Innealta CAPITAL SPECIALISTS IN ACTIVE MANAGEMENT OF ETF PORTFOLIOS

June 2017

EARNINGS, TRUMP TRADES, AND EMERGING MARKETS

KEY TAKEAWAYS

- U.S. corporate earnings have exceeded expectations and are on pace for the highest year-over-year earnings growth since Q3 2011.
- Investment themes tied to the passing of U.S. fiscal and monetary reforms, such as Financials and Industrials, continue to underperform during 2017 and are approaching opportunistic, asymmetric levels.
- Recent volatility in Brazil, an emerging market country, highlights the fact that some investors overreact. Investors should focus on fundamentals, not headlines.
- Emerging Markets remain attractive compared to Developed Markets based on valuation. Additionally, these markets exhibit a lower correlation to U.S. equity markets.

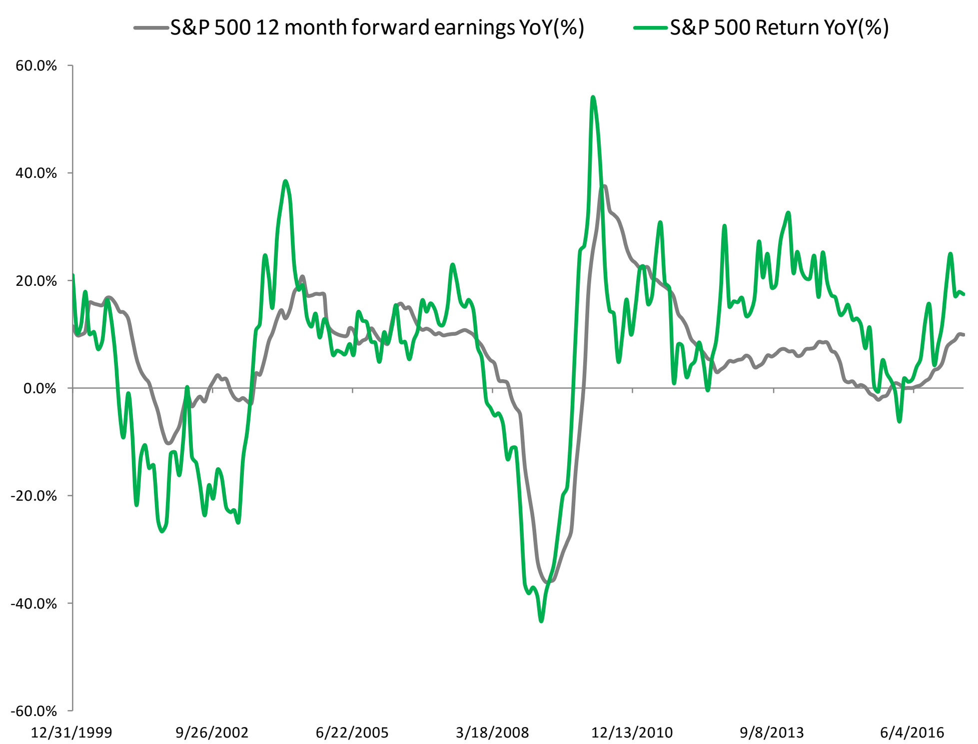
EARNINGS

Throughout April and May, the Q1 2017 corporate earnings were the market's focal point as results exceeded expectations. As of this writing, 98% of S&P 500 companies reported corporate results with 75% beating mean EPS and 64% beating mean sales estimates. Growth compared to last year also improved. The blended earnings growth rate was 14.7%, the highest year-over-year earnings growth for the index since Q3 2011, and the blended sales growth rate for Q1 2017 is 7.9%. At the beginning of the reporting season, the expected EPS growth rate was 9.0%. The positive news from earnings helped to support the performance of the overall U.S. equity market. Shown in figure 1 is the rolling year-over-year change in twelve-month forward S&P 500 earnings expectations and S&P 500 performance. Earnings expectations appear to be highly correlated to S&P 500 performance and vice versa (66%). The strong corporate results and the increase in forward earnings expectations have helped support the 17.7% one-year performance (as of 05.31.2017) of the S&P 500.

