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JULY 2015

The successful campaign against the Swiss National Bank and the Saudi Arabians

"War does not determine who is right – only who is left." Bertrand Russell

In this report we wanted to take a look at two instances where our investment and thought process have worked well recently and to shine a light on one of the ways in which we conduct our business. It is important for our investors to understand this aspect of our methodology, as the battle to preserve the purchasing power of invested capital still has a long way to run with the financial system having expanded dramatically since the crisis of 2008. Investors who are able to reach the end of this monetary expansion phase with their purchasing power relatively intact will count themselves as victors. In this respect, Bertrand Russell's above quote is noteworthy.

We would like to give you some insight into our analytical process and why we took the steps that we did based on specific technical signs and factors. In this way we hope to give you useful pointers in keeping on a successful path. As a starting point it is worth explaining what we mean when we talk about the inflation still to come and this 9 minute-long Youtube video covers this ground very well:

10 evils of inflation: https://www.youtube.com/watch?v=XyW_aRocj1I

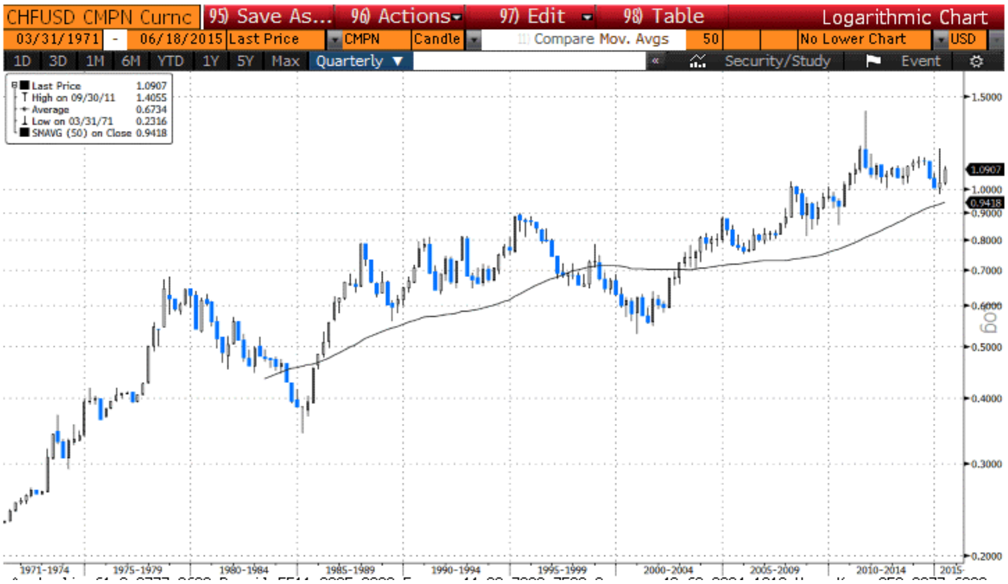
The Swiss Franc and the Central Bank

We always try to combine the technical and the fundamental skills that exist in the dual offices of the fund advisers based in London and in Austria. This combination informs all of our investment decisions regardless of whether it is currency, equity, commodity or macro-economic related. In the case of looking at the Swiss franc the fundamental picture was helped by our proximity to our Swiss neighbours, as well as by the many commuters who travel from Austria to earn their living in both Liechtenstein and Switzerland.

From the perspective of our Austrian colleagues, two things were clear to them concerning Europe.   They go on to explain in more detail:-

