LABHA
INVESTMENT ADVISORS SA

Market Commentary

September 2014

MARKET ANALYSIS

One of the major trend changes this year has been the weakening of the Euro, especially against the dollar. We had been expecting this move and wrote about it in our first and second quarter reports. At the time the Euro was trading at 1.40 to the dollar and very few market participants were willing to consider a reversal in Euro strength. We positioned client portfolios accordingly and they have benefited greatly from this almost 10% move. Now as the Euro has dropped under 1.26, many expect to see 1.20 in the near future. We believe this will eventually happen but expect some consolidation after the recent big move. We have therefore booked some dollar profits in client accounts.

The threat of deflation is growing in the Eurozone and a matter of great concern to the ECB President Mr. Draghi. He has mentioned several times in recent speeches that while he stands ready to act as needed, governments must speed up structural reform and adjust fiscal policy as monetary policy alone cannot solve all problems. The Eurozone is lagging both its growth and inflation targets and even though many of the measures announced by Mr. Draghi in June are just being implemented this is still cause for concern. These measures are expected to have an effect three to six months after implementation so the next couple of quarters could be tricky.

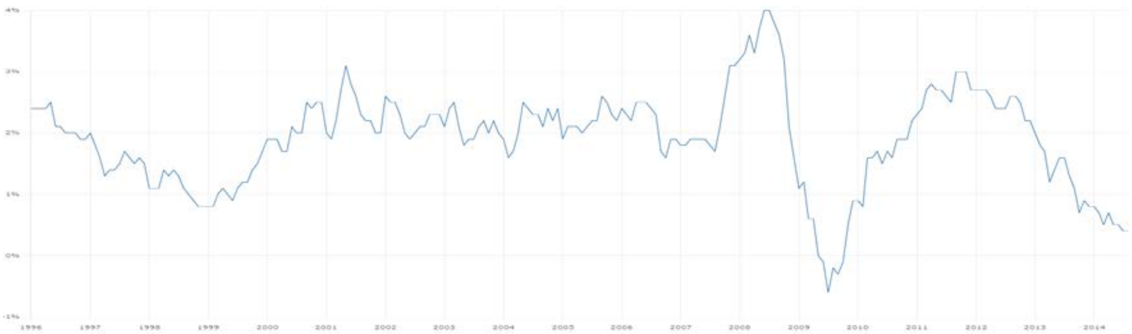

Fig. 1 Eurozone inflation from 1996 – August 2014 Source: ECB

The Euro weakening has been the most clearly positive effect of Mr. Draghi`s June announcements. This major change in direction holds out the hope that all those exporters who have been complaining bitterly about competitiveness, forex adjusted sales and margins should be able to benefit.

Bonds

We mentioned in our last report that shorter duration Norwegian bonds looked more attractive than Spanish, Portuguese, French or German bonds on a risk adjusted basis. Recently, the Norwegian central bank revealed their assessment that the economy is progressing as expected so they may raise rates in 2015. Until now market consensus was expecting a reduction of interest rates from Norway and our opinion expressed in several of our reports was that “interest rates in the Norway are likely to rise next year while European interest rates will rise much later.” Clients have benefited from this positioning both from the higher interest rates being paid by their Norwegian bonds as well as the strengthening of the Norwegian Kroner after the announcement.

We also mentioned that we were concerned about investor appetite for high yield bonds and that we felt that risk adjusted returns did not justify investment at price levels reached this year. This year 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. As can be seen from Fig. 2, the past two quarters have been excellent for emerging market bonds bringing their total return year to date to 7.3% whereas global bonds and high yield bonds produced a total return of about 2.5%. We booked some profits in emerging market bonds when they reached their highs earlier this quarter but still hold smaller positions.

FINMA Authorized Asset Managers

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

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 for most of this year and have underperformed the emerging market bonds by a large margin.

Fig. 2 YTD performance of Emerging market (solid), High Yield (orange) and Global (dash) bonds Source: Bloomberg

Equities

At different times this year, US, European and Emerging market equities took turns in outperforming. However, as the dollar started to rally strongly, Europe has performed better than both of the other regions. The stronger dollar has been weighing on the US stock market and especially the emerging markets. For the European markets the stronger dollar is expected to bring relief to exporters and has supported the rally. The strong dollar has also been a headwind for gold.

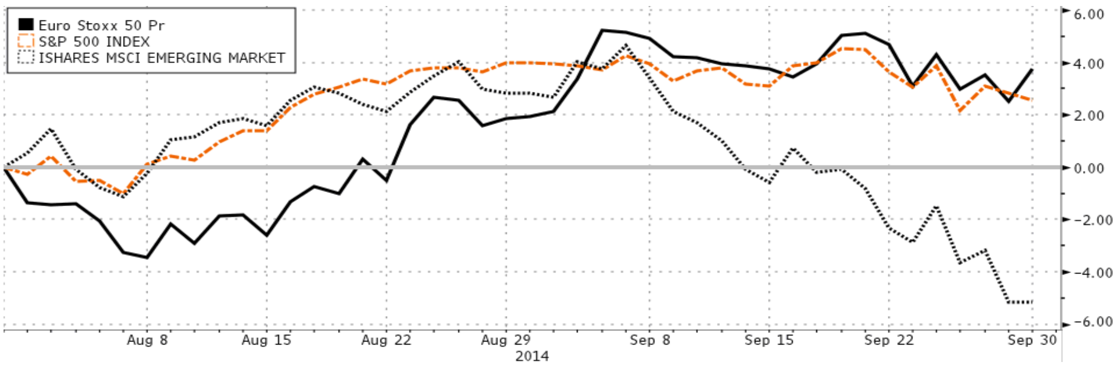

Fig. 3 European (solid), US (orange) and Emerging market (dashed) equities since August Source: Bloomberg

Holding the US dollar position while reducing exposure to US and emerging market equities has been a performance enhancer. The higher allocation to European exporters and the Japanese equity exposure (Japanese Yen hedged) has also been good for performance. Some equity winners this year have been Potash (+14%), Microsoft (+27%), Intel (+34%), Cisco (+12%), Novartis (+28%), Zurich (+17%), Shell (+20%), Sanofi (+18%) and Larsen & Toubro (+35%).

General Thoughts

We believe that market participants will continue to chase yield, and due to several factors mentioned in this report, they should find the larger exporters in Europe attractive. However, we expect some consolidation in the near term both in the US dollar and stock markets. We have therefore reduced equity and US dollar exposure but intend to rebuild them on setbacks.

Gillian Hollenstein