

For professional clients only, not suitable for retail investors.

Outlook 2021



CONTENTS

| | |
|--|----|
| The devil's in the detail _____ | 3 |
| The challenges awaiting bond investors _____ | 6 |
| Shouldn't there be more defaults? _____ | 9 |
| What will drive global equities in 2021? _____ | 11 |
| Will 2021 be the year to invest in the UK? _____ | 14 |
| Sustainable investing in 2021 _____ | 16 |

INTRODUCTION

At a human level many people will be happy to see the end of 2020. For investors, while it has been a rollercoaster, most major asset classes have produced positive returns. As we head into 2021, a huge amount of uncertainty remains. Governments and central banks helped avoid a short-term meltdown during the crisis, but as we move into a post-vaccine world, can they help mitigate the longer-term impacts? In our 2021 outlook, we ask key investors at RLAM what they are focusing on and the potential opportunities and pitfalls in their asset classes, to help you make informed investment decisions.

One lesson we all take from 2020 is that thinking and strategy has to be flexible in the face of changing events. To see our latest thinking through the year, follow us at @RLAM_UK on Twitter or on LinkedIn, subscribe in our email preference centre, or check the 'Our Views' section of www.rlam.co.uk which will be updated regularly.



Piers Hillier

Chief Investment Officer

Piers joined RLAM in January 2015 as Chief Investment Officer, with responsibility for managing and developing RLAM's investment capabilities. He has over 25 years of investment experience, including roles as Head of International Equities and a member of the Strategic Policy Group responsible for setting Asset Allocation for multi asset portfolios at Kames Capital. Prior to this, he was CIO and Head of Asset Allocation for LV= Asset Management and previously CIO European Equities for WestLB Asset Management. He also previously held the position of Head of European Equities at Deutsche Bank and Schroders. In his current role, Piers is a director of Royal London Asset Management Ltd, a member of the RLAM Executive Committee, and chairs the RLAM Investment Committee. He holds a Bachelor's degree from the University of Bristol and Masters degree from the University of Oxford.

“ You can't predict extreme events, but you can prepare your infrastructure and portfolios to give them the best chance of weathering the storms. ”

The devil's in the detail

Many of us are familiar with the term 'black swan' – shorthand for the unpredictable and unforeseeable based off the book of the same name.

It is tempting to look at 2020 and say that the coronavirus pandemic is a black swan event. This certainly helps us as investors to rationalise what has happened and decide that we could not have foreseen this or prepared for it. But in this case, labelling 2020 as a black swan and moving forward feels too simplistic.

It is true that no-one – certainly not us – foresaw this. Even in late January, when we started to see reports of an outbreak in China, no-one expected that it would cause such disruption. But while we can't have foreseen the specific event, I am at least happy that RLAM had taken steps to prepare for the unpredictable. At an organisational level, this included robust business continuity planning, one element of which was the ability to transition to work at home (albeit this ended up being for much longer than we had ever expected). The lesson is one that applies to investing: you can't predict extreme events, but you can prepare your infrastructure and portfolios to give them the best chance of weathering the storms that will undoubtedly come our way.

As we came into the final months of 2020, the large uncertainties were around the pandemic, the US elections and the UK/EU Brexit deal. At the time of writing, it appears that we have positive signs on the first two, with the third still in the balance

A shot in the arm

The positive news around the Pfizer, Oxford and Moderna vaccines gave markets a fillip in November, and lifted spirits everywhere. The effectiveness of these vaccines, and the speed at which vaccination can be rolled out, is unsurprisingly the biggest single swing factor for 2021. The global economy took a massive blow in 2020. A full recovery – even under the most optimistic assumptions – will take several years. But a relatively swift vaccine roll-out, and the associated reduction in lockdowns, will give scope for a decent bounceback in 2021. We know that sentiment is an enormous factor in economic activity: as consumers, do we feel confident enough to spend in the shops, eat in a restaurant and go on holiday? Do businesses feel confident that we are returning to something approaching 'normal' – and can therefore invest in their businesses? The faster we answer 'yes' to those questions, the faster we recover – but note that markets are forward looking and will try to anticipate this.

Split decisions can be market friendly

Although legal wrangling continues, it appears that Joe Biden will be sworn in as US President on 20th January 2021. Some policy actions are relatively easy to predict, with the US highly likely to re-join the Paris Climate Change agreement. There are two areas where it is harder to predict what happens next: the first is relations with China, where it appears that Biden will follow the harder line taken in recent years, particularly if news from

Hong Kong doesn't change. The second is domestic fiscal policy, where the split control of Congress means that Biden will not have a free rein to pass a fiscal stimulus package. It's not that I think no bill is passed – with the damage caused by the outbreak, I feel that a bill is certain – but that a Republican-controlled Senate will demand that he tempers his instincts somewhat, which will please markets worried about increasing levels of government debt.

Brexit talks: here to stay

Brexit is a thornier issue. As an optimist, I believe that a deal will be agreed before the end of the year. As an optimist who is also a fund manager, I think that the devil will be in the detail. I think that a deal gets done because not doing so is just too painful for both sides. My expectation is that we will see a classic EU deal: lots of last minute discussions; announcement of a deal that agrees some aspects; a lot of details to be agreed at later talks; both sides able to say that they stuck to their principles.

The main point here is that Brexit is not a one-time event. This is a process that will not be completed by policy makers in the next few months, because replacing a complex political and trade framework built over 40 years takes time. Some areas look like they will be easier to resolve – for instance state aid, where there is a long history of both sides using this. An example of this can be seen in during the financial crisis, where the KfW, which is nominally an entity separate from the German government, stepped in to support banks that were in trouble. This was the right thing to do, but shows that state aid rules have always been blurred, and I expect both sides will ultimately acknowledge this. Similarly fishing, although an emotive

area, is very small in terms of GDP and I would therefore expect something to be agreed.

Financial services is a harder nut to crack. Financial services across Europe provide attractive tax revenues and thousands of well paid jobs. This is an industry overwhelmingly biased towards the UK, and not surprisingly, EU governments are aggressively trying to entice parts of that industry from London to the EU, as they would be mad not to. EU governments will no doubt use regulations and incentives to do so, while the UK will point to historic strength and the pool of expertise that exists in the UK. Ironically, the success of each will rely predominantly on the large US and global financial institutions. If they want to stay in London, then London will remain pre-eminent in Europe. If they decide to move, then Frankfurt in particular may challenge.

