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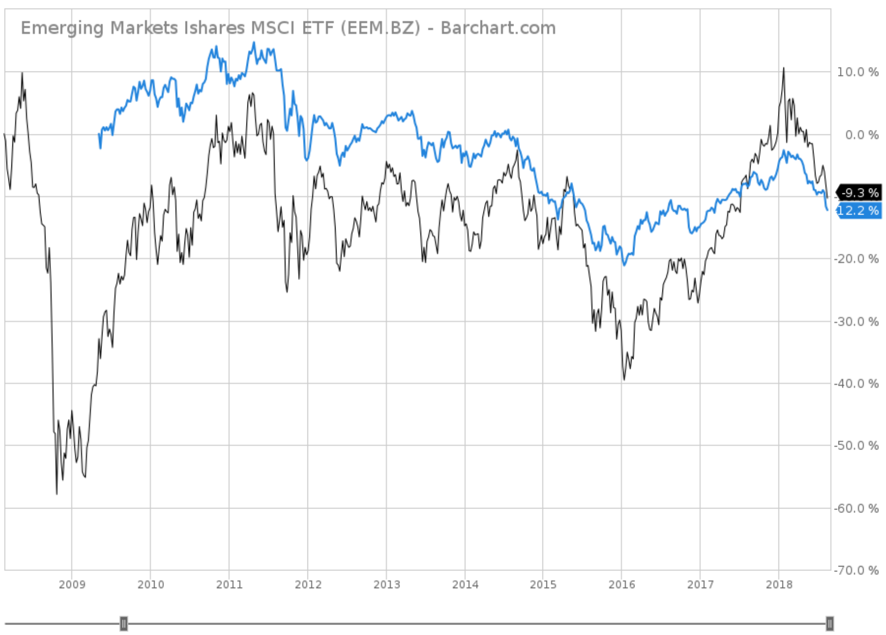
August 31, 2018

GREENBACK'S COMEBACK

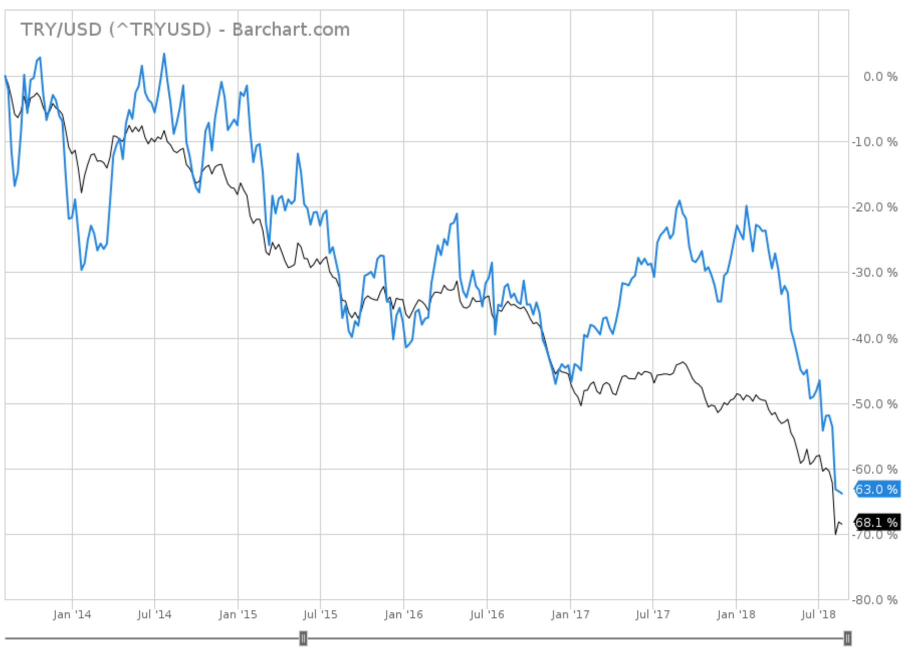
The U. S. Dollar (USD) has rebounded sharply against emerging markets (EM) currencies since finding a three-year bottom in February of this year. EM equities, on the other hand, have been on a downward spiral since hitting a ten-year peak around the same time. The chart below shows that noticeable inverse relationship for the last 10 years with the blue line representing EM currencies (CEW) and the black line representing EM equities (EEM).



