Psigma
Investment Management

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Brief View from Psigma

"Will the Long Goodbye Become the Long Good Buy?"

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After four and a half long years, it now appears that we are finally able to move on from discussions around the UK's exit from the European Union. Following the announcement of a new trade deal between the UK and the European Union on Christmas Eve, over the last week we have seen both provisional approval from the European bloc and ratification of the deal from the British Parliament, in time for the start of the New Year.

Our view over the lengthy divorce process did not change much, as from the very day of the referendum we believed that a "no-deal" Brexit would be avoided, but that any deal would be very hard to achieve and that it would likely end up entirely pleasing very few people. We also expected any agreement to come at "five minutes to midnight", forecasting that the European politicians' history of coming up with last minute agreements would be repeated in this acrimonious situation. The final obstacles were the much discussed "level playing field" on the future trade relationship between the EU and the UK and the fishing rights of the EU in the UK's waters from the start of 2021. These obstacles appeared to have sufficiently cleared in the days before Christmas, allowing the agreement to come to pass. Both sides will try to claim victory, but the deal does appear to have been balanced between both sides. It is not perfect, and we would certainly question the outlook for the UK's vital services sector, which makes up about 80% of our economy and looks less provided for in the details of the deal. We are awaiting comments from the banking and financial sectors, which so far have been quite quiet on the deal, to evaluate how they will be able to operate once this new agreement comes into effect.

Now that we can move on from discussions over "deal or no deal", the questions that we now need to answer are: how will the UK economy now fare in the post-divorce years, and can UK investments start to play catch-up with global asset markets?

How the UK economy recovers over the next year will be dictated by how quickly we can reopen from the current restrictions in place to limit the spread of COVID-19. The current expectation is that enough of the elderly and vulnerable members of society will be vaccinated by Easter, ensuring that a near-full reopening of the economy can finally occur. Any further delay to this prediction would lead to a continuation of the current disastrous performance of the UK economy. Our economy was the worst-faring of all major developed economies last year, and sadly that performance trend is persisting through these long winter months. The latest round of restrictions have dealt a mighty blow to the already stricken retail, hospitality and leisure sectors, and with restrictions set to be tightened further in the coming days, it could well be a case of it being "darkest just before dawn" for the UK economy. Thereafter, if those people for whom it is considered necessary take the vaccine and medical conditions improve as we head into the summer, the UK economy should enjoy a vigorous recovery, as pent up demand spurs the economy into a higher gear.

After the cyclical recovery we are forecasting for the second half of 2021, we have less conviction for 2022 and beyond. Certainly, we feel that the extreme projections from the last four years, ranging from "London will be a ghost town" to "London will be Singapore-on-Thames" will not be realised and that the UK economy will probably still plod along the same economic course that we would have done anyway. Hopefully our politicians can turn some of their promises of the UK becoming a "Global Britain" in to reality and we can benefit as fully as possible from the growth of developing nations, who want to use the UK's businesses out of admiration for our services sectors and respect of our legal system.

On the more negative side of the equation, there is bound to be some post-Brexit uncertainty, as well as the risks posed by the gargantuan debt pile that we have created over the last two decades, which itself is a global phenomenon. The quantity of the debt that exists in the UK economy (government debt is now over 100% of GDP for the first time since 1963), as well as the likelihood that taxes will have to rise to pay for our government's actions in the COVID crisis, will act as a suppressant upon growth through the post-COVID recovery years.

One inescapable feature of the post-EU Referendum years has been the relative underperformance of UK assets in what has been a boom period for global asset markets, as valuations outside the UK have been propelled higher on a tidal wave of liquidity provided by central banks and interest rates being cut to 0% across the developed world. From the date of the UK's decision to leave the EU, UK equities have risen a mere 25% during a period where global equities have nearly doubled. There is little doubt that the negative sentiment towards the UK due to our political situation and the relatively poor performance of the UK economy has been a major factor in this underperformance of our domestic equity markets.

The natural and reflexive reaction would be to look at the relative weakness of UK equities and decide to just buy a UK equity index tracker on the basis that the Brexit "overhang" has been removed and that the COVID crisis, during which both the UK economy and equity market have fared relatively poorly, should be behind us as we head deeper in to 2021. We have some sympathy with such a view, but are not convinced that it is as simple as that. For a start, it may be true that UK equities are relatively cheap, but this point needs further scrutiny. Detailed analysis shows that UK equities trade at a 30% earnings discount and a 40% assets discount to global peers, a shortfall that has all been created since that fateful day in June 2016, but this is in no small part down to the constituent parts of the UK equity index.

