



How Low Can They Go? | November 2019

“It was time to raise the bar higher, or lower if you’re doing limbo.”

Frank Edwin Wright III (Tre Cool)

In limbo, the bar has been set, or more appropriately lowered, to an astonishing height of 8.5 inches. On September 16th, 2010, Shemika ‘The Limbo Queen’ Charles contorted and shimmied her way to this incredible world record. Given the physical limitations on how low one can go, she has left the competition very little wiggle room (pardon the bad pun).

Much like the limbo bar, people once thought the ultimate lower bound for interest rates was zero. After all, the bar can’t be on the floor, and who would lend money at a loss? But with over \$17 trillion of debt trading at negative yields, one of those notions has been firmly dispelled.

Harkening back to the days when wealthy nobles (and Scrooge McDuck) incurred costs to store and protect their pools of gold, European clients now even pay banks to keep large deposits.

The fact remains that money can’t exist in the ether, and it needs a home. And since stuffing cash under a mattress has practical limits, today, many are willing to pay governments, banks, and select corporates to store it in their houses.

That negative rates can exist and persist is a confirmed reality. But many unknowns remain, including whether they can migrate to Canada.

The list of explanations for sub-zero yields is long and varied. The most frequently cited culprits are central banks, inflation (or the lack thereof), demographics, regulations, and pessimistic outlooks for the future. Given the number and diversity of theories, including some entertaining conspiracies, it appears the reasons for negative rates are not fully understood.

At this point, what we can conclude is that a strong precondition is central bank action. Thus far, negative yields have only occurred in jurisdictions where central bankers have taken the overnight rate below zero.

So, what motivates them to push overnight rates into negative territory? The theory is that lower rates stimulate borrowing and spending, and the lower they go, the greater the degree of economic stimulus delivered. Although there were concerns about the impact of sub-zero rates on the banking sector, for the most part, theorists felt the pick up in demand would offset this drag.

While hypothetical debate can be a lot of fun, nothing beats empirical evidence. And thus far, the experiments in Japan and Europe have revealed a number of unintended consequences.

Rather than promoting an increase in consumer spending, the opposite is happening. Ultra-low yields mean people need to save more for retirement. And since the introduction of negative yields, European savings rates have increased. Low yields also push savers to take more risk to reach financial goals, encouraging less prudent investments and reducing resilience in stressed markets. These issues extend beyond the individual and include pension plans, which might be forced to reduce benefits or raise contributions. The combination of these factors has weighed on consumer spending and consumption.



Low interest rates also reduce the return hurdle for new projects and investments, which allows for all manner of dubious schemes to be funded. Similarly, minimal debt servicing costs allow zombie firms, who would otherwise be insolvent, to continue to exist. This comes at the expense of healthier companies gaining more market share and reinvesting profits to increase productive capacity.

Accommodating monetary policies have also had political implications. The ensuing rapid rise in asset prices has disproportionately benefited the rich and furthered the 'wealth divide'. With the rising tide of low rates not lifting all boats, we are witnessing an increase in political risk and social unrest (i.e. gilet jaunes, Hong Kong, Chile, Brazil, Hungary, Italy, Brexit, Trump...).

The staff at the Bank of Canada are analyzing these mixed results from the Japanese and European experiments. As a consequence, we suspect they are more reluctant to move into negative territory than they would have been several years ago. Fortunately for them, Canada enjoys a couple of factors that ought to reduce the need to do so.

Population growth is hovering around 1.4% per year (thanks to flexible immigration policies), while growth in Europe is barely positive and is slightly negative in Japan. The federal government also has the willingness and flexibility to run deficits and employ fiscal stimulus. Thus, reducing the reliance on monetary policy as the only tool to fight off a recession.

While there is no doubt that negative yields are still part of the Bank of Canada's playbook, given the above factors coupled with empirical evidence thus far, the bar to go lower has moved a little higher.

The Fund

The largest single focus for the market remains the state of US/China trade negotiations. Optimism around a Phase 1 deal helped propel risk assets higher, with broad credit indices rallying by 7 bps in Canada and 5 bps in the US.

High cash levels in domestic bond funds and light bank inventories meant a robust demand for new issues. For the most part, deals performed well, with investors even piling into the unloved auto sector (Ford, GM and BMW all successfully tapped the market). Other interesting deals, to name a few, included offerings from Ventas, Morguard, Saputo, Capital Power, and Inter Pipeline.

Amidst the rally in credit, the performance of the provincial sector was notable. Typically, provincial spreads move in the same direction but with a smaller magnitude than corporate credit. Last month, they matched the pace of corporate spread tightening.

The Fund was well-positioned for the rally in spreads and benefitted from investments in outperforming securities.

	1M	3M	6M	YTD	1Y	3Y	SI
X Class	0.90%	2.32%	3.34%	8.85%	7.97%	6.21%	11.36%
F Class	0.81%	2.06%	2.89%	7.93%	6.96%	5.34%	N/A

As of November 29th, 2019

The Algonquin Debt Strategies Fund LP was launched on February 2, 2015. Returns are shown on 'Series 1 X Founder's Class' since inception and for 'Series 1 F Class' since May 1st, 2016 and are based on NAVs in Canadian dollar as calculated by SGGG Fund Services Inc. net of all fees and expenses. For periods greater than one year, returns are annualized.



Credit

Looking to year-end, conditions appear to be in place for the frequently observed ‘Santa Claus’ rally in credit. There is good demand for quality paper, dealer inventories are light, and although the new issue market will still be active with banks and financials reporting, the deal window normally closes in the third week of December.

From a fundamental perspective, US corporate earnings have looked okay so far, in spite of a substantial slowing in revenue growth. Strength was unsurprisingly concentrated in defensive sectors such as utilities and health care, with poor results in the energy and auto sectors. The expectation is for muted earnings growth to continue in the near term.

On balance, we expect a steady grind tighter in spreads into early January barring any hiccups with the US/China Phase 1 trade deal. We will maintain a reasonable risk posture while remaining very aware that liquidity will decrease as the month progresses, which means unfavourable surprises could create added volatility.

Rates

The Federal Reserve should be content to observe how the economy responds to the recent cuts. The timing and direction of the next move are highly dependent on how the US/China trade negotiations turn out. Until further clarity on this matter, US treasury yields will remain in a narrow range.

The Bank of Canada seems to be having a little trouble determining where to place the bar for a rate cut. Having seemingly tilted towards monetary stimulus, the Bank has recently walked back expectations a little bit. Judging from their recent comments, they too are having trouble gauging the impact of trade tension on the economy. As a result, expect heightened volatility in yields as traders adjust forecasts after each data release.

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