Economic update

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Brian reviews events in Australian and overseas markets during December.

How did markets perform in December?

It wasn't a great end to the year for most world share markets. While losses were fairly widespread over the month, a lot of the weakness was concentrated in some key emerging markets, such as Russia and Brazil, and in the peripheral eurozone markets, which lost quite a lot of ground in December.

In contrast, Chinese shares ended the year on a very strong note, with the Shanghai Composite Index posting a return of just over 20% in December and a gain of close to 53% for the year, despite generally disappointing economic news during much of 2014.

For Australian investors, unhedged global shares still managed a positive return because the Australian dollar continued to fall. Over the year, the Australian dollar has fallen by more than 8% against the US dollar, and that's provided quite a boost to unhedged global share returns.

Bond investors both here in Australia and globally enjoyed solid returns as government bond yields posted some quite significant falls. Non-government bonds tended to underperform government bonds.

Australian shares made solid gains in December – more than 2% despite the fact that mining and energy stocks continued to weaken. The sectors that contributed the most to the gains in the local market were a rebound in the banks and some good gains in industrials and listed real estate trusts.

Looking at the year as a whole, Australian investors enjoyed pretty good returns from most asset classes, especially listed real estate securities both here in Australia and globally and also unhedged global shares and global fixed income. But the Australian share market has underperformed other world markets, and a near halving in the iron ore price clearly hasn't helped. The overall Australian market posted a return of just 5.6% for 2014.

What were the key factors driving global markets?

The geopolitical environment has been a source of uncertainty for financial markets all year, and December was no different. Whether it's Iraq, Ukraine or elsewhere, geopolitical developments still have the potential to unsettle markets. However, events in Iraq haven't prevented further falls in oil prices, and those falls in oil prices are probably positive overall for the world economy.

We've also seen a big step up in concerns about the eurozone. Not only is the eurozone economy still struggling, but Greece has re-emerged as a major source of concern. National elections have had to be brought forward after the government failed to get its preferred presidential candidate elected. There's a real fear that a left-wing government will emerge that won't be anywhere near as amenable to the kind of austerity policies that have been adopted in recent years, and that it may insist on another restructuring of Greece's debt.

Prices for Greek bonds have fallen sharply. The share market posted a -15% return in December and lost 34% over the year.

The actions of the central banks are still a key influence on markets. The end of quantitative easing in the US has passed without major incident, at least so far, which probably reflects the fact that the US economic data suggest that the economy no longer needs the extra help. The US economy has had a very solid year.

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The really aggressive steps taken by the Japanese authorities, together with the hope for some more action from the European Central Bank, have also had a big influence on markets. In contrast to the US, the data in those countries suggest they do need to take extra steps to boost growth. The eurozone has hovered dangerously close to recession during 2014, and the Japanese economy has fallen back into recession.

What about developments in Australia?

We tended to see disappointing economic news here over the last month. But we're still seeing signs of a recovery in the non-mining economy coming through – lower interest rates are working, housing activity indicators remain quite solid, and there's a pick-up in the demand for credit. Most importantly, we're seeing some growth in business credit, and that's consistent with some other key data released during the month which provided more evidence of a recovery in business investment outside the mining industry.

On the other hand, mining investment continues to taper off and the sharp falls in the iron ore price are significantly detracting from our national income. And the labour market is still struggling.

It's still an uncertain environment, and it probably means that the Reserve Bank of Australia (RBA) will leave interest rates on hold for a while. But the weakness in the labour markets, very weak wages growth, and an extremely benign inflation outlook do give the RBA room to cut rates further if they think it's necessary.

There is no video update this month, but Brian will be back in February 2015 with a video update for January.