Innealta
CAPITAL

COMMENTARY: OCTOBER 2, 2013

THE FALLACY OF ADDRESSING STRUCTURAL ISSUES THROUGH MONETARY SOLUTIONS

In this edition of our monthly commentary, we discuss the current U.S. economic environment by examining important macroeconomic variables and their recent trends. We place particular emphasis on the unemployment rate, which of course has received much attention in recent press. While examining the components of the unemployment rate and its underpinnings, we discuss the importance of the employment report and discuss the impact of employment on other macroeconomic variables.

The level of (un)employment is important, since earning income is required for supporting one's existence and enables the purchase of basic necessities such as food, shelter and clothing. Additionally, discretionary spending on goods and services increases one's standard of living beyond mere survival. Clearly, the ability to earn a wage is necessary for consumption spending, and, as we will illustrate later, consumer spending is an important driver of economic output. Overall, the (un)employment report gives insight to health of the economy, as employment opportunities and economic prosperity correlate positively. Further, there exist many social costs when there are fewer employment opportunities. These include increased burdens place on social programs, externalities such as crime, and lower-than-projected tax revenues, which further exacerbate economic problems by increasing government fiscal deficits.

The unemployment rate is influenced by methodological assumptions.

In the most basic sense, the unemployment rate is the fraction of the labor force that has not matched with a job. There are several possible reasons a worker may be unemployed. These include a lack of jobs to match that worker's skills, workers who voluntarily separate to pursue other employment opportunities and workers searching for work. The typical job search involves significant search costs, resulting in some positive steady-state level of unemployment, referred to as the "natural rate of unemployment."

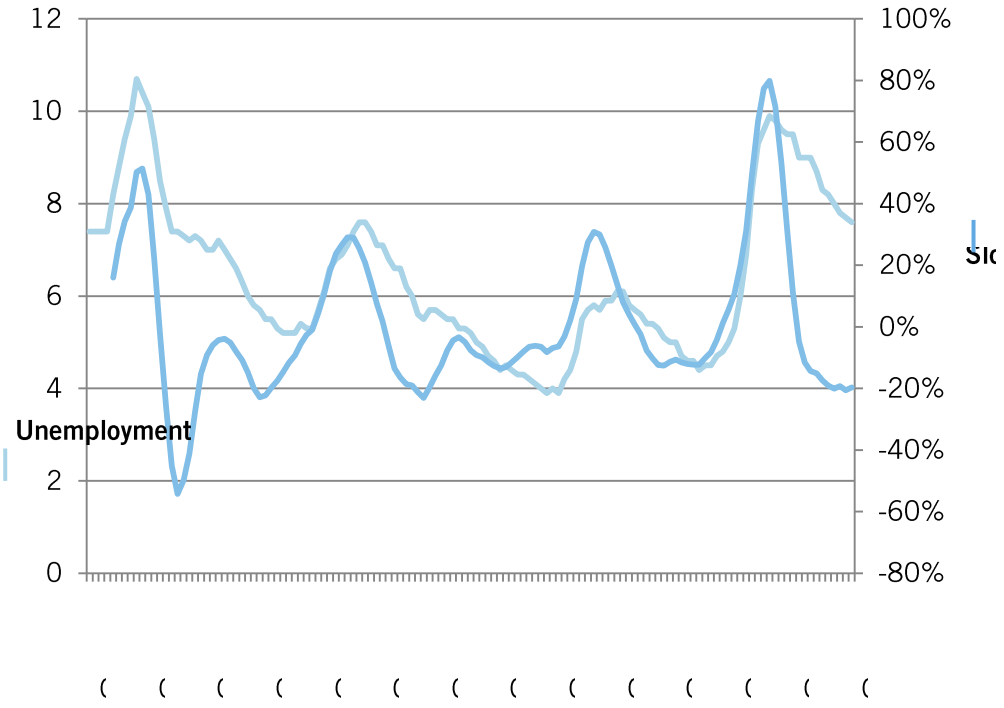
The domestic population roughly divides into those both able to work and eligible for employment, and those who are not. The latter consists of children, retirees and the disabled. The former consists of those actively working, actively searching for work or out of work and not looking for work. How to delineate between the last two categories is important, as is the decision to categorize among the unemployed those workers fit for employment that are not actively searching for employment.

