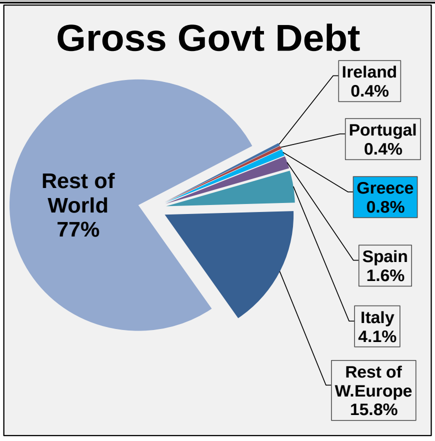
PHILO CAPITAL ADVISERS

# MONTHLY MARKET MONITOR – End May 2012

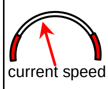
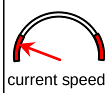
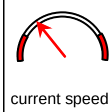
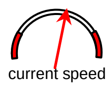
## Chart of the month: How large is the "PIIGS" debt problem?




It is important to keep the government debt problems in Portugal, Ireland, Italy, Greece and Spain (the "PIIGS" or "GIPSI" countries) in perspective. Greece has 0.2% of the world's population, it generates 0.4% of the world's output (twice its per capita share) and has 0.8% of the world's government debt (4 times its share). The PIIGS together total just 7% of global government debt.

The other 93% of government debt is owed by countries that are paying their interest bills and repaying (or rolling over easily) the principal as bonds mature. Yields on government bonds of virtually every country other than the PIIGS are at ultra-low levels, meaning investors everywhere are supremely confident that the debtor countries can keep paying their debts for the next decade and beyond – including and especially the big debtor countries – US, Japan and Germany.

The problem is that the main holders of PIIGS government debts are European banks and these are highly leveraged, meaning they will need massive capital injections from their governments (and probably nationalisation). Austerity is not the answer – it leads to larger deficits & debts. Nor is an uncoordinated exit from the Euro system, as this will trigger domino-like bank runs and collapses. The problem is not insurmountable, but leadership, diplomacy and patience are being put to the test as European politicians edge slowly and painfully toward fiscal co-operation.

