Sterling abrdn CPI+2.0% Portfolio

Quarterly Review
March 2024

abrdn

I. Quarterly commentary summary

1. Macro and market commentaries

Global equity markets advanced in the first quarter, while in fixed income markets, government bond prices declined as core inflation stayed elevated.

Global equity markets ended the first quarter of 2024 notably higher, supported by reduced inflationary pressures in most developed markets (DMs) after a prolonged period of monetary tightening. Meanwhile, economic data was generally more robust than was feared, meaning that a likely scenario would be a mild economic slowdown rather than a recession. Australian equities advanced over the fourth quarter, with the ASX 200 Total Return Index returning 5.3% (in Australian dollar, AUD, terms).

Australian equities registered robust gains over the first quarter, reaching new all-time highs, driven by continuous positive momentum. Especially the technology, real estate, financials, and consumer discretionary sectors were among the primary drivers. The Reserve Bank of Australia (RBA) maintained the cash rate at a 12-year-high of 4.35% throughout the quarter, aiming for 2-3% inflation by 2025 amid an economic slowdown. Over the past two years, policy makers have raised interest rates by a total of 425 basis points (bps). February's Melbourne Institute Monthly Inflation Gauge fell 0.1%, marking the first drop since October 2023, and the monthly consumer price index (CPI) hit a two-year low of 3.4%. Similarly, consumer inflation expectations declined from 4.5% in February to 4.3% in March 2024. The seasonally adjusted unemployment rate dropped to 3.7% in February, the lowest since September 2023. In March, the Judo Bank Australia Composite Output Index climbed to 52.4, indicating private sector growth led by services. Finally, the Westpac-Melbourne Institute Leading Economic Index increased from -0.1% in January to 0.1% in February, registering the highest reading in two years. However, Australia's NAB business confidence index slipped from 1 to 0 in February, with the retail sector struggling due to high borrowing costs and inflation. Finally, the Australian dollar remained under pressure and declined against the US dollar, ending the quarte slightly above 0.65.

Elsewhere, US equities advanced over the review period, with major indices posting strong gains despite lingering economic and geopolitical uncertainties. The S&P 500 index surged 10.55% during the first quarter of 2024, marking its best first-quarter performance in well over a decade. The tech-heavy Nasdaq Composite index also gained 9.32%, propelled by the ongoing artificial intelligence (AI) tailwinds and robust quarterly performances from mega-cap technology stocks like NVIDIA, Microsoft, and Meta Platforms. Similarly, as inflation showed signs of cooling, European equity markets enjoyed robust gains, with major indices reaching new highs. UK equities ended higher but underperformed most other regional indices. The internationally focused FTSE 100 Index outperformed the domestically focused FTSE 250 Index, thanks to the strength in energy, financials, aerospace and industrials sectors. Japanese equities also rallied, with the Nikkei 225 index reaching a multi-decade high and the TOPIX also posting robust gains. Emerging markets (EMs) generally ended higher given increased optimism about the global growth outlook as falling annual inflation rates led to central banks considering future interest-rate cuts. However, Chinese equities languished despite China's authorities announcing fresh stimulus measures to support the economy. Indian equities outperformed as fourth-quarter gross domestic product was better than expected. Stocks in Taiwan and South Korea were supported by their relatively high exposure to the buoyant technology sector.

In Australian fixed income, the Australian 10-year government bond yield dipped below 4%, spurred by soft domestic inflation data and speculation of future RBA rate cuts. Elsewhere, in global fixed income markets, government bonds mostly fell in local-currency terms. As price pressures continued to ease in most major economies, investors began to look ahead to potential rate cuts in 2024. However, with core inflation still elevated, central banks have maintained a data-dependent stance. Meanwhile, concerns about the risk of a global economic recession lessened given the robust economic data, particularly in the US. Elsewhere, corporate bonds had a solid quarter. In the US, riskier high-yield (HY) bonds outperformed higher-quality investment-grade (IG) bonds, with the spreads on both instruments tightening. HY bonds were supported by their income attractions and a better outlook for issuers' credit quality. IG bonds lagged due to their longer duration, or sensitivity to changes in interest rates, as underlying government bond yields increased.

2. Performance review

The portfolio returned 2.79% over the first quarter, with all asset classes ending positively. The largest contributor was our multi-asset strategy exposure, followed by our global DM IG bonds, EM hard-currency debt exposures and thematic equity allocation (such as moat-based and quality equity). On a relative basis, Australian equities, global ex-Australian equities, Australian government debt, Australian IG bonds and our cash holding underperformed against the benchmark.

