Discovery

Discovery Flexible Property

31 May 2024

Market background

May was a more upbeat month for capital markets, with most asset classes recovering from the losses of April. Although markets were more challenged towards the end of the month as global inflation data proved stickier than expected, overall investors grew more confident that rate cuts would still happen this year.

In emerging markets, performance was influenced by various factors, including negative economic indicators from China, which weighed on the overall performance of the EM index. Elections in key EM markets, including India, Mexico and South Africa, kept markets somewhat subdued.

South African equities closed the month broadly firmer, supported by hopes that the US Federal Reserve could begin cutting rates this year, a viewpoint that subsequently lost momentum towards month-end. On the political front, sentiment turned somewhat cautious ahead of the national elections.

Commodities had a strong month in May, with energy stocks the exception as the price of crude oil weakened. Gold continued its upward march, touching new highs as investors sought perceived safe havens.

Performance review

For the month, the portfolio outperformed the benchmark.

Global property counters followed global equity markets higher in May, as slowing US inflation and a weaker labour market boosted hopes of a soft landing in the world's largest economy.

Following this trend, both dual-listed and non-JSE-listed global counters contributed positively to performance. Dual-listed examples included the likes of UK retail-focused names, such as Shaftesbury Capital and Hammerson. In terms of non-JSE-listed counters, performance was not limited to a specific sector or geography, with UK industrial property counter, Segro, along with German residential-focused Vonovia, and US-based American Tower, all contributing to performance.

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 a pivot on rate decisions entered the fray in late 2023, property globally has benefitted, as interest rate sensitive instruments re-rated.

Although there is much debate on whether markets have moved too much too soon, property yields continue to provide a decent yield despite troughs in earnings growth, after having been impacted by the steep rate increases of 2023.

As the interest rate cycle turns, the positive impacts for the property sector are compounded. Alongside rating support, the bottom line benefits from decreased finance costs. Typically, property companies hedge out c.90% of their interest rate exposure on average. In anticipation of rate changes, many have not renewed their hedging instruments. As such, the average for the sector sits below 80%, the lowest at 55%. This provides a material upside opportunity for earnings and dividends in the sector as the cycle turns.

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In our view, the improving fundamentals are supported by reasonable valuations; total returns being underpinned by income yield rather than re-rating potential within the year. The sector trades on a forward distributable income yield of c.11% and a c.35% discount to net asset value.

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.