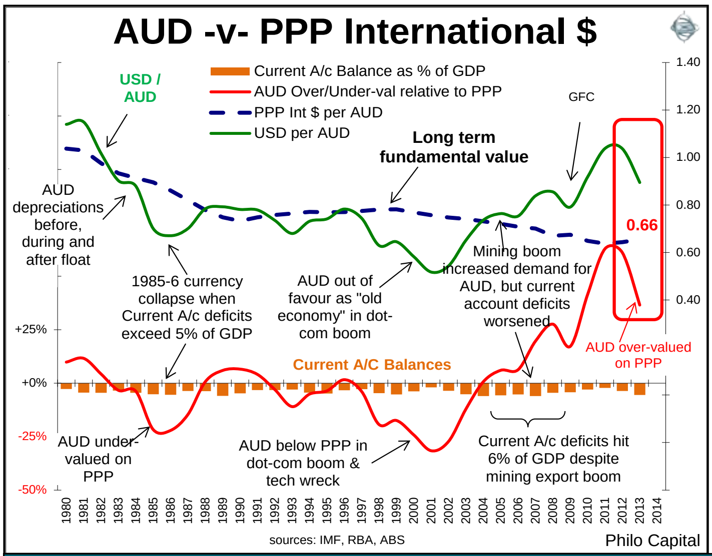
PHILO CAPITAL ADVISERS

PHILO MARKET MONITOR

End March 2014

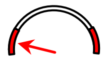
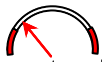
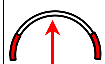
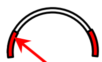


AUSSIE DOLLAR STILL OVER-VALUED

Over the very long term (periods of a several decades), currencies tend to revert to their fundamental values, determined by their relative purchasing power, which in turn is driven by their relative inflation rates, current accounts and reserve backing. On this basis the AUD is still significantly over-valued, even after the 15% decline over the past year.

Our chart shows how the AUD has oscillated around its long term fundamental "Purchase Price Parity" value over the past 35 years. The underlying fundamental PPP value of the AUD has been in long term decline over the past century due mainly to: structurally high inflation relative to other developed markets; high relative interest rates; chronic current account deficits (still has the worst current account deficits in the OECD despite our so-called mining export booms), and our heavy reliance on foreign debt at relatively high interest rates.

The AUD is still at least 30% above its underlying fundamental PPP value (which is around 65-70 US cents) and it should fall further as China slows, as over-capacity brings down commodities prices and as global interest rates rise.

