

It's the End of the World as We Know It | February 2019

“People are predicting the end of the world like there's no tomorrow.”

Mr. Greg Jeffs

Since the beginning of civilization, people have been predicting its end. Everyone from religious figures to psychics and scientists have warned of nuclear holocausts, asteroids, zombie invasions, and other apocalyptic events leading to the extinction of the human race. In a 2012 poll conducted across 20 countries, 14% of respondents expected the world to end in their lifetimes.

This morbid fascination with the ‘end of days’ extends to the financial markets, where bouts of volatility are met with pundits calling for the next crash or collapse. The latest market ups and downs (or more accurately downs and ups) have seen fingers pointed at the ticking time bomb in credit as the potential cause of the next disaster.

So, is there a corporate debt bubble that is ready to pop?

As is the case with many doomsday prophecies, there is a little basis in truth. Credit markets have grown substantially over the past decade. Low-interest rates created a thirst for yield, which allowed many new issuers to access the market. Furthermore, until recently, the US tax code led many companies to issue debt to minimize tax while rewarding shareholders with dividends and stock buybacks. The result is that the level of corporate bonds and loans outstanding has never been larger. At first blush, this seems terrifying, but should it be?

While the level of corporate debt as a percentage of GDP has never been higher, the same is also true of assets. It's natural that growing corporations finance their investments with a combination of debt and equity. To do otherwise, would be an inefficient use of shareholder capital. Although it is difficult to determine the degree to which the corporate debt pile should have naturally grown, we think it is reasonable to believe some excess exists.

The real question thus becomes, what happens in a recession or economic slowdown?

While borrowers of all stripes have been to the trough, not all debtors are created equal. Thus, it is important to separate any analysis between the low and high-quality issuers.

Let us take a look at investment grade borrowers first. These corporations tend to employ lower amounts of leverage and are cash flow positive, in many cases, even when the economy is contracting. The bond market generally remains open to them when it comes time to refinancing maturities, albeit with investors demanding higher compensation. Should the bond market not be receptive, these companies tend to have undrawn bank lines that can be used as a bridge until sunnier days emerge. Senior executives also have a variety of other levers at their disposal including cost-cutting, dividend reduction, and asset sales to shore up their balance sheets.

Lower quality borrowers who depend on the high yield or levered loan market are a different kettle of fish. These companies are typically highly levered and/or cash flow poor. Often, they are reliant on a strong economy to execute their business plan. Also, given the risky nature of their debt, there is a smaller pool of lenders willing to extend them capital. Should a recession hit, these businesses have few options within their control to improve cash flow. If their limited pool of creditors disappears when they need to roll over maturing debt, they could find themselves battling to survive. In this scenario, defaults can occur quickly.

The doom merchants would have us believe that such a wave of defaults would trigger a tsunami and plunge the economy into a sequel of the Global Financial Crisis. Given that there hasn't been a recession since 2008, 'recency bias' skews us towards viewing that as the base case of what should occur. While it is impossible to rule out such a scenario completely, we think the odds are remote.

2008 was about the real possibility of a complete collapse of the banking system. Since then, governments, and those who finance banks have brought about much change in the way financial institutions conduct business. One of the reasons for the tremendous growth in the corporate bond and levered loan space has been that banks are more selective with their lending.

Although vulnerabilities in credit could contribute to or exacerbate future recession dynamics, we don't see the magnitude of the risk being equal to that of the household and financial leverage that led to the crisis of 2008. Also, amongst all the doom and gloom, there have been a few positive developments that could cushion any blows sustained by corporate debt.

With sovereign yields not expected to rise significantly, the demand for fixed income should be stable. And on the supply side, issuance is expected to fall this year as companies no longer issue debt to pay dividends or finance buybacks.

Another, more recent, positive development has been the alignment of interests between bond and equity investors, two camps that are usually at loggerheads. Corporations that are taking bondholder friendly steps to reduce leverage, including taking drastic measures such as selling assets or cutting dividends, are being rewarded with a surge in their stock price. Furthermore, while the earlier stages of the cycle saw substantial debt-financed M&A, the latest deals have leant towards share financing, with the costs/risks skewed to shareholders rather than the fixed income investor. If these trends continue, we could see more corporations joining the debt diet.

Until the next recession occurs, there will be no shortage of doomsayers vying to predict the event and its causes. And just like a 'stopped clock is right twice a day,' they too will eventually be correct. But it is important to remember that economic slowdowns occurred many times before 2008 for a variety of different reasons, and it is far likelier the next one will occur due to events that few foresee today. And whilst some financial forecasters and conspiracy theorists make repeated apocalyptic prophecies, the reality is, that the world will only end once.

The Fund

February saw a continuation of the rally that started in early January, although at a less frenzied pace. Canadian investment grade spreads were generically lower by 7 bps on the month. With the banks in a blackout period, new issues were a scarce commodity. Artis REIT, Brookfield Properties, Canadian National Railways, Enbridge Pipelines, Wells Fargo and Manulife Bank were the featured issuers in an otherwise quiet month.

There were a few signs that supply was not being easily absorbed and with spreads having narrowed substantially since the beginning of the year, our enthusiasm has waned slightly. We took the opportunity to take some profits, reduce a few holdings, and modestly increase hedges through short credit positions.

The impact of tighter spreads, active trading and the yield earned contributed to a 1.15% gain for the February.

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2019	2.03%	1.15%											3.20%
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

March is expected to be (and thus far has been) busier with respect to new issuance, especially from banks and financials. Supply from the telecoms should also gear up to fund the spectrum auction later this month. The pick up in issuance will be a real test of demand. In the fall, fears of rising rates led to redemptions in fixed income funds. With those concerns behind us, the question is whether the hunt for yield will be strong enough to digest the heavier supply without materially impacting spreads.

On the macro picture, simmering trade tensions and the uncertainty around Brexit still overhang the market. Also given the pace and magnitude of the recent rally, a mild retracement is possible. As such a defensive position, concentrated in short maturity, high-quality names is still warranted.

Rates

The best-laid schemes of mice and men and central bankers have gone awry. Evidence that the domestic economy is much weaker than expected has forced the Bank of Canada to shift to a neutral position joining the Federal Reserve who capitulated in December.

With the next rate move a toss-up, the year might not be as boring for bond traders as we initially thought.

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