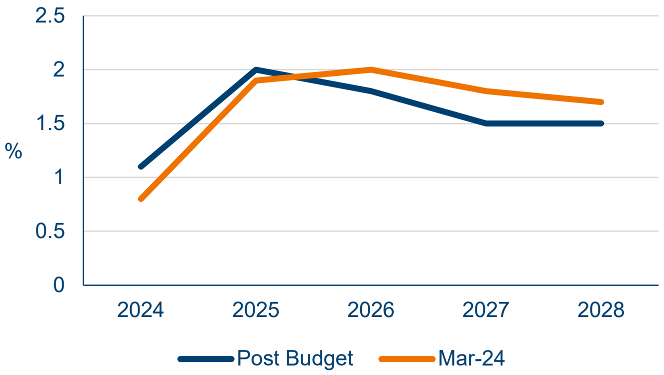
UK Value Opportunities

George Godber and Georgina Hamilton, Fund Managers

George Godber (GG), Fund Manager, Polar Capital UK Value Opportunities Fund: We want to assess the impact of the Budget, what it means for the economy and for our portfolio, so let's start by focusing on GDP growth.

This is a fiscally-expansive budget. Taxes went up by £40bn, spending went up by £100bn – and that spending is front-end loaded. The OBR (Office of Budget Responsibility) and several investment banks have subsequently upgraded their near-term GDP forecasts. The OBR downgraded their cumulative growth over the five-year period because they have assumed, probably conservatively, that the savings rate will remain higher for much longer and well above its long-run average.

OBR GDP forecast



Source: OBR, 31 October 2024. Forecasts contained herein are for illustrative purposes only and does not constitute advice or a recommendation.

As a result of the Budget, we've got more spending now on investment and capital projects, which many other countries are doing and in fact is probably much needed in the UK. Overall, it should be positive for GDP growth, should be positive for the FTSE 250, and positive for our Fund given we are significantly overweight the FTSE 250.

In our last quarterly commentary, we published a G7 GDP table showing the UK's relative position compared to other members.

Forecast YoY GDP Estimates by the IMF

	2023 (%)		2024 (%)		2025 (%)
US	2.9	**US**	2.8	**Canada**	2.4
Japan	1.7	**Canada**	1.3	**US**	2.2
Canada	1.2	**France**	1.1	**UK**	1.5
France	1.1	**UK**	1.1	**Japan**	1.1
Italy	0.7	**Italy**	0.7	**France**	1.1
UK	0.3	**Japan**	0.3	**Italy**	0.8
Germany	-0.3	**Germany**	0.0	**Germany**	0.8

Source: IMF estimates, 31 October 2024. Forecasts contained herein are for illustrative purposes only and does not constitute advice or a recommendation.

Since we published that, the IMF has further upgraded UK GDP growth for 2024 to 1.1% and, with the rises we now expect to come into next year, you can see the relative position of the UK is looking a lot more promising, especially when you think about those tougher periods of the past few years.

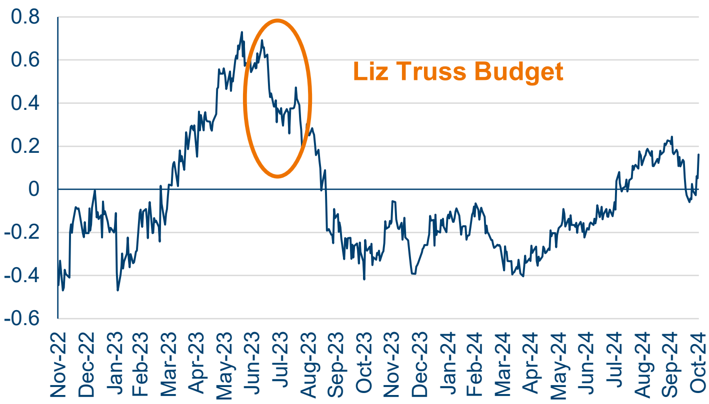
GDP growth is accelerating. It's good news for the FTSE 250, but what about the consumer?

Well, consumers didn't really get any giveaways in the Budget. In fact, we can pretty clearly argue that the impact of the hike of National Insurance will likely slow wage growth, probably lead to an increase in unemployment and, as it stands, the Budget is unlikely in the near term to unlock that elevated savings ratio. Given that consumption is two-thirds of GDP, that falling savings ratio is absolutely pivotal to getting a more sustained improvement in GDP.

