

LABHA
INVESTMENT ADVISORS SA

Strategy 2014

Catching up with the US?

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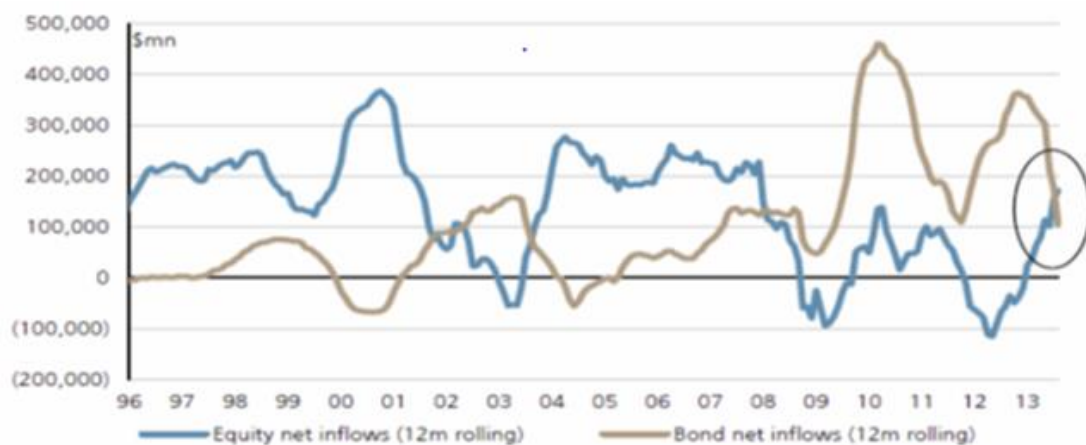
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Strategy Overview

At the start of 2013, there were more concerns for global growth than there are now as we approach 2014. The US fiscal cliff discussions and their side effects, Europe in recession and China in danger of a hard landing were major issues for the markets to deal with last year. As it turned out all three economies did better than expected. The US showed continued improvement, Europe emerged from recession and China avoided a hard landing.

As we look forward to 2014, US growth has improved enough for the US Federal Reserves (FED) to reduce their asset purchasing programme/Quantitative Easing (QE). Growth in Europe though weak seems to be improving and Chinese growth has done better than expected for the year and could surprise in 2014 as the newly established reforms are rolled out. Therefore, for the first time since the financial crisis the three key contributors to growth are moving in the same positive direction and Japan which has struggled with its growth even before the crisis is also a positive contributor.

The graph below shows the net inflows into Equity funds in blue versus bond funds in brown. This is the first time since the financial crisis that equity fund net inflows have exceeded those of bond funds. Even though recently flows into equities have been larger than into bonds for the first time in six years, estimates are that only one tenth of the money which flowed into bonds has returned so far. Therefore, there is still a lot of potential for flows into equities especially if, as we are expecting, growth steadily improves and operational leverage, especially in Europe, contributes substantially to earnings per share improvement. Equity markets re-rated in 2013 based on the assumption that the worst of the financial crisis is behind us. However, for markets to rally further, earnings per share gains and revenue gains need to be the drivers. Except for the base effect driven bounce in 2009/2010, 2014 could be the strongest year for global growth since before the crisis started. Though corporate margins recovered to peak levels in 2010 they have fallen 150 bps since then. The Q3 2013 reporting season showed the first signs of margin improvement in two years. Upgrades to margins typically lead revenue growth.