Longer term, although it seems a fair bet that some parties will want to blame the terms of any deal, the success or failure of UK Plc rests with us: we will need to build on the example of the recent trade deal with Japan, but leveraging our traditional strengths such as the rule of law, business services and financial services, as well as building upon our more recent areas of strength such as life sciences and technology.

What is fiscal responsibility?

A key issue for all governments in 2021 will be fiscal policy. An orthodox way to look at the current situation would be to see the extraordinary amount of government spending that was needed in 2020, and as the economy recovers (hopefully) in 2021, to think about ways to cut spending and generally 'balance the books'. I think this would be grave error

and hope that policymakers will take the same view.

This is not a new idea. I was fortunate enough to be interviewed by the FT¹ in 2016 and thought then that we needed to be more imaginative in addressing the problems faced by our economy (and society). Low rates and lashings of QE were absolutely the right call in 2008, because that was a banking sector and liquidity problem. In the initial period of this crisis, QE was an important component in funding that emergency government support. The emphasis now needs to be on encouraging long-term investment – not just in traditional areas such as housing and roads, but modern economy infrastructure such as 5G, fibre, and education not only for the young but to help people develop and reskill through their working lives.

Sourcing that investment will not be easy. Government can help this – both by encouraging foreign direct investment, but also through using public funds. Finally, part of this solution means looking at encouraging private sector change: a huge proportion of UK savings and investments go into cash ISAs². This hurts savers who receive poor real returns, but also the economy, which is deprived of long-term funding.

The base effect

This backdrop is one that obviously affects markets over the medium term, but perhaps not one that has immediate impact. Markets tend to be driven by data releases – whether economic or corporate – and these releases are all going to look odd in 2021. In effect, the extraordinary data seen in 2020 has automatically bequeathed an extraordinary 2021. So for example, UK GDP growth will look much higher than

in recent years simply because of the fall in 2020. Similarly in corporate earnings, companies that had to shut or severely restrict their activities in 2020 (and hence saw big negative earnings) may see big rebounds in 2021. The inverse will probably also be true – we saw a massive increase in online sales in 2020 and it would not be a surprise if growth in 2021 looked lacklustre by comparison.

Fiscal deficits and increased economic activity could see an increase in inflation – for instance driven through commodity prices, which have been weak in 2020. Ordinarily this would be a concern, but in this instance, this will be driven by this same base effect: I don't see inflation as a major concern simply because wage inflation is unlikely to be a problem at a broad level simply because unemployment is going to be a lot higher.

But the market will ultimately be driven by vaccine news in the near term as that is the swing factor. If a roll-out progresses well, not only will this support risk assets, but at some point the market will start to price in an end to ultra-low rates – even if this is still a reasonable way off – which means that long-term rates could be expected to rise from the currently very

depressed levels. We will all be keeping an eye on the US treasury 2s10s chart. (See figure 1)

Investing in a post-covid world

I'm often asked as a CIO what you do when everything appears different. The conversations I have with fund managers across RLAM are usually focused on sticking to what we know. While we have different investment processes across different asset classes, we do have a focus on stock selection and knowing what we are investing in. Credit is an excellent demonstration of this: our philosophy is to act as medium-term lenders rather than short term bond traders. Defaults have been very low so far thanks to the various emergency support measures, and also the fact that companies have been able to benefit from those ultra-low rates to raise money from capital markets. As those rates increase, will the economic recovery be enough to compensate for this higher cost of capital? We will see, but it could actually lead to higher default rates than we see right now. And it is at this point that our research, due diligence and

analysis of covenants will demonstrate their value.

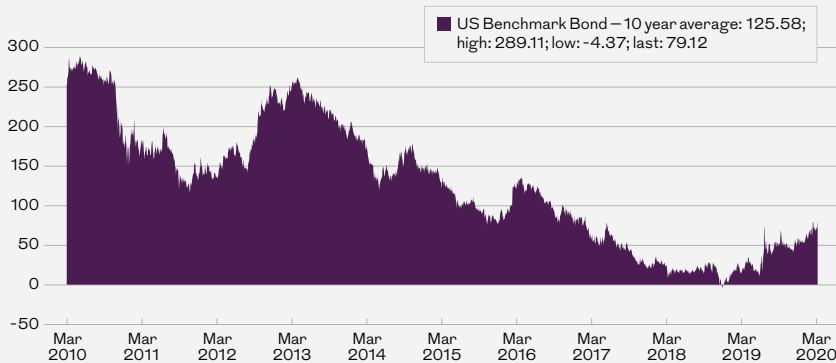
As we look back on 2020 with hindsight, it was clear that it was a year to be thematic; as an equity investor, if you avoided banks and energy stocks you were probably okay. As the cost of capital starts to increase, economies recover and the 'new normal' starts to assert itself, I believe that 2021 will be a year for stock pickers across asset classes, as it becomes clearer whose business model is robust, who can adjust, and who can't.

I also expect to see more emphasis on responsible investment, in the widest sense of the phrase. We will use our influence on policymakers to build back better³ and support initiatives such as the Just Transition⁴. As part of a mutual and customer oriented organisation, we believe that the integration of ESG factors is more important than ever. We believe that companies that have stronger ESG credentials will perform better over the longer term. If we look at the initial stages of the crisis, this gave everyone insights into how companies view their staff and customers: did companies try to do the right thing? Did directors push staff towards furlough while taking full pay and bonuses?

We would argue that in a post-pandemic world, consumers and therefore investors will increasingly shun companies that are seen to behave in these ways. We've placed a great emphasis on responsible investment for a long time, partly because of this, but also because it fits with our purpose as a mutual. If the macro environment is still uncertain in 2021, I believe that the trend to hold companies (and the asset managers that invest in them) to account will only gather even more pace.

Figure 1: US 2 year 10 year spread over last decade

Source: FactSet as at 12 March 2020



Past performance is not a reliable indicator of future results.



