Discovery

# Discovery Flexible Property

## Market background

Equity markets experienced some reprieve in July after the negative returns experienced over the second quarter. The MSCI All Countries World index gained 7.0% over the month (though it is still down 14.6% year to date), led by developed markets (MSCI World Index), which rallied 7.9%. Emerging market (EM) indices across Latin America and Europe, Africa and the Middle East all rallied over the month, but overall, the MSCI EM Index declined slightly (-0.7%), dragged lower by particularly weak performance from China, where the mainland's CSI 300 Index sold off a hefty 7.0%. All returns are quoted in US dollars.

Markets continue to be driven by inflation and central bank policy. While equity markets ended the month in the green, it was only in the last week of the month that most of the gains were made, following the perceived more-dovish-than-expected rhetoric from the US Federal Reserve (Fed). This was in the aftermath of a unanimous 75 basis points (bps) increase in the Federal funds target range (to 2.25%–2.50%) by the Federal Open Market Committee.

However, in the subsequent announcement, Fed Chair Jerome Powell suggested that, depending on the data, it may become appropriate to reduce the pace of hikes while the Fed examines the effects on the economy; this boosted risk assets. Expectations are now for smaller future hikes (50bps), which are expected to put less pressure on equity markets and associated valuations. With the prospects of easing inflationary pressure and a less hawkish Fed, bond markets also found reprieve during the month as developed market government bond yields tracked lower (yields fall as prices rise).

Back in South Africa, business confidence has fallen to the lowest level since Q1 2020, pre-COVID, while consumer sentiment is at levels last seen in 1986. At the same time, headline inflation soared further above the South African Reserve Bank's (SARB) 3%–6% target range, printing at 7.4% y/y in June (the highest reading since May 2009), from 6.4% in May and above consensus expectations of 7.2%. The biggest drivers of this were fuel and food inflation. The SARB surprised the market with a larger-than-expected 75bps rate hike at its 21 July MPC meeting as it aims to arrest inflation. Constructively for the

market though, the central bank further guided for more stern monetary policy for the remainder of the year.

The FTSE/JSE All Share Index gained 4.2% over the month. The JSE All Bond Index recouped some of the heavy losses of the previous month, returning +2.4% in July., while listed property (JSE ALPI) recovered remarkably well, delivering a +9.1% return for the month.

## Performance review

For the month, the Fund outperformed the benchmark.

The offshore names held in the portfolio starred as the largest contributors to performance, with more value-orientated South Africa-focused counters, Redefine Properties and SA Corporate Real Estate also contributing positively on the local front.

Underweight positions in the two units (A & B) of Fortress REIT detracted from performance, as the company is in the throes of a scheme of arrangement to potentially collapse the dual-share structure currently in place.

## Portfolio activity

The Fund continues to reduce its underweight in Growthpoint Properties, as the share price provides attractive entry points into weakness, in a stable income-producing fund with exposure to the Australian economy. Similarly, we took advantage of share price movements to increase exposure to UK-focused retail play Hammerson Plc.

## Outlook and strategy

After a strong 2021, in 2022, the listed property sector has been impacted by sentiment surrounding around rising interest rates. However, the sector's operations have shown significant recovery since their COVID-induced lows, particularly in retail and industrial, while office continues to suffer from an oversupplied market. Retail vacancies are squeezing lower, and with no new retail space supply, the tide is turning in favour of landlords. The operational finance cost impact of rising interest rates is also expected to be relatively muted, as the majority of debt in the sector is hedged at historically high levels. Thus, earnings will continue to be driven by property fundamentals.

In our view, the challenging fundamentals continue to be offset by supportive valuations. The sector trades on a forward yield of c.10% (c.11% 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. In 2022, companies have shown a return to consistent dividend payments, which is more sustainable as companies' cash flows and balance sheets are largely restored.

We believe the sector offers attractive value over a medium- to long-term time horizon, primarily underpinned by a relatively high sustainable cash-covered yield, together with a supportive valuation Over the medium term, we remain constructive with 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.

Discovery Life Investment Services (Pty) Ltd, branded as Discovery Invest, is an authorised financial services provider. Company registration number 2007/005969/07.