UK EQUITIES

2024 Outlook

MARTIN CURRIE
A Franklin Templeton Company

DECEMBER 2023 For institutional, professional and wholesale investors only.

Signs that the storm is over...

Reasons to be cheerful about UK equities

We are entering a new post-Covid regime. Inflation and rates are higher than in recent years and both are set to moderate the significance of market returns as central banks pivot to fight fires regionally rather than bolster the wider, global economy.

Stock selection is increasingly important to an overall return profile, and the opportunities for skilled, high conviction managers to add active returns will significantly outweigh the opportunity for market returns.

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Turbulent times

A quick look in the rear-view mirror and the detritus of recent times isn't far behind us. As a nation we've experienced significant turbulence; a divisive split from the European Union, rocked capital markets with the short-lived "Trussonomics" administration, a cost-of-living crisis, industrial unrest at multi-decade highs, and a well-publicised and controversial North/South High Speed 2 (HS2) railway network that still appears just out of reach.

The abandonment of HS2 is estimated to save the government £36bn, and with tax revenues forecast to rise to just shy of 38% of GDP by 2028[1], could a dose of fiscal stimulus be on the cards to ignite the UK's growth engine? Probably not. Pro-growth measures during a period of high inflation will undoubtedly pique the interest of the Bank of England's Monetary Policy Committee (MPC), and a push/pull between fiscal and monetary policy will not help the credibility of an increasingly ill-favoured conservative government.

With a general election looming and a shift in power looking ever-more likely, Labour party leader, Sir Keir Starmer, has already committed to not raising income taxes or VAT. But, with the general public encouraging investment in public services, and parliament still haunted by the ramifications of unfunded spending some 12 months ago, something has to give. As the UK Consumer Price Index (CPI) falls and base rates looked to have peaked in this cycle, there may be some comfort for UK-based corporates and consumers alike, that the nadir of the squeeze is behind us.

No plain sailing

There is no denying that challenges lie ahead. Interest rates are higher than they have been in decades. The full effect on the consumer is likely to drip through in the coming years as fixed rate mortgages refinance. And economic signals are frequently diverging both domestically and overseas too; this is particularly relevant to the swathes of the UK market generating international earnings.

Geopolitically, we keep a close eye on the tragedies unfolding in the Middle East. Humanitarian welfare remains a priority. Although trivial in comparison, knock on impacts will undoubtedly occur. An escalation of the Israel/Hamas conflict into Iran, Lebanon, or involving the US could result in a supply-driven oil price rally to around US$150/bbl. This could lead to a period of supernormal profits for UK-listed oil majors, but the impact on consumer budgets and corporate expenses will be profound.

[1]Source: Office of Budget Responsibility, November 2023.

Until now, the impact of government debt on interest payments has been moderated by the decline in market interest rates. This looks set to change. Chancellor, Jeremy Hunt, recently warned that the government needs to locate an extra £23bn to service its debt compared with March 2023, due to the recent gilt sell-off. Forecasts predict that this could mean the UK will allocate 3% of Gross Domestic Product (GDP) solely to paying its outstanding debt obligations over the coming years, versus 1% two years ago.

UK valuations are already well below their long-term average, and this is compounded as one descends the capitalisation spectrum. To illustrate, the FTSE Small Cap (ex losses) now yields a premium to the FTSE 250 (ex losses), which itself delivers a premium versus the FTSE 100[2]. Many of these businesses are in sound financial positions, so when stable dividends meet irrational selling pressure, mathematical oddities can occur leaving investors feeling all at sea.

Is the tide turning?

Considering our base case environment where rates are higher for longer, supportive statistics do exist – corporate debt and deposits as a percentage of GDP remain historically attractive, and as quality focussed managers this only broadens the universe that we are able to search in. By navigating portfolio construction in a core, style agnostic manner we mitigate extreme style risk – high growth portfolios are set to encounter challenges in an extended period of elevated interest rates.

The opportunity that lower valuations present is extreme, enabling both income and growth to thrive. Dividends are such an important and integral component of UK total returns. And we remain of the view that companies in quality financial positions are set to outperform given the propensity to weather choppy market environments whilst continuing to return capital to shareholders. We think that areas such as tobacco, oil and gas, pharmaceuticals, and miners are all set to benefit from this trend, particularly in a risk-off environment, which bodes well for the UK Blue-chip index.

Reasons to be cheerful

We view stable-dovish policy as a key catalyst that could spark a rebound in the recently observed small and mid-cap underperformance, particularly as these businesses have gone on to materially outperform in the immediate periods following a peak in interest rates. With UK small and mid-cap earnings forecast to grow by over 22% in 2024[2], the prospects of upgrades and re-ratings are increasingly considered. Areas such as the housebuilders have fared very well in 2023 despite the hawkish rhetoric – now with a dovish tailwind. The outlook is bright, and we believe there is scope for continued outperformance through 2024.

[2]Source: Bloomberg as of 31 October 2023.

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