3. Macro and Market outlook

Our base case is for a US "soft landing", in which growth slows but remains positive. The drivers of US growth exceptionalism should fade somewhat over 2024. However, the benign cooling in the labour market and moderation in inflation over the past year mean that an outright contraction in growth is not needed to tame inflation.

Key information[1]

This portfolio aims to achieve a real return equivalent to 2% per annum above inflation (before fees) over a rolling 3-year period.

- **Benchmark:** CPI plus 2.0% p.a.
- **Investment Time Horizon:** 3+ Years
- **Portfolio launch date:** 31 August 2020

[1]Source: abrdn, 31 March 2024

That said, there are significant uncertainties including a higher-than-normal probability of a US recession on the back of the drag from past monetary policy tightening that may still be in the system.

Looking ahead, the last mile deceleration in inflation is likely to be slow and bumpy. With wage growth moderating in many economies, and some drivers of the latest sticky inflation figures in the US are likely temporary, while inflation should inch closer to most central banks' targets over the course of 2024. Therefore, most major develop market central banks are likely to begin interest rate cuts around the middle of this year. Across EMs, cooling inflation and the high starting point for real rates leave room for further rate cuts this year. Chinese policy should continue to ease, although de-risking and national security considerations are likely to keep this limited.

Our asset class views remain largely unchanged. On equities, there is still a need to remain nimble as stretched positioning is offset by supportive fundamental and momentum. The better probability-weighted economic outlook should continue to support earnings growth, which has been notably resilient of late. Finally, despite recent headwinds, equity valuations in China are reaching attractive levels. The government has put a floor under the market, but it still lacks a meaningful stimulus or a catalyst to turn around China's growth prospects and unlock China's attractive valuations.

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, 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.

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 rose steadily over the first quarter of 2024 posting a strong gain over the period. Increasing expectations of a soft landing in the US and positive company results helped drive positive sentiment towards the equity market.

Australian equities joined the global market rally during the period, continuing the gains from the last quarter of 2024, as hopes for central bank rate cuts grew.

Fixed Income:
Australian government bonds yielded positive returns over the first quarter, due to 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 advanced as spreads tightened.

Infrastructure:
Our infrastructure allocation produced a negative return over the quarter driven by a combination of rising bond yields and sector/company specific headwinds.

Elsewhere within infrastructure several social and renewable infrastructure companies reported NAVs to end December 2023. NAVs were broadly flat to slightly down over Q4 but NAV total returns for the year were generally positive.

With infrastructure, companies are generally trading on a discount to NAV, several companies announced asset disposals at or above carrying value, with the proceeds being used to buy-back shares or reduce debt.

Our battery storage investments, Gresham House Energy Storage and Harmony Energy published trading updates that pointed towards the weak revenue environment and the slower-than-expected pace of commissioning on new projects. As a result, both companies decided to postpone the declaration of their fourth quarter dividend for 2023. Subsequently, both companies experienced share price declines as investors become increasingly concerned over the weak trading environment for UK batteries and the impact this could have on both the valuation of current portfolios and impact to cash flows.

Special Opportunities:
Special opportunities includes allocations to a diverse range of exposures with differing return drivers and risk characteristics. At an aggregate level, there was a positive contribution from special opportunities mainly driven by our allocations to biotech credit and shipping.

Coming into the quarter it was announced that LumiraDx (BioPharma Credit's third largest borrower) had agreed to sell its point of care diagnostics business from administration to Roche with proceeds used to repay BioPharma Credit's loan. The result of this is an 82% principal recovery for BioPharma Credit and the company's share price responded positively to the news.

Our shipping investment, Tufton Oceanic Assets, announced a fourth quarter NAV total return of 6.7%. The Board also announced the result of a recent strategic review, concluding that strong supply-side fundamentals will continue to support yields and second-hand values, and that the company should continue with the existing strategy in the near-term but begin realising assets from 2028. The dividend target was increased by 17.6% to 10c per share. Lastly, recognising the current discount to NAV, the Board are evaluating a potential capital return in the second quarter of 2024, equivalent to 5-10% of NAV. The share price reacted positively to this news.

III. Outlook and positioning

During the earlier part of the first quarter, we implemented an S&P 500 options put spread strategy for downside protection against potential headwinds and uncertainty.

Late in February, we maintained our long Chinese exposure through a call option to capture any potential tactical bounce but limit the downside if that scenario failed to materialise.

Coming to the end of quarter, we held our slight overweight in equity and duration, and rebalanced our foreign exchange (FX) positions back to the target level to reap the benefit of our strategic allocations.

