Sterling abrdn CPI+3.5% Portfolio

Quarterly Review
June 2023

I. Quarterly commentary summary

1. Macro and market commentaries

Global equity markets were robust in the second quarter, while fixed income markets had a mixed performance

Global stock markets ended the second quarter of 2023 higher, with the MSCI AC World Index returning 7.3% (total return in Australian dollars, AUD). Despite continued volatility over the review period, investor appetite for equities remained strong.

Australian equities gained slightly over the second quarter, with the ASX 200 Total Return Index up 1.2% (in AUD terms). Investors remained cautious, especially due to economic uncertainties in China, Australia's most important trading partner, and given the potential for further monetary tightening by major central banks. Technology shares were robust, driven by global generative artificial intelligence (AI) enthusiasm. The Reserve Bank of Australia (RBA) continued to raise interest rates, pushing borrowing costs to an 11-year high of 4.1% in June, up from 3.85% in April. The Judo Bank Australia Manufacturing PMI fell for the fourth consecutive month to 48.2 in June, reflecting weakened demand and pressure from higher borrowing costs. Australia's monthly Consumer Price Index of annual inflation rose by 5.6% in May, slower than the 6.8% increase in April. Recent data from the Australian Bureau of Statistics showed that retail turnover rose 0.7% in May, following a flat result the previous month.

In fixed income, Australia's 10-year government bond yield hovered near 4%, one of its highest levels this year, in part driven by an increasing likelihood of rising global bond yields. Investors are now keeping an eye on the RBA interest rate decision expected on 4 July. Meanwhile, the Australian dollar ended a volatile quarter at slightly over 0.66 against the US dollar.

Elsewhere, equities in the US advanced. The technology sector outperformed, benefitting from optimism around AI. Equities in Italy, Spain, France and Germany all advanced as well. However, shares in the UK, where inflation remains high, declined (in sterling terms). Elsewhere, the Japanese stock market made strong gains in yen terms, given the Japanese yen depreciated. Emerging market (EM) shares gained but returns were less than developed market (DM) peers. While India and Latin America (including Brazil) rose, Chinese shares underperformed.

Globally, government bond markets ended lower. The persistent strength of the US economy was a constant theme throughout the period, with US Treasury yields rising as a result of higher interest rate expectations. Corporate bonds had a resilient quarter. In the US, riskier high-yield bonds outperformed their investment-grade (IG) counterparts as investors were attracted by the former's relatively high starting yields.

2. Performance review

The portfolio returned 0.13% over the quarter. Global and Australian equities contributed positively over the quarter.

The allocation to Australian government bond and Australian fixed income detracted from performance on the back of rising yields.

3. Macro and market outlook

With the resolution of the US debt ceiling, market focus has shifted toward pricing growth and inflation dynamics, central bank policies and market liquidity. The resilience of US economic activity reduces the risks of an imminent recession. Despite the weakening manufacturing sector, the services sector is still expanding. Core service inflation remains sticky and the labour market continues to surprise to the upside.

Against this backdrop, the US Federal Reserve (Fed) skipped a rate hike in its June meeting but kept the door open for one to two additional hikes in July and September 2023. Central bankers of the Fed, European Central Bank (ECB) and Bank of England all struck a hawkish tone at the ECB forum as of late June. There remains the risk that the market is underestimating terminal rates in the DMs.

In Asia Pacific, we expect strong economic growth relative to the US and an improving corporate earnings outlook, driven by India, China reopening and a bottoming tech cycle. China's growth momentum moderated in the second quarter and the risk of a double dip is on the rise, but the outlook might still improve in the second half of 2023. In summary, we expect the US to potentially avoid a recession this year. Headline inflation in the developed world will likely moderate but core inflation remains persistent. Asia is projected to be the primary driver of global growth. Most central banks will likely continue rate hikes in the second half of 2023 but reach terminal rates by year end.

Stress on US Treasuries due to debt ceiling default risks is expected to diminish, allowing Treasuries and duration to perform as US growth moderates. Tech is currently overbought, but with the AI theme tailwinds and tech earnings outperforming low expectations, we see supporting factors for tech to do well, post a pullback from overbought positions.

4. High level portfolio positioning

The portfolio is defensively positioned. We have a large exposure to defensive assets – such as Australian IG bonds, Australian government bonds, Australian inflation-linked bonds, a money market ETF and cash – as a layer of cushion. While we are underweight equities, we focus on markets that are expected to provide more resilience such as MinVol equity. We also have positions in Chinese equities to harvest the benefit of the economy reopening.

