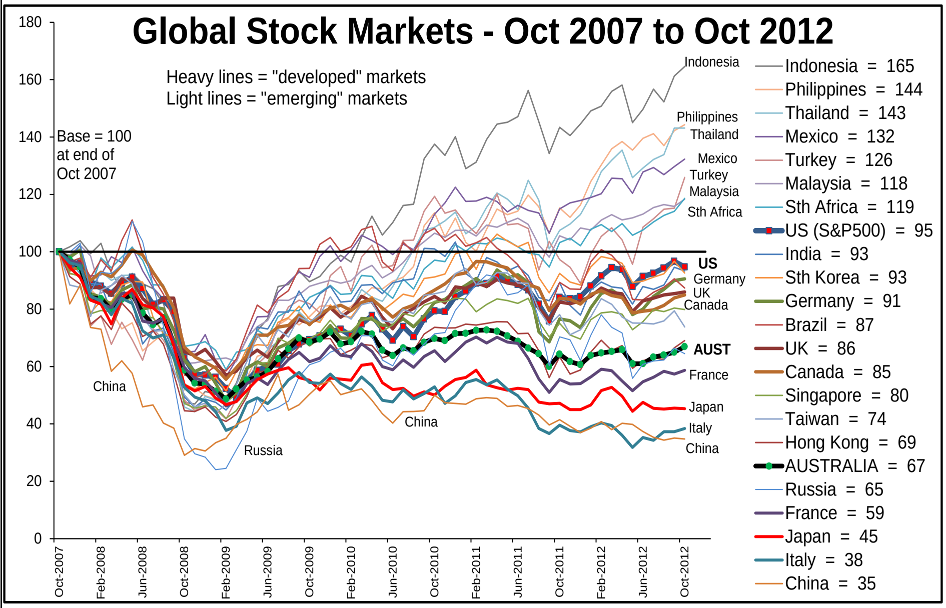
PHILO CAPITAL MARKET MONITOR – End October 2012

Chart of the month: Five Years On – Where do we Stand?

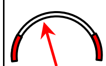
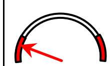
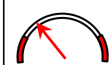
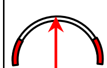


It has been five years since the top of the global stock market boom. Here is a snapshot of how various markets have fared since October 2007.

The Australian market is still 33% below its 2007 high despite our "miracle" economy, the huge deficit-funded stimulus spending sprees and the mining boom.

Chinese stocks have fared worst, despite enjoying the highest economic growth rates. It had the biggest bubble in 2005-7, so had further to fall. Its stock market is dominated by the big state-owned banks that are suffering from the effects of China's credit-fuelled GFC spending spree. Hong Kong, Taiwan and Korea are closely connected to China and are also down. The South East Asian markets, being less affected by China, are the stand-out successes, and are all well above their 2007 highs.

Industrial giants US and Germany are the strongest of the developed markets, with UK and Canada not far behind.

