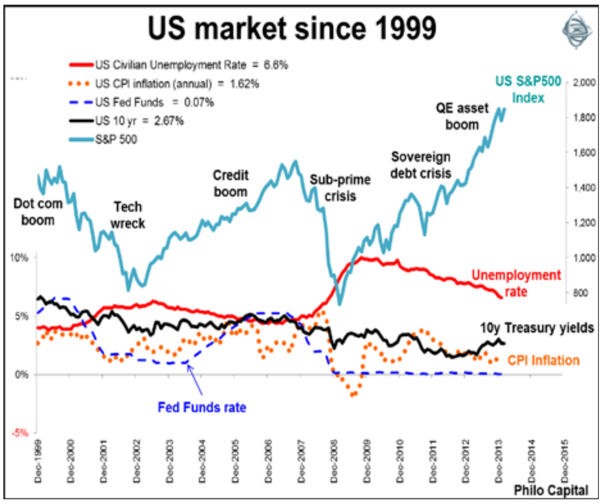
Philo Capital Advisers

Philo Market Monitor

End February 2014

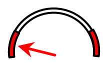
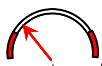
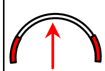
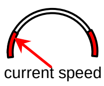


The Taper Caper

The main driver of global markets so far this year has been, and may continue to be for some time, the US Federal Reserve and how it adjusts its "QE taper" program in response to local developments in the US economy. The two main areas of focus are US jobs and consumer prices. Over the past couple of years share prices have boomed, supported by the Fed's "QE" programs, while the unemployment rate and inflation rate have both gone in the right direction – down.

The Fed has kept short term interest rates near zero since December 2008, and has also kept long term rates (which drive most mortgage interest rates) artificially low by buying $40b of bonds per month since September 2012 (dubbed "QE-3") and $85b per month since December 2012 ("QE-4"or "QE forever"). This has been enough to prevent deflation and economic contraction in the US, and has also stimulated modest recoveries in the US economy and jobs market.

Over the past three months, the QE bond buying program has been taken down by two notches without damaging the critical unemployment / inflation equation. Bond yields remain relatively flat, the unemployment rate continues to fall, inflation remains very low, and so investors have not panicked and sold off shares.

