Crescat Capital LLC
1560 Broadway
Denver, CO 80202
(303) 271-9997
info@crescat.net
www.crescat.net

September 15, 2018

Dear Investors:

Our current three best macro ideas today are complementary plays on the unwinding of currency and financial asset bubbles at a likely peak of a global capital cycle, the most leveraged in history:

1. Shorting US stocks at proven, historic-high valuations relative to underlying fundamentals with abundant catalysts for a near-term bear market leading to a US recession;
2. Shorting the overvalued and weakening Chinese yuan and China contagion plays to express the unwinding of a credit bubble that is unprecedented in scale and already bursting; and
3. Buying precious metals commodities at record deep value compared to the global fiat monetary base and related miners at record cheapness to the underlying fundamentals with an increasing number of important new signals showing rising US and global inflationary pressures and a hamstrung Federal Reserve that is unable to stop them.

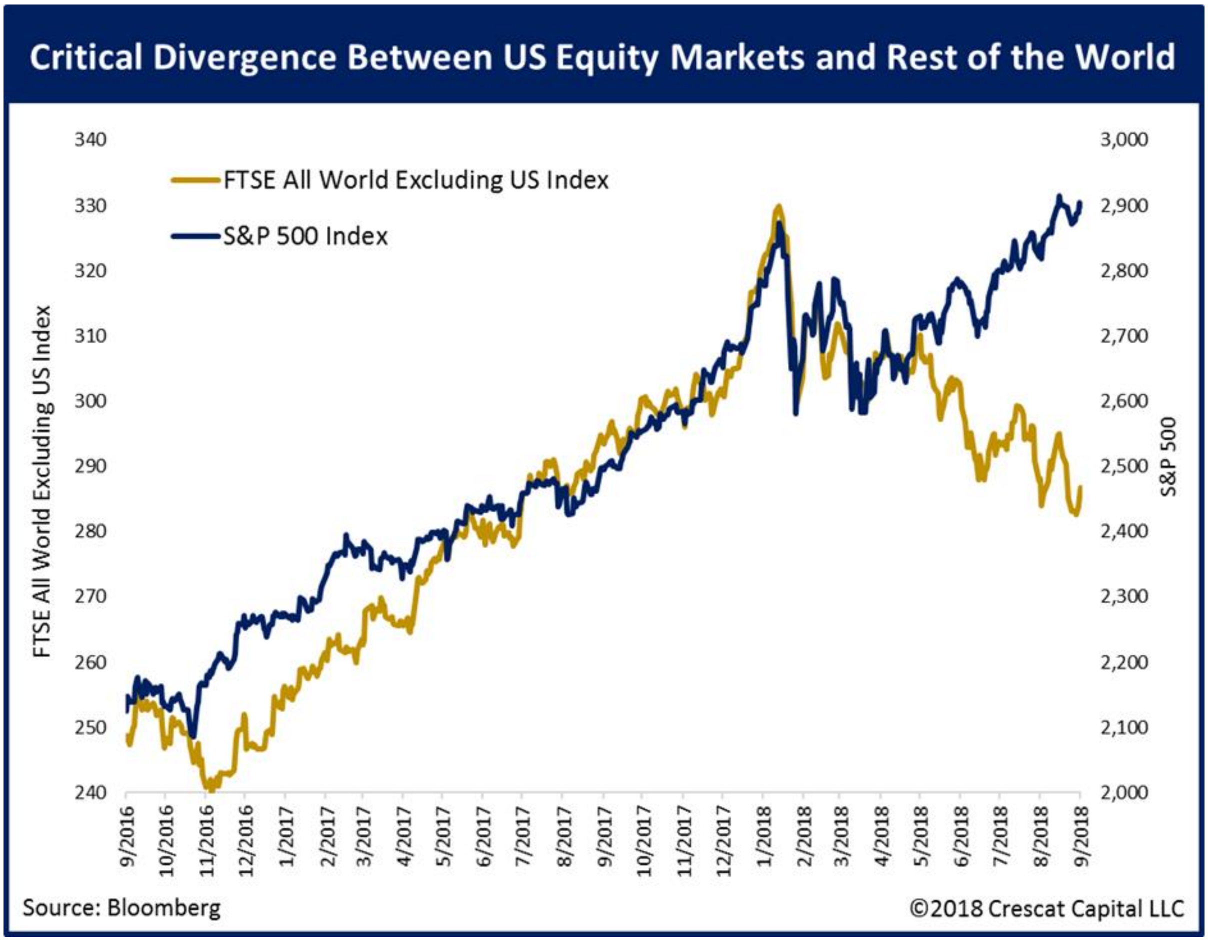
These themes represent what we believe are the biggest macro imbalances in the world today. By constructing a portfolio across them, we strive to position our clients to profit from the emerging storm rather than be swept up in it. Our goal is to generate high absolute return and alpha (risk-adjusted relative performance) vs. popular benchmarks and the masses of herded and wrong-footed investors and investment managers. It is very late in the global economic business and investment cycle. China and other emerging markets are already in a financial crisis that is spreading. Meanwhile, US financial asset bubbles are set up to burst on their own as well as to get caught up in the contagion.

The Hamstrung Fed

The Fed is raising interest rates late in the economic cycle. The problem is that inflationary pressures have finally reached a critical mass where they have rendered the Fed's monetary policy ineffective. The Fed cannot fight inflation and prevent financial asset bubbles from deflating at the same time. If the Fed raises interest rates to any further significant degree, higher rates will burst US financial asset bubbles. However, if the Fed does not raise rates substantially, rising inflation itself will burst US financial asset bubbles. In either case, there is no escape from bursting financial asset bubbles. There is likely no escape from future rising inflation either.

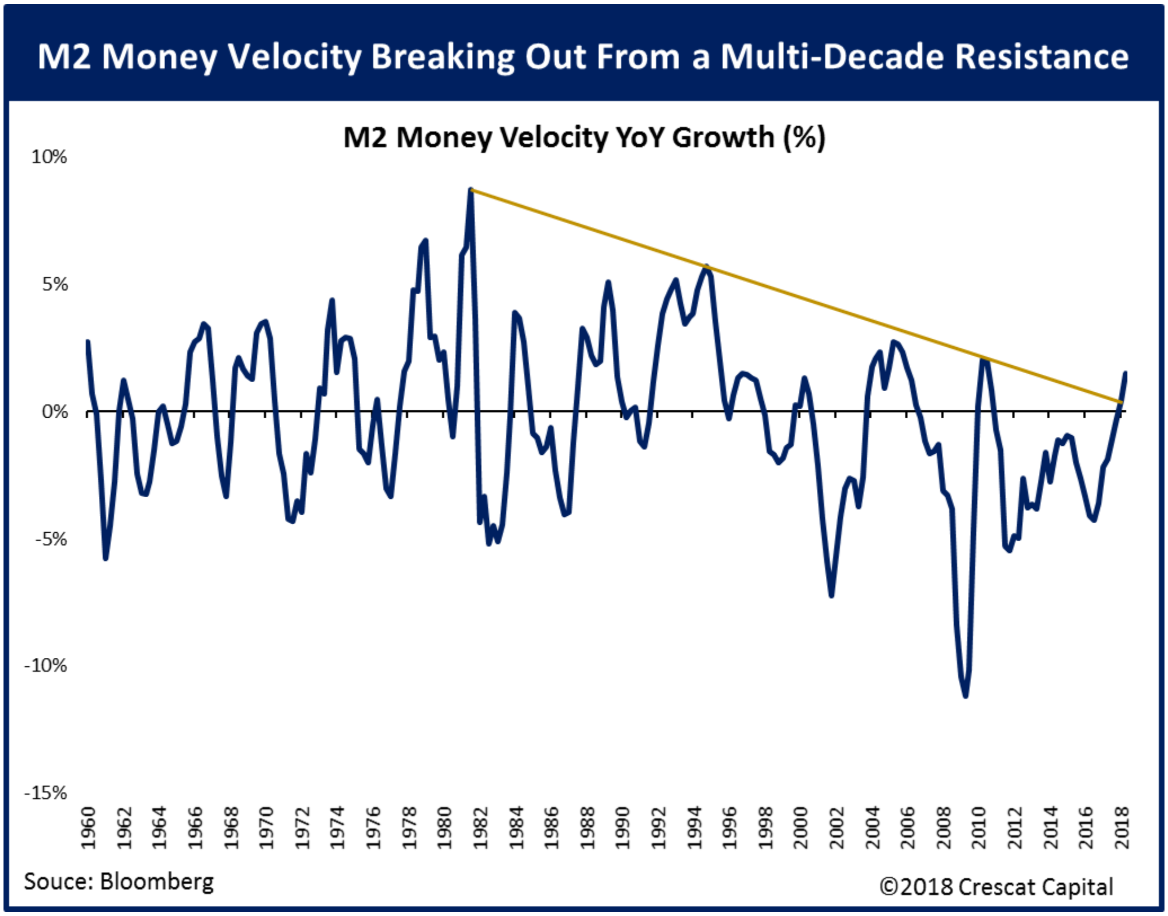
With the Fed on the tiller of the world reserve currency, its recent rate increases have already contributed to a temporarily strong dollar and the bursting of financial asset bubbles in China and other emerging markets. Our hedge funds have already been benefitting from our short positions in those markets.

