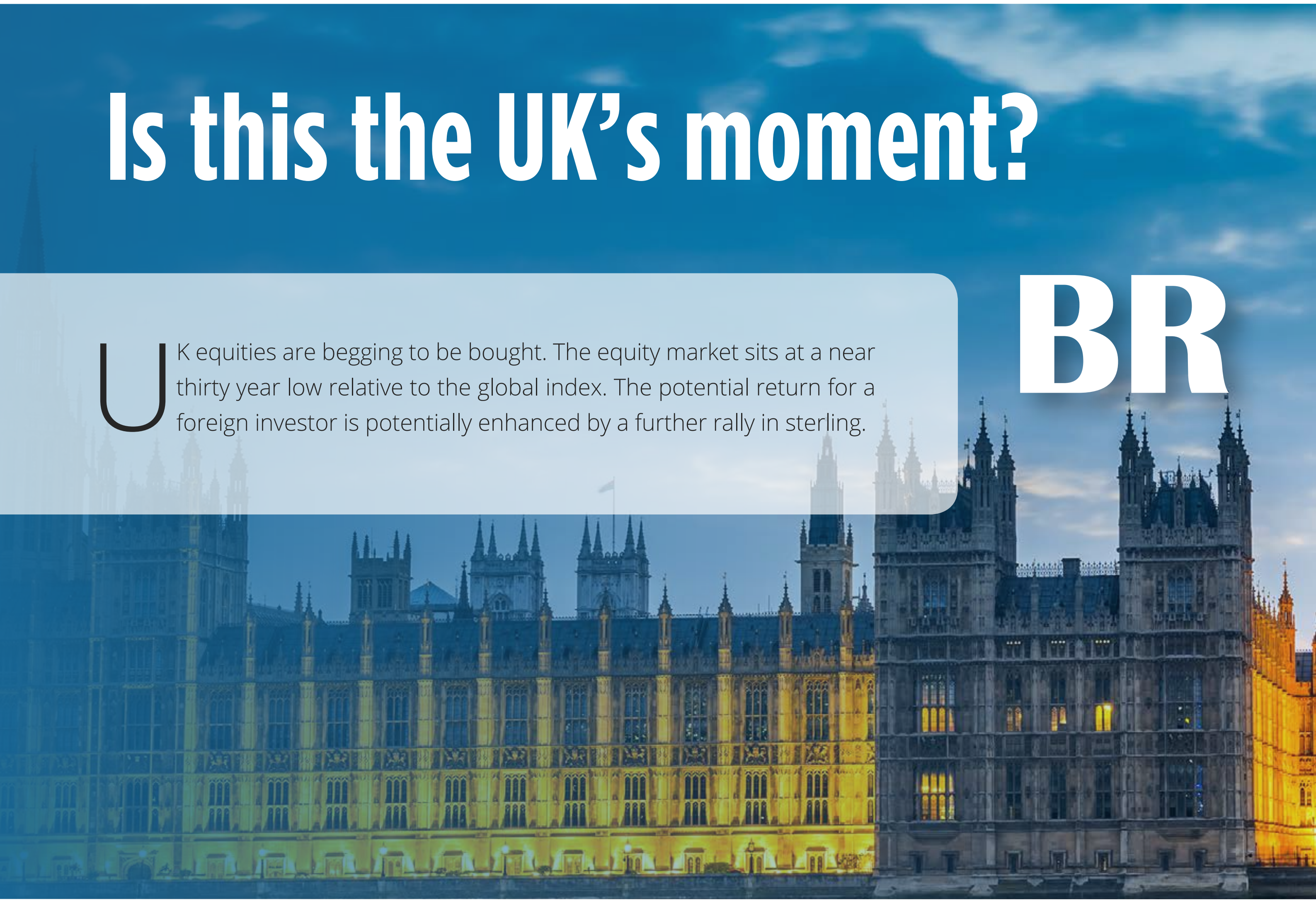
