REFLECTION

2nd QUARTER 2022 REVIEW

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SUMMARY

The volatility in bond prices reached a fevered pitch just as the central banks finally admitted that they were wrong about inflation.

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CANADIAN MANAGER OF ALTERNATIVE FUNDS, SINCE 1998

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AMETHYST ARBITRAGE FUND

Markets Sink

The stock markets were in flux throughout the first quarter. With the exception of Toronto's S&P/TSX index, which managed to stay afloat, all the U.S. and European indices posted significant losses. Although the markets recovered rather well in the first two weeks of March, they then fell further, and the second quarter proved to be even worse. But the rout in the stock market was only compounded by the debacle in the bond market.

Exceptional Volatility in the Bond Market

The volatility in bond prices reached a fevered pitch just as the central banks finally admitted that they were wrong about inflation. This seriously complicated some of the arbitrage strategies at the heart of our efforts to create alpha.

Yet despite the weak markets, the Amethyst Arbitrage Fund performed well in the first quarter, achieving a very attractive return through our diverse range of non-directional strategies and risk management. All was going well when excessive volatility in the bond markets in the last two weeks of June eroded market valuations of some bond positions, resulting in the Fund posting losses for both the month and the quarter.

Setbacks Often Present Opportunities

There is nevertheless some cause for optimism: given the nature of our strategies, the ground that was lost may be quickly recovered, and we think could open the door to enviable performance by the end of the year. We have faced similar situations in the past, and our track record, particularly during similar episodes in 2009 and 2016, shows how we have been able to quickly profit from them each time.

MARKET EVENTS

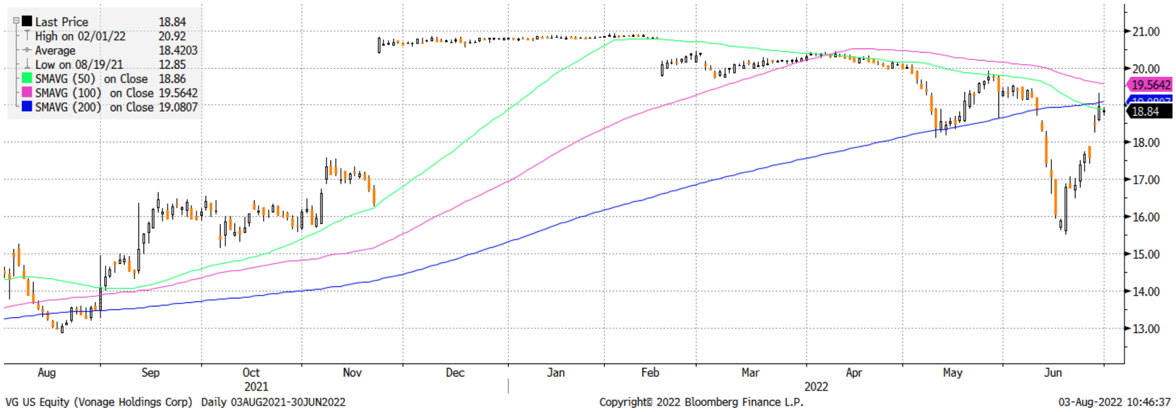
Our M&A arbitrage strategy continued along much the same lines as in the first quarter. We took part in 34 new deals, but each of them involved mergers that we felt were fairly easy to assess, with transactions expected to close within no more than three months. Since the beginning of the year, we have believed that this is the right approach to take in this type of market, which continues to offer robust levels of M&A activity and good opportunities within our prudent risk management parameters despite the high volatility. The market volatility in the second quarter confirmed the wisdom of this approach. ***But even for straightforward transactions, the unrelenting swings in market direction sometimes required nerves of steel.***

One Good Example

In November 2021, Ericsson, the Swedish telecommunications company, reached an agreement to buy Vonage Holdings Corp., which is based in New Jersey. Of course, the transaction needed to be approved by the Committee on Foreign Investment in the United States (CFIUS). Given the general lack of concern about the deal in an already highly consolidated market, CFIUS approval seemed like a simple formality, or close to it. And yet...

