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UK equities: don’t believe the doom mongers

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In brief

- While Labour’s first Budget was a surprise in terms of the scale of the fiscal loosening, there remain grounds for cautious optimism about UK equities
- The Bank of England’s cycle of rate cuts should support equities, as history shows the market rises in the 12 months following a cut
- With valuations a key indicator of long-term future returns, the UK market has the advantage of being at a wide discount to other developed equity markets

Remember Tony Blair? When Labour won a landslide election victory in 1997 after 18 years of Conservative rule, it inherited an economy on the rebound after a bout of inflation and high interest rates in the early 1990s. In the months that followed, sterling surged and UK stocks rallied.

There were early signs of a similar carnival spirit after the current Labour government's election in July – until the Budget on 30 October dampened the mood. Despite the press leaks in advance, the scale of fiscal loosening was a surprise. The Office for Budget Responsibility thinks this will stoke inflation, thus reducing the Bank of England's scope for near-term interest rate cuts.

Before we get too miserable, however, there remain reasons for cautious optimism around UK equities. After all, the UK government still professes to have a pro-growth agenda, rate cuts should continue (if at a slower rate), and the equity market remains on a substantial discount to international peers. What's more, with the largest majority government in 25 years, Labour should at least deliver the political stability that investors have long craved.

It is true that the scale of the extra taxes and borrowing in the Budget led to a decline in the pound and spooked the gilt market. However, tax increases were less steep than had been feared in some respects. The economy appears resilient and there are good reasons to remain optimistic with hopes that an increase in public investment should encourage a move towards a more productive economy.

A resilient economy, with growth measures to come

Although economic growth has slowed since the strong first half of 2024, UK household disposable income has been rising. The Asda UK income tracker follows the amount families are left with each week after paying for bills and other essentials. It showed disposable income rising by 12.7% in the third quarter of 2024 compared with the previous year, reaching an average of £248.[1] The improvement primarily resulted from a greater-than-expected fall in inflation to 1.7% in September. This follows increases in spending power throughout 2024 as wage growth outstripped rises in consumer prices.

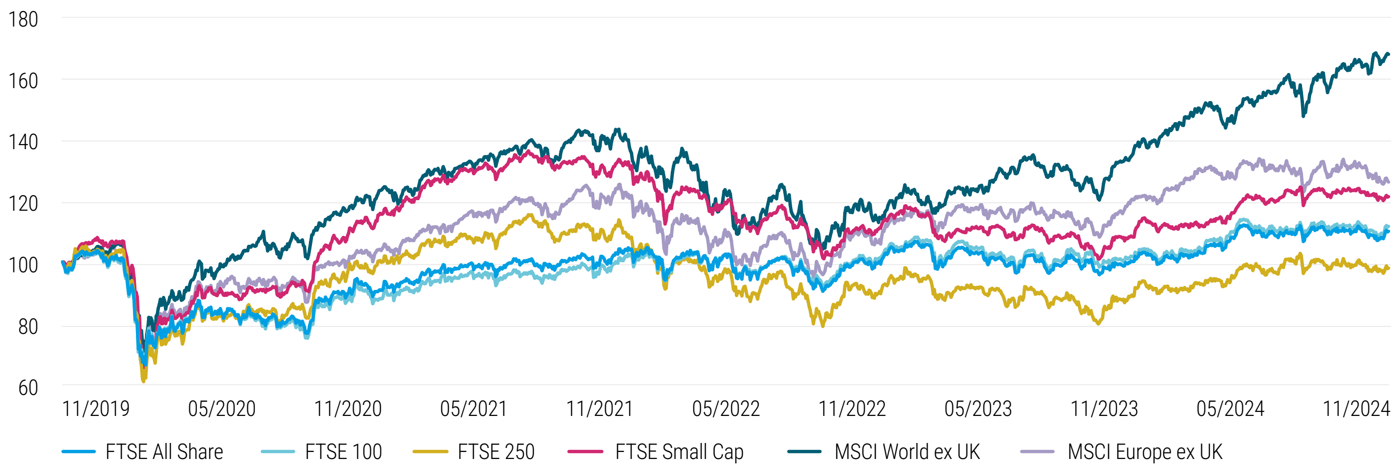
Household savings remain high compared to history, with Covid-era "piggy banks" still intact. The UK stands out as the region where consumers have been most cautious relative to history. If interest rates continue to fall and the economy remains stable, that should encourage consumers to spend rather than save. The UK might not enjoy the mini boom that accompanied Blair's win, but it should at least remain robust.

Returning to Labour's policy, it has also promised pro-growth measures. This is evident, for instance, in Chancellor Rachel Reeves' plan to merge 86 council pension schemes and multiple small workplace pensions into a handful of pension "megafunds".[2] This should encourage higher domestic investment and create much greater scale, allowing more scope to invest in longer-term assets. Another example of pro-growth measures is the Financial Conduct Authority enhancing access to market data and investment research to support growth and competitiveness.

Fundamental grounds for optimism

All of this is happening against the backdrop of a longstanding valuation discount in UK equities to their international peers. How out of favour are UK equities? While US equities now account for more than 70% of developed markets in the MSCI World Index, the UK has sunk to less than 4%.[3] What's more, UK equities are also trading at a wide discount to European equities on a P/E (price to earnings ratio) basis.

