Economic update

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John reviews events in Australian and overseas markets during October.

How did markets perform in October?

Share markets performed strongly in October, going some way to recovering the losses of the previous two months.

All of the world's major share markets recorded positive returns in local currency terms. America's S&P500 Index increased 8.3% while the UK's FTSE100 Index advanced by 4.9%. In Europe, Germany's market performed exceptionally well, rising by 12.3% while the French market was up by 9.9%. In Asia, Japan's Nikkei Index recorded a return of 9.8% while the Hang Seng Index in Hong Kong avoided a sixth consecutive negative month by rising 8.6%. In China, the Shanghai market was up 10.8%.

Australia's share market also delivered a positive return with the S&P/ASX200 Accumulation Index rising 4.4% in October. However, this return lagged many global peers. Unlike recent months, the S&P/ASX 200 Energy Index was the best sector performer with a return of 8.0%. This increase was due largely to corporate activity involving Santos and Oil Search rather than a significant recovery in the price of oil. Telecommunications was the only industry sector to record a negative return this month as Telstra's share price was weak for the third consecutive month. However, Consumer Staples also came close to recording a negative return after Woolworths issued a profit warning, which also adversely impacted the price performance of other supermarket operators Wesfarmers and Metcash.

In the year to 31 October 2015, share market returns were broadly positive. America's S&P500 Index was up 3.0% with uncertainty over the timing of an interest rate rise a constraining factor. The best market performers were in Europe and Japan where there are significant quantitative easing strategies in place to help revive economic growth. Japan's Nikkei Index in local currency terms increased 16.3%, making it the best performer amongst developed markets for the second consecutive month. The German and French markets also performed strongly with returns of 16.3% and 15.7% respectively. However, the FTSE100 Index in the UK fell 2.8%. In Asia, Hong Kong's market also lost ground with the Hang Seng Index falling 5.7%. As for the Shanghai Stock Exchange, it was still up by 39.8% in the year despite the pronounced weakness and volatility in recent months. Australia's S&P/ASX200 Accumulation Index was marginally negative, falling just 0.7%, this was again due largely to the price weakness of the Resources and Energy sectors.

What were the key factors driving global markets?

Reassuring comments and action by central banks to ease monetary policy were undoubtedly important factors behind the markets' recovery. During October, the president of the European Central Bank commented that further quantitative easing would be considered if required late in the year to support eurozone growth.

In China, the People's Bank of China surprised markets by reducing official interest rates, the sixth reduction since November last year, as well as reducing banks' reserve requirements and scrapping deposit controls.

In America, the US Federal Reserve's decision to keep rates on hold and its more relaxed commentary about the US economy and global outlook compared to a month ago were also factors behind the market's October revival.

What is the outlook from here?

The share market recovery in October was no doubt welcome news for investors. However, it follows two very poor months in August and September when markets lost significant ground. The recent market volatility reflects the uncertain environment we are in. Conflicting economic data and confusion about when the US Federal Reserve will start raising interest rates, how weak the Chinese economy is, what's going to happen to oil prices, and whether US company earnings have stalled have taken their toll. There is also a growing realisation that the extraordinary monetary policy stimulus in the last few years has certainly led to asset price rises but the flow through to the real economy has been limited.

Caution is also warranted from an Australian market perspective. While recent market falls have improved valuations, the risks for our economy from China's economic slowdown outweigh the positives. China is the largest or second largest destination for eight of Australia's top 10 exports. China's intention to adjust the drivers of its economy away from capital intensive activity (such as infrastructure construction) to a consumer and services orientation will have obvious implications for our economy in the coming years. This is occurring at a time when the prices of our major exports such as iron ore have fallen and the peak of the mining and energy capital spending cycle is behind us.

How are MLC's portfolios positioned?

Even though markets performed well in October, our preference to have our multi-asset MLC Horizon, Index Plus and Inflation Plus portfolios defensively positioned hasn't changed. While the recent share market falls have created better value opportunities, especially in some emerging markets, the current environment presents some significant challenges and they outweigh the positives. However, if markets decline further, buying opportunities may start to outweigh the risks and we would likely increase our exposure to shares to exploit return opportunities.

For the moment though, the focus is on managing risk by defensively positioning our portfolios.