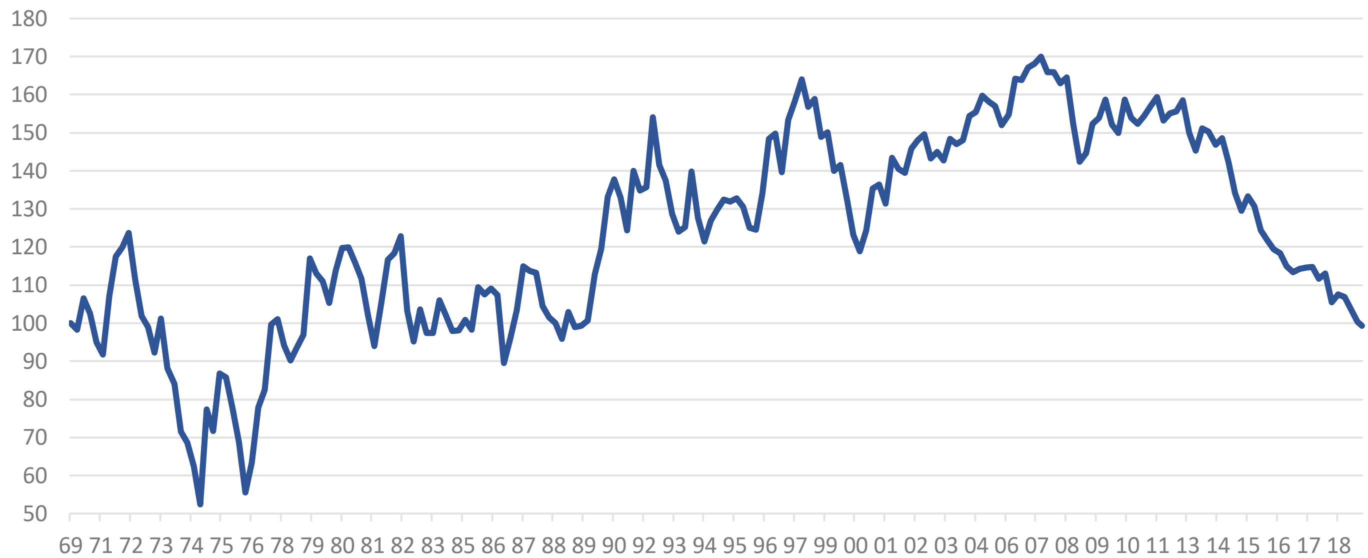
Is this the UK's moment?



