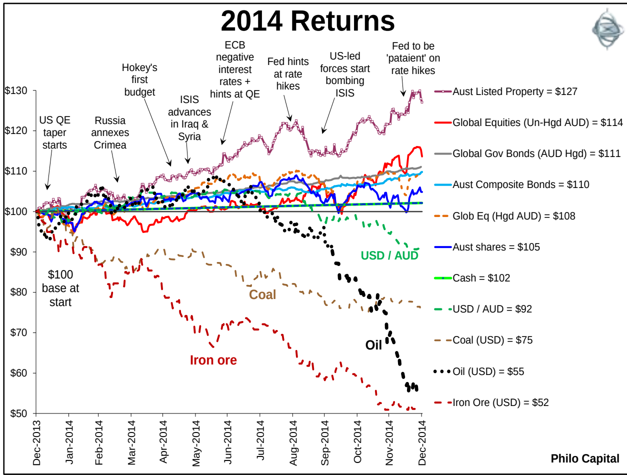
# Philo Capital Advisers

# Philo Market Monitor

End December 2014

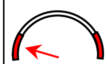
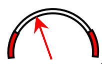
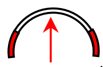



## Another Good Year for Investors

Slowing economies, recessions, war in the Middle East, fears of deflation in Europe and of rate hikes in the US, did not prevent 2014 from being another good year for investors. All the major asset classes generated positive returns and beat inflation and cash, like in 2012 and 2013. Prices of housing and direct commercial properties were also stronger this year, driven by cheap debt and foreign buying.

Shares had a good year globally, driven by low interest rates and cost-cutting. Bonds also did well globally, with yields falling across the board in almost all countries as investors chased yield in a low-yield world as a result of record low interest rates, money-printing and asset-buying by central banks.

The lower part of the chart tells a different story: commodities prices collapsed mainly due to over-supply. This hit share prices in Australia's over-weight mining sector, and it also battered tax revenues, sending the government budget into another huge deficit, adversely affecting consumer & business confidence and spending. Falling prices are also causing mines to be closed and new resource projects to be delayed, scaled back or abandoned.

