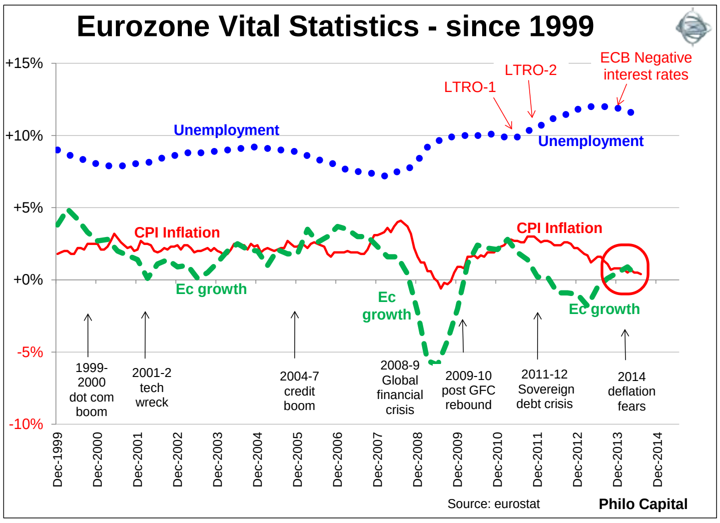
PHILO MARKET MONITOR

PHILO CAPITAL ADVISERS

End August 2014

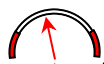
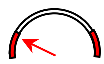
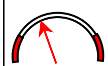
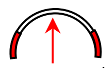
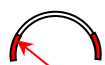


EUROZONE NEEDS CPR

Over the past 15 months since May 2013 the number one 'macro' factor affecting global markets, including Australia, has been fears over the pace and impact of the withdrawal of the US Federal Reserve's "quantitative easing" program. (Under "QE", the Fed bought $85b of bonds per month with newly printed money). With US QE coming to an end relatively smoothly, the so-called "QE taper" fears have been replaced with fears over the pace and impact of interest rate rises in the US as its economy continues to recover (refer to last month's report).

Europe is also a concern. The Eurozone economy has stalled, with the big three economies of Germany, France and Italy hitting a wall. The unemployment rate has been falling slowly from 12% last year but is still very high at 11.5%, and is still above 20% in Greece and Spain. Youth unemployment for 15-24 year olds is running at 22% across the zone, but over 50% in Greece and Spain and over 30% in Portugal and Italy.

A major contributing factor is inflation, or rather the lack of it. Inflation is now just 0.4% in the Eurozone, down from 3% in 2011, and there are gathering signs of deflation. This discourages consumer spending and business investment, which are the engines of economic and jobs growth. The main theme now affecting markets is speculation over when the European Central Bank (ECB) will start its own "QE" money printing program. Speculation received a boost with ECB President Mario Draghi's 'Jackson Hole' address at the end of August. This is buoying shares, bonds and property, and depressing the Euro. But talk can only do so much. The ECB will need to back it up with action.

