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An update from Neil
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The recent run of macro data from around the world provides further evidence of the challenges that lie ahead for the global economy. Outside of the UK, with the possible exception of the US economy which is plainly strong, the rest of the world is now clearly slowing. As I have been saying for some time now, this has significant implications for global equity markets and for the recent and future performance of the portfolios.

China and the emerging world

The slowdown is most obvious in China and in emerging economies where stresses are beginning to become very visible. For example, the fall in emerging economy currencies and, in particular, the weakness of the renminbi are the clearest guide to economic stress.

In China, the authorities' clampdown on wealth management products and bank lending have clearly impacted money supply with consequent deflationary impacts. Recent announcements regarding fiscal packages are a direct response to these influences but will, in turn, transmit further deflationary forces, which will be felt externally by further falls in the currency.

For some time now, I have believed that China would have to embark on money printing to recapitalise its banking system and that this would result in currency weakness. In other words, China would export deflation to rest of the world economy via its currency. This is happening and in quite a dramatic way right now.

Europe

Europe has posted a lot of disappointing macro data in the first half of 2018. This has surprised the market consensus, but I believe this weakness will continue. In my view it is directly the result of the withdrawal of extraordinary monetary stimulus in the absence of an appropriately capitalised banking system.

Banks are not growing lending because they have not repaired their balance sheets adequately and as a direct consequence, as stimulus is withdrawn (in the form of tapering QE), so broad money growth collapses and, in turn, the economy suffers. I expect this to get worse in the second half of 2018 – see French GDP data last week for a guide.

United States of America

The US economy is strong and so is the dollar. The policy mix now in the US is, very basically, tightening (arguably excessively) monetary policy and very loose fiscal policy, at a time when the economy is strong and, some would argue, at full employment.

This, combined with the dollar repatriation scheme (a direct product of Trump's tax changes), is having a profound impact on the world economy. I believed this would harm the non-US dollar economy (by draining dollar liquidity and through higher rates) and that it would drive the dollar up vs emerging market economy currencies.

It is doing precisely that (so much so that the head of the Indian central bank was complaining in June, about tight non-US dollar liquidity). The real economy impacts of this will be felt across the world economy – see this as effectively policy tightening over and above what is visible through higher policy rates.

I expect to see more distress in emerging market economies and highly-levered emerging market corporates. The tide is now going out so, to paraphrase Warren Buffett, it may be time to see who's been swimming naked.

Looking ahead

As I look into the second half of 2018 with respect to the US, I still believe that the accelerating pace of QT will have a significant impact on the US (both financial assets and the real economy) and that very few are taking any notice of this. I still see the Federal Reserve committing policy error by tightening excessively and that this will have an increasing impact as we navigate the second half of the year.

Add in the increasing likelihood of further trade tensions especially between the US and China and I believe we are absolutely on track with what I predicted at the start of the year – the world economy slows in 2018 and the risks now look increasingly to the downside.

Back home

Now to the UK. I am very happy with progress in the UK economy which remains significantly better than was forecast by consensus. Nevertheless, it is increasingly clear that recession-like conditions are now discounted in the price of many UK economy-facing assets.

To recap on some of the key metrics – the labour market is very strong, real wage growth has returned, we still have record job vacancies, investment spending is growing, Government finances are improving (and are way ahead of the OBR's hopeless forecasts), we're seeing strong growth in bank lending at very attractive rates (see the mortgage market for details, e.g. NatWest's 5 year fixed rate 90% loan-to-value mortgage, at 1.25% for new customers).

Weak weather clearly affected Q1 GDP in the UK – the first estimate of growth was clearly wrong and has already been revised up. More contemporaneous data point to acceleration through the year.

There is a perception, in the equity market and indeed in much of what we read, that house prices are plummeting in the UK and that the economy has been paralysed by fears of a Brexit cliff in March 2019. The reality, as reflected in the hard economic data we are seeing all the time, contradicts this perceived wisdom, however.

That is not to say that the media and political frenzy has not had an impact on business confidence in some quarters because it clearly has. I have no doubt that without all the Brexit hysteria, the economy would be growing more quickly (the currency would be a lot higher for starters).

