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UK Market Strategy

In the space of a few weeks, investor sentiment has shifted from being extremely pessimistic to much more enthusiastic, as potential "green shoots" of economic recovery spring up across the global economy. Is this optimism justified or are the green shoots of recovery little more than weeds which may ultimately wither?

After months of dire economic data, there is no question that some of the recent indicators are suggesting that the pace of decline is slowing. It would appear that the central authorities have not only averted a complete financial meltdown, but may also have injected enough stimulus to the global economy to avoid a depression. The most likely outcome we are left with is a deep recession, the shape and duration of which is uncertain. Given such a sharp downturn, should we expect a V-shaped recovery? Analysis of previous recessions would suggest that the swifter the decline, the faster the recovery - except when the recession has been caused by a banking crisis. The main reason for this is that after a financial maelstrom, banks take time to repair their balance sheets and are unwilling or unable to provide the quantities of credit required to fuel a rapid economic recovery. This seems to be the case in the UK at present and points to a weaker than average expected recovery. An additional constraint on the likely pace of economic recovery is the state of the public finances. The recent Budget predicted a mushrooming of public borrowing, the effects of which will be felt for years to come. The combination of higher taxes and reduced spending necessary to redress the public sector deficit will act as a brake on the growth achievable by the UK economy over the next few years. On the positive side, however, the recent sharp fall in sterling will improve the competitive position of the export sector, while the fall in energy prices since last year will reduce input costs for industry. Nevertheless, the likely outcome for the UK economy is that economic recovery will be fairly anaemic.

Having bottomed in March, the UK market has bounced by 25% since then, with cyclicals and financials leading the way. Given how depressed the economic outlook was then, and how cheap the market looked both in absolute terms and relative to bond markets, a swift rally always looked likely at some point. The key question is whether this is just another "bear market" rally, or the start of something more durable. The rise we have seen in equity prices, as well as the downgrades in corporate earnings, has pushed the prospective p/e of the market up from 8x to 12x this year's earnings. The low yield on cash and bonds makes the trailing dividend yield of 4.8% look attractive. However, further expected dividend cuts leave the prospective yield closer to 4%. On a p/e of 12x and a yield of 4%, therefore, the UK market is fair value rather than outstandingly cheap. Further meaningful progress in the FTSE from here will need greater visibility and confirmation that the pace of economic recovery will more resemble that of a conventional "V" rather than the more likely "bath-shaped" or anaemic recovery. Nonetheless, investor euphoria could drive the market higher in the short-term.

What strategy should one adopt in the UK market at present? As previously mentioned, the sectors which have led the market recovery have been the economically sensitive cyclicals, the very ones which led the downturn. Given the apparent easing of economic headwinds, this may seem rational, but it only makes sense if the recovery is a "normal" one. Since major economic imbalances remain, and are likely to do so for some time, the recovery in unlikely to be normal. Defensive stocks have lagged this rally badly and on valuation grounds now look very attractive. They have been sold off to fund rights issues and to make way for the purchase of "resurrection" stocks whose re-rating now seems to discount too optimistic an economic picture. A period of weak economic growth in the UK will favour companies whose earnings and cash flows are resilient in a tough environment and those whose order books are geared towards areas of the world where economic growth will be superior to ours. In addition, the deteriorating public finances are likely to lead to a long term decline in sterling, which in turn, will be positive for companies with a more international profile and those with an export bias.

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Sector strategy

Oil & Gas (21% of market) - Neutral

The oil price has moved back up to around $60 per barrel on expectations that economic growth in China will rebound from its recent slowdown. This gives greater comfort over the sustainability of dividends of the UK majors. BP has indicated that it will freeze its dividend this year, while Shell has forecast a 5% rise. Elsewhere, BG is worth picking up on a bad day as bid speculation will undoubtedly reappear, while Dana looks attractive when compared with a forecast NAV of £18.

