Global Product Solutions – EMEA Investment Strategy

BlackRock.

UK assets: unlocking growth

November 2024

Quick read

We see value across UK assets – our highest-conviction call in Europe. A favourable UK macro backdrop, improving consumer confidence and attractive valuations present opportunities for investors, in our view.

In equities, we look to skilled alpha-seeking managers to unlock growth opportunities in the UK across different market cap segments. We like index solutions for building portfolio resilience through exposure to UK large caps.

In bonds, we see a favourable backdrop for gilts and sterling credit. Both offer attractive income opportunities and could be undervalued in the current environment.

Contributors

GPS EMEA Investment Strategy

Fundamental UK Equity

Fundamental Fixed Income

ETF & Index Equity Product Strategy

EMEA Product Distribution

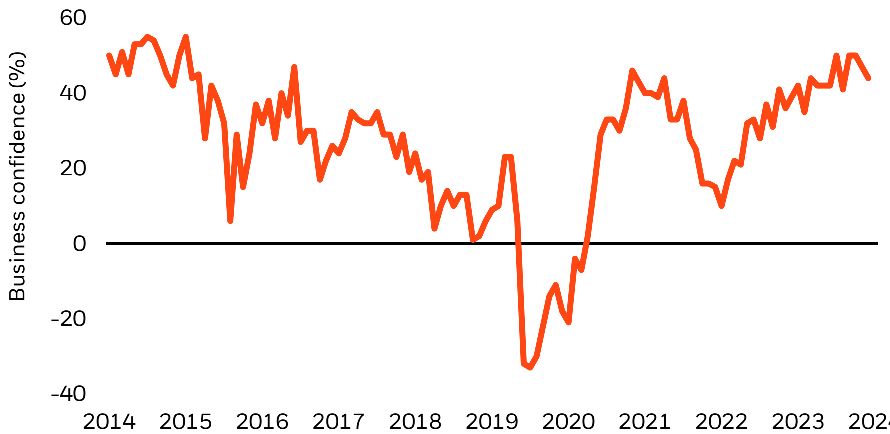
We see compelling opportunities in UK equities and bonds. In equities, our view is underpinned by greater political certainty, attractive valuations and deep value within the UK market. At the same time, the Bank of England (BoE) has begun its cutting cycle – with disinflation remaining a key theme, we think the case for gilts and sterling credit has strengthened. Below, we lay out the case for UK assets in the current environment, with implementation ideas across alpha-seeking and index exposures.

Better days ahead?

The outlook for the UK has brightened off the back of greater political certainty and a stronger macro environment. On the political front, Labour's large parliamentary majority following the July general election has removed a key layer of uncertainty for UK companies. The UK's political environment was volatile previously – the average tenure of a government minister had been just eight months since 2019, down from an average of close to three years in 2010.[1] We now see scope for political stability, coupled with an appetite to invest in infrastructure and long-term capex. The Chancellor's Autumn Budget cleared up a further layer of uncertainty for UK companies. While changes to National Insurance, inheritance tax, capital gains tax and public sector funding were announced, the government also unveiled plans to free up fiscal headroom. Overall, we'd expect the higher level of spending to be a net benefit for the UK economy. We maintain our positive view on equities, as well as gilts and credit for their income potential.

The economic outlook also appears brighter. UK consumers are seeing real wage growth for the first time since late-2021,[2] while inflation has fallen below target – UK CPI registered at 1.7% YoY in September.[3] Inflation on items that directly impact households, such as food, has returned close to pre-pandemic levels (1.6% YoY In September), while energy inflation has been declining and in negative territory since March (-0.9% YoY in September).[4] Meanwhile, the BoE's cutting cycle looks to be well-priced by markets, and we expect the central bank to cut at a quarterly pace going forward. This should help boost business confidence, which has already recovered significantly from turbulence since 2022 – see chart 1.

Chart 1: UK business confidence, 2014 – October 2024



Source: Bloomberg and Lloyds Bank Commercial Banking, as of 25 October 2024.

1 Source: The Guardian, 17 March 2024. **2, 3, 4** Source: Bloomberg, as of 23 October 2024.

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1 UK equities: combining alpha and index solutions

We see multiple portfolio roles for the UK equity market. UK equities have been largely unloved by investors, opening pockets of deep value within the exposure. We see UK large caps adding defence in portfolios, helping to manage key risks such as global equity tech sector concentration and the potential for a global trade slowdown. UK equities have been relatively unloved, with $16.8 of outflows from active funds globally over the last 12 months (25.4% of AUM),[5] although UK equity ETPs have seen a slight pickup in sentiment, with $2.5B of global inflows YTD after $0.5B of outflows in 2023).[6] With overall positioning still relatively light, we think there is room for allocations to the UK to increase, and changes in the market could attract domestic and international interest.

