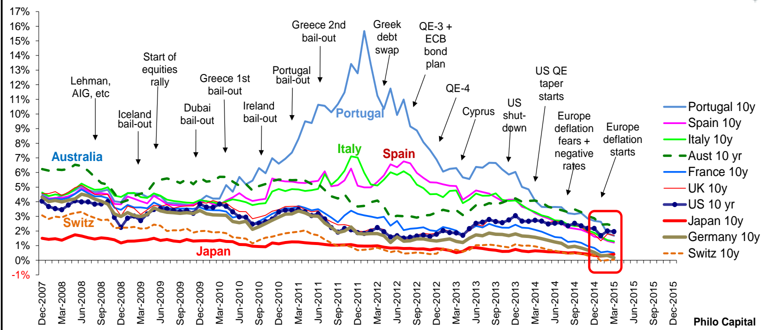
PHILO CAPITAL ADVISERS

PHILO MARKET MONITOR

End March 2015



NEGATIVE YIELDS ON 'RISK-FREE' BONDS

Bond yields fell in March in most markets, with the main exceptions being Greece where yields rose as it lurches toward its 3rd bailout and/or possible Euro exit, and yields also rose a little in Japan with its renewed money printing efforts and exit from recession.

The chart shows yields on 10 year government bonds rising during the 2010-12 'PIIGS' crisis and then declining as Europe slowed into deflation prompting the start of Eurozone 'quantitative easing'. Numerous European countries now have short, medium and even long term government bonds offering investors negative yields – including Germany, Switzerland, France, Denmark, Netherlands, Sweden, and even Ireland and Portugal!

European investors are either predicting decades of price deflation ahead (Europe entered deflation late last year), and/or they are simply terrified of putting their money anywhere else. They prefer buying loss-making bonds instead of just hiding their money 'under the bed' or in a safe at home or in a safe deposit box at their local bank branch, where they would at least get their money back intact. They seem to prefer the certainty of losing money invested in government debt than the remote risk of theft if their homes, banks and/or countries are invaded and plundered. Switzerland makes sense as a trusted safe haven for Europeans, but Germany? Germans tried to invade and conquer Europe by military force 3 times in the past 150 years. Strange days indeed!

With yields so low investors are accepting longer and longer terms in the search for yield, fuelling a boom in multi-decade sovereign and corporate debt. On 10 March the UK government issued 53 year bonds at an incredibly low 2.62% yield as the UK enters deflation.