UK equities are begging to be bought. The equity market sits at a near thirty year low relative to the global index. The potential return for a foreign investor is potentially enhanced by a further rally in sterling.

Chart 1: MSCI UK equity index net total return underperforms global ex UK index (1969=100)



Source: Bloomberg

The UK equity market's poor relative performance was not just a reflection of 2016's Brexit referendum result but also a reflection of listless policymaking in the UK in the wake of the global financial crisis. It has been an economy without purpose exacerbated by the dithering around its relationship with the EU. The equity market has suffered net selling by domestic institutions. The Investment Association reports monthly outflows from UK equity mutual funds since 2016.

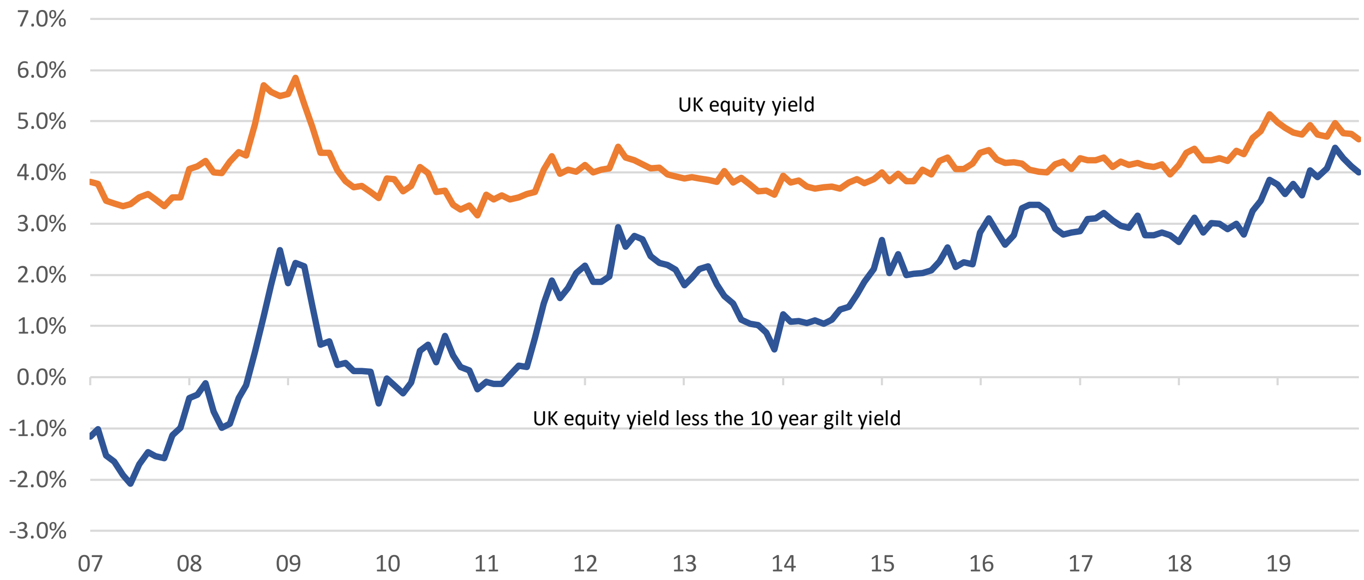
As we turn the year, some of the fog around the financial markets is clearing. The country has a majority government that will take the UK out of the EU. After years of austerity, the government is set to relax fiscal policy and pump prime growth through tax cuts and spending increases.

In our view, investors should focus on domestic plays probably through small/mid-cap indices such as the FTSE250. We expect returns from the equity market to be enhanced for foreign investors by a further rally in sterling against the dollar.

UK equities have one particular attraction at this point – yield. Yielding equities are not just attractive to portfolio managers but also to private equity investors. There have been several private equity deals where PE firms buy out high yielding equities.

The level of equity market yield is also quite remarkable relative to longer-term gilt yields. While off their high, UK equity yields are nearly 400bps higher than the ten-year gilt yield, close to the highest in twelve years.

Chart 2: UK equity dividend yields high and very high relative to gilts



Source: Bloomberg

Even with Brexit by the end of January, the problems of Brexit do not just go away. The next challenge is likely to be the trade deal discussions between the EU and the UK. The current plan is that the UK and EU will discuss a trade deal over the course of the next year with a deadline at the end of 2020. On the UK side, there will be pressure for the discussions to be concluded as quickly as possible. During the negotiations, the UK will still have to make contributions to the EU, allow freedom of movement of people and abide by the European Court of Justice framework.

The UK economy will have to re-establish its credentials in the post Brexit era. A good deal of damage has been done. The last five years have been lost to the Brexit debate. Consumers have been reticent to spend, companies have been even more reticent to invest, and the government has run tight fiscal policy. The next effect has been to reduce productivity growth to less than 0.75% from the 2.25% achieved before the Brexit issues. Fears over immigration and immigrants' right of abode has slowed the pace of the growth of the labour market.

