Quarterly Report

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SECOND QUARTER
2018

FRIEDBERG MERCANTILE GROUP LTD.

Contents

Second Quarter Report 2018

FRIEDBERG MERCANTILE GROUP LTD.

MESSAGE TO OUR INVESTORS

Please note that I wrote this letter on June 24th and emailed it on June 26th to clients who receive their quarterly report by email. I am appending some fresh remarks at the end of this letter.

These lines are being written on Sunday, June 24, just a few days before the quarter end, in an attempt to convey to you in as timely a manner as possible what has transpired in recent weeks. To be very brief, we reached the end of our patience with the bets on homebuilders and Brazil and decided to exit these trades. These two positions accounted for 85% of our losses this quarter and 114% of losses for the year to date.

Let me explain our thinking on homebuilders first. We began with the assumption that the deep recession of 2007 to 2009 brought about a severe shortfall of housing, both multifamily and single-family dwellings, but particularly the latter. The facts are indisputable: the shortfall, given present demographics, is in the order of 1.5 million units; inventory of units for sale stands at four months of sales, possibly the lowest in history. At the present rate of construction, the shortfall will continue to widen. Weak demand ex ante, a clear result of little to buy, still exceeds supply. As a result, prices continue to rise, at a rate of just under half a per cent/month. This is simple economics. Higher mortgage costs, a widely suggested reason for stagnating sales, have little to do with the modest pace of sales (though, admittedly, some impact has been noticed in the past two months at the lowest price range serviced by the Federal Housing Administration). A recent Harvard study found that debt service is cheaper today than it was in the late 1980s (!) even though home prices have more than doubled (or tripled, depending on location). The reason is that interest rates are much lower today than they were then.

Despite the fact that housing starts have managed to climb steadily over the past seven years, although admittedly at a modest pace, naysayers have thrown at the bull case all kinds of negative arguments. Among them, that dwelling prices relative to income have risen too much (though they remain below the levels reached in 2006-7), that margins will have to be shaved to move homes at these higher prices, and that the shortage of labour and land will continue to put a crimp on production. As an example, homebuilders have recently complained that rising lumber prices have added as much as $9,000 to the cost of a home. Admittedly, production constraints, especially labour shortages, will slow gains in new construction, though that is a far cry from saying that home-building activity will turn lower. Even at this time, and despite the obvious negatives, housing starts have managed to climb to seven-year highs, and there are few if any signs that profit margins have been sacrificed. Since the shortfall of supply continues to grow, long-term prospects remain excellent. Still, the bears have gained the upper hand, and homebuilders' stocks have continued to weaken relative to the S&P 500, having now returned to their September 2017 levels. Weak relative action in what may turn out to be a period of weak stock prices in general (see below) has persuaded me to give up this position for now. I intend to return to the homebuilders in the not-too-distant future, depending on market conditions. I have liquidated the entire outright position and now hold only the long option position, which represents an exposure equal to 56% of NAV (though a very reduced risk as we stand to lose only the option premium).

The Brazilian story, too, has been a major disappointment. While I believe that the market is misreading the situation, there is a practical limit to the amount of punishment we are willing to endure given our highly concentrated position. It began in early 2016, with purchases of local-currency bonds yielding close to 12%. Since we had projected inflation to fall below 3% per annum, we thought these bonds represented great value.

The initial position was well rewarded. Bonds rose and yields fell to about 9.5%. At that point, I made a fateful decision and decided to liquidate the bonds, where we saw further but limited progress, and shift the Brazilian exposure to equities. Lower inflation, lower interest rates, relatively modest valuations (especially the banks) and prospects of a strong cyclical upswing in earnings as we came off a severe three-year depression made for an excellent case. In addition, the Temer government —unpopular but politically savvy and deeply committed to reform — managed to pass a number of significant economic initiatives, the most important of those being the adoption of a long-term cap on expenditures and a resumption of large privatizations. Finally, the Car Wash investigations led to a large number of high-profile indictments and convictions, marking an important milestone in the fight against endemic political corruption.

The stage was set for a long-running bull market. Unfortunately, the all-important reform that attempted to rein in the explosion in government pension expenditures failed to pass for lack of sufficient votes, even as Temer, in a desperate gambit to pass it, watered down its main provisions. Pension reform has always been an unpopular subject matter, all the more so in front of the upcoming October election, and this caused legislators to back away from supporting such measures. As a result, equity and currency markets in Brazil began to weaken in earnest in early May. To make matters worse, a strong and renascent US dollar put pressure on a number of emerging markets at the same time. Wide cracks appeared in Argentina, South Africa, Turkey, and even China. The extreme interconnectedness of these markets — a factor to which I gave insufficient attention — led to selling that affected other members of the "emerging market group," including, of course, Brazil.

