# REFLECTION

## 3rd QUARTER 2016 REVIEW

CRYSTALLINE MANAGEMENT

Canadian Manager of Alternative Funds, Since 1998



### ECONOMY

Until recently, the expansion of global central bank balance sheets seemed condemned to increase indefinitely. But (thankfully), monetary policy makers have had a serious wakeup call: quantitative easing ("QE") is less and less economically effective and potentially harmful in the setting of risk premiums via negative short-term interest rates.

The Bank of Japan ("BoJ") has already put an end to its infinite quantitative measures, by replacing its balance sheet objectives with a 0% long-term interest rate target. Even some of the Governing Council members of the European Central Bank ("ECB") are questioning the practical limits to bond purchases, while other members want to end the current practices in light of economic improvement[1]. The US Federal reserve, meanwhile, stands alone contemplating a first rate hike by the end of the year, bolstered by a relatively healthy economy.


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In the UK, the effects of "Brexit" have been less pronounced than expected in light of the postponement of European Union exit negotiations to March 2017. However, the consequences should nevertheless influence markets over the coming quarters, since the negotiation of terms will begin this spring with an expected two year deadline.

OPEC Agreement Pushes Crude Above 50$


According to Atlanta Federal Reserve Bank estimates (dated October 5th), the US economy grew at a seasonally adjusted annual rate of 2.2% in the third quarter. Leading indicators remain positive and employment is strong.

The price of oil has fluctuated widely in response to numerous rumors about a possible production cut. An informal agreement was finally reached at the end of the quarter, as OPEC committed itself to reducing output to between 32.5-33m b/d.

[1] Financial Times of London


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Although investors continue to cling to the accommodative monetary policies that have buoyed markets since 2008, they will have to get accustomed to the new reality. The ECB and BoJ will try to pass the torch to their respective governments, who in turn will enact expansionary fiscal policies (infrastructure projects for example). With respect to the Fed, it will aim to raise its benchmark rate by 0.25% before the end of the year, probably in December, with two more hikes to follow in 2017 and long-term rates expected to.

The US economy is expected to continue along its growth trajectory, albeit at a modest pace, in the next 6 to 12 months. Anything over and above moderate growth will have to emanate from one or more of the following contributors: a reduction in the savings rate, a rise in wages, growth in capital expenditures and expansionary fiscal policies. However, before these potential growth catalysts can materialize, we will have to await the US presidential election outcome. In the end, the US remains the safest option for investors: interest rates are comparatively higher and the risk of recession is lower. However, volatility will be pervasive.

## AMETHYST ARBITRAGE FUND

### *Event Driven Arbitrage*

The Chinese Ministry of Commerce («MOFCOM») and the State Administration of Foreign Exchange («SAFE») continue to approve transactions at a very slow pace, but have finally ratified Starwood Hotel's acquisition by Marriott and the foreign exchange outflow for Bankers Petroleum, two months late, however. These delays require arbitrageurs to factor into their analysis a much later closing date for transactions needing approval.

By contrast, the Committee on Foreign Investment in the United States ("CFIUS") surprised investors by giving its support to the purchase of Lexmark Intl. by a consortium of Chinese buyers. This approval lead to a reduction of deal spreads for all transactions involving a Chinese buyer. Previously, as result of potential regulatory denials, these deals were perceived to be riskier.

A reduction in merger and acquisition activity, in Canada as well as in the United States, also created a tightening in deal spreads. Arbitrageurs are faced with limited opportunities to deploy their capital.

Deal spread compression, combined with the risk surrounding the US presidential election and the recent 10Y yield increase, leads us to be prudent in our capital redeployment. We are maintaining 10 to 15% of our capital utilised to better face potential headwinds, as well as profit from buying opportunities. In the meantime, our M&A sub-portfolio remains well-diversified across some 50 situations as of September 30.

### *Convertible Securities Arbitrage*

The good performance of the sub-strategy over the third quarter is partly due to its structural carry, on top of the small tightening of credit spreads. Despite a slight retracement of spreads in the latter part of September, we are still well ahead, performance-wise, from the end of Q2. Volatility in the middle and latter part of the quarter contributed positively to overall performance. No additions of positions were made to the portfolio during the quarter, already well hedged and built around high quality credits.

