# UK EQUITIES

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# 2023: SIZING THE SLOWDOWN

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# Macroeconomic trends

**If 2023 is anything like 2022 then the UK may be in for a bumpy ride – inflation surged, interest rates soared, currencies swung, and the UK government clashed. But for us, one of the main challenges ahead for UK equities can be succinctly summarised: Will inflation begin to moderate as economic activity wanes?**

Indeed, macroeconomic headwinds remain. Investors remain hopeful that UK inflation has peaked, but continue to balance the prospect of surging prices with the rising cost of debt. Whilst the notion of transitory inflation has largely been disproven through 2022 as CPI data remained elevated, some factors are undoubtedly considered stickier than others. Frictional supply chain costs as the world emerges from the Covid-19 pandemic are already beginning to subside, but secular impacts on inflation such as globalisation and demographic change should not be overlooked. Thus, as the prospect of a technical recession is increasingly considered within the UK, the inflationary backdrop will be key to shaping its severity.

Fortunately, an easing of global inflationary pressures is beginning to unfold. Data released in November showed that US consumer prices had risen by 7.7% over the past 12 months, falling short of the 8% estimates. In December, China announced a reversal of key zero-covid policies after weeks of civil unrest. And indeed, global commodity prices have moderated since their extreme volatility earlier in the year. As inflation looks like it is peaking in the UK, the news of a cooling backdrop in the US has helped drive a re-rating of equities and a pullback in government bond yields domestically. Inflation in the UK is expected to continue to fall back from highs over the next few months although the impact from changes in consumer energy support policy will likely be a key determinant as to how this plays out.

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Assuming an easing in headline inflation figures, we expect the central bank to be nearing a peak in its monetary tightening programme. The Bank of England recently made steps to reduce its balance sheet, embarking on a programme of quantitative tightening in Q4 2022. Higher interest rates mean higher financing costs for corporations and consumers. Combined with the tighter flow of liquidity, this may present some short term challenges for UK equities whilst the positive effect of moderating inflation takes its time to embed into supply/demand habits. Key economic concerns are the length and depth of this inevitable slowdown – investors remain closely focussed on the central bank response as the risk of a policy mistake is increased.

As the short-lived "Trussonomics" regime unwinds, the central bank at least has some relative market stability in order to play its best hand. Market inferred peak base rates have moderated by over 100bps since the (not so) mini budget was announced earlier in 2022. The perception of a safe pair of economic hands in the Sunak/Hunt duo has improved sentiment to the UK into 2023. With gilt yields stabilised, and an economic catastrophe seemingly circumnavigated, relatively benign markets will be well received by the Bank of England as they execute monetary policy over the coming months.

One must be reminded that not all consumers are proportionately impacted by the enduring cost-of-living crisis consuming the UK. The UK remains in a position of strength from the perspective of excess household savings – savings accumulated throughout the Covid-19 pandemic are now earning an attractive rate of interest income. Furthermore, the UK mortgage market has evolved since 2005 – the last meaningful period of central bank tightening – when 70% of mortgages were financed on variable terms. Today, only 14% of the UK mortgage market is financed with variable rates. The extent of fixed rate mortgage financing and indeed outright home ownership within the UK should continue to partially offset the cost-of-living burden instilled by soaring consumer energy bills. But we do expect a degree of consumer caution to remain until broader costs begin to moderate.

The labour market has continued to demonstrate resilience throughout this period of volatility. Although latest data indicates that unemployment rose to 3.7% in Q3 2022 and that vacancies dropped for the fifth consecutive quarter, one must be reminded that the labour market remains buoyant relative to historic levels. Signals such as a falling labour inactivity rate are indicative of employment re-engagement particularly amid the over 50s, as soaring costs prompt 'early retirees' back into employment. Thus, we do not expect a surge in the unemployment rate, which should provide some protection against the risk of a prolonged, severe recession.

Despite the relative strength of the UK equity market throughout a period of heightened volatility, investors remain mindful of the value that remains. The UK market is trading on a forward P/E ratio of around 10x – 20% beneath its 15-year median – and offers a dividend yield of 4%. Contrasting with the US, trading on a forward P/E ratio of around 18x – 12% above its 15-year median – and a dividend yield of 1.7%, UK equities look cheap. An economic slowdown is widely anticipated across global markets and as such, should investors continue to address the notion – is this bad news already priced in to UK assets? The UK market remains forward-looking, and in our mind is pricing in an excess of pessimism given where valuations are today. Thus, the attractiveness of the region is enhanced to investors as evidenced by ongoing M&A activity, as indeed are the prospects for continued resilience through 2023 and beyond.

