# MLC's view and Strategic Overlay positions

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After a year of double-digit equity market returns plus some strong returns in the riskiest bond markets, investors may be asking whether the developed world's problems are largely solved.

Equities indices are up, bond indices are up, sentiment is up (and the VIX down), commodities are up and the AUD is stronger. But are things really as benign as this market behaviour suggests? Is risk really lower now than it was 12 months ago, and what can we expect in 2013?

To get an idea of what may happen in 2013 we need look no further than the strong markets of 2012. In 2012 the key driver of returns was not economic fundamentals, but the weight of money driving investors out of less risky assets (as yields shrank to nothing) and into riskier assets. The lower yields are and the longer these levels are expected to persist, the higher the prices of riskier assets are encouraged to go. This basic factor was the primary driver of returns during 2012 (as discussed below, this outcome was reflected in our QE3 scenario).

Looking to 2013, we observe that this driver has increased in strength (and the QE3 scenario, renamed "Extended quantitative easing" or "EQE", remains highly relevant). The increased strength of this driver comes from the US Federal Reserve, which will continue its unconventional monetary stimulus until the unemployment rate declines sufficiently (and assuming inflation remains below 2.5%). The Bank of England is taking a similar tack, and through 2012 the ECB became more flexible and increased its financial accommodation. Greater accommodation is also anticipated from the Bank of Japan. In short, monetary policy has become more accommodative, which provides support for a continued rally in risk assets.

This presents us with a difficult balancing act. While there is clear potential for another year of strong returns, and while there has been some stabilisation as the very accommodative policies reduce the interest burden, the basic problem of reducing debt levels has not been resolved.

US policy makers have so far managed to muddle through and reduce the fiscal and current account deficits while maintaining economic growth. The immediate dynamics of the situation are looking less worrying, and there may be the prospect of stabilisation if (which is not certain) the economy continues to grow and interest rates remain low. Once stabilised, however, there is still the hard work of reducing debt levels. And stabilisation of public debt requires both further austerity and continued growth—a difficult task for policy makers. These are huge hurdles and policy makers would, we suspect, welcome help from a 'contained' rise in inflation—an even more difficult and dangerous policy challenge.

### What is Strategic Overlay?

- The process we use to make adjustments to our portfolio asset allocations.
- We base these adjustments on our medium-term assessment of the market environment.
- Our assessment of return potential, risk and diversification relies on comprehensively assessing what the future might hold. By considering a range of potential futures (or scenarios) we can build a deeper understanding of risk and generate more reliable returns with the required risk control.
- We contemplate what might go wrong and what might go right, and assess how reliably (or not) different asset allocations will help achieve our investors' objectives. We'll generally reduce exposure to assets if we believe they have high risk that is not matched by a commensurately high return. We prefer exposures with limited downside risk compared to upside potential.

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Elsewhere there is also progress of a sort, notably in shrinking peripheral European current account deficits. However, this improvement is not the result of increased competitiveness but of a collapse in demand. The inability of peripheral European economies to devalue their currencies (without exiting the Euro) means that the adjustment process is far longer, slower and more painful. In these countries, significant further adjustment in wages is required to restore competitiveness and get their economies growing rather than continuing to shrink. Structural reform is fastest in Ireland and there are encouraging signs in Spain. Elsewhere, competitiveness remains rock bottom, which means demand must remain depressed until this changes. The good news is that in aggregate the Eurozone is not increasing its borrowings, but nor is it repaying the outstanding debt. It still has to roll its massive debt stock, which will continue to create risk and the potential for new crises.

And it's not just the debt burden in itself that is an issue, but the global distribution of debtors and creditors. The creep toward higher indebtedness in the developed world has been in train for a long time. The US ceased being a net creditor to international markets in 1985 and now owes roughly 27% of its annual GDP to foreigners; the UK followed in 1995, crossing from creditor to debtor, and now owes nearly 17% of its annual GDP to foreigners. Both the US and the UK may increase foreign indebtedness further, but external debt cannot grow faster than GDP indefinitely. On the other side of the ledger, too much external investment—especially if heightened by lack of domestic opportunity—is also unsustainable. Japan can attest to this.

The overriding de-leveraging theme and regional imbalances are related components of a long phase credit cycle. What has become confounding since the crisis is not so much the growth-crimping impact of transitioning from leveraging to de-leveraging, but (as already mentioned) the stimulus to risk assets from unorthodox monetary policy. Deleveraging and foreign funding imbalances are long-run themes that have long-run implications for markets. The medium term, however, is much more nuanced and grounded in contemporary policy changes.

The macro-economic environment remains complex, difficult and challenging, but perhaps the biggest risk investors face is that of asset bubbles. There is undoubtedly a bubble currently in global bond markets which is spilling over into other assets. Assets that offer relative safe havens are progressively being consumed by this bubble.

The bubble environment may run and run. And it will be welcomed by investors. This may be a difficult time for risk-aware investors such as ourselves. Before 2007, investors tired of our incessant talk about risk and the possibility of a risk scenario emerging. We may be getting into a similar situation today. And the old adage 'don't fight the Fed' may assume even greater meaning for us. The monetary stimulus-driven rally may be of such long duration that the market may eventually be convinced to stop worrying about risk. However, ultimately returns must be supported by the underlying economic fundamentals; monetary stimulus may prove to be hot air which ultimately subsides. How it subsides will depend on both the course of the real economy and how far out of line asset prices get with fundamentals.

While the US muddle-through is encouraging, the risks are numerous. There is still ample opportunity for policy mistakes. For instance, investors' tolerance for ultra-low yields, with debt levels still rising and inflation worries below the surface, is unknowable. Central banks can control cash rates but their influence on bond yields is less direct (though the Fed's bond buying program has increased control).

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## 2012 scenarios in review

While our scenarios are never designed on a 12 month basis, we recently compared 12-month index returns to return expectations in the MLC scenarios model one year ago. One year is of course too short a period over which to attempt meaningful forecasts—it is too much at the mercy of the fickle flow of individual data points (which are often contrary to the true trend) and investors' emotional responses to these. This makes shorter-term outcomes essentially unpredictable. However, 2012 was a highly distinctive year in which risk asset prices defied the extent of risk, so it warrants review.

