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CMG Opportunistic All Asset Strategy
2018 Q3 Quarterly Update

The CMG Opportunistic All Asset Strategy began the quarter in a defensive position but added risk in equities as the quarter went on. Our relative strength models have kept the portfolio in a defensive positon for several months with a large portion of the portfolio allocated to short duration fixed income positions which have, on a risk-adjusted basis, scored much better than other asset classes in our model. In July, 100% of the strategy's equity position, which represented 27% of the portfolio, was invested in the utilities sector. The balance of the portfolio remained invested in short duration fixed income along with a 10% allocation to municipal bonds. In August, the strategy increased equity exposure modestly. The strategy's utilities position was reduced while new allocations to Indian stocks and the pharmaceutical sector were added. Fixed income allocations remained steady, biased towards short duration fixed income positions with modest exposure to municipal bonds. The strategy maintained its positioning from August through September and remained in a conservative risk position heading into the fourth quarter.

After starting the year heavily invested, the strategy had a quiet second quarter before putting some risk back on in the third quarter. For the past two quarters, the strategy has been underinvested as our relative strength algorithms have avoided more volatile asset classes like technology and small caps. As we discussed in our last quarter update, our relative strength process seeks to identify assets that are trending higher, albeit with a smooth and steady trend. Furthermore, to measure a trend, our model requires a certain amount of measurements, in this case days of price data to analyze, to determine if a trend is positive and how that ranks relative to other asset classes. Our models typically analyze 45-75 days' worth of price data in calculating a relative strength reading. That means that as trends change our model's interpretation of those trends changes as well. If we measure a trend over a short-term period of time, we may participate in more uptrends but are likely to have more false positives as well. If our lookback period is too long, we may stay in trends longer but at the cost of added volatility because it would take a larger sell-off before our strategy moves to cash or a defensive position. Our strategy is an intermediate-term trend following strategy which attempts to balance the latter with the former and we seek further diversification by mixing various lookback periods.

Looking at the equity market (although the same could be said for fixed income markets) this year, stocks began in a strong uptrend that was broken by the large sell-off in February. It took almost a full quarter before the markets consolidated those losses, found some footing and started trending higher in the third quarter. However, that trend has petered out at the start of the fourth quarter. Tech and small caps trended higher during this period but now are significantly off their highs; their short-term uptrend has been broken. Tech stocks are now almost 10% off their highs while small caps are down more than 10% from their highs and are flat for the year. What looks like an opportunity missed in the third quarter has become a sell-off avoided at the start of the fourth quarter. No strategy is perfect; both passive and active investment strategies have their pros and cons and while diversification is always preached in theory, it is often disregarded in practice. The quiet uptrends in the middle of the year are now bookended by two of the sharpest sell-offs we've seen in years. While this correction could very well be a short-term decline, the overall character of the market looks to be changing, exhibiting the characteristics of a late stage bull market.

The strategy held the following allocations (individual portfolio allocations may vary) to equities, fixed income, commodities and cash at the end of July, August and September:

	Equities	Fixed Income	Commodities	Cash
July	26.58%	8.87%	0.00%	64.55%
August	26.79%	8.87%	0.00%	64.34%
September	26.11%	0.00%	0.00%	73.89%

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Equity markets had a quiet but strong third quarter, trending higher and setting new highs several times during the past three months. However, as the summer doldrums fade into the rearview mirror, the focus for investors is what is on the horizon. If October is any indication, there are storm clouds on the horizon. Market breadth continued to narrow during the past quarter to the point where just a handful of stocks have driven indices higher (think FANG – Facebook, Amazon, Netflix and Google). When market leadership becomes overly concentrated, new highs bring a false sense of confidence, which can be turned upside down in a short period of time. It happened in February and its happening again in early October. The reality is that many domestic stocks continue to hit 52 week lows, a sign of internal weakness and that something is not right with this market. Investors are responding by rotating out of higher beta growth positions (tech, small caps) and into more defensive sectors like utilities and consumer staples.