MAJOR MARKETS		Current position	Direction / Trend	Pace of growth
Australia	The Reserve Bank sees signs of a pick-up in the local economy and has flagged its view that interest rate cuts are likely to be over for this cycle. Exports are strong (mining and especially agricultural), retail sales are robust, household spending is up, household savings rates are running down, housing approvals are rising and so are house prices. On the other hand there are several aspects that are still weak including consumer confidence, business confidence and business investment. Mining commodities prices are all down for the month (aside from nickel), largely due to slower growth outlooks for China. At least we can all be comforted by the fact that the Queen and the Mother Country will be looking after us once again now that Tony Abbott has brought back knighthoods!	Below average growth rate	Growth slowing	
Europe	Growth outlooks are picking up for the Eurozone, in both the core and the periphery. In particular the 'PIIGS' appear to be recovering well but are still vulnerable to further shocks. Italy has taken the furthest steps down the anti-austerity path, with new Prime Minister Matteo Renzi's mid-month announcement of tax cuts and labour reforms. Bond yields on 'PIIGS' government debt are back down to new all-time lows, reflecting confidence in the Eurozone mechanisms and commitment to prevent further defaults / restructures. This is even the case for Greek debt, as Greece appears to be on the path toward its third debt restructure in the current sovereign debt crisis. The big event in Europe in March was Russia's invasion and annexation of Crimea from Ukraine. While making for sensational news headlines, so far it has had little impact on markets. Even gold and oil finished the month lower after rising sharply during the crisis in the first half of the month, before falling back. Next stop for Russia: taking a piece of Moldova.	Still virtually Stagnant	Recovering very slowly	
US	The US economy appears to be recovering from the impact of the big storms and bad weather over the northern winter. Growth is encouraging enough for the Federal Reserve to cut back its bond-buying program by another $10b per month to $55b (step 3 in the "taper" from the original $85b per month). The Fed has also acknowledged that employment lags well behind economic growth, and so it has dropped former Chairman Ben Bernanke's unemployment target of 6.5% and the link to the QE taper plan. This has been interpreted negatively as possibly speeding up the full withdrawal of QE. As a reminder that fiscal policy is still in crisis at all levels across America, the largest ever municipal government bankruptcy, that of Detroit, is also coming to a head. Bond holders have been offered an 80% haircut (ie loss) on their bonds, and pensions are to be cut by 34%. The Federal government is staying well away and declining to step in to rescue the city, the bond holders or the pensioners. One aspect that may be contributing to improved business confidence in the US is the increasing momentum for Republicans due to a crescendo of dissatisfaction over the implementation of Obamacare, in the lead up to the Congressional mid-term elections this year. It is looking increasingly like Republicans can hold the House and perhaps even take the Senate from the Democrats.	Below average growth rate	Recovery remaining slow	
Asia	Chinese growth targets and credit markets continued to feature in March. On the 5th March at China's annual People's National Congress (single party parliament) premier Li Keqiang set this year's growth target at "about" 7.5%, but Finance Minister Lou Jiwei later admitted that growth was likely to be lower. Then on the 16th the government outlined its urbanisation target – to rise from the current level of 54% of the population living in cities, to 60% by 2020. Urbanisation is Li Keqiang's primary policy model for economic growth, and it should mean plenty more construction of housing, commercial buildings and infrastructure in the cities for years to come. When the economy falters the government is likely to step in to boost state-sponsored construction to keep employment up and civil unrest down. During the month we also saw the first significant corporate defaults in China since the post-GFC credit boom. These could be signs of a widening crisis in the shadow banking and property markets. The first victim was Shanghai Chaori Solar Energy (1st March), followed by Zhejing Xingrun Real Estate Co (18th). Rather than bail out every collapse as it occurs, the government is keen to see the creditors (bond holders and banks) share the pain of the losses. In the case of Zhejing Xingrun, the government will assume 70% of the debt but banks will need to write off the remaining 30%. The other major development for markets was the central bank engineering the exchange rate lower in order to assist exporters and to deter speculative hot money inflows. This has not gone unnoticed in Washington, and it may lead to a step-up in currency/trade war rhetoric between the US and China.	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	March was a flat month on the local stock market, coming after the 5% dip in January and then the recovery in February during the benign profit reporting season. Share prices for banks and insurers were up in March but virtually all other major stocks were weaker. Notably, mining stocks were down for the month as commodities prices fell due to the China effect – slowing Chinese growth and a possible property construction market bust. The broad All Ordinaries index has now risen nearly 40% since the lows of September-October 2011 (while the US S&P500 index has risen nearly 70% over the same period). Both markets have had very weak earnings growth and only modest dividend growth during the rally. We have been over-weight Australian shares in portfolios for the past two years since early in the current rally. The market was strong in 2012 and 2013 but earnings growth was poor, barely keeping pace with inflation. Earnings are now starting to catch up, but it is mainly through cost cutting and lower interest costs, while sales revenue growth is still anaemic in most companies.	Around fair value	Around average long run returns
