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MARKET INSIGHT

MARCH 2021

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THE COMEBACK OF UK EQUITIES

Despite the measures still in place around the world to contain the pandemic, financial markets have been anticipating a post-pandemic global economic recovery for many months. This reflationary environment is favourable to financial assets most sensitive to a synchronised global recovery, to the commodity cycle and to interest rates. In the stock market, this is reflected in a marked revival of interest in cyclical and value stocks, which have significant upside potential.

The UK stock market, measured by the FTSE 100 large-cap index, looks particularly attractive from this perspective. Since the Brexit vote on 23 June 2016, the UK market has been shunned by international investors. However, since the fiercely negotiated eleventh-hour deal struck with the EU on 24 December 2020, UK assets have rebounded strongly as the political risk premium has evaporated. This is demonstrated by the performance of sterling, which has recorded the strongest rise in the G10 block this year against both the US dollar and the euro.

ATTRACTIVE FUNDAMENTALS

Since the low point of the Covid-19 stock market crisis in March 2020, the performance of the UK index has fallen markedly behind – amounting to a 20% shortfall compared with Eurozone stocks – due to fears of a hard Brexit. This has resulted in a significant valuation discount compared with global equities, the highest level in more than 20 years, making the UK market the least expensive among developed countries. Statistically, and uniquely among the main indices, the FTSE 100 is almost twice as sensitive to the value factor as to the growth factor.

The arguments in favour of a tactical overweighting of the UK market are not limited to valuation considerations, however. At 3.8%, UK stocks also have the highest dividend yield of any market. EPS growth expectations for 2021, meanwhile, stand at 49%, surpassing those of the US (22%), the Eurozone (29%), Japan (46%) and emerging markets (39%).

AN INDEX ADAPTED TO THE MACRO ENVIRONMENT

The cyclical nature of the FTSE 100, resulting from its sectoral composition, is another particularly interesting characteristic of the UK index. With 19% exposure to financial companies, which benefit directly from a rise in interest rates, and 21% exposure to commodities (energy and basic materials), the UK market is particularly well-suited to the reflationary environment. Including the industrial and consumer discretionary sectors, which are also very sensitive to the economic recovery, more than 60% of the FTSE 100 index is set to benefit from the economic recovery.

BETTING ON THE POST-COVID RECOVERY

The UK is one of the countries hardest hit by the pandemic, forcing the government to impose unprecedented restrictions and resulting in a contraction in GDP of more than 10% in 2020. However, the UK is the third most advanced country in the world in terms of vaccine roll-out, with 30% of the population having already received their first jab by the end of February 2021. This heralds a reopening of the economy ahead of most European countries and a spectacular economic rebound. The UK's average GDP growth forecast is also the highest out of the G10 countries for 2021-2022.

THE THREAT OF A RISE IN STERLING

This favourable scenario for UK stocks is not without its potential problems. The reflationary environment could push interest rates up and lead to a possible further rise in sterling. With almost 80% of the FTSE 100's turnover derived from abroad, a rise in the pound could weigh on multinationals' earnings and the positive momentum of earnings revisons. However, although the FTSE 100's relative performance is strongly tied to movements in sterling, we see the potential rise in the pound over the coming months as a side issue after the impressive re-rating since Q3 2020.

After more than five years of shunning the UK, global investors remain extremely under-invested in this market. Given the cyclical nature of the FTSE 100, its attractive valuation and profit growth expectations as the economy reopens, there is no shortage of catalysts to drive capital flows towards UK equities. Furthermore, since the start of the year, we have seen a rapid increase in assets of ETFs replicating the FTSE 100, indicating that this reallocation towards UK equities has already begun.

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