Innealta
CAPITAL

COMMENTARY: OCTOBER 31, 2012

THE EUROZONE CRISIS AND THE EURO

- In our last commentary on Europe (November 2011) we argued that the Eurozone isn't in any sense what economists would consider an *optimal* currency area. Since that time, the region presented volumes more evidence to prove that point, confirming our then (and still...) very negative views. In fact, it has become very clear to us that Europe isn't just sub-optimal, it simply *does not work* as a currency union.
- Given that assessment, in our mind there seem to be but two paths for the future course of the region. Europe can restructure Eurozone membership, the Eurozone itself or even retire the Euro in its current format. Otherwise, the surplus nations (really Germany) must commit to and then follow through with massive capital transfers to the deficit Eurozone nations for a *very long time*. Trouble is, only the first path is possible, in our view.
- Part of any rationally designed experiment must be a plausible set of broad conditions under which the experiment might be considered a success. Outside of mostly illogical arguments suggesting otherwise and an otherwise "for the Greater Good" approach to civic management, the Euro never satisfied that very basic constraint. European governments need to realize that, at some point, additional sacrifice is too much sacrifice for the sake of the Euro's survival. A break-up of the Eurozone in some form or shape would certainly be an enormous challenge and present tremendous difficulties. However, there comes a point when a break-up will be the lesser evil, even considering all manners of cost...macroeconomic, political and civil.
- While a crisis like the current one could be a buying opportunity from an investor's point of view if it is associated with an exaggerated market selloff, we don't believe that either the global equity or debt markets sufficiently reflect the gravity of the current situation in the Eurozone. In fact, we view current equity valuations over there as quite the contrary, a stance very much expressed by reviews of our quantitative framework.
- Even more, we currently don't see the region as attractive from a long-term investment perspective, as European decision makers have demonstrated time and again that they are incapable of sensible crisis management. Instead, they remain dogmatic in their beliefs, oriented towards short-term objectives, and are mostly self-interested in their actions and dealings.
- Readers should trust that monitoring the situation in Europe remains top of tasks. As the scenario shifts, we stand ready to exploit any opportunities that might arise.

A widely held opinion in Europe is that Eurozone nations are now at a crossroads and will have to choose between a dangerous step backward—a Eurozone breakup—or a braver transfer of sovereignty to the greater union. Hopes concentrate on a 'political union,' even when the manner of that union is still unclear. Over the past few decades many different versions of a political union have been discussed, but almost none of them ever had a realistic chance of being adopted unanimously. So the different versions have been watered down to the current hodgepodge of pacifications. And in this marriage, there're devils in all those compromises, that crack, rather than fortify, the very union they are meant to protect.

Nobody should underestimate the nationalism still very present across the European Union. Even now it seems very unlikely that countries such as France would ever vote for giving up most of their sovereignty to the European level. And why should they, given that European affairs have been so badly mismanaged not just by the Eurozone countries but by the European institutions themselves? For this very powerful counterforce alone, more European integration does not seem to be a workable solution. Certainly not in the near or even medium term. Over a very long time, closer-to-ideal political unity might be found. The Eurozone crisis, however, won't wait.

BREAKING UP IS HARD, BUT STICKING TOGETHER...

A Eurozone breakup need not be the end of the world...or even the end of Europe. For the stability and economic success of the European Union, a common currency is not required. A fact supported by each new headline regarding the Eurozone's crisis, the common currency has become a hindrance to the greater goods of economic, political and civil stability.

The European Economic Community (EEC), the predecessor of the EU, was much more suitable for a stable development of all European countries involved than the common currency regime. The EEC allowed exchange rate adaptations as a last resort. One can fault France's hubris for the transition to a common European currency. Even as it envied the strong German Mark, France shied away from fiscal policies that would have strengthened the Franc. That pressure, combined with the then German Chancellor Helmut Kohl's foolhardiness, resulted in the 1992 Treaty on European Union (the Maastricht Treaty), a provision of which was the Euro. So little space was there for sound economics to get in the way of politics and ego.

Many politicians and even some economists lead us to believe that if the Euro fails, so too will Europe. We're rather inclined to believe, however, that the personal failure of the breakup, or otherwise forcefully corrective restructuring of the Eurozone, would be for so many of the architects of the experiment the truer cause for apprehension and delay. So many weaknesses of the structure, long dismissed as unlikely or even impossible hypotheses, have returned to haunt these technocrats, who don't have the courage and honesty to admit the folly of the experiment's design, meantime looking all the more foolish for their ineptitude in handling the crisis that's come of it.

