Innealta
CAPITAL

COMMENTARY: AUGUST 31, 2012

PARSING THE POLICIES

- Likely well known to longer-term readers is our interest in U.S. politics. Not solely, of course, for the dark humor in it all—the fiscal (and, more often nowadays, monetary) shifts that are the consequences of these matters generally are of great importance to our investment outlook. It stands to reason, then, that the pronouncements to date in the race toward the upcoming election—in particular, those related to fiscal policy—offer reasonable fodder for review.
- This month's commentary starts with a review of why we care about such things when determining our investment outlook. We then look at a few of the more notable pronouncements, comparing the differences of opinion and extrapolating the potential impact of each approach. The idea here is not to be comprehensive. We'll leave that to the politblogs. Rather, we want to instill a confidence that we are watching the process unfold for its implications to our investment theses and asset class exposures.
- Thankfully, there remain remedies to our problems. And we can believe we are making progress, if only so far by raising the discourse to the national level. Whether we'll proceed on an alternative path, in our view, will be determined by the November election. There is no choice to be made that will provide an easy transition; even now, none will be easy to execute or kind to medium-term growth. That is, *we will at some point* feel the negative effects of reversing the path the country has been on, regardless of who is in charge next year. The magnitude of those negative effects will depend on how long it takes for Washington to accept and execute against its responsibility to defend the nation's fiscal health.
- Critical to the conversation, our core investment philosophy is based on a risk-relative view of the world and an adaptable portfolio management process that enables a flexibility to shift exposures quickly and efficiently on an as-decided basis. It is geared to maneuver through the impending election and any divergent paths that might result from either scenario. That is, we believe we are prepared to respond to either case.

RATIONALE FOR THE REVIEW

Not all work of the Executive Branch of the U.S. government is consequential in regard to the investment environment. Many aspects are, however, and the greatest among them are fiscal policy. There currently is no greater existential threat to our nation than its solvency. And fiscal policy is the determining factor. Without an extraordinary rework of the federal budget, the nation is on course to a destination as or even more dire than that currently facing Europe.

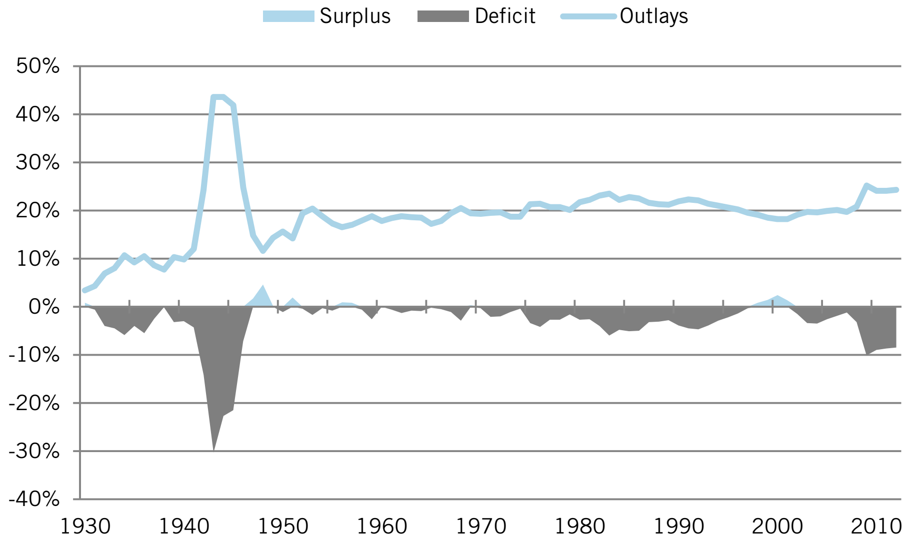
The country can choose now to come to terms with this truth, cutting spending and coupling those cuts with a more rational tax policy, or we can choose to hasten our path to the abyss. It seems, given that threat, the choice for our next President is clear. Though we think the efforts to right the unsustainable growth of the federal deficit and de-lever the Federal Reserve's balance sheet must extend even well beyond the plans the two so far have expressed, candidates Romney and Ryan have at the very least offered a tone and a perspective that match the seriousness of the situation. On the contrary, President Obama would rather we tweak the status quo, pretending that further *financial* support from the government is somehow a better solution to a list of the nation's ills that includes weak macroeconomic growth, high unemployment and grand uncertainty than additional *structural* support, which would include a smaller governmental role in the economy, less restrictive tax policy and broadly reduced regulatory burdens.

As we further the discussion, we'll seek to highlight what we think are the potential ramifications of the various platforms and platitudes. We'd much rather one outcome over the other. Importantly—and we'll come back to this thought several times—there is pain to be felt no matter the course we choose. But, we believe we can manage through the consequences of either, glimpses of which we'll offer as we move through the commentary.

