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The Great Transition- One Year Later

August 2012

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We wrote our first report on “The Great Transition” last year and are following it up with an update of where we stand today. We believe that we are in the infancy of the “Great Transition” and it is useful at this point to look at the fundamentals of the global economy in more detail in order to gauge the direction in which we might be heading. In the short term markets are ruled by noise. However, in the medium to long term the structural changes are what count when it comes to achieving good returns on assets.

The Great Transition - Equities vs. Bonds

Though we believe that we are at a turning point for equity performance, versus bonds, these transition periods are usually more volatile and drag on for longer than expected. The current rally in equities is a combination of short covering and the reflection of reduced levels of fear regarding the European debt situation. For the rally to continue there has to be a re-rating based on future growth potential versus valuations. We think it is a bit early for that due to all the European monetary and policy events approaching in September which we believe will cause headline risk to dominate once again.

The pressure on equity prices over the past two years has not been due to a fall in earnings but rather a fall in the price investors are willing to pay for the earnings due to the perception of high risk to the entire global financial and economic system. Equity markets do not necessarily only perform when areas or sector are growing. The starting level of valuations and the demand for equities are the key factors influencing equity market performance. At the moment valuations are towards the lower end of historical averages but demand for equities is still depressed (Chart 1). If GDP in developed countries remains low, real interest rates stay negative and wage pressures are benign, corporate profitability especially for multinationals will remain elevated. Cheap credit and excess cash is being put to use to support “Return On Equity”. From 2007-2009 companies were working primarily for their bondholders and equities suffered. Since 2009 companies are working primarily for equity holders as they can borrow at historically cheap rates and lock in these rates for 10 years while expanding in emerging markets to generate returns far exceeding their cost of capital which is a major plus for their shareholders. The earnings of a company are distributed between its employees, the government and shareholders. At the moment the bargaining power of employees is limited. Governments are being stricter with private taxes than with corporate taxes as they wish to encourage job creation. Therefore, the shareholder is the winner. Even if margins and profits have peaked, cash flow generation should find its way into dividend yield growth which is a major positive in the on going low yield environment even if markets stagnate.

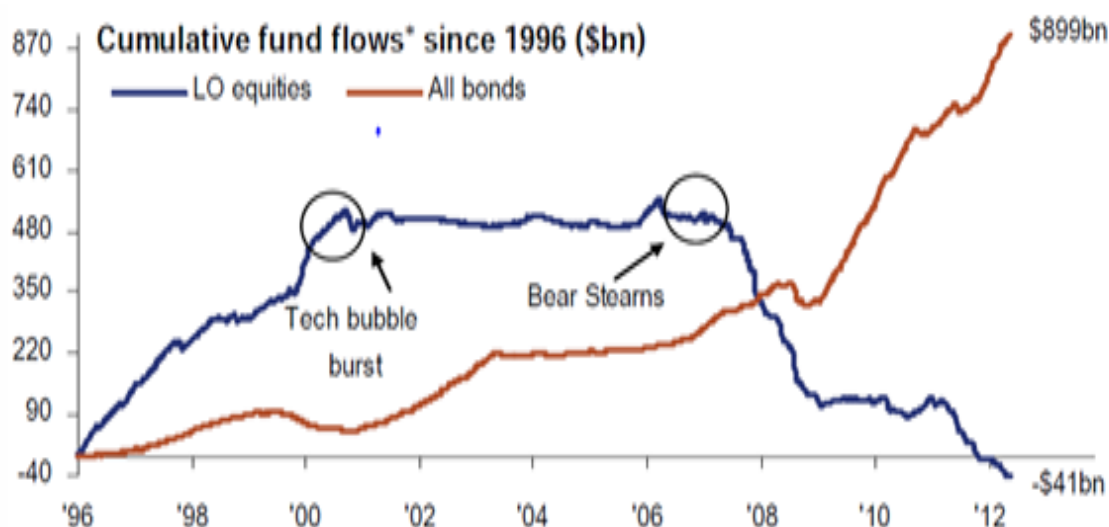


Chart 1: Cumulative Fund Flow

Source: BofA ML, EPFR Global, Lipper FMI

Even though 2011 gravely damaged the concept of risk free sovereign debt, equities with low valuations, good earnings and huge cash hoards still had a tough year. In 2011 we were emphasising the purchase of shares in large cap, defensive, quality companies with high dividend yields. These shares have now risen substantially and we have trimmed positions. However, given today's environment and the demographics of the developed world, companies with moderate growth, growing or stable dividend yields, reasonable valuations and healthy balance sheets will probably continue to outperform for a while. The average payout ratio for dividends is at 28% which is near an all time low versus the long term average of 40%. Therefore as the economic and financial environment shows signs of stabilising or at least avoiding another disaster, there is a strong likelihood of dividends rising. The Tech sector has the most potential to raise dividends. Many of these companies can raise their dividends substantially and still add to their cash piles.

