VT Tyndall Real Income Fund

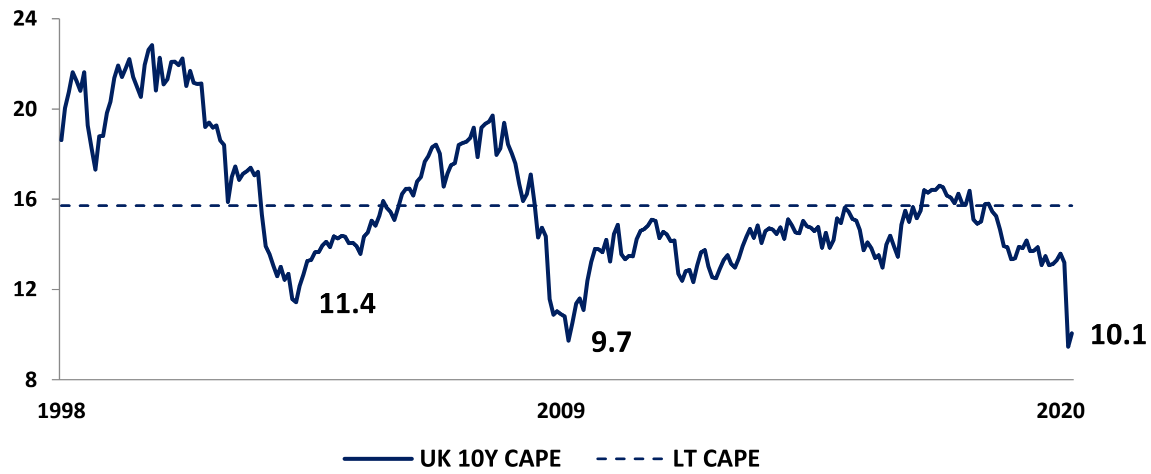
COVID-19 Commentary 29th May 2020

TYNDALL

Guess Who's Back? Brexit's Back!

At the turn of the year we thought it might just be safe enough for investors to start returning to the UK equity market after several years of political and Brexit related malaise. We had a resounding conservative party election victory, progress on getting Brexit done, and the economy was showing signs of life once again – was that really just a few months ago!? Then, as we all know, the dreadful Covid-19 pandemic struck and equity markets around the globe suffered mightily – with the UK being no exception.

As economies now slowly reopen, and with equity markets being forward looking in nature, should we be thinking more positively about UK equities once again? As active UK equity investors we are obviously minded to say yes! The key point here though is that UK equities in our view are just really, really good value. The chart below shows the cyclically adjusted P/E ratio for the UK using a 10-year average of earnings (CAPE). On this measure the UK market is almost as lowly rated as it was at the bottom in March 2009 and cheaper than the bottom in March 2003 – both, with the benefit of hindsight, extremely useful entry points for UK equity investors.



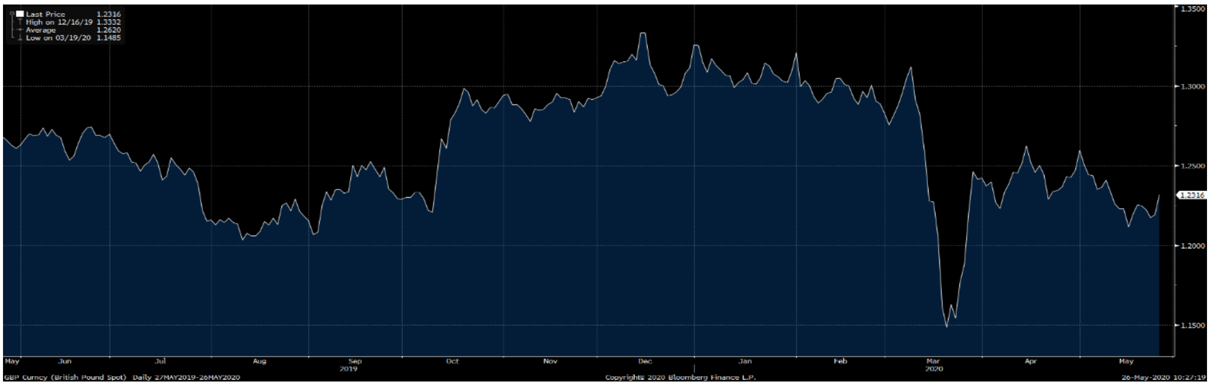
Source: Panmure Gordon

Of course, there are always seemingly highly plausible reasons why equities, when cheap, are likely to stay cheap and vice versa. Indeed, one of the most common phrases in investing is that 'bull markets climb a wall of worry'. Today the wall of worry is of course sizeable globally but is particularly steep, we would suggest, for the UK. In no particular order, the worries include:

