MERGENCE
INVESTMENT MANAGERS

Macro and Multi-Asset

July 2021

July has seen a continued reversal of the reflation trade as US bond yields fell and concerns were felt over slowing growth rates, Fed tapering and the spread of the COVID-19 Delta variant.

In this note we present our asset allocation views, an update of our key forecasts and macro indicators. Please see under “Current views” below. In our research piece for July, Multi-Asset analyst Unathi Hewana discusses some of the macro factors impacting the SA property sector.

Current views

NEUTRAL	OVERWEIGHT	PREFER	NEUTRAL	OVERWEIGHT
Risk Assets	**Value vs Growth**	**South African equity over Emerging Market equity**	**USDZAR**	**SA Bonds and Property**

Asset allocation views

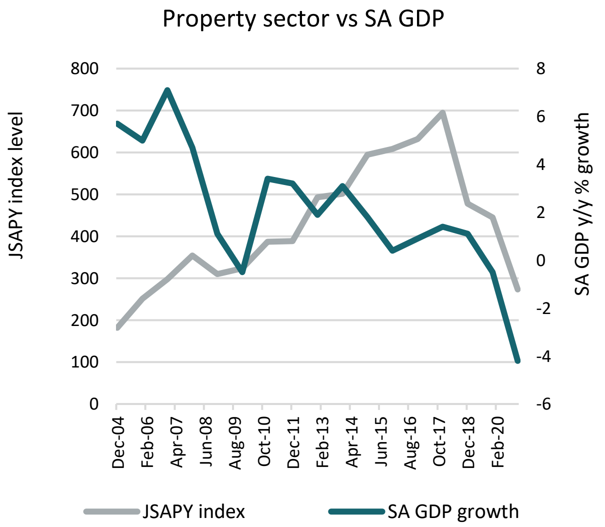
Asset Class	Underweight	Neutral	Overweight
SA Equity		Neutral	
SA Property			Overweight
SA Fixed Bonds			Overweight
SA Inflation Linked Bonds			Overweight
Emerging Market Equity	Underweight		
Developed Market Equity	Underweight		
US Large Cap	Underweight		
US Mid Cap Value		Neutral	
UK Equity			Overweight
European Equity		Neutral	
Japanese Equity			Overweight
Global Bonds	Underweight		
USD Cash	Underweight		

Source: Mergence Calculation. All forecasts in ZAR

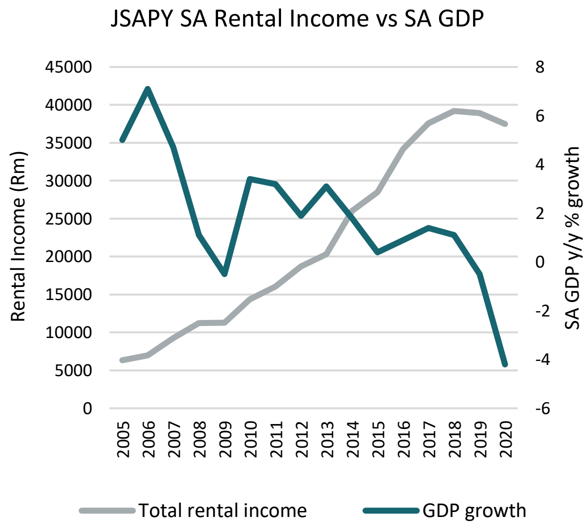
Macro factors affecting property

The South African Property Sector, as measured by the JSE's JSAPY index, suffered a significant decline in value in 2020, driven largely by the Covid-19 impact on the local and international economies to which the different property names are exposed. However, the sector has had a protracted decline in value over the past three years. A large contributor to this has been the overall poor state of the South African economy which has resulted in negative growth in GDP in that period.

The graphs below show how the property sector as a whole, and in particular, rental income growth from South African properties, has performed relative to the SA economy. The sector experienced positive growth in the years preceding 2017, despite the decline in the SA economy, until performance and rental income growth also started to decline in 2017.

