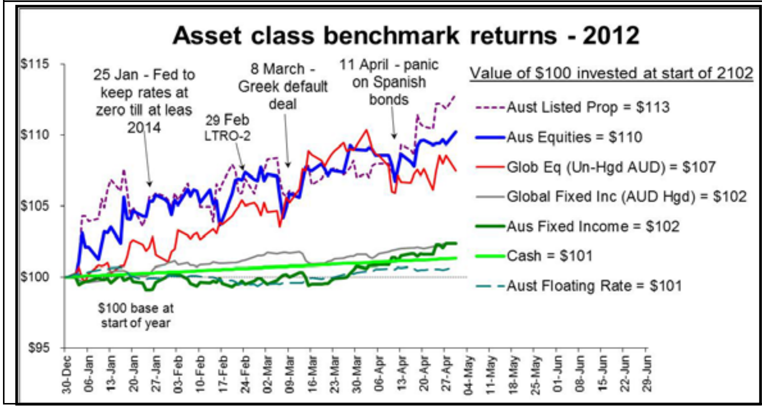
PHILO CAPITAL ADVISERS

PHILO CAPITAL MARKET MONITOR – End April 2012

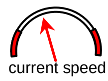
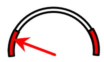
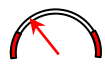
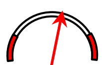
Chart of the month: A good year for all asset classes so far…



So far 2012 has been pretty good for all asset classes – with shares, property and fixed income all generating returns higher than their long term averages.

This is despite the Greek default, recessions in Europe and the UK, a very weak US economy, rising unemployment rates and increasingly violent riots across Europe, slowdowns in the major emerging markets, the escalating nuclear showdown with Iran, and $100+ oil prices.

It is a good reminder of the value of focusing on asset markets directly rather than on the day to day news in the media, which is always biased toward bad news.

		Economies	Current position	Direction/ Trend	Pace of growth
Economies	Australia	Despite the tremendous increase in export revenues and lower import prices resulting from the current mining boom, Australia still does not generate a surplus as a nation. We still spend more than we earn from other countries and have to borrow from foreigners or sell assets to fund the shortfalls. This is not new of course. We somehow managed to get through the 2 last mining booms (1960s and late 1970s/early 1980s) without ever recording a current account surplus. We have generated a surplus in only 3 years since 1950, and the last was in 1972-3. Importing capital from foreigners is fine if it is used to build productive capacity, but we haven't been doing this. Productivity growth has stopped and much of the foreign debt just funds consumption and housing. Plus the federal government has turned record budget surpluses into record deficits. One positive outcome is that both of the major political parties now claim to agree on the need to get the government back into surplus to pay off debt. We find out when the 2011-12 budget is announced next week.	Below average growth rate	Growth flattening	 current speed
	Europe	The effects of "LTRO-2" (round 2 of the Long Term Refinancing Operation) are wearing off and yields on PIIGS bonds are on the rise again. Germany/ECB is now locked in to continue transferring wealth from German tax-payers and pensioners to European bank shareholders and PIIGS governments and citizens. This may take years because PIIGS governments are still in deficit and will require funding for years to come. The ECB is not allowed under its constitution to lend directly to governments so instead it has lent more than €1 trillion at 1% for 3 years to more than 500 European banks for them to on-lend to PIIGS governments. The aims of the plan were (1) to bolster the profitability and capital reserves of European banks by handing them "free" profits (they borrowed from the ECB at 1% and on-lent it at 5-6% to the Spanish and Italian governments); and (2) to artificially reduce bond yields (the cost of debt) for the PIIGS governments. Both rounds of LTRO worked to hand profits to the banks and reduce PIIGS bond yields for a while, but it was only temporary. Governments are still in deficit, and so Germany has little choice but to keep doing it. It is not a long term solution and just increases the debt pile.	Contracting	Weak growth	 current speed
	US	The March quarter GDP growth number for the US was lower than the market expected, but it still showed growth of 2.2% pa, which is higher than the rest of the "developed" world. UK, Europe and Japan are all still travelling along the bottom, dipping in and out of recession. Although US manufacturing output is still very slow, there are signs that the housing market has bottomed in some markets. Home sales are starting to stabilise and housing construction is showing some signs of life after four very lean years. Household consumption is also relatively strong, and rising more quickly than incomes, meaning households are using up savings and/or borrowing more to spend. While this is bad in the long term (it shows that the "spend now, pay later" mentally is still alive and well) it is good for company revenues and earnings in the current cycle. However, oil prices remain high due to the on-going tensions in Iran and Syria.	Below average growth rate	Recovery remaining slow	 current speed
	China	There are early signs that a cyclical re-bound in China may play out over the next few months. When world trade collapsed in the global recession following the Lehman crisis, China reacted with massive stimulus programs that went too far. The result was explosive growth in credit, infrastructure spending and inflation in asset prices and consumer prices. Throughout 2011 the government reacted by tightening credit and money supply but the tightening policy also went too far. So the policy switched in late 2011 from tightening money and credit to fight inflation, to a policy of easing money and credit to try to prevent a hard landing. Since the policy moves require many months to take effect, conditions are still tough in the first half of 2012 (slower growth, lower levels of investment and spending, falling housing prices and lower corporate profits) but we expect to see growth pick up in mid-late 2012. We are already seeing early signs of first home buyers starting to return to the market and steel production starting to turn the corner.	Cyclical slowdown	Growth recovering in coming months	 current speed

