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Royal London Market update

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

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The first quarter of 2020 was one of the worst we have ever seen. Economic data shows a shrinking economy with the UK services sector contracting the most as the impact of Coronavirus continues to dominate life. Many stocks are cutting dividend payments and it appears that no industry will ultimately be immune. This lack of good news and visibility around when we may return to something approaching normality is reflected in double digit falls from equities, commodities and high yield. Conversely market uncertainty is driving up demand for UK gilts which have delivered positive returns over the quarter. Property has been largely flat however we do expect some downward movement in the market as a result of the valuation uncertainty clauses which have now been added by independent valuers. This should be seen in the context of the current market and extreme volatility and our view is that property continues to offer valuable diversified exposure for our customers, particularly at this time.

These returns remain within the range of scenarios we model as part of our governance and oversight process for the Governed Range. We continue to follow our enhanced monitoring process throughout this period and have scheduled a special meeting of our Investment Advisory Committee for Wednesday 8th April. This allows us to discuss the impact of recent events on our investment strategies. We will continue to keep a close eye on economic indicators and market sentiment factors which inform our models and review any impact on our longer term assumptions. Rest assured that if these are triggered, we will take action to adjust our strategic asset allocations which set the guidelines for our tactical positions. This will be done through our governance process and will follow recommendations from our Investment Advisory Committee. The portfolios remain well diversified across a range of asset classes and as long term investors we are well placed to take advantage of the buying opportunities when the time is right.

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

Stock markets bounced sharply last week, after a violent sell-off earlier in March, with more optimism on counter measures to mitigate coronavirus related damage to the global economy, after the USA has approved a $2 trillion dollar package; however, markets have seen more volatility and weakness this week as uncertainty over both the depth and duration of the health and economic crisis remains high.

We have moved to be broadly neutral in equities but have not gone underweight as US and European public health experts are beginning to talk of some hope regarding the virus impact peaking which may lead to lockdowns being eased; also a broad range of monetary and fiscal stimulus measures have been announced which will significantly help growth once restrictions on activity can be eased. We remain slightly overweight US equities (including the tech sector) given the relatively defensive nature of the market; 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. We remain overweight high yield bonds, particularly short duration high yield, as we expect the asset class to be resilient over the medium term. We remain broadly neutral on UK commercial property where we have seen diversification benefits relative to equities. We have de-risked our currency positions, remaining short the economically-exposed Australian dollar and more recently moving short sterling while shifting in favour of the more defensive US dollar and Japanese yen.

Market outlook, Trevor Greetham, Head of Multi Asset Funds, RLAM

We may not yet have seen the lowest point in equity markets as the virus is spreading rapidly in the US and Europe with volatility remaining high. Sustained recovery in markets will probably have to wait until there is more confidence on the virus being under control globally, shuttered parts of the world economy are re-opened and consumer confidence rises from its lows as people are allowed to return to work. We expect our Investment Clock model to reflect this situation by moving quickly into disinflationary Reflation before moving sharply upwards into Recovery when the crisis ends. 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 policy responses being implemented.

RLAM Economic Viewpoint

Although there has been some encouraging news from countries where the growth in new cases has been slowing, it is clear from incoming case numbers that we are still some way off being able to contemplate easing social distancing measures in Europe, let alone the US. In the meantime therefore, levels of economic activity remain well below pre-crisis norms. Data has underscored the challenge facing policymakers. Over the week, the latest US weekly initial jobless claims number showed another a record jump of more than 6 million. Benefit claims have risen sharply in the UK too and incoming March survey data reflects a large hit to business activity and confidence in Europe and the US.

Economic activity data in China has improved as social distancing measures have eased and March business surveys show significant improvement. However, business surveys generally ask firms whether activity has increased or decreased, not by much. That is important in the current context where the level of economic activity is likely still significantly below pre-crisis levels. Export-related components of the surveys still signal contraction, consistent with weak global demand now holding back China's recovery. Meanwhile reminders that things aren't normal and that social easing can't be unwound in one easy move while there is re-infection risk, came in the shape of some reversals of social easing (e.g. cinemas shutting again and lockdown being re-imposed in Jia county).

In the US unemployment numbers this week highlight the scale of the challenge policymakers face in trying to limit the long-term economic damage from this crisis. The good news is that policymakers globally continue to step up and introduce measures that improve the likelihood of economic activity being able to pick up robustly once social distancing measures ease. Again, we've seen measures designed to keep the financial system working (e.g. Fed's announcement this week of a repo facility for overseas central banks), limit damage to household finances (e.g. the direct wage subsidy scheme announced by Australia at the start of the week) and keep viable businesses afloat. Other highlights included a 50bps rate cut in Canada late last Friday and a policy easing message from Chinese authorities.