Unlocking value through alpha solutions

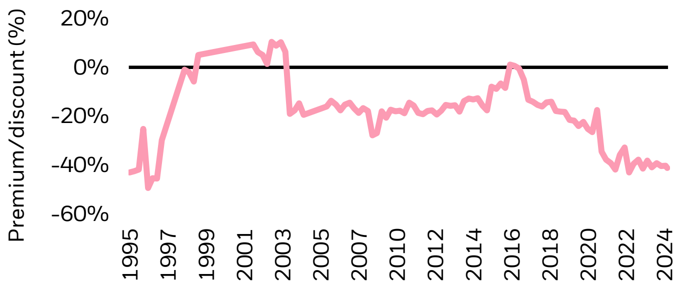
We favour an alpha-seeking approach to target undervalued and attractive UK businesses. High shareholder returns through increased buybacks, attractive valuations and macro strength make for a supportive backdrop. Our UK Fundamental Equity team also looks to identify companies that are led by strong management teams, hold leading market positions and offer durable cash-flow generative businesses.

In the small and mid caps (SMID) space, we're cognisant that overall analyst coverage remains low relative to large cap peers. For example, just four sell-side analysts cover the average SMID, versus 18 for large caps.[7] This coverage gap opens room for skilled, experienced managers to gain an edge, in our view.

UK equities are attractively valued. UK large caps trade at a 40% discount to developed market (DM) equities – see chart 2 – while SMIDs currently trade below their 10Y averages on a 12-month forward P/E basis.[8] We're seeing increased interest in the region in the form of M&A, where transaction volume has risen to $443.9B across 5,052 deals YTD, compared to $396.2B across 5,645 deals in 2023 overall.[9]

Structural changes within the UK pension market could offer a further boost. The government has continued to review the UK pension funds industry, with an aim of directing more investment into UK businesses. Only 2% of UK pension fund assets are currently invested in UK companies – with advocates hoping reforms could bring £1T of productive investment into UK companies and increase both domestic and international allocations to UK equities.[10]

Chart 2: MSCI UK 12m forward P/E premium/ discount vs. DM equities (MSCI World), 1995 – October 2024



Source: Bloomberg, as of 28 October 2024.

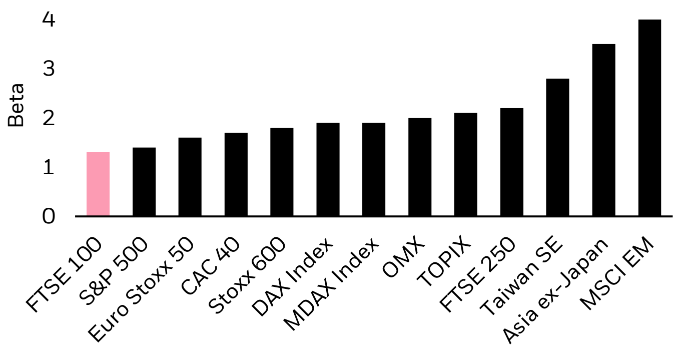
The Chancellor's Mansion House speech in November 2024 also announced plans to merge local government pension schemes, creating 'megafunds' to unlock £80B of investment for infrastructure and business.[11] The plan could reduce costs for funds to invest in large investment projects, potentially increasing productive investment.

We see compelling opportunities in areas including homebuilders, brick manufacturers and select consumer companies. UK housebuilding has had a tough few years – housing starts are currently at their lowest since 2020, at similar levels to the GFC.[12] Trading within this sector has also been depressed. We think green shoots could emerge thanks to lower interest rates and ambitious government targets to build 1.5m houses over the next five years.

We see scope for consumer confidence and spending to rise, given continuing improvements in disposable income and real wage growth. We look to businesses in the leisure sector to take advantage of this trend, especially as select companies report positive outlooks.

