Strategy Espresso: Why the UK is a buy – the countdown to Brexit

Sharon Bell, CFA
+44(20)7552-1341 | sharon.bell@gs.com
Goldman Sachs International

Peter Oppenheimer
+44(20)7552-5782 |
peter.oppenheimer@gs.com
Goldman Sachs International

Lilia Peytavin
+44(20)7774-8340 |
lilia.peytavin@gs.com
Goldman Sachs International

Guillaume Jaisson
+44(20)7552-3000 |
guillaume.jaisson@gs.com
Goldman Sachs International

Andrea Ferrario
+44(20)7552-4353 |
andrea.ferrario@gs.com
Goldman Sachs International

1. We expect a free-trade deal...

While the UK-EU trade talks have taken longer than originally planned, our economists continue to expect a 'thin' free trade agreement in goods; the EU Council meeting on 10-11 December looks like an achievable goal to see a final agreement, in our view.

2. ...And a strong Economic turn

Our economists see substantial room for a rebound in 2021, as activity remains depressed (12% below the pre-COVID level in our Q4 forecast) and the UK is well positioned with regard to vaccine distribution. We expect widespread vaccination from COVID-19 to be underway across Europe in 2021Q1, with a large share of the population vaccinated by end-Q2, a quarter earlier than we had previously expected. Our economists look for UK growth of 7% in 2021 and 6.2% in 2022, significantly above consensus. Encouragingly, the latest PMI data held up well, especially for manufacturing.

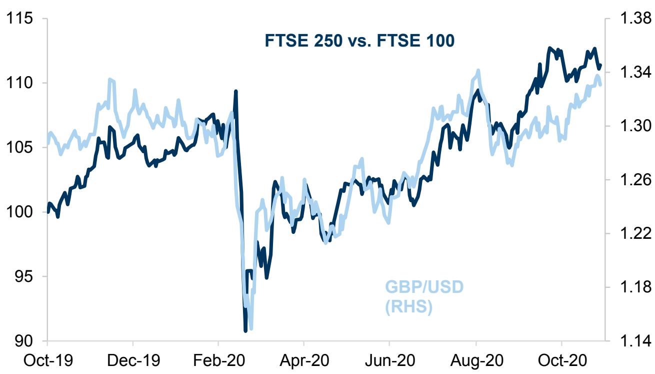
3. These should support GBP...

Based on a 'thin' trade deal and tailwinds from cyclical optimism and vaccine distribution, our FX strategists expect GBP to maintain an upward trend. They continue to recommend going short EUR/GBP with a target of 0.87 (c.3% upside versus the EUR). They also expect broad dollar weakness next year together with domestic economic improvement, driving GBP/USD to 1.44 in 12m (c. +8%).

4. ...And UK domestic stocks (GSSTUKDE)...

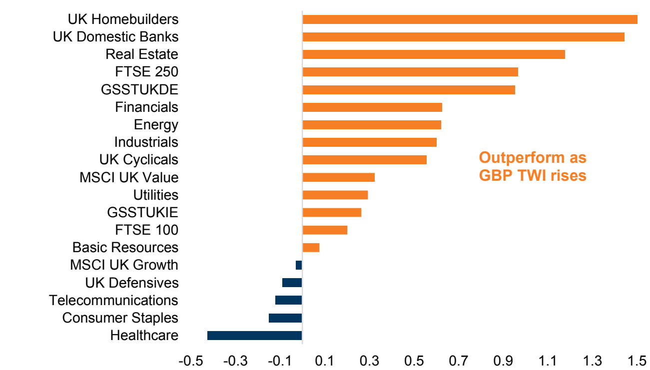
UK domestic stocks (GSSTUKDE) are the most sensitive slice of the market to GBP, along with FTSE 250, which has about 50/50 domestic and non-domestic sales. UK homebuilders (GSSBUKHO) and Domestic banks (GSSBBKDU) are also sensitive FX moves and would benefit from a growth improvement next year – see Exhibit 2 for betas to GBP moves.

Exhibit 1: FTSE 250 has outperformed with the stronger GBP
Price performance



Source: Bloomberg, Goldman Sachs Global Investment Research

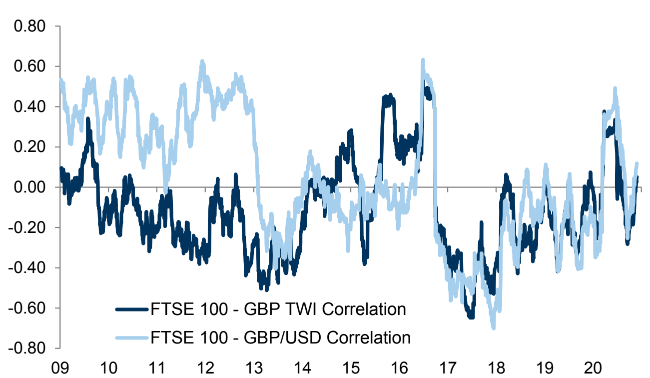
Exhibit 2: Domestic stocks have the highest beta to GBP moves
beta of w/w absolute performance to w/w change in GBP TWI (4y data)



