London Calling at Last?

UK Equities

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In Focus

Of all the major global stock markets, perhaps only China's is currently more unloved than the UK's. Out of favour with both retail and institutional investors alike—UK equity funds have racked up 34 consecutive months of net outflows, according to fund data group Calastone, while UK banks and insurers now own just 4% of the UK stock market (down from over 50%)—investing in UK stocks has become something of a fringe pursuit.

But at a time when allocating to the 'Magnificent Seven' US large-cap technology stocks continues to be the most crowded trade,[1] with a collective market capitalisation for this high-flying set that would make it the world's second-largest stock market,[2] we believe it is worth restating the case for a market that is still the third-largest country constituent within the MSCI World Index and the ninth largest market by market capitalisation, even after almost a decade in the doldrums. The return of interest-rate volatility after rate-tightening across developed and emerging economies and associated sharp movements in currencies have reminded many investors of the potential for adding value through foreign exchange (FX).

- After years of outflows and dwindling investor interest, the UK equity market may be about to undergo significant reform, while new pockets of demand are starting to emerge.

- UK shares continue to trade at a steep discount to their international peers at a time when market leadership is highly concentrated in the US and Europe.

- Calm has been restored to UK politics, while 2024's general election is widely expected to herald a smooth transfer of power to a moderate Labour government, even if a new administration will face the same familiar challenge of growing the UK economy and restoring productivity.

Catalysts Coming?

Since the 2016 Brexit vote, the UK has been a cheap market in need of a catalyst to unlock its value. Perhaps such a catalyst is finally hovering into view. The steady decline of UK equities, coming at a time when the UK economy has struggled for growth, has finally caused policymakers to sit up and take notice.

On the supply side, several reforms have been slated: the Mansion House reforms, partly intended to boost the pull 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, specifically the introduction of dual share class listings (favoured among technology firm founders) and a single listing segment (instead of the split between the standard and main market). All these measures would mark welcome progress, if implemented.

On the demand side, after months of speculation, Chancellor Hunt unveiled a British ISA in the spring Budget. The details are still to be ironed out over a consultation period set to complete in June 2024. However, the expected result is that investors will have £5,000 of additional tax-free firepower to funnel exclusively into UK equities and funds. With close to two million people maxing out their ISA contributions each year, one might expect these investors to also make use of the new incentives.[3] More broadly, the new ISA rules should encourage UK retail investors to take a fresh look at the UK market. While just one of many factors needed to boost demand for UK shares, we see this as a positive move, even if the proposal received a mixed reception.

The spring Budget also contained an announcement that the government will bring forward requirements for UK defined contribution pension funds to disclose their asset allocation breakdowns, including their UK equities weightings, with similar proposals made for Local Government Pension Scheme (LGPS) funds in England and Wales. Such public disclosures and the potential for negative publicity for pension funds with low exposure to domestic equities could mark a turning point in institutional investors' attitudes towards UK stocks after many years of divestment.

Perhaps more important than Mr Hunt's plans, given the strong likelihood of a new government later in the year, the Labour Party's vow to "reinvigorate our capital markets" also seems like a step in the right direction, if it can deliver on its promises. In its 'Financing Growth' plan, Labour has pledged to review the pensions and retirement savings landscape, enabling greater consolidation of all types of schemes. It also plans to give the British Business Bank latitude to invest more in growth capital. And in other proposals, the party wants to emulate the French Tibi fund to boost institutional investment in venture capital and small cap growth equity, as well as increase investment in infrastructure and green industries through Solvency UK reforms.

Of course, promises do not make delivery, but the fortunes of the UK capital markets are on the minds of policymakers to an extent hitherto lacking.

