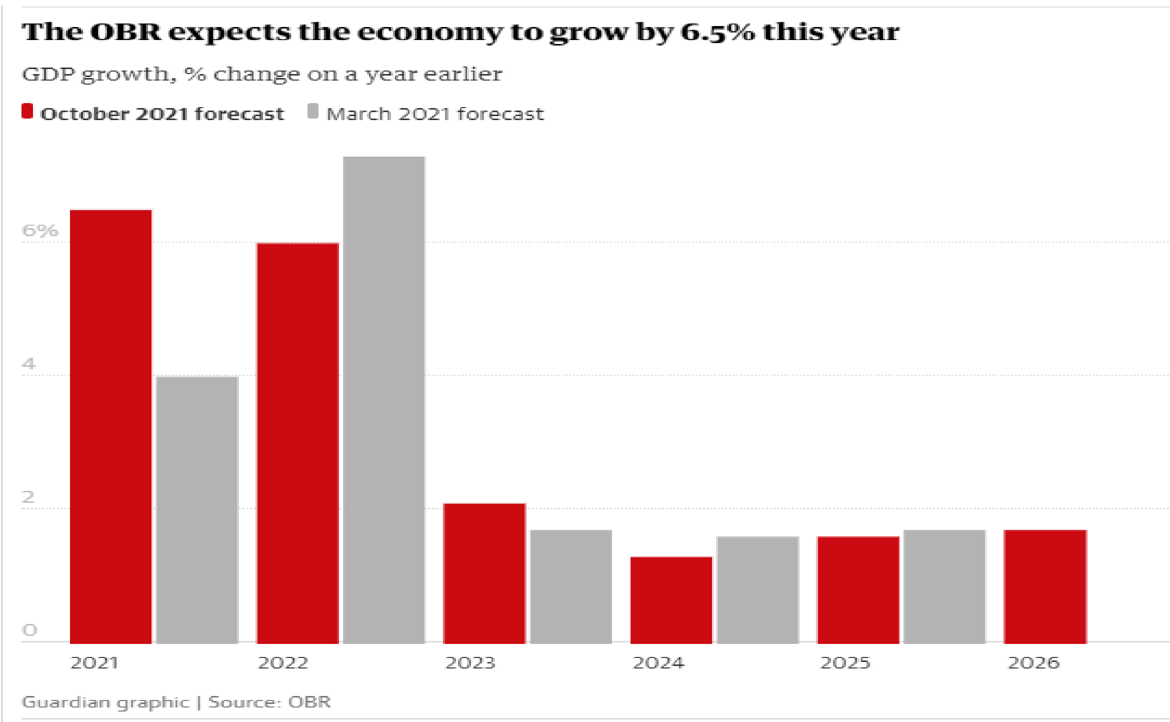
Don't Reject the UK Domestic Story

We have made the argument on numerous occasions that the UK equity market looks extremely good value, and we firmly stick with that view. We are also unashamedly positive in our outlook for the UK economy and domestic related shares. This latter view is, seemingly, increasingly controversial, and it is in defence of this view that we devote this week's commentary.

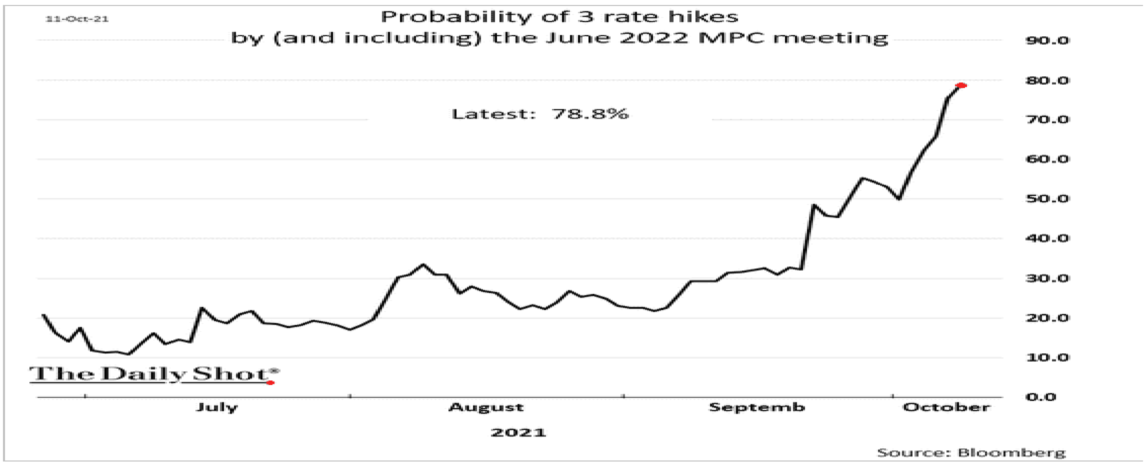
That the UK economy has been bouncing back sharply from the enforced lockdowns of the Covid-19 pandemic is not exactly a surprise, with the latest forecasts from the OBR expecting the economy to grow by 6.5% in 2021 as can be seen in the chart below.



