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Capital Management Group

News

Global Growth to UK Value

Why has Japan surged but not the UK? What are the signs of pending change?

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As investors look to a developing environment of moderating inflation and cuts in interest rates, now is the time to consider how to position portfolios for a changing cycle.

Rising inflation drove investors to extremely narrow safe-havens, cash-rich mega-techs in the US and large-cap defensives in the UK. In both markets, a handful of stocks drove performance. At one point, seven stocks accounted for a quarter of the FTSE All Share.

Looking forward, cyclicals and value are attracting attention, as are small and mid-cap. We only need to look to Japan to see the impact of shifting views. After decades of torpor, the Nikkei 225 has risen 30% in a year, finally topping its 1989 peak. Low valuations, potential in the SMID area of the market and the changing geopolitical outlook have all been part of the revival.

The UK is already following the trend. Looking at its long-term performance, the FTSE All Share has been grinding higher for the past six months, reaching a string of historic highs in April. Large-caps have led the way, but we believe small and mid-cap will increasingly take the lead.

As in Japan, geopolitical biases are favouring the UK. Although the switch from UK equities to global has persisted over the past two decades, Brexit accelerated the trend, with the UK appearing isolated and its future uncertain. Since then, the UK's economic resilience has been clearly demonstrated, while the UK is now front and centre of a re-emerging global democratic alliance.

In Japan, the trigger for change could hardly have been more obscure or less expected, a letter from the Tokyo Stock Exchange threatening delisting to companies whose book value was above their

market capitalisation.

In the UK, the early warning signals are proliferating. In 2023 M&A deals worth around £20 billion were announced, equivalent to nearly 1% of the FTSE All Share. This has markedly accelerated this year with £17 billion in bids already announced.

The vigour in M&A is matched by the number and scale of share buybacks. According to Morgan Stanley, as at the end of last year, half of UK listed companies had buyback programmes. Some of these are very substantial. Barclays, for example, plans to buy back a third of its shares over the next three years.

A third signal is the rate of director purchases. This is not an indicator for which there is reliable aggregate data but anecdotal evidence is that it has been and remains persistently strong.

It is hard to know what the trigger will be in the UK but an increasingly likely divergence from US interest rates would not be a bad guess. This would make sterling-denominated goods more price-competitive, widening the window through which UK investors benefit from a valuation discount on the global income of the companies they hold.

When the breaking point comes, the reaction is likely to be rapid. Like a tsunami, once you've seen it it's too late, which is why investors are advised to watch the early warning signs rather than wait for the flood.

An interesting characteristic of the current trend in M&A is that much of it is taking place in the value/cyclical areas of the market, an indication of where the epicentre of the move is likely to occur. The simplest way to access stocks in this area is through a value-driven income strategy, but investors need to be wary of 'style drift'. Given the risks of short-term underperformance, there is often the temptation to hedge the allocation with defensives.

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