abrdn Target Return MPS

Quarterly commentary

Q2 2024

Investors should remember that the value of investments and the income from them can go down as well as up and that past performance is not a guarantee of future returns.

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Objective

The abrdn Target Return Managed Portfolio Service (MPS) is designed to target a return of SONIA +1%, +2%, 3%, 3.5% and 4% (after assumed fees and charges of 2%) through an actively managed discretionary portfolio.

Discrete annual returns - year to 30/06

	2020	2021	2022	2023	2024
abrdn Target Return MPS 1	2.66%	3.70%	-5.88%	-2.53%	6.65%
SONIA +1%	1.53%	1.05%	1.35%	4.12%	6.19%
abrdn Target Return MPS 2	2.15%	6.05%	-6.91%	-2.93%	8.12%
SONIA +2%	2.55%	2.05%	2.35%	5.15%	7.23%
abrdn Target Return MPS 3	1.64%	8.56%	-7.92%	-3.30%	9.59%
SONIA +3%	3.56%	3.05%	3.36%	6.18%	8.28%
abrdn Target Return MPS 4	1.49%	10.31%	-8.32%	-1.87%	10.90%
SONIA +3.5%	4.06%	3.55%	3.86%	6.69%	8.80%
abrdn Target Return MPS 5	0.70%	12.30%	-9.36%	-0.83%	11.92%
SONIA +4%	4.57%	4.05%	4.36%	7.21%	9.33%

Portfolio performance is based on abrdn Target Return MPS hosted on the abrdn Wrap platform. Performance figures are net of the abrdn Portfolio Solutions Ltd management fee and underlying funds OCF. Source: abrdn, Financial Express. As at 30.06.2024. ARC Private Client Indices are based on actual client portfolio returns provided by various investment management companies. These portfolio returns are allocated to one of four categories based on the volatility of their returns relative to world equities, and an average return is calculated for each category. Grouping portfolios by their volatility differs from the traditional approach, which compares portfolios which have similar asset allocations. Instead, investment managers may use whatever asset allocation they consider appropriate to achieve the desired levels of return and volatility.

Key points

- Global markets endured a choppy start to the quarter as worries over higher-for-longer interest rates and escalating tensions in the Middle East weighed on investor sentiment. Breaking the recent trend of rising markets, both equity and bond markets began the quarter on the back foot.
- However, such pessimism was short-lived. Equity markets in particular rebounded, driven by growing expectations for interest rate cuts and a relatively strong corporate earnings season. Indices in the US, UK and Europe all hit record highs during the second part of the quarter.
- The European Central Bank became one of the first major central banks to cut interest rates, lowering its borrowing costs by 25 basis points to 3.75%. The well-telegraphed move is seen as the start of its easing cycle, but lingering price and wage pressures are clouding the outlook and may force the Eurozone's central bank to wait months before cutting again. The move came after the central banks of Canada, Sweden and Switzerland all cut rates as inflation begun to abate in their respective economies.
- Moving in the opposite direction, the Bank of Japan ended eight years of negative interest rates, marking a historic shift away from its focus on reflating growth

with decades of massive monetary stimulus. While the move was Japan's first interest rate hike in 17 years, rates remain stuck around zero as a fragile economic recovery forces the central bank to take a slow approach, characterising this quarter with a wait-and-see approach towards inflation data.

- A snap election was called in France towards the end of the quarter after Marine Le Pen's far right National Rally party polled first in the European parliamentary elections. With the far right and leftist coalition polling well in the French national election on the back of proposals to lower the retirement age and tie salaries to inflation, a new government looks set to usher in higher spending. If elected on the back of this populist policy, there are likely to be further clashes with the European Commission as France's budget deficit is already in excess of the 3% allowed.

Market commentary

Looking out to sea during the Battle of Marathon, the soldier Pheidippides noticed something strange. It appeared a vessel from the losing Persian army had changed its course and was heading directly for Athens. Wondering why this could be, it dawned on the soldier that the Persians were off to claim a false victory in the capital in an attempt to trick its citizens into accepting them as their new rulers.

