LABHA
INVESTMENT ADVISORS SA

From Castles In The Air To Windmills On The Coast

December 2009

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Summary

Having guided our client accounts through the turmoil of 2008 and the early part of 2009, we decided to put our thoughts and predictions in a document titled “From Castles in the Air to Windmills on the Coast”. This paper was published on the 10th of March 2009 and the name was chosen to indicate how we felt this crisis has been a catalyst for accelerating a much overdue and major structural change in economies and the way we invest globally.

The paper lays out our premises for the conclusions we have drawn and makes several predictions, most of which have been fulfilled even more rapidly than we expected. The following are some exerpts from the paper written at the bottom of the market in March 2009 :

“Even though growth may slow from 12% to 6% in China and even 4% / 5% in Q109. Q209 should see 7-8% growth.” ***March GDP was 6%, June GDP 8%.***

“At today’s prices buying commodities and investing in the infrastructure projects that will be completed faster, way under budget and create much needed jobs would be a good use of reserves (for China).”

Prices of Oil and copper are up 250% since then.

“The US would be very comfortable with a weaker dollar for the medium term. This would make exports cheaper, fight deflation, moderate the trade deficit and make debt repayment easier. All of this is to the detriment of those who lent to them and those who they are asking to lend to them at the moment.”

The dollar has fallen 20% versus the Euro and Swiss Franc since then.

“So in H2 09 we should have a weaker dollar, higher long-term interest rates and higher commodity prices.”

All of this has taken place as mentioned above and the 10yr Treasury Yield doubled from December 2008 to June 2009.

“The biggest winner from the fall in confidence in the leading global currencies has been and should remain gold.” ***Gold rose from USD 890 in March to USD 1226 in December 2009.***

“It seems to be most probable that China will lead the world out of recession.”

“The countries for which the financial sector has been the focus of asset inflation are diverting money from valuable and necessary investment in infrastructure to filling the holes in the financial system. This money will not bring real returns in the future, just stop a disaster now. Prevention of disaster does not amount to high “Returns On Investment”.

China, Asia ex Japan and parts of Latin America can benefit by using their reserves for more fruitful purposes to bring mid/long-term returns rather than just to stop a banking crisis. They can purchase real assets for future use and invest much more of the reserves available to them to increase competitiveness and efficiency. Those are high “Return On Investment” uses of money.”

We hope you will enjoy reading this document and find it helpful in planning your investments for the future.

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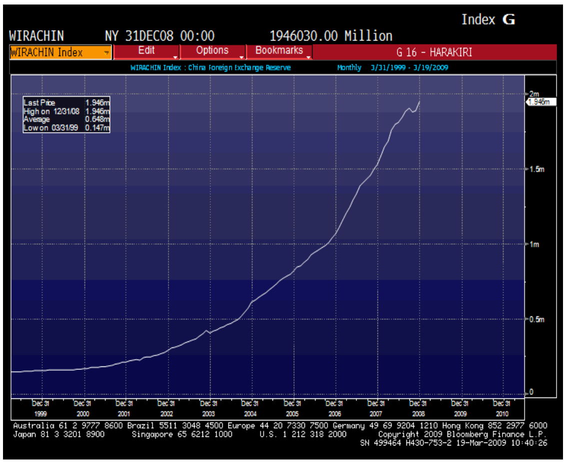
From Castles In The Air To Windmills On The Coast

10th March 2009

When the current economic crisis started there were some major imbalances in place globally. Cheap credit for too long had led to a housing bubble in the US, UK, Spain and Ireland and several smaller regions of the developed and emerging world. Home equity withdrawal to fuel excessive consumption had driven savings in the US to all time lows. The average savings rate in the US had been at 7% for the previous 50 years and had been over 9% till the 90s. By 2006 the rate of saving in the US had dropped to 0%. This excessive consumption had benefited manufacturers in emerging markets. Emerging markets especially China manufactured the goods to fuel this consumption boom and built up large foreign exchange reserves. The reserves they accumulated were recycled into further US consumption with their purchase of US treasuries which kept yields down for longer. As a result an unhealthy situation was being exaggerated further with each passing year. The populations in emerging markets tend to be savers as social security and health care systems are either very unreliable or nonexistent. Though this situation had been in place for a few years, it took the present crisis to bring about the structural shift which is necessary to even out these imbalances.

US Personal Savings as % of Disposable Income



Chinese Reserves Source Bloomberg

To rectify the above mentioned imbalances, house prices needed to fall and the cost of credit had to rise. This would lead to a drop in consumption and an increase in savings in the US and force an increase in consumption (to partly compensate for drop in export driven GDP growth) and a reduction in savings in emerging markets especially China. This has already started to happen.

However, now the U.S. is pumping more cheap credit into the system and hoping that people will spend rather than save. This looks like an attempt to delay the completion of the shift outlined above till the economy stabilises somewhat. While it is necessary to take the steps they are taking at the moment to avoid dislocations and an even deeper and longer recession, these measures will at best serve to smoothen the unfolding of the structural shift but will not be able to perpetuate old imbalances. That is not something that is intended or desirable.

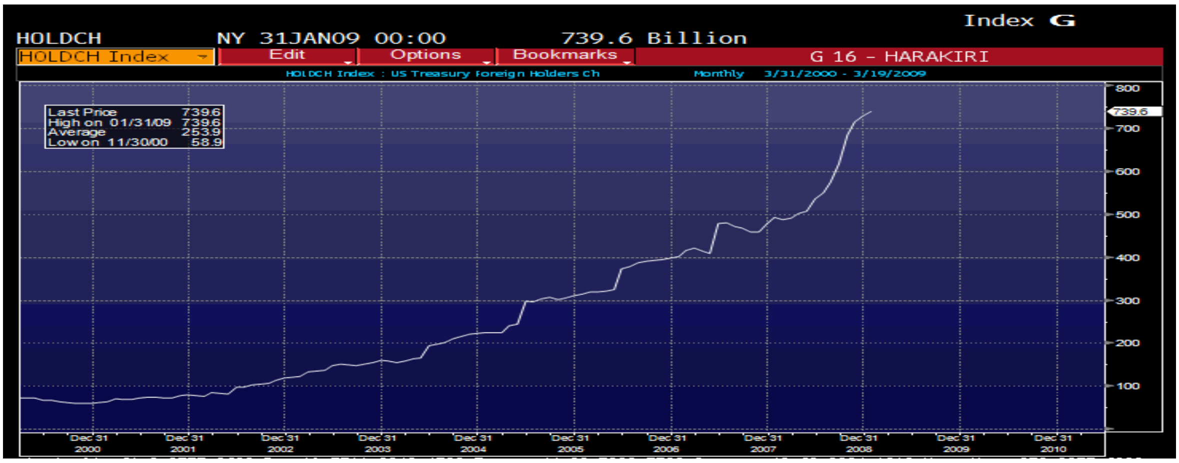
Though this reserve building in emerging markets was interrupted by the crisis in 2007, China, some Latin American and Asian countries have substantial reserves with which to stimulate domestic growth and consumption. In the early stages of development all economies rely on exports as a source of revenue with which to fund local investments in education, infrastructure, health care and social security. They can now deal with slower exports by using reserves to increase domestic consumption and increasing government expenditure to build and invest for the future.

Therefore even though growth may slow from 12% to 6% in China and even 4% / 5% in Q1 09. Q2 09 should see 7-8% growth. The difference could be that instead of Industrial Production (IP) capacity growth of 20% / year for export purposes, rails, roads, energy, agriculture will see the 20% growth and IP will be flat to weed out excess capacity in certain areas. Introduction of social security will also encourage people to save less and spend more.

What does this mean for Interest rates and currencies?

The above mentioned situation would imply lower interest rates in the countries with higher savings rates and low or no deficits and higher interest rates in the countries with lower savings rates and large deficits in the medium term. This would encourage saving in the first group and spending in the second, which would lead to a narrowing of trade imbalances between the importers and exporters of the world.

China has $2 trillion in reserves. $700 billion of which is in treasuries.



Chinese holdings of US Treasuries Source Bloomberg

The U.S. is selling $2-3 trillion worth of treasuries and hoping that China and Japan will absorb at least 1/3rd . The rest of the world 1/3rd and their own population 1/3rd .

The 1/3rd expected to be absorbed by Japan and China is likely to face a disappointing response. A third of 2-3 trillion = 700-1000 billion. The split $500-700 billion China and $200-300 billion Japan would double each countries holdings in Treasuries. This is unlikely as both countries anticipate dollar weakness and the Chinese have been expressing concern about this and the safety of their capital.