We like index exposure to UK large caps to build defence against risks of a tariff-driven global trade slowdown and tech concentration in US equities. UK large caps offer a relatively diversifying sector makeup, with significant weighting to sectors like consumer staples (17.7%) and healthcare (12.1%).[13] Tech makes up less than 1% of the FTSE 100, with a 0.2 correlation to the Magnificent 7 mega-cap tech stocks from 2020 to now.[14] Large-cap UK equities also offer a hedge against global trade developments: the beta of UK equity market returns to changes in world trade is the lowest among DM equity indices – see chart 3. Services-heavy UK exports are also more shielded from a potential increase in global goods tariffs.

Chart 3: beta of equity returns to world trade growth across global markets, 1997 – July 2024



Source: Datastream, WorldScope, Goldman Sachs Global Investment Research, July 2024.

	BlackRock UK Equity Fund	***Broad UK exposure***
	BlackRock UK Income Fund	***UK large cap focus***
ISF	**iShares Core FTSE 100 UCITS ETF**	***UK large cap exposure***

References to specific investments are for illustrative purposes only and are not intended and should not be interpreted as recommendations to purchase or sell such investments.

5 Source: Liberum, as of 31 October 2024. **6** Source: BlackRock and Markit, as of 6 November 2024. **7** Source: JP Morgan, Bloomberg, Factset, January 2022. **8, 13-14** Source: Bloomberg, as of 28 October 2024. **9** Source: Bloomberg, as of 28 October 2024. Based on the FTSE 250 (mid-caps) and MSCI UK Small Cap Index (small caps). **10** Source: "Pension reform is the key to unleashing investment boom and turning round stock market", The Guardian, as of 21 July 2024. **11** Source: FT Adviser, as of 14 November 2024. **12** Source: Bloomberg and Dept for Communities and Local Government, as of 28 October 2024.

2 Seeking income in UK bonds

The outlook for UK fixed income remains bright, despite recent volatility as markets have digested spending and debt issuance announcements following the Autumn Budget in October. This has particularly come through in the gilts market, as higher borrowing concerns have hit sentiment.

In gilts, we look to lock in attractive income at the front end. Post-Budget, we think the rise in front-end yields has opened an attractive entry point into the exposure. While the Budget has the potential to boost growth and inflation in the near term, we think it's unlikely to change the BoE's cutting path. We feel more comfortable in short-duration gilts over US Treasuries. We think valuations in the long end also look cheap – the 10Y gilt-to-bund spread remains elevated, at levels near the 2022 Mini-Budget – see chart 4. This reaction seems overdone, in our view, and we'd look to take advantage of this opportunity. Investor appetite has also picked up for gilts: investors have already added $3.0B to UK gilts ETPs globally this year, putting 2024 on track to be the second-highest inflow year on record.[15]

Chart 4: 10Y gilts-to-bund spread, 2019 - October 2024

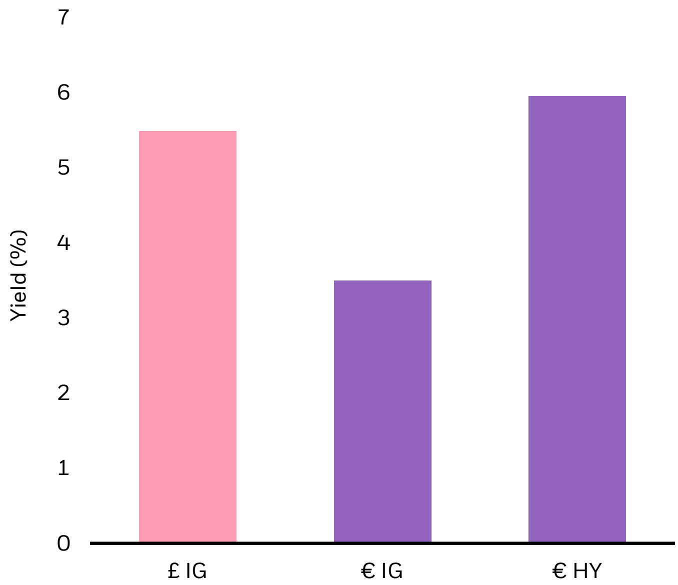
Source: Bloomberg, as of 4 November 2024.

Sterling corporates have emerged as one of our high-conviction credit trades, offering a compelling relative value proposition compared to their USD and EUR counterparts at a time of elevated yields but historically tight spreads.