Jonathan Platt
Head of Fixed Income

Jonathan Platt joined RLAM in 1985 and became Head of Fixed Income in 1992. Jonathan has managed a range of funds throughout his tenure at RLAM. He has overseen the development of both the fixed income process and the highly respected Fixed Income Team. He remains committed to the management of client portfolios. Jonathan is a director of RLAM and has an MA in Philosophy, Politics & Economics from Oxford University.

“How do we get off the QE merry-go-round? Not easily and not for some time.”

The challenges awaiting bond investors

The magic money tree is alive. Governments around the world have been able to issue vast quantities of IOUs without disturbing the price of this debt. Some governments are even paid to issue debt.

Government actions have cushioned economies and central banks have stepped up with renewed quantitative easing (QE). This interaction of fiscal and monetary policy has meant that equity prices, bond yields and commercial property valuations have not reflected the economic upheaval we are experiencing. In the UK, QE has been expanded so that by the end of next year, assuming no further expansion, the Bank of England (BoE) will own almost £900bn of UK government debt and total government debt will equate to £30,000 per head, and this does not include unfunded pension commitments.

The reason that UK bond yields are so low in the face of large supply is twofold: the economic shock has further pushed down real yields and the extra supply of debt resulting from this shock has been neutralised by the BoE. This is a global phenomenon and is not uniquely British.

How do we get off the QE merry-go-round? Not easily and not for some time. We expect a further extension of QE in 2021 as the government and BoE will not want a rise in government bond yields that would result from heavy net supply. The Magic Money Tree (MMT), or Modern Monetary Theory as economists prefer, says this is not a problem and that governments with their own currencies can carry on spending and issuing debt until inflation becomes a problem. Add

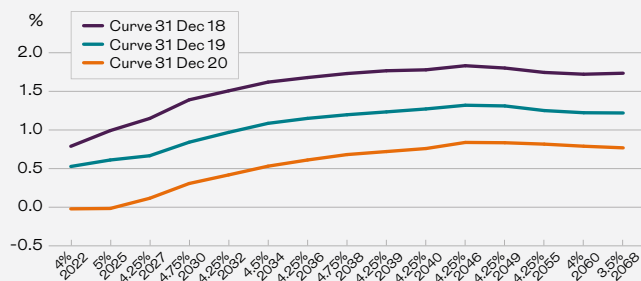
to this the accommodating stance of the BoE, and it seems very unlikely that we will have a return to the financial restraint introduced after the Great Financial Crisis.

What does this mean for bond yields? Short rates are anchored at near zero and will stay there for a long time (possibly five years). As BoE intervention via QE becomes a diminishing support for government bonds, expect long yields to go higher – hence the favouring of short duration strategies in the medium term. This has to be set in context: higher long yields will still look low by post-war standards, but remember a 1% rise in 50-year gilt yields implies a capital loss of 30%. (See figure 2)

So should we worry about inflation? One of the traits fund managers have to fight against is anchoring their expectations to the conditions that prevailed in their formative years. For those that grew up in the 1970s and 1980s, inflation seemed endemic and some have spent the last 30 years looking over their shoulders for its return. Global markets see no imminent return. If we look at long-dated US treasuries the implied long-term inflation rate is below 2%, and for German bunds it is nearer 1%. The UK is a bit of an outlier, with CPI implied inflation a bit above 2%. For those that forecast an economic “Ice Age” even these implied inflation rates seem high. For others, the consequences of Covid-19 are inflationary and inflation-protected bonds offer insurance against uncertain times; an uncertainty heightened by US/China trade tensions and the change in US leadership.

Figure 2: Gilt yield curve

Source: RLAM as at 31 October 2020



UK yield curve

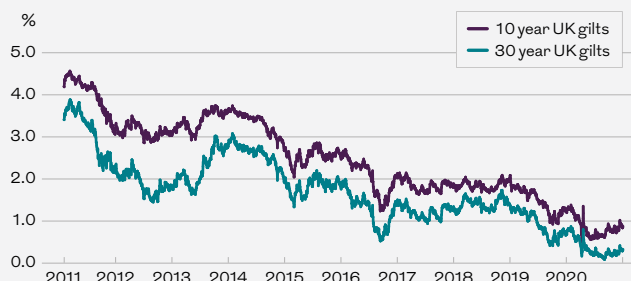
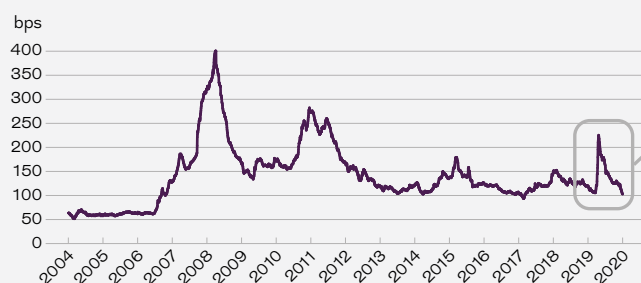
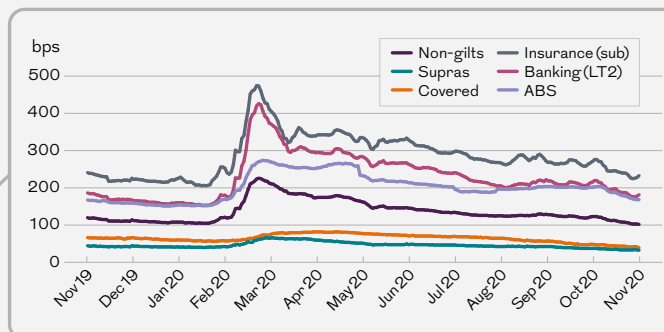


Figure 3: Average investment grade sterling credit spread

Source: RLAM as at 31 October 2020



Average investment grade sterling credit spread (12 months)



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.

Where do we stand? Index-linked bonds comprise two key elements: real yield and inflation. In our opinion the real yields segment is too low and will rise over time. By any past standards the real yield on government debt is off the scale - never has the UK government (or actually any government over the last 300 years) been able to issue long-term debt with the promise that the return will be 2% less than inflation. Conversely, inflation protection appears cheap. In an environment of changing supply chains (less efficient), low capital investment, rising protectionism and declining globalisation the current pricing of inflation looks attractive. This is not because we expect a surge in inflation but due to uncertainty. We do not know how Covid will play out in the longer term but there appears to be asymmetry of

risk. If we enter a deep economic recession governments will spend more, supported by electorates. If economies rebound more quickly governments will continue to provide significant support, fearing premature fiscal or monetary tightening. When inflation is priced to reflect the circumstances of the last 30 years and we have had such a shock, it may pay to be prudent and get some added insurance. Again, our preference is for shorter-duration strategies.

