
Outlook on
UNITED KINGDOM
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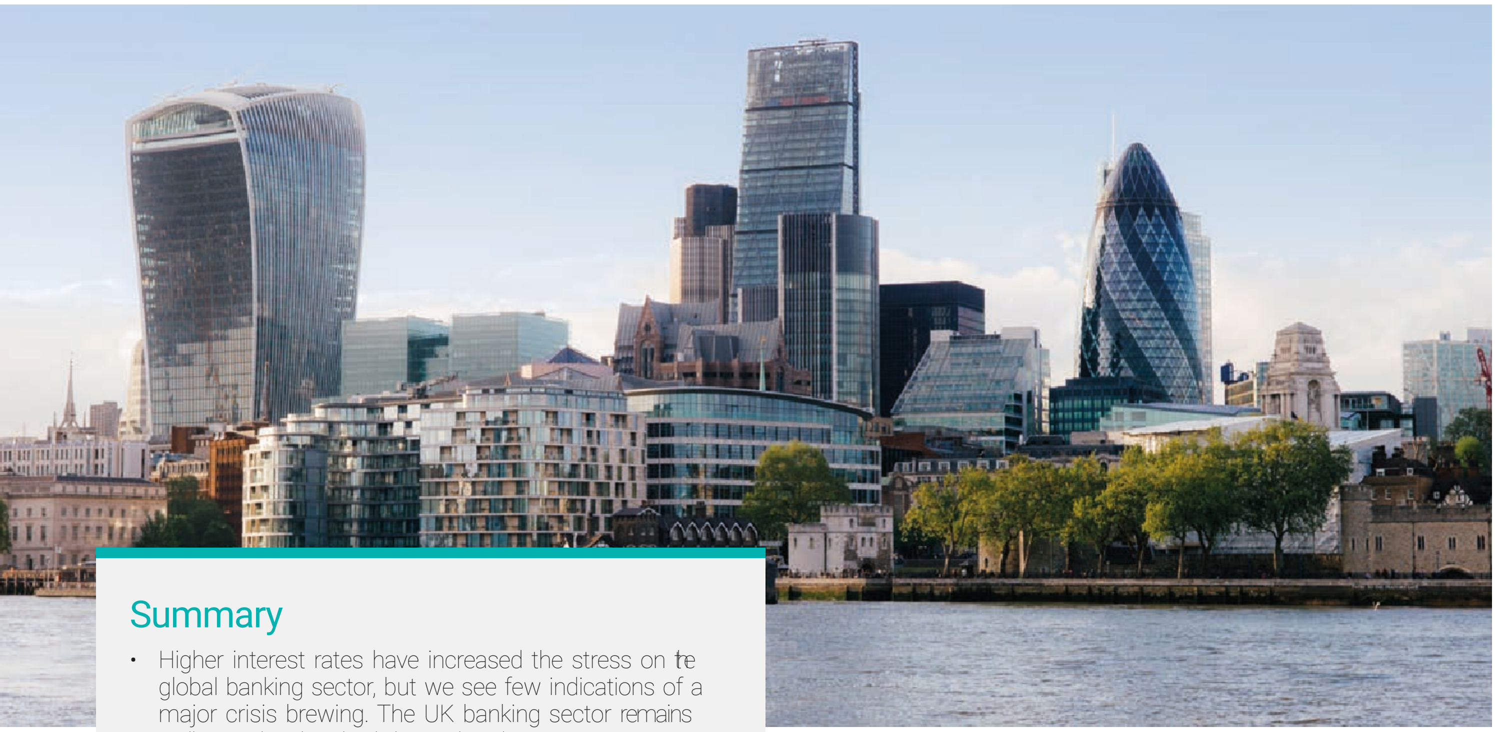
Outlook on

UK Equities

MAY 2023



Summary

- Higher interest rates have increased the stress on the global banking sector, but we see few indications of a major crisis brewing. The UK banking sector remains well-capitalised and tightly regulated.
- Although its growth remains sluggish, the UK economy has proved to be more resilient than many predicted. We continue to anticipate a slow but steadily improving consumer outlook while interest rates are now close to their peak.
- Political progress with the EU marked a welcome thawing of European relations and may be a step toward the UK stock market shedding its pariah status with international investors.