		Economies	Current position	Direction / Trend	Pace of growth
Economies	Australia	In Australia the trade deficit widened further and the unemployment rate jumped from 5.1% to 5.4%. It was not all bad news - job numbers are up since participation rates are rising, as more people look for work - perhaps to pay for rising household expenses. Consumer price inflation was up, with electricity costs up 15% and gas prices up 14%. Underlying "core" inflation is up by a robust 2.5% pa. We expect the unemployment rate to rise further if governments (federal, state and local) get serious about cutting spending, and as companies cut staff further. As foreshadowed in last month's report, the government faces a budget blow-out due to falling tax revenues, but much of the elusive extra tax revenue has already been spent. As expected, the government is now targeting business to fill the gap. NSW and WA are also facing possible credit rating downgrades, adding to the pressure to accelerate budget cuts.	Below average growth rate	Growth flattening	 current speed
	Europe	European airlines must be doing well – flying entourages of politicians, economists and media between the succession of "emergency" summits all over Europe. On the ground, anti-austerity riots gathered pace across Europe from Britain to Greece. Germany (on behalf of the north) seems to be gaining the upper hand over France (on behalf of the south), by insisting on strict conditions for countries that wish to access the new "permanent" bail-out fund. Germany is also resisting all talk of joint liability for government debts. German Finance Minister Wolfgang Schauble once again raised hackles all over the Mediterranean states with his plan for a "Currency Commissioner" with power over national budgets of Euro countries. Angela Merkel also asserted her dominance by striking down what would have been the biggest deal of the year – the proposed merger between BAE Systems (British) and EADS (French-German). The merger would have created a defense and aerospace giant to rival the Americans. Meanwhile Britain appears to have emerged from recession once again, despite the austerity program.	Contracting	Remaining very weak	 current speed
	US	Third quarter economic growth numbers for the US were a little stronger, with 2% annualised growth (up from 1.3% last quarter). Home building, consumer spending and defence spending were all stronger. The labour market keeps improving tentatively, and the housing market also continues on its slow recovery path, with home prices and new home sales rising further. Consumer sentiment is now the highest it has been in five years. In contrast, business confidence and investment is weak – perhaps awaiting the outcome of the election. Regardless of the outcome of the Presidential election, confidence is likely to get a further boost.	Below average growth rate	Recovery remaining slow	 current speed
	China	Economic growth in China has officially slowed to an annualised 7.4%, which was seen as good news, as recent months have seen growth rates pick up. Corporate profitability is also rising, manufacturing is looking likely to be at the cusp of turning the corner after nearly 2 years of slowdown and exports are also improving. These green shoots in the economy have largely been overshadowed by the increasingly bizarre political manoeuvrings in the lead-up to the transition of leadership of the Communist party, where one band of crony-capitalist billionaires will hand over power to the next at the upcoming National Congress in November. Corruption scandals continue to intrigue. Former Chongqing party leader and Politburo aspirant Bo Xilai has now been stripped of all party roles and looks set to face criminal charges, while his wife Gu Kailai was convicted of murder at a hurried show trial. Presumably more heads will roll in the wake of new revelations detailing billions that Premier Wen Jiabao's family has gained during his reign. The party is finding it much harder to control social media channels than TV and newspapers which it still censures heavily. So far they have managed to prevent protests from escalating into an "Arab Spring"-like uprising or a repeat of Tiananmen Square.	Cyclical slowdown	Growth recovering in coming months	 current speed

