COLUMBIA THREADNEEDLE INVESTMENTS

# UK equities: the song remains the same

Equities | May 2023

**Jeremy Smith**
Co-Head of UK equities

- **Despite the cost-of-living crisis we believe the gloom overhanging the UK economy is overdone**
- **UK stocks continue to trade at a discount of around 30% to global equities, which is likely to attract further merger and acquisition acitivity**
- **We remain true to our enduring style of high-conviction value investing, which we believe will continue to serve us well over time**

In late summer 2022 we wrote a viewpoint[1] citing Ian Dury & The Blockheads' 1979 hit, "Reasons to be cheerful, part 3". In it we argued that despite the prospect of public sector and other strikes, and hardship for many families and consumers – both of which played out – things were not as bad as they seemed for UK plc. UK equities were under-valued, the economy was more resilient than it seemed, and the power of UK dividend payments would continue to boost returns for investors.

Now, as the summer of 2023 gets underway, we have seen much change. Three US banks and a Swiss bank have failed[2]. Equity markets have rallied and then corrected, reminding us of the danger of whiplash investing. And Richard Colwell, our previous Head of UK equities, retired after a successful 25 years in asset management.

[1] Columbia Threadneedle Investments, UK equities: winter of discontent?!, September 2022

[2] The Guardian, JP Morgan boss plays down risk of crisis after second biggest bank failure in US history, 2 May 2023

At this point I'd like to cite another 70s rock band, Led Zeppelin, and in particular their 1976 album The Song Remains the Same. Because despite this change – both macro and internal – our views remain the same, our investment style remains the same, and the rest of the UK equities team remains the same. Richard and I worked closely for 17 years, seven of which were at Columbia Threadneedle Investments. We are both patient investors, confident to wait for a company's intrinsic long-term value to be released. No two fund managers are the same, but this style is entirely embedded in how we run money.

### Banks take a beating

In the past four months the market has been on a round trip from initial new year animal spirits to sobering up. Money initially moved into banks and cyclical stocks before core US inflation proved stickier than the market had anticipated, suggesting that US interest rates would stay higher for longer and US gross domestic product would fall in the second and third quarters. Then, of course, came the news in March that Silicon Valley Bank and Signature Bank had failed, followed by the Credit Suisse rescue and, most recently, First Republic.

Bank stocks took a proper beating and oil stocks retreated as a weaker economy would mean lower oil prices. But it is worth reminding readers that as contrarian investors with a laser focus on company fundamentals to target strong risk-adjusted returns, we have limited exposure to banks, oil and mining on the UK equities desk. Never say never, but they're clearly not contrarian ideas having previously been fantastic performers.

Instead, our bottom-up style means we select shares on their merits, irrespective of what is in the index and other people own. Over the past six months we have tilted more into domestic cyclical companies with valuations below book value and without much debt. However, this is very much an iteration of what we've always done.

### More of the same

We echo much of what we wrote last summer. In contrast to the US, the UK now looks likely to avoid a recession[3] and nominal GDP is expected to exceed the US over 2023-24 – an outperformance that has rarely happened in the past two decades. The UK's cost-of-living crisis also appears set to ease, as the recent big fall in energy prices will pass through to gas and electricity. Even a 20% fall would bring average household bills back below £2,000 a year[4].

Turning to the UK equity market, stocks are still trading at a discount of around 30% to global equities when valued on a 12-month forward price/earnings basis[5]. Showing just how cheap the UK stock market is, takeover bids are continuing for reasonably sized businesses. These remain attractive to private equity investors who have raised a lot of money that they need to invest, despite the high cost of borrowing through leveraged finance to support bids and the typical 50% takeover premium that bidders pay. The UK is cheap, it's got a common language, highly respected regulatory and accounting standards, and strong supervisory bodies. With the slowing US economy and its high valuations, why wouldn't US companies look at UK stocks?

### Looking ahead

[3] BBC.co.uk, IMF expects UK economy to avoid recession, 23 May 2023

[4] Cornwall Insight price cap predictions for July and October 2023

[5] Bloomberg, as at May 2023

So, much has changed – but so much remains the same. We remain positive but realistic about the UK economy, going against the fashion for gloom. We remain convinced that the long-term value in many of the UK companies in our portfolios will be realised over time. And we remain a team of high-conviction investors committed to long-term ownership and quality stewardship.

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