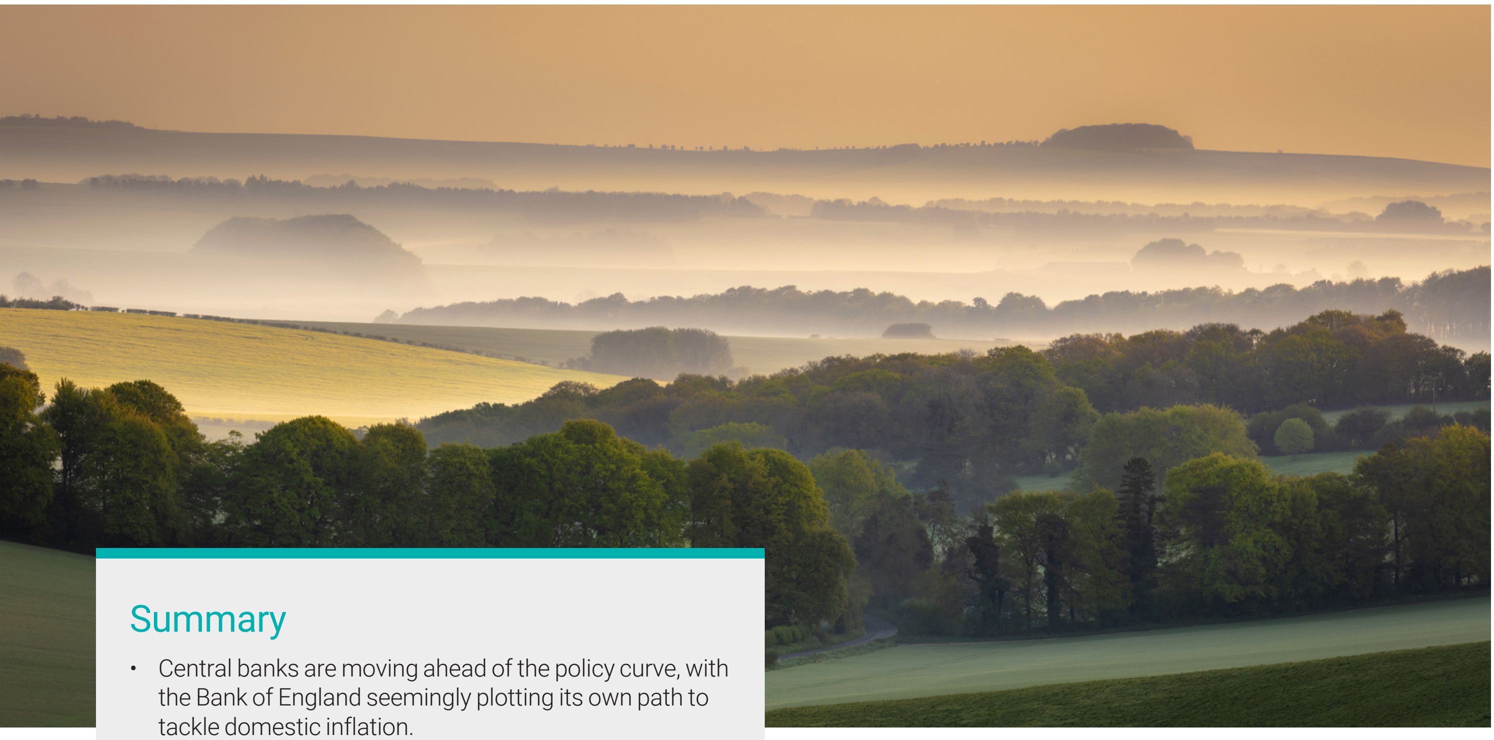
Outlook on

UK Equities

OCT 2024



Summary

- Central banks are moving ahead of the policy curve, with the Bank of England seemingly plotting its own path to tackle domestic inflation.
- Despite economic challenges, UK equities have shown strong performance and resilience, offering attractive investment opportunities.
- With more rate cuts likely and a stable political environment, the UK market is poised for positive momentum into 2025.

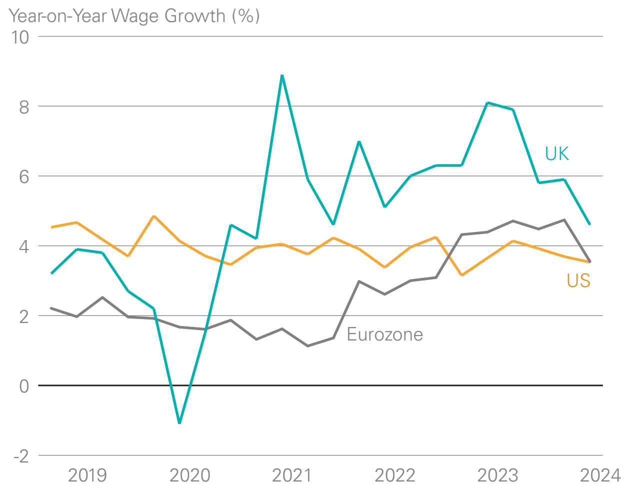
Reassuringly, central banks in the developed world have started to move ahead of the policy curve, and the Bank of England (BoE) is no exception. However, the UK seemingly has a different rate-setting agenda compared to the United States and Europe, as it grapples with its own unique mix of domestic inflationary pressures.