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

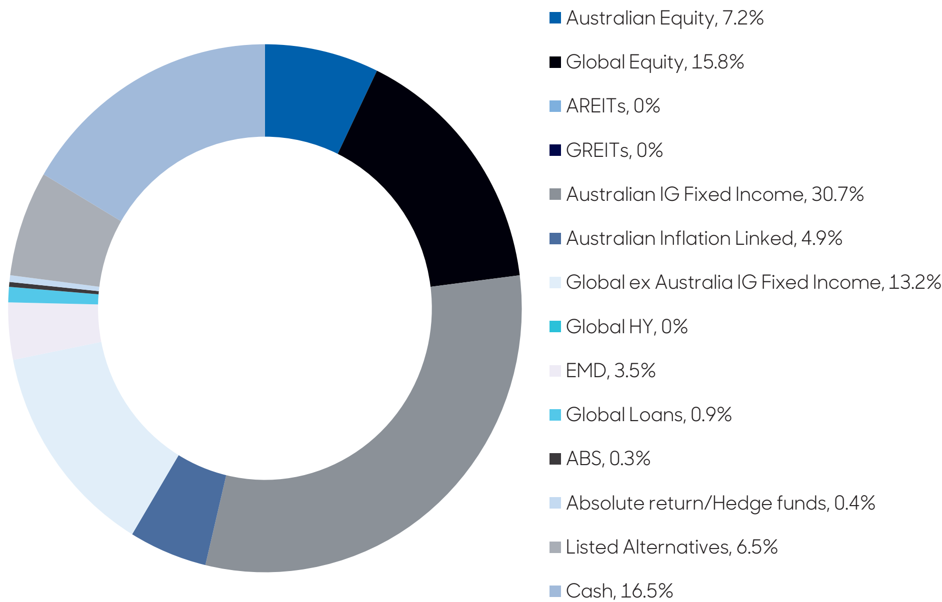
In January, given the uncertain start to the year and potential headwinds, we decided to implement a put spread across the S&P 500. The objective was to add some downside protection in light of the attractive level of pricing. We also replaced some of the direct Chinese equity exposure with a call option to still provide exposure to any potential tactical bounce but limit the downside if that scenario failed to materialise.

Later in February, we rolled the existing S&P 500 Index (SPX) put spread options from April to July 2024 to protect the portfolio against a potential decline. We also rolled our call option on Chinese equities from March to June 2024 to allow more time for the China upside scenario to play out, given the prospect for China equities to stage a potential rebound as green shots emerged in activity data post Lunar New Year.

Finally in March, although Fed pushed interest rate cuts to the second half of 2024 following the small uptick in US inflation. there was not much portfolio activity except for rebalancing of our FX positions back to the target level to reap the benefit of our strategic allocations. The reason behind this decision is that the portfolio is already slightly overweight its equity and duration targets.

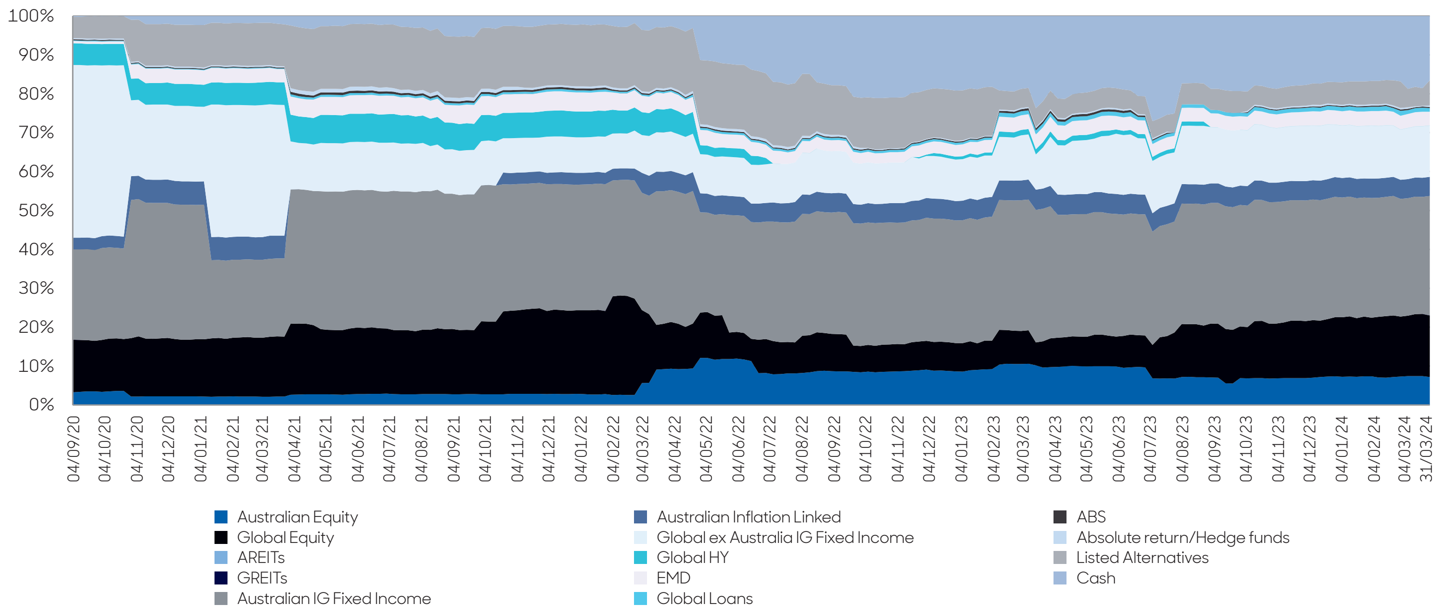
While we do see compelling risk-adjusted return prospects in some traditional asset classes, we remain cautious on relying on them alone to generate returns. Our portfolios also have meaningful allocations to alternative asset classes, many of which have compelling direct links to inflation; limited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

