OceanSquare Asset Management

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Investment Outlook for Global Multi Asset – March 2018

Regime Change: The Investment Landscape Trends Are About to End

From the end of 2016 into beginning of 2018 we saw some broad-based investment trends:

- Stock market up 26.70% into the January 29th high
- Morgan Stanley US Momentum Index up 24.76% into the March 9th high
- Dollar Index (DXY) down 14.05% into the February 16th low
- 30-year US Treasuries prices sideways to down 5.00% into the February 21st low
- Lower trending volatility (VIX) for stocks into a low of 8.56 on November 21st

Equity

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US Momentum

Source: Bloomberg

US $Dollar

Source: Bloomberg

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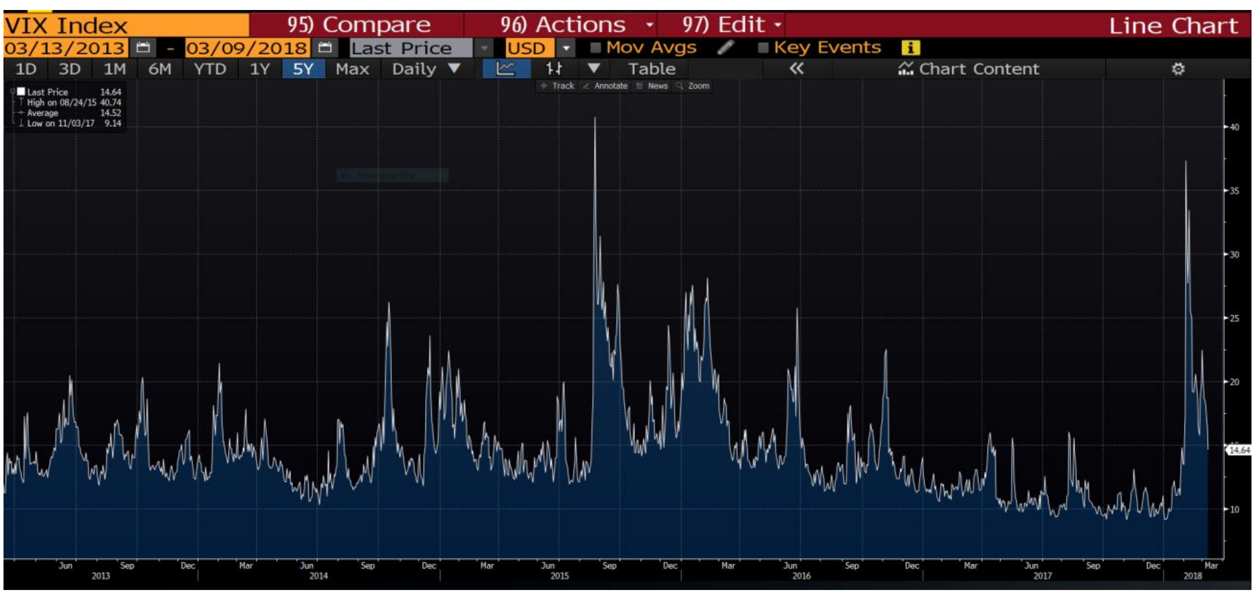
Bonds