MAJOR MARKETS		Current position	Direction / Trend	Pace of growth
Australia	One factor affecting consumer spending and business investment in Australia is the on-going budget impasse. Recall that Federal Treasurer Joe Hockey's first budget in May aimed to reduce the federal deficit from $50b for the 2013-4 year down to (a still very high) $30b deficit for next year. The problem is that $40 billion of spending cuts and tax measures in the budget have now stalled and are tied up in complex political manoeuvring with the minor parties and independents, flexing their muscles in the new Senate. August saw the dramatic rise in popularity of (or at least media attention given to) Clive Palmer's Palmer United Party, which is now gearing up for the Victorian elections. The budget debate has now turned to possible new taxes and spending cuts – including scaling back tax breaks on superannuation, amongst other measures rumoured. Australia's government debt is still manageable – so far (but it does have a big household debt problem). However, it will have a government debt problem in time if the budget is not brought under control soon. Meanwhile, the unemployment rate rose to 6.4%, on a steady march upward from 4.9% in early 2011. On the 8th August Russia announced sanctions against imports from Australia in retaliation for Australia backing sanctions against Russia over Ukraine. The sanctions mainly affect beef and butter exports. Now it seems the government is preparing to join the US once again in Iraq.	Below average growth rate	Growth slowing	 current speed
Europe	Further to the lead story above, in August the ECB also launched a new program - 'TLTRO' (Targeted Long Term Refinance Operations). This is an extension of 'LTRO' (Long Term Refinance Operations) – with 'LTRO-1' in December 2011 and 'LTRO-2' in March 2012. In LTRO-1&2 banks used cheap loans from the ECB to buy government bonds (as was the ECB's main intent at the time) instead of lending to businesses to invest and create jobs. Unlike the dramatic expansions of central bank balance sheets in the US, UK and Japan, the ECB balance sheet actually shrunk under LTRO – as banks started repaying their ECB loans in order to boost investors' and depositors' confidence in their strength. LTRO-1&2 were aimed at keeping government bond yields down to relieve the government debt crisis at the time, but now it is time to stimulate lending to businesses as this is the key to creating jobs and growth. Another key event in Europe came on 3rd August when Portugal's Banco Espirito Santo was rescued by the Portuguese government in a €5b restructure. Bank depositors were saved, but big losses were borne by shareholders and bond holders. The bank's bad debts were largely unrelated to Portugal's housing-based banking crisis and government debt crisis. Portugal is actually making good progress, exiting early from its 2011 €78b bailout. The Espirito Santo rescue shows how far the European policies and mechanisms have come since the disastrous handling of the Cyprus bank crisis in March 2013.	Still virtually Stagnant	Growth stalled	 current speed
US	Also making a major policy announcement at the Jackson Hole meeting, US Fed Chair Janet Yellen hinted at rate rises starting possibly early next year rather than mid-year, given the progress being made on the economic recovery. Unemployment is still running at around 6%, down from the peak of 10% in October 2009, but the level of 'under-employment' is still a concern for Yellen. Inflation is running at 2% (with 'core' inflation at 1.9%), up from 1% at the end of 2013. The 'QE' bond buying program progressively scaled back during 2014 and is due to end in October. Bond yields - a gauge of future inflation fears - keep on declining, indicating the market (in its wisdom or otherwise) is not expecting any inflation for the next three decades!	Below average growth rate	Recovery gaining pace	 current speed
Asia	In China the decline in housing prices continues to gather pace, but overall prices in most large cities are still around where they were a year ago. There are still many instances of distressed property developers affected by the shadow-banking credit squeeze, dumping properties at deep discounts. This is creating doubts in the minds of potential buyers who, up till now have hoped for easy profits from never-ending price rises. The price declines contributed to the 8% fall in iron ore prices for the month, and smaller falls in most industrial metals prices. On the other hand, the broad money supply is still growing by around 12% pa, which is still a relatively high real rate of 10% (with inflation is running at just 2%). Retail sales are also growing at a similar relatively healthy pace. In a major policy move, the government is starting to unwind the *hukou* household registration system for controlling internal migration, which selectively rations access to jobs, schooling and healthcare. This reform will be vital for labour productivity growth in future.	China: Cyclical slowdown Japan: Early recovery	China: Lower structural growth trend Japan: Stimulus improving exports, production & growth	 current speed  current speed

