ONE-MARKET SHOW

Likely obvious to most reading this note, December was a volatile month for both emerging-market and U.S. high-yield fixed income. Contributing to the malaise were compounding trends in foreign exchange rates, oil prices and geopolitical stress. The inevitable consequence of heightened investor fear, these trends drove asset flows away from emerging-market and high-yield debt toward U.S. Treasuries. Credit yield increases were not as significant as spread increases due to the reduction in Treasury yields which was a result of both flight to quality as well as muted economic growth expectations.

Even as we scratch our heads marveling at the extent of the broadly unexpected shift in enthusiasm, while we revisit our investment themes with renewed focus on the evolving risk characteristics of our preferred fixed income allocations, our long-term outlook on our allocations to these markets remain intact. In the end we remain resolute in our belief that our current exposures will add value on a risk-adjusted basis over the coming months.

Dollars Wanted

Reflecting similarly divergent macroeconomic trends in those regions, a trio of developed-nation central banks (we're looking at you, Ms. Yellen, Mr. Draghi and Messrs. Kuroda and Abe) have sought opposing monetary policies. These differing policy goals greatly complicate the work of their emerging market peers. Further easing in Japan and Europe coincided with the end of quantitative easing in the U.S., producing real-rate differentials that have resulted in a strengthening dollar relative to many developed and emerging market currencies. We chart a range of exchange rates in Figure 1.

FIGURE 1

Year-to-Date Change in USD Exchange Rate

From 12.31.13 to 12.20.14.
SOURCE: Innealta Capital using data from Datastream

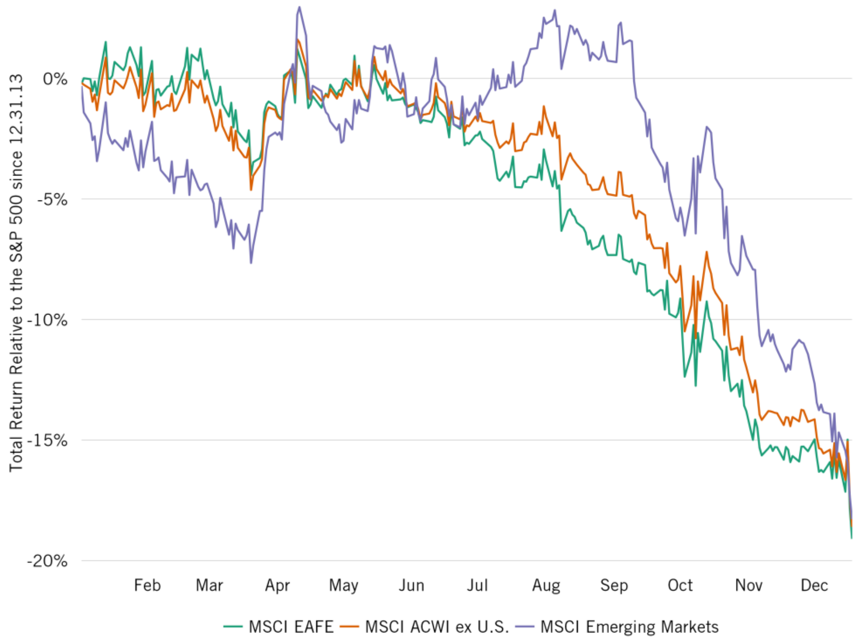
A strengthening dollar weakens the funding positions of debt issuers with different home currencies, increasing the overall burden and likelihood of duress. Though emerging market governments over the past few decades may have shifted away from debt issuance in foreign currency, that void has to a broad extent been filled by emerging market corporations. These fixed income segments of our portfolios have experienced the more substantial declines over the past few months, with December showing particular weakness.

The dollar trend is no less starkly obvious in the relative performance of global equity markets. In Figure 2 we chart the deviation in total return for 2014 in the U.S. market, versus international aggregates. In relative performance terms, the Country Rotation Portfolio mostly sidestepped the declines in international markets, as we have been increasingly narrow in our tactical equity exposures as the year progressed.