While a union between European member countries involving open borders, political coordination, etc. deliver significant benefits, the common currency has always been problematic. While it facilitates payments and eliminates exchange rate risk within the Eurozone, its drawbacks (as discussed above) far outweigh any benefits. The reasons for this will become clearer in the discussion which follows. So, let us ponder the proposed benefits of maintaining the union, or is it strictly loss aversion (averting the alleged disastrous fall-out)? Loss aversion and hubris seem to be the only answers. No long-term economic reasons exist. Perhaps a fear of change and the transitional turmoil that comes with it? These are unfortunately often more powerful than those forces directing decision makers to do what's right economically and fiscally. It is as true here in the United States as it is in Europe.

COMMON CURRENCY GUARANTEES PEACE AND PROSPERITY?

Historically speaking, the politics and cultures of Europe are far broader than the politics and culture of the EU. As a result, it makes no sense whatsoever to equate Europe's destiny as a whole with the destiny of a currency union. On purely economic grounds one has to observe that about 40% of Europeans do not use the Euro on a daily basis[1] and those EU countries that are not participating in the Euro have experienced much better economic growth and employment since the introduction of the Euro than the Eurozone. Non-Eurozone EU countries have had average GDP growth rates of 2.62% per year since 2004 whereas Eurozone members have only experienced an average GDP growth rate of 1.98% per year over the same period. Also since the beginning of 2004 the average unemployment rate in non-Eurozone EU countries has risen by less than 4%, whereas Eurozone countries have seen an average unemployment rate increase of almost 20%. These crucial developments somehow get lost in the rhetoric of politicians.

After two world wars that originated in Europe, many Europeans (especially politicians) have come to believe that a common currency is somehow a guarantee for peace between the members of the currency union. At first glance, it might seem a tough argument to challenge. Still, there isn't any historical evidence for the presumption. While a common currency might support peaceful coexistence, such calm does not require a common currency, nor does a common currency virtuously define peace. Before WWI, Europe had a *de facto* common currency: the European currencies were linked by the gold standard. There were no exchange rate problems, no differing inflation trends and no country was illiquid. If a stable monetary order was a necessary and sufficient condition for peace, the first world war should never have happened. The U.S. and Spanish civil wars are additional examples. The potential of a common currency to promote peace and prosperity have been (and still are) dramatically overestimated, while the risks have been underestimated. Again, the elected leaders consistently seem to ignore history.

As for prosperity, well, walk a few main streets in Greece, Portugal or Spain and ask around for individual takes on prosperity, either personal or collective.

EVER MORE GUARANTEES AND BAILOUTS

The solution to the Eurozone's perils is often seen in more European integration. And, yet, no one seems to have a clear plan defining what policies such additional integration might entail. Are there benefits to be had greater than simply saving the union? When the Eurozone periphery states "more integration" they generally mean that additional bailouts and guarantees should be for them, thereby limiting the competitiveness of the northern member countries. More integration for the Eurozone periphery means "more solidarity" and a mutualization of all debt among all Eurozone members, in addition to a banking union.

Obviously this type of integration creates a moral hazard problem as incentives to be more disciplined in the future would be diminished even further if not completely eliminated. Such socialization of risk can thus never prove a viable solution. And so Germany and some other more fiscally responsible Eurozone countries believe that "more integration" should mean binding fiscal budgets in order to prevent Eurozone members from exhibiting further fiscal transgressions. But that manner of integration demands a loss of sovereignty that none in need of help seem willing to allow.

[1] http://europa.eu/pol/emu/index_en.htm

SO MANY NON-SOLUTIONS

Even if we can prevent further fiscal transgression via political union, however, we must figure a way to close the gap in the competitiveness that has emerged since the beginning of the monetary union. Compared to Germany, the gap in the competitiveness among the Eurozone's periphery is large. This is according to the Global Competitiveness Index maintained by the World Economic Forum, select relevant measures from which we show in Exhibit 1. A function of the common currency, this competitiveness gap obviously cannot be eliminated by adjustments in currency exchange rates. These gaps have been written about extensively, but the economic magnitude of the imbalances needs highlighting.

