woodford

CHINA MATTERS

Neil Woodford, 2 October 2015

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.

August's abrupt sell-off ensured that the summer holidays were not quite as relaxing as many market participants had hoped. Much has been written about the causes and influences of the extreme volatility, but it is clear that fundamentals played a significant role. Developed world stock markets suddenly appeared to acknowledge something that other asset classes have been concerned about for some time – in particular, that the fundamental health of the Chinese economy is nowhere near as robust as had hitherto been implied by valuations.

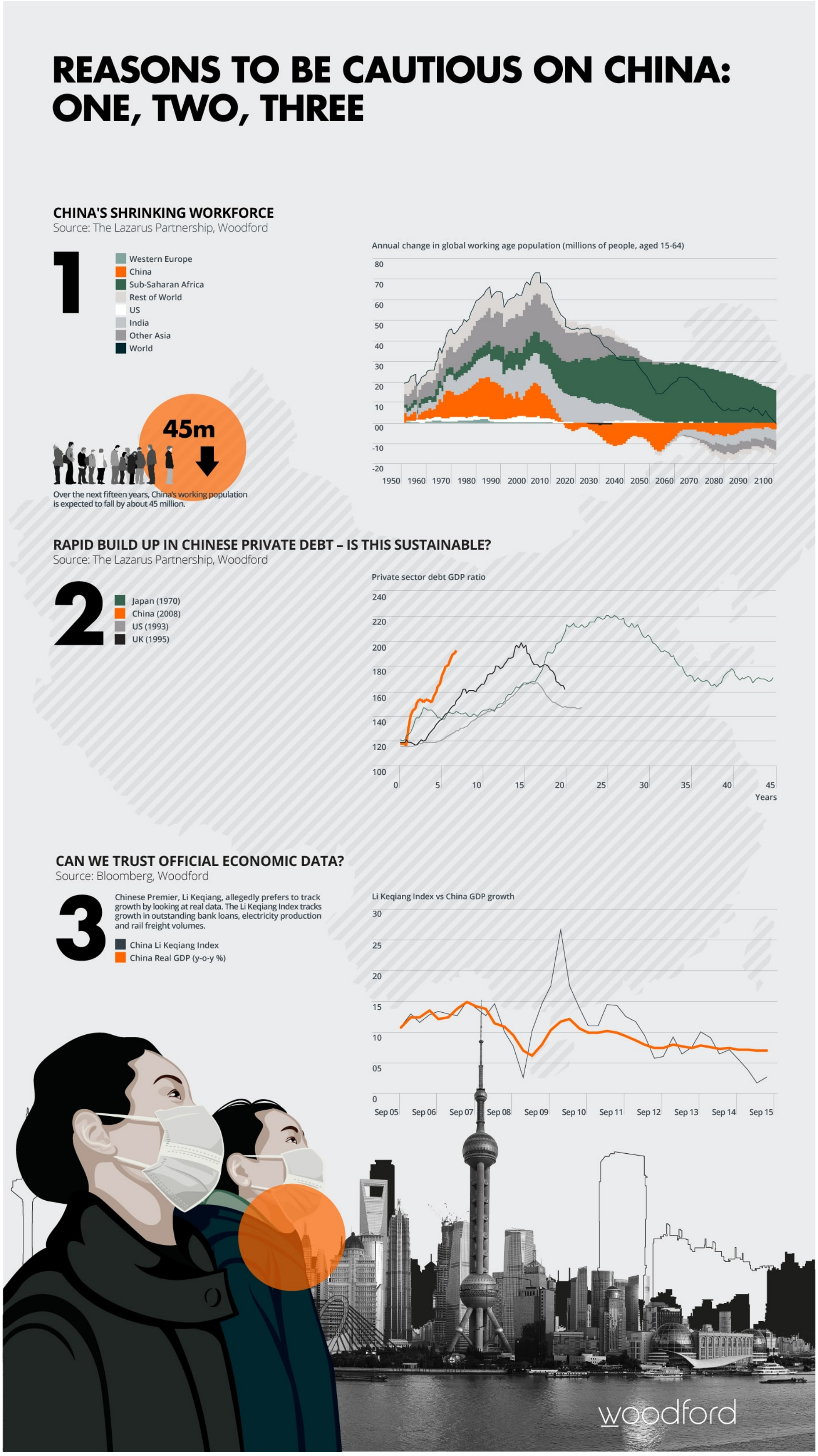
That the Chinese economy is slowing should not have come as a surprise – recent quarterly growth figures have lacked credibility when compared with other real economic data. Even the Chinese Premier, Li Keqiang, allegedly mistrusts the country's official economic statistics, preferring to track growth by looking at real data. The Li Keqiang Index, as it has become known, tracks growth in outstanding bank loans, electricity production and rail freight volumes, and currently shows a reading of just 2.5% year-on-year. It last visited that level in November 2008, just after Lehman collapsed.

