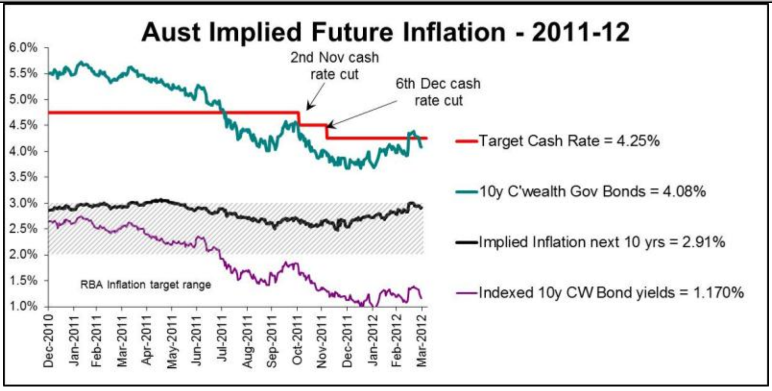
PHILO CAPITAL ADVISERS

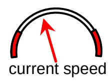
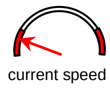
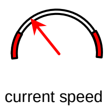
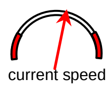
MONTHLY MARKET MONITOR – End March 2012

Chart of the month: Inflation outlook for Australia



Australia has the highest inflation rate and interest rates of any major developed country. Our relatively high interest rates are hurting local businesses by keeping the dollar high and keeping interest rates high on loans for businesses and households.

Our chart shows yields on regular 10 year Commonwealth bonds and on inflation linked 10 year bonds since the start of 2011. The difference between the two yields is the expected inflation rate over the next 10 years. Apart from a brief dip during the US and Greek debt crises in August to October last year, the expected inflation rate for the next 10 years in Australia is near the top of the Reserve Bank's target range of 2-3% inflation. The RBA will be reluctant to cut rates while the threat of inflation persists.

		Economies	Current position	Direction/ Trend	Pace of growth
Economies	Australia	The high dollar and rising wages and input costs remain the main problems for Australian businesses. Apart from mining and mining investment projects (which are largely foreign owned) the rest of the economy is slow. Mining employs just 2% of the workforce but the industrial relations system results in wages rises in one sector being transferred into wage claims across the rest of the market. Tax revenues at federal and state level are under pressure – with lower corporate taxes and GST receipts at the federal level and lower property taxes in the states. More new taxes passed into law in March – the mining tax and higher compulsory superannuation contributions. Unlike the wages Accord in the 1990s where increases in superannuation contribution levels were traded off against wage claims, unions this time have ruled this out. We expect non-mining sectors to slow and unemployment to rise in the coming months.	Below average growth rate	Growth flattening	
	Europe	Greece finally defaulted on its government debt during the month and, as expected, it passed with little impact on capital markets. Greek has defaulted 8 times in the past 180 years and has spent most of the past two centuries in debt "restructure". This latest default/restructure in theory puts off the crisis for another three years, but Greece will find it very difficult to stick to the program to reduce its deficit and debt levels. Spain is a much larger problem than Greece. Unemployment rates are soaring and riots are gathering pace against the budget austerity plans and proposed reforms to labour laws. Although Europe is stagnant and unemployment is rising, this is more than outweighed by growth in the US and continued strength (albeit at reduced rates) in the emerging markets.	Contracting	Weak growth	
	US	The recovery in the US economy continues to gather pace. More and more companies are "on-shoring" jobs – moving operations back to the US - not just because of more flexible labour laws and lower wages, but because of greatly improved productivity of US workers. For example in General Electric five years ago it took 16 man-hours to build a fridge in a US factory but it now takes just 4 hours. In contrast, wages in China are rising 20% per year and productivity is still a fraction of the US levels. One dark cloud on the horizon is petrol prices. US gas prices at the pump were below $2 per gallon in 2005, rose to above $4 by mid 2008, fell to below $2 again by the Christmas 2008 in the sub-prime crisis, but are now back up near $4 (which is around $1 per litre). This is putting pressure on consumer spending. The other looming problem will be inflationary expectations as the economy gathers pace. The Fed keeps vowing to keep interest rates near zero for years to come, in order to let inflation reduce the real size of household and government debts, and to encourage spending. As banks start lending again and borrowers start borrowing again, it will be very hard to contain inflation once it rears its ugly head. But for the time being, the high unemployment rate and excess industrial capacity are keeping prices and wages low.	Below average growth rate	Recovery remaining slow	
	China	China lowered its economic growth target from 8% pa to 7.5% pa in recognition of the unsustainable pace of the previous target. When global markets for China's exports collapsed in the GFC it shifted quickly to capital investment programs including infrastructure and property developments, funded largely with debt. This kept employment high (and boosted commodities exporters like Australia). The legacies of those programs are a property bubble, countless projects with questionable returns on investment, and potentially enormous bad debt levels in the banks and local governments. China has the resources to re-capitalise the banking system, as it has done in the past, and has the political commitment and the motivation to contain the slowdown to a "soft landing" if it can. The battle for the leadership of the Communist Party is heating up. In March we saw the sacking of the hard line Maoist governor of Chonqing, Bo Xilai, who had a wide following. We also had the closing and suspension of several social media sites and jailing of dozens of bloggers, to "cleanse" them of views inconsistent with the official party line. Citizens are free to share their views on blogs and social media sites (those that are allowed to remain open anyway), as long as they register with the communist party first!	Strong growth still	Growth slowing	

