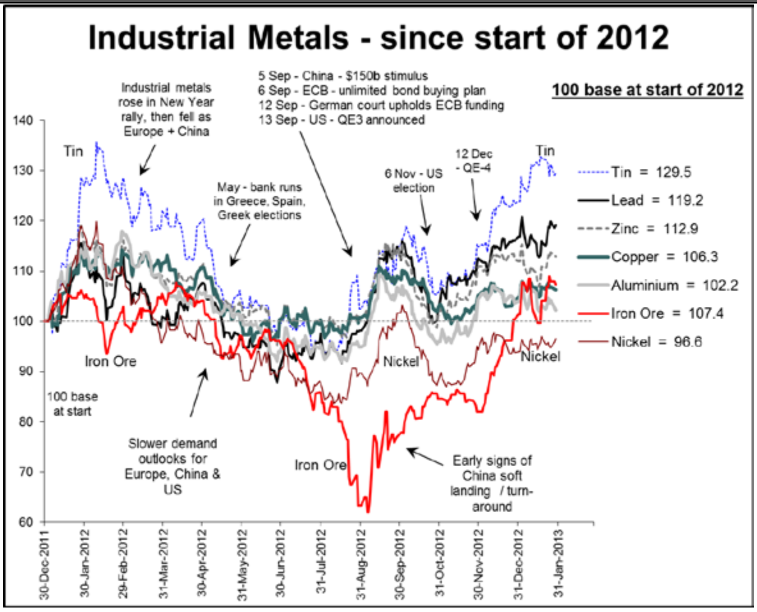
PHILO CAPITAL MARKET MONITOR – END JANUARY 2013

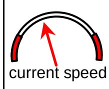
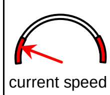
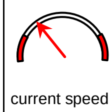
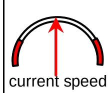
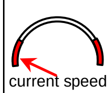
Chart of the month: Industrial Commodities point the way



Industrial metals prices tend to be barometers of global growth outlooks. Our chart shows metals prices since the start of 2012, with a common base of 100. The 2012 new year rally saw prices rise for all metals but the January optimism soon turned to pessimism from February as the Chinese and US economies slowed and as the European debt crisis deteriorated rapidly. Metals prices turned negative in May with the Greek election chaos and the Greek and Spanish bank runs.

Iron ore (Australia's largest export) was hit hardest, down more than 40%. Signs of a turnaround in China, "QE-3", and progress in Europe buoyed markets from early September, and metals prices shot up. The pessimism over Barak Obama's re-election in November and the "fiscal cliff" soon turned to relief with the announcement of "QE-4", and markets have been soaring since.

So far 2013 has been a repeat of 2012 for metals. Despite the optimistic new year rally, the big problems have not been solved but this time around the US and Chinese economies appear to have turned the corner and are improving, not slowing. The Europeans have opted for growth instead of harsh austerity, and they now have a range of new mechanisms to handle flare-ups in the on-going debt crisis, which seem inevitable this year.