Market view from Piers Hillier, CIO, RLAM

In the past week, the number of confirmed COVID-19 cases around the world has more than doubled. The global total now stands at over one million, and the US has taken on the mantle from Europe as the new epicentre of the crisis with around 250k confirmed cases; more than double any other country. We had noted last week that the 3.3m US jobless claims two weeks ago far exceeded previous records and economists' expectations. It emerged yesterday that the number of claims for first-time unemployment benefits surged to 6.6m in the past week, shocking economists once again.

The survey data that has been released today reiterates the sharp contraction in economic activity, with the composite PMI figures hitting all-time lows across the UK and the eurozone. Sweden has adopted a less draconian approach to managing the pandemic and whilst economic activity there also slowed in March it was relatively muted by comparison to the dramatic falls in Italy and Spain that have been in lockdown. In light of these economic challenges, the credit rating agencies have been aggressively downgrading their assessments of companies. According to a report from Bank of America, March featured the most downgrades since records began in 2002. Among them, Fitch downgraded the UK to AA- from AA on account of the country's "loosening fiscal stance" and weakening public finances.

As many companies appealed for help in the form of governmental bail-outs, regulators made it very clear that such companies should not be distributing dividends to their shareholders. Under pressure from the UK's Prudential Regulation Authority, the UK's banks announced that they would cancel dividend payments for 2019, as well as withholding 2020 dividends and share buybacks, this despite all of them passing the Bank of England's stress tests last year. The total cut to UK dividend pay-outs could well be around 50%, which compares to only 14% during the global financial crisis. The same theme can be seen in Europe whilst many companies in the US have suspended share buy-back programs. Whilst prudence is rightly front of mind as we tackle this major economic shock, we must remember that dividends play an important part of meeting the income needs of small investors and in particular pensioners.

Despite the gloomy backdrop, sentiment and liquidity actually improved in a number of markets over the week. Of particular note, the high yield credit market, which had been beaten up for much of the crisis owing to its riskier characteristics, saw record inflows amid a seven-day rally. Supported by accommodative central bank policies and higher oil prices, investors flooded back to the sector in pursuit of the income it could offer. Given the pressure on dividends, we feel that the search for income – a significant issue for many clients given the demographics in developed markets – is about to become even more challenging.

Brent crude oil enjoyed its biggest ever one-day rise on Thursday, with the commodity settling 21% higher having been up as much as 46.7% at one point. The spike came after President Trump, who is overseeing negotiations between Russia and Saudi Arabia in an effort to stop their oil price war, said that he expected the nations to cut production by approximately 10 million barrels a day. Trump's announcement was, however, given a cool reception by the two countries and they refused to publicly commit to any such cuts, but agreed to convene a meeting of OPEC next Monday.

The past week has seen a few tentative signs of normality. While conditions are still stressed, the new issue market has been operating in both investment grade and high yield bond markets. This doesn't mean that we're on a fast-track back to where we were before the crisis, but it is an important and positive marker in the proper functioning of markets. As you would expect, our credit teams analysed these as they would other deals – notably passing on one high yield deal that was heavily oversubscribed and paying a high coupon as the fundamentals didn't add up for us. This is the sort of work that you have to do as active managers, and while some aspects of this are going to change, the basic process does not.

Equities

In tough economic times, when assessing existing holdings and new investments, our primary focus is the balance sheet rather than the profit and loss account. As a consequence, we have spent a lot of time recently reviewing balance sheets of portfolio companies, as well as the relevant covenants attached to banking facilities and the financial liquidity available to companies overall. We have tried to stress test the earnings and balance sheets of our holdings in scenarios where future profits (and cashflows) could be significantly lower depending on the time their end markets are in lock-down. Cineworld, Weir and Senior were sold after this exercise.

There are others which appear in need of more capital, but we believe could be the beneficiary of a significant valuation uplift if they were to raise money, thereby removing solvency risk through this period of uncertainty. Investors are sitting ready at the sidelines with cash, with relatively few fund outflows and a willingness to support good companies who have been caught out by the sudden and catastrophic impact of this virus. Recent equity issuances by City Pubs, SSP and Ten Entertainment were all over-subscribed, and the shares subsequently rallied to trade at significant premiums to their placing price – evidence of investor support.

It is clear that earnings expectations throughout the market remain too high and need to adjust to the full implications and ramifications of the virus and its medium-term effects on industry and consumers. Even companies that appear well capitalised may struggle in an environment where revenues could disappear for a period of weeks or months. With this in mind, many companies have taken the decision to cut their dividend, suspend all but essential capital expenditure and cut operating costs to a bare minimum. This will have a very real effect on economic growth in 2020, and associated mass redundancies are likely to have a damaging effect on consumer confidence that outlasts the virus itself.

