Rathbone Unit Trust Management

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Rathbone Income Fund

Monthly update November 2022

In the last few years, advisers have steadily migrated client money out of the UK market, predominantly into the US. The UK market has seen net outflows every single year since 2016. Outflows peaked in 2021 and slowed, but only slightly, this year. As we head into the New Year, the question we must ask is: why on earth invest in the UK?

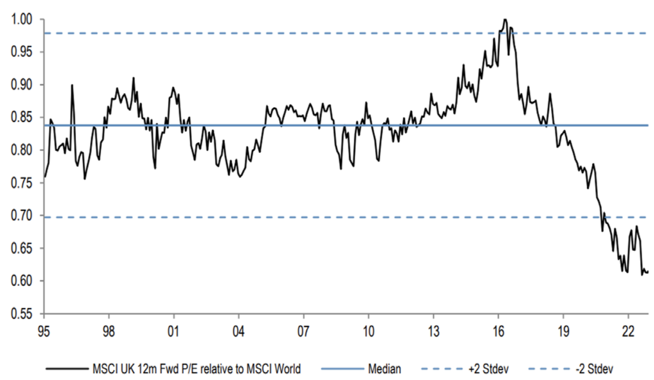
Let's be honest about the key factors that have trashed the UK market's reputation as a sensible and lucrative place in which to invest. Irrespective of individual perspectives on Brexit, it seems reasonable to argue that the decision to leave the European Union damaged investor sentiment. Confidence has been further eroded by the political shenanigans of the last few years, which reached their nadir in the autumn. And the FTSE All Share Index, with its high exposure to commodities and financials and its paucity of high growth technology, had racked up many years of underperformance until this year. All together, this created just the right environment for money to flow out of the UK market, encouraging a nasty downward spiral of yet more underperformance.

The news hasn't got much better in recent weeks. The OECD ranks the UK above just Chile and Sweden at the bottom of its growth forecasts for 2023, and 38th out of 38 OECD countries for 2024. It cites tighter monetary policy, persistently high energy prices and low household incomes as severe brakes on growth. The OECD expects the US and Europe to decelerate sharply, but the UK is right at the bottom of the growth pile. No wonder investors have turned their backs on UK stocks.

But the UK economy is not the UK stock market. The UK's dismal rankings in global growth forecasts don't explain the doom and gloom that's already baked in to share prices. We see a case to argue that the UK market looks attractive on a risk/return basis. We also offer a humble reminder that it is the UK's very weighting towards 'old' industries, like miners, energy companies and financials, that has driven its outperformance this year. And the very low base stemming from depressed sentiment and valuations means there's plenty to play for.

As ever, valuation matters. Despite its recovery in 2022, the UK market is rarely this cheap and still trades at an exceptionally large discount to the rest of the world.

The UK market is exceptionally cheap



Source: JP Morgan Research, Datastream. 30 November 2022.

There's an obvious riposte to this particular argument. The commodity giants benefited from inflated prices this year, but these prices will probably fall if there's a global recession. Indeed, just such a rationale informed our decision to reduce our commodity exposure over the last few weeks, after its very strong run this year. But it's also valid to believe that earnings expectations in the US need some re-basing. As Robert Armstrong in the Financial Times puts it: "recession is coming and earnings are going to roll over hard."

Inflation may boost some companies' revenues, but it will have a bigger effect on profit margins. We wager that analysts are behind the curve here. If a harsh recession hits US shores, revenues will also come under pressure, doubling up the pressure on earnings. After many years of outperformance attracting money out of the UK, and a mighty mismatch in US valuations versus their UK counterparts, we see a clear and present danger that the US market could give back a lot of its gains as both earnings and multiples retreat further.

Of course, investors have every right to be sceptical. If domestic economic recovery is the incentive required to lure investors back to the UK, we may have a while to wait. But compelling evidence of UK stock market outperformance may very soon be hitting investors right between the eyes. When people look at their portfolio valuations next year, returns from the UK are almost certainly going to look pretty good versus other markets. And that's not just over one year, but over two and three. We believe there's more to play for: with expectations and sentiment at such a low ebb, any good news will be incrementally positive. The downward spiral of falling earnings and falling expectations could well be broken.

A brief outlook before year-end

If the last three years have taught us anything, it's never to try to predict the future. This truism is embedded in our flexible approach to portfolio construction. The global economy faces considerable headwinds in 2023. The ongoing conflict in Ukraine and rising tensions in China represent a challenging backdrop for economies slowing amid aggressively tightening monetary conditions. Is this yet priced into global markets? The FTSE 100 is dominated by global businesses, so we must accept that it probably won't escape the impact of an increasingly likely global slowdown.

On the other hand, as we've already noted, the UK market remains cheap. Just how much bad news is priced in? A brief period of relatively stable government, plus policies that seem inspired by economic imperatives rather than political expediency, have recently steadied UK markets and strengthened sterling. We can only hope these trends continue into 2023.

Meanwhile, the best UK businesses are managing to deal with supply chain issues, rising costs and workforce challenges, as evidenced by the latest round of corporate results. If they can maintain this momentum into next year, we believe there's great value to be had, particularly from more cyclical businesses. Notwithstanding the economic challenges confronting them, they offer good value versus defensives.

We've been looking to buy selectively into both 'growth' and 'cyclical' stocks. The former have mainly been niche ideas like **Games Workshop**, **Experian** and **Dechra Pharmaceuticals**. Our cyclical additions have been cherry-picked industrials, like **Vesuvius** and **IMI**. Across equity styles, we think it's critical to look at each individual business and ask if it's positioned to deal with its own unique set of challenges and opportunities.

We must look forward with confidence. For all the bad news out there, there's the hope that things will slowly improve. And every bit of good news will highlight the value that abounds in the UK market. By paying the right price for any business, whether it offers growth or economic sensitivity, global exposure or domestic, opportunities will always be on offer.

Recent Trading: November was an important trading month for us. We sold **Glencore**, putting some of the funds back into **BHP**. To ramp up our confidence in the UK market's prospects, we took profits from two of our global quality defensive names, **Bunzl** and **BAE Systems**, and added to our already large positions in FTSE 100 stalwarts **Legal & General** and **Aviva**, as well as consolidating **B&M European Retail**, **Big Yellow Group** and **Vesuvius**.

Companies seen in November: GlaxoSmithKline, DCC, Big Yellow Group, SSE and **Halfords**.

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