

## MID-YEAR OBSERVATIONS

Neil Woodford

For me, investment is about a rational, disciplined analysis of the fundamentals of individual businesses and the broader industries and economies in which they operate. That allows me to form judgements about the intrinsic value of those individual businesses and make investment decisions based upon the differences between the market's perception of value and my own.

In the broader economic context, I don't feel the need to form specific forecasts for things like inflation, GDP growth and unemployment – but I do try to form a clear understanding of their likely direction of travel. Again, there is an opportunity to take advantage of differences between my own expectations and those that are implied in market valuations. It's about trying to understand what's priced in to the market's expectations and exploiting situations where the consensus has, for a variety of potential reasons (in my view, for example, markets are neither rational or disciplined most of the time), got things wrong.

Going forward, I expect the investment backdrop to look very different to the one that has prevailed for the last two years. And it is an environment for which I am very confident that the Woodford funds are positioned appropriately. Indeed, as you will read, there is a growing body of evidence to support my view of the world, highlighting the risks that exist in many parts of the market, and the long-term opportunity that our strategy is looking to exploit.

GLOBAL  
LIQUIDITY  
TO TIGHTEN



VALUATION STRETCH  
TO NORMALISE

CHINA GROWTH  
to SLOW

IMPROVING  
UK ECONOMIC  
FUNDAMENTALS

## GLOBAL LIQUIDITY TO TIGHTEN

In this inter-connected, globalised economy, dollar liquidity is key. Its importance as the grease in the wheels of the global financial system is easily underestimated. In simplistic terms, when dollar liquidity is abundant, global trade tends to be strong, the dollar is typically weak, commodity prices rise and equity markets do well. In the post-financial-crisis world, these relationships seem to have become more pronounced. But when dollar liquidity tightens, all of these things go into reverse.

We believe that liquidity conditions in the global financial system have started to contract and that this is likely to gather pace in the second half of the year. The primary reason for this is that central banks, led by the Federal Reserve (Fed), are now tightening policy.

The Fed has already increased interest rates twice this year (in March and in June, both times by a quarter of a percent) and, if its dot plots are to be believed, we should expect another two 0.25% interest rate increases this year. Meanwhile, its quantitative tightening (QT) programme will cause global liquidity conditions to deteriorate further. On current plans, by the end of the fourth quarter in 2018, QT will be draining an annualised \$600bn from the financial system, exerting deflationary pressures on the US economy, with huge potential implications for global financial markets and the world economy.

We are already seeing the consequences of tighter liquidity conditions, most acutely in emerging markets, with steep declines in many South American and Asian stock markets and increasing signs of tension in foreign exchange markets. Although financial markets in the developed world have so far been resilient to this development, the deterioration in global liquidity conditions will inevitably have an impact in the months ahead.



**"WE BELIEVE THAT LIQUIDITY CONDITIONS IN THE GLOBAL FINANCIAL SYSTEM HAVE STARTED TO CONTRACT AND THAT THIS IS LIKELY TO GATHER PACE IN THE SECOND HALF OF THE YEAR."**

**-12.6%**

US dollar value of global money supply, last three months annualised

**-9.9%**

JP Morgan Emerging Markets currency index since mid-February

**-\$600BN**

Annual rate of Fed's Quantitative Tightening by the end of 2018



**"THE CONSENSUS EXPECTATION IS THAT TRUMP'S TAX REFORMS WILL LEAD TO A BETTER GROWTH OUTCOME FOR THE US ECONOMY – I DO NOT BELIEVE THAT WILL HAPPEN."**

- US economy continues to grow faster than most other major economies but has not accelerated
- **\$600bn** headwind in the form of QT
- Repatriation of foreign earnings exacerbates liquidity squeeze elsewhere – **\$633bn** decline in foreign earnings held abroad in first 3 months of 2018
- Risk of major monetary policy error is growing

**"THE RECENT IMPROVEMENT IN EUROPEAN ECONOMIC DATA IS A BELATED RESPONSE TO EXTRAORDINARY MONETARY POLICY AND WILL NOT BE SUSTAINED."**

