



FAILING THE INTUITION TEST

For all the applauding of central bank efforts around the globe to stimulate growth, we can only offer the reminder that excess debt and unsustainable spending are among the exact stresses that wrought the Financial Crisis. To believe that more of the same policies will lead us to a different destination this time around is pure folly.

We stand at a very precarious juncture in capital markets. A brewing stew of potent toxins—struggling global macroeconomic growth, competitive central bank policies, roiling geopolitical tension, haunting humanitarian crises, inundating refugee flows and escalating anger and rhetoric among increasingly hostile political factions—threaten to upend the “stability” achieved by securities markets, many of which now are rich-to-strenuously overvalued as a result of global central bank policy that quixotically has sought to spark real growth from feigned wealth.

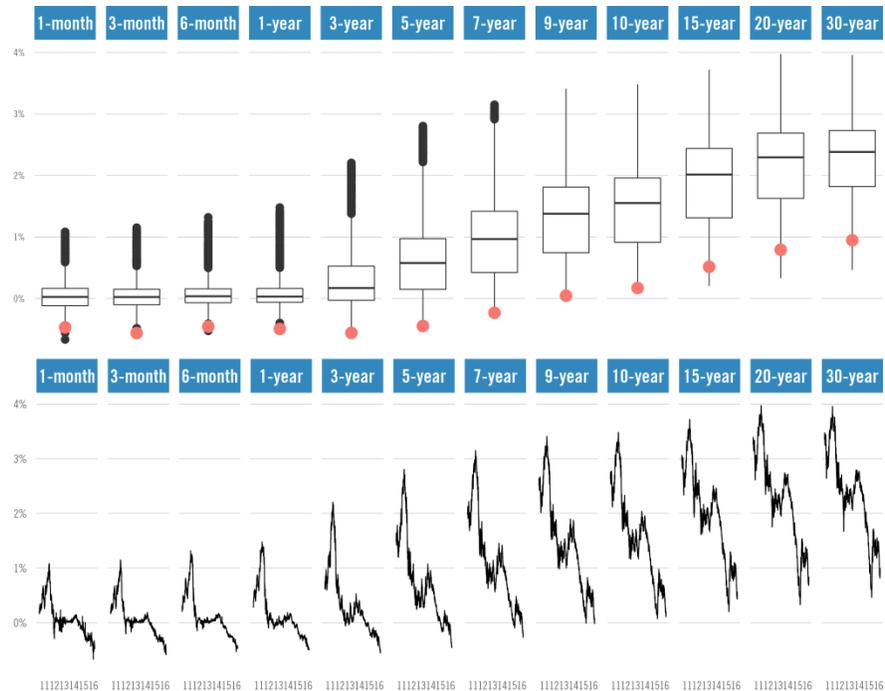
These desperate times are breeding even more desperate measures. The first day of March, Japan sold 10-year bonds at a negative yield for the first time and, as we show in Figure 1, negative yields among German bunds have extended out to nine years. In fact, exploring the holdings of a widely used international bond ETF (Vanguard Total International Bond ETF: BNDX¹) we see that nearly a third of the portfolio showed a negative yield to maturity at the end of February 2016, while more than two-thirds of the portfolio showed a yield to maturity less than 1%. The Federal Reserve, too, is pondering negative interest rates; yet another entirely unremarkable aspect of the present upside-down policy world. Even if somewhat of a growth salve in the near term, we believe negative rates ultimately will leave the world poorer, worse off than before.

¹ Data provided by Bloomberg. BNDX tracks a currency-hedged version of the Barclays Global Aggregate ex. USD index. The index provides a broad-based measure of the global, investment-grade and fixed-rate debt markets, including government, government agency, corporate and securitized non-U.S. investment-grade fixed income investments, all issued in currencies other than the U.S. dollar and with maturities of more than one year.

FIGURE 1

German Bunds: Key Rates Through Time

From 06.14.10 to 03.03.16. Red dots denote latest values. SOURCE: Innealta Capital using data from Bloomberg



THEN AGAIN...

Even so, we must accept the fact that continued central bank generosity might be exactly what capital market participants want. And want so badly that it is almost assuredly what they will receive. That potential leaves the Innealta Investment Committee balancing caution and opportunism. Many areas of the historically more gracious and genteel fixed income markets are now grumpy, stingy or worse. Credit spreads remains volatile, while yields outside of the credit space are generally unkindly weak. This is particularly true among international bonds.

In this environment, we are mindful that financial markets have temporarily departed from fundamentally based valuations and our investment framework is putting an increased emphasis on the very nature of those departures. For example, we continue using metrics such as favorable relative momentum, valuation levels and trends, among others to inform our tactical trades. We remain truthful to our fundamentally driven view of the markets, and we also recognize that as tactical managers we must adapt to this unusual period driven by irresponsible central bank policies.

In this new policy-driven world, we will see more abrupt fluctuation in prices. This increased volatility may be harmful for many traditional portfolios with impatient investors. However, tactical managers face a somewhat unique opportunity to prove their worth.

LEANER TIMES...

The consequence of global monetary policy trends is that expected returns for all asset classes are lower, given the combination of generally stretched equity valuations (future growth already paid for) and sparing yields. We believe that consumers may be more aware of this fact than central bankers give them credit. These consumers—that monetary policy makers are so stridently seeking to force into consumption-oriented abandon—are rightfully focusing on the increasingly difficult task of securing long-term funding needs. In what ways does it make sense to penalize savers, forcing them to spend monies they otherwise would set aside for long-term spending requirements, such as education and retirement?

We believe that further yield repression is more likely to spur even greater caution, working against any growth-spurring intentions. And, who knows what will happen if banks actually begin to pass negative rates on to customers? We imagine the outcomes to prove exclusively negative. If not entirely in the short term, then almost assuredly in the long term as the astoundingly weak yield environment leaves many nest eggs far smaller than they otherwise might have been, with the associated long-term social support costs far outpacing any near-term aggregate gains in growth.

..BUT MORE OPPORTUNITIES AHEAD

Our portfolio has in the last few months benefited from this enhanced price volatility and has found positive returns where others may have failed. For example, as of the beginning of March, we find ourselves with moderately boosted equity exposures across the two Rotation Portfolios relative to the beginning of the year; this shift so far has proved beneficial in terms of benchmark-relative performance.

The Investment Committee remains ever mindful of the range of risks and opportunities in fixed income and equity markets and continuously aims to find the right mix to help clients achieve their investment goals. Our more active tactical approach together with our core strategic allocations provide a mix that, we believe, is optimal for this volatile environment.

IMPORTANT INFORMATION

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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.

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 ETF 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.

The MSCI All Country World Index Ex-U.S. is a market-capitalization-weighted index designed to provide a broad measure of stock performance throughout the world, with the exception of U.S.-based companies. It includes both developed and emerging markets. The S&P 500 Index is S&P's broadbased market index representing a sample of leading companies in leading industries. A person cannot invest directly in an index. Blended benchmarks are rebalanced quarterly.

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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