Outlook on

UK Equities

Jan 2024

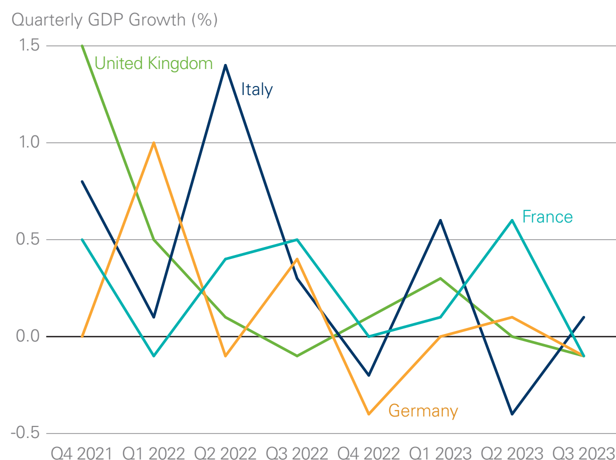
Summary

- Higher rates have brought UK economic growth to a halt in the past two quarters, but falling inflation, rising real incomes, and a relatively resilient consumer mean the gloom should not be overdone.
- In common with other developed stock markets, excitement about the scope for interest rate cuts this year has generated exuberance in UK equities in recent weeks, leaving share prices vulnerable to a potential pullback should rate expectations recalibrate to more realistic levels.
- The sickly state of the UK stock market is finally commanding the attention of policymakers. With a pipeline of possible structural reforms and the potential new Labour government committed to harnessing the pension sector to boost domestic investment, could the despair surrounding UK equities finally begin to lift in 2024?

A new year brings a familiar challenge for the UK economy: how to achieve growth. Revised data, released before Christmas, which downgraded UK GDP growth over Q2 and Q3 2023 to 0% and -0.1%, respectively, from earlier estimates of +0.2% and 0%, point to a flatlining economy. The UK is by no means unique in this respect. The German, French, and Italian economies are all struggling for momentum in the face of higher interest rates (Exhibit 1).

But perhaps a slightly more glass-half-full interpretation is warranted. Having absorbed 14 interest rate hikes since December 2021, taking the base rate from 0.10% to 5.25%, the UK economy has arguably proved far more resilient than many may have expected, even allowing for the likelihood that the impact of rate rises has not yet been felt.

Exhibit 1
Low Economic Growth Is Not Just a UK Problem



As at 31 December 2023

Past performance is not a reliable indicator of future returns and does not guarantee future results.

Source: FactSet

Adding to the reasons to be (relatively) cheerful—as one feels obliged to be in the early days of a new calendar year—there has been unexpectedly good news on the inflation front. November's headline inflation print of 3.9% was well below economists' forecasts of 4.4%, while core inflation (which strips out volatile food and energy prices) dipped to 5.1%, its lowest level since January 2022 and again a much bigger-than-expected fall.

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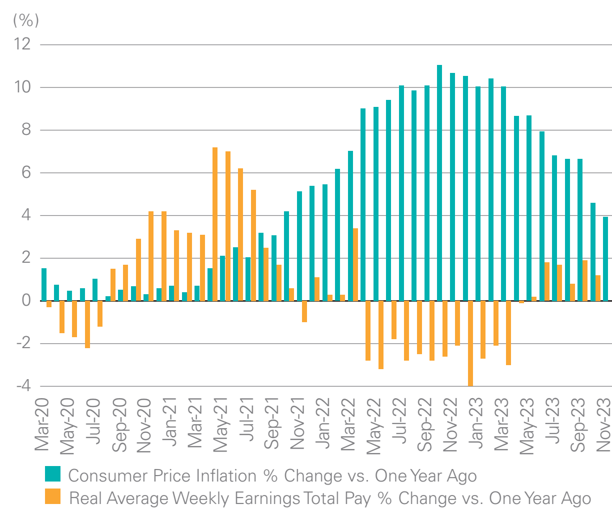
Consider other factors, too, and the overall picture of the UK economy that emerges is arguably not as acutely gloomy as much media coverage may suggest: real incomes are creeping up again (Exhibit 2) having previously been eroded by high inflation—average weekly earnings including bonuses for the three months to September 2023 increased by 7.2% year-on-year, well above the inflation rate, while a 10% hike in the minimum wage is coming in April; unemployment remains low; consumer confidence is stable, albeit muted; savers are enjoying higher savings rates; the housing market has largely weathered the interest rate storm and should benefit from the recent easing in fixed-rate mortgage pricing; and the slow post-Brexit recovery in business investment should be further boosted from the full expensing of capital investment being made permanent.

