



## Since The (W)ides of March | April 2020

“There'll be ups and downs, smiles and frowns.”  
Snoop Dogg

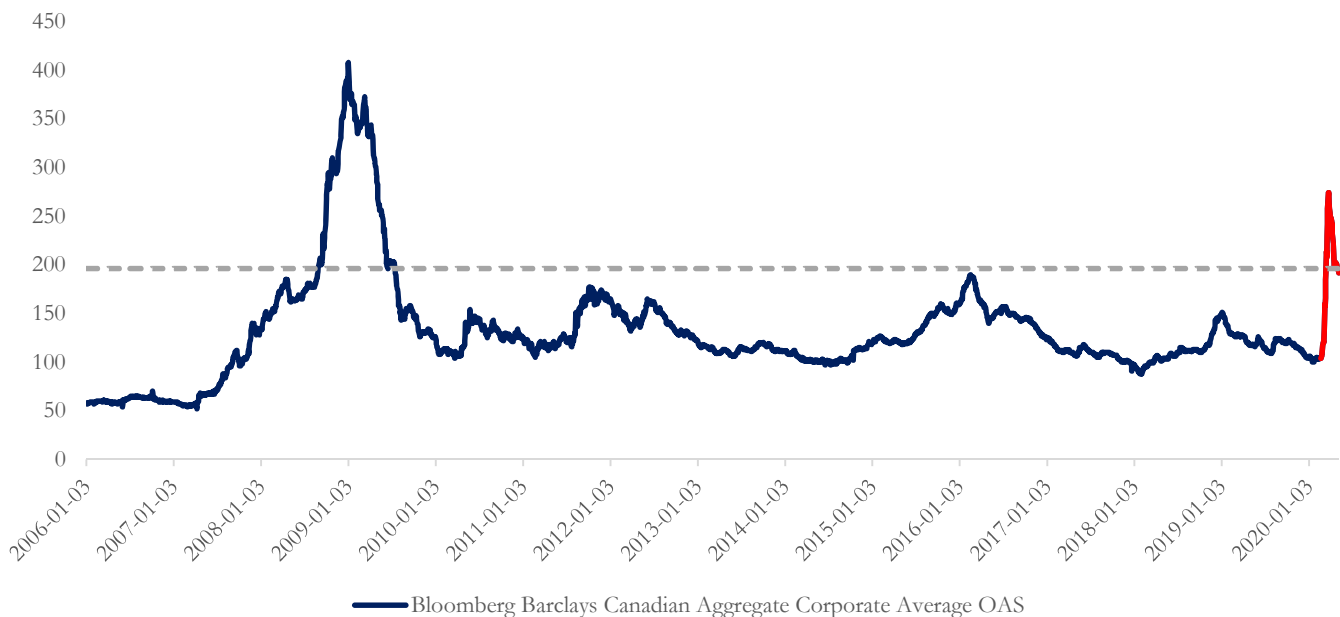
Last month we noted that one of the greatest commodities right now is patience (apologies to the ‘gold bugs’). After all, the road to social and economic recovery could be long and jagged, and we can't let emotions and short-term thinking get the better of us at every twist and turn.

The first such turn occurred last month. After the initial shock of a global shutdown, markets rebounded on optimism around economies reopening and the programs introduced by central banks and governments.

Given the rapid changes in the marketplace, we decided to pick up where our March report left off, with an update on credit markets and a deeper look at the portfolio, our outlook, and management strategy.

The Credit Spread Zig-Zag.

Canadian Investment Grade Corporate Bond Spreads.



