REFLECTION

4TH QUARTER 2018 REVIEW

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SUMMARY

AMETHYST ARBITRAGE FUND

What a tumultuous quarter!

By mid-December stock markets had become so volatile that the financial markets were under a cloud of fear. Despite a rally that began on Christmas Eve, the markets racked up record losses for the month of December and were down sharply for the year. At year end, the S&P/TSX composite total return index was down 5.4% on the month, and down 8.9% on the year. The bond markets were also buffeted from all sides.

The Amethyst Arbitrage Fund nevertheless held up. By limiting its losses in December and posting a more or less flat return for the quarter, the Fund served its investors well by diversifying their portfolios.

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MARKET EVENTS

For Crystalline the quarter was nothing short of exhilarating. We added 37 new positions, and many of our existing deals finally closed. And since December's high volatility considerably increased deal spreads of several M&A transactions, we took advantage of these bargains to increase some of our positions.

Unpleasant surprise

Of course not everything could be perfect. On December 5 we had a nasty surprise. The State of Washington's Public Utilities and Transportation Commission (UTC) rejected the proposed merger of Avista Utilities with Hydro One. Their reason? That the Government of Ontario has a 47% stake in Hydro One. The Premier of Ontario, Doug Ford, had forced out the CEO of Hydro One, Mayo Schmidt, leading to the resignation of the entire board of directors. According to the UTC, this demonstrates that Doug Ford is willing to put political interests above those of shareholders. But the merger proposal indicated that Avista, in becoming a wholly owned subsidiary of Hydro One, would continue to be run out of its Spokane, WA head office, with the same name, the same management team and the same staff...

ANNUALIZED RETURNS, NET OF ALL FEES, as of Dec. 31, 2018

	AMETHYST Onshore	AMETHYST Offshore	HFRI Conv. Arb.	HFRI Merger Arb.	HFRI Event Driven
Last quarter	-0.4%	-0.9%	-4.7%	0.1%	-5.2%
Last 12 months	-2.2%	-3.7%	-3.9%	6.0%	-0.5%
Since inception	8.1%	7.1%	5.8%	5.4%	6.8%

CONVERTIBLES SECURITIES

It came as quite a relief to finally be able to invest at reasonable prices. We had held back for much of the year, since we considered many convertible securities to be overvalued. Credit spreads had been narrow for several months, but the stock market decline brought valuations back to more attractive levels. The correction was particularly severe in the energy sector.

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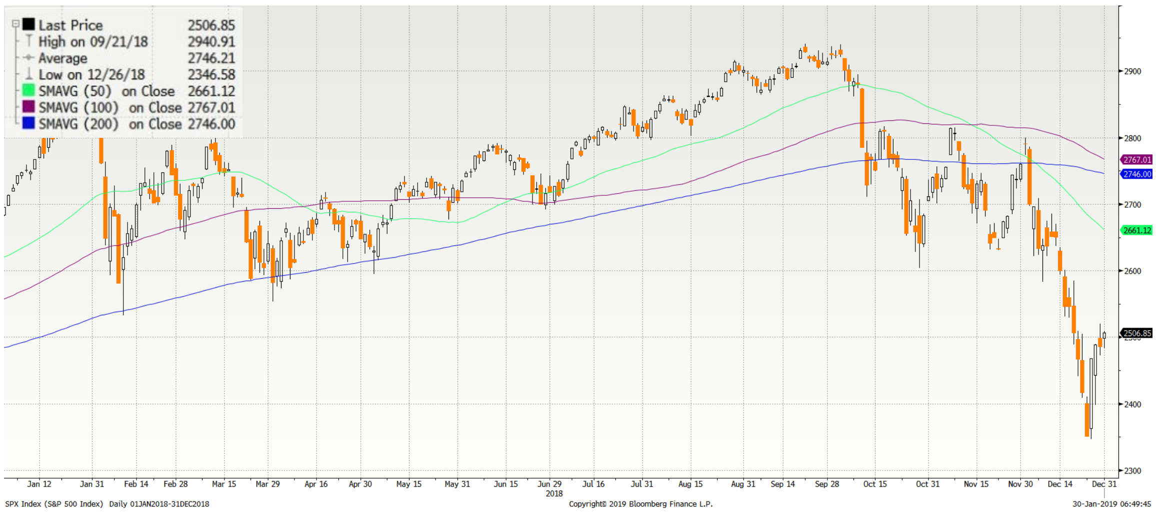
CANADIAN MANAGER OF ALTERNATIVE FUNDS, SINCE 1998

1002 Sherbrooke Street W
Suite 2110
Montreal (Quebec)
Canada H3A 3L6

TEL. +1 514 284 0248
info@cristallin.ca

S&P 500 Index



Rather than sell off our core positions, we instead add to them when prices slipped during the quarter. We expect that following the recent weakness, prices will rise in the New Year.

