MONTRUSCO BOLTON

THIRD EYE CAPITAL

President's Letter

as of December 31, 2018

PRESIDENT'S LETTER

Dear Investor,

Powell Put

Returns for nearly every investable asset class, from stocks to government debt to corporate bonds to commodities, were either flat or down in 2018. The reason propounded by most economists and analysts was the tightening monetary policy of the U.S. Federal Reserve. However, after a broad-based correction in asset prices in Q4-2018, affecting equity values, credit spreads, commodity prices, and inflation expectations, the U.S. Federal Reserve made a dovish pivot.

Financial markets have exaggerated the Fed's intentions at its last policy meeting and believe that a reprieve in the central bank's rate tightening is a "green-light" for risk asset speculation. The recent bullish sentiment of investors that was revived by the Fed's action (or rather, inaction) can only be short-lived when examined in the context of a market characterized by extreme valuation for risk assets, a lower earnings outlook, and weaker economic activity. Recall that the Fed eased aggressively throughout the 2000-2002 and 2007-2009 market collapses with no effect. Some of the most severe market losses during the GFC occurred very shortly after Fed easing; the S&P 500 fell over 40% in twelve weeks between September and November 2008. Investors should be alert to occasional air-pockets and bouts of volatility while markets try to recalibrate risk/reward.

Nevertheless, Fed Chairman Jerome Powell's forbearance has probably postponed a recession by at least twelve months. Economic expansions do not die of old age, they are murdered usually by higher interest rates. The Fed's pause will allow cost pressures to continue to rise and increase chances of an earning recession. BCA Research found that earnings growth tends to move in lock-step with equity prices (Figure 1). Stocks tend to bottom simultaneously with earnings growth bottoms. Current analyst estimates based on IBES data expect first-quarter 2019 earnings to fall over 1%, a sharp contrast from estimates at the end of the 2018 for 5% growth.

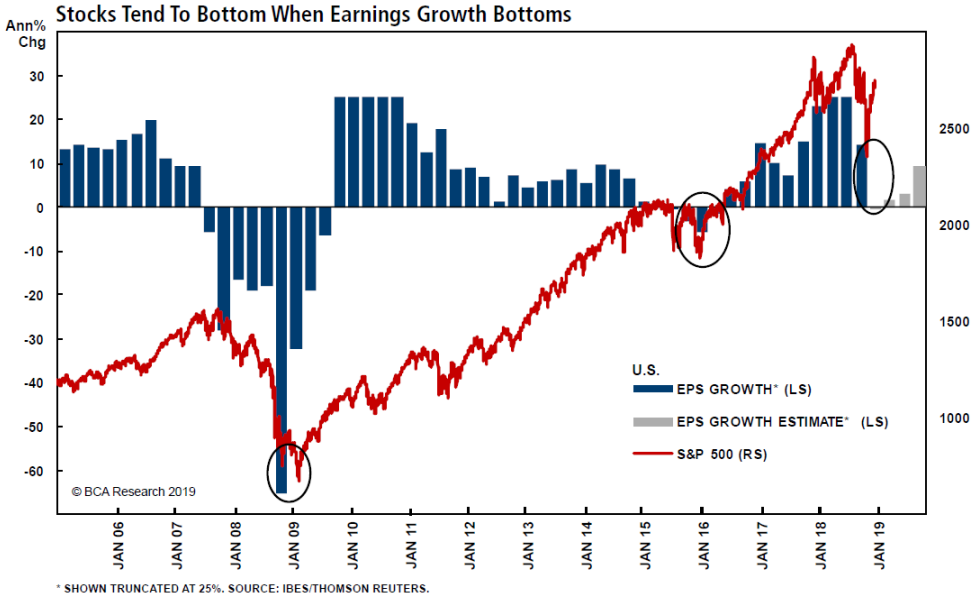


Figure 1: Stocks and EPS Growth
Source: BCA Research

Tight global labour markets are pushing up costs even as growth slows, due in part to the fact that wages do not usually peak until after a recession is underway. Wages are the largest portion of corporate costs and are rising at the fastest pace in a decade. In many developed countries, wage growth has recovered to 2007 levels that were recorded just ahead of the GFC. According to the Bureau of Labor Statistics ("**BLS**"), in 2018, average hourly earnings in the U.S. rose 3.1% and are accelerating with the three-month annualized growth rate exceeding 5%. A recent study by a group of researchers at the Federal Reserve Banks of Dallas and Cleveland concluded that the BLS understates real wage growth by a "notable amount". The rise in wages is leading to a peak in U.S. corporate profit margins.

