



COMMODITIES PRICES COLLAPSE IN 2014

Prices of nearly all commodities have fallen heavily this year. The world is producing too much supply as a result of the mining construction boom that peaked in 2011-12, and also thanks to constant innovation and development of new production techniques and technologies. At the same time global demand for most commodities is falling for a variety of reasons, both cyclical and structural.

Lower commodities prices are generally a good thing. Everything we use every day is made from commodities, so lower commodities prices reduce the cost of everything humans buy and consume. Lower commodities prices mean lower costs for energy and raw materials for manufacturers, and this favours commodities importers and manufacturing exporters like the US, Western Europe, Japan and China.

Australia is a commodities exporter and manufacturing importer. Our stock market is heavily laden with resources stocks and our stock market has lagged the rest of the world this year. Australia's dollar has also declined with commodities prices, increasing the cost of imports and contributing to inflation. Our higher inflation structure keeps our interest rates higher than the rest of the world.

MAJOR MARKETS

		Current position	Direction / Trend	Pace of growth
Australia	With the mining construction boom well and truly over, residential construction is now starting to fill the gap. The boom is skewed toward high-rise units – driven by Chinese demand and also by banks lending to investors. The RBA wants to stop the boom before the market over-heats and collapses into a general recession, as has happened in numerous cycles in the past. The traditional way to do that is via interest rate hikes, but rate hikes will support the dollar and discourage all borrowers, including segments the RBA wants to assist, notably businesses and first home buyers. Instead the bank regulators are toying with taking more direct steps to control bank lending on investment properties. On the political front the main development was the fracturing of the Palmer United Party, which no longer controls the balance of power in the Senate. The new volatile, unpredictable and quaintly self-styled “coalition of common sense” will make the government’s legislative and budget agenda even more difficult than it has been to date.	Below average growth rate	Growth slowing	current speed
Europe	October saw much talk from the European Central Bank (ECB) on the monetary front but November saw action. On 21 st October the ECB started talking up the idea of buying corporate bonds in the secondary market to reduce interest rates and to encourage borrowing & investing. Then on 21 st November, in the wake of very weak 0.4% inflation for the Eurozone the ECB started buying asset-backed bonds from European banks. ECB President Mario Draghi said that “excessively low inflation” had to be raised quickly - “We will do what we must to raise inflation and inflation expectations as fast as possible”. This statement echoed his 26 July 2012 promise to “do whatever it takes to preserve the Euro”. So far the Euro has survived. European stock markets rose 4% on that day in 2012, and they rose 3% on 21 November this year. As expected the ECB bond buying was opposed by German Bundesbank President Jens Weidmann. German resistance is slowing growth at the core of Europe and also on the periphery. For example, the €240b Greek bailout plan is again in trouble as it looks like it will miss the December target to get its 2015 budget approved. It will also miss growth targets because of the austerity measures imposed by the bailout conditions insisted upon by Germany. Another Greek crisis is likely as Prime Minister Antonis Samaras proclaimed: “Measures that will annoy citizens will not be taken. This is a fundamental decision from which we will not stray.”	Still virtually Stagnant	Growth stalled	current speed
US	President Obama may still be popular on his overseas trips but he is deeply unpopular at home. The Republicans already control the House of Reps and in the Congressional mid-term elections on 4 th November they easily took control of the Senate as well, completing the alienation of the White House. Initiatives trumpeted on the global stage, like those at the recent APEC summit and the greenhouse gas deal with China, are unlikely to pass Congress. Part of the reason for the President’s unpopularity is the economy, but this is continuing to improve. Unemployment rates are still falling, inflation is still low, fuel costs are falling, and house prices are rising. Consumers are spending and businesses are investing. On 25 th November the 3 rd quarter economic growth number was revised upward from 3.5% to a robust 3.9%. In financial markets the main game is “monetary policy normalisation” – predicting the pace and timing of interest rate hikes to bring interest rates back from zero to more “normal” levels of around 4-5%. The most likely cause of sell-offs in stock and bond markets will be unexpected bumps along this interest rate road.	Below average growth rate	Recovery gaining pace	current speed
Asia	The big news in China was also on the monetary front - the surprise rate cut on 21 st November. Despite government’s repeated claims that the economy is growing strongly at more than 7% per year, the central bank suddenly cut one year benchmark lending and deposit rates, the first rate cut since July 2012. Economic growth has fallen to a 5 year low and fixed asset investment is down to a 13 year low. Residential construction, the engine of Chinese economic growth, has faltered as price falls accelerate and extend nationwide, and unsold empty homes are up by 30% on last year. There are now 4 million unsold empty homes. To fill the yawning gap between supply and demand for housing, the government is now planning to buy new apartments directly from property developers to try to shore up prices and prevent bankruptcies, and then use the units for social housing. Meanwhile bad debts are continuing to pile up in the banking system, although not in the official numbers. Late in the month China’s bank regulator expanded authorities to municipalities to create asset-management firms to deal with non-performing loans held by lenders and local governments, as they are coming under increasing financial pressure to clean up their balance sheets.	<u>China:</u> Cyclical slowdown	<u>China:</u> Lower structural growth trend	current speed
		<u>Japan:</u> Back in recession	<u>Japan:</u> Growth stalled	current speed

