GLOBAL EXCHANGE TRADED FUND STRATEGIES

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Third Quarter 2016 Performance Review

Global Balanced Strategy

Our global balanced strategy, which allocates among bonds, stocks, and commodities around the world, gained 3.0% last quarter, raising the year-to-date return to 8.0%.

Global asset markets enjoyed another positive quarter: Bonds finished in the black, and equities sailed to this year's highs. The result was quite a surprise, considering the stormy start after the Brexit late in June – world equities lost $3 trillion in two trading days. However, the market made a quick comeback, anticipating brighter global earnings and the Federal Reserve's gradual rate increases. Global stock market indexes rebounded swiftly in July, climbed to the highest level of the year in August, and stayed robust throughout September. As a result, equities closed higher, returning over 5% for the quarter, and bonds, although trading under the threat of a higher rate, were almost flat.

The improved growth outlook was the key factor behind the stock market recovery. Since the 2008 financial crisis, the world economy has been haunted by deflation, but the upturn appears to have finally emerged. First, manufacturing activity in emerging markets picked up as China's spending on infrastructure helped a rebound in commodity demand; while oil and gold prices dipped in the third quarter, for the YTD period they are both significantly higher. In the developed world, Europe's economy proved resilient after the British referendum. Industrial activity swung to the upside despite a soft expansion. Optimism from overseas economies lifted the MSCI Emerging Market Index to return 9.2% for the quarter and its sister index (MSCI EAFE), focusing on advanced countries, to gain 6.4%.

US equities increased less than their peers, gaining 4.4% for the quarter. The weaker result was due to the concerns of stretched valuations and continued poor earnings growth. Analysts' estimates for the third quarter's earnings growth on the S&P 500 Index are negative, predicting a 2% decline from a year ago. This will mark the sixth consecutive quarter of year-over-year declines in earnings since the 2008 financial crisis. Also, the second quarter 2016 real US GDP growth rate was downgraded to 1.4% as productivity growth faltered.

The upbeat view of overseas economies and no immediate rate increase helped to lower risks of higher yielding corporate bonds and sovereign debts. US high-yield bonds and emerging market bonds benefited most as their yields over US Treasury yields continued to shrink, and both assets performed spectacularly well this year, returning 15%--over double what Barclays US Aggregate Bond Index delivered.

Sovereign bonds, as a traditional safe play, were out of favor during the third quarter. First, the mixed signals of the US economy kept a lid on US 10-year yields. Although inflation expectations in the US increased as wage growth picked up, the 10-year Treasury yields cautiously moved only 20 basis points higher from this year's low of 1.4%. This tiny movement in yield made the US Treasury yield curve less flat than last quarter, but the curve was still lower than a year ago. About 70% of developed market sovereign bonds that are outstanding now offer depressing yields of below 1%.

Our strategy's equity portion returned 5.3% for the quarter, increasing the year-to-date return to 7.5%, and the bond portion gained 1.3%, bringing the year-to-date return to 8.4%. The equity and commodities portion accounted for 55% of the strategy's assets, and bonds accounted for the remaining 45%. Specifically, 2% of strategy assets were invested in US equities, 23% in foreign equities, 25% in US bonds, 20% in foreign bonds and 8% in commodities.

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Emerging Markets Strategy

Our emerging markets strategy, which invests in less developed companies and economies, returned 5.7% in the third quarter, increasing the year-to-date return to 17.4%.

Emerging market (EM) assets led the global rally during the third quarter for a number of reasons: cheaper valuations, rising global earnings, lower real yields, higher commodity prices, and China's fiscal stimulus. Also, the Federal Reserve left the policy rate unchanged over the summer, reining in dollar bulls. A stable US interest rate propped up emerging market currencies against the dollar and prompted more global funds to seek quick, higher profits in the emerging world, making emerging market assets the darlings of world financial markets this year. EM equities surged over 9% for the quarter, raising the year-to-date return to 16.4%. Similarly, EM debt gained 3.5% over the third quarter, accumulating a 16.1% gain in the past nine months.

Today's buoyancy is very different from what happened in the past two years. The drastic change in market sentiment often makes investors feel putting money into emerging markets is like riding a roller coaster. Less than two years ago, Russian financial markets were bleeding red as falling oil prices and Russia's invasion of Ukraine sent share prices down by 45% in dollars. However, this year fortune has returned to the country. Russian stock markets rallied 30% this year as oil prices strengthened. Meanwhile, financial misfortune visited Brazil, which not only suffered from low raw material prices but was also hit by a number of political scandals that brought her people to the streets. Brazil's stock market, as a result, tumbled by 40% in 2015, but the situation has reversed; Ibovespa, the Brazilian stock market index, skyrocketed nearly 60% in dollars over the past three quarters.

The drastic turnaround of market sentiment has a lot to do with what is going on in China, which was the key driver behind the latest rally. Its fiscal-stimulus spending not only boosted commodity demand, which lifted raw material prices out of their three-year slump but also stimulated more Chinese exports to Latin America and the rest of the world. The effect of China's stimulus also helped energize its industrial activity at home. The country's industrial sector has seen its earnings growth rising from the 2015 low. During the third quarter, the BRIC (Brazil, Russia, India, and China) group gained 11%; the rally was led by China and Brazil, both gaining over 10%. Other commodity-related funds also experienced larger inflows, which topped a seven-year record.

Like EM equities, EM debts lure yield-seeking investors in a low yield world. The EM bond spread has been falling this year and contracted to around 350 basis points as of third quarter's end, with the average yield falling to around 4.2%. Local and US dollar-denominated debts both delivered relatively strong returns over last quarter, gaining over 3%, while US bonds were flat.

Our strategy's equity portion returned 8.0% for the quarter, raising the year-to-date gain to 20.6%, and the bond portion gained 3.0%, bringing the year-to-date return to 14.8%. Equities constituted 61% of the strategy, of which 40% was invested in Asia, 7% in Latin America, 9% in Eastern Europe, and 5% in the Middle East and South Africa. The balance of the strategy was invested in fixed income securities.