Exhibit 2
UK Real Incomes Are Rising



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Source: FactSet, Office for National Statistics

Rate Cut Hopes Are Up as Inflation's Grip Weakens

The biggest global economic story currently, of course, is easing inflation and the implications for interest rates. As a caveat, geopolitical shocks could yet upend the falling inflation narrative and reignite the dying inflationary embers—for example, an escalation of the Israel/Palestine conflict in the Middle East, including greater disruption to shipping routes through the region, as seen in the Red Sea in recent days. Currently, though, inflation's grip on the global economy seems to have been broken.

Fading inflation pressures across the world have put rate cuts firmly on the agenda in 2024, which was the source of marked seasonal joy for investors in December. Federal Reserve (Fed) Chair Powell's comment that the US benchmark rate was now "likely at or near its peak for this tightening cycle", along with the Fed's "dot plot" chart that showed most Fed officials expected the fed funds rate to sit at 4.5%–4.75% by the end of 2024, implying cuts this year, triggered a sharp end-of-year rally in both equity and bond markets: the S&P 500 Index hit its highest level since January 2022, close to its highest ever level, while the FTSE 100 Index climbed to a seven-month peak.

Frothy Markets

While there are reasons to believe the economic outcome for the UK in 2024 may be a little better than expected, we do think near-term caution is merited over these equity market levels. At the risk of being labelled party poopers, we believe investors have probably got ahead of themselves in this journey, particularly on the question of interest rate cuts. Central banks are likely to be cautious about declaring victory over inflation and will presumably take their time in adjusting policy. Indeed, we believe Bank of England Governor Bailey's December comments that rates will need to be kept "high for an extended period of time" should be taken at face value. Therefore, there is significant potential for the current stock market optimism, which has built very quickly, to evaporate just as speedily.

Not 1997 Redux

Switching from economics, politics will take centre stage in 2024. This year will almost definitely herald another general election in the UK—as it will in many other parts of the world, including the US, India, and across Europe—given the Conservatives must go to the polls by January 2025 at the latest.

Readers over a certain age, or anyone who has watched the final few episodes of the Netflix hit "The Crown", will recall the images from 1997 when a fresh-faced and victorious Tony Blair swept into Downing Street to the sounds of cheers and the D:Ream song 'Things Can Only Get Better'. As in 1997, the Labour Party, led by a North London lawyer, is the odds-on favourite to form a majority government and defeat a Conservative Party that has held power for well over a decade and, to its critics, could be described as running out of steam.

While there may be political echoes with 1997, from an economic perspective the UK is in a much different place. Back then Britain's national debt stood at 37% of GDP compared to 97% today, while the economy was motoring along—annual GDP growth was 4.9% in 1997, a rate of expansion that would be unimaginable now.[1] The newly elected Labour government of 1997 was able to increase spending on public services, but strained state finances and a low-growth economy are likely to crimp the ambitions of any new government this year. Nevertheless, the high likelihood of a decisive Labour Party victory on a moderate policy platform offers the prospect of political stability and predictability (something that might not necessarily be said for the US presidential election later this year). It could well prove to be a market-clearing event, given investors have been focused on the implications of a change of government for some time. As a side note, the looming general election and current poor polling from the Conservative Party suggest we can likely expect some voter-friendly moves on personal tax rates and housing from the Sunak government in March's budget.

