

31 October 2022

## Market review

Australian equities rose in October, in line with the majority of global equities. The ASX 200 TR Index returned 6.04% while the MSCI World Index returned 7.11% in October (total return in Australian dollars). Corporate and sovereign bond prices fell as yields rose in the face of weak global economic data.

Stocks increased in Australia, the US, Europe, UK and developed Asia. However, emerging markets (EMs) fell in aggregate. In Australian dollar terms, European along with US equities were the top-performing markets, with the Dow Jones Industrial Average posting its best monthly gain since 1987, having risen for four consecutive weeks. However, weak corporate results from major technology companies indicated a slowing economic landscape. The US economy recorded an annualised growth rate of 2.6% in the third quarter, having been in a technical recession during the first half of the year. Regionally, Europe was strong, with its index rising even as economic data painted a challenging outlook for the region's economy. UK shares rose as a month of political turmoil culminated in the appointment of Rishi Sunak as the new prime minister. Australian equities had a solid month as investor confidence improved globally. Financial stocks led the rally in Australia. Lithium companies continued to show strong performance, although some of the larger mining firms and industrial cyclicals underperformed. Developed Asian shares rose, including Japan, where Prime Minister Kishida released an economic stimulus plan. South Korea was among the top-performing markets, supported by foreign buyers, moderating inflation and third-quarter GDP growth that was in line with expectations. However, EM shares fell in aggregate. In particular, Chinese shares pulled down the group as economic data in China weakened. Furthermore, the focus was on China's 20th Communist Party Congress. President Xi Jinping's opening remarks suggested a continuation of existing 'zero-Covid' and economic policies, along with potentially more support for the weak real estate sector. Sentiment remained resilient in India and most parts of South-East Asia. Latin

American indices rose notably, including in Brazil, where "Lula" da Silva beat incumbent President Bolsonaro in the general election towards the end of the month.

In Australian economic news, the Reserve Bank of Australia (RBA) raised interest rates again to 2.60%, which was 25 basis points (bps) below expectations. However, third-quarter inflation came in above expectations, at 1.8% quarter on quarter and 7.3% year on year. Food prices increased by 9%. As broadly expected, the RBA raised rates again on 1 November to 2.85%

- the fastest tightening cycle since 1994. Meanwhile, Australian employment data for September came in below expectations, with just 900 jobs added during the month versus the expected 25,000. In global fixed income, US Treasury yields rose in October, translating into a fall in government bond prices. Consumer prices in the US rose by 0.4% month on month in September, increasing 8.2% in annual terms. While inflation was lower than June's high, the US Federal Reserve (Fed) is still expected to raise rates by 75bps in November, with the market debate moving to whether they downshift to 50bps in December. Meanwhile, gilt markets settled in the UK after the volatility arising from the September mini-Budget. In particular, government bond prices rose as Chancellor Kwarteng and then Prime Minister Truss both resigned, with former chancellor Rishi Sunak succeeding her. Economists now forecast a 75bp rise from the Bank of England in its November monetary policy meeting as central bankers try to bring down annual consumer price inflation, which hit 10.1% in September. In October, the European Central Bank raised interest rates by 75bps, mirroring its action in September. The hike brought rates to 1.50%, the highest level since before the 2009 global financial crisis. Despite rising rates, Eurozone annual consumer price inflation hit 10.7% in October, significantly above economists' forecasts. The 10-year Australian government bond yield declined to 3.76%. Finally, corporate and EM bonds fell over the month, with safer bonds holding up better than riskier issues.

## 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).

## Portfolio review

In October, the fund was up by 0.75% in gross terms, and by 0.65% net of fees. The portfolio's exposure to equities contributed positively with equities being up almost across the board with the exception of EM and China. Fixed income which is mainly orientated towards the domestic market also contributed positively over the month. The listed alternatives, having been a detractor last month, rebounded to post positive returns this month. In particular, social housing/property exposures rebounded strongly as well as the exposure to litigation financing contributed to returns.

On portfolio activity, there were no significant changes to portfolio allocations over the month. We maintained reduced allocations to equities, fixed income and alternatives in favor of cash. We continue to have around 30% in cash in the portfolio given the fundamental risks that still exist and the more attractive yields that cash provides as the RBA continues to increase the cash rate. With such a large cash exposure in the portfolio, we are ready to deploy back to risk assets when sentiment improves, and opportunities arise.

## Outlook

As we head into the end of the year, there are a number of positives driving improved investor sentiment. Inflation is showing signs that it may be peaking while we might also be reaching peak hawkishness from central banks. The RBA has already downshifted to 25bp hikes from 50bps and it looks like the Fed could follow suit in December with a reduced hike compared with what we have seen so far. Despite the potential for downshifting, inflation will remain the key driver of policy and there is still a way to go to bring inflation back to within target ranges. This view is also being reflected by the market, which has increased expectations of where peak rates could land in the US, i.e., to around 5% compared with 4.5% a month ago.

While inflation remains sticky, there are signs it is beginning to soften. However, inflation has already taken its toll on the wider economy. Inflation impacts are starting to permeate through the corporate world, with a number of companies issuing profit warnings and announcing impending job cuts. For us, earnings expectations are still too high and need to be further revised. It could be the first quarter of next year when the effect on earnings fully materialises.

Our portfolios are still positioned with a

defensive tilt. The improving sentiment that we are seeing in the marketplace could be temporary as there are still a number of risks to the broader outlook that we believe are not yet fully priced. Global equity valuations have priced in the monetary tightening, but earnings expectations have further room to fall. The current price-to-earnings ratio on the S&P 500 is around 18x but we would expect to see this in the low to mid-teens under an earnings-based recession.

We have gradually been adding back to our fixed income positions. Higher government bond yields provide more attractive levels to gain exposure. This is especially true for Australian government bonds, given our view that the RBA is further along with its rate-hiking cycle than other central banks. Spread widening across credit and high yield is also beginning to look more attractive in the short term, but we are wary that they could see further sell-offs in a recession, which is our base case. We will continue to monitor how markets and central bank policy/rhetoric evolve and gradually add back to risk when opportunities arise.

*Fund performance is available on the relevant factsheet.*

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