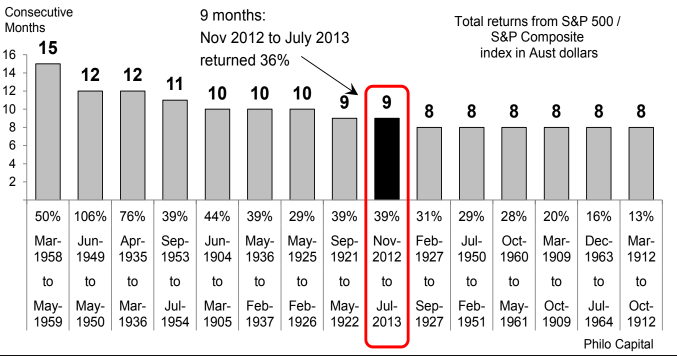
Philo Capital Advisers

Philo Market Monitor

End July 2013

Longest Runs of consecutive positive months since 1900: Total Returns from US shares in Aust dollars



Once in a Lifetime Returns from the US

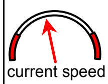
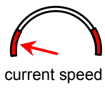
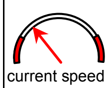
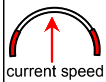
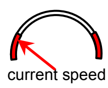
Investors look for high returns as well as consistency. That is what the US stock market has delivered this year for Australian investors. The S&P500 index has generated positive total returns in Australian dollars for nine consecutive months from November last year to July.

This run of 9 positive months makes it into the list of top 10 longest runs of positive returns from US shares in Australian dollars since 1900. It has been the longest positive run since 1958-59, which ran for a record 15 months. There have been only three positive runs longer than 8 months since WW2 but they were all before I was born (just!), so I never saw them.

Not only has the US market returned 39% in Australian dollars over the past 9 months, volatility has not been lower since the mid-2000s. So it has been the best run of consistent, high returns in my lifetime. So much for the so-called "high volatility, low return, new normal"!

This does not imply that the run will continue of course, but it does show the value of ignoring the media hype and focusing on the facts. (Over this period our portfolios have been over-weight global equities, of which the US comprises about half, with the currency un-hedged).

