

UK equities: unloved and underrated

Weekly Digest

17 September 2018

– Andrew Hardy, CFA

With Brexit looming many of our clients have asked us how we are managing exposure to UK assets within our global portfolios. The challenge of positioning portfolios appropriately for Brexit, be it to mitigate risk or take advantage of potential opportunities, is tough as the negotiations could go either way: an acceptable future trade relationship with the EU or a no-deal outcome. These potential outcomes would have substantially different implications for investors.

We have always held the view that a deal will ultimately be done, primarily because it is so plainly in the interests of both parties to do so, but the risks of a no deal outcome have clearly increased recently. It may be a long time before any degree of certainty is delivered, as the original intent to have in place a detailed outline agreement for the future relationship at the same time as the exit arrangements will likely be softened, if nothing else because time is running out and key issues seem far from being agreed. All of this spells heightened uncertainty, particularly among the business community.

Investors have shunned UK assets in the past two years leaving the equity market undervalued. Large cap UK equities are priced at a forward earnings multiple of just 13x and a dividend yield of 4.3%, compared to 17x and 1.8% for US equities respectively*. The spread between the UK market's dividend yield and the 10 year gilt yield is close to the highest levels in over 20 years.

An acceptable deal should see sterling and UK equities rise, possibly substantially. Under this scenario sterling should also be supported by the likelihood that the Bank of England would be emboldened to lift interest rates further. On the other hand a no deal outcome would undoubtedly

see sterling take the brunt of investors' worries about the potential damage to the UK economy. The Bank of England might then even loosen monetary policy as it did immediately after the referendum. UK equities would probably decline; led lower by domestically focused small and mid-cap companies, but as we saw in the referendum's aftermath, many large caps could perform well as they derive most of their revenues from overseas.

Taking an extreme position based on an expected outcome to the negotiations is risky given the widely divergent impact on markets of the possible outcomes. Instead we have kept exposure to the UK reasonably balanced in portfolios, focusing on large cap equities as these should do relatively well in either outcome. We have no exposure to UK gilts in most portfolios. Furthermore, we reduced sterling currency exposure in many portfolios earlier this year in favour of increased US dollar exposure, just before this extended period of US dollar strength began. Should sterling fall significantly further between now and Brexit day we would view this as an opportunity to rebuild exposure.

We are optimistic about the prospects for the UK in the long term. A no deal scenario would be damaging to confidence, the economy and markets in the short term but we would not expect this to be long lasting, while an acceptable deal which keeps a free trade relationship with the EU and allows the UK to enter into free trade arrangements with other countries would be a bullish outcome. We acknowledge the shorter term risks but we also recognise that a successful deal will be very positive for UK markets, hence the need for a measured approach to portfolio construction in what are especially uncertain times.

* MSCI index data, as of 31st August 2018

The Marketplace

- Brent crude oil was up 1.6% at \$78
- Gold finished the week flat at \$1195
- Markets showed growth last week, though EM still weak
- Uncertainty around the US/China trade war sees markets set to lose gains

Market Focus

US

- The Dow Jones was up 0.9% on the week at 26,154
- The Nasdaq was up 1.5% at 7545.5
- US jobless claims at a 48 year low for the second week in a row, standing at 204k vs an estimated 210k
- August CPI print came in just under the estimated consensus view of 0.2 . A drop in inflation for clothing and medical services were significant factors in the continued softening

UK

- Michel Barnier, the EU's chief negotiator has said that a brexit deal is a 'realistic' proposition by November: GBP rose nearly 1% on the news

- BoE estimates third quarter growth at 0.5% versus 0.4% previously expected as pay strengthened. Interest rates kept on hold at 0.75%
- The FTSE 100 finished the week up 0.4% at 7304

Europe

- The Eurostoxx 50 rose 1.6% to 3344.6
- The CAC40 was up 1.9% at 5352.6
- The ECB have confirmed that Quantitative easing will be phased out in Q4 . They also announced that there are no plans to alter rates

Asia / Rest of The World

- Russia and China staged joint large-scale military exercises, a sign of closer cooperation emerging between both countries, partly in response to US sanctions
- The South African Reserve Bank is expected to keep rates on hold and to focus on the unexpectedly weak growth data. A recent gauge of business confidence gave a reading of 38 way - below the neutral level of 50
- MSCI Emerging markets rebounded from a 16 month low after rumours of renewed trade talks between US and China, however the WSJ reports that China are considering cancelling the talks over what they perceive as blackmail from the US
- The Hang Seng falls into a bear market finishing the week at 26932.9

