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UK election

If the polls are right, UK risk premium set to fall

Edison themes

11 December 2019

If the current Conservative lead in the polls is reflected in this week's UK election, it would appear an outright majority is within reach for Boris Johnson's Conservative Party. In this note, we examine the potential outcomes of a workable Conservative majority. We suggest that there may be a rally in UK banks and asset managers, a short-term recovery in stocks that would have been affected by Labour policies, a continued rotation into UK mid-cap stocks and beneficiaries in the housing and infrastructure sectors.

UK risk premium reduces with a shift to the centre

In the event of a Conservative majority, the position of Jeremy Corbyn as leader of the opposition may become untenable. A change to the Labour leadership and a shift to more centrist policies on both sides of the political spectrum are arguably as important to reducing the perception of UK political risk as resolving Brexit. If the risk of a radical government in the UK recedes, so should the risk premium. The uncertainty of the last two years has led to potential pent-up demand for private investment, for which we are seeing evidence in subdued 2019 economic activity yet significant forward order books. Should this investment spend become unlocked, the UK may again become a more attractive home for capital.

Valuations: Only UK banks stand out as cheap

UK equities have underperformed global indices by 14% since the EU referendum. However, a relief rally has already started, with the more domestically focused UK mid-cap sector outperforming the large-cap sector by 10% since the summer. The combination of a weak sterling and the structural attractions of the UK has attracted overseas corporate interest, with a number of public companies being acquired by non-UK corporates and private equity firms. A look at valuations suggests that only the bank sector is significantly undervalued. However, the key issue for durable equity returns is whether we see improved investor sentiment after the election drive an improvement in the real economy – and if we do, the potential for upgrades to consensus earnings forecasts should not be understated.

Likely winners…

- High-quality stocks continue to outperform and trade on a premium given potential trade deal uncertainties.
- Short-term rally in rail, mail, water and energy stocks that risked nationalisation.
- UK banks and asset managers, as the yield curve steepens and asset flows out of UK equities stop and become net inflows.
- UK mid-cap stocks continue to outperform large-cap overseas earners.
- House builders and infrastructure plays benefit from manifesto pledges.

Likely losers…

- Overseas earners or exporters with a UK listing, as sterling appreciates.

Winners and losers: the companies shown above do not translate into buys and sells as other themes (and valuation parameters) may conflict with this one.

Viewpoint

If it turns out that the polls are correct, it is our view that the UK will become one of the most attractive markets to invest in financials, with pent-up private investment being unlocked, fiscal spending being boosted (government debt GDP is only 85%), GDP accelerating (economists expect a +0.5% addition) and the potential for interest rates to rise in late 2020. – Tosca Fund.

Edison themes

As one of the largest issuer-sponsored research firms, we are known for our bottom-up work on individual stocks. However, our thinking does not stop at the company level. Through our regular dialogue with management teams and investors, we consider the broad themes related to the companies we follow. Edison themes aims to identify the big issues likely to shape company strategy and portfolios in the years ahead.

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Global perspectives: Re-centring UK politics

