Discovery

Discovery Flexible Property

Market background

The fourth quarter (Q4) of 2022 started on a solid footing before tailing off into December, as the risk of a global recession began to grip the market.

Although December's risk-off sentiment curtailed October and November's gains, net positive returns for the fourth quarter were welcomed by investors. For Q4, developed markets (MSCI All Country World Index) returned +9.4%, marginally outperforming the +9.2% generated by emerging markets (MSCI Emerging Markets Index) over the same period. In the US, the S&P 500 Index returned +7.1% in Q4, despite losing -5.9% in December, while in Europe the STOXX 600 Index continued its forward momentum with a robust +14.2% for the quarter. In fixed income, US Treasuries ended the quarter largely flat, after yields rose in December on the likelihood of further interest rate hikes and slower economic growth leading into 2023. Policymakers now forecast the terminal rate to be around 5.10% next year. European sovereigns also lost ground, with the 10-year bond yield (AAA-rated composite) climbing to 2.55% at the end of December, compounded by news that the European Central Bank would begin reducing its €5 trillion bond holdings as of March 2023.

The US Federal Reserve (Fed) closed off the calendar year by raising the fed funds rate by 50bps to 4.25% – 4.5%, largely in line with market expectations and pushing interest rates to their highest levels since 2007. Monetary policymakers signalled that further interest rate hikes would be appropriate as the Fed continues its battle to bring inflation back to within its 2% target. Meanwhile, inflation continued to show signs of cooling despite remaining elevated, slowing to 7.7% in October and 7.1% in November. The Fed's preferred measure of inflation (core PCE Index) also eased to a four-month low of 4.7% in November from 5% in October.

Across the pond, the Bank of England (BoE) raised its key interest rate by 50bps to 3.5% in December, just one month after making its single largest hike in 33 years (75bps). The Monetary Policy Committee continued its hawkish narrative, stating that it will continue to tighten monetary policy as necessary if inflationary pressures persist. Euro Area GDP growth for Q3 was confirmed at an annualised 0.3% q/q, marginally higher than preliminary estimates of a 0.2% expansion. Of the region's largest economies,

Italy and Germany grew by an annualised 0.5% and 0.4% q/q respectively, while France and Spain grew by 0.2% q/q. Forecasts from the European Central Bank (ECB) suggest a possible contraction in the Euro Area economy over the next few quarters, largely on the back of the growing energy crises, higher interest rates and rising consumer costs.

In China, the economy expanded by an annualised 3.9% q/q in Q3, marginally above market forecasts of a 3.5% increase and significantly beating the 2.7% contraction recorded in the previous quarter. Economic activity over the period was buoyed by a series of pro-growth policies and stimulus measures put forward by the government to help revive economic activity, including the partial relaxation of its COVID policies and the further reopening of its economy. Since the easing of China's COVID restrictions, the country has experienced a sharp rise in new infections, placing significant downward pressure on investor sentiment and short-term economic growth prospects.

The South African Reserve Bank (SARB) raised its repo rate by 75bps to 7% in November, marking the seventh consecutive rate hike since November 2021. The SARB's decision was widely expected and broadly in line with international economies, as local policymakers continued the battle to bring inflation back to within the SARB's 3-6% target range. South Africa's 10-year government bond yield rose to around 10.9% after an advisory panel reported that there could be grounds to impeach President Cyril Ramaphosa after he failed to report the theft of millions of US dollars from his Phala Phala game farm. The perceived risk of Ramaphosa's political future soon dissipated, however, following his re-election as the leader of the ruling African National Congress, which saw the 10-year government bond yield return to a slightly more palatable 10.1%.

Global equities rallied into the last quarter of 2022, pulling the local market higher with South African equities as measured by FTSE/JSE All Share index up 15.2% over the quarter. Resources lead the rally (16.1%) followed by industrials (15.7%) and financials (12.9%). In yield-oriented assets, South African government bonds were the standout performer across emerging market debt, capping off the quarter with the JSE All Bond Index up 5.7%. Listed property (JSE ALPI) recovered from a tougher Q3 ending the fourth quarter significantly higher (18.2%). Cash, as measured by the STeFI Composite Index, returned a respectable 1.6% over the period. In currencies, the rand was a mixed bag, ending higher against the US dollar, flat against the pound sterling and lower against the euro.

Performance review

The Fund outperformed the benchmark over the quarter.

The Fund's overweight position in Hammerson PLC contributed significantly to relative performance over the quarter. The company released indicative trading numbers that suggested a strong and sustained recovery in the portfolio. Updated earnings numbers also tracked largely well ahead of market expectations.

Detracting from relative performance over the quarter were overweight positions in Prologis and American Towers, as a fairly hawkish Fed continued to subdue listed real estate returns, which was further compounded by a weaker dollar relative to the rand.

Portfolio activity

Over the quarter we increased the Fund's exposure to local names that offer a combination of highly attractive and sustainable yields, coupled with moderate growth outlooks and improving balance sheets. This included the likes of Redefine Properties and SA Corporate, both of whom are offering earnings yields in excess of 12%.

We also further reduced the Fund's position in Equites Property Fund as the company continues to face headwinds from rising interest rates in the UK, which is likely to negatively impact its UK property valuations.

Outlook and strategy

The sharp increase in interest rates over 2022 appears to have driven a steep derating of the listed property sector, both locally and abroad. However, the sector has shown a significant recovery of earnings from its COVID lows. Sector fundamentals continue to improve and support earnings into the future, particularly in the retail and industrial sectors. The operational finance cost impact of rising interest rates is also expected to be relatively muted, as most real estate companies did not benefit from lower interest rates over the last two years as the majority of their debt was hedged at historically high levels. Hence, the combination of yield and growth has helped stave off the impact of the large derating the sector experienced in 2022.

In our view, the improving fundamentals are further supported by relatively attractive valuations. The sector trades on a forward yield of c.11% (c.12% for SA only) and a c.30% 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 likely to be more sustainable and in line with international best practice. In 2022, companies showed a return to consistent dividend payments that are more sustainable as their cashflows and balance sheets are largely restored.

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

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