12 month rolling net flows into equity and bond funds

Source ICI, Haver, UBS

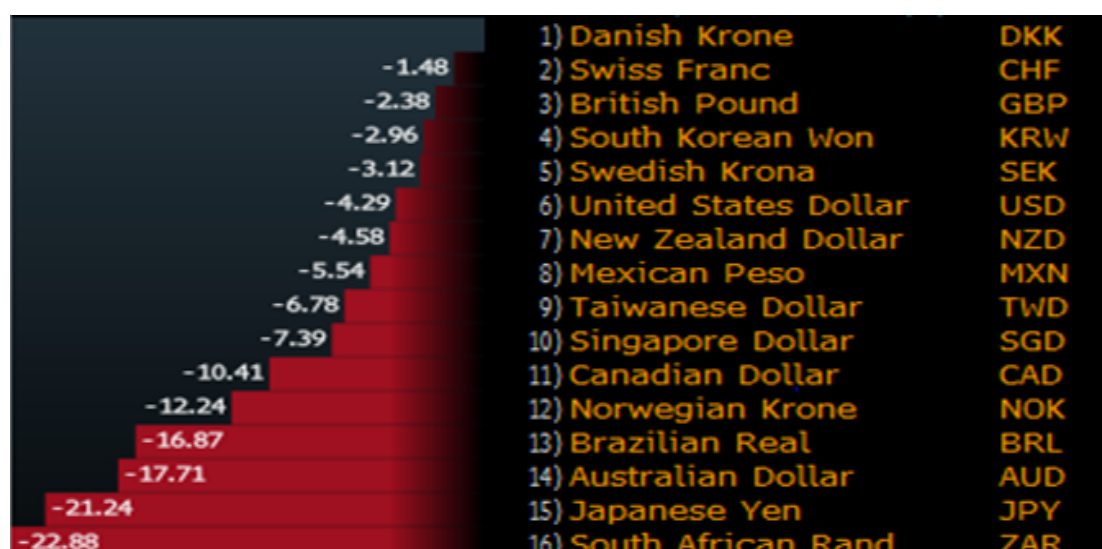
The key concern for markets in 2014 is the tapering of the QE programme of the US FED. Equity markets sold off in May and June 2013 as bond yields in the US rose due to discussions regarding the US FEDs' intentions to reduce QE later in the year. Even though the tapering of QE was delayed, investors knew that it was a matter of weeks or months before it got underway. The FED announced the start of the tapering process in December and the markets seem to have handled the news a lot better than most expected. We believe that the reason for this relative resilience is that the following points were given more attention than the fact that the FED has begun tapering. 1) The US is now issuing less Treasuries than it was a year ago due to the reduction in the deficit which has reduced debt financing requirements. As a result the US FED was buying 80% of issuance in December and would have reached 100% by Q1 2014 if it continued its purchases at the same pace. This would cause a problem for anyone else wanting to buy Treasuries, e.g., Pension funds and insurance companies. They would have little or no supply and would be competing on price with the FED. Therefore, despite the taper, the stimulus effect of buying such a high percentage of treasuries should be even greater.

than when the program first started. 2)The FED has emphasised that it will keep interest rates at current levels for longer than the market was expecting. Therefore, moderate tapering, low interest rates for an extended period and economic growth improving has contributed to market resilience.

Historically when yields started to rise from very low levels, equities rallied strongly as this was a sign that growth was improving from depressed levels. So it is more important to keep an eye on the reason for a yield rise and not the mere yield rise itself. If yields are rising because of poor credit quality, lack of demand for debt or to combat inflation while growth is weak or stagnating, it would be damaging to equity markets. However, if yields are rising as global growth is picking up, it could be very positive for equities. Either way it appears that market volatility will rise but that investors will probably see no way around equities to earn a return on their assets for the foreseeable future.

Currencies

The Euro and CHF turned out to be the strongest of the major currencies in 2013. The strength of these two currencies has been exaggerated by various central banks from Norway to Australia talking down their currencies.



Performance of global currencies vs Euro 2013

Source Bloomberg

What has also been surprising is that despite the perpetual discussion with regard to the US Federal Reserve tapering Quantitative Easing, the dollar weakened versus both the EUR and the CHF in 2013. A combination of less reliance on imported oil, better competitiveness in the manufacturing sector, smaller deficits and the expectation of a reduction in QE should have been supportive of the dollar. Dollar weakness has helped US exporters at the expense of European exporters and considering the fact that the US was growing at 3.6% in the past quarter and European growth turned positive only recently, this is bound to be a concern for European governments and the ECB. We expect the ECB to announce some measures in the first quarter of 2014 which should weaken the Euro and per default the CHF.

In our opinion, commodity supported currencies like the Australian Dollar and Canadian Dollar will probably continue to experience bouts of volatility as they did last year but should develop favourably as growth improves globally and the market takes note of the recent strong increases in copper imports into China and the rise in iron ore prices. In summer this year emerging currencies fell as a result of the discussion regarding the FED taper. The most effected currencies were the Turkish Lira, Indian Rupee, Indonesian Rupiah, South Africa Rand and Brazilian Real. i.e. countries with internal and external deficits.