Many emerging markets are already in a bear markets (down more than 20%) relative to their January highs just this year. The FTSE All World Ex US Index as we show below is down 13% since January 26. Global equity market contagion now threatens to drag the US market down with it. Our US equity shorts were successful in February and March for our hedge funds, but the US stock market has chugged higher to our mild frustration. Weakening market internals give us much confidence to stay short. Even while pushing to new highs recently, the US stock market is running out of steam. Market internals are weakening across multiple breadth indicators. These indicators are diverging compared to the January prior high in the S&P 500: substantially lower new 52-wk highs, much lower % of stocks above 70 on RSI, and much lower percent of stocks above 200-dma. We strongly believe the US stock market is poised to follow the rest of the world down.



The Fed is hamstrung because, while it has been raising rates, it continues to run a hot monetary policy in the US, one that is still way too loose to fight rising domestic inflationary pressures according to our model as well as the Fed’s own Taylor Rule.

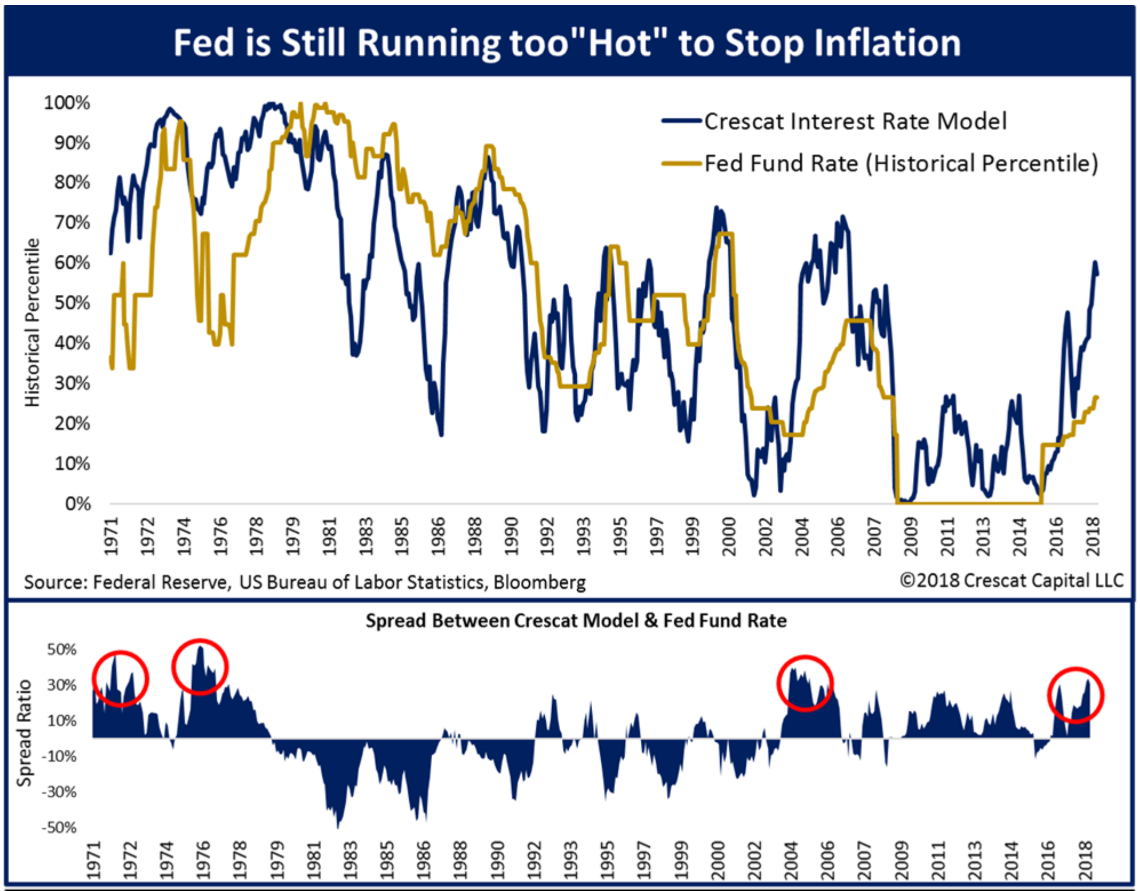
Rising M2 money velocity is one sign of rising inflationary pressure today that many people have overlooked. For much of the last decade, money velocity has been declining, but it has recently broken out of a long-term downtrend as we show in the chart below.



Money velocity is difficult for the Fed to control, because it is based on people's actions with respect to their inflationary expectations. Money velocity and inflation can get out of control if people lose confidence in a central bank's ability to control inflation, a central bank's worst nightmare. The Fed had the benefit of fighting deflationary expectations after the Global Financial Crisis and was aided by a trend of positive deflationary forces including globalization and technological advances. But globalization also increased the wealth gap, the share of a business's production that accrues to owners of capital versus wage earners. The wealth gap has become too extreme in the US and globally, so today we are facing a counter trend of de-globalization that includes rising populism, nationalism, and protectionism. De-globalization presents inflationary forces both in US and throughout the global economy. The US tax cuts and increased fiscal deficits are also a substantial new inflationary force in the US.

The Fed's unconventional monetary policies (money printing) since the Global Financial Crisis were successful in fighting deflation in the last economic cycle. The problem is that then Fed's accommodation has led to record financial asset inflation. The Fed has already proven that money printing can counter deflationary pressures in the real economy. We strongly believe that the idea of needing to fight deflation today is same idea as "fighting the last war" because it ignores all the signs that we are presenting herein that we are in a rising inflationary environment now. If the Fed were to panic and print money in a financial asset bubble meltdown and inflationary environment like today, it could lead to a disaster such as the 1973-74 bear market where money printing would feed a vicious cycle of rising money velocity, sharply rising inflation, loss of confidence in central banks, and further financial asset bubble meltdown.

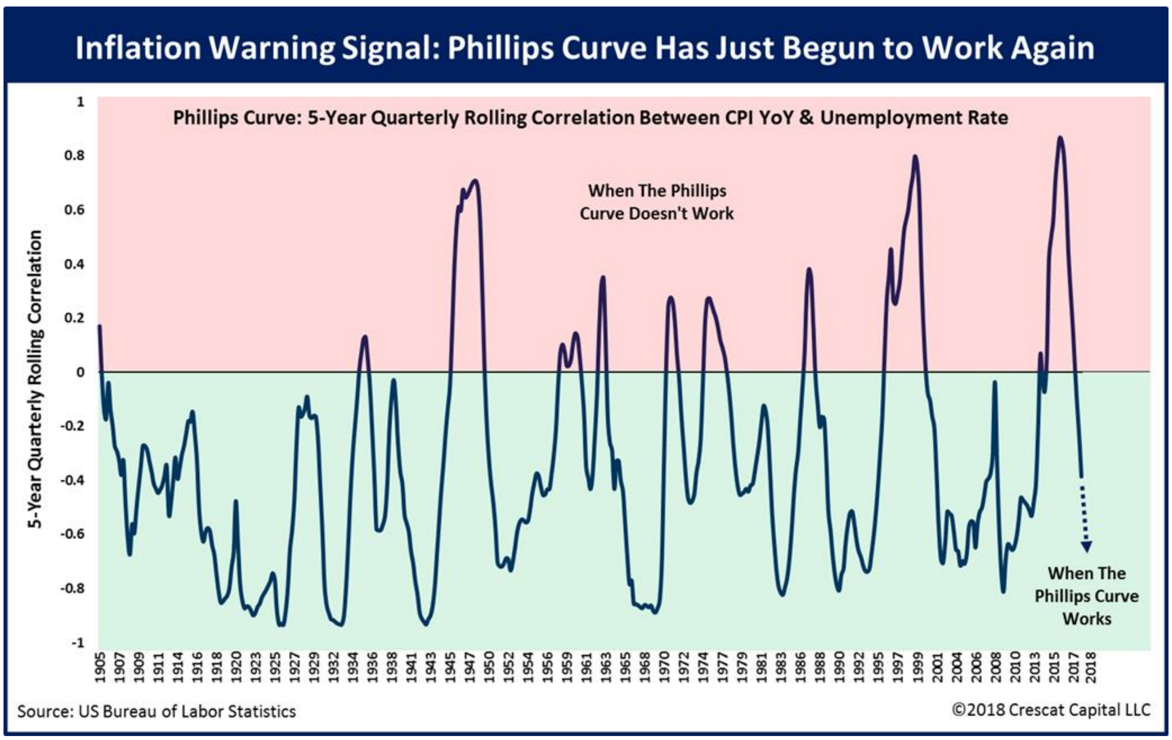
Per Crescat's model, the neutral Fed funds rate that would be necessary to control rising inflationary pressures today is 5.5%. The current Fed funds rate, however, is only 2%. Our research is based on the history of a breadth of inflation and labor market indicators and the Fed Funds rate going back to 1971. Please see our model in the chart below.



