



## MACROECONOMIC INDICATORS: AN INTERNATIONAL PERSPECTIVE

Our recent commentaries have focused on the U.S. macroeconomic landscape, highlighting important trends in variables that are reasonable gauges of the health of the U.S. economy. We have focused on the link between those variables and domestic equity market environments. This month, we extend that survey internationally, focusing on the macroeconomic landscape across many of the economies that we consider in our quantitative framework.

Here, we focus on the reasons why these macroeconomic variables are important barometers of the economy's health. Throughout, we compare and contrast trends internationally, taking such opportunities to comment on and reinforce the Investment Committee's views on potential beta exposures in the context of our quantitative framework.

One important dimension to consider when analyzing macroeconomic variables internationally, particularly those compiled through the use of surveys, is that methodologies vary across countries. This aspect of the work is important, since the methodologies used can influence the computed values, and thus influence judgments made through analysis of those values. These differences are unavoidable realities faced by researchers when evaluating the international landscape. We take great care to account for such differences to avoid drawing incorrect comparisons that may be influenced by the data collection methodology. In some cases, the desired data may not be available for a particular country. For example, important employment variables in Brazil, such as the number of employed people, come from a survey of five cities, which is not representative of the overall population. In our quantitative framework, we take great care to consider differences in the methodologies used to construct economic series in each country we model and to account for the impact of such differences in our analysis.

## UNEMPLOYMENT

We begin with the unemployment rate. The level of (un)employment is important since income is required for 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 work is necessary for consumption spending, and, as we have illustrated in past commentaries, consumer spending is an important driver of organic economic growth. Overall, the (un)employment report provides insight to the health of the economy. Not surprisingly, employment opportunities and economic prosperity correlate positively. Further, there exist many social costs when there are fewer employment opportunities. These include increased burdens placed on social programs, externalities such as crime and lower-than-projected tax revenues.

Exhibit 1 presents historical unemployment rates across many of the countries the Investment Committee monitors as potential investment allocations. One initial reaction to the table is that the number of country-specific exposures available through ETFs has increased dramatically and presents exciting investment opportunities. Even more exciting is that providers continue to expand the product space, and we continue to monitor new offerings for additions to our investment opportunity set.

The exhibit presents unemployment rates every five years from 1990 to 2010, as well as the most recent available rate for each country. In the final two columns, the table presents the absolute changes in the unemployment rate from 2005 to 2010, as well as since 2010. Given the rate of job losses during the financial crisis, many countries suffered increases in the unemployment rate from 2005 to 2010. Note that in certain cases, historical data are not available during the entire time period. Those cases are denoted as "NA."

Several important patterns emerge from analyzing the exhibit. First, the unemployment rate varies regionally. In general, countries in the Asia & Pacific region have, by comparison, low and fairly stable unemployment rates. For example, South Korea's unemployment rate has fallen from 4.8% in 2000 to 3.1%, and did not exhibit a volatile spike during the financial crisis, as did the unemployment rate in many other countries. Additionally, Australia's unemployment rate has exhibited a secular decline over this time period. Much of this decline is driven by the country's geographic proximity to China, and that their mining and natural resources sectors have benefited tremendously from demand growth in China. These factors partly explain our more positive outlook on Asian equity markets.

In Western Europe, many countries have high current unemployment rates, such as France (10%), Greece (27%), Italy (12%) and Spain (27%). Given these rates, and these countries' significance to the Eurozone economy, it is not surprising that our framework is quite bearish on most beta exposures across this region. High levels of unemployment, as we see in many countries across Western Europe, mean incomes and consumption will remain depressed. Additionally, many people will be forced to continue to rely on social

programs assisting the unemployed. Thus, these economies clearly continue to suffer from falling incomes and spending, as well as increased social costs.