Performance of INR, BRL, TRY, ZAR, IDR vs USD 2013

Source Bloomberg

What is noticeable however, is that even though most of the above mentioned currencies are hovering around their lows for the year versus the US dollar, the Indian Rupee has recovered half its initial losses. India has been the most successful in reducing the current account deficit and has implemented measures to attract foreign exchange inflows. Though there is a lot of work still to do as far as financial and economic reform are concerned, we believe that markets were surprised at the speed and effectiveness of the measures implemented to reduce the current account deficit from levels of 6% in the second quarter of 2013 to below 3% today. We believe that the Rupee is now at levels at which Indian exports are supported and the oil import bill is not too much of a burden. We therefore expect the Reserve bank to be comfortable with the 57-63 range versus the dollar and take action whenever necessary to maintain it. The reserves used to defend the Rupee in 2013 have already been replenished and even increased.

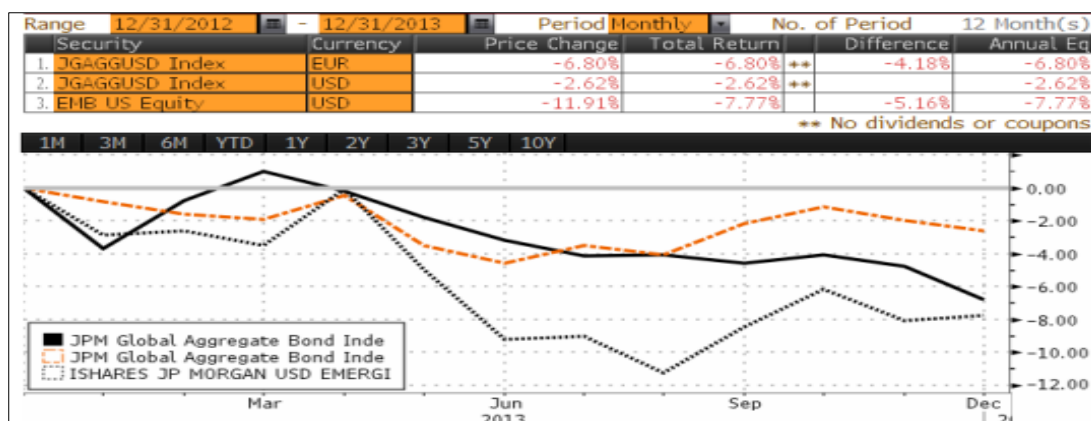
The Japanese Yen has weakened considerably in the past quarter as a result of political and central bank posturing and we expect this trend to continue with some consolidation expected in the short term. However, we must realise that currencies are being driven much more by politics and central bank intervention than fundamental value and the resulting moves have been and will probably continue to be substantial.

The Norwegian Kroner is a very good example of this. Norway is one of the few countries with current account (11.8% of GDP) and budget (13.8% of GDP) surpluses. It has real GDP growth of 2.1%, inflation of 2.5% and unemployment of 2.6%. Though the government intends to spend more of petroleum revenues in the coming year, it will still be "just" 2.9% of the value of their Pension Fund Global (4% is the maximum amount). The market value of the Pension Fund Global is estimated at NOK 4,863bn at the end of 2013, and NOK 5,340bn at the end of 2014 (or 160% of GDP). Despite all of this it has been possible for the Norwegian central bank to talk down the Kroner 12% versus the Euro by simply postponing interest rate rises and saying that they are not satisfied with growth. When we look at the European Union with its -0.4% real GDP growth, inflation of 0.9%, unemployment at 12.1%, current account balance of 2.2% of GDP and Budget balance of -2.3% of GDP, this currency move becomes hard to comprehend. Mr Draghi, the president of the ECB, has confirmed several times that interest rates will stay low for a very extended period of time but all of this put together seems to have no impact at all for the moment. We believe that this unbalanced situation will correct itself in 2014.