China has much better investment opportunities in the present environment. At today's prices buying commodities and investing in the infrastructure projects that will be completed faster, way under budget and create much needed jobs would be a good use of reserves. They have already started to forge large deals with Rio Tinto, Russia and Petrobras – "Natural Resources For Credit". Politically this is less sensitive than an outright share purchase and they can store future resources in the ground instead of having to warehouse them. Chinese investment has always been anti-cyclical and this time will be no different. They are likely to buy $300-$400 billion worth of treasuries but not the $500 - $700 billion the U.S. would like them to buy. This will cause treasury yields to rise and the dollar to weaken. 10 year Treasury yields already rose to 3% in Q1 09 up from 2% in December 2008.

The US would be very comfortable with a weaker dollar for the medium term. This would make exports cheaper, fight deflation, moderate the trade deficit and make debt repayment easier. All of this is to the detriment of those who lent to them and those who they are asking to lend to them at the moment.

When Emerging Markets needed to borrow from the developed world 10 years ago they had to agree to high yields and tough covenants. Somehow the developed world seems to think that when the tables are turned they can borrow from the Emerging Markets at the lowest interest rates ever and no covenants. This is probably not going to happen. A permanent extension of the G7 to G8 /9 /10 may also be imminent!

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So in H2 09 we should have a weaker dollar, higher long-term interest rates and higher commodity prices.

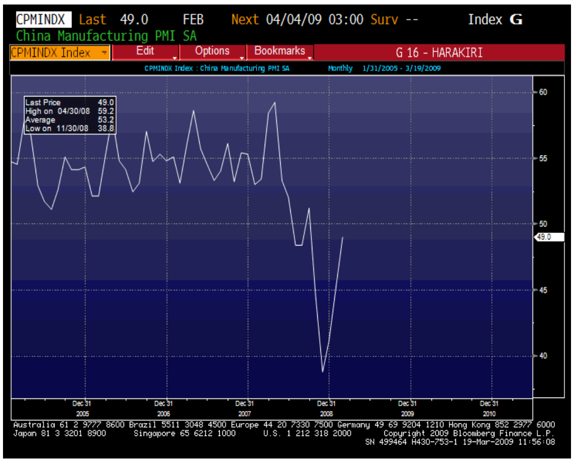
The US dollar should weaken but not excessively because the other global reserve currencies have problems of their own and all of them are hoping for relative currency weakness to help support export and fight deflation. However, the biggest winner from the fall in confidence in the leading global currencies has been and should remain gold.

What does this mean for global equities?

A weaker dollar makes it more attractive for China to import the technical equipment needed for the investment in their infrastructure from the west and particularly the US causing trade deficits to moderate as China temporarily exports less to the US and the rest of the developed world.

It seems to be most probable that China will lead the world out of recession. They have $2 trillion in reserves and a command economy which means decisions are made fast and implemented efficiently. They need to absorb a lot of labourers made redundant by the fall in manufacturing, in order to avoid unrest.

Where can they create jobs for these people displaced from manufacturing? Rail / road building and agriculture - all of this requires commodities, energy and water. To move 1 billion people to a higher standard of living takes a lot of energy, metals, food and water. China just bought more cars than the U.S. for the first time.



China PMI

US PMI

Source Bloomberg

Capital worldwide is being re-allocated from speculative, unproductive financial products which do not produce sustainable future growth or raise the standard of living of the broader population to real assets and investments to raise global standards of living, productivity and the ability to compete.

Governments need to concentrate on sustainable energy and job creation. Financial and service industries which are less commodity intensive are probably going to fall in importance and the manufacturing and infrastructure sectors increase in relative importance. These are commodity intensive sectors.

The countries for which the financial sector has been the focus of asset inflation are diverting money from valuable and necessary investment in infrastructure to filling the holes in the financial system. This money will not bring real returns in the future, just stop a disaster now. Prevention of disaster does not amount to high "Returns On Investment".

China, Asia ex Japan and parts of Latin America can benefit by using their reserves for more fruitful purposes to bring mid/long-term returns rather than just to stop a banking crisis. They can purchase real assets for future use and invest much more of the reserves available to them to increase competitiveness and efficiency. Those are high "Return On Investment" uses of money.

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Therefore, if we compare developed (non-resources) countries with developing countries.

Developed	Developing
Large Budget Deficit	Small Deficit or Surplus
No /low Forex Reserves	Good to High Forex Reserves
Low/no savings	High Savings
High Debt /GDP>60%	Low Debt/GDP <60%
Cost of borrowing rising	Cost of borrowing flat or falling
Decreasing share of Global GDP	Increasing share of Global GDP
Stagnating to falling real income	Rising real income
Aging population, individual taxes tend to rise as a smaller population of a mature economy has to support a larger social obligation.	Balanced population taxes tend to fall as more people become tax payers with rising prosperity.
Fears of the system failing will cause people to save more.	Social systems are just being introduced. This new security will encourage people to spend more and free up savings

This is a re balancing of world order from US dominance to less US reliance and will require a lot of natural resources. Even if the US grows at just 1.5%-2.0% for 5-10 years and Europe 1 – 1.5%, China and Asia can grow 7-9% during the same time. Due to the number of people living in these areas it will be very resource and infrastructure intensive.

Therefore, just as the Dow fell 89% in 1929-32, The Shanghai Index fell 74% from October 2007 to October 2008. The US had large reserves at the time. This time around it is China. However, unlike the US citizens at the time the Chinese have not lost their savings as none of their banks have gone bust. At the time the importance of the US was on the rise as they were taking over from Europe as the driver of global growth. This time it appears to be China rising.

As cycles tend to be shorter in a faster paced world, it is possible that the 32 month (Nov.1929 - July1932) slump has happened in 20 months (Aug. 2007 - Mar. 2009) and the political fiscal and monetary decisions that took 30 months to make in the 30s have been made in 20 months. In fact the Fed raised interest rates initially in the 30s to defend the gold standard. And this caused a huge set back for the markets and the economy.

It took the Dow till 1957 to recover 1929 levels. For that to happen it had to rise from 50 to 350, i.e. 700%. However, the rise from 50-100 happened in 1.5 years and 200 was attained in 1937. Therefore the rise from 50 to 200 took 5 years. That was 400%. The Chinese stock market has rallied nearly 50% from the low in October 2008 and may remain choppy for a while but still has the possibility to double over the next 2-3 years.

Even if recession ends in H2 2009 we will not return to boom time. Global imbalances (old and new) need to work themselves through. By 2006 US savings were at 0% and consumption 70% of GDP. By 2007 China exports were higher than those of Germany or Japan and were aimed at feeding this over consumption.

US consumption needs to fall in percentage terms and savings need to rise. The current saving rate in the US is 5% but a lot of it has been forced savings due to the state of the credit markets. This number needs to be monitored as credit markets improve. Chinese reserve accumulation needs to slow through reduced exports and increased imports. This implies that Japanese, German and Swiss exports of machines to China which were used to produce goods for export, i.e., textiles, autos, toys, household goods will fall.

The biggest risk is that of protectionism and artificial currency devaluation by the surplus countries that would further aggravate the current situation. The other risk is that China over-stimulates and this leads to inflation returning faster than expected.

Commodities - a major beneficiary

Commodity prices rise as the dollar falls and /or inflation rises as the demand for real assets to protect purchasing power increases. If emerging markets have to increase domestic spending and all countries are increasing infrastructure projects, this will be a further boost to commodity demand. At the same time exploration and production projects by mining companies have been postponed indefinitely due to the current crisis. This will cause a considerable delay in supply response when demand normalises.

However, infrastructure projects are already adding to GDP in China and commodity inventories were down 30 -40% in 6 months at the start of 2009. China knowing that tightness in supply will return rapidly as soon as growth picks up slightly is replenishing inventories at these lower prices just as it ran them down when prices were high – this is the correct anti-cyclical approach.

The same applies to soft commodities. Food inventories are in some areas at the lowest level in 50 years. Farmers are aging, as this was not an attractive profession in the past 30 years so it was not the profession of choice for younger generations. Additionally the recent credit crisis makes financing for farming machinery and fertiliser to increase productivity hard to come by. In the first half of 2008 food prices had reached a level that was so prohibitively expensive for the average worker in the emerging world that riots had started in the streets of several Asian and Latin American cities. The present crisis has caused prices to correct from their highs as fast money has left the sector. However, the structural dynamics outlined above have not changed and governments are painfully aware of that. As urbanization takes hold globally, the growth in food production slows in deference to the manufacturing of goods. However, demand for food increases with the general increase in prosperity from very low levels in emerging markets. A lot of the farmland, especially in China has been converted to industrial land as it is located close to scarce water sources. This has reduced the average productivity of farmland in these countries. The solution seems to be mechanization and increase in the use of fertiliser.