| | | Economies | Current position | Direction/ Trend | Pace of growth |
|---|---|---|---|---|---|
| Economies | Australia | Australians remain relatively pessimistic despite enjoying the fastest growing economy and one of the lowest unemployment rates in the developed world (plus cleaner air, safer water, safer streets and a host of other advantages). The negative sentiment is affecting consumer spending, and even on-line sales growth is now slowing. The pessimism may be partially to do with property prices (which continue to fall) and partially due to politics. The Federal budget for the 2012-13 year (released on 8th May) aims for a monumental fiscal turnaround, from a $45b deficit this year to a targeted $1.5b surplus by June next year. The proposed budget cuts are largely achieved by tricks including accelerating and delaying spending; and the budgeted tax receipt gains are based on assumptions of high commodities prices, which are highly unlikely to be achieved. The government has as much chance of achieving an actual surplus next year as Julia Gillard has of winning the Melbourne Cup with Kevin Rudd riding on her back.<br>Meanwhile, even without the restrictive budget stance, the non-mining economy (the industries that employ the other 98% of workers in Australia) is showing little growth. However, the recent falls in the dollar, interest rates and oil prices should ease some of the pressure on businesses and households, as will the latest "cash splashes" in the budget. | Below average growth rate | Growth flattening |  |
| | Europe | European economies continue to contract, with Germany being the only saviour. The 6th May was one of the key turning points in the Euro saga, with elections in France and Greece resulting in overwhelming rejections of the austerity programs. In France, socialist Francois Hollande romped home with his promises of higher government spending and 75% tax rates on the rich. In Greece there was no clear winner and a new election is planned for 17th June.<br>Yet another emergency "summit" of Eurozone leaders over the Greek debt crisis (the 19th by our count) failed to agree on any coherent plan of action to deal with the debt crisis. With no action from politicians, bank depositors accelerating their cash withdrawals from Greek and Spanish banks, and bond yields in Spain and Italy back on the rise, a 3rd round of cheap loans from the ECB to European commercial banks under the Long Term Refinancing Operation ("LTRO") is looking increasingly likely. Spain's 4th largest property lender, Bankia, was nationalised, costing the Spanish government €23b, adding to Spain's deficit and debt. | Contracting | Weak growth |  |
| | US | May also saw yet another massive "rogue trader" loss on derivatives trading. This time, US investment bank JP Morgan revealed a $2 billion loss from trading in credit derivatives (by Greek trader Achilles Macris) which could be as much as $3b or more once the dust settles. JP Morgan had previously boasted that it had the best risk management in the world, and that it had even invented the famous "Value at Risk" models that failed so spectacularly in the GFC (the disastrous "VaR" model is still used by banks worldwide to "manage" risk for some inexplicable reason). Meanwhile the US housing market is improving gingerly. Housing is strategically important as it drives consumer confidence, and spending on house purchases, renovations, home wares, construction and building materials. Also contributing to improving confidence is the recent fall in oil prices, which are now back well below $100 per barrel. | Below average growth rate | Recovery remaining slow |  |
| | China | The cyclical slowdown in China continues – with bank lending, house prices, manufacturing, exports, retail spending, and investment spending rates all slowing. On the 13th May the bank reserve ratio was cut for a 3rd time since the easing cycle started in November last year, and this sent the AUD back below parity. Then on the 20th Premier Wen Jiabao announced a plan for further stimulus spending. Unlike the US, Europe or Japan, China has plenty of ammunition to stimulate its economy and is committed to do what it takes to restore growth and stability. Inflation is now down to a more manageable 3% to 3.5% (having come down from a 6.5% peak in July last year). However, the party is reluctant to hit the stimulus button as heavily as they did in 2009 for fears of re-igniting the housing boom, which they took two years to control amid rising social and political unrest. The cyclical rebound later this year will probably be slower and more subdued than the strong 2009-10 re-bound in which inflation and housing prices soared. | Cyclical slowdown | Growth recovering in coming months |  |

