JEMEKK
HEDGE FUND
Q4 2017 COMMENTARY



Frank Mersch, CFA
Portfolio Manager

Gerard Ferguson, CFA
CEO, Portfolio Manager

Rick Ummat, CFA
Portfolio Manager

Over the last quarter of 2017 the fund achieved a 4.07% return. While slightly behind the TSX (4.45%) it never the less achieved the results we forecasted. At year end the fund declared a distribution of 11% for both classes of units. We opted to realize gains on some long-term holdings such as Kinaxis, Decartes, Altus and Savaria. Kinaxis and Decartes were completely sold while we continue to hold a third of our positions in Savaria and Altus. While we are not negative on the names we just felt their valuations were stretched.

Below is a statistical representation of the Fund to comparative benchmarks in Q4:

	Q4 2017	YTD 2017	SINCE INCEPTION
Jemekk Hedge Fund	4.07%	1.99%	571.54%
S&P/TSX Composite	4.45%	4.45%	244.02%

Benchmark is quoted in Total Returns

As we stated, the fourth quarter typically is better for cyclicals and that was somewhat the case in 2017. While we saw a rebound in the commodities, it still appears that the stocks are lagging the underlying commodities. We would expect equities to catch up in the first quarter of 2018. With the likelihood of further rate hikes, we also feel that the Canadian financials will continue to provide high single digit to double digit returns in the coming year. Thus, we have employed a barbell approach to the market with Materials (ex gold) and Energy weighted on one end versus Financials on the other. The area we have missed has been the highly speculative marijuana stocks. While we invested in Aphria at its early stages we exited way too early. With total market values exceeding $30 billion as we write this commentary, we believe the group exhibits all the characteristics of a mania we have seen many times over the years. Similarly, the crypto currency craze shows us that we are entering bubble like territory. While we believe in blockchain technology we have yet to see any real companies in Canada. Until a protocol is developed, we would rather be on the sidelines.

In our last quarterly we put forward our key themes. Let us revisit them and perhaps add a few new ideas as well as risks for 2018.

1. **Global growth synchronization -** real GDP growth in the US will accelerate to 3.0% plus. Canadian growth surprisingly remains strong supported by good Canadian employment numbers. Europe continues to rebound led by German retail sales and strong industrial manufacturing. In Asia, China appears to be reaccelerating while the Japanese economy continues to rebound strongly. With Asia, the U.S. and Europe all on the upswing the growth synchronicity story is still intact.

2. **Continued stimulative monetary policies -** outside the US and North America, nothing has changed yet. The ECB will likely stick to its declared plan to continue quantitative easing at a reduced pace. We consider this stance to be accommodative relative to the strong expansion dynamics in Europe. Japan at this juncture has not raised rates despite strong productivity gains and slowing wage restraints. However, we do see some hints of inflation ticking up. As such we perceive a risk that the status quo may be broken. We believe that global bond yields have been anchored lower because of the Bank of Japans peg on their government bond yields, but should this peg be tested it sets in motion the likelihood of higher global rates, a phenomenon not seen in quite some time.

3. **Positive Earning Outlook -** Even without the tax cuts the US is poised to have exemplary earning growth in the 4th Q (+10%-14%). As such we now see a boost to a broader base of companies that will benefit (industrials, heath care, financials, etc.) In fact the tax cuts are forecast to lift US GDP by 1.1%. Further deregulation will likely add to growth as shackles are

removed. As a result of these factors bottom up consensus numbers for S & P earnings in the first Q are now 13.7%.

4. **Odds of US Tax cut -** Well it got done and now the question is how long lasting will it be. Will trade issues wipe out some of the gains, and how long will the honeymoon period last?

5. **Low risk of Recession -** While it is likely we will see some interest rate hikes in 2018 at this juncture we believe everything is as it has been. Rates have not accelerated to 3% on the 10 year as of yet and the peg is still in place, although rhetoric regarding a de-pegging is growing.

6. **Time for Canadian stocks to wake up -** Outside of marijuana stocks, the Canadian market attracts very little interest from non-residents. While we will derive benefits from US economic activity we believe Canadian investors remain fixated on prior cycles and are missing the fact that Canada is increasingly aligned in terms of earnings and GDP growth with the US. In our last piece we talked commodities and while both energy prices and metal prices have gone up on average 20% the underlying securities have not participated, much to our disappointment. In the case of the oil & gas stocks, the gas glut continues to weigh heavily on the group. On the oil front, the lack of transportation and access has created a bottleneck. As such the differential between Canadian crude (specifically heavy oil) and US crude continues to widen. Our policy to not expand our end markets is now coming back to bite us. Having said that crude oil remains in a strong, stable and structural position consistent with global growth. In this environment there is still growth opportunities in some names, but it is important to be selective and nimble. As a result of transportation issues, we will continue to focus on oil and US centric drillers.

Finally let us look at some new themes that could evolve.

1. Emerging Market / Commodity Currencies are in a strong position consistent with global growth.
2. 2-year yields surge while 10-year yields have subdued.
3. Continued weakness in the US dollar.
4. Health Care rebound and outperforms.
5. NAFTA is given the boot, but Congress and the Senate fails to ratify.

