Elston

17th February 2023

Elston Insights

FTSE past 8,000 reflects strong global sectors, not the UK economy

- The FTSE 100, broke through 8,000 for the first time
- This is good news for investors…
- …but the index is less related to the UK economy

A new record: good news for investors

This week saw a landmark event when the UK's leading equity index – the FTSE 100 – broke through the 8,000 level for the first time.

Representing the largest UK registered and listed companies by market capitalisation it is testimony to the success of the largest British companies and UK-based multinationals.

So whilst very welcome news for UK investors how have exposure to large cap equities either through active funds or index funds, this is not an indicator for the health of the UK economy as some journalists and perceptions would imply.

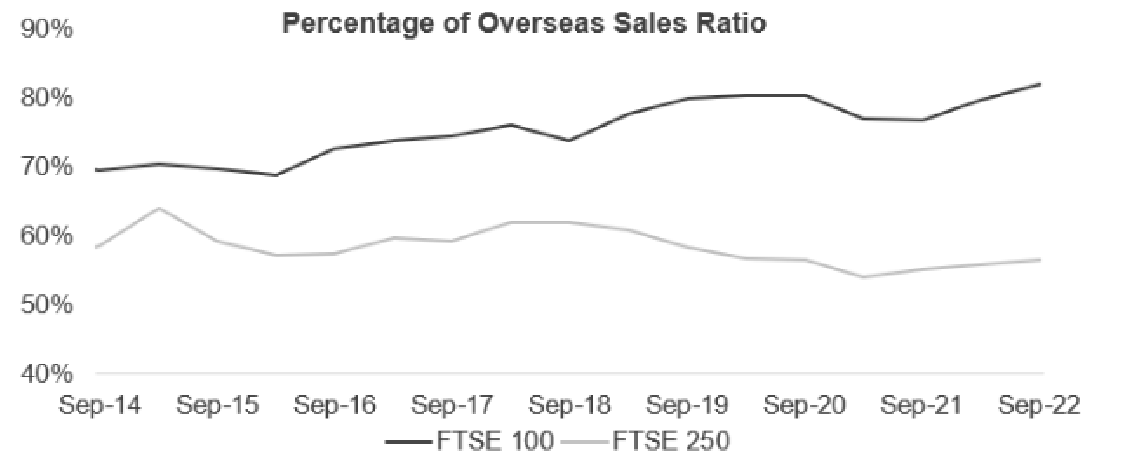
Reflects good news for those companies, not the UK economy

It's worth noting three key things about this positive news: the overseas revenue proportion, the sector positioning and the GBP/USD translation effect.

Firstly, the overseas (predominantly dollarized) revenues of FTSE 100 companies is 82% of total revenues (up from 70% in 2014), compared to 57% for the more UK oriented FTSE 250 mid-cap index, according to research by FTSE Russell which administers this flagship index[1]. So, revenue (and earnings) growth of these 100 largest UK-headquartered companies has little to do with the strength of the UK economy and is in fact an indicator more of the worldwide health of the sectors those companies are in.

[1] https://www.ftserussell.com/blogs/overseas-revenues-boon-ftse-100-performance

