

# UK equities: On the brink of a new era

Get ready for a shift in UK market leadership, says Stephen Message, manager of the L&G UK Equity Income Fund



Stephen Message is a fund manager on the Global Equity Income team within LGIM Active Equities and manages the L&G UK Equity Income fund. Stephen is a CFA charterholder and has a MEng in Aeronautical Engineering from Imperial College London.



The UK equity market has recently danced to a beat set by two types of stock: so-called 'bond proxies' and 'dollar earners.' We believe this rhythm is set to be drowned out by a very different sound – and are positioning accordingly.

The depreciation in sterling triggered by the EU referendum provided a significant tailwind for those companies that derive the majority of their earnings from overseas, particularly the US, given the scale of the pound's decline versus the US dollar. Overnight, their profits rose in value for sterling-based investors.

Yet ever since it hit an intraday low of 1.18 against the greenback in October 2016, sterling has mounted an impressive recovery. This has occurred as the risk of a 'hard' exit from the EU, without a deal in place, appears to have ebbed; the economy has held up better than initially expected; and the Bank of England (BoE) has reversed its final spasm of monetary stimulus.

As a result, that tailwind is set to become a headwind, with US dollar earnings declining in value for UK investors.

## The pound rebounds versus the dollar



Source: Bloomberg, as at 29 January 2018

## HAWKISH NOISES

As the BoE cut interest rates to yet another historic low in the wake of the referendum, and conducted other stimulus measures, those stocks that displayed similar characteristics to bonds received a large boost. UK and global developed-market debt surged, as the rates on offer plunged to new, frequently negative troughs, pushing investors to hunt even harder for yield. Unsurprisingly, stocks that paid regular and often steadily increasing dividends – consumer goods, for example – appeared highly attractive.

This supportive backdrop has begun to unravel, however, as major central banks scale back the extraordinary monetary accommodation they have put in place since the global financial crisis. The US Federal Reserve has been the most aggressive in doing so, but the BoE has also raised interest rates – in what we believe is unlikely to be a ‘one and done’ move.

Elsewhere, investor focus on the European Central Bank has moved from when the monetary guardian might halt its asset purchases to when it might raise rates. Some hawkish noises have even been sensed at the Bank of Japan. Bond markets, and bond proxies, have struggled in this context.

In light of these changes, we prefer to have greater exposure to UK domestic earners while holding an underweight stance on bond proxies. Our view on utility stocks, in the latter group, is reinforced by a darkening regulatory and political outlook for the sector.

## FAVoured FINANCIALS

Two other, related factors that have weighed on bond markets are also likely to shape the future contours of the UK equity market. These are global growth, which appears increasingly synchronised, and developed-market inflation, a quickening of which may be underpriced by investors.

Taken together, these factors imply long-end bond yields may rise further, in a boon to financial stocks such as banks, which tend to borrow in short-term markets and

lend in long-term ones. Insurance companies, which are forced to load up on these types of bonds, are also likely to benefit. It is for this reason that we favour an overweight position in financials.

A key driver of inflation has been the rebound in global commodity prices from a trough in early 2016. This has put companies in the basic materials sector – another area we expect to outperform – in a sweet spot.

In response to the end of the commodities ‘super-cycle,’ many materials companies embarked upon large cost-cutting exercises, curtailing capital expenditure and selling off non-core assets. These efforts, alongside the recovery in commodity prices, have produced a materially positive impact on earnings. We see scope for this trend to run further.

## THE ‘B’ WORD

Consumer cyclicals constitute another previously out-of-favour area that, in our view, may grow in appeal. These stocks tend to be more focused on the domestic UK market; as such, they are pricing in a lot of bad news regarding the eventual outcome of the Brexit talks.

We certainly know no more than any other keen observer of the tortuous negotiations as to what the UK-EU relationship will look like in five or ten years from now. But we do believe that the equity market may be factoring in more bad news for UK-orientated retail, leisure and media stocks over Brexit than the currency market is for sterling – whose recent resilience is likely to benefit importers. This apparent mispricing is the rationale underpinning our constructive stance on consumer services.

While the catalysts for these shifts in market leadership are already in place, we expect the process to play out over the next few years; volatility is likely over the near term, not least due to the lack of clarity surrounding Brexit. But as long-term investors, we are acting now to help our clients accrue the potential benefits from the outset of a new era for UK equities.

---

### Important Notice

The term “LGIM” or “we” in this document refers to Legal & General Investment Management (Holdings) Limited and its subsidiaries. Legal & General Investment Management Asia Limited (“LGIM Asia Ltd”) is a subsidiary of Legal & General Investment Management (Holdings) Limited. This material has not been reviewed by the SFC and is provided to you on the basis that you are a Professional Investor as defined in the Securities and Futures Ordinance (Cap.571) (the “Ordinance”) and subsidiary legislation. By accepting this material you acknowledge and agree that this material is provided for your use only and that you will not distribute or otherwise make this material available to a person who is not a Professional Investor as defined in the Ordinance.

This material is issued by LGIM Asia Ltd, a Licensed Corporation (CE Number: BBB488) regulated by the Hong Kong Securities and Futures Commission (“SFC”) to conduct Type 1 (Dealing in Securities), Type 2 (Dealing in Futures Contracts) and Type 9 (Asset Management) regulated activities in Hong Kong. The registered address of LGIM Asia Ltd is Unit 5111-12, Level 51, The Center, 99 Queen’s Road Central, Hong Kong.

The contents of this document may not be reproduced or further distributed to any person or entity, whether in whole or in part, for any purpose. All non-authorised reproduction or use of this document will be the responsibility of the user and may lead to legal proceedings. The material contained in this document is for general Information purposes only and does not constitute advice or a recommendation to buy or sell investments. Some of the statements contained in this document may be considered forward looking statements which provide current expectations or forecasts of future events. Such forward looking statements are not guarantees of future performance or events and involve risks and uncertainties. Actual results may differ materially from those described in such forward-looking statements as a result of various factors. We do not undertake any obligation to update the forward-looking statements contained herein, or to update the reasons why actual results could differ from those projected in the forward-looking statements. This document has no contractual value and is not by any means intended as a solicitation, nor a recommendation for the purchase or sale of any financial instrument in any jurisdiction in which such an offer is not lawful. The views expressed in this document by any contributor are not necessarily those of the LGIM Asia Ltd affiliates and LGIM Asia Ltd affiliates may or may not have acted upon them.

The value of investments and the income from them can go down as well as up and investors may not get back the amount originally invested. Past performance contained in this document is not a reliable indicator of future performance whilst any forecast, projections and simulations contained herein should not be relied upon as an indication of future results. Where overseas investments are held the rate of currency exchange may cause the value of such investments to go down as well as up.

We accept no responsibility for the accuracy and/or completeness of any third party information obtained from sources we believe to be reliable but which have not been independently verified.

Legal & General Investment Management Asia Limited, Unit 5111-12, Level 51, The Center, 99 Queen’s Road Central, Central, Hong Kong.  
www.lgim.com.

M1601\_ASIA

---