California is well known for being prone to earthquakes, but the tremors that rippled out from the Golden State in mid-March were financial rather than physical. The collapse of Silicon Valley Bank (SVB), America's 16th-largest lender, was arguably more idiosyncratic than systemic in nature—as outlined in an early take on the situation by our US-based investment colleagues—but had wider ramifications.

SVB's failure placed other US regional banks under immediate pressure, including Signature Bank, which also collapsed. The aftershocks were acutely felt in Europe, too. Amid fears of contagion, beleaguered Credit Suisse was forced into an unequal shotgun marriage with Swiss rival UBS, controversially wiping out contingent convertible (CoCo) bondholders in the process. In the UK, HSBC rescued SVB's UK operation and picked up its attractive technology-biased loan book, in doing so safeguarding the future of many UK tech start-ups. Meanwhile, the SVB episode hit UK bank shares hard—the FTSE Banks sector dropped 12.0% in March—as the sector's risk profile worsened.

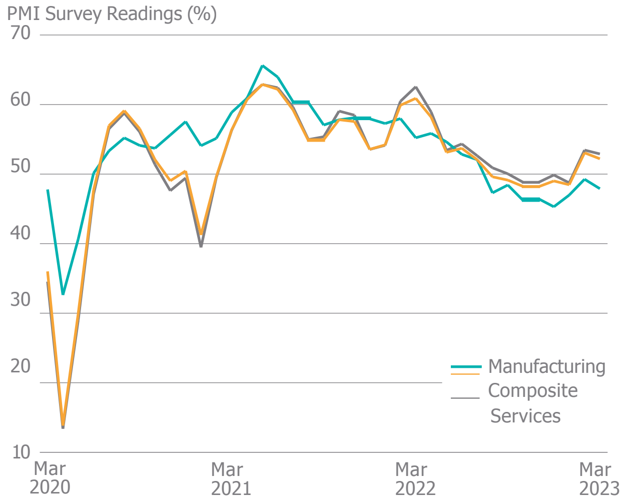
SVB's demise was a reminder that the traditional banking model of borrowing short and lending long can trip up poorer-quality franchises lacking the requisite risk controls. As to its near-term implications, SVB's collapse may further drive up borrowing costs for venture capital firms and unprofitable, early-stage growth companies. As an aside, we trimmed our overweight bank exposure slightly in reaction to the strains in the sector. Our bank exposure continues to be biased towards large-scale, relatively low-risk franchises including those with a significant presence in the growth markets of Asia. These are banks with high-quality assets (i.e. loan books) as well as robust deposit books, giving them excess funding.
As such, they are typically beneficiaries in any flight to safety by depositors. We witnessed such a flight in the US after SVB's failure. Customers withdrew c.$120 billion from small banks in the week ended 15 March, according to Federal Reserve data, while deposits at the 25 largest banks rose almost $67 billion. Billions of dollars also found a home in money market funds.

Financial accidents happen when interest rates rise as rapidly as they have in the last 12 months. We may well see further stresses and strains in the global financial sector in the months ahead, but we do not believe this will be 2008 redux.

Recession fears fade

Turning to the UK economy, the story of late has been one of incremental improvements, albeit not yet the green shoots of recovery that we associate with spring. The growth outlook has modestly picked up, with the economy expanding 0.3% in January after a 0.5% fall in December. Bank of England Governor Andrew Bailey now expects the UK economy to avoid a recession this year.[1] Meanwhile, in its latest economic and fiscal outlook, released alongside the Spring Budget on 15 March, the Office for Budget Responsibility (OBR) significantly upgraded its forecast for 2023 growth, from -1.4% to -0.2%.[2] Furthermore, the composite purchasing managers' survey (PMI) has been broadly moving in the right direction, even if the manufacturing PMI survey has been in contraction territory for eight consecutive months (Exhibit 1). Given the UK's dominant services sector, February's services PMI survey reading of 53.5, its highest level in eight months, was encouraging; March's reading of 52.9 was down slightly but still consistent with expansion.[3]

Exhibit 1
Services Recovery



As at 31 March 2023
Source: FactSet

A key reason for the less gloomy economic vista has been an uptick in consumer sentiment. Consumer confidence has continued to climb from last autumn's post-mini-budget nadir, suggesting that consumers may be starting to believe the worst of the cost-of-living crisis is behind them (notwithstanding February's higher-than- expected inflation print, which we discuss below). Retail sales data also showed strong-than-expected growth in January and February.