		Asset Classes	Current position	Long term returns (1)
Shares	Australian shares	The local stock market was up a little in April, continuing the run of positive returns each month of this year so far. The big banks were up slightly as they continue to focus on maximising margins and cutting costs. In the resources sector the big miners were flat, oil/gas stocks were down, but hardest hit were gold stocks, with the gold price continuing to slide after the January spike. Telstra was up strongly on news on the likely future distribution of the benefits from the NBN deal. Our outlook remains positive for shares in the coming months, benefiting from continuing growth in the US economy and a cyclical rebound expected soon in China.	Below fair value	Above average long run returns
	Developed markets shares	The major markets were flat in April, except Japan, which was down 6% after its 20% gain in the March quarter. The US market was flat, with good earnings results in most sectors. Repeating the pattern in recent quarters, around 70% of companies have beaten analysts' expectations (which were already reasonably bullish) for March quarter earnings, despite the sluggish economy. Most of the US attention is still focused on the Fed and whether it will embark on further monetary stimulus. Over the past couple of years, whenever the Fed announces that the economy is so sick that more artificial stimulus will be needed, investors rejoice and the stock market surges, but when the Fed announces that the economy is strong enough to recover under its own steam, investors dump shares. The Fed has not hinted at a possible further round of quantitative easing for a while now, so shares have been propelled by good earnings results and strong cash flows.	Around long run fair value	Below average long run returns (2)
	Emerging markets shares	Emerging markets were down a fraction in April, but are still up by around 9% so far this year. Chinese stocks were up strongly in April, after having lagged in the March quarter global rebound, while the rest of the BRICs were down a little. The emerging markets are now well into stimulatory mode, in a reversal of last year's tight policy settings, as the focus has now switched from cooling inflation to one of stimulating growth and avoiding the prospect of a hard landing. Of the big markets, Brazil started easing last year, then China at the end of the year, and now India has started to cut interest rates to stimulate growth as the economy slows. Economic nationalism is rising in many markets as they try to bolster economies and votes. Argentina has now followed Venezuela's lead in its move to expropriate and nationalise the 51% share in the Argentinian oil/gas firm YPF held by Repsol of Spain. Argentina is of little interest as it was dropped from the "emerging markets" index years ago and relegated to "frontier market" status once again. What is starting to worry investors is Brazil's support of the expropriations.	Around fair value	Above average long run returns, but high volatility (2)
Fixed Income	Australian Gov't bonds	Bond yields fell across all maturities in April as more foreign "hot money" flooded into the country in search of yields, resulting in a good month for commonwealth government bonds, although state government bonds haven't had the same benefit. Australian and AUD-hedged global government bonds have now both returned a little over 2% for the year to date, while Australian and global shares have returned around 9% this year. We remain of the view that government bond yields in Australia are too low (especially commonwealth bonds) and are more likely to rise in the months ahead, leading to relatively low returns from bonds. We expect the surge in foreign buying to wane as the currency falls and commodities prices remain weak.	Yields below (prices above) long run average level	Below average long run returns
	Bank Term Deposits	As official cash rates fall further this year, banks are unlikely to pass on the rate cuts in full on term deposit rates (or on loans), so depositors 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 April, making it six months in a row of positive returns. Continuing the see-saw pattern of the past year, yields in the "safe haven" countries of the US, Germany and Japan fell, offsetting yield increases in the weaker countries. Yields in Spain and Italy rose back toward 6% as default fears returned and as the artificial buying support funded by ECB loans wore off once again. Germany and the ECB have little choice but to keep throwing more borrowed money at the problem in order to keep yields in Italy and Spain from rising to dangerous levels.	Yields below long run average level	Below average long run returns (2)
Cash	Australian target cash rate	Weaker inflation and employment numbers have provided the Reserve Bank with leeway to cut interest rates. However, the impact will probably be relatively minor, as banks are unlikely to pass on the rate cuts in full to either borrowers or depositors. We are expecting employment growth to remain low, with residential and commercial construction remaining very weak, manufacturing falling, retail remaining slow and banks continuing to cut staff.	Cash rates below long run average level	Variable, rising over medium term
Real Estate	Australian commercial property	The listed property market had a good month in April, adding to the strong gains in the March quarter. All sectors were up, with Mirvac in particular bouncing back after a poor month in March. We remain relatively bullish on the market. More trusts are undertaking buybacks and investors are steadily gaining confidence in the claimed book values of properties as more major transactions are done in the market. As confidence grows we expect to see prices rise to narrow the discount gaps.	Around long run fair value	Around average long run returns
	Australian residential property	New dwelling approval levels are still weak and prices remain weak in most markets. But housing "affordability" is still relatively low for owner-occupiers, and net rental yields are still low for investors, so prices are not low enough (or rents not high enough) to entice buyers in big numbers. Even "mortgagee-in-possession" sales are having trouble finding buyers. Prices are certainly down from the boom time levels of five years ago, but the general feeling is that it may be better to wait for further falls rather than trying to "catch falling knives" now. The positive impact of RBA cash rate cuts, if and when they are delivered, will probably be more psychological than real.	Varies by market, but over-valued overall	Average long run returns
Australian Dollar		The Australian dollar was flat in April. It rose a fraction against the USD and the weakening Euro, but fell against Sterling and particularly against the Yen, which gathered strength as the effects of the Bank of Japan intervention wore off. We expect our dollar to weaken further, but may see a pick up later in the year as the expected cyclical recovery in China flows through to commodities prices and "hot" commodity currencies like the AUD.	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