It is all the more peculiar since most economic indicators are healthy: consumer and business confidence are strong, earnings growth is robust and unemployment remains near decade lows. However, the dark clouds rolling in are in the form of rising interest rates, a rapid rise in the U.S. deficit and a rapidly escalating trade war. Internationally, concern over Italy and its unsustainable debt position has overshadowed the difficult Brexit negotiations. Investors are trying to balance these risks all while keeping one eye on what will be a closely contested midterm election season. While the long-term bull market trend in U.S. equities remains in place, we are starting to see cracks. We'll break down some of the risks above in greater detail below.

Up, Up and Away

Fed Chairman Jerome Powell is worried and spending a lot of time meeting with members of Congress. In his first six months as Chairman, he has met or called lawmakers 48 times, almost three times more than his predecessor, Janet Yellen. There is nothing particularly controversial about the Fed's pace of interest rate hikes. It has been gradual, well telegraphed and complemented by other accommodative policies like QE. So what is weighing on the Fed Chairman's mind? Independence – specifically the Fed's independence from the executive branch. Although the economy is doing well, some cracks are starting to show, in particular a trade war that has stung constituencies supportive of Trump and rapidly rising deficits, the result of large corporate tax cuts. With one eye on midterms and the other on 2020, Trump has started to message who will be to blame for a market decline or economic slowdown. It should come as no surprise that someone who has binged on debt their entire business life would rally for an accommodative Fed policy. It is clear that Trump is laying the blame at Powell's feet, suggesting that rising interest rates are undermining his economic agenda. Powell is right to be concerned, hence the shoring up of support on the Hill.

The irony of Trump's approach is that while attacking the Fed chair may be popular with large segments of the country, it is likely to achieve the exact opposite; the Fed will act more independently if for no other reason than to bolster its credibility. Threats to the Fed's independence are not unprecedented. In his new memoir, former Fed Chairman Paul Volcker recalls President Reagan's chief of staff ordering him to not raise interest rates ahead of the 1984 election. Reagan was in the room and Volcker recalls being stunned. While we don't expect the Fed to submit to Trump's tantrums, there is now a good chance that the Fed will pause after a December rate hike (the probability of that hike has come down as well), the fourth of the year. Ten year interest rates spiked from a level of 2.82% in late August to over 3.20% in September and have remained above 3% for several weeks now. We started the year at 2.43%. The impact has been particularly severe on homebuilders and the real estate sector in general. As mortgage rates hit their highest levels in years, approaching 5% on a 30-year, the impact on mortgage applications has been swift and severe: applications were down 7% in the first week of October. Homebuilder stocks are down over 40% from the January highs. Powell has a difficult task of balancing his goal of normalizing rates (and creating some room to cut rates in the next downturn) and not choking off the current economic expansion. With inflation subdued, in particular wage inflation, there is room for Powell to be more accommodative, to pause. If that happens, we expect bonds to rally,

recovering some of their losses and for the dollar to pullback from its elevated levels. Given this scenario, it is likely that equities, both domestic and international, would rally into year end.

La Dolce Vita

Winston Churchill once said that "the best argument against democracy is a five-minute conversation with the average voter". While his quote may speak to the lack of engagement or intelligence of the average voter, it does not address what happens when that voter is angry, much less in a rage. The wave of populist governments that has washed over the developed world has shown us that voters, when angry, are likely to be irrational. Italian voters are angry; they are no richer on average than they were twenty years ago, 10% are out of work and 20% live on less than $12,000 a year. The result of their anger has been an irrational coalition of left and right wing partners, joining the Five Star Movement (M5S) with the Northern League. On September 27, that irrational coalition delivered a budget that is absurd and will complicate Italy's relationship with the EU. Both of the governing parties have chosen to avoid addressing the systemic issues that hinder Italy's productivity growth and competitiveness in favor of delivering on the narrow promises their bases are calling for. The result is a budget that promises basic minimum income for voters on the left (M5S) and a flat tax for voters on the right. Both parties support rolling back pension reforms. In sum, the new budget pushes the fiscal deficit to 2.4% next year, 50% bigger than the level at which Italy could run without adding to its debt load which currently stands at 132% of GDP. Its public debt is the highest in the Eurozone with the exception of Greece.

