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No major surprises in the UK budget; outlook improving. Stay overweight equities and positive on Sterling

Summary

- **The outlook for UK equities remains positive.** A growth recovery is supporting earnings, low rates are good for valuations, and the wide yield gap with fixed income is encouraging inflows.
- **UK equity offers cyclical exposure, value and high dividend yields.** These are features that we are favour globally right now.
- **Sterling is well underpinned.** Valuation is undemanding, positioning is not over-extended and there is pent-up demand for UK assets. The currency's attractions could grow in the coming weeks as the challenges relating to the UK's EU exit slowly ease and as the country's rapid COVID vaccine rollout progress continues.
- **The UK's 3rd March budget struck a balance.** On the one hand, the UK is extending immediate emergency support measures and medium-term growth initiatives. On the other, it has set out an early roadmap for long-term fiscal retrenchment. There were no major surprises. Equities and Sterling were unchanged on the day. Gilts weakened, in line with global weakness today in sovereign bonds. The rise in gilt yields also partly discounts the earlier growth pick-up expected by the UK government and the heavy issuance outlook of £296 billion for the 2021-22 financial year.

Key measures announced in today's budget

In aggregate, emergency fiscal support is extended by £59 billion, equating to 2.9% of GDP. A sharper rebound is expected, albeit to a still-weak level of GDP. Business investment gets a £25 billion subsidy over two years, but then corporation tax will rise from 19% to 25% in 2023.

COVID-19 support: The UK's furlough scheme has been extended until the end of September 2021, with the government continuing to pay 80% of employee wages for the hours that cannot be worked. With widening grants, 600,000 more self-employed people will be eligible. The £20 weekly uplift in Universal Credit – the UK's principal payment to unemployed and low-income individuals – is extended for another six months until September. The minimum wage will also be increased from £8.72 to £8.91 from April 2021.

Taxes: There are no changes to income tax, national insurance or VAT. Personal income tax and higher rate thresholds are frozen from 2022 to 2026. By contrast, corporation tax will increase from 19% to 25% in April 2023. However, the 19% rate will be maintained for smaller companies with profits below £50,000. The stamp duty exemption on property transactions will be extended to June 2021.

Business support: Firms will be able to offset investment costs against tax bills, reducing taxable profits by 130% over the next two years. Reduced VAT will be held at 5% until September, with an interim rate of 12.5% for the following 6 months.

Infrastructure: A new £12 billion Infrastructure Bank will be established in Leeds, which will seek to fund £40 billion worth of private and public projects. The transition to a net zero carbon economy will be supported by £15 billion in green bonds.

Healthcare: £1.65 billion to support the UK vaccination roll-out scheme.

Regional support: £1.2 billion of funding for the Scottish Government, £740 million for the Welsh Government, and $410 million for Northern Ireland.

Economy expect to rebound strongly from the second quarter

The Chancellor of the Exchequer (chief UK finance minister) highlighted that the country's economy contracted 10% in 2020, with projected GDP growth in 2021 of 4%. The latter has been revised lower from an earlier forecast of 5%. This is still slightly more aggressive than Citi Private Bank's expectation of 3% for 2021, and follows a likely first quarter slump of approximately 4%. The government's forecasts show that GDP is only expected to return to pre-pandemic levels by mid-2022 with projected GDP growth of 7.3% in 2022. Significant support also means unemployment is expected to peak at 6.5% in 2022, well below the originally predicted peak of 11.9%.

The UK budget deficit continues to rise to peacetime highs. Including today's announcement, the total government response to COVID-19 will total an estimated £407billion. With regard to public finances, borrowing is set to total £234 billion in 2021-2022, with a peacetime record of £355 billion this year.