Referring to the last two columns of Exhibit 1, where we present the absolute changes in the unemployment rate around the financial crisis, it is alarming to see that among the Western European countries that have very high unemployment rates, the unemployment level is increasing. Although most countries experienced job losses around the Financial Crisis, the fates of Western European economies have largely diverged since then. Among one set of countries, including Sweden and the U.K., job losses began to level off by 2010 and unemployment has declined subsequently. On the contrary, there is another group of countries, including France, Greece, Italy and Spain, where the upward trend in the unemployment rate cries out as a very bearish indicator for the monetary union. This trend is consistent with the assessment of our quantitative framework and bolsters the conclusion that underlying support for valuations in this region is absent.

Many of the European economies that are not part of the monetary union, such as Switzerland, Norway, Denmark and the U.K., have much lower current levels of unemployment. Their economies have remained relatively strong, compared to the southern periphery economies. Many of these economies have shown surprising resilience, but given their proximity and economic interdependence, one must wonder for how long they will be able to side-step the problems in which the neighboring economies are mired.

Many of the emerging market economies of Eastern Europe and Central and South America exhibit higher rates of unemployment. In the case of Eastern Europe, the high unemployment rates seen historically stem from the economic restructuring necessary as these countries emerged from their former Communist rule. Across many of these countries, such as Poland and Russia, the unemployment rates have declined dramatically over this time period. This pattern is consistent with the general assessment of our quantitative investment framework, as we have in the past exposed the portfolios to beta exposures in this region.

**Exhibit 1: Unemployment Rates (%) By Country**

Region/ Country	1990	1995	2000	2005	2010	Current	Crisis Relative to 2005	Change From Crisis Level
<b>Asia &amp; Pacific</b>								
Australia	7.6	9.5	7	5.6	5.8	5.6	0.2	-0.2
China	NA	NA	NA	4.2	4.2	4	0	-0.2
Hong Kong	1.2	2.4	5.8	6.2	4.7	3.3	-1.5	-1.4
Indonesia	2.5	7.2	6.1	11.2	7.1	5.9	-4.1	-1.2
Japan	2.1	3	4.8	4.5	5	4	0.5	-1.1
South Korea	NA	NA	4.8	3.8	4.3	3.1	0.5	-1.2
Taiwan	1.7	1.7	2.9	4.2	5.7	4.2	1.5	-1.5
<b>Western Europe</b>								
Austria	6	7.8	7.7	8.7	8.3	6.8	-0.4	-1.5
Belgium	6.4	9.7	7.3	8.3	8.3	8.8	0	0.5
Denmark	9.9	11.1	5.3	5.4	4.4	4.4	-1	0
France	7.9	10.3	9.1	8.7	9.4	10.5	0.7	1.1
Germany	5.9	9.9	10.8	12.6	8.6	6.7	-4	-1.9
Greece	NA	NA	NA	10.4	11.7	27.1	1.3	15.5
Italy	NA	NA	NA	7.9	8.5	12.3	0.6	3.8
Luxemburg	NA	2.6	2.5	3.9	5.8	7	1.9	1.2
Netherlands	4.1	4.9	2.7	3.7	3	2.7	-0.7	-0.3
Norway	4.1	4.9	2.7	3.7	3	2.7	-0.7	-0.3
U.K.	5.9	7.9	3.8	2.6	4.8	4.2	2.2	-0.6
Spain	14.2	20.5	12.2	9.8	19.4	26.6	9.6	7.2
Sweden	NA	NA	NA	7.7	9.4	7.3	1.7	-2
Switzerland	0.6	4.3	2	3.8	3.7	3.2	-0.1	-0.5
<b>Eastern Europe</b>								
Czech Republic	NA	NA	NA	7.1	7.6	7.5	0.5	0
Hungary	NA	NA	6.7	7.1	11.7	10.3	4.6	-1.4
Israel	9.8	7.3	8.6	9.2	6.9	6.1	-2.3	-0.9
Poland	NA	NA	NA	19.3	13	13	-6.3	0
Russia	NA	7.7	11.8	8.2	8.8	5.3	0.6	-3.5
Turkey	NA	NA	NA	10.4	12.8	9.6	2.4	-3.2
<b>Americas</b>								
Brazil	NA	NA	NA	10.6	7.4	5.4	-3.2	-2
Canada	9.1	9.6	6.9	7	8.2	7.1	1.2	-1.1
Columbia	NA	NA	NA	13.5	13	9.4	-0.5	-3.6
Mexico	NA	NA	NA	3.8	5.4	4.9	1.6	-0.5
Peru	NA	NA	NA	11.3	9.2	5.9	-2.2	-3.3
United States	6.1	5.5	4	5.3	9.8	7.3	4.5	-2.5

