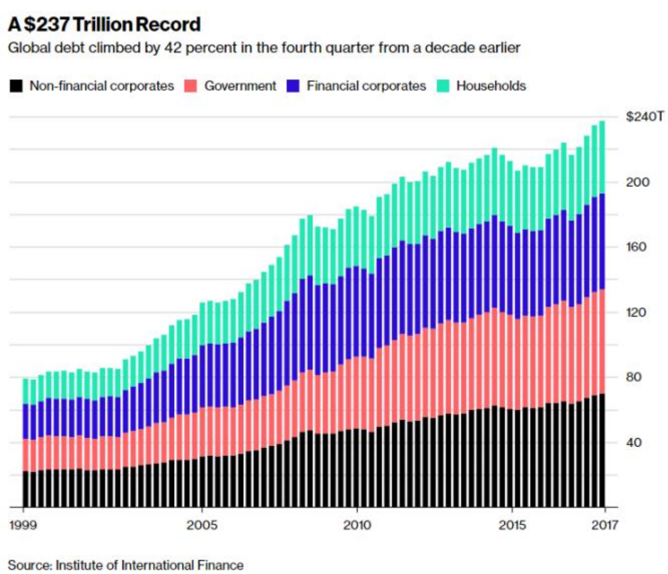
www.arxmgmt.com

DECEMBER 2018 MARKET COMMENTARY *"Flirtin' With Disaster"*

December was a month of firsts for the markets, but not in a good way. The S&P 500 had its worst December ever, losing over 9% of its value, and the Christmas Eve trading session was the worst on record. As we have been predicting all year, investors finally woke up and realized the risks of the Fed's removal of accommodation with both fists near the end of a 9-year bull market. The selloff that began in October (see our commentary "Pain" here) was kicked into overdrive after the Fed raised its overnight rate to the 2¼ - 2½% range, which is still low by historical standards. While the rate hike was fully anticipated, investors were spooked by Fed Chairman Jay Powell's comments indicating more rate hikes in 2019. This was exacerbated by President Trump's tweets threatening to fire Powell and Treasury Secretary Mnuchin's ill-advised attempt to calm the markets by announcing the banking system is healthy, which instead gave everyone Financial Crisis PTSD. A free-fall ensued, wiping out 2018 equity market gains as the S&P 500 closed down 6% year over year.

US Government bonds enjoyed a flight to quality bid, as yields gapped lower by about a third of a percent on all maturities outside of one year. Interestingly, the associated yield curve flattening has pushed yields on all maturities inside 10 years below the level on the 1-year treasury. We have been highlighting the good relative value in short-term US Government bonds all year, and they still provide attractive returns and safety during this period of volatility.

The most vocal (obnoxious) market pundits and the President claim that the Fed is solely responsible for the selloff, but that isn't true. The reality is that we are at the early stages of unwinding the largest debt bubble in world history - and the question is whether the deleveraging is orderly or if this bubble will burst.



Global debt has <u>tripled</u> over the past 20 years.

During the depths of the Financial Crisis, the Fed, Treasury Department, and White House collaborated on a program that was absolutely necessary to prevent the collapse of the global financial system. This was achieved with a mix of conventional policy, Fed rate cuts to 0%, and the unconventional step of flooding the US financial system with liquidity in an operation known as Quantitative Easing (QE) - also known as "printing money". At the time, QE was pitched as a temporary program to avert a near term disaster. The only problem is that it wasn't temporary, and the Fed is just now rolling off a portfolio that grew to *$4.5 Trillion,* which is more than twice the entire continent of Africa's annual GDP[1]. This program delivered on its intention of saving the financial markets, as the banking system avoided collapse and markets roared back. In fact, the S&P 500 delivered a 300% return from 2009 to mid-2018, even though real US economic growth over that time grew just 22%. This has exacerbated an already problematic wealth gap and left the US with historically high debt while interest rates are rising and the economic growth is waning. Not good.

