HALITE PARTNERS

Quarterly Letter - Q1 2018

EXECUTIVE SUMMARY

The first quarter of 2018 included a strong equity rally in January, a historic volatility blowup in February, and elevated trade war rhetoric in March, culminating in a negative quarter for stocks and bonds. Through all of this, fundamentals remain strong. Unemployment is nearing multi-decade lows,[1] wage growth is strong and accelerating, global growth remains healthy and robust, and equity earnings and growth expectations remain elevated.[2] ***Despite strong fundamentals, our outlook for equities remains muted due to rising inflation (which typically leads to higher interest rates), above-average stock valuations,[3] and a tightening Federal Reserve.***

RISK TYPE	ASSET CLASS	ASSET NAME	Q1 2018	YTD	1 YEAR
Risk Asset	Equities	MSCI Emerging Markets Index	1.4%	1.4%	25.3%
		MSCI ACWI Index ex-US	-1.1%	-1.1%	17.0%
		MSCI EAFE Index	-1.4%	-1.4%	15.3%
		MSCI ACWI Index	-0.9%	-0.9%	15.4%
		S&P 500 Index	-0.8%	-0.8%	14.0%
	Fixed Income	BC US Corporate High Yield	-0.9%	-0.9%	3.8%
	Commodities	BC US Commodity Index	-0.4%	-0.4%	3.7%
	Alternatives	TR PE Index	-4.9%	-4.9%	14.3%
		HFRI Fund of Funds Index	-1.0%	-1.0%	3.2%
Risk Mitigator	Fixed Income	BC US Aggregate Index	-1.5%	-1.5%	1.2%
		BC US Treasury	-1.2%	-1.2%	0.4%

Data Source: Bloomberg

"THE FOUR MOST DANGEROUS WORDS IN INVESTING ARE: 'THIS TIME IT'S DIFFERENT.'"

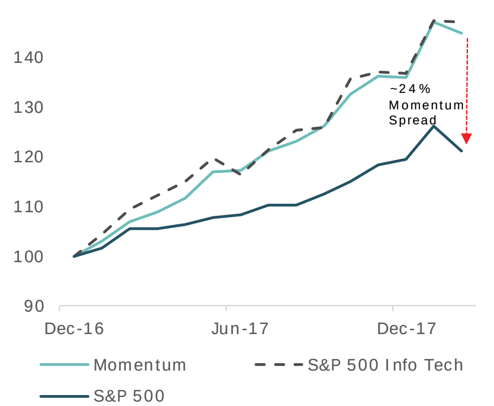
– Sir John Templeton

QUARTERLY COMMENTARY

In Q1 2018, markets realized significant risks we had warned about in previous letters and commentary, most notably the emphatic return of volatility accompanied by a market drawdown of over 10%. Despite strong economic fundamentals, volatility as measured by the VIX Index spiked 115% in a single trading day,[4] the largest daily spike ever. In other words, in a period with robust economic growth, earnings that generally beat expectations,[5] and healthy but not yet overheated inflation, we saw volatility skyrocket even faster than it did during the 2008 credit crisis. To us, the historic lack of investor fear over the past year made this type of event almost inevitable.

One current area of interest to us is the "momentum" factor, which is a systematic method of buying stocks that have performed well and selling stocks that have performed poorly across all sectors. In 2017, momentum had its best risk-adjusted return on record, surpassing even the Dot-com bubble. This is not to say we will repeat the drawdown of the early 2000s, but we caution that history often rhymes, and what we see today shares similar characteristics. Stocks are trading at above-average valuations,[6] with tech valuations even higher and seemingly on a new paradigm of valuation. We believe there is now an elevated probability that momentum performance violently reverts, causing a large market selloff of not only the technology names that investors associate with momentum but high flyers in other sectors as well.[7]