**-0.8%**

German GDP downgraded from 2.6% to 1.8% for 2018

**-100.1**

Citigroup Eurozone Economic Surprise Index hits lowest level since 2011

Source: Bloomberg, Macrostrategy Partnership, IFO Institute, Woodford

For further reading on this subject, please visit: <https://woodfordfunds.com/bigger-picture/global-liquidity-tighten/>

## CHINA GROWTH TO SLOW

There is growing evidence to suggest that, with Xi Jinping having consolidated his power base at the Communist Party Congress last year, the priorities of the Chinese authorities going forward will be profoundly different to the 'growth at all costs' mantra of the last decade.

From the 'Minsky moment' comments made by China's central bank governor, through to the cancellation of several massive infrastructure projects, there have been a number of tangible signals to suggest that the Chinese authorities are no longer prepared to ignore the economic risks that have accompanied several years of unbridled credit expansion.

This year we've already seen a surge of corporate bond defaults, demonstrating that these risks are starting to surface. Although monetary policy has been loosened slightly in response (for example the People's Bank of China reduced the reserve ratio requirement for banks so they can lend out a higher proportion of their deposits), Chinese policymakers no longer have the firepower to sustain an artificially high growth rate supported by excessive credit expansion. China's leadership is intent on reducing debt as part of its longer-term objectives, but one thing is clear from economic and financial history – there is no such thing as a painless deleveraging.

Against a backdrop of rising trade tensions, the economic implications of this are clearly not positive for China, nor for the rest of the world. Already, we've seen indications of a Chinese economy slowdown, such as disappointing trade data, a decline in fixed asset investment and the lowest level of money supply growth since records began in 1996.

Consequently, we believe we'll see progressively slower growth from China in the months and years ahead, as the country faces up to its massive bad debt problem and exports deflation to the rest of the world via its currency.

**"THE PRIORITIES OF THE CHINESE AUTHORITIES GOING FORWARD WILL BE PROFOUNDLY DIFFERENT TO THE 'GROWTH AT ALL COSTS' MANTRA OF THE LAST DECADE."**

**5.5%**

Even the IMF expect China growth to slow - to 5.5% by 2023

**-64%**

Shadow banking crackdown leads to -64% fall in lending

**6.1%**

China fixed asset investment falls to lowest level since the 20th century

**"MORE THAN HALF OF THE WORLD'S STEEL, CEMENT, COAL AND COPPER IS CONSUMED BY CHINA'S STAGGERING DEMAND FOR COMMODITIES."**

**CEMENT  
59%**



**ALUMINIUM  
47%**



**NICKEL  
56%**



**COPPER  
50%**



**STEEL  
50%**



**GOLD  
27%**



**RICE  
31%**



**PORK  
47%**



**CORN  
23%**



**COAL  
50%**



**OIL  
14%**



**COTTON  
33%**



Source: Bloomberg, IMF, Macrostrategy Partnership, Visual Capitalist, Woodford

For further reading on this subject, please visit: <https://woodfordfunds.com/bigger-picture/china-growth-slow/>

## IMPROVING UK ECONOMIC FUNDAMENTALS

We believe that the market consensus has misread the outlook for the UK, where economic fundamentals are improving, not deteriorating. Looking forward, we see UK economic health improving, with more people in work, more wage growth, less inflation, more investment spending, better public finances and a continued recovery in manufacturing and exports.

We expect the UK economy to grow by at least 2% this year – that isn't a spectacular rate of growth but it is a considerably better outcome than the recession that some of the more pessimistic commentators are forecasting and what appears to be priced in to valuations. It will also compare very favourably with other major economies in Europe and North America, many of which are rapidly losing momentum amid increased political risks and tighter monetary policy.

Overall, the data we've seen this year points to a strong labour market, real wage growth and a strong banking system. In April, real wage growth re-emerged as the post-referendum inflation, which was caused primarily by the decline in sterling, started to moderate – we expect this to continue going forward.