IDENTIFYING THE PROBLEM

Federal government spending factors strongly into the nation's output, currently comprising 24.1% of total GDP in 2011, according to the Congressional Budget Office (CBO), which expects that figure to drop a bit to 23.4% of GDP this year. The President holds primary responsibility for setting the budgets that direct that spending. Congress, in turn, figures how to appropriate funds allocated within the budgets, pending the President's ultimate approval.

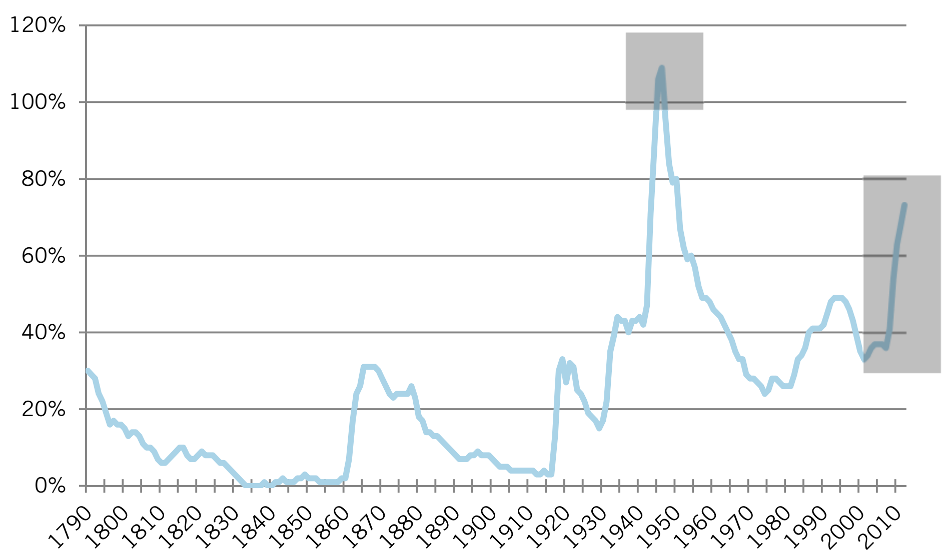
Figure 1: Federal Outlays and Budget Surplus/Deficit as Percentage of GDP



From 1930 through 2012. 2012 data are estimated. SOURCE: Office of Management and Budget

So, for the past 10 years—and a bit more loosely for the past 50 or so years—we've grown spending more quickly than revenue, recession or not, a fact reflected in Figure 1. Whatever gap is left, borrowing by the Treasury makes up the difference. And that difference is remarkable. Detailed in Figure 2, after great progress in reducing publicly held U.S. Federal debt from a peak after World War II through the mid-70s—including a dozen years of surpluses, with four of those from 1998 through 2001—the consequence of the global macro meltdown (lower GDP) and subsequent efforts to grease the wheels (higher spending), the share of U.S. domestic output represented by outstanding debt has soared from a trough of 24% in 1974, to a CBO-projected 73.2% at the end of 2012.

Figure 2: Federal Debt Held by the Public as Percentage of GDP



From 1790 through 2011. Data through 1939 are based on debt at the end of the calendar year; data for 1940 and later are based on debt at the end of the fiscal year. SOURCE: Various, via Congressional Budget Office

We're guessing that's news to no one. But we offer the review as a reminder that Federal spending is a team effort, and that team has been on a binge for several decades. Given the polarization of views in Washington, one should expect that progress in breaking those bad habits will be tormented and halting.

Bad Gets Worse

Over the last four years, the Federal government has chosen *to be* the means for macroeconomic growth, again couched as *support for* growth, as opposed *to enabling* the means for macroeconomic growth.

The noted economist Friedrich August von Hayek penned in the foreword[1] to the 1956 American paperback edition of the book he published in 1944, *The Road to Serfdom*, "The hodgepodge of ill-assembled and often inconsistent ideals which under the name of the Welfare State has largely replaced socialism as the goal of the reformers needs very careful sorting out if its results are not to be very similar to those of full-fledged socialism."

In that brevity, of course, we do the words of Mr. Hayek little justice. It's a nuanced (though intuitively and rationally so) work that transcends the time in which it was written and begs for broad review in the context of the current proposals for our nation's future path. Speaking to the path toward and the perils of transitions from (very much our words here) *supported* to *planned* to *controlled* economies, Mr. Hayek paints a picture of a slippery slope...one found in many geographies around the world through history.

There's a well-defined course there to take, so long as the nation chooses to pursue greater 'support'—for which we should read 'control'—of the economy over a more rational approach that lets the economy chart its own course. As importantly, Mr. Hayek did not suggest that the path must be inevitable. We can admit that we have a problem and choose to pursue its remedy. That problem for us in the unsustainable level of fiscal and monetary focus on broad support of the economy that is leading us to levels of unsustainable debt. Broad support begets even broader support, which begets even greater debt, which requires even more burdensome remedy to the point at which only the strictest command might rescue the nation.

