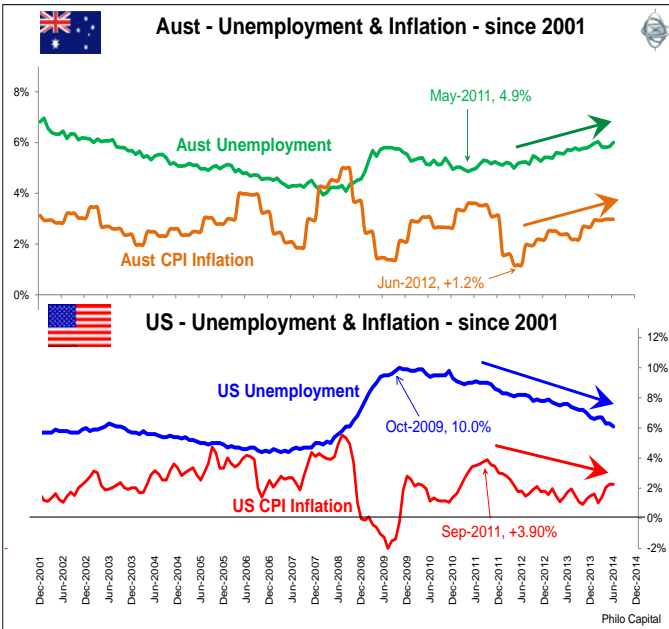
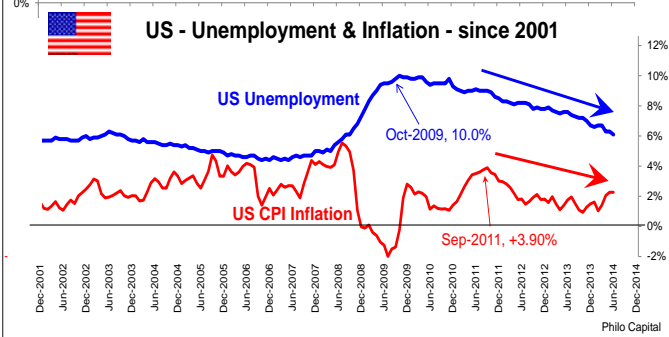




**Aust - Unemployment & Inflation - since 2001**



**US - Unemployment & Inflation - since 2001**



## POLICY PINCERS: AUSTRALIA -V- USA

In the US, the two big policy imperatives – unemployment and inflation – have been going in the right direction (down) since 2011. Ultra-loose fiscal policy (four years of trillion dollar budget deficits) and ultra-loose monetary policy (near- zero interest rates and unprecedented money printing) have borne fruit, albeit slowly:- the economy is growing, the unemployment rate is falling, the budget deficit is contracting, deflation has been avoided, inflation has been low, and asset prices are rising (including shares, bonds, housing and commercial property). The 'QE' money printing program is coming to an end without rattling asset markets or investor confidence.

Falling unemployment plus very low inflation, despite the strong dollar and tightening budget, mean the Fed can start tightening monetary policy by raising interest rates. The big risk is that the Fed continues to dismiss rising inflation as "noise", and keeps interest rates too low for too long. The likely outcome is that the Fed will wait too long and have to hit hard with unexpected interest rate hikes, rattling investment markets, as in 1994.

It is the reverse in Australia. Here we have rising unemployment rates and rising inflation. In addition we still have very loose, and now politically chaotic, fiscal policy (big budget deficits and a hostile, volatile Senate). Inflation is already at the top end of the RBA's target range but the RBA cannot raise interest rates to kill inflation and cool the housing market for fear of causing the dollar and unemployment to rise even further.

As a result, the RBA, like the Fed in the US, will also probably act too late and too harshly with rate hikes. Indeed the RBA may even try another rate cut first to try to bring down the dollar. This would probably further inflame prices in the property and share markets, as well as accelerate consumer price inflation. That would mean it would need to come down even harder and harsher with rate hikes later on.