Major Markets		Current position	Direction / Trend	Pace of growth
Australia	The local economy is still relatively weak, with mining investment declining sharply and business confidence and investment remaining subdued. Consumer confidence has also declined sharply since the relatively bullish mood in September and October of last year. One contributing factor may the unemployment rate as it continues to rise steadily to 6% from its post-GFC low of 4.9% in April 2011. The current unemployment rate is now higher than the GFC peak of 5.8% in May 2009. These conditions have given rise to the topic that has dominated political and media debate during the month - government protection of local manufacturing jobs. This was triggered by the announcements of the closure of the last remaining local car manufacturing plants after many decades of being propped up by subsidies, tariff walls, tax breaks and straight-out tax-payer funded hand-outs. Add to that the looming crisis in Qantas, now seemingly in its death throes as an Australian-owned "national carrier". This debate over protection of Australian jobs mirrors the rising protectionist sentiment in the US White House and Congress, and also the festering protectionist rhetoric in North Asia. Prices of industrial metals and gold were up in February after falling in January, but iron ore and coal prices continued to fall. Iron ore prices are now down below $120/t and are at their lowest levels since the dip in June of last year, but Australian export volumes and Chinese import volumes remain strong.	Below average growth rate	Growth slowing	
Europe	Europe has become a two–speed zone. Growth outlooks are slowing in the centre, and Germany in particular is once again flirting with deflationary fears. In contrast, the smaller "club-med" countries are recovering from their contractions on the periphery of Europe. Spain, Italy and France remain the three big risks to European and global growth, due to their sheer size, their deficit and debt problems, and unstable politics. In February the big change was in Italy. New centre-left leader Matteo Renzi replaced Mario Letta as PM, who was in power since April 2013 following the comedic February 2013 elections. Renzi is young and inexperienced but has a grand plan for widespread reform, especially to labour laws and taxes. Time will tell if he is able to gather the broad-based support required to give his plan any chance of success. Meanwhile a major power play between the west and Russia is playing out in the Ukraine. In recent years the Ukrainian economy and political regime have been propped up by cheap Russian oil and loans, to further Vladimir Putin's designs on the Ukraine as a key part of Russia's buffer zone and sphere of influence, after Russia lost its buffer zones in the early 1990s. Russia is now gearing up to invade. Thus far the crisis has had little impact on broader markets.	Still virtually Stagnant	Recovering very slowly	
US	The US economy continues on its slow recovery path from the long and deep 2008-9 recession. Under Fed Chairs Ben Bernanke and now Janet Yellen the main focus has been on jobs, instead of the Fed's prior primary task of fighting inflation first (instituted by Paul Volcker in 1979). The unemployment rate continues to decline steadily from its peak of 10% in October 2009 down to 6.6% now. On the surface this looks like a strong jobs recovery but in reality the jobs market has been weak. The declining unemployment rate has been due largely to people giving up the search for work so they are no longer counted as "unemployed" in the official numbers. One fly in the ointment could be President Obama's current push to increase the minimum wage significantly as part of his "war on inequality".	Below average growth rate	Recovery remaining slow	
Asia	In China the economy continues to grow at around 7% or better as per the government's official script. It is no wonder, since it is still due primarily to government directed infrastructure investment funded by government directed lending by government controlled banks, to local government controlled financing vehicles, and not due to genuine consumer or business demand. The shadow banking crisis continues to simmer, and there were some more relatively minor rescues/bailouts in February following *China Credit Trust Co's* $500m "*Credit Equals Gold*" bailout in January. The 10 trillion RMB shadow banking system includes unregulated trusts that raise money from the public at relatively high interest rates, and then on-lend it to businesses at even higher rates. These trusts are the main sources of credit to private businesses, while the official banking system operates at artificially low interest rates but lends mainly to government-owned factories and to local governments to finance infrastructure projects. In Japan the pro-inflation push may be running out of steam. Share prices have fallen this year (albeit after the stellar run up last year), and consumer prices and wages are still not following the script, after 15 months of "Abenomics". Consumer and producer prices growth has been relatively weak, and real wages are actually declining. However business and consumer confidence remains relatively buoyant, but one negative consequence of that has been record trade deficits.	China: Cyclical slowdown Japan: Early recovery	China: Lower structural growth trend Japan: Stimulus improving exports, production & growth	 