Despite this, there is a real difference between this economic period we are entering and previous recessions. We have consistently heard from companies across the market that banks are much more supportive than typical and are prepared to waive financial covenants for 6-12 months and extend banking facilities to what they see as otherwise solid and successful companies. These financial institutions are willing and able to do this because they approach this downturn with relative financial strength and repaired balance sheets (following the 2008 credit crisis). The government is also encouraging this behaviour and has been fast to provide support in the form of ample liquidity to bank funding markets.

Within active global equities we are increasingly positive on long-term valuations for equities given the recent market falls, the increasingly accommodative monetary policy and the lack of return in many alternative asset classes. It has been a slightly disorderly market driven by what appears to be quantitative and macro funds rather than long-term stock pickers. At the stock level we see individual investment opportunities across the corporate Life Cycle and across sectors and are utilising our process to identify these and increase holdings where the price is right.

Property

Sentiment in the real estate sector is contingent on many factors, but the underlying health of the economy plays a fundamental role.

A significant slowdown is now underway. Prior to this crisis, values of retail properties were already in decline, with the other main market sectors stable or rising, off the back of the December General Election result. However, across most sectors we now expect to see an increase in property yields and for asset valuations to fall, as a combination of investor uncertainty and near term occupier stress take hold. RLAM are no longer proceeding with a number of investment transactions and expect others to take stock and pause, whilst the ramifications of this global crisis become clearer.

Investment volumes will therefore be suppressed. There are signs that some private equity funds are still active and seeking opportunities, particularly in the industrial sector. Recent deals saw transactions completed last week achieve, and even exceed, asking prices. This demonstrates the view that despite current uncertainty, key industrial locations could benefit from the growth in online and last mile logistics. However, we expect these types of deal to be in fairly short supply.

As social distancing intensifies following the government's soft lockdown approach, the effects are already beginning to appear in economic indicators. One recent example, particularly pertinent to the property sector, saw this week's statistics indicating that certain London retail destinations have seen a 90% decline in footfall year-on-year. This is inevitable under the circumstances, but the effects are only beginning to emerge.

We are seeing a significant number of requests for a quarter's rent concession from retail and leisure tenants. These range from requests to pay monthly rather than quarterly, to occupiers seeking a rent free period. This has now spilled out to other sectors, with industrial based tenants requesting similar concessions, particularly those supplying restaurants and high street stores. Hotel operators are another area of concern. Without doubt, some operators won't survive and we've received multiple requests for landlord concessions and assistance. This situation will separate those well-run companies with robust balance sheets from the rest, a matter requiring considerable oversight over the coming weeks/months.

RLAM have been proactive in engaging with our tenants and are trying to take into account the individual circumstances of each occupier, keeping in close contact with managing agents and landlords to gauge the stance others are taking, and understand themes as they emerge.

These risks to near-term income alongside weak investor sentiment, will lead to a sudden re-pricing of UK real estate. It is difficult to judge how far values will fall off the back of limited investor demand, and occupier pressures, combined with record low market sentiment; but it could be dramatic, in both quantum and speed. We would hope that in the short term, rents recover and yield increases reverse, as confidence returns and people revisit shops and leisure destinations – potentially just as dramatically on the upside

RLP Property Fund update

Our RLP Property Fund has been put into deferral, effective from Monday 30 March 2020. This means that some transactions will be temporarily restricted from the fund.

This decision has been made in the long-term interests of our customers as a whole and we'll continue to closely monitor the fund and provide updates throughout the restricted period.

To find out what transactions have been restricted and more, visit our RLP Property Fund update.

Investment grade credit

Our focus has been very much on managing liquidity and taking advantage of market opportunities. The tone of the market has definitely improved, with liquidity improving. The Bank of England helped matters, particularly with the bonds that would be bought under the programme (utilities, housing associations).

We do not know how long this will last, but the economy will eventually recover. In retrospect, this could look like an attractive buying opportunity, and we are selectively taking advantage of wider spreads. In the Sterling Credit fund, this included a purchase of Finance For Residential Social Housing, while in the Short Duration Credit fund we have added EDF, Wells Fargo and Investec.

Both funds have underperformed their respective benchmarks to 27 March, primarily reflecting sector selection. The biggest impacts have been exposure to sub-investment grade bonds, overweight positions in banks and insurance and an underweight in supranational bonds. However, both funds are very well diversified, have a bias towards secured debt and have yields above their respective benchmarks.