The consequence to investment, thus, is obvious...in a controlled economy there is no investment. We don't mean to be hyperbolic. Each step toward that state is a reduction in the favorability of the environment toward investment. As the government interventions become more volatile and unpredictable—whether we're talking about fiscal or monetary policy—it fosters greater uncertainty of the investment environment, near- and long-term. Thus any investment manager must be prepared to adjust exposures that offer the best risk-reward that the capital markets have to offer along this potentially treacherous path—whether it be here or abroad.

Instead of resolving over time to foster more efficient and higher quality health care in the U.S., Team Obama threw together a plan that it hoisted on a populace fully unprepared to first accept the ideals as rationale and then plan personal and corporate activities around them. And instead of enforcing strict, rules-based mechanisms for devising and executing monetary policy, Chairman Bernanke's 'do anything' approach not only hasn't in our view defensibly (certainly difficult to say definitively) enabled progress toward the Fed's dual mandate, it has counter-progressively engendered greater anxiety over subsequent moves, thereby leaving Fed actions to have a more destabilizing impact on the economy, as opposed to nurturing greater certainty and stability.

These capricious interventions don't necessarily make our jobs any harder. They do change the risk/reward math for various asset classes, with the general effect of shrinking the list of potentially attractive investment opportunities. Sufficient diversity of exposures still may be found. But the mix of those exposures shifts well to the 'averse' side of the risk spectrum.

[1] Excerpted from, *The Road to Serfdom: Text and Documents—The Definitive Edition (The Collected Works of F. A. Hayek, Volume 2).*

The Impact Will Be Felt

Thankfully, there remain remedies to our problems. And we can believe we are making progress, if only so far by raising the discourse to the national level. Whether we'll proceed on an alternative path, in our view, will be determined by the November election. There is no choice to be made that will provide an easy transition; even now, none will be easy to execute or kind to medium-term growth. That is, we *will* feel the negative effects of reversing the path the country has been on, regardless of who is in charge next year. The magnitude of those negative effects will depend on how long it takes for Washington to accept and execute against its responsibility to defend the nation's fiscal health.

Again, we believe we are prepared to respond to either case.

Net/Net on Debt

Even outside of the philosophy of the policies that have driven their expansions, there are a host of reasons to find fault with the current level of Federal debt and deficit spending. Foremost, obvious to most anyone without the ability to write checks against the 'limitlessness' of U.S. Treasury's balance sheet, an ever-expanding debt-load relative to income will at some point prove disastrous.

As the nation's debt grows, interest rates should rise over time to reflect the growing risk of holding that debt. Broadly speaking, rising rates weaken the near-term outlook for fixed income securities as the value of existing debt falls. And Treasury debt becomes more susceptible to sentiment shifts in regard to the creditworthiness of the U.S. Treasury; volatility thus rises.

This upward shift in rates will affect the cost of capital for the nation's corporations and citizens. Marginal increases in the cost of debt spawn marginal decreases in consumption and investment, limiting growth in the near and long term. Weakening expectations for growth crimp the current value of equity investments, lifting the hurdle we think we must clear to invest in them.

And as systemic risk rises, risk management grows ever more paramount in the portfolio management process, while expectations for risk-adjusted long-term returns fall along in step.

Role of the Federal Reserve

For the time being, the Federal Reserve can accommodate the rise in debt both by keeping rates low—supported by the even greater magnanimity of foreign lenders—and by purchasing new debt via quantitative easing. But the Fed soon will run out of ammo, as its balance sheet stretches beyond sustainability (we might already be there...) and its own efforts fail to keep pace with those of other lenders looking to reduce the growing impact of the reduction in American solvency on the risk in their investment portfolios.

For these and other reasons, we expect the role of the Fed in the economy to at least make an appearance during the campaign season, if not altogether likely on the center stage. Were the Romney ticket to take home the win, however, we'd expect to see some proposals put forth to amend the Federal Reserve Act. Mr. Romney already has professed that he would not reappoint Mr. Bernanke to the Chair of the Fed (though his alternative choice is not yet known). We'd hope the replacement would take a more sensible, predictable approach to monetary policy. Were President Obama to retain his office, we'd expect more "whatever it takes" from Helicopter Ben.

TARGETING SPENDING

We have the sense that even most Europeans are coming to the realization that such grand levels of debt are bad. One might have thought that the folks who control the remotes in D.C. would be getting that same message.

The evolving conversation would make it seem so. Except that many are making the process sound a lot more simple than it will prove. Lots of, “We’ll match those revenue cuts with spending cuts.” But the lists of cuts, at least in recent pronouncements, mostly have been insufficiently specific. And building that list is one thing. Ticking off the cuts on that list is an entirely more challenging matter. That’s the challenge with short-term political thinking. Choices too often reflect the more powerful demand for reelection than they do the greater longer-term benefit to the country. And the fault for that short-term thinking lies both in the decision makers and the people that elect them.

