Innealta CAPITAL

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CRITIQUING THE FED

Within a well-functioning economy, macroeconomic forces incentivize the efficient allocation of resources by properly rewarding only those entities that offer sustainable value-added products and services, in turn fostering broad, sustainable economic growth. Despite volumes of empirical and conceptual evidence in support of that statement, massively inefficient bureaucracies and horrifically poor leadership have destroyed incomprehensible amounts of wealth over the past few decades as they forced a decoupling in the valuation dynamic, consequently perverting the allocation of resources.

Much of that destruction has come as fiscal policy increasingly has been based on faulty, subjective ideology, rather than those objective empirical data. It's that gap in political sensibility that monetary policy has sought to fill. The result is an unprecedented macroeconomic environment. Against this backdrop, capital market risks have swelled, even as valuations reflect broad naiveté in regard to these inherent risks. As we find capital markets now predominantly driven by blind faith in central bank authority and power, we believe investors must retain great caution in the face of the growing likelihood of a shift in confidence in the power of policy to cure all ills.

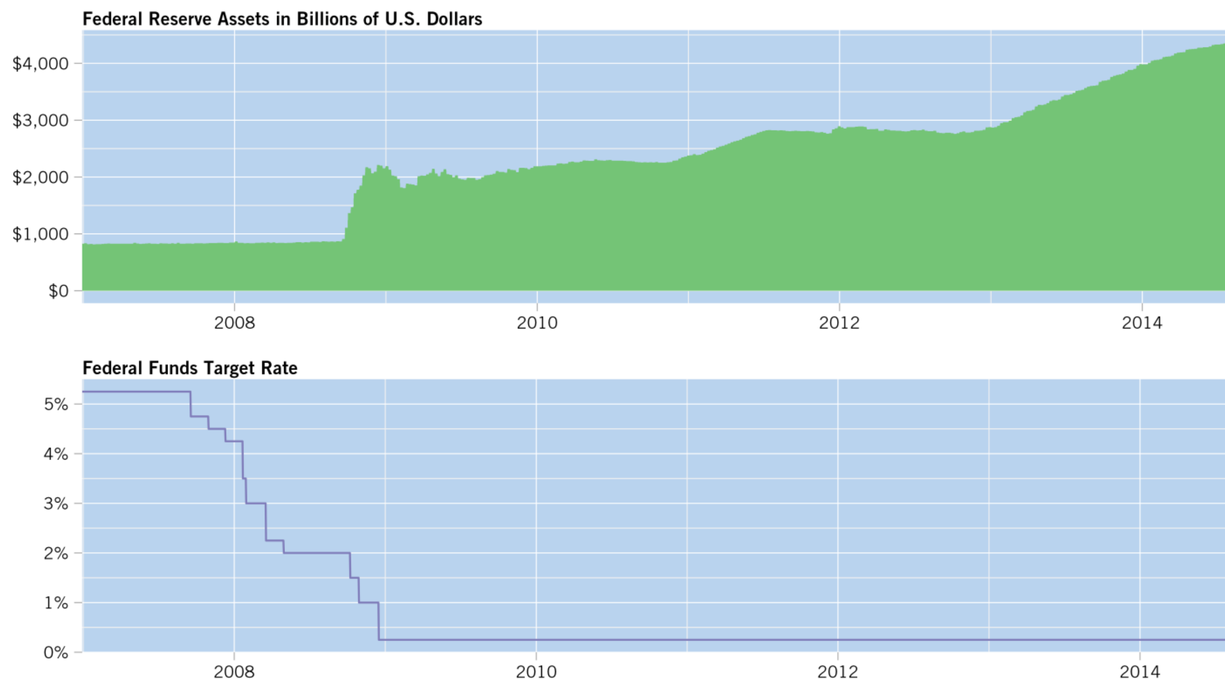
Ideology over Economics

Per our count, no genuinely growth-friendly fiscal policies exist or have been initiated in the past decade. Rather, most all such endeavors effectively have thwarted sustainable organic growth. And the depths to which etiquette and cooperation in Washington have fallen ensure the near impossibility of any dissimilar result in the medium term. With no fiscal policy guiding a proper course to growth, the Federal Reserve has become the leader of last resort. In light of this void of governance, and against the presently confounding macroeconomic backdrop, the Federal Reserve has resorted to increasingly "creative" efforts to execute against its dual mandate to promote maximum employment and stable prices.

As this creativity has intensified, systemic risk has increased. And yet these unorthodox strategies have produced little in the way of a sustainably positive impact on the real economy in terms of economic growth, full-time employment, employment participation, wage growth, consumer income and consumer spending.

