

Market Commentary

February 2014

In our strategy paper published last month we outlined our asset allocation as a slight overweight equities while underweighting the US and overweighting Europe and the emerging markets. Our bond exposure was underweight and we preferred emerging market bonds over high yield bonds. We also preferred Norwegian Kroner bonds over those of similar duration in Euros. Gold positions were maintained in all client accounts and were more positive on the commodity complex than the consensus. We had used most of the cash from the underweight bond position to invest in gold and maintained a minor cash holding.

Bonds

As the graph below shows, global bonds, high yield and emerging market bonds have produced about the same return year-to-date. However, there has been a change in the trend more recently. Emerging market bonds have performed a lot better over the past month as outflows have subsided and institutional investors with longer holding periods have started to show interest in the sub-asset class.

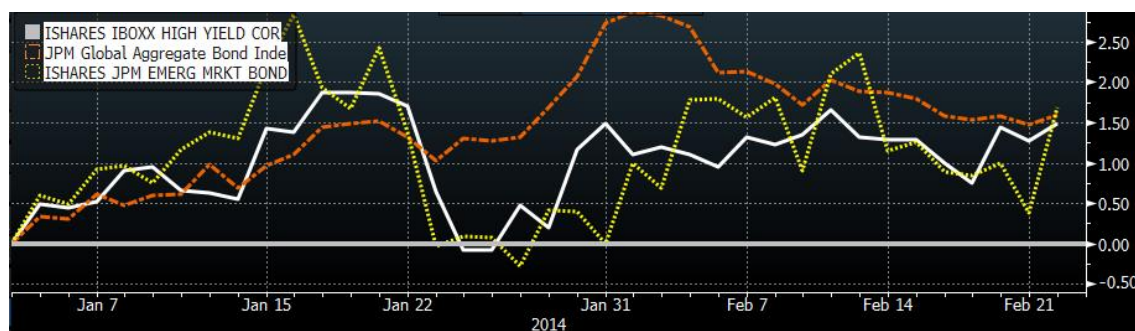


Fig1. Year-to-date performance of Global (orange), High yield(white) and Emerging market(yellow) bonds. Source: Bloomberg

Investment grade corporate bonds in Norwegian Kroner (NOK) with a remaining life of 2 years are yielding 2% as opposed to less than 1% for similar bonds in Euro (EUR) and about 1.25% for High yield bonds of similar duration in EUR. After the NOK fell over 10% versus the EUR and the Swiss Franc (CHF) last year, we expressed our preference for NOK denominated bonds of similar duration and quality to their EUR counterparts. This year the NOK has advanced 0.5% versus the CHF and 1% versus the EUR further enhancing the total return. Even without additional NOK appreciation the extra yield for the same duration and quality looks attractive as the fundamentals underpinning the NOK are far stronger than those related

Real GDP	1.1	.5
CPI	2.3	.8
Unemploy	3.0	12.0
Curr Acc Bal	11.9	2.2
Budget Bal	11.3	-3.4
3-Month Rate	1.70	.29
Bond Yield	2.89	1.69

to the EUR as can be seen from the tables to the left – Norway column 1, EU column 2. Additionally we are expecting some EUR weakening policies from Mr Draghi which will be aimed at supporting competitiveness and therefore growth while attacking any deflationary tendencies in the region as well. The EUR has been supported over the past couple of quarters as many European banks

repatriated capital to their European head quarters in order to comply with the ratios necessary to pass the upcoming stress tests. This tailwind should also subside in 2014.

Equities

So far this year Europe has been the strongest performing region as we were expecting. However, though many investors shared this view, we have noticed in recent surveys that portfolios are still positioned overweight the US which would imply that any further positive news or gains in Europe could result in substantial rotation into European equities. In fact European equities only started their outperformance

FINMA Authorized
Asset Managers

Seefeldstr. 301
8008 Zurich
Switzerland
T +41 43 497 2688
F +41 43 497 2686
E info@labha.com

very recently (Fig 2., orange line) as economic numbers from the US were less positive and those out of Europe more positive than consensus expectations.

