

30 September 2022

Market review

Equities fell sharply in September on concerns about higher inflation and tighter monetary policy. As a result, benchmark indices closed lower across the board. The MSCI World Index returned -3.3% in September (total return in Australian dollars), with similar returns for the US and Europe while Australian and Asian markets sold off even further.

Due to persistently high inflation levels, the US Federal Reserve (Fed), Bank of England (BoE) and European Central Bank (ECB) all raised interest rates. The Reserve Bank of Australia (RBA) also raised rates by 50 basis points (bps) to 2.35%, close to levels last seen ten years ago. These steps amplified market fears of a global economic downturn. As a result, September was one of the worst months for markets since the start of the pandemic. Australian markets declined in September, with the ASX 200 (TR) returning -6.2%. In the US, equities fell sharply after inflation data was released mid-month. In the 12 months to August, the US consumer price index rose by 8.3%, slightly lower than July's reading, primarily due to rising food and rent costs. The S&P 500 Index recorded its biggest daily loss in over two years. Meanwhile, the high-tech NASDAQ Composite Index fell further, dropping more than 10% over the month in US dollar terms. The UK markets came under further pressure as the pound weakened and UK bond yields surged substantially after Chancellor Kwasi Kwarteng announced major tax cuts in the mini-Budget. Meanwhile, European stocks fell but performed slightly better than the global average. Asian indices, including Japan, also came under pressure as part of a global sell-off due to growing fears of recession, while currencies weakened. Emerging markets (EMs) sold off over the month with the MSCI Emerging Market Index returning -6% in Australian dollar terms through September in part due to the weakness across Asian EM.

In fixed income, corporate and sovereign bond prices fell throughout September on the back of the slew of interest rate hikes worldwide. With the RBA raising

the cash rate by 50bps, yields across Australian government bonds increased across the board. The Australian 10-year bond yield increased to 3.88% resulting in a corresponding sell-off. In the US, the Fed raised rates by 75bps at its September meeting. While August's US unemployment rate, at 3.7%, was higher, weekly jobless claims hit a five-month low late in September. The ECB also raised rates by 75bps as annual consumer price inflation across the eurozone rose to 10% in September. In the UK, Chancellor Kwarteng's slew of tax cuts in the UK prompted a historic sell-off in bond and currency markets, which forced an emergency intervention in long gilts from the BoE. The 10-year gilt yield finished the month above 4%. Despite the interest rate hikes by the RBA, Fed, BoE and ECB, the Bank of Japan again held rates, maintaining a relatively dovish stance. Unlike many developed economies, inflation remains relatively subdued in Japan, with the Japanese central bank keeping monetary policy loose as a result. However, the policy tightening bias in Western economies was evident in Asian countries facing sticky core inflation, with Indonesia and the Philippines hiking rates by 50bps. The People's Bank of China announced plans to allow some cities to cut mortgage rates for first-time home buyers and to expand a lending programme to ensure the delivery of delayed housing projects.

Commodities mostly fell through the month. In precious metals, gold dropped back, although silver rose slightly. Meanwhile, energy prices also declined, with West Texas Intermediate finishing September under US\$80 per barrel. Natural gas prices fell, although, late in the month, leaks were discovered in the Nord Stream pipelines. In addition, European energy ministers agreed to ration electricity by 5% in peak times over the winter.

Portfolio review

In September, the fund fell by -3.05% in gross terms and by -2.96% net of fees. The portfolio's exposure to equities, fixed income and infrastructure/real estate, held as part of the listed alternatives (alts)

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).

exposure, detracted from the overall performance. However, this was partially offset by the positive contribution from futures and spot exposure. Year to date, the fund is down by -12.23% gross of fees.

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In terms of portfolio activity, we continued to maintain a reduced allocation to equities, fixed income and alternatives in favour of cash. We trimmed down alternatives to ensure that the asset class did not lead to an outsized contribution to total portfolio risk. However, some of these holdings were exposed to the overall sell-off in the UK, which resulted in a negative contribution, primarily from the infrastructure and real estate holdings.

We now have around 30% cash in the portfolio, ready to deploy when opportunities arise. However, given weaker fundamentals and continued inflationary pressures, we maintain our overall bearish view around markets. These factors will likely feed into our recessionary base case and manifest in weaker corporate earnings.

Outlook

We think the significant major risks faced by global financial markets remain in place: hawkish central banks, multi-decade high inflation and a growth slowdown amid tightening financial conditions. The latest data flow sends mixed signals as consumer sentiment plunges and earnings begin to be guided down. However, the labour market remains tight. Meanwhile, headline inflation pressure eased with the US CPI September print continuing to fall but the core inflation reaccelerated. As a result, markets have now pushed the Fed terminal rate sharply higher to 4.87%, to be reached by the end of May 2023 and cut to 4.5% by the end of 2023. Thus, the rate cut path is also expected to be much slower than the previous market pricing.

Our portfolio is positioned at the low end of the risk range due to increasing evidence of uncertainties regarding inflation, growth, and monetary policy. We think the global equity valuations have priced in monetary tightening, but earnings expectations have further room to fall. Long-end interest rates face the near-term risk of sticky inflation and higher terminal Fed funds rate but should eventually fall once the recession - our base case - sets in. We will keep this defensive stance and wait for a more precise signal on the inflation peak and the Fed's pivot before adding back risk meaningfully.

Fund performance is available on the relevant factsheet.

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

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