Exhibit 1: Eurozone Competitiveness

		Germany	France	Ireland	Spain	Italy	Portugal	Greece
Overall	score (1-7)	5.5	5.1	4.9	4.6	4.5	4.4	3.9
	rank (of 144)	6	21	27	36	42	49	96
Basic Requirements	score (1-7)	5.9	5.5	5.1	5.1	4.8	5	4.1
	rank (of 144)	11	23	35	36	51	40	98
Macroeconomic environment	score (1-7)	5.5	4.6	3.4	4.2	4.2	3.9	2.4
	rank (of 144)	30	68	131	104	102	116	144
Efficiency Enhancers	score (1-7)	5.3	5	4.8	4.7	4.4	4.4	4
	rank (of 144)	10	18	25	29	41	44	69
Goods market efficiency	score (1-7)	4.9	4.5	5.2	4.4	4.3	4.3	3.9
	rank (of 144)	21	46	9	55	65	61	108
Labor market efficiency	score (1-7)	4.5	4.4	5	4	3.7	3.8	3.6
	rank (of 144)	53	66	16	108	127	123	133
Innovation and Sophistication factors	score (1-7)	5.6	5	4.9	4.1	4.2	4	3.4
	rank (of 144)	4	18	20	31	30	3.7	85

SOURCE: World Economic Forum's Global Competitiveness Index (GCI), which measures the microeconomic and macroeconomic foundations of national competitiveness

Simply stated, feasible ideas to close the gaps in the competitiveness do not exist. A lengthy process of deflation in the Eurozone periphery is practically improbable and would hardly be desirable. At the same time, it would be unreasonable and unfeasible for the northern Eurozone members to maintain inflation levels far above what they have seen in recent history in order to subsidize lack of competitiveness in the periphery. The devaluation of German savings, in effect, would finance consumption in the periphery.

And we're back to the origin of the conundrum: to sustain the Euro experiment, extensive further capital transfers will be necessary and the richer Eurozone nations will have to pay for them, regardless of whether the capital comes from savers, national governments or some kind of pan-European fund. This cannot be the solution for the indefinite future and will only meaningfully exacerbate the problems in the long term.

Before the introduction of the Euro, apart from agricultural commodities market interventions and the then very limited resources of the European structural funds, the common market abstained from transfers between member states. Member states benefited from free competition within the European Union. The enormous economic surge after the war and the assimilation of living conditions among member states took place without any significant capital transfers between countries. This used to be the state of affairs until the introduction of the Euro and it still is within the EU as a whole, albeit not within the Eurozone.

The increasing political need for capital transfers or some form of debt mutualization has nothing to do with the logic of the original common currency concept, but it results exclusively from mistakes and neglect among some of the Eurozone members. Countries such as Spain, Italy and even Greece actually have the wherewithal

instruments to align the qualities of their administration, education system, tax laws and labor laws with more competitive Eurozone members. However, for internal political or social reasons they are unwilling or unable to do so. That their cultural and political norms are so grandly divergent, again, is at the core of the Eurozone debacle. It's, perhaps, pure folly to have suggested these differences were surmountable on the path to common progress.

GREAT IMPOSITION

Given the various states of development, policy, stability, industrial structure and culture, there have always been divergent economic developments among EU members. Before the common currency was adopted, though, these differences were reflected in the exchange rate mechanism, a competitiveness-balancing force that no longer exists. If the exchange rate mechanism is eliminated, negative divergences for relatively less competitive countries manifest in higher trade balance deficits, lower economic growth, higher unemployment and higher government debt. As a result, investors either demand higher yields on a country's government bonds, or worse, investors become unwilling to lend more money to a country in financial difficulties and the affected country loses access to public debt markets.

Such differences were made obvious in the capital markets until about 2007, when investors began to assume that because all countries in the Eurozone now had a common currency, the creditworthiness of all Eurozone countries would be the same. This bizarre and conceptually incomprehensible belief was reflected in the fact that all Eurozone countries were able to borrow at almost exactly the same low interest rate, a rate that was more reflective of the strongest Eurozone countries such as Germany and some other Northern European nations. Equal borrowing rates across Eurozone nations is something that never existed before the introduction of the Euro and for good reason. Until that point, Italy or Greece, for example, always had to compensate investors for their lower creditworthiness with higher yields than did Germany. The assumption that differences in creditworthiness across Eurozone nations would simply be eliminated by the introduction of the Euro was, and continues to be, a very dangerous illusion.

Even though it's a symptom of relative lack of competitiveness, weak to no access to capital markets has emerged as the most pressing problem for the Eurozone periphery. Given their perpetual deficits, this development is an inescapable result of the very presence of the Euro...there is no passive inter-sovereign mechanism to balance relative competitiveness. That's no excuse for inaction, however, on the part of the periphery. The affected countries can reverse this fate (could have averted...) through appropriate structural reforms (e.g. economic, political, labor-market and regulatory).

