Wealth through ingenuity.

CMG Opportunistic All Asset Strategy
2018 Q1 Quarterly Update

The CMG Opportunistic All Asset Strategy was aggressively positioned to start the quarter as equity markets traded higher at the beginning of the year. The strategy was 98% invested in equities, the largest and most equity oriented allocation in well over a year. During January, the portfolio held positions in domestic mid and large cap equities but the majority of the portfolio was tilted to international stocks. Over 60% of the portfolio was in international equities, split roughly evenly between developed and emerging market positions. Equity markets stumbled in February on inflation concerns and rising interest rates and the strategy began reducing risk during the month as our proprietary relative strength readings favored cash (or short duration 1-3 month T-bill positions that are not inflation sensitive) over equity and traditional fixed income positions like government bonds and corporates. By the end of the month, the strategy had moved 20% into defensive positions. The strategy reduced domestic equity exposure while maintaining its international positions. The volatility continued in equity markets throughout March albeit the concerns driving market gyrations shifted from inflation and interest rates to the impact on growth of an escalating trade conflict between the U.S. and China. As a result, during March, the portfolio further reduced equity exposure to its most defensive position in several years with over 70% of the portfolio in cash and/or short duration fixed income positions. The balance of the portfolio remained invested in international equities, which held up better in March than domestic stocks.

Equity markets remain choppy and range-bound after reaching new highs this year. Our relative strength readings continue to favor risk-off assets, primarily cash, and are likely to remain there until a sustained trend in equities re-emerges. For the better part of two months, equities have taken one step forward and two steps back, painting a poor technical picture, one suggesting that short-term resistance is strengthening. Despite a challenging quarter, we are pleased with the strategy and our model's ability to respond to the change in equity risk and move from an aggressive to a defensive position in such a short window of time. The ability to change asset allocations in response to changing market conditions is the essence of the value proposition for tactical strategies and why they play such an important and complementary role to traditional long-only portfolios. The strategy held the following allocations (individual portfolio allocations may vary) to equities, fixed income, commodities and cash at the end of January, February and March:

	Equities	Fixed Income	Commodities	Cash
January	100.00%	0.00%	0.00%	0.00%
February	81.92%	0.00%	0.00%	18.08%
March	26.78%	0.00%	0.00%	73.22%

It's been a great party but as with any good soiree, the day after is time to clean up. For over a decade markets have feasted on low interest rates, accommodative fed policy and stable trade pacts. Equity markets set new highs, ample liquidity has pushed real estate back to pre-crisis highs (and beyond in many regions) and unemployment is at multi-year lows. After tax cuts passed last year and the roaring start to the year for equity markets across the world, it looked as if the party might roll on forever.

What a difference a couple of months makes. The concerns we shared in our last newsletter, rising interest rates and trade conflicts, revealed themselves during the first quarter showing that volatility and risk are alive and well. Five hundred to 1000 point swings in the Dow became daily occurrences and lead to the blow-up of volatility-based investment products that employ the "pennies in front of steamroller" investment approach. Inflation and trade war concerns knocked markets around for the better part of February and March and April is bringing more of the same. All indications point to a change in the state of mind of the market: things are going to be tougher and the technical charts

are telling us we are heading into choppy waters. The upward trendline on U.S. market indices has been broken and there is now ample resistance to this market reaching new highs. Like a mountaineer attempting to summit, each failed attempt saps him of strength, lowering the prospect of reaching the peak on another attempt. It will take a lot of energy to break through and reestablish another cyclical bullish upswing in the intermediate term.

Investors found few safe havens during the market declines. Domestic and international stocks fell in tandem and few sectors were spared. Facing a headwind, fixed income allocations failed to offset equity losses in portfolios. Cash and commodities, underappreciated for years, served as bulwarks against portfolio losses and will remain critical components for asset allocators moving forward. What has, to some extent, been lost during the drama of the first quarter is the economy is doing well – not great but certainly not about to decline or go in a recession. That view, as we have recently seen, can change quickly, but it is going to take more negative data and/or news to get there. We continue to believe that rising interest rates and trade conflicts are the biggest headwinds for markets and how risks associated with them evolve will in large part determine whether markets can move higher.

