

Conference call highlights

UK equities

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The world has decoupled

The divergence in the economic fortunes of the emerging and developed world has been a key investment theme over the past year, and this divergence remains a feature today. Growth is set to be significantly higher in China, Brazil, Russia, India and a number of other emerging economies than in the UK, US, Europe or Japan in 2011. Meanwhile, many developed economies also have sizeable fiscal deficits. Tackling these deficits will place further downward pressure on growth in the UK and other mature economies in the coming years.

Walking the tightrope

The UK government is attempting to maintain loose monetary policy for as long as possible to balance the effects of fiscal tightening. Indeed, fiscal consolidation is still in its infancy – of the £128bn of savings targeted by 2015/16, only £9bn is likely to have been achieved by the end of the current financial year. However, high commodity prices and the recent VAT increase have placed upward pressure on inflation, causing some members of the Bank of England's Monetary Policy Committee to call for higher interest rates. We anticipate that monetary policy will begin to be normalised before the year-end, but that any hikes will be modest given the need to continue to support growth.

Refinancing risk

If the balance between fiscal and monetary policy is not maintained, economic growth could turn out to be significantly lower than the government's forecasts. This, in turn, would affect the government's ability to meet its likely financing needs in the coming years. The Debt Management Office forecasts that the government will need to issue more than £500bn of gilts in the next four financial years. Any sign that the government is losing its grip could lead to the market demanding a higher rate of interest on this debt. This, in turn, would place further pressure on future growth.

Investing in companies, not the economy

Despite the challenging domestic economic background, we remain positive on the outlook for equities. We are investing in companies, not the economy, and share prices clearly have scope to rise. Valuations are attractive, with the market trading below its long-term averages on most measures. Meanwhile, our conversations with companies give us confidence in the outlook for earnings growth and dividend progression.

Healthy growth in profits and earnings

Our current forecast is for aggregate earnings growth of 16.9% in 2011. Meanwhile, we expect dividend growth of 11% as good quality businesses raise their distributions and high profile companies such as BP return to the dividend list. This confidence is further boosted by rhetoric from the government, which has clearly stated the desire for corporates to lead the UK economy into its next phase of expansion. We believe that the government will continue to do all it can to provide a corporate background that is conducive to growth.

Broad opportunity set

Last year, the spread of returns provided by different sectors was particularly wide, with areas such as industrials, materials, luxury goods and technology performing strongly, while healthcare, energy and financials significantly underperformed. This sector divergence is now on the wane and we expect 2011 to be more about picking the right stocks within sectors. We are certainly finding many attractive valuation opportunities across the market. The breadth of the opportunity set is illustrated by the fact that, at the end of January 2011, the ten largest overweight stocks in the Threadneedle UK Fund came from ten different FTSE sub-sectors.

Further to go in industrials

We were early adopters of the industrials sector, seeing it as a good way of playing the international earnings potential of UK PLC. This positioning worked well for our funds in 2010, but it has become an increasingly consensus view in recent months and some commentators now believe that the story has been played out. We disagree: the current results season is illustrating the continued earnings potential of the sector and, although valuations are stretched in some areas, a more selective, stock-picking approach should deliver further value from good-quality industrials.

Long-term value in domestics

Nevertheless, we have trimmed our industrials overweight in recent months, locking in profits for the funds. We have been deploying the proceeds selectively in domestically-focused stocks in areas such as house builders, retailers and pubs. The lacklustre domestic growth outlook represents a headwind for each of these industries. However, we believe that certain companies have been oversold and offer good long-term value. We have been gradually establishing positions in such companies. Elsewhere, we are continuing to hold a number of restructuring/recovery situations and also have a focus on strong franchises in areas such as media.

Strong performance record

Our UK equity funds performed well in 2010 and we are pleased to say that no-one has more outperforming UK equity funds over 1, 2, 3, 4 and 5 years. Our product range spans growth and income portfolios as well as smaller companies and absolute return offerings. The culture of communication and teamwork that characterises Threadneedle ensures that all of these products benefit from the combined thinking of the team. This ethos has been a key driver of the funds' strong performance over the short and long term.

Summary

The UK economy continues to face significant headwinds, with the government's fiscal consolidation programme in its early stages, while heightened inflation is beginning to put upward pressure on interest rates. However, it is important to distinguish between the outlook for the domestic economy and the prospects for the equity market. We believe that equities can make good progress over the next 12 months. Valuations are attractive relative to history and to other asset classes such as gilts. Meanwhile, companies are generating healthy earnings growth and robust levels of cash, which they are putting to use in shareholder-friendly ways. We are finding good opportunities in a range of sectors, as evidenced by the diversity of the top ten overweights in the Threadneedle UK Fund. We are confident that this fund, and the other products in our extensive UK equity range, will continue to deliver strong relative performance in the months to come.