

investmentbriefing

May 2010

Recent Market Volatility and MLC Fund Returns



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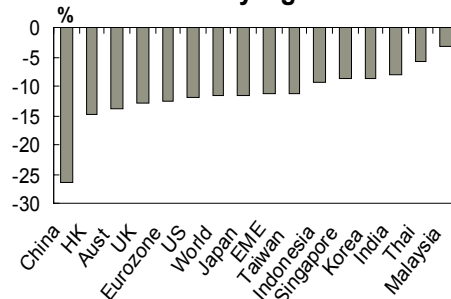
“I didn’t like this movie the last time I saw it”

May has been a terrible month so far for investors. Share prices across the globe have fallen dramatically. Europe’s woes (or more particularly, the woes of peripheral Europe) have cast renewed doubt over the durability of global recovery and the health of the financial system.

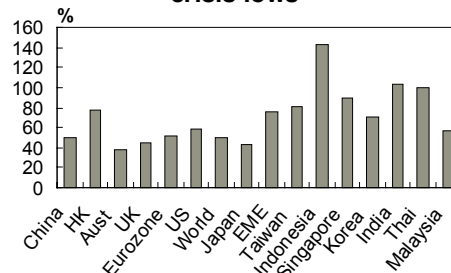
The European Union’s \$A1 trillion support plan for the worst affected European economies which, on paper, looked to be sizeable enough to ease concerns over the ability of countries such as Greece to meet their funding needs, did prompt a positive market reaction – for about a day or so.

The charts below show put the latest damage to equity markets in perspective. Since their recent peaks, world share markets as a group are down by around 12%, with the emerging markets slightly outperforming developed world markets.

Change in share prices from recovery highs



Change in share prices from crisis lows



Source: Datastream. Data as at 20 May 2010

The damage has not been restricted to share markets. Credit spreads have also widened – dramatically so in the case of US high yield securities – and prices for oil and a range of key industrial metals have also fallen. While part of the commodity price fall reflects a stronger US Dollar, prices are still lower against a range of currencies.

Closer to home, the Australian Dollar (for some time now, a very reliable indicator of the world’s appetite for risk, and a decent leading indicator of world growth prospects) has also declined, most notably against a resurgent US Dollar. The fall in recent days has been particularly dramatic. At time of writing, the \$A will fetch you just over US81 cents – it was close to US90c about a week ago! In addition to global developments, the Government’s decision to impose a tax on above-normal mining profits has also raised eyebrows and concerns on the part of some investors, particularly given the relatively low hurdle rate used to define excess mining profits.

In this environment, nominal government bonds (at least outside of peripheral Europe) have still benefited from a flight to quality, despite concerns over massive budget deficits and soaring public debt levels in the US, the UK and elsewhere.



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So far, what we have seen in share markets probably qualifies as a somewhat overdue correction, albeit a savage one. The really surprising thing about market developments over the past year or more is not that we had a recovery nor that we are now in the midst of a correction, but that markets rose such a long way with such speed last year, and that in the process we were prepared to overlook a range of unresolved issues and imbalances in the world economy and financial system. In our written and recorded comments this year, we described last year's market action as like an enormous sigh of relief on the part of millions of investors world-wide, and that this year would be tougher, and that further market gains would be more of a slow grind, with further setbacks along the way. Needless to say, that is still how we would describe the environment today.

Every quarter, MLC produces estimates of medium-term potential returns for a range of asset classes, and these are published on our website. At the end of March, these estimates showed that prospective real returns from equity markets were somewhat lower than longer-term norms, although not drastically so. However, the fact that prospective returns were below normal at a relatively early stage in the market's recovery phase was testament to just how far and how fast share prices rose in 2009. From here, prospective equity market returns are likely to be significantly higher than they appeared at the end of March. Nominal government bond prospective returns looked poor then, and probably look worse now with yields having fallen.

At MLC, falling equity markets have meant that we are re-balancing portfolios away from debt instruments back into equity markets, ensuring that our investors will benefit fully from the inevitable recovery in markets. Weaker markets also provide opportunities for our managers to acquire quality assets at attractive prices.

Rising risk concerns and shrinking return potential led us to implement the first change to our diversified fund asset allocations under the Strategic Overlay process in January 2010.

While Government bonds have performed well recently, in our assessment the future return potential from these assets remains poor, particularly since the ultimate solution to the crisis may well be higher inflation, which allows Governments and households to bring down the real value of debt, and allows Governments to reduce their deficits by absconding with more of our money via bracket creep. The duration or weighted maturity of our bond portfolios has been reduced to protect against the risk of sharply higher yields.

In late 2009, we viewed the strength of the Australian Dollar as fundamentally unsustainable, and we regarded the Australian dollar as vulnerable to a return of risk aversion - recent market behaviour has confirmed this view. Consequently, we increased the foreign currency exposure in our diversified funds. That decision has begun to benefit the performance of our funds, and for the time being, it remains in place.

The renewed sense of crisis in markets makes it all the more likely that the range of extraordinary monetary and fiscal measures that central banks and Governments have put in place to deal with the crisis will remain for some time, and will doubtless speed up the implementation of the EU's rescue plans. For fiscal policy in many economies, there is little, if any room to move, if further stimulation is required. Central banks do have room - even if that only means extraordinary measures such as further asset purchases and liquidity injections, and further monetisation of budget deficits (i.e. "printing money" in the language of the textbooks) even for those central banks (most notably the European Central Bank) where such a move would usually be viewed as inconceivable.

The depth and duration of any market downturn is highly uncertain, and this one is no different. The only thing that we can be certain of is that these downturns will continue to happen from time to time, and that they are all followed by recoveries.