WEEKLY ANALYSIS

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SIGNIFICANT DISCOUNT FOR UK EQUITIES

Reduced risk of recession. Wages support purchasing power. Inflation declining too slowly. Relaunch of rate hike cycle. Capital and real estate markets in disarray. Favorable valuations for equities.

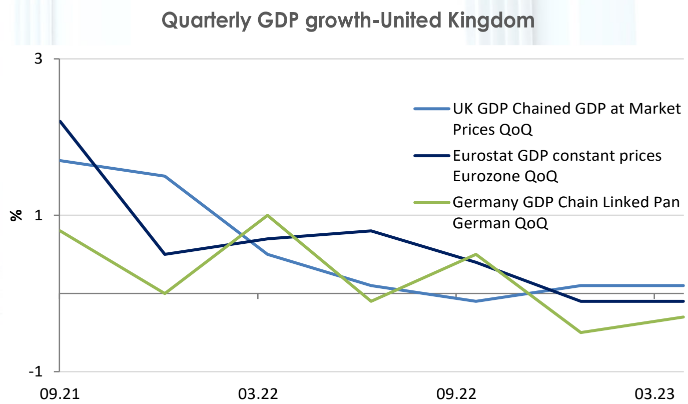
Key points

- British economy still flirting with recession
- Difficult 2nd quarter ahead
- Further worrying declines in leading indicators
- Nominal wages continue to rise
- Household confidence strengthens gradually
- Inflation still falling too slowly
- BoE forced to maintain restrictive policy
- Towards new highs for interest rates
- Sterling benefits from more attractive yields
- Real estate collapses in the face of rising interest rates
- Significant discount for UK equities

British economy still flirting with recession

We were expecting another difficult first quarter, albeit probably a slightly positive one for the British economy, threatened by a complicated situation in the employment market, real estate, foreign trade, industrial production, inflation and finally, domestic demand. Zero growth in UK GDP in Q4, following a -0.4% fall in Q3, would have enabled the UK economy to avoid a technical recession, which has now been averted by the expected resilience of the economy at the start of 2023. The +0.1% growth recorded is not very encouraging, however, and still leaves a great deal of uncertainty on the British economy's ability to avoid a recession, even though this has often been predicted for several quarters. It has to be said that uncontrolled inflation and rate hikes have not yet had the logically expected effects, as they have not weighed sufficiently on momentum to push the economy into a decline. In our view, the outlook is logically no better today than it was a few months ago, particularly given the persistence of inflation and the need for the BoE to pursue its policy of rate hikes in an attempt to bend the trajectory of price rises.

The British economy is therefore virtually in recession, and the outlook for Q2 2023 is once again uncertain. Over the year as a whole, GDP grew by just +0.2%. Over the quarter, private consumption was virtually unchanged, growing by barely +0.1%, while investment rose by +1.3% and it was the -2.5% contraction in government spending that weighed on GDP growth. Recent monthly evolution showed a fall of -0.3% in March, which was not offset by a recovery of +0.2% in April, accompanied by a fall in industrial production of -1.9%. This result is not encouraging for the second quarter, which is already marked by persistent inflation and a further rise in BoE key rates. The environment in the UK remains highly uncertain.



Sources: Bloomberg, BBGI Group SA

Difficult 2nd quarter ahead

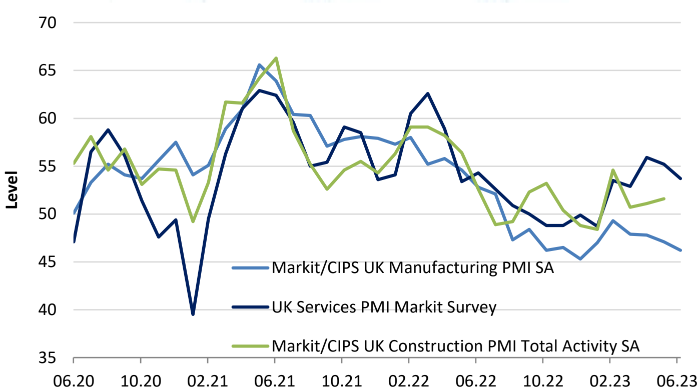
PMI leading indicators for June remain mixed, with essentially a further deterioration in the manufacturing sector below the growth threshold and a gradual erosion in services, which are still in the growth zone, with GDP nonetheless up +0.2%. The rebound has been driven by consumer spending and retail sales, but this is probably not the first sign of a recovery or a trend reversal. The weakness of the economy seems to us to be persistent, and April's rebound is certainly no more than a reaction to the drop in activity recorded in March.