A calamitous 10-day truckers' strike, which saw 1 million truckers place a choke on the Brazilian economy, put the kibosh on markets. Central bank intervention to maintain stability in the real was of little avail, and the currency fell to early 2016 levels. Stocks and bonds followed through on the downside.

The extreme oversold condition stayed my hand from liquidating the position at an earlier moment, but concerted selling, via EM funds, left me with little choice. We have taken measures to reduce our exposure to a more manageable size,

“WITH DISAPPOINTMENTS IN HOMEBUILDERS AND BRAZIL NOW BEHIND US, LET’S LOOK AHEAD. IN OUR LAST LETTER, WE NOTED THE VULNERABILITIES OF THE GLOBAL ECONOMY, IN PARTICULAR THE HUGE BUILD-UP OF CORPORATE AND GOVERNMENT DEBT. WE ARGUED THAT THESE VULNERABILITIES WERE DANGEROUS IN POTENTIA BUT NEEDED A CATALYST TO TRIGGER THEM BEFORE WE COULD FORESEE A BEAR MARKET. WE ADDED THAT WE DID NOT SEE A SUSTAINED RISE IN INTEREST RATES, THE MOST OBVIOUS CATALYST, OWING TO WHAT WE THOUGHT WAS AN ABSENCE OF INFLATIONARY PRESSURES; WAGES WERE RISING, BUT TOO SLOWLY, AND COMMODITY PRICES HAD FAILED TO BREAK OUT ON THE UPSIDE. I SAW STOCK PRICES RISING MUCH FURTHER, ON THE BACK OF A TOO-WIDE EQUITY RISK PREMIUM. I STAND BY THESE COMMENTS, BUT A NEW AND DISTURBING FACTOR HAS NOW ENTERED THE PICTURE: A POTENTIAL TRADE WAR.”

which will afford us the ability to patiently await the expected recovery. October elections will bring in a new government; it is hoped and expected that, whatever its orientation, the new government will want to tackle effectively the much needed pension reform. This, and a resolution of whatever is troubling global markets today (more below), should allow us to reinstate this promising bet in the not-far-off future.

What remains of our positions (after liquidating US stock indices and calls at a profit and assuming a complete liquidation of homebuilders' calls and Brazilian equities) is a long position in Greek banks (equal to about 25% of NAV), a strong short position in Australian banks (equal to just over 60% of NAV), a short position via H shares in mainland China real estate developers and secondary banks (equal to about 20% of NAV), and a short position, via out-of-money puts, in the Chinese offshore renminbi (with a Delta-adjusted exposure equal to 44% of NAV).

With disappointments in homebuilders and Brazil now behind us, let's look ahead. In our last letter, we noted the vulnerabilities of the global economy, in particular the huge build-up of corporate and government debt. We argued that these vulnerabilities were dangerous in *potentia* but needed a catalyst to trigger them before we could foresee a bear market. We added that we did not see a sustained rise in interest rates, the most obvious catalyst, owing to what we thought was an absence of inflationary pressures; wages were rising, but too slowly, and commodity prices had failed to break out on the upside. I saw stock prices rising much further, on the back of a too-wide equity risk premium.

I stand by these comments, but a new and disturbing factor has now entered the picture: a potential trade war. What started out as a negotiating move is now shaping up as a bare-knuckles fight and a lose-lose war. I will let Nancy Lazar, a well-respected Wall Street economist from Cornerstone Macro, tell it in her words in her most recent dispatch under the title "Will Trade Wars Wreck our American Rejuvenation Theme?" She says: "Last Sunday, our narrative focused on keeping the tariffs on $50 billion in perspective, i.e., they are small. And there were signs China was offering an olive branch, slightly easing their import restrictions. Well, what a difference a day makes. On Monday, President Trump suggested tariffs could be imposed on an additional $200 billion…the rest is history. The market obviously reacted very badly to ramping up the Trade War. …the intensification of the Trade War is obviously a significant risk to our overall thesis [American Rejuvenation based on rising capex, improving productivity].

"In today's narrative, we outline the signs that the small tariffs already in place are incrementally weakening growth … one significant trade war consequence would be a continued rally in the dollar, potentially destabilizing markets/economies … last week's sharp decline in Markit's manufacturing orders component … may have been an important turning-point report. In addition, Fed Chairman Powell said he's already hearing from businesses that the Trade War is hurting activity …."

