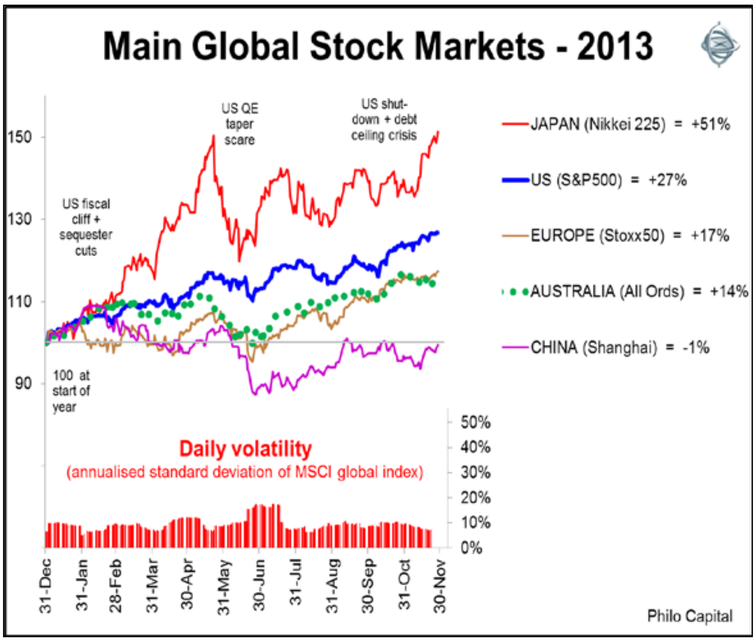
PHILO CAPITAL ADVISERS

PHILO MARKET MONITOR

End November 2013



GLOBAL EQUITIES: HIGH RETURNS + LOW VOLATILITY - AGAIN!

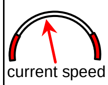
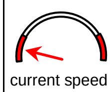
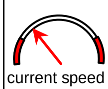
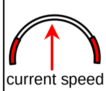
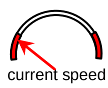
As we near the end of 2013 it looks like it will be a repeat of 2012 for shares in the major "developed" markets - high returns and super-low volatility - just like last year. Stock markets in the US, Europe and Japan have all done very well again, despite their moribund economies being on life support in intensive care, their crippling government debt levels and debilitating political wrangles.

The US market in particular has had a remarkably smooth upward run this year, cruising right through the "fiscal cliff", the "sequester cuts", the "QE taper" scare, the government shut down, the debt-ceiling crisis, plus the acrimony and dysfunction in Washington.

Volatility has also been incredibly low again this year, on any measure. The chart shows the annualised standard deviation (the most common measure of price volatility) for the global index. It has averaged an amazingly low 9%, and has been below 10% for 74% of the year.

In spite of all of this we still see almost daily headlines bemoaning these "volatile times" in this "low return" world!

We have been over-weight Australian and global shares in portfolios since early 2012 and all the way through 2013.