- **In recent years, UK investing has become something of a special situation.** Investors in the UK have had to consider a fundamental re-write of the UK's relationship with the EU and the rest of the world. This uncertainty has pressured investment and growth. Populism has also pushed an unusual polarisation of UK politics, with the UK's Labour Party now proposing a clearly socialist manifesto, an anathema to equity investors more used to a laissez-faire approach to the corporate sector.
- **Consensus points to the obvious – the UK Conservative Party is in a strong position in the closing days of the election campaign.** Provided the current c 10-point lead in the polls is maintained, it would appear an outright majority is within reach. If so, we can agree that this should trigger a rapid resolution to ratifying the Withdrawal Agreement and the UK's exit from the EU. However, it does not resolve the question of a future trade agreement – which is where the focus will immediately shift.
- **A polling disaster for Labour increases the likelihood of a shift in British politics back to a competition for the middle-ground.** Labour leader Jeremy Corbyn's position may be untenable in the event of a Conservative majority. UK-specific political risks such as a major expansion of the state's role in the UK economy may recede, as support for more popular centrist opposition policies increases. A reduction in the risk premium for UK assets should be expected in such circumstances.
- **UK equities have underperformed global indices.** Across the major sectors, UK equities have underperformed global peers by 14% on average since the EU referendum. This may be a substantial gap, but it is insufficient in our view to draw investors in on this reason alone. There are also other dynamics to consider, such as the increasing impact of global digital business on UK retail and real estate.
- **Sterling is partway through a significant re-rating.** Sterling remains below its long-run trade-weighted average, but the recent rally suggests a Conservative victory is already discounted or at least in part. We would expect steady rather than spectacular gains in the currency from this point in the event of a Conservative majority.
- **In common with global peers, UK government bonds remain unappealing at currently low yields.** We recognise the economic data are mixed, but a political relief rally would in our view be associated with modestly higher yields as UK GDP growth expectations improve and businesses investment rebounds as uncertainty recedes.
- **Post-election UK: business as usual rather than euphoria.** The Conservative manifesto is *conservative* with modestly increasing government expenditure rather than any bonanza. We expect any post-election bounce will give way to a more measured but positive market reaction over the course of 2020. Valuations of UK equities are only modestly discounted relative to historical norms, rather than outrageously cheap in our view.

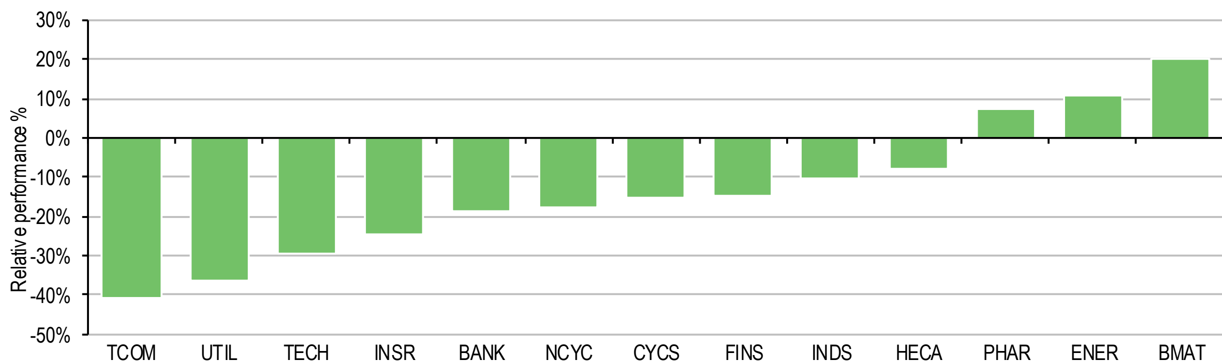
UK election: Re-centring British politics

Delivery of Brexit and a defeat of radical Corbynism?

Opinion polls may have been misleading in recent years but there are no alternative data that provide any greater clarity on the outlook for the next UK parliament. At present, it appears that the UK's Conservative Party is on course for an outright majority, provided its c 10-point lead in the polls is maintained. This puts PM Johnson on course to deliver Brexit as promised in early 2020. Such an outcome also represents a significant defeat for the Labour Party, which appears to have become caught on a radical manifesto whose popularity may have peaked.

At first sight, this appears to be qualitatively something of a best-case (realistic) scenario for UK investors, who have suffered systematic underperformance across sectors since the EU referendum of 2016. We believe the political deadlock and uncertainty since then may have been as damaging to the UK's economic prospects as the direct impact of Brexit itself. As Exhibit 1 shows, the combination of a weak currency and unfavourable sector performance has meant UK equities have underperformed global indices by 14% on average since the EU referendum.

Exhibit 1: Consistent underperformance of UK sectors since the 2016 EU referendum



Source: Refinitiv. Note: Price returns as of 9 December 2019.

Nevertheless, we believe a relief rally in UK assets may already be underway. Mid-cap UK indices, which have proportionately greater exposure to the UK domestic economy, have outperformed large-cap peers by over 10% since the summer. UK-listed large-caps may have suffered somewhat by the rise in sterling, which on a trade-weighted basis is now 6% higher over the same period, Exhibit 2. The risk premium for UK assets has clearly diminished in recent months as political risks, which include both a continued parliamentary deadlock in respect of Brexit and a Labour-led administration, have receded.

