HOW OIL STOLE THE SHOW

KEY TAKEAWAYS

- Asset classes across the globe maintained a high level of performance dispersion: global equity and commodities showed positive performance, foreign exchange markets exhibited mixed performance, and U.S. treasury markets exhibited negative performance.
- Towards the end of the month, the market reacted positively to the news of a potential OPEC agreement to limit oil supply. However, there is still significant noise around the likelihood of a sustainable agreement.
- October marks the start of the third quarters U.S. corporate earnings season. Expectations remain mixed as sales are likely to increase, actual earnings are likely to decrease, yet actual earnings will likely beat analyst estimates.

PERFORMANCE REVIEW

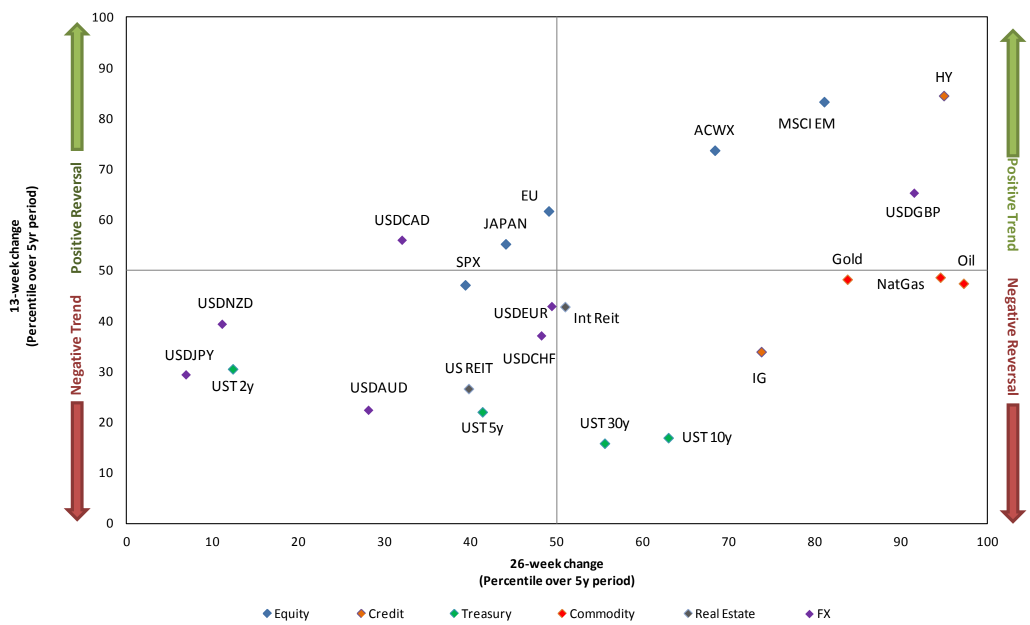
U.S. equity performance was mixed this month, with the Dow Jones Industrial Average, S&P 500, and Russell 3000 returning -0.41%, +0.16%, and +0.19% respectively. Though equity performance could be considered being flat for the month, spikes in daily volatility were not absent as the CBOE volatility index, also known as the VIX, reaching 18.14 on 09/14/2016. This level constitutes the highest since the "Brexit" referendum in late June.

Performance dispersion in global markets remained elevated in September. Figure 1 shows the rolling 13-week and 26-week performance percentile rankings of each asset over the last 5-year period. Assets in the top-right quadrant, for example, have performed well in the last 13- and 26-week periods, constituting a positive trend in the asset's price. Within our categorization, the top performers are MSCI Emerging Markets, High-yield fixed income, and MSCI All Country World ex. U.S. Short term performance of sovereign fixed income markets has been weak, and shorter maturity Treasury markets such as the UST 2yr and UST 5yr are in negative trends. Finally, the foreign exchange market, particularly the British pound and Japanese Yen, continue to exhibit opposing trends relative to the dollar and have further contributed to FX return dispersion.