Our long-term allocation to listed alternatives that tap into idiosyncratic price drivers, with some of the investments with direct or indirect linkage to inflation, provide diversification. We keep a close watch on any market developments and manage the portfolio actively.

Key information[1]

This portfolio aims to achieve a real return equivalent to 3.5% per annum above inflation (before fees) over a rolling 5-year period.

- **Benchmark:** CPI plus 3.5% p.a.
- **Investment Time Horizon:** 5+ Years
- **Portfolio launch date:** 31 August 2020

[1]Source: abrdn, 30 June 2023

II. Asset class review

Listed equities:

Over the review period, investors paid close attention to central bank policy globally as interest rates continued to rise in the US, Europe and the UK due to sticky core inflation levels, which excludes food and energy. Meanwhile, investor appetite for technology stocks linked to generative AI platforms were strong, leading to robust gains worldwide.

Fixed Income :

Australian government bonds and corporate bonds delivered a negative return over the quarter given that inflation was higher than the market expected, and RBA took action to combat inflation.

Infrastructure:

Our infrastructure allocation produced a negative return over the quarter. This came as a result of concerns including rising interest rates and the potential impact on discount rates used to value underlying assets; the relative attractiveness of infrastructure yields versus other asset classes; higher short-term debt costs; and specifically for our renewables, declining short-term power prices.

We continue to assess the impact of these factors on long-term expected returns. However, we still believe there are potentially offsetting factors to many of the above concerns including inflation-linked cashflows that could help offset the potential impact from rising interest rates, as we saw playing out when several renewable companies reported broadly stable first-quarter net-asset values (NAVs); more compelling valuations; and specifically for our renewables, generally high degrees of near-term power prices fixing, which could dampen the impact from declining short-term power prices. Ultimately, we continue to see compelling long-term return opportunities across many areas of infrastructure, reflecting stable income across different economic scenarios and positive inflation linkage.

Special Opportunities:

Special opportunities include allocations to a diverse range of exposures with differing return drivers and risk characteristics.

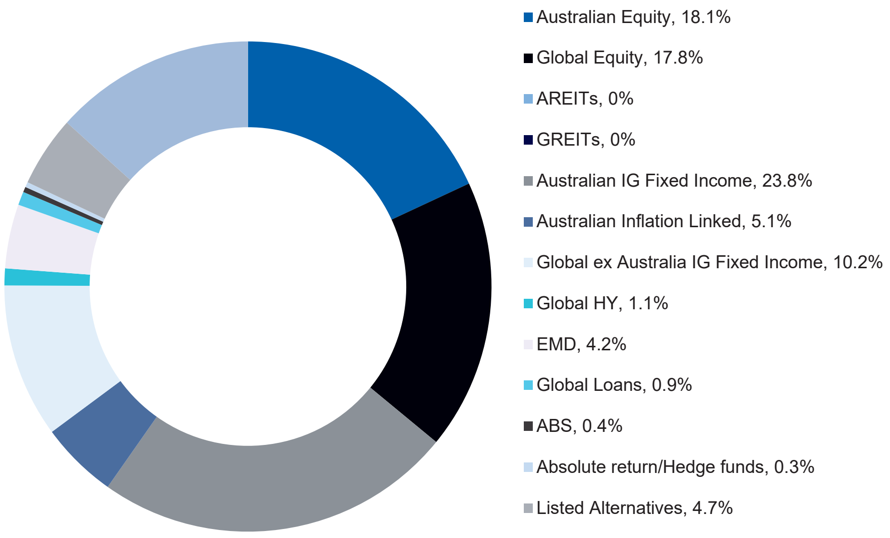
Burford Capital, our litigation finance investor, produced a notable positive return. As discussed in our first-quarter update, Burford received a summary judgement on its highest profile investment – the Petersen and Eton Park cases against the Republic of Argentina and YPF. This happened on the final day of March with the shares responding positively in April (the shares have increased around 70% since the judgment announcement on 31 March). As a result, it was a notable positive contributor to performance at the start of the quarter.

Round Hill Music, the music royalty owner, released full-year results to the end of December. The NAV total return was 17.8% for the year with fair value gains as a result of strong income generation. Underlying organic income growth was robust at 15% year-on-year.

