REFLECTION

1ST QUARTER 2019 REVIEW

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SUMMARY

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AMETHYST ARBITRAGE FUND

A satisfying quarter

Even though the period was marked by an unusual combination of upward trends, on both the equity and bond markets, and by a remarkable about-face by the U.S. Federal Reserve (the Fed), the Amethyst Fund performed well at the start of the year. The Fund's three segments were able to seize opportunities and deliver attractive returns on the first quarter.

More surprises can be expected this year: the global economy is clearly losing momentum, and the risk that the White House will interfere in the Fed's decision-making will only complicate things for forecasters of U.S. monetary policy. But before we examine these issues, we will present a review of our first-quarter achievements.

MARKET EVENTS

Oddly for this time of year, there were relatively few opportunities to take positions on mergers and acquisitions. We took part in 24 new transactions, rather than the usual 35 or 40, in the first three months of the year. But market watchers generally agree that all the conditions are in place for an eventful year in mergers and acquisitions, given the resilience of markets and the abundant and highly affordable financing available in the junk bond market. So in an environment marked by lots of capital chasing relatively few opportunities, deal spreads were slimmer, but most of the transactions were of good quality.

As should be expected, some of our positions were affected by specific events during the quarter. On March 10, Luxfer Holdings announced that it was cancelling its acquisition of Neo Performance Materials. Then, in response to criticism from major shareholders of Newmont Mining, including the renowned manager John Paulson and the portfolio management firm VanEck, Newmont announced a special dividend of $0.88, conditional on shareholder approval of the Goldcorp Inc. acquisition. This substantially altered the math of this transaction for anyone that had a short position on Newmont.

In addition, we were pleasantly surprised when Crius Energy Trust, which is being acquired by Vistra Energy, announced that the acquirer would increase the amount it would pay unitholders from $7.57 to $8.80 in reaction to an offer from a competitor. So, all in all, not that bad.

ANNUALIZED RETURNS, NET OF ALL FEES, as of Mar. 31, 2019

	AMETHYST Onshore	AMETHYST Offshore	HFRI Conv. Arb.	HFRI Merger Arb.	HFRI Event Driven
Last quarter	2.2%	2.0%	5.6%	2.8%	5.1%
Last 12 months	3.0%	1.6%	0.5%	8.3%	4.3%
Since inception	8.1%	7.1%	6.1%	5.5%	7.0%

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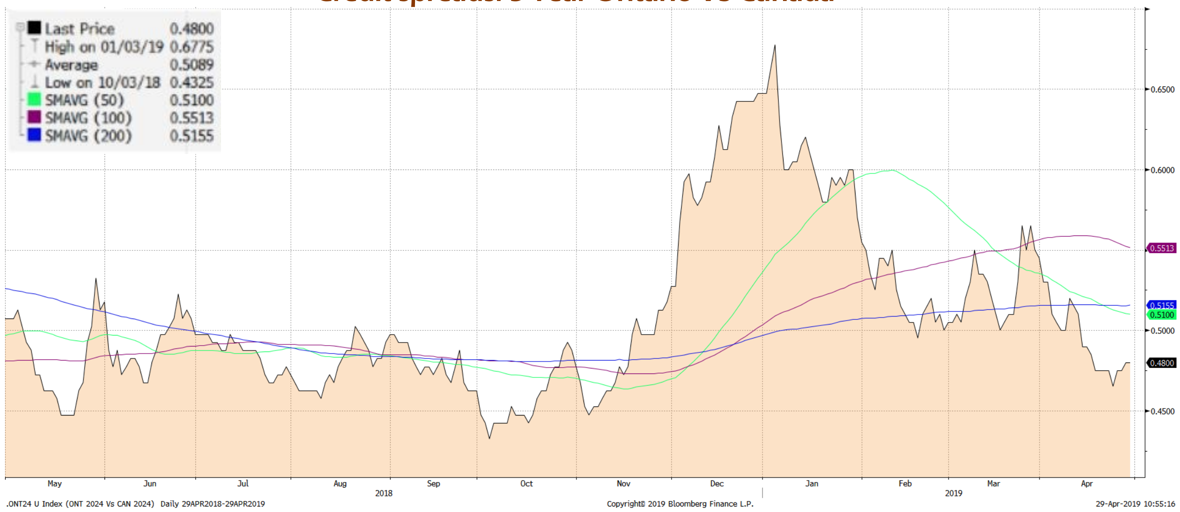
Credit spreads: 5 Year Ontario VS Canada



