

The year in review

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‘As we near the end of 2013, it’s time to review the year that was and to look ahead to the New Year.’

Another strong year for share markets

World share markets have performed extremely well in 2013. As the year draws to a close, the MSCI All Country World Index (comprising both developed and emerging share markets) seems on track to produce returns well above 20% for the year for Australian investors. Here in Australia, investors in our share market have enjoyed returns of better than 21% so far this year.

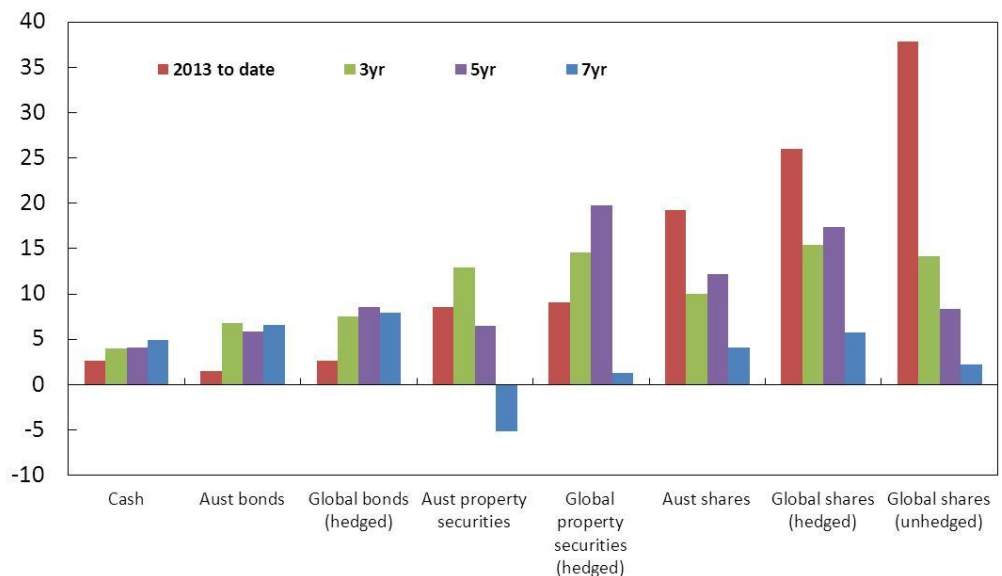
For bond investors, 2013 has been more challenging. The sharp falls in bond yields across much of the globe during the aftermath of the global financial crisis led to very strong returns from bonds. However, yields in most major bond markets

have moved higher this year, which has meant returns from both Australian and global bonds have been very modest.

The robust performance of share markets in recent years has also boosted longer term returns for investors. The chart below shows the performance of the major asset classes in Australian dollar terms so far in 2013, and for longer time periods. All asset classes now show positive returns over the three and five year periods to the end of November.

The year to date and three year returns from Australian and global shares are particularly strong.

Returns in Australian dollar (%) – periods to end November 2013



Benchmark data are UBS Bank Bill Index (cash), UBS Composite Index (Australian bonds), Barclays Global Aggregate hedged to \$A (global bonds), S&P/ASX200 A-REIT Accumulation Index (Australian property securities), MLC global property strategy benchmark hedged to \$A (Global property securities), S&P/ASX200 Accumulation Index (Australian shares) and MLC global equity strategy benchmark (MSCI All Country Indices hedged and unhedged in \$A).

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Economic growth around the world is still patchy

If the returns from shares have been so strong, was this because there was very little to concern investors this year? Not exactly. In fact, in 2013 the old saying, 'share markets climb a wall of worry', was clearly demonstrated again.

In particular, the performance of the world economy, and Australia's, gave markets little to cheer about. Economic growth in the US remained disappointing, and growth in China and India, as well as elsewhere in the emerging world, has clearly slowed, despite some better data from China lately.

Conditions in Europe showed some signs of life this year, partly reflecting the confidence-boosting statements and measures announced by the European Central Bank in 2012. These helped to bring down key borrowing rates across the troubled economies of the eurozone. But while economic growth returned to much of the eurozone in the first half of 2013, economic conditions across much of peripheral Europe (including Greece, Spain, Portugal and Italy) are still dire.

In Japan, the newly-elected Prime Minister announced a series of steps to boost the Japanese economy, and the new Governor of the Bank of Japan announced a massive program of monetary policy measures, or 'quantitative easing'. While the announcements were greeted favourably by financial markets, it remains to be seen whether the boost to Japanese economic growth will be sustained.

