MARTIN CURRIE
A Franklin Templeton Company

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NO MUDDLE IN THE MIDDLE!

With history set to repeat itself, why now is the time for UK mid-caps

- As interest rates fall, UK mid-cap stocks have predominately outperformed the wider UK stock market
- As the Bank of England (BoE) consider cutting rates, we believe it's time to consider an investment in mid-cap stocks
- Active management can help navigate the volatility between falling rates and economic recovery

Michael Browne
Chief Investment Officer

The underlying feeling in the equity markets is that good news is coming. The inverted yield curve was right in forecasting a recession, even if it was much milder than the BoE's Monetary Policy Committee (MPC) prediction[1]. We are on the cusp of falling interest rates again as central banks await the data that will allow them to start what looks like a long descent.

A lesson from history

Equity markets appear excited by both the prospect of rate cuts and of a much better backdrop in 2025.

So, what next? What has happened when the MPC cuts rates? It doesn't happen often, but we looked at the rate cutting cycles of 1992-94, 2000-03 and 2007-09 for guidance and if this feels from a long time ago, it was! Such was the legacy of the Global Financial Crisis (GFC).

Bank of England – base rate* September 1992 - August 2023

Source: Bank of England, December 2023. *Repo Rate (1994 – 2005) and Official Bank Rate (2006 – date) are interest rates. The Minimum Band 1 Dealing Rate are discount rates (1992-1994). 16.9.92, UK leaves the European Exchange Rate Mechanism. Base rate was raised to 12%, and planned to be 15% (with effect from 17.9.92; never implemented).

> We are on the cusp of falling interest rates again as central banks await the data that will allow them to start what looks like a long descent.

[1]Source: Bloomberg as at September 2022. An inverted yield curve shows that long-term interest rates are less than short-term interest rates. Sometimes referred to as a negative yield curve, the inverted curve has proven in the past to be a reliable indicator of a recession.

Negative markets?

In 1992-94 equities rose with the FTSE All Share rising a phenomenal 49%.

This was in sharp contrast to their performance since the Millenium. During the rate cut periods, they fell 27% in the dot.com bubble of 2000-03 and dropped 44% in the GFC[2].

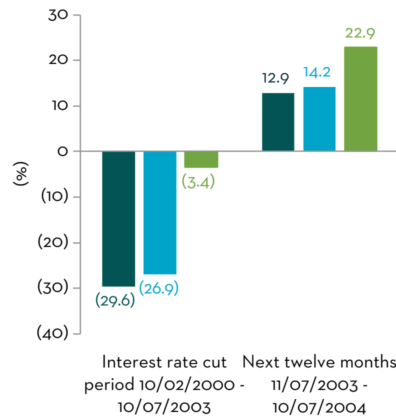
It's a different picture across the market cap spectrum

Underneath the FTSE All Share there are some surprises.

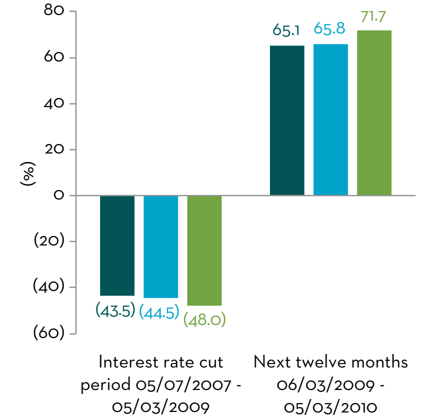
In 1992-94 whilst every part of the index rallied, the FTSE 100 was the worst performer, with the total return of 40%. But the FTSE 250 (ex-Investment Trusts)* rose an astonishing 87%. Halcyon days.

Period 1: Post the early 1990s recession

Period 2: dot.com bust



Period 3: Global Financial Crisis



Past performance is not a guide to future returns. The return may increase or decrease as a result of currency fluctuations.

Source: Morningstar over periods shown. Performance of FTSE 100, FTSE All-Share and FTSE 250 (ex-Investment Trust) shown. Performance in £.

