WEEKLY ANALYSIS

M. Alain Freymond—Partner & CIO

ATTRACTIVE DISCOUNT FOR UK EQUITIES

Recession likely in 2nd half. Leading indicators fall. Household confidence erodes. Inflation finally falls. End of rate hike cycle. Real estate consolidates. Attractive valuation of equities.

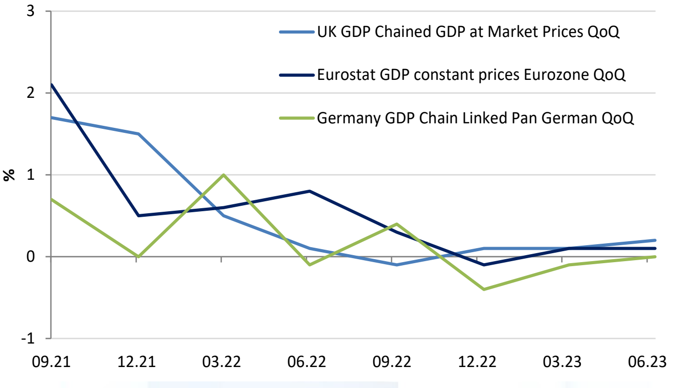
Key points

- Resurgence of risks to the British economy
- Recession in the 2nd half
- Further worrying declines in leading indicators
- Significant downturns in the job market
- Household confidence and questioning
- Inflation finally coming down
- The Bank of England sees the end of the interest rate hike cycle in sight
- New highs for interest rates?
- Sterling could benefit from more attractive yields
- Real estate continues to consolidate
- Discount still attractive for equities

Resurgence of risks to the British economy

For several quarters now, the British economy has been resisting economists' forecasts of a likely recession. In Q2, it seems once again to have surprised forecasters, posting another slight increase of +0.2%, ahead of the forecast of stagnant growth (0%). This follows a small rise of +0.1% in Q1, but is the strongest increase for a year. However, the British economy remains threatened by a complicated situation in the labor market, real estate, foreign trade, industrial production, inflation and, finally, domestic demand. This positive result once again enables us to avoid a recession at the end of June, and to avert the immediate spectre of two consecutive quarters of decline. At the end of June, inflation still out of control, a restrictive monetary policy and rising financing costs had not yet had the effects logically expected, as they had not weighed sufficiently on momentum to push the economy into decline. Naturally, the outlook does not seem any better to us today, particularly in view of 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 economy's overall resilience is essentially due to a domestic dynamic that remains surprisingly resilient, underpinned by a +0.7% rise in private consumption and a marked +3.1% rise in public spending over the quarter. At the end of June, therefore, the British economy was in a very weak state of growth and, in our view, temporarily in a state of suspended animation, as the forces at play should eventually bite back more sharply on consumption and investment, which were stable over the period. On an annual basis, GDP growth was still +0.4%. We do not believe that this result is a sign of recovery, but rather that the third quarter should begin to show real weakness in the economy, which should then be less supported by these two domestic components.

Quarterly GDP growth-United Kingdom



Sources: Bloomberg, BBGI Group SA

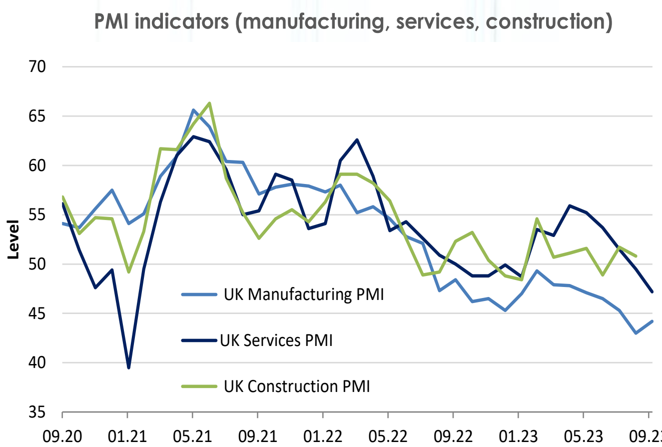
Recession in the 2nd half

Household resilience is likely to flag a little as government spending also stabilizes. As a result, a real slowdown should finally occur in Q3, and certainly continue towards the end of the year. The recent publication of GDP figures for July already seems to confirm this forecast of a decline in UK activity. The British economy recorded a net decline of -0.5% in July, the sharpest fall for seven months.

