3EDGE
ASSET MANAGEMENT

Investor Letter **Quarter ended June 30, 2018**

For the quarterly period ended 06/30/2018 (Q2-2018), the 3EDGE Total Return Strategy earned a positive rate of return, while the 3EDGE Conservative Strategy experienced a negative return for the quarter. Our holdings in U.S. equities, U.S. fixed income and commodities contributed positively to returns while losses in Japanese equities, emerging market equities (Total Return Strategy) and gold contributed negatively.

Currently, the global capital markets are experiencing a period of monetary policy divergence among the world's major central banks. In the U.S., Federal Reserve (Fed) tightening continues apace. The Fed began raising short-term interest rates in December of 2015 and has done so six additional times. The Fed has indicated that it may raise short-term rates two more times in 2018 and an additional three times in 2019. As a result, the yield on U.S. Treasury bills now approximates the current dividend yield of the S&P 500 index. This has not been the case for many years. In addition, the 3-month Libor rate has increased even faster than the Fed funds rate, indicating a further tightening of financial conditions. The Fed is also in the process of reducing its balance sheet, and this process of unwinding quantitative easing (QE) continues to accelerate. Meanwhile, the European Central Bank (ECB) has delayed any short-term interest rate increases for the time being, while Japan continues to promote a program of highly stimulative QE. As the Fed has tightened, real interest rates (nominal interest rates minus the rate of inflation) in the U.S. have climbed and as a consequence, the U.S. dollar has strengthened relative to the world's other major currencies. A continued strengthening of the U.S. dollar can act as a head-wind for U.S. exporters and cause instability in emerging markets that have increased their U.S. dollar-based debt over time.

Another cause for concern revolves around trade tensions not only between the U.S. and China, but also involving Europe and NAFTA (Canada and Mexico). Potential consequences of proposed tariffs include threats to global supply chains, uncertainty around future terms of trade and the fear of escalation and an all-out trade war. There is also a concern that a trade war between the U.S. and China could trigger the Chinese to substantially devalue their currency as a countermeasure, and this could have the effect of exporting deflation around the world. When this happened in August 2015 and then again in January 2016, global equity markets reacted negatively until the yuan rebounded. History has shown that protectionism and trade wars are almost always costly and threaten global economic growth unless the disputes are resolved in a timely manner with trade settlements. Should the Fed raise rates as projected through 2019 -- five more times, while long-term rates remain stable, the U.S. Treasury yield curve will most likely invert. There are already arguments surfacing as to why this time is different and an inverted yield curve (short-term yields higher than long-term yields) shouldn't matter to global markets. However, we believe that such arguments are dangerous since history shows that after a lag, inverted yield curves discourage liquidity creation and bank lending often leading to stock market and economic downturns.

The famous investor, George Soros, may be best known as the man who broke the Bank of England when he made more than a billion dollars shorting the British pound. In his writings, Soros has always insisted that to be successful, investors must be willing to consider the possibility of a variety of logical but opposing market scenarios playing out in the future to be ready to take advantage of opportunities that may lay ahead.

Sensitivity and scenario analyses play a complementary role during our model research and portfolio construction processes, helping to balance return opportunities with risk.

At this juncture, the base-case from our model research indicates:

- Somewhat limited upside potential in the major equity indices including the U.S., Europe, Japan and emerging markets.
- In addition, as the U.S. dollar has strengthened, U.S. long bond yields have reversed course and have begun to fall below the higher yields that were experienced earlier in the year. As long as the U.S. dollar remains strong and the Fed hikes rates in advance of inflationary pressure, our research indicates that long-term yields could remain stable at this time. However, as the yield curve continues to flatten, we believe that a shift to higher quality bonds such as U.S. Treasuries and away from lower quality corporate credit and high-yield bonds is warranted.
- As the Fed attempts to normalize rates, rising real interest rates have pressured the price of gold lower. Recently, gold has dipped below its recent trading range causing further selling. In early June we began to reduce our allocation to gold. Then, during the month of June, we further reduced our holdings to our strategy minimums.
- As we reduced our equity exposure earlier in 2018, we invested the liquidity in ultra-short-term fixed and floating income vehicles to take advantage of the increase in short-term yields. As the Fed continues increasing short-term interest rates in the U.S., for the first time in many years cash has become a relatively attractive asset class. By investing in ultra-short-term fixed and floating income instruments, we are able to earn a decent yield on this liquidity with low duration risk while accumulating "dry powder" to reinvest in the equity markets at more favorable prices if the equity markets experience a downturn and our model research indicates a higher likelihood of a rebound from an undervalued state.

Potential alternative scenarios:

- Should the Fed become fearful that economic growth is in danger of slipping backwards or that simply they have reached their dual mandate of sufficient and stable growth and inflation, they could *blink*, as they did in early 2016, and curtail increases in short-term interest rates, putting the brakes on the increasing strength of the U.S. dollar and providing a potential measure of relief to the equity markets.
- Another potential contributor to an upside scenario could result from tariff and trade wars subsiding, thereby eliminating an important cause of investor concern.
- Additionally, should U.S. corporate earnings continue to grow despite the headwinds from a rising dollar, trade worries and a flattening yield curve, investor psychology could grow stronger and propel the S&P 500 to new all-time highs creating a bandwagon effect, attracting capital and resulting in an equity market melt up.
- Continued financial tightening in the U.S. in advance of inflation could keep the U.S. dollar moving higher, thereby pushing the Chinese yuan and other currencies lower. A stronger U.S. dollar would increasingly act as a head-wind for U.S. exporters and the U.S. economy.
- Signs of inflation ticking higher (a recent ISM survey of manufacturers in the U.S. shows that manufacturers' prices for their means of production are rising quickly) could also keep the Fed tightening for the remainder of 2018 and into 2019.
- Should U.S. tariffs and retaliation from trading partners devolve into a full-scale trade war, continued global economic growth could be at risk, possibly triggering a major correction in the equity markets.
- Lastly, it may be that second-quarter 2018 earnings will prove to be the peak in economic growth and corporate earnings globally. Even though the current economic expansion was never seen as especially robust, it has already lasted 95 months, and is now the third-longest in U.S. history (through 33 business cycles) going back to 1854.[1]

Longer term considerations: While investors have focused on what has been referred to as *synchronized global growth*, focus may well turn to what could be described as a *synchronized global debt* build-up as global debt has risen to a level that is even higher than at the time of the financial crisis of 2008.[2] Such a debt build-up could act as a restraint to further growth particularly as central banks attempt to normalize monetary policy. As Europe turns more towards nationalism and populism, the Italian debt situation also bears watching. Debt problems in Greece in the recent past were less problematic since Greece is a relatively smaller economy and easier to support and the potential crisis in Europe from Brexit was buffered by the fact that the UK retained its own currency, which acted as a shock-absorber supporting Britain's markets and economy as it fell in value. However, should Italy's debt situation worsen, the contagion could be quite serious since Italy's economy is relatively large and is tied to the euro, meaning that markets could perceive that the EU itself is under threat. China is also a concern, as its equity market -- the Shanghai index -- has now declined by more than 20% from its peak earlier this year into bear market territory.[3] Investors are worried that a trade war could act as a brake on China's economy, and there is also fear of rising corporate defaults amid the Chinese government's financial deleveraging program. As always, we continue to watch a myriad of potential geopolitical risks to investors related to North Korea, Syria, Iran, Saudi Arabia and Russia.

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. 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.

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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Sources:

1. Goldman Sachs
2. Bloomberg
3. Bloomberg