April's good results are unlikely to be transmitted with the same vigor to the quarter as a whole. However, the economy is showing surprising resilience, which could continue if household consumption proves more robust or government spending strengthens. The economic environment in the UK therefore appears surprisingly resilient, despite tighter monetary conditions and falling household disposable incomes. We believe a recession is still possible, but the risks are diminishing. Our GDP growth forecast for the year has been adjusted to +0.1%.

Further worrying declines in leading indicators

After two months of slight recovery, manufacturing PMIs have been on the decline again for the past four months, sinking back into the contraction zone and approaching their December 2022 lows. As for services PMIs, the weakness is more recent, since the Markit/CIPS indicator has only been falling for two months and remains well above the growth threshold. The composite indicator therefore remains positive, thanks to the services component. Taking into account the existing statistical relationship between PMI indicators and GDP, current results suggest GDP growth of +0.4%. We believe, however, that this statistical relationship overestimates the real chances of growth in Q2. Although there is some better news on the inflation front (Producer Prices), other factors remain uncertain. Indeed, business confidence measures showed a second monthly fall in May, probably suggesting a decline in investment. As the PMI measures do not include the public sector, we must remain cautious in view of the recent fall in government spending, which will still have a negative impact on GDP if it remains on this trend, while industrial production returned to contraction territory (-0.3%) in April.

PMI indicators (manufacturing, services, construction)



Sources: Bloomberg, BBGI Group SA

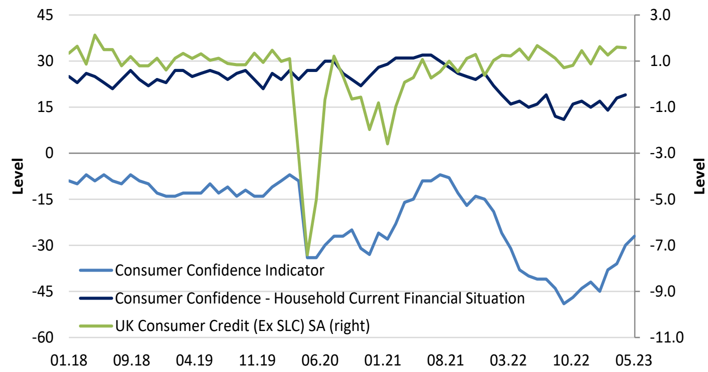
Nominal wages continue to rise

The labor market remains resilient, as indicated by the unemployment rate, which barely rose from its low of 3.7% to 3.8% in April, below expectations of 4%. There are still no clear signs of deterioration. Three-month job growth again exceeded expectations, with an advance of 250,000 new jobs, above the consensus estimate of 150,000. This dynamic seems to further underline the resilience of the labor market in the face of the growing difficulties facing the British economy. The labor market is resilient in the face of worsening economic conditions, and the adverse effects of the energy crisis and inflation on business health. The potential risks of wage-led inflation are still significant, and add to the other inflationary factors. Wage growth reached +7.2% in April, making it one of the strongest year-on-year increases among developed countries by international comparison. It remains difficult to predict whether wage growth has peaked, but these nominal income increases are helping to limit the loss of household purchasing power. The reduction in this risk will only be very gradual, and probably not sufficient in the eyes of the central bank for it to change its policy for several months.

Household confidence strengthens gradually

The consumer confidence indicator (GFK) has been gradually improving since September, but is still very depressed and well below its pre-health crisis level. Sentiment has improved, however, in the absence of a collapse in labor market conditions and rising wages. The indicator rebounded from -49 to -24, and is now at its highest level for the last eighteen months. Consumers are remarkably resilient in the face of inflation and rising financing and credit costs. Retail sales slightly surprised analysts with a better-than-expected result. A rise in May followed an increase in April, which may be motivated by fears of higher prices in the future during a period of inflation. The contraction in household purchasing power is partly offset by rising wages. Since October 2022, inflation has declined, falling to +8.7% in May. It remains too high for households, but compared with the +7.2% wage readjustment, the loss of purchasing power is barely -1.5%.

Household confidence



Sources: Bloomberg, BBGI Group SA

Inflation still falling too slowly

Inflation figures for May show an increase of +0.7%, bringing the year-on-year consumer price index to +8.7%. Although inflation has begun a new downward trend in the UK too, its decline clearly seems too slow and gradual to satisfy consumers and the central bank. While the trend is too uncertain for consumer price indices, the picture is fortunately clearer for producer price trends. May's -0.5% fall has enabled the year-on-year downward correction in prices to continue at a remarkable pace. Producer prices, which had risen by +19.7% in July 2022, have now fallen to +2.9% year-on-year. While these few measures may be a source of satisfaction, the evolution of the core CPI index, excluding food and energy, remains largely a source of concern.

