Innealta CAPITAL
SPECIALISTS IN ACTIVE MANAGEMENT OF ETF PORTFOLIOS
November 2016

INCREASING EARNINGS, YIELDS, AND ELECTION PROBABILITIES

KEY TAKEAWAYS

- Performance: For the four-week period ending 10/28/2016, international equities, commodity markets, and the U.S. Dollar Index yielded positive returns while fixed income sovereign, fixed income credit, and real estate ended negative.
- Earnings: 58% of the S&P 500 companies have already reported on Q3 2016, and the year-over-year growth rate in earnings is 1.6%[1]. This marks the first positive growth rate since Q1 2015, a sign that the overall domestic economy continues to improve.
- Monetary Policy: During October, the likelihood of a December FED rate hike increased to close the month at 59%. The correlation between the probability of a FED rate hike and U.S. 10 year treasury yields increased.

PERFORMANCE REVIEW

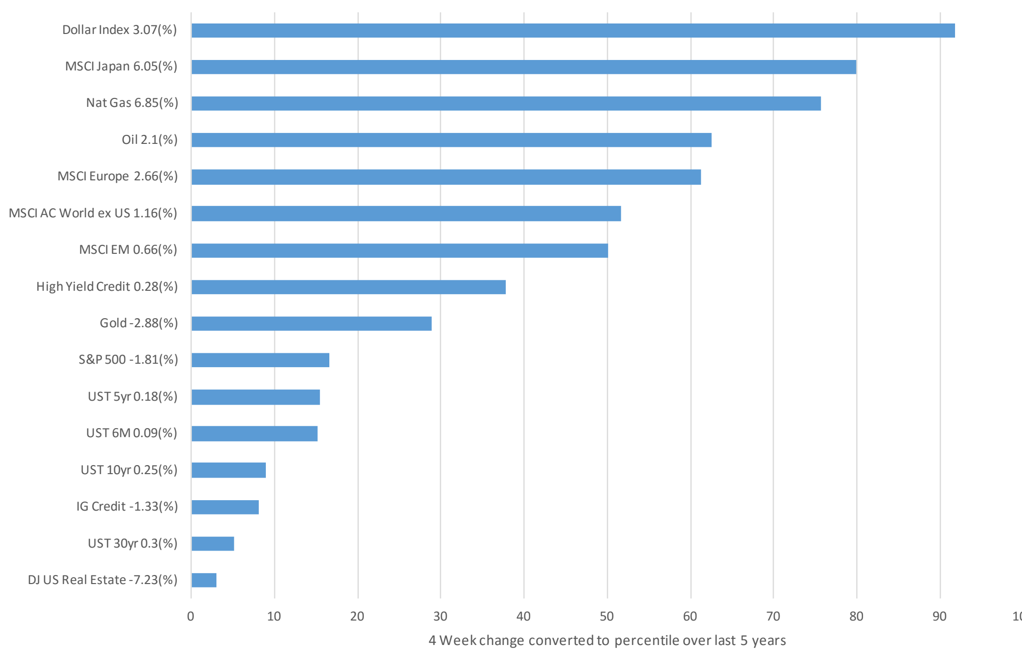
Over the last four weeks ending on October 28th, 2016, global asset market performance was positive for international equities, commodity markets and the U.S. Dollar index, and negative for fixed income and real estate. Figure 1 shows the respective 4-week change in each market relative to each market's unique 5-year history. Fixed income sovereign markets across the maturity curve increased in yield as the probability of a FED rate hike increased. Real estate and investment grade credit, which are highly correlated to fixed income sovereign markets, also experienced poor performance over the last four weeks. International equity markets posted positive performance due to positive growth data. Commodities markets were mixed as oil and natural gas performed positively, but gold performed negatively.

Figure 1

GLOBAL ASSET LEVELS

Data from 10.31.2011 to 10.28.2016
SOURCE: Innealta Capital using data from FactSet Research Systems Inc.

Note: 4-week change refers to change from 9.30.2016 to 10.28.2016.



