# Q2 2020 COMMENTARY
# HIGHER INCOME FUND

## QUARTER TO END JUNE 2020

### PERFORMANCE

| | 3 Months | 6 Months | 1 Year | 3 Years | 5 Years | 10 Years |
|---|---|---|---|---|---|---|
| Fund Performance (B Class) | 9.94% | -13.07% | -8.90% | -2.28% | 15.54% | 78.52% |
| FTSE World TR GBP | 10.17% | -17.51% | -12.99% | -4.60% | 15.17% | 91.84% |
| IA Global | 13.09% | -4.13% | 0.10% | 9.00% | 29.56% | 90.41% |
| Sector Quartile | 4 | 4 | 4 | 4 | 4 | 4 |

Source: Morningstar. Figures compared on a Bid to Bid basis with Net Income Reinvested.

### REVIEW

Global investment markets rebounded sharply in the second quarter, driven by progress in the battle against the coronavirus (COVID-19) and the massive stimulus efforts deployed by both major central banks and governments. Following a first-quarter crash, equity markets bounced back in April, May and early June as many countries gradually reopened their economies for business. Toward the quarter-end, returns moderated slightly amid concern that infection rates were increasing. While elevated volatility persisted, the FTSE World Index jumped 19.9% in the second quarter (on a total return basis, in sterling terms), taking it in to marginal positive territory year-to-date. Fixed interest markets also climbed higher over the period, although the asset class failed to keep pace with equity bourses. Broadly, government bond yields saw a degree of divergence over the quarter, with the US and Germany's 10-year yields little changed, but those more sensitive to risk sentiment declined (meaning prices rose).

In the UK, national lockdown and social distancing measures more eased as capacity levels in hospitals improved. The government began to ease lockdown measures with people encouraged to return to work where necessary and a phased reopening of schools and various industry sectors confirmed. This occurred as the cost of the government programmes announced in the first quarter to cushion the blow from unemployment and the loss of income as a result of the lockdowns became apparent in borrowing figures released in Q2. The economic waters were ice cold in April in the UK, a month in which the British economy shrank 20.4% from the month before amid the pandemic-driven lockdown. Industrial output fell by a similar percentage while services declined by 19%. All the declines were the largest on record. The drop in gross domestic product was approximately ten times greater than any previous monthly decline. In a bid to combat the weakness in economic activity, the Bank of England's announced that it was expanding its quantitative easing (QE) programme by a further £100bn (with an 8-1 vote in favour). As expected, there was a unanimous vote to maintain Bank Rate at 0.1%. Within this context, domestic equity markets underperformed broader global bourses. A number of economically sensitive areas of the market outperformed amid a general improvement in investor sentiment, largely driven by global considerations. The mining sector, for instance, performed very well, in part due to the ongoing recovery in Chinese economic activity and new stimulus measures. Within sterling denominated fixed interest markets, as Brexit came back in focus, the UK 10-year bond yield was 18bps lower at 0.17% over the quarter, while the UK two-year yield dropped below zero for the first time, finishing at -0.08%, as the central bank discussed the possibility of negative interest rates. Corporate bonds performed strongly, outpacing government bonds, as they benefitted from stronger risk appetite.

In continental Europe, data confirmed that the eurozone economy shrank by 3.6% in the first quarter, compared to the final three months of 2019, as lockdown measures were widely introduced in March. However, surveys of economic activity showed marked improvement through the spring. The flash eurozone composite purchasing managers' index (PMI) for June rose to 47.5, compared to 31.9 in May and 13.6 in April. (50 is the level that separates expansion from contraction. The PMI surveys are based on responses from companies in the manufacturing and services sectors). Regional equity markets posted strong gains over the course of the quarter as countries began to lift lockdown restrictions. Another source of support for shares was news of the European Union's plans for a post-COVID-19 recovery. European Commission president Ursula von der Leyen called for the power to borrow €750 billion for a recovery fund to support the worst affected regions within the bloc. This would be in addition to a €540 billion rescue package agreed in April. The European Central Bank also offered support, expanding its pandemic emergency purchase programme to €1.35 trillion.

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Across the Atlantic, at the beginning of the quarter, economic readings confirmed the severe economic impact of lockdown measures. This included a plunge in nonfarm payroll employment, which fell from 151.6 million in March to 131.1 million in April, a 13.5% decline. However, the subsequent easing of lockdown restrictions, ongoing loose monetary policy from the Federal Reserve (Fed) and early indications of a recovery led to widespread US equity market gains, with both the S&P 500 Index and the Nasdaq Composite Index outperforming global bourses over the period. Weekly claims for unemployment insurance slowed substantially and retail sales rebounded strongly from April to May, however, this has been somewhat aided by stimulus cheques and unusually generous unemployment benefits, which are due to expire at the end of July. If these benefits are not extended, many unemployed Americans could experience a significant reduction in their incomes in the second half of the year.

