Arrow Capital Management Inc.

Experience. Active Management.

ARROW GLOBAL GROWTH FUND

Q4 2018

The Arrow Global Growth Fund (F Class) returned 4.70% for the quarter and 3.53% for the year. This compares favourably versus all asset classes from bonds to equities and cash. Please see the summary of the various asset classes and markets below:

	Q1	Q2	Q3	Q4	2018Y
Equities					
MSCI World Index	-1.30%	1.70%	5.00%	-13.40%	-8.70%
S&P 500	-0.80%	3.40%	7.70%	-13.50%	-4.40%
S&P TSX 60	-4.50%	6.80%	-0.60%	-10.10%	-8.90%
Nikkei 225	-5.00%	4.20%	8.90%	-16.80%	-10.30%
STOXX Euro	-3.80%	2.90%	0.40%	-11.50%	-12.00%
ASX	-3.90%	8.50%	1.50%	-8.20%	-2.80%
Emerging Markets	1.40%	-8.00%	-1.10%	-7.50%	-14.60%
Fixed Income					
US 10 YR	-1.90%	-0.08%	-0.73%	3.76%	0.97%
German 10 YR	-0.13%	1.23%	-1.17%	2.02%	2.69%
BAML Hyield	-0.92%	1.02%	2.02%	-4.67%	-2.26%
FTSE CAD Universe Bond	0.10%	0.51%	-0.96%	1.76%	1.41%
Commodities					
Gold	1.70%	-5.50%	-4.90%	7.70%	-1.60%
WTI Oil	7.70%	14.20%	10.50%	-37.50%	-20.90%
Copper	-7.40%	-1.30%	-5.60%	-4.70%	-17.70%
Ags (DBA)	0.30%	-4.10%	-6.20%	0.20%	-9.70%
Currencies					
USD/CAD	2.49%	1.93%	-1.71%	5.65%	8.48%
AUD/USD	-1.68%	-3.56%	-2.44%	-2.42%	-9.73%
USD/JPY	-5.56%	4.07%	2.65%	-3.53%	-2.66%
EUR/USD	2.46%	-5.01%	-0.68%	-1.18%	-4.48%

Source: Bloomberg

The quarter was highlighted by a steep fall in equity markets and a corresponding rise in bond prices – a complete reversal of Q3. We noted our position in our last letter was decidedly bearish on stocks and bullish bonds – this was proven to be the correct strategy and completely the opposite of consensus – particularly bonds.

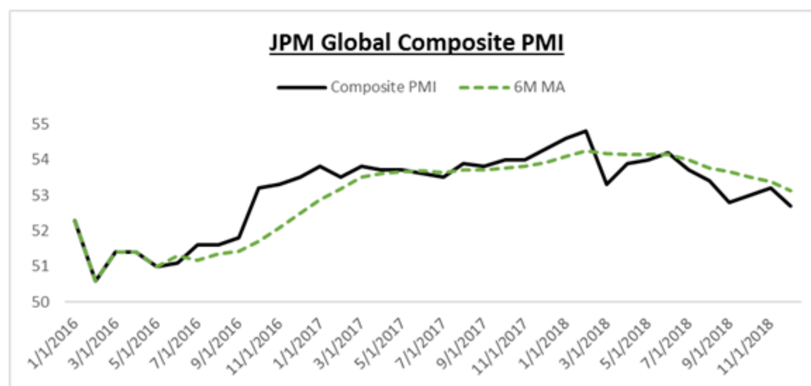
Our positioning was not a matter of being contrarian or market timers but rather a function of our process. We identified that given the pending falls in both headline CPI (inflation) and real GDP growth (driver of corporate profits), trouble was not far off for equities. This was especially true given the previous 9 quarters of rising real GDP growth and the build up of the “buy the dip” mentality – this proved hard to “break” – but when it did the drawdown was swift and furious. While we are happy to have profited, we are focused on what comes next – as always. In the short run, we expect volatility to remain high and a continued defensive positioning (although not as outright bearish equities) is the best strategy.

