Economic update

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Brian Parker, CFA
Senior Investment Consultant
MLC Investment Management

Brian reviews events in Australian and overseas markets during October

How have world markets fared over the last month?

We've just finished another great month for share markets. World share prices were up by 3.8% in October – in fact they're up by nearly 20% so far this year.

Here in Australia, share prices were also stronger, up by around 4% over the month.

In the last couple of months emerging markets have enjoyed some very solid gains, despite lagging markets in the developed world so far this year

The Australian dollar gained some ground in recent weeks, so unhedged global shares lagged a little in October compared to hedged global shares.

If we look at fixed income, yields fell in most of the world's bond markets during October, and credit spreads over government bonds also tended to narrow. This meant we saw some solid returns in global bond markets.

In Australia, though, yields rose a little, and Australian bond returns were slightly negative. Markets have become less convinced that the Reserve Bank of Australia will cut official interest rates further, especially since Australia's inflation rate for the September quarter was a little higher than expected.

What were the key events that influenced markets?

The world received another lesson in just how dysfunctional policymaking has become in Washington. After a partial shutdown of the US government and threats that the US government's debt ceiling would not be raised, which could have forced the US Treasury to default, a deal was finally done to reopen the government and raise the debt ceiling.

However, the deal only pushes the problem out till early next year. This is going to remain a source of uncertainty for markets for some time.

In fact, what's been most remarkable about this debacle is just how relaxed world bond and share markets were. We really didn't see big, sustained falls in share prices, or any really sharp increases in US bond yields.

In terms of economic data, the month was a very mixed bag. In Australia the economic news tended to disappoint, but we are seeing signs that housing activity is starting to pick up – so lower interest rates are having an impact.

Generally, the economic news coming out of China, Europe and the UK was better than markets had expected. So was the data from the US, but given that the government was shut down for a large part of the month, the data calendar was a bit thinner than usual.

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The government shutdown is clearly going to have hurt the US economy. That was one of the reasons cited by the US Federal Reserve when it decided to keep its monetary policy unchanged (in other words, to keep on injecting around $85 billion a month into the US financial system, at least for the time being). The massive monetary policy stimulus is continuing to provide very strong support for financial markets.

What's the outlook?

As share markets have climbed over the last year, we've become increasingly concerned that share prices are running too far ahead of the fundamentals. World share markets as a whole aren't cheap, though they still seem to offer better medium term return prospects than either bonds or cash.

In the US in particular (but also elsewhere) share prices seem to have run well ahead of corporate earnings, and indeed well ahead of the likely outlook for earnings.

Share prices have clearly been supported by the actions of the world's major central banks. If that support remains in place, we could still see share markets perform well from here. On the other hand, markets could struggle if that central bank support is withdrawn too soon or too aggressively.

In short, this is an uncertain environment for investors. This is no time to be trying to forecast exactly how the world will pan out from here, or to base investment decisions on those forecasts. It's a time to be as well diversified as possible and to be very focused on managing risk.

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