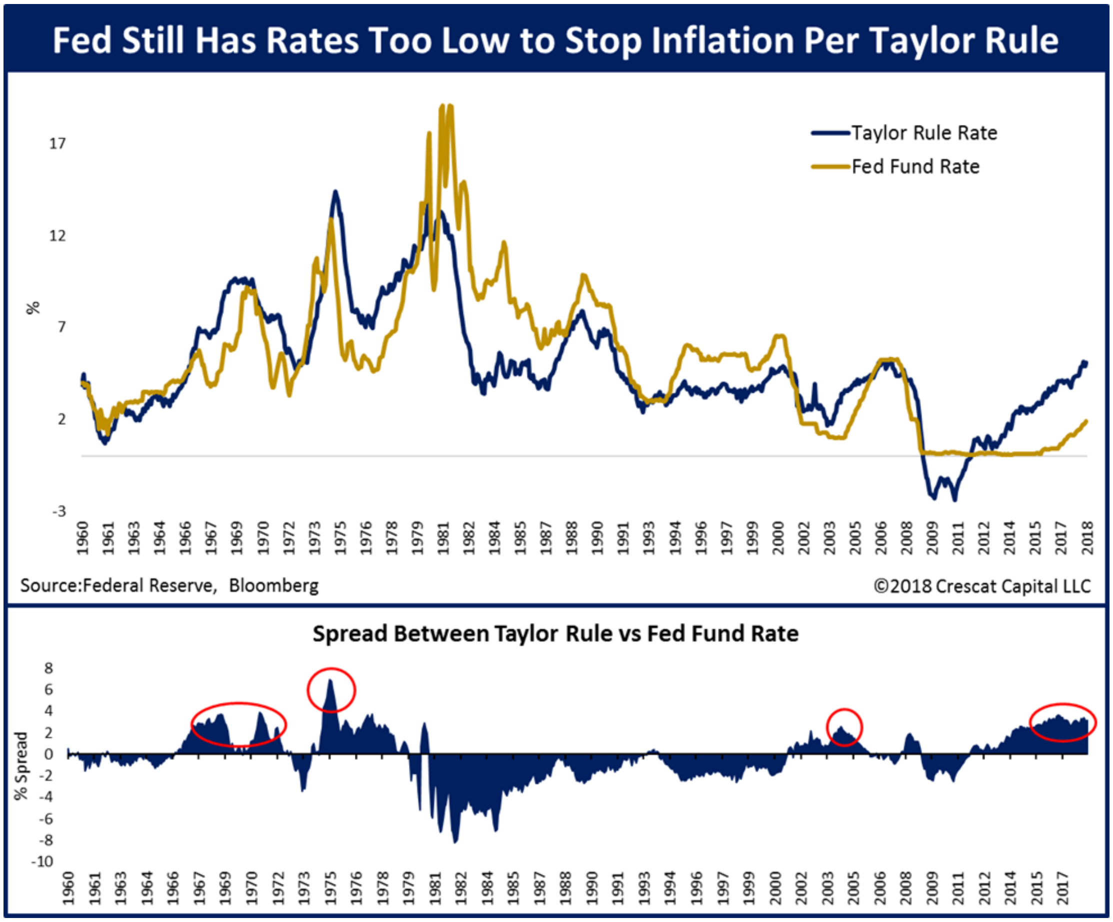
Factors	Historical Percentile
Personal Income YoY	21%
Core CPI Inflation YoY	40%
CPI Inflation YoY	53%
ISM Manufacturing PMI	78%
Unemployment Rate	90%
PCE Core Price Index YoY	41%
Nominal GDP YoY	21%
Oil Prices YoY Change	83%

Based on our model, the period that we are in today most closely resembles the circled periods in red, the inflationary 1970s, also the housing bubble period in mid-2000. Indeed, those were periods when we had rising inflation because the Fed kept rates too far below the neutral rate. When the Fed keeps interest rates too low for too long, it creates financial asset bubbles that it has difficulty extricating itself from. It also creates real-economy inflationary pressures. If the Fed were to raise interest rates by 3.5% to get to the neutral rate to prevent rising inflation, it would be catastrophic for today's financial asset bubbles. Doing so would massively invert the yield curve, crash the stock and credit markets, and create a recession. Such is the tradeoff between inflation and financial asset bubble deflation that we face today. Rising future inflation and the bursting of financial asset bubbles are the consequences that we must now face for the Fed's unconventional monetary policies in the wake of Global Financial Crisis. The Fed is now between a rock and hard place such that it can neither prevent rising future inflation nor the bursting asset bubbles.

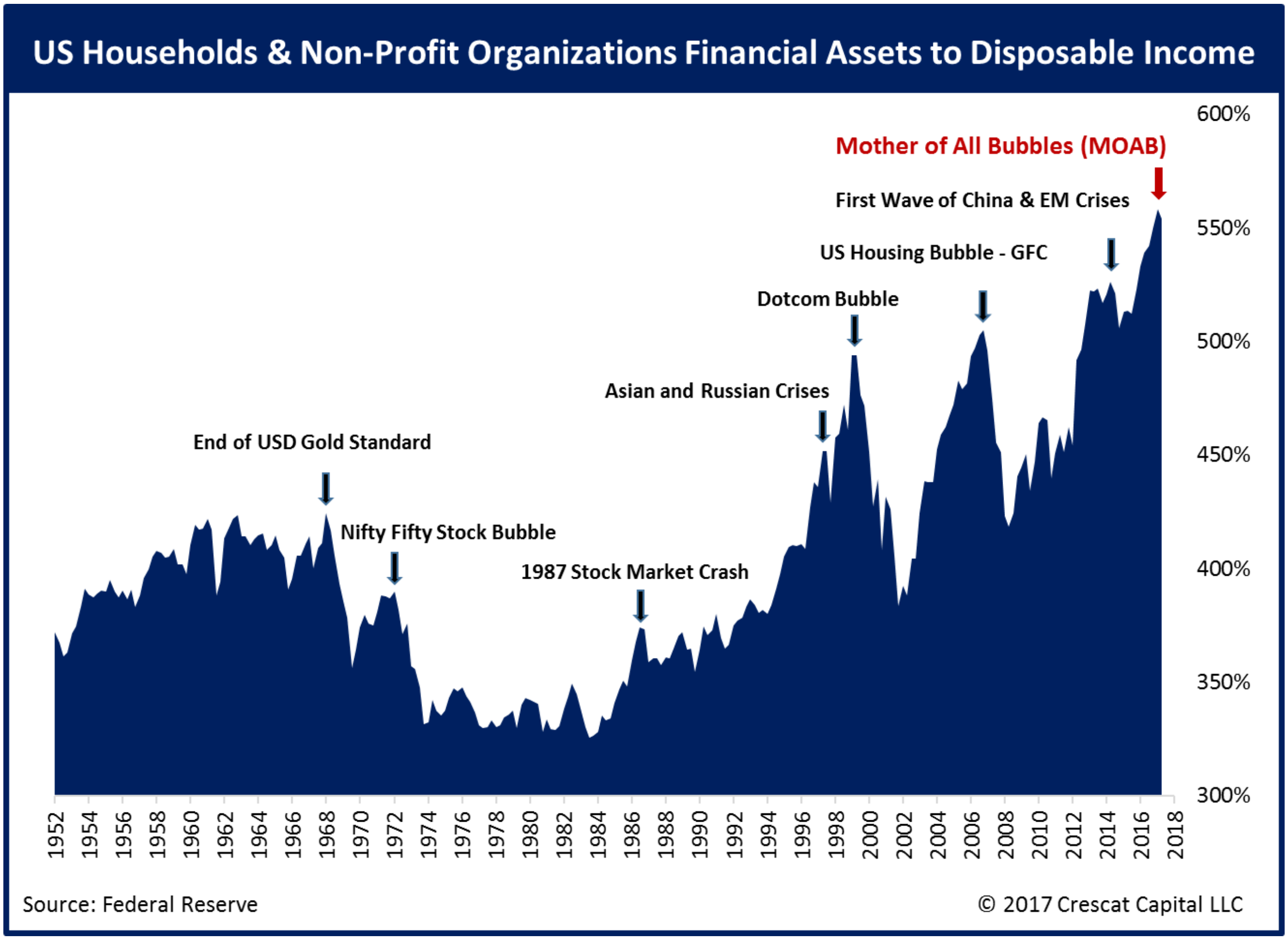
Real economy inflation is also rearing its head today according to our analysis of Phillips curve data shown below. Based on 5-year rolling correlations, it appears that the traditional Phillips Curve tradeoff between inflation and unemployment is back in force again. What this means is that the current low unemployment rate is indeed creating inflation.



As a further indicator that we are in an inflationary environment today, the Fed's own Taylor Rule model shown below also illustrates that the Fed would need to raise rates by 3.1% today to get to a neutral rate to be able to stop rising inflation, a level of increase just shy of our own model and one that would also certainly burst asset bubbles if the Fed were to get serious about fighting inflation.

