# Target Return

## Managed Portfolio Service - Portfolio 4

Quarterly Update - Q3 2021

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### In brief

- Despite a sell-off in September, US, UK and European equities advanced during the quarter despite concerns over slowing growth, supply bottlenecks and an uptick in inflation.
- Asia was mixed with a broad sell off in Asian bourses but with strong returns from the Tokyo Stock Price Index.
- In China, slowing growth, ongoing regulatory intervention and heavy indebtedness at property developer Evergrande dampened emerging market performance.
- Talk of tapering and rising inflation saw yields rise on conventional bonds.
- It was a tough quarter for the Target Return MPS portfolios with returns negative and below target.

### Market Commentary

Oscar Wilde most famously quipped that conversing about it was the last refuge of the unimaginative, while in more recent times Bill Bryson noted that its most striking characteristic is that there isn't much of it. However, recent research carried out by the BBC shows that 94% of Britons admit to having talked about the weather in the past six hours, while 38% have mentioned it in the past hour or less.

Of course, several features of the UK's geography make our climate overtly unique, often changeable but always wholly unpredictable. Firstly, there's the Gulf Stream, raising temperatures to above where they should be at this latitude, coupled with the fact that the UK is made up of islands, resulting in a lot more moisture in the air. Collectively, this can make for fairly erratic weather.

Forecasting in the UK is no easy occupation, weather or otherwise, something that the Bank of England (BoE) has come to realise only too well over the years, especially after the gale force-like headwinds brought about by a global pandemic. Even outgoing chief economist Andy Haldane protested earlier this year that the BoE is too gloomy in its outlook for the UK economy.

The (supposedly) sunnier skies of July provided something of a port in storm on domestic shores, a culmination of a more successful Covid-19 vaccine rollout than anticipated, allowing the government to usher in 'freedom day' on 19 July. Despite warnings from both scientists and advisory groups over the growing Delta variant, a persistent cloud on the horizon of a post-pandemic UK, the government saw it fit to remove nearly all social distancing rules. Although peaking mid-month, the new variant went on to disrupt supply chains and lead to staff shortages throughout the summer as companies struggled to fill job vacancies.

Meanwhile, the US seemed to be making hay while the sun shone. With lawmakers working to pass a major infrastructure spending bill amid a wave of positive economic updates, any worries about the sharp rise in Covid cases were far outweighed, with all US stock market indices, much like the thermometers in the country's western states, regularly hitting record highs.

With an economic bounce back much more pronounced than most commentators had predicted, data showed that US inflation went on to strike a new high of 5.4% in July. However, Federal Reserve Chairman Jerome Powell, much like his central bank counterparts around the world, deemed that such a spike was likely to be transitory, reiterating the 'lower for longer' outlook for interest rates. However, as the economy continued to recover, the Fed went on to use increasingly hawkish language in relation to its bond purchasing programme.

It was very much a case of sunshine after the rain for Japanese equites. A notable laggard during the early summer months, August saw the land of the rising sun post some of the strongest gains among developed markets. After a shambolic vaccine rollout and tumultuous build-up to hosting the already delayed Olympic Games, Prime Minister Yoshihide Suga's approval rating fell to an all-time low, prompting an announcement that he was stepping down and hopes of a snap election to reinvigorate the economy, possibly as early as October.

It was European markets that were in gold medal position during August however, buoyed by a combination of improving economic data and recovering corporate earnings. In fact, the proportion of companies beating analysts' forecasts on the continent hit its highest level in five years, as the bloc's vaccine rollout gathered pace, even overtaking the US in terms of percentage of second vaccines administered.

September also saw the European Central Bank start to introduce the notion that it would taper its asset purchasing programme. Although inflation data showed that prices rose at their fastest pace in 10 years, the central bank was quick to reassure investors that any moves in interest rates would be well telegraphed and the taps could be turned back on if needed.

While the end of September saw many Britons queuing at their local petrol station, many Germans were queuing outside their local polling station, as the winds of political change blew through the Eurozone's largest economy. The last weekend of the quarter saw Angela Merkel, German Chancellor for 16 years, stepping down and waving auf wiedersehen to the country's Bundestag for the final time. Although the EU has lost the presence of a great diplomat who was central to holding the bloc together during various crises during her tenure, other developments soothed markets. In a surge reflective of gas prices during the month, the incredibly strong rise of Olaf Scholz's Social Democratic Party was well received by financial markets as a poor showing from the far left party, Die Linke, meant that a fully left leaning coalition for Germany was out of the question.

With European markets proving to be hot property throughout the quarter, in China, it was the property market that was proving to be too hot. They say that when it rains, it pours, and for China's second largest property company, September saw that old adage ring true. A fall in property prices, triggered by a growing reluctance on both the part of the Chinese consumer to move house and the government to support the sector, left Evergrande Group unable to sell properties and other assets quickly enough to service its US$300 billion obligations. Famously now the world's most indebted company, Evergrande has seen its shares tumble by up to 75% this year, sparking fears of contagion that spread through China's financial system and reverberated around global markets.

