Sterling abrdn CPI+3.5% Portfolio

Quarterly Review

June 2024

abrdn

I. Quarterly commentary summary

1. Macro and market commentaries

Global equity markets advanced in the second quarter, while in fixed income markets, government bond prices declined.

Global equity markets ended the second quarter higher. Given continued disinflation in recent months, the European Central Bank (ECB), the Bank of Canada and the Swiss National Bank all cut interest rates, which in turn boosted sentiment. Moreover, investors are factoring in further interest rate cuts in most regions later in 2024. However, Australian equities declined slightly over the period, with the ASX 200 Total Return Index returning -1.05% (in Australian dollar, AUD, terms).

Australian equities weakened over the second quarter amid geopolitical tensions and global market developments. Utilities, healthcare and technology sectors drove gains, while materials shares came under pressure. The Reserve Bank of Australia (RBA) maintained its cash rate at a 12-year-high of 4.35% throughout the quarter, citing inflation above the 2-3% target range. As a result, the RBA's commentary and tone became more hawkish. The Melbourne Institute's Monthly Inflation Gauge increased by 0.3% month-on-month in May and the monthly consumer price index (CPI) indicator reached 4%, a six-month high. The Judo Bank Australia Composite Output Index fell to 50.6 in June, driven by slower service sector growth and sharp declines in manufacturing output. Australia's NAB business confidence index dropped to -3 in May from 2 in April, signalling subdued economic activity into the second quarter of 2024. Conversely, the Westpac-Melbourne Institute Consumer Sentiment Index hit a three-month-high of 83.6 in June. The Westpac-Melbourne Institute Leading Economic Index stagnated, with a six-month annualised growth rate declining to -0.24% in May amid higher interest rates, lower commodity prices and housing weakness.

US equities mostly advanced during the second quarter of 2024 in US dollar (USD) terms although there were divergences among indices. The S&P 500 index advanced 4.28%, reaching all-time highs. The tech-heavy Nasdaq Composite index also gained 8.47% over the same period. Large technology companies, led by NVIDIA, fared especially well as they benefited from their exposure to the fast-growing area of artificial intelligence (AI). On the other hand, the Dow Jones Industrial Average lost -1.27% while the small-cap Russell 2000 index slid -3.28%, underperforming the broader US equities asset class. European equities rose in euro terms over the quarter but underperformed most other regional indices. French President Emmanuel Macron announced a snap general election after his centrist alliance suffered a shock defeat to the far-right National Rally in the European Parliament elections, heightening political uncertainty. Elsewhere, the UK stock market rose over the period. The internationally focused FTSE 100 Index marginally outperformed the domestically focused FTSE 250 Index. Prime Minister Rishi Sunak called a snap general election for 4 July. Japanese equities rose in yen terms while the currency came under pressure, especially against the USD. Chinese equities weakened despite the Chinese authorities announcing fresh stimulus measures to support the economy. The yuan depreciated on continued worries about the country's uncertain economic outlook and indebted property sector. On the other hand, Indian equities outperformed despite initial volatility, after a surprising election outcome saw the ruling Bharatiya Janata Party (BJP) fail to secure a single-party majority. However, the market recovered quickly after the BJP, led by Prime Minister (PM) Narendra Modi, formed a coalition government with its key allies. Stocks in Taiwan were supported by the country's relatively high weighting to the buoyant technology sector.

In Australian fixed income, Australia's 10-year government bond yield fell over the quarter from 4.41 in early April to end June around 4.35%. Meanwhile, the S&P Australia High Yield Corporate Bond Index advanced slightly over the same period as investors put their faith in riskier high-yield (HY) issues. The strong corporate earnings and limited defaults have meant narrow spreads for corporate bonds. The AUD appreciated slightly against the USD and ended at 0.667. Elsewhere, global government bonds fell in local-currency terms and by more in sterling terms. As price pressures continued to ease in most major economies, investors began to look ahead to potential rate cuts in 2024, especially in developed market (DM) economies. In response to continued disinflation in recent months, the ECB cut its main refinancing operations rate by 25 basis points (bps) to 4.25% at its June meeting. Meanwhile, strong economic data, notably in the US, alleviated concerns about the risk of a global economic recession. The yields on 10-year government bonds in the US, UK, Germany and Japan all trended up over the quarter as investor concerns about inflationary pressures lingered. Corporate bonds had a solid quarter. In the US, HY bonds outperformed higher-quality investment-grade (IG) bonds, with the spreads on both instruments marginally widening.

