

MARKET INSIGHT

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A Year of Challenges



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A YEAR OF CHALLENGES

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It's been a busy year for financial markets with multiple hurdles testing investors' nerves along the way. It has been so busy, in fact, that we could be excused for forgetting that a little over twelve months prior to writing this article the UK was grappling with the fall out of the disastrous mini-budget that caused turmoil in both the pensions market and the Conservative party. Since then, we've seen new political leadership, a market rally, a wobble in the banking sector and numerous interest rate increases. Aside from these headline-grabbing events, there have been less well covered updates coming through, from average investment trust sector discounts widening to levels not seen since the financial crisis, to a spate of merger and acquisition activity in pockets of the UK market. We'll reflect on the events experienced since that ill-fated mini-budget later in this edition of *Market Insight*.

Through the events mentioned above, cash has proven to be attractive, with fixed-rate cash ISAs and NS&I bonds showing returns of 5-6% at their peak. With expectations now for central banks to start cutting rates mid-way through 2024 and short-end yields moving down, the attractiveness and potential opportunity cost of holding cash is starting to be questioned. Exploring this topic, we'll break down the returns on offer from cash, using government bond yields as a proxy, against a corporate bond index of similar maturity to explore whether cash is still attractive, and the associated potential costs.

Sticking with the topic of cash, the US Government needs more of it and the debt ceiling debate continues to rear its head. With large debt refinancing coming in 2024, questions continue to be raised over the level of yield required to make new issues attractive, aiding in some recent volatility at the longer end of the US Treasury curve. Paying close attention to US Treasury auction results, the primary process of issuing new bonds to the market should reveal the appetite of investors and yield required to raise new funds. With markets still seemingly adjusting to a higher interest rate environment, volatility at the long end of the curve is likely to remain heightened as investors weigh up the returns required.

Finally, our Stock Focus article explores a UK defence company which has recently endured its own challenges, ones that it looks to be coming out the other side of. Babcock International, one of the UK's largest defence companies, is seemingly back on track with a new management team, a growing order book and a steadied balance sheet that enabled it to recently confirm a dividend for the first time in years. The announcement follows a four-year restructuring programme and the appointment of CEO David Lockwood in 2020, whose turnaround efforts at Cobham, a fellow defence company, resulted in the controversial sale to a US private equity firm in a £4bn deal.

STOCK FOCUS



BABCOCK INTERNATIONAL GROUP PLC

OSCAR SHEEHAN | INVESTMENT EXECUTIVE



Who doesn't love a good comeback story? It is exhilarating to see something that has come so close to extinction turn its fortunes around and soar to new heights. One company that seems to have survived its darkest days and is now generating consistent revenue growth is Babcock International. Babcock was a darling of the UK market for much of the noughties with its share price rising to over £12 in 2014 as it snapped up defence, engineering, and military training contracts wherever it could get its hand on them. The company

had a reputation for providing high-quality training and producing excellent military hardware.

Unfortunately, the chaotic nature of its expansion led to the company taking on a large number of unfavourable contracts that weren't profitable and called the sustainability of its balance sheet into question. Poor management will almost always spook investors. This was no exception, and Babcock saw its share price tumble all the way down to £2.10 during at the start of 2021. For a company that prides itself on the

quality of its warships, its share price was sinking rapidly. Since 2021, with new management at the helm, the company seems to have turned a corner. However, we must be careful when examining companies such as this and not be sucked in by the story. Cheap valuations do not guarantee returns and we must carefully analyse any investment to determine its long-term viability.



First, we should examine what initially went wrong for Babcock. It was caught in something of a perfect storm for much of the last decade, with many events out of its control. Fear around defence budgets being cut following the Brexit vote, the growing anti-nuclear sentiment within the UK, and the fact that the company came under heavy pressure from an anonymous group of suspected short sellers working under the name Boatman Capital Research. From 2015 through 2019, profits rose while the share price halved. That said, some of this was undeniably of its own making. In 2021 the company made £1.6bn in operating losses, with the majority of this coming from the writing down of assets and contracts entered into by the previous management team. These contracts had plagued the company for the preceding six years and revaluing or removing them was an essential, if painful, step towards restructuring the business. If markets were ever to regain faith in Babcock, managerial discipline was essential and it needed to be demonstrated.