Classically, the Federal Reserve sought to achieve its dual mandate through the indirect management of the federal funds rate, the rate Federal Reserve depository institutions charge each other for overnight loans. By exerting control over the amount of excess reserves in the system—by conducting open market operations; modulating the discount rate (the Fed's rate for overnight loans, set above the fed funds target); and varying reserve requirements—the Fed can seek to control short-term interest rates.

Figure 1: Reflections of the Fed's Unprecedented Creativity



From 12.29.06 to 08.14.14. SOURCE: Innealta Capital using data from Thomson Reuters Datastream

The effects of these efforts normally propagate through the financial system in a predictable way, enhancing liquidity in lean times and restraining liquidity in times of excess. But these are no normal times. Critically, the transmission mechanism depends on reserves moving between the banking system and the real economy. That transmission largely has been broken since 2008, when the Fed, in a panic, mistakenly exhausted the fed funds targets to zero. The results have been increasingly desperate attempts to stoke animal spirits among the masses in a faulty belief that greater wealth (as measured, in the end, by increasing risk-asset valuations) would promote macroeconomic growth.

Instead of specific actions that can be directly connected to specific results, the Fed in its desperation has sought to coach the broader populace into a perceived-wealth-induced spending frenzy. Trouble is, not a broad enough swath of the public has bought into that head-shrinking mumbo-jumbo. And even if a required supermajority was confident in the Fed's new role as Market Psychiatrist, most could not have benefitted from that belief...ownership within the capital markets is simply too narrow to find the resulting boost to wealth worthy of an increase in marginal spending.

We like to actually think better of the Common Intelligence, at least as it exists outside the confines of Wall Street. Perhaps the supermajority understands all too well that the Fed's experiment with expectations management and strong-hand capital-market control will see no safe passage to normalization. Rather than the peaceful denouement of crisis-time strategies the Fed presently foresees, perhaps the broader masses believes there's no nonviolent end to this story.