Favoured stocks - Royal Dutch Shell, BG Group, Dana Petroleum

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Basic Materials (7% of market) - Neutral

The mining stocks led the market down and have been at the vanguard of the recovery as economic green shoots appear and China stockpiles raw materials. The industry itself remains cautious on prices and there is danger of investor over-exuberance. The fate of Rio Tinto remains uncertain and there is the possibility of a rights issue to help repair its balance sheet. BHP Billiton remains the diversified producer of choice given balance sheet strength and a low cost model. Elsewhere, platinum prices have been impacted by the drought in new car sales, hitting Johnson Matthey, but it remains a class business and worth buying on weakness.

Favoured stocks - BHP Billiton, Johnson Matthey

Industrials (7% of market) - Overweight

Many of the defensive growth stocks such as Bunzl and Serco have not participated in the recent rally and as such have been heavily de-rated relative to the market as a whole. However their defensive characteristics leave them well placed in what is likely to be a tough economic environment, with their emphasis on cost control and cash flow generation. Elsewhere, Weir Group remains well placed within the more cyclical engineers and is worth picking up on any setback in the mining sector.

Favoured stocks - Bunzl, Serco, Weir Group

Consumer Goods (13% of market) - Underweight

Food and beverage companies have been out of favour in the last few months as the market focuses on more economically sensitive sectors. However, the high input costs of last year have eased somewhat, giving the leaders more pricing power and improved margins. Unilever and Reckitt have demonstrated good cost control and successful brand loyalty among consumers, while A.B.Foods has seen a major improvement in the sugar division as well as strong growth within Primark. Diageo remains a quality act, although there could be a share issue if they buy Moet-Hennessy.

Favoured stocks - A.B.Foods, Unilever, Reckitt Benckiser

Healthcare (10% of market) - Neutral

The major pharmaceutical companies are virtually priced for zero growth into perpetuity. Given the prodigious cash flows generated and ongoing consolidation within the industry, investors could be missing a trick. Transformational deals may not be possible among the majors anymore, but infill acquisitions and cost cutting should be more than sufficient to offset the attrition of blockbuster drug sales as they move off patent.

Favoured stocks - GlaxoSmithkline, AstraZeneca

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Sector strategy contd.

Consumer Services (10% of market) - Overweight

Food retailers at the value end are benefiting from trading down among consumers. Tesco has successfully repositioned itself and is now seeing a pick-up in like for like sales. Trading at a discount to its peers, the shares look attractive. Compass produced another strong set of results with growth in both margins and cash flow. The shares are still cheap. Meanwhile, Inchcape post its rights issue, has a stronger balance sheet and offers a global recovery play.

Favoured stocks - Tesco, Inchcape, Compass

Telecommunications (7% of market) - Underweight

Recent results from Vodafone showed good cash generation and a 3.5% rise in the dividend. The company is accelerating its cost-cutting programme and although growth has slowed in Europe, Asia and the Middle East remain buoyant, as does its Verizon subsidiary in the US.

Favoured stocks - Vodafone

Utilities (5% of market) - Overweight

Another sector which has been out of favour, utilities should come into their own as dividends shrink elsewhere. Centrica's recent renegotiation of its purchase of a stake in British Energy leaves it with firepower to make more acquisitions. Meanwhile, National Grid's latest figures, which saw the dividend raised by 8%, should provide comfort, particularly given the upbeat statement on current trading.

Favoured stocks - National Grid, Centrica

Financials (19% of market) - Underweight

UK domestic banks have come back from the brink, but investors are painting too optimistic a picture of the capital strength of the sector, particularly given the alarming increase in bad debts recently reported. Of the majors, HSBC remains the strongest player, with adequate capital, good global reach and a stronger market position going into an upturn. It also pays a dividend. Among the life insurers, Prudential remains positively geared into growth in Asia. Within the non-life insurers, Brit remains on a discount to NAV, pays a good dividend and is benefiting from firmer industry pricing. Real Estate remains volatile, but TR Properties is a lower risk, diversified way into the sector.

Favoured stocks - HSBC, Brit Insurance, Prudential, TR Properties

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Technology (1% of market) - Neutral

Aveva has seen its share price hit in the wake of the global recession. The company is well positioned in a variety of sectors, both growth and cyclical, and has the benefit of £120 million of cash on the balance sheet. This looks like a good recovery situation.

Favoured stocks - Aveva

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