### The Zig.

The initial reaction to the coronavirus and its containment measures was a sharp and violent widening of credit spreads.

|                                          | 2/19/2020 | 3/24/2020 | Change |
|------------------------------------------|-----------|-----------|--------|
| Canadian Investment Grade Credit Spreads | 104       | 274       | 170    |

The two main drivers of the sharp sell-off:

- Credit risk. With businesses shutting down across the globe, the creditworthiness of corporations declined, and the risk of delinquencies increased
- Liquidity premium. A scarcity of cash in the financial system had banks, institutions, and asset managers selling high-quality corporate bonds to raise cash for their immediate needs

### The Mini-Zag.

While the Ides of March is on the 15<sup>th</sup>, the ‘wides’ of March occurred on the 24<sup>th</sup>. Since then, corporate bonds have experienced a partial recovery as investors recalibrated the appropriate credit and liquidity premiums.

|                                          | 3/24/2020 | 4/30/2020 | Change |
|------------------------------------------|-----------|-----------|--------|
| Canadian Investment Grade Credit Spreads | 274       | 196       | -78    |

The two main drivers behind the partial recovery:

- Optimism over the effectiveness of public health measures and the partial re-opening of the economy
- The speed and scale of the response from central banks and governments provided liquidity and stability to the corporate bond market

## The Fund Performance.

Not even record-shattering amounts of new issuance on both sides of the border could stop the credit rally in April. Although we should note that Canadian spreads were more hesitant to tighten than in the US, with the Bank of Canada taking a slower and more measured approach than the Federal Reserve.

- Canadian investment-grade credit spreads tightened 47 bps in April
- US investment-grade credit spreads tightened 70 bps in April

While these were the average moves in corporate spreads, there was a high-level of performance dispersion across sectors and specific issuers, with telecommunications shining and REITs lagging the pack.

After remaining more on the defensive side from mid-February to the end of March, the portfolio exposure was taken to a medium risk-posture in April. Although credit offered attractive value, given all the uncertainty, we didn't feel it prudent to become overly aggressive or take big swings.

- Net credit exposure was increased from an average CR01 of 6 bps in March to 9 bps in April (representing a medium risk position for the Fund)
- Exited short credit positions (hedges) in the CDX derivative indices
- Opportunistically rotated from spicier issuers to higher-quality names (i.e. companies with continued or resilient business operations during this period)
- Selectively participated in new issues from banks, telcos, utilities, grocers, and the stronger names in the energy space (i.e. pipelines)
- Portfolio earned over 1% in yield on the month and over 4% through performance in credit and active trading to end April with a net return of 5.20%

|         | 1M    | 3M      | 6M     | YTD     | 1Y     | 3Y     | 5Y    | SI    |
|---------|-------|---------|--------|---------|--------|--------|-------|-------|
| X Class | 5.20% | -11.84% | -9.47% | -11.21% | -7.15% | 0.38%  | 7.29% | 8.16% |
| F Class | 5.15% | -11.93% | -9.82% | -11.38% | -7.86% | -0.36% | NA    | NA    |

## Our Portfolio.

Below is a summary of our portfolio as of April 30<sup>th</sup>, 2020.

### Risk Metrics.

- Portfolio Yield: 10.5%
- 98.3% Investment-grade
- Average Term to Maturity: 2.0 years
  - 37% matures within 12 months
  - 82% matures within 3 years
- Net Credit Exposure: CR01 9.24 bps (medium)
  - Conservative 5-8 bps, Medium 9-11 bps, Aggressive 12-15 bps
- Net Credit Leverage (5y): 1.85x
- Total Long Credit Exposure: 5.2x (not including hedges)

### Issuers & Sectors.

- Largest issuer exposures: TD, Bell Canada, BMO
- Largest sector exposure: Banks
- No exposure to airlines, cruises, hotels, restaurants, and related sectors and businesses

The two sectors we anticipate being the most volatile are Energy and REITs.

#### Energy exposure

- 30% of the energy exposure matures within 3-months
- Only exploration and production exposure are two positions in Canadian Natural Resources which mature in 1-month and 3-months, respectively. The remainder is in companies less tied to the price of oil (i.e. energy infrastructure, natural gas, pipelines, and midstream)
- The most volatile issuer we own is Inter Pipeline, with over half the position maturing in July

## REIT exposure

- 28% of the exposure is in REITs with grocers as anchor tenants (i.e. Loblaws, Sobeys)
  - Remaining exposures concentrated in short-dated bonds with 34% maturing in 2020 and 90% maturing by November 2022
- We have been fine-tuning exposures between issuers and will continue to do so as further details on rent relief programs, rental collection, and other operational updates are released