Sources of Returns

There are three factors that generally determine the return on our convertible security activities, and two of them contributed to a positive return for the quarter. First, there is the "in–and-out" activity, i.e. buying and selling a position, of which there was more of due to market volatility. But there was also a positive carry, as is usually the case in this type of transaction, which heightened the return. The third factor is credit spreads, which unfortunately widened, eating into our profits for the quarter.

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FIXED INCOME

The fixed income market did not escape the volatility in recent months, either. What was most striking was a highly unusual widening of provincial spreads, much like during the 2008 financial crisis. Our portfolio suffered as a result of this unusual behaviour by provincial bonds. One explanation is that when investors want to "sell credit", they generally sell provincial bonds, which are more liquid than corporate bonds. This was the case over the last few months, as the volatility almost paralyzed the corporate bond market. Since November, the rush to sell provincial bonds has caused spreads on 10-year Government of Ontario bonds to widen by 20 basis points. These wider spreads were also the cause of last quarter's negative return in the fixed income segment of the portfolio.

Market Reversal

Our directional positions produced a positive return. The problems in the equity market made bonds more attractive to investors. Starting in November, we added long positions, and they served us well. It should be recalled that approximately six months ago, the yield on 10-year U.S. Treasuries rose above 3% and seemed destined to stay there. But this is far from what happened, since they fell back to 2.55% in the darkest days of the market rout.

Will investors return to the credit sector? For now the answer remains elusive, but this issue will surely influence performance in the next quarter. For the next 1 to 3 months, we will probably have to live with high volatility. But a slowdown in the economy, even a modest one, should help support the bond market over the next quarter.

THE ECONOMY AND FINANCIAL MARKETS

The global economy continued to grow in the last quarter, but that did not prevent a severe correction in the stock markets. It had been expected for some time and finally arrived in the fourth quarter. The correction was severe and affected almost all sectors. For many investors, it wiped out all their gains in 2018, which had been a relatively good year up until then. Almost all classes of financial assets posted negative returns for the last 12 months.

The Economy Continues to Grow… at a Slower Pace

Although the U.S. economy grew less strongly than in previous quarters, the growth was nevertheless healthy. GDP growth is expected to be 2% to 3% for the last quarter of 2018. The Canadian economy also continued to grow. Here we are talking about 2% GDP growth in 2018, but there is slightly less enthusiasm going forward, due to the sharp drop in the price of oil. Stephen Poloz, the Governor of the Bank of Canada, has already announced that the Bank has revised its growth forecast for 2019 to 1.7%.

In Europe and Asia, the economic environment

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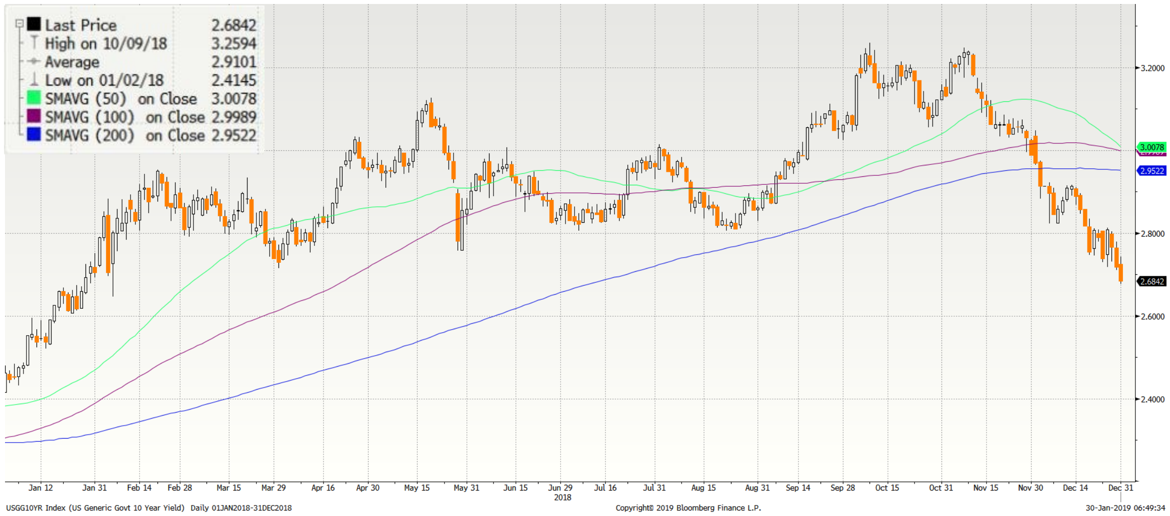
U.S. Treasuries - 10 Year Yield



remains strained and the pace of growth is slowing. Growth has been anemic, particularly in Germany, where the economy is thought to have just avoided a technical recession (i.e. two consecutive quarters of negative economic growth). Following a third negative quarter (- 0.2%), Germany's fourth-quarter growth is expected to have been between 0.1% and 0.3%, as estimated by economists. As for the emerging economies, most have suffered from the strength of the U.S. dollar.

