CRESCAT CAPITAL
VALUE-DRIVEN PERFORMANCE

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March 16, 2016

Crescat Capital Quarterly Investor Letter, Q1 2016

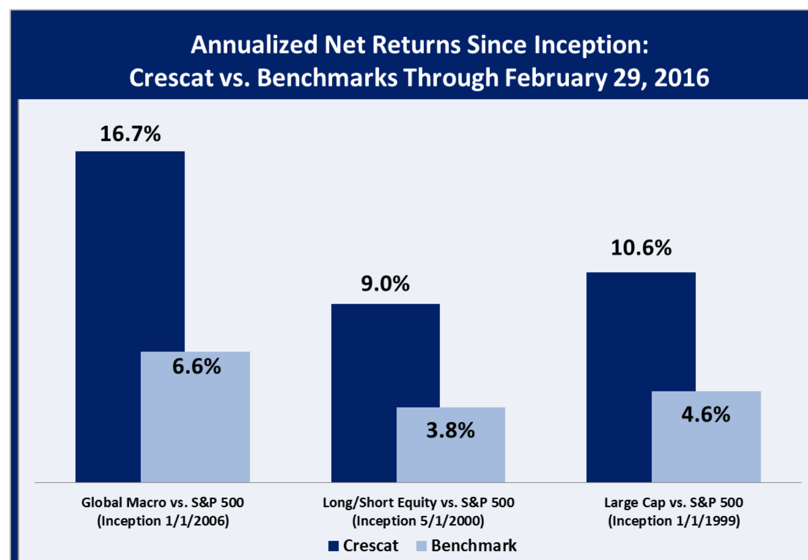
Dear Investors:

We are pleased to announce that Crescat Global Macro Fund was recently named 2015 Global Macro Fund of the Year in the HedgeFund Intelligence Absolute Return Awards for its absolute and risk-adjusted performance among hedge funds less than $500 million.

All three Crescat strategies posted gains through the first two months of 2016 while the S&P 500 index declined 5.1%. Crescat Global Macro Fund returned 7.2% net through February and Crescat Long/Short Fund was up 6.3% net. Crescat Large Cap Composite gained 1.7% net, significant for a long-only strategy in a down market. Performance across all three strategies was driven by a range of our global macroeconomic themes. Crescat's best performing theme year to date has been Global Fiat Currency Debasement, as our long precious metals positions have been bid up amidst rising global credit risks and ongoing expansionary monetary policies. Our Biotech Bubble theme was a strong performer in both hedge funds as overvalued biotech companies continued to sell off benefitting our short positions as the SPDR S&P Biotech ETF (XBI) had its worst month ever in January. Another big gainer in both hedge funds was our China Currency & Credit Bubble theme, which is the focus of the majority of our outlook in this letter.

Net Returns through 2/29/2016

Crescat Strategy	Last Month	Year to Date	Annualized			Cumulative Since Inception
			1 Year	3 year	Since Inception	
Global Macro Hedge Fund	2.7%	7.2%	16.3%	16.2%	16.7%	379.7%
Long/Short Hedge Fund	2.8%	6.3%	11.9%	13.6%	9.0%	289.9%
Large Cap SMA	4.1%	1.7%	-1.3%	10.7%	10.6%	466.7%