So what about credit markets? In sterling, as in dollar and euro markets, credit spreads on investment grade bonds are broadly back to where they started the year. Does this make credit expensive? No – although not as cheap as it was in March when the average credit spread in sterling rose towards 2.5%. In our

opinion, credit has been an undervalued asset for long-term investors, with spreads more than compensating for default risk, and it is attractive for those investors that can accept periods of heightened illiquidity so that they can benefit from the significant extra yield available relative to government bonds. This has not changed. However, Covid has created winners and losers in the short term and the ongoing economic realignment will lead to significant shifts over the medium term. The immediate losers have been the travel, leisure, transport and retail sectors, while the winners have been in pharmaceuticals, food, logistics and technology. So within investment grade credit an unchanged credit spread disguises a lot of variation. (See figure 3)

What does the future hold? The banking sector has performed relatively well so far, cushioned by government intervention to protect against a rise in bad debts. They will come, but capital positions are far healthier than in 2006. Intervention by regulators to prevent dividend distributions shows that UK banks are not truly independent (if they ever were); from a bond perspective this is encouraging and we continue to be overweight the sector. Expect to see consolidation among challenger banks and further cost reductions in the majors as digitalisation and technology change the way people bank. Similarly, and driven by valuation, we like the insurance sector and have been adding to it throughout the year. In a more precautionary world, personal savings will rise and life insurance may benefit from these changes. We believe reinsurers will bear the brunt of Covid claims but will be able to weather this storm.

In consumer areas the biggest challenge will be in retail and we

remain underweight issuers with a high dependency on discretionary spending. An exception is the pub sector where seniority, security over assets and low loan-to-values give us strong conviction over the strength of our lending position. In essence, our clients get paid well for these risks. The retail fallout has impacted the real estate sector with Intu going into administration and Hammerson struggling under its debt burden. Longer-term out-of-town shopping may be a relative winner, but a key challenge will be transforming shopping centres to compete (in a different way) with the online experience.

Some of the sectors in which we are overweight: utilities, social housing and infrastructure (hospitals, military accommodation and offshore transmission operators) have come through the crisis pretty well and we expect this to continue. These sectors are much less susceptible to business model disruption from technology, an impetus greatly accelerated by Covid.

More challenging is our exposure to transport through airports, train and bus operators. Government support has been vital here, dampening the impact on borrowers' balance sheets. In the case of Heathrow and Gatwick, while they have been substantially impacted in the short term, we believe that they are vital infrastructure with long-term futures, and that security and covenant protection in our senior bonds have proved vital in protecting clients' interests through this exceptional stress.

We remained committed to identifying risk (financial and ESG) and ensuring that our clients are appropriately rewarded for the positions we take. We believe that our approach of capturing extra income, aligned with risk mitigation through security and sector diversification, a preference for secured bonds and strong covenant protection is ideally suited to the challenges that lie ahead.





Azhar Hussain
Head of Global Credit

Azhar has 24 years of direct experience of investing in an array of strategies across the Global Fixed Income and Leveraged Finance arenas. He trained as a chartered accountant with Deloitte before starting his investment career as a high yield credit analyst at Gulf International Bank. He subsequently became Head of Corporate Debt being responsible for IG & HY absolute and relative return strategies. He left to join Insight as Head of HY & Leveraged Loans before joining RLAM, initially as Head of Global High Yield, where he has successfully launched funds across the Global HY & Multi Asset credit strategies. Azhar holds a BA in Economics & Law from SOAS, University of London and recently obtained an MSc in Behavioural Science from LSE.

“The outlook for the high yield market has become dramatically brighter.”

Shouldn't there be more defaults?

March was a scary time for high yield investors. Just a month earlier the high yield spread had been close to its tightest post-crisis level, yet in March investors found themselves contemplating a frightening spread of c. 1200 basis points. Moody's was forecasting a 10% US default rate as its base case, with 16% as its worst case scenario, while the market spread implied that investors thought it could be much worse than even that.

The rationale for all of this pessimism was the experience of 2007/8. Recessions tend to be correlated with high rates of default, collapses in revenues and plummeting oil prices; serious given that the energy sector constitutes around 15% of the high yield market. All this prompted central banks and governments to respond with unprecedented speed and scale in an effort to restore confidence to save their economies.

Central banks reduced interest rates to rock-bottom levels and unveiled enormous stimulus packages. The US Federal Reserve pledged direct support for the high yield market as it committed to buying fallen angels (bonds which had recently lost their investment grade status) as well as high yield exchange-traded funds. For its part, the European Central Bank also announced that it would purchase fallen angels.

This flushed the market with liquidity at reasonable levels, radically altering the fate of the pessimistic high yield investors. It also turned out that many of the things that investors had spent years complaining about (such as the looseness of covenants) gave companies the lifelines they needed to survive. Even when the covenants were genuinely tight, companies found that

bondholders were often happy to forgive and waive them. So companies could continue paying interest, servicing debt and funding operations despite the absence of revenue streams.

There was also positive news on the coronavirus. The lockdowns turned out to be shorter than many had envisioned back in March, enabling economies to reopen briefly. That means that unemployment numbers are lower today than had been expected in March, albeit there could be a surge as furlough schemes roll off. It also resulted in generally upbeat earnings seasons as companies reported better-than-expected revenues.

Although the high yield market has recovered quite remarkably this year, the high yield spread is still above its levels before the March meltdown. Nevertheless, because the cost of capital (the risk-free rate) has fallen to all-time lows, companies in the high yield market are currently able to borrow at the cheapest levels ever in absolute terms.

At the same time, the composition of the market has significantly changed as a result of the influx of fallen angels (primarily in the energy sector) and the elimination of the most vulnerable credits. This has increased the quality of the market since fallen angels tend to be bigger, more complex capital structures that are usually BB rated. The rush of companies seeking to raise liquidity following support from the Fed, many of which did not need it, has also helped the market to grow in size.

