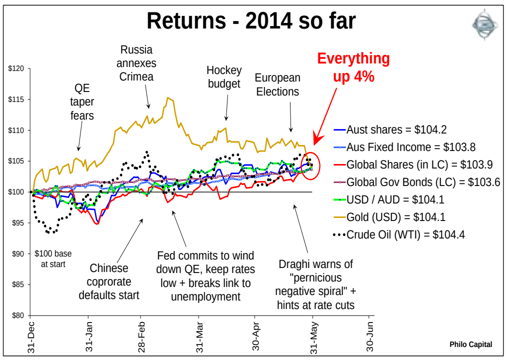
Philo Capital Advisers

Philo Market Monitor

End May 2014

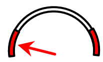
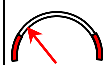
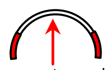
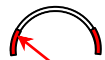


The Calm Before the Even Calmer

Over the past two years we have commented on the incredible calmness in financial markets. Volatility has not been this low since the middle of last decade. In 2014 markets have drifted up quietly and after five months to the end of May, just about everything is up by a neat 4%.

The financial media have found plenty of headlines to scare investors. The US QE taper scare, the Russian incursions into Ukraine, the rise of extremist political parties in elections across Europe, the threat of deflation in Europe, the shadow banking crisis and corporate collapses in China, the escalation of Chinese territorial disputes with Japan, Vietnam and the Philippines, and even the 'horror' Hockey budget in Australia. Throughout it all, markets have sailed along quietly and calmly. Australian shares, Australian bonds, US and global shares, global bonds, gold, oil, and even the Australian dollar – are all up by a sleepy 4% this year.

The problem is that almost all assets in the world are over-priced (even cash), thanks to unprecedented money printing by the major central banks of the world. We remain vigilant for signs of stress in markets, but over the past two years we have been over-weight Australian and global shares and the strategy has paid off for investors, with high returns and low volatility.

