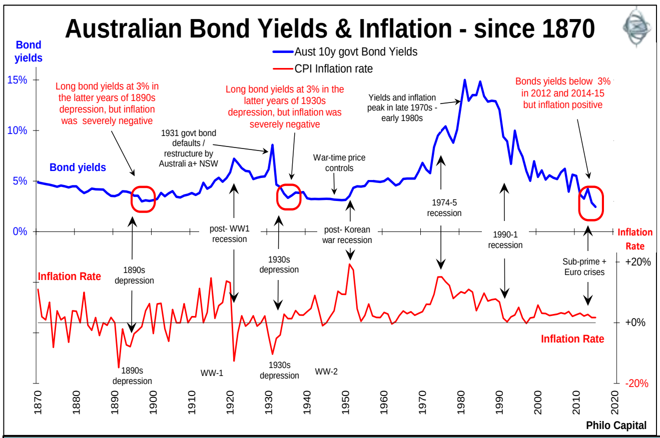
Philo Capital Advisers

Philo Market Monitor

End January 2015



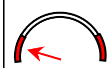
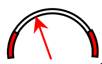
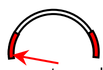
Australian Bond Yields at Depression Era Lows

Australian government bonds are trading at extraordinary high prices and low yields. The only times yields were anywhere near this low were in the 1930s depression and in the 1890s depression, but in both of those depressions inflation rates were severely negative (deflation), but today inflation is positive.

Australian inflation linked bonds are now trading at such high prices and such low yields that they imply that inflation will average just 2% per year for the next 10 years. But the last time inflation in Australia averaged 2% or lower for 10 years was also in the1930s depression and the 1890s depression.

Unless you believe Australia is heading for another 1930s depression or 1890s depression in the next 10 years, bonds would appear vastly over-priced at current levels. Yields may fall even further due to the weight of foreign money chasing our yields, but real returns for bond holders are likely to be very poor over the medium to long term from current levels.