In many instances this liquidity-driven issuance reflected an abundance of caution, as companies feared undergoing years without revenues. The recent wave of positive vaccine news suggests

Figure 4: Market expectations of defaults

Source: RLAM as at end September 2020

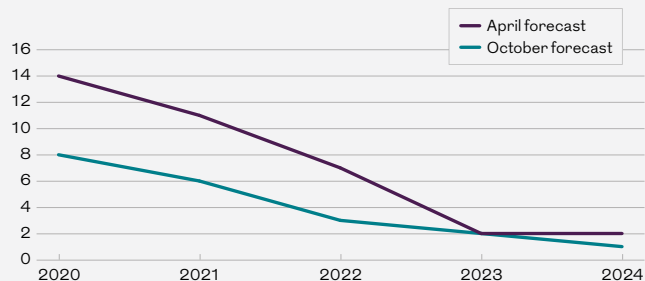
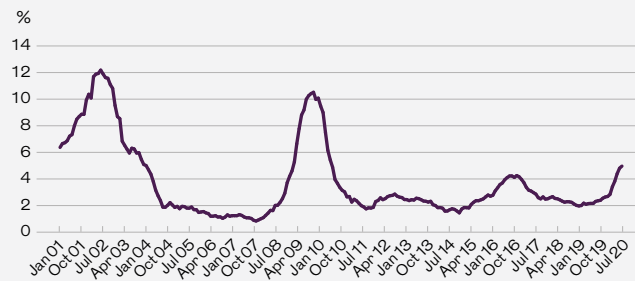


Figure 5: Defaults should remain manageable

Source: RLAM as at end September 2020



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.

that the return to normality is likely to be much faster than that and so we think that many of these cautious companies, not needing so much liquidity, will repay their debt over the next couple of years as they revise their pessimistic assumptions for the broad economy made in March.

Even the most Covid-facing credits have been able to raise substantial liquidity. Of course, these credits are still going to be where we will see the most defaults in the future. Yet in most of these situations, the likelihood of default is relatively well priced, which reduces the market impact. Whether an individual company will default depends upon several factors: how much leverage did the company have before the crisis hit? For how long has it lost revenues? How much has it compensated for that by issuing debt? Can it grow into its capital structure by increasing EBITDA?

A great example of the difference that these factors make can be seen in the cinema sector. This is among the most Covid-exposed sectors, having been penalised by lockdowns severely with chains having to operate on zero revenues for most of the year. Let us compare the world’s largest cinema chain AMC Entertainment, which operates AMC Theaters in the US and the Odeon in the

UK, with the Cinemark, which runs cinemas across the US, Latin America and Taiwan.

Heading into the crisis, AMC had leverage of around 6x. It is likely to emerge from it (assuming that its EBITDA returns to pre-crisis levels) with over 8x total leverage and 5x senior leverage. It is certain to impair its subordinated debt and it is reasonable to assume that it will do the same with its senior debt as well. The company currently has liquidity to last until January by virtue of issuing additional debt, waiving covenants and issuing equity, but even with entirely open economies from January it is going to struggle to grow back into its capital structure. It is reasonable to assume the company will default at some point.

By contrast, Cinemark had 2x leverage heading into the crisis and will probably emerge with 3x leverage. Rather than until January, it has sufficient cash to survive with zero revenues for the next 18 months. At that point it has a very reasonable chance of being able to refinance its debt, grow back into its capital structure and avoid defaulting. Cinemark was one of the first companies to issue senior debt in the market (at 8.75% at the time) following the Fed’s intervention in April. It probably won’t need that liquidity because there is a

good chance that cinemas will reopen by the middle of next year.

Back in March the market assumption was that both companies were doomed to default. But this all changed with the Fed’s intervention. Cinemark now looks like a survivor, while the default probability for AMC has remained largely unchanged. Central banks have not simply delayed inevitable defaults for Covid-exposed companies, they have provided crucial lifelines that have turned many into long-term survivors; with the proviso that they were in reasonable health prior to the crisis.

So the outlook for the high yield market has become dramatically brighter. Many investors have been very slow to realise quite how significant the central bank interventions have been, continuing to operate for months afterwards with the pessimistic assumptions that they made in March, before the bulk of the interventions took place. Market expectations for the default rate have been steadily falling, but we still think they are overly bearish. We think the high yield spread significantly overcompensates investors for the risks they take. All this leaves us feeling incredibly bullish for our asset class in the year ahead.



Peter Rutter
Head of Equities

Peter Rutter is Head of Equities at Royal London Asset Management (RLAM). Prior to joining RLAM, Peter was Head of Global Equities at Waverton Investment Management. His team manages equity mandates for institutional, pension, charity and retail clients. Peter is also a global equities portfolio manager with over 18 years' experience, and as head of RLAM's global equities investment team, he leads a differentiated and successful investment process which is built around a corporate Life Cycle concept and includes ESG integration. Peter is a CFA charterholder, a chartered management accountant (CGMA) and read Geography at Cambridge University, where he achieved a double First Class degree with distinction.

“After the wild ride of 2020, plenty of challenges remain for the year ahead.”

What will drive global equities in 2021?

This year has been both challenging and full of longer term opportunities for equity investors with market volatility and dislocations caused predominantly by the COVID-19 pandemic, but also the US elections and Brexit.

Assuming the Republicans retain their Senate seats in Georgia (January election) there will be a significant degree of political deadlock in the US. Historically this kind of deadlock has been good for equity markets as the regulatory and policy environment is more likely to be stable for the next 4-5 years.

Looking forward

So, if political risks and pandemic related volatility are less significant going into 2021, which factors could most influence global equities in 2021? The timing of investment themes and topics can be hard to predict so these are some key issues that could develop over the next six to 24 months:

1 Trade wars aren't going away, they will instead morph into technology wars.

While 2020 started with the signing of the phase one trade deal between the US and China, before Covid-19 it was likely that President Trump would have played the underlying tensions to maximum effect in the run up to the elections. However, it would be wrong to see them purely as a Trumpian electoral device. While President Biden will be more constructive in tone, the US-China tensions are real with high levels of

cross party consensus, and are likely to evolve into a cold war centred on technology. Geopolitical tensions will ebb and flow, with crisis periods that could affect markets, but the ongoing battleground will be through technology and partisanship – Huawei and 5G was the opening salvo in a longer-running conflict. We are likely to see the emergence of two global technology supply chains in critical areas like 5G, and this may impact stocks and sub-sectors both positively and negatively.

