



INVESTING IN A NIRP WORLD

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INVESTING IN A NIRP WORLD

At the start of 2016, we published a report entitled, "Investing in a ZIRP (Zero Interest Rate Policy) World". At the time, there were three countries with negative interest rates, Switzerland, Sweden and Denmark. Their short term bonds were trading at negative rates and it was the first time in recorded history that this had been observed. When interest rates are lower than inflation, it is said that real interest rates are negative. i.e. the lender is losing purchasing power because the interest earned is below the rate of inflation. This in itself is a very unusual situation and has not occurred very often. However, now we have Negative Interest Rate Policy (NIRP). In this situation not only are real interest rates negative but the lender is paying the borrower for the "privilege" of lending money!! At the start of the year the three countries with negative rates were remarkable but less significant as their economies are relatively small. However, now Europe and Japan have joined the fray.

At the start of the year around 4trillion dollars worth of sovereign debt was trading with negative rates. By the end of June, this figure had reached almost 12trillion! As can be seen from Fig. 1,

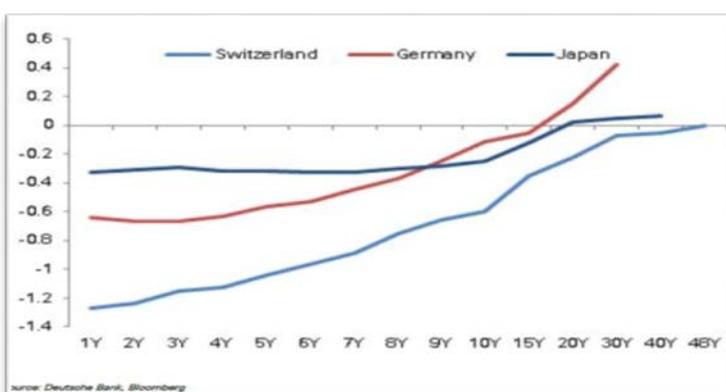


Fig. 1: Government bond yields

negative yields now extend past 15years for Germany, Japan and Switzerland. In fact Swiss 30year bonds are trading at negative rates! Additionally, French, Swedish and Dutch 10 year yields are hovering just above 0%. This situation results in an environment in which a lender has next to zero possibility of achieving a

risk free return on savings. To top it all, holding cash incurs a penalty as many banks are passing the negative short term rates onto clients. NIRP is a tax on savers and like inflation results in a reduction in purchasing power.

The intention of central banks is to make holding excess cash unattractive, forcing savers to invest or spend. NIRP allows companies to borrow at interest rates which are the lowest in recorded history, even for periods in excess of 10 years. This dramatically reduces the rate of return required by companies to take on new projects and would normally lead to an increase in investment in future production. However, besides cheap money, companies need to be confident that the capacity they build will be required in the future. If this is not the case and current capacity is not being fully utilised, it may make more sense to buy a competitor or to replace equity with debt and reduce the weighted average cost of capital. Buying a competitor or reducing equity may be good for shareholders of companies, however, it does very little for GDP growth or employment. In many cases there is even a loss of jobs due to synergies between the two merging entities. The end result is that 8 years after the financial crisis even though government debt to GDP is over 100% in the US and most of industrialised Europe, growth is still anaemic.

EFFECTS ON GROWTH AND DEBT SUSTAINABILITY

Central Banks implementing negative interest rates and buying government bonds has done very little to increase capital flow to small and medium sized companies struggling to stay afloat and retain employees. Even though banks are being penalised for holding cash in their central

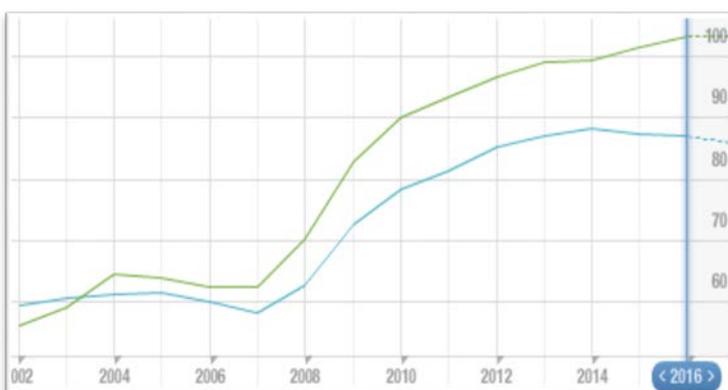


Fig. 2: Debt / GDP in % for EU (blue) and US (green)

Source IMF

bank reserve accounts, regulation is prescribing what assets banks can hold and how much capital they need which is preventing a healthy resumption of lending. Large companies are suffering from over capacity and have little incentive to invest even at historically low interest rates. Consumers plagued by worries about their jobs and finances tend to save more than they used to.

