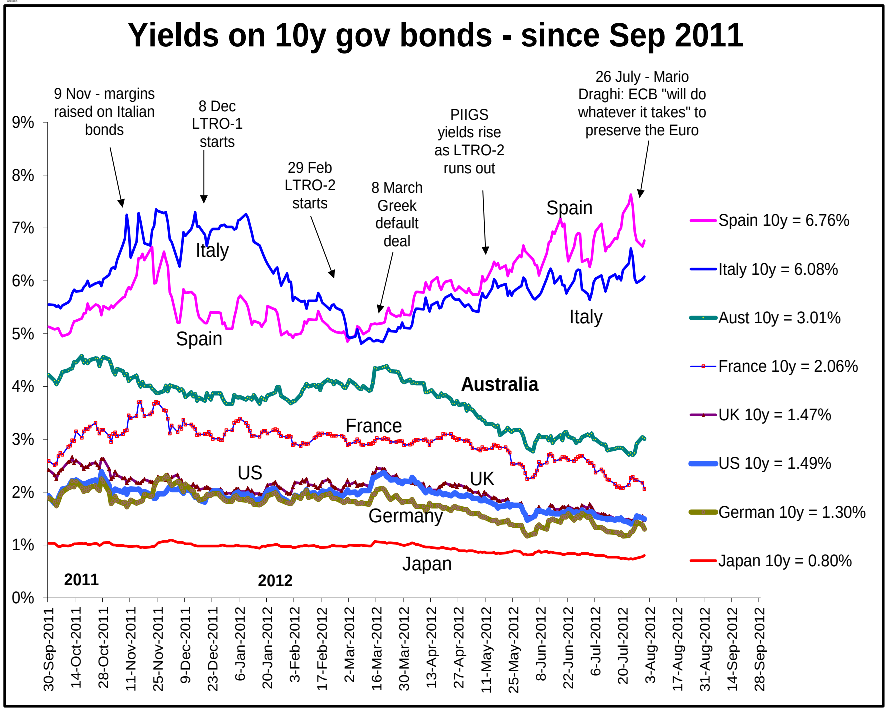
PHILO CAPITAL MARKET MONITOR – End July 2012

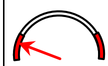
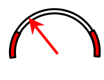
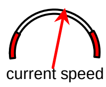
Chart of the month: Global bond yields head in two directions



2012 has seen a dramatic pattern emerge in government bond yields. Governments (including in Australia) have been piling on debt over the past 3 years. First, many took on debts to bail out their banks in the sub-prime crisis, and then they borrowed even more in their attempts to spend their way out of recession. Instead of bond yields rising to price in the increased risks of default and currency devaluation, yields are instead being kept artificially low by central bank buying programs, funded by newly "created" money - in Japan, US, UK, Europe and Switzerland. There are three main aims of this "quantitative easing" policy:

- lowering borrowing costs for governments,
- lowering borrowing costs for companies and households, encouraging them to borrow and spend, and thus create/save jobs; and
- depressing their currencies, to stimulate exports and jobs in their home markets.

Some of this newly created money, and money borrowed cheaply by speculators, has headed for Australia, chasing our relatively high yields. This has brought down local bond yields and kept the Australian dollar high, as the RBA hasn't joined in the money printing / currency depreciation game.

