REFLECTION

20 ans de passion et de rendement
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3rd QUARTER 2018 REVIEW

CRYSTALLINE

Canadian Manager of Alternative Funds, Since 1998

AMETHYST ARBITRAGE FUND

Concerns that hacking represents a national security risk have become so serious that we now need to factor them into our transactions in the mergers and acquisitions market. An unusually high rate of failed transactions led us to examine why this happened, and we have taken the necessary measures to manage this risk.

MARKET EVENTS

We participated in 30 transactions in the last quarter, which is more than usual during the summer quarter. Two of them nevertheless fell through when they were blocked by the authorities: one was refused by SAMR (China's competition agency), and the other, in the U.S., was refused by the FCC (the Federal Communications Commission). This makes 6 out of 100 transactions that have fallen through since the beginning of the year, or twice the usual ratio. More and more bids, particularly by Chinese companies, have been rejected on national security grounds in the U.S, Australia and even Canada. In early October, Bloomberg, the information services company, revealed that a Chinese assembler of servers—designed by SuperMicro Computer, an American company—had slipped a chip into its servers that could be used to spy on these. SuperMicro computers are used in thirty of the largest U.S. companies, including Apple and Amazon. Hence the climate of mistrust.

We have therefore decided that we will no longer take part in transactions involving a Chinese entity taking control of a foreign company in an industry that is in any way strategic.

This situation has undoubtedly added to the skittishness in the mergers and acquisitions market, and we are not exempt. We have therefore decided that we will no longer take part in transactions involving a Chinese entity taking control of a foreign company in an industry that is in any way strategic. Fortunately, the market still has an abundance of transactions with attractive arbitrage opportunities. While 2018 may have been a difficult year so far, we are optimistic about the outlook for the last quarter.

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

	AMETHYST Onshore	AMETHYST Offshore	HFRI Conv. Arb.	HFRI Merger Arb.	HFRI Event
Last quarter	-0.2%	-0.2%	0.6%	2.3%	1.0%
Last 12 months	-1.3%	-2.4%	2.1%	5.9%	7.0%
Since inception	8.2%	7.3%	6.2%	5.5%	7.2%

CONVERTIBLE SECURITIES

Although our quarterly results for this segment were good, they could have been much better. The lion's share of our positions (i.e. over 90%) generated positive returns. Unfortunately, three positions impeded performance.

The problems in this last quarter began when significant cracks appeared in the markets. First, there was a drop in liquidity. Then spreads between bid and ask prices widened, complicating the task of arbitrage. But there was also the com-

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U.S. Treasuries - 10 Year Yield

parative weakness of small-cap securities vis-à-vis the large caps. Investors increasingly appear to be

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abandoning these securities, which have not performed well since the beginning of the year. And they are proceeding indiscriminately. This phenomenon suggests that the markets are entering a more difficult period. When fear settles in, investors seek liquidity, and they do this by buying securities that have appreciated and selling those that have waned.

This somewhat irrational attitude should nevertheless generate some good opportunities, which we intend to seize over the next few months. For now we are underinvested, but we expect to deploy new capital between now and the end of the year.

FIXED INCOME

The fixed income segment posted a positive return for the quarter, despite a slightly more difficult period in August. Ongoing trade negotiations between Canada and the U.S. narrowed credit spreads and widened spreads between Canadian and U.S. rates in August, and this has complicated management. Narrower credit spreads toward the end of the quarter nevertheless allowed us to close the period on a positive note.

Even if we may have entered a temporary consolidation phase, bond yields are expected to rise slightly by the end of the quarter.

For most of the quarter, interest rates moved within a well-defined corridor before veering onto a clear upward trend in the last two weeks. The yields on 10-year U.S. Treasuries are now over 3%, or about 75 basis points above where they were at the start of the year. Even if we may have entered a temporary consolidation phase, bond yields are expected to rise slightly by the end of the quarter. Rate hikes are common at this time of year, from October to January. Accordingly, since September we have been favouring short-term positions, and this has served our purposes very well for now. At this juncture we also prefer to sell Canadian bonds over their U.S. counterparts.

Despite their volatility, Canadian credit spreads were slightly narrower overall during the quarter, which gave us some gains on the period. Several factors favoured the Canadian credit market: rising interest rates, the successful negotiation of a free trade agreement between Canada, the U.S. and Mexico, and the good performance of U.S. equity markets and their impact on credit.

THE ECONOMY AND FINANCIAL MARKETS

Clear dichotomy

The U.S. economy appears to have maintained its momentum in the second quarter, with GDP posting over 4% growth for the three-month period ended June 30. The impacts of tax cuts are still apparent, so much so that third-quarter growth will probably be around 3.5% to 4%. There is good reason to believe that U.S. GDP will have grown by more than 3% for the whole of 2018. This will encourage even more swagger from Donald Trump, who is sure to take all the credit.

