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James de Uphaugh: The UK market's Achilles heel is turning into a positive

The UK's equity market has regained its mojo of late, but the valuation on a whole host of metrics is still low relative to many markets. In our view, the factors driving this low starting valuation are unduly skewed towards muscle memory: factors that are firmly in the past, less evident in UK quoted companies, or of rapidly declining impact.

First, looking at the prolonged uncertainty around Brexit as one example, it was difficult enough for UK voters to understand the range of potential Brexit outcomes, so you can imagine global investors parked it in the *too difficult* category and gave the UK market the proverbial long spoon treatment.

But that is over – quoted companies can live with the reality of Brexit. The current geopolitical crisis is also driving a rapprochement between the UK and Europe.

Second, it is often noted that UK productivity lags our major peers. This may well be right at a macro level but the companies we invest in certainly do not.

Third, there is also the long trend towards investing in global equities to consider – which in reality means buying US equities, given that it makes up about 60% of global benchmarks – and the trend of pension schemes to take on less risk, which amounts to selling equities and buying bonds.

Both trends have come at the expense of investing in UK equities but are decreasing in intensity. After all, if UK equities amount to a small percentage of pension schemes, there is not much left to sell. For example, the National Employment Savings Trust (NEST) has only 4.5% of its 60% allocation to equities in UK listed shares.

This under-ownership and skinny positioning is a good starting point for the current trends and it shouldn't take much buying interest to turn the tide.

What are the trends? Economies are in a late cycle (which suggests economic growth will remain positive but a lot slower) and central bankers are half-heartedly burnishing their Volcker t-shirts as they look to raise interest rates and where applicable shrink their balance sheets to reduce inflation expectations before they get entrenched at higher levels. All this is not easy, with actual inflation rates reaching generational highs and more in the pipeline near term. A ready meal of two chickens in Aldi was £1.10 in October 2021. That pack is now £1.79. What will that pack be in March 2023? This is just one of the myriad examples consumers face.

"Old economy" stocks have been reinvigorated

One investor perception of the UK is that the market is full of banks, international energy companies and miners. This is seen to be the Achilles heel.

On banks, it has been a long work out since the global financial crisis of 2007-08. Regulators have forced capital raises and profits have been eaten up in conduct charges – remember PPI? But this is all over. The likes of NatWest are seeing profits convert into distributable cash. It has a chunky dividend and an ongoing buyback programme done at a discount to its book (or accounting) value.

Next up are those international energy companies. The Russian invasion of Ukraine has shown that where you get your energy from matters. Shell has been a pioneer in liquefied natural gas (LNG). Moreover, Shell could generate up to 40% of market capitalisation in cash over the next three years.

A good chunk will be reinvested in energy transition spend, so the company is not only seeking to supply our current energy needs responsibly but is also investing to help its customers decarbonise their energy needs in the future. Where is it listed? The UK.

Finally, amongst the miners, there are groups like Anglo American, which is about to bring on stream a significant long duration copper project. The world desperately needs copper to transition our energy sources. Anglo American is an agent of this change.

I would argue that what was once an Achilles heel is now definitively a positive. Investment is full of 180-degree changes in perception but they take time to effect. We are in the early innings of one now.

Private equity spree shows the value on offer in the UK

Finally, let us look at the UK through the lens of private equity (PE) or an activist. The growth in money allocated to PE has been huge over the last decade, and that "dry powder" needs to be invested to earn the full fees. The UK is a fertile hunting ground: there will be more Morrisons – snapped up by PE last year – as the gap between the earnings yield and the cost of borrowing remains wide.

Then there are the activists. Activists come in many guises and when on the shares register can accelerate change. Activists are currently on the register of three of the UK's largest companies: Shell, Unilever and GSK. Mega cap is no longer too large for such action.

There are multiple reasons why we believe the UK equity market is in the foothills of a multi-year rehabilitation and will benefit from the return of its mojo.

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