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Roll on Recession

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Last December I professed that 2023 would likely be a good year for UK mid-caps. Many would have found it difficult to envisage that at the time, given how poorly the UK mid-cap equity market performed in 2022. It felt the full brunt of the inflationary spiral that was turbo-charged by Russia's invasion of Ukraine, finishing the year down over 18%. My projection isn't looking too clever now, with UK mid-caps having been modestly in the red last week since the start of the year.

All was looking good up until 6 March 2023, with UK mid-caps up 8% and our own UK equity portfolio up 12%[1]. But then Silicon Valley Bank (SVB) got itself into a spot of bother, soon followed by other questionably managed mid-sized banks, Signature Bank and First Republic Bank. Credit Suisse's demise didn't help sentiment.

Whilst one was unlikely to have foreseen such banking failures that brought into question the health of the entire US banking system, it also wasn't that surprising in hindsight, given the record-breaking speed at which the Federal Reserve had raised interest rates. However, authorities were quick to react to the crisis. The US Federal Deposit Insurance Corporation (FDIC) quickly moved to guarantee all deposits, whilst Union Bank of Switzerland (UBS) was strong-armed into acquiring Credit Suisse. These prompt actions significantly reduced the risk of contagion.

Since then, UK mid-caps are now down 9% and our own portfolio has suffered too[2], despite some good earnings releases and healthy share price performances from the likes of Games Workshop (the fantasy miniature games manufacturer), and household name Marks & Spencer. Ironically, both are exposed to the UK consumer, the outlook for whom is arguably now what is holding the stock market back.

There's one thing that markets don't like and that's uncertainty. Where and when interest rates will peak has been a big source of uncertainty this year, made worse by the UK's most recent inflation print (core inflation was up for the fourth month in a row), swiftly followed by a "surprise" 50bps hike in interest rates by the Bank of England.

That said, the market now has much better visibility on this than it did 12 months ago. Arguably, it is the prospect of a recession and what that means for the UK consumer that occupies the mind of equity investors the most, especially investors in UK mid-caps.

As perverse as it may seem, an imminent recession could actually be good for UK mid-caps. There are plenty of companies reporting decent current trading, but the problem is that the market often has the attitude of "things might be okay now, but what about this time next year or even in six months' time". They do say one should sell on the rumour and buy on the news.

Companies are therefore not being rewarded for delivering in-line results or even results that are ahead of expectations. A great example was Marston's, the national pub operator, when it delivered a healthy set of interim results in May. The shares opened higher but then quickly sold off and have continued to do so since. They are now trading close to where they were in the depths of the pandemic in March 2020.

Back then, its pubs were shut and there was no sign of them reopening any time soon. It also had much higher debt levels than it does today, having since sold some property assets and 60% of its brewery business to Carlsberg. The valuation it achieved when selling the 60% stake to Carlsberg means that the remaining 40% of the brewery business that Marston's still own is valued at around £250 million today[3]. That compares to a market capitalisation for Marston's of just £190 million[4] and I strongly believe somebody will look to buy that remaining 40% ownership stake from Marston's in the future.

Also, bear in mind that Marston's has close to £1.8 billion of freehold property with just £1.2 billion of debt against it[3], i.e., £600 million of equity in its property estate which dwarfs the market capitalisation of the whole business. The entire pub estate should also be able to generate earnings before interest and tax of more than £170 million in the near future[5]. In my opinion, it is obvious that the shares are currently massively mispriced.

If it was clear we are currently in a recession, then the market could look through an imminent drop in profits and start to price in a subsequent recovery. However, the economy has been remarkably resilient so far, which is complicating matters. Roll on a recession, allowing UK mid-caps and the likes of Marston's to rally.

Sources
1 Bloomberg Finance L.P. 31.12.22-06.03.23
2 Bloomberg Finance L.P. 06.03.23-23.06.23
3 https://www.marstonspubs.co.uk/investors/results-presentations/
4 Bloomberg Finance L.P. on 29.06.23
5 Bloomberg Finance L.P., sell-side analyst consensus forecast of £177 million on 29.06.23

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