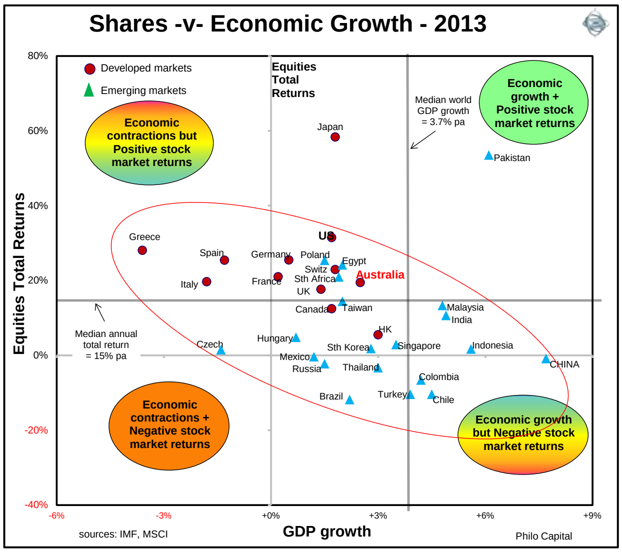
Philo Capital Advisers

Philo Market Monitor

End January 2014

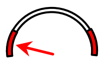
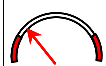
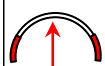
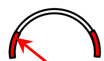


2013 Economic Growth + Stock Markets

2013 was another year of counter-intuitive relationships between economic growth, earnings and stock market returns - where stock markets go in different directions to economic growth and earnings. Aside from two outliers - Pakistan (high economic growth + high stock market returns), and Japan (due to the yen collapse and 'Abenomics') - in 2013 every other major country fell into a band that stretches from top left to bottom right on the chart - ie poor economic growth + good stock market returns (top left segment), or good economic growth + poor stock market returns (bottom right segment).

If economic growth and stock market returns were positively related, the band should extend from bottom left to top right, but this is not how it works in most years in the real world. In 2013 China again enjoyed the highest economic growth rate but suffered negative equity returns. Greece, Spain and Italy suffered the deepest economic contractions but enjoyed high equity returns.

Today the outlook is for improved global growth for 2014, to a rather healthy 3.6% or even better, and there is a widespread assumption amongst the media and commentators that this should be good for equity returns. However the world does not work like that in real life, as the historical facts demonstrate.

