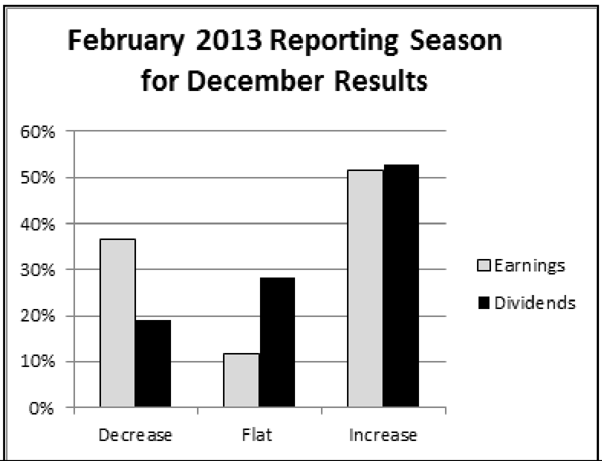
PHILO CAPITAL MARKET MONITOR – END FEBRUARY 2013

Chart of the month: Australian Earnings and Dividends firming

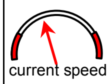
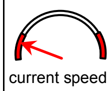
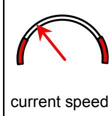
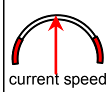
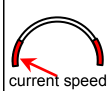


February was reporting season for Australian companies and overall it was a fairly benign one. Amongst the largest 100 listed companies, the majority reported higher earnings and raised their dividends.

The overall tone of management guidance was that earnings were stabilising to slightly recovering. This has given company boards the confidence to increase dividends.

Resource company profits down year on year (after one-off write-downs), but slightly ahead of expectations due to aggressive cost cutting programs and effective resource tax management – ie the big miners paid virtually no MRRT (Minerals Resources Rent Tax), but they paid all the usual corporate taxes.

The banks reported solid profits on the back of expanding margins as their funding costs continued to decline. Shares in cyclical industrials and retailers generally outperformed over the month, as companies presented results slightly above dismal market forecasts. On the other hand, profits in the healthcare and energy sectors struggled to beat lofty market expectations.

		Economies	Current position	Direction / Trend	Pace of growth
Economies	Australia	Business confidence is showing signs of improvement, reflected in the moderately up-beat February reporting season. Companies are finally starting to get serious about cutting costs, and this is helping boost share prices. Most Australian companies were lazy during the GFC, but are now finally taking action, perhaps due to the high dollar and slowing China. On the other hand consumer confidence remains subdued, with the prospect of another six months of tedious election campaigning ahead. Of special interest to investors is the fact that both sides have set their sights on raiding the superannuation pot to try to balance the budget. This is one of the few issues (aside from the mining tax and carbon tax) on which both sides have aired concrete policies. The Libs want to wind back tax-breaks & subsidies for the poor, while Labor plans to wind back tax breaks and subsidies for the "rich". The government also announced that bank deposits with no transaction activity for a year, and superannuation accounts with no transactions for three years, will be "transferred" to the government. All of this is looking increasingly like Argentinian President Cristina Kirchner's desperate moves to confiscate retirement savings to plug holes in the budget and pay off government debt.	Below average growth rate	Growth flattening	
	Europe	Europeans munch on horse burgers, horse lasagne and horse pizzas as they watch the Italian comedy version of the Greek election fiasco of last year. This time it is on a much larger scale. Greek debt was relatively small but caused big headaches, and it provided a useful test case for the development of the new European bail-out mechanisms. Italian government debt is a much more serious $1.5 trillion. After an encouraging start to reforms to pensions, spending and taxes last year, Mario Monti was forced out as Italy's stand-in PM, and he polled very poorly in the elections. The big winner was the "Five Star Movement", led by Beppe Grillo, a popular TV comedian who mocks politicians and wants to ditch the Euro. Both of the other major parties – Bersani's union-backed centre-left coalition and the centre-right coalition led by Berlusconi (yes, him again!) - are anti-reform and anti-austerity. France is siding with Italy in the battle of words with the Germans over austerity and budget discipline. Francois Hollande is actively talking down the benefits of the Euro, and is pleading for more time in which to reduce France's deficit. Meanwhile, Cyprus is the latest country to fall, as it negotiates a €17b bailout.	Contracting	Remaining very weak	
	US	The two major issues facing US markets are the fiscal cliff (again!) and the future of "QE" ("quantitative easing"). The political posturing and short termism continues in Congress and in the Obama administration, with no sign of real leadership or long term solutions from either side. With time ticking away, the automatic "sequester" is looming - which involves across-the-board budget cuts of $85b this year and $1 trillion over the next 10 years. Although it sounds like a lot of money it will put only a minor dent in the deficit and debt. On the "QE" front, Federal reserve minutes revealed deep divisions over support for the $85b per month buying of bonds with newly created money. Sooner or later the Fed will need to stop buying, and then start selling those bonds, which will cause prices to fall and interest rates to rise. Through all of this, companies are doing well and are churning out so much in cash profits they don't know what to do with it all. Consumers are spending, emerging markets demand is strong, wages are falling, energy costs are falling, interest rates are near nil and inflation is low.	Below average growth rate	Recovery remaining slow	
	Asia	China has avoided a hard landing – this time. Imports are rising (mainly coal, iron, steel) and exports are rising (despite slow growth in the developed markets). Inflation has reduced but is now rising again (now back above 2%), and interest rates are likely to rise next (after rate cuts in 2012). The party has announced a new reform agenda - to raise incomes and reduce "dangerous" inequalities by increasing minimum wages and boosting spending on education and housing. They will also allow banks greater flexibility to set interest rates, introduce property taxes and reform the *hukou* household registration system. The talk of property restrictions has caused a fall in commodities prices in late February after the promising rise in January. In Japan, the falling yen is driving export growth for the first time since the middle of last year and share prices continue to rocket upwards. Rather than enter a verbal currency war with Japan (*a la* 1985), this time the US supports Japan's money printing and currency depreciation, as Japan is America's key ally in the bigger economic and military tussle with China.	China: Cyclical slowdown ending Japan: Very slow	China: Growth recovering in coming months Japan: Remaining slow	 