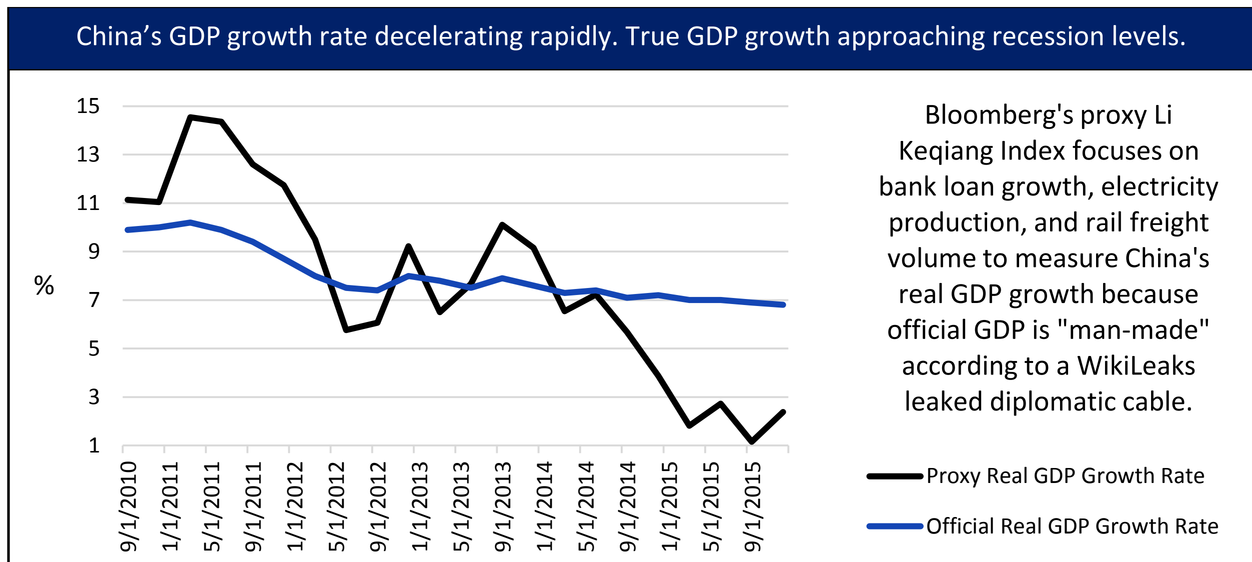


A Twin Crisis Brewing in China

Many believe that if China were to devalue its currency, it would be in an effort to wage a currency war, or a competitive devaluation to boost exports. The idea of a mere currency war represents a misunderstanding of China's economic imbalances. In our opinion, China is not on the verge of a currency war; it's on the verge of a currency crisis. And it is not just facing a currency crisis, but rather a twin crisis: a combined currency and credit crisis.

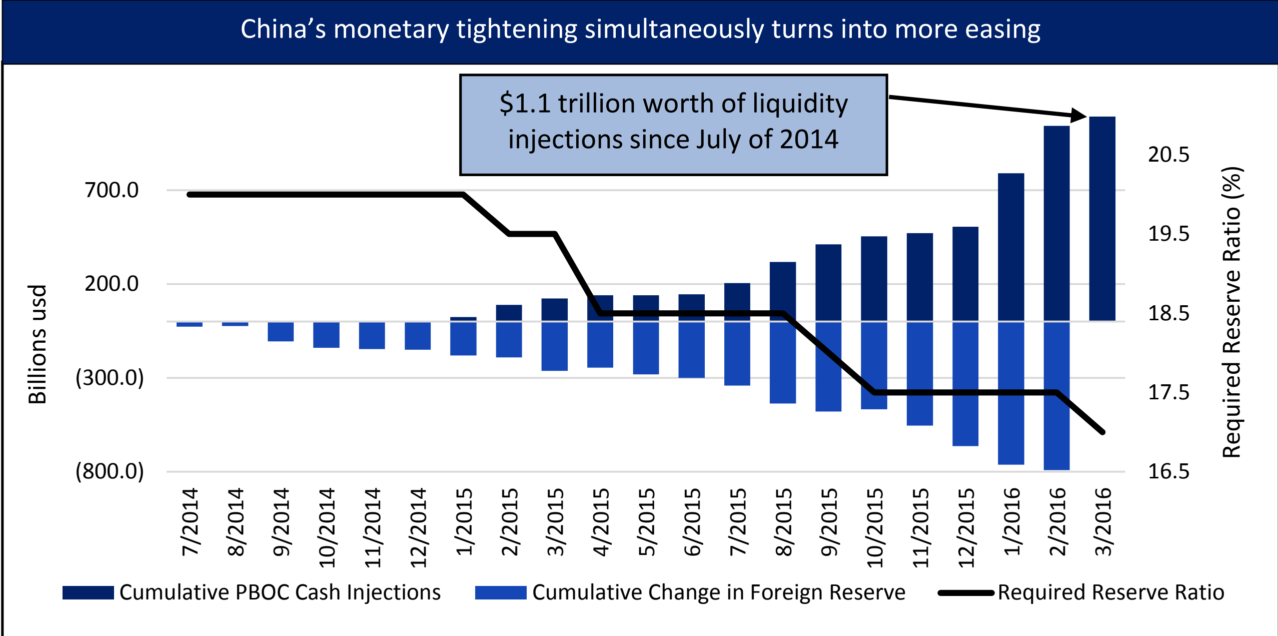
For the past two years, we have been writing about the growing credit problems in China, its illicit capital outflows, and the extreme overvaluation of the yuan. Through a combination of money printing and new debt, the People's Bank of China (PBOC) has created the largest money supply and total banking system assets of any country in the world. Over the last fifteen years, China's M2 money supply has grown at a 17% compounded annual rate to $21.7 trillion. To put the absurdity of the yuan overvaluation into perspective, China's M2 is now valued 75% greater than the entire US M2 at the current USDCNY exchange rate. But China's GDP is 57% smaller than the US.