| Major Markets | | Current position | Direction / Trend | Pace of growth |
|---|---|---|---|---|
| Australia | The main factor affecting the Australian economy and investment markets in 2014 was the collapse in commodities prices – including Australia's main exports (iron ore and coal), oil and most industrial metals. The problem is not the slowdown in China – Chinese import volumes are still quite strong. The problem is over-production by Australian and other global miners during the mining investment boom that peaked in 2011-12. The gap left by declining mining investment is being filled only partially by housing construction, mainly in Sydney. Regulators are now trying to stop the housing boom as house prices are still among the highest in the world and still rising, and there is a speculative bubble in investment units. The commodities price collapse has hit tax revenues and the Federal Budget has blown out by $20b to a $40b deficit, with some $28b of cuts stuck in the Senate now controlled by minor parties and independents with changing allegiances. In the December budget update the Treasurer announced that 175 government agencies are to be scrapped – which makes one wonder just how many hundreds of government departments and agencies there are! With the economy now being propped up mainly by government deficit spending, unemployment is now at its highest level in 12 years and still rising. The jobs market is likely to weaken even further if commodities prices continue to fall and if business confidence, lending and investment remain weak. | Below average growth rate | Growth slowing |  current speed |
| Europe | In Europe, the UK recovered well in 2014 but the Eurozone stagnated, especially in the big three – Germany, France and Italy. Unemployment rates had been falling during 2013 but have stalled at around 11.5% across the Eurozone. Jobs growth is strong in Greece, Spain, Portugal and Ireland, but unemployment is on the rise again in Italy and France. Germany has been slowed by austerity measures, and its dogmatic refusal to use fiscal stimulus (deficit spending). France and Italy are slipping behind on their targets under the EU's "Stability and Growth Pact" to cut structural deficits by 0.5% per year until their budgets balance. 2015 will probably see the pendulum swing back again from German-led austerity toward stimulus spending championed by the IMF and ECB. The ECB has been slow to pull out all stops and start full-blown 'QE' as its hands are still tied by the Germans. The trigger for the next crisis will probably once again be Greece, which has missed bail-out conditions and targets. In December, Greek PM Samaras was forced to call an election for January after the Parliament failed 3 times to elect a President. The election may see the rise of the anti-austerity, anti-Euro Syriza party, which will probably get investors worrying once again about a possible break-up of the Euro or at least a Greek exit – the wonderfully named "Grexit". | Still virtually Stagnant | Growth stalled |  current speed |
| US | The US economy is improving steadily but it is still in intensive care. In 2014 one of the life-support machines was turned off – 'Quantitative Easing", which is a fancy name for central bank buying of assets with newly printed money in the hope of creating inflation and depressing the currency. 'QE' achieved neither of these aims – inflation rates fell and the US dollar surged - but it did prevent deflation. A second life-support machine – trillion dollar budget deficits – is also being scaled back as tax revenues grow and welfare costs recede as the unemployment rate falls. In 2015 a third life-support machine will be turned off – zero interest rates, and this is what is keeping investors awake at night. After much speculation and hinting, the Federal Reserve in December finally withdrew its promise to keep interest rates near zero 'for a considerable time', and replaced it with a statement that it will be 'patient' with rate hikes. The timing and pace of US rate hikes will probably be the dominant factor affecting global investment markets in 2015. | Below average growth rate | Recovery gaining pace |  current speed |
| Asia | For China 2014 was a year of slowing growth, falling housing prices but soaring share prices. The Chinese economy is heading for its slowest growth rate in 20 years, due to the continued decline of its dominant industry - housing construction - as a result of supply vastly outstripping demand. Falling prices have sent numerous property developers to the wall, threatening the opaque banking system. With consumer price inflation down to near 1% (the lowest in 5 years) and wholesale prices still falling for the past three years, the Chinese government has now joined the other big global economies in trying to use monetary policy, fiscal policy and a raft of reforms to try to stimulate lending, spending and growth. The biggest growth industry is now empty apartments - there are now around 4 million and growing by 30% per year. The government has had to become the 'buyer of last resort' - buying up empty apartment blocks from developers to use as social housing, hoping to stabilise prices and to prevent developer bankruptcies.<br>In Japan the economy slid back into recession in 2014 following the ill-fated sales tax hike in April which slowed demand and spending. The 'Abenomics' spending spree has certainly boosted asset prices but, as in Europe, has done little to generate growth in lending, investment, spending or jobs. Prime Minister Shinzo Abe won a snap election in December, effectively renewing his mandate for radical change – especially the '3rd arrow' of the plan, structural reform. Structural reforms, while necessary, will be slow to take effect. | China: Cyclical slowdown<br>Japan: Back in recession | China: Lower structural growth trend<br>Japan: Growth stalled |  current speed<br> current speed |