See, many are quick to pooh-pooh synchronized swimming as a non-sport, until they 1) look under the water to see the effort required when the pressure’s on, and/or 2) jump in the pool and try it for themselves. Applying the metaphor to this discussion, 1) readers should note the difficulty Greece, Italy and Spain (Ireland and Portugal, too; France isn’t even trying) are finding in their efforts to force austerity on the populace, and 2) readers should recall Vice Presidential candidate Paul Ryan’s first attempt at injecting more sanity into the budget, which was batted down by both parties as cruel and unusual punishment for those partaking in entitlement programs. This, even though the outline offered was incremental and despite the fact that the plan vastly improved upon the little-to-no progress reflected in President Obama’s budget.

Let’s be clear, though, his original plan is the only quasi-solution presented to date. “Quasi” in that it was incomplete; it did not identify all the means to arrive at a budget positive effect, conveniently leaving out the offsets to tax cuts likely to prove most contentious...and therefore mostly unlikely.

Spending as Revenue

Naturally, most of the equity sectors that might potentially find our favor either directly or indirectly benefit from D.C. largesse. Aerospace and Defense (which, by the way, falls into the Industrials sector) is merely the most obvious. Many members of the Consumer Goods space also benefit from the eventual spending that is sourced from entitlement programs.

Critically, in our view, the fact that equity markets might find candy sweets in the Federal budget is by no means even remotely sufficient support for maintaining the current level of spending. It’s an unsustainable cycle of dependency. Far better, in our view, for firms to find sustainable long-term revenue sources from private-sector-sourced growth, than to remain dependent on a stream of revenue that is in no small part sourced from their own pockets.

FOSTERING UNCERTAINTY

The reason we initiated this commentary with the implications of already high and growing national debt is that the discussion has moved much closer to the center of this presidential campaign—in our opinion only prompted by what’s gone on in Europe and the addition of Paul Ryan to the Republican ticket...otherwise it would have remained an ignored issue. No matter the driver of the heightened attention, we certainly welcome it.

It would seem that the candidates are making the best efforts they can to reduce the level of uncertainty. However, the manners in which the various tickets are choosing not only to frame the issue, but also to manage through it are well divergent. ‘Solutions’ can create as much uncertainty as the problem itself; the uncertainty generated by weak leadership can be just as onerous as that created by strong leadership of bad policy. We thus can question the quality of those efforts, in terms of quieting fears and, more importantly, having a net long-term positive effect on macroeconomic growth.

CEOs Agree!

There are two facets (at least) to that thread: 1) formulating policy and 2) executing policy. In the process of formulating policy, presidents and legislators create uncertainty. One must look no further than President Obama's healthcare initiative to find evidence of this truth. There is no good uncertainty when it comes to long-term investing. By their nature, investments incorporate, implicitly or explicitly, some kind of forecast. Any hindrance to setting those expectations can only reduce the value of the end results of related calculations. That is, more uncertainty about the future lowers the current value of the expected return.

Some CEOs of U.S. companies agree. Not only are the levels of debt and trends in spending fundamentally scary in the context of the investment environment, the drama that infuses the discussion heavily weights the sentiment of the investor class. Executives are fearful of what's next, given the breadth of possibilities, and therefore hold back on investments in the future. We welcome the positive effect such caution has had on U.S. corporate balance sheets—one reason we're finding greater opportunity in U.S. corporate debt than we are in U.S. corporate equity. But, we wonder just how negative is the consequence for future growth potential, knowing full well that it's at best very bad.

An example of what we mean, here's Mr. Scott David, CEO of UPS, on the company's July 24th Q2 earnings call:

> *"In the U.S., uncertainty stemming from this year's elections and the looming fiscal cliff constrains the ability of businesses to make important decisions, such as hiring new employees, making capital investments and restocking inventories. This will further restrict economic growth"*
>
> SOURCE: Bloomberg

TIDE SHIFTING?

We'll have to admit, though, to seeing some glimmers of hope in all the domestic fuss over what's going on in Europe and the potential for the U.S. to look not so different in a couple decades' time. A notable example: in August of 2011, a debate over the Federal debt ceiling—the max level of barrowing limited by Congress—actually became a debate, rather than a moment for lip service to parsimony. The result was the Budget Control Act of 2011, which created a 'super-committee' of Republicans and Democrats, called the Joint Select Committee on Deficit Reduction, charged with coming up with a real solution for the emerging debt crisis America faces. That group failed to work out a compromise, leading to a fallback option built into the Budget Control Act that provided for automatic, nearly across-the-board sequestration (cuts) of spending starting in 2013.

