Innealta
CAPITAL

COMMENTARY: MAY 4, 2015

MAKING UP SNOW DAYS

With another first quarter GDP report chock full of excuses for weaker-than-expected growth in the history books, we'll turn to a more interesting year-on-year review for this month's commentary. While more generously positive, and even seemingly trending more so when one considers various views of longer-term trends (one of which we show in Figure 1), we are left wanting more. We find the discourse particularly void of factual, empirically defensible contentions that extraordinary monetary policy has worked. Meantime, metrics that aren't so lagging as GDP tell an even more tempered story for Q2 and the near-beyond. The upshot is that we expect to remain highly discerning in our chosen beta exposures, with as careful an approach to our selection of fixed income allocations, in light of still very strained valuations across much of the capital markets.

FIGURE 1

U.S. GDP Growth

From 03.31.90 to 03.31.15.
SOURCE: Thomson Reuters Datastream

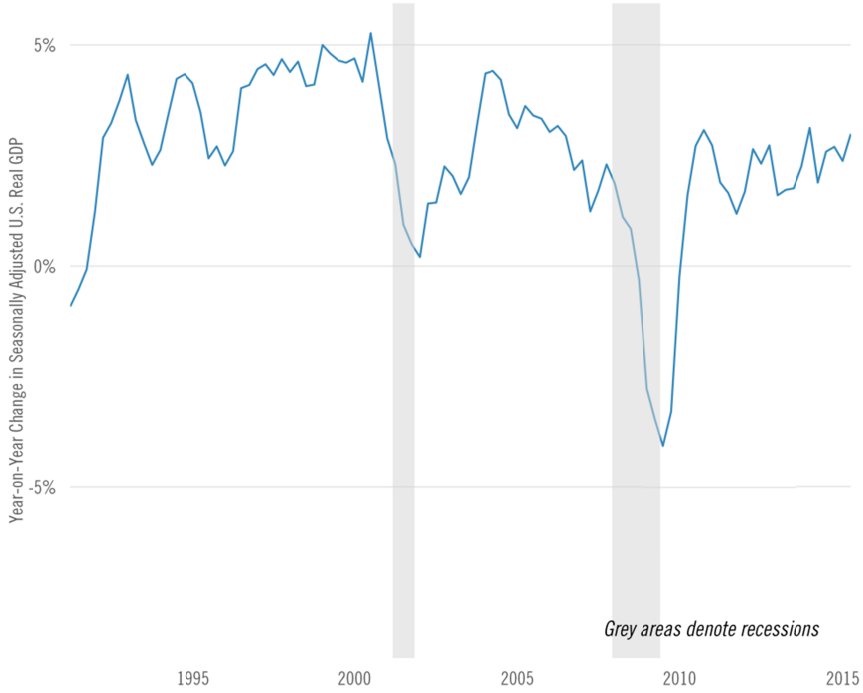
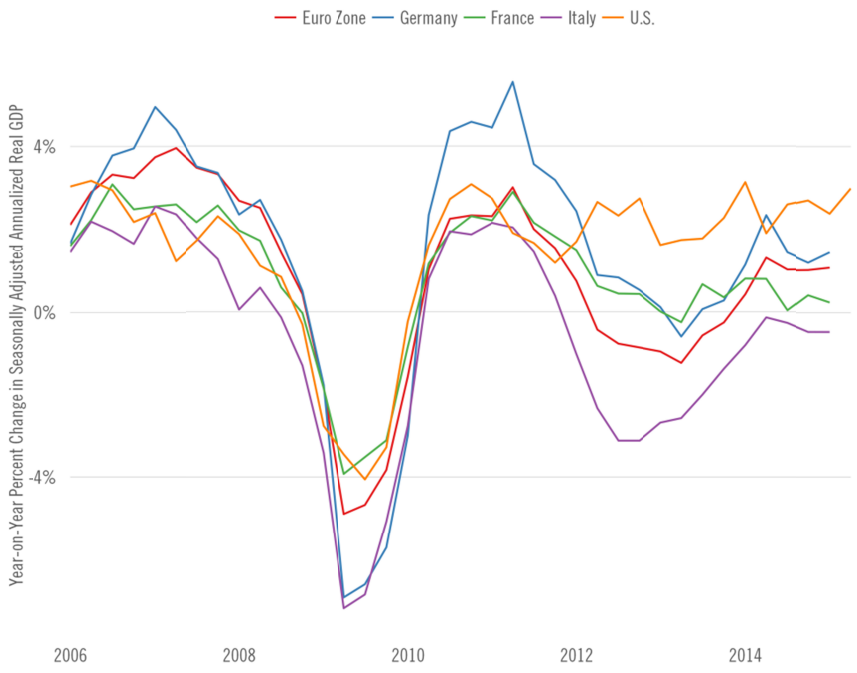


FIGURE 2

Developed Market GDP Growth Rates

From 12.31.05 to 03.31.15.
SOURCE: Thomson Reuters Datastream



The global macro story offers more of the same. Europe is weak and vacillatory (Figure 2), while China is slowing, too, just with more conviction. Most critically, the global growth dynamic suggests continued pressure on U.S. corporate top lines, aggregate growth of which is heading in the wrong direction (Figure 3).

