

Half Time | June 2018

“In football everything is complicated by the presence of the opposite team.”

Jean-Paul Sartre

As the calendar flips from June to July, it marks the midpoint of the year and the first weeks of summer (yeah). And while the temperatures in Toronto have warranted heat warnings, it's a different type of fever that has been running through our office, that of the World Cup.

With the first of the semifinals set to kick off later today, we offer our version of a halftime report (minus the funky graphics and British accents). After the commercial break, we'll look at the markets and fund performance over the past six months and our approach heading into the second half.

While the 21st FIFA World Cup has delivered many memorable moments, for credit traders, 2018 has so far been a year we'd rather forget. After a strong start out of the gates in January, Canadian investment grade spreads have widened 22bps taking them higher by 13bps on the year. South of the border, they are experiencing the worst first half to a year in over a decade (including 2008), with spreads now sitting at levels last seen 18 months ago.

Meanwhile, equities have traded in a 10% range, and at the end of June were modestly higher on the year. While much of the attention lately has been on interest rates, the Canadian 10y has traded in a normal 0.5% range and is close to unchanged from December. And after drifting higher from a starting point of 2.4%, the US 10y seems to have settled between 2.8% and 3%.

The disconnect and weakness in corporate debt appear foreboding, with a few folks fretting that a recession might be lurking around the corner. However, it is worthy to note that the moves in credit have not been violent but have been more of a steady leak wider. And while macro uncertainties have contributed to higher spreads, the main drivers appear to be technical, supply and demand factors.

With bankers and corporations keen to issue new bonds ahead of further rate increases and the ECB unwinding QE, the market has seen a heavy amount of supply. Domestic issuance is up year-over-year, and the pace in the US is close to 2017's record-setting totals. Given the widespread perception that yields are heading higher, the demand for fixed income product has generally been lukewarm. As a result, new deals have been coming cheap and repricing secondary debt lower.

US tax reform has also sideswiped bond investors. Many companies invested their offshore holdings in short-dated corporate paper, which was sold to repatriate the cash. Furthermore, the usually reliable demand from Asian investors has slumped since the derivative market is not conducive to purchasing dollar-denominated debt on a currency hedged basis. This accumulation of factors has resulted in sloppy price action.

As for the fund's performance, the 1.17% YTD doesn't look so good on the halftime scoresheet, especially when measured against the annual 6% to 9% target. Prevailing market conditions meant the focus was more on keeping the ball out of our net than on scoring goals. The moves in credit led to losses, but defensive positioning and portfolio hedging mitigated the negative impact and preserved some of the carry and gains from active trading. The silver lining of wider spreads is greater compensation for credit exposure resulting in a higher yield on the portfolio going forward.

The natural question is whether we will try to engineer a 'come from behind' victory in the second half.

Unlike the beautiful game, where teams that fall behind take additional risks to stage a comeback, the score in portfolio management is cumulative. So, to determine if a change in tactics is warranted, we need to assess whether the investment environment will be different. Other than the potential for a lower amount of supply, the rhetoric around trade and the removal of monetary stimulus by central banks indicate a continuation of the choppy trading environment.

Accordingly, we will continue to play tight defence while looking for opportunities to counterattack and shift to offence again. Although scoring goals is more fun than defending your net, our experience has taught us the value of living to fight another day.

The Fund

Last month saw a continuation in the supply theme, with \$14.5bn of Canadian issuance setting a June record. As usual, domestic and foreign banks were featured sellers. Also coming to market were TransCanada Pipelines and Hydro One, who both managed to issue sizeable 30-year deals. Keyera Corporation did an inaugural 10-year public deal, while Canadian Tire returned to the market after a ten year plus hiatus.

Despite the record-breaking volume, prices held up quite well until the last week of the month. Much like some teams that flubbed the ball during stoppage time, the market couldn't hold as the 'tariff chirping' gave way to concrete actions. The result was a two to three basis point widening on the month, which cut into some of the return generated by carry and active trading, leaving the fund with a 0.26% gain.

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2018	1.19%	(0.45%)	(0.35%)	0.77%	(0.25%)	0.26%							1.17%
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 one of the headwinds for credit has been the imbalance between supply and demand, a shift in this dynamic could offer spreads some stability and perhaps performance. And there are signs that the scales could be tilting back towards normal.

The repatriation related selling of US paper appears to have run its course, with elevated spread levels having attracted buyers to the front end. On the new supply front, the summer months should offer the markets some respite, with issuance typically light until labour day. Also, with the issuance of bail-in debt by domestic banks widely expected in the fall, there is speculation that the supply of deposit notes will be carefully managed to



increase the receptiveness of investors for the new paper. An overall reduction in the amount of supply could lead to portfolio managers chipping away at dealer inventories and helping spreads to narrow.

The other key determinant will be how the macro picture unfolds, with the dominant themes being trade and the withdrawal of monetary stimulus. Given that the unpredictable nature of these factors could offset the positive technical developments in the corporate market, our game plan remains defensively opportunistic.

Rates

Bond traders had their hands full in June as the odds of the Bank of Canada hiking on July 11th waxed and waned. A few pockets of weak data sent the shorts scurrying for cover ahead of speeches by Governor Poloz and the release of the Business Outlook Survey. Given the barrage from the US administration about how 'Canucks' have been taking advantage of American workers, people feared that business investment and exports were heading over a cliff. Surprisingly the Survey revealed little weakness, as firms struggle to keep up with demand. As a result, the odds are around 85% that the Bank hikes rates 25bps on July 11th.

Governor Jerome Powell held his first FOMC meeting as chairman. The press release, as well as comments made in the press conference, suggest that the Federal Reserve is on track to raise rates two more times by Christmas. The European Central Bank also revealed how they intend to scale back their quantitative easing plans in the fall. Despite these rather 'rate unfriendly' developments, yields remain well off the highs for the year.

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