This restructuring was, in essence, what signalled that times were changing for Babcock. The share price has almost doubled from its low point in 2021. Management has shifted £580m worth of assets which it has used to pay down its debt levels and improve the overall condition of its balance sheet. Net debt to earnings before interest, taxes, depreciation, and amortization (EBITDA) came down to 1.5x at the end of 2022, down from 2.8x just six months earlier. This indicates that the company is much more able to pay its debts at present than it has been in the past. The firm has seen strong organic growth and investment analysts are starting to look more favourably at the company. Another significant factor in this turnaround has been the more selective approach the firm's management has taken when bidding for contracts and expanding operations. By focusing on areas of excellence, reducing debt levels and increasing the amount of revenue it generates, it has been able to rekindle investor confidence.

Part of Babcock's resurgence has been the result of a sector-wide uptick since the invasion of Ukraine and the renewed

commitment from NATO and other European countries to invest 2% of their GDP into defence each year. Babcock itself has recently secured the contract to provide Poland with its new Type 31 frigate. From a valuation perspective, the company still lags behind much of the sector. Currently Babcock trades with a price to earnings ratio of 10.62x, substantially lower than BAE Systems which trades at 17.41x, indicating that markets are placing far more faith into BAE than they are in Babcock. BAE is substantially larger with a market cap of £33.29bn compared to Babcock's £2.03bn. BAE has more resources available for research and development and, as a result, can produce more market leading hardware across a wider area of operations. It also has a consistent track record of generating revenue growth and a strong management team with an excellent track record. This management has earned the trust of its shareholders.

“While companies such as Babcock are enticing and do present an interesting opportunity, it is important that we view them in comparison with what else is available in the sector.”

While companies such as Babcock are enticing and do present an interesting opportunity, it is important that we view them in comparison with what else is available in the sector. It is easy to get swept up in the story of a resurgent company, but the reality is often more complex. This is not to say that Babcock is not worth a look, it still trades at a 25% discount to the wider sector and there could well be value to be found here. The point is that the investment must make sense for the investor. A smaller company with a questionable historical record is clearly more of a risk than a larger, more consistent player with a more diversified selection of products. For some the extra risk might make sense, while for others it will not. ■

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INSIGHT



12 MONTHS ON: THE MINI-BUDGET

SAMANTHA CORY | INVESTMENT RESEARCH TEAM



The 23rd of September 2023 marked the one-year anniversary of the infamous Liz Truss and Kwasi Kwarteng UK mini-budget, following which UK financial markets and the economy descended to turmoil. It was a controversial proposal, consisting of £45bn of unfunded tax cuts, substantial amounts of government borrowing and a windfall tax exemption for energy companies. The motive behind the budget was to catalyse the post COVID-19 economic rebound and combat slow post-Brexit growth. Yet, the execution of this 'growth plan' led to a diametrically different set of outcomes. Instead of providing the catalyst for a post-COVID-19 economic rebound and combating slow post-Brexit growth, Liz Truss became Britain's shortest serving Prime Minister, resigning after seven weeks.



The consequences were far-reaching, impacting the Pound, government costs, mortgage rates and other thematic areas of the economy. Immediately, the Pound fell against the US Dollar to a record low since 1985, arising from lost faith in the UK economy from global investors. There was also a sharp rise in the cost of government borrowing, due to the rise in interest rates and yields, and this fed through to mortgage rates. Pension funds were also at risk, with the Bank of England (BoE) having to step in to safeguard the sector with a support scheme worth around £65bn, as the collapse in gilt prices induced a liquidity crisis in the industry.

In the year since this low point, the UK economy has seen a turnaround. At the start of 2023, Rishi Sunak, the new Prime Minister, outlined five key targets that he pledged to reach

this year: halving inflation; growing the economy; reducing national debt; cutting NHS waiting lists and passing new laws to stop immigration. Since then, the economic outlook has stabilised and confidence has increased, although concerns do linger around the stagnation of growth levels.

“Most of the disruption has been undone, with faith being restored in the UK’s financial credibility. The economic landscape has shifted, with interest rates likely peaking, as inflation begins to be brought back under control, and corporate bonds prove themselves to be an appealing investment choice.”

The Pound has rebounded and risen 15.7% against the US Dollar from the low of September in 2022, strengthening the Pound and reducing inflationary pressure from imports. Additionally, the credibility of UK institutions has been restored, with 30-year gilt yields declining from a peak of approximately 5% in October 2022 to between 3–4% in the last two months of that year. As of November 2023, the yield is floating around 4.6%, which is still lower than the peak of the mini-budget disruption, despite interest rates soaring.