## MAJOR MARKETS

		Current position	Direction / Trend	Pace of growth
<b>Australia</b>	Further to the story above, July saw the unemployment rate rise to 6%, up from a pre-GFC boom-time low of 3.9% in February 2008 at the peak of the commodities boom. Inflation is now up to 3%, the top of the RBA's target range, and up from just 1.2% two years ago. Even 'core' inflation is now 2.9%. July also marks the start of the new Senate, with Palmer and other micro parties making fiscal policy more challenging.	Below average growth rate	Growth slowing	
<b>Europe</b>	The development in European markets in July has been the dramatic decline in bond yields. It is a direct result of what we reported here as the big development in June – the European Central Bank's cut in interest rates to record lows on 5 <sup>th</sup> June, including negative interest rates, plus the ECB's tantalising hint of possible 'quantitative easing' (bond buying) to fight deflation. In July, yields fell to all time record lows in some countries and multi-century lows in others. Part of the higher demand for bonds may have been in response to the Russian developments in Ukraine, but this is not a flight to safety – the biggest rushes have been into the still risky PIIGS bonds. Most bonds in Europe are now trading well above par value, so investors are guaranteed to suffer capital losses at maturity even if the governments do not default. Investors have dismissed any fears of inflation, but they have also forgotten that deflationary conditions limit the ability of fiscally challenged governments to grow and inflate their way out of debt. This is especially difficult in Europe with their stifling labour laws, low productivity growth, fixed currency, aging populations and ballooning pension burdens. As real debt burdens rise, so too does the likelihood of default. One positive has been the declining Euro, which is down against all major currencies in 2014, a turn-around from its strength in 2013. Another headache for Europe is Russia, for at least two reasons. The first is the political vacuum being left as Germany's Angela Merkel starts to wind down her role after her election win last year. What Europe needs is a strong leader to stand up to Putin, but there are no obvious contenders after Merkel. A second problem is that sanctions against Russia are likely to further stymie European economic recovery because of Europe's heavy reliance on Russian gas for its energy. It may be several years before we see the full benefits of cheap imports from the US, the great coal revival, or local unconventional gas production.	Still virtually Stagnant	Very slow Recovery	
<b>US</b>	Refer to the above story on the US fiscal & monetary policy dilemma. Investors want to see the Fed keep interest rates low for longer, but not so long that it will be forced to act suddenly and unexpectedly to tackle inflation. All eyes and ears are on Fed Chair Janet Yellen and how she views inflation and unemployment. In July she indicated that the rising inflation was merely "noise"; that monetary policy (rate hikes) should not be used to address asset bubbles; and that her main focus is now on 'under-employment', which is running at twice the rate of unemployment. These are all signs that interest rates may well remain low for longer.	Below average growth rate	Recovery gaining pace	
<b>Asia</b>	The Chinese economy continues to slow (despite the pretty set of official numbers miraculously meeting the government's proclaimed target). Housing prices continue to fall in a growing number of cities but, aside from a few isolated exceptions, the declines have been contained to a dull roar rather than a calamitous general downward price spiral. Housing construction is important because it is the largest component of national economic growth. The key to it all is property finance – primarily for developers, because the main risk to housing prices is supply in the form of distressed developers having to dump stock at big discounts, rather than demand. In the past month there have been more developer bankruptcies and defaults, and the government has responded by allowing property developers to raise funds by selling bonds directly rather than rely on the shadow banking system and retail trust products. In the face of a weakening housing construction market the government is continuing to support construction jobs, and also demand for raw commodities, by announcing infrastructure projects left, right and centre. Industrial metals prices were stronger for the month, while iron ore and coal prices halted their slide.	<u>China:</u> Cyclical slowdown  <u>Japan:</u> Early recovery	<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 had a good month in July after a flat June. The broad market returned 4% for the month, bringing returns to a modest 7% for the year to date. Of interest during the month was the re-float of the old, but now rather expensive, Healthscope Ltd after a quick start-up for sale by private equity firms to take advantage of the current bullish sentiment. It was the largest float since QR National (since re-named Aurizon) in November 2010. The modest success of Healthscope is likely to entice a raft of similar opportunistic floats in the coming weeks. This pattern is typical of the latter stages of bull market rallies. August is reporting season in Australia and we are expecting more modest profit growth numbers than the rather bullish February profit announcements. 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
	Developed markets shares	Global stock markets had a flat month in July. US markets were down a fraction after a last day sell-off, Asia was up but Europe was down. European growth prospects were down-graded during the month and money shifted out of shares and into bonds. This pushed bond yields down to record lows across Europe, well below dividend yields on most quality European-based global companies. Share prices are not stretched in most of the major European markets, and many good companies are continuing to benefit from healthy sales to the growing middle classes in the 'emerging' markets.	Mixed – US over-priced on long term measures, but other markets varied	Around average long run returns, but currency gains expected (2)