Bonds

In our 2013 strategy paper we stated that "When rates are as low as they are now (at the start of 2013) and when so many extraordinary measures have already been taken to keep them low, the danger that sudden upward moves can result in substantial losses for bondholders is ever present. We had bought corporate bonds in 2009 and 2010 with average durations of about six years. The duration of these portfolios is about three and a half years now and we intend to keep it that way." This positioning resulted in a much better performance in our developed market bonds portfolios than could have been expected. We continue to advise a lower than average allocation to bonds with shorter durations in the developed markets. What we have noticed is that though peripheral European bond markets have recovered and high yield debt in developed countries has rallied strongly, emerging market debt has been hit across the board and looks attractive at current levels. This especially applies to higher grade issuance from governments or government agencies. We therefore maintain a small diversified exposure to this segment. There is a tendency for investors to buy high yield bonds in Europe in preference to emerging market bonds or even high quality dividend yielding equities- This logic is

surprising because if the latter two are being avoided due to a fear of rising interest rates then one could conclude the high yield bonds must be avoided too.



Performance of Developed market bonds vs Emerging market bonds 2013

Source Bloomberg

Equities

As noted by Barron's in their December 9th issue "if you purchased a portfolio of the 50 most shorted stocks at the beginning of 2013, that group - mostly low quality companies with challenged business models - outperformed the market by 16 percent." Or as BoAML puts it "The 'Boom' which began in June is clearly different to that of previous cycles. Measures of risk aversion have gone from fear to greed and this has been reflected in the performance of *low Quality* and *high Risk* stocks."

Most investors imagine that if Indices across the developed world are up 15-20%, that this applies to most stocks in the Indices. This is not the case. The higher quality and better cash flow companies underperformed by substantial amounts ranging from 5-10% whereas the low quality companies mentioned above outperformed by 16% on average. Therefore the low quality was up 30-35% and the high quality just 5-10% giving an average of 15-20%.

After being extremely risk averse in 2011 and 2012 and buying only companies with reliable balance sheets and cash flows, risk appetite seems to have shot through the roof in 2013. Investors seem to have gone from a preference to bonds over equities to a preference for the riskiest equities over anything else. The result is that many high quality companies with stable cash flows and solid balance sheets have been neglected and are now being mentioned in the newspapers as attractive stocks with good potential to gain over the coming year.

Our preference has always been to buy companies with solid balance sheets and good cash flows when they are being ignored by the market. We have continued to accumulate such shares in 2013 and they are recently being mentioned in the media which is an encouraging sign. While there is no way to predict what the market might do in any 6-12 month period, history has proven time and time again that undervalued stocks with solid balance sheets and reliable cash flows with the potential to increase dividend payouts have performed better than their low quality counterparts and done so with less volatility which means less risk for the holders of such shares. We believe that 2014 is the year when quality returns as a focus for investors.

Regions

Emerging markets were the worst regional performers of 2013. While the average equity market was up 15-20%, emerging markets were down 5-15%. This is despite the fact that they are trading at low valuations in both absolute and relative terms. China trades at 8 times earnings with dividend yields of 3.75% which compares to 17 times earnings and 2% yield in the US and 17 times earnings and 3.6%

yields in Europe. This spread is extreme and is discounting a lot of good news for the US and very pessimistic views on emerging markets. We saw similar valuation discrepancies in European markets in 2011 just before they started to rally strongly. We believe that though Europe has some catching up to do versus the US, the Emerging markets are a cheap and neglected segment and are worth a second look.

Just as the idea of decoupling was proven false in 2007 and 2008, we believe the same is true now. In 2007 and 2008 many investors were very convinced that Emerging markets could continue to grow irrespective of issues in the US and Europe. This assumption was proven false. Therefore, it is worth noting that as investors have become more positive regarding global growth, they have now decided that decoupling is happening in the reverse direction and that even if US and European economies recover the emerging markets will not. Recent manufacturing and export numbers from China and India have indicated that growth is better than expected. Additionally, with the increase in iron ore and copper imports to China as well as increased global demand due to the gradual recovery, resource producing countries should benefit as well. We are by no means arguing that there is a boom in the making. However, when a region has been neglected by most investors to the extent that it is discounting so much bad news and therefore is looking very cheap, even small bits of good news could lead to a substantial rally.

We have noticed that though the consensus has high conviction that Europe equities are the place to invest for 2014, there is already some interest growing with regard to emerging markets. If Investors are already very overweight the US, overweight Europe and very underweight emerging markets, it is very likely that minor positive news flow from the emerging markets will force many to increase their allocations to the region.

