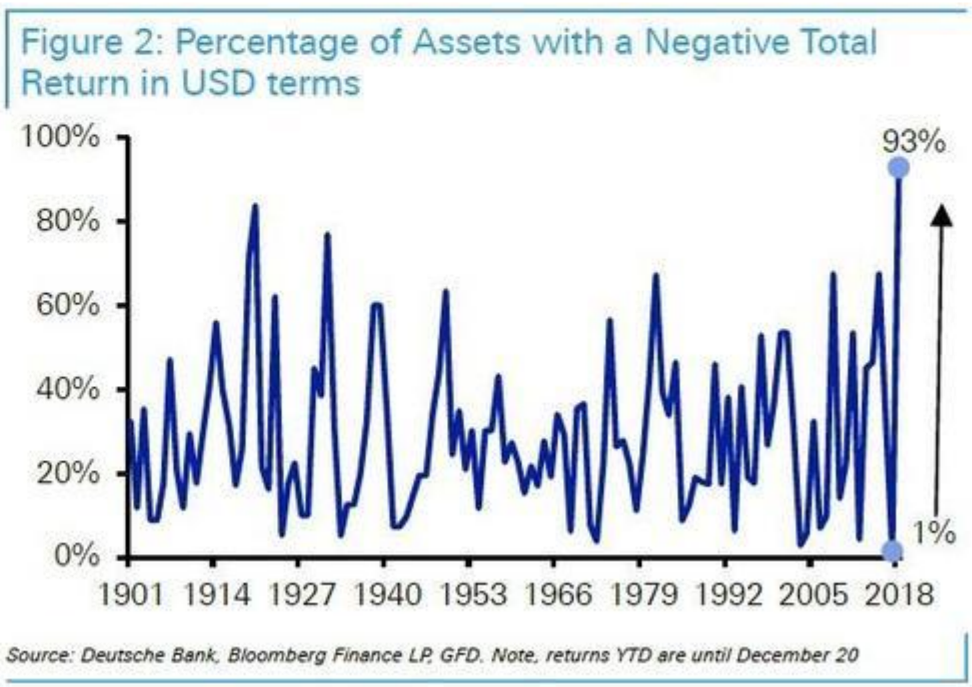
<u>Market Review, and 2019 outlook</u>

Brace for the impact. If you are still standing, you are the WINNER

The year when nothing worked.

The chart, below, from Deutsche bank shows a striking observation of a market in which quite literally nothing worked. Deutsche Bank said that "this is what happens when the vast majority of global assets are expensive historically due to extreme monetary policy. **When the tide goes out, you're more likely to get en mass negative months rather than rotation from day equities into bonds or visa-versa."**



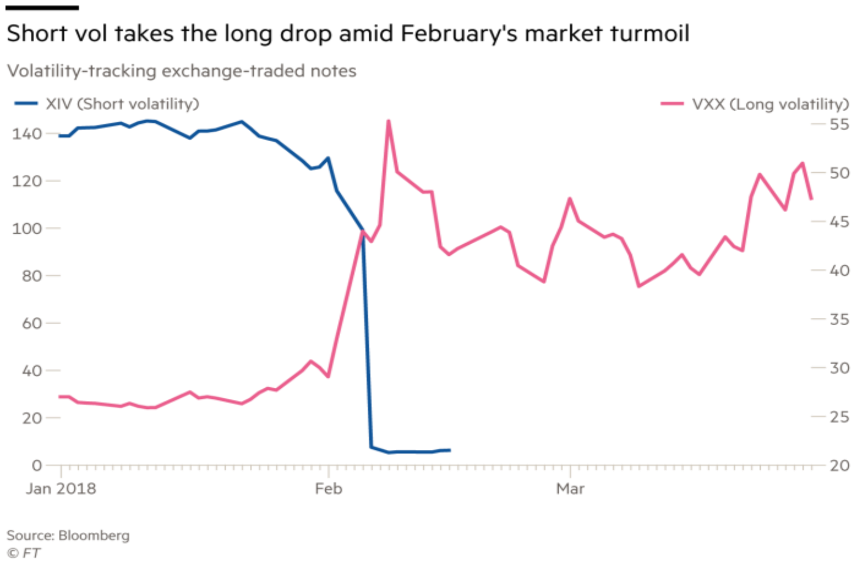
See those red’s down there in the chart, that’s how bad returns are across assets classes.

