REFLECTION

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2nd QUARTER 2018 REVIEW

CRYSTALLINE

Canadian Manager of Alternative Funds, Since 1998

Twenty years ago, with the world just getting back on its feet in the wake of the Asian financial crisis, Crystalline Management opened for business. And what an adventure it has been! The investment world has been rocked by myriad events – in particular, the financial crisis of 2008-2009. Now well established in the Montreal finance community, Crystalline is celebrating 20 years in business and looks to the future with the same passion, still looking to provide consistent returns for its clients.

ECONOMY

Yes, it's war... a trade war

Throughout the second quarter there were hopes that the U.S. administration would finally understand that imposing tariffs, first on steel and aluminum and then on a long list of Chinese products, could only be bad for both the U.S. economy and the global economy. This hope quickly faded. The trade war between the U.S. and China began on July 6, when President Trump confirmed that he was imposing tariffs on $34 billion of Chinese products. An eye for an eye, a tooth for a tooth: as promised, China's leaders quickly responded by imposing tariffs on the same amount of goods. However, the Americans then raised the stakes, announcing new tariffs on products worth another $200 billion, only to be quickly matched by the Chinese. With the improvisation and chaos that seem to govern decision-making at the White House, it is impossible to have any sense of where this trade war will end. What we do know is that an economic shock is inevitable.

ANNUALIZED RETURNS, NET OF ALL FEES, as of Jun. 30, 2018

	AMETHYST Onshore	AMETHYST Offshore	HFRI Conv. Arb.	HFRI Merger Arb.	HFRI Event Driven
Last quarter	1.3%	0.7%	-0.8%	2.8%	3.8%
Last 12 months	-0.3%	-1.0%	2.9%	4.4%	7.5%
Since inception	8.3%	7.5%	6.2%	5.5%	7.2%

Resilient economies

The global economy continued to grow over the last three months but at a slower pace, if we are to believe the global Purchasing Managers' Indexes (PMIs), which have fallen for a second consecutive quarter.

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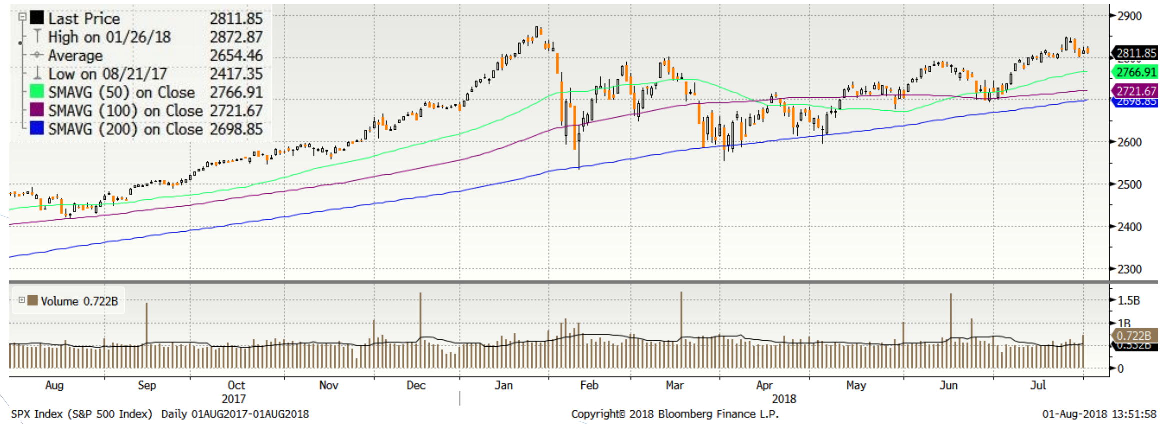
Meanwhile the U.S. economy seems to have rebounded following a disappointing first quarter. The economists' consensus is for 4% growth in the second quarter, considerably higher than the 2% attained in the first quarter. This renewed vitality can be seen in the strength of the labour market. The monthly job creation figures were 213,000 in June, 244,000 in May and 175,000 in April. All indications suggest that large American corporations will report strong profits again for the second quarter. Analysts believe that the income of companies comprising the S&P 500 index grew by close to 20% during the second quarter compared to the same period of 2017.

