Trade Booster

23 July 2014

Valuation premium of UK mid-caps over large-caps at risk. Hedge!

Summary

- **Robust domestic demand and entrenched inflation risk pressuring UK bond markets. The slowing growth effects of rising bond yields will work ahead of any action taken by the BoE.**
- **Most at risk are UK mid-cap stocks. High valuations and strong domestic exposure to UK's interest rate sensitive sectors are putting pressure on the FTSE 250.**
- **Asset allocations out of fixed interest and into large-cap dividends stocks may work in favor of the FTSE 100. Its dividend beats inflation on growth and bonds on yields.**
- **Investors who share this sentiment may consider the following Boost ETPs: *(www.boostetp.com/products)***

Short UK mid-cap equities:

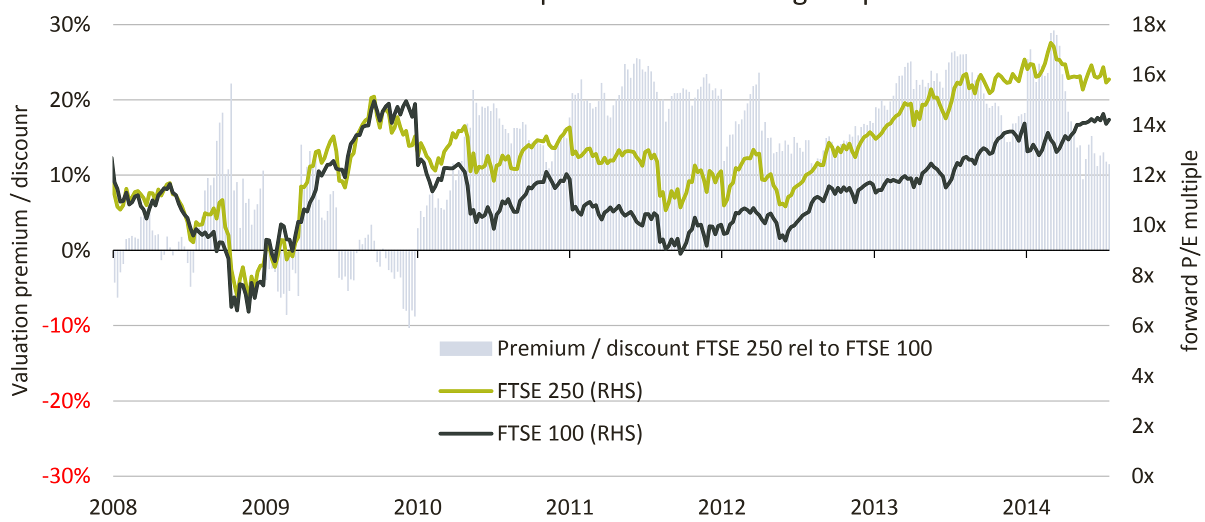
1. **Boost FTSE 250 1x Short Daily ETP (1MCS)**

Long UK large-cap equities:

2. **Boost FTSE 100 3x Long Daily ETP (3UKL)**
3. **Boost FTSE 100 2x Long Daily ETP (2UKL)**

Chart 1: Overrated growth stocks in the UK

Premium valuations of UK mid-caps relative to UK large-caps



source: Boost ETP research, Bloomberg. Data as at 18 July 2014

The risks to UK mid-cap stocks are rising. Driving this are rising interest rates in the UK as the bond market adjusts to robust domestic demand-led growth and inflation becomes more entrenched. Coming ahead of potential action by the BoE to reverse exceptionally accomodative monetary policy, the impact of rising bond yields may initially curtail UK growth expectations. This undermines the valuation premium of mid-cap equities. Inflationary pressures may set in motion asset allocation shifts out of UK fixed income and into UK dividends, favouring large-cap equities.

Investors who share this sentiment may consider the following long equity ETPs:

Short UK mid-cap equities:

1. **Boost FTSE 250 1x Short Daily ETP (1MCS)**

Long UK large-cap equities:

1. **Boost FTSE 100 3x Long Daily ETP (3UKL)**
2. **Boost FTSE 100 3x Long Daily ETP (3UKL)**

Following the recovery of global equity markets in 2009, UK mid-cap equities have produced strong returns in recent years. The FTSE 250, which captures the UK mid-cap equity market, has risen more than 88% since 2010 (to 18 July 2014), almost twice the increase of the FTSE 100 (UK's large-cap equivalent, which rose 46% in the same period). Much of the UK mid-caps' strong showing came in the last two years, as the FTSE 250 rose by 26% in 2012, and 32% in 2013. However, too much UK growth may now be priced into the UK mid-cap equity market.