The Great Transition – US - China

Structural imbalances have built up globally over the past 10-15 years, due to money printing and overconsumption as well as underinvestment in major parts of the globe and the opposite extreme in others. The dot com and housing bubbles generated plenty of disposable income for US consumers, who became the dominant force with regard to GDP growth in the US at the expense of investment and net exports. Cheap imports from China and other emerging markets are useful for keeping inflation low. However, the cash leaving the US creates jobs elsewhere and the capital returning buys US financial assets which do not stimulate local growth. Now as both the above mentioned sources of discretionary spending have dried up consumers have to live within their means and consumption is moderating. On the other hand the explosion in money supply is being used for asset shuffling and financial speculation and not for investment in future employment growth or production. Additionally, as a result of the financial crisis and its aftermath, not only are banks hoarding cash but treasurers of companies are too. This has highly reduced the velocity of money. Today more and more wealth is moving from investments which might support innovation and employment to art, gold, land, gems aimed at capital preservation and purchasing power maintenance in the midst of crisis and negative real interest rates.

However, recently, there is a transition towards an increase in production in the US again. Though this transition is in its infancy, it is an indication that the falling dollar and wage depression in the US is attracting investment once again. Productivity growth, subdued wages and a weak dollar are boosting the attractiveness of manufacturing in the US. Chinese wages have moved from 0.5\$/hr in 2000 to currently 3.5 \$/hr and non-wage expenses are higher too. At the moment Chinese wage costs are a tenth that of the US. However, even though their productivity has increased ten fold in twenty years, it is still less than one third that of the US. Therefore, after taking into consideration productivity and transportation costs, the US is looking attractive again for higher value added manufacturing. By 2015 China is unlikely to have a cost advantage over US factories in making products like construction machines which require frequent design changes and are made in small volumes.

On the other hand China and the rest of the emerging markets have started to emphasise consumption and though this transition is also in its infancy, it is an important step in the right direction. Unlike in the US, household income as a percentage of GDP is rising and business profit is falling. We must remember of course that decades of overconsumption and under investment in the US counterbalanced by overinvestment and under consumption in some emerging economies will not right itself overnight. The path to a sustainable rebalancing will be long and volatile but does offer several opportunities.

The Great Transition - The role of the Central Banks

All the major central banks are printing money. During QE2 the FED bought over half of treasuries. Of the 10Trillion outstanding US treasuries about half is held by official investors such as central banks. Over the past year China and Russia have been net sellers reducing holdings. This selling has been offset by private investors seeking safety from the EU crisis, banks being forced to own treasuries to boost capital ratios and the FED purchases. Foreign central banks have been buying hard assets to move away from the

dollar and other weak currencies gradually, as sovereign debtors attempt to inflate their debts away. Money Supply has been growing even in the emerging markets. Demand for gold in China is rising. India and China absorbed 50% of mine production in 2010. People in China are hoarding real assets due to negative real interest rates.

What has happened so far is that the FED and ECB are committed to keeping rates low in order to enable deleveraging of private, government and bank balance sheets. The FED tried to use inflated financial asset prices to get the high end consumer to spend and prompt the corporations benefitting from that spending to increase employment. Though the first part of the equation has worked, the hiring has not come through due to prevailing uncertainties. Neither of the central banks wants to be too aggressive as they do not want to cause a commodity rally and inflation issues which would undo a lot of what they are trying to achieve as far as growth and consumption are concerned. China and India spent most of last year fighting inflation and raised interest rates and reserve ratios several times to achieve their goal. So far China seems to have succeeded better than India has in controlling inflation. However, the growth in both countries has slowed from about 9% to about 7% due to the measures implemented. They have both reduced interest rates in the past few months which so far has been good for their bond markets but not so good for their currencies. This could cause inflationary pressures if the price of oil stays elevated. In September 2007 oil was at USD 78 despite solid global growth. However, as soon as the FED started to slash rates, oil rose to USD 147 even though there was a recession unfolding. As a result the oil bill for US consumers went from USD 75 Billion in 1998 to USD 500 Billion in 2006 and USD 1 Trillion in 2008. This was a huge tax increase for the consumer and worsened the recession in the US while causing a downturn in the emerging markets. This was an unintended consequence of loose money.

