3EDGE ASSET MANAGEMENT

Investor Letter **Quarter ended March 31, 2018**

For the quarterly period ended 03/31/2018 (Q1-2018), both the 3EDGE Total Return Strategy and the 3EDGE Conservative Strategy earned negative rates of return. The first quarter of 2018 marked the first time since Q4 2012 that both the S&P 500 index[1] and the U.S. Treasury bond index[2] declined during a quarterly period. Bonds did not provide downside protection against a declining stock market during this period. While the Total Return and Conservative strategies were negative for the quarter they were both down less than the S&P 500 index[3], given our attention to downside risk management. We believe that the key to investment success over the long term is to participate during significant equity rallies while protecting capital during downturns, thereby generating not only favorable risk-adjusted returns but also attractive absolute returns over time.

The low level of volatility experienced during 2017 appears to be no longer supporting the global capital markets. For example, during Q1 2018 there were 22 days when the S&P 500 index closed up or down by 1.0% or greater[4]. For all of 2017, that happened only eight times, and S&P 500 index returns were positive every month. For most of the latter half of 2017, the Total Return and Conservative strategies were at or near their maximum equity allocation. However, by January 2018, our model research indicated that the contribution of economic and fundamental factors to further gains in the equity markets had greatly diminished, leaving equities overly dependent on continued positive momentum and favorable investor psychology. Further, our sensitivity analysis revealed that the equity markets were becoming vulnerable to a change in investor sentiment. After making strong gains through the first three weeks of January of this year, the equity markets began to encounter headwinds. From the record high reached on January 26th through February 8th, the S&P 500 index declined by over 10%[5] including one day, Monday, February 4th, when the S&P declined by over 4%[4]. February 2018 ended up being the worst month for equities in two years, with the S&P 500 Index down 3.9%.[6]

During February and March, our model research continued to indicate lower projected risk-adjusted rates of return across the major equity asset classes. Consequently, we reduced our overall equity allocation in both the Total Return and Conservative strategies. Our model research currently suggests the potential for only modest gains in U.S. and Japanese equities and even lower projected risk-adjusted returns for European and emerging market equities. We have increased our allocation to gold, while our allocation to fixed income currently maintains a larger than usual position in ultra-short fixed income with a duration of one year or less.

The selling pressure that the equity markets have experienced over the course of February and March has often been attributed to a variety of factors, including fear over a potential global trade war between the U.S. and China, uncertainty as to the pace of interest rate increases by the Fed and potential troubles with FANG stocks and the technology sector more broadly. Our research model has identified other potential risks to the global capital markets, including the flattening of the yield curve, a rise in the 3-month Libor rate, increases in credit spreads (i.e. low-quality corporate yields vs. high-quality corporate yields) and a widening of the *TED spread* (the difference between the Libor rate and the Treasury Bill rate). Each of these indicators could foreshadow either a tightening of liquidity or the potential for stress in the credit markets. *Flattening yield curve* - the difference between the 2-year and 10-year U.S. Treasury yields is now below 50 basis points, its lowest spread since 2007 and down from over 100 basis points a year ago. Short-term rates are rising in concert with the Federal Reserve Board's six rate hikes since December 2015, however subdued inflationary pressure is helping to keep longer term yields low. A flattening and ultimately inverted yield curve could be an indicator of economic weakness and ultimately the onset of a recession. *Rising Libor rates* - the London interbank offered rate, a measure of what banks pay to borrow on a short-term basis from one another has steadily moved higher, and 3-month Libor is currently about 2.32%, which is its highest level since 2008. Last month, 3-month Libor was at 2.05%, and one year ago it was at 1.15%. Approximately $350 trillion of assets are pegged to Libor, and its recent rise could mean higher adjustable mortgage payments and increased borrowing costs for both companies and consumers. A rising Libor rate indicates a further tightening of financial conditions at a time when the Federal Reserve is unwinding quantitative easing (QE). Changes in *corporate credit spreads* indicate expectations for economic growth, with widening credit spreads often associated with concerns about the economy going forward. Lastly, the *TED spread* has now hit its highest level since 2009, an indication of perceived credit risk in the economy.

Despite the recent equity market volatility and periods of rather dramatic equity market down-drafts this year, it is still possible to construct a bull case scenario for the equity markets. For example, should April's series of corporate earnings announcements exceed analysts' expectations of 17% year-over-year growth, perhaps investors could drive equity prices to new highs, reestablishing the positive momentum and favorable investor psychology that existed before February, which may result in an increase in our risk-adjusted projected returns for equities.

We continue to watch a myriad of potential geopolitical risks to investors related to North Korea, Syria, Iran, Saudi Arabia and Russia as well as controversy surrounding developments in Washington D.C. We conduct our research and run our models daily to analyze any changes in key economic, fundamental and behavioral factors that may provide early warning signals of adverse market conditions. We will also be closely monitoring how any additional rate hikes and the potential for the unwinding of quantitative easing may affect 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 targets alpha, or attractive risk-adjusted returns, by following our investment discipline of seeking to identify undervalued asset classes across the globe that may be poised to enter a period of market outperformance. At the same time, we prioritize risk management and seek to limit potential portfolio drawdowns as we believe that investment portfolios need protection from a variety of possible "fat-tail" or "black swan" events.

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 3EDGE.

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Footnotes:
1,2,3,4,5,6 Bloomberg