[2]Source: Morningstar. Periods shown are 17/09/1992 - 16/09/1994, 10/02/2000 - 10/07/2003 and 05/07/2009 - 05/03/2009.

*References to FTSE 250 throughout the remainder of the document are to the ex-Investment Trust index.

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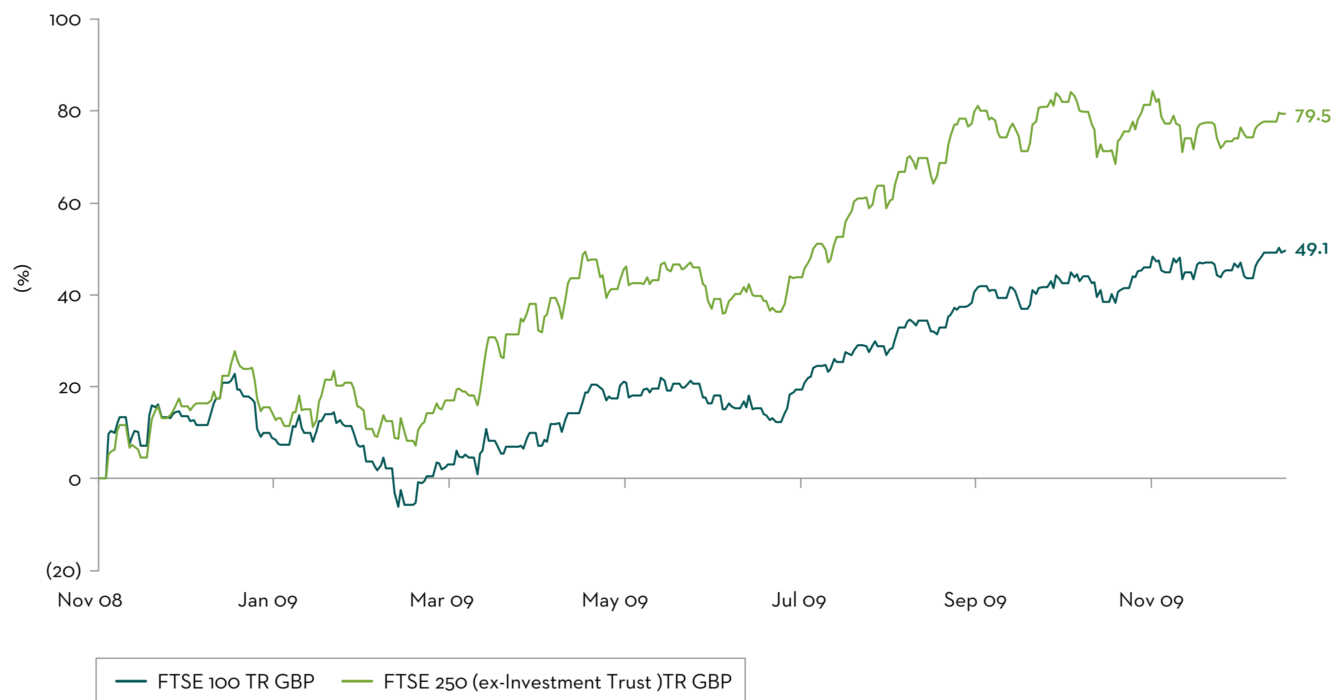
But what of returns in the negative post-Millenium period? In 2000-03 the FTSE 100 total return was a horrible -30%, however the FTSE 250 outperformed, down a "mere" 3%. This was the markets' "Fright Night".

The GFC saw further losses as rates were cut, markets fell and the FTSE 100 was down 43%. The FTSE 250 was worst affected down 48% over the whole period. **But**, this doesn't show the whole picture[3]. If we look at the chart below, the FTSE 250 recovered earlier, hitting the market low in November 2008, and recovering quicker than the FTSE 100 in the subsequent 12 months.

So, in periods of economic stress, we believe it is time to start looking at UK mid-caps.