Fresh Hopes for UK Equities?

The travails of the UK stock market have been well documented over the past 12 months. One statistic among many that underlines the shrivelled status of UK equities is that pension funds and insurance companies owned 48% of the UK stock market in 1997; today, they own just 4%.[2] Nonetheless, a new year musters new hope. In that vein, we draw two positives.

First, it is almost impossible for allocations to UK equities to go any lower—to channel that D:Ream Labour Party anthem, things can only get better.

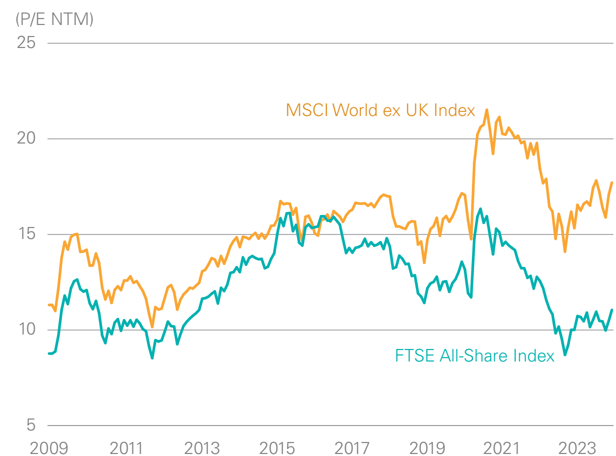
Second, the dismal state of the UK market, including the dwindling number of IPOs, is belatedly getting the attention it deserves. Key areas of reform proposed lately have included, amongst others, the Mansion House reforms, part of which are designed to enhance the attraction of the UK as a listing destination, the Investment Research Review, aimed at supporting research on small and mid-cap companies and boosting access for retail investors, and listing and prospectus reforms.

Of course, these mooted changes only address the supply side of the problem. Remedies for boosting demand—for example, increasing ISA or SIPP allowances while mandating a specific percentage to be invested in UK assets as a quid pro quo for the improved tax benefits—remain absent. Nonetheless, we draw encouragement from the focus UK equities are finally receiving from regulators, trade bodies, and government. Furthermore, a change of administration may also provide added impetus in the quest to revive the moribund UK market. Encouragingly, the Labour Party, under shadow chancellor Rachel Reeves, has expressed its commitment to harnessing the UK pension sector to drive investment in the domestic economy and capital markets.

In summary, there is opportunity for the UK economy to surprise on the upside in 2024. But it does not need to do so for UK equities to make progress this year, even if the exuberance of December leaves the UK market, along with global stock markets, vulnerable to a near-term pullback.

Acknowledging the dangers of sounding like a broken record, we reiterate that the pessimism surrounding UK equities is fully priced in. Unlike the historically expensive and narrowly led US market, UK stocks remain cheap across the board, in our view, both versus history and their international counterparts (Exhibit 3). Furthermore, with UK interest rates likely to remain high, in our opinion, the interest rate differential should support a stronger pound. This may pique the interest of domestic UK investors previously attracted elsewhere, most notably the US market. Finally, UK plc's under-priced assets are unlikely to be ignored by competitors, domestic and foreign, or private equity firms. M&A activity involving UK companies picked up in the final quarter of 2023 amid signs of an improving rate outlook. This may well continue into 2024. The 50% average premium seen in last year's deals merely underlines the undervalued nature of UK stocks.[3] Even if investors still fail to recognise this value, trades buyers and private equity may well continue to do so.

Exhibit 3
UK Equity Valuations versus International Equity Markets



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Source: FactSet

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Notes

1 Source: Office for National Statistics

2 Source: Office for National Statistics, 'Ownership of UK quoted shares: 2022', 4 December 2023

3 Source: Peel Hunt Research, 'M&A', 3 January 2024

Important Information

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