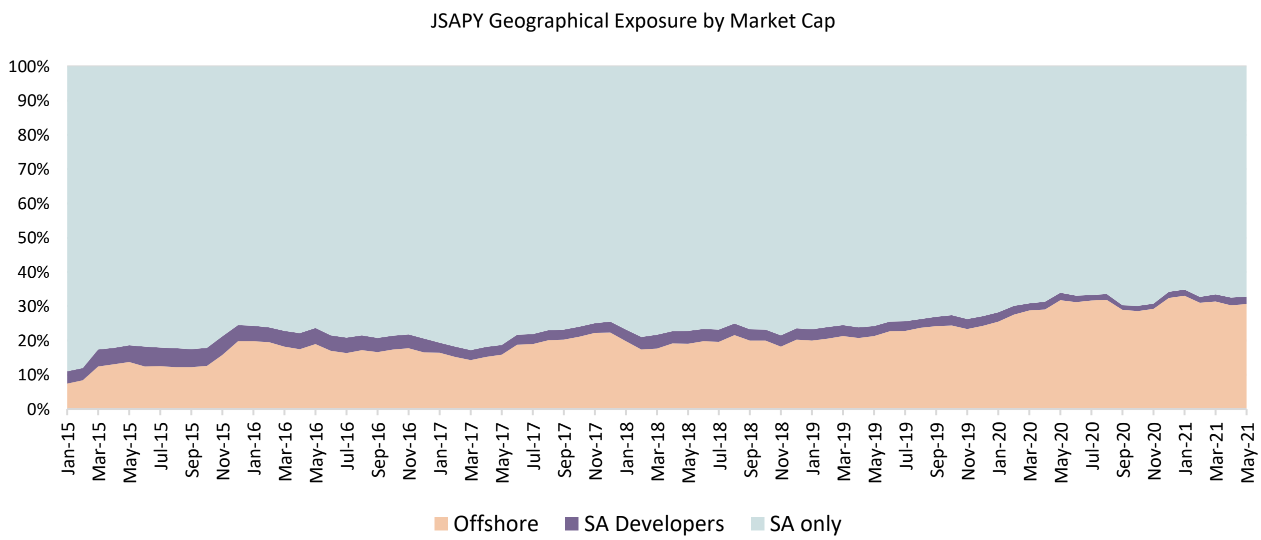


Source: Bloomberg, Mergence



Source: Company Reports, Mergence

With a correlation of 0.87 between total rental income growth from SA properties in the JSAPY, and SA's economic growth, the property sector's performance can be partly attributed to its large exposure to South Africa, despite overall exposure to international markets increasing over the long term, as shown in the graph below.



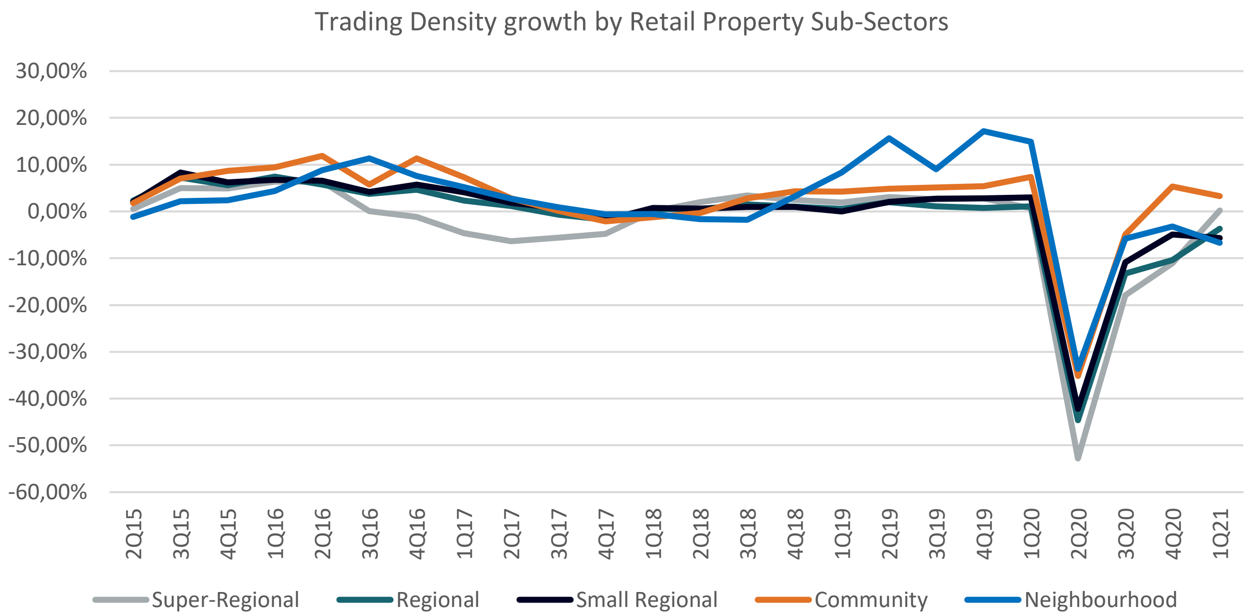
Source: SBG Securities, Mergence

With the SA economy forecasted to grow by less than 2% year-on-year over the longer term, the correlation between SA economic growth and the property sector's growth begs the question whether SA property might be worth investing in, as the relationship between the two suggests that the property sector may also have poor growth prospects going forward. We believe that although the property sector as a whole might not provide as an attractive return over the longer term as it has done in the past, there are some counters, based on some of the macro factors they are exposed to, that screen better than others and could generate attractive returns still.