The contraction in July's GDP completely wiped out June's advance, and came in well above expectations (-0.2%). This result is probably an indication of weakness that could plunge the British economy into a new phase of decline. The BoE was expecting growth of +0.4% for Q3, which is unlikely to materialize given the growth shock recorded for July. The downturn in activity was relatively widespread, with industrial production falling by -0.7%, echoing the -0.8% decline in the manufacturing segment, while construction declined by -0.5%, as did the services sector (-0.5%).^In July, the PMI leading indicators also followed a similar trend, pointing to a worsening short-term outlook. The manufacturing PMI slipped to 45.3, while the services PMI fell more rapidly from 53.7 to 51.5, both pulling the overall index to 50.8, close to the growth limit. The economic context in the UK is therefore worsening, pointing to a negative third quarter and another difficult end to the year. Our GDP growth forecast for the year has been adjusted to +0.1%.

Further worrying declines in leading indicators

As we approach the end of Q3, the leading indicators published for August confirm expectations of economic decline over the summer period. The manufacturing PMI is now down to 43, well below the theoretical growth threshold of 50, the lowest level ever reached after a steady decline that began in May 2021, with the exception of the low point reached in April 2020 in the midst of the pandemic. The services PMI (49.5) also fell below the growth threshold, hitting its lowest level in recent years, which is also a worrying result for the overall performance of the domestic segment. The composite indicator (48.6) also fell below the 50 growth mark. As the PMI measures do not include the public sector, we believe that they should not be able to compensate for the decline in private-sector activity.



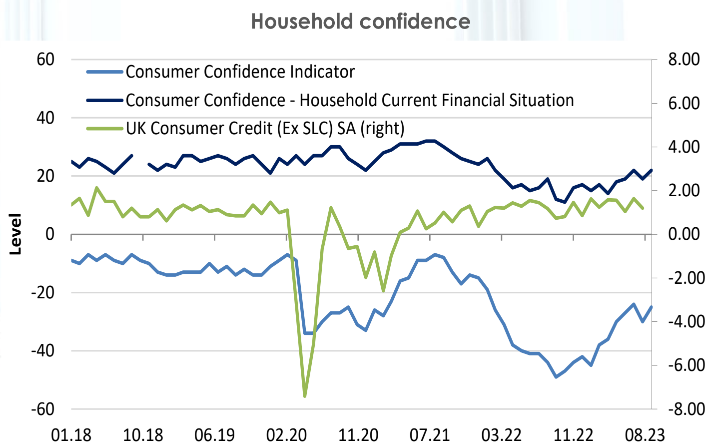
Sources: Bloomberg, BBGI Group SA

Significant downturns in the job market

The labor market is beginning to show some signs of weakness, as can be seen from the level of the unemployment rate, which has finally been rising above 4% for several months. The July unemployment rate (4.3%) is the highest in a non-recessionary context. Employment growth has plummeted since its April peak (+250k), and contracted again in July (-207k) following a -66k decrease in June. The change in momentum is finally clear, and should reinforce the BoE's policy of calming the labor market. The potential risks of wage inflation picking up again are thus diminishing significantly, but the +7.8% rise in weekly earnings excluding bonuses (3m/GA) remains very high. It is at its highest for a decade, and shows no sign of abating yet. 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 for the central bank to change its policy for several months.

Household confidence and questioning

Household living standards are up again for the first time since early 2002, thanks to a rise in real wages and a significant increase in nominal wages. Although we expect these increases to stabilize rapidly, for the time being, households appear to see this rise as a very positive factor boosting their confidence levels. Indeed, the household confidence indicator (GFK) in August (-25) continued the gradual upward trend begun in September, although it remains well below its pre-health crisis level. The recent rise in the unemployment rate and the fall in job creation are bound to worsen consumer sentiment and resilience in the face of slowing inflation and the sustained rise in financing and credit costs. Retail sales reacted with a drop of -1.2% in July, suggesting that household expectations and confidence are being called into question.



Sources: Bloomberg, BBGI Group SA

Inflation finally coming down

Inflation figures for July show the first month-on-month price contraction of -0.4% since January (-0.6%). On a year-on-year basis, the CPI index for July falls to +6.8%, clearly down on its June level (+7.9%) and its peak of +11.1% in October 2022. Although inflation has begun a new, clearer downward trend in the UK, it should now record several negative periods to satisfy consumers and the central bank. On the producer price index (PPI) side, the decline is much sharper, and is very encouraging for the forthcoming evolution of the CPI indices. Indeed, the year-on-year decline of -0.8% in July represents a significant reversal of the trend, compared with the +19.7% rise recorded in July 2022.

