

Rates They Are A-Changin | November 2016

"You don't need a weatherman to know which way the wind blows."
Bob Dylan

As the world tries to figure out what to expect from a Trump presidency, it appears the market has reached its conclusion. With US 10y bond yields up 0.60% in November, the expectation is for stronger growth and higher rates.

Investors, shocked with losses of 2% in their fixed income portfolios, have been wondering what happened and what's next?

To answer these questions let us begin by looking in the rear view mirror. Historically, government debt has yielded 1% to 2% above inflation. When US 10 year notes traded at 1.75%, one could assume that people expected changes in consumer prices to be roughly zero for a decade. This seemingly bold bet suddenly appeared to be a silly one, prompting people to hit the sell button.

What drove the panic selling? The anticipation of a substantial supply of new bonds and inflation.

As the Dylan song goes, "Come senators, congressmen, please heed the call." With Republican's in full control of US policy, the door is open to significant tax cuts and infrastructure spending. Since such policies would need to be financed with an abundance of debt, investors are rightfully demanding a higher return as compensation.

Donald and friends have also raised the inflation spectre. With US unemployment at 4.9% and a tough stance on illegal immigrants, there may be a limited amount of labour to meet the demand created by fiscal stimulus. This could lead to a substantial rise in wages to attract employees.

Further stoking the inflationary flames is the potential for a trade war. There have been forecasts showing that the imposition of 15% tariffs on Mexico and China could add 1% to US consumer prices.

This combination of rising wages and prices would push the Federal Reserve to steadily hike rates through 2017, forcing bond prices lower. As long as the promise of fiscal stimulus remains, US yields will likely remain under upward pressure. The path won't necessarily be a straight one; however, it does seem that the 'bottom' is in.

What about O Canada, our home and native land?

Unlike the Federal Reserve, we expect the Bank of Canada to remain on the sidelines for the foreseeable future. This will keep short end rates anchored, but longer-dated yields have to adjust higher in sympathy with the US in order to entice global investors.

So how much higher will Canadian interest rates go?

To answer this, we revert back to our trusty rear view mirror. The Bank of Canada has successfully managed to keep inflation at roughly 2% for the last 25 years. Assuming history is a reasonable guide and rates normalize, one can expect 5 and 10 year yields to reach somewhere between 2.5% and 4%. These levels are more than double today's yields, meaning more losses from traditional fixed income could be on the way.

How long will it take for rates to reach these levels?

'The answer, my friend, is blowin' in the wind.

The answer is blowin' in the wind.'

The Fund

Given the uncertainty heading into the election, we significantly reduced our risk posture by liquidating most of our lower rated securities and hedging the portfolio with a selection of short positions. As the election results poured in and Dow futures plunged 800 points, we were happy to have gotten out of the way and wished we had put on a bigger hedge. The rapidity with which the market stormed back completely caught us off guard. As a result, we elected to 'sit on our hands' for a couple of days and watch.

After concluding the "the Trump bump" had legs, we aggressively increased the fund's risk posture, including adding to bank NVCC and midstream energy positions. NVCC performed well on the speculation that less regulation and a lower cost of business will boost bank profits. Our energy exposure also performed well, with the last remaining position benefiting from a fortuitous bounce when OPEC decided to cut production.

Having hedged against the rise in interest rates and capitalized on the narrowing of credit spreads, the fund generated a return of 1.60% in November.

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2016	0.19%	1.49%	5.32%	3.51%	0.60%	0.54%	1.73%	1.63%	1.01%	1.86%	1.60%	-	21.18%
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

December is typically a favourable month for credit since new issue supply is often light. The issuance calendar seems abnormally empty as it appears that very few corporations need to borrow money, especially those rated BBB. Without a clear reason to worry about credit spreads, we continue to maintain a reasonable posture heading into the holiday season.

Rates

It is a foregone conclusion that the Federal Reserve raises rates on December 14th. The only unknown is their outlook for future hikes. The Bank of Canada, noting significant slack in the economy, will remain on hold for quite some time. Because interest rates ought to remain volatile, we will maintain tight hedges on the portfolio.



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