Why have markets been so weak in 2016 so far?

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The new calendar year has started on a particularly bleak note with widespread share market falls recorded in the first week of trading. The following table shows the returns (in local currencies) for the week to the end of trading on Friday 8 January 2016 for a number of share markets and currencies, and it is not pleasant reading.

Market Currency	Week to COB Friday 8 January 2015
S&P500 (USA)	-6.0%
DAX (Germany)	-8.3%
CAC (France)	-6.5%
Nikkei (Japan)	-7.0%
Hang Seng (Hong Kong)	-6.7%
Shanghai (China)	-10.0%
FT100 (UK)	-5.3%
S&P/ASX200 Accum. (Australia)	-5.8%
A$/US	-4.6%
A$/Yen	-7.2%

The initial trigger of the weakness and volatility in markets last week was further evidence of a slowdown in China's manufacturing sector, heightening long-held market concerns that China's economic slowdown was more pronounced than anticipated and jeopardises the global growth outlook. The latest China Caixin Manufacturing Purchasing Managers' Index (PMI) was released on Monday 4 January. It showed manufacturing activity weakened in December, albeit a small fall from 48.6 in November to 48.2 in December. However, it was the 10th consecutive month the PMI has fallen.

China's share market response was fairly immediate. It fell as much as 7%, prompting officials to implement for the first time the (poorly designed) new circuit-breaker trade suspension mechanism designed to prevent share prices free-falling. Aside from concerns arising from the PMI survey, the expected lifting of a ban scheduled for last Friday that has prevented large investors from selling shares probably added to the selling pressure in China's share markets early in the week. It has emerged that this ban has been extended indefinitely.

We were not surprised that the authorities were forced to act again on Thursday when the market again reached the -7% trigger within the first half an hour of trade – the tightness of the trigger decline may itself have exacerbated the volatility as investors scramble to exit before the market is halted. The trigger for this substantial fall was the surprise decision by Chinese authorities to further devalue the Chinese renminbi against the US dollar, however this in unfinished business from last year. Policies to promote share ownership inadvertently triggered a bubble which incompletely deflated due to extensive curbs on selling.

While the decision to devalue is linked to a necessary long term policy initiative by China to de-peg its currency from the US dollar in preference for a basket of currencies (against which the RMB has been broadly stable over the past year), market's interpreted the move as further evidence that the Chinese economy continues to weaken.

Somewhat ironically, the circuit breaker mechanism which the Chinese authorities had hoped would help calm markets was scrapped on Friday only a week after its introduction. The credibility of China's policymakers as they have attempted to manipulate their market in the last few months has deteriorated. Rightly or wrongly, events in the last week will do little to improve the impressions of mismanagement and desperation. While current China's policy makers are regarded by many as very competent managers of their economy, there is a palpable sense that they are learning on the job as far as financial markets are concerned.

Not surprisingly, what happens in China's economy is significant for the world economy (and certainly Australia's) so the impact of these developments last week was widespread, impacting investment markets, commodities and currencies (see earlier table). Rising tensions between Saudi Arabia and Iran added to markets' uncertainty and contributed to the 11.3% fall in the price of oil (Brent crude) last week. In Australia, sentiment wasn't helped by new data showing new building approvals, a key source of growth for our economy in the post-resources era, fell 12.7% in November.

At a time of elevated valuations in many markets and poor return potential, any news that doesn't conform with what we believe have been overly optimistic market expectations was likely to lead to potentially harsh market falls.

Portfolio implications

We have been assessing the potential for adverse developments in China and the implications for Australian investors for an extended period of time. Our Investment Futures Framework, which focuses on what the future could hold by assessing return potential and downside risk in many positive and negative scenarios, includes a number of China specific scenarios. For example, "Australian stress scenario" is a tailored scenario looking at the consequences of a more pronounced slowdown in China for Australia.

Aside from China-specific developments that are adverse to Australia, we have been concerned for some time that policy-makers actions have distorted asset valuations to the point that return potential looks poor and risk is elevated.

As a result, we have been managing our multi-asset Horizon and Inflation Plus portfolios in a defensive manner: underweight shares; overweight defensive and liquid multi-asset strategies, defensive global shares and the low correlation strategy; overweight to foreign currency (i.e. unhedged global shares) and maintaining adequate cash balances. While this positioning is unlikely to be enough to prevent negative returns in the current market conditions, it should be providing a degree of insulation.

For our MLC Inflation Plus portfolios which have flexible asset allocations with few constraints, we've focused on positioning these portfolios for preservation of capital by increasing their exposure to cash. Cash currently accounts for 34% of the MLC Inflation Plus Conservative portfolio, 21% and 15% (respectively) for the MLC Inflation Plus Moderate and Assertive portfolios. This was done to improve their liquidity and 'nimbleness' in the current market environment in which almost all asset classes are expensive relative to the risks involved, and almost any scenario could unfold.

While the recent market falls have created better value opportunities, the current environment presents some significant challenges and they still outweigh the positives. It goes without saying that if markets decline further, buying opportunities may start to outweigh the risks and we would consider increasing exposure to risk assets to exploit return opportunities. For the moment though, our focus remains on managing risk by defensively positioning our portfolios.

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