Major Markets		Current position	Direction / Trend	Pace of growth
Australia	In May the financial and general media in Australia were dominated by the Federal budget, the first for new Treasurer Joe Hockey. After the series of deficits under Labor during and since the global financial crisis, the new government's budget aims to reduce the deficit from $50b expected for the current year to June 2014, down to (a still very high) $30b deficit for next year. Many of the measures are likely to be opposed by Labor and the minor Senate parties, so the final package is far from certain. The public are not buying into the government's claims that there is an urgent government debt crisis, since Australia's government debt ratios are almost the lowest in the world. Australia does have a debt problem, but it is household debt, not corporate or government debt. Consumer and business confidence is down, due to the budget uncertainty and also due to perceptions of the likely flow-on effects of the slowdown in China. However consumer spending remains relatively strong and there are signs of a pick-up in business investment. The economy is tracking along below par but is still growing. Consumption and exports are relatively strong, and investment in housing and non-mining construction is picking up, partially offsetting the rapid decline in mining investment. The unemployment rate is flat at 5.8% and the RBA is once again trying to talk the dollar down since it can't cut interest rates, for fear of encouraging even further speculation in residential units.	Below average growth rate	Growth slowing	
Europe	We have been writing here for some time about the shift in the political landscape in Europe - away from the middle and toward the radical right and left, fuelled by rising anger against austerity being imposed by the EU, the encroaching power of Brussels, and the Euro. These themes showed up in the rise of extremist parties in the European parliament elections in May. The National Front won in France, the UK Independence Party in the UK, the Danish Peoples' Party in Denmark, while the far left Syriza party won in Greece. The only major country not affected was Italy, where the new PM Matteo Renzi cemented his power with his anti-austerity program. Aside from the possibility of widespread unrest and revolt, the biggest risk in Europe is deflation, with inflation running at less than half of the targeted 2% rate. Europe appears destined for Japanese-style stagnation for perhaps many more years, especially if reforms are further stifled by the rise of anti-EU sentiment across the continent and in the new European parliament. On 26th May ECB's Mario Draghi warned that low inflation and weak credit growth may create a "pernicious negative spiral", as Japan suffered in the 1990s. The ECB is standing ready to do more to create inflation and growth, with lower interest rates the most likely mechanism. This prospect buoyed bonds and shares.	Still virtually Stagnant	Very slow Recovery	
US	Economic recovery continues to take hold very slowly in the US. On 29 May figures revealed that total output contracted in the March quarter for first time in three years, mainly due to the effects of the severe winter, but growth is expected to rebound in the June quarter. House prices are still rising strongly (still double digit year-on-year growth in many major cities) but the pace of rises is now slowing. Consumer confidence is still relatively robust and households are starting to borrow again. Inflation is still benign and the unemployment rate continues to drift downward, from its 10% peak in October 2009 to 6.3% now. The prices of shares and bonds are still rising. The Fed's 'QE taper' program is going according to plan and outcomes are better than most expected – with bond yields actually falling and share prices also continuing to rise. Share markets posted numerous record highs for the month. As in Europe, the political landscape is changing and shifting to the right, with the Republicans gaining strength in the lead-up to the Congressional mid-term elections in November. It is looking increasingly like the Republicans can control the House and the Senate, leaving the President isolated in the White House.	Below average growth rate	Recovery remaining slow	
Asia	Election fever gripped India in May as Narendra Modi and his Hindu Nationalist BJP took a landslide victory from the Congress Party. India's big problems are inflation, a stalled reform program and low confidence from domestic and foreign investors. Investors have high hopes that Modi can make real progress on these. In China the property market continues to slow, and the central government announced a raft of new projects in industries controlled by state-owned enterprises, which would now be opened up to private sector investment in the hope of boosting productivity. China continues to flex its muscles with its neighbours and territorial disputes are escalating – with Vietnam over the Paracel Islands, with the Philippines over the Spratley Islands, and with Japan over the Senkaku Islands. The war of words with the US is also escalating, as the US pointedly strengthened military ties with Japan and the Philippines in May. Across the water in Japan the Bank of Japan has declared that it has won the war on deflation – probably too early - and is now focussing on helping the government implement structural reforms. Recent 'good' inflation figures were mainly due to import price rises and retailers increasing prices before the consumption tax hike, while labour costs actually fell. The record trade deficit also narrowed thanks to lower import demand, but Japan posted another record current account deficit. On 22 May there was another military coup in Thailand, ousting Yingluck Shinawatra, daughter of Thaksin Shinawatra, who was in turn ousted by the military in 2006. The Thai stock market ended flat for the month.	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	It was another very calm month on the Australian stock market, with the broad market index drifting up a little further in May, bringing total returns for the year to date to 4%. Among the big stocks, the best were energy leaders Santos, Woodside and Origin. The banks had another solid reporting season, but earnings growth came mainly from fiddling with reserves and cost cutting, rather than lending growth. CBA was strongest for the month (+3%), but Westpac leads for the year (+6%), while NAB was the weakest (down 5% for the month). Industrial metals prices were all up a little but iron ore continued to fall, and is down 30% for the year. Big diversified miners BHP and RIO were down a little for the month, but iron ore specialist Fortescue was down 13%. We have been over-weight Australian shares in portfolios since early 2012, near the start of the current rally.	Around fair value	Around average long run returns