Exhibit 2: Trade-weighted sterling recovers as the political risks recede

Source: Refinitiv, Bank of England

In our view, a modest Conservative majority is probably the most UK investor-friendly political scenario at this time. Investors will be thankful that the more radical Labour proposals for employee ownership and board representation, and nationalisation of utilities are looking increasingly theoretical possibilities, both for this election and for the future as UK politics shift back to the centre ground, post-Brexit.

Conservative offers more of the same to the UK

The Conservative election manifesto offers few distractions from the central campaign message of 'get Brexit done' and instead pitches a message of business-as-usual, which for many companies will be a welcome relief from the political volatility of the past three years. Avoidable errors that cost votes at the previous elections – such as a promised review of state care provisions – have been dropped. Additional funding has been promised for the traditional electoral priorities such as the NHS and police forces.

These near-sacred offerings on public services may be necessary gambits to win over the electorate, but suggest limited practical change based on spending projections. Under the Conservative manifesto, plans for the overall fiscal trajectory of the UK to the middle of the next decade would be largely unchanged from previous announcements. The contrast with Labour and the Liberal Democrats is stark – both have promised to raise annual spending by £60–80bn pa, lifting the government share of GDP close to that of other European nations. For investors, the Conservative stability in spending plans is, in our view, one less risk to incorporate into asset prices.

However, there are Conservative proposals for infrastructure investment over the next 10 years of approximately £100bn in the areas of transport, housing and civic development. We are reluctant to consider these initiatives as a reason to invest in the UK, however; this will be the fourth time a £100bn infrastructure spend has been promised by the government in this decade, and the effects to date on the listed corporate sector have been modest at best.

For the Labour Party, plans for further additional spending on infrastructure come with a state-directed approach and nationalisation of key segments of the economy. This would in our view clearly be an unwelcome development for investors in UK infrastructure, despite the promised increased levels of government spending.

UK valuations below average – but only modestly, except for bank sector

Since the EU referendum, the combination of a weak sterling and discounted valuations has not gone unnoticed. Corporate and private equity buyers have spotted the dual discounts in UK equities and sterling, and it has led to M&A activity, as shown in Exhibit 3. M&A is typically driven by more than one factor, but recent opportunistic in-bound deal announcements for Cobham, Greene King and Entertainment One highlight the appetite of non-UK corporate buyers for UK assets.

