Economic update

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Ben reviews events in Australian and overseas markets during February

How did markets perform in February?

Despite some weakness that continued on from late January, global markets generally did well last month. Overall, global shares advanced just over 3.5%, US shares were up a little over 4% and Australian shares worked through reporting season to deliver 4.3% to investors.

Global bonds were steady and the Australian dollar inched up to 90 US cents.

How is the global economy faring?

I think it's difficult to read the global economy on a month-by-month basis. The noise in short term data and high frequency of some key releases can make it hard to see the forest for the trees.

But taking a step back and looking at themes over a longer period can make things a little clearer. If you take that perspective then it's fairly clear that key developed economies are muddling through for now. Growth in the US is OK, but less impressive than you'd expect in a recovery. The UK is making some progress, but risks blowing a bigger credit bubble.

Meanwhile, Japan is trying to reflate its economy but is finding it hard to make the structural reforms necessary for robust growth. In the emerging world, China's fairly new leadership seems well aware of the risks building up from over a decade of unbalanced growth and a rapid expansion of credit, and has begun focusing on important reforms.

This is not an easy task but I'd say it has a greater chance of succeeding under China's command-structure economy.

How is the domestic economy faring?

If you exclude the export boost we get from trade with China, Australia is not too different to other developed economies. Growth is sub-par and hamstrung by high levels of private debt, and employment is weakening. On the other side of the coin, historically low interest rates are stimulating housing demand and spurring building activity.

The real macro picture is better when you include the trade impact from China's consumption of our iron ore, but this in turn creates an uneasy reliance. The importance of China to Australia's prosperity means that we need to look beyond a hard versus soft landing in China's growth rate. We also need to consider the implications of China rebalancing from a focus on investment to consumption. In our view, this probably means cooling growth for Australia's exports and a lower terms of trade. This is not necessarily a bad thing for the economy as it will temper the exchange rate, which should help rebuild some of the sectors hit by a high dollar. Along with this, there's the possibility of a hard landing in China which, coupled with the high private debt burden in Australia, is a scenario that could spell serious trouble for our economy.

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What is the outlook?

The seemingly steady economic progress since, say, the US debt ceiling risk-escalation in October 2013, combined with a low yield environment, has engendered a sense of complacency in global markets and pushed prices higher. Short term shocks are a risk to this complacency – and I think the Ukraine flare-up has focused investors – but longer term, the risks lie more in growth falling short of expectation or an adverse change in inflation. On the other hand, very accommodative central banks and some glimmers of hope, like the potential for US shale gas, mean that markets could well continue to rally.

How is MLC positioned?

Our focus on risk control means that the uncertainty hanging over markets – combined with low yields and elevated equity valuations – leads us to a defensive positioning, especially for the MLC Inflation Plus portfolios. Exposure to foreign exchange remains an important source of risk control, but we have progressively trimmed exposure to straight shares and emerging markets. At the same time, we are trying to maintain as much exposure as possible to sources of return that have limited downside.