## Portfolio Activity

We have become increasingly concerned about a mid-cycle economic slowdown due to the impact of the spread of the Delta variant of Covid-19, rising input cost pressures as well as US dollar appreciation. As such, we see less upward pressure on US interest rates and have closed the short US interest rate, short US real yields, US interest rate butterfly and US yield-curve steepener strategies. The US versus German interest rates strategy was also closed as it achieved its central return target, with some of the US bond futures recycled into a new US real versus nominal flattener. With the US treasury curve remaining steep and inflation expectations high relative to history, we expect this new strategy to perform well in an environment of policy normalisation which pushes up front-end yields relative to the long end and removes some support for inflation breakevens. We also opened a US flattener strategy, as we expect the US treasury curve to flatten as policy tightens, and a New Zealand versus Australian interest rates strategy. The market is pricing in an extended economic slowdown and continued loose monetary policy in Australia and a much more positive economic outlook in New Zealand, which is supportive of monetary tightening. We expect greater interest rate convergence given trade and economic linkages and deem it unlikely that New Zealand will be able to tighten policy so far ahead of Australia.

Within equities, we made changes to lower equity exposure as the proliferation of the Delta variant slows the recovery from Covid. We closed the global equity growth recovery and sustainable staples strategies and reduced the industrial automation strategy. We initiated a new global equity quality growth strategy, which invests in a basket of attractively valued quality growth companies with above-average earnings growth and below-average volatility. We also added to our China A-share exposure, which has low correlation with the other equity strategies and attractive diversification benefits.

We closed the global equity metals and Chinese equity renewable energy strategies during September. Both strategies have performed well and we took profits near recent highs. We have become more cautious on the demand outlook for the metals strategy, while increased Chinese regulatory risk has dampened investors' enthusiasm for Chinese equities. We used the proceeds from these sales to scale up the global equity quality growth strategy. We also trimmed exposure to European equities and bolstered our US exposure as we think a supportive Federal Reserve and elongated recovery favours growth-oriented US equities over their more cyclical European counterparts.

We opened a Mexican interest rate strategy, which offers high yields relative to volatility levels. We expect domestic Mexican inflation to moderate and allow the central bank to shift to a more neutral/accommodative stance. We also think that too many rate hikes are priced in by the market. Stable US treasury yields should encourage investors to reach for yield in emerging markets and we expect Mexican economic fundamentals to improve as Covid vaccine programmes progress and the economy reopens.

We opened a new credit decompression strategy, which seeks to profit from tight credit spreads. These appear priced for perfection and do not fully reflect latent risks, such as variants preventing economies from fully reopening or central bank liquidity being withdrawal. We are positioned for the spreads of a basket of cyclical credits, such as autos and materials, to widen more than the broader market.

The short UK inflation strategy works well as a diversifier from equity risk. We trimmed the position to balance the reduction in equity exposure outlined above. The European inflation strategy has performed well and we trimmed it a couple of times during the quarter, firstly, due to increased uncertainty driven by lockdown extensions or expansions in Europe which delayed expectations for higher levels of demand, and secondly, because we think there is greater risk that a Chinese slowdown reduces global inflationary pressures.

We opened four new currency strategies during the quarter. The favoured FX carry strategy looks to maximise yield from major currency markets. These positions were informed by qualitative and systematic input from abrdn's foreign exchange (FX) steering group. The portfolio is long the high yielding Russian rouble, Indian rupee and Indonesian rupiah and short the Japanese yen, Swiss franc and Taiwanese dollar. The global FX behavioural relative value strategy is driven by a model that combines the three signals with highest conviction from the macro systematic team. It aims to harvest dispersion in economic activity, interest rate/central bank activities and trends in capital flows within FX markets. We opened an Australian dollar versus New Zealand dollar strategy as we think excessive positivity is priced into the New Zealand dollar and we expect it to weaken relative to the Australian dollar. Lastly, we opened a US dollar versus euro position at the quarter-end as we expect the strength of the US economy will allow it to raise interest rates well ahead of the Eurozone, supporting a stronger dollar.

## Investment Strategy

The reopening of economies at varying speeds around the world heavily influenced markets during the third quarter of 2021. The imbalance between supply and demand for goods, services, materials and labour all played a part in shaping the views of central bankers and market expectations for growth, inflation and monetary policy.

The economic growth outlook broadly deteriorated during the quarter as the Delta variant of Covid-19 affected the speed at which economies could reopen. Economic expansion is expected to remain well ahead of trend growth seen in the years preceding the pandemic, albeit we are likely past the peak with much of the rebound from the lows of 2020 behind us.