EARNINGS REVIEW

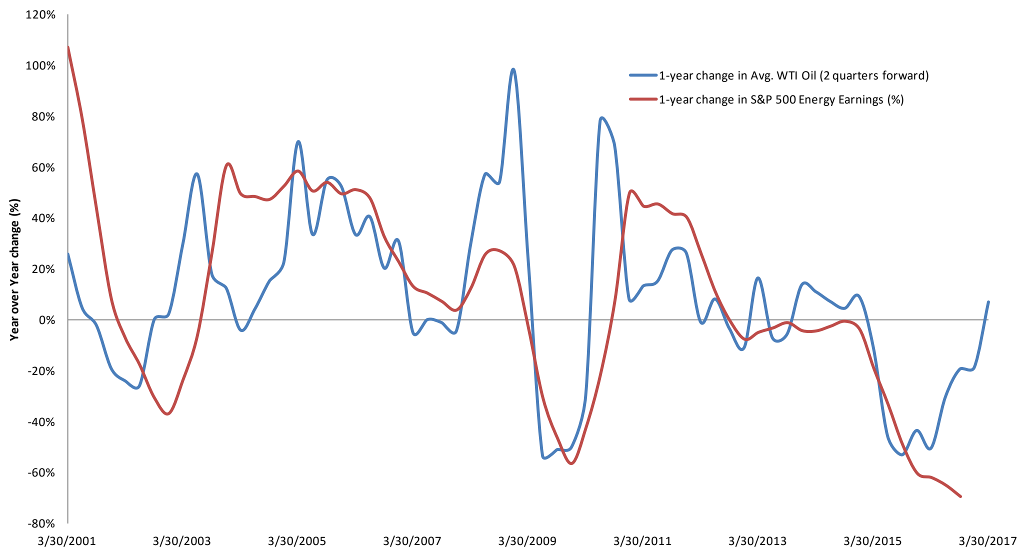
For the first time since Q1 2015, the year-over-year growth rate in actual S&P 500 earnings is positive. As of 10/28/2016, only 58% of S&P 500 companies had reported Q3 2016 and the blended earnings growth rate is +1.6%[1]. Behind the aggregate numbers, all eleven sectors have contributed to the earnings increase, with the Financials sector accounting for the largest contribution. The largest relative drag on S&P 500 earnings is coming from the Energy sector. Figure 2 shows the annual growth rate in S&P 500 Energy earnings and the annual growth rate in the average WTI oil market. If Energy sector earnings follow the path of oil and the growth of all other S&P 500 sectors remains the same, then the overall growth rate of S&P 500 earnings should increase. A positive growth rate in corporate earnings is yet another sign that the overall domestic economy continues to improve.

Figure 2

GROWTH PATH OF S&P 500 ENERGY EARNINGS AND AVERAGE, TWO-MONTH FORWARD WTI OIL PRICE

Data from 3.30.2001 to 9.30.2016
SOURCE: Innealta Capital using data from FactSet Research Systems Inc.

Note: "Average WTI Oil" refers to the average WTI oil price observed in each calendar quarter.



MONETARY POLICY FOCUS

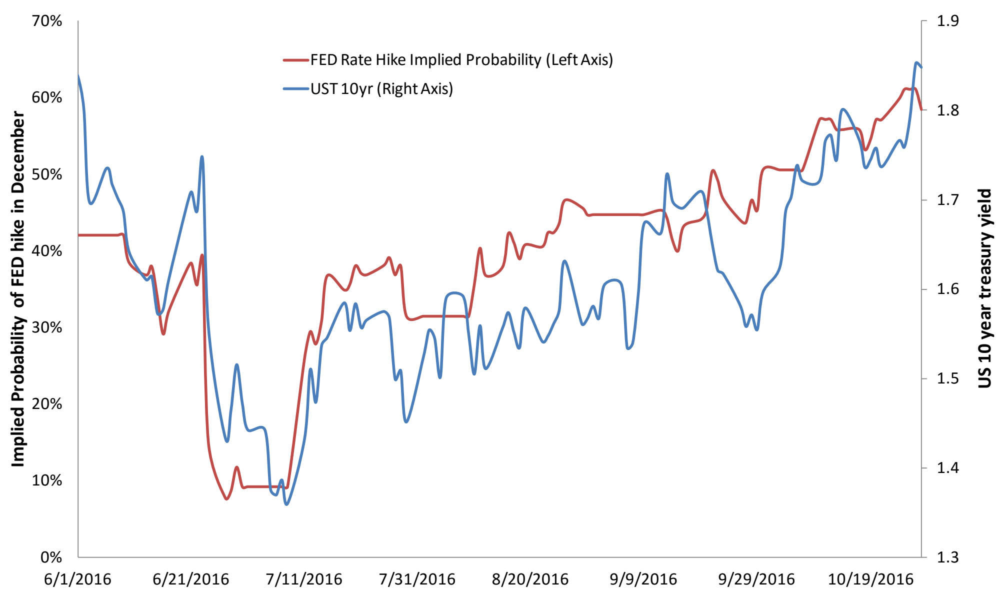
Receiving less attention than the U.S. presidential election and the S&P 500 corporate earnings season, monetary policy expectations of a FED rate hike had a profound impact during October. Shown in Figure 3, the implied probability of a 25 bps FED rate hike closed the month at 59%. That marks the highest level in the December 2016 contract since June 1st, 2016. Not-so-coincidentally, U.S. treasury yields moved in a similar pattern, increasing in yield as FED rate hike expectations increased. For the broader fixed income market, treasury yields serve as the basis for relative attractiveness for other fixed income sectors. So as the U.S. 10-year treasury bond yield rose, so did yields in many fixed income sectors. Heading into November, and after the presidential election is complete, the market will remain focused on any changes in monetary policy as monetary policy will reflect any changes in financial conditions.

