Discovery Flexible Property

Market background

After a highly volatile end to the first quarter of 2023, April proved to be a reasonably calmer month by comparison.

Returns across global financial markets were fairly benign but broadly positive for the month, as the prospect of a slowdown in global economic growth and stubbornly high inflation weighed on investor confidence. For April, global equities as measured by the MSCI All Country World Index returned +1.4%. Developed markets outperformed emerging markets, with the MSCI World Index returning +1.8%, while the MSCI Emerging Markets Index ended the month down by 1.1%. In fixed income, global bonds as measured by the Bloomberg Barclays Aggregate Bond Index delivered positive returns at +0.4% for the month, largely on the back of positive gains across credit markets.

Concerns that the US may be heading towards a recession escalated after first-quarter (Q1) estimates showed that the US economy had grown by a mere +1.1% quarter on quarter (q/q), below market expectations of +2%. The result pointed to a third successive quarter of slower growth, with declines in business investment, inventories, and the housing market among the key detractors. On the inflation front, annual inflation (CPI) slowed for a ninth consecutive month to 5% year on year (y/y) in March. However, the Core Personal Consumption Expenditure (PCE) Price Index – the US Federal Reserve's (Fed's) preferred gauge to measure inflation – rose by 4.6% over the same period.

In the UK, economic data during the month was mixed. Retail sales fell below expectations to 0.9% in March and manufacturing PMI contracted to 47.8 in April – pointing to a second consecutive month of downturn. Meanwhile, consumer prices accelerated above market expectations to 10.1% y/y in March, but core inflation remained unchanged at 6.2%. Turning to the Euro Area, GDP growth expanded by an annualised 0.1% q/q in Q1. Of the region's largest economies, Germany recorded no growth, while France, Italy, and Spain recorded positive growth over the quarter. Consumer inflation in the region increased to 7.0% y/y in April, while inflation remains at elevated levels and above the European Central Bank's target range, suggesting that policymakers will continue their rate-hiking cycle over the near-to-medium term.

In Asia, China's GDP growth accelerated for the third consecutive quarter, advancing by an annualised 2.2% q/q in Q1, ahead of consensus forecasts. Inflation data also came as a positive surprise, printing at 0.7% for March – below market forecasts of 1.0%. The economy continues to show encouraging signs of recovery after the government lifted its zero-COVID policy and policymakers began easing their stance on tech firms and property companies. In South Africa, high levels of nationwide loadshedding continued to weigh on economic activity, with companies in various sectors citing continued power outages as a leading cause behind weaker results. Retail trade fell in February (-0.5%), while mining production contracted for the 13th consecutive month (-5%). Meanwhile, South Africa recorded a trade surplus of R6.9 billion in March, supported by a surge in imports (+31.7%) and exports (+26.9%), with both reaching all-time highs.

South African equities closed the month broadly firmer, in line with global markets. In April, both the FTSE/JSE All Share Index and Capped SWIX gained 3.4%. Resources advanced 4.0%, led by gains in precious metals and mining sectors (+14.6%). Industrials added 3.1%, supported by stronger tobacco (+7.2%) and personal goods (+6.4%) sectors. Financials closed 3.4% higher, with real estate investment and services (+8.8%) the standout performer. The FTSE/JSE All Property Index gained 5.8% for the month, while the JSE All Bond Index fell by 1.1%. Cash, as measured by the STeFI Composite Index, delivered +0.6%. In currencies, the rand closed the month weaker against the US dollar, euro and pound sterling.

Performance review

For the month, the portfolio outperformed the benchmark.

The overweight position in Industrials REIT was among the largest contributors to relative performance in April. This was driven by corporate action after private equity firm Blackstone made an offer for all the stock in the business at a +40% premium on the prevailing market price. Industrials REIT operates in a niche segment of the highly popular industrial sector. Meanwhile, among the largest detractors from relative performance was the portfolio's underweight position in Fortress Real Estate Investments (Previously Fortress A). The stock's current capital structure continues to hamper shareholder returns and dividends, with the current level of uncertainty regarding potential outcomes keeping us on the sidelines.

Portfolio activity

We have increased our exposure to local names offering a combination of highly attractive and sustainable yields, coupled with moderate growth outlooks and improving balance sheets. This includes the likes of Investec Properties and SA Corporate Real Estate, both offering earnings yields in excess of 13% and favourable medium-term growth prospects. We reduced the portfolio's exposure to Industrials REIT into the abovementioned corporate action, rotating the capital to highly attractively valued mid-cap stocks with SA exposure.

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. Sector fundamentals continue to improve and support earnings into the future, particularly in the retail and industrial sectors. The impact of rising interest rates on operational costs is also expected to be manageable, as most real estate companies did not benefit from lower interest rates over the last two years with the majority of their debt being hedged at historically high levels. Hence the combination of yield and growth has helped stave off the impact of the large derating that the sector experienced in 2022. While increased loadshedding has added another curve ball, the listed real estate sector has been ahead of the curve, as most companies have the majority of their portfolios covered by backup power or renewable energy.

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 also likely to be more sustainable and in line with international best practice. In 2022, companies showed a return to consistent dividend payments which were more sustainable as their 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 more 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 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 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 outcomes.