Property:

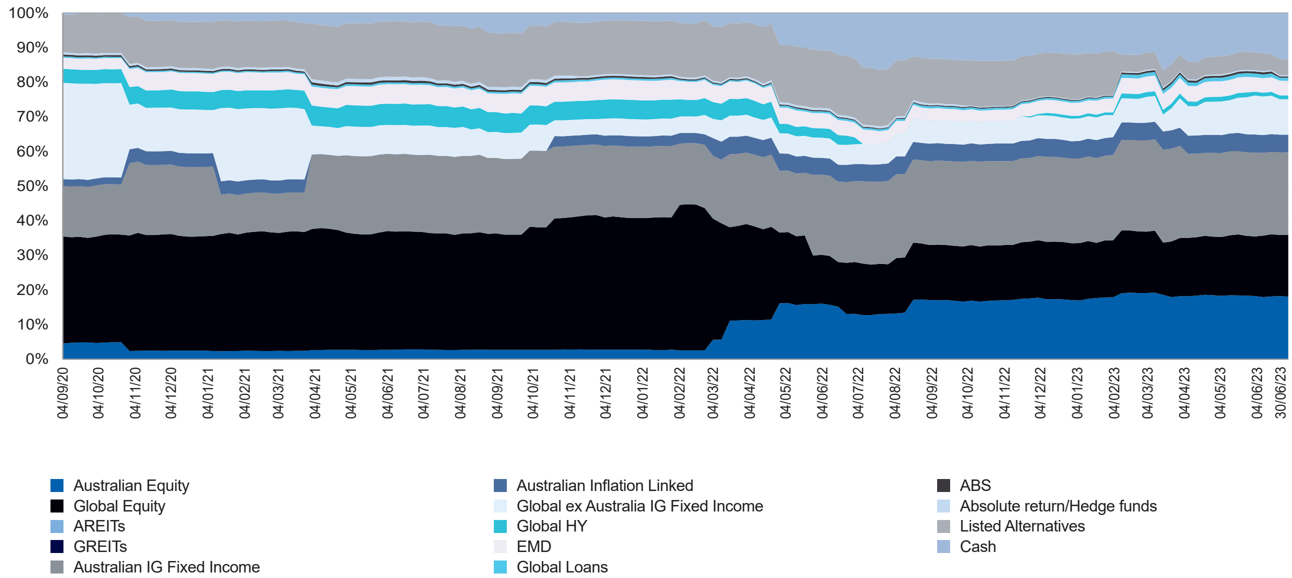
Our property allocation produced a marginal negative return over the quarter. Notable company news came from Unite Group, the student accommodation provider, which published its first-quarter 2023 trading update revealing that 90% of rooms are sold for the upcoming academic year, which is significantly ahead of previous sales cycles. While Unite's property yields marginally expanded over the quarter, this was offset by strong rental growth. Indeed, rental growth is expected to be 6-7% this year given strong demand.

Chart 01: Current asset allocation



Source: abrdn, 30 June 2023

Chart 02: Historic asset allocation evolution



III. Outlook and positioning

At the top level, we moderated our more defensive exposures within our equity allocations by rotating from the Healthcare ETF to the Vanguard MSCI Index international Shares ETF.

Within the multi-asset strategy, the portfolio invests in the abrdn Multi-Asset Real Return Fund. We added back to equities and moderated our more defensive exposures within our equity allocations early in the quarter. In addition, we rotated from global healthcare to information technology (IT) given the crowded healthcare positioning and higher sensitivity of the IT sector to falling rates in response to downside growth risks. We also trimmed the exposure to a more defensive positioning and decreased the EM exposure in favour of having more balance through DM equities.

In May, given the risk moderation in our view, we added back growth assets into the portfolio. Having been underweight equities and tilted toward more defensive styles, we decided to close the underweight positioning and added exposure to NASDAQ 100 to bring some growth exposure back to the portfolio. While we still perceive risks to the downside, our timeframe for them has been updated and pushed further out. In the short to medium term, we see positive momentum and sentiment carrying markets forward.

In June, within our equity allocations, we took partial profit from the IT sector and Chinese equities, where part of the proceeds was added to defensive equity over the month. As for fixed income, we kept our duration profile unchanged in June. However, we switched the instrument to the long end of the curve given the yield levels are more attractive than before.