2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018*
Commodities 31.8%	US Treasuries 6.7%	Commodities 25.9%	MSCI EM 56.3%	REITS 32.0%	MSCI EM 34.5%	REITS 37.5%	MSCI EM 39.8%	US Treasuries 14.0%	MSCI EM 79.0%	Gold 29.2%	US Treasuries 9.8%	REITS 23.8%	S&P 500 32.4%	S&P 500 13.7%	S&P 500 1.4%	Global HY 14.8%	MSCI EM 37.8%	Cash 1.8%
US Treasuries 13.4%	Global IG 4.6%	Gold 25.6%	MSCI EAFE 39.2%	MSCI EM 26.0%	Commodities 21.4%	MSCI EM 32.6%	Gold 31.9%	Gold 4.3%	Global HY 62.0%	MSCI EM 19.2%	Gold 8.9%	Global HY 19.3%	MSCI EAFE 23.3%	REITS 11.7%	US Treasuries 0.8%	S&P 500 12.0%	MSCI EAFE 25.9%	US Treasuries 0.3%
REITS 8.5%	Cash 4.4%	Global IG 14.9%	REITS 33.5%	MSCI EAFE 20.7%	Gold 17.8%	MSCI EAFE 26.9%	Commodities 16.2%	Cash 2.1%	MSCI EAFE 32.5%	Commodities 16.8%	Global IG 4.5%	MSCI EM 18.6%	Global HY 8.0%	US Treasuries 6.0%	Cash 0.1%	Commodities 11.8%	S&P 500 22.0%	REITS -1.1%
Cash 6.2%	Global HY 3.1%	US Treasuries 11.6%	Global HY 30.7%	Global HY 12.4%	MSCI EAFE 14.0%	Gold 23.2%	MSCI EAFE 11.6%	Global IG -8.3%	REITS 31.7%	REITS 15.9%	Global HY 2.6%	MSCI EAFE 17.9%	REITS 0.7%	Global IG 3.2%	MSCI EAFE -0.8%	MSCI EM 11.2%	Gold 12.9%	Global HY -2.6%
Global IG 3.1%	Gold -0.7%	Cash 1.8%	S&P 500 28.7%	S&P 500 10.9%	REITS 10.7%	S&P 500 15.8%	US Treasuries 9.1%	Global HY -27.9%	S&P 500 26.5%	S&P 500 15.1%	S&P 500 2.1%	S&P 500 16.0%	Global IG 0.1%	Gold 0.1%	REITS -3.4%	Gold 8.6%	REITS 11.5%	Global IG -3.4%
Gold -5.4%	MSCI EM -2.4%	Global HY -1.1%	Commodities 23.9%	Global IG 9.4%	S&P 500 4.9%	Global HY 13.5%	Global IG 7.3%	Commodities -35.6%	Gold 25.0%	Global HY 13.9%	Cash 0.1%	Global IG 11.1%	Cash 0.1%	Cash 0.0%	Global IG -3.8%	Global IG 4.3%	Global HY 10.2%	Gold -3.7%
Global HY -5.8%	REITS -7.8%	REITS -2.4%	Gold 19.9%	Commodities 9.1%	Cash 3.1%	Global IG 7.2%	S&P 500 5.5%	S&P 500 -37.0%	Global IG 19.2%	MSCI EAFE 8.2%	REITS -9.4%	Gold 8.3%	MSCI EM -2.3%	Global HY -0.1%	Global HY -4.2%	REITS 1.3%	Global IG 9.3%	S&P 500 -6.1%
S&P 500 -9.1%	S&P 500 -11.9%	MSCI EM -6.0%	Global IG 14.5%	Gold 4.6%	US Treasuries 2.8%	Cash 4.9%	Cash 5.0%	MSCI EAFE -43.1%	Commodities 18.9%	Global IG 6.0%	MSCI EAFE -11.7%	US Treasuries 2.2%	US Treasuries -3.3%	MSCI EM -1.8%	Gold -10.4%	US Treasuries 1.1%	Commodities 7.6%	Commodities -11.6%
MSCI EAFE -14.0%	Commodities -19.5%	MSCI EAFE -15.7%	US Treasuries 2.3%	US Treasuries 3.5%	Global HY 1.5%	US Treasuries 3.1%	Global HY 3.0%	REITS -50.2%	Cash 0.2%	US Treasuries 5.9%	Commodities -13.3%	Cash 0.1%	Commodities -9.5%	MSCI EAFE -4.5%	MSCI EM -14.9%	MSCI EAFE 1.0%	US Treasuries 2.4%	MSCI EAFE -12.6%
MSCI EM -30.6%	MSCI EAFE -21.2%	S&P 500 -22.1%	Cash 1.1%	Cash 1.3%	Global IG -3.0%	Commodities 2.1%	REITS -10.0%	MSCI EM -53.2%	US Treasuries -3.7%	Cash 0.1%	MSCI EM -18.2%	Commodities -1.1%	Gold -27.3%	Commodities -17.0%	Commodities -24.7%	Cash 0.3%	Cash 0.8%	MSCI EM -14.7%

