ROYAL LONDON

15 June

Royal London Market update

Lorna Blyth provides an update on the impact of recent market events on the Governed Range.

The start of June had seen risk assets continue their upward momentum however the Fed announcement at the end of last week sparked a sell off as economic data suggested a worsening outlook. Year to date returns show the GPs now delivering between -3% to -10% while GRIPs range from 1% to -4%. All performance numbers quoted are net of a 1% charge and you can find returns for all the portfolios over the short and long term in the link at the end of this update.

Our Investment Advisory Committee met on 3 June to review the latest data set from Moody's which informs our strategic asset allocations and sets the guidelines for our tactical positions. The model shows projected short term interest rates have fallen in line with gilt yields at all points on the curve. Following a significant widening of corporate credit spreads, short-term return expectations of corporate bonds are up significantly whilst longer term projections are marginally lower. Equity volatility over one year is significantly up in line with covid-19 uncertainty but remains broadly unchanged over longer term horizons. All of the Governed Portfolios remain within their volatility target range and continue to show efficient risk return characteristics. Minutes from the meeting will be published on our website shortly.

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Please note that this is a fast-moving environment and markets and impacts on portfolios are changing. Opinions contained in this document represent views of our fund managers at time of writing.

Governed Range investment activity - Trevor Greetham, Head of Multi Asset Funds, RLAM

Markets have continued their positive momentum, since March lows, based on fiscal and monetary policy measures designed to mitigate damage to the global economy and diminishing virus risk. We remain slightly overweight equities in the portfolios but are aware of the still uncertain path back to normality for the global economy. On the plus side, public health experts suggest the virus impact may have peaked, lockdowns are being eased and a broad range of monetary and fiscal stimulus measures are in place. However, the level of economic activity post lockdowns could disappoint markets, with many sectors of the economy probably staying weak and unemployment possibly staying higher for longer than some expect.

We are slightly overweight in equities and see opportunities as well as risks in other asset classes. We remain overweight high yield bonds, particularly short duration high yield, as we expect the asset class to be resilient over the medium term and the US Federal Reserve is directing its support towards US credit markets. We are underweight commodities, however, as demand is likely to remain weak and supply, for example of oil, is plentiful. We are also broadly neutral to slightly underweight UK commercial property across most funds as we expect rents could fall and capital values see downward pressure, particularly in the retail and leisure sectors; exposure to property gives diversification benefits to the portfolios.

Within equities we remain overweight US equities (including the tech sector) given the relatively defensive nature of the market and the resilience of technology earnings in the pandemic; we are also moderately overweight Emerging Markets, potentially a safer haven as the virus appears to be under control in China. We are underweight UK equities, a long-term underperformer hampered by a heavy resource sector weighting and underweight financials. Our currency positioning is light. We have moved to be moderately overweight the economically-exposed Australian dollar but remain underweight sterling given ongoing political and trade uncertainty; we have reduced our position in the more defensive US dollar as confidence in the global economy has improved and are now slightly underweight.

Market outlook

Sustained recovery in markets will probably have to wait until there is more confidence that the coronavirus pandemic is under control globally and a serious second wave of infections hasn’t happened. We expect our Investment Clock model to reflect the eventual re-opening of the world economy by moving from the disinflationary “Reflation” zone, with weak growth and falling inflation, and into its equity-friendly “Recovery” zone, as growth improves with lockdowns being eased, but the timing of this move is uncertain. We intend to make full use of our active tactical asset allocation risk budget to add to equity exposure when we judge the time is right. Our investment process has weathered difficult markets in the past and we added significant value over the 2007-9 Global Financial Crisis. We believe a disciplined and active approach to both risk control and tactical asset allocation will be crucial in portfolios, as markets respond to the current crisis and the economic recovery when it comes.

RLAM Economic Viewpoint

The mechanical recovery

Data increasingly confirms that the global economy is on the recovery path and past the trough in activity. High frequency, e.g. mobility data has been suggesting that for several weeks. Business surveys – to generalise – have improved, although most remain at weak levels. Last week also saw a massive positive data surprise, with the US unemployment rate falling and the number of jobs (payrolls) rising, when sizeable moves in the opposite direction had been expected. Logically, however, all of this is consistent with the steps taken in major economies to ease social distancing measures. In other words, we are likely seeing the more 'mechanical' part of the recovery as activities not allowed before are now permitted, all helped, of course, by a supportive policy backdrop.