Figure 1

GLOBAL ASSET ROTATION

Weekly price and yield data from 09.30.2011 to 09.30.2016
SOURCE: Innealta Capital using data from FactSet Research Systems Inc.



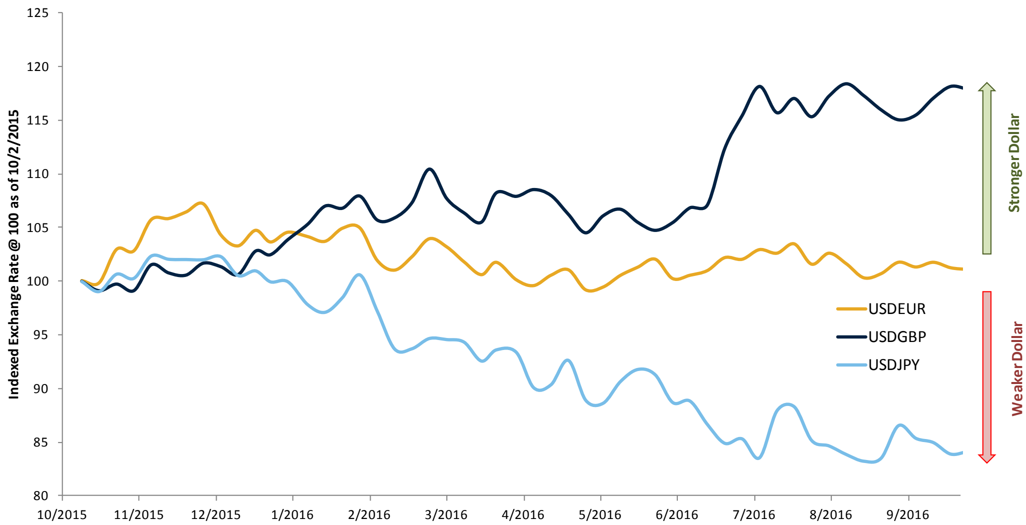
FOREIGN EXCHANGE FOCUS

Currencies, relative to the dollar, have followed divergent paths over the last year. Particularly, the British Pound remains weak, the Japanese Yen remains strong, and the Euro remains within a tight trading range. Figure 2 shows the change in FX rate between USD and GBP, USD and EUR, and USD and Yen respectively. The rates are indexed to 100 in order to show how these currencies have fluctuated over the last 12 months. Uncertainty around the British exit from the European Union continues to weaken the British Pound. The Bank of Japan, by not increasing the amount of monetary intervention, helped the Japanese Yen to continue strengthening relative to the dollar. In addition, during September, both the FED and the European Central Bank (ECB) met market expectations by maintaining benchmark lending rates. With no significant change in expectations, the exchange rate between dollars and euros has remained within a tight trading range. The ECB holds another meeting on 10/20/16 and the FED releases its September minutes on 10/12/16. Unfortunately the market will wait until early November for additional monetary policy data when the Bank of Japan and the FED holding meetings on 11/01/16 and 11/02/16, respectively.

Figure 2

TRAILING TWELVE MONTH INDEXED FOREIGN EXCHANGE RATES

Data from 10.02.2015 to 09.30.2016
SOURCE: Innealta Capital using data from FactSet Research Systems Inc.