1002 SHERBROOKE ST. WEST
SUITE 2110
MONTRÉAL (QUÉBEC)
CANADA H3A 3L6

TEL. +1.514.284.0248
info@cristallin.ca

S&P 500 Index



In Canada, real GDP grew at a rate of 1.3% on an annualized basis in the first quarter, and economists expect a 2% to 3% rally in the second quarter. It should be noted that Canada's trade balance deteriorated in the first quarter, when import growth easily outstripped export growth (4.9% compared to 1.7%). This trimmed 1.1 points from real GDP growth.

Interest rates and stock indexes on the rise

The news had been somewhat telegraphed over the last month, so no-one was surprised when the Federal Reserve announced a 0.25 percentage point rate hike on June 13. It was the second increase this year. Since the Fed began normalizing interest rates in 2015, the federal funds target range has climbed from 0%–0.25% to 1.75%–2%. The Bank of Canada (BoC), after having stayed on the sidelines since mid-January, raised its key interest rate by 0.25 percentage point on July 11, to 1.50%.

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The major stock indexes generally performed well in the second quarter. In the U.S. the gains were 2.9% for the Dow Jones, 3.2% for the S&P 500, 6.3% for the Nasdaq and 7.4% for the Russell 2000. The Canadian market also delivered an excellent return, with the S&P/TSX appreciating 5.9% on the quarter. However, the best performance was in the United Kingdom, where the FTSE 100 surged 8.2% in this period.

Dangerous deterioration of political discourse

One can only conclude that the financial markets have been rather indifferent to the increasingly chaotic and, in many ways, totally irresponsible management of executive power in the U.S. government. Unimaginable things have happened. In just one month, Donald Trump disavowed the G7 agreement that he had signed just a few hours earlier, while openly insulting the Prime Minister of Canada, Justin Trudeau. A few weeks later, the same Donald Trump thwarted a meeting of the leaders of the member countries of the North Atlantic Treaty Organization (NATO), even threatening at one point to blow up the organization, which provides for the defence of the European allies. And he ended it all with a summit meeting with the President of Russia, Vladimir Putin, during which he cast doubt on the work of the U.S. intelligence services, with the whole world watching. Just how far will he go?

AMETHYST ARBITRAGE FUND

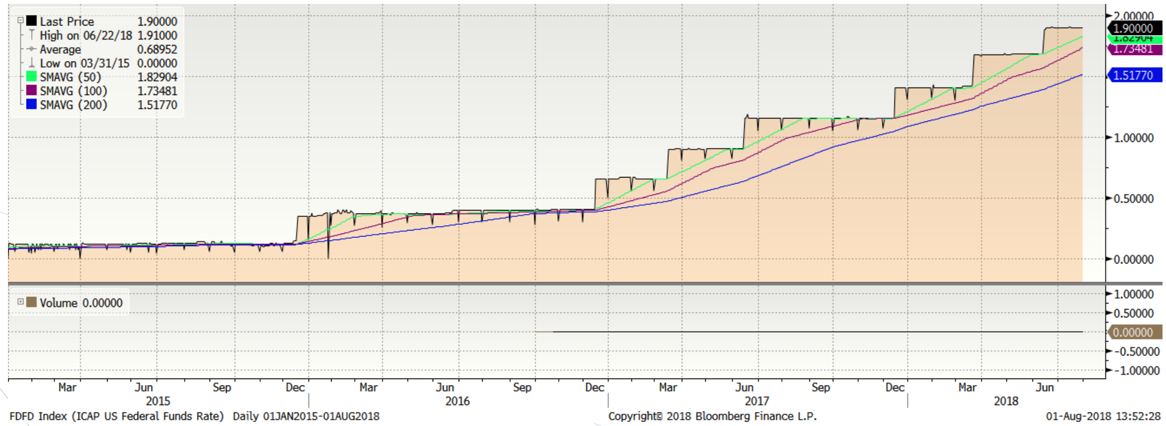
EVENT DRIVEN ARBITRAGE

In the wake of a difficult first quarter, it took only a few good news stories to cheer arbitrageurs in the mergers and acquisitions market: first, the State Market Regulatory Administration approved the acquisition of Microsemi Corporation by Microchip Technology Inc., but there was also the unconditional approval of the merger of Time Warner and AT&T granted by Judge Richard Leon, of the U.S. District Court for the District of Columbia, following six weeks of hearings. It should be recalled that the Department of Justice tried to block this transaction, which did not please the current occupant of the White House. These two events fostered a return to a more rational and efficient market, which is now more fairly valuing such transactions.

We participated in 29 new transactions during the quarter. Overall, the volume of activity during the period was slightly below average, but we nevertheless saw an upsurge in merger and acquisition transactions in the Canadian resource sector.