Not out of the woods; policy support still needed and still being provided

Conditions in the global economy are, of course, still far from normal and it remains important that policymakers continue to provide ongoing support as economies reopen and that they do not wind back that policy support too early. Although lower than expected, the US unemployment rate, at 13.3%, is still higher than at any point during the financial crisis. The global composite PMI business survey measure improved sharply, but at 36.3 is at around the levels reached at the trough of the financial crisis. The UK's record GDP fall (-20.4%M in April), was also another reminder of the huge economic hit from this crisis.

As the recovery gets underway, there remains much uncertainty…

…about the ultimate strength and shape of that recovery. One of the key determinants will be 'scarring' and the degree of longer lasting damage that has been done. It is far too early to judge the degree of permanent job losses and detachment from the labour force from the data we have so far. Unemployment rates in Europe are likely to rise as firms reassess their labour force needs beyond furlough schemes. In the US, (high) unemployment rates are likely to fall as employees on temporary layoff are re-hired. Until the data is 'cleaner' the damage will be hard to assess. One important element we have had some evidence on is the degree of damage that has been done to household finances, at least in the US. In April, the personal savings rate jumped to a whopping 33%, reflecting fiscal support to households and, as seen in other countries during lockdowns, a drop in spending. That suggests some US households will enter this recovery period with their finances in better shape and considerable spending power. However, much still depends on re-hiring and continuation of fiscal support, e.g. more generous levels of unemployment benefit.

Another key determinant of the recovery will be fear

When the recovery is a fearful one - COVID numbers remain high, where there is no effective treatment/vaccine, when there is a risk of lockdowns being re-imposed, a risk of policy backstops being withdrawn and with all of these implying higher risks to job security – then that recovery is likely to be held back, particularly in terms of consumer spending. Australia remains interesting to watch, where new COVID case numbers remain at very low levels. Recent survey data has suggested a sharp improvement in Australian consumer confidence back to more 'normal' levels already. Economies like the US and UK are still a long way off such a position with respect to the virus.

Still adding support

With all this as a backdrop, policymakers are still adding support to the economic recovery. The ECB increased the envelope for asset purchases in their Pandemic Emergency Purchase Programme last week. This week, the US Federal Reserve said that they would not be reducing the pace of asset purchases further and published a median profile for policy rates showing the Fed Funds target range staying at 0- ¼ % in 2021 and 2022. The Bank of England decision is scheduled for next week, where additional asset purchases are likely to be announced. Over the next weeks, we are likely to hear more on the shape of another fiscal package in the US and the European Recovery Fund. It is important that we see progress on both.

Market view from Piers Hillier, CIO, RLAM

The recoveries in equity and bond markets have continued over the past couple of weeks, with several US equity indices hitting, or nearing, all-time highs earlier this week. The jubilant sentiment has been driven by a combination of incredibly supportive central bank policies, upbeat US labour market data and optimism as lockdown measures are eased in developed economies. We have seen a huge rotation towards deep value stocks, with many names up 50-60% in a few days.

The upwards moves have been retraced slightly over the past couple of days after Jerome Powell, the Chair of the US Federal Reserve, provided a rather grim outlook for the US economy. The Fed forecasts a 6.5% contraction in US economic growth in 2020, expecting the unemployment rate to end the year at an ugly 9.3%. At the same time, there have been signs of a second wave of Covid-19 cases in several US states that have eased their lockdowns.

The downbeat news sparked a global selloff in equity markets, with the worst single-day declines in US and European stocks since March. Credit spreads widened in the equity sell-off, driven by the same factors, though there is still notable demand for good quality assets. The events have resulted in surging volatility in markets, with the VIX index, a gauge of the market's expectations for future volatility, hitting 42.43% on Thursday.

Recent economic data releases have confirmed the extent of the damage to economies as a result of Covid-19 and the efforts to contain it. Following a 5.8% contraction in March, which was a record, the UK economy shrank by 20.4% in April. According to the ONS, that is almost 10 times as severe as the greatest pre-Covid-19 fall. Meanwhile, the global composite PMI business survey has improved, but at 36.3 still indicates a further slowdown in business activity.