Let us consider why the conviction regarding Europe is so high.

Even though, for the first time in 20 years, the valuation gap between the US and Europe has normalised, the earnings gap is 40% as European profits have been stagnant since 2010. Margins have fallen back to 2009 levels. As seen from the chart below, European earnings have always lagged the US in the first stages of recovery after a recession and then finally caught up. This time due to the European crisis in 2011 a huge gap in earnings between the two regions has opened up.



The US has surpassed its 2007 earnings level and is trading at 17 times earnings. However, though Europe is trading at the same multiple, it does so based on the depressed 2013 earnings. If we would take 2013 stock prices and 2007 earnings then Europe would be trading at just 9 times earnings.

Margins have fallen in Europe over the past 2 years due to austerity and if they rise as a result of a little top-line growth and a little operating leverage, then the earnings will improve enough to support a further rally. Recently earnings in Europe have been the worst since 2009 due to the strong Euro. Still

earnings per share have been better than expected. Therefore if the Euro levels off or continues to weaken, it will be very favourable for revenues and earnings.

Europe is just exiting austerity and has just started to outperform. As shown in the graph below, European markets have underperformed the US by over 40% since 2008. Manufacturing numbers show improvement, fiscal drag is fading, and credit may be easing. The real upside comes from margin expansion from 10 year lows. In the US trailing earnings per share are 20% above peak and Europe 25% below.



US vs European Equity performance rebased to 2009

Source Bloomberg

The EU has seen growth returning gradually in late 2013 and this should continue in 2014 as current account deficits as percentage of GDP have fallen substantially for the periphery and austerity is being emphasised less as a result. Growth and employment are more the focus and should take centre stage. The major fiscal and trade adjustment occurred in 2012.

Sectors

Based on our assumption of a gradual improvement in global growth supported by less austerity and adequate liquidity, sectors we favour are basic materials, oil and gas, technology and industrials. These sectors usually perform well as growth improves even if this is accompanied by an increase in interest rates. Due to the substantial operational leverage in these cyclical sectors, small improvements in revenues and /or margins tend to produce much larger improvements in earnings. As 2014 is expected to be the strongest year for global growth since before the crisis started (except for the 2009-2010 bounce from extremely depressed levels), the earnings improvement in these sectors could positively surprise investors. Allocations to commodity related equities are at extremely low levels and any positive surprise will force a substantial rebalancing of portfolios.

As previously discussed low quality and high risk stocks performed better in 2013 than the rest of the market. This has opened up several opportunities in the above mentioned sectors as high quality stocks in each of the sectors are available at reasonable or even cheap valuations. These stocks have been left behind in the rally but offer strong balance sheets and attractive dividend yields. If we now add margin improvement and earnings growth to the mix these stocks offer very compelling value.

Several large cap technology stocks in the United States are trading at 10-12 times earnings which is a very substantial discount to the almost 17 times earnings of the S&P500. They also have dividend yields on average 50% higher than the S&P, are generating 2-7 times cash required to run their businesses and are buying back shares. All of this does not seem to count for anything as markets continue to focus on lack lustre growth. We believe that the over 30% discount to the broader market already reflects the sluggish growth and the free cash flow profiles make these stocks attractive.

Commodities

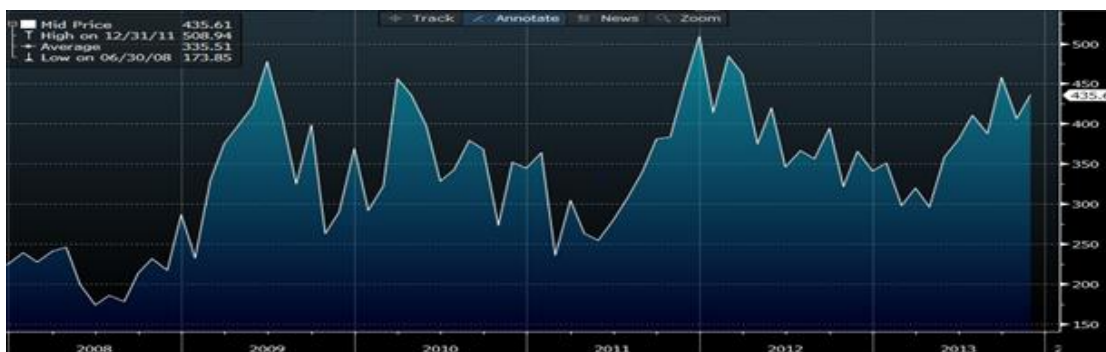
Commodities and precious metals were the worst performing asset class of 2013. It appears that though investors were willing to re-rate equity markets (especially the lower quality equities) substantially, they were not yet feeling optimistic enough about global growth to justify higher commodity prices. The graph below shows the relative movement between the S&P 500 and the commodities Index re-based to 2009. It appears an extreme in the divergence of performance has been reached this year and this should correct in 2014.