The third commodity theme is that of energy. The global shock produced by oil at USD 147 has not been forgotten by governments. The dependency on oil producing nations with unstable politics is also a concern. Therefore a reduction in energy dependency is vital for a stable future. There are now several viable alternatives available for the production of electricity for industrial and domestic use and the reduction of gasoline use in transportation. These technologies are being supported by governments globally (those dependent on oil, gas and coal imports to support growth). Wind energy seems to be the most popular of all the alternatives at the moment. Large coastal projects are being executed and even more are being planned.

Therefore, it may be difficult to predict when global markets will bottom and when housing will stabilise or consumers start spending again. However, it is clear to see that the trend in government spending globally is aimed at the areas outlined above. Consumers may continue saving for a while in order to re-build their balance sheets. However, governments have re-affirmed once again that they are willing to do anything it takes to stimulate growth. The things they can do that will bring the quickest results, all involve investment directly or indirectly in the above mentioned areas. These are also politically popular measures which will put voters in a better mood. Unlike the private households which will not be able to increase leverage and are being forced to save, governments can print money to make the necessary investments to stimulate the economy. Many of them have already shown a propensity to do so.

Therefore our main areas of investment for the future are based on this structural change “*From Castles In The Air To Windmills On The Coast”.*

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Follow Up - 21st of April 2009

In March we wrote:

"If emerging markets have to increase domestic spending and all countries are increasing infrastructure projects, this will be a further boost to commodity demand. At the same time exploration and production projects by mining companies have been postponed indefinitely due to the current crisis. This will cause a considerable delay in supply response when demand normalises. *China knowing that tightness in supply will return rapidly as soon as growth picks up slightly is replenishing inventories at these lower prices just as it ran them down when prices were high – this is the correct anti-cyclical approach.*"

The Financial Times, 21st April, "View of the Day" by Jing Ulrich, JP Morgan states:

"The surge in Chinas' commodity imports reflects *strategic government purchases* and rising demand from traders and producers. The Chinese government is also aiming to *increase its strategic petroleum reserves*. Crude oil imports reached a 12 month high in March, and government plans call for a tripling of Chinas' crude reserves to 40 days of demand. The country's ultimate reserve target is to meet 90-100 days of demand, comparable with OECD norms."

What does this mean for prices in the future?

1. Not only has our view that China was building strategic reserves in industrial commodities been confirmed, they have even stated clear goals for crude oil reserve building.

2. Asian energy ministers will be meeting with OPEC in Tokyo this week to discuss ways to revive investing in future supply to ensure energy supplies after the global recession ends.

3. Even if Oil importing countries decide to invest in alternative energy over the next few years it will take 5-10 years at the least to build the infrastructure necessary to make a significant impact on oil dependency.

4. Though OECD oil demand has been weak this year, the increase in demand from China and reduction in supply from OPEC has been sufficient to produce a 50% rally in oil prices in a period of 2 months. The same is true for copper prices.

Therefore let us assume consensus projections that OECD growth rates will be significantly under par for another 6-12 months and then will struggle to make headway. This would keep oil prices below USD 50 for 2009. However, there have been a lot of high volume buyers below USD 40. China has clearly stated its reserve goals and has built new storage capacity to start the next phase of reserve building. This should put a floor under oil prices around USD 35-40.

If on the other hand the leading economic indicators in OECD countries start to show signs of improvement in Q2 09, oil prices could easily exceed USD 60 and could even head to USD 70 or higher temporarily.

Therefore at today's prices of USD 45 oil seems to be in the middle of a trading range with a USD 35 floor and a USD 60 ceiling. We thought oil was over stretched at USD 55 and were expecting a pull back to test USD 45. However, we would be buyers of oil and oil related stocks under USD 45.

Copper prices also looked stretched at USD 4800 but we would be buyers of copper and copper related stocks below USD 4000.

Yellow-Commodities Index, White-Gold price, Orange-MSCI World Index, Pale Yellow-S&P 500 Source Bloomberg

The chart above shows the stock gold and commodity indices in US dollars starting in 1959. For about 10 years one or the other index out performed the rest each year but the trend that was forming was bullish for commodities and gold. Over the next 15 years commodities and Gold outperformed equities by a large margin. In 1983/84 the marked out performance in equities started and this bull market lasted for 15 years as well. During the 1984-1999 period commodities and gold prices were volatile but were heading lower.

However, from 1999 to 2007 this trend reversed sharply and held till mid 2008. During this period commodities and Gold did far better than equities. The out performance was especially pronounced from 2000-2003 when equities dropped sharply and commodities and gold rallied strongly. From 2003-2007 all four indices rallied but over the period commodities outperformed the rest. For the first six months of 2008 commodities continued to rally even as equities fell as worries about inflation and the weaker dollar dominated the economic backdrop globally.

From the middle of 2008 equities dropped sharply but commodities fell much more and have now reached levels they were at in 1985, 1990 and 1999. Gold has held up the best of all these indices as fear has gripped investors globally. If looked at in an historic context the drop in commodities prices looks too severe and shows the biggest potential to catch up over the next few years. There have been 8 years of commodities out performance from 1999-2008. The usual cycles have been 15 years on average. We believe that the 70% drop in commodity prices from July 2008 to December 2008 was a dislocation caused by the seizing of credit markets and the mass redemptions of hedge funds and commodity funds. These funds in our opinion were the main drivers of the overshoot in commodity prices from mid 2007 to mid 2008 and the unwinding of their highly leveraged positions led to an overshoot in the opposite direction. Though there was definitely a fundamental aspect to both the upward and downward moves the exaggeration in both directions were driven by leverage in our opinion.

We were skeptical of the move in commodities from the middle of 2007 to the middle of 2008 as we found the move too exaggerated and the speed of the move up with the backdrop of a global financial crisis appeared out of place. However the sharp fall since then especially that of Q4 2008 looks equally exaggerated. The move from mid 2008 till the fourth quarter was the reversal of the exaggeration of the previous year and was to be expected. However the overshoot in Q4 2008 was a buying opportunity for our clients and has worked well so far.

In general volatility in commodity prices will remain elevated this year and next in our opinion. However, there are several structural factors that are supportive of prices. We have listed some of them above but the list is not exhaustive, e.g., if the USD weakens substantially (over 5%), oil prices could be given an extra boost and reach the upper levels of the range much faster.

Therefore we recommend building a portfolio of commodity and commodity related stocks as an important element of asset allocation for the next 3-5 years.

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Follow Up - 28th of May 2009

The following quotes are taken from our theme paper " From Castles In The Air To Windmills On The Coast " dated 10th March 2009.

Then, we were expecting the situation for the dollar and dollar bonds to worsen as Japan and China were anticipating "dollar weakness and the Chinese have been expressing concern about this and the safety of their capital. "

"China has much better investment opportunities in the present environment. At today's prices buying commodities and investing in the infrastructure projects that will be completed faster, way under budget and create much needed jobs would be a good use of reserves. This will cause treasury yields to rise and the dollar to weaken. 10 year Treasury yields already rose to 3% in Q1 09 up from 2% in December 2008."

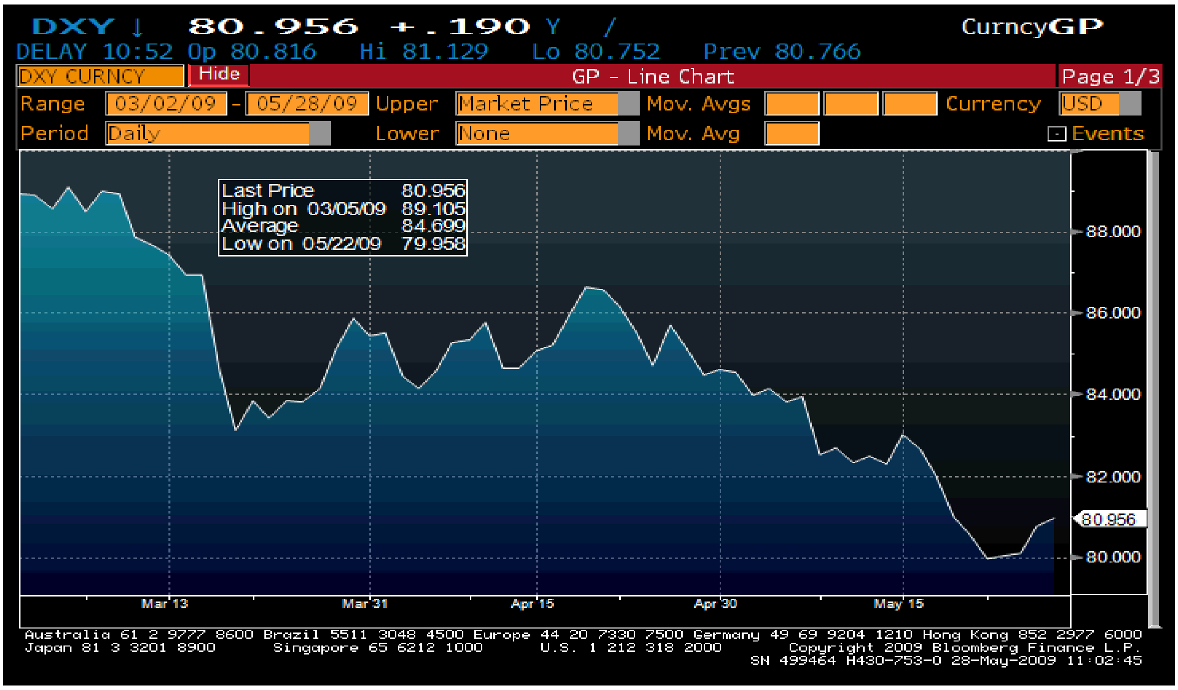
"The US would be very comfortable with a weaker dollar for the medium term. This would make exports cheaper, fight deflation, moderate the trade deficit and make debt repayment easier. All of this is to the detriment of those who lent to them and those who they are asking to lend to them at the moment.