Supply chain issues have left many businesses unable to fulfil orders, while demand has continued to increase, leading to both higher input and output costs. This, in turn, has led to the highest inflation in more than a decade.

Central bankers have been keen to reiterate that this is largely transitory. Although their tone is largely reassuring, their plans for reducing monetary stimulus and increasing interest rates have undoubtedly been brought forward. Expectations for higher interest rates weighed heavily on both bonds and equities towards the end of the quarter, with government bond yields (which are inversely correlated with prices) rising sharply across developed markets. Equity markets (which have become more reliant on cheap money) ended the period considerably lower than their mid-quarter highs.

The short UK inflation strategy held across mandates continued to suffer as shortages of gas and petrol (among other commodities) stoked inflation expectations. On an absolute basis (and relative to other countries) the implied level of inflation in the UK continues to defy fundamental analysis, but with pandemic supply challenges further compounding Brexit woes there seems to be little relief on the horizon in the short term.

Our European inflation strategy has performed well in this environment and still appears to offer good value, especially when viewed relative to the implied level of inflation in the UK. Positive returns from this strategy did not fully offset losses from our short UK inflation position, however.

After a strong start to the year, thanks to an 11th hour Brexit deal being agreed, sterling had a much tougher third quarter, weakening against eight of the G10 developed nation currencies. This weakness benefited our portfolios as the translation effect of overseas currency exposure augmented returns for sterling investors.

## Outlook

Despite the setbacks brought about by the emergence of the Delta variant of Covid-19 throughout the summer, we believe the investment barometer still points to ‘fine’. The clouds that dominated the horizon at the beginning of the year continue to part, with the inclement weather many had feared during lockdown yet to materialise.

The synchronised accommodative central bank policy and increasing vaccination rates imply a mainly sunny outlook with sporadic showers. The spread of the Delta variant continues to present challenges to company supply chains and logistics and future variants pose unknown threats, at least until the world is fully vaccinated. However, we have transitioned to ‘living with Covid’, the new normal, and the outlook for many companies seems to be stabilising, albeit they face higher costs.

Perhaps the largest challenge for central banks is forecasting just how robust their economies are in the face of forthcoming interest rate increases. Our base case remains for central banks to hike rates in 2022 at the earliest, with several recent hawkish statements from various central banks only reaffirming this view. The coming months, just like those in the previous quarter, could well be characterised by the debate on whether inflation is here to stay or will merely blow on through.

On a corporate level, we expect earnings momentum evidenced by recent investor updates to continue apace, especially in developed markets. However, we are now more cognisant of potential pockets of low pressure as Covid-induced supply shortages take their toll. With the US having potentially reached peak growth, we look towards Europe and the UK to take up the mantle of those nations emerging from the pandemic with a brighter outlook.

## Performance

**Portfolio performance is based on abrdn MPS hosted on the abrdn WRAP platform.**

Please note: portfolio constituents and performance may vary on other platforms.

The portfolio has not been available on all platforms since inception.

Performance figures are net of the abrdn Discretionary Management Charge. However they do not include the deduction of product and adviser specific charges. The effect of these charges would be to reduce the performance levels shown. In addition, MPS portfolios are subject to fund level annual management charges, which vary over time in line with the composition of the portfolio. Please refer to the relevant Managed Portfolio Service Annual Charges Summary for more information on charges.