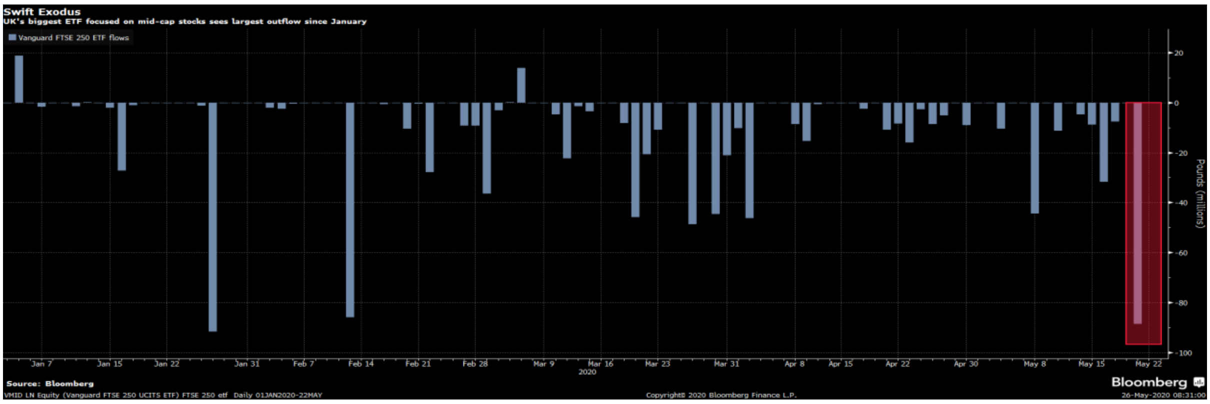
- How meaningful will the economic recovery be when we eventually emerge from lockdown? What about a second wave of infections?
- How will the nation pay for the extensive support mechanisms that have been established during the Covid-19 crisis?

- Will we now have a ‘hard Brexit’? We only have until the end of June to extend the Brexit transition period. If we don’t do that how can we get a sensible deal by December?
- Negative interest rates are being openly discussed by members of the Bank of England monetary policy committee. How would that impact the economy and banks in particular?
- Has the conservative government been fundamentally undermined by criticism of their handling of the crisis and other matters such as the Dominic Cummings ‘scandal’?

These issues, and no doubt several others, have weighed heavily on UK financial markets recently, and we would suggest the re-emergence of Brexit concerns has been the most pressing. We can see the impact on the exchange rate (Sterling vs US Dollar below) with Sterling falling from a high of $1.26 in mid-April to the recent low of $1.21 in mid-May.



It has also been evident in the performance of UK domestic related shares which have materially underperformed internationally focused businesses recently. The chart below highlights recent outflows from the most popular UK mid-cap ETF – mid-caps being typically much more heavily exposed to the UK domestic economy than larger companies.



We have no better crystal ball than anyone else when it comes to the resolution of these issues, and in the short term it is entirely possible that things get seemingly worse for the UK before they get better – particularly when it comes to Brexit news flow. For sure, volatility is likely to remain elevated as these issues play out. However, now more than ever, we feel strongly that a medium-term perspective is the right approach to adopt and in our view the medium-term issues to focus on include:

- UK equities look attractive on longer term valuation measures such as the CAPE which have historically proved good predictors of future market returns.
- Parts of the market look exceptionally good value relative to history. Domestically facing sectors, financials, energy and 'value' factors all look extremely interesting to us.
- According to fund manager surveys, UK equities remain highly unpopular with international investors given historic and current issues. To us this is a bullish, contrarian, signal.
- We do believe, over the course of the next 12 months, we will have considerably greater clarity on the issue of Brexit and our future trading arrangements with our neighbours.
- We do believe in the powers of recovery for the UK economy and the powers of human ingenuity to resolve the risks surrounding the virus and potential second wave effects.

Bringing all these thoughts together we conclude that, with a medium-term horizon, now is an excellent time to be investing in UK equities again. Indeed, in some areas of the market the term 'generational buying opportunity' is appropriate, and we are not generally inclined towards hyperbole. We can't, and won't, try to predict the near-term news flow and associated movements in equity prices.

We have built a portfolio of quality cyclical franchises focussed mainly in the areas of interest noted above. These are well placed to thrive in a recovering UK and global economy and look to us to be excellent value on any sensible valuation metrics. This is good enough for us and we hope it will be for our clients too.

Simon Murphy, Fund Manager, VT Tyndall Real Income Fund, 29th May 2020

Source for Data and Charts (Unless Otherwise Stated): Bloomberg

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