More specifically, our view is that companies with exposure to value retailers or retail space predominantly located in non-metropolitan areas stand to benefit from the trends seen in real disposable income growth and consumer confidence, whether increasing or decreasing, whilst companies with exposure to logistics, warehousing and/or multi-purpose space stand to benefit from trends seen in industrial and manufacturing activity, as well as overall business confidence, whether increasing or decreasing, in the case of the latter.

The South African consumer has seen real disposable income decline year-on-year due to lackluster growth in earnings, largely driven by the negative growth in the economy, and high living costs. This has led to a large consumer base changing its spending habits, downtrading to more affordable retail points and opting to visit more local shopping centers and smaller regional malls, instead of the larger regional and super regional malls where travel to and from, combined with spend can be more costly. Companies with exposure to value retailers or retail space in non-metropolitan areas could benefit from this change as consumers will most likely continue to spend more prudently as economic growth remains low and unemployment remains high. Companies with such exposure have already shown resilience compared to their counterparts with greater exposure to regional and super regional malls as their trading densities have increased in the past three years, as opposed to declining or remaining stagnant like their counterparts', with the exception of 2020, whilst their vacancy rates have been less volatile.

The graph below shows how trading densities in neighbourhood and community retail properties have grown, despite overall rental income in SA properties and the SA economy in general decreasing over the past three years. In contrast, as mentioned, trading densities in super-regional, regional, and small regional retail properties have largely remained unchanged.



Source: MSCI, SBG Securities, Mergence

Increases in real disposable income and consumer confidence would however also benefit such companies as that would encourage an increase in spend overall, enabling all retailers and their landlords to achieve an improvement in performance.

Companies exposed to logistics, warehousing and/or multi-purpose spaces have benefited from businesses wanting to cut costs by either moving some operations online and renting space for inventory, moving some equipment and infrastructure off their own premises so they can reduce the space occupied and thus paid for, or renting operating space instead of owning it and being solely responsible for the associated property operating costs. These decisions have largely been driven by those businesses' view of the economy going forward i.e., business confidence. With the economy forecasted to have relatively low growth over the longer term, business confidence will likely remain low and persuade these customers to continue looking at such measures to cut costs further.

Improvement in business confidence however would help drive manufacturing activity and industrial capacity utilisation, which would then lead to those customers once again, requiring logistics, warehousing, or other multi-purpose space to help facilitate or accommodate that increase in activity.

While quality and value remain important factors to consider when determining whether to invest in a particular property stock or not, it is worth making note that some macro factors are large contributors to overall performance as well. This past year has made that very evident. We therefore believe that once these macro factors have been identified and their impact on property has been established, it can help filter out which stocks on which to conduct a deeper, more fundamental analysis, in order to get more conviction on their potential to generate attractive returns over the longer term.

