9th September

Royal London Market update

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

- Most asset classes have traded in a narrow range over the summer months but the start of September has seen renewed enthusiasm for equity volatility which increased as US tech stocks led a marked sell off.
- In the UK Sterling moved lower as Brexit talks resumed and the Prime Minister called out the 15th October as the next key date in the Brexit talks.
- There was some light at the end of the tunnel for Property funds as the Royal Institution of Chartered Surveyors (RICS) announced they were set to remove material uncertainty clauses.
- One year returns across the portfolios have improved to end of August and range from -1.5% to -3% in both the GPs and GRIPs.
- All the underlying funds are outperforming their benchmarks with the exception of commodities, longer duration bonds and high yield.
- Longer term returns remain strong with GPs returning between 5-8% annualised since launch and GRIPs returning between 4-7%.
- All performance numbers quoted are net of a 1% charge and you can find returns for all the portfolios in the link at the end of this update.

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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 Activity and market view, Trevor Greetham, Head of Multi Asset, RLAM

"Royal London's Governed Portfolio's lagged behind simple balanced funds in the deflationary environment of the Covid-19 shock amidst an unexpectedly strong performance from gilts however we believe our broader asset mix will put us in good stead in what could be a more inflationary period going forward. Policy is extremely loose, as the surge in gold testifies, and central banks have no plans to tighten until the virus has gone. We are moderately overweight equities and commodities with a large position in high yield bonds. Immunity levels are low and a relapse is possible but we would ultimately buy dips in the expectation of further stimulus.

Markets hint at inflationary future

We set the strategic asset allocation for our Governed Range in order to maximise long-run returns after inflation. The surge in the dollar gold price since March suggests a more inflationary outlook in which broader diversification is likely to pay off. Policy makers would rather err on the side of doing too much stimulus rather than too little.

The Investment Clock & the 'square root economy'

The Investment Clock slumped into Reflation in Q1 when growth and inflation collapsed and it's retracing its steps just as quickly as social distancing measures are eased. Strong data should support further market gains but the current V-shaped recovery could flatten out into something more like a square root symbol while we wait for a vaccine or for herd immunity to set in. We are moderately overweight equities and commodities but taking a flexible view allowing for virus news and rising geopolitical tensions. We continue to tilt portfolios towards high yield bonds, US and emerging market equities and the technology sector, all high conviction positions we held before the crisis that continue to perform well."

Market view from Piers Hillier, CIO, RLAM

"The remarkable run of the global equity market continued in August, reaching all-time highs led by the US. The rally has been supported by signs of recovery in underlying economic data and progress in the development of vaccines and treatments for Covid-19. While there was a significant market sell-off at the end of last week, led by technology stocks, US equity indices remain markedly higher than they were at the start of August.
Equity markets were relatively calm for most of August. The VIX index, a measure of expected volatility based on S&P 500 index options, spent most of August hovering around 22 (a six-month low). However, the market correction at the end of last week caused the index to surge to around 37.5 although this has declined towards 30 as I write. For many, US equity markets near all-time highs will seem bizarre, but as I noted in March, markets are forward-looking, and just as they fell sharply as the uncertainty of Covid-19 emerged, so in response to the record monetary and fiscal stimulus they are taking the view that ultimately, there will be a substantial economic rebound. What is interesting is the acceleration of certain trends – notably technology-related areas such as digitalisation. While stocks will see the normal ebb and flow in sentiment, there can be periods where markets over-extrapolate trends and this can manifest itself in higher price multiples that investors are prepared to pay to own assets with exposure to that trend. While there has been some evidence of these trends starting to emerge in part of the technology complex, underlying earnings growth and cashflow generation have been strong this year, but when this comes with multiple expansion we need to approach this appropriate caution.

The risk-on sentiment seen in equity markets was replicated in government bond markets, with yields surging globally. Within this, European government bond markets strongly outperformed, while the UK gilt market lagged on anticipation of a massive supply of long-dated gilts over the next few months. One of the key strategies for our government bond funds this year, given the many uncertainties for investors, has been to embrace tactical, rather than strategic, trading around supply events. The next few months should provide ample opportunities for that approach.

Within investment grade credit, spreads (the yield difference between corporate bonds and government bonds) are now only about 0.2% wider on the year, with the average spread 1.25% at the end of August, though there is a lot of sectoral variation within this. Financial bonds (banks and insurance) have been notably strong in recent weeks, which have benefitted our credit portfolios given that they are typically overweight in this area and in particular subordinated financials. The high yield credit market has performed particularly well since the market crash in March, with August being no exception. It looks likely to have been one of the most significant months of issuance ever, with companies keen to take advantage of the high level of demand in the market. Periods of significant corporate issuance are often supported by increased risk appetite for the asset class but can see investors being prepared to accept reduced covenant protections. As fundamental investors we need to be especially diligent when these trends start to emerge and position our high yield funds accordingly.