Major Markets

		Current position	Direction / Trend	Pace of growth
Australia	The dominant theme for Australian markets in January was the question of whether the Reserve Bank will be pulled into the global currency war and have to cut interest further to reduce the support for the Aussie dollar. Local inflation appears to be contained (kept low mainly by the recent oil price collapse), but unemployment is falling (due mainly to strong residential construction) and housing prices continue to rise. Further rate cuts may scare away some foreign investors but they would further accelerate the chase for yield by local investors and throw further fuel on the already over-heated speculative property market. The other big theme affecting markets has been the dwindling confidence in the government. Concerns over budget discipline and the unpredictable Senate have now spread to concerns over Tony Abbott's leadership of his own party. In January the Abbott government kicked several 'own goals' – including the numerous policy shifts on Medicare, leaks of possible GST hikes, and finally his knighting of Britain's Prince Philip. That was the last straw, and his own party has now put him on final notice. January also saw the start of LNG exports from Queensland, as British Gas' Curtis Island project shipped its first load from Gladstone. But prices are falling due to declining demand and expanding oversupply. More and more LNG projects are now being cancelled or put on hold due to collapsing oil/gas prices and rising local construction costs.	Below average growth rate	Growth slowing	
Europe	2015 will probably be a year in which Europe shifts away from German-led austerity and Euro unity, toward loosening monetary and fiscal policies, and more agitation for Euro exits. These will probably be driven by political fragmentation – away from the centre and toward radical far left parties in some countries and far right parties in others. The two big events in January were the ECB "QE" plan and the Greek election. On the 22nd the European Central Bank finally announced its money-printing plan after fighting off German resistance. The plan will see €60b of bonds per month being bought until at least September 2016. It is probably too little, too late, coming six years after US/UK started their QE plans. Nor is it likely to generate much lending growth. Banks don't want to lend – they need to re-build capital and reduce gearing; and consumers and companies are reluctant to borrow. Even if lending does increase, it adds even more to the total pile of debt in an already heavily indebted system. It may temporarily boost spending in the immediate term but it reduces spending and growth in the long term as borrowers have to repay the interest and debt. European QE probably will have some success in depressing the Euro, especially against the US dollar and Sterling but not against the Yen. January also saw one major casualty of the global currency war - the Swiss franc jumped an extraordinary 40% in minutes after being un-pegged from Euro on the 15th, wiping out several FX brokers and numerous currency speculators. The Greek election on the 25th was won by the far left wing Syriza party, promising even more government spending (including hiring more government workers and raising pensions), even more debt, and stopping the asset sale program that was to raise money to repay foreign creditors. Greece now looks fairly certain to default on its debt once again (although this time it is being called "debt relief" to make it sound more palatable!) Depositors are rapidly pulling their money out of Greek banks and shifting them out of Greece as a hedge against Greece exiting the Euro.	Still virtually Stagnant	Growth stalled	
US	The US economy remains on its slow recovery path. Unemployment is receding steadily, inflation remains benign, and confidence is relatively high amongst consumers and businesses. There are two main themes for investors. The first is the pace of interest rate rises, and the second related theme is the strength of the US dollar as US QE has ended but is ramping up in Japan and Europe. Also the Chinese government is once again engineering the RMB lower as it did in January to April last year, raising the ire of the US. Even the Fed now says it is transfixed on the sidelines watching the global currency war play out.	Below average growth rate	Recovery gaining pace	
Asia	China continues to slow, but at what rate is anybody's guess. Official figures show 7.4% growth but that is probably a vast over-statement. The government is trying to prop up growth in the largest sector, residential construction, by cutting interest rates and buying apartment blocks directly from property developers struggling to offload them into an over-supplied, falling market. This also prevents property developer losses from infecting the banking system – for the time being anyway. Complicating this are government freezes on apartment sales over allegations of corruption. As all levels of government in China from top to bottom are poisoned by corruption, these freezes are probably more to do with party political manoeuvring. Through all of this, Chinese imports from Australia continue to do well – with strongly rising volumes albeit at lower prices. We see slowing growth and civil unrest in China as positive for Australia as it will force the government to placate the masses by building even more roads, rail, schools, hospitals, etc - and that means even more imports of rocks and dirt from countries like Australia. It would also accelerate the flight of Chinese capital and people into Australia, boosting prices of housing and other assets here.	China: Cyclical slowdown Japan: Back in recession	China: Lower structural growth trend Japan: Growth stalled	 