An Expensive Pony

If you drive anywhere in this country, you have likely noticed our infrastructure looks a little run down – like last century run down. I know for a fact that certain roads and bridges in our area have not been touched in over 30 years. Other aspects of our infrastructure look much the same. I get it – it's not easy. To fix 50+ years of underinvestment takes a lot of work. In fact it takes a lot more work than just cutting taxes and hoping for the best. The reality is that our country has an investment problem, public and private, and our leaders, in Congress and in the C suites have turned into one-trick ponies.

The tax cut approach has never really worked for most of America and it overshadows other good ideas that could make the economy grow, increase worker productivity and at the same time increase standards of living. Investments in education and teachers, nationwide broadband, better and more easily transferable healthcare and a real commitment to a new energy future (not doubling down on coal) are just some examples that would boost economic growth.

Corporations received a huge windfall from the tax cuts last year, and as we anticipated, rather than spurring investments or hiring, most of the windfall is going to executive bonuses, dividends and buybacks. American companies have announced $171 billion of stock buybacks, a record high for this point in the year according to Biryini Associates, and more than double the $76 billion that corporate America disclosed at the same time last year. Further, JP Morgan estimates that gross share buybacks will reach a record $800 billion in 2018, up from $530 billion in 2017.

Much like their counterparts in Congress, there is a lack of commitment to investment. While that may help short-term profitability, it ultimately sows the seeds of a more difficult economic future, one where those investments are going to be more expensive to finance. If corporate America can't find attractive investments at a 3% ten year, what are they going to do at higher rates? If Congress can't find a way to rebuild our country at near record low rates, what incentive will they have as the cost goes up? One of the drivers of interest rates over the quarter was the reaction to the budget deal that projects trillion dollar deficits for the foreseeable future. Combined with tax cuts, over the next ten years, we could see over 10-20% added to our national debt. If the economic growth doesn't show up, it could be an expensive one-trick pony indeed.

The more immediate issue is that recent budget decisions have put additional upward pressure on interest rates and the headwind facing bonds blows stronger. Here are some other data points to consider as the supply of debt coming to market continues to increase and put pressure on rates:

- According to the Congressional Budget Office, the U.S. budget deficit will surpass $1 trillion by 2020, two years sooner than originally estimated.
- The U.S. budget deficit was $215 billion in February alone, the largest in six years.

CAPITAL MANAGEMENT GROUP
1000 Continental Drive (800) 891-9092
Suite 570 (610) 989-9090
King of Prussia, PA 19406 (610) 989-9092 FAX
www.cmgwealth.com

- The Treasury Department, in March, auctioned its largest supplies of debt since the financial crisis. Sales of shorter-term debt in particular are rising as the government's financing needs have increased due to the tax overhaul.
- China holds over $1.7 trillion of U.S. debt and between December and January of this year, the Chinese reduced their holdings by 1.4%. The Chinese are considering scaling back more in response to U.S. tariffs.
- Per the National Association of State Budget Officers, 27 states saw revenues fall below expectations last year. These states will need to borrow more in a market already overflowing with new issuance.
- Teacher Populism: Cuts to education have been one way to balance budgets but appear to have reached a limit. Teachers in West Virginia, Oklahoma, Kentucky, Arizona, Louisiana and Colorado have gone on strike this year. Governments in many of these states have a tough choice: raise taxes or raise more debt.

Trade Wars and Real Wars

Although the first leg of the market drawdown this quarter was precipitated by a spike in interest, it was the escalating rhetoric on trade that left a more lasting mark on investors' psyche. What started with the administration's roll-out of steel tariffs evolved to several rounds of tariffs targeting China over the past months. There was a decidedly different tone and calculation to each of the tariffs: the steel tariffs were introduced on the grounds of questionable national security concerns while the tariffs against China were targeted at very specific sectors like electronics, medical equipment and televisions. The difference between how they were rolled out plainly shows the bipolar nature of the Trump administration. For the first year of this presidency, markets were willing to ignore a certain amount of bluster assuming that policy would not change much. This quarter brought reason for a reassessment of that view. Although Trump appears fluid on most policy issues, he has for most of his life held anti-trade views, frequently venting about the poor quality of trade deals as if the trade deficit was the only score that matters. That has markets rattled and it is likely to spur bouts of volatility over the coming months.

