Economic update

6 October 2015

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John reviews events in Australian and overseas markets during September.

How did markets perform in September?

Share market returns moved into negative territory for the second consecutive month. While they were not as severe as those that we saw in August, it was nonetheless another challenging month for investors.

America's S&P500 Index was one of the better performers, falling by 2.6% in local currency terms over the month. The UK's FTSE100 Index was not far behind, falling by 3.0%. In Europe, returns were a little worse with the German and French markets falling 5.8% and 4.3% respectively. In Asia, Japan's Nikkei Index was down by 8.0% while the Hang Seng Index in Hong Kong fell 3.8%, its fifth consecutive negative monthly return. Elsewhere in Asia, China's Shanghai market fell another 4.8%, which looks relatively modest compared to August's 12.5% fall.

The weakness in overseas markets spread to Australia where the ASX200 Accumulation Index returned -3.0%. All but two of the industry sectors lost ground with resource related companies amongst the worst performers as concerns grew that commodity prices have further to fall. BHP Billiton was down 11.8% and Rio Tinto fell 3.4%. For the second month in a row, Energy was the weakest sector, falling by 12.2%. While further oil price weakness didn't help, stock specifics contributed most to the negative return, in particular Santos and Origin Energy who have high levels of debt at a time when earnings are lower. Woodside Petroleum's share price was also under pressure following its takeover offer for Oil Search.

Market returns were mixed in the year to 30 September. The S&P500 Index was down by 2.6% in local currency terms while in the UK, the FTSE100 Index fell 8.5%. In Europe, the German and French markets returned 2.0% and 0.9% respectively. Japan's market continues to outperform with the Nikkei Index rising by 7.5% in September. However, Hong Kong's Hang Seng Index fell 9.1%. As for the Shanghai Stock Exchange, it was still up by 29.1% in the year despite the pronounced weakness and volatility in recent months. Australia's ASX200 Accumulation Index fell 0.7% and this was again due largely to the price weakness of resource and energy companies.

What were the key factors driving global markets?

Markets have been uncertain about the outlook for global growth and perceptions have been changing almost on a daily basis. As we saw in August, slower growth by China's economy was the dominant influence on markets in September. Recent data did little to alleviate those concerns. For example, a recent Chinese manufacturing activity survey fell to its lowest level since early 2009. The possibility of slower growth in China accentuated concerns about other emerging economies, particularly commodity dependent economies.

Comments by the US Federal Reserve (Fed) following its decision to leave interest rates unchanged did little to ease concerns about the health of the global economy. In its statement, the Fed cited a more uncertain global outlook and "heightened concerns about growth in China" as reasons for a cautious approach to raising rates.

What is the outlook from here?

There are a number of reasons to be cautious about the outlook and return potential from here. The performance of China's economy and the degree to which it is slowing is an ongoing source of uncertainty. As it is Australia's largest export market by far, what happens in China has direct consequences for our terms of trade, currency and the economy overall at a time when prices for our major exports such as iron ore have fallen and the peak of the resources capital spending cycle is behind us. The impact of what happens in China is also relevant to our other trading partners, such as Japan and South Korea, and the global economy in general.

However, there are some positives that may have been overlooked during the recent market weakness:

- The US economy continues to perform well. A recent report by the Commerce Department said the US economy grew by more than initial estimates in the second quarter, leading to an upgrade to the annual growth rate from 3.7% to 3.9%, although it is worth asking how much better could it get from here.
- Growth in the other developed economies such as the eurozone and Japan is either stable or improving, albeit very slowly.
- The substantial fall in the price of oil combined with the quantitative easing programs in the eurozone and Japan will benefit consumers and help support global growth.
- China's economy is still growing, perhaps not by as much as markets were hoping for, and the Chinese authorities have a good track record in responding robustly to difficult economic circumstances when required.

How are MLC's portfolios positioned and how have they performed recently?

The comments we made last month are still appropriate. For some time now our multi-asset MLC Horizon and Inflation Plus portfolios have been defensively positioned. This cautious approach, which we believe remains appropriate, is because the global environment has been so uncertain at a time when the valuations of many traditional asset classes and securities have been high and return potential has been low. In other words, there has been insufficient reward for taking risk.

As a result, we have been focused on managing risk and searching for ways to help insulate client portfolios from significant negative returns. This has lead us to do a number of things such as reducing our exposure to Australian shares, positioning our global shares exposures to benefit from anticipated Australian dollar weakness, being selective in our bond holdings, having higher than average cash holdings and overweighting defensive and liquid multi-asset strategies.

While this positioning hasn't been enough to prevent negative returns for the month of September, it has provided a degree of insulation particularly in our MLC Inflation Plus portfolios where we have significant management flexibility to reduce the risk of negative returns. One year returns to the end of September remain in positive territory with the MLC Inflation Plus portfolios outperforming similar MLC Horizon portfolios.

Valuations in markets should be lower to reflect these uncertainties. Even after the recent falls in markets, we need to see more attractive valuations before stepping into riskier investment markets. Early in September we made further reductions to risk in our Inflation Plus portfolios by decreasing our emerging markets and inflation linked bonds exposures and increasing cash. Depending upon the scenario that plays out and further market activity, it is possible that a buying opportunity in risk assets, such as shares, could present itself at some stage.

We believe taking a cautious approach is in the best interests of our investors. We continue to review the risks within our multi-asset portfolios and ensure our portfolios have sufficient liquidity to either increase our defensive or offensive positions in the coming weeks and months.