INVESTMENT ADVISORS SA

Market Commentary

May 2014

MARKET ANALYSIS

Since our last commentary at the end of the first quarter, global equity markets have been moving within a range of +/-2% but there has been a lot of movement in the regional, sector and individual stock level. Gold which had rallied 12% by mid- March gave back a third of its gains. Bonds and Equities have produced similar performance year-to-date, though Equities have been a lot more volatile. There were times in January and March when bonds performed a lot better than equities but the gap was closed within a couple of weeks. Equities have rallied 3.3% in CHF mostly due to the strength of the last few trading days. Bonds much to the surprise of most investors are up 3.8%. (Fig1). The setbacks in equities were either due to economic numbers from China and the US which did not live up to expectations or the turbulence in the Ukraine. The lower bond yields and the perception that risk is more prevalent now than in the second half of last year has led investors to seek equities with higher free cash flows and dividend yields. Predictability has become more important and therefore sectors and stocks that offer these characteristics have done well. We had been accumulating these equities last year when they were not in favour and are pleased with their performance.

Fig1. Year-to-date performance of Gold (yellow), Bonds (orange) and Equities (white). Source: Bloomberg

Bonds

We had mentioned in earlier reports that we favoured emerging market bonds issued in USD and EUR over high yield corporate bonds in Europe and the US as we felt they offered better risk adjusted returns. In our end of quarter report we noted that the outperformance of emerging market bonds was gaining momentum. As can be seen from the figure below April has been an excellent month for emerging market bonds bringing their total return year to date to 6.6% whereas global bonds and high yield bonds produced a total return of about 3.8% each (Fig2). The important point to note is that despite the higher risk and volatility associated with the high yield bonds, they have not performed better than the average global bond index. It appears that investors have taken note of the risk/return discrepancy we had mentioned in our earlier reports and have shown a preference for emerging market bonds over developed market high yield bonds.

Fig2. Year-to-date performance of High Yield (white), Global (orange) and Emerging market (yellow) bonds. Source: Bloomberg

We also indicated a preference for Norwegian Kroner, Australian and Canadian dollar bonds of the same duration over their Euro or Swiss counter parts. They offered a higher yield for the same maturity and the potential for currency appreciation as well. The Norwegian Kroner has risen about two and a half percent

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versus the Swiss Franc and the Euro this year and the Australian dollar has rallied more than 5%. The laggard till the end of March was the Canadian dollar which has since rallied 1.73%. We were expecting economic indicators from Canada to be supportive of the Canadian dollar and this has been the case so far. After the strong rally in the Australian dollar we have reduced positions and have preferred the other two currencies or the Swedish Kroner for bond purchases.

Equities

At the start of this year we were expecting European equities to perform better than their US counterparts and emerging markets to do better than most market participants were expecting. As can be seen from the graph below European equities have outperformed US equities by almost two percent on a total return basis. Emerging markets lagged badly till mid-March but have since staged a powerful rally, rising 13% in the last two months while the US rose by 5.5% and Europe 7.9%.

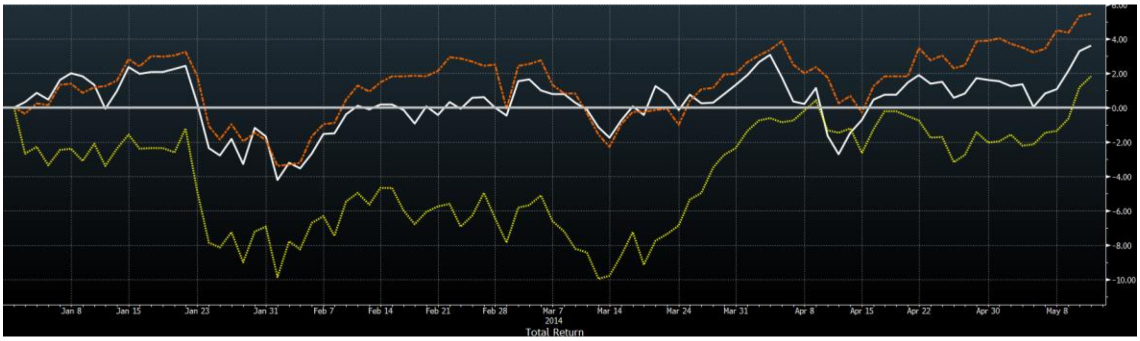

Fig3. Year-to-date performance of European (orange), US (white) and Emerging market (yellow) equities. Source: Bloomberg