Asset Classes			Current position	Long term returns (1)
Shares	Australian shares	The local Australian stock market had its first 5% dip for the year (between 2nd January and 5th February). Then February saw strong rebounds across the board, more than recovering from the January dip and leaving the market ahead by 1% for the calendar year to date. The banks were all stronger in February, except CBA which reported solid growth in profits and dividends. The other stars were Newcrest (on a partial recovery in the gold price), QBE, AMP and Telstra (finally lifting its dividend after seven long years of no growth, i.e. negative real dividend growth). The February reporting season was generally favourable, on the surface at least. Top line sales growth was weak (not even keeping pace with inflation and population growth in many cases). Earnings growth was a little better, but it was largely through cost-cutting, fiddling with provisions and/or lower interest costs, rather than by growing their businesses. Dividend growth was also reasonably good, but dividend payout ratios are running at high levels, so many companies are sacrificing future growth potential to placate yield-hungry investors in the short term. We have been overweight Australian shares in portfolios since early 2012, near the start of the 2012-3 rally, and our internally run direct stock portfolios and external managed fund portfolios have also added value above the market index during the rally.	Around fair value	Around average long run returns
	Developed markets shares	Developed world stock markets had a strong month in February, also more than recovering from their January dips. Amongst the main developed markets the only exception was Japan, which was flat, but is down 9% for the year to date. Despite this pull-back, the Nikkei index is still some 70% higher than it was at the start of the rise of "Abenomics" in late 2012. The biggest deal of the month was Facebook's astounding $19b purchase of "WhatsApp", a four year old start-up business that runs a free messaging service with no ads but has 450 million users. It will be fascinating to watch Facebook try to make a return on its $19b investment on that one!	Mixed – US is moderately over-priced on long term measures, but most other markets are under- priced to fairly priced	Around average long run returns, but currency gains expected (2)
	Emerging markets shares	Emerging markets also did well in February after a poor January when markets fell as foreign money was withdrawn due to QE taper fears. South East Asian markets were strong, and even China/HK/Taiwan/Korea were up a little, while Brazil and the other Latin American markets were down. The smaller peripheral markets of Southern Europe (which we regard more as "emerging" than "developed") did best as they rebound strongly out of their contractions, led by Cyprus (up 33% for the month), Greece (+11%), Ireland (+12%) and Portugal (+8%). Stock markets in the trouble-spots of Turkey, Egypt and Thailand were also up, despite escalating civil unrest there. For the past year we have favoured developed over emerging markets, which have lagged.	Difficult to value. Many appear inexpensive to fair value, but are reliant on fickle global sentiment	Above average long run returns, but high volatility (2)
Fixed Income	Australian Fixed Income	The local bond market was up a little in February after a strong January. Yields rose across all maturities in the first half of February, but fell back in the second half after the release of weak jobs market numbers, and ended the month flat. However credit spreads on semi-government and corporate bonds tightened even further during the month as global credit sentiment improved, leading to modest returns in those sectors. We are expecting yields to rise further over the medium term. We have been under-weight bonds in portfolios in 2013, reducing to zero weighting for Australian bond funds during the year, preferring bank term deposits instead.	Yields below (prices above) long run average level	Below average long run returns
	Bank Term Deposits	Bank TD rates remain low although yields on treasuries of equivalent maturities have risen up to 1.5% over the past 18 months. Banks will eventually need to raise rates if and when demand for loans picks up, but demand for business and housing lending remain relatively weak.	Rates below long run average	Below average long run returns
	Global Bonds	February was virtually a repeat of January, as yields on government bonds fell again in all of the major government bond markets. Yields fell in the US and Europe with slowing growth outlooks as QE is being withdrawn. Japanese yields were also down a little, with 10 year yields back down below 0.60%, their lowest level in nearly a year. Yields also fell in the PIIGS with their recovering economic outlooks pointing to lower risk of default. We remain under-weight as current bond prices offer little or no compensation for default risk or inflation risk.	Yields below long run average level	Below average long run returns (2)
Cash	Australian target cash rate	The RBA has left the target cash rate at 2.5% since the 8th rate cut made in August of last year. Yields on short term treasury bills were below the target rate for most of last year but have been back up at the target rate since November, indicating little expectation of rates falling further in the near future. This has been confirmed in recent RBA minutes, as the RBA's intentional boost to the housing market in particular now appears to be starting to have the desired effect.	Cash rates below long run average level	Variable, rising over medium term
Real Estate	Australian commercial property	The listed property market had a good month in February (+3%), with all the main trusts up. The main winners for the month were SCP (the ex-Woolworths shopping centres) and trusts exposed to the much-hoped-for for residential construction upswing (Stockland, Mirvac). The Lowy family is pressing ahead with yet another restructure plan. The Westfield empire will be split into two parts: one focusing on Australia and the other on US/UK/Europe. Shareholders remain sceptical that this latest grand US adventure will be any more successful than their previous attempts. The underlying commercial property market remains weak, with rising vacancy rates, weakening net rents, rising unemployment rates and weak business investment.	Over-valued on long run measures	Around average to below average long run returns
	Australian residential property	The housing market continued to strengthen, especially in the Sydney market. However there is little evidence that the current mini-boom is extending more broadly beyond investors and foreign buyers. Canberra's great hope is that new housing construction will miraculously fill in the hole left by rapidly declining mining investment and weakening business investment.	Varies by market and by property	Varies by market and by property
	Australian dollar (AUD)	The AUD was up in February against all major currencies, after falling in January. It was up mainly against a weaker US dollar (AUD up 2%), but less so against the strengthening Euro, Sterling and Yen. The US dollar weakened a little after its strong run since October last year as the QE taper plan evolved. Our portfolios benefited significantly from our un-hedged stance over the past year as the AUD has fallen, and the AUD is still over-valued on 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