UK Equities
Interesting and Challenging
October 2013

The FTSE All-Share has enjoyed a strong period, rising by 15% in the last 12 months. Much of this performance has been centred upon domestically focused businesses as the UK economy has been showing some interesting and significant signs of recovery.

First the positives, nicely summarised by Bank of England Monetary Policy Committee member David Miles:

> "For the first time in some years, the news on the outlook for economic activity in the UK over the past month or so has been overwhelmingly positive… (I am) now more confident that we are on path to recovery than at any time since I joined the MPC in the first part of 2009."

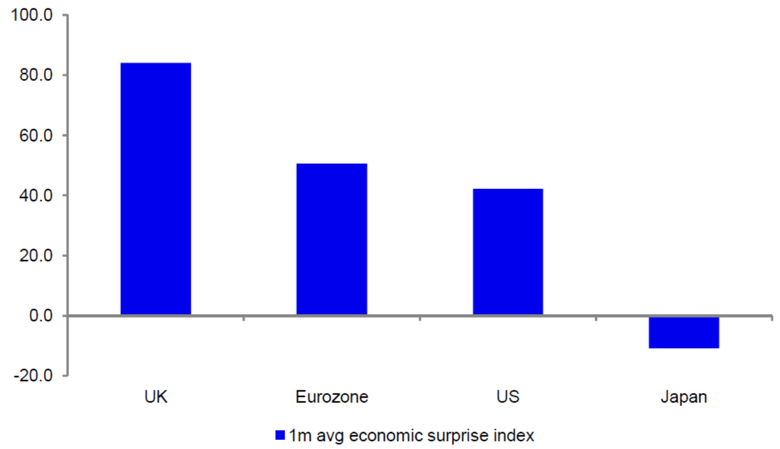
The outlook for activity levels across many parts of the UK economy are looking up. Retail sales are up, house prices are up, mortgage approvals are up, consumer confidence is up and, unsurprisingly, GDP is up.

Figure 1: August composite PMIs relative to peak globally

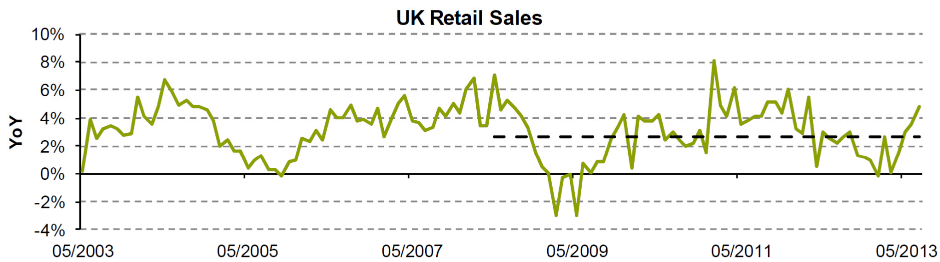
Composite PMIs	Historic maximum	Current	Historic maximum minus current	Date
U.K.	60.8	60.8	0.0	Aug-13
Japan	54.1	51.9	2.2	May-13
U.A.E.	60.1	56.6	3.5	Apr-11
Ireland	62.9	57.6	5.3	Jul-00
Global	63.0	55.2	7.8	Jan-04
Germany	61.5	53.5	8.0	Jun-06
China	59.8	51.8	8.1	Sep-07
Brazil	60.4	49.7	10.7	Apr-07
Russia	62.1	51.4	10.7	Aug-03
Spain	63.4	50.8	12.6	Feb-00
Italy	63.3	50.3	13.1	Apr-00
Saudi Arabia	73.2	59.6	13.6	Jan-11
Hong Kong	65.2	49.6	15.7	Dec-99
India	64.3	47.6	16.7	Oct-07
Egypt	53.5	36.5	17.0	Apr-12
France	66.3	48.8	17.5	Mar-00

