2019 year in review

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After a poor finish to 2018 and despite numerous economic, trade and political concerns throughout the year, markets delivered good returns to investors in 2019.

Despite many economic and political concerns, 2019 was a good year for investors.

Despite the slowdown in global growth in 2019 and numerous issues such as the ongoing US-China trade dispute and Brexit, markets delivered significant returns to investors. Share investors, in particular, were handsomely rewarded with most developed markets recording double digit returns, although these returns were measured off a low base as markets lost considerable ground in the December quarter 2018. Despite modest earnings growth, markets were underpinned by more monetary easing with very low interest rates (or negative rates as in Japan and Europe) plus widespread stimulus by central banks. This was especially the case in Australia as the Reserve Bank of Australia cut the cash interest rate on three occasions to a historic low of 0.75%. Monetary policy in the US did a u-turn with the Federal Reserve also cutting rates three times, after raising rates in recent years. Low inflation remains the norm across the developed world as central banks struggle to get inflation back up to their respective targets, leading to calls for more government spending to improve economic growth. The strength of investment returns in 2019 contrasted sharply with the considerable complexity in the global environment.

Table 1: Asset class returns in Australian dollars – periods to

Asset class	Returns*			
	1 yr	3 yrs (pa)	5 yrs (pa)	10 yrs (pa)
Cash	1.5%	1.7%	1.9%	2.9%
Australian bonds	7.3%	5.1%	4.2%	5.7%
Global bonds (hedged)	7.2%	4.1%	4.2%	6.3%
Australian property securities	19.6%	9.5%	11.2%	11.6%
Global property securities (hedged)	22.3%	9.0%	7.8%	11.6%
Australian shares	23.4%	10.3%	9.0%	7.9%
Global shares (hedged)	25.4%	11.7%	9.5%	11.3%
Global shares (unhedged)	26.8%	13.6%	11.8%	11.5%
Emerging markets (unhedged)	19.1%	13.1%	9.3%	6.6%

31 December 2019

Benchmark data: Bloomberg AusBond Bank Bill Index (ca
Yr Index (Aust bonds), Bloomberg Barclays Global Aggre
S&P/ASX200 A-REIT Total Return Index (Australian prop
Developed Index (gross) hedged to $A (global property se
Index (Aust shares), MSCI All Country World Indices hedg
shares), and MSCI Emerging Markets (gross, unhedged)

* Annualised returns. Past performance is not a reliable indicator of future performance.
Sources: FactSet, MLC Asset Management Services Limited.

Global growth moderated as the year progressed

Conditions in the global economy moderated as the year progressed with slower growth most evident in Australia, parts of Asia and Europe. In contrast, the US economy continued to perform well.

The US

The US economy was the stand out performer amongst its developed market peers. Economic data released through the year was indicative of continued growth at a moderate sustainable pace. However, much of the economy's strength was due to solid household spending as business investment spending was stagnant. The US consumer remained in an enviably strong position. Aside from the beneficial impact the 2018 tax cuts have had on household incomes, the tightness of the labour market with unemployment of only 3.5% has forced companies to pay higher wages to retain and attract workers. Accordingly, consumer confidence and household spending were strong.

In contrast, business indicators and confidence surveys painted a more sedate picture. Business investment remained weak and output by the manufacturing sector was below last year's. Due in part to the subdued business conditions and persistently low US inflation, the US Federal Reserve (the Fed) chose to reduce interest rates by 0.25% on three occasions during the year. This represented a significant shift in the Fed's interest rate policy compared to 2018 when it raised rates by 0.25% on four occasions. Despite this action, the Fed warned late in the year that manufacturing conditions were unlikely to improve in the short term due to weak global growth and trade uncertainty. Comments by the Fed suggest it will leave interest rates on hold unless there is a material change to economic conditions.

Europe

Economic conditions in the eurozone were subdued for much of the year although they varied across national borders. The slowdown was most evident in Germany's and Italy's manufacturing based export oriented economies as global trade and confidence continued to be impacted by the US-China trade dispute. However, France, Spain and even Greece fared better. Fortunately, private consumption held up reasonably well for the first half of the year as eurozone unemployment continued to fall (7.5% in October) though a 0.6% decline in euro-zone retail sales in October was a worrying sign that household consumption may also be slowing.

