

Commentary

24th of August 2011

After the extreme volatility of the past weeks, it is worth pausing to review what is happening in financial markets.

SOVEREIGN DEBT ISSUES

The European Sovereign debt crisis has been the primary concern for investors in August. The market was already unsettled from the haggling in the US with politicians unable to put forward an acceptable budget targeting US debt reduction in the medium term. The downgrade of the US long term debt rating by S&P added further to investor unrest and the risk-off trade. As the focus moved to Spain and Italy, investors became concerned that politicians and Central Banks are not prepared to tackle the very serious escalation of yields for these two large nations. Portugal, Ireland and Greece are relatively small and since the leaders in Europe did not show enough conviction when dealing with them, their capacity to do what is needed for a comprehensive solution to the debt crisis is in serious doubt.

RECESSION FEARS

While political decisions are very unpredictable and therefore a source of concern, the recent worries about a global economic slowdown turning into a recession seem overblown. It is unfortunate that all of the above mentioned issues coincided with macro economic data showing a slowdown in China and the US. However, the markets completely ignored the fact that the effects of events in Japan this March have shown up in June and July with a delay. Besides, the slowdown in Japan itself turned out to be less drastic than previously feared. The reduction in growth in China is something the Chinese have been trying to achieve since October 2010 and should be seen as positive as this should calm inflation fears. We should also remember that high oil prices in Q2 2011 coupled with worries that government employees and social security recipients would not receive their salaries and payments due to the debt ceiling issues caused consumer confidence to be very low. Oil and commodity prices are lower now and the debt ceiling decision has ensured that people depending on their monthly payments actually receive them.

Last week, leading indicators in the US were positive and the capital goods numbers this week were far stronger than expected. Therefore, with the back drop of low inventories, normalisation in Japan and China being able to concentrate more on growth than inflation, a slow down is in place but we believe a recession can be avoided.

OUR CLIENT PORTFOLIOS

In June and July we reduced risk in client portfolios as we were expecting some market consolidation. This has helped keep portfolio volatility in check. However, the speed at which several support levels were broken on major markets worldwide has caused concern among investors that things could get a lot worse. While this possibility cannot be completely ruled out, we feel it is important to examine a few points in more detail.

1. We have stayed completely away from bank stocks and bonds since 2007 before the crisis and have not invested in the instruments of this sector since then. The banking sector has suffered the most losses in the recent sell off and our client portfolios have been protected from this negative influence.
2. Several funds have received redemptions or margin calls and had to liquidate their most profitable positions to meet these payments. As a result many companies that recently published strong results beating consensus estimates and presenting confident forecasts have also felt the brunt of the risk-off trade.
3. These include multinational companies with strong balance sheets and cash flows which have the possibility to borrow in bond markets at historically low interest rates and invest in growth markets in Asia and South America to achieve excellent returns on equity. Additionally, they pay dividends that are higher than the interest paid by their respective sovereign entities. Some of these companies even have a higher rating than their respective sovereign entities.

It is our opinion that when the focus on fundamentals returns, the regions, sectors and companies with the best balance sheets and cash flows will be the winners.

OUR ASSUMPTIONS

Barring an unexpected geo-political event or political/central bank policy surprise we believe that markets should move as follows.

Gold, the Swiss Franc, Japanese Yen and Bonds have benefited from the flight to safety trade. Bonds have become even more expensive than they were last year before they sold off. We had sold bonds last summer before their fall, and had simultaneously increased our equity holdings. After having benefited from this position we simultaneously reduced our equity holdings especially the more cyclical stocks and increased bond positions in H1 2011. We believe it is time to once again gradually start reversing this position. As we expect equities to outperform bonds going forward. We expect Gold, the Swiss Franc and Japanese Yen to correct as well, as they consolidate from these overextended levels.

The emerging markets have had to tackle inflation for the past year and have dampened growth in their economies as a result. Even so, they are growing at rates ranging from 2-5 times that of the US and Europe. Many of them have accumulated foreign exchange reserves and are either running surpluses or have improved their budget deficits since 2008. After the recent correction in oil and some industrial commodities, we believe that the focus in these nations will return to growth as concerns about inflation fade. This should have a positive effect on equities in these nations but also those in Europe and the US supplying them with their infrastructure and consumption requirements.

As investors search for yield, the multinational companies mentioned above will prove to be attractive investments. These companies present the possibility of capital appreciation in the medium to long term while paying excellent dividends each year. They have volatility that lies somewhere between that of the average equity and bond markets and we believe that this profile will be favoured by investors in the coming months.

Therefore, though we accept that we are experiencing a time of great uncertainty, we believe that we should not completely ignore the positive indicators. Investor sentiment is at very low levels and we believe that as even small bits of good news trickle through, the positive effect on equity markets could be substantial as most market participants are underexposed to equities and overexposed to bonds. We are not inclined to rush in or out of any particular asset class but believe that a gradual move at these levels will prove to be fruitful in the medium term.

Gillian Hollenstein

Important Disclosures

This report provides general information only. Neither the information nor any opinion expressed constitutes an offer or an invitation to make an offer, to buy or sell any securities or other financial instrument or any derivative related to such securities or instruments. This report is not intended to provide personal investment advice and it does not take into account the specific investment objectives, financial situation and the particular needs of any specific person. Investors should seek financial advice regarding the appropriateness of investing in financial instruments and implementing investment strategies discussed or recommended in this report and should understand that statements regarding future prospects may not be realized.

Any decision to purchase or subscribe for securities in any offering must be based solely on existing public information on such security or the information in the prospectus or other offering document issued in connection with such offering, and not on this report. Securities and other financial instruments discussed in this report, or recommended, involve numerous risks, including, among others, market risk, counterparty default risk and liquidity risk. No security, financial instrument or derivative is suitable for all investors. In some cases, securities and other financial instruments may be difficult to value or sell and reliable information about the value or risks related to the security or financial instrument may be difficult to obtain. Investors should note that income from such securities and other financial instruments, if any, may fluctuate and that price or value of such securities and instruments may rise or fall and, in some cases, investors may lose their entire principal investment. Past performance is not necessarily a guide to future performance. Foreign currency rates of exchange may adversely affect the value, price or income of any security or financial instrument mentioned in this report.

Copyright LABHA Investment Advisors SA, All rights reserved