We bring attention to the above relationship because EM as an asset class has long looked unattractive to us given the strength of the U.S. economy and the subsequent tightening stance the Federal Reserve (Fed) adopted some 5 years ago. We expected those factors to lead to a stronger USD which, of course, would be a major headwind for EM assets. Indeed, those expectations have played out since the Fed's "tapering" announcement in 2013, although, it must be pointed out that EM had already started rolling over in the aftermath of the European debt crisis in 2011. Since the beginning of 2016, however, EM assets have had a huge rally which has been quite baffling to us, to put it mildly.

As we indulge in some Monday morning quarterbacking, two events since early 2016 strike us as having the potential to move markets significantly, namely, the "yes" Brexit vote in June 2016 and the election of President Trump in Nov 2016.

While the Brexit vote primarily affected the U.K. with longer term implications for the European Union project, it probably had limited impact for EM. The election of President Trump, however, does have major negative implications for EM given his *America First* agenda. We suppose a case could be made that a business-friendly U.S. administration may generate enough global growth to offset any trade related negatives. While we sort of agree with that rationale, we still think a stronger USD should be a more important determinant of returns. Hence, the dramatic fall in EM assets since the beginning of this year makes perfect sense to us and we expect more of it unless the USD reverses course which is unlikely until the Federal Reserve (Fed) stops raising rates. More on that later.



We should admit here that the USD strength may not all be due to the domestic economic strength. There is almost certainly an element of flight to quality as some prominent emerging markets are dealing with difficult domestic issues. That brings us to Turkey, the talk of the town. As can be seen from the chart above, the Turkish currency Lira (black line) and Turkish Equity market (blue line) have declined by 68% and 63% respectively in the last five years. While Turkish president Erdogan is blaming it on a spat with the U.S. over a pastor imprisoned in Turkey, the reality is that markets have been in a downtrend way before the pastor issue came up. Factors such as high inflation and the central bank's inability to manage it effectively have weighed heavily for years now. The culminating point came on July 24^{th} when the Turkish central bank left benchmark interest rate unchanged against expectations of raising it by 1- 1.25% points. Markets took that as a confirmation of President Erdogan's influence on the central bank given his public denouncement of higher interest rates as "the mother and father of all evil." While in theory, the Turkish central bank is still independent, it is apparent that participants have been concluding otherwise.

For EM in general though, even without such self-inflicted wounds, we expect the Greenback's strength to continue for the foreseeable future and so should the weakness of EM assets. We remain unexposed to EM.

Performance Review

Core strategy

OppoQuest's Core strategy (CORE) gave back some of its recent gains and posted a gross return of -3.13% for the 1st half of 2018 versus -0.67% for the benchmark, S&P Target Risk Growth Index. Declines in Financials, particularly European banks, and General Electric (GE) contributed to the underperformance. Weakness in European banks largely reflects concerns of the sector's exposure to Turkey. While some banks in Italy and Spain are certainly looking at meaningful losses if things get really bad in Turkey, none of the top ten holdings of our position (EUFN) have reported any noteworthy exposure to it. We don't think Turkey's problems will materially impact most European financials.

With respect to GE, we continue to be amazed at investors' skepticism about the company's ability to restructure successfully. Even a decent 2Q18 earnings report which actually is a break from a string of recent disappointments, has not allayed fears of another shoe dropping at GE Capital or that GE Power is a broken business. While we beg to differ, we also admit that so far, the skeptics have been correct. Our thesis on GE assumes that all the bad news on GE Capital is probably already out as GE's new CEO has no incentive to keep any known problems lingering. If anything, we hope the capital infusion plan ($15B) announced in January assumes the worst-case scenario. Problems at GE Power, on the other hand, are known and there is little to suggest it is a broken business. We think the issue is excess capacity. A closer look at its major competitor, Siemens, (combined market share of ~ 60%) will reveal a similar picture and confirms that it is an industry problem not just a GE problem. We fully expect GE to successfully restructure its power business and return it to profitability.

Offsetting the performance detractors mentioned above, were gains in Energy and cybersecurity positions. Within the Energy sector, midstream companies saw unprecedented amount of volatility during the half following a Federal Energy Regulatory Commission (FERC) directive to Master Limited Partnerships (MLPs) that would result in some MLPs having to lower the fee they charge to customers using certain pipelines. Despite the volatility, it was notable that the sector made a positive contribution and validated our assessment that the FERC ruling would not have any material impact to the underlying businesses.