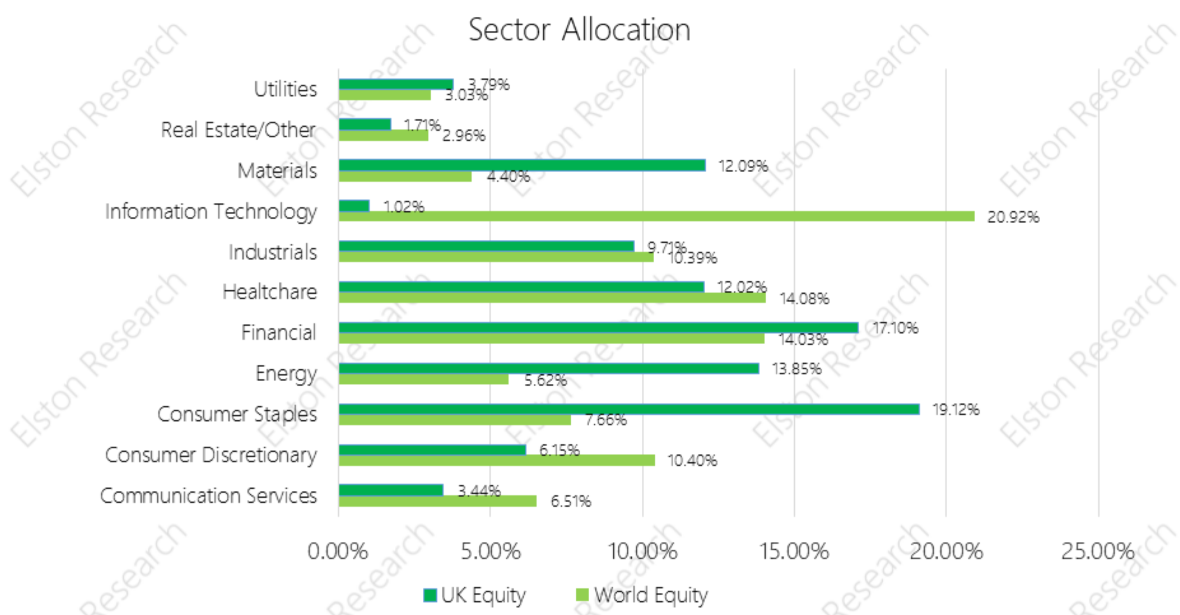
Fig.1. FTSE 100 mainly reflects overseas revenues



Source: FTSE Russell as at September 30, 2022. Past performance is no indication of future performance. Please see end for important disclosures

Secondly, the performance of the FTSE 100 has less to do with the UK economy and more to do with the sectors and factors that it represents from a global perspective. From [a sector perspective](), the absence of technology and the relative concentration in inflation-resilient traditional sectors such as Consumer Staples, Energy, Financials, and Materials means that the index is structurally overweight inflation-resilient value-oriented sectors, and underweight more growth-oriented sectors such as the tech-heavy World equity exposure.

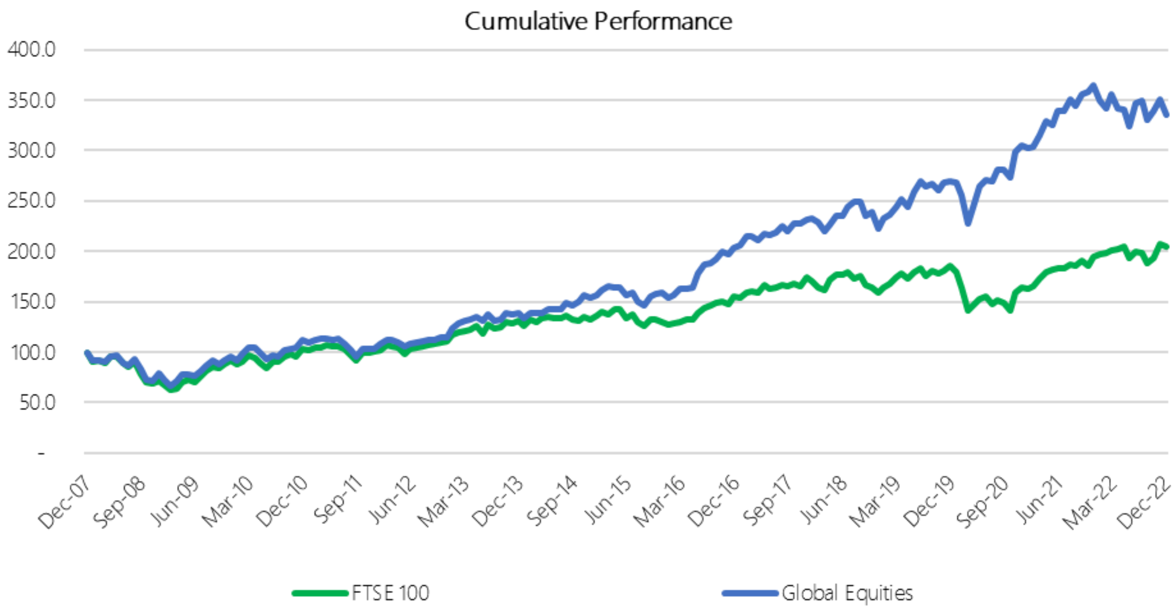
Fig.2. FTSE 100 vs MSCI World index-tracking funds sector allocation as at Dec-22