We mentioned in earlier reports that Emerging markets were starting to show similar behavior to that of the US markets in 2009 and the European markets in 2011 when additional bad news did not seem to have as much impact and tiny bits of good news caused markets to rally. Most investors were extremely underweight emerging markets and therefore the rally has been exaggerated due to short covering and benchmarking of positions. We expected some consolidation in the near term but believe that the strength in emerging markets is sustainable.

It is a concern for most European producers that Euro strength is weighing on their competitiveness versus the US and more recently Japan. Germany and Japan compete for sales in many segments of the export market and if the current foreign exchange situation prevails or worsens, this could prove to be a significant issue for German exporters. The ECB is very aware that a weaker Euro would help support growth and prevent any threat of deflation. They have therefore announced their intention to take action in June, though the market has been kept guessing as to what exactly this would be. The announcement caused the Euro to drop from almost 1.40 to the dollar in just three days to 1.37 where it is currently. While a small rebound in the short term is possible, we expect levels of about 1.35/1.36 leading up to the June actions from the ECB.

We mentioned in our last report that the private sector velocity of money in the US has been rising and companies are starting to consider increasing investment according to the latest surveys. We were also expecting a rise in government spending due to the lower US government deficit and the expectation that it will shrink further over the next couple of years. This expectation seems to be reflected in the recent rallies we have noted in engineering companies, resource producers, technology firms and other capital goods providers. The implied increase in capacity utilisation has been reflected in higher projected inflation for the next couple of years and this should support the price of gold.

Commodities & Gold

As we were expecting all of the developments in the US and Europe outlined above, we were more positive than the consensus on mining companies and gold at the start of 2014. So far our position has paid off. Several shareholder friendly announcements from Rio Tinto, BHP Billiton and other miners have supported the rally in a sector which has been completely disregarded for most of last year. Several commodities are in backwardation which is a situation not seen for several years and is taken by traders to be a positive sign for future price development. Copper has staged a strong rally recently, contrary to the expectations of most market participants. All of this is causing renewed interest in the sector which should continue as valuations are still reasonable.

The chart (Fig4) below shows the development of the gold price versus the 2-year inflation expectations. For the last year there has been a strong correlation until recently when the gold price has lagged. If this gap closes the gold price should reach USD 1’500.

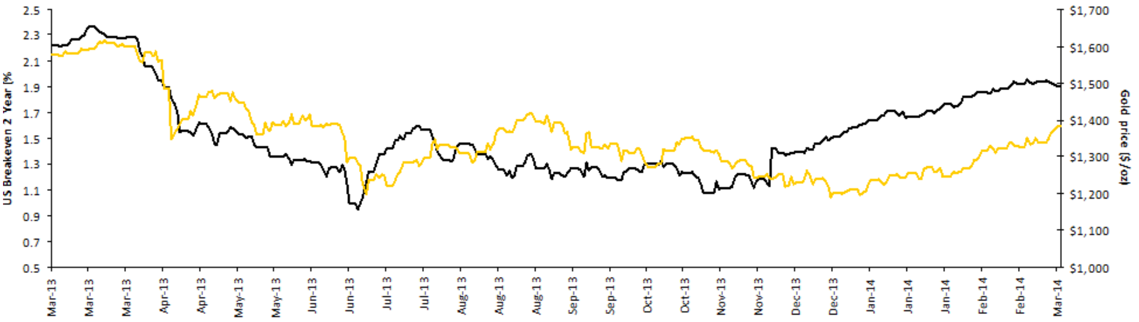

Fig4. 2-year inflation expectation vs gold price. Source: RBC Capital Markets & Bloomberg

As can be seen from the chart (Fig5) below, even though the FED is only tapering the QE3 program, almost all the money which flowed into the gold ETFs during the QE1, QE2 and QE3 programs has exited since the start of 2013. Speculative positions are also at the lowest levels in almost 10 years. We therefore believe that the current holdings in ETFs are more long term in nature and the recent data showing stability or increase in gold ETF holdings seems to confirm this.