House prices are rising across the UK – they are down in London but appear to be in the process of bottoming. I believe that recent London house price declines have a massive impact on perception – because large swathes of the national media and market participants are based in London, they have confused what they have seen there with what has happened in the rest of the country. This is a mistake which, I believe, at least in part, explains the negative market sentiment towards the housebuilding sector recently.

Furthermore, as a result, it is regularly suggested that we are at the end of the housing cycle here in the UK. I have a very different view. If anything, we are at the start of a long cycle of improvement, which is enabled, at last, by an appropriately capitalised banking system. For ten years after the financial crisis, banks did not lend because they were effectively bust – they had inadequate capital and so could not lend. Mortgages were apparently cheap (because of low interest rates) but rationed by design – for example, no high loan-to-value borrowers could get a mortgage. The housing market was, therefore, for a long time, constrained by the availability of finance. That is no longer the case.

In London, where cash rich foreigners (Russians and Chinese, for example) were prevalent, the market marched to a different tune. Now, London is constrained by affordability and the rest of the UK housing market is in the process of being liberated by rising mortgage availability. (Banks are now repaired and lending again, not least because most now have surplus deposits and all have more than adequate capital).

At the bottom of the recession (2009-2010) there were 150,00 first time buyers in the housing market. Today, there are 370,000 and that is forecast in some quarters to grow to 500,000 (annually) over the next two-to-three years.

Housing is a central focus of Theresa May's UK economic policy agenda and, in November, the Government will announce how they will allocate the additional £10bn on Help to Buy in order to extend the scheme beyond 2021.

The housebuilders will see rising volumes, price, profits and cash as this new cycle unfolds. It will be further elongated by the changes to planning which are effectively either capping or driving land prices down (and availability up). This is probably the cheapest sector in the market and, arguably, it has the most attractive growth dynamics of any!

One final point, the number of new mortgages remains cyclically low at about 65,000 per month. I expect this will now progressively climb towards more normal levels, on the back of the very significant shift in mortgage availability and pricing that we are now seeing. This will, of course, be very good news for the economy because a house purchase leads (as we all know) to significant further spending.

Brexit

I have always believed that via a process of brinkmanship, we would arrive at a negotiated deal that would satisfy neither extreme of the Brexit divide but would approximate to a unique customs relationship with the EU. I still believe that this is the most likely outcome.

Just remember, when you read or hear that planes won't take off, that there will be no food in the shops and that we will be on our knees praying for divine salvation come the end of March 2019, that in 2017, the UK imported £270bn of goods from the EU, meaningfully more than the £164bn that it exported. Specifically, imports from Germany were £70bn, which is almost the same amount as its exports to US and China combined. That is one big headache for many European companies and their CEOs and national leaders – not least Mrs Merkel.

I believe a deal will be done simply because it makes sense for both sides to do a deal.

Portfolio implications

So, what does all this mean for the portfolio and my investment strategy? For example, clients often ask, if I am right on China, why does this have any relevance to my portfolio and, in particular, the significant weighting in the funds to the UK economy?

To answer this and many other linked questions I will try to walk you all through two things. First, a revisit of my fundamental approach to fund management and secondly, how that approach is informed by the current mix of global macro outlook and stock market behaviour.

Investment principles

First, some fund management principles.

I am an active fund manager. Clients have invested with Woodford based, in part, on an implicit belief that the market is inefficient. My job is to exploit inefficiency as appropriately as I can within the constraints that are placed on a specific fund or mandate.

An active fund manager is quite simply attempting to exploit market inefficiency where the value of a business has diverged from its price. Price is easy to discover – look on the Bloomberg screen.

The more difficult thing to discern is the ‘right’ value of a business. This will always be a matter of opinion involving some science and a lot judgement. But this is where the relevance of macroeconomics must invade the pitch.

All businesses, to a greater or lesser extent, are influenced by two distinct 'forces': 1) the actions of the businesses' management and employees; and, 2) the behaviour of the economy in which that business operates.

I have to know and understand both of these forces. I must understand the businesses in which we invest and indeed the ones we don't. This is the more obvious stuff.