While these few measures may be a source of satisfaction, the trend in the core CPI index, excluding food and energy, remains largely a source of concern for the BoE. The latest published figure of +6.9% is now similar to that of the overall index, but remains close to its all-time high.

This last point still suggests that the British central bank will not be able to change its policy and should maintain pressure on rates. A more marked slowdown in the UK economy clearly seems essential to the decline in the level of household consumption of services, in order to have a positive impact on the core index.

Bank of England sees the end of the interest rate hike cycle in sight

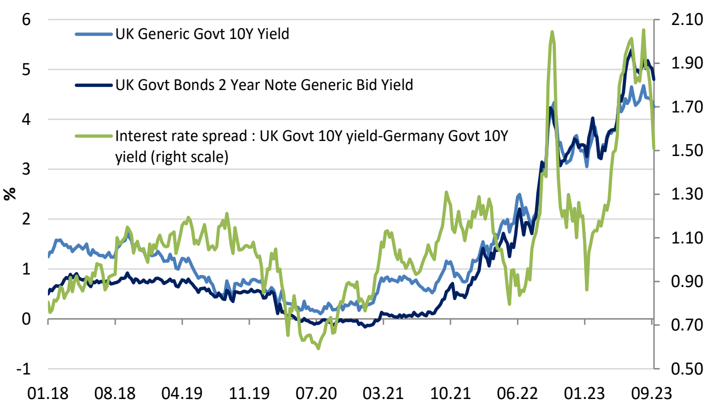
The economic slowdown that is beginning to emerge, increasing the risk of recession, is certainly beginning to fuel debate among the members of the UK central bank's Monetary Committee. After fourteen consecutive rate hikes and one of the quickest restrictive monetary policies to be implemented in December 2021, the BoE is now facing a new predicament just days before it has to decide whether to proceed with a fifteenth hike or whether the time for a pause has finally come. Despite an already severe restrictive policy, the fight against inflation does not yet seem to be won. Indeed, British inflation is almost twice as high as in the USA, for a similar level of interest rates and virtually zero growth. The current level of key rates at 5.25% is still well below annual inflation. A further increase on September 21 still seems highly likely, despite a number of statistics suggesting a clear economic slowdown since July, while the probability of a status quo is now 50%. The BoE had already been hoping for several months that its action would have a more rapid impact on consumption and growth, which finally stalled in the 3rd quarter. The fall in energy prices has not been enough to significantly calm the rise in prices, while wage growth remains strong. These factors show no signs of a forthcoming slowdown trend, which would enable the necessary adjustments to be made to bring down inflation in services.

However, the British monetary authorities are likely to consider that the current economic slowdown and signs of a softening labour market already offer encouraging prospects for a reduction in inflation. Our central scenario takes into account the positive effects of a fall in producer prices on consumer price indices, which should enable the BoE to pause its rate hike policy in September. However, it remains likely that the MPC will prefer to perhaps raise rates one last time, suggesting at the same time that a pause from this point onwards would certainly be appropriate while we wait to see the full effects of the restrictive cycle transmitted across the various sectors of the economy.

New highs for interest rates?

Ten-year UK government yields have once again reached the 4.5%-4.75% threshold that was hit in September 2022, when a wave of panic swept through the sterling capital markets following the announcement of the "mini-budget", which set the world alight and quickly engulfed both foreign exchange and capital markets. Long-term gilt yields thus rose to 4.75% in August, driven by the disappointing trend in inflation and the prospect of further key rate hikes that could take short-term rates to 6%. Over the past three months, long rates have hovered around 4.5%, awaiting clearer signs that the long-awaited recession is finally upon us. Following this development, the sterling yield curve remained inverted, as short rates also rose by 0.25% in August, taking the short end of the curve to 5.5%. 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 close to +7%. By international comparison, the yield curve still seems too low for the level of inflation observed in the UK. However, following recent macroeconomic developments, a phase of stabilization and limited decline in long yields could still materialize, particularly if the BoE were to decide on September 21 to pause in its strategy.