2 Inflation is a low probability but key risk.

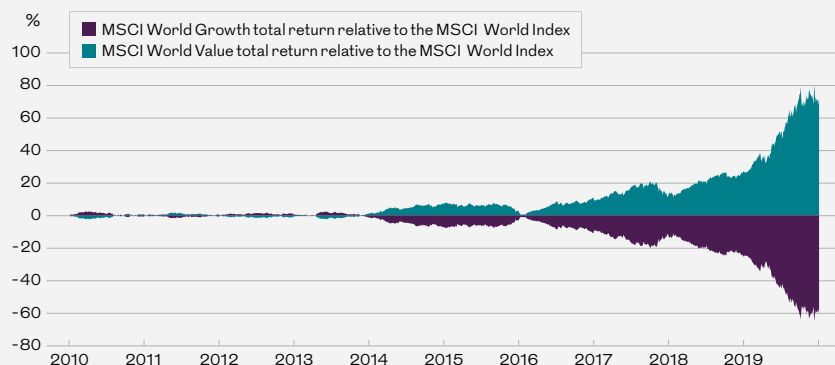
The shape and speed of the recovery from Covid-19, and how inflationary this is, are key questions. A successful vaccine will certainly have an impact, but the extent to which certain sectors, countries, consumer and corporate behaviours are scarred or permanently changed will be key to understand.

In terms of portfolios, inflation could be a key risk given the sheer scale of government and central bank support. It won't be high by historical standards, but after recent years, record low bond yields are incredibly vulnerable to inflation perceptions and any changes could have significant knock-on impacts to equity markets.

Were inflation to start to rise, and central banks feel constrained by political pressure, there could be a significant reversal of the growth versus value trade (see figure 6) that has paid off for the last decade or more.

Figure 6: Growth stocks have outperformed in recent years

Source: RLAM as at 30 November 2020



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.

This structural inflation risk would appear to be relatively low probability given some very significant deflationary forces in markets – excess capacity, high unemployment, high levels of debt and low population growth. However, at the same time no-one really knows the impact of ever more aggressive monetary policy and the effects of central banks funding government deficits.

3 Stock selection will be essential.

After this year's wild dispersions between some technology leaders and more cyclical or leveraged sectors, it's hard to say that stock selection will be more important in 2021 – however, demanding valuations make some stocks vulnerable. For example, we need to differentiate between those technology companies that have done very well because they have pulled demand forward, and those for whom there has been a more positive structural shift in their end markets. In the former category, some companies will face difficult days as they update

the market on subscriber numbers.

Similarly, there could be significant disparities between the more cyclical companies that have been hit by COVID-19 but ultimately have strong management, business models and resources to do well over time compared to those that were already struggling before the pandemic and after the COVID recovery bounce those major issues remain.

4 Fiscal stimulus will be crucial.

Even before Covid-19 required massive fiscal support from governments and central banks, there had been a shift away from purely monetary to fiscal support. The new Conservative government that was elected last December and the German government had been talking about fiscal packages, particularly in support of environmental policies and to boost regional economic growth. However, this option now seems less likely in the US with the more fiscally-conservative Republicans controlling the Senate. This will have implications

for portfolios: if monetary stimulus is paramount, this will favour growth stocks, but with fiscal stimulus it would be better to buy banks, consumer discretionary and materials sectors.

5 The UK stock market is not anomalously cheap.

The FTSE 100 has endured another poor year in 2020, failing to recover strongly following the impact of Covid-19 and with the ongoing uncertainty over a post-Brexit trade deal with the EU. Some commentators have speculated that the UK market is particularly 'cheap' and will bounce back in 2021 after several years of underperformance, which coincide with the period since the Brexit referendum in 2016.

This assumes, however, that the underperformance of the UK market has been wholly due to Brexit uncertainty. In fact, other factors, such as the sectoral composition and the maturity of the companies in the UK market are arguably just as important. It is a myth that the UK is anomalous. It may look cheaper than other markets, but this differential falls markedly once you adjust for the 'quality' of companies and the sector exposure of the FTSE. Indeed, if you reweight the S&P 500 to have the same sector exposure as the UK, it would be on a similar aggregate valuation.

Furthermore, the idea that a trade deal might catalyse a rerating of the UK stock market is questionable. It could lead to sterling strengthening against global currencies, which would be unhelpful for the FTSE 100 as c. 70% of corporate revenues come from outside the UK. What this all means is not so much that the UK is an obvious valuation buy versus the

rest of the world but it is a potential compositional, thematic and style rotation buy. A reasonable Brexit outcome and a recovery in financials, energy and materials could see the UK significantly outperform global peers. Within the large number of companies in the UK as well there will always be some high quality stock selection opportunities as well – something that can be forgotten in a market that has been weak in aggregate.

After the wild ride of 2020, plenty of challenges remain for the year ahead. In practice, in most years relative performance isn't driven by black swan events, but instead by the relentless focus on quality, positive change, stock specific wealth creation and valuation. We believe that a very well diversified portfolio is the most effective way of coping with risk and uncertainty, particularly where stock selection is active through shareholder wealth creation and valuation insights.





Henry Lowson

Senior Fund Manager – Equities

Henry joined Royal London Asset Management in September 2016 as a Senior Fund Manager and is lead manager on the RL UK Smaller Companies Fund and RL UK Mid Cap Growth Fund. Henry began his fund management career in 2005, spending almost 12 years working for AXA Investment Managers. In May 2012 he became lead Fund Manager of the AXA Framlington UK Smaller Companies Fund, which he ran successfully until joining RLAM. He was also responsible for co-managing a variety of segregated UK small/mid cap mandates while at AXA. He is a CFA Charterholder and a Member of the Chartered Institute for Securities and Investment. Henry graduated from Edinburgh University in 2004 with a MA (Hons) degree in Economics and Geography.

