Innealta CAPITAL

International Equity Commentary August 2018

WHERE CAN WE FIND GROWTH?

- Higher economic growth rates in Emerging Market ("EM") countries relative to Developed Market ("DM") countries should result in higher earnings growth in EM countries relative to DM countries. EM remains attractive, but more so when compared to their DM peers.

- Despite the sell-off in International Market equities during Q2 and Q3 of 2018, global growth expectations remain positive. Moreover, EM growth is likely to exceed DM growth both on a nominal and real basis.

- The weighted average real (nominal minus inflation) GDP growth of the MSCI EM index is over two times (4.5% vs 2.1%) the weighted average real GDP growth of MSCI DM ex US.

IF U.S. SPENDING KEEPS INCREASING, WHERE IS THE DOLLAR HEADING?

- Our long-term view is U.S. dollar depreciation, relative to foreign currencies, due to growing U.S. fiscal and U.S. current account deficits, increasing U.S. inflation due to employment costs, and the increasing likelihood that foreign central banks will need to begin increasing their respective short-term interest rates.

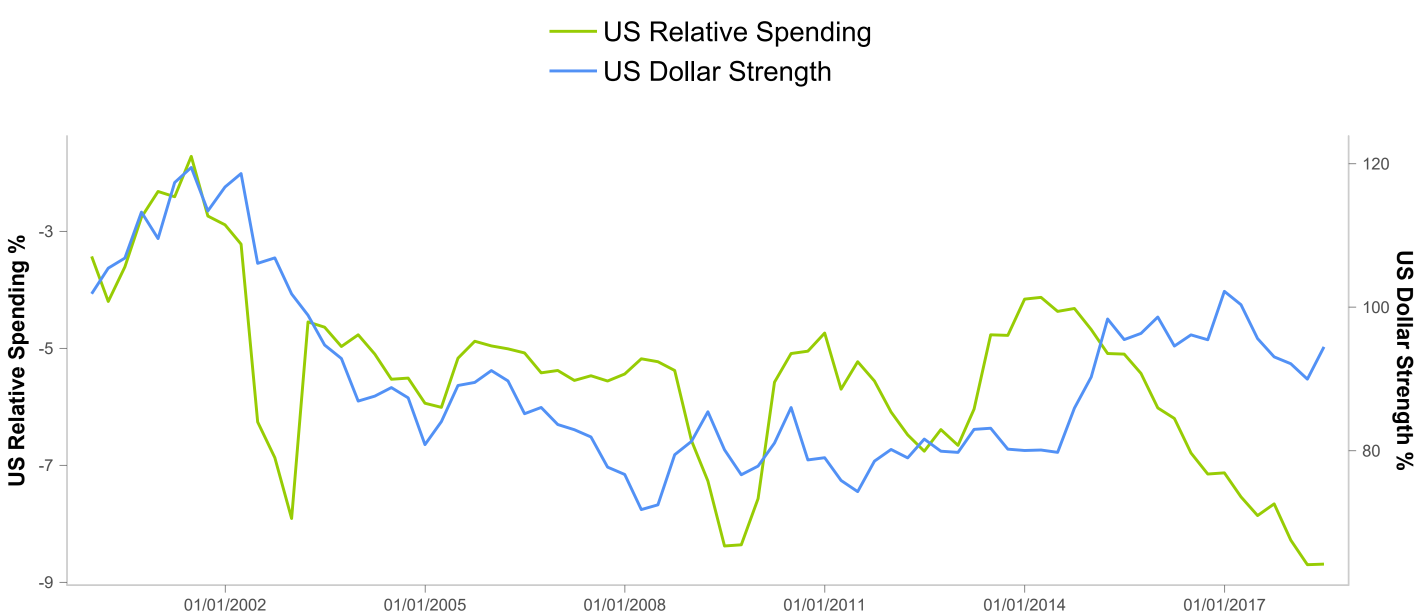
- If the U.S. dollar depreciates, all else equal, then the value of international equity market assets owned by U.S. investors would increase.

- We don't give much credit to the thesis that yield pickup in U.S. treasury markets, compared to a foreigner's respective local market, is attracting foreign investment. Accounting for the cost of a foreign exchange ("FX") hedge and the volatility within FX markets, foreign investment into US Treasuries does not seem that attractive.

- Empirically the relationship between U.S. spending, which we approximate as the U.S. fiscal deficit as a percentage of gross domestic product ("GDP") plus the U.S. current account as percentage of GDP, and European spending - note that the euro is the largest component in the U.S. Dollar index - has tracked the U.S. Dollar index. This relationship would imply a much weaker U.S. Dollar.

FIGURE 1: U.S. SPENDING AND THE U.S. DOLLAR

Takeaway: The value of U.S. Dollar would likely depreciate given historical relationship to U.S. spending.



SOURCE: Innealta Capital. Time frame 12/31/99 to 06/30/18. Frequency quarterly. "US Relative Spending" refers to the sum of the U.S. current account (% of GDP) and U.S. fiscal deficit (% of GDP) less the sum of the Eurozone current account (% of GDP) and the Eurozone fiscal deficit (% of GDP).

WHAT IF COMMODITIES MARKETS ARE RIGHT?

- Using our quantitative framework we see two major themes within the international equity space: improving macroeconomic growth and divergence in the EM asset performance relative to commodities prices. The latter, we believe offers an attractive investment opportunity.

