Economic update

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John reviews events in Australian and overseas markets during November.

How did markets perform in November?

After recording strong gains in October, share market returns were more subdued in November. The best returns in local currency terms were in Europe where the German and French markets rose 4.9% and 1.2% respectively. Small returns were recorded by the US and UK share markets. America's S&P500 Index increased 0.1% while the UK's FTSE100 Index fell 0.1%. In Asia, Japan's market was a robust performer with the Nikkei Index returning 3.5% in November. However, Hong Kong's Hang Seng Index fell 2.8% while the Shanghai market was up 1.9%.

Australia's share market lost ground in November with the S&P/ASX200 Accumulation Index returning -0.7%. As in previous months, the weakness of resource and energy stocks was the main contributor to our market's negative return. BHP Billiton was a major drag on the market's performance. Its share price fell 21.4% in November in the aftermath of the mine disaster in Brazil and growing market doubts that the substantial fall in the price of iron ore and its impact on earnings could force BHP to abandon its progressive dividend policy. Elsewhere in the resources market, Rio Tinto fell 9.4%, gold miner Newcrest Mining was down 11.4% while South32 fell 18.8% to new lows since its listing in May this year.

In the year to 30 November 2015, market returns were varied though we saw a continuation of themes that have been in play for some time. European markets delivered strong returns with the German and French markets returning 14.0% and 12.9% respectively in local currency terms. Japan's market was another strong performer where the Nikkei Index increased 13.1% over the year. As we observed last month, these are regions where there have been significant quantitative easing (QE) programs in place to revive economic growth. In contrast, America's share market return barely made it into positive territory. The 0.6% increase recorded by the S&P500 Index reflects an aversion by investors to the market's overvaluation at a time when there are concerns that earnings momentum will slow.

Australian investors in global shares who have had an unhedged global shares strategy have benefitted from the weakness of the Australian dollar (AUD). In the year to 30 November, the AUD fell 15.0% against the US dollar and 11.8% versus the yen.

Australia's market underperformed many of its global peers in the year to 30 November. The S&P/ASX200 Accumulation Index returned 1.9% over the year. As we have commented before, the pronounced weakness of resource and energy companies was the major cause of this modest return. Bank stocks were also weak over the year due to substantial equity raisings to satisfy new capital standards and concerns earnings and dividend momentum would slow.

What were the key factors driving global markets?

Monetary policy continues to be an important influence on markets. It's no coincidence that some of the best performing markets, namely Japan's and selected markets in Europe, happen to be where there are significant monetary stimulus programs in place. The impact of these programs may be ongoing. For instance, expectations are growing that the European Central Bank will shortly announce that its QE program will be broadened and extended. This could see the euro weaken further, which should be positive for European exports and the eurozone economy, which is improving slowly.

It's worth noting that, despite the extraordinary monetary stimulus measures that have been in place for some time, inflation in Europe and Japan has been declining (as it has also in the US and the UK) and economic recovery has been slow and fairly modest. While QE has produced asset price inflation, as we have seen with share and bond prices rising over the last few years, the flow through into the real economy has been limited.

Elsewhere in the world, China has taken its own steps to support its economy by reducing official interest rates and banks' reserve requirements. In contrast, the US Federal Reserve is poised to raise rates though this is indicative of America's robust economic fundamentals, unlike many other parts of the world.

What is the outlook from here?

The market volatility we have seen in the last few months reflects the uncertain environment we are in. Looking ahead, we believe a cautious approach is warranted. While the global economy continues to grow, thanks largely to the US economy, expectations have been revised downwards. Rightly or wrongly, the timing of an interest rate rise in America remains a short term obsession for markets.

From an Australian perspective, developments in China remain of greatest importance. China is the largest or second largest buyer for eight of Australia's top 10 exports so what unfolds in China's economy has a direct bearing on us. China's intention to adjust the drivers of its economy away from capital intensive activity (such as infrastructure construction) to a consumer and services orientation will have obvious implications for our economy in the coming years. This is occurring at a time when the prices of our major exports such as iron ore have fallen, although volumes are holding up well, and the peak of the mining and energy capital spending cycle is behind us.

How are MLC's portfolios positioned?

At MLC, we work continually to evolve our portfolios as the investment environment changes and opportunities arise. That's why in November we changed our high yield fixed income manager arrangements. We have high yield bonds in our portfolios because in some market conditions, they offer attractive returns that more than compensate investors for their risks. We've removed one of our high yield managers, W.R. Huff, and reallocated to one of our existing managers Loomis. Loomis is a well-credentialed and experienced manager of fixed income, with the capability to manage across a broad range of high yield sectors in developed and emerging markets. We believe this change of managers will increase the diversity of our clients' high yield investments, further increase our ability to deliver more stable returns and improve our ability to respond to changing market conditions.

Despite better returns from markets in the last couple of months, we continue to manage our multi-asset MLC Horizon and Inflation Plus portfolios in a defensive manner. While the recent share market falls have created better value opportunities, the current environment presents some significant challenges and they still outweigh the positives. It goes without saying that if markets decline further, buying opportunities may start to outweigh the risks and we may consider increasing our exposure to shares to exploit return opportunities.

For the moment though, our focus remains on managing risk by defensively positioning our portfolios.

And on behalf of my colleagues in the investment management team, I'd like to wish you a very happy Christmas and a fantastic new year.