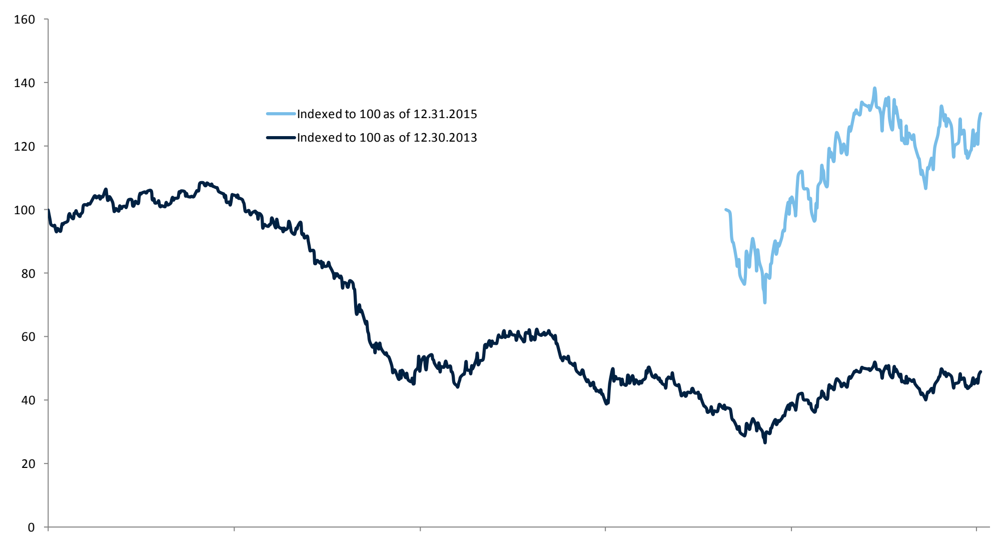
OIL FOCUS

On September 28th, 2016, news of a potential OPEC oil production freeze shifted market expectations of the commodity's price. The proposed production cut ranges from 200,000 to 700,000 barrels per day and requires agreement during OPEC's 11/30/16 meeting. Assuming the midpoint of 450,000 barrels per day, the cut represents a decrease of approximately 0.47% of world oil production. If the agreement occurs and demand remains flat, it will mark the first time since December 2013 where supply is less than demand.[1] On the day of the news, oil and oil-sensitive markets rallied as WTI crude oil futures increased 5.3%, the S&P 500 energy sector increased 4.3%, and the U.S. High Yield credit market increased 0.67%. Despite the recent optimism, a performance analysis of different time frames shows a different story. Figure 3 indexes the price of crude oil to 100 as of 12/31/2013 and, subsequently, as of 12/30/2015. From a shorter-term perspective, oil has increased approximately 30%, while from a longer-term perspective, oil prices would need an increase greater than 100% to reach it former peak.

Figure 3

WTI CRUDE OIL PRICES

Monthly price data of WTI crude continuous 1-month contract from 12.31.2016 to 09.30.2016
SOURCE: Innealta Capital using data from FactSet Research Systems Inc.



EARNINGS REVIEW

Outside of monetary policy decisions, the next big market event relates to the Q3 2016 corporate earnings announcements season. So far, market expectations estimate another quarter of year-over-year earnings declines. Should this be the case, it will be the first time we experience six consecutive quarters with year-over-year earnings declines since the 2008 recession. Additionally, 16% of S&P 500 companies have already issued negative earnings per share (EPS) guidance, compared to only 7% that have issued positive EPS guidance. The largest detractor of earnings growth in the S&P 500 continues to be the energy sector, which is still experiencing the effects of relatively low oil prices. Nine of the now eleven sectors are expected to report year-over-year sales growth. The estimated sales growth rate for Q3 2016 is 2.6%, which is 0.1% higher than the same estimate from the beginning of the quarter. As of the end of September, the forward 12-month P/E ratio of the S&P 500 is 16.6, down from 16.9 one month ago. With earnings season fast approaching, it will be interesting to see which sectors 'hit' and which sectors 'miss' earnings.[2]

LOOKING FORWARD

The calendar of future macroeconomic data will follow the traditional pattern. The Bureau of Labor Statistics releases September's Employment Situation report on October 7th, Alcoa Inc. kicks off the earnings season on October 11th, and the FOMC publishes its minutes from the September policy meeting on October 12th. Retailers in the U.S. are gearing up for the seasonal boost in spending from holiday shopping sprees; a phenomenon that has on average benefited the retail sector in the month of October since 2009, as measured by the S&P Retail Select Industry Index.[2] The combination of earnings announcements, the upcoming unemployment statistics, and other macroeconomic data will provide insights for the Fed, which meets only twice more in the balance of 2016.