## Downgrade Risk.

- While we are comfortable with the solvency of the issuers in our portfolio, we do anticipate downgrades
- The Fund can hold up to 15% high-yield, and thus is not a forced seller and can opportunistically take advantage of the dislocation downgrades can create

## Liquidity.

- Bonds maturing each month naturally create liquidity for de-levering or re-deployment
- Portfolio concentrated in liquid securities
- In good standing with prime brokers with significant excess margin (>35%)
- Subscriptions/Redemptions: through March and April the Fund experienced net inflows (i.e. more subscriptions than redemptions)

## Looking Ahead.

While we expect a bumpy road ahead, credit does offer a very compelling opportunity for those with a medium-term investment horizon and the ability and willingness to withstand short-term volatility.

## The 12-month Asymmetry.

The portfolio yield provides a solid base case, a cushion for further sell-offs, and a very attractive return on recovery. The below offers estimates of returns over the next 12-months through different market scenarios (i.e. return from May 2020-2021).

### The Base Case

- Markets remain relatively unchanged
  - Return estimate: 8-12%

#### Credit Spreads Widen 100 bps

- Credit spreads sell-off to beyond their March wides
  - Return estimate: 0-5%

#### Credit Spreads Tighten 100 bps

- Credit spreads return to February 2020 levels
  - Return estimate: 15-20%

#### The Outlook.

We anticipate further market zig-zags to come, as developments unfold and sentiment sways between optimism and pessimism. While credit will not be immune to the volatility, we do expect a more muted ride going forward. As even after the recent recovery, spreads are still at their widest levels outside of 2008 and countering the uncertainty of the current climate are tailwinds supporting the corporate bond market.

#### Tailwinds.

- The Bank of Canada has injected liquidity into the markets and continues to do so
- The Bank of Canada purchasing programs of corporate bonds, commercial paper, and provincial bonds offers credit markets stability and confidence
- The Federal and Provincial governments have introduced fiscal measures which address personal and business solvencies
- Credit has lagged the recovery of other asset classes and on a relative basis is rather cheap

While there is great uncertainty as to how this story unfolds and what positive and negative plot twists await, the tailwinds in credit markets should help dampen the sell-offs and support the overall recovery.

#### The Management Strategy.

On the one hand, we have credit markets offering attractive valuations and receiving support from the central bank and government. And on the other side, we have the uncertainty and unknowns of the current environment. Accordingly, we feel the right balance is maintaining a medium level of exposure and increasing the portfolio's flexibility to navigate the inevitable twists and turns.

- As bonds mature and we exit positions, our re-deployment of capital is being split between the under 3y space and attractively priced new issues further out the curve. This balance offers a healthy amount of exposure while creating dry powder to opportunistically invest and take advantage of sell-offs

Not only do we expect the path ahead to be jagged but also anticipate it to diverge, with bifurcation across sectors and individual companies.

- At the end of March and beginning of April, we saw value in the ‘no brainer’ sectors such as grocers, utilities, and telcos. Unsurprisingly, we were not alone in our assessment and these sectors outperformed in April. Our focus now shifts to rotating into more attractive opportunities
- While overall exposures to vulnerable sectors are being opportunistically trimmed, we have also broken out our shovels to look for the diamonds hiding in the rough of these troubled industries. We are interested in companies with strong balance sheets, good management, and the resilience and flexibility to adapt and prosper in this new environment

### The Fundamental Question.

We chose careers in fixed income because we are simple-minded folk, and as credit investors, the basic question we are asking is whether or not a company will remain solvent over a specific time period. We have a lot of empathy for equity analysts having to project earnings far into the future and arrive at a fair value for the stock price today.

Take for example the mighty Canadian banks. At this stage, it is very difficult to forecast the magnitude of losses from their lending businesses, the increases to operational costs, the drag on efficiency and productivity, let alone the impact these will have on earnings, dividends, and share prices. But despite all these uncertainties, we can be very confident that they will not go bankrupt and default on their debt over the next few years.

At the end of the day, if the credit investor has the patience and stomach to ride the volatility, the ultimate question should be the issuer’s ability to service its debt until the bonds mature. And with the current level of credit spreads, that patience can pay handsomely.

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