"Commodity prices rise as the dollar falls and /or inflation rises as the demand for real assets to protect purchasing power increases. If emerging markets have to increase domestic spending and all countries are increasing infrastructure projects, this will be a further boost to commodity demand. At the same time exploration and production projects by mining companies have been postponed indefinitely due to the current crisis. This will cause a considerable delay in supply response when demand normalises."

"So in H2 09 we should have a weaker dollar, higher long-term interest rates and higher commodity prices. "

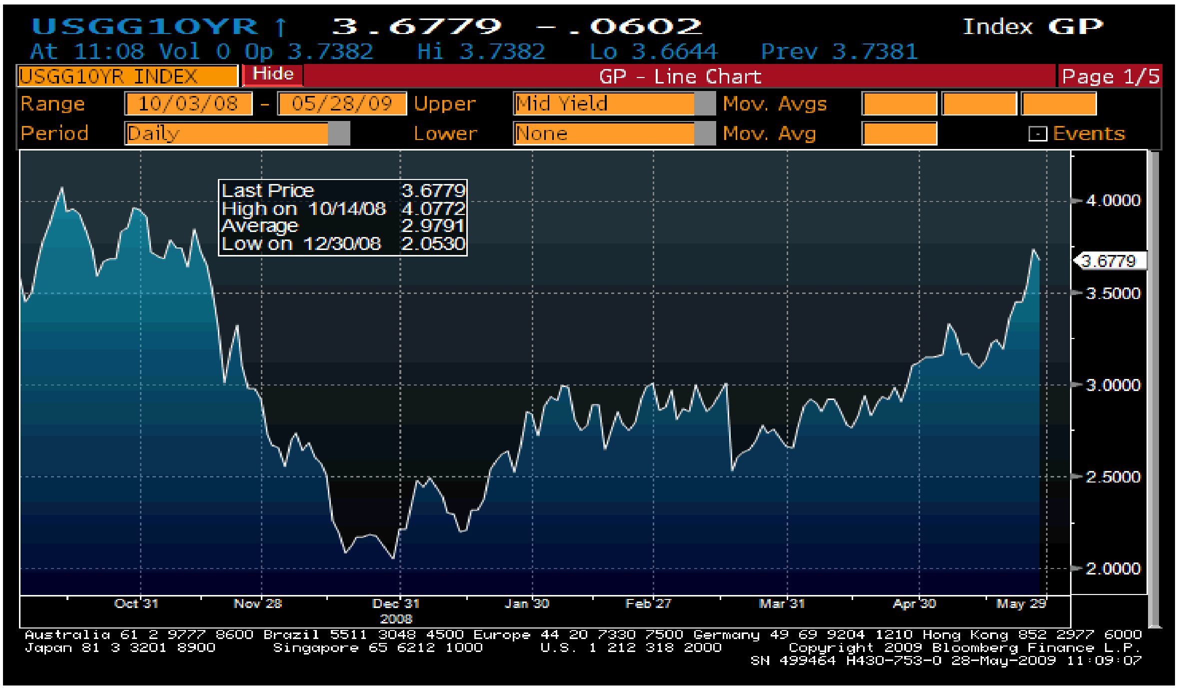
The dollar and long-term interest rates:

Lets us take a look at what has happened to the dollar and interest rates since March.



The dollar Index **Source: Bloomberg**

The dollar index has dropped over 10% since March. China has been voicing its concerns over the dollar very openly and has even proposed the formulation of reserve alternatives. They have reached an agreement with Brazil to conduct all future trade in the currencies of the two countries and not in dollars.



US 10 yr Treasury Yield **Source: Bloomberg**

The US 10 year Treasury Yield has risen from its low of 2% in December 2008 to almost 3.7% as of today !! Weak equity markets in March did not cause yields to fall below December levels. In fact the March low was 2.5 % . Rates are now almost as high as they were before the demise of Lehman Brothers.

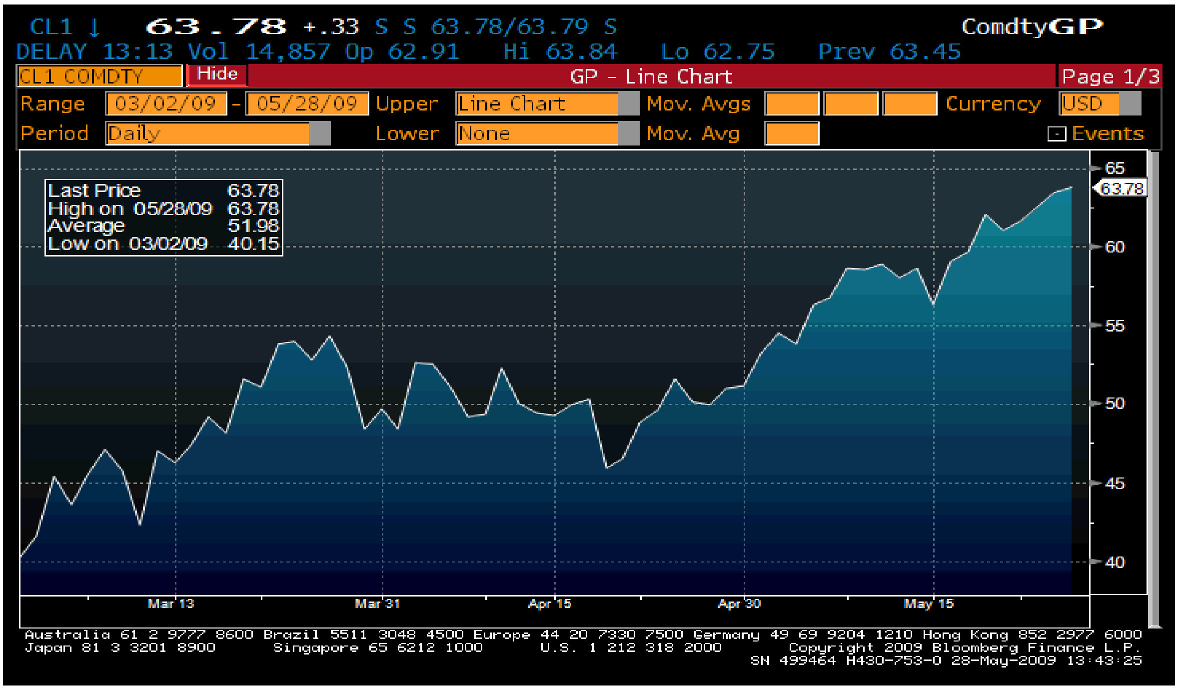
Todays' Financial Times article "Treasury yields give cause for concern", points to the Credit Suisse research which shows China's holdings of US Bonds and Notes fell from 15.1% in August 2008 to 13.7% as of March. Their holdings in Treasury bills however have risen from just over 1% to 10%. This implies a hesitancy to hold longer dated US debt and a shift to the relative safety of the shorter term bills.

Therefore, the moves we were anticipating have already started to take place.