Of course, as a long-term fund manager, I am more concerned by the long-term outlook for the Chinese economy and what that means for the global economy as a whole, than I am about its current predicament. I have been consistently cautious in this respect for several years and I see no reason to change this view yet. Indeed, the number of reasons to be cautious about China is increasing.

The transition from an economy relying heavily on fixed asset investment to one which more closely resembles the Western, consumption-based economic model, has been achieved before by other developing economies. It is a very long road, however, and one with many bumps in it. In the case of China, the transformation also requires a different political approach but recent interventions in the stock and currency markets suggest the authorities are struggling to let go of the controls.

CHINA MATTERS

Neil Woodford, 2 October 2015



Meanwhile, the level of private sector debt in the Chinese economy is increasingly attracting attention. As the chart above demonstrates, Chinese private debt already surpasses the peak reached in the US in 2008 and is fast approaching the level of the UK's debt burden, reached just before the financial crisis. This is alarming and suggests that the Chinese economy will have to go through a period of prolonged debt moderation too at some stage, with negative implications for Chinese growth and in particular for its banking system.

woodford

CHINA MATTERS

Neil Woodford, 2 October 2015

The risks facing the Chinese economy are substantial and the market was right, in my opinion, to start to worry more about them, albeit belatedly. But although the market correction implies that the risks are now discounted more appropriately, it doesn't mean they have gone away – far from it!

In 2009, China rode to the rescue of the global economy with a massive fiscal stimulus package. It does not have the balance sheet to repeat this trick now. Unlike other major economies, however, Chinese interest rates are not yet at the zero-bound so it does have scope to loosen monetary policy and has already started to do so. This in turn, creates problems for the rest of the global economy. Instead of facing an internal deflation, China could export deflation to the rest of the world. The deteriorating fundamentals of the Chinese economy therefore have signification ramifications for the global economic outlook.

Recent events haven't necessitated any changes to my portfolio strategy but they do provide further vindication to the cautious view of the global economy that I have held for some time. I have built the portfolios on the expectation that they will receive little help from macroeconomic trends.

Nevertheless, there are some parts of the market that could continue to be very negatively impacted by China's ongoing woes. Commodity prices and commodity-related stocks, for example, have already fallen a long way but are still far from low by historical standards. I continue to prefer companies that are more in control of their destiny. In turn, this allows continued confidence in what the portfolios can deliver in the long-term but it is important to remain very aware of the risks.

This article first appeared in Money Marketing on 1 October 2015

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 ongoing charges figure 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 – some of these security types could increase the fund's volatility and increase the level of indirect charges to which the fund is exposed
- The fund may invest in overseas securities and be exposed to currencies other than pound sterling – as a result, exchange rate movements may cause the sterling value of investments to decrease or increase
- The fund may invest in unquoted securities, which may be less liquid and more difficult to value, because they are generally not publicly traded – the lack of an open market may also make it more difficult to establish fair value

Important information

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.

The Woodford Funds (Ireland) ICAV (the "Fund") has appointed as Swiss Representative Oligo Swiss Fund Services SA, Av. Villamont 17, 1005 Lausanne, Switzerland. The Fund's Swiss paying agent is Neue Helvetische Bank AG. All fund documentation including, Prospectus, Key Investor Information Documents, Instrument of Incorporation and financial reports may be obtained free of charge from the Swiss Representative in Lausanne. The place of performance and jurisdiction for all shares distributed in or from Switzerland is at the registered office of the Swiss Representative. Fund prices can be found at www.fundinfo.com.

CHINA MATTERS

Neil Woodford, 2 October 2015