

The Risk That Time Forgot | June 2019

“Inflation is when you pay fifteen dollars for the ten-dollar haircut
you used to get for five dollars when you had hair.”

Sam Ewing

In 1970, you could strut to your local store and style yourself in the latest bell bottom jeans, belted turtleneck, and platform shoes, all for under \$25. You could then boogie on down to your local Chevy dealer and drive off in a shiny new Corvette for a mere five grand.

While the desire to purchase such iconic items is a matter of personal taste, we can all appreciate the retro pricing.

But these bargains didn't last long, as the disco decade also kicked off an era of 'rocking' inflation. Much like the hairstyles of the time, it was the beast that couldn't be tamed. That is until Paul Volcker became Fed Chairman and hiked rates to 20%. This move plunged the US economy into a deep recession, resulting in widespread protests including indebted farmers driving their tractors through the streets of Washington.

For decades afterwards, the spectre of inflation stalked the fixed income world. But since 2008, the fears have shifted from its revival to its extinction. And with yields in free-fall, it appears the bond markets see inflation going the way of the dinosaurs.

With 30-year Government of Canada bonds yielding 1.7% and inflation hovering around 2%, we can arrive at one of two conclusions. Either people are willing to accept negative real returns from government debt, or they expect consumer prices to remain benign for decades to come.

Now, there are some cool cats who purchase sovereign debt for non-economic reasons, such as liquidity management, liability matching, or regulatory restrictions. These institutions have even supported sub-zero interest rates in some countries, despite how irrational accepting a sure loss seems. But for most of us squares, losing purchasing power every year is unpalatable.

For an investment to merely maintain purchasing power, the generally accepted benchmark is 2%. A hurdle which is well supported by historical evidence. From 1914 to 1970, the Canadian Consumer Price Index (CPI) averaged 2.2%. Between 1970 and 1990 it spiked to 6.9%, and since then has normalized back to 2.0%.

Based on these averages, the after-tax returns from GICs and traditional fixed income would lead to a loss of purchasing power. Thus to allocate to these securities, one must expect the trends in consumer prices to deviate significantly from the past. Is such pessimism warranted or have bond markets overreacted?

While bond traders are pessimistic by nature, there is something, in particular, troubling them these days. Despite historically low unemployment levels, economic growth, and low interest rates; inflation remains stubbornly contained. Several factors are being cited as the causes of this 'lowflation' conundrum. Globalization and technology reduce production costs, while e-commerce saves vendors from the expenses of retail infrastructure and creates a more competitive pricing environment. There are also those that question the validity of the current CPI measures, pointing to increases in healthcare and necessities being well above 2% per annum.

The reasons as to why inflation is tenaciously low will undoubtedly be the subject of scintillating conversation amongst central bankers and economists. Meanwhile, there will be no dearth of financial pundits offering their

predictions of where we go from here. For the rest of us, the key is to be aware that bond markets are concerned with inflation moving lower and have priced government debt accordingly.

Thus, to invest in traditional fixed income, one needs to have a strong conviction that CPI will disappoint even more than the currently pessimistic picture. Historically, full employment, economic growth, growing deficits, zero or negative real interest rates, rising financial asset prices, and low inflation have not coexisted for long periods. So, either something has to give, or else we need to believe in theories that hinge on Sir John Templeton's four most dangerous words, 'this time it's different.'

The Fund

After a difficult May, credit spreads staged a strong recovery in June. The promise of rate cuts by the Federal Reserve coupled with optimism over the China/US trade negotiations saw money flowing back into risk assets. Canadian investment-grade credit spreads were broadly lower by 9 bps, while the US tightened 13 bps. The star performers were the CDX derivative indices with IG improving 16 bps and HY 70 bps.

New issue activity did pick up, with \$16 bn of corporate and ABS deals getting done. Domestic banks were the main event as they issued NVCC, bail-in, deposit notes, and covered debt. Telus, Fairfax and Epcor also tapped the market, while Keyera issued a high yield rated hybrid security. Despite the large amount of issuance, the new supply was easily absorbed.

We significantly reduced our credit hedges/short positions early in the month and added to select holdings in both the primary and secondary market. These moves allowed the fund to benefit from the strong spread performance resulting in a 1.04% gain in June (0.94% F Class).

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2019	2.03%	1.15%	0.36%	1.54%	0.15%	1.04%							6.43%
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

Music genres are often defined by their rhythm (who can forget disco's 'four-on-the-floor' beat.). Credit markets are also subject to a cadence that often corresponds to the level of primary issuance. With the 'dog days of summer' descending upon us, investors become distracted with vacations, BBQs, and time with family. As such, most issuers take a seasonal pause, and the volume of supply can drop significantly. Absent any



external shocks; the new issue drought often leads to a grinding tighter of spreads as portfolio managers pick away at dwindling dealer inventories.

The 'skinny' on primary issuance is that it trails last year's numbers by 15%, making it difficult for portfolio managers to replace securities they sell or that mature. As we saw last month, the heavier supply was met with cash from coupons and maturities that needed to be put to work.

While the supply side looks constructive, spreads have come in a long way this year and are near their long-term average. This tempers the strong technical outlook and leads us to medium risk posturing, with continued caution around the dicier parts of the credit spectrum. Thus, in the months ahead, we will look to capitalize on the summer doldrums, with one eye on the powder keg of trade negotiations, Brexit and central bank meetings.

Rates

The US bond bulls have rushed to price in 75 bps of cuts by the Federal Reserve for 2019, including a healthy chance of a 50bps cut later this month. We think they will be bitterly disappointed, as even James Bullard (St Louis Fed), a noted 'dove,' thinks only 25bps or 50bps of insurance cuts will be needed.

So far Canadian data has been groovy, beating the pundits' depressed expectations, allowing Governor Poloz to remain on the sidelines. The Bank of Canada could probably take a chill pill and hold steady if the Federal Reserve delivers less than 50bps of cuts, however, deeper cuts would likely lead to a much stronger Canadian dollar, which could prompt a cut or two by the BoC.

Expectations for significant cuts by central banks are really high dude, can ya dig it? The bummer is that even if the Fed delivers a couple of rate cuts, yields could still tilt a little higher.

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