In Canada, labour markets are at their tightest levels in four decades. Business outlook surveys by the Bank of Canada are showing a growing number and intensity of labour shortages (Figure 2). Higher wages are increasing along with job churn, mostly outside of the oil-producing regions, and will inevitably affect the profitability of companies already operating close to capacity. Wage inflation is a key risk to profit margins in the U.S. and Canada and will force their respective central banks off the sidelines to raise rates again.

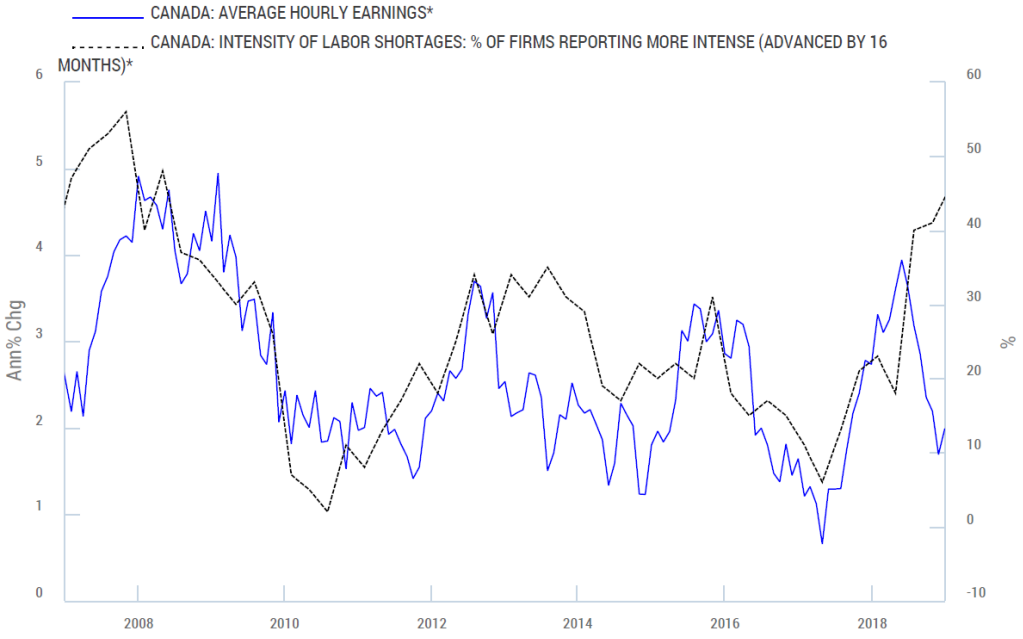


Figure 2: Wages Rising in Canada
Source: BCA Research

Today's Deals, Tomorrow's Meals

In recent meetings with investors across the country, we were confronted about our views on the duration and severity of the next default cycle. Our investors know that we think the outlook for default rates is being artificially suppressed by the dominance of low-covenant/ no-covenant loans in the market. The default rate of the S&P/LSTA Leveraged Loan Index hovered around a 14-month low of 1.63% (par-weighted) at the end of 2018. During the GFC, bond and loan defaults in the U.S. climbed to 12% and 11%, respectively. We do not think loan default rates will be as high in the next downturn but that they will remain above the 3.1% average for a longer period of time (i.e., more defaults spread out over time) and that defaulted loans will have much lower recovery rates.

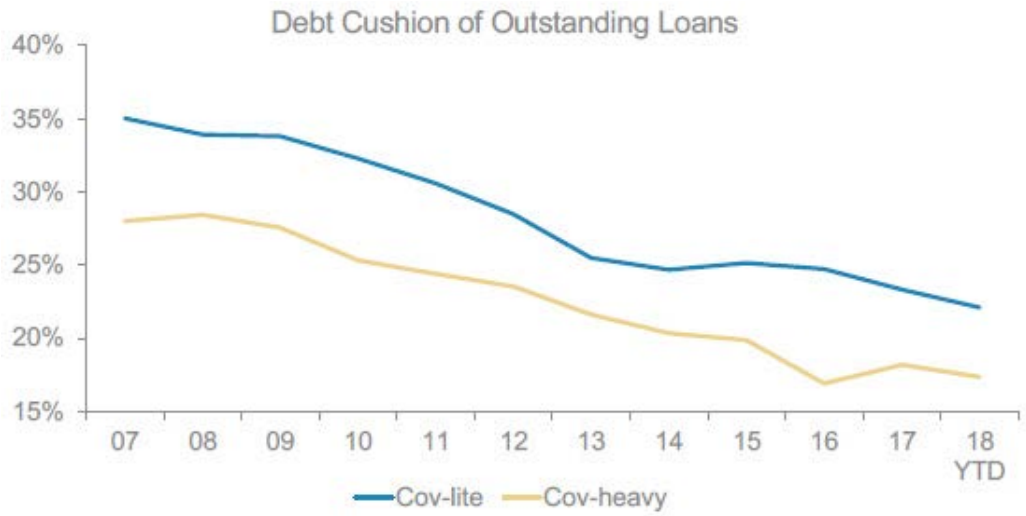
In the current credit cycle, loan defaults reached a bottom in 2014 at less than 1%. Monthly defaults since then have been consistently running above although the overall default environment remains benign by historical standards. In contrast to the previous cycle, defaults by count are not isolated to a single sector. Energy, consumer discretionary, consumer staples and industrials have all been experiencing elevated defaults since 2014. Sentiment among loan managers is still high; on average, they predict the default rate to climb to just 2.16% by end of 2019 and 2.79% by end of 2020.