Meanwhile, according to ONS data released in June, the unemployment rate is the lowest since 1975, and, with more than 800,000 job vacancies waiting to be filled, we think the UK economy will benefit from further employment growth. Meanwhile, the UK has a healthy banking system that is very well placed to ramp up lending to businesses and consumers and consequently, to support broad money supply growth, which has been around 5% per annum for the past two and a half years – this, coupled with all the other positive trends in the domestic economy that we are seeing and the disappointing data elsewhere, leads us to believe that the UK may exit 2018 as the fastest growing OECD economy.

**"WE BELIEVE THAT THE MARKET CONSENSUS HAS MISREAD THE OUTLOOK FOR THE UK, WHERE ECONOMIC FUNDAMENTALS ARE IMPROVING, NOT DETERIORATING. LOOKING FORWARD WE SEE UK ECONOMIC HEALTH IMPROVING."**

**427,000**

UK jobs created in Q1 2018

**816,000**

Job vacancies in UK economy

**43 YEARS**

Since unemployment was this low



**"...MORE WAGE GROWTH, LESS INFLATION..."**

**2.4%**

UK CPI inflation, down from 3.0% at start of year

**2.8%**

Wages growing at 2.8% per annum

**"...AND BETTER PUBLIC FINANCES."**



**15 YEARS**

Since UK last posted a full year current budget surplus

**£42.2BN**

Budget deficit for 2017-18 – OBR had predicted deficit would be £16bn larger

Source: Bloomberg, Lazarus Partnership, Woodford

For further reading on this subject, please visit: <https://woodfordfunds.com/bigger-picture/uk-economy-defy-slowdown-expectations/>

## VALUATION STRETCH TO NORMALISE

The bubble-like characteristics that have become increasingly evident in financial markets, add considerable risk to the investment backdrop. The elastic between the valuation of the popular stocks (such as the FAANGS\* in the US, or in the UK, anything which offers investors exposure to Asian growth) and the unpopular stocks (the healthcare sector has been in a bear market for a long time now, for example, and in the UK, anything domestically-focused is completely out-of-favour) has reached breaking point, in my view.

We have already seen more than enough evidence to suggest that this valuation stretch is now on the cusp of reversing: tighter liquidity conditions, pressure on emerging markets, slowing growth in China, vanishing momentum in the eurozone economy, an increased likelihood that the failure of the US economy to accelerate despite the tax-cut boost, along with the continued resilience of the UK economy – all point to a stock market which cannot remain in denial of fundamentals for much longer.

**“TIMING A MARKET REVERSAL, OR PINPOINTING A SPECIFIC EVENT THAT WILL TRIGGER IT, IS NOT POSSIBLE BUT NEITHER IS IT NECESSARY. IT IS AN INEVITABLE CONSEQUENCE OF THE WAY THAT FREE FINANCIAL MARKETS WORK AND HAVE ALWAYS WORKED –IN THE END HOWEVER, FUNDAMENTALS ALWAYS REASSERT THEMSELVES AND THEREFORE, THEY ARE THE ONLY THING MATTERS IN THE LONG RUN.”**

## Important information

### What are the risks?

The value of investments and any income from them may go down as well as up, so you may get back less than you invested

- Past performance cannot be relied upon as a guide to future performance
- The annual management charge applicable to the funds is charged to capital, so the income of the funds may be higher but capital growth may be restricted or capital may be eroded
- The funds may invest in other transferable securities, money market instruments, warrants, collective investment schemes and deposits
- The funds may invest in overseas securities and be exposed to currencies other than pound sterling
- The LF Woodford Income Focus Fund will be invested in a concentrated portfolio of securities – the fund is not restricted by reference to any geographical region, sector or market capitalisation
- The LF Woodford Equity Income Fund may invest in unquoted securities, which may be less liquid and more difficult to realise than publicly traded securities

Before investing, you should read the Key Investor Information Document (KIID) for the fund, and the Prospectus which, along with our terms and conditions, can be obtained from the downloads page or from our registered office. If you have a financial adviser, you should seek their advice before investing. Woodford Investment Management Ltd is not authorised to provide investment advice.

You should note that capital is at risk with these investments and you may get back less than you invested. The value of the fund or trust as well as any income paid will fluctuate which may partly be the result of exchange rate changes.

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