

Economic update

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John Owen
Portfolio Specialist

John reviews events in Australian and overseas markets during December.

How did markets perform in December?

Share markets concluded the year on a subdued note with most recording negative returns in December.

Monetary policy remained an important influence on markets, particularly uncertainty over the timing of a rate rise in the US. Markets were quite weak in the first half of December leading up to the last meeting for the year of the US Federal Reserve's Open Market Committee. At the meeting, the long anticipated decision to raise the federal funds rate, the first rate hike since 2006, was finally made. Markets rallied following the announcement, due in part to positive comments by the Federal Reserve on the US economy and a reassurance that the pace of further upward rate adjustments should be gradual, depending on how the US economy performs.

In a number of cases though, the rally failed to extinguish the lost ground from early in the month. This was especially the case in Europe where expectations had grown of further European Central Bank (ECB) action to broaden and extend its quantitative easing (QE) program. The additional initiatives announced by the ECB early in December fell short of those expectations and market returns remained in negative territory for the month. Germany's market fell 5.6% while France's market was down by 6.5% (in local currency terms). In Asia, Japan's Nikkei Index fell 3.6%. However, Australia's market managed to rise by 2.7%.

In the year to 31 December 2015, the presence and intensity of monetary stimulus programs was also a key driver of market returns. The best performing markets were in Europe and Japan where there are significant QE programs in place to revive economic growth. Germany's market was up 9.6% in local currency terms for the year while the French market increased 8.5%. In Japan, where there are both monetary and government stimulus programs in place to kick start the economy after years of disappointing performance, the Nikkei Index was up 9.1%.

Australia's market struggled to record a positive return in the year to 31 December. The 2.6% rise by the S&P/ASX200 Accumulation Index was the lowest calendar year return since 2011 and this was due largely to price weakness by banks, resource and energy companies.

In the US and the UK where monetary policy has been moving in the opposite direction towards a tightening phase, market returns were weak. The US S&P500 Index fell 0.7% in the year while the UK's FTSE100 Index was down 4.9%.

What is the outlook from here?

The market volatility we have seen in the last few months reflects the uncertain environment we are in. Looking ahead, we believe a cautious approach is warranted. While the global economy continues to grow, thanks largely to the US economy, expectations have been revised downwards. Europe continues to recover but it is occurring slowly. In Japan, despite considerable policy stimulus through 2015, it's still not clear whether it will escape economic stagnation. US growth remains on a firm trajectory but share valuations may not have sufficiently priced in potential earnings headwinds such as higher wage costs and the detrimental impact of the US dollar's strength on export oriented companies.

From an Australian perspective, developments in China remain of greatest importance. China is by far our largest export market and is also important to our other major export destinations (such as Japan and South Korea) so what unfolds in China's economy has a direct and indirect bearing on us. At the time of preparing this commentary early in January, markets had fallen heavily in response to poor manufacturing data in China and the suspension of Chinese stock trading after the market benchmark fell 7% in a day. While China's economic growth rate remains the envy of the world, this short term data reminds us that the adjustment China intends for its economy to one with a greater consumer and services orientation won't always be smooth and could have adverse consequences for us.

How are MLC's portfolios positioned?

We believe managing risk in our portfolios is the key to generating sustainable returns – and in this unpredictable investment environment, we think it's more critical than ever. In December we increased exposure to cash in the MLC Inflation Plus portfolios to improve their liquidity and nimbleness in the current market environment in which almost everything is expensive relative to the risks involved, and almost any scenario could unfold. In such an environment we've focused on positioning these portfolios for preservation of capital.

Despite better returns from markets in recent months, volatility remains high and we continue to manage our multi-asset MLC Horizon and Inflation Plus portfolios in a defensive manner.

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