Some investors have argued that near-term default risks are low because only a negligible amount of loans are set to mature in the next couple of years. Approximately USD$33 Billion of loans are coming due before the end of 2020 and, in 2021, just USD$70 Billion is now scheduled to be repaid. We do not put much credence into a backdated maturity wall at the top of a credit cycle because companies should be using bull markets to term out debt. In fact, maturities are more front-loaded today than they were in 2000 or 2007, before those default cycles began. When credit conditions tighten or earnings fall, credit markets will price in defaults quite quickly and lenders will care more about "if" they can get repaid not "when".

There are several reasons why the next default cycle will last longer. Unlike in the GFC, leverage is sitting on non-financial balance sheets and not in the banking system. There is less risk of a systemic crisis and so no government bail-out or other policy tools to promote a quick recovery; besides, the U.S. government's high debt levels make it difficult to enact fiscal stimulus, especially after recent tax cuts. The prevalence of covenant-lite loans and low interest rates (and therefore high interest coverage) will mean defaults take longer to materialize, extending out the default cycle. Annual covenant-lite issuance was the second highest on record in 2018 and, at 85% share of total outstanding volume, is the highest it has ever been.

Leverage is at unprecedented levels across the risk spectrum of debt, even within investment grade ("**IG**") corporate debt. Morgan Stanley has examined non-financial, corporate IG debt outstanding and noticed that over 50% of IG corporate debt today is rated BBB (the lowest credit rating still considered IG), up from just 25% in the 1990s. Net leverage of BBB non-financial corporates was 2X on average in 2008 and now exceed 3X. Close to a third of BBB debt is leveraged at or above 4X – if it were not for sufficient interest coverage, 55% of BBB debt would be considered "junk". Non-financial BBBs now represent USD$1.8 Trillion in par value, up 181% since 2009, and greater than double the size of the entire high-yield bond universe. It is naïve to expect better earnings growth to drive lower leverage and help alleviate BBB risks (see section above). When the downturn occurs, or higher interest rates compromise debt servicing capacity, the wave of downgrades will be significant.

Recoveries will be disappointing in the next default cycle. Moody's Investor Services is forecasting first-lien loan recoveries to be just 61%, down from the historical average of 77%. Second-lien loans may recover just 14 percent. A report by S&P Global Ratings that looked at recoveries for covenant-lite loans in 2016 and 2017 found that losses were 20-27 percentage points higher than those of non-covenant-lite loans. We think actual loan recovery rates will be even lower than these estimates due to higher leverage levels and larger EBITDA adjustments (see "Some Things Just Don't Add-Up" from our Q3-2017 investor report), smaller debt cushions beneath the loans outstanding (Figure 3), and lack of tangible asset coverage in cyclical sectors most exposed in a recession. Moreover, recovery rates are negatively correlated with defaults so they will be much lower in high default environments.



Source: Morgan Stanley Research, S&P LCD

Figure 3: Debt Cushion of Leveraged Loans

In the next downturn, credit markets will be pushed to valuations that fall well below what fundamentals should imply (a reversal of the current situation), and this is going to be exacerbated by liquidity challenges stemming from (i) the rapid growth in corporate credit markets, (ii) inability by certain funds to hold sub-investment grade debt, (iii) higher, mutual fund/ETF/retail holdings of loans and bonds, and (iv) smaller balance sheets of dealers able to absorb the forced selling. Fortunately, firms like ours will be adroit liquidity providers capable of pricing and managing risks in a downturn. We are anxiously licking our chops.