Fiscal Cliff

Those impending cuts are part of a broader set of changes in taxation and government spending fondly being referred to as the "Fiscal Cliff," for the sheerness of the shifts in both revenue and outlays. The CBO-expected[2] total reduction in the deficit (funny thing here, in that a reduction would normally be a good thing...) is $607 billion from calendar 2012 through 2013, or 4.0% of GDP.

Altogether, various expirations and contingencies combine for a $399 billion expected specific increase in taxation and a $103 billion expected specific decrease in spending, on top of an additional mix of $105 billion in changes to taxation and spending. Offsetting those changes is the expected reduction in tax revenue associated with the expected decrease in economic output and the increase in spending (unemployment and such), totaling

[2] http://www.cbo.gov/publication/43262

an expected $47 billion. That leaves the net expected impact at $560 billion, or 3.7% of GDP, according to the CBO.[3]

That's a grand hit to the economy...if folks in D.C. do nothing. And fears are that the upcoming election, were it to produce some sort of legislative/executive branch stalemate, might just result in the economy Thelma and Louise'ing right off that Fiscal Cliff. The dislocation that would result from such an abrupt change would be dire. Consumers would shut their wallets, many of which would be much lighter anyway. Corporations would scale back investment even more as they wait to see the impact of the changes work their way through the economy. Especially considering that they seem to be discounting a resolution before year end, equity markets very likely would be rocked as uncertainty gaps higher and expectations for growth wane.

IT'S THE SPENDING, STUPID!

Even if we fall off the Fiscal Cliff, however, we're still left with an expected deficit of $612 billion in 2013. *That's correct...even all those changes aren't enough to right the U.S. Federal budget.* We'd still be running close to a 4% deficit.

It's sad that, "we have a spending problem," has turned cliché, because it's true. It's impossible to fix our problems by shifts in taxation. Rather, the next president and Congress must reduce spending to cause any meaningful diversion from the course laid out above. Unfortunately, revolutions in this realm seem impossible. Call it the overwhelming inertia of 'my share' politics and the enormous political cost of getting things moving quickly.

And this is the problem with the manner in which equity markets seem to be discounting the medium term. As we've outline above, the nation's debt load is rapidly becoming a structural impediment to long-term growth. We need look no further than Europe to see that when the weight becomes so heavy that austerity is the only solution, the impact of such abrupt shifts is overwhelmingly negative in regard to macroeconomic growth (the cost of capital rises, thereby reducing the incentive for spending and investment), and therefore overwhelmingly negative in regard to the outlook for equity investments. Even more, the worldview on the safety of U.S. fixed income investments might also shift to the negative, a mood clearly seen in the yields now found on sovereign securities for a good portion of Europe. We got a hint of as much when Standard & Poor's saw fit to reduce the credit ratings of the nation's debt.

In sum, the worsening scenario leads to a very ugly environment for investing in a broad swath of U.S.-focused asset classes. Again, we can be prepared for that. We expect there still to be opportunities for sound acceptance of risk for eventual reward, even as we potentially scale down expectations for both measures within our portfolios. Certain exposures might fall out of the favorable investment opportunity set, but that's another reason why we continue to interface with the ETF providers. Having conversations well in advance about the exposures we'd like to see under various scenarios will help to ensure (as much as we can) that those exposures are available when we'd like to include them in the portfolios.

Focus on Entitlements

These challenges we face are real, despite the ease with which they can be dismissed as too far in the future. The solutions must come soon, must be comprehensive and must be fully vetted prior to execution. Any fix likely will prove painful in some way to a large swath of the populace. That's because the primary drivers of the problem are social contracts that are near and dear to many: Social Security, Medicare and Medicaid. But in those three tunnels, alone, there are so many third rails there's no room for the train.

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[3] http://www.cbo.gov/sites/default/files/cbofiles/attachments/FiscalRestraint_0.pdf

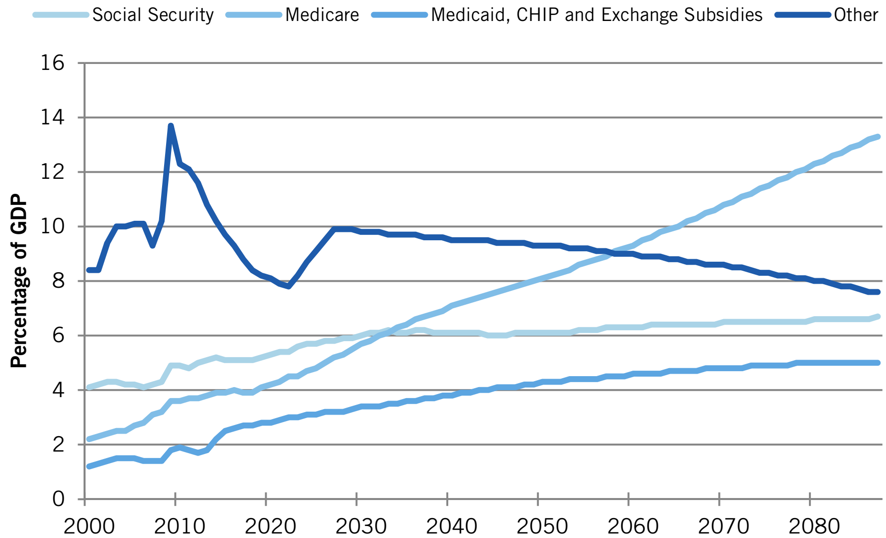
Readers will note how quickly the campaign conversation has turned from the economy and jobs to Medicare. And it's not only because the current President wanted to shift the focus. Republican VP candidate Paul Ryan, arguably, has offered the most frontal attack on entitlements program, but those efforts found quick denunciation as, "right-wing social engineering."