Source: Bloomberg, Datastream, Goldman Sachs Global Investment Research

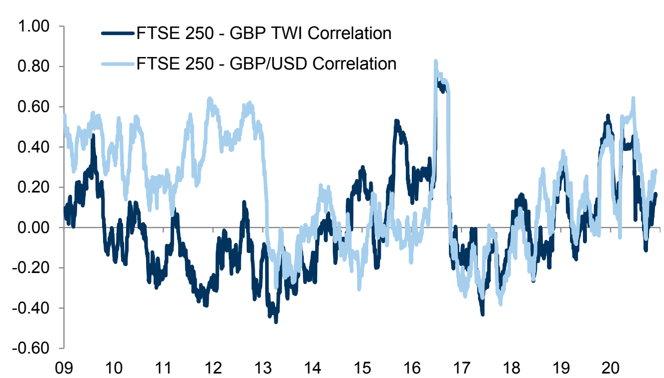
As the FTSE 100 is an international index with 70% non-UK sales, rising GBP will tend – all else equal – to be a drag on index performance. That said, we do not see a move up in GBP – driven by a trade deal – as a significant impediment to FTSE 100 performance. We'd note that the relationship between FTSE 100 and FX moves has not been consistent through time, and in the last 3 months the correlation with GBP has been slightly positive.

Exhibit 3: The correlation between UKX and GBP has generally been negative, but is currently slightly positive...
3m rolling correlation of daily return



Source: Goldman Sachs Global Investment Research

Exhibit 4: ...And for MCX the relationship with GBP has been positive for most of the last 3 years
3m rolling correlation of daily return



Source: Goldman Sachs Global Investment Research

5. ...Which continue to trade at a discount

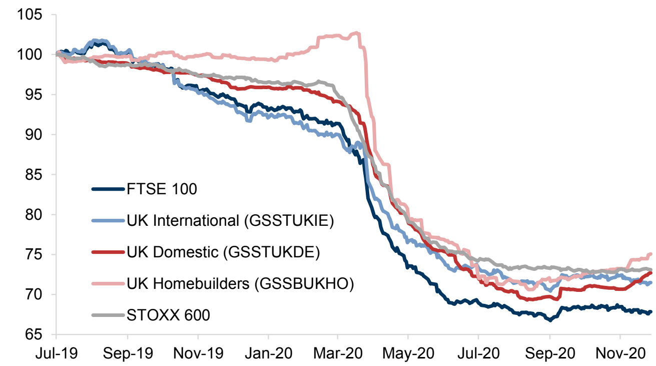
Since end-October UK domestic is up 16% and FTSE 250 is up 13%. That said, STOXX Europe has also risen, by 15%. The outperformance of UK domestic so far is small, and we would expect a further bounce relative to European shares assuming a trade agreement.

UK domestic stocks have re-rated but remain on a 10-15% P/E discount to the broad European market; given the prospect of a sharp UK economic recovery next year we think this offers good value. We note that EPS revisions have started to move up for UK domestic stocks (Exhibit 6).

Exhibit 5: UK Domestic stocks are at a discount to European equities
UK Domestic (GSSTUKDE) vs. STOXX Europe 600 24m fwd P/E Premium/Discount

Source: I/B/E/S, Datastream, Goldman Sachs Global Investment Research

Exhibit 6: EPS revisions for UK Domestic stocks have recently turned positive
2021 EPS revisions



Source: FactSet, Goldman Sachs Global Investment Research

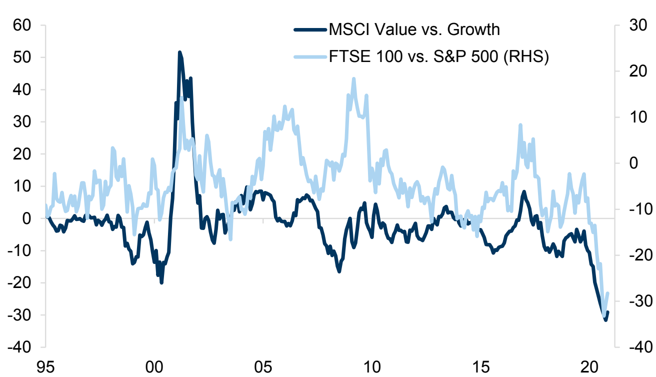
6. The broad UK market has underperformed for several years....