Shares	Developed markets shares	Share prices in developed markets also drifted up calmly in May, with almost all country market indexes up by around a couple of per cent for the month. The US market was buoyed by continued positive sentiment regarding the steadily recovering economy and ongoing take-over activity. Also assisting share prices were declines in bond yields as the Fed's QE taper program kept going according to plan. Apple shares continued to rise strongly in May following its late April plans for additional buy-backs, a dividend hike and another stock split. European markets also drifted upwards during the month. Any uncertainties relating to the lurch toward radical anti-EU and anti-Euro parties in the European elections were countered by the ECB President Mario Draghi's soothing words giving investors hope of a possible interest rate cut soon.	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	Emerging markets also had a mostly positive month. The star was Argentina (+14% in May and +43% for the year). The Russian index was also up strongly in May and has gained 23% since mid-March when Russian tanks rolled into Ukraine. Putin's expansionist moves have been good for investors and it appears sanctions against Russia are not concerning them yet. The Ruble also held up in May despite evidence of foreign and domestic capital fleeing Russia for safer havens. Even after the invasion rally, the Russian index is still down 10% for the year. Indian markets also had a strong month as Narendra Modi's BJP won a resounding victory in the elections. The BJP is perceived to be better for business than the outgoing reform-shy Congress Party. Chinese stock markets rallied in the second half to claw back to par for the month, but they are still down a little for the year.	Hard 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	Commonwealth bond yields declined steadily all month, especially at the long end. Yields are back down to where they were in July of last year after the shock of (then) US Federal Reserve chair Ben Bernanke's 19th June scare on tapering the QE program. The yield declines are probably being driven by domestic factors (investors fearing economic slowdown with the big budget deficit contraction in the coming year) as well as foreign factors (receding fears of European credit crisis and increasing fears of a Chinese slowdown and/or credit crisis). Credit spreads above the government yield curve are also at boom-time ultra-fine levels, as investors continue to underestimate risk and over-price securities in the endless search for yield in this artificially low-yield world. We remain under-weight domestic bonds in portfolios as we expect yields and credit spreads to expand in the medium term.	Yields below (prices above) long run average level	Below average long run returns
Fixed Income	Bank Term Deposits	Bank TD rates remain low and are edging still lower as the underlying yield curve falls further. Long term 'breakable' bank TDs remain our preference over Australian fixed interest (bond) funds, although rates on these TDs are also declining further in recent months.	Rates below long run average	Below average long run returns
Fixed Income	Global Bonds	Global government bond returns continued their nice slow but steady upward path since the start of this year as bond yields declined in the safe havens and also in the PIIGS. Fears of inflation and default are now the last things on investors' minds, as they bid up prices to bubble-like levels. Yields even declined a little in the biggest debtor, Japan, even as the Bank of Japan was congratulating itself for defeating deflation and engineering inflation at last. Yields on US Treasuries declined even further in May, and have been declining steadily since the first day of January this year. However, US yields are still one percentage point higher than the bottom reached in July 2012. We remain underweight global bonds in portfolios due to their over-priced levels, however they are providing modest returns and they also usually provide a useful counter-balance when share prices fall, as in 2008 and 2011.	Yields below long run average level	Below average long run returns (2)
Cash	Australian target cash rate	In May the Reserve Bank left its 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. With global markets continuing to improve and the European government/bank debt crisis now a fading memory, the RBA is now likely to raise rather than cut rates. The RBA has once again started talking down the Aussie dollar from its still high levels.	Cash rates below long run average level	Variable, rising over medium term
Real Estate	Australian commercial property	Listed property trusts also had a flat month in May, with the retail-oriented trusts doing best (CFS Retail, Charter Hall Retail and Bunnings). Heavyweights Westfield Group and Westfield Retail were flat as the Lowys locked horns with shareholders to try to force through their latest restructure plan. In other deals, Australand was flat after Stockland upped its all scrip bid late in the month. The underlying commercial property market remains weak but prices continue to be strong as yields are compressed, mainly by foreign buying demand in the global search for yield. We remain a little under-weight in our portfolios as we regard the sector over-priced on fundamentals.	Over-valued on long run measures	Around average to below average long run returns
Real Estate	Australian residential property	There is evidence of house prices now declining a little in the major cities, following modest rises this year. In May both the RBA and APRA, the main bank regulator, expressed their concerns with the level of speculation in some markets and they warned of the risks of declining credit standards for housing lending by the banks and especially the non-bank lenders. We are not expecting big declines in house prices soon, but several 'flats-off-the-plan' unit markets favoured by foreigners and self-managed superannuation funds are over-supplied and vulnerable.	Varies by market and by property	Varies by market and by property
Australian dollar (AUD)		The AUD also had a very quiet month. It ended flat against a stronger US dollar, but it was up against the Euro which weakened on talk of possible rate cuts in Europe. The AUD weakened against most Asian currencies including the yen and Chinese RMB. The RMB finally resumed its rise against the USD after four months of declines engineered by the Peoples Bank of China. We see the AUD as still being over-valued on fundamentals and we remain 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