		Economies	Current position	Direction / Trend	Pace of growth
Economies	Australia	The economic numbers for Australia are still relatively good. Unemployment rates are relatively low (at around 5.4%, but up by half a percentage point from 2011) and interest rates are at very low levels (relative to Australia's historical experience but not relative to other countries). The benign-looking inflation numbers would appear to allow some scope for interest rates to fall further. However the inflation rate is being kept below 3% by declining prices of imports, while anything with Australian labour costs in it is rising strongly (services, education, healthcare, utilities, financial services, insurance, etc). With unemployment rates still low and wages rising, the RBA has little leeway to cut rates much further. Unemployment should rise this year as companies hopefully start to get serious about cutting costs. If so, it should take some of the pressure off wages and increase the possibility of further rate cuts.	Below average growth rate	Growth flattening	
	Europe	The European debt crisis has eased a little further in January. The 10th of January was the key day for the month - when Spanish 10 year government bond yields dipped below 5% for the first time in a year (down from more than 7.6% in late July of last year). ECB President Mario Draghi also made his "positive contagion" comment on that day ("*There is a positive contagion when things go well and that's what's in play now*"). The German economy is slowing but confidence in the future is rising as it seems the risk of a cataclysmic collapse of the banking system has eased. The PIIGS governments are still heavily reliant on artificial support mechanisms, but European banks have been weaning themselves off life support over the past several months, and are now able to regularly raise long term debt on their own. The renewed sense of relief bordering on optimism is being reflected in bond yields and in share prices.	Contracting	Remaining very weak	
	US	The "fiscal cliff" crisis continues to dominate US affairs. The "past midnight" deals in the Senate and the House in the early hours of New Year's Day merely delayed the problem to the end of February. The bill raised taxes on the rich (slightly) but did nothing to cut costs. On 24th January, the House passed another bill to postpone the debt ceiling issue again to July. The bill allows the Treasury to effectively ignore the debt ceiling (which was exceeded on 1 January) until 18th May, after which time the House has vowed to take "extraordinary measures" to cut spending. In light of these two major negotiating setbacks on the part of the Republicans, this now appears to be an empty threat. The latest bill requires the Senate to pass a budget bill by 15th April or the Senators' salaries will be docked until it does (seriously!). The two sides remain as far apart as ever. The Democrats are still refusing to consider any cuts, and the Republicans are refusing to allow any more tax hikes, still smarting after their tax hike concession in the New Year's Day deal. The balance of power has clearly shifted toward the Democrats.	Below average growth rate	Recovery remaining slow	
	Asia	The cyclical up-turn in the Chinese economy continues to gather pace, with manufacturing, construction and housing looking stronger in recent months. In Japan, rather than cut spending and/or raise taxes to pay off debt, the new government is doing the reverse – ramping up spending and stepping up efforts to depress the yen and create inflation so it can pay off its growing mountain of debt with devalued yen. Parts of the plan are working - the yen has fallen by 13% in the past three months and exports are up. The search is now on for a more compliant Bank of Japan Governor who will "*take responsibility for the real economy*" and create inflation. Things are hotting up in the waters around the disputed islands. China, Japan and Taiwan have ships circling, and Chinese and Japanese fighter planes have been darting in and out of the danger zone, issuing warnings and scrambling communications but not actually firing shots yet. The US has openly sided with Japan, and this has clearly annoyed the Chinese. The new leaders of China and Japan, Xi Jinping and Shinzo Abe, won office on nationalist platforms and it seems each is keen to show they are prepared to back their words with action. Meanwhile North Korea is planning more nuclear tests, specifically naming America as their target.	<u>China</u>: Cyclical slowdown ending <u>Japan</u>: Very slow	<u>China</u>: Growth recovering in coming months <u>Japan</u>: Remaining slow	 