The UK has not always been an underperformer; from 1970 to 2009 the FTSE All Share was up 7.6% pa in GBP and 6.5% in USD, slightly above MSCI World at 6.3% pa. But since 2010 the UK market has lost roughly half of its value versus the World index, both in dollar and GBP terms.

The FTSE 100 has been one of the worst-performing equity markets YTD; down 16% in GBP, 15% in USD. But this is not, in our view, chiefly a function of Brexit risk/uncertainty. We believe the key factors driving FTSE 100 remain commodity prices and value vs. growth.

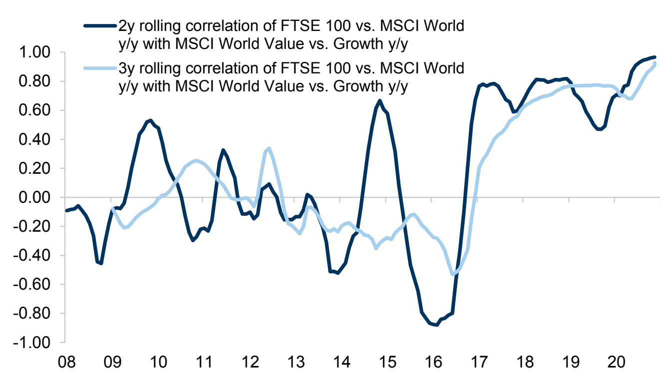
Even with the recent bounce and rotation, the Brent price is down 28% and Value stocks have underperformed YTD. As we show in Exhibit 7, the fit between FTSE 100 vs. S&P 500 and Value vs. Growth is close. FTSE 100 has 8% of its weight in Energy, 17% in Financials, and 10% in Basic resources. Value sectors are more than a third of the index, whereas the UK has very little weight in Tech, especially in the large caps.

Exhibit 7: MSCI World Value vs. Growth and FTSE 100 vs. S&P 500



Source: Datastream, Goldman Sachs Global Investment Research

Exhibit 8: FTSE 100 performance is increasingly tied to the Value trade
Correlation of UK vs. World with Value vs. Growth



Source: Datastream, Goldman Sachs Global Investment Research

We argued in our *Time for Value* report that the valuation gap between Growth and Value had become too extended and that this, combined with the expectation of economic improvement next year, would catalyze a shift into more value and cyclical sectors. The speed of the move into Value so far has been fast, but we continue to believe there is more to go – markets often under-price inflection points – and we would argue the UK in particular should stand to benefit from continued re-positioning.

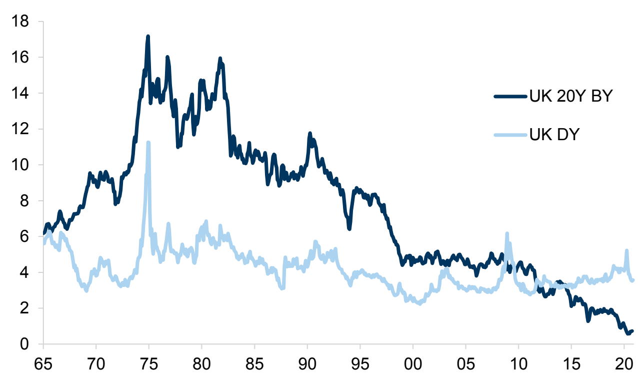
Moreover, our commodities team thinks all major commodity markets are in deficit; they expect Brent prices to rise to US$63/bbl in the next 12 months; see *2021 Commodity Outlook: REVing up a structural bull market,* 18 November 2020. Again the UK is more exposed to this inflection than most markets.

7. ....And valuation is compelling

The UK market remains comparatively cheap – both versus other asset classes and relative to other equity markets.

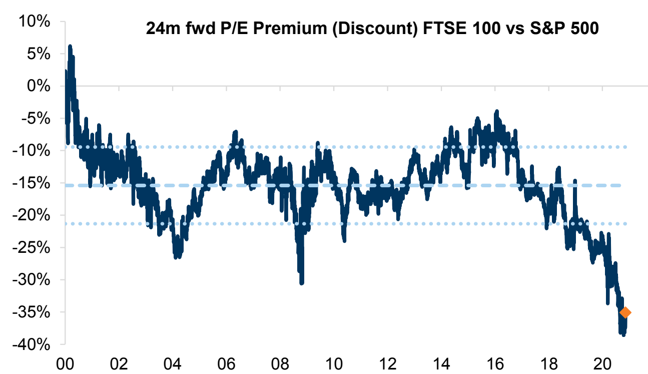
The DY is roughly 350bp above the UK 20-year Gilt yield, high even relative to the history of recent years. And the UK market is on a 35% P/E discount to the US, even based on 24m-forward EPS (so already accounting for some recovery in economic growth). The recent relative outperformance of the UK has only closed a fraction of the valuation gap.