European inflation remains low and well under the European Central Bank's (ECB) 2% target. As a result, ECB policy settings remain biased towards providing stimulus as it reduced deposit facility rates further into negative territory (from -0.4% to -0.5%) and recommenced its bond purchase program from 1 November, albeit at a reduced 20 billion euros per month. Markets are expecting the ECB, under its new President Christine Lagarde, to retain its stimulus bias and take more action as eurozone growth and inflation remain sluggish and governments have been reluctant to provide adequate fiscal stimulus.

Concerns that the US could widen its protectionist policy beyond China to include eurozone manufacturers proved to be well founded. In December, the US proposed applying 100% tariffs on US$2.4 billion of French luxury goods in retaliation for the introduction by France of a 3% digital services tax which the Administration believes unfairly targets US technology companies. The imposition of tariffs by the US on European auto imports continues to be a major risk that is affecting business confidence. If tariffs are imposed, they would have serious consequences for German (and Japanese) vehicle manufacturers. Not surprisingly, these risks have shown up in business confidence surveys.

The United Kingdom

Brexit was the dominant political and market theme in the UK throughout 2019. Intense negotiations to reach a Brexit arrangement acceptable to both the UK and the European Union (EU) were ultimately unsuccessful, requiring an extension to the Brexit date on three occasions with 31 January 2020 the latest exit date agreed to by the EU. Failure to achieve a Brexit strategy acceptable to Conservative Party members forced Theresa May to resign as Prime Minister. She was replaced by Boris Johnson, whose authority to break through the Brexit impasse was enhanced in December when the Conservative Party won a large majority in the UK general election. This enabled the government to progress its Withdrawal Agreement Bill which, once it is passed into law by both houses of parliament early in 2020, will allow the UK to leave the EU on 31 January 2020 and transition towards final separation at the end of the year.

However, the path to final separation is still uncertain. The UK and the EU now have less than a year before separation to negotiate and agree the myriad of deals that will govern their ongoing economic and social relationship (and with the rest of the world). Importantly, the proposed Withdrawal Agreement Bill rules out any extension to the transition period's conclusion in December 2020, which means a 'no-deal' departure is still possible if the UK and the EU cannot reach agreement.

The Brexit uncertainty and political instability has taken its toll on the UK economy. The economy is ailing with statistics indicating the three months to 31 October was the worst quarter for over a decade. Manufacturing and construction activity contracted. The Brexit uncertainty and global growth slowdown has meant UK business investment spending fell through the year. Despite this, labour market conditions remain strong with the 3.8% unemployment rate at a 44-year low.

Japan

Despite years of substantial monetary stimulus by the Bank of Japan (BoJ), economic performance continues to disappoint with growth barely above 0% and inflation stubbornly below the BoJ's 2% target. October's consumption tax increase from 8% to 10%, the first rise for five years, created headwinds for the economy. Weaker external conditions including China's growth slowdown and the ongoing US-China trade dispute impacted Japan's export sectors. These conditions necessitated the Japanese Government to announce a 26 trillion yen stimulus package for 2020 with increased spending divided between infrastructure, funding in support of private sector capital investment and a range of other initiatives including disaster relief and education. Japan's central bank continues to provide its own stimulus by keeping rates close to zero and continuing to buy government bonds.

China

China's economy slowed during the year due to the ongoing trade dispute with the US and weak global growth. China's official data indicated growth was around 6% in the year to 30 September but monthly data suggest this may be overstated with actual growth lower. While high in absolute terms (and by Australian standards), various indicators of economic activity were below last year's. China's industrial production and retail sales grew at annual rates of 6.2% and 8.0% respectively (to November). Policy makers responded to the slowdown with more supportive fiscal and monetary initiatives.