All Eyes on Inflation Trends and Wage Pressures

Inflation has been decisively trending down towards the BoE's 2% target. Despite this progress, the central bank refrained from cutting interest rates at its September meeting—after lowering the benchmark rate to 5% in August—guided by a desire to "squeeze persistent inflationary pressures" out of the UK economy.

Energy prices, a major contributor to inflation, have eased considerably. However, an escalation of tensions in the Middle East could disrupt global oil supply and push up prices. In the United Kingdom specifically, the energy price cap has recently risen by approximately 10%, which should reverse some of the downward momentum. Meanwhile, wage inflation remains notably stronger in the UK relative to the United States and Europe (Exhibit 1). Above-inflation public sector wage increases have kept wage inflation sticky.

Exhibit 1
UK Wage Growth Is Trending above the United States and Europe



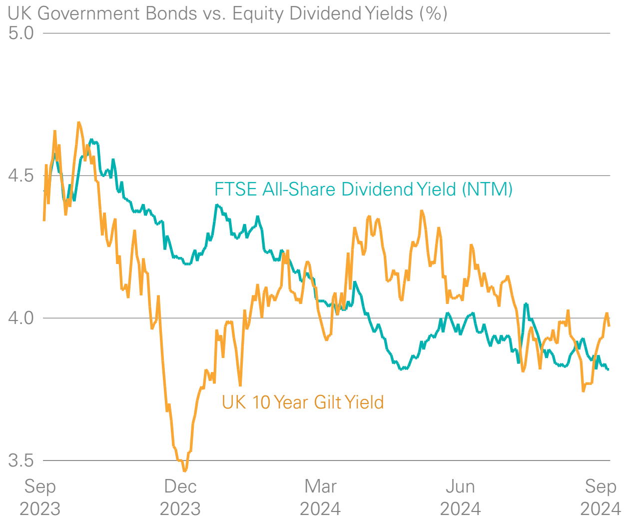
As at 28 June 2024
Source: FactSet

LAZARD ASSET MANAGEMENT

Although the government does not directly control interest rates, it has inadvertently influenced the rate environment through its wage agreements. This complex interplay between government policy and central bank decision-making might garner more international attention in the coming months, particularly as we approach the UK Budget announcement on 30 October.

Whilst the BoE decided to keep rates unchanged at 5% by a vote of 8-1—a seemingly hawkish stance—a sharp fall in the growth of prices for services suggests other domestic price pressures are easing, likely paving the way for further cuts ahead. The UK economy is primed to build on positive momentum quickly as households benefit from positive real income growth and relatively low unemployment. Coupled with high household savings, any further rate cuts could spark meaningful spending growth, boosting consumer-focused stocks. As such, we believe there is scope for interest rates to fall further and faster. Indeed, base interest rates have only dropped by 25 basis points, but medium-term rates—such as those for swaps and bonds—have decreased significantly, whilst there has been a convergence of bond yields and equity dividend yields (Exhibit 2).

Exhibit 2
UK Dividend Yields and Bond Yields Have Converged



As at 27 September 2024
Source: FactSet

Resilient Returns

Normally, a falling rate environment tends to coincide with underperforming equity markets, as investors tend to tie looser monetary policy with a deteriorating economic outlook. However, the converse has played out so far in the United States, Europe, and the United Kingdom—with the latter proving to be one of the strongest-performing markets this year compared to other regional indices. We view this as a signal that equity market performance has decoupled from economic developments and is instead being driven by idiosyncratic factors, offering ample scope for active managers to identify attractive investment opportunities at compelling valuations.

As interest rates continue to fall, the cost of borrowing for companies should decrease, making it cheaper for them to finance their operations. This improvement in the cost of capital makes previously undervalued stocks more attractive, creating potential investment opportunities among stocks with strong long-term potential but which were previously discounted due to higher borrowing costs.

In a signal of broader strength, UK stocks also held up well against the increased volatility in August following events in Japan, where rising interest rates prompted the unwind of the popular yen carry trade. We believe this resilience is further proof of the growing appeal of UK stocks. Alongside this, we view valuations as attractive—both historically and compared to other regions—Whilst the dividend yield is fully covered, and the political backdrop is more stable despite ongoing political shocks elsewhere.

Currency Considerations

Currency market effects will remain an important feature in the months ahead as central banks continue to adjust rates, and we will watch developments closely. UK equity market performance is more heavily impacted by profits and revenues generated abroad than those generated domestically. If the US dollar depreciates more considerably, it could result in unexpected earnings downgrades. Already weakened sectors, such as the automotive and chemical industries, appear to be more vulnerable to this.

A deterioration in fundamentals would require careful navigation, but equally, we could see attractive value opportunities develop, particularly among cyclicals, into 2025. Cyclicals could receive an additional fillip after China's central bank recently unveiled a broad package of monetary stimulus measures.

Sterling strength tends to have a more positive impact on FTSE 250 companies—potentially setting the stage for a continued rotation that supports FTSE 250 leadership amidst ongoing improvements in domestic activity—as well as domestically focused large-cap stocks, such as retailers and real estate companies.

Whilst investors continue to evaluate the various factors amidst an ongoing adjustment in global central bank policy, we maintain a positive outlook. The resilience of UK equities, combined with attractive valuations and a stable political environment, suggests the balance is tipped towards more positive momentum building into 2025.

This content represents the views of the author(s), and its conclusions may vary from those held elsewhere within Lazard Asset Management. Lazard is committed to giving our investment professionals the autonomy to develop their own investment views, which are informed by a robust exchange of ideas throughout the firm.

Important Information

Published on 14 October 2024.