Mid-caps recovered quicker post GFC

FTSE 100 versus FTSE 250: November 2008 - December 2009



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Source: Morningstar. Returns shown from 21 November 2008, this was the market low for the FTSE 250 following the GFC. Performance of FTSE 100 and FTSE 250 (ex-Investment Trust) shown. Performance in £.

Mid-caps have led in the recovery

After the dust settles, what is next?

What happened in the year after these rate cuts had ended? UK equities made positive returns. The post GFC wild ride saw increases of 60% + for all the indices, but mid-caps were once again the winner with a 71% total return.

Life was a little more sedate in 2003-04 when the FTSE 100 rose by 13%. But again the more growth orientated FTSE 250, consisting companies with greater exposure to the domestic economy was arguably better positioned into the recovery: and it returned 23%.

30 years ago, in 1994-95 is the only time when the FTSE 250 does not keep its crown despite returning a respectable 7.5%. The FTSE 100 produced its only gold medal finish, a podium topping return of 21%.

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[3]Source: Morningstar, 17/06/1994 – 16/09/1995, 11/07/2003 – 10/07/2004 and 06/03/2009 – 05/03/2010. Performance of FTSE 100, FTSE All-Share, FTSE 250 (ex-Investment Trust) shown.

Active management can help navigate volatility

We've made the case that when BoE is cutting rates is the time to consider investing in UK mid-caps, but investors need to be aware of significant sector rotations and volatility.

It is during these periods of strain and volatility when active management can help.

For example, in the 1992-94 period, healthcare went from worst to best in the subsequent recovery. The opposite was true for basic materials. In wake of the 'dot.bust', industrials went from being from one of the weakest sectors to leaders. Likewise, in the GFC, Healthcare and Utilities were relatively the strongest, but became the worst performers in the recovery, while financials and basic materials powered back to the top (please see appendix).

When economic conditions change, it can lead to a changeable market backdrop. An active approach focused on the companies themselves can capture the potential of the mid-cap space – and limit exposure to weaker performing areas to help navigate the volatility. While limiting exposure to weaker performing areas to help navigate the volatility.

Is there a sea change coming for UK Equities as we enter a period of sustained rate decreases? Mid-caps have been overlooked, so is this time to consider looking at the FTSE 250?

Appendix

All change at the top

FTSE All-Share top and bottom three performers

Sept-92 – Sept-94	%	Sept-94 – Sept -95	%	Feb-00 – Jul-03	%	Jul-03 – Jul -04	%	Jul-07 – Mar-09	%	Mar-09 – Mar -10	%
Top three sectors				Top three sectors				Top three sectors			
Financials	72.6	Healthcare	23.6	Utilities	10.2	Industrials	23.9	Healthcare	10.2	Basic Materials	23.9
Basic Materials	64.3	Financials	18.6	Basic Materials	6.7	Cons. Stpls	22.0	Utilities	6.7	Financials	22.0
Energy	59.4	Telecoms	15.3	Healthcare	0.2	Energy	20.8	Energy	0.2	Technology	20.8
Bottom three sectors				Bottom three sectors				Bottom three sectors			
Technology	29.8	Industrials	7.0	Industrials	(45.7)	Healthcare	8.0	Cons. Disc	(45.7)	Healthcare	8.0
Telecoms	22.1	Cons. Stpls	6.3	Telecoms	(69.3)	Telecoms	6.0	Basic Materials	(69.3)	Telecoms	6.0
Healthcare	(2.0)	Basic Materials	(0.9)	Technology	(93.2)	Financials	4.1	Financials	(93.2)	Utilities	4.1

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Source: Morningstar over periods shown. Performance of FTSE All-Share sectors shown. Performance in £.

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- Smaller companies may be riskier and their shares may be less liquid than larger companies, meaning that their share price may be more volatile.

MARTIN CURRIE
A Franklin Templeton Company

Martin Currie Investment Management Limited, registered in Scotland (no SC066107), 2nd Floor, 5 Morrison Street, Edinburgh EH3 8BH

Tel: (44) 131 229 5252 Fax: (44) 131 228 5959 **www.martincurrie.com**

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