Outlook on

UK Equities

APR 2024

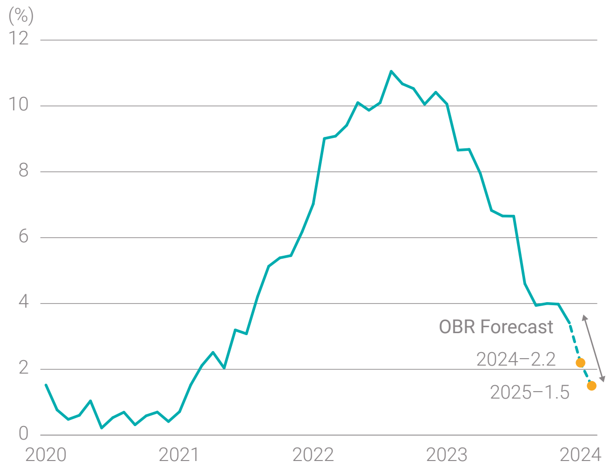
Summary

- In our view, ongoing success in the battle against inflation, potentially leading to the start of a measured interest-rate-cutting cycle, and real wage increases suggest that life might slowly begin to get better for the under-pressure UK consumer after two torrid years.
- UK stocks trailed strong-performing international developed markets again over the opening quarter. The valuation gap with international stocks is now even more eye-catching.
- The proposed British ISA, announced in the spring Budget, is the latest in a series of proposals designed to restore the UK stock market to its former glory. We remain hopeful that a combination of policy interventions and low multi-decade valuations will eventually pique investor interest in UK stocks.

Is the beaten-up UK consumer about to climb off the canvas after two years of being pummelled by a generational cost-of-living crisis and one of the most aggressive interest rate-tightening cycles in modern monetary history? Recent data suggests that the outlook for all-important British consumer, responsible for around two-thirds of UK GDP, slowly continues to improve.[1]

Overall, inflation continues to move in the right direction, even if price pressures persist in the substantial services sector, with February's services inflation print lower but still elevated at 6.1%. Annual consumer price inflation dropped slightly more than expected to 3.4% in February, marking its lowest level since September 2021. Core inflation, which strips out volatile food and energy prices, has also continued to slide, down from 5.1% to 4.5%. With household energy bills scheduled to fall by 12% on 1 April when Ofgem cuts its domestic price cap, we believe it is possible for headline inflation to reach the Bank of England's (BoE) 2% target by the summer (Exhibit 1); indeed, it may overshoot next year: the Office for Budget Responsibility (OBR) forecasts inflation will drop to an average of 2.2% this year and 1.5% in 2025.[2]

Exhibit 1
Inflation Continues to Fall Towards the BoE's 2% Target



As at 31 March 2024

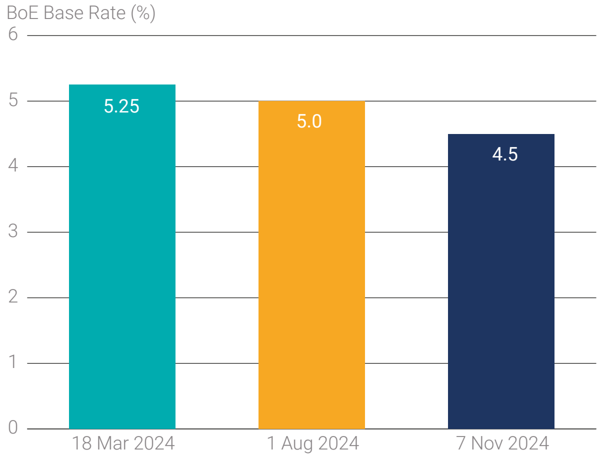
Forecasted or estimated results do not represent a promise or guarantee of future results and are subject to change.

Source: FactSet, ONS

LAZARD ASSET MANAGEMENT

This positive trajectory for inflation has altered the mood music on Threadneedle Street. While the BoE left rates unchanged at 5.25% at its March meeting, the two most hawkish members of the Monetary Policy Committee (MPC) this time voted to hold rates rather than raise them, as they have previously. Adding to that notable shift in the MPC's directional bias on rates, BoE Governor Bailey sounded an upbeat tone in an interview with the Financial Times, stating that rate cuts were "in play", pointing to the unwinding of global inflationary shocks and the current absence of second-round inflationary effects. Some commentators are now anticipating a first rate cut in June, with money markets projecting two further 0.25% cuts in the remainder of the year to leave the base rate at 4.5% by the end of the year (Exhibit 2).

Exhibit 2
Market Expectations of UK Base Rate



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Source: Bloomberg

Providing further succour to consumers will be the two-pence reduction in the employees' national insurance rate announced in the spring Budget, which takes the rate from 10% to 8%. This comes on the heels of a 2% cut that came into effect in January. Meanwhile, April heralds a 9.8% increase in the national minimum wage. Although low-income families clearly remain under considerable financial pressure, the higher marginal propensity to consume of low-income households should be positive for aggregate consumer demand.