“ Earnings forecasts for 2021 now look eminently achievable. ”

Will 2021 be the year to invest in the UK?

It is no secret that global asset allocators have been pessimistic about UK equities, but could 2021 be the year when sentiment changes? The UK has faced a number of geopolitical and macroeconomic headwinds in the recent past and the composition of the FTSE All-Share Index, namely its high exposure to relatively unpopular sectors such as oil & gas, mining and banking, has only reinforced its unpopularity.

Furthermore, Covid-19 has had a profound impact on all economies and company earnings expectations during 2020. Changing corporate and consumer behaviour has led to acceleration in digitalisation, which has favoured technology stocks, in particular, during the year. The UK market's lack of exposure to this sector has resulted in marked underperformance relative to US and European markets.

However, with this level of bearishness, it would not take much to see a major unwinding of the underweight positioning towards the UK. Indeed, some of the headwinds are already clearing, as the UK economy has bounced back hard from the effects of Covid-19 and has entered the final phases of Brexit. There are currently unprecedented monetary and fiscal stimuli driving the recovery, with historically low interest rates, government-backed loans, tax holidays, increased infrastructure spending programmes and housing support, among many others. The consequence of these measures has been borne out in some of the recent data, with significant improvements in industrial production numbers, inventory data and business

confidence. 2021 could well be a year in which the major economies experience synchronised growth.

From a bottom-up perspective, these improvements have manifested in company earnings. The net earnings revision ratio has been on an upward trajectory as analysts' overly pessimistic earnings forecasts for 2020 have recently been raised following upbeat corporate trading statements. Companies have proven themselves adept at not only cutting costs and capacity but also at managing debt and balance sheet liquidity. Earnings forecasts for 2021 now look eminently achievable.

We believe that despite the challenges of Covid-19, well-managed and well-invested companies are set to benefit from three important new growth drivers. First, the lockdown has been an opportunity for some companies to acquire new customers that ordinarily they might not have been able to. For example, discount retailer B&M, which gained essential status in lockdown, video games developer Team 17 and financial platform AJ Bell are just a few of the companies to have benefitted from a significant increase in their customer base, and thus long-term revenue-generating potential.

Second, geographical lockdowns have focused customers' attention on risk in their supply chains. For example, in the food producing industry the retailers are placing a premium on the continuation of service levels during these turbulent times, and reassessing the ability of their suppliers to cope with the massive

fluctuations in demand that have been experienced. This period has therefore been an opportunity for well-invested suppliers like Cranswick (pork and poultry) and Hilton Foods (red meat and fish) to gain market share off their rivals. Other retailers, such as those selling eyewear, have sought to diversify from a predominantly Chinese supply chain by increasing their sourcing from other countries such as Vietnam. Inspecs, the eyewear manufacturer, has been a beneficiary of this trend (it operates facilities in both Vietnam and China).

Third, some companies have raised money not just to strengthen balance sheets but to give them firepower to make acquisitions in an environment where valuations for targets are likely to be lower. For example, Diploma, the specialist distributor, recently raised money to acquire ‘Windy City Wire’, a US provider of premium quality, low voltage wire and cable. This was a significantly earnings-accretive deal. Others, like the Lloyds Insurance vehicles Lancashire and Beazley, have raised money to take advantage of accelerating growth

opportunities. These companies are seeking to expand and capitalise on the hardening insurance premium rate cycle when other companies, without the ability to resort to shareholders, have been exiting the markets.

As ever, the severe lack of research for smaller companies continues to result in plentiful opportunities for discovering under-appreciated gems (see figure 7). A great example is the miniature wargames manufacturer Games Workshop, which until recently had only one analyst covering it. The company performed strongly throughout the lockdown (increasing its customer base by 40% to 8m) as it engaged with customers that had more time on their hands via social media, and sold to them directly rather than through third-party suppliers. It is now worth more than £3bn.

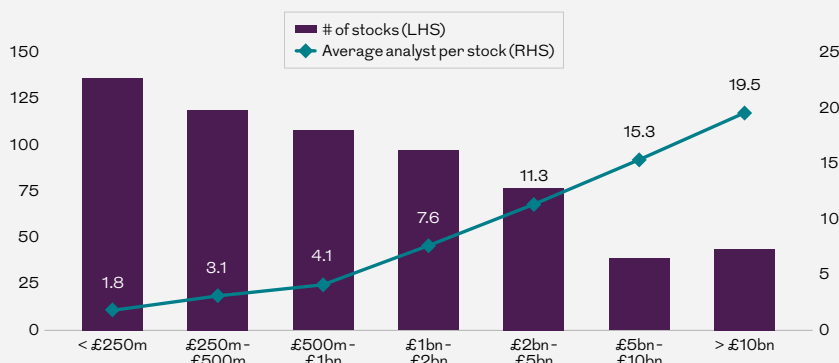
Merger & acquisition activity has also continued despite the market volatility, such as a bid for our holding in video games company Codemasters. The low cost of debt, appealing equity market valuations and weakness in

sterling (which lowers the valuation of UK companies for overseas buyers) all render such activity more attractive. We expect these conditions to remain in place in 2021, providing a tailwind for UK market performance.

The UK small and mid-cap markets are particularly exciting places to invest because it is possible to find dynamic and innovative companies that can grow in spite of what may be challenging economic conditions. This has been borne out in 2020, with the FTSE AIM All Share Index currently in positive territory this year. The survivors of 2020 will inherit a world of opportunity, and for the reasons we have outlined we think it is an exciting time to be invested in the UK.

Figure 7: Declining sell side coverage

Source: Citi Research as at 31 August 2020



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.



Mike Fox

Head of Sustainable Investments

Mike joined Royal London Asset Management in August 2013 following the acquisition of The Co-operative Asset Management by the Royal London Group. He is Head of Sustainable Investments at RLAM. Mike became a fund manager in November 2003 when he took over managing the RL Sustainable Leaders Trust. Mike originally trained and qualified as a chartered accountant with Ernst & Young in Manchester.

“The consideration of ESG factors was already going mainstream, but 2020 has supercharged this trend.”