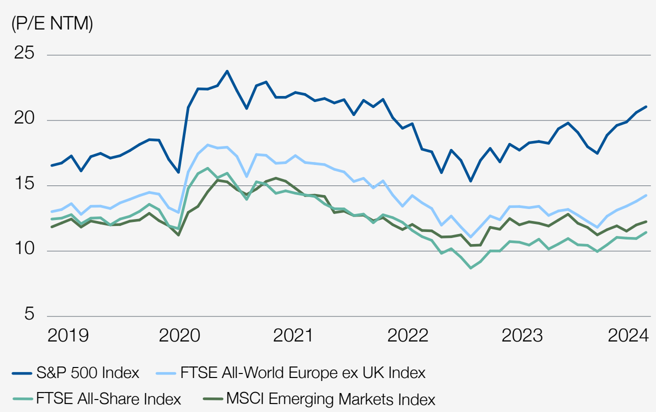
Valuations Drive Future Returns

Several leading global stock market indices have hit record highs in recent weeks, including the S&P 500, the Nasdaq Composite, the STOXX Europe 600, the Nikkei 225 and Germany's DAX. Equity markets have surged in recent months on AI-related excitement and swelling market optimism that the global economy is enjoying a surprisingly soft landing after one of the steepest and quickest periods of monetary policy tightening in modern history.

Frustratingly, the UK market has largely remained on the sidelines during this rally, with the FTSE All-Share Index up 8.4% over the 12 months to 31 March 2024. This compares to a 27.1% increase in the S&P 500 Index, 23.5% rise in Japan's TOPIX Index and an 13.8% climb in the FTSE Europe ex UK Index (all in sterling terms). Consequently, the already pronounced multi-year valuation gap between UK and international stocks has widened even further (Figure 1). If, as we do, you subscribe to the view that starting valuations are a good predictor of future investment success, then it should be hard for the dispassionate investor to ignore the UK stock market.

Figure 1.

UK Stocks Remain Unloved Versus International Peers



As at 31 March 2024. Source: FactSet.

In Figure 2 we highlight some examples of how this dramatic undervaluation plays out a stock level, comparing holdings in our portfolio versus global competitors from a range of sectors. Put simply, there are numerous UK-listed global market leaders that are being punished by the market for nothing other than their listing domicile. If these discounts are not reversed through re-ratings, private equity and trade buyers may well continue to exploit these significant anomalies. Meanwhile, a significant number of companies are taking advantage of their knockdown ratings to buy back their shares, which enhances future earnings and dividends.

Figure 2.

Select UK Stocks and Their International Equivalents

UK Stock	Industry	Price to Earnings (NTM)	International Equivalent	Price to Earnings (NTM)
BP	Oil & Gas	7.3	Exxon	11.9
Whitbread	Hospitality	14.4	Marriott	25.9
Unilever	Consumer Products	16.4	Procter & Gamble	23.4
IMI	Industrial Machinery	13.5	Parker-Hannifin	20.5
BT	Telecomm	5.8	Orange	9.2

As at 29 February 2024. Source: FactSet.

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Figure 3.

UK Listed M&A Activity YTD 2024

Target	Bidder(s)	Industry	Size	Move in Target's Undisturbed Share Price	Deal Status
DS Smith	Mondi & International Paper	Packaging	£5bn	+40%	Agreement in principle
Virgin Money	Nationwide Bank	Consumer Banking	£2.9bn	+34%	In progress
Redrow	Barratt Developments	Property Development	£2.5bn	+12%	In progress
Spirent Communications	Viavi Solutions and Silver Lake	Telecommunications	£1bn	+64%	Agreement in principle
Wincanton	GXO Logistics	Logistics	£760m	+48% on first bid from Ceva Logistics/ additional +18% on second bid from GXO	In progress
Ascential's digital commerce business, Flywheel Digital	Omnicom	E-commerce	£700m	+41%	Completed
Currys	Elliott Advisors / JD.com	Consumer Electronics	£700m	+28%	Elliott Advisors dropped out after having two bids rejected. Chinese online retailer JD.com is apparently evaluating a possible bid

As at 13 March 2024. Source: FactSet

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Stirrings in M&A Activity

After a quiet year of M&A activity in 2023, the opening months of 2024 have seen a revival in deal-making (Figure 3). The attractive valuations of UK stocks are catching the eyes of bidders, both domestic and international. As long as valuations remain subdued, we would expect UK companies to continue receiving takeover offers, with accompanying uplifts in their share prices.