2. Performance review

The portfolio returned 0.37% over the second quarter. The largest contributor was our multi-asset strategy exposure followed by global and emerging market (EM) equities as well as our cash holdings. DM IG bonds and Australian corporates also had a positive quarter. However, Australian government bonds and Australian equities declined significantly, while EM government bonds detracted marginally.

Key information[1]

This portfolio aims to achieve a real return equivalent to 3.5% per annum above inflation (before fees) over a rolling 5-year period.

- **Benchmark:** CPI plus 3.5% p.a.
- **Investment Time Horizon:** 5+ Years
- **Portfolio launch date:** 31 August 2020

[1]Source: abrdn, 30 June 2024

3. Macro and Market outlook

The remaining US inflation overshoot primarily stems from housing costs, but rental prices indicate that this effect will diminish. The labour market seems to be cooling, which is likely to result in slower wage growth. A combination of a restrictive monetary policy, reduced support from savings stocks, and a less supportive fiscal impulse should lead to more stable US growth. Later this year, the Federal Reserve and Bank of England (BoE) may join the global rate-cutting trend, although there are clear risks associated with a delayed start. Despite falling rates, policy will continue to be restrictive. We anticipate that the Fed will cut interest rates once in the second half of this year, but if inflation remains benign, there could be room for two cuts. ECB and BoE might also consider up to three rate cuts this year.

Looking ahead, persistent inflation concerns may contribute to elevated volatility in interest rates. However, the medium-term outlook for bonds remains positive due to favourable valuations and an expanding trend of rate cuts. We maintain a positive view on duration, and within fixed income, IG yields appear attractive, given the soft-landing scenario. However, HY spreads are too narrow, considering the risks associated with corporate refinancing in a higher interest rate environment. Consequently, we favour higher-quality corporate bonds over those with HY issues. Supportive nominal gross domestic product growth and the influence of secular tailwinds argue for an overweight position in DM equities. Yet, behavioural signals and valuations warrant some caution. Regionally, European economic recovery, attractive valuations, and Japanese corporate governance reforms (along with index exposure to key parts of the AI value chain) could support European and Japanese equities. We maintain a neutral stance on EM equities, while Chinese equities remain appealing but face investor wariness due to property market uncertainties. Indian equities benefit from strong macroeconomic fundamentals, even with a reduced governing majority under PM Modi's leadership, although valuations largely reflect this optimism. In the realm of EM local currency bonds, they hold a real yield advantage over their DM counterparts. However, geopolitical risks loom large. Factors such as higher US interest rates, the resilience of the US economy, and upcoming elections could bolster the USD. Nevertheless, valuation models indicate that the USD is expensive, and positioning may be stretched.

Overall, we expect the USD to depreciate in a soft-landing scenario, but it could serve as a portfolio diversifier against higher inflation scenarios.

Our asset class views remain largely unchanged. On equities, there is still a need to remain nimble as stretched positioning is offset by supportive fundamental and momentum. The better probability-weighted economic outlook should continue to support earnings growth, which has been notably resilient of late. Finally, despite recent headwinds, equity valuations in China are reaching attractive levels. The government has put a floor under the market, but it still lacks a meaningful stimulus or a catalyst to turn around China's growth prospects and unlock China's attractive valuations.

4. High level portfolio positioning

The portfolio is diversified. We have a sizeable exposure to defensive assets – such Australian government bonds, Australian IG bonds, Australian inflation-linked bonds, global DM IG bonds, EM debt, a money market ETF and cash – as a layer of cushion.

Similarly, we have an important exposure to equities, where we focus on markets that are expected to provide more resilience

such as MinVol, moat-based, and quality equity. We also have

positions in Chinese equities as the current cheap valuation is difficult to ignore, but its near-term direction will be determined by the forcefulness of policy stimulus and geopolitical development.

Our long-term allocation to listed alternatives that tap into idiosyncratic price drivers, with some of the investments with direct or indirect linkage to inflation, provide diversification. We keep a close watch on any market developments and manage the portfolio actively.

II. Asset class review

Listed equities:
Equity markets produced a positive return during the second quarter. At the start of the period, equities declined reflecting increasing concerns on economic growth, inflation and interest rates. However, this trend reversed as the quarter progressed reflecting better inflationary data, robust earnings and strong

performance from US equities in particular. Contrasting this was the performance of European equities, which declined towards the end of the quarter on the back of French election risk.

Against this backdrop, our ESG enhanced core equity allocation and our listed private equity allocation performed broadly in line with global equities. Our Euro Stoxx dividend futures position underperformed global equities in response to the French election risk.