Firstly, we grew up during a wonderful period of peace and prosperity just one generation after the Second World War, with the reconstruction of the continent that took place in the sixties, seventies and eighties. Admittedly, the peace was interrupted by the Vietnam War, the oil crisis and the Balkan War but in general there was real growth generated in this timeframe. The second thing that was clear to us from an early age was that the currencies of the countries in the south of Europe became cheaper year-by-year because of devaluation and inflation and this held true for Italy, Greece, Spain or Portugal. On the other hand, Switzerland was one of the few currencies to beat our own *"hard"* Austrian Schilling. Switzerland's economy is a model that has performed strongly over many decades. One Swiss national asked me once, what I thought the difference was between Austria and Switzerland? I asked him for his opinion and he said that *"you have a minus sign in your flag and we have a plus".* Someone else had a different observation and said that: *"You are ruled by bureaucrats and we are ruled by corporations."* There is certainly some truth to the latter observation and officials sit not only in Vienna but now also in Brussels on behalf of the Eurozone. For us it is clear that the Swiss model of a low tax burden, a high level of education, less bureaucracy imposed by central planners, a high and protected level of personal freedom, low inflation, high real wages and successful large multinational companies, is a model of long-term success in Europe and indeed many other parts of the world.

The following long-term charts of the Swiss franc versus the US dollar, Sterling and the Euro provides the technical confirmation of our fundamental understanding that Switzerland and the Swiss franc is a long-term winning model:



Source: Bloomberg (CHFUSD from1971 to 2015)

Source: Bloomberg (CHFGBP from1971 to 2015)

The Swiss franc has demonstrated its successful economic model with long-term uptrends of the franc vis-à-vis the US dollar as well as the British pound. This uptrend is punctuated every now and again by corrections or pauses but the overall trend is still upwards over a forty year period. This means that at the very least there is already ongoing upward pressure on the franc based on just these two currencies. However, what is the picture against the euro which has been trading as a currency (after the ECU) since 1999? Secondly, can an artificial market intervention for just one currency pair (euro against Swiss franc) be effective and successful over the long run, operating as an “official” manipulation of the market’s natural path?

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Source: Bloomberg (EURCHF from 1.1.1999 to 31.12.2014)

The above chart tells us three important things: the franc traded more or less sideways for the nine years since the euro currency started trading at a level of 1.60. Closer observation of the chart shows that the franc tended to be stronger and trade below 1.60 for 7 out of these 9 years and only two years saw the euro over this level of 1.60 and then only for part of the year in question. The rise of the franc became stronger in the aftermath of the financial crisis in 2008 and there appeared to be some (covert) attempt to halt this rally of the Swiss currency at the 1.50 level. This attempt to stem the currency's strength failed and the next attempt to draw a line in the sand took place at 1.30 in 2010. However, this resistance point was soon breached and the franc moved dynamically in a victory march for the Swiss economic model until the 1.20 level was taken easily and panic in the currency markets ensued. It reached a crisis on 9th August 2011 when the franc came close to parity with the euro and the Swiss National Bank mobilised its reserves to halt the franc's further progress.

This intervention hauled the exchange rate back in the direction of 1.20, fended off a counter attack from the bulls at 1.10 and regularised the line in the sand "forever" with the statement on 6th September 2011 as follows: *"with immediate effect, it will no longer tolerate a euro-franc exchange rate below the minimum rate of 1.20 francs"* . At this moment the Swiss National Bank had won the battle but certainly not the war. Instead of just listening to the words coming from central bankers, the media, analysts and politicians, we continued to observe market movements closely in order to have an early warning of when the line in the sand would give away once more…

Source: Bloomberg (EURCHF from 1.1.2011 to 31.12.2014)

For the remainder of 2011 the Swiss franc bears tried to push the line in the sand so as to bring the euro higher, much to the relief and tremendous applause of the thousands of investors who had borrowed Swiss francs (because of the lower interest charged on franc loans); many such borrowers are Austrian as well as a significant number in Eastern Europe generally, all of whom watched the exchange rate very closely but without much analysis and based more on hope. However, this counter-attack was a spectacular failure and it was not even possible to regain the 1.25 level. This gave a 3-mountain top formation for the end of 2011 (see below). At this point we were very grateful to have a solid grounding not only in Japanese karate-do as dan grade black belts, but also in having a good grasp of Japanese candlestick chart techniques. This huge top formation appeared as if it were taken straight from a text book and delivered a large bearish engulfing pattern on 15.12.2011, seen as a closing/ confirming pattern (a strong signal indicating a change of trend – the body of the second candle encloses the body of the first candle entirely and is in the opposite colour. This indicates a change in the balance of power between opposing market forces and participants and the pattern often offers good opportunities to enter a trade when the trend is about to change).

