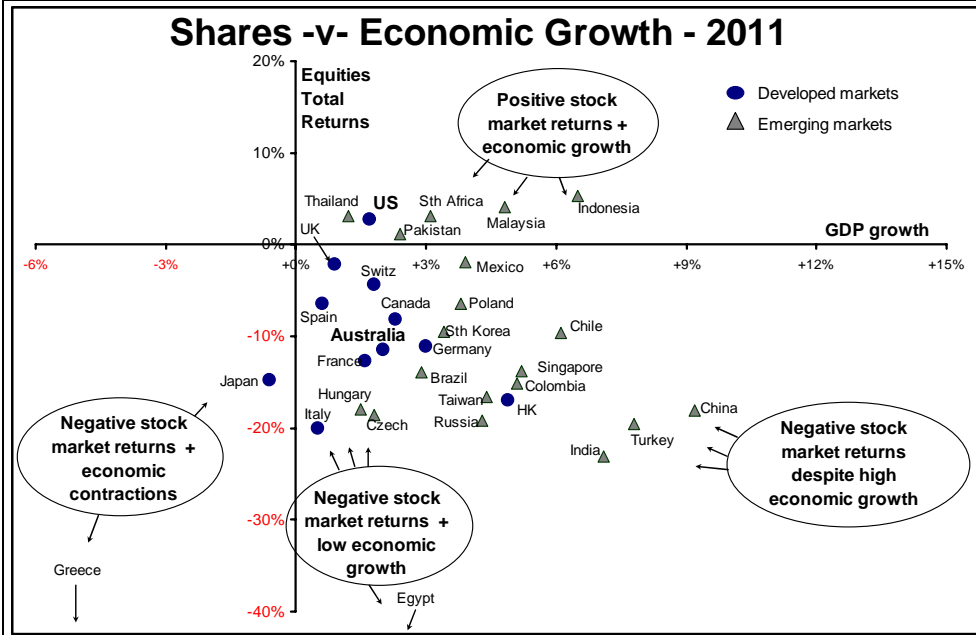




MONTHLY MARKET MONITOR – End January 2012

Chart of the month: Stock Markets -v- Economic growth - 2011



Our primary focus is on investment markets and not just on economies, because high economic growth rates do not necessarily lead to good stock market returns. This was true again in 2011.

The US was the only developed world market to register positive stock market returns in 2011, in spite of its relatively poor economic growth, high unemployment rate, housing collapse and budget deficit crisis. In contrast, despite Australia's more favourable economic conditions and the mining boom, our stock market was once again among the laggards along with European markets.

China and India continue to enjoy the highest economic growth rates in the world, but once again this did not flow through to stock market returns.

Indonesia, Malaysia, Thailand, Pakistan and Sough Africa all posted gains in 2011, continuing their good returns in 2010.

