



BRACED FOR THE NEW YEAR

- As we head into the new year, we'll admit to no less gripping a struggle fathoming the course of markets over the medium-term past. Well, it's easy enough to offer an explanation—the bulk of active participants are unfettered gamblers. That momentum has well overtaken sound valuation. That wholly dubious exercises in faith-based fiscal and monetary engineering will erase any macroeconomic and market errors that arise. That it's fully proper to discount well-in-the-future growth at a rate that greatly underestimates the true risk embedded in fundamental scenarios. And that—regardless of one's take on their collective sanity—it's hard to blame traders for chasing such obvious trends in return streams.
- We'll gladly accept criticism for our more cautious course through it all. Because, critically, with every whip there's a saw. Cuts both ways, that is. And just as the equity markets have moved up with great gusto, with Treasury markets moving in the opposite direction as briskly, without a marked shift in the broader macroeconomic picture—we don't see one, and that's not for not looking (and hoping) for it—they very easily can shift course back in the opposite directions.
- In our opinion, much of the recent increase in Treasury yields may have to do with the incorporation of a credit spread into Treasury yields. Macroeconomically speaking, it is difficult to defend a sustainable increase in yields with the current output gap, level of unemployment, state of residential real estate and probable high elasticity of demand across much of the consumer space. Moreover, if the new Congress is able to instill some fiscal discipline we may experience further reasons to see yields wane.
- As exemplified by recent shifts in the fixed-income portion of the Rotation portfolios, we are as vigilant of the expansion in the opportunity set provided by the ETF marketplace as we are the existing investments within our portfolios. And we remain ever-focused on the management of the risk relative to the potential reward those existing and new opportunities may provide. As we head into 2011, we remain honored with the continued trust you have placed in Innealta Capital. Wishing you the grandest of starts to the New Year.

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Quite honestly, we'll gladly accept criticism for our more cautious course through it all. Because, critically, with every whip there's a saw. Cuts both ways, that is. And just as the equity markets have moved up with great gusto, with Treasury markets moving in the opposite direction as briskly, without a marked shift in the broader macroeconomic picture—we don't see one, and that's not for not looking (and hoping) for it—they very easily can shift course back in the opposite directions.

KEEPING FOCUS

The underlying dynamics of equity and fixed-income (Treasury in particular) markets aside, it's the fundamentals that remain truly worrisome. We can handle the volatility. What's exhausting is keeping up with the euphoria driving the former and managing the despair burdening the latter.

For starters, we'll readily acquiesce to the belief that equity markets were broadly—but briefly—undervalued in March of 2009. The subsequent rebound was warranted, but we've gone well ahead of what should be considered a natural level of valuation. And by that, we suggest a mean that takes into consideration the fact that we've experienced two anomalous periods of extended valuations over the past 12 years that have, in our view, unnaturally skewed upward the long-term average. And, further, that expectations for profit have unduly discounted continued above-normal growth in earnings that we find unlikely to come to pass. Broadly speaking, these aren't fairly-valued equity markets. Not by virtue of a century's worth of experience, not by deduction of truly reasonable forward expectations.

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Not just those beliefs, of course, that keep us broadly removed from the equity markets in our Rotation portfolios and underweight optimization-driven strategic allocations in our Risk-Based portfolios. These are the findings of the models that drive our investment choices. That the valuations of most equity markets, within the context of the current macroeconomic picture and expressed as they are in both the volatility and direction of equity prices, do not warrant our investment over what we consider a more suitable basket of fixed income securities.

Were that the fixed income markets supporting our view! The interest rate dynamic throughout the fourth quarter of this year has been nothing short of extraordinary. We've experienced a remarkable shift in the geometry of the U.S. Treasury yield curve—a meaningful increase in yields across the curve as well as an increase in the concavity of the curve. That's upward altogether, with a more obvious bump in the middle, reflecting two-year yields that have increased approximately 30 basis points (1 basis point equals 0.01%)

and 30-year yields that are up by approximately 86 basis points, with intermediate yields higher by almost 100 basis points.

This is all the more astounding considering that current monetary policy, also known as Quantitative Easing II (QE2), was supposedly designed to keep yields low, particularly along the front end of the yield curve. By this measure QE2 has been an unmitigated failure. It also has failed miserably in its effort to weaken the dollar relative to other major currencies.

Perhaps its most dire consequence, QE2 has materially altered investor psychology in terms of expectations for continued monetary profligacy. Expectations now are such—and this can be tracked at the news release level—that the federal government with all its various appendages will seek at any cost to support continued (we should write “resumed” here, but many might view that nuance as mincing words...even though clearly it’s not) economic growth. Ours first, of course, and then everybody else’s.

