Special Coverage:

Market uncertainty and cyclical headwinds weigh on UK stocks

Key takeaways

- Gilt yields have spiked sharply, and although the Bank of England (BoE) has stepped in to try to calm markets, volatility remains elevated. The concern over inflation should lead to continued rate hikes.
- The major tightening of financial conditions should have a quite negative effect on growth, consumer and business confidence, and weigh on companies' profits. In addition, it will take time to repair investor confidence regarding UK assets. Lastly, further GBP weakness is likely to take a toll on returns for foreign investors. We downgrade UK stocks to underweight.
- As a result, this leads to an underweight on global equities, adding to the risk reduction measures we've been taking by focusing on quality, sticking to a defensive sector exposure, and (in the Eurozone and UK) preferring large cap stocks.

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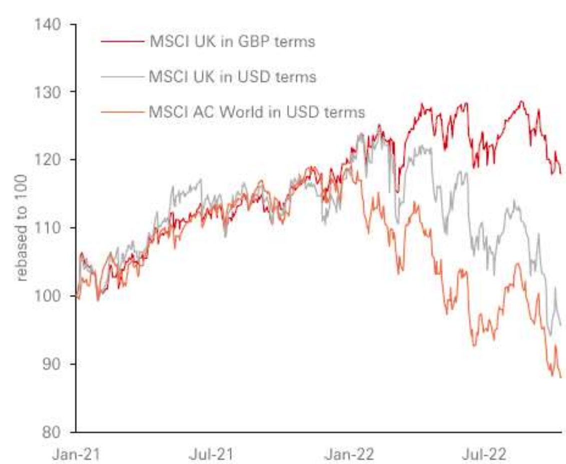
A challenging outlook for the UK assets

- Financial conditions have tightened dramatically for the UK as the gilt market struggles to cope with the selling pressure from the pensions industry and Liability Driven Investment (LDI) strategies.
- Since gilt yields rose and volatility surged after the government's "mini budget", the BoE has stepped in with broad government bond purchases that calmed but did not heal the underlying problems. This Scheme was due to end on 14 October.
- The Pensions and Lifetime Savings Association stated that the pension industry is not yet ready for the BoE to stop intervening in the market, arguing that those in the industry were calling for an extension until at least the end of the month.
- BoE Governor Bailey responded that as far as bond purchases go "we will be out by the end of this week. We think that the rebalancing must be done". Following his comments GBP/USD fell below $1.10 and gilt yield volatility remains exceptionally high.
- It has been reported that the BoE may continue to intervene to prevent a liquidity crisis in gilts. It seems entirely reasonable that, when push comes to shove, the BoE is likely to find ways to ensure that the gilt market functions, even after the October 14th deadline.

The global exposure of the UK index benefits from GBP weakness, but the rapidly deteriorating UK economy should increasingly weigh on stocks



Source: HSBC Global Private Banking and Wealth as at 12 October 2022. Past performance is not a reliable indicator of future performance.

- We think that the BoE will conclude in their early November monetary policy meeting that a more hawkish fiscal policy is needed in the face of the increased fiscal loosening next year.
- Markets and economists around the world are increasingly concerned about the effect of monetary tightening on economic growth. With mortgages rates now hovering around 6% in the UK, consumer spending is likely to be negatively impacted, and GBP is at risk of further weakening. GDP growth fell 0.3% in August and we think that such aggressive tightening in financial conditions risks a harder landing for the UK economy.

Investment Implications

- We now see the risk to UK equities more firmly to the downside. **We therefore move our tactical weighting to an underweight and move the funds to cash.** We have a preference for more defensive sectors and energy within the globally focused FTSE 100 index.
- **For gilts**, in the long run we expect that slowing UK growth next year will eventually lead to falling yields. But in the near term, the market is too volatile to take a strong directional position so we stay on the sidelines for now.
- **The risks to GBP remain to the downside** as it will take time for confidence to return, and some of the current weakness is also a consequence of the continued strength of the USD. Against a broader basket of currencies, GBP hasn't yet reached previous lows, which it could test as the economic climate becomes more strained.

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