The Bureau of Labor Statistics conducts monthly surveys to construct statistics describing the labor market condition. The survey methodology has important implications for the reported outcome. Additionally, the BLS has made recent changes to the survey methodologies that in some cases result in discontinuities in reported statistics. While we save a discussion of the methodologies for another forum, here we simply mention the complication and that we carefully monitor changes to the survey methodologies when interpreting the reported statistics. Traditionally, the financial press and economists focus on "headline unemployment," which is the fraction of the labor force out of work for 15 or more weeks. In this case, the measure considers only the unemployed workers actively seeking employment and does not distinguish between part-time and full-time work. There are additional considerations that are not captured by the headline number, such as the length of unemployment (longer searches are obviously more costly), geographic dispersion and variation across sectors.

Exhibit 1 presents the reported headline unemployment rate. The cyclical nature of unemployment is immediately clear upon visual inspection. There are four notable peaks in the unemployment rate: Q4 1982, Q2 1992, Q2 2003, and Q4 2009. It is interesting to note that, although the unemployment rate has declined meaningfully since its peak in 2009, the current levels remain above the previous peaks in 1992 and 2003, consistent with the view that the unemployment rate remains high when measured against those seen in the past few decades.

Additionally, the figure presents the rate of change in the unemployment rate, or the trend based on the last two years of data. Focusing on the recent experience, it is of interest to note that the rate of change in the unemployment rate has held steady over the past couple of years, despite significant accommodative monetary efforts. When we consider the second moment of the series (not presented), the line is in the early stages of showing a reversal, which means the rate at which unemployment decreases is slowing. This is an early indicator that the decreases in the unemployment rate will likely taper going forward.

Exhibit 1: Unemployment Rate and Its Rate of Change



SOURCE: Innealta Capital using data from U.S. Bureau of Labor Statistics

At this point, some caution is warranted, since the classification of labor market participants influences the measured size of the labor force. We next re-consider what it means to be "employed" since there are likely different types of employment and workers may be employed part time or may be under-employed, meaning they are in a job for which they are over-qualified and thus presumably earning a lower income than typical for their skill sets. Under-employment has negative economic consequences identical to those of unemployment. In cases where workers are unable to find full-time employment, they may accept part-time employment to make ends meet while they continue to search for full-time arrangements.

The employed versus unemployed: is there a binary distinction?

What about the under-employed? This distinction includes part-time workers who likely prefer full-time employment were they able to find it, as well as workers who have capitulated and taken jobs for which they are overqualified. In both cases, the worker counts as employed for the purpose of headline unemployment, but this type of employment does not have the same economic meaning as if these workers were employed full time with earnings matching their full earning power. The under-employed will have less income to spend, which means their impacts on consumption spending (a GDP driver) as well as tax revenues are muted.

When individuals cease to actively look for work, they are removed from the computation of headline employment. For example, an individual may return to school to pursue additional training, planning to re-enter the workforce better skilled and hopefully under more favorable labor market conditions. Other workers simply may become discouraged and give up after a prolonged and futile search. The impact of these workers' departures from the labor force is a spurious reduction in the unemployment rate, since they are no longer included in the labor force. Unfortunately, the reasons for their departures from the labor market do not reflect labor market strength, despite the reduction in the unemployment rate resulting from their terminated search.