Major Markets

		Current position	Direction / Trend	Pace of growth
Australia	The inflation numbers came in weak for the June quarter, bringing headline CPI inflation to 2.4% for the June year. Prices of items containing local labour costs rose by around 5-10% for the year, but prices of imports fell by around 5%. The collapsing prices of imports, due to global over-capacity in just about every industry, should help to keep imported inflation relatively low despite the falling dollar. On the other hand, energy prices rose by another 15-20%. Someday someone will explain to me why the supply increases due to the energy revolution in the US is resulting in ***lower*** energy prices for American consumers and businesses (helping driving their economic rebound), but the supply increases due to the energy revolution in Australia is resulting in price ***increases*** of 15-20% per year for Australians. In the US the benefits are going to Americans and the big debate over there is whether or not they should be allowed to start exporting cheap energy to benefit foreigners. But in Australia all the benefits are being exported to foreign countries, while Australians are slugged with higher prices!	Below average growth rate	Growth slowing	
Europe	Unemployment rates continue to climb across recession-ridden Europe, but there are some early signs of growth returning. Early in the month the European Central Bank and the Bank of England made soothing statements promising to keep interest rates at very low levels for an extended period of time - echoing the US Fed's similar statements in 2010 and 2011. At one end of Europe, Greece is edging ever-slowly toward reform and toward the next round of its €173b bailout plan. At the other end, Spain's PM Mariano Rajoy is losing his tentative grip on power, with more corruption scandals engulfing him and his embattled government. Next door in Portugal the Coelho government is also teetering on the edge, facing intensifying public backlashes against the harsh austerity program. Things hotted up in Egypt as the elected President Mohammed Morsi was forced out by the army after weeks of mass protests in Cairo's Tahrir square. The main grievances were high unemployment rates and widespread disillusionment over the lack of progress toward the lofty goals of the 2011 Arab Spring uprising. The coup caused oil prices to shoot back above $100, and this will ricochet around the world, putting extra strain on the recoveries in the US and Europe in particular.	Contracting	Remaining very weak	
US	In recent months the only game in town has been trying to interpret Ben Bernanke's various fumbles in attempting to explain how letting long term interest rates rise by scaling back the Fed's bond buying program does not amount to monetary tightening. Bernanke triggered a mild panic in May and June in his statements suggesting a withdrawal of the bond buying programs as the economy continued to strengthen. However, with unemployment still around 7.5% and CPI inflation still well below 2%, it looks like there will be more money printing for some time yet. At the end of the year there will be a new spanner in the works as Bernanke is due to be replaced. Both front-runners, Janet Yellen and Larry Summers, are likely to focus on jobs as a priority over fighting inflation or re-regulating banks. The US economy continues to gather pace despite the headwinds of tightening on both the monetary and fiscal policy fronts, plus the uncertainty over Bernanke's replacement. The steady increase in optimism is being reflected by credit rating agencies S&P and Moody's both removing their "negative watch" outlooks for US treasuries. It is not all plain sailing - Detroit's $18b bankruptcy filing during the month became the largest in US history, topping Jefferson County's $4b bankruptcy in 2011.	Below average growth rate	Recovery remaining slow	
Asia	The Chinese slowdown continues. June quarter economic growth came in at 7.5% annualised, down from 7.7% in the March quarter. Exports and imports were both down. The main component holding up growth rates was fixed asset investment (most of which is state-directed and debt funded), up by 20%. China's new Finance Minister Lou Jiwei caused some confusion by suggesting a 7% growth rate rather than the official party line of 7.5%. This may be setting the scene for a downside "surprise" growth rate in the coming months. But no matter. Chinese tourists are still coming to Australia in record numbers, Chinese steel plants are still buying Australian rocks in record volumes, and the Chinese Government continues to announce grand new projects like railways and tunnels to keep the growth numbers up. New Premier Li Keqiang announced more market-oriented economic reforms, departing further from former President Hu Jintao's *guojinmintui* policy ("the state advances, the private sector recedes"). The announcement of a new free trade zone for the Pudong district in Shanghai and removal of the floor on bank lending rates are two recent examples of this shift. They will need to go further and remove the ceilings on lending and deposit rates as well, if they are to make any real impact on the shadow banking system, the main target of the reforms and source of much of the bad debt problem.	<u>China</u>: Cyclical slowdown <u>Japan</u>: Very slow	<u>China</u>: Lower structural growth trend <u>Japan</u>: Stimulus improving exports, production & growth	 