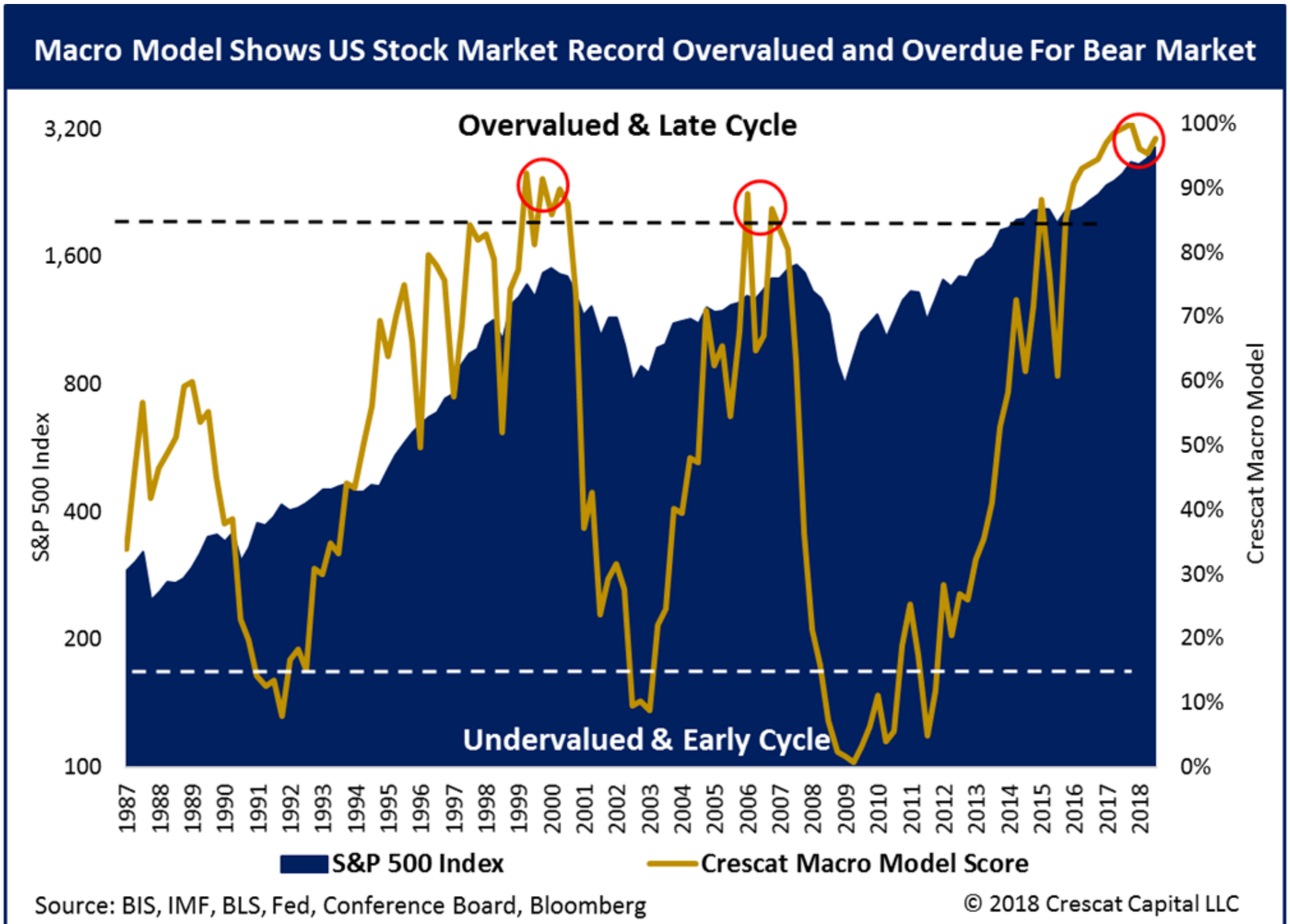


We can prove that aggregate US financial asset valuations are at excessive, all-time highs, by looking at the ratio of financial assets to income as shown below. Today's US equity and credit markets valuations combined are what we call MOAB, the mother of all bubbles:



US Stock Market Bubble

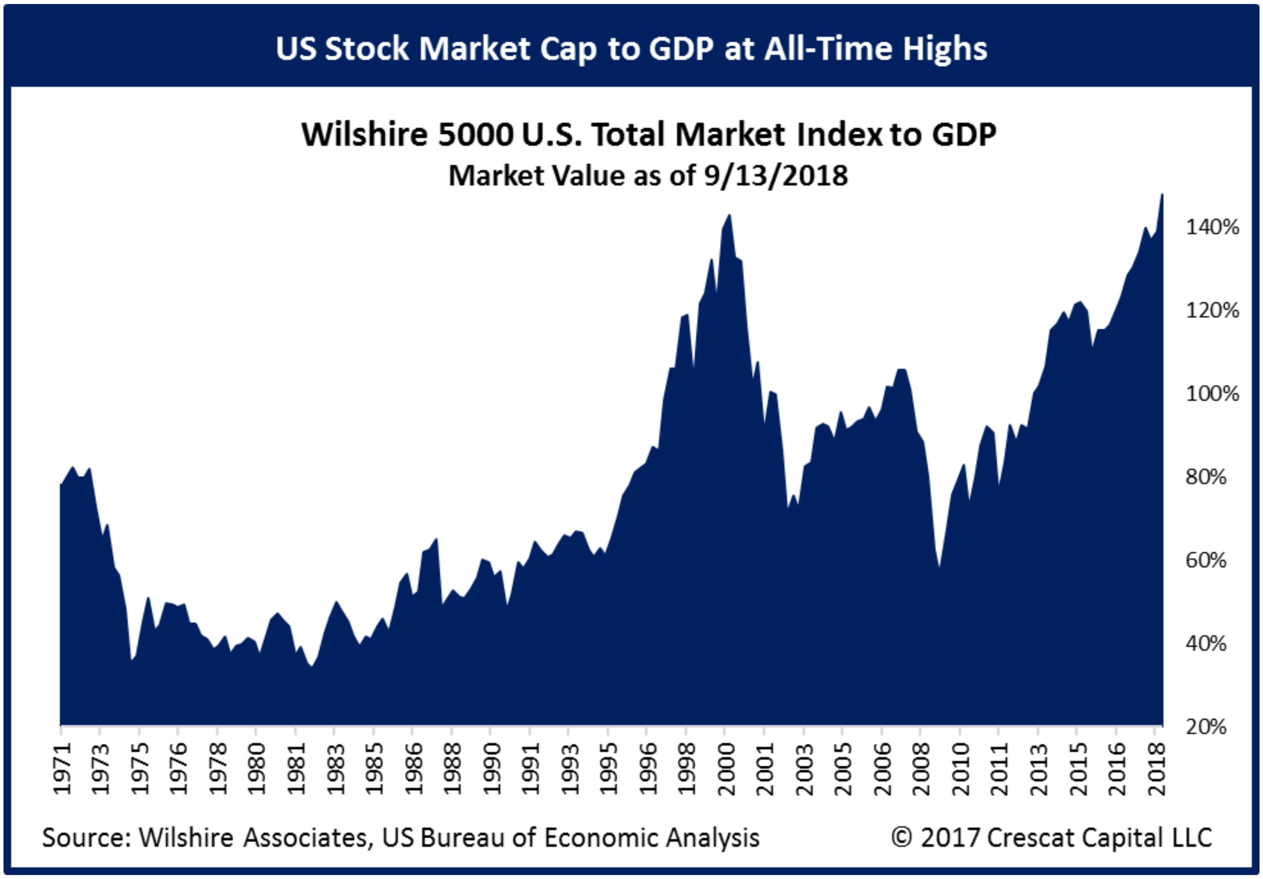
We have updated our macro model below which we first released on January 26. It still shows across sixteen indicators that the US stock market is highly vulnerable to a major correction or crash.



Crescat Macro Model Indicators	Historical Percentile at Previous Peaks		
	03/31/2000	06/30/2007	Today
UST Yield Curve (10s-2s)	95%	77%	75%
US Unemployment Rate	89%	66%	86%
Initial Jobless Claims	87%	70%	91%
High Yield Credit Spread	22%	89%	79%
Consumer Confidence	96%	75%	86%
Savings Rate	93%	98%	69%
Total Economy Debt to GDP	52%	72%	95%
S&P 500 % of 200 DMA	99%	70%	61%
# of Quarters Since Last Recession	97%	76%	96%
Shiller P/E Ratio (CAPE)	100%	90%	94%
EV to FCF Margin Adjusted	37%	61%	96%
Median Price to Book	35%	77%	94%
Median EV to Sales	21%	79%	99%
Median Corporate Debt to Assets	84%	12%	98%
Fed Funds Rate of Change 24 months	74%	79%	91%
Volatility Index (VIX)	20%	79%	35%
Average of Percentile Ranks	69%	67%	91%
Crescat Macro Model Score (Historical Percentile)	**86%**	**80%**	**100%**

We have already shown the record overvaluation of the US stock market across six fundamental valuation measures that encompasses all aspects of the balance sheet, cash flow statement, and income statement. You can read our main work on this subject on our website or check it out in Meb Faber's 2018 book, The Best

Investment Writing – Volume 2, a compilation of 41 excellent recent analytical investment essays. US equity valuations are still in the same stratosphere today as when we wrote about them in late 2017. We will not repeat that analysis in this letter, but here we show yet a seventh measure that proves record stock market valuations today, total US stock market cap to GDP:



And here is an eighth measure that also shows record valuations, market-cap-weighted price to sales, in blue below that in January 2018 went to higher valuations than the 2000 tech bubble. We already showed median price to sales (the red line) in other work.

Source: The Leuthold Group

Our valuations still do not square with those of Robert Shiller whom we greatly admire because of his Nobel Prize-winning work on cyclically-adjusted P/E (CAPE) ratios. We think Shiller has a minor flaw in his CAPEs make them somewhat misleading today. We watched Shiller on Bloomberg TV this week saying that CAPE ratios show that US stock market valuations were higher in 2000 at the tech bubble peak. He said that since CAPE ratios were 50% higher in 2000, today's market could easily go 50% higher from here because "animal spirits" are strong right now and they could keep getting stronger. We think this is highly misleading analysis and advice right now that is only contributing to a likely market top at current levels. Shiller might be leading the lambs to the slaughter.

