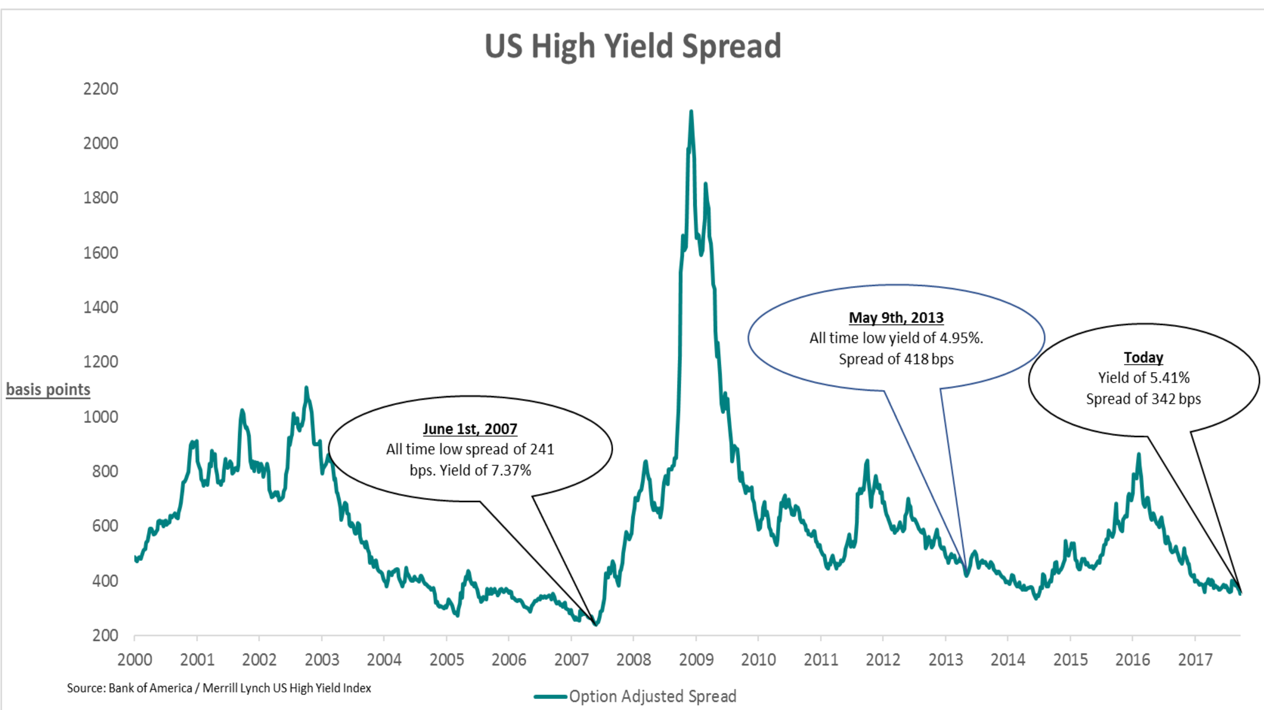
October 24th, 2017

Fulcra Credit Opportunities Fund

Q3 2017 Commentary

Year to date, 2017 has blessed most risk asset classes, such as equities and commodities, with robust positive returns and in the case of equity indices, all-time highs! Additionally, in the last few weeks the VIX index[1] has hit an all-time low and closed below 10, three times more than in the previous 28 years combined! We are not suggesting that this backward indicator is telling investors that negative returns are around the corner, but we do think a fair bit of complacency has overcome markets.

Couple this feel good back drop with the presence of Halloween and, superstitiously, it feels like a Freddy Kruger capital markets moment is lurking right around the corner. While we aren't the first to highlight this sleepy eerie feeling that has blanketed capital markets, the capital protecting pragmatic contrarian in us is saying heed the warning.



