Economic update

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Brian Parker
Investment Strategist
MLC Investment Management

Brian reviews events in Australian and overseas markets during June and over the 2013 financial year

How did markets fare in June?

June was a disappointing month for investors. Share prices fell across most of the world, and bond yields rose, which meant fixed income portfolios suffered another month of negative returns.

Apart from cash, the only major asset class to produce a positive return for the month was unhedged global shares, which benefitted from a sharply weaker Australian dollar.

While we've had a disappointing end to the financial year for investors, it's important to remember that the past twelve months have produced very strong returns from share markets. All the major asset classes produced positive returns for the year, but it was share markets that really delivered.

Why have share markets been so strong this year?

I've talked a lot in previous updates about how share markets have been supported for some years by the extraordinary monetary policy measures, or "quantitative easing", implemented by the US Federal Reserve (the Fed) and the Bank of Japan, among others.

The fact that the world economy continues to grow, despite much of Europe either remaining in recession or teetering on the brink of one, has also been positive for share markets. But I think it's difficult to argue that share market returns would have been as strong without that central bank support.

In June, investors became increasingly concerned that the Fed would start to wind back some of its monetary stimulus earlier than previously thought. This caused the sell-off on share markets and the rise in bond yields.

Despite the improvement in the US economy over the past few years, many people have wondered just how markets would react if the Fed did begin unwinding some of that extraordinary support. Could the economy continue to grow if the Fed started to turn off the tap? That's going to remain a big source of uncertainty.

What about the local share market?

In June, Australian share prices fell broadly in line with prices around the world. However, if you look at the return from Australian shares over the last year, it's been close to 23%, which was a terrific result – certainly the best financial year result since before the GFC.

How is the global economy faring?

The economic data released around the world during June has been pretty mixed. Some of the more recent data from Europe have improved a little, and we've also seen some better numbers out of Japan.

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On the other hand, some US data have fallen short of expectations, and China's economic data remain worrying – signs of weaker growth are still coming through.

However, the world economy is growing at a reasonable pace.

What about Australia?

There are signs that lower interest rates are beginning to have an impact. For example, the leading indicators of housing activity are improving.

The weaker Australian dollar will probably take some pressure off some sectors of the economy, like tourism, education and manufacturing.

However, the key question remains: will a recovery in the non-mining sectors of the economy, and in mining exports, make up for weaker mining investment as the huge amount of spending in the resources sector comes to an end? That's still a big source of uncertainty both for financial markets and for policy makers.

What's the outlook for investment returns?

As share markets climbed over the last year, MLC became increasingly concerned that share prices were running too far ahead of the fundamentals (in other words, corporate earnings). This was even though future returns from shares still looked very favourable against those from cash and fixed income. The recent weakness in share prices probably means future returns from shares have improved a little.

As for bond markets, higher government bond yields have improved the future returns from fixed income, but it's important to remember that yields remain historically quite low.

We still believe this is a highly uncertain environment for investors, and being well diversified and managing risk carefully are the most important things to focus on.