A turning point for UK mid-caps

Global Matters Weekly

5 December 2022

– Mark Wright, CFA — *Portfolio Manager*

So far, the year 2022 has been one that investors in UK mid-capitalisations (mid-caps) would probably prefer to forget. The first six months of this year witnessed the worst relative performance of UK mid-caps vs UK large capitalisations (caps) on a rolling six-month basis since 1986 (as far back as I could find data). By 30th June, they had underperformed UK large caps by a staggering 18%. The performance gap has since widened a little to over 19% on a year-to-date basis[1]. The absolute performance of UK mid-caps is not as stomach churning, but at -15% it is still poor.

The miserable returns are not because earnings have fallen. They have grown significantly. Profits in the first six months of this year (H1 22) were 80% higher than the first six months of 2021 (H1 21), because companies benefitted from increased demand for their products and services, as COVID-19 restrictions were loosened.

Earnings were clearly depressed in H1 21, making for an easy comparative. However, earnings in H1 22 were still ahead of the last six months of 2021 (H2 21) by 6%. If forecasts are to be believed (questionable), earnings in the second half of this year (H2 22) are expected to increase by a healthy 36% on H1 22.

So, it's clearly not earnings that are the problem. Or maybe I should be more precise with my words… it is not THIS year's earnings that are the problem. Of course, stock markets are a discounting mechanism, and all eyes are on the outlook for profits in 2023.

One needn't be a member of Mensa to see that there might be a squeeze on corporate earnings next year (higher interest rates, higher taxes, higher costs etc.) and that will no doubt be one reason why UK mid-caps, which generate a much larger percentage of revenues from the UK economy than UK large-caps, have suffered so much this year.

But have they suffered too much? We all know markets overshoot in both directions, because ultimately share price moves are the result of human behaviour which itself is victim to the uncontrollable influence of animal instincts (fear and greed).

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Fearful investors heading for the exit have crushed valuations this year by driving down share prices. At the start of 2022, UK mid-caps traded at 1.8x book value (net assets). On 12th October they traded at just 1.1x book value. That is the lowest valuation they have traded in the last two decades, matched only during the first quarter of 2009, in the nadir of the Global Financial Crisis (GFC), and in the depths of the pandemic during the first quarter of 2020.

Pricing the equity of companies at close to book value implies that investors don't believe those companies will be able to earn a return over and above their cost of equity ever again. I find that hard to believe.

There are simply too many vested interests in improving returns for shareholders. Companies do not stand still, boards and management work hard to improve returns on equity, regardless of the environment they are operating in. Over the last decade, prior to the pandemic, UK mid-caps earned a return on equity exceeding 10%, which is above any reasonable estimate of the cost of equity for a developed market such as the UK .

It is also notable that companies have much stronger balance sheets now than when they were heading into both the GFC and the pandemic. So, as is customary as we enter December, I am going to put my head above the parapet and make a prediction for 2023 (hopefully no one will remember if I am wrong). I think there is a very good chance that the market for UK mid-caps bottomed on 12th October and that returns in 2023 will be much better than they have been this year, which is why we have an overweight position in our portfolios.

Sources: [1]31st December 2021 to 24th November 2022. Unless stated, all data from Bloomberg Finance L.P.

Aside from attractive valuations and stronger balance sheets, the 4% upward move in UK mid-caps on the day of softer than expected US inflation data (10th November) warrants attention. It was the second biggest daily rise in the market this year. For the chartists out there, there is a growing number of companies with share prices now trading above their 200-day moving average. This is presently the case for almost half of UK mid-caps[2]. Less than two months ago, the figure was just one in ten company share prices.

Going back to valuations, a look at history provides further reason for optimism. If we look back at 18-month returns following similarly low valuations, such as 18 month returns from the end of Q1 2009 and end of Q1 2020, the numbers are +73% and +57%. Maybe this time is different, but that's usually a phrase that leaves people with egg on their face

Sources: [2]As of 24th November 2022. Unless stated, all data from Bloomberg Finance L.P.

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5 December 2022

The Marketplace

- Global equities returned 1.1% last week
- Most World indices saw positive returns
- Brent crude rose 2.3% to $85.57 per barrel
- Gold rose 2.4% to $1797.63 per ounce

Market Focus

US

- US equities returned 1.2% last week
- Comments from Federal Reserve chairman Jerome Powell signalling smaller interest rate hikes going forward drove U.S. Treasury yields lower this week. He also highlighted the risk of relaxing monetary policy too soon and reiterated that the peak interest rate for this tightening cycle is likely to be “somewhat higher” than previously estimated
- Data from the Bureau of Labor Statistics showed that the number of job openings declined by about 353,000 to 10.3 million—a level that was slightly below a consensus estimate for 10.4 million available positions

Europe

- European equities returned 0.5% last week, the seventh consecutive week of gains
- European Central Bank (ECB) Governing Council member François Villeroy de Galhau says the ECB should raise interest rates by 0.5% this month to help tame surging consumer prices, adding that inflation should peak during the first half of 2023
- French President Emmanuel Macron says he and Joe Biden agreed to “fix” a dispute over the U.S. president’s Inflation Reduction Act, which includes new subsidies for North American-made electric vehicles that allies have criticized
- The European Union agreed a price cap on Russian oil at $60 a barrel, paving the way for a wider Group of Seven deal. Moscow says it won’t accept the barrel price cap agreed by the bloc