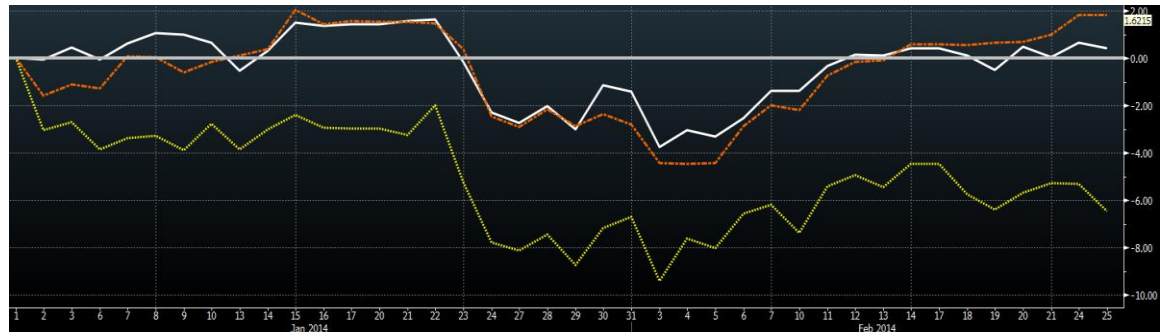


Fig 2. Year-to-date performance of European (orange), US (white) and Emerging market (yellow) equities. Source: Bloomberg

Even though emerging market equities have underperformed this year, outflows have subsided and we have noticed more comments in the media about the valuation spreads versus developed markets being very substantial. The key to these markets stabilising and rallying from current levels lies with China. Recent news has been mixed. PMI numbers have been weaker than expected, though this may be attributed to the turbulence in the Chinese debt markets of the past two months. However, these numbers combined with more recent events like the weakening of the RMB and a more subdued real estate market (18% of GDP) are causing investors to worry about the ability of the government to deliver on their growth targets. As a result Chinese Equities which had staged a solid rally recently have given back approximately half their gains. The economic numbers published and policy moves over the next couple of months will therefore be crucial to determining the position taken by investors on the course for emerging markets this year. We find the weakening in the RMB to be an attempt to support growth and fight speculation and it is timely as inflation is under control. Repo rates have dropped in the past week after shooting up earlier this year and are now in line with the three year averages. Liquidity conditions in the real economy have also eased. We have noticed a definite improvement in the sentiment of CEOs of large developed market conglomerates selling into China and emerging markets over the past quarter and believe that if there is no further turbulence in the debt markets; growth should remain on track and may even exceed expectations in the second quarter. The National People's Congress starting on the 5th of March could also positively impact sentiment if reforms that support business and employment while focusing public spending on the most needed and effective investments are implemented.

European Macro data has been steadily improving over the past two to three quarters but this usually takes a while to feed through to company earnings. This is evident from the current earnings season in which company reports show that in most sectors sales have continued to fall. The weakest revenues since 2009 are being blamed on the strength of the Euro, emerging market turbulence and sluggish growth globally. Profits on the other hand have managed to rise due to cost cutting efforts across the board. Even though these adjustments have resulted in an improvement in profit margins, operating margins are below their 10 year average. It is our opinion that the trough has probably been reached and that improvements in margins followed by revenues lie ahead. This process would be given considerable momentum if the ECB policies result in a weaker Euro.