We are not surprised that the actual 12 month return pattern mimics one (and only one) of our tailored scenarios: Extended quantitative easing, or EQE (called QE-3 last year). EQE was (and still is) a key scenario within the tailored scenario set.

Outright positioning for QE-3 (betting on a single scenario) would have meant more equities and a higher exposure to the AUD (lower exposure to foreign currencies). If it were possible to know with certainty that this is what the future held then this would have been the correct positioning. The future is never known with certainty and we position portfolios by considering the range of distinctive potential futures. Portfolio positioning depends on tolerance for risk—we seek the highest returns while taking into account what might go wrong and how tolerable that is for investors. This means that we will never bet on a single scenario and that we will always build in risk hedges. The most difficult markets for us are those where share prices depart from the underlying fundamentals. This occurred during the late 1990s tech bubble, and there is potential for a similar experience now, this time driven by the highly accommodative monetary policy.

Looking back, the other distinctive scenarios in our tailored set included the risk of a severe breakdown in Europe, growth risks in China, and stagnation or recession-like conditions lingering in key developed economies. Both deflation and inflation were (and still are) credible scenarios.

In designing our strategy for the MLC Long-Term Absolute Return Portfolio (LTAR), we recognised that positioning against the pervasively high AUD enabled us to maintain a higher exposure to equities than would otherwise have been the case. This in fact has paid off. Not only did we carry a greater degree of certainty about future returns (the benefit of not betting on a single scenario), but global equities returned nearly 20%, while the AUD was only marginally stronger. In other words, while we paid a small amount for increased certainty, we paid in a way that was efficient.

## Looking forward

Now let's think about where we might be in, say, three years' time. In our view, the range of credible scenarios is still as wide as it was a year ago. The threat of a prolonged slowdown in the real economy globally will remain throughout the de-leveraging cycle and austerity pressures will persist until poor fiscal positioning in the developed world begins to change. Europe, while subdued for now, will likely remain a source of risk until significant political, structural and economic (rebalancing) progress is made. At the same time, experimental monetary policy and financial repression can drive asset prices higher, keep bond yields low and the AUD raised for some time. But too much monetary stimulation and the prospect of outright deficit monetisation heightens the risk of a disruptive inflationary outbreak. History warns that this is a risk that we should worry about now. In the near term, ultra-low borrowing costs could discourage private savings, reignite leverage and push against rebalancing, and set a path toward inflation, bust or both. There is a chance, though, that policy and psychology somehow mesh globally to restore balance and maintain growth,

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and that any inflation outbreak remains contained. Such an outcome relies on either productivity gains (mainly from reform but maybe also from technology, eg, shale gas, and further trade liberalisation) to elevate growth. This, together with a dose of stable inflation, is what's required to defeat debt. Unfortunately, while this is in many respects an attractive and benign scenario, higher inflation spells risk for savers.

Setting medium term asset allocation from this thorny starting point is difficult. The wide array of credible near-term environments makes it cumbersome to understand how each scenario impacts the portfolios' ability to meet its objectives. For the most part, complexity remains more static than pricing, so decisions are most influenced by movements in asset class pricing. For now, we believe that exposure to foreign currency continues to provide an efficient source of diversification that partially offsets the loss of diversification from extremely low government bond yields. Stock selection, too, will likely become a more important component of return generation, meaning that private equity – with a very high 'alpha component' – is an attractive allocation that brings with it the benefit of smoother returns.

## Our scenarios

We assess investment strategy using our proprietary Scenarios Model. This comprises both the generic broad set of 40 scenarios we use in designing our neutral asset allocations and current positioning as well as a smaller set of focused or tailored scenarios which adds to the assessment of the current strategy. Both sets of scenarios are used in our Strategic Overlay process.

As with last quarter, we still maintain 13 tailored scenarios that explore in more detail how the current environment may evolve. While the tailored scenarios contain the set of most obvious potential futures, the generic 40 set is more comprehensive and has proved to be a reliable assessor of risk across a broad range of environments. In particular, the generic set helps ensure that not too much emphasis is given to the most obvious and immediate issues, and reduces the risk that less obvious, but in fact important, factors and paths are overlooked.

In looking at the tailored scenarios, it seems to us that the most credible transition paths to growth normalisation are still likely to involve an inflationary resolution of the debt overhang and a significant contribution from high growth markets. However, we also take into account the potential for decisive reforms to restore growth potential faster than is currently anticipated. The prospect of austerity-fed deflationary scenarios is also captured within the set.

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**The following tailored scenarios are current at 31 December 2012 and are shown in order from highest probability to lowest probability.**

| Scenario | Probability | Description |
|---|---|---|
| Two speed recovery | Higher | Asia continues to over-invest while the developed world more or less continues to stagnate or at best, achieve only modest growth. Could evolve into a three speed economy or precede a hard landing for China. This scenario is differentiated by economic behaviour of emerging markets and Australia (by virtue of the continued investment in fixed assets). This is a strong scenario for both the Australian economy and the AUD. Demand for bulk metals remains high, with supply continuing to lag. Energy demand is also high, as is the demand for industrial metals. |
| Extended quantitative easing | | Central banks of the US, UK and Japan continue to print currency. The ECB also embarks on quantitative easing. This scenario includes the impact of expanded USD, GBP, JPY and EUR liquidity which principally finds its way into asset prices, rather than spurring consumption. Bubbles are particularly pronounced for high growth economies (Asia and even Australia) and real assets as investors seek inflation protection. The AUD remains very strong against major trading crosses. China continues to maintain a closed capital account but tends to accept more foreign direct investment. Sourcing these funds externally—rather than from within China—could act as a 'backdoor bailout' of China's poorly performing projects from the 2008/9 stimulus. |
| Three speed global economy (China soft landing) | | The world splits into three distinct economic growth zones. China and other emerging markets continue to grow strongly, the US grows below trend (but is not woeful), while Europe stagnates. This scenario is a variant of the two Euro-scenarios that do not involve a break-up. The key difference is that the US and emerging markets do not suffer as distinctly as they do in the Euro-specific scenarios. In other words, the trade disruption assumed in the other scenarios is augmented by increased ex-Europe international trade—Europe is essentially excised and isolated. Greater domestic activity also plugs the output gap to a degree. |
| One speed slow growth world | | There is growth convergence as persistent slow growth in the developed world spills over into the emerging world. |
| Early re-leveraging | | Low yields and a period of policy stability prompt a resumption of credit growth in developed economies. Economic growth picks up more quickly than expected and unemployment recedes. Debt imbalances begin worsening again as the developed world quickly re-levers and Asia focuses on investment. This scenario could precede an inflation shock, a second crisis or, if policy makers are nimble enough, a transition to a mild inflationary resolution. |
| Developed market austerity, recession, stagnation | | A distinctive and hence important scenario. Prolonged deleveraging of both the private and public sectors combined with lack of policy reform removes growth potential for developed economies. This scenario is not dependent on a particular European outcome, but simply assumes that the environment is highly constrained. Developed market economic expansion is negligible and emerging markets slow down significantly but avoid a crash. Equities perform poorly. Commodities fall. Nominal yields rally further and remain low. |
| (Mild) inflationary resolution | Lower | Monetary stimulus and some form of resolution for Europe are combined with sensible policy to stimulate growth. Widespread USD, GBP (and Euro) liquidity provides inflationary pressure that is countered to a degree by slightly sub-capacity growth … a very fine balance, and as such a very low probability. Inflation is high enough to help inflate away the debt burden. Emerging markets experience more severe inflation than the developed world, slightly normalising the growth differential across the emerging markets/developed markets divide. |

