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The Great Transition

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After the “Great Recession” followed by a two year rally in equity markets globally investors now face the typical mid-cycle anxieties with the additional insecurities of a sovereign debt crisis and a troubled MENA (Middle East and North Africa).

We believe that we are now at the start 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.

Liquidity

A major reason for the dramatic fall of the equity markets in Q4 2008 and Q1 2009 was the complete drying up of liquidity even for the best rated companies in the world. To counter balance this situation global monetary policy followed a path of liquidity injection which led to the rapid deleveraging of corporate balance sheets and a sharp rebound in equity markets till spring 2010.

In spring 2010 when deflation scares returned, global equity markets dropped sharply until summer 2010 and only started the six month rally till February 2011 when the FED announced the second round of quantitative easing (QE2). QE2 was aimed at moving away from a deflationary scenario and has worked a little too well as it created substantial inflation problems in the emerging world and inflation/stagflation concerns in the developed world. The emerging world has tried to peg their currencies to the USD in order to support their export driven growth. QE2 resulted in a weaker dollar and massively higher commodity prices and the importation of inflation through commodity prices into the emerging markets. As food and energy make up a very large percentage of the consumer price basket of most emerging countries, this resulted in an increase in inflation that was well above what the local authorities found acceptable. This rise in inflation put upward pressure on wages in the emerging world. The rise in consumer prices translated fairly quickly to wage inflation and/or social unrest as seen in the MENA.

Therefore emerging market central banks and those of the commodity producing nations which have benefited from the growth of the emerging markets have raised interest rates and increased bank reserve requirements in an attempt to engineer a soft landing. This implies lower inflation but also lower growth. Additionally, the FED has announced that there are no plans for QE3 when QE2 ends this month and the ECB has indicated a rate rise in July.

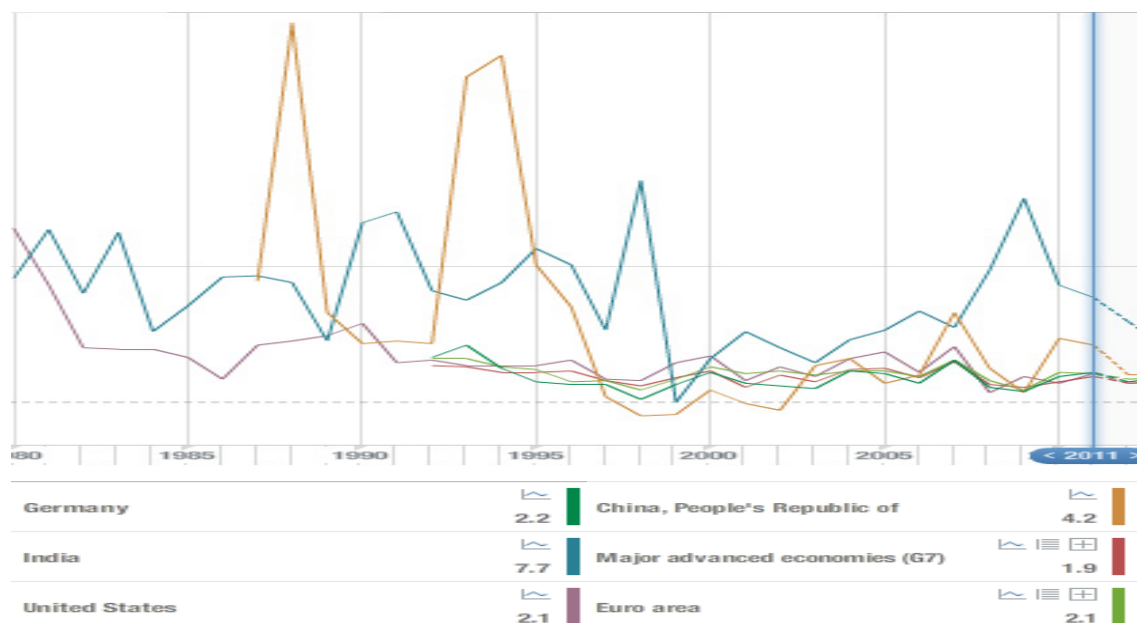


Chart 1: Consumer Price Inflation and projections 1980-2013

Source IMF

However, all of this means that liquidity is still plentiful; it is not rising as it has been for the past two years but there is no substantial withdrawal either. In the emerging markets, there are signs that inflation has peaked (Chart 1) which would indicate a pause in the tightening cycle. The FED is ending QE2 and not adding liquidity to the market with QE3 but not removing liquidity from the market either. All of this should be viewed positively as the FED seems confident that the economy can grow albeit slowly and that QE3 would not add much to growth but rather exacerbate the already delicate inflation situation. At the moment inflation not growth is the bigger concern as it is eating into spending power in developed countries and causing emerging countries to suppress growth in order to fight inflation. As the world is increasingly dependant on the emerging markets for growth it would be counter productive to launch QE3 which would result in more inflation and more growth hampering measures in the emerging world.