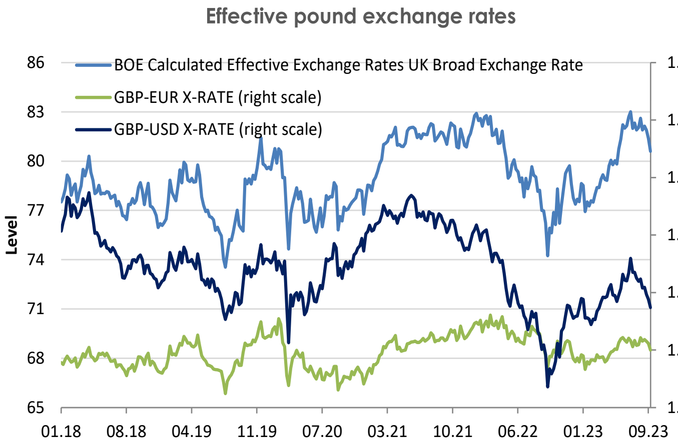
Government rates (2y-10y)



Sources: Bloomberg, BBGI Group SA

Sterling could benefit from more attractive yields

Rising key rates and higher yields are supporting the currency. Yield differentials favor the pound against most currencies, including the dollar on longer maturities. Nevertheless, these factors do not seem to be working in favor of an appreciation of the pound, which has only just stabilized against the euro over the last three months at around the pivotal level of 0.86, and close to 1.11 against the Swiss franc. The dollar's rebound in recent weeks has also affected the USD/GBP pair. The interest-rate differential could bolster investor interest in the British currency, but we believe that an appreciation is not yet on the agenda, and prefer a more moderate outlook for the British currency, which will soon be negatively affected by the publication of statistics highlighting the slowdown in the British economy.



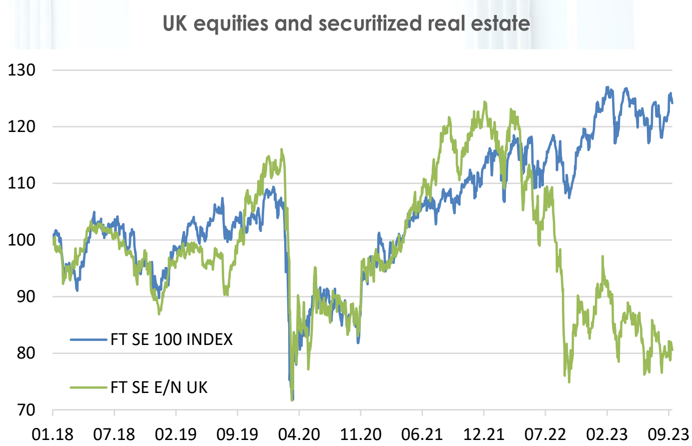
Sources: Bloomberg, BBGI Group SA

Real estate continues to consolidate

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 +1.7% in June 2023. This is the smallest increase since June 2020. According to figures published by Nationwide Building Society, the average house price even declined by -5.3% in August since its peak the previous year, which represents the sharpest contraction in the last ten years. The decline is clear across all regions of the UK. The property boom is finally showing signs of weakness. Since the peak in July 2020, prices have fallen sharply. Rising financing costs are beginning to have an impact on households, who are facing a shock when they renew 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 property prices over the coming months. The situation of households, already difficult 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 6.5%, with five-year rates at 6%. Around 1.7 million households are directly affected by the trend in short-term rates. In 2023, the UK property market is likely to feel the effects more strongly of households' reduced ability to invest, or even to maintain their property investments. Against the backdrop of an expected economic slowdown in 2023, we consider a decline in property prices of around -10% less severe than the -16% fall in prices in the wake of the 2008 financial crisis. UK securitized real estate, already down -34% in 2022 due to negative expectations linked to the prospect of higher financing costs, has fallen 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 appears to offer opportunities for repositioning, not least because of its attractive valuations.

Discount still attractive for equities

For some weeks now, the FTSE100 index has been feeling the effects of expectations of restrictive monetary policy and rising interest rates. However, the monthly volatility observed over the summer leaves the equity market virtually unchanged at the end of September. The current economic slowdown could prove a positive factor for the UK market, which would finally benefit from a less unfavorable monetary policy and interest rate scenario. The current level of the UK market offers some opportunities due to rather attractive absolute and relative valuation measures. All FTSE100 companies continue to enjoy a relative advantage, with an average PE (10.7x) well below that of the US S&P500 (18x) and the SMI. However, the discount to European equities has narrowed to just 10%. Technical valuation measures also suggest an oversold situation, from which a new uptrend seems likely.



Sources: Bloomberg, BBGI Group SA

BBGI Group
Place de Longemalle 1
1204 Geneva
Switzerland
T: +41225959611
reception@bbgi.ch
www.bbgi.ch