Active is: Challenging convention

Brexit done, Covid continues: what's next for the UK?

12/01/2021

Summary

The UK market has been deeply out of favour for some time now. The agreement of a UK-EU trade deal marks an essential step towards making the UK "investable" again but several other factors – not least the ongoing Covid-19 pandemic – will continue to weigh on sentiment.

Key takeaways

- The UK capital markets have been undervalued for some time, and while the agreement of a UK-EU trade deal points to the beginning of the path back, the worsening Covid-19 situation and renewed national lockdown will continue to depress UK markets
- Given the outlook, we do not expect the pound sterling to strengthen further in the near term following its brief rally on the deal's announcement
- The UK seems likely to return to economic growth later in 2021, but the equity market still has structural disadvantages to contend with, not least its sector mix

The trade deal with the European Union removes some of the uncertainty facing the UK, even though the agreement is relatively "skeletal" and includes little to address the service sector. It closely resembles what was once considered a "hard Brexit". Moreover, the ongoing Covid-19 crisis and a third national lockdown will continue to depress the UK economy.

However, following a year in which the UK's FTSE 100 index fell more than 14% – its worst performance since the financial crisis – the agreement with the EU removes one source of uncertainty that has weighed on the UK market since the Brexit referendum in 2016. While the deal is unlikely to transform sentiment towards the UK overnight, investors may begin to see buying opportunities in an equity market that is widely undervalued. Moreover, the prospect of mass vaccination against Covid-19 allows investors to look beyond the pandemic, and we expect the UK economy to return to growth in the second half of 2021:

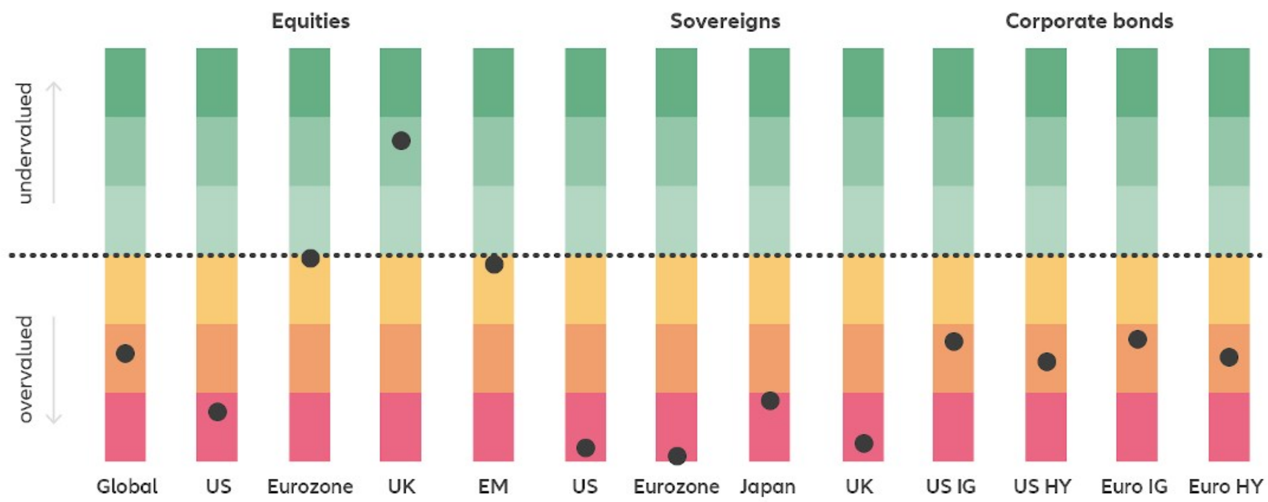
- Sectors that were hit hard by the pandemic – such as hotels, food service, transport, leisure and arts – will likely see improved annual growth rates after the first quarter of 2021, particularly relative to how they performed in 2020.
- The logistics sector is expected to expand forcefully, driven by the acceleration of e-commerce as people stayed at home during the pandemic.
- The construction sector should profit from fiscal measures to boost infrastructure investment as the UK government puts a "green recovery" at the heart of its post-Covid vision.

Beyond the ongoing pandemic, the UK stockmarket has structural issues to deal with – specifically the sector mix of its industries. This is a market with fewer technology- and growth-centred firms and more "old economy" and structurally challenged sectors, such as energy and banking. This limits the upside, but even allowing for this, the UK appears very cheap.

The other factor to consider is that the UK equity market is different from the UK economy. Many of the largest UK corporations are really multinationals that just happen to be listed in the UK – they get a large percentage of their sales and profits from overseas. This means they benefit when sterling is weaker because their overseas revenues are worth more.

While sterling enjoyed a rally in the immediate aftermath of the Brexit deal's announcement, we do not expect it to strengthen significantly from here. And, with the worsening Covid-19 situation in the UK, we expect the Bank of England to continue to pursue quantitative easing – likely by buying UK gilts – and dip into negative interest rate territory only as a last resort.

UK equities appear undervalued – unlike almost all other major asset classes



Source: Allianz Global Investors, Bloomberg, Datastream. Data as at November 2020. Valuation score = current score relative to historical distribution of scores. Equity valuation based on Shiller-PE, price/book, 12-month forward PE. Sovereign valuation based on 10-year real interest rate and term premium. Corporate-bond valuation based on implicit default probability and respective sovereign valuation.

How Allianz Global Investors is prepared

Given the UK's challenges, we expect higher short-term volatility. It will be critical to be more selective to take advantage of the right opportunities. As an active manager, we will continue to seek to help our clients by taking an active investment approach in UK bonds as well as UK equities.

The future shape of the regulatory environment in the UK isn't yet clear, as the new trade agreement has little to say on financial services. While there will undoubtably be some divergence between the UK and the EU, it's unlikely there will be a "bonfire of regulations".

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Active is: Investing with conviction

Expect US market momentum to continue – but watch for inflation

by Mona Mahajan | 13/01/2021

Summary

Investors can start the year with a positive outlook for the markets thanks to three drivers: higher spending from the new Biden administration, wider uptake of vaccines and continued Fed support. Consider layering in exposure to value and cyclical stocks, small cap and international assets – but keep an eye on rising inflation.

Key takeaways

- We expect economic growth in the US and globally to reaccelerate in 2021 – a positive sign for many risk assets, but it may push inflation higher over time
- The Biden administration will prioritise putting money into the hands of consumers and back into the economy – which will likely support value and cyclical sectors broadly
- Successful vaccine distribution could release pent-up consumer demand – particularly in areas (such as travel and leisure) that stand to benefit as the economy reopens

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