Source: Bloomberg – own calculations (EURCHF from 23.6.2011 to 23.3.2012)

It was then only a question of exercising patience and recognising when the established level for the exchange rate would break down. Until the break occurred it was appropriate for clients to be long of CHF whether in cash, bonds or equities and for the SUNARES fund it was appropriate to look for the right Swiss franc investments.

For the years 2013 and 2014 it was important to observe that there was a controlled retreat where intervention occurred at round numbers, as an attempt to regain these psychological key levels. Up until the end of 2013 the 1.22 level was defended, then 2014 saw this level regained until year end when it traded down and under the 1.21 level, which was close to the announced “Francogeddon line” of 1.20, which was to be defended at all costs. When the 1.2050 level was reached in November 2014 and took some time to head back over 1.21, alarm bells started to ring for us. We warned clients whom we knew had Swiss franc loans against euro assets and told them to cover the position and take on further Swiss denominated investments. There was one more counter attack against the Swiss franc bulls but this too failed just before Christmas 2014, with the exchange rate coming close to 1.21 but at the close it did not even achieve 1.2050. At the start of 2015 when the rate marched towards the abyss of 1.2010 it was obvious that an explosive market event lay ahead. For those of us who live in the mountains and have observed avalanches in the winter with a mixture of fear, respect and wonder - we had an inkling of what was to come. Any trader or investor who believed that a stop-loss would protect them against this dramatic “slab avalanche” has not understood the speed and extent of moves when defensive lines are finally broken. In spite of the technical warnings there was one last news conference from the Swiss National Bank (SNB) on 5th January 2015. The President of the SNB described the euro-Swiss peg as central to their policy and a cornerstone. Furthermore he warned of inflationary and deflationary risks if the policy was not held in place. He declared that the bank had an unlimited ability to defend the exchange rate using derivative instruments etc. Many investors took Mr Jordan at his word and were reassured that the peg would be defended at all costs.

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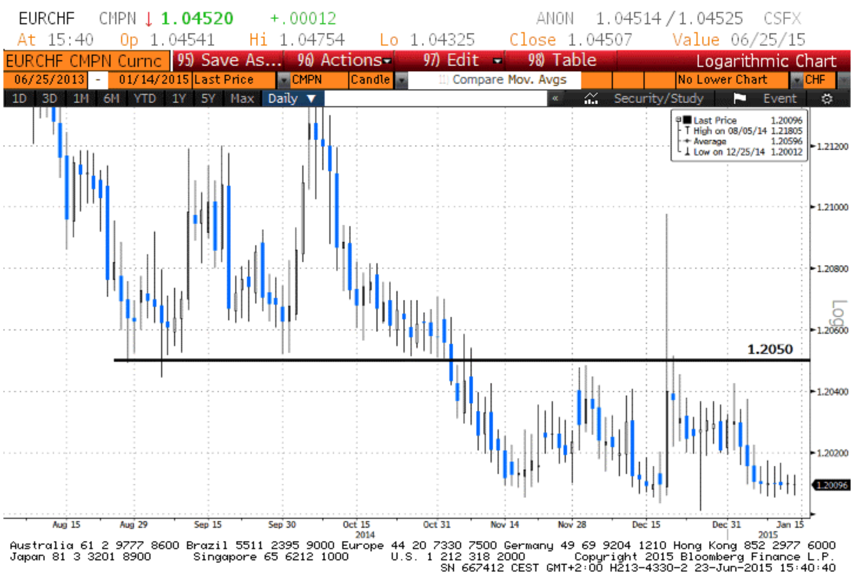
In spite of his press conference and speech we trusted our own technical analysis rather than the words of the central banker. In the days after his speech the euro was not able to recover against the franc, a further dangerous sign and warning us that an extra snowflake landing on the pile could set the avalanche in motion. This finally happened on 15th January when the SNB announced the removal of the peg. Currency markets responded violently and currency traders went bankrupt and several currency funds closed as a result of the carnage.

