

Inflection Performance: October 2016

November 8th, 2016: Inflection Ho! (All hail President Volatility)

Although the founder of Inflection Management Inc. has made a specialty of forecasting and benefitting from major inflection points in markets for over 20 years, rarely have we been able to point to a specific date as the inflection point around which markets pivot. More usually markets inflect around a series of events like the collapse of the tech bubble in 2000 or the domino unwinding of markets that stretched from 2007 to the Great Collapse of September 2009.

However, as with most things Trump™, this time it's different. In November the US elected President Volatility and we expect the next four years will be very rewarding for managers who embrace change and disruption rather than try and use traditional strategies to benefit from the policies of a president who has shown no qualms about reversing his opinion on major issues three times over the course of a day.

Whether you love Trump or loathe him, the November election may very well prove to be a watershed moment for the global economy. The world of rising equity values and falling interest rates, with low growth and low inflation is over. The 2009-2016 playbook has been thrown out. Higher growth of the type Trump will try and stimulate will likely lead to inflation and higher interest rates in the US which, happily for the Inflection Strategic Opportunities Fund ('ISOF'), favours the lower duration assets like CLOs, MBS, and High Yield debt, and low duration strategies such as Merger Arbitrage, that our portfolio managers specialize in.

Moreover, in our view, Trump's pro-growth and protectionist agenda will promote US growth at the expense of global growth, creating winners and losers and the kind of favourable dispersion which our long/short managers can capitalize on.

Already particular equity sectors have risen (Industrials, Financials, and Healthcare) and fallen (Utilities, Consumer Staples) based on Trump's campaign promises. But, in our view, it's likely to be a very bumpy (i.e. volatile) ride because even the President-elect himself has yet to think deeply on the issues and the possible consequences. And rather than rely primarily on the seasoned professionals who have been running the government for the last eight years, he is relying on a new team who are quite likely to be challenged by some unforeseen consequences.

To take just one example: During the campaign Trump vowed to enact a 45% tax on all Chinese products. While clamping down on some of China's more egregious export policies might be a goal on which both Democrats and Republicans can agree, one of the reasons so little has been accomplished over the past decade is that the world's developed economies have become so locked together that harming your neighbor can just as easily harm yourself. You can't just impose a 45% tariff on another country and not expect serious retaliation, especially when that country is your biggest foreign creditor and has many means of escalating the stakes.

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And that's just the foreseeable consequences. The unforeseeable may be even more detrimental to traditional portfolios. A 45% tariff could further de-stabilize China's economy which is already showing signs of teetering under its mountainous debt. A collapsing Chinese economy would have profound consequences for the rest of the world and unleash a torrent of volatility.

If Trump delivers even partially on his promises of growth, we believe the ensuing inflation and volatility is certain. We believe that's not something to hide from; it's something to embrace by pivoting your investment portfolio and diversifying your holdings.

Market Review

October was a tough month for most asset classes. The S&P 500 declined -1.82% as the market started to price in the increasing possibility of a Trump Presidency, the Canadian dollar declined over 2% against the greenback, and high yield bonds appeared to top out after their impressive rally from the lows seen last February.

The bond market sell-off continued through most of October with the same catalysts as September: Firming growth expectations for Q3 and central banks leaning towards tightening.

The November election result will likely have profound implications for the global economy. All indications are that Trump will scale up fiscal stimulus to ignite above trend growth in the US. How this will affect the rest of the world is less clear. Leading up to the election, many emerging economies had started to improve as the US dollar fell and financial conditions eased. This could now reverse if the US follows a more protectionist agenda. The near term outlook depends very much on the size and timing of new policies from the Trump administration.

More active fiscal policy will also affect monetary policy. The US Federal Reserve has been the prime mover in returning the US economy to full employment until now. But post-election the outlook for inflation has turned up. With the labor market already tight, we believe new fiscal stimulus will accelerate the time table for further rate hikes, and rising rates in the US will likely create upward pressure on interest rates in the rest of the developed world. In emerging markets the policy outlook is less certain, as the rising USD could create an adverse currency shock to local economies.

