Sterling abrdn CPI+3.5% Portfolio
Quarterly Review
December 2023

abrdn

I. Quarterly commentary summary

1. Macro and market commentaries

Global equity markets rebounded in the fourth quarter, while fixed income markets saw a surge in government bond prices amid declining yields, fueled by rate cut expectations.

Global equity markets ended the quarter higher. With inflationary pressures declining, major central banks kept interest rates on hold as they adopted a data-dependent approach to monetary policy for the time being, before they looked to possibly start monetary easing in 2024. Also, fears of a global recession fell, particularly given the robust performance of the US economy. Australian equities advanced over the fourth quarter, with the ASX 200 Total Return Index returning 8.40% (in AUD terms). Notably, the health care, real estate and materials sectors were the primary drivers, while declines in the energy and utilities sectors partially offset overall gains during the quarter.

Data released in October 2023 showed that Australia's headline inflation softened to 5.4% in the third quarter, with a slowdown fuelled by declining goods and services costs, while underlying price pressures remained significant keeping inflation well above the central bank's target range of 2-3%. The Reserve Bank of Australia (RBA) maintained a 4.35% cash rate throughout November and December, citing concerns regarding domestic inflation and slower progress towards its inflation target. Policymakers pledged careful monitoring of both domestic data and global trends for future decisions. In December, the Melbourne Institute's Monthly Inflation Gauge sharply accelerated to 1.0%, in contrast with a 0.3% rise in November and a 0.1% decline in October. The Judo Bank Australia Composite PMI inched up from 46.2 to 47.4 in December, marking business activity decline amid economic softening and elevated interest rates. Despite this uptick, the index continued to hover below the expansion threshold of 50, with ongoing falls in new orders for the third consecutive month across manufacturing and service sectors. Elsewhere, the National Bank of Australia's (NAB) business confidence index plummeted to -9 in November, with multiple industries experiencing declines, particularly a steep 16-point drop in the retail segment. Meanwhile, the seasonally adjusted unemployment rate edged up to 3.9% in November and the Westpac-Melbourne Institute Consumer Sentiment Index rose marginally to 82.1 in December from November's 79.9, maintaining a pessimistic outlook and marking its second-worst year.

In fixed income, the Australian 10-year government bond yield declined over the three-month period, particularly in December, slipping below 4% to reach its lowest level in four months by year-end. This was in line with the drop in US bond yields, driven by reinforced expectations that the US Federal Reserve (Fed) will likely cut interest rate cuts in 2024. Australian corporates had a mixed quarter returning 3.2% according to the Bloomberg AusBond Credit 0+ Yr Index and slightly underperforming Australian government bonds that returned 4% according to the Bloomberg AusBond Govt 0+ Yr Index. The latter had a strong rally over the last two months of the year as bond yields fell from peak levels to just below 4%. Meanwhile, over the fourth quarter, the Australian dollar traded slightly over 0.68 against the US dollar, approaching its five-month high.

Top of Form:

Over the fourth-quarter, US equities enjoyed double-digit gains. Inflationary pressures eased following multiple interest-rate increases from the Fed since early 2022. European equities also advanced over the quarter, mirroring the robust gains in the US. UK equities ended higher but underperformed most other regional indices, while the domestically focused FTSE 250 Index outperformed the internationally focused FTSE 100 Index. Japanese equities rose slightly in Japanese yen (JPY) terms, while the volatility in JPY continued as the currency appreciated against the US dollar. Latin American markets, especially Brazil, were particularly strong, and Indian shares also enjoyed double-digit returns. Indices in Taiwan and South Korea were supported by their relatively high exposure to the buoyant technology sector. However, investors remained concerned about the outlook for China, particularly the country's highly indebted property sector and the decrease in consumer spending. As a result, Chinese equities declined in the final quarter of 2023.

In global fixed income, government bonds rose in local-currency terms. As mentioned, major developed market (DM) central banks held interest rates over the quarter but stressed maintaining a data-dependent stance. Meanwhile, investors became less concerned about the risk of a global economic recession given robust economic data, particularly in the US. Elsewhere, 10-year government bond yields in the US, Germany and the UK all notably declined over the final quarter of 2023. Corporate bonds had a strong quarter globally as investor risk appetite improved. In the US, higher-quality investment-grade (IG) and riskier high-yield (HY) bonds performed well, with the spreads on both instruments tightening. IG bonds benefitted from their longer duration, or sensitivity to changes in interest rates. HY bonds were supported by their income attractions and a better outlook for issuers' credit quality.

2. Performance review

The portfolio returned 5.65% over the quarter, while all asset classes contributed positively. The largest contributor was our multi-asset strategy, followed by our Australian equity holding, and Australian government debt exposures. Our DM IG and Australian IG exposures as well as global equity allocations also had solid advances over the fourth quarter.