SOURCE: Datastream

**PERSONAL CONSUMPTION EXPENDITURES**

Next, we turn to personal consumption expenditures. Not surprisingly, consumer spending is positively correlated with employment. When jobs are more plentiful, or real wages are higher, the average worker has more disposable income to spend on goods and services, resulting in an increase in consumption expenditures. Additionally, consumer spending is an important driver of economic growth. As a point of reference, we note that consumer spending accounts for approximately 69% of U.S. GDP. In fact, during the previous decade,

consumer spending accounted for the primary driver of U.S. GDP growth. Further, the U.S. consumer supported global economic growth as export-oriented economies, such as China, benefited mightily from rising exports driven by U.S. consumer spending.

Before we proceed further, we must emphasize that the Investment Committee considers many facets of the dynamics of consumer expenditures. We consider properties such as the rate of change, the direction of change and changes in the rates of change, among others. For illustrative purposes, however, it is very informative to compare the growth rates of consumer spending internationally, particularly in light of increased opportunities to access equity markets through ETFs that previously were unavailable.

Referencing Exhibit 2, which presents historical growth rates in real consumer expenditures by country, wide variations in expenditure growth rates are immediately evident. Across the Asia & Pacific region, the more developed economies of Australia and Japan have had the lowest average growth rates in recent years. The emerging economies have had large, positive increases in real consumption expenditures, which is not surprising since these export-oriented economies have experienced rapid growth over the last decade. Additionally, the baseline levels were very low, enabling these types of rapid and somewhat ridiculous, ascents. China's real personal consumption expenditures have increased approximately 35% since 2010, after having risen 94% from 2005 to 2010. Across the region, the rapid growth of emerging market Asian economies is reflected in the increases in consumption expenditures.

A theme we have mentioned frequently in our recent commentaries is the ongoing efforts to shift China's economy from one that is heavily reliant on exports and investment as drivers of growth towards one more supported by domestic consumption. The table highlights that growth in China's consumption expenditures have been tremendous compared to that of other countries. Sustaining such large increases will be very difficult going forward as these high growth rates are typically achievable when starting from relatively low starting points. That such extraordinary growth in consumer expenditures has not had the desired results of accomplishing this secular rotation suggests to us that these demands are beyond the means of the Chinese consumer.

In Western Europe, the pattern that emerges from the Exhibit is that the average growth rates of real consumer expenditures have been lower and are decreasing over the last two decades. Across the board, several European countries exhibit real declines in personal consumption expenditures since 2010 (Italy, Denmark, Netherlands and Spain). Spain's decline is the most severe, at -4%. This is not surprising, since Italy and Spain are mired in high unemployment. Among Eurozone members, only Germany and Luxemburg exhibit strong growth in recent years. Growth in consumption expenditures tends to be stronger in non-member countries, such as Sweden and Switzerland.

In Eastern Europe, real consumption expenditure growth is largely a mixed bag. Growth has been positive and large in magnitude in Poland, Russia, Israel and Turkey over the last decade. Recently, real expenditures growth in Hungary and the Czech Republic have been lower and, in fact, have declined since 2010.

Turning to the Americas, real consumption expenditures are generally positive, although lower in magnitude than those in the Asia Pacific region. Emerging economies in this region tend to have the largest consumption expenditure growth rates, for example Brazil, Columbia, Mexico and Peru. The growth rate in Peru's double-digit consumption expenditures since 2010 is noteworthy and is consistent with the general backdrop of our quantitative framework, which is positive on Peru. Unlike many developed economies today, Peru's consumption expenditure growth rate is indicative of a healthy economy in which the unemployment rate is declining, consumer incomes rising and, importantly, current valuations are well supported by the underlying fundamentals and macroeconomic environment.

