COMMONWEALTH LIQUID ALPHA FUND

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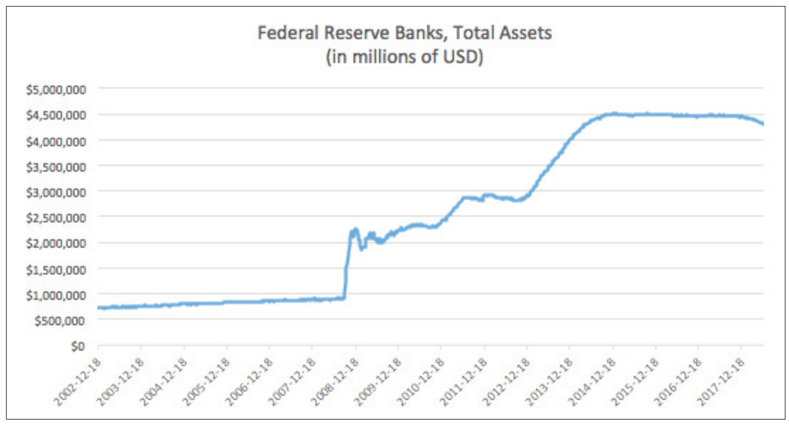
2Q18 PERFORMANCE REVIEW

Commonwealth Liquid Alpha Fund ("Liquid Alpha") returned 3.85% in 2Q18 net of all fees and expenses, and returned 3.79% YTD through June 30. The fund continues to outperform the benchmark SG CTA Index, which returned -1.87% for the quarter and is down -4.76% YTD. Performance also compared favorably to the largest comparable mutual fund strategy, which was down over -2.5% on the quarter and nearly -6% YTD. Broad US stock and bond indices were positive during the quarter, with the S&P 500 gaining a bit over 3%. Despite directionally similar performance over 2Q18, Liquid Alpha was only 0.14 correlated with the S&P 500 on a daily basis during the quarter.

Liquid Alpha differs from every other fund we manage here at Commonwealth in that it is a global macro strategy. That is to say, Liquid Alpha focuses on market opportunities that are related to broad macroeconomic conditions, not idiosyncratic security-specific risks. One nice thing about approaching markets from a top-down macro level is that while market prices move up and down daily, the economic backdrop doesn't change meaningfully very often. Accordingly, the crux of our year-end 2017 letter, which we also quoted in the 1Q letter in April, remains relevant:

"While it may take time to percolate through the system, we believe that the reversal of the Fed's near-decade long policy of liquidity provision, the slowing of ECB bond-buying, and the reduction in Chinese fixed asset investment together represent a three-pronged attack that will likely lead to less complacent, more volatile, and more divergent markets."

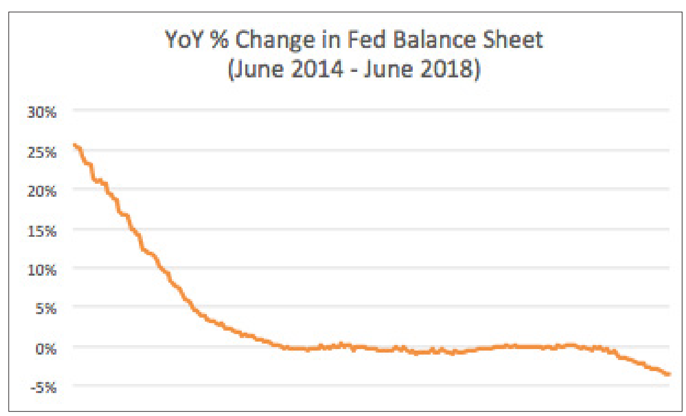


Source: Federal Reserve Bank of St. Louis

Market commentators talked a lot in 2Q about the impact of the Trump tariffs, blaming them for the (relatively minor) market sell-offs we saw late in the quarter. There's little doubt that escalating protectionist bloviating has been, and will continue to be, a headwind for many markets, particularly if the Chinese continue to retaliate by devaluing their currency. But we think the real driver of cracks in the equity bull market lies with quantitative tightening ("QT"). If $15 trillion of monetary stimulus since 2008 made for smooth sailing for long-only, passive stock and bond investors, it is paradoxical to think that draining that same liquidity will not have an opposite effect.

From 2008 until 2015, the Federal Reserve created money and used it to buy debt from the Treasury, injecting liquidity into the financial system on an unprecedented scale and ballooning their balance sheet to around $4.5 trillion.

But since 2015, the Fed has been shrinking its balance sheet, and this QT has accelerated of late. While tariffs and trade wars get the headlines, it's the systematic reversal of the pro-cyclical policies that buoyed the market for the last decade that we think warrants more attention, if not worry. Yes, the Fed's balance sheet is still huge, but on the margin we have gone from historically accommodative monetary policy to incremental tightening. The US central bank is removing liquidity from the system. While this looks like a blip on the chart above, the change in sign is more obvious when we look at year-on-year change, and zoom in on the last 4 years.