As we've said before, the coronavirus pandemic has changed things forever. Our autumn investment series webinars at the end of September have been put together to look at how these changes will play out in various asset classes. We're also providing an update on how RLAM functions, not because this is intrinsically interesting, but to give you confidence in how we are operating and have adjusted to this new world. In addition, I'm delighted that we will have Andrew Neil doing a session for us. Andrew has a unique insight into the political process here in the UK. Ten years ago there was an argument that politics mattered less given the consensus that existed at the time. In an age of Brexit and Coronavirus, that is certainly not the case, and I'll be listening to what Andrew has to say with great interest. You can sign up for Andrew's session, and see what else we are putting on, here.

RLAM Economic Viewpoint

The months of economic recovery post-lockdown, into the early part of the summer were strong, bolstered by the release of pent-up demand. The current phase of the recovery looks more challenging and the pace appears to be slowing in many places. In recent weeks, data has been more mixed. US and euro area business survey data for August indicated growth, but with some survey indicators rising and some falling – sending mixed signals on whether growth is slowing or speeding up. Higher frequency mobility indicators have flattened in several countries over July and August. 'Hard' data for July, such as retail sales and manufacturing production, suggest that the pace of growth slowed in the US and euro area, although the latter is not yet available in the euro area. China's business surveys suggest that the recovery continues, but the pace of improvement in 'hard' data series like retail sales has slowed.

Several factors seem likely to help hold back the pace of recovery, especially until an effective vaccine is widely available:

1. Mandated social distancing;
2. Damage done/scarring – relating to permanent job losses, permanent business closures and household/business balance sheet damage;
3. Fear – of the virus itself, but also of shutdown risks and related risks to job security and around the outlook for the return on any planned investment.

The progress of the virus will affect these (new case numbers have fallen in the US, but are rising in Europe). Governments have a direct role to play in 1); have pumped in a huge amount of economic policy support to limit 2); and through ongoing public health measures and economic stimulus, can help dampen 3).

Over the last few weeks, the role of governments is one area where risks are building, particularly in the US. US monetary policy remains accommodative and the FOMC's recent adoption of an average inflation targeting framework further underscores that they will be in no hurry to take back that stimulus. Fiscal policy, however, has disappointed. There was some expectation that US politicians would agree a fiscal package earlier in the summer to offer at least some continuity after the provisions of the CARES Act rolled off – in in particular, the boost to unemployment benefits. With election campaigning now in full swing, it is less clear that both sides will be able to come together and pass a package. Another government funding deadline approaches at the end of this month, bringing the prospect of shutdown risk too.

Here in the UK, there are reasons to worry as well. Some temporary government interventions have been a big boost/support to activity, but it is not clear how well the economy will do once they are unwound. Eat Out to Help Out has been a success in getting people eating out, although it is too early to judge whether the effects will last. The heavily used furlough scheme is discontinued entirely in October. So far, the UK unemployment rate has stayed at very low levels as take up of the scheme has been high. That will have helped to shield many households from the effects of the crisis. As that support is unwound, more job cuts are likely as firms reassess their finances. It was notable that in the – generally strong – August PMI business survey, that the employment component remained weak. In their press release, compilers IHS/Markit comment that "lower payroll numbers were primarily attributed to redundancy programmes in response to depleted volumes of work and the need to reduce overheads before the government's job retention scheme winds down".

As for inflation, the data has yet to give a clear steer on whether the worst of the deflationary effects of the crisis are behind us. Across many developed economies, July inflation data surprised on the upside. However, euro area inflation went on to surprise on the downside in August, recording a first negative year-on-year print since March 2016 and the next print of UK inflation will incorporate the effects of the VAT cut and Eat Out to Help Out. As for how deflationary/inflationary the crisis will ultimately prove to be, the odds on an inflationary outcome have arguably risen after the FOMC's change in monetary policy framework.

However, "likely" aiming for "inflation moderately above 2% for some time" after inflation has been persistently below 2% – as has been in the US – is not a green light for a high inflation environment. Several other factors, including a boost for online retailing from the pandemic, are likely to work in the opposite direction on inflation."

Sustainable Funds – Mike Fox, Head of UK Sustainable Investments

"The last few months have turned the world upside down with Covid-19 leading to lockdowns unprecedented even in wartime. The social and financial costs are still unknown, but the impact has been staggering. Financial markets fell precipitously in March, only to recover some or all of their losses, buoyed by huge stimulus packages and an end to lockdowns. Yet it would be a mistake to conclude that life will be back to normal for some time. And some things will never go back to how they were – there really will be a 'new normal', even when social distancing, facemasks and other measures are a distant memory. The pandemic will catalyse changes that were already happening, having a considerable impact on financial markets. Sustainable investing had already experienced a remarkable surge into the mainstream in recent years. This had taken a bit of getting used to. I've spent much of my career on the margins of investment management, often unable to persuade investors of the merits of considering environmental, social and governance (ESG) factors. This started to change around 2016, but the last four months have arguably seen more change than the previous decade. There are several forces at play here. It's far too early to make grand pronouncements about the impact on society, but the existential threat posed by Covid-19 seems to have started a process of reflection about how we live. People seem more aware of their relationship to society and the environment, and expect governments to keep them safe. There is an increased awareness of some potential drawbacks of globalisation, particularly in extended supply chains. Many companies that had focused on shareholders at the expense of their wider stakeholders – sweating financial, physical and human assets to increase their returns on capital – have struggled. Conversely, businesses that have a positive relationship with their customers, employees and other social and environmental stakeholders, as well as their shareholders, have been more resilient. The strong performance of sustainable funds shouldn't be a surprise.