Figure 1

CHANGES IN S&P 500 EARNINGS EXPECTATIONS AND S&P 500 PERFORMANCE

Source: Innealta Capital using Bloomberg data from 12.31.1999 to 05.31.2017 with monthly frequency. Rate of change for each time series calculated using a rolling 12-month window.



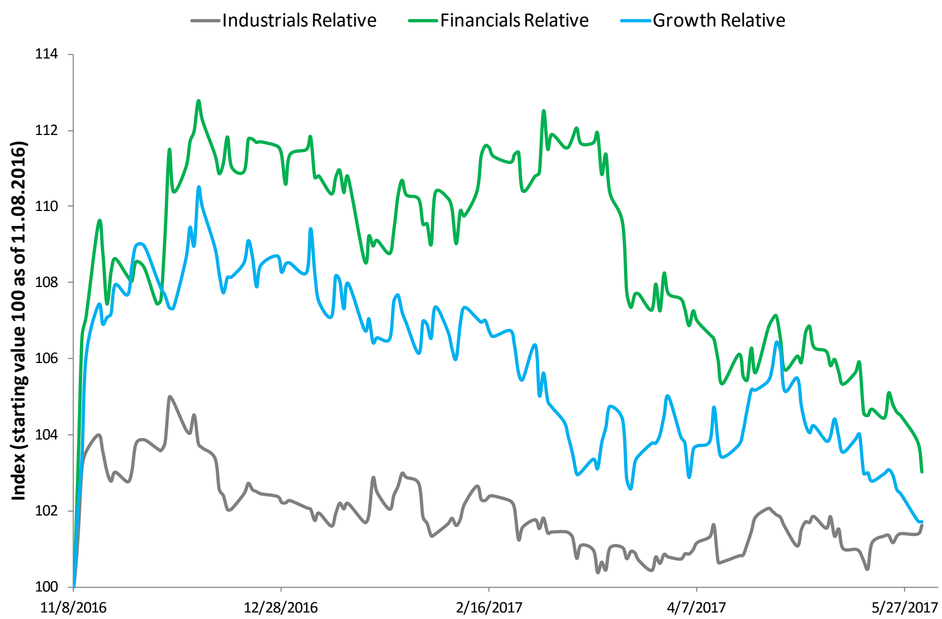
TRUMP TRADES

As earnings were the bright spot in data during May, popular investment themes that hinge on fiscal and monetary reforms, known as "Trump" trades, continue to deteriorate as concerns that Trump reforms will take longer to materialize. In particular, the likelihood that the U.S. Congress will enact infrastructure, tax, and financial reforms before year end has declined. Figure 2 shows the performance of the S&P 500 industrial sector relative to S&P 500, the S&P 500 Financials sector relative to the S&P 500, and the Russell 2000 relative to the S&P 500. We use the first two time series as proxies for the infrastructure and financials reforms respectively while the third time series is a proxy for growth. Theoretically, an infrastructure spending bill would strengthen the Industrials sector and a reform of the Dodd-Frank bill would likely improve financial companies' return on assets. Cumulatively the infrastructure spending, financials reforms as well as other reforms not mentioned in this writing would theoretically stimulate growth. Relative performance increased dramatically following the U.S. presidential election; however, since the start of 2017, each theme has underperformed. In the case of financials and growth proxies, these themes have almost entirely retraced move from November and are now offering increasing asymmetric opportunities to potential reforms.

Figure 2

RELATIVE PERFORMANCE OF POPULAR "TRUMP" TRADES

Source: Innealta Capital using Bloomberg data from 05.31.2016 to 05.31.2017 with daily frequency. "Industrials relative" refers to the ratio of the S&P 500 Industrials Index to the S&P 500. "Growth relative" refers to the ratio of Russell 2000 to the S&P 500. "Financials relative" refers to the ratio of the S&P 500 Financials Index to the S&P 500. All ratios indexed to 100 as of 11.08.2016.