FROM Jul. 1998 to Jun. 2022	ANNUALIZED RETURNS (%) *Net of all fees*							Volatil.	Correl.	% Mths > 0	Sharpe Ratio
	YTD	1 yr	3 yr	5 yr	10 yr	20 yr	Incep.				
Amethyst Arbitrage Fund - Cl. F	**-3.0%**	**-2.2%**	**1.2%**	**1.4%**	**4.2%**	**6.9%**	**7.8%**	**8.0%**	**-**	**74%**	**0.71**
HFRI - Global Fund Weighted	-5.8%	-5.3%	6.1%	5.1%	5.0%	5.5%	6.1%	7.0%	0.48	65%	0.58
S&P 500 (TR)	-18.9%	-9.5%	11.1%	11.6%	13.1%	9.1%	7.2%	15.5%	0.44	65%	0.31
S&P/TSX Composite (TR)	-9.9%	-3.9%	8.0%	7.6%	8.2%	7.9%	6.6%	14.8%	0.49	63%	0.31
EAFE World Equity (TR)	-21.0%	-19.9%	-1.3%	-0.4%	2.6%	2.5%	1.3%	16.7%	0.44	56%	-0.05
FTSE CAN Long Term Bond	-22.1%	-19.7%	-5.8%	-1.0%	1.9%	5.4%	5.3%	7.6%	0.14	59%	0.42

Vonage Holdings Share Price



On November 22, Ericsson announced that it was buying Vonage for US$21 per share. The deal was expected to close in the first half of 2022. Ericsson's offer carried a good premium, as Vonage was trading at US$16.50 at the time. But the stock was then buffeted by considerable volatility, even though the deal never seemed to be in danger of falling through.

Volatility Sows Doubt

Even though volatility opens up some good opportunities, it will always have an unsettling effect on investors. In May, Vonage's share price fell from US$20.29 to US$18.39 and then rallied to US$19.37. In June, the stock fell to US$15.83 and then quickly recovered to US$18.84. On July 21, the deal finally closed at US$21. What a rollercoaster ride, when, for all appearances, the deal was so simple! Of course, we took advantage of this volatility to increase and scale back our position when we felt this was appropriate. Although we generated a solid profit, we did choose to trade off some potential return as our risk management framework and objective of capital protection mandate more caution when a stock is fluctuating this much. But we do not fear this kind of volatility; rather, our arbitrage strategies allow us to profit from it. This is the essence of the Amethyst Arbitrage Fund.

CONVERTIBLE SECURITIES

A combination of several negative factors, including the risk of recession, inflation, rising interest rates and confusion among central bankers, finally took their toll on the bond market. This led to high volatility in some M&A-related securities and convertible bonds when stock markets plummeted in the first two weeks of June. The Fund was not spared, which explains our losses in the second quarter. They occurred mainly toward the end of the quarter, when credit sold off considerably.

Troubled Securities

Many bonds linked to M&A transactions fell sharply as fears grew among investors that the deals might not go through. In convertible bonds, fears of bankruptcy or an inability to redeem the securities at maturity drove many bonds down to levels that reflected these problems coming to fruition. Despite a dearth of new issues, there was a clear lack of interest among buyers on the secondary market.

Signs of Stabilization

While numerous risks persist, equity markets are finally showing some signs of stability. The S&P 500 index, to name but one, seems to have bottomed out, at least for now, and has been moving in a horizontal range since June 20. Could this mean that the market decline is now over? Clearly we still face considerable economic and geopolitical challenges, but so far a major crisis has been avoided. For now, the markets are holding up.

There is a lot of cash on the sidelines right now, and it continues to accumulate. This could certainly help spark a market rally at some point. As for us, our capital reserves will allow us to take advantage of opportunities as they arise, once the situation has stabilized. But for now, caution is still the order of the day.

FIXED INCOME

Although we did not fully recover the ground lost due to the irrational distortions in government agency credit spreads, our fixed income arbitrage strategies provided a positive and attractive return for the quarter. We realized gains on credit spreads as well as on the yield curve and duration.

The agency credit spread segment has finally stopped underperforming. A more rational market has taken its place, due to few new issues in the primary market, the generally defensive nature of these bonds and rising interest rates. But for the credit market as a whole, it should be noted that performance has been dampened by fear, not necessarily of a recession but at least of a serious economic slowdown.

