TOO MUCH GLOOM HAS DESCENDED ON THE UK STOCK MARKET

By Henry Dixon

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Brexit has delivered a potent cocktail of economic and political uncertainty. From the perspective of UK stocks, this has been expressed in a record exodus from the asset class. But we believe this significant underweight in UK equities, at a time of near-record relative value, is unnecessarily gloomy.

This is because the data we have in hand regarding tax receipts is encouraging and there is the prospect that all three of the key parts of the UK economy (the consumer, the government and business) could contribute to growth in the year ahead. That is something that has not happened since before the 2008/09 crisis.

Around this time of the year, an increasing amount of data emerge regarding the tax receipts from the UK economy. For the third year in a row, the growth in tax receipts materially exceeded that of nominal gross domestic product, with the 15% rise in self-assessed income tax a particularly eye-catching feature.[1]

This growth is all the more impressive considering that there have been meaningful tax breaks for workers in the form of the personal allowance and the basic rate threshold, which have both risen approximately 10% over the past three years.

The consumer is the most important part of the UK economy. As such, when the tax receipts data cited above is complemented by record levels of employment, record job vacancies and improving wage growth, then we believe there are reasonable grounds for continuing optimism.

There are, however, two other key players in the economy: the government and business. The UK government has had a difficult balancing act since the financial crisis, owing to the record peacetime budget deficit registered afterwards. As a result, fiscal spending has made little incremental contribution to the economy.

However, over the past year, government finances have finally moved to a position whereby tax receipts more than cover day-to-day spending, for the first time since 2002.[2] The narrative surrounding the end of austerity is, therefore, supported by the relatively healthy state of public finances, which could boost economic growth accordingly.

Moving to business, recent data show an encouraging 13% increase in tax receipts, according to the Office for National Statistics. This has been achieved against the backdrop of a reduction in the rate of corporation tax. It is impossible, though, to deny the fact that business investment as a share of GDP has been on a disappointing trajectory over the past year, falling to 9.2%, according to our calculations – the lowest reading since 2013.

Here, there are three factors at play. Firstly, it is of course hard to ignore the impact that Brexit will have had on investment planning given the many possible pathways that lie ahead. Here, the hope is that some clarity can emerge, unlocking investment that has been postponed due to political uncertainties.

Secondly, some of the best-known legacy businesses of the UK are hamstrung by pension deficit payments.

For example, BT Group, the telecoms company, has to pay more than GBP1 billion every year to top up its pension fund. This figure represents almost 5 basis points of UK GDP.[3] If this were to be spent on an accelerated roll-out of a better broadband network, for example, not only would there be more investment spending, but there would probably be a boost to the broader economy too.

Only in the fullness of time will we know whether the current set of actuarial assumptions, which require these top-up payments to be made by so many companies, are tilted too favourably towards pensioners.

Recent mortality trends would definitely lend some weight to this argument; the assumed increase in longevity within current estimates has failed to come to pass so far.[4] But if our life expectancy is increasing less than expected, so is the potential future payout a company will be required to make.

Finally, the rate of business creation is at a higher level than before the crisis. We therefore need to think in a more nuanced fashion about the contribution to the economy from a typical start-up business today. Investment could mostly be in people, rather than plants and equipment.

The salaries paid to staff will be captured in the GDP calculation, but in the event that the company loses money, then this is a debiting item from the calculation of economic output. So the contribution from a new venture could be a negative one. This not only wholly underestimates the contribution to the economy from the entrepreneurs of today, but it also clearly lacks economic reality.

Since 2016, the narrative about the UK economy and UK stocks, too, has been persistently downbeat. This is now unjustified in our view. Encouraging tax receipts data and the possibility of consumers, government and the business world all contributing to growth now provide hard evidence to help challenge the tale of doom.

1. http://moneyage.co.uk/HMRC-figures-show-rise-in-number-of-self-assessment-receipts.php
2. https://www.independent.co.uk/voices/editorials/spring-budget-balanced-say-to-day-spending-deficit-debate-on-public-spending-a8250721.html
3. https://www.btplc.com/Sharesandperformance/Annualreportandreview/2018summary/documents/financial_statements.pdf
4. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/786515/Recent_trends_in_mortality_in_England.pdf

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IMPORTANT INFORMATION

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