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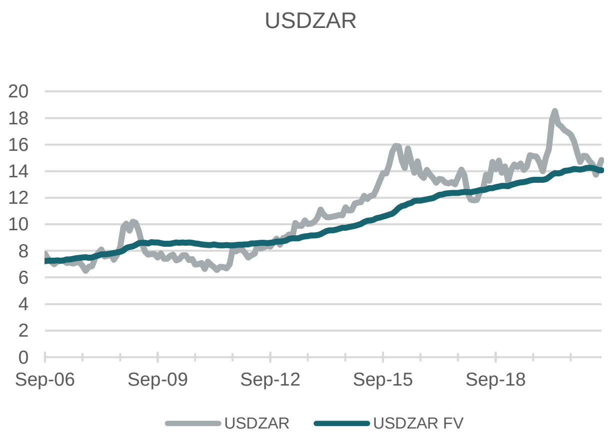
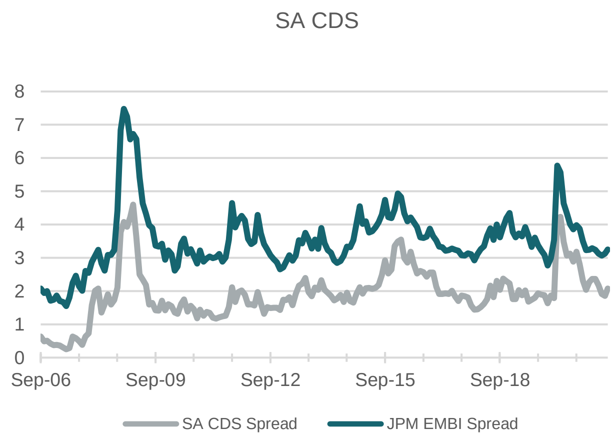
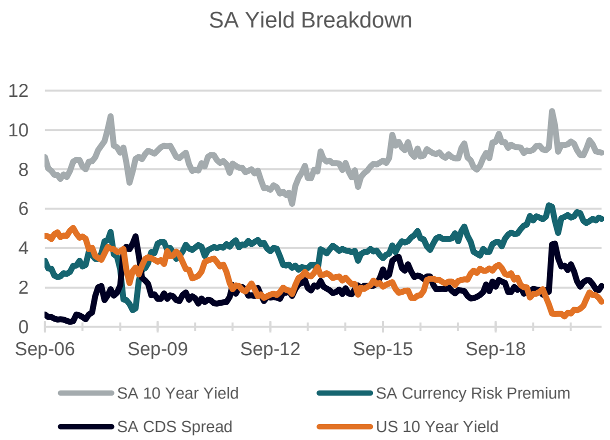
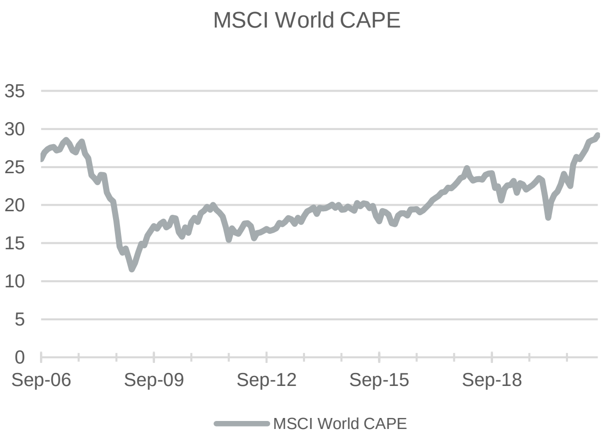
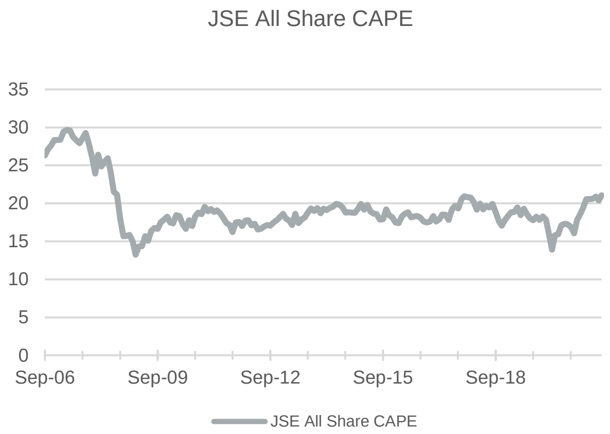
Key charts

