VT Lyndon Fund

Quarterly Commentary 30th June 2023

ContraCapital

Global equity markets were a little less disorderly in Q2 than they had been in Q1, with the rash of banking failures seen in March not proving to be contagious or to foreshadow anything more systemically threatening. Not yet at least. US equities were notably strong again, with Big Tech very much back in favour after last year's sell-off. However, the very best performing major equity market year-to-date has been Japan, which after many, many years of disappointing its numerous contrarian fans by resolutely failing to rally, has suddenly sprung to life. Another few strong quarters and the Japanese equity index may even threaten its all-time high which, astonishingly, it hit as far back as 1989. These 'lost decades' for Japanese investors have far more to do with the starting valuation in 1989 than with the country's subsequent economic performance, which has really not been all that bad. After one of the greatest bubbles in investment history, by 1989 the Japanese equity market was trading on a price-to-earnings ratio of over 60, accounted for about 50% of the global stock market by value and featured 8 of the 10 largest companies in the world by market capitalisation. Whilst valuations in the US now look decidedly stretched versus historical norms, they are a long way shy of the lunacy of 1980s Japan.

European equity markets, including the UK, have been relative laggards this year and were typically flat to slightly down in Q2. The pall of gloom hanging over the UK equity market darkened, as during the quarter the Bank of England twice raised the Base Rate, first by 0.25% in May and then by 0.50% in June. This took the benchmark rate to 5.00%, up from just 0.25% at the start of 2022. Assumptions regarding where UK interest rates are ultimately headed also rose further, and the 10-year gilt yield increased by 0.9% to 4.3%, with this rate having been below 1% at the beginning of last year. Mortgage rates have moved correspondingly upwards, with the average two-year fixed rate available in the market now well north of the 6% level that was briefly breached during the Truss derangement.

Those areas of the market perceived as most sensitive to interest rates, such as the construction sector or economic segments driven by discretionary consumption, were generally softer during the quarter. With names like Grafton Group, SIG, Forterra, Headlam, Travis Perkins, Kingfisher, ScS and Wickes on the portfolio, the Fund is not short of such exposures. However, the drag from a large number of stocks in this part of the portfolio was almost precisely offset by a smaller number of holdings that generated very strong returns, such that the Fund was flat over the quarter (-0.1% return for the B Acc units). A particular standout was 888 Holdings, a position we added to during the quarter, which was up by +90%. This did, though, follow a sharp decline in Q1 and a torrid 2022. Further volatility in this name can be expected.

In spite of the significant headwind of rising interest rates, it is notable that some of the portfolio's best performing holdings year-to-date, such as Marks & Spencer and its peer, Next, are exactly the sort of interest rate sensitive, consumer-facing stocks that should be suffering in current conditions. Perhaps they were just too cheap to begin with.

3 PMs, 4 Chancellors and a Funeral

There continues to be no shortage of such cheapness available in the UK equity market, with a recent piece of strategy research from Morgan Stanley observing that investor pessimism around the UK economy is so deep that the nation's stocks and credit are now the cheapest globally. Our chums at Morgan Stanley conclude that the extremely poor sentiment and rock bottom valuations that obtain in the UK market represent an investment opportunity. After all, when something is really, really bad, whilst it can always get worse, the scope for it to improve is much greater. To put it another way, the upside for markets and stocks that are widely despised and lowly rated is greater than the downside.

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UK Equities Are Among World's Cheapest

Source: Bloomberg

When observing the UK market many other investors continue to draw precisely the opposite conclusions from the same set of objective facts. For instance, a recent article on Bloomberg cited a strategist at the giant asset manager, Blackrock, who agreed that 'It's a cheap market' but 'we're not overweight despite the cheap valuations.' In some ways this seems hard to fathom, but then those that remain pessimistic on the UK's prospects are not short of ammunition as, over recent years, bad has almost inevitably tended to go to worse. Or, to put it more bluntly, those who have eschewed the UK market have been right to do so.

At some point, though, valuation gravity does tend to assert itself, the elastic can only be stretched so far. Another investor quoted in the Financial Times said of the UK market that 'companies here are 20 to 30 per cent cheaper than their rivals overseas but they are not 20 to 30 per cent worse.' And, if anything, that is to understate the valuation discount, as shown in the chart above. Valuation anomalies such as these ultimately get arbitraged away one way or another.

Alternatively, and bear with me here, things might even begin to improve in the UK. After the end of the quarter we have just had the first positive inflation surprise in many months, with CPI coming in at 'only' 7.9% in the 12 months to June, an unexpectedly large drop from the 8.7% reported the previous month. Inflation running at nearly 8% (and well ahead of earnings growth) scarcely merits breaking out the cake and party hats, but the marginal improvement versus expectations was sufficient to drive the biggest weekly gain in the UK equity market since January. Good or at least slightly less bad news tends to have an outsized positive effect when it collides with beaten down sentiment and depressed valuations.