According to prominent banking analyst Charlene Chu of Autonomous Research, China's total banking system assets have grown by $21 trillion over the last seven years and now stand at $31 trillion. The rampant money and credit creation have been responsible for excessive domestic capital investment with diminishing returns. As a result, China's GDP growth has been lagging its debt growth, and in fact has been decelerating rapidly. Moreover, China has a non-performing loan problem that threatens the largest banking system collapse in history. Chu estimates that based on return on assets, China's non-performing loan ratio stands at 22%, while Chinese official estimates report that ratio to be just 1.6%!



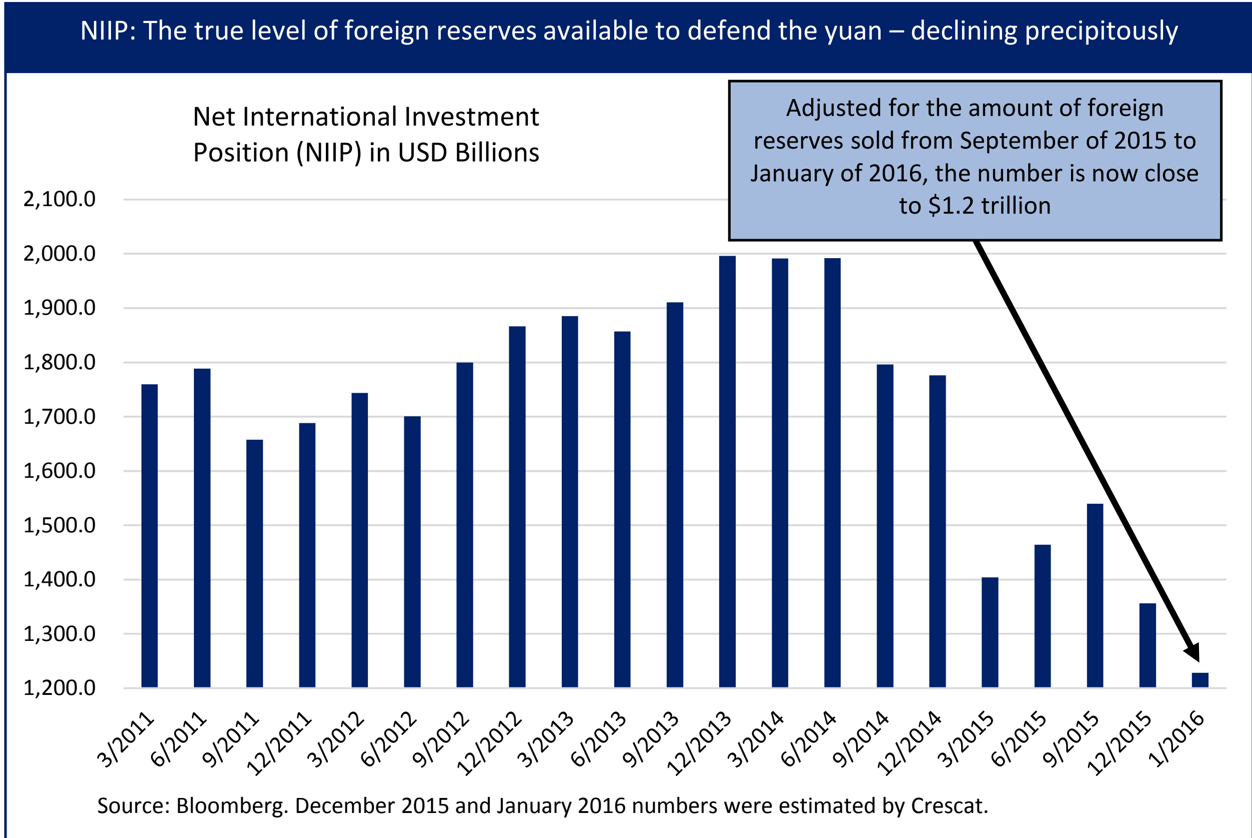
China's current monetary policy has inherent conflicts in its attempts to fend off the twin crisis. In order to defend its currency peg while preventing a banking system collapse, China's tightening decisions have been simultaneously turning into more quantitative easing. As the PBOC has been supporting the yuan by selling foreign reserves, it has also been sterilizing this deflationary force by injecting even more stimulus into its domestic banking system. For instance, since June of 2014, the Chinese central bank sold over $791 billion of foreign