The latest published figure of +7.1%, although lower than that of the overall index, is an all-time high and shows a solid and still worrying upward trend. These elements will not be viewed favorably by the British central bank, which had hoped to be able to bend its policy by pausing, but which in the current context will be clearly ruled out. Indeed, whereas the evolution of commodity prices over the last few months, and in particular the declines in oil and gas prices, are conducive to a reduction in the pressure on global indices, the trend in services remains all too clearly upwards. A more marked slowdown in the UK economy clearly seems essential to the decline in household consumption of services, in order to have a positive impact on the core index.

BoE forced to maintain restrictive policy

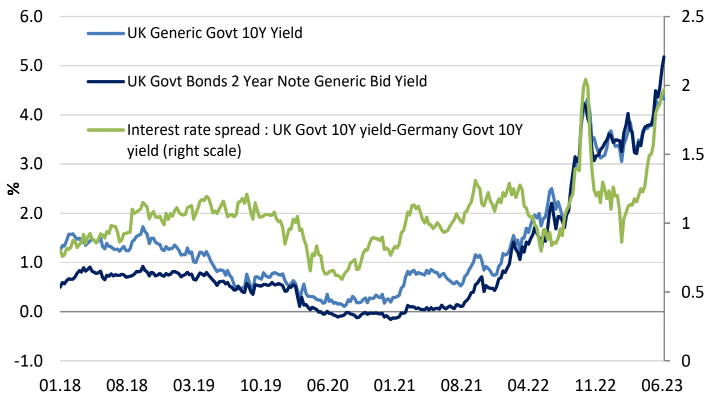
In retrospect, the UK central bank raised its key rates relatively quickly, at a similar pace to the US Federal Reserve. It was the first to decide on an increase in December 2021, before it was joined in its restrictive action by the Fed. However, after a further thirteen hikes in 2022 and 2023, it will not have succeeded in curbing the upward trend in prices. With its key rate now at 5%, the BoE is now significantly behind schedule in its fight against inflation, having perhaps over-optimistically assessed the likelihood of an economic slowdown and its potential positive effects on the price level in 2023. The British economy is slow to slow down, avoiding the recession that the BoE would like to see in order to curb price rises. The fall in energy prices seems insufficient, and wage trends show no signs of the slowdown in adjustment that is needed to bring down inflation in services. The continuing rise in commodity prices is forcing the BoE to tighten its key rates even further. The 50 bp hike decided on June 22nd contrasts with previous hikes limited to 25 bp, and surprises the consensus, which was expecting only a quarter-point increase. This decision underlines the institution's determination to regain control and assert its fight against a still overly dynamic trend in core inflation. The Monetary Policy Committee took account of recent inflation data, and dismissed the risks posed by the turbulence in the banking system in March. Price stability has once again become the BoE's sole objective. The British monetary authorities are now facing a new and worrying situation, forcing them to react more forcefully and resume their restrictive policy course. Our central scenario also takes into account the resilience of the UK economy in the first half of 2023, the slippage in core inflation and the slowdown in global price indices, which is too slow to support the prospect of further tightening by the BoE in August, September and November, reaching a cycle peak of between 5.75% and 6% in the fourth quarter.

Towards new highs for interest rates

Ten-year UK government yields have once again reached the 4.5% threshold they hit in September 2022, when a wave of panic swept through the sterling capital markets following the announcement of the mini-budget, setting the foreign exchange and capital markets ablaze. Long-term gilt yields thus touched 4.5% in June, driven by the disappointing trend in inflation, the BoE's reversal of policy and the prospect of further key rate hikes that could take short-term rates to 6%.

The sterling yield curve is thus clearly inverted, with short-term rates close to 5.5% and ten-year rates close to 4.5%. The inversion of the curve is thus mainly observable between short and lower-medium maturities. On all maturities, real yields are negative, with inflation still above +7-8%. Monetary policy is once again in a phase of temporary acceleration, which implies a still highly uncertain context for capital markets. In our view, the current level is still insufficient for inflation. Bond yields are therefore still likely to rise by around 50-75 basis points over the coming months.

Government rates (2y-10y)