	Developed markets shares	The major developed markets had a flat month following February's recovery from January's fall. The US market has led the way over the past two years. It has enjoyed a relatively smooth 70% rise since the credit grade downgrade crisis in August-September 2011. There have been a variety of minor hiccups along the way, the most recent being the QE taper jitters in January and Russia's invasion and annexation of Crimea in the past month. The so-called 'PIIGS' of southern Europe have been strongest this year. The standout in March was Italy (up 5% for March and 13% year to date) as the policy direction switched from austerity to tax cuts under new PM Matteo Renzi. Also strong for the year are Portugal and Greece, even as Greece heads toward its 3rd debt restructure and bail-out. We have been over-weight global shares in portfolios for the past two years since early in the current rally.	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 also had a mostly flat month. Russia (and eastern European markets to a lesser extent) suffered from a flight of capital as investors feared the broader implications of sanctions following Russia's capture of Crimea. Chinese markets were also weak, with negative sentiment over the credit crisis, slower growth and the possible escalation of property developer collapses. Trouble spots Turkey and Thailand were again strong. India, Brazil and Indonesia also had strong rises in March. All three are burdened by widening corruption scandals and are also gearing up for critical elections that could result in significant policy shifts.	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 local bond market was flat in March following modest gains in the first two months of the year. Treasury yields rose a little for short to medium term maturities (1 year to 5 years) on signs of a cyclical up-turn in the local economy, echoed by RBA comments. Offsetting this, credit spreads firmed further on positive sentiment regarding the global credit market, epitomised by declining spreads on PIIGS bonds in Europe. Due to their high prices and low return outlooks, we have been under-weight bonds in portfolios in 2013, reducing to zero weighting for Australian bond funds over the past year, preferring bank term deposits instead.	Yields below (prices above) long run average level	Below average long run returns
	Bank Term Deposits	With interest rates on TDs remaining low, investors are increasingly abandoning TDs in search of yield elsewhere – including residential and commercial property, and shares, especially bank shares. By owning the bank's shares instead of deposits, they can easily obtain twice the yield plus the prospect of an inflation hedge and also the prospect of rising real cash dividends and share prices (and of course the prospect of capital losses). Long term 'breakable' bank TDs remain our preference over Australian fixed interest (bond) funds.	Rates below long run average	Below average long run returns
	Global Bonds	In the US, yields on short to medium maturities picked up sharply on the Fed's commitment on the 19th to wind back QE. On the other hand long yields remained little changed, due to the perceived negative impact of withdrawing QE on the economy's ability to recover. Japanese and German yields were little changed, but yields on the risky states – the PIIGS and France – continued to tighten to pre-GFC levels. All the big global bond markets (Japan, Europe and the US) are in an over-priced twilight zone – no margin for default and also no margin for inflation.	Yields below long run average level	Below average long run returns (2)
Cash	Australian target cash rate	In March the Reserve Bank left the target cash rate at 2.5%, where it has been since August of last year when it made its 8th rate cut in this cycle. The RBA hinted strongly that it is unlikely to cut its policy target cash rate any further in this cycle, as the economy is showing signs that it is about to pick up pace in the months ahead. The RBA's deliberate boost to the housing market appears to be starting to have the desired effect.	Cash rates below long run average level	Variable, rising over medium term
Real Estate	Australian commercial property	Listed property trusts were mostly down in March after a strong February, and the sector ended up +2% for the quarter. Yields are still attractive relative to bank deposits, and most trusts are increasing their cash distributions. In the underlying commercial property market, fundamentals continue to weaken but prices are strong. Investors are still chasing yield in an environment of artificially low global interest rates thanks to quantitative easing and 'financial repression'.	Over-valued on long run measures	Around average to below average long run returns
	Australian residential property	The housing market continues to pick up, especially in Sydney. However enthusiasm from many buyers has been dampened somewhat by talk of an end to interest rate cuts, and even the possibility of rate hikes in the coming year, plus rising rates on fixed rate loans. On the supply side there is a glut of units in several segments of the market – with construction and completions increasing, vacancy rates rising and rents falling. This is concentrated in markets targeted at self-managed superannuation fund investors and foreigners.	Varies by market and by property	Varies by market and by property
Australian dollar (AUD)		The AUD had its strongest month since September of last year. It was up mainly against the weaker Yen, Sterling and especially against the weakening RMB. It was up by less against the strengthening Euro and US dollar. The Aussie is still significantly over-valued on fundamentals and we retain our un-hedged stance for global equities portfolios. Our portfolios benefited significantly from our un-hedged stance over the past year as the AUD fell heavily.	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