It is said that our man Pheidippides then ran the entire distance (around 25 miles) to Athens without stopping, discarding his armour and even his clothes in an attempt to run faster. Once in Athens, he burst into the city's government building, exclaiming "we have won" before collapsing of exhaustion and dying.

Today we commemorate that feat of human endurance by running marathons all over the world, with none more famous than in London, with more than 53,000 runners taking part during late April this year alone. Somewhat aptly, the route the runners take winds past the London Stock Exchange, with domestic markets seemingly having taken inspiration from those brave souls who conquered the 26.2-mile course during the quarter. Having been something of a running joke itself due to chronic underperformance against other markets in recent years, our very own blue-chip index has achieved a few new personal bests of late, benefitting from a weakening pound, higher commodity prices and a pickup in mergers and acquisitions.

Helping investor sentiment, economic data released in May showed that the UK had exited the mild recession it endured during the end of 2023 in something of a sprint, growing by 0.6% from January to March, the fastest rate for two years. The figures also showed that growth in the early part of the year was led by the services sector, including areas such as hospitality, arts and entertainment, and had likely been helped by an early Easter in March.

The pacemaker for the period was undoubtedly Asia. Chinese stocks rose, albeit from a lowly level, as the government released a slew of economic reforms targeting renewed growth for the world's second largest economy. This also provided a tailwind for India, which had a very positive start to the quarter during the build up to its national elections. It suffered a strong pullback in June, however, as the ruling BJP led by Narendra Modi failed to secure as a big a majority as it had previously, potentially stymieing its chances of passing meaningful legislation during the next term.

With inflation rising at a quicker pace than anticipated coupled with a persistently strong labour market in the US, the quarter's early backmarkers were US Treasuries, which suffered as investors bet that potential interest rate cuts would be pushed further and further out. Employment data consistently surprised to the upside, with many more Americans joining the labour market than forecast during the quarter. As expected, the US Federal Reserve held rates unchanged throughout the duration of the period, with Fed Chair Jerome Powell stating that despite the stronger data, it was unlikely that the central bank's next move would be a hike.

Having endured a difficult April, May saw the start of a good run for both stock and bond markets. Interpreting comments from certain central bankers that they were happy that inflation was heading in the right direction, investors took solace that an easing of policy could soon be on the cards, especially in Europe. Indeed, it was European bourses turn to hit the front, cheered on by a mixture of upbeat economic data and strong corporate earnings, which allowed the continent to hit record highs.

Although German inflation came in slightly higher than expected, this was not enough to deter the European Central Bank (ECB) from a well-telegraphed rate cut just weeks later in June. Cutting by 25 basis points to 3.75%, the move was largely priced in by investors, with futures seeing a 92% chance of such a move in the weeks prior. Acknowledging the progress made in its battle against price rises but also signalling that the fight had yet to be won, the ECB was careful to flag that this move would not usher in a rapid rate-cutting environment.

On domestic shores, May also saw Prime Minister Rishi Sunak fire the starting gun on a snap general election, scheduled for July. Allegedly hoping to capitalise on a report earlier that day showing inflation continued to fall, the political announcement seemed to have very little effect on markets, with investors pricing in a strong Labour majority that had effectively been forecast since the start of the year.

Acting as a potential boon for the Conservatives however, inflation did drop to 2% in the following reading, falling within the 2% target set by the Bank of England (BoE) for the first time since 2021. However, the data also showed services price inflation, which the BoE believes gives a better picture of medium-term inflation risks, came in at 5.7%. While down from 5.9% the previous month, the reading was higher than the 5.5% consensus estimate and much more than the 5.3% the central bank had predicted just a few weeks previous.

The following day in June, as expected, the BoE kept domestic rates at 16-year highs, voting 7-2 for the status quo. However, its accompanying policy statement was noteworthy, with the decision described as "finely balanced" for some members of the Monetary Policy Committee, leaving the door ajar for a potential cut at its August meeting.

