

Trade War, Huh, Yeah, What Is It Good For? | March 2018

“Trade wars are good, and easy to win.”

Donald J Trump

After months of protectionist rhetoric and threats of looming trade wars, it appears that the first shots have been fired. Trump followed-up his steel and aluminum levies by targeting \$60bn worth of Chinese imports as recompense for the alleged misappropriation of American intellectual property. China retaliated earlier this week with tariffs of their own on \$3bn worth of US exports, with the 128 products aimed at hurting Trump’s heartland. The EU, seeking leverage to gain permanent exclusion from the metal duties, also targeted Trump and Republican strongholds with threats of tariffs on Harley-Davidson motorcycles, Levi’s jeans, and bourbon.

What ensues will likely resemble a rolling barroom brawl rather than a precise military operation. Instead of swift and decisive action, the expectation is for a prolonged series of negotiations, duties, and other restrictions, as countries engage in tit-for-tat measures that gum up the flow of goods and services.

At first glance, the reasoning behind such protectionist maneuvers seems logical. By imposing steep taxes on imports, domestic producers can thrive. But as with most wars, things are never that simple, and we civilians are left wondering if there truly are any winners and what outcomes, both intended and unintended, will arise.

To gain some insights into these questions, we took a page from military strategists and studied some historic battles. Whilst doing our research, we came across one particularly amusing story involving William of Orange. To boost development of the national booze industry, King William imposed steep tariffs on French brandy and allowed unlicensed gin production. The plan worked, perhaps too well. For the next 50 years or so, Britain was gripped by the so-called Gin Craze, with overindulgence being blamed for a surge in crime, death, and unemployment. But in the end, perhaps William of Orange was a long-term visionary, as today the UK is the world’s largest exporter of the spirit.

Aside from those that enjoy a good gin and tonic, who else benefits from trade wars? In the short-term, levies protect inefficient local producers and their employees who experience an uptick in orders and wages. The downside, of course, is that there is no impetus for them to invest in improving technology, design, and processes. The result is less competitive industries becoming even more uncompetitive.

The obvious ‘losers’ are the foreign and domestic exporters that are subject to the various retaliatory duties. But even greater losses can be experienced by industries hit with higher input costs. The Bush-era steel levies of 2002 (rescinded in 2003) resulted in material shortages, production delays, increased costs, and the loss of 200,000 jobs.

In the end, the increased costs of both foreign and local goods get passed onto the consumer and add to inflationary pressures. Higher inflation could ultimately push Central Bankers to more aggressively hike rates and remove monetary stimulus, which has the markets nervous.

But the more disconcerting outcome would be if an escalation in trade wars leads to a drag on the global economy. In 1930, the US enacted the Smoot-Hawley Act, with the initial objective of protecting domestic farmers. But after passing through Congress’ game of ‘support my tariff and I’ll support yours,’ they ended up raising 890 tariffs on over 20,000 imported goods. The Canadians and Europeans responded in kind, leading to a 66% decline in world trade by 1934. Although there were other causes behind this drop, it is widely



believed that the Smoot-Hawley trade war contributed to half of the fall and helped deepen and prolong the Great Depression.

Despite such scary outcomes, given the slow-moving nature of trade disputes, the consequences can take years to emerge. In the meantime, it is likely that markets are moving into a higher volatility regime, especially since much of the battle is being waged through traditional and social media. Although the uncertainty can make committing capital more worrisome, the volatility also presents a greater array of opportunities. While politicians of all stripes often forget the lessons of the past, those that feel the brunt of the pain rarely do.

The Fund

March proved to be another challenging month with investors continuing to react to trade-related issues and technology-lead equity weakness. Corporate credit was no exception with broad spread indices wider by 13bps in the US and 8bps in Canada. Higher beta securities and sectors such as energy hybrids, bank subordinated NVCC debt, REITs, and retail underperformed.

On top of the already weak backdrop, March was also the second highest volume month for C\$ corporate new issues ever (second only to March 2015), as approximately \$15bn of debt hit the Canadian market. Notable deals included the long-awaited return of VW Canada with a three-tranche \$1.5bn deal, a massive \$1.3bn 2-part REIT offering from Choice, and an attractively priced \$1.5bn NVCC deal from CIBC.

The new issue process often provides a good indication of the health of the credit markets. While many of the recent deals were launched with healthy concessions, instead of rallying on the break, they just repriced secondary bond spreads wider. A change in this dynamic would be an early sign of improving sentiment.

Although our portfolio is concentrated in defensive short-dated securities, losses from the weakness in credit were only partially offset through active trading and the yield earned over the month. The net result for March was a loss of (0.35%).

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2018	1.19%	(0.45%)	(0.35%)										0.39%
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

Corporate debt has been caught up in the broader market volatility. Days of strength and stability in equities were met with the better selling of credit, as portfolio managers took advantage of the increased liquidity to lighten exposure.



There are some tentative signs that investor behaviour might change. South of the border, dealer inventories are very low, and the expectation is for a lighter supply calendar ahead of earnings season. Despite US bonds funds and ETFs experiencing significant outflows in the quarter, we have seen little evidence of such activity from Canadian investors. Overall credit spreads are far more attractive than they were two months ago and with issuers on both sides of the border poised to slow down their activity, a few days of lower equity volatility could bring out the corporate bond buyers.

Due to the somewhat erratic nature of the US administration's tactics in the budding trade skirmish, we remain wary of being too aggressive in adding exposure.

Rates

Sovereign yields grudgingly moved lower even when equity indices plunge. The moment that stocks stabilize, rates start the march higher. Our interpretation is that people simply don't see government debt as a safe place to park cash. As such, the balance of risk remains tilted towards higher rates in the coming months.

The Bank of Canada will meet later this month; however, the slow progress on the NAFTA negotiations, the uncertainty surrounding the health of the housing market and signs that GDP has slowed should allow them to leave rates unchanged.

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