Fixed Income:
Australian government bonds yielded negative returns over the second quarter, due to increasing yields amid sticky inflation. Australian IG bonds saw strong returns and credit spreads tightened with improved investor sentiment. Global IG bonds also advanced as spreads tightened.

Infrastructure:
Within our economic infrastructure allocation, 3i Infrastructure, Cordiant Digital Infrastructure released positive full year results. 3i Infrastructure produced a full year net asset value (NAV) total return of 11.4%, which reflected good operating performance from many of the company's larger assets and the disposal of Attero during the year at a 31% premium to holding value. Cordiant produced a NAV total return of +9.3% largely driven by positive valuation movements and strong asset performance. Pantheon Infrastructure also reported a quarterly NAV return to the end of March of +4.1%.

Cellnex, the European cell tower owner, released first quarter results, which were broadly in line with consensus. Organic revenue growth was 7.5% year on year (YoY) with EBITDA up 8.9% YoY. HICL Infrastructure released full year results to the end of March with a NAV total return of 0.9%. Strong operational performance and asset sales at a premium to holding value were offset by higher discount rates used to value assets and lower than forecast inflation during the period.

Several renewable infrastructure companies reported full year results or quarterly updates. In aggregate, total returns were slightly negative reflecting lower power prices and higher discount rates. More positively, there has been an increase in asset disposals throughout the year.

Next Energy Solar Fund (NESF) produced a full year NAV total return of -1.1%, largely driven by lower power prices. The company has recently disposed of an asset at a 14% premium to last NAV and has now completed circa.40% of their capital recycling programme. JLEN Environmental produced a NAV total return of -1.6% driven by lower power prices and increased discount rates. SDCL Energy Efficiency Income Trust produced a NAV total return of -4.7% largely driven by increased discount rates. Post period-end the company announced a sale of United Utility assets for £90m with proceeds used to reduce the revolving credit facility.

Gresham House Energy Storage reported full year results and a quarterly NAV update. NAV returns were negative reflecting weaker cashflow generation and a reduction in near-term third-party revenue forecasts. More positive, the company announced an agreement with Octopus Energy to secure two-year fixed-price contracts for 14 of its projects in June.

Special Opportunities:
Special opportunities include allocations to a diverse range of exposures with differing return drivers and risk characteristics. At an aggregate level, there was a negative contribution from special opportunities.

Our litigation financing investment, Burford Capital, released first quarter results during the month. It was a slower period for realised gains, which declined as a result on losses in one portfolio of assets. It was also a relatively slow period for new commitments and deployments. More positively, cash received increased markedly while its high-profile case against Argentina continues to progress.

Tufton Oceanic, our shipping investment, announced a proposed one-off return of capital representing between 5-10% of the company's NAV.

Lastly, our precious metals royalties' investment, Wheaton Precious Metals, produced positive returns during the quarter reflecting higher gold prices.

III. Outlook and Positioning

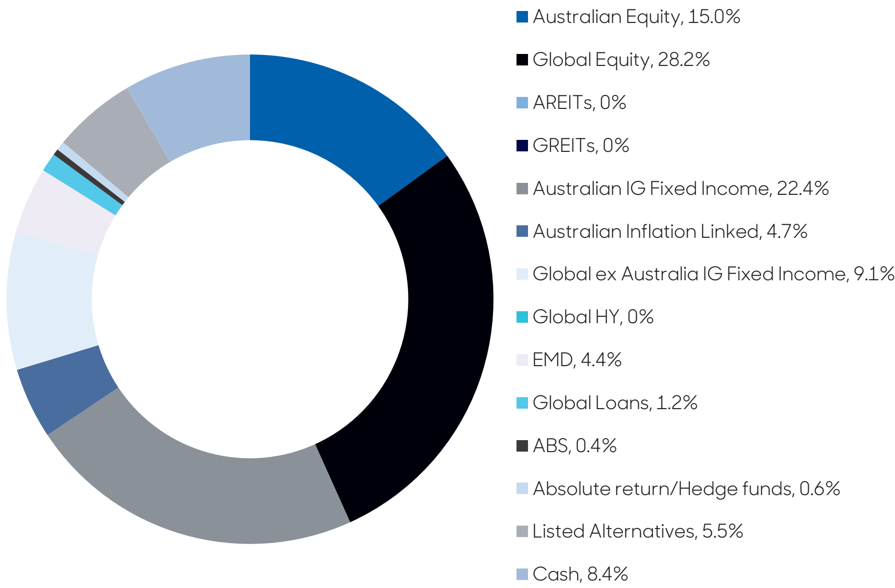
At the start of the second quarter, in terms of activity, we rolled our SPX put spread options to delta for better downside protection. We also took profit and diversified part of the EM hard currency exposure to EM local currency, which should benefit from the start of the rate cutting cycle in EM countries. Towards the later-half of April, we also added energy and gold commodity exposures on the back of sticky inflation, the global manufacturing cycle bottoming and geopolitical uncertainty, funded out of Russell 2000 and Japan. Given the increased likelihood of rising inflation, we added short-dated inflation linker from Australian bond futures and kept duration neutral. In addition, we also rotated from US equities - Moat to Nasdaq, to hunker down amid rising uncertainty and to gain upside should rates rebound. Lastly, we trimmed Japanese equities due to slower buyback and foreign flow amid geopolitical uncertainty.

