

Exit Stage Left | January 2019

“All the world's a stage,
And all the men and women merely players”
William Shakespeare

From his days as a businessman and TV personality to his tenure in the White House, the President has never shied away from the spotlight. With his and China's cold trade war representing the greatest source of risk and uncertainty for investors, the question is, how will he fare in the market's limelight?

Although Trump likes to brand everything from towers to steaks, there is something he would rather not have his name attached to; a recession.

But if a deal can't be reached and 'Tariff Man' follows through on his threats of 25% duties on everything made in China, this could be the unwelcomed outcome. So as the President tackles the perceived problem of a trade deficit and saving America from foreign exploitation, the rest of us are left watching and wondering.

Given the euphoria currently gripping the markets, it's hard to believe that only weeks ago, the stage was being set for a recession. The first cracks started appearing in European and Chinese growth, and Canadian GDP slipped from 2.9% to 2.0%. This global slowdown was attributed to a drop in confidence exacerbated (or even caused) by the trade tensions. This lack of confidence led to a decline in both business investment and equities.

These developments dragged another set of actors into the spotlight; the central bankers. The precipitous drop in stocks was enough to push the Federal Reserve to let the curtain fall on their rather mechanical tightening program. US yields declined as expectations for two or three hikes in 2019 faded to none at all. With the 'patient' Fed providing some relief, Trump's negotiations with China have retaken centre stage.

And we find ourselves at the point where 'two roads diverge, and we can't travel both.' The question is whether or not we take the one less travelled.

The outcome the investment community desires is the well-worn path; a deal that sees all tariffs removed. Such a move would essentially restore the free-trade trend that the world has embraced for decades. With confidence being a fickle beast, this could result in a rapid recovery in business investment and markets. The burst of activity would underpin an improvement in GDP, employment, and likely wages. Under this scenario, we expect the Federal Reserve and the Bank of Canada would restart their dormant hiking programs, and sovereign yields would gradually rise.

The alternate storyline, escalating the global trade war, is a path not followed since the 'dirty thirties.' The US slapping 25% tariffs on everything Chinese would certainly leave a mark. The tariffs currently in place are estimated to have a 0.25% drag on global growth. A massive escalation of duties would almost certainly drop the US and most of the world into a recession. Equities would likely see a sharp move lower, and the knee-jerk reaction would be for yields to drop in anticipation of looser monetary policy.

But perhaps there won't be heroes in this play. Although investors have grown accustomed to central bankers bailing them out, we are not so sure they will ride to the rescue this time. In an all-out trade war, GDP and employment would very likely drop while inflation rises. Central bankers would find themselves in 'another fine mess,' as monetary policy cannot simultaneously offset recessionary and inflationary forces. If they lower rates to stimulate growth, they risk adding to inflationary pressure, however, raising rates may make the slowdown even worse.

In the early '70s, the Federal Reserve faced a similar conundrum when the oil price shock resulted in both higher inflation and an economic slowdown. The Fed eased to support growth, which resulted in a period of very high inflation, ultimately damaging GDP and employment for a generation. While investors often forget the lessons of history, central bankers rarely do.

The hope is that this entire plot twist can be avoided and that the story has a happy ending, which brings us back to the negotiating table. As we learnt from the 'Art of the Deal,' 'always go into the deal anticipating the worst. If you plan for the worst--if you can live with the worst--the good will always take care of itself.' The question for the President is can he live with the worst, taking the US 'economic miracle' into a recession and risk being ousted in 2020. Although his desire might be to settle the score with China, we certainly hope re-election fears trump Trump.

The Fund

With issuers unable to tap the market in December, portfolio managers feared that a 'great, great wall' of supply was building and that desperate CFOs and treasurers would immediately grab any chance to raise money. Much like Trump's border wall, it failed to materialize. The first few deals came with significant concessions and found eager buyers.

Autos (Ford and BMW) kicked off the issuance calendar and were followed by CIBC and BNS. The sentiment was strong enough to allow some 'trickier' names such as Capital Power, Algonquin Power, and Morguard to sell debt.

Sensing that the herd was moving, managers started putting money to work. The new-found enthusiasm for credit amidst a positive backdrop saw Canadian investment-grade spreads decline 16 bps. But as is the habit of Americans to do everything bigger, spreads south of the border rallied a healthy 25 bps.

We entered the month with the accumulated hedges of the past months in place but quickly started paring these back as it became clearer that positive momentum was building. This allowed us to benefit from credit tightening without clamouring for product in a heated market. With the Fund well positioned for the rally, we ended the month with a net return of 2.03%.

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

Outside trade negotiations, the supply and demand side of the story revolves around maturities, coupon payments and financing activity. The banks are in blackout for the latter half of February, so issuances should underwhelm again. As such, the path of least resistance is for tighter spreads, albeit at a more moderate pace.

We sense that people are more comfortable with the general level of spreads so that attention should shift to idiosyncratic stories. In particular, companies that are focussed on delivering and improving their balance sheet are being rewarded by the equity market, while those that continue to issue debt to fuel buybacks and dividends are being punished. This aligns 'C-suite' executives with bondholder interests, as companies are incented to reduce leverage.

Despite the positive tone, a cautious approach is still warranted. The levered loan space remains a nagging concern. Borrowers continue to find favourable terms in this space, however, should bankruptcies increase or lending criteria tighten, some companies will be forced to find other sources of financing or default. As a result, prices of high yield and lower-rated securities would fall.

As their name would suggest, investment grade issuers tend to generate enough internal cash flows to service their debt obligations or have levers to pull (asset sales, dividend cuts, equity raises, multiple sources of funding). Accordingly, we are not as concerned from a fundamental standpoint but do acknowledge that there may be a knock-on pricing effect.

So while the near-term outlook is optimistic, it is cautiously so with the usual hint of healthy skepticism.

Rates

The recent volatility caught the attention of central bankers everywhere. Despite the strong US economy, the Federal Reserve has noted that inflation remains muted. As such, they have decided that since the overnight rate is near the bottom of the neutral band, that they can be patient with further hikes. Furthermore, the pace of balance sheet shrinkage is open to alteration depending on the situation.

The Bank of Canada also adopted a 'wait and see' attitude, although they still hold the view that further removal of accommodation is required.

Given the rather sanguine central bank stance, sovereign yields drifted lower to hover close to the overnight rates. At this point, it certainly does appear that it will be a very boring year for government bond traders.

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