Unfortunately, several Eurozone periphery countries early on decided against taking on such reform, either because of complacency or because they counted on the stronger countries eventually, "to do whatever it takes." In other words, they assumed (it turns out rather rightly) that a put option existed for them were life to get ugly on the home front, protecting them from further deterioration and promising a much more comfortable recovery than the scenario that would have avoided the current drama in the first place.

What's interesting is that in exercising that put, an effort which might normally have been paired with some manner of regret and promise for grand reform, some within the periphery have assumed the stance of victim. We guess in part because of this shift in tone, greatly exacerbated by the growing enormity and severity of the dislocation in the cost to service and raise debt, the stronger Eurozone members gradually have agreed to more and more monetary transfers to weaker nations in return for restrictive fiscal commitments. For a number of reasons, though, the commitments demanded make very little sense. First, even if these commitments successfully reduced fiscal deficits in the affected countries, they would not increase the competitiveness of those countries and therefore would not improve trade balances, economic growth and employment. Second,

and most importantly, fiscal commitments can be promised and contractually agreed upon again and again, but how should these promises be enforced? Déjà vu? The current framework suffers from the lack of recourse as there is no mechanism to pursue bad debtors on a sovereign level within the Eurozone. For example, if Greece decided to take all the bailout funds it can get but did not deliver on any promises that had been made in return for the funds (a scenario that does not sound too unrealistic), there is very little that the EU institutions or other Eurozone members could do about it. This is simply a fact.

LIMITS OF LEGALITY

The issues associated with a union of states, with or without a common currency, are very macroeconomically complex in nature so they tend to be very difficult to put into law. Laws on that level can either be very general in nature and therefore very much subject to interpretation in a given circumstance or they can be very specific and prescriptive. If the law is too general, it isn't readily applicable as it can be interpreted in various ways by various parties with divergent interests (a feature that has become frustratingly familiar to anyone following the Eurozone debacle!). If the law is too specific and prescriptive, it often cannot be directly applied to a given situation and is therefore simply ignored. Fine examples are the very specific rules regarding the three-percent maximum government deficit and the cap on government debt at 60% that has been prescribed in Europe. Obviously, none of these rules are relevant anymore, since they have not and will not be adhered to. All economists knew that these types of quotas could never be enforced and could only be viewed as rough guidance on what it takes "to be a good citizen." It doesn't aid compliance that the relevant EU rules are enforceable in court.

Some of the seemingly most blatant breaches of EU law have been the initial Greek bailout by the other Eurozone nations and the start of the ECB government bond purchasing program. Against all common sense, then, we otherwise safely can conclude that all European law governing sovereign financing in general can be ignored. If a majority of European decision makers want to pursue certain actions, even if they might be deemed unlawful, there is nothing to stop them. The evidence on this issue is already overwhelming. This extraordinary state of affairs is not unlike the Wild West. If the law is not or cannot be enforced, is it really a law?

CONCLUSION

Part of any rationally designed experiment must be a plausible set of broad conditions under which the experiment might be considered a success. Outside of mostly illogical arguments suggesting otherwise and an otherwise "for the Greater Good" approach to civic management, the Euro never satisfied that very basic constraint. European governments need to realize that at some point additional sacrifice is too much sacrifice for the sake of the Euro's survival. A break-up of the Eurozone in some form or shape would certainly be an enormous challenge and present tremendous difficulties. However, there comes a point when a break-up will be the lesser evil, even considering all manners of cost...macroeconomic, political and civil.

Sticking to the common currency just because politicians fear the consequences of a break-up certainly doesn't seem to be sensible. Here again, were one to be able to develop a set of broadly sensible conclusions to further fiscal support of the periphery, we might think otherwise. But there are no such plans. Almost assuredly, Greece simply cannot *grow* out of this mess. The same might plausibly be said of the remaining strugglers. We're left, then, to conclude that a managed restructuring of the current membership of the Eurozone is, at the very least, a more workable way forward.

No one wants to be at the helm when the Euro fails. This, even though fiscal and economic forces might demand it. Such are the makings of true macroeconomic disasters. We very much believe that the current path leads only

to eventual catastrophe. One can only hope that European leaders will realize this and act to avert that fate before it is too late.