Elections and geopolitics dominated the final stretch of the quarter. With the finish line nearly in sight, a snap election was called in France, riling markets on the continent. With the far-right wing National Rally party having humiliated the incumbent French president Emmanuel Macron in the recent EU elections, Macron opted to call the French electorate's bluff, calculating that the prospect of a radical right prime minister in the Élysée would "clarify" its thinking. The gamble looks to have failed with Macron's party languishing in third place after the first round of voting, eclipsed by both far right and left candidates. Market reactions were blunt, with the spread in borrowing costs between French and German government bonds reaching levels not seen since the sovereign debt crisis of 2011, jogging investors' memories of the tumultuous time endured on the continent over a decade ago.

Investment strategies

The second quarter of 2024 proved to be a reasonably volatile period with plenty of surprises from an economic, markets and political perspective. Target Return mandates delivered positive returns across the board, with higher-risk mandates outperforming their lower-risk counterparts.

The last mile from an inflation perspective has proved to be less straightforward than central bankers would have wanted in both the US and UK, and to a lesser extent Europe. Stubborn inflation prints supported by firm labour markets and wage data led to markets pricing in as few as one rate cut in the US during 2024 by the end of April, which was a world away from the near seven cuts suggested in the middle of January. This backdrop meant that fixed interest assets had a pretty difficult quarter with government bond yields reacting to not just macroeconomic data releases but also the rhetoric from central bankers. UK gilts and global government bonds more broadly were deeply in the red by the end of April, but a more favourable inflationary backdrop over May and June allowed government bonds to rebound towards where they had started by the quarter end. Investment grade bonds faced similar headwinds. Although they don't have the same level of interest rate sensitivity, they suffered from a slight widening of credit spreads and ultimately delivered broadly flat returns. Global high yield bonds fared marginally better than investment grade. They suffered less from the shift higher in rates and spreads were flat over the quarter, which led to a modestly positive return.

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Within equity markets there were pretty varied outcomes during the quarter. In local currency terms most regions delivered positive returns, but the range of them was quite wide. Geographies considered to have a more growth orientation performed strongly with headline returns from the US, Asia ex-Japan and emerging markets returning 4.3%, 7.6% and 5.3%, respectively. Value orientated regions such as Japan and the UK delivered positive but more pedestrian returns of 4.3% and 2.3%, respectively. Europe ex-UK equity markets were heavily affected by the snap French parliamentary election called by President Emmanuel Macron following the strong showing of the far-right National Rally in the EU parliamentary elections. The French equity market was down by more than 6.5% during the quarter, while the broader European ex-UK indices were up by about 1%.

From a currency perspective, sterling was relatively stable against most developed nation currencies, so there was little translation effect on overseas asset class returns. The only major currency where that wasn't the case was the Japanese yen, which weakened by around 6% versus the pound – a not inconsiderable headwind for Japanese assets.

Alternative assets delivered some divergent returns. Global real estate investment trusts (REITs) suffered considerably in a market adjusting to a higher-for-longer interest rate environment. Global REITs were down some 2.3%. Global infrastructure assets were a little more stable, up 0.8%. Much of the cash flows received are inflation-linked, providing some protection in the current environment. The allocation to absolute return Funds also delivered a small positive return during the quarter.

Portfolio Activity

We were reasonably active within the Target Return MPS during the quarter.

Early in the period, we had become more constructive on developed world risk due to our evolved view that the US would avoid a recession (though growth would continue to slow). This would ultimately mean that company earnings would likely be higher than previously envisaged and meant that equity assets looked more attractive. To this end, we increased both our US and UK equity allocations, funding this predominantly from local currency emerging market debt holdings. We added a new Fund into our US allocation at this point in the form of the T Rowe Price US Structured Research Equity Fund, so that it represented around 10% of the overall US basket. This Fund recently launch in the UK market and abrdn managed to secure an allocation at very attractive terms. The strategy has been running for 25 years in the US and is an analyst-driven research portfolio, combined with a portfolio oversight team to generate alpha via stock selection with benchmark-like volatility and characteristics. The Fund's track record has shown consistently strong returns across various market environments. We have been given access to an attractively priced share class.