ASSET CLASSES			Current position	Long term returns (1)
Shares	Australian shares	In November the local stock market gave back nearly all of October's gains. Oil/gas and mining stocks were hit hardest by the collapse in commodities prices. Gold stocks had a rare good month, with a minor uptick in the gold price (gold is still down 38% from its 2011 peak). Banks were also down in the wake of more proposals for tougher capital rules and lending restrictions. Overall the market is ahead slightly for the quarter to date and +3% for the year, lagging global markets. Last month we reduced weights of Australian shares in portfolios due to deteriorations in our outlooks. The sell-down was done near the end of the month, after the rebound from the September-October dip, and before November's market slide.	Around fair value	Around average long run returns
	Developed markets shares	Global stock markets had another good month in November, following October's gains. Lower commodity prices benefited manufacturing countries like Germany (+7%) and Japan (+6%) but hurt commodity markets like Australia. Also benefiting were the US (+2%) and UK (+3) despite threats of rate hikes there. We have been over-weight global shares in portfolios since early 2012 near the start of the current 2012-14 rally. While portfolios benefited from being over-weight during the rally, return outlooks have steadily deteriorated and so we have recently reduced weightings in portfolios.	Mixed – US over-priced on long term measures, but other markets varied	Around average long run returns, but currency gains expected (2)
	Emerging markets shares	Emerging stock markets were flat overall for November. The stand-out was China. Shanghai 'A' shares were up most (+11 and 27% YTD) despite the worst economic growth rate for 20 years and mounting property and banking problems. November's returns were boosted by a flood of money coming through Hong Kong via the new exchange linkup that allows foreigners to buy Shanghai 'A' shares through the HK exchange. Shanghai 'B' shares were up by only half that, and Shenzhen shares were up by less (no exchange link with HK). It remains a mystery why foreign investors are now racing headlong into Chinese shares. Despite having the highest economic growth rate in the world, China has had just about the worst stock market in the world since its disastrous 71% collapse in the GFC, and it has been going down in pretty much a straight trend line over the past 5 years. At the other end of the scale the Russian market was down another 8% in November (-30% year to date) with the lower oil prices and also the impact of economic sanctions over Ukraine. Year to date the best market is still Argentina (+150% or +115% in USD terms) despite its government default.	Hard to value. Many now appear expensive but are reliant on fickle global sentiment	Moderate long run returns, with high volatility (2)
Fixed Income	Australian Fixed Income	November saw a frenzy of buying in the local bond market, driven mostly by Japanese and European investors faced with lower yields in their home markets, driven by more central bank bond buying. Corporate credit spreads also tightened further after their spike in the mid-October bond 'flash crash'. Inflation linked bonds did even better as local investors bid up prices, expecting higher inflation in future. We are under-weight domestic bonds in portfolios as we expect yields and credit spreads to expand over the medium term from current unsustainably low levels.	Yields below (prices above) long run average level	Below average long run returns
	Bank Term Deposits	TD rates are still falling due to the declines in the underlying yield curve, and also because banks have been able to get cheaper money from foreign debt markets as global credit markets remain favourable. We have significant holdings of 'breakable' TDs in most portfolios as they have provided superior return for risk than the bond market. However these breakable TDs are likely to be modified in the new year with new bank liquidity regulations for the 'Basel-III' banking reforms.	Rates below long run average	Below average long run returns