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| Scenario | Probability (Higher ↑ Lower) | Description |
|---|---|---|
| Reform | | A growth upside scenario contingent upon coordinated reforms that address inefficiencies that are idiosyncratic to particular economies (eg labour in the UK, infrastructure in the US, sector contribution to growth in China and structural issues in the Eurozone). This is an unlikely scenario, but is possible and has distinctive growth outcomes. Most economies return to trend growth with moderate inflation. |
| China hard landing | | A combination of poor allocation of capital, greater than anticipated loan losses, lower external demand, currency appreciation and monetary policy error causes a crash in Chinese output. This most likely emanates from a property crash, though failure to contain inflation and/or social unrest are also possible flash points. Australia suffers severely under this scenario (recession). Income is shocked and the AUD corrects to sub-PPP rates. This causes a flow-on impact through to employment (weakness) and housing crashes. Thus, both materials and financials are hit, causing very poor Australian shares performance. Japan and Korea also suffer due to their export trade exposure to China. The US, Europe and the UK are somewhat insulated from the Chinese crash, the main effect being a disruption to imports. |
| Inflation shock | | Similar to stagflation, though assumed growth is higher. Sharp rise in inflationary expectations. |
| Sovereign yield re-rating | | Low starting yields are a valuation risk for bonds. Yields could rise to more normal levels even in the context of low growth/inflation expectations. High government debt burdens (UK/core Europe/Japan/USA) provide the potential for a bond-vigilante style re-rating of sovereign yields. This is not a likely near-term scenario, but given the low yields and high level of indebtedness as a starting point, there is a risk that the environment could progress to one where apparently safe paper becomes compromised. This in turn increases the cost of funding and reduces corporate activity. At the same time, government spending is curtailed by enforced austerity in an effort to limit yield increases, remain liquid and stay solvent. This may be a precursor to a 'Prolonged stagnation' scenario. |
| Stagflation | | With no roadmap for the withdrawal of policy stimulus, the inflation risks from quantitative easing may be much bigger than are currently appreciated. In this scenario, policy stimulus is not withdrawn fast enough, perhaps coupled with increased policymaker tolerance for an inflationary work-out which gets out of hand. Run-away inflation in this scenario is likely to be negative for real growth, which could in turn lead to 'stagflation'. |
| Extended risk aversion | | A generic scenario to capture prolonged aversion to risk. |

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## Our current positioning

Unconventional monetary policy is distorting all major asset classes, particularly currency, bonds and equities. These distortions mean that risk-aware strategies (such as LTAR), need to accept a lower prospective return in order to avoid taking unacceptable risks. Greater participation in genuinely uncorrelated strategies and benchmark-agnostic investing help, but do not fill the gap entirely. On the other hand, our more peer-aware portfolios (the MLC Horizon Series and MLC Index Plus portfolios) benefit not from large changes in asset allocation but by maximising diversification efficiency as much as is feasible.

The Australian dollar remains high and continues to provide sensible diversification in our scenarios model. Because of this, we have significant exposure to unhedged foreign assets within LTAR and remain overweight to foreign currencies across MLC Horizon 2 to MLC Horizon 7. Our positioning against the AUD does not mean that the scenarios process "expects" the Australian dollar to fall—indeed, two of our tailored scenarios expect the dollar to rise (others expect the AUD to fall, and by a greater amount). Instead, the model suggests that the AUD is an efficient source of diversity that decreases overall risk, allowing greater exposure to other sources of risks than we would otherwise have carried in the portfolios. In short, in many scenarios the AUD is a perceived safe haven that turns out to be something of an illusion.

Nonetheless, multiple foreign currency devaluation is a legitimate concern against our AUD position. Printing of key foreign denominations (USD, GBP, EUR and JPY) tends to depress their exchange rate against the AUD. To help address this, we have searched for alternate currencies that are both undervalued against the AUD by traditional measures and carry less devaluation risk. The Canadian dollar falls within these specifications. Currently, the CAD trades near parity with the AUD, while the purchasing power parity valuation of the AUD/CAD rate is $0.80. Currency debasement risk, while not zero, is lower for the CAD than other major currencies as Canada has begun to raise rates from crisis lows. Importantly, the export drivers of Canada are different in both composition and destination to those of Australia. Canada's commodity exposure is focused on the energy complex and precious metals, with most exports going to the US, while Australia's is driven by iron-ore and coking coal to China. Our scenarios model supports a short AUD/long CAD position as an efficient means of currency diversification for LTAR, and we initiated a small position this quarter (2%).

## MLC Long-Term Absolute Return Portfolio

The risk profile of LTAR remains somewhere between MLC Horizon 4 and MLC Horizon 3. However, LTAR's absolute return focus means that the portfolio's positioning is very different to that of the MLC Horizon Series and so performance in any specific scenario compared with the Horizon Series of portfolios is quite variable. The opportunity for diversification has been progressively shrinking as relative safe havens are progressively being consumed – this is the current challenge in positioning LTAR. We continue to seek to enhance return potential while controlling risk exposure.

