PHILO CAPITAL ADVISERS

PHILO MARKET MONITOR

End October 2014

US 'QE': FACT -V- FICTION (THEORY & LOGIC)

	Impact of QE on markets	
	What was ***SUPPOSED*** to happen (fiction / theory / logic)	What ***DID*** happen (FACT)
Inflation	**Higher**	☒ **Lower**
Gold	**Higher** (inflation hedge)	☒ **Lower**
Bond yields	**Higher yields** (inflation fears)	☒ **Lower yields**
US Dollar	**Lower** (inflation, credit downgrade, gov shutdown)	☒ **Stronger**
Shares	**Lower** (inflation/interest rate fears)	☒ **Higher**
Lending	**High** credit growth	☒ **Lower** credit growth
Commodities	**Higher** (inflation hedge)	☒ **Lower**
Oil	**Higher** (middle east, inflation hedge)	☒ **Lower**
Volatility	**Higher** (un-tested policy)	☒ **Lower**

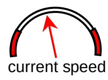
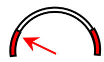
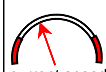
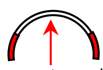
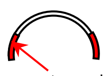
October 2014 marks the end of the US Federal Reserve's monetary policy it called "quantitative easing" (QE) but the rest of us called plain old "money-printing". The Fed's aim was to create inflation by buying assets with newly printed money (instead of paying for them with cash raised by selling securities into the market), and crediting commercial banks' reserve accounts in the hope that banks would increase lending to borrowers to invest and spend. A second aim was to depress the US dollar to help exporters (the theory being that money printing should devalue the currency because more money is chasing the same supply of assets).

There was much doom & gloom and even panic in the financial media, about what QE might mean for markets. The resultant inflation or even hyper-inflation was supposed to be bad for share prices and bond prices, while the prices of inflation hedges like gold, oil and metals should soar. All this was supported by logic, theory, conventional 'wisdom' and the weight of opinion.

As it turns out virtually all of the outcomes predicted by theory, logic and the shrill financial media were wrong. Driven by QE, markets did the opposite of what the conventional wisdom and weight of opinion expected. Prices of shares and bonds soared, the US dollar strengthened, and inflation and inflation hedges (gold, oil, metals) all fell.

But US QE was not a failure. It prevented deflation, which is far more debilitating than inflation. It also provided enough stimulus to bring unemployment down from 10% to 6%. These benign outcomes inspired central banks in UK, Japan and now Europe to take similar action.

