Economic update

3 July 2015

John Owen
Portfolio Specialist

John reviews events in Australian and overseas markets during June.

How did markets perform in June?

June was a difficult month for investors, with falls recorded by all of the world's major share markets.

Limited downside occurred in America where the S&P500 Index fell by just 1.9% in local currency terms. Across the Atlantic, the UK's FTSE100 Index suffered a fall of 6.4%. European markets were also weak with the German, French and Italian markets all down by around 4%. In Asia, Japan's Nikkei Index recorded a return of -3.1% while China's Shanghai Index fell by 5.5%. Overall, the MSCI All Countries World Index returned -2.7% in Australian dollar (AUD) terms.

The return of the Australian share market was also negative with the ASX200 Accumulation Index falling by 5.3% in June. The weakness was widespread with all industry sectors losing ground. The most resilient stocks were Listed Property Trusts, Telstra and selected companies within Financials (such as Commonwealth Bank, Macquarie Bank, Suncorp and IAG). The Consumer Discretionary sector was the worst performer, due in part to a profit downgrade by Flight Centre.

What were the key factors driving global markets?

Concerns that Greece would default on its end of month loan repayment to the International Monetary Fund, and possibly leave the eurozone, unsettled markets in June. These concerns and subsequent market volatility grew as the month unfolded, and proved to be well-founded, as Greece failed to repay the 30 June loan. Market uncertainty was accentuated by the suspension of talks between Greece and its creditors following the Greek government's unexpected decision to hold a referendum on 5 July regarding the terms of a proposed bailout package.

Markets have since recovered some of the lost ground but the situation remains uncertain. That's why investors should be prepared for more market volatility.

However, it's worth remembering some facts that help counter what looks like a gloomy situation.

- Firstly, the economic fallout from a Greek default and possible exit from the eurozone is likely to be limited because Greece represents only 2% of the European economy and is just 0.3% of the world's economic output.
- Secondly, the European Central Bank's massive quantitative easing (QE) program will help shield the eurozone from the consequences of a Greek default and possible exit from the eurozone.
- Thirdly, compared to when this crisis began a few years ago, European banks have a much lower exposure to Greece.

How was the 2015 financial year for investors?

Despite a range of market and economic challenges that unfolded during the year, 2015 was another good year for investors. Market returns were broadly positive, especially for Australian listed property, which returned 20.2% for the year, and unhedged global shares, which was up 24.3%.

The Australian share market returned just 5.7%, underperforming most developed markets due to the weak performance of resources and energy companies. Unhedged global shares outperformed hedged global shares by a wide margin because the AUD was down by 18.3% versus the US dollar.

Bond market returns were comparatively modest with interest rates around the globe at or close to historic lows. In this environment, cash rates are very low, forcing many investors to look for alternative sources of income. Some sections of the Australian share market offering sustainable or growing dividends benefited from this search for income. However, dividend growth from here is likely to be small in magnitude because many companies are already paying out a high proportion of their earnings as dividends and earnings growth should be low in the next year or two.

The positive market returns occurred against a mixed economic backdrop. Central banks in Australia, Europe, Japan and China were forced to provide stimulus via lower interest rates or QE in response to sluggish or declining economic conditions. In contrast, stronger economic conditions in America and the UK will lead at some stage to higher interest rates in those countries.

As for MLC portfolio returns in the year to 30 June, investors have enjoyed another good year. Based on preliminary pricing data and before fees and tax, the MLC MasterKey Super Horizon 4 and 5 funds returned 11.8% and 13.1% respectively. The MLC MasterKey Super Inflation Plus Assertive portfolio returned 18.4%, also before fees and tax.

How are MLC's portfolios positioned?

We remain in an environment where we believe our portfolios should be defensively positioned. This is because the global environment is so uncertain at a time when the valuations of many traditional asset classes and securities are high and return potential from here is low.

This is the kind of environment when the things we do at MLC to manage risk have to be at least as important as the things we do to generate returns.