Exhibit 9: UK DY remains substantially above the long-term BY
12m trailing Dividend Yield vs. 20Y BY



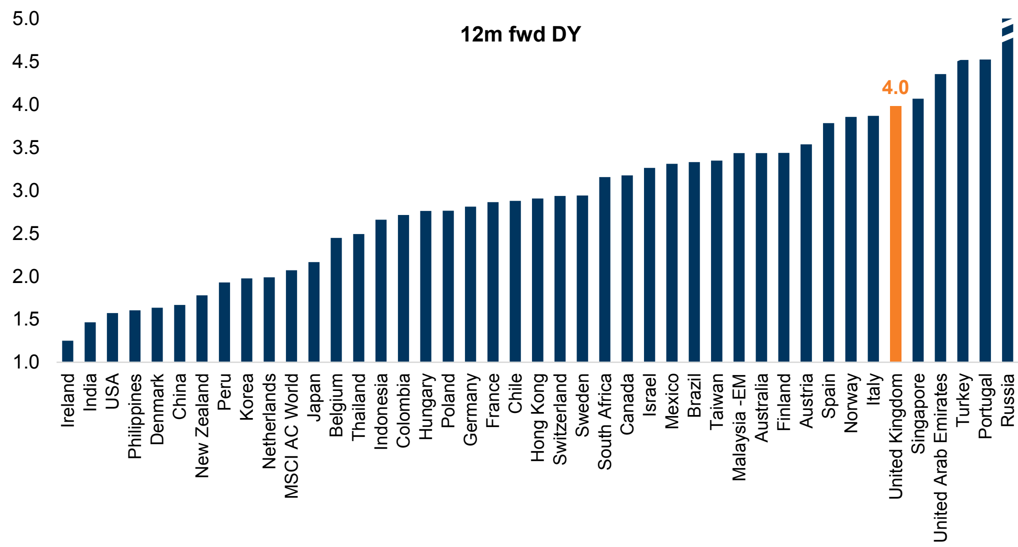
Source: Worldscope, Datastream, Goldman Sachs Global Investment Research

Exhibit 10: FTSE 100 looks cheap compared to the S&P 500



Source: FactSet, Goldman Sachs Global Investment Research

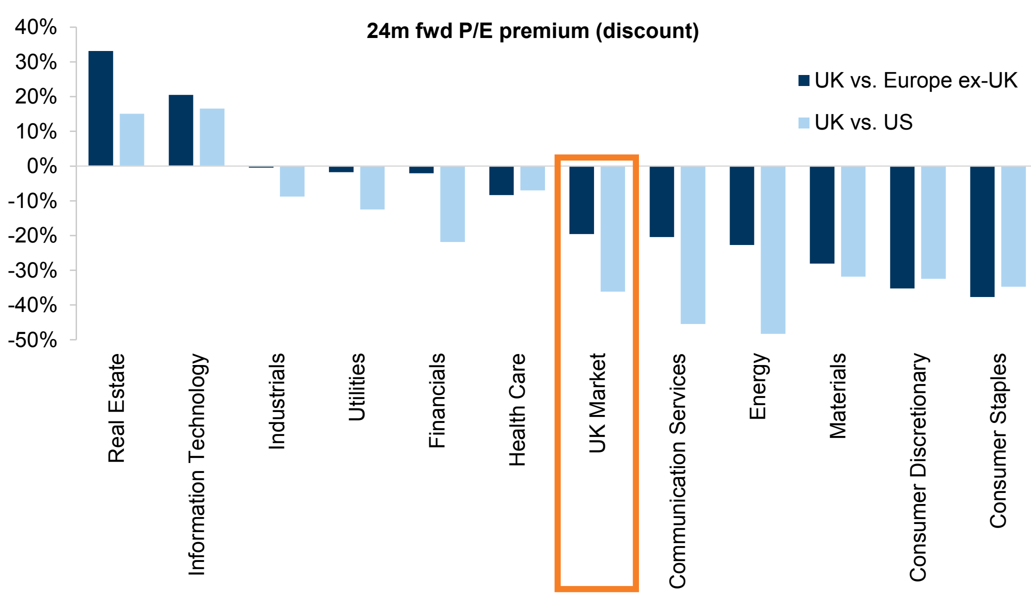
Exhibit 11: UK offers the highest 2021E DY of all large DMs



Source: FactSet, Goldman Sachs Global Investment Research

Some of the discount is down to sector exposure, but looking sector by sector most UK sectors are on a substantial discount to both Europe and the US. We think this reflects two factors: under-positioning in UK indices by global investors, and diminished holdings of UK equities by UK pension funds and insurance companies as they continue to switch into bonds.

