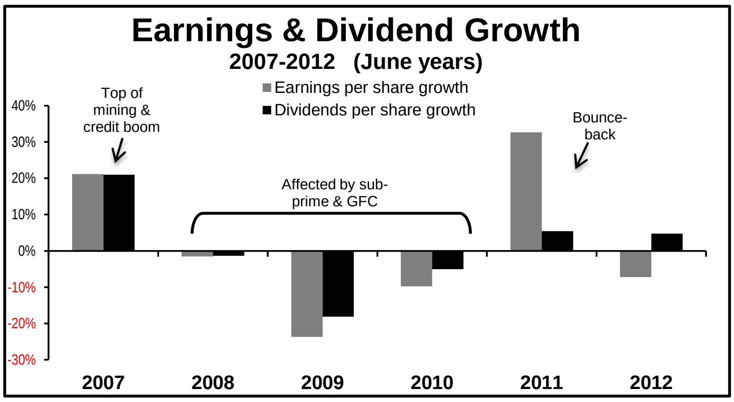
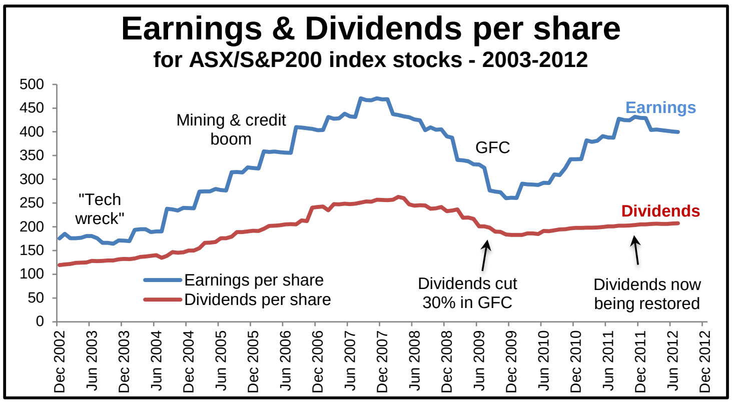
PHILO CAPITAL MARKET MONITOR – End August 2012

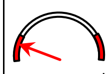
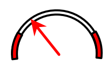
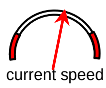
Chart of the month: Profit Reporting Season in Australia





In the August reporting season for Australian listed companies, earnings across the broad market index were lower by 7% compared to the previous year. Even excluding the big write-offs in BHP and RIO, operating earnings for the market are still a little down from the strong 2011 bounce-back from the GFC. When it comes to dividends, companies have been hoarding cash, paying off debt and cancelling expansion plans. Companies have always been slow to cut dividends in recessions, then slow to restore them in recoveries, and it has been the pattern in this cycle. Dividends were raised by an average of 5% across the market this year, well above inflation.

Earnings per share are now 15% below their pre-GFC peak levels and dividends per share are 20% below peak levels. In contrast, share prices across the market index are still around 35% below the peak nearly five years ago. This is a reflection of the level of over-pricing of the whole market at the top of the 2000s mining & credit boom, whereas shares of most companies are much better value today.

