TELLWORTH
Investments

Tellworth Insights

Q2 2018

Is it time to start buying UK domestics?

To many casual UK equity market observers, the effect of the Brexit vote on share prices was short-lived. The seemingly perverse impact on the FTSE All Share – it hit a new YTD high a week later – was tacit proof for Brexiteers that the outcome was a positive one for UK plc, whereas in fact, of course, it was the simple arithmetic of an index with 70% foreign earnings. In my last piece, I discussed the apathy that major asset allocators have shown towards UK stocks since the referendum – the number of managers 'underweighting' the UK market was the highest on record– and the resulting P/E discount on LSE listed stocks in the months since the referendum (when measured against global counterparts). The multiple for the FTSE All Share is still 15% lower than where it was pre-vote, relative to MSCI World.

Indeed the aftershocks of Brexit are also still keenly felt on company valuations *within* the UK market. The combined performance of domestic earners – typically those with >70% UK revenues – is a popular stock-market bellwether for the UK economy and several commentators have noted very weak performance of these stocks in 2018, even worse than Emerging Markets in one analysis[1].

How pessimistic are investors? Zeroing in on domestic cyclicals

The key metric we use here is the P/E premium of domestic stocks within cyclical sectors (e.g. Banks, Real Estate, Retail etc.) against the market. This can help assess whether the equity market in particular is being overly pessimistic on domestic growth, as in the aftermath of the vote when the premium was more negative than any time post 2008 at -27% (Fig 1). Whilst some of the subsequent re-rating resulted from negative earnings revisions, many sectors saw strong price performance (Banks, Housebuilding and Staffing) as market groupthink on an imminent economic crisis proved misplaced.

Sectoral earnings estimates, in most cases, were eventually re-revised higher. But as the slowing of UK GDP growth forecasts began in earnest in 2017, largely driven by weaker investment including an ailing property

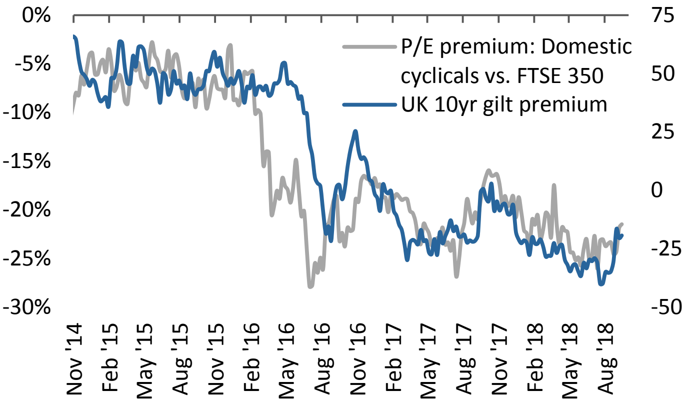
[1] WARD - http://moneymovesmarkets.com/journal/2018/8/30/are-uk-monetary-clouds-lifting.html

market, again domestic cyclicals have de-rated. The pessimism has been broad based, although the over representation of Real Estate in Figure 2, whilst clearly partly related to Brexit, can also be explained by the sharp increase in CVAs from Retail and Leisure tenants in the last 12 months.

Undemanding multiples, but not obviously 'cheap'

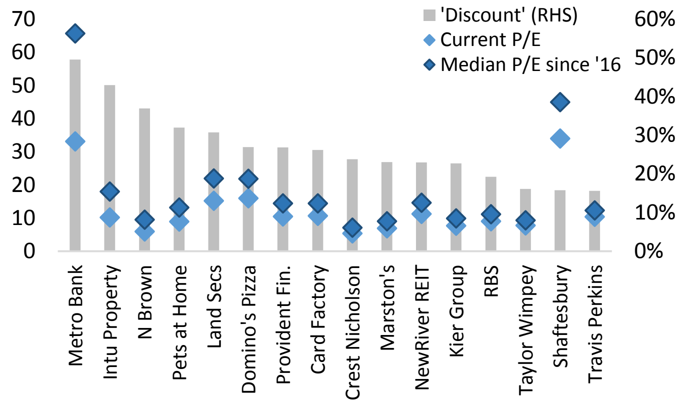
We would contest the view that UK domestic equities currently represent an 'obviously cheap' sector, as we have heard from some press and peers. Relative to other asset markets, domestic cyclicals appear to be relatively fairly valued. Unlike the panic that ensued in late June and July 2016 – nearly every Bank trading on 6x P/E, Real Estate stocks marked down irrespective of asset use – there are few instances of indiscriminate discounts on companies with certain characteristics or end markets. Structural growers are generally rewarded as such (e.g. industrial REITs). And more specifically, when we plot relative multiples against other 'Brexit barometers' such as currency pairs or gilt yield premium in Figure 1, we find that generally UK equity market pricing is consistent with them. There is limited evidence of irrational pricing.