CONVERTIBLES SECURITIES

Several factors allowed us to lock in profits, take some new positions and rebalance certain parts of the portfolio while reducing risk. This allowed us to reduce certain positions that had surpassed our objectives during the quarter, for attractive gains. We added some U.S. convertible bonds to the portfolio, as well as convertible bonds from two Canadian companies on the secondary market.

We also bought several short-term bonds whose issuers had announced their redemption in order to replace them with other types of financing. These situations provide only very small gains, but the associated risk is close to nil.

Since interest rates are low, we expect that some companies will be eager to refinance some of their borrowings before the summer. This could prompt us to liquidate some positions that are already offering attractive gains and to take positions in certain issues that meet our investment criteria.

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Furthermore, during bull markets like the one we are experiencing now, convertible bonds that are priced far from their conversion price tend to approach a point where their price will rise when the underlying asset appreciates in value but it will slip only marginally when the underlying declines. We are carefully monitoring the secondary market in search of convertible securities that meet this criterion.

We are nevertheless well aware that with markets up, statistical indicators suggesting that economic growth is slowing and geopolitical tensions that are not going away, we need to position our portfolio carefully by spreading the risk and adding new positions.

FIXED INCOME

In fixed income the tone was set for the rest of the quarter as early as January 4. After having announced a hike in the Federal Funds target rate just two weeks earlier, Jerome Powell began to change his tune; market participants took this to mean that the Fed would stop hiking interest rates and that the bond market would rally.

Following several hesitant sessions in early January, credit spreads tightened sharply in the period from mid-January to mid-February. They contracted most in sectors with the lowest credit quality: municipal and corporate bonds. Provincial bonds made up for much of their underperformance in the fourth quarter of 2018 (as discussed in our previous quarterly report).

We took advantage of these narrower spreads, but clearly their relative value has now diminished. Credit spreads have now fallen back to below their historical averages by approximately one-half of a standard deviation, or into expensive territory. We took profits at the end of March and have adopted a cautious approach.

Our reading of changes in the yield curve remains the same. We are holding onto our positions in anticipation of a flattening of the shortest part of the curve and a steepening in the longest part. Moreover, we are keeping long positions on Canadian bonds and short positions on U.S. bonds.

As for the trend in bond rates, given the change in tone at the central banks, the slowing economy and the absence of inflation, we are keeping our positions on long-term securities, both Canadian and American.

U.S. Treasuries - 10 Year Yield

THE ECONOMY AND FINANCIAL MARKETS

The Economy

Generally speaking, the year got off to a rocky start with signs of a slowdown cropping up in several places, including China. The Chinese economy was showing the effects of the trade war that began when the U.S. imposed tariffs. The eurozone, Japan and the emerging countries were not spared, either.

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The Purchasing Managers' Index (PMI) slipped again in the first quarter, confirming a downward trend in the global economy. The European economy appears to have continued to stagnate, sustaining a trend that began in the second half of 2018. The European Central Bank (ECB) expects the economy to grow by only 1.1% in 2019. And this is without factoring in the fallout of Brexit's ultimate resolution, a situation that becomes more complicated with each vote put to the British Parliament.

In the U.S., growth appears destined to be slower than last year. The first quarter was ordinary, but what follows could prove more satisfactory. The Fed's about-face, described in more detail below, and a strong labour market should help. Economists are forecasting 2% growth in the U.S. economy in 2019.