		Economies	Current position	Direction / Trend	Pace of growth
Economies	Australia	Debate is reaching fever pitch over the question: “Is the mining boom over?” China’s growth rate has slowed significantly and minerals and energy prices are continuing to fall sharply. Mining companies are reporting lower earnings, cancelling planned projects, and are writing off billions on acquisitions they bought at boom-time prices. In Canberra the budget situation continues to worsen. On the revenue side, revenue forecasts from the mining tax are falling as commodities prices fall, and also on the carbon tax, with the decision to cut the floor price on emmissions. On the cost side, the spending spree continues, with the new National Disability Insurance Scheme, new dental scheme, and increased spending on education – funded with more foreign debt. The government continues to borrow around half a billion dollars each week to fund the deficit. These factors are no doubt contributing to the weakness in consumer and business confidence. Households are now facing higher bills, but much of the “compensation” has long since been spent (retail sales and gambling revenues were both up in June-July immediately following the June cash splash).	Below average growth rate	Growth flattening	
	Europe	Economic activity in Europe is still contracting and unemployment levels and civil unrest are rising. Germany has slowed a crawl, France is flat and the southern countries are contracting, as the austerity programs and slowing consumer demand take their toll. The main debate now is over how much extra time and money Germany will allow for Greece on its promised austerity measures. Spain so far is adhering to the plans but its banks remain vulnerable. Slovenia looks to be next in line for government debt bailouts, which will make it the 6th country after Greece, Ireland, Portugal, Spain and Cyprus to require bailing out. The Germans are slowly coming around to the idea of allowing more time for economies to grow instead of rigid insistence on the harsh austerity plans. This sense of optimism over a solution is being reflected in the declining bond yields on the PIIGS government debts and in rising share prices.	Contracting	Weak growth	
	US	Inflation has slowed even further in the US, with overall consumer prices up only 1.4% for the year, and core inflation (excluding food and fuel) now 2%. This leaves room for more monetary stimulus which, despite unprecedented amounts of stimulus and money printing over the past four years, has not been inflationary so far. The presidential election is now well underway and Barak Obama is still doing surprisingly well in the polls despite the stalled economy and high unemployment rates. Republican nominee Mitt Romney is proving a relatively easy target, with a number of question marks concerning his enormous wealth, past business dealings and his tax returns, together with his rather liberal policies as governor of Massachusetts. Romney has selected Paul Ryan as his running mate and Ryan’s more traditional right wing policies (tax cuts especially for the rich, small government, repealing healthcare, pro-guns, anti-abortion) are sure to boost Romney’s appeal with many voters. Neither side has set out any coherent plans to address the budget crisis.	Below average growth rate	Recovery remaining slow	
	China	The Chinese situation is now quite similar to the US in many respects. Both economies are growing more slowly than their governments expected or hoped. In both cases, residential property prices continue to show signs of sustained turn-around, but lending growth is still very slow. Inflation rates are now very low, and both governments are hesitating on the next round of stimulus. Declining prices for raw materials and energy are benefiting manufacturing industries in both countries, but China’s trade balance is worsening, while in the US it is improving. Chinese over-capacity and over-production in many industries are worsening, while in the US it is improving. Also, consumer spending in the US is starting to improve, but is still slowing in China. The biggest difference is that China, unlike the US, has enormous fiscal and monetary firepower at its disposal to stimulate its economy as and when it sees fit.	Cyclical slowdown	Growth recovering in coming months	