reserves. Defending the currency in this way is a monetary tightening policy, but it would have triggered debt defaults given China's non-performing loan problem. So, to prevent such defaults, the PBOC injected $1.1 trillion into the banks through the repo market over the same time, more than reversing the tightening effect.



This new liquidity, accompanied by several required reserve ratio reductions, continued to promote unhealthy credit expansion. For example, in 2015, China's M2 money supply grew by $1.7 trillion. Over the same time, Total Social Finance (the Chinese version of M3 money supply) also known as TSF increased by $2.9 trillion. TSF increased by another half-trillion dollars in January of this year alone, revealing recent accelerating debt growth through China's shadow banking channels. Consequently, rather than fixing China's bad debt problem to support the yuan, the current policy of printing money and extending more credit will ultimately exert even more downward pressure on the currency by creating the incentive for greater net capital outflows. China is in the midst of a self-defeating policy spiral that only makes a twin currency and credit crisis more inevitable.

The PBOC has pegged the yuan exchange rate to the dollar rather than allowing it to depreciate meaningfully in the face of China's economic imbalances, and has been drawing down foreign reserves at a rapid pace. China's currency bulls remain focused on the still significant size of foreign reserves, $3.2 trillion. But one must also consider that China has a significant amount of foreign debt. Therefore, we believe that Net International Investment Position (NIIP) is a better measure of the true level of reserves available to defend a currency from the pressure of capital outflows. This figure, last reported in September of 2015, is close to $1.5 trillion. If you adjust for the amount of foreign reserves sold from September of 2015 to January of 2016, the number is now close to $1.2 trillion.



In 2011, Glick and Hutchison[1] studied the macro-empirical regularities that precede currency crises. They featured a number of important crisis precursors that include increasing M2 to foreign reserve levels, drawdowns in foreign reserve levels, increasing real exchange rates, high and increasing levels of domestic credit to GDP, and a slowdown in output growth. We highlight every one of these factors in this paper with respect to China today.

NIIP, which we believe to be a more precise measure of foreign reserves, relative to M2 has fallen from over 15% to just 6% of China's M2 over the last five years. China policy makers are reaching the end of their runway. As the PBOC strives to maintain the currency peg by depleting foreign reserves, while earning negligible GDP growth from its ongoing credit expansion, the country has little ammunition left to keep its twin currency and credit bubbles aloft.

