



Surf's Up | February 2016

"Waves are not measured in feet or inches, they are measured in increments of fear"
Buzzy Trent

Warren Buffet famously quipped that 'only when the tide goes out do you discover who's been swimming naked'. Given that the markets of late are more like a series of mammoth waves, we thought a surfing analogy was appropriate for February's commentary.

As in the world of money management, when things are calm and the waves manageable, everyone is happy to stay in the water. It is in places like Mavericks, California, where waves have been known to reach 25 metres, that one's hard work, skill and nerve are put to the test. The currents underlying the choppy markets of the past few quarters have been more like the latter, filled with more pounders than ripples.

Concerns about global economic fundamentals, declining confidence in central banks, the precipitous fall of oil and a myriad of geopolitical risks have all contributed to some gnarly conditions. Riding every wave leaves you at the mercy of the ocean and increases the odds of a wild wipe out. On the other hand, if you hide on the shore for too long, you risk not getting back into the water and missing out on some great opportunities.

Our preferred approach is to remain in the water but be selective, choosing which waves to sit out and which to catch. We constantly remind ourselves that when taking on big surf that we have to remain focussed, agile and ready to paddle 'like hell' to get out of the way if necessary.

The Fund

Since the latter half of December we have chosen to ride a few safer swells, but mainly watched from the line-up as things developed. Around the middle of February, with credit spreads generally wider by over 25 bps since year end, it seemed that the market was becoming too pessimistic and that conditions were right for more aggressive positioning. We took the opportunity to add a few short-dated oil bonds and increased the overall credit exposure of the portfolio. The rally in the second half of the month coupled with active trading opportunities generated a strong 1.49% return for the Fund.

At current levels, investment grade bonds compensate investors well on a risk adjusted basis, and with folks becoming receptive to new issues, we expect to be busy in March.

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2016	0.19%	1.49%	-	-	-	-	-	-	-	-	-	-	1.68%
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

Despite the tightening of spreads in the latter two weeks, credit still ended the month wider. Trading in the secondary market continues to be erratic with liquidity waxing and waning based on equity volatility. New issue volumes picked up after an exceptionally quiet couple of months, although supply was well down compared to last February. TD issued Canada's first ever 10 year NVCC bond (Tier 2 Capital), which was very well received and could pave the way for other banks to launch similar products. Otherwise, banks continue to raise money offshore, which has helped stabilize domestic spreads.

The oil sector finally received a little good news. First of all, Enbridge bond holders who have endured upwards of 60 bps of spread widening since early December saw spreads tighten 10 to 15 bps when the \$2B equity raise was announced. The rating agencies completed their reviews of oil & gas companies resulting in downgrades including Encana and Cenovus joining the ranks of 'junk'. With this event out of the way, energy debt started performing a little better. There should be mondo opportunities in the coming weeks to keep us on our toes.

Rates

Government bonds remained volatile as investors reacted to dramatic swings in equities. At one point, Canadian 10 year yields hit a record low yield of 0.917%. While that may be a decent save percentage for an NHL goalie, it is a dreadful return for locking up your money for a decade. Short yields rose slightly as traders scaled back bets on the Bank of Canada easing rates in the near future. We expect Governor Poloz to hold steady for some time as he assesses the impact of fiscal stimulus on the economy.

In the US, the odds of a March rate hike by the Federal Reserve declined to nearly zero as the economy struggles with the impact of a strong dollar and foreign economic weakness. That said, domestic demand should remain fairly strong, leaving the window open for the Fed to raise rates a couple of times this year.

The European fixed income market continues to bewilder, as German yields out to 8 years are now negative. Expectations are extremely high that the European Central Bank will either aggressively push rates more negative or expand the quantitative easing program. Given their track record of under-delivering in times of need, the risks are that they will disappoint, which could spark yet another bout of € yield volatility.

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