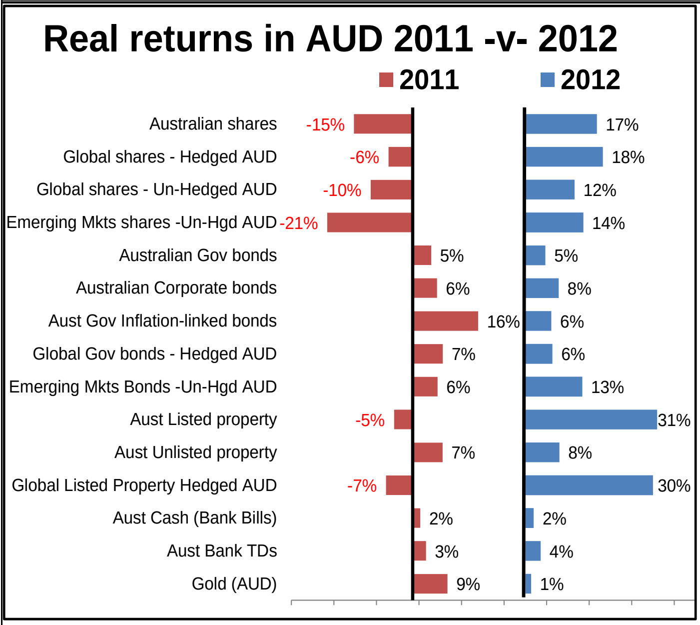
PHILO CAPITAL MARKET MONITOR – END DECEMBER 2012

Chart of the month: 2012 – one of the best years ever for investors



2012 was just about as good as it gets for investors. Almost every stock market in the world was up, including all of the main developed and “emerging” markets. 92% of all markets were up, two thirds were up by more than 10%, and a third were up by more than 20%.

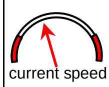
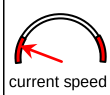
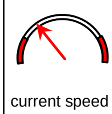
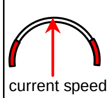
Every bond market in the world was also up (the best returns were from Greek, Portuguese, Irish and Italian debt). Also, every type of bond market was up (sovereign, semi-government, corporate, high yield, emerging market, mortgage-backed, asset-backed, distressed, covered and inflation-linked).

For Australian investors (allowing for currency effects), not only was every major asset class up in nominal terms, but every asset class was also up by more than inflation (which is very unusual). Even more remarkably, every asset class was up by more than its expected average long term real return. This is extremely rare and has only happened in three other years since federation (1904, 1993 and 1997).

It was a great year for all markets despite rolling recessions in the UK, Europe and Japan, sluggish growth in the US, slowdowns in the major emerging markets, political turmoil and rising violence in many countries, “fiscal cliff” crises in the US and Japan, a global currency “war”, escalating military conflict between China and Japan, and rising nuclear tensions in North Korea and Iran.

The “worst” asset classes were gold, TDs and cash, but they were still up in real terms, just. (No reliable data is available yet for housing).

Another remarkable feature of 2012 was the low volatility. On any measure of volatility, it was the calmest year on markets since 2005.

