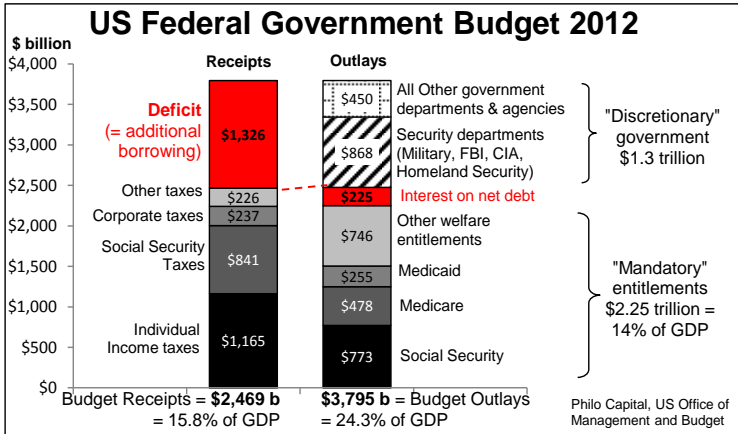




Chart of the month: US Budget Deficit Crisis



As the White House and Congress failed to agree on a compromise on the US federal government debt ceiling by the twice-delayed deadline, a set of across-the-board budget cuts came into force automatically on 1 March – the “sequester” cuts.

\$85 billion will automatically be cut from the budget this year, and around \$1 trillion over 10 years. Although this sounds like a lot of money, \$85b is only 2% of the US federal budget.

Even if the entire US government closed down forever, it still would not balance the budget, because total tax revenues collected (\$2.47 trillion) don't even cover mandatory welfare payments plus interest on existing debt (\$2.48 trillion) (see chart). Negotiations remain strained, and it may well come to a point where the government misses payments on its debts and/or has to partially close down government departments. It has done both in recent years when similar debt ceiling talks broke down.