Source: Federal Reserve Bank of St. Louis, CBandT Estimates

It could be said that the Fed passed the liquidity torch to the ECB in 2015 when the latter began negative interest rate policy (NIRP). While short-term interest rates in the EU remain negative, the ECB is set to begin their own QT at year-end, reversing the liquidity flows on that side of the Atlantic as well.

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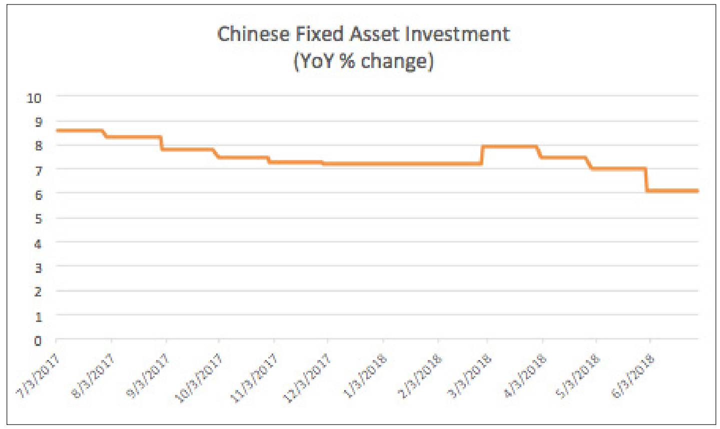
And what about the world's largest economy (if we measure by GDP at purchasing power parity)? Through the end of last year, China's real GDP has grown around five-fold since 2000. Compare that to less than 40% for the US over the same period. While it's somehow considered impolite to point it out in the media, China is (increasingly, with the elevation of Xo Jinping to President-for-life) a communist dictatorship with a command and control economy. Unlike the West, where we refer to consumer-driven economy, China's rise in the 21st century has been primarily driven by fixed asset investment (FAI). Household consumption makes up 65-70% of GDP in the US and UK, and a bit over 50% in Germany. In China, GDP is closer to 40% consumption and more than half FAI, and was even more skewed earlier in the century. But as Xi seeks to curtail malinvestment and curb debt growth, as well as grow the Chinese middle class, consumption is driving an increasing share of GDP growth, and FAI is rapidly decelerating.

As this chart illustrates, Chinese state-sponsored stimulus is decelerating, particularly relative to GDP, and doesn't look likely to come to the rescue of a global financial system from which liquidity is being systematically drained. And what of the burgeoning Chinese middle class? Maybe the shift from an investment economy to a consumption economy will take the torch from the central banks and drive the global economy.



Source: Bloomberg

However, this will require a reversal of recent trends, since Chinese retail sales growth continues to decelerate as well. These numbers are far from falling off a cliff, but the trends are all moving in the wrong direction at present.

Liquid Alpha was reasonably well-positioned for the choppy market conditions that dominated the quarter as a result of this shift in global liquidity conditions, exploiting relative value opportunities in fixed income and currencies, as well as the general strength in the US dollar. Large trends in commodities, particularly grains and other agricultural commodities, also added to performance. The petroleum complex also provided profitable trading, both from a directional and relative value perspective. Trading in global equity indices, which tended to be largely short throughout the quarter, was a modest drag on performance.

	2Q 2018	Since Inception (Jan 2016)	Sharpe Ratio (LTD)
Liquid Alpha	3.85%	3.97%	0.24
SG CTA Index	-1.87%	-4.68%	-0.21
AQR Managed Futures (AQMIX)	-2.57%	-9.27%	-0.36
S&P 500	3.43%	34.83%	1.66
Barclays Aggregate	-0.16%	4.55%	0.64
50 / 30 / 20 Stock / Bond / Alts	2.37%	19.01%	1.68

Source: Morningstar, CBandT estimates

2Q18 OUTLOOK

It increasingly appears that the Jan/Feb equity market sell-off represented a Gestalt shift in the macro backdrop (see last quarter's letter for a discussion of Gestalt shifts and the psychology behind them). Markets have moved from a global asset bull market, characterized by low volatility and little dispersion (think every stock in your portfolio moving quietly, in lockstep), to something less placid. Are we entering a global asset bear market? Certain