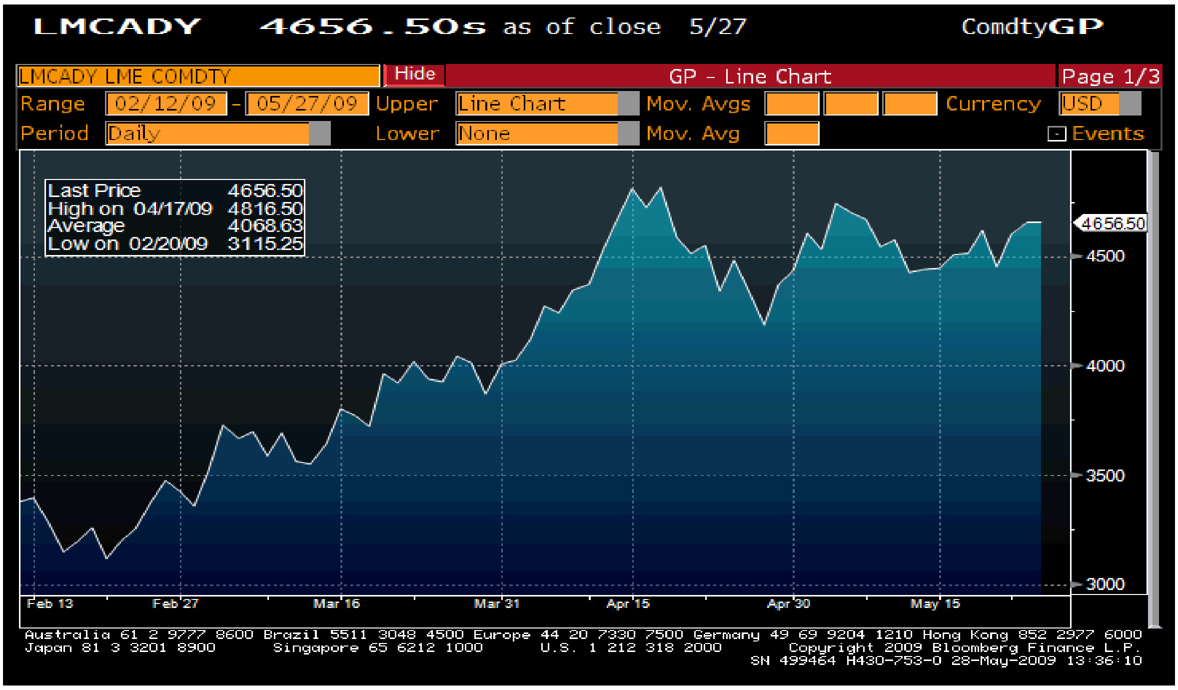
All those who fled the equity markets, especially the emerging markets and commodity stocks in favour of US Treasuries in November last year are nursing large losses on US Treasuries and the dollar and have lost out on the capital gains in emerging market equities and commodity stocks.

The flight to safety trade worked for a few weeks at most and then turned out to be loss making.

While treasury yields were rising from 2 - 3.7%, the price of oil has risen 90% from its low of USD 33 in February to almost USD 64 now. Copper has risen 45% during the same period. Both these moves have been brought about by improving leading indicators and an increase in imports by China. China has been building reserves at low prices just as it sold excess stock when prices seemed excessive. Meanwhile the global economy is still not in great shape and end demand has not improved much. Therefore, this move has been brought about by sentiment change and provisioning for the future. When real demand starts to increase and supply has trouble catching up prices should escalate much more rapidly.



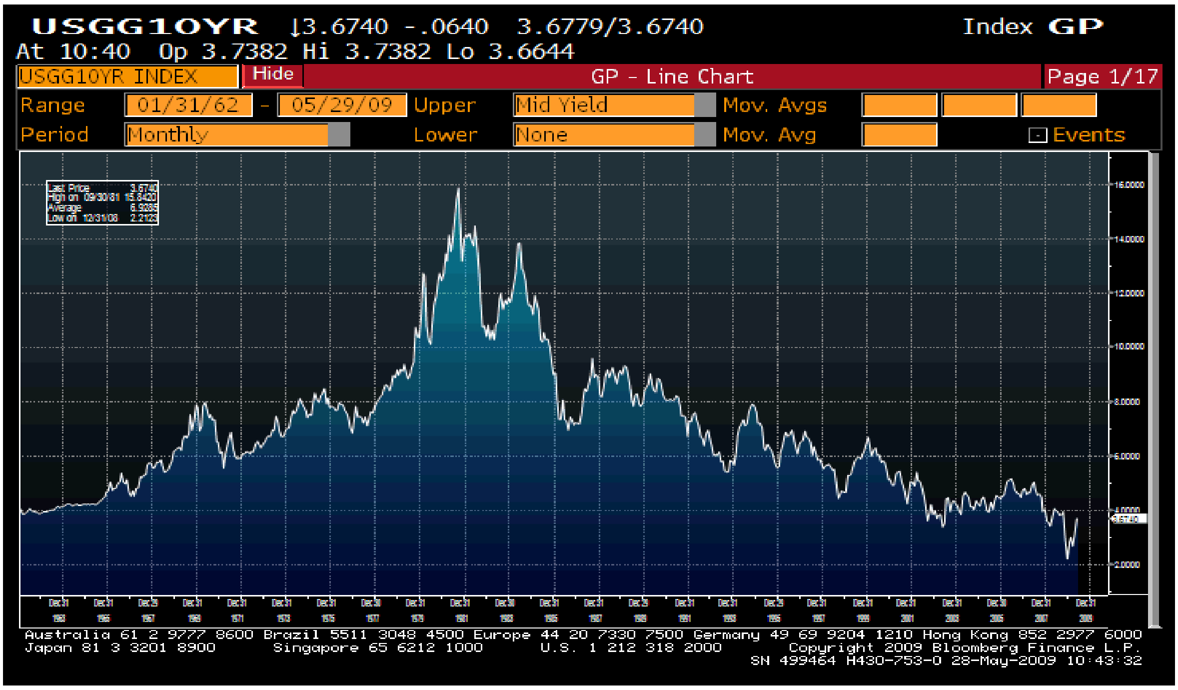
Oil Source: Bloomberg



Copper Source: Bloomberg

Conclusion

We have advised taking some profits in oil, commodity and emerging market equities after the recent rise. However mid to long-term these trends look set to continue.



US 10 yr Treasury Yield Source: Bloomberg

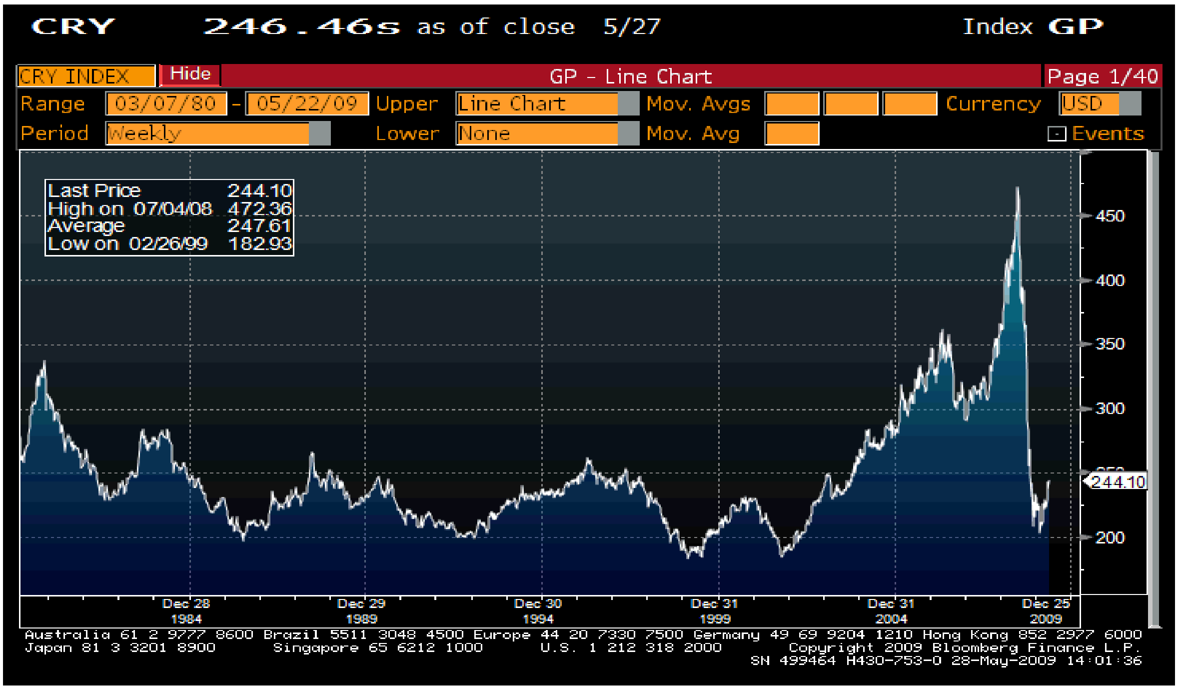
The chart above shows 10 yr treasury yields from 1962 till today. Treasuries have been in a bull market fro the early 80s till 2002 approximately. Falling interest rates during the period produced good returns with very low risk. After the brief exaggeration in December last year yields have rapidly returned to 2002 levels despite the on going recession and bond purchases by the FED.