We continue to review and rebalance credit risk, valuations, the risk budget and opportunities for dynamic profit taking, with the objective of reducing and diversifying risk. We continue to seek opportunities to deploy capital in both the Canadian and US convertible markets, employing the criteria we have found to be profitable.

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Our warrant positioning remains stable and some offer portfolio protection in the event of a financial crisis. We continue to use options to enhance the risk-reward profile of the overall portfolio.

### *Fixed Income Arbitrage*

Unlike the first two quarters of the year, volatility was rather limited during the last three months. Despite a significant narrowing since the start of the year, agency and provincial credit spreads remain attractive on a historical basis, especially in the 3 to 10-year segment. Like in the second quarter, corporate spreads are not attractive enough to warrant anything other than a minor position in the portfolio.

The strategy's performance was positive during the quarter, helped by spread compression, however minor. Our curve flattening positioning, both in Canada and in the United States, was profitable up to the beginning of September. Since then, yield curves have steepened in most markets. A strategic reversal of our positions towards steeper slopes is to be expected sooner than later.

The credit strategy used 65% of its risk budget, on average, during the third quarter, a decrease from the first two quarters. A put spread hedge (maturing in November) was taken on the US equity market ("SPY").

**Rate Hike Expectations Undermine Bullion**


Strategically, we do not feel any urgency to add positions, and are waiting for better conditions. Since the Brexit vote, risky assets have not been volatile and their demand has stayed strong. Nevertheless, we are entering the fourth quarter with numerous potentially disruptive factors: the US elections, crude prices, rate hikes and a steepening of the curve that will follow.

## EMERALD GLOBAL-MACRO FUND

The Emerald Global-Macro Fund's performance was negative during the third quarter, an underperformance attributed to a difficult September. At the outset of the month, a strategic short reversal in both the bond and stock markets hurt the strategy. Expectations of a yield rise and market correction did not materialize within our predicted time horizon.

Despite being positioned for a rise in crude prices, its ups and downs in September hurt performance. The same absence of a clear trend in gold prices led us to rethink our positive views.

Despite the emotionally charged nature of the upcoming negotiations, a soft Brexit is our predicted scenario, which explains our long-term long position on the British pound against the Canadian dollar. In the short-term (last quarter) though, this position went against us.

Tactical positions were eliminated due to the volatility in many assets. We are currently reassessing our tools for evaluating these types of trades.

Sizable volatility in most asset classes is to be expected in the coming months. Events to watch for are plenty:

1. US elections: besides the choice of President, control of Congress will be key

2. Central banks: monetary easing shall gradually make room for fiscal easing in Japan and Europe, and a rate rise is expected in the US before year end. We expect a rising and steepening yield curve, without falling into a secular bear market. Equity markets will bear the brunt of the end to quantitative easing, which has supported valuations since 2008.

3. Oil: an informal deal was reached at the end of September. If maintained, we could see a return to a 55-60$ range before the end of 2016. This in turn would lead to increases in capital spending within the industry, cement a positive inflation rate, and push higher long-term yields.

Global growth will remain relatively modest in the coming quarters. The probability of a recession is low in the US, but capital spending is weak. Corporations can support valuations by rising dividends and reducing the cost of capital, but without reinvestment to support future growth, these will remain stretched.

With the recent change in rhetoric emanating from central bankers concerning QE, our strategic views on the bond market supports a short position on 75% of the net value of the portfolio (through 10+year contracts in Canada, the United States, Germany and the UK) and a steepening of the curve.

We maintain a long position on crude. The recent OPEC agreement and reserves correction points towards a 55-60$/barrel price. As for other commodities, we maintain a positive view on copper, but are negative on gold and gold producers, in anticipation of a US rate hike.

A modest long bias is kept in the stock market (10% of the portfolio) as volatility will remain high around the November US elections. Insurance through put options maturing in mid-November and mid-December will protect the portfolio from political or rate shocks.

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In view of rising US rates, a soft Brexit and more fiscal stimulus coming from Japanese policy makers, we are keeping long positions on the US$ against its basket ("DXY"), on the Japanese yen against the US$ and on the British pound against the Canadian dollar.