Given the fall in equities and rates, many investors will be tempted to buy stocks now that they are truly “on sale”. Of course everything in investing is a matter of time frame but if you are thinking out less than one year, we would caution you. Yes P/E multiples have fallen but we would caution that they are likely to go lower. Why? We continue to expect wage inflation to rise (albeit more slowly) but also expect headline CPI and real GDP growth to fall in Q4 and Q1 2019 – this is a double whammy especially for leveraged companies with cyclical type revenues.

Source: Bloomberg, Bear Traps Report

We believe high yield (aka "junk") bonds and "zombie" small cap companies in Canada and the US to experience a second leg lower as profit margins are squeezed. This comes at a time when the level of corporate debt outstanding is high as a percentage of GDP. Consensus earnings estimate are also way too high as we are just in the beginning stages of a profit growth deceleration so be wary of anyone who tells you the P/E is historically low so buy "cheap" stocks. They will likely get cheaper in the next 6 months. Of course it is likely that the FED's rate hike and the continuation of Quantitative Tightening (i.e. FED balance sheet reduction) in December will need to "modified" to an easier/dovish position. We expect this to occur officially at the next FED meeting on January 30th. The FED made a big mistake with this last hike into a GDP slowdown – it will not be felt for at least 12 months in the real economy so the pivot dovish will likely be swift given our view that the first estimates of Q4 GDP will likely disappoint. This may create a short term bounce in equities but the cycle will not change in the next 3 to 6 months. We will try to trade this bounce to protect our capital and set up for the next phase.

A quick comment or two on the rest of the world. In a word, it continues to worsen in the developed world as seen by the JPM Global PMI Index - an excellent leading indicator of economic activity.



Source: Bloomberg Data

As you know, we divide our Fund into two parts: a global macro portion (trading FX, commodities, equity indices and fixed income) and a global long/short equity sector portion. The amount of capital allocated to each "bucket" is a function of market volatility and correlations. Our aggregate position was 183% (including FX) at year end.

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Global Macro Portfolio (135%)

	Gross	Net
Equity Indices	18.03%	-8.52%
Bonds	84.82%	78.32%
Commodities	3.61%	3.61%
Net	106.45%	73.40%
FX Pairs	28.84%	
TOTAL MACRO	**135.29%**	

Equity Indices/Futures

Our equity exposures in the 4th quarter were decidedly net short with our emphasis on U.S. small cap stocks, Canadian, European and EM equities. We expressed some of these positions with put options and so captured some of the volatility expansion as well.

On the long side, we have owned select country ETF's like Brazil. Our economic data is showing "less bad" for many EM countries so we expect to be buyers in 2019 - the first time in years!

Fixed Income

Our fixed income exposures rose to their highest levels ever (90% gross exposure at one point). We bought all along the US Treasury curve but with an emphasis on the 2yr UST. At one point in late December the 2 yr traded inside the Fed Funds rate band! It looks like the market is telling the FED that short rates need to fall or face an inverted yield curve. On the short side we have added puts on high yield bonds and have also started scaling into leveraged loan puts. As we noted earlier, corporate spreads – especially junk – are a non trivial risk at this point in the cycle.

Commodities

The big change from Q3 has been the addition of gold futures to the Fund. We are positive on gold as a currency that will trade higher on falling real yields in the US. We are using options on futures around the January FED meeting expecting a dovish FED pivot after the rate hike in December. Gold is also heavily shorted according to COT data - another positive if our call is correct.

Foreign Exchange

A contributor to performance in Q4 was our short on the Canadian dollar which fell 5.65% versus the USD. We have reduced our exposure here in early January to roughly 12% of the portfolio. The other key pair was our short on EUR/JPY – we have discussed this trade before as a great portfolio hedge. This performed very well generating a 5% return. We have since closed out this position but will look to reload at higher levels.