Our feeling that 10yr yields were far too depressed was one obviously shared by several corporate boards. Many companies that needed capital (Roche) and several who did not (Cisco) issued bonds in the first quarter of this year. Even though spreads were higher than the historical average they were able to issue bonds with 4% coupons which is historically very low. Roche used the debt to buy Genentech and Cisco has been buying back its shares. These companies based their decisions on the assumption that growth will return no matter how slow the process is and they have rarely been able to finance future growth and acquisitions at such a low cost. This was a window of opportunity that they were happy to take advantage of.

We think that yields will continue to rise as demand for treasuries does not keep up with supply, the risk premium demanded by those buying long dated bonds increases due to concerns about ratings, and quantitative easing stokes dollar and inflation fears.

The US government has been increasing its leverage to compensate for the deleveraging of the consumer and the financial sector. Some believe that they can continue to do this as the dollar is the reserve currency of the world and the US is still the world's largest economy. However, we believe that a large structural shift has taken place in the current crisis. Though we are not proponents of the scenario that predicts the end of the US and the US dollar as significant global forces, we believe that their importance has been structurally diminished.

The US may become technology leaders in alternative energy or other innovations once again and their position may strengthen if they manage to clean up their balance sheet. However, the total dominance of the past 50 years is a thing of the past and may be the best outcome for the global economy including the US, as forces become more balanced.



Commodities Index Source: Bloomberg

During the same period 1980 to 2002 as Treasuries were rallying, commodity prices were in a bear market. The bull market that followed was in our opinion overinflated by speculation from 2007 to 2008 and then punctured by the exit of speculators in the third quarter of 2008. The latest unprecedented downward move in commodities resulted in them returning to price levels last seen in 2002. We believed this was a dislocation in a structural move which has just resumed and has a long way to go. Though levels in 2008 were highly exaggerated, 2004 prices could be reached fairly quickly.

It is our opinion that commodity prices will continue to be supported by provisioning for the future in emerging markets, scarcity of supply / lagging supply response, increasing volume requirements as more people in emerging markets enter the middle class, the weak dollar as well as other major currencies and inflation worries fuelled by quantitative easing.

In the short term we may see a pull back in 10 yr yields as commodity and equity markets consolidate. However, we believe the long-term trend has turned.

Gillian Hollenstein

Follow Up - 27th of July 2009

The media, economists and analysts have been paying close attention to the consumption of resources in the US and in particular the use of energy. They point to the fact that consumption is lower this year than at the same time last year and that unless this improves, the prices of oil and other commodities will fall. We consider this view relevant only in the very short-term. While it is true that consumption of resources is lower in the US this year, the difference is in the 2-3% range. This is because there is a minimum sustenance amount of resource consumption in developed markets. However, the emerging market economies have a long path of growth before them and their consumption of resources will rise for many years to come. This is already evident from the table below. Emerging markets are consuming 5% more energy today than they were a year ago despite the financial crisis and its consequences!

22 EquityWEC

BP World Total Energy Consumption

1) World	Current (MM Tons OE)		1 Yr Ago (MM Tons OE)		% Change 1 Yr Ago
5) World	11294.9	12/08	11104.4	12/07	1.72%
6) Emerging Markets	4757.5	12/08	4513.3	12/07	5.41%
7) Asia Pacific	3981.9	12/08	3816.0	12/07	4.35%
8) Europe	2964.6	12/08	2956.9	12/07	.26%
9) North America	2799.1	12/08	2849.4	12/07	-1.76%
2) North/Latin America					
10) United States	2299.0	12/08	2359.6	12/07	-2.57%
11) Canada	329.8	12/08	326.1	12/07	1.14%
12) Brazil	228.1	12/08	220.4	12/07	3.50%
3) Europe/Africa/ME					
13) Russian Federation	684.6	12/08	679.7	12/07	.72%
14) Germany	311.1	12/08	309.3	12/07	.60%
15) France	257.9	12/08	254.8	12/07	1.19%
16) United Kingdom	211.6	12/08	214.7	12/07	-1.45%
17) Italy	176.6	12/08	178.5	12/07	-1.03%
4) Asia/Pacific					
18) China	2002.5	12/08	1862.8	12/07	7.50%
19) Japan	507.5	12/08	515.8	12/07	-1.61%
20) India	433.3	12/08	409.2	12/07	5.89%

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Global energy consumption broken down by region. **Source Bloomberg**

The developed world has benefited disproportionately from global growth over the past 50 years and consumed global resources far in excess of their share of global population. Now, emerging markets are experiencing a collective rise in their standard of living based on growth and productivity and this is a very resource intensive process. Developed nations will have to increase education and innovation and simultaneous try to decrease costs in general as growth slows and efficiency must rise to compensate. This concentration in the developed nations on education, innovation and alternative energy, energy efficiency and reduction of economic dependency on manufacturing will gradually reduce their per capita energy consumption. This reduction in resource demand from developed nations will be absorbed by the increase in demand from emerging markets, leading to tightness in the demand supply equation for the medium to long term. That is unless an incredible jump in innovation makes present sources of energy redundant. China knows this and so do all the other emerging markets. Therefore, we have observed them buying substantial amounts of commodities when prices drop and storing them for future use. This provisioning has put a floor under oil and other commodity prices in the first half of the year and we believe that this floor will hold. However, volatility can continue to cause 20-30% fluctuations in the short-term, even if the general price trend is upward

In our opinion, the key to building out performance over the next 3 –5 years is going to be the positioning of portfolios to take advantage of this structural shift which has been moving forward gradually over the last 10 years and has accelerated substantially due to the financial crisis.

The U.S. has not created any jobs in the private sector for more than 10 years. Net new jobs created have been in governmental organisations and have to be financed by the tax payer. Manufacturing has been moving to the emerging markets, so have standard services like call centres, preparation of tax returns, medical documentation etc. Instead of growing through technical innovation in real goods and services and investment in infrastructure to further future intellectual property and efficiency, the focus in developed nations has been financial engineering and innovation and ever rising health and social costs. Now the US government is trying to fill the holes left by the mistakes of the past 10 years by adding even more government sponsored jobs. The story in Europe and Japan is slightly better but not by much. Of the developed markets the healthiest are Canada, Australia and Norway as these resource rich nations have benefited and continue to benefit from the urbanisation of the emerging markets. These countries have added substantially to private sector jobs over the past decade.

In contrast, the emerging markets are producing millions of private sector jobs. They are also urbanising at a rapid pace. Over the next 10 years approximately 400 million Indians are expected to migrate from villages to cities. Similar movement will be seen in China, Brazil, Russia, South East Asia and Eastern Europe. This urbanisation is extremely energy and commodity intensive. Though the biggest global mining and energy companies are developed market companies and they will benefit from this trend, their impact on domestic economic growth is significant only in Australia, Canada and Norway. Infrastructure and technology companies will be the other big winners as emerging market technology, though it is improving rapidly, has a long way to go. Technology will have to be imported from the developed economies for at least a decade longer. Therefore those sectors in the developed nations will continue to be beneficiaries of globalisation. It is possible that many companies in the US, Europe and Japan produce solid profits over the next decade by benefiting from the urbanisation of the emerging markets. However, as an ever increasing proportion of their manufacturing and service inputs are moved to the emerging markets due to lower labour costs and proximity to the fastest growing markets, the populations in the developed world will face the prospect of having to add substantial value through their contributions to end results if they wish to maintain their current wage differential and the standard of living that this brings with it. This is a change that will take time and will be resisted by societies and their governments all over the developed world. However, the tide has turned and there is no going back.

The consequences of this structural shift will be both broad and deep. The US is still the biggest consumer of resources, goods and services in the world but its dominance is being reduced. The same applies to other developed nations in the Euro zone and to Japan in the Asian region.

All regions of the world are going to have to invest. This is going to be a very capital intensive decade. Those with capital will be the greatest beneficiaries. This applies to companies, countries and individuals. Therefore, portfolios must be dominated by good regional and corporate balance sheets as they can participate in growth organically or through acquisitions with a lower cost of capital.

