Economic update

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Ben reviews events in Australian and overseas markets during August

How did markets perform in August?

Global share prices generally slid, with major global indices down around 1% for the month.

The US market fell 3.5%, Japan was down just under 1% and the UK also fell back, but European shares ended the month higher, which was probably more a reflection of low valuations than a bright outlook.

The riskier end of the emerging world was aggressively sold off. Share markets in Thailand, Indonesia, Turkey and India declined by more than 8% in local currency terms and even more in both US and Australian dollar terms as emerging market currencies weakened.

Meanwhile, in Australia, the local share market moved up 2.5% as both reported earnings and accompanying outlook statements, while subdued, were more or less in line with expectations. Mining stocks continued to recover and contributed most of the gains but some weakness has seeped into the important Industries sector and listed property trusts continued to fall.

Along with global shares, bonds also fell. Yields were up – and therefore bond prices down – pretty much across the globe, especially for longer term bonds. The US 10 year government bond yield has now jumped 1.4% in just over three months, a fairly significant move. Yields on 10 year government bonds touched 3% last week.

On the currency side, the Australian dollar halted its decline against the US dollar and is now trading at 92 US cents.

How is the global economy doing?

In simple terms, this is a glass half full-half empty environment. The optimistic slant is that although economic growth rates are subdued, the change in many economic indicators has been positive across most of the developed world.

This view sees Europe as showing early signs of emerging from recession, progression in Japan, stability in China and continued expansion in the US.

On the other hand, geopolitical risks loom with the situation in Syria and we can't be sure the global recovery is robust enough to sustain momentum in the face of rising bond yields. This is related to the second problem of what I'd term the dilemma of "high prices". Based on fundamentals, or valuations, it's hard to argue that both stocks and bonds aren't expensive.

So what we might be looking at are markets that are expecting a robust recovery, and if it doesn't play out the way markets are priced, then asset values are likely to fall.

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Weakness in emerging markets has become particularly noticeable in the last year or so. But it's important to be aware that not all emerging markets are equal. The economies that have become stressed, like India, Indonesia, Thailand and Turkey, are those that rely on external funding and suffer when capital is withdrawn. On the other hand, self-funded countries with a solid balance of payments position, like China, have actually fared quite well.

How is the domestic economy doing?

The major Australian economic data that came out in August was generally steady. GDP was slightly below trend, but in line with expectations. The good news is that there was no bad news in the balance of payments data.

House prices, though, appear to be on the rise in major centres and this will be a key watchpoint for the Reserve Bank of Australia as it tries to manoeuvre monetary policy through weak demand and a falling currency.

It would be remiss not to mention the election. Tony Abbot's victory probably heralds tighter fiscal policy, but we'll have to wait to see how his policies unfold. And while Mr Abbott was handed a clear majority in the House of Representatives, he'll have to deal with a diverse senate.

What is the outlook for financial markets?

We're on the cautious side. While there's a recovery story that might support share price gains, valuations are high and there are too many unresolved issues to justify increasing exposure to riskier assets like shares – especially when it's hard to find asset classes that produce different returns.

One issue posed by both stocks and bonds being expensive is that it's hard to diversify risk. The tendency that I spoke about in last month's update for stocks and bonds to move in the same direction continued in August.

Foreign currency goes some way to helping out with diversification but with the Australian dollar lower it's not as effective a strategy now as it was previously. Alternative assets and strategies help too.

Our message is to sit tight and manage risk carefully.