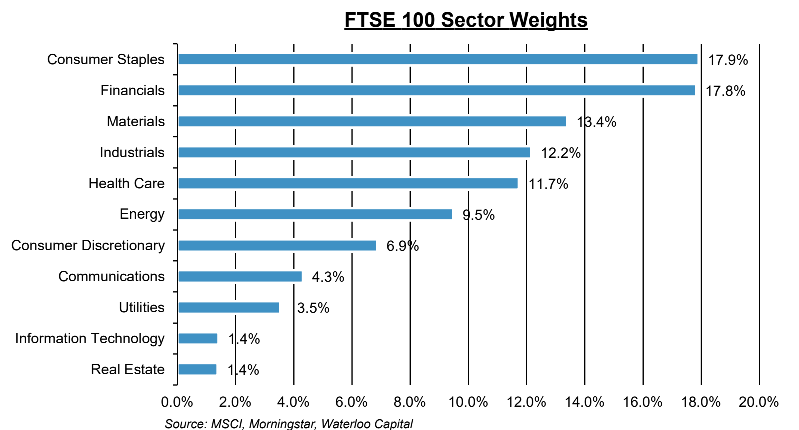
Foreign Equities: United Kingdom

Quicktake: Sitting firmly in the global value category the UK offers intriguing exposure to financial, cyclical, and defensive positions at historically low relative valuations. These factors also tend to perform well during mid-cycle expansions. Political uncertainty and a habit of aggressive covid lockdowns have turned many investors away from the relatively smaller equity market. Brexit uncertainty is still an issue which will need to be watched given its effect on foreign trade which makes up a large portion of the UK's GDP. Additionally, the Bank of England (BoE) and their lack of concrete forward guidance has embedded unnecessary volatility in the bond and stock markets. Positive policy and government activity would support greater upside for the region, but to start the year, we prefer foreign developed exposure in the euro area over a more concentrated UK allocation.

The FTSE 100 has remained stuck below its pre-pandemic levels which makes the UK one of the worst laggards of the post-covid recovery. After a lackluster relative year, we see signs of momentum building for UK earnings growth which will provide much needed support for the equity market. With one of the lowest P/E ratios (12.4x) and P/B ratios (1.8x) in Europe, UK shares are trading at more than a 40% valuation discount versus global peers. The UK stands to benefit from attractive valuations on both an absolute and relative basis at a time when macro trends are beginning to favor value factors.

As with their EU neighbors, the UK markets are highly exposed to cyclical and defensive sectors. Sectors which tend to exhibit high valuations and growth factors such as Information Technology, Consumer Discretionary, and Communications make up a combined 12.6% of the index versus 50.7% for the S&P 500. A lower exposure to factors which are negatively impacted by higher interest rates and inflation will help support UK equities in an environment of higher but steady interest rates and inflation while a defensive tilt offers some protection against market volatility.

UK index exposure is dominated by cyclical and defensive sectors



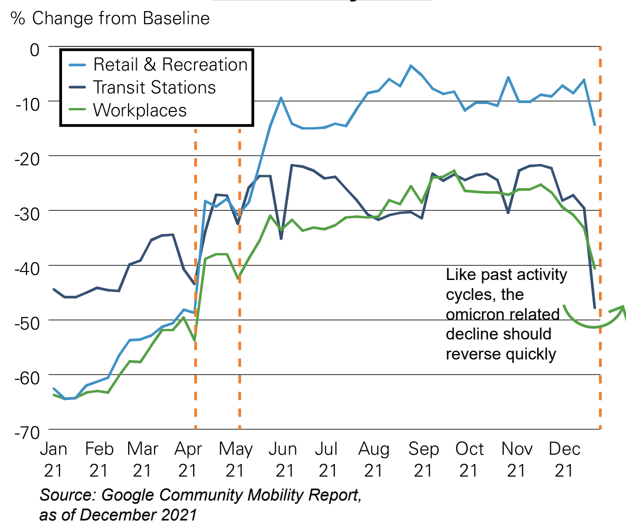
UK markets should also benefit from a rebound in consumer mobility and activity as the Omicron wave subsides. Rapid spikes in activity following the April and May re-opening measures indicate strong demand for a return to normal activity. A strong labor market and covid stimulus have shored up consumer balance sheets, and another rebound in activity will brighten the outlook for revenue growth early this year.

We would be remiss to ignore the shifting monetary landscape in Great Britain. The Bank of England (BoE) was one of the first to blink in the face of post-covid economic normalization and inflation conditions. The BoE raised rates for the first time since 2018, and policy makers have given forward guidance for rate hikes to continue over the next two years. The move was a vote of confidence in the trajectory of the UK economy, and additional hikes should quickly move the key rate back up to the

bank's 0.5% target. A nearly 18% index weighting to financials will help the FTSE benefit from the Bank of England's (BoE) rate hike trajectory. Going forward, persistent inflation could put pressure on policy makers to raise rates further, but future hikes are unlikely to occur until later in the year after the flow through effects of the first hikes have been observed. Forward guidance has been opaque at best, but the negative reaction of both the stock and bond markets to recent surprises in central bank activity should encourage more thorough guidance going forward.

The potential for a rebound in relative performance is there, but potential means it has not been done yet. Risks to our outlook include uncertainty around politics, Brexit, and the potential for the BoE to move too fast and stymie the current recovery. UK markets have a bigger reliance on strength in foreign economies than many other developed markets. Nearly 80% of company revenues come from outside the UK. As the global market cycle continues to mature, a decline in demand would lower our return expectations. Additionally, this leaves the UK more susceptible to foreign inflation and currency shifts. A stronger pound would negatively impact export prices and weigh on export demand. Brexit risks cannot be fully discounted yet either. On the political front, the ongoing implementation of post-Brexit import and export rules and the potential for government turnover raise more risks. Persistent political uncertainty would likely lead to reduced business spending and a decline in future production and revenue projections as companies take a wait-and-see approach to investing. Finally, the BoE runs the same risk that many of its peers have taken on this year in raising rates enough to combat inflation, but not enough to create headwinds to growth. Raising rates too quickly could create the opposite of the intended effects and keep UK equity performance near the bottom of the developed markets category.

We expect a quick turnaround in consumer activity post-omicron



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