Set against this better-than-expected growth outlook, we anticipate the recent small but steady improvement in consumer spirits will continue over the next few months. The labour market remains strong: the unemployment rate stands at 3.7%, near a 50-year low, and there are currently 1.1 million job vacancies, although the number of open positions has fallen for eight months straight. This is providing workers with negotiating power, as evidenced by the recent wave of strikes and growth in wages: average regular pay growth for the private sector was 7.3% for October to December 2022 and 4.2% for the public sector. Admittedly, though, this still represents a cut in real terms.[1]

On top of a still buoyant employment market, the government's extension of the Energy Price Guarantee until the end of June, along with the prospect of easing energy prices from the summer due to much lower wholesale prices, should also help to underpin consumer confidence over the next few months.

There are some cautionary notes to sound, however. One is the potential for weakness in the housing market. The OBR predicts house prices will fall 10% this year, while Nationwide reported a 3.1% drop in prices over the year to March, its largest decline since July 2009.[2] Yet Rightmove's March survey pointed to a far more resilient market that is on a "much more stable footing than many anticipated" after the turmoil caused by the Kwarteng–Truss mini-budget. Meanwhile, February's better-than-expected mortgage approvals number, admittedly down 34% on February 2022's figure, was up 10% on this January's outcome. As the first monthly increase since last August, this suggests stability is perhaps returning to the residential market.

More importantly, the stubbornness of inflation was visible in February's shock increase in the annual rate of consumer price inflation to 10.4%, outstripping forecasts of 9.9%.[1] Disappointingly, core inflation rose over the month. This left the Bank of England with little choice but to raise rates again by 0.25% as the quarter closed, despite some calls for a pause in the rate-hiking cycle to assess the fallout of the banking sector turmoil. Nonetheless, market expectations for UK interest rates suggest we are now close to a peak in the base rate, which seems appropriate given the lagging effects of interest-rate policy.

As we observed in our January 2023 Outlook, we think high inflation is here to stay and has become baked in across the economy; it is not just an externally caused phenomenon driven by energy prices. To that end, Chancellor Hunt's forecast that inflation will fall to 2.9% by the end of the year strikes us as wishful thinking. Housebuilders, for example, continue to face 5%-10% increases in their input costs. We may have to learn to live with higher prices for some time to come.

China caution, OPEC cuts

Looking overseas, the reopening of the Chinese economy after the abandonment of its zero-COVID policy late last year boosted hopes for a world economy short on growth engines. While clearly a welcome development, we think the implications for the big UK-listed commodity-related names remain modest at this early stage. The economic reboot has understandably proved tentative after such a long shutdown, and we do not now expect the Chinese economy to return to normal operating conditions until 2024.
Moreover, the Chinese government appears to be prioritising consumer-led growth over investment-led growth. Consumption should be the "main driving force" of the Chinese economy, according to comments made by Li Keqiang, the former premier, in January—consumption accounts for just 38% of Chinese GDP (based on 2021 data).[4] This suggests a limited role ahead for the infrastructure and investment-led spending that benefits the global mining companies.

Turning to the energy market, oil prices have fallen sharply since last autumn although they have ticked up in recent weeks. This weakness arguably reflected concerns over the outlook for global growth, although there is evidence that options hedging trading activity may also have suppressed prices. Adding to the oil price's softness has been Russia's ability to maintain oil production and supply key markets like China and India, despite international sanctions. As the new quarter began, OPEC+'s need to keep the oil price above $80 per barrel resulted in a surprise cut to production of more than 1 million barrels per day, which had the desired effect in the immediate term.

Bonjour, Europe

One of last quarter's biggest political developments was the unveiling of the Windsor Framework, an agreement between the UK and EU that alters the Northern Ireland Protocol, a key part of the Brexit deal. A major aspect of this new understanding relates to the movement of goods from Great Britain to Northern Ireland.
Goods staying in Northern Ireland for final sale will no longer face many checks and requirements (entering via a "green lane"). Meanwhile, goods destined for onward movement into the Republic of Ireland or the wider EU will be subject to the usual third-country checks (via a "red lane").

