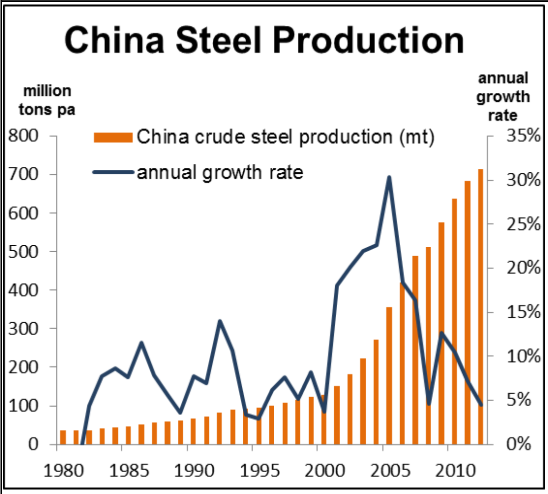
PHILO CAPITAL MARKET MONITOR – End September 2012

Chart of the month: Chinese steel driving our mining exports

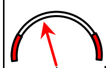
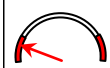
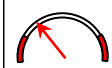
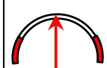


By the time you finish reading this newsletter, China will have produced the equivalent of a Sydney Harbour Bridge worth of steel. China will produce and use 700 million tons of steel this year, which is the equivalent of building 18,500 Harbour Bridges in a year. The Sydney Harbour bridge contains 38,000 tons of steel and it took 8 years to build.

China now builds the equivalent of another Harbour Bridge worth of steel every 15 minutes. That's four every hour, 12 hours per day, 365 days per year. China's massive urbanisation and infrastructure construction boom has fuelled Australia's mining boom as most of the Chinese steel is made from iron ore and coking coal from Australia.

Chinese steel production grew by an average of 7% pa during the 1980s & 1990s. It then surged to 20% growth pa between 2001-2007 following China's entry into the World Trade Organisation in 2001, boosting manufacturing, exports, and urbanisation.

Growth rates have since fallen to around 7% pa again, and that includes the massive infrastructure spending boom funded by the post-GFC stimulus program. Growth rates in the demand for steel may flatten even further in future as China's economy shifts away from being dominated by exports and construction, and more toward domestic consumption and services, which require less bulk raw commodities.

		Economies	Current position	Direction / Trend	Pace of growth
Economies	Australia	The headline numbers for Australia are enviable: - low inflation, low real interest rates, a low unemployment rate, a growing economy, and a skilled workforce. On the other hand, the costs of doing business here are rising – with rising energy prices, rising wages, industrial unrest, more regulations & taxes, and a high currency. Falling commodities prices are a negative for a commodities exporter like Australia, whereas it is a bonus for the US, Western Europe, Japan and China, which are commodities importers. We see the government cutting spending further and tightening the screws on business as its optimistic budget assumptions continue to unravel.	Below average growth rate	Growth flattening	 current speed
	Europe	There were several positive developments in the Euro debt crisis this month. On the 6th the European Central Bank's Mario Draghi announced plans for unlimited buying of government bonds of up to 3 years maturity. The plan is open-ended ("no ex-ante quantitative limits are set"), and the ECB is even prepared to waive its senior creditor status on bonds it purchases, so they would be treated equally with private creditors. However, unlike "QE" in the US, Japan or UK, the Euro bond purchases are to be "unsterilized", meaning the ECB will need to raise cash from elsewhere to fund the purchases (by selling or raising short term paper, resulting in no net increase in liquidity in the system). Also, the plan will only be used if the offending governments agree to reforms, spending cuts and/or tax hikes. On the 12th the German Constitutional Court approved Germany's participation in the European Stability Mechanism up to €190b. This boosted shares and commodities markets, and yields on Italian & Spanish bonds fell. Tentative progress was also made on plans for the ECB to take over supervision of Eurozone banks, but Germany and France still have major disagreements over the details.	Contracting	Remaining very weak	 current speed
	US	The main event in the US during the month was the announcement on the 13th by the Federal Reserve of the much anticipated "QE3". This 3rd round of "quantitative easing" (money printing) comprises an open-ended commitment to buy up to $40b of mortgage backed securities per month until the labour market "improves substantially", and as long as inflation remains low. Also, the promise to keep interest rates near zero was extended into 2015. The announcement sent the US dollar down, the prices of gold and metals up, and shares up around the world. The government also sold down more of its stake in AIG, which it rescued with $182b in September 2008. US tax-payers have made $15b in profits on the rescue so far, with more to come. The election campaign is hotting up, and Mitt Romney continues to lose more votes every time he opens his mouth – whether it is about taxes, welfare or foreign policy.	Below average growth rate	Recovery remaining slow	 current speed
	China	The government announced spending plans totalling 1 trillion RMB ($150b) on rail, roads & ports, but most were previously announced projects and so it was not "new" spending. Housing prices and lending volumes are showing signs of a turn-around but consumer spending is still relatively weak – even on some luxury brands. In another example of China's "tofu engineering", the Yanmingtan bridge in Harbin collapsed, killing 3 people. It was built less than a year ago, costing $300m as part of the rushed 4 trillion RMB stimulus in the GFC. It was yet another engineering and PR disaster in a long line of similar episodes, the most notable being the bullet train crash in Wenzhou in July of last year, which led to widespread riots over corruption and poor safety standards. Recently the 15 storey Ark Hotel in Changsha was built in just 6 days, and a 31 storey hotel in Dongting Lake was built in just 15 days. There are now plans to build a 220 storey building in just 90 days! This month also saw an escalation in tensions with Japan (China's largest export buyer) over the Senkaku/Diaoyu islands that lie between Okinawa and Taiwan. Anti-Japanese protests across China escalated into violent attacks on Japanese embassies, consulates, businesses and factories. There were boycotts of Japanese goods and even panic buying of salt, reminiscent of the nuclear fall-out crisis last year. Anti-Japanese sentiment heightened during the anniversary of Japan's 1931 invasion of China. The US has backed Japan and China has sent more war ships to the area. There could be fireworks, although it is more likely to be resolved peacefully as there is too much trade at stake.	Cyclical slowdown	Growth recovering in coming months	 current speed