As a result even though Government Debt to GDP levels have almost doubled since the crisis (Fig. 2), GDP is still under 2008 levels in Europe (Fig. 3). Growth is still substantially lagging the trajectory of past recoveries.

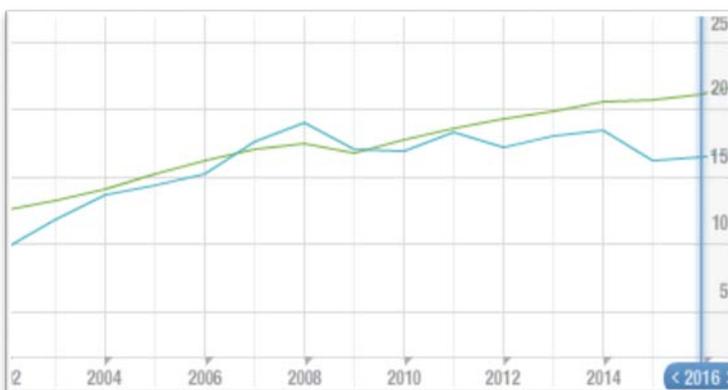


Fig. 3: GDP in USD Trillion for EU (blue) and US (green)

Source IMF

Now that government debt to GDP is around 100% in the US and EU, it is extremely important to maintain GDP growth rates exceeding that of nominal interest rates. To put it simply, in order to service a debt burden at or exceeding 100% of GDP without borrowing additionally, GDP growth must exceed nominal interest rates. In the past Debt to GDP ranged from 40-60% and the debt burden was sustainable even through cyclical recessions.

At current Debt levels, recessions, even normal cyclical downturns and deflation become a big issue for debt sustainability. This is the reason why the next step, i.e. "helicopter money" is being discussed by governments and central banks. The idea is for central banks and governments to inject cash directly into the economy by investing in infrastructure or providing tax reductions or rebates to stimulate consumption. It is hoped that, as government investment and private consumption increases, companies will be encouraged to build capacity and this altogether will result in growth levels closer to the level required to service and hopefully reduce the current debt.

PORTFOLIO POSITIONING

At the start of the year we outlined three scenarios - moderate improvement, deflation & loss of confidence and inflation exceeding targets. We believed that in all three scenarios gold would fare well due to NIRP. We accumulated gold in the last quarter of 2015 and focused our equity exposure on companies paying sustainable dividends.

1. In Q1 2016, the *Deflation & Loss Of Confidence* scenario was playing out in the markets. Chinese currency devaluation and fears of weak global growth caused equities, especially the cyclical sectors which were already beaten down, to fall further. In general equities markets sold off and bonds, gold and cash performed best. The lack of confidence in governments and central banks to remedy the situation resulted in gold being the best performing of the three assets. Gold returned over 16% in Q1, its best quarter in 30 years.
2. In Q2 2016, until the BREXIT vote, the *Moderate Improvement* scenario was supporting markets as governments and central bankers fearing the threat of deflation increased stimulus and pledged to do even more if necessary. The Chinese managed to support growth using targeted stimulus and in the US and Europe growth and inflation appeared to be heading in the right direction. The fear of losses then rapidly changed to opportunity seeking and equities, especially US equities were the beneficiaries. Oil prices recovered from their Q1 lows, benefiting the whole commodity complex which had been severely punished earlier in the year and Gold produced a performance exceeding 25% in the first half of 2016.
3. The scenario that is being given very little attention by market participants at the moment is **Inflation Exceeding Targets** (especially in the US). We believe it will be given more weight in the second half of 2016. In this scenario the losses would be in bonds. If inflation is due to growth picking up, equities should do well even if inflation slightly exceeds 2%. The energy, material and industrial sectors would be the major beneficiaries in this scenario. Gold would gain if, real rates remain negative. However, in light of BREXIT and the weaker numbers from the US recently, we need to consider the possibility of **Stagflation**. When low growth is

