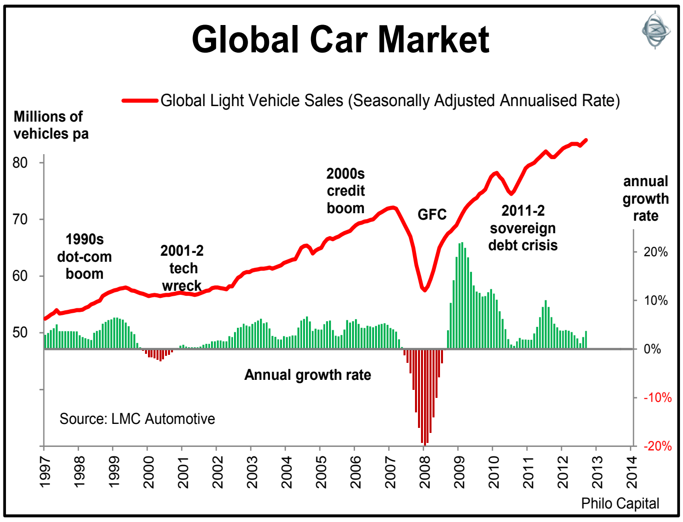
PHILO CAPITAL ADVISERS

PHILO MARKET MONITOR

End September 2013



GLOBAL CAR MARKET

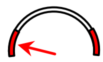
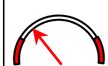
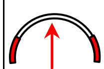
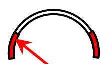
The global car market provides a useful barometer of global confidence, incomes, economic activity and demand for labour and raw materials.

Global car sales are up steadily in 2013, and are now running at a rate of 84 million new cars per year. Since the pre-GFC peak in 2007 there are now 7% more people on the planet but they are buying 16% more new cars per year now than they were in the 2007 boom.

US demand has been strong this year and is now back up above pre-GFC levels, with Americans buying 16 million new cars per year. The Chinese are now buying around 24 million cars per year, and growing at around 12% per year. The European market is still contracting but car sales in Japan are rising again as consumer and business confidence improve.

In terms of production, the Chinese now produce twice as many cars as the Americans, but American and European-owned car makers are among the big winners from the Chinese growth story. The 3 top selling cars in China are the VW *Lavide*, the Buick *Excelle* and the Chevrolet *Sail*.

The chart also shows how quickly and savagely sentiment can turn sour. Global car sales collapsed by 20% in 2008, leading to widespread layoffs all along the global supply chain right back to raw material suppliers like Australia. However, car demand and sales bounced back strongly and quickly to boom-time levels within 12 months in 2009.

