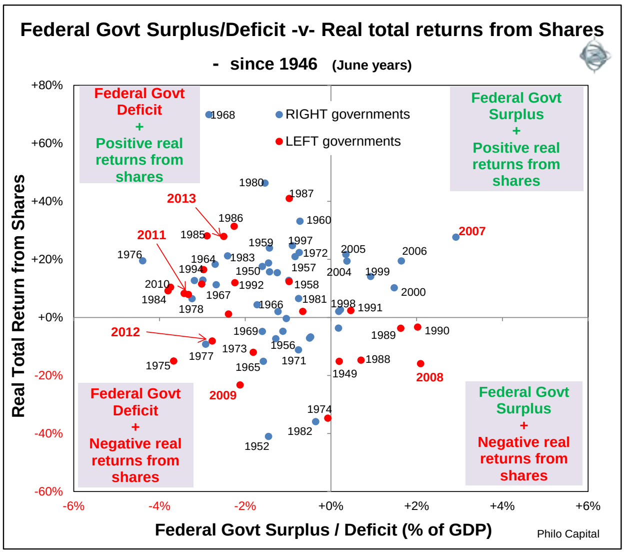
PHILO CAPITAL ADVISERS

PHILO MARKET MONITOR

End April 2014



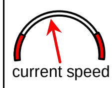
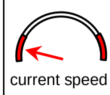
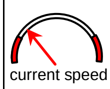
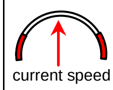
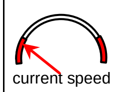
BUDGET DEFICITS ARE GOOD FOR SHARES

With Treasurer Hockey's first budget due in early May we put aside debates about whether budget deficits or surpluses are good for the economy or for tax-payers present and future, and focus instead on impacts on share market returns. The chart shows the annual federal government balance each June year plotted against real (after inflation) total returns from shares for that June year. Labor government years are shown in red and Liberal/National years are shown in blue.

There has been a *negative* correlation between the government balance and stock market returns. Most of the high return years from shares were government *deficit* years (top left section). This includes the 2011 and 2013 June years, and the likely outcome for the current 2014 June year (likely high return plus big fiscal deficit).

Government deficits have been good for shareholders and surpluses have been bad for shareholders. In the post-war era the median real total return from shares was 10.8% pa in the deficit years but only 2.4% pa in the surplus years, which is a very significant difference. There are two main reasons for this outcome.

The first reason is that deficits come about by governments spending more money (and/or taxing less), and much of the additional cash ends up in company coffers, either directly via contracting directly to government, or indirectly via household spending. The second reason is one of timing. Government deficits tend to be high in mid-late recessions (when tax revenues are down and welfare spending is up), and this is when shares generally do best, rebounding out of the middle of recessions. This was the case in 1954, 1972, 1983, 1992 and 2010, (and in the pre-war years 1922, 1923 and 1932).