Many individual, institutional investors are expecting inflation by 2011/2012 and have started investing in commodities and equities to preserve purchasing power. We believe that those who point to the deflationary forces of weak demand and over capacity are focusing too much on the developed world. Inflation when it appears will probably take root in emerging markets and will be exported to the developed markets. We have to remember that those with the capital will determine interest rates, not those who wish to borrow. Those who need to borrow will probably be paying twice as much for 5 – 10 year debt in 2- 3 years time; therefore many solid companies looking to grow in the future have been issuing bonds to take advantage of the low interest rates in the first half of this year. Governments are also trying to get their treasuries issuance out of the way as soon as possible. Real rates are now zero or negative and will have to rise 1-2% to persuade people with cash to lend it instead of investing in commodities and equities.

We therefore believe that equities and commodities will substantially outperform bonds over the next few years and that though regional and sector allocation will be important stock picking will play an increasingly important role in relative performance.

Gillian Hollenstein

Follow Up - 5th of October 2009

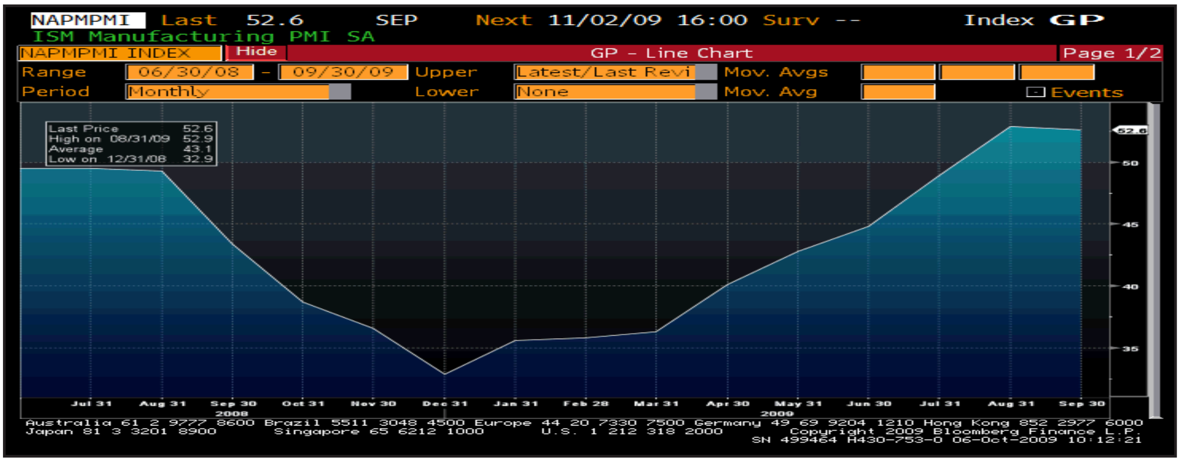
Now that markets have rallied over 50% from their lows in March this year, the question on everyone's mind is "what next".

We believe that the move from March till July was mainly driven by the re-rating of the general macro scenario. In March dire predictions for the global economy were being priced into markets and the consensus could not see any improvement "in the foreseeable future". Several market commentators were predicting even worse markets in the second quarter than we had experienced in the first.

Then as the various measures of central banks around the world started to have a positive effect on credit markets, the first big move upward from March to May reflected the improving credit spreads.

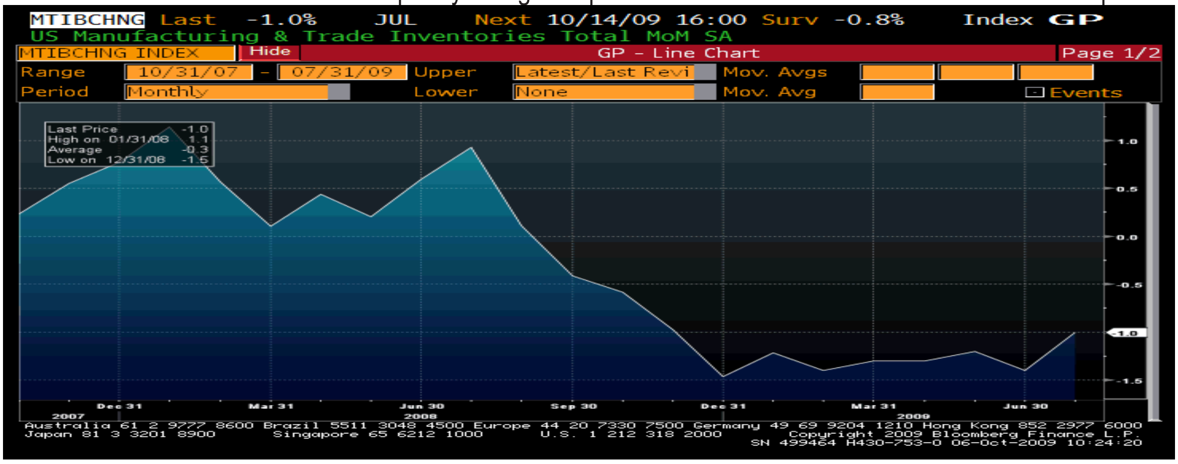
TED Spread | Source Bloomberg

The turning point in economic indicators soon followed with Chinese PMI staying consistently above 50 and those of the US and Europe moving towards 50 from very depressed levels. This produced the second leg of the rally from May till July.



US PMI | Source Bloomberg

The third leg which started in August was brought about by the fact that inventories were at historically low levels and this combined with the general improvement in macro data led to an uptick in new orders. Markets therefore started to believe that revenue growth would drive earnings in the next result season instead of purely margin improvement as was the case in the second quarter.



US Manufacturing & Trade Inventories **Source Bloomberg**

Chicago PMI New Orders **Source Bloomberg**

Most companies beat second quarter consensus earnings estimates as we expected. However, this increase in earnings was achieved mostly through cost cutting as companies had taken rapid action to minimise costs in the last quarter of 2008 and the first quarter of 2009 and their worst fears with respect to the economic downturn were not realised. In the first and second quarters, markets were expecting the worst and the likelihood of being positively surprised was high. The probability of disappointment has now risen as most market commentators are expecting good macro and micro numbers for at least the next two quarters.

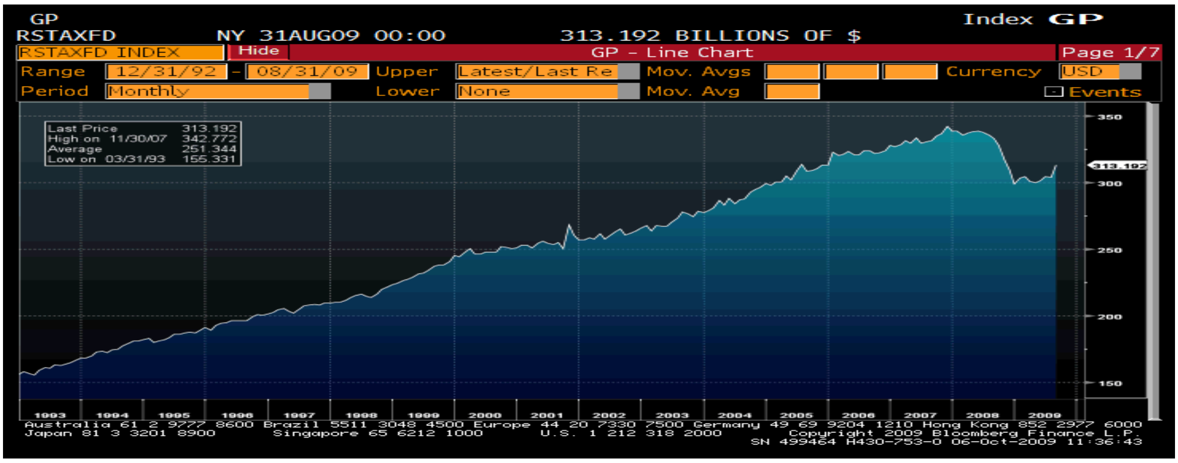
There is however one major factor supporting the market. Many market participants have missed one of the biggest rallies in history and are getting increasingly nervous about facing clients as the quarter and year end approaches. As a result most 2-3% drops have been bought so far as the race to increase equity allocation continues. Though we are cautious going into the notorious month of October, we are also aware of the fact that cash and treasuries have lost their attraction as yields are low and risk aversion has moderated. Many investors still have an undesirably high allocation in these two areas. The corporate bond market is now looking fairly priced in most cases and the hunt for yield is leading investors to high yield stocks with good cash flows, especially as the dividend paying quarters approach.