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When Ben Bernanke and other Federal Reserve Board members began hinting in late August that they would continue this ill-advised monetary policy experiment, we witnessed an extraordinary decrease of yields into early October. The bond markets at that time bought on the rumor that QE2, once enacted, would shift the demand curve for Treasuries so much that it would drop real yields appreciably. The speed and magnitude of the initial decrease in yields across the maturity spectrum was somewhat surprising. Overdone, in our opinion, given the macroeconomic situation at that time.

Not that they might have changed course anyway, the grand shift in expectations ensured that the Fed had to execute QE2. In our opinion, the effort was just so poorly thought through that it’s really discouraging to realize the Fed is being held responsible for the well being of our economy. It is clear to us that they have very little idea what they’re doing and seem to have given almost no forethought to the consequences of their policies. Have to give them a little room, we suppose, as in a more logical world they would not be in this position. But, such has been the evolution of American capitalism. Fail and ye, too, shall be saved by the almighty Fed. Unless, of course, you’re funding the rescue. It seems that the policy put (socialized risk) is being exercised (privatized return) by the markets with great frequency these days.

WHIP...SAW.

The hangover from the QE2 party started following the Fed announcement on how they would implement the program. With rumor now news, fixed-income ‘investors’ began dumping into the Fed’s buying. Only they weren’t really matching purchases either by underlying duration or by overall magnitude. Treasury markets began to sell off and yields rose. This shift was further exacerbated by more bad fiscal policy during the lame duck Congress as the ‘compromise’ found on the extension of the current tax code inflamed concerns over government spending.

The mood reached a fever pitch when Moody’s again implied that a reduction in U.S. Treasury ratings is a possibility unless debt levels are reduced. In our opinion, much of the recent increase may have to do with the incorporation of a credit spread into Treasury

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yields. Though there's validity to the dynamic, as with the overbought situation of October, the current sell off, too, seems overdone. Macroeconomically speaking, it is difficult to defend a sustainable increase in yields with the current output gap, level of unemployment, state of residential real estate and probable high elasticity of demand across much of the consumer space. Moreover, if the new Congress is able to instill some fiscal discipline we may experience further reasons to see yields wane. We realize that this latter observation might be wishful thinking, but it's that time of year for optimism.

A VILE PLAGUE...

The chasing of policy initiatives is a plague on capital markets. Poor monetary and fiscal policies have pushed the capital markets away from a fundamental-driven sustainable equilibrium to one of pure policy anticipation. Equities rise either because the Fed will support them by making alternatives unattractive, or the Fed won't need to support them because the economy is growing. The only consequence...the solvency of our Federal government. (Lest we forget, widely reported but barely discounted are state and municipal woes, but that discussion is for another day. Traders: be sure to save some dry powder for the equity boost the bailout package will provide!) Little regard is offered the thoughtfulness of the policy in consideration. Neither the causes of the whipsawing of valuations (remember that year-over-year yields comparisons for Treasuries are actually lower now).

That it sticks to the wall makes it no less acrid. A market that depends on capricious and exogenous policies is not sustainable and very, very difficult to endure as an investor. In our opinion most of the fiscal and monetary strategies enacted since the onset of the credit crisis have been decoupled from anything that can possibly be explained through fundamentals. From Keynesian spending to experimental quantitative easing it seems that we have experienced the gamut of bad policy and, not surprisingly, our economy remains precariously positioned. Furthermore, we are no less concerned that the consequences of these policies are understood neither by the policymakers themselves, nor by the capital markets so enthused by them. Until we see evidence that rates are on a sustainable path toward higher levels, we believe that this latest rise will be short lived...perhaps even offering a fine entrance point.

ENGAGING THE NEW YEAR

Exemplified by recent shifts in the fixed-income portion of the Rotation portfolios, we are as vigilant of the expansion in the opportunity set provided by the ETF marketplace as we are the existing investments within our portfolios. And we remain ever-focused on the management of the risk relative to the potential reward those existing and new opportunities may provide. As we head into 2011, we remain honored with the continued trust you have placed in Innealta Capital. Wishing you the grandest of starts to the New Year.

Gerald Buetow is Chief Investment Officer of Innealta Capital. Innealta Capital is a quantitative asset management firm specializing in the tactical management of Exchange Traded Fund (ETF) portfolios. 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.

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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 US 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 949.424.1010.

**Al Frank Asset Management, Inc
32392 Coast Highway, Suite 260
Laguna Beach, CA 92651**

P: 949.499.3215 / 888.994.6827 F: 949.499.3218