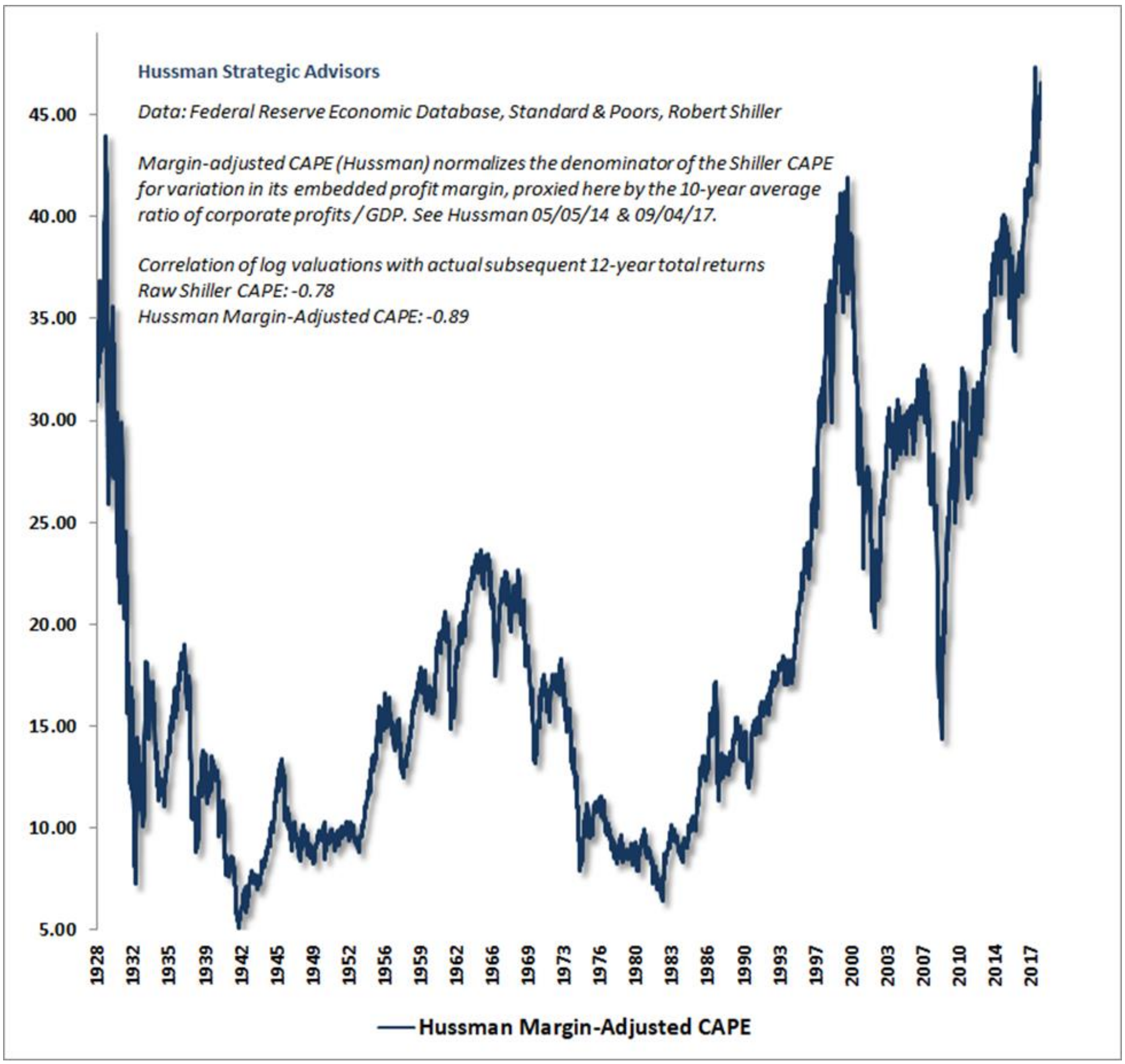
We have now shown eight valuation measures that comprehensively prove that the US stock market has reached record, all-time high valuations this year, 2018, not in 2000. We agree with Shiller, however, that today's mood is already one of high animal spirits. We call it euphoria. Like the cryptocurrency euphoria that peaked in January of this year, we see that the combination of euphoria and asset bubbles is one that can quickly transform to decimation and despondency. 2018 US stock market euphoria is yet another indicator of a market top.

The problem with Shiller's CAPE ratios, and the reason they do not align with all our other measures, is that they do not account for cyclical and long-term swings in corporate profit-margins.

Corporate profit margins matter because they have reached a combined cyclical and secular peak creating a serious value trap, especially when looking at P/E multiples, but also to a lesser degree when looking at CAPEs. There are two major factors creating unsustainably high profit margins today:

1. A high wealth gap that has favored owners of capital over wage-earners over a long-term trend. This trend is now likely reversing under rising populism and de-globalization; and
2. The recent corporate tax-cuts at the peak of a business cycle.

When Shiller's CAPEs are profit-margin adjusted, it becomes clear that the highest prior CAPE was not in 2000 but in 1929. Furthermore, Shiller's margin adjusted CAPEs at their highest ever this year, 2018, not in 2000. Margin-adjusting Shiller's CAPEs is the work of Stanford PhD, John Hussman. Using margin-adjusted CAPE, as shown by Hussman below, we can see that we have already reached the heights of the frothiest stock market bubble ever in 2018.