Another development from the mini-budget has been the halving of inflation, an objective that Rishi Sunak laid out upon entering office. Inflation dropped from the flying heights of 10.7% to 4.6% in January to October 2023, contributing to a more optimistic economic backdrop. The four-decade-high level of inflation was mainly driven by the sharp incline in

energy prices and the outbreak of war in Ukraine. The recent reduction in the Ofgem energy price cap is the main indicator of a drop in and stabilisation of wholesale gas prices this year. This, in conjunction with the resolution of some global supply chain issues and constrained consumer spending growth, due to interest rates which have made loans and mortgages more expensive, has resulted in a deceleration of inflation growth to more manageable levels. Despite this, the BoE’s 2% inflation target has not yet been reached, meaning that interest rates have been unchanged at 5.25% for two successive terms, following on from 14 consecutive increases.

Amid this economic backdrop, corporate bond yields have risen, rendering them an investment to watch. Currently, investment grade corporate bonds can be expected to yield around 7%, which is the highest level since the Global Financial Crisis of 2008. This reverses the trend of gradually decreasing yields on sterling corporate bonds which stood at 5% in 2011, falling to a low of approximately 1.5% in 2020, before recovering in late 2021.



To summarise, the mini-budget brought about a short-lived period of market mayhem, as the ill-timed implementation of an expansionary fiscal policy was not well received by investors and economic institutions, causing a major stress test for the UK financial system. Since then, most of the disruption has been undone, with faith being restored in the UK’s financial credibility. The economic landscape has shifted, with interest rates likely peaking, as inflation begins to be brought back under control, and corporate bonds prove themselves to be a potentially appealing investment choice, while other securities struggle. ■

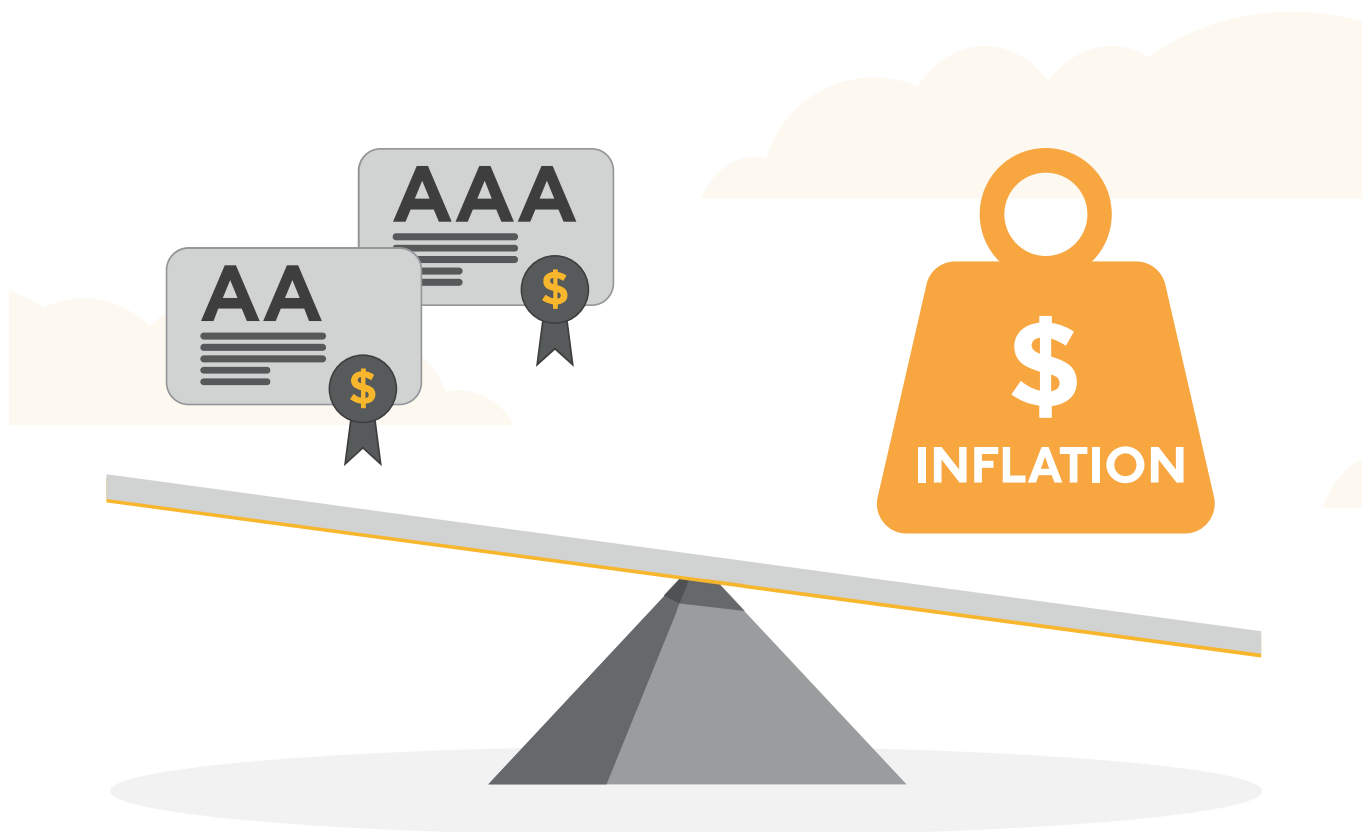
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TOPIC OF THE MONTH



