UK equities: valuations and dividends are supportive

ROYAL LONDON ASSET MANAGEMENT

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What important lessons did you learn from 2023?

When I look back on 2023, one of the important features that sticks in my mind is the impact on businesses of destocking within supply chains. This happened across a wide range of industries and hit some manufacturers hard. The origins of the problem go back to Covid lockdowns when some goods were hard to source.

This prompted many consumers and the supply chains servicing them to over-order goods once they were available again, and to carry higher inventory levels. As supply chains normalised, that stock build has been unwound. Essentially, in many industries, end customers found their demand satisfied from their own existing stocks or from stock held by intermediaries in the supply chains, leading to sharp decreases in demand from manufacturers. As manufacturing volumes fell, operational gearing came into play, causing sharp falls in profitability for manufacturers. These impacts are transitory, but painful nonetheless.

In what way will 2024 be different from 2023?

Every year throws up new challenges and frequently ones that are very hard to foresee. I suspect 2024 will be a year when investors spend less time worrying about the path of inflation or pondering the implications of artificial intelligence, but other issues will no doubt take their place. I try to never get too fixated on the macroeconomic or political environment. While it is important to be very aware of the broader picture and how that impacts the companies held in a portfolio, it can be very dangerous to assume the world will be a particular way and to predicate the entire shape of your portfolio on that view. I believe it is better to drive performance by stock picking – understanding the businesses you invest in and how they might navigate the challenges of the macroeconomic environment.

> “It can be very dangerous to assume the world will be a particular way.”

What is your view on UK equities?

The UK market had a rough year in 2023, if not in terms of returns, then certainly in terms of fund flows. As has been widely discussed, the UK market has been unpopular with investors for some time. Pension funds have generally been reducing exposure to equities, particularly UK equities, with many asset allocators moving more of their equity exposure into overseas markets.

The persistent selling has left the UK market valuations looking relatively low compared to other markets and this has attracted bid activity, with an increasingly long list of companies being taken over by overseas companies or taken off the public market in private equity backed bids. The other balancing factor, offsetting the persistent selling, has been share buybacks by companies themselves. UK companies have bought back their shares in unprecedented quantities over the last couple of years. Finally, I would say that I do not subscribe to the view that the UK market lacks interesting businesses. While we may not have an Apple or an Amazon, the UK market is home to many businesses that have world leading technologies or market positions in their particular fields.

> “Persistent selling has left the UK market valuations looking relatively low.”

What are your expectations for inflation and interest rates next year?

Inflation is clearly on a downward path from its 2023 highs, but personally I don’t see it getting down to the low levels that some had assumed are the norm from the experience of recent years. From what we hear from the many companies we speak to, the costs of many things like materials and shipping are generally coming down, but wage inflation is still running at elevated levels.

Structurally, after Covid and with an element of deglobalisation, many supply chains have been changed to prioritise resilience over simply the lowest price, which has inflationary implications. Energy is also a major factor in inflation, and with elevated geopolitical risks, oil price volatility cannot be ruled out. As the world gradually transitions away from fossil fuels, as it must for the state of the climate, this linkage can be reduced. However, this will be a process of many years and the vast amount of infrastructure and materials that will be required to achieve that will need to be paid for, which could itself be an inflationary factor.

After their sharp rise in 2023, interest rates are now at what I would see as a normal rather than elevated level. In the long term I would expect UK interest rates to be around the level of nominal growth in the economy. If we assumed that long-term real growth were 1% p.a. and long run inflation were 3 to 4%, an interest rate of around 4 to 5% does not seem unreasonable.

What does the landscape for UK equity dividends look like?

Long-term dividend growth is obviously a key element of equity income investing. 2023 was a year that saw the dividend income into our fund outstrip the levels seen in 2019, that being a useful comparator as this was the year before the severe disruption to corporate pay outs seen in the Covid lockdown. This was pleasing, as the dividend growth was widespread across many sectors and offset the considerable headwinds to growth from the large mining companies like Rio Tinto not paying special dividends in the year.

> “Dividend growth was widespread across many sectors.”

My base expectations for 2024 would be for modest growth in dividends again this year. The UK market currently has a dividend yield that is not dissimilar to the interest yields available on cash, but dividends can grow, which can help investors offset the impact of inflation on their savings.

Are there any areas of UK equities that you would avoid or be cautious of investing in next year?

There are very few areas of the market that I routinely avoid, but there are themes that will need to be closely watched and considered for our investments. Debt is likely to be a key theme. Stocks exposed to consumer spending will need to be monitored carefully. Even though inflation appears to be on its way down to more moderate levels, many households will see their spending power impacted by the gradual ongoing repricing of fixed rate mortgage deals. The counter to this headwind is that wage growth seems to be growing at reasonable levels. Indebted companies will also have to be watched, as many companies will see their interest costs rise significantly either due to higher interest rates feeding through to bank facility costs or maturing corporate bonds needing to be refinanced at much higher rates.

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