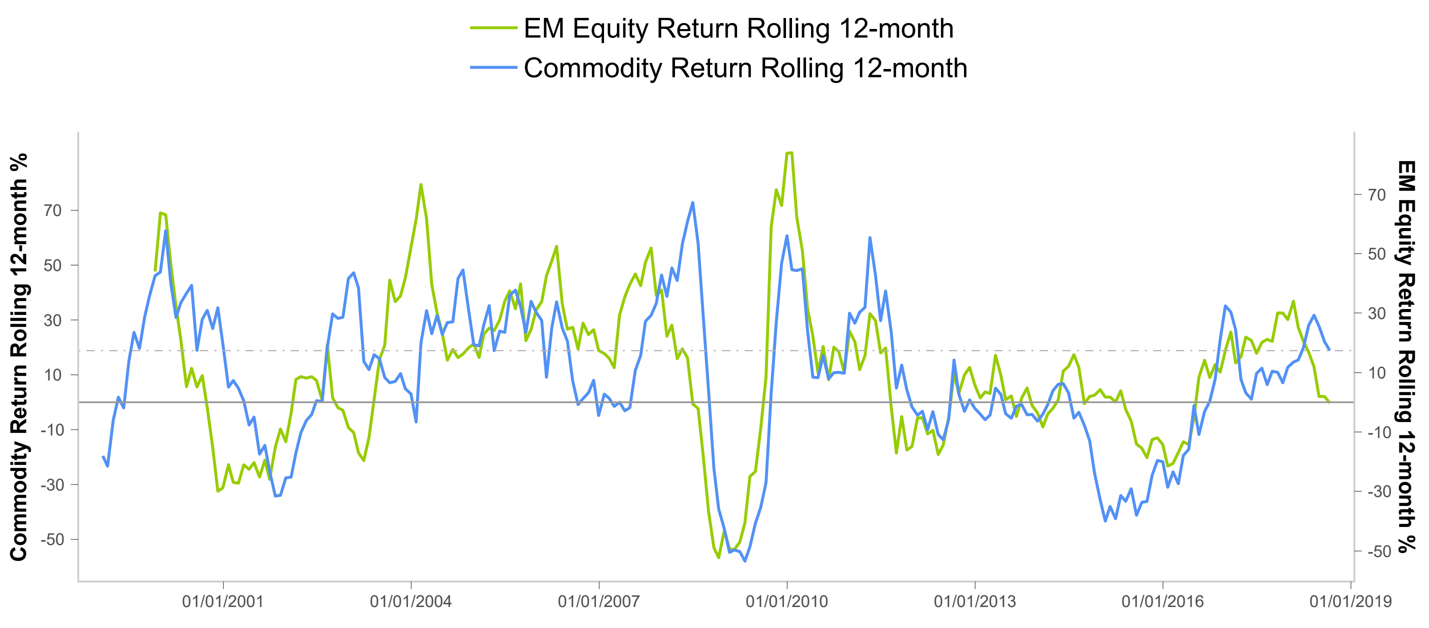
- The empirical relationship between the MSCI EM Net USD equity index and the GSCI commodities index observed over the past fifteen years, would indicate that the MSCI EM Net USD equity index should have appreciated over 25% over the past twelve months (see Figure 2 below). However it has depreciated 0.68% over the past twelve months. We see this as an investment opportunity. Although some of the negative performance of EM equities can be associated with the fact that the U.S. Dollar index has appreciated 2.67% over the past twelve months, we believe the under performance is more related to fear than fundamentals. The current divergence, in our opinion, represents one of the most attractive opportunities within financial markets.

- The EM America equity region is attractive because it has the most growth potential pickup, in our opinion, and a high beta to commodities.

- The bonus of EM equity markets relative to DM ex US equity markets is that they are cheaper on a valuation basis and more profitable on profitability basis (return on equity, return on capital, etc).

FIGURE 2: COMMODITIES AND EMERGING MARKET EQUITY GROWTH

Takeaway: History and current commodity performance imply significant return potential for EM equities.



Source: Innealta Capital using Bloomberg data. Time frame 01/01/1994 to 08/31/2018. "EM" refers to the rolling twelve month percentage change in the MSCI Emerging Net Total Return USD Index. "Commodities" refers to the rolling twelve month percentage change in the S&P GSCI Total Return Index.

WHAT DO WE EXPECT MOVING FORWARD?

- Bilateral trade deals between the US and its trading partners, including China. No deal is going to immediately impact the growing U.S. current account deficit, which we believe is a long-term negative to the value of US Dollar.

- A decrease in the speculative positions that the U.S. Dollar index would increase.

- Investors will begin to recognize that the sources of EM fears – Turkey and Argentina – represent less than 1% of the MSCI EM equity market, a large percentage of EM countries are current account positive, and EM financial markets are much stronger than they were in the late 1990s. Given these dynamics, in our opinion, EM assets are worth the risk.

Disclosures & Important Information

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Glossary & Risk Considerations

*The **MSCI Emerging Markets Index** is a free float capitalization index that covers large and mid capitalization companies categorized as Emerging Market by MSCI. The index covers approximately 85% of the free float market capitalization in each country.*

*The **MSCI Emerging Markets Net Total Return Index** is a the net return of a free float capitalization index that covers large and mid capitalization companies categorized as Emerging Market by MSCI. The index covers approximately 85% of the free float market capitalization in each country.*

*The **U.S. Dollar Index** is an index of the value of the United States dollar relative to a basket of foreign currencies, often referred to as a basket of U.S. trade partners' currencies. The Index goes up when the U.S. dollar gains "strength" (value) when compared to other currencies.*

*The **S&P GSCI Index** is the first major investable commodity index. It is one of the most widely recognized benchmarks that is broad-based and production weighted to represent the global commodity market beta. The index is designed to be investable by including the most liquid commodity futures, and provides diversification with low correlations to other asset classes.*

Unmanaged index returns do not reflect any fees, expenses or sales charges, and it is not possible to invest directly in an index.

Past performance is no guarantee of future results.

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