View from the UK Equity Desk
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In this article we discuss the outlook for the UK equity market, highlighting important themes as well as our key sector likes and dislikes.

A look back over the second quarter

UK equities fell sharply, suffering their biggest quarterly reversal in nearly two years, as investors concluded that severe fiscal austerity measures being imposed in the UK and continental Europe risks pushing the region back into recession and squeezing corporate earnings. The FTSE All-Share returned -11.8 per cent, which left the index nursing a 6.1 per cent loss over the year to date. Higher interbank rates, which reflected increasing reluctance by banks to lend to one other, raised fears a renewed credit shortage could choke off the fragile economic recovery.

Financial shares paced the decline on concern a number of financial institutions could be forced into a fresh wave of write-offs on their holdings of sovereign debt as concern over the ability of several European governments to repay their obligations mounted. Other areas of the market that are especially sensitive to the economic environment, such as oil & gas producers and miners, also fared poorly. The weakness of the oil & gas sector was in large part due to a slump in BP's share price as the catastrophic Gulf of Mexico oil spill led some observer's to call into question the oil giant's very existence. Mining shares were hurt by an Australian proposition to impose a 40 per cent tax on company profits, while China's decision to raise its deposit reserve requirement for the third time this year added to the sell off.

By contrast, defensive sectors such as utilities, healthcare and telecommunication services significantly outperformed the broader market as investors sought shelter in firms that are best placed to withstand a weaker economy.

Our outlook for UK equities

With interest rates likely to remain close to zero for longer than previously anticipated, our UK equity team continues to expect shares to generate a reasonable return for investors. The recent slide in equity markets has left valuations looking increasingly attractive, particularly in relation to cash and other risk-free investments such as medium to long-term UK government securities. Whilst efforts to reduce its budget deficit are expected to harm UK medium term economic growth, this should benefit quality stocks that are able to display genuine growth prospects in spite of the weak economic backdrop.

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Analysts have already responded to strong first quarter company results by lifting their earnings forecasts. And while companies have been using healthy rates of cash generation to reduce debt, we believe expectations are in danger of getting ahead of themselves. For instance, it should be remembered that much of this excess cash generation has been of a one-off nature. Our analysis therefore remains focused on the quality and sustainability of cash generation. In 2010 we believe companies who have managed to grow earnings by cutting costs are likely to find their shares de-rated. Conversely, shares in those companies that are benefiting from sustainable revenue growth are likely to do well.

Going forward we also see equities gaining support from resurgent M&A activity.

M&A and quality growth prove key stock-specific performance drivers

In our first quarter review we mentioned that growth in 2010 is likely to be spread across a greater number of sectors – particularly those which were left behind during the rally of the past year. In terms of specific themes, merger and acquisition (M&A) activity was also cited as being one of the major catalysts for growth in 2010, especially as firms looking to cut costs as a means of boosting earnings in a low-growth environment. Going forward our analysis continues to focus on identifying cash rich companies, with strong balance sheets and which offer historically high (dividends) returns relative to risk free assets such as cash; whilst with regards to M&A activity we have seen evidence that this will continue to be supportive for equities. With company balance sheets strong and borrowing costs still low, M&A remains a logical method of growing earnings in a low growth environment. Examples of bid activity seen thus far in 2010 include Babcock/VT Group, Travis Perkins/BSS and the ongoing bidding wars for Chloride and Scott Wilson Group.

Economic backdrop

Sub-trend growth envisaged in the UK

Though we expect the economic growth cycle to mature further in 2010, we see the rate of recovery proving modest at best given the headwinds that have to be addressed. As the year progresses we expect the deteriorating prospects for consumer cash flows in 2011 to receive increasing investor attention. Furthermore, efforts by central banks and governments to withdraw the significant monetary and fiscal stimulus is bound to be fraught with difficulty as policy makers risk derailing the recovery by removing accommodative monetary conditions prior to growth becoming entrenched. In the UK fiscal woes are now being addressed which while positive for sterling's outlook, is likely to have a negative impact on the disposable income of UK households and consequently the UK's medium-to-longer term growth prospects.

Although it faces similar headwinds to those in the UK, the US economy appears in better shape, helped by the manufacturing sector's sizeable contribution to economic output. However, with the European sovereign debt crisis stoking concerns of a double-dip recession globally the US economy now seems in a more vulnerable position than it did over the first quarter. By contrast, economic growth in Europe is likely to be lower than previously expected as the use of fiscal austerity measures by various regional governments to reduce their budget deficits is expected to have a detrimental impact on aggregate demand.

It is worth mentioning this as the UK equity market is no longer dominated by the domestic economy, with almost two thirds of UK companies deriving their earnings from overseas.

Goldilocks scenario – still don't believe it.