		Economies		
		Current position	Direction/ Trend	Pace of growth
Economies	Australia	The local economy is still growing, but employment growth is subdued and confidence levels are low due to the accident-prone federal government in Australia, the on-going debt crisis and recessions in Europe, and the slowdown in China. Mining exports are boosting the trade balance but we still run a current account deficit – meaning we still spend more than we earn as a nation, despite the so-called mining export boom that is now fading. (Australia hasn't produced a current account surplus since the wool price spike in 1973, and before that, 1957). Inflation was flat in the December quarter but consumer prices were still up by more than 3% for the 2011 year, which is at the top of the Reserve Bank's target range. In spite of this, the RBA will still probably need to cut cash rates this year as the economy slows.	Average growth rate	Growth flattening
	US	The US economy continues to recover slowly. Late in January the Fed announced that it intends to keep interest rates at "exceptionally low levels" until at least late 2014, which would make it 6 years of zero interest rates since late 2008. It will continue to switch its treasury holdings away from short term and toward long term bonds to try to reduce long term interest rates even further, to encourage home buyers to borrow more. However, a quarter of all American home borrowers still have negative equity in their homes, and this is depressing confidence and spending. The Fed has also left the door open for further rounds of "quantitative easing", which it still may do since inflation is still low and employment is still weak. For the first time the Fed set an explicit target for inflation at 2%, which is higher than expected, and confirms the Fed's plan to try to inflate its way out of debt if it can. It has been trying to do that since 2008 with no success. One positive factor for the US is the flexibility of its labour laws. Detroit is now hiring workers on less than half their pre-crash salaries (\$15 per hour instead of \$35+) and production and exports are now growing again.	Below average growth rate	Recovery remaining slow
	China	The clampdown on credit growth in China last year is taking its toll on property prices, which are now rapidly deflating, and on businesses, which already had to contend with fine margins, a rising currency and rising wage costs. With weak export markets, currency appreciation has been put on hold, and this is certain to increase political pressure from the US (especially in an election year) and to inflame the currency/trade protection war of words. As the economy slows, authorities have managed to keep public riots over rising food & fuel prices, falling apartment prices, illegal land seizures and lack of democracy, down to a dull roar. Hardliners in the Communist Party are hitting back against increasing consumerism by stepping up media censorship, and a raft of TV popular game shows have been cancelled and replaced by documentaries about household chores! Discontent is rising.	Strong growth still	Growth slowing
	Japan	The Japanese economy is still sluggish, with export demand suffering from the European recessions and subdued demand from the US. In 2011 Japan recorded its first trade deficit since 1980. This is a major milestone in Japan's economic history. In the 1950s to the 1970s Japan was the great "emerging market" as it re-built after the war, led the world in manufacturing efficiency & quality, and ran almost continuous trade surpluses since 1965. It is now in terminal decline, with a shrinking workforce, declining and aging population (Japan has the oldest population in the world), and an escalating welfare bill financed by a growing mountain of government debt. The new Prime Minister Noda is nibbling away at the fiscal problem by doubling sales taxes. It will probably not go far enough, but at least it is a start.	Chronic recession, deflation	Remaining weak

