



No Bregrets | June 2016

“But apart from the sanitation, the medicine, education, wine, public order, irrigation, roads, the freshwater system and public health, what have the Romans ever done for us?”

Monty Python

After a century of watching countries declare their independence from them, the British decided it was their turn. With a vote to leave the European Union, Britain enters into uncharted territory, and that too without a prime minister, a functioning leader of the opposition or a football manager. And everyone knows how the markets love uncertainty.

As can be expected, sterling has taking a pounding (bad pun intended). Equities have become more volatile and bond yields are dropping in anticipation of further stimulus by the Bank of England and the European Central Bank. Gold bugs are overjoyed to see their precious metal rocket higher as people seek safety, and punsters are having a field day creating catchy exit terms in case another domino falls. Our personal favourite so far is “Austria la vista, baby.”

At this stage, with so much undetermined, it is still too early to tell how this story will unfold. While markets showed some optimism late in the month, we expect little follow through in the near future. Currently, the list of unanswered questions is growing much faster than the list of answers. As a result, imaginations and the media can run wild forecasting a variety of negative scenarios. This has the potential to roil markets from time to time.

As this saga continues to develop, we will focus on identifying potential pitfalls and opportunities that may arise. Given that market reaction to a negative surprise could be swift and severe, our larger concern for the moment is avoiding landmines.

The Fund

The run up to voting provided lots of lively debate and discussion, but not a good basis for investing. Given the ‘too close to call’ nature of the referendum, we felt risking capital based on a view of the result constituted gambling not investing. Accordingly, our focus was on potential reactions to either outcome. We concluded that a decision to leave could result in significant turmoil, while a vote to remain would cause a small relief rally.

Due to this asymmetric payoff profile, we opted to significantly reduce exposure and sit on the sidelines for most of June. On referendum day, a rate position was added to hedge the remaining credit risk. Had the outcome been to remain, the fund would have missed out on a bit of performance. But with an eye to protecting capital, we decided it was better to miss an opportunity than take on imprudent risk.

As results from polling stations started pouring in, we were extremely pleased with our decision to be conservative. In the aftermath, we cautiously added to the portfolio at attractive entry points.



	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2016	0.19%	1.49%	5.32%	3.51%	0.60%	0.54%	-	-	-	-	-	-	12.11%
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

Although credit spreads were generally flat on the month, they moved through a tremendous range based on daily poll results. During a bout of misguided enthusiasm just prior to voting, spreads tightened significantly. Immediately after the outcome was known, they widened 10 to 25bps with subordinated financial issues leading the way. Portfolio managers opted not to do any significant selling. This was probably to avoid adversely impacting their performance versus the index by incurring significant trading costs so close to quarter end. Other factors that likely held back the urge to liquidate include an expected summer slowdown in new issuance and limited liquidity. We are cautiously optimistic that July will see a modest tightening in credit, although fragile market psychology means volatility can quickly return.

Rates

The big question with rates is 'how low can they go?' The relentless drop in Canadian and US yields seems set to continue. On the domestic side the jury remains out on the prospects of improvements in our economy. While higher oil prices are a welcome relief, it will still take some time before energy investments pick up. Concerns are growing in the export sector as there are doubts around the strength of our favourite trading partner south of the border. With these factors and the increased uncertainty caused by Brexit, both central banks will be on hold as they assess the consequences.

Adding further downward pressure on North American rates is the fact that almost 10 trillion of government debt is now trading at negative yields. Relative to European and Japanese bonds both Canadian and US securities will look very attractive to foreign investors. Canada will have a particular lustre as the UK's drop from the AAA ranks may force a few managers to increase their allocation to Canadian debt. The patience of bond bears (if there are any left) will continue to be tested.

Regards,

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