[1] CBOE's Volatility Index (ticker: VIX) measures volatility of S&P 500 index options

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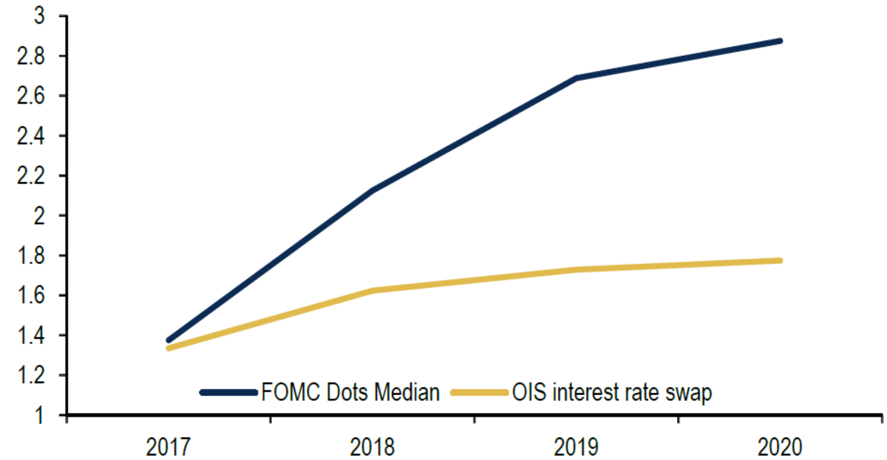

Source: BofA Merrill Lynch Global Investment Strategy, Bloomberg

More specifically, the yield[2] on US High Yield bonds[3] at 5.41 % as of Oct. 20th, is less than half a percent above the all-time low yield achieved in the 2nd week of May 2013. Back then, the yield on High Yield bonds didn't stick around the 4.9% range for long as later that month a fellow by the name of Ben Bernanke started what is now known as the "Taper Tantrum". Between May 9th to June 25th, 2013 High Yield bonds dropped 6 percent. Investment Grade bonds[4] , not wanting to be left out, fell 6.2 percent over this same period.

While yields today are not quite as low as they were back in 2013, the additional yield ("spread") investors are receiving over government bonds today is less than it was in May 2013. More precisely, at a yield of 5.41% today, investors in a High Yield index are receiving 342 bps more yield than government bonds versus 420 bps in the 2nd week of May 2013.

Today's near all-time low yield environment coupled with tighter spreads than May 2013 has us concerned about longer duration income markets, including credit markets. Corporate bond ETF's of both the High Yield and Investment Grade variety, in our opinion, are at that point of the Grand Canyon like tight rope walk where turbulent winds may arise.

This low interest rate environment has made investors acutely aware of the fees they pay. We suspect that for many this has is more important than the risk of long duration "group think" ETF's where most of these market leading low fees sit. Market timers we are not. It would seem, however, a ghoulish outcome for fixed income markets has reached a level of probability where a healthy dose of caution is warranted.

[2] Yield to Worst
[3] Bank of America/Merrill Lynch US High Yield Index
[4] Bank of America/Merrill Lynch US Corporate Index

The graph to the right highlights the difference between what the Federal Reserve Board (blue line) expects the level of the Fed Funds Rate to take versus the market (yellow line). The difference in expectations of over 100 basis points in 3 years' time is too wide, in our opinion, and if not softly brought into balance could induce more than just a juvenile blood curdling scream from investors.

So what is the catalyst of such potential volatility? That is a very good question and one which is difficult to predict.

At Fulcra, these broader market signals are worrisome and may continue for a week, month or a year and even longer. We have continued to keep the duration of the Fund very short at 1.75 years. While some positions are longer than 2 years, these are investments where we have been able to locate a catalyst which, in our opinion, increases the probability of the bond being shorter than its duration would suggest.

One such example of this are Rite Aid's 6.125 % bonds due April 2023. Although they have a duration of 4.5 years we believe the current asset disposition arrangement with Walgreen's will see a significant amount redeemed early. As the sales of stores to Walgreen's plays out and Rite Aid builds its cash reserves, the Fund generates a healthy cash yield of 6.4% from this bond with $3+ points of potential upside in 6 to 12 months' time.

Catalyst investing may come with less total return than other strategies we employ but certainty in markets, for which there is none, combined with historically high price levels makes capital preservation our top priority today. Catalyst investing meets this capital preservation priority by linking an investment outcome directly with a defined corporate action that can reduce broad capital market exposure. Despite the presence of Halloween, we see the risk of many investments as being far too scary to pursue currently.

Best regards,

Fulcra Asset Management Inc.

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