The macro arguments are, however, are often poorly understood and overlooked. But, if all businesses are influenced by the economy in which they operate, their value must, in some way, be the product of what will happen to the economy. As a result, I believe it is imperative that my judgements are informed by a clear and considered view of the macro environment.

Market inefficiencies

It's easy to say that markets are inefficient, but it is harder to describe how and why. I will, however, try to summarise what I mean here. Stock markets, indeed all financial asset markets, are to a greater or lesser extent, inefficient. Thank God, because if they weren't we wouldn't be in business.

Inefficiency is not, however, consistent over time and between individual assets.

In the more than 30 years over which I have been managing equity portfolios, markets have gone through periods of relative efficiency. At a broad level, market valuations have, for a period, looked rational and relatively few stocks have appeared to be either dramatically under- or over-valued.

For example, there was a period in the 1990s when I was criticised for being a closet index manager because my portfolio looked very like the index. That was a time when I found it hard to find that many valuation anomalies.

The more 'normal' environment I have witnessed over the years does not reflect this sort of relative calm. More frequently, equity markets have been through periods of irrationality characterised by excessive over- and under-valuation.

These are the periods when markets offer up the best opportunities to active managers but at the same time these are the periods when it is most difficult to exploit them. Why? Because market irrationality, which is the primeval driver of asset market inefficiency, is fundamentally momentum-driven – the madness of a crowd. It is very difficult to resist the allure of consistently rising prices, whether it is in tulip bulbs, railway stocks, Japanese real estate, TMT stocks, banks or FANGS.

Standing back from asset price anomalies on the upside is one of the hardest things for investors to do.

Of course, there is one other important characteristic of momentum-driven pricing in asset markets. Whilst the crowd rushes towards an asset class that everyone wants to own, they are always deserting another. Over- and under-valuation are the Siamese twins of the equity market.

The most attractive and simultaneously dangerous periods in financial asset markets occur when momentum, or crowd-like behaviour, drives prices far from fundamental value both on the upside and on the downside.

It is my firmly held view that we are in a period of relatively extreme inefficiency in equity markets, not just in the UK, but globally.

This mispricing event is the product of many different influences. Some are driven by the dramatic shifts that have taken place in the fund management industry over the last ten years including the rise of passive investing (index and ETF) and, by the dominance of algorithmic strategies.

Other influences are more obvious and are the product of consensual thinking about the world economy which I believe to be fundamentally wrong. Either way, and perhaps regardless of cause, we are in a momentum-driven market characterised by extreme over- and under-valuation.

I am employed to exploit these anomalies but whilst doing so I have to step away from the crowd. I acknowledge that this is uncomfortable for you, our clients. It is also uncomfortable for me, and indeed for everyone at Woodford. I strongly believe, however, that it is the right thing to do and that any other course of action would be a betrayal of everything that I stand for as a fund manager.

Portfolio composition

The portfolios now reflect, in stark relief, where I see the most attractive (and extreme) under-valuation anomalies that I can find within the various constraints I have to work within.

The composition of the portfolios is a reflection of both the most attractive opportunities but, equally, a reflection of where I see the most risk. And this is where we come back to the China question posed above.

China's economic outcomes will have an effect on the UK economy, but this is likely to be muted. Where China's economic performance will be felt more dramatically, of course, is in the businesses that interact with what China buys and sells and those that have invested in the economy directly. This is, of course, therefore very relevant to some of the UK's largest businesses (index constituents) in the oil, mining, luxury goods and financial services sectors.

It is worth reiterating here, that the UK economy and the UK stock market are two very different beasts. There are 2.5m non-financial companies in the UK – just 1% of them are foreign-owned. Companies in the FTSE 100 employ just 3m people in the UK out of a workforce of 33m. As a result, China's influence on the UK economy will, as I have said, be relatively small. But it's influence on the UK stock market, is profound.

So, China is most relevant to what I don't own. Clearly, all of this is more pertinent to the performance of the portfolios from a relative perspective. However, given the yin and yang nature of momentum-driven market inefficiencies, there is an absolute perspective too.

