

30 June 2022

## Market review

Global investment grade corporate bonds fell sharply in June. Sovereign bond yields rose sharply, with the 10-year US Treasury closing the month up 13 basis points (bps) at 2.97%, while the 10-year German bund yield finished 22 bps higher at 1.34. Credit spreads also widened by 31bps. As a result, the total index return for the period was negative at -2.92% (hedged to Australian dollars).

The selling was, once again, motivated by persistently high inflation and fears that central banks' reactions will harm economies. The US Federal Reserve (Fed) raised interest rates by 0.75% in June - the largest hike since 1994. After a small dip in April, May's data showed US prices rising by 8.6%, an over 40-year high and the third month in a row above 8%. The situation was similar in the UK, with the Bank of England raising the base rate by 0.25%. The European Central Bank (ECB) bucked the trend, keeping rates unchanged in June, but it indicated its intention to hike rates by 0.25% in July as it downgraded its 2022 growth forecast for the Eurozone.

## Portfolio review

The Fund underperformed its benchmark in June, mostly due to an overweight holding of BBB and high-yield bonds while underweight in A rated issues.

Health issuers were among the Fund's detractors, including insurer UnitedHealth Group and pharmaceutical companies Viatrix and Bayer. As oil prices came off their recent highs, TotalEnergies also detracted. On the upside, the Fund's defensive US Treasury holding held up as riskier credit sold off. European banks BCPE and ABN Amro also outperformed.

We made selective purchases in new-issue bonds where we see some value. In the primary market, we bought the attractive new euro 2025 bonds from Mitsubishi UFJ. In US dollars, we bought new 2025 bonds from Enel and the 2024 bonds from Eversource Energy.

In the secondary market, we reduced our

duration in BBB rated issues, switching out of Carrier Group's 2050 bonds to buy the 2031 issue. We also switched out of Sysco's 2048 bonds to buy Keurig Dr Pepper's more defensive 2032 bond. We also sold down Salesforce's 2061 bond, as our analyst is more cautious over the company's prospects due to potential mergers and acquisitions risk.

## Outlook & strategy

June has been another difficult month for global credit. Concerns about inflation remained high, and additional uncertainties came from a slowing growth dynamic and the war in Ukraine's impact on food prices and gas supplies. Credit spreads widened sharply as investors priced in a potential gas curtailment, which could lead to a recession in Europe, and an aggressive Fed, whose monetary policy could lead to a recession in the US. In euros, credit spreads are now 200bps above government bonds, a level which historically has only occurred in recessionary times. In US dollars, credit spreads are now at 160bps over government bonds, 60bps higher than the start of the year and 25bps short of mild recession pricing in the US.

Further curtailment of Russian gas flows, with rationing affecting European industrial production, would drive spreads wider but would likely trigger governmental and ECB-led support to reduce the overall impact. In US dollars, persistently high inflation and tighter financial conditions could result in wider spreads. Conversely, spreads could tighten if the Ukraine war de-escalates, Russian gas flows resume after maintenance on the North Stream 1 pipeline in July, inflation rolls over or there is a step-change in central bank policy. One positive is that corporate fundamentals are strong, going into a potential slowdown. While inflation remains high, it is likely to roll over in the third or fourth quarter as growth slows. Government bond yields peaked in mid-June and have fallen since, indicating that central banks will hike rates in the short term but may stop or reverse course in 2023, against the backdrop of a possible recession.

## Investment strategy

The Fund is actively managed and may invest in a wide range of bonds (e.g. corporate bonds including high yield bonds, government backed securities, overseas bonds, index-linked bonds, floating rate notes ('FRNs') and asset backed securities ('ABSs')) and/or money market instruments) in order to take advantage of opportunities identified.

## Investment objective

The Fund aims to provide long term growth and outperform the Benchmark over rolling 3 year periods (before deduction of fees, costs and taxation) by investing predominantly in global investment grade bonds.

With this more pessimistic outlook, we are positioning the Fund more defensively. We have increased cash, reducing some higher beta subordinated and cyclical bond holdings. We have further reduced our spread duration, but recently moderated our short interest rate duration exposure. With exposure to subordinated debt and being overweight BBBs, we maintained a moderate overweight credit risk position. The outlook for the next six to 12 months is attractive. Historically, when credit spreads have been above 200bps in euros and 160bps in US dollars, relative returns have been good over a 12-month period. We maintain a preference for banks over corporates, which we think will outperform in most scenarios.

*Specific share class performance is available on the relevant factsheet.*

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**Contact us**  
Telephone:  
1800 636 888 or +61 2 9950 2853 if  
calling from outside Australia  
Email: [client.service.aust@abrdn.com](mailto:client.service.aust@abrdn.com)

[abrdn.com.au](http://abrdn.com.au)

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