In addition to the ongoing fiscal accommodation, these are the additional economic drivers:

Vaccine progress: The UK's vaccination progress this year has been far more impressive than its virus containment efforts last year. The early procurement of at least 400 million vaccines from seven suppliers has led to an impressive total of 27 million people vaccinated so far. The government's targets of vaccinating all over-50s by the end of April and all adults to have had a first vaccine by the end of July look realistic. With infections, hospitalizations and deaths all falling, the country has probably passed through the worst phase of the pandemic.

Reflecting this progress, UK prime minister Boris Johnson has announced a "cautious but irreversible" plan to ease lockdown restrictions gradually over the coming months in four stages. This will begin with schools re-opening on 8th March and conclude with all businesses resuming operations and the lifting of all restrictions on 21st June.

Bank of England (BOE) support: BOE Chief Economist Haldane has recently compared the economy to a "coiled spring," highlighting the possibility of the £125 billion of savings built up during the pandemic being released. Despite this potential rebound and with a stronger-than-expected rise in January inflation, we still see a rise in the deposit rate as most unlikely. That will remain the case while pandemic pressures persist and with ongoing economic scarring likely. The BOE has increased its asset purchase program by £150 billion to £795 billion and could still add to this if necessary.

Gradual pickups in services sectors are expected. In the current lockdown, the economic downturn has been much less severe than in the second quarter of 2020. This is because UK factories, shops, and consumers were better prepared and more adapted this time. The manufacturing rebound reflects this. Our expectation is that inventory rebuilding still has further to go, and that services should pick up alongside vaccine momentum, driven also by high savings levels, low rates, and substantial pent-up demand. While social distancing and wariness may linger, the second half should see a steady recovery in services.

Asian import demand. As Asia has contained the virus relatively well, its economies have recovered over recent months. China has led the rebound in global trade activity. Its import growth recovered sharply in late 2020, with imports booming from a 16% decline in early 2020 to over +10% now. The UK has significant exposure to Asia, with approximately 14% of exports going to the region.

Three reasons to overweight UK equities

1. **Valuation is attractive in absolute and relative terms:** The UK's 15x prospective multiple remains attractive relative to the global average of 21x – **figure 1**. This multiple looks sustainable, with record low rates keeping discount rates low. In addition, this is supported by expected average 2021 EPS growth of 40%. Furthermore, in this era of financial repression, equities look particularly attractive versus fixed income. The UK yield gap – the difference between average dividend yields and average investment grade bond yields – is wider than in any other region. The catalyst for this gap to close could be the resumption of dividend payments this year.

2. **The UK market is under-owned.** The issue of Brexit hung over the UK for five years, dampening foreign investor interest. The country's disappointing COVID-19 containment efforts were also unhelpful in this regard last year. That is now changing, however. Underweight global investors are showing renewed interest in UK markets.

3. **The UK is a great play on our preferred global areas.** Over recent years, its markets were held back by the lack of sizeable technology sector exposure. However, the UK is now starting to benefit from its substantial exposure to areas that are increasingly favoured at a global level, namely cyclicals and value.

Four UK investment opportunities

1. "COVID cyclicals" (*) such as industrials and materials are favoured

While services have lagged, manufacturing has shown resilience. The recent results season was positive for industrial and material companies, with more upgrades than downgrades. Materials companies could see significant earnings and cashflow improvements in 2021, as the economic recovery gathers momentum. Recent commodity strength bodes well for materials performance, which was also reflected in recent corporate earnings results for the sector. The materials sector saw an average 13% earnings upside surprise and posted positive earnings growth in 4Q20.

2. Dividends strategies expected to continue to outperform

The average UK dividend yield is 3.3% - **figure 2**. We see three reasons why investors should revisit dividend strategies. Firstly, we have high conviction that dividends will rebound from their 2020 lows as GDP growth rebounds, supporting a recovery in earnings and cashflow. Secondly, while many companies had cancelled or suspended dividends in 2020, many of these companies have now reinstated their 2021 dividends. Thirdly, dividend-orientated strategies are heavily biased towards "COVID cyclicals", with a weighting in the UK market of 65%.

