

It's Not You, It's Me | February 2018

“People change and forget to tell each other.”

Lillian Hellman

Ask any couple that has been together for a while, and they will tell you that relationships change. They go through phases, have their ups and downs, and experience shifts in dynamics. Through her neuroimaging research, Dr. Helen Fisher has even shown how our brain's chemistry evolves through the various stages of love, from the intensity of initial attraction to the deeper bonds of attachment.

As far as relationships go, the star couple of most investment portfolios, the ‘Brangelina’ if you will, are bonds and equities or ‘Bequities.’ While they lack the glitz and glamour of Brad and Angelina, their relationship is a key driver of portfolio returns and should be central to asset allocation decisions. The trouble is, as with so many famous couples, theirs is a turbulent and often unpredictable affair, at times pulling in opposite directions and at others moving in tandem.

Last month, both partners made headlines as a rise in yields not only took fixed income lower but precipitated a sharp sell-off in equities. This was not only painful for investors but raised questions on the interplay between the two asset classes.

Over the past two decades, the expectation has been that fixed income would provide at least a partial offset to losses from equities. The assumption being that meddling on the part of central banks would prop up securities, in what became known as the ‘Fed Put.’ This has certainly been the case since 2009, with lower interest rates and monetary stimulus creating a honeymoon period with strong performance across risk assets. But it now appears that investors need to realize that the central bankers are ‘just not that into you,’ and that the correlation between stocks and bonds could be changing.

In trying to understand the dynamics of romantic relationships, the psychologist Robert Sternberg developed a triangular theory of love with the three components being intimacy, passion, and commitment. When it comes to the relationship between stocks and bonds, economists see the key drivers being valuations, inflation, unemployment, growth, and the level of interest rates.

Taking valuations as a starting point, there are concerns around the expensiveness of stocks, and given the low to rising yield environment, it is difficult to see much value in fixed income. Although it is far too early to call for ‘inflationary times,’ with unemployment near historic lows, strong global growth, and the potential for trade wars putting upward pressure on prices, there is the possibility that inflation surpasses current forecasts. All of this combines to create a difficult environment for the traditional beta portfolio.

So after almost a decade of being the investors’ darlings, with both of them performing well, the outlook for ‘Bequities’ isn’t so rosy. The return expectation for fixed income is flat to small negative, with the risk being that rates rise faster and higher than anticipated, turning the small negative into a large one. If this does happen, there is potential that an already jittery stock market follows suit on the downward path. Perhaps then it is time for this couple to consider following ‘Brangelina’ and start dating other asset classes.



The Fund

The markets seemed intent on solidifying February's reputation as a miserable month. Credit gave back January's performance and then some, with spreads widening 5 to 25 bps on the month. The recent outperformers such as bank subordinated debt (NVCC) and REITs were particularly hard hit. Generically, spreads are 2 to 3 bps wider YTD in Canada, and roughly 7 bps wider YTD in the US.

The initial damage resulted from the dramatic drop in equities, although when stocks recovered and stabilized (sort of), credit continued to leak wider under the weight of new supply. Despite the poor tone, issuers (perhaps concerned about rising rates) sold \$9.6B in the primary market (2nd highest February issuance in history), with the vast majority coming at the tail end of the month. This led to the market being overfed in a short period of time, particularly as US bond funds/ETFs experienced large redemptions, forcing managers to liquidate holdings. We don't believe Canadian managers are experiencing significant redemptions. However, the situation south of the border kept some people on the sidelines. The dynamic in the marketplace meant there was no place to hide, as even normally 'safe' short maturity bonds were pressured wider as well.

After January's solid rally in credit, we had trimmed longer maturity positions preferring to concentrate in the two-year and under space. Throughout February we used pockets of liquidity to reduce risk further and add to hedging positions. Although we did not give back all of January's gains, the fund was down 45bps this month.

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2018	1.19%	(0.45%)											0.74%
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

Given the turmoil in the markets, any forward-looking views should be taken with a grain of salt, and we remain prepared to adapt to changing situations. Accordingly, we continue to maintain a more defensive and flexible posture but are mindful that volatility can create some interesting opportunities. With that in mind, there are a few particular developments that we are watching closely.

One of which is how well the flood of M&A related new issuance from CVS and Choice REIT is digested. Also, high on our radar are the inflows and outflows from bond funds and ETFs, which will determine the buying or selling pressure exerted by traditional asset managers. Furthermore, with the rise in interest rates the all-in yields of the 5y space have become particularly attractive, therefore, we are monitoring further term extension from the long only crowd, as they move from shorter to longer-dated securities.



As always, one eye must be kept on the chaos within the White House as protectionist threats at month-end led to another risk-off move. With equities already in a fragile state, we are hopeful to get a more rational direction in trade policy from the U.S. administration but remain cautious of the headline risk that can come from 4 am tweets.

Despite the negativity pervading the markets, higher credit spreads do not seem to be attributed to fears that a recession is looming. Instead, it appears that investors are reassessing valuations and are struggling to digest a deluge of issuance. The silver lining is that widening episodes set the conditions for better prospective returns either because carry improves or spreads narrow.

Rates

The big picture view remains the same. Global growth remains strong enough to prompt central banks to move away from monetary stimulus. The risk is that US yields move higher than most people expect. Fortunately, Canadian rates shouldn't move as much. A potential creeping trade war with our largest trading partner, high personal debt levels, and an uncertain housing market will likely temper the Bank of Canada's enthusiasm to pursue multiple rate hikes this year. The Federal Reserve will likely deliver three or four more hikes in 2018, while the Bank of Canada might just have one more left to do.

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