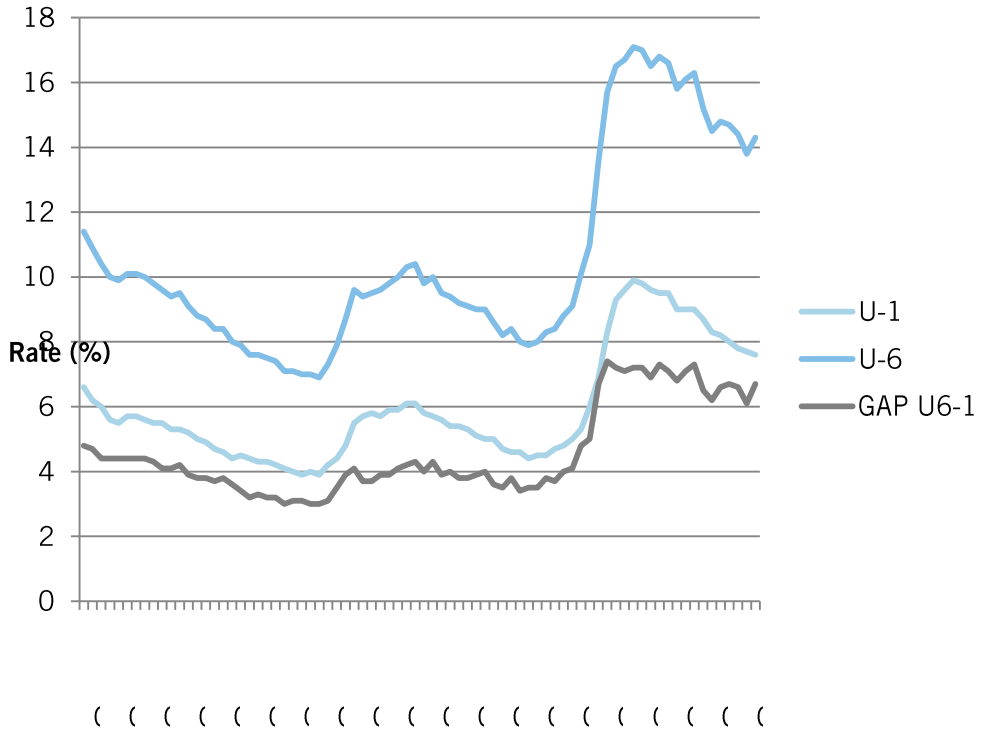
Thus, a more accurate depiction of the labor market would include workers who have become permanently unemployed or who have stopped searching for labor-market related reasons.

For this purpose, it is useful to add to the pool of eligible workers "marginally attached" workers, such as those who have left the labor force due to a job-market-related reason. This group includes "discouraged workers" that would return to the labor force if there were the hope of finding a job in the future. It is useful to include part-time workers who would prefer full-time employment to their part-time engagement if such an opportunity arose. Frequently referred to as U-6, this measure of unemployment more accurately captures the true state of the labor market.

Exhibit 2 presents the headline employment rate (blue) and the U-6 measure, which includes marginally attached workers, those employed part-time for economic reasons (part-time job better than no job), as well as the unemployed. The picture is much grimmer, as one in six U.S. workers falls into the definition of unemployed or marginally attached.

It is important to note that the gap between the two definitions of employment experienced a shock in the mid-2000s, which is reflective of a structural shift, as opposed to a transitive economic condition. Of note, despite small declines in both rates, the fraction of the work force falling into the marginally attached or under-employed remains fixed, despite tremendous monetary efforts by the Federal Reserve. As we will argue below, this persistence results from structural issues in the labor market and cannot be affected by monetary policy.

Exhibit 2: The Unemployed and Under-employed



SOURCE: Innealta Capital using data from U.S. Bureau of Labor Statistics

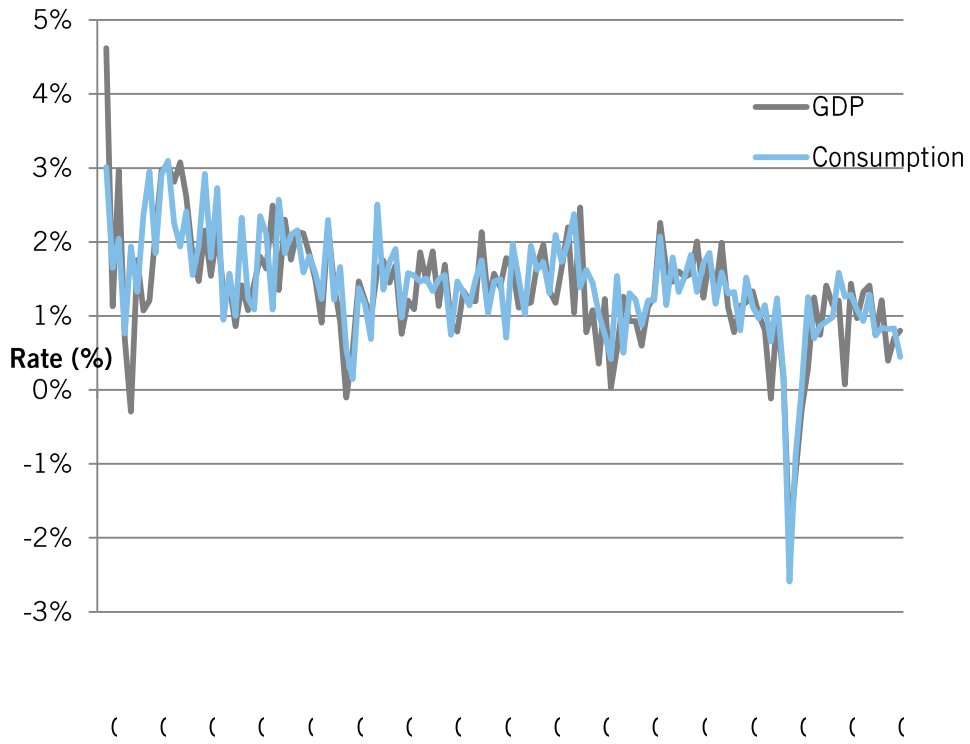
Illustrating the importance of consumption