		Asset Classes	Current position	Long term returns (1)
Shares	Australian shares	The local stock market had another great month – up 5% following 5% in January and 20% returns in 2012. Cyclical sectors like banks, industrials and consumer discretionary have been the strongest so far this year. Miners were flat, with higher sales volumes but on lower commodities prices, while gold miners were once again the worst performers. BHP followed RIO and replaced its CEO after nearly six years of expensive deal-making with mixed success. The main game for miners now is to focus on running leaner businesses in an environment of lower prices, higher costs and increasing supply. We are over-weight Australian shares in portfolios.	Below fair value	Above average long run returns
Shares	Developed markets shares	The main developed stock markets had a quieter month, after three strong months of returns. Japan was the exception and is up 10% for the 2013 year to date, fuelled by the lower yen and talk of increased stimulus spending. In the US, two big deals dominated the news. The first was Michael Dell's $24b privatisation bid for his troubled Dell Inc. The proposed price is a quarter of its peak share price at the top of the dot com boom when Dell was then the largest PC maker in the world (and Apple was near bankruptcy). The second was Warren Buffett's Berkshire Hathaway in a deal to buy Heinz for an over-the-top $28b, the largest food industry takeover in history. In another sign of the times, Atari (founded 41 years ago) finally filed for bankruptcy, while Google (formed only 14 years ago) posted sales of $50b for the first time and hit a record $800 per share. We are over-weight global shares 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)
Shares	Emerging markets shares	Emerging markets had a flat month overall, again weighed down by the BRICs. Chinese stocks followed the prices of industrial metals and iron ore – up in the first half of the month but falling back after the Chinese new year break and after the announcement of new measures to dampen the Chinese property market. While the BRICs were softer, smaller markets were stronger, in particular Indonesia, Thailand, Philippines and Pakistan. This continues the theme of the past couple of years in which markets did best the further from China they were.	Around fair value	Above average long run returns, but high volatility (2)
Fixed Income	Australian Gov't bonds	Yields on government bonds across all maturities drifted up a little in February, with large offshore selling mainly from Japan, and as domestic money shifted into shares. However, yields on corporate bonds fell as credit spreads continued to tighten. Returns on the composite bond index (which includes government, semi-government and corporate bonds) have been flat since September 2012. Yields have risen by 70-80 basis points since their lows of June-July last year, but the sector remains over-valued. Yields on government bonds are still too low, and credit spreads are too narrow. We prefer bank TDs for fixed rate exposure.	Yields below (prices above) long run average level	Below average long run returns
Fixed Income	Bank Term Deposits	Although treasury yields continue to drift up, rates on bank term deposits are have been falling. Banks are now less desperate to raise funds locally as global credit conditions ease, wholesale funding costs fall, and lending growth remains subdued. 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.	Rates around long run average	Around average long run returns
Fixed Income	Global Bonds	February was another "risk-off" month for bond markets – like April, May and July last year. Yields fell in the "safe havens" (US, UK, Germany and Japan), while yields in the PIIGS rose due to renewed fears of instability following the Italian election. In Japan, yields fell below 0.70% despite the deliberate inflation targeting; in the UK yields fell back below 2% despite the credit downgrade; and in the US they fell below 2% despite emerging fears that the economy is so strong that the Fed may soon end bond buying, which should see yields rise. The net effect was a return of 0.6% for the month, which is around the long term expected average return.	Yields below long run average level	Below average long run returns (2)
Cash	Australian target cash rate	The RBA is clearly concerned over the high dollar but is reluctant to cut rates much further for fear of igniting credit growth and inflation. The RBA is opting to keep its powder dry in case global conditions deteriorate significantly this year.	Cash rates below long run average level	Variable, rising over medium term
Real Estate	Australian commercial property	The listed property trust market delivered another solid 3% for the month, continuing the very steady upward trend over the past year. February proved to be another positive reporting season for the LPT sector, with earnings growth being delivered by modest revenue increases and significant reductions in interest costs. The sector is benefiting from both an overall reduction in interest rates and the renegotiation of GFC-era debt, which was generally set in favour of the lender. Fund managers Goodman and Charter Hall performed well on increasing transactional volumes. Stockland was higher despite earnings falling by 26% and assets being impaired, mainly on expectations that the housing market will recover and that worst is now over for the company. The passive rent collecting trusts had an unexciting month, as the companies had announced their distributions in December and January. We are neutral on the sector.	Over-valued on long run measures	Around average to below average long run returns
Real Estate	Australian residential property	Median house prices ended up a little in 2012. Prices fell in the sub-prime crisis in 2008, rose with the stimulus in 2009, flattened off in 2010, fell again in 2011 before recovering a little in the second half of 2012. The case is building for a rise in prices, with low interest rates, low vacancy rates, rising rents and signs of investors returning to the market, but this takes time to flow through to higher prices.	Varies by market, but over-valued overall	Below average to average long run returns
Australian Dollar		In the midst of escalating global currency tensions, the US dollar continues to strengthen as its economy recovers, and it was the strongest of the major currencies in February. The Australian dollar was lower against the US dollar but was stronger against the weaker pound and Euro, while the yen slide continued. 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