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THE BIGGER PICTURE

Mitchell Fraser-Jones, 15 January 2018

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.

We have been through some challenging performance conditions recently, the product of some disappointing stock specific developments (e.g. Capita, Provident Financial, Prothena) and, more importantly, a late-stage bull market environment that has been increasingly momentum-driven.

The valuation extreme in markets has, in our view, reached breaking point and there are sound reasons to expect a very different investment backdrop in the years ahead than the one that has prevailed – with positive implications for the Woodford funds.

Global liquidity

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 under-estimated. We believe that liquidity conditions in the global financial system have already started to tighten and that this is likely to gather pace as the year unfolds. The primary reason for this is that central banks, led by the US Federal Reserve (Fed), are now tightening policy.

Nobody fully understands how the Fed's quantitative tightening plans will play out because it has never happened before. But from our perspective there are valid reasons to expect tighter global liquidity conditions to act as a brake on economic growth and on financial asset prices.

Our non-consensual strategy has actively avoided areas of the market that look most vulnerable to this in the months and years ahead, focusing instead on stocks that have not benefited from abundant liquidity. As always, valuation guides this disciplined investment approach.

China growth

There is growing evidence to suggest that the priorities of the Chinese authorities going forward will be profoundly different to the 'growth at all costs' mantra of the last decade. Policymakers no longer seem prepared to ignore the economic risks that have accompanied several years of unbridled credit expansion.

The economic implications of this are not positive for China in the near-term, nor for the rest of the world. We believe we'll see progressively slower growth from China as the year unfolds, as the country faces up to its massive bad debt problem and exports deflation to the rest of the world via its currency. The most obvious route back into financial markets here is via a lower contribution to global growth from China and indeed Asia more broadly. A further market impact should arrive through commodity prices, which will not greet the absence of demand growth from China favourably.

The funds have actively avoided exposure to parts of the market that are vulnerable to the slowdown that we expect to see in the Chinese economy.

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 a considerably better growth outcome than the recession that some of the more pessimistic commentators are forecasting and what appears to be priced in to valuations.

If the UK economy performs better than people think, then by extension, it is logical to expect that some companies which are exposed to the UK economy, will also perform much better than people think. Herein lies an opportunity which we have positioned the funds to exploit. The valuations of many housebuilders, construction businesses and retailers are simply too cheap and growth expectations far too low.

We believe that the share prices of many domestically-focused businesses will stage an impressive recovery in 2018 and the funds are positioned to benefit from this.

Valuation stretch to normalise

The bubble-like characteristics that have become increasingly evident in financial markets, add considerable risk to the investment backdrop.

We believe the elastic between the valuation of popular and unpopular stocks is starting to reverse – partly as a result of the macroeconomic conditions described above, but also because fundamentals always eventually have a gravitational effect, which pulls share prices into closer alignment with reality.

It is a simple mantra but all we're trying to do is avoid the risk and capture the opportunity. This leaves us confident of delivering the attractive and positive long-term returns that investors have come to expect from Woodford funds.

What are the risks?

- The value of the fund and any income from it 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 is charged to capital, so the income of the fund may be higher but capital growth may be restricted or capital may be eroded
- The fund may invest in other transferable securities, money market instruments, warrants, collective investment schemes and deposits
- The fund may invest in overseas securities and be exposed to currencies other than pound sterling
- The fund may invest in unquoted securities, which may be less liquid and more difficult to realise than publicly traded securities