JUSTIFICATION WANTED

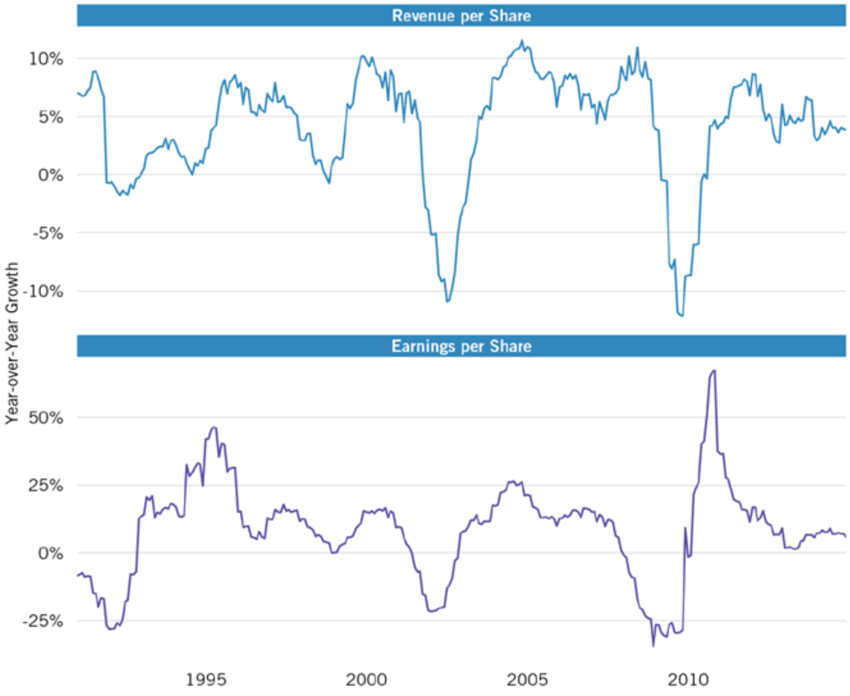
Over the past several years, with each passing disappointment—and there have been many—commentators mostly have assured us that more recent data posit an improving trend and that, since markets are discounting mechanisms, to worry about the past is a waste of focus and effort. Readers know that we have been skeptical of the confidence investors have placed in the global macroeconomic backdrop and, in turn, equity market valuations. Global growth has been slow and so, too, not so surprisingly has been the expansion in corporate top lines.

Charted in Figure 1 is the year-over-year change in the per-share revenue and earnings of S&P 500 companies. One can see the weak and waning growth in revenue. Earnings growth coming out of this latest recession was comparatively strong, in no small part because the plunge was so steep. Now that much, if not all, of the gains from cost-cutting are had, relatively weak top-line growth has constrained the ability to maintain earnings expansion.

FIGURE 1

Growth in S&P 500 Revenue and Earnings

From 01.31.90 to 12.01.14.
SOURCE: Innealta Capital using data from Bloomberg



The S&P 500 continues to rise nonetheless, and its valuations have soared as a result, surpassing the peak prior to the latest recession and entering into ranges not seen since the pre-2000 tech boom. That observation is supported by Figure 2, which charts the S&P 500 price-to-sales ratio. While we generally prefer to look directly at trend math, one doesn't need any fancier an analysis to see that the broader U.S. equity market is expensive by this metric, even when compared to the relatively richly valued past 25-ish years. And it's getting more expensive more quickly…not the sort of scenario that should warm one to increased broad equity exposure.

FIGURE 2

S&P 500 Price-to-Sales Ratio

Trailing data. From 01.31.90 to 12.01.14. SOURCE: Bloomberg

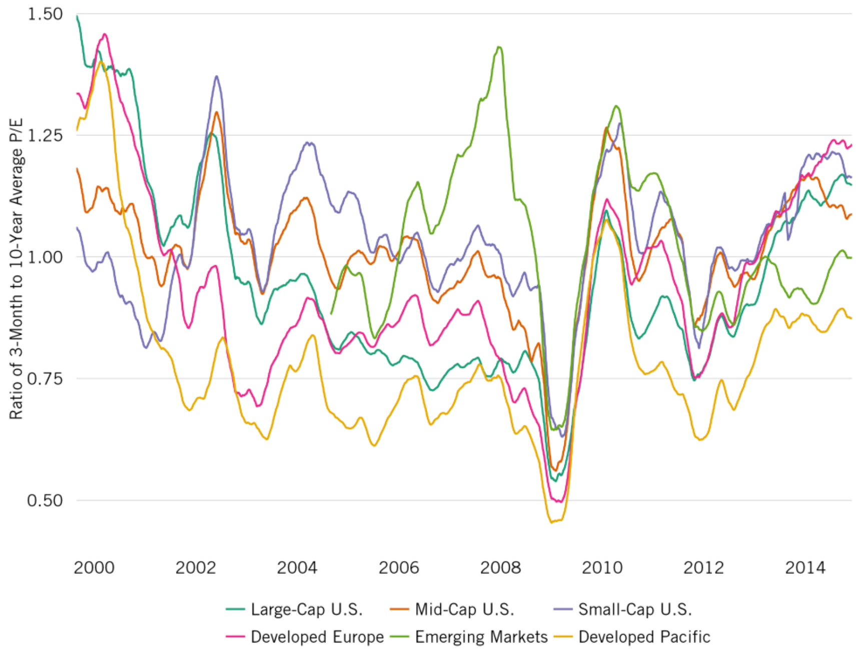
And U.S. large-cap stocks aren't alone in the league of rich valuations. Nearer-term price-to-earnings ratios for a range of developed equity markets are quite stretched relative to their respective averages for the past decade. We chart a few such series in Figure 3, which provides further reason for suspicion in regard to investor enthusiasm for U.S. and developed European equity markets. Conversely, the chart also provides some support for our relatively greater interest in emerging market and developed Asian equities of late.

Or course, these metrics are snippets of a much larger dashboard that informs the Investment Committee's decisions in regard to tactical equity exposures across all Innealta products. That dashboard incorporates a range of metrics within four primary buckets: 1) Fundamental / Valuation 2), Distributional Characteristics / Risk, 3) Macroeconomic and 4) Behavioral / Technical. The framework aggregates an ensemble of signals evaluated in each bucket to arrive at a composite score for each equity market considered. We therefore generally are hesitant to focus on any individual metric as reasons to be bullish or bearish on any individual equity market. Nonetheless, we present these narrow views to suggest that even the starting points for assessments of many developed equity market valuations challenge notions of relative attractiveness. While we remain on constant watch for tactical equity investment opportunities, in our view they remain quite rare, the full content and context of the framework considered.

FIGURE 3

Ratio of Short-Term to Long-Term P/E

Trailing data. From 08.26.99 to 12.01.14. SOURCE: Innealta Capital using data from Thomson Reuters



THANKS AND WELL WISHES

On behalf of the entire Innealta team, we want to express our appreciation and gratitude for the confidence and trust that you have placed in our work and welcome the ability to continue serving your investment needs as we head into 2015 and beyond. Best wishes for a safe and festive holiday season and a grand start to the New Year.

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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.

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