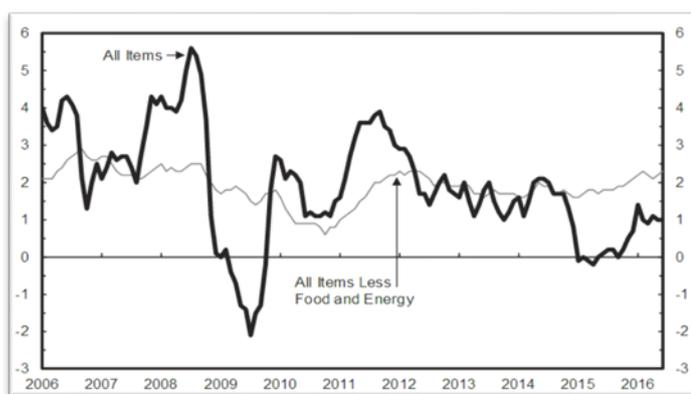


Fig. 4: US Inflation in %, All Items (black), Less Food & Energy (grey)

accompanied by inflation, monetary policy decisions become very difficult. The US has been running at over 2% inflation (Fig. 4) for a few quarters already. While growth was improving, this was a desirable outcome. However, now that growth shows signs of dwindling, stagflation could be the

next threat to the economy and financial markets. In this scenario as long as real interest rates remain negative, gold should gain. Stocks and bonds as well as cash would be the losers, with some stocks outperforming due to their relative advantage in a stagflation environment.

RISKS

We believe that the current environment must be approached with care. If the governments and central banks underestimate the current situation or fail to adequately address the threat of deflation or stagflation a substantial loss of confidence would lead to large drops in equities and bonds. For example:

- The BREXIT discussions are just getting started and could result in unfavourable headlines for the Eurozone as a whole;
- political tensions in Spain could escalate.
- NIRP has reduced bank revenues and could lead to pressure on banks which so far seem stable, e.g., Italian Banks are in bad shape and urgent action is needed to restore stability, Deutsche Bank needs careful monitoring as it is a institution with potential drastic negative global impact.
- There is also the possibility that Greek debt returns to focus.
- In the US, presidential elections are just three months away, and
- in China growth though it has improved, is not yet at levels indicating expansion.

The rally in financial asset prices has been driven to a large extent by ZIRP+QE+ NIRP. These monetary policies drove large volumes of liquidity into the financial markets instead of the real economy. There has not been enough fiscal reform to encourage spending and investment. As the incentives to invest were not as great as the incentive to borrow many companies borrow at low rates and buy back shares, further supporting share prices.

Hedge funds have also been able to borrow at very low interest rates and make better returns using large amounts of leverage that can quickly turn into large losses. Many of them base their positions on algorithms and high frequency trading, which has already caused excessive volatility and exaggerated market moves in the past. This is especially true if the output of their trading algorithms start to correlate

Governments in Germany and Switzerland are issuing debt for 10 or more years today and are guaranteed to have to pay less than they borrowed. The losers in this scenario are:

- the savers who depend on a decent return on their savings to finance their retirement or to match their liabilities or just to preserve the purchasing power of their capital.
- the pension funds which will be forced to reduce the future payments to retirees.

People have figured out or will in time that in order to bail out the banks, governments took on debt and now in order to be able to sustain this debt, savers and retirees are being penalised. Therefore, their confidence in the governments and central banks has diminished. This low level of confidence may lead to a complete loss of confidence if the weak economic growth and high indebtedness are not addressed.

We therefore believe that there will be a deployment of "helicopter money" by governments to force GDP growth and inflation upward. The danger is that though initially this may work, there may be a more permanent effect on inflation than on GDP growth

GOLD

In our report on ZIRP, we had outlined our reasons for buying gold in detail. Our timing proved to be very advantageous as gold has rallied over 25% since then. The question now is where do we go from here?