Perception vs reality

So, referencing what I said earlier about the outlook for the global economy. In brief, the world is slowing most obviously in China, emerging economies and continental Europe. The US is clearly benefiting from the Trump tax cuts but policy error looms in the second half of 2018. US dollar strength is both a manifestation of these changes and in part a cause. The UK economy continues to confound consensus. Growth here is accelerating and the UK's economic fundamentals are improving.

Put simply, absolute and relative share price performance in the UK equity market over the last 2 years (really, since the June 2016 vote to leave the EU) has reflected a crowded consensus view that global growth is both strong and accelerating, and that the UK is crippled by Brexit (with an overlay of political risk). Neither of these views is right, in my view, and I would argue both look increasingly wrong.

Logically, therefore, risk lies in stocks whose share prices and valuations have risen on an increasingly false premise, and opportunity lies in stocks whose share prices have been weak (in many cases very weak), predicated on a misguided and clearly wrong view that the UK economy is about to go into recession.

This is a generalisation and there are clearly many exceptions. But as a summary, it is an accurate reflection of the way the stock market has been behaving.

Portfolio themes

So, the portfolios I run reflect a number of themes that I have talked about at length and will repeat here.

UK domestic exposure

I have a significant exposure to the housebuilding sector here in the UK (see above) and I continue to add to it (it has been very weak over the last three months).

I have further UK domestic economy exposure through a number of different holdings, which include some building materials stocks (Forterra, Breedon, Eurocell), some financials (Lloyds, Legal & General, Provident Financial and others), construction stocks (Kier), outsourcers (Capita, Babcock International) logistics stocks (Eddie Stobart Logistics, Stobart Group), media companies (ITV) and some property businesses (New River REIT, Warehouse REIT, Watkin Jones). Other UK plays which don't neatly fit into a sector bucket would include BCA Marketplace, Purplebricks and Paypoint.

Special situations

Elsewhere, there is a bucket of what I will call special situations. I own these businesses because they share a common characteristic, namely, profound under-valuation. There is not a common theme between them other than that.

This group includes British American Tobacco, Imperial Brands, Burford Capital, Raven Property, Hostelworld and IP Group amongst others.

Disruptive technology

Finally, there is the significant technology exposure (when most people talk about tech they immediately think about Facebook, Google, Apple, Amazon. etc – I never do, I think about the sorts of businesses we are investing in).

There is, in this group, a clear focus on healthcare through our unquoted exposures (such as Oxford Nanopore, Immunocore and Proton Partners), alongside companies like Theravance Biopharma, Prothena, Autolus and BTG. But healthcare is not our only tech exposure.

There is also much to be very excited about in holdings like Xeros, Industrial Heat, Benevolent AI, Idex, Thin Film Electronics, Federated Wireless and Spin Transfer, amongst others.

When?

Finally, to the big question. When will my strategy work and when will performance start to improve?

I accept it has been a long wait and I can understand the frustration and concern that it has caused. Nevertheless, I am utterly convinced that I am pursuing the right strategy. I have never been more convinced of anything I have ever done in my career as a fund manager.

I believe that what I have been doing with the funds is not only the purest expression of my investment principles, it is also entirely consistent with what I tell you, our clients, drives my investment process.

I do not pretend to know when things will change (this is after all the 'catalyst' question I often talk about), but everything I look at in financial markets tells me we are at a turning point.

I also believe we are seeing the early signs of this inflection point playing out almost daily. You only have to look at what happened last week (a picture of stuttering momentum, with news of stimulus measures from China being greeted by a short-lived rally in commodities and other ‘reflationary’ assets, before being replaced by a sombre mood amid disappointing economic data and weaker performance from popular stocks such as the FANGs) to see this. I am, therefore, very optimistic about prospects in the near term, as well as the longer term.

Of course, I would like some clarity around Brexit and a successful conclusion to the negotiations in October would clearly help the portfolio in absolute and relative terms. But, equally, it would be very wrong to think that this is a portfolio that will be liberated by Brexit resolution. It will be liberated by the inevitable and unstoppable realisation of the incredible value that lies in the companies in which we have invested.

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