Economic update

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John reviews events in Australian and overseas markets during August.

How did markets perform in August?

August was another challenging month for investors as share markets around the globe lost ground and displayed considerable day to day volatility. The falls were widespread and in some cases were substantial in magnitude. America's S&P500 Index was actually one of the better performers but it was still down by 6.3% in local currency terms over the month. European markets also performed poorly with the German and French markets falling 9.3% and 8.5% respectively. The UK's FTSE 100 Index was also weak with a fall of 6.7%. In Asia, Japan's Nikkei Index was down by 8.2% while the Hang Seng Index in Hong Kong fell 12.0%.

The most closely watched market was the Shanghai Stock Exchange. Its performance during the month was particularly volatile and despite feverish attempts by the Chinese administration to stabilise the market, it still fell by 12.5% in August, its third consecutive monthly decline. In the three months to 31 August, the Shanghai market has fallen 30.5%. However, this is the same market that increased 13.2% in March and 18.5% in April, so substantial month to month movements is nothing new when it comes to this market.

The Australian share market was not immune to the weakness globally with the ASX200 Accumulation Index falling by 7.8%, its worst monthly return since October 2008. The weakness was widespread with all industry sectors losing ground. Energy was one of the weakest performers, falling by 13.9% as a number of companies reported lower earnings and dividends due to the fall in the price of oil. Bank stocks also underperformed as investors digested recent and current capital raisings by the National Australia Bank and the Commonwealth Bank.

Overall, the MSCI All Countries World Index (unhedged) returned -3.5% in Australian dollar terms in August.

Market returns were mixed in the year to 31 August. The UK was one of the worst developed market performers where the FTSE100 Index fell by 8.4%. America's S&P500 Index returned -1.6% for the year while Australia's ASX200 Accumulation Index was down by 3.2%, which was due largely to the price weakness of resource and energy companies. However, a number of markets have delivered good one year returns. Japan's Nikkei Index increased by 22.5%, while in Europe the German and French markets returned 8.3% and 6.2% respectively. As for the Shanghai Stock Exchange, despite the pronounced weakness and volatility in recent months, it was still up by 44.6% in the year to 31 August.

What were the key factors driving global markets?

Concerns regarding China were the dominant influence on markets in August. Investors have become increasingly worried that China's economy is slowing faster than anticipated and it's not hard to find evidence that this is occurring. Manufacturing activity has been declining for some months, weakness in the construction sector remains a key drag on industrial output and the pace of investment growth continues to decline as China transitions away from a capital intensive economy towards a more consumer oriented model.

China's decision to devalue its currency during the month not only surprised markets but was interpreted, perhaps wrongly, as a sign of a more serious economic slowdown.

Concerns regarding the outlook for other emerging markets, particularly commodity dependent economies such as Brazil, Malaysia, Mexico and Russia also contributed to market volatility.

What is the outlook from here?

We continue to remain cautious of the uncertainties that caused the recent volatility in share markets. We question whether the fall in share markets, while significant, has been of sufficient magnitude to address the overvaluation concerns we have had for some time. As a result, we are hesitant to add more risk to our portfolios.

However, there are some positives that may have been forgotten during the recent market weakness:

- The US and UK economies continue to perform well and growth in the other developed economies such as the eurozone and Japan is either stable or improving, albeit slowly.
- The substantial fall in the price of oil combined with the quantitative easing programs in the eurozone and Japan will help support global growth.
- Aside from their clumsy attempt to stabilise China's share market, the Chinese authorities have a good track record in responding robustly to difficult economic circumstances when required.

How are MLC's portfolios positioned and how have they performed recently?

For some time now our multi-asset MLC Horizon and Inflation Plus portfolios have been defensively positioned. This cautious approach, which we believe remains appropriate, is because the global environment has been so uncertain at a time when the valuations of many traditional asset classes and securities have been high and return potential has been low. In other words, there has been insufficient reward for taking risk.

As a result, we have been focused on managing risk and searching for ways to help insulate client portfolios from significant negative returns. This has lead us to do a number of things such as reducing our exposure to Australian shares, positioning our global shares exposures to benefit from anticipated Australian dollar weakness, being selective in our bond holdings, having higher than average cash holdings and overweighting defensive and liquid multi-asset strategies.

While this positioning hasn't been enough to prevent negative returns for the month of August, it has provided a degree of insulation particularly in our MLC Inflation Plus portfolios where we have significant management flexibility to reduce the risk of negative returns. One year returns to the end of August remain in positive territory, with the MLC Inflation Plus portfolios outperforming similar MLC Horizon portfolios.

Given the current uncertainty and valuation levels, even after the recent fall back, we need to see more attractive valuations before stepping into riskier investment markets. However, depending upon the scenario that plays out and further market activity, it is possible that a buying opportunity may present at some stage.

We believe it is a time to be cautious. We continue to review the risks within our multi-asset portfolios and ensure our portfolios have sufficient liquidity to either increase our defensive or offensive positions in the coming weeks and months.