Source: BofA Merill Lynch Global Investment Strategy, Bloomberg. *YTD annualized returns

Volatility strike back

Volatility In 2017, one of the biggest niche money-spinners in financial markets, was betting that markets would remain tranquil. But in February 2018 those punts unraveled in dramatic fashion and this year the smart money has been wagering on renewed turbulence. Two popular Vix volatility index-linked exchange traded notes highlight the abrupt shift. XIV, an “inverse-volatility” ETN that makes money when markets are calm, was shredded by a spurt of volatility on February 5 and was swiftly shut down by its sponsor after losing more than 90% in one day. Meanwhile, its “long” counterpart, VXX, has benefited from the choppy market environment in 2018 and notched up a return of 50% its best annual performance since inception. In fact, 2018 was its only positive year.



So, if portfolio was anything other than Cash, short VIX (volatility), long Burgundy wine index or carbon credit then there is a reasonable assumption that portfolio delivered negative returns this year.

The outlook for year ahead.

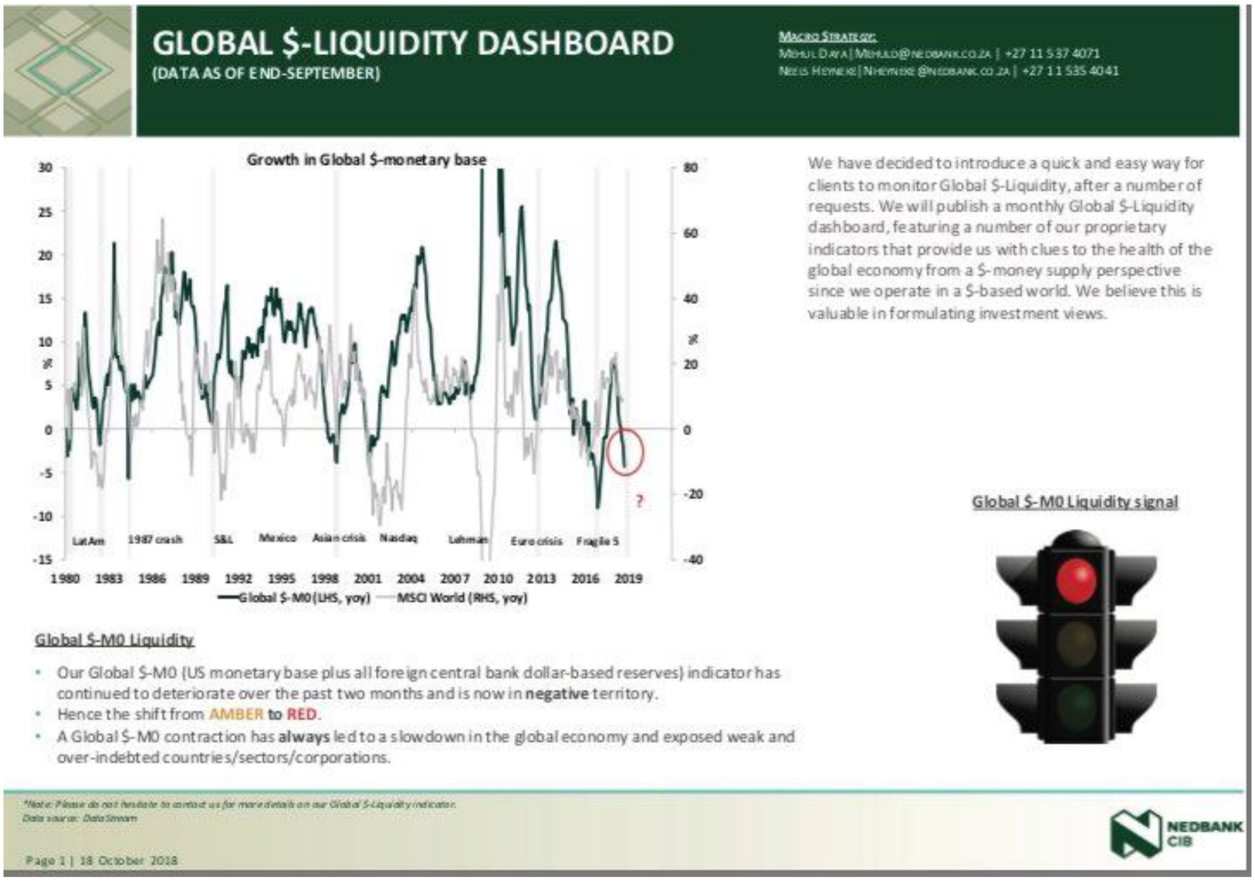
I think if we continue to look at investment purely on basis of fundamentals then we will again be disappointed at the returns we generate next year. Global Bonds look expensive with more than 6 trillion of global bonds still having negative yields. Equities might not look attractive, but they have seen correction from lofty levels and after a promising start, commodities have faltered so much that Reuters CRB commodities index is at a 20-year low. Emerging markets continue to be a hope trade with market trying to put behind the ghost of Turkey and Argentina. Before you forget, Argentina was the same country which issued 100 years bond last year just to default on its debt obligation this year before getting bailed out by IMF.

What a difference a year can make to investors perception and changing investment landscape!

I believe next year is going to more challenging than current year and although I do believe fundamentals have a role to play in mean reversion of asset valuation, I think 2019, or at least for first half will feel like an extension of this year.

Let’s go through some charts through which I will try to make my view much clearer.

The chart below is about global monetary base and its correlation with global LIQUIDITY. Except for a brief period in 2015-16 when markets feared CNY devaluation, the global $ LIQUIDITY has not contracted for long time, but now central bankers are determined to close that tap with FED already taking the lead with almost $ 400 billion of QT this year. ECB will also suspend balance sheet expansion starting calendar year 2019. Tightening dollar liquidity along with rising market determined rates (3 months LIBOR) is a dangerous combination and markets are in turmoil which is evident from returns across different assets this year.



This can also be seen from the lens of global foreign exchange reserves which seems to be declining for the first time in last 30 years. An increase in global foreign exchange reserves is a signal that global dollar liquidity is ample, and this money finally finds its way into either asset markets or stimulate real economic activity. But most investors don't realize that with the US now being completely energy independent, petrodollar system is now over and US neither wants to share its GDP with other countries through trade deficits nor it wants to provide its military umbrella to countries which have been dependent on US for their security. This has two clear implications