Although we are not able to expand on every aspect of the discussions and communications between London and Austria on this subject we hope that we have given you some insight into our thought process and our way of looking at markets from a technical and fundamental angle. The following chart shows the final trading days of this episode in more detail and how our approach has benefitted our clients:



Source: Bloomberg (EURCHF exchange rate from 25.6.2014 to one day prior to Francogeddon 14.1.2015)

This analysis allowed us to avoid unnecessary losses as well as benefit from being long of the correct currency. 15th January 2015 – a good day for our duly informed clients but unfortunately a very sad day for thousands of Austrian franc borrowers including the City of Vienna.

In the slipstream of the Saudis with falling oil prices

When oil prices started to falter in the second half of 2014, despite the world economy seeming to be performing relatively well, we became more cautious about the future development of energy prices. In order to avoid falling into the trap of looking too closely at the daily trading charts we instead focussed on monthly candle charts, coupled with a 21 month moving average.

On a monthly basis we had a bearish engulfing pattern in July as well as a break of the medium term uptrend , which was in place since the lows established at the time of the financial crisis in 2008. Finally the price attempted to find a bottom with a small hammer (a monthly reversal pattern). However, the candle remained dark (closing price lower than the opening price on a monthly basis) and also under the 21 month moving average line. The following month the attempt to find a bottom in August was swept away with the appearance of a dark bearish negative candle. Technically, the oil price was on a *"sell"* at the end of the third quarter 2014. If this signal was confirmed by the fundamental background then it was time to look at reducing allocations. Investors who were relying on the Saudis to come to their rescue could have looked back to the mid-1980s when the oil price dropped from US$23 to US$10 per barrel. At that time Saudi Arabia made no efforts to defend a higher oil price and in fact were seemingly unconcerned when they confirmed in August 1985: *"Let the oil price find a bottom."* For Saudi Arabia it is their share of the market that they are concerned about protecting rather than the price itself and as low cost producers they can outlast almost all of the rest of the oil producing countries. With the new kid on the block in the from of the US fracking industry it was thought that they want to see the American producers falter, go bankrupt and for Saudi Arabia to retain their market dominance.

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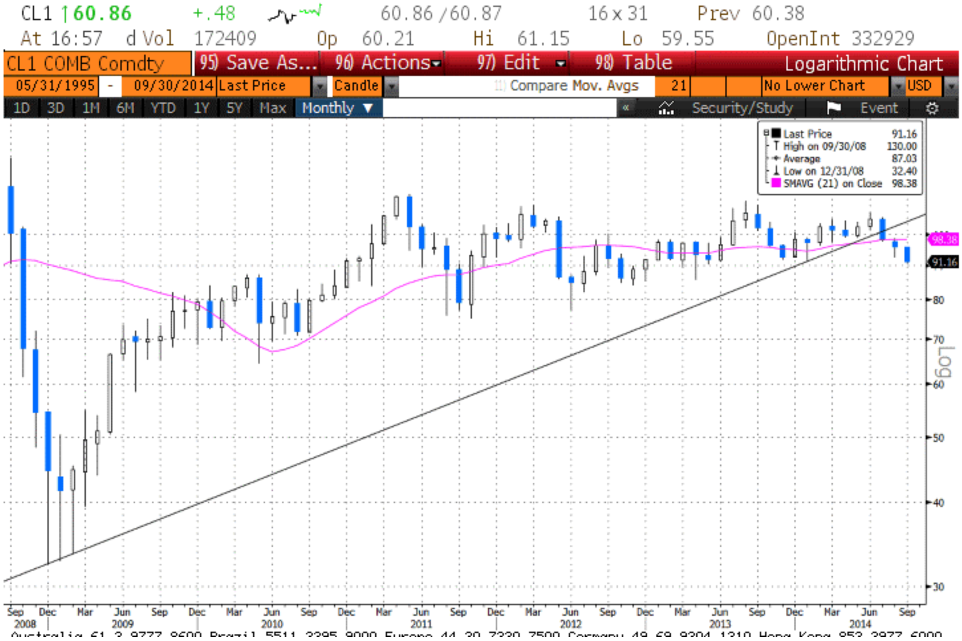