		Economies	Current position	Direction / Trend	Pace of growth
Economies	Australia	Consumer price inflation for the June quarter was 0.5% after two weak quarters, bringing the annual inflation rate to just 1.2%. This is well below the 3% inflation in 2011 and 2.7% in 2010, but is still above the low inflation rates of the late 1990s. The unemployment rate edged up to 5.2%, mainly due to increases in South Australia and Tasmania. The labour participation rate also declined, meaning more people gave up looking for work, masking a broader softening in the employment market. The overall unemployment rate is still very low, and wage pressures are continuing to fuel industrial unrest across many industries, not just in mining. Further weakening in jobs is likely in the coming months as governments cut staff and companies start to get serious about cost-cutting.	Below average growth rate	Growth flattening	 current speed
	Europe	There is a dance going on in Europe. The Germans, led by Chancellor Angela Merkel, Finance Minister Wolfgang Schäuble, and Bundesbank President Jens Weidmann have now come to realise that forcing strict hard-line austerity measures on the PIIGS governments (cuts to staffing levels, wages and pensions, and tax hikes) will lead to larger budget deficits and larger debts. They know the Greeks, Spaniards and Italians need more time to pursue growth in order to balance their budgets and pay off their debts. The Germans are now thinking what was unthinkable only a month ago - planning for a partial break-up of the Eurozone, with Vice-Chancellor Philipp Rösler publicly admitting that "a Greek exit has long since lost its horrors". But the Germans are terrified of looking soft to their constituents – angry German tax-payers who will have to foot the bill for their southern neighbours. Markets jump every time the ECB's Mario Draghi or the IMF's Christine Lagarde talk about stimulus plans and giving the PIIGS more time & money, but markets slump every time the Germans frown and shake their heads.	Contracting	Weak growth	 current speed
	US	The US economy continues to grow slowly. Some positive signs include declining numbers of jobless claims and rising durable goods orders. Retail sales remain relatively slow. Fed Chairman Ben Bernanke gave solid hints at a possible "QE3" in his mid-July testimony to Congress, and specifically uttered the dreaded "deflation" word three times (CPI inflation was negative in the past two months). Nevertheless, gold bugs continue to buy gold, pushing the gold price above $1,600 once again (having been below that level for most of the time since early May). Meanwhile borrowing costs continue to plummet, benefiting home loan borrowers and businesses, and this is starting to have flow-on effects in the real economy.	Below average growth rate	Recovery remaining slow	 current speed
	China	The rate of slowdown in China has been faster than policy makers probably anticipated. The June CPI inflation rate was down to just 2.2% and the annual GDP growth rate was down to 7.6%. The government has announced stimulus spending packages (mainly in infrastructure), but it is being very careful in its stimulus programs this time around for fear of triggering another housing boom, so many restrictive policies remain in place (minimum deposit requirements for housing purchases and limits on the number of properties owned). There are early signs of a bottoming in the housing market, with price rises being recorded in many cities. Private construction is showing virtually no growth, but all the growth is in the government's "social" housing program, where the government is building approximately 8 million apartments per year for workers. There are also encouraging signs of industrial production being relatively strong but it has not been enough to trigger meaningful rises in commodities prices as yet.	Cyclical slowdown	Growth recovering in coming months	 current speed

