Innealta CAPITAL

COMMENTARY: JANUARY 8, 2014

THE YEAR 2013 IN REVIEW AND THE YEAR THAT LIES AHEAD

As we bid farewell to 2013 and look ahead to 2014, we take pause to reflect on the previous year, and provide some comments on the state of capital markets and the opportunities on the horizon in the year ahead. The year 2013 proved particularly challenging for risk-conscious investors. Apart from brief periods of volatility surrounding the potential tapering of the Federal Reserve's unprecedented quantitative easing, the near-involvement of the United States and allies in the Syrian conflict and the government shutdown, 2013 saw equity markets trend higher with abnormally low levels of volatility. We do, however, expect 2014 to be more rewarding for risk-conscious investors.

The year 2013 was one in which U.S. equity markets seemingly interpreted all news as some varying degree of good news, regardless of whether that news was objectively positive for valuations or not. U.S. equity markets ended the year with their largest annual gains in decades, with the S&P 500 increasing nearly 30% for the year. Internationally, developed equity market gains outpaced those of emerging markets, largely driven by continued support from central banks through low interest rates and asset purchases. The year just closed seemed to be one of relief among equity investors, resulting in a broad sense of euphoria that "at least the global economy didn't crash and burn this year." As we have highlighted in so many of our recent commentaries, this is a very different rally than one supported by improvements in fundamentals able to sustain expanding valuations. This is evidenced in expanding valuation multiples and earnings growth that has been driven by margin improvements, as opposed to top-line growth. Such a relief rally, however, seems both unsupported and unsustainable given our ongoing concerns over macroeconomic growth challenges around the globe, ongoing solvency strains in Europe and still very volatile political discourse in the United States. The ongoing, unprecedented support by central banks around the world during the year bolsters the view that positive, enduring macroeconomic trends were few to be found. And those positive trends identified by the Committee for the most part remained weak at best.

The year began with great uncertainty owing to looming government spending cuts. Much uncertainty about GDP growth stemmed from the U.S. political showdown over sequestration—those budget cuts mandated with the intention of never being implemented and put in place only as a mechanism to force cross-aisle compromise. Illustrating the extent to which domestic policy making has become dysfunctional, such a resolution never materialized as gridlock prevailed. Further, tax increases relative to the prior year, in the forms of the cessation of the payroll tax holiday and tax increases on top earners to fund Obamacare, threatened to provide significant headwinds to economic growth. Nonetheless, equity markets trended higher, seemingly ignorant to underlying fundamentals.

Hurdles for the Long-Term Unemployed

Interestingly, apart from the mandated spending cuts, we start 2014 in a similar place as 2013, with our Congress allowing many tax cuts and social benefits to expire. For example, long-term unemployment benefits expired and many popular tax credits and deductions have expired. Not to miss an opportunity to introduce counterproductive uncertainty into the system, speculation runs rampant as to whether Congress will reverse course. Should Congress not act (retroactively at this point), the conjunction of these changes (expiring benefits and tax increases) reduces the resources that economic agents have available for spending. In the case of the long-term unemployed, they have no other source of income to provide the basic necessities. Most alarming for these folks is that, although the headline unemployment rate declined during 2013, new jobs have seemingly gone to those who have been unemployed for short periods of time, not the longer-term unemployed. Sadly, policy makers continue to ignore the reality that the long-run unemployment phenomena results from structural issues that are not addressed through unemployment benefits, which are akin to band-aids, and fail completely to address the underlying structural issues. Of course such long-term subsidies also distort incentives, likely reducing the urgency with which unemployed workers pursue new employment opportunities. After failing to address these undeniable structural issues since at least the Financial Crisis of 2008-9, policymakers have now decided to rip off the band-aid they gave to those affected as a result of such poor policies. Going forward, we hope that policy makers will follow through and focus their efforts on policies that are likely to address the underlying structural issues that lead to long-term unemployment and refrain from short-term, distortive measures.

The impact from the expiration of long-term unemployment benefits on measures of unemployment remains to be seen. Given the long duration of their job search, it is not clear if these roughly 1.3 million potential workers will leave the labor force, disheartened by their extended unemployment and the cessation of their benefits (which may have provided the only incentive they have at the moment to search for a job). Alternatively, faced with no other choice, these workers may rotate to lower paying jobs, which would put downward pressure on wages in those areas. The impact on the unemployment rate is significant as it influences the Federal Reserve's decisions regarding quantitative easing. Should these workers leave the work force, the unemployment rate will decline significantly, possibly accelerating the tapering of asset purchases. This counterintuitive result may enable the economy to gain sounder footing following the short-term disruptions that are likely to ensue.