It is also important to note that two developed market economies in the region, Canada and the U.S., have positive growth rates in real consumer expenditures in all time periods, but that the rate of growth has declined dramatically in recent years. For the U.S., the growth rate has declined to 5.3% from 2005 to 2010 and 4.8% since 2010, whereas previously the five-year growth rate was in double digits. Similarly, Canada's consumer expenditures growth rate has declined dramatically since 2010 to 4.2%.

Internationally, the general picture emerges of historically low growth rates in real consumption expenditures among developed market economies. In some cases, such as the Eurozone, the rates are negative. This is particularly troubling for a number of reasons. First, these marginal increases, or declines, in real consumer expenditures are consistent with economic environments in which economic growth is not robust. One of the main drivers of economic growth is consumer spending. That it is flat in so many large economies is a picture of anemic economic activity, as opposed to one that supports the rapidly expanding valuations that we have seen in the U.S. equity markets. The second reason is that many policy makers have pursued policies aimed at devaluation a nation's currency to aid their nation's exporters in trade. In contrast, the limited growth in consumer expenditures among the world's largest economies, which are the most important export markets, suggests these policies are misguided and likely to be more deleterious than beneficial. For example, Japan's policies aimed at devaluing the Yen rely crucially on the assumption that consumption expenditures in key export markets will support growth in Japanese exports. In contrast, the exhibit is consistent with the view that in many of the potential export markets, consumer spending is increasing at rates well below what we have seen in the previous decade, and in some cases are actually declining in real terms. As we will discuss below in the section summarizing the current state of our framework, the framework and the Investment Committee remain unconvinced that policies such as those pursued by Japan under Prime Minister Abe will produce meaningful results to the real economy.

**Exhibit 2: Growth in Real Personal Consumption Expenditures**

Region/ Country	1995-2000	2000-2005	2005 - 2010	2010-2013
<b>Asia Pacific</b>				
Australia	22.9%	14.9%	15.9%	2.2%
China	98.0%	54.8%	94.3%	34.5%
Hong Kong	9.3%	9.6%	24.9%	11.6%
India	NA	NA	48.7%	13.0%
Indonesia	NA	21.8%	25.3%	10.2%
Japan	4.1%	6.1%	3.1%	2.8%
Malaysia	NA	NA	37.6%	15.0%
South Korea	19.2%	20.3%	16.4%	4.1%
Taiwan	33.8%	16.1%	7.5%	4.8%
<b>Western Europe</b>				
Austria	10.6%	7.1%	7.2%	1.2%
Belgium	11.7%	5.7%	9.0%	0.0%
Denmark	7.5%	11.6%	3.9%	-0.8%
France	13.1%	10.3%	7.0%	0.2%
Germany	7.7%	1.5%	3.4%	3.0%
Italy	13.4%	3.7%	1.6%	-4.4%
Luxemburg	22.2%	7.1%	7.0%	2.8%
Netherlands	23.9%	4.6%	0.9%	-2.7%
Spain	22.2%	18.6%	3.0%	-4.0%
Sweden	18.4%	11.6%	10.5%	3.4%
Switzerland	10.4%	6.5%	8.7%	3.5%
U.K.	26.5%	18.1%	0.8%	0.8%
<b>Eastern Europe</b>				
Czech Republic	6.3%	16.3%	8.1%	-6.1%
Hungary	11.6%	27.5%	-8.1%	-1.6%
Israel	NA	NA	NA	7.2%
Poland	NA	40.8%	38.9%	11.7%
Russia	NA	NA	42.9%	13.4%
Turkey	NA	NA	14.7%	7.1%
<b>Americas</b>				
Brazil	10.3%	10.4%	31.7%	7.3%
Canada	19.2%	17.0%	15.9%	4.2%
Columbia	NA	12.0%	20.9%	8.4%
Mexico	29.4%	15.5%	9.5%	9.3%
Peru	10.2%	19.3%	36.5%	12.4%
United States	25.3%	16.4%	5.3%	4.8%