Global Sector Portfolio (48%)

At the end of the year, our global sector long/short exposures were as follows:

SECTOR EXPOSURE	NET	GROSS	LONG	SHORT
Communication Services	0.7%	0.7%	0.7%	0.0%
Consumer Discretionary	1.2%	11.0%	6.1%	-4.9%
Consumer Staples	2.4%	3.2%	2.8%	-0.4%
Energy	2.0%	3.4%	2.7%	-0.7%
Financials	-0.7%	6.2%	2.8%	-3.5%
Health Care	2.2%	2.8%	2.5%	-0.3%
Industrials	0.2%	5.3%	2.8%	-2.6%
Information Technology	-0.7%	5.5%	2.4%	-3.1%
Materials	5.5%	5.6%	5.6%	-0.1%
Real Estate	4.1%	4.1%	4.1%	0.0%
Utilities	0.3%	0.3%	0.3%	0.0%
EQUITIES SUB TOTAL	**17.1%**	**48.1%**	**32.6%**	**-15.5%**

Source: Bloomberg

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Our sector exposures remained defensive in Q4. In terms of sectors of note, we have been net long utilities, REITs, and consumer staples and net short industrials, technology, consumer discretionary. In each case, we have had both longs and shorts in all sectors with no sector greater than 5% net either long or short i.e. we have tried to focus on generating alpha in this portfolio by security selection and net sector tilts.

One area that we are watching carefully is energy. Clearly there are a number of moving parts from pipeline to geopolitical issues. Valuations appear to be very attractive but we need some further clearing of global inventories before we get more bullish. By our work, this looks to be sometime later in Q2 2019.

Some Final Thoughts (a small rant)

We closely follow the hedge fund manager community and only a handful posted positive returns on the year – in fact many fell in line with the market. To say these managers do a disservice to our business is an understatement – unfortunately many managers simply do not hedge and would prefer to gamble with your savings. Advisors need to do more due diligence than chasing a "hot" number or taking a manager at face value. That being said, I am also disappointed in some advisors for redeeming from our Fund at year-end. Why? They felt that because we "saved" capital, it is now time to abandon "hedging". In my humble opinion, nothing could be further from the truth. We are in for a difficult period here – for any manager to deliver decent results you will need to be able to trade/invest in FX, all forms of fixed income, equities long and short and commodities as well. And, you will need a real process to exploit the coming turbulence across markets and asset classes. We can help.

We are changing the name of Fund to Arrow Global Advantage Fund (and lowering fees!)

A good number of advisors have confused our Fund with a traditional growth equity fund so we have decided to change the name to the Arrow Global Advantage Fund. We will not use the term "hedge" as the media and others have a pejorative view of the term largely based on the failure of many "hedge" funds to actually hedge. But at least nobody will confuse the Fund any longer with a growth equity fund. We are also lowering our management fee to 95 bps from 1% effective January 1, 2019.

Thank you for your continued interest in the Fund. For further information, please contact your regional Arrow Capital Management representative.

Yours sincerely,

Jim McGovern
Managing Director & CEO

Ted Whitehead
Senior Portfolio Manager

Ahson Mirza
Portfolio Manager

Effective January 1, 2019, the fund was renamed Arrow Global Advantage Fund.
Effective January 1, 2015, this fund was renamed Arrow Global Growth Fund and James McGovern was appointed as the sole portfolio manager. Prior to January 1, 2015, the fund was managed by different teams with substantially different investment parameters. For a complete history of this fund, including returns, please contact Arrow Capital Management Inc. Unless otherwise stipulated returns are net of all fees, in Canadian dollars, reflect class "F" units and assume reinvestment of all distributions.

This document is not to be construed as a public offering of securities in any jurisdiction in Canada. The offering of units of the Fund is made pursuant to the Offering Memorandum only to those investors in all jurisdictions of Canada who meet certain eligibility of minimum purchase requirements. Important information about Arrow Funds, including statement of each fund's fundamental investment objective, is contained in their respective offering memorandum, a copy of which may be obtained from Arrow Capital Management Inc. Please read the applicable offering memorandum carefully before investing.
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