EMERGING MARKETS

Within global equity markets, the major story during May occurred in Brazil. On Wednesday, May 17th, 2017, allegations surfaced that Brazilian President Michel Temer attempted to bribe a jailed, former congressional leader. The previous Brazilian President, Dilma Rousseff, was removed from office via impeachment less than one year ago. When trading opened on Thursday, May 18th, 2017, the Brazilian Bovespa index closed down -8.80% in local terms, and the Brazilian Real depreciated relative to the U.S. dollar by -7.1%. The combined effect to Brazilian equities owned in US dollars was a decline of approximately 16%. Since May 19th, 2017 through the end of the month, the Brazilian Bovespa, in USD terms, has returned 5.6%. Within various Innealta portfolios, we used the market volatility created around the Brazilian presidential corruption allegations to increase that desired Emerging Market exposure. Despite all of the uncertainty within the US and Brazilian executive offices, it is important to remember that one person does not define an economy and in the case of the Brazil, the macroeconomic data and the potential fiscal reforms appear supportive of future growth.

LOOKING FORWARD

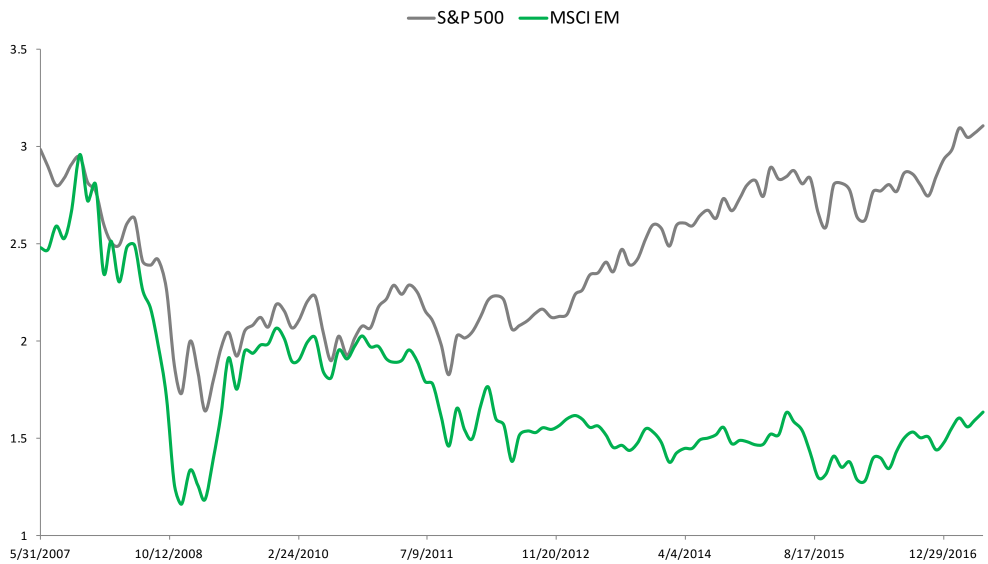
Heading into June, we maintain our view on the attractiveness of Emerging Markets relative to Developed Market assets for three key reasons. First, Emerging Market economies have higher population growth, 1.4% annualized from 2005 to 2015, compared to Developed Market Economies, 0.9% annualized from 2005 to 20151. Assuming that population growth is directly related to labor growth, and increasing labor growth increases the gross domestic output of a given economy, then an equity investor would prefer to own higher growth, all other things being equal. Second, the equity markets of the individual, Emerging Market countries exhibit a lower overall correlation to the S&P 500 index compared to equity markets of the individual Developed Market countries. This fact suggests that equity markets from Emerging Market countries could provide a portfolio diversification benefit. Finally, as shown in Figure 3, the valuation gap between Emerging Market equities and U.S. equity markets remains compelling.

Shown in figure 3 is the price-to-book ratio, a widely used valuation metric, for both the S&P 500 and the MSCI Emerging Market index rolling through time. The valuation gap has continued to widen since late 2010 and is currently at the most stretched level over the past ten years. Valuations alone, however, do not tell the complete story as one should consider whether profitability has changed.

Figure 3

EVOLUTION OF VALUATION GAP BETWEEN S&P 500 AND EMERGING MARKET EQUITIES

Source: Innealta Capital using Bloomberg data from 05.31.2007 to 05.31.2017 with monthly frequency.