Sustainable investing in 2021

Our outlook as sustainable fund managers shouldn't change too much from year to year. Sustainable themes tend to unfold over a decade or more – 12-month investment periods are rather short term when facing global challenges like climate change and plastics pollution. Nonetheless, clients quite reasonably like to know that we've identified potential risks and opportunities in the near term.

One might imagine that after such a tumultuous year next year will be much more stable and predictable. It seems reasonable that 2021 will see vaccines rolled out and a return to some sort of normality by the second half of the year. The US election results support this, particularly as the likely split of the Presidency and Senate creates the kind of stasis that markets like.

Yet this ignores maths. After such a challenging year, against very weak comparisons 2021 must be exceptional in its own way – the next 'normal' year will be 2022. While markets have managed to look through the shorter-term impact of the pandemic, with government and central bank support on an unprecedented scale, this creates challenges for fund managers as we try to identify the winners and losers over the full period.

In theory, the sectors that have been most impacted by Covid-19 in 2020 should benefit most from a return to normality, while financials will be supported by a rise in bond yields, albeit from very low levels. In contrast, some 'lockdown winners' could struggle if their 2020 sales bonanzas reverse as life

becomes more normal. Will many people still be organising Zoom quizzes for their friends this time next year?

Dialling up digitalisation

Against this, we have seen a quantum leap in some activities and processes that will never reverse. Since Satya Nadella, the CEO of Microsoft, said earlier in the year that Covid-19 has led to two years of digital transformation in two months, such phrases have become rather clichéd.

Nonetheless, the shift in working practices and online retail has been profound and has surely accelerated the decline of the physical world (retail, transport and offices), offset by the rise in the digital economy. This is very positive from a sustainable perspective, although the social upheaval in terms of employment prospects and possible social exclusion will need to be mitigated.

Some may feel that the rate of technological change must slow from here, yet the opposite could be true. Why should trends such as industry 4.0 (based on 'big data') and artificial intelligence slow down? More prosaically, less than 30% by value of retail activity is currently online, with food and clothing potential areas of further growth; Amazon has also identified the pharmacy market as an underpenetrated niche. It has recently been interesting to hear the shock of housebuilders that people were prepared to buy new houses online when show homes had to close.

Similarly, 80% of work processes are still hosted on work premises, so cloud-based working has plenty of room for growth. Investors have been over-estimating the level of technical progress for the last 20 years and value rotations have nearly always been short lived, so it seems sensible to stick with the themes that we've identified over recent years. I'm not saying that there can't be a correction, but we invest for the long term and will stick to what has worked well.

The bigger picture

Covid-19 put the brakes on the world, stopping the hamster wheel for long enough for governments, businesses and consumers to reflect on what we are doing; how we are allocating capital and how sustainable our way of life is. Away from the pandemic, the temperatures in the Arctic are rising quickly, while wildfires in California and Australia have increased in frequency, scale and ferocity.

Whether in spite of or because of Covid-19, this year has also seen a sharp increase in social awareness, most radically demonstrated by Black Lives Matter, but also in a wider focus on diversity and inclusion. Companies have faced more scrutiny of their cultures and how they intersect with multiple stakeholders. It can be easy to hide behind PR initiatives when times are good, but the pandemic has given us an opportunity to compare how companies in the same sector made choices around competing factors, such as redundancies, executive pay, dividend cuts, balance sheet resilience and future investment.

Many companies have faced tough choices, but those with strong corporate values and R&D programmes that are aligned with sustainability have fared better. Others will find it much harder to 'greenwash' investors in future.

This year has also seen a further shift in the understanding of and commitment to sustainable investing. The consideration of environmental, social and governance (ESG) factors was already going mainstream, but 2020 has supercharged this trend. Yet, according to the Investment Association, less than 5% of assets under management are in sustainable funds. There is still a long way to go.

For society and governments to achieve the various targets that they have set, finance and capital allocation will be a critical component of these changes. New EU regulations that will come into effect in 2021 are part of the carrot and stick approach that is shifting the dial for the asset management industry. While investors must be cognisant of the risk of investment greenwashing by asset managers that have been slow to react to the changes, we prefer to focus on the progress.

Summary

A range of vaccines for Covid-19 will enable 'normal life' to resume from next summer as social distancing is no longer necessary. In the meantime, President Biden has committed to reversing his predecessor's decision to leave the Paris Agreement on climate change. To some extent, this will be a headline change as much of the legislation is actually made at a state level, but it's far better to have the global economic superpower inside the tent, particularly as China recently committed to 'net zero' by 2060.

With politics and the pandemic potentially less disruptive in 2021, we will continue to focus on identifying companies that support the transition to a cleaner, healthier, safer and more inclusive society, and those that show ESG leadership in their sectors. This is how we define sustainable investing.



Notes

- 1 <https://www.ft.com/content/807f6896-6e91-11e6-a0c9-1365ce54b926>
- 2 <https://www.royallondon.com/siteassets/site-docs/media-centre/policy-papers/royal-london-policy-paper-10-the-curse-of-long-term-cash.pdf>
- 3 <https://www.rlam.co.uk/intermediaries/our-views/2020/esg-factors-will-remain-important-in-post-coronavirus-economy/>
- 4 <https://www.rlam.co.uk/intermediaries/our-views/2020/expectations-for-energy-utilities-just-transition-strategies/>

For professional clients only, not suitable for retail clients.

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.

Any portfolio characteristics and holdings referenced are subject to change without notice. These are included for information purposes only and do not constitute an investment recommendation.

Unless otherwise noted, the information in this document has been derived from sources believed to be accurate as of December 2020. Information derived from sources other than Royal London Asset Management is believed to be reliable; however, we do not independently verify or guarantee its accuracy or validity.

The views expressed are the author's own and do not constitute investment advice.

Telephone calls may be recorded. For further information please see the Legals notice at www.rlam.co.uk

Issued in December 2020 by Royal London Asset Management Limited, 55 Gracechurch Street, London, EC3V 0RL. Authorised and regulated by the Financial Conduct Authority, firm reference number 141665. A subsidiary of The Royal London Mutual Insurance Society Limited.

Ref: MC RLAM PD 0006



Contact us

For more information about our range of products and services, please contact us.

Royal London
Asset Management
55 Gracechurch Street
London EC3V 0RL

020 7506 6500
communications@rlam.co.uk
www.rlam.co.uk