

2020 Hindsight | December 2019

“We have long felt that the only value of stock forecasters is to make fortune-tellers look good.”

Warren Buffet

Our minds inherently loathe uncertainty. Not knowing what to expect is unnerving, as it threatens our primary instinct to survive. Perhaps this explains and underlies our affinity for prophecies and predictions. A source of comfort amidst the unpredictable future.

At this time of year, there is no shortage of such prophecies. Bold calls from politics and sports to fashion and technology. And of course, the usual smattering of financial forecasts of investment profits for 2020.

Most of these predictions are based on extrapolations of the present and the past, based on the logic that history doesn't necessarily repeat but rhymes. And given the immense computational power and data available, there is growing confidence in these forecasts.

But given the narrow range of these investment predictions, we suspect some overconfidence on the part of financial pundits. After all, markets are unpredictable and subject to bouts of volatility, making accuracy in foretelling the next twelve months very difficult. We would much rather make our bold calls for the year 2050.

Although it might seem counterintuitive, predicting long-run asset returns is far easier than forecasting them in the short run. If you want to know what fixed-income will generate, a simple approach is to look at the information available from tradeable securities. A Government of Canada 30-year bond yields 1.7%, while one issued by Hydro One yields a lofty 3.0%. Thus, one can easily build a portfolio of long bonds that should earn 2-3% per annum for the next three decades.

Relative to the past 50 years, this return spectrum might seem rather low and depressing. But we will note that the high interest rates of the 70s, 80s, and 90s were an anomaly. Based on data from the Bank of England the range for interest rates from 1870 to 1970 was 2-5%. So while today's climate of ultra-low yields is in sharp contrast to recent history, it is not too far out of whack from the previous centuries.

When it comes to equities, there are unfortunately no cheats like in fixed income, via long-dated securities. Fortunately, Professor Randy Cohen of Harvard University does offer a rather elegant and simple approach using a few key metrics. The theory is that long-run equity gains are a function of GDP, inflation, and dividends. With an expected inflation rate of 2% (observable in 30-year real return bonds), expected real GDP growth of 2% (based on demographics), and a dividend yield of 3% or so, one can conclude that equity returns will fall in the range of 5% to 7% over the next few decades.

Based on the above, an investor running a basic 60/40 portfolio can expect gains of 4% to 6% before fees and expenses. While we look forward to being judged in January 2050 on the accuracy of these calls, we understand that such long-term forecasts don't offer the amusement of single year predictions. But instead of wasting time on guessing what the market will deliver, we thought we would offer far more valuable insights:

- Vancouver will see plenty of rain and the mosquitos will be bad in Winnipeg this summer
- After the Maple Leafs recent bout of success, Toronto fans will be planning a parade
- Greg Jeffs will be one year older (allegedly)
- Interest rates will go up, and down, and up, and down and ... (we couldn't resist an investment call)



- We will all lose 10 lbs

Now that we've armed you with our 'pearls of wisdom,' we wish everyone a prosperous, healthy, and happy 2020.

The Fund

The holiday season is typically quiet with credit modestly performing on a lack of supply, thin liquidity, and lighter dealer inventories driving the usual Santa Claus rally. With the headwinds of US/China trade, USMCA, and Brexit moved to the back burner (for now), the seasonal grind tighter turned into a more pronounced rally with investment-grade credit spreads lower by 8 bps in Canada and 12 bps in the US.

CIBC, BNS, RBC, Crombie, Welltower, Smart Centres, Telus and Shaw took advantage of the positive tone to raise debt. Even National Australia Bank returned to the Canadian market after a long hiatus with a Tier 2 capital deal. Despite the unusually large amount of supply for a December (> \$10 bn), the deals were well received by buyers flush with cash.

The continued performance of credit coupled with yield earned allowed the fund to end 2019 with a strong return of 1.05% (F Class 0.94%).

	1M	3M	6M	2019	3Y	SI
X Class	1.05%	2.35%	3.35%	9.99%	6.01%	11.40%
F Class	0.94%	2.09%	2.90%	8.95%	5.15%	N/A

As of December 31st, 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 dollars as calculated by SGGG Fund Services Inc. net of all fees and expenses. For periods greater than one year, returns are annualized.

Credit

After a difficult 2018, credit markets experienced strong performance in 2019. Domestic spreads were 45bps better on the year, while US spreads moved in an impressive 58bps.

Looking at the month ahead, after the holiday lull, new issue activity is expected to pick up. US estimates for January supply are in the area of \$125-130 bn. Getting estimates for the domestic market is tougher, but we think issuance will be in line with historical norms (i.e. \$7bn). The appetite for new deals remains robust as portfolio managers have healthy cash piles to deploy, and in particular, demand for BBB paper remains strong.

The main headwinds that dominated the stage last year (China-US trade, USMCA, and Brexit) have receded, but a new protagonist (US-Iran sabre-rattling) has made an entrance. We don't believe either side desires an open conflict. However, we are aware that accidents do occur.

The Fund has plenty of dry powder on hand to take advantage of the opportunities that are sure to arise when the deal flow materializes.



Rates

The Federal Reserve is expected to leave rates unchanged later this month as they continue to observe the impact of previous cuts. US treasury yields should remain range-bound for several more months until a clear trend in GDP and/or inflation emerges.

The Bank of Canada remains on edge as the domestic economy appeared to falter in December. Worries about whether the data was merely a blip or the beginning of a trend will keep yields anchored at current levels until the question is resolved.

Contact

Algonquin Capital Corporation
1 King Street West, Suite 1502
Toronto, Ontario, M5H 1A1
www.algonquincap.com

Raj Tandon
Founding Partner
raj.tandon@algonquincap.com
+1 (416) 214-3493

Disclaimer

Algonquin Capital Corporation ("Algonquin") is registered with the Ontario Securities Commission as an exempt market dealer, investment fund manager, and portfolio manager. This commentary is confidential and for authorized use only. Under no circumstances are its contents to be reproduced or distributed to the public, media, or potential investors without written authorization. The information contained herein, while obtained from sources believed to be reliable, is not guaranteed as to its accuracy or completeness.

The information contained in this commentary is not investment or financial product advice and is not intended to be used as the basis for making an investment decision. This commentary by Algonquin is not, and does not constitute, an offer to sell or the solicitation, invitation, or recommendation to purchase any securities.

This commentary contains statements that constitute "forward-looking statements". Examples of these forward-looking statements include, but are not limited to, (i) statements regarding future results of operations and financial condition, (ii) statements of plans, objectives or goals and (iii) statements of assumptions underlying those statements. Words such as "may", "will", "expect", "intend", "plan", "estimate", "anticipate", "believe", "continue", "probability", "risk" and other similar words are intended to identify forward-looking statements but are not the exclusive means of identifying those statements. Forward-looking statements included herein are based on current expectations and beliefs, and Algonquin disclaims, other than as required by law, any obligation to update any forward-looking statements whether as a result of new information, results, future events, circumstances, or if Algonquin's expectations or opinions should change, or otherwise. By their very nature, forward-looking statements involve inherent risks and uncertainties, both general and specific, and risks exist that such predictions, forecasts, projections, and other forward-looking statements will not be achieved. A number of important factors could cause Algonquin's actual results to differ materially from the plans, objectives, expectations, estimates, and intentions expressed in such forward-looking statements. As such, undue reliance should not be placed on any forward-looking statement.