

# Realising value in UK equities

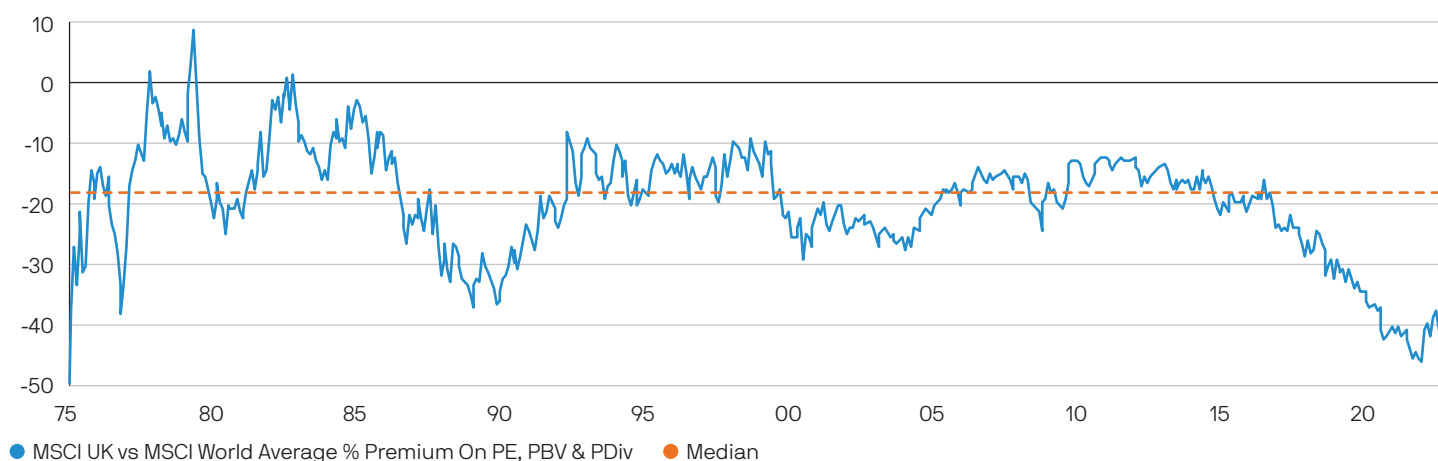
Callum Abbot, Portfolio Manager

The UK stock market is categorically cheap. We've been showing clients the chart in **Exhibit 1** for a while, which shows the UK market's valuation based on a blend of metrics, relative to the valuation of world equity markets.

The first thing to note is that the UK is trading on a 40% discount to global equities. In absolute terms, this level of discount is clearly enormous, but it is also attractive compared to the long-run average discount of around 18%. We argue this is a once in a generation value opportunity, as one must look back to the mid-1970s to find a period when the discount was previously as wide.

The second observation is that the discount has moved in cycles over long periods. Until recently, the UK market has been in a prolonged period of de-rating, which I would argue began in the early 2010s and accelerated following the Brexit referendum vote in 2016. To me, there are two factors at play. First, Brexit has created sterling volatility and made owning UK assets less appealing for overseas investors. Second, and I believe more importantly, a period of abnormally loose monetary policy has lent itself to growth stocks, and growth markets.

Exhibit 1: Premium/discount for the MSCI UK Index vs. MSCI World Index



Source: J.P. Morgan Asset Management using data from MSCI, I/B/E/S, Morgan Stanley Research. Based on PE (Price to Earnings), PBV (Price to Book Value) and PD (Price to Dividend). Average relative valuations use 12-month forward data where available. Data from 31 December 1987 to 30 September 2022. **Past performance is not a reliable indicator of current and future results.**