FIGURE 3

Growth in S&P 500 Revenue and Earnings

From 01.31.90 to 04.30.15.
SOURCE: Innealta Capital using data from Bloomberg

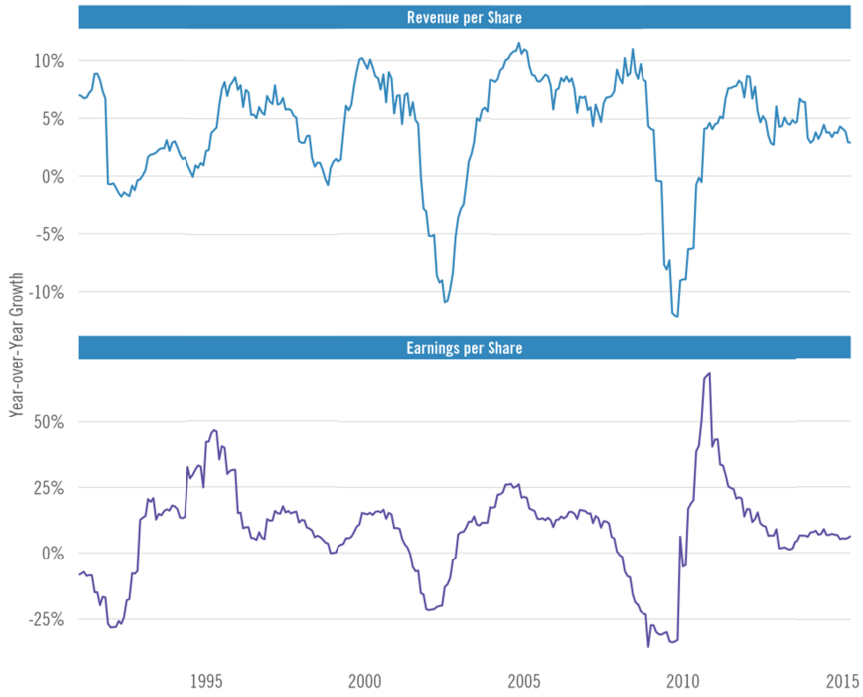
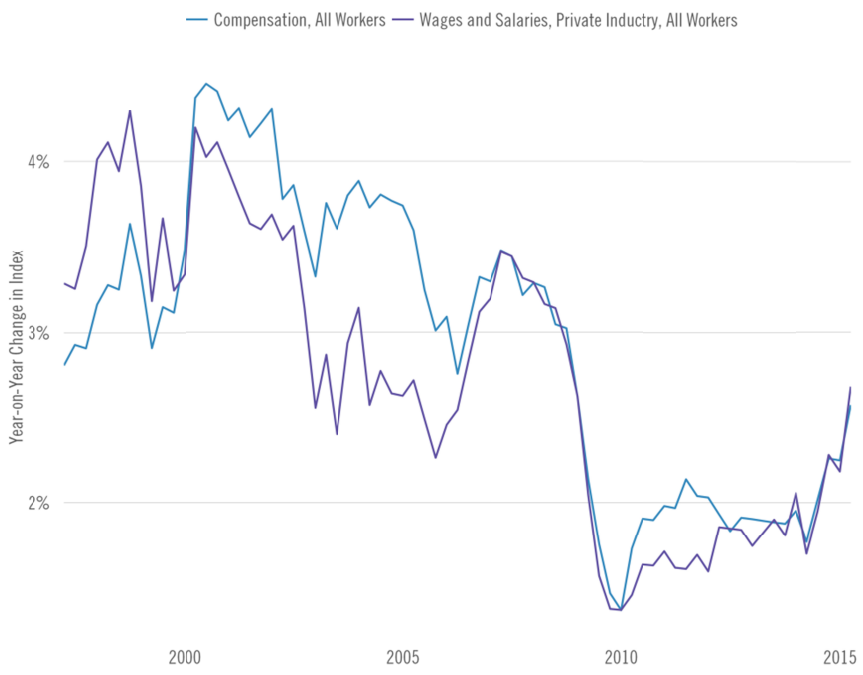


FIGURE 4

Change in Employment Cost Index

From 03.31.97 to 03.31.15. SOURCE: Bureau of Labor Statistics via Datastream



Turning to the bottom line, while the Federal Reserve has been focusing on quickening the pace of inflation in goods pricing, employment costs are showing a demonstrably more powerful trend. Charted in Figure 4, these cost trends are likely to weaken the profit growth story many have been using to support stretched U.S. equity valuations. We have included in Figure 5 a long-term view of the price-to-earnings dynamic (ratio of short-term to long-term values) for the large-cap U.S. equity space, to how express how presently strained is the domestic market by this measure.

FIGURE 5

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

Trailing data. From 08.24.00 to 05.04.15. SOURCE: Innealta Capital using data from Thomson Reuters

Though still historically tame, capital markets this year have continued to demonstrate something closer to their truer natures in terms of volatility. Expectations for shifts in monetary policy in our view will continue to be the primary drivers of capital market trends. Global macro shifts, however, have the increasing potential to disrupt the relative calm, as do still simmering geopolitical tensions. All the while, broadly stretched equity market valuations continue to leave less-than-normal opportunity to add beta. Even so, opportunities should continue to present.

While the Investment Committee continues to monitor the range of exposures available to the Innealta Portfolios for attractive risk-relative return opportunities, the broader stance remains one of conservatism. We expect capital markets to prove challenging in 2015, but we also expect them to present greater opportunities for tactical equity investments as volatility increases.

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