SOURCE: Datastream

**CURRENT STATE OF SOLUTIONS—MONTHLY UPDATE****United States**

U.S. Equity markets rose further in November. Many equity analysts and fund managers continue to talk about a new paradigm into which we have entered, where traditional approaches to valuation are no longer relevant. Their assertion that things appear to be different this time around is partially correct. Never before has monetary policy distorted financial markets so much as now. To that extent, we agree that this time things are

different. However, if people then continue and claim to be able to reasonably justify current equity market valuations by “extraordinarily strong fundamentals,” reality is replaced by fiction. As we have argued numerous times before, U.S. equity markets are overvalued by any conventional metric. Further, the assertion that the unhinging of equity market valuations and the underlying economic and fundamental support for valuations represents a new equilibrium is preposterous, in our opinion.

U.S. equity investors should be clear and honest that current valuations, which are broadly at levels not seen since the 1920s, have been wholly driven by unsustainable Federal Reserve policy and are not supported by the underlying fundamentals.

Although on a smaller scale, we cannot help but draw comparison to the U.S. Federal Reserve’s monetary policy experiment and another recent government distortion. This example comes from the U.K. government’s decision to subsidize purchases of new homes in order to help particularly younger real estate buyers in a relatively difficult economic climate. Since the U.K. economy subsequently has improved further than had been expected by both the government and many market participants, and since the home subsidy has been contributing to a real estate price bubble in London, the Central Bank governor last week announced that the subsidy would be phased out. As a result of that decision, share prices of U.K. homebuilders tumbled around 10% within a few hours. Something far worse could happen to the entire U.S. equity market once the Fed makes even minor changes to its monetary policy or merely states its intent to make changes to the unprecedented and unconventional policies.

Given that Fed policy currently dominates U.S. equity market valuations, a beta exposure to this market presents an immensely risky and undiversified bet. The decoupling of risk from potential returns due to Fed policy has entered into a dangerous phase. We are just not willing to take such a gamble with our clients’ capital. Instead, we remain long-term investors and we continue to invest based on whether the underlying fundamentals support current valuations. In the long run, this approach has always been the best way of preserving and growing wealth.

## Europe

It is well known that the Fed’s monetary policy strongly affects not only U.S. capital markets, but all global capital markets. As a result of the Fed’s accommodative policies, much capital has flown from the U.S. into these markets. Additionally, other major countries and economic regions adopted similarly loose monetary policy regimes as the U.S. in an attempt to boost their economies and in order to prevent their exchange rates from appreciating and therefore making domestic goods uncompetitive on world markets.

Any small change in the Fed’s monetary policy will almost surely have a strongly detrimental impact on foreign capital markets as well. The dependence of foreign equity valuations in particular on the U.S. Fed became clear over the summer when the Fed started toying with the idea of tapering their monetary transactions “at some point.” Merely spelling out this possibility immediately sent shockwaves through the entire global financial system.

Reiterating this concern, the European Central Bank (ECB) recently issued a statement warning of the threat to Europe, and the Eurozone in particular, posed by scaling back U.S. monetary stimulus. Such a move will have broad, deleterious impacts on both mainstream institutional investors and European banks.

In addition to the potential impact of changes in the Fed’s quantitative easing policy, we remain concerned about the underlying economic fundamentals across the region. To reiterate the issues we have highlighted above, many Eurozone economies continue to be mired in high unemployment and declining real consumption expenditures. These are indicators of unhealthy economies—ones that fail to generate sustainable economic



growth, that are unable to produce jobs and in which incomes fail to support consumption expenditures that are crucial drivers of sustainable economic growth. Across the region, the underlying fundamentals are consistent with our interpretation that policies have been insufficient and poorly designed.