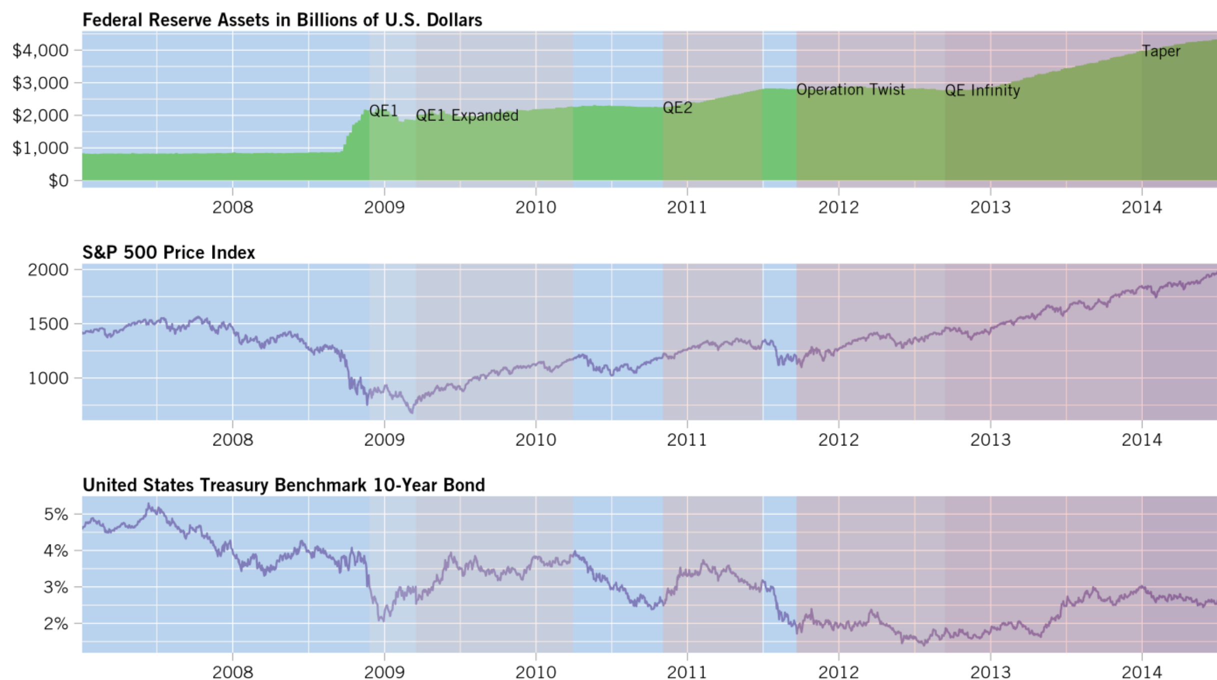
Federal Reserve vs. Capital Markets

Never has the Fed so aggressively inserted itself into the day-to-day operations of risky assets. Neither ever have its peers: the European Central Bank, the Bank of England and the Bank of Japan. The assertiveness has bred a confidence that exceeds hubris. In turn, the capital markets have bowed in complete faith in the ability of the Fed to deliver sustainable growth, evidence of which is mixed at best. This dynamic has meaningfully thwarted the capital markets' price discovery capabilities. As a result, capital markets have become less efficient and policy makers and corporate managers have avoided the discipline that price discovery normally imposes.

Meantime, the Fed's work has perverted investor preference away from income-generating asset classes toward risky assets, thereby exacerbating the overall riskiness of asset allocations. Indeed, due to negative real interest rates, capital preservation strategies are now effectively wealth destroying.

By these activities and the resulting effects on market psyche, the Fed has boxed itself into a no-win scenario. Markets have violently reacted to any change in Fed-manipulated expectations. The Fed, in turn, has back pedaled and in some cases even doubled down. Having thus ceded the power to surprise to the markets, the Fed has lost its ability to maintain and project independent thought and action. One now must wonder, "Who is leading whom?"

Figure 2: Fed Leads or Follows?



From 01.03.07 to 08.08.14. SOURCE: Innealta Capital using data from Thomson Reuters Datastream

Federal Reserve Hypocrisy

What's laughable is the Fed's contention that any concerns in regard to capital market riskiness have been confined to leveraged loans and lower-rated corporate debt, with a nod toward overvaluation among smaller, social media and biotechnology firms. Confusing, too, the Fed's concerns about historically low volatility, when they are solely responsible for this outcome. Indeed, the Fed and its peers have so distorted the beta vs. duration vs. commodity relationship that well-functioning multi-asset-class portfolios are being abandoned in a belief that they "no longer apply." The magnitude of systemic risk owing to this policy is enormous and worthy of investor caution as the Fed now seeks to manage its way out of its own messy creation.

Fed Communications

An increasing cuteness in Fedspeak is part and parcel to this process. We more often hear terms like "macro-prudential policy," nomenclature implying that historical policies were not prudent, or at least not as prudent as those of today's Fed. Leaves us wondering...do the capital markets now require more psychologically sensitive terminology to retain confidence in monetary policy? Do Fed governors follow a well-choreographed marketing plan in an effort to test market ideas? Do Fed governors purposefully divulge conflicting concepts in order to give the Fed as much latitude as possible?

Monetary Policy and Exogenous Risks

The power of the new process, posture and rhetoric can be seen no more clearly than in the capital markets' reactions to increasingly violent confrontations on the geopolitical front. To name just a few—Russia, Ukraine, Syria, Gaza, Iraq, Libya, Nigeria, China Sea—numerous now mostly regional geopolitical risks are capable of mushrooming into global problems. The potential economic impacts are non-trivial, but other than an occasional blip in valuations they seem to be largely ignored. How about natural disasters? Terrorism? What happens to market valuations in the event of an exogenous disruption? Will any of these trigger significant value adjustments? When will real economics catch up with the distortions? Ever?

Risk Management

Perfect hindsight (as painful as it sometimes is) should not cloud investment objectives, as risk management remains every bit as important as the generation of positive return. With fiscal policy among developed nations ranging from vacant in the U.S. to mostly deleterious in Europe, monetary policy is the only game in town, still very much seen as the panacea for all illnesses. We remain highly concerned of the impact to capital markets when the Fed pulls the dice and heads home. Within this context, Innealta believes the *objective* assessment and management of financial risk is arguably the most important objective in the present market environment. The quantification of opportunity costs across the expected risk-return spectrum will be vital to wealth preservation and growth and remains core to the ongoing work of the Innealta Investment Committee.

PRESENT POSITIONING

The Committee maintains careful watch of all existing potential beta exposures, while engaging regular, comprehensive reviews of fixed income allocations and opportunities. As we head further into 2014, with the end of QE tapering near and the market's focus turning increasingly to rising interest rates, we foresee tactical opportunities becoming more frequent as risk-market volatility rises. Meantime, to the extent any more rapid shifts in the term structure create opportunity to alter fixed exposures to a more optimal yield/duration dynamic, the Investment Committee stands ready to do so.

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.

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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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