This highlights the need for accommodative monetary policies that will help businesses recover when economies reopen. The European Central Bank expanded its pandemic emergency purchase programme last week, and there have been a number of fast-flowing developments in establishing a European Recovery Fund. Additionally, the market is expecting the Bank of England to announce more asset purchases at its meeting next week.

We've now had twelve weeks of lockdown. Limited relaxation of lockdown guidance and a wider re-opening of schools and shops is now underway. Looking past this morning's data release, we know that it will be at least a few months until the full scale of the immediate economic damage becomes apparent. While markets have superficially recovered from the sell-off in late March, we know that this is quite fragile.

Sustainable Funds – Mike Fox, Head of UK Sustainable Investments

What is happening?

Equity markets have continued their stunning recovery, with the US S&P 500 closing up on the year on 9 June. Just to recap, this index started the year at 3231, rose to 3386 on 19 Feb, fell to 2237 on 23 March and then fully recovered to 3232 on 9 June. We are often asked what is different about this market cycle. Our answer: speed. In previous bear markets and recessions these moves would have taken months, maybe years to play out. In today's markets, weeks are like months and months are like years.

As often happens with big market moves, the arguments for and against them become more emotive as time goes on. Those on the wrong side of them find new reasons each day to be negative, whilst those on the right side of them try to link cause and effect in ways that are often debateable. In March we felt we were in the midst of a good old fashioned market panic and, believing that panic is a temporary not permanent state of mind, we found a number of attractive investment opportunities. Once this panic subsided (we would say at around 2900 on the S&P 500 in mid-May) we felt that the risk reward was much more balanced. Markets are submissive to no one however, and rode straight on past us! We think there are three reasons for the continued march higher:

- Infinite money vs finite assets – the amount of money being created by central banks, trillions and trillions of it, is – in all practical senses – infinite. And their promise (threat?) to continue doing this until economies recover is stark. Where does all this money go? Consumers and corporates aren't borrowing new money; they are too focused on servicing existing debt. It therefore ends up in financial assets such and bonds and equities. There are of course only a finite number of securities listed on equity and debt markets, now being bid up by infinite money. It is simple economics to know infinite money versus finite assets will result in rising prices.

• There is no alternative (TINA) – this is an idea Ed Yardeni, one of our research providers, has created when commenting on equity markets. The reality is corporate pension funds and individual savers, as a generalisation, cannot meet their future liabilities owning government bonds with low/negative interest rates.
The yields on cash are pitiful too. Their only alternative is equities. This speaks to an idea we think is under discussed, that the value of an equity is both a function of the future profits of the company it is attached to, and the required return of the investor to own it. Historically equity investors have wanted 6-8% pa returns to compensate them for the risk of owning them. If cash returns zero, government bonds 0-1% and credit 2-3% (these are not forecasts but sensible numbers relative to today's reality) then investors will be willing to take lower equity returns. If 6-8% pa goes to 4-6% pa then equity prices will, and have, readjust upwards.

• The global economy is re-opening – investors have also been spurred on by the early signs of economic reopening being faster and less impaired by a second wave of virus infections than expected. Each month the US publishes employment data. Last Friday, the last time they did this, expectations were that the US economy had shed a further 7.5m jobs in May; it actually created 2.5m jobs! For those wishing to believe in a V shaped economic recovery, this was encouraging.

Place these three points in front of a bear, and they will say this is a liquidity fuelled rally and the economic recovery is too nascent to prove anything. Place them in front of a bull, and they will say the Fed is doing what it has done since Alan Greenspan in the 1980s, and supported the business and investment cycle until the economy recovers, which has now started to happen.

We have to confess to not finding either of these choices attractive. Fortunately our investment process can work well without having to take sides, so we are intrigued to watch and see how this plays out. We would however say that a bit more caution seems sensible given overall market levels, and that when we look at the output of our investment process it is telling us more defensive, less cyclical investments have the best risk/reward. This is very different from March, when our process was telling us nearly all risk was priced too cheaply.

What will happen next?

We have a strong view that we need to deal with the reality in front of us at the moment, rather than devising grand theories about how all of the above influences markets on a multi-year view. Many of the theories that came out of the financial crisis (QE would be inflationary, sub-trend growth) proved incorrect or at best debateable. What we can see though is the world in front of us becoming more digital, less carbon intensive, more health focused and generally more attractive for socially and environmentally useful companies, which will remain the bedrock of our sustainable funds.

