Discovery

Discovery Flexible Property

Market background

January saw volatility ratchet higher owing to a confluence of slowing earnings; rising inflation and hawkish pivots by major central banks to counter it; and intensifying geopolitical concerns as tensions between Russia and the West over Ukraine continued to escalate.

Global equities posted their weakest monthly performance since the March 2020 nadir, as investors grew wary of rising US interest rates and the sustainability of rich valuations in certain pockets of the market. There was sharp divergence over the month, with growth-oriented sectors coming under pressure from looming liquidity withdrawals and rising interest rates, while higher oil prices and rising government bond yields were a boon for the value segment, with the financials and energy sectors outperforming. Developed market (DM) stocks (MSCI World Index) closed the month down 5.3%, while emerging markets (MSCI Emerging Markets Index) did relatively better, limiting losses to -1.9%. Regionally, we saw US indices post heavy losses, with the S&P 500 down 5.2% for the month, while the tech-heavy NASDAQ suffered even bigger losses, with a -9% return. The Euro Stoxx 600 also lost considerable ground, down 5.2% for the month as investors reassessed their positions amid a higher interest rate outlook and heightened geopolitical tensions in the region. Elsewhere, Asian markets were not spared from the sell-off, with Japan's Topix losing 4.9%, as expectations of rising US interest rates and an Omicron-led spike in COVID infections soured risk sentiment. China's blue-chip CSI 300 Index also ended in the red as the US Federal Reserve's (Fed') hawkish policy tone prompted selling by foreign investors.

In fixed income markets, government bond yields climbed with investor attention zeroing in on inflation and quantitative tightening. The yield on US 10-year Treasuries rose to 1.78% at month end, while Europe's benchmark German 10-year bund yield moved into positive territory for the first time since May 2019, ending the month at 0.01%. The Bloomberg Barclays Global Aggregate Bond Index returned -1.8% for the month, outperforming equities, but proving less effective as a safeguard against inflationary risk, while corporate bonds also underperformed government bonds given a widening of spreads as investors' appetite for risk weakened.

The Bloomberg Commodities Index rose 8.8% over January. Oil had a very strong run (Brent Crude and West Texas Intermediate up 17.3% and 17.2% m-o-m, respectively), while returns were more mixed in industrial metals, with nickel and aluminium showing strength, while copper ended in negative territory.

All returns are quoted in US dollars.

South African equities bucked the trend in global markets, with the benchmark FTSE/JSE All Share Index (ALSI) gaining a modest 0.9% over the month, while the Capped SWIX delivered even stronger gains, up

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2.4% over the same period. At a super-sector level, resources (+3.6%) and financials (+2.5%) helped prop up the bourse, while industrials snapped their winning streak, down 1.9% for the month. In yield-oriented assets, the JSE All Bond Index (+0.9%) ended the month higher, with the yield curve steepening over the month and non-residents becoming net buyers of local currency debt. The listed property sector (JSE All Property Index) slid back into negative terrain after a strong 2021, losing 2.9% over the month. Cash, as measured by the STeFI Composite Index, returned 0.34%. In currencies, the rand was the best-performing emerging market currency in January, strengthening by around 4% against the US dollar.

Sentiment on South African factory floors got off to a cheerful start in January, with the monthly manufacturing PMI coming in at 57.1, following moderation at the onset of the Omicron-induced fourth wave of infections in recent months. Consumer prices (CPI) accelerated further to 5.9% y/y in December, from 5.5% in November and above economist expectations of 5.7%. The December print was the biggest rise in inflation since March 2017, stemming largely from food and non-alcoholic beverages and transport costs, amid record increases in the price of fuels. In efforts to stem the tide in rising prices, the South African Reserve Bank's (SARB) MPC delivered a 25bps rate hike at its January meeting. The central bank also revised lower its growth forecasts for 2021 to 4.8%, down from 5.2% in November.

Performance review

For the month, the Fund performed broadly in line with the benchmark.

Overweight exposure to more value-orientated stocks in conjunction with underweight positioning in counters typically considered as 'growth compounders' such as Sirius Real Estate and Equites Property Fund, contributed positively to performance. This is not dissimilar to global dynamics, as the 'value trade' reared its head at the onset of the year.

The Fund's exposure to off-benchmark global counters detracted from performance across the board. Negative relative performance was driven by local currency performance, with the rand's strength proving a headwind.

Portfolio activity

We continuously look to seek out counters offering strong combinations of sustainable earnings and growth at reasonable valuations. During the month we continued to add to names that offer more attractive medium- and long-term fundamental stories. These include Stor-Age Property Fund and Capital and Counties PLC. The former benefitting from structural trends within the self-storage space, coupled with an innovative management team, reasonable valuation, and conservative balance sheet. We also took the opportunity to increase exposure to Redefine Properties on the back of share price volatility, understanding that the yield on a sustainable basis is highly attractive by a significant margin relative to peers, while it continues to improve its balance sheet.

Outlook and strategy

The listed property sector has seen a strong recovery in 2021 following years of dismal returns. While the recovery has been substantial, it remains one of the few sectors still below its pre-COVID levels. The pandemic has created an unprecedented environment, particularly for real estate markets. However, a level of normalcy has returned to the sector, as all metrics continue to show improvement or least a bottoming in performance. Demand will likely continue to be subdued across most occupational markets (specifically office) and will result in muted rental growth prospects. Vacancies have been well-contained but at the cost of rental declines.

In our view, the challenging fundamentals are offset by supportive valuations. The sector trades on a forward yield of c.9% (c.10% 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. 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 cash-covered yield, together with a supportive valuation that reflects near term operational and balance sheet concerns.

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.