Quarterly Letter Quarter-ended March 31, 2019

For the quarterly period ended 03/31/2019 (Q1-2019), each of the 3EDGE strategies made positive returns due to gains in U.S. and emerging market equities, U.S. Treasuries, U.S. Treasury TIPs, gold, and cash & equivalents.

Current Global Capital Market Environment:

In the first quarter of 2019, the S&P 500 index gained over +13%[1] which was the best three-month period for the index since September of 2009. However, the strong returns in Q1 2019 came on the heels of a material decline across equity markets during the fourth quarter of 2018. By Christmas Eve of last year, the S&P 500 index had suffered a drop of nearly -20%[2] from its September 2018 highs and of the four major equity asset classes that we model only emerging market equities ended up with positive returns for the two quarters combined.

At this juncture, we believe that the U.S. stock market presents a potential danger to investors, not only because by our measure U.S. equities appear to be overvalued, but also because history has shown that overvalued markets can become even more extended over time and breed complacency only to be followed by a severe market decline. Based upon our valuation model the degree of overvaluation in the U.S. equity market is now approaching levels seen just before the bursting of the tech stock bubble in the year 2000 and the stock market crash of 1929.

We believe that the most significant market driver of U.S. equities this year is the abrupt about-face by the Federal Reserve Board which has now paused in their program of increasing short-term interest rates and normalizing their balance sheet. We also believe that another factor supporting the equity markets in Q1 has been efforts by China to use both monetary and fiscal stimulus to energize growth in the Chinese economy. An important question that we discuss internally is whether the rebound since the December 2018 low represents a quintessential bear market rally or a continuation of the 10-plus year bull market. Historically bear markets are punctuated by a series of intermittent rallies typically caused by monetary or fiscal intervention designed to prop up a falling stock market. So far, the current rally in U.S. stocks fits this description quite well; however, should U.S. equities rally to new all-time high levels then there is the possibility that investor psychology could extend the rally higher.

Emerging Market vs. U.S. Equities

Emerging market equities have significantly underperformed the U.S. stock market since the financial crisis of 2008, and by our measure emerging market equities are more fairly valued than the U.S. market. Emerging market companies and governments carry a substantial amount of U.S. dollar-denominated debt, and EM equities greatly benefit from a weakening of Federal Reserve Board policy which relieves pressure on their local currencies relative to the U.S. dollar. Future gains in emerging market equities may be influenced by China's ability to translate recent monetary and fiscal stimulus measures into economic growth of the Chinese economy. However, this becomes more difficult for China as their debt-to-GDP ratio rises to new all-time highs.

Current Outlook and Positioning

Asset Class		Negative		Mixed	Positive	
Equity	U.S.				●	
	Europe		●			
	Asia			●		
	Emerging					●
Fixed Income	Rates			●		
	Credit			●		
Real Assets	Gold					●
	Commodities				●	
Cash				●		

Equities: We maintain a positive outlook towards Emerging Market and U.S. equities to different degrees, and we currently maintain long positions in both. **Emerging Market (EM) Equities** are more attractive on a valuation basis than U.S. equities, and declining long yields in the U.S. are also supportive of EM equities. Also, the negative impact from monetary authorities in emerging market countries having to lower short-term interest rates to stimulate their economies seems to be stabilizing. However, a potential reversal of positive investor psychology in the face of economic data that may indicate an impending global economic slowdown, or the inability of the U.S. and China to strike a meaningful trade agreement could negatively impact our outlook for EM equities.

U.S. Equities remain modestly positive, at least in the short-term, and continue to benefit from the Fed's pivot towards a pause in monetary tightening. Recently we have seen the tightening of the TED (Treasury-Eurodollar) spread which is an indication of adequate liquidity available in the financial system. In addition, the narrowing of both investment grade and high yield credit spreads are also contributing near-term positive factors for U.S. equities. However, as previously mentioned, our research model continues to indicate that U.S. equities remain overvalued and this is weighing negatively on our current projection for the asset class. **Japanese equities** have a mixed outlook while **European equities** remain negative. Both Japan and Europe have flattening yield curves suggesting limited growth opportunities, and in Europe, this is compounded by negative investor psychology. Currently, we do not maintain long positions in either Japanese or European equities.

Fixed Income: The outlook for **U.S. fixed income** remains mixed to positive. The U.S. dollar has had a mixed performance against leading currencies, strengthening against some and weakening against others, creating an offsetting effect for U.S. Treasury securities. Our yield curve measure (which is somewhat more nuanced than just 3-month T-Bills vs. 10-year U.S. Treasuries) while still positively sloped continues to flatten indicating the potential for a slowdown in economic growth which would be favorable for bonds. We remain cautious of credit due to record high corporate debt / GDP and corporate debt / cash flow ratios. We are long U.S. Treasuries of shorter duration, and we are currently avoiding portfolio investments in credit-related fixed income such as high-yield bonds.

Real Assets: Gold maintains a positive outlook due to low and declining real yields (nominal yields adjusted for inflation), an increase in central bank purchases, positive investor psychology, and the Fed's policy reversal. The outlook for **commodities** has improved due to low real yields and the potential for a continued rebound in EM demand driven by China stimulus. We now maintain long positions in both gold and commodities.

Cash & Equivalents remain attractive on an absolute yield basis, but less attractive on a relative basis due to the positive outlook for Emerging Market and U.S. equities, U.S. Treasuries, gold, and commodities. Our current portfolio positioning reflects our goal of seeking to safely participate in the rising equity market while at the same time being especially prepared to weather the next bear market which we believe has the potential to be particularly severe.

Potential Market Risks

There is indeed ample evidence that global economic growth may be slowing, and the U.S. economy and U.S. equities would be hard pressed to remain strong in the face of a deepening slowdown in the global economy. There is also a question as to whether the Fed and other of the world's central banks are in a position to backstop a global economic slowdown since it is debatable as to whether they have achieved a sufficient level of policy normalization to enable them to reverse course effectively.

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.

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

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

Sources: Bloomberg 1, 2