The US maintained an antagonistic trade policy throughout the year

2019 marks the second year of the trade dispute between America and China and this was as turbulent as the previous year. There was hope of a truce very early in the year following the G20 Summit in December 2018 where President Trump and China's President Xi agreed to reopen trade discussions and delay further tariff changes. Those talks eventually failed, leading to another round of tariff increases by the US and retaliatory action by China. The two leaders met again at the G20 in June which led to another cease fire, delays on additional tariffs and the resumption of negotiations. Market scepticism that a deal is possible were confirmed in August when President Trump threatened to increase the existing tariff of 25% on US$250 billion of Chinese imports to 30% and raise the 10% tariff to be imposed on the remaining US$300 billion of imports to 15%.

A glimmer of hope that the two countries may reach a truce emerged in December when a "phase-one" trade deal was announced. The deal entails the US agreeing to defer new tariffs it was going to impose from December 15, halving 15% tariffs on US$120 billion of Chinese imports to 7.5% but leaving existing 25% tariffs intact. In return, China is expected to buy an addition US$200 billion of US imports over the next two years, including up to US$50 billion of agricultural products. The deal is expected to be signed by both countries early in 2020 but there remains uncertainty as to whether the terms of agreement announced so far are final and if there will be a "phase-two".

Markets have been concerned for some time that the Trump Administration could escalate US protectionism beyond China by targeting other countries and trade regions. These concerns proved to be well founded in October with the US imposing new tariffs on a range of European Union goods including aircraft, consumer goods, foods and agricultural products. In December, the US Government said it may introduce new tariffs on Argentinian and Brazilian steel and a 100% tariff on a range of French luxury products. An example of the Trump Administration's preparedness to use trade policy to achieve domestic political goals occurred in May when the US threatened to impose tariffs on Mexican imports to pressure that country to stem the flow of illegal immigrants into the US. Trade is likely to remain a tactical weapon for the Trump Administration in the lead up to the Presidential election late this year.

A very good year for global share investors

After a disappointing conclusion to 2018 when share markets lost considerable ground in the December quarter, global share markets rebounded and recorded strong gains in 2019. Global shares returned 26.1% for the year on an Australian dollar hedged basis while the marginally higher 27.5% unhedged return reflected the slight weakness of the Australian dollar against some currencies. These high returns are measured off a low base and are more a reflection of how far markets fell in the last quarter of 2018.

The US share market was one of the better performers. The S&P500 Index increased by 30.7% (in local currency terms) and finished the year close to an all-time high. This was a creditable performance given the distractions and frustrations caused by the US-China trade dispute. Aside from continued good news on the US economy and reasonable growth in corporate earnings, the policy u-turn by the Fed and subsequent rate cuts helped underpin investor sentiment. Impeachment proceedings against President Trump had little impact on the market as it has been assumed the Republican controlled Senate will acquit the President.

Despite the weakness of the eurozone economy, European share markets recorded strong gains. Germany's market was up by 25.5% while the French market rose by 30.5%. Markets were encouraged that further rate cuts and monetary policy support by the ECB will contribute to better economic circumstances in 2020. Despite the drawn-out Brexit process and the adverse impact it has had on the UK economy, the FT100 still managed to rise by 17.3%.

Markets in Asia delivered good returns. The MSCI China Index returned 23.6% and Japan's Nikkei index was up by 20.7% over the year. Civil unrest in Hong Kong and its negative impact on the economy caused the share market to rise by only 9.1%.

Our share market also performed exceptionally well

Australian shares returned 23.4% in the year to 31 December. This was a pleasing outcome compared to the -2.8% return in 2018. However, this year's return is abnormally high because it is measured off a low base as the December quarter 2018 was one of the worst quarters for markets since the GFC.

Our market began the year with seven consecutive monthly gains through to July. Further evidence of challenging conditions in the Australian economy raised expectations the Reserve Bank of Australia (RBA) would need to reduce interest rates, which it subsequently did on three occasions (June, July, October). This was particularly favourable for the Australian share market. The market also responded positively to the re-election of the Coalition LNP Government as Labour's proposed capital gains, franking credit and negative gearing changes would not be implemented. Prior to the election in May, share investors benefitted from many companies deciding to clear undistributed franking credits via special dividends or share buybacks ahead of a possible change of government.