As can also be seen, growth is expected to remain extremely healthy at c.6% in 2022. The stock market currently is, in our view, starting to call that growth into question, as illustrated by the chart below highlighting the significant underperformance of UK mid-sized companies, which are typically more domestically focused, relative to the broader market since the beginning of September.

The list of worries regarding the UK economy appears lengthy and includes persistently high Covid-19 cases, ongoing Brexit related frictions ranging from Northern Ireland to fishing licences, fuel shortages, rising energy bills, ending of government support schemes, cancelling of Christmas for lack of presents on the shelves and, most recently, worries that the Bank of England are about to embark on a rapid increase in interest rates (chart below) that could potentially crush economic growth.

The probability of three BoE rate hikes by next June is approaching 80%.



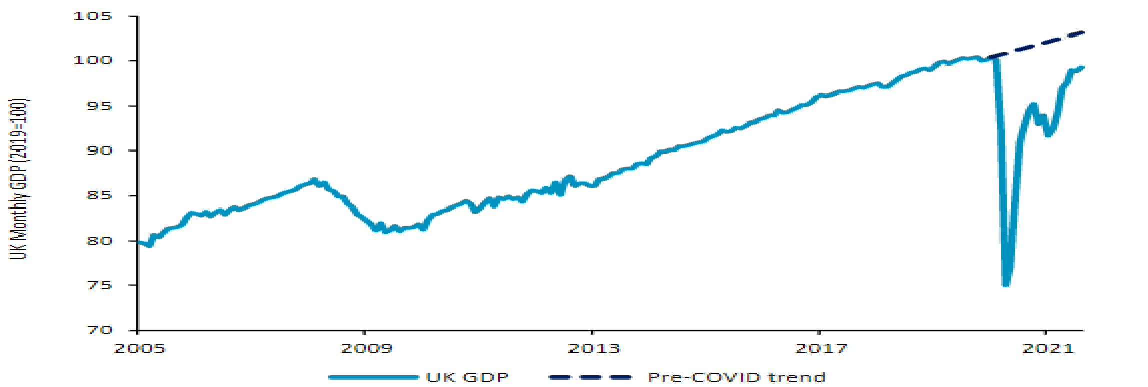
Source: The Daily Shot

It is not our intention to belittle these concerns, and we understand for example, as the chart below highlights, that worries about a lack of stock on shelves are very real currently.

However, we do believe that most of these issues will, ultimately, prove to be temporary in nature and not sufficient to derail the ongoing recovery from the worst pandemic in over 100 years. We will resolve supply chain bottlenecks in due course, including for energy supplies, and indeed refilling those depleted stock levels will be a helpful demand driver into the medium term. It is in all parties' interests for Brexit frictions to be ironed out after inevitable disagreements, and it may well be that Covid-19 cases are at, or close to, peaking currently and, thankfully, vaccines have been having their intended effect in reducing hospitalisations and deaths.

It is worth reminding readers that, notwithstanding the rapid recovery seen so far, the UK economy still has a way to go in terms of growth catch up, relative to trend, as the chart below highlights.