MAJOR MARKETS		Current position	Direction / Trend	Pace of growth
Australia	In November the OECD downgraded its outlook for Australia's economy, due to declines in Chinese growth rates, commodities prices, and mining investment. It sees the main sources of vulnerability being: high wages, high levels of household debt, high house prices, and the heavy reliance on foreign debt. The local unemployment rate edged up by 0.1% to 5.7% this month, bringing it very near the peak level of 5.8% reached in May 2009 in the depths of the global financial crisis. In a dramatic about-face from its election rhetoric, the new government is now talking up the idea of significantly increasing debt levels to fund infrastructure spending to fill the gap being left by the end of the mining investment boom. In an effort to lengthen the term of government debt, federal government also issued $6b of 20 year debt at a rather expensive yield of 4.9%. This is nearly 2% per year more expensive than similar Canadian debt, reflecting our less favourable inflation, currency and current account outlooks.	Below average growth rate	Growth slowing	
Europe	The tentative European economic recovery appears to be running out of steam once again. On 7th November the European Central Bank surprised markets by cutting the refinancing rate by 0.25% to 0.25%, and cutting the emergency borrowing rate by 0.25% to 0.75%. ECB President Mario Draghi warned of the dangers of deflation and he said that the ECB still maintained an "easing bias", meaning more rate cuts were possible. This represents a further shift in the dynamics of the tussle between the hard line pro-austerity "north" led by the Germans and the pro-growth, anti-austerity "PIIGS" led by France and the IMF. Following the win by Angela Merkel's Christian Democrats in the German Bundestag elections in September, the feeling in markets had been that the Germans would be likely to continue with their bias toward a moderately hard-line stance on austerity and fiscal rectitude, which is deflationary and stifles growth at least in the short term. Inflation and growth numbers out of Europe over the past several weeks have being pointing to a slowing in the anaemic European recovery. Merkel's recent coalition deal with the left wing SPD party, which includes raising wages and pensions and winding back labour market reforms, is also dampening hopes of an economic revival.	Still virtually Stagnant	Recovering very slowly	
US	"QE taper" talk once again dominated US markets in November. Third quarter US economic growth numbers came in better than expected and this raised fears of early tapering, causing shares and bonds to sell off briefly. The recently released minutes of the October Fed meeting also showed that the Fed is intending to taper, but it is also keen to reinforce its commitment to keeping interest rates very low for as long as possible. Incoming Fed Chair Janet Yellen, even more "dovish" (ie less concerned with inflation) than Ben Bernanke, also talked about the need to keep interest rates at the short and long end very low to support jobs growth. Companies have paid off debt and are sitting on huge piles of cash but are opting for buybacks rather than invest or hire new workers.	Below average growth rate	Recovery remaining slow	
Asia	In China the dominant event was the Third Plenum meeting of the Communist Party leadership. The resultant communique announced far-reaching reforms in many areas, including reforms to the one-child policy in urban areas; rural land sales; the "hukou" system of residency and access to welfare; allowing competition in markets currently dominated by state-owned enterprises; and acceleration of financial market reforms. Unfortunately there was little detail provided, and it runs the risk of being frustrated in execution. Importantly, President Xi Jinping has also consolidated and centralized executive power in the hands of a small band at the top of the Party at the expense of the currently powerful state owned enterprises and local government leaders, so we can expect an increase in internecine battles and Bo Xilai-style intrigue. If successful, this dramatic Deng Xiaoping-like shift in power may be enough to see the reforms through to fruition, where the previous leadership foundered. Japanese exports are recovering but trade deficits are still near record high levels. Japan has been running trade deficits since the March 2011 tsunami/nuclear crisis. The Yen weakened a little during the month but has been more or less flat since mid-year after having collapsed from 80 to 100 Yen per USD. We are seeing improvements in business investment, machinery orders, office vacancy rates, construction, household spending and credit spreads, but credit growth now appears to be slowing.	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 stock market took a breather in November (with the All Ordinaries index down 2%) after four strong months (up 13% during July to October, following the QE taper sell-off in May-June). The overall market is still up 14% for the 2013 year to date, and 19% including dividends. In November the big miners held up (except gold), thanks largely to iron ore prices remaining elevated in the face of price declines in most other commodities. The big banks reported record profits totalling $27b, up 8% from last year. While this looks good on the surface it did not help their share prices as the profit growth is not sustainable, coming mainly from fiddling bad debt provisions which are at unsustainably low levels. Another positive on the surface was rising dividends, but these mostly came from increasing pay-out ratios, also not sustainable. We have been over-weight Australian shares in portfolios since early 2012, benefiting from the market's strong surge over the period. Although the market is approaching over-priced territory relative to earnings in many sectors, cash dividends are still relatively strong and rising.	Around fair value	Around average long run returns