Performance of S&P 500 vs commodities rebased to 2009

Source Bloomberg

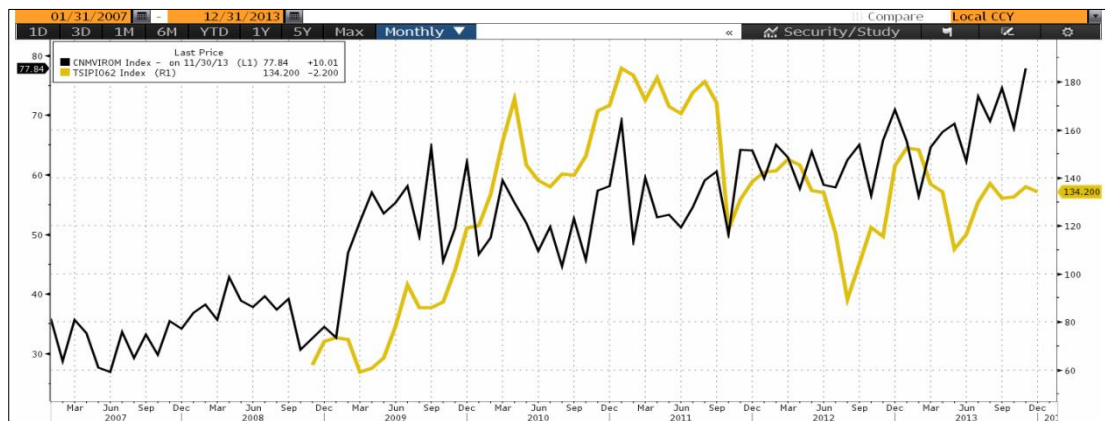
Base metals like copper and iron ore were held back by lack lustre Chinese demand in the first two quarters of 2013 but have recovered strongly since. Investors are still not willing to believe in this trend and equities related to this area are still trading at a discount and pricing in a much more disappointing view than current prices would suggest. As seen from the chart below, copper imports into China have risen sharply in the past two quarters to the highest levels in nine months. Copper prices have risen 6% over the same period but are still down over 10% for the year. We believe that if we see signs of further recovery in the US housing market, as well as better growth out of Europe and China (also the consensus view), copper prices should recover further from current levels as inventories are at their lows for the year. Barclays which in September forecast that supply would beat demand this year now expects a shortage and has cut its estimate of oversupply for next year by 34%. Meanwhile total short bets on copper have almost tripled since October.



Chinese imports of copper 2008-2013

Source Bloomberg

Iron ore prices have risen even more sharply (20% since June 2013) during the same period and demand remains robust. The chart below shows the development in iron ore imports into China (White) and prices (Orange). Prices look like they have room to catch up and as expectations are low even small surprises can make a large difference.



Chinese imports of iron ore (White) and the price of iron ore (orange) 2007-2013

Source Bloomberg

Gold

The price of Gold has been a major topic of discussion this year and remains one of the key concerns for many clients.

Consensus opinion is that gold has risen with QE programmes and that as QE is tapered gold prices should fall. The FED has increased its balance sheet three fold since 2007 and the bank of England and Japan have also embarked on very substantial QE programmes. Even as the FED tapers their QE programme from current levels of 85bn dollars a month to an estimated 45bn by the end of 2014 (consensus opinion), they have added over one trillion dollars in 2013 and will be adding over 500 billion in 2014. We can understand the logic of gold prices moving up with an expanding monetary base, therefore they need to fall back as the monetary base shrinks. However, the base has increased one Trillion in 2013 and gold prices have fallen more than 25% in one year.