		Economies	Current position	Direction / Trend	Pace of growth
Economies	Australia	2012 was a reasonably good year for Australia – a growing economy (although it was due mainly to population growth - mostly from immigration - rather than productivity growth), low inflation, low interest rates and low unemployment rates. It will go down as the year the mining investment boom ended. Prices of commodities were mixed for the year. Iron ore ended up flat, coal is down, while gold and most base metals are up a little – but all are well down from their boom time peaks. While demand remains week, supply is escalating. Spiralling wages and costs are eating into profit margins, causing several major projects to be shelved. It was also a year of political scandals – with the news dominated by Craig Thompson, Peter Slipper, Gillard’s union slush fund, Eddie Obeid, and Wayne Swan’s fanciful budget surplus fairy-tale providing some light relief. The hand-outs of tax-payers’ money to foreigners to prop up inefficient industries continues, and the year ended with yet another example - a $250m gift to Belgians to protect 2,500 jobs at a loss-making zinc/lead smelter in Port Pirie, SA (that’s $100k per job/vote). 2013 is an election year, so we can expect the hand-outs to escalate.	Below average growth rate	Growth flattening	
	Europe	2012 was German Chancellor Angela Merkel’s year. She solidified her leadership within Germany and also across the Eurozone, while leaders in other countries either fell or weakened. During the year the German stance on debt staged a dramatic shift. At the start of the year Germany was committed to enforcing hard-line austerity on the PIIGS, but by year end Germany has accepted that austerity leads to slower growth, lower tax revenues, larger deficits & debts, and escalating civil unrest and violence. Unthinkable a year ago, they now have “permanent” bail-out funds, unlimited bond-buying programs, mechanisms for debt “haircut” deals and bank recapitalisations, and there is even talk of outright debt forgiveness. The resultant outlook for slower growth and lower interest rates was good for bond investors, and was also good for shares, with the prospect of a calamitous Eurozone collapse abating. There will be many more bumps along the road ahead, and Merkel faces an election in September 2013, but so far she is holding Germany and Europe together.	Contracting	Remaining very weak	
	US	Conditions for US companies are continuing to improve. US worker productivity is rising relatively strongly (hourly output per worker is up nearly 3% pa), as output is growing strongly (more than 4% pa) but working hours are increasing by 1%, so unit labour costs (labour costs per unit of output) are falling, unlike in Australia. At the same time, businesses are also benefiting from price declines in raw materials and energy. With improved worker productivity, companies are in no hurry to hire more workers, and so the unemployment rate is falling only slowly. This is the usual pattern after every recession, but it still manages to surprise policy makers every time. The Federal Reserve has now more than doubled its money printing program, and is committed to buying $85b worth of bonds per month with newly created money to depress the dollar and interest rates until the unemployment rate falls below 6.5%. There is a tentative budget deal on the table to delay the “fiscal cliff” but time will tell how long it lasts.	Below average growth rate	Recovery remaining slow	
	China	2012 was a year of intense political intrigue leading up to the once in a decade change in leadership of China. The economy suffered a self-induced slowdown to curtail the excesses of the credit fuelled construction binge that resulted from the GFC stimulus spending spree. Inflation and property prices have been brought under control and this has been achieved thus far without requiring large-scale government bail-outs of the banking system (as was needed in 1998, 2001 & 2004) and without a violent civil uprising (as in 1989). The recovery is slowly gathering pace, although export markets remain weak and the new government is reluctant to re-ignite another speculative building boom.	Cyclical slowdown	Growth recovering in coming months	

