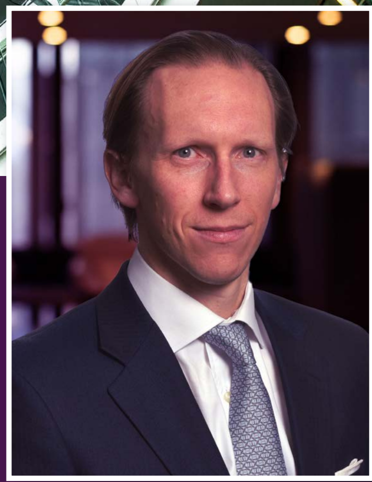
A rewarding long term

Henry Lowson
Head of UK Alpha Strategies



UK equities

This time last year, the UK was emerging from a technical recession and the stage looked set for improving economic growth, a declining rate of inflation towards the Bank of England target of 2% and a series of cuts to UK interest rates.

Together, these conditions should have been conducive to better equity returns. Rarely, however, do consensus macroeconomic forecasts turn out to be reality. While the UK has delivered GDP growth and UK CPI inflation has eventually stabilised closer to 2%, the decision to cut interest rates (the first cut since March 2020) was delayed until August and it looks unlikely to be followed by the sequential reductions that many expected.

This has held back consumer and corporate demand, resulting in a UK stock market which stuttered and started through 2024 as corporate earnings struggled to find much positive momentum.

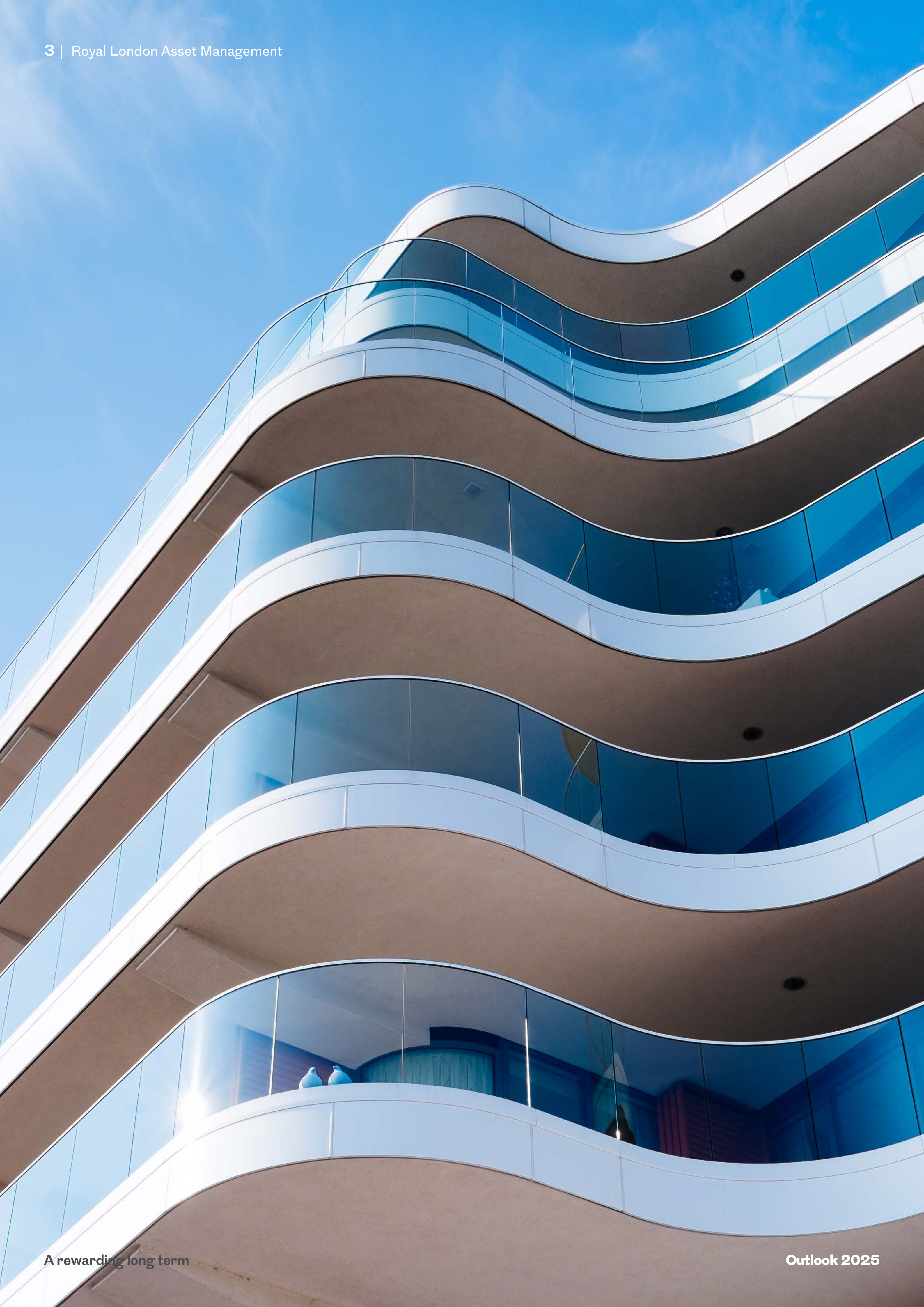
As well as interest rates remaining elevated, the industrial destocking cycle proved to be more extended than anticipated (the last vestiges of the Covid-related impact on supply chains). Consumer and business confidence, which had been on an improving trajectory after the election, was thrown into uncertainty as the new government set a late first budget date – some 118 days after the election – and spent the interim period sending mixed messages about the state of the UK balance sheet, along with their spending and funding intentions. This uncertainty delayed corporate decision making and led to some deferral of expenditure, stalling the economic recovery seen through the first half of the year.