Cybersecurity names continue to perform well and we believe there is a lot of runway still ahead given that cybersecurity remains one of the top areas of capital spending projects for corporate CEO's and governments worldwide. Projections are all over the map but consensus is looking for 8-10% annual growth in cybersecurity market according to Menlo Park, CA based researcher Cybersecurity Ventures (CV) whose own projections are for 12-15% annual growth over the next 5 years which will put the spending at $1 Trillion by 2022. For context, the market was at $ 3.5 B in 2004 and grew 35x to $120 B by 2017 according to CV.

Turning to changes in the CORE strategy, we have substantially decreased our exposure to the U.S. housing industry by exiting Zillow (ZG) and Redfin (RDFN). While weak housing data in recent months has damaged the thesis on both, ZG also announced that they were getting into the house flipping business which we think is a terrible idea. Another housing related position, Sleep Number (SNBR), which had been a long-time holding was also sold given the huge run it had and limited upside potential.

Within midstream energy, we converted all of our exposure from MLPs to C-Corp companies due to the FERC ruling mentioned earlier. Our very constructive outlook for midstream remains unchanged.

Finally, we initiated a new position in Dominion Energy (D), a Virginia based utility which also has substantial exposure to midstream assets and the first company to own an LNG export terminal on U.S. east coast at Cove Point. This facility has recently started operations which adds another stream to its earnings and cash flow. D's publicly traded midstream subsidiary, Dominion Midstream (DM), whose value went down by more than 50% after the FERC ruling, offers a great opportunity for D to buyback DM. Even without that strategic move, we think D offers substantial upside given its attractive valuation and a hefty 5.5% yield.

Conservative Strategy

OppoQuest's Conservative strategy (CONS) continued its outperformance streak versus its tracked benchmark, the S&P Target Risk Moderate Index with 1H18 gross returns of -0.51% against -0.86% for the benchmark. Similar to the CORE, Financials and GE weighed on the CONS returns as well. We will not rehash the same comments but will point out that GE is higher weighted in the CONS versus the CORE and so had a bigger impact.

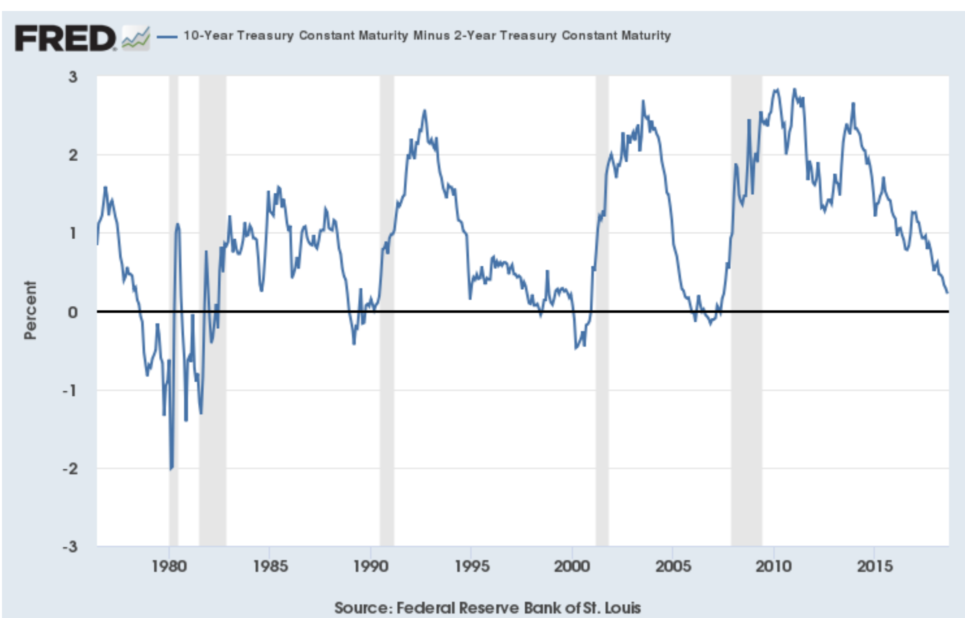
On the flip side, Nokia (NOK), BHP Billiton (BBL) and Glaxo (GSK) contributed positively. NOK continued its rebound as 5G capex plans gained traction and more wireless operators revealed ambitious plans to capitalize on the potential of 5G technologies. BHP's announcement to sell its on-shore U.S. business to BP was well received and investors seem to get more convinced that the company will maintain capital discipline i.e. no major M&A. Finally, participants seemed to have gotten over the jitters of GSK suspending its dividend after it dropped the plan to buy Pfizer's consumer division even as it bought Novartis' stake in their consumer business joint venture. Even if the transaction with Pfizer were to go ahead, we think GSK would have laid out a clear path to the reinstatement of its dividend, maybe at an enhanced level.