Asset Classes			Current position	Long term returns (1)
Shares	Australian shares	The local market had another good month in January. The broad index ended up 3%, having recovered 9% since the mid-December mini-selloff. Banks and insurers led the way, driven by record low interest rates and investors' search for yield. Mining/energy stocks continue to be hit hard by falling commodities prices but gold stocks were again the exception, thanks to the mini-rally in the gold price and the lower Aussie dollar. Telstra was also up strongly but is still some 30% below its peak 15 years ago. We have been over-weight Australian shares since early 2012, near the start of the 2012-14 'QE' asset boom. We are still reasonably bullish for the local market for the time being.	Around fair value on long term measures	Around average long run returns
	Developed markets shares	Developed stock markets followed up their solid rise in 2014 with a quiet January, with just about every market advancing. The US was down a little, weighed down by oil/gas stocks. Swiss shares were down but more than made up for it with the soaring Swiss franc after the Euro peg was lifted. European markets were particularly strong, with shares jumping around 10% across the board in the fortnight before the European Central Bank announced its money-printing plans. European markets have now more than recovered their 13% decline between mid-June and mid-October last year.	Mixed – US over-priced on long term measures, but other markets varied	Lower than average long run returns, but currency gains expected (2)
	Emerging markets shares	Emerging markets were also mainly stronger in January. Chinese markets took a breather after their huge rises in November and December. The Shanghai market (half of which consists of the big state-controlled banks) has now put on 55% in the past 12 months, driven by margin lending fuelled speculation in the face of a slowing economy and looming bad debt crisis. Indian stocks kept on their strong upward path since the Modi election win, and other Asian markets were also up across the board. Brazilian stocks were down again, reflecting the pessimistic mood in the wake of Rousseff's re-election three months ago. At the other end of the scale, Russian stocks rose despite oil prices declining another 10%, but returns to foreign investors suffered because the of the Rouble's continued slide. Nearby Eastern European markets were mostly stronger, especially in the Baltics.	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	Although the cash rate is at record lows, yields all across the curve up to 10 years are even lower, down to as low as 2% for 1 to 5 year terms. Even 20 year bonds are yielding less than 3%. All of these are record lows, driven down mainly by foreign money. Inflation linked bonds are at such high prices they are priced to assume inflation will average just 2% for the next 10 years. One would have to conclude that the 'safest of all assets' in Australia – inflation linked government bonds with very little risk of default – is in a speculative bubble like other 'risky' assets. Thanks to the declining yields, returns got off to a decent start – ahead 2% for the month, the same as the returns for the whole of 2013. However, even with yields at such low levels, they are still very attractive to global investors. The only bonds trading at higher spreads are in Greece, as it lurches toward another likely default.	Yields below (prices above) long run average level	Below average long run returns
	Bank Term Deposits	Rates paid on bank TDs remain on a downward path, and likely to fall lower still if cash rates are cut. Even if rates are not cut, lower TD rates are likely if bank lending remains weak and foreign investors keep lending to banks at ultra-low rates. We, via our banks, are once again addicted to foreign debt.	Rates below long run average	Below average long run returns
	Global Bonds	Global government bonds had their best month of returns since November 2008 – at the height of the Lehman Brothers crisis. Investors kept bidding up bond prices in January, forcing yields down by as much as 0.50% virtually across the board. The only yield increases were for Greek bonds as Greece looks like heading for another debt restructure. Yields in nearly all other markets are at historic lows across the globe. Japanese yields are down below 0.3% for 10 year bonds and below 1.3% for 30 years. German yields are down to 0.3% for 10 years and below 1% for 30 years, even lower than in Japan, meaning the market now expects Europe's malaise to be even worse than Japan's 'lost decades'. Swiss bonds are trading at negative yields over all maturities up to 10 years. Nearly all government bonds in the world are trading above their par values. This means investors holding them to maturity are happy to suffer capital losses, because even if governments do pay up when due, investors are guaranteed not to get all their money back. We hold global government bonds tactically in portfolios because of their smooth moderate returns in this type of environment.	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 2013, and money markets are now pricing in an almost certain cut or two in the coming months. Bank bill yields were hovering around the treasury yield curve all last year but shot up suddenly from mid-September on talk of credit rationing by regulators to kill off the housing boom. We hold minimal cash in portfolios and every other asset class generated higher returns over the past couple of years and is likely to so again this year.	Cash rates below long run average level	Variable, rising over medium term
Real Estate	Australian commercial property	Listed property trusts had another very strong month – up 7%, similar to October last year. Unit prices were up across the board. The price rises have now driven yields down below 5% for the sector, which is no higher than shares but without the franking credit tax advantages of share dividends. For our portfolios we continue to favour listed property over unlisted property, and returns from the listed market have been more than double the returns from unlisted. We were over-weight listed property during the 30%+ in rally in 2012, but we no longer over-weight in portfolios as they are fundamentally over-priced and gearing levels are rising again. 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. One continuing theme is aging office blocks being bought up at ultra-high prices by Chinese developers to build investment units for Chinese investors.	Over-valued on long run measures	Around average to below average long run returns
	Australian residential property	Residential prices are still rising but at a slower pace than last year. The market is being driven largely by investors and foreigners. Investment property lending is still growing at a robust 10% pa. The market would probably get another shot in the arm if interest rates are cut further this year, and the resultant lower dollar would probably attract even more foreign buyers, supporting prices further.	Varies by market and by property	Varies by market and by property
Australian dollar (AUD)		The AUD fell in January, but this was more a function of the surging US dollar and Swiss Franc. The USD had its strongest rise since September 2011 – in the middle of US credit downgrade / debt ceiling crisis, and the Swiss Franc soared when its peg to the Euro was lifted. We have been un-hedged in our global equities portfolios over the past couple of years, benefiting investors from the AUD's decline. 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
(2) Returns for non-Australian assets are in AUD terms – ie including any profits/losses from hedging or currency movements

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