Quarterly Letter **Quarter-ended December 31, 2018**

For the quarterly period ended 12/31/2018 (Q4-2018), the 3EDGE Total Return Strategy and the 3EDGE Conservative Strategy experienced negative rates of return. Gains from holdings in fixed income, gold and cash & equivalents were not enough to offset losses in holdings of U.S. and Japanese equities during the period. The bulk of the losses occurred in October prior to exiting U.S. and Japanese equity positions and assuming a substantially more defensive positioning as determined by our research.

Current Global Capital Market Environment

During the fourth quarter of 2018, the global capital markets were subjected to extreme bouts of volatility. For example, in the fourth quarter of 2017 the daily average level of the VIX (CBOE Volatility Index®), which measures the market's expectations of future volatility was approximately 10.31. In the fourth quarter of 2018 the daily average level of the VIX was 21.05, an increase of over 100% in Q4 2018 vs. Q4 2017. In addition, in Q4 2018, the maximum drawdown (worst peak to trough) of the S&P 500 was -19.6%.[1]

Headwinds buffeting global markets in 2018 included a series of Fed rate hikes (one every three months), uncertainty over a potential trade war between the U.S. and China, fears of slowing economic growth in China, continuing political instability in Europe and a political stand-off and partial government shutdown in the U.S. Equity markets experienced two market downturns in the fourth quarter, once during October and then again in December. Most asset classes finished the year with losses, including U.S., European, Asian and emerging market equities, long duration U.S. Treasury bonds, corporate bonds, commodities and gold. As the Fed continued to raise short-term interest rates every three months throughout 2018, cash became a relatively attractive asset class for the first time since the financial crisis. By year-end, 3-month U.S. Treasury bills yielded 2.35%2, higher than the S&P 500 dividend yield and a level not seen since 2008. However, the yield on longer-dated U.S. Treasuries declined during the fourth quarter in response to fears of a global economic growth slowdown, causing the yield curve to continue to flatten.

The Economy vs. The Market

Despite the volatility and market declines in the fourth quarter, the U.S. economy entered into 2019 in excellent health with the unemployment rate at a 49-year low, wages increasing at a rate of approximately 3%[3] year-over-year, corporate earnings still rising and consumer confidence reaching a high level. If the current U.S. economic expansion continues through July of 2019, it will become the longest economic expansion on record. However, the U.S. economy may gradually slow in 2019 from its pace of above 3%[4] GDP growth in the second and third quarters of 2018 given that the economic acceleration in 2018 was due in large part to the fiscal stimulus provided by the corporate tax cut, the benefits of which could begin to wane in 2019. It is unlikely that the U.S. economy can continue to grow at a rapid rate while the global economy continues to slow.

Monetary Policy
Throughout the fourth quarter of 2018, the U.S. Federal Reserve was very much top of mind for investors. The market decline which began in the first days of October seemed to be a direct result of Fed Chair Jay Powell's off the cuff comments that interest rates in the U.S. were "nowhere near their neutral rate", which is the rate that neither stimulates nor restrains the economy. This commentary was interpreted by investors to be a signal that the Fed intended to continue to raise short-term interest rates faster and further than market consensus at that time. Then in mid-December, as expected, the Fed increased the benchmark rate for the fourth time this year and for the ninth time since they began to tighten monetary policy in December 2015, bringing the benchmark rate to the highest level in over a decade. Even though the Fed's action in mid-December fell in line with most market participants' expectations, the immediate reaction to the rate hike, policy statement and news conference indicated that investors were disappointed that the Fed had declared that their balance sheet reduction would continue on "autopilot" and that they didn't deliver a more dovish message about potential future policy changes. Immediately following the announcement of the mid-December rate hike, markets dropped precipitously, before recovering some of the decline in the final week of December. Entering into 2019, investors will be faced with a myriad of questions concerning the future direction of monetary policy and economic growth. Will the Fed continue to increase short-term interest rates and invert the yield curve, which could be a harbinger of an economic recession? Has the Fed already raised rates too many times, since at the same time they have also been materially reducing their balance sheet through quantitative tightening? Has the Fed already made the inevitable "policy error" that could push the U.S. economy into a recession, based upon the lagged effect of monetary policy? Will the next Fed policy move be a rate cut?

U.S. - China Trade
The ongoing trade dispute between the U.S. and China continues to be of utmost importance to the ongoing health of the global economy since these two countries represent the two largest economies in the world today, and because there exists such a high degree of connectivity and linkage among integrated global supply chains. The impact of these disagreements over trade is already seen to be impacting the Chinese economy as well as many satellite emerging market countries.

