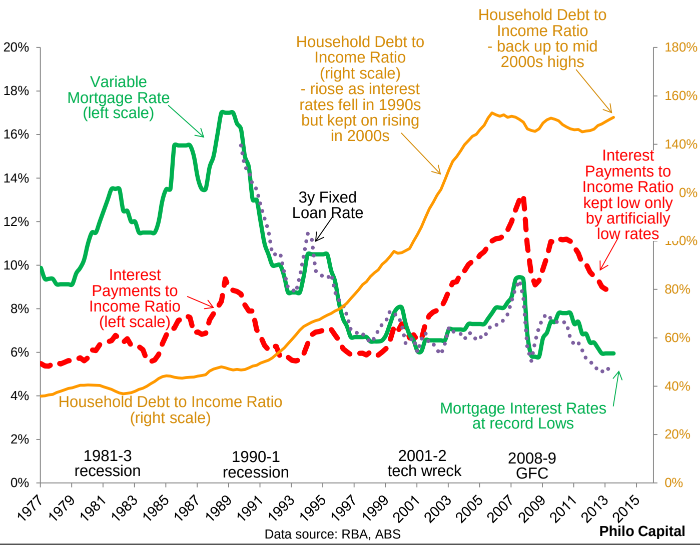
PHILO CAPITAL ADVISERS

PHILO MARKET MONITOR

End September 2014

Household Debt Ratios & Mortgage Interest Rates



Data source: RBA, ABS

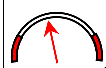
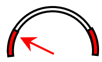
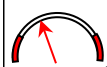
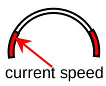
Philo Capital

HOUSING & HOUSEHOLD DEBT

Inflation in Australia is running at the top of the RBA's target range, household debt levels are at record levels and still rising, and residential and commercial property prices are also sky high and still rising. The price rises are being driven largely by investors using ultra-cheap debt, and by foreigners chasing yields in a world of artificially low interest rates.

As we have opined here in previous months, regulators have little choice but to re-impose direct controls on banks and other lenders to take the heat out of the property market. It needs to target specific areas of concern rather than use the blunt instrument of interest rates, which affect all borrowers. The RBA can't raise interest rates for fear of causing the dollar to rise and risk increasing unemployment, which is already relatively high and on a rising trend for the past 2½ years. In recent weeks we have seen the RBA, APRA, Treasury Department and the Treasurer all talking up the prospect of unconventional 'macro-prudential' measures (ie direct controls of bank lending) to deflate the market.

This is far from unconventional – let's not forget that direct government control of bank interest rates and loan volumes were primary policy tools to keep interest rates low and to control bank lending and economic activity from the start of the 2nd World War up to the mid-1980s.