		Asset Classes	Current position	Long term returns (1)
Shares	Australian shares	We have favoured the local stock market since earlier this year, and September was another solid month. The overall market returned 2% for the month, bringing total returns to 12% (including dividends) for 2012 so far. Mining stocks shot up with the mini-spike in commodities prices induced by QE3, but fell just as quickly as the effect wore off. Prices of most commodities are still well down from their boom-time peaks, and mine development and operating costs continue to rise. Mining stocks are still down for the year. Even the gold sector, which has been the strongest of the mining sectors, spurred by ongoing fears of future inflation in the US due to excess money printing. Despite recent gains, the overall market remains relatively good value on long term measures but our near term outlook is now beginning to weaken somewhat.	Below fair value	Above average long run returns
	Developed markets shares	We have also favoured global shares since earlier this year and this month saw more good gains. The broad global index was up 2% for the month, and is now ahead 12% in foreign currency terms, and up 10% in AUD terms for un-hedged Australian investors, so far in 2012. All major developed markets were up for the month with Germany once again being the star, despite weakening economic growth in Germany and the rest of Europe contracting. In the US market, Apple & Google were the stand-outs, both benefiting from the on-going battle for the global smart phone market. Apple shares hit $700 and Google shares hit $750. Apple sold an incredible 5 million iPhone 5's in the first weekend after the launch on 21st September. The Japanese market was also help up despite the dispute with China. The highlight was the $8.5b re-float of Japan Airlines after its bankruptcy in the GFC. European luxury brands are starting to see weakening sales in the emerging markets. In China, the power of "bling" is waning with upwardly mobile consumers as they moderate their tastes and spending patterns.	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)
	Emerging markets shares	Emerging stock markets as a whole continued to do well this month, with most markets rising. In most cases the gains were further assisted by their currencies gaining against the Australian dollar. The main exception was China, weighed down weakening manufacturing and exports, the government's go-slow on stimulus spending, and growing fears of possible bad debts problems in the banking system following the huge post-GFC stimulus spending spree. Russia had a particularly good month despite declining oil prices. For the year to date, the South East Asian markets remain the strongest, with most markets up by double digits so far this year.	Around fair value	Above average long run returns, but high volatility (2)
Fixed Income	Australian Gov't bonds	Yields stayed low at the short end but rose a little across medium and longer terms in September, but not by enough to cause negative returns. Despite good returns this year as yields have fallen, we prefer bank term deposits over bonds for domestic fixed income exposures in long term portfolios, as they offer superior rewards for risk.	Yields below (prices above) long run average level	Below average long run returns
	Bank Term Deposits	Interest rates on bank TDs continued to weaken at the short end in September. As the yield curve steepens, banks are paying a little over 5% for 5 year terms, 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
	Global Bonds	September saw flat returns from global government bonds in hedged Australian dollar terms. Yields fell by 60-70 basis points on Italian and Spanish long term bonds during the month, following the announcement of the ECB's bond buying program. The effect of this was offset by yields rising in the "safe havens" – the US, UK and Germany, reflecting future inflation fears with the further quantitative easing measures, while Japanese yields have been virtually unchanged.	Yields below long run average level	Below average long run returns (2)
Cash	Australian target cash rate	The RBA is under increasing pressure to cut cash rates further to help bring down the Australian dollar, which remains high despite the collapse in commodities prices. The RBA has been reluctant to enter the global currency war, preferring to wait for the European situation to worsen, but the Europe crisis has remained relatively contained with recent positive developments there. If cash rates are cut, bank deposit and loan rates are unlikely to mirror the full extent of the fall.	Cash rates below long run average level	Variable, rising over medium term
Real Estate	Australian commercial property	We have favoured the Australian listed property trust sector since earlier this year and it continues to be the best performing asset class, returning 25% (including distributions) so far in 2012. After these tremendous gains many trusts are looking fully priced. Almost all trusts traded at a discount to NTA a year ago, but several are now trading at a premium. The retail and residential segments continue to see weak growth in rents and capital values. The strongest segment, the office market, now looks to be weakening. Rents are likely to soften in all cities except Brisbane over the next few years as the mining boom fades and companies and government cut back staff. Woolworths is looking to off-load some of the $4b in property it owns into a new trust. It may provide an interesting opportunity, depending on structure and pricing.	Around long run fair value	Around average long run returns
	Australian residential property	In the mass market, there is some optimism in the air with the hope of further interest rate cuts in the coming months, and first home grants are on the rise. At the top end there are still many instances of properties being sold under pressure from banks, at huge discounts below boom-time prices paid before the GFC. With banks keen to clear their books, there are bargains to be had in most markets, but there is still a sense of uncertainty over the impacts of the fading mining boom, sluggish US growth and recessions in Europe and the high dollar.	Varies by market, but over-valued overall	Below average to average long run returns
Australian Dollar		The AUD was a little stronger against the US dollar in September, with the USD weakening thanks to QE3. However the AUD was weaker against most other currencies, in particular against the much stronger Euro following positive developments in the Euro crisis, and also against a stronger Swiss Franc, Sterling, and most emerging markets currencies, with the global commodities mini-rally. We expect the AUD to weaken further 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