

Double Bubble: The ‘Bubble’ Bubble | April 2018

“Bubble, bubble, you’re in trouble.”

Duck Tales

As long as humans are involved in the activities of investing and speculating, bubbles will occur. And while policymakers and academics debate whether and how to mitigate or lean against them, it is the job of investors to recognize irrational exuberance and have a plan for dealing with it.

The first part of this process, identifying bubbles as they occur, is no easy task. And one that has been further complicated given the clickbait nature of the word and the media’s proclivity to use it. With the term being liberally applied to any asset with a steep valuation, an argument could be made that there is a bubble in the use of the word ‘bubble.’

To filter through some of the noise of the ‘bubble’ bubble, we look at the defining characteristics and drivers of parabolic price increases, and how people often react to them.

One of the common denominators underlying such episodes is the introduction of something ‘new’: a technology, product, financial instrument, or macroeconomic condition. This new development forms the basis and rationale of the investment thesis underpinning the bubble. In 17th century Europe, Tulips were exciting new flowers that would demand a premium. At the end of the 20th century, the information superhighway and dotcoms were poised to revolutionize commerce. These ‘truths’ propel the initial moves higher.

As the profits and excitement grow, new players are drawn in. Some expect the meteoric rise to continue indefinitely as markets adjust to the new development. Others speculate on the basis of finding a ‘greater fool’ tomorrow who will pay an even higher price without regard for fundamentals or value. This creates a reflexive feedback loop where the price momentum feeds off itself and is fuelled by our fear of missing out, overconfidence, and extrapolations into the future.

Rather than leaning against the euphoria of the masses, ‘sophisticated’ asset managers add more fuel to the fire. With the high business and career risks of underperforming peers and benchmarks and the proliferation of index tracking funds, the industry is incited to follow the herd and ‘rationally’ ride the bubble (so to speak).

Now assuming you can recognize when prices have grossly deviated from fundamental values, then what?

One option is to jump on the bandwagon with the hopes of getting out before the bubble bursts. The challenge with such an exercise in market timing is that the catalysts for a collapse are usually unpredictable and even undecipherable post-mortem. Sir Isaac Newton famously exited his position in the South Sea Company after doubling his money, only to re-enter towards the end of the bubble and incur significant losses.

Another option is to bet against or short the asset in question (if you can). The difficulty here is that in the late stage of a bubble prices can go from irrational to ludicrous, with investors forced out of their short positions before the inevitable pop. A third approach is to allocate to anti-bubbles, sectors or markets that have been ignored and where low valuations offer significant safety cushions. But just as momentum can carry prices to stratospheric levels, unloved assets can continue to collapse longer than the investor can remain solvent.

So perhaps the most prudent course of actions is to step aside. After all, bubbles are the result of systematic (not idiosyncratic) errors; innate biases that compound rather than cancel each other out. ‘No Bubbles, No



'Troubles' was once a public health slogan aimed at reducing the consumption of carbonated drinks. Perhaps the message can be recycled as a reminder to avoid chasing wildly inflated asset prices.

The Fund

After two months of challenging credit markets, April brought with it a modicum of relief. Broad corporate indices ended the month tighter by 1 bps in the US and 3 bps in Canada. Despite the modest improvement, spreads are still wider year-to-date by 15 bps south of the border and 5 bps at home.

Domestically, insurance names performed well, while airport related securities lost their shine as the federal government put a halt to the speculation of potential privatization. On the new issue front, we saw a healthy amount of supply in April but nowhere near the onslaught of March. Banks lead the charge with RBC, BNS, CWB and BofA issuing \$6 billion of new bonds. In addition, there were deals by other interesting issuers such as Chartwell REIT, Enbridge Inc., and Coast Capital.

The portfolio was well hedged against interest rates, as the 8 to 20 bps rise had minimal impact on the fund. The slight improvement in spreads, active trading, and carry contributed to a net return of 0.77% for the month.

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2018	1.19%	(0.45%)	(0.35%)	0.77%									1.16%
2017	1.73%	1.30%	0.44%	1.03%	(0.22%)	0.53%	0.94%	(0.09%)	0.70%	0.83%	0.45%	0.50%	8.46%
2016	0.19%	1.49%	5.32%	3.51%	0.60%	0.54%	1.73%	1.63%	1.01%	1.86%	1.60%	1.62%	23.15%
2015	-	2.29%	2.51%	1.27%	2.46%	0.25%	0.73%	(0.25%)	1.68%	1.71%	1.37%	0.87%	15.86%

The Algonquin Debt Strategies Fund LP was launched on February 2, 2015. Monthly returns are based on 'Series 1 X Founder's Class' NAV as calculated by SGGG Fund Services Inc. and are shown in Canadian dollars, net of all fees and expenses.

Credit

The final 'bail-in' guidelines were released in mid-April. These guidelines mean that the senior unsecured bonds issued by the Big-6 Canadian banks will be subject to conversion, in whole or in part, into common shares at the discretion of the regulator. The first such issuance is expected in the fall of this year. Since bank debt represents a significant portion of the corporate index, there will be much debate around proper pricing, the relative value of other issuers, and whether the banks will try and flood the market with senior debt (not subject to conversion) in the next few months. As a result of these changes, we anticipate some interesting trading opportunities will arise in the near future.

Heading into May the tone in risk assets felt better with volatility in equity markets subsiding despite concerns that global growth may be slower than anticipated. With dealer inventories at comfortable levels and what appears to be a manageable supply calendar ahead, continued stability in equities could mean better performance in credit. Although there is room for spreads to narrow, we continue to maintain a modest risk posture.



Rates

Sovereign debt markets continued to grapple with increased supply and stronger than expected economic numbers. Canadian five-year yields reached 2.18% before recovering to end the month at 2.12%. In response, domestic banks announced further increases to five-year mortgage rates.

Despite the headwinds of higher rates, lower US corporate taxes making Canada a less attractive place to invest, and pipeline uncertainty, the domestic economy continues to hum along. With inflation above 2%, the surprisingly resilient economic performance presents a conundrum for the Bank of Canada. They need to hike again but worry about over-levered consumers.

With half of the outstanding mortgages due for renewal this year, and a large percentage of these being rolled over in the next few months, presumably into fixed-rate mortgages, the Canadian consumer will be slightly less sensitive to interest rates by early summer. As such, we are leaning towards the Bank of Canada slipping in a move in July.

Contact

Algonquin Capital Corporation
1 King Street West, Suite 1502
Toronto, Ontario, M5H 1A1
www.algonquincap.com

Raj Tandon
Founding Partner
raj.tandon@algonquincap.com
+1 (416) 214-3493

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