

Out of the Frying Pan, Into the Fire | July 2015

"A good retreat is better than a bad stand."

Irish Proverb

To use a very technical term, the markets in July can be best described as 'poopy'. As the Greek saga disappeared from the radar screen, the market shifted its focus to the ever puzzling Chinese stock market. For the most part, many markets managed to shrug off the volatility in China, concluding that an index which surged almost 100% in six months was probably due for a significant correction. Some pundits were keen to link the plunge in Chinese equities to the collapse in commodity prices, however, we note that commodities were struggling when the Shanghai index was rocketing higher. Our view is that the precipitous fall in the commodity complex has more to do with global supply and demand imbalances rather than with Chinese stocks. Whatever the causes may be, the effects were certainly felt at home, wreaking havoc on the TSX and Canadian dollar. In our space, domestic credit was uncharacteristically spooked. Typically, Canadian credit markets are resilient and it takes some sizeable external shocks to impact them. This time things are really different, as Canada managed to underperform most G7 markets due to concerns that recent economic weakness will persist. We worry that the underperformance will continue for quite some time.

The Fund

After taking a very defensive posture through June, we began July by investing in opportunities we had been monitoring and ramped up our market exposure anticipating the return of vibrant markets. Our enthusiasm quickly waned and midway through the month we beat a hasty retreat as tone and liquidity in the credit markets were dreadful. Although credit spreads widened 5 to 10 bps on the month, our active trading allowed us to generate good returns. While we believe that credit spreads are on the 'cheapish' side, we remain wary of committing too much capital in August as tone remains poor.

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%	-	-	-	-	-	9.87%

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 post Greece enthusiasm brought out the issuers, and for a short while it appeared that the party had started once again. New issue concessions were generous which meant they performed reasonably well. We noted that only 'A' rated credits or better were able to come to market as the 'BBB' space still suffered from poor liquidity forcing these issuers to defer deals or issue in the US market. Throughout the month liquidity steadily worsened as dealer inventories continued to grow. We remain hopeful that August will bring a long pause to issuance which might settle the market as we wrap up the summer and head into fall. While we are maintaining a concentration in more liquid high quality names, we look to selectively add certain 'BBB' names in short-dated maturities. The challenge for August will be generate strong active trading returns, as bid-offer spreads continue to widen.



Rates

Canadian yields continued to drop all month as the Bank of Canada cut rates 25 bps in acknowledgement that the oil shock is going to have a longer impact. Currently, the market has priced in another 25 bps cut by year end. We also observed that the debate about quantitative easing has already begun. We feel that the Bank of Canada is still a long way from unleashing this weapon, and would only do so after another 25 bps cut and the use of 'forward guidance' is exhausted. At current yield levels, the market is vulnerable to any positive economic news. We suspect that better news is coming as it takes time for the non-commodity export sector to benefit from the weaker loonie which has depreciated approximately 13% since December 31st, the benefit of which will not be felt until early 2016.

The Federal Reserve set a fairly low bar for economic performance over the next six weeks in order to hike rates. It is clear to us that Governor Yellen is keen to raise rates this year (we still think September) so that she can avoid the risk of having to move aggressively in the future. The key will be wage growth. Since the Employment Cost Index was disappointing, the Federal Reserve needs to see good hourly earnings numbers on each of the next two payroll releases. We expect both the bond and equity markets to take the first few hikes in stride, meaning the risk of another 'tantrum' is likely a 2016 event.

Regards,

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