UK

- UK equities returned 0.9% last week
- Swati Dhingra, the newest member of the bank’s monetary policy committee says
- The Bank of England’s benchmark interest rate should peak below 4.5% if the central bank wants to avoid deepening and prolonging a recession
- The Confederation of British Industry has warned the UK economy faces a decade of lost growth unless the government acts on investment tax reliefs, the Northern Ireland protocol, and the shrinking workforce

Asia/Rest of The World

- Global emerging market equities returned 3.5% last week
- Japanese equities fell 3.1% last week
- Chinese equities returned 8.1% last week
- Japan’s industrial production fell 2.6% month on month in October. The decline, stemmed from decreases across the production machinery, electronic parts and devices, and chemicals industries
- Chinese authorities eased COVID-19 testing requirements across major cities over the weekend as Beijing appears to be engineering a gradual shift away from its strict COVID-19 Zero policy amid elevated cases and public protests
- The Organisation of the Petroleum Exporting Countries+ alliance decided to maintain production at current levels, pausing to take stock of a global oil market that’s roiled by uncertainty over Chinese demand and Russian supply.

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5 December 2022

Asset Class/Region	Currency	Currency returns			
		Week ending 2 Dec. 2022	Month to date	YTD 2022	12 months
Developed Market Equities					
United States	USD	1.2%	-0.2%	-13.7%	-10.0%
United Kingdom	GBP	0.9%	-0.2%	8.4%	12.3%
Continental Europe	EUR	0.5%	0.7%	-8.9%	-4.5%
Japan	JPY	-3.1%	-1.6%	0.6%	4.2%
Asia Pacific (ex Japan)	USD	3.7%	0.7%	-16.5%	-16.2%
Australia	AUD	0.6%	0.2%	2.4%	5.7%
Global	USD	1.1%	0.5%	-14.1%	-10.7%
Emerging markets equities					
Emerging Europe	USD	-0.9%	-0.1%	-72.9%	-73.6%
Emerging Asia	USD	4.4%	0.6%	-20.0%	-20.4%
Emerging Latin America	USD	3.1%	-0.3%	13.1%	16.4%
BRICs	USD	6.3%	0.5%	-21.6%	-23.3%
China	USD	8.7%	0.9%	-25.1%	-27.7%
MENA countries	USD	-0.1%	-0.2%	-4.0%	-1.5%
South Africa	USD	-3.8%	-6.1%	-6.1%	-4.8%
India	USD	1.4%	-0.2%	-0.1%	0.3%
Global emerging markets	USD	3.5%	0.2%	-18.8%	-18.9%
Bonds					
US Treasuries	USD	1.5%	1.1%	-10.5%	-11.0%
US Treasuries (inflation protected)	USD	2.7%	2.0%	-9.9%	-9.6%
US Corporate (investment grade)	USD	1.7%	1.6%	-13.9%	-13.9%
US High Yield	USD	0.9%	0.8%	-9.8%	-8.4%
UK Gilts	GBP	-1.1%	-0.4%	-21.6%	-23.7%
UK Corporate (investment grade)	GBP	-0.4%	0.0%	-18.3%	-19.5%
Euro Government Bonds	EUR	0.9%	0.7%	-13.9%	-15.5%
Euro Corporate (investment grade)	EUR	0.9%	0.7%	-12.0%	-12.4%
Euro High Yield	EUR	0.3%	0.4%	-10.5%	-10.0%
Japanese Government	JPY	-0.1%	0.2%	-4.3%	-4.4%
Australian Government	AUD	1.3%	0.9%	-7.6%	-7.5%
Global Government Bonds	USD	1.6%	1.9%	-15.7%	-16.5%
Global Bonds	USD	1.5%	1.8%	-15.6%	-16.0%
Global Convertible Bonds	USD	1.8%	2.1%	-17.5%	-17.5%
Emerging Market Bonds	USD	2.4%	1.5%	-23.5%	-23.0%

Source: Bloomberg. Past performance is not indicative of future returns

Asset Class/Region	Currency	Currency returns			
		Week ending 2 Dec. 2022	Month to date	YTD 2022	12 months
Property					
US Property Securities	USD	0.7%	-0.5%	-21.6%	-15.8%
Australian Property Securities	AUD	-0.6%	-1.6%	-20.8%	-16.7%
Asia Property Securities	USD	-0.3%	-1.6%	-11.6%	-11.6%
Global Property Securities	USD	0.4%	0.0%	-21.4%	-17.4%
Currencies					
Euro	USD	1.2%	2.0%	-7.6%	-6.9%
UK Pound Sterling	USD	1.5%	2.8%	-9.3%	-7.7%
Japanese Yen	USD	3.3%	3.5%	-14.6%	-15.9%
Australian Dollar	USD	0.8%	1.3%	-6.6%	-4.2%
South African Rand	USD	-2.3%	-3.1%	-9.0%	-8.8%
Swiss Franc	USD	0.8%	1.5%	-2.8%	-1.8%
Chinese Yuan	USD	1.6%	0.5%	-9.9%	-9.6%
Commodities & Alternatives					
Commodities	USD	1.1%	-1.0%	19.5%	27.3%
Agricultural Commodities	USD	-1.1%	-1.9%	5.7%	9.0%
Oil	USD	2.3%	0.2%	10.0%	22.8%
Gold	USD	2.4%	2.6%	-1.7%	1.9%
Hedge funds	USD	0.3%	0.1%	-4.2%	-3.7%

Source: Bloomberg. Past performance is not indicative of future returns

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