		Asset Classes	Current position	Long term returns (1)
Shares	Australian shares	The broad market index ended October on a high note, up 3% for the month, and up 15% for the year to date (including dividends). The QE3-inspired mini-boom in commodities prices has faded, but the big miners – BHP & RIO (both in our recommended portfolio) were up 3% and 7% for the month. ANZ (in our portfolio) reported a record $6b profit but NAB (not in portfolio) reported weaker results. Telstra (in our portfolio) was the other big gainer and is back above $4 on talk of a possible rise in dividends. The big loser was Newcrest (not in portfolio), which fell heavily with the gold price. Santos ushered in the shale gas revolution in Australia with production starting at its Cooper Basin operation in South Australia, and a US raid on Graincorp saw its share price spike. We remain over-weight Australian shares in model portfolios.	Below fair value	Above average long run returns
	Developed markets shares	Global equities markets were flat overall in October, and the lower Australian dollar put un-hedged investors a little ahead. The US was down 2% and Germany was flat, while other major developed markets were little changed. Germany and the US remain the best markets this year, up 23% and 12% respectively. Several major US stocks reported weaker revenue and earnings growth, even Apple following the launch of its mini-iPad™. Google also disappointed, but Facebook surprised on the upside. Caterpillar, the world's largest mining equipment manufacturer, reported weak earnings, reflecting the slowdown in global growth.	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 markets as a group also had a flat October, but are up 10% for the year. Continuing the pattern this year, China and the closely related Korean and Taiwan markets were down, but South East Asian markets were stronger, as were most of the Latin American markets. In China, profits have been rising in most sectors, but Chinese banks (which dominate the stock market indices) are under pressure, with weak loan growth and looming bad debts problems from their GFC stimulus lending spree. Samsung is winning the mobile war, but the Korean market was weighed down by the big car makers Kia and Hyundai, due to weak demand in export markets.	Around fair value	Above average long run returns, but high volatility (2)
Fixed Income	Australian Gov't bonds	Returns from bonds were flat in October, but are up 7% for the year to date. The yield curve has twisted a little more anti-clockwise over the month, with yields at the short end falling and yields at the medium and long end rising as inflation expectations re-emerged after the September quarter inflation numbers. The government's budget blow-out has meant it has been issuing more debt than expected, and it is also lengthening the term of bonds.	Yields below (prices above) long run average level	Below average long run returns
	Bank Term Deposits	Despite bond yields rising during the month, bank TDs rates weakened further. For 5 year terms, rates at or near 5% are scarce, and rates for 3 and 2 years are now around 4.5% or less. With low TD rates, investors are looking elsewhere for yield, but the collapse of yet another mortgage fund, Banksia Financial (with $660m owed to retail investors), will come as a timely reminder for investors to focus on quality rather than chase high yields.	Rates around long run average	Around average long run returns
	Global Bonds	Returns from Australian dollar hedged global bonds are up a fraction in October, making 7% total returns for the year so far. Yields rose a little on higher growth outlooks in the stronger markets (US, Germany and the UK). Offsetting these were falling yields in the big problem markets (Italy, Spain and the smaller PIIGS) following the establishment of the European bailout mechanism over the past couple of months. Japanese yields remain extremely low, and actually fell further in the past week despite a budget deficit crisis similar to the US "fiscal cliff". The US and Japanese deficit issues will need to be solved over Christmas, but investors continue to pile into Japanese and American debt as they remain the chief "safe havens" for global money.	Yields below long run average level	Below average long run returns (2)
Cash	Australian target cash rate	The RBA is still under pressure to cut interest rates to try to bring down the dollar which remains stubbornly high. However, higher inflation numbers and rising wages may limit their options, especially with signs of turn-around appearing in the US and Chinese economies.	Cash rates below long run average level	Variable, rising over medium term
Real Estate	Australian commercial property	The listed property sector had another good month - up another 5%, making it 30% for the year (including distributions). We have been over-weight in recent quarters but now believe the sector is fully priced, and are reducing the over-weight position. We see office vacancy rates rising in the coming year (but probably not as serious as the early 1980s or early 1990s recessions), and will be shifting more toward non-discretionary retail. The big news in the sector was the spin-off of 69 Woolworths shopping centres into a new trust, Shopping Centres Australia, which will offer investors exposure to a relatively stable and defensive rental stream.	Around long run fair value	Around average long run returns
	Australian residential property	Pressure is building for a turn-around in house prices. Rents are continuing to rise in many markets (especially in Sydney, Perth and Darwin), populations are rising (mainly through immigration), and loan interest rates are falling. Home building approvals are picking up in Queensland, but not in other states. New home sales and mortgage lending growth remain very weak. In one positive development Resimac is re-entering the sub-prime securitisation market, re-opening an avenue of finance for "low-doc" borrowers that has been closed since the GFC. The carnage continues in the Gold Coast flats market with the $850m 77 storey "Soul" development put into receivership after off-the-plan buyers to settle at their pre-GFC boom-time prices. Soul joins a long list of major developments in similar trouble, like Oracle and Hilton, where prices are down 30-40%. It is still very much a buyers' market while prices fall.	Varies by market, but over-valued overall	Below average to average long run returns
Australian Dollar		The immediate effects of QE3 on commodities prices and currencies have worn off. The AUD was weaker against the USD, Euro and Swiss Franc in October but stronger against the weaker Yen and Sterling. The RBA has taken a small tentative step into the global currency war, and has been intervening quietly in foreign exchange markets over the past two months to help bring down the dollar – selling AUD and taking more foreign currencies onto its books. So far it has only been a trickle - $860m – and with little effect. Meanwhile Japan recently announced another 11 trillion yen ($140b) of asset-buying. 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