Exhibit 12: Most UK sectors are on a substantial discount to both Europe and the US
MSCI Indices, GICS Level 1 sectors



Consumer Discretionary: Consumer Durables & Apparel, Consumer Services and Retailing with UK weights

Source: FactSet, Goldman Sachs Global Investment Research

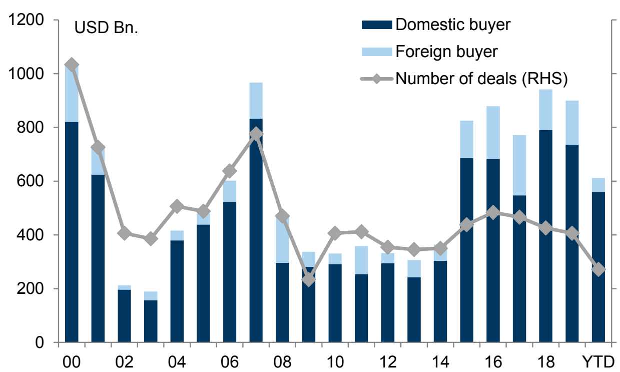
8. Investment in the UK has been lacklustre

Investment in the UK has been hit by Brexit in several ways: international investors have been reluctant to position in UK assets, M&A activity has been low and investment by UK companies has also been hit.

Recent academic research conducted by the Bank of England suggests that the level of business investment was around 11% lower by mid-2019 as a direct consequence of Brexit uncertainty. Our economists estimate that the lion's share of the Brexit drag during the three years that followed June 2016 was directly attributable to a deceleration in private-sector capital expenditure; see *European Economics Analyst: UK — Brexit vs. Covid (Paul),* 14 September 2020.

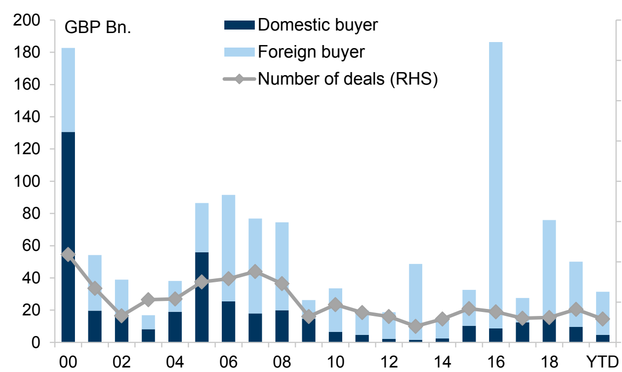
As we show in the charts below, while M&A activity has been relatively robust in the US in recent years – close to the levels since in 2007 – whereas M&A has been weaker in the UK. This is perhaps because the UK relies more on foreign buyers than most other markets and non-UK buyers have remained reticent given the lingering uncertainty over Brexit and the UK's ultimate trading relationship with Europe.

Exhibit 13: US M&A activity
Target: US listed companies; M&A volumes aggregated by completion date



Source: Bloomberg, Goldman Sachs Global Investment Research

Exhibit 14: UK M&A activity
Target: UK listed companies; M&A volumes aggregated by completion date



Source: Bloomberg, Goldman Sachs Global Investment Research

An economic recovery in 2021 combined with a trade deal with the EU agreed before the end of this year would, in our view, catalyse a catch-up for UK stocks. We continue to expect FTSE at 7,200 over 12 months.

9. How about EU stocks with UK exposure?

We see the trade deal (or lack thereof) as significantly more important for the UK than for the EU countries. We show in the Appendix a list of companies in Europe (ex UK) with high UK exposure. This list has on average just 20% UK exposure, which makes it less exposed to the UK than, say, the FTSE 100.

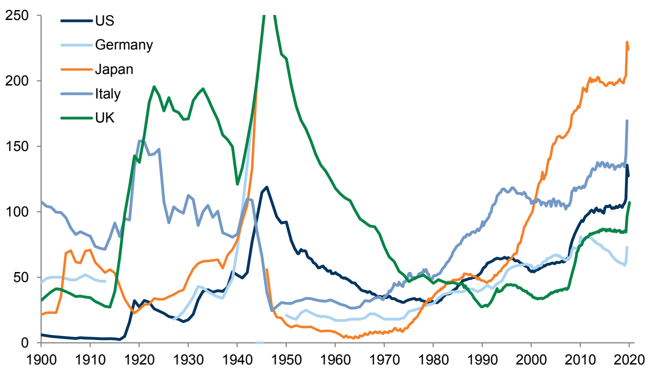
Also, in many cases these are continental European companies that own businesses in the UK, rather than, say, companies that export from Germany/France/Spain to the UK. That said, if GBP rises on the back of an UK-EU trade deal completed in the coming weeks, these companies should see a modest FX tailwind to their earnings.

