

28 February 2023

Market review

Australian equities declined in February, with the S&P ASX 200 Total Return Index returning -2.45%, while the MSCI World (hedged to AUD) Index fell 1.65%. With the Australian dollar selling off over the month, the MSCI World (unhedged) Index in AUD returned +1.76%.

Australian shares, like global equities, came under pressure as investors continued to assess the outlook for the global economy and central bank policies, while major central banks continued to raise interest rates to contain surging inflation. Among the largest losers were materials, financials, energy and consumer discretionary shares. The Reserve Bank of Australia (RBA) raised the cash rate to a decade-high of 3.35% in February and in a hawkish tone flagged further rate hikes as inflation remains high. Australia's fourth-quarter inflation rate was 7.8%, the highest since 1990. In fixed income, the Australian 10-year government bond yield rose above 3.9%. The Australian dollar weakened to a two-month low of around 0.67 against the US dollar, driven by US Federal Reserve (Fed) hawkishness, concerns over Australia's persistently high inflation and rising unemployment.

US equities fell over the period, as the US fourth-quarter earnings season was relatively weak, particularly in the technology sector. Conversely, European markets closed the month higher, with the region benefiting from a lower exposure to the technology sector. UK companies rose, with the blue-chip FTSE 100 Index outperforming the mid- and small-cap indices. Asia Pacific stocks fell in aggregate, with particular losses in China where the financials and real estate sectors came under pressure.

Government and corporate bonds fell in February as major central banks raised interest rates early in the period and data indicated global inflation is still persistently high. The Fed raised the federal funds rate by 25 basis points (bps) at its February meeting. Although this move marked a further deceleration in the pace of interest-rate hikes, US Treasury yields rose as data

implied the economy is still running hot. The European Central Bank (ECB) and the Bank of England both raised rates by 50bps in February. Investors sold European sovereign bonds in anticipation of higher rates to come, although corporate bonds performed slightly better. Gilt prices jumped at the beginning of the period but fell back to close the month lower, while global high-yield (HY) and emerging-market (EM) bonds fell over the month.

Commodity markets ended the month lower. Oil prices declined on concerns about the demand outlook, while natural gas prices decreased in Europe but rose slightly in the US. Gold fell due to a stronger US dollar. The prices of iron ore and copper were mixed as investors weighed up the reopening of the Chinese economy and restricted supplies on the one hand, and concerns about a global recession on the other.

Performance

In February, the Fund returned -2.28% in gross terms and -2.34% net of fees.

The portfolio still maintains an overall defensive stance in its positioning, slightly underweight across all asset classes in favour of cash, while risk assets are tilted toward more defensive styles, particularly across equities. Despite this positioning, the equity exposures could not avoid the general downturn seen across markets in February. Asian exposures underperformed developed markets over the month, giving back some of the strong gains in January.

In fixed income, the syndicated loan strategy, floating-rate notes and subordinated debt posted positive returns, while the government bond exposures sold off as yields moved higher.

Activity

We added a put spread on the S&P 500 to provide some downside protection to the Fund's equity exposure. Pricing for the option was attractive given the recent fall in equities. We adjusted some of the currency exposures, removing the long JPY exposure in favor of the USD, which we believe is well

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).

supported in the short term, although we remain cautious over the longer term.

Outlook & strategy

Our economic growth forecasts suggest below-trend global growth in 2023. The key theme for 2023 will be global divergence, as the Chinese economy (and EM economies) should grow strongly from the lifting of the zero-Covid-19 policy.

Our base case remains for the US economy to enter recession later this year. Yet, the depth of the contraction should be shallower than first anticipated. A milder winter has helped the Eurozone economy avoid a recession. However, persistently strong core inflation is forcing the ECB to hike rates further. Coupled with spillovers from the US, the Eurozone area should enter into recession later this year. Headline inflation remains elevated, but it has peaked and likely to fall sharply in 2023. Core inflation will be stickier but should moderate amid easing supply chains and higher unemployment. Central banks will raise interest rates further in the near term. But we think that once the recession begins and core inflation falls, a pronounced cutting cycle will begin.

As central banks combatting inflation end up damaging aggregate demand, we see the macroeconomic environment as not supportive for global equities and HY bonds, as earnings forecasts are currently too upbeat, with top-line and margin assumptions too optimistic for the expected recessionary environment. For now, longer-term themes such as deglobalisation, geopolitics and climate change remain the crucial drivers for the market.

Therefore, we prefer quality defensive equity markets over cyclically exposed ones, and higher-quality corporate bonds over HY. Sovereign bond yields have risen to levels that offer value. Their attractiveness has increased as a recession nears and given that the market is not pricing counteractive policy. We feel the US dollar provides protection against some of the more adverse potential scenarios. There is room in the risk budget to add risk should fundamentals improve.

Specific share class performance is available on the relevant factsheet.

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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.

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