

31 July 2022

Market review

Global equities rose in July, partially rebounding from falls earlier in the year. Positive corporate results gave investors confidence, particularly in the energy and technology sectors. The US was particularly strong, with Australian, UK, European and Japanese stocks also rising, although emerging markets (EMs) slightly fell. The MSCI World Index returned 6.84% in July (total return in Australian dollars). Government bond prices rose in July, even as the Reserve Bank of Australia (RBA), European Central Bank (ECB) and US Federal Reserve (Fed) hiked interest rates. The US economy shrank again in the second quarter, pushing the country into a technical recession. Corporate and EM bonds also gained over the month, with riskier bonds outperforming.

Most major equity indices finished higher in July. While the macroeconomic challenges that have rattled investors in previous months persisted, investors took comfort in an earnings season that saw robust results. Regionally, the US was one of the strongest markets, returning its best monthly performance in over 18 months. In particular, the high-tech NASDAQ Index rose by 11.5% (in AUD) during the month. Europe and UK shares rose, with the mid-cap FTSE 250 Index outperforming the blue-chip index. In the Asia-Pacific region, Australian equities performed well, led by a recovery in technology stocks, which rebounded following a torrid start to the year for the sector. The materials and resource sectors, which have performed well for most of the year, were affected by the decline in commodity prices and slowing growth in China. However, solid results for the June quarter helped to cushion these headwinds. The Australian dollar also did well against the US dollar, recovering from a two-year low towards the middle of the month. Elsewhere, Japanese equities performed well, with the yen strengthening over the month. EMs were more mixed, as India and Latin America performed well over the month, while Chinese shares fell. In aggregate, commodity prices fell back in July. Precious metals trended lower and oil prices fell, with West Texas Intermediate closing July under US\$100 per barrel. However, European gas prices climbed higher as Russia opted to cut its supply to Germany through the Nord Stream pipeline.

The RBA raised interest rates again to 1.35% and guided that there was still more to come, given strong spending data and household savings.

Employment data in Australia remained strong, with the unemployment rate hitting its lowest level in 48 years at 3.5% in June. Meanwhile, the ECB raised interest rates by 0.5 percentage points in July, its first hike in over a decade. ECB President Christine Lagarde noted that inflation was 'undesirably high', flagging food and fuel costs, as well as rising wages. Annual inflation in the Eurozone reached 8.9% in July. While economists still fear a European recession later in 2022, tourism has supported economic growth across the region. The Eurozone's GDP grew by 0.7% in the second quarter, surpassing estimates of 0.1%. Late in the month, the Fed raised interest rates by 0.75 percentage points, a repeat of its last meeting in June. The move was in line with expectations, as Chair Jerome Powell indicated that the Fed's September action is yet to be decided as data shows signs of economic weakness. US GDP contracted in the second quarter, putting the economy in a technical recession.

Portfolio review

In July, the portfolio returned 0.93% in gross terms and 0.86% net of fees. Over the year, we reduced our exposure to equities and fixed-income assets, given risks in the market, but those exposures still maintained in the portfolio contributed to the positive return in July. Over the year to date, the portfolio is down by -9.74% (gross of fees).

On portfolio activity, since early July, we continued to reduce equity risk and rotate from markets, such as EMs. This included sales of the abrdn Emerging Opportunities Fund, as well as the China equity exchange-traded fund, as short-term risks from renewed Covid lockdowns and signs of property sector stress spread across eight provinces. Given the decrease in international equities, we also trimmed our Australian equities exposure, via the abrdn Ex-20 Australian Equities Fund, in order to maintain the relative weighting of Australian equities to international equities.

To further reduce the overall risk in the portfolio, we reduced our exposure to Chinese bonds, given the less attractive relative level of yield and risks to the growth outlook.

Outlook

The two major risks faced by financial markets are global recession and declining corporate earnings.

For the former, there is a dichotomy of views in

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).

the market. On the one hand, the equity market seems to be pricing in a more positive outlook, where central banks that have already front-loaded interest rates can begin to think about pausing and even reversing course as headline inflation rolls over. The fixed-income market is on the opposing side with a more bearish outlook. Bond yields continue to rise on expectations of core inflation being stickier and remaining elevated. In turn, this will force central banks to continue raising rates, putting the growth outlook further at risk.

For the latter, earnings so far have managed to remain relatively robust. While there have been some downward revisions, equity analysts are still forecasting double-digit earnings growth for now. The pullback in equity markets earlier this year was driven by multiple compression, and we are cautious that we could see another leg down as a result of an earnings recession. Based on similar periods in the past, such environments can see as much as a 50% drawdown from peak to trough.

With two very distinct views in the market, our view leans towards that of the fixed-income markets. However, we are conscious that equity markets will be driven by improving sentiment in the short term, which will provide upside potential, but the risks to the downside need to be managed. Earnings weakness is likely still to come, and we could see equity markets quickly reprice to the downside.

Fund 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.

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