'Should I Stay Or Should I Go'
Or
'End Of The Road'

November 3rd, 2022 UK Market Analysis

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Readers will know Arlington's penchant for music. For this UK centred piece we couldn't decide on just one anthem, so we've gone for two! On politics 'Should I Stay Or Should I Go' from The Clash is appropriate after three Prime Ministers and four Chancellors. Rather like the politicians, the song was only moderately successful when released.

In our mind, 'End Of The Road' by Boyz II Men summarises most people's views on UK financial markets. With 13 weeks at number one in the US the hit was the number one single of 1992. If you combine this with Warren Buffett's comment we think you get a good summary of 2022 so far, "You don't know something will happen until it happens. A shock could come at any moment."

Since the war in Ukraine began, investing in the UK has been anything but a calm enterprise. So, we've put pen to paper to try and distinguish the wood from the trees and the realistic from the sensationalist news now commonplace. This year the UK stock market, Sterling and gilts, at times, have suffered sustained selling. So, is the UK still a good place to invest?

Investors had a stark reminder it's essential to have a competent and respected government. It was financial markets that called time on Liz Truss's short-lived premiership and the music changed once again in October with the appointment of Rishi Sunak as PM. The immediate result was UK asset prices and Sterling strengthened as, clearly, markets were pleased at the prospect of a PM who could restore fiscal credibility. Crucially, government bond yields fell on the news, which lowers the cost of borrowing for everyone. There is obviously more to play out, but the government got the message to deliver a credible economic plan the markets believe. The FT has called the lowering of the gilt rates a "dullness dividend", bringing down the hole in the budget and a renewed sense of post crisis calm.

We're now all experts on the topic of the day, fuelled by data and analysis on a 24-hour news cycle. Almost everyone has gone from being an amateur virologist to a weapons expert. Now the public are all looking at weather dials trying to work out if we could or should (given the geostrategic implications of our decision) turn the heating on. On that, there is good news here as the cost of gas has fallen below GBP300 / therm and Europe is experiencing an exceptionally mild autumn so far, leading Goldmans to predict a further 30% drop. As a direct result the implied cost of the UK's Energy Price Guarantee is fast coming down, with the Indicative Daily Average Wholesale Price of electricity dropping from GBP0.58 pkWh in August to GBP0.10 pkWh at time of writing.

There is other evidence to show that inflation expectations are beginning to temper. Yet the Bank of England's 75bps rate rise, while being pitched as harsher now to be kinder later, seeking to get ahead of inflation, could hardly have been anything but a mirror to the Fed's rate rise yesterday, and the ECB's similarly strong action. Otherwise, the BoE would risk looking out of step to the market. Some traders clearly expected a full point, so the pound fell back nearly 2% immediately after the announcement, only some of which is explained by dollar strength as the Euro is down 1.25%.

Sterling

2022 has not been a great year for Sterling, but Bill Gross, the fund manager renowned as the "bond king" and co-founder of Pimco, recently told investors that he was now "long the pound", betting that a strong dollar would soon reverse and lift Sterling after it hit its weakest level since 1985. "Despite fiscal and political problems, I am long the pound because of an overvaluation of the dollar against all major currencies," the American billionaire said. "Continued large trade deficits and a ceiling on the Fed's ability to raise rates to anticipated levels due to future recession will limit further depreciation of the pound and likely lead to future relative increases compared to the dollar."

Cable recovered to around $1.15-1.16 to greet the new PM from almost parity, allowing UK assets to recover some recent losses as buyers have returned, despite the latest fall. UBS see potential for further dollar and Swiss franc appreciation against the pound, but do, like us, see more value in UK equities and long-term income as a defensive strategy.

Real Estate Asset Prices

We see a few forced, fearful or simply refinancing sellers offering opportunities for buyers, both domestic and particularly dollar buyers, of real assets. Long term income asset values are holding up well and closing, where for more risky value add opportunities prices are being clipped back in firm buyers' market territory. Smart investors have been holding cash in anticipation of this point in the cycle and are now quietly buying UK assets either on or off market. Discounts for UK real estate range about 10-15% at present, with cash buyers the main movers as leveraged buyers pause to see where rates settle. With the dollar having come off from $1.30 in 2017 to around $1.12 at the time of writing, and if one factors in inflation, the market may well dip to 2013 prices. In those terms, US dollar buyers are making purchases at over a 30% discount and locking-in increasing real yields, reflecting a market price of risk which we see as well overblown.

When the market senses a change there will be swift price movements in the other direction. Buyers seeking to find the bottom of the market to make purchases run the deeper risk of being left behind and losing out on much of the gains of seeming brave. Remember Nathaniel Rothschild's attributed dictum of 1810: "Buy to the sound of cannon. Sell to the sound of trumpets."

So how does all of this translate into the equity markets?

Interest rate-driven market falls tend to happen fast; once central banks are expected to raise base rates, the rate at which future equity cash flows are discounted rapidly follows suit. Other things being equal, discounting back prospective cash flows at a higher rate results in a lower company value and thus share price. Whilst this first order impact of higher rates on valuations happens almost automatically, the effect on the economy and corporate earnings is more complex, and tends to hit consumers and company profits after a lag. We believe it is to this that share prices are now most vulnerable.

Are we there yet? UK company earnings have remained broadly resilient year to date, but the PMI numbers have stalled, with manufacturing falling from 48.4 to 45.8 (50 is the cut-off for growth) and services PMI falling from 50-0 to 47.5. But compared to what? The US PMI figures are broadly the same as ours and Germany's PMI is now 44.1. It seems inevitable that there will be a wave of recession driven profit warnings to come for all. Companies will be battling slowing growth, rising costs and wage demands, and significantly higher interest payments against a shaky geopolitical environment and

myriad other inflationary pressures, particularly if energy prices remain high and central banks continue to raise rates higher and faster.

One bright spark is some inflationary pressures easing, the most notable being the oil price, freight rates and building costs to name three data points. Longer term US inflation expectations eased, with University of Michigan Survey of Consumers showing US consumers' five-year ahead inflation expectations down to 2.7%, the lowest since July 2021. Year ahead expectations lowered to 5.1%, though that was up from 4.7%. Jay Powell has indicated that the Fed by going hard now could become less aggressive in tightening over the cycle, provided inflation tracked back. This would likely help moderate the US dollar rally against Sterling and ease some of the pressures globally in 2023. Andrew Bailey for the BoE likewise spent much of his press conference today making the case that the market is significantly over pricing forward interest rates.

Outlook

Synchronized stock and bond selloffs have been the signature feature of 2022. In an environment of rising real yields and decelerating growth you want to be as defensive as possible and spread bets widely across sectors with exposure to real assets. Looking at sentiment indicators we believe that that investors might be worried, but not panicked. Our central view is that there will be an orderly repricing like in the early 1980s or early 2000s and not the 'systemic shock' of 2008 or the 'getting out of control' of the 1930s.

Doom and gloom over the UK economy looks overdone. Clearly, we have entered a period in which growth will be hard to come by. A mild recession is looking certain, but compared to the wild Covid related swings of the past couple of years, including a phenomenal 20% plus drop in GDP over two quarters in the first half of 2020, a 2023 recession will be small beer in relation and will help to sort out the imbalances in the economy. To believe this, one needs a cool headed view of dreadful news headlines and remember the UK has just had a decade of growth well ahead of the dire predictions splashed on the front pages.

We believe smart investors will emulate Nat Rothschild and add to their Sterling based investments, particularly in defensive equities and long-term asset backed income.

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