Innealta Capital
Innealta Commentary
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LITTLE PROGRESS ON ALL FRONTS

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- We hope that the days of quantitative easing are quickly coming to an end. There have been a few outspoken Reserve members that have been pretty critical and we hope that they prevail in the quarters ahead. It is our current thinking that policy is placed on pause after the end of QE2 in June. Between the monetary pause and other demand sources, along with wage and real estate deflation, we remain well comfortable with our Treasury exposure.

- How high can oil go? The bottom line is that the resulting gas prices are very real and will indubitably affect consumer spending habits. Recall that the employment backdrop remains dire, with employment participation at troublingly low levels.

- Gold plays a very interesting role when it comes to both economic and investment theory. It is a store of value, an inflation hedge, a medium of exchange, a precious metal and a standard for collateral for fiat currencies. For all of these reasons we like gold in the intermediate and longer terms, especially in how we've placed it within our portfolios. We will continue to examine our exposures over the coming days and will alter our exposures accordingly.

- It should be obvious that we remain wary of current equity valuations overall and so our most immediate investment focus is on our current exposures to equities. Further, given the potential for further inflation pressures, as well as not-so-positive consideration of our nation's long-term solvency, we are examining more closely our exposures to long duration products and commodities. Over the coming days we may make some alterations to these exposures. This would be implemented in an effort to better manage our risk-return characteristics throughout our portfolio strategies.

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We repeatedly have argued for the separation of ideology from economics in developing monetary and fiscal policies. Unfortunately, it appears that the current administration has completely abandoned economic theory, replacing such principles with dogma. This is an extremely dangerous approach with consequences that may include a generational economic disaster the likes of which have never been experienced in our nation's history.

For sure, questions in regard to whether or not a given governmental structure is laudable may never be adequately addressed, either before or after its implementation. But...one may always, to a certain degree, be able to determine whether or not some policy effort is logical, based on such antiseptic measures as potential affordability, executability and extensibility (yes...even estimations may prove logical).

In effect, we must...and this can be a simple exercise...ask ourselves in advance whether a given exercise is feasible. And by that simple metric, the Obama plans fail miserably. That's not necessarily because components of the plan are not the right things to do (a question of laudability). Rather, the plan fails on perhaps the simplest test of them all: affordability. And if it fails by that measure, it eventually will fail by all others, including any that rely on societal mores for support. There truly never is a free lunch.

The ideologues have become acerbic in their comments and misrepresent or misdirect the dialogue toward one of social injustice. Though, sadly, it often works, the approach is irresponsible, short-sighted and based on pure political expediency. Our problems are just too significant to be dealt with in such a puerile manner. We need earnest and constructive debate and it appears such negotiation is beyond the abilities of our elected officials.

The administration's proposed budget and its extraordinarily unusual re-proposed budget are both pure fantasia and steeped in economically unsustainable ideology. They are truly insulting to anyone of fair mindedness. The alternative congressional proposal minimally presents a framework from which constructive dialogue can begin. Even then, it is conceptually impossible for any objective economist to even consider which budget proposal attempts to address the central issue of deficits. A recent opinion piece in The Wall Street Journal by John Taylor (April 22) frames the distinctions very well and highlights the intuition and reasonableness (or lack of) across the different proposals. We could throw more data into the discussion, but ultimately Taylor does a great job in presenting the principal components of each proposal. Readers can judge for themselves.

The debate in re: the raising of the debt ceiling also has devolved into a similar abyss of finger pointing and name calling. Not raising the debt ceiling DOES NOT have to lead to default. Neither will it lead to economic Armageddon. We can sustain current levels for a long time and easily make all of our liability payments. It's ludicrous for any politician to suggest otherwise. It's pure fear mongering and is insulting to anyone with even the most basic sense of home economics: when times are tough, cut spending on nice-to-haves, then other discretionary, then buy generic. We all do this almost daily. Though we obviously understate the perhaps overwhelming inertia the system maintains, the government needs simply to redirect revenue to priority expenditures until real resolutions are legislated. This can be accomplished for a very long time before the shift becomes constraining. The threats of insolvency by none other than our Treasury Secretary are simply beyond the pale (especially when combined with comments following the S&P rating watch downgrade—he clearly hasn't had enough time to study demographic trends). We wish we could state he knows better but we wonder if he actually does. It is indeed a sad and pathetic state of affairs.