Since 2000, the contribution of non-OECD economies to global growth has increased more than 50% and energy demand growth 90%. Therefore, it is important that those overzealous actions by central banks are kept in check in order to avoid a repeat of the last round of inflation and its consequences i.e. a downturn in emerging markets. (Chart2)

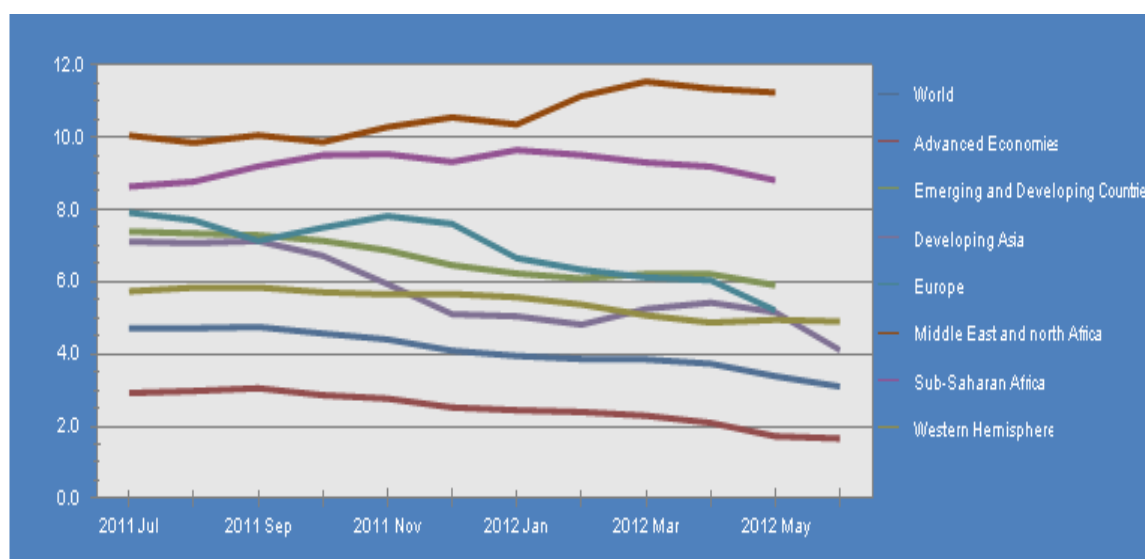


Chart 2: Consumer Price Inflation year-on-year

Source IMF

Deflationists are concentrating on the decrease in private credit but are ignoring the increase in public debt. Total debt payments are almost 1/3rd of total US tax revenues now. Therefore, the FED wants to keep real rates negative for as long as possible. This environment is unfavourable for cash and bonds which are experiencing negative real returns and favourable for assets like equities, commodities and real estate. The volume of dollars has tripled since 1995. However, the velocity of money has collapsed so consumer inflation has remained contained for the moment despite the rise in commodity prices.

Just as in Q4 2008 when investors were paying the US treasury to keep their money safe. So too investors are now paying the treasuries of the “safer” countries of Europe to ensure the return of their capital. The last time we saw this negative yield environment was very positive for equities over the next year and we expect the same this time around in Europe. Recently there were several countries with negative yields for government debt with maturity under two years e.g. Germany, Finland, Denmark, Switzerland and the Netherlands.

Even though the US, UK, Germany and Sweden have vastly deferring Debt/GDP ratios, budget surpluses or deficits, and current account surpluses or deficits, all the countries' 10year yields are about 1.5%. This is one more result of central bank intervention which will have to unfold over time.