For sure, though, the Big Three social programs are in need of restraint. The magnitude of the expected increase in spending, on Medicare in particular, is breathtaking. The CBO currently is maintaining two estimations for growth in spending. The first, called Extended Baseline, very basically assumes the status quo, Fiscal Cliff and all. The Alternative Fiscal Scenario seems to be the more likely of the two. In CBO's words, "the alternative fiscal scenario incorporated several changes to current law that were widely expected to occur or that would modify some provisions of law that might be difficult to sustain for a long period. Those changes included an extension of the 2001 and 2003 tax cuts (except for rate reductions that applied to high-income taxpayers), broad relief from the alternative minimum tax, and growth in discretionary spending that matched the rate of growth in GDP, among others."

Importantly, the spending side of the equation doesn't differ near as much as the revenue side between the two scenarios, so we've charted the latter, more likely one in Figure 3. We understand any estimate more than 5 years out is pretty much useless, let alone one 75 years out. Unless, of course, we simply mean to understand trajectory. And in this sense, the data are a clear warning signal that the path is unsustainable, with expected *non-interest spending* to top 25% of GDP in 2031 and to exceed 30% of GDP in 2066. Even more than a bit harder to believe that the "Other" category, which includes Defense and everything else, will so nicely proceed on that downtrend.

Again, one should ask why we care about this trend. First, because taxes are not expected to keep up with the spending, the nation's debt level is expected to scale along with, surpassing 100% of GDP by 2024 and 200% of GDP just 14 years later. And as time goes on, the interest on that debt will command an ever growing proportion of Federal spending. Clearly, the nation can't let the scenario come to pass. Revisiting the argument against an expanding debt load, we can add to the caution the thought that at some point the debt becomes intractable, as the rates charged by lenders rise with the risk of the debt burden on the American taxpayer. Meantime, policy efforts might seek to inflate away the debt problem, further exacerbating the interest rate picture. Rates quickly begin to eat away at the expected returns of capital investments, further inhibiting growth. This cycle feeds on itself through to insolvency.

Figure 3: Noninterest Spending and Revenues



From 2000 through 2087. Under CBO's Extended Alternative Fiscal Scenario. SOURCE: Congressional Budget Office

INDIVIDUAL TAXATION

A more certain tax environment should incentivize growth-oriented investment. Ideally, rather than toying with current rates, Washington should seek to simplify the tax code. And, further, we'll contend that lower taxes spur consumption and investment that in turn supports far greater long-term macroeconomic expansion than the equivalent spending by the government. The government is not good at generating growth. Abysmal, actually.

Messrs. Romney and Ryan would like to make permanent the Bush Tax Cuts, which created a new 10% tax bracket, left alone the 15% bracket, and dropped the 28%, 31% 36% and 39.6% brackets to 25%, 28%, 33% and 35%, in that order. They'd also like to eliminate taxes on capital gains and dividends. Under current law, capital gains are taxed at 15% for taxpayers in individual income tax rate brackets above 15% and 0% for the rest. Same for dividends.

The President would leave all but the highest two marginal tax rates alone and reinstate the former two highest levels of 36% and 39.6%. He would like to keep those rates for couples with income below $250,000 that file joint tax returns and for single filers making less than $200,000 (with income levels adjusted for inflation since 2009). For those earning more, the President wants to tax dividends and net short-term capital gains as ordinary income and tax net long-term capital gains at 20%. These changes would add to the 3.8% "Unearned Income Medicare Contribution" tax[4] on high-earners (defined by the same limits as above and applied to interest, dividends, annuities, royalties and rents, excluding income from active participation in S corporations) pressed by The Affordable Care Act.