ASSET CLASSES			Current position	Long term returns (1)
Shares	Australian shares	The local stock market was up 5% in July, more than recovering its 3% decline in June. This was achieved in the face of a string of earnings downgrades issued during the month. As the mining boom has shifted from a price boom (where explorers do well), to a construction boom (where mining construction firms do well), and now to a volume boom, this is the environment in which the big low cost players like BHP and RIO (both in our portfolios) should do relatively well. The big miners are now reporting stronger profit outlooks from higher sales volumes, plus the benefits of a lower Aussie dollar. Gold stocks shone brightly for once as the gold price recovered 10% with the easing of the Bernanke scare. Newcrest (not in our portfolios) was for once a star stock for the month, up 26%, but from a very low base. It is still down 47% for the year to date, and 70% below its peak two years ago. We remain over-weight Australian shares in portfolios.	Around fair value	Around average long run returns
	Developed markets shares	Global stock markets had another good month in July, up 4% plus another 2% from the lower AUD. Total returns in AUD are now 27% for 2013 to date, and 40% for the past 12 months. We have been over-weight global equities (and un-hedged on the currency) since early 2012. Markets have certainly come a long way since the nail-biting European summits following the fiascos surrounding the Greek elections and bank runs of last year. All of the major developed markets were up by around 5% in July (except Japan which took a late dive to end flat), with confidence improving. The US economic rebound is the most advanced, while the Japanese shock treatment is paying dividends, and early signs of recovery are now appearing in Europe.	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	Shares in the debt-ridden, deficit-plagued developed world are doing well while their economies limp along on life support. On the other hand the big emerging market economies are much stronger but their stock markets have been doing poorly in recent years. The BRICs are slowing and having trouble dealing with inflation, reform stagnation, and rising social unrest. However the post-taper global rebound was even enough to lift three of the four BRIC markets in July, a relatively rare event. Nearly all of the smaller markets were stronger, with Argentina, Venezuela and Pakistan all posting double digit gains for the month, as did Egypt in the wake of the coup.	Extremely hard to value. Many appear inexpensive to fair value	Above average long run returns, but high volatility (2)
Fixed Income	Australian Gov't bonds	Australian yields ended down a little in July, mainly at the short end. The slowing local economy is keeping yields low at the short end, while the easing of concerns over the US Fed's taper plan are keeping yields low at the long end. Inflation linked bonds recovered a little of their losses in the relatively heavy sell-off in May-June, while corporate spreads have narrowed a little. The overall return index is now ahead 1% for the year to date after the May-June sell-off. We have been under-weight bonds in portfolios, with small holdings retained mainly for liquidity purposes.	Yields below (prices above) long run average level	Below average long run returns
	Bank Term Deposits	Rates on bank TDs remain little changed in July while the underlying money market rates have remained flat. The total volume of TDs increased by a mammoth 60% (or \$200b) between late 2009 and the middle of 2012 as investors sought safety in the sovereign debt crisis. However TD volumes have remained flat over the past year as money shifted into other assets offering higher returns as TD rates fell. For fixed income exposure we still prefer TDs over bond funds.	Rates around long run average	Around average long run returns
	Global Bonds	In July global bond markets recovered much of the ground they lost in June. The benchmark global index is still ahead 1% for the year even after the Bernanke "taper" sell-off in May-June. Yields were up a fraction more in the US in July after the big surge in May and June, but yields were down a little in the other major markets. This includes Japan, despite the strong electoral endorsement of Abe's pro-debt stimulus plan to import inflation through a lower yen. Investors seem reassured that yields will be kept low in Europe for many years to come, and that the US recovery is not strong enough yet to see any sudden reduction in the US Fed's bond buying plan for some time. We remain under-weight as we see yields rising even further in the medium term.	Yields below long run average level	Below average long run returns (2)
Cash	Australian target cash rate	The low inflation numbers and the deteriorating jobs market leave the RBA with some leeway to reduce rates further. However, wages are still rising in union-dominated sectors, and the falling dollar also runs the risk of importing inflation. The new Treasurer has even started talking down the economy, perhaps trying to put pressure on the RBA to cut rates in time for the election.	Cash rates below long run average level	Variable, rising over medium term
Real Estate	Australian commercial property	The listed property sector was having a very quiet month until it was suddenly awakened by Commonwealth Bank's long awaited announcement of its intention to exit its listed property funds. This includes CFS Retail Property Trust (CFX) and Commonwealth Property Office Fund (CPA), together comprising 10% of the listed property index. Both jumped on the news, and the overall index ended flat for the month. Total returns (including distributions) are now at 8% for 2013 to date. In contrast, the underlying commercial property markets remain rather weak, with rising vacancy rates and weak rents in the retail and office sectors. However continued foreign interest is keeping prices relatively firm in both the listed and unlisted sectors.	Over-valued on long run measures	Around average to below average long run returns
	Australian residential property	Low interest rates are finally starting to flow through into stronger home loan approval levels and into house prices. This is now extending beyond the investor market although rising unemployment rates, high savings rates and reluctance to borrow is still hampering first home buyers and the up-grader market. At the top end we are seeing more evidence of banks finally losing patience and dumping mortgagee sales for fractions of their boom-time prices. There is also evidence of money flowing into the housing market from the new accelerated visa scheme, mainly from cashed up Chinese, but their main focus is on flats sold off the plan.	Varies by market and by property	Varies by market and by property
Australian dollar		The Aussie dollar fell by a couple of per cent in July, adding to its 11% decline in the QE taper scare in May-June. It was down mainly against the stronger Euro, and the yen also strengthened in the wake of the upper house elections in Japan. Our un-hedged stance has significantly boosted returns on global shares this year thanks to the AUD's decline. Even after the recent falls, the AUD remains over-valued on a range of measures.	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