Discovery

Discovery Flexible Property

Market background

Markets continued to trend higher in August buoyed by strong company earnings, expanding vaccinations and continued government support, despite sustained angst around the surge in Delta-variant cases.

Growth stocks again emerged as the winner over the month as lower US Treasury yields provided support. Developed market stocks (MSCI World Index) closed 2.5% higher, only marginally behind emerging market peers (MSCI Emerging markets Index +2.6%). Regionally, the S&P benchmark gained a further 3% over the month, as tech and growth names drove the market higher. Bond markets (as measured by Barclays Bloomberg Global Aggregate Bond Index) ended the month 0.4% lower, amid very little activity during the month. All returns are quoted in US dollars.

In the US, economic data was largely underwhelming as the rapid spread of the Delta variant impacted consumer spending and economic growth. Although still in positive territory, the manufacturing purchasing managers' index (PMI) came in at 61.1, down from 63.4 a month earlier. The services PMI (August, 55.2) fell for the third consecutive month, impacted by the increase in COVID cases and labour shortages.

Across the Atlantic, Europe surpassed the US in terms of vaccination rates over the month. In similar fashion, PMIs slowed in August (61.4) although remained well within expansion territory, while high-frequency data continued to show strong activity within the region. In the UK, the last of the COVID restrictions were lifted and hence the region's economic recovery is likely past its peak. While inflation data tapered off to 2% year on year (y/y) in August, the Bank of England maintained their plans to rein in stimulus measures to counter anticipated inflationary pressures.

China saw a material slowdown in August, also impacted by the rampant spread of the Delta variant. Authorities were quick to respond with various lockdown measures, however official PMIs showed the first contraction in services since February 2020. Although the near-term growth outlook is likely to be weaker over the next six months, The People's Bank of China (PBoC) has pledged additional support for small businesses and better utilisation of government bonds.

After the riot impact seen in July, South African indicators rebounded strongly in August. The manufacturing PMI reached record levels of 57.9, as sectors including hospitality and alcohol saw a significant rebound. However, labour markets were less resilient as unemployment data rose from 32.6% in Q1 2021 to 34.4% in Q2 2021. Inflation data eased in line with expectations, increasing by 4.6% y/y in August. This should bode well for the upcoming South African Reserve Bank's monetary policy meeting on 23 September, where expectations are for an extension of the current accommodative policy.

South African equites ended August in negative territory, largely impacted by the regulatory impact on index heavyweights, Naspers and Prosus. The FSTE/JSE All Share ended the month 1.7% lower, while the Capped SWIX finished 2% higher (benefitting from the capping of Naspers and Prosus), respectively. At the super-sector level, resources declined -4.8%, followed closely by industrials (-4.5%). Financials fared much better posting gains of 11.9% for the month. Local bonds managed to outperform their equity peers on the back of a dovish US Federal Reserve (Fed) and strong domestic support for the asset class. The JSE All Property Index pared back their riot-induced losses of the prior month, to close 7.1% higher. Cash, as measured by the STeFI Composite Index, remained broadly stable at 0.3% for the month. In currencies, the rand firmed against the US dollar, euro and pound Sterling over the period.

Performance review

For the month, the portfolio slightly underperformed the benchmark.

The month saw a strong recovery of the local currency, which offset decent performance in the offshore selection of stocks including Prologis, Vonovia and Digital Realty. These counters continue to be driven by strong fundamentals and structural tailwinds; thus, the medium-term outlook remains constructive.

Underweight positions in Fortress B and Liberty Two Degrees contributed to performance. The former continues to have a complicated capital structure that hinders the share class in the current environment, while the latter's assets are most exposed to the negative dynamics currently being experienced within the retail environment.

Portfolio activity

We continuously look to seek out counters offering the right combination of reasonable value, sustainable earnings, and growth. During the month, we added to our preferred and underappreciated mid-cap section of the sector, increasing exposure to the likes of Investec Property Fund.

We continue to support a selective group of large and mid-cap South Africa-focused companies with attractive combinations of yield and sustainable growth, supported by solid fundamentals and track records. These include Redefine and Attacq.

Outlook and strategy

The listed property has begun to stage a recovery in 2021. The pandemic has created an unprecedented environment, particularly for real estate markets where buildings were under enforced shutdowns. However, data is beginning to emerge that the outcome post COVID is not as bad as initially expected, although there will be a lasting impact on the economy and therefore the sector. A level of normalcy has returned to rental collections, while certain tenant categories, specifically restaurants and entertainment remain under pressure. As the lasting economic impacts of the forced shutdown takes hold, demand will be subdued across most occupational markets and will result in muted rental growth prospects. Thus far vacancies have been well-contained but at the cost of rental declines and higher levels of concessions. These concessions continue to slow and are expected to be largely insignificant over the next 12 months.

In our view, the challenging fundamentals are offset by supportive valuations. The sector trades on a forward yield of c.9% (10.0% for SA only) and a c.30% discount to net asset value (NAV). While dividend yields are likely to be lower due to reduced 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. On a sustainable earnings basis, like-for-like rental growth is forecast to be below inflation for the next two-to-three years, while deleveraging will further dampen growth prospects.

We believe the sector offers attractive value over a medium- to long-term time horizon, primarily underpinned by a more sustainable yield, together with the prospect of the sector re-rating as dividends become more regular and balance sheet structures are corrected. While near-term volatility is likely to persist given current macroeconomic conditions, 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’ portfolios with the best risk-adjusted medium- and long-term outcomes.

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