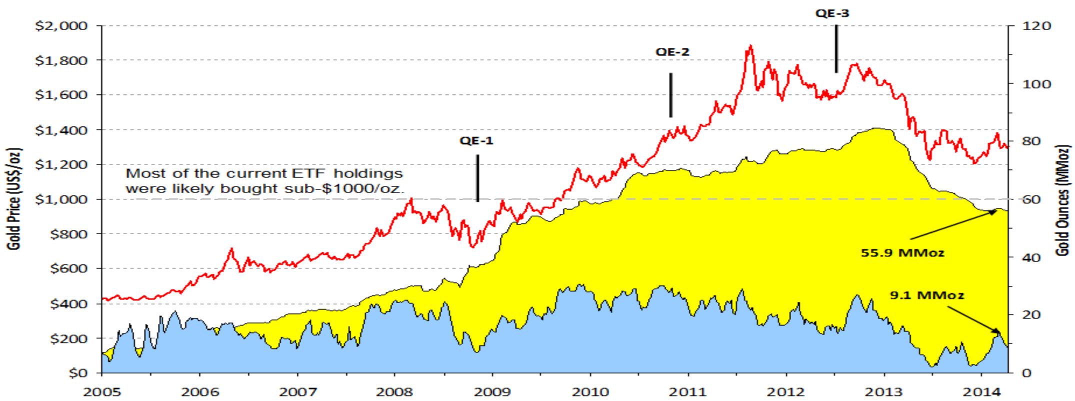

Fig5. ETF holdings (Yellow), Net speculative positions (Blue), Gold price (Red) Source: RBC Capital Markets, Bloomberg

Recent demand from China has been robust and the government is encouraging the purchase of gold by individuals. 34% of gold demand came from China last year, up from 22% in 2012. The average for India was 24% for many years and this level has been surpassed by China last year. Restrictions on gold imports into India are expected to be substantially reduced post-elections and the pent up demand for gold in the Indian market should be an additional positive factor.

Taking all of these factors together, we believe that the gold price is supported around USD 1’300 and should trend higher as all of the above mentioned factors start to be priced in.

General Thoughts

We mentioned in our last report that the velocity of money in the US appears to be ticking up as Quantitative easing is winding down. The ECB has for the first time stated clearly that it is willing to support growth and curb deflation using all tools, conventional and unconventional, at its disposal. The Japanese are determined to achieve their inflation targets through continued stimulus and the Chinese have announced measure to support domestic growth and employment. Put together, this is the most favourable back ground for coordinated global growth we have had in any year since the financial crisis.

We also pointed out that, due to the strong rally especially in the US last year, many stock prices already reflected a lot of this good news and some were at levels reflecting over-optimistic forecasts in our opinion. We believed that as a result stock pickers needed to sift through regions and sectors to look for those stocks that have been neglected in last year’s rally and should benefit substantially from their operational leverage and low valuations going forward.

This fundamental analysis and its implementation have produced good results for our clients as can be seen from the performance of several stocks in the portfolios. While equity markets are up about 3.5% for the year Microsoft (+8%) MacDonald’s (+7%) Potash (14%), LVMH (+8%), BASF (+8%), Royal Dutch (+12%), ENI (+8%), Holcim (+20%), Nestle (+7%), Novartis (+11%) and Larsen and Tubro (+32%) have done substantially better.

We believe that market participants will continue to seek investments in companies with free cash flow improvements and this should be positive for several of the portfolio positions.

Gillian Hollenstein

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