Innealta
CAPITAL

COMMENTARY: OCTOBER 1, 2014

WHETHER WITHER OR WIN IN EMERGING MARKETS

With the end of the Fed's taper imminent and the advent of fed funds target hikes on the horizon, concerns have grown in regard to the potential impact of these moves on emerging market (EM) investments. As was seen in last summer's "Taper Tantrum," investors grow skittish when confronted with unrehearsed potential outcomes. Barring any grand surprise from Team Yellen—and to be clear, the Investment Committee presently is not expecting any—one might expect a little less volatility this time, given the experiences of developing economy capital markets over the past year.

In sum, while the Fed's impending end to quantitative easing and the still unknown path to rate normalization may add to emerging market debt volatility over the coming months, the Innealta Investment Committee continues to find the additional yield presented by emerging market debt exposures, in the additional context of the added portfolio diversification these exposures bring, to warrant continued holding of the allocations.

DIVERSE AND DIVERSIFYING

There are ample reasons to own EM debt in fixed income portfolios. Foremost among them is the more generous absolute levels of yield, as well as yield per unit of duration, the exposures offer. That extra income has the ability to dampen the volatility that those exposures tend to see during times of regional instability and broader market stress.

EM debt also adds substantial diversification to the portfolio at several levels. Not simply generically allocated to "EM debt," the Fixed Income Portfolio is diversified across EM exposures, via holdings in three distinct EM-focused ETFs: iShares Emerging Markets High Yield Bond ETF (EMHY), Market Vectors Emerging Markets Local Currency Bond ETF (EMLC) and Market Vectors Emerging High Yield Bond ETF (HYEM). Each fund maintains specific characteristics sought by the Investment Committee, and the present mix offers a broad range of access to EM regional debt: across currencies: denominated in U.S. dollars and local currencies; across sectors: variously focused on or allocated between sovereign and corporate; across ratings: variously focused on or allocated between investment grade and high yield; and across the maturity spectrum. In the Committee's view, given present and potential global fixed income dynamics, the total return opportunities in this space remain attractive.

THAT TIME WAS A BIT DIFFERENT

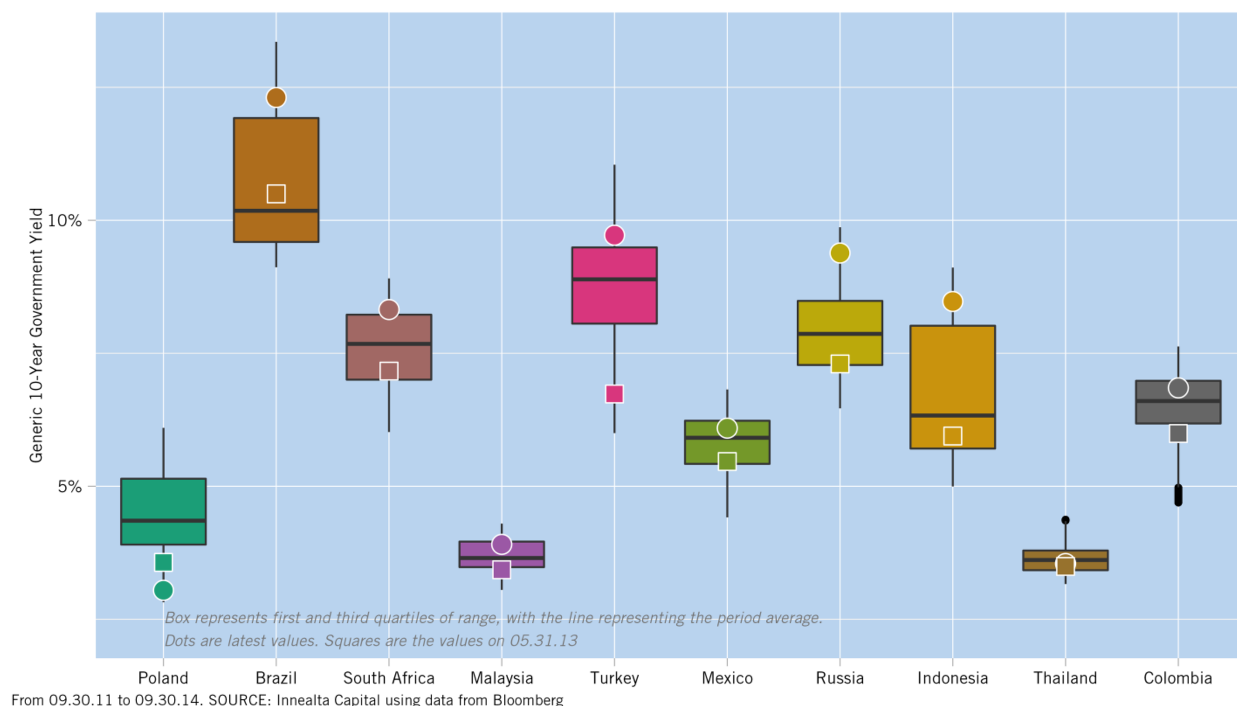
Though the exposures still faced a bout of volatility over the summer of 2013, the diversity of the EM group and that of the broader set of exposures helped the overall portfolio weather the Taper Tantrum a bit more successfully. Going forward, there are reasons to believe that the exposures are better "prepared" now for the eventual normalization of Federal Reserve policy.

In the year between the summers of 2012 and 2013, investors scooped up emerging market debt as the Fed's quantitative easing forced buyers out along the risk spectrum in the search for yield. Even as EM debt issuance expanded to meet the increased demand, those flows suppressed emerging market yields, in the interim providing substantial capital gain.