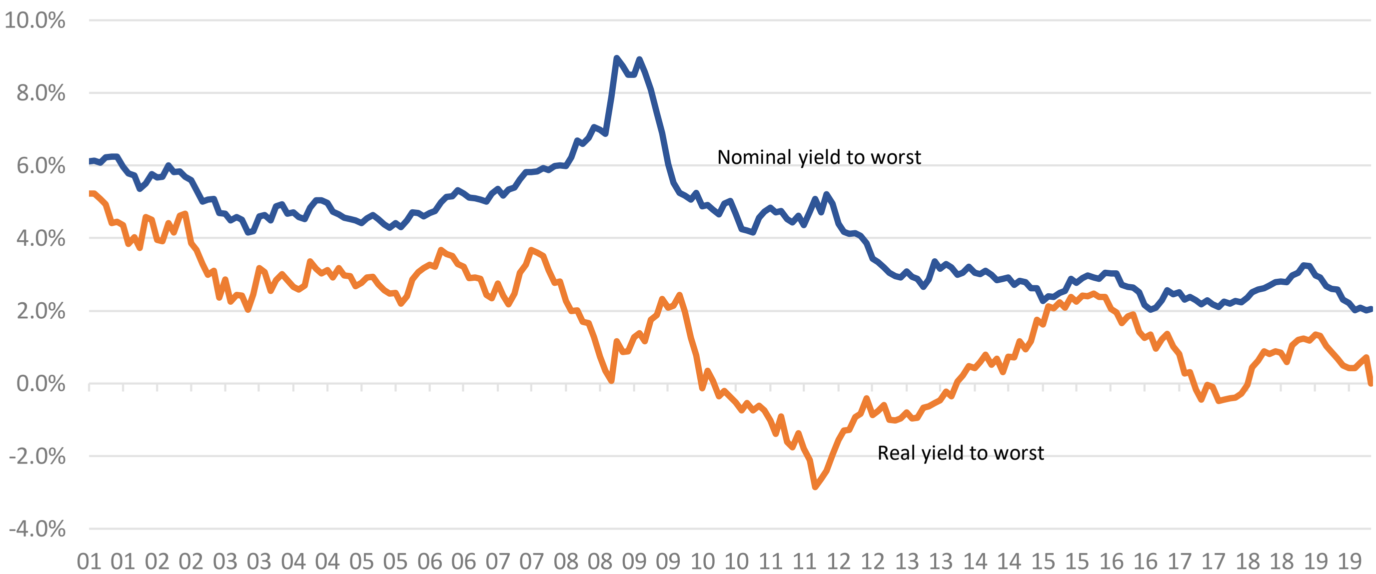
The Bank of England forecasts a gradual recovery in growth through 2020 and 2021 boosted by consumers, industry and government all increasing spending. Monetary policy is likely to remain accommodating. Inflation has been tracking around 2%, and yet policy rates are at 0.75%, leaving the economy supported by negative (accommodating) real interest rates.

Monetary policy should remain accommodating. An expected rise in the value of sterling should keep inflation in check. A rate change seems unlikely with risks to the upside or downside about in balance.

UK gilts should be marginally attractive to international investors if they believe that sterling can rebound still further. A 10-year gilt yield of 0.69% compares to negative yields on equivalent bonds issued in France and Germany. A rise in sterling would reinforce the returns from the asset class as it would push inflation down, and with-it gilt yields. The one factor that has some investors concerned is the decision by Moody's to put the UK on negative watch for a potential downgrade. However, they comment that "no matter what the outcome is of the general election Moody's sees widespread political pressures for higher expenditures with no clear plan to increase revenues to finance this spending". It seems disingenuous to pick on the UK; every government in the developed world is likely to adopt such a strategy. Also the EU is awash with low-yielding bonds with much worse metrics.

In a global context, UK corporate debt on the surface looks attractive, given the nominal yields of 2.0%. Most of the concerns about the asset class remain macro with investors concerned about the damage to the UK economy from Brexit. Clearly, the issues around Brexit will continue well beyond the actual day that the UK leaves the EU. Sterling-based investors should be encouraged that unlike in 2011/12, corporate debt does provide a real yield that will protect the investor's real wealth.

Chart 3: UK Corporate Debt yields – low in nominal terms, fair value in real terms



Source: Bloomberg

Disclaimer

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