Taxes on the Rise

The expiration of popular credits and deductions should be expected to have a similar adverse impact on economic growth. Homeowners are impacted adversely as they are no longer able to deduct the cost of mortgage insurance. Importantly, corporations' ability to deduct research and development expenditures is impacted adversely, which reduces their incentive to invest in projects likely to lead to the type of innovations that drive sustainable economic growth. Whether or not these tax deductions and credits should have existed in the first place is beside the point here. When assessing the economic backdrop as we begin the New Year, the relevant facet is that, compared to the previous year, the year 2014 begins with headwinds to consumer spending, productivity and investment spending, all of which constitute significant headwinds to real economic growth. Set against the backdrop of already paltry economic growth, this is particularly concerning. Even more concerning to us is the lack of concern exhibited by many market pundits and prognosticators about these factors that actually impact the underlying fundamentals. Instead, they emphasize the positive benefits of the "wealth effect" created by expanding equity valuations and loose monetary policy. Monetary policy-induced expansion of equity valuation multiples is simply unsustainable. As the majority of Americans have at most small equity investments, the effective tax increases and reduced unemployment benefits are no doubt much more important to the majority of Americans than the impact of the wealth effect created by the stock market this past year. To ignore such economic headwinds is to suffer from selective myopia.

Challenges Remain for Fixed Income

Unlike developed economy equities, 2013 was a dismal year for bond markets. Bond funds experienced large redemptions throughout the year, driven by the growing anticipation of the Fed tapering its asset purchases. With interest rates driven to historic lows by the actions of developed world central banks, it is not surprising that bond markets reacted violently during June 2013 at the heightened risk of Fed tapering. Importantly, long-duration exposures have underperformed this year as longer-term benchmark rates have moved higher. Since interest rate risk is highest at low yields for many bonds (those that are non-callable), and given the historically low interest rate levels seen recently, it is not surprising that even modest increases in yields have resulted in large losses among longer duration exposures.

Among the corporate fixed income space, U.S. credit spreads remained narrow by historical standards and maintained a relatively tight range compared to the past few years. The yield opportunity presented by sovereign fixed income investments remains low among the perceived safer developed sectors, but greater among the emerging country set. Spreads within high yield and investment grade corporate securities provided attractive cover for those exposures to varying degrees during the year. That said, emerging market fixed income securities proved more volatile through the year. Given the committee's anticipation of rising longer-term rates, we continue to tilt our fixed income allocations aggressively towards low duration exposures, while placing emphasis on diversification both across domestic sectors and internationally.

Emerging Markets Present Opportunity

The year 2013 was not nearly as kind for investors in emerging markets as it was for developed world equity markets. Potentially as a result of the actions of their developed-world peers (for example, quantitative easing in the U.S. is widely perceived to have increased demand for emerging-market currencies and securities), many emerging economy central banks were pressured to increase rates in light of weakening currency values and rising inflation. Fears of a nearer-term decrease in Fed efforts caused a substantial dislocation in many risky assets during June 2013, with those sourced in emerging market currencies among the particularly hard hit. Further, the expectation of Federal Reserve tapering of asset purchases led investors to sell foreign assets and reverse the capital flows which have benefited emerging market economies so greatly in recent years. Such periods of volatility present opportunities for patient investors.

Across the emerging market equities space, the Investment Committee expects there to be attractive opportunities in the near future. This space remains vulnerable to tapering by the Federal Reserve. Further, many countries rely heavily on foreign capital and remain exposed to volatility ensuing from outflows that may result from rising rates in developed markets. Such volatility, however, presents opportunities for investors to establish beta exposures. Our framework reflects that valuations in these markets, which have generally not experienced the large gains seen in developed economy equities during this past year, are much closer to attractive valuation levels. We have added and continue to consider additional international beta exposures to the portfolios. The asymmetry between the risk and return profiles of these markets and those of developed equity markets, and even some credit sectors, suggests select exposures are attractive investment opportunities.

Global Growth Remains Weak

As we look ahead to 2014, many of the same concerns remain in the forefront for the Investment Committee. Despite nascent signs of improvement, the economic measures required to support equity valuations remain small at best. U.S. GDP growth remains low (2.2%) by any historic perspective. Most disturbing is that hopes for growth in many export-oriented economies internationally depend heavily on U.S. economic growth. That a paltry 2.2% growth rate will provide the engine for global gains is hard to conceptualize. Certainly, such growth is not supportive of the 30% valuation expansions seen in the prior year. Thus, we expect 2014 to be a year in which carefully selected beta exposures outperform and overall equity returns are less memorable than 2013.

We expect that the first part of the year will be one in which the economic picture continues to clarify and we pursue select opportunities as they arise. Although rare in the current environment, there can be found examples in the developed world in which the economic outlook improved during the past year. An example is the United Kingdom, where policies have addresses some of the underlying issues and our framework suggests the underlying fundamentals have improved the point where current valuation levels are attractive.

