



EQUITIES UK



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## Tempered optimism in a much changed landscape

By no means has 2009 been an average year for the UK market, with interest rates hitting unprecedented lows, the economy experiencing its longest period of economic contraction since the Second World War, and equity markets bouncing 50% from the six-year lows they reached in early March.

Record rights issues and savage dividend cuts were also witnessed across the market spectrum. The extremes of these moves have obviously been the result of a multitude of causal factors; many of these will continue to influence the UK markets in the year ahead while there will evidently be some new forces to consider.

For example, it's likely that we will see a continuation of the trends that have served to dampen consumer confidence in 2009; ongoing corporate belt-tightening, feeding through into further increases in unemployment and muted wage growth. There will also likely be a continuation in the rise in the household savings ratio towards a more sustainable long-term level, as consumers seek to get their domestic balance sheets in order.

### A changing landscape

The seemingly limitless appetite for borrowing that stoked economic growth for much of this decade has now become a drag, as the cost of borrowing increases and the fear of unemployment looms large.

We have finally reached the point where the housing market is no longer operating as a cash machine for consumers.

The year ahead will likely see the beginning of the gradual removal of ultra low interest rates, as the Monetary Policy Committee (MPC) shifts away from its emergency stance. Furthermore, with the MPC deploying quantitative easing for the first time in 2009, it is now faced with its first experience of 'exit strategies', and how best to turn off the monetary stimulus taps.

Next year also looks set to be one of new market forces with the likelihood of a change in government. But for whoever wins the next election, the lack of choices remain the same. Unless a credible plan is laid out to get the public finances under control, sterling and UK gilts look likely to struggle. So we expect to see taxation increases way beyond the reversal of the VAT cut, along with big cuts to public spending – the painful yet unavoidable consequences of the economic downturn.

### Calmer waters ahead

The balance of these factors suggests that the UK may well be entering more austere times, with economic activity muted for some time. From an investment perspective this will act as a considerable drag on the domestic and consumer focused parts of

the market, such as banks, retailers, house builders and leisure companies. When considering the prospects for the UK stock market for 2010, it is necessary to consider what is already being reflected in share prices. Given the market moves we have seen since the lows in March, it is clear that investor sentiment has moved swiftly from discounting an Armageddon scenario towards pricing-in a sustained recovery.

Although the emergency stimulus measures have managed to stabilise the UK and indeed the global economy, it is far too early to suggest that this marks the beginning of a new leg of economic expansion, where the world bounces back to how things were before the credit crisis hit. Simply piling on public debt to plug the hole created by the withdrawal of private borrowing does not provide a sustainable basis for economic progression.

### Separating the wood from the trees

Yet that does not mean that there are not opportunities to be found for the equity investor. With regards to the positive trends, there has been evidence of a mergers and acquisitions environment emerging during 2009, and there seems to be no reason why this cannot continue to influence the markets into 2010. For investors that require income, those companies that cannot support their dividend commitments on an ongoing basis have now been largely shaken out, such that the yield support for equities remains attractive from here, especially when compared with base rates.

It is by no means certain that economic recovery will take hold in 2010, particularly as stimulus measures begin to roll off. However, the rotation effect within the equity market means that there is value

to be found amongst the non-cyclical sectors, where you do not need to rely upon a sustained global upturn in order to justify share prices. There are many stocks available on very reasonable valuations that will continue to deliver profit progression regardless of the prospects for the wider economy.

Added to this, there are opportunities across the market spectrum in companies that can demonstrate an ability for self-help, once again allowing profit progression in an environment that may still be more challenging than many are currently expecting. When such opportunities are available, often paying attractive dividend yields, it becomes a question of weighing up the balance between risk and reward, given the difficulties we are still facing. The economy is not out of the woods yet, but there are quality companies available that are not reliant on it being so.

## UK HOUSEHOLDS' SAVING RATIO



Source: Datastream, November 2009

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