Outlook on **UK Equities**

JAN
2016

Summary

- Heading into 2016, we are positive in our outlook for UK equities. The UK economy is in good shape; market expectations are for GDP growth of 2.25% to 2.5%, with unemployment continuing to fall and wage growth nudging up to 3%.
- In terms of interest rates, the great divergence in international monetary policy has taken place; for UK investors, interest rate rises have been pushed out again due to a lack of inflationary pressure, which is likely to keep rates unchanged for the foreseeable future.
- Although we expect significant market uncertainty and volatility in the lead-up to the referendum on Brexit, the date of which is as yet uncertain, ultimately we think the UK will remain in the EU. From a valuation perspective, we believe volatility is already partially priced in to UK corporate assets; listed UK companies have been more cheaply valued compared to their Eurozone peers for some time.

Heading into 2016, we are positive in our outlook for UK equities. The UK economy is in good shape; market expectations are for GDP growth of 2.25% to 2.5%, with unemployment continuing to fall and wage growth nudging up to 3%, as the labour market tightens and the introduction of the national living wage from April 2016 exerts a knock-on effect for up to a quarter of the workforce, according to estimates from the government's budget watchdog. Concurrently, falling oil prices have resulted in more cash in the hands of consumers; household discretionary income increased by over 10% year-on-year to September 2015 and now stand at £192 per week, as measured by the Asda Income Tracker.

In terms of interest rates, the great divergence in international monetary policy has taken place; for UK investors, interest rate rises have been pushed out again due to a lack of inflationary pressure, which is likely to keep rates unchanged for the foreseeable future. Although we are now approaching the anniversary of the weak oil price and consumer price inflation turned positive in November, significant deflationary pressures still exist. Figures in December showed that manufacturers' output prices were 1.2% lower year-on-year, suggesting that the commodity rout and the strong pound are depressing prices. While the governor of the Bank of England is, for the moment at least, disinclined to raise rates, macro prudential tools are being employed to the same effect such as the attack on buy-to-let properties.

The US, in contrast, has ended its seven-year experiment with near-zero interest rates and indecision by raising the range of its benchmark interest rate by a quarter-point to between 0.25% 0.50% and has pledged a gradual increase over the next few years. Europe, in contrast, has gone deeper into negative territory; of the 13 countries with negative yields in international debt markets, 12 are European. Additionally, the European Central Bank (ECB) recently lowered its interest rate further, to -0.3%. However, the ECB's rate drop was not as large as the market anticipated due to signs of a nascent rebound in Europe, with eurozone unemployment falling further than expected in November, to a three-year low watermark of 10.7%. Across the EU as a whole, unemployment remained steady at a six-year low of 9.3% in November. In Germany, unemployment fell to a record 6.3% in the same month, while Italian unemployment plummeted to a three-year trough of 11.5%. The promising employment figures aligned to the fact that Greece has voted for another bout of austerity, means that, all in all, we are expecting Europe to continue its rehabilitation going into 2016.

The price of oil has more than halved since June 2014 and is now trading at an eleven-year nadir of below $36 a barrel, causing increased scrutiny by banks into loans made to oil and gas-reliant businesses. As oil and gas represent 10% of the FTSE All-Share Index, the UK market stands to benefit from what we anticipate will be a slight upward movement in the oil price as we move through 2016. As a corollary to the annualised lag on the oil price, we expect a disinflationary benefit in the first quarter of 2016. This in turn may influence the timing of an interest rate increase in the UK, although current estimates put this at the tail end of 2016.

We expect absolute dividend payments by companies to drop in 2016. The FTSE 100 is currently yielding about 4%, which is a significant spread over anything in the five- to ten-year bond market. The payout ratio i.e., the proportion of earnings paid out as dividends to shareholders, for the UK stock market has been rising steadily over the past three years, and is now more than 60% higher than pre-crisis levels. Additionally, according to figures from Thomson Reuters, the average dividend cover – the degree to which a company's profits exceed its dividend – for the UK stock market is at a 20-year low.