Source: Bloomberg (oil price futures in the US from May 1995 to September 2014 monthly candles)

On a purely technical basis, first support stood at US$70 and a failure at this level would see next support at US$50 with subsequent and significant support at the US$40 price point. As the lowest cost producer of oil it is clear that Saudi Arabia are the determining force in setting the oil price. Even though the Saudis are the lowest cost producers in the world, the lower price hurts them too, but this is a price worth paying if it takes out the competition and leads to higher prices for oil in the future as they will be the principal beneficiaries.

Many large oil projects went ahead based on a long term price of US$80, from Kazakhstan, Brazil to Venezuela etc, and it is these projects that will remain on ice, be postponed or cancelled. In order for these shelved projects to be given the green light to start up again will require considerably higher prices and for an extended period of time, so that those providing the funding will be more certain that these huge investments will be profitable. With the world's population growing and more people joining the ranks of the middle classes, it is no secret that oil demand will continue to grow over the coming years. The immediate beneficiaries will be producers that remain in business during this period of low prices and there will be less remaining producing countries and companies who will benefit. The International Energy Agency (IEA) recognised this in their latest World Energy Outlook: *"The short-term picture of a well-supplied oil market should not disguise the challenges that lie ahead as reliance grows on a relatively small number of producers."* At the end of November 2014 when, as head of the OPEC group, Saudi Arabia made it clear that there would be no cuts in production, it confirmed the technical signals that appeared in the charts. From there the oil price dropped to US$52 per barrel by year end.

Source: Bloomberg: oil price futures in US$ 30.06.2014 to 31.12.2014

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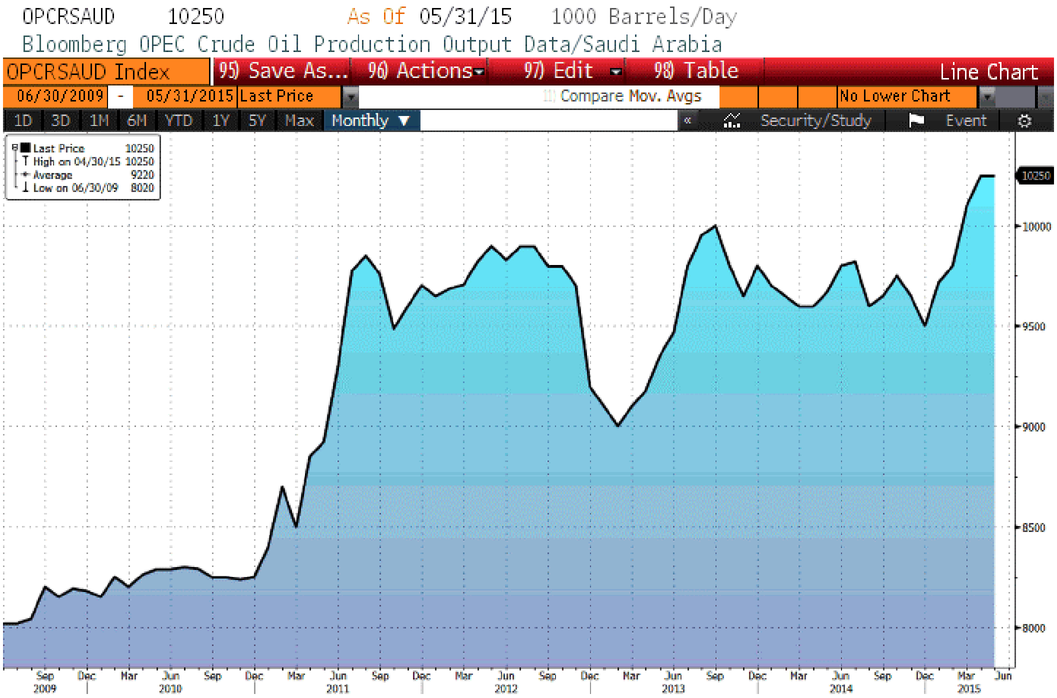
In spite of the fact that the oil price had more than halved in the second half of 2014, down to US$50, there was still no buy signal being generated technically on the charts for either oil or the oil stocks. It was important to understand if the oil price had found a technical bottom but the fundamental picture was basically unchanged. In other words, the charts were saying that the Saudis wanted to maintain production, cement or even grow market share, with higher prices to eventually help them out in the future. Current production by Saudi Arabia is around the 10.25m barrels of oil per day, which is an all-time high.