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## MLC Long-Term Absolute Return Portfolio

| | MLC Long-Term Absolute Return Portfolio weights | | Comment |
|---|---|---|---|
| | Decrease | Increase | |
| Australian shares | | | Steady allocation |
| Global shares (unhedged) | | X | We continue to prefer unhedged global equity exposures. This is for risk control reasons, appropriate on the basis of an exceptionally strong local currency and significant global uncertainty |
| Global shares (hedged) | X | | |
| Defensive global shares (unhedged) | | | Steady allocation |
| Emerging markets strategy | | | Steady allocation |
| Global private assets | | | Steady allocation |
| Global property securities | X | | Zero direct exposure |
| Global government bonds | X | | Zero direct exposure |
| Australian inflation-linked bonds | | | Steady allocation |
| Global multi-sector bonds | X | | Zero direct exposure |
| Multi-asset real return strategy | | | Steady allocation |
| Hedge funds – Low Correlation Strategy (LCS) | | | Steady allocation |
| Borrowings | | | Steady allocation |

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## MLC Horizon Series of portfolios

Early on in the September quarter we increased the overweight to foreign currencies for MLC Horizon 5, 6 and 7. The change occurred early in the quarter and was flagged in our previous Strategic Overlay update.

| | MLC Horizon Series of portfolios weights | | | Comment |
|---|---|---|---|---|
| | Under | Neutral | Over | |
| **Growth assets** | | **X** | | |
| Australian shares | | X | | |
| Global shares (unhedged) | | | X | We continue to be overweight foreign currencies (underweight the Australian dollar), with an increased allocation to unhedged global shares at the expense of hedged global shares. This is a risk control position, appropriate on the basis of an exceptionally strong local currency and significant global economic uncertainty. |
| Global shares (hedged) | X | | | |
| Global property securities | | X | | Retain neutral allocation |
| Global private assets | | X | | Retain neutral allocation |
| **Multi-asset strategies** | | | | |
| Emerging markets multi-asset strategy | | X | | Maintained |
| Multi-asset real return strategy | | X | | Maintained |
| **Fixed income** | | **X** | | Reduced duration maintained |
| Australian bonds – All Maturities | | | X | 1% overweight (MLC Horizon 4 and 5 only) |
| Australian inflation-linked bonds | | X | | Retain neutral allocation |
| **Global bonds - All Maturities (1% underweight (MLC Horizon 4 and 5 only))** | X | | | 1% underweight MLC Horizon 4 and 5 only |
| Global absolute return bonds | | X | | Retain neutral allocation |
| Global government bonds | X | | | Retain underweight global government bonds and overweight cash |
| Global non-government bonds | | X | | Retain neutral allocation |
| Global multi-sector bonds | | X | | Retain neutral allocation |
| Global non-investment grade bonds<br>• high yield bonds<br>• bank loans<br>• mortgages | | X | | Retain neutral allocation |

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### MLC Index Plus portfolios

The increase in unhedged global equities and decrease in hedged global equities mentioned above for MLC Horizon was also applied to MLC Index Plus (Growth).

| | MLC Index Plus portfolio weights | | | Comment |
|---|---|---|---|---|
| | Under | Neutral | Over | |
| **Growth assets** | | **X** | | |
| Australian shares | | X | | Retain neutral allocation |
| Global shares (unhedged) | | | X | We continue to be overweight foreign currencies (underweight the Australian dollar), with an increased allocation to unhedged global shares at the expense of hedged global shares. This is a risk control position, appropriate on the basis of an exceptionally strong local currency and significant global economic uncertainty. |
| Global shares (hedged) | X | | | |
| Global property securities | | X | | Retain neutral allocation |
| **Debt securities** | | **X** | | Reduced duration maintained |
| Australian All Maturities | | | X | 1% overweight (Index Plus Balanced and Growth only) |
| Australian inflation-linked bonds | | X | | Retain neutral allocation |
| Global All Maturities | X | | | 1% underweight (Index Plus Balanced and Growth only) |
| Global absolute return bonds | | X | | Retain neutral allocation |
| Global government bonds | X | | | Retain underweight global government bonds, and overweight cash |
| Global non-government bonds | | X | | Retain neutral allocation |
| Global multi-sector bonds | | X | | Retain neutral allocation |

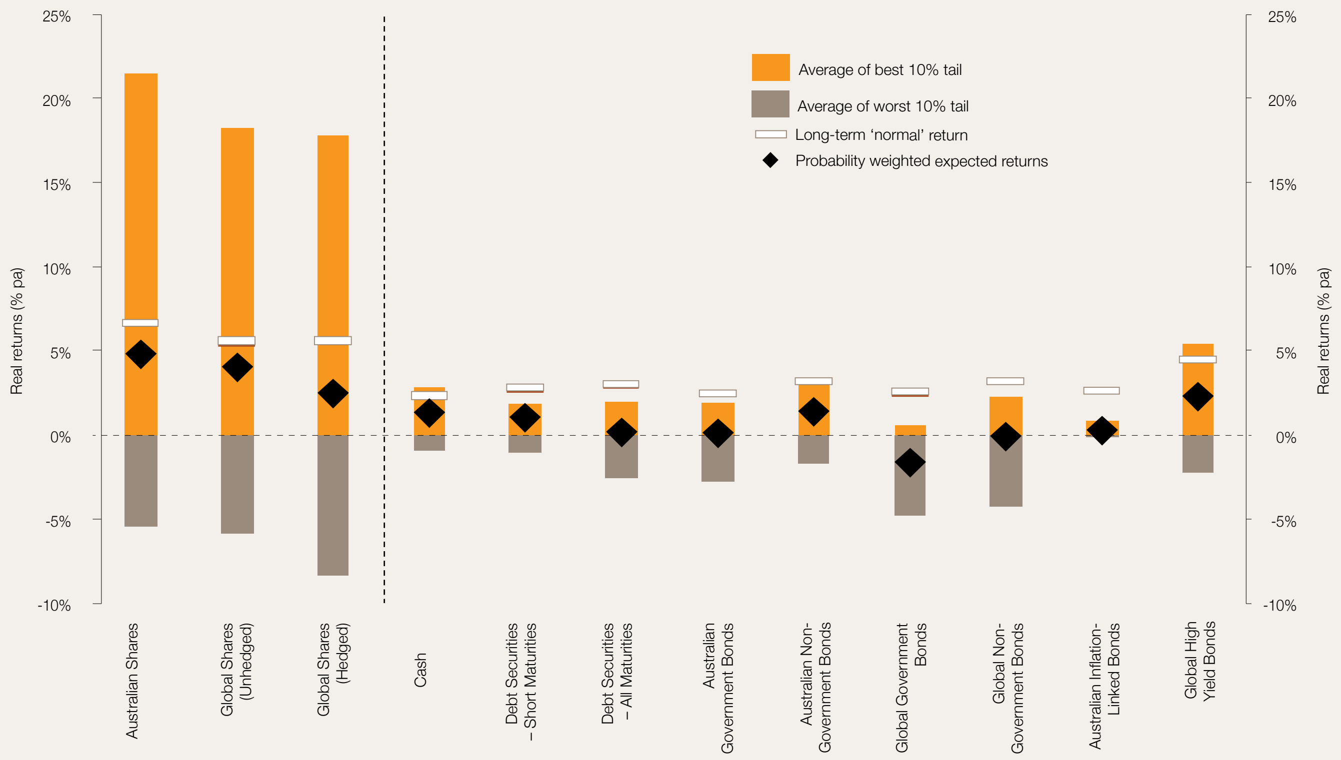
# MLC's view and Strategic Overlay positions