Now that the major re-rating has taken place we believe that sector rotation, rebalancing and stock picking will continue to drive outperformance for a few more quarters. Companies will have to show revenue growth in third quarter results in order to sustain and further this rally. It appears that this could be the case for industrial, technology and consumer staples stocks but the rest of the market could show mixed results. The infrastructure investments authorised in the stimulus packages in the US and Europe are just starting to have an effect. Also those sectors that have suffered from a delay in capital expenditure are now benefiting from the improved credit and macro conditions. Additionally, alternative energy, water and agriculture are three areas we continue to highlight. These sectors should benefit from new investment and demand spurred by governments' world wide. There is some overcapacity in these sectors at the moment due to the present slump but we believe that this will be met with demand as stimulus packages are implemented. The main beneficiaries over the medium to long term will be those sectors which require a lead time of more than three years to add capacity and which have a significant brand, technology or resource edge. It all boils down to basic supply / demand and speed of capacity addition or reduction.

Our outperformance this year has been achieved despite the underweighting of the financial and consumer discretionary sectors which have performed very well in the second quarter. We believe that there is structural overcapacity in these sectors in the major developed economies and this over capacity is going to take years to work through. There may be strong intermittent rallies in both sectors but their general performance will probably lag that of other areas which have not over expanded in the past years by feeding off the liquidity and leverage in the market.

The financial service sector is bloated as too many products were launched to take advantage of the easily available credit. The same applies to the retail sector as too many stores were opened to absorb the ever increasing consumption fuelled by the psychological effects of dramatic home price appreciation and easy re-financing or home equity withdrawal possibilities offered by banks.

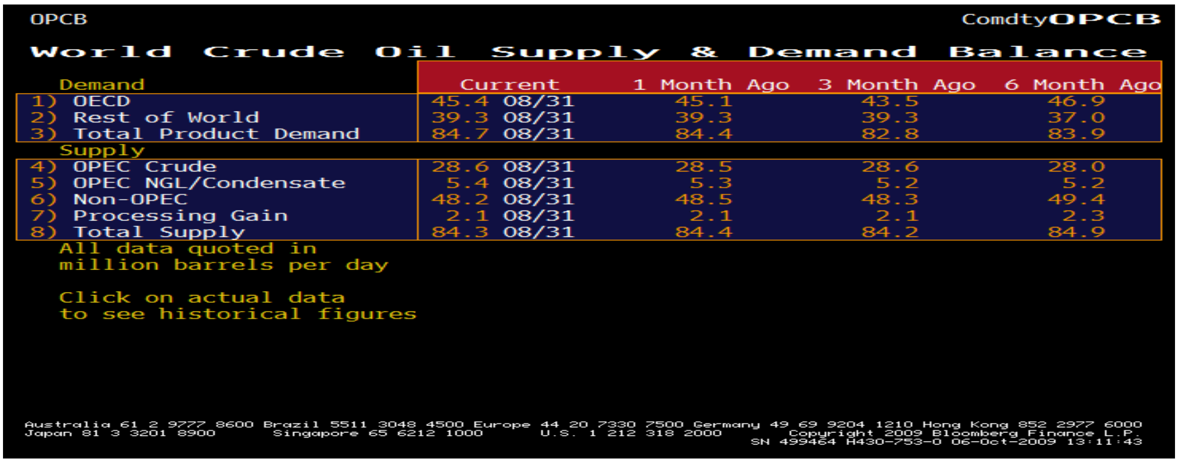
Although consumer discretionary stocks will announce higher revenues coming off a very low base, the strength of the improvement could turn out to be disappointing. Many retailers have cut back on or completely stopped new store openings. They have had to close stores which used to be situated in profitable neighbourhoods that have dramatically shrunk in size. There is an extreme overcapacity in the sector and margins are under pressure as each outlet competes with the other for market share.



US retail sales Index (ex food) **Source Bloomberg**

The financial sector will probably show good results relative to Q3 and Q4 last year but digging beneath the surface will provide some unpleasant surprises. Some banks produced much better than expected earnings numbers in Q2 as a result of strong trading profits. This quarter might show the additional boost from "write backs" as the spreads on some of the speculative paper they are holding have narrowed considerably and accounting rules will allow for adjustments to reflect this. However, this does not mean that their business model or regulatory environment has improved going forward. Quite the opposite is the case. Banks are still in the midst of major restructuring and are getting rid of certain departments completely. They are having to return to traditional sources of earnings with little or no leverage to boost their results and are facing increased regulation from their governments. Despite the huge advantage that the current yield curve offers banks, they seem to be able to derive very limited advantage from it. The retail client is deleveraging and therefore not keen to take on any more debt. The corporate client who wishes to raise capital is better off going directly to the market and issuing bonds. So what are the banks doing with all the cash they have to keep on their balance sheets? They are buying treasuries. They are borrowing from the FED at next to zero interest rate and lending the money to the US Treasury at 3-4%!!!!!

At the start of this financial crisis the concept of too big to fail was being severely criticised. However, if we examine the US financial sector we will find that those larger companies that have survived the crisis so far are larger than ever as they bought out their bankrupt peers. If nothing is done to address this issue the next crisis will be even more severe.



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World Crude Oil Supply & Demand Balance

Demand	Current	1 Month Ago	3 Month Ago	6 Month Ago
1) OECD	45.4 08/31	45.1	43.5	46.9
2) Rest of World	39.3 08/31	39.3	39.3	37.0
3) Total Product Demand	84.7 08/31	84.4	82.8	83.9
Supply				
4) OPEC Crude	28.6 08/31	28.5	28.6	28.0
5) OPEC NGL/Condensate	5.4 08/31	5.3	5.2	5.2
6) Non-OPEC	48.2 08/31	48.5	48.3	49.4
7) Processing Gain	2.1 08/31	2.1	2.1	2.3
8) Total Supply	84.3 08/31	84.4	84.2	84.9

All data quoted in million barrels per day

Click on actual data to see historical figures

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Global Oil Demand/Supply **Source Bloomberg**

Those who have read our previous theme papers and followed our recommendations know that we have be overweight the basic material sector especially the metals and mining subsector since March this year. This is a volatile sector and we have booked profits after the recent strong performance. However, we would be buyers on setbacks. We increased our exposure to the energy sector earlier this year and though it has not performed as well as the basic material sector we consider many of the stocks to be cheap and the sector has a high and reliable dividend yield. China has spent USD 200 billion on oil and has made deals with some Arab states, Venezuela, Brazil and is trying to corner oil supplies out of Nigeria. Why? The reason is that they know that it is getting more and more difficult to access oil and the demand supply equation can tighten very quickly. It is also a great way to preserve the purchasing power of all those dollars that they are holding. In fact the table above shows that as of the end of August global demand exceeded supply by 400,000 barrels per day.

Natural gas prices have been under pressure for the past 12 months but fell to extreme lows in September as US inventories were at historic highs. However, they have rallied 40% off their lows. The US has abundant supplies of natural gas. The cheapest way of reducing dependence on foreign oil and reducing carbon emissions at the same time would be for them to switch energy generation for industrial and domestic use gradually from coal and oil to gas. We believe that this will happen and that demand for natural gas will recover as will prices.

US Natural Gas price **Source Bloomberg**

The other major point of contention is the shape of the recovery. Is it a "V", "W", "L" or "U". The answer is probably all of the above depending on where you look. At the regional level, some key emerging markets have the best chance of a "V" shaped recovery with some experiencing a "W" with a shallower second leg.

As far as the US and some parts of Europe are concerned a "W" shape is more likely. However, there are parts of Europe and above all some sectors, which will experience an "L" or a very drawn out "U".

In our opinion the shape of the recovery is of some interest. However, each region and even sectors and subsectors will experience different shapes of recovery as already has been the case. Therefore, it is more important to position portfolios in the regions and sectors whose relative advantage is growing and avoid those whose relative advantage is decreasing.

The financial crisis has been the catalyst for a major structural change. We have written in great detail about this in our earlier theme papers. What the markets are concentrating on now is the cyclical move in various markets which though powerful will be of short-term relevance only. In our opinion, the major trends have been fortified by the events of the past two years and investing in those secular moves will be the key to investment returns over the next decade.

Gillian Hollenstein

Conclusion

We have managed our clients accounts very successfully using the strategies outlined in this document. The performance we have achieved has been realized without taking on additional risk. Buy investing in structurally strong themes and building or reducing positions with discipline risk has been held in check even though performance has been very strong.

We believe that in the future many themes outlined in this paper will continue to develop and will be drivers of the global economy and investment performance. This move will be accompanied by increased volatility and unpleasant surprises but we believe that the trend will persist.

We therefore hope that you have enjoyed reading this document and that it has provided a good overview of the structural changes “From Castles in the Air” i.e. over leveraged, inflated notions of the world, to “Windmills on the Coast”, i.e. real, growth supportive investments that we think has started and is set to continue.

Gillian Hollenstein

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