MAJOR MARKETS		Current position	Direction / Trend	Pace of growth
Australia	After a relatively quiet start to his role as Federal Treasurer, Joe Hockey took centre stage in April as he prepared the electorate for the prospect of big spending cuts and tax hikes in his first Federal budget to be delivered in May. All sorts of possible new measures were flagged, including cuts to pensions, superannuation subsidies, raising new taxes and even a possible change in the Goods & Services Tax rate, previously a no-go area for both sides of government. We also saw Hockey's feud with the Reserve Bank over its stated intention to return policy interest rates toward more normal levels (around 5% to 5.5%) in due course. On the 23rd April the March quarter CPI numbers came out lower than the market had expected, easing fears of a rate rise in the coming months. The annual CPI inflation rate of +2.9% is still at the top of the RBA's 2% to 3% target range, and the more critical underlying 'trimmed mean' rate was still a rather high +2.6%. Whilst still high, they were lower than expected, and so they kept a lid on the Australian dollar and boosted share prices. On the commodities prices front, iron ore prices were down a little but coal recovered slightly. Industrial metals were all up, but gold remained flat at around $1300 per ounce with the US recovery on track and the QE taper remaining benign. PM Abbott also ventured into north Asia and secured trade deals with Japan and South Korea, and also re-started trade negotiations with China.	Below average growth rate	Growth slowing	
Europe	April saw continued recoveries and revivals in the worst hit southern European "club-med" nations. Portugal is looking like emerging from its bail-out soon, and conditions in Spain are still improving steadily. Even Greece is looking much stronger. Greece and Portugal had their first issues of bonds to the public since their respective bail-outs. Both were raging successes – over-subscribed many times over, and at super-tight credit spreads. The key date was 10 April, with Greece's first bond issue since its bail-out, raising €3 billion of 5 year money at yields below 5%, and it was seven times over-subscribed by over-eager investors. It seems Europe is now entering a sweet spot for investor over-confidence and over-pricing (and therefore future potential losses) - with little fear of inflation and interest rate rises, and also little fear of defaults, bank runs or a break-up of the Eurozone. It is a dramatic turn-around since the start of the recovery in mid-2012. Things continued to hot up in the Ukraine during April. With Russia having taken Crimea in March, Putin ramped up Russian agitation within eastern Ukraine (east of Crimea). A peace deal between the US, EU and Russia on the 17th was immediately ignored by Russia, and now the west watches and wonders how to stop Putin without triggering a major military confrontation. This tension is keeping oil prices high.	Still virtually Stagnant	Very slow Recovery	
US	The US economy continues to pick up steam as it emerges from life support (the unprecedented fiscal and monetary support) over the past five years. The housing market has been strengthening for the past two years (since early-mid 2012) but house prices and lending activity are now slowing. Prices have risen well in excess of rental growth, and mortgage interest rates have risen by 1% over the past year, with more rises on the horizon as the Fed continues to press on with withdrawing QE. While monetary stimulus is being withdrawn (QE) the fiscal position is also looking much stronger, and the trillion dollar budget deficits are now coming in at a less than half a trillion. Consumer confidence and spending are strong, unemployment is declining and inflation remains very low. Businesses are investing, giving confidence to investors.	Below average growth rate	Recovery remaining slow	
Asia	In China the central government is walking a tight rope. It must cool the speculative property market while keeping economic growth rates and employment strong. It must limit moral hazard by allowing some lenders and property developers to fail, but must contain the losses and fallout so that prices don't fall too far and risk causing panic selling and a collapse in confidence. All the while it must keep political dissent and worker unrest down to a dull (and heavily censored) roar. Factory riots over pay and conditions escalated in April, centering on Yue Yuen (a Taiwanese company that makes most of the world's running shoes for the big global brands) in Dongguan in Guangdong province. Violence could escalate along the lines of the Foxconn riots in the past couple of years (Foxconn is another Taiwanese company in Shenzen, Guangdong that makes most of the world's mobile phones for the big global brands). In mid-April a raft of statistics were released that pointed to China's slowing economy – slowing economic growth (+7.4%), declining exports, decelerating fixed asset investment and construction, and lower money supply and credit growth rates. Consumer inflation remains low (+2.4%), and producer prices are still declining (-2.3%), reflecting slowing demand and chronic over-capacity in many industries.	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 Australian stock market was up a little in April, bringing returns from the broad market to 4% (including dividends) for the year so far. Among the major stocks the strongest for the month were Worley Parsons, Woodside, Origin Energy and Westpac (all in our portfolios). Falling iron ore prices adversely affected iron ore miners like Rio and FMG. A highlight of the month was the battle between old retail dinosaurs Myer and David Jones. The latter finally fell to the South African Woolworths retail chain which has great hopes of reviving the glory days for DJs. We remain over-weight Australian shares in portfolios, and have been over-weight for the past two years since early in the current rally.	Around fair value	Around average long run returns