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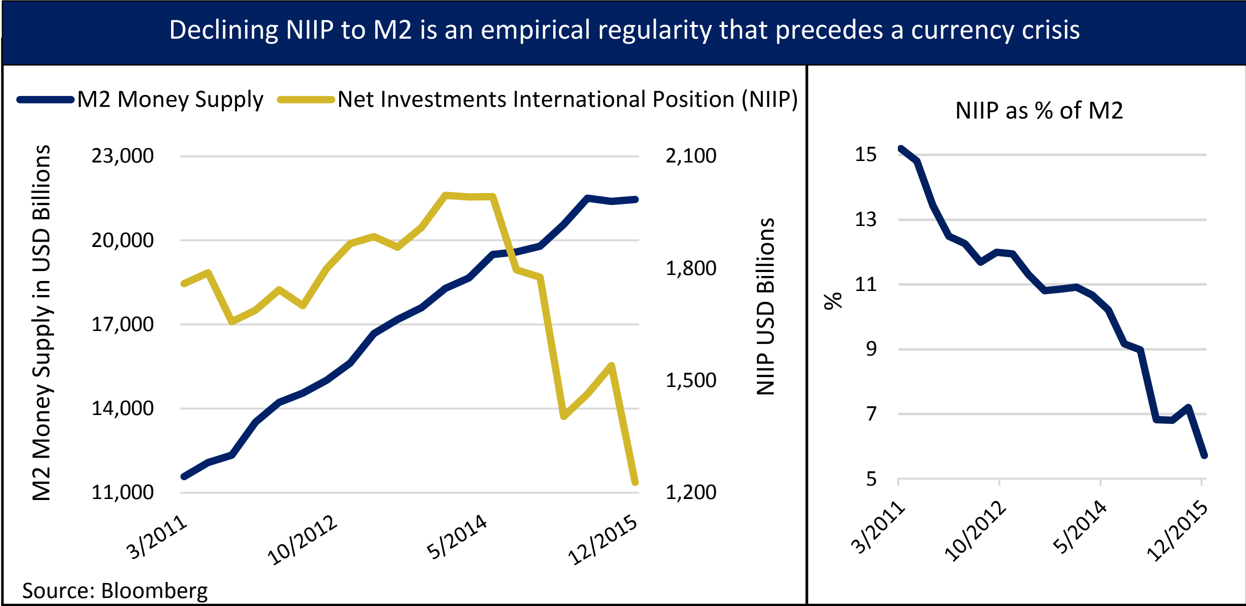
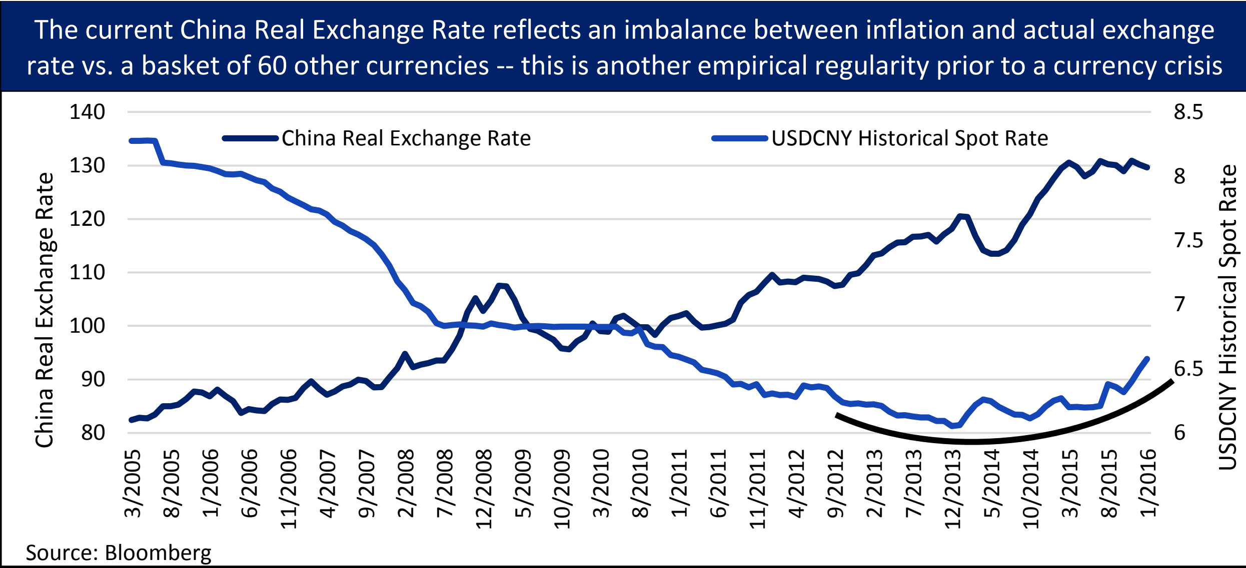




A yuan crisis could certainly act as a contagion and trigger a domino effect with other Asian-Pacific currencies. In our opinion, New Zealand and Australian currencies are the most exposed candidates to a Chinese contagion. The circumstances in Australia and New Zealand are eerily similar to the 1997 Asian Financial Crisis (The Asian Contagion), in which Thailand, Indonesia, and South Korea amassed high levels of external and household debt, and extremely low foreign reserve to GDP ratios.