Andy Laperriere, of the same organization, has warned that the fight is for real and that the market may not be appreciating it yet. "Trump and his advisers believe China has hollowed out the manufacturing base and want to fix it. Importantly, secondary impacts, such as hits to business confidence, capex, headwinds from a strong dollar, loss of competitiveness, and supply chain disruptions suggest more extensive danger than is generally thought."

We should also note that, aside from a tit for tat in tariffs, the Chinese can impose very painful restrictions on US companies operating in the mainland, with obvious consequences for S&P 500 earnings. We also observe that the pain is starting to spread to Taiwan, South Korea, and other Southeast Asian countries, while Singapore banks, normally excellent indicators of global economic health and until very recently on track to multi-year highs, have begun to weaken significantly.

Here, then, is a serious catalyst. What started out as an apparent negotiating manoeuvre to obtain some trade benefits may end up resulting in a very damaging, no-quarters-granted fight. If there is no let-up, confidence will erode very rapidly. And, given the vulnerabilities discussed, selling could snowball.

The investing climate has become a great deal more complicated than we projected just a few months ago. We are in the process of making changes to the portfolio that I believe will enable us to deal successfully with the uncertainties created by these most recent developments.

Thanking you for your trust,

ALBERT D. FRIEDBERG

APPENDED REMARKS

Positions continue to harden in the tariff war. China has retaliated and other countries promised to do so. In response, the US has threatened to double up on products covered by tariffs. Disconcertingly, the US has as yet to explain what it seeks. We do not know if it is negotiating leverage or instead seeking permanent protection for its industries. And yet, the market, in its collective and unfathomable wisdom, has decided to ignore for now the potential dangers, and has turned up to challenge the January highs. We are back to our original observation: the global economy has been greatly weakened by the explosion of credit and the consequential deterioration of corporate balance sheets; but there is no serious trigger in sight to detonate the bomb. If anything, easy money continues to drive money into equities.

Cautious optimism is warranted by way of maintaining long positions in our favourite ideas (though positions have been reduced); but we are starting to put greater emphasis on some particularly weak narratives around the globe – China banks and developers, and Australian banks.

Friedberg Asset Allocation Funds

Friedberg Asset Allocation Fund Ltd.
Friedberg Asset Allocation Fund

The Fund is a multi-strategy fund whose investment objective is to seek significant total investment returns, consisting of a combination of interest income, dividend income, currency gains and capital appreciation. Allocations are reviewed periodically.

MODEST RISK: Absolute return.

Performance[1] as of June 30, 2018

	NAV	Quarterly	One Year	Two Years	Three Years	Five Years
Friedberg Asset Allocation Fund Ltd.	1,551.46	-8.84%	-2.77%	-1.03%	3.50%	3.10%
Friedberg Asset Allocation Fund	16.60[2]	-8.74%	-2.06%	-0.09%	3.88%	3.38%
CSFB/Tremont Hedge Fund Index[3]		N.A.%	4.47%	5.36%	1.65%	3.30%

[1] Net of fees
[2] NAV adjusted to reflect distributions reinvested in the fund
[3] Compounded annual rate of return through May 2018

Friedberg Asset Allocation Funds

Capital allocation of the Friedberg Asset Allocation Fund Ltd. as of June 30, 2018 is as follows:

INVESTMENT		CURRENT ALLOCATION	TARGET
FIXED INCOME		14.84%	15.00%
U.S. Ten-Year Treasury Futures	*14.84%*		
EQUITIES		72.96%	75.00%
U.S. Homebuilders	*30.07%*		
U.S. and Australian Gold Miners	*16.43%*		
Brazilian Banks	*9.91%*		
Greek Banks	*8.57%*		
Cybersecurity ETF	*7.97%*		
FUTURES		11.56%	12.00%
Gold	5.82%		
Silver	5.74%		
CASH / MONEY MARKET		0.64%	0.00%
		100.00%	100.00%

Friedberg Asset Allocation Fund Ltd.