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, 31 December 2023

3. Macro and Market outlook

Looking ahead, there are multiple key aspects that will keep volatility elevated. As markets try to price in the turning points of monetary policy (i.e., when central banks will likely cut rates), we expect a tug of war between the "higher for longer rates scenario" versus the "monetary policy pivot scenario".

Adding to this debate, there are several significant national and presidential elections that will add to geopolitical volatility. The most impactful event will be the US presidential election in November 2024, with former President Trump likely to get the Republican nomination, and running against President Biden.

Elevated volatility presents entry points for three key themes that will drive markets for 2024: (a) slower growth, (b) moderating inflation, and (c) falling interest rates. As such, under a falling interest rate environment, we expect longer duration assets such as sovereigns and real estate investment trusts (REITs) to outperform. On equities, there is a need to be nimble. Markets will swing between moderating inflation and lower inflation supporting equities, and slowing growth raising concerns for a soft landing turning into a contraction resulting in a drag on equities. In terms of equity regions, we expect the "Magnificent 7" stocks in the US to benefit from lower discount rates. We expect Japan to do well from a shift in corporate behaviour placing strong emphasis on profitability and returning excess capital to shareholders. Last but not least, equity valuations in China are reaching attractive levels. Should the Chinese government decide to introduce meaningful stimulus to turn around China's growth prospects, this move will be the trigger to unlock China's attractive valuations.

4. High level portfolio positioning

The portfolio is defensively positioned. We have a large exposure to defensive assets – such as Australian government bonds, Australian IG bonds, Australian inflation-linked bonds, global DM IG 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, moat-based, and quality equity. We also have positions in Chinese equities as the current cheap valuation is difficult to ignore, but its near-term direction will be determined by the forcefulness of policy stimulus and geopolitical development.

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.

II. Asset class review

Listed equities:
Equities started the fourth quarter weakly, as markets continued to be impacted by the higher-for-longer interest rates narrative and continued recessionary concerns. This was exacerbated by the outbreak of war between Israel and Hamas at the start of October. However, from the end of October onwards equity markets rallied strongly with encouraging economic data, easing inflation and with investors seeing a potential end to the rate hiking cycle and increased likelihood of a soft landing.

Australian equities joined the global market rally during the period, rebounding from October's losses, as hopes for central bank rate cuts grew.

Fixed Income:
Australian government bonds yielded positive returns over the fourth quarter, aligning with the global trend of falling yields amid rate cut expectations. Australian IG bonds, particularly longer maturities, saw strong returns and credit spreads tightened with improved investor sentiment. Global IG bonds also thrived as yields dropped, spreads tightened, and the extended duration proved advantageous amid changing interest rates.

Infrastructure:
Our infrastructure allocation produced strong returns as government bond yields fell. Broadly stable third quarter net asset values (NAVs) were released and further asset sales at premiums to holding valuations were announced, which in turn, supported valuations. NAV total returns from our traditional renewable investments were broadly flat to slightly positive, with headwinds from discount rate increases and reduced power price forecasts partly offset by increasing inflation forecasts and share buybacks.

Battery storage investor Harmony Energy produced a 2.3% NAV total return over the third quarter. Foresight Solar Fund announced the sale of a 50% stake in three Spanish solar farms for €27 million, a 21% premium to the third quarter holding value. Bluefield Solar Income Fund (BSIF) announced a strategic partnership with GLIL Infrastructure – a group of UK pension funds.

Within our social infrastructure allocation, HICL Infrastructure announced half-year results to end-September, producing a NAV total return of 0.9% with positive underlying performance. Elsewhere, International Public Partnerships announced the sale of four debt investments and the acquisition of the Moray East OFTO for £80 million, as well as a £30 million share buyback programme. Lastly, 3i Infrastructure, the economic infrastructure investor, released half-year results to end-September, revealing a NAV total return of 6.3%, ahead of targets. During the period, the company announced the sale of its holding in Attero for a 31% premium to the latest holding value.

Special Opportunities:
Special opportunities, which include allocations to a diverse range of exposures with differing return drivers and risk characteristics, contributed a slight positive return, mainly driven by our allocations to litigation finance and precious metals royalties. Burford Capital performed positively on the news that the Argentinian President, Javier Milei, was considering issuing a perpetual bond to pay for the damages awarded in the YPF case. Elsewhere, LumiraDx, one of BioPharma Credit's borrowers, announced the sale of its point of care diagnostics platform business to Roche with proceeds to be used to repay lenders including BioPharma Credit.

III. Outlook and Positioning

During the earlier part of the quarter, we trimmed the EM equity exposure given the challenging macro-outlook and tightening global financial conditions. Also, rate volatility was reduced given the continued uncertainty reflected in the long end of the curve.

