

Econophysics 101 | January 2018

“Gravity wants to bring me down.”

John Mayer

Since the Great Recession of 2008, interest rates, like early aviators, have had to contend with the power of gravity. But while the Wright Brothers were dealing with a natural physical force, the downward pressure exerted on bond yields has been an artificial phenomenon.

Through aggressively cutting overnight rates and the implementation of Quantitative Easing, central bankers have pushed interest rates to generational lows. But with global economies gaining rather than losing steam and few signs of faltering amidst the strength, the central banks are poised to reverse polarity.

If our memory of force diagrams from high school physics serves us correctly, by removing gravity and applying upward pressure, rates should rise. Even though investors and markets are expecting this, there is much uncertainty about the pace and magnitude of the rise, and the impact of removing stimulus.

Given that we broke our crystal ball and the countless paths interest rates could take, we prefer to focus on where we are and what we know to gain some insights into where we might be going.

From 2015 to 2017 the US, Europe, and Japan issued USD 3.77 trillion of debt. Over the same period, the Bank of Japan (BoJ) and European Central Bank (ECB) purchased USD 4.88 trillion of sovereign bonds. The sheer scale of the purchasing programs is believed to have lowered yields by more than 1%. While the BoJ will likely continue its buying, the ECB is expected to start scaling back later this year. The great unknown is what yields will investors require to shed other assets and fill the void left by the central banks.

Turning our attention to economic health, things are going very well south of the border. It is highly probable that the large dose of fiscal stimulus (tax reform and deregulation), delivered at a time of low unemployment (4.1%), will eventually translate into wage growth. In the near term, real GDP and inflation could reach 3% and 2% respectively. A 5% nominal GDP (compared to around 4% for the past decade) coupled with the government needing to fund a growing deficit by borrowing USD 200 billion more than last year, and it isn't surprising that yields have been rising. Perhaps the biggest surprise is that the move hasn't been larger.

The picture in Canada is a bit murkier due to concerns around the indebtedness of our fellow citizens and other potential headwinds for the economy. The Bank of Canada has responded to tremendous employment growth by raising rates 0.75% since July. On the surface, this may not seem like much, but some estimate that the increase in debt service costs will shave 0.7% off disposable income. With 60% of our domestic GDP coming from consumer spending, this could create a 0.4% drag on growth.

The hope is that exports and capital investment will pick up the slack. Although deals with Europe and Asia are positive for trade, the lack of clarity around NAFTA may hurt exports and capital spending. These factors won't likely be powerful enough to alter the upward direction of Canadian rates but could limit the extent of the move or slow the pace of increase.

Further complicating the domestic interest rate outlook is the global nature of sovereign bond markets, with demand from international investors often determining the yields at which governments can finance debt. This means that interest rate moves in one part of the world can spill over to other jurisdictions. As long the



government needs to access debt markets, their bonds will have to offer attractive yields relative to other countries, even if the preference is to keep rates low.

While we agree with Yogi Berra, that ‘it’s tough to make predictions, especially about the future,’ from what we know today, it does appear that interest rates are on an upward trajectory. But as early aviators discovered, the journey higher can take many different paths and often involves bouts of turbulence.

The Fund

On Friday, February 2nd, our Fund turned three years old, and like many new parents, we’re surprised at how the time has flown. As we have said before, it takes a village to raise a Fund, and we would like to mark this milestone by thanking all our ‘villagers’ for your tremendous support.

In January, credit markets zigged while bond and equity markets zagged. With interest rates moving higher the Canadian Universe Bond Index was down (0.8)%, the TSX dropped (1.36)%, but the momentum in credit continued as spreads tightened 8-9 bps. Corporate new issues started off slowly but picked up materially as the month progressed. These deals were very well received as the demand for corporate bonds remained extremely robust.

On top of the general performance in credit, the Fund benefitted from exposure to REITs and bank subordinated debt which outperformed other sectors. We did take some profits by trimming positions into the rally. We were also rewarded for having increased our floating rate note (FRN) holdings over the past several months, as rising rates saw demand for these securities pick up. We added to this exposure in January but are paying close attention to valuations on these offerings as the heightened demand for FRNs has tightened coupon spreads.

Through maintaining tight interest rate hedges and capitalizing on the performance in credit, the net result was a gain of 1.19% on the month.

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

All eyes are on the shaky equity markets, and this is certainly the near-term focus. Although credit markets have been more orderly, spreads are trading moderately wider. Sustained weakness in stocks should lead to further widening.

On a positive note, dealer inventories are currently on the lighter side (especially in the US), and the supply calendar looks very manageable. Also, volatile markets tend to reduce the propensity for dealers to bring new issues even though rising yields make them more attractive.

We continue to maintain a modest risk exposure, with positions concentrated in shorter-dated securities. We will be proceeding with great caution, looking for attractive opportunities, and remain prepared to increase our hedging activity if warranted.

Rates

The Bank of Canada raised the overnight rate 25bps and bond yields moved roughly 20bps higher in January. Neither the Bank of Canada nor the Federal Reserve meets in February. The bond bears should not care because both banks are on track to raise their respective overnight rates two or three more times this year.

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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