We are now in the big liquidity transition from abundant and ever increasing liquidity to stabilising and mildly contracting liquidity. This transition is obviously causing a lot of anxiety as there are concerns that the global economy is not strong enough to grow without this perpetual stimulus. The sovereign debt crisis in Europe further aggravates the situation as investors fear that it could result in another liquidity and solvency crisis with similar consequences to the Lehman Brothers demise.

We believe that the end of QE2 will be a net positive for global growth and inflation as emerging markets can return to concentrating on growth without the excessive worries of inflation that QE3 would almost certainly trigger.

Global Economic Dynamics

The Dynamics of global economics before the financial crisis were unsustainable. The US was the world's biggest consumer and demanding vast amounts of goods from China which was the producer of choice as

Developed	Emerging
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

their cap on the appreciation of their currency kept export prices low. This led to large trade deficits in the US and surpluses in China. The Chinese surpluses were returned to the US in the form of treasury purchases, capping interest rates and leading to a hunt for yields in housing, mortgage backed securities commodities etc. and ultimately the worst crisis since the great depression.

In March 2009 we published the table above indicating the global contrasts which would influence growth and private/public finances in the future. Monetary policy globally prevented a depression but the "Great Recession" and its aftermath will have to be digested over a decade or more. After the financial crisis the US is expecting China to play a bigger role in global consumption and to let its currency appreciate gradually but substantially to make the transition more affordable. This would result in a moderation of trade deficits/surpluses between the two nations. At the GDP level, this would mean a slightly stronger growth for the developed countries and a slightly lower growth rate for the emerging markets which would also keep commodity prices more manageable. Chinese growth should be less dependent on the export of consumer goods from China to the US and more on domestic consumption. Right now 2/3rds of Chinas

growth is export driven and 2/3rds of US growth is consumption driven. China should also increase the import of US and European consumer brands and industrial products and services.

So far the Chinese have let their currency appreciate only slightly. However, the need to do more has been acknowledged and China is well aware that if they want to progress to a point at which their currency is viable for global trade, they need to start reform in the near future. Their growth has moderated due to interest rate and reserve requirement increases. This has had a dampening effect on global commodity prices. The lower prices should help the US and developed market consumers as well as the emerging market consumers. China has also implemented several measures in its current 5 year plan to improve social security and the development of areas other than the coastal hubs. These measures should reduce the savings rate in China and increase private consumption. In the US and other developed countries savings rates have increased as households worry about their future and as wage caps result in increased productivity some developed nations will find it more profitable to conduct the higher skilled manufacturing for local consumption domestically.

Therefore the transition should lead to US and developed country wages stagnating, productivity increasing and GDP growth low but improving. Chinese and emerging market wages rising, productivity at some levels of skill falling but at other levels rising and GDP growth moderating at high levels (Chart 2). Inflation rising in the developed countries but at moderate levels and moderating in the emerging countries as growth is less export driven and more domestic consumption driven based on gradually appreciating currencies.

It appears that there is a commitment globally for the above outlined transition to take place. However, as with all transitions this one has been and will remain volatile.