Australia has also been a beneficiary of China's massive capital outflows. A large portion of this money has been flying into the Australian real estate market and Australia is in the midst of one of the world's most aged and excessive housing bubbles. The household debt-to-income ratio has spiked to a record 155% recently in Australia.

According to a research piece from Variant Perception, in Sydney and Melbourne, median home prices have skyrocketed and are now over 10x gross household income. In Ireland, at the peak of its housing bubble, the ratio was 8x. For the rest of the Australian cities, price to gross household income is 6x. By comparison, the United States reached 5x at the peak of the US housing bubble.

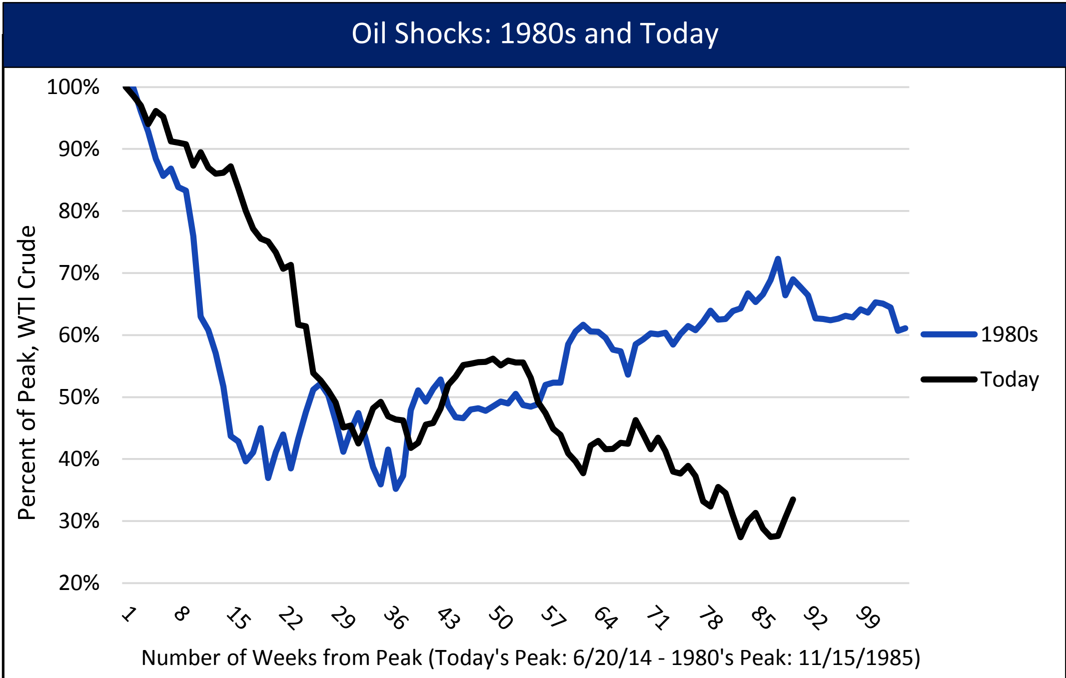
Among the four largest Australian banks, the median price to book is close to 1.52 – which compares to 1.30 from the top five US banks in 2007. We strongly believe these Australian banks and their valuations are at risk of a meltdown. The excessive lending has stretched the money multiplier to near 18 times; therefore, stressing the imbalance between the monetary base and the M2 money supply.

Australia is a $1.3 trillion economy, and holds about $1.4 trillion of external debt. After netting its external financial assets, it holds approximately 64% net of the country's GDP in foreign debt. The Reserve Bank of Australia only owns $65 billion of foreign reserves, which is about 5% of its GDP, leaving its currency vulnerable to a speculative attack.