The Great Transition - Europe

In Germany wages were kept low over the past decade and as a result German consumers became cautious and saved more than before. German banks channeled these savings into cheap loans to the booming European periphery and fueled the present bubble and resulting crisis. Now the periphery wants the German consumer to start spending more and the Germans want the periphery to provide them with products at better prices. The elements needed for the rebalancing seem to be in place; in fact the process seems to have started as trade surplus with the rest of the Eurozone has halved since the financial crisis. The drop in German exports to the periphery has happened not only due to the current crisis but also due to a rise in German imports. Germans are planning to travel more in 2012 than in 2011, listing Spain and Italy as their favourite destinations. Italy and Spain exported more goods to Germany in Q1 2012 compared to Q1 2011. However, the bulk of the increase in imports was driven by German industry importing parts and components from Spain and Italy in order to assemble and re-export a higher value product. Despite this, things seem to be moving in the right direction as private consumption is on the rise.

It is necessary for Germany to reflate while the south of Europe deflates. There has been a lot of resistance to this adjustment due to the historical experiences related to such moves. However, the Bundesbank has recently indicated that it is willing to accept higher inflation in Germany as a side effect of increasing the growth and competitiveness of the periphery. This comment has reduced fears among investors that the Germans would insist on an exit from the low interest rate environment earlier than would be desirable. A further important step would be if the proposal of the EU Commission that the ECB should be given responsibility for supervision of all banks, not only the largest ones, is approved by mid September.

The necessary steps towards a tighter Fiscal Union and the ECB as lender of last resort are both hanging in the balance as Germany is demanding fiscal reform before moving towards a guarantor status along with the IMF and ECB. The effect will be a systematic wealth transfer over many years which simultaneously addresses the differences in competitiveness. The decision of the German constitutional court on the ESM is due on the 12th September. Mid September is also when the IMF and EU decide on the Greek debt terms and conditions before releasing the next tranche of assistance. All of this uncertainty is causing caution in hiring, investment and spending, worsening prospects for economic growth and creating a vicious cycle.

Italy contributes 17% of European GDP and though its debt to GDP is currently 123%, it has no housing bubbles or private sector debt issues to deal with, so the economic outlook is more hopeful. Spain represents 11.5% of Eurozone GDP. However, even though their debt to GDP ratio is under 90% they have the additional aspects of a housing bubble bust and very leveraged banking and private sector to deal with which is adding to budget and current account strain. The ECB is ready to buy the short term bonds of Italy and Spain with conditions attached. Italy has asked that there be no conditions. Since the announcement yields have already dropped significantly enough for both countries to delay asking for help. These moves in yields will also encourage them to drag their feet on austerity measures as there is already a lot of popular opposition to the cuts. Therefore, the whole situation has probably got to get worse from

this point to trigger a request for help which will not be good for markets in the short term even though we believe a solution will be found.

The Great Transition - Emerging markets

In India the middle class is the fastest growing of all BRICs and is expected to equal the US by 2020, i.e. those with more than USD10,000 of disposable income. Its workforce is amongst the youngest in the world today. India will add more workers than any country in the world over the next decade. The workforce will equal that of China by 2020 and it will have fewer dependants per working person. China needs to climb the value added ladder as more than 30 million people are expected to leave the workforce by 2020 and this will sustain the upward pressure on wages. Indonesia, Philippines and Vietnam will add about 20 million new workers in total and India will add about 70 million on its own! The workforce is also getting more productive. Therefore, India will gradually transition from exporting mainly services to exporting goods as well and hence will start to increase their export contribution to GDP. Unlike China the bulk of India's GDP is currently driven by domestic consumption. Structural credit growth is three times that of the US with low penetration and good credit quality. Through the crisis and over the past four years India has reduced its debt as a proportion of GDP. However, at the moment the Indian stock market is the most expensive of all the BRICs and stock picking rather than index tracking is our recommendation.

Chinese inflation is now below 3%. Therefore, there is plenty of scope to use stimulus and currency weakness to promote growth. The biggest risks to growth come from exports and the real estate markets, the primary drivers of GDP over the past decade. Chinese urban population has grown from 10% in the 70s to 50% now. This has increased demand for housing and consumer goods. Retail sales have doubled since 2007. However capital expenditure still dominates GDP growth and capital has been allocated less than wisely. Official Chinese debt to GDP is low but hidden debts in banks and local governments make the picture murkier. The Eurozone is China's biggest export destination and synchronised deleveraging is leading to subpar export growth for longer. We believe that these factors will force the transition towards more consumption even if the process takes longer than we would like.