Economies		Current position	Direction/ Trend	Pace of growth
Australia	<p>Business and consumer confidence improved in March, with higher company profits, stronger share prices, and the labour market holding up more strongly than many expected. PM Gillard clung onto power in the 21 March spill when Kevin Rudd once again failed to get the numbers. He has plenty of time yet (despite assurances he won't run) - the election is still 170 days away.</p> <p>The long running Rinehart squabbles caused people everywhere to ponder: “How much is enough?”, following Hope Rinehart's rejection of an offer of \$300 million. The four Rinehart children continue their very public fight over the family trust worth around \$4 billion. This is around one quarter of Gina's total estimated wealth, assuming iron ore prices hold up.</p> <p>All eyes are now on the May budget. The current year 2012-3 budget outcome is looking like a deficit of at least \$10 billion, instead of Wayne Swan's planned magic pudding “surplus”.</p>	Below average growth rate	Growth flattening	current speed
	<p>Progress on Europe's debt problems hit a speed bump with Cyprus in March as foreshadowed in last month's report. The surprise element was Germany's insistence that bank depositors bear some of the losses from bank mismanagement. Germany's Angela Merkel continues to lose popularity at home and is under increasing pressure to toughen up on the PIIGS and not be too generous with German tax-payers' money. Germany's main hard line partner, Austria, also hardened its stance during the month after a new anti-Euro party polled well in elections.</p> <p>Cyprus is a tiny country with a relatively large banking system that is mainly an off-shore banking haven for foreigners, especially Russians. The notion that ordinary bank deposits are now at risk is a big shift in policy. On 16 March “Plan A” raised the fear of potential losses for bank depositors across Europe. On 25 March a revised “Plan B” was announced: €10b in bail-out funds on the condition that Cyprus Popular Bank (Laiki, the 2nd largest bank) be wiped out, but insured deposits up to €100k are guaranteed and not taxed. The Bank of Cyprus (the largest bank) is to receive any good assets and its depositors are also to lose up to 40% of their deposits above the €100k guarantee cap. Banks remain closed to prevent panic withdrawals.</p>	Contracting	Remaining very weak	current speed
US	<p>Aside from the automatic “sequester” budget cuts (see above), the other major development on the US front was that Ben Bernanke re-gathered support within the Fed. He re-asserted the Fed's commitment to keep the “QE” bond-buying programs going and keep interest rates near zero until the unemployment rate is below 6.5% (which is not far away), and while inflation remains benign (which it is). The Fed is buying \$85b of bonds <i>each month</i>, the same amount as the <i>whole year's</i> budget cuts. The money from QE is still sitting in commercial banks' reserve accounts at the Fed and hasn't been lent out yet, so credit growth is slow and inflation is benign. So far QE hasn't created inflation as intended, but at least it has prevented deflation.</p>	Below average growth rate	Recovery remaining slow	current speed
Asia	<p>China's soft landing is proving even softer than policy makers intended. Industrial production is improving, inflation is back above 3% and housing prices are threatening to cause renewed unrest, so the government announced a new round of housing restrictions to curb speculation.</p> <p>On 15 March Xi Jinping and Li Keqiang were officially anointed as the new President and Premier in the formal rubber-stamp “elections”. Xi Jinping is a “princeling” – the son of one of Mao's revolutionaries and his family has made untold billions from the “communist” system. Li Keqiang is from humbler beginnings and trained as a lawyer and economist. He is one of the very few trained economists in power and he famously admitted that China's official economic figures are “man-made”. Li is the main driver of China's mass urbanisation push, and his elevation is likely to mean that government-directed investment (mainly housing and urban construction) funded by government controlled banks lending to provincial governments and government controlled agencies, will remain a dominant feature of the economy for some years.</p>	China: Cyclical slowdown ending	China: Growth recovering in coming months	current speed
	<p>With hard liners firmly entrenched, civil unrest continues to be fuelled by scandals involving tainted food and even rice wine. Peering through the toxic air pollution, Shanghai residents saw many thousands of rotting pigs wash up in the river that supplies Shanghai's drinking water.</p> <p>Across the disputed seas, Japan's new pro-debt, pro-inflation, pro-deficit agenda continues on track – with the yen falling further, exports stronger, confidence lifting and share prices still surging. This is providing a powerful case study for the PIIGS of Europe, who are finding the going tough under the hard-line medicine of deflation, savage budget cuts and a fixed currency.</p>	Japan: Very slow	Japan: Stimulus improving exports, production & growth	current speed