One thing we would like to share though, which we find fascinating, is how the path of a number of economies and markets are following is similar to that of Japan, with a time lag. For the majority of my investment career (21 years and counting) I was told that Japan was an outlier. Low, then negative, bond yields? Yes in Japan, it won't happen here! Central banks buying government bonds, credit and equities? Yes in Japan, it won't happen here! Low growth and low inflation, despite huge stimulus packages? Yes in Japan, it won't happen here! Levels of debt to GDP which make levels in the US and UK look conservative? Yes in Japan, but it won't happen here!

The truth is that Japan has not been an outlier in my career, it has been a lead indicator. Where they have gone first, we have followed. Is this still the case now? Possibly. And if it is the case there are two important lessons to learn. The first lesson is that despite all their printing of money and large government deficits, nothing bad actually has happened. Inflation and economic growth have remained subdued and equity markets continued to rise. The second lesson is that in a world of permanently low interest rates, which Japan has seen for much longer that we have, the value ascribed to equities, and growth equities in particular, is an order of magnitude above what is perceived to be expensive in markets such as the US and UK. Japan embraced TINA some time ago!

So if Japan is a lead indicator still, maybe everything will be okay after all?

What are we doing?

Activity levels have been relatively low in the last two weeks, reflecting contentment with the existing portfolio structures and fewer opportunities post the market rally. We have supported two of our companies, Dechra and Segro, in fund raisings they have done.

Interestingly neither of them needs the money to sustain their current businesses; these are not distressed companies, but both see the economic disruption as a catalyst for greater opportunities as other distressed companies may need to sell assets fast. As such they think they can accelerate their strategic development in a positive way, so have raised money to support this.

Asset allocation in the mixed asset funds remains pro equity. After such a run in equity markets it is worth reminding investors that we have relatively fixed asset allocation in our mixed asset funds, give or take a few percent related to market movements, and that it is pro equity. Our view, not unlike that expressed above, is that cash and credit provide a low hurdle rate of return beyond which equities are attractive, especially when considering we typically invest over a 3-5 year time horizon.

How are we performing?

In the rally of the last two weeks the highest risk investments have tended to perform best. For investors believing in a V-shaped recovery, and a faster resolution to Covid-19 than previously expected, purchasing those investments most impacted in recent market fall makes sense. These tend to be the indebted, cyclical and less liquid names which we have something of an aversion to. As such the funds have seen some underperformance. The operational performance of the companies we own remains very good and we'd expect them, once this more aggressive period of risk taking ends, to be excellent investments. Year to date performance remains strong

Anything else?

Although lockdown has presented many challenges, it has at least offered, for most, a less frantic pace of life. One of the big benefits of this I've found has been more time to read. When we look for common characteristics of successful investors, one thing that stands out to us is how well read they are. Investing is in essence a quest for knowledge, and more specifically diverse knowledge. The best investment books, as in most additive to investment decision making, are not investment books at all. They can be about science, psychology, art, business, philosophy and many other topics. My own experience of investing has been something similar to looking at the stars and trying to find the shapes. Each piece of knowledge can be thought of as a star, and the more of these you have the more likely we can find shapes, which in my world are investment ideas. Breadth of thinking is a huge competitive advantage in fund management, but it is something that only comes with a determination to read and to learn about areas broader than those traditionally considered relevant for investment professionals. If there is perhaps one thing I'd like to keep as (hopefully) the world returns back to normal, it is more time to read.

UK Equity Income – Martin Cholwill, Snr Fund Manager, UK

During May, we have seen more UK companies stop paying dividends, as the response to coronavirus continues to take a heavy toll on the economy. As lockdown restrictions begin to be lifted in the UK and across Europe, it is not yet clear how quickly economic activity will recover, but in the immediate future a sharp recession feels inevitable. Few companies are giving any guidance at this stage. In addition, it is unclear the extent to which individuals will be able to decide their own risk appetite for what activities they choose to do going forward. My view is that virtually no industry will ultimately be immune from the economic and political impact of coronavirus, which is likely to cast a shadow over the global economy for a significant period of time. I am very much sticking to my investment process and using this to guide me through the crisis.