Major Markets		Current position	Direction / Trend	Pace of growth
Australia	With the mining construction boom past its peak and slowing further with each passing month, there are some signs of activity in the residential property construction industry, spurred on by recent house price rises, very low interest rates, and the wealth effect from rising share prices. It is unlikely to be enough to overcome the effects of cost cutting and job shedding in both the private and government sectors. The unemployment rate has edged up to 5.8%. It has drifted up by 0.5% over the course of 2013, and is now just above its GFC peak level reached in May 2009. Rising house prices and an inflation rate closer to 3% than 2% are likely to prevent the Reserve Bank from cutting interest rates further from their current very low levels. Although mining production and sales volumes remain relatively strong, metals prices were down a little for the month. Iron ore fell 8% but remains relatively healthy at above $120/tonne, where it has been for the past six months. Base metals prices also fell slightly but have also remained relatively steady since July of last year. Coal prices have shown a similar pattern.	Below average growth rate	Growth slowing	 current speed
Europe	Europe is gradually emerging from its long on-and-off recession since the financial crisis. Growth rates in the Eurozone are making very slow but positive progress - with December quarter growth of around 0.2%, up from 0.1% in the September quarter. But growth is still too slow to make any serious inroads into the high unemployment rates that average around 12% across the region. The ECB has re-committed to keeping short term interest rates near zero for as long as it takes. Long interest rates have also fallen back in January, reflecting renewed fears of deflation, but consumer and business confidence continue to improve slowly. The key to the recovery is Germany. German business investment and employment are visibly stronger, and the job market is also strengthening. German inflation is also now looking more dangerously like deflation (particularly in the eyes of the pro-inflation IMF). This may prompt further rate cuts from the ECB in the coming months and that would likely provide a further boost to share prices. The main obstacle to growth is still the banking system, with lending constrained by the new Basel rules and the banks' unknown levels of hidden bad debts.	Still virtually stagnant	Recovering very slowly	 current speed
US	The US economy continues to accelerate. Fourth quarter GDP growth came in at a relatively strong 3.2%, with consumer spending, business investment and exports all strengthening. Calender year 2013 growth was a rather slow 1.9%, down from 2.8% in 2012, but growth is now accelerating in recent quarters despite the government shutdown. However, inventories were also up strongly, meaning production may weaken in the coming months unless consumption picks up further. The positive tone of economic news has given the Fed the green light to press on with its plan to wind back the rate of bond-buying, and the $85b per month program has now been cut to $65b per month. The unemployment rate is continuing to drift down, house prices are rising and inflation is still benign.	Below average growth rate	Recovery remaining slow	 current speed
Asia	As China ends the year of the snake and enters the year of the horse, the economy appears to have stabilised at a growth rate of around 7.7%. However it is still being supported primarily by debt-funded state-directed construction projects, instead of genuine consumer demand and business investment. Late in January there was another crisis in the "shadow banking" system, with the last minute rescue of China Credit Trust Co's $500m "*Credit Equals Gold*" private wealth management product. The problem was that it was distributed as a safe investment to retail investors by China's largest (and state-owned) bank, the Industrial & Commercial Bank of China. The unofficial 10 trillion RMB shadow banking system plays a critical role in the Chinese economy as it is the main source of funds for private businesses (while the official state-controlled banks lend mainly to state government bodies). It appears to be a gigantic accident waiting to happen. In Japan the "Abenomics" policy experiment continues to boost confidence, spending and investment. Since the start of the rally in November 2012, the yen has fallen by 22% and the Nikkei index has risen by 72%. One consequence has been a record trade deficit for 2013 of 11 trillion yen, up 65% on the 2012 deficit. Only half of this was due to the collapse of the yen (fewer yen received for exports) but the other half was due to lower trade volumes, which is worrying. PM Shinzo Abe has committed to pressing on with his sales tax increase in the coming months, but he has also promised to cut company tax rates from their currently very high levels later in the year.	China: Cyclical slowdown Japan: Early recovery	China: Lower structural growth trend Japan: Stimulus improving exports, production & growth	 current speed  current speed

