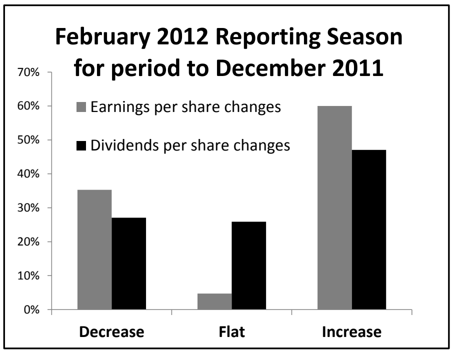
PHILO CAPITAL ADVISERS

MONTHLY MARKET MONITOR – End February 2012

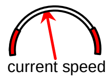
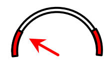
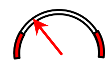
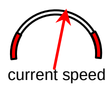
Chart of the month: Earnings and Dividends up in Australia



February was reporting season for Australian listed companies reporting either their half year or full earnings to December. As the outlooks for the local and global economies deteriorated in 2011, the expectations for profits and dividends from Australian companies were reined in. The chart shows that 60% of companies reported higher earnings, and about 50% raised their dividends.

Most of the profit growth came from Telstra, Rio, Newcrest, Woodside, Santos, Origin, News Corp, AMP, and from the big banks other than NAB. The major down surprises were QBE (caused by losses from natural disasters), and BHP(due to lower commodities prices), and the steel-makers OneSteel and BlueScope.

In the current environment the results have been received well by investors, and shares of most companies have done well so far this year.

		Economies	Current position	Direction/ Trend	Pace of growth
Economies	Australia	The markets continue to shake their collective heads in disbelief over the continuing circus in Canberra. Meanwhile the hand-out mentality continues to win over market forces everywhere we look. The enduring lesson from the Lehman crisis in 2008 has been that governments everywhere are now throwing borrowed money at anything and everything that moves, rather than let "evil" market forces run their course. We are seeing this play out all over the world, from stringing along the bankrupt Greek government by feeding it even more debt, all the way to throwing Australian tax-payer funded hand-outs and subsidies to foreign owned car-makers, aluminium smelters, steel mills and even shipping lines. Although the Australian government had low debt levels before the GFC our politicians are trying their hardest to rectify that historical anomaly. Our politicians think they are doing such a great job they voted themselves a 25% pay-rise for Christmas! Our PM is now paid more than almost every other leader in the world, including the US President and every European leader.	Average growth rate	Growth flattening	 current speed
	Europe	Europe is slowing, with most of the major economies contracting except France. European governments are attempting to pay off their government debts and they are taking the most direct route by attacking the immediate cause of the problem – government deficits. They are attacking both sides of the ledger – cutting spending and raising taxes – with German inspired (or directed) vigor. This has very bitter side-effects in the short term. In cutting spending they need to fire government workers, cut back social services, and reduce pensions and unemployment benefits. When taxes are raised, companies lay off staff and individuals reduce spending. Wages fall dramatically, unemployment and poverty levels rise, spending collapses and tax revenues fall. The Irish have stoically accepted their tough medicine with few complaints, but the Greeks have responded by rioting and looting, and the austerity has only just begun. The English dipped their toe into the water of austerity last year and found it too painful, so they retreated. The Greek farce is just a prelude to the main show. The real action will be in how the big economies cope in the coming years.	Below average growth	Growth slowing	 current speed
	US	The US is taking the opposite approach. Congress hasn't been able to agree to reduce spending nor to raise taxes. The only measures that have been passed have extended tax cuts and extended unemployment benefits, which are the opposite of austerity. Democrats refuse to cut spending and Republicans refuse to raise taxes. So the budget remains in deficit and the debt pile grows even larger. With Congress grid-locked and interest rates at zero since late 2008, all the Fed has been able to do is promise to keep interest rates at zero until at least 2014, and to buy up trillions of dollars of government debts and mortgage bonds with newly printed money to reduce interest rates in order to depress the currency and entice households and business to borrow even more money. So far it is working. The US hasn't "double-dipped" into recession, the economy continues to recover, the unemployment rate is falling slowly, people are still spending, and companies have low debt levels and are brimming with cash. What is important for us is that these conditions have been ideal for investors. US bonds have generated great returns, and the US stock market has been far and away the best performing stock market in the developed world over the past two years (and has also beaten most emerging markets, including the BRICs).	Below average growth rate	Recovery remaining slow	 current speed
	China	Apartment prices in cities across China have continued to fall for several months but it hasn't yet turned up in the form of bad debts in the big banks because buyers have been paying for them mostly using cash, with relatively low levels of mortgage debt. Of more concern is the rising level of debt owed by local government authorities that have built up large debts to fund their pet infrastructure projects, but this growing problem also remains dormant for the time being. There are two more pressing concerns for the government. The first is the credit crunch that has hit small businesses severely, and this prompted the bank reserve ratio to be cut again on the 20th of February in an attempt to boost bank lending. A second concern is the rising tide of civil unrest – mainly peasants protesting about illegal land seizures and rising food prices - that is becoming increasingly hard to quell and cover up.	Strong growth still	Growth slowing	 current speed

