



The Virus Goes Viral | February 2020

“It’s a mess, ain’t it, Sheriff?”
“If it ain’t, it’ll do till the mess gets here.”
No Country for Old Men

A big and often underappreciated part of any epidemic is fear. The basic emotion (Eckman, 1992a) that invokes extreme instinctual reactions that can either protect us or cause further harm.

In their 2008 paper, Epstein et al. argued that behavioural changes driven by fear need to be factored into epidemiological models. The authors divided the at-risk population into three categories: ignorers, hiders, and fleers. If we all ignore the problem, lo and behold, the disease spreads until we all get infected. Hiding and self-isolating contribute to containment while fleeing from infected regions exacerbates the problem.

Unfortunately for us, flight is a very natural response. In 1994, half a million Indians fled the city of Surat to escape a supposed outbreak of pneumonic plague. To this day, controversy exists as to whether any confirmed cases occurred.

Predictably, economic epidemiology assumes people act rationally to achieve an optimal outcome. COVID-19 could test this assumption. After several weeks of ignoring the risks, a spike in cases outside of China has seen investors flee the markets to hide in cash and government debt.

As we write, equities have fallen nearly 20%, and 10y government bond yields in the US and Canada are sitting at 0.43% and 0.39% respectively.

The panic is a product of uncertainty. At this stage, there is a very short list of known knowns, a long list of known unknowns, and an unknown list of unknown unknowns.

Let’s begin with what we know, or at least can infer thus far. The medical and public health experts seem to agree that the number of cases will increase and that an effective vaccine will take time to develop. Amongst economists, there is consensus that the virus will hurt economic growth and that central banks and governments will deliver both monetary and fiscal stimuli as countermeasures.

As for the unknowns, underlying this long list are questions about the magnitude and severity of the problem. There is still a lack of understanding around the transmission of the virus, mortality rates, and whether it will recede or persist. There are also questions over the containment measures various countries will take and the efficacy of these responses. While the Chinese model appears to be working, few nations have the same combination of authority and competence to deal with an outbreak.

From an economic perspective, the containment playbook of ‘hiding’ results in a rather unique predicament of creating both a supply and demand shock. A supply shock is occurring because factories are being shuttered which is disrupting the flow of production from raw material to finished goods. A demand shock is occurring because fewer people are flying, going on cruises, and venturing out to social gatherings such as movies, entertainment events, restaurants etc.

In a classic recession, demand is lower than supply, so central banks lower interest rates to incent consumers to borrow money and spend. But rate cuts will do little to reopen factories or return people to work. Inventive fiscal policies such as programs to boost confidence and keep credit flowing will be required to



protect the economy. The question is whether any of these measures can prevent empty factories, restaurants, and shops from causing empty earnings. As such, this is an unprecedented event with no visible timeline, making it impossible to quantify the economic impact. Nonetheless, many pundits are taking guesses. To steal a line from Howard Marks, there are as many forecasts as there are forecasters.

The added wildcard to this already uncertain situation is investor psychology, which can quickly shift from fear to greed and back again. Such swings can be fast and furious as information and misinformation circle the globe in a matter of minutes. Thus, while we don't know the path the virus will take nor the economic damage it will cause, we do feel it is reasonable to assume that markets will continue to be volatile until the scourge stops or infects us all.

The Fund

Credit was not immune to the virus-infected sell-off. By the end of the month, investment-grade spreads were generically wider by 13 bps in Canada and 20 bps in the US.

For some time, the Fund has been conservatively positioned with the portfolio concentrated in higher-quality, short-dated securities. Around 97% of our positions are investment-grade with a focus on issuers with the resilience to withstand a recession. Furthermore, almost half the securities mature in less than one year, with 32% coming due over the next six months. The cash from these maturities provides a tremendous degree of flexibility to take advantage of dislocations.

As active traders, we have been working within this portfolio structure and dynamically managing our exposure. Last month, we felt that spreads were underpricing the coronavirus risk, in particular within credit derivatives. Accordingly, we built a decent short position in the CDX credit indices (IG & HY), as a hedge for the macro uncertainty. We also reduced higher-beta corporate bond holdings and positions with greater than 4 years to maturity.

Our hedges blunted and offset the losses from corporate bond holdings leaving us relatively unscathed during the sharp market decline. Thus despite the weakness in spreads, the Fund finished the month in the black.

	1M	3M	6M	YTD	1Y	3Y	5Y	SI
X Class	0.12%	1.88%	4.25%	0.83%	7.45%	5.24%	10.88%	11.18%
F Class	0.07%	1.65%	3.74%	0.70%	6.48%	4.43%	NA	NA

As of February 29th, 2020

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

For the typically boring credit markets, the widening move of today and the last two weeks has been dramatic. Whether this trend continues and where all-in corporate yields and spreads settle will depend on the severity and duration of COVID-19. At this stage, it's just too early to know. Not only is the path of the pathogen unpredictable, but the damage it has caused thus far is also still unknown. There is still lots of information and data that needs to come to light before gaining clarity on the longer-term implications.

In the shorter term, we expect investors to react to any new developments in the story. The upshot of this extreme volatility is that assets can become available at attractive prices. Not all economies, sectors, and



companies will be equally affected (or infected) by the virus. Indiscriminate selling by index funds, ETFs, and portfolio managers experiencing outflows, can lead to interesting dislocations and opportunities.

We feel it's too early to look for value in lower-quality issuers, so our focus remains on companies that have strong balance sheets to weather a long period of sub-par economic growth. There is still too much fear and uncertainty to become aggressive. Currently, any news of more cases is met with the selling. It would be a reassuring sign to see markets go from fleeing to ignoring reports of further outbreaks and cities being locked down.

Based on the current sentiment and the complex nature of the situation, defence remains our highest priority. With that in mind, we continue to maintain hedging positions and adjust our exposures dynamically as new information becomes available. Fear, irrational behaviour, and wider credit spreads will create some enticing opportunities, but for now, defence is the best offence.

Rates

As policymakers at all levels grapple with how to manage the disruption beset by COVID-19, both the Federal Reserve and Bank of Canada chose to deploy their weapon of choice as each delivered a 50 bps rate cut with the promise of more to come if warranted. The Federal Reserve's move came as the first emergency cut since the financial crisis of 2008.

Sovereign bonds responded by pricing in another 100 bps of cuts. Furthermore, long end yields are setting new historic lows as traders bet that deflation risks are rising.

With the speed at which information travels today, yields will remain volatile for the foreseeable future as traders react to new information.

Contact

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

Raj Tandon
Founding Partner
raj.tandon@algonquincap.com
+1 (416) 306-8401

Peter Zwicker
Partner
peter.zwicker@algonquincap.com
+1 (416) 451-5139

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