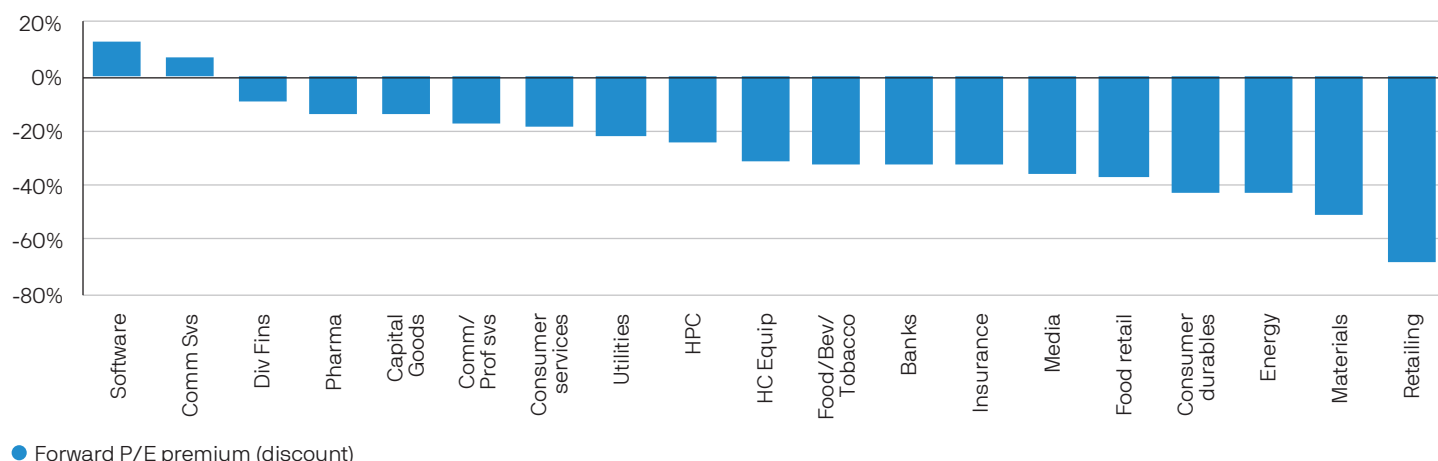
A common observation is that the UK equity market lacks exposure to high growth sectors and has a significant weighting in value sectors. However, this view is well reflected by the UK's long-run 18% median discount to the world equity market, which means the current discount reflects more than just the market's composition.

**Exhibit 2** compares the valuation of the UK and US equity market, sector by sector. For every sector bar two (which are small for the UK) the UK market is trading at a discount to its US equivalent.

If we look at a more granular level, we can see that the UK's discount persists when comparing similar stocks. **Exhibit 3** compares three UK-listed stocks with three US peers. In each case, the companies are global in nature and are closely related. To me, the most striking example is Shell vs. Exxon. Both are integrated energy companies that, at a high level, do the same thing with a similar strategy. Shell arguably has a better portfolio due to its exposure to liquefied natural gas. Yet Shell is trading at a staggering 43% discount to Exxon. I cannot see a fundamental justification for this discount, or any of the others illustrated in **Exhibit 3**.

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Exhibit 2: Premium/discount of the UK market vs. the US market

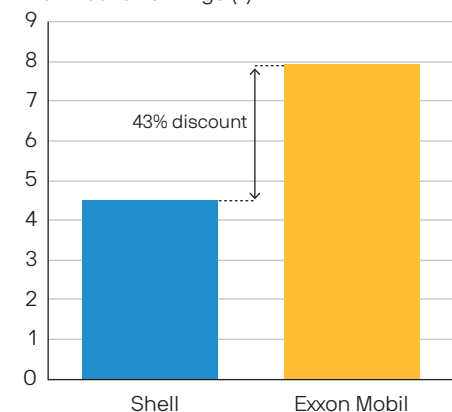


Source: J.P. Morgan Asset Management using data from Credit Suisse. Data as at 10th October 2022

Exhibit 3: Valuation discounts to US peers

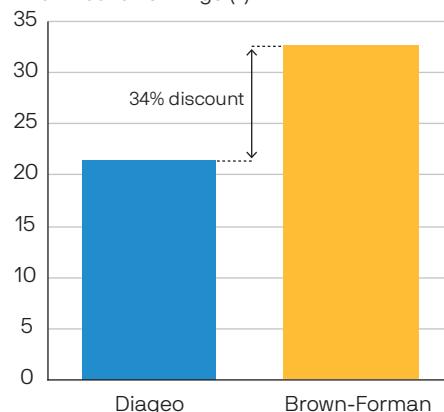
### Shell vs. Exxon Mobil

Fwd Price to Earnings (x)