		Asset Classes	Current position	Long term returns (1)
Shares	Australian shares	The local stock market had a pause in February after the strong new year rally in January. The shift from defensives to cyclical stocks continued this month, after the big swing to defensive sectors late last year. Oil & gas (led by Woodside), industrials, and consumer discretionary stocks were up a little, while the banks and miners were flat after big rises last month. The reporting season for the December half year produced few surprises. Most companies reported earnings rises and many lifted dividends, with a few notable exceptions. For the market as a whole, earnings and dividends were up moderately, averaging around 5-6% increases on last year's levels. This is spot on both the long term average historical growth rate for earnings and dividends in Australia, and it is also on a par with our long term expected future growth rate. Earnings and dividend growth of around 5-6% per year plus dividend yields of 4-5% makes up total returns of around 10-12% which is what the Australian stock market has delivered over the past century, and is in line with the long term expected future returns.	Below fair value	Above average long run returns
	Developed markets shares	After a horror year in 2011, Japan was the star stock market in February, re-bounding 10% for the month, assisted by a weakening yen despite continued losses from market leader Sony. European markets were up between 3-6% in the euphoria over the prospect of a second round of unlimited, no-strings-attached ultra-cheap debt from the European Central Bank, which was eagerly anticipated during the month and announced on the last day. The US market was also up 4% for the month, due mainly to Apple surging 19%, making it a rise of 33% since the start of January. Like Europe, the US is also drunk on central bank money-printing but there are a couple of key differences. In the US, the banks have been either closed down, re-capitalised or slashed to a fraction of their previous size, but in Europe the huge "zombie" banks still dominate all the major stock markets and the ECB is still feeding them with unlimited cheap debt, which they are using to lend to teetering European governments. Further, Europe's economy is contracting, but the US economy is growing and continuing to show signs of further recovery.	Around long run fair value	Below average long run returns (2)
	Emerging markets shares	Emerging stock markets were up further in February but by less than in January's great run. Of the main markets, Russia was strongest, where more than half of the market is in oil/gas stocks. Oil prices are back above $100 a barrel, thanks to the Iranian stand-off. High oil prices have been good to oil producers, but will damage economies all over the world. It may soon get worse as a military strike against Iran is looking increasingly likely. China, Brazil and India also continued their bounce-backs after the losses of last year. Emerging markets are up an average of 12% so far this year, and even after the effects of the rising AUD, are still up 10% for the year in Australian dollars.	Around fair value	Above average long run returns, but high volatility (2)
Fixed Income	Australian Gov't bonds	The anticipated rise in yields continued in February after the rises in January, especially in the middle of the curve in the 2 to 5 year region. Yields on 2 and 3 year bonds are now around 0.5% higher than the ultra-low levels reached at the end of December last year. Consequently returns from bonds have been flat this year. We are expecting bond yields to rise even further, meaning returns are likely to be quite poor, as they were during the stock market recovery in 2009.	Yields below (prices above) long run average level	Below average long run returns
	Bank Term Deposits	Interest rates on bank TDs are still well above the yields on government bonds and notes of similar terms, even after the rises in government yields over the past couple of months. If official cash rates fall even further this year, banks will be reluctant to pass on the rate cuts to TDs, so investors should continue to benefit from relatively good interest rates by using TDs rather than bonds.	Rates around long run average	Around average long run returns
	Global Bonds	Australian dollar hedged global government bonds returned 0.5% in February, making it 1.5% for 2012 so far, continuing the good steady returns from 2011. Bond yields rose a little in the "safe havens" of US, Germany and Japan, but fell in higher yield markets, notably Italy. This shift of money out of safe havens into higher risk / higher yield markets like the PIIGS (and Australia) was driven by the European Central Bank's first round of unlimited 3 year 1% loans to European banks in December, and it is set to continue with the 2nd round of cheap money announced on 29th Feb.	Yields below long run average level	Below average long run returns (2)
Cash	Australian target cash rate	The official target cash rate remains at 4.25%. In an unusual turn of events the Reserve Bank governor has made public statements supporting the big banks' decisions to add their own margins to interest rates and almost thanking them for helping him manage interest rates in the economy. The dollar is still rising (attracted by our relatively high interest rates), employment growth is slowing, and banks are reluctant to pass on interest rate cuts, so the RBA should have scope to cut rates further, but it hampered by the fact that inflation is still at the high end of the target range.	Cash rates below long run average level	Variable, rising over medium term
Real Estate	Australian commercial property	Listed property trusts prices were up a percent in February after the strong January rally which saw prices rise by 5%. The stand-outs were Westfield Group and Goodmans, which were both up strongly again for the month while the rest of the market was relatively flat. Yields are still relatively attractive, several trusts raised distributions in the recent reporting season, and most of the major trusts are undertaking buy-backs, all of which are providing good support for unit prices.	Around long run fair value	Around average long run returns
	Australian residential property	After a very quiet summer, buyers, sellers and agents are hoping for more activity in the up-coming autumn selling season. It is still very much a buyers' market with many more sellers than buyers, and banks reluctant to lend. Rents are continuing to fall especially at the top end of the market, and are likely to fall further as global banks continue to downsize, sell off or close down operations around the world, especially in far-flung outposts like Australia. In most segments of the market, net rental yields are still too low. Prices need to fall and/or rents need to rise substantially before housing stacks up as a long term investment again.	Varies by market, but over-valued overall	Average long run returns
Australian Dollar		In February the Aussie dollar rose a little against a weaker US dollar and sterling, and rose significantly against the sliding yen, but it fell against a stronger Euro and Swiss Franc. The continued high dollar is still hurting exporters, manufacturers, local tourism and education businesses, but not enough to tempt the Reserve Bank to lower interest rates yet this year. The dollar is still substantially over-valued and we recommend foreign shares remain un-hedged.	AUD Above fair value	Currency gains for Australian investors 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