In Canada, the outlook appeared bleaker at the start of the year, but the recent jump in the price of oil has somewhat renewed economists' confidence. Many are now projecting growth of close to 1.5% this year. In addition, the Bank of Canada is expected to leave its key interest rate unchanged in 2019.

The Fed's about-face

Where the Fed goes, the financial markets will follow. Until last December, Jerome Powell, the Chair of the Fed, was saying that the institution would continue to normalize monetary policy, so he raised the Federal Funds rate again on December 19 and said that he was ready to continue shrinking the institution's balance sheet. A sharp downturn in equity markets nevertheless appears to have convinced him otherwise.

In a sudden and surprising about-face in early January, his rhetoric changed completely. Even though the indicators were not signalling a significant slowdown in the U.S. economy any time soon, comments by the Chair of the Fed suggest that there will be no more rate hikes for the next year, that, starting in May, the institution will slow the pace at which it is reducing its balance sheet, and that the program would be ended in September. The rest is history. The equity markets bounced back, with the S&P 500 up by over 13% on the quarter as the yield on 10-year U.S. Treasuries plunged as much as 2.40%.

No inflation

In order to prod the world's economies out of the deep recession that followed the 2008 financial crisis, most central banks undertook virtually unprecedented expansionary policies. Governments did the same, launching infrastructure programs that stretched their budgets to the extreme. Normally this would have generated strong inflationary pressures, but not this time around. Since 2009, the inflation rate has been relatively flat, and is still within a range of 1.5% to 3.5% in most countries. What is going on here?

Economists greatly underestimated the impacts of globalization – just think “Made in China” – and, above all, the impacts of new technologies on the prices of goods and services – including online shopping through Amazon. This moderate inflation is undoubtedly supporting the arguments being made by those who want expansionist economic policy to continue.

OUTLOOK

Low risk of a recession

Governments and central banks have realized that the economic and fiscal policies of the last ten years have not spurred unhealthy inflation, so they are preparing more of the same medicine, i.e. more debt and, above, all, very low interest rates.

We believe that the U.S. economy will not slip into recession until interest rates rise from 2% to 3%, and then from 3% to 4%. The likelihood of this would appear to be very low at this time, given the Fed’s about-face. Instead, the year will be marked by a generous monetary policy that will leave room for slightly lower interest rates, and slightly higher equity markets.

Powell and the Fed between a rock and a hard place

The Fed’s spectacular change in direction since the last hike in the Federal Funds rate in December nevertheless gives cause for concern. First, such a reversal raises questions about the very competency of Jerome Powell and the members of the Federal Open Market Committee (FOMC). Was their assessment of economic conditions so off-the-mark that the institution needed to send policy in the opposite direction?

But above all, how independent is the Fed in the face of the executive power wielded by the White House? Would the members of the FOMC have given in to President Trump’s unrelenting criticism and his calls for lower interest rates? If so, then this can only shake investors’ confidence in the central bank of the world’s largest economy.

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Inconsistency and chaos

Even though the 2020 presidential election is a year and a half away, it is already garnering far too much attention in the news. Clearly the performance of equity markets has been a significant help to President Trump. His re-election in 2020 seemed unlikely just a few months ago, but it is now a distinct possibility.

The ongoing inconsistency in the Oval Office and the chaos filtering out of the West Wing of the White House continue to defy understanding. As he draws strength from the undying loyalty of his supporters, the President is unlikely to change his ways and restore dignity to his office.

The battle that has begun with the Democratic majority led by Nancy Pelosi is therefore expected to be merciless, on both sides. Over the next few months, financial markets risk being seriously disrupted by these political tensions in the United States. This could very well create a favourable environment for our arbitrage strategies. Once more, the need for increased portfolio diversification can be satisfied by adding uncorrelated and low volatility strategies such as those of the Amethyst Arbitrage Fund.