Figure 1: UK indices performance versus rest of the world



Source: Bloomberg Finance LP, as at 30 November 2024

[1] Asda, 22 October 2024
[2] Gov.uk, Mansion House 2024 speech, 14 November 2024
[3] MSCI, as at 31 October 2024

The level of valuations is often said to be a key indicator of future returns, and on this basis the UK should be one of the more attractive developed equity markets. Illustrating the value in corporate UK, the total equity value of the 40 bids announced year-to-date, and still live, is £47 billion.[4] The average bid premium is currently running at 40% above the share price before the bid was announced.

Adding to the UK's advantages, it is expected to be the most generous developed equity market in terms of both dividend and share buyback yields combined in 2024.[5] History shows that dividends have been a key driver of returns.

Figure 2: UK has a total shareholder yield of 5.9%

	Share buyback yield (%)*	Dividend yield (%)
UK	**2.0**	**3.9**
Canada	1.6	3.0
Europe ex-UK	1.2	3.4
Australia	0.4	3.7
Japan	1.1	2.4
USA	1.6	1.4
Median	**1.3**	**3.3**

Source: Bloomberg Finance LLP, as at 30 September 2024. Note: Buyback yield as % of the index market cap. MSCI Index for Australia, Europe ex-UK, Japan and Canada; S&P 500 for US.

Certainly, if the Bank of England continues the cuts to interest rates started in August 2024, this should support equity prices. Looking back over the past 50 years, UK equity markets have on average risen by 18.2% in the 12 months after the first rate cut (Figure 3).[6]

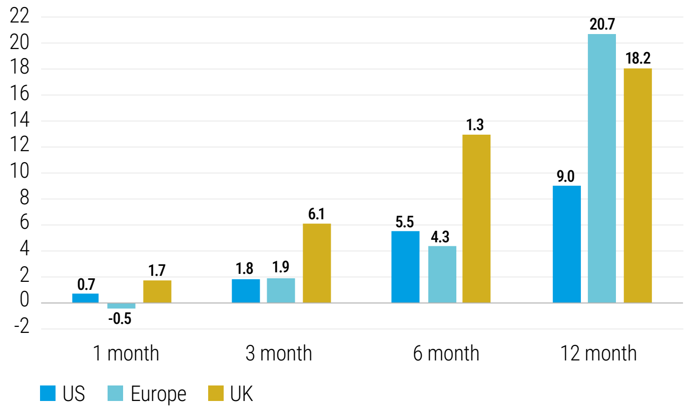
The UK stock market ≠ UK economy

It should be remembered that companies listed on the UK stock market are not operating solely within the UK. In fact, more than three-quarters of UK companies' revenues come from international markets. So although we are cautiously optimistic around UK plc, the market should be driven by global GDP – investing in the UK is more of a bet on the global economy than the British. So investors can follow the macro trends without exposure to the UK's idiosyncratic issues with the many proven international franchises listed here – and at a valuation discount that is highly disproportionate to reality.

Our approach

As an investment team we have always believed that we are owners not renters of businesses. Despite having exposure to "old economy" sectors, we believe the UK is not a dinosaur stock

Figure 3: UK equities performance strongly correlated to rate cuts



Source: Bloomberg research, Eikon, 2024. Average returns for US, European and UK equity markets after first rate cut (past 50 years). Note: Bundesbank rate cuts used as a proxy prior to inception of the ECB

market. Rather it provides a rich set of opportunities to invest in global structural leaders – be it in healthcare technology, regeneration and infrastructure, or digitisation.

Labour government plans point towards an increasing focus on responsible investing: Reeves launching the National Wealth Fund to unlock private investments in "green and growth industries", and a new target to cut the UK's annual emissions by 81% versus 1990 levels by 2035, which will lead to further jobs and investment in this space. Along with the UK Stewardship Code (of which Columbia Threadneedle Investments is a signatory) and the UK Sustainability Disclosure Requirements, this creates a forward-looking marketplace with a solid responsible foundation for owners and investors alike.

This is supportive of our investment philosophy, which believes that companies that invest in their people and products can deliver outperformance over time and make a positive contribution. Our detailed constructive engagement process enables us to have a long-term view and is a competitive advantage in identifying the best companies.

Conclusion

Despite the surprise around Labour's first Budget, there are reasons to remain optimistic about UK equities – not least that with more than 75% of UK company revenues coming from overseas, they are resilient to any potential domestic economic headwinds. The country's shares are also the cheapest in developed markets, while rate cuts should support the economy and equity prices. So although Blair's honeymoon period seems unlikely to be repeated, the UK remains a large and diverse market with overlooked businesses – and we remain committed to finding the best ones to deliver strong, risk-adjusted returns.

[4] As at 30 September, 2024.
[5] MSCI indexes. 2024.
[6] Bloomberg research, Eikon, 2024.

Meet the author

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Sonal Sagar is a portfolio manager in the UK equities team. Sonal joined Columbia Threadneedle Investments in 2015 and has been a member of the investment community since 2005. She is a portfolio manager on the UK Equity Core strategy and the UK Sustainable/Responsible Equity strategy. Previously, Sonal worked at Jefferies International, latterly covering European Aerospace and Defence, and before this Global Pharmaceuticals. She was also an analyst in Equity Capital Markets at Nomura International. Sonal has a BSc in Economics, Politics and International Studies from the University of Warwick and holds the Chartered Financial Analyst designation.

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