Source: Bloomberg

Volatility Index



Source: Bloomberg

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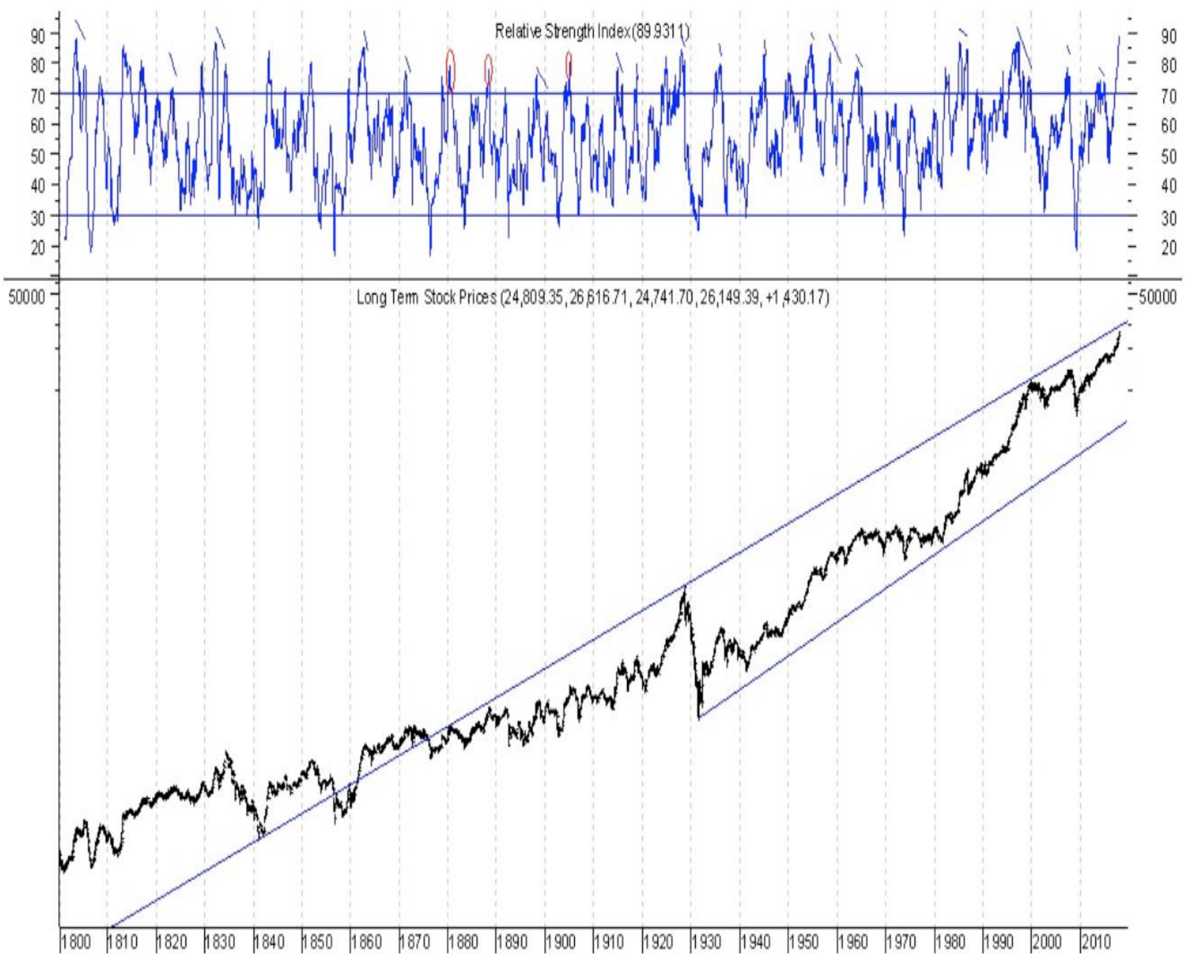
Utilizing a combination of both technical and fundamental analysis, our view is that these trends are in the beginning stages of simultaneously topping (Stocks & US Momentum) and bottoming (Dollar & US Long Bond Price). First, we see both the Dollar and Bonds (Price) potentially making their 4-year and 3-year cycle lows respectively (charts on page 5), which given negative sentiment extremes makes perfect sense. Conversely, on US stocks we see extreme positive sentiment particularly within the Momentum factor which currently resides mostly in the tech stocks including the illustrious "FANG" combo of Facebook, Amazon/Apple, Netflix and Google. In fact, the US stock market hit the highest relative strength index (RSI) reading ever recorded in the history of the stock market last November (see chart below), so yes stock investors appear quite giddy.