Sustainable investing is about identifying companies that provide solutions to global challenges, such as climate change and pandemics, rather than companies that exacerbate these problems.

We also invest in companies that show ESG leadership in their sectors. This applies to both equity and credit in our sustainable multi asset funds. Additionally, in sustainable equities, we favour companies with good long-term growth potential and strong balance sheets. Value creation and valuation are key factors in our investment process. It is understandable that companies that meet these criteria have done well in a period of profound societal challenge and economic distress. Performance is about what you invest in and what you don't. It's an obvious point, but in the recent financial meltdown and recovery, certain sectors have stood out. In particular, the technology and healthcare sectors have performed well as remote working has become mandatory for many and authorities have sought a response to the virus.

Sustainable investing isn't a magic bullet, though. Active investment has been a key factor in performance. In healthcare, we prefer companies with broad pharmaceutical research and development capabilities and effective distribution across therapeutic categories, rather than looking for the single winner of the race to develop a vaccine. We have also benefitted from owning companies that have strong positions in diagnostic testing. In technology, the key to remote working has been the cloud, through which so many digital solutions operate. Other technology subsectors have also performed strongly, including digital payments systems, ecommerce platforms and remote medical patient monitoring. Likewise, software companies are thriving, in areas such as virtual safety testing, digital documentation and architectural design. The trend to digitisation was already underway, of course, but has accelerated hugely. Satya Nadella, CEO of Microsoft, recently said that Covid-19 has led to two years of digital transformation in two months. The challenge for investors is to identify whether these trends are one-off boosts or will lead to a sustained uplift in growth. Performance has also benefitted from not owning sectors that have performed poorly, such as energy, leisure and travel, or being underweight banks, which have performed poorly on the fall in yields and increased risk of defaults. Some of these sectors should recover as long as the companies aren't dragged down by their leveraged balance sheets, but energy and business travel feel particularly vulnerable.

There have been various step changes brought on by Covid-19. Some may peter out, but others will continue and accelerate trends that were already in play. Having been boosted by the pandemic over recent months, sustainable investing is well placed to continue to benefit from the societal and political changes that it has catalysed. "

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Property update

The UK commercial property market has recently shown some signs of improved sentiment. The MSCI UK Monthly Index, which measures investment performance of 43 UK portfolios valued at £38.2bn, has seen month-on-month improvements since March, with total returns in June only marginally negative at -0.23%. We are expecting to see a further improvement in the July data when this gets released next week, however confidence remains fragile and economic indicators point towards a fragmented occupier market.

The retail sector continues to face strong headwinds; consumer confidence is low and as the furlough scheme unwinds at the end of October, job security is likely to fall further, which could diminish retail spending. Retail sales values in June showed a surprise return to growth of +1.5%. Volume growth outstripped value growth in June though which suggests that retailers are discounting heavily to stimulate sales. More store closures have been announced including Pizza Express (67 outlets), Oak Furnitureland (27 showrooms), Burger King (50 – 100 outlets), Pret a Manger (30 stores) and TUI (166 high street stores). Greggs has cut its expansion plans. Having originally announced it wanted to open 100 stores by the end of the year, it has now stated that is will open 60 new shops but close 50 existing stores. Retail vacancy rates rose slightly in the second quarter of the year from 12.2% to 12.4%. According to the MSCI Monthly Index, retail rental values fell on average by 3% over the quarter. This is the sharpest quarterly decline on record, highlighting the current weakness in occupier demand for physical space.

In contrast, the logistics sector remains relatively buoyant. Colliers reported that take-up for H1 2020 was 17.7 million square feet, which was 20% ahead of the same period last year. Given the challenges tenants have been facing, this is a remarkable figure.

In the office sector, take-up levels in Central London were 66% below average as the lockdown caused the market to halt, but there are now signs of recovery as restrictions ease. There have been mixed headlines as some lettings have been put on hold, particularly expansionary moves, but expiry driven activity continues. Availability has increased. CBRE report London vacancy at 5.3% up from 4.4% in Q1 and above long term average of 5.1%, the result of a rise in second-hand space. There is still demand for best-in-class though, with 50% of space under construction either let, or under offer.

Data from Savills indicates that Q2 2020 was the weakest quarter on record for investment activity in the UK commercial property market. They estimate that investment volumes in the first half of 2020 were 43% below the five-year average. We expect to see investment levels rebound in H2 as buyers seek to take advantage of opportunities and London's pricing relative to other European office markets, especially when accounting for its higher liquidity. Demand for warehouse and logistics investments continues to be strong with pricing for prime assets still trading at pre-lockdown levels. The next few months will serve as an interesting barometer to gauge how quickly confidence returns.

The current restrictions on **RLP Property fund** remain in place however we expect our valuers to remove the material uncertainty clauses later this month and will provide further information when we are in a position to do so.

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.