		Asset Classes	Current position	Long term returns (1)
Shares	Australian shares	The Australian market was positive again in July, making it six good months out of seven so far this year. May was the exception, down 7%, but total returns from the overall market are still ahead 7% for this year. Banks were stronger and Telstra continued its stellar run, hitting $4 (but still less than half its share price in the dot com boom 12 years ago). Miners remained weak as commodity prices fell and costs soared. Early on in mining booms, prices rise but volumes are low because production takes many years to catch up, but late in the cycle prices fall while volumes rise as the new mine capacity comes on stream. Add rising wages and new taxes to that mix and the result is falling profit margins for miners. The August reporting season will probably reveal little or no earnings growth for the year to June for the market as a whole, but prices are still relatively cheap even if no growth is recorded for the next year as well. Earnings expectations for next year (to June 2013) are still for 12% growth which is far too bullish, and we expect earnings downgrades to continue in the coming months. Fears/hopes of further "quantitative easing" may also boost gold stocks in the coming months.	Below fair value	Above average long run returns
	Developed markets shares	The US had another good month and is now up 10% for 2012. So far the 2nd quarter profit reporting season has seen around 2/3 of companies growing their earnings, despite the slow US economy and high unemployment rates. The best sectors for earnings growth have been oil/gas, telcos and the banks. The 2nd quarter earnings reported were around 8% growth on last year's earnings and are now 8% above their pre-GFC peak earnings levels. This is very solid earnings growth in light of the sluggish US economy and slowing global growth. Market expectations are still very bullish for next year and are bound to be downgraded in the coming months or early next year as the fiscal tightening cuts in. JP Morgan's derivatives trading losses have now escalated from the initial estimate of $2b to a staggering $6b. That's what they will admit to anyway. All we know is that bankers' bonuses are doing just fine. The main European markets were also up in July, with much relief coming for banks in the hope that the ECB's promise to do "whatever it takes to preserve the Euro" will extend to providing direct capital injections to the beleaguered European banks. In Japan, manufacturing levels are recovering well from tsunami, and Toyota is now regaining its former title as biggest global car manufacturer, edging ahead of GM and VW.	Mixed – many markets under-fair to priced	Around average long run returns, but currency gains expected (2)
	Emerging markets shares	After losing around 20% last year, the major emerging markets are holding up relatively well this year. The Russian market shot up 27% in the first three months of this year as oil prices rose, but has lost all of those gains as oil prices have fallen back. As was the case last year, the smaller markets in south east Asia are again the stars, with most markets up strongly. In Korea, Samsung reported $6b in profits for the June quarter, having sold 51 million phones, double that of Apple.	Around fair value	Above average long run returns, but high volatility (2)
Fixed Income	Australian Gov't bonds	The flood of foreign money continued to keep bond yields down at the medium term and long end, but yields were higher at the short end as fears of a near term recession abated. Long yields are clearly in bubble territory, fuelled by virtually free money created artificially by central banks and sloshing around the world chasing yield. Bond yields on other AAA-rated commodities countries like Canada and Norway are below 2%, so yields on Australian bonds may go even lower than the current ultra-low levels.	Yields below (prices above) long run average level	Below average long run returns
	Bank Term Deposits	Bank TD rates fell a little further in July as short term interest rates fell, but banks are still desperate to retain depositors. Retail investors are starting to eye better yields on listed property and shares, which offer not only higher rates, but also a partial inflation hedge and potential capital growth. Term deposits still offer a better return for risk trade-off than bonds.	Rates around long run average	Around average long run returns
	Global Bonds	Returns on AUD-hedged global government bonds were up another 1% in July, bringing returns to 5% for 2012 to date. Yields on Spanish and Italian bonds rose above 7% and 6% respectively as fears of austerity-induced defaults returned, but this was more than outweighed by good returns from falling yields in the "safe havens" of the US, Japan, Germany and the UK. Even some of the PIIGS debt has generated great returns this year, supported artificially by ECB bond buying. Portuguese debt has returned 30% this year, Irish debt 20%, Italian debt 10%.	Yields below long run average level	Below average long run returns (2)
Cash	Australian target cash rate	The RBA now admits that one of the main reasons the target cash rate is so low is that banks are not passing on the rate cuts. The target cash rate is just 3.5%, but all banks are paying up to 5% on cash accounts, and lending rates are correspondingly higher. Even if the policy target rate is dropped to say 2%, banks would probably still need to offer around 5% to attract depositors.	Cash rates below long run average level	Variable, rising over medium term
Real Estate	Australian commercial property	The listed property market continues to do well, up another 5% in July, bringing total returns for the year so far to 23%. We have favoured this sector all year and we believe there is still room for further gains. Office markets are doing well, with rents showing some rises in Perth, Brisbane and Sydney, but residential development remains sluggish. Unit prices are likely to continue to benefit from buy-back activity and strong interest from foreign buyers in the coming months.	Around long run fair value	Around average long run returns
	Australian residential property	Prices remain weak across most markets as record numbers of properties sit on the market waiting for buyers to materialise magically. Rents are rising, which is an encouraging sign, but rents will need to rise a lot further and/or prices will need to fall a lot further before net rental yields are high enough to entice investors back into the market in meaningful numbers.	Varies by market, but over-valued overall	Average long run returns
Australian Dollar		The Australian dollar gained in July, mainly against the much weaker Euro (and Swiss Franc), but it was up by less against a stronger Yen and pound sterling. Finland is now the only AAA rated country in the Eurozone not on "negative watch" by the rating agencies, and this leaves Australian bonds still relatively attractive to foreigners. The AUD remains significantly over-valued on fundamentals.	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