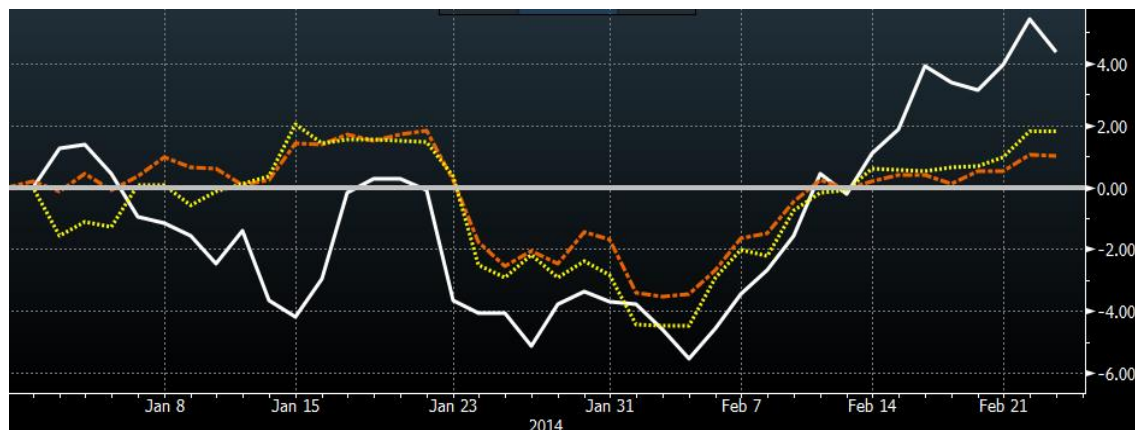
In the US after 5 years of deleveraging, Americans are starting to borrow again. Companies on the other hand are still focused on cost cutting and M&A to boost earnings. EPS have risen 118% since 2008 due to cost cutting and share buybacks while revenue rose just 7%. Capacity utilisation is close to 80% in the US. This level usually coincides with an increase in capital expenditure and as US infrastructure is in dire need of an upgrade, we should see some moves in this direction soon both from the government and companies.

Commodities

As mentioned earlier we were more positive than the consensus on commodities and gold at the start of 2014. So far our position has paid off. Gold is up over 10% and so is the broad commodity index CRB. We have participated in this move with holdings in gold and gold miners as well as BHP Billiton and other mining companies. We were of the opinion that too much pessimism was priced into mining shares and that they had substantial capacity to implement self-help measures which would be very investor friendly.

In fact, BHP Billiton and Rio Tinto posted earnings that grew over 30% in the second half of last year. They have both announced an approximately 40% reduction in capital expenditure and an increase in efficiency which should boost shareholder returns. Both companies are expected to grow earnings by about 10% this year and next and return substantial amounts of cash to shareholders through dividends and share buy backs. Even relatively slow growth from China and other emerging markets would still lead to growing demand for commodities, as Europe continues to strengthen and the US continues to improve, total volumes should get a boost. Additionally, Chinese concerns about pollution are leading them to emphasise the use of higher grade iron ore for steel making and this would favour the Australian producers.

At the moment both stocks already have dividend yields of over 3% and are trading at about 10 times earnings. With earnings expected to grow 10% for the next two years and cash flows driving an increase in shareholder returns, these shares should re-rate. We purchased the shares when they were cheaper and yielding more than they are now, however, they should appreciate further even though near term consolidation cannot be ruled out after the recent strong rally.



Year-to-date performance Global equities (orange), European equities (yellow), BHP (white)