A tough budget

From a business perspective, the first Labour fiscal event after nearly 15 years in opposition was a tough budget. Businesses will bear much of the brunt of the tax rises due to employer national insurance contributions increasing to 15%, in addition to having to shoulder the burden for another substantial increase in the minimum wage, particularly for the 18–20-year-old age group (+16.3%), while business rates relief was reduced from 70% to 40%. The impact is likely to be felt most keenly by the retail, leisure, hospitality and food retail sectors and more generally for labour intensive industries with lower margins. Companies will have to work hard to mitigate these structural cost headwinds but automation, labour efficiencies and higher prices are likely to be part of the solution and companies have proved adept at doing this in the recent past. On the positive side, housebuilding, construction, infrastructure and the defence sectors look well positioned to benefit from increased government spending and available funding.

> **After three years of obsessing over macroeconomic and political headlines we believe that the focus can switch back to the analysis of business fundamentals and prospects.**

We view the removal of political uncertainty as a significant clearing event for markets, while acknowledging that this fiscal stimulus risks further higher inflation. Corporate balance sheets and cost bases are generally in good shape, UK consumers have generally come through the interest rate cycle in good health and with multiple headwinds removed we now have the basis for a cyclical upswing in the UK economy. After three years of obsessing over macroeconomic and political headlines, we believe that the focus can switch back to the analysis of business fundamentals and prospects. This is what ultimately drives earnings and long-term shareholder returns, and is where we spend most of our time.



The importance of strong balance sheets

The last three years have demonstrated the importance of strong balance sheets (in the face of the rising cost of debt), healthy free cashflow (providing companies strategic optionality to enhance financial returns) and management teams who understand how to allocate capital efficiently to deliver shareholder value creation. Capital allocation is particularly important as we look to 2025 because capital is no longer 'free'. Not all companies will be able to raise and deploy capital easily in a 'higher for longer' world; well capitalised public companies will be at an advantage, leaving management teams with a range of opportunities to put capital to work in organic expansion, acquisitive expansion or through share buybacks. The opportunity to deploy capital at attractive rates of returns should be positive for corporate earnings growth, and as such it should be a good time to be an active investor in public companies.

In recent years, UK equity market valuations have been heavily distorted by the macroeconomic and political factors mentioned previously, as well as technical selling pressures – UK equity funds have been subject to over three years of significant and persistent outflows. In my view, these depressed valuations are part of the reason why elevated merger and acquisition activity has been such a feature of the UK small and mid-cap market. Takeover approaches have provided a material source of returns due to the premiums offered by acquirers, demonstrating healthy private equity and international corporate appetite for UK stocks. It is also why an increasing number of UK public companies sought to enhance shareholder returns by buying back their own stock through 2024, permanently reducing their equity base and accreting their earnings per share. If valuations remain depressed, we expect elevated takeover and buyback activity to persist in the near term.

A rewarding long term

In his parable of 'Mr Market', Benjamin Graham said that 'over the short term the market is a voting machine but in the long run it is a weighing machine'. This seems a very appropriate statement in view of the recent short-term headwinds that the UK stock market has faced and as alluded to earlier. Looking into 2025, I think the fundamentals of UK equities look very compelling – cheap valuations (on almost any metric), with the potential for a re-rating and an earnings recovery.