		Asset Classes	Current position	Long term returns (1)
Shares	Australian shares	Australian shares had another good month in August. The broad market index is up by 2% (including dividends) and has returned 10% so far this year (including dividends). Our direct "Core Equity Portfolio" and also our portfolio of active managers both continue to out-perform the overall market index. The best sector in August was gold mining, driven by the recent rise in the gold price, spurred by renewed hopes of "QE3" in the US. But the gold sector is still the worst sector of the stock market so far this year (down 15%), as the gold price has fallen 13% from its peak a year ago, and mining costs have risen. In the reporting season for the year ending June, more than half of all companies reported better than expected earnings, despite the media doom and gloom over the slowdown in China and the end of the mining boom. The main negative earnings surprises came from Commonwealth Bank, Telstra, NAB, ANZ and Suncorp, and the main positive surprises were from BHP, Wesfarmers, QR National, Rio and Newcrest.	Below fair value	Above average long run returns
Shares	Developed markets shares	The US stock market was up another 2% in August and is now up 13% for 2012 (including dividends). Apple continues to churn out huge cash profits and recently won a billion dollar lawsuit against Samsung. Apple is now the most valuable US company of all time, although adjusted for inflation it is still some 10% behind Microsoft's peak levels in the dot com boom. Remarkably, Apple's share price has nearly doubled since the death of Steve Jobs late last year, and the company is now more than double Microsoft's current size. Shares in the big European markets were strong in August despite the slow progress on the Euro debt crisis. British, French and German markets were all up around 2% for the month, and Spanish and Italian markets up around 10%. The Japanese market was also stronger this month, despite falling production and exports.	Mixed – US is over-priced on long term measures, but other markets are under-priced to fairly priced	Around average long run returns, but currency gains expected (2)
Shares	Emerging markets shares	In Asia, nearly all markets (aside from China and Sri Lanka) have had a strong year so far. Chinese markets were down in August, continuing the slide since April. In contrast, Singapore, Philippines, Thailand, India and Pakistan are all up by double digits this year, with the rest of the markets up by single digits. India (up 2% in August and up 13% for 2012) is still doing well despite the slowing economy. It is starting to look as if inflation is finally coming under control. In Latin America, Colombia remains the stand-out market. Brazil has been flat this year but is starting to pick up, despite the stagnant economy, falling prices for iron ore, oil & gas, 5% inflation and strikes across several areas of government services. Elsewhere, South Africa is also doing well and Poland remains the stand-out market in Eastern Europe. Interestingly, both markets have followed the Australia pattern of strong stock markets despite falling commodities prices and widening industrial unrest.	Around fair value	Above average long run returns, but high volatility (2)
Fixed Income	Australian Gov't bonds	Yields on benchmark 10 year Australian government bonds have risen from the record low of 2.7% in late July, and are now up above 3% again. In the August sell-off, some of the money has shifted into shares, boosting share prices, and some has been pulled out of Australia, resulting in a lower dollar. Bonds had good months in April and May, but we expect lower returns in the months ahead. We have been under-weight Australian bonds in recent months and prefer bank term deposits for our domestic fixed income exposures.	Yields below (prices above) long run average level	Below average long run returns
Fixed Income	Bank Term Deposits	Interest rates on bank TDs continued to weaken slightly in August, mainly at the short end. As the yield curve steepens, banks are paying a little over 5% for 5 year terms, and near 5% for 3 year terms, but lower rates for shorter terms. Rates may well fall further in the coming months as banks restructure their deposit products in readiness for the new Basel III bank capital rules.	Rates around long run average	Around average long run returns
Fixed Income	Global Bonds	August saw flat returns from global government bonds in hedged Australian dollar terms (as our global bond exposures are hedged). Yields moved up slightly in the US (with the improving outlook for the US economy) and were also up a little in Germany and France. The negative effects of these rises in yields were offset by the positive effects of yields falling in Italy and Spain, driven by the reassuring noises from Germany about future support for bond markets from the ECB. Returns have been 6% for 2012 and we remain confident in moderate returns for this year, as bond yields in the big markets – US, Japan, Germany – are likely to remain low.	Yields below long run average level	Below average long run returns (2)
Cash	Australian target cash rate	The RBA has indicated that is prepared to lower the target cash rate further if the European situation deteriorates materially. Domestic inflation rates are low, but the labour market is still tight, wages are rising, and industrial action has been increasing recently. These factors are likely to limit the scope for rates to fall much further in the current cycle.	Cash rates below long run average level	Variable, rising over medium term
Real Estate	Australian commercial property	Listed property trusts had a flat month in August, but the sector has returned 23% so far in 2012 (including distributions), driven by buy-backs and distribution growth in most trusts. The August reporting season continued the trend of good growth in earnings and distributions. In addition, most trusts are also planning for distributions to rise again for the 2012-3 June year, with a few notable exceptions (eg Stockland and FKP, due to continued weakness in the residential sector). We have favoured the listed property sector this year, and there is still some upside left. In the unlisted market, there are signs of activity in the small end (under $5m) as investors are increasingly being attracted by rental yields in the wake of declining rates on term deposits.	Around long run fair value	Around average long run returns
Real Estate	Australian residential property	Declining interest rates on loans and deposits should also start to provide some stimulus for potential buyers of residential investment properties. However, confidence is still low due to domestic and global political and economic uncertainties.	Varies by market, but over-valued overall	Average long run returns
Australian Dollar		The AUD weakened in August, especially against a much stronger Swiss Franc and Euro. Our dollar is still up around 2% for the 2012 year to date, but we expect it to weaken as commodities prices fall further and foreign money chasing yields on Australian bonds loses momentum.	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