Entering into 2019, there appears to be some optimism about the potential for a negotiated trade deal between the U.S. and China based upon upcoming meetings between their trade delegations. However, a mutually acceptable agreement in January or anytime in the near future is far from certain since the significant issues involved in the negotiations would be difficult to resolve quickly. The issues for U.S. companies include access to China's markets, protection of intellectual property and protection from technology transfer requirements. Disagreements over trade between the U.S. and China also represent a legitimate threat to the future corporate earnings of a significant number of major companies that rely on either exporting or importing goods and services with China. Unless there is some resolution relatively soon, the slowdown in China could accelerate, and China's high level of debt to GDP may well preclude it from stimulating a slowing economy to the extent that they have in the past. It is also true that even while U.S. economic growth remains strong, the U.S. economy will not be able to grow indefinitely should economic growth in China and the rest of the world slow precipitously.

Current positioning

Our outlook for U.S. equities remains neutral. While our U.S. yield curve factor is a positive contributor due to the lagged effect of earlier monetary stimulus, it is offset by continued Fed tightening and widening credit spreads. Despite the market correction during the fourth quarter, by our measures U.S. equities continue to be overvalued. While P/E ratios of U.S. equities may now appear to be more reasonable, price to sales ratios are near levels last seen at the top of the tech stock bubble in early 2000. In addition, earnings margins for U.S. companies have been at near-record high levels, and this is not likely to continue particularly in the face of continued monetary tightening and the waning benefits of the one-time corporate tax cut. Further, U.S. corporations have engaged in large share buyback programs for some time, and this has also contributed positively to earnings per share growth. However, going forward, higher borrowing costs and high levels of corporate indebtedness could hinder many companies' capacity to continue with share buybacks in the future. Unless earnings margins enter a new, higher permanent plateau which seems unlikely, the eventual reduction of earnings margins to more normal levels could leave U.S. equity prices vulnerable to further declines.

Although developed European and Asian equity valuations appear reasonable, our outlook remains negative due to low growth prospects as evidenced by continued flat yield curves, high debt levels, recent discussions and attempts to begin normalizing monetary policy and negative investor psychology.

Emerging market (EM) equities struggled throughout 2018 for a variety of reasons including the ongoing trade dispute between the U.S. and China, higher U.S. interest rates and a strong U.S. dollar, among others. Since the financial crisis of 2008, EM equities have substantially underperformed U.S. and other developed market equities, leaving EM equity prices undervalued by our measure. Entering into 2019, our model research now suggests the potential for a near-term rebound in EM equity prices, particularly relative to U.S., European and developed Asian equity markets. The decline in U.S. Treasury and EM long yields along with recent dollar weakness are supportive of the capacity for both EM corporate and government borrowers to service their debts. In addition, the extended sell-off experienced by EM equities in 2018 places the asset class into a somewhat oversold behavioral condition which when combined with the positive economic catalysts mentioned above, could be supportive of EM equities in the near-term.

Gold ended 2018 near a six-month high, and our model research indicates that gold has now moved to a more positive outlook due to the recent decline in real (inflation-adjusted) yields, U.S. dollar weakness and positive investor behavioral factors.

Our outlook for U.S. fixed income is mixed. The positive effects of declining U.S. Treasury yields during the final days of 2018 more than offset weakness in the U.S. dollar. By the end of 2018, the yield on the 10-year U.S. Treasury had fallen back to 2.68%[5], the lowest level since February 2018. Meanwhile our outlook for credit remains negative based on our concerns over the high level of corporate debt outstanding relative to GDP combined with widening credit spreads and the potential for slowing economic growth. To mitigate both credit and duration risk, our fixed income positions are currently more focused on short-term U.S. Treasuries.

Commodities (excluding gold) continue to maintain a decidedly negative outlook given a high degree of negative investor psychology towards the asset class and the potential for weakening demand as the global economy enters the latter stages of the current economic cycle.

Alternative Scenarios and Potential Risks

There are two potential scenarios which could serve as catalysts to ignite a rally in equities. First, if the U.S. and China were to find a way to reach a negotiated settlement of their current trade disputes, or even an agreement to continue negotiations and delay further tariff increases, such an outcome could serve to spark at least a short-term market rally. Second, if the Fed were to pause or make an explicit statement that they intend to pause raising short-term interest rates in the future as fast and as far as investors are now expecting, then this could also cause a short-term equity market rally, provided such an announcement did not lead to increased fear about an impending economic slowdown. Should the Fed pause their financial tightening, we believe that gold and EM equities would benefit relatively more than U.S., European or Asian developed equities.

Longer-term considerations

A topic of concern facing investors that we have previously mentioned is the fact that global debt relative to GDP has now risen to a level even higher than at the time of the financial crisis of 2008. High debt levels among both governments and corporations could prove to be problematic particularly as the Fed and other central banks continue normalizing monetary policy at the same time that the current economic cycle enters its latter stages. In addition, the Italian debt situation and Brexit in the U.K. continue to bear watching. 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 will continue to conduct our model research into the significant 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.

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Sources:
1, 2, 3, 4, 5 - Bloomberg