Innealta CAPITAL

Innealta Commentary

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STATE OF THE UNION

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- It's an impossible dream...the one that begins and ends with no consequence for such frivolity. Rather, we foresee a darker nightmare of economic malaise such as this country has not experienced since the 1930s.

- The equity markets obviously disagree with us currently. This is by no means a desirable place for Innealta. There is no other economic destination we'd rather go to than one that includes sustainable and organically driven growth. One where the unconstrained free market forces can ensure the efficient allocation of capital and Adam Smith's invisible hand can move without government shackles. However, we believe that the current policies being deployed have done nothing to address the economic realities facing our country other than to artificially alter the perception of risk. Unfortunately, the State of the Union address didn't alter our perspective. This notion of an asymmetric and disproportional return-to-risk profile that is being promulgated throughout much of the equity markets is classic blunder. The recognition of this will be accelerated when investors realize that there really is no policy put option to exercise. History has shown that it just can't continue indefinitely. We hope to take advantage of that eventuality.

STATE OF THE UNION

This week's State of the Union address read more or less as expected. The empty rhetoric has become insulting to anyone with a pulse and a synapse. The President of the United States continues to mandate failure via his misguided directives. Spending disguised as "investment" is just not enough to move our economy out of the current situation. In fact, it most likely make will matters worse. We need policies that will meaningfully alter the direction of our economic trajectory such that we can overcome the onerous secular realities burdening the nation. Sadly, it seems not in within the capacity of most members of the political elite—let alone the full bodies they comprise—to devise or otherwise embrace any such endeavor. It is not solely or even mostly with a political mind that we brood over these matters; the upshot of this ineptitude is the continued degradation of our sovereign solvency, a course with plausibly grand effects on the contexts for U.S. equity and fixed income investments.

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Politicians have become almost exclusively focused on reelection and as a result refuse to lead. True leadership requires of politicians the creation of economic friendly legislation that will bridle government actions for generations. In particular, we mean laws that limit government size and its interference in private enterprise. Under the guise of crisis our government has trespassed way too far into the private operations of our once great economy. Rather than allow the forces of free markets to work policy makers have created capital markets that are now addicted to the unsustainable (e.g. endless Fed-provided liquidity) and behave as though the policy put options will eliminate all downside risk.

It's an impossible dream...the one that begins and ends with no consequence for such frivolity. Rather, we foresee a darker nightmare of economic malaise such as this country has not experienced since the 1930s. Yet, it was the extension and broadening of such fantasy that seemed to be at the heart of the speech. Our president just seems flat-out incapable of appreciating that resources are most efficiently allocated when the forces of risk and return are unimpeded. Frighteningly, Federal Chairman Bernanke seems to agree with this approach and has become obsessed by directing monetary policy toward the artificial boost of equity valuations with the intention of altering consumer psychology.

CLEAN, HIGH-SPEED RHETORIC

Among the President's most comical comments were those regarding the development of high-speed trains, broadband Internet and alternative "clean" energy, along with his takes on "tax-cuts", tort reform, Social Security and corporate taxes. As I listened to the address I found myself desperately trying to source the meat of the pro-growth agenda. And his supposed move to the center on economic issues was clearly nowhere to be found.

High-speed trains? Meaning...like Amtrak? Embarrassingly, Amtrak cannot be used as a model for anything other than how not to run a business as, with few exceptions, Amtrak is a monumentally failed enterprise. The United States extended vast resources in developing our highway systems—in fact, it was this infrastructural investment that contributed to our economic successes during the middle part of the last century. It enabled far more efficient transportation throughout the continental United States. This in turn contributed to economic growth. The idea of building government-run high-speed trains in a country with such an extensive and far reaching highway system is so extraordinarily foolish that it challenges comprehension. It would merely misallocate resources away from superior infrastructure-improvement opportunities throughout the private sector. It would be nothing more than another cost center with large negative return on investment (e.g., Amtrak). So we're supposed to get excited about the growth potential high-speed trains? The analogy with the failed European welfare state is almost too much to bear. This notion that the government should lead the private sector in determining efficient uses of capital is and has always been woefully misguided.

And what is he thinking when he states that the government needs to insert itself into the telecommunication and technology sectors in order to make high speed Internet available? One can nearly be assured that where true demand for digital services—and we mean economic growth-spurring services, not, for example, the greater availability of enterprise-sapping social networking services—intersects with a profitable service model, a provider will enter the picture (so long, of course, as the government lifts its equally heavy hand in support of the continued dominance of a select few communications carriers...but that's a thread for another day).