In both cases it is important to look at the likely incidence of default. The most likely sectors are leisure, travel and those areas most exposed to a decline in discretionary consumer expenditure. Whilst our overweight position in secured debt will not prevent defaults risk it puts us in a better position to achieve a higher recovery rate in case of default.

High Yield

Market yield spreads have widened significantly across all market sectors and for all grades of credit quality. At the time of writing, current levels are now slightly less wide than their widest levels. These moves have few parallels; the prior week's moves in investment grade spreads were greater than the spread widening in the whole of the month of September 2008, with returns to suit, and the single day move of 100bps in high yield spreads on 19 March was the third largest single day move ever, behind only 9/11 and the day that Lehman filed for bankruptcy.

Interest rates are likely to remain very low for some time, and growth prospects lowered. While initial market reflections on inflation (especially after the oil price move) were negative, the longer term outlook is far different. Elevated volatility is expected to continue and credit yield spreads are expected to remain wider until confidence is regained but there are already signs of this. Although markets could deteriorate further in the interim, we are well positioned to benefit from a recovery in credit markets when they happen.

We believe the portfolio is robust, with a focus on credit fundamentals; maintaining our medium to longer term philosophy-based approach, resulting in an emphasis on security and income, continues to be the best way of navigating the current environment through to market recovery. However, liquidity management is important; market liquidity across all asset classes is reduced and pricing challenging, and we are focused on maintaining the integrity of the portfolio, including servicing any disinvestments and treating all investors fairly, without changing the fund's fundamental investment approach.

Government Bonds

It definitely feels like government bond markets have moved past the 'shock' phase in this crisis. Initially yields dived as investors sought traditional safe haven assets. As one government after another stepped in to announce huge spending packages to support domestic economies – most of which were of a scale and depth unlike anything see before – yields on sovereign bonds rose as markets panicked about how the spending might be financed. Central banks subsequently stepped in and confirmed that they would essentially buy this enormous issuance, settling markets, and pushing yields down once more. For government bonds, this has been a period of almost unparalleled volatility. With the broad mechanisms of spending and funding the expenditure now in place, markets are moving to assess the longer term impact of this.
Inflation is perhaps the first and most obvious consideration: in theory, record borrowing and spending, with interest rates at rock bottom, is a recipe for higher inflation. And given the forecast debt levels, many governments would not be unhappy to see inflation increase and thus decrease the real levels of total debt. But theory doesn't always translate to markets – we can look at what happened in the wake of the global financial crisis and see that record issuance and QE did not push inflation to dangerous levels. It is still too early to predict what the outcome of these policies will be on markets over the next few years, but having weathered the initial storm, this will be the question increasingly occupying government bond markets.

Cash

Market spreads have widened despite the Bank of England base rate cut to 0.10%. This has been driven by a wider credit spread move in both investment grade and high yield in response to the impending economic recession caused by the COVID-19 global lockdown. The spread widening is less a concern about the credit viability of a company, but more about the likely length of the lockdown and the ability for firms to remain solvent throughout this period.

Our cash funds invest in financial assets issued by global financial institutions. These institutions have received generous support and funding terms through this period to allow them to provide support to ailing companies and individuals alike. This is therefore unlike the global financial crisis which was a bank liquidity crisis. In addition, the covered bonds that the fund owns are also backed by a pool of residential mortgages and throughout this period governments are relaxing conditions to allow homeowners to continue to facilitate their mortgages as opposed to defaulting.

Responsible Investment update

The COVID-19 pandemic has brought about many profound effects and challenges to several companies and comes as a real test to their corporate governance structures in surviving through this unprecedented time. As of late, we have witnessed a range of actions from dividend withdrawals to abrupt annual general meeting (AGM) cancellations as we approach our busiest time of the year. While these issues continue to trickle down into corporate governance matters, shareholders of these companies are left grappling with what should be considered an appropriate action in their voting outcomes. As we will soon come to realise the full economic fallout from this global pandemic, decisions made now will speak volumes later as we review this period in years to come.

As we approach this voting season, we must be mindful of the challenging circumstances many companies find themselves in. However, we also think this is a time when strong governance practices are essential for protecting investors and savers. Ineffective board oversight stemming from a weak or ineffective chairman, insufficient independent directors, or directors with too many commitments and not enough time, are governance factors that often determine whether companies thrive or fail in a crisis. Companies should not automatically be given a pass to weaken governance standards in the current environment. Our approach will be to continue upholding high governance standards during these turbulent times, while working collaboratively across our business to make sure that we make appropriate voting decisions where companies are truly in distress.

