Discovery Flexible Property

31 December 2024

Market background

Robust US economic data and higher inflation made for a volatile end to the year for bond markets, pushing up yields and strengthening the US dollar. A more hawkish tone from the US Federal Reserve (Fed) further dented optimism around the path of interest rate cuts, resulting in a more subdued end to an otherwise strong year for equity markets. In South Africa, financial markets came under pressure over the quarter, with December marking the third consecutive month of equity declines. Global headwinds were among the main drivers behind risk-off sentiment, particularly in the US, where uncertainty over monetary policy and the possibility of a Federal Government shutdown gained momentum. Also weighing on investor sentiment were concerns over South Africa's inclusion in the AGOA trade programme after reports emerged that South Africa's participation could come under review. Turning to Europe, equity markets had a weak quarter as concerns over trade tensions in the export-dependent region weighed on sentiment following the US election. In particular, automakers came under pressure, although concerns were broad-based after US President-elect Donald Trump warned the EU would face trade tariffs on its exports to the US unless its member states increased their purchases of American oil and gas. In China, after the excitement of September's policy announcements, October was a much quieter month as investors digested the stimulus measures, which were interpreted as being more risk "mitigation" than "growth stimulation". December saw the market recover some ground, however, largely in anticipation of the annual Central Economic Work Conference and the Politburo meeting for indications of policy stimulus in the coming year.

Performance review

For the quarter, the portfolio underperformed its benchmark.

The general trend of rising bond yields globally made for a challenging macro environment, leading to a broad-based negative impact on our offshore positions. Our overweight exposure to **Segro** and **American Tower** weighed on performance as a result, despite both companies having reported results that were in line with expectations. Underweight exposure to **MAS Plc** also detracted from performance after the company released a cautionary announcement that highlighted the possibility of a potential corporate action. At the same time, local names **Hyprop** and **Fairvest B** were among the largest contributors to performance over the quarter, with the latter having announced better-than-expected financial results and earnings guidance that came in ahead of market expectations.

Outlook and strategy

The sharp increase in interest rates over 2022 and into 2023 resulted in a steep derating of the listed property sector, both locally and abroad. However, as increased rhetoric regarding monetary policy easing entered the fray in late 2023, property globally benefitted as interest rate sensitive instruments rerated. The property market has been further supported by the Fed initiating its rate cutting cycle, together with soft but not collapsing economic data out of the US.

In our view, the improving fundamentals support current valuations. However, the total return outlook depends heavily on ratings remaining stable on the back of a loosely predictable cutting cycle without massive geopolitical surprises. Looking forward, total returns will be underpinned by income yield and growth, with the sector having enjoyed significant rerating in the second half of the year. 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 a supportive valuation that reflects near-term operational and balance sheet concerns.

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 with the best risk-adjusted medium- and long-term outcomes.