The Road Ahead: Addressing the UK's Economic and Market Uncertainty

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CREATIVITY WITHIN EXCELLENCE

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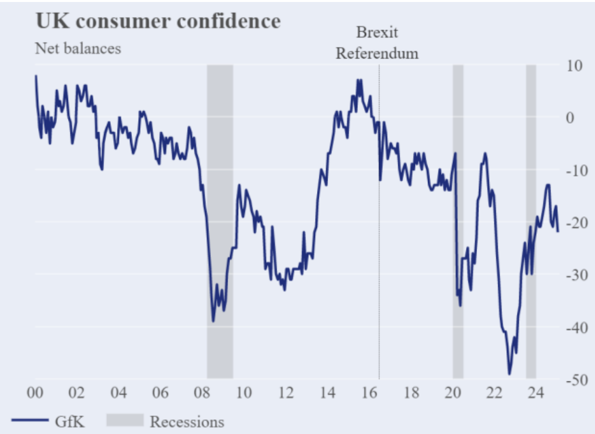
The UK economy has long faced a subdued economic outlook due to low investment, weak labor productivity growth and an aging population. In addition, Brexit, political and policy instability have added uncertainty and dampened activity.

A fiscal policy called into question

In October 2024, Chancellor of the Exchequer Rachel Reeves delivered an expansionary budget with a package of tax hikes that will not cover the massive increase in public spending. Although expansionary, this budget has depressed both consumers and businesses given the tax increases announced. Businesses have complained about the announcement of a large increase in employment taxes, and have said they plan to cut jobs and raise prices in response. The new spending package (GBP 70 billion over the next five years) is designed to boost long-term growth through capital spending, education and health and social care. However, it mainly affected sentiment and created uncertainty, causing economic agents to delay their decisions. A recent KPMG survey points to a deterioration in the health of the labor market, with no sign of employer confidence rebounding.

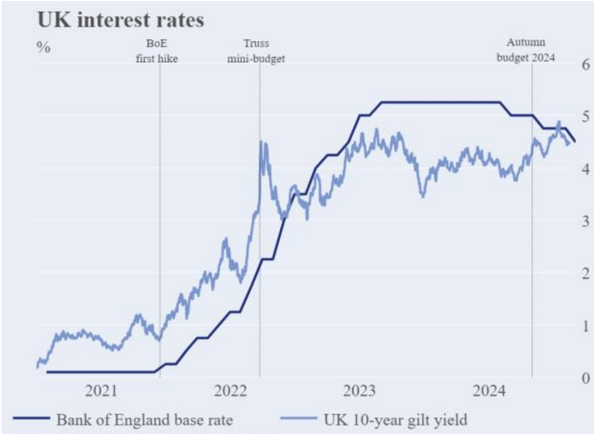


Source: LSEG Datastream/ CBH Investment Management

Even though economic activity grew by 0.1% in the last quarter of the year, mainly supported by a large increase in the change in inventories, the economy is still struggling to gain momentum. Real GDP per capita is estimated to have fallen by 0.1% over the same period.

UK growth has disappointed, the economic outlook is weaker and borrowing costs are higher. Such a situation could force the government to tighten its spending program or raise additional taxes in the Spring Statement on March 26, 2025. This highly anticipated event will showcase the latest economic and fiscal forecasts from the Office for Budget Responsibility (OBR), as well as a parliamentary statement from the Chancellor.

The bond markets are concerned about the increase in spending, which has led to a sharp rise in gilt yields. Since the Truss government and its mini-budget, which caused bond turmoil, markets have been very sensitive to UK government debt issues.



Source: LSEG Datastream/ CBH Investment Management

Gradual monetary easing expected

On the monetary side, the Bank of England cut its policy rate three times since August 2024, from 5.25% to 4.5%. Nevertheless, the bank rate is still well above most estimates of the so-called neutral rate, the point at which monetary policy is neither expansionary nor restrictive. With weak demand, inflation close to target, and hiring slowing, the policy rate is seen as too restrictive.

However, uncertainties are high. Prices are expected to rise in the near term due to gas prices, minimum wage increases and social security contributions. Moreover, the potential impact of the trade war on the UK economy remains unclear, even though the UK economy appears to have little exposure to the risk of Trump's tariffs, as the US has a trade surplus with the UK. In other words, the Bank of England is likely to proceed with gradual interest rate cuts.

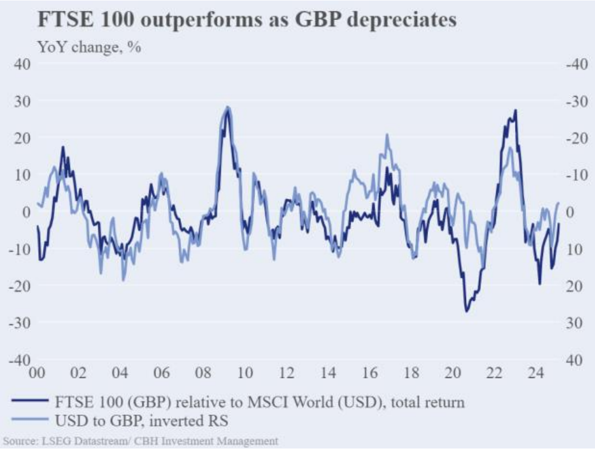
In this context of weak economic activity, questions about the trajectory of public debt and expectations of monetary easing, the British pound faced renewed downward pressure, adding a layer of volatility.

