A new megalo-dawn

Why the FTSE 100 is ready to shake off its shackles...

Update
01 May 2024

Analysts:

Jo Groves
Jo@keplerpartners.com

Kepler Partners is not authorised to make recommendations to Retail Clients. This report is based on factual information only.

The material contained on this site is factual and provided for general informational purposes only. It is not an invitation or inducement to buy, sell or subscribe to any product described, nor is it a statement as to the suitability or otherwise of any investments for any person. The material on this site does not constitute a financial promotion within the meaning of the FCA rules or the financial promotions order. Persons wishing to invest in any of the securities discussed in the website should take their own independent advice with regard to the suitability of such investments and the tax consequences of such investment.

The FTSE 100 may be (rather harshly) branded the 'Jurassic Park' of indices but the dinosaurs certainly came out to play last week as the UK's large-cap index hit an all-time high. Putting this into context, the FTSE 100 has delivered higher returns than the S&P 500 over the last three months as fears of stagflation have started to dull the sparkle of US equities.

Predatory activity also continued apace, with 2024 ushering in a marked shift up the market cap spectrum after 2023 saw bargain hunters hoover up 10% of the FTSE Small Cap Index. Last week brought a £31bn offer for Anglo American by fellow miner BHP, hot on the heels of the tussle between Mondi and International Paper for packaging supplier DS Smith.

This flurry of activity is testament to the attractive valuations on offer in UK equity markets, but, as my colleague surmised in a recent blog: we already know. What has been less clear, however, is the timing of the long-awaited recovery and we explore some of the likely catalysts in our latest report on **investing in the UK**.

As a result, investors will be hoping that the latest climb in the FTSE 100 will mark the first step towards a sustained recovery. It's fair to say that valuations of UK equities remain subdued and, even after the recent bounce, the MSCI UK is still trading on a forward price-earnings multiple of 11.3, not far from half the valuation of the 20.5 of the MSCI US (Yardeni, as at 29/04/2024).

Returning to the Jurassic Park analogy, this valuation discount is often attributed to the weighting of 'old economy' sectors in the UK stock market relative to the proportion of high-growth technology mega-caps in the US. There is some truth in this but, in our recent **webinar series**, Sue Noffke, manager of **Schroder Income Growth (SCF)**, argued that this clear valuation differential also extends across comparable sectors.

Sue pointed out that all but one of the 30 plus sectors in the MSCI UK Index trade at a discount to their US equivalents, with a discount of more than 50% in the transport, automative, retail and real estate sectors (based on forward price-earnings ratios as at 31/01/2024). Picking a few examples, BP is trading on a forward price-earnings ratio of 8 compared to 13 and 14 for fellow US energy companies Chevron and ExxonMobil respectively (as at 30/04/2024) and it's a similar story for British American Tobacco, GSK and AstraZeneca.

Before I attract the ire of the Kepler analyst team, I should add the caveat that price-earnings ratios are somewhat of a blunt instrument and other factors (including forecast earnings, strengths of the balance sheet and corporate strategy) can create significant valuation differentials. However, given that Yardeni reports a forecast earnings growth of almost 8.4% for the MSCI UK in 2024, not far below the 9.4% forecast for the MSCI US, a discount of this magnitude seems hard to justify.

Advocates of the FTSE 100 would also argue that the Jurassic Park tag is unfair, to say the least. The index boasts a blue-chip roster of market-leading multinationals and generates more than three-quarters of revenue from outside the UK. It's also well-positioned to ride the secular growth drivers of mega-trends such as the soaring demand for commodities in the net-zero transition and the increasing dependence of an ageing population on the pharmaceutical industry. We shouldn't ignore the impressive returns generated by some of those 'old-school' companies either, with BP and Shell delivering total returns of more than 100% over the last three years (as at 30/04/2024).

That said, not all dinosaurs are created equal. Rolls Royce and NatWest have rewarded investors with year-to-date share price gains of almost 40% (with Barclays not far behind) but it's a very different story at the bottom of the table: Ocado has suffered a halving of its share price this year and Rio Tinto, Mondi and Reckitt Benckiser are also in the red.

This is not substantive investment research or a research recommendation, as it does not constitute substantive research or analysis. This material should be considered as general market commentary.