Chart 01: Current asset allocation



Source: abrdn, 31 March 2024

Chart 02: Historic asset allocation evolution



IV. Performance and risk contribution

1. Performance table

The Portfolio returned 2.79% over the quarter. Since inception the Portfolio has delivered a return of 0.73%.

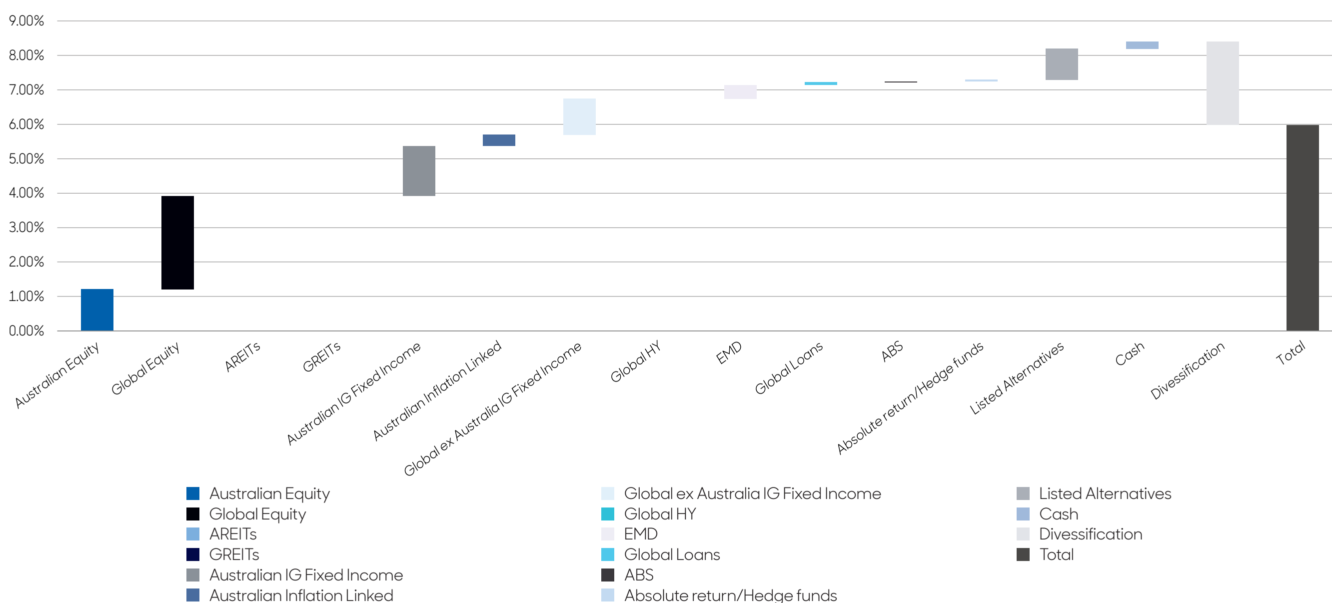
Sterling abrdn CPI+2.0% Portfolio	1 Month %	3 Months %	6 Months %	YTD %	1 Year %	Inception (p.a)%
Portfolio	1.50	2.79	8.15	2.79	7.60	0.73
Benchmark: CPI plus 2.0%p.a.	0.52	1.52	3.27	1.52	7.41	5.72

Portfolio performance is provided net of fees on underlying investments but gross of Advisory/Platform fees.
Source: abrdn Lipper, 31 March 2024
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 6.0%.

Chart 03: Risk Contribution



Source: abrdn 31 March 2024

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.