		Asset Classes	Current position	Long term returns (1)
Shares	Australian shares	The broad stock market ended up 14% for the year, and returned 19% including dividends. This 16% real return after inflation puts 2012 in the top quartile of annual returns in all years since 1900. Defensive sectors were strongest – healthcare, gambling, telecoms, and the big banks (except NAB). Mining and resources weighed down the market once again. Aside from BHP and RIO, which eked out small gains, almost all other miners were down heavily. Our portfolios beat the overall market index comfortably (our internally-run listed portfolio and our selection of managed funds). In addition our portfolios were over-weight Australian shares for most of the year. We remain relatively bullish on the outlook for the coming months.	Below fair value	Above average long run returns
Shares	Developed markets shares	Almost all markets were up for the year. Germany, Denmark, Austria, NZ and Japan were all up by more than 20%, and most of the others were up by double digits. In the US the star sectors were technology (led by Apple, Oracle, Amazon and eBay), all of the large retailers, banks, financials, and most manufacturers. In Japan, the car makers were up strongly (except Mitsubishi), along with engineering firms, retailers, property, banks & insurers. It was the same in Germany, with car markers, manufacturers, banks, insurers, consumer goods and healthcare up strongly. France was up 15% (banks, consumer brands and car-makers except Peugeot Citroen), despite the radical shift to the left under new Socialist PM Hollande imposing tax hikes and spending increases. The UK market was up 6%, weighed down by resources but banks, manufacturers and consumer stocks rebounded strongly, despite the UK being caught in a vicious cycle of recessions and austerity cuts.	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	Nearly all of the “emerging” markets had a great year in 2012, with numerous country stock markets up by more than 20%. China was the worst of the big markets, barely ending up above par after enjoying a late recovery from the policy induced slowdown during the year. South East Asian markets were up strongly – notably Thailand, Philippines, Singapore and Vietnam. Also up strongly were India, Hong Kong, South Africa, Turkey and Mexico leading Latin America.	Around fair value	Above average long run returns, but high volatility (2)
Fixed Income	Australian Gov't bonds	2012 saw good returns in all segments of the Australian bond market, especially corporate bonds (thanks to declining credit spreads) and inflation linked bonds. The overall composite bond index returned 7.7% for the year, down from the 11% return in 2011. More than half of the returns in 2012 came in May and April when bond yields fell heavily with the China slowdown, the Greek debt crisis and Greek election fiasco, bank runs and bank downgrades in Europe. Since then yields have risen and are unlikely to fall back below those levels again in the current cycle unless the situation in Europe or the US deteriorates dramatically.	Yields below (prices above) long run average level	Below average long run returns
Fixed Income	Bank Term Deposits	Although money market yields for 2 to 5 year terms have risen by 40-50 basis points since the lows reached in May, term deposit rates have kept declining, leaving investors with slim pickings. Rates for term of 3 years and longer are paying around 4.5%, compared to more than 5.5% at the start of the year. We have been recommending longer term TDs this year as rates have fallen, so those investors are still receiving relatively higher locked in rates.	Rates around long run average	Around average long run returns
Fixed Income	Global Bonds	2012 was a good year for credit markets, with all types of bonds generating good returns as fears of inflation and default abated. The global government bond index (in hedged Australian dollars) returned 8% for the year (after returning 11% in 2011 and 8% in 2010). Yields fell in Europe, both in the high risk countries due to the progress being made in the debt restructure and bail-out mechanisms, and also in Germany as the safe haven. Yields in Japan also fell due to the ongoing recession/deflation cycle there. US yields ended up a little lower, but are on the rise since QE4 was announced, the “fiscal cliff” danger subsides and inflation fears return.	Yields below long run average level	Below average long run returns (2)
Cash	Australian target cash rate	December saw the sixth cut to the Reserve Bank's target cash rate, bringing it down to 3%, the level last reached in the depths of the global credit crisis in 2008. Australian interest rates are still the highest in the “developed” world and are still attracting yield chasing foreigners in droves, which is keeping the dollar high. The Reserve Bank may cut rates further to bring down the dollar, and further softening in labour markets would be accommodating. The sharp slowdown in mining investment and the budget blow-out will also help to weaken the dollar.	Cash rates below long run average level	Variable, rising over medium term
Real Estate	Australian commercial property	This year we favoured listed property over unlisted, and we were over-weight for much of the year. The listed sector returned 33% (30% real return) making 2012 the 2nd best year since the industry began in the 1970s. It was not far behind the best ever real return of 36% in 1983 coming out of the 1981-2 recession. Conditions were ideal in 2012 - modest gearing levels, declining borrowing costs, extensive buy-backs, sizable discounts to underlying property values and attractive yields relative to falling deposit rates. Unit prices across the sector moved from under-valued to fully-valued and we recently reduced our over-weighting for the sector.	Around long run fair value	Around average long run returns
Real Estate	Australian residential property	We are seeing signs of activity in two sectors of the market – the bottom end 1st home buyer market and the investor market. Rents are rising, interest rates are falling, unemployment is still low and consumer sentiment seems to be shifting from bank deposits toward housing once again. There are signs of improvement in investment lending volumes. In a “Basel-3” world, banks will be heavily constrained and what little lending they do will be targeted toward housing.	Varies by market, but over-valued overall	Below average to average long run returns
Australian Dollar		The Australian dollar is at the wrong end of a global currency war in which all of the main central banks are printing money furiously to debase their currencies, inflate away their debts and assist their exporters. Our RBA has been reluctant to join in and the AUD remains far above its fundamental value. In 2012 our dollar rose less than 2% against our trade-weighted index of currencies, and 2% against the US dollar, but it rose 14% against the dramatically weaker Yen. The AUD remained flat against the Euro and Chinese RMB but fell against Sterling and most south east Asian currencies. This means that in most Asian markets for our exports and tourism, our dollar is no stronger and in many cases actually weaker (aside from Japan).	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 AUD terms – ie including any profits/losses from hedging or currency movements