What are the investment implications of the Eurozone crisis? While a crisis like the current one could be a buying opportunity from an investor's point of view if it is associated with an exaggerated market selloff, we don't believe that either the global equity or debt markets sufficiently reflect the gravity of the current situation in the Eurozone. In fact, we view current equity valuations over there as quite the contrary, a stance very much expressed by reviews of our quantitative framework.

Even more, we currently don't see the region as attractive from a long-term investment perspective, as European decision makers have demonstrated time and again that they are incapable of sensible crisis management. Instead, they remain dogmatic in their beliefs, oriented towards short-term objectives, and are mostly self-interested in their actions and dealings.

Readers should trust that monitoring the situation in Europe remains top of tasks. As the scenario shifts, we stand ready to exploit any opportunities that might arise.

ENVIRONMENT AND POSITIONING

In particular after these latest sales—Colombia, Hong Kong, Singapore and South Africa in the Country Rotation Portfolio (Russia remains) and Energy from the Sector Rotation Portfolio—all of our portfolios remain quite defensive. Having offered more than a few words on the situation in Europe, we'll add that there seems little enamoring us to most equity markets. If they weren't there already, most series covering fundamental dynamics are turning bearish, such that the expectations for the levels of fundamentals are rather sour. It's a feeling so far more than heartily confirmed by this latest quarter's earnings reports. According to a summaries by Bloomberg, with more than half (274 as of 10.26.12) of the S&P 500 index members reporting, 53% have turned in sub-expectation revenue tallies. In fact, only the Energy market is showing a season-to-date positive comparison between total revenue reported relative to pre-report expectations. In terms of profits excluding the ugly and otherwise inconvenient stuff, the comparison is a bit better, with positive surprises taking more than 63.5% of the total, but that compares to 69% of the total by quarter end in Q3 2011.

Yes, we're not fond of estimates, but they're naturally far closer to actuals when it comes time to report, so the misses are telling...at least in terms of weakening in the forces that might have been supporting the equity markets so far this year. And we're already seeing these lackluster reports filter into the quantitative dashboard, an effect we had predicted we'd see coming out of Q2 as we found few reasons even then to expect otherwise.

The U.S. election is less than two weeks away. Obviously, it's still near impossible to predict the outcome of the election...almost certainly impossible to predict the consequences. But it remains relatively easy to imagine various repercussions, the greater breadth of which still leave us well comfortable remaining on the defensive in the portfolio.

Turning to the global support mechanisms that are...*were*...Brazil, China and India, all seem more likely to find slower growth on the horizon. What with best hopes for China being a bottom, rather than any quick return to moderate growth. Suppose that's a good thing, considering the shaking grounds upon which growth over the past few years has been built, but such conservatism provides little reason to be more bullish on the state of the global macroeconomy.

Importantly, various metrics in our framework are bearing witness to this muddle. Whether in increased volatility or deteriorating dynamics of the fundamental underpinnings for various equity markets. To reiterate,

our portfolios remain mostly defensive. Readers should trust that where opportunities present themselves, we're prepared to take advantage of them. Meantime, we're more than comfortable maintaining relatively—compared to equities—tame exposures within the fixed income realm.

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), a division of AFAM Capital, Inc. and the performance results of such recommendations are subject to risks and uncertainties. For more information about AFAM Capital, Inc. please visit afamcapital.com. Past performance is not a guarantee of future results.

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. 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.

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 exchange-traded fund 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.

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.

Registration of an investment adviser does not imply any certain level of skill or training.

AFAM Capital, Inc. is an Investment Adviser, registered with the Securities & Exchange Commission and notice filed in the State of California and various other states. For more information, please visit alfrank.com. Registration as an investment advisor does not imply any certain level of skill or training.

Innealta is an asset manager specializing in the active management of portfolios of Exchange Traded Funds. Innealta's competitive advantage is its quantitative investment strategy driven by a proprietary econometric model created by Dr. Gerald Buetow, Innealta's Chief Investment Officer. The firm's products include Tactical ETF Portfolios, a U.S. Sector Rotation Portfolio and a Country Rotation Portfolio. Innealta aims to beat appropriate benchmark performance by tactically managing portfolios utilizing a proprietary econometric model. By harnessing the benefits of ETFs, Innealta is able to provide investors with exposure to multiple asset classes and investment styles in highly liquid, low cost portfolios.

For more information, contact Scott Silverman at 949.540.7307 or your financial advisor.

AFAM Capital, Inc.
12117 FM 2244 Bldg. 3 -#170
Austin, TX 78738
P: 512.354.7041 F: 512.402.1014