MARKETS ADJUST TO US TREASURY BOND YIELD MOVEMENTS

GREG LODGE | PERFORMANCE & RISK ANALYST



Imagine if for all the little DIY jobs around the house, your toolkit consisted entirely of a sledgehammer. Dripping tap? Squeaky floorboard? Hit it with a big hammer. You might end up with your desired result, but there may also be some collateral damage. This may be how it feels to be a central bank. The main tool at their disposal is to raise or lower interest rates to dampen an overheating economy, manage inflation, or to invigorate an ailing economy. Broadly speaking, raising rates will increase the cost of borrowing, reducing consumer

spending and business activity, and thereby bringing inflation down. This may have the side effect of inducing a recession. Conversely, cutting rates to boost spending unleashes a flow of cheap money, which can cause inflation to spike.

With such an influential force in play, bond markets are very attentive to the direction in which rates are going, as this has a direct impact on the yield available. As rates rise, bond prices fall and so the yield increases in something of a seesaw action.

Bond markets are considerably larger than equity markets. The largest and most important government bond market is, unsurprisingly, United States Treasuries. The US Department of the Treasury issues four types of debt: Treasury Bills, Treasury Notes, Treasury Bonds and Treasury Inflation-Protected Securities (TIPS). Their maturities and features vary, but all are backed by the US Government and thus considered to be low-risk. Charged with maintaining monetary stability, the Federal Reserve (Fed) has an inflation target of 2%, as does the Bank of England, and has the power to set interest rates as a tool to achieve this. It has made 11 increases since March 2022 and benchmark rates currently stand between 5.25% and 5.5%.

While the Fed has pressed ahead with its monetary policy tightening programme, the US economy has shrugged this off over the summer and gone into overdrive, expanding by an annualised rate of 4.9% in the third quarter. September also saw an unexpectedly large number of jobs added. This economic resilience has been attributed mainly to consumer spending, which had remained strong on the back of an estimated US\$2tn in excess savings accumulated during the pandemic era. The data showing the robustness of the US economy caused US Treasury yields to reach their highest level in 16 years in October, as market participants concluded that the Fed was likely to keep rates higher for longer.

There have been signs more recently, however, that this economic surge is running out of steam. October saw 150,000 jobs added to the economy; fewer than had been expected. This helped increase market expectations that rates have now peaked and caused US stocks to see their strongest week in a year. The yield on a two-year Treasury Note fell to a two-month low. The Fed also suggested that it has concluded this latest cycle of rate rises after the Federal Open Market Committee voted to hold rates at their current level. Chairman Jerome Powell said in the press conference that followed: "Given how far we have come, along with the uncertainties and risks we face, the Committee is proceeding carefully."

With markets adjusting to a potential new period in the rate cycle, what yield will investors expect from new Treasury issuances? The US Government intends to continue with a substantial borrowing programme to cover a budget deficit, which is predicted to exceed 8% of the US's GDP this year. While there will always be demand for US Treasury Bonds, this appears to be waning in some quarters. The Fed has ended its quantitative easing programme – in effect stopping buying bonds – which removes a consistent and reliable buyer from the picture. Large overseas investors such as Japan and China have reduced their holdings or stopped buying altogether. Relatively smaller investors on the other hand have become enthusiastic buyers. US hedge funds and households own 9% of the Treasury market, increasing from 2% at the beginning of 2022.

Another factor for investors to contend with is the volume of the current output of issues. The Department of the Treasury has issued US\$1tn over the last three months. At the same time, yields have grown by a whole percentage point. Investors have attributed this increase in yields to concerns over who exactly was going to buy such a large volume of debt.

“The US Department of the Treasury issues four types of debt: Treasury Bills, Treasury Notes, Treasury Bonds and Treasury Inflation-Protected Securities (TIPS). Their maturities and features vary, but all are backed by the US Government and thus considered to be low-risk.”

While Treasury yields may rise and fall, the United States' position as the world's dominant global economy, underpinned by the power and heft of the dollar, remains unmatched. Investors, both domestic and overseas, will continue to watch this market closely. ■

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IS CASH STILL KING?

