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## **UK EQUITIES – TIME FOR GLOBAL INVESTORS TO TAKE A LOOK DECEMBER 2011**

Markets have had to contend with a series of challenges this year, from the earthquake and nuclear emergency in Japan to social unrest in the Middle East, concerns about Chinese growth and, of course, the possible collapse of the eurozone. Against this difficult backdrop the FTSE All Share has delivered a creditable performance, falling by just 4.3% to the end of November.

This performance, which places the UK second among the major markets over the year to date, can be attributed to a number of supportive factors. We believe that these factors will increasingly attract international investors to UK equities in the coming year.

### **A high quality, defensive market**

Successive UK governments have understood the importance of business to the UK's prosperity. The current leadership has continued this trend by placing the corporate sector at the heart of its structural reform programme. Low corporation tax encourages high quality, global businesses to locate to the UK. Meanwhile, a clear and well-established legal framework makes the UK one of the easiest markets in which to conduct corporate activity, which in turn promotes the efficient allocation of capital.

These factors, together with London's heritage as a global financial centre, have helped to create a broad, highly liquid market characterised by good corporate governance and featuring truly multinational corporations as well as small and medium-sized businesses.

The UK index also offers significant exposure to defensive sectors, with oil & gas, healthcare, consumer goods, telecoms and utilities accounting for half of the market in capitalisation terms. This defensive nature stands the market in good stead during uncertain times, with Credit Suisse data showing that the UK has historically outperformed other global markets when the ISM Index of economic activity falls below 50, a level typically associated with recession.

### **Access to growth**

As more multinational corporations have located to the UK, the earnings profile of the market has become more international and today, more than 75% of UK companies' sales are derived from overseas, compared with 39% for Europe ex UK, 33% for Japan and 29% for the US. This profile partially insulates the UK stock market from the current tough domestic economic conditions as well as giving investors access to robust demand from fast-growing markets such as China.

Although emerging economies have outperformed their developed counterparts in 2011, their stock markets have lagged. Accessing emerging market demand through companies listed in the developed world has been the most effective way of harnessing the superior growth prospects of Asia and Latin America this year. Given high levels of uncertainty and global risk aversion, this trend could continue in 2012. Among the many potential UK beneficiaries are:

- Smith & Nephew – as a maker of replacement hip and knee joints, this company has specialist products that it sells broadly across the developed world. It is also a beneficiary of rising standards of living and increased life expectancy in emerging markets;
- Tesco – traditionally seen as a UK retailer and with 68% of sales still generated in its home market, this highly successful company has been expanding its overseas operations and is seeing strong growth in international sales;
- Unilever – this leading consumer goods company has more than 400 branded products and generates 53% of its sales in emerging markets.

In addition to these three names, BP generates more than half of its revenues in the US; Vodafone generates a similar proportion in Europe; AstraZeneca's UK sales represent just 3% of the total; and SABMiller and BAT's revenues generated outside the UK, Europe and North America stand at 71% and 78% respectively.

### A clear plan

In common with a number of other developed economies, the UK's high level of debt is likely to constrain growth over the medium term. However, the UK has some advantages over its competitors in addressing this problem. It has a stable government with a clear plan of fiscal consolidation; it also benefits from an independent central bank that is committed to maintaining appropriately loose monetary policy to balance the effects of fiscal tightening. Importantly, low interest rates and quantitative easing are also likely to subdue sterling, which will further strengthen the competitive position of the UK's many exporters.

### Challenges already priced in

Valuation is one of the principal factors that have helped to limit losses from UK equities this year. With a price-to-earnings ratio of 8.6 times 2012 earnings, the market is cheap relative to history and arguably already reflects a significant slowing in earnings momentum in 2012. The UK PE ratio is also attractive relative to the other major equity markets - as shown below – helped by our expectation that the UK market will produce better earnings growth than Europe or the US. At this stage of the cycle, when earnings visibility is relatively poor, it is prudent to consider other measures of valuation and UK stocks are also trading well below their long-term average on metrics such as price-to-book and price-to-cash-flow.

	UK	US	Europe ex UK	Japan
2012 price-to-earnings ratio	8.6x	12.0x	9.8x	10.1x
2012 earnings growth	9.9%	0.0%	-7.0%	12.0%

Source: Threadneedle, based on Threadneedle forecasts as at 25 November 2011

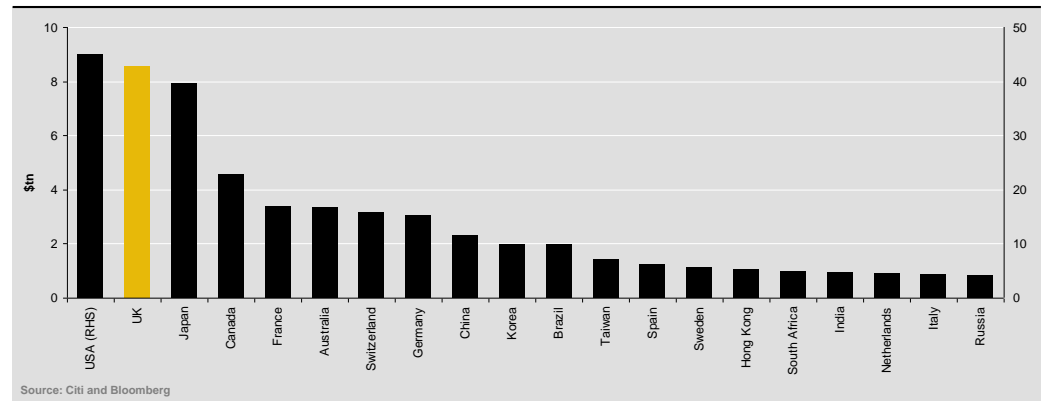
UK companies continue to generate healthy cash flows and are returning much of this cash to shareholders. Dividends have been a key tool in this regard and, following 11% growth this year, the aggregate dividend yield of 3.8% is in line with the long-term average and well above the yield on gilts. Moreover, although we expect little or no dividend growth in 2012, the dividends paid by UK companies are not under significant pressure despite the testing domestic economic outlook. High quality companies in a diverse range of sectors, such as Vodafone, GlaxoSmithKline and Shell, are all offering above-market yields backed up by strong balance sheets and historically low payout ratios.

In an era of low interest rates, modest nominal growth and meagre government bond yields, high-yielding equities are likely to be in favour globally in 2012. The UK is well-placed to benefit from this demand.

### Conclusion - time for global investors to take a look

As well as being the second-best performer over the year to date, the UK is also the world's second-largest stock market in capitalisation terms, as illustrated by the chart below.

Market capitalisation of global stock markets



Despite this ranking, however, allocations to UK equities by global investors are typically low. Overseas managers of global equity portfolios have started to recognise the relative value argument and this has led to some modest inflows. However, meaningful asset allocation moves from large pools of capital such as sovereign wealth funds have not yet happened. With UK companies maintaining a high profile in supplying emerging governments with specialist products and expertise, and the relative weakness of sterling likely to enhance the cheapness of UK assets, this could be set to change in 2012.

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