JEMEKK HEDGE FUND

Inception date: August 1999
Q2 2019 Commentary

	Q2 2019	YTD 2019	Since Inception
Jemekk Hedge Fund	0.09%	7.85%	520.74%
S&P TSX Composite	2.58%	16.22%	280.52%

**Benchmarks quoted in Total Returns*



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Following the best first half of the year for the S&P 500 since 1997, the narrative has changed from the Fed increasing rates coming into the year to now cutting rates. The markets have rallied in the past couple weeks anticipating a rate cut as early as July, a complete 180 from 6 months ago. The markets are going up on bad news in an attempt to force the Fed's hand to begin easing for the first time since 2008. In terms of performance, major North American indices continued in Q2 where they left off in Q1. Specifically, the TSX was up 2.6% and the S&P 500 was up 4.3% in Q2. Never pleased with underperforming, the Fund was relatively flat as a result of hedged positions and other specifics we will address later in the commentary.

After a very strong Q1, the second quarter started off again very strong but that all came to a screeching halt in early May when Trump ("Tweeter-in-Chief") threatened new rounds of tariffs. This scenario has plagued the markets for some time now. Meaning, the market is now trading off Trump's tweets, a medium he uses to spew off anything that comes to mind. We have long said the market continues to overshoot on both sides. May gave back almost all of April's gains for the TSX – another 'V' shaped move. In terms of performance, the TSX showed good breadth with strong gains from Technology, Material, and Consumer Cyclical sectors, while detractors came from Health Care (cannabis related stocks namely) and Energy. In Q1, the top 10 performing stocks were cannabis related whereas in Q2 there were no weed stocks in the top 10 possibly signaling investor fatigue in the space. At the time of writing Bank of Canada has made its July decision to keep benchmark rates at 1.75%. BoC halted rate hikes as of April, a decision we agree with based on the health of the current economy. 2020 growth projections ticked down and inflation is expected to remain close to 2%, which is within the bank's target range.

The economy performed reasonably well over the first half of 2019, and the current expansion is now in its 10th year. However, inflation has been running below the Federal Open Market Committee's target of 2% and crosscurrents, such as trade wars and concerns about global growth have been weighing on economic activity and the outlook. But there has been a growing disconnect between equity markets and growth signals. North American markets have been marching higher as Fed loosening has now become almost certain. But can the stock market continue to rise as global economic growth slows threatening corporate profit growth, a chief driver of market fundamentals? The market has 100% priced in a July cut but it takes approximately a year for the effects of a rate move to impact the economy, meaning, some of the rate hikes from last year are technically not in the market yet. The case for rate cuts stems from the widespread belief that the US economy will cool in the next couple years as the 10-year expansion comes to an end. After tax cuts ignited growth in 2018 the pace of expansion has been moderating. The trade 'truce' reached in June between Trump and Xi was a positive for the markets as it removed some of the ongoing uncertainty between the two countries. We say 'some' because the previous tariffs are not being rolled back; this agreement was merely to continue negotiating and not invoke the then upcoming new round of tariffs. We view this as a short-term win at best with the potential of increased rates and new rounds being initiated. Presently, there are 25% tariffs in place on US$250b of Chinese exports to the US and 20% tariffs on US$110b of US exports to China.

The Fund entered Q2 on a bullish tone (75% net long) as exposure increased systematically throughout Q1. However, as Q2 unfolded and material macro and geopolitical risks emerged we decreased our exposures ending Q2 net long 62%. Never pleased with reporting an underperforming quarter the Fund on a year to date basis is performing as expected given its hedged nature.

On the performance side, we had strong gains from Shopify and Air Canada while our Energy holdings impacted our P&L negatively. On a net long basis, we are at average historical levels which for the time being we are comfortable with given how well North American markets have performed while uncertainty such as trade tension remains. Given the buildup in cash as a result of the neutral positioning currently, and relatively miniscule overnight cash rates, we have begun to build a portfolio of Preferred Shares which offer a greater return, as discussed below.

The Fund has begun to purchase a basket of Perpetual Variable Rate (PVR) Preferred shares as they appear to be trading at valuations that are not congruent to their competitive yields (6-7%). The concept is that the Pref's currently offer a competitive yield at their par value levels relative to prevailing market interest rates because dividends are regularly adjusted based on interest rate benchmarks (i.e. variable). However, the relationship with benchmarks (be it, Bank Prime, Gov't of Canada 3-month T-Bill or 5-year bond rates) partially broke-down in 2015 when already historically low interest rates took an additional step lower. The current highly competitive yields not only provide an attractive alternative to the Funds' recent higher cash balances (which offer closer to 1% - 2% yields), but at their substantial discounts to their par values we see the potential for capital gains over the medium term to be positive. In addition, they offer a hedge against higher rates as they should appreciate if and when rates eventually begin to tick higher (although not expected currently) and could approach their par values in a more normalized environment. This combination offers capital appreciation and attractive income generation.

At the time of writing the S&P 500 hit 3,000 for the first time after surpassing 2,000 five years ago and the Dow Jones hit 27,000. With the strongest first half in equity markets in decades the market has already priced in a rate cut at the end of July. This shows us the markets and economy don't need to move together and can diverge especially when we look at central bank activity on a global scale. So, where do we go from here? The markets will surely welcome a rate cut because, by definition, it will increase the value of stocks, but this only lasts so long, and the cuts need to stimulate corporate spending or else the cut will have no real economic effect. We feel the back half of the year will be more volatile than the first half as a lot is seemingly being priced in. We remain committed to sourcing the best risk adjusted returns for our loyal clients.

We have written before we believe we are in a late cycle environment and WCN fits in nicely with this backdrop. In the quarter we met with management at a conference in Orlando and we came away bullish on the stock. WCN is positioned well as pricing continues to trend positively and recycling headwinds are largely passed. Potential risks to WCN are wage inflation and capacity constraints, but net/net we continue to stay positive on the waste business and prefer to play it by owning WCN as it has industry leading metrics (i.e. FCF conversion) executed by the best management team in the business.

One last operational note is on our growing team. Michael Lam has joined Jemekk in the second quarter of 2019 from another Toronto-based hedge fund who also has a long track record in the North American investing space. A generalist, Michael brings a deep knowledge base from both the buy and sell-side of the street across many sectors and types of securities. We look forward to sharing his ideas and contributions with you in future commentaries.

Thank you for your continued support and we look forward to reporting to you at the end of the third quarter 2019.

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