MAJOR MARKETS		Current position	Direction / Trend	Pace of growth
Australia	Refer to the lead story above. A number of factors are worrying foreign investors: - the worsening budget crisis; the control of minor parties in the new Senate; the RBA's unwillingness to raise interest rates; the RBA's statements on likely widespread economic damage from a housing correction; and the record levels of household debt. These factors, on top of the slowdown in China, have spooked foreign investors. They have sold off Australian bonds and shares, especially in the banks, which could be hurt by credit controls and rising global rates.	Below average growth rate	Growth slowing	 current speed
Europe	Europe's economy has hit a wall. Following ECB President Mario Draghi's speech at Jackson Hole on 22nd August in which he hinted at quantitative easing to depress interest rates and stimulate lending, the ECB cut interest rates on 4th September. This included charging banks negative rates on their deposits in order to encourage them to lend. The ECB also announced plans to buy covered bonds and asset backed securities from commercial banks. Then on the 18th the ECB lent out the first 82b euro tranche of 'TLTRO' (Targeted Longer Term Refinancing Operations) – which are cheap 0.15% medium term loans to banks to on-lend to businesses. On the 24th Draghi renewed his pledge to keep monetary policy loose for an extended period. But Germany, the engine room of Europe, remains weak, with very low levels of business confidence and investment. Contributing factors include the impact of sanctions against Russia, and also the steady political fragmentation across Europe, and even within Germany. During the month we saw the continued rise of right wing extremist parties, like the new "Alternative for Germany" party which polled strongly in elections in Thuringia and Brandenburg, following up its success in Saxony on 31st August. This political fragmentation within countries, as well as fragmentation and alienation between countries across Europe, will make genuine Europe-wide reforms even more difficult in future than it is at present.	Still virtually Stagnant	Growth stalled	 current speed
US	US monetary policy remains the number one driver of markets globally, including share markets, money markets, bond markets, property markets and foreign exchange markets. During September Federal Reserve Chair Janet Yellen confirmed the plan to end the 'quantitative easing' bond-buying program in October, and also to keep interest rates low for a 'considerable time'. The US economy is recovering, with a strong June quarter following the March quarter contraction. Inflation is still low but rising, unemployment is still falling, but Yellen still sees 'significant slack' in the labour market. Until there are more concrete signs of rate hikes, share prices remain relatively strong and calm. But bond prices have fallen over the past month (as foreshadowed in last month's report) and yields have risen in anticipation of future rate hikes. So has the US dollar, which has had its strongest month since its surge in May 2013 when then Fed Chair Ben Bernanke kicked off the whole 'QE taper scare'. So far, exports have been strong despite the higher dollar.	Below average growth rate	Recovery gaining pace	 current speed
Asia	In China the economy continues to slow as the largest sector, construction, is hit by falling prices and property developer credit stress. Declining prices are causing cautiousness in consumer spending. Fortunately the weaknesses in domestic sales and imports are being more than offset by increases in Chinese exports to the US and Europe, and manufacturing appears to be picking up. President Xi Jinping is proving to be a strong and popular leader, and he appears to be serious about favouring major reforms instead of knee-jerk stimulus injections to bolster growth, which was how the previous government kept growth and jobs on track. This new reform-over-stimulus stance was echoed in a speech by China's finance minister, Lou Jiwei on the 22nd. While that may be good for China in the medium to long term, it leaves the economy and commodities prices vulnerable to sharp declines in construction and manufacturing activity in the short term. On the 17th and 18th the central bank took big steps to ease monetary policy following the 3rd quarter slowdown, by injecting liquidity and cutting interest rates to try to stimulate bank lending. September also saw the float of Chinese e-commerce giant Alibaba, raising a world record $25b from the public. The 38% share price surge on its first day instantly made Alibaba more valuable than eBay and Amazon combined, and it became one of the dozen largest listed companies in the world. It is profitable and is still growing rapidly, with Chinese e-commerce penetration rates still quite low. (In contrast, Amazon pioneered the e-commerce industry 20 years ago but has never figured out how to make any money from it)	China: Cyclical slowdown Japan: Early recovery	China: Lower structural growth trend Japan: Stimulus improving exports, production & growth	 current speed  current speed