Source: Deutsche Bank, Markit, Haver

Figure 2: DM's economic surprises over the month



Source: Bloomberg, Citi



Source: ONS, Haver and Bernstein analysis

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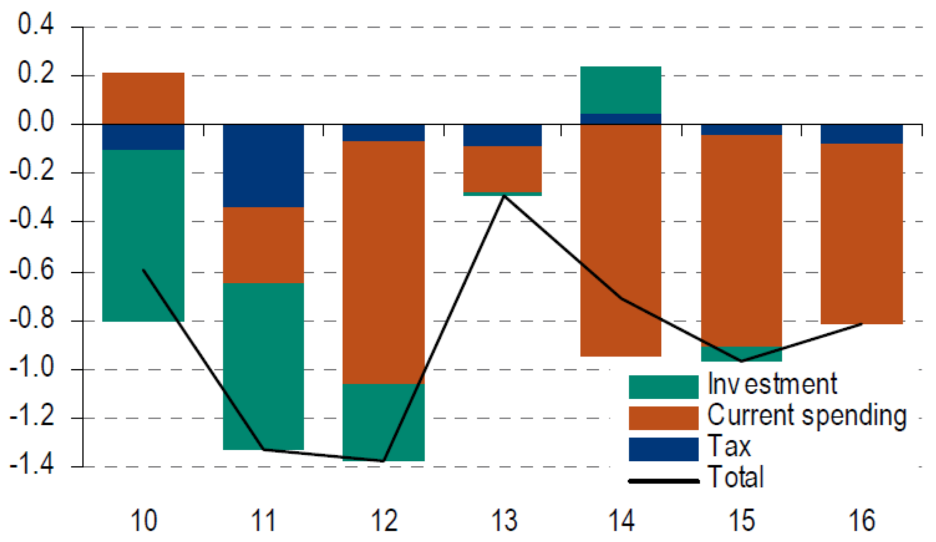
Chart 8: Fiscal austerity drag on GDP growth? (pps)



Source: BofA Merrill Lynch Global Research

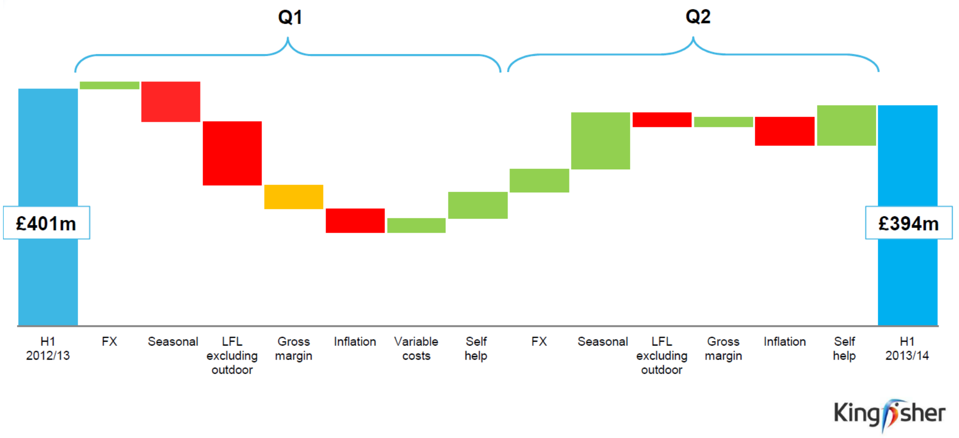
It is especially interesting that this resurgence has come as such a surprise to so many economists and commentators. Before leaping into UK equity investments it is worth understanding some of the moving parts that have led to this period of surprising success and optimism.

We suspect that the "surprise" came from the confluence of multiple factors: sterling remained weak and the Eurozone stabilised which boosted exporters, stimulus measures from the Bank of England (supported by Quantitative Easing in the USA) have lowered costs of borrowing to consumers and corporations, the government has materially backed away from austerity measures and has introduced measures to stimulate the housing market directly and the UK enjoyed the best summer for several years after 2012 was one of the wettest and coldest on record.

The challenge for investors is to pick out what is indeed sustainable and self-reinforcing and what could be cyclical and temporary.

In typical British fashion, let's first deal with the weather! The chart below from Kingfisher, owner of the largest DIY franchise in the UK, highlights the issue: in Q1 the weather ("seasonal") effect was still poor and swamped the company's self-help efforts; whereas in Q2, the positive effect was overwhelming. It is a little disconcerting that the company's best estimate of true underlying trading remained negative.

Retail profit drivers across Q1 and Q2



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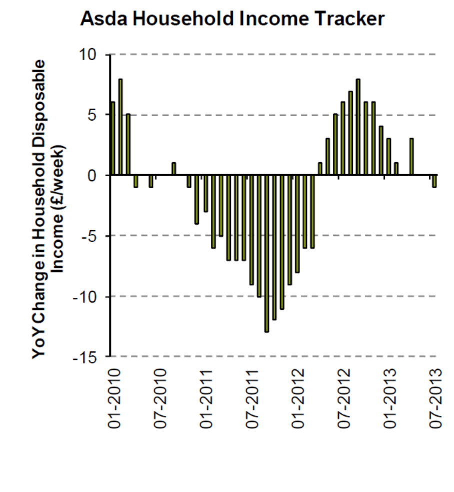
The housing market raises a similarly vexed question. The national level figures are quite cheering, but largely reflect very strong performance in London property, which has as much to do with capital flight from the Middle East and Southern Europe, as well as international investment from Asia and Russia, as it does with genuine domestic demand.