In May, we continued to take a pro-risk stance in the portfolio and were overweight equities and long the USD to hedge the downside. In terms of portfolio activity, we rolled the HSCEI option from the June contract to the September contract to allow more time for the China upside scenario to play out given the potential for Chinese equities to stage a rebound within next three months. We also rebalanced our listed alternative holdings.

Over June, the portfolio allocation was largely unchanged. Overall, the fund was positioned for a soft landing in the US, with long dollar and diversifier positions to balance risks for adverse macro scenarios.

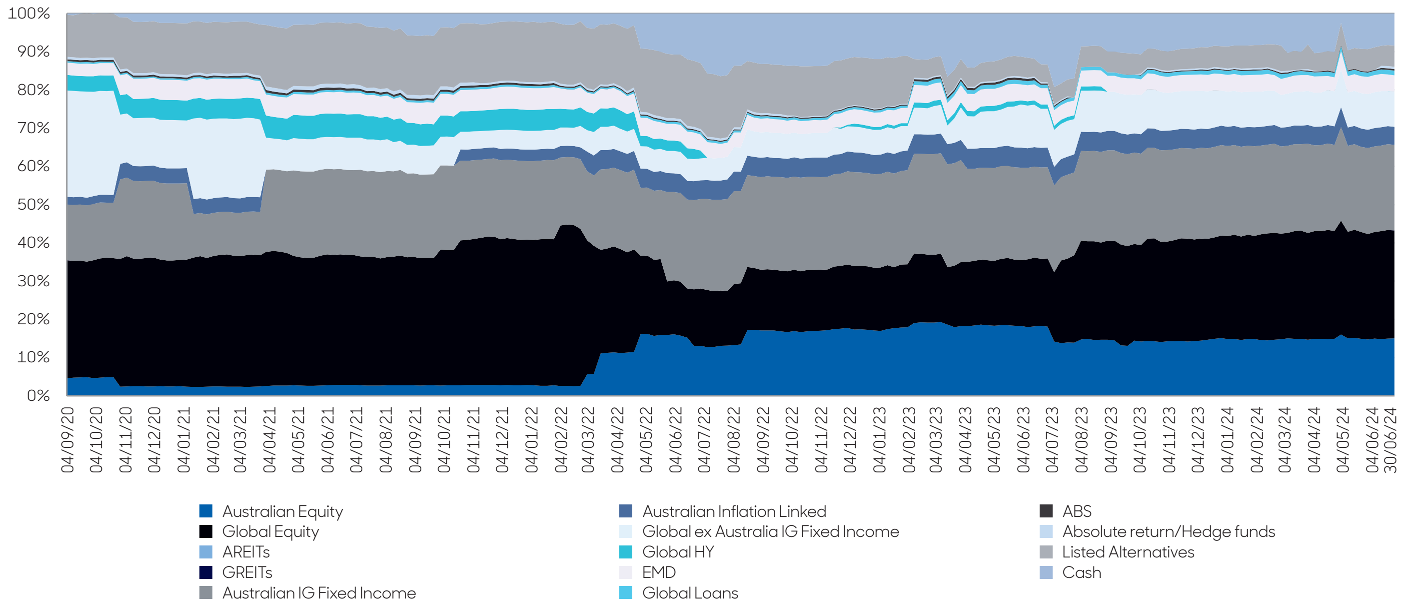
While we do see compelling risk-adjusted return prospects in some traditional asset classes, we remain cautious on relying on them alone to generate returns. Our portfolios also have meaningful allocations to alternative asset classes, many of which have compelling direct links to inflation; limited economic sensitivity; and compelling risk-adjusted return prospects.