Then there's the infatuation with alternative "clean" energy. I'm not sure the president truly understands what the term means. He made disparaging comments toward the oil industry and then later implied that pursuing all potential energy sources is desirable. Does he not realize that the energy companies are among those best positioned to develop these alternative resources? These aren't the auto companies...a quick read of BP's recent global outlook suggests these folks can appreciate the changing global energy dynamic.

Rather, if the president were to approach the issue with an objective mind (instead of sailing the windbaggery of the venture-minded pitching their personal portfolios), he might recognize that among the best ways to further energy efficiency would be to address obvious deficiencies within the nation's electrical grid. That is, it's not so much changes at the source where we'll find the most reward for the effort, but rather changes in the distribution of the energy that show great promise. No sense in donning Sunday best, only to head to church in the back of a pickup. Policies over the past 40 years have always concentrated either on the source (e.g., oil, solar, etc.) or the end-use of energy (fuel efficiency, electrical use, tax subsidies toward more efficient HVAC, etc.). It's time to concern ourselves with the entire energy infrastructure and upgrade our distribution. This has the potential to meaningfully improve economic prosperity for several generations. This is the one area where we think that the federal government could offer impactful opportunities across the privately run utilities sector. Without long-term incentives utilities have no reason to upgrade the ever-decaying energy grid. To date the government has effectively accomplished quite the opposite. Building bankrupting battery factories using tax payer funds is hardly going to offer the same economic impact.

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EFFICIENT TAXATION OR TAXATION EFFICIENCY?

Is President Obama finally finding religion on stimulative fiscal policy? We'll believe it when we see it. Note that within the same paragraph he claims he's going to reduce corporate taxes without impacting the deficit. The clear message here is that a reduction in the absolute tax rate will be accompanied by the elimination of tax deductions. This was pushed as "leveling the playing field"—which of course is so riddled with hypocrisy that it leaves us numb. Ultimately, though, this means that, on average, corporations will have no more resources to expend on growth-oriented projects. Don't get us wrong...we are all in favor of a simplification of the tax code. However, for any change in the tax code to be stimulative, it must result in a tax savings. It is the tax savings that is stimulative not the tax code itself. A new tax code that is easier to understand and that results in the same net liability is obviously not stimulative (if anything, a bunch more accountants will be out of work). We are also willing to bet that somehow the proposed change will include the repatriation of foreign income which will result in a net increase in corporate taxes. The fact that the equity markets are responding favorably to these comments is yet another illustration of how the capital market participants generally refuse to understand basic fundamentals. A basic bait-and-switch should not be a reason for an increase in equity valuations—and yet that is exactly what seems to be the rationale.

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HISTORY REFORM

The president's comment regarding medical malpractice reform is beyond duplicity. For him to now suggest that he is willing to work in a bipartisan manner regarding malpractice reform is historical revisionism at its worst. Medical malpractice reform was at the heart of the debate last year and was completely ignored. As hypocritical were his references to "our tax cuts"—he fought the extension of the current tax rates until the very end. And the resulting legislation contained more government spending. In our opinion this was a major legislative and policy misstep as the spending completely neutered the tax extension.

More revisionism included the president's comments regarding his bipartisan Fiscal Commission. The commission effectively suggested an overall reduction in government spending relative to tax revenue of 3-to-1. This would be a combination of significant government spending reductions (including impactful reductions across entitlement spending), accompanied by tax increases. Somehow President Obama has interpreted this differently. He highlighted reductions only in "excessive spending" which has no definition. The implication here is obvious. He has no intention of cutting spending in any meaningful way. He even metaphorically compared spending cuts to the removal of a jet engine during flight in order to lighten the load. Additionally, his comments about Social Security seem completely decoupled from the recommendations of the commission. Other revisionist and hypocritical tidbits throughout the speech included the elimination of the earmarks and how Obamacare reduces both health care and government costs. And then there was the Sputnik metaphor. Still scratching our heads on that one...

Hypocrisy and revisionism are common in politics, but remain no less frustrating for those of us who hold ourselves accountable and responsible. Perhaps one day we will have elected representatives who are the same. Meantime, we need to keep a close eye on both fiscal and monetary policies in an effort to identify true sources of organic economic growth. If this latest State of the Union address is any indication of forthcoming policy initiatives, then it is clear that the executive branch of government has learned very little over the last few years. The rhetorical subterfuge may be less vitriolic, more centrist, but the underlying policies are the same old Keynesian craziness that has proved most ineffective.

EQUITIES SHRUG AND MOVE UP (AND UP)

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Gerald Buetow is Chief Investment Officer of Innealta Capital. Innealta Capital is a quantitative asset management firm specializing in the tactical management of Exchange Traded Fund (ETF) portfolios. 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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