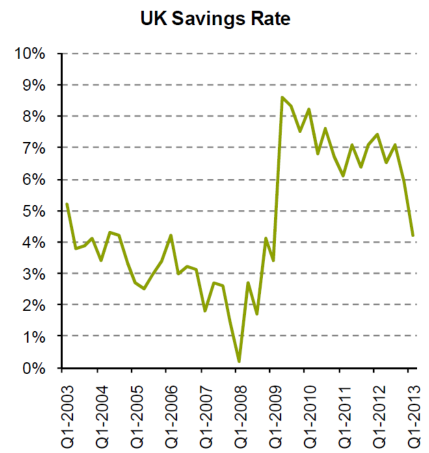
ASDA, one of the UK's largest supermarket chains and more reflective of the British economy as a whole, conducts a monthly survey of the income of the UK consumer which chimes with the official data on UK real earnings growth: there is not much about.

Unemployment has stabilised and consumers have become more confident in the value of their properties (by far and away the largest asset on the UK consumer's balance sheet) which has led to a drop in the savings rate in the UK and a pick up in broad consumption.



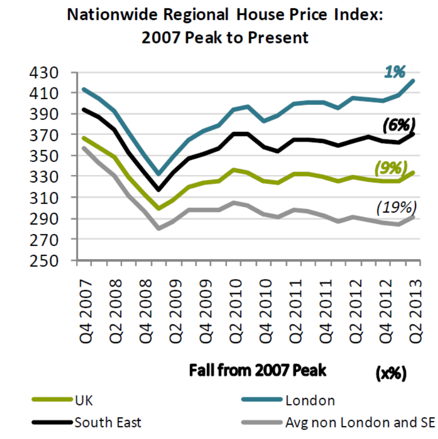
Source: Asda and Bernstein analysis

However, as Next, arguably the UK's most successful retail operator of recent years, pointed out: until you have real wage growth they remain very wary of becoming too enthusiastic about the prospects for the UK consumer.



Source: ONS, Haver and Bernstein analysis

On the domestic front, the signs are definitely positive. The pick-up in activity should lead to an improvement in employment and real wages which would make everything else considerably more sustainable and self-reinforcing. The banking system has gone a long way towards repairing itself



Source: Communities and Local Government Department, Bernstein analysis and estimates

and should be in a good position to begin extending credit to both businesses and consumers. There is, however, a caveat: all of this depends upon the current conditions remaining unchanged.

The Eurozone recovery has to remain robust, the US debt ceiling and political impasse needs to not derail the US economy, sterling needs to remain well anchored and the UK government needs to retain a relatively pro-business bias with regard to rebalancing the economy.

UK stocks remain vulnerable to all of these exogenous factors as ultimately much of the UK economy remains fragile as consumer and government balance sheets are dependent upon low interest rates and asset price stability.

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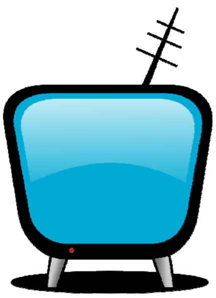
As a result, we believe that gaining sensible, sustainable exposure to strengthening economic activity in the UK requires careful stock selection. We are enthusiastic about the prospects for the house builders, due to changed competitive dynamics and structural supply shortages, despite relatively full valuations.

We are more cautious about the retail sector as competitive strengths appear less reliable with greater online spending (winners win big, but can soon fall out of favour), but enthusiastic about the leisure industry where, again, strong incumbents appear well set to take market share from smaller competitors with upside from any broader consumer recovery.

Investors should bear in mind that the FTSE All-Share Index is home to a vast array of global businesses whose prospects have little to do with activity levels in the UK. These stocks do have an advantage over many other investment universes: the UK enjoys some of the highest standards of disclosure, corporate access, shareholders rights and legal protections as well as a very effective framework under which to engage in international trade.

We expect a pick-up in corporate activity to benefit the UK stock market, especially compared to other countries in Europe. It is also worth remembering that the UK market has a relatively high dividend yield compared to many of its peers, which is an important contributor to total return.



David Kneale — Philip Watson