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		Asset Classes	Current position	Long term returns (1)
Shares	Australian shares	Our last couple of reports foreshadowed a likely recovery for local shares in 2012, and this got off to an early start with the global new year rally. The local market index was up 5% as investors suddenly switched out of defensive stocks and into cyclicals. Miners bounced back strongly with commodities prices recovering some of their 2011 falls - industrial metal prices are up 10-15%, iron ore and coal are both up slightly, and gold is also up 10% for the month. Bank share prices have remained flat due to continuing concerns about rising funding costs and slow lending growth.	Below fair value	Above average long run returns
	Developed markets shares	Global stock markets rallied in January, but on very low volumes and not underpinned by positive news of much substance. On the contrary, Europe is heading back into recession, China and India continue to slow and the US recovery is not as strong as the numbers suggest. In fact the Fed was forced to admit that the US economy is so sick that it will need to keep interest rates at zero for another three years, and that it may even need more money printing. Perversely, this is seen as a good thing by the markets and everybody rushed to buy shares! Just as the announcement of QE1 and QE2 boosted share prices, so did the talk leading up to the latest Fed announcement. The main factor that was positive in January was that European politicians were on holidays, so there were no failed "grand solutions" or summits to collapse in farce as they did throughout last year. As a sign of the times, Facebook announced its plans to raise \$5b in a float that would value the company at around \$80b, putting it on a price/earnings multiple of 80, clearly in dot-com bubble territory. Facebook's customer growth rate is slowing, revenue growth is slowing, costs are rising and it has endured numerous backlashes over its business model of selling personal customer data without consent. One for the die hard dot-com speculators! Germany has been the strongest of the European stock markets, aided by slightly stronger manufacturing and exports. European luxury brands continue to enjoy strongly rising revenues and profits, driven by growth in Asian spending.	Around long run fair value	Below average long run returns (2)
	Emerging markets shares	Shares in emerging markets rebounded in January in the global new year rally, after the sharp sell-off in late 2011. Hot money returned to all "risk" assets globally, including emerging markets, commodities and currencies (including the AUD and Australian shares). As with many share rallies, there were few reasons for it that related either to economic or company-specific fundamentals. Russia was the strongest, buoyed by the high oil price, with the escalating Iran stand-off and the crises in Venezuela and South Sudan. Chinese markets remain weak, with concerns over how collapsing property prices may affect the big state-owned banks that dominate the stock markets.	Around fair value	Above average long run returns, but high volatility (2)
Fixed Income	Australian Gov't bonds	As expected, yields on medium and long term government bonds have started to rise from their very low levels reached at the end of 2011, as those ultra-low yields assumed a massive recession in Australia over the next year or so, which is unlikely at this stage. After good returns from bonds and poor returns from shares in 2011, our outlook for the coming months is for those positions to be reversed, with lower returns from bonds, but better returns from shares.	Yields below (prices above) long run average level	Below average long run returns
	Bank Term Deposits	Banks continue to offer interest rates on TDs that are well above treasury notes and bonds of similar terms. From 1 st February, the cap on the government's guarantee for bank, building society and credit union deposits falls from \$1m to \$250k per institution, so investors should talk to their advisers about diversifying deposits across banks if they hold more than \$250k with any one bank.	Yields above long run average	Above av. long run returns
	Global Bonds	The global government bond market was up a little in January. Yields rose slightly in the "safe haven" markets - the US, Germany (but fell further in Japan), while yields in the PIIGs fell due to bond buying by the ECB and by banks using re-cycled ECB loans. This year we are not expecting a repeat of last year's big gains from the global bond market, but stagnation in Europe, Japan and slow growth in the US should keep yields relatively low (and returns relatively good) for some time.	Yields below long run average level	Below average long run returns (2)
Cash	Australian target cash rate	Money markets are still pricing in the prospect of several more rate cuts in 2012. With the dollar too high, employment slowing, and banks reluctant to cut interest rates on loans, there is scope for further interest rate cuts, despite inflation being at the high end of the target range. If and when rates fall, banks will probably keep interest rates on deposits relatively high, benefiting depositors.	Cash rates below long run average level	Variable, rising over medium term
Real Estate	Australian commercial property	After a flat year in 2011 (in which listed property beat shares by 10%), property trust prices were off to a good start to 2012, rising along with the general stock market in the new year rally. The office sector still holds the best prospects this year, despite slowing employment growth. Vacancy rates are relatively low, and rents and capital values are stable. The retail and industrial sectors remain slow, with weak retail spending in Australia, US and Europe. However, good yields, low debt levels, buy-backs in several trusts, and rising pay-out rates make the property trust sector quite attractive relative to the general stock market that dominated by miners and banks, which are more directly affected by the recessions in Europe and the slowdown in China respectively.	Around long run fair value	Around average long run returns
	Australian residential property	For all the talk of a so-called housing supply shortage in Australia, there are still record numbers of properties on the market with no buyers, and prices continue to fall. Hardest hit are properties bought at inflated prices in the 2004-7 boom fuelled by boom-time bonuses and loose lending policies, especially discretionary purchases like holiday flats, beach houses & hobby farms, and first homes bought in the 2009 "cash splash". Housing in Australia is still too expensive on a range of measures, and prices are likely to continue to fall in real terms as bank lending is restricted by new capital rules and credit restrictions. On a positive note, there is a growing tide of Chinese buyers looking to buy housing here as safe havens away from possible future turmoil in China.	Varies by market, but over-valued overall	Average long run returns
	Australian Dollar	As a "risk" currency, the AUD has risen strongly in the new year rally – up 5% against the USD and up 3% against other major currencies. The "carry trade" has lost some of its appeal after the two rate cuts here late last year, but foreigners continue to buy up our government bills, notes and bonds, driving yields lower and the dollar higher. As the carry trade builds it forces the currency up and yields down to a point where it inevitably collapses under its own weight. When that happens the carry trade unwinds rapidly as speculators stampede for the exits, causing the currency to fall and interest rates to rise. It is only a matter of time. The property bust in China may be the trigger.	AUD Above fair value	Currency gains for Australian investors in foreign assets as the AUD falls

(1) Expected "long term" returns refers to periods of 10+ years (looking through economic cycles) starting from the current position

(2) Returns for non-Australian assets are in local (foreign) currency terms – ie hedged to AUD but excluding any profits/losses from hedging