A trade war would have an immediate impact on economic growth and trade, but it is the long-term impacts on the U.S. that could have more lasting consequences. The current skirmish with the Chinese also highlights a global dichotomy on trade: developed counties are downbeat on trade while emerging markets are increasingly optimistic. Public policy polls bear this out as the recent McKinsey survey of global business leaders lists changes in trade policy as the number one risk to global growth. While rising interest rates are number two, both doubled (in terms of respondents citing them as a risk) from the previous survey in December. One estimate from UniCredit Bank suggests a trade war would reduce global growth by 0.50% - 1.0% a year and could spark a recession. While significant, how does that compare to the cost of the U.S. relinquishing its leadership on global economic affairs?

Relying on national security justifications to pass steel tariffs is one example of this. While WTO rules permit members to impose tariffs under this premise, it is a highly cynical approach to trade – every country, including China, could use national security to justify trade protectionism. Additionally, the steel tariffs targeted allies that were puzzled by the administration's mixed signals. Tariffs against China targeting intellectual property theft actually have a fair amount of support amongst allies in Europe and Canada but the lack of coordination with allies has undermined their effectiveness. The Trans Pacifica Partnership, which Trump abandoned, actually has some of the strictest intellectual property protections of any trade deal. It is no wonder that the global community is puzzled by such a duplicitous economic policy and is looking to diversify away from the U.S. Canada and Mexico, concerned about NAFTA, have both joined the TPP and Mexico most recently agreed to a new trade deal with the EU (the largest common market in the world) that virtually eliminates tariffs between them. Clearly, both countries are looking for leverage and planning contingencies if NAFTA negotiations don't go well.

As much as the world is weighing how to engage with an "America First" policy, the biggest geopolitical risk this quarter is Trump decertifying the Iran deal on May 12. The additions of Mike Pompeo at state department, John Bolton as national security advisor and the outsourcing of Middle East policy to Saudi Arabia and Israel increases the likelihood of a larger conflict with Iran. While that would be devastating for an already war-torn region, the global fallout of the U.S. withdrawing from a well-negotiated deal could have major ramifications for U.S. global leadership for years. Most immediately, it would undermine the positive overtures between the Koreas. Indeed, it appears that Kim Jong-un may have timed his trip to South Korea precisely because it puts pressure on the U.S. If the Iran deal falls apart and negotiations with North Korea don't go well, the U.S. may well look like the rogue. Internationally, this drives up the status of Russia and China and undermines trust in the US as a global leader.

Recently departed Secretary of State Rex Tillerson left the state department in shambles. Dismissed under his tenure as overly bureaucratic, our diplomatic corps has been hollowed out and is contracting at a time when China is investing a huge amount of political capital to sell its brand around the globe. This was the job our diplomats did very well, often to the significant benefit of business, for over a half century. Now it is the Chinese building roads, infrastructure, making investments and influencing young minds in the emerging and frontier countries. They are seeing the American brand less and less. A further sign of China's outsized role was the launch of the first ever Yuan denominated crude oil futures contract by the Chinese. A weakened, isolated or less trusted U.S. may no longer get financing at the same attractive rates in what is still a dollar-centric world. Yet another tailwind for rising rates and inflation and a good reason to diversify equity holdings into international and emerging markets.

Kindest regards,

PJ Grzywacz
President

CAPITAL MANAGEMENT GROUP
1000 Continental Drive (800) 891-9092
Suite 570 (610) 989-9090
King of Prussia, PA 19406 (610) 989-9092 FAX
www.cmgwealth.com

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