Where does this all end up? Most likely no real solution is agreed upon until after the next election. That's just a woeful truth. The two parties just seem too far apart. Compromise would be great, but the problem is that the current congressional proposal is in our opinion already what we'd hope to be the eventual compromise. To move more toward the administration's proposal just kicks the can to 2012 anyway. Better to have gridlock until then and hopefully be able to address the issues properly once and done rather than have to undo any short-term politically expedient policies. With gridlock we wouldn't expect any more fiscal largesse (in almost all reasonable scenarios we expect the fiscal insanity to slow, halt or reverse), which incrementally helps reduce the deficit and places downward pressure on Treasury yields.

Monetary Policy

We wrote disparagingly toward current monetary policy in last month's commentary. Nothing has changed. We hope that the days of quantitative easing are quickly coming to an end. Rhetoric from the Fed implies that perhaps some kind of hybrid QE program would continue that includes the reinvestment of income from their engorged portfolio toward the purchase of Treasuries. The Fed, it seems, has returned to sample marketing of ideas. They make statements to test the markets' reception and then seem to develop policy based on that feedback. That is how QE2 was born. It just seems so obvious that the Fed hasn't a clue how to implement policy. QE2 is an abject failure—unless one considers a greatly weakened dollar, commodity inflation and rising long-term interest rates as successful results.

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Did we think we'd ever see a day when monetary policy would be based almost exclusively on psychological (consumer behavior) and marketing strategies? Clearly, no. Other than for its moments of benefit for speculators on Wall Street, current policy is bordering on disastrous.

There have been a few outspoken Reserve members that have been pretty critical and we hope that they prevail in the quarters ahead. It is our current thinking that policy is placed on pause after the end of QE2 in June. It seems almost impossible to consider any continuation of QE policy given the results. Ideally, restrictive policy would reduce inflation expectations which would put downward pressure on yields. We're not too worried about the end of QE2 on the demand for Treasuries—despite what PIMCO wants us to believe. Between the monetary pause and other demand sources along with wage and real estate deflation, we remain well comfortable with our Treasury exposure.

The French to the Rescue in Libya

For levity: the French military is now apparently taking a more assertive leadership role in the NATO operations throughout Libya. If you're a Libyan citizen doesn't that make you feel more secure? Historical references aside—how can the rebels be so incompetent as to need French military expertise? Wow. Compound that with the arrival of none other than John McCain declaring that the rebels are "heroes," all in tandem with a U.S. policy that is best described as capricious. Golly, it appears that our foreign policy is right there with both our fiscal and monetary policies. Mr. Gaddafi has to be smiling somewhere. Unfortunately, innocent lives are at stake and the citizens of Libya deserve some legitimate policy and military leadership. The current Keystone Cops routine isn't going to get the job done. This and other geopolitical instability in the region will produce more upward pressure on the level and volatility of oil prices, and as a consequence downward pressure on global economic growth.

Oil

How high can it go? Is it all speculators (as the administration is now suggesting)? Is it demand driven? Or supply driven? The reasons change almost literally by the minute. The bottom line is that the resulting gas prices are very real and will indubitably affect consumer spending habits. Recall that the employment backdrop remains dire, with employment participation at troublingly low levels. There is absolutely zero logic to talking-head banter that suggests high energy prices are nothing to worry about. How can they make those statements when almost literally every time energy has spiked in this manner it has had both a meaningfully negative economic impact and a corresponding deleterious response throughout the capital markets? What data and economic history are these pundits looking at? Apparently, the school of thought on folks selling risky asset classes is that, as long as the risky asset classes are trending upward, economics don't matter. We have seen this defiant euphoria before and it didn't end well. Is it different this time? Doubtful.

It should be obvious that we remain wary of current equity valuations overall and so our most immediate investment focus is on our current exposures to equities. Further, given the potential for further inflation pressures, as well as not-so-positive consideration of our nation's long-term solvency, we are examining more closely our exposures to long duration products and commodities.

Gold

Gold plays a very interesting role when it comes to both economic and investment theory. It is a store of value, an inflation hedge, a medium of exchange, a precious metal and a standard for collateral for fiat currencies. For all of these reasons we like gold in the intermediate and longer terms, especially in how we've placed it within our portfolios. At current levels though we wouldn't be surprised if it corrected a bit, but given the frothy dynamic in the silver markets, gold looks downright sedentary. We will continue to examine our exposures over the coming days and will alter our exposures accordingly.

Conclusions for the portfolios

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Gerald Buetow is Chief Investment Officer of Innealta Capital. Innealta is an asset manager specializing in the active management of portfolios of Exchange Traded Funds. 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 US 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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