Eurozone banks remain a particularly weak spot within the region. Bank profitability has remained poor and markets have become more and more fragmented. Foreign banks have often retreated from other markets and domestic banks hold concentrated loan and investment portfolios of their own market. In many cases, especially within the Eurozone periphery, domestic banks have been the main buyers of government bonds, a situation that could potentially result in a vicious cycle where countries in financial difficulties could cause domestic banks to collapse, or the reverse. It is also a sign of continued weakness if the governments of weaker economies are only able to finance themselves through domestic banks rather than the global financial markets, especially if the ECB at some point decides to withdraw its promise as the lender of last resort and of taking any measures necessary to keep weaker economies afloat.

While domestic banks have been one of the main buyers of their governments' bonds, they have often been cutting loans to companies and individuals as they have been pressured by E.U. institutions to reduce the risk of their asset base. Government bonds have served that purpose due to being backed by the ECB if things go wrong. However, companies and individuals have obviously not been able to take advantage of the same ECB backing. Thus, it is not surprising that the effect has been the crowding out of capital to consumers and companies, resulting in sluggish consumer demand and corporate investment.

Moreover, as Eurozone banks are able to refinance themselves through the ECB system at artificially low rates, they have had no need to use public capital markets for funds where they would have to pay the significantly higher interest rates that would be more in line with their underlying credit risk. At the same time there appears to be substantial demand for Eurozone bank bonds that cannot be satisfied. The ECB's ultra-cheap lending facility to banks has grossly distorted debt markets. Interbank lending has become almost non-existent. This situation is clearly not sustainable in the long term. In our view, the ECB should attempt to gradually phase out its ultra-cheap refinancing facility for Eurozone banks. While it may have been necessary as a rescue measure, it clearly does not create the right incentives for bank managers and causes moral hazard problems. Like the U.S., only a well-functioning debt market will foster a solid and sustainable economic environment.

Despite the fact that this problem is generally recognized among Eurozone policy makers and ECB personnel, we fear that the political pressure on the ECB to retain the status quo will be too strong for them to phase out the program in the near or medium term. This echoes the concerns we have in the U.S. that the Fed's QE policy, although increasingly recognized as marginally beneficial at best, will become a permanent fixture, since the costs of unwinding the policy are too heavy to bear.

In summary, even if we put aside our reservations about Eurozone policies and economic development, we believe that in the near future, the main risk for European equity markets is more or less the same as for the U.S., namely the potential scaling back of bond purchases. While, in our opinion, European equity markets are not quite as fragile as the U.S. market, both are dominated by the same risk. Equity valuations in Europe are generally overextended, and until they have returned to more attractive levels we do not find it prudent to add these exposures to our portfolios. When valuations adjust, we will be interested in some of the non-Eurozone European markets, such as the U.K., which is more supported within our quantitative framework.

## **Asia-Pacific**

We have been more optimistic about Asia-Pacific than about the U.S. and Europe for quite some time. While U.S. monetary policy has a strong impact on equity market valuations in this region as well, some of the Asian

markets are less overextended. In the case of South Korea, we have taken advantage of an existing opportunity with an investment in the country's equity market. Our quantitative framework has been favorable on South Korea for quite some time. We believe that current equity valuations in Korea are well supported by the underlying fundamentals, despite the fact that Korea, as a highly export oriented economy, has been adversely affected by very loose Japanese monetary policy and a resulting weak yen.

In China, almost all of the attention has been on the 3rd plenum and the socioeconomic reforms that were expected to be announced. In our opinion, the goals of the announced reforms are lofty and progressive, but they lack a clear implementation plan. For example, one of the seemingly groundbreaking reforms that have been announced is the abolition of the one-child policy. This change was made mostly in an attempt to help China's growing pension problem that will require fewer and fewer young people to support an increasing number of retired people, a situation which has been artificially created (or at least severely aggravated) by decades of one-child families. While the rationale behind the reform is clear, the implementation leaves many question marks. One issue is that subsidies will be directed to areas that continue to follow the policy, thereby creating a strong disincentive for families to have more than one child.