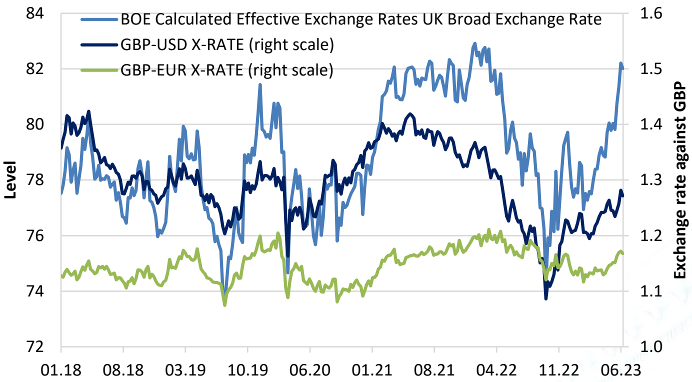


Sources: Bloomberg, BBGI Group SA

Sterling benefits from more attractive yields

After the shock of September 23rd, which caused extreme volatility in the currency and a two-day fall of -5.4% against the euro, -8% against the dollar and -7% against the Swiss franc, the pound stabilized without much conviction. Since then, however, rising key rates and rising yields have provided support for the currency. The USD/pound sterling exchange rate had already appreciated in the fourth quarter of 2022, rapidly erasing the effects of the September crisis. Since then, the trend against the dollar has gradually improved, taking the exchange rate from 1.20 to 1.27. The pound also appreciated against the euro, the yen and even the Swiss franc. Despite record inflation in the UK, the exchange rate is appreciating due to the growing interest rate differential in its favor. This factor could sustain investor interest in the British currency, but we believe that an appreciation is not yet on the agenda, and favor a more moderate outlook for the currency's future evolution.

Effective pound exchange rates



Sources: Bloomberg, BBGI Group SA

Real estate collapses in the face of rising interest rates

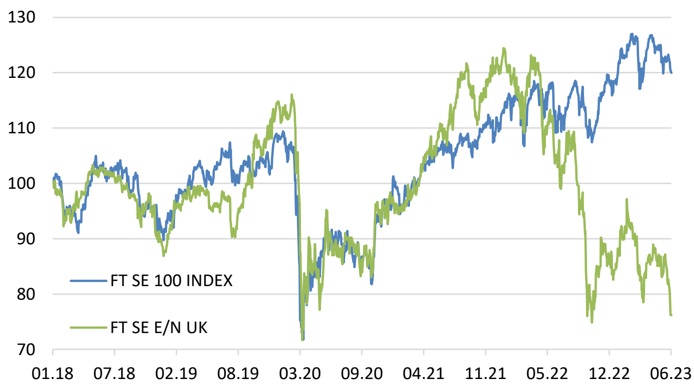
Annual house price growth continues to consolidate sharply in 2023. After reaching +14.3% year-on-year in July 2022, property prices rose by just +3.5% in April 2023. This is the smallest increase since October 2020. The decline is clear across all regions of the UK. Price rises in London are now down to +2.5%. The monthly indicator published by the Nationwide Building Society even shows a year-on-year fall of -3.4%, the sharpest contraction in ten years. The property boom is finally showing signs of weakening. Since peaking in July 2020, prices have thus fallen sharply. Although financing rates have eased in recent months, households are facing a shock when it comes to renewing their mortgages. The fall in mortgage financing approvals has stabilized, but is now almost 50% below the level of summer 2022. This indicator points to a further fall in house prices over the coming months. Households' already difficult situation due to rising inflation will be further exacerbated by the increased cost of mortgage financing on their budgets. Average two-year mortgage rates have reached 4.7%, while five-year rates have reached 4.3%. Around 1.7 million households are directly affected by short-term interest rate trends. A rise in financing costs above 5.5% to 6% is likely, making mortgage financing and property purchases particularly fragile. In 2023, the UK property market is likely to feel the effects of a decline in households' ability to invest, or even to maintain their property investments. In the context of the expected economic slowdown in 2023, a fall in property prices of around -10%, less severe than that induced after the 2008 financial crisis which saw prices fall by -16%, seems likely. UK securitized real estate, already down by -34% in 2022 due to negative expectations linked to the prospect of higher financing costs, has fallen by a further -11% in 2023, bringing the overall price correction for listed securities to almost -45%.

Nevertheless, we believe that while the fall in the price of direct physical real estate has not yet reached its equilibrium point, the same cannot be said of securitized real estate, which already seems to present opportunities for repositioning, not least because of its already attractive valuations.

Significant discount for UK equities

For some weeks now, the FTSE100 index has been suffering from expectations of restrictive monetary policy and rising interest rates. The fall in share prices in May and June contrasts with the generally more favorable trend in both Europe and the United States. Furthermore, the composition of the British index, with little exposure to technology stocks and rather a high proportion of stocks of substance, does not contribute to the current trend in favor of growth sectors in particular. Falling oil and gas prices are causing concern, calling into question the positive outlook for the energy sector so far, as well as the lack of momentum in all commodity-related stocks. The fall in UK stocks in recent weeks may already be proving excessive. Technical valuation measures suggest an oversold situation. On the other hand, from a fundamental point of view, they still enjoy a relative advantage thanks to much lower PEs (10x) and a discount of -17% compared to the Euro Stoxx 50 (PE 12x) and -45% compared to the S&P500 (18).

UK equities and securitized real estate



Sources: Bloomberg, BBGI Group SA

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