



“One, two, three...” | August 2015

“Everyone has a plan until they’ve been hit.”

Joe Louis

Those that have seen Ronda Rousey fight (she won three UFC title defences in a combined total of 64 seconds) or have witnessed the ferocity in her eyes cannot fathom why anyone would be willing to step into the ring with her. We suspect many investors felt the same way about putting capital to work in August. The sheer magnitude of the moves and subsequent knee jerk reactions in stocks and bonds made it virtually impossible to navigate a sensible course without suffering a bit of bruising.

The heart of the matter lies squarely with perceptions surrounding the health of the Chinese economy. For as long as we can recall, few people have trusted China’s official economic statistics and have looked to other indicators such as commodity prices, electricity consumption and satellite imagery to get an objective sense of the nation’s economic health. When China devalued the Yuan, they caught the market by surprise and sparked fears that policymakers were beginning to panic about the true state of the economy, triggering a violent international sell off across financial assets.

The Fund

We anticipated that August would provide little in terms of active trading opportunities, so we decided to employ a bond trader’s version of the ‘rope-a-dope’ strategy that propelled Muhammad Ali to victory over George Foreman. We increased our holding of short-dated bonds with the belief that interest earned would exceed losses from credit widening. For the first two weeks, we slugged it out toe-to-toe with the market with the yield from the bonds offsetting the losses from the gradual widening in credit spreads. The turning point came when China devalued the Yuan. In the days that followed, we endured a relentless volley of head-shots as equities melted and the appetite for investment grade credit seemed to evaporate. The street had no interest in buying securities, and market makers dramatically lowered their bids in order to discourage further selling. Even the typically stable front end of the credit curve was hammered, leading to a modest loss for the fund this month. While we are greatly annoyed with ourselves for missing an opportunity to reduce our risk further, in a month where the TSX was down 4.2% and the Canada Universe Bond Index lost 1%, we won’t beat ourselves up too badly.

Looking ahead, we do think credit spreads at their current levels offer tremendous value for patient investors. Market dislocations often create a myriad of opportunities that can be exploited once volatility dissipates. We look forward to a very interesting September.

Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
N/A	2.29%	2.51%	1.27%	2.46%	0.25%	0.73%	(0.25%)	-	-	-	-	9.58%

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

We had to look back to the fall of 2008 to find a period where credit spreads widened as violently as they did in August. The 'triple B' space has been in trouble since early summer as the unprecedented growth in supply pointed to the need to re-evaluate pricing, but the dramatic widening in higher rated credit spreads was rather surprising. We suspect that nervous fund managers preferred to increase their cash allocations and ended up selling whatever they could, not necessarily what they should. With bond dealers already full up to their eyeballs in 'triple B's' and an effective buyers' strike in place, accounts started selling bank paper and short-dated corporates. Volatile equity markets pressured dealers to reduce prices even further in order to avoid increasing their already bloated balance sheets.

While credit spreads are at extremely attractive levels, we remain wary as anxious issuers are lining up to borrow at the first available opportunity. In this environment, any new supply will require hefty concessions in order to whet the appetites of investors courageous enough to put money to work. That said, we intend to be very selective ourselves with respect to how and when we re-enter the ring.

Rates

We may be on the cusp of an extremely important change in global bond markets. Since 2003, China has engaged in an unprecedented accumulation of reserves, buying almost 4 trillion of foreign assets mostly in the form of bonds. This buying has essentially been a form of quantitative easing and has also been blamed as the cause of the 'Greenspan Conundrum,' as well as significantly contributing to the decline in real yields. Now that China has turned its attention to managing and defending its currency, it has started selling foreign assets. There are estimates suggesting that China sold 100 billion of US treasuries in August. Should China need to continue to defend its currency, we could see a prolonged trend where real yields continue to rise irrespective of actions by the Bank of Canada or the Federal Reserve.

On the topic of central banks, we think the Bank of Canada will be patient with rates. They will assess a few months of data to determine whether a weaker currency will offset weaker commodity prices. Furthermore, the various political parties have different fiscal plans which the Bank of Canada can only take into account after the federal election. Meanwhile, making a call on when the Federal Reserve will raise rates has become more difficult due to the volatility in stocks. We remain in the camp that 'lift-off' is a 2015 story, but acknowledge the Federal Reserve is not married to a particular start date, and will have little difficulty deferring a decision until the market settles down. At this point we see a 50% chance of the Federal Reserve hiking rates in September.

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