Chart 01: Current asset allocation



Source: abrdn, 30 June 2024

Chart 02: Historic asset allocation evolution



IV. Performance and risk contribution

1. Performance table

The Portfolio returned 0.37% over the quarter. Since inception the Portfolio has delivered a return of 1.82%.

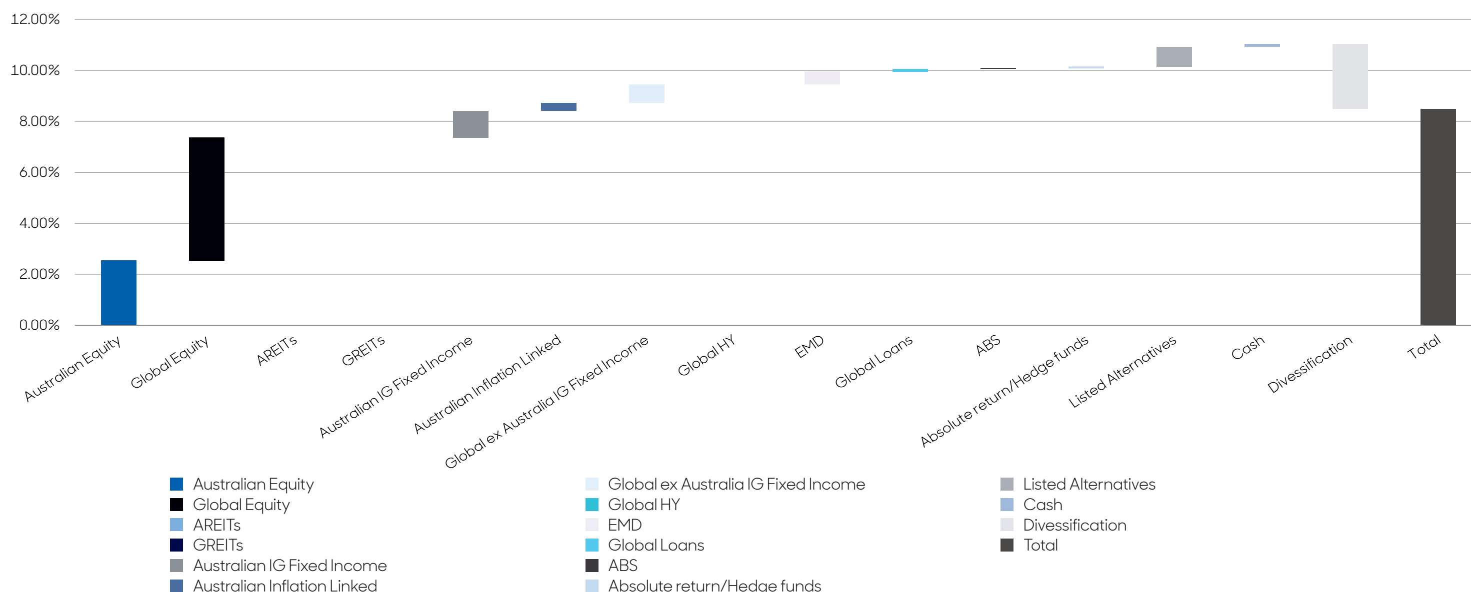
Sterling abrdn CPI+3.5% Portfolio	1 Month %	3 Months %	6 Months %	YTD %	1 Year %	Inception (p.a)%
Portfolio	1.19	0.37	4.87	4.87	9.41	1.82
Benchmark: CPI plus 3.5%p.a.	0.60	1.82	3.75	3.75	8.95	7.24

Portfolio performance is provided net of fees on underlying investments but gross of Advisory/Platform fees.
Source: abrdn Lipper,30 June 2024
Past performance is not a guide to future results

2. Risk Contribution

Our long-term proprietary estimations of risk and correlation continue to suggest a high degree of diversification across the various asset classes that compose the portfolio. The portfolio's long-term expected volatility remains well below that of equity at 8.5%.

Chart 03: Risk Contribution



Source: abrdn 30 June 2024

Important Information

Financial commentary contained within this document is provided by abrdn Oceania Pty Ltd ABN 35 666 571 268, the portfolio manager responsible for designing and managing the composition of this managed portfolio to meet the investment objectives and investment strategy detailed in the model portfolio sub-advisory agreement. abrdn Oceania Pty Ltd (ABN 35 666 571 268) is a Corporate Authorised Representative (CAR No. 001304153) of AFSL Holder MSC Advisory Pty Ltd, ACN 607 459 441, AFSL No. 480649 and CAR No. 001304154 of AFSL Holder Melbourne Securities Corporation Limited, ACN 160 326 545, AFSL No. 428289.

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