Innealta CAPITAL

COMMENTARY: AUGUST 2011

WITNESS THE TRAGIC COMEDY

- As I watch the news flow over this past weekend (and over the past few weeks) I can't help but think I am watching a poorly directed choreography of a script directly from the book, *Too Big to Fail*. A tragic comedy of pomp and farce. As we've stated repeatedly, defaulting on our Treasury obligation is going to be an active choice by the Treasury. To suggest otherwise is just disingenuous and nothing more than politics at its absolute worst.
- Capital market efficiency is based on the notion that relevant information is reflected in asset valuations quickly. Over the years I have challenged this concept particularly as it applies to equities and other risky asset values. To some degree it's the basis for tactical investing. I have also long argued that the fixed income markets, and the Treasury market in particular, are the closest to being efficient. This is partly due not only to the investment structure of the securities themselves, but also the sophistication of the average fixed income investor. In the current context, then, what information is being conveyed in Treasury prices? We'd argue no default, slow growth and very low inflation for the foreseeable future. This matches our logical view as well. In the unlikely event that the folks in D.C. were to choose to temporarily default (perhaps to prove their own self proclamations) it would most likely offer an investment opportunity.
- Rest assured that we stand ready to act within our disciplined investment process when opportunities present themselves. This is perhaps the most frustrating and aggravating investment environment we have ever experienced in our almost 25 years in the industry. We remain confident in our framework and will always do our absolute best to optimize risk and return for our clients.

As I watch the news flow over this past weekend (and over the past few weeks) I can't help but think I am watching a poorly directed choreography of a script directly from the book, *Too Big to Fail*. A tragic comedy of pomp and farce. The fear tactics and synthetic drop dead dates are getting too much to bear at this point. The sheer idiocy emanating from Washington over the debt ceiling has become so ridiculously artificial it's embarrassing to watch. As we've stated repeatedly, defaulting on our Treasury obligation is going to be an active choice by the Treasury. To suggest otherwise is just disingenuous and nothing more than politics at its absolute worst. And politics at its absolute worst is as wretched as it gets.

At this point in the debate it's almost impossible to determine who is exactly is leading the conversation—the media, the capital markets, the House of Representatives, the Senate, the Treasury, the Executive branch or the ever so prescient credit agencies...but certainly not the electorate. Without a doubt leadership is nonexistent. The finger pointing, arrogance, bully pulpit tactics and outright intransigence between all of our elected officials has become so counterproductive that assuredly only a suboptimal approach will be agreed upon in order to meet the self-imposed deadline. Lies and propaganda tactics continue to dominate the discussions.

CUE SCARY MUSIC..."THE DEADLINE APPROACHES!"

Furthermore, this deadline issue is really absurd. The looming date currently is August 2 and over the weekend it was "before the Asian markets open." Are we really to believe that these dates mean anything? The issue hasn't exactly sneaked up out of nowhere. I just can't stand being treated like I am a fool. It seems that Washington believes we all are fools—and the media absolutely reinforces, promotes and exploits that point of view. It's really maddening.

I, for one, am weary of headlines declaring the end of the world as we know it if an agreement isn't met by some made up due date. Capital market participants threaten Armageddon-like reactions if there is no "resolution," which then leads to some politician expectorating rhetorical urgency, which leads to inane media headlines and the process repeats. This positive reinforcement loop produces a circular logic that results in a self-fulfilling psychology where those involved don't know who started it or why. No one seems to be stopping and asking logical and conceptually sound questions. Wall Street economists contribute to the harangue by offering speculative extrapolations that are nothing more than intellectual perversion. Has our society really devolved that far into the abyss that logic fully eludes us? Is vitriol and venom all we know? Are we incapable of productive discourse and mutually beneficial compromise? Is there even a modicum of patriotism remaining in our political leaders? Witnessing the goings on in D.C., the answers are obvious.

FARCE AND FACT

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What's the alternative to Treasuries? They are effectively interest bearing put options protecting portfolios from geopolitical and sovereign risk. This is despite what the media grabbers at the credit agencies are trying to convey. The credit agencies seem to be more desperate and aggressive than ever before in trying to proactively warn sovereign issuers. This is hard to take terribly seriously given their historical performance. That is, their credibility is more than somewhat suspect. So we take the credit raters with a grain of salt. Additionally, one simply has to look at yields on Japanese bonds to realize that credit rating downgrades are not terribly meaningful for economies the size of the United States. Back to Treasuries—given the events in Europe, do investors really prefer those sovereign exposures over Treasuries? Politicians and regulatory authorities across the Atlantic are more concerned with redefining once well understood financial terms—like default. This semantic dance has no greater purpose than the avoidance of a crescendo of derivatives-based contingency payments. But like our debt ceiling debate—does anyone really believe it? We're at a loss of words to describe the emotions experienced when we analyze the goings on by the EU leadership. It's preposterous and perhaps worse than the U.S. situation. Emerging markets must be watching in complete bewilderment by what is transpiring in much of the "developed" markets. We certainly are and we're not going to unnecessarily expose our portfolios to these risks.

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For more information, contact Scott Silverman at 949.540.7307.

AFAM | Innealta Capital
85 Argonaut, Suite 220
Aliso Viejo, CA 92656
P: 949.499.3215 / 888.994.6827 F: 949.499.3218