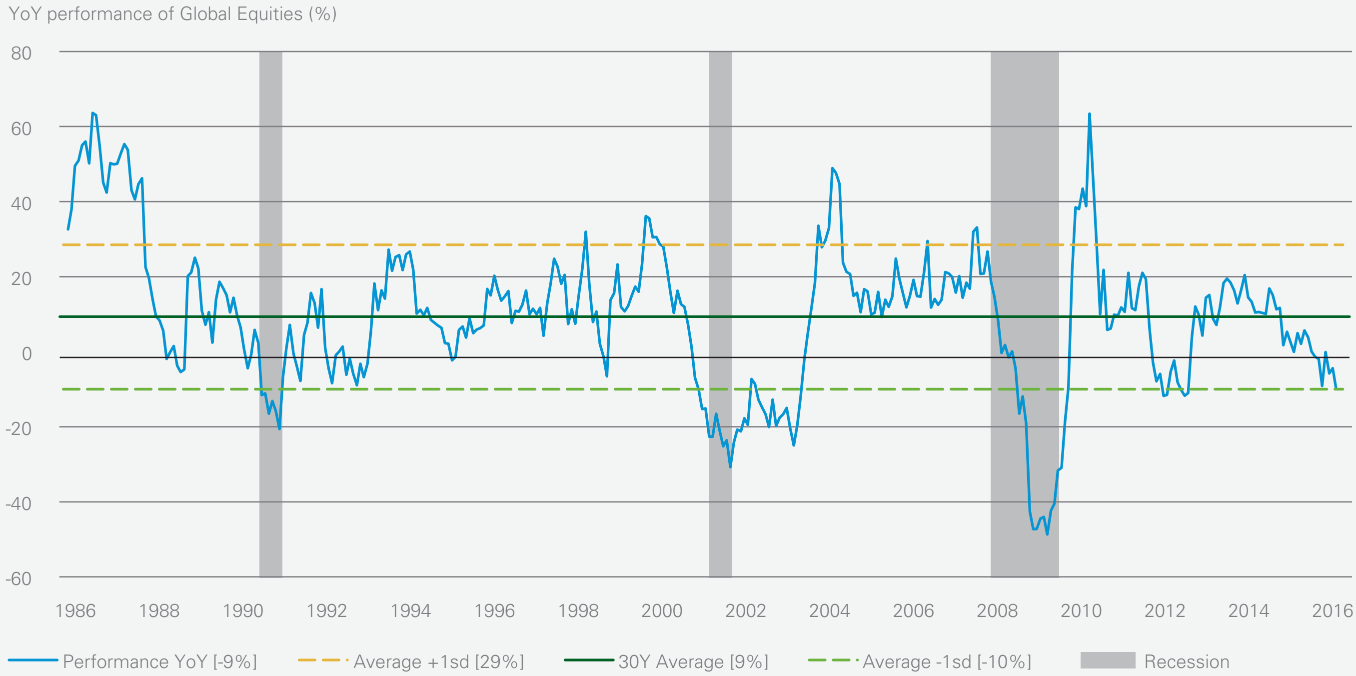
Companies cannot continue to pay out this level of dividends indefinitely, especially when one considers that Britain's 15 biggest payers accounted for 60% of the UK stock market's income last year and a number of these face severe headwinds e.g., both BP and Royal Dutch Shell have taken significant hits to their profits from the oil price slump (although the market is not currently forecasting either company to cut its dividend at present). The combination of these factors suggests that the absolute level of dividend payments will remain under pressure in 2016.

In terms of valuation, the UK market represents reasonable value in historical terms; this time last year, the FTSE 100 had a price-to-earnings (P/E) ratio of 15.2, slightly above its long-term average of 14.7. In contrast, 12 month forward P/E ratio is 15.3. With this in mind, moving into 2016, the sectors we favour are banks and insurance companies. The successful completion of the Bank of England's second annual stress test of the banking sector and the acceptance of 19 insurers' Solvency II models for capital ratios suggests that regulators now regard the financial sector as having accrued sufficient capital; therefore the dividend paying capability of banks is now clearer than it was previously.

Although we expect significant market uncertainty and volatility in the lead-up to the referendum on Brexit, the date of which is as yet uncertain, ultimately we think the UK will remain in the EU. From a valuation perspective, we believe volatility is already partially priced in to UK corporate assets; listed UK companies have been more cheaply valued compared to their Eurozone peers for some time. Global equities also appear to be starting to discount recessionary conditions in the US, which we feel is not supported by economic data, such as jobs growth, and rising interest rates (exhibit 1). We will endeavour to look through the static and understand the prolonged post-event impact; for stock pickers able to do so, the volatility can translate into an opportunity to pick up attractively valued positions.

Exhibit 1

Global equities appear to be discounting a US recession



As at 13 January 2016

Source: ASR Ltd./Thomson Reuters Datastream

Important Information

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