Our main disappointment with the announced reforms is that they fail to address the growing problem of local government debt, which, according to some estimates, has grown to about one third of China's GDP. Overall, we believe that euphoria on the country is premature as important progress on stimulating domestic consumption still lags behind that required to transform the economy from one relying on investment spending and exports. As we discussed above, with the growth rates of real consumption expenditures globally well below the levels seen in the previous decade, such dependence on exports for growth is clearly not sustainable for China. Although China's own consumption expenditure growth rate is among the highest globally in recent years, that level remains well below what is required to support the necessary structural rotation away from dependence on exports and investment spending.

Turning to Japan, our quantitative framework is currently neutral and we remain to be convinced that Prime Minister Abe's great inflationary experiment is going to succeed in the end. The most recent economic figures on Japan are certainly not favorable. For example, the depreciating yen has exacerbated the country's trade deficit as it has made imports more expensive and exports less valuable. At the moment, the evidence appears to suggest that the entire policy perversely misestimated the price elasticity of Japanese imports and exports. Overall, we need more evidence of the real economic impact of Japan's grand policy experiment before we are willing to allocate the portfolios to this potential beta exposure. In stark contrast to our view, the equity markets there have seemingly priced in policy perfection.

India's economic growth has remained sluggish. While the country's economy grew slightly faster than expected in the latest quarter, its GDP again grew less than 5%, which has generally been interpreted as disappointing. In fact, India's growth rate has halved over the last two years. The country also continues to suffer from high inflation of about 10% annually, as well as the threat of higher interest rates that might be necessary to tackle inflation. The risk of higher interest rates, combined with the government's determination to control the country's budget deficit (thus moving away from pro-growth measures), raise strong doubts in regard to support for economic growth. Our quantitative framework is currently neutral on India. We require either a significant improvement in the country's fundamentals or a meaningful equity valuation adjustment before we would consider any exposure to Indian equities.

## **Latin America**

We have retained our exposure to Peruvian equities. Despite the fact that we have experienced losses since our initial investment in June, we continue to believe that the country's equity market is more realistically valued

than most other markets, a belief that is supported by our quantitative framework. We therefore plan to retain this investment.

Our quantitative framework has become less favorable on Brazil, as its fundamentals have deteriorated. The country continues to be plagued by stubbornly high inflation, which has made it necessary for the Brazilian central bank to increase its benchmark interest rate even further to 10%, its highest level for quite some time and 275 basis points higher than in April this year. Economic growth, which has been slow for quite some time, has understandably been further restrained by the interest rate increase as there is no room for pro-growth policies for now. This reality is clearly evident in the above Exhibits, where Brazil has suffered negative real GDP growth and contracting consumer spending during the first few years of this decade. Nevertheless, several commentators have interpreted recent statements by the Brazilian central bank as an indication that further interest rate rises have become less likely. We continue to watch for signs indicating which direction the economy will take, which likely will present a better opportunity for a potential beta exposure.

Our quantitative framework continues to be negative on Mexico due to the country's poor fundamentals. There are very few signs of an economic recovery. In fact, Mexican banks' bad debts have just reached their highest levels in a decade mostly as a result of problems in the construction sector as well as consumer credit.

## SUMMARY

Global financial markets continue to be impacted strongly by the U.S. Fed's monetary policy, probably more so than ever. Any change in the Fed's policies, or even policy intention, has the potential to cause strong adverse equity market moves. This "Fed policy factor" is likely to swamp all other economic developments currently taking place. The disconnect between equity valuations and the underlying real economy, which we have mentioned frequently over the last few months, has become even worse, particularly in the U.S. In fact, the disconnect has grown to be so large that the pejorative term "bubble" seems appropriate at this point.

While some Asian and Latin America economies continue to look more attractive than Europe and the U.S. on a relative basis, almost all equity markets continue to be overvalued. Given that the Investment Committee requires that any potential investment is supported by strong fundamentals, in the current environment our equity exposures are small and selective. Further, in keeping with our investment discipline, we refuse to be drawn into the global (particularly U.S.) monetary policy frenzy.

## IMPORTANT INFORMATION

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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.

Diversification does not protect against loss in declining markets.

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

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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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