Undoubtedly, the negative sentiment towards UK assets has not helped in the post-Referendum period, but the UK equity market's poor performance over the last four and a half years has mostly been attributable to the fact that there are heavy weights in sectors like energy, resources and banks. These sectors have materially lagged other sectors that are more heavily represented in global markets, with technology being the obvious winner in the latter (the UK index's weight in technology is basically 0%). Further analysis shows that if we adjust the sectoral weightings in the UK to reflect a fairer comparison to global markets, the earnings discount narrows to "only" 20%.

So, there is a case that UK equities are cheap by comparison to global peers, but we would suggest that we will need to see a significant structural economic improvement from the global economy to act as a tailwind for the cyclical-economy focused UK equity index. A major issue for the UK equity market has been that there simply hasn't been any corporate earnings growth in the last few years, which has meant that while UK equities are cheap by comparison to global companies' valuations, they are not necessarily cheap in absolute terms (the UK equity market trades on roughly 15 times next years' expected earnings, a level we would describe as "fair"). Assuming our predictions for economic activity next year are not totally wrong, this should lead to a better relative performance from UK equities as the global economy improves from its recent economic malaise.

Another factor is that the UK equity market has been shrinking into obscurity. You will all have read the facts about how the market capitalisation of the UK equity market (now around 5% of the global index) is now smaller than that of Apple, the US consumer technology giant. This has made the UK market an easy market for global investors to avoid and ignore over the last five years. In recent weeks, global investor interest has picked up considerably, according to reported fund flows, and the best chance the UK market has of catching up with its global peers is, ironically, if it starts performing well. So much of today's liquidity-fuelled market environment is based upon narrative and momentum, so relative success for the UK market could breed further success as international investors take notice of a market they have chosen to ignore in recent years.

Another positive for the UK equity market could well be an increase in inbound mergers and acquisitions activity, just as we saw in the first decade of this century. The nature of the UK equity market and our legal system are such that it is very easy for global predators to buy UK-listed companies; with UK companies relatively cheap, and international companies and private equity firms sitting on large cash piles, with easy access to cheap debt, we could well see a "golden age" of takeovers of UK companies. This would certainly attract the attention of global investors.

A negative factor for investors in the UK equity market could well be the international focus of UK-listed companies. Nearly 70% of the earnings of UK companies are derived internationally, so if we were to see a major rise in the pound, which still trades nearly 10% lower against the dollar than it did in June 2016, it would crimp the profitability of UK-listed companies and reduce the valuation pillar of support that UK companies currently have. It is also likely that the direction of dividends will be key for UK companies; the speed with which UK-listed companies can reinstate or boost dividends in the post-COVID years will be vital to UK equities' success or failure.

Across our portfolios, we currently have a "neutral" stance towards UK equities, with our most recent decision to increase UK equities in September helping portfolios' performance in recent months as the UK equity market has clawed back some of its 2020 losses. Certainly, we will be evaluating whether the UK allocations in our portfolios deserve a higher weighting early this year, but this decision will be based more upon how we expect the world to fare as it hopefully improves, as global medical risks subside. The UK equity market will need to see evidence of a cyclical economic improvement for it to outperform on a sustainable basis.

It probably doesn't matter what one's views are on the original decision that saw the UK leave the European Union; the fact that we now have a trade deal in place and can stop fearing a "no-deal Brexit" is a relief. We hope that the UK can now move on to focusing on managing the COVID crisis better and growing again once both the medical and Brex-it crises are, hopefully, behind us. There will likely continue to be lots of extreme views over the UK economy for some time to come, but the reality is that the UK economy will likely continue to grow at slow pace in the coming years, much as it would have done anyway. There is the hope that the UK can use the strength of its services and financial sectors to power economic success in the coming years, as well as recalibrating our economy towards those parts of the world that will see growth in the future. We hope that the days of UK assets' relative weakness are finished, but we will need to see more than just the fact that Brexit is now behind us to enjoy a renaissance for UK equities; taking a balanced view, as always, is appropriate.

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