State of Play

3 February 2022

Our Investment Specialist, Simon Durling, shares his thoughts on the UK stock market. Why did it fall out of favour in the shadow of the UK Referendum result in June 2016? And does the tide appear to be turning as we emerge from the pandemic?

Referendum shock

At 4:40am on 24 June 2016, both the BBC and ITV announced their projections that there was no way the 'Remain' side could overtake the 'Leave' side. Against all expectations, Britain had voted to leave the European Union (EU). The result was just the beginning of a painful and fractious political period where leaders on all sides found it incredibly difficult to agree on how the largest divorce in history would be implemented. State of Play this week looks at what happened and asks whether there now appears to be light at the end of the tunnel for UK investors.

Humble beginnings

It was 1571 when the Royal Exchange was established by Sir Thomas Gresham as the centre of commerce in the City of London where all kinds of goods were traded. At that time stockbrokers were seen as loud and uncouth in such a royal institution and were banned soon after. However, their behaviour was more than acceptable in the seventeenth century social centre

- the coffee house. Stockbrokers therefore began to trade informally in the City's coffee houses – most notably Jonathan's Coffee House owned by John Castaing who started to publish a list of prices for stocks and commodities which in 1698 he named 'The Course of the Exchange and Other Things'.

Following a fire in 1748 when the coffee shop burnt to the ground, a new venue opened in 1773 in Sweeting's Alley under a new name: 'The Stock Exchange'. Many decades later in 1801, a formal system was created to avoid dodgy traders and fraudsters, including membership fees and a set of rules - creating the first formal regulated exchange and moving to a new building in Capel Court the following year. The business was transformed in 1830 when financial information flowed through electric telegraph machines transmitting prices by ticker tape with company announcements pinned up on noticeboards.

Many notable changes took place over the stock exchange's long history, but none more important than the de-regulation of financial markets in 1986 coined the 'big bang' as fixed commission charges were abolished alongside the distinction between stockjobbers and stockbrokers. In addition, the exchange changed from open outcry trading to screen based bringing it in line with the changes in technology. Today the London Stock Exchange (LSE) operates as an independent institution itself listed on the stock market as a public limited company (PLC).

Old world versus new world

Since the vote to leave more than five years ago the UK stock market has endured a difficult period underperforming all other major stock markets around the world. The investment returns since that infamous day when compared to the best performing market, the US, is stark. The Standard & Poor's 500 Index (S&P 500), which represents the largest companies listed in the US, has produced a total investment return of 142% since 23 June 2016, when compared to the FTSE 100 which has produced just over 50%.[1] In normal market conditions most investors I suspect would be reasonably satisfied with 50% returns in just over five years.

However, the last bull market (the longest in history, fuelled by low interest rates and vast quantities of quantitative easing) produced extraordinary returns when compared to the past. The US returns were driven by the continued success of the FAANGs plus Microsoft (Meta formerly known as Facebook, Apple, Amazon, Netflix, and Alphabet formerly known as Google) which now dominate both the US and World markets in terms of market value. These technology giants also helped drive the NASDAQ technology index to total investment returns over the same period of 274%![2] The top 10 shares in the US now account for 29% of the US market value and account for

[1] FE Fund Info 2022, 31/01/21

19% of the world's stock markets with the US growing from just over 50% to 69% of the MSCI World Index.[3]

The UK stock market by contrast has fallen from 7% in 2016 to just 4%[3] of the global market as the shares listed have failed to keep pace with their international peers. Whilst there are varying opinions on the cause of this, the two main drivers appear to be Brexit uncertainty triggering a large outflow of investors' money to other markets following the UK Referendum result and the sector breakdown of the UK market. As the NASDAQ returns demonstrate, technology and innovation have captured much of the additional returns for investors in recent years making up nearly 25% of world markets. The UK is a more traditional 'old style' value index which has just 1.4% of technology companies. Instead financials, consumer staples and materials make up nearly half the index.

Is the UK market finally starting to emerge from the Brexit shadow?

More recently, following the announcement of the vaccines in early November 2020, UK shares rallied strongly as the world economy started to reopen and commodity prices began to rise sharply. Many market commentators and some investment companies have signalled that in their opinion the UK is trading at a significant discount to other international markets, especially the US. Also, the outlook, which includes rising interest rates and the ending of financial support from central banks printing vast quantities of new money via quantitative easing, may mean that investors conclude that value companies now offer better long-term returns than growth companies.