Source: Elston research, provider data, as at Dec-22

Similarly because of this sector allocation, from a Factor perspective, funds tracking the FTSE 100 has an inherent tilt towards Value factor. Hence the structural and material underperformance of the FTSE 100 relative to (US-heavy and tech-heavy) global equities since the Global Financial Crisis, penalising investors whose managers implemented portfolios with a heavy UK home-bias. So whilst the uptick is welcome, it follows a decade of structural undperformance: there is a lot of catching-up to do.

Fig.3. Long-term performance since Dec-07



Source: Elston research, Bloomberg data as at Dec-22. UK Equities is FTSE 100, Global Equities is MSCI ACWI Index. Total returns data in GBP.

In this respect, the FTSE 100 is "having its day" owing to it sector allocation is part of the broader rotation to Value (which tends to outperform in higher inflation regimes), rather than any positive statement about the health of the UK economy or UK companies in general.

Finally, because of the high dependency on dollarized overseas revenues, the currency translation effect FTSE 100 translation effect of USD vs GBP is a key consideration. Ironically the FTSE 100 performs better in GBP terms when Sterling is weakening (a sign of a weaker economy). This "translation effect" was visible both during Brexit in 2016/17 and again in 2022, where the FTSE 100 returned approximately -5% in USD terms, but +5% in GBP terms, owing to the -10% depreciation in Sterling.

Fig.4. Currency matters: GBP weakness means FTSE 100 strength

Source: Bloomberg Markets, data as at 17-Feb-23

What this milestone does represent

In this way, the FTSE 100's rise above 8,000 remains a good reason for celebration. For investors with exposure to the index directly or indirectly (through their pension fund), the strong performance is welcome.

But the reasons why don't reflect the strength of the UK economy or economic outlook (look at the yield curve and break-even inflation rates for that).

Instead this milestone reflects:

1. The improving outlook for those multi-national companies and the sectors they operate in
2. The positive outlook for those companies is a result of rising energy prices (good for energy companies), commodity prices (good for materials companies) and interest rates (good for banks) – all of which point to inflation getting stickier, which is not a cause for celebration.
3. GBP is weakening against the USD owing to weaker relative outlook compared to the US. This boosts those companies revenues in GBP terms and creating a translation effect for the index

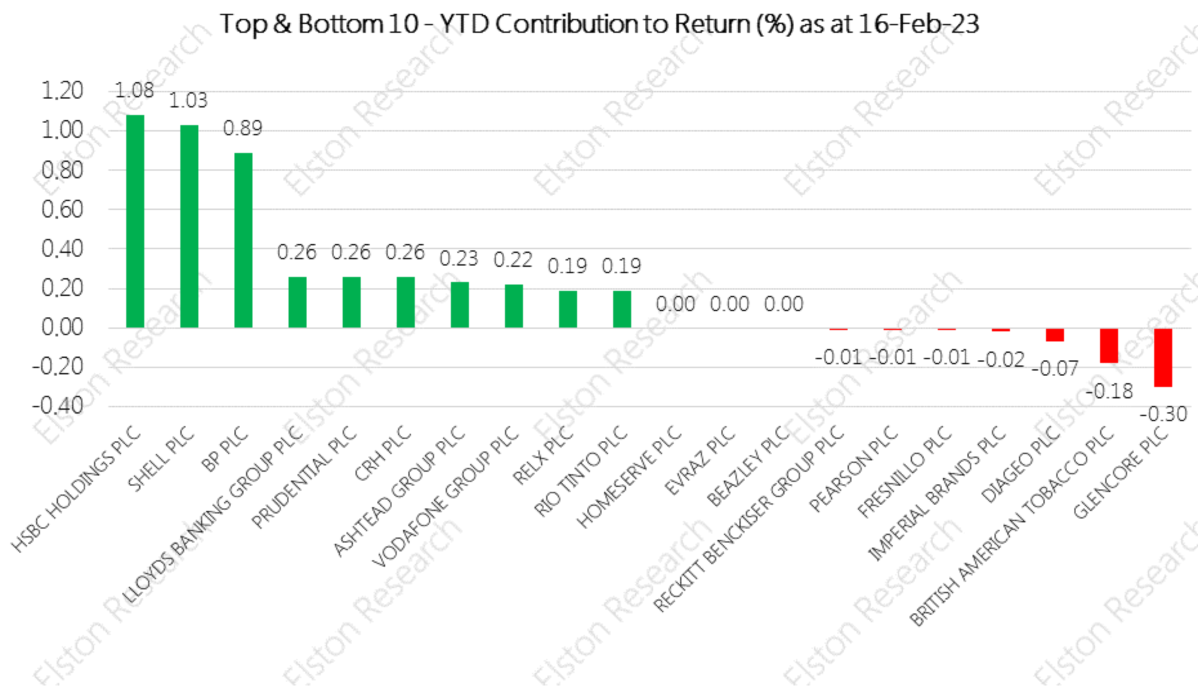
Energy & Financials are the Performance drivers

