3EDGE Asset Management

Quarterly Letter December 31, 2016

December 31st 2016 marks both the end of the fourth quarter of 2016 and the conclusion of the first year of operations for our firm, 3EDGE Asset Management. For the year, the **3EDGE Total Return** strategy earned a positive rate of return of +8.08% net of fees,[1] and the **3EDGE Conservative** strategy earned a positive rate of return of +4.70% net of fees.[2] However, investment performance during the fourth quarter was negative as gains in our holdings in U.S. equities, Japan equities - currency hedged (Total Return strategy) and ultra-short duration U.S. bonds less than offset declines in emerging and frontier market equities, global infrastructure equities (Total Return strategy), international real estate (Total Return strategy), gold and U.S. Treasuries.

The biggest surprise of the fourth quarter came in early November, when contrary to almost all polls and prognosticators, Donald Trump was elected to be the next President of the United States. After a short-lived but intensely negative market reaction during the early morning hours of November 9th, the global capital markets quickly recovered, seemingly encouraged by Trump's conciliatory victory speech. In anticipation of an incoming Trump administration, investors turned their attention towards the potential for a growth package of fiscal stimulus, regulatory reforms, tax cuts and tax reform that could include a program to repatriate the large cache of funds currently held offshore by U.S. corporations. These may have a reflating effect on the US economy and finally induce the much sought after *animal spirits* which monetary policy alone has not been able to rekindle. These potential policies from the Trump administration could accelerate the rotations that were already underway prior to the election, including a rise in world interest rates from the extremely low levels reached in the summer of 2016, a shift away from globalization towards more nationalistic policies, a shift in capital flows out of fixed income and into equities and a strengthening of the U.S. Dollar which began almost immediately following the election. Since expectations that the U.S. dollar could continue to strengthen and serve as a head wind for emerging market equities and gold, soon after the election we adjusted our equity exposure more towards U.S. domestic equities, and decreased our holdings in both emerging market equities and gold.

Near the end of the summer, we had begun to adjust our fixed income holdings away from longer duration bonds. After the U.S. election, we adjusted our strategies further towards more short duration bonds thereby decreasing exposure to the potential for rising interest rates and increasing inflationary expectations. As the U.S. Dollar continued to strengthen post-election, we also added to our existing holdings of Japan equities - currency hedged (Total Return strategy), as a rising U.S. dollar and weakening Japanese yen could be supportive of Japanese export companies.

It is interesting to note both the similarities and differences between year-end 2015 and 2016. In both years, there was a quarter point Fed rate increase in December. However, the differences between this year (2016) and last year (2015) are worth noting. When the Fed raised short-term rates in December of 2015, credit spreads were widening and yield curves were flattening, indicating potential economic weakness and even a possible recession in the near-term. In December of 2016, the Fed's quarter point rate increase was accompanied by narrowing credit spreads and a steepening yield curve. This difference is important since a narrowing of credit spreads and a steepening yield curve may be an indication of economic strength and a lower probability of an economic recession.

2017 - Hope, Reality and the Race Against Time

Post-election, we perceive the current market phase as the hope phase. Markets are reflecting the hope that the policies of the incoming administration, which may include increased fiscal spending, tax cuts and regulatory reform, will be reflationary. We are keenly observing those metrics that may indicate a rise in so-called "animal spirits" such as money velocity, which collapsed during the great recession and has remained low ever since, as well as capital investment which has been negligible over the past eight years. John Maynard Keynes in his book, *The General*

Theory of Employment, Interest and Money, described animal spirits as, "the instincts, proclivities and emotions that ostensibly influence and guide human behavior,"[3] and he went on to state that, "a large proportion of our positive activities depend on spontaneous optimism rather than mathematical expectations."[4] The potential for the rekindling of animal spirits is important since it may not only reflect changes in the economy and the markets but could actually serve as a driver of growth in the underlying economy and the markets. The next phase in the global markets could well be a reality phase. How quickly this reality phase arrives depends on whether the economic policies enacted by the Trump administration and Congress will succeed in lifting economic growth commensurate with the appreciation of the financial markets. The question for investors is, will economic growth take hold in time to justify the prospect of future rising interest rates, inflation and deficits? Herein lies the race against time.

Presently our research analysis continues to indicate positive risk-adjusted projected returns for equities relative to other major asset groups including bonds, cash and real assets. Given the breakout of some equity indices to new highs, there exists the potential of a continued momentum-driven equity market rally. However, should a rally turn into an accelerated equity market *melt-up*, equities could become increasingly vulnerable to a sharp correction, particularly if expected economic growth does not materialize or if the world devolves into either a global currency or trade war.

The rise in global political, economic and geopolitical uncertainty will require extraordinary vigilance in what could be an age of extreme uncertainty. Even with many positive factors in place, we are watching a myriad of potential risks to investors including uncertainties as to the future policy directions of the Trump administration and Congress, rising geopolitical tensions, China's debt challenges, rising U.S. interest rates, strengthening U.S. Dollar and the potential for global currency and/or trade wars, among others. We will be closely monitoring how any additional rate hikes in 2017 affect expected real (inflation-adjusted) interest rates to gauge whether the U.S. Dollar is likely to strengthen in a sustained fashion, or whether real assets may have an opportunity to appreciate. The 3EDGE approach to portfolio management prioritizes risk management and seeks to limit potential portfolio drawdowns. We continue to believe that investment portfolios need protection from the potential for a variety of "fat tail" or "black swan" events. However, we also believe that going forward it will still be possible to generate attractive risk-adjusted returns by continuing to follow our investment discipline of seeking to identify undervalued asset classes that may be poised to enter a period of market outperformance.

As always, please feel free to reach out to us if you have any questions and thank you for the confidence that you have placed in our firm.

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Footnotes

1: Investment performance for the 3EDGE Total Return strategy represents composite performance for January 1, 2016 through December 31st, 2016. Returns for investors who were not invested in the strategy for all of 2016 will vary. Performance for the 3EDGE Total Return Strategy composite is shown net of actual management fees and all other expenses and includes the reinvestment of dividends and other earnings.

2: Investment performance for the 3EDGE Conservative strategy represents composite performance for January 1, 2016 through December 31st, 2016. Returns for investors who were not invested in the strategy for all of 2016 will vary. Performance for the 3EDGE Conservative Strategy composite is shown net of actual management fees and all other expenses and includes the reinvestment of dividends and other earnings.

3 and 4: John Maynard Keynes, *The General Theory of Employment, Interest and Money*, 1936.