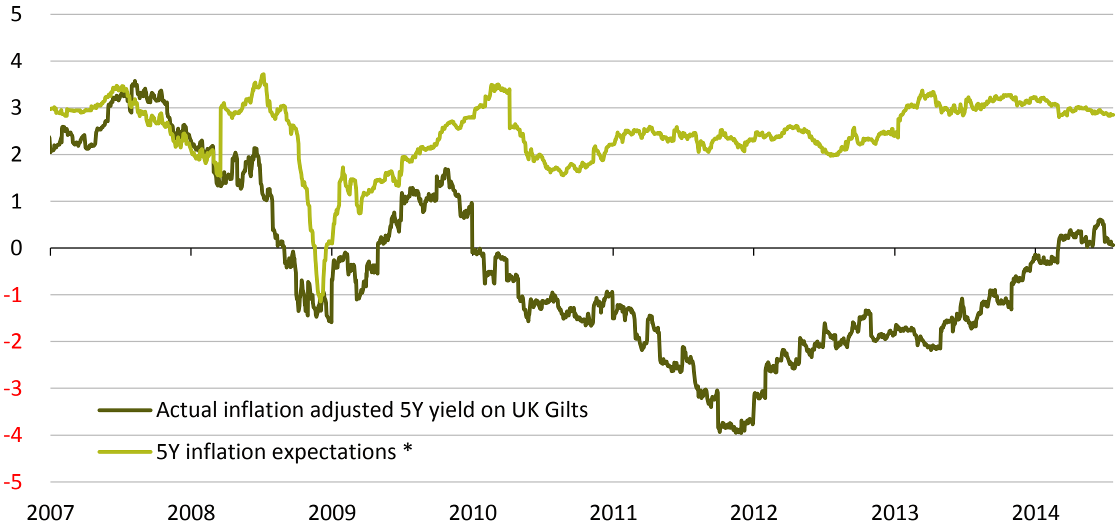
At 16x forward earnings, (a valuations multiple capturing growth expectations in equities), the valuation of the FTSE 250 looks rich (see chart 1 on previous page). Apart from the fact that these valuations are high relative to its own history and trade at an 11% premium to the FTSE 100, the strong growth expectations for the UK economy are undermined by risks of rising interest rates. What accompanied the UK's economic performance since 2010 was the extraordinarily accomodative monetary policy. This occurred even while indications of weakening inflationary pressures, such as seen in the US and the Eurozone, remained largely absent in the UK. In fact, whilst in 2012 the average monthly readings of UK CPI was 2.8% (y-o-y), in 2013 inflation did not fall below the 2% implicit target aimed at by most central banks of Western economies today. Holding back the decision to raise interest rates was sluggish recovery in employment, which has resulted in the UK's base policy rate remaining unchanged at 0.5% since 2009. However, following several years of subdued growth rates, economic growth accelerated in 2013 driven by marked negative real interest rates that incentivised businesses and households to spend.

The extent of the UK's negative real interest rate environment cannot be overstated. For instance, when adjusting for inflation, the average yields on 5-year UK Gilts were -2% in 2012 and -1.3% in 2013 (see chart 2). This is much lower compared to equivalent inflation adjusted yields in the US (-1.4% in 2012 and -0.3% in 2013) or Germany (-1.5% in 2012 and -0.9% in 2013). The exceptionally accomodative monetary policies (think of the Funding for Lending Scheme to support businesses and the Help to Buy schemes to support households, coming on top of the low UK base policy rate of 0.5%) have spurred domestic demand led growth in the UK over the last two years. Reflecting this strong economic rebound has been the marked outperformance of UK mid-caps over UK large-caps in recent years.