More broadly in terms of the labour force, wages continue to run ahead of inflation, with average weekly earnings including bonuses rising 5.6% year-on-year over the three months to January. This means real incomes are continuing to grow, while the BoE will have noted the clear trend of easing wage pressures with some comfort.

Adding to a somewhat rosier consumer picture are signs of a modest improvement in the housing market. Mortgage approval numbers have been climbing since September, helped in part by lower interest rates for new mortgages in the last couple of months, and house prices have stabilised after weakness in the first half of 2023 in the wake of the Truss/Kwarteng mini-budget shambles.

Given all the above, it was perhaps surprising that the latest GfK consumer confidence survey reading for March stalled at -21, having generally shown small improvements since the autumn. This does chime with anecdotal feedback we have received from the retail sector of customers deferring big ticket purchases for a few months. Beneath this disappointing headline survey number, however, are signs that consumers finally see a light at the end of the tunnel in terms of their personal financial circumstances: GfK's score capturing people's outlook on their personal finances for the next 12 months turned positive for the first time since December 2021.

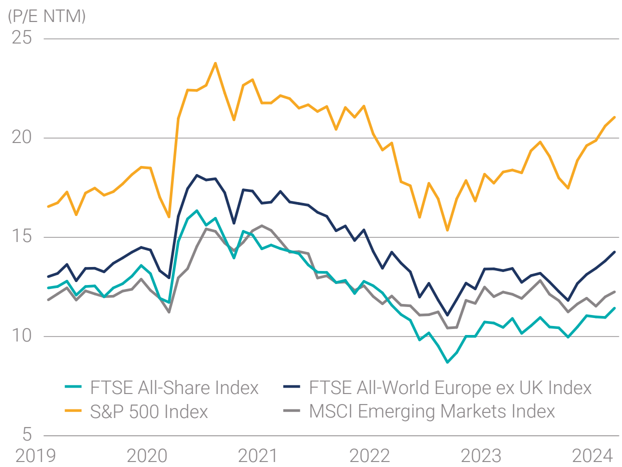
A seemingly recovering consumer bodes well for the growth-starved UK economy. With an upturn in private consumption expected as household incomes recover, the OBR's latest forecast points to 1.9% real GDP growth next year, before the UK economy resumes its trend growth path of around 1.7%. The UK's deep-seated challenges around economic productivity persist, but the dangers of a sharp recession that we and many others feared appear to have passed.

London Calling?

Turning away from the domestic economy, in a strong opening quarter for global equities when the Nasdaq Composite, Stoxx Europe 600, the Nikkei 225, and Germany's DAX index all made record highs, the UK market trailed again, extending its underperformance versus foreign stocks. The FTSE All-Share Index is up just 8.4% over the 12 months to 31 March 2024. This underwhelming showing compares to a 27.1% increase in the S&P 500, 23.5% rise in Japan's TOPIX index, and a 13.8% climb in the FTSE Europe ex UK Index (all in sterling terms). International equity markets have powered ahead, boosted in the US by exuberance over all things AI and, more widely, growing investor confidence that the global economy, led by the US, may have a soft landing after one of the more remarkable episodes of monetary policy tightening in modern history.

Consequently, the multi-year valuation gap between UK and international stocks has widened even further (Exhibit 3). These discounted valuations are prompting a stirring in M&A activity

Exhibit 3
Valuations of UK Stocks vs. International Stocks



As at 31 March 2024
Source: FactSet

this year, as trade buyers look to snaffle up competitors at what we would regard as bargain-basement prices. Even if investors continue to pass up the value in UK stocks, growth-hungry corporates may not.

As UK equities investors, we are accustomed to this depressing déjà vu. However, we do not believe UK shares will remain out in the cold forever. The London stock market was once a jewel in the UK economy. That jewel seems to have lost its lustre. But as we explore in "UK Equities: London Calling at Last?" (This paper is only available to UK residents), there is now an urgency from policymakers in seeking to revive the once internationally significant UK market. Slated reforms include a proposal in the spring Budget for a British ISA to promote retail investment in UK equities and funds. Collectively, these policy moves, if enacted, may be the catalyst needed to reignite investor interest and realise the compelling value in UK stocks.

Like the UK consumer, the UK equity market has been on the ropes. In our view, though it might never be a heavyweight again, at least the recognition now exists from financial policymakers and politicians that it needs to get itself back into shape. We need to start somewhere, and soon.

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Notes

1 https://obr.uk/forecasts-in-depth/the-economy-forecast/expenditure/#consumption

2 https://obr.uk/docs/dlm_uploads/E03057758_OBR_EFO-March-2024_Web-AccessibleFinal.pdf