It has been an exercise in delayed gratification for UK investors but has the potential to be very rewarding over the long term.

> “I think the fundamentals of UK equities look very compelling – cheap valuations (on almost any metric), with the potential for a re-rating and an earnings recovery.”

Important information

Investment risks

Past performance is not a guide to future performance. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested. Changes in currency exchange rates may affect the value of these investments.

Important information

For professional clients/qualified investors only, not suitable for retail investors.
This is a marketing communication.

This is a financial promotion and is not investment advice. Telephone calls may be recorded.
For further information please see our Privacy policy at **www.rlam.com**

The views expressed are those of Royal London Asset Management at the date of publication unless otherwise indicated, which are subject to change, and is not investment advice.

Bloomberg® is a trademark and service mark of Bloomberg Finance L.P. (collectively with its affiliates, "Bloomberg"). Barclays® is a trademark and service mark of Barclays Bank Plc (collectively with its affiliates, "Barclays"), used under license. Bloomberg or Bloomberg's licensors, including Barclays, own all proprietary rights in the Bloomberg Barclays Indices. Neither Bloomberg nor Barclays approve or endorse this material or guarantees the accuracy or completeness of any information herein, or makes any warranty, express or implied, as to the results to be obtained therefrom and, to the maximum extent allowed by law, neither shall have any liability or responsibility for injury or damages arising in connection therewith.

This document is private and confidential and only for use by "permitted clients" in Canada. This document is for information purposes only and is not intended as an offer or solicitation to invest. This document does not constitute investment advice and should not be relied upon as such. Royal London Asset Management Limited is authorized to provide investment services in Canada under the International Adviser Exemption. Royal London Asset Management's principal place for business is in the United Kingdom, and it is not registered as a manager in the provinces of Alberta, British Columbia, Ontario, and Québec.

Issued in December 2024 within Europe (ex-Switzerland) by FundRock Distribution S.A. ("FRD") the EU distributor for Royal London Asset Management Limited. FRD is a public limited company, incorporated under the laws of the Grand Duchy of Luxembourg, registered office at Airport Center Luxembourg, Level 2, 5 Heienhaff, L-1736 Senningerberg, Luxembourg, and registered with the Luxembourg trade and companies register under number B253257. FRD is authorized as distributor of shares/units of UCIs without making or accepting payments (within the meaning of Article 24-7 of the 1993 Law), as updated from time to time. FRD is authorised and regulated by the Commission de Surveillance du Secteur Financier (CSSF). Portfolio management activities and services are undertaken by Royal London Asset Management Limited, 80 Fenchurch Street, London, EC3M 4BY, UK. Authorised and regulated by the Financial Conduct Authority in the UK, firm reference number 141665. A subsidiary of The Royal London Mutual Insurance Society Limited.

For Switzerland: Copies of the Memorandum and Articles of Association,the Prospectus, KIIDs and the annual and semi-annual reports of the fund may be obtained free of charge from the fund's representative in Switzerland, ACOLIN Fund Services AG, Leutschenbachstrasse 50, CH-8050 Zurich. The Paying Agent in Switzerland is Banque Cantonale Vaudoise, Place StFrançois 14, CH-1003 Lausanne.

Issued in December 2024 within Switzerland and the UK by Royal London Asset Management Limited, 80 Fenchurch Street, London, EC3M 4BY. Authorised and regulated by the Financial Conduct Authority, firm reference number 141665. A subsidiary of The Royal London Mutual Insurance Society Limited.

Contact us

For more information about our range of products and services, please contact us.

Royal London Asset Management has partnered with FundRock Distribution S.A, who will distribute its products and services in the EEA. This follows the United Kingdom's withdrawal from the European Union and ending of the subsequent transition period, as UK Financial Services firms, including Royal London Asset Management, can no longer passport their business into the EEA.

Royal London Asset Management
80 Fenchurch Street
London EC3M 4BY

For advisers and wealth managers
bdsupport@rlam.co.uk
+44 (0)20 3272 5950

For institutional client queries
institutional@rlam.co.uk
+44 (0)20 7506 6500

For any queries or questions coming from EEA potential investors, please contact:
Arnaud Gérard, FundRock Distribution S.A. Airport Center Luxembourg, Level 2, 5 Heienhaff, L-1736 Senningerberg, Luxembourg +352 691 992088 arnuad.gerard@fundrock.com

For further information, please visit **www.rlam.com**

We are happy to provide this document in Braille, large print and audio.