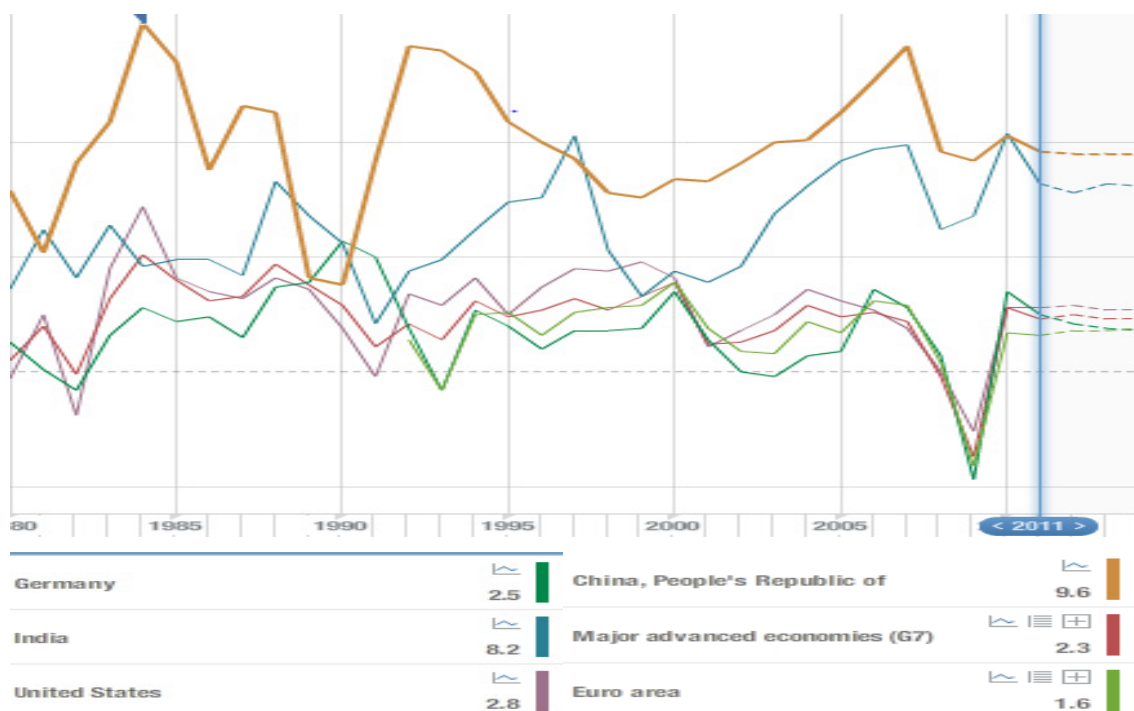


Chart 2: Real GDP Growth and projections 1980-2013

Source IMF

Health of the Public and Private Sector

The Public debt situation in most developed countries is a major source of concern for investors as it should be. In order to save the financial system the governments of Europe and the US have taken on a debt burden which is unsustainable.

In the US, several states and municipalities are technically bankrupt and in Europe the situation in Greece, Ireland, Portugal and to a lesser extent Spain and Italy is causing anxiety on a daily basis. On the other hand corporate balance sheets in the US and Europe are looking better than at anytime in the past 50

years. Companies (ex-financials) learnt the liquidity lessons from the fourth quarter of 2008. As a result, over the past two years, they have reduced their dependency on banks by issuing long maturity bonds at historically low interest rates. This has reduced their cost of capital considerably. The extra return has enabled deleveraging of balance sheets and the return of cash to shareholders through higher dividends and share buybacks. Investors have realised this to a certain extent as they have been keener to lend to companies than to governments over the past year.

In 2001 developed country balance sheets looked a lot better than corporate balance sheets (Chart 3). Ten years later the situation has reversed with the exception of financial companies.

