

## *Discovery Flexible Property*

### Market background

The buoyant equity market momentum at the end of 2020 carried into the first three weeks of January as the Democrats won the Senate and fuelled hopes of increased fiscal stimulus. This optimism, however, petered out in the final week, as the market gave back all the gains in the wake of a spike in volatility. The VIX (CBOE Volatility Index) rose sharply as a group of retail traders inspired by Reddit posters drove up the share prices of the most heavily shorted stocks (such as GameStop and AMC Entertainment), causing some hedge funds to incur billions of dollars in losses as they had to liquidate their positions. In the end, emerging market (EM) stocks (MSCI Emerging Markets Index, +3.1%) significantly outperformed their developed market (MSCI Developed Markets Index, -1.0%) peers over the month, led by the Asia ex-Japan region, that benefited from strong inflows and good economic data out of China.

2020 saw the US economy record its first contraction since the Global Financial Crisis (GFC). Year on year (YoY), GDP shrank 3.5%, capping the worst performance since the year following World War II. On the monetary front, the US Federal Open Market Committee (FOMC) kept the federal funds target range at 0.00% - 0.25% at its January meeting with Chair Jerome Powell quelling fears of tapering and emphasising the need to keep policy supportive until the economy and the labour market recover from the pandemic.

The rampant surge in infections across the area saw countries such as Germany, France and the Netherlands implement stricter lockdown measures, which will no doubt cause further damage to the region's economy, and potentially lead to a double-dip recession. Meanwhile, the rollout of vaccines has been slow, meaning herd immunity will take much longer, while new mutations have become more virulent. On the monetary front, the European Central Bank (ECB) Governing Council (GC) kept its

policies unchanged, as widely expected. Elsewhere, the UK's COVID-19 vaccination programme got off to a much better start relative to its European peers but a resurgence in infections and suggestions that the new so-called 'Kent variant' may be spreading faster and proving more intense than the original strain, compelled Prime Minister Boris Johnson to introduce a third lockdown. The new tougher restrictions and regressive PMI readings all suggest that UK GDP will drop off sharply in Q1, with a double-dip recession looking more and more a likely outcome.

Locally, despite an upward surprise in the manufacturing PMI in January (up to 50.9 from 50.3 in December), this reading still in came in lower than the average recorded over the final three months of 2020. The business activity index meanwhile declined for the fourth straight month as production activity suffered from extended lockdowns and interrupted energy supply from rolling blackouts. The IMF downgraded its forecast for South Africa's growth this year to 2.8% from 3%, with the economy likely to have endured its worst contraction in decades last year, as lockdown restrictions kept the economy stuck in its longest economic downturn since war time, while load shedding and the burden of flailing state-owned enterprises saw fiscal metrics deteriorate even further.

The South African Reserve Bank (SARB) Monetary Policy Committee (MPC) opted to keep rates steady at 3.50% p.a. at its scheduled January meeting, with two members voting for a 25 basis-point cut and three members against. The MPC currently views risks to the local growth outlook to be balanced, but noted that constraints to energy supply, subdued investment and uncertainties surrounding the rollout of vaccines pose "serious downside risks to domestic growth".

The South African stock market had a very strong start to the year, building on the momentum experienced in the last two months of 2020, with the FTSE/JSE All Share Index rising 5.2%. The JSE All Bond Index delivered a modest return of 0.8% with non-residents continuing to be net-buyers of local bonds, albeit at a reduced pace. Listed property (FTSE/JSE All Property Index) pared back gains, kicking the year off back in red territory as the All Property Index closed 3.0% lower.

## Performance review

For the month, the portfolio outperformed the benchmark.

Positions in non-JSE listed offshore counters, Simon Property Group and Tritax Big Box REIT, contributed positively to performance. On the other hand, underweight exposure to other international counters included in the benchmark, Irongate Group (previously Investec Australia Property Fund), and RDI REIT, detracted from performance.

## Portfolio activity

The element of recovery seen in the fourth quarter of last year failed to carry over into the new year as we witnessed a slight pullback in the asset class. Nonetheless, there remains exceptional value in a number of names, in our view. We thus, continue to have exposure to these counters, rotating as strong performance is realised, and picking up laggards on weakness. These are typically a selective

group of large and mid-cap South Africa-focused companies with attractive combinations of yield and sustainable growth. Emira Property Fund, SA Corporate Real Estate Fund and Attacq remain attractive plays.

## Outlook and strategy

The listed property sector has incurred various setbacks over the past few years, including deteriorating fundamentals, governance and reporting-related concerns, rebasing of earnings, and the introduction of pay-out ratios. Prior to COVID-19, the South African property sector was on a slow road to recovery as many of the detractors appeared to be captured in valuations and reflected expectations of more sustainable earnings profiles. The pandemic has created an unprecedented environment, particularly for real estate markets where buildings were under enforced government shutdowns. Data is beginning to show that the outcome post-COVID-19 is not as bad as initially expected, however, there will be some long-term 'scarring' on the sector from the pandemic. 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. So far vacancies have been well-contained but at the cost of rental declines and higher levels of concessions. These concessions are slowly but surely being weaned out.

In our view, the challenging fundamentals are offset by deeply depressed valuations. The sector trades on a forward sustainable earnings yield of 12% and a +40% discount to net asset value (NAV). Dividend yields are likely to be lower given expectations for reduced pay-out ratios in favour of liquidity and balance sheet support, while some companies use solvency and liquidity requirements to retain cash and further bolster their balance sheets. 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 horizon, primarily underpinned by yield, together with the prospect of the sector re-rating as more clarity on operational and financial metrics is ascertained. We remain constructive of a return to earnings and distribution growth off a sustainable income base as the economy recovers.

While markets and economic conditions remain fluid, 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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