As a reminder, growth and value are two fundamental approaches of investing. Growth investors seek companies that offer strong earnings growth while value investors seek stocks that appear to be undervalued in the marketplace. Growth has enjoyed many years of success with financial conditions supporting their continued rise. However, with the tide changing, value investing could make a significant comeback. Again, reflecting on last week's update, in which we explored price versus future earnings (P/E Ratio) as a measure of share values, the US market has reached 39 times future earnings against an historic 50-year average of 21.

In contrast the UK market's historical average over the last 30 years has been just over 14 - the same exact ratio as at today. As State of Play explained in last week's edition, this ratio is not the only consideration of value, but when you remember that the US is currently almost double the historical average and the UK market is trading much lower, it does beg the question – is the UK market lower cost when compared to its peers? One small indicator is the performance of the UK market since the start of this year.

Find out more

Unsure about what growth and value investing entails? Learn more in our About Investing article **here**.

[2] FE Fund Info 2022, 31/01/21
[3] MSCI.com, 1/02/22

As mentioned earlier, the UK market has lagged other markets since 2016 and rarely enjoyed periods of outperformance versus the main peers. However, this year has started with investors worried about inflation and interest rate rises. Against this backdrop all the major indices have fallen in January, with the NASDAQ Index the worst performer, being close to 15% down at one point, before a small recovery in the last couple of days of the month, finishing nearly 8% below the start of the year. In contrast, whilst the UK market has suffered similar volatility, it is the only major market to finish January 1% higher, modest, but much better than the rest.[4]

The final aspect which could attract a change in attitude from international investors is the dividends paid by the companies listed in Britain. Last year saw a huge recovery in the pay-outs, especially from the major mining companies. Also, when you analyse the investment returns since the Brexit vote over five years ago, 29% of the 50% overall return came from dividends.[4] Contrast this with a much smaller slice of the overall return in either the S&P 500 or NASDAQ indices with 20% and 18% respectively, you start to see the attraction.[4] So, with arguably a cheaper valuation, more value companies than growth companies against a changing financial backdrop and steady income revenues, perhaps at long last, the UK may start to see light at the end of the Brexit tunnel.

Market update

Markets began this week breathing a sigh of relief as most major indices responded to the recent sell-off with sharp upward movements on Monday (31 January) carrying this momentum through to Tuesday and Wednesday, signalling that perhaps some investors see the small corrections during January as an investment opportunity. My view is it is too early to say that this represents a recovery in values, especially when crucial economic data in the next few weeks could drive fear into investors once again, triggering additional volatility. At the time of publishing, as expected, the Bank of England increased interest rates by 0.25% taking the base rate to 0.5%. This is the first back-to-back rate rise for 17 years in an attempt to get a grip on soaring prices rises. Importantly, four of the nine members of the Monetary Policy Committee wanted to implement a higher increase of 0.5% to 0.75%, reflecting their growing concern about rising prices.

This fear was backed up almost simultaneously with an announcement from the Office of Gas and Electricity Markets (OFGEM) that the energy price cap will rise 54% from the current £1277 to £1971 for the average household, affecting 18 million households in England, Wales and Scotland, as State of Play reported on a few weeks ago. The UK Chancellor of the Exchequer, Rishi Sunak, in response announced a package of measures to support families using council tax rebates to help with their energy bills. According to the

[4] FE Fund Info 2022, 31/01/21

Asset Management

Treasury, this would provide the majority of families with a total of £350 to help them adjust to the higher prices, split into a £200 rebate on energy bills for households from October, which will be paid back over the next five years at £40 per year starting in April 2023. Meanwhile, in England, households in council tax bands A to D will get a £150 discount from April, the Chancellor added. Funds for the equivalent discounts would be provided to devolved nations in the UK. The response by the UK Government importantly does not reduce the inflation impact for those unaffected by the rebates. Some market commentators have recently predicted that inflation could rise to above 7% in April once the energy price cap is implemented. Markets became very volatile in response to the new announcements with share prices across Europe falling and UK 10-year Government bond yields rising to over 1.35%, the highest since November 2018.

Find out more!

Listen **here** to our latest Market Views from Stefano Amato, Head of Systematic Research for TAA and Alpha as he shares his thoughts on the main themes dominating markets.

Note: Data as at 3 February 2022.

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