirius Real Estate contributed to performance. While the former continues to battle against a complicated capital structure, the latter is impacted by the current turmoil taking place in the Eurozone and the impact that may have on interest rates and the property market.

An overweight position held in Tritax Bix Box and an underweight position in Fortress REIT B-share detracted from performance. Fortress B-share has traded inversely to the A-share although the current capital structure does not allow for either share to be valued with any level of certainty, hence we remain underweight until which point better clarity on the capital structure outcome is provided.

Portfolio activity

We have taken the opportunity to increase our exposure to the local names who offer a combination of a highly attractive and sustainable yield coupled with a moderate growth outlook and improving balance sheet. This includes the likes of Redefine Properties and SA Corporate, both offering earnings yields in excess of 12%

The fund also reduced its underweight in Growthpoint Properties as the current share price weakness provides a more attractive entry point into a stable income producing fund and the sole exposure to Australian economy which is expected to be particularly resilient in the current market slowdown.

Outlook and strategy

After a strong 2021, in 2022, the listed property sector has been impacted by sentiment surrounding around rising interest rates. However, the sector's operations have shown significant recovery since their COVID-induced lows, particularly in retail and industrial, while office continues to suffer from an oversupplied market. Retail vacancies are squeezing lower, and with no new retail space supply, the tide is turning in favour of landlords. The operational finance cost impact of rising interest rates is also expected to be relatively muted, as the majority of debt in the sector is hedged at historically high levels. Thus, earnings will continue to be driven by property fundamentals.

In our view, the challenging fundamentals continue to be offset by supportive valuations. The sector trades on a forward yield of c.11% (c.12% for SA only) and a c.25% discount to net asset value (NAV). While dividend yields have been reduced due to pay-out ratios in favour of liquidity and balance sheet support, they are now also likely to be more sustainable and in line with international best practice. In 2022, companies have shown a return to consistent dividend payments, which is more sustainable as companies' cash flows and balance sheets are largely restored.

We believe the sector offers attractive value over a medium- to long-term time horizon, primarily underpinned by a relatively high sustainable cash-covered yield, together with a supportive valuation that reflects near term operational and balance sheet concerns. Over the medium term, we remain constructive with distribution growth off a sustainable income base, as the economy recovers.

In the current environment, we continue to assess the portfolio risks and actively screen for opportunities that market dynamics such as these are likely to offer. Ultimately, we aim to provide our clients' portfolios with the best risk-adjusted medium- and long-term outcomes.