10. Long-term picture for the UK — not all negative

Even assuming a zero-tariff/zero quota trade deal is agreed there is likely to be medium-term damage to UK growth, compared with the current arrangement. The EU has been the predominant destination for UK exports for more than 20 years. From a supply-chain perspective, for example, UK exporters are now twice as reliant on inputs from EU suppliers as they are on inputs from suppliers in the US and China combined.

In addition, the expenditure related to the pandemic has pushed up UK debt to GDP over 100% and our economists expect it to be sticky at that level through to at least 2024. Of course, the UK is not alone in this respect and debt to GDP is a similar level in the US and France and much higher in Italy.

Exhibit 15: Global debt/GDP ratios have increased sharply during the COVID-19 crisis

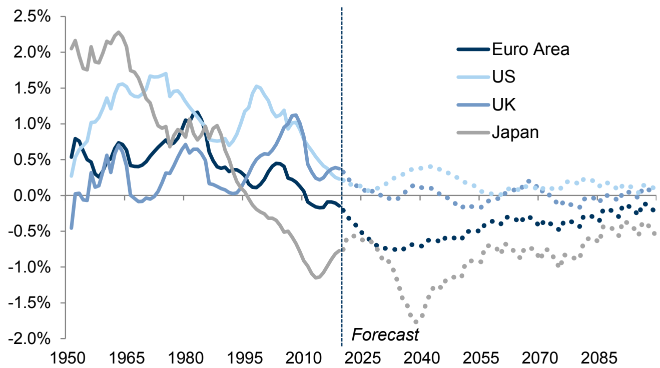


Note: Germany and Japan defaulted on their debt in WW2. Germany and Italy data are as of end of June 2020.

Source: GFD, Goldman Sachs Global Investment Research

Exhibit 16: Euro area working-age population growth is shrinking; the UK looks closer to the US

Working age (15-64) population growth yoy



Source: United Nations, Goldman Sachs Global Investment Research

Finally, in one respect the UK is more like the US than it is Euro area. Working-age population growth is set to be slightly positive in the next few years and roughly zero thereafter. In contrast, it is deeply negative in several Euro area countries; and far closer to that in Japan than we see in the UK or the US.

Appendix

Exhibit 17: Constituents of GSSTUKDE

UK Domestic Exposure (GSSTUKDE)											
Company name	Basket weights	Market cap (GBP Bn)	NTM P/E	NTM P/B	UK Sales Exposure	Company name	Basket weights	Market cap (GBP Bn)	NTM P/E	NTM P/B	UK Sales Exposure
Banks	**5.7%**					**Real Estate**	**14.3%**				
Lloyds Banking Group	2.9%	26.4	11.6	0.6	97%	SEGRO	2.9%	10.7	NM	1.2	77%
Natwest Group	2.9%	19.5	15.4	0.5	92%	Landsec	2.9%	4.9	15.0	0.7	100%
Financial Services	**2.9%**					British Land	2.9%	4.4	17.7	0.8	100%
M&G	2.9%	5.0	8.7	0.9	92%	Derwent London	2.9%	3.5	27.7	0.9	100%
Industrial Goods & Services	**8.6%**					Great Portland Estates	2.9%	1.6	30.0	0.8	100%
Travis Perkins	2.9%	3.3	15.2	1.2	100%	**Retail**	**17.1%**				
Royal Mail Group	2.9%	3.1	18.1	0.6	73%	Ocado Group	2.9%	16.6	NM	11.8	100%
Babcock International	2.9%	1.8	7.3	0.7	66%	Next	2.9%	8.7	17.5	9.7	88%
Insurance	**11.4%**					B&M European Value Retail	2.9%	4.8	14.6	6.9	91%
Legal & General Group	2.9%	15.3	8.9	1.4	94%	J Sainsbury	2.9%	4.8	11.0	0.6	100%
Admiral Group	2.9%	8.4	20.5	8.2	83%	Morrison	2.9%	4.4	12.6	1.0	100%
St. James's Place	2.9%	5.5	21.4	5.6	100%	Marks & Spencer	2.9%	2.5	12.2	0.7	91%
Direct Line Group	2.9%	4.1	11.0	1.5	100%	**Telecommunications**	**2.9%**				
Media	**8.6%**					BT Group	2.9%	12.0	6.3	0.9	84%
Rightmove	2.9%	5.4	32.4	NM	100%	**Travel & Leisure**	**5.7%**				
Auto Trader Group	2.9%	5.3	28.8	11.4	99%	Whitbread	2.9%	6.4	-61.0	1.5	99%
ITV	2.9%	3.8	9.2	3.6	70%	William Hill	2.9%	2.8	36.9	4.2	76%
Personal & Household Goods	**11.4%**					**Utilities**	**11.4%**				
Persimmon	2.9%	8.6	11.4	2.4	100%	SSE	2.9%	14.4	16.9	2.8	88%
Barratt Developments	2.9%	6.4	11.4	1.2	100%	United Utilities Group	2.9%	6.1	18.7	2.1	100%
Berkeley Group Holdings	2.9%	5.9	13.9	1.8	100%	Severn Trent	2.9%	5.7	20.1	4.6	100%
Taylor Wimpey	2.9%	5.7	11.5	1.3	100%	Pennon Group	2.9%	4.1	30.5	1.5	100%
Median		**5.4**	**15.0**	**1.4**	**100%**						