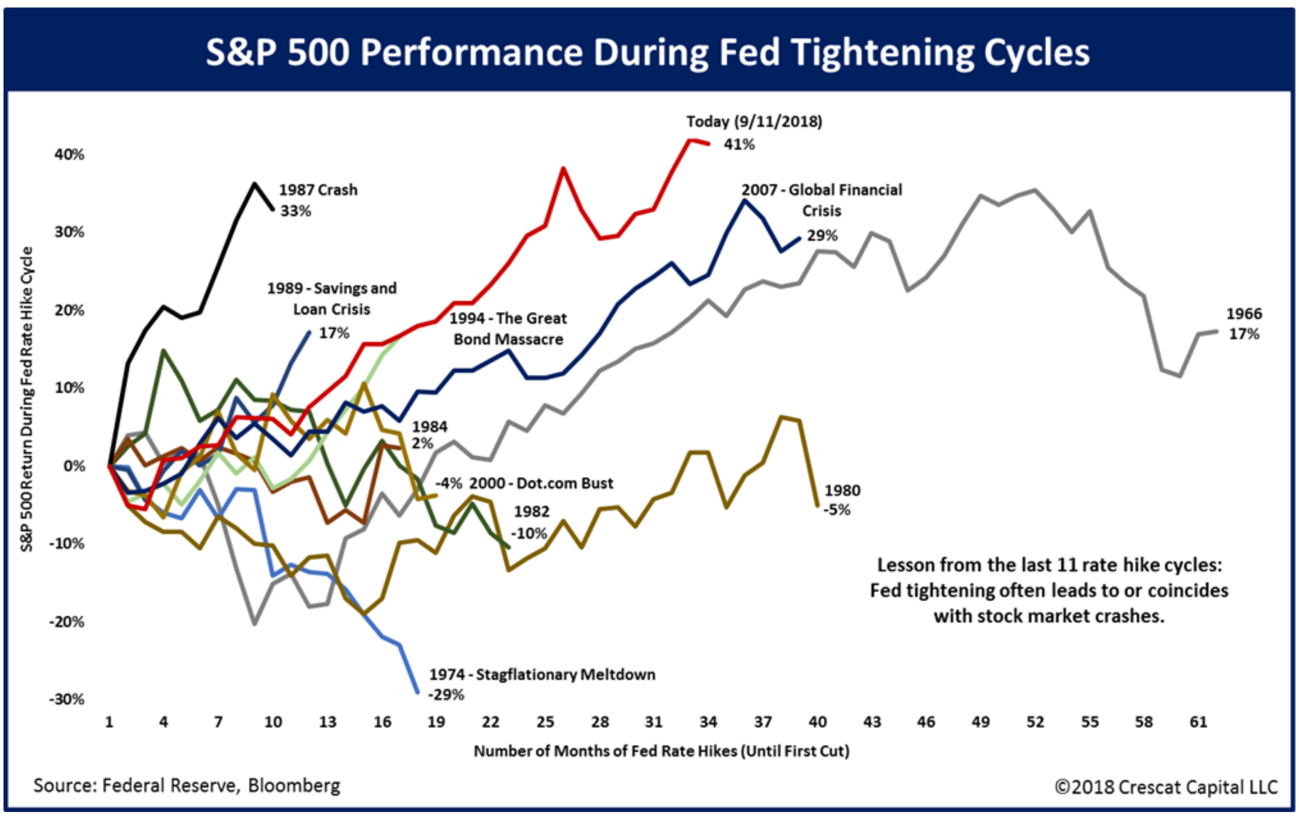


Source: Hussman Strategic Advisors

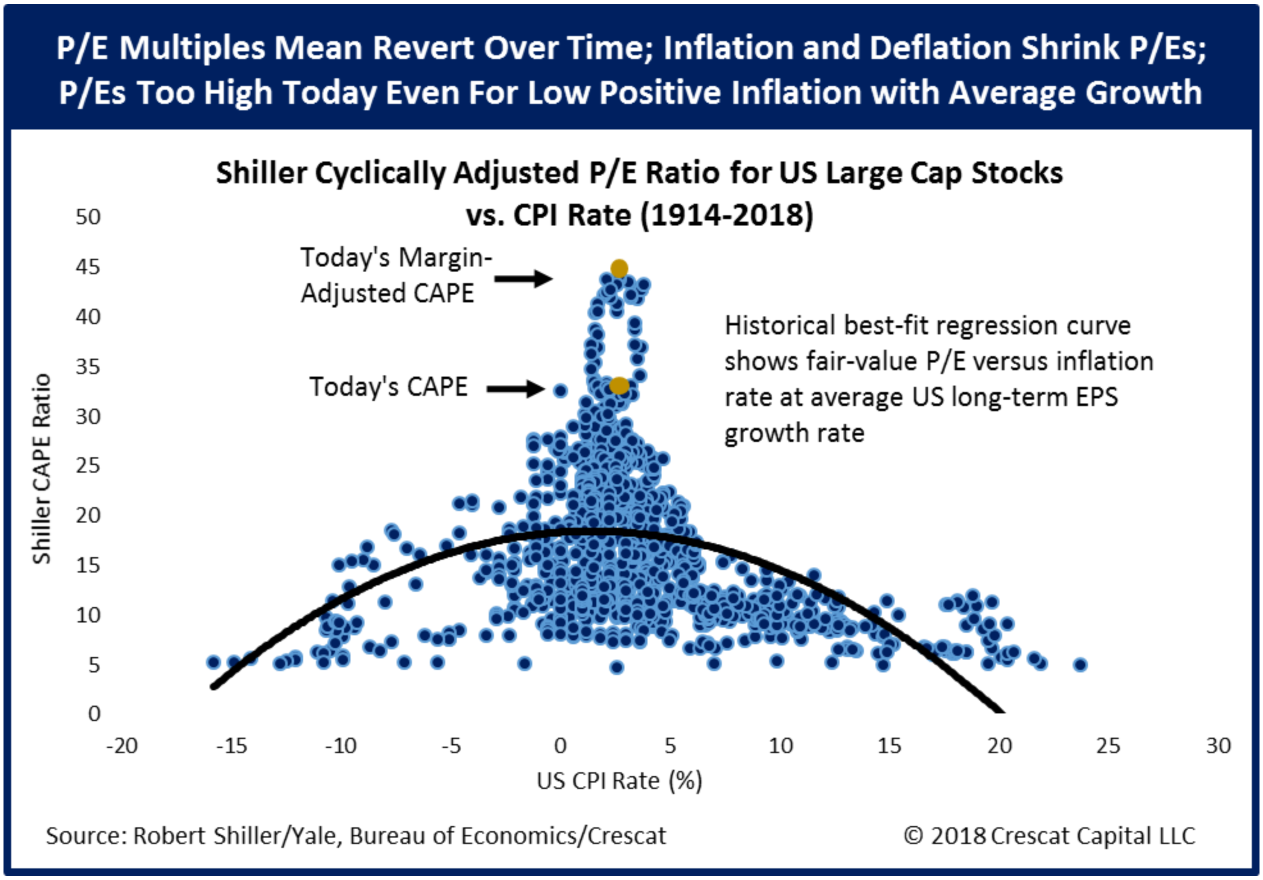
Don't believe the trend-is-your-friend crowd. Momentum fails badly at bubble valuation market tops and there are big gains to be made by going opposite the crowd. If one is looking for an asymmetric risk/reward investment opportunity, we are convinced that the overwhelming odds of a payoff are on the short side of the US stock market today.

There are many catalysts for the market to peak and decline imminently. First and foremost is the divergence in the rest of the world's equity markets year to date as we showed above.

Another major catalyst is that Fed rate hike cycles often lead to US stock market crashes, particularly when it is late in the business cycle. Note, this was the case in the 1987 Crash, the Dotcom Bust, and the Global Financial Crisis. The frothier it gets during a tightening cycle, and the later in an economic cycle, the harder it falls. Today's run up in the S&P 500 to record valuations is the highest ever during a Fed tightening cycle as shown below:



It doesn't matter whether we have stable low inflation, inflation, or deflation, valuation multiples are simply too high today and will shrink in all cases based on history as illustrated in the chart below. The market is simply discounting way too much future growth and is not discounting a recession.



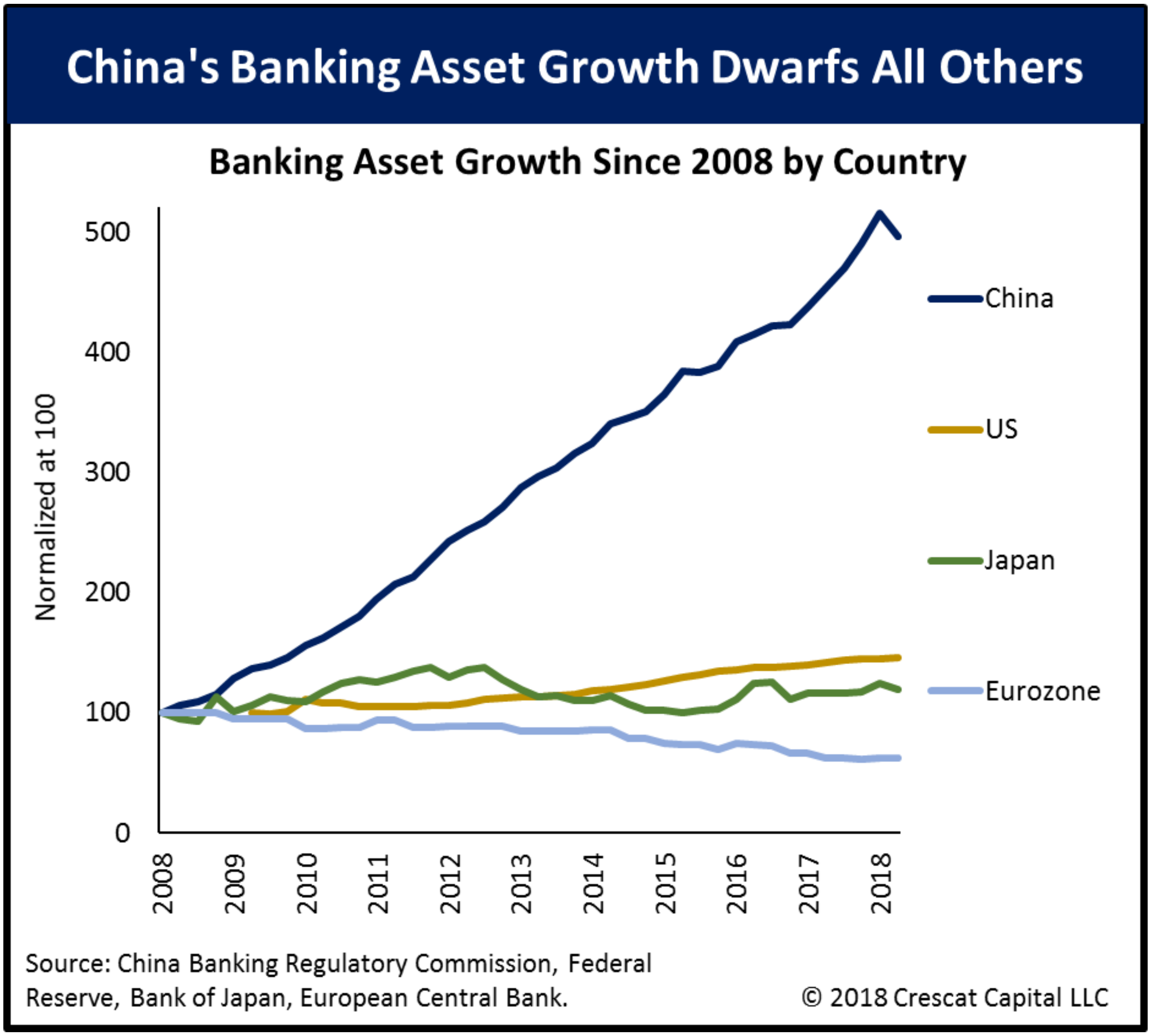
China Credit Currency and Credit Bust

While the mother of all financial asset bubbles is represented by US stocks and credit today, China represents the mother of all credit bubbles based on its massively overvalued currency and banking system.

In June, we showed how Crescat can perform as the China credit bubble just started to burst. Crescat Global Macro Fund was one of the top hedge funds through June YTD thanks to our significant yuan short position and other China credit bust plays. We strongly believe there is so much more to play out, especially with respect to China's currency devaluation.

China has been the fastest growing major GDP economy in the world, contributing over 50% of global GDP growth since the Global Financial Crisis. But the China miracle has all been accomplished by unsustainable debt growth, non-productive capital investment, and a massive hidden non-performing loan problem. China's NPLs are estimated at close to USD 10 trillion according to one respected China credit analyst, Charlene Chu, at Autonomous Research. Our analysis concurs. We published our most in-depth China credit bubble research letter last year and we believe that China is now entering a recession that would occur with or without Donald Trump's trade war which is hastening it.

As shown in the charts below, China's massive and unsustainable banking asset growth represents a substantially bigger banking imbalance than that of the US prior to the Global Financial Crisis and a bigger imbalance than the EU banking bubble prior to the European Sovereign Debt Crisis.