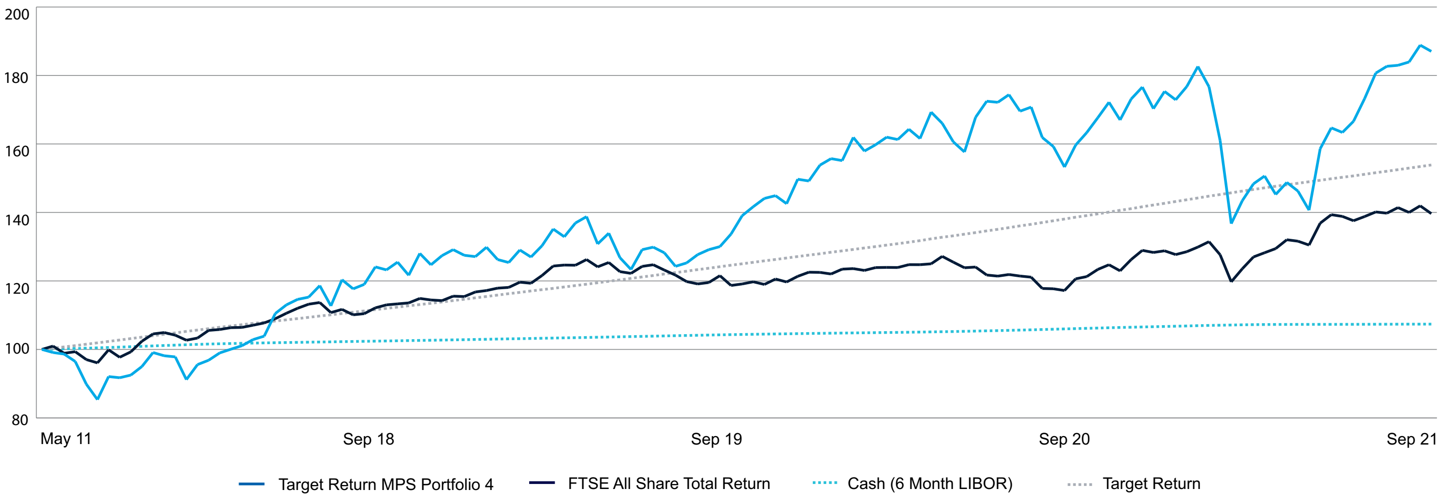


### Performance: Target Return MPS Portfolio 4

| | Performance (%) 3rd Quarter 2021 | Performance (%) 3 years | Performance (%) Since Inception[1] | Volatility Since Inception (%) |
|---|---|---|---|---|
| Target Return MPS Portfolio 4 | -1.24 | 15.33 | 39.66 | 5.19 |
| Target Return[2] (Cash+3.5%) | 0.90 | 12.69 | 53.87 | 0.11 |
| FTSE All Share TR | 2.23 | 9.53 | 87.05 | 12.23 |
| Cash (6 month LIBOR) | 0.02 | 1.58 | 7.39 | 0.09 |

The performance figures may vary due to product specific charges and should be viewed on an indicative basis.
[1] 03/05/11 - 30/09/2021
[2] 6 month LIBOR +3.5% annualised over rolling 3 year periods
Volatility calculated using monthly returns. Any holdings referred to relate to the abrdn MPS hosted on the abrdn WRAP platform. Differences in holdings may occur on other platforms due to fund and shareclass availability.

### Performance: Target Return MPS Portfolio 4 Inception to end Q3 2021



## Asset allocation: Target Return MPS Portfolio 4

| Asset allocation | MPS Model Strategy 4 as at end Jun 2021* (%) | MPS Model Strategy 4 as at end Sep 2021* (%) | Change +/- |
|---|---|---|---|
| UK Government Bonds | 2.7% | 2.6% | -0.1% |
| UK Corporate Bonds | 1.0% | 1.0% | 0.0% |
| US Investment Grade Bonds | 4.7% | 4.7% | 0.0% |
| Global High Yield Bonds | 4.0% | 4.1% | +0.1% |
| Euro Corporate Bonds | 2.3% | 2.4% | +0.1% |
| Emerging Market Debt Local Currency | 5.6% | 5.6% | 0.0% |
| Emerging Market Debt Hard Currency (£ Hedged) | 2.0% | 2.0% | 0.0% |
| UK Equity | 14.8% | 14.8% | 0.0% |
| North American Equity | 14.6% | 14.1% | -0.5% |
| European Equity | 5.3% | 5.1% | -0.2% |
| Global Equity | 4.8% | 4.8% | 0.0% |
| Developed Asian Equities | 2.0% | 2.0% | 0.0% |
| Japanese Equity | 1.6% | 1.7% | +0.1% |
| Global Infrastructure | 3.9% | 3.9% | 0.0% |
| Volatility Management[1] | 30.4% | 30.9% | +0.5% |
| Cash | 0.5% | 0.5% | 0.0% |
| **Total** | **100%** | **100%** | |

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The Portfolio has not been available on all Platforms since inception.

[1] Volatility management is achieved via holdings in the abrdn Strategic Investment Allocation Fund (SIA Fund). The SIA Fund is designed to be used as part of a strategic approach to individual client wealth objectives and should not be considered as a stand-alone investment.
The fund is designed to generate an absolute return when viewed with other assets in the client's portfolio. As a result, if other assets in the portfolio are performing well, this fund may not produce a positive return.
The SIA Fund is complemented by holdings in the abrdn Active Overlay Fund, which aims to add alternative return seeking strategies to the portfolio.
The use of derivatives in the funds may result in increased volatility in their fund price.
Due to the leveraged nature of derivatives, gains and losses can be greater than associated with traditional investment instruments.
The funds will have the ability to hold short derivative positions. This means that the funds will not necessarily follow market trends i.e. if stock markets rise the funds may not do so at the same rate, or at all.
*The data is rounded to 1dp and small variances to totals may occur. This data is based on the abrdn MPS hosted on the abrdn WRAP platform.

**The figures shown here refer to the past. Past performance is not a reliable guide to future performance. As with any investment, the value of your fund can go down as well as up and may be worth less than you invested.**



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