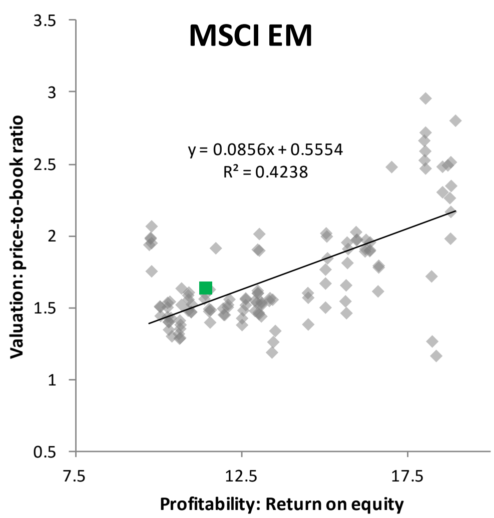


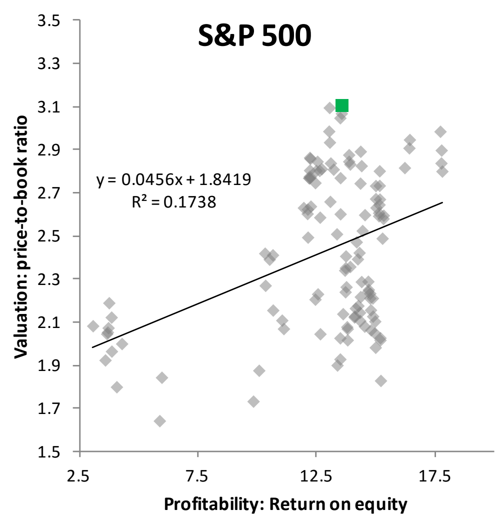
In Figure 4, we compare the price-to-book ratio (valuation) versus the return on common equity (profitability) of the MSCI Emerging Market index and the S&P 500 index. The green dot in each graph represents the values as of 05.31.2017. The relationship in each graph empirically shows that as profitability has increased, so has valuations. In our opinion, this makes economic sense. The graphs also highlight a significant divergence. In the MSCI Emerging Market case, the current value is only slightly above the best-fit line. However, in the S&P 500 index case, the current value is significantly above the best-fit line. Said differently and based only on the empirical relationship between valuation and profitability, the MSCI Emerging Market index is neither over- nor undervalued while the S&P 500 is significantly overvalued.

Figure 4

VALUATION VERSUS PROFITABILITY FOR MSCI EMERGING MARKET AND S&P 500

Source: Innealta Capital using Bloomberg data. Time frame 05.31.2007 to 05.31.2017 with monthly frequency. Values for price-to-book ratio and return on equity represent trailing twelve-month values.





SUMMARY

Despite the current low volatility in financial markets, we continue to find attractive opportunities. The strong results from U.S. corporate Q1 earnings and the increasing expectations of future earnings helped to support the year-over-year performance in U.S. equity markets. Within U.S. equity markets, “Trump” investment themes continue to underperform in 2017 despite a strong performance in 2016. Outside of U.S. markets, volatility in Emerging Markets provided an occasion to increase our overweight, and we remain convicted in our preference for Emerging Market assets relative to Developed Market assets.

IMPORTANT INFORMATION

The information provided comes from independent sources believed reliable, but accuracy is not guaranteed and has not been independently verified. The security information, 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.

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Chart Definitions

S&P 500 refers to the S&P 500 Index (Large Cap Equity), which 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. **Industrials** refers to the S&P 500 Industrials Index, which comprises those companies included in the S&P 500 that are classified as members of the GICS industrials sector. **Financials** refers to the S&P 500 Financials Index, which comprises those companies included in the S&P 500 that are classified as members of the GICS financials sector. **The Russell 2000 Index** (Small Cap Equity) measures the performance of the small-cap segment of the U.S. equity universe and is comprised of the smallest 2000 companies in the Russell 3000 Index. **The MSCI Emerging Markets Index** captures large and mid cap representation across 23 Emerging Markets (EM) countries.

It is not possible to invest directly in an index.

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191-AFAM-6/2/2017

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