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Year
2018	3.62%	-6.33%	0.31%	-0.68	-6.06%	-2.29%							-11.25%
2017	6.57%	2.07%	-0.54%	-1.54%	-1.12%	3.55%	1.31%	1.99%	-0.39%	1.38%	2.60%	2.32%	19.48%
2016	-3.94%	5.15%	3.28%	8.82%	-4.95%	7.51%	4.24%	-3.87%	1.15%	-4.46%	-5.46%	0.90%	7.18%
2015	3.45%	0.31%	-1.31%	-0.74%	-1.03%	-1.67%	0.74%	-2.21%	-2.67%	3.79%	0.91%	-2.86%	-3.49%
2014	3.55%	3.30%	-1.58%	0.25%	0.32%	3.29%	-2.41%	2.93%	-5.79%	-1.39%	2.06%	0.78%	4.94%
2013	0.91%	-1.21%	0.89%	1.47%	-5.07%	-7.09%	1.98%	-0.95%	1.22%	1.99%	-0.80%	-2.20%	-8.94%
2012	5.10%	-0.08%	-2.83%	-0.77%	-3.22%	1.21%	0.40%	0.72%	1.43%	1.24%	2.83%	-1.16%	4.70%
2011	-4.11%	4.18%	1.11%	5.56%	-1.67%	-1.98%	4.65%	5.15%	-2.86%	3.31%	-1.05%	-1.58%	10.52%
2010	-0.27%	0.99%	0.56%	3.47%	1.10%	0.99%	-2.23%	3.36%	3.91%	2.57%	-0.06%	0.83%	16.14%
2009						0.38%	2.62%	0.09%	2.91%	0.53%	7.15%	-3.63%	10.13%

*** PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS ***

Friedberg Global-Macro Hedge Funds

Friedberg Global-Macro Hedge Fund Ltd.
Friedberg Global-Macro Hedge Fund

A multi-strategy fund. Allocations are reviewed periodically.

Performance[1] as of June 30, 2018

	NAV	Quarterly	One Year	Three Years	Five Years	Ten Years
Friedberg Global-Macro Hedge Fund Ltd.	2,828.29	-21.59%	-8.09%	-0.88%	-9.53%	-0.43%
Friedberg Global-Macro Hedge Fund	61.74[2]	-21.89%	-6.43%	-0.22%	-9.64%	0.88%
CSFB/Tremont Hedge Fund Index[3]		N.A.%	4.47%	1.65%	3.30%	3.26%

[1]Net of fees
[2]NAV adjusted to reflect distributions reinvested in the fund
[3] Compounded annual rate of return through May 2018

Friedberg Global-Macro Hedge Funds

Friedberg Global-Macro Hedge Fund Ltd.

Monthly Performance (%) Net of Fees

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Year
2018	4.82%	-18.57%	4.07%	-3.39%	-13.97%	-5.66%							-30.36%
2017	0.23%	3.14%	-0.44%	-1.76%	1.05%	1.22%	-2.39%	2.14%	-0.77%	10.58%	15.85%	4.13%	36.47%
2016	4.54%	9.86%	-9.79%	0.72%	-3.39%	1.30%	3.67%	-6.83%	-1.93%	-10.13%	-3.70%	0.49%	-15.94%
2015	4.75%	-1.16%	2.73%	-14.00%	3.14%	0.08%	11.12%	6.69%	-0.21%	0.16%	5.70%	-2.68%	15.09%
2014	17.06%	0.30%	-17.58%	-3.84%	-3.35%	1.27%	-12.07%	5.19%	-4.38%	-1.53%	7.09%	1.60%	-13.70%
2013	7.65%	-3.74%	3.04%	-1.90%	-5.62%	-13.17%	-14.23%	-1.28%	-11.27%	-4.80%	4.84%	1.87%	-34.43%
2012	-15.04%	-5.20%	1.64%	8.84%	11.22%	-2.12%	-0.69%	1.00%	0.84%	0.70%	-2.43%	-5.29%	-8.72%
2011	-10.28%	7.67%	-0.71%	9.53%	-5.06%	-3.23%	15.96%	16.22%	18.69%	-21.76%	11.47%	4.60%	40.86%
2010	2.99%	0.36%	-7.34%	3.76%	13.22%	4.75%	-13.76%	6.95%	9.11%	1.69%	-1.61%	-6.16%	11.36%
2009	-5.85%	-3.88%	3.65%	-7.15%	14.97%	-7.85%	9.47%	1.97%	5.02%	-2.21%	9.56%	-3.34%	12.02%
2008	7.18%	9.57%	-1.04%	-6.48%	4.51%	8.58%	-0.24%	-6.85%	4.18%	-5.96%	5.85%	19.06%	41.52%
2007	-1.01%	1.07%	-3.44%	-1.28%	-0.80%	1.57%	10.06%	2.80%	-1.33%	5.89%	7.91%	3.00%	26.27%
2006	1.88%	1.06%	-1.81%	2.07%	-0.75%	1.27%	2.04%	-0.09%	-0.56%	3.10%	2.43%	0.54%	11.64%
2005	1.04%	0.84%	-1.13%	1.31%	1.06%	2.47%	0.08%	0.95%	2.75%	-1.38%	2.56%	2.20%	13.41%
2004	4.03%	3.44%	1.36%	-7.84%	-0.39%	0.27%	1.02%	1.90%	1.45%	1.67%	2.76%	3.24%	13.09%
2003	3.11%	3.06%	-4.58%	-1.15%	9.26%	-3.77%	-8.04%	2.91%	5.49%	1.69%	1.49%	1.10%	9.76%
2002	-1.46%	2.04%	-2.22%	4.41%	5.41%	6.16%	-2.42%	4.45%	2.80%	-6.70%	0.32%	7.56%	21.17%
2001											0.00	-0.40%	-0.40%

*** PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS ***

Global-Macro Hedge Fund Ltd. (Cayman)

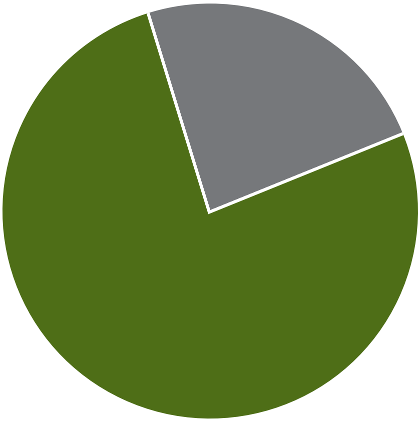
Breakdown as a Percentage of Total Assets

AS OF JUNE 30, 2018

U.S. and Global Equities*	76.39%
Fixed Income	0%
Currency Program	23.61%
Commodities	0%

Total Exposure per dollar of capital: 2.45x

* Contains long/short equities



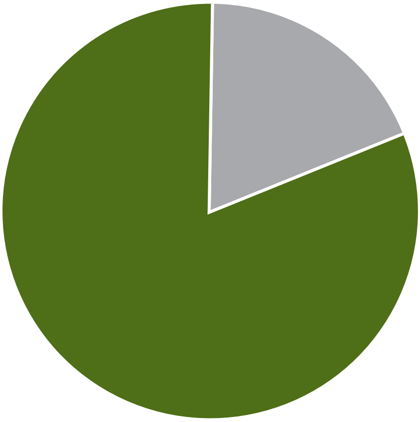
Breakdown as a Percentage of Total Assets

AS OF MARCH 31, 2018

U.S. and Global Equities*	81.50%
Fixed Income	0%
Currency Program	0%
Commodities	18.50%

Total Exposure per dollar of capital: 2.59x

* Contains long/short equities



Closed Funds

Fund	Inception Date	Inception NAV	Liquidation Date	Liquidation NAV	Size of Fund at Liquidation	Annual % Rate of Return
Friedberg Diversified Fund	13-Sep-96	10.00	31-Oct-06	48.43	$4,642,228	16.90%
Friedberg Global Opportunities Fund Ltd.	13-May-97	1000.00	28-Feb-05	501.89	$5,700,000	-8.46%
Friedberg Equity Hedge Fund L.P.	15-Feb-98	10.00	31-Oct-06	22.12	$6,784,836	9.50%
Friedberg International Securities Fund	31-Mar-98	10.00	30-Nov-05	11.49	$4,500,000	1.83%
Friedberg Futures Fund	8-May-98	10.00	31-Oct-06	19.59	$1,126,409	8.10%
Friedberg Global-Macro Hedge Fund L.P.	31-May-02	10.00	31-Oct-06	19.00	$30,691,202	15.64%
Friedberg Equity Hedge Fund Ltd.	16-Oct-96	1000.00	30-Apr-07	2951.78	$31,540,284	10.81%
Friedberg Currency Fund II Ltd.	6-Mar-97	1000.00	30-Jun-08	1019.23	$35,599,879	0.17%
Friedberg Total Return Fixed Income Fund Ltd.	2-Oct-96	1000.00	31-Jul-09	2155.93	$94,686,020	6.17%
First Mercantile Currency Fund	7-Sep-85	10.00	30-Dec-09	8.29	$848,443	N.A.
Friedberg Foreign Bond Fund	19-Aug-96	10.00	30-Jul-10	9.84	$13,336,465	6.91%
Friedberg Total Return Fixed Income Fund L.P.	19-Feb-97	100.00	28-Dec-11	325.47	$11,776,462	8.27%
Friedberg Forex L.P.	13-Jun-91	10.00	28-Dec-11	11.78	$2,558,382	2.66%
Friedberg Currency Fund	3-Jan-95	10.00	30-June-13	8.41	$1,932,936	-0.93%

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