CONTRASTING EXPECTATIONS

Mitchell Fraser-Jones, 29 June 2017

The views expressed in this article are those of the author at the date of publication and not necessarily those of Woodford Investment Management Ltd.

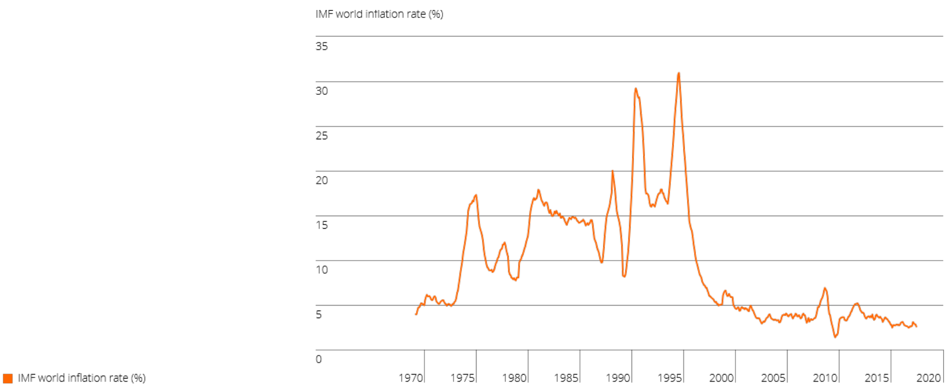
This post is part of a series explaining why we are more positive on the UK economy.
Find out more

Many readers have asked what implications our increasingly benign view of the UK's economic prospects has on our outlook for domestic inflation and interest rates. In short, the answer is very little.

We wouldn't describe ourselves as raging bulls on the UK economy, but we do have a more upbeat view of its prospects than an increasingly downbeat consensus. In reality, this means decent growth but not the sort of rampant conditions that would squeeze inflation higher or require the Bank of England to raise interest rates to cool economic activity.

Furthermore, we believe it would be wrong to view the recent return of inflation in the UK economy as enduring. Given that current inflation is primarily a function of the post-referendum decline in sterling, we expect that, once it has washed through the system, the UK will once again prove susceptible to the deflationary forces that have continued to suppress inflation elsewhere around the world.

Global inflation rates have rarely been this low
Sources: Bloomberg, Woodford



Of course, there is a risk that the Bank of England fails to look through this temporary bout of UK inflation and tightens monetary policy pre-emptively. Given the recent voting behaviour on the Monetary Policy Committee (MPC), we cannot completely rule this out. However, even if there is a vote to increase rates, we doubt that the MPC would move very far or fast, particularly when we consider the backdrop of Brexit negotiations over the next couple of years.

Consequently, we anticipate that interest rates will stay at the current ultra-low levels in the years ahead, in a world economy that remains far from normal. Given the right ingredients however, individual economies can perform robustly even in an abnormal environment. In this respect, we expect the UK to embark on an economic path similar to that of the US over the last five or six years, since it became the first developed world economy to emerge from the global financial crisis. A fully repaired banking system in the US allowed a period of credit-fuelled, inflation-free expansion, with growth rates the envy of a developed world that remained mired in a post-crisis stagnation. Now it's the UK's turn – not for spectacular growth, but for a better economic outturn than most.

So, we find ourselves at odds with consensus on the UK – we expect reasonable growth, while the market consensus expects somewhere between a slowdown and a collapse in economic growth. By contrast, the opposite is true for the global economy. The market consensus has become increasingly optimistic about global growth over the last twelve months, buoyed by Trump's reflationary agenda, better data in Europe and signs of stability in China. Here too, we find ourselves disagreeing with the market that now looks complacent on the global outlook. Our expectation is for lower global growth than that implied by stock market valuations.

Much of what we try to do as investors, is aimed towards positioning the portfolios to exploit differences between what we believe about the future and what the market has baked into valuations. At the macroeconomic level, these differences may appear quite modest but their impact on the valuations of individual stocks can be profound.

With that in mind, we have been keen to take advantage of a contrarian opportunity to invest in undervalued, high-quality domestic cyclical businesses, with a view to enjoying their attractive yields, sustainably growing dividends and, over time, as the market recognises that these businesses are not as challenged by the economic outlook as share prices would imply, a return to more appropriately attractive valuation territory.