NEIL WOODFORD ON STERLING, INFLATION AND RATES

Mitchell Fraser-Jones, 28 October 2016

With sterling recently falling to multi-decade lows amid Brexit concerns, Neil answers investor questions on what this means for inflation, interest rates and, most importantly, the portfolios.

Should investors be concerned about the fall in sterling?

No, I don't think investors should be overly concerned about the fall in sterling. Although the outcome of the referendum is seen as the catalyst for sterling's weakness, in my view the fall was inevitable. The pound has looked overvalued for years when you consider the many imbalances that we've seen building up in the economy for a very long time now.

Over the last few weeks, the market has been trying to discount the prospect of a 'hard Brexit' into sterling, even though it is uncertain whether this outcome will prevail or not, and will remain so for some considerable time. A hard Brexit probably represents a worst-case scenario for the pound, suggesting that any other outcome could be positive for the currency.

Weaker sterling will lead to higher inflation in the near-term and it certainly isn't good news for UK citizens travelling abroad. However, it will be beneficial for some parts of the economy. For example, any business that exports its goods or services will be benefiting from an immediate improvement in competitiveness as a result of the fall in the sterling.

Thus far, the UK stock market clearly isn't that worried about the pound's decline, as we've seen the market reaching all-time highs recently. The rise in the overall index has, however, masked quite extreme differences in performance at a sectoral level. Domestic sectors have tended to be quite weak, for example, whilst overseas earners have been generally strong.

If the currency were to weaken significantly further, that would be a worrying sign that the situation is worsening towards a crisis of confidence in the UK more broadly. Although I do not expect that to happen, it is not beyond the realms of possibility. This would be a destabilising and unnerving event for investors but, ultimately I think it would represent a really compelling long-term buying opportunity.

Where do you think inflation will be in the short-term and what is your longer-term outlook?

We tend not to make predictions about exactly where an economic variable will peak or trough. Our economic analysis tends to focus on the future direction of variables such as inflation, rather than forecasting precise numbers. Having said that, we would expect inflation to rise above the 2% target over the course of the next 12 months or so. But, not significantly so. Longer-term, I am still more worried about deflation than I am about inflation.

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What, if any, catalysts do you see for a reversal in the bond market?

I think the answer to this question is more likely to depend on global factors than it is on purely domestic ones. Having said that, I do not expect that the return of some inflation in the UK near-term will prompt a material reversal in the UK bond market. In this era of low interest rates and low sovereign bond yields, worries about deflationary pressures have clearly trumped concerns about the sustainability of government debt burdens, for example, and I expect that to continue.

Will UK interest rates ever rise? What about the US?

Forever is a long time. However, I do find it hard to see interest rates increasing here in the UK over the next three years at least.

In the US of course, the Fed already has increased rates last December, albeit marginally and, in my view, unnecessarily. I do not believe that rates will go up again this December, even though that is what the market currently expects. In fact, I wouldn't be surprised if US interest rates didn't rise at all in 2017 either.

What does this mean for the fund?

Not a lot has changed. We had been expecting sterling weakness and were positioned to benefit from it. Now sterling has weakened, I am considering at what level I should start to hedge the portfolio's US dollar exposure. That would mark the first time that I have chosen to hedge US dollar exposure since the week after Lehman's went bankrupt in 2008.

More broadly, I believe the fund's prospects remain very bright. We have a good mix of global and domestic exposures in businesses that can deliver sustainable long-term growth, a great balance between high quality dependable growth companies and earlier-stage businesses with incredible long-term potential and, consequently, every confidence that we can deliver attractively positive long-term returns to investors.

This Q&A first appeared on www.hl.co.uk on 24 October 2016.

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

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