Fig 1: UK domestics in cyclical sectors appear 'cheap' vs. other stocks… but gilts imply weak GDP growth



Source: Bloomberg. NB: UK 10yr gilt premium is UK 10yr gilt yield vs. an average of UST and DBR. Cyclical sectors: Banks, H'building, Real Estate, Retail, Leisure, Industrials, Div. Fins

Fig 2: UK cyclicals where multiples have fallen the most since Nov '16 – A third are Real Estate



Source: Bloomberg. NB: P/E is 12m fwd. consensus.

Is the market right about the UK economy?

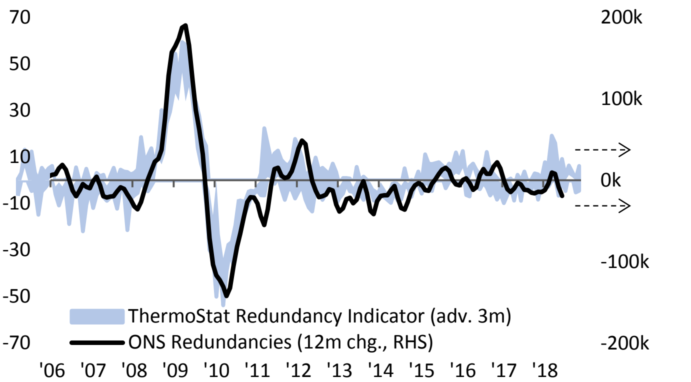
To help answer this we turn to our ThermoStat suite of models, which have good forecasting power on a 2-6m horizon and predominantly use 'alternative' datasets (e.g. web traffic, search volumes, web databases like Adzuna and Loqate) to measure consumer/corporate behaviour *now* and then map the effect on key macro data points in the future. Some of the lags are fundamental; if an individual starts the search for a house they typically visit Rightmove or download the app before arranging a mortgage. If a company is planning a large investment they will increase liquidity - either by monetising a less liquid asset like a bond or by raising cash in a debt financing. And some of the lags are technical; the typical measurement-release lag for ONS statistics, for example, is around two months. Both contribute to the advantage that using alternative data has over 'classical' and therefore in, say, evaluating a likely central bank reaction, or FX impact.

Our ThermoStat models suggest there may be a better entry opportunity

Currently, the ThermoStat outlook for the UK is mixed but probably consistent with a 'weaker than consensus' economic outlook, as has been the messaging for several months. Redundancies, having worsened marginally at the start of the year, should stay low (this model uses job security related keywords and traffic to advice websites, etc.). Mortgage approvals, which have even underperformed our model this year, will probably continue trending lower (we use searches and portal traffic, as well as some RICS data). Online retail is weak though this might be partially weather related (Fig 5). Other datasets not shown are also uninspiring – travel agents don't look to be recuperating lost bookings from the world cup and the hot UK summer, household cash flow, though potentially inflecting if nominal wage growth is sustained at >2.5%, has been dampened by higher fuel, auto-enrolment and the nascent effects of two rate rises.

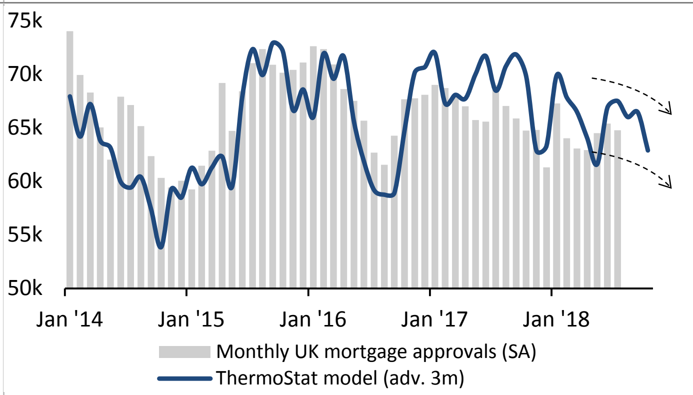
The main positive message comes from our money supply indicators, which measure the liquidity impulse on both consumers and corporates and has historically led the economic cycle by 6-9m. These indicators correctly signalled a red hot economic climate for the consumer (read: borrowing binge) into the 2016 Brexit vote, and then subsequent sharp slow-down into 2017. Whilst a whisker away from flashing the red recession warning earlier this year (negative real money growth), they have since tentatively recovered despite a base rate rise. This may signal some improvement in domestic spending and investment in early 2019.