MAJOR MARKETS		Current position	Direction / Trend	Pace of growth
Australia	The release in March of December quarter economic growth numbers showed weak growth but stronger consumer spending and housing. On 3rd March the RBA left the target cash rate at a record low 2.25%, held back by fears that even lower rates will further inflame the house price boom that has been fuelled by rate cuts since start of this cycle in November 2011. The biggest issue in Canberra was the deficit blow-out in the current year due to rapidly declining revenues from exports and the host of proposed budget cuts that have been abandoned or are stalled. On the 18th, after railing for years about Labor's budget deficits and debt build-up, PM Tony Abbott suddenly announced that he is now comfortable with the current budget and debt blowout, and he foreshadowed a mild budget that would not tackle big spending cuts and reforms. This came only a few days after the release of the government's 'Intergenerational Report' warning of budget deficits for the next 40 years due to the impact of the aging population and declining productivity growth and immigration. By the end of the month the Treasurer signaled that a whole range of taxes and tax breaks now are on the table for the upcoming May budget - including capital gains tax, negative gearing, franking credits, the GST, and superannuation tax breaks. Many of these will directly affect investors and investment markets. Providing some light relief, Glen Lazarus abandoned the Palmer United Party, leaving it with only one Senate seat (Dio Wang) and one House seat (Clive Palmer, who rarely makes an appearance).	Below average growth rate	Growth slowing	current speed
Europe	The big story in Europe in March was the start of Euro 'QE' – the €1.1 trillion 'quantitative easing' program. The ECB had been buying corporate bonds and asset backed bonds for some time but central bank buying of government bonds started on Monday 9th March – exactly six years to the day after stock markets bottomed and started their post GFC rebound on 9th March 2009. The main goal of QE is to raise the inflation rate to 2%, the same target as in the US and Japan. But in Europe, as in the US and Japan after years of QE, inflation remains very low. The perverse effect of QE has been that the low interest rates entice companies like BHP to borrow more at record low rates and increase production, putting downward pressure on prices and lowering inflation instead of raising it. Another goal of QE is to depress the currency. It did so in Japan but the US dollar soared under US QE. So far the Euro has declined like the Yen, and QE has caused bond and stock markets to take off. The Greek debt fiasco continued, and is getting very interesting with Greece raising old war wounds and claiming Germany still owes it war reparations for its invasion and occupation of Greece in WW2. The stand-off continues, but the repayment dates are looming.	Still virtually Stagnant	Growth stalled	current speed
US	The biggest game in town for global investors is getting a handle on the timing and pace of the US Federal Reserve's plan to return short term interest rates to more normal levels. March saw numerous mixed signals from the economy, shedding little light on the subject. The clearest development was Fed Chair Yellen saying on the 18th that the Fed would no longer be "patient" but it would not be "impatient" either! Rate rises are a sign that the economy is improving, which should be good for company revenues, earnings and share prices. But this only translates into share price gains if the Fed is cautious and raises rates too little and too slowly. In that case shares do well – that is until the Fed suddenly gets tough and jacks up rates suddenly to kill off inflation. Thus far unemployment is falling, inflation remains very low and bond yields imply inflation will be low for decades to come, but the Fed is still holding back on rates for fear that an even higher dollar will cause exports and jobs growth to relapse. Prices of shares, bonds and property are up so far this year.	Below average growth rate	Recovery gaining pace	current speed
Asia	For China the month started with another sudden interest rate cut (following the first sudden cut last November), but by the end of the month central bank governor Zhou Xiaochuan admitted that growth was still slowing "a bit too sharply". He worried whether continuing disinflation would lead to price deflation – the first time deflation risk has been mentioned officially - but he said he would be "patient" before taking further stimulus measures using interest rates and QE. Premier Li Keqiang repeated his comfort with growth slowing to 7% for 2015, but in reality growth is probably currently tracking around 6%. Manufacturing activity is off to a slow start this year and housing prices and construction continue to tumble, but the stock market had a stellar month – up another 14%. Meanwhile India (which is also slowing and had a 2nd rate cut) is overtaking China's growth rate. India's population is 10% larger but it generates just one third of China's output. Japan emerged from last year's recession triggered mainly by the sales tax hike in April. Japan has strong exports, strong corporate profits, low oil prices, and a low yen. Inflation is barely above zero, miles from the 2% target, and so the Bank of Japan renewed its commitment to its ¥80 trillion stimulus plan. There are early signs of price inflation and companies are finally starting to grant wages rises.	China: Cyclical slowdown Japan: Back out of recession	China: Lower structural growth trend Japan: Growth stalled	current speed current speed