Portfolio Review

ISOF was up 0.04% in October with 6 of our 12 strategies being profitable, led by Equity Market Neutral up 0.22%, Community Banking up 0.22%, European Credit up 0.20%, Multi-Strategy up 0.14%, Convertible Arbitrage up 0.11%, and CTA up 0.02%. Detractors from performance for the month were Energy Trading down -0.41%, Volatility down -0.31%, Short Credit down -0.04%, ABS Trading down -0.04%, and Merger Arbitrage down -0.01%.

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In October, ISOF's Series A net return was 0.04% bringing our year to date net return to -4.11%. By comparison, the HFRI Fund Weighted Composite Index returned -0.61% for the month (3.58% YTD), the S&P TSX Index returned 0.62%, (16.54% YTD) and the Barclays Global Aggregate Bond Index declined 2.78% in October (6.80% YTD). The Scotiabank Canadian Hedge Fund (Equal Weighted) Index declined 2.81% in October (5.33% YTD).

Since inception in October 2010, ISOF Series A has produced a cumulative return of 23.10% outperforming the Scotiabank Canadian Hedge Fund Index by 10.77%, the HFRI Hedge Fund Index by 0.85%, and the Barclays Global Aggregate Bond Index by 12.90%. With only 59% of the volatility, ISOF has trailed the S&P TSX Index by 19.83% since inception, with a Sharpe ratio of 0.55 and a correlation to the S&P TSX Index of 0.57.

Business Update

We are pleased to welcome a new member to the Inflection Team. Mark Bardsley joins us as our Toronto-based Director of Business Development and assumes the responsibilities previously handled by Paul Mayer. We would like to take this opportunity to thank Paul and wish him well on his new endeavors.

Mark can be reached at (647) 669-6844 and mbardsley@inflectionmanagement.com.

Sincerely,

The Inflection Team

The Inflection Strategic Opportunities Fund (ISOF) invests in a broad array of carefully selected hedge fund strategies in order to capitalize on dislocations and market opportunities. The Fund has a global mandate and focuses primarily on the Americas, Europe and Asia, providing access to the expertise of hedge fund managers in identifying what we believe are exceptional investment opportunities throughout the world. Some taxable investors may find that the Fund's option structure has significant tax benefits. Please refer to the attached Factsheet for additional information.

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Disclosure

ISOF performance presented are USD net returns after investment management and performance fees and is not an estimate of any specific investor's actual performance, which may be materially different from such performance depending on numerous factors. ISOF returns represent historical returns adjusted for the June 2015 performance fee structure change to the current fee structure. Information presented is believed to be correct and accurate at the time of production but may change due to circumstances beyond our control. Returns may be amended after these numbers have been reported due to repricing adjustments or receipt of more recent data, among other things, and will be reflected in the most recent document. Comparative returns selected are for informational purposes only and may or may not accurately represent the composition or potential performance of Inflection Strategic Opportunities Fund and may not be useful for comparison purposes. The HFRI Fund Weighted Composite Index is a global, equal-weighted index of over 2,000 single-manager hedge funds that report to HFR Database. Constituent funds report monthly net of all fees performance in US Dollars and have a minimum of \$50 Million under management or a twelve (12) month track record of active performance. The HFRI Fund Weighted Composite Index does not include Funds of Hedge Funds. The S&P/TSX Composite Index (Net TR) is the Net Total Return version of the S&P/TSX Composite Index and is presented in Canadian Dollars. The Net Total Return Index Value is based on the aggregate, float quoted market value of the index constituents (Stock Price Index Value) plus their paid net dividends/distributions after applying a withholding tax at the national level. The Barclays Global Aggregate Bond Index is a market capitalization-weighted index denominated in US Dollars representing the universe of investment grade bonds available for purchase in the United States, securities underlying the index include Treasuries, Agencies, Mortgages, and Corporate Bonds. ISOF is an exempt market fund available to Canadian resident accredited investors in British Columbia, Alberta, Saskatchewan, Ontario, and Quebec and to a limited investor base in certain provinces under the Minimum Amount exemption. Investing involves risk. Please seek professional advice before making any investment. This is not an offer to purchase or sell securities. It is for information only. Please refer to the Confidential Information Memorandum for more detailed information.