# 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

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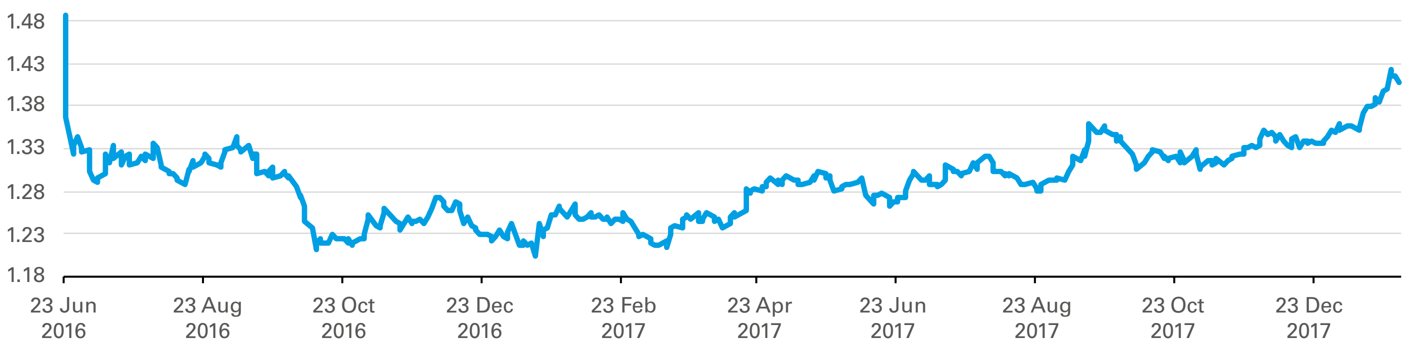
The UK equity market has recently danced to a beat set by two types of stock: so-called 'bond proxies' and 'dollar earners.' We believe this rhythm is set to be drowned out by a very different sound – and are positioning accordingly.

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 under-priced 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**