Oiling Up

The biggest surprise in 2018 that caught nearly every energy investor and trader off-guard was the steep 30% decline in oil prices at the beginning of the fourth quarter. Not surprisingly, this large pullback has resulted in a surge of bearish calls for a collapse in oil prices similar to those in 2001, following the 9/11 terrorist attacks that caused oil prices to fall more than 40%. Back then, everyone assumed that oil demand would fall after the attacks. Instead, oil demand exceeded expectations and non-OPEC oil supply was a huge disappointment. The same setup looks likely to occur today. Given our existing energy-related investments and continuous access to upstream, midstream and oilfield services lending opportunities, we examine current oil markets.

Many analysts blame a combination of weak global demand and surging shale production in the U.S. for the rise in oil inventories and price weakness. The facts do not support this assessment. In April 2018, OPEC states and Russia (together known as "**OPEC2**") were producing 43.3 million barrels per day ("**bpd**"). By November 2018, OPEC2 increased production 1.4 million bpd adding approximately 175 million barrels to global oil markets over seven months. However, global inventories grew by only 25 million barrels relative to long-term averages so without the OPEC2 production increase inventories would have drawn massively by 150 million barrels even accounting for the stronger than expected production from U.S. shale basins.

The short-cycle nature of shale production and the intensity of activity in basins like the Permian, Bakken and Eagle Ford is resulting in drillers being forced into less desirable locations. Production from Tier 1 well locations (i.e., those with the best pay and optimum pressure) is starting to shift to Tier 2 wells that do not have the same rates of productivity. Production per new well in 2018 from U.S. shale grew by less than 1% even though average drilling lengths and proppant (solid materials like sand used to keep well fractures open)

loads increased. Standard Chartered Bank believes producers have gone from drilling 100% Tier 1 wells in both the Eagle Ford and Bakken to 50% and 30% Tier 2 wells in each basin, respectively. If this trend continues then productivity per well will decline and U.S. shale will see production rollover sometime in 2019. In a recent earnings conference call, oilfield services giant Schlumberger alluded to disappointing results in so-called "child wells" in the Permian, "Parent" wells refer to the first well drilled on a pad in a virgin section of land, while "child" wells simply refer to the subsequent wells drilled. When child wells are experiencing performance degradation of as much as 30% compared with parent wells, then it is a sign that a field is already in the middle-phase of its development. This confirms that shales are showing signs of exhaustion. There is also anecdotal evidence that many shale producers are overstating well projections in their corporate presentations[1], further highlighting the steep decline rates of shale basins.

It is clear that the largest oil exporting countries are keen to drain global inventories. A coalition (the "**Oil Coalition**") of OPEC states, led by the Kingdom of Saudi Arabia ("**KSA**"), and non-OPEC states led by Russia, recently agreed to cut production by approximately 1.2 million bpd to reduce oil inventories and re-balance supply globally. KSA alone cut nearly 450,000 bpd of production in December 2018 and has indicated plans to drop production further by March 2019. Russia's production quota in the Oil Coalition is 11.2 million bpd in 2019, which is 200,000 bpd less than October 2018 reference levels. While there is some disagreement among top ranking Russian officials over production cuts, to the extent that participation in the Oil Coalition satisfies Russia's economic and geopolitical interests, primarily higher revenues and deeper ties with KSA, then Russia should continue to honour its quota.

Non-OPEC oil supply outside of the U.S. and Russia has been in secular decline. Over the past decade, conventional non-OPEC discoveries totaled just 110 billion barrelswhile consumption equaled 360 billion barrels. We believe most market participants are underestimating the intense deterioration of oil production in the rest of the world. The supply estimates of the International Energy Agency ("**IEA**"), which form the basis of most energy analysts' models, called for non-OPEC supply ex U.S. and Russia to grow by 600,000 bpd in 2018; that figure has now been revised down to 200,000 bpd, a massive 65% reduction. The IEA expects non-OPEC production outside the U.S. and Russia will grow by 125,000 bpd in 2019, which seems too high when considering the December oil curtailments in Alberta and chronic underinvestment in the North Sea and Mexico over the past decade.

The IEA's projections on demand have also not fared well. Over the past eight years, the IEA has underestimated oil demand seven times by an average of 1.2 million bpd on average. According to official IEA statistics, 2018 oil demand averaged 99.3 million bpd, which was an increase of 1.3 million bpd over 2017. However, the IEA also reports a "miscellaneous to balance item" account of 1 million bpd, which are essentially "missing" oil barrels that are unreported and have gone into commercial storage away from official inventory counts (for example, in ocean tankers or cargo trains owned by private trading firms). According to Reuters, these missing barrels represent underestimated non-OECD demand. These missing barrels have been accelerating in recent months and will further narrow global oil balances in 2019.