This divergence in performance demonstrates the value of active stock-pickers such as Merchants Trust (MRCH). The trust has a dual aim of income and capital growth and over half of the portfolio is currently invested in the FTSE 100, with GSK, Shell and BAT comprising the top three holdings (as at 31/03/2024). Merchants has delivered a five-year net asset value total return of 50% (the second-highest in the AIC UK Equity Income sector) and is currently trading on an attractive dividend yield of 5.1% (as at 29/04/2024).

Alternatively, **Law Debenture (LWDB)** takes a highly-differentiated approach to its equity income peers, combining a traditional UK equity portfolio with an independent professional service business. The cash-generative nature of this business funds over a third of dividends, allowing the managers to pursue a more flexible investment strategy beyond a pure income focus.

This blend of income and capital growth has propelled LWDB to the top of the AIC Equity Income sector with a five-year net asset value total return of 61%, in addition to a current dividend yield of 3.8% (as at 29/04/2024).

James Henderson and Laura Foll, managers of LWDB, look for high quality, undervalued businesses. The recovery of Rolls Royce has been a strong contributor to recent returns, as well as the significant premium paid on the acquisition of DS Smith. While FTSE 100 companies such as Shell, BP, GSK and HSBC dominate the top ten holdings, the managers also cast their net over the lower-end of the market cap spectrum and have recently added FTSE 250 food supplier Cranswick to their portfolio.

Another trust that has benefited from M&A activity is **CT UK Capital & Income (CTUK)** which was a long-term investor in DS Smith. The trust has a diversified portfolio, with over half invested in FTSE 100 companies (such as AstraZeneca, Unilever, RELX and Legal & General), together with companies such as Vistry, OSB Group and LondonMetric Property from the FTSE 250. CTUK is also an AIC 'dividend hero' thanks to 30 years of consecutive dividend increases.

It remains to be seen whether the FTSE 100 will continue to maintain its upwards momentum and offer a fertile hunting ground for would-be acquirers. However, after a decade in the unloved category, a pivot in investor sentiment towards UK equities may prove the necessary catalyst for the hoped-for uptick in valuations. If this comes to pass, the so-called dinosaurs could have the last roar after all.

Disclaimer

Past performance is not a reliable indicator of future results. The value of investments can fall as well as rise and you may get back less than you invested when you decide to sell your investments. It is strongly recommended that if you are a private investor independent financial advice should be taken before making any investment or financial decision.

Kepler Partners is not authorised to make recommendations to retail clients. This report has been issued by Kepler Partners LLP, is based on factual information only, is solely for information purposes only and any views contained in it must not be construed as investment or tax advice or a recommendation to buy, sell or take any action in relation to any investment.

The information provided on this website is not intended for distribution to, or use by, any person or entity in any jurisdiction or country where such distribution or use would be contrary to law or regulation or which would subject Kepler Partners LLP to any registration requirement within such jurisdiction or country. In particular, this website is exclusively for non-US Persons. Persons who access this information are required to inform themselves and to comply with any such restrictions.

The information contained in this website is not intended to constitute, and should not be construed as, investment advice. No representation or warranty, express or implied, is given by any person as to the accuracy or completeness of the information and no responsibility or liability is accepted for the accuracy or sufficiency of any of the information, for any errors, omissions or misstatements, negligent or otherwise. Any views and opinions, whilst given in good faith, are subject to change without notice.

This is not an official confirmation of terms and is not a recommendation, offer or solicitation to buy or sell or take any action in relation to any investment mentioned herein. Any prices or quotations contained herein are indicative only.

Kepler Partners LLP (including its partners, employees and representatives) or a connected person may have positions in or options on the securities detailed in this report, and may buy, sell or offer to purchase or sell such securities from time to time, but will at all times be subject to restrictions imposed by the firm's internal rules. A copy of the firm's Conflict of Interest policy is available on request.

PLEASE SEE ALSO OUR TERMS AND CONDITIONS

Kepler Partners LLP is authorised and regulated by the Financial Conduct Authority (FRN 480590), registered in England and Wales at 70 Conduit Street, London W1S 2GF with registered number OC334771.