	Developed markets shares	Developed world markets were mostly flat again in April. Tech stocks came under scrutiny as investors expressed doubts similar to those at the height of the dot com boom in 1999-2000, about the sustainability of share prices at current levels. One prime example is Amazon.com (AMZN), which still can't work out how to make money in the market it pioneered 20 years ago and has dominated ever since, with sales of $80b. It trades on an astronomical price/earnings ratio of around 500, yet it loses money in most years, and has still never paid a dividend. Amazon.com was down 10% for the month. At the other end of the spectrum, Apple (APPL) announced another $30b in stock buy-backs (bringing the total to $90b), an 8% dividend rise and a 7 for 1 stock split. It has now become a mature low-growth stock trading on a price/earnings ratio of just 14 and sitting on a $150b pile of cash it can't find a use for. It is a far cry from the dynamic high growth innovator under Steve Jobs before he died in late 2011. Apple recovered 10% for the month but is still some 15% below its September 2012 peak price.	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 had an unusually flat month, despite election fever in several major markets and political turmoil in others. The Russian index sank a further 3% on increased sanctions over Ukraine and fears of a capital flight, bringing losses to 20% for the year so far. Greece was the other outlier (down 8% for April, but still up 6% for the year) despite improvements in local economic and credit market conditions there. Chinese markets were flat as investors quietly digested a flurry of news confirming the economic slowdown. India also had a rare quiet month during its election campaign which is likely to see power shift from the incumbent Congress Party to the Hindu nationalist BJP. Up most are rebound markets Egypt and Argentina (both up more than 20% for 2014).	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	Yields on Australian bonds fell back a little in April, mainly at the long end, as fears of future inflation were replaced by fears of a slowdown. The first reason for the yield declines was renewed fears of a Chinese property bust in the first week of the month, and the second was mid-month when Treasurer Hockey starting to soften the public up for big cuts in the May Federal budget. On the other hand the RBA took the unusual step during the month of publicly warning of likely losses on government bonds as it expected yields to rise in future. The composite bond benchmark has returned just 2% for the year to date. We remain under-weight bonds in portfolios as we expect yields to rise and credit spreads to expand from their current uber-bullish levels.	Yields below (prices above) long run average level	Below average long run returns
	Bank Term Deposits	TD rates remain very low even though underlying market interest rates have risen over the past 18 months. Investors have been shifting money from TDs in search of yield in other assets like residential apartments, commercial property and shares. Long term 'breakable' bank TDs remain our preference over Australian fixed interest (bond) funds, although rates on TDs are also still declining.	Rates below long run average	Below average long run returns
	Global Bonds	Bond yields remained very flat to a little lower in April in all the major global markets. Yields on the 'safe havens' (ie the biggest debtors) have been flat for three months, but yields on PIIGS debt fell further as European conditions continued to improve. Inflation fears and default fears both receded even further into the distance in investors' minds as they bid up prices to very bullish levels. Yields on benchmark 10 year bonds in Italy and Spain are now down near 3%, which is extraordinarily low (and a good 1% lower than on Australian bonds) and even Portuguese yields are below Australian yields. We remain underweight global bonds in portfolios due to their over-priced levels, however they generally provide a useful counter-balance when share prices fall, as they did in 2008 and 2011.	Yields below long run average level	Below average long run returns (2)
Cash	Australian target cash rate	In April the Reserve Bank left the target cash rate at 2.5%, where it has been since August of last year when it made its 8th rate cut in this cycle. The RBA hinted strongly that it is unlikely to cut its policy target cash rate any further in this cycle as the economy is showing signs of picking up pace later this year. Treasurer Hockey voiced his concern over the RBA's intention to return cash rates from their ultra-low inflationary levels back to normal rates, but the government's political desire for low interest rates should have little impact on RBA deliberations.	Cash rates below long run average level	Variable, rising over medium term
Real Estate	Australian commercial property	Listed property trusts were almost all up in April after their March declines. The rebound was led by the two Westfield entities following their relatively poor performance in recent months due to the uncertainty surrounding their latest controversial restructure proposal. Total returns for the sector are now ahead 8% for the year to date including distributions. While distributions are being increased modestly this year in most trusts, unit price rises are being driven largely by multiple expansion (paying more for the same level of earnings or dividends) as investors search for reliable yield in a world of ultra-low local and global interest rates. The underlying commercial property market remains weak but prices continue to be strong as yields are compressed, mainly by foreign buying demand. We remain a little under-weight on the sector in our portfolios as we regard the sector over-priced on fundamentals.	Over-valued on long run measures	Around average to below average long run returns
	Australian residential property	Only a few months ago newspaper headlines were trumpeting a new boom in house prices, but now headlines warn of falling prices and an end to the boom. Construction and supply of investment units are booming, causing vacancy rates to rise, rents to fall and prices to fall in many markets as supply exceeds demand – especially in parts of Melbourne, Sydney, Brisbane and Perth. The house market is different – with supply still tight and demand relatively strong, but mainly from investors and foreigners.	Varies by market and by property	Varies by market and by property
Australian dollar (AUD)		The AUD was fairly flat against most currencies in April but was stronger against the Chinese RMB, which continued to weaken against the USD, drawing even more ire from US Congress. The AUD rose early in the month with renewed confidence in China, but receded again toward the end on the weaker than expected inflation outcomes and the fears of fiscal tightening in the up-coming Federal budget. The AUD is still over-valued on fundamentals and we remain un-hedged for global shares.	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