Coming to the end of year, we increased the overall growth exposure to global equities after the recent benign US job market and inflation data, which continue to point to a soft-landing regime, while the December dovish pivot by the FOMC should support further upside for risk assets.

Within the multi-asset strategy, the portfolio invests in the abrdn Multi-Asset Real Return Fund, which was dynamically managed throughout the quarter.

In October, we reduced our long duration positions over concerns that yields could still push higher before a retracement.

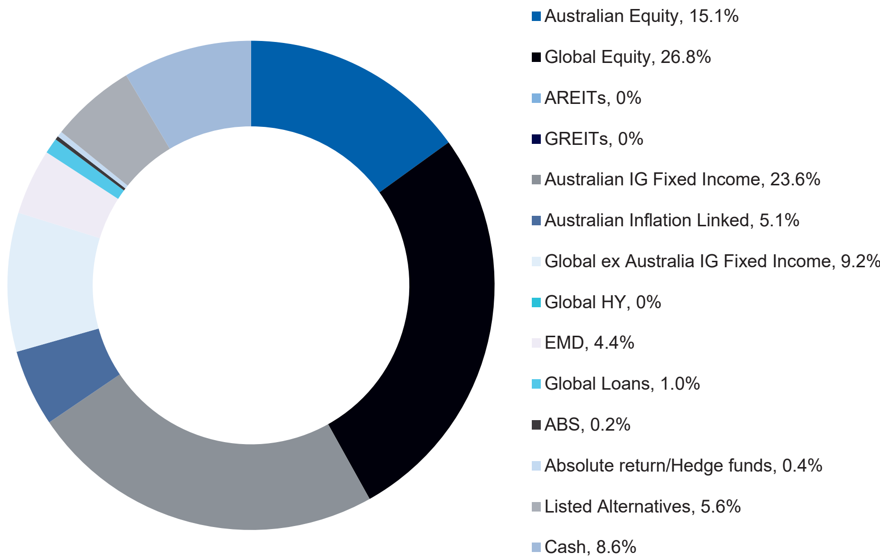
Through the first half of the month, we also reduced the exposure to the VanEck Wide Moat ETF while adding to broader equities and an energy sector exchange-traded fund (ETF) to add more growth exposure relative to value within the portfolio.

Later in November, we reduced our long duration positions taking profit given the strength of the bond rally over the month. We also closed out the short option position we had maintained as a hedge, and rebalanced our overall equity allocation to get back to the target level.

Finally in December, we trimmed our long duration positions, once again taking profits off the bond rally over the month. We re-allocated the capital to equities after benign US job market and inflation data that continued to point to a soft-landing, while we also saw a Federal Open Market Committee dovish pivot which should be supportive for risk assets. The addition to equities also introduced an exposure to Japanese equities on the back of strong earnings momentum and also as a safe haven from China/US geopolitical tensions, as well as being supported by structural tailwinds from reflation and corporate governance reforms.

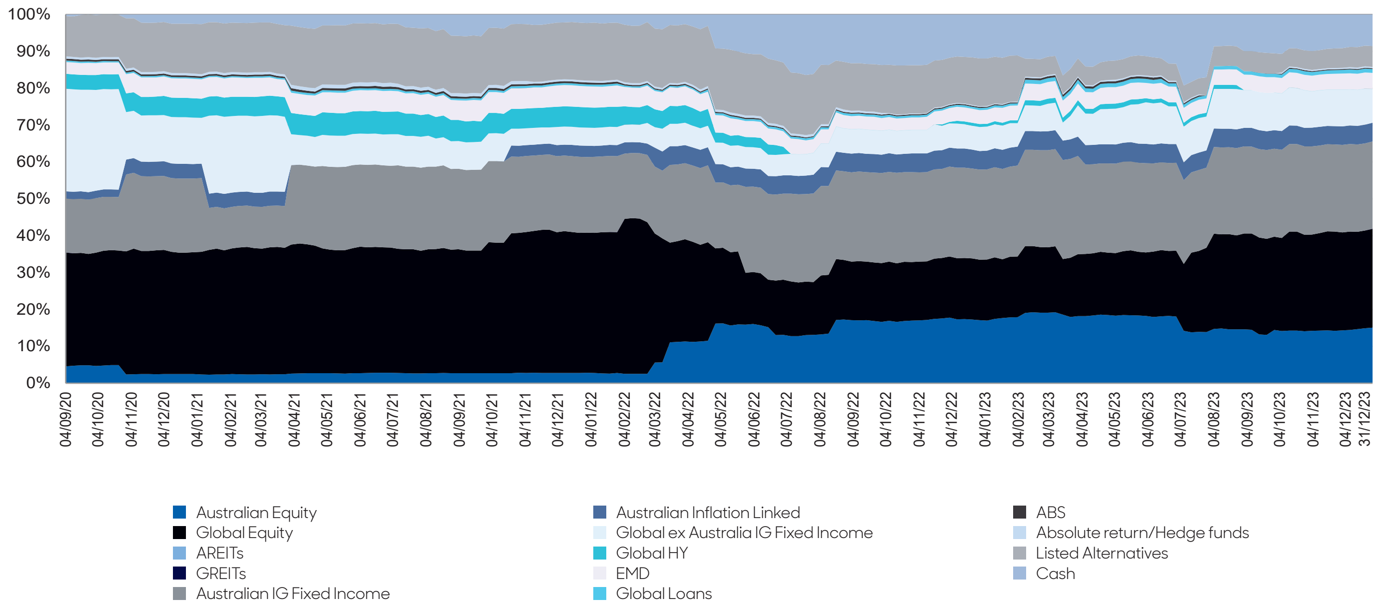
While we do see compelling risk-adjusted return prospects in some traditional asset classes, we remain cautious on relying on them alone to generate returns. Our portfolios also have meaningful allocations to alternative asset classes, many of which have compelling direct links to inflation; limited economic sensitivity; and compelling risk-adjusted return prospects.