In May of last year, the Fed made sufficiently specific its intent to set course for an end to quantitative easing and a commencement of upward shifts in the fed funds target rate. Investors fled EM exposures, fearing capital flows into these countries would wane, fueled by rising concerns over fundamental challenges that included (variously by country and extent) current account deficits, slowing growth and rising inflation. In fact, the capital flow reversal reinforced a negative cycle in exchange rates that pushed some countries to hike interest rates, thereby reducing expectations for macroeconomic growth and furthering the negative impact on EM debt holdings.

One notable difference between last summer and now is the broader level of interest rates among emerging economies. In Figure 1, we show the three-year range of generic 10-year bond yields for the present 10-largest holdings by country-level weight in EMLC (with the x-axis sorted from left to right in falling weight order). We chose to look at EMLC weights, as that fund is the only ETF in the portfolio with EM local currency debt, which faces the most significant potential adversity in any scenario involving policy, macroeconomic and geopolitical surprises. With the exception of the regionally distinct Poland, each country is showing 10-year yields at average or higher, with all well above the levels seen at the end of last May. Further, EM-debt spreads over the U.S. 10-Year Bond, shown in Figure 2 have widened for most countries as well.

Figure 1: Emerging Market 10-Year Government Yields



From 09.30.11 to 09.30.14. SOURCE: Innealta Capital using data from Bloomberg

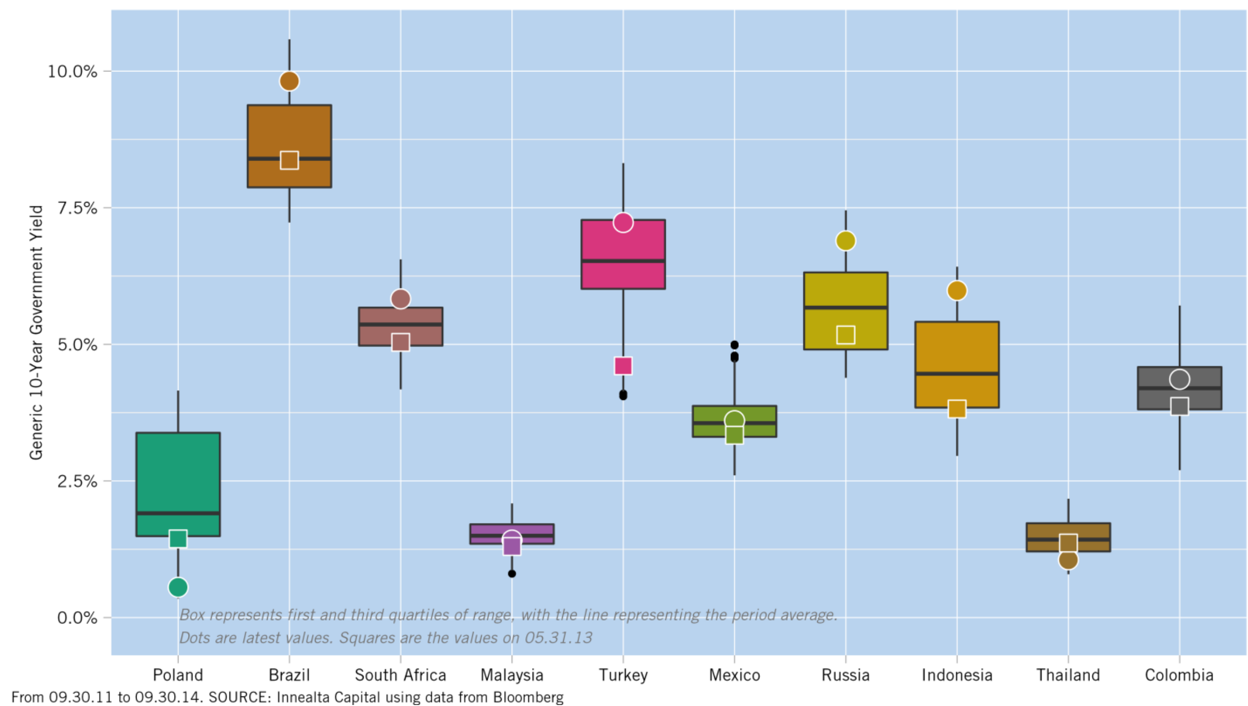
PRESENT FIXED INCOME POSITIONING

The Investment Committee remains confident in the ongoing development of firmer macroeconomic foundations among most developing economies (nominally germane to these portfolio exposures). More relevant in the medium term, the Team continues to expect a mostly orderly and slow-paced return to more normal domestic monetary policy, even while allowing for potential policy surprises abroad, from Europe in particular. With yields mostly on the higher end of the trailing three-

year range and spreads over U.S. Treasuries mostly showing a wider gap presently, there may be a more substantial cushion built into the emerging market exposures to soften the impact of any unexpected monetary policy effort, macroeconomic trends and geopolitical events. Meantime, the higher yields, particularly in the context of the interest-rate risk assumed, should continue to augment portfolio total return.

With emerging market debt one such example, the fixed income segment of the ETF universe remains an area of intense innovation in terms of exposure breadth and depth. Providers not only have incorporated more unique offerings in their opportunity sets, they also have increasingly disaggregated broader exposures. Both trends have furthered the Investment Committee's ability to fine tune the Fixed Income Portfolio (and therefore the Equity Rotation Portfolios) to reflect evolving experience and expectations in regard to the macroeconomic and other drivers of global interest rates. And as the asset levels reflected by these ETFs continue to grow, the Committee expects to continue to gain in its ability to efficiently and rapidly alter portfolio exposures to address the potential repercussions of these dynamics.

Figure 2: Emerging Market 10-Year Government Yield Spreads over U.S. 10-Year Treasury



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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.

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