

Cloudy With a Chance of Meatballs | May 2018

“Politics is not the art of the possible.
It consists in choosing between the disastrous and the unpalatable.”
John Kenneth Galbraith

For centuries, Italian chefs and vintners have been serving up a wide array of culinary delights. However last week, it was their politicians adding some spice and flavour to the markets, leaving many investors with a case of indigestion.

Amidst the political uncertainty and fears of a Euro exit surfacing, Italian 2-year yields went from being negative in the middle of May to as high as 2.75% last Tuesday. The velocity of the move sparked flashbacks to the summer of 2011 and the Greek debt crisis, leading to negative ripples across global markets.

Untangling the developments out of Rome is like unwinding a bowl of spaghetti, and is a task that we do not claim to have successfully undertaken (it's all Italian to us). But we thought a summary of the events and the backdrop would at least offer some vague insights into the situation.

On March 4th the Italians went to the polls, with an electorate not only despondent about failing to qualify for the world cup but also frustrated with their economic prospects. Contrary to global and European trends, Italy has seen weak economic growth, high unemployment, and declining house prices. On top of this, there have also been concerns over social cohesion and a rising tide of anti-migrant sentiment.

The result of the election was a hung parliament with the big winners being two populist parties. The anti-establishment Five Star Movement won the greatest proportion of the vote, 32%, with the far-right League tripling their share to just under 18%. Despite both parties appearing to support an 'Italeave' from Europe, Italian bond yields declined, and equities rose in the months that followed. That was until May.

On May 21st, after over two months of limbo and negotiations, the two parties proposed the relatively unknown law professor Giuseppe Conte as the Prime Minister of their coalition. But after President Sergio Mattarella vetoed their nomination of Paolo Savona for finance minister, a known Eurosceptic, Conte and the coalition abandoned their mandate to form a government. Consequently, this ignited fears of a July election that would act as a proxy referendum for exiting the EU and in which the populist parties were expected to strengthen their foothold.

These developments led to a quick repricing of Italian bonds, a country that ranks third globally in most outstanding debt after only the US and Japan. In the case of the Greek crisis, interest rates rose over 20% in 2011, so relatively speaking this was a modest move. Perhaps it was just an overdue repricing of risk or a cautionary signal to the Italians of the path they were heading down. If it was a warning shot across the bow, it appears to have worked.

Only a few days after the President installed Carlo Cottarelli, former director of the IMF, as the caretaker Prime Minister, the coalition formed a government with Conte as PM. The Five Star Movement and League also walked back rhetoric of leaving the single currency and shifted towards negotiating changes to EU rules and regulations. These moves calmed investors and took two-year rates to just above 1.5% (as we write).



With Germany and Brussels likely to play hardball, the stage is set for a long game of political back and forth. The diplomatic dance will continue to add spice to the markets, as people react to the latest developments. And as is so often the case in such affairs, the outlook is murky with the chance of some unexpected twists, or in other words, ‘cloudy with a chance of meatballs.’

The Fund

For the first four weeks of the month, domestic credit experienced modest weakness, with the Fund tracking towards a small positive on the back of active trading and interest earned. But in the final few days of May, Canadian corporate spreads widened 5-10bps due to the political uncertainty in Italy and concerns over Trump’s steel tariffs.

Further exacerbating the move wider was \$5.25 billion of issuance last week, taking the May total of new supply to over \$11 billion. The concessions on the new deals were generous, but given the weak environment, rather than rallying, these bonds simply repriced existing debt wider. While higher spreads were seen across the board, bank subordinated bonds, auto finance, and “hybrid” securities underperformed.

The rapid widening turned what would have been a small gain for the month into a small loss of 25bps.

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2018	1.19%	(0.45%)	(0.35%)	0.77%	(0.25%)								0.91%
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

With the moves last week, the difference between corporate and government debt has increased by over 20bps since February. US credit is wider by roughly 22bps year-to-date, making it the worst start to a year since 2008. Whereas geopolitical events have contributed to the weakness, a slightly larger-than-expected supply of new issues hasn’t helped.

The pace of issuance generally declines in the summer, so there is a tendency to see credit perform (absent twitter or other geopolitical bombs). And while the decline has been orderly, a few pockets of value have opened up, creating some interesting investment opportunities.

Although the current environment remains a little volatile, the reward for taking credit risk has improved. Accordingly, we continue to proceed with caution while looking to take advantage of the dislocations that such markets generate.



Rates

In response to 'the Italian Job,' Canadian yields dropped 20 to 30bps lower. As some of the uncertainty ebbed, a portion of the move did reverse.

The Bank of Canada meeting, which was held in the midst of the mayhem, turned out to be a bit more interesting than expected. The press release was a touch more forceful about the need to raise interest rates in the coming months. As a result, the odds of a 25bps hike in July now sit around 75%.

South of the border, the good times continue to roll, keeping the Federal Reserve on track to raise rates again in June. At some point, it's possible for worries about a more aggressive hiking path to roil the markets.

Across the Atlantic, speculation about when and how the European Central Bank will taper from their quantitative easing program is starting to build. As a result, the upward pressure on yields remains.

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