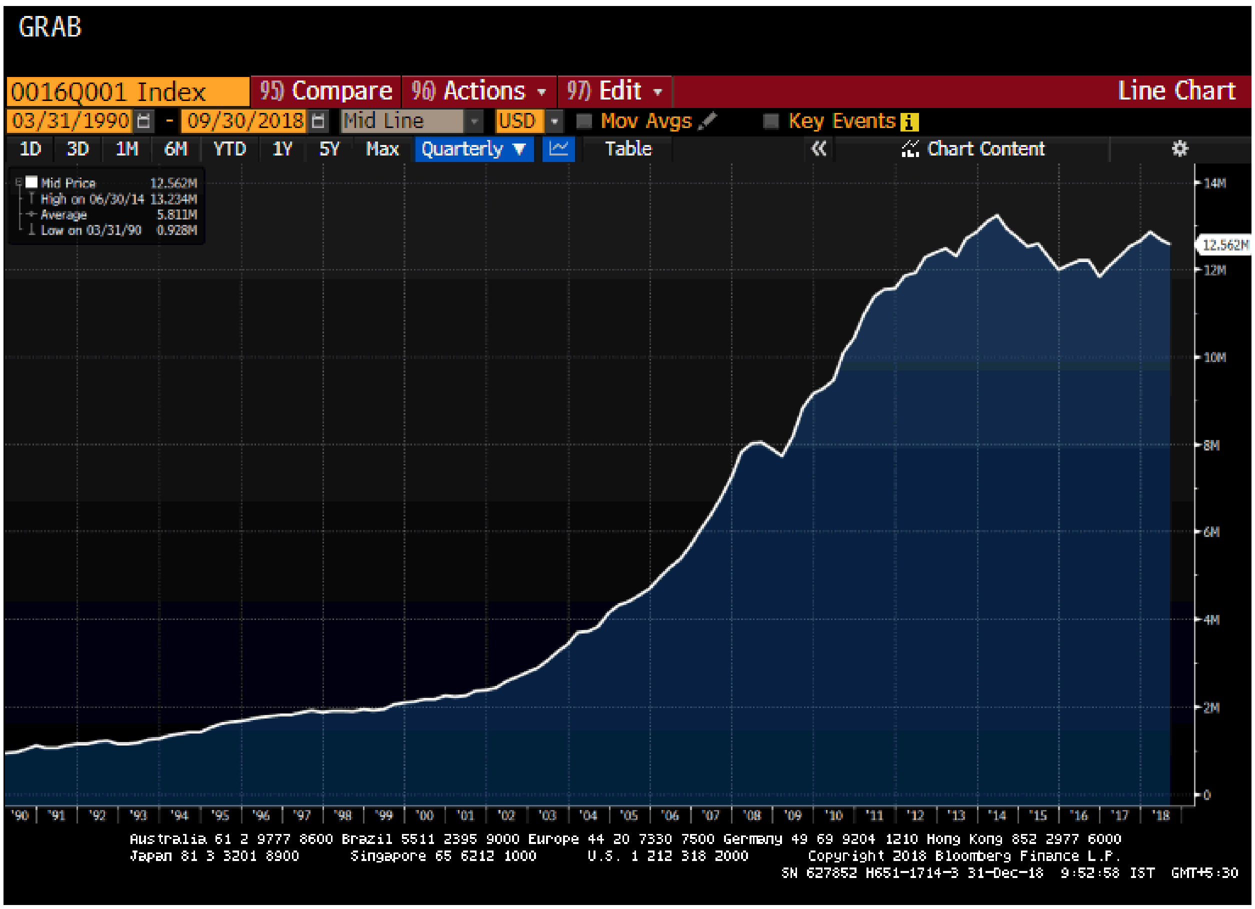
1. Less supply of Dollar
2. New Arms race and a volatile world with an increased chance of military conflicts.