## Return potential

Each of our two scenarios sets gives a perspective on prospective return and risk. The first chart (of the broad 40 scenario set) still shows very compressed return potential from all bond sectors and relatively high risk. The same pattern can be seen in the chart of the smaller tailored scenario set. As the two scenario sets point in the same direction, the implications are clear: bonds remain risky. The longer downside tail for bonds within the tailored set reflects a deliberate emphasis on higher inflation outcomes compared to the broad set. As for equities, the broad set has a more robust skew than the tailored set, where upside is limited and downside more exaggerated. Over the quarter, the return potential for Australian equities shifted down slightly as the market rallied and valuations expanded, while the probability-weighted return for global equities crept up slightly on valuation contraction.

### 40 Scenario Set Probability Weighted Real Returns (December 2012)

(5 years, 0% tax with franking credits, pre fees, pre alpha)




**Source:** MLC Investment Management

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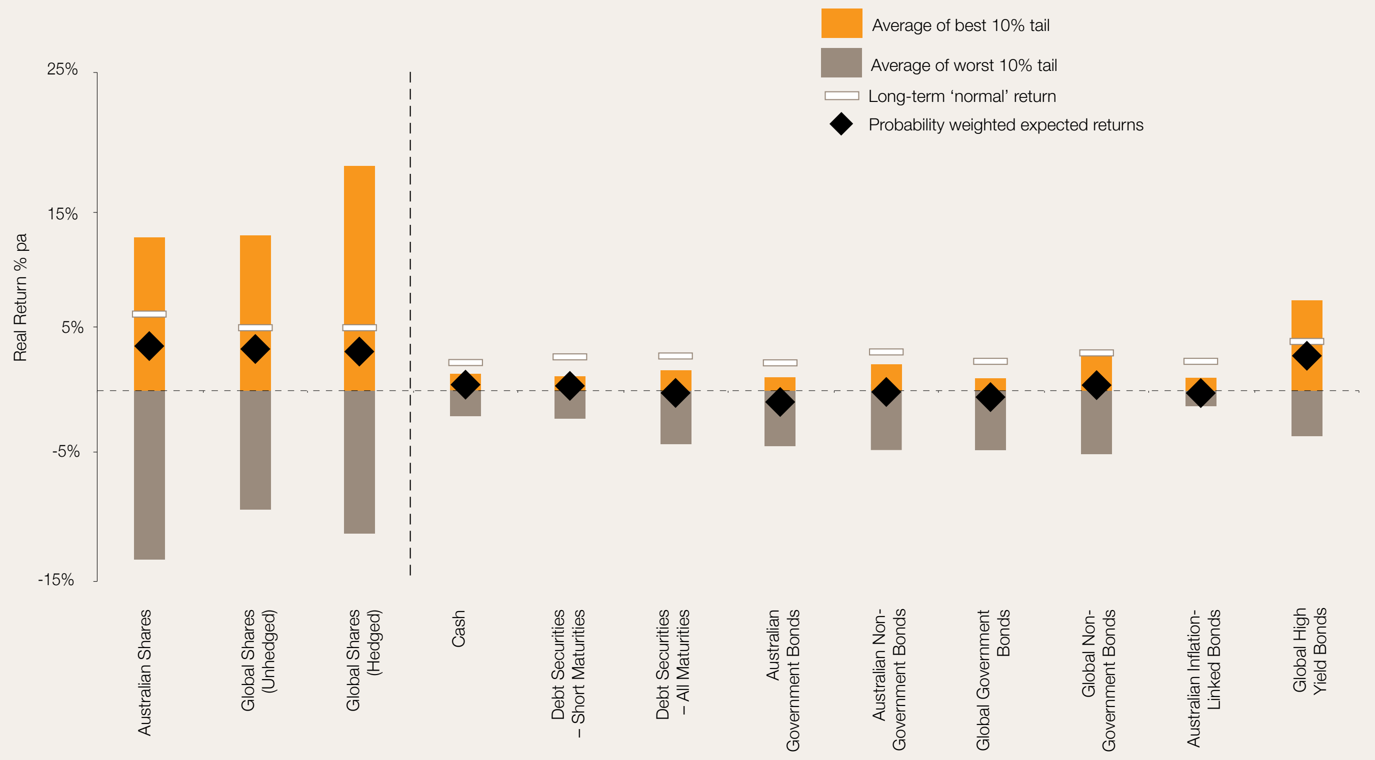
The probability-weighted real returns are shown in the graphs (diamonds). For comparison, we've provided long-term 'normal' return expectations which are set by considering a stable fair value world—these are shown by the horizontal lines. Also, as an indicator of how uncertain these returns are, we've taken the bottom (and top) 10% of the scenario real returns and calculated the probability-weighted average in those 'tail' outcomes. These are shown in the bars.

We've also included a return potential graph for the portfolios in Appendix 1.