## Small and mid cap UK equities

UK small-and-mid (SMid) cap has been an asset class that has been hugely out of favour over the last 12 months, leading to significant underperformance versus the wider UK equity market. Yet, we believe that the prospects for many companies in this area of the market remain much brighter than the investor value inferred in today's constricted valuation multiples. Amongst the current barrage of UK negativity, short termism and ongoing selling pressure, opportunities are emerging that set the stage for a recovery in 2023.

The issues that the UK economy is facing are real. However, we believe that next year we are likely to see interest rate expectations peaking, inflation falling, and a manageable trading downturn. We are increasingly enthused by some of the compelling opportunities that we observe within the Smid cap market which lays the foundation for future returns.

We do expect earnings to come under pressure in the short term, but the degree of valuation discount observed assumes a wide margin of safety. Currently, Smid cap companies are trading towards the lower end of their historical valuation range, along with attractive dividend and free cash flow yields. Many businesses are entering this well signalled downturn with significant balance sheet strength, and this enables them to continue to invest and take advantage of the opportunities which will inevitably arise. After exiting a disruptive pandemic period, not only in sound financial shape, but also operationally and competitively, we believe that many businesses and their prospects have actually been significantly strengthened. We believe that the flexibility, strength and resilience engrained in many Smid cap companies is being underestimated. Thus, the prospects of the UK Smid cap market are enhanced, where the risk/reward opportunity is beginning to look compelling over the long term.

# Large cap UK equities

UK large cap businesses kept the UK equity market afloat through 2022, as many other developed markets suffered at the hands of an inflationary resurgence. As humanitarian tragedy and geopolitical unrest reverberate across Europe, investors continue to shelter in recognised safe havens; this has led to an encouraging period of attractive relative returns for the FTSE 100 index.

**Looking forward into 2023 and the FTSE 100 looks well positioned to continue to demonstrate resiliency in the face of global headwinds. Of course, investors are presented with many unknowns...**

**Will an enduring economic recession engulf the market?** The FTSE 100 is comprised of some of the highest quality, cash generative businesses listed within the UK. These businesses are well capitalised and many raised equity where needed during the pandemic, thus start from a position of strength relative to speculative/higher leveraged alternatives. Defensive havens remain prevalent – tobacco, pharmaceutical and utility businesses are demonstrably less sensitive to economic cyclicality.

**Will inflation persist?** The FTSE 100 is constructed by many companies that exhibit innate inflationary resistance. Real asset businesses such as oil and gas majors and metal miners account for over 20% of the index. Whilst some may argue that their fate is in the hands of global commodity volatility, most would concur that these remain an effective hedge against soaring inflation. Furthermore, regulated businesses such as utility companies have a reliable mechanism for protecting their revenue streams from inflation.

**Will interest rates settle at 3-4%?** Inherent interest rate protection is prevalent within the index. Multinational banks are now beginning to earn material interest income margins from their lending, after over a decade of frankly negligible rates. Furthermore, long term liabilities for life assurance businesses are now discounted at a higher rate, reducing the value of their liabilities in today's terms. The UK market has lagged the US market for some time due to the notable omission of high-growth, pre-profit stocks where the terminal value is discounted from many years into the future. These businesses were able to thrive in a zero-rate environment. But as rising interest rates inflate the discount rate used for equity valuations, these high-growth stocks are disproportionately sensitive to hawkish policy relative to the established, profitable, and mature businesses prominent within the FTSE 100 index.

**Should investors not know what steps to take next.** Then in our mind the notion of being "paid to wait" is an attractive concept amid the UK large cap market. The mature nature of the UK large cap landscape instils a degree of resilience in the propensity of businesses to return capital to shareholders. This may be derived from reliable dividend income – the FTSE 100 is a natural hunting ground for income, yielding over 4.5% - or indeed the opportunity to benefit from share buybacks which remain commonplace, particularly amongst businesses generating windfall profits.

Source: Bloomberg as at 16/12/2022 unless otherwise stated.

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# Important information



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