China's Banking Asset Growth Dwarfs All Others
Banking Asset Growth Since 2008 by Country
Normalized at 100
500
400
300
200
100
0
2008
2009
2010
2011
2012
2013
2014
2015
2016
2017
2018
China
US
Japan
Eurozone
Source: China Banking Regulatory Commission, Federal Reserve, Bank of Japan, European Central Bank.
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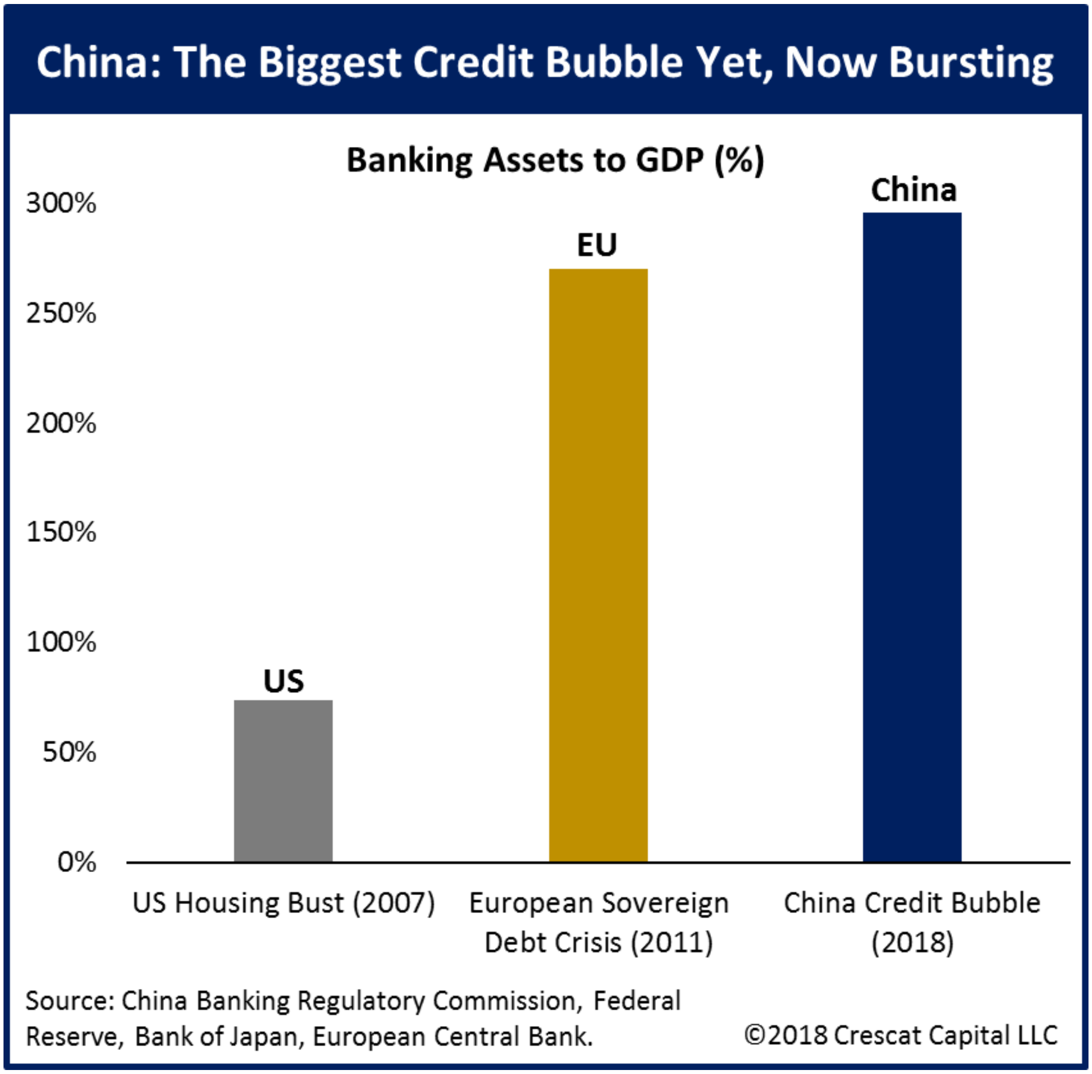
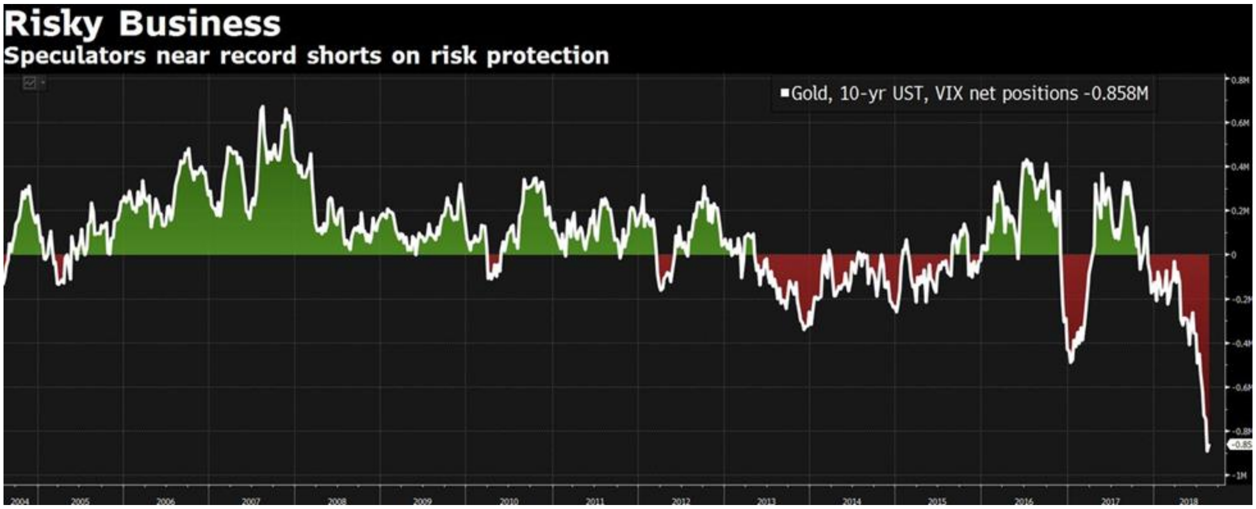


Precious Metals

Gold is cheapest ever in history compared to the global fiat monetary base as we recently showed. Silver is historically cheap to gold. Miners are historically cheap to their own fundamentals, and even cheaper when one considers depressed gold and silver prices today. Precious metals are the ultimate inflation hedge and haven asset of our two MOABs, China credit bubble and the US financial asset bubble burst. Too many investors fear another deflationary bust if they fear one at all. Asset bubbles will certainly deflate. But real economy deflation is the last war. The Fed has already proven in the last cycle that money printing conclusively can beat deflation. We have shown above the many signs of rising inflation today, from rising money velocity, to de-globalization, to new higher fiscal deficits from tax cuts, to Phillips Curve pressures, to Crescat and Fed models that show the Fed still way too accommodative to stop rising inflation. The Fed is currently rendered ineffective in fighting inflation because any serious effort to do so would risk bursting record financial asset bubbles.

Therefore, if we could own just one asset class to hedge against ultimately rising inflation as record financial asset bubbles are bursting, it's precious metals. Next to the US dollar, gold remains the most ubiquitous central bank reserve asset in the world and global central banks have been net acquirers of it since it bottomed in 2015. We want to be on the same side of central banks.

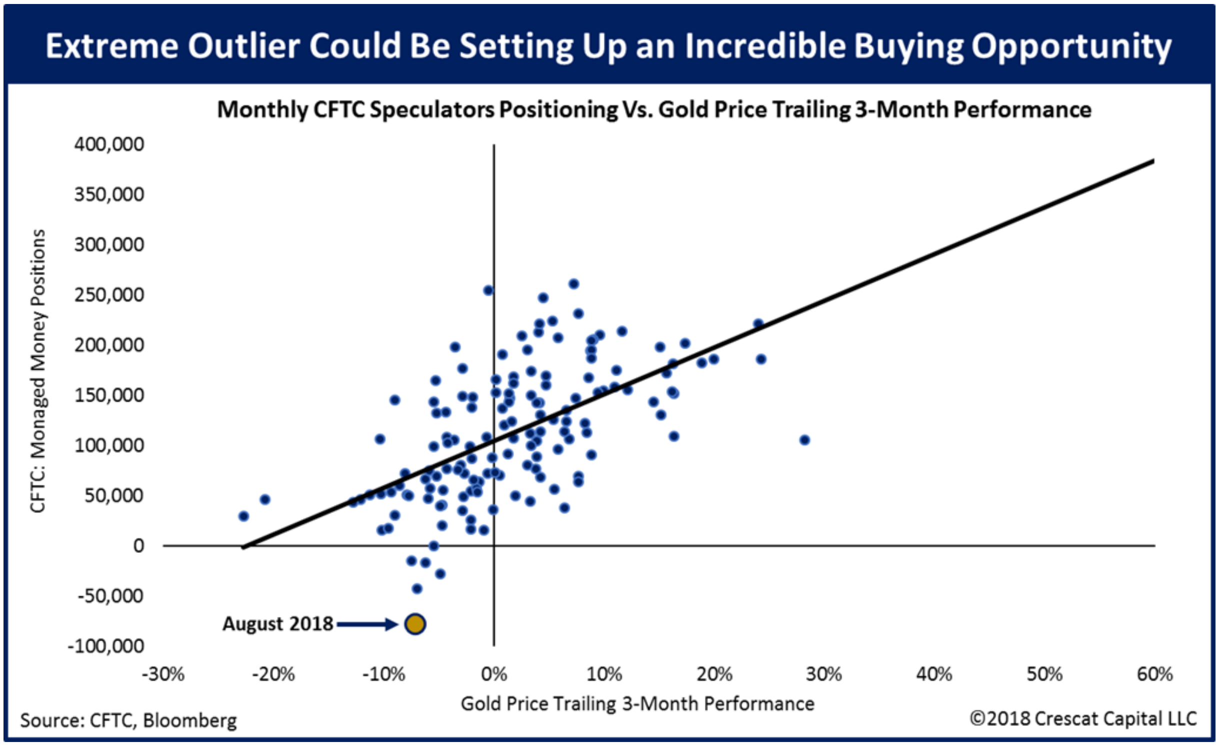
Recently, speculators were record net short gold and other risk protection assets per CFTC data including VIX and 10-year USTs as shown in the chart below.