It's in these circumstances where having an in-house team can be invaluable. No level of automated voting can cope with the rapidly changing circumstances facing companies currently, and the impact this will have on the AGM season and voting outcomes. Companies may need to make temporary changes to their board elections, capital raising activities, or executive pay, and RLAM's in-house governance experts will be reviewing all voting decisions to ensure we are voting in line with the best long-term interests of our customers.

Finally, we think it is worth noting that the consideration of wider 'stakeholders' may be even more critical now than it ever has been, with a number of companies taking desperate measures to reduce costs, shore up capital and limit expenditure. In essence, we need to consider what actions are appropriate as executive bonuses come to a vote this proxy season, especially as we see more workforce redundancies and adjustments taking place. Now is the time when companies need to 'walk the talk' in terms of their commitment to being good corporate citizens. We believe those companies that have truly embedded the views and needs of their stakeholders into their business models are likely to be the ones that come out of this crisis on top.

Performance year to date

Governed Portfolios

Portfolio Name	Percentage Growth 31.12.19 03.04.20 % Chg
Governed Portfolio 1	**-15.88**
Composite Benchmark	-13.62
Difference	-2.26
Governed Portfolio 2	**-13.40**
Composite Benchmark	-11.30
Difference	-2.10
Governed Portfolio 3	**-8.07**
Composite Benchmark	-6.15
Difference	-1.92
Governed Portfolio 4	**-18.81**
Composite Benchmark	-17.04
Difference	-1.77
Governed Portfolio 5	**-16.59**
Composite Benchmark	-14.42
Difference	-2.17
Governed Portfolio 6	**-11.33**
Composite Benchmark	-9.25
Difference	-2.08
Governed Portfolio 7	**-20.59**
Composite Benchmark	-20.03
Difference	-0.56
Governed Portfolio 8	**-19.51**
Composite Benchmark	-17.66
Difference	-1.85
Governed Portfolio 9	**-13.96**
Composite Benchmark	-12.16
Difference	-1.80

Governed Retirement Income Portfolios

Portfolio Name	Percentage Growth 31.12.19 03.04.20 % Chg
Governed Retirement Income Portfolio 1	**-5.23**
Composite Benchmark	-3.23
Difference	-2.00
Governed Retirement Income Portfolio 2	**-8.17**
Composite Benchmark	-6.14
Difference	-2.03
Governed Retirement Income Portfolio 3	**-11.36**
Composite Benchmark	-9.27
Difference	-2.09
Governed Retirement Income Portfolio 4	**-14.48**
Composite Benchmark	-12.12
Difference	-2.36
Governed Retirement Income Portfolio 5	**-17.02**
Composite Benchmark	-14.81
Difference	-2.21

Underlying Funds

Portfolio Name	Percentage Growth 31.12.19 03.04.20 % Chg
RLP Absolute Return Government Bond-Pen	**-2.00**
Benchmark	-0.11
Difference	-1.89
RLP Commodity-Pen	**-18.95**
Benchmark	-16.87
Difference	-2.08
RLP Deposit-Pen	**-0.07**
Benchmark	-0.12
Difference	0.05
RLP Global High Yield Bond-Pen	**-16.00**
Benchmark	-15.77
Difference	-0.23
RLP Global Managed-Pen	**-23.59**
Benchmark	-23.64
Difference	0.05
RLP Long (15yr) Corporate Bond-Pen	**-3.32**
Benchmark	-2.40
Difference	-0.92
RLP Long (15yr) Gilt-Pen	**9.37**
Benchmark	8.38
Difference	0.99
RLP Long (15yr) Index Linked-Pen	**4.32**
Benchmark	3.16
Difference	1.16
RLP Medium (10yr) Corporate Bond-Pen	**-4.38**
Benchmark	-2.87
Difference	-1.51
RLP Medium (10yr) Gilt-Pen	**5.69**
Benchmark	5.18
Difference	0.51
RLP Medium (10yr) Index Linked-Pen	**2.50**
Benchmark	1.54
Difference	0.96
RLP Short (5yr) Corporate Bond-Pen	**-3.61**
Benchmark	-2.64
Difference	-0.97
RLP Short (5yr) Gilt-Pen	**2.53**
Benchmark	2.27
Difference	0.26
RLP Short (5yr) Index Linked-Pen	**0.68**
Benchmark	0.68
Difference	0.00
RLP Property-Pen	**-0.95**
Benchmark	-1.73
Difference	0.78
RLP Sterling Extra Yield Bond-Pen	**-11.56**
Benchmark	-7.49
Difference	-4.07
RLP Short Duration Global High Yield-Pen	**-8.68**
Benchmark	-0.09
Difference	-8.59

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.