**Tailored Scenario Set Probability Weighted Real Returns (December 2012)**

(5 years, 0% tax with franking credits, pre fees, pre alpha)




**Source:** MLC Investment Management

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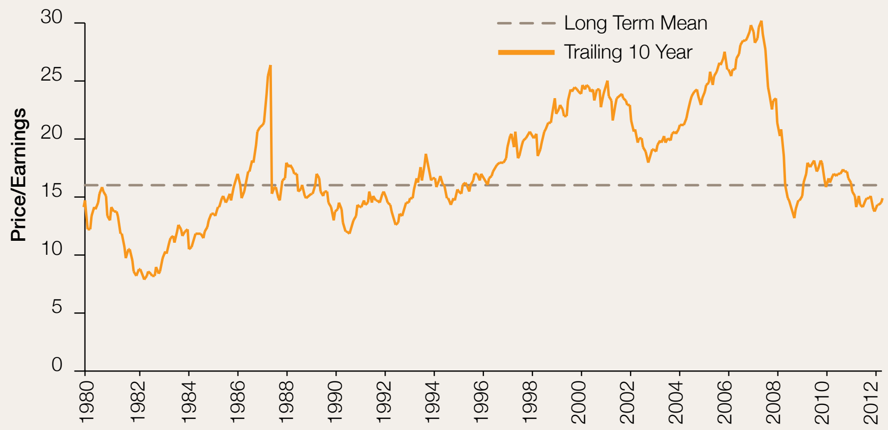
## Asset class indicators

Our view of the main asset classes is as follows.

### Australian shares

#### Market indicator

ASX/S&P 200




**Source**: Datastream

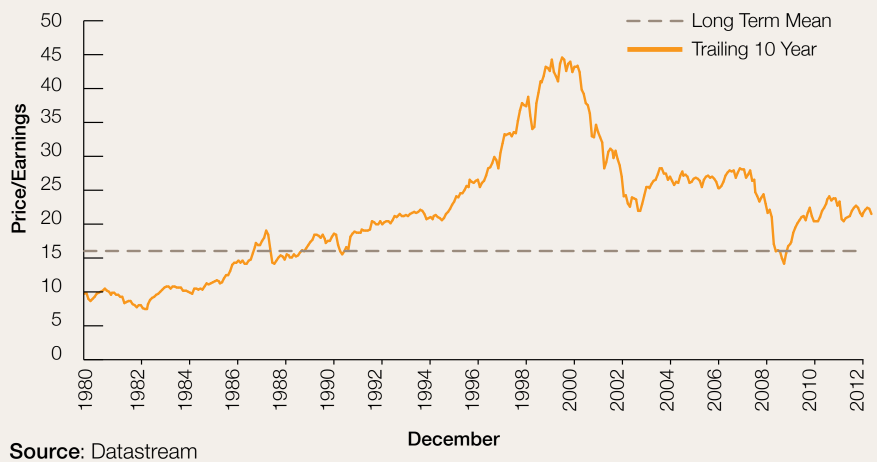
#### Comment

Australian shares continued to rally in Q4, again outperforming global indices. In 2012 there was a P/E re-rating of the market: earnings were revised down while share prices rose sharply. Performance within the market was strongly influenced by the focus on yields. While the market is less attractive than at the start of the year, it remains within a reasonable range of normal valuation levels.

### Global shares (including currency)

#### Market indicator

Datastream World Index




**Source**: Datastream

#### Comment

Share prices continued to rise in Q4, completing a year of strong positive returns. On the other hand, global earnings fell in 2012, evidence that delivering top-line growth is getting more challenging. There is also evidence of downward pressure on margins, which had to happen at some point.

The Australian dollar tends to be correlated with risk appetite. When share markets decline, the Australian dollar tends to depreciate, which partly offsets the decline in global share returns. While there are some changes to correlations in today's unusual environment, there is still benefit in reducing exposure to the Australian dollar to increase the robustness of returns in a number of (though not all) risk scenarios.

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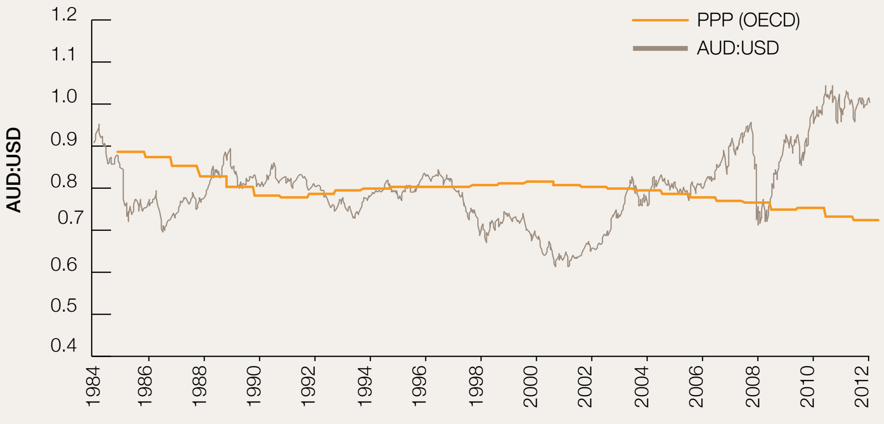
## Asset class indicators continued

### Australian dollar

#### Market indicator

Australian Dollar Purchasing Power Parity

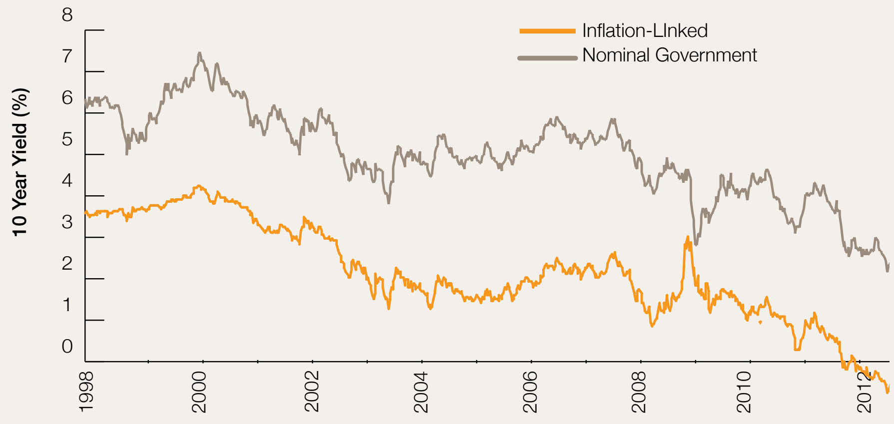



**Source**: Bloomberg

### Global government bonds

#### Market indicator

10 Year Bond Yields – United States




**Source**: Bloomberg

#### Comment

Nominal yields on US treasuries were only marginally higher over the quarter. The Strategic Overlay position to reduce our exposure to global sovereign and instead favour exposure to domestic cash in the All Maturities Debt Strategy detracted from performance during the quarter. We will retain this position given the extremely low level of yields in these markets and the risk of capital loss. This position reflects the increasing risks of spiralling public sector debt, but also recognises that yields will rise if and when confidence in a self-sustaining recovery begins to emerge.

