

The Good, The Bad, and The Ugly | November 2018

“In the short run, the market is a voting machine,
but in the long run it is a weighing machine.”

Benjamin Graham

Although November marks the Day of Remembrance, for most credit managers it was a month they'd rather forget. To borrow an analogy from investment guru Ben Graham, Mr. Credit Market's mood went from sour in October to rather ugly in November. Spreads on domestic BBB corporates (i.e. Rogers, Loblaws, Enbridge) were 25-35 bps higher over the month, preferred shares dropped 6%, and even the great Canadian banks saw their spreads move out over 10 bps.

Mr. Credit's mood swings caused jitters, made some headlines and led to the Fund enduring its worst period of performance since inception. With that in mind, we decided to begin this month's commentary with a broader look at the credit markets and our strategic approach to managing the portfolio going forward.

When most people hear about weakness in credit, their mind flashes back to 2008. The sheer magnitude and impact of the Global Financial Crisis left an indelible mark in our memories. And with no shortage of self-proclaimed pundits selling the 'debt bubble end of the world' story, fears of a repeat performance have been creeping into people's minds.

While there are grains of truth to the 'sky is falling' claims, it is important to understand the assumptions and uncertainties of these predictions. The odds of a 2008 repeat are low, and a recession is not a foregone conclusion. Having said that, the expectation is for growth to decelerate, and a move from 4% GDP in the US to 2% will feel recessionary rough. Such a slowdown would lead to rating downgrades of investment grade issuers and defaults by riskier (i.e. high yield) borrowers. It would also test the structure and liquidity of credit markets. We think the greatest areas of concern lie in leveraged loans and the debt of lower quality high yield borrowers, who need the economic tide to continue to rise. To poorly paraphrase Warren Buffet, 'you never know who is borrowing naked, until the economy weakens.'

On top of a slowdown, we have a backdrop of rising rates, the withdrawal of monetary stimulus, and an expansion that is long in the tooth. As these developments unfold, markets will continue to re-price assets and recalibrate return expectations. While the eventual magnitude and impact are unclear, what we can be certain of is an increase in volatility across asset classes.

For the past few years, volatility has been tempered with Mr. Market's mood swings moderated by central bank 'anti-depressants.' But with the meds being taken away, he is left to navigate the changing world on his own. Throwing in wildcards such as Donald the 'Tariff Man' Trump, the China Syndrome, a Shakespearean Brexit tragedy, and the Italian opera, doesn't help the withdrawal symptoms.

While his mood swings can be nerve-racking and test our patience, turbulent times create interesting opportunities. We look to capitalize on the strengths of our strategy and offer an interesting investment option amidst the uncertainty. As for overall positioning, we will remain focused on shorter-dated, high-quality securities where we feel the risk of default is de minimus. At present, the average maturity of our corporate positions is 1.7 years, the interest rate duration is 0.39, and the levered yield on the portfolio is around 6% (after funding costs).



By holding shorter-dated, liquid, investment grade names, we retain the flexibility to respond to both positive and negative shocks. Another advantage is that mark-to-market losses, while painful in the short term, are much easier to stomach when the recovery to par is within sight.

As always, we will remain dynamic in managing and hedging the portfolio's exposure. In the longer term, we will be looking for the babies that get thrown out with the bathwater in the form of opportunities to buy good assets at fire sale prices. Thus, boosting prospective yields by taking incremental amounts of risk while maintaining a substantial margin of safety.

We do expect the ride to be bumpy, but given the limited time to maturity and quality of securities in our portfolio, the key for us is to dig in and allow the bonds to do their job; to repay coupon and principal. As always with investing, the greatest advantage is often to play the long game, particularly when the rest of the world is reacting to volatility and caught-up in short-term thinking. As Warren Buffet says, "games are won by players who focus on the field, not by those whose eyes are glued to the scorecard."

The Fund

November saw volatile equities and government bonds close slightly positive, in response to soothing comments by Federal Reserve Chairman Jerome Powell. As for corporate debt, "there was no putting lipstick on that pig." With the dawning realization that risk premia ought to widen, bond portfolio managers rushed to reduce exposure. The one-sided nature of the flow resulted in one of the worst months (post-2008) in domestic credit that we can remember.

In addition to the host of aforementioned factors, there are specific triggers impacting the corporate bond world.

Once a market darling, with an AAA rating, General Electric (GE), has joined Ford as a pariah. Having been downgraded to the BBB bucket, GE has sparked worries that a wave of downgrades is imminent. At the start of the year, it would have cost 40 bps to insure oneself from General Electric defaulting. Now one would pay 205 bps, and in mid-November, it got as high as 265 bps. As a fall from grace is usually swift and painful, portfolio managers are carefully going through their holdings looking for other potential idiosyncratic problems, often selling anything perceived to be slightly risky (especially BBBs) without regard for the fundamentals.

New issue supply was light in November as investors moved to the sidelines awaiting some stability. The supply we did see was mostly utility and auto finance names. There was, however, a large \$800 million two-tranche BBB deal from Loblaw's that was successfully placed at the end of the month. Investors were enticed by attractive pricing from this infrequent bond issuer, but the cheap level at which the deal came caused secondary spreads to reprice wider.

Despite concentrating the portfolio in securities with less than 2y to maturity, the broad sell-off in spreads left nowhere to hide. Normally short maturity bonds are more insulated. However, the poor liquidity in longer maturities forced portfolio managers experiencing/fearing redemptions to liquidate short-dated paper. The forced selling pushed one-year credit spreads quickly wider. While we did have some selective short positions in the portfolio, they were simply too small to offset the impact of the dramatic move. The net result was a loss of 1.57% on the month.

	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%	0.46%	0.52%	0.47%	(0.34%)	(1.57%)		0.69%
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

It appears that fixed income managers still need to raise cash, resulting in net selling pressure. Given the dramatic reduction in new issues in what is normally a very active period, the need to sell might be waning, but we have yet to see concrete signs of this is occurring.

Normally, December sees a significant reduction in trading volumes during the second half of the month and is usually blessed with spreads grinding tighter as new issue supply dwindles and dealer inventories shrink. Perhaps this will be the case this year. However, since the latter half of December is a poor time to trade, flows (even small ones) can have a disproportionate impact on prices. We will be watching carefully. After all, like the Bank of Canada, we are data dependent.

From a portfolio positioning standpoint, we will maintain a cautious stance until a catalyst emerges for a reversal. Certainly, substantive progress on China/US relations would be a good start. It is always difficult to time the markets, and given the tone, the widening in credit spreads could persist. But valuations are starting to look more attractive and indiscriminate selling results in mispricings and investment opportunities. Accordingly, we will continue to concentrate on shorter-dated paper and remain patient for opportunities to establish positions from both the long and short side.

Rates

Both the Bank of Canada and Federal Reserve have been raising interest rates for several months. As a result, rates are nearing the neutral interest rate range. Unfortunately, nobody, including central banks, knows precisely what that rate is. Instead, as is the case with hand grenades and horseshoes, 'close enough' is the order of the day. But even 'close enough' is difficult given the volatility in other asset classes and the vast unknowns introduced by geopolitical events.

Sovereign bond traders are struggling to figure out when and where the central banks pause. As an example, only six weeks ago, they expected three hikes by the Bank of Canada in 2019. Now they expect only one. If the US and China suddenly reach a trade agreement and end all tariffs, the betting odds can quickly shift back to three.

As discussed throughout the commentary, volatility is the new normal!



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