Source: Bloomberg: crude oil production Saudi Arabia June 2009 to May 2015

Our current position is that we have probably seen the lows for oil in the first quarter of 2015 but have no further forecasts to add at this moment. What we can say is that the energy sector has many varying sub-sectors and some of these are doing well, even in a period of weaker oil prices and have upward trending share prices. There are also companies in the sector that have not gone down as much as some other companies and are therefore expensive on a peer comparison basis. In other words there is always something that can be done to optimise and improve the portfolio and that this is the basis of what we do.

We hope that you have enjoyed this short journey through one aspect of our work and thought process and that this may offer you some pointers for your own work in analysing markets, stocks etc.

Finally we have added a comparison of the SUNARES fund against several of our largest competitors in the natural resource sector (BlackRock World Mining, JP Morgan Natural Resources und Allianz Commodity Fund), which demonstrates that the combination of our fundamental and technical approach has been working well in the last year-and-a-half. The outperformance of SUNARES in this time frame is significant and validates our optimisation process, especially as markets themselves have trended sideways. Graph on the following page:

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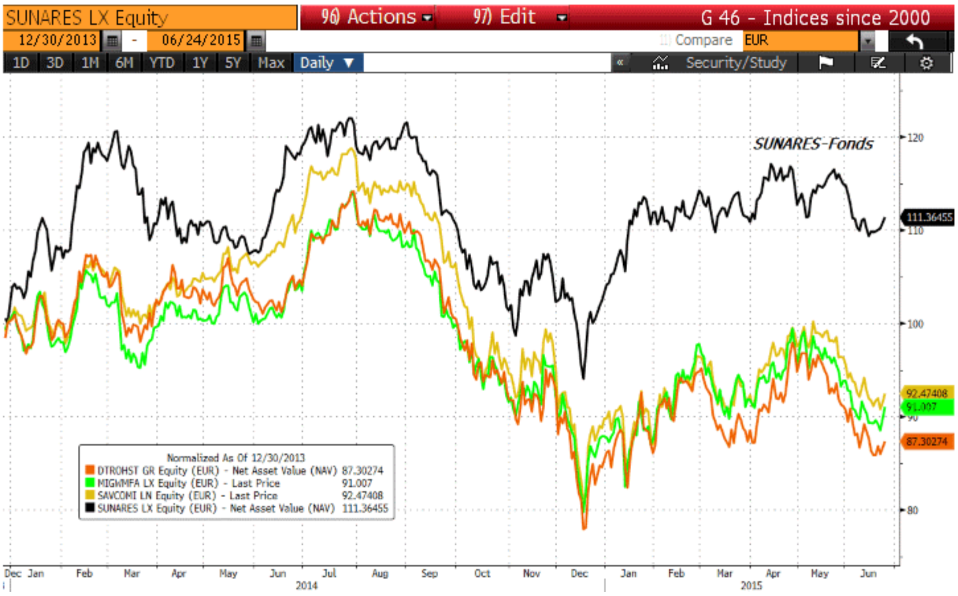

Source: Bloomberg: (SUNARES LX, SACOMI LN, MIGWMFA LX, DTROHST GR 30.12.2013 – 24.06.2015)

We look forward to being in touch with you again soon.

With kind regards,

Colin Moor & the SUNARES team