ASSET CLASSES

			Current position	Long term returns (1)
Shares	Australian shares	The local stock market paused in March after a strong start in January and February. The banks were all up even further during the month and are over-priced on many measures. They are extremely highly geared and reliant on artificially low interest rates to support lofty property prices. Countering the banks' rises were falls in mining and energy stocks. Iron ore miners were hit especially hard by a further 18% fall in iron ore prices. This prompted Andrew Forest, founder of Fortescue Metals (a high cost producer) to invite BHP and RIO (low cost producers) to join him in an OPEC-style cartel to cap production in order to force up prices. Competition regulators were not amused! We have been over-weight Australian shares since early 2012, near the start of the current 'QE' asset boom, and we are still reasonably bullish for the local market for now. Although fully valued, we expect the market will continue to be supported by strong dividends, cost cutting and continued low interest rates.	Near fair value on long term measures	Around average long run returns
	Developed markets shares	Developed stock markets had a relatively quiet month in March (flat) following a very strong February (+6%). After a dip in early March, markets recovered from mid-month after Euro QE started on the 9th and the Bank of Japan reiterated its commitment to QE on the 10th. For the year to date it is a familiar picture where stock markets and economic growth go in opposite directions. Countries with the weakest economies (Europe) have the best stock markets this year (European markets are up +15-30%), while those with the strongest economies (US, UK, Canada, NZ) have had the weakest stock markets (up by low single digits). We have been over-weight global shares since early 2012, near the start of the current 'QE' asset boom. Developed markets have returned +55% in that time in US dollar terms plus 30% in currency gains thanks to the falling Aussie dollar (as we have been un-hedged). We are still reasonably bullish on the current outlook, despite current full valuations in many markets.	Mixed – US over-priced on long term measures, but other markets varied	Lower than average long run returns, but currency gains expected (2)
	Emerging markets shares	Emerging markets also had a flat month overall after their February rises. Chinese shares shot up once again after a 2 month rest, despite the slowing economy and collapsing property prices. In contrast Russia had flat month on minor recoveries in oil prices and the Rouble after stocks surged 20+% in February. The star was Venezuela, surging another 40+% in March after a brief pause in February. The broad market has doubled over the past 12 months in the face of the oil price collapse, domestic economic & political crises, and US sanctions against the Maduro dictatorship.	Many appear expensive but are reliant on fickle global sentiment	Moderate long run returns, with high volatility (2)
Fixed Income	Australian Fixed Income	Australian yields edged a little lower across most maturities, especially at the long end. The yield curve retains its deep dip over the next decade and only yields of 10 years and longer are above the current ultra-low cash rate. Bond investors are betting inflation and interest rates are heading much lower for at least a decade. The market is being driven mainly by foreign investors who are happy to see their meagre yields wiped out by currency losses as the AUD falls. On the other hand, low rates are good news for high quality borrowers. BHP raised $1b in 5 year bonds at a record low rate of 3.15% just days after low-rated Fortescue abandoned a refinancing issue at a Greek-style rate of 9%.	Yields below (prices above) long run average level	Below average long run returns
	Bank Term Deposits	Rates on bank TDs remain very low and under pressure to be lowered further as yields fall in the money and bond markets. Holders of maturing TDs written at rates of 7% or more several years ago are opting to roll the money into higher risk assets like property and shares, further fuelling the boom.	Rates below long run average	Below average long run returns
	Global Bonds	Refer to lead story on page 1. Global bond returns in March more than recovered from February's mini-selloff in the US, UK, Japan & France. The global government bond index is up 1% for the month, +3% year to date following +11% return in 2014. We hold global government bond funds tactically in portfolios because of their smooth moderate returns in this type of environment.	Yields below long run average level	Below average long run returns (2)
Cash	Australian target cash rate	The RBA has cut the target cash rate nine times in the current cycle that began in November 2011 after the US & Greek debt crises. Money markets are pricing in more rate cuts over the next several years, made necessary by a local recession caused perhaps by collapses in residential property prices and construction. We hold minimal cash in portfolios since every other asset class has generated higher returns over the past couple of years and is likely to so again in the coming months.	Cash rates below long run average level	Variable, rising over medium term
Real Estate	Australian commercial property	Listed property trusts ended down a little in March and lost February's gains. Prices of the major trusts remained within a couple of per cent of square for the month. The market index has returned a robust 8% for the 2015 year to date (a little behind shares) due to the surge in January. The market is over-priced and is trading on distribution yields averaging just 5% (much lower in some trusts). These yields are barely higher than shares, but lacking the upside of shares – including the prospect of real dividend growth and franking credits. Listed trusts and the underlying commercial property market are being driven up mainly by demand from Asia. The frothy state of the commercial property market even prompted warnings from the Reserve Bank, which is also having little success talking down the residential housing market. We continue to favour listed property over unlisted property, and returns from the listed market have been more than double the returns from unlisted property in recent years.	Over-valued on long run measures	Below average long run returns
	Australian residential property	The housing market continues to rise, powered by ultra-cheap debt and strong Chinese demand. (your correspondent sold his Sydney harbour-front home to Chinese buyers during the month). The housing price boom remains the main obstacle preventing the Reserve Bank from cutting interest rates further to bring down the dollar. The 'macro-prudential' measures (a fancy name for old-fashioned government control of bank lending) are having little effect in dampening the market. Limiting investment property lending growth to 10% is still expansionary as it is still more than twice the rate of nominal GDP growth. Limiting it to zero growth or even mandating a reduction in loan outstandings might be more effective. Also the new nominal fees on foreign buyers are hardly a deterrent. Consequently, housing affordability is back down to record lows reached in 2004, 2008, 2010 and 2012. Regulators had some success in deterring illegal foreign buyers when the Chinese buyer of the $39m 'Ville de Mare' in Sydney's Point Piper was ordered to sell it again within 90 days.	Varies by market and by property, but most markets appear over-priced	Varies by market and by property
	Australian dollar (AUD)	The AUD fell a little in March. The big currency story has been the ongoing rise of the US dollar as the Fed tightens monetary policy while Japan and Europe loosen theirs further with money printing. The rising US dollar is hampering US exports and jobs growth. As the Euro and Yen fall the only 'win' for the US has been to stop the Chinese government engineering its RMB down against the USD from November to February. Australia's Reserve Bank joined the global currency war by admitting it has been forced to cut rates due to money printing by the major central banks of the world. We have been un-hedged in global equities portfolios for the past couple of years, benefiting investors from the AUD's decline. The AUD is still over-valued on fundamentals and we remain strategically un-hedged.	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

Ashley Owen, CFA, PHILO CAPITAL ADVISERS

This report has been prepared for clients of Philo Capital Advisers Pty Ltd ABN 70 119 185 974 AFSL 301808 and others on request. The report is based on generally available information and is not intended to provide you with financial advice or take into account your objectives, financial situation or needs. You should consider obtaining financial, tax or accounting advice on whether this information is suitable for