Source: LSEG Datastream/ CBH Investment Management

The equity market does not reflect the UK economy

The UK stock market is largely exposed to international demand, with an estimated three-quarters of FTSE 100 constituent earnings coming from outside the UK. The market is dominated by the financial sector, with a significant representation of commodity-oriented sectors such as miners and energy companies, and a lack of technology companies exposed to the AI revolution.

Given the FTSE100's significant foreign exposure, particularly to the US, there is a strong correlation between the index's relative performance against the MSCI World and the GBPUSD. When the pound depreciates, the UK equity market outperforms.



In view of the expectations with regard to the development of the British currency and the interest rates, the FTSE 100 appears to be attractive.

Compared to the EuroStoxx 50, the index is particularly weighted towards defensive sectors such as healthcare and pharmaceuticals, as well as commodity-linked sectors. The latter is particularly vulnerable to declines in commodity prices, especially oil, and are also sensitive to the potential escalation of the trade war, although the UK is not a primary focus of the Trump administration.

It is worth noting that while UK economic surprises and momentum remain in negative territory, there are signs of improvement. Meanwhile, valuations are unlikely to act as a major catalyst, with the FTSE 100's forward P/E slightly below its historical average. In addition, the FTSE 100 would likely struggle to absorb any further rise in the UK 10-year bond yield, leading to volatility in the equity market.

Investment opportunities

The UK economy faces structural and cyclical challenges, exacerbated by a lack of confidence among international investors, consumers and businesses. Looking ahead to 2025, the GDP growth differential with the euro area is not significant. In addition, while the country may be less exposed to the trade war than its European neighbors, the stock market is sensitive to trade uncertainties given its international exposure.

A disciplined, cautious approach is recommended for investors. While the FTSE 100 may offer short-term opportunities, particularly if sterling continues to underperform, the long-term outlook will be heavily dependent on the government's ability to manage economic and fiscal headwinds, as well as the performance of commodity prices amid the prevailing trade uncertainties. A targeted investment strategy that emphasizes sectors with less exposure to trade risk and capitalizes on the more decorrelated components of the FTSE 100 is likely to offer the best risk-adjusted returns: FTSE companies in Financials (with a strong momentum and still some value left in the sector) and Healthcare (with attractive valuations and a strong megatrend linked to an aging population) are worth investing in. However, this sector is not immune to periods of volatility, particularly due to uncertainties surrounding Donald Trump's statements on import tariffs for pharmaceutical products, which account for 12.5% of the US trade deficit in 2024.

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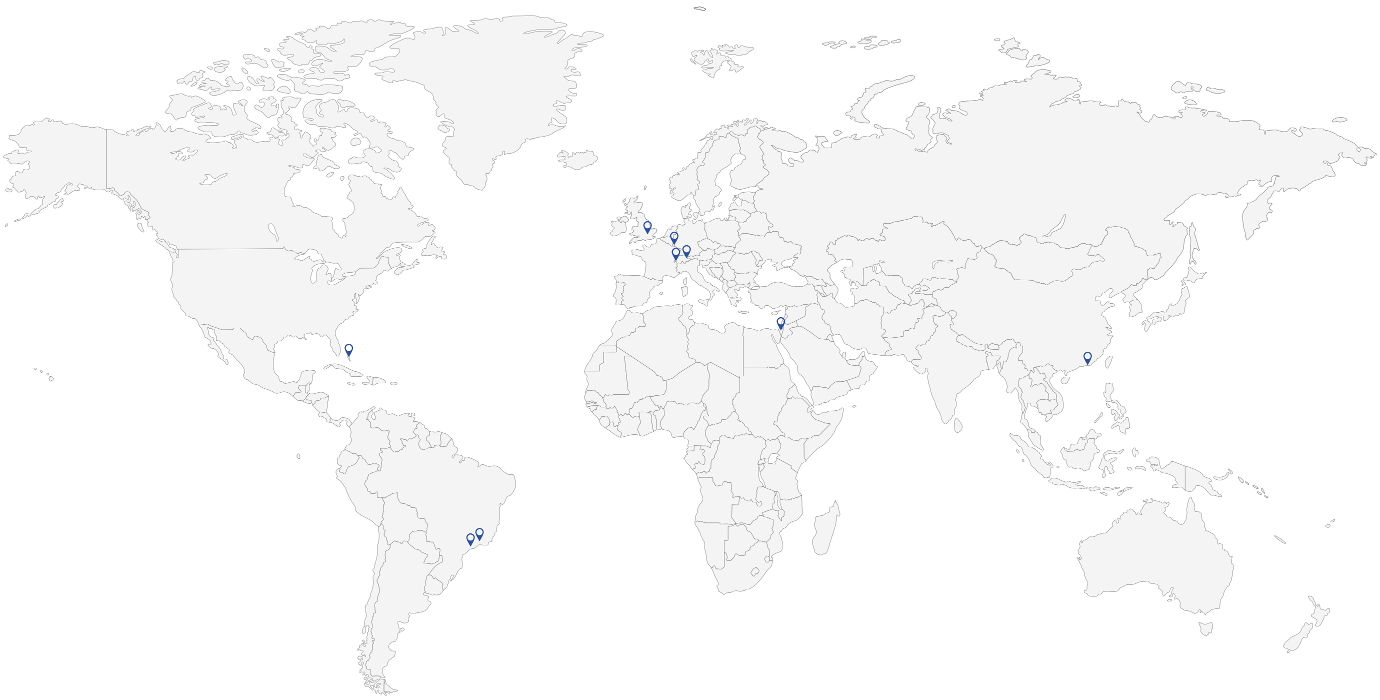

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