Brazil has announced a large stimulus package to support growth and has reversed measures implemented last year to weaken the Real. Russia has joined the WTO and its stock market is trading at the lowest multiples of P/E and P/B of all the BRICs. All the BRICs are going through transitions of their own and this is happening simultaneously which is never a smooth ride. However, structural changes open up plenty of opportunities.

Our opinion of how things should unfold

The emerging markets have moved from inflation fighting to stimulating growth, the US does not intend to raise rates till 2014 and is contemplating further quantitative easing. The Bank of England has expanded its asset purchasing programme, the ECB is moving in a similar direction and the Japanese easy money policy is decades old and going strong. This is the first time since the crisis that all the major banks are in easing mode simultaneously.

We believe that a short term solution for Greece will be found even if it is at the very last minute. Italy and Spain are more manageable and should be addressed in a more confident manner than was the case with Greece. We have seen very positive reactions from the markets every time a step is made towards avoidance of disorder and contagion. In past recessions no new capacity was built. However, in this one 7% of capacity has actually been destroyed. Therefore, a turnaround could be quite strong. Borrowing from banks is low because companies have enough cash of their own and capacity to borrow cheaply from the markets. Therefore, if investors get the impression that there is a viable plan, a revaluation rally in equities would follow the current short covering rally.

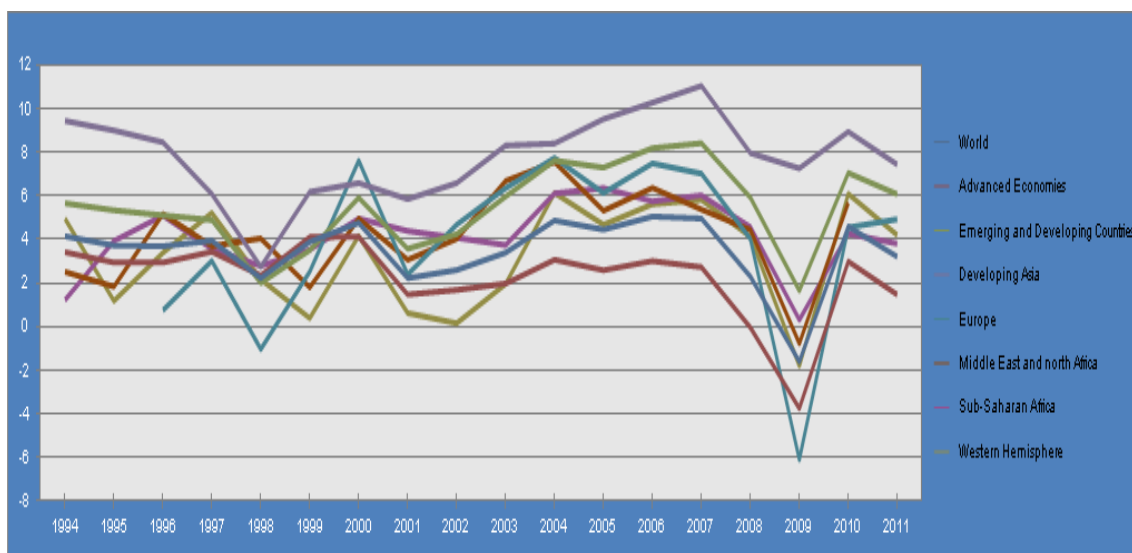


Chart 3: Real GDP Growth

Source IMF

We expect lower economic activity in developed regions than markets would like, resulting in low interest rates prevailing for longer. Even if interest rates rise gradually, it will take a while for real interest rates to turn positive and this is supportive of riskier assets like equities and commodities. The “emerging” economies should grow at a healthy pace even if it is lower than the recent past. (Chart 3)

In April this year we reduced our total equity exposure by cutting back the cyclical exposure of our client portfolios. We added further to the weight of the more defensive and high dividend paying equities. In June we added slightly to our cyclical exposure and have recently trimmed the more defensive positions which we had initialized last year but are now looking a bit overstretched. We remain underweight bonds and temporarily underweight commodities and emerging markets but have added to positions over the summer.

This regular rebalancing of portfolios has proved to be positive for the performance of our client portfolios once again and though it is almost impossible to time market moves, we believe that the prudent approach based on fundamental analysis increases opportunities and reduces risks and has lead to consistently superior performance for our clients.

Gillian Hollenstein

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