The Fed Amplifies Volatility

The lack of consistency in comments made by Jerome Powell, Chair of the U.S. Federal Reserve, only seemed to heighten market volatility. He is thought to have triggered the market decline in October and November when he said that interest rates were still far from neutral. This led many to believe that several more rates hikes were coming. President Trump, as is his habit, added fuel to the fire by missing no opportunity to call the Chair of the Fed incompetent and by demeaning the Fed's monetary policy. But on November 28 Mr. Powell surprised market participants when he suggested that we were close to the neutral rate, even though two months had passed since the Fed's last hike. A fevered climate took hold in the stock markets, but it was not to last. Just one week later they were jittery again, and the Dow Jones plummeted 800 points in just a few hours.

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Happily, the Fed seems to have recovered control on December 19 by raising the target for the federal funds rate by 0.25 points, despite repeated warnings from President Trump not to do so. The hike was relatively well received, in particular since Jerome Powell used the press conference to suggest that the Fed may take a break from its normalization of interest rates.

As for the Bank of Canada, Governor Poloz's comments in early December leaned toward caution, and at the Bank's last meeting of the year it refrained from raising interest rates.

Still no recession in sight

Even though the purchasing managers' indices (PMIs) continue to trend downward from their peaks in the fourth quarter of 2017, with some now below the psychological barrier of 50, our models show the probability of a recession in the next 12 months in Canada, the U.S. and China at only about 20%.

As for inflation, there are no signs of any significant acceleration, despite very low unemployment rates. The drop in oil prices is certainly an indication that inflation is contained.

In international trade, the China/U.S. dispute remains in deadlock. Since the spring China has responded firmly to the U.S. President's insults and tariff increases by announcing similar tariff hikes. President Trump nevertheless began an attempt at dialogue by declaring a 90-day delay on any new tariffs.

OUTLOOK

Will Washington stop tearing itself apart?

The arrival of a Democratic majority in the House of Representatives was probably a good thing as a way to bring some order back into the country's economic and political management. President Trump, who was already having considerable difficulty advancing his program, despite Republican majorities in both houses of Congress, now finds himself facing down a seasoned politician, Nancy Pelosi. She is determined to confront the chaos that has reigned in the White House for the last two years. But this will not be an easy task. A prime example is the budgetary deadlock that lasted 35 days and led to the closure of a portion of the public service on December 22. Even though government workers are back on the job, the issue has not been settled and another confrontation on the issue is set for February 15. The President is already weakened by an approval rating below 40%. How stubborn will he be in order to hold on to the support of his base? Can Nancy Pelosi develop some sort of dialogue to end the budgetary deadlock? Its effects on the economy will begin to show if an agreement cannot be reached soon. Unfortunately there is no reason for optimism at this time. Will this first power struggle between the President and Madam Speaker be followed by other, equally tough confrontations? Given the track record of the 45th president over the last two years, we should expect the worst.

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Has there been a change of direction at the central banks?

As one might have surmised at the beginning of the year, the Fed announced four interest rate hikes in 2018, in March, June, September and December. A few months ago it seemed as if this normalization of interest rates would continue in 2019, but market participants' expectations have changed significantly over the last few months. At the end of the third quarter there was still talk of three rate hikes over the next 12 months, but since the hike in December all talk of more increases in 2019 has disappeared. Have market participants gotten it right, and there has in fact been a change of course at the Fed? In addition to inflation, employment and economic growth, the outlook for interest rates will soon need to take another factor into account: the next U.S. presidential election in November 2020. Even if the economy continues to do well, the risk is that Donald Trump will exert even more pressure on the Fed to stop the rate hikes.

The Bank of Canada's decisions will depend on economic conditions. Given the drop in oil prices, which can only have an adverse impact on the Canadian economy, and the fragile stock markets, we are less and less convinced that the Bank of Canada will be able to raise its key interest rate in 2019.

Brexit: The Deadline Looms

The British Parliament has been in the headlines often over the last few weeks. Prime Minister Elizabeth May has been unable to find an acceptable compromise that would allow the United Kingdom to harmoniously leave the European Union. But she won a no-confidence vote, and she is the one who will now need to orchestrate the March 27 separation, with or without an agreement with the European Parliament. Between now and then, anything could happen. But one thing is for sure: it will not give a boost to stock markets on the Old Continent.