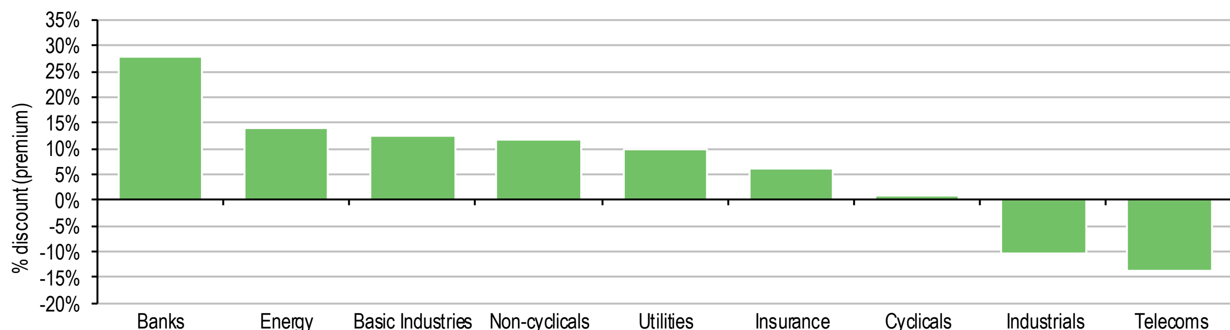
Exhibit 3: Recent UK M&A Activity

UK target	Date	Sector	Acquiror	Acquiror country	Acquiror sector	Size of deal (£m)
accesso Technology	24/07/2019	Technology	N/A	N/A	N/A	N/A
BCA Marketplace	20/06/2019	Retail	TDR Capital LLP	UK	Private equity	1,906
Brady	14/10/2019	Technology	Hanover Active Equity	Luxembourg	Private equity	8
BTG	20/11/2019	Healthcare	Boston Scientific Corporation	US	Healthcare	3,256
CityFibre	23/04/2018	Telecommunication	Connect Infrastructure Bidco	UK	Financials	538
Cobham	25/07/2019	Industrials	Advent International	US	Private equity	3,945
Dairy Crest	22/02/2019	Consumer	Saputo	Canada	Consumer	966
Entertainment One	22/08/2019	Retail	Hasbro	US	Consumer	2,789
Eddie Stobart	09/09/2019	Industrials	DBAY Advisors	Isle of Man	Private equity	N/A
Elegant Hotels	18/10/2019	Consumer	Marriott International	US	Consumer	98
Faroe Petroleum	26/11/2018	Oil & Gas	DNO ASA	Norway	Oil & Gas	608
Fenner	17/03/2019	Industrials	Michelin	France	Industrials	1,300
Greene King	19/08/2019	Retail	CK Asset Holdings	Hong Kong	Industrials	2,635
Inmarsat	19/03/2019	Telecommunication	Apax Partners	UK	Private equity	2,521
Jimmy Choo	25/07/2017	Retail	Michael Kors	US	Retail	896
Low & Bonar	20/09/2019	Materials	Freudenberg & Co	Germany	Consumer	107
Merlin Entertainment	28/06/2019	Consumer	Kirkbi	Denmark	Financials	3,281
Millennium & Copthorne Hotels	07/06/2019	Leisure	City Developments	Singapore	Real Estate	2,227
Murgitroyd	15/10/2019	Consumer	Sovereign Capital Partners	UK	Private equity	61
Premier Technology Services Group	20/06/2019	Industrials	Macquarie Group	Australia	Financials	265
Randgold Resources	22/09/2018	Mining	Barrick Gold	Canada	Mining	5,000
RPC Group	31/01/2019	Materials	Berry Global Group	US	Materials	3,216
SCISYS	14/06/2019	Technology	CGI	Canada	Technology	75
Shire	29/11/2018	Pharmaceuticals	Takeda Pharmaceuticals	Japan	Pharmaceuticals	46,000
Sky	20/09/2018	Media	Comcast	US	Media	30,600
Sophos	14/10/2019	Technology	Thoma Bravo	US	Private equity	2,856
StatPro	20/09/2019	Technology	Confluence Technologies	US	Industrials	152
Stride Gaming	31/05/2019	Technology	Hong Leong	Malaysia	Financials	114
Telford Homes	03/07/2019	Industrials	CBRE Group	US	Real estate	266

Source: Refinitiv, Edison Investment Research calculations

Given the disappointing performance of the UK stock market since the EU referendum, we are somewhat disappointed to find that only the bank sector stands out in terms of a discounted valuation compared to historical trading levels. We have taken the simple average of the P/E, price to book and dividend yield discount compared to the 15-year history for each sector. On this basis, there is a modest degree of undervaluation of around 10% for energy, basic industries, non-cyclical consumer goods and utilities, but this is hardly exceptional from a valuation perspective.

Exhibit 4: UK bank sector looks cheap but other UK sectors at best only modestly undervalued



Source: Refinitiv, Edison Investment Research calculations. Note: Simple average of P/E, price to book and dividend yield compared to 15-year average.

We believe the UK bank sector is worthy of closer examination for 2020 on a valuation basis, yielding close to 5% and on a forward book value multiple of 0.75x. Stability in the political dimension and a pick-up in loan demand may improve sentiment towards a UK sector that has languished, following a long period of recapitalisation and a torrent of financial claims from legacy business practices.

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However, outside the banking sector it is more difficult to detect a substantive 'Brexit' discount following the rally in the mid-tier segment of the UK stock market since October. We would prefer to characterise the overall market as modestly undervalued, which underpins our belief that the market gains assuming a Conservative majority are in turn likely to be modest in the first instance but may build over time, on the assumption of a recovery in business investment and easing political risks.