Figure 3

PROGRESSION OF FED RATE HIKE IMPLIED PROBABILITIES AND U.S. 10-YEAR TREASURY YIELDS

Data from 6.01.2016 to 10.28.2016.
SOURCE: Innealta Capital using data from FactSet Research Systems Inc. and Bloomberg.

Note: U.S. 10-year treasuries expressed in yield terms.



LOOKING FORWARD

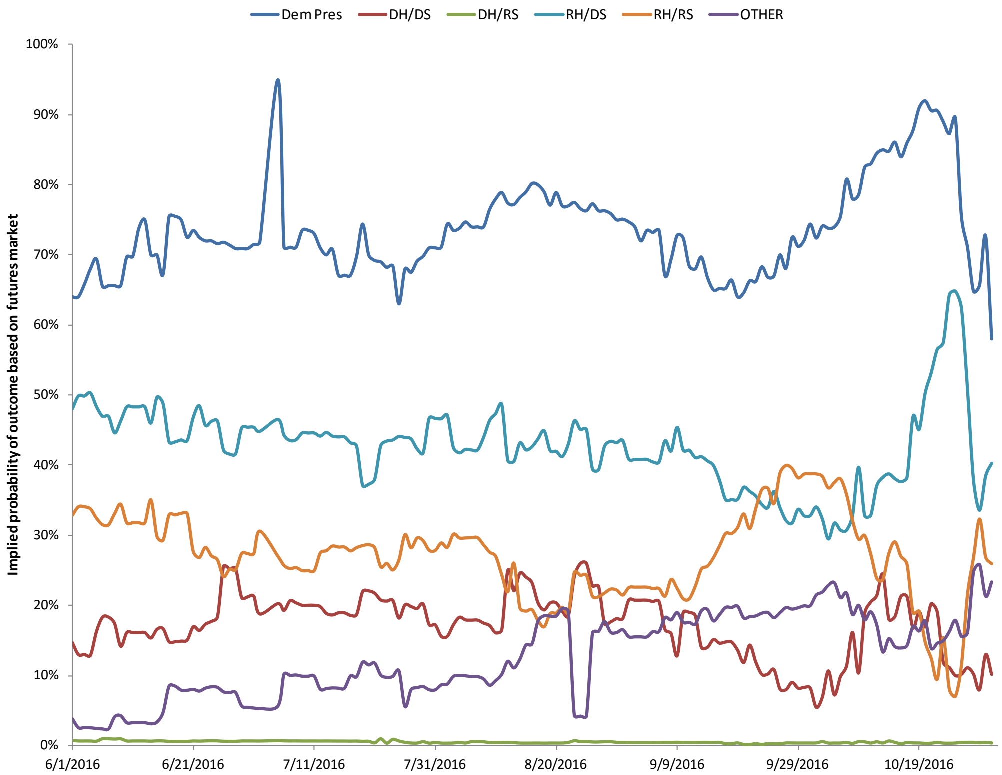
During November, the market's main focus will likely be the U.S. election. As of October 31st, 2016, market expectations on which party would win the U.S. presidency and which party would control the house and/or the senate experienced an abrupt change. On Friday, October 28th, FBI Director James Comey sent a letter to Congress suggesting that the FBI may reopen the Clinton email investigation. The immediate impact can be seen in Figure 4, which contains the implied probability of winning from the Iowa Electronic Markets. As of the last day of October, the one week change in the probability of a Democrat presidential win moved from 87.3% to 58% (a -29% change). Additionally, the chances that Democrats could regain the U.S. senate dropped significantly. Markets reacted quickly. The CBOE volatility index ("VIX") increased by 4.93 points over the month, closing the month at 19.32[1]. As the election concludes we would expect the general positive trend in macroeconomic and corporate data to outweigh the election uncertainty and provide additional support for risky assets.