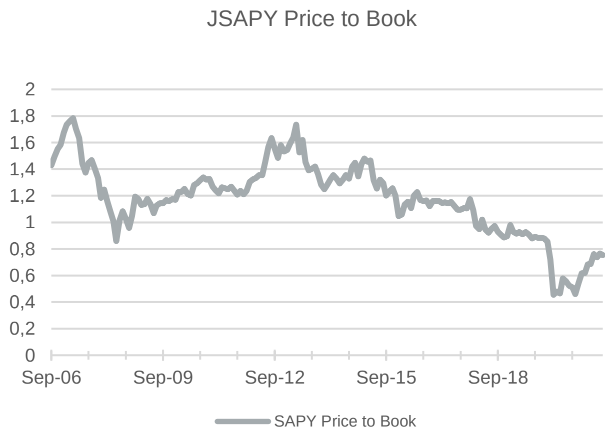


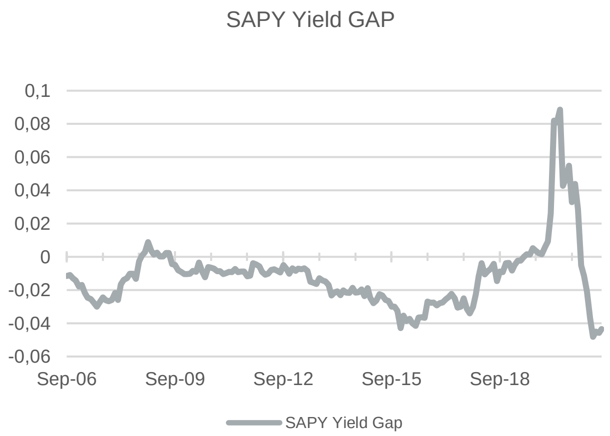


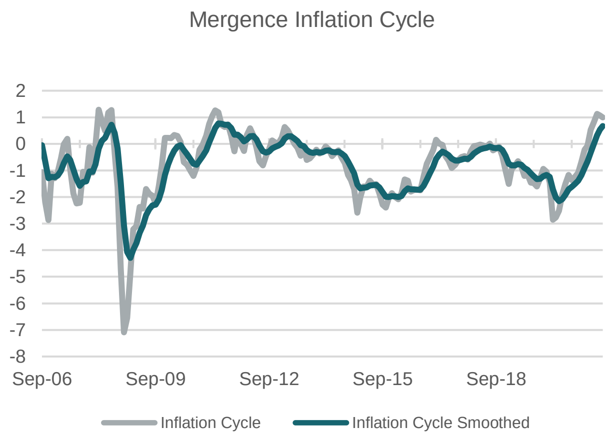


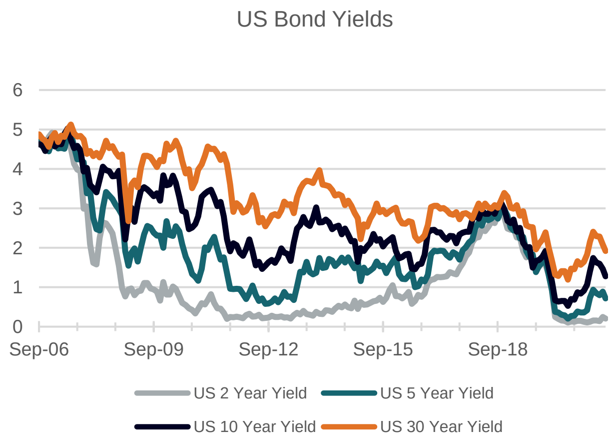


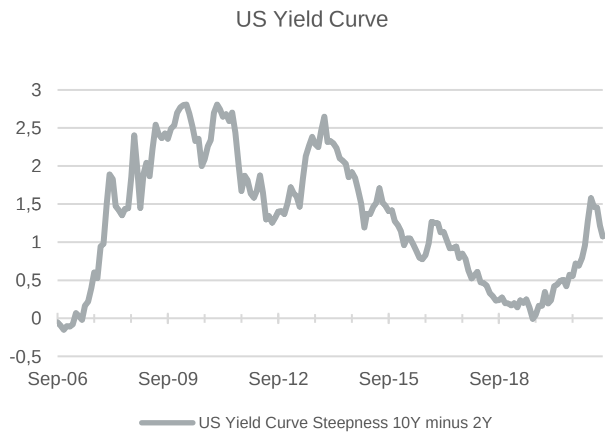

JSE All Share CAPE
35
30
25
20
15
10
5
0
Sep-06
Sep-09
Sep-12
Sep-15
Sep-18
JSE All Share CAPE


JSAPY Price to Book
2
1,8
1,6
1,4
1,2
1
0,8
0,6
0,4
0,2
0
Sep-06
Sep-09
Sep-12
Sep-15
Sep-18
SAPY Price to Book


SAPY Yield GAP
0,1
0,08
0,06
0,04
0,02
0
-0,02
-0,04
-0,06
Sep-06
Sep-09
Sep-12
Sep-15
Sep-18
SAPY Yield Gap


Mergence Inflation Cycle
2
1
0
-1
-2
-3
-4
-5
-6
-7
-8
Sep-06
Sep-09
Sep-12
Sep-15
Sep-18
Inflation Cycle
Inflation Cycle Smoothed


US Bond Yields
6
5
4
3
2
1
0
Sep-06
Sep-09
Sep-12
Sep-15
Sep-18
US 2 Year Yield
US 5 Year Yield
US 10 Year Yield
US 30 Year Yield


US Yield Curve
3
2,5
2
1,5
1
0,5
0
-0,5
Sep-06
Sep-09
Sep-12
Sep-15
Sep-18
US Yield Curve Steepness 10Y minus 2Y

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