Italy was already a worry for investors and the EU but markets reacted immediately, signaling that the surprise budget (no one expected a deficit of this magnitude) was a ticking time bomb for the country and its banks, holders of large quantities of Italian debt. The stock market in Milan sold off hard and the Italian 10-year reached its highest level since 2014, increasing the cost of rolling over Italian debt and financing the proposed budget. There is more trouble on the horizon: S&P and Moody's are set to review Italy's bond ratings by the end of October and next year will see European leaders negotiate the appointment of Mario Draghi's successor as President of the ECB. The three key players in this drama, Italy, France and Germany, all have weak governments and could try to cater to domestic voters with extreme or rigid positions. As if that was not enough, the EU (and its individual members) are caught up in the global rivalry between China and the U.S. as each superpower seeks to redefine global trade. Chinese investments in Europe doubled in 2016 and despite Chinese FDI declining in 2017, the share going to Europe still rose from 20 to 25% of the total. If the EU drives a hard bargain with Italy, the current coalition could turn to China for additional financing.

Trade Wars, Currency Wars, Cold Wars and Real Wars

The U.S. and China continue full steam ahead with a trade war. Running on a parallel path is a growing cold war, with each side testing the other. The current animosity is likely to escalate in the short term. The conclusion of NAFTA negotiations and the earlier de-escalation with Europe on trade are signs that the Trump administration is going to further intensify its efforts against China. Better to secure your flanks before going to war. Although the current situation with China is not the Cold War of the past century, it is exhibiting the characteristics of something deeper than a disagreement on trade. When the U.S. and the USSR were the dual superpowers, economic expansion and influence was as critical (if not more critical) as ideological indoctrination. Both sides spent heavily to support regimes in parts of the world that were irrelevant to their citizens.

It was not always the threat of military invasion that drove leaders into the arms of the U.S. or the Soviets. For many emerging economies during this time, it was about investment, access to markets and buying weapons. Most of the world moved into one camp or the other and each superpower nurtured its client states at great cost. Although China is not prepared to engage militarily to the extent the Soviets did, their expansion into the South China Sea, the Silk Road initiative and the proactive policy of engaging countries where an American presence has pulled back harkens back to the 60s and 70s. The risk is that what started as a trade war is now a cold war that could turn hot. One example is the ongoing posturing in the South China Sea where the Chinese have asserted themselves, claiming disputed islands and

building military bases. The U.S., along with other allies, have increased "freedom of navigation operations" to demonstrate they will not be intimidated. In early October, this form of saber-rattling resulted in a Chinese destroyer coming within 40 meters of a U.S. destroyer. The two countries, much like the U.S. and the Soviets, maintain numerous agreements and backchannels to de-escalate this type of situation. In this case, it is the Military Maritime Consultative Arrangement that allows for each side to lodge complaints on maritime activity. If we see agreements like this start to deteriorate or they are abandoned entirely, the risk of a conflict, premeditated or accidental goes up. To date, the trade war has had a limited impact on the economy as a whole for either country. However, as things get tighter on both sides and there are fewer goods to tariff, it is likely that each side looks to use less orthodox policies to pressure the other side. For example, the next round could very well feature a fight over exchange rates and currency manipulation. China could choose to change its composition of foreign reserves, signaling it's less willing to keep buying U.S. Treasuries. History has shown us that once the momentum towards a conflict gets going, it is hard to stop. The current conditions echo many of the global issues that led to the first and second World Wars. While not trying to sound alarming, it is worthwhile to examine the parallels of those periods with today to determine the impact on a global economy that, today, is more interconnected than ever before. At the very least, these concerns are likely to weigh on investors' minds to a greater extent than a year ago, leading to further risk reduction in portfolio allocations.

Kindest regards,

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