In the United States, personal consumption expenditures account for 69% of annual gross domestic product. The influence of personal consumption on GDP has increased significantly since 1980, when it comprised about

60% of GDP. Clearly, the labor market is an important driver of consumption growth, which in turn has a large influence on economic growth. A healthy labor market corresponds to higher incomes, which may be used for consumption and investment.

To reinforce our assessment of the domestic labor market, we present annualized growth rates in U.S. domestic production and consumption expenditures. Exhibit 3 presents the annual growth rates for each series. The series are highly correlated, which is not surprising since consumption growth is a large component of GDP. Visual inspection shows that the growth rates of both series are well below average levels of the previous three decades. Additionally there appear to be downward trends in both growth rates, despite claims from the press and politicians of a robust recovery underway. Importantly, the clear downward trend in personal consumption growth is inconsistent with the belief that labor market conditions are improving. In fact, it is consistent with the view that U.S. workers continue to suffer from long-term, structural labor market problems that restrict their incomes and curtail consumption spending. Thus, monetary policy is ineffective at ameliorating this type of unemployment.

Exhibit 3: GDP and Personal Consumption Growth Rates.



SOURCE: Innealta Capital using data from U.S. Bureau of Economic Analysis

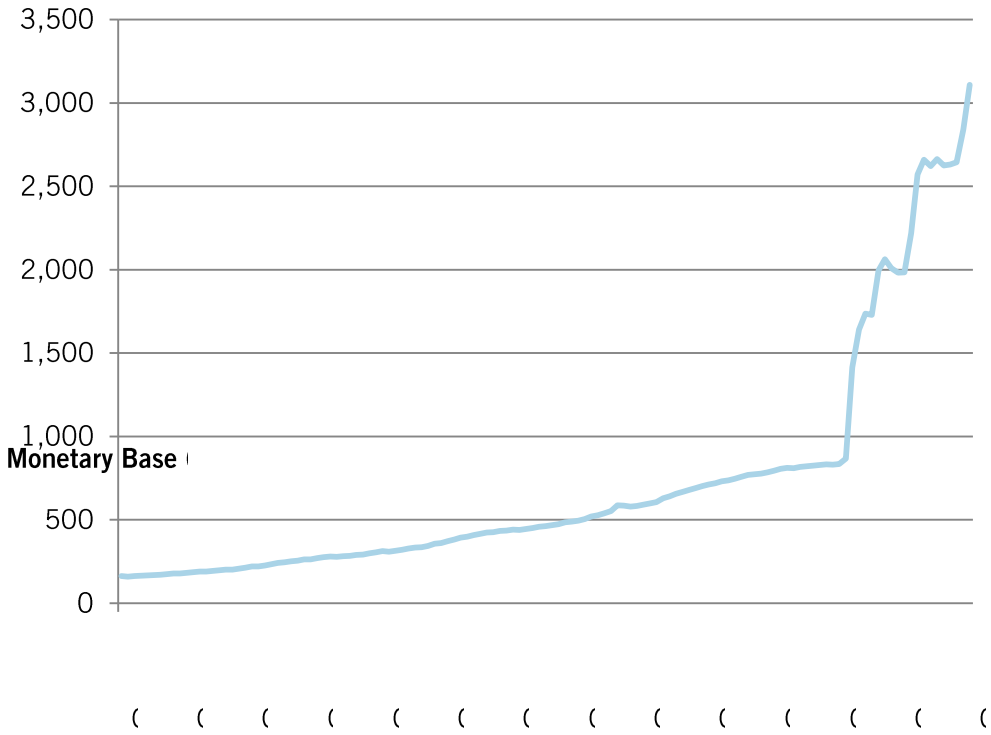
Policies and their impact on the labor market

The Federal Reserve's dual mandate charges the central bank with pursuing monetary policies that are sufficiently accommodative for the economy to add jobs, but yet are sufficiently conservative in that the monetary base does not expand at a pace that produces rampant inflation. The Fed must strike some balance between these two diametrically opposed mandates. However, monetary efforts to encourage employment result in upward pressure on wages, which contributes to inflation. For these reasons, policies designed to encourage employment but not result in rampant inflation must strike a balance between these two objectives.