Figure 4

IMPLIED PROBABILITY OF WINNING BASED IN U.S. PRESIDENTIAL AND CONGRESSIONAL FUTURES MARKETS

Data from 6.01.2016 to 10.28.2016. SOURCE: Innealta Capital using data from Iowa Electronic Markets.

Note: "Dem Pres" refers to democratic win of U.S. presidency. "DH/DS" implied democratic controlled house and democratic controlled senate. "DH/RS" refers to democratic controlled house and republican controlled senate. "RH/DS" refers to republican controlled house and democratic controlled senate. "RH/RS" refers to republican controlled house and republican controlled senate. "Other" refers to any other house and senate combination. Source: Innealta Capital using data from Iowa Electronic Markets.



SUMMARY

November will be a significant month for markets. Outside of the normal macroeconomic data, the United States public will decide on the next president and which party will control the House of Representatives, the Senate, or both. Each outcome and the combination of outcomes will have a long term effect on both the economy and asset markets. Corporate earnings will conclude in November, and if the current reporting season trends hold, the S&P 500 will experience the first year-over-year earnings growth since Q1 2015. Changes in monetary policy expectations will drive asset markets, particularly fixed income sovereign markets. As of this note, the probability that the FED will increase the FED fund effective rate by 25 bps was 59%. Finally, with the upcoming election on November 8th, markets are sure to react as the new political regime takes the reins.

IMPORTANT INFORMATION

1. Data from FactSet Research Systems, Inc. as of 10/31/2016.

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Any investment is subject to risk. Exchange traded funds (ETFs) are subject to risks similar to those of stocks, such as market risk, and investors that have their funds invested in accordance with the portfolios may experience losses. Additionally, fixed income (bond) ETFs are subject to interest rate risk which is the risk that debt securities in a portfolio will decline in value because of increases in market interest rates. The value of an investment and the return on invested capital will fluctuate over time and, when sold or redeemed, may be worth less than its original cost. This material is not intended as and should not be used to provide investment advice and is not an offer to sell a security or a solicitation or an offer, or a recommendation, to buy a security. Investors should consult with an investment advisor to determine the appropriate investment vehicle. Investment decisions should be made based on the investor's specific financial needs and objectives, goals, time horizon and risk tolerance. All opinions and views constitute our judgments as of the date of writing and are subject to change at any time without notice.

Figures References:

Dollar Index refers to the U.S. dollar index (USDX), which is a measure of the value of the U.S. dollar relative to the value of a basket of currencies of the majority of the U.S.'s most significant trading partners. The **MSCI Japan** Index is designed to measure the performance of the large and mid cap segments of the Japanese market. **Nat Gas** refers to the dollar-per-million-BTUs spot price of Natural Gas on the New York Mercantile Exchange (NYMEX). **Oil** refers to the spot price of a barrel of WTI Crude on the New York Mercantile Exchange (NYMEX). The **MSCI Europe** Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of the developed markets in Europe. The **MSCI World ex USA** Index captures large- and mid-cap representation across 22 of 23 Developed Markets (DM) countries*–excluding the United States. Net total return indexes reinvest dividends after the deduction of withholding taxes, using (for international indexes) a tax rate applicable to non-resident institutional investors who do not benefit from double taxation treaties. **MSCI EM** refers to the MSCI Emerging Markets Index which captures large and mid cap representation across 23 Emerging Markets (EM) countries. **High Yield Credit** refers to The iBoxx USD Liquid High Yield Index, which is an index composed of U.S. dollar-denominated, investment-grade corporate bonds. **Gold** refers to the near-term futures price of an ounce of gold on the New York Mercantile Exchange (NYMEX). The **S&P 500** Index (Large Cap Equity) measures the performance of the large capitalization sector of the U.S. equity market and is considered one of the best representations of the domestic economy. **UST 5yr** refers to the yield of the on-the-run 5-year U.S. treasury bond. **UST 6M** refers to the yield of the on-the-run 6-month U.S. treasury bill. **UST 10yr** refers to the yield of the on-the-run 10-year U.S. treasury bond. **IG Credit** refers to the iBoxx USD Liquid Investment Grade Index, which is an index composed of U.S. dollar-denominated, investment-grade corporate bonds. **UST 30yr** refers to the yield of the on-the-run 30-year U.S. treasury bond. **DJ US Real Estate** refers to the Dow Jones U.S. Select REIT Index, which intends to measure the performance of publicly traded REITs and REIT-like securities.

It is not possible to invest directly in an index.

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AFAM Capital, Inc.
12117 FM 2244
Building 3, Suite 170
Austin, TX 78738
P: 512.354.7041 F: 512.597.2500