Enduring Yield Attractions

The UK stock market has long been regarded as a good source of income given its engrained dividend culture. For domestic investors, the FTSE All-Share Index currently yields a similar level to the 10-year Gilt yield—3.6% versus 4.1%—but with the obvious potential for capital growth on top. For international investors, the yield premium offered by the UK market is evident (Figure 4).

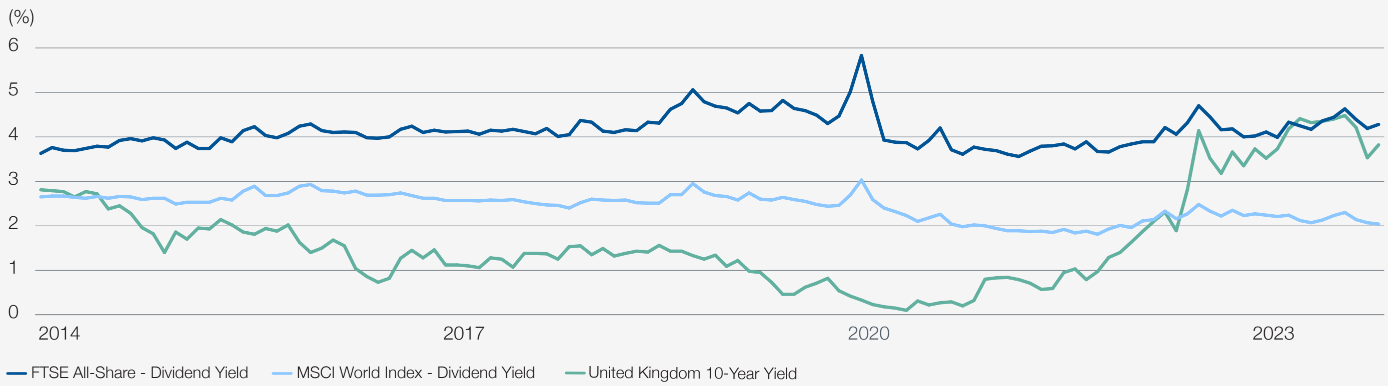
Calm Restored at Westminster

Since the earthquake of the Brexit vote, UK politics has been defined by turbulence and turmoil. But in a year of elections globally, the UK looks highly likely to deliver one of the more straightforward transitions in power.

With a commanding lead in the opinion polls, a Labour government seems by far the most likely outcome of the general election that will almost certainly take place this year. Unforeseen events could yet derail this narrative, but a moderate, technocratic Starmer government armed with a large mandate appears the most likely denouement. A settled political landscape might be a welcome relief for investors after the post-Brexit vote turbulence.

Figure 4.

The Higher-Yielding UK Stock Market



As at 29 February 2024. Source: FactSet.
Dividend yield are on a NTM basis.

In Summary

Undeniably, the UK stock market has felt like a distant backwater in recent years. Arguing the case for UK equities has been a thankless task. However, as fundamental investors, we believe valuations must eventually assert themselves. The catalyst to this recalibration has been missing for several years. Whether overdue recognition and reforms from policymakers and government can be that much-needed catalyst will only become clear over time. But this policy momentum, combined with rock-bottom valuations at a time of investor excess elsewhere, especially in the US, signs of a revival in M&A activity, and a healthy market yield, all set against the backdrop of relatively peaceful domestic politics after the un-British drama of the post-Brexit period, suggests to us that there is life in the London market yet.

Important Information

Notes

1 February's Bank of America Global Fund Manager survey
2 Deutsche Bank, 'A Macro Guide to the Magnificent Seven'
3 https://www.gov.uk/government/statistics/annual-savings-statistics-2023/commentary-for-annual-savings-statistics-june-2023

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