



The Bulls Strike Back | October 2015

“Adventure. Excitement. A Jedi craves not these things.”
Yoda

Not so long ago, in a galaxy not far, far away, equity markets shed more than 10% of their value. It was a period of great terror and despair. Investors lived in fear of a slowing global economy and the Empire unleashing their much dreaded weapon, the Fed rate hike.

But in the early days of autumn with the Fed unexpectedly turning dovish, and China and Europe reaffirming their commitments to further monetary stimulus, optimistic investors managed to regroup, force the ‘bears’ to retreat and take equities back to the levels from where they had fallen.

Easy it would be to get excited by this victory and the dramatic drop in market volatility, but as students of master Yoda, we exercise patience and prudence. After all, many of the factors prevalent in August remain the same. The Federal Reserve is once again poised to raise rates, China continues to grapple with the transition from being an export-lead to a market-based economy, and commodity prices are in a funk, which continues to exert a drag on domestic growth.

At the end of September we felt the market had priced in a significant amount of bad news. At current levels we feel greater prudence is in order, as we wouldn’t be surprised to see further volatility as sentiment waxes and wanes.

The Fund

The Fund had another strong month, although the path to success was not a particularly straight one. Early in the month we were caught off guard when BMO spooked the market with a C\$600mm placement of 5-year rate reset preferred shares with a 5.85% coupon. The deal was extremely cheap, which sparked a dramatic widening of bank NVCC bonds. We were long TD NVCC bonds and decided to liquidate the position as the volatility of the securities became too great for our comfort. This position resulted in a loss of 35 bps for the fund.

Fortunately, our investment in VW C\$ bonds more than offset this loss. A couple of days after the initial scandal was reported, we felt that VW bond prices had fallen too far. We purchased one and two year bonds which performed strongly in October. Gains on this position coupled with an improved tone in credit and a myriad of opportunities to trade actively contributed to a net return of +1.71%.

Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
N/A	2.29%	2.51%	1.27%	2.46%	0.25%	0.73%	(0.25%)	1.68%	1.71%	-	-	13.32%

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

Although credit spreads continued to widen at the start of the month, once it became apparent that the new issue supply would be limited, market tone improved considerably. Liquidity generally improved as dealers felt more confident making markets in a calmer environment. Autos and Telco's performed very well, while TransAlta (a name we consistently avoid) widened dramatically. Bank NVCC spreads were extremely volatile, widening 30 bps before staging an impressive rally to finish the month unchanged.

We continue to see reasonable value in corporate debt at current levels, especially since the potential for new issue supply remains fairly low. Given our concern regarding bouts of volatility, we prefer shorter dated notes over longer maturities bonds.

Rates

The Bank of Canada left the benchmark interest rate unchanged at 0.5% and revised growth and inflation forecasts lower. The C\$30bn fiscal deficit the new Liberal majority government intends to run over the next three years should provide a modest dose of fiscal stimulus that reduces the need for an additional rate cut from the Bank of Canada. As a result, we expect short rates to drift slightly higher in the coming weeks as bond investors adjust to a neutral central bank.

With respect to the US, the FOMC removed language from their October policy statement which pointed to a stable global economy as a precondition for hiking rates. Ms. Yellen and company are certainly setting the stage to raise rates in December. We expect the Fed to hike 25 bps in December, barring another bout of hysteria in the markets. That said, we believe the Fed will move very slowly and deliberately in 2016.

Regards,

The Algonquin Team

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