The tools available to the Federal Reserve to influence the U.S. labor market are limited to those that impact the monetary base. Since the onset of the Great Recession, the Fed has gone to great measures to use the tools available to them in efforts to reduce the unemployment rate. The U.S. labor market, however, suffers from undeniable structural problems that are beyond the scope of the Federal Reserve's powers to correct. Before we discuss the structural issues, let's take a look at the monetary base to get a visual picture of the tremendous accommodative efforts of the Fed.

It is clear from Exhibit 4 that the Federal Reserve has expanded the money supply considerably over the last decade through accommodative policies targeted towards reducing the unemployment rate. As we have seen in Exhibit 2, unfortunately there is marginal, at best, evidence of the success of such policies.

Exhibit 4: Growth of U.S. Monetary Base



SOURCE: Innealta Capital using data from U.S. Federal Reserve

If not the money supply, from what does the labor market suffer?

First, economies have become increasingly integrated globally. As capital and resources move across borders with increased efficiency, the entry to the global work force of billions of workers in emerging market economies have reduced the real wage for many jobs. The legislated minimum wage in the U.S. is far above the global real wage, making it unsurprising that for many jobs, U.S. workers are not competitive globally (they are too expensive even at minimum wage). The decision to further increase the minimum wage, although likely well intentioned towards improving the standard of living for many low-income workers, almost surely will result in further job losses and economic hardship. Add to the picture labor unions, and it is not hard to see how these structural impediments will lead to a continuing weak labor market for the U.S. worker. Sadly, today's policies amount to anachronisms, appropriate for times past, but not appropriate for the current environment.

Additionally, legislation such as ObamaCare and the poorly crafted Dodd-Frank Act, adds significant costs to employers for full-time employees. Not surprisingly, faced with a slack labor market, many employers have chosen to hire multiple part-time employees for few enough weekly hours to avoid providing health care benefits. In fact, the average hours worked per week have declined from 35.3 to 33.7 in recent years. This decline is consistent with increased reliance upon part-time workers and is consistent with the view that many of the new jobs created since the recession are inferior to those lost during the Great Recession.

Apart from arguing for protectionist tariffs on imported goods, potentially productive avenues for policy would focus on education and retraining of workers. Our legislative and executive leadership, however, are firmly divided along partisan lines and largely serve only their special interests, making comprehensive and effective education reform impossible. With such political quagmire, the economy seems doomed to continue on its current path, which does not present an optimistic forecast for macroeconomic growth in the interim. It is important to note that this outlook is in stark contrast to the view that the U.S. consumer will continue to purchase imported goods, thereby rescuing the balance of the global economy and aid in maintaining aggregate growth levels. Such an outlook is simply fiction, as the U.S. consumers' situation gives no indication of their ability to support either domestic or global growth.

CONCLUSIONS

We are often challenged for our view that domestic equity markets are distorted and have become dislocated from the underlying fundamentals. Thus, this month we return to basics by revisiting macroeconomic variables, focusing our discussion on those variables that most directly reflect the health of the labor market and the corresponding impact of the labor market on the macro economy. What emerges is the picture of a slack labor market struggling to create full-time jobs, despite large accommodative monetary stimulus efforts.

Ultimately, equity markets must reflect the health of the overall economy, which is to say there cannot be sustainable earnings growth (driven from top-line sales growth, as opposed to cost-cutting) without private sector jobs to support consumption growth. Consistent with this view, and despite decreases in headline unemployment, personal consumption expenditures continue to grow at paltry and decreasing rates—levels that are in fact comparable to historical low points in consumer growth. Against this dire backdrop, one truly wonders how the U.S. consumer can be expected to fuel global growth, particularly among export-oriented economies dependent heavily on Western consumption. The picture is equally or more dire in Western Europe, consistent with our very cautious and skeptical views on global growth.