As at 16th February 2023, YTD performance for index funds tracking the FTSE 100 was +7.53%.[2]

By combining each company's weight in the index with that company's return, we can look at each company's contribution to this return.

[2] We analyse the performance of the iShares Core FTSE 100 UCITS ETF and its constituents.

Fig.5. FTSE 100 index fund holdings: Contribution to Return



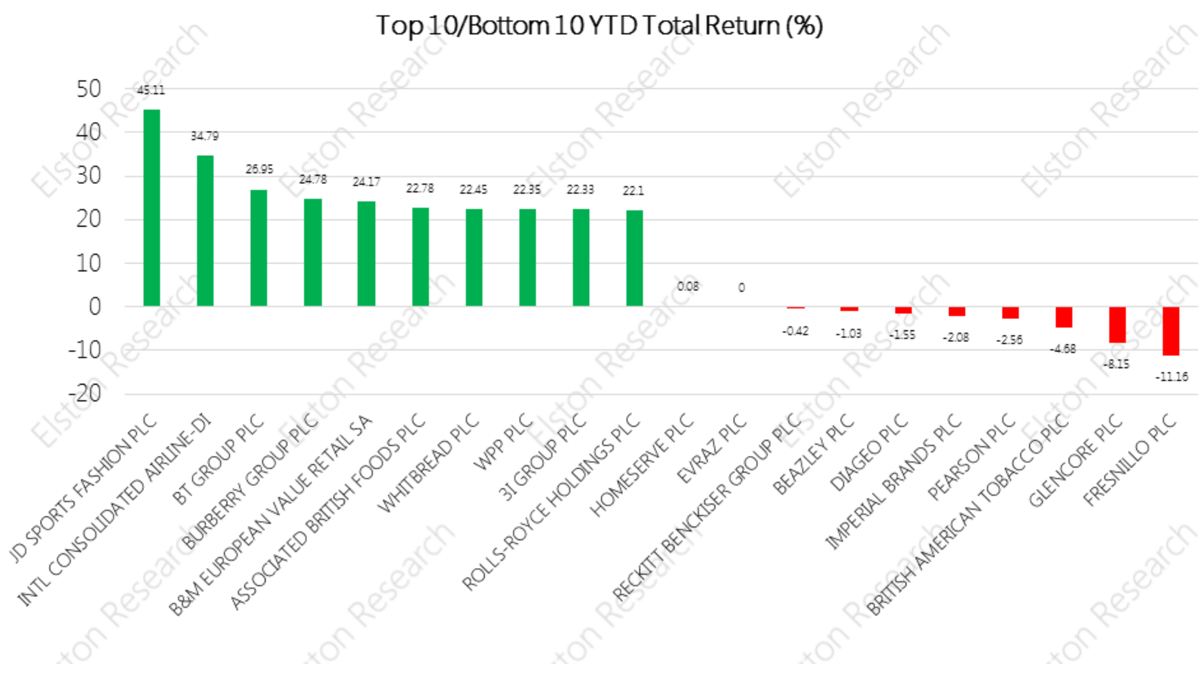
Source: Elston research, Bloomberg data, BlackRock data as at 16-Feb-23

So for index-tracking funds, the top 5 contributors to return were HSBC, Shell, BP, Lloyds Bank and Prudential (Financial companies on higher interest rates/net interest margins and Energy companies on higher energy prices).

