Economic update

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Brian reviews events in Australian and overseas markets during October.

How did markets perform in October?

October was a better month for investors. Share markets regained the ground they lost in September, and bond investors benefitted from lower bond yields (and therefore higher bond prices) in most major markets.

But if we look at individual markets, it was quite a mixed bag. US and Japanese share markets posted some decent gains, as did the emerging markets, but European and UK share prices went backwards.

Australia went from being one of the worst performing markets in September to being one of the best performing markets in October. Most Australian industry sectors produced positive returns, particularly the banks, but mining stocks declined, as did energy stocks. In fact, energy stocks fared poorly across the world on the back of sharply lower oil prices.

What were the key factors driving global markets?

The best that can be said about the geopolitical environment over the month is that things didn't get substantially worse. The reality is that the geopolitical environment remains a source of uncertainty for financial markets.

The lower oil price is worth a comment. You wouldn't have thought that a major crisis in Iraq would be accompanied by abruptly lower oil prices, but it highlights the extent of the oversupply in world oil markets right now.

In terms of the economic data flow, the news on global growth fell short of market expectations almost everywhere – most notably in Europe and Japan, but also in China. The major exception was the US, where we're still seeing quite good news on the economy. That news has continued to pleasantly surprise financial markets.

And the difference in economic performance among the major economies is being reflected in the actions of the major central banks. As expected, the US Federal Reserve decided to bring its quantitative easing program to an end. On the other hand, the European Central Bank started its own program of asset purchases in response to very low inflation readings and disappointing economic news. And at the end of October, the Bank of Japan took markets by surprise by deciding to ramp up its quantitative easing program.

What about developments in Australia?

Over the month, we tended to see better-than-expected economic news. We're still seeing signs of a recovery in the non-mining economy coming through: lower interest rates are working, housing activity indicators remain quite solid and there's a pick-up in the demand for credit – most importantly, we're seeing some growth in business credit. And the lower Australian dollar does take some of the pressure off some key export industries.

However, mining investment continues to taper off and the sharp falls in the iron ore price are significantly detracting from our national income. In addition, problems with labour force data are making it that much harder to get a reliable read on how the labour market is faring.

It's still an uncertain environment, and it probably means the Reserve Bank of Australia (RBA) will leave interest rates on hold for quite a while yet. Their latest comments have reinforced that. The economy isn't weak enough to cut rates even further, but it's not strong enough to force the RBA to raise rates, either.

How are MLC's portfolios positioned?

We haven't made any major shifts in asset allocation in the last month. If we look at the general picture of how our multi-asset funds are positioned:

- we're still defensively positioned in world bond markets
- we still prefer foreign currencies over the Australian dollar, and
- we've reduced our exposure to Australian shares in recent months.

In the MLC Inflation Plus Conservative and Moderate portfolios, we've been holding significant allocations to cash and short-term Australian corporate bonds. We've also had very little exposure to Australian shares in any of the MLC Inflation Plus portfolios. This positioning means that when share markets are strong our expectation is that those portfolios will underperform the MLC Horizon portfolios, and that's what's happened in October.

If there are further falls in share markets, the MLC Inflation Plus portfolios are likely to outperform the MLC Horizon portfolios. The reverse is still true, too: the MLC Horizon portfolios are better positioned if markets continue to recover strongly.