

Are We There Yet? | June 2017

“If you don't know where you're going, you'll end up someplace else.”
Yogi Berra

With the kids out of school, families across the country are packing up their cars and embarking on summer road trips. Journeys filled with bad dad jokes, frequent pee stops, and that oh too familiar backseat chorus.

‘Are we there yet?’

After years of wondering when interest rates will rise, the 0.45% increase in the Canadian 5 year yield in June has many bond investors asking the very same question. While the markets have cried wolf before only to see rates back down a month or two later, there is the nagging feeling that this time is different.

Previously, rising yields were met with central bankers steadfastly beating the drum of deflationary concern. No amount of economic data could shake their belief that the abyss of deflation lurked around the corner. As a result, they implemented and maintained the extraordinary measures of negative real (and nominal) rates and quantitative easing to stimulate economic growth.

Although lacking hard evidence that inflation is rising, policymakers have begun to change their tune. The Federal Reserve has laid out how it will begin its tapering process. The ECB has started to mull an exit from quantitative easing and negative rates. And even the Bank of Canada publicly stated that the economy had recovered from the shock of plunging oil prices.

The abrupt change of heart by the Bank of Canada caught many flat-footed. Despite the domestic economy performing better than predicted, CPI has not been particularly high. And since economic growth hasn't led to rising inflation in the G7, concerns around the perils of excessively low rates had faded.

Nonetheless, those driving the car have determined that deflation risks have considerably diminished and that reflationary forces now have the upper hand. As a result, they seem to be quite willing to remove the ‘emergency’ or ‘insurance’ stimulus that they have been relying on since the ‘Great Recession.’

Based on the data this may seem premature. But CPI tends to lag GDP growth, and changes to monetary policy can take several months to have an impact. Thus central bankers have to make decisions based on forecasts and often act before the economic numbers exhibit significant change.

So while we might not be there yet, it appears we are finishing the long stretch of the deflationary highway and moving onto the side roads. And like kids waking up when the car changes speed on the off-ramp, the Canadian market is now preparing for an interest rate hike tomorrow, the first in seven years.

Over the balance of the year, we expect to see a modest rise in yields, particularly once central banks commence the tapering process. But as is so often the case after a long road trip, the visibility on the side roads can be poor, and we can expect a bumpy and unpredictable ride en route to our final destination.

The Fund

After a record-breaking amount of new issues in May, supply moderated in June to a mere \$8B, the lowest print for the month since 2012. This breather gave the market an opportunity to digest the excess issuance

from May. As a result, credit traded sideways for the first half of June before tightening towards month end, despite negative returns in equities and bonds.

Bank NVCC was the star performer of the month, narrowing over 20 bps on the news that newly issued bonds (and potentially the existing ones as well) are to be included in the FTSE TMX index. The only laggard in June was Oil & Gas, which was knocked back by the violent move lower in commodity prices. However, the sector did begin to recover late in the month along with the price of oil, as investors took advantage of some compelling credit spread levels.

With the portfolio's interest rate sensitivity tightly hedged, the significant jump in yields had a minimal impact on the return. The improvement in credit spreads coupled with the interest earned contributed to a gain of 0.53% for the month.

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2017	1.73%	1.30%	0.44%	1.03%	(0.22%)	0.53%	-	-	-	-	-	-	4.91%
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

For many, the summer equates to vacation time. The corporate bond market often takes this theme to heart, so the supply of new issues can be light. Portfolio managers are thus forced to pick away at secondary offerings to deploy cash. The resulting reduction in dealer inventories can create the right environment for a steady “grind tighter” in credit spreads. Barring any “tape bombs” (or should we say “Twitter bombs”?), we would expect a modestly constructive summer for credit.

We have added to our floating rate notes while reducing the credit duration of more cyclical names. We feel a prudent exposure to bank NVCC debt is warranted based on the already mentioned bond index developments.

Rates

Both the Bank of Canada (July 12th) and the Federal Reserve (July 26th) meet this month. The market has the odds of the Bank of Canada hiking 25 bps in the region of 90%. The great debate following the meeting will be whether another 25 bps hike will come in September or whether the Bank of Canada will wait until late fall to raise rates again.

Federal Reserve Chair Yellen and company are poised to commence a far trickier operation as they exit quantitative easing. To avoid confusion, the Fed will take a pause from hiking, to focus on the mechanics and impact of exiting their purchasing program. We, therefore, expect them to be on hold until the end of the year and raise rates 25 bps in December.

As the central banks change course, investors have to hope they know where they're going.



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