FIGURE 2

Total Return Relative to the S&P 500

From 01.02.14 to 12.18.14.
SOURCE: Innealta Capital using data from Bloomberg



Drowning in Oil

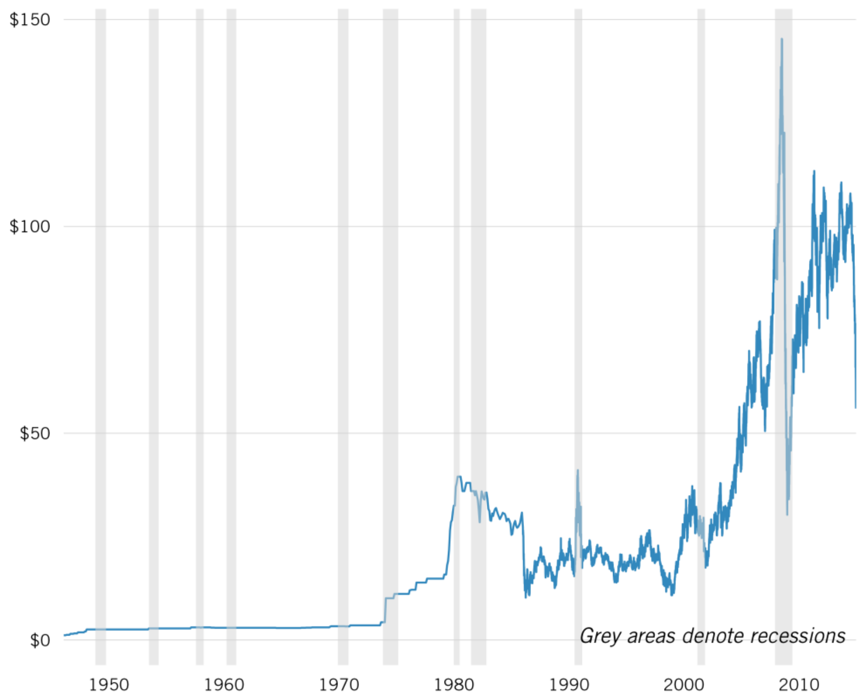
We would be surprised if readers had not already spent a good amount of time reflecting upon the recent plunge in oil prices, but we thought we would reprise recent trends in the context of their long-term history. As shown in Figure 3, the world has experienced large declines in oil prices in the past, though outside of the 2008 plunge, the extent and rapidity of this year's drop are on the far side of abnormal.

Oil-exporting emerging markets like Venezuela, Russia, Mexico and Brazil all have been negatively impacted by the nosedive in the price of crude. Prompting a bit more head scratching on our part, supply and demand dynamics within the energy sector cannot legitimately explain the sudden change in price. There simply was not sufficient depth of novel and consequential news to justify the decline, leading us to believe this drop will prove relatively short-lived, offering opportunity for aggressive rebalancing of unfairly beaten down positions and even a few specific buying opportunities. The recent introduction of the Energy sector exposure in the Sector Rotation Portfolio reflects just such an opportunity.

FIGURE 3

Crude Oil Prices: West Texas Intermediate (WTI)

From 01.31.46 to 12.15.14.
SOURCE: Dow Jones & Company and US. Energy Information Administration via FRED, Federal Reserve Bank of St. Louis



Localized Chaos

Exhibit #1 among the recent examples of the universe conspiring to undo a reasonably well-supported risk-on trade: Vladimir Putin's Russia is on the verge of a financial meltdown. The already-discussed dollar and oil trends compounded the effects of (relatively very weak) sanctions to produce a storm of pressures on the Russian economy and its capital markets. While our indirect exposure to Russia among the fixed income segments of our portfolios is relatively light, our tactical equity position in the Country Rotation Portfolio remains under sincere and severe scrutiny. As it stands, we remain confident in the potential for a return of greater sanity to the region, spurred on in no small part by the macroeconomic necessity of it all. Even so, we are not so naïve to believe that Mr. Putin will prove a humbled negotiator, though we expect him to find very willing conciliators among the German business public, weakened as they have been by mounting macro pressures in the Eurozone. The upshot is that the team presently is standing firm in the holding, with the more obvious rationale for any premature sale likely to be any move to introduce capital controls or increased aggression in Ukraine or elsewhere along Europe's eastern periphery.

Trouble Even at Home

Domestically, we have seen yield spreads over U.S. Treasuries widen across U.S. credit markets, even as a relatively heavy cap has continued to weigh U.S. Treasury yields. In our view more a function of a flight to quality and headline risk than macroeconomic reality, we believe that this spread dynamic will equilibrate in the coming months. The knowledge of the potential for such shifts in investor preference in part drove our own partiality to lower-duration exposures in the credit markets. That preference mollified the price dynamics (relative to longer-duration exposures) that came about among the high-yield segments as a result of the widening. We detail the spread shift in the U.S. high-yield and in emerging-market sovereign debt in Figure 4.

FIGURE 4

U.S. High Yield and Emerging Market Spreads

From 12.31.12 to 12.19.14.
SOURCE: BofA Merrill Lynch and JPMorgan via FRED, Federal Reserve Bank of St. Louis and Bloomberg

FOCUSED ON THE HORIZON

While the final months of 2014 saw a confluence of detrimental trends pressure many of our fixed income exposures, we will remind readers that our portfolios have endured similar bouts of stress in the past. And we have on occasion managed to dampen or avoid the impacts of the reemergence of fear within fixed income markets over the past few years. To be clear, we expect fixed income markets will be challenging to navigate in 2015. Nonetheless, we will remain vigilant of the ongoing risks assumed by the diversified exposures we maintain in the portfolios. Even more, we continue to believe that our duration, credit and yield tradeoffs will prove themselves for our clients in the coming months, quarters and year.

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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.

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