The macroeconomic environment and strong fundamentals further bolster the case for sterling corporates. Despite global economic uncertainties, the UK market has shown resilience, supported by a robust regulatory framework and a proactive monetary policy stance from the BoE. This creates a favourable backdrop for sterling corporate bonds, in our view. Additionally, the fundamentals of sterling corporates remain strong, with many issuers maintaining solid balance sheets and healthy cash flows. The default rate is currently below 2%, significantly lower than the historical average and below EUR and USD exposures (3.9% and 3.3%, respectively, for FY24), indicating strong credit quality.[16] Despite the shallower market depth compared to peers, the ongoing demand from bulk annuity purchases and institutional investors has provided a stable demand base, offering continued support for the market.[17]

The most attractive characteristic of sterling investment grade (IG) is the yield profile, which is closer to EUR high yield (HY) bonds than EUR IG bonds – see chart 5. Sterling IG at the index level also has a higher tilt to financials (34%) than USD (22%) or EUR exposures (31%), which is our favoured sector exposure in the space.[18] We see sterling credit as an additional income generator in portfolios, preferring shorter-duration maturities in the current environment.

Chart 5: sterling IG yield vs. EUR IG and EUR HY, October 2024



Source: Bloomberg, as of 18 November 2024.

IGLT	**iShares Core UK Gilts UCITS ETF**
	BlackRock Sustainable Sterling Short Duration Credit Fund
	BlackRock Corporate Bond Fund

References to specific investments are for illustrative purposes only and are not intended and should not be interpreted as recommendations to purchase or sell such investments.

15 Source: BlackRock and Markit, as of 6 November 2024. **16** Source: Goldman Sachs, as of 17 October 2024. **17, 18** Source: Barclays, as of 18 October 2024.

BlackRock UK Equity Fund
The Fund is actively managed and the investment adviser (IA) has discretion to select the Fund's investments. In doing so, the IA will refer to the FTSE All-Share TR Index (the "Index") when constructing the Fund's portfolio, and also for risk management purposes to ensure that the active risk (i.e. degree of deviation from the index) taken by the Fund remains appropriate given the Fund's investment objective and policy. The IA is not bound by the components or weighting of the Index when selecting investments. The IA may also use its discretion to invest in securities not included in the Index in order to take advantage of specific investment opportunities. However, the geographical scope of the investment objective and policy may have the effect of limiting the extent to which the portfolio holdings will deviate from the Index. The Index should be used by unitholders to compare the performance of the Fund.

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BlackRock Sustainable Sterling Short Duration Credit Fund
The Fund is actively managed. The IM has discretion to select the Fund's investments and is not constrained by any benchmark. 3 Month SONIA compounded in arrears + 1.5% should be used by unitholders to compare the performance of the Fund. Compounding in arrears is a methodology that compounds daily values of the overnight rate throughout the relevant term period (i.e. 3 Months). The Fund's carbon emission intensity score is measured against the Index.

BlackRock Corporate Bond Fund
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Risk Warnings

Investors should refer to the prospectus or offering documentation for the fund's full list of risks.

Capital at risk. The value of investments and the income from them can fall as well as rise and are not guaranteed. Investors may not get back the amount originally invested.

Past performance is not a reliable indicator of current or future results and should not be the sole factor of consideration when selecting a product or strategy.

Changes in the rates of exchange between currencies may cause the value of investments to diminish or increase. Fluctuation may be particularly marked in the case of a higher volatility fund and the value of an investment may fall suddenly and substantially. Levels and basis of taxation may change from time to time and depend on personal individual circumstances.

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iShares Core FTSE 100 UCITS ETF GBP (Acc)
Concentration Risk, Counterparty Risk, Equity Risk

iShares Core UK Gilts UCITS ETF GBP (Dist)
Counterparty Risk, Credit Risk, Liquidity Risk

BlackRock Sustainable Sterling Short Duration Credit Fund
Combined Credit and Non-investment Grade Risk, Counterparty Risk, Credit Risk, Derivatives Risk, ESG Screening Risk (ETF), Liquidity Risk

BlackRock Corporate Bond Fund
Counterparty Risk, Credit Risk, Derivatives Risk, Liquidity Risk

BlackRock UK Equity Fund
Concentration Risk, Counterparty Risk, Equity Risk, Smaller Company Investments

BlackRock UK Income Fund
Concentration Risk, Counterparty Risk, Equity Risk

Description of Product Risks

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Investment risk is concentrated in specific sectors, countries, currencies or companies. This means the Fund is more sensitive to any localised economic, market, political or regulatory events.

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