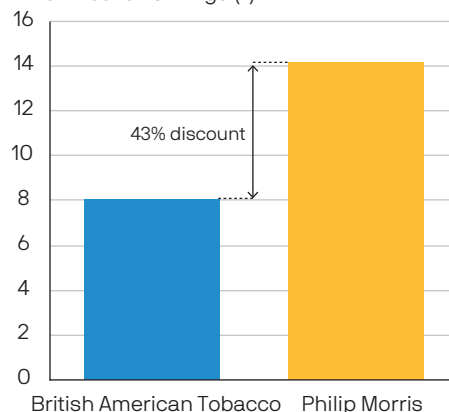
### Diageo vs. Brown-Forman

Fwd Price to Earnings (x)



### British American Tobacco vs. Philip Morris

Fwd Price to Earnings (x)



Source: J.P. Morgan Asset Management, Factset; data as of 3 October 2022. The securities above are shown for illustrative purposes only. Their inclusion should not be interpreted as a recommendation to buy or sell. Opinions, estimates, forecasts, projections and statements of financial market trends are based on market conditions at the date of the publication, constitute our judgment and are subject to change without notice. There can be no guarantee they will be met.

The valuation opportunity is significant. The question is, what leads to the opportunity being realised?

**Exhibit 4** shows the global value spread based on the forward earnings yield. A rising blue line implies that the difference between expensive and cheap stocks is widening, and, typically, that growth is outperforming. The opposite is true when the blue line is falling, which is when value outperforms. The run up to the tech bubble in the late 1990s, and the subsequent bursting of that bubble, is the clearest example of this.

Anyone with half an interest in investing will know that growth investing was the trade for the entirety of the 2010s. They will also know that the last nine months has been challenging for growth strategies.

I think a number of things have driven this growth sell off. Primarily, the 2010s were characterised by low inflation and ultra-loose monetary policy, which built up to a crescendo through the pandemic. This benign macro environment has now been replaced by significantly higher inflation, a decent proportion of which is in sticky core areas and reflects a structurally diminished labour market.

Also, valuations, supported by cheap debt and helicopter money (quantitative easing by central banks), became too extreme and bubbles formed (in cryptocurrencies, non-fungible tokens, unprofitable tech stocks, etc.). These bubbles have now burst.

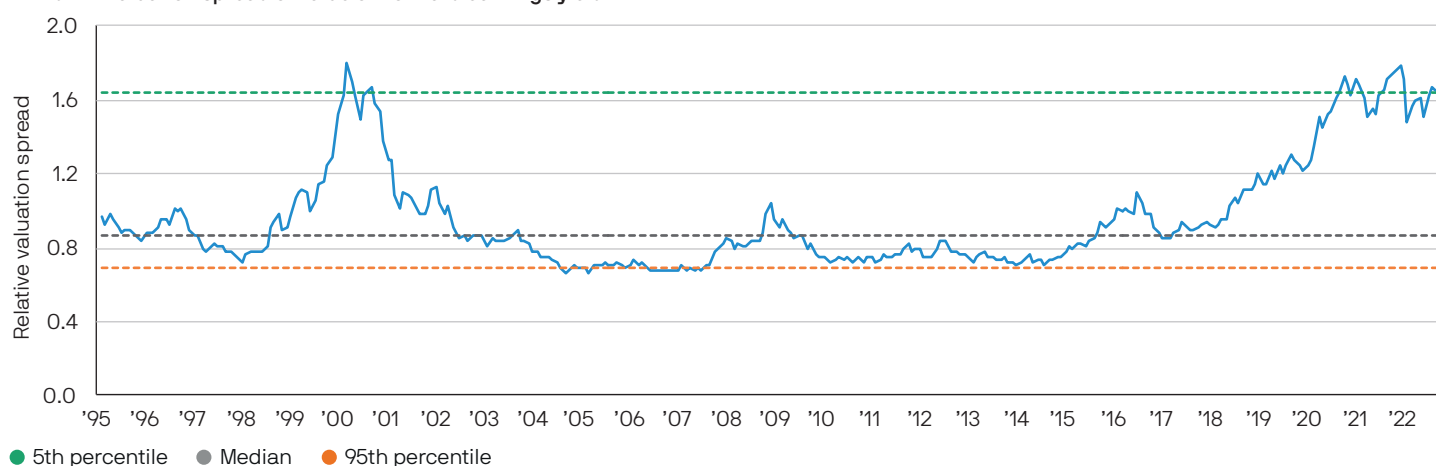
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Finally, the assumption that the pandemic drove a structural acceleration of growth for many tech stocks has proved erroneous (see Mark Zuckerberg's letter to staff announcing huge job cuts at Meta).

