Outlook on

UK Equities

JUL 2024

Summary

- The Labour Party's landslide win in the UK general election has provided stability at a time when politics elsewhere is proving more volatile.
- The UK economy showed improved momentum going into the general election, with a strong GDP print for Q1 2024 and consumer confidence continuing to recover, while a potentially imminent turn in the interest rate cycle should be supportive for the consumer and wider economy.
- We believe domestic UK equities in sectors such as construction may benefit from a post-election policy drive by the new government, while internationally focused UK stocks remain attractively valued.

At a time when French and US politics have been producing shocks, the political guard has changed in the UK without any great drama, a welcome dullness after the volatility that has plagued British politics ever since the 2016 Brexit vote.

Many British citizens will doubtless be glad an uninspiring general election campaign is over. But the landslide win for the Labour Party has heralded few signs of the public optimism that often accompanies the election of a new government, especially one replacing an incumbent seen by some as exhausted and rudderless after 14 years in power.

The public's recognition of the weakness of the state's finances perhaps partly explains why expectations for Prime Minister Starmer's incoming government seem so modest. Faced with UK government debt to GDP standing at 98% and the tax burden already forecast to hit its highest level since the end of World War Two, the Labour Party has ruled out increased public spending to fix Britain's struggling public services, remedy the country's inadequate infrastructure, and boost productivity. Instead, it has promised to stick to the previous Conservative government's spending plans and meet its rule that debt as a percentage of GDP must be lower after the five years of a parliamentary term. Having campaigned on a policy platform of fiscal restraint, it seems likely the new government will abide by these spending controls, at least in the early years of the Starmer administration.

Inflation on Target, Summer Rate Cut Ahead?

Accepting that the UK has deep-seated, long-term challenges around growth and productivity, we do see evidence of further incremental economic improvements in the near term, which should be supportive for UK equities in the second half of the year.

First, headline annual consumer price inflation has finally returned to the Bank of England's (BoE) 2% target. Admittedly, the annual core inflation rate, at 3.5% in May, remains higher and stickier than the BoE would like to see, in part due to persistent price pressures in the service sector. However, core inflation remains on a downward trajectory (Exhibit 1).

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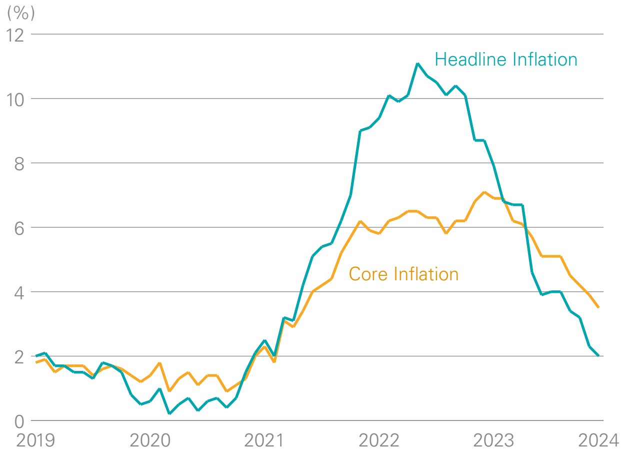
Exhibit 1
Cooling UK Headline and Core Inflation



As at 5 July 2024
Source: FactSet

Second, with inflation largely subdued, interest rate cuts are now in play. The BoE would have been reluctant to make its much anticipated first rate cut during the election campaign for fear of being charged with politicising monetary policy. But with the election now behind us and inflation in line with its target, the central bank is expected to undertake its first move of this cycle in August. A cut over the summer would likely put the BoE ahead of the Federal Reserve's rate-cutting cycle, where despite signs of faltering US consumer strength, higher levels of inflation have seemingly postponed any rate moves till the end of the year.