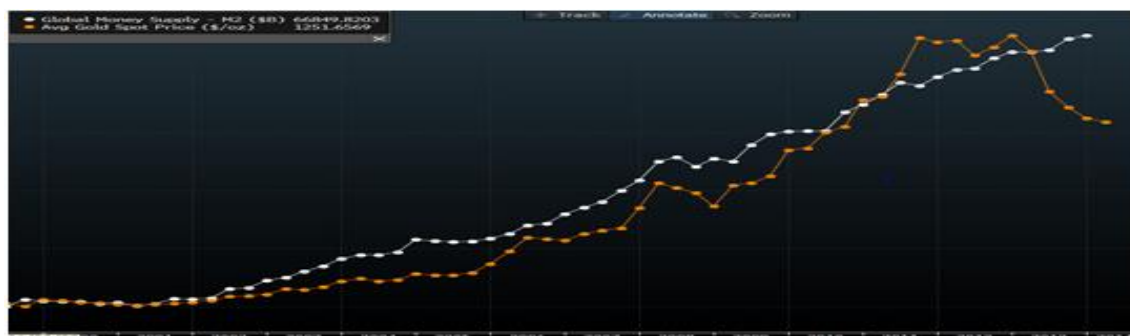
Source: Bloomberg

Gold

In 2013 Chinese and Indian investment in gold bars and coins was up 38% and 16%, respectively despite the restrictions imposed by the Indian government. Although much smaller markets in terms of volume, in the US, bar and coin demand was up 26% to 68 tonnes, and in Turkey it was up 113% to 102 tonnes, demonstrating solid support on a global basis. Global bar and coin demand was up 28% to 1,654 tonnes. Meanwhile demand for jewellery, increased by 29% from 519 tonnes to 669 tonnes in China, and by 11% from 552 tonnes to 613 tonnes in India, reaching 2,209 tonnes globally (+17%), the highest figure seen since the onset of the financial crisis in 2008. In 2013 the gold market saw 21% growth in demand over 2012 from consumers to 3,864 tonnes. This very positive development in the physical gold market was offset by outflows of 881 tonnes (three years of purchases) from ETFs. The net result was that global gold demand in 2013 was 15% lower than in 2012. However, this year there have been net inflows into ETFs

and physical demand remains strong. Worries about global growth as well as currency turmoil in emerging markets have also had a positive effect on the gold price.

The graph below plots global money supply versus the gold price since 1999. The two have been closely correlated from 1999 till 2012. The only major breakdown in the correlation occurred in 2013. We believe that just as there was an overshooting in 2011, there has been a large undershoot in 2013 and the relationship should normalise.



Global Money Supply (white) versus the gold price (orange)

Source: Bloomberg

General Thoughts

The G20 has emphasised its focus on growth, not austerity and said that it has no objection to Japan's easing program. The majority of managers surveyed are still overweight the US though it has underperformed Europe year-to-date. We therefore see more potential for outperformance in Europe.

For now due to the stagnation in revenues and the struggle with profit margins, many European companies especially those in the mining and oil sectors have announced reductions in capital expenditure with the aim to increase the efficiency and productivity of their assets and return cash to shareholders through higher dividends and buy backs. We have noticed that the announcements have attracted new money to these equities and they have been performing well relative to the rest of the market. Last year was a re-rating year based on reduced fear even though earnings and profit margins were lack lustre. We think that this year will be more rewarding for those companies which can show increased efficiency in the use of their capital and boost the return of cash to shareholders.

Gillian Hollenstein

Important Disclosures

This research report provides general information only. Neither the information nor any opinion expressed constitutes an offer or an invitation to make an offer, to buy or sell any securities or other financial instrument or any derivative related to such securities or instruments. This report is not intended to provide personal investment advice and it does not take into account the specific investment objectives, financial situation and the particular needs of any specific person. Investors should seek financial advice regarding the appropriateness of investing in financial instruments and implementing investment strategies discussed or recommended in this report and should understand that statements regarding future prospects may not be realized.

Any decision to purchase or subscribe for securities in any offering must be based solely on existing public information on such security or the information in the prospectus or other offering document issued in connection with such offering, and not on this report. Securities and other financial instruments discussed in this report, or recommended, involve numerous risks, including, among others, market risk, counterparty default risk and liquidity risk. No security, financial instrument or derivative is suitable for all investors. In some cases, securities and other financial instruments may be difficult to value or sell and reliable information about the value or risks related to the security or financial instrument may be difficult to obtain. Investors should note that income from such securities and other financial instruments, if any, may fluctuate and that price or value of such securities and instruments may rise or fall and, in some cases, investors may lose their entire principal investment. Past performance is not necessarily a guide to future performance. Foreign currency rates of exchange may adversely affect the value, price or income of any security or financial instrument mentioned in this report.

Copyright LABHA Investment Advisors SA, all rights reserved.