The remarkable thing is that spreads are still at extreme levels and have a long way to go before they look even slightly normal. One of the most discussed market events, is when will the Federal Reserve (and other central banks) pivot away from tighter monetary policy. Following the release of the below expectation October US inflation data, growth stocks have rallied aggressively, as investors believe this pivot is coming into view. The implication is a pivot will occur, and then

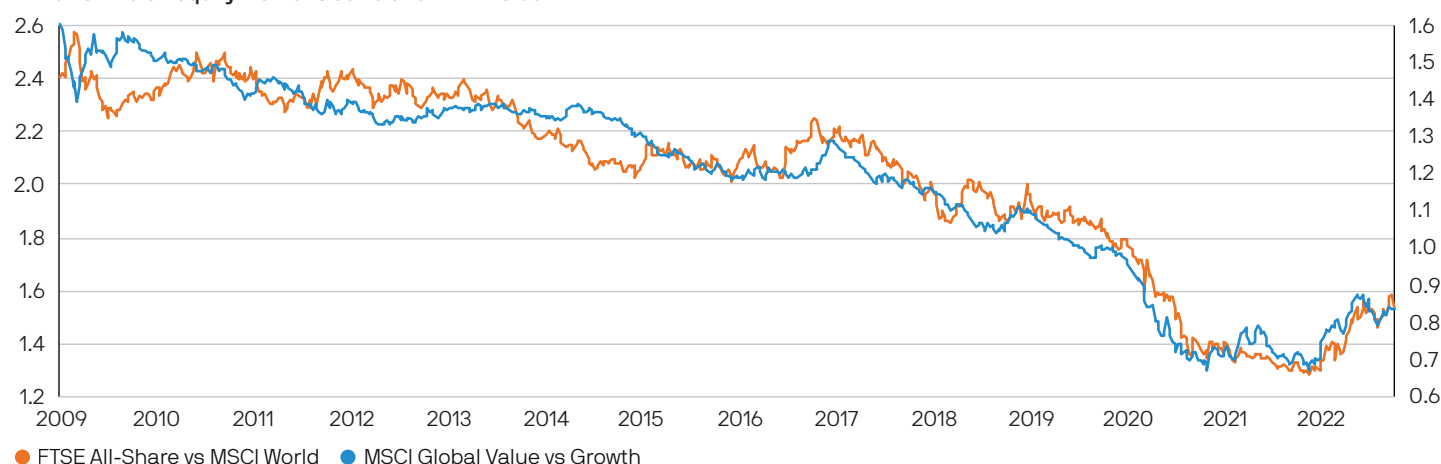
there will be a return to business as usual, and the supremacy of growth investing. To me, this assumption seems premature, perhaps reflecting recency bias and how investors are positioned, rather than the macro environment. History suggests inflation takes a while to bring down, with the valuation cycles you can see in **Exhibit 1** and **Exhibit 4** mostly lasting for multiple years. Given the current level of valuation spreads, high inflation and the corresponding tighter monetary policy, now seems like an environment where value can outperform. This is a good backdrop for the UK stock market. As **Exhibit 5** shows, when value outperforms, so do UK equities.

Exhibit 4: Valuation spread of value on forward earnings yield



Source: J.P. Morgan Asset Management, Factset; data as of 1 November 2022. The chart is for the period 31 December 1994 to 1 November 2022. Valuation spreads are calculated by subtracting the median valuation of stocks in the lowest ranked quintile from the median valuation of stocks in the highest ranked quintile and then dividing this by the median valuation of the market. Data starts from 31/12/1994. 1st percentile is cheap, 100th is expensive. The universe is the global investable universe.

Exhibit 5: The UK equity market's correlation with value



Source: J.P. Morgan Asset Management using data from Bloomberg. Data as of 10 October 2022. Past performance is not a reliable indicator of current and future results.

In summary, we believe that the UK equity market is trading at a once-in-a-generation valuation discount to other markets. This discount has built up over a market cycle characterised by low inflation and ultra-loose monetary policy. We are now likely in a new cycle that

could last multiple years, and which favours different market leadership. We believe that, in this favourable environment, the UK is well placed to outperform as the extremity of the valuation discount normalises.



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