The performance of the market in the second half of the calendar year was less consistent with falls in August (-2.4%), October (-0.4%) and December (-2.2%), partly diluting very positive returns in July (2.9%), September (1.8%) and November (3.3%). The lacklustre profit reporting period in August/September plus ongoing uncertainty about the US-China trade dispute and its impact on the global economy contributed to this volatility.

All industry sectors recorded positive returns but there were notable highlights and lowlights. Healthcare (43.5%) was by far the best sector performer for the year as investors were attracted to companies such as CSL (48.9%) for their superior earnings performance and growth potential. Consumer Discretionary (32.4%) outperformed despite the weak retail environment as retailers such as JB Hi-Fi (70.1%) and Harvey Norman (32.1%) were expected to benefit from the Federal Government's income tax cuts. Aristocrat Leisure (54.2%) also contributed to the sector's superior performance. Telecommunications Services performed well (27.3%) as Telstra's share price improved by 24.2% amid signs of a more benign competitive environment following the decision of the Australian Competition and Consumer Commission to block the proposed merger of two rival companies. The low interest rate environment raised the attractiveness of sectors such as Australian Real Estate Investment Trusts (REITs, 19.4%) because many REITs have provided growing income and a distribution yield higher than government bonds and term deposits.

Resource based sectors also performed well. The 27.2% return of the Materials sector reflected good performances by iron ore miners who benefitted from higher iron ore prices after a tragic tailings dam collapse at a major Brazilian mine cut global supply at a time of elevated demand. Fortescue Metals Group was a standout performer with a rise of 173.4% compared to the more modest returns of BHP Group (13.7%) and Rio Tinto (27.9%). The performance strength of gold producer Newcrest Mining (38.8%) as the gold price increased by 18.9% also contributed to the Materials sector return. The Energy sector returned 22.9% as the oil price was higher by 22.7% (Brent Crude) due to concerns growing tensions in the Middle East could disrupt supply.

The Financials ex-AREITs index returned 13.5%, underperforming the market's return by a significant margin. The four major banks and AMP had to contend with a multitude of issues that had both reputational and financial implications. The Banking, Superannuation and Financial Services Royal Commission released its final report in February, with criticism resulting in the resignation of National Australia Bank's Chairman and CEO. Fears that banks' and AMP's earnings and dividends could be impacted by substantial remediation and compliance costs as well as the weaker economy and housing sector also contributed to their underperformance. Late in the year, Westpac's CEO resigned following the launch of civil proceedings by AUSTRAC in relation to multiple transactions that are alleged to contravene the Anti-Money Laundering and Counter-Terrorism Financing Act. Commonwealth Bank (10.4%) was the best performer of the four major banks while AMP shares (-21.6%) reached a historic low during the year.

Another mixed report card for Australia's economy

Australia's economy remained in the 'slow lane' for much of the year, forcing the RBA to reduce the cash rate by 0.25% on three occasions to a record low of 0.75% by year's end. Australia's economic growth fell to an annual rate of just 1.4% for the year to 30 June, the slowest annual growth recorded since the GFC in 2009. The growth rate recovered to 1.7% for the year to 30 September but remains below the economy's growth potential. Inflation remained subdued and stubbornly below the RBA's preferred 2-3% band.

Comments by the RBA late in the year point to further interest rate cuts in the new year if sluggish economic conditions prevail. This is understandable as evidence of soft economic conditions has been widespread in both consumer and business segments of the economy. The NAB Monthly Business Survey saw business confidence and conditions weaken through the year. The deterioration was evident in most industry sectors with retail confidence being particularly weak. While there was a small improvement in business conditions and confidence late in the year both remain under average levels.