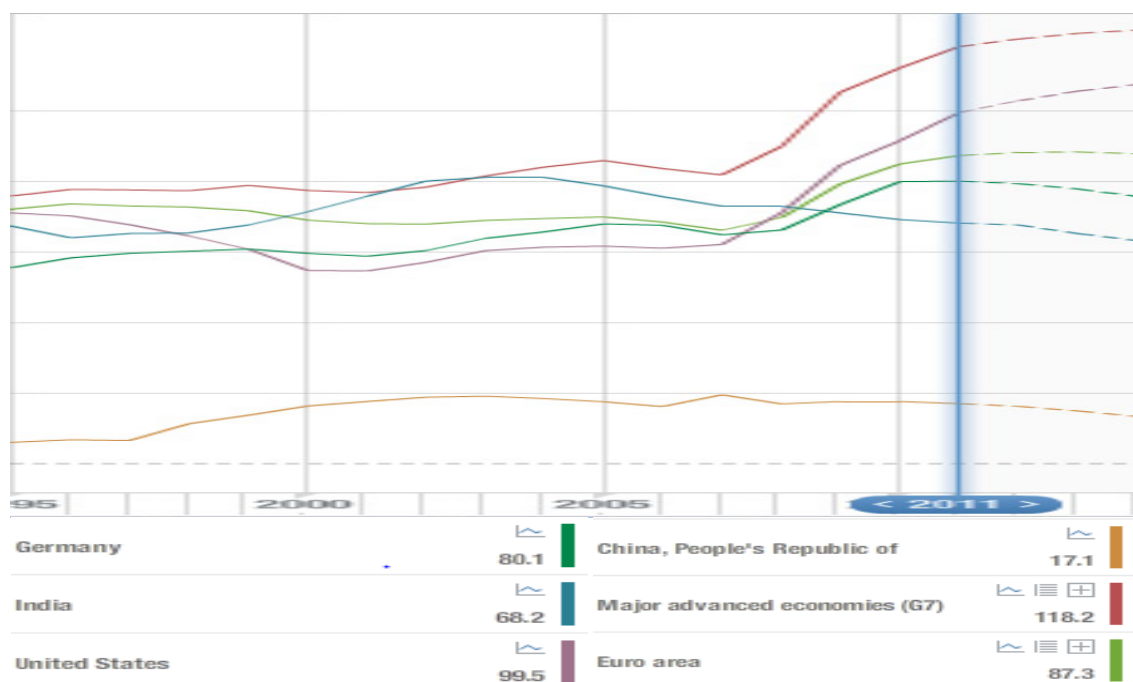


Chart 3: Government Debt as a percentage of GDP and projections 1995-2013

Source IMF

Households in the US are overleveraged on average but the situation has improved. In Europe there is a mixed picture but on average households have a much higher level of savings and lower level of debts than the US. Emerging market households tend to be the least leveraged on average and have the highest levels of savings.

Due to the events of the last three years we have seen the level of savings in the US and in many countries of Europe rising as individuals become more concerned about the future and about their governments ability to meet the promised entitlements payments. In the emerging markets as future prospects look brighter and job security as well as social security improves, there is a tendency to save less. This transition should also contribute positively to the rebalancing of global balance sheets over the next five to ten years.

Our opinion of how things should unfold

We believe that the fact that emerging markets and the US are both addressing inflation simultaneously is a good sign. The US is ending QE2 and the FED seems to be leaning toward improving its balance sheet very slowly as a first small move towards reducing excess liquidity. The emerging markets and commodity producing nations have been raising interest rates to stem bubbles in their countries and cap inflation. The ECB has telegraphed an interest rate hike at their next meeting as well. Therefore the global environment seems to be in transition from excessive liquidity and very negative real interest rates to reduced liquidity and less negative real interest rates which should lead to more fundamentally driven investment and less speculation.

We believe that a solution for Greece will be found even if it is at the very last minute. The result of the European debt crisis should be a transition towards more centralisation of debt issuance and budget

control in the medium term. Even though we do not expect these moves to happen in the near future, if the general direction of development is established as a result of the crisis, the markets should look upon it favourably.

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.

Every cycle has a mid-cycle hiccup when growth stocks and regions stop out-performing and the value areas do not have enough backing from investor conviction to outperform either. We seem to have reached this place in the first half of 2011. When QE2 started last year it was popular to short the dollar and buy commodities and growth regions and stocks. As the end of QE2 approaches, this trade has lost momentum. It appears that the US dollar has stabilised and could rise about 10% versus most of the major currencies. Commodities, equities and emerging markets have lost their momentum and prices are now trying to find their level of support. This means that emerging markets can gradually step off the brakes with the threat of inflation reducing and the need for growth taking on greater significance.

Most multinational corporations (ex-financials) in the “developed” world have healthy balance sheets and good cash flows and have increased productivity and reduced costs in the past two years. Even before the financial crisis hit, they were facing very lukewarm growth in the “developed” world and looking for growth in the “emerging” world. This has not changed. However, their circumstances have improved and so have their valuations. They are able to borrow at interest rates 2-3% cheaper than they could in 2007 and expand their businesses in emerging markets with returns significantly higher than the cost of capital. This increased profitability has already given rise to higher dividends and share buy backs and this trend is set to continue. Taking this background into consideration, it appears that bond holders are lending at low rates to the equity investors of these companies and receiving little in return. They are also exposing themselves to interim capital losses as interest rates rise.

In March this year we reduced our total equity exposure and within it the cyclical exposure of our client portfolios. We increased the weight of the more defensive and high dividend paying equities. Our clients have benefited from the additional stability and income that this positioning has brought to their portfolios. We have recently started to add some cyclical exposure but will proceed slowly watching for the confirmation of the scenario we have outlined above. We remain underweight bonds and temporarily underweight commodities and emerging markets but intend to add to positions over the summer.

We have successfully applied this rebalancing approach in the past and believe that though it is almost impossible to time market moves, 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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