But a u-turn in the UK's interest rate cycle risks cutting the momentum in the UK's mid-cap equity market short. Tentative signs of this are evident from the rise of long dated UK Gilt yields since 2012 which in nominal terms have risen approximately 100 bps and in real terms have more than tripled. For instance, when adjusted for the actual inflation rate, the yields on long dated UK Gilts have been back in positive territory effectively since March 2014, a marked reversal from the persistent negative real interest rate environment that prevailed in the UK since 2010. However, against the backdrop of the improving fundamentals on which UK's economy is now enjoying broad-based growth, the bond yields in the UK look too low for comfort. An ndication of pressures mounting on UK interest rates to rise further is the robust demand for UK government inflation-linked securities (ILS). Given the positive nominal yields of UK Gilts (of approx. +2%), the negative real yields of 5 year ILS (of

Chart 2: A Return of higher growth and higher inflation

Inflation expectations vs real interest rates in the UK



Source: Boost ETP Research, Bank of England, Bloomberg. Data as at 18 July 2014
* 5-year yield differential between UK Gilts and UK Inflation-linked securities

approx. -0.9%) suggest a 5 year forward-looking inflation rate of close to 3%[1]. Hence, investors are pricing in approximately 1% more inflation over the next 5 years than the latest actual June inflation reading of 1.9% y-o-y indicate.

The difference between the higher expected rate and the lower actual rate of inflation may be indicative of future inflation increasingly carried by real demand forces and less by loose monetary supply conditions. It would represent a marked turnaround from how markets priced in UK inflation expectations 5 years ago. If the period of 2008 and 2009 was an environment of widespread deflation fears caused by the credit crunch and recession, then 2010 and 2011 was one of reviving inflation expectations induced by exceptional monetary stimulus in the absence of real growth drivers, while 2012 and 2013 was one of rising inflation expectations spurred on by loose monetary in the presence of broad-based economic revival.

Hence, given the prevailing loose monetary supply conditions against which economic activity in the UK is gaining further steam in 2014, the risk of interest rates going up is growing. The pressure would likely first occur in the long-end of the yield curve, as investors asset allocate away from Gilts and into FTSE 100 stocks where dividends offer investors viable alternatives to fixed interest as stable income streams. For instance, cash dividends paid to common stockholders in 2013 by FTSE 100 companies totalled GBP 68 billion, which is a CAGR of 7% since 2010, and comfortably beats UK inflation of 3.2% p.a. over the same period. Given the large dividend cutbacks of FTSE 100 stock heavyweights in energy (as a result of the Mexico oil spill disaster in 2010, BP's 2013 cash dividend of GBP 4.3 billion was still 35% below its 2009 peak) and financials (the state ownership of Lloyds TSB and RBS has led to a suspension of cash dividends since 2009), the resilience with which aggregate dividends of UK large-caps have been able to grow and outpace inflation is testament to their commitment to uphold a generous payout policy. Furthermore, on the back of robust earnings performance of UK large-caps, the dividend yield of the FTSE 100 has steadily risen to the point where, at approx. 4.6%, it is 2% higher than the bond yield of long dated UK Gilts.

Further out, the pressure on interest rates would likely come from the BoE, which so far has avoided raising the policy rate for fear of destabilising the regional economies outside London and the South-East, where the property market has been stagnant and is showing no evidence of overheating. Last month's policy action by the BoE, which is aimed at curtailing bank mortgage lending to overextended households, is unlikely to have a major effect on UK economic growth, not least because, following years of balance sheet repair, UK banks themselves have become more prudent in extending credit. Hence, without a major policy reversal coming from the BoE anytime soon, domestic demand-led growth in the UK is likely to continue unabated. In so doing, the BoE is prepared to allow inflation expectations to become more entrenched than they already are. But while employment growth is gaining momentum, the UK equity market is lacklustre. If this year's growth is merely a reflection of what the equity investors have priced in to UK mid-cap's stock prices last year, then the 1.6% pull back of the FTSE 250 so far this year (to 18 July 2014) may be a prelude to the looming risks ahead for UK growth stocks. In this environment it may be prudent to hedge your UK mid-cap equity exposure and seek inflation protected income in UK large-caps.

All data is sourced from Boost ETP, the Bank of England and Bloomberg

[1] Based on the 5 year bond yield differential between UK Gilts and UK inflation-linked securities

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