We believe that as long as Real interest rates remain negative gold will continue to rally. At the moment NIRP has produced even more support for gold than negative real interest rates

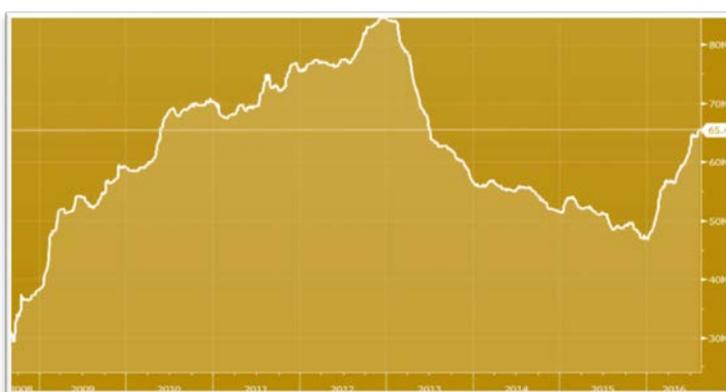


Fig. 5: US Gold ETF Holdings in troy ounce (oz t) Source Bloomberg

alone would have. Instead of paying the bank or the government (NIRP) to hold their cash, more people are turning to gold. However, the majority of investors still hold little or no gold in their portfolios. The first half of this year saw inflows into gold ETFs which equalled the

outflows of the previous three years (Fig 5). It appears that these flows have been driven mostly by institutional investors, large Hedge funds and family offices. Most individual investors have not participated in this rally and are just starting to consider gold for their portfolios. Therefore, even if there is some consolidation from current levels, we believe that there will be enough interest in buying the dips to support the gold price. ETF holdings are still substantially below their levels in 2011 when gold made its all time high.

As gold has rallied 25%, gold mining stocks have risen more than 100%. We built a position in gold mining stocks last year and our clients were able to benefit from this very substantial appreciation. Gold rises and falls less than gold mining stocks. In the period from 2011 highs in gold to 2015 lows, gold lost 40% and gold mining stocks lost 80%. We hold gold to avoid the inflation and negative interest risks associated with the monetary policies since the financial crisis. It has also provided stability in times when crisis hit share and bond prices in the past and earlier this year as well. Gold has no debt attached to it.

Gold equities are higher risk and behave like other stocks driven by earnings, the debt issued by the companies and the future growth expectations. Each share behaves differently depending on how well the company and its future reserves are managed and the varying costs of producing gold, which can be substantial. Therefore the two positions have very different roles in the portfolio and even though it may be the opinion of some investors that they rather hold only gold shares and not gold, we believe this would change the whole risk profile of the portfolio and is not advisable. These opinions are usually voiced when an asset class is doing well and disappear rapidly when prices fall.

CONCLUSION

This year diversification of asset classes and regional holdings has been an effective tool for enhancing return and reducing risk. Not only has gold stabilised portfolios when stock markets have fallen sharply but stock markets like India have done well, while Europe and Japan have not. The Indian stock market has rallied almost 10% at a time when Europe is down 6% and Japan has lost 11%. India has been named “the bright spot” in the global economy by the IMF and benefits substantially from the low oil price. Indian GDP is currently growing at the rate of 7.9% and it is the fastest growing major economy of the world. We have positions in Indian Stocks and bonds in client portfolios and they have contributed favourably to returns. However, valuations are not as attractive as they were when we built these positions and volatility will probably remain elevated as news flow from geo-political events effect market sentiment.

Markets have managed to rally strongly off their lows after the BREXIT vote and are now looking for direction. BREXIT discussions, US Elections and Italian bank problems are all sources of volatility. Though there are some companies which are reporting better than expected earnings and are growing at a healthy pace, it is the risk on or risk off decision that is driving stock markets and therefore the macro environment continues to dominate. It has been almost eight years since the financial crisis and despite ZIRP+QE+NIRP global economic growth has not gained traction and inflation in the EU is very low. In order to deal with the huge Debt loads that Governments have chalked up since the crisis, it is imperative that both growth and inflation rise. If there is a threat that this might not happen, “helicopter money” would probably be employed. We believe that the decision to deploy “helicopter money” will probably be made within the next 6-12 months. There could then be another rally in stock markets anticipating a pick up in growth and this would favour cyclical industries the most. Investors are being forced into the stock market due to lack of alternatives and gold has re-gained favour due to NIRP. We believe that holding dividend paying stocks and gold will continue to be a favoured strategy for 2016 and into 2017.

We hope you have found this report informative and look forward to hearing from you with any feedback or questions.

Gillian Hollenstein

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