New Zealand is faced with a similar debacle. Known as the world's largest dairy exporter, it has accumulated over $91 billion in net external debt -- this figure accounts for about 51% of its nominal GDP. Furthermore, its largest net importer is Australia, followed closely by China. With a 1.28 M2 money supply to GDP ratio, the Reserve Bank of New Zealand has approximately 8% of foreign reserves to GDP to shelter its currency.

We expect both the Australian and New Zealand dollar to devalue substantially, followed by a downgrade in sovereign credit rating – both are currently rated triple A by Moody's. South Korea could also suffer from a devaluation of the yuan, as it is the largest net exporter to China, with approximately $100 billion worth of exports annually.

New Oil and Gas Resources



New Oil and Gas Resources is a long-running theme at Crescat which has been highly successful over the past two years. We first began shorting upstream Master Limited Partnerships (MLPs) and normally structured exploration and production companies in mid-2014, then moved to midstream MLPs in mid-2015. We may have seen the lows of the cycle and are in the process of forming a bottom in crude oil prices. As seen in the graph above, the current price decline is proving to be worse than the mid-80s cycle.

Many E&P companies have seen their share price drop precipitously since the middle of 2014. Bankruptcies will continue, but there are few short opportunities left among the most indebted operators with weak asset bases. In our view, E&P short opportunities remain not in the worst operators that are already bankrupt or near bankrupt, but in the most overvalued names. Numerous favorites among sell-side analysts are tremendously overvalued and score poorly in Crescat's model. These names include Pioneer Natural Resources (PXD), Concho Resources (CXO), and Diamondback Energy (FANG). The valuations on these and many other sell side analyst favorites do not reflect the bearish fundamentals and slow recovery prospects for crude oil.

After having long positions in refining stocks for much of 2015, we now see short opportunities in that space. The Brent-WTI spread is not likely to be larger than +/- several dollars now that the US can export crude oil. Even though gasoline demand is likely to be solid due to low oil prices, efficiency improvements will continue to temper US gasoline consumption in the longer term. Large refined product inventories will also weigh on refiners, and in the end, these are cyclical stocks experiencing peak margins. As oil prices stop their decline and slowly recover, we are likely to see investors shift from refiners into E&Ps, further hurting share prices.

Upstream capex cuts will soon contribute to declines in production not only for US shale, but also for most other producers in the world. Once the current crude storage glut begins to moderate, these production cuts should have a more positive impact on the crude market. In our view these bullish forces will be balanced by underwhelming demand statistics in the US and especially in China and emerging markets, and crude price recovery will be a long and volatile process.

In our Global Macro fund, we have recently re-entered long positions in natural gas futures. This trade acts as a hedge against our oil and gas related equity shorts, but has many positive fundamental drivers of its own. The "BTU Spread", or energy equivalent difference between crude oil and natural gas, remains well above its long term average, suggesting that oil needs to come down or natural gas needs to come up. Given the recent drop in oil prices, there is a better likelihood that natural gas will be the next to move. We believe US natural gas production is visibly rolling over, power plant demand will continue to increase as coal plants are retired, and US exports will eventually put upward pressure on Henry Hub prices.

At Crescat, our investment strategies are designed to excel in a variety of market environments based on a time-tested investment process. We develop and maintain a diverse set of top-down global macroeconomic themes, follow signals from our carefully refined fundamental equity model, and adhere to strict risk management criteria. We employ a diversified and hedged approach. We budget risk by theme using Conditional Value at Risk (CVaR) to ensure that no one theme or position becomes too concentrated. The results of this can be seen in our strong risk-adjusted performance since inception across all three Crescat strategies.

We truly appreciate your investment.

Sincerely,

Kevin C. Smith, CFA
Chief Investment Officer

Tavi Costa
Emerging Markets Analyst

Nils Jenson
Energy and Materials Analyst

References

[1]Glick R., and Hutchison, M. (2011). "Currency Crises" *Encyclopedia of Financial Globalization: Evidence on Financial Globalization and Crises*, edited by Gerald Caprio et al.

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