| Asset Class/Region | Currency | Currency returns | | | |
|-------------------------------------|----------|---------------------------|---------------|----------|-----------|
| | | Week ending 14 Sept. 2018 | Month to date | YTD 2018 | 12 months |
| Developed Market Equities | | | | | |
| United States | USD | 1.2% | 0.2% | 9.7% | 18.0% |
| United Kingdom | GBP | 0.4% | -2.6% | -2.0% | 3.9% |
| Continental Europe | EUR | 1.2% | -1.8% | -0.1% | 0.8% |
| Japan | JPY | 2.6% | -0.6% | -3.8% | 8.2% |
| Asia Pacific (ex Japan) | USD | 0.8% | -3.2% | -6.7% | -0.8% |
| Australia | AUD | 0.5% | -2.4% | 5.1% | 12.1% |
| Global | USD | 1.4% | -0.6% | 4.5% | 11.3% |
| Emerging markets equities | | | | | |
| Emerging Europe | USD | 3.0% | 0.5% | -12.6% | -9.5% |
| Emerging Asia | USD | 0.6% | -3.1% | -7.7% | -1.4% |
| Emerging Latin America | USD | -0.7% | -0.1% | -12.1% | -15.3% |
| BRICs | USD | 0.0% | -3.4% | -10.4% | -5.9% |
| MENA countries | USD | -0.5% | -2.6% | 5.4% | 3.1% |
| South Africa | USD | 0.9% | -5.2% | -24.5% | -12.0% |
| India | USD | -0.5% | -2.6% | -1.8% | 3.3% |
| Global emerging markets | USD | 0.6% | -2.7% | -9.5% | -4.3% |
| Bonds | | | | | |
| US Treasuries | USD | -0.3% | -0.7% | -1.6% | -2.0% |
| US Treasuries (inflation protected) | USD | -0.4% | -1.0% | -0.8% | -0.2% |
| US Corporate (investment grade) | USD | 0.1% | -0.4% | -2.4% | -1.1% |
| US High Yield | USD | 0.5% | 0.3% | 2.3% | 3.3% |
| UK Gilts | GBP | -0.8% | -0.9% | -1.0% | 0.2% |
| UK Corporate (investment grade) | GBP | -0.4% | -0.6% | -1.9% | -0.3% |
| Euro Government Bonds | EUR | -0.2% | 0.2% | -0.2% | 0.2% |
| Euro Corporate (investment grade) | EUR | 0.0% | -0.3% | -0.6% | 0.0% |
| Euro High Yield | EUR | 0.3% | 0.1% | -0.2% | 0.9% |
| Japanese Government | JPY | 0.0% | 0.1% | -0.1% | 0.1% |
| Australian Government | AUD | -0.3% | -0.1% | 2.6% | 3.8% |
| Global Government Bonds | USD | -0.1% | -0.4% | -1.9% | -1.8% |
| Global Bonds | USD | 0.1% | -0.3% | -2.0% | -1.5% |
| Global Convertible Bonds | USD | 0.9% | -0.3% | 0.2% | 0.3% |
| Emerging Market Bonds | USD | 1.2% | 1.1% | -6.0% | -6.9% |

| Asset Class/Region | Currency | Currency returns | | | |
|---------------------------------------|----------|------------------------------|------------------|----------|-----------|
| | | Week ending 14 Sept. 2018 | Month to date | YTD 2018 | 12 months |
| Property | | | | | |
| US Property Securities | USD | 0.1% | -0.8% | 3.0% | 2.5% |
| Australian Property Securities | AUD | 0.6% | 0.0% | 4.1% | 9.7% |
| Asia Property Securities | USD | 1.4% | -2.3% | -6.8% | -3.3% |
| Global Property Securities | USD | 0.5% | -1.5% | -1.2% | 1.6% |
| Currencies | | | | | |
| Euro | USD | 0.7% | -0.2% | -3.2% | -2.1% |
| UK Pound Sterling | USD | 1.1% | 0.5% | -3.3% | -2.3% |
| Japanese Yen | USD | -0.9% | -0.7% | 0.5% | -1.1% |
| Australian Dollar | USD | 0.7% | -1.4% | -8.3% | -10.2% |
| South African Rand | USD | 2.0% | -1.2% | -17.0% | -11.7% |
| Swiss Franc | USD | 0.3% | 0.4% | 0.7% | -0.1% |
| Chinese Yuan | USD | -0.2% | -0.3% | -5.2% | -4.7% |
| Commodities & Alternatives | | | | | |
| Commodities | USD | 0.0% | -1.5% | 1.0% | 7.7% |
| Agricultural Commodities | USD | -0.9% | -0.9% | -4.5% | -5.4% |
| Oil | USD | 1.6% | 0.4% | 16.8% | 40.8% |
| Gold | USD | -0.1% | -0.3% | -8.5% | -9.8% |
| Hedge funds | USD | 0.1% | -0.9% | -1.4% | 0.5% |

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