During the quarter we tilted the debt strategies of MLC Horizon 4 and 5 away from global and toward Australian debt, reflecting a perception of lower risks and higher return potential in the domestic market.

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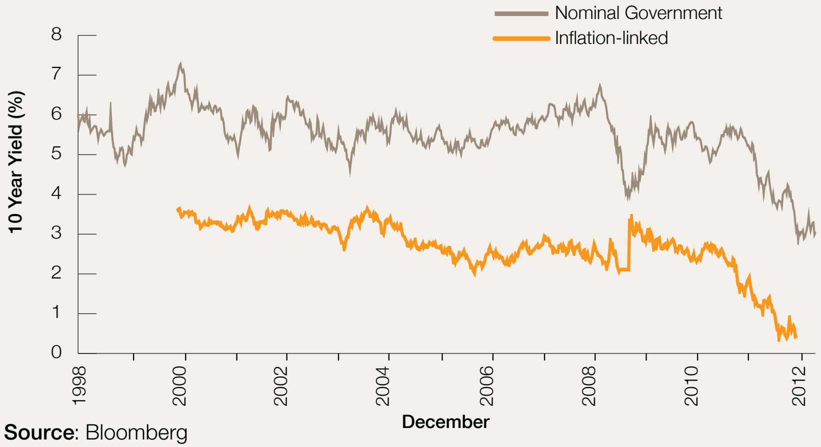
## Asset class indicators continued

### Australian government bonds

#### Market indicator

10 Year Bond Yields – Australia




**Source**: Bloomberg

#### Comment

Australian government nominal bonds inched higher during the quarter following the rise in US yields, while spreads narrowed. This was in spite of domestic economic data, which showed worrying signs that the economy was losing some growth momentum. The negative combination of falling commodity prices and a stubbornly strong AUD are creating growing concern for the economy.

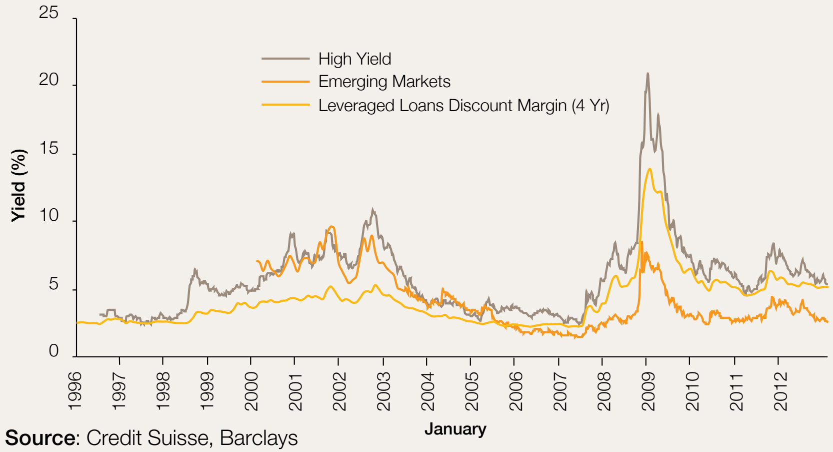
In response, the Reserve Bank of Australia cut the official cash rate by a total of 50 bp during the quarter, with the cash rate falling to 3.0%. This is equal to its historic low, last seen during the GFC in early 2009.

Given the inflation priming by multiple central banks and the prospect of higher inflation from a depreciating AUD, our analysis indicates that domestic inflation-linked bonds remain an attractive asset compared with nominal equivalents.

### Non-investment grade bonds

#### Market indicator

Fixed Income Spreads




**Source**: Credit Suisse, Barclays

#### Comment

Performance across the various credit sectors was solid, in spite of ongoing bond market volatility. US high yield corporate bond spreads narrowed by almost 40 bps during the quarter as investors continued to look for higher yielding assets. Global USD emerging markets also delivered a strong positive return, with relative bond spreads narrowing by approximately 39 bps during the quarter. The solid performance of many credit sensitive assets continues to be due mainly to the combination of relatively low developed bond market yields and confidence that central banks will continue to provide monetary stimulus and keep official cash and government bond rates low.

