Discovery

Discovery Flexible Property

Market background

Markets got off to a strong start in January, as declining inflationary pressures across key economies drove speculation that central banks might be approaching the end of their rate hiking cycles. In the US, consumer inflation recorded its largest monthly decline since the beginning of the pandemic. Investor sentiment improved on the back of stronger-than-expected corporate earnings and the prospect that the Federal Reserve (Fed) could begin slowing the pace of interest rate hikes as early as February . While in Europe, falling energy prices and downside inflation boosted sentiment. The reopening of China's economy further supported risk appetite, as did signals from Chinese policymakers that they would put in place measures to help boost economic growth. In South Africa, equity markets tracked their global peers higher, buoyed by a less hawkish reserve bank.

South African equities closed the month in positive territory, with the FTSE/JSE All Share Index and Capped SWIX gaining +8.9% and +7.0 respectively, buoyed by the prospect of a less-hawkish Fed and renewed optimism over the reopening of China's borders. Other news lifting investor sentiment came in the form of a smaller-than-expected rate hike from the South African Reserve Bank (SARB). The central bank raised the benchmark repo rate by 25bps to 7.25%, below market forecasts of a 50bp increase. In its monetary policy statement, the SARB painted a sobering picture of the country's economy, highlighting rolling blackouts and other logistical constraints as key risks to economic growth. The SARB's latest GDP forecast now sees the economy expanding by just 0.3% (vs 1.1%) in 2023 and 0.7% (vs 1.4%) in 2024. While in more positive news, the reserve bank expects headline inflation to continue its trajectory towards the midpoint of its 3-6% target band over the next two years. Meanwhile, annual inflation continued to show signs of slowing after easing to 7.2% y/y in December from 7.4% in November. South Africa's retail trade surprised on the upside, rising 0.4% y/y in November following two straight months of declines, beating market forecasts of a 0.2% fall.

Discovery Life Investment Services Pty (Ltd): Registration number 2007/005969/07, branded as Discovery Invest, is an authorised financial services provider.

Performance review

The portfolio outperformed the benchmark for the month.

The largest contributors to relative performance came from the portfolio's unique exposure to off-benchmark international counters. Long-held overweights in Tritax Big Box REIT and Vonovia both added value, supported by positive economic data coming out of the US, UK and Europe. Easing inflation across key economies benefitted the portfolio's offshore component, as did the prospect of a slowdown in interest rate hikes. In terms of on-benchmark international counters, the portfolio's overweight positions in UK retail players, Hammerson and Capital & Counties, along with Eastern European-focused NEPI Rockcastle, also contributed meaningfully to relative returns.

Portfolio activity

Over the month, we increased the portfolio's exposure to local names that offer a combination of highly attractive yields and valuations, such as Redefine Properties. We also took the opportunity to upweight the portfolio's exposure to most of its off-benchmark international positions, as macroeconomic indicators showed constructive signs.

Outlook and strategy

The sharp increase in interest rates over 2022 resulted in a steep derating of the listed property sector, both locally and abroad. These negative impacts, however, were offset by a significant recovery of earnings from its COVID lows. We remain constructive on the listed real estate outlook for the year ahead, as the stablistaion in the rates outlook, along with improving sector fundamentals, will support future earnings, particularly in the retail and industrial sectors.

In our view, the improving fundamentals are further supported by relatively attractive valuations. The sector trades on a forward yield of c.10% (c.11% 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 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 cash flows 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 portfolio's 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.