CURRENT STATE OF OUR SOLUTIONS–MONTHLY UPDATE

As the early days of October saw the government partially shut down upon legislative impasse and heightened potential for even greater tension over the nation's debt limit, the Investment Committee remained focused on its assessments of the firm's quantitative framework and the broader global macroeconomic landscape. The team's regional reviews and portfolio positioning follow.

United States

Equity markets have risen further over September, in no small part due to the Fed's decision to further postpone the tapering of monetary stimulus. A decision to taper, at the earliest, now can be made at the next Fed meeting in October. The Fed's decision not to taper is partially a reflection of the significant problems that remain in the real economy and partially due to the fact that the macro-economy—not just in the U.S. but the global economy—has become addicted to ever-greater stimuli, a situation that is clearly unsustainable.

Given current conditions, it is ironic to see equity markets maintain such strength. Given that stock prices are equal to the present value of future cash flows that equity investors receive, this increase has to mean that either the discount rate has changed or that investors are bullish about companies' earnings (that can be used to sustain larger cash flows), which would mean that a strong economic recovery is in sight. This is in stark contrast with the Fed's own bleak outlook on the U.S. economy, which has prevented it from tapering monetary policy stimuli. If the Fed is correct, then that means that stock prices are too high—a fact that we have been arguing for quite some time. At some point these obvious discrepancies have to be reconciled. The fact is that the U.S. economy continues to be sluggish and unemployment remains elevated.

In our opinion, the further we go along the slippery slope of widening monetary stimuli, having already reached enormous proportions, the steeper the fall in asset prices is going to be in the future. The situation is becoming more and more fragile but the enormous risk inherent in these policies has largely remained below the surface, with risk levels in the market (as measured by the volatility index (VIX), for example) at record-low levels. It seems as though as long as the music is playing, everybody is dancing, but once it stops everyone might be heading for the exits at the same time! However, a number of the more knowledgeable market participants are beginning to realize that we have reached dangerous territory. Equity and fixed income valuations are almost entirely driven by U.S. monetary policy now rather than by the real economy. An enormous asset price bubble has developed that is not rooted in fundamentals.

We believe that we have a duty to protect our investors from such follies as they occasionally occur in financial markets. Even if our portfolios temporarily may suffer on a relative return basis, we strongly believe that our approach is in the best interest for our investors over the longer term.

Europe

Europe will gradually be getting back to its real problems, namely the Eurozone debt crisis, within the coming weeks and months. The German election is over and, predictably, the current government will remain in power (although in a new coalition). Chancellor Merkel has received a strong vote of confidence in the election, but she will need either the Social Democrats (the main opposition party) or one or more of the smaller parties as a coalition partner. Coalition talks have now begun and may carry on for another couple of weeks, which will further delay any significant new decisions on Europe.

We hope that the German government, as the main creditor within the Eurozone, will feel confident enough to attach tough conditions to future bailout packages provided to weaker Eurozone nations. As we have argued in the past, only a return to financial sanity—as painful as that may be in the short run—will enable the Eurozone to get back on its feet, rather than continuous postponement of more radical measures. However, we remain concerned that potential coalition partners, who tend to have a softer stance than Merkel herself on the Eurozone crisis, will partially force their preferred policies on her. The outcome remains to be seen. One thing is for sure, though: market volatility is bound to increase as these challenges come to the surface.

Either way, one issue seems to be clear, namely the fact that painful decisions will need to be made soon in the Eurozone, which will create investment opportunities going forward. Currently, financial markets in Europe are still in a wait-and-see mode. However, everyone knows that Greece and several other countries will need substantially more bailout funds to prevent them from collapse. All of these issues will result in investment opportunities in the future, if not in the immediate term.

Asia-Pacific

Almost straight across the board, our quantitative framework views equity markets in this region slightly unfavorably to neutral. However, at the same time, we are more positive about this region than most others,

particularly the U.S. and Europe. Even so, we need to caution somewhat as our relative optimism for Asia is a bit like the one-eyed man being king among the blind! Plenty of risks remain to global growth and risk appetites. As many of the economies in this region are heavily reliant on exports rather than domestic consumption, they are particularly influenced by global macroeconomic issues such as the health of the U.S. economy, incomes and wealth of U.S. and other western consumers, and lack of coherent fiscal policies and monetary policies.