The fund performed behind the All Share index, but in line with competitor funds during May. Positive contributors to performance included Hargreaves Lansdown, Dunelm and Signature Aviation. The largest detractors to performance this month included Imperial Brands, WH Smith and Land Securities. Whilst there has been little impact on tobacco demand from coronavirus so far, Imperial Brands have decided to prioritise debt reduction over dividend payments. Whilst their dividend cut was not wholly unexpected, it weighted on the share price this month.

We further added to our position in Segro, taking the holding up to 2%. The company is better placed than many property companies and it is still paying a dividend. Its exposure to warehousing, last mile delivery and data centres makes its cashflow potentially more resilient and less structurally challenged than property companies with exposure to shops and offices. Holdings in HSBC were reduced to 1%. HSBC will not be paying any dividend for the foreseeable future and their growth of its risk weighted assets will be heavily influenced by government initiatives, as big banks need to be seen as good corporate citizens. In addition, Hong Kong increasingly looks likely to be a focus of geopolitical tensions between the US and China. The Fund also took a few profits in Restaurant Group, with the share price having risen over 12% since last month's placing

Property

The past week has seen further job losses caused by the pandemic, with major restructures announced at The Restaurant Group, Monsoon Accessorize and fashion chain Quiz. These groups will seek to renegotiate rents and terms on a number of their sites. Further announcements of this type are expected as retail and hospitality businesses struggle to cope with the unprecedented challenge that COVID-19 brings.

For operators and landlords of retail property, there are two important dates looming. Firstly, 15th June when the vast majority of retailers are permitted to reopen stores and secondly, 24th June, when the next quarter's rent is due.
In advance of the 15th June retailers are trying to work out how they can reopen stores and adhere to Government guidelines. One example of the type of issues they face, is how to deal with stock that has been handled by or tried on by customers. Some items could be disinfected and returned to the shop floor whilst others could be quarantined. The latter is likely to cause logistical difficulties for retailers as they wrestle with how to ensure they separate "clean" and "dirty" stock.
Understandably, many retailers seem to be adopting a cautious approach to reopening with their store portfolio opening in phases. John Lewis is initially only opening two stores on the 15th albeit others will open shortly thereafter. Frasers on the other hand is planning on reopening all stores on the 15th. Bluewater expect circa 95% of retail stores to reopen in the first week albeit some will be reducing opening hours. In contrast, only 9% of the Food and Beverage offer is expected to reopen, highlighting the more significant challenge this sector will face going forward.
On a more positive note, there are signs that the industrial sector has recovered confidence. Segro has acquired Perivale Park, a warehouse estate in London, for £202.5m, reflecting a yield of 3.5%. This is one of the largest investment transactions during lockdown and a deal that was initially put on hold. It is encouraging to see that it has now completed, furthermore at a price that appears unaffected by recent events. Transactions such as this provide investment evidence to valuers and the Material Uncertainty Clauses has now been lifted from this segment of the market.
The Central London office investment market remains muted, with sporadic activity and a handful of deals on the go. Pricing broadly seems to be holding firm for the best properties, and we expect this to be the next sector to have the valuers' Material Uncertainty Clause removed. The sense is the owners of Grade A assets will (and can) wait for the storm to pass, which could happen sooner, rather than later.

Performance year to date

Governed Portfolios

Portfolio Name	Percentage Growth 31.12.19 12.06.20 % Chg	Percentage Growth 12.06.19 12.06.20 % Chg
Governed Portfolio 1	**-7.38**	**-3.08**
Composite Benchmark	-5.74	-2.31
Difference	-1.64	-0.77
Governed Portfolio 2	**-5.78**	**-2.07**
Composite Benchmark	-4.42	-1.52
Difference	-1.36	-0.55
Governed Portfolio 3	**-3.36**	**-1.31**
Composite Benchmark	-2.14	-0.73
Difference	-1.22	-0.58
Governed Portfolio 4	**-9.30**	**-4.49**
Composite Benchmark	-7.99	-4.05
Difference	-1.31	-0.44
Governed Portfolio 5	**-7.91**	**-3.57**
Composite Benchmark	-6.39	-2.95
Difference	-1.52	-0.62
Governed Portfolio 6	**-5.47**	**-2.63**
Composite Benchmark	-4.05	-1.98
Difference	-1.42	-0.65
Governed Portfolio 7	**-9.89**	**-4.66**
Composite Benchmark	-9.67	-5.13
Difference	-0.22	0.47
Governed Portfolio 8	**-9.66**	**-4.76**
Composite Benchmark	-8.33	-4.27
Difference	-1.33	-0.49
Governed Portfolio 9	**-6.58**	**-3.00**
Composite Benchmark	-5.36	-2.52
Difference	-1.22	-0.48

