REFLECTION

3rd QUARTER 2019 REVIEW

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SUMMARY

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AMETHYST ARBITRAGE FUND

Summer began as if the financial markets would be relatively calm. The recovery in mergers and acquisitions, which had started in the previous quarter, quickly lost momentum. But the markets still delivered some surprises, as we know can happen. Air Canada announced its intention to acquire all the outstanding shares in Air Transat, and bond rates suddenly became highly volatile in early September. Once again, our diversified positions allowed us to post a positive return for the quarter. Now let's take a more detailed look.

MARKET EVENTS

The recovery that was expected in the previous quarter did not materialize. The mergers and acquisitions market was so quiet that we took part in only 21 new transactions during the quarter, our lowest level of activity in years. The spreads associated with many transactions were for the most part too narrow, and the risk was too high, to our liking. However, Air Canada's offer on Air Transat shares presented an attractive opportunity.

The transaction announced on June 27 was indeed worth our attention. We immediately took a small position at close to $13.50, slightly above the initial $13 offer, because the stock would likely rise to above Air Canada's offer.

Air Transat's main shareholder is Letko Brosseau, a portfolio management firm with a nearly 20% stake. Letko Brosseau quickly indicated that it would not accept this offer, saying that it fell well short of the mark. As the firm is known for being somewhat intransigent, Air Transat's share price dropped to as low as $11.48 in July. We substantially increased our position as the price fell. The strategy resulted in a loss in July, but this was largely offset in August when Air Canada announced that it was raising its offer to $18, thereby ensuring Letko Brosseau's satisfaction. The stock then climbed to $16.75/share and we began to scale back our positions until it had slipped back to $15.21.

We still hold a number of shares, but we believe this story is probably far from over. The transaction's potential impact on airline competition must now be scrutinized. To this end, Federal Transport Minister Marc Garneau has given the Competition Bureau an extension until May 2, 2020 to render a decision. Unfortunately, this long delay seems to be cooling market participants' interest in the transaction, at least for now.

CONVERTIBLE SECURITIES

The quarter was profitable, but poor performance by a few companies in the health care sector limited our gains somewhat, as it did for numerous investors. We disposed of several positions that were simply becoming overvalued because of high demand. Even deep in-the-money convertible bond positions, which normally act as put options, had gone so high that they could easily result in a loss, regardless of the direction taken by the underlying equity. In addition, with the year-end approaching we preferred to close out certain positions that we considered of lesser quality. We wanted to free up capital to take advantage of the inevitable lack of market liquidity in December.

FROM July 1998 TO September 2019	**ANNUALIZED RETURNS (%)** *Net of all fees*						Volatil.	Correl.	% Mths > 0	Sharpe Ratio
	1 yr	3 yr	5 yr	10 yr	15 yr	Incep.				
Amethyst Arbitrage Fund	**3.0%**	**2.9%**	**6.2%**	**6.2%**	**6.6%**	**7.7%**	**7.5%**	**-**	**74%**	**0.75**
HFRI - Global Fund Weighted	0.3%	3.8%	2.9%	4.0%	4.7%	6.0%	6.6%	0.42	67%	0.56
S&P/TSX Composite (TR)	7.1%	7.4%	5.3%	7.0%	7.4%	6.5%	14.4%	0.44	63%	0.29
EAFE World Equity (TR)	-4.3%	3.5%	0.5%	2.0%	2.4%	1.5%	16.5%	0.41	55%	-0.05
FTSE CAN Long Term Bond	17.1%	4.5%	22.4%	11.1%	7.2%	7.0%	6.8%	0.03	61%	0.70

Evolution of Air Transat

For now, we are looking for opportunities that are being neglected by investors but are nevertheless of good quality, or whose risk can be sufficiently covered. It goes without saying that we have been building liquidity, since current prices do not justify the risk, given the potential return. This has somewhat hampered performance, but we are being deliberately cautious.

The roller-coaster market of recent months has been driven by a clear trend: investors have been abandoning non-performing companies, without giving it a second thought, in order to redirect capital to more dynamic stocks and corporate bonds. But the list is getting shorter by the day.

To our mind, the fact that the S&P 500 Index has failed to climb above its recent highs speaks volumes about the fact that large investment funds doubt that the economic and geopolitical conditions can deliver significant earnings growth over the coming months. Are they right? Well, we'll know by the end of the year. At Crystalline, our priorities are still to protect capital, to improve the quality of investments (i.e. lower risk) and to bolster the structure of our portfolio.

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FIXED INCOME

Since the end of last November, we have been holding a position long duration that has served us well. But in September the market shifted, becoming exceptionally volatile. The rate on 10-year U.S. government bonds jumped 50 basis points in less than 10 days, representing a change of more than 5 standard deviations on a weekly basis. Given the disciplined rules underlying our portfolio management, this volatility forced us to temporarily reverse our position on duration and thereby realize a loss for the month. However, most of the other components of the portfolio made contributions that nevertheless resulted in our fixed income arbitrage activities posting a positive performance year to date.

Despite this somewhat unusual episode of volatility, interest rates have continued to fall.

The U.S. Federal Reserve (the Fed) lowered its target rate for federal funds in July and September, and it will likely announce another cut between now and the end of the year.