Source: Tim Wood Cycles News & Views

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US $Dollar 4-year Cycle

Source: Bloomberg

30-year US Bond Price 3-year Cycle

Source: Bloomberg

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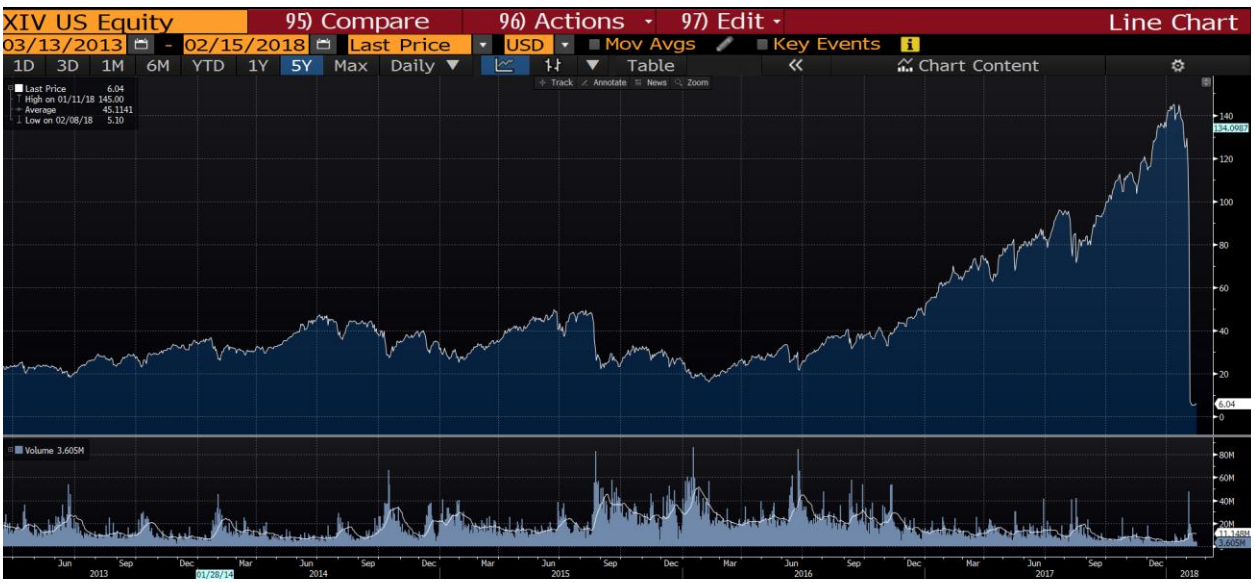
Fundamentally we are long in the tooth on the current business cycle (one of longest in US history) and view the risk reward in stocks, investment grade bonds and high yield bonds as very underwhelming given the valuation & sentiment extremes. We view the dollar potentially bottoming and a subsequent rally as bearish for global growth and additional tightening versus what the Fed is already signaling. It should also be remembered that most downturns in the US economy have been induced by the Fed after a rate hike cycle. Additionally, the low volatility environment we saw throughout much of 2017 has ended with quite a bang in February of 2018 as the VIX spiked to over 50, a level last seen in 2015 when we had China devalue its currency. In concert with the 10% stock market correction in February, we also saw the implosion of the very popular short volatility trade as illustrated by the liquidation of CSFB's XIV ETN (see chart below) which eroded to zero overnight on February 6th.



Source: Bloomberg

We suspect that this date will be heralded as the beginning of the end for the extreme financial calm in stock markets we have seen since 2009. This may be the equity investor's version of February 27, 2007 which fixed income investors remember as the day the subprime market peaked and began its decent into the abyss. Is it the end of the world? No, but generally speaking higher volatility means lower asset prices. We are not suggesting that we are going to get the exact timing of these volatile moves down to the day but instead acknowledge that stocks may go higher in the short-term or that bond prices may drift lower in the short-term. However, we are confident that we are closer to the end of these trends rather than a continuation over the intermediate term.

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Portfolio Positioning

In accordance with our outlook, we have changed our equity and fixed income portfolio weightings considerably. We have gone from 55% long only equity position to a 2% net long position with the introduction of some momentum technology shorts, most notably Facebook, Google & Tesla. We recently went to Washington DC to speak with GOP consultants and found that the sentiment for regulating Google & Facebook is quite high. The Facebook and Google shorts are due to technical and fundamental issues (see charts below). The Tesla short is due to continued Model 3 delays, high cash burn, a high US Momentum factor score, poor relative stock performance, and multiple key executive departures (most recently Chief Accounting Officer). Additionally, CEO-Elon Musk has come under considerable criticism for making bold claims regarding many projects and failed times lines.

Short Sale - Investment Thesis

- ✓ Both the sides of the political spectrum, as well as Europe have their targets set on regulation of Facebook and Google for different reasons
- ✓ Barack Obama, George Soros & Hillary Clinton have recently called for regulations while victims of conservative censorship on these platforms are lobbying the White house for relief
- ✓ Regulatory uncertainty will dampen multiples and potential future revenue streams
- ✓ Technicals suggest a short term sell signal and topping process for both stocks
- ✓ Stop losses for each position are set at previous highs

Source: Bloomberg

Our long positions are mostly idiosyncratic risk situations with negative momentum price characteristics that should solidly outperform US momentum when it rolls over. We are 90% net fixed income with an emphasis on long duration in 10, 20, and 30-year US Treasuries.

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Conclusion

Our unique ability for both fixed and equity portfolio managers to collaborate across asset classes gives us an edge over other investors who remain siloed in their own slices of the investment pie. Together we are seeing multiple asset classes converging on major tops and bottoms and a rising level of volatility that will temper or lower asset prices. While stocks may yet go to new highs, we see at a minimum a violent rotation out of momentum stocks into negative momentum (value) stocks over the near-term with potential for the US stock market (S&P) to struggle mightily this year, hence our introduction of equity short positions to the portfolio. Conversely, we are constructive on longer dated US Treasuries as well as the dollar (DXY), which we may get long to augment our current stance. The prevailing market sentiment and portfolio positioning extremes suggest to us that many investors across the globe are all on one side of the boat and may have to quickly move before disaster strikes.

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