MAJOR MARKETS		Current position	Direction / Trend	Pace of growth
Australia	The Federal elections dominated news here in September. The Liberal/National coalition won the lower house easily in a lurch toward the conservative right. In contrast the Senate looks like being a mess of tiny splinter parties potentially controlling the legislative agenda from July next year. The national accounts for the June fiscal year revealed economic growth of +0.6% for the June quarter and +2.6% for the year. This is a little below the potential long run growth trend of around 3% per year. Mining investment was down 3% but mining export revenues were up, and total exports increased by 6%. Consumer spending has remained relatively slow as households are still opting to save rather than spend, although there are signs that this is changing. The unemployment rate continues to edge higher as companies cut costs, but there are early signs that the much hoped for housing construction boom may emerge to fill the gap likely to be left by lower mining construction.	Below average growth rate	Growth slowing	
Europe	The pivotal event this month in Europe was the German Bundestag elections. Chancellor Angela Merkel's CDU (Christian Democratic Union) continued its post-war dominance by winning the most votes but it lost its long standing coalition partner, the liberal FDP (Free Democrats). Merkel must now negotiate a new coalition with one of two reluctant parties: the centre-left SPD (Social Democrats) or the Greens. Either way the outcome will probably mean a continuation of the middle road between hard line austerity and pro-inflation growth path. The final make-up and terms of the coalition agreement will influence how Germany handles the upcoming third bailout for Greece. We can see how far the bail-out machinery has progressed over the past year with the Slovenian bank collapses in September. While depositors were rescued, shareholders and bondholders were wiped out, yet it barely raised a ripple. Slovenia has double the population of Cyprus and yet the Slovenian bank collapses passed without fanfare or widespread panic, unlike the Cyprus bank debacle in March.	Stagnant	Remaining very weak	
US	The US is facing yet another twin crisis over its budget deficit and debt ceiling. The end of September closed off the US fiscal year and the budget position is recovering steadily, but not quickly enough. After four years of trillion dollar deficits the budget outcome this year is heading for a deficit of "only" around half a trillion dollars. The recovering economy produced higher tax revenues and lower welfare spending, and the automatic "sequester" cuts also assisted. The problem is that new fiscal year spending requires approval from Congress. The President is holding out on a deal by refusing to cut back on Obamacare payments, but his negotiating power has been weakened somewhat by his recent outmanoeuvring over Syria at the hands of Russia. If a budget deal is not done in time the US Treasury will need to either close down parts of the government or miss payments on debts, including missing repayments on treasuries. It has done both in the recent past, with positive effects. Meanwhile the financial markets have been dominated by Fed Chairman Ben Bernanke's confusing signals over the planned tapering of its bond-buying program that has supported markets around the world. For now the bond-buying will continue at the rate of $85billion per month, but it is expected to start being scaled back in the coming weeks or months. The unemployment rate continues to head downward and inflation remains contained, so nobody should be surprised when the QE taper starts.	Below average growth rate	Recovery remaining slow	
Asia	A clutch of good numbers out of China points to the Chinese economy continuing to grow at a rate of at least 7% this year. Industrial production and retail sales are up and consumer price inflation remains relatively low, although it is rising slowly. One significant change is that producer prices are now rising after six months of declines, so higher inflation is now in the system. New housing prices are still accelerating despite repeated government efforts to rein in credit and speculation. From Australia's point of view, the number of rocks we ship to China continues to rise, and the number of Chinese tourists and students coming here also continue to rise. The Japanese recovery continues apace, with steady rises in domestic confidence and spending. Exports are also up strongly, driven by a lower yen and the recoveries in the US and Europe, together with continued strength in China. Japan also won the right to host the 2020 Olympics, which should lead to a boost in construction and spending. The 2020 Tokyo Olympics could even possibly herald Japan's re-emergence into a new era of growth, as it did the last time with the 1964 Tokyo Olympics.	<u>China</u>: Cyclical slowdown <u>Japan</u>: Early recovery	<u>China</u>: Lower structural growth trend <u>Japan</u>: Stimulus improving exports, production & growth	 