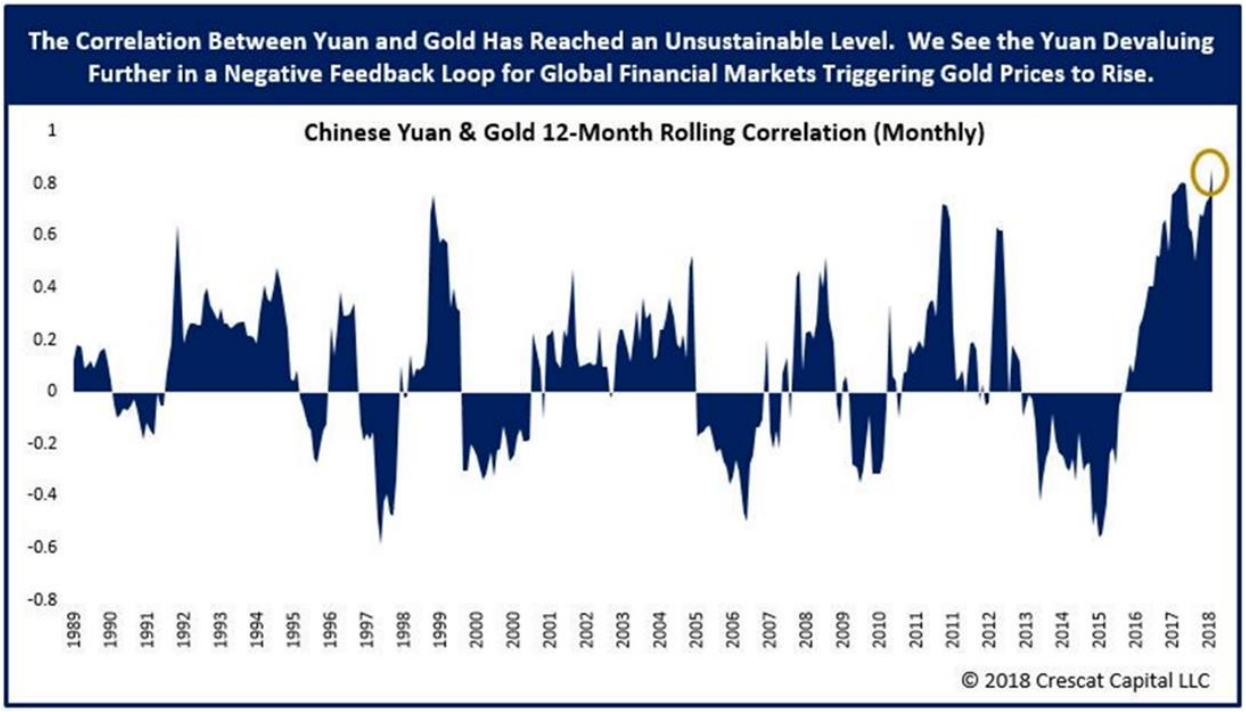
It is possible that this is a technical setup right now for a combined stock market dislocation, temporary flight to safety in Treasuries (fighting the last war still), and new flight to gold as these positions are all forced to unwind.

That is what happened last time these combined positions were at short extreme on 12/31/2015. In just the six week that followed: Gold rallied 17%; gold mining stocks rallied 37%; silver stocks were up even more; 10-year USTs rose 9%; the S&P 500 dropped 9%; crude oil fell 21% (CFTC data supports same directional move for crude today); the Chinese yuan was down 1.2%; and Chinese equities as measured by the iShares China Large Cap ETF (FXI) were down 18%. Suffice to say, Crescat's portfolios performed extremely well absolutely and relatively during those six weeks. We believe we are positioned today for similar future break-away performance.

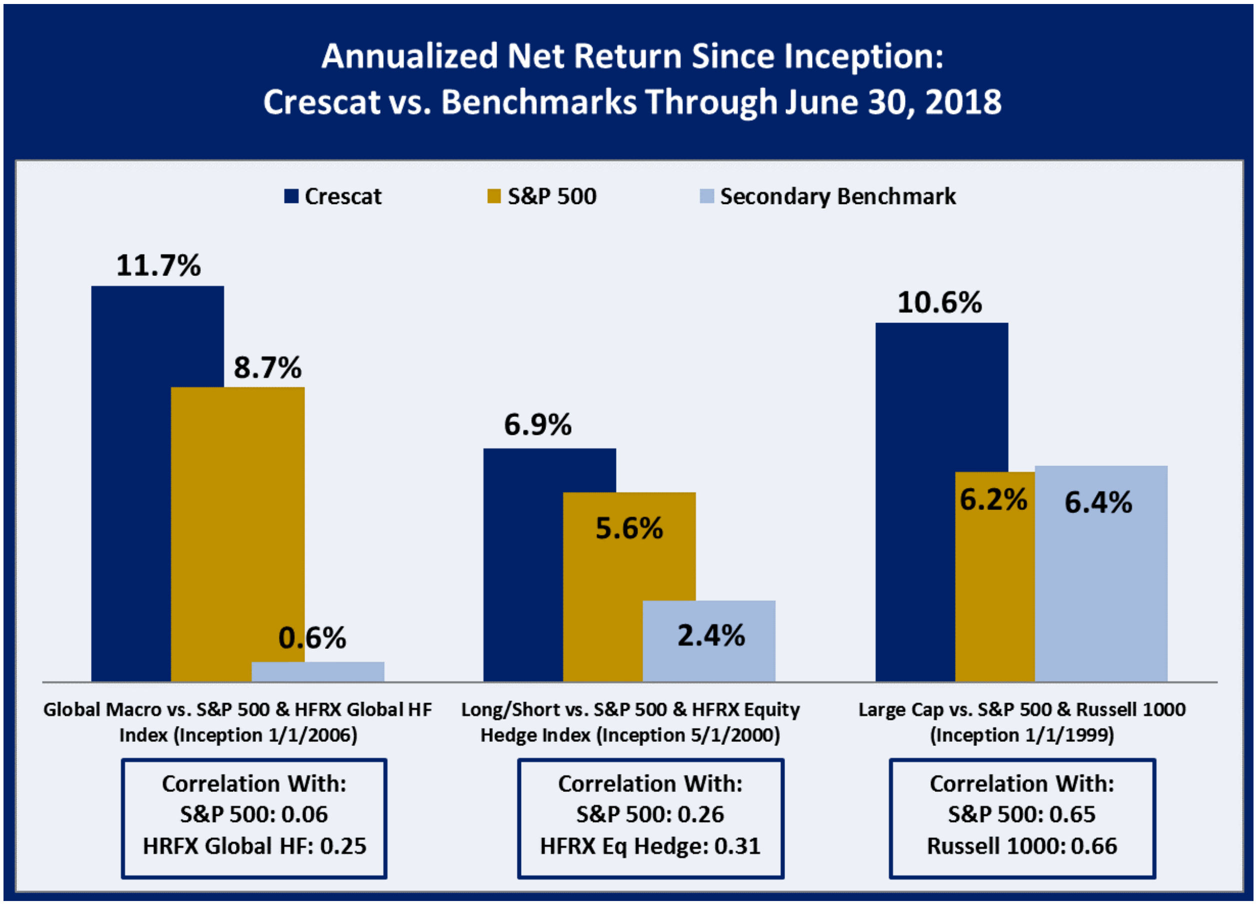
The recent weakness in gold combined with record speculative short interest presents a great deep-value buy today for gold. The chart below shows extreme outlier down move for gold in August combined with the record speculative net short position.



A strange phenomenon recently for gold has been its high correlation with the Chinese yuan. It is almost as if the yuan is acting like it is pegged to gold which is absurd given how much China will need to devalue the yuan to save its banking system and its economy. So, it must be some other phenomenon, perhaps the same hedge fund algos that are record net short gold right now. Interestingly, in our global macro fund where we are short yuan, our long gold position has been acting like a hedge for our large yuan short position. The chart below shows that the correlation with yuan and gold is not stable over time. We expect the yuan to de-couple from gold very soon with gold going up and yuan going down.



The recent selloff in gold and silver has held back Crescat's performance in all Crescat's strategies in Q3 to date, but the quarter is not over yet, and there are some very encouraging signs for precious metals such are the CFTC and inflation data we presented above.



Net Returns through 6/30/2018

Crescat Strategy/Benchmark (Inception Date)	June 2018	Q2 2018	2018 YTD	Annualized Since Inception	Cumulative Since Inception
Global Macro Hedge Fund (1/2006)	**8.4%**	**10.2%**	**13.9%**	**11.7%**	**298.3%**
-Benchmark: HFRX Global Hedge Fund Index	-3.5%	0.2%	-0.9%	0.6%	8.3%
Long/Short Hedge Fund (5/2000)	**4.0%**	**3.7%**	**10.0%**	**6.9%**	**234.5%**
-Benchmark: HFRX Equity Hedge Index	-0.7%	-0.9%	0.2%	2.4%	54.6%
Large Cap SMA (1/1999)	**0.5%**	**2.0%**	**3.6%**	**10.6%**	**616.2%**
-Benchmark: S&P 500 Index	0.6%	3.4%	2.7%	6.2%	220.4%

Crescat Global Macro Fund Net Performance Estimates by Theme YTD through June 2018 (Basis Points)	
Asian Contagion	245
Aussie Debt Crisis	32
Canadian Housing Bubble	91
China Credit Bust	139
European Disunion	190
Genomic Revolution	57
Global Fiat Currency Debasement	-104
Maturing Expansion	-147
New Oil and Gas Resources	-115
Opportunistic	202
Peak Deflation	-44
Security and Defense	208
Yuan Devaluation	639
Discontinued Themes	-5
Total (Net Estimate)	**1388**

Sincerely,

Kevin C. Smith, CFA
Chief Investment Officer

Tavi Costa
Global Macro Analyst

For more Information please contact Derek Chow at dchow@crescat.net or (303) 350-4287 revision following each monthly reconciliation and annual audit. Current performance may be lower or higher than the performance data presented. Crescat is not required by law to follow any standard methodology when calculating and representing performance data. The performance of Crescat funds may not be directly comparable to the performance of other private or registered funds. Investors may obtain the most current performance data and private offering memorandum for a Crescat fund by contacting Linda Smith at (303) 271-9997 or by sending a request via email to lsmith@crescat.net. See the private offering memorandum for each Crescat fund for complete information and risk factors.