	Global Bonds	With growth slowing and deflation fears accelerating in Europe and Japan, bond yields fell in virtually all markets in November. Market pricing assumes decades of economic stagnation in Europe, with Spanish 10 year bond yields below 2%, Portugal below 3%, Italy at 2%, UK below 2%, French below 1% and German yields just 0.70%. Only Greek yields are rising as the bailout plan looks like missing deadlines. The US is different of course, with its economy recovering reasonably well, but US yields are also falling as the market fears the Fed may raise rates too soon and slow the economy before it has fully recovered. With yields falling all year global government bonds have generated very steady and smooth returns of 10% so far this year in our portfolios – similar to the returns in 2011 and 2012.	Yields below long run average level	Below average long run returns (2)
Cash	Australian target cash rate	The RBA's target cash rate has been at a record low 2.5% since August of last year. Short interest rates again receded during the month after September's gains, due to lower global growth outlooks and lower local inflation, meaning local rate hikes are less likely in the coming months. Over the past few months the RBA has appeared to shift from a rate hike bias to a rate cut bias as the jobs market is weak and likely to weaken further as commodities prices continue to collapse. Although inflation is still troublesome, the RBA is only likely to cut rates if housing prices stop rising and start to fall.	Cash rates below long run average level	Variable, rising over medium term
Real Estate	Australian commercial property	Listed property trusts held up in November and kept their October gains, thanks to Westfield, while the broad listed equities market fell. For our portfolios we continue to favour listed property over unlisted. The listed market has returned 21% for the year to date, which is more than double the returns from the unlisted market. We were over-weight listed property during the big 30%+ in rally in 2012, but we now are a little under-weight in portfolios as they are still fundamentally over-priced. In the underlying direct commercial property market strong transaction volumes have been boosting prices and compressing yields to unrealistically low levels, driven primarily by foreign investors.	Over-valued on long run measures	Around average to below average long run returns
	Australian residential property	The Reserve Bank and the bank regulator, APRA, have been threatening to impose new rules to control bank lending by the end of this year if banks don't tighten lending standards and if they continue to fuel the rise in housing prices, especially for investment units. Price growth appears to be slowing but lending for investment properties is still growing at twice the pace of lending to owner-occupiers. It may take a combination of lending controls and interest rate hikes to end the boom.	Varies by market and by property	Varies by market and by property
	Australian dollar (AUD)	The AUD fell 3.6% against the strong US dollar, but it rose 3.5% against the much weaker yen which was sold off heavily in the wake of the Bank of Japan's renewed pro-inflation programs. The Euro was also sold off with the ECB buying up bonds to lower interest rates and to weaken the Euro. As a result the Aussie dollar held up well despite the sell-off in local shares and 'risk-off' sentiment, supported mainly by strong foreign buying of Aussie assets (mainly by Japanese government and institutions). We have been un-hedged in our global equities portfolios over the past couple of years, benefiting investors from the AUD's decline over the period. Even after the recent slide the AUD is still over-valued on fundamentals and we remain strategically 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

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