Discovery Flexible Property

Market background

Global equity markets tracked higher in the face of numerous headwinds, including soaring energy prices, rising inflation and weak US and economic data. While equity markets were buoyed by a strong start to the corporate earnings season, bond markets struggled to gain traction, weighed down by the risk of tapering and rising interest rates.

Developed market stocks (MSCI World Index) bolstered a strong recovery closing 5.6% higher in October after a hammering the previous month, while the emerging market (MSCI Emerging markets Index +0.6%) recovery was more subdued. Regionally, the US S&P 500 Index gained a further 6.9% over the month, as the tech-heavy NASDAQ managed an impressive 7.3% increase over the month. European equities recovered their September losses with the pan-European Stoxx 600 closing 4.6% up in October. On the Asian front, markets were more mixed as Japan's Topix closed 1.4% down.

The US grew at a slower pace than expected and could only muster an annualised GDP growth rate of 2% over the third quarter, shy of consensus expectations of 2.6%. Supply chain disruptions continued to hinder the recovery, with the manufacturing purchasing managers' index (PMI) coming in at 60.8 in October, down from 61.1 a month earlier. Headline inflation also surprised, but this time to the upside, printing at 5.4% in September.

In Europe, the region delivered strong growth in Q3, ahead of both the Chinese and US economies, although off a lower base. Higher vaccination rates through the summer appear to be supporting a stronger rebound, driven by domestic demand. Growth in the UK was more subdued in Q3, following a strong Q2, expanding only 0.4% in August. However, the labour markets remain strong with unemployment falling to 4.5%, thus putting upward pressure on wages. The Bank of England (BoE) has

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raised concerns around inflation pressure, driven by supply constraints and labour shortages, hence the market is keeping a keen eye on the Monetary Policy Meeting (MPC) in November.

China's recovery slowed down 4.9% year on year in Q3, a steep decline from the 7.9% in the previous quarter. Again, supply side constraints coupled with global chip shortages, regulatory crack downs and higher commodity prices all contributed to the slower growth delta. That said, the 6% annual growth target set by the Chinese government at the outset of 2021 remains within reach, on account of robust growth earlier in the year.

South Africa saw its manufacturing PMI weaken again in October, with a reading of 53.6, from 54.7 in September. The month also saw the return of rolling blackouts as Eskom's systems came under maintenance pressure, while inflation continued to trend higher at 5% year on year in September. The South African Reserve Bank (SARB) has warned about the inflationary pressure driven by fuel prices and currency depreciation and hence money markets have priced in a 25-basis point hike at the November policy setting meeting, a quarter earlier than previously expected.

South African equites followed their global counterparts, with the benchmark FTSE/JSE All Share Index up 5.2%, well ahead of the Capped Swix which closed 2.7% higher. Resources (+8.6%) led the market higher followed by industrials (+6.7%), while financials closed down 2.9%.

The JSE All Bond Index closed 0.5% lower as headwinds around inflation and more hawkish central banks continued to plague the asset class. The listed property (JSE All Property Index) sector pared back some of its year-to-date gains, closing down 1.4% for the month. Cash, as measured by the STeFI Composite Index, remained broadly stable at 0.3% for the month. In currencies, the rand's vulnerability to external pressure showed over the period as the currency depreciated against the US dollar, euro and pound sterling.

Performance review

For the month, the portfolio outperformed the benchmark.

The month was dominated by the offshore theme, owing largely to a weaker rand. Top contributors included our overweights in the likes of Prologis and Tritax Big Box. However, a strong improvement in balance sheet metrics by Hyprop Investments in the full year 2021 results ultimately made our overweight in the stock the top contributor for the month.

Underweight positions held in the locally listed, predominantly offshore names detracted from performance. This included Equites Property Fund and Irongate Property Fund, with the latter benefiting from a buyout offer from one of their large shareholder's, 360 Capital Group.

Portfolio activity

We took the opportunity to crystalise some of the profits on the strongest gainers over the past year, including Hyprop Investments and Emira Property Fund. While we remain constructive on the equity story, the stocks have rerated strongly off their lows and hence their level of overweight in the Fund has been reduced.

We also added to some of the names that offer more attractive medium- and long-term fundamental stories. These include Equities Property Fund and NEPI Rockcastle. The former benefitting from structural trends in the logistics sector, while that latter continues to hold attractive regional fundamentals in terms of growth and consumption.

Outlook and strategy

The listed property recovery is well underway in 2021. COVID has created an unprecedented environment, particularly for real estate markets where buildings were under government-enforced shutdowns. The latest results have showed a moderate recovery in fundamentals from their pandemic lows and while they remain under pressure, they appear close to bottoming. A level of normalcy has also returned to rental collections, which bodes well for cash flow generation across the sector. Demand will likely continue to be subdued across most occupational markets (specifically office) 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% (c.10% for SA only) and a c.25% 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 cash covered yield, together with the prospect of the sector re-rating as dividends become more regular and capital structures are corrected. Near-term volatility has also reduced and the sector trades below equities and above bonds in terms of volatility. 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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