

What Goes Down Must Go Up | September 2016

"For every action, there is an equal and opposite reaction."

Isaac Newton

The big, and perhaps most perplexing, question in fixed income land is: When will interest rates rise?

Unfortunately, we broke our crystal ball a few months back and will have to rely on economic theory and a bit of physics to unwrap the problem.

Theoretically speaking, rates should rise when the risk of lending money rises. When dealing with governments, the risk of default is typically assumed to be negligible (not a good assumption across the board – think Greece or Argentina). Accordingly, the focus tends to be on inflation. As such, prior to the economic meltdown of 2008, government yields generally traded one to two percent higher than expected inflation.

But over the past eight years this relationship has broken down. Today, government securities return less (sometimes far less) than inflation. One could argue that investors are so risk averse that they would rather lose purchasing power slowly than face potential capital losses in riskier assets. Others claim that we are in the grips of deflation and that bonds actually offer good value. Try telling that to anyone buying a home in Vancouver or Toronto, or to those who pay attention to their household bills.

So to answer the big question we must first ask, what's keeping interest rates so low?

The simple answer is Central Banks. Through their quantitative easing programs (QE) they have been aggressively buying government securities in an effort to reduce long-term yields and spur the economy. As an example, the Bank of Japan (BoJ) owns a third of the government's outstanding debt and continues to buy more. They, along with the Europeans, have driven rates into negative territory.

The impact of these purchasing programs is felt across the globe. In comparison to negative rates, Canadian and US bonds look very appealing. These relatively 'juicy' returns attract foreign buyers and apply downward pressure on domestic yields.

So what then will cause rates to rise?

Here we turn to physics for some help. All things being equal, if we remove a downward force on a stationary object, it will rise. If we were to remove gravity, we would float up and away. Since yields are being depressed by central bank buying, it stands to reason that when the buying ceases, rates should move higher.

In 2013 when the Fed revealed that they were going to scale back their purchase program, government yields shot up by half a percent in the aptly named 'taper tantrum'. Should the European Central Bank (ECB) and BoJ end or curtail their operations, it wouldn't be surprising to see similar and possibly even greater moves.

So while much is being made of the looming US interest rate hikes, we see this having little impact on the domestic bond market. Instead, if Canadians want to get an idea of when rates could be going higher, they should be looking east rather than south, searching for any signs that the ECB or BoJ are going to stop the QE gravy train.

The Fund

While credit spreads were generally unchanged over the month, the fund managed to capitalize on sector outperformance and generate yield from maintaining positions through the noise.

In anticipation that new issues from the energy sector would be well received, we purchased existing pipeline bonds in the secondary market. Inter Pipeline did a 7-year deal which was a riot. This led to a rally across the sector, creating a nice gain for the fund.

While the dust was settling in pipelines, our attention turned to insurance which had been a laggard for several months. Sun Life and Industrial Alliance did deals which performed well. Observing this behaviour, we opted to increase exposure to the sector and benefited as spreads tightened.

Active positioning and carry resulted in a gain of 1.01% for the fund in September.

	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%	-	-	-	17.09%
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 support from a lower than forecasted amount of supply, credit spreads performed well over the summer. But as with the autumn weather, the climate is looking a little less sunny and bright.

In addition to lingering concerns about the Fed and Trump gaining in the polls, another worry has emerged. Deutsche Bank is facing a significant fine from the US Department of Justice, putting the firm in a precarious position. A bank crisis of this magnitude would wreak havoc in global markets. For more on this please refer to our piece entitled [Gesundheit](#).

Also, on the domestic front, bank dealers may be reluctant to significantly increase inventories ahead of the October 31st bank year end. As such, we think a medium risk posture with a fair degree of caution is justified at the moment.

Rates

Government yields moved in a fairly wide range throughout September, but finished little changed. Bond prices fell after the ECB failed to increase their quantitative easing program, but reversed course after the BoJ tweaked their program and the Fed opted not to hike rates. As discussed earlier, government bonds will continue to defy gravity for some time to come.

Surprisingly weak Canadian inflation data will keep the Bank of Canada on the sidelines, although the risk remains tilted towards further easing. With the US election weeks away, the Fed will say little and most certainly do nothing until a new president is selected.



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