

Show Me The Data | December 2018

“Only time will tell if it was time well-spent.”

Jimmy Buffett

With calendars flipping from December to January, we rang in the new year and bid adieu to 2018. For most portfolio managers and investors, this was not a sad farewell. Equities endured their worst performance in a decade, and there was little respite elsewhere, as most asset classes posted negative returns.

Amidst the volatility and pain of losses, sentiment shifted from the glass being half full to half empty to fears of it shattering completely. The shift has led to some rather gloomy predictions and outlooks for 2019.

While we aren't fans of crystal balling, we do focus considerable energy on understanding the current environment. To paraphrase Howard Marks, 'you might not know where you're going, but you sure as hell better know where you are.'

So, for our new year's commentary, we look at what happened, where we are, and what factors could influence where we're going.

In their simplest form, markets reflect our expectations of the future. And in the latter half of the year, investors braced themselves for weaker economic data and lower corporate earnings. Concerns over a slowdown and less accommodating monetary stimulus were exacerbated by the escalation of the US/China trade battle and other political dramas. Accordingly, investors demanded substantially greater premiums for taking on risk, and prices dropped.

The question is whether the adjustment is too much or too little, or like the baby bear's porridge, just right. This is what the markets appear to be grappling with right now. Having priced in weakness on the prospects of lousy headlines to come, investors have moved into the 'show me' phase. So, what are we waiting to be shown?

The dominant story is Trump vs. China. The good news is that both sides are engaged in negotiations, the bad news is that if a deal isn't reached by March 1st, Trump is threatening to both raise and broaden tariffs on virtually everything made in China.

The 'deal or no deal' outcome will also have knock-on effects on another topical topic, rates. Under the 'no deal scenario,' higher and more expansive tariffs raise the spectre of 'stagflation.' A world of high inflation coupled with low growth. Given the Federal Reserve's dual mandate (inflation and employment), such a scenario would make it very difficult to predict whether they would raise or lower the overnight rate. But there is little doubt that stocks and bonds would suffer from the uncertainty. On the other hand, if a deal is reached the markets would cheer, and sentiment would improve.

The other political drama unfolding is Brexit, with the UK scheduled to leave the EU on March 29th. It is difficult to see how this story will end. Perhaps Theresa May's deal gets parliamentary approval, but it seems far likelier to fail. If Parliament chooses not to accept her proposal, there will be a frenzy of activity as people advocate for a variety of possibilities ranging from another referendum to a hard exit. Although folks on this side of the 'pond' have not been bothered by the shenanigans so far, they might change their minds if chaos engulfs Westminster and the odds of a hard Brexit rise.

The next issue being followed is closer to home. Despite significant advances in alternative energy, oil still matters. Declining prices spooked markets and helped prevent the Bank of Canada from delivering another

rate hike. As such, strength in Canadian oil would spice up the bond market, which is not expecting another move by the central bank this year. Higher prices in Western Canada Select will test this conviction. A bonus for world travellers is that higher oil prices should strengthen the floundering 'loonie.'

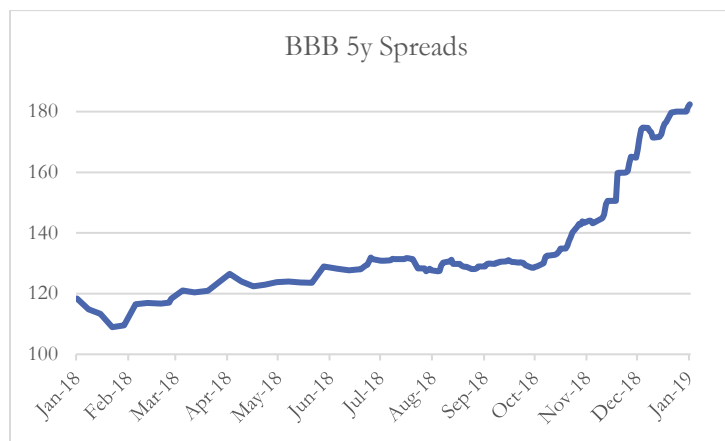
While the aforementioned items will make headlines, it is also worth paying attention to the less riveting economic numbers. Investors are preparing themselves for very poor growth and possibly a recession in the near future. That makes corporate earnings (especially any forward guidance), employment trends, and inflation numbers very important. In particular, the bears need to see poor corporate results, very low or possibly negative job growth, and core inflation dropping well below 2%.

In terms of recession indicators, another valuable tool is the shape of the interest rate curve. Before the last three recessions, the yield curve inverted, with shorter-term rates higher than longer ones. The tricky question is which part of the curve to watch. We feel the spread between 3-month T-Bills vs. 2-year government debt is the most important. This spread is currently +22 bps. Seeing this go negative would be an ominous sign.

Although following the flow of information and data seems an easy task, untangling the facts and developments is difficult given the myriad and often conflicting items that need to be parsed in order to develop a clearer picture. A task that is further complicated given that we humans are not the rational agents of economic models, and there are psychological 'forces' amplifying the pendulum's swing. Based on the current tone, we expect bad news to be overweighted and good news underemphasized or brushed off as 'fake news.'

So, while the markets have priced in a bleak future, data lags, 'people be crazy', and in the end, only time tells.

The Fund



Source: BMO Corporate Debt Research

As per the ugly picture above, the generic Canadian five-year BBB spread widened 70 bps from the euphoric levels reached in January 2018. The most violent move transpired over the last six weeks of the year (15 bps in December). Canadians were not alone in their misery, as US credit experienced similar moves.

Underperforming sectors included most things energy-related, as well as Maples (foreign debt issued into Canada), REITs and subordinated financial debt. Preferred shares were particularly hit hard on ETF and retail selling in a very thin market. Although our exposure to preferred shares is small (<1% of the portfolio), the large move inflicted moderate pain.

December typically sees a significant reduction in liquidity as the holiday season kicks in. The reduction was far more pronounced this time as fixed income funds struggled to keep up with redemption requests. Furthermore, extra pressure was exerted as portfolio rebalancing saw bonds being sold to purchase equities. New issue activity was exceptionally light as negative sentiment kept everyone on the sidelines.

Our holdings are concentrated in short maturity securities and included some tactical short positions as hedges. Nonetheless, we were roughed up a touch and ended the month (0.81%) as the hedges were simply not enough relative to the widening move.

	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%)	(1.57%)	(0.81%)	(0.13%)
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

The carnage of the past few months has left corporate debt much cheaper. In the short term though, the challenge will be to navigate the new issuance market. After the illiquidity and risk-off move of Q4 2018, issuers sat on their hands and deals are backed up.

New supply will need to come at meaningful concessions on top of already much wider secondary spread levels. This presents the opportunity to enter positions at attractive prices but also has the potential of repricing existing debt wider in response to the new issue levels. Our approach is to actively manage positions in sectors and issuers where we anticipate heavier volumes of supply. And over the coming weeks and months, we will be watching primary issues very carefully. In particular, we will gauge the magnitude of supply versus forecasts, the concessions required to place deals, the performance of secondary markets, and the amount of cash on the sidelines available to go to work.

There is no rush to significantly increase exposure given the 'wall of worry' to be climbed, however, we do expect activity to pick up and are prepared to exploit any opportunities that arise.

Rates

Canadian and US sovereign yields marched steadily lower as traders reduced the odds of central bank hikes in 2019. At this point, expectations of continued hikes by The Bank of Canada and the Federal Reserve are very low.

Bond traders are 'twitchy' by nature and will be quick to move yields in response to the unfolding economic data, which will test the conviction of anyone making long term duration calls.



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