Georgina Hamilton (GH) , Fund Manager, Polar Capital UK Value Opportunities Fund: More borrowing means issuing more gilts. Gilts issuance was forecast to be £270bn next year and it looks like this will be raised by about 10%, by £30bn. There has been a move up in the [10-year] gilt yield as a consequence of this, but it's been a commensurate move up. It's been nothing like the move after the Liz Truss budget. If we look at the spread of the UK gilt yield over the US over the budgetary period, we can see there has been a move up but, again, nothing like after that disastrous Liz

Truss budget.

UK 10 year yields vs US 10 year yields



Source: Bloomberg, 31 October 2024.

Now as we turn towards the interest rate curve, there has been a 20-basis point move up there, which means instead of the market forecasting a rate cut in November and in December, one of those rate cuts has been taken out. So, most likely there will only be one rate cut, in November. This is negative for consumer savings being unlocked but also negative for the cost of capital falling. At the margin, this has been unhelpful but it's absolutely manageable and not a disaster.

The market has ruled that this budget is inflationary, but the jury is possibly still out on that because while more government spending and more public sector wage rises may be inflationary, on the flipside wage inflation may be a bit lower for the private sector and unemployment a little bit higher and that could counterbalance it.

And it is also not taken as a given that the Bank of England will necessarily step off its aggressive rate-cutting commentary of late. As we take a step back from it all, the trajectory of interest rates is still down. There will be cuts this year, there will be cuts next year and cuts the year after. This will lower the cost of capital in the UK over time and that should drive a rerating of UK equities more broadly, for the FTSE 250 in particular where the Fund is significantly overweight,

GG: Turning to sectors, we could talk at length about the Budget and its political implications, but it's so much more important to focus on what's actually going to do well and what will not. Infrastructure – what was announced, because this is probably the most interesting area? A £24bn increase in capital investments, including £1.4bn on rebuilding schools; an extra £1.2bn on prisons; £1.6bn for road maintenance and for new road systems; and an extra £1bn to replace reinforced autoclave aerated concrete (RAAC) and supplement some of the existing backlogs of maintenance that were needed across the NHS estate.

We have considerable Fund exposure in this area through Kier Group, Renew Holdings, Breedon Group and Morgan Sindall Group.

Turning now to banks and other financials, if we've got 'higher for longer' on rates and the additional benefit of no additional banks tax or any form of levy with the budget, that should be a great help there. We've got significant Fund exposure with about 11% of the Fund's capital in this area.

Corporation tax was also flatlined at 25% and, importantly, that was confirmed for five years and that really leaves businesses in a much better place to plan for capital investment and for projects going forward.

GH: Coming onto the sector negatives, labour as a cost in the P&L for companies has gone up as a consequence of the Budget and there has been a layering of labour market changes. There has been the hike in the national living wage. There has been the hike in National Insurance but also the [reduction in the] level at which this starts to be paid. And, on top of all of this, you've got the Employment Rights Bill as well. So this is particularly difficult for the really big employers and, when we think about those, it's about supermarkets, hospitality and leisure names. There could be some risk of earnings downgrades here.

That said, year-to-date, the consumer's been pretty strong. We'll see how significant those downgrades are. On the flipside, consumer real incomes should continue to be really strong next year so, as a consequence, we haven't made any changes at the portfolio level.

GG: So, in conclusion we've got a near-term boost to GDP growth. That's really helpful for earnings in certain domestic shares and sectors, and that should help to continue to drive a UK rerating. UK GDP growth in 2025 is looking relatively good. That's in stark contrast to what was going on in 2023 and it's very important that it's looking a lot better than other parts of Europe and that's helping drive flows back into the UK equity market.

The cost of capital has been marginally raised but the trajectory is still down. Near term, we've got no unlocking of the savings rate and the messaging to the consumer from the government is going to be absolutely key here.

Within the portfolio, we've got significant exposure to infrastructure spend and to the domestic banks. Our exposure to the FTSE 250, which benefits from GDP growth, is also high.

The UK market remains extremely attractively priced for somewhere that's seeing improving GDP, falling inflation and still has that exposure to falling interest rates.

George Godber and Georgina Hamilton
Fund Managers, Polar Capital UK Value Opportunities Fund

04 November 2024

Polar Capital UK Value Opportunities

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