Australia's economy remained slow

On the domestic front, economic growth also remained weak, and unemployment drifted higher. There are still concerns about our economy's ability to maintain reasonable growth in the face of a slowdown in mining investment.

These concerns, and a stubbornly high Australian dollar, have worried the Reserve Bank of Australia enough for it to cut official interest rates to their lowest level in many decades. The cash rate is now just 2.5%.

In the US, compromise and common sense failed

We started 2013 with the first of two demonstrations of just how dysfunctional economic and other policymaking in Washington has become.

In early January, the US economy narrowly avoided the so-called 'fiscal cliff': a large, automatic tightening in fiscal policy which could have seriously derailed US economic growth. Both houses of Congress eventually passed a bill that allowed some tax cuts to expire, raised taxes on high income earners and postponed the debate on spending cuts. Later, Congress agreed a temporary increase in the federal government's borrowing limit.

Recently, the world received its second lesson in dysfunctional US policymaking. Congress and the White House failed to agree on even a temporary budget that would fund the US government and raise the debt ceiling further. The US

government partially shut down for several weeks in October and the world faced the threat of the US Treasury having to default on its obligations, a development that would have been catastrophic for world financial markets.

Although yet another last minute deal was stitched together, there is still no lasting solution – we are quite likely to have to revisit this situation again early in the New Year.

US monetary policy unsettled markets

The outlook for US monetary policy also generated a great deal of uncertainty in markets this year.

Early in 2013, there were suggestions that, given the apparent improvement in the US economy, the US Federal Reserve (the Fed) might start to wind back, or 'taper', its massive program of monthly asset purchases earlier than expected.

This was enough to send chills through global share markets, cause bond yields to rise sharply, and unsettle a number of emerging economies and currencies that had been key beneficiaries of the extraordinarily loose monetary policy.

The 'will they or won't they?' debate on tapering persisted throughout the year. We tend to think the Fed should probably just do it. After all, this isn't really a case of a central bank taking away the punchbowl when the party is getting started (which is the way the central bank's role is often described). Rather, this is the central bank deciding to 'taper' the amount of extra tequila they add to the punchbowl!

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A decline in the Australian dollar

On a more welcome note, the possibility that the Fed would unwind its quantitative easing provided support for the US dollar. That in turn helped to lower the Australian dollar, boosting returns from unhedged global shares (whose foreign currency exposure is not hedged to the Australian dollar). It also eased some of the pressure facing Australian export and import-competing industries.

Despite this, the Australian dollar remains overvalued and in our view, still vulnerable to further falls in a range of potentially difficult environments.

Middle East events unnerved markets

Outside of economics and debates over economic policy, markets were also rattled by turmoil in the Middle East. The civil war in Syria is ongoing, and Egypt once again faced political turmoil and widespread social unrest. The tentative agreement reached with Iran over its nuclear program has eased some tension in the Middle East, but there's a very real risk that Iran won't fulfil its side of the bargain.

Outlook

The improvement in returns this year will be a relief to many investors, particularly retirees. But many important issues around the world remain unresolved and the investment environment uncertain. The ongoing farce that is US fiscal policy and the continuing structural problems in the eurozone are just two of many sources of stress for financial markets.

Central bank action has clearly supported share markets over the last year. If that support continues, we could still see share markets rise. On the other hand, share markets could struggle if central bank support is withdrawn too soon or too aggressively.

Over the longer term, there remains a real danger that quantitative easing by the world's major central banks could lead to higher inflation. In fact, such an outcome may well be their objective, as it effectively reduces the burden of public debt.

However, engineering higher inflation and keeping it under control will be extremely difficult. For investors, it is real (after inflation) returns that matter, and in any well-diversified investment strategy, it's important to have assets that will protect against rising inflation.

As share markets have gone from strength to strength, we've become increasingly concerned that share prices are running too far ahead of both corporate earnings and the likely outlook for earnings. Despite this, with interest rates around the world very low, share markets still seem to offer better prospects over the next few years than either bonds or cash.

What is MLC doing?

The best investment responses to the very uncertain environment are diversification and careful risk management. And with future developments in the global environment so unclear, it's more important than ever that our clients' investment portfolios have resilience in a wide range of possible market conditions.

MLC's market-leading investment approach means we constantly consider how a wide range of potential market scenarios could affect our portfolios. We can then adjust the portfolios to manage potential risks and seize potential return opportunities.

This careful analysis means our portfolios are widely-diversified, risk-aware and are well positioned for many market environments.

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