Fig 3: Redundancies are unlikely to worsen materially over the next 3-5 months…



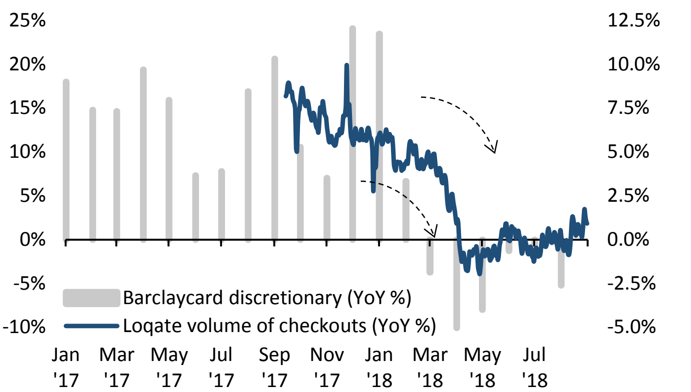
Source: Bloomberg, Google. NB: P/E is 12m fwd. cons. (median), UK 10yr gilt premium is UK 10yr gilt yield vs. an average of UST and DBR

Fig 4: …However our mortgage model forecasts a further deterioration in approvals towards 60k *(SA)*



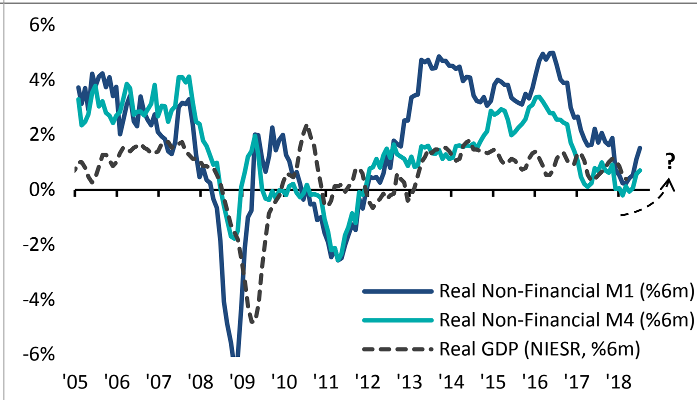
Source: Google, RICS, ONS, Tellworth

Fig 5: An online retail "nowcast" – Loqate checkouts – indicates a shallow bounce from weak summer trading



Source: Barclaycard, Loqate (a GBG solution), Tellworth

Fig 6: But beyond 2018, a fresh liquidity impulse towards more mid-cycle levels could reignite UK growth



Source: Datastream, Tellworth

Conclusion: Stock pickers can play dispersion over Macro

For us then, there is not quite enough positivity in the runes to make the case for an outright bullish stance on UK domestic equities, despite optically cheap valuations. Away from the data, there is also the binary Brexit outcome and a residential property market (60% of UK assets vs. 10-40% globally) still cooling from significant regulatory change. But it does seem like there has been 'travel and arrive' in many sectors recently as pricing has caught up with reality, and therefore sector wide short positions are less palatable. Within domestic sectors interesting ideas remain and pair trades have been especially effective this year as dispersion has increased and intra-sector correlation has fallen. Proper bottom-up analysis, supported by differentiated data, has paid off where directional macro calls were more relevant in prior years. The bifurcation between value traps and structural winners has continued to widen. At Tellworth we continue to monitor the heartbeat of consumer and corporate behaviour – if the UK economy regains its potency before the global cycle finally withers, the reward for owning domestics will be considerable.

Seb Jory

Head of Data Driven Strategies

TELLWORTH Investments