

31 December 2022

Market review

Australian equities declined in December, with the ASX 200 Total Return Index down 3.5% in Australian dollar (AUD) terms. All sectors came under pressure, while the largest declines were in the consumer discretionary, technology and industrials sectors. Despite the volatility during the month, the Australian dollar roughly ended December flat against the US dollar (USD) and British pound (GBP), but was down against both the euro and Japanese yen (JPY). The MSCI World Index declined slightly more than the domestic market, returning -4.9% in December in AUD terms.

During the month, the Reserve Bank of Australia (RBA) increased interest rates by 25 basis points (bps) to 3.1%, with further rate rises expected in 2023, where another 50 bps is likely before the end of the first quarter. Economic data supports this view, as inflation came in marginally higher than consensus expectations and the employment data showed a higher-than-expected 64,000 jobs created in December, along with an improved participation rate of 66.8%. Meanwhile, the purchasing managers' index (PMI) reading for Australia fell more than expected, with the latest measure from December firmly in contractionary territory.

The US Federal Reserve (Fed) continued its hawkish tone despite increasing evidence that the inflationary pressures were easing. Most global central banks continued rate hikes, albeit at a slower pace. Meanwhile, in early December, in a policy change, China announced it would no longer pursue a strict 'zero-Covid-19' approach. Against this backdrop, global equities suffered losses. In the US, the S&P 500 declined 6.6% over the period, while in the UK, the blue-chip FTSE 100 Index lost 0.8% and the Euro Stoxx 50 Index returned -0.5% (all in AUD terms).

In the first half of December, Chinese stocks were buoyed by optimism regarding the reopening of the domestic economy. As a result, Hong Kong and mainland Chinese markets were the strongest performers in Asia. However, the picture elsewhere in the

region was more mixed.

In fixed-income markets, bond markets fell as major central banks continued hiking rates. Thus, government bond yields rose. The Australian 10-year yield increased from around 3.5% to end the month at just over 4.0%, while the US 10-year Treasury yield increased to 3.87%. Yet, Japan unexpectedly increased its 10-year benchmark bond yield curve control target from 0.25% to 0.5%. Corporate bonds slightly outperformed sovereign issues, while US high-yield bonds declined, as evidenced by the decline in the ICE BoA High Yield Index, which the St. Louis Federal Reserve publishes. Yet, emerging market debt (EMD) was a bright spot for the month.

Commodity prices were volatile as well. Brent crude had wild swings in December, only to finish the month with a slight decline. European natural gas prices continued to fall, partly due to the mild winter in the continent. On the other hand, the reopening of the Chinese economy was positive for base metals. The decline in the US dollar index was positive for gold.

Performance

In December, the Fund returned -0.68% in gross terms and -0.75% net of fees. The portfolio maintains a defensive stance given the numerous headwinds we believe remain ahead, which includes a US recession. Therefore, the portfolio is slightly underweight across all asset classes in favour of cash. Our more cautious approach to the impending risks that we see also means that as we go into the new year, the portfolio remains tilted towards more defensive styles of equities, which softened the drawdown through December as markets sold off across the board. In fixed income, the syndicated loan strategy and the recently added exposure to floating-rate notes and subordinated debt enjoyed rallies through the month to post positive returns as more traditional government bonds sold off.

Activity

In portfolio activity, given the continued reopening taking place in China—due to

Investment strategy

The Fund will apply dynamic asset allocation to a diversified portfolio of traditional and alternative assets, without reference to a benchmark. The Fund may shift its investments quickly and significantly, based on valuations and expected returns, and may completely divest from a particular asset class. Fund volatility will be controlled through the use of dynamic asset allocation and effective diversification of assets.

Investment objective

To achieve a real return equivalent to 5% per annum above inflation (before fees) over a full market cycle (generally 3 to 5 years).

an apparent turning of the corner in the zero-Covid-19 policy as well as further policy measures that remain supportive of the reopening—we further added to our China equity exposure. In addition, we also added to our broader Asia exposure to diversify some of the exposure, while benefiting from the same China reopening drivers. We also continued to buy back some of the high-yield and EMD credit exposure in the portfolio, given the recent price adjustment and improved risk-reward on offer.

Outlook & strategy

For 2023, we are faced with an environment where fundamentals deteriorate, driven by quantitative tightening and a surge in central bank rates. As a result, we expect two distinct phases of market performance in 2023-24.

The first phase will be driven by our view that central banks, in particular the Fed, kills the economic cycle. The US will enter a recession with the Fed continuing to hike the policy rate and holding it at an elevated level until inflation eases. We also expect 2023 earnings growth to be downgraded. Therefore, there is a need to be selective as developed market risk assets remain under pressure.

The second phase will be driven by central banks pivoting and signalling rate cuts. There is uncertainty on the timing of the pivot, as it may take some time before the necessary conditions are met. However, when the central banks pivot, we expect a meaningful recovery.

Across both phases, we expect sovereign bonds to benefit. In the first phase, as growth deteriorates and recession risks increase, markets will reallocate more to sovereign bonds as a safe haven play. In the second phase, with central banks cutting rates and easing, sovereign bonds will receive an additional monetary policy tailwind.

While we expect central bank driven volatility in developed markets, we see countercyclical opportunities in areas such as China. With reopening on the way in China, current market pricing of Chinese earnings growth and valuations seem modest. As reopening accelerates, it will likely support growth in the Asia region, offsetting some of the drag from the slowdown in developed markets. With policy likely to undergo a transition in 2023, we see numerous opportunities to benefit portfolios through both phases, and will be positioning the portfolios based on key drivers identified to take advantage of

market dislocations as they play out.

Specific share class performance is available on the relevant factsheet.

The opinions expressed are those of abrdn as of the date of publication and are subject to change at any time due to changes in market or economic conditions.

Companies selected for illustrative purposes only to demonstrate the investment management style described herein and not as an investment recommendation or indication of future performance.

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

abrdn.com.au

Important information

Issued by abrdn Australia Limited ABN 59 002 123 364 AFSL No. 240263. This document has been prepared with care, is based on sources believed to be reliable and opinions expressed are honestly held as at the applicable date. However it is of a general nature only and we accept no liability for any errors or omissions. This is not an offer of securities. A Product Disclosure Statement (PDS), application form, and Target Market Determination (TMD) is available for each Fund by calling abrdn Australia Limited Client Services on 1800 636 888, at www.abrdn.com/aus, or from your financial adviser. This document has been prepared without taking into account the particular objectives, financial situation or needs of any investor. Investments are subject to investment risk, including possible delays in payment and loss of income and principal invested. It is important that before deciding whether to acquire, hold or redeem an investment in a Fund that investors consider the Fund's PDS, the Fund's appropriateness to their own circumstances, objectives and financial situation and consult financial and tax advisers. Past performance is not a reliable indicator of future results. All dollars are Australian dollars unless otherwise specified. Indices are copyrighted by and proprietary to the issuer.