Highly Volatile Bond Prices

At the risk of repeating ourselves, the bond market has been highly volatile in recent months, with the yield curve shifting often and very rapidly. ***As for bond durations, the changes in prices have been abrupt, rapid and considerable, with frequent changes of direction.***

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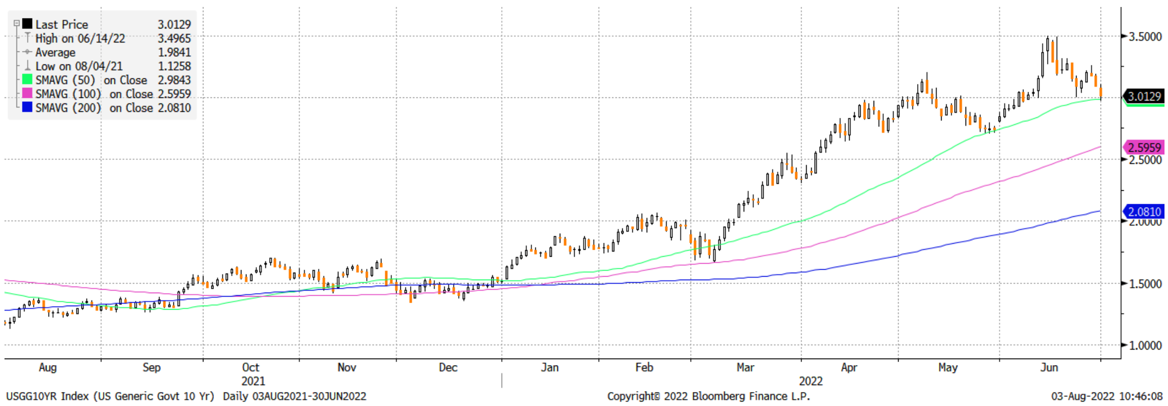
U.S. Treasuries - 10 Year Yield



Given these conditions, we have been exercising caution in our yield curve and duration arbitrage strategies. We nevertheless achieved a positive, albeit modest, return.

In May and June, we gradually reduced our long position in agency bond spreads and our short position in provincial bond spreads, when agency bonds finally outperformed relative to provincial bonds.

We enter the third quarter positioned for a flattening of the yield curve, but we are continuing to limit our exposure due to the ongoing volatility. We are also positioned long Canadian bonds Vs. short US bonds, and we remain somewhat defensive on long-duration positions.

THE ECONOMY AND FINANCIAL MARKETS

Recession Coming Anytime Soon?

For the time being, the chances of a recession in the United States appear rather slim, with the New York Federal Reserve estimating them at less than 10%. However, the Fed's tightening of monetary policy, as it ends quantitative easing programs and effects ever more vigorous hikes in the key interest rate, can only slow economic growth, perhaps considerably.

Most economic indicators continue to show growth or they are just neutral, with few pointing to a deteriorating outlook. So if for the moment the US economy is not really in danger of slipping into recession risky assets such as stocks may have already fallen sufficiently.

And Inflation?

If anyone hoped that the inflation rate would ease in June, they were certainly disappointed. The U.S. consumer price index jumped to 9.1%, the highest it has been since November 1981. Core inflation, which excludes the more volatile food and energy components, rose by 0.7% in June for its largest monthly jump in a year.

It is true that higher oil prices have had an impact, with prices at the pump up by almost 60% in the last year. But the price increases have clearly been across the board: automobiles, housing, clothing, food… everything was affected.

OUTLOOK

Role Played by Central Banks

Ever since last fall, the central banks have dithered in the face of the inflation outlook. Confidence in central bankers took a hit when they had to admit that they had erred when they called the inflation situation "transitory." Many observers blame them for having been slow to raise their policy rates, and now they are playing catch up. The Bank of Canada has just announced a 1% hike, and the Federal Reserve may well follow suit. This is a far cry from the days of the gradual 0.25% hikes we had become so accustomed to. There can be no doubt that the decisions of central bankers will play a crucial role over the next few months.

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Politicians Under Fire

As summer comes to an end, the focus will be back on several politicians whose images have suffered considerably since the beginning of the year. We will no longer be talking about Boris Johnson; criticism of Joe Biden and Justin Trudeau could further tarnish their image at a time when the economy needs leaders who enjoy broad-based confidence. This fall will see Joe Biden in the hot seat, after he returned from Saudi Arabia without an agreement that would have reduced oil prices and with midterm elections looming that could take away his legislative authority. He will need to find a way to prevent the U.S. administration from slipping into a state of inertia. Here in Canada, Justin Trudeau is unlikely to face any threats to his position as Prime Minister for a few more years, but he remains a prime target for opponents of all stripes, both in terms of his policies and how he communicates them. Yet the Canadian economy will also require strong leadership. Where will it come from?

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