We believe that the jump in bond rates in September was mainly due to how most investors were positioned. Everyone was holding long positions, and this accentuated the movement when many of them had to liquidate their positions at the same time.

Both our strategic and tactical credit spread positions made slightly positive contributions to the quarter's results. The credit spread curve became slightly steeper during the quarter: spreads narrowed in the short end of the curve and widened at the long end. Given the sharp decline in rates since the beginning of the year, many investors have been moving towards longer maturities and / or to higher risk securities to capture higher returns.

Overall, credit spreads are slightly more expensive than their historical averages, ranging from 0.50 to 2.00 standard deviations relative to the type of debt and / or maturity. Among the most expensive securities at this time are provincial government and corporate bonds with maturities of under three years. The best returns on capital for us are in the bonds of federal agencies and provincial securities, which offer 6% to 7% returns on 5 to 7-year maturities.

Our positions on the yield curve made a slightly negative contribution to results. We incurred small losses on our long positions in Canadian bonds relative to short positions in U.S. bonds, as well as on the steepening of the yield curve in the United States. But we are maintaining our outlook, and we continue to buy Canadian bonds and sell U.S. bonds.

THE ECONOMY AND FINANCIAL MARKETS

Let there be no doubt: according to the International Monetary Fund (IMF), the global economy is in the throes of a significant slowdown. The IMF, U.S. Treasuries - 10 Year Yield

which has just revised its forecasts, now expects—at best—3% growth in 2019. This is the lowest pace since the 2008 economic crisis. Global GDP grew 3.6% last year and 4% in 2017.

The trade tensions between the United States and China have been identified as the main cause of the slowdown, given that they are eroding business confidence. The deceleration would have been even more pronounced if the main economies had not benefited from accommodative monetary policies in the United States, Europe and Japan.

This has led Gita Gopinath, the IMF's chief economist, to comment: "At 3% growth, there is no room for policy mistakes."

The last quarter was also marked by a sudden, chaotic turn in the U.S. repo market in mid-September.

The U.S. economy is believed to have grown approximately 2% for the third quarter. As for what happens next, there are fears of a slight ebb in economic activity. However, even if we are clearly at the end of the economic cycle, it is by no means certain that the U.S. economy will be in recession in 2020 or 2021. The American consumer's real income is currently growing at close to 4% annually, and consumption of goods and services is increasing by only 3%, so the American savings rate is close to 8%.

The economic outlook is closely tied to the twists and turns in the U.S.-China trade war, and the Chinese do not appear to be in any hurry to nail down an agreement before the U.S. presidential election in 2020.

The Canadian economy is believed to have grown about 1.7% for the third quarter. Here too, foreign trade is a cause for concern. On the other hand, the recent election of a Liberal, albeit minority, government gives hope for expansionary fiscal policies to stimulate the economy.

Good Results in the Stock Market

The S&P 500 Index was up 1.3% in the third quarter. This may be a nice return, but it nevertheless marks a pause in the otherwise buoyant equity market: the New York Index is up 18.7% since the beginning of the year.

This expansion has been largely due to a 2.5-fold expansion in the price-to-earnings ratio during the period.

The Canadian stock market has been no slouch either, as the S&P/TSX Composite Index reached a record high of 16,900 points in the September 20 session. This was due to simultaneous upswings in September in the Financials and Energy sectors, which account for much of the Canadian index.

The last quarter was also marked by a sudden, chaotic turn in the U.S. repo market in mid-September. The Federal Reserve had to intervene, which certainly only added to the nervousness in the fixed-income market at a time when companies are issuing bonds to satisfy a large portion of their financing needs.

The Fed and Good Common Sense

This report has already mentioned the disrespect shown by President Trump toward Jerome Powell, Chair of the Fed. Donald Trump has repeatedly tried to force Mr. Powell to cut the federal funds rate to zero as quickly as possible. Market watchers all agree that this is a purely political calculation by the President, who would like to profit from an economy on steroids as he heads into the 2020 election. The Chair of the Fed has ignored Mr. Trump's insults, instead pursuing a policy of gradual easing.

This means that good common sense has prevailed. The Fed has announced two rate cuts so far this year, with a third probably coming in December. So the U.S. central bank has pursued an accommodative policy to help the economy cope with new tariffs, while keeping some ammunition for later when the need will be greater.

OUTLOOK

The inquiry in the House of Representatives could lead to an impeachment trial of the U.S. President in the Senate under the leadership of John Roberts, Chief Justice of the Supreme Court. The great majority of the news networks are sure to emphasize this inquiry over the next few months, but what effect will this process have on financial market volatility?

Political events rarely affect the fundamentals of an economy (with the exception of very short-term effects).

However, the past three years have shown us that President Trump tends to make irrational decisions when he feels he is not getting what he wants. The timing should have been right over next two months for the Chinese and American negotiators to find some common ground and solutions to the current trade war. Now, anything could happen.

Intemperate Morning Habit

As the President tends to post short messages on Twitter early in the morning, before the U.S. financial markets have even had a chance to open, he has sometimes moved markets. How often have the stock markets, as well as bond or currency markets, jumped or plummeted at opening following a single tweet from the President? Given the inquiry that may lead to an impeachment trial, he is not likely to change his ways. Rather, it could only make things worse. So we should be prepared for markets to be rocked quite unpredictably, at any time.