Asset Classes			Current position	Long term returns (1)
Shares	Australian shares	The local stock market was flat in August. Best of the big stocks were plasma specialist CSL (up 9%, in our portfolios) and Origin Energy (up 8%, in our portfolios). The worst was iron ore miner Fortescue Metals (down 15%, not in portfolios), on lower iron ore prices due to the China property slowdown. In the August profit reporting season earnings were up modestly but dividends were up by around twice as much. Dividend payout ratios are back up near all-time high levels, meaning companies are retaining a smaller share of profits to re-invest for future growth. One highlight of the month was the plan by BHP (in our portfolios) to spin off a collection of poorly performing operations (mainly nickel, manganese and alumina/aluminium), which are essentially the mines BHP paid too much for in the Billiton merger in 2001. (That was a bad deal, although not as bad as BHP's disastrous $3.2b purchase of Magma Copper in 1996). The slightly slimmer BHP will now focus on iron ore, coal, copper, oil/gas and potash. BHP shares were down 5% for the month. We have been over-weight Australian shares in portfolios since early 2012, near the start of the current 2012-14 rally.	Around fair value	Around average long run returns
Shares	Developed markets shares	Global share markets were up another couple of per cent in August. The US was the best of the developed markets, up 4%. Late in the month the S&P500 index reached 2,000 for the first time – well above its previous peak of 1,565 in October 2007 at the top of the 2000s credit bubble, and also well above its 'dot-com' boom high of 1,527 in March 2000. One highlight (or lowlight) was Bank of America being fined another $17b for selling toxic sub-prime mortgage securities. (Its total legal costs from the sub-prime mess are now up to around $65b). Bank of America shares were up 5% for the month. European markets were mostly up a little, as hopes of 'QE' from the ECB more than offset fears of economic slowdown and deflation. We have been over-weight global shares (favouring US shares) in portfolios since early 2012, near the start of the current 2012-14 rally.	Mixed – US over-priced on long term measures, but other markets varied	Around average long run returns, but currency gains expected (2)
Shares	Emerging markets shares	Emerging markets were also up a couple of per cent on average for the month. Argentina was the best (+20%) as the government battled to rectify its default last month. Argentina's broad index has doubled over the past year through the default crisis. Saudi Arabia also surged in August (+8%) as the US waded yet again into neighbouring Iraq. Egypt was also strong (+7%). The Indian market also continued to surge on Narendra Modi's election win and reform agenda. With the exception of China and Russia, most emerging markets appear expensive. They are being supported mainly by the flood of cheap money flowing out of developed markets, and are vulnerable to adverse macro shocks.	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	Yields across all maturities fell a little in August, favouring the long end. As in recent months it was mainly driven by foreign money in search of higher yields. Treasuries returned around 1% for the month (+6% for the year to date), with inflation linked bonds doing a little better, as inflation and expectations of future inflation edged up. Corporate spreads widened a little but are still unsustainably skinny, under-pricing default risks. We have been under-weight domestic bonds in portfolios as we expect yields and credit spreads to expand over the medium term from current unsustainable levels.	Yields below (prices above) long run average level	Below average long run returns
Fixed Income	Bank Term Deposits	Bank TD rates have been falling in recent months, not only due to the declines in the underlying yield curve, but also because banks have rediscovered cheaper foreign debt markets. We have significant holdings of 'breakable' TDs in most portfolios as they have provided superior return for risk than the bond market. 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
Fixed Income	Global Bonds	Yields on government bonds fell in all major markets, especially in the PIIGS. The biggest decline was in Portugal following the €5 billion rescue of Banco Espirito Santo. Most bonds in the world are trading above their par value so investors are guaranteed capital losses if they hold to maturity. It would only make sense if we get a decade of deflation instead of inflation. We hold small allocations to global bonds in portfolios but we remain underweight. 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 policy rate has been at a record low 2.5% since August last year. Treasury bills with terms up to a year are still trading at the same 2.5%, indicating little market expectations of any move up or down over the coming year. There is already inflationary pressure in the economy, with CPI inflation running at 3%, core inflation at 2.9% and house prices and investment housing speculation growing at rates well above the RBA's comfort level. However the RBA can't raise rates without also risking a higher dollar and higher unemployment rate.	Cash rates below long run average level	Variable, rising over medium term
Real Estate	Australian commercial property	The listed property market had a flat month in August. Shopping Centres Australia, Goodman and Stockland were up 5%, but the two Westfield heavyweights and most of the other trusts were flat. The listed market is relatively expensive - trading well above net asset backing and on low yields relative to historical levels. This year's strength in the listed and unlisted property markets is being driven largely by yield-chasing foreign investors (and take-over speculation in the case of the listed market), rather than by fundamentals. We were over-weight during the big 2012 rally in the listed market, but we now are a little under-weight in portfolios as they are fundamentally over-priced, and shares offer more upside potential. We cannot find much value in the unlisted market at present.	Over-valued on long run measures	Around average to below average long run returns
Real Estate	Australian residential property	The current residential property boom has a number of unhealthy aspects - its relatively heavy reliance this time on investors, off-the-plan unit sales and foreign buyers, rather than owner-occupiers, houses and local buyers. It is also being driven by ultra-cheap credit, and relatively high growth rates in investment lending in particular. Houses prices are rising modestly, but rental yields are low and falling. There is a looming glut of units in several markets, with rising vacancy rates and falling rents in Perth, Canberra and hot spots in Sydney, Melbourne and South-East Qld. This is likely to lead to falling prices, as in prior cycles, as interest rates rise back to more 'normal' levels.	Varies by market and by property	Varies by market and by property
Australian dollar (AUD)		The US dollar had another strong month in August – mainly against the weakening Yen and especially against the Euro with the market anticipating the start of ECB money printing soon. The Aussie dollar kept pretty flat against the USD, with high demand from foreign speculators buying 'hot' local assets, mainly government bonds and properties. 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