Economic update

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Brian reviews events in Australian and overseas markets during January

Market performance in January

2013 was a terrific year for share markets, but 2014 has started poorly. Share prices across the world fell by more than 3% in January, and emerging share markets fared even worse. Prices in those markets were down by more than 4.5% over the month.

For Australian investors, a weaker Australian dollar provided a boost to unhedged global share returns, but returns were still negative over the month.

Investors clearly don't have the same appetite for risk they had for most of 2013. They opted for safety in January, so gold regained some lost ground and investment grade bonds, particularly government bonds in the major markets, performed very strongly.

Key factors driving markets

Let's focus on three key issues.

First, the US Federal Reserve (the Fed) has started scaling back, or "tapering", its quantitative easing program, and this has been pretty well flagged for months now. The market impact probably hasn't been as negative as some had feared, but markets are still concerned about just how durable the US economy – and indeed the world economy – will prove without the sort of massive central bank support we've seen in recent years.

The second key global issue has been the volatility we've seen in the emerging markets. A lot of these markets were beneficiaries of money flowing out of the US when QE was in full swing. Now that the Fed is scaling back its quantitative easing, we've seen capital flow back to the US.

And a lot of attention has been focused on countries that commentators have referred to as the "fragile five" – Brazil, India, Indonesia, South Africa and Turkey. These are countries that have become heavily dependent on foreign capital. Their currencies have come under severe pressure, and in some cases their share markets have fallen sharply.

Third, and closer to home, any hopes that the Reserve Bank of Australia (RBA) would be cutting interest rates again anytime soon were probably dashed by the December quarter inflation figures. These showed much higher inflation than either markets or the RBA were expecting.

The fact that the Australian dollar has fallen further is another reason for the RBA to keep interest rates on hold.

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MLC's views on prospective returns

As I've discussed previously, at MLC we've been increasingly concerned about world share prices running too far ahead of fundamentals – in particular, too far ahead of corporate profits. Even after the share price falls in January, we still have those concerns, and share markets look – at the very least – fully priced to us.

In bond markets, we did see yields rise in 2013. That made bonds a little more attractive, or at least less unattractive. But yields fell back in January, and future returns from government bonds still look poor.

How is MLC positioned?

Over recent years, we've introduced a number of new strategies into the MLC Horizon portfolios that are designed to better manage risk; in particular, to cushion more of the blow in difficult market environments and to produce more reliable real returns over time.

We're still defensively positioned in world bond markets, given that we still see poor future returns from government bonds. We also continue to favour foreign currencies over the Australian dollar, even though the currency has fallen quite substantially over the last year.

In some of the MLC Horizon portfolios, we've also included an exposure to our recently-launched MLC Inflation Plus portfolios. Those new portfolios are designed to provide a smoother pattern of returns for investors over time and, most importantly, to produce reliable "real", or after inflation, returns. We think exposure to this approach will provide real benefits to investors in MLC Horizon.

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