Shares	Developed markets shares	The cyclical rebound in developed market shares continued in November following strong rises in September and October. Japan remained the star amongst the big markets, as shares surged back to their pre-QE taper highs in May. The Nikkei 225 index is now up 50% for the year and up 80% over the past 12 months since the rally began in the lead-up to the Abe/Aso election win. The Twitter IPO on the 7th captured most attention in the US. The $26 Twitter shares opened at $41, shot up to $50, ended the first day at $44.90, and have since drifted down to $41. Thus far Twitter has avoided the "face-plant" of the Facebook float in May 2012. Facebook shares are now a respectable 22% above their first day price. JP Morgan shares were up 12% for the month after it copped another $13b in penalties over fraudulent selling of mortgage backed securities before the crash, and posted its first quarterly loss in 9 years. The more the bank gets fined for fraudulent practices and market rigging, the more its owners (shareholders) love it! Morgan shares are up 30% for the year while the S&P500 index is up 26%. We have been over-weight global equities since early 2012. Dividends have been rising, but earnings have yet to catch up.	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)
Shares	Emerging markets shares	The largest "emerging" stock market is China, and Chinese stocks reacted positively to the Third Plenum outcomes. India, the best of the BRIC markets this year, was down a little for the month, bringing a pause to the "Rajan rally" (Raghuram Rajan became Governor of the Reserve Bank of India on 4 September, and his arrival boosted investor confidence significantly). India appears to have stabilised after the recent currency crisis:- exports are showing signs of expanding and the economy recovering, but inflation is still too high. This year the big emerging stock markets (with their relatively healthy economic growth rates, low debts and deficits) have lagged well behind the developed markets (with their sluggish economies, huge debts and deficits).	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 Australian yield curve steepened further during the month as the bond sell-off continued. Worst hit were inflation linked bonds, as inflation expectations receded and investors sought higher yields elsewhere. The only sector not suffering was corporate credit, where spreads continued to firm to unsustainably low levels. We have been underweight long duration bonds in portfolios this year and we reduced bond exposures to zero in October, before the latest sell-off. Yields are still very low and returns are likely to be adversely affected when QE tapering starts.	Yields below (prices above) long run average level	Below average long run returns
Fixed Income	Bank Term Deposits	Although treasury yields have continued to rise over the past 16 months, rates on bank TDs remain low due to subdued demand for bank credit. Business lending is still dormant and housing lending has yet to rise significantly, so banks have little need to chase deposits at this stage. Despite the low rates on offer we prefer TDs over bonds on a risk-reward basis.	Rates below long run average	Below average long run returns
Fixed Income	Global Bonds	Sovereign yields rose a little in most of the major developed markets as economic outlooks improved and the prospect of QE tapering loomed large. The exceptions were Italy and France. Italian yields fell as the Berlusconi factor finally fades from the picture. France was downgraded by S&P again and, as usual, bond yields fell as investors raced in to buy more French bonds after they were rated more risky after the downgrade. We remain under-weight global bonds, as they have virtually no credit risk or inflation risk built into their pricing.	Yields below long run average level	Below average long run returns (2)
Cash	Australian target cash rate	The RBA kept the target cash rate at 2.5% (where it has been since 6 August of this year) at its November meeting. The dollar is still too high and the jobs market is still weakening but the RBA is reluctant to cut interest rates further for fear of sending house prices and housing debt levels even higher. Our cash rate (and inflation rate) is still the highest in the "developed" world.	Cash rates below long run average level	Variable, rising over medium term
Real Estate	Australian commercial property	The listed property market fell during the month after a couple of strong months. Trust prices fell across the major stocks and across all sectors. The main exception was Commonwealth Office (which is in our portfolios), the subject of a take-over battle between Dexus and GPT. In the underlying commercial property market, foreign investors continue to compress yields, resulting in higher valuations in spite of weak rental demand, declining net rents and rising vacancy rates in most markets. We retain neutral weights for the sector in portfolios, as yields are still relatively attractive, albeit well below historical average levels.	Over-valued on long run measures	Around average to below average long run returns
Real Estate	Australian residential property	Housing prices are still rising in most areas across Australia, driven largely by investors, in particular foreign investors. It is part of the unintended global consequences of artificially low interest rates boosting speculation and prices of unproductive assets like existing shares and housing, rather than investment in productive capacity. Pressure is building in Canberra to intervene in the housing market to limit price rises, as several other countries have this year.	Varies by market and by property	Varies by market and by property
	Australian dollar	The Reserve Bank "jawboned" the Australian dollar down by a couple of per cent in November by threatening to intervene in foreign exchange markets. Half of the AUD fall was due to the strengthening US dollar and Sterling, while the Yen and Euro weakened. The AUD remains "uncomfortably high" but it is hard to see the RBA cutting rates further if it encourages people to bid up house prices and increase housing debt levels even further, as it is doing at the moment.	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