MAJOR MARKETS

		Current position	Direction / Trend	Pace of growth
Australia	The local inflation rate fell from 3.0% to 2.3% pa, taking some pressure off the RBA to raise interest rates. The target cash rate remains at 2.5%, but short term treasury bills (up to 1 year) moved back below the cash rate as the market factored in the global slowdown trickling down under to slower growth and possibly lower interest rates here. China slapped a surprise tariff on coal imports to help its local miners in the face of the continuing slide in coal prices. Coal prices have fallen another 25% this year, and are now just one third of their price at the top of the mining boom. Iron ore prices are also down 40% this year.	Below average growth rate	Growth slowing	
Europe	October saw more torturously slow progress in Europe toward US-style money printing. The trigger for the latest baby step was the stalling of Germany, the so-called 'engine of Europe'. Chancellor Angela Merkel stood her ground and vowed to resist all calls for stimulus spending to boost growth. Out of frustration from having to do all the heavy lifting in the face of German fiscal conservatism, the ECB on 21st October started talking up the prospect of buying corporate bonds in the secondary market – to reduce interest rates, to encourage borrowing & investing. European shares had fallen further than most in the September-October sell-off – down 12%, compared to 7% for US shares – but they recovered partially by month-end. Europe has yet to acknowledge and clean up its banking system, something the US did immediately after Lehman. Previous attempts to investigate the strength of bank balance sheets merely papered over problems, but 25 major banks failed the ECB's latest 'stress test', and needed $25b more in capital. This probably vastly under-states the true problem, but the truth would probably be too scary and would ignite a wave of bank runs across Europe, not just in the PIIGS. As a sign of the times, VW had to recall more than a million cars in October due to faulty suspension. The wheels have fallen off Europe and it is in for a bumpy ride.	Still virtually Stagnant	Growth stalled	
US	The dominant issue affecting global financial markets over the past 18 months has been the US "QE taper" - kicked off by the then Federal Reserve Chairman Ben Bernanke's first statements in May 2013 about possible tapering of the Fed's $85b per month bond-buying program. The much heralded and much feared QE taper began in January this year and ended in October. Despite all the scare-mongering in the chattering financial media and the usual doomsayers throughout the period, financial asset markets have boomed – shares, bonds, property and credit. With the end of US QE, the dominant theme driving US and global markets has now become speculation over the timing and pace of US interest rate hikes. US Inflation is down to 1.7%, and core inflation (which excludes food and energy prices) is also down to 1.7%, which takes a bit of the pressure off the Fed to raise interest rates in a hurry. Retail sales declined and producer prices also fell. This trend is being echoed by companies like Walmart cutting revenue outlooks. On the other hand house prices and sales volumes are rising again after a pause caused by rising bond yields in 2013. To further stimulate home lending the government has boosted measures to encourage risky lending to borrowers who can't afford it. Like Australia and many other countries, regulators in the US are taking more hands-on control of bank lending to try to prevent future bubbles/busts, and also to help first home buyers who are being forced out of the market. The SEC and Fed adopted a "risk retention" rule that banks need to retain 5% of securitised loans. They can no longer offload 100% of the risk, so maybe they might start showing some vague interest in finding out if the borrower can actually afford to repay the loan!	Below average growth rate	Recovery gaining pace	
Asia	In China and Japan, as in Europe, the twin themes were slowing economies and more stimulus. China's economic growth rate slowed to 7.3% per year, lower than the official target of 7.5%. Exports and domestic consumption were stronger but housing construction, the largest sector, was weaker. Housing prices and sales volumes continue to slide. The central bank relaxed mortgage restrictions to try to stimulate borrowing & buying, but this will take time to take effect. The pro-democracy riots in Hong Kong appear to be contained to a dull roar so far, and have yet to trigger an increase in riots and unrest on the mainland. In Japan the main development affecting markets was the Bank of Japan's surprise announcement on 31st October to step up its asset-buying stimulus program – increasing its annual target for monetary base expansion to 80 trillion yen per year, and tripling its purchases of exchange traded funds and property trusts. This was in response to the slowing economy and the government's slowness in implementing economic reforms. The new measures should keep the Yen low and, along with the ECB's asset-buying programs, support global asset prices as the US tightens monetary policy in the coming year.	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	The local stock market was up 4% in October, recovering most of the September sell-off. Mining and energy stocks were lower but the market was dragged up by stocks benefiting from the lower dollar via high exposures to foreign revenues, like Orica, CSL, Sonic Healthcare, and Incitec. Banks were also stronger in the face of talk of higher capital requirements touted by APRA. The broad Australian market has now returned 7% so far in 2014, after returns of 20% in both 2012 and 2013. We have been over-weight Australian shares in portfolios since early 2012, near the start of the current 2012-14 QE rally. Return outlooks have steadily deteriorated this year, the big gains are probably behind us so we have recently reduced weightings in portfolios.	Around fair value	Around average long run returns
