

Discovery Flexible Property

Market background

The month was marked by bouts of volatility as investors balance an encouraging global economic recovery against associated inflation worries. Expectations of a robust global economic recovery and the return of inflation saw value continue to garner favour over growth stocks. Developed market equities (MSCI World Index) ended the month 1.5% higher, lagging their emerging market peers (MSCI Emerging Markets Index) which posted gains of 2.3%.

Regionally, US equities (S&P 500 Index, +0.5%) touched all-time highs during the month, with first-quarter (Q1) corporate earnings posting a strong beat on consensus expectations. While European equities (Euro Stoxx 600 Index, +3.6%) record a fourth straight month of gains on the back of global growth optimism, improved vaccination rollout, alongside a dovish European Central Bank (ECB)

It was another flat month in bond markets, as inflation jitters continued to fuel volatility over the period. The Bloomberg Barclays Global Aggregate Bond Index recorded its second straight month of positive gains, up 1.1% for the period.

The US economic revival is running full steam ahead on the back of a consumer turbocharged by the US government's fiscal largesse, re-openings and an impressive inoculation programme. The Fed's preferred inflation measure, the personal-consumption expenditures index, rose to 3.1% in April, above the Fed's 2% target. Despite this, the Fed remained steadfast in its view that these prints are for the most part being driven by "transitory factors" which are likely to dissipate later in the year. However, some murmurs from certain officials in recent weeks suggest the Federal Open Market Committee is inching ever closer to commencing discussions on when to begin tapering.

The UK economy continued its recovery with GDP rising 2.1% month on month in March. Retail sales saw a rise of 9.2% in April on the back of pent-up household savings and fiscal stimulus. However, as is the recurring theme in reopening economies, businesses have struggled to keep up with the strong rebound in demand due to supply-chain bottlenecks and delivery delays, and input costs soaring to record levels. Unsurprisingly, producer price inflation soared to 3.9% in April. The Bank of England (BoE) Monetary Policy Report (MPR) published during the month projected that consumer prices would indeed breach the bank's 2% target by the end of 2021. Like the Fed, BoE policymakers expect above-target prices to be transitory and revert to near 2% in the outer years.

Meanwhile, incoming data points to a modest expansion of the SA economy over Q1 2021, following the contraction in 2020, the worst in 100 years. South Africa recorded its twelfth consecutive trade surplus April, aided by robust prices in precious metals exports and reflecting weakness in imports demand. Headline inflation (4.4% year on year, from 3.2% in March) rose to a 14-month high in April. The South African Reserve Bank's (SARB) policy committee unanimously left interest rates unchanged at its 21 May meeting.

The South African stock market capped the seventh straight month of positive gains, tracking higher in line with global peers. The benchmark FTSE/JSE All Share Index ended 1.6% higher, while the Capped SWIX posted an even better 2.9% at the close. Local bonds outperformed equities two months on the trot, as the bond market continued to find favour from a supportive external backdrop and positive domestic dynamics, with yields edging lower, while foreigners returned to be net buyers over the period. Listed property (JSE All Property Index) pared back some of its stellar gains in May, falling 3.2% over the month.

Performance review

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

We witnessed a pullback in the local property sector during the month, following robust performance in April. Exposure to off-benchmark, international counters (barring German REIT, Vonovia) contributed to relative performance despite South African rand strength over the period. Vonovia weighed negatively on performance despite a degree of recovery on the back of news regarding corporate action, as the company made an offer for German counterpart, Deutsche Wohnen.

Portfolio activity

The value rotation we have experienced since November 2020 continues to run its course, with the gap between the COVID winners and losers gradually narrowing. As such, we have continued to seek out counters offering the right combination of reasonable value, sustainable earnings, and growth. During the month, we maintained our preferred exposure to the mid-cap section of the sector, with exposure to the likes of SA Corporate Real Estate, Emira Property Fund, Investec Property Fund and Attacq.

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.

Outlook and strategy

After what has been a testing few years for the listed property sector, the sector has shown the first signs of recovery in 2021. 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 is not as bad as initially expected, however, there will be a lasting impact on 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. To date, 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 9% (10.5% 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.

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.

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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