STEADY MOMENTUM PERFORMANCE VS. S&P 500



Data Source: Bloomberg, MSCI

The portfolio continues to be underweight equities and overweight TIPS (Treasury Inflation-Protected Securities), and within equities it is overweight value and underweight momentum.`

CRITICAL ISSUE - RISING INFLATION

Inflation occurs when the prices of goods and services increase over time, typically measured by the price of a basket of goods that represent personal consumption. The Federal Reserve and policymakers analyze a variety of "core" inflation metrics, which excludes items that are volatile in price like food and energy, to determine inflation trends. The Federal Open Market Committee, which consists of 12 Federal Reserve officials, implements monetary policy to target a core inflation rate of 2% over the medium term.[8]

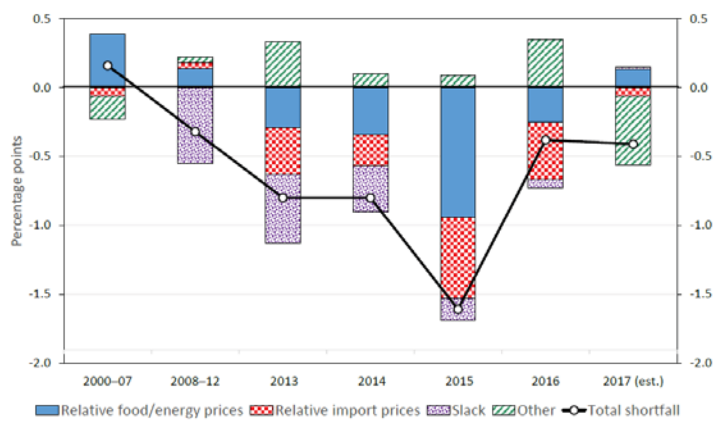
After years of deflationary fears in the post-crisis world, we are reaching a point where inflation is once again approaching 2%. With unemployment near multi-decade lows,[9] low savings rates,[10] and strong wage growth,[11] there is risk that inflation surprises to the upside, which would be met with a policy response of raising interest rates faster than expected. This pressures company balance sheets and would likely be a negative shock to equity and fixed income markets, which thus far have been calmly guided by Central Banks. ***In the current environment, we believe the risk of an inflationary shock outweighs that of deflationary shocks.***

The chart below visualizes ex-Federal Reserve Chair Janet Yellen's "simple" inflation model that analyzes why the low levels of inflation may prove to be transitory. In her model, she disaggregates the factors that have caused inflation to run below the 2% target.

The known factors that have collectively contributed to sub 2% inflation (which let us call "disinflationary" factors) have turned from headwinds to tailwinds. ***Upwards inflation momentum is approaching levels not seen since before the 2008 crisis.***[12] The following summarizes recent trends and why risks may be tilted towards higher inflation:

- "Slack"[13] has gone from a strong disinflationary force to an inflationary one, and with unemployment at multi-decade lows, this trend likely stays in place.
- Oil has rallied significantly from the bottom in 2016, and food/energy has gone from a disinflationary force to net inflationary.
- Relative import prices have gone from largely disinflationary to near neutral and, as indicated by Trump's rhetoric around trade wars and tariffs, looks to be a continuing trend.
- The biggest disinflationary contributor right now is "Other", a catch-all for unidentified factors. This has typically been net inflationary over the past ten years and only recently turned disinflationary.

WHY HAS PCE INFLATION BEEN RUNNING BELOW 2 PERCENT?



Source: Federal Reserve Board calculations using data from the BEA, BLS, CBO and SPF.

We would like to emphasize that we are not trying to forecast inflation. However, we do like the asymmetry of our portfolio positioning as noted below:

- If inflation comes in below expectations, then equity and fixed income markets should perform well, while TIPS would lag a little but likely still have decent absolute returns.
- If, however, inflation shocks to the upside, rates rise faster than expected, and equity markets sell off, then we expect to protect your capital and materially outperform the benchmark due to our equity underweight and TIPS overweight.

