

Don't Fight The Fed | October 2018

“Every time we do something great, he raises the interest rates.”

Donald Trump

To get the bad Hallowe'en puns and movie references out of the way, Red October offered investors more tricks than treats. The S&P and TSX were down over 6%, and bond funds posted negative results on the back of higher rates.

The sting from such losses is painful and leaves investors searching for causes. Most market observers attributed the weakness to concerns over US bonds yields, increased trade friction, instability in emerging markets, and the uncertainties around Saudi Arabia, Brexit, and the Italian budget.

With boring old rates and central banks in the spotlight as the main ingredients in this cocktail of causes, we thought it apt to dust off the old Wall Street expression, ‘don't fight the Fed.’ Grizzled market veterans use the saying as a reminder to not bet against monetary policy. If central bankers are stimulating growth with lower rates, the conventional wisdom is to be fully invested. Conversely, when they're taking the punch bowl away and hiking, it's time to pull back on the throttle.

Perhaps this Wall Streetism can also be repurposed as a message to the White House. In 2016, presidential candidate Trump criticized then Fed Chair Janet Yellen for not raising rates and creating a ‘false stock market.’ But last month, after the market decline, he pointed an accusatory finger at the path to higher rates being pursued by Chairman Powell, the ‘wise steward’ he appointed last year. The President even went so far as to call the Fed ‘loco’ (a word we thought only ‘bad hombres’ used).

So when it comes to a rising rate environment, should investors and presidents alike refrain from fighting the Fed?

While the past 25 years have seen the oval office abstain from meddling in the affairs of the central bank, the Donald isn't the first president to do so. Nixon bullied Chairman Burns to engage in expansionary monetary policies prior to his 1972 re-election campaign. He won the election, but the US economy was burdened with soaring inflation which lingered for a decade. In 1992, George H.W. Bush tried a similar approach, but Alan Greenspan held firm and raised rates to reduce inflation (some suspect as a signal that the Fed couldn't be pushed around). Unemployment remained high, Bush lost the election, and the economy went on to enjoy a boom in the mid-90s.

So for presidents, it seems the best practice is to avoid pressuring the central bank to ‘juice’ the economy and to respect its independence. But what about investors? Should they be withdrawing from the market as the Fed hikes?

The historical evidence doesn't paint a very convincing argument. From 1946 to 2006 the S&P rose during all but two of the twelve Fed tightening cycles. Old-timers will point to the deep recession of the early eighties precipitated by Volcker raising the federal funds rate to 20% in his battle with double-digit inflation. But since then there have been six hiking cycles (excluding the current one), and the average S&P return for the two years following the initial hikes was over 14%, with the only negative period being the bursting of the dot-com bubble. There were pockets of weakness and increased volatility around the hikes (on average peak-to-trough declines of 10%), but equities were generally able to weather the storm.

Thus it seems there are no hard and fast rules to investing in a rising rate environment, and further consideration must be given as to why the central banks are hiking. In the past, the Federal Reserve raised interest rates, because inflation was heading higher. The current situation is very different. Despite having risen recently, core inflation is hovering around 2% which is well within the comfort zone for central bankers. But with unemployment below 4% and growth at 3.5%, the goal and challenge for Chairman Powell is to find the balance between sustaining expansion without choking growth.

Also important to consider is the base level from which the increases are occurring. At current levels, rates are still accommodative with the Fed quite clear that the pace of increases will be measured and that they expect to stop somewhere around the 'neutral mark' (3% or so). Also, the hikes thus far have been of the 'garden variety' 25bps, unlike the 50 and 75bps of 1994 when rates rose 3% in nine months.

Nonetheless, after such a long period of ultra-low interest rates, trepidation over the move higher is only natural. Some of the fear is around the potential for the Fed to be more aggressive than what has been projected and communicated. We see the risk of this being remote and requiring core inflation to reach 3%. So when it comes to rates, we believe people need to think longer term, and pay more attention to 10-year yields than overnight rates.

The drivers of where governments can borrow 10-year money are factors such as inflation expectations and supply/demand imbalances. For many years, various central bank quantitative easing programs meant that demand for bonds outstripped supply. With these same central banks starting to scale back purchases, in a time when government borrowing is on the rise, the risk is that a sharp upward rate move might be right around the corner. Such a move would make it far more expensive for corporations to service debt raising fears of lower profits or a decrease in investment spending.

So while the Fed might serve as a useful scapegoat for Trump should the economy turn, it's of little value for investors who have to negotiate the markets and could be distracting them from more pertinent risks and uncertainties. And while we advise more attention be paid to 10-year rates than monetary policy, we're not expecting to see any 'Unwinding QE very bad. Not good. Sad. #BringbackQE' tweets anytime soon.

The Fund

While equities were the standout underperformers last month, fixed-income markets were not spared from the maelstrom. While interest rates did move lower from their early October levels, they still ended the month higher by 7-11bps in Canada, raising questions about the notion that overvalued government bonds are a sure way to preserve capital during a risk-off move.

The rise in rates combined with the equity induced credit weakness made for a difficult month in the bond markets (FTSE Canada Universe Bond Index -0.61% in October and -0.96% YTD). Broad credit spread indices were wider by 12bps in the US and 6bps in Canada, with BBB spreads underperforming (broadly +15bps in Canada). On the Domestic front, the hardest hit were auto finance (Ford 5-year bonds +45bps), bank subordinated debt, and energy-related credits (WTI down \$10).

We generally reduced market risk, ran almost no exposure to rates, and had tactical short credit positions in place to soften the blow, however, the violence of this month's down trade resulted in a modestly negative (0.34%) month. The silver lining in a difficult year for credit is that with domestic BBB spreads now 35bps wider than the January tights, the yield on the portfolio is higher, and the forward outlook on valuations is more compelling.

	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%)			2.29%
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

Looking ahead to the end of the year, Red October did create some interesting opportunities. We reduced short credit positions at month end and selectively added risk as equities settled down (for the time being) and valuations moved to more attractive levels. There were also select opportunities to enter positions at attractive prices as bank dealers sold stale positions heading into their fiscal year end (October 31st).

December will see a significant amount of bond coupons and maturities with the resulting cash flows needing to be deployed. Due to the turmoil, new issue supply was naturally quieter than average in October, and while we expect things to pick up, the forward calendar still looks manageable.

We will remain watchful and dynamic with respect to our market exposure. If equities can maintain their footing, then we would expect a modest credit spread rally into year end.

Rates

Governor Poloz has certainly made the market more interesting by dropping all forward guidance and firmly stating that the Bank of Canada's interest rate policy is completely data dependent. As a result, traders have decided to place about a 25% chance of another 25bps hike on December 5th. Those odds will materially change as the next meeting date approaches.

There is an 80% chance that the Federal Reserve delivers a 25bps hike on December 19th. Ironically, the more President Trump publicly complains, the greater the chance Chairman Powell defends the Federal Reserve's independence and raises rates.

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