ASSET CLASSES			Current position	Long term returns (1)
Shares	Australian shares	After 20% returns in both 2012 and 2013, the broad stock market index was down 3% per cent in January 2014. Among the main stocks, banks and insurers suffered the most, except QBE (flat in January after its 9th December collapse). Gold miners rebounded along with the gold price (a minor consolation prize after their disastrous 80% declines over the past two years). Aside from gold miners, the best sectors for the month were defensives like healthcare and utilities. The best of the big cap stocks (after Newcrest) were Incitec Pivot, CSL, AGL, QBE, Transurban, Sonic Healthcare and Woolworths (all of which are in our portfolios). Fox (the media and entertainment parts of the old News) will delist in Australia after six decades on the local stock markets, leaving just the much smaller "new" News (which retains the old print businesses) listed here. News/Fox was the best stock in our portfolio last year (up 70%). 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 significant value above the market index during the rally.	Around fair value	Around average long run returns
	Developed markets shares	The main developed markets were down in January after two years of very strong returns. Japan was down the most for the month, down 9%, after being up 57% in 2013 as a result of the "Abenomics" policies. Some smaller markets were up for the month, led by New Zealand (up 3%). The US market was down 4%, but the US profit reporting season is progressing well, with most companies reporting better than expected results. The main European markets were also weaker, although the PIIGS were relatively strong. Our portfolios have benefited from being over-weight global equities since early 2012, and un-hedged on the currency as the AUD has fallen over the period.	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	Some emerging markets are being hit by the rapid withdrawal of foreign money in the wake of US QE tapering, and several countries are having to raise interest rates to try to defend their currencies. Turkey in particular was down another 9% in January, and the BRIC markets were all down. On the other hand, January was a good month for stock market rebounds despite domestic economic contractions and/or political turmoil: the PIIGS markets were up nicely (except Spain was flat); Argentina also continued its strong rebound, up another 12%; and Egypt was up another 9%. (The PIIGS markets are technically regarded as "developed" by index publishers but we regard them more as "emerging" markets).	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	After rising steadily since April of last year, bond yields fell a little in January, mainly at the long end. However we still have a very steep upward sloping yield curve, stretching from 2.5% for Treasury bills, then progressively higher yields for longer terms, and up to 4.6% for 20 years. Australia seems to have lost its "flavour of the month" status it had last year among global bond investors. Not only are investors losing money as the AUD falls, but the promised scarcity of bonds due to the rapid return to surplus as per last year's election promises, has now turned into a potential glut of supply, with the government abandoning its surplus promise and instead talking up plans to spend and borrow up big for many years to come. This is not good for bond investors and we expect 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.	Yields below (prices above) long run average level	Below average long run returns
	Bank Term Deposits	Despite rising money market yields over the past year, bank TD rates continue to fall as banks have little need to raise new deposits until lending demand picks up substantially, and wholesale debt markets continue to improve. Business lending remains dormant but housing lending, particularly for investment, is now rising, so we may see TD rates rise in the coming months.	Rates below long run average	Below average long run returns
	Global Bonds	Global bond yields also fell in all of the major government bond markets. In developed markets yields fell due to slowing growth outlooks with QE being withdrawn. In the PIIGS yields fell even more as a result of their recovering economic outlooks and consequent lower likelihood of default. We still see yields continuing to rise over the medium term and we remain under-weight, as current bond prices offer virtually no compensation for credit risk or inflation risk.	Yields below long run average level	Below average long run returns (2)
Cash	Australian target cash rate	The RBA has cut its target cash rate eight times since the cycle began in November 2011, from 4.75% to the current 2.5%. Even though the job market is weak and the unemployment rate is drifting upward, the RBA seems to be at the end of the rope on rate cuts in this cycle as inflation is running at a rather robust 2.7% and house prices and housing speculation are on the rise.	Cash rates below long run average level	Variable, rising over medium term
Real Estate	Australian commercial property	The listed property market held up in January with most trusts little changed for the month. The big news was the end of the battle for Commonwealth Office (CPA). Our portfolios have benefited from owning both the acquiree (CPA) and the losing bidder GPT, which was up 6% in January on its decision to bow out of the race and not to over-pay for CPA. Dexus (not in our portfolios) won the take-over battle and will probably now have trouble digesting its over-priced purchase in a weakening office market. The next big development in the market will be how the Lowy family manages to sell the latest in their long line of restructures of the Westfield group. Meanwhile the underlying commercial market remains rather weak - with rising vacancy rates, weakening net rents, and governments and private businesses in staff-shedding mode.	Over-valued on long run measures	Around average to below average long run returns
	Australian residential property	House prices have been rising modestly over the past year, mainly in Sydney, driven by investors and foreigners. We don't see a major collapse on the horizon but the current minor rally is not likely to last long. Household debt levels are already at unsustainably high levels, the employment market is weakening, the economy is being kept alive mainly by government deficit spending, and interest rates are unlikely to fall further and may well start to rise soon.	Varies by market and by property	Varies by market and by property
	Australian dollar (AUD)	The AUD continued on its slide and fell further in January along with other "hot money" currencies in the global fallout from the QE taper. The US dollar continued on its stronger trend in 2013 and strengthened further in January this year (except against the stronger Yen in January) with the start of the QE taper plan. Our portfolios benefited significantly from our un-hedged stance during 2013 as the AUD fell, and it 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