	Developed markets shares	Global stock markets fell in the first half of October due to renewed fears over global growth. The US is still relatively weak, Europe is stagnant and the China slowdown is accelerating. But share prices recovered by month-end spurred by strong earnings growth. The US led the way while European markets lagged. Global markets are now ahead 8% for the year to date, following 25% in 2013 and 16% in 2012. We have been over-weight global 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, return outlooks have steadily deteriorated and so we have recently reduced weightings in portfolios.	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	‘Emerging’ markets ended the month more or less flat after declines early on and recoveries at month-end. Chinese markets held up in the face of rising concerns over the property development market with accelerating housing price declines and more property developers under debt stress. The Chinese stock market finally looks like having its first good year since 2009 despite this year having the slowest economic growth rate since 1990. Brazilian shares were very volatile as Dilma Rousseff won a second term on the back of promises of more unaffordable spending measures. She spent her first term as President unwinding two decades of positive reforms under former leaders Cardoso and Lula Da Silva, but she is probably lower risk for investors than the alternative candidates.	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 bond yields resumed this year’s downward trend after the mid-September sell-off. Foreign investors returned as their nerves were calmed a little when the Australian dollar stabilised following its sell-off last month. October saw some unusual volatility in the local bond market, echoing the “flash crash” on global bond markets (see below). Local credit spreads also shot up in the second week of October with the bond flash crash, but tightened somewhat by month end. However, credit spreads remain too fine overall, and corporate issues remain over-priced for risk generally in the global search for yield. 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 unsustainably low levels.	Yields below (prices above) long run average level	Below average long run returns
	Bank Term Deposits	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 as global credit markets remain benign. 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 may be modified or restricted with new bank liquidity regulations flowing from the ‘Basel-III’ banking reforms.	Rates below long run average	Below average long run returns
	Global Bonds	Bond yields fell around the world by as much as they fell in August. US yields are now back down to levels last seen in the QE taper scare in May-June 2013. Bond prices have been supported by money printing and asset buying in Japan and now Europe as US QE comes to an end. The US Fed looks like raising rates sooner rather than later and this would slow future inflation and interest rates, keeping long bond yields low. There was a mini “flash crash” in bond markets mid-month. Instead of panic *selling* as there was in the 6th May 2010 “flash crash” in US shares, in the bond flash crash there was a rush of panic *buying* for an hour or so before reversing. The other unusual feature in bond markets in October was the fallout from the flood of money pulled out of the world’s largest bond fund manager PIMCO following the sudden exit in late September of its founder Bill Gross amidst investigations into pricing irregularities in PIMCO funds. Despite these events, the bond market has generated remarkably smooth returns of 8% so far this year – similar to the returns in 2011 and 2012.	Yields below long run average level	Below average long run returns (2)
Cash	Australian target cash rate	The RBA’s target cash rate remains at a record low 2.5%, where it has been since August of last year. Short interest rates receded during the month after September’s gains, due to lower global growth outlooks and lower local inflation, meaning local rate hikes are less likely in the coming months. For what it is worth, Treasurer Hockey claimed that interest rate cuts have little effect in stimulating economic growth as they just make the rich richer. Local rate cuts are unlikely anyway in the absence of a global economic catastrophe. Bank bill spreads above treasuries rose to their highest levels since 2012 reflecting increased bank risk in the wake of the European bank stress tests together with talk of tighter bank regulation and higher capital requirements for Australian banks.	Cash rates below long run average level	Variable, rising over medium term
Real Estate	Australian commercial property	The listed property market returned 6% for the month, more than making up for the September decline. All major trusts were up across the board. The market has returned 21% for the year to date, driven mainly by the ‘risk-on’ global carry trade by foreign investors who appear to favour listed property over shares as they do not receive the benefit of franking credits available to local investors. 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
	Australian residential property	House price rises now appear to be slowing, possibly due to the Reserve Bank’s numerous warnings and veiled threats to get more involved in directly controlling lending because it is reluctant to raise interest rates. Buyers are also watching top end prices fall in London with the UK government’s threatened ‘mansion tax’ to capitalise on the flood of foreign money into London housing.	Varies by market and by property	Varies by market and by property
Australian dollar (AUD)		After the sell-off in September, the AUD stabilised and gained a little in October, particularly against the weaker Yen and Euro. The US Dollar strengthened for a 4th month, especially toward month-end as US shares rallied strongly. 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 September 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) (1) Expected “long term” returns refers to periods of 10+ years (looking through economic cycles) starting from the current position

(2) (2) Returns for non-Australian assets are in AUD terms – ie including any profits/losses from hedging or currency movements