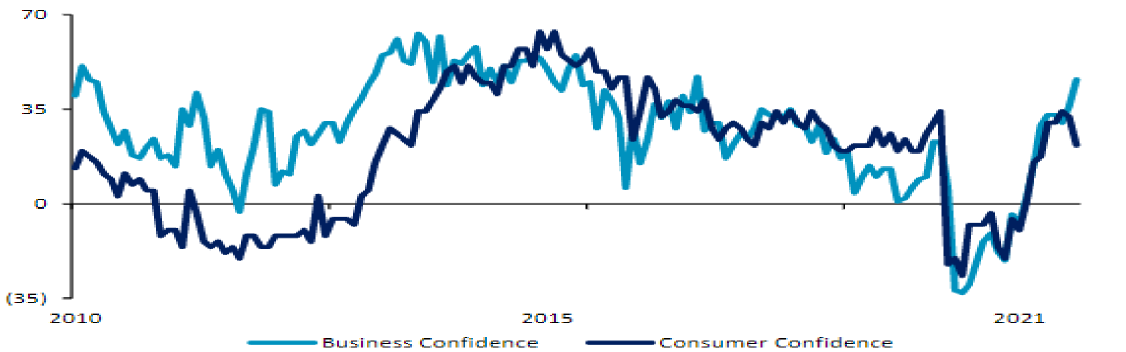
Figure 9: UK GDP, Pre-COVID-19 Trend



Source ONS, OBR

It is also worth remembering that business and consumer confidence in the UK continues to recover strongly, indeed business confidence recently reached a four-year high as can be seen below.

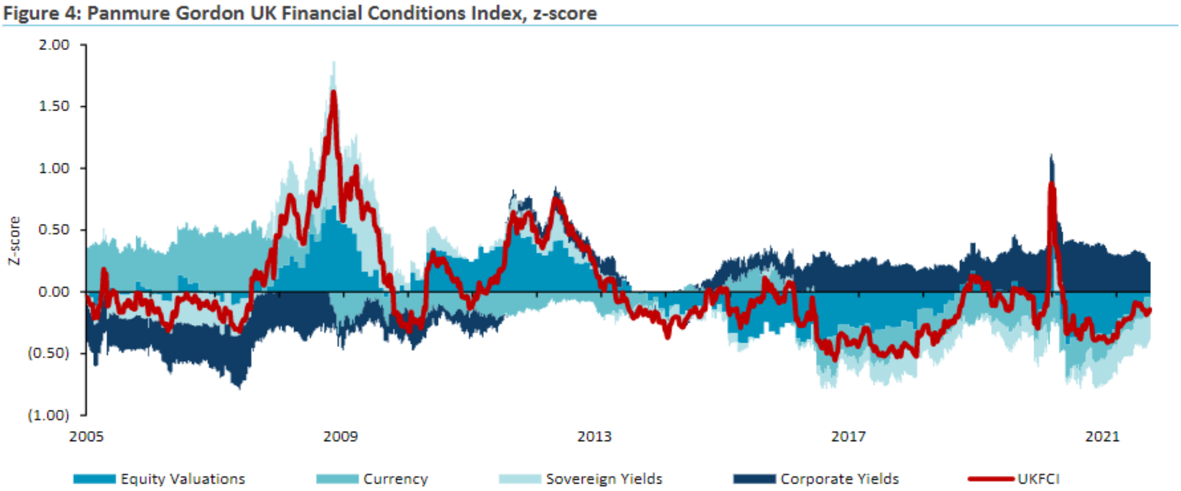
Figure 5: Consumer, Business Confidence (UK)



Source GfK, Lloyds Bank

Turning specifically to government and central bank policy changes, firstly we felt last week's budget was generally well balanced and certainly did not set the stage for the rapid fiscal retrenchment some had feared. Secondly, whilst the Bank of England may well be the first major central bank to start the process of increasing interest rates soon, from the current ultra-low rate of 0.10%, we do not expect a particularly aggressive series of increases that would endanger the ongoing recovery. In this regard the chart below is, we think, particularly insightful.

Figure 4: Panmure Gordon UK Financial Conditions Index, z-score



Source Panmure Gordon, Refinitiv

The UK Financial Conditions Index above incorporates Sterling exchange rates, corporate bond yields, government bond yields and equity valuations and, despite recent upward shifts in short term yields, remains more accommodative, on average, than has been the case over the last 16 years.

In summary, we think the UK domestic economy has plenty of room for further growth in the medium term because of the continued release of pent-up demand, healthy corporate and household financial positions, ongoing housing and job market strength, and still very favourable, even if modestly tightening, financial conditions. We believe plenty of companies will benefit from these tailwinds and we have a disproportionate exposure to those opportunities in our portfolio, in areas such as retail, leisure, house building, and financial services, and we remain hugely excited by their upside potential.

Simon Murphy, Fund Manager, VT Tyndall Real Income Fund, 5th November 2021
Data source (unless otherwise stated): Bloomberg.

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