Consumer sentiment also deteriorated as evidenced by the Westpac-Melbourne Institute Consumer Sentiment survey which fell through much of the year. This was consistent with the weakness seen in other consumer oriented economic indicators. Traditional retailers continued to struggle as retail sales grew by only 2.1% in the year to 31 October and new car sales have fallen for twenty consecutive months. Consumers have been concerned about house price weakness and low income growth at a time of high household debt. The reluctance of consumers to spend occurred despite the benefit of income tax relief announced in the Federal Budget for low to middle income earners and the RBA cutting the cash rate to only 0.75%. The RBA has acknowledged this year's interest rate cuts may have increased consumer anxiety.

Spare capacity in the labour market remains elevated and continues to constrain wages growth, adding to the challenges facing many indebted Australian households. Wages growth was just 2.2% through the year (to 30 September) as the unemployment rate increased to 5.2% (November) and the underemployment rate, which measures part-time workers who want to work longer hours, remained high at 8.3%. The underutilisation rate of 13.5% (unemployment + underemployment rate) was 0.2% higher than last year. The serious drought affecting much of the country has adversely impacted farm income, cutting 0.2% from the economy's growth potential.

Residential property values rebounded in the second half of the year after a weak first half. The national median dwelling value was up 2.3% in the calendar year (as measured by the Core Logic survey) with both Sydney and Melbourne enjoying the highest annual gain of 5.3% over the year. However, prices continued to fall in Perth (-6.8%%) and Darwin (-9.7%). Despite the recovery in 2019, residential property prices in all state capitals except Hobart and Canberra remain below their 2017 peaks. The improvement in property indicators such as auction clearance rates and housing loan approvals point to further price recovery in the new year.

Despite the recovery in residential values, residential construction remained weak. Approvals for the construction of houses fell 15.1% in the year to 31 October while apartment construction approvals were down by 23.5%. The value of residential construction work done in the year to 30 September was down by 10.1%. The RBA expressed concern that further sizeable falls in housing prices could weaken retail conditions even further as consumers limit their spending.

Australia's terms of trade (the ratio of export prices to import prices) improved through the year, due in part to higher prices for key Australian exports. The iron ore price was up by 32.2% over the year after the tailings dam collapse in Brazil curtailed global supply. The higher iron ore price may prove to be fortuitous for the Federal Government which has prioritised returning the Federal Budget to surplus in 2019-2020.

Bond market conditions changed markedly during the year

2019 delivered strong returns for both government and corporate bonds, as a combination of monetary policy easing and stable, if slow, growth produced near-perfect conditions for higher quality fixed income assets. The year started with the US Federal Reserve in the midst of a dramatic pivot, from a goal of 're-normalisation' of interest rates, to a recognition that they may have tightened too much, too fast in 2018. By the middle of the year, most developed market central banks had followed suit and were back in easing mode, as impacts of the ongoing trade war started to bite, in particular in Germany's and China's export oriented economies. This was reflected in slowing global economic growth, especially in manufacturing, due in part to low levels of investment as businesses grappled with uncertainty around tariffs and trade policy.

In Australia, inflation and GDP growth continued to come in below target, and with unemployment increasing modestly and a weak housing market, there was ample justification for further monetary policy support. The RBA started to reduce the cash rate in June, eventually cutting rates three times, taking the target cash rate down to a record low of 0.75%. The weaker economic picture both locally and globally was also reflected in longer term bond yields, with the 10 year government bond yield rallying from 2.3% at the beginning of the year to an all-time low of 0.9% in August, before bouncing somewhat to finish the year at 1.3%. Australian corporate credit was relatively stable, with economic conditions not so bad as to stoke fears of recession and an end to the credit cycle, but not so good as to encourage reckless spending by businesses. Spreads tightened somewhat through the year, adding to returns for fixed income investors.

In the US, GDP growth continued at a relatively steady rate and unemployment remained at very low levels, but this still did not lead to rising inflation. The headline data also masked an increasing disparity within the economy, with the manufacturing sector entering recession while the services sector remained in positive growth territory. With the benefits of the 2018 tax cuts starting to wane and the ongoing trade war starting to drag on the economy, President Trump ramped up the pressure on the Fed to help stimulate the economy. The US yield curve inverted (meaning the 10 year bond yield was lower than short term cash rates) in March and then again in May, which is an historically reliable recession-predictor. The result of all this was the first rate cut in August, followed by two further cuts before the end of the year. The benchmark 10 year Treasury bond yield rallied from 2.7% to a low of 1.5% in August, before ending the year at 1.9%.