Within equities, we took the opportunity to streamline our allocation through the sale of global equity Funds, to allocate all our exposure through regionally orientated positions. The global equity Funds used have provided a well-diversified means to gain exposure to world equity markets, but we believe being able to actively manage regional exposure is likely to deliver better outcomes in the future.

Within global government bonds, we switched from the Vanguard Global Bond Index Fund to the abrdn Global Government Bond Tracker Fund. The Vanguard Fund follows an index that contained both government and corporate debt and this has benefited clients, but we wanted a vehicle that was purely exposed to government debt and the abrdn Fund provides this exposure at a lower cost than both the Vanguard Fund and other providers in this space.

With the expectation that interest rates are likely to fall during the rest of this year and beyond, we also wanted to increase the exposure within mandates to interest rate sensitivity. We own a diversified basket of government bonds through global Funds, as well as specific holding in UK gilts and US treasuries. One area that we did not have specific exposure was European government bonds and with the likelihood of European rates being cut first we believed this provided an opportunity to drive returns while also increasing diversification. To this end, we added the Vanguard Euro

Government Bond Index Fund to mandates. We funded this by selling exposure to hard currency emerging market debt and reducing exposure to global high yield, where spreads look tight after a period of strong returns, and absolute return Funds.

Towards the end of the quarter, we made a slight change within our European equity basket. Over the last nine months or so, we have been slowly increasing our small-cap exposure as we believe this area of the market looks undervalued versus larger cap peers. Small caps have also historically performed strongly in markets where interest rates are being cut. With the European Central Bank reducing interest rates by 25 basis points at the June meeting, we took the opportunity to increase the allocation to small caps from 10% to 15% of the basket. We did this by reducing the allocation to the Invesco European Equity Income Fund and increasing the allocation to the Janus Henderson European Smaller Companies Fund.

Outlook

With record highs in a number of markets during the second quarter amid resilient economic data in the face of falling inflation, the chances of a global recession have now markedly diminished. This should continue through the rest of the year as inflation falls back towards central bank targets and wage growth cools. While this combination should be supportive for consumer sentiment and spending, wage growth will need to slow further before underlying inflation pressures settle at a consistent rate, albeit not quite as rapidly as previously expected. We are now more positive on a number of asset classes as central banks gear up to begin cutting rates. Despite this, we are cognisant that inflation could remain sticky during the coming months, damaging sentiment, and that heightened geopolitical volatility in both France and later in the US could accelerate price pressures.

However, against any market backdrop, a professionally managed, well-diversified and longstanding investment plan is essential. As they say, it's all about investing for the long run.

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Risks
All investments involve risk. The risks of some of the funds may be comparatively high. The risk descriptions at the end of this document correspond to the main risk factors for each fund within the model. "General Risks" mostly apply to all funds within the model. A fund could potentially be affected by risks beyond those listed described in this document, nor are these risk descriptions themselves intended as exhaustive. For full information and key risks, please refer to the end of this document.

Credit risk: The fund invests in securities which are subject to the risk that the issuer may default on interest or capital payments.

Interest rate risk: The fund price can go up or down daily for a variety of reasons including changes in interest rates, inflation expectations or the perceived credit quality of individual countries or securities.

Equity risk: The fund invests in equity and equity related securities. These are sensitive to variations in the stock markets which can be volatile and change substantially in short periods of time.

Emerging Markets risk: The fund invests in emerging market equities and / or bonds. Investing in emerging markets involves a greater risk of loss than investing in more developed markets due to, among other factors, greater political, tax, economic, foreign exchange, liquidity and regulatory risks.

Derivatives risk: The use of derivatives carries the risk of reduced liquidity, substantial loss and increased volatility in adverse market conditions, such as a failure amongst market participants. The use of derivatives may result in the fund being leveraged (where market exposure and thus the potential for loss by the fund exceeds the amount it has invested) and in these market conditions the effect of leverage will be to magnify losses.

High Yield Credit risk: The fund invests in high yielding bonds which carry a greater risk of default than those with lower yields.

For more information visit abrdn.com

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