Sterling remains at the lower end of its 15-year range on a trade-weighted basis, Exhibit 2, but has already made a meaningful recovery since the announcement of PM Johnson's Withdrawal Agreement during October. We believe that markets have sensed that the political deadlock has been broken and have moved to reflect the likely election result.

In a similar manner to equities, further gains in sterling in our view are likely to be predicated on a positive evolution of both the domestic UK economy in early 2020 and the tone of the EU/UK negotiations in respect of a future trade agreement. The time to be aggressive on sterling was in our view during Q3, when there was real concern that a no-deal Brexit was a possibility. Exhibit 2 may also somewhat overstate the case for sterling, which has been on a declining trend in real terms since the 1990s.

The sterling surge around the time of Chancellor Osborne's mini boom prior to the EU referendum coincided with a 30% decline in the euro, following the introduction of the ECB's quantitative easing programme. This was a factor in sterling's strength at that time, which was separate from Brexit and in any case is unlikely to be repeated in 2020. Furthermore, in coming quarters the UK economy must contend with this quarter's 8% currency appreciation headwind; a further significant advance would risk becoming disruptive to the UK economy and is therefore in our view less likely.

While the UK may leave the EU with the Withdrawal Agreement in place in January, we believe that no-deal concerns should not have faded so quickly from the political discourse. There remain risks to sterling and UK equities, such as a failure to achieve a UK/EU deal on a future trade agreement, which would in effect put the UK on the same WTO trading terms as a no-deal Brexit.

Conclusion

It is tempting to express the view that the resolution of the UK's parliamentary deadlock following the election will trigger a major uplift in UK asset prices. However, an overall Conservative majority is precisely what public polls have consistently indicated during the election campaign and we believe this has been at least partially discounted in asset prices in recent months, notably in sterling and mid-cap UK equities. We believe a modest fillip on the day cannot be excluded in the event of the election matching expectations, but larger gains will have to wait for evidence of an improvement in UK business investment and constructive progress towards an EU/UK future trade agreement.

From a fiscal perspective, a Conservative victory in the 2019 UK election is not about change but continuity. Therefore, in the absence of a significant fiscal boost, the primary benefit to investors in UK assets following the election should be a reduction in uncertainty. This should not be underestimated as a source of returns for equity investors; in the best case, improved market and business sentiment can lead to a positive cycle of improved business investment and profit growth for the UK corporate sector.

Following a Conservative win, any re-centring of British politics in 2020 and beyond would significantly reduce international perceptions of UK political risk after a difficult decade of introspection. The act of Brexit may yet catalyse a new consensus on the UK's role in the world. A return of UK popular support to the political middle ground would allow a greater sense of national purpose and open the way for international business investment into this new UK proposition.

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Nevertheless, the Conservative Party offer of continuity is double-edged. In respect of Brexit, there may be some disappointment by mid-2020 as investors realise the negotiation of a permanent trade agreement between the UK and EU will be complex, time-consuming and may involve further brinksmanship by both sides. Furthermore, until this is resolved, this issue is likely to act as a drag on UK business investment, at least for sectors linked to export markets.

We note the underperformance of UK sectors relative to global peers on a relative basis since the EU referendum, which suggests a degree of further catch-up performance in 2020. However, following the recent rally, investors must consider all relevant factors before attributing underperformance to Brexit. For example, with the acceleration of the transition to a digital economy in recent years, for sectors such as retail or retail property there has been a permanent loss of profitability for smaller domestic companies unused to facing global competitors.

Nor should the election-specific nature of this note distract attention from the continued run of mixed incoming economic data in respect of the global economy during December, which will have an at least equal weight in determining the direction of UK asset prices in 2020 as the UK election.

Stocks themes that benefit from a Conservative win

If the polls are correct and a Conservative majority is the outcome of the 12 December election, then we would anticipate a positive reaction in equity markets reflecting the reduction in uncertainty and lowered political risk and a gradual rally in sterling. Set out below are some key themes we expect to play out in the event of a Conservative win.

