

The Law of Unintended Consequences | September 2017

“The road to hell is paved with good intentions.”

Proverb

One of the great dilemmas in moral philosophy is whether actions should be judged based on their intentions or consequences. The difficulty, of course, arises when the impact of our intentions are unforeseen, unexpected, or unintended.

This concept of unintended consequences was popularized by the twentieth-century sociologist Robert K. Merton. In his 1936 paper, *The Unanticipated Consequences of Purposive Social Action*, Merton examined the causes behind and the types of unanticipated outcomes. These ranged from pleasant surprises to perverse results, where the action backfires producing the opposite of the desired effect.

Take for instance the British Raj’s (not to be confused with the Algonquin raj) attempt to curb the cobra population in Delhi by offering a bounty for each dead snake. The plan was a success until some enterprising people started breeding cobras for income. Eventually, the scheme became so big, that authorities were forced to scrap the program, causing the cobra breeders to release their now worthless snakes. In the end, the net effect of the initiative was to increase the cobra population.

Another historical backfire was the ‘Four Pests’ campaign during Chairman Mao’s Great Leap Forward. The Chairman introduced a new hygiene initiative that targeted rats, flies, mosquitoes, and sparrows. Because the sparrows ate the grain that the farmers sowed, Mao believed they were depressing crop yields. Unfortunately, he didn’t know that the sparrows also consumed vast quantities of locusts. Once the sparrow population was decimated, the locust swarms took over the country, devouring entire crop fields at a time, leading to mass starvation.

These examples serve as reminders for us at a time when several complex ‘government actions’ are unfolding or about to unfold. The Federal Reserve will commence their exit from quantitative easing, the Bank of Canada (BoC) may continue increasing interest rates, and there is the potential for significant changes to the tax codes on both sides of the border.

Over the course of three quantitative easing programs, the Federal Reserve acquired \$4.5 trillion in assets which lowered long-term government bond yields by an estimated 1%. Although the Fed believes their exit plan will be an orderly one, there is a non-trivial chance it won’t be. After all, where is the \$4.5 trillion going to come from to fill the void when they step back?

On the domestic front, the BoC is bent on adding volatility to the bond market as they remain tight-lipped about their plans. In a world, where central bankers are opting for a very slow withdrawal of stimulus, the Bank’s eagerness to hike stands out as an anomaly. At this point, it’s interesting to note, that one of the earliest references to unforeseen outcomes was in a letter from John Locke to Sir John Somers (MP) about the unintended impact of interest rate regulation.

Lastly, the ‘minor tweak’ proposed by the Canadian government, is the most significant change to the tax code in years, while the promised US tax overhaul may end up being only temporary. As tax policy affects return on capital, succession planning, business expansion plans, etc. it is difficult for the bureaucrats to predict the medium and long-term consequences of their planned changes.



We are not necessarily foreshadowing doom and gloom, as “undesired effects are not always undesirable” (Merton, 1936). But given the sheer scale and complexity of these endeavors, it seems reasonable to “expect unexpected” (Algonquin raj, 2017).

The Fund

September was a busy month with approximately \$15bn of new issues coming to market. While domestic bank supply continues to underwhelm (due to international issuance) foreign and corporate issuers have more than picked up the slack. Amongst the new deals were infrequent issuers such as Capital Power, Morguard, and Finning. Enbridge also brought a subordinated “hybrid” deal, and the Maple market (foreign issuers bringing C\$ deals into Canada) continues to be very robust providing diversification for domestic investors.

Despite the heavy volume, there is lots of cash available for new issues as the deals were well received and oversubscribed. The positive reception resulted in credit spreads remaining roughly unchanged.

Stable spreads allowed the fund to capture all its carry, and the increased deal flow presented several good trading opportunities, leading to a 0.70% return for September.

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2017	1.73%	1.30%	0.44%	1.03%	(0.22%)	0.53%	0.94%	(0.09%)	0.70%	-	-	-	6.53%
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

Last month's good momentum should make for a busy October. The rates traders will agonize over every data release, while the credit crowd will have several deals to muddy their hands.

Despite interest rates moving higher after the Bank of Canada hike, we see no evidence of investors pulling back from fixed income. Instead, higher yields might be attracting new money or prompting some folks to add duration to their portfolios.

We see a couple of positive tailwinds ahead. First of all, there are a growing number of strategists calling for Canadian equities to close the performance gap with other markets. Should this occur, the enthusiasm will likely spill over from equities to corporate debt. The other factor is US tax reform. Although a detailed plan is months away, it does appear that reform will reduce the incentive, need, or both for corporations to borrow money. The scarcity of product could lead to a healthy rally in corporate debt.

Rates

Yields are clearly on the rise. The Federal Reserve will commence the exit from quantitative easing in October and is now widely expected to raise rates in December. Governor Poloz is holding his cards 'tight to the chest,' however, he does seem bent on raising rates over the next year or so. Although bond yields have risen, the market has been quite orderly. A wild card could be the European Central Bank which is expected to reveal its exit plan in the coming months.



Given the complexity of unwinding the buying programs, a small difference in procedure could result in a big difference in the outcome. Accordingly, one should be prepared to be surprised.

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