## Asset Classes

| | Asset class | Commentary | Current position | Long term returns (1) |
|---|---|---|---|---|
| Shares | Australian shares | The local stock market had a strong last couple of weeks but ended up just 1% for the year, or 5% including dividends. Price declines in bulk commodities and most metals sent most mining share prices down for the year. Bucking this trend was a rally in the gold sector. While the USD gold price was flat for the year, the falling Aussie dollar boosted returns. The strongest performing companies were those benefiting from the falling AUD – including healthcare stocks Cochlear, CSL and Sonic, and other global players like Incitec. The banking sector was held back by fears over the housing boom, and the possible impacts of tightening global and local banking rules. We have been over-weight Australian shares since early 2012, near the start of the great 2012-14 'QE' asset boom. | Around fair value | Around average long run returns |
| Shares | Developed markets shares | Global shares ended up a solid 9% for the year in spite of slow economies in the US, stagnation in Europe and Japan, and slowdowns in the BRICS. Nearly all developed markets were up for the year, with the US, NZ, Denmark, Sweden, Belgium and Swiss markets posting double digit gains. Australia, with its so-called 'miracle economy', was near bottom of the pack. Despite stagnant growth, war in the Middle East and fear of deflation in Europe, we were over-weight global shares all year and it paid off. We were also un-hedged on the currency, which added 4%, bringing returns to 14% for the year. | 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 market shares also had a reasonably good year (up 5% in local currencies, and up 7% in unhedged AUD terms) even though all the big markets suffered slowdowns, stagnation or recession. Chinese stocks surged 50%, their best since the GFC despite the Chinese economy slowing to the lowest growth rate in 20 years. The surge in Chinese share prices was driven mainly by speculators switching out of property as property prices collapsed (after having switched from shares to property when the stock market collapsed by 70% in 2008-9). Also contributing to China's surge were monetary easings and freeing up of margin lending rules. Aside from Hong Kong, Korea and Taiwan, most other Asian markets were up by double digits. Argentina was also up 60% with its default on its restructured government bonds. At the other extreme, the Russian market fell 45% as the Russian economy and Rouble collapsed due to the halving of the oil price and sanctions over Ukraine. | 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 | November and December saw a frenzy of buying in the local bond market, sending yields lower across all maturities. It was led by Japanese and Europeans buyers facing record low yields in their home markets due to economic stagnation and central bank bond buying. Long yields are now nearly as low as they were at their bottom in July 2012. As a result the composite bond index returned 10% for the year (including interest) – beating the local stock market for the first time since 2011 and 2010. The best sector was inflation linked bonds (up 14% for the year) as investors bid up prices in expectation of higher inflation ahead. We are under-weight domestic bonds in portfolios as we expect 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 |
| Fixed Income | Bank Term Deposits | TD rates fell all year with the declines in the underlying yield curve, and also because banks have been borrowing more cheaply from foreign debt markets once again. We have significant holdings of 'breakable' TDs in most portfolios, but these will be modified in the new year with new bank liquidity regulations for the 'Basel-III' banking reforms. | Rates below long run average | Below average long run returns |
| Fixed Income | Global Bonds | The global government bond index (hedged in Australian dollars) has been up every month this year, something that has not happened since 2000. The sovereign bond market produced total returns of 11% for the year in hedged AUD, similar to 2011 and 2008. Sovereign yields were down across the board except in Greece as it heads towards another likely default/restructure. European yields are down to record low levels and still falling. In Japan 10 year yields are down to 0.3% and 20 year yields down to just 1%, meaning the market is expecting economic stagnation to continue for decades. In contrast the US yield curve took a dramatic clockwise twist – jumping at the short end in anticipation of cash rate hikes soon, while yields fell back a little at the long end, reflecting fears that rate hikes will slow the recovery. We hold global government bonds in portfolios because of their smooth moderate returns in this type of environment. In contrast junk bonds sold off during the year, triggered by the oil price collapse, but we hold none in portfolios. | Yields below long run average level | Below average long run returns (2) |
| Cash | Australian target cash rate | The RBA's target cash rate has been at a record low 2.5% since August of last year. The central bank would like to lower rates further to bring down the dollar but that would be inflationary and would pour further fuel on the speculative housing boom already underway. The RBA is only likely to cut rates if inflation falls and if housing prices stop rising and/or start to fall, but that usually only occurs after a number of rate hikes. Bank bill yields were hovering around the treasury yield curve all year but shot up suddenly from mid-September on talk of credit rationing by regulators to kill off the housing boom. We hold minimal cash in portfolios and every other asset class generated higher returns this year. | Cash rates below long run average level | Variable, rising over medium term |
| Real Estate | Australian commercial property | Listed property trusts had a strong December – led by Westfield, capping off a strong year in which the listed property sector beat shares. The listed property index returned 27% including distributions (similar to 2012), compared to 5% for the broad equities market. For our portfolios we continue to favour listed property over unlisted property, and returns from the listed market have been more than double the returns from unlisted. We were over-weight listed property during the big 30%+ rally in 2012, but we now are a little under-weight in portfolios as they are still fundamentally over-priced. In the underlying direct commercial property market strong transaction volumes have been boosting prices and compressing yields to unrealistically low levels, driven primarily by foreign investors. | Over-valued on long run measures | Around average to below average long run returns |
| Real Estate | Australian residential property | After much anticipation and verbal warnings the bank regulator finally announced rules intended to restrict bank interest-only loans and investment property loans to stem the speculative boom in investment units, but they are unlikely to have much impact on the broader housing market. It usually takes high unemployment and/or a series of interest rate hikes to bring prices down after a boom. As rate hikes are probably a long way off yet, we may see more lending controls in 2015. | Varies by market and by property | Varies by market and by property |
| Australian dollar (AUD) | | In 2014 the AUD fell against the US dollar and most Asian currencies but it rose against the Euro and Yen which were weakened by central bank asset buying and money printing. The exchange rate story for the year 2014 has been the surging the US dollar against everything else, especially its 12% rise since June. 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
(2) Returns for non-Australian assets are in AUD terms – ie including any profits/losses from hedging or currency movements

**Produced by Philo Capital Advisers P/L AFSL 301808**

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