But the view of the global economy is somewhat different. Global PMIs continued on a downward trend that began in the fourth quarter of 2017, and the drop in commodity prices suggests that the global economy has lost momentum, in contrast to the situation in the U.S. The trade barriers announced by the U.S. and the countervailing action taken by its trade partners have been important contributing factors, provoking a drop in global trade volumes. The European and Asian economies have continued to grow, but the pace of growth seems slower than in the previous quarter.

A cloud lifts

The cloud that hung over the Canadian economy has now lifted. In the wake of protracted negotiations, a substitute was found for NAFTA, with Canada escaping relatively unscathed. The Canadian economy is believed to have grown another 2.5% for the third quarter, in step with the previous quarter. Clearly this represents good performance, given the very weak prices for Canadian oil compared to U.S. crude. The industry is hampered by a woefully inadequate ability to export its output, despite its importance to the entire Canadian economy. And there is no consensus in sight in the political debate over the construction of pipelines to alleviate the problem.

Busy times at the central banks

On three occasions this year the U.S. Federal Reserve raised its target range for the federal funds rate: in March, June and September. The last hike provoked a rebuke from President Trump, who even questioned the competence of Jerome Powell, Chairman of the Fed, who was appointed by Trump himself at the start of the year. When the markets were badly shaken in September, the Chairman of the Fed became the White House's perfect scapegoat. It is highly unusual for a U.S. president to publicly criticize the Chairman of the Fed, given that the organization should be independent of the executive branch. Market watchers still expect the Fed to announce three more rate hikes over the next 12 months. But the institution's decision-making may take more than economic theory into account, and this could leave financial markets embroiled in even more volatility.

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The Bank of Canada (BoC) raised its key interest rate in July. No-one was surprised by this second rate hike of the year and, given the economy's good performance, the BoC may well raise rates three more times over the next 12 months, including in October. The Bank was dealt a free hand when a new trade agreement was reached between Canada, the U.S. and Mexico.

Trade and geopolitical tensions

Although there was much to cheer about in Canada when an agreement was reached on North American trade, global trade remains fragile, particularly that between the U.S. and China. The world's two main economic blocks have been bombarding each other with tariffs since the spring, and for now the negotiations are in deadlock.

International relations have been extremely tense since the U.S. pulled out of the nuclear deal with Iran. Many countries have refused to endorse this decision. In response, the White House has threatened sanctions on any country that continues to buy Iran's oil. Iranian output has nevertheless fallen by 1 million barrels per day over the last three months, explaining at least part of the upward pressure on the price of oil, mainly European crude (Brent).

OUTLOOK

Midterm elections in the U.S.

November 6 is fast approaching, and this time the results of the midterm elections will surely matter to the financial markets. The chaos that has reigned in the White House for almost two years has diminished the presence and stature of the world's greatest economic power. Even though many observers fear that the long-term impact will be negative, both for the economy and international relations, financial markets have responded very favourably, at least for now. Investors have clearly been pleased by the tax cuts and deregulation, and Republicans are promising more of the same. However, the midterm elections may be a game changer. For now, surveys are suggesting that the Democrats could take back the House of Representatives, with the Republicans maintaining a small majority in the Senate. This would certainly complicate the exercise of legislative power. Moreover, if the House of Representatives and the Senate are both taken by the Democrats, that will probably mean no more tax breaks and, above all, a challenge to the U.S. President's moral authority. This would certainly not be well received in the markets. On the other hand, if the Republicans maintain their majorities in both houses, the bull market is probably set to continue.

Recession and interest rates

The odds of a recession in the U.S. economy within the next 6 to 12 months remain quite low – less than 15%. Despite President Trump's impetuous remarks and the general absence of inflationary pressures at this time, the Fed is expected to continue normalizing interest rates, probably as soon as this December. Unless, of course, the midterm elections drive U.S. politics into a crisis exacerbated by a president who will not easily give up the almost unconditional power currently conferred by the Republicans' lock on the two legislative houses.

Canada's trade agreement with the U.S. and Mexico has effectively removed a major uncertainty from the economic outlook. The BoC now has some leeway and should be able to move quickly on interest rates, as long as the economy continues to grow at its current pace.

Repercussions of the Khashoggi affair

The geopolitical landscape in the Middle East has changed considerably since Donald Trump moved into the White House, with the U.S. withdrawing from the nuclear agreement with Iran, pledging unconditional support for Israel, maintaining a vague and, above all, improvised policy on the Syrian conflict, and demonstrating a lack of judgment in its support for Saudi Arabia. But now the Khashoggi affair may force the White House to reconsider U.S. foreign policy in this part of the world. Should the crisis make Saudi Arabia a pariah state in international affairs, the geopolitical situation in the Middle East may become more explosive than ever. And that will not be good for financial markets.

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