Indeed these 5 holdings contributed almost 50% of the index's YTD performance and were not offset by its few detractors.

For actively managed funds, it's also interesting to look at the largest "winners and losers" within the FTSE 100. This highlights the potential for alpha relative to the index through astute active security selection where there is no obligation to hold the same companies as are in the index (low active share). The Top 10 best and worst performers (unadjusted for size) are presented below.

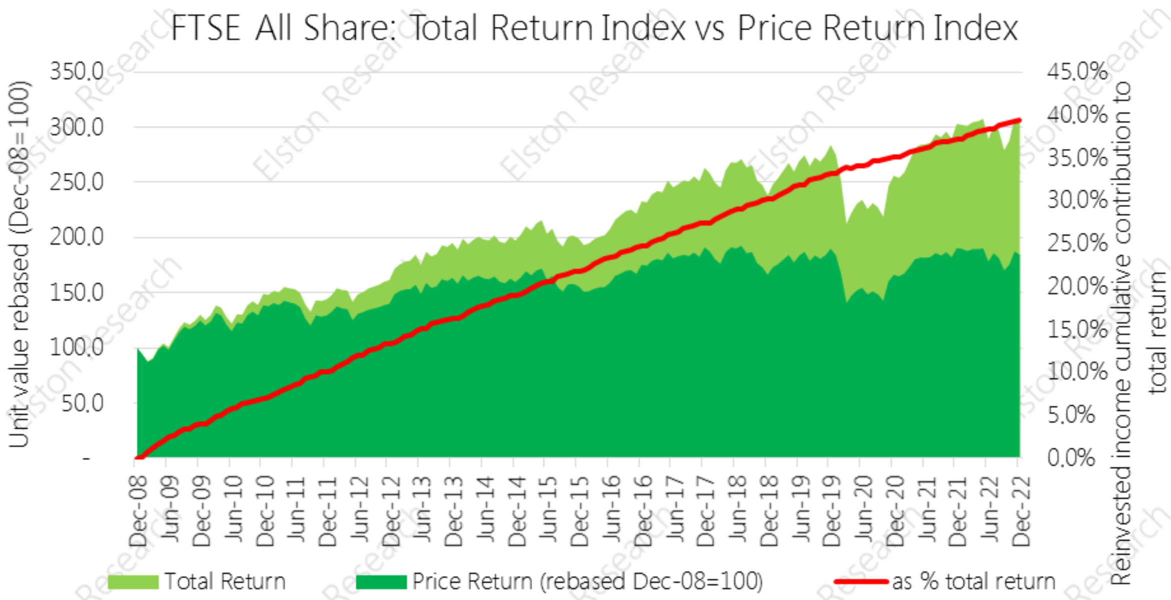
Fig.6. FTSE 100 index fund holdings: winners and losers



Source: Elston research, Bloomberg data, BlackRock data as at 16-Feb-23

The importance of Dividends

No discussion of UK Equities would be complete without reiterating the importance of dividends to help underpin returns. As the chart below shows, dividends have made up 40 % of FTSE All Share total returns since Dec-08 to Dec-22.



Source: Elston research, Bloomberg data as at end Dec-22

Summary

The FTSE 100 strength is welcome news for UK investors and for portfolios holding above market-weight allocations to UK equities and are incorporating a deliberate or unintentional UK home bias.

However contrary to press articles, this is more a function of the UK economy's vulnerability (sticky inflation drivers, weaker Sterling), than its strength.

Furthermore UK dividends help underpin returns in an environment where yield is back,

It also shows the importance of holding equities with a value/income bias as a medium- to long-term inflation hedge, and accept higher volatility risk, to create lower inflation risk.

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