	Emerging markets shares	Most emerging markets had a good month, especially in Asia, Middle East and Africa. China had a rare good month on benign macro numbers. The Shanghai index was up 7% in July, its best month since December 2012, but is up just 4% for 2014 to date. The Indian market was up strongly again, continuing the euphoria over Modi's BJP election win. So too was the Indonesian market following Widodo's tense election win during the month. Argentina lost 9% on the day it defaulted (again!) but is still up 4% for July and 50% year to date. Most emerging markets are trading on relatively high multiples - in the late teens to twenties, and look stretched and reliant on the 'risk-on' tide of cheap foreign money to support prices. The notable exception is China, which still trades on single-digit price/earnings multiples and relatively high dividend yields. We prefer to obtain our exposure to the growing emerging markets via well-established global brands operating from developed markets.	Hard to value. Many now appear expensive but are reliant on fickle global sentiment	Moderate to above average long run returns, with high volatility (2)
Fixed Income	Australian Fixed Income	The local yield curve twisted clockwise over the month as short rates rose while long rates fell. This is a sign that the market expects rate rises in the coming year to stem future inflation. It is the first clockwise twist since September 2013 following the August 2013 rate cut, which was the most recent and 8 <sup>th</sup> cut in the current cycle. The overall bond market generated returns of 0.3% for July, after three relatively strong months. The main winners this year have been corporate credit and inflation linked bonds, as investors bid up prices as inflation has accelerated, and as corporate credit spreads continue to tighten to unsustainably low levels. We have been under-weight domestic bonds in portfolios as we expect yields and credit spreads to expand over the medium term from current levels.	Yields below (prices above) long run average level	Below average long run returns
	Bank Term Deposits	Bank TD rates kept sliding as local banks increased the shift in their funding sources away from domestic deposits and toward cheaper foreign debt markets. Global credit spreads continue to contract, favouring borrowers over lenders. We have favoured 'breakable' TDs over bonds this year as they have provided superior return for risk. However these breakable TDs are likely to be modified or restricted with the new bank liquidity regulations flowing from the 'Basel-3' banking reforms.	Rates below long run average	Below average long run returns
	Global Bonds	July was the seventh straight month of smooth, moderate returns from the broad bond market indexes. Yields continued to fall around the world, particularly in Spain, Switzerland and Germany as the flood of cheap money forced prices up and yields down. Yields also fell in Japan, even after the huge money-printing and asset-buying efforts of the Bank of Japan to create inflation. In the US, the yield curve also twisted clockwise as yields rose at the short end (with expectations of future rate hikes in the next year or so) while long yields fell. We hold global bonds in most portfolios but we remain underweight due to their lofty prices. They are providing modest returns and they also usually provide a useful counter-balance when share prices fall, as they did in 2008 and 2011.	Yields below long run average level	Below average long run returns (2)
Cash	Australian target cash rate	The Reserve Bank's target cash rate remains at a very low 2.5% where it has been since August 2013. This is very loose monetary policy as inflation is already 3% and climbing. But the dollar is still too high, and so the RBA is prevented from raising rates to stem rising inflation and the growing tide of housing lending which is just pushing up existing house prices and doing little for the real economy.	Cash rates below long run average level	Variable, rising over medium term
Real Estate	Australian commercial property	The listed property market had another good month in July – up 5% for the month, bringing total returns to 18% for the year to date. On the surface, this appears reminiscent of the 33% rally in calendar 2012 but it is very different in nature this time. When the market rallied in 2012 most trusts were trading at significant discounts to their net asset backing, and distribution yields were relatively healthy at around 7%. This time the market is trading at well above net asset backing property values (and the underlying property markets are also over-priced), and yields are historically very low at just 5%. The current rally is being driven largely by yield-chasing foreign investors and take-over speculation, rather than fundamentals. We were over-weight during the 2012 rally, but we now are a little under-weight in portfolios as they are fundamentally over-priced.	Over-valued on long run measures	Around average to below average long run returns
	Australian residential property	Housing prices are still relatively strong, but a number of over-supplied investment unit markets are weak, with falling prices, rising vacancy rates and declining rents. With Australian housing prices and household debt levels amongst the highest in the world, the Reserve Bank has stepped up its attempts to verbally coax the housing market down by warning banks and borrowers alike to be more conservative in their lending/borrowing, and to lower their expectations of future price growth. This will probably be no more successful as the RBA has been in trying to talk the dollar down. Rather than verbal threats, the thing that will stop borrowers taking on even more debt and paying even higher prices is the RBA raising interest rates or imposing direct lending controls on banks, which other countries are now starting to do because their hands are tied on interest rates.	Varies by market and by property	Varies by market and by property
	Australian dollar (AUD)	The AUD was down a little in July. It was stronger against the weaker Euro and Yen, but weaker against the strong US dollar. It was also weaker against most Asian currencies, particularly the Indonesian Rupiah which strengthened with Joko Widodo's election win. The AUD is still significantly 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

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