The Windsor Framework potentially marks the start of a welcome rapprochement between the UK and Europe. The UK became a pariah market for many international investors after the Brexit vote. A more constructive relationship between the UK and the 27-member bloc may help at the margins to improve the appeal of UK shares to overseas investors. This is critical. The shrinking pool of assets being directed toward UK equities by local investors, not least dwindling domestic equity allocations by UK pension funds—down from 53% in 1997 to 6% in 2021, according to the Capital Markets Industry Taskforce—means the only way the UK stock market will regain its lustre is if it can attract international institutional investors.

New York calling, not London

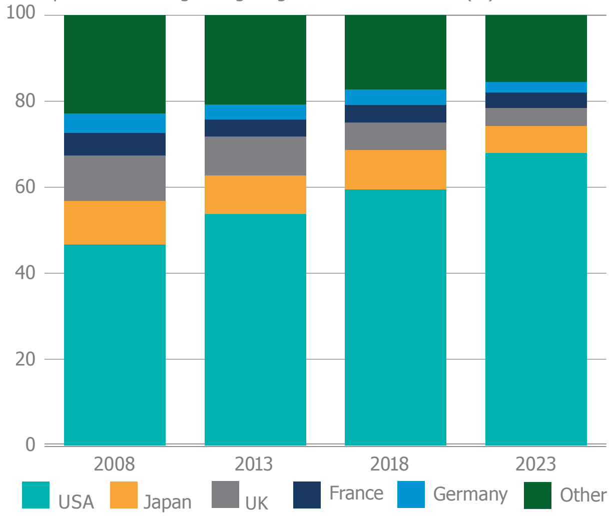
The past quarter also brought much coverage about UK-listed companies relisting elsewhere, most notably in the US, further contributing to the handwringing over the diminished status of the UK market (Exhibit 2). Irish-headquartered buildings materials giant CRH announced its intention to delist from London and relist in the US; Cambridge-based chip designer Arm, owned by Japan's SoftBank, said it will IPO in New York; and betting group Flutter is contemplating a secondary listing in the US that may in time become a primary listing. Until the unloved UK market recovers its international standing or finds greater domestic support, we think it is understandable if major UK-listed international companies explore re-listing overseas to command a higher multiple, especially companies with substantial US-based operations that may want to re-list there.

Putting to one side the challenge of halting the long-term decline in the UK stock market from an international perspective, the macro backdrop should be supportive for UK equities in the second half of the year. We remain mildly positive about the prospects for consumers and the broader UK economy, helped by a likely peak in rates. To that end, we expect to add gently to our consumer-related exposure, including within the travel and leisure sector, in the coming months. This follows the addition of a couple of mid-cap consumer names to our UK portfolios during the first quarter.

With the overall market, based on the FTSE All-Share Index, trading on just 10 times 12-month-forward earnings, clear value at a sector level versus the US and Europe (Exhibit 3), an aggregate return on equity of 14.8%, a 3.6% dividend yield,[1] balance sheets generally in good shape, sterling stable after last autumn's gyrations, and a Sunak government seemingly intent on repairing relations with Europe in a calm and constructive fashion, we think domestic and international investors alike should be focusing on the real value on offer in the UK market. That is hardly an observation to register on the Richter scale, but we think it is one worth repeating.

Exhibit 2
Declining Relevance

UK Equities Percentage Weighting in MSCI World Index (%)



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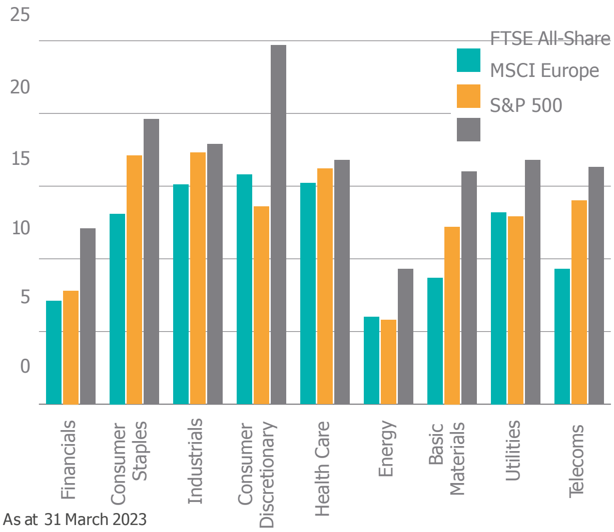
Source: FactSet

Exhibit 3
Bargain Britain

UK vs. US & Europe Sector Valuations (Price/Earnings, 12-Month Forward)



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