3. Value sectors including banks starting to outperform

The yield curve had steepened slightly. This has historically correlated with value performing stronger relative to growth**.** Value has suffered a period of prolonged underperformance – **figure 3**. Our favoured value sector remains banks. Steeper yield curves should help profitability, balance sheets are generally strong, and lending growth is expected to pick up. Average valuations at 0.4 times average price-to-book value are historically cheap, with returns on equity expected to rise from depressed levels.

Dividend resumptions will be a key catalyst for the banking sector in 2021. Following suspensions in 2020, the UK Prudential Regulatory Authority (PRA) has now allowed dividends to resume in 2021. UK banks can now resume dividend distributions capped at the higher of 20 basis points (bps) of CET1 ratio at end-2020 (or 25% of 2019 and 2020 combined net income).

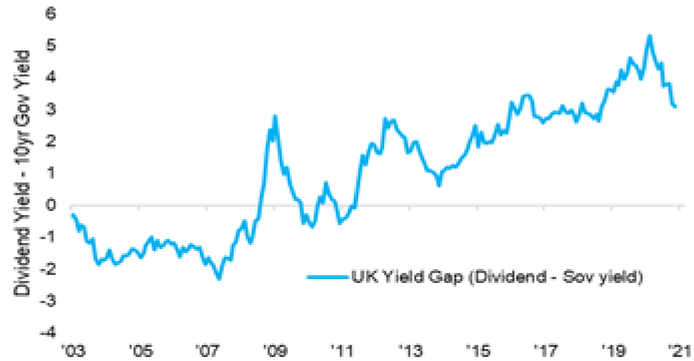
4. Keep accumulating sterling into weakness

Our advice over the past six months is unchanged: buy in tranches into any weakness. Sterling is already up 2% year-to-date against the dollar, 6% against the Swiss Franc, and the same against the Japanese yen. Since its March 2020 lows, the gain is much greater, rising from $1.15 to near a three-year high of $1.40. The next resistance level is expected at $1.42-43. The valuation measured by the real-exchange rate remains attractive, 3-month implied volatility has fallen to 8%, and the open interest of 13% is off the lows but not overly extended – **figure 4.**

Figure 1: UK equities trade cheap globally

Source: Bloomberg as of March 3 2021. UK, Europe-ex-UK, US and World represented by FTSE 100, Stoxx Europe Index, S&P 500 and MSCI World. For illustrative purposes only. Past performance is no guarantee of future results. Real results may vary. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment.

Figure 2: UK yield gap (%)



Source: Bloomberg as of March 3 2021. UK and Europe represented by FTSE 100 and Stoxx Europe Index. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

Figure 3: UK value underperformance

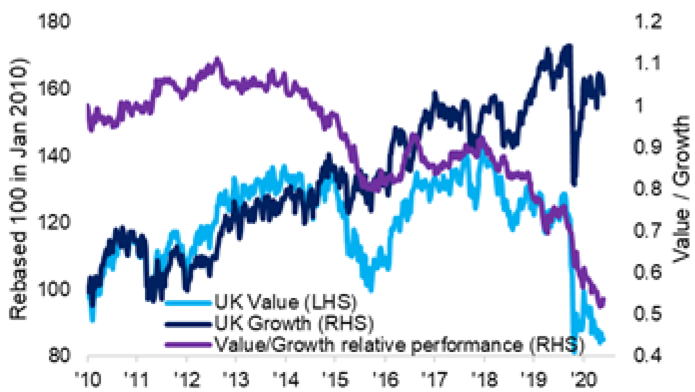


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Figure 4: Sterling net open interest not yet extended

Source: Bloomberg as of March 3 2021. For illustrative purposes only. Past performance is no guarantee of future results. Real results may vary.

(*) "Covid Cyclicals": Financials, industrials, materials, real estate, consumer discretionary. "Covid Defensives": IT, healthcare, communication services, consumer staples, utilities.

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