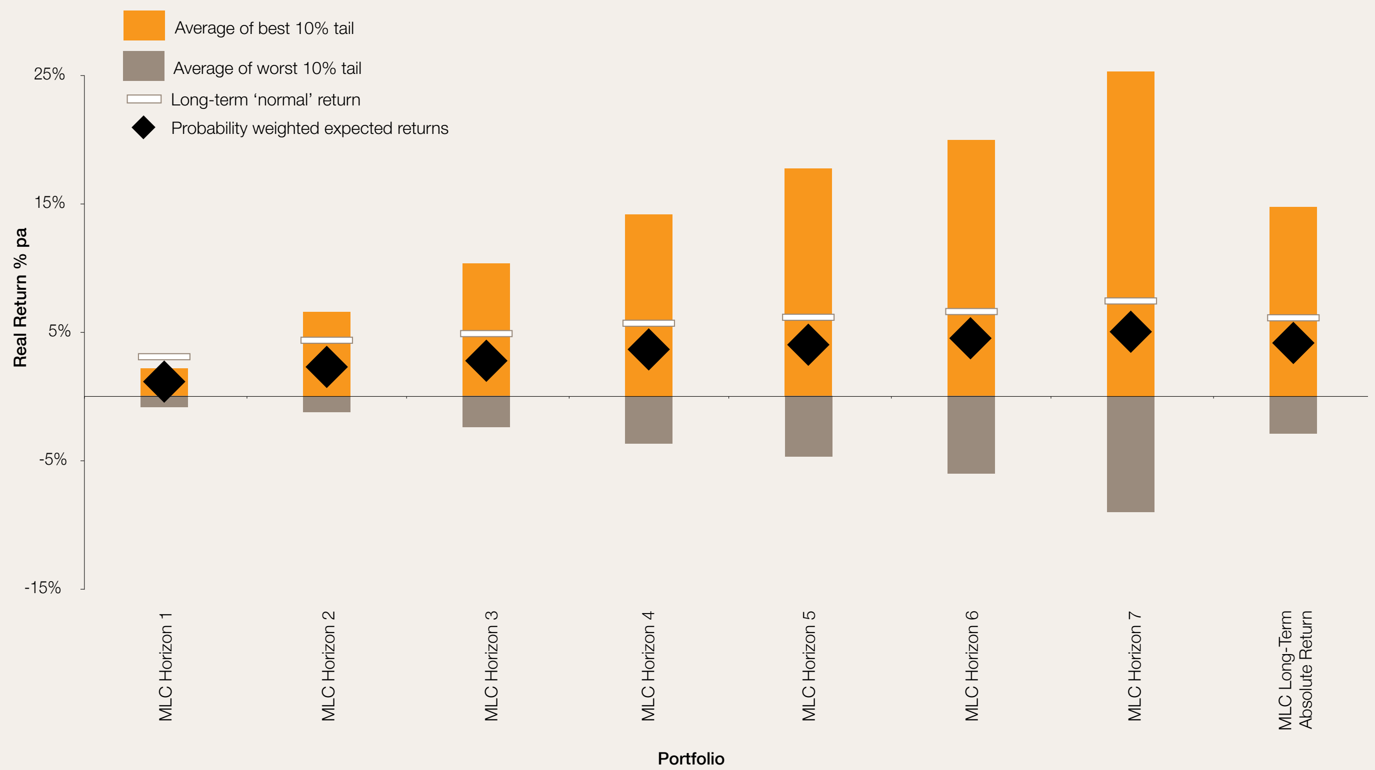
# MLC's view and Strategic Overlay positions

## Appendix 1

Diversified portfolio prospective return potential is below typical levels when viewed from both the perspective of the **broad (or generic) 40 scenario** set and the tailored set. This is primarily due to very low starting yields for debt assets, which are offsetting reasonable (though sub-par) prospective returns from shares.

**40 Scenario Set Probability Weighted Real Returns - Strategic Overlay allocations**

(5 years, 0% tax with franking credits, pre fees, pre alpha)

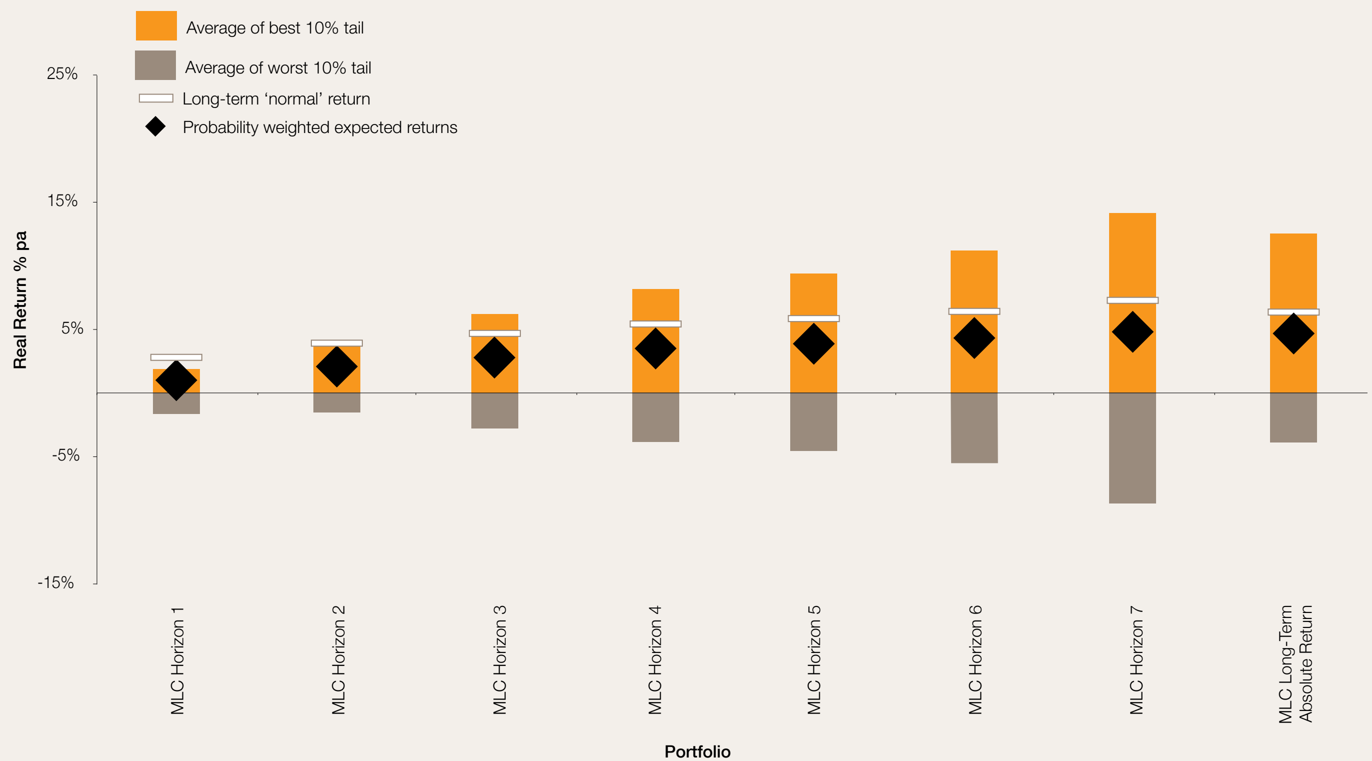



**Source:** MLC Investment Management

# MLC's view and Strategic Overlay positions

**Tailored Scenario Probability Weighted Real Returns – Strategic Overlay Allocations**

(5 years, 0% tax with franking credits, pre fees, pre alpha)




**Source:** MLC Investment Management

Investment Management

## Important information



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