Governed Retirement Income Portfolios

Portfolio Name	Percentage Growth 31.12.19 12.06.20 % Chg	Percentage Growth 12.06.19 12.06.20 % Chg
Governed Retirement Income Portfolio 1	**-0.62**	**1.36**
Composite Benchmark	0.60	2.04
Difference	-1.22	-0.68
Governed Retirement Income Portfolio 2	**-2.60**	**0.01**
Composite Benchmark	-1.24	0.75
Difference	-1.36	-0.74
Governed Retirement Income Portfolio 3	**-4.64**	**-1.35**
Composite Benchmark	-3.07	-0.42
Difference	-1.57	-0.93
Governed Retirement Income Portfolio 4	**-6.88**	**-2.98**
Composite Benchmark	-4.95	-1.82
Difference	-1.93	-1.16
Governed Retirement Income Portfolio 5	**-8.36**	**-3.88**
Composite Benchmark	-6.42	-2.69
Difference	-1.94	-1.19

Underlying Funds

Portfolio Name	Percentage Growth 31.12.19 12.06.20 % Chg	Percentage Growth 12.06.19 12.06.20 % Chg
RLP Absolute Return Government	**-0.42**	**1.29**
Benchmark	-0.29	-0.45
Difference	-0.13	1.74
RLP Commodity-Pen	**-18.53**	**-16.70**
Benchmark	-16.90	-15.84
Difference	-1.63	-0.86
RLP Deposit-Pen	**-0.17**	**-0.30**
Benchmark	-0.29	-0.47
Difference	-0.12	-0.17
RLP Global High Yield Bond-Pen	**-4.45**	**-0.16**
Benchmark	-4.94	-1.18
Difference	0.49	1.02
RLP Global Managed-Pen	**-10.40**	**-4.17**
Benchmark	-10.64	-4.87
Difference	0.24	0.70
RLP Long (15yr) Corporate Bond-	**7.00**	**12.67**
Benchmark	6.96	13.06
Difference	0.04	-0.39
RLP Long (15yr) Gilt-Pen	**11.76**	**12.93**
Benchmark	10.84	13.04
Difference	0.92	-0.11
RLP Long (15yr) Index Linked-Pen	**7.78**	**5.14**
Benchmark	6.60	4.41
Difference	1.18	0.73
RLP Medium (10yr) Corporate Bond-	**3.74**	**7.96**
Benchmark	3.60	7.64
Difference	0.14	0.32
RLP Medium (10yr) Gilt-Pen	**7.18**	**7.97**
Benchmark	6.64	7.61
Difference	0.54	0.36
RLP Medium (10yr) Index Linked-	**4.65**	**2.50**
Benchmark	3.82	1.86
Difference	0.83	0.64
RLP Short (5yr) Corporate Bond-	**0.56**	**2.70**
Benchmark	1.04	3.09
Difference	-0.48	-0.39
RLP Short (5yr) Gilt-Pen	**3.02**	**3.15**
Benchmark	2.83	2.92
Difference	0.19	0.23
RLP Short (5yr) Index Linked-Pen	**1.31**	**-0.37**
Benchmark	1.08	-0.50
Difference	0.23	0.13
RLP Property-Pen	**-4.20**	**-3.73**
Benchmark	-3.96	-5.32
Difference	-0.24	1.59
RLP Sterling Extra Yield Bond-Pen	**-7.89**	**-4.59**
Benchmark	-0.81	3.56
Difference	-7.08	-8.15
RLP Short Duration Global High	**-3.95**	**-2.61**
Benchmark	-0.19	-0.32
Difference	-3.76	-2.29

Longer term performance

Please see **our latest performance**.

Past performance is not a reliable indicator of future results. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested.