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What has happened in the first half of the year in your area?

The first half of the year in UK equities may appear from the top-level return to have been a bit of a score draw, but there has been a lot going on under the surface. While the FTSE 100 posted a total return of 1.7%[1], we have seen some of the extreme market performance from 2017 begin to unwind. This broadening out of market leadership has helped a number of our UK equity strategies.[2]

UK equities, along with most other global equity markets, had a more volatile first quarter in 2018 amid concerns about the approaching end of "easy money" and, latterly, the potential for a global trade war, which has since crystallised. In the second quarter UK equities performed well, with sterling weakness helping the FTSE 100 to outperform the broader market[3] due to its high exposure to overseas earners. The continued rally in oil prices also proved supportive, as the index has a large weighting to energy stocks.

What was expected and what surprised you in the first six months?

Last year we noted that there was very narrow market leadership, with the market driven predominantly by short-term earnings momentum. We thought there had been too much disparity between stock performance and that the elastic was very stretched. This year our view has started to be validated as we have seen increased bid approaches and activists taking stakes in UK stocks, taking advantage of the low valuation relative to international peers, as well as weak sterling. As such, we have started to see performance broaden out. With some further volatility we might get further rotation as well.

I'd say the continued strength of commodities was more surprising given the trade war and a softening of synchronised global growth. Given the elevated level of Chinese debt to GDP, the demand profile for commodities is not without risk.

[1] FTSE Russell, 30 June 2018.
[2] The UK Equity Income strategy and the UK Growth & Income strategy.
[3] In Q2 2018, the FTSE 100 returned 9.6% versus 9.2% FTSE All-share return. Agency Partners, 30 June 2018.

What do you expect to happen in your area in the next six months?

While there are still uncertainties about the UK's domestic political and economic prospects, we believe the outlook for UK equities is more measured. As already stated, a relatively narrow range of highly valued stocks led the market in 2017, especially in the second half of the year. Market complacency, low volatility and excessive risk taking were a worry. However, now that volatility has returned we have begun to see market leadership broaden out.

Over the rest of 2018, we would expect a continued appraisal of reflation trades. Although trade wars have sparked some rotation into defensives, we would note that there are still several defensive sectors which are very out of favour having been sold off to fund the prior year rotation into banks and cyclicals. But if the trade war escalates and quantitative tightening (QT) is extended, such reflation trades could come under more pressure.

In general, we still believe there are lots of good value opportunities in the UK market. Favourable valuations should help ensure that UK firms remain popular candidates for takeover bids.

In a broader context, we are mindful that quant machine-driven investments have had an increased influence on the market, accentuating movements. However, these can provide opportunities for active managers who are able to take a longer-term view.

As patient, conviction investors we will continue to avoid whipsaw momentum trades and instead concentrate on company fundamentals to target strong risk-adjusted returns.

What are the key opportunities and challenges for investors in the second half of the year?

The strength of the US dollar, the removal of quantitative easing (QE) in Europe and QT in the US are all threats to the low volatility that has supported markets. Alongside this, in the UK Brexit presents a key challenge for investors. We have a weak government moving towards a position whereby nothing will seemingly be decided until everything is decided. But even if investors believe Brexit will damage the UK economy, a lot of potential misery has already been priced into valuations.

We believe the foundations of this consensus will come under increasing pressure. A strengthening dollar, rising short rates and the withdrawal of QE will likely result in tightening liquidity conditions globally. If this transpires, however, the UK equity market should be able to show more resilience with its defensive qualities, depressed valuations and decreasingly correlated returns.

Confusion around Brexit, political risk and currency weakness has seen global asset allocators significantly underweight UK. However, prices remain attractive, creating the aforementioned valuation arbitrage opportunity regarding UK companies against their internationally listed peers. You must be brave where others are fearful; avoid the short-term noise (which actually provides a fertile environment for active managers to invest). Our method is: don't wait on news flow clarity; act on valuation basis!

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