Asset classes		Current position	Long term returns (1)
Shares	Australian shares	The overall Australian market was down a little in March, but is still up 7% for the year to date, following returns of 20% in 2012. Mining stocks were generally down for the month, hit by falls in commodities prices, while energy stocks were flat. The market was supported mainly by the big banks, assisted by higher dividends. On 18 March CBA hit a record \$70 per share, bringing its market value to \$112 billion and overtaking BHP as the largest Australian listed company. (However if BHP's UK shares are included, BHP's total value is still 50% larger than CBA). The main excitement during the month was the Leighton board ructions with its German/Spanish majority owners, ending Leighton's 50% share price run-up since September. We have been over-weight Australian shares over the past year during the great run. In addition, our internally run portfolio and also our externally-run funds have added significant value.	Below fair value Above average long run returns
	Developed market shares	Despite the Cyprus crisis, global shares were up again in March, with the global index up 8% for the year to date. The US stock market brushed off the automatic "sequester" budget cuts and gained another 3% in March, making it 9% for 2013 to date. It is not just the side-effects of "quantitative easing" supporting prices. US companies have amassed huge piles of cash profits and are now increasing earnings expectations further as the US economy continues to improve. The other major markets were up, including UK, Germany and France despite their flat economies. The standout once again was Japan - up another 8%, and 20% year to date. We have been over-weight global equities in portfolios during the rally.	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	Despite their relatively high economic growth rates, emerging markets shares continue to lag the "old world". The "BRIC" markets continued to head downward in March. Many of the emerging markets suffer from domination by government-controlled enterprises, poor governance practices, questionable accounting, corruption and political interference. One casualty in March was Suntech, the now bankrupt solar panel giant founded by Australian-Chinese entrepreneur Shi Zhengrong, once one of Australia's and China's wealthiest billionaires. We broadly prefer to tap into the tremendous growth in emerging markets middle classes through profitable companies based in the major developed markets, and may selectively gain local market exposure with firms that are expected to have supra-normal growth.	Around fair value Above average long run returns, but high volatility (2)
Fixed income	Australian gov't bonds	Yields rose across the board in March. Yields on all maturities longer than 1 year are now above the cash rate for the first time since June 2011. This leaves open a slight possibility of further temporary rate cuts this year, but then on to higher interest rates, growth and inflation thereafter. Returns on bond funds were flat for the month and have been flat all year. We had been expecting poor returns and we only hold minimal exposure in portfolios for liquidity purposes.	Yields below (prices above) long run average level Below average long run returns
	Bank term deposits	The Cyprus crisis brought global attention to the safety of bank deposits, which had up to now been regarded by investors as "safe as a bank" - protected from bank losses and from arbitrary taxes. Australian banks are amongst the safest in the world, and about 37% of the \$1.7 trillion of deposits in Australian banks are covered by the federal government's deposit guarantee, and 99% of depositors by number are covered. Rates on term deposits remain low despite treasury yields rising in recent months. With banks now raising fixed loan rates we expect them to start raising TD rates as well, so we are staying at the short end rather than lock in now at low rates, and using our "breakable" longer term TDs.	Rates around long run average Around average long run returns
	Global bonds	Returns from global government bonds have been on a gradual, steady, almost straight-line upward path for the past couple of years throughout the sovereign debt crisis. In March US yields remained flat with the steady US economic recovery, but yields fell in all other major markets, including Japan despite their renewed inflation strategy. In Europe, yields fell significantly in Germany, France, and the UK, where stop-start austerity has put yields back below US yields. We remain under-weight the asset class. Although returns have been positive, returns from shares and commercial property have been much higher over the past year.	Yields below long run average level Below average long run returns (2)
Cash	Australian target cash rate	The RBA is reluctant to cut rates much further for fear of igniting credit growth and inflation. With the unemployment rate remaining relatively low and wages still rising, there is little scope to cut rates much further, in the absence of a major contraction in Europe or China.	Cash rates below long run average level Variable, rising over medium term
Real estate	Australian commercial property	The listed property trust market was a little lower in March, but has still returned 5% for the year to date. In the underlying commercial property market, yields remain robust and are even tightening further. This is being driven largely by strong demand from foreign buyers, despite weak outlooks for rental growth across all of the main sectors. We are neutral on the asset class and expect solid but unexciting returns this year, after being over-weight during much of the great run-up last year.	Over-valued on long run measures Around average to below average long run returns
	Australian residential property	House prices are showing modest rises in the major markets (barely keeping pace with inflation), and home loan approvals for investors & non-first home buyers are improving. The main sectors yet to move are the first home buyer market and the holiday flat market. Many thousands of flats are still empty and/or on the market at big discounts below their boom-time "off the plan" purchase prices, mainly on the Gold Coast, Sunshine Coast and Melbourne Docklands. There may be some "bargains" buying cheaply from desperate mortgagees, but in past cycles it has taken many years to clear the backlog of over-supply before prices start to rise.	Varies by market, but over-valued overall Below average to average long run returns
	Australian dollar	The Aussie dollar was up a little in March, especially against the much weaker yen. The Euro weakened with the Cyprus crisis. So far this year the AUD is up a couple of per cent, but has been virtually flat for the past 8 months. It remains over-valued on fundamental measures.	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

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