SUMMARY

During September, the market absorbed unexpected news within oil markets, digested expected results from central banks, and saw further dispersion in world currencies relative to the dollar. The unexpected news of an OPEC supply freeze on 09/28/2016 reversed the negative intra-month performance and helped WTI crude oil and the S&P 500 energy sector to post +0.80% and +1.34% returns in September, respectively. Across monetary policy, the FED and ECB matched market expectations with no change in target rates or monetary intervention. The Bank of Japan, however, did not meet market expectations of new stimulus; they announced targeting the yield curve with remaining purchases. Relative to the dollar, the British pound continues to decline as "Brexit" fears remain, while the Japanese Yen continues to strengthen as the Bank of Japan offered no incremental increase in monetary stimulus. In October, United States corporate earnings will be an important economic new data point, which will surely capture the attention of investors.

IMPORTANT INFORMATION

1. Data from Bloomberg and FactSet Research Systems Inc., 9/30/2016
2. Data from FactSet Research Systems Inc., 9/30/2016

The information provided comes from independent sources believed reliable, but accuracy is not guaranteed and has not been independently verified. The security in¬formation, portfolio management and tactical decision process are opinions of Innealta Capital (Innealta), and the performance results of such recommendations are subject to risks and uncertainties. Past performance is not a guarantee of future results.

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 invest¬ed 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.

The Russell 3000 Index measures the performance of 3,000 publicly held US companies based on total market capitalization, which represents approximately 98% of the investable US equity market. 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. The Dow Jones Industrial Average is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ. The S&P Retail Select Industry Index provides investors with equity benchmarks for U.S. traded Retail related securities.

Figures 1 and 2 References:

USDJPY denotes the amount of Japanese yen that 1 U.S. dollar can purchase. **USDNZD** denotes the amount of New Zealand dollars that 1 U.S. dollar can purchase. **UST 2Y** refers to the FactSet total return index of owning 2-year U.S. Treasuries. **USDAUD** denotes the amount of Australian Dollars that 1 U.S. dollar can purchase. **USDCAD** denotes the amount of Canadian Dollars that 1 U.S. dollar can purchase. **SPX** Denotes the S&P 500 Index. **US REIT** refers to The Dow Jones U.S. Select REIT Index, which intends to measure the performance of publicly traded REITs and REIT-like securities. **UST 5y** refers to the FactSet total return index of owning 5-year U.S. treasuries. **JAPAN** refers to the Nikkei 225, a price weighted index of the 225 top-rated companies listed in the First Section of the Toyko Stock Exchange. **USDCHF** denotes the amount of Swiss Francs that 1 U.S. dollar can purchase. **USDEUR** denotes the amount of Euros that 1 U.S. dollar can purchase. **EU** refers to the Eurostoxx 50, a market capitalization weighted index of the leading 50 stocks covering Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal and Spain. **Int Reit** refers to the Dow Jones Global ex-U.S. Select Real Estate Securities Index (RESI), which represents equity real estate investment trusts (REITs) and real estate operating companies (REOCs) traded globally, excluding the U.S. **UST 30y** refers to the FactSet total return index of owning 30-year U.S. treasuries. **UST 10y** refers to the FactSet total return index of owning 10-year U.S. treasuries. **ACWX** refers to the MSCI ACWI ex. U.S. Index, a market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets excluding the United States. **IG** refers to the iBoxx USD Liquid Investment Grade Index, an index composed of U.S. dollar-denominated, investment-grade corporate bonds. **MSCI EM** refers to the MSCI Emerging Markets Index, which captures large and mid cap representation across 23 Emerging Markets (EM) countries. **Gold** refers to the Gold NYMEX Near Term ($/ozt). **USDGBP** denotes the amount of GBPs that 1 USD can buy. **NatGas** denotes Natural Gas NYMEX Near Term ($/btu). **HY** refers to the iBoxx USD Liquid High Yield Index, an index composed of U.S. dollar-denominated, investment-grade corporate bonds. **Oil** refers to Crude Oil WTI / Global Spot NYMEX.

It is not possible to invest directly in an index.

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