INSIGHTS

MIRABAUD ASSET MANAGEMENT

UK EQUITIES: FEAR HAS PEAKED

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In September 2021, the UK manufactured its own mini fuel crisis. This was the first (and possibly silliest) cause for worry in what proved to be a near-incessant drum beat of bad news. Around the same time, domestic energy prices began spiking, as much due to poor regulation and bad business management as any real global issue.

November marked the arrival of the Omicron Covid variant, which further undermined investor confidence. Meanwhile, supply chain bottlenecks, excessive monetary stimulus and pent-up animal spirits drove demand well in excess of supply.

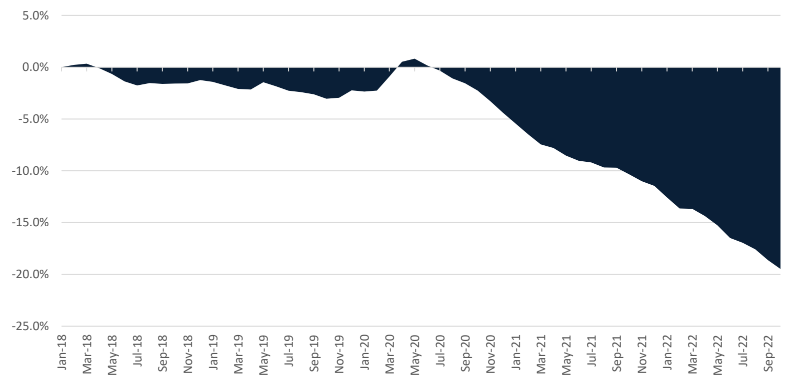
All of the above should have been relatively short-term, 'look-through' events for valuations. They were ignored by global markets but led to a 15% de-rating across much of the UK equity market.

Moving into 2022, petrol shortages and Omicron variants were superseded as energy prices became a more significant problem, as did developed market central banks' attitudes towards inflation.

This proved a deadly combination: rising inflation squeezed consumers, rising energy imports undermined the currency and rising interest rates drove a higher cost of capital and a de-rating across all asset classes.

The result: UK equity outflows (as monitored by the Investment Association) reached breath-taking proportions as summer rolled into autumn (see chart overleaf). Trussonomics crashed into a desperately illiquid and stressed bond market. When the pensions industry has to 'fire-sell' long-dated inflation-linked bonds (their most prized liability-matching possession) you know the problems are serious. This amplified the effects of an ongoing global equity sell-off in the UK.

UK EQUITY OUTFLOWS



Source/ The Investment Association and Mirabaud estimates, 31 October 2022

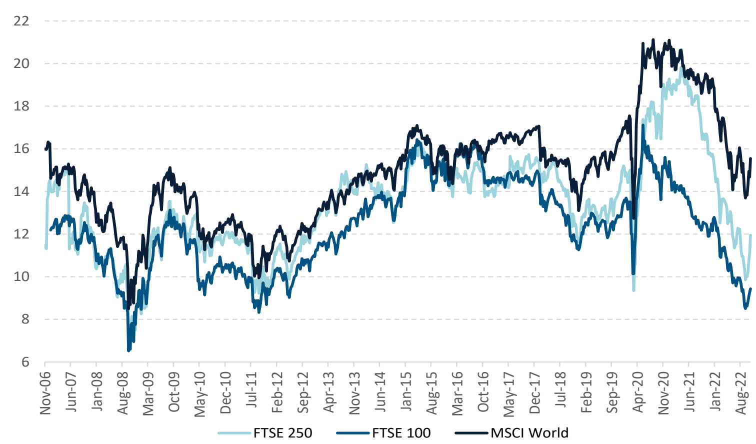
VALUATION DISCONNECT

UK equities spent most of the last decade trading broadly in line with global equity valuations. Today, global equities have shaken off a post-Covid froth and look reasonably fully valued in a historical context.

Conversely, UK equities widely have plunged to crisis levels. When we adjust for the improvement in balance sheets (businesses are more reticent to borrow heavily and, in many instances, are flush with cash after the pandemic), UK equities have, in many cases, plunged to valuations below 2008/2009 Global Financial Crisis levels. While we acknowledge the market faces challenging problems, they are not close to the severity of failure of the global banking system.

