Economic update

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John reviews events in Australian and overseas markets during May.

How did markets perform in May?

World share market performances were mixed in May. Japan was the best of the major global markets, rising by 5.1% in local currency terms - while the US market delivered a relatively modest gain of 1.3%. Elsewhere, Germany, Hong Kong and Singapore delivered negative returns. Emerging markets also lost ground with Brazil, Russia and South Africa recording the largest falls.

During May, the Australian dollar (AUD) performed poorly against most of the major currencies (excluding the Japanese yen). It was down by 3.3% against the US dollar, 2.9% versus pound sterling and 1.2% against the euro. This weakness was due in part to the Reserve Bank of Australia's (RBA) decision in May to reduce the cash rate by a quarter of a percent to 2.0%.

Overall, global shares managed on an unhedged basis outperformed the return on a hedged basis.

The return of the Australian share market was relatively modest, up just 0.4%. Unlike previous months, resource companies performed well as oil and iron ore prices recovered from recent lows. Aside from materials, healthcare, industrials and property trusts were some of the best performing sectors. However the major banks lost ground, as well as consumer staples (such as Wesfarmers and Woolworths).

What were the key factors driving global markets?

We've commented before that very accommodative monetary policies and historically low interest rates have helped under-pin share prices and the month of May was no exception.

The European Central Bank launched its own quantitative easing (QE) program in March this year while Japan's has been in place for some time. Japan's anaemic economic performance and the slow recovery in Europe highlight the need for monetary stimulus. In contrast, America is expected to commence raising interest rates later this year.

In Australia, the RBA reduced the cash rate by another 0.25% after a similar reduction in February. The RBA took this action because Australia's economic growth is likely to remain below trend for longer than previously had been expected.

While low interest rates and QE have helped markets achieve strong returns in recent years, it also means return potential from here looks very limited. This is because valuations in both share and bond markets are at high levels. Bargains are hard to find.

What about developments in Australia?

The RBA's decision to cut interest rates again is a sure sign that the Australian economy needs a helping hand. The economy is growing but it is below trend growth and has been for some time. Of concern is the continued decline in mining sector investment. Non-mining business investment remains subdued and is likely to remain so into 2016.

Economic statistics released during the month confirmed the immediate outlook for growth is restrained. Wages growth of 2.3% in the year to 31 March was the slowest since 1998 and the unemployment rate increased 0.1% to 6.2% in April. However, it's not all negative. Dwelling investment, exports and consumer spending are growing, as is consumer sentiment.

How are MLC's portfolios positioned?

During the last month, we've made some further changes to our portfolios as we continue to increase their defensive positioning.

In all our portfolios we've again trimmed our exposure to the Australian share market and also reduced our allocation to inflation linked bonds. While we like the inflation protection those securities provide, the reality is that the yields on those bonds are just too low.

In our MLC Horizon portfolios' we increased exposure to the inflation plus strategies because they provide a packaged means of increasing real return potential and helping manage risk. And while we continue to prefer foreign currencies over the AUD, we trimmed our unhedged global shares allocation and put the money into hedged global shares.

Recent falls in the value of the AUD, while positive for the portfolios' returns, weakens the potential benefit of having foreign currency exposure. In the MLC Inflation Plus portfolios, we've made an increase in exposure to defensive global shares and global bank loans.

This month we also made the following changes to our fixed income strategy:

- we've removed global mortgages. Although the sector has performed strongly since we introduced it to our portfolios early in 2010, we believe it's now fully priced and offers limited return potential from here
- we've appointed two managers, Fischer Francis Trees & Watts and Insight Investment Management (Global) Limited, to manage our global absolute return bond allocation, and
- Peridiem has closed its business so we terminated our mandates with them.

This is the kind of environment when the things we do at MLC to manage risk have to be at least as important as the things we do to generate returns.