The fact that economies within this region are heavily influenced by changes in U.S. monetary policy was made abundantly clear during this past June. Talk of tapering monthly bond buying resulted in strong capital outflows harmful to many of these countries that have benefited from foreign capital available in response to loose monetary policy across the developed world, namely the U.S. Fed, the Bank of Japan, and the European Central Bank.

Speaking more specifically of Japan, the Bank of Japan has voted unanimously to stay the monetary policy course aimed at boosting the monetary base by ¥60-70 trillion annually. Policymakers noted that "Japan's economy is recovering moderately," which seems to be an improvement from their previous statement a month earlier that the economy was "starting to recover." Much focus now remains on whether a sales tax hike (designed to help shore up the country's public debt) will constitute significant headwind and derail the recovery. Most importantly, policymakers express concern over the ability to bring debt levels back to more sustainable levels. We expect an increase in the market volatility in Japan.

Turning to China, we recently have seen some positive surprises in the generally dubious economic data. Significant problems remain, however, that in our opinion aren't adequately priced in at current equity market valuation levels. Domestic inflation has been on the increase, reflected in wage increases (14%) and property price increases that have outpaced economic growth. This development is likely to leave policy makers with few choices but to revisit policies aimed at curbing price increases at the expense of growth. Moreover, weak domestic consumption leaves China heavily dependent on exports, which can be problematic in a world economy that is still relatively weak and fragile.

We have substantially benefited from the recent strength of Hong Kong equities, given our investment in that market within the Country Rotation Portfolio. Our quantitative framework continues to view Hong Kong in a favorable light, despite elevated equity valuation levels. Hong Kong enjoys the benefit of a U.S. dollar peg, as well as close economic ties and geographic proximity to mainland China. Moreover, it continues to have a favorable business environment.

India has been adversely impacted by capital flows out of emerging markets, in addition to high inflation and low growth. Industrial output growth has been higher than expected in July (2.6% vs. -1.8% in June). While this is a positive development, India's economic advisory panel cut growth estimates to 5.3% from 6.4%. It remains to be seen how India's new central bank chair Ragu Rajan will prioritize fighting inflation and accommodating growth.

Australia continues to see a slowdown in its important mining and natural resources sectors. The Australian central bank has held the short-term interest rate constant at 2.5%. Since the country's election, equities have benefited from the fact that a six-year Labor Party leadership has come to an end after overseeing monotonic increases in government spending. The stated priorities of the new government include reversing the tide of increased government spending, infrastructure investments, immigration reform and tax incentives to both the mining and manufacturing industries.

Latin America

We currently are invested in the equity market of Peru. Since our initial investment in June this year, that market has moved sideways. In a world of equity market overvaluation, Peru remains a rare case of more realistic valuation levels and we therefore remain confident that our investment expectations will materialize in this country. We are also moderately positive about Brazil. If an equity market correction in Brazil of at least around 10% were to materialize, we would consider making an investment. Despite Brazil's main problems, namely slow economic growth and inflationary pressure, equity valuation levels in Brazil are relatively realistic and may present an opportunity were they to compress further. In the medium to longer term, the Brazilian economy is likely to benefit from the soccer World Cup next year and from the Olympic Games in 2016 as infrastructure development and other investments have yet to be made by the government.

SUMMARY

As market valuations continue to be almost entirely driven by monetary policy decisions, rather by the real economy in the U.S. and Europe, we believe that significant market corrections are needed to make these two regions attractive again. Asia Pacific and Latin America continue to look relatively more attractive. However, even in these markets, a price correction would be required before we would view them as immediate investment opportunities. Moreover, we expect a further depreciation in the U.S. dollar against other major currencies due to the continued extremely loose monetary policy.

On the geopolitical front, immediate concerns over a war in Syria temporarily have dissipated, as our politicians seem to believe they have found a way forward that could prevent a military conflict in the region and that, perhaps most importantly to them, may allow them save face on their previous rhetoric. Whether this is going to lead to a long-term solution to the problem remains highly doubtful nonetheless.

Given our economic and geopolitical concerns we continue to increase our allocation to short-duration fixed income securities and to equity positions only on a very selective basis. After a very quiet summer we foresee significant negative developments in the world economy over the fall and early winter—particularly in the U.S. and in Europe—which we expect to result in more attractive equity valuations.

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.

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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.

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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.

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