| | | Asset Classes | Current position | Long term returns (1) |
|---|---|---|---|---|
| Shares | Australian shares | After four positive months in a row, the overall stock market was down 7% in May, but is still ahead for the year to date. The fall in May was mostly due to mining stocks. Miners are essentially leveraged bets on commodities prices, and commodities were down virtually across the board in May, with the European recession and slow-down in China. Miners are now sensibly scaling back their massive plans to spend tens of billions on LNG projects in the face of collapsing LNG prices and rapidly rising costs. Last year BHP spent $20b buying up gas projects in the US and is already having to write off several billion dollars (as US gas prices have halved since the purchase). RIO still holds the record for the worst late-boom “investment” of all time – forking out $38b (funded 100% by short term debt) to buy Alcan at the very top of the market in 2007. Hopefully the miners have learned the lesson that over-supply generally kills prices more than falls in demand. The mining stocks in our model portfolios have fared better than the mining sector as a whole.<br><br>The overall stock market remains reasonably attractively priced and our model portfolios are positioned to benefit from the falling dollar. | Below fair value | Above average long run returns |
| | Developed markets shares | Developed markets were down by an average of around 7% in their local currency terms, but this has been largely neutralised by falls in the Australian dollar. The US and big European markets were all down by similar amounts. Despite the May falls, the industrial giants – US and Germany – are up solidly for the year. The main event in the US market was the Facebook flop, which has turned into a bonanza for lawyers as just about everybody is suing everybody else. The float was vastly over-priced at 100 times earnings, despite weakening revenues and earnings. The float valued the company at an incredible $104 billion for a company that started in a college dorm room just 8 years ago. The share price collapsed 25% in the first week despite artificial price support from the sponsoring broker, Morgan Stanley. The whole mess will clog up the courts for years to come. Meanwhile, real companies with real earnings are continuing to generate very profitable sales, especially into the emerging markets, and many remain attractively priced. | Mixed – many markets under-fair to priced | Around average to below average long run returns, but currency gains expected due to our high dollar (2) |
| | Emerging markets shares | Emerging stock markets were also down in May, with China (flat) the best of the BRICs and Russia (down 20%) the worst. Around 60% of the Russian market is in oil/gas related stocks and oil prices fell 15% in May. In Brazil the economy remains slow despite stimulus efforts, and the stock market was down heavily again in May, especially mining. Emerging markets as a whole are still up 2% for the calendar year to date in their local currencies, but are up 4% in un-hedged AUD terms given the fall in our dollar against most currencies. | Around fair value | Above average long run returns, but high volatility (2) |
| Fixed Income | Australian Gov’t bonds | Bond yields continued to fall even further throughout May, and are now below their ultra-bearish levels reached at the end of 2011. Yields on long term government bonds have not been this low since 1897, which was in the midst of the massive 1890s banking crisis and depression. With implied future inflation in Australia still running around 2.5% pa, this allows no compensation for locking money up for years. At these levels it is hard to see good returns from bonds for the rest of this year, and bank term deposits are offering significantly more attractive yields. | Yields below (prices above) long run average level | Below average long run returns |
| | Bank Term Deposits | Bank deposit rates have fallen, but not as much as bond yields of similar maturities, as banks seek to reduce their reliance on foreign debt. While local bonds have done well this year, it is hard to see bond yields falling further and we now prefer term deposits for fixed income exposure. | Rates around long run average | Around average long run returns |
| | Global Bonds | Hedged global bonds returned another 1.5% for the month, making it 4% for the year so far. Good returns from declining yields in the “safe havens” (US, Germany and Japan) more than made up for rising yields in the PIIGS as the effect of the ECB’s “LTRO-2” cheap money wore off. Spanish yields crept back above 6% from the 2nd week of May and remain dangerously high. Italian yields hit 6% a week later and remain a concern. UK yields are well below 2%, and nearly as low as US yields. We are expecting reasonably good returns from this asset class to continue this year. | Yields below long run average level | Below average long run returns (2) |
| Cash | Australian target cash rate | The cash target rate was cut by 0.50% to 3.75% on 1st May, in the third rate cut in the current easing cycle. Headline inflation has been low in the most recent two quarters but much of that was due to fruit & vegetable prices falling from their flood-induced price spikes last year, and due to over-production of TVs and other gadgets in Asia. The money markets are pricing in more rate cuts in the coming months as the local economy slows further. With unemployment low and wages rising strongly, further rate cuts are likely to fuel inflation sooner rather than later in Australia. | Cash rates below long run average level | Variable, rising over medium term |
| Real Estate | Australian commercial property | The listed property trust sector is the best asset class so far this year – returning more than 11% year to date. In May the sector held up well while shares fell. Office values are showing signs of life, with most of the interest still coming from foreign buyers, despite the doubling of withholding tax on trust distributions to foreign investors in the federal budget. Unit prices are being supported by good yields (above 6.5% still) in the face of falling yields on cash and bonds. The swathe of buy-backs at large discounts to NTA are also supporting prices.<br><br>US retail trusts are continuing to do well, posting good gains in rents and net income, which is supporting the outlook for Westfield Group in particular. | Around long run fair value | Around average long run returns |
| | Australian residential property | First home buyer interest is showing some signs of picking up, with residential rents at the bottom end firming and mortgage interest rates (for variable and fixed rates) falling. At the top end and in secondary markets (beach houses, rural retreats), prices are still down heavily. | Varies by market, but over-valued overall | Average long run returns |
| Australian Dollar | | The Australian dollar fell around 5% in May, helped by the half per cent cut in cash rates on the 1st May. The AUD is now back below $1USD and well below 80 yen, and it even fell against the weakening Euro and Swiss Franc. Our un-hedged stance worked well this month. The fall in global share prices was almost entirely cushioned by similar falls in the AUD against global currencies, leaving Australian shareholders largely unaffected. Despite recent falls, the AUD remains over-valued and is likely to fall further as local interest rates fall and Europe continues to slow. | 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