With the uncertainties in the market, we take a cautious approach to the impending risks, and the portfolio remains tilted toward more defensive equities. On the other hand, we have exposure to China that is expected to benefit from the reopening of its economy.

IV. Performance and risk contribution

1. Performance table

The Portfolio returned 0.13% over the quarter. Since inception the Portfolio has delivered a return of -0.74%.

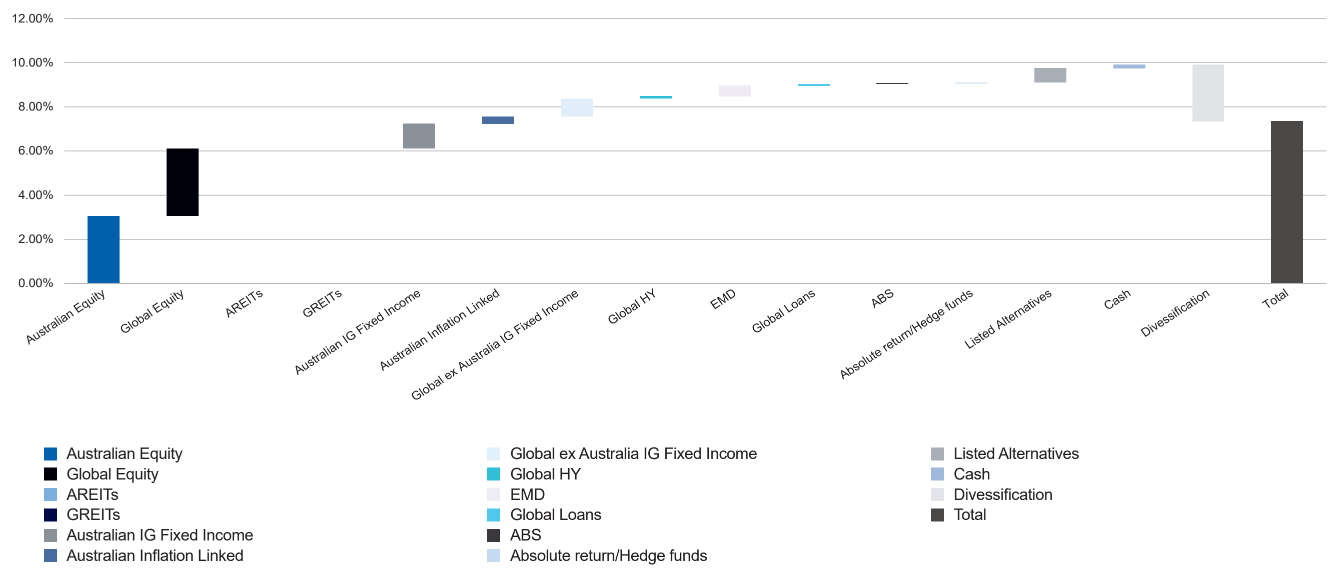
Sterling abrdn CPI+3.5% Portfolio	1 Month %	3 Months %	6 Months %	YTD %	1 Year %	Inception (p.a)%
Portfolio	0.15	0.13	2.12	2.12	3.42	-0.74
Benchmark: CPI plus 3.5%p.a.	0.80	2.44	5.01	5.01	9.64	6.88

Portfolio performance is provided net of fees on underlying investments but gross of Advisory/Platform fees.
Source: abrdn Lipper,30 June 2023
Past performance is not a guide to future results

2. Risk Contribution

Our long term proprietary estimations of risk and correlation continue to suggest a high degree of diversification across the various asset classes that compose the portfolio. The portfolio's long-term expected volatility remains well below that of equity at 7.4% per annum.

Chart 03: Risk Contribution



Source: abrdn 30 June 2023

Important Information

Financial commentary contained within this document is provided by abrdn Oceania Pty Ltd ABN 35 666 571 268, the portfolio manager responsible for designing and managing the composition of this managed portfolio to meet the investment objectives and investment strategy detailed in the model portfolio sub-advisory agreement. abrdn Oceania Pty Ltd (ABN 35 666 571 268) is a Corporate Authorised Representative (CAR No. 001304153) of AFSL Holder MSC Advisory Pty Ltd, ACN 607 459 441, AFSL No. 480649 and CAR No. 001304154 of AFSL Holder Melbourne Securities Corporation Limited, ACN 160 326 545, AFSL No. 428289.

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