It appears that we were right not to subscribe to the consensus 'goldilocks' view of economic recovery gathering momentum globally, particularly without any pressure on interest rates to rise from emergency levels. And with economic growth prospects deteriorating across the world, it now also appears that interest rates will remain lower longer than we previously expected.

Also, whilst it is true that vast quantities of cash are still sitting in low-return asset classes, we still believe it is too simplistic to assume that these funds will be ploughed into risky assets to the same degree as they were in previous economic cycles. Regulatory requirements and two significant bear markets within six years are likely to result in structurally higher allocations to risk-free assets, despite the unattractive returns on offer.

Other considerations

On the desk we are also uncomfortable with the view that a long period of low interest rates in the US will cause the dollar to be weak and assets to continue flowing into emerging markets, commodities and risk assets generally.

The dollar's strength seen thus far in 2010 is no surprise and we expect this to continue given the relative strength of the US recovery. Meanwhile, there is a risk that growth expectations for China have become too optimistic given the enormous stimulus required to generate growth in 2009 and China's ongoing efforts to get rampant credit growth under control. Furthermore, whilst we see commodities benefiting from a recovery in US demand, commodity prices are likely to be affected more by what happens in China.

The recent debt crisis in Greece is a clear example of the major dangers that still lurk within the global economy. Greece's issues remain unresolved and are likely to be an ongoing theme throughout 2010, with the threat of contagion to other 'periphery' southern European nations remaining a real possibility. Nonetheless, we welcome the resultant increase in equity market volatility as it has thrown up investment opportunities or anomalies that were previously unavailable. For instance valuations in the mining sector are now a lot more attractive than in previous years.

Key sector views

Mining (underweight)

Over the quarter we increased our exposure to the sector in light of falling valuations. Driving mining shares lower was an Australian proposition to impose a 40 per cent tax on company profits and China's decision to raise its deposit reserve requirement for the third time this year. The latter had a detrimental effect on commodity prices as it threatened the perception that strong Chinese demand would keep commodity prices high over the long term. In our opinion balance sheets within the sector are also largely repaired. We have increased our exposure to Rio Tinto due to its leading position in iron ore and the prospects of increased shareholder returns.

Oil & Gas (underweight)

We continue to believe that oil majors face a challenging future with existing productive assets in decline and access to new resources proving both difficult and expensive. Though we have been very underweight the two oil majors (i.e. BP and Shell) over an extended period, the collapse in BP's share price has led us to increase our exposure to the company to a neutral position. This is because we think it is worth considerably more than the current share price indicates, even after all its cleanup costs from the Gulf of Mexico oil spill are accounted for. We do nonetheless have sizeable positions in some exploration and production companies, such as British Gas and Premier Oil, where we feel growth opportunities are significantly better.

Banks (underweight)

Whilst we believe the process of re-capitalisation is largely complete, banks' will continue to reduce the size of their balance sheets for some years yet. This will weigh on profits. In addition, stricter regulation, including greater capital requirements, will lower returns on a permanent basis. In terms of individual stocks, we prefer HSBC, which we believe offers global growth prospects and have emerged as a competitively stronger franchise following the global financial crisis. The Lloyds Banking Group is another stock we favour as we see considerable recovery potential as the merger synergies with HBOS kick in.

Pharmaceuticals (overweight)

We are overweight pharmaceuticals, mainly for stock-specific reasons. With regard to GlaxoSmithKline, we believe the market is yet to fully recognise the improved quality of cash flows, as earnings are driven by a wider set of growth opportunities, including emerging markets, consumer healthcare and vaccines. For AstraZeneca, the share price under- estimates the ability of management to use cash flows to reduce the impact of foreseeable patent losses.

Industrials (overweight)

We continue to prefer exposure to recovering global growth through industrial stocks as opposed to miners. The manufacturing base that remains in the UK is of higher quality than during previous economic downturns and this has been clearly evident in more resilient earnings than most commentators expected. Nonetheless, we have recently been reducing our exposure to the sector as current economic growth expectations may have been too optimistic. With shares in the industrial sector having performed strongly and with better opportunities arising elsewhere we thought it wise to begin locking in profits.

Media (overweight)

Overall, we see media sector valuations as attractive given that many companies have more robust cash flows than the market perceives. Pearson, Reed and United Business Media all offer strong market positions and trade on modest multiples of 2010 forecast earnings after which strong growth should resume. Currently, we are exposed to recovering advertising trends through ITV and newspaper publishers, where we see positive operational gearing being underestimated. In addition, we have purchased Aegis, where profits have been successfully protected through the downturn via cost cutting. The stock remains a long-term growth franchise and is an obvious consolidation candidate.

Source of market data: Bloomberg, FactSet