		Asset Classes	Current position	Long term returns (1)
Shares	Australian shares	The local stock market ended up flat for March, and is still up 8% so far in 2012 (or 9% including dividends). After the sudden switch away from defensive sectors toward cyclicals from the start of the year, investors have become more defensive over the past few weeks, with money switching back in to defensives once again. The big miners were down an average of 4%, while the big banks were up an average of 4%, and industrials were generally flat. The biggest gains for the month were: QBE up 22% (recovery from the fall in January), Computershare up 16% (with the strong global equities markets), Onesteel up 17% (but still half the price of a year ago), Campbell Brothers up 13% (mining services), and Seven Group Holdings up 11% (after the falls in 2011). The main losers were specialized miners – Newcrest, Paladin Energy, Oz Minerals, Lynas, Pan Aust, Mt Gibson Iron, and Perseus Mining. Aside from miners, Leighton was down 17% (on news of more losses) and David Jones (-11%) with softer retail spending. We expect local share prices to benefit from favourable developments in the US and also from a weaker Australian dollar in the coming months.	Below fair value	Above average long run returns
	Developed markets shares	The safe havens of the US, Germany and Japan were up strongly again in March following strong returns in January and February. For the March quarter the US is up 12%, Germany up 18% and Japan up 19%. Other developed markets, including the UK and the rest of Europe, were flat. Un-hedged Australian investors also gained from the additional currency effect of the Australian dollar falling 4% for the month, and we expect this trend to continue.	Around long run fair value	Below average long run returns (2)
	Emerging markets shares	The major emerging markets all fell back in March, but are still ahead for the year to date. China is up 3%, India up 12%, Russia up 18% and Brazil up 13%. Among the smaller markets, Malaysia, Thailand, Philippines, Indonesia and Pakistan continue to surge. The emerging markets ETF "IEM" is up 10% for the quarter in Australian dollars. Looking at China, the strongest sectors for the quarter were property developers (up 10%) and miners (up 9%), with rare earth miner Inner Mongolia Boatou up 77%, and copper/gold miners also up strongly. Chinese banks were up around 5% but the securities houses were all up strongly due to the turnaround in the stock market. Across in Hong Kong, property developers were up strongly, as were industrials (mainly manufacturing in China) and HK listed Chinese miner. Foxconn (which makes phones and tablets for Apple and for most other global phone brands in its Chinese factories) remains the best performing Asian stock over the past year (mirroring Apple's rise in the US) and is one of the very few Asian stocks that kept rising strongly throughout the rout in 2011.	Around fair value	Above average long run returns, but high volatility (2)
Fixed Income	Australian Gov't bonds	Yields remained flat for short to medium term maturities but kept rising at the long end. Yields across all maturities remain above those at the start of the year, leading to flat returns from bonds. We remain of the view that bond yields are too low and will rise further in the months ahead, leading to low returns from bonds. Yields are being depressed by a surge in foreign buying, but this is likely to wane as the currency falls further with the slow-downs in China and commodities prices.	Yields below (prices above) long run average level	Below average long run returns
	Bank Term Deposits	Last year we favoured bonds over TDs, and bonds beat TDs as market yields fell. This year we have favoured TDs over bonds, and bonds have been flat due to rising yields. If official cash rates fall 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	Returns on AUD-hedged global government bonds were up a little in March, and are up 1.6% for 2012 to date (better than Australian bonds again). We are expecting inflationary expectations to return in the US first and this was the theme in March, with US yields rising, while yields in Japan, Germany and the rest of Europe remained flat. We don't expect inflation to re-emerge in Europe or Japan for some time, but we see yields in the US continuing to rise as the economy improves.	Yields below long run average level	Below average long run returns (2)
Cash	Australian target cash rate	With inflation at the high end of the target range, the Reserve Bank is reluctant to cut rates. However see unemployment likely to rise in the coming months, with residential and commercial construction remaining very weak, manufacturing falling, retail remaining slow and banks shedding staff.	Cash rates below long run average level	Variable, rising over medium term
Real Estate	Australian commercial property	The listed property market was flat again in March, and is now up 5% so far in 2012 (and up 8% including distributions). The main negative was in Stockland, and to a lesser extent Mirvac, which fell on concerns over the very weak residential market to which they are heavily exposed. Nearly all listed trusts are trading well below their claimed underlying net property values, and most are under-taking buy-backs to reduce the discounts. We expect the relatively attractive yields and buy-back activity to continue to support prices in the coming months.	Around long run fair value	Around average long run returns
	Australian residential property	Falling prices and low sales volumes are putting pressure on stamp duty revenues for state governments. It is getting to the point where state governments are starting to think about more hand-outs for first home buyers (which just artificially prop up prices and line the pockets of developers, who are among the largest donors to political parties). Hopefully sanity will prevail and they will let prices fall to levels where first home buyers can actually afford to buy houses again. As prices in most segments in all the major cities are still over-priced, we see further weakness ahead.	Varies by market, but over-valued overall	Average long run returns
Australian Dollar		The Australian dollar fell from 1.08 USD (which was the highest level since before the US/European debt crisis last August) back down to 1.04 during March, as commodities prices fell across all the base metals and China slowed. This AUD fall benefited un-hedged investors in foreign shares. We see further falls in the Australian dollar as local interest rates stay low and we expect this to benefit investors in global shares and also boost local companies.	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