The other consensus argument is that as there is no sign of an inflation threat in the developed world, so there is no need to hold gold for inflation protection. However, every central bank from the US to Japan is very focused on bringing inflation to their target 2% level and history has shown that there is usually an overshoot when this happens. In emerging markets inflation is a problem now and this along with the recent turbulence in their currencies has also led to an increased demand for gold.

There is in general a reduced fear of renewed crises and people are willing to take more risk especially as the equity market has rallied. Therefore, investors do not feel the need to hold gold as crisis protection and therefore the opportunity cost of holding gold versus equities appears to be too high especially as gold does not produce any income. From 2007 till 2011 investors were concerned more about the return of their assets than the return on the assets and this was a favourable environment for gold. Since 2012 the focus has returned to a return on assets and not of assets which is a head wind for gold. If investors focus on weekly and monthly returns on this basis and forget completely about the longer term effects of all the quantitative easing and inflation targeting mentioned above, this line of argument makes sense. Those taking a slightly longer term view are holding onto their gold positions.

We wish to draw investors to the additional factors outlined below:

- 1) From a high of 2'700 metric tonnes, gold holdings in physically backed ETFs have fallen to 1'800 metric tonnes in December 2013 which is the lowest level since February 2010. 400oz bars are the only acceptable form of backing for gold ETFs. Gold has been flowing from London to Switzerland where the 400oz bars are cast into kilos and sent to China, India, the Middle East etc. Therefore if there were to be a rise in world gold price that leads to an increase in demand for gold ETFs it will not be so easy to reverse the flow of acceptable physical gold bars to back the ETFs and this could push the price of gold up dramatically.

2) We must note that as gold has flowed from West to East, it has gone from the hands of speculators on price to long term holders of physical gold in smaller quantities, like the Chinese and other Asian countries or to emerging market governments. These holders of physical gold are not prone to trade it. Therefore, this supply once absorbed usually stays absorbed.

3) Seventy five percent of the known gold reserves have been mined already and the cost of mining has been on the rise for several years as the remaining reserves are much less accessible. The all in cost of mining an ounce of gold is estimated to be around USD 1'200. Below this price it is likely that supply will be constrained or delayed in order to achieve a higher average gold price.

4) Unlike the US and Europe, Chinese investors have not yet had the opportunity to invest in gold backed ETFs. This might be changing in 2014. In the U.S. and Europe, ETFs, including the SPDR Gold Trust, buy bullion to back each share sold to clients and store the gold in vaults. The first two gold ETFs introduced in China in June 2013 provide exposure to gold through gold contracts without the obligation of taking delivery. If this changes, the demand for physical gold could rise substantially.

Even without the ETFs China's consumption of gold jewellery, bars and coins reached 1'000 metric tons in 2013. China surpassed India as the No. 1 gold consumer in 2013. It has recently relaxed gold import restrictions, while India has moved in the opposite direction, raising import tariffs and imposing other measures to crimp demand in an effort to control its current-account deficit. Despite China now being the biggest gold consumer, the per capita consumption is 4.5 grams per year compared with a 24 gram global average. Investment demand for gold should pick up further as Chinese become wealthier. China's proposal in late September to relax rules and to expand the list of approved importers will likely lead to more physical gold flowing into the Chinese market.

