WHV International Equity Strategy

Third Quarter 2014 Commentary

GLOBAL ECONOMIC GROWTH DECELERATES

The WHV International Equity strategy declined and underperformed the MSCI EAFE Index during the third quarter as disappointing economic growth in the eurozone and China placed downward pressure on our economically sensitive investments. Expectations for global growth were downgraded as the quarter progressed, which negatively impacted our stocks in the energy and materials sectors. The International Monetary Fund's (IMF) forecast for the world's real GDP growth rate for 2014 was reduced from 3.6% to a 3.3%[1], which would only be equal to 2013's tepid growth rate. An acceleration in global growth has been delayed a year as the IMF now expects global growth to rise to 3.8%[2] in 2015. We believe that the markets would be expected to resume their focus on WHV's preferred sectors of energy, materials and industrials once positive growth momentum resumes. Despite the weak quarter, the WHV International Equity strategy still generated a small positive return for the nine months ending September 30, 2014 compared to a small loss for the benchmark index.

Eurozone growth rate estimates for 2014 deteriorated from 1.2% to only 0.8%[3] as the region continued to be negatively impacted by structural and deflationary forces, which have been deleterious to consumer and business confidence. Lackluster job creation and negligible inflation has discouraged consumer spending and business investment in the region. The European Central Bank's (ECB) monetary policies are still not sufficiently stimulative to allow the eurozone to both reduce its unemployment rate from 11.5%[4] into the single digits and to push its inflation rate significantly above 0.5%[5]. However, the ECB President has stated that more aggressive monetary accommodation could be implemented if the financial and economic health of the eurozone deteriorates further.

The eurozone's sluggish growth has been compounded by the turmoil in neighboring Ukraine. The instability instigated by pro-Russian separatists in eastern Ukraine has compelled the United States and Europe to institute multiple rounds of economic sanctions on Russia, a major trading partner of the eurozone. The sanctions will likely have the intended effect of reducing exports from the eurozone to Russia as they will likely cause a lower Russian growth rate and thus, potentially, lower import requirements. The eurozone also relies on Russia for a substantial percentage of its oil and gas supplies, and a potential risk is that Russia retaliates against the West by either curtailing energy exports or raising prices to the eurozone, which would increase Europe's fuel costs.

China also weighed on global growth during the third quarter. In March, China's Premier Li boldly forecasted that his country would grow 7.5% in 2014 and, so far, the government's micromanagement of their economy with small stimulus programs has brought the country close to that growth target. China's real GDP growth for the second quarter ticked up to 7.5% compared to 7.4% for the first quarter,[6] more than double the growth rate for the rest of the world. However, some economists are concerned that China's superior growth rate gradually slipped during the third quarter as its policymakers engaged in monetary and fiscal policies to rebalance the economy towards consumption and away from industrial production while simultaneously attempting to deleverage the public and private sectors.

We would expect China's policymakers to engage in additional mini-stimulus programs if its growth rate slips below 7% during the 2014 to 2015 period—as they have historically—as we believe history has shown that higher unemployment could lead to social instability and threaten the state. The Communist Party of China has witnessed how mass social unrest can develop quickly into full-scale revolution that can then overthrow unpopular regimes: examples include Eastern Europe (1989), Soviet Union (1991), Egypt (2011), Libya (2011), Tunisia (2011) and Ukraine (2014). China has the potential financial firepower to cushion shortfalls in economic growth and job creation if it were to deploy part of its massive foreign exchange reserves of $4 trillion to support its economy. We believe the financial strength of a nation may be expressed in the value of its currency, and China's currency has been one of the strongest in the world. The Chinese yuan has advanced 11% over the past five years relative to the strong U.S. dollar, which compares favorably against the other major currencies of the world over the same time period: the British pound sterling up 1%, the euro down 14% and the Japanese yen down 18%.[7]

Finally, there was the drop in the price of oil. North Sea Brent crude oil prices fell 16%[8] during the third quarter as the Islamic terrorist group ISIS' invasion into oil-rich Iraq was halted by a U.S.-Arab coalition in Iraq and Syria. In addition, the conflict between the Ukrainian government and Russian-supported separatists in eastern Ukraine has evolved into an uneasy stalemate with periodic ceasefires interrupted by violence. Market participants pushed oil prices up during the second quarter with the expectation that oil production in Iraq and/or Russia would be threatened, and then they liquidated long oil positions in the third quarter as major oil production curtailments appeared highly unlikely over the short-term. However, the five-year forward oil futures price has advanced 7% this year[9] as energy market participants appear to be concerned about the longer term production growth profile for both Iraq and Russia. Heightened security risks, economic sanctions and the potential for energy resource nationalization may motivate Western energy companies to deploy fewer investment funds to Iraq and Russia, which would reduce the oil production growth profile for both countries and tighten the longer term supply/demand balance for oil. The instability in Syria, Iraq, Ukraine and Russia could continue for an indefinite period and support a geopolitical risk premium for the crude oil markets and energy equities.

In summary, events in the eurozone and China appeared to lead a deceleration of global growth during the third quarter, which appeared to act as a headwind for WHV's economically sensitive investments. We would expect the ECB to launch more aggressive monetary easing programs to strengthen the eurozone's weak banking system and stimulate both economic growth and moderate inflation as its unemployment rate has only improved marginally from the Great Recession peak of 12% to 11.5%.[10] While China's policymakers have stated that they will not engage in any major new stimulus policies, additional mini-stimulus actions would be expected if the country's growth rate falls significantly short of its announced growth targets since the Communist Party of China's primary goal is social stability. Such a potential acceleration in the rate of global growth in 2015 would tend to favor WHV's energy, materials and industrials investments, and the WHV International Equity strategy.

Sincerely,

Richard Hirayama

Richard Hirayama
Managing Member
Hirayama Investments, LLC

INTMIE 3Q14PM

[1, 2, 3] Source: International Monetary Fund. Data as of April 7, 2014 and October 7, 2014.

[4, 10] Source: Eurostat. Data as of September 30, 2014.

[5] Source: Morgan Stanley. Data as of September 30, 2014.

[6] Source: National Bureau of Statistics-China. Data as of September 30, 2014.

[7] Source: Bloomberg. Data as of September 30, 2014.

[8, 9] Source: ICE Futures Europe. Data as of September 30, 2014.