ALASTAIR POWER | INVESTMENT RESEARCH MANAGER



Interest rate increases have been a fatigue-inducing focal point of investor communications in recent times and for good reason given the impact of rate hiking cycles on financial market performance. The increased rates available on cash ISAs, however, has been an undeniable benefit for savers. With rates seemingly having settled, offers as of November 2023 show one-year fixed rate cash

ISAs at 5.71% and two-year products at 5.41%, according to moneysavingexpert.com. While still attractive to many in their search for secure income for many, questions are asked, issues are raised as to the level of opportunity cost which might be associated with running large positions in cash products.

Exploring this is best done with a simple example. For this, we'll take a three-year time horizon and assess the returns on offer from a fixed-term cash product against returns showing in the sterling corporate bond market. Before we look at the example, there are some key points to remember when investing in corporate bonds. Firstly, bonds have a final maturity date at which time the issuer pays back the final coupon and face value of the bond, returns from bonds can include both capital return and income return from the coupons, and the starting yield is a very strong indication of the returns on offer if the bond is held to the maturity date. As a corporate bond index is a basket of corporate bonds meeting a defined criterion, they don't have a finite life and, as such, the starting yield and maturity are a guide to potential future returns, but in no way a guarantee as the underlying constituents are constantly changing.

Personal finance website moneyfactscompare.co.uk currently shows the best three-year fixed-rate ISA rate as 5.16%. As outlined in the below table, utilising the full ISA allowance of £20,000 would provide a return of £3,258.50, or 16.29%, over the three-year life of the product.

| | INITIAL | YEAR 1 | YEAR 2 | YEAR 3 | TOTAL |
|--------------|------------|------------|------------|------------|------------|
| VALUE | £20,000.00 | £21,032.00 | £22,117.25 | £23,258.50 | £23,258.50 |
| YIELD/RETURN | | 5.16% | 5.16% | 5.16% | 16.29% |

In comparison, the near-term yields of the sterling corporate bond market indicate a 19.19% return on offer over the coming three-years, three percentage points, or £600, higher than the fixed-term cash ISA.

| | INITIAL | YEAR 1 | YEAR 2 | YEAR 3 | TOTAL |
|--------------|------------|------------|------------|------------|------------|
| VALUE | £20,000.00 | £21,205.20 | £22,483.03 | £23,837.85 | £23,837.85 |
| YIELD/RETURN | | 6.03% | 6.03% | 6.03% | 19.19% |

If we extend this exercise over a five-year period, return differentials become more pronounced. moneyfactscompare.co.uk highlights the most attractive five-year fixed rate of 5.00% from Melton Building Society. Expected returns from the product come out at 27.63% over the five-year period, an attractive return considering the expected path of inflation and where cash ISA rates have been in recent time.

| | INITIAL | YEAR 1 | YEAR 2 | YEAR 3 | YEAR 4 | YEAR 5 | TOTAL |
|--------------|------------|------------|------------|------------|------------|------------|------------|
| VALUE | £20,000.00 | £21,000.00 | £22,050.00 | £23,152.50 | £24,310.13 | £25,525.63 | £25,525.63 |
| YIELD/RETURN | | 5.00% | 5.00% | 5.00% | 5.00% | 5.00% | 27.63% |

A comparison against the iBoxx Sterling Corporates index yields over the same period reveals an expected return of 33.72%, six percentage points, or nearly £1,200 higher than the cash ISA.

| | INITIAL | YEAR 1 | YEAR 2 | YEAR 3 | YEAR 4 | YEAR 5 | TOTAL |
|--------------|------------|------------|------------|------------|------------|------------|------------|
| VALUE | £20,000.00 | £21,205.20 | £22,483.03 | £23,837.85 | £25,257.75 | £26,744.68 | £26,744.68 |
| YIELD/RETURN | | 6.03% | 6.03% | 6.03% | 5.96% | 5.89% | 33.72% |

Clearly there is some validity to recent questions around the potential opportunity costs associated with cash ISAs. There are, however, some considerations, the main being the inclusion of risk associated with the purchase of corporate bonds, but this is somewhat mitigated by the index's investment grade quality of which over 50% is rated A-grade or above, and the changing nature of market expectations which could lead to returns being notably different from those outlined above. There are some benefits of the corporate bonds, namely the liquidity, which enables a no-penalty sale of the positions and a greater than £20,000 ISA subscription limit can be invested for those carrying healthy cash balances.

As always, there's no guarantee within financial markets. Investing will always involve the risk of losing capital and must be considered alongside the wider financial goals of the individual. The above examples are intended to be a guide to a thought process when weighing up investment options. ■

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