In terms of good or at least incrementally less bad news, we are surely nearing the increasingly bitter end of this singularly inadequate government. The restoration of some base level of governmental competence can only improve the market's mood music and will likely be a more significant positive for some sectors in particular. Very low levels of investment are a long-standing and deep-seated problem for the UK economy and this has undoubtedly been exacerbated by the profound lack of stability and predictability in regulation, taxation and international relations that the UK has suffered over the last decade or so. Business leaders are always going to be less inclined to invest when they lack confidence in the returns that will be generated on that investment. A country that has had three Prime Ministers, four Chancellors and four Budgets in 12 months, seen tax policy all over the place and relations with its main trading partners deliberately shredded, is never going to top any polls for investment allure.

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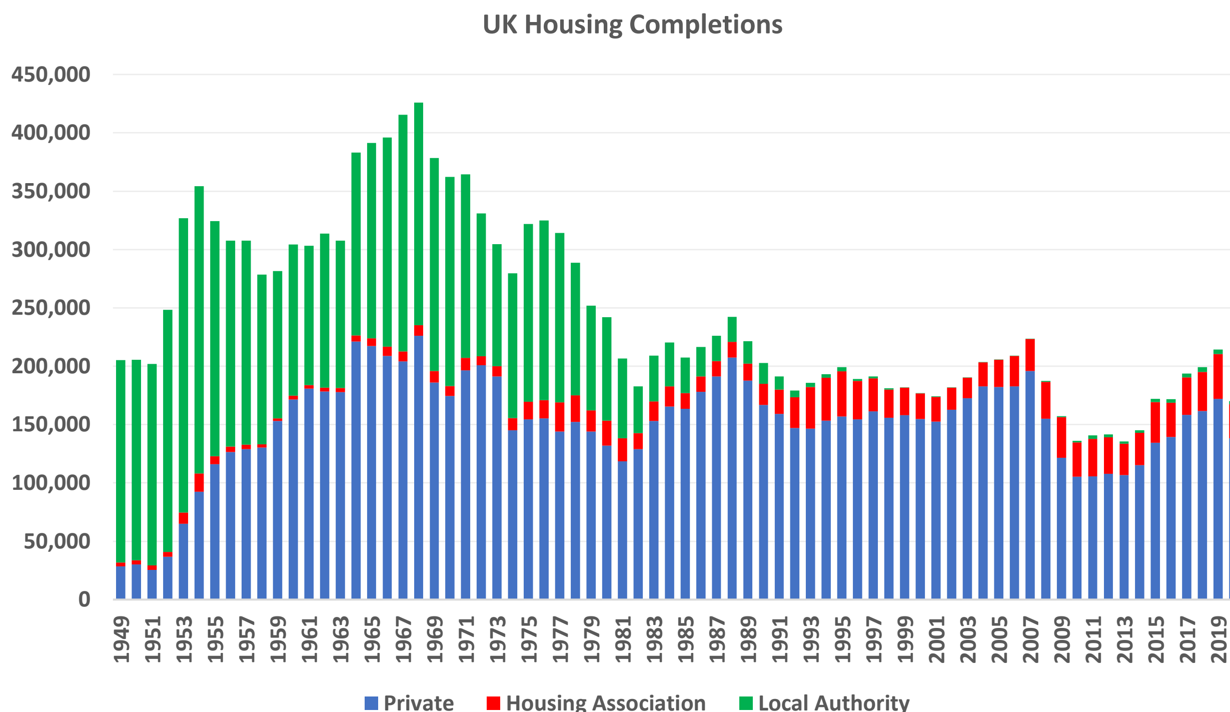
No one is at risk of getting overly excited by the prospect of a Starmer government, which is both just as well and precisely the point. A dearth of excitement is very much not what has been holding back the UK's economy and equity markets. Dull, plodding predictability in a government are decided virtues as far as financial markets are concerned. Strong and stable beats weak and wobbly every time.

There is one policy area, and perhaps it is the only one, where Starmer has adopted what Sir Humphrey Appleby might characterise as a 'brave' position. Starmer has pledged (yes, I know) to substantially boost housebuilding by bringing back mandatory housing targets, forcing landowners to sell their land cheaply to local authorities and building on green belt land where appropriate. It is the last bit that is uncharacteristically 'brave' / controversial, but this has not only been committed to, but also very recently reiterated. The anti-growth coalition centred in Number 10 Downing Street is naturally dead set against the much-needed expansion in housing supply and the 'trampling on' of the sacred green belt. No one should tell them that only 45% of the green belt is, in fact, green with much of that being monoculture farmland too harsh for most wild plants to survive.

Multiple successive governments have targeted the building of 250,000 new houses per year, but as shown below, none of them have come close to hitting this number in decades. The last time that the UK did manage to build more than 250,00 houses? Why, it was 1979, of course. The truth is that the UK has never managed to build more than 250,000 homes in a year, never mind Labour's current target of 300,000, without the government taking a very active hand in the market. Whether a Labour leadership seemingly afraid of its own shadow would have the requisite bravery in office to follow through remains to be seen, but should it do so it would be a real boon to the UK economy. More than that, though, it would likely be hugely beneficial to our portfolio, given that it is heavily stacked with very cheap construction stocks that are absolutely not discounting any such possibility.



Source: UK Government

(Source for equity returns and index movements is S&P CapitalIQ and are quoted in local currency unless otherwise noted).

David Lynch, Fund Advisor, VT Lyndon Fund, July 2023

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