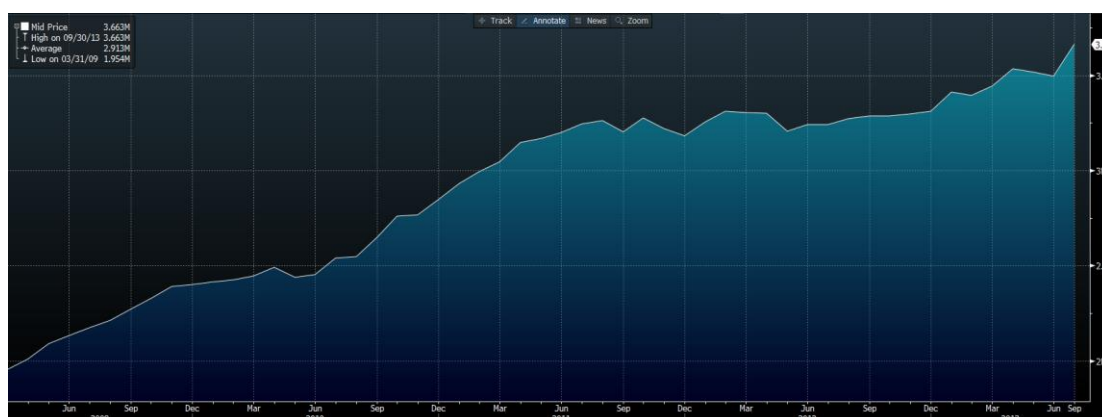
		Tonnes	% of reserves			Tonnes	% of reserves
1	United States	8,133.5	72%	21	Austria	280.0	49%
2	Germany	3,390.6	69%	22	Belgium	227.4	35%
3	IMF	2,814.0	-	23	Philippines	193.0	10%
4	Italy	2,451.8	67%	24	Algeria	173.6	4%
5	France	2,435.4	66%	25	Thailand	152.4	4%
6	China	1,054.1	1%	26	Kazakhstan	137.0	24%
7	Switzerland	1,040.1	9%	27	Singapore	127.4	2%
8	Russia	1,015.1	8%	28	Sweden	125.7	8%
9	Japan	765.2	3%	29	South Africa	125.1	11%
10	Netherlands	612.5	54%	30	Mexico	123.5	3%
11	India	557.7	8%	31	Libya	116.6	4%
12	ECB	502.1	28%	32	BIS	115.0	-
13	Turkey	490.2	16%	33	Greece	112.1	78%
14	Taiwan	423.6	4%	34	Korea	104.4	1%
15	Portugal	382.5	85%	35	Romania	103.7	9%
16	Venezuela	367.6	70%	36	Poland	102.9	4%
17	Saudi Arabia	322.9	2%	37	Australia	79.9	7%
18	United Kingdom	310.3	12%	38	Kuwait	79.0	10%
19	Lebanon	286.8	25%	39	Indonesia	75.9	3%
20	Spain	281.6	25%	40	Egypt	75.6	17%

Top 40 reported official gold holdings (September 2013)

Source IMF, World Gold Council

From the table above we see that even though the US (72%) and many European countries (about 65%) hold a large part of their reserves in gold, this is not the case for most emerging markets including China (1%). The private individuals in India have for decades been major purchasers of gold, the Indian government on the other hand has only 8% of its reserves in gold despite its large purchase in 2010. In past decades the developed nations held large and growing reserves. More recently the emerging markets, especially China have been increasing reserves and looking for a way to diversify away from the increasing number of fundamentally weak currencies. Those with a bearish view on gold were pointing to the fact that many emerging market central banks including the Chinese bought less gold in 2013 than they did in 2012 and this is another reason to be negative on the gold price. It must be noted that the slowdown in purchases was from record high levels in 2012 and coincided with the slowdown in foreign exchange reserve growth in some countries including China. However, as the chart below shows, reserves in China have been growing again in 2013 after stagnating for a couple of years. We

therefore wonder if they might not decide that this is a good time to add to their gold reserves especially as they have voiced their intention to do so over the past years and the price is much more attractive now.



Chinese Foreign Reserve growth 2009-2013

Source Bloomberg

Conclusion

In the past two years we have bought the DAX and SMI listed quality stocks at cheap valuations when we believed that too much negativity was priced in. Sometimes these positions paid off handsomely in less than a quarter and sometimes they took more than two quarters to show their potential. However, they did rise substantially as their fundamental value was appreciated and the very pessimistic outlook was adjusted. We believe that large cap technology in the US, Some emerging market stocks and some commodity stocks are at levels which offer the same appeal. We have accumulated these positions over the past quarter and have noticed from the media that some investors are starting to take a closer look at these areas.

To summarise, for 2014, we recommend a slightly overweight position in equities while underweighting the US and overweighting Europe and the emerging markets. Our bond exposure remains underweight. We maintain current gold positions and are more positive on the commodity complex than the consensus as global growth shows signs of improvement. Our tactical stance may differ from the strategy outlined above from time to time as we rebalance portfolios in response to market volatility.

Gillian Hollenstein

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