In Asia Pacific, China's economy contracted 6.8% YoY in Q1 2020, compared with the gain of 6.0% in Q4 2019. The Q1 decline in GDP was generally larger than expectations. The plunge is the worst for a single quarter that China has recorded since it started publishing figures in 1992. It was also the first time China has reported an economic contraction since 1976, when Communist Party leader Mao Zedong's death ended a decade of social and economic tumult. China's three major engines for growth, consumer spending, exports and fixed asset investment, all sputtered as large swaths of the country were placed on lockdown in late January and early February to contain the spread of the virus. Retail spending dropped 19% last quarter, while exports plunged more than 13% and fixed asset investment declined 16%. However, as the period progressed, economic activity began to show signs of recovery, with China's manufacturing PMI reached 51.2 in June. Meanwhile the government announced further fiscal support at the National People's Congress in May. However, geopolitical concerns increased as the US-China confrontation expanded beyond trade and technology issues.

Meanwhile, in Japan, the government also continued to step up its fiscal response to the crisis and drew up a second supplementary budget, as expected, in May. Following the increase in its pace of exchange-traded fund (ETF) purchases from March onwards, the Bank of Japan also announced additional monetary policy initiatives. Additionally, during the quarter, China announced the imposition of a national security law in Hong Kong SAR, which came into effect on 30 June and consequently, political tensions between China and the rest of the world are escalating.

## PERFORMANCE & ACTIVITY

Over the three-month period to the end of June 2020, the Higher Income Fund climbed by 9.9% on a total return basis, marginally underperforming the FTSE All-Share Index by 23 basis points and underperforming the IA sector by 316 basis points. For the second quarter of the year, all allocations at an asset class level positively contributed to absolute performance. With regards to the fund's performance relative to the benchmark, the allocation to UK equities was the primary contributor to overall underperformance during the quarter. Relative weakness in the domestic equity market was largely attributable to an underweight allocation to the economically sensitive areas of the market such as Industrials and Basic Materials, which outperformed amid a general improvement in investor sentiment, largely driven by global considerations. The continued bifurcation of returns between "Value" and "Growth" equity baskets also provided an additional headwind for the fund's relative performance, as the latter outperformed the former by approximately 8 percentage points over the period.

Despite robust absolute performance over the second quarter, the fund's fixed interest portfolio also weighed on relative returns, as the asset class failed to keep pace with equity returns over the period. At a sector level, the fund benefitted from the strong returns delivered by Preference Shares and Permanent Interest Bearing Shares (PIBS), both of which benefitted from stronger risk appetite among investors during the second quarter. Conversely, the fund's relative performance over the second quarter was boosted by allocations to international equities, which were broadly lifted by improving investor sentiment as major global economies began to re-open. At a regional level, the fund delivered strong returns in continental Europe (BillerudKorsnäs, Sanofi, Bayer and Bekeart) and Asia Pacific (TSMC, Sumitomo Mitsui Financial Group and Mapletree Logistics).

In terms of investment activity over the course of the period, the fund took profits from its positions in European pharmaceutical giants Roche, Sanofi and AstraZeneca, following a sustained period of strong share price performance for each respective company. The fund also top-sliced its position in the renewable packaging materials company BillerudKorsnäs following a similar strong trajectory in the company's share price. Additionally, the fund augmented existing positions in the Renewables Infrastructure Group and the Lloyds Banking Group.

## OUTLOOK

The initial economic contraction related to the COVID-19 pandemic is larger than the great financial crisis (the "GFC"), however, we believe that its cumulative impact on the global economy could be shorter in duration as long as the policy response from governments and central banks remains strong enough to cushion the blow. Ultimately, the depth and breadth of the current downturn remains unknown and largely determined by the success of current efforts to contain and even cure COVID-19. There are tentative signs that the spread of the virus may be decelerating, which may provide respite for struggling health services as the Northern Hemisphere moves through the summertime, whilst the potential for a vaccine would likely help calm market nerves. A crucial point of note is how the situation unfolds as restrictions begin to be lifted and whether this leads to a second wave of cases.

In the meantime, policymakers have sought to use their government and central bank balance sheets to preserve the structure of their economies over a near-term, variously guaranteeing subsidised business loans, providing grants to small and medium sized businesses as well as households, underwriting the private sector wage bill, and implementing a range of regulatory and accounting forbearance measures. While large fiscal and monetary packages cannot cure a global health pandemic, these programmes can address cash flow pressures at a business and household level, and resolve some of the dislocations seen in markets. Ultimately, the longer the economic stoppages last, the higher the risk of persistent damage to the economy.

Geopolitical concerns also continue to present risks to our outlook, and this includes the escalation of the trade war between the two global economic superpowers, the US and China. Finally, we remain concerned about the levels of debt in the world, particularly sovereign and corporate debt, with net debt to GDP in the likes of China looking increasingly unsustainable. However, while as ever, some political and economic risks lie ahead, we remain focused on finding new long-term investment opportunities in companies that have a sustainable competitive advantage, are run by strong management teams with a history of good capital allocation and prudent balance sheet management.

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