Geopolitical Risk Still Underappreciated

As always, geopolitics remain an unpredictable source of risk. Leaders of rogue states continue to defy the international community and recent conflicts have shown there is clearly no world power willing to stand up (with force), even to objectively brutal regimes. Foreign policies across much of the developed countries seem more focused on complete capitulation and a “not our problem” mentality. Such short- and medium-term gratification may very well lead to major problems down the road. For example, the U.S. withdrawal from Iraq has left fertile ground for militant groups, as evidence by the fact that 2013 was the deadliest year in Iraq since the U.S. invasion. The picture that emerges is one that is alarming and presents significant risk. Syria has turned into a training ground for tomorrow’s terrorists. That conflict has seen many foreign fighters enter Syria from European nations. These mercenaries fight side by side with Al-Qaeda fighters, becoming increasingly radicalized and fortified in battle. When the conflict ends, a new generation of terrorists with greater ability to cross Western borders and travel within Western countries undetected will present a grave threat to these countries. Most disturbingly, equity market valuations appear to ignore entirely even the possibility of geopolitical risks arising in the near future. While such events are unpredictable and impossible to time, they are real and always present. That equity market levels and the dearth of volatility suggest otherwise is an alarming fact that may even further embolden poor policy making.

Opportunities Remain

In the year ahead, central bank policy will continue to be a dominant determinant of risk asset performance. The Committee intends to be more aggressive in the coming year about pursuing opportunities, but we note that we are not alone in the investing world as having found the QE-driven environment difficult to navigate given its effect of dislocating asset prices from their underlying fundamentals. That equilibrium, however, cannot persist indefinitely without the total surrender of capitalism and a market based economy in favor of a totalitarian central planner. As capital markets become free of policy makers' distortions, opportunities will again return to capital markets. We look forward to a prosperous new year, and eagerly await the challenges it holds, ever mindful of the importance of our decisions and the trust placed in us.

IMPORTANT INFORMATION

The information provided comes from independent sources believed reliable, but accuracy is not guaranteed and has not been independently verified. The security information, portfolio management and tactical decision process are opinions of Innealta Capital (Innealta), a division of AFAM Capital, Inc. and the performance results of such recommendations are subject to risks and uncertainties. For more information about AFAM Capital, Inc. please visit afamcapital.com. Past performance is not a guarantee of future results.

Any investment is subject to risk. Exchange traded funds (ETFs) are subject to risks similar to those of stocks, such as market risk, and investors that have their funds invested in accordance with the portfolios may experience losses. Additionally, fixed income (bond) ETFs are subject to interest rate risk which is the risk that debt securities in a portfolio will decline in value because of increases in market interest rates. The value of an investment and the return on invested capital will fluctuate over time and, when sold or redeemed, may be worth less than its original cost. This material is not intended as and should not be used to provide investment advice and is not an offer to sell a security or a solicitation or an offer, or a recommendation, to buy a security. Investors should consult with an investment advisor to determine the appropriate investment vehicle. Investment decisions should be made based on the investor's specific financial needs and objectives, goals, time horizon and risk tolerance. All opinions and views constitute our judgments as of the date of writing and are subject to change at any time without notice.

Sector ETFs, such as Real Estate Investment Trusts ("REITs") are subject to industry concentration risk, which is the chance that stocks comprising the sector ETF will decline due to adverse developments in the respective industry.

The use of leverage (borrowed capital) by an exchange-traded fund increases the risk to the fund. The more a fund invests in leveraged instruments, the more the leverage will magnify gains or losses on those investments.

Country/Regional risk is the chance that world events such as political upheaval or natural disaster will adversely affect the value of securities issued by companies in foreign countries or regions. Country/Regional risk is especially high in emerging markets.

Emerging markets risk is that chance that stocks of companies located in emerging markets will be substantially more volatile, and substantially less liquid, than the stocks of companies located in more developed foreign markets.

Securities rated below investment grade, commonly referred to as "junk bonds", may involve greater risks than securities in higher rating categories. Junk bonds are regarded as speculative in nature, involve greater risk of default by the issuing entity, and may be subject to greater market fluctuations than higher rated fixed income securities.

Diversification does not protect against loss in declining markets.

Registration of an investment adviser does not imply any certain level of skill or training.

AFAM Capital, Inc. is an Investment Adviser, registered with the Securities & Exchange Commission and notice filed in the State of California and various other states. For more information, please visit afamcapital.com. Registration as an investment advisor does not imply any certain level of skill or training. Innealta is an asset manager specializing in the active management of portfolios of Exchange Traded Funds.

Innealta's competitive advantage is its quantitative investment strategy driven by a proprietary econometric model created by Dr. Gerald Buetow, Innealta's Chief Investment Officer. The firm's products include Tactical ETF Portfolios, a U.S. Sector Rotation Portfolio and a Country Rotation Portfolio. Innealta aims to beat appropriate benchmark performance by tactically managing portfolios utilizing a proprietary econometric model. By harnessing the benefits of ETFs, Innealta is able to provide investors with exposure to multiple asset classes and investment styles in highly liquid, low cost portfolios.

For more information, contact Scott Silverman at 949.540.7307 or your financial advisor.

AFAM Capital, Inc.
12117 FM 2244 Bldg. 3 -#170
Austin, TX 78738
P: 512.354.7041 F: 512.402.1014