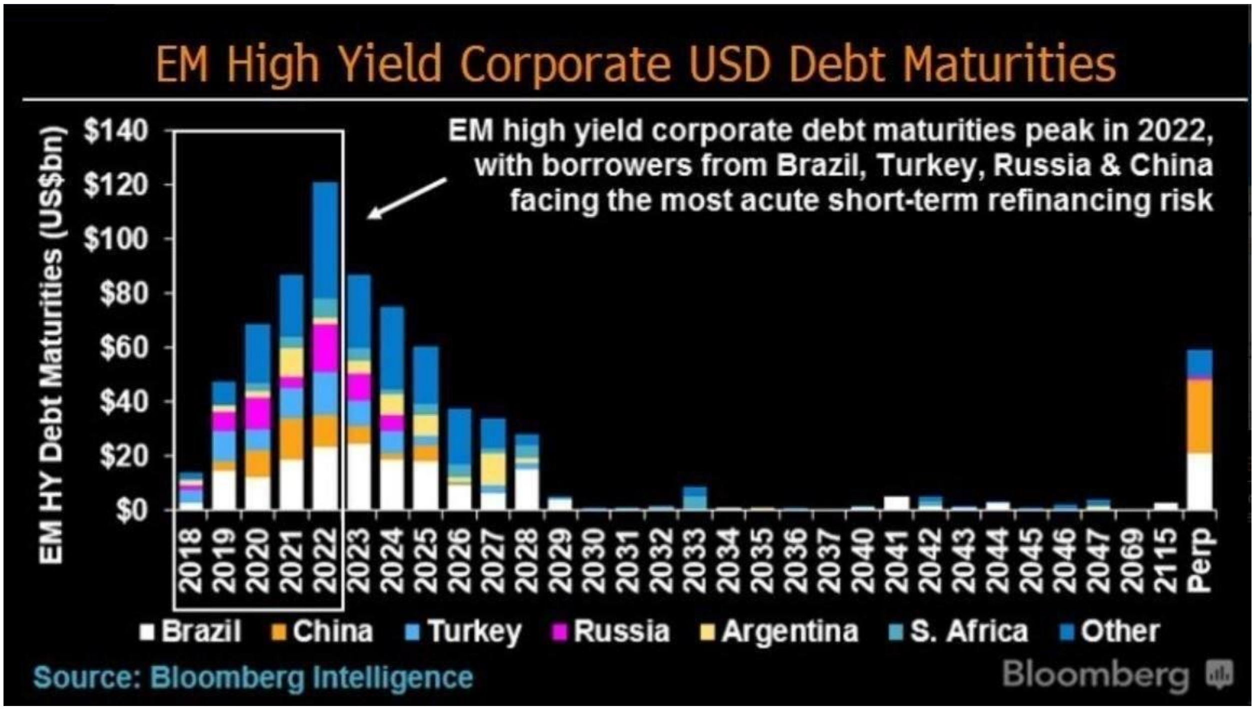
For investment purpose we will focus only on "Less supply of Dollar Liquidity" because a reduced supply of dollar is deflationary in an indebted world and this is what will weigh on assets in coming year.

The chart below is world forex reserves. There has never been a period (except 2008-09 briefly) till 2015 when global FX reserves have not grown. For the last 3 years these reserves were not growing but until recent QE by major central banks, the liquidity has been kept easy. When forex reserves grow it is easy to conduct domestic monetary policy in emerging countries because they just have to sterilize dollar inflows. Moreover because of low $ interest rates vs their own, $ borrowing by various EM's and their corporates in Eurodollar goes up.

What will happen if these reserves will not grow.

1. Funding and refunding pressure on EM's and their corporates will go up.
2. Dollar demand will be more vs supply.
3. EM's will have to sacrifice their already slow growth by hiking rates to incentivize and support inflows





Make or Break ideas for next year.

I believe that Volatility will reach all time high in coming year and deflationary environment will favor US long bond and US dollar. The US budget deficit is rising along with QT which will lead to higher supply of UST in the market. This will suck global savings into US Treasuries at the expense of every other asset class. Since volatility is back, I expect bear market rallies to be vicious. Mohd El Erian writes that 1000 point move in Dow will be the new norm. I am more bearish on European markets as their banking system is most undercapitalized and any small rise in Bond yields, from depressed levels due to rising tensions in Eurozone, can create havoc with their banking system, with ECB on sidelines.

As Kevin Muir writes “Most important chart right now is the 2 year TIP yield. This is the after inflation yield that an investor can achieve (i.e.: the real yield) for next two years. For the first time in a decade, this yield is now firmly positive. In this kind of environment, it is tough for risky assets priced for perfection to compete.

At some point during next year relentless rise in US dollar along with recessionary economic condition will compel FED to stop its quantitative tightening (rate hikes will stop much before that) which will lead to a short- lived relief rally in equity markets. But the need for LIQUIDITY infusion will be apparent and then conditions will be ripe for QE4 which will put a cap on US dollar rally as market starts pricing STAGFLATION.

This will lead to rally in gold along with crude and other soft commodities and will finish the 30- year bull run in bonds

Till then be on defensive with exposure to US treasuries, have cash because the value of cash is going to skyrocket as value of assets plummet.

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