



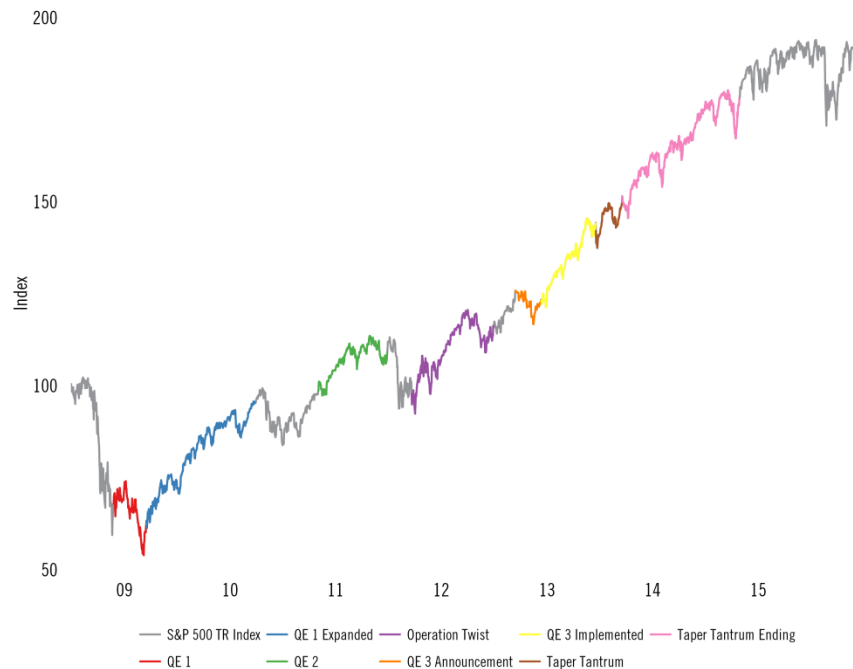
## INTEREST RATE REGIMES AND INTERNATIONAL EQUITY PERFORMANCE

Since 2008, the Federal Open Market Committee (FOMC) has maintained one of the most accommodative monetary policy regimes since the Federal Reserve Board began open market operations in the 1920s. The Fed's unprecedented efforts, in our view, have contributed to the third-longest bull market in the S&P 500 Index's history, resulting in a period that ranks among the richest in terms of equity valuations on record. Waning global macroeconomic and corporate fundamental growth are likely to worsen the extreme. The path to normalization...of monetary policy and equity market valuations...is thus likely to prove long, slow and treacherous.

FIGURE 1

### Quantitative Easing Programs: S&P 500 Performance

As of 11.30.15. Indexed to 100 on 06.30.08. The color of the S&P 500 index line denotes the Federal Reserve program in effect. SOURCE: Innealta Capital using data from Bloomberg



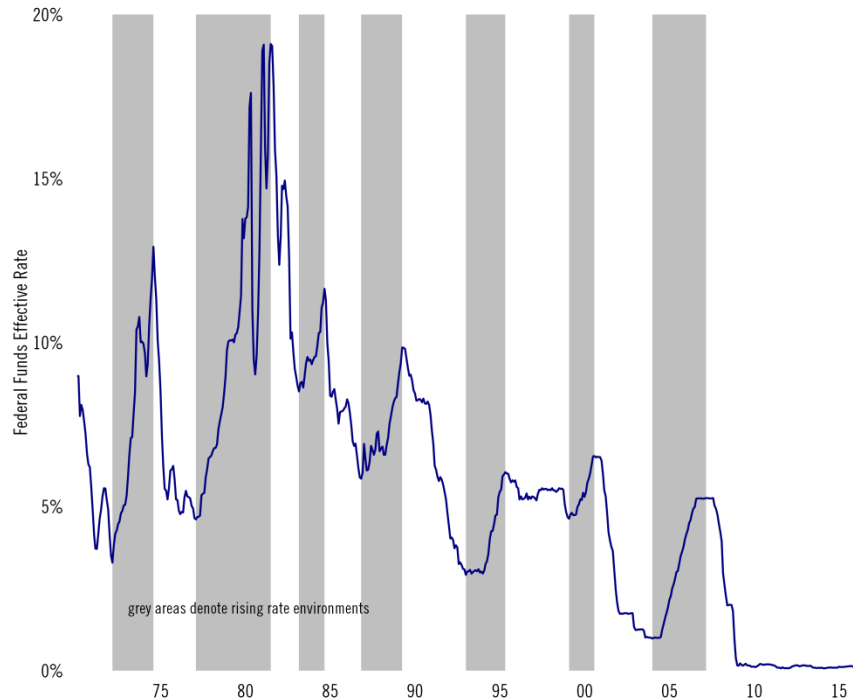
The Innealta Research Team recently reviewed the effects of rising interest rates on global equity markets to identify trends in international equity markets during periods of rising domestic interest rates. While rising interest rate environments are often associated with an improving domestic economy, the knock-on effects of shifts in Federal Reserve policy can be less clear for international equity market performance.

We define a period of rising rates as an increase in the U.S. Federal Funds Effective Rate of 1.25% or more over at least a 12-month period. Similarly, falling rate environments are defined as a 1.25% or larger decline in the Effective Fed Funds Rate over at least 12 months. Figure 2 identifies periods of rising domestic interest rates since 1970.