ASSET CLASSES

	Asset class	Commentary	Current position	Long term returns (1)
Shares	Australian shares	Australian shares were sold off more than most other markets during the month. The local market was down 6% in September, its worst month since May 2012. That was at the height of the European sovereign debt crisis with the Greek election fiasco and fears of a break-up of the Euro system. All sectors were down in September. The best sectors this year have been Utilities and Healthcare, while mining is down the most, driven by falling commodities prices. All the big stocks in the market were down for the month (except QBE & CSL, both in our portfolios). Iron ore miner Fortescue (not in our portfolios) was down another 16% as the iron ore price slid further. We have been over-weight Australian shares in portfolios since early 2012, near the start of the current 2012-14 rally. While portfolios benefited from being over-weight during the rally, outlooks have steadily deteriorated and the big gains are probably behind us. On several measures the market is still not over-priced.	Around fair value	Around average long run returns
Shares	Developed markets shares	Global stock markets were flat overall in September, but currency gains with the falling AUD turned this into a 3% gain for the month, and a respectable 6% for the year to date. The US market was flat for the month. Best were the big banks, despite the rate rise fears. On the other hand oil & gas stocks dragged the market back, as oil prices fell even as war in the Middle East hotted up. Apple ended flat after the launch of iPhone 6 and Apple Watch, but Facebook was strong. Among other developed world markets the star was Japan (+5%) despite its economy contracting sharply. Best for 2014 to date has been Denmark (+24%) as its economy also hit a wall. 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 down a little on average for the month. The best markets were the countries going through economic and political crises. Argentina was the star again – up another 28% for the month (133% for the year so far) after its default on government bonds it originally defaulted on back in 2001. It has also recently legislated to confiscate private assets. At the other end of the scale Russia lost another 11% (down 22% year to date) as sanctions bit hard and capital continued to take flight on fears the Kremlin might confiscate assets of foreigners. Chinese markets had a good month (up 7%) despite the economic slowdown, collapsing property market, escalating corporate defaults and higher exchange rate, and it looks like they are finally heading for their first good year since 2009.	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	Australian yields were up sharply across all maturities in September, breaking their steady slide over the eight months since the start of January this year. One factor was the rising impetus for a local rate rise to kill of the so-called housing "boom", but the main factor has been the global sell-off with the Fed talking up the prospects of rate cash hikes from early next year. We have been under-weight domestic bonds in portfolios as we have expected yields and credit spreads to expand over the medium term from current unsustainable levels. At the floating end, it is good to see prices fall in September as credit spreads expanded to more sustainable levels. We have been out of the hybrids market this year because prices have been too high and credit spreads too tight for the risk involved.	Yields below (prices above) long run average level	Below average long run returns
Fixed Income	Bank Term Deposits	Bank TD rates have kept falling due to the declines in the underlying yield curve, but also because banks have been able to get cheaper money from 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-III' banking reforms.	Rates below long run average	Below average long run returns
Fixed Income	Global Bonds	Yields rose as bonds sold off across the world (but not as much as for Australian bonds) during the month as the Fed confirmed the end of the 'QE' bond-buying program in October and geared up for rate hikes next year. Portugal was the exception, where yields continued to recede following the €5 billion rescue of Banco Espirito Santo in August. We hold small allocations to global bonds in portfolios but we remain underweight, given the rising inflationary outlook in the US. They are providing modest returns (up more than 7% so far in 2014), 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 has been at a record low 2.5% since August last year. One year treasury bills had also been flat at 2.5% for several months but rose steadily over the past month, indicating market expectations of local rate rises in 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. It will probably only raise rates if it fails to bring down house prices via direct rationing of bank lending.	Cash rates below long run average level	Variable, rising over medium term
Real Estate	Australian commercial property	The listed property market fell in 5% in September. Westfield and GPT (both in our portfolios) held up well but the rest were down 5-10% each. Foreign speculators were responsible for much of this year's rise and they are the first to race for the exits when the falling AUD upsets the 'carry trade' game of musical chairs. Even after the fall in September the listed market has returned a solid 14% for the 2014 year so far. We were over-weight during the big 30%+ in rally in 2012 in the listed market, but we now are a little under-weight in portfolios as they are still fundamentally over-priced. The unlisted commercial property market is also over-priced and largely driven by yield-chasing foreign investors.	Over-valued on long run measures	Around average to below average long run returns
Real Estate	Australian residential property	Refer to the lead story on page 1.	Varies by market and by property	Varies by market and by property
Australian dollar (AUD)		The AUD fell heavily during the month as the 'carry trade' quickly unwound and foreign speculators fled back to US dollars. The AUD was sold off more than almost every other developed and emerging market currency, just like it was in the May-June 2013 'QE taper' scare and also in the 2008-9 global financial crisis. We have been un-hedged in our global equities portfolios over the past couple of years, benefiting investors from the AUD's decline. Even after the recent slide, the AUD is still 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