October 11, 2018

Investor Letter **For Quarter ended September 30, 2018**

For the quarterly period ended 09/30/2018 (Q3-2018), both the **3EDGE Total Return Strategy** and **3EDGE Conservative Strategy** earned a positive rate of return. Our holdings in U.S. equities, Japanese equities and ultra-short-duration fixed income contributed positively to returns while losses in emerging market equities, fixed income, gold and commodities contributed negatively.

Current Global Capital Market Environment:
Entering into the final quarter of 2018, U.S. economic growth remains quite robust, aided by the effects of tax cuts and fiscal stimulus from U.S. government spending. The unemployment rate in the U.S. is now approaching multi-decade lows, consumer confidence is at a 17-year high and manufacturing activity is at its highest level in 14 years.[1] Meanwhile, in mid-September the Federal Reserve raised short-term interest rates for the third time this year and for the eighth time since December 2015. The FOMC also dropped the word accommodative from their written statement and signaled their intention to continue to tighten monetary policy well into 2019. Fed tightening is continuing to support U.S. dollar strength which is negatively impacting emerging market currencies. In addition, the relative performance of the S&P 500 index vs. the rest of the world reached its most extreme level since 1970[2], indicating that strong U.S. economic performance may already be reflected in U.S. stock prices.

As the fourth quarter begins, global equity markets declined in dramatic fashion while at the same time interest rates surged higher. There are a number of reasons that might help to explain the recent equity market declines. The Fed's announcement of its intention to continue to increase short-term interest rates through 2019 may have been seen as being more hawkish than most market participants were expecting. The outcome has been a surge in interest rates that led to equity investors taking profits. As bond investors fear further rate hikes and the possibility of an increase in inflation, they are demanding a higher term premium, leading to higher real (inflation-adjusted) interest rates. The result is that bonds have proven not to be a good hedge against the recent downturn in equities, consequently we have re-deployed the proceeds from our recent equity sales into cash equivalent instruments for the time being. Should Fed Chair Powell decide to back away from his explicit intentions to continue to raise short-term interest rates well into 2019, then the equity markets could experience a significant bounce-back rally.

An additional concern weighing on investors is the potential for a significant and prolonged trade war with China, which could negatively impact both the U.S. and China's economies and raise the risk of a broad pullback in global business confidence. 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.

Monetary Policy Divergence:
While the U.S. Federal Reserve continues to tighten monetary policy, the world's other major central banks are remaining accommodative. The Bank of Japan is maintaining ultra-low interest rates and quantitative easing. In China, the PBOC has recently moved to ease monetary policy to avoid an economic slowdown amongst weaker economic indicators and perhaps to buffer the country from the negative impact of trade tensions with the U.S. The European Central Bank has indicated that it will cease quantitative easing by year-end, citing a strengthening

economy and an uptick in inflation. However, the ECB has indicated its preference to keep rates low for an extended period.

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

- The recent global sell-off in equities, rising U.S. Treasury yields and growing concern about a potential trade war with China have combined to elevate equity risk around the globe. As equity market volatility has now increased, we could see wide price swings in either direction over the coming days.
- Our outlook for U.S. Treasuries is mixed. While the attractiveness of U.S. treasuries benefits from the strength of the U.S. Dollar, duration risk as evidenced by the recent rise in treasury yields negatively impacts bond prices.
- Projection for cash and equivalents is modestly higher due to increased short-term interest rates. Yields from cash and equivalents now exceed dividend yields from equities.
- Real Assets continue to maintain a decidedly negative outlook. Gold and commodities projections remain unattractive given the strength of the U.S. Dollar, rising real (inflation-adjusted) interest rates and negative investor psychology but could become attractive again should the U.S. Dollar reverse course and fall.

Alternative Scenarios and Potential Risks:

- In the U.S. equity markets, growth and momentum stocks have greatly outperformed value stocks since the financial crisis of 2008, with value stocks at a near record discount to growth stocks as of quarter-end. A higher growth, rising rate environment could trigger a reversal of relative performance, leading to a rotation out of growth and into value stocks.
- A potential trade war with China could negatively impact both the U.S. and China's economies and raise the risk of a broad pullback in global business confidence. 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 slower growth and/or deflation around the world, as non-Chinese firms have difficulty competing. In the past, when the yuan experienced a material devaluation (August 2015 and January 2016 are recent examples), global equity markets reacted negatively until the yuan rebounded. The Chinese equity market -- the Shanghai index -- has now declined by more than 20% from its earlier peak 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.
- Occasionally, the last stage of a long-running bull market is a "market melt-up" or sharp rise in equity prices before the inevitable correction. As investors fear missing out in a sharply rising market, escalating prices become self-reinforcing in a virtuous cycle, drawing additional funds feeding market demand until the market no longer reaches new highs. The resulting unwind can be just as sharp on the downside as the climb on the upside. The tech-stock bubble of the late 1990s into 2000 represents such an example. Should U.S. equities reach new all-time highs consistently during the fourth quarter, this scenario remains a possibility.
- Other potential risks to the global capital markets include; the potential for rising U.S. wage and inflationary pressures, rising oil prices as a result of the Iran sanctions and the fast approaching November mid-term elections.

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.[4] 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. 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. As always, we continue to watch a myriad of potential geopolitical risks to investors related to North Korea, Syria, Iran, Saudi Arabia and Russia.

As always, we will continue to conduct our model research into the major economic and behavioral forces which may drive markets either higher or lower from this point. The 3EDGE approach to portfolio management targets alpha, or attractive risk-adjusted returns, by following our investment discipline of seeking to identify undervalued or overvalued asset classes across the globe that may be poised to enter a period of market outperformance or underperformance. 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.

Stephen Cucchiaro
President & Chief Investment Officer
3EDGE Asset Management, LP

DeFred G. Folts III
Chief Investment Strategist
3EDGE Asset Management, LP

Sources:

1. Bloomberg
2. Morningstar
3. Bloomberg
4. Bloomberg