**FIGURE 2**

**Long-Term Rising Rate Environments**

From 12.31.69 through 11.30.15. Rising rate environments are defined as periods where the Federal Funds Effective Rate rose at least 1.25% over one year or more. Falling rate environments are defined as periods where the Federal Funds Effective Rate fell at least 1.25% over one year or more. SOURCE: Innealta Capital using data from Professors Eugene F. Fama and Kenneth R. French, and Bloomberg

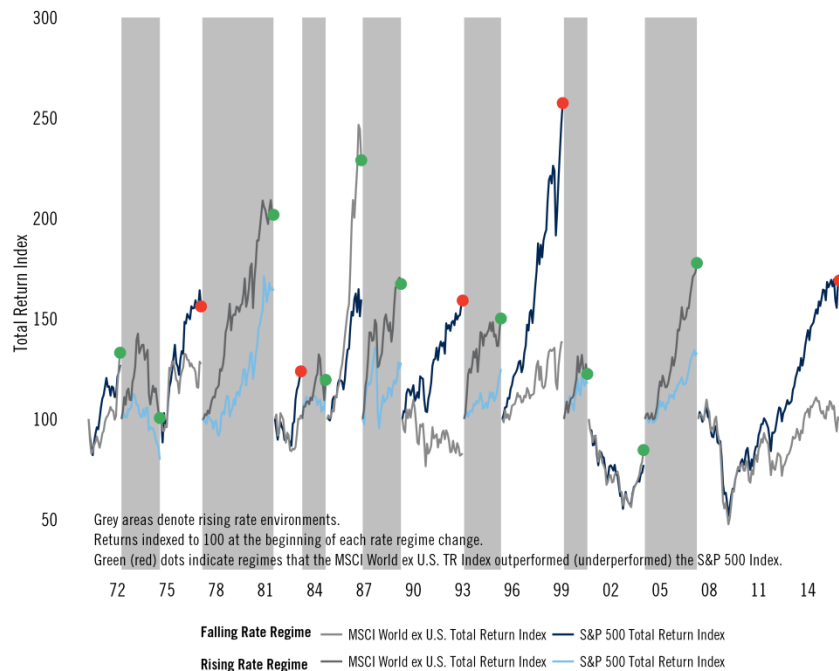


Having identified periods of rising interest rates, we can examine the equity performance across different environments. In Figures 3 and 4, we indexed returns at the beginning of each rising and falling rate period to 100, and observe that broad-market domestic and international returns vary substantially depending on the direction of the federal funds effective rate.

**FIGURE 3**

**Rate Regime Relative Equity Performance**

From 12.31.69 through 11.30.15. Index performance is presented as excess total return. Rising rate environments are defined as periods where the Federal Funds Effective Rate rose at least 1.25% over one year or more. Falling rate environments are defined as periods where the Federal Funds Effective Rate fell at least 1.25% over one year or more. SOURCE: Innealta Capital using data from Professors Eugene F. Fama and Kenneth R. French, Morningstar and Bloomberg



In *rising* rate environments, the MSCI World ex U.S. Index tends to outperform the S&P 500. The exact opposite is true during periods of *falling* interest rates: domestic equities historically outpace international stocks. These findings may have profound implications for an investor's portfolio. Figure 4 summarizes the performance of these mutually exclusive

environments since December 31, 1969. The table sheds light on the fact that rising rate environments can present challenges for U.S.-centric investors. However, one can potentially take advantage of temporary price misalignments with tactical asset allocation through selection/rotation of countries included in the international allocation of a portfolio.

**FIGURE 4**

Summary Return Statistics	Interest Rate Environment	Months Count	S&P 500 Index Excess Annualized TR	MSCI World ex. U.S. Index Excess Annualized TR
	Rising	216	2.67%	10.98%
	Falling	335	9.21%	2.05%
	Difference		-5.97%	8.41%

From 12.31.69 through 11.30.15. Index performance is presented as excess total return. Rising rate environments are defined as periods where the Federal Funds Effective Rate rose at least 1.25% over one year or more. Falling rate environments are defined as periods where the Federal Funds Effective Rate fell at least 1.25% over one year or more. SOURCE: Innealta Capital using data from Professors Eugene F. Fama and Kenneth R. French and Bloomberg

## INTEREST RATE OUTLOOK

With the Federal Reserve having in December finally shifted direction in terms of the Board's federal funds rate target, the course of rate history has turned. This change will mark a new era as rates in the U.S. and elsewhere have been heading in the opposite direction for long enough to consider it as much. Even so, the Innealta Investment Committee does not expect this new era to prove any less uncertain from a policy standpoint, in particular given more recent macroeconomic leading indications. With industrial output sagging along with new orders for future output, amidst a still weakening global backdrop, we expect rates rises from here to prove deliberately hesitant and slow. Much will rest on the ability of developed markets to pull the world out of the doldrums.

The Investment Committee does not expect those trends to change dramatically anytime soon. Uncertainty in regard to global macroeconomic growth remains high, with a negative bias in the near term. These uncertainties will continue to pressure the Federal Reserve to step very lightly on the path to normalization, with the upshot being enhanced volatility in the capital markets.

As we head into 2016, there should be no sign of relief from any change in approach to monetary policy. We believe the evolving dynamic of divergence among central bank policies will provide a new source of market instability as capital flows seek an optimal course. In that environment, we will continue to monitor our exposures to try to achieve the optimal risk-reward. With capital gains weighted by relatively rich valuations in so many markets, developed-markets equities in particular, we will seek to position portfolios to favor relatively stronger yield production, while still taking care to choose our beta and credit exposures with the evolving macro dynamic in mind.

It would not surprise us were heightened equity market volatility to present additional tactical beta opportunities in the New Year, especially as we saw another year of significant divergence among major regional markets, which alleviated some valuation pressures in specific pockets around the world. We expect fixed income markets to remain unsteady, too, as capital market participants address shifts in relative safety and opportunity in what we expect will prove an environment of relatively rapid change. And on that front, we too expect to endure a moderate greater amount of volatility in our portfolios as such shifts in investor sentiment may move against portfolio exposures in the near term, even as we maintain them for their longer-term risk-reward potential.

## 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.

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