On the risk side - what can go wrong

1. **Inverted yield curve -** it is imperative the Fed moves the long end higher to avert an inverted yield curve (which typically signals the end of a bull market) while still trying to achieve normalization. We will keep an eye on Japan.
2. **Inflation-** while we believe there are some transitory spurts to inflation, we continue to see technology as a brake. Never the less concerns are likely to surface, impacting capital markets.
3. **Regulation -** specifically in the Tech sector. Will roll back of net neutrality cause volatility? Does Europe impose restrictions? Is Amazon, Facebook, and Google impeding innovation and thus a case for censure?
4. **Geopolitical -** Does middle east erupt? Does Trump rollback Obama Iran Deal? Does Venezuela default and spiral into chaos? Can the President survive?
5. **US dollar rallies -** consensus is that we can expect further weakness in the US dollar. If it rallies does it create headwinds to multinationals?
6. **Trade -** NAFTA and trade wars have never been good for markets. Does Trump move from NAFTA to more isolationism? Early indications are yes.
7. ***Melt-up -*** Meltdown - fear of missing out (FOMO) is becoming more and more popular. Are we at the blow off stage?

Strategy

Our view is that we are in the most speculative period for the markets. While these periods tend to last longer than most expect they invariably lead to a correction. Given the earnings, consumer confidence and complacency a melt-up is likely to occur. As such we are likely to stay invested but recognize that valuation risks are on the rise. Given our view that rates are likely to rise we have positioned the portfolio as follows:

Financials 32%, Materials (ex gold) 9.0%, Consumer/ Communication 11%, Energy 17%, Industrials 17%, Technology 7%, Cash 7%.

On any rallies we are likely to decrease out commodity weighting due to seasonal factors. Typically, materials register their best gains in the first quarter. Barring any geopolitical events, we still believe oil is in a trading range albeit at higher levels and thus will trade the rallies. We are quite sanguine about gold. We currently have only a very small position in Franco Nevada and B2 Gold which we are like to trade. From this commentary you should expect liquidity to remain pertinent and for us to adjust the portfolio on short notice as the year unfolds.

As an aside, we thought it would be worthwhile to address the Cannabis Mania. The marijuana sector has been on a tear and while we believe the business is for real, we believe the securities are exhibiting bubble characteristics. The sector has exploded since the Constellation Brands investment in Canopy(weed)and daily volatility has gone through the roof. So, lets do some research. KPMG has issued one of the most comprehensive studies on the industry in our opinion. The study suggests that in 3 to 5 years, the market will mature at an

$8 to $10 billion-dollar industry. For a point of reference, the current size of the black market is approximately $5 billion.

First lets' do some valuation work.

ASSUMPTIONS

• Black market goes from $5 to $2 billion. Given that the black market pays no tax we do not believe it goes completely away.
• Taxes matter. The Feds take the greater of 10% or 1 dollar plus HST/GST and provincial tax. If the retail price is $9.00. Thus, the net revenue to the retailer is $ 9.00 – $1.00 -$1.17(13% of $9.00) = $6.83
• Stores (distributor) will require 100% gross margin (likely low) $6.83 X 50%= $3.415
• Gross industry revenue in a 10 billion industry would be $3.48 billion.
• Cost to produce. Many producers believe they can produce at $1.00 to $1.25 per gram. This means the industry could generate approx. $2 billion pre-tax profits.
• To produce 7500 g you would require 100,000sq ft. At 10 billion of sales the industry would require approx. 11 million sq. ft.
• To date announced planned capacity is 17 million sq. ft. likely to be 20 million sq. ft. plus

Based on plans the industry will soon have **OVERCAPACITY**

A recent report, provided an update on Canopy and Aurora with respect to valuations. It stated that Canopy with $7 bn of enterprise value sits at 43X 2021 EBITDA, and Aurora with $6 bn EV trades at a 46X. Compare this with other sin names tobacco 12.9X and alcohol 15X. Conclusion; while we believe this will be a highly profitable industry we believe caution is warranted and thus have limited our exposure to the group.

Finally, an update on the transition to Jemekk. Although changes from the outside may seem minor, if at all noticeable, in fact the Fund has benefitted from the transition. As the responsibilities of managing other Funds have been lifted, and the entire focus has been on Jemekk Hedge, the Fund has enjoyed a good 6 months since the transition. The Jemekk team, led by Gerard Ferguson and Rick Ummat, have become increasingly involved in the day to day management of the Fund, a trend that will continue as the Fund progresses. They look forward to reaching out to investors in the coming months and will continue to add to the Fund's ability to generate returns that investors have come to expect. Although the Fund's strategy remains unchanged, there will be operational changes behind the scenes that we will keep investors appraised of, such as an expected change of Auditors from Deloitte to KPMG for the 2017-year end. We wouldn't expect this, or any of the other operational changes, to impact investors, but are cognizant of disruptions and their impact on unitholders. In the meantime, feel free to reach out to me, or anyone on the Jemekk team, at our contact details below.

We look forward to reporting to you again at the conclusion of the first quarter of 2018.

Frank Mersch 647- 341-2700
Gerard Ferguson 416-777-4491
Rick Ummat 416-777-4496