The biggest headwind to oil prices is the global economy and more specifically the world's demand for oil. Emerging market commodity demand growth, the engine for global growth, has been slowly trending down since the beginning of 2018. BCA Research recently developed a proprietary index, the Global Industrial Activity ("**GIA**") index that measures the strength of the underlying global demand for commodities (Figure 4). The GIA, according to BCA Research, is close to or in a bottoming phase and ready to turn up within the first half of 2019. The GIA captures more than 80% of the variation in the movement in oil prices

[1] https://www.wsj.com/articles/frackings-secret-problemoil-wells-arent-producing-as-much-as-forecast-11546450162

and lagged the synchronized global upturn of 2017 by only a couple months. The long-term energy demand story for emerging markets remains in place. According to Energy Intelligence Group, oil demand outside the OECD is at the highest levels in two decades and exceeds OECD oil demand by more than 4 million bpd.

Figure 4: GIA Index and Oil

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NOTE: THE INDEX IS LAGGED BY 1 TO 3 MONTHS.
SOURCE: WORLD BANK, BCA RESEARCH.
*THE BCA GLOBAL INDUSTRIAL ACTIVITY INDEX IS A WEIGHTED AVERAGE OF SELECTED TRADE, CURRENCIES, MANUFACTURING PRODUCTION AND CHINESE INDUSTRIAL SECTOR VARIABLES THAT ARE SENSITIVE TO GLOBAL INDUSTRIAL ACTIVITY CYCLES.

The production discipline of OPEC2 and the Oil Coalition, slowing shale-oil output, and rising industrial commodity demand from emerging market countries have setup oil markets for another surprise – this time, to the upside.

Private Debt Market Activity and Outlook

Dry powder in private debt, specifically direct lending, grew the most of any private capital strategy last year. Private debt is becoming a core allocation in institutional portfolios but is still a child in terms of its stage of growth. The number of institutions actively investing in private debt has increased from about 2,600 in 2016 to over 3,600 in 2018, which still represents only 30% of all investors tracked by Preqin. In 2018, private debt provided a ballast to credit portfolios. The Cliffwater Direct Lending Index, which seeks to measure the unlevered, gross performance of U.S. middle market corporate loans, was up 9.34% for the trailing twelve-month period ending September 30, 2018. Private debt has been a top performer for most of the past decade, which has encouraged scores of managers with varying degrees of skills and experience to enter the market. Investors, however, acknowledge current late cycle dynamics and are placing greater emphasis on manager track record and their ability to perform during challenging times.

Time and experience provide invaluable learning to help make better choices. A long track record of making, harvesting, and exiting loans creates managers capable of pattern recognition, knowing almost intuitively what works and what does not. Cycle downturns definitely create opportunities, but our experience is that default cycles do not last very long. During the GFC, we experienced supernormal risk/reward tradeoffs for about eighteen months before credit markets thawed and competition returned with a vengeance. We need

to be ready to capitalize when the downturn occurs and strike aggressively as the credit cycle plays out. The best returns are made when and where others are unable or unwilling to invest.

We have noticed an uptick in idiosyncratic corporate stress, something we are an expert at capitalizing on. Anecdotally, special account management units ("**SAMUs**") within banks, a hospice for defaulted borrowers, have become very active lately. We are receiving more in-bound calls from SAMUs in recent weeks than we have since 2009, entreating us to help the bank offload non-performing loans. According to government data, after declining for most of the past decade, business restructurings and insolvencies are now rising in Canada by more than 8% on a year-over-year basis. Filings made under the Companies' Creditors Arrangement Act ("**CCAA**"), a federal law allowing insolvent companies in Canada that owe creditors in excess of $5 Million to restructure their affairs, show that in 2018 the total liabilities of debtors were $5.2 Billion, a 34% rise over 2017. Total assets of CCAA debtors were just $4.7 Billion, a $500 Million shortfall. Considering that less than thirty-percent of the liabilities were actually secured, creditors face the prospect of scant r e c o v e r i e s .

We see several headwinds to the Canadian economy and reaffirm our view that banks will tighten loan availability as they provision for higher than expected losses due to weaker credit fundamentals. Increased activity by SAMUs is a leading indicator for higher future bank loss provisions. In fact, first quarter earnings reported by Canada's Big Five banks, except Bank of Montreal, were all below expectations due in large part to deteriorating credit quality. 2019 is definitely setting up plenty of opportunities for our differentiated style of lending.

Yours very truly,

Arif N. Bhalwani
President & CEO
MBI/TEC Private Debt GP Inc., general partner of
MBI/TEC Private Debt GP L.P., general partner of
MBI/TEC Private Debt Opportunities Fund I, L.P.

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