Europe faced many of the same issues as the US, with low growth and inflation, and slowing global trade placing a significant drag on output. However, with a more export-oriented economy and with cash rates already in negative territory, Europe faced stronger headwinds with fewer levers to pull to add the necessary stimulus. The continuing Brexit process didn't help sentiment either, although an improvement in the Italian political situation in June provided some respite. The negative outlook was reflected in record low bond yields across Europe, as investors looked for the safety of high quality bonds as protection against recession and deflation. By August, an astonishing US$17trillion worth of bonds had negative yields, meaning investors paid more for them than they would receive back at maturity. The ECB did take some action in September, lowering the cash rate to -0.5%, restarting bond purchases (quantitative easing) and providing some support for banks which are struggling with the side-effects of negative interest rates. But the consensus is that the ECB is very close to the point where further cuts would be counter-productive, meaning that it now falls to European governments to provide some fiscal stimulus if the expansion is to be maintained.

In credit markets, performance was strong across most markets, but again the headline numbers hid some increasing dispersion, especially at the lower quality end of the market. Following several years of very benign credit conditions, concern around leverage levels and underwritings standards started to build, in addition to worries about a potential recession in 2020. Offsetting that somewhat was support from central banks, while the low level of yields around the world meant that investors sought out higher quality credit assets for some extra return. The net result was that the majority of credit assets performed well, but some lower quality names underperformed significantly.

In terms of index performance, global government bonds delivered 6.3%, with investment grade corporate bonds higher at 11.4% over the year in Australian dollar (hedged) terms. Australian yields fell further than other major markets, but global credit outperformed local, with the result that Australian bonds (7.3%) slightly outperformed global (7.2%). High yield bonds (13%, hedged) outperformed floating rate bank loans (7.9%). Australian inflation-linked bonds returned 8.5%.

MLC portfolios remain defensively positioned while looking for attractive risk-reward opportunities

MLC has believed for some time that the medium term potential reward for taking risk is limited, which has justified maintaining a defensive orientation in our multi-asset portfolios − the MLC Inflation Plus, MLC Horizon and MLC Index Plus portfolios. This positioning has presented challenges as most asset classes have continued to provide high returns and thereby reduced future return potential. More recently, lower central bank cash rates have eroded the positive aspects of holding cash to help manage risk.

Looking ahead, we continue to believe the complexity of the global environment requires us to maintain the multi-asset portfolios' defensiveness while also maintaining adequate participation in market upside. In response to much lower cash rates, we've reduced cash holdings to invest more in short maturity fixed income assets. We continue to prefer unhedged global shares to hedged global shares, albeit at a lower exposure than previous years. Unhedged exposure provided our portfolios valuable returns when the Australian dollar fell and continue to provide an important diversification source to equity market exposures. However, benefits from future falls of the same magnitude aren't as likely at current lower values of the Australian dollar. We continue to employ innovative alternative investments such as risk controlled real return strategies and also derivative strategies to help preserve investors' capital in potentially volatile or adverse equity market outcomes and provide another source of returns.

While our focus on managing risk in our multi-asset portfolios may not prevent negative returns in weak share market conditions, it should provide some insulation for investors.

How does MLC's investment process deal with an uncertain future?

Rather than basing portfolio decisions on a single future, we attempt to understand the many different ways in which the future may unfold and the trade-offs between risk and return that each future may entail. A continuation of the current environment is only one of many scenarios that could unfold. By understanding how our multi-asset portfolios are likely to perform in many potential market scenarios, both good and bad, we can adjust their asset mix to manage possible risks and take advantage of potential return opportunities.

This careful analysis means our portfolios are prepared for the range of outcomes that may occur, including having adequate diversification, being risk-aware and being positioned for a range of future market environments.

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