Interestingly, one of our transactions failed following a decision that we found questionable, to say the least, and that brings to mind certain recent decisions by CFIUS (the Committee on Foreign Investment in the United States). On May 24, the Canadian government announced that it would block the acquisition of Aecon Group Inc., a construction company, by the China Communications Construction Company International Holding Limited (CCCI), arguing that this foreign investment would be injurious to Canada's national security. We were surprised to see the Canadian government make such a decision, since we do not believe that Aecon holds any technological patents or has any links with Canada's National Defence. So,

Fed Funds rate since 2015



going forward, we will need to consider this new atmosphere of protectionism, which could scuttle certain transactions.

CONVERTIBLE SECURITIES

Not to be discouraged by the political uncertainty, the convertible and high-yield securities market provided some good investment opportunities and allowed us to post an acceptable return for the quarter. We took advantage of these conditions by adding positions across a range of sectors and strategies, in order to optimize the risk/return profile of the portfolio while also scaling back other positions when the bull market allowed us to profit from higher prices.

We participated in five new issues of Canadian and U.S. convertible bonds, and we bought five other convertible securities on the secondary market. Above all, we opted for high-coupon bonds maturing in two to five years. These securities will generally provide better protection in the event that market conditions deteriorate.

We also added eight new securities to the portfolio whose redemption has been announced by the issuers. The return on these positions is limited, of course, but also very secure.

As part of the fund's merger and acquisition strategy, we acquired seven Canadian and U.S. bonds. They contribute to the strategy's return when the merger-acquisition takes more time to close, in contrast to positions in equities, which return more when the transactions are completed quickly.

FIXED INCOME

U.S. bond yields continued to rise in the second quarter, albeit more slowly than in the previous quarter. The rate on 10-year Treasury bonds has climbed 11 basis points over the last three months, compared to a 35-basis-point increase in the previous quarter. The yield on 10-year Canadian bonds also rose, but by only 8 basis points, or about the same as in the first quarter.

Trading on the bond market became particularly difficult several times during the quarter, due to high intraday volatility characterized by sudden changes in direction. The slightly negative performance of the fixed income segment during the quarter was in part due to certain stop limits and hedges being triggered during this period of volatility. Our strategic positions on credit spreads also played a role. Widening spreads on these long positions resulted in a loss that the positive carry associated with these positions could not fully offset.

In addition, our positioning on the yield curve proved profitable. We realized gains when the curve flattened, both in Canada and the U.S. But above all, we realized an attractive gain on long Canada – short U.S. positions across the entire curve.

OUTLOOK

Midterm elections just around the corner

The upcoming mid-term elections in the U.S. will see the election or re-election of a third of the members of the Senate and everyone serving in the House of Representatives. They will not be held until November, but will probably be front and centre on the financial and political stage over the next few months because their outcome has rarely been so crucial. Over the last few months, but in particular over the last few weeks, the U.S. President has exceeded all bounds of what is acceptable and decent in the performance of his duties, both abroad and at home. The situation is such that many political experts believe that Donald Trump now represents a clear and present danger to his country. They say that returning the Democrats to a majority in Congress appears to be the best if not the only means to bring the current madness to an end.

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More interest rate hikes

The optimism expressed by Jerome Powell, the new Chairman of the Fed, about the outlook for the U.S. economy suggests that the institution will continue to normalize American interest rates. Two other hikes are expected to be announced between now and the end of the year, probably during meetings of the institution's Federal Open Market Committee (the FOMC) in September and December. In Canada, the indicators suggest that the economy is performing well. A new increase in the key interest rate can therefore be expected this fall, given the BoC's current economic forecasts. However, trade tensions and the uncertainties surrounding the renegotiation of the North American Free Trade Agreement (NAFTA) add an element of risk to this forecast. If the U.S. continues down this ill-advised protectionist path, the BoC may be tempted to bide its time.

Where potential gains will be found

We believe that the current occupant of the White House will certainly play a role. Over the last quarter the fund has accumulated a cash reserve. It will be deployed tactically and effectively when market volatility inevitably materializes, driven by the administration's erratic management of the economy and its international relations. This is sure to generate new opportunities for the convertible arbitrage segment, but interest rates will need to be factored into the equation. Recently Mr. Trump openly criticized the Fed's latest interest rate hike. This stab at the independence of the Fed, highly unusual coming from a President, may now cloud fund managers' perceptions of where interest rates are likely headed.