Source: Goldman Sachs Global Investment Research

Exhibit 18: Constituents of GSSTUKIE

UK International Exposure (GSSTUKIE)											
Company name	Basket weights	Market cap (GBP Bn)	NTM P/E	NTM P/B	Ex-UK Sales Exposure	Company name	Basket weights	Market cap (GBP Bn)	NTM P/E	NTM P/B	Ex-UK Sales Exposure
Banks	**6.1%**					Weir Group	2.4%	4.4	21.3	2.8	98%
HSBC	3.1%	82.5	12.2	0.6	83%	**Insurance**	**3.1%**				
Standard Chartered	3.1%	14.6	10.5	0.4	94%	Prudential	3.1%	31.6	9.2	2.1	100%
Basic Resources	**12.0%**					**Media**	**9.2%**				
Rio Tinto	3.0%	61.4	10.0	2.3	99%	RELX	3.1%	33.7	19.2	12.9	85%
BHP Group	3.0%	36.7	11.3	2.2	99%	Informa	3.1%	8.1	22.1	1.4	92%
Glencore	3.0%	28.5	14.4	1.0	98%	Pearson	3.1%	4.9	16.5	1.1	91%
Antofagasta	3.0%	12.2	23.3	2.1	97%	**Oil & Gas**	**6.1%**				
Chemicals	**3.1%**					BP	3.1%	53.3	15.7	1.0	78%
Croda	3.1%	8.3	30.0	5.8	95%	Royal Dutch Shell	3.1%	48.3	14.1	0.8	86%
Food & Beverage	**9.2%**					**Personal & Household Goods**	**12.0%**				
Diageo	3.1%	68.6	24.8	8.3	94%	British American Tobacco	2.4%	61.4	7.8	0.9	99%
Coca-Cola HBC	3.1%	8.0	18.1	3.1	100%	Unilever	2.4%	53.6	20.3	8.9	89%
Tate & Lyle	3.1%	3.0	11.5	1.9	98%	Reckitt Benckiser	2.4%	46.4	20.4	4.1	91%
Health Care	**12.0%**					Imperial Brands	2.4%	13.4	5.6	2.6	86%
AstraZeneca	3.0%	102.0	21.1	9.6	89%	Burberry	2.4%	7.0	26.8	4.8	89%
GlaxoSmithKline	3.0%	69.4	11.8	5.1	89%	**Technology**	**6.1%**				
Smith & Nephew	3.0%	12.7	19.9	3.0	94%	Aveva	3.1%	9.7	38.3	3.9	96%
Hikma Pharmaceuticals	3.0%	6.1	18.6	3.3	100%	Micro Focus	3.1%	1.2	3.3	0.3	94%
Industrial Goods & Services	**12.0%**					**Telecommunications**	**3.1%**				
Rentokil Initial	2.4%	9.1	31.0	7.2	88%	Vodafone	3.1%	33.5	16.0	0.6	85%
Rolls-Royce	2.4%	9.0	-25.4	NM	90%	**Travel & Leisure**	**6.1%**				
Melrose	2.4%	7.7	27.4	1.2	90%	Compass Group	3.1%	25.3	38.2	5.0	88%
Smiths Group	2.4%	5.8	17.9	2.4	95%	InterContinental Hotels	3.1%	8.7	45.7	NM	97%
Median		**13.4**	**18.1**	**2.4**	**94%**						

