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2010: A year in the UK

Richard Buxton, Head of UK Equities, looks ahead to 2010



- Uncertainty over the pace of the UK economic recovery and interest rate policy is likely to dominate sentiment
- Volatility liable to increase, but fully supportive valuations should limit the downside
- Clear growth potential for many UK firms even given sluggish domestic demand.

“We believe we are facing the prospect of very limited levels of UK economic growth, and, in that environment, global interest rate rises pose a challenge for the UK’s politicians and policymakers.”

Considering all the forecasts of economic Armageddon and financial sector collapse that were being put forth 12 months ago, 2009 has proved to be a relatively ‘painless’ and straightforward year. Indeed, the introduction of massive monetary stimulus by the world’s central banks has succeeded in averting a depression, and has acted as a huge source of liquidity, pushing up risk assets across the board. The UK stockmarket has been no exception to this trend, seeing a significant and virtually straight line increase since the March lows, led by cyclical and financial stocks. We believe 2010, in comparison, is going to be a much less straightforward ride.

What happens when the global stimulus tap gets turned off?

For the time being, equity markets are being helped upwards by the immense level of liquidity being pumped in by the central banks, but, clearly, this will not last forever. We have already seen the first signs of monetary tightening in certain countries around the world, much discussion as to the potential for interest rate rises in China, plus the withdrawal of QE and interest rate rises in the US. It seems likely that over the course of 2010, we will see further examples of liquidity measures being withdrawn, and the big question as far as the struggling UK economy is concerned is – can it weather this reversal in policy successfully?

Major headwinds for an economy that is being left behind

The major issue for the UK, at present, is that its economic recovery continues to lag that of its peers. We have seen positive signs of a stabilisation in the housing market, but the third quarter GDP numbers showed that the recession is still technically with us. Furthermore, the savings rate has been increasing, but the UK consumer remains overleveraged, with credit availability still falling as banks continue to shrink their balance sheets. The outlook for 2010 also looks increasingly bleak, with the immense government deficit driving the return of 17.5% VAT and possibly 20% thereafter, the likelihood of higher income tax and national insurance across the board, and public sector job cuts, which will compound a rising unemployment trend. All of this begs the question – what kind of economic recovery can we expect?

‘V’, ‘W’, ‘L’?

If we are looking at a ‘v-shaped’ recovery for the UK then a degree of interest rate normalisation on a global scale should not pose too much of a problem. Any decent bounceback in growth would leave the Bank of England able to start nudging up interest rates alongside its peers. Unfortunately, however, it is our belief that the headwinds are too great for such a strong rebound in the UK economy. Instead, we believe we are facing the prospect of very limited levels of growth, and, in that environment, global interest rate rises pose a bigger challenge for the UK’s politicians and policymakers.



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**Richard Buxton,
Head of UK Equities**

Richard Buxton's extensive investment career spans nearly 25 years – of which 19 have been focused exclusively on UK equities.

Richard joined Schroders in 2001 and has been Head of UK Equities for the past six years.

If growth is fairly scarce, any interest rate rises in 2010 run the risk of choking the recovery before it really gets going. Conversely, though, should the Bank of England leave monetary policy much looser for longer than the rest of the world, what consequences could that have for sterling and the bond market? Further weakness in sterling, a currency crisis, rising gilt yields relative to other bonds are all possibilities for 2010. Uncertainty over the pace of recovery, the maintenance of low rates for longer and these possible consequences are likely to dominate sentiment towards UK stocks over the course of 2010.

Valuations supportive, but stockpicking to be key

This uncertainty over monetary policy will be compounded initially by electoral nervousness as well, with much twitching over opinion polls and fiscal policy 'promises' no doubt overshadowing the early months of the year. Volatility is bound to increase over the next six to nine months, particularly when compared with the relatively straight run seen since March. Encouragingly, however, valuations on UK equities are completely supportive and in no way stretched, which should limit the downside during periods of volatility.

Equally, no matter how subdued the outlook for the UK economy in 2010, UK equities offer far more than pure UK-based profits streams. Moreover, companies have been exceptionally swift at cutting costs to protect profits, so it is far more appropriate to anticipate a v-shaped recovery in profits than it is in the economy. We still find many UK companies with clear potential to grow. This may be because of their geographic exposure to faster growing markets than the UK, product innovation, or a renewed business focus following management change. Whichever it may be, we believe the resulting ability to generate top-line growth against an extremely sluggish economic backdrop holds the key to delivering attractive UK equity returns during 2010.

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