Third, a rate cut in the next few months would come at a time when the UK economy is already exhibiting improved momentum. Growth over the first quarter of 2024 has been upgraded to 0.7%, its strongest expansion in two years and ending the short-lived and shallow recession. Consumer sentiment has continued to recover from the late 2022 Truss mini-Budget nadir, with June's -14 reading in the GfK Consumer Confidence survey beating expectations. Real wage growth remains positive, given average weekly earnings including bonuses grew 5.9% year on year in the three months to April 2024. Adding to further signs of a brighter mood amongst consumers, residential housing transactions increased in May and mortgage approvals are well up on 2023's levels, albeit they dipped slightly in May. Retail sales also recorded a better-than-expected 2.9% month-on-month increase in May, helped by improved footfall after a long overdue improvement in the weather.

A Cooling Labour Market

Countering these positive trends, we have seen warnings from consumer-facing companies, such as sofa retailer DFS Furniture and floor coverings distributor Headlam Group, that consumers have been deferring big-ticket purchases, although this hints at pent-up demand ahead. In contrast, though, travel and leisure spending is holding up well.

In the labour market, the unemployment rate remains low but has continued to tick up, hitting 4.4%, amid some evidence of companies accelerating automation to offset wage inflation. Meanwhile, vacancies have fallen further, although show signs of bottoming out at the pre-pandemic level.

We will continue to monitor whether these signs of a cooling labour market indicate the UK's recent economic momentum is already petering out, but equally we note they make it easier for the BoE to cut rates soon.

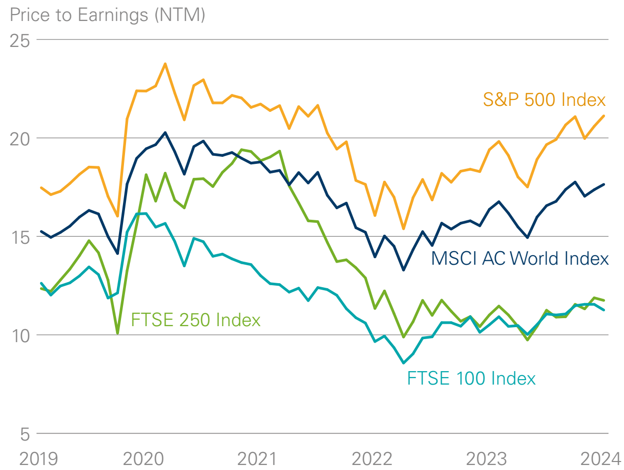
A Clearing Event

The general election could prove to be a market-clearing event for UK equities. Given the size of the new government's mandate and Prime Minister Starmer's apparent intention to lead a moderate technocratic government, UK politics may now become a tailwind for international investors after almost a decade of being a reason to shun the UK market, especially given current political turbulence in Europe and potentially in the US later this year.

Over the longer term, the new government may also bring much-needed impetus to construction and housebuilding, helped by its proposed planning reforms. We will await with interest whether Labour can deliver on its manifesto commitments. The underwhelming experience of UK housebuilding in recent decades suggests it will be a major undertaking to build Labour's promised 1.5 million homes over the next five years. However, it does seem that the construction and infrastructure sectors should have a powerful wind at their backs over the next few years. Elsewhere, we will also be hoping that Labour's pledge to harness the UK pension sector to drive investment in the domestic economy and capital markets is borne out with actions.

As we look ahead over the next few quarters, we believe there are grounds for optimism towards UK assets. The UK economy was already showing better momentum going into the general election, and it seems likely to receive the fillip of an interest rate cut before the summer is out. A unambiguous election outcome should provide domestic political stability and a mandate for overdue reforms, including an overhaul of the UK's sclerotic planning system. With UK stock market valuations continuing to compare favourably versus history and international markets (Exhibit 2), we believe UK equities look well placed to progress over the second half of the year.

Exhibit 2
UK Stock Market Valuations Lag Other Regions



As at 5 July 2024
Forecasted or estimated results do not represent a promise or guarantee of future results and are subject to change.
Source: FactSet

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Published on 15 July 2024.

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