Asset Classes			Current position	Long term returns (1)
Shares	Australian shares	The local stock market continued its rebound from the 11% fall in the May-June QE taper scare. It has been 7 straight weeks of gains, a feat not seen since the top of the boom in Sep-Oct 2007. The main gainers last month were banks, iron ore miners and energy stocks, while defensives were less favoured and gold miners lost their rare August gains. The broad market is now up 12% for the year, and 16% including dividends, which is not far short of last year's 19% market returns. We have been bullish on Australian shares since early 2012 and have been overweight in portfolios since then, benefiting from the market's 35%+ returns for the period. In addition our internal and externally managed equity funds have added value through stock selection within the asset class. Great runs of returns like these don't last forever of course. While the market remains reasonable value on a number of long term metrics, our return outlooks have been declining over the past year and some early warning signs are appearing for the coming year.	Around fair value	Around average long run returns
	Developed markets shares	In September most stock markets regained the ground they lost in the May-June Bernanke QE scare, and all of the developed markets were up for the month. All except Luxembourg are also up for the year to date, and all except Luxembourg, Austria and Canada are up by double digits or better. (Australia is right in the middle of the pack amongst developed markets). September was a month for big moves in the global mobile phone market. Nokia's mobile phone business (which pioneered and dominated the mobile revolution in the early years but was overtaken and sidelined years ago) was acquired by Microsoft (which missed the mobile boat altogether). Their theory is that an also-ran plus a never-ran-at-all can somehow create a winner! Canada's Blackberry, another former winner that once led the business mobile phone market, is now to be privatised in what may well be its final death throes. Apple launched a pair of new phones in the hope of re-capturing some of the market lost to the current global leader, South Korea's Samsung. Remarkably, shares in both Apple and Samsung are down by 9-10% this year, while most of the rest of the world is up (except miners).	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 did even better than developed markets for the month, with nearly all emerging markets gaining strongly. It seems the QE taper-inspired capital flight has turned into a risk-on surge after the QE delay in September. The BRIC markets (Brazil, Russia, India, China) were each up for the month, but the only BRIC market ahead for the year is India (just). China, by far the largest emerging market, has been rising steadily after the People's Bank of China belatedly eased the inter-bank credit squeeze at the end of June. Since then Chinese stocks have been supported by a stream of mostly positive economic news.	Extremely hard to value. Many appear inexpensive to fair value, but reliant on fickle global flows	Above average long run returns, but high volatility (2)
Fixed Income	Australian Gov't bonds	Australian bond yields jumped in the first half of September but fell back in the second half after a higher unemployment rate was announced on the 12th. Yields ended the month little changed across all maturities, a reprieve from the yield spike in August during the global capital flight. Amongst the market segments, corporate issues did a little better as spreads tightened, but inflation linked bonds remained weak. We have been under-weight Australian bonds in portfolios all year, with only small holdings retained mainly for liquidity purposes.	Yields below (prices above) long run average level	Below average long run returns
	Bank Term Deposits	Rates on bank TDs have fallen over recent months while yields on government bonds of equivalent terms have risen. Improvements in global credit markets have lowered banks' cost of debt, and they have not raised TD rates to stem the shift in retail funds from TDs into shares and/or property. Despite the low rates, we prefer TDs over bond funds on a risk-reward basis.	Rates below long run average	Below average long run returns
	Global Bonds	Bonds sold off around the world early in the month in anticipation of the Fed QE taper, but prices recovered after the taper was delayed. This left yields a little lower for the month in most markets, especially in Spain, France and the US. As a result, bonds had their best month since April of this year, before the taper talk started in May. Even emerging markets bonds recovered some of their big August losses, but remain down for the year. Bond returns from the big developed markets have been low but positive for the year to date, and we remain under-weight.	Yields below long run average level	Below average long run returns (2)
Cash	Australian target cash rate	With inflation remaining low and unemployment rates rising, some economists are predicting more rate cuts ahead, especially in light of the recent pause in the dollar's decline and the absence of imported inflation to date. Any future acceleration in the recent modest rise in house prices would probably limit any further cash rate cuts in this cycle.	Cash rates below long run average level	Variable, rising over medium term
Real Estate	Australian commercial property	The listed property sector was up a little in September after three flat months, as bond yields ended their rise since May. The main gainers for the month were Mirvac and Stockland on hopes of a revival in residential construction, and also Goodman. The listed market index is down 8% from pre-taper levels, but still has returned 9% for the year to date. We prefer the listed sector to unlisted and have neutral weightings for the listed sector in portfolios. The unlisted sector remains less attractive, with relatively weak underlying supply & demand fundamentals.	Over-valued on long run measures	Around average to below average long run returns
	Australian residential property	It seems everybody has jumped on the band wagon in warnings of a housing bubble in Australia. A "bubble" is usually where prices double in a year or so (as they have done in several past cycles), but Sydney median prices are up by around 6% over the past year and have only just recovered their 2004 levels after inflation. The RBA is facing a dilemma in trying to reduce interest rates to bring the dollar down while preventing a speculative bubble in the property market. It may need to resort to direct lending controls as many other countries are now doing, including New Zealand, Canada and of course China. The longer interest rates remain this low or even lower, the more people are encouraged to gear up and bet the house on….the house.	Varies by market and by property	Varies by market and by property
Australian dollar		The Australian dollar recovered a little against most currencies in September, especially against the weaker Yen, although Sterling was also strong with the revival in the UK economy. Even after the rise in September, the AUD is still down 11% from its April levels before the QE taper talk triggered a capital flight out of high risk markets, and it is still over-priced 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