Our investment philosophy centers on preservation of capital and portfolio purchasing power. Thus, we are currently underweight equities and overweight TIPS (Treasury Inflation-Protected Securities).

As always, we welcome your feedback, so please do not hesitate to contact us should you have any questions or comments.

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An index is a portfolio of specific securities, the performance of which is often used as a benchmark in judging the relative performance of certain asset classes. An investor cannot invest directly in an index. An index does not charge management fees or brokerage expenses, and no such fees or expenses were deducted from the performance shown.

INDEX DEFINITIONS

Equities

The **MSCI Emerging Markets (EM) Index** is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

The **MSCI ACWI (All Country World Index) Ex-US** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets, excluding the U.S.

The **MSCI EAFE Index (Europe, Australasia, Far East)** is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada.

The **MSCI ACWI (All Country World Index)** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets.

The **S&P 500 Index** is widely regarded as the best single gauge of the U.S. equities market. The index includes a representative sample of 500 leading companies in leading industries of the U.S. economy. The S&P 500 Index focuses on the large-cap segment of the market; however, since it includes a significant portion of the total value of the market, it also represents the market.

Fixed Income

The **Bloomberg Barclays (BC) US Aggregate Bond Index** is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS (agency and nonagency).

The **Bloomberg Barclays (BC) US Treasury Index** measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury. Treasury bills are excluded by the maturity constraint, but are part of a separate Short Treasury Index.

The **Bloomberg Barclays (BC) US Corporate High Yield (HY) Index** measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on Barclays EM country definition, are excluded.

Other asset classes

The **Bloomberg Barclays (BC) Commodity Index** and related sub-indices are composed of futures contracts on physical commodities and represents 22 separate commodities traded on U.S. exchanges, with the exception of aluminum, nickel, and zinc.

The **HFRI Monthly Indices (HFRI)** are equally weighted performance indexes, utilized by numerous hedge fund managers as a benchmark for their own hedge funds. The HFRI are broken down into 4 main strategies, each with multiple sub strategies. All single-manager HFRI Index constituents are included in the HFRI Fund Weighted Composite, which accounts for over 2200 funds listed on the internal HFR Database.

The **Thomson Reuters (TR) Private Equity (PE) Buyout Index** replicates the performance of the Thomson Reuters Private Equity Buyout Research Index through a combination of liquid, publicly listed assets. The Index is calculated from the performance of six private equity sector portfolios.

ENDNOTES

1. Unemployment as measured by U-3 Unemployment Rate, currently at 4.1%. Source: Bureau of Labor Statistics

2. For Q1 2018, estimated earnings growth rate for the S&P 500 is 17.2%, which would be the highest earnings growth since Q1 2011. Source: Factset

3. As measured by price/earnings ratio (currently at 21x) and price/sales ratio (2.15x). Source: Bloomberg

4. The spike was from 17.3 to 37.3. Source: Bloomberg

5. In the S&P 500, 76.1% of companies have reported earnings above analyst expectations for Q4 2017. Source: Thomson Reuters

6. As measured by price/earnings ratio (currently at 21x) and price/sales ratio (2.15x). Source: Bloomberg

7. As measured by the top 600 momentum names of the Russell 3000 (the technology sector only comprised 22% of the names and 44% of the market capitalization as of 12/31/17). Source: Bloomberg

8. Source: Federal Reserve. Read more at: https://www.federalreserve.gov/faqs/economy_14419.htm

9. Unemployment as measured by U-3 Unemployment Rate, currently at 4.1%. Source: Bureau of Labor Statistics

10. Source: Federal Reserve Bank of St. Louis.

11. Source: Bureau of Labor Statistics

12. Source: VanEck, Bloomberg

13. Slack refers to the quantity of labor and capital that could be productively employed but isn't

14. Deviation of PCE inflation (4th quarter to 4th quarter) from 2 percent, total and portion attributable to specific factors