With respect to the changes in the CONS, we have initiated a position in First Trust Technology Dividend Index Fund (TDIV), a broad-based technology focused ETF. We have been looking for opportunities to increase the technology exposure in CONS and the recent pullback in TDIV provided a good opportunity to execute on it. We expect TDIV to be a long-term holding with potential for add-ons in future. Also added was D based on the rationale already discussed earlier in the CORE section. Exiting the strategy was utility peer Duke Energy (DUK) whose risk reward proposition was less attractive compared to D. Finally, MLP related positions were switched to C-Corp entities for reasons described earlier. All these changes resulted a significant reduction of the CONS's cash position which bumped up the yield of the strategy markedly to 4.13%.

Outlook

As expected, U.S. equity markets have recovered fully from the shake-out in the early part of this year as focus returned to fundamentals. The economy continues to hum along with the 2nd quarter GDP growth being revised upwards to 4.2% which is its best pace since 3Q14. The widely followed Atlanta Fed forecast indicates that momentum will continue into 3Q18 with expectations of GDP growing 4.1% as of late August. And all this strength comes despite trade frictions and tariff actions which are almost certainly subduing numbers.

While the set-up looks really good, there are some issues that could potentially derail this strong economic momentum. First, the U.S. yield curve is getting closer to inversion and the Fed hasn't been clear about whether it will continue to raise rates if inversion actually occurs. As a reminder, inversion of the yield curve happens when the difference between long-term interest rates (typically referenced by U.S. 10-Year Treasury Note) and the short-term rates (typically referenced by the 2-Year Note) becomes negative. Currently, that difference is around 22 basis points or 0.22% as can be seen in the chart on the left.



What is more important is that every inversion since 1980 has been followed by a recession (shaded area in the chart). While we are not big fans of formulating economic forecasts based on historical patterns, the inversion of yield curve is more than a pattern, in our view. It's more like a law of physics and challenging it makes no sense. So, if the Fed believes that it can keep raising rates in the face of an inverted yield curve, like Loretta Mester, the president of Cleveland Fed seems to suggest, then we are headed for a classic policy mistake by the Fed. Her comments, in fact, appear to go along that dreaded notion of "things are different this time." However, we do draw some comfort from the views expressed by James Bullard, president of the St. Louis Fed, who has stated clearly that the Fed should not challenge the yield curve. We sincerely hope that other Fed members are more in line with Mr. Bullard and not Ms. Mester.

The second factor that concerns us, but to a much lesser extent, is the upcoming mid-term elections in the U.S. Most polls indicate that the Republicans are going to lose their majority in the House while retaining it in the Senate. If that happens then the worst-case scenario would be political gridlock which should be neutral to positive for risk assets like equities. However, if the Senate were to flip as well, then we could see political risk creep in and volatility rise. Needless to say, markets would prefer gridlock over political risk.

Finally, the simultaneous renegotiations of trade agreements with multiple trading partners presents some risk given the complexity and time-consuming nature of these discussions. So far, there haven't been many noticeable adverse consequences on the overall economy of the tariffs being levied on one another but that will likely not last forever. Time is of the essence here. The successful agreement with Mexico announced in late August is a major positive in that regard as it shows willingness on both sides to reach consensus. While we do expect others partners like Canada and the European Union to follow suit, China will likely present the biggest challenge to the administration.

Overall, we remain cautiously optimistic that the strength of the U.S. economy will sustain. Our positioning in all strategies is balanced now having added some risk during the February sell-off. So, we have enough risk to participate on the upside and just enough defensiveness to capitalize on any downside. Goldilocks would surely like that!

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