Heartwood
Investment Management

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Investment Insight

Weekly Insight

UK equities: still cautious but seeing opportunities in our home market

Needless to say, these are unpredictable times for the UK given the gathering uncertainty over the Brexit negotiations and the flickering possibility of a Corbyn-led government. Our view is that the UK's challenges are economic as well as political, something which has been reflected in the relative underperformance of UK equities vis-à-vis global indices.

From a structural point of view, the UK economy appears to have made little progress over the past couple of years. While the manufacturing sector has seen some benefit from the post-referendum devaluation of sterling, it remains a small part of the economy and has not lifted the UK as a whole. The consumer has also been under pressure, responsible for weak retail sales data and declining domestic car sales, with incomes squeezed by rising inflation and a lag in wage growth.

There is, however, some light at the end of that particular tunnel. We believe that headline inflation has passed its peak at the same time that wages in the UK, while not accelerating rapidly, are at least moving in the right direction. Our view is that disposable incomes will start to pick up from here, easing the squeeze on households.

Trying to put Brexit to one side

While the outcome of Brexit negotiations seems as murky as ever, as investors we cannot simply sit on the sidelines waiting for some magic agreement to appear. This might sound strange given its importance for the future of the UK, but investors and businesses almost have to put Brexit to one side. The likelihood must be that there will be some kind of transition deal that will allow the UK to muddle through, but even that is no certainty.

There is also the possibility that the Conservative government could split in two over the Brexit issue. However, there seems to be a strong sense of self-preservation about the government, so while we have not dismissed the possibility of an earlier-than-expected general election, we are probably now a little bit more relaxed about that than we were six months' ago.

Have we now passed 'peak Corbyn'?

Clients are right to be concerned about the potential policies of a Labour government, which would likely be unfriendly towards savers and to those who are invested in the UK and financial markets. However, given Labour's less-than-impressive results in the recent local elections, there is a sense that we have passed 'peak Corbyn', reducing this particular risk.

Where are we finding value in the UK stockmarket?

Since before the 2016 Referendum we have remained somewhat cautious about the UK and have positioned accordingly in UK equities, property and government debt. That was not originally a statement about Brexit, nor a bet on the referendum vote, but more a judgment on how we saw the prospects for the UK economy. We are still in no hurry to bring money back to the UK given ongoing Brexit uncertainty, currency volatility and the general softness of the economy.

At the same time, within the UK equity market our bias has been towards larger companies which have performed well over the last twelve months, particularly ▶

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more recently as sterling has weakened. There is an argument to be made though, that the more domestic parts of the UK market have over-discounted the well-understood political and economic uncertainties and that investors might have been exaggerating these risks. We are now seeing some potential opportunities in smaller and medium sized domestically-oriented shares, many of which are trading at their biggest discount to the UK exporters in almost a decade.

Within the UK, we are therefore looking opportunistically at reducing our bias towards the more internationally-focussed companies in favour of those that generate the majority of their revenue in their home market.

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