Chart 01: Current asset allocation



Source: abrdn, 31 December 2023

Chart 02: Historic asset allocation evolution



IV. Performance and risk contribution

1. Performance table

The Portfolio returned 5.65% over the quarter. Since inception the Portfolio has delivered a return of 0.93%.

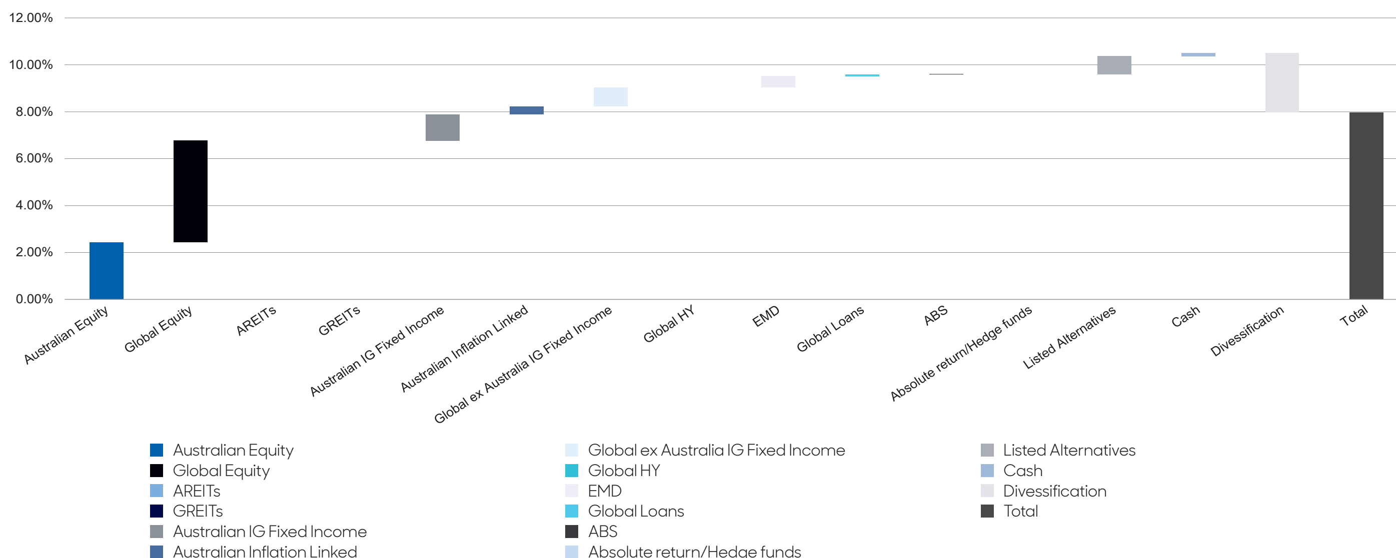
Sterling abrdn CPI+3.5% Portfolio	1 Month %	3 Months %	6 Months %	YTD %	1 Year %	Inception (p.a)%
Portfolio	3.13	5.65	5.31	7.54	7.54	0.93
Benchmark: CPI plus 3.5%p.a.	0.70	2.09	4.41	9.64	9.64	7.19

Portfolio performance is provided net of fees on underlying investments but gross of Advisory/Platform fees.
Source: abrdn Lipper,31 December 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 8.0%.

Chart 03: Risk Contribution



Source: abrdn 31 December 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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Model Portfolio performance is based on the theoretical performance of the model portfolio, and does not take into account any fees applicable to the model portfolio. Actual portfolios may not perform in the same manner as the model portfolios, depending on customisations and timing issues. Accordingly, the actual after tax returns you receive are likely to be different from the model portfolio returns and those of other investors. Rounding used in the presentation of data may result in minor variations.