Outlook:

Even though the market has stabilized in early January due to strong economic data and hopes of a trade deal with China, the underlying factors that caused the violent selloff are still present. Investors have now taken the baton from the Fed and are sucking liquidity out of the markets, extending the challenging environment for risky assets such as equities, junk bonds, and real estate. The Fed has now shifted to a "data dependent" posture, which really means market dependent – if stocks stabilize the Fed will try to raise rates two more times during 1H19, and if the volatility continues a rate cut will be in play. In this environment, we expect rates to remain range bound, and find good value in 1-year treasuries and short-term high-quality spread product. With the 1-year yielding ~2.60%, we are getting paid to wait.

Market Snapshot:

	11/30/18	12/31/18	December 2018	2018
Fed Funds Target Rate	2 -2¼%	2¼ - 2½%	+ ¼%	+1%
3-month US Treasury	2.36	2.41	+5	+100
2-year US Treasury	2.80	2.50	-30	+57
10-year US Treasury	3.00	2.68	-32	+22
30-year US Treasury	3.30	3.01	-29	+19
S&P 500	2,760	2,507	-9.2%	-6.3%
Stock Mkt Volatility (VIX)	18.07	25.42	+7.35	+15.65 / +260%
US Dollar (DXY)	97.22	95.87	-2.4%	+4.4%
Oil	50.70	44.87	-21.9%	-22.7%
Gold	1,228	1,288	+0.9%	-4.5%
Bitcoin	3,934	3,839	-2.4%	-74%

This month's theme song on the ARX Spotify Playlist: **"Flirtin' With Disaster" by Molly Hatchet**

[1] Africa's 2017 Nominal GDP was $2.19 trillion, per the International Monetary Fund.

ARX
FUND MANAGEMENT
www.arxmgmt.com

Predictions:

For the final edition of the 2018 commentary, we thought it would be fun to make some predictions for 2019 that might seem like a bit of a stretch. I bet at least 50% of these will happen.

- The Fed will raise rates at least once.
- Major US stock indices will end the year lower, proving all major Wall St. market strategists wrong.
- Equity market volatility will set a record, with the VIX index breaking above 60 for the first time.
- GE bonds will be downgraded to junk, limiting its access to liquidity, and the company will be forced to sell assets and massively reduce headcount to prevent bankruptcy.
- The German government will take over Deutsche Bank after its massive derivatives book implodes, reigniting investor fear and talk of another financial crisis.
- Wells Fargo will incur several billion more dollars in fines as years of institutional corporate malfeasance continue to be revealed piecemeal. Under Congressional pressure, the Bank will replace its CEO and several members of its Board of Directors.
- Several ETFs will break as algorithm-driven selling will not find market context bids on the other side. Investors chasing "cheap beta" will get exactly what they paid for.
- Neither Fed Chair Powell nor Treasury Secretary Mnuchin will hold their posts entering 2020.
- President Trump will again replace his Chief of Staff, Secretary of Defense, and Attorney General.
- The House will bring impeachment proceedings against President Trump - the state of the economy and markets will dictate whether he survives his first term.
- 2019 will be a turning point, marking a new renaissance for active investment management.

Here are some of our personal favorites from 2018:

Two articles detailing how hubris and complacency brought down seemingly impenetrable objects. Might there be a lesson for investors in here?

- GE Powered the American Century – Then It Burned Out
- "The Clock Is Ticking": Inside The Worst U.S. Maritime Disaster In Decades

A book with work and life lessons from one of the best investors of our generation.

- "Principles: Life and Work." -Ray Dalio

An excellent new guitar rock-pop album without a bad track

- "Hope Downs" - Rolling Blackouts Coastal Fever

About ARX Fund Management:

Established in 2011 by professionals with direct experience in complex litigation and institutional investment management, ARX offers an unmatched mix of capabilities relevant to managing 1.468B Qualified Settlement Funds. Our expertise investing conservative capital preservation products is directly related to the management of institutional QSFs. Contact us today at arxadmin@arxmgmt.com to discuss a customized QSF for your settlement.