Source: Goldman Sachs Global Investment Research

Exhibit 19: Europe ex UK companies with UK exposure

Sales Exposure

Europe ex UK, high UK sales exposure					
Name	**Industry**	**UK**	**Name**	**Industry**	**UK**
Getlink	Industrials	60%	Deutsche Bank	Financials	18%
Orsted	Utilities	54%	Svenska Cellulosa	Basic Materials	18%
DCC	Industrials	48%	Aib Group	Financials	18%
Flutter Entertainment	Consumer Discretionary	40%	Evotec	Health Care	17%
Intl.Cons.Airl.Gp.	Consumer Discretionary	33%	Technogym	Consumer Discretionary	17%
Tui	Consumer Discretionary	32%	Uniper	Utilities	17%
Vidrala	Industrials	31%	Atos	Technology	17%
Mckesson Europe	Consumer Staples	29%	Netcompany Group	Technology	16%
Subsea 7	Energy	28%	Telefonica	Telecommunications	16%
Deutsche Boerse	Financials	23%	Hannover Rueck	Financials	16%
Lotus Bakeries	Consumer Staples	22%	Svenska Handelsbanken	Financials	16%
Ryanair	Consumer Discretionary	22%	Iberdrola	Utilities	16%
Banco De Sabadell	Financials	22%	Coloplast	Health Care	15%
Partners Group	Financials	22%	Sinch	Technology	14%
Kerry Group	Consumer Staples	22%	Leonardo	Industrials	14%
Boliden	Basic Materials	20%	CRH	Industrials	13%
Udg Healthcare Public	Health Care	19%	EDF	Utilities	13%
Bank Of Ireland Group	Financials	19%	Worldline	Industrials	13%
Kingspan Group	Industrials	19%	Pandora	Consumer Discretionary	13%
Sopra Steria Group	Technology	19%	Hugo Boss	Consumer Discretionary	13%
Average		**22%**			
Average STOXX Europe 600		**9%**			

Source: Goldman Sachs Global Investment Research

Exhibit 20: UK companies with Europe-UK exposure
Sales Exposure

Name	Supersector	UK	Europe ex UK	North America	APAC	Other EM
Wizz Air	Consumer Discretionary	11%	67%	5%	6%	11%
Smith (Ds)	Industrials	14%	64%	11%	0%	12%
Vodafone	Telecommunications	14%	58%	0%	2%	22%
Easyjet	Consumer Discretionary	40%	58%	0%	0%	0%
Just Eat Takeaway	Technology	32%	57%	0%	0%	10%
Tui	Consumer Discretionary	32%	56%	1%	1%	10%
Computacenter	Technology	31%	50%	15%	2%	1%
Mediclinic International	Health Care	0%	47%	0%	0%	53%
Synthomer	Basic Materials	5%	46%	7%	31%	10%
Kingfisher	Consumer Discretionary	39%	46%	0%	0%	15%
Dixons Carphone	Consumer Discretionary	55%	45%	0%	0%	0%
Smurfit Kappa	Industrials	9%	45%	29%	0%	17%
Hays	Industrials	21%	43%	6%	24%	5%
Coca-Cola Hbc	Consumer Staples	0%	41%	0%	0%	59%
Bodycote	Basic Materials	9%	39%	36%	10%	6%
Mondi	Basic Materials	3%	38%	10%	9%	40%
SSP Group	Consumer Discretionary	30%	37%	19%	9%	5%
Dechra Pharmaceuticals	Health Care	12%	36%	35%	6%	10%
RSA Insurance Group	Financials	32%	36%	27%	0%	4%
Aviva	Financials	55%	34%	5%	4%	2%
Electrocomp.	Industrials	26%	33%	26%	10%	4%
Grafton Group	Industrials	67%	33%	0%	0%	0%
Imi	Industrials	5%	33%	25%	22%	16%
Sage Group	Technology	20%	33%	34%	6%	8%
Imperial Brands	Consumer Staples	12%	32%	13%	27%	16%
Pagegroup	Industrials	19%	32%	8%	17%	25%
National Express Gp.	Consumer Discretionary	22%	31%	45%	0%	2%
DCC	Industrials	46%	30%	6%	12%	6%
Croda International	Basic Materials	4%	29%	27%	22%	18%
Associated Brit.Foods	Consumer Staples	38%	28%	6%	14%	13%
Rentokil Initial	Industrials	10%	28%	38%	16%	6%
JD Sports Fashion	Consumer Discretionary	43%	26%	27%	4%	0%
Britvic	Consumer Staples	65%	26%	0%	1%	8%
Glencore	Basic Materials	3%	25%	6%	43%	23%
Rotork	Industrials	11%	25%	23%	27%	15%
List		**24%**	**40%**	**14%**	**9%**	**13%**

Some companies are not UK domiciled but all of them are listed on FTSE 350.

Source: Goldman Sachs Global Investment Research

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Reg AC

We, Sharon Bell, CFA, Peter Oppenheimer, Lilia Peytavin, Guillaume Jaisson and Andrea Ferrario, hereby certify that all of the views expressed in this report accurately reflect our personal views, which have not been influenced by considerations of the firm's business or client relationships.

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