EQUITY VALUATIONS: GLOBAL FAR OUTPACE UK

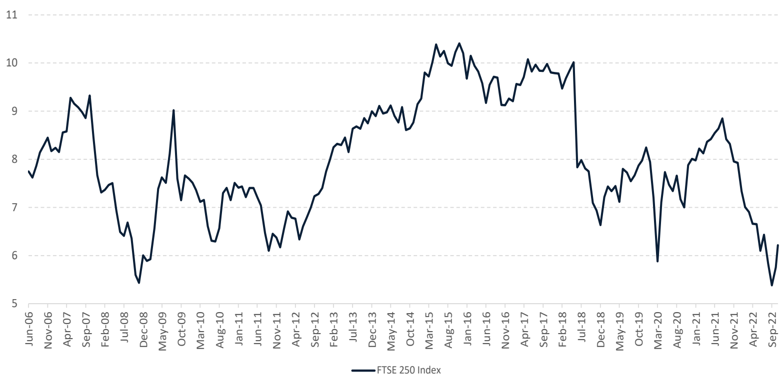
Estimated P/E 12-months forward



Source/ Bloomberg, 11 November 2022

UK EQUITY VALUATIONS PLUNGE BELOW 2008 LOW

EV to estimated EBITDA 12-months forward



Source/ Bloomberg, 17 November 2022

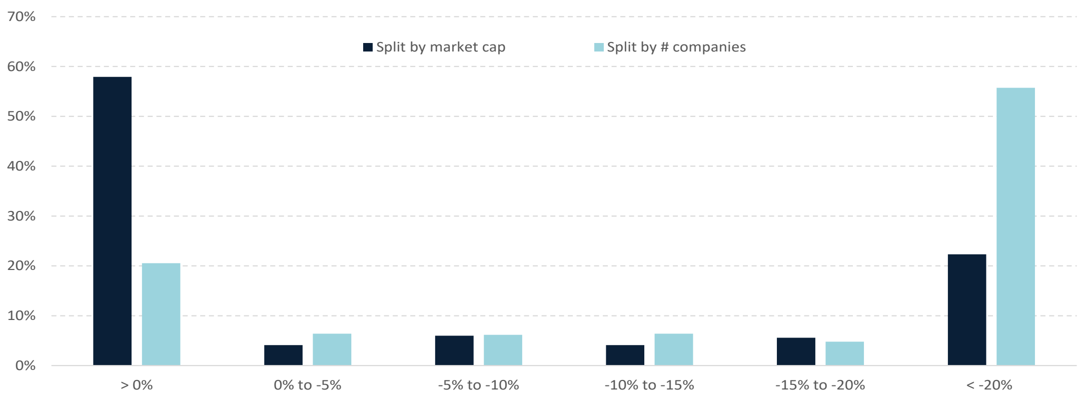
LOOKING UNDER THE SURFACE

This 2021-2022 period of panic has had an extraordinary impact on individual companies' share prices. Since August 2021, 80% of UK shares have underperformed the FTSE All Share Index; the majority have underperformed by more than 20%. This is mind-boggling.

A normal year would perhaps see 20% of companies underperform by 20%; and unsurprisingly (given this is relative performance), 40-60% of companies would outperform the index, not just 20%. Aggregate index performance, propped up by the resilience of the 20 biggest companies in the UK market, masks a bloodbath underneath.

80% OF COMPANIES UNDERPERFORMED AN INDEX PROPPED UP BY A HANDFUL OF THE LARGEST CONSTITUENTS; THE MAJORITY UNDERPERFORMED BY 20% OR WORSE

Distribution of FTSE All-Share Index constituents split by market cap and by number of companies, between different relative performance cohorts (August '21 to November '22)



Source/ Bloomberg, November 2022

HAVE WE REACHED PEAK FEAR?

In absolute terms, valuations have not priced in this much fear for decades. In relative terms, comparing UK-listed businesses (the majority of which have only partial exposure to the UK economy) with similar internationally listed peers, I suspect this is the most fearful valuations have ever been.

It is usually best to avoid making predictions, especially about the future. However, some things seem reasonably predictable:

- Car prices are falling in the UK and the US.
- House prices are falling in the UK and the US.
- The cost of shipping goods is falling in the UK and the US.
- Sharply elevated interest rates are slowing demand in the UK and US (especially sharply in the UK).

Some of the major drivers of inflation are likely to be negative next year, making it extraordinarily unlikely that headline inflation will remain as high as it currently is. In the UK, disinflation seems a more likely concern in late 2023.

Declining expectations for interest rates should remove some of the valuation pressures, but attention will likely turn to earnings forecasts instead.

Might earnings forecasts be too high? Almost certainly – much as earnings forecasts were too high in 2008.

Might the UK's upcoming recession last an unusually long time? It is certainly possible, but two consecutive years of economic decline would be a very unusual phenomenon. And remember, for UK equities (not the UK economy) this needs to be a phenomenon affecting economies globally (due to their international revenue streams), so best described as vanishingly unlikely.

Traders might fear the risks of bad news through the winter (with a remote possibility of blackouts), but investors with sensible time horizons investing in UK businesses with strong balance sheets that remove the ruinous possibility of recapitalisation, should perhaps be rubbing their hands with glee. Warren Buffett put it better than I can:

> "When it's raining gold, put out the bucket, not the thimble."

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