Here, again, we can expect two impacts from the scenario: increased uncertainty and a shift in expectations for investments. For the time being, at least until the election is decided, uncertainty in regard to taxation is weighting spending and investment. Those potentially being impacted by the increased rates at the high end may well be reducing spending in order to boost reserves in advance of the expected lower take home. Perhaps more weighty is the potential impact of the change in dividend and capital gain taxes. Some might be selling positions with potentially large capital gains in advance of a potential increase. And taxation at ordinary income

[4] http://www.whitehouse.gov/health-care-meeting/proposal/titleix/targeted-healthcare-tax

rates might shift the risk/reward calculations of dividend-paying stocks relative to other investments. Indeed, were President Obama to win another term, we may well see some year-end volatility induced by such flows in advance of changes in next year's tax scenario.

All That Fuss, Still More Debt

We interpret work of the CBO[5] to suggest that the Republican scenario results in a deficit increase of $1.781 trillion over the five years, versus a baseline of no extensions for any of the cuts. Conversely, the President's plan results in a lesser $1.483 trillion increase in deficits. The net of those, $297 billion over five years—we think; so long as we've read the CBO's notes correctly—is the effect of limiting the extension of tax cuts only to those with ordinary income tax rates below the 36% level.

These changes only exacerbate the deficit, with the Obama plan only marginally better by that measure, albeit a win driven by a tack we dislike. Again, alterations to the tax code are likely to prove insufficient in addressing our growing debt problem; current proposals only add to it. Meanwhile, indecision on rates and applicability will only lift the risk of and therefore push into the future or otherwise limit investments. Given the resulting detriment to long-term growth, these shifts further obscure prospective views for investment environment, prompting a continued emphasis on risk aversion, income and safety.

CAREFUL WHAT WE WISH FOR

For now, everyone is focusing on the likelihood and characteristics of various scenarios of impending doom and discussing—mostly in the very general terms they've been offered—the plans the two candidates have devised to avoid them. There have been some proposals, however, that deserve special light; some remedies that could well worsen the problem.

Municipal Bond Interest

The President has proposed in his latest budget the capping of exempt municipal bond interest (and all itemized deduction and other tax preferences for families with incomes over $250,000) at 28%[6], meaning any interest above that level is taxed up to the investor's tax rate. Others have suggested the potential complete elimination of the Federal tax-free status of municipal bond income.

According to the Joint Committee on Taxation (JCT, a Congressional committee)[7], the annual volume of new tax-exempt bond issuance by state and local governments was $340 billion from 2001 through 2010, with an additional $60 billion in annual issuance of tax-exempt notes. At the end of 2011, the total value of tax-exempt state- and local-government debt outstanding was $3.0 trillion. The JCT calculated that, for 2007, the total value of tax-exempt interest reported on tax returns was $78.8 billion for individuals and $34.9 billion for corporations.

We can debate the merits of subsidizing the debt loads of municipal America. Of course, we could have the same debate about the debt of Federal America. But such debates are better left to other eras of relative solvency. Critically, that the income from these bonds is tax exempt has the effect of lowering the yields municipalities must offer to raise the debt. In an age of overwhelmingly tense local-government budget trends, any near-term shift upward in funding costs could prove immensely deleterious to local solvency. Yields on new debt would jump. Too, yields on old debt would jump as markets adjusted to reflect the revised post-tax math of the

[5] http://cbo.gov/publication/43547
[6] *Cutting Waste, Reducing the Deficit, and Asking All to Pay Their Fair Share*, http://www.whitehouse.gov/sites/default/files/omb/budget/fy2013/assets/cutting.pdf
[7] *The Federal Revenue Effects of Tax-Exempt and Direct-Pay Tax Credit Bond Provisions*, https://www.jct.gov/publications.html?func=startdown&id=4469

ownership of formerly tax-exempt bonds. Local taxes could (would) rise as a result, with knock-on effects of less money in consumer and corporate pockets.

Such a change, not telegraphed with sufficient advance, will almost certainly constrain growth.

Mortgage Interest

In a vein similar to that of the tax exemption for municipal bond income, those on both sides of the aisle looking to right the budget have mentioned a reduction in the deductibility of mortgage interest as a potential source of new revenue. It remains a potential target for the President's budget (but only as part of the 28% cap on deductibility). The Republicans, while avoiding any absolute language, have just recently included in their platform a note that suggests, barring comprehensive tax reform, they will preserve the ability to deduct mortgage interest.

We'd have to think it's not a terribly bad idea to jettison the mortgage interest deduction, so long as the shift is made up for by lower marginal tax rates in order to simplify the code (part of a comprehensive reform). At least at some point in the future. Would have made for a great and timely shift back in 2006. But closing that loophole will almost assuredly suck any life that now exists (barely registering...) right out of the housing market, a cornerstone of the American economy. Like the tax exemption for municipal bonds, the mortgage interest deduction reduces the effective interest rate on mortgage debt. Changing that math also changes the inherent value of the investment, thereby altering investment trends. Would houses still sell? Likely, but for less, perhaps, as the pile of dough available for purchases effectively shrinks. In the meantime, we'd have to expect fewer purchases as folks adjust their home economy spreadsheets. On the flip side, the lack of the deduction at some marginal point reduces the affordability of many homes, leaving the owner to put the home on the market or into distress.