		Asset Classes	Current position	Long term returns (1)
Shares	Australian shares	The local stock market got off to a good start in January, returning 5% for the month, after a 20% return in 2012. Over-sold cyclical stocks and banks were the main leaders this month, while miners were flat (dragged down by gold miners again), on rising export volumes but rising costs. The defensive gainers from last year were more subdued, as investors sought out better value in cyclical stocks. During quiet holiday trading, the main excitement for the month was provided by RIO's spectacular $14b write-down. It wrote off another $11b of its disastrous $38b top-of-the-market acquisition of Alcan, and also wrote off $3b of the $4b it paid only a couple of years ago for Riversdale (coal in Mozambique). This was the last straw for RIO's board and the CEO (American Tom Albanese) was swiftly replaced by Australian iron ore head Sam Walsh. (RIO is in our portfolio, and it was up for the month). We have been relatively bullish on Australian shares since early last year, and remain over-weight in our portfolios.	Below fair value	Above average long run returns
	Developed markets shares	Global markets also got off to a good start in January, with all of the major developed markets up by around 3% to 6%, but on light holiday volumes. The US rise was driven by higher earnings (despite the US economy contracting in the December quarter), especially from the banks, including the big commercial banks and also the big investment banks. Japanese markets continue to thrive on the lower yen and new stimulus plans, but clouds are developing on the horizon with the escalating dispute with China. European markets are also enjoying a cyclical rebound, again led by banks and manufacturers, despite the Euro strengthening against the dollar and in particular against the yen. We have also been relatively bullish on global shares since early last year and remain over-weight in portfolios.	Mixed – US moderately 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 shares were also mostly off to a positive start to the year. The Chinese and Russian markets were the strongest of the big emerging markets. Chinese stocks are being buoyed by the early signs of a cyclical turn-around, with the likelihood of a hard landing receding, and Russian stocks are benefiting from higher oil & gas prices. The markets in Brazil and India were slower, but most of the smaller emerging markets were up strongly for the month, after very strong returns in most markets last year.	Around fair value	Above average long run returns, but high volatility (2)
Fixed Income	Australian Gov't bonds	Australian treasury yields spiked up a little across all maturities in January as money moved out of bonds and into shares. Credit spreads still appear too thin and don't offer adequate compensation for credit risk. We have been warning of the potential for a bond yield spike since late last year and recommend domestic fixed income allocations be held mainly in bank term deposits, which offer superior return for risk at current levels.	Yields below (prices above) long run average level	Below average long run returns
	Bank Term Deposits	Although treasury market yields for most terms have risen by more than half a percentage point over the past nine months, rates on term deposits have kept declining. Within the fixed income asset class, term deposits still offer more attractive returns for risk than bonds even at the current lower interest rates on offer. This is because bond yields are still too low, and credit spreads on credit securities are too narrow.	Rates around long run average	Around average long run returns
	Global Bonds	Bond yields have fallen in the higher risk countries like Spain and Italy, but yields are rising in the "safe" countries as economic conditions improve in the US, UK and even in France. The exception is Japan, where yields remained flat despite the best efforts of the new government to revive inflation. The benchmark global government bond index was up 8% last year and is down a fraction for January due mainly to the yield rises in the US, UK, Germany and France. We are expecting only very modest returns from global bonds in 2013, and are under-weight in portfolios.	Yields below long run average level	Below average long run returns (2)
Cash	Australian target cash rate	Even after six rate cuts in this cycle, Australian interest rates are still the highest in the "developed" world and they are still attracting yield chasing foreigners in droves, keeping the dollar high. The RBA probably has little scope to reduce cash rates further unless Chinese or global growth takes a dramatic turn for the worse.	Cash rates below long run average level	Variable, rising over medium term
Real Estate	Australian commercial property	The listed property trust sector had a solid first month for the year but under-performed shares. The sector returned 33% last year and our portfolios were over-weight for much of the year. We have reduced weights back to neutral since the start of the December quarter, shifting the weight in favour of shares and since that time shares have out-performed listed property. Commercial property still offers good yields relative to cash and bonds, but the upside is limited from current levels of pricing. The outlook is for supply to exceed demand in some of the key markets.	Over-valued on long run measures	Around average to below average long run returns
	Australian residential property	At the top end and discretionary sectors (beach houses, holiday flats, hobby farms, etc) there has been an increase in sales activity at mortgagee sales (mostly at very low prices), with sellers finally meeting the market and/or lenders finally pulling the plug. At the other end of the market, declining interest rates are starting to encourage first home buyers back into the market and the recent improvements in investment loan volumes are starting to show up in building approval numbers. This activity has yet to translate into broad rises in prices.	Varies by market, but over-valued overall	Below average to average long run returns
Australian Dollar		Our dollar has been trading sideways for the past two years, rising and falling within a narrow range with the oscillations in the global "risk-on, risk off" cycle. The dollar was a fraction higher against most currencies in January. The exception was the Yen, which collapsed another 6% as an intended consequence of its dramatic re-inflation plan. The Australian dollar remains significantly over-valued on long term 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 AUD terms – ie including any profits/losses from hedging or currency movements