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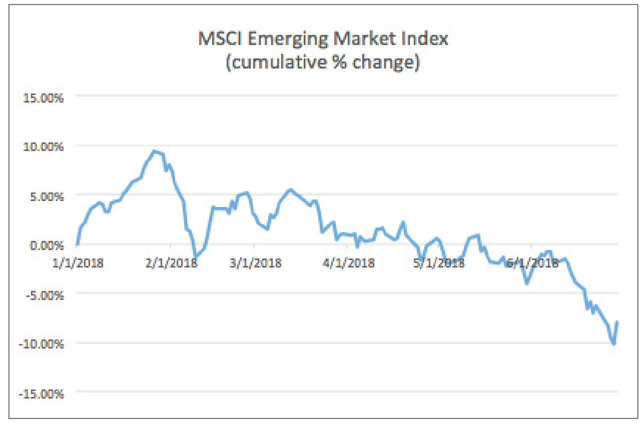
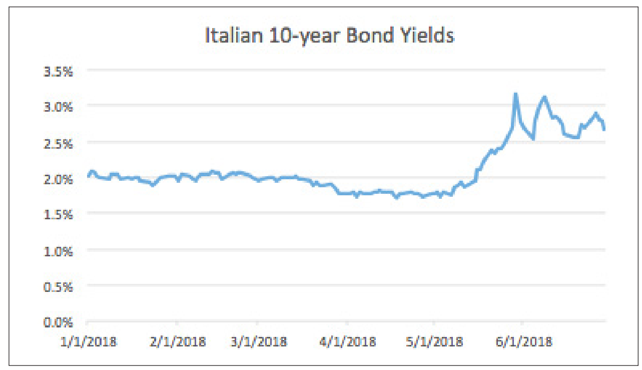
asset classes, like emerging markets, Italian bond, and the Euro currency (among other non-USD currencies), certainly do not look healthy.

US equities are among the best performing asset classes in the world year-to-date, with the US-centric Russell 2000 up 7% YTD and the NASDAQ up 9% (in case you were wondering, Saudi Arabia has the best-performing stock market in the world YTD, up just over 15%). But gains in the US indices continue to be driven by a few companies: the "FANG" stocks are responsible for nearly all of the YTD gain in the S&P 500 and over 20% of S&P 500 components are more than 20% below their 2018 closing highs. Market strength has not been especially broad-based.

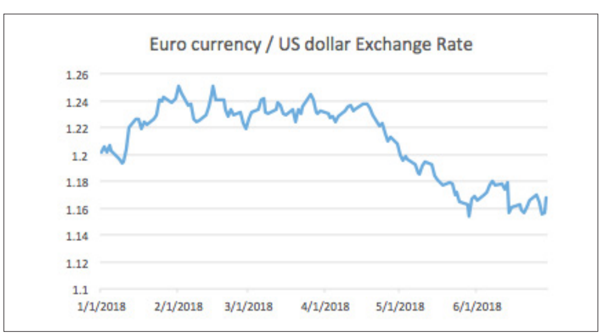
As we've discussed before, this shift doesn't necessarily mean an imminent bear market for US equity and credit. It does not mean we are living through another 2000 or 2008. But asset prices do not exist independent from liquidity conditions (which are diminishing) or risk premiums (which are rising). Different assets will adjust to this new paradigm with differing paths and timing. In short: volatility and dispersion will continue to rise. The "buy the dip" mentality that pervaded across all risky assets over the past few years looks less likely to work in the foreseeable future. Such market conditions lend themselves to exactly the type of tactical global macro strategies that make up Liquid Alpha. They are also precisely why we continue to tilt the portfolio away from directional trendfollowing strategies that make explicit bets on equity market beta (both long and short) and toward more orthogonal relative value and market-neutral strategies. That said, we maintain a core allocation to momentum-based strategies, as those have historically been the winners in periods of truly extreme markets. If we do enter a global bear market, this less nuanced exposure will likely prove valuable.



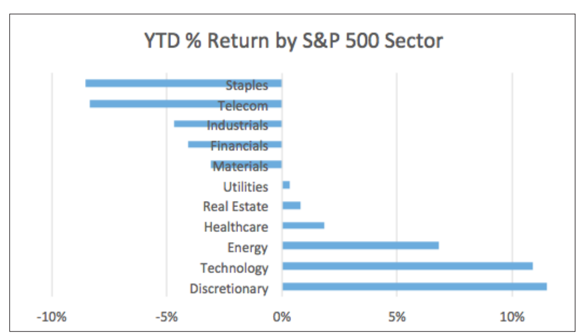


Source: Bloomberg

The late, great investment manager and financial historian Peter Bernstein is quoted as saying "diversification is the only rational deployment of our ignorance." With Liquid Alpha, we continue to offer what we believe is a unique value proposition for trust and wealth clients: a rules-based global macro asset allocation approach, that makes diversified investments across every liquid global asset class, via best-in-breed managers, while harnessing structural alpha (in the form of reduced fees and transaction costs). When added to a traditional 60/40 portfolio, this "all weather" approach has historically increased returns and significantly reduced volatility. In light of increasing uncertainty around monetary and fiscal stimulus in the US, Europe, and China, we think now is a very good time to be deploying our ignorance. Thank you for your support and best of luck in the remainder of 2018.



Source: Bloomberg



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