Quality stocks will continue to outperform on a 12-month view

Given our expectation that trade-deal concerns are likely to persist, we would continue to expect the polarised market where investors are prepared to pay premiums for high-quality stocks to continue. Edison's Illuminator screen identifies stocks that are delivering the attributes of a high-quality business and we highlighted **Coats Group**, **Rightmove**, **4imprint, Gamma Communications**, **FDM Group**, **JD Sports**, **Hilton Food Group**, **Avon Rubber**, **Greggs** and **Fever-Tree** as stocks to focus on in our November publication.

In addition to the Illuminator names, we highlight two others:

- **Games Workshop Group** (GAW.L, market cap £1.8bn), a leading international specialist designer, manufacturer and multi-channel retailer of miniatures, scenery, artwork and fiction for tabletop miniature games set in its fantasy Warhammer worlds, which has strong IP and strong barriers to entry with the potential to scale internationally. The company has continued to beat earnings expectations and is growing rapidly.
- **Strix** (KETL.L, market cap: £340m, (f) dividend yield: 4.2%), an Isle of Man-based company engaged in designing, manufacturing and supplying kettle safety controls as well as other components and devices involving water heating and temperature control, steam management and water filtration. The company benefits from 90% recurring revenues as its kettles are replaced on average every three and a half years, and an income stream that is heavily patent protected and enforced vigorously through intellectual property actions. Operating profit margins are in excess of 30% and it has a c 85% conversion rate of cash profit to operating cash flow. Strix aims to raise its market share to 40% by 2021, mainly by raising market share in less regulated markets from 20 to 28%, and lifting its share in China to 50%. Trading on c 11x forward earnings and with a cash-rich balance sheet, we believe Strix remains attractively valued and somewhat isolated from geopolitical risks.

Relief rally in Corbyn policy stocks

The Corbyn pledge of bringing 'rail, mail, water and energy companies into public ownership' led to investors avoiding a number of stocks and sectors. The removal of this risk could lead to a near-term bounce in names such as **Royal Mail** (RMG.L, market cap £2.2bn), **BT** (BT.L, market cap £19bn), **National Grid** (NG.L, market cap £31bn), **SSE** (SSE.L, market cap 14bn), **United Utilities** (UU.L, market cap £6bn), **Pennon** (PNN.L, market cap £4bn), **Go-Ahead Group** (GOG.L, market cap £868m), **National Express** (NEX.L, market cap £2bn) and **FirstGroup** (FGP.L, market cap £1bn).

Apart from these obvious names, we would highlight **John Laing Group** (JLG.L, market cap £2bn). The UK represents a much-diminished part of the portfolio and an even smaller part of the pipeline for growth. Although highly unlikely given the latest polls, the prospect of a Labour government, given its anti-PFI stance, is a clear negative, but one that is well understood by the market and reflected in JLG's strategy of minimising the importance of the UK (a trend of the last two to three years).

Rally in banks and UK asset management stocks

As noted earlier in our valuations section, UK banks are notable for being on discounted valuations. If 2018 and 2019 have been characterised by uncertainty, the removal of some of that uncertainty has the potential to unlock pent-up private investment (see comment of Severfield below as a further example). Should we start to see this improvement in investment after the election, we believe UK banks are likely to rally on improving economic conditions and growth, and the potential for a steeper yield curve benefiting future earnings.

Following the EU referendum, the UK has also seen an outflow from UK asset managers. We would anticipate that that these flows have the potential to reverse if the outlook for the UK as risk premiums for UK assets fall.

Stocks to highlight include **Barclays** (BARC.L, market cap £30bn), **Lloyds Banking** (LLOY.L, market cap £44bn), **Royal Bank of Scotland** (RBS.l, market cap £28bn) on the large cap banks, **Jupiter Fund Management** (JUP.L, market cap £1.8bn), **Standard Life Aberdeen** (SLA.L, market cap £7.3bn) and **M&G** (MNG.L, market cap £5.8bn). On the mid cap segment we would highlight **Polar Capital** (POLR.L, market cap £512m) and **Gresham House** (GHE.L, market cap £161m). We also believe that names such as **Numis** (NUM.L, market cap £278m) are worth focusing on as ECM activity levels are likely to pick up from the lows of 2019.

