Discovery Flexible Property

Market background

The second quarter (Q2) began on a positive note as risks facing the global banking sector began to dissipate. Investors then shifted their focus to global growth dynamics and signals of further rate hikes from key central banks.

Within global equity markets, the big focus on Artificial Intelligence (AI) and its productivity-boosting potential drove gains in tech sector stocks, helping the NASDAQ Index to end the quarter 13.1% higher. The broader improvement in risk appetite helped the S&P 500 Index to post an +8.7% total return for the quarter.

Concerns relating to US debt ceiling negotiations weighed on financial markets in May. President Joe Biden and House Speaker Kevin McCarthy eventually reached an agreement regarding the debt deal, which would see the debt limit suspended until 2025 and prevent the US from defaulting on its debt obligations. At the start of the second quarter, recession fears raised its head again after Q1 estimates showed that the US economy had grown by a mere +1.1% quarter on quarter (q/q), market expectations shifted as this figure was revised up to 2%. On the monetary policy front, after a 25 basis point (bp) hike in May, the Fed kept the Federal Funds rate at 5%-5.25% in June, suggesting a pause in the hiking cycle. However, Chair Powell later signalled that two further hikes could be needed this year.

In the UK, the economy grew by 0.1% q/q over Q1 2023, largely in line with market forecasts. A key development over the quarter was a stubbornly high annual inflation print, at a higher-than-expected 8.7% y/y in May. This led to a bigger-than-expected rate hike from the BoE in June (50bps) and pointed to rates having to remain higher for longer. In the Eurozone, early estimates pointing to +0.1% annual growth in GDP in Q1 2023 were subsequently revised down to -0.1%. Once again, inflation remained stubbornly elevated for policymakers. The ECB raised its key interest rates by 25bps in May with ECB President Christine Lagarde noting that the central bank still had more ground to cover and would not be pausing its rate-hiking cycle anytime soon.

At the start of Q2, China's re-opening from COVID continued to benefit the economy, with headline GDP printing better than expected for Q1, growing at an annualised 2.2%. Trade data was impressive, with exports up 14.8% versus a contraction of -7.1% expected. This meant the trade surplus was over double the figure expected. Meanwhile, in the property sector, the positive trend in home sale prices continued.

Momentum waned somewhat as the quarter progressed, economic activity data for April came in weaker than expected and this weighed on sentiment toward the country. With economic data continuing to disappoint, in June the PBoC announced some monetary policy easing measures. Although there is still no clear sign of the big monetary policy response that the market is looking for, the upcoming Politburo meeting is scheduled to take place post the next GDP print, which could drive a more aggressive response on the back of a disappointing print.

While load shedding weighed on the economic outlook, the economy managed to grow 0.4% in Q1 2023. Although important export sectors such as manufacturing and mining suffered from lower volumes during the quarter, towards the end of the period, general growth indicators surprised to the upside. The country's trade balance printed slightly better than forecasts, while imports and exports softened due to a slowdown in economic activity.

During the quarter, the rand reached a new record low against the US dollar on the back of accusations by the US that the South African government had loaded weapons onto a US-sanctioned vessel while docked in local waters also weighed on local asset prices. After the SARB hiked rates by more than expected in March, the central bank governor was more hawkish than expected in his April speech. Earlier in the quarter, inflation proved stickier than expected, largely due to elevated food inflation, further fuelling the central bank's hawkish tone. Reflecting concerns over inflation and rand weakness, the SARB increased rates by an additional 50bps in May. Positively, also in May, annual inflation printed lower than expected at 6.3%.

Local equities closed the quarter marginally firmer, with the FTSE/JSE All Share Index and Capped SWIX posting +0.7% and +1.2% respectively. Resources closed 6.1% lower, weighed down by a weaker precious metal. Industrials added 3.4%, while the standout performer was financials with +5.3%. The FTSE/JSE All Property Index gained +1.0% for the quarter, while the JSE All Bond Index fell by 1.5%. Cash, as measured by the STeFI Composite Index, delivered +1.9%. In currencies, the rand closed the quarter weaker against the US dollar, euro and pound sterling.

Performance review

The portfolio underperformed the benchmark over the quarter.

Detracting from performance over the period was the portfolio's underweight position in Fortress Real Estate Investments (Fortress A and Fortress B), which outperformed over the quarter. The stock's current capital structure continues to hamper shareholder returns and dividends, with the level of uncertainty regarding potential outcomes keeping us on the sidelines.

Among the largest contributors to relative performance over the quarter were underweight positions in Growthpoint Properties and Equites Property Fund, with the latter rebasing its earnings significantly on the back of unsustainable earnings practices, which resulted in the stock de-rating.

Portfolio activity

Over the quarter, we took the opportunity to increase our exposure to local names that offer a combination of a highly attractive and sustainable yield, coupled with a moderate growth outlook and an improving balance sheet. This includes the likes of Investec Properties and SA Corporate Real Estate, both of which offer earnings yields in excess of 13% as well as favourable medium-term growth prospects.
We reduced the portfolio's exposure to Industrials REIT, leading into the corporate action, rotating the capital to fund purchases in attractively valued mid-cap stocks with SA exposure.

Outlook and strategy

The sharp increase in interest rates over 2022 appears to have driven a steep derating of the listed property sector, both locally and abroad. However, the sector has shown a significant recovery of earnings off its COVID lows, with sector fundamentals continuing to improve and providing support to earnings into the future, particularly in the retail and industrial sectors. The operational finance cost impact of rising interest rates is also expected to be manageable, as most real estate companies did not benefit from lower interest rates over the past two years, with the majority of their debt having been hedged at historically high levels. Hence, the combination of yield and growth has helped stave off the impact of the large derating the sector experienced in 2022. While increased loadshedding has added another level of complexity, the listed real estate sector has been ahead of the curve, with most companies having the majority of their portfolios covered by backup power or renewal energy.

In our view, the improving fundamentals are further supported by relatively attractive valuations, although an improvement in local bond yields is required for enhanced returns. 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 cash flows and balance sheets are restored.

We believe the sector offers attractive value over the medium-to-long-term, primarily underpinned by a more sustainable cash-covered yield, 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 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.