Good policy? Perhaps. Bad timing? Almost certainly. With the consumer class a large driver of domestic growth, the uncertainty an impending shift in the policy—let alone an actual change—will restrain home budgets through this year and next unless concrete proposals suggest otherwise. And that lack of confidence crimps growth.

BRACING OURSELVES

We initiated this commentary, actually, many months back. The thinking was that we'd find greater emphasis on new policy as the summer progressed. Unfortunately, the President is sticking to his existing plans, likely knowing full well many components of them are non-starters in Congress. Meantime, with the nomination in hand, Mr. Romney continues his full-court press on taxes, but has offered few specifics in terms of his intentions in regard to spending. His partner Mr. Ryan offered some specifics, and got the quick smack down from party elites. Turns out *specific* spending cuts aren't to be the focus of the campaign season.

Perhaps they will find greater emphasis over the coming months. Not likely for the candidates' bringing them up, but for the louder voices demanding the President to express a stronger will to address national solvency in a more direct, comprehensive and expedient fashion and expecting Mr. Romney to be more explicit in his plans to do the same.

Whether sooner or later, Washington must address the tethered issues of spending and debt. So long as each ticket would follow through on its word, we can take the medicine in the form of a hit to the economy over the short and medium term via the more austere approach of the Romney/Ryan team, or we can plunge ourselves further into the abyss via the misguided policies of big-government Democrats.

Either way, we maintain that investor uncertainty and market volatility will remain elevated—likely even increase—over the next year as we first resolve the election and then experience the winner's follow through. Higher uncertainty means lower equity valuations, which in turn means we're likely to continue to see our portfolios maintain the sort of stance they have over the past two years.

A cautionary note, however: we greatly fear another four years of Obama presidency. The source of that fear is the understanding that the policies of this President have not been based on sound macroeconomic theory or policy. Misguided and ultimately failed fiscal policy has been compounded by confused and confusing monetary policy to bring the nation close to structural breaking point. We'd have to think we'd see more of the same—or worse—were the election to turn out in his favor.

ENVIRONMENT AND POSITIONING

We'd be remiss if we did not acknowledge the run experienced in many equity markets over the past 13 weeks. Not that we're sad about it or anything. There's a discipline that's imperative, in our view, for navigating these markets, one particularly relevant when risk-runs can leave a risk-relative focus lagging expectations.

Notably, we were only lightly participating in the upward equity trend—via the 10% position in the Energy space within the Sector Rotation portfolio and via the 5% allocation to the Russian equity market within the Country Rotation portfolio. But while we might have been 'missing out' on the equity markets, we were partaking in a far smoother ride in our fixed income portfolio.

And as the exuberant pace of equity gains trails off, we continue to be confident in our portfolio's positioning. Outside of the many fiscal and political pressures confronting the U.S., we remain in a world chock full of risk. The have-nots in Europe are increasing their demands for aid, while seeking to decrease the weight of austerity. On the opposite end of the table, the haves continue to hold firm in their stance that no further support can come without greater integration. The back/forth of it all reminds us that the solution is one made not of weekend summits, but of months and years of government and policy restructuring.

Still not so present in the minds of equity investors, it would seem, are the growing risk of tumult in the Middle East. Lacking leadership from the United States (another thread in favor of the Romney ticket) the region has been left to work a path toward eventual confrontation. Any such flare-up will prove detrimental to most equity investments, though we might expect our current equity positions to see some benefit as the energy markets price in less supply and more risk.

One can almost never be sure of the drivers of most multi-day market moves, but it certainly would seem the risk-on folks are gassing up for another round of Fed intervention. What'll be left in the tank by the time Mr. Bernanke actually chooses to do something is even harder to forecast. One can bet, though, that the equity markets already have priced in whatever net positive they believe can come from a QE3. We think there's a 'nothing' to 'less-than-nothing' to be generated from that work...but we tend to think those in the risk-on camp aren't of the same perspective.

So be it. Our view—very much supported and confirmed by our quantitative framework—is that the global risk environment, against a backdrop of ongoing and often rising pressures on the fundamental front, continues to warrant defensive positioning. We remain well vigilant of any opportunities that may arise, seeing few even moderately enticing today, and...not holding our breaths...look forward to the day when our review of the world supports broader exposure to the equity markets. Indeed, as tactical managers we're rather excited about the potential investment opportunities that the global capital markets might offer as a result of the whimsical policy decisions of our elected and appointed public servants.

IMPORTANT INFORMATION

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Diversification does not protect against loss in declining markets.

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

AFAM | Innealta Capital
12117 FM 2244 #170
Austin, TX 78738
P: 512.354.7041 F: 512.402.1014