Housing, infrastructure and energy efficiency stocks to benefit

The 2019 Conservative manifesto appeared to water down previous 2017 proposals to build 300,000 homes a year. That target was always regarded with some scepticism given that level of new-build completions has not been achieved over the last two decades. In FY18/19, the figure reached 213,000 for new-build completions and including conversions was 241,000. Instead there is a pledge to continue progress towards the 300,000 target and a commitment to build one million new homes over the next parliament (200,000 a year, effectively). We think that the supportive policy towards the housing sector, in particular extending Help to Buy to 2023, plus the removal of market uncertainty and a pledge to hold income taxes, will be a boost to the housing sector.

The housing policy came with a commitment to spend on infrastructure (schools, GP surgeries, etc) before housing and a pledge to invest £100bn on new infrastructure. The pledge to improve energy efficiency for social housing by committing to spend £6.3bn in England is also noteworthy.

In terms of stocks, house builders such as **Taylor Wimpey** (TW.L, market cap £6n), **Persimmon** (PSN.L, market cap £8bn), **Barratt Developments** (BDEV.L, market cap £7bn), **Redrow** (RDW.L, market cap £2bn), **Bovis** (BVS.L, market cap £2bn) and the less well-known Inland Homes are all

likely to benefit. We also think names such as **Sureserve** (SURS.L, market cap £52m), which are focused on improving energy efficiency for housing associations, may benefit as well.

On the infrastructure side, a key difference to the subdued activity of 2019 vs a decade ago was that when **Severfield** (SFR.L, market cap £226m) came to report interims this year, it had a significantly larger order book compared to a decade ago. The uncertainty of 2019 has led to decisions being deferred and we believe this has a good probability of starting to unwind in 2020. Severfield is fairly late stage in the cycle as structural steel tends to be used in the later stages of a construction process.

Polypipe's (PLP.L, market cap £1bn) products are used much earlier in the infrastructure cycle. Operating in the residential, commercial, civil and infrastructure sectors, this manufacturer of plastic piping systems benefits from diverse growth drivers. Historically, Polypipe has maintained its high operating margin and resilient performance in challenging trading environments. With an acquisitive strategy of becoming a 'one-stop shop' for its customers, we believe it is well placed to diversify further by geography. Polypipe has a flexible cost base and a high operating margin at c 18%. Notwithstanding recent acquisitions, net debt stands at c 2x adjusted cash profits, which indicates that the group is not over-stretching itself at present. Given the higher quality of earnings relative to the sector, we believe the shares are attractively priced trading on 12x forward earnings.

Continued rotation out of large-cap beneficiaries of weak sterling

We have already seen the FTSE 250 outperform the FTSE 100 over the last year as the attractions of the more domestically focused FTSE 250 have grown. We would anticipate this continuing in the event of a Conservative win. FTSE 100 earners such as **Diageo**, **GlaxoSmithKline** and **Glencore** are likely to come under pressure. In the FTSE 250, we would highlight stocks such as:

- **HarbourVest** (HVPEa.L, market cap £1bn), a listed private equity play that has demonstrated a strong track record of delivering uncorrelated NAV returns, but, despite the UK making up a small proportion of its portfolio, the stock price has been highly correlated to the UK market.
- **TalkTalk** (TALK.L, market cap £1bn), a UK telecom services provider, where the sale of FibreNation, which stalled when Jeremy Corbyn raised the possibility of nationalising BT, has a greater probability of